Central Bank of Malta

THIRTY-SECOND ANNUAL REPORT

AND

STATEMENT OF ACCOUNTS

1999

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MISSION AND OBJECTIVES

OUR MISSION

To contribute professionally and with autonomy to national economic development by fostering an environment which ensures overall price stability and a sound financial system.

OUR OBJECTIVES

We will seek to achieve this mission by:-

- Promoting sound monetary policies within the framework of economic objectives.
- Managing the exchange rate policy and the official external reserves in the best interests of the country.
- Safeguarding the integrity and efficiency of the financial sector.
- Conducting research in economic matters particularly in national and international monetary issues.
- Developing and motivating competent staff with the structure to handle the tasks required to fulfil its mission.
- Enhancing the quality of customer service.
- Maintaining good working relationships with the domestic and international financial communities.

CENTRAL BANK OF MALTA

BOARD OF DIRECTORS

(As at 31st December 1999)

Mr Michael C Bonello
Governor

Mr David A Pullicino
Deputy Governor

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

Executive Management Committee
(As at 31st December 1999)

Governor
Mr Michael C Bonello
Chairman

Deputy Governor
Mr David A Pullicino

Deputy General Manager
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
Research Management
Mr Alfred Demarco

Deputy General Manager
Resource Management
Mr John Agius

Monetary Policy Council
(As at 31st December 1999)

Governor
Mr Michael C Bonello
Chairman

Deputy Governor
Mr David A Pullicino

Director
Mr Alfred F Lupi

Director
Prof Edward Scicluna

Director
Mr Saviour Falzon

Deputy General Manager
Banking Supervision and Audit
Mr Herbert Zammit Laferla

Deputy General Manager
Financial Markets
Mr Rene G Saliba

Deputy General Manager
Research Management
Mr Alfred Demarco

Investments Policy Committee
(As at 31st December 1999)

Governor
Mr Michael C Bonello
Chairman

Deputy Governor
Mr David A Pullicino

Deputy General Manager
Finance and Banking
Mr Godfrey Huber

Deputy General Manager
Financial Markets
Mr Rene G Saliba

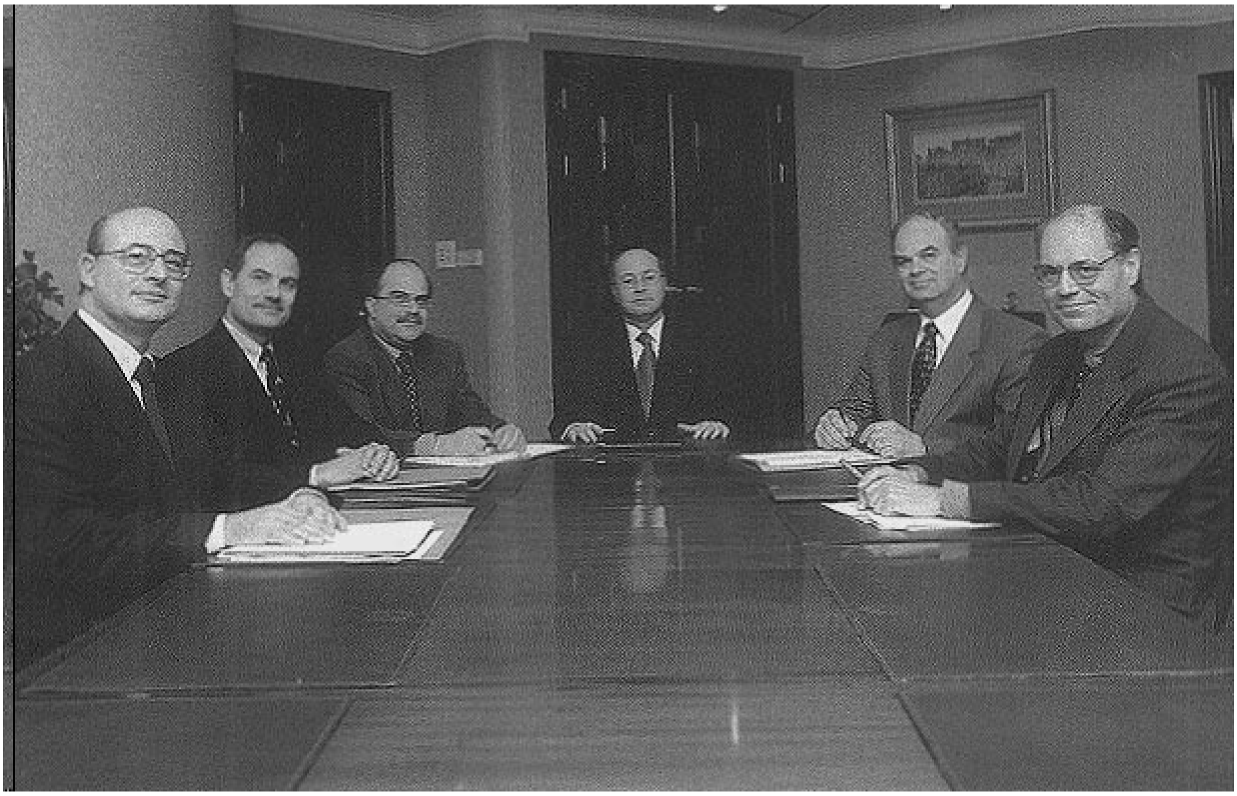
Manager
Economics Department
Mr Anton Caruana Galizia

Manager
Investments & Reserves
Mr Saviour Briffa

Mr Emanuel Ellul was Governor until September 30, 1999. Mr Michael C Bonello was appointed Governor on October 1, 1999. On July 1, 1999 Mr David A Pullicino was appointed Deputy Governor. Prior to this appointment, Mr Pullicino held the post of Deputy General Manager, International Markets. Mr Joseph V Laspina was General Manager until his retirement on September 30, 1999.

THE BOARD OF DIRECTORS

(As at 31st December 1999)



Left to right:

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

Organisation of the Central Bank of Malta

(showing the different departments and offices in the Bank)

- Governor
  Mr Michael C Bonello
  - Deputy Governor
    Mr David A Pullicino
    - Deputy General Manager
      Banking Supervision and Audit
      Mr Herbert Zammit Laferla
      - Banking Supervision
      - 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*
        - *Governor's Office*
    - Deputy General Manager
      Resource Management
      Mr John Agius
      - Human Resources
      - Information Technology
      - Administration
      - Security
  - Correspondent Banking

December 1999

LETTER OF TRANSMITTAL

CENTRAL BANK OF MALTA
VALLETTA

30th March 2000

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 1999, and a report on the Bank's operations during that year.

Yours sincerely
MICHAEL C BONELLO
Governor

Contents

Governor's Statement

The Economic Situation

The performance of the Maltese economy in 1999 has served to focus attention further on the nature of the challenges which must be overcome if the country is not only to safeguard its past economic achievements but also to build on them by competing successfully in a globalized world economy driven by trade, technological innovation and mobile, profit-seeking investment capital.

Preliminary estimates for 1999 suggest that the economy approximated the previous year's performance when real GDP grew by 3.1%. For at least four years, therefore, the economy appears to have been operating below its full potential. Apart from the strong contribution of the export sector, which compensated for the subdued level of domestic demand over this period, a constant feature of this scenario has been the prominent role of the public sector, and the Government in particular, as a source of economic activity. In 1999 the public sector accounted for fully a third of total employment and a quarter of total expenditure, and the budget deficit, although well below its 1997 peak, still exceeded 8% of GDP. The absorption of resources on this scale – which reflects and, in turn, perpetuates structural inefficiencies in the economy – cannot continue without diminishing the economy's ability to seize the opportunities inherent in the globalization process.

Further evidence in support of this conclusion is provided by recent investment trends. In spite of an upturn in manufacturing investment, the share of investment in GDP fell in 1999 for the fourth consecutive year. This not only explains a good part of the recent slowdown in economic growth but also, and perhaps more importantly, bears implications for the economy's future growth prospects.

The imperative of fiscal consolidation, which dictated a more prudent approach towards public sector employment, combined with relatively low investment levels, contributed to a continuation in 1999 of the slow but steady rise in unemployment in evidence since 1996. By year end the unemployment rate had put on nearly half a point to 5.5%. From a policy point of view, a development which is perhaps even more noteworthy is the emergence of a marked mismatch between the skills possessed by those seeking employment and those required to fill the available job vacancies. During the year there were on average three times as many unemployed persons for each vacancy in the unskilled job category as there were for job vacancies generally.

Reflecting conditions at home but particularly abroad, retail price inflation declined further in 1999 and the twelve-month moving average stood at 2.1%. The imported component of inflation decreased during the year under the impact of lower inflation in Malta's main trading partners and the Maltese lira's appreciation against the euro. Domestic inflation, on the other hand, remained above that of both our trading partners and our competitors. To some extent this reflects the existence of demand pressures flowing from the fiscal deficit, and market rigidities which raise costs and profit margins. If allowed to persist, this inflation differential will erode the country's international price competitiveness and could affect the stability of the currency.

One feature of the labour market which appears to be having an impact on the economy's export competitiveness is the existence of a nation-wide quasi-wage indexation system whereby wage levels are adjusted annually to reflect changes in the Retail Price Index. In addition, collective agreements concluded between individual employers and trade unions almost always provide for further upward wage adjustments. Estimates for 1999 based on such agreements suggest that average wages rose by some 4.5% over 1998, or twice as much as inflation. It is doubtful that the implied increase in real incomes was earned through gains in productivity throughout the economy. To the extent that this does not happen, inflationary pressures are built up and competitiveness is eroded.

With regard to the country's external trading performance, the attenuation of fiscally-induced domestic demand pressures and the slowdown in investment activity during the past few years have combined to reduce the deficit on merchandise and services transactions. In 1999 the imbalance narrowed slightly but was still equivalent to over 5% of GDP. As with fiscal imbalances, external deficits need to be contained as there is a limit to how much, and for how long, they can be financed by capital inflows or by drawing on the country's reserves.

Policy Implications and Outlook

The current state of the Maltese economy is the product of strategies and policies put in place over many years. The main causes of to-day's symptoms are, therefore, well known and understood. By the same token, so should the policies most likely to succeed in correcting existing weaknesses and in translating the economy's undoubted potential into faster, higher quality growth.

The Government's commitment to rein in the budget deficit and to stabilize the public debt is a positive development and must be pursued as a national goal. The implications of a public debt whose servicing absorbs one in every eight liri of tax revenues, exceeds recurrent expenditure on health and is one-and-a half times as large as expenditure on education need to be more widely understood. The same applies to the fact that social welfare benefits as well as wages and salaries of Government employees each absorb almost one half of tax revenues.

This year the 7.1% of GDP target for the budget deficit is within reach, but reducing it further to sustainable levels by 2004 will call for a determined effort to increase revenues and reduce expenditures: the former preferably through efficiency gains in tax collection rather than through higher tax burdens, which could discourage new economic activity; the latter through further pruning of the public sector; the reduction of waste and abuse as well as reform in the realm of social welfare benefits, including pensions; and the privatization of activities than can be undertaken more efficiently by the private sector.

Apart from a responsible and sustainable fiscal policy stance, another necessary element of a stable macroeconomic environment is a monetary policy that delivers price stability. During the past year the Central Bank continued to pursue a policy designed to contain inflation through the use of a clear and transparent anchor for monetary policy – an exchange rate pegged to the currencies of low-inflation economies, viz. the euro, the pound sterling and the US dollar. As a result, interest rates were reduced to levels not seen in many years. The Bank's commitment to this policy should assure the social partners that the prospects for maintaining price stability remain favourable and this should hopefully lead them to conclude collective agreements which do not themselves constitute threats to price stability in the medium term and, by extension, to the economy's external competitiveness.

Fiscal and monetary policies in 1999 have, therefore, been consistently aimed at preserving macroeconomic balance and stability. These are necessary, but not sufficient conditions for achieving higher, sustainable rates of growth. In a small, open economy which is lacking in natural resources, another important condition is the attraction of investment in higher value-added activities, both in manufacturing and in services. Such investment will only materialize if capital is assured of earning a reasonable return in a stable legal, social and economic environment. The structural reforms currently being undertaken in both the product and the labour markets should contribute to achieving this objective. Meanwhile, there are already a number of investment projects in the pipeline, most of them in the private sector, which are expected to generate additional economic activity this year.

During the past year, Malta became a candidate for accession to the EU. The period during the negotiations process itself should see the economy undergo structural and institutional changes which will ultimately create new investment and export possibilities through further integration with the world's largest economic grouping.

The growth prospects for the Maltese economy in 2000 will, therefore, be strongly influenced by the pace of the restructuring process in both the private and public sectors and by the timing of the implementation of the new investment projects. On current indications, the growth rate is expected to remain roughly at 1999 levels. If the investment projects come on stream earlier than expected, then a GDP growth rate in excess of 3% is possible. More importantly, however, this year should mark a period of rationalisation and consolidation for the Maltese economy aimed at placing the country on a sound competitive footing, able to integrate successfully with its main trading partners.

There should be no illusions, however, about the complexity of the task at hand. And yet, reform cannot be further postponed if the country is to keep pace with its many existing and prospective competitors and to be able, therefore, to fulfil its people's expectations of higher living standards. At the same time, comfort can be derived from the experience of other countries which shows that it is possible for the costs of reform to be minimised and shared by all the social partners through the creation of a "virtuous circle" of policy complementarities.

Such synergies have recently been achieved in some European countries. The process started with a reform of the social benefits system. This helped restrain public spending, and thus reduced the budget deficit and also allowed for some lightening of the tax burden. In addition, cutting taxes and reforming benefits served to foster and sustain a policy of wage moderation. And wage moderation, combined with a reduction in the real minimum wage for first-time entrants to the labour market, in turn helped to strengthen the demand for labour over time. Finally, as employment started to grow, the tax base increased and tax rates could be lowered further.

In summary, it should not be beyond our country's ability to similarly spur job creation and growth. With the necessary macroeconomic policies now in place, the task remains to underpin these policies with appropriate structural reforms and to secure broad public support to sustain them.

Central Bank Operations

As stated previously, monetary policy is geared to maintaining price stability through the use of an exchange rate peg for the Maltese lira. In January 1999 the Bank updated the composition of the currency basket to which the lira is pegged following the launching of the single European currency.

The Bank uses a variety of tools to maintain the exchange rate peg. It buys and sells foreign exchange at the official rate to satisfy market needs. It also adjusts official interest rates to manage movements in the Bank's external reserves. During 1999, in response to weak domestic demand, falling inflation and lower interest rates abroad, the Bank gradually reduced official interest rates, bringing its discount rate and its central intervention rate down to 4.75% by the end of the year. The Bank ensures that short-term interest rates are compatible with its monetary policy stance by using open market operations to influence liquidity in the banking system. During the year, the Bank revised the term to maturity of the instruments used in its open market operations and introduced an overnight deposit facility. It also removed a number of restrictions on bank deposit and lending rates, while controls on capital movements were eased further.

The Bank supports the market for Government securities by standing ready to buy them on the secondary market. However, it does not participate in the primary market for Treasury bills and has reduced its participation in the primary market for Government Stocks. During 1999 the Government made no use of its overdraft facility with the Central Bank. Indeed, at the end of the year, the amendments to the Central Bank of Malta Act that abolished this facility were brought into force. This welcome development reinforces the independence of the Central Bank and promotes fiscal discipline. Further amendments to the Act will be adopted during 2000 in order to give the Bank full autonomy.

The Bank is also responsible for promoting a sound financial structure and an orderly capital market in Malta. In terms of the Malta Stock Exchange Act, the Bank supervises the Exchange to protect investors and 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 capacity, the Bank licensed two new banks and one financial institution during 1999. During the year the Bank amended the limits on the amount of foreign assets that banks may hold, setting them in proportion to each institution's own funds and introduced the final two annexes to the Capital Adequacy Directive.

As part of the screening process that the European Commission conducted with Malta, the Bank examined a number of chapters of the "*acquis communautaire*", including those on banking, capital movements, money laundering, payments systems and Economic and Monetary Union. Towards the end of the year, the Bank hosted a workshop for central bankers from EU applicant countries, while official contacts with the European Central Bank were also formally initiated.

During the year the Bank successfully introduced a new accounting system to increase efficiency and provide users with real-time information. The Bank also took steps to ensure that its operations would remain unaffected by the millennium changeover. A website displaying information about the Bank, economic and financial statistics and its publications was launched early in the year.

The Bank's financial performance was satisfactory during 1999 in spite of higher than usual payments of interest to Government and to banks occasioned by high liquidity conditions in the market, as well as of lower interest rates on the Bank's foreign assets throughout most of the year. As a result, net profits amounted to Lm23.1 million, compared with Lm30.7 million in 1998.

On behalf of the Board of Directors, I would like to thank the Bank's staff for their dedication and hard work without which the Bank's achievements in 1999, which are detailed 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

After the turbulence of 1997-98, the prospects for the world economy brightened considerably in 1999. In fact, global growth was expected to rise to 3% - from 2.5% in 1998. This improving performance was mainly generated by a faster-than-expected rebound by South Korea and other Asian economies as well as signs of recovery in Japan and better growth prospects in Europe. Meanwhile, the US economy continued to expand robustly.

The economic performance of the **advanced industrial countries** as a group improved significantly during the year, as calm was restored in the global economic and financial scenario. In fact, the industrial countries' combined GDP growth was expected to rise to 2.8%, 0.6 percentage points more than in 1998. At the same time, inflation in most of these countries remained low. In the second half of the year, however, inflationary pressures started to rise in both the US and Western Europe. This was mainly on account of a sharp rise in oil prices and, in the case of the US and the UK, tight labour-market conditions. Accordingly, most central banks raised official interest rates pre-emptively. The US economy remained remarkably strong, largely reflecting successful monetary-policy management and structural policies to intensify the flexible working of markets. Economic growth also began to pick up again in much of Western Europe, helped by an easy monetary policy and a modest upturn in business sentiment in the euro zone. In the UK, a markedly improved labour-market performance and the skilful management of monetary policy resulted in a pick up in growth, after the economy had bottomed out without a recession. In Japan, however, although concerns about the financial system receded, fears of deflation persisted.

Economic growth in the **developing countries** also accelerated modestly in 1999, with these countries'

Table 1.1
INTERNATIONAL ECONOMIC INDICATORS
Percentage change from previous period

Country	Real GDP % Change			Inflation (Consumer Prices) % Change			Current Account Balances US$ billions		
	1997	1998	1999	1997	1998	1999[1]	1997	1998	1999[1]
Canada	4.0	3.1	3.7 [1]	1.6	1.0	1.5	-10	-11	-2
United States	4.5	4.3	4.1	2.3	1.6	2.2	-144	-221	-339
Japan	1.4	-2.8	0.3	1.7	0.6	-0.4	95	121	120
France	2.0	3.4	2.7	1.2	0.8	0.5	38	40	34
Germany	1.5	2.2	1.5	1.9	0.9	0.4	-2	-4	-1
Italy	1.5	1.3	1.4	2.0	2.0	1.5	34	20	7
United Kingdom	3.5	2.2	1.9 [1]	3.1	3.4	2.3	10	0	-22
Advanced Countries	3.2	2.2	2.8 [1]	2.1	1.5	1.4	81	37	-77
Developing Countries	5.8	3.2	3.5 [1]	9.2	10.3	6.7	-62	-77	-56
Countries in Transition[2]	2.2	-0.2	0.8 [1]	28.2	20.9	39.3	-26	-25	-16

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

*SOURCE: IMF, **World Economic Outlook (September 1999)***
*OECD, **Economic Outlook (December 1999)***

combined GDP growth expected to rise to 3.5%, from 3.2% in 1998. The rise mainly reflected a marked improvement in the performance of the Southeast Asian economies and the stabilisation of the Chinese economy in the second half of the year, as most Latin American countries, with the notable exception of Brazil, were going through severe recessions.

Meanwhile, the economies of the **countries in transition** registered an expansion in their GDP of 0.8%, as against a contraction of 0.2% recorded in the previous year. This took place mainly on the back of a rebound in Russian GDP and industrial output, as export and import-substituting industries took advantage of a weaker rouble. Moreover, the maintenance of tight financial policies, combined with a strong turnaround in Russia's current account, helped to improve the country's macroeconomic situation. Despite these positive trends, however, the Russian economy remained fragile, and the establishment of an efficient market economy was still hampered by weak governance structures, while the transition countries in Central and Eastern Europe were still suffering the effects of the Russian crisis.

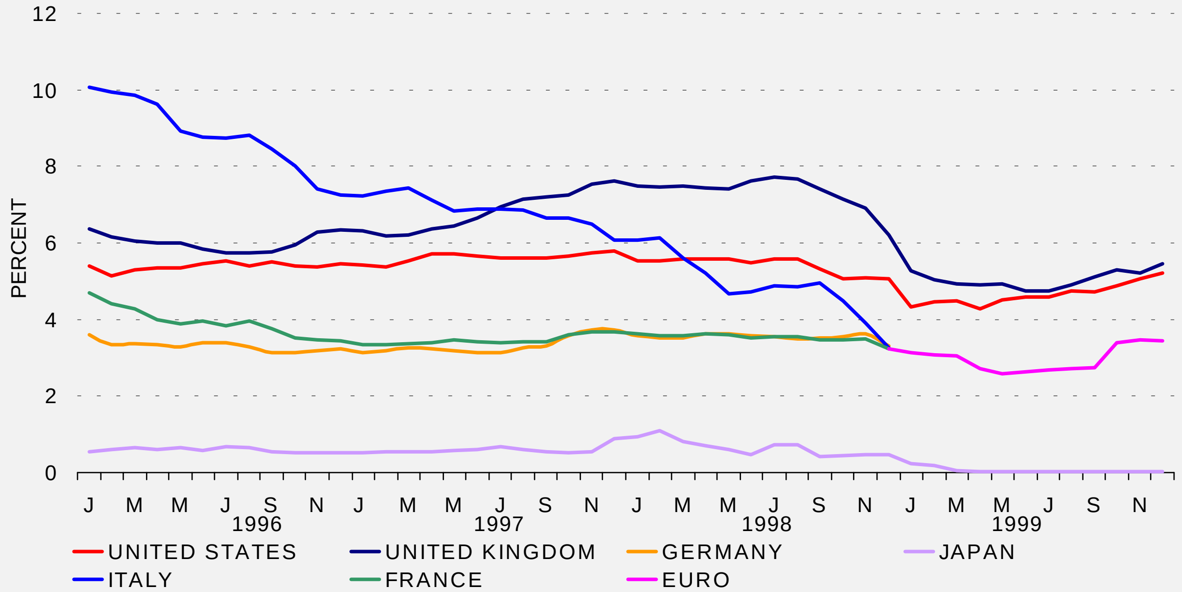
In the **United States**, economic growth continued at a vigorous pace for the ninth consecutive year, with GDP growing at 4.1% to mark a third year of expansion at that rate or higher. Productivity, meaning the output per hour of workers outside the farm sector, rose by 3.0% in 1999, while productivity in the manufacturing sector rose by 6.4%. Labour-market conditions tightened further during the year, with the unemployment rate falling to a 30-year low of 4.1% in December. In spite of this, unit labour costs rose by only 1.7% during the year. Meanwhile, consumer spending went up by 6.9%, the strongest yearly gain since 1989. This took place mainly on the back of record-high activity in the housing market, which in turn was aided by the wealth factor of rising stock-market prices and soaring home-equity values. As a result, and on the negative side, the US trade deficit widened further, fuelled by surging imports and a notable rise in oil prices.

In contrast, the **Japanese** economy failed to pull out of its severe recession as private demand, which accounts for 60% of Japan's economic activity, remained sluggish. Nevertheless, Japan did exhibit signs of moderate improvement, mainly on the back of an expansionary fiscal policy, the Bank of Japan's easy monetary stance and the recovery elsewhere in Asia. In fact, Japan's GDP grew in the first half of the year before shrinking again in the third quarter owing to a slump in private investment and consumption. Provisional forecasts indicated a further contraction in GDP in the fourth quarter, hence returning the Japanese economy to a technical recession. Consequently, unemployment tended to rise, reaching a record high of 4.9% in June and July, as Japanese firms, under pressure to restructure, started to abandon traditional employment practices that put stability and loyalty before efficiency. On the other hand, despite the strength of the yen, Japan continued to register a huge current-account surplus and remained a substantial net external creditor.

Meanwhile, in **Euroland**, GDP growth was forecast to fall to 2.1% in 1999, from 2.8% in 1998, as a slowdown early in 1999 masked a pick up in activity towards the end of the year. In the early months of the year, growing regional imbalances, combined with structural unemployment, continued to characterise the euro-zone economic scenario. By mid-year, however, economic data started to point to a recovery, and this picture was reinforced later in the year. This improved performance took place on the back of a marked strengthening of industrial-production growth and a significant rise in demand, which was boosted by improving market conditions both within the euro area itself and in its export markets. As a result, the jobless rate fell to 9.6% in December, from 10.5% a year earlier. In the financial sector, participation in EMU gave rise to a sharp increase in cross-border capital flows, especially of the portfolio type. This was motivated by new opportunities for diversification and Europe-wide business, particularly in the banking sector.

In Germany, economic recovery became evident in the Spring and accelerated in the second half of the year, mainly on account of an export-driven increase in industrial orders and output and a rise in business confidence. This was reinforced by an upturn in domestic demand brought about by higher

Chart 1.1 SHORT-TERM INTEREST RATES *
(MONTHLY AVERAGES)



* TYPICAL THREE-MONTH MONEY-MARKET RATES IN MAJOR INDUSTRIAL COUNTRIES
SOURCE: OECD FINANCIAL STATISTICS AND IMF

infrastructure spending and private consumption. As a result, Germany's jobless rate eased to 10.2%, from 10.7% in 1998. Meanwhile, booming consumer spending and strong exports placed France at the forefront of Euroland's recovery. Thus, the French jobless rate fell to 10.6% in December, its lowest rate in more than two years. In Italy, a modest economic recovery started to take place in the later months of the year. In fact, in December, Italian business confidence and orders expectations hit their highest level since May 1995 - mainly on the back of an improvement in both export markets and the domestic climate. Italy's notably high unemployment rate thus eased slightly, to 11.1%, in November.

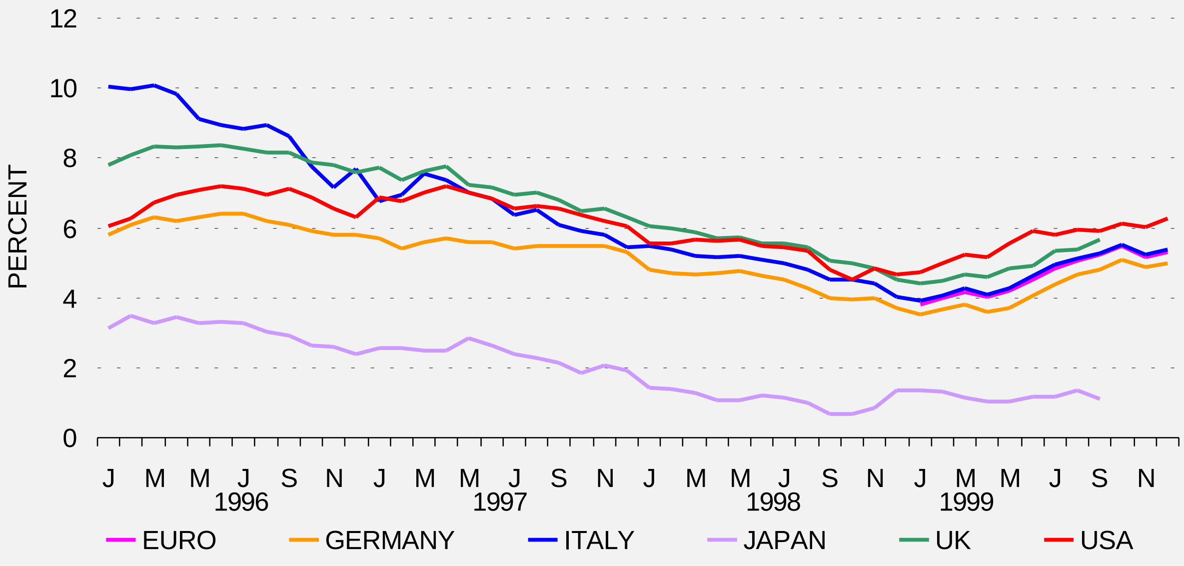
Economic activity in the **United Kingdom** kept just clear of a technical recession in the first quarter of the year but it rebounded strongly afterwards. Accordingly, the UK's GDP is estimated to have expanded by 1.9% in 1999, not far short of the 2.2% growth rate recorded in 1998. This growth was largely generated by the buoyant services sector, which expanded for the tenth consecutive month in December, and, to a lesser extent, by the manufacturing sector. Britain's labour market remained tight during the year, with the jobless rate falling to 4% in December. The decline in Britain's unemployment, coupled with a recovery in real income growth, boosted consumer confidence, and this, in turn, generated a notable rise in retail sales and house prices. On the other hand, the UK's trade deficit widened further, generating fresh concerns about the strength of sterling.

1.2 Interest Rates and Exchange Rates

Short-term interest rates during 1999 fluctuated in line with developments in inflation expectations and underlying economic conditions. Hence, in the US, money-market rates rose in line with the Federal Reserve's monetary-policy tightening. In the UK, rates fell in the first half of the year but rose in the second half as Britain's economic recovery gained momentum. In Euroland, short-term rates fell in April and May but tended to rise later, particularly in the last quarter of the year. Meanwhile, Japan's money-market rates fell to near 0% in the early months of the year and continued to fluctuate thinly above that level throughout the remaining months of 1999.

In the **United States**, money-market rates tended to rise during 1999, particularly in the second half of the year. The Federal Reserve Bank kept its target for the Federal funds rate unchanged until June 29 in view of the conflicting economic scenarios in the US and in the rest of the world, and the relatively stable

Chart 1.2 LONG-TERM INTEREST RATES*
(MONTHLY AVERAGES)



inflationary environment. Between June 30 and November 16, however, the Federal Reserve raised the Federal Funds rate three times in a pre-emptive strike against inflation. Short-term money-market rates tended to stay slightly below the Federal Funds rate throughout the year.

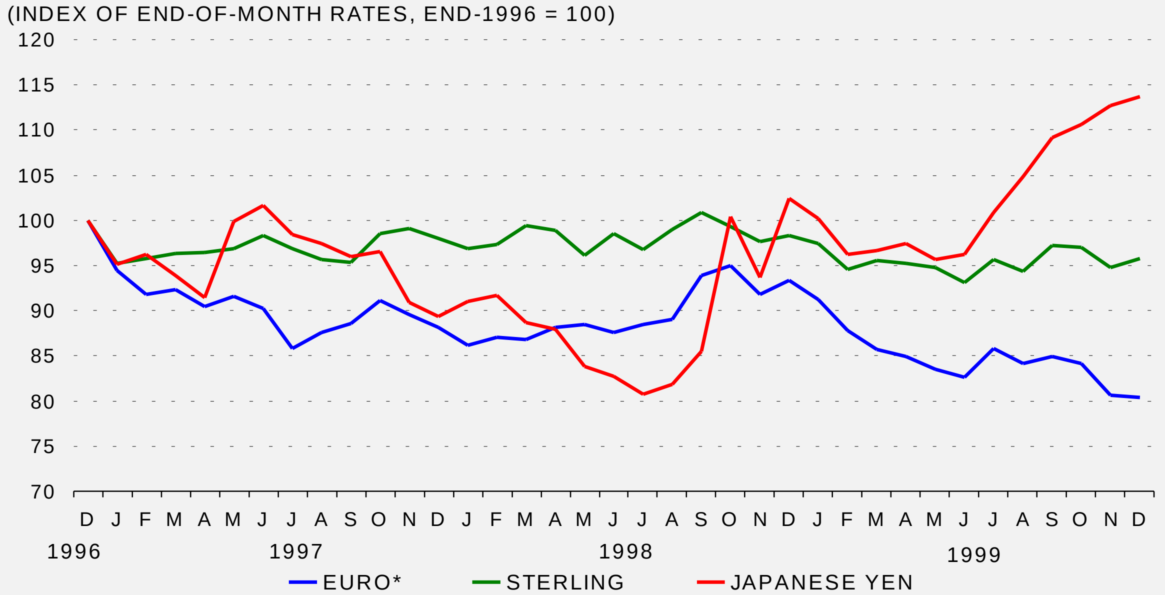
Meanwhile, **Japanese** money-market rates fell to just over 0% in the early months of 1999 and fluctuated narrowly above that level throughout the remaining months of the year. The Bank of Japan kept its discount rate unchanged at 0.5% throughout the year, and on February 12, in an effort to stave off deflationary pressures, it even lowered the target for its overnight call rate from 0.25% to 0.15%.

In **Euroland**, money-market interest rates remained relatively stable until March, reflecting the ECB's decision to keep official rates unchanged. In the next two months, however, after the ECB cut its main refinancing rate by a bigger-than-expected 50bps to 2.5% on April 8, money-market rates fell notably. This took place within the context of subdued inflation and sluggish economic growth in the euro zone. Subsequently, money-market rates followed an upward trend, rising sharply in the final quarter of the year. By and large, this pattern reflected the ECB's monetary stance. In fact, official rates in the euro zone were left unchanged until November 4, when they were raised by 50bps in order to keep inflation expectations under control.

In the **United Kingdom**, money-market rates tended to decline in the first quarter of the year, following two reductions in the Bank of England's repo rate. These took place against the backdrop of a slowdown in Britain's economic growth and a subdued inflationary environment. After some thin fluctuations, money-market rates fell again in June, following two further reductions in official rates. Thenceforth, however, short-term rates tended to rise until October, mainly reflecting the market's optimism regarding Britain's economic recovery. On its part, the Bank of England raised rates in both September and November in order to keep long-term inflation on track. Money-market rates fluctuated below official rates practically throughout 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 rates embarked on an upward path in 1999, in view of expectations of further economic growth in the US and an economic recovery in the UK, Euroland and Japan. Long-term rates were highest in the US, followed by the UK and Euroland,

Chart 1.3 EXCHANGE-RATE MOVEMENTS OF SELECTED CURRENCIES AGAINST THE US DOLLAR



and lowest in Japan. Nevertheless, Japan's rates also followed an upward trend through most of the year, mainly on account of the Japanese Government's rising borrowing requirement.

In the first half of 1999, the **foreign-exchange markets** were characterised by a strengthening US dollar, reflecting the resilience of the US economy within a global scenario that was still beset by serious problems and unbalanced growth. In the second half of the year, as conditions elsewhere improved, the dollar changed direction, registering substantial losses, particularly against the Japanese yen and sterling. In contrast, Europe's single currency, the euro, which started trading on a strong footing on January 4, weakened across the board almost throughout 1999, undermined by the weak economic performance and structural rigidities in Euroland. The euro also suffered from a large net outflow of direct investment, with euro-zone companies investing up to 151bn euros outside the zone in the first ten months of the year against inward investment of 53bn euros.

In the early months of the year, the dollar strengthened against the euro and sterling mainly on account of strong economic fundamentals in the US as against weak German and UK manufacturing sectors. Against the Japanese yen, the dollar fluctuated widely until around mid-February, when the yen embarked on an upward trend that lasted to mid-March. This occurred mainly on the back of rumours that the US administration was urging Japan to loosen monetary policy - as well as yen repatriation by Japanese firms ahead of their financial year end. On its part, the euro weakened against sterling, mainly on account of interest-rate differentials, while it fluctuated widely against the yen.

In April, the dollar continued to strengthen against the euro as the US currency assumed a safe-haven status in view of the crisis in the Balkans. Through most of May, the dollar was buoyed by a rally in US asset markets, comments by the US Treasury Secretary designate supporting a strong dollar policy, and an announcement by the Federal Reserve Bank that it was adopting a monetary-policy tightening bias. Nevertheless, by the end of May, the dollar began to lose ground against the yen, as the latter was supported by the prospect of additional measures to boost the Japanese economy. Towards the end of June, however, the yen was depressed by central-bank interventions in the foreign-exchange markets.

At around mid-July, emerging-market jitters emanating from Argentina depressed the dollar. Subsequently, the US unit fell further, especially against the yen, as

Table 1.2
AVERAGE EXCHANGE RATES OF THREE MAJOR CURRENCIES AGAINST THE US DOLLAR - 1999

	US$ per Euro	US$ per Stg	Yen per US$
January	1.1616	1.6506	113.0
February	1.1215	1.6291	116.6
March	1.0893	1.6204	119.7
April	1.0710	1.6099	119.6
May	1.0636	1.6150	121.9
June	1.0393	1.5967	120.7
July	1.0354	1.5743	119.7
August	1.0609	1.6066	113.4
September	1.0502	1.6234	107.0
October	1.0717	1.6578	106.1
November	1.0352	1.6235	104.8
December	1.0114	1.6125	102.5
Average for the year	1.0676	1.6183	113.8
Closing rate on 30.12.99	1.0058	1.6193	102.1
Closing rate on 31.12.98	1.1678	1.6626	113.3
High for the year	1.1875	1.6763	124.4
	(Jan. 04)	(Oct. 22)	(May 20)
Low for the year	1.0003	1.5522	101.5
	(Dec. 03)	(Jul. 12)	(Dec. 23)
Percentage appreciation (+)/depreciation (-) of the currency vs the dollar from closing rate on 31.12.98 to closing rate on 30.12.99	-13.9	-2.6	9.9

positive sentiment in favour of the Japanese economy induced investors to purchase yen heavily. The dollar also fell against the euro, following a robust June business survey from Germany. The dollar's weakness against the euro at this stage, in turn, benefited sterling, which climbed back towards $1.60 against the US unit. The dollar weakened further against the pound, which even firmed against the euro, following stronger-than-expected UK second-quarter GDP data.

By around mid-August, however, the dollar rebounded against the euro, mainly on the back of technical factors. The dollar also strengthened against the pound, as US interest rates rose above British rates for the first time since the mid-1980s. But the dollar's strength did not extend to the yen, which continued to draw support from positive prospects for the Japanese economy. Moreover, towards the end of August, the dollar suffered substantial losses against sterling, which was considered to be a somewhat less risky version of the US unit.

At the end of September and mid-October the dollar also fell against the euro - mainly on account of a record second-quarter US current-account deficit, though positive French economic data and a revival in German business confidence also contributed. Nevertheless, the euro continued to suffer losses against sterling, which was supported by the Bank of England's successful gold auction and expectations of a sizeable UK budget surplus. After some fluctuations, the dollar came under pressure again, particularly against the yen and the euro, as nervousness about US stocks, coupled with better prospects for growth in Europe, Japan and the UK, dampened sentiment for the US currency.

Throughout most of November, the dollar tended to rise against the other major currencies, buoyed by stronger US equity prices, benign labour-market data and technical factors associated with the liquidation of long-euro positions. Towards the end of November, however, the dollar fell almost continuously against the yen, as the prospect of a sustained economic recovery in Japan boosted Japanese share prices and attracted foreign capital. Consequently, the Bank of Japan intervened repeatedly in the foreign-exchange markets, selling yen for dollars and probably euros, in order to smoothen out disruptive currency-market movements.

In early December the dollar tended to strengthen against both the euro and the yen, but it suffered losses against sterling, which benefited from positive UK economic data. After some fluctuations, the dollar fell again against the other major currencies, particularly the yen, following news of another record US trade deficit in October. Subsequently, however, the dollar moved on an upward trend, benefiting from safe-haven flows associated with the year 2000 date change.

Nevertheless, towards the end of the year, the dollar fell against the yen, mainly as a consequence of the repatriation of year-end profits by Japanese companies. Both the dollar and the yen, in turn, fell against the pound, which benefited from strong UK retail sales data and expectations of higher UK interest rates. On its part, the euro fell to near parity against the dollar, as the European currency suffered from scepticism about structural reform and political uncertainties in Euroland.

1.3 Commodities

In the early months of 1999, the prices of **base metals** fell - but they subsequently rebounded and followed an upward trend, ending the year 32.3% up from end-1998 levels. The rapid collapse of the Brazilian real in early January hit the price of copper, as traders feared that the global downturn was at last about to reach North America. In February, both copper and aluminium slumped to their lowest levels in 12 and 5 years, respectively, on account of oversupply. Towards the end of February, however, the prices of most base metals posted modest gains, mainly on account of falling stocks. Afterwards, prices followed an upward trend, which extended over the remaining months of 1999, supported by the economic recovery in Asia. Growing confidence over global economic prospects and a spate of consolidation in the base-metals industry fuelled speculative and consumer buying, with copper, zinc, nickel and aluminium being the main beneficiaries. Thus, towards the end of the year, nickel reached its highest level for 3 years, aluminium hit a two-year peak, and copper touched its best price since April 1998.

The price of **oil** continued to drop during January and February before rebounding sharply in March, following agreements by OPEC and non-OPEC members on fresh cuts in output. Key oil producers agreed to cut about 2.1 million barrels per day, over and above previous commitments, from world markets from April 1, 1999 until March 2000 in order to boost prices. By mid-year it was becoming apparent that, unlike previous occasions, producers were abiding by their agreements. In fact, the discipline exercised by the OPEC producers was the principal impetus behind the oil-price recovery. Oil prices also drew strength from the reawakening of demand from Southeast Asia and fears of a Northern Hemisphere Winter supply shortfall. The long running dispute between Iraq, potentially the second largest OPEC producer, and the UN regarding the terms of the oil-for-food deal was another factor behind the price rise. Moreover, the advance in the price of oil was fuelled by a string of speculative buying by investment funds betting on further price rises. As a result, oil ended the year at US$25.28 per barrel, more than double the price of US$10.44 that prevailed at the end of 1998.

Food prices declined through most of 1999, as the output of soft commodities - including coffee, sugar and cocoa - rose substantially while consumption remained practically unchanged. Another significant factor behind the fall in food prices was Brazil's devaluation, which lowered costs and encouraged exports. In fact, Brazil's coffee sales in the year to October 1999 totalled 23m bags, compared with 17m bags previously. On the sugar market, Brazil's soaring exports pushed raw sugar futures to 13-year lows, with Brazilian growers sharply undercutting other large exporters, such as Australia. Meanwhile, cocoa production turned out to be better than expected, mainly on the back of good weather conditions in the Ivory Coast, which produces 40% of world supplies. With plenty of cocoa around, manufacturers moved from holding large stocks to a just-in-time buying policy that put further pressure on prices, which halved over the year to Stg550 a tonne. In the last few months of the year, however, coffee futures rose as the forecast for a record Brazilian crop was scaled back after some unusually dry weather. Sugar futures also rose, largely on account of higher-than-expected imports by Russia. Thus, on balance, food prices ended the year 11.3% down from end-1998 levels.

Meanwhile, prices of **non-food agricultural commodities**, particularly natural rubber, wool and cotton, came under pressure mainly on account of excess supplies and subdued demand. Throughout most of 1999, the market for natural rubber suffered from 1998's global surplus and the poor level of demand from Asian buyers, especially China. Matters were not helped by the collapse of the International Natural Rubber Organisation (INRO), which used to serve as a price-stabilisation mechanism. After hitting a 30-year low in the Summer, the price of rubber picked up on increased forward covering by tyre makers, disrupted supplies (due to heavy rains in Indonesia) and speculative Japanese buying. Continuing high stocks also kept wool prices under pressure in 1999, even though global production in 1998/99 had been cut to hit its lowest level since at least the early 1950s. The market's problems were compounded by poor import demand from China, where domestic output is expanding rapidly, reducing import needs. Changing fashion trends and competition from much cheaper synthetic fibres added to wool's woes. Cotton also faced competition from synthetics. This took place against a background of continued excess supplies and abundant stocks in China and America. Moreover, the cotton market had been negatively hit by the withdrawal of US government support for export subsidies. As a result, prices of non-food agricultural commodities at the end of the year were, on balance, down by 1.2% from December 1998 levels.

The price of **gold** continued to follow the downward trend in evidence in recent years until September, when it rose sharply. Although it later lost most of these gains, gold managed to end the year at US$289.90 per ounce, up by 0.9% from the US$287.35 per ounce at which it ended 1998. While demand for gold continued to outstrip mine supply, sales and leasing of gold by central banks increased the amount of metal on the market and forced prices lower. Furthermore, low inflation and weak global commodity prices have eroded gold's traditional role as a hedge against price rises. The threat of central bank sales, particularly by the European System of Central Banks, and of sales by the IMF, was the main factor depressing gold prices in the early months of 1999. Then, on April 18, Swiss voters approved a new constitution severing the Swiss franc's gold backing, and on May 7, the UK Treasury surprised the market when it announced that it would sell 125 tonnes of gold from its reserves in the years 1999-2000. The UK Treasury also expressed its intention to reduce its gold reserves by more than half in the medium term in a major restructuring of Britain's reserve holdings. Following this announcement, the price of gold collapsed to 20-year lows. In July and August, the price of bullion continued to decline as the prospect of sales by a number of European central banks, particularly those of Britain and Switzerland, and the IMF undermined the market. Towards the end of September, however, a number of leading European central banks pledged to limit bullion sales, lending and derivatives for the next five years. Moreover, opposition in the US Congress to the IMF's plan to sell gold led the Fund to alter its plans. As a result, gold prices soared. Subsequently, however, the price of bullion fell again, particularly in December, following an announcement by the Dutch central bank that it planned to sell 300 tonnes of gold to boost its cash reserves.

2. The Domestic Economy

According to Central Bank estimates, the Maltese economy grew by around 2.5%-3.0% in real terms during 1999, compared with the official growth rate of 3.1% registered in 1998. GDP growth continued to be export-led, mainly reflecting buoyant activity in the electronics sector of the manufacturing industry and in the tourism industry. The contraction in gross fixed capital formation observed during the previous three years was arrested and possibly reversed during 1999, in spite of activity in the construction industry remaining subdued. There was also a notable increase in consumption expenditure, but this was channelled predominantly into a higher level of imports.

The continuing weakness of domestic demand for locally-produced goods and services was reflected in a higher rate of unemployment, which averaged 5.3% during the year compared with 4.9% in 1998. At the same time domestic retail price inflation eased further in line with the downward trend in imported inflation. Thus, the annual rate of inflation stood at 2.1% at the end of the year compared with 2.4% a year earlier. However, as a result of domestically-generated price pressures, notably higher indirect taxes and increases in wages which did not appear to be fully matched by productivity growth, the rate of domestic inflation continued to exceed that of Malta's main trading partners and competitors.

2.1 Aggregate Demand

The estimated moderation in the GDP growth rate during 1999 reflected a relatively weak domestic demand, partly due to a prudent fiscal stance. In

Table 2.1
GDP BY CATEGORY OF EXPENDITURE

Lm millions

	1995	1996	1997	1998	January-September 1998	January-September 1999
AT CURRENT MARKET PRICES						
Private Consumption Expenditure	700.4	764.9	803.5	843.3	628.2	677.8
Government Consumption Expenditure	235.2	259.8	264.1	269.5	192.2	201.4
Gross Fixed Capital Formation	365.2	345.3	326.4	331.3	240.1	235.9
Inventory Changes	1.2	-1.4	3.0	-10.4	-12.5	-9.0
Domestic Absorption	**1,302.0**	**1,368.6**	**1,397.0**	**1,433.7**	**1,048.0**	**1,106.1**
Exports of Goods & Services	1,074.7	1,045.6	1,095.8	1,194.7	901.8	975.5
Imports of Goods & Services	1,231.2	1,212.8	1,204.6	1,270.3	934.2	1,002.0
Balance of Trade in Goods & Services	**-156.5**	**-167.2**	**-108.8**	**-75.6**	**-32.4**	**-26.5**
GROSS DOMESTIC PRODUCT	**1,145.5**	**1,201.4**	**1,288.2**	**1,358.0**	**1,015.7**	**1,079.6**
AT CONSTANT 1995 PRICES						
Private Consumption Expenditure	700.4	750.2	762.1	778.9	576.6	613.2
Government Consumption Expenditure	235.2	254.9	252.0	242.5	178.9	178.3
Gross Fixed Capital Formation	365.2	334.5	319.3	306.4	222.6	223.3
Inventory Changes	1.2	-1.4	2.9	-9.6	-11.3	-8.1
Domestic Absorption	**1,302.0**	**1,338.2**	**1,336.3**	**1,318.2**	**966.8**	**1,006.7**
Exports of Goods & Services	1,074.7	1,011.3	1,051.5	1,137.1	846.4	888.9
Imports of Goods & Services	1,231.2	1,158.3	1,138.8	1,167.4	857.1	897.9
Balance of Trade in Goods & Services	**-156.5**	**-147.0**	**-87.3**	**-30.3**	**-10.7**	**-9.0**
GROSS DOMESTIC PRODUCT	**1,145.5**	**1,191.2**	**1,249.0**	**1,287.8**	**956.0**	**997.7**

SOURCE: Central Office of Statistics

Table 2.2
YEAR-ON-YEAR PERCENTAGE CHANGES IN GDP

Percent

	1995	1996	1997	1998	1999[1]
AT CURRENT MARKET PRICES					
Private Consumption Expenditure	15.1	9.2	5.0	5.0	4.0 - 5.0
Government Consumption Expenditure	12.3	10.5	1.7	2.0	3.0 - 3.5
Gross Fixed Capital Formation	19.6	-5.4	-5.5	1.5	0.0 - 0.5
Exports of Goods & Services	8.1	-2.7	4.8	9.0	10.8 - 11.2
Imports of Goods & Services	12.0	-1.5	-0.7	5.5	9.8 - 10.2
GROSS DOMESTIC PRODUCT	**11.4**	**4.9**	**7.2**	**5.4**	**5.0 - 5.5**
AT CONSTANT PRICES					
Private Consumption Expenditure	10.5	7.1	1.6	2.2	3.0 - 3.5
Government Consumption Expenditure	8.5	8.4	-1.1	-3.8	0.0 - 0.5
Gross Fixed Capital Formation	17.8	-8.4	-4.5	-4.0	0.0 - 0.5
Exports of Goods & Services	5.4	-5.9	4.0	8.1	4.5 - 5.0
Imports of Goods & Services	10.0	-5.9	-1.7	2.5	4.5 - 5.0
GROSS DOMESTIC PRODUCT	**6.2**	**4.0**	**4.9**	**3.1**	**2.5 - 3.0**

[1] Central Bank of Malta Estimates

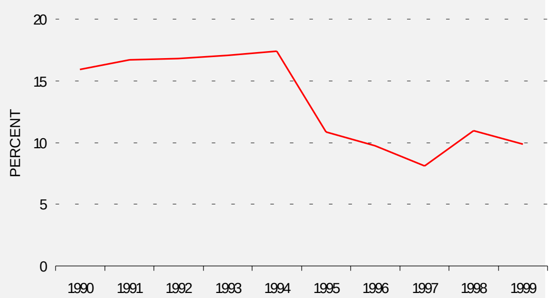
SOURCE: Central Office of Statistics

contrast, more favourable conditions in foreign markets, where demand continued to pick up, contributed to further growth in exports of goods and services.

2.1.1 Consumption Expenditure

Private consumption expenditure in 1999 is estimated to have grown by around 3.0 - 3.5% in real terms, faster than in the previous two years. Excluding the import content of consumption expenditure, however, - the past year saw an increase in imports of consumer goods, in particular motor vehicles - the contribution of consumption to domestic output was less significant.

Chart 2.1 HOUSEHOLD SAVINGS RATIO*
(HOUSEHOLD SAVING AS A PERCENTAGE OF DISPOSABLE INCOME)



* DATA FOR 1999 ARE CENTRAL BANK OF MALTA ESTIMATES

SOURCE: ECONOMIC PLANNING DIVISION, ECONOMIC SURVEY

Meanwhile, the household saving rate is estimated to have declined slightly to 9.9% in response to the pickup in consumption combined with the impact of the increase in social security contribution rates on household disposable income.

The fiscal measures introduced at the beginning of 1999 were a major determinant of the small growth in Government consumption. In real terms the latter is estimated to have risen by less than 0.5%, compared with 3.0 – 3.5% in nominal terms. The stronger growth in nominal terms was mainly a result of higher wages and salaries, as the number of Government employees dropped slightly during the year.

2.1.2 Gross Fixed Capital Formation

Though investment activity remained weak in 1999, signs of a recovery began to emerge towards the end of the year. Purchases of machinery by the manufacturing industry, particularly the electronics sector, were the main source of growth. Investment in construction[1] continued to drop - mainly reflecting lower public sector outlays as a number of projects reached completion while activity on others, such as

[1] excluding oil exploration.

the new hospital, slowed down - but at a slower rate than in 1998. Investment growth during 1999 was also dampened by a special factor, the disposal of aircraft by the national airline, which is now leasing the equivalent flight capacity.

2.1.3 External Demand and Supply

Activity in the export-oriented sectors remained buoyant during the year under review, although the underlying rate of growth in exports of goods and services was somewhat slower than in 1998, when manufacturing exports had been boosted by an upgrading of product lines in the electronics sector. In real terms, exports of goods and services are estimated to have risen by 4.5% - 5.0%, while in nominal terms export growth was substantially higher, partly on account of the surge in the price of re-exports of petroleum. The electronics sector remained the primary source of growth of visible exports during the year under review, while on the services side the tourism sector led the field.

Imports of goods and services are estimated to have expanded by 4.5% - 5.0% in real terms, roughly double the 1998 growth rate. The increase in merchandise imports was driven by the demand for consumer goods, notably motor vehicles, while the sharp hike in international oil prices was an important factor behind the nominal increase in imports. The value of services bought abroad also increased, mainly on account of higher shipment charges, but constituted only about a third of total imports.

2.2 The Labour Market

Labour market developments during 1999 were broadly in line with demographic and economic trends. The labour supply grew by over 1,500, two-thirds of whom were women. The demand for labour was boosted by the services sector, but the slowdown in construction activity dampened employment growth. Hence, the unemployment rate continued to rise, edging up to 5.3% from 4.9% in 1998, as Table 2.3 shows. In part the increase reflects a structural factor, the mismatch between skills in demand and those possessed by the unemployed.

Table 2.3
LABOUR MARKET: MAIN INDICATORS
Number of Persons - Yearly Averages

	1998	1999
Labour Supply	144,054	145,590
Males	104,534	105,000
Females	39,520	40,590
Registered Unemployed	7,060	7,684
Males	6,062	6,537
Females	998	1,147
Unemployment Rate (%)	4.9	5.3
Gainfully Occupied	136,995	137,906

SOURCE: Employment and Training Corporation

The private sector accounted for all of the 911 rise in average employment levels during 1999, as the number of public sector employees was sharply reduced. This mainly reflected the privatisation of Mid-Med Bank in June, which boosted average private sector employment and correspondingly reduced that of the public sector, though a reduction in Government employment also contributed.

Employment in direct production was down by an average 1.3% during the year under review. The construction industry accounted for well over half of the decline, partly due to the downsizing of a public sector entity, while the rest occurred in the manufacturing industry. Jobs created in some sub-sectors, notably in electronics, were offset by losses elsewhere, particularly in footwear and clothing.

Employment in market services compensated for the net job losses in direct production and rose by around 2.1% during 1999. As can be seen from Table 2.4, most of this increase was generated by the community and business sub-sector and by hotels and catering establishments. Employment growth in the latter reflected both the positive performance of the tourism industry and the opening of a number of new establishments. On the other hand, employment in the wholesale and retail trades, which accounts for around one fourth of employment in services, fell slightly in line with the prevailing demand conditions.

Table 2.4
GAINFULLY OCCUPIED BY SECTOR
Number of persons

	1998				1999			
	Public	Private	Total	Percent of Gainfully Occupied	Public	Private	Total	Percent of Gainfully Occupied
i. Direct Production	**3,489**	**37,447**	**40,936**	**29.9**	**3,243**	**37,148**	**40,391**	**29.3**
including								
Footwear and Clothing	0	3,954	3,954	2.9	0	3,597	3,597	2.6
Construction	480	5,563	6,043	4.4	336	5,387	5,723	4.1
Electronics, Appliances & Supplies	0	5,076	5,076	3.7	0	5,212	5,212	3.8
Food	34	3,228	3,262	2.4	23	3,188	3,211	2.3
Agriculture[1]	0	2,558	2,558	1.9	0	2,517	2,517	1.8
Transport Equipment[2]	845	2,117	2,962	2.2	828	2,182	3,010	2.2
Other[3]	2,130	14,951	17,081	12.5	2,056	15,065	17,121	12.4
ii. Market Services	**14,255**	**45,217**	**59,472**	**43.4**	**13,062**	**47,644**	**60,706**	**44.0**
including								
Wholesale and Retail	15	15,322	15,337	11.2	15	15,284	15,299	11.1
Hotel and Catering	371	8,750	9,122	6.7	364	9,082	9,446	6.8
Community and Business	3,748	9,478	13,227	9.7	3,749	9,870	13,619	9.9
Transport	2,165	5,327	7,492	5.5	2,282	5,356	7,638	5.5
Malta Drydocks	3,142	0	3,142	2.3	2,970	0	2,970	2.2
Banks & Financial Institutions	2,162	1,805	3,966	2.9	1,149	2,901	4,050	2.9
Other	2,652	4,535	7,187	5.2	2,533	5,151	7,684	5.6
iii. Temporarily Employed	**3,885**	**595**	**4,480**	**3.3**	**4,064**	**668**	**4,732**	**3.4**
including								
Apprentices and Trainees	656	595	1,251	0.9	825	668	1,493	1.1
Pupil workers	3,201	0	3,201	2.3	3,229	0	3,229	2.3
Student workers	28	0	28	0.0	10	0	10	0.0
iv. Government[4]	**32,107**	**0**	**32,107**	**23.4**	**32,044**	**0**	**32,044**	**23.2**
Gainfully Occupied	**53,736**	**83,259**	**136,995**	**100.0**	**52,445**	**85,461**	**137,906**	**100.0**

[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 Planning Division, ***Economic Survey*** *; Employment and Training Corporation*

Part-time employment again grew rapidly in 1999, rising by nearly 3,000. As can be seen from Table 2.5, two thirds of this increase was accounted for by persons for whom part-time employment constituted their primary or only job. Part-time employment is, in fact, becoming increasingly popular with married women and students. Meanwhile, the number of part-timers who also held a full time job continued to grow, though at a slower rate than in 1998.

2.2.1 Unemployment

The rising trend in unemployment in evidence since 1996 continued during 1999, as lower domestic demand impacted on the demand for labour by the construction industry and the services sector and efforts were made to reduce employment in the public sector. Furthermore, manufacturing industry, domestically-oriented firms in particular, continued to rationalise their operations in view of the gradual

Table 2.5
PART-TIME EMPLOYMENT
Number of Persons

	1997	1998	1999
Part-time Employees holding Full-time Jobs	**14,029**	**15,415**	**16,514**
Males	10,959	11,765	12,370
Single Females	2,003	2,346	2,761
Married Females	1,067	1,304	1,382
Part-time Employment as a Primary Job	**12,608**	**13,447**	**15,327**
Males	4,905	5,268	6,076
Single Females	2,603	2,765	3,184
Married Females	5,100	5,414	6,067
Total Part-time Employment	**26,637**	**28,862**	**31,841**
Males	15,864	17,033	18,447
Single Females	4,606	5,111	5,946
Married Females	6,167	6,718	7,448

SOURCE: Employment and Training Corporation

removal of protective levies.

Data relating to the distribution of the increase in unemployment in 1999 by type of skill, presented in Chart 2.2, confirm these developments. The largest addition was, in fact, recorded in the number of persons registering for work in the skilled services category, half of whom were searching for a clerical job. The gap between the supply of people seeking a manual job and the demand for manual workers also continued to widen, although at a somewhat slower rate than in 1998. Manual workers, especially the unskilled, continued to make up the bulk of the unemployed, outnumbering those searching for non-manual work by more than four to one.

Moreover, as can be seen from Table 2.6, there exists a significant mismatch between the skills required to fill the available job vacancies and those possessed by the unemployed. Whereas 4,713 persons were seeking an elementary occupation or registering as machine operators during the December quarter of 1999, there were only 111 vacancies for these kinds of jobs. This suggests that a substantial part of the rise in unemployment is attributable to long-term structural problems rather than to short-term cyclical factors.

Meanwhile, the age structure of the unemployed continued to shift towards the older age categories. In fact, the number in the 49 years and over category rose by 13.8% during the year. At the same time, the

Table 2.6
JOB VACANCIES AND UNEMPLOYMENT BY SKILL CATEGORY DURING DECEMBER QUARTER 1999

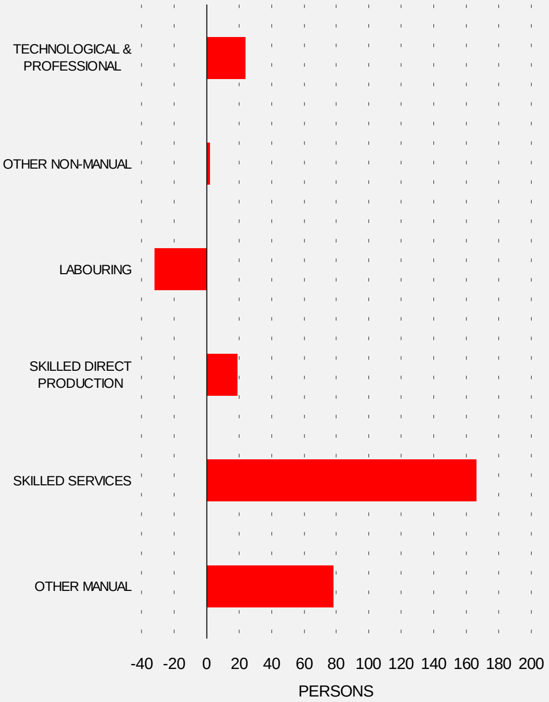
Skill	Vacancies	Unemployed	Unemployed per Vacancy
Professions[1]	134	401	3.0
Clerks	81	705	8.7
Skilled Workers[2]	205	1,969	9.6
Machine Operators	35	1,355	38.3
Elementary Occupations	76	3,358	44.4
Total	**531**	**7,788**	**14.7**

[1] Including Legislators, Senior Officials, Managers, Professionals, Technicians and Associate Professionals.

[2] Including Service Workers, Shop and Market Sales Workers, Skilled Agricultural, Fishery Workers, Craft and Related Trade Workers.

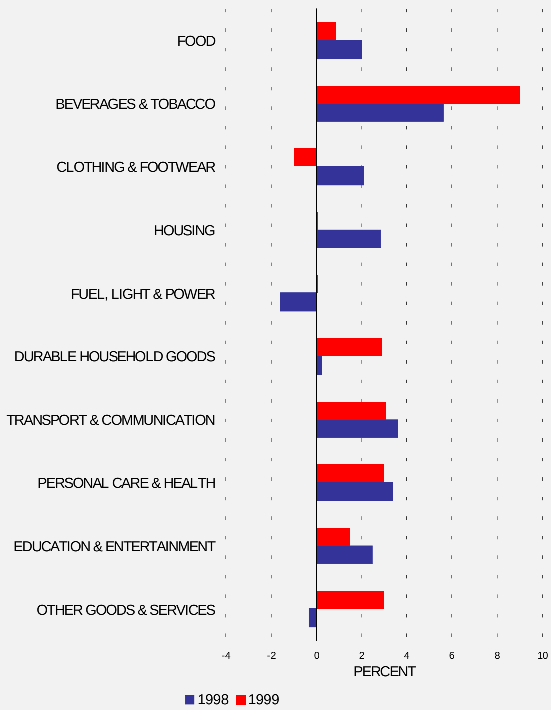
SOURCE: Employment and Training Corporation, Central Office of Statistics, Press adverts.

Chart 2.2 INCREASE IN REGISTERED UNEMPLOYED BY TYPE OF SKILL
(YEAR TO DECEMBER 1999)



SOURCE: EMPLOYMENT AND TRAINING CORPORATION

Chart 2.4 INFLATION RATES OF COMMODITY SECTIONS IN THE RPI



SOURCE: EMPLOYMENT AND TRAINING CORPORATION

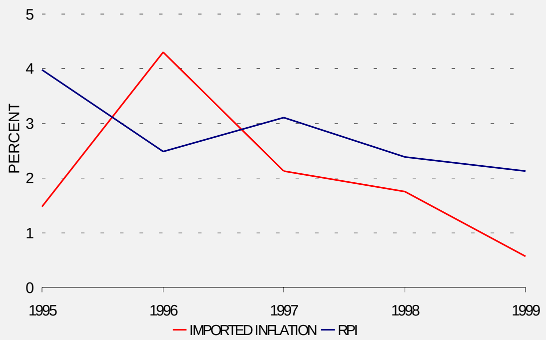
average duration of unemployment continued to lengthen, with the number of those registering for over 51 weeks going up by nearly 14%. Conversely, there were fewer persons registering for work for less than 20 weeks. In short, the fastest growing category of the unemployed are unskilled workers aged over 49, who cannot easily be trained and for whom few openings are available.

2.3 Prices and Wages

2.3.1 Retail Prices

As can be seen in Chart 2.3, retail price inflation declined further in 1999, albeit at a slower rate. The twelve month-moving average measure of inflation

Chart 2.3 RETAIL PRICE INFLATION



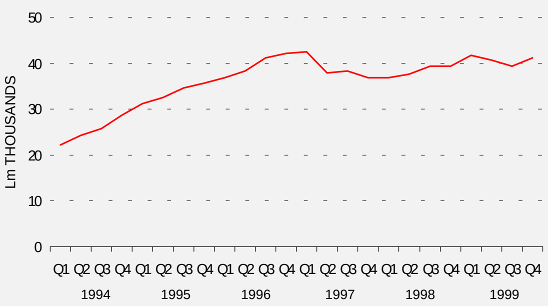
SOURCE: CENTRAL OFFICE OF STATISTICS, CENTRAL BANK OF MALTA ESTIMATES

fell by 0.26 percentage points, to 2.13%, compared with a decrease of 0.73 points in 1998.

A lower rate of increase in import prices was the main factor underlying the decline in domestic inflation. In fact, as a result of lower inflation in Malta's main trading partners and favourable exchange rate movements - particularly the Maltese lira's appreciation against the euro - imported inflation is estimated to have fallen by 1.2 percentage points during the year. At the same time, weak domestic demand and higher unemployment helped to dampen wage pressures. Thus, underlying inflation, i.e. retail price inflation netted of the effects of changes in indirect taxes, is estimated to have remained broadly stable at about 1.9% during 1999. Furthermore, while certain budgetary measures may have pushed prices upwards, the re-introduction of VAT at the beginning of the year seems not to have had any noticeable impact on prices.

The decline in the rate of inflation during the year was reflected in several of the sub-indices making up the Retail Price Index (RPI). In particular, the food sub-index, which has a weighting of nearly a third in the

Chart 2.5 ADVERTISED REAL ESTATE PRICES



SOURCE: ESTATE AGENTS, PRESS ADVERTS

total index, rose by only 0.8%. This was less than half the 1998 increase, which in turn had been relatively low compared to the earlier years of the 1990's. Although lower imported inflation may have helped bring about this deceleration in the rate of inflation of food items, more intense competition in the distribution sector probably also contributed.

This last factor may also in part explain the drop in the clothing and footwear sub-index and the slower rise in the personal care and health and the education and entertainment sub-indices during the year. The transport and communication sub-index also rose at a slower pace. It should, however, be noted that by the end of the year this index had as yet not fully assimilated the extension of the current 15% rate of VAT to petrol and diesel as from November 1999.

Conversely, there were four sub-indices, together accounting for nearly a quarter of the RPI, that recorded a faster rate of increase during 1999. The most significant rise was recorded in the beverages and tobacco index, and in the main this reflected the tax measures introduced in the budget for 1999[2]. The fuel, light and power index also advanced slightly, in contrast with the sharp drop recorded in 1998.

2.3.2 Real Estate Prices

Chart 2.5 illustrates movements in the average asking prices of dwellings (including finished terraced houses and flats and maisonettes in shell-form) over the six years to 1999. This suggests that house prices, which had fallen slightly in 1997 before recovering in 1998, remained relatively stable during 1999. This slowdown in real estate price inflation during the last three years may be due to a combination of two factors: the relative weakness of domestic demand and the fact that during the early 1990's the number of newly constructed dwellings far outstripped demand, leaving a surplus on the market.

2.3.3 Wages

Table 2.7 presents the Central Bank's estimates of average wage trends based on data gathered from collective agreements. These estimates, however,

Table 2.7

ESTIMATED CHANGE IN AVERAGE WAGES[1]

Percent

Category	1995	1996	1997	1998	1999
Unskilled	4.9	6.9	6.3	5.5	4.7
Skilled	4.9	5.4	5.7	3.7	4.9
Clerical	3.7	6.9	7.8	4.9	5.1
Administration[2]	3.9	2.1	3.7	2.3	2.9
Average Wage across Categories	**4.6**	**6.1**	**6.3**	**4.6**	**4.7**
Excluding Government Employees	**3.8**	**6.1**	**7.0**	**5.1**	**4.6**

[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] These measures had not been captured in the RPI for November and December 1998. Similarly the increase in the excise duty on cigarettes and the effects of the imposition of duties on locally processed alcoholic beverages, announced in the budget for 2000, are yet to be incorporated in the RPI.

exclude overtime pay, production bonuses, and any other allowances or income in kind, all of which also add to total labour costs. Moreover, the coverage of this analysis is limited to unionised firms, and these may not be representative of the non-unionised sectors of the labour force.

The survey suggests that the rate of wage inflation during 1999 remained at just above 4.5%. This is higher than the increase in prices, and probably exceeded the rate of productivity growth. To the extent that wage demands are not matched by increased efficiency, this erodes business competitiveness and fuels inflation. This consideration is significant because wage pressures could well build up further in the medium term as a result of the provisions of the latest civil service collective agreement. This envisages a revision of the salary structure in 2001 so as to incorporate the lump sums given to date and to restore the relativities prevailing in 1991.

2.4 Sectoral Analysis

2.4.1 Manufacturing

A survey of large firms conducted by the Department of Industry (see Table 2.8) indicates that manufacturing activity slowed down during the first nine months of 1999. Total turnover at current market prices increased by 6.6%, compared with 11.6% in the same period of 1998, reflecting both a sharper drop in local sales than that registered the previous year and a less pronounced expansion of exports. On the other hand, net investment in manufacturing rose substantially. Most of the Lm8 million increase was attributable to two leading firms, one in the communication equipment and other apparatus sector[3], and the other in the plastics and rubber products sector.

The growth rate of manufacturing exports during the nine months to September 1999 fell by almost 7 percentage points to 9%. This was attributable to the fact that the profits of the major firm in the electronics sector returned to more normal levels after the exceptional increase recorded in 1998. Furniture-exporting firms also fared less well during the year under review. These developments were partly offset by the improved export performance of firms in the machinery and equipment, printing and publishing, and clothing sectors. Growth was concentrated in the major firms in each sector. Thus, for example, in the case of printing and publishing, the improved performance reflected a turnaround in the activity of the largest operator in the sector, which had downsized its operations in 1998.

The drop in the local sales of the larger manufacturing firms mirrored the subdued domestic demand conditions. Nearly all sectors of domestically-oriented manufacturing industry reported lower or stagnant sales. The only exceptions were the furniture and the basic metals sectors, which recovered from the declines registered in 1998. The gains in these sectors were, however, more than offset by the lower domestic sales reported by the tobacco, fabricated metals and other non-metallic minerals sectors. These data appear to confirm the impression that the increase in real consumption expenditure recorded during 1999 mainly reflected a higher demand for imported consumer goods.

Although net investment in manufacturing recovered from the slowdown recorded in 1998, it was, as pointed out earlier concentrated in a few sectors and was relatively low. Taken as a whole, the firms surveyed devoted on average just 3.8% of their total turnover to net investment during the first nine months of 1999. Capital formation was significantly higher in the printing and publishing, chemicals, and plastic and rubber sectors. On the other hand, investment in the communication equipment and other apparatus sector increased, though not up to the levels recorded in the mid-1990s. Furthermore, the results of the Department of Industry's survey would seem to indicate that most investment is being undertaken by foreign-owned firms producing for overseas markets, rather than by domestically-oriented firms. Little, if any, investment

[3] The communication equipment and other apparatus sector, which in the Department of Industry's Survey comprises the electronics industry, is the largest manufacturing sub-sector in Malta.

Table 2.8
MANUFACTURING PERFORMANCE - SELECTED INDICATORS[1]

	January-September		
	1997	1998	1999
Growth in Exports (%)	**-0.4**	**15.9**	**9.0**
of which:			
Communication Equipment and Other Apparatus	-3.3	14.3	5.7
Machinery and Equipment	-0.3	0.2	0.6
Printing and Publishing	-1.6	0.1	1.0
Plastic and Rubber	0.4	0.6	0.7
Electrical Machinery	1.4	0.6	0.3
Fabricated Metals	0.6	-0.1	-0.2
Furniture	0.9	0.2	0.0
Textiles and Clothing	1.5	-0.6	0.4
Other	0.0	0.6	0.5
Growth in Local Sales (%)	**2.4**	**-0.1**	**-1.1**
of which:			
Food and Beverages	-1.8	-0.1	-0.1
Tobacco	1.3	1.3	-0.3
Chemicals	0.7	0.2	-0.1
Plastics and Rubber	0.8	-0.7	0.3
Printing and Publishing	0.5	0.0	-0.3
Fabricated Metals	1.6	0.2	-1.8
Other Non-Metallic Minerals	0.0	0.3	-1.5
Furniture	-0.6	-1.3	1.4
Basic Metals	-0.2	-0.1	0.9
Other	0.1	0.1	0.4
Net Investment (Lm millions)	**17.1**	**16.9**	**24.9**
of which:			
Communication Equipment and Other Apparatus	9.9	7.9	10.5
Plastics and Rubber	1.5	1.3	4.0
Chemicals	0.5	0.6	2.5
Prining and Publishing	0.3	1.0	2.1
Food and Beverages	1.3	1.8	1.2
Fabricated Metals	0.2	0.5	1.3
Furniture	0.5	1.1	0.3
Other	2.9	2.7	3.0

[1] Based on a survey of representative firms conducted by the Department of Industry.

seems to have been undertaken thus far by firms in the furniture and the food and beverages sectors, both of which need to upgrade their operations in view of the removal of protective levies and the resulting exposure to international competition.

2.4.2 Tourism

Although the performance of the tourism industry remained positive, the growth rate of tourist arrivals decelerated from its 1998 level and the average length of stay was slightly lower in 1999. On the other hand, gross earnings increased substantially, implying a significantly higher level of tourist expenditure per capita. A marked expansion was also recorded in the number of cruise liner passengers visiting Malta.

The main factor behind the deceleration in the growth rate of tourist arrivals – from 6.4% in 1998 to 2.7% in 1999 - was the performance of Malta's main source market, the UK. As can be seen in Table 2.9, arrivals from the UK were down by 5.9% in 1999, the first contraction since 1996. This decline cannot be attributed to adverse exchange rate or economic developments, as both the pound sterling and the

Table 2.9
TOURIST ARRIVALS BY NATIONALITY

Nationality	1998	1999	Change		% share in total arrivals	
			Persons	Percent	1998	1999
Austria	23,741	29,027	5,286	22.3	2.0	2.4
Belgium	25,146	28,349	3,203	12.7	2.1	2.3
France	72,512	73,264	752	1.0	6.1	6.0
Germany	203,199	212,428	9,229	4.5	17.2	17.5
Italy	90,558	92,726	2,168	2.4	7.7	7.6
Libya	37,509	44,968	7,459	19.9	3.2	3.7
Netherlands	56,534	65,345	8,811	15.6	4.8	5.4
Scandinavia	35,414	46,365	10,951	30.9	3.0	3.8
Switzerland	24,776	23,448	-1,328	-5.4	2.1	1.9
United Kingdom	448,763	422,368	-26,395	-5.9	38.0	34.8
Others	164,088	175,942	11,854	7.2	13.9	14.5
Total	**1,182,240**	**1,214,230**	**31,990**	**2.7**	**100.0**	**100.0**

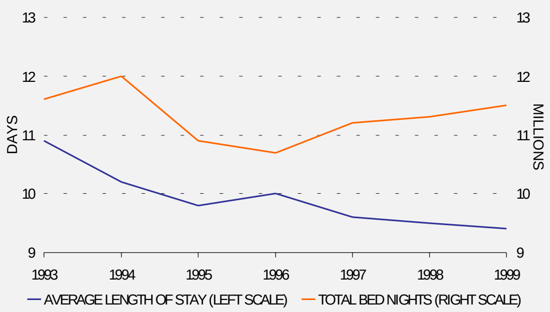
SOURCE: Central Office of Statistics

British economy performed better than expected during the year. It is rather more a consequence of the fact that a Malta holiday became relatively more expensive for British tourists in 1999.

The loss of trade from Britain was more than compensated for by increases in arrivals from other countries, such as Scandinavia, Germany, the Netherlands and Libya, especially during the first quarter of the year. Arrivals from Germany, Malta's second largest source market, increased at about the same rate as in 1998. Arrivals from France grew at a much slower rate, while those from Switzerland actually fell.

Cruise passenger activity continued to expand rapidly during the year under review, with arrivals rising by 30.4%. Although this line of activity is still in its infancy, its potential for growth is evidenced by the fact that since 1996 the number of cruise passenger arrivals has nearly trebled.

Chart 2.6 AVERAGE LENGTH OF STAY AND TOTAL TOURIST BED NIGHTS*

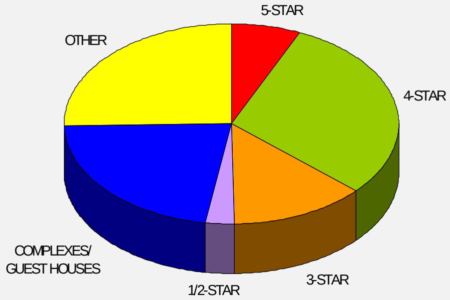


* DATA FOR 1999 ARE CENTRAL BANK OF MALTA ESTIMATES
SOURCE: CENTRAL OFFICE OF STATISTICS

Trends in the number of tourist arrivals do not necessarily constitute a reliable indicator of the industry's overall performance. More significant conclusions can be drawn from an analysis of visitors' average length of stay and the revenue they generate. Central Bank estimates, shown in Chart 2.6, indicate that the average length of stay declined for the third consecutive year in 1999 to 9.4 days. As a result, the increase in the total number of bed nights spent by tourists in Malta, at 1.8%, was below the growth in the number of tourist arrivals. Furthermore, the overall occupancy rate is estimated to have declined slightly, to 68.4%, as the growth in bed capacity surpassed that in the number of bed nights stayed.

On the other hand, the tourism industry's performance in terms of revenue generated improved during 1999. As already stated, gross earnings are estimated to have increased by 6.6%, whereas in 1998 they had risen by only 1.8%. If the revenue earned from passenger carriage by the national airline were to be added, then the total revenue generated by tourism is estimated to have expanded by Lm22.5 million, or 7.4%, during 1999. Nevertheless, the industry's contribution to nominal GDP net of its import

Chart 2.7 DISTRIBUTION OF TOURISTS BY ACCOMMODATION CATEGORY - 1999



SOURCE: CENTRAL OFFICE OF STATISTICS

content[4], remained almost unchanged from the previous year's level, at around 15%.

The expansion in tourist earnings may reflect in part the continuing shift of incoming tourists towards the upper end of the accommodation spectrum. In fact, data for the first half of the year indicate that the four- and five-star hotel categories continued to experience significantly higher occupancy rates. This rise reflected the increase in bed capacity, which led these hotels to compete with other hotel categories in terms of prices.

2.4.3 Construction

Indicators of construction industry activity, presented in Table 2.10, point to further declines during the first nine months of 1999. Unfortunately, data relating to approved building permits in terms of floor space area, which could give a more accurate picture, are not available for 1998 and 1999.

Even though construction estimated turnover remained unchanged from the previous year's level of Lm82 million, its share in total value added eased to 2.7% in 1999. In fact, both employment income and profitability declined from their levels in the same period of 1998. Sales to both the private sector and to government enterprises were also down from 1998 levels, as can be seen from the Table. Moreover, the rise in outlays by the Government essentially reflected the expenditure incurred on the oil exploration project in Gozo.

The construction industry is particularly prone to boom-bust cycles, expanding in the wake of large public projects and rising property prices, and contracting sharply when projects are completed or demand for residential property slackens. Thus the completion of the Freeport Terminal II project, which resulted in the restructuring of a publicly-owned construction firm, appears to have contributed significantly to the decline in construction activity in 1999. Nevertheless, the main factor underlying the contraction in the industry's turnover was the continuing slack demand from the private sector. As a result, employment in the industry, which had risen steadily between 1994 and 1996, has been declining

Table 2.10
CONSTRUCTION ACTIVITY INDICATORS

	January-September		
	1997	1998[1]	1999[2]
Sales (Lm million) of which:	**85.6**	**82.0**	**82.0**
Private Sector	57.6	55.5	53.2
Government Enterprises	4.0	4.0	1.8
General Government	24.0	22.5	27.0
Value Added (Lm millions)	28.1	27.8	25.2
Share of value added in GDP (%)	3.4	3.1	2.7
Employment (Average for January-December - No. of persons)	6,279	6,043	5,723
Share in gainfully occupied (%)	4.6	4.4	4.1

[1] Provisional
[2] Estimates
SOURCE: Economic Planning Division, ***Economic Survey***

[4] In a recent study made by the NTOM, 'The Economic Impact of Tourism in Malta', the import content of the tourism industry was estimated at around 30%.

ever since. Prospects are expected to improve in 2000, however, when work on a number of large-scale tourism projects should commence.

2.5 Outlook for 2000

Central Bank projections for 2000 see real GDP growth remaining at 1999 levels, as Table 2.11 shows. Growth should continue to be mainly export-driven, although to a lesser extent than in 1999, as the exceptional rise in tourist earnings recorded during that year is not expected to be repeated. This notwithstanding, the performance of the tourism industry should be broadly positive in 2000. At the same time, manufacturing exports are projected to expand moderately as a result of the continuing recovery in trading partner countries.

Gross fixed capital formation is projected to contribute positively to growth during 2000. The extent of this contribution will depend in some measure on the commencement of work on the above-mentioned tourism projects that had been postponed from previous years. Construction will be the main direct beneficiary of these projects, which should boost the industry's employment and profitability. Investment in plant and machinery is also expected to grow, as the restructuring of the manufacturing sector gathers momentum.

Conversely, the other components of domestic demand, namely private and public consumption, are not expected to provide a major impetus to real GDP growth. In particular, the rise in private consumption expenditure recorded in 1999, which mainly reflected a temporary surge in imports, is not expected to be repeated. Import growth in 2000, in fact, should be more restrained, even though the value of fuel imports may rise in line with the sharp increase in the price of oil on international markets. Moreover, the fiscal measures introduced in the 2000 Budget should have a dampening effect on private consumption in the short term. At the same time, Government consumption in real terms is expected to remain virtually unchanged from 1999 levels.

Price inflation may accelerate during 2000. Imported inflation may rise somewhat, especially if higher fuel prices trigger inflation in Europe and if the euro recovers on international currency markets. Domestically-induced price pressures could also rise, reflecting higher indirect taxes and production cost increases that are not matched by productivity growth. Wage pressures should, however, remain contained in view of industry's efforts to maintain price competitiveness and to restructure and of continued slack in the labour market.

Although the expected recovery in construction

Table 2.11

OUTLOOK FOR SELECTED ECONOMIC INDICATORS

Percent

	1998	1999	2000
GDP Growth at Current Market Prices	6.4	5.0 - 5.5	4.5 - 5.0
GDP Growth at Constant Market Prices	3.1	2.5 - 3.0	2.5 - 3.0
Growth in GDP Components at Constant Prices			
Private Consumption Expenditure	1.4	3.0 - 3.5	2.5 - 3.0
Government Consumption Expenditure	(3.8)	0.0 - 0.5	(0.5) - 0.0
Gross Fixed Capital Formation	(4.0)	0.0 - 0.5	1.0 - 2.0
Exports of Goods & Services	8.1	4.5 - 5.0	3.5 - 4.5
Imports of Goods & Services	2.5	4.5 - 5.0	3.5 - 4.5
Unemployment rate	5.1	5.3	5.2 - 5.7
Inflation rate	2.4	2.1	2.0 - 2.5
Fiscal Borrowing Requirement (% of GDP)	11.0	8.6	7.0 - 7.5
External Goods and Services Deficit (% of GDP)	5.3	5.2	5.0 - 5.5

Figures in parenthesis are negative.

activity should help to sustain employment levels in 2000, the industry's contribution to job creation depends on the extent to which it becomes even more capital-intensive. The main gains in employment during 2000 are, in fact, expected to come from the electronics industry and tourism. At the same time, job losses may be recorded in the other manufacturing sectors, especially in firms facing the removal of protective levies as a result of the need to enhance the overall competitiveness of Maltese industry. Hence, the growth of the labour supply may continue to surpass the rate of job creation, resulting in a further accentuation of the structural element in unemployment.

3. The Balance of Payments and the Maltese Lira

3.1 The Balance of Payments[5]

3.1.1 Introduction

According to Central Bank estimates, the overall balance of payments showed a surplus of Lm65.4 million during 1999, nearly double the previous year's surplus. As can be seen from Table 3.1, this improvement was mainly attributable to a contraction in the deficit on the current account.

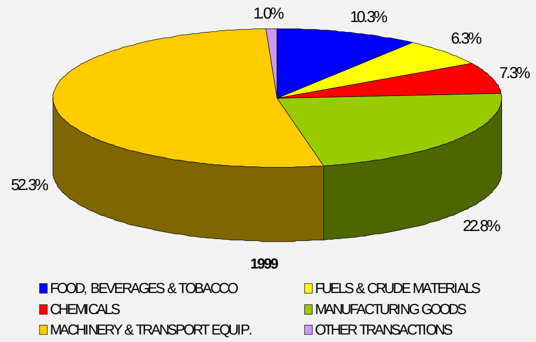
3.1.2 The Current Account

The Lm26.3 million improvement in the current account was almost wholly due to the investment income balance, which swung into surplus following the exceptionally large net outflow recorded in 1998. Meanwhile, the balance on goods and services remained virtually unchanged in 1999 at Lm74.4 million.

A. Merchandise Trade Balance

The shortfall on merchandise trade is estimated to have widened by about Lm5 million in 1999, following the previous year's contraction. Both imports and exports increased, by Lm91.5 million and Lm86.6 million, respectively. The merchandise trade gap would have been wider had it not been for the sale of two aircraft, together worth about Lm6.1 million. The deterioration occurred entirely during the final quarter of the year, mainly on account of the sharp rise in oil prices.

Chart 3.1 IMPORT SHARES BY COMMODITY SECTORS



SOURCE: CENTRAL OFFICE OF STATISTICS

The 9.8% rise in imports during 1999 mainly reflected increased imports of machinery and transport equipment, particularly electronic components and motor vehicles - although imports of capital goods, mainly in connection with the construction of the new Gozo ferries and new investment by a firm manufacturing rubber products also contributed. At the same time, the rise in oil prices pushed up the share of imports of fuel and crude materials in the country's total import bill to 6.3%, from 5.2% a year earlier.

Merchandise exports (including re-exports) rose by 12.6% during 1999. Customs data show that machinery and transport equipment accounted for about half of the increase, largely reflecting increased activity in the electronics industry, although the above-

Table 3.1
MAIN BALANCES

Lm millions

	1997	1998	1999[1]
Overall Balance	**-33.2**	**35.7**	**65.4**
Current Account	-79.1	-75.9	-49.6
Short- and Long-Term Financial Flows	45.9	111.6	115.0
Movements in Reserve Assets[2]	**-2.6**	**-78.2**	**-96.5**
Statistical Discrepancy	**35.8**	**42.5**	**31.1**

[1] Central Bank of Malta Estimates

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

SOURCE: Central Office of Statistics

[5] Compiled on an accruals basis.

Table 3.2
THE CURRENT ACCOUNT

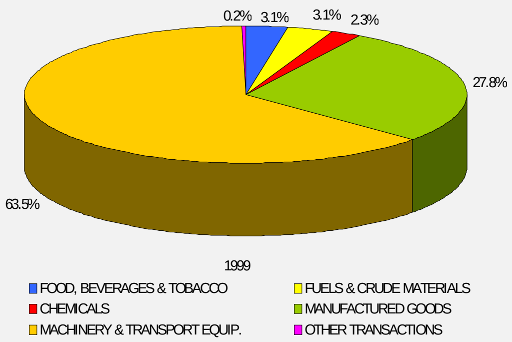
Lm millions

	1997		1998		1999[1]	
	Credit	Debit	Credit	Debit	Credit	Debit
CURRENT ACCOUNT BALANCE		**79.1**		**75.9**		**49.6**
Goods and Services Balance		**108.9**		**75.7**		**74.4**
Merchandise Trade Balance		**271.3**		**241.3**		**246.1**
Merchandise f.o.b. (including ship building and repairing)	612.8	884.1	688.5	929.8	775.1	1021.3
Services Balance (net)	**162.4**		**165.6**		**171.7**	
Shipment	27.6	96.1	29.2	101.3	27.6	111.3
Other transportation	109.0	54.1	113.9	58.9	132.2	69.7
Travel	249.8	73.6	254.6	74.9	271.4	80.5
Other services						
Official	8.6	10.8	9.5	13.2	7.6	15.7
Private	87.9	85.9	98.9	92.2	113.1	103.0
Investment Income (net)	**4.1**			**27.4**	**2.2**	
Dividends, Reinvested Earnings, Interest, Other	137.6	133.5	194.7	222.1	484.1	481.9
Unrequited Transfers (net)	**25.7**		**27.2**		**22.6**	
Private	26.6	12.4	20.9	4.7	16.6	5.8
Official	14.4	2.9	15.7	4.7	16.3	4.5

[1] CBM Estimates

SOURCE: Central Office of Statistics

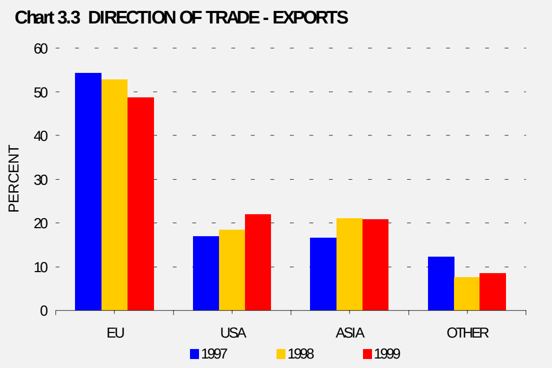
Chart 3.2 EXPORT SHARES BY COMMODITY SECTORS



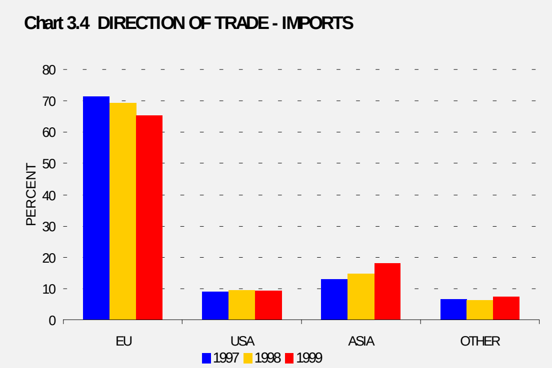
mentioned re-export of aircraft also contributed. Despite these increases, however, the share of machinery and transport equipment in total exports declined by one-and–a-half percentage points to 63.5%. This was partly due to the hike in oil prices, which boosted the value of re-exports arising from oil bunkering activity[6]. Indeed, the value of re-exports of fuel almost doubled during 1999, their share in total exports rising by half to 3.1%. Meanwhile, higher exports of manufactured goods other than machinery and transport equipment accounted for about 30% of the total increase, taking the share of this sector to 27.8%. These gains mainly reflected buoyant activity in the paper and printing industry and in firms producing rubber products.

Charts 3.3 and 3.4 show that the EU remained Malta's main trading partner in respect of both exports and imports. However, the share of exports to the EU has declined during the past three years to just below the 50% mark in 1999. This mainly reflected the impact of the leading firm in the electronics industry on Malta's trading patterns. In fact, the drop in the share of exports to the EU coincided with a rise in the share of exports to the USA, which mainly comprise exports of electronic components, although during 1999 the USA was also the destination of the exceptional re-export of aircraft. Meanwhile, the share of exports to Asia

[6] Oil bunkering activity is included in exports in customs-based data, but classified under "other transportation services" in the accruals-based balance of payments.



SOURCE: CENTRAL OFFICE OF STATISTICS



SOURCE: CENTRAL OFFICE OF STATISTICS

remained virtually unchanged from the previous year's level, though this was attributable to the fact that the 1998 figures had been boosted by the one-off export of vessels to the region. If these were to be excluded, the share of exports to Asia in 1999 would have been substantially higher than in 1998.

A similar trend emerged in imports, though in this case the share of the EU, at 65% of the total, was greater than it is for exports, mainly because most of Malta's imports of consumer goods come from Europe. On the other hand, the value of imports from Asia has been rising, so that their share in the total nearly reached 18% in the year under review. This in part could reflect the strong appreciation of the Japanese yen, which boosted the Maltese lira value of imports from the region. At the same time, the share of imports from the USA remained stable at just under 10%.

B. Balance on Services

During 1999 the surplus on the services account continued to improve, rising by Lm6.1 million to Lm171.7 million. As in the case of the merchandise trade account, both exports and imports of services were higher, with receipts up by some Lm46 million and payments by Lm40 million.

As in 1998, the improvement in the services balance was underpinned by the positive performance of the tourism industry. This was reflected in higher net receipts both in the other transportation and in the travel accounts. The former were up by almost Lm5 million, while the travel account balance, which includes net receipts from accommodation services and other tourist expenditure, rose by Lm11.2 million.

The increase in tourism earnings was strongly correlated with the increase in the number of tourist days stayed. But a 30% rise in the number of cruise passenger arrivals and a shift in preferences towards the upper end of the accommodation spectrum undoubtedly also helped to boost tourism earnings.

Another factor that contributed to the improvement in the services balance was an increase in net receipts from the provision of ship stores and bunker fuel stemming mainly from the rise in oil prices. These increases were, however, partly offset by higher net payments for repairs to locally-owned ships and aircraft provided by non-residents as well as for shipment of imports. There was also a Lm1 million drop in the positive balance on the other services account. This arose from lower receipts from official transactions which were only partly offset by a decline in payments for other private services, with net receipts from labour income and non-merchandise insurance remaining virtually unchanged from the previous year's level.

C. Investment Income and Transfers

As Table 3.2 shows, the 1999 debits and credits on the investment income account were both more than twice as large as in 1998. This, however, mainly reflected the transactions of the international banking institutions, which only take deposits from, and lend to, non-residents. The contribution of these activities to the net position on the investment income account is therefore relatively small.

During 1999 the balance on the investment income account once again swung into surplus, following

Table 3.3
THE FINANCIAL ACCOUNT[1]
(Net Balances)

Lm millions

	1997	1998	1999[2]
FINANCIAL ACCOUNT BALANCE	**43.3**	**33.4**	**18.5**
Long Term	**-141.8**	**99.9**	**154.8**
Direct Investment	24.8	98.7	286.9
Long Term Loans	-166.6	1.2	-132.2
Short Term	**187.7**	**11.7**	**-39.8**
Portfolio Investment	42.4	-34.7	-230.2
Other Short Term Investment	145.3	46.4	190.4
Reserve Assets	**-2.6**	**-78.2**	**-96.5**

[1] A positive sign indicates an increase in foreign liabilities and a negative sign indicates an increase in foreign assets.

[2] Central Bank of Malta Estimates

SOURCE: Central Office of Statistics

the deficit of Lm27.4 million recorded in 1998. This sharp improvement was partly attributable to the fact that the 1998 shortfall was mainly due to exceptional one-off factors. These included significant dividend payments by some foreign-owned companies operating in Malta and a charge incurred by a public corporation following a refinancing agreement. Higher investment income earned by the Central Bank on its portfolio also contributed to the turnaround on this account during 1999.

Net inflows by way of unrequited transfers were down by Lm4.6 million from the previous year's level, reflecting a decline in private inward transfers, particularly receipts from emigrants and pensions and gratuities from abroad. These decreases were partly offset by marginally higher receipts of official grants.

3.1.3 The Financial Account[7]

The financial account remained in surplus – by Lm18.5 million – in 1999 as substantial long-term capital inflows outweighed short-term capital outflows and a Lm96.5 million addition to the official reserves[8]. However, both in 1998 and in 1999 there were a number of exceptional factors (such as sales to non-residents of shares in public sector companies) that may have obscured the underlying performance.

A. Long- and Short-term Capital Flows

As can be seen from Table 3.3, net inflows of long-term capital were up by nearly Lm55 million from the 1998 level. At the same time, there were net outflows of short-term capital of almost Lm40 million, as against net inflows of Lm11.7 million a year earlier. However, these financial flows were highly influenced by the activities of the international banking institutions, which, as explained above, only take deposits from, and lend to, non-residents. Hence, though involving large movements of capital, these have practically no impact on the domestic economy.

Over half of the increase in foreign direct investment in 1999 was attributable to the international banking institutions' borrowing from their parent companies. If such borrowing were to be excluded, net foreign direct investment would show an increase of almost Lm90 million, with the greater part of this being accounted for by the sale of Mid-Med Bank to the HSBC Group. However, greater inflows from the acquisition of immovable property by non-residents were also reported.

Net direct investment flows to and from Malta are further analysed in Table 3.4. This shows that net equity investment in Malta by non-residents had been following a downward trend until they were boosted

[7] Traditionally known as the Capital Account.
[8] Additions to the reserves are shown as a debit in the balance of payments. They do in fact constitute an outflow of capital.

Table 3.4
FOREIGN DIRECT INVESTMENT

Lm millions

	1995	1996	1997	1998	1999[1]
Direct Investment in Malta by non-Residents					
Share Capital	22.7	12.9	4.2	4.5	72.4
Reinvested Earnings	26.9	34.1	17.0	34.2	41.8
Other Investment	-3.1	52.8	10.1	65.7	184.6
Total	**46.5**	**99.8**	**31.3**	**104.4**	**298.8**
Direct Investment Abroad by Residents					
Share Capital	1.7	2.5	7.2	6.9	12.6
Reinvested Earnings	0.0	-0.2	-0.7	-1.1	-0.7
Total	**1.7**	**2.3**	**6.5**	**5.8**	**11.9**
Net Direct Investment	**44.8**	**97.5**	**24.8**	**98.6**	**286.9**

[1] Central Bank of Malta Estimates

SOURCE: Central Office of Statistics

by the privatisation of Mid-Med Bank in 1999. In the latter year, however, there was also an increase of about Lm7.6 million in re-invested earnings. The growth in other direct investment essentially reflected the transactions of the international banking institutions. At the same time, direct investment abroad by residents appears to be following an upward trend, mainly reflecting purchases of hotels overseas by a Maltese group of companies, though the activities of an international banking institution were largely responsible for the outward flow recorded in 1999.

Data available at the Central Bank and at the Malta Financial Services Centre show that 68 new companies with non-resident shareholding were established in Malta in 1999. As Table 3.5 shows, the value of paid-up share capital in these companies amounted to Lm1.4 million, up by 73% from the previous year's level. These companies' share capital constitutes only part of the equity investment inflows shown in Table 3.4, as the latter, apart from new investment, also includes share transfers between residents and non-residents and increases/decreases in non-resident share capital in existing companies.

Around 71% of the share capital invested in newly formed companies in 1999 was channelled to firms involved in the provision of services, particularly fund management, catering and tourism services, while the rest was accounted for by manufacturing and construction firms.

As Chart 3.5 shows, Europe remained the largest

Table 3.5
SOURCE OF NON-RESIDENT PAID-UP CAPITAL

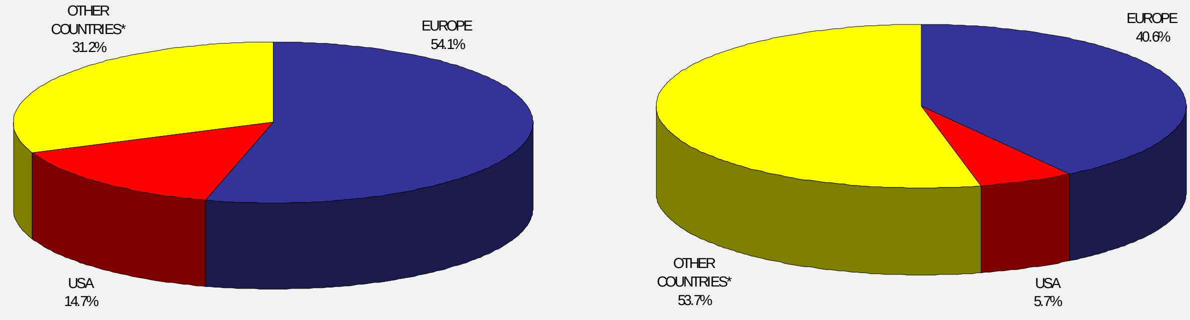
Lm

	1998	**1999**	**% Change**
Manufacturing and Construction	146,822	295,676	+
Services	573,395	826,706	44.2
Offshore and International Trading Companies	93,518	287,592	+
Total	**813,735**	**1,409,974**	**73.3**
No of Companies	**62**	**68**	**9.7**

+ indicates a change of over 100%

SOURCE: Central Bank of Malta, Malta Financial Services Centre

Chart 3.5 PERCENTAGE SHARE OF NON-RESIDENT PAID-UP CAPITAL



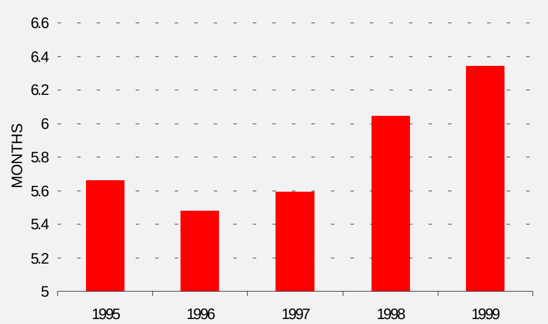
* INCLUDES OFFSHORE AND INTERNATIONAL TRADING COMPANIES
SOURCE: CENTRAL BANK OF MALTA

source of new equity investment in Malta during 1999, although its share fell to just over 40% from 54% a year earlier. Nevertheless, new equity investment from this source was still almost 30% higher than in 1998, with the UK accounting for nearly half of the total and Italy for some 30%. Meanwhile, new equity investment from the USA was down by around a third, reducing its share in the total to 5.7%. At the same time, investment in a single company providing fund management services was behind the increase in the share of other countries from 31.2% in 1998 to 53.7% in 1999.

Meanwhile, a net outflow of Lm132.2 million by way of long-term lending abroad was recorded (Table 3.3), as against a small net inflow in 1998. The large swing in this balance was mainly attributable to transactions of international banking institutions, though a decline in borrowing by public sector corporations also contributed.

As regards portfolio investment, this resulted in net outflows of Lm230.2 million, up from Lm34.7 million in 1998. Deposit money banks and other banking institutions were behind most of this outflow, although a decline in portfolio investment in Malta by non-residents (following the sale of Maltacom shares to foreign investors in 1998) and higher portfolio investment abroad by Maltese residents also contributed. Meanwhile, other short-term investment inflows amounted to Lm190.4 million, up from Lm46.4 million in 1998. These, too, mainly reflected transactions of international banking institutions.

CHART 3.6 OFFICIAL RESERVES - COVERAGE OF IMPORTS
(IN MONTHS)



SOURCE: CENTRAL OFFICE OF STATISTICS, CENTRAL BANK OF MALTA

B. Movements in Reserves

As a result of the developments outlined above, the reserve assets of the monetary authorities (i.e. the official reserves) rose by Lm100.4 million[9] to Lm 740.3 million in 1999, an increase of almost 16%. At this level, the reserves amounted to 6.3 months worth of imports of goods and services, up from 6.1 months in 1998.

3.2 Foreign Exchange Transactions between Residents and Non-Residents[10]

3.2.1 Introduction

The analysis in this section has in the past been referred to as the "cash-based balance of payments". The term "balance of payments", however, strictly refers to the accruals-based system of accounts analysed above. Hence, in this Report, the terminology is being changed to conform with international practice. In effect, there are a number of differences concerning timing, coverage, and valuation

[9] The increase in the official reserves differs slightly from that shown in Tables 3.1 and 3.3 on account of revaluation adjustments.
[10] On a cash settlement basis effected through the local banking system.

Table 3.6
MAIN BALANCES OF TRANSACTIONS BETWEEN RESIDENTS AND NON-RESIDENTS[1]

	1997	1998	1999
Balance on Current Transactions	-88.2	-22.6	-7.3
Balance on Financial Transactions	3.9	20.5	74.8
Overall Balance	-84.3	-2.1	67.5

[1] On a cash settlement basis effected through the local banking system.
SOURCE: Central Bank of Malta

methods, between the two systems. The so-called "cash-based balance of payments" is basically a cash flow statement of transactions between residents and non-residents effected through the domestic banking system. In contrast, the accruals-based system, which is the true balance of payments, is more complete and includes offsetting transactions, receivables and payables, and payments through overseas accounts. Furthermore, the accruals-based system also includes the banks' own transactions in the financial account - which the cash-based system does not.

As Table 3.6 shows, there was an improvement in Malta's foreign currency cash flow position during 1999, as the overall balance on foreign exchange transactions effected through the domestic banking system turned positive. This turnaround was attributable to a significant inflow of foreign currency arising from financial transactions, primarily the privatisation of Mid-Med Bank. A sharp contraction was also recorded in the deficit on current transactions.

3.2.2 Transactions of a Current Nature

The negative balance on current transactions contracted to a third of its 1998 level, or Lm7.3 million. This mainly reflected higher net inflows emanating from services, although the balance on trade in goods also showed a slight improvement. Indeed, the deficit on trade in goods, at Lm333.6 million, was Lm5.4 million lower than that recorded during 1998.

Meanwhile, the services account surplus recorded a 9% increase in 1999. This improvement largely reflected the positive performance of the tourism sector, highlighted earlier. At the same time, the

Table 3.7
CURRENT TRANSACTIONS[1]
(Net Balances)

	1997	1998	1999
BALANCE ON CURRENT TRANSACTIONS	**-88.2**	**-22.6**	**-7.3**
Balance on Goods	**-361.1**	**-339.0**	**-333.6**
(including ship building, freight and insurance)			
Services Balance (net)	**206.5**	**241.0**	**262.6**
of which:			
Transportation (other than freight and insurance)	49.3	75.0	80.0
Travel	143.7	146.0	155.5
Other Services	13.5	20.0	27.1
Investment Income (net)	**33.1**	**47.8**	**36.4**
Balance on Goods, Services and Income	**-121.5**	**-50.2**	**-34.6**
Unrequited Transfers (net)	**33.3**	**27.6**	**27.3**

[1] On a cash settlement basis effected through the local banking system
SOURCE: Central Bank of Malta

Table 3.8
FINANCIAL TRANSACTIONS[1]
(Net Balances)

Lm millions

	1997	1998	1999
BALANCE ON FINANCIAL TRANSACTIONS	**3.9**	**20.5**	**74.8**
Long Term	**-19.4**	**-29.1**	**42.8**
Direct Investment	-15.4	-1.0	63.6
Long Term Loans	-4.0	-28.1	-20.8
Short Term	**23.3**	**49.6**	**32.0**
Portfolio Investment	24.5	45.3	25.7
Other Short Term Investment	-1.2	4.3	6.3

[1] On a cash settlement basis effected through the local banking system.
SOURCE: Central Bank of Malta

increase of Lm7 million in other services largely reflected higher receipts reported by a resident company engaged in catering services overseas. Other transportation services, mainly shipping, brought in Lm5 million more in 1999.

Net investment income flows were down by Lm11.4 million from the 1998 level. Movements in this balance, however, largely reflect the activities of international banking institutions. Indeed, if transactions carried out by these institutions were to be excluded, the investment income balance would show an increase of Lm6.5 million in 1999. Meanwhile, the balance on unrequited transfers was marginally down from the previous year's level, mainly as receipts of pensions and gratuities from abroad declined.

3.2.3 Transactions of a Capital Nature

Financial transactions between residents and non-residents effected through the local banking system resulted in a substantially higher net inflows during 1999. As can be seen from Table 3.8, the favourable balance was about three-and-a-half times larger than in 1998. This was entirely attributable to higher net long-term inflows, as net short-term inflows were down by Lm17.6 million. However, both 1999 and 1998 were characterised by exceptional developments. Thus, the Lm64.6 million increase in direct investment inflows in 1999 was entirely attributable to the privatisation of Mid-Med Bank. Meanwhile, the drop in short-term investment was entirely attributable to a decline in portfolio investment inflows from the exceptional level of 1998, which was due to the sale overseas of shares in Maltacom plc. Nevertheless, even if this item were to be excluded, portfolio investment would still have been lower in 1999.

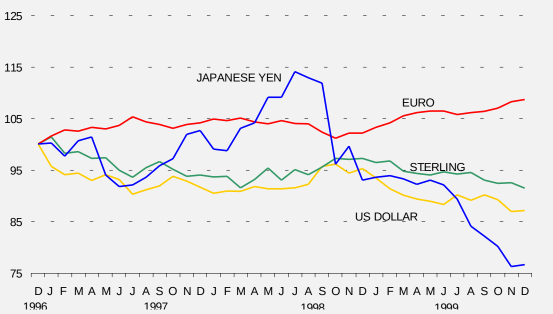
Thus, after combining the balance on current and financial transactions, and after effecting certain accounting adjustments - such as the revaluation of foreign asset portfolios and the reclassification of certain liabilities as equity by international banks - the net foreign assets of the banking system show an increase of Lm72.4 million during 1999. This is the outcome of the Lm100.4 million addition to the official reserves of the monetary authorities referred to earlier and the Lm28 million decline of the holdings of the rest of the banking system.

3.3 Exchange Rate Developments and External Competitiveness

3.3.1 The Maltese Lira

During 1999, the Maltese lira continued to be pegged to a basket of currencies. With effect from January 1999, however, the weights of the components of the Maltese lira basket were revised to take into account the introduction of the euro at the start of the year. The euro replaced the ECU in the basket and was allocated the weight of the ECU component less the proportionate weight that sterling had within that component. This weight was in turn added to the previous sterling component, so that sterling retained its effective weight within the Maltese lira

Chart 3.7 EXCHANGE RATE MOVEMENTS OF THE MALTESE LIRA AGAINST SELECTED CURRENCIES
(INDEX OF END-OF-MONTH RATES, END-1996 = 100)



SOURCE: CENTRAL BANK OF MALTA

basket. The US dollar component of the basket was left unchanged. These changes were intended to neutralise, as far as possible, any effects that the launch of the euro might have had on the value of the lira. Thus, on the first trading day of the year, the Maltese lira basket comprised the euro, sterling and the US dollar, with weights of 56.8%, 21.6% and 21.6%, respectively.

Movements in the exchange rate of the Maltese lira against the major currencies during the year under review reflected the developments in international foreign exchange markets outlined in Chapter 1 of this Report. Thus, as Chart 3.7 shows, the lira lost ground against the US dollar, sterling and (especially) the yen, but appreciated against the euro during the year. Given the relatively strong weight of the euro in the Maltese lira basket, these movements largely reflected the European unit's persistent weakness on the foreign exchange markets.

As a result of these developments, the Maltese lira ended the year 8.6% lower against the US dollar, while

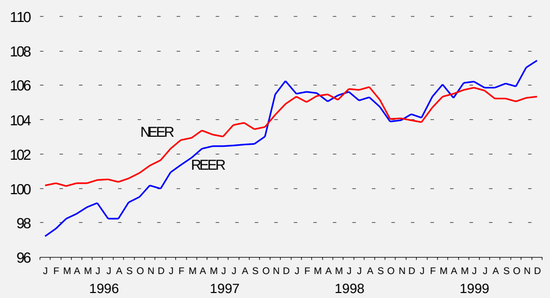
Table 3.9
EXCHANGE RATES OF THE MALTESE LIRA AGAINST SELECTED MAJOR CURRENCIES FOR 1999

	US$	Stg	Yen	Euro[1]
Monthly Averages:				
January	2.6345	1.5958	298.0	2.2693
February	2.5749	1.5814	300.5	2.2980
March	2.5317	1.5619	303.1	2.3254
April	2.5049	1.5556	299.6	2.3396
May	2.4971	1.5462	304.5	2.3485
June	2.4597	1.5408	297.1	2.3672
July	2.4472	1.5547	292.7	2.3639
August	2.4909	1.5507	282.3	2.3482
September	2.4829	1.5294	265.8	2.3650
October	2.5217	1.5212	267.4	2.3547
November	2.4629	1.5176	258.0	2.3810
December	2.4294	1.5063	249.1	2.4030
Average for 1999	2.5032	1.5468	284.8	2.3470
Average for 1998	2.5758	1.5547	336.7	2.2957
% change 1999/1998	-2.8	-0.5	-15.4	2.2
Closing rate on 31.12.99	2.4230	1.4983	247.6	2.4114
Closing rate on 31.12.98	2.6496	1.5935	300.7	2.2640
% change 1999/1998	-8.6	-6.0	-17.7	6.5
High for the year	2.6746	1.6099	311.7	2.4114
	(Jan. 04)	(Jan. 05)	(Mar. 04)	(Dec. 30)
Low for the year	2.4097	1.4976	246.3	2.2523
	(July 12)	(Dec. 30)	(Dec. 23)	(Jan. 05)

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

Chart 3.8 REAL AND NOMINAL EFFECTIVE EXCHANGE RATE INDICES FOR THE MALTESE LIRA*

(1995 = 100)



* 1999 DATA ARE PROVISIONAL

SOURCE: CENTRAL BANK OF MALTA

its average value against the American currency was 2.8% lower than in 1998. By the end of July, the Maltese lira had already lost some 7.6% of its value against the dollar, before it recovered slightly during the three months to October. But these gains were wiped out during the final two months of the year.

The Maltese lira also lost ground against sterling, against which it ended the year down by nearly 6% from its end-1998 value. The weakening of the Stg/Lm rate was in evidence almost throughout the year, although it recovered somewhat during the summer months. The lira's average value for the year vis-à-vis the British currency was 0.5% lower than in 1998.

During the year under review, however, the Maltese lira lost most ground against the Japanese yen, in terms of which it ended the year down by 17.7% from its end-1998 value. During the first half of the year, the Maltese lira fluctuated in a relatively narrow band. During the second half of the year, however, as the yen strengthened sharply on international markets, the yen/Lm rate fell steeply, as the chart shows. The average value of the Maltese lira against the yen during 1999 was about 15% lower than in 1998.

In contrast, the Maltese lira made strong gains against the euro[11] during the year, appreciating by 6.5%. During the first half of the year, the Maltese lira rose by about 4.6% against the euro, was relatively stable between June and October, then resumed its upward path and gained a further 1.5% in value by the end of the year. The average value of the Maltese lira against the euro for the year was up by 2.2% from its average value against the ECU in 1998.

3.3.2 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 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.

After a steep rise in 1996 and 1997, the NEER index followed a relatively stable course, fluctuating within a band of 2 percentage points, as Chart 3.8 shows. Indeed, the NEER index ended 1999 only 0.02% above its level at the start of 1998. During the first half of 1999 the NEER index tended to follow an upward path, mainly reflecting the appreciation of the Maltese lira against the euro. During the third quarter, however, the temporary recovery of the euro led to a decline in the NEER, but this was reversed in the final two months of the year. The index thus ended the year 1.3% higher, indicating a loss of competitiveness on account of exchange rate movements.

As for the REER index, which apart from exchange rate movements also takes account of changes in relative inflation rates, this followed a similar trend to the NEER, as the chart shows. However, the rise in the REER during the final two months of 1999 was more pronounced than the rise of the NEER index. In fact, the REER index ended the year 3% above its end-1998 level. This loss in relative price competitiveness during November and December 1999 reflected the faster rise in domestic inflation relative to that of partner and competitor countries.

[11] The ECU prior to January 1, 1999.

4. Government Finance

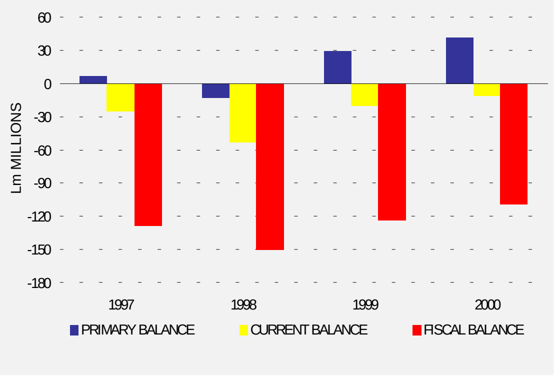
In 1999 the fiscal deficit narrowed to 8.6% of GDP in line with the Government's target for the year and its longer-term objective of reducing the deficit to around 4% of GDP by the year 2004. Higher ordinary revenue, which outpaced expenditure growth, was the main factor behind this improvement. Nevertheless, at Lm124 million, the fiscal deficit remained large and continued to exert pressure on prices and on the balance of payments. Estimates for the year 2000, however, project further fiscal consolidation, as revenues are again expected to increase faster than expenditures.

4.1 Fiscal Performance in 1999

A significant increase in ordinary revenue, which was boosted by special factors, reversed the deterioration in government finances witnessed in 1998. In addition, expenditure growth was contained as Government transfers to public entities were considerably reduced. This partly offset the significant increases in social security payments and debt servicing costs.

As can be seen from Chart 4.1 and Table 4.1, some improvement was registered in all the main public finance indicators. Thus, the **primary balance**, which measures the difference between ordinary revenue and recurrent expenditure excluding interest payments, swung from a deficit in 1998 to a surplus in 1999. This implies that a part of the interest on the public debt was financed out of ordinary revenue. The improvement in the **current balance**, which includes interest payments, was more contained. This was on account of the large increase in interest payments as a result of the mounting stock of debt built up in previous years. In turn, higher capital expenditure reduced the extent of the improvement in the overall **fiscal balance**.

Chart 4.1 PUBLIC FINANCE INDICATORS



4.1.1 Ordinary Revenue

In 1999 ordinary revenue increased by Lm47 million, mainly as a result of higher tax revenues. As can be seen from Table 4.1, **income tax** yielded Lm128 million, Lm17 million more than in the previous year. This reflected general income growth and some improvement in the tax collection process, including the collection of arrears. The latter yielded Lm15.4 million, compared to Lm13.7 million in 1998. Revenue from **social security contributions**, meanwhile, amounted to Lm96.6 million, up by Lm6.1 million from the previous year's level, mainly as a result of the higher contribution rate.

During 1999, Lm208 million were collected from **indirect taxes**, a year-on-year increase of some Lm22 million. Revenue from VAT amounted to Lm85 million, accounting for around half of this additional revenue. Higher revenue was also collected from customs and licenses, reflecting the sharp increase in imports of motor vehicles that occurred in 1999.

Revenue from **non-tax sources** remained relatively stable. A Lm6 million increase in Central Bank profits was offset by a decline in other revenues, partly as a result of the transfer of civil aviation responsibilities from the Government to Malta International Airport plc. Furthermore, figures for 1998 included one-off revenues, such as those derived from the one-time tax on bank profits and the payment of interest arrears by the Water Services Corporation.

4.1.2 Expenditure

In 1999 **total recurrent expenditure** (including interest payments) amounted to Lm525.6 million, Lm14 million more than in the previous year. **Contributions to**

Table 4.1

GOVERNMENT BUDGETARY OPERATIONS[1]

Lm millions

	1998		1999		2000	
REVENUE						
Income Tax	110.6		128.0		137.0	
Social Security [2]	90.5		96.6		108.7	
DIRECT TAX		201.1		224.6		245.7
Customs and Excise Duties	52.7		55.4		60.2	
Licenses, Taxes and Fines	60.7		67.2		68.3	
Consumption Tax	72.6		85.0		100.0	
INDIRECT TAX		186.0		207.6		228.5
Total Tax Revenue		**387.1**		**432.2**		**474.2**
Central Bank Profits	24.1		30.2		27.0	
Other Non-Tax Revenue[3]	47.1		42.5		39.2	
Total Non-Tax Revenue		**71.2**		**72.7**		**66.2**
ORDINARY REVENUE		**458.3**		**504.9**		**540.4**
EXPENDITURE						
Social Security [2,4]	191.7		202.5		211.8	
Personal Emoluments	163.6		165.8		172.9	
Contributions to Entities	38.7		29.8		30.1	
Other	77.2		77.3		84.3	
RECURRENT EXPENDITURE[5]		**471.2**		**475.4**		**499.1**
Primary Balance[6]		**-12.9**		**29.5**		**41.3**
Interest Payments	40.5		50.2		52.7	
Current Balance[7]		**-53.4**		**-20.7**		**-11.4**
Asset Formation	53.4		58.4		60.6	
Subventions	43.4		45.4		37.3	
CAPITAL EXPENDITURE		**96.8**		**103.8**		**97.9**
FISCAL BALANCE		**-150.2**		**-124.5**		**-109.3**
FISCAL DEFICIT to GDP ratio		**11.1%**		**8.6%**		**7.1%**

[1] Data for 1999 are revised estimates, and for 2000 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 assets.
[4] Includes social security benefits, family and social welfare, care of the elderly, and treasury pensions.
[5] Excluding interest payments.
[6] Ordinary revenue less recurrent expenditure (excluding interest payments).
[7] Ordinary revenue less total recurrent expenditure (including interest payments).

SOURCE: *Ministry of Finance*

public entities were however Lm9 million lower, in the main reflecting smaller transfers to the Water Services Corporation.

Expenditure on **social security benefits** continued to rise in 1999, maintaining the momentum observed in recent years. At more than Lm200 million, these outlays were some Lm11 million higher than in the previous year. The rising number of beneficiaries and the various social policy initiatives undertaken over the years are contributing to the steady increase in these expenditures.

Interest payments were another main source of expenditure growth in the year under review, reflecting the higher stock of debt. Interest payments reached Lm50.2 million, up by Lm10 million when compared to 1998.

Capital expenditure in 1999 amounted to Lm104 million. This was Lm7 million more than in the previous year and was mainly attributable to the payment of wage and redundancy payments connected with the downsizing of a Government-owned company and to a one-off payment in connection with oil exploration.

4.2 Projected Fiscal Performance in 2000

The Budget for the year 2000[12] seeks to reduce the deficit-to-GDP ratio further, to 7.1%, as Table 4.1 shows. The revision in the income tax bands and the increases in social security contribution rates are expected to provide a further boost to direct tax revenues. Similarly, as a result of the widening of the VAT tax base and the increase in some excise duties, higher indirect tax revenues are also projected.

However, recurrent expenditure is also expected to continue increasing. In 2000, expenditure on social security is set to rise by a further Lm9 million, to Lm212 million. Expenditure on personal emoluments is also to increase, by some Lm7 million, reflecting both higher salaries and the recruitment of new employees, mainly in the health and education sectors. Increases in the *other* expenditure category include a Lm4 million one-off payment to households to make up for the removal of the bread subsidy.

Since the amount of Government stocks issued in 1999 was less than in the previous year, interest payments are expected to increase at a significantly slower pace. Nevertheless, the share of interest payments in total government expenditure is expected to increase marginally, to 8.1%.

It is estimated that as a result of the measures introduced in the budget for the year 2000, the fiscal deficit will narrow to Lm109 million.

4.3 Government Debt and Financing Operations

As Table 4.2 indicates, in 1999 the fiscal deficit was primarily financed by means of issues of long-term stock and sale of assets. During the year, Government issued Lm84 million worth of stocks. This was less than in 1998, - partly mirroring the reduction in the fiscal deficit, and partly because Government obtained more funds from the sale of assets. In fact, privatisation proceeds during 1999 amounted to Lm71 million, or double the previous year's amount. Since the total financing obtained during the year exceeded the Government's borrowing requirement, surplus funds were used to replenish government deposits held with the banking system.

As can be seen from Chart 4.2, at the end of 1999, the

Table 4.2
GOVERNMENT FINANCING OPERATIONS[1]

Lm millions

	1998	1999	2000
Local Loans	110.0	84.0	0.0
Foreign Loans	0.0	0.0	3.0
Grants	10.0	10.1	10.0
Sale of Assets	35.4	71.0	62.0
FINANCING	**155.4**	**165.1**	**75.0**
FISCAL BALANCE	**-150.2**	**-124.5**	**-109.3**
Financing less Fiscal Balance[2]	5.2	40.6	-34.3

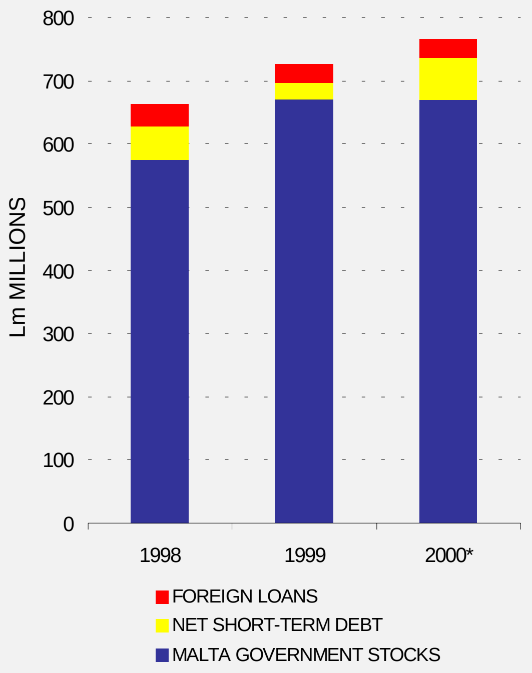
[1] Data for 1999 are revised estimates, and for 2000 are estimates issued by the Ministry of Finance.

[2] A negative figure indicates that Government utilized additional financing from issues of treasury bills, running down of deposits, or through financing from sinking funds.

SOURCE: Ministry of Finance

[12] For further details, refer to "The Budget Estimates for 2000: An Analysis of the Government's Budgetary Operations", Central Bank of Malta Quarterly Review, December 1999.

Chart 4.2 COMPOSITION OF GOVERNMENT NET DEBT OUTSTANDING



* CBM PROJECTIONS
SOURCE: MINISTRY OF FINANCE

net outstanding balance of Malta Government Stocks – which excludes the value of such stocks held by sinking funds - stood at Lm669 million, up from Lm575 million at the end of 1998. Moreover, as a result of the surplus long-term financing, the Government's net short-term debt position – which nets out deposits held by the Government with the banking system from the outstanding level of Treasury bills - improved significantly.

In 2000, the net outstanding balance of Malta Government Stocks is expected to remain unchanged, as the Government plans to finance the fiscal deficit for the year mainly from privatisation proceeds and the surplus finance obtained in 1999. On the other hand, the net short-term debt is expected to increase, as Government plans to finance part of the deficit for 2000 by running down deposits with the banking system accumulated during 1999, and possibly by increasing the stock of Treasury Bills in issue.

5. Monetary and Financial Developments

The annual rate of growth of broad money accelerated during 1999, driven by a combination of increased credit to the private sector and capital inflows. On the other hand, the Government's reduced borrowing requirement dampened credit growth and, hence, monetary expansion. The sale of Government's majority shareholding in Mid-Med Bank to the HSBC Group had a significant impact on monetary aggregates during the year and also boosted trading in equities.

During the year the Central Bank cut official interest rates in response to falling interest rates abroad, declining inflation and weak domestic demand. The Bank's central intervention rate was lowered in stages from 5.45% at the end of 1998 to 4.75% a year later. The discount rate, which was formally linked to the central intervention rate in June, was also lowered to 4.75%. These cuts in official interest rates were swiftly transmitted to money market rates. Government bond yields and retail interest rates also fell, while equity prices rose sharply, particularly towards the end of the year.

5.1 The Monetary Base

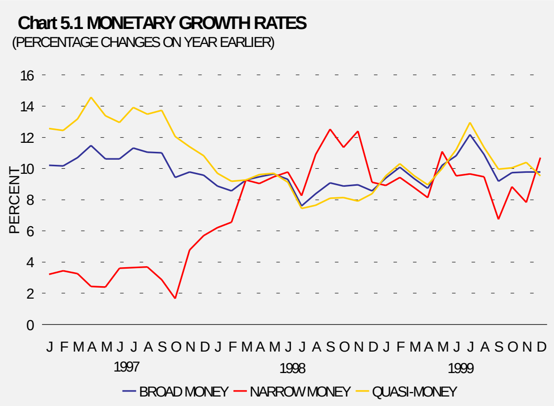
The monetary base, M0, consists of currency in issue and banks' deposits with the Central Bank, excluding term deposits. It is a measure of the Central Bank's monetary liabilities and captures the impact of all the Central Bank's operations on the banks' liquidity and the potential for credit expansion in the economy.

Table 5.1 shows the components of the monetary base and its sources, derived from the Central Bank's balance sheet. Because the latter must balance, M0 equals the sum of the Bank's assets minus the Bank's remaining liabilities. Therefore, all else being equal, an increase in the Bank's assets leads to an expansion in M0, while an increase in the Bank's remaining liabilities causes it to contract. During 1999, the monetary base expanded by Lm38.6 million to Lm544.7 million, equivalent to an annual rate of growth of 7.6% and up from 4.3% in 1998. As the Table shows, most of the growth in the monetary base took the form of an increase in currency in issue, while the primary source of this growth was an increase in the Central Bank's foreign assets. The latter was partly offset by a drop in claims on Government and an increase in

Table 5.1
THE MONETARY BASE AND ITS SOURCES

Lm thousands

	1998	1999	Change
Currency in Issue	390,911	418,485	27,574
Banks' Deposits	115,195	126,224	11,028
Monetary Base	**506,106**	**544,709**	**38,602**
Assets			
Foreign Assets	639,972	740,303	100,331
Claims on Government	24,322	6,153	-18,169
Fixed and Other Assets	50,715	67,152	16,437
Less:			
Remaining Liabilities			
Private Sector Deposits	7,361	4,608	-2,752
SDR Allocations	6,006	6,390	384
Government Deposits	48,207	96,207	48,000
Capital and Reserves	93,050	93,050	-
Other Liabilities	54,279	68,643	14,365



Government deposits with the Central Bank.

The ratio between the Central Bank's net foreign assets and the monetary base is an important lead indicator of possible pressures on the exchange rate. A fall in the ratio could be due to excessive bank liquidity which has in turn given rise to rapid domestic credit expansion and, because of the economy's high import propensity, to a net outflow of external reserves. During 1999, however, the Central Bank's net foreign assets increased at a faster pace than the monetary base. Hence, the ratio between the two rose by almost ten percentage points to 135.9% at year end, indicating that no pressures on the exchange rate were present.

5.2 Monetary Aggregates

During 1999 **broad money**, M3, which is made up of currency in circulation and residents' deposits with the banking system, increased by Lm217.8 million to Lm2,440.4 million. As this was a larger increase than those recorded in recent years, the annual rate of growth of this aggregate, which had been slowing down since 1996, accelerated. As Chart 5.1 shows, the annual rate of growth of broad money was on a general upward trend during the first half of the year, peaking at 12.2% in July. Although it dropped to 9.2% in September, when Government stocks were issued on the primary market and when tax payments fell due, it rose again to end the year at 9.8%.

The increase in M3 took place almost entirely in residents' deposits denominated in Maltese liri. Thus, although residents' foreign currency deposits increased by Lm14.4 million, or 7.5%, their share in M3 declined to 8.5% at the end of the year under review.

The pick-up in the growth rate of **narrow money**, M1, noted in 1998, continued in 1999. As can be seen from Table 5.2, narrow money, which consists of

Table 5.2
MAIN MONETARY AGGREGATES

Lm millions

	1997		1998		1999	
	Amount	% Change	Amount	% Change	Amount	% Change
Broad Money	**2,047.0**	**9.6**	**2,222.6**	**8.6**	**2,440.4**	**9.8**
of which:						
Narrow Money	**479.9**	**5.7**	**523.6**	**9.1**	**579.7**	**10.7**
Currency in Circulation	363.8	0.5	369.5	1.6	384.6	4.1
Demand Deposits	116.1	26.2	154.1	32.7	195.1	26.6
Quasi-Money	**1,567.1**	**10.8**	**1,699.0**	**8.4**	**1,860.7**	**9.5**
Savings Deposits	574.1	6.9	585.1	1.9	637.4	8.9
Time Deposits	993.0	13.2	1,113.8	12.2	1,223.3	9.8
Foreign Currency Components of Broad Money[1]	**182.7**	**5.5**	**192.2**	**5.2**	**206.6**	**7.5**
Demand	7.4	+	8.9	20.4	10.4	17.0
Savings	111.6	9.0	107.3	-3.8	122.6	14.3
Time	63.7	-5.5	76.0	19.3	73.5	-3.3

[1] Including External Maltese Lira Deposits.
+ Indicates change greater than 100%.

currency in circulation and demand deposits, rose by 10.7%, the largest increase recorded during the past decade, to Lm579.7 million. As Chart 5.1 shows, narrow money growth fluctuated considerably during the year: a small increase in M1 during the first quarter was followed by a strong expansion in the second, with the annual rate of growth climbing to 11.1% in May; it then rose slightly during the third quarter, with the annual growth rate dropping to 6.8% in September. Towards the end of the year, however, M1 increased robustly, under the impact of an expansion in both demand deposits and currency in circulation.

Demand deposits expanded vigorously for the third year in a row, rising by Lm41 million and accounting for most of the year's increase in narrow money. Although their annual rate of growth slowed down to 26.6%, as Table 5.2 shows, these deposits remained the fastest-growing component of broad money. Deposits belonging to private firms accounted for more than half the increase in absolute terms, but those belonging to households also rose.

Currency in circulation rose by Lm15.1 million, or 4.1%, to Lm384.6 million during 1999, as Table 5.2 shows. This contrasted with annual increases of just 0.5% and 1.6% during 1997 and 1998, respectively. There was a large increase in December, possibly because of concerns about the millennium changeover and the concentration of bank holidays towards the end of the year.

As in previous years, growth in **quasi-money** accounted for most of the increase in broad money during 1999. In fact, quasi-money, which consists of savings and time deposits, expanded by Lm161.7 million to Lm1,860.7 million: a larger addition, in absolute terms, than any registered in the past five years. As a result, the annual rate of growth, which had been decelerating since 1994, picked up to reach 9.5%, as Table 5.2 shows. Quasi-money grew rapidly during the first seven months of the year, with the annual growth rate peaking at almost 13% in July, as can be seen from Chart 5.1.

After having slowed down steadily since 1990, growth in savings deposits accelerated during 1999, when they rose by Lm52.3 million, or 8.9%. Expansion during the first two quarters was followed by a contraction during the third, when Government stocks were sold on the primary market, and a resumed upward trend during the final quarter. Growth in savings deposits belonging to households, which rose by Lm34.6 million, accounted for most of the increase registered during the year. However, deposits belonging to private firms increased much more rapidly, adding Lm23.1 million, or 32.1%, after having fallen during the previous year. As Table 5.2 shows, savings deposits denominated in foreign currency, which rose by Lm15.4 million, or 14.3%, accounted for a significant proportion of the total increase.

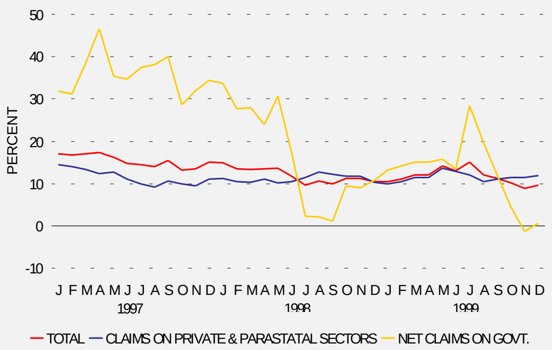
In contrast, time deposits again expanded more slowly during 1999, by Lm109.4 million, or 9.8%, compared with 12.2% in 1998. Depositors' behaviour shifted substantially during the year. Time deposits increased strongly during the first half, but grew more slowly afterwards. In particular, whereas the growth rate of deposits held by households halved, that of deposits belonging to private firms accelerated sharply. Moreover, while deposits with a term to maturity of less than one year continued to increase rapidly, those with a term to maturity of five years and over slowed down sharply. Time deposits denominated in foreign currency contracted.

5.3 Determinants of Monetary Growth

Monetary expansion during 1999 was driven by a combination of increased credit, particularly to the private sector, and capital inflows that boosted the net foreign assets of the banking system. "Other items (net)", which consist of the non-monetary liabilities of the banking system minus its other assets, continued to rise, dampening monetary growth.

Domestic credit expanded by Lm175.1 million to Lm1,991 million during 1999. Nevertheless, the annual rate of growth continued to decelerate, dropping from 10.4% at the end of 1998 to 9.6% a year later, as Table 5.3 shows. Furthermore, as Chart 5.2 indicates, the annual rate of growth of domestic credit moved on a general upward trend during the first seven months

Chart 5.2 DOMESTIC CREDIT
(PERCENTAGE CHANGES ON YEAR EARLIER)



of the year, peaking at 15% in July, before slowing down gradually thereafter.

The reduction in the fiscal deficit and the sale of its majority shareholding in Mid-Med Bank resulted in a substantially smaller Government borrowing requirement in 1999. Consequently, the banking system's **net claims on Government** increased by just Lm2.1 million, or 0.6%, compared with 10.7% in 1998 and 34.5% in 1997. This deceleration accounted for the overall slowdown in domestic credit growth.

The timing of privatisation receipts had a significant bearing on the evolution of net claims on Government during the year. As Chart 5.2 indicates, the annual rate of growth of these claims rose during the first seven months of the year, peaking at 28.4% in July before falling sharply in the following months. In fact, net claims on Government actually fell during the second half of the year, when part of the proceeds from the sale of Mid-Med Bank shares was received. This coincided with a bunching of tax receipts and the sale of stocks to the non-bank private sector on the primary market. Together, these receipts boosted the Government's deposits with the Central Bank.

Claims on the private and parastatal sectors, which expanded by Lm173.1 million to Lm1,632.9 million, accounted for almost all the domestic credit growth during the year under review. Since this was the largest increase in such claims since 1995, the annual rate of growth, which had fallen steadily since 1996, rose to 11.9% in 1999, as Table 5.3 shows. Claims on the private sector expanded at a slower pace during the year, as Table 5.4 shows, with the annual growth rate dropping to 12.4%. In contrast, claims on the parastatal sector, which had contracted during 1998, rose by 9%. The latter increase resulted entirely from the re-classification, in May, of one bank's holdings of debt securities issued by a public corporation.

Loans and advances, including discounted bills, account for most of the banking system's claims on the private and parastatal sectors. During 1999 they expanded at a faster pace, with the annual growth rate accelerating from 8.7% in 1998 to 10.5%, as Table 5.4 shows. Lending to most categories of borrower grew more rapidly. This could reflect an increased demand for credit, possibly stimulated by lower retail lending rates. It could also indicate slower loan repayments, as the increase in bank provisions discussed in the

Table 5.3
DETERMINANTS OF MONETARY EXPANSION

Lm millions

	1997		1998		1999	
	Amount	% Change	Amount	% Change	Amount	% Change
Broad Money	**2,047.0**	**9.6**	**2,222.6**	**8.6**	**2,440.4**	**9.8**
Domestic Credit	**1,644.7**	**15.1**	**1,815.8**	**10.4**	**1,991.0**	**9.6**
Net Claims on Government	321.5	34.5	356.0	10.7	358.1	0.6
Claims on Private and Parastatal Sectors	1,323.3	11.2	1,459.8	10.3	1,632.9	11.9
Net Foreign Assets	**735.2**	**-2.5**	**864.1**	**17.5**	**936.5**	**8.4**
Monetary Authorities	561.7	1.4	640.0	13.9	740.3	15.7
All Banking Institutions	173.5	-13.2	224.1	29.2	196.1	-12.5
Less						
Other Items (Net)	**332.9**	**5.6**	**457.4**	**37.4**	**487.1**	**6.5**

Table 5.4
CLAIMS ON PRIVATE AND PARASTATAL SECTORS [1]

	1998			1999		
	Amount Lm000s	Annual Growth (%)		Amount Lm000s	Annual Growth (%)	
Claims on the Private Sector	1,216,549	14.1		1,367,776	12.4	
Claims on the Parastatal Sector	243,266	-5.5		265,091	9.0	
TOTAL	**1,459,815**	**10.3**		**1,632,866**	**11.9**	
LOANS AND ADVANCES	Amount Lm000s	Annual Growth (%)	Share of Total (%)	Amount Lm000s	Annual Growth (%)	Share of Total (%)
Energy and Water	106,900	9.0	7.6	108,906	1.9	7.0
Agriculture & Fisheries	11,106	-1.0	0.8	10,767	-3.1	0.7
Manufacturing, Shiprepair/Building	204,640	-4.1	14.5	204,971	0.2	13.1
Building & Construction	82,571	14.3	5.8	96,880	17.3	6.2
Hotel, Restaurant & Tourist Trades	190,872	9.4	13.5	221,972	16.3	14.2
Wholesale & Retail	250,736	9.6	17.7	275,698	10.0	17.6
Personal	292,109	16.1	20.6	342,580	17.3	21.9
Transport, Storage & Communications	84,609	7.6	6.0	81,097	-4.2	5.2
Other Services	62,708	11.0	4.4	81,631	30.2	5.2
All Other	128,474	10.1	9.1	136,436	6.2	8.7
TOTAL LOANS AND ADVANCES[2]	**1,414,733**	**8.7**	**100.0**	**1,562,804**	**10.5**	**100.0**

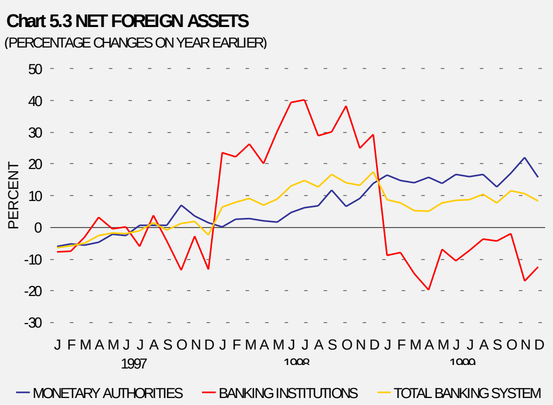
[1] Claims on the private and parastatal sectors consist of loans and advances (including bills discounted) and holdings of securities, including equities, issued by the private sector and public non-financial corporations. Inter-bank claims are excluded.
[2] Includes lending by International Banking Institutions licensed under the MFSC Act 1994, for which sectoral distribution is not available.

next Chapter suggests. Conversely, in some areas of manufacturing and in the energy and water sector, slow credit growth could reflect an improvement in borrowers' cash flow.

The Table shows that credit to the "other services" sector, to the personal sector, to the construction industry and to the tourist trade expanded at a faster pace in 1999. Albeit to a lesser extent, credit to the wholesale and retail trades also accelerated, while manufacturing credit, which had fallen in 1998, rose slightly. On the other hand, lending to the agriculture and fisheries sector and to the transport, storage and communications sector contracted, while credit to the energy and water sector and to the "all other" sector grew at a slower pace.

Personal lending accounted for the largest increase in absolute terms during the year, rising by Lm50.5 million, or 17.3%, taking its share in the banks' total loan portfolio to 21.9%. Most of this was associated with the purchase or construction of housing. Credit to the tourist industry, which expanded by Lm31.1 million, also accelerated after a sharp slowdown in 1998. Around one-third of the overall increase funded the acquisition of existing establishments in the industry. Credit to the wholesale and retail trades expanded by Lm25 million, with the annual growth rate rising to 10% as a result.

The recovery in loans and advances to the construction industry noted in 1998 continued during the year under review with a Lm14.3 million expansion, equivalent to an annual rate of growth of 17.3%. Loans and advances to the "other services" sector - which includes professional and repair and maintenance services - continued to expand rapidly, rising by Lm18.9 million, or 30.2%, compared with 11% in 1998.



The slowdown in credit to manufacturing industry in evidence since late 1995 was arrested in 1999, when a small, Lm0.3 million, or 0.2%, increase was registered. Credit to the electronics sub-sector and to the shipyards continued to contract, but at a slower pace than before.

Capital inflows boosted the **net foreign assets** of the banking system and contributed to monetary expansion during 1999. In fact, they rose by Lm72.3 million, or 8.4%, to Lm936.5 million. This was a smaller increase than in 1998, when there had been changes in the accounting treatment of certain categories of capital reported by international banks and of the Central Bank's external reserves. The net foreign assets fell during the first quarter of the year, but rose considerably during the following two quarters. As Chart 5.3 shows, the annual growth rate peaked in October.

Continued growth in the net foreign assets of the monetary authorities, that is the Central Bank's external reserves, accounted for the entire increase in 1999. As Table 5.3 shows, the Bank's external reserves expanded by 15.7% to Lm740.3 million during the year. The receipt of part of the proceeds from the sale of Government's shares in Mid-Med Bank in June and November boosted the external reserves considerably, as did the introduction of new prudential regulations on banks' foreign exchange positions in October, which led to substantial sales of foreign exchange to the Central Bank.

The net foreign assets of the rest of the banking system, which had increased by Lm50.6 million during 1998 - mainly because of the change in the accounting treatment of certain capital items referred to earlier - resumed their downward trend, shedding Lm28 million, to Lm196.1 million, over the year. Consequently, the annual growth rate, which had risen to 29.2% because of the extraordinary increase in the banks' net foreign assets during 1998, swung to -12.5% during the year under review. A Lm35.8 million drop in the net foreign assets of the domestic banks accounted for the entire change[13], as those of the international banks rose by Lm7.8 million.

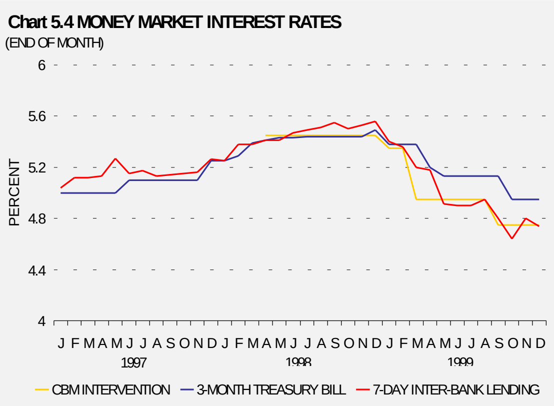
The net foreign assets of the rest of the banking system dropped during the first quarter, but recovered during the second, although the increase was dampened by the reclassification of one institution's portfolio of debt securities in May. The recovery gathered pace during the third quarter, in line with the normal seasonal pattern. This was followed by a sharp drop during the final quarter as a result of sales of foreign exchange to the Central Bank and a widening of the deficit on the balance of payments.

5.4 The Money Market

The Central Bank operates in the money market to inject or absorb liquidity temporarily from the banking system and thereby influence short-term interest rates. These open market operations are discussed in more detail elsewhere in this Report. The Government also raises finance in the money market by issuing Treasury bills. Finally, the banks themselves borrow and lend liquid funds in the inter-bank market.

As Chart 5.4 shows, **money market interest rates** decreased during 1999, tracking the reductions in the Central Bank's intervention rate. For example, the primary market yield on the three-month Treasury bill dropped from 5.49% in December 1998 to 4.95% at the end of October 1999, when these bills were last issued. Similarly the interest rate charged on seven-day inter-bank loans dropped by almost a full percentage point, from 5.6% at the end of 1998 to 4.7% a year later.

[13] 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.



Turnover in the primary **Treasury bill** market increased during 1999. Bills with terms to maturity ranging from one month to one year totalling Lm363.9 million were issued during the year. However, since Lm364.3 million worth of bills matured, the value of bills in issue at the end of December was almost unchanged from the previous year's level, at Lm83.3 million. Primary market activity was heavy during the first half of the year, but it slowed down considerably thereafter as tax receipts rose and the Treasury received the proceeds from the sale of Government stocks and the privatisation of Mid-Med Bank. In contrast with the previous two years, the banks were active in the primary Treasury bill market, taking up 55.5% of the bills issued. Most of the remainder were absorbed by Malta Government Sinking Funds (MGSF).

Despite this primary market activity, the secondary market for Treasury bills continued to shrink. Thus, the value of bills traded dropped from Lm402.2 million in 1998 to Lm288.8 million during the year under review. In particular, trading involving the Central Bank fell sharply. The Bank bought Lm44.3 million worth of bills and sold Lm44.1 million. In contrast, during 1998 the Bank had bought and sold Lm116.3 million and Lm79 million worth of bills, respectively. The value of trading in Treasury bills outside the Central Bank decreased slightly, falling from Lm206.9 million to Lm200.4 million. As in 1998, transactions between the MGSF and the banks accounted for most secondary market trades.

Activity in the **inter-bank market**, which had expanded rapidly between 1994 and 1998, stabilised during 1999. The value of short-term inter-bank loans traded in this market reached Lm954.8 million, marginally below the previous year's total. Loans with a term to maturity of one week or less accounted for most of the turnover in the market.

5.5 The Capital Market

Equities and debt securities with a maturity of more than one year are traded in the capital market. During 1999 both the Government and private firms tapped

Table 5.5

ISSUES OF LONG-TERM DEBT SECURITIES

Lm thousands

	1997	1998	1999
Government			
Total Issues	188,250	158,452	125,565
New Issues	168,250	125,852	84,065
Conversions	20,000	32,600	41,500
Redemptions	1,000	15,852	5,250
Net Issues	167,250	110,000	78,815
Private Corporations			
Total Issues	3,000	-	17,000
Redemptions	-	-	3,000
Net Issues	3,000	-	14,000
Total Net Issues	**170,250**	**110,000**	**92,815**

Note: Includes public issues of debt securities in Maltese liri by Government and non-banks. Long-term securities are those with an original term to maturity exceeding one year.

SOURCE: The Treasury

Table 5.6
TURNOVER OF GOVERNMENT STOCKS IN THE SECONDARY MARKET

Lm thousands

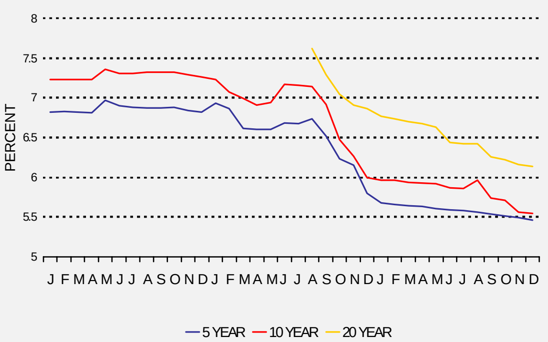
	1997	1998	1999
Purchases to CBM portfolio[1]	19,640	8,034	3,831
Sales from CBM portfolio	60,082	63,793	16,938
Other Deals[2]	32,123	40,237	29,934
Total	111,844	112,064	50,703

[1] Includes a purchase by CBM of Lm7.1 million from Malta Government Sinking Fund holdings which took place outside the Malta Stock Exchange during 1997.
[2] Including deals effected by the CBM broker on behalf of Government Sinking Funds and Ecclesiastical Entities.
SOURCE: Central Bank of Malta, Malta Stock Exchange

the primary market to raise long-term finance, albeit to a lesser extent than in the previous two years. In the secondary market, while trading in Government stocks halved, equity trading expanded considerably. Bond yields continued to fall while share prices climbed steeply.

Net issues of Government long-term debt dropped from Lm110 million during 1998 to Lm78.8 million during the year under review. As Table 5.5 shows, the Government issued a total of Lm125.6 million worth of stocks during 1999. However, Lm41.5 million were issued to replace maturing debt while a small amount of stocks were redeemed. Most **Government stocks** were issued in September, when Lm84 million were issued with terms to maturity of six, ten and twenty years. The non-bank private sector bought over half the amount issued, signalling the growing importance of collective investment schemes in the domestic capital market. For the first time, the Government allocated stocks on the primary market through auctions which, in the context of a high liquidity situation, led to lower primary market yields.

Chart 5.5 GOVERNMENT BOND YIELD
(END OF MONTH)



Two private firms also issued debt securities on the primary market during the year, for a total of Lm17 million. At the same time, corporate bonds worth Lm3 million matured.

Activity in the secondary market for Government stocks halved during 1999, as domestic investors shifted their attention to the equity market and as the Central Bank's holdings of stocks declined. The value of stocks traded on the Malta Stock Exchange fell from Lm112.1 million in 1998 to Lm50.7 million during the year reviewed. Accordingly, as Table 5.6 shows, trading involving the Central Bank dropped sharply. Central Bank sales fell to Lm16.9 million, less than a third of the 1998 level, whereas purchases halved to Lm3.8 million. Trading that did not involve the Central Bank, which fell to Lm29.9 million, accounted for more than half the annual turnover.

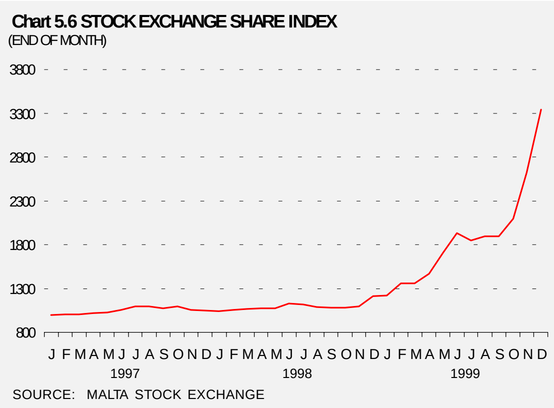
In contrast, turnover in the secondary market for **corporate bonds**, including preference shares, rose from Lm1.6 million during 1998 to Lm2.3 million in 1999. Trading in Corinthia Finance Bonds, which were issued during the year, accounted for almost half the total turnover.

After a steep fall during the final quarter of 1998, **yields** on Government bonds declined more gradually during 1999, as Chart 5.5 shows. For example, the yield on ten-year Government stocks, which had fallen by 127 basis points during 1998, dropped by 44 basis points, to 5.6%, during 1999. Similarly, the yields on five-year and twenty-year bonds fell by 34 basis points and 72 basis points to 5.46% and 6.14%,

Table 5.7
THE EQUITY MARKET

Listed Company	Turnover Lm000s		Number of Shares		End of Year Price (Lm)		Average Price (Lm)	
	1998	1999	1998	1999	1998	1999	1998	1999
Bank of Valletta	5,792	16,906	3,806,414	5,712,364	1.70	4.68	1.52	2.96
Mid Med Bank	1,863	85,552	1,029,986	28,480,472	2.10	6.80	1.81	3.00
Lombard Bank	3,162	1,258	1,515,763	346,644	2.38	4.63	2.09	3.63
Middle Sea Insurance	2,984	7,890	2,254,563	3,364,139	1.61	3.31	1.32	2.35
Farsons	77	205	145,957	378,590	0.52	0.66	0.53	0.54
Suncrest	203	252	346,147	402,286	0.59	0.65	0.59	0.63
Maltacom[1]	6,887	25,206	8,067,383	8,489,121	0.90	2.42	0.85	2.97
Total	20,968	137,269	-	-	-	-	-	-

[1] Listed on 22 June 1998.



respectively.

The privatisation of Mid-Med Bank and the growth of collective investment schemes were two driving factors behind the surge in trading in listed **equities** during 1999. Turnover in equities listed on the Malta Stock Exchange, which had almost tripled in 1998, expanded six-fold during 1999. In June the Government sold its shares in Mid-Med Bank to the HSBC Group in a number of special deals on the Malta Stock Exchange that had a combined value of Lm80.1 million. These transactions accounted for over half the annual turnover in the equity market. Moreover, the privatisation process stimulated investor interest in other equities. As a result, the value of shares traded rose from Lm21 million in 1998 to Lm137.3 million during the year under review, as Table 5.7 shows.

Share prices, which had already risen by 15.3% during 1998, climbed steeply during the year under review. In fact, the index of share prices compiled by the Malta Stock Exchange almost trebled during the year, to 3341.61. The increase in share prices was fuelled by heavy demand for a limited supply of equities and was particularly strong during the final quarter, as Chart 5.6 shows.

6. The Banking System

The banking system comprises deposit money banks, international banks that conduct business from Malta, and other, smaller banking institutions that mainly provide specific banking services. During 1999 the aggregate balance sheet of the deposit money banks and that of the international banks continued to expand, although in the case of the latter growth was less marked than in 1998. The balance sheet of the other banking institutions, on the other hand, contracted slightly.

The performance of the deposit money banks was characterised by a drop in profits which was largely occasioned by a significant increase in provision charges following a re-assessment of asset quality in loan portfolios. At the same time, the banks' capital adequacy and liquidity ratios, though marginally down on the year, remained well above the statutory requirements.

6.1 Deposit Money Banks' Balance Sheet

In 1999 the aggregate balance sheet of the deposit money banks expanded by 13.1%. As in past years, this was a significantly faster pace of growth than that of the economy as a whole. As a result of this trend, the ratio of the deposit money banks' total assets to nominal GDP has increased from 164% in 1995 to 209% in the year under review.

6.1.1 Liabilities

Residents' deposits are the main source of funds for the deposit money banks. As can be seen from Table 6.1, these deposits amounted to Lm2,039 million at the end of 1999, up by Lm209 million, or 11.4%, from the previous year's level. However, as Chart 6.1 shows, the share of residents' deposits in the banks' total liabilities at the end of the year lost one percentage point to stand at 68%.

Time deposits increased by Lm116 million, of which Lm59 million were in the one-year category. Deposits with a maturity of less than a year increased by Lm43 million. The corporate sector contributed Lm61 million of the increase in time deposits, as against Lm50 million contributed by the personal sector. Meanwhile, savings deposits were up by 8.7%,

Table 6.1
DEPOSIT MONEY BANKS' BALANCE SHEET

Lm thousands

	1997		1998		1999	
	Amount	% Change	Amount	% Change	Amount	% Change
ASSETS						
Cash and deposits with CBM	125,183	29.4	140,172	12.0	169,909	21.2
Foreign Assets	534,756	-9.1	575,077	7.5	615,109	7.0
Loans and Advances	1,205,349	11.7	1,324,629	9.9	1,464,365	10.5
Local Investments	365,333	38.8	477,853	30.8	574,198	20.2
Fixed and Other Assets	120,979	5.9	128,861	6.5	168,529	30.8
LIABILITIES						
Capital and Reserves	112,694	17.3	115,258	2.3	126,829	10.0
Foreign Liabilities	226,806	-1.2	305,527	34.7	356,384	16.6
Other Domestic Liabilities	339,765	6.2	395,919	16.5	469,904	18.7
Deposits	1,672,335	11.7	1,829,888	9.4	2,038,993	11.4
Time	987,497	13.3	1,102,040	11.6	1,217,858	10.5
Savings	574,352	6.7	581,875	1.3	632,675	8.7
Demand	110,486	26.6	145,973	32.1	188,460	29.1
AGGREGATE BALANCE SHEET	**2,351,600**	**9.8**	**2,646,592**	**12.5**	**2,992,110**	**13.1**

Chart 6.1 COMPOSITION OF LIABILITIES OF DEPOSIT MONEY BANKS AS AT YEAR-END 1999

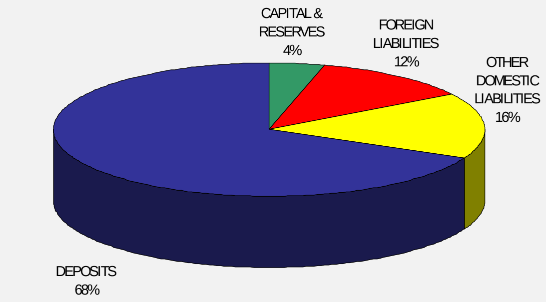
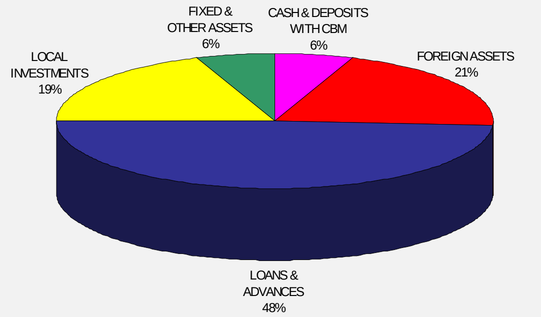


Chart 6.2 COMPOSITION OF ASSETS OF DEPOSIT MONEY BANKS AS AT YEAR-END 1999



standing at Lm633 million at year-end. This was a slower rate than in the case of the other types of deposits, but was significantly faster than that observed in 1998. Nevertheless, the share of savings deposits in total deposits continued to decline, as can be seen from Table 6.1. Finally, demand deposits increased by 29.1% to over Lm188 million. Over the past three years, this deposit category has exhibited the fastest growth rate, taking its share in total deposits from 6.6% to 9.2%.

At the end of 1999 the deposit money banks' **foreign liabilities** amounted to Lm356 million, or an increase of Lm51 million. Balances due to other banks abroad dropped slightly, but this was offset by an increase in repos, which went up from Lm105 million to Lm144 million.

The deposit money banks' **other domestic liabilities** mainly include deposits due to the banks' subsidiaries, accrued interest expenses, debentures, subordinated loan stock and certain categories of shareholders' funds. In 1999 these liabilities increased from Lm396 million to Lm470 million. This was partly attributable to higher deposits by subsidiaries with their parent banks and other inter-bank deposits, as well as to the substantial increase in provisions referred to earlier.

As at year-end the deposit money banks' **capital and reserves** were a tenth higher over the year at Lm127 million, mainly reflecting greater retained earnings by one bank.

6.1.2 Assets

Loans and advances represent the largest asset category on the deposit money banks' balance sheet, making up around half of their total assets, as can be seen from Chart 6.2. At the end of 1999, loans and advances stood at Lm1,464 million, some Lm140 million more than the year before. The largest nominal increase was registered in advances to the personal sector, which rose by Lm51 million, or 27%.

In 1999 the banks added Lm40 million to their **foreign assets**, taking the total to Lm615 million, or 21% of their total assets. This roughly matched the Lm51 million increase in the banks' foreign liabilities. A drop in the deposit money banks' foreign government securities portfolio was more than offset by an increase in their holdings of other foreign securities.

The deposit money banks' **local investments** also continued to grow, albeit at a slower rate than in the previous year. At the end of 1999, local investments stood at Lm574 million, or 19% of total assets. Holdings of Treasury bills were up by Lm43 million, whereas Malta Government stock holdings increased by Lm30 million. The banks also added Lm23 million to their local portfolio in the shape of non-governmental securities.

At the end of 1999 the deposit money banks' **reserves** stood at Lm170 million. Cash in the banks' tills and deposits with the Central Bank, most of which are required reserves, were up by over a fifth, Lm30 million, from the previous year's level.

6.2 Deposit Money Banks' Performance

The deposit money banks' aggregate profits before tax fell by 27% to Lm18.6 million in 1999. This resulted from a 16% growth in operating costs and sharply higher provisions, which outweighed an increase in

Table 6.2
DEPOSIT MONEY BANKS' INCOME STATEMENT

Lm thousands

	1997	1998	1999
Interest Income	149,800	164,547	170,539
Interest Expenses	97,421	111,018	118,537
Net Interest Income	**52,379**	**53,529**	**52,002**
Non-Interest Income	16,490	18,120	26,976
Gross Income	**68,869**	**71,649**	**78,978**
Operating Expenses	**40,476**	**41,963**	**48,613**
Wages	24,410	24,618	28,740
Rent, Depreciation and similar expenses	6,310	7,391	8,134
Other	9,756	9,954	11,739
Provisions	**5,156**	**4,196**	**11,753**
AGGREGATE PROFITS BEFORE TAX	**23,237**	**25,490**	**18,612**
(% of Gross Income)	%	%	%
Net Interest Income	76.1	74.7	65.8
Non-Interest Income	23.9	25.3	34.2
Operating Expenses	58.8	58.6	61.6
Wages	35.4	34.4	36.4
Provisions	7.5	5.9	14.9

the banks' gross income. On the other hand, the banks continued to maintain levels of capital and liquidity which were well above statutory requirements.

6.2.1 Revenue

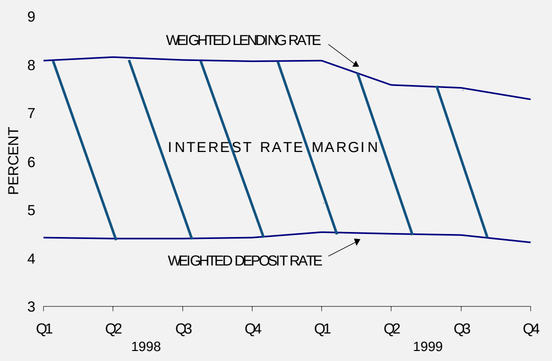
Banks derive their revenues from both interest and non-interest sources. As for **net interest income**, this represents the difference between the interest income earned on their asset portfolio and the interest payable on deposits. Their **non-interest income**, on the other hand, mainly consists of revenues derived from fee-earning services, including the sale of financial products.

Table 6.2 shows that interest income in 1999 was Lm170.5 million, an increase of Lm6 million, or 3.6%, which is a lower rate of growth than in 1998. On the other hand, interest payments grew by Lm7.5 million, or 6.8%, to Lm118.5 million.

The declining trend in domestic interest rates during the year also left its mark on bank income. In fact, as Chart 6.3 shows, the weighted lending rate fell from 8.08% to 7.28% during 1999, a drop of 80 basis points. The weighted deposit rate also fell, albeit to a lesser extent, shedding 10 basis points to 4.32%. These reductions followed the lowering of the Central Bank's discount rate and reflected intensified competition in the banking sector. This led to a narrowing of 70 basis points in the net interest margin to 2.96%. The nominal increase in interest paid out on deposits was thus higher than the rise in interest paid by borrowers, resulting in a drop of Lm1.5 million in net interest income to Lm52 million. Consequently, the share of net interest income in the deposit money banks' gross income fell from 74.7% over the year to 65.8%.

In contrast, strong growth was registered in the banks'

Chart 6.3 DEPOSIT MONEY BANKS' INTEREST RATE MARGIN



non-interest income, which reached Lm27 million in 1999, up by 49% from the previous year's level. Banks appear to have responded to stiffer competition in lending and deposit-taking by offering a wider range of fee-earning services. In this manner, banks not only compensated for the decline in net interest income, but also provided a further boost to their gross income. In fact, whereas in 1997 non-interest income represented 24% of the banks' gross income, the share of such income increased to 34% during the following two years. However, in 1999, non-interest income was also boosted by the one-off gain resulting from the sale, by one institution, of its substantial shareholding in two companies.

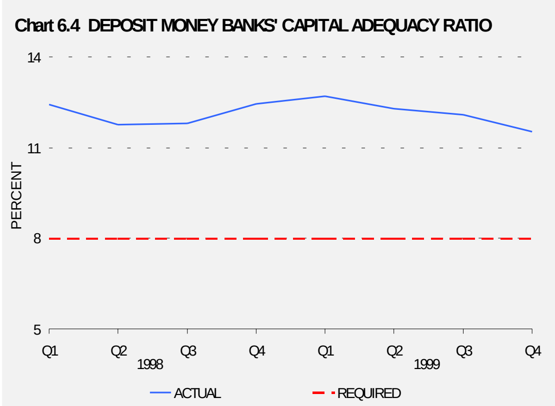
6.2.2 Expenditure

In 1999 the deposit money banks' **operating expenses** amounted to Lm48.6 million, Lm6.6 million more than in 1998. Wages make up around 60% of the banks' operating expenses. In the year under review, wage expenses increased by Lm4.1 million, or 17%, while the ratio of wage costs to the banks' gross income increased from 34.4% to 36.4%. The significant growth in wage costs reflected the payment of arrears, higher consultants' fees, and the introduction of early retirement schemes.

However, the most notable increase during the year took place in the value of **provision charges**, which were raised from Lm4.2 million to Lm11.8 million. This mainly reflected a re-assessment of the quality of the banks' loan portfolios, particularly in view of the slowdown in economic activity in recent years. This led to the adoption of a more conservative approach with respect to provisioning for outstanding loans and advances.

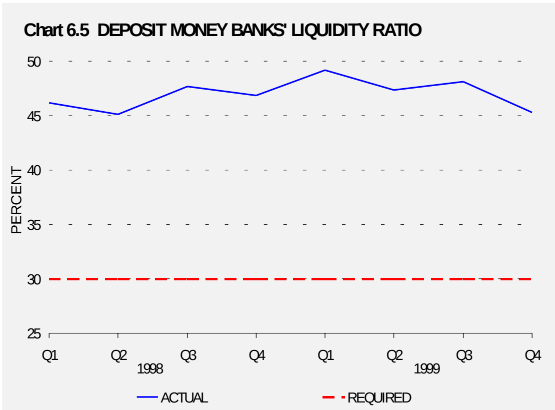
6.2.3 Profitability, Capital Adequacy and Liquidity

As noted above, the deposit money banks reported reduced aggregate **profits before tax** of Lm18.6 million, down from Lm25.5 million in 1998. The significant increase in non-interest income more than offset the marginal decline in net interest income, thus yielding a higher level of gross income. But higher operating expenses, two-thirds of which were attributable to higher wage costs, offset the increase in the banks' gross income, thereby eroding their profitability. This, in turn, was reduced further by the large increase in provisions.



The banks' **capital adequacy** is assessed by means of a ratio which compares the value of their own funds to a measure of risk weighted assets and off-balance sheet items. Chart 6.4 shows that the deposit money banks' capital adequacy ratio at the end of 1999 stood at 11.5%, one percentage point lower than at the end of 1998, implying that growth in the banks' own funds was slower than that in their risk-weighted assets. In turn, growth in the banks' risk-weighted assets was slightly higher than that of their total (non-weighted) assets, suggesting a small shift towards more risky assets. Nevertheless, the banks' capital adequacy ratio remained comfortably above the statutory requirement of 8% throughout the year.

The **liquidity** of the banks is assessed by comparing the value of the liquid assets on their balance sheets to their net short-term liabilities. During 1999, the banks' liquid assets increased by Lm97.7 million, whereas their net short-term liabilities were Lm259.4 million higher. Therefore, as Chart 6.5 shows, their



liquidity ratio dropped by 1.6 percentage points to 45.3%, but remained well above the statutory requirement of 30%.

6.3 International Banks

Locally based international banks are licensed under Maltese law to conduct banking business almost exclusively with non-residents. The aggregate balance sheet of these international banks continued to expand at a fast rate during 1999, partly as a result of an increase in the number of reporting banks. Nevertheless, at 36%, the growth of this sector was significantly lower than the 82% growth observed the previous year. This was mainly the result of some contraction in the value of these banks' total assets during the last four months of the year.

Foreign liabilities are the major source of funds for the international banks, making up 90% of their total liabilities at the end of 1999. Foreign liabilities increased by Lm639 million to Lm2,330 million over the year. Around four-fifths of this amount reflected a higher value of balances due to other banks abroad. The international banks' **other liabilities** also increased, by Lm21.9 million, to reach Lm39.3 million. On the other hand, their **resident deposits**, which make up less than 1% of their total liabilities, remained relatively stable, as a small decline in time deposits was almost completely offset by an increase in savings and demand deposits. Meanwhile, the international banks' **capital and reserves** rose from Lm162 million to Lm189 million, a slower rate of growth than that reported in the previous year.

In line with the nature of their business, most of the funds raised by the international banks continued to be re-invested abroad. The value of **foreign assets** held by these banks increased by Lm641 million in 1999, going up from Lm1,653 million to Lm2,294 million, and mirroring the increase in their foreign liabilities. Their holdings of foreign securities doubled over the year, so that the share of such holdings in the international banks' foreign assets surpassed the 50% mark. **Local investments**, which represent the second largest asset component on the international banks' balance sheet, also increased, rising from Lm231 million to Lm260 million, as two banks increased their deposits with parent banks in Malta. **Loans to residents**, which constitute a minimal proportion of the international banks' total assets, expanded from Lm1 million to Lm6 million. **Other assets** almost tripled to Lm17 million.

6.4 Other Banking Institutions

This category includes one credit institution specializing in housing finance and three other financial institutions - two of which mainly focus on investment banking services. Three of these institutions are subsidiaries of deposit money banks. In 1999 the aggregate balance sheet of the other banking institutions contracted, reversing the growth registered in the previous year. Their total assets

Table 6.3
INTERNATIONAL BANKING INSTITUTIONS' BALANCE SHEET

Lm thousands

	1997	1998	1999
ASSETS			
Cash and Money at call	867	1,236	1,892
Foreign Assets	817,949	1,652,699	2,293,592
Loans to Residents	598	996	6,135
Local Investments	217,221	231,290	260,458
Other Assets	5,249	5,729	16,853
LIABILITIES			
Capital and Reserves	63,912	161,866	188,740
Foreign Liabilities	950,186	1,690,832	2,329,618
Other Liabilities	12,881	17,382	39,250
Resident Deposits	14,905	21,870	21,323
AGGREGATE BALANCE SHEET	**1,041,884**	**1,891,950**	**2,578,931**

Table 6.4
OTHER BANKING INSTITUTIONS' BALANCE SHEET

Lm thousands

	1997	1998	1999
ASSETS			
Cash and Deposits with CBM	94	321	368
Claims on Government	842	5,794	4,555
Claims on Private and Parastatal Sectors	142,170	150,313	139,217
Foreign Assets	7,047	7,030	6,545
Other Assets	7,554	7,832	7,637
LIABILITIES			
Capital and Reserves	21,414	22,846	20,568
Debentures	60,000	60,000	60,000
Borrowing from Banks	67,904	74,600	60,392
Foreign Liabilities	-	-	198
Other Liabilities	8,389	13,844	17,164
AGGREGATE BALANCE SHEET	**157,707**	**171,290**	**158,322**

dropped by 7.6% to stand at Lm158 million at year end.

Borrowings from banks are the main source of funds for these institutions. These borrowings, however, dropped from Lm74.6 million at the end of 1998 to Lm60.4 million a year later. The institutions' **capital and reserves** declined slightly, to Lm20.6 million. This reflected a change in policy by one institution regarding the retention of part of its profits in a special reserve fund, as a result of which these funds were classified as other liabilities. The institutions' **other liabilities** thus increased to Lm17.2 million, reflecting the policy change as well as a change in the accounting reference date by one institution.

Claims on private and parastatal sectors remained the principal asset for the other banking institutions, accounting for 88% of the total at the end of 1999. In absolute terms, however, such claims dropped from Lm150 million to Lm139 million, as the institutions shifted more towards fee earning merchant banking. The institutions' **claims on government** also fell, from Lm5.8 million to Lm4.6 million, as one institution disposed of all its holdings of Treasury bills during the year.

Part II

CENTRAL BANK POLICIES,

OPERATIONS AND ACTIVITIES

1. Monetary and Exchange Rate Policy

1.1 Policy Overview

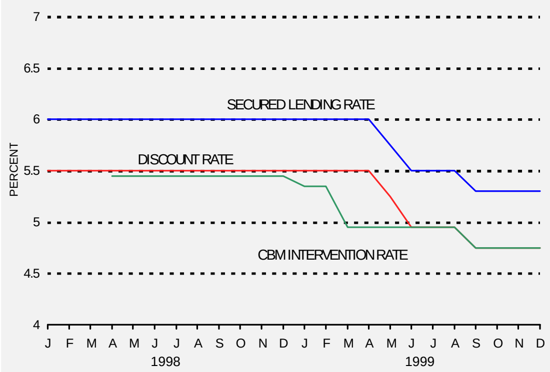
The Central Bank is responsible for the conduct of monetary policy in Malta. It also plays an important role in the formulation of exchange rate policy. More specifically, the Central Bank of Malta Act requires the Bank to "promote the orderly and balanced economic development of Malta and a rising level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

The primary objective of the Central Bank's monetary policy is the maintenance of price stability, since this provides the basis for balanced economic development and sustainable growth in employment and incomes. To help achieve these objectives, the Maltese lira is pegged to a basket of currencies of low-inflation countries. By maintaining this exchange rate peg, the Bank links domestic inflation to that in Malta's key trading partners. This helps to reduce imported inflation and to restrain excessive increases in domestic prices and wages. Exchange rate stability is also important in view of the economy's dependence on external trade and on inflows of foreign investment.

The basket to which the Maltese lira is pegged consists of three currencies: the euro, the US dollar and sterling. On January 4, 1999, in view of the launching of the single European currency and the replacement of the ECU by the euro, the Central Bank of Malta revised the portions of the currencies making up the Maltese lira basket. Thus, the initial weights of the euro, the dollar and sterling were set at 56.8%, 21.6% and 21.6%, respectively. With these changes, the effective weight of sterling - which had formed part of the ECU but did not join the euro zone - in the Maltese lira basket remained unchanged.

The monetary policy stance is decided by the Central Bank's Monetary Policy Council. The Council, which is chaired by the Governor and consists of the Board of Directors and senior officials of the Bank, met twelve times during the year, generally on the last

Chart 1.1 TRENDS IN OFFICIAL INTEREST RATES



Thursday of the month. During 1999, as Chart 1.1 shows, the Council lowered official interest rates several times. It cut the Bank's central intervention rate from 5.45% to 5.35% in January and to 4.95% in March. The Council also reduced the Bank's discount rate twice, in May and in June, to equate it with the central intervention rate. Finally, in September, the Bank's central intervention rate and its discount rate were each lowered by 20 basis points to 4.75%.

In October the Central Bank abolished the remaining restrictions on the interest rates which the banks can offer on savings and time deposits, as well as the controls on interest rates charged on loans denominated in foreign currencies. The relevant Central Bank Notice was amended accordingly.

1.2 The Tools of Monetary Policy

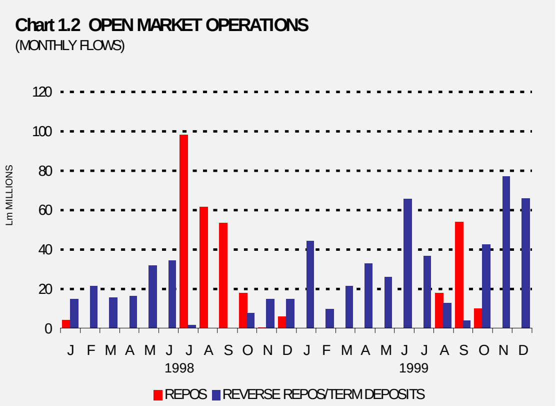
In order to maintain the exchange rate peg, the Central Bank uses a variety of policy tools. First, the Bank intervenes in the foreign exchange market, buying and selling foreign exchange to support the exchange rate. Second, the Bank alters official interest rates. Changes in official interest rates are transmitted to the money market and thence to the rest of the economy. Normally, an increase in interest rates curbs domestic demand and reduces capital outflows which, in turn, reduces downward pressure on the Maltese lira. In addition, the Central Bank uses open market operations to influence liquidity in the banking system and, hence, ensure that short-term interest rates are in line with its monetary policy stance. To a lesser extent, the Bank also uses reserve requirements, standing facilities and controls on capital movements as tools of monetary policy.

1.2.1 Open market operations

The Central Bank uses open market operations - that is, transactions in domestic financial markets - to influence the level of liquidity in the banking system. Since the banks, during 1999, were generally liquid, the Bank carried out weekly auctions of term deposits to absorb liquidity during most of the year. However, as Chart 1.2 indicates, between August and October the Bank used auctions of repos to inject funds into the banking system. These repo auctions coincided with the issue and take-up of Government stocks in the primary market, which resulted in a temporary liquidity shortage. In a repo, the Bank buys Government securities from a bank in exchange for liquid funds while agreeing to re-sell the same securities after a stipulated period of time. On aggregate, the Central Bank accepted term deposits worth Lm437.9 million from the rest of the banking system during the year, and injected Lm81.8 million into the system through repos. In contrast, during 1998, the Bank had injected Lm241.3 million and absorbed Lm173 million. In July, the Bank lengthened the term to maturity of both the repos and the term deposits being auctioned from seven days to fourteen. In line with the reduction in its central intervention rate during the year, the interest rate offered by the Central Bank on term deposits fell from 5.43% to 4.7%, whereas that charged on repos decreased from 5.5% to 4.8%.

1.2.2 Reserve requirements

The Central Bank continued to require the domestic banks to maintain reserve deposits with it equivalent to 5% of their deposit liabilities during 1999. In September, the definition of the deposit base used in the calculation was widened to include certain categories of inter-bank demand deposits. The Central Bank allows banks to hold these required reserves on a monthly average basis. That is, it allows the banks to go below the required ratio at times, provided that, on average, over the month, the ratio is maintained. Balances held to fulfil the reserve requirement were



remunerated at 2.7% per annum, the same rate in force during 1998.

1.2.3 The discount window and other standing facilities

Although the Central Bank may discount Treasury bills and other eligible securities to provide liquidity to the banking system, the discount window was not activated during the year under review.

In case of a temporary shortage of liquidity, the Central Bank also offers a collateralised loan facility to banks. In June 1999, the Bank reviewed this facility to bring the authorised limit in line with the amount of eligible collateral pledged. At the same time, credits began to be offered on an overnight basis rather than being repayable "as soon as possible" as was previously the case. The basic interest rate on this facility was set at 55 basis points above the Bank's central intervention rate. Banks borrowed an aggregate of Lm4.4 million through this facility during the year.

In September the Bank introduced an overnight deposit facility to absorb excess liquidity from the banking system. The facility is available to credit institutions licensed under the Banking Act to conduct business in Maltese liri and is activated on their initiative. The interest rate offered on the facility, which acts as a floor for inter-bank rates, was set at 295 basis points below the Bank's central intervention rate.

1.2.4 Administration of capital controls

The Central Bank administers exchange controls as an agent of the Government in terms of the Exchange Control Act. In many cases, however, the authority

Table 1.1
TRANSACTIONS PROCESSED BY THE CENTRAL BANK IN TERMS OF THE EXCHANGE CONTROL ACT

Lm millions

	1998	1999
Transactions approved by the Central Bank		
Remittances of funds overseas	43.3	58.4
of which:		
Repatriation of investments by non-residents	7.7	6.6
Insurance premiums	7.3	6.7
Trans-shipment/drop shipment	9.7	18.1
Equity investment in new companies with non-resident participation		
Paid-up share capital	3.0	5.0
of which:		
Non-resident capital	1.4	1.2
Increase in paid-up share capital of companies with non-resident participation	5.7	1.5
Transfers of shares from residents to non-residents	0.3	0.5
Transfers of shares from non-residents to residents	2.5	5.8
Direct investment overseas by residents	7.2	4.6
Transactions notified to Central Bank		
Cash gifts	6.4	6.4
Portfolio investments in foreign currency	5.2	18.2
Borrowing by local companies owned by non-residents		
From domestic banks	6.8	4.9
From foreign shareholders	0.4	3.7
Borrowing by resident companies from overseas lenders	93.2	39.7
Borrowing by resident persons from overseas lenders	0.2	0.4
Borrowing by non-residents from domestic banks	0.3	0.2

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.

to approve transactions between residents and non-residents has been delegated to authorised dealers - that is, credit institutions and foreign exchange bureaux. The Bank also compiles data on certain transactions between residents and non-residents for statistical purposes.

In January 1999 the Bank amended a number of Exchange Control Circulars to reflect the liberalisation measures that had previously been announced by the Minister of Finance. In particular, the limit on direct investment abroad by residents of Malta was raised from Lm150,000 to Lm300,000, while the annual ceiling on personal portfolio investment abroad was raised to Lm8,000 from Lm5,000. The period during which local companies could retain export proceeds in foreign currency was extended from four to six months. In addition, the Bank issued guidelines to authorised dealers on lending in foreign currency to residents. Finally, all restrictions on the amount that authorised dealers could lend to non-residents in connection with the acquisition of property in Malta were removed.

In November 1999 the Minister of Finance announced a range of measures to liberalise exchange controls further. These included the abolition of restrictions on direct investment abroad by companies resident or domiciled in Malta, an increase in the ceiling on personal portfolio investment abroad by residents to Lm15,000 and the relaxation of restrictions on the surrender of foreign currency receipts by export-oriented companies in the services sector. Furthermore, in December, the Minister transferred the responsibility for approving applications for the registration of companies with non-resident participation to the Malta Financial Services Centre. These measures were to enter into force in January 2000.

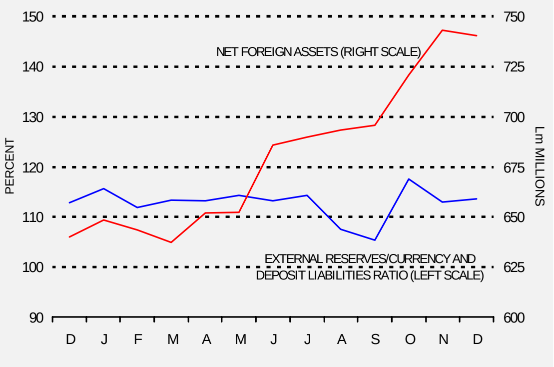
During the year the Bank approved transactions between residents and non-residents in line with its remit. As Table 1.1 shows, the Bank approved remittances abroad worth Lm58.4 million, compared with Lm43.3 million in 1998. The transactions approved included drop shipments and trans-shipments, the payment of insurance premiums and the repatriation of funds by non-residents. The Bank also approved short-term loans between residents and non-residents and equity investments in companies with non-resident participation. The Bank continued to compile data on other loans between residents and non-residents, as well as on portfolio investments abroad and cash gifts from residents to non-residents.

1.3 Managing the External Reserves

The Central Bank of Malta Act obliges the Bank to keep external reserves in proportion to its currency and deposit liabilities. The proportion, which is established by the Minister of Finance, remained unchanged at 60% during the year under review. In line with this requirement, the Bank manages a portfolio of external reserves which it also uses to intervene in the foreign exchange market to support the exchange rate peg when necessary.

As Chart 1.3 shows, the Central Bank's external reserves rose from Lm640 million at the end of 1998 to Lm740.3 million a year later. The sale of Government's shareholding in Mid-Med Bank plc to the HSBC Group accounted for most of this increase. As the Chart also shows, the ratio between the Bank's external reserves and its currency and deposit liabilities exceeded the statutory limit throughout the year. The ratio increased from 112.7% in December 1998 to 113.6% at the end of 1999.

Chart 1.3 THE CENTRAL BANK'S FOREIGN ASSETS



The Bank's reserve management policy is set by its Investments Policy Committee, which is chaired by the Governor and includes the Deputy Governor and senior Bank officials. The Committee meets monthly to monitor the performance of the Bank's external portfolio, to discuss investment policy and to establish guidelines for the Bank's dealers in the international markets. Part of the Bank's external portfolio consists of liquid assets, which allow it to intervene in the domestic foreign exchange market as and when necessary. The remainder is invested to earn income while minimising risk. The Bank's portfolio largely consists of placements with foreign banks and debt securities issued by non-residents. It also contains gold, Special Drawing Rights and claims on the International Monetary Fund. To minimise credit risk, the Bank only holds claims on top-rated banks and issuers of securities. Furthermore, it has established limits on exposures to individual countries and counter-parties.

During the year the Bank traded foreign exchange against Maltese lira with domestic credit and financial institutions. In the spot market the Bank deals in the US dollar, the euro and the pound 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 through Reuters.

During 1999 the number and value of deals carried out by the Bank in foreign exchange against Maltese liri with domestic credit and financial institutions increased considerably. Spot purchases and sales of foreign exchange rose to Lm119.2 million and Lm55 million, respectively. During 1999 the Bank also entered into forward contracts involving net purchases of Lm42.7 million worth of foreign exchange. A downward revision to the limits on banks' holdings of foreign exchange in October led to substantial sales of foreign exchange to the Central Bank[14]. This partly

[14] See the Section on policy developments in the following Chapter.

explains the rise in turnover. Moreover, an increase in the number of forward contracts concluded with the domestic banks in connection with the Tour Operator Support Scheme (TOSS) boosted activity in the forward market. The importance of swaps as a policy tool declined, with the Bank carrying out only two swaps against the Maltese lira, for a value of Lm6 million, during the year.

The Bank also trades in gold. During the year it sold 1,105 kilograms of gold grains, with a value of just over Lm4 million, to local manufacturers. In 1998, the Bank had sold 1,405 kilograms worth Lm5.2 million.

The Bank, through its links with the credit institutions' trading desks, monitors developments in the local foreign exchange market closely. Credit institutions report details of their transactions in foreign exchange against Maltese liri daily. Turnover in the domestic foreign exchange market rose from Lm1,500 million in 1998 to Lm1,900 million in 1999[15]. In addition, the Bank encouraged the development of an inter-bank market in foreign exchange. This market continued to grow, with the value of inter-bank deals expanding from Lm3 million in 1998 to around Lm30 million in 1999.

1.4 Money and Capital Markets

Apart from conducting open market operations to influence liquidity in the banking system, the Central Bank supports the market for Government securities by standing ready to buy Treasury bills and Malta Government Stocks in the secondary market.

In line with the policy followed in previous years, the Central Bank did not participate in the primary market for Treasury bills. The Bank, however, continued to act as a market maker in the secondary market for bills, quoting buying and selling prices regularly. However, when the term to maturity of open market operations was extended to fourteen days, the Bank ceased negotiating bills with less than 15 days to maturity. Activity in the secondary Treasury bill market - as well as the Bank's share in it - fell during 1999. Thus, during the year, the Bank bought Lm44.3 million worth of bills and sold Lm44.1 million. In contrast, during the previous year, the Bank had bought and sold Lm116.3 million and Lm79 million worth of bills, respectively. The interest rates quoted by the Bank in the secondary Treasury bill market varied in line with market developments.

The Bank again participated in the primary market for Malta Government Stocks in 1999. In September the Bank bought Lm12.3 million worth of new issues on the primary market. During the year it also purchased Lm0.9 million worth of conversion stocks. Nevertheless, the share of the Bank's purchases of new issues in the total continued to fall, dropping to 10.5%. Moreover, towards the end of the year, the Bank, for the first time, refrained from participating in the primary market sale of conversion stocks. Neither did the Bank underwrite issues of Government stocks during the year.

The Bank remained active in the secondary market for Government stocks, where its broker stands ready to purchase stocks to safeguard market liquidity. Since turnover in the secondary market dropped sharply in 1999, the value of transactions involving the Bank also decreased. In fact, total trades involving the Bank dropped to Lm20.8 million from Lm71.8 million in 1998. The Bank made purchases and sales of stocks worth Lm3.8 million and Lm16.9 million, respectively. There were no secondary market deals involving the Central Bank outside the Malta Stock Exchange.

In May the Minister of Finance amended the Statute of the Malta Stock Exchange to enable the Bank's broker to execute transactions on behalf of the Government in quoted securities issued by Government-owned companies[16]. Following this amendment, the Bank's broker acted on the Government's behalf in the sale of Mid-Med Bank plc shares to the HSBC Group.

[15] These totals exclude transactions carried out by the Central Bank on behalf of the Government and parastatal entities, inter-bank transactions and deals between credit and financial institutions and the Central Bank.

[16] See Legal Notice 91 of 1999.

1.5 Economic Information and Statistics

In order to enable the Central Bank to fulfil its statutory role as adviser to the Government on economic and financial matters and to conduct its monetary policy effectively, the Bank continuously monitors economic and financial developments both in Malta and abroad. Furthermore, during 1999, the Bank intensified its efforts to 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. In this regard, the Bank also started to review the relevant legislation in order to ensure that it had all the statutory powers necessary for collecting the required data.

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. During 1999, the Department's professional staff also provided briefings to the Minister of Finance and the Prime Minister. Additionally, the Department continued to conduct research on specific topics for the Bank's senior management.

The Economics Department regularly provides the Central Office of Statistics (COS) and the Government's Economic Planning Division with monetary and exchange-rate data. Similar statistical information is also supplied regularly to the International Monetary Fund (IMF) and the World Bank - as well as to international credit-rating agencies. During 1999 the Department also compiled the required statistical information and answered the detailed questionnaire on the Maltese economy in preparation for the IMF Consultation Mission that visited Malta in March.

The Central Bank 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 *Statistical Release on Monetary Aggregates and their Determinants*. These are all issued by the Economics Department.

During 1999 the Statistics Section of the Department continued to compile statistics on government finance and the public debt, and to report on these to the IMF and the World Bank. These tasks were taken over from the Ministry of Finance in 1998. Moreover, the Section, in collaboration with the Malta Financial Services Centre (MFSC), continued to collect data on collective-investment schemes, while towards the end of the year it undertook the preparatory work on a set of data and metadata which are to be submitted to Eurostat by early 2000. The Bank also worked closely with the COS to produce a quarterly set of balance-of-payments statistics in line with the standards required by the IMF, while a project to compile Malta's international investment position was also initiated.

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*. During the year the Bank also continued to develop and refine its econometric models of the Maltese economy and to extend their use to other Government agencies. With the assistance of a technical mission from the World Bank, the Bank also developed expertise on pension-reform models.

During the year the Bank participated in a number of forums involved in economic analysis and data compilation both in Malta and abroad. Staff members from the Economics Department sat on joint committees with personnel from the relevant Government departments working on statistics and welfare reform as well as budgetary analysis. Representatives from the Bank, in conjunction with officials from the Ministry of Finance, the Treasury and the COS, also formed part of the Action Group on Government Finance Statistics. The Action Group's remit is to make amendments to the Government's Chart of Accounts so as to ensure that the government-finance statistics are classified in accordance with EU requirements.

2. Regulatory and Supervisory Activities

The Central Bank is responsible, in terms of the Central Bank of Malta Act, for promoting a sound financial structure and fostering an orderly capital market in Malta. Furthermore, as the Competent Authority in terms of the Banking Act, 1994 and the Financial Institutions Act, 1994, the Bank has the duty to licence, regulate and supervise banks and financial institutions, while in terms of the Malta Stock Exchange Act it is also responsible for supervising the Exchange so as to protect investors and promote a sound securities market.

The Joint Banking Committee, which is set up in terms of the Banking Act, is the body responsible for formulating banking regulatory and supervisory policy and monitoring the soundness of the banking system. The Committee is chaired by the Governor and includes four other officials of the Bank, two representing the Bank as the Competent Authority and two in connection with the Bank's responsibilities under the Central Bank of Malta Act. During 1999 the Committee met eight times to discuss and approve amendments to Banking Directives and Financial Institutions Directives.

The Central Bank of Malta, the Malta Financial Services Centre and the Malta Stock Exchange continued to discuss matters of mutual interest within the Regulatory Co-ordination Forum.

During the year a senior Central Bank official, together with a senior official from the Malta Financial Services Centre, visited the Austrian Federal Ministry of Finance and the central bank of Austria as part of a programme of regular meetings between the regulators from the two countries. In this regard it is of interest to mention that in recent years a number of Austrian banks were granted licenses to operate in Malta.

2.1 Policy Developments

In September the Minister of Finance published the Penalties for Offences Regulations 1999[17]. These regulations specify the penalties, including fines and terms of imprisonment, to be imposed in the case of violations of the Banking Act. In certain cases they also empower the Competent Authority to impose administrative penalties. Appeals against decisions imposing such penalties may be lodged with the Tribunal for Financial Services.

In October the Bank amended the procedures for the establishment of limits, in terms of Section 38B of the Central Bank of Malta Act, on the amount of foreign assets that banks may hold. Whereas previously these limits were expressed in absolute terms, they are now set as a proportion of each bank's own funds.

During 1999, following approval by the Joint Banking Committee, the Central Bank amended a number of Banking Directives and Financial Institutions Directives so as to bring them in line with internationally recognised standards. The amendments, which were largely administrative, concerned the Directives on licensing, large exposures, own funds, solvency and the submission and publication of financial information. Furthermore, the final two annexes to the Capital Adequacy Directive, those concerning large exposures and commodities risk, were issued during the year.

As Competent Authority the Bank also issued a number of notices and policy documents to banks and financial institutions so as to help them conduct their business prudently. Three notices addressed to banks dealt with internal control systems, interest rate risk and advertising for deposits. Two policy documents, dealing with venture capital activities and financial leasing, were addressed to financial institutions.

The Bank intends to continue introducing and upgrading regulations, particularly on deposit

[17] See Legal Notice 155 of 1999.

Box 1: Banks and Financial Institutions Licensed to Operate in Malta

Credit Institutions Licensed under the Banking Act (1994)

APS Bank Ltd[1]	HSBC Home Loans (Malta) Bank Ltd[8]
Bank of Valletta plc[1,9]	Iktisat Bankasi AS[2,3]
Demirbank T.A.S.[2,3]	Investkredit International Bank Malta Ltd[2,5]
Disbank Malta Ltd[2,5]	Izola Bank Ltd[2,6]
EGS Bank[2,3]	Lombard Bank Malta plc[1]
First International Merchant Bank Ltd[6]	Raiffeisen Malta Bank plc[2,5]
HSBC Bank plc - Malta Branch[1,3,8]	Tekstil Bankasi AS[2,3]
HSBC Bank Malta plc[1,8]	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[8]
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[9]
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[2,9]	HSBC Overseas Bank (Malta) Ltd[2,8]
Erste Bank (Malta) Ltd[2,7]	Volksbank Malta Ltd[2]

1 Deposit money bank
2 Licensed to operate with non-residents
3 Licensed to operate as a branch
4 Licensed to provide foreign exchange services
5 Subsidiary of foreign bank
6 Established and incorporated in Malta
7 Erste Bank (Malta) Ltd was set up on May 23, 1998 following a merger between First Austrian Bank Malta Ltd and GiroCredit Bank Malta Ltd.
8 Member of HSBC Group
9 Member of BOV Group

guarantee schemes and the consolidated supervision of credit institutions, so as to bring them in line with EU law and international standards.

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 1999. In order to obtain a licence, banks and financial institutions have to satisfy a number of requirements, such as holding a minimum level of own funds. Additionally, shareholders and managers must be deemed “fit and proper” persons.

In the course of the year the Central Bank, as the Competent Authority in terms of the Banking Act, licensed two new credit institutions to start operating from Malta. In January it licensed Tekstil Bankasi AS to conduct the business of banking through the operation of a branch in Malta. In March, the Bank granted a similar licence to Iktisat Bankasi AS. Both banks have their head offices in Turkey and they were licensed to carry out business solely in foreign currency and with non-residents. Furthermore, in

June, Barclays Bank plc was authorised to open a representative office in Malta.

In May, a licence was granted to Change Mart Financial Services Ltd to carry out the business of a financial institution in terms of the Financial Institutions Act, 1994. The company can issue and administer means of payment and trade in foreign exchange.

Following the acquisition by HSBC Bank plc of the Government's majority stake in Mid-Med Bank plc earlier in the year, the Central Bank issued a licence to HSBC Bank Malta plc to reflect the change in the name of the institution. All the other terms and conditions of the original licence remained unchanged. Similarly, new licences were issued for Mid-Med Bank's subsidiaries, Lohombus Bank Ltd and Mid-Med Finance Ltd, which changed their names to HSBC Home Loans (Malta) Ltd and HSBC Finance (Malta) Ltd respectively.

During the year the conditions of one licence granted to a financial institution were amended to extend the range of activities it was allowed to carry on. No licences were restricted or revoked during the year. A list of credit and financial institutions that are licensed to operate in Malta is given in Box 2.

2.3 Supervision of Credit and Financial Institutions

As the Competent Authority in terms of the relevant legislation the Central Bank supervises credit and financial institutions to ensure that they comply with the provisions of the relevant Acts and Directives. Supervision is carried out by a team of 14 inspectors and is conducted through a combination of on-site inspections and off-site supervision. In both cases inspectors apply a risk-management approach. Inspection reports on their findings are transmitted to the institutions concerned. As part of the supervisory process, the Bank also meets licensed institutions' external auditors and evaluates their annual management letters and each institution's replies.

During 1999, the Bank's inspectors carried out twenty on-site inspections. These covered a range of issues including credit risk and asset quality, the preparations for the millennium changeover, internal audit functions and adherence to licensing requirements and internal controls at financial institutions. The inspectors also checked the accuracy of reporting by licensed institutions. Local subsidiaries and branches of foreign-owned institutions were included in the inspection programme.

Off-site supervisors examine the statutory returns that credit and financial institutions regularly submit to the Central Bank. Apart from the structure of the institutions' balance sheets, inspectors focus on market risk and profitability and assess the management and organisation of each institution. During the year the Bank carried out surveys on a number of issues, including operational risks and corporate governance, as part of its assessment of licensed institutions' risk management capability.

2.4 Other Activities

During 1999 the Bank continued to monitor developments on the Malta Stock Exchange through its representative on the Stock Exchange Council and through regular liaison with the Exchange itself. In particular, the Bank examined various internal workings of the Exchange. The Bank evaluated the Exchange's responses in a series of bilateral meetings.

The Central Bank continued to play a key role in combating money laundering. The Bank is represented on the Joint Committee on the Prevention of Money Laundering, which includes representatives from the Attorney General's Office, the Police, the banks and other regulators. A senior Bank official participated in the meetings of the Council of Europe Select Committee of Experts on the Evaluation of Money Laundering. In March, the Bank organised a seminar on money laundering for gaming board inspectors aimed at increasing awareness of the legal requirements in this area.

During the year the Bank also monitored the preparations being made by credit and financial institutions for the Year 2000. Banks and financial institutions acted to ensure that the date change would not affect their operations and drew up contingency plans in line with an agreed national programme. The Bank reported on the status of compliance of the local banking sector to the Bank for International Settlements in Basle. The Bank planned to continue to follow progress in this area to minimise spillover risks, particularly in the first quarter of 2000.

3. Banking and Currency Operations

3.1 Banking Operations

As banker to the Government and to the domestic banking system, the Central Bank of Malta provides various banking services to government departments, public sector corporations and credit and financial institutions. The Bank also advises the Government and public corporations on financial matters and provides a limited range of banking facilities to its own staff.

3.1.1 Banker to the Public Sector

The services offered by the Bank in its role as banker to the Government, include the acceptance of deposits and the provision of payments, foreign exchange and money transmission services.

Deposit and Credit Facilities

The Central Bank maintains a variety of deposits, including demand and time deposits, both in Maltese lira and in foreign currencies, for the Treasury and other government departments, public sector corporations and Malta Government Sinking Funds.

Since 1995 the Government has not had recourse to the short-term borrowing facility, known as the Ways and Means facility, available at the Bank. On December 31, 1999, the Minister of Finance, through Legal Notice No 224, brought into force, with effect from January 1, 2000, the provisions of Section 15 of the Central Bank of Malta Act which effectively abolished the Ways and Means borrowing facility.

Payments Services

As in past years, the Central Bank continued to cash cheques drawn on itself and issued by government departments. The number of such cheques cashed in 1999 remained stable at around 2.3 million. The value of these cheques, however, at Lm429.5 million, was Lm5 million below the previous year's level – possibly due to the increased use of credit cards and direct credits. During the year, the Central Bank adopted a policy of truncation of cheques whereby the Bank retains all the cheques drawn on it, providing cheque images only when requested.

In order to reduce costs relating to the processing of cheques, the Bank continued to encourage the direct crediting of accounts when effecting government payments. In 1999 the value of payments effected in this way amounted to Lm75.9 million, an increase of 32% over the previous year. Part of the increase was attributable to the direct crediting of old age pensions, which had been introduced in December of the previous year. Increases were also registered in direct credit payments of salaries, pensions and social security benefits, as more people began to appreciate the advantages of this system.

Foreign Exchange Services

The Bank provides foreign exchange services to the Government and public sector corporations. These include transactions supported by letters of credit, inward/outward bills for collection, inward transfers and guarantees. Other foreign exchange transactions are carried out by means of SWIFT or bank drafts. The Bank also provides foreign exchange to government delegations travelling abroad. During 1999 the value of foreign currency receipts processed on behalf of the Government and public sector corporations rose from Lm52.5 million to Lm156.1 million. Of this amount, about Lm71 million represent part proceeds from the sale of Mid-Med Bank plc. At the same time, the value of foreign currency payments made on their behalf rose from Lm75.4 million to Lm84.7 million.

Other Services

The Central Bank also effects payments connected with the servicing of Government's external debt. During 1999 repayments of capital amounted to Lm4 million, whereas Lm1.7 million were paid in interest. During the year the Government transferred

Lm2.9 million to sinking funds earmarked for future external debt repayments.

The Bank also administers 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 on a quarterly basis.

The Central Bank also administers the Foreign Pensions Subsidy Scheme on behalf of the Government. Under this scheme Maltese nationals who receive a pension in foreign currency from the United Kingdom, the United States, Australia or Canada are entitled to a means-tested subsidy if they suffer losses on account of exchange rate fluctuations. In view of the strength of the relevant currencies during 1999, the total amount of subsidy paid under the scheme, Lm28,463, was down by 21% from the previous year's level.

3.1.2 Banker to the Banking System

In terms of the Central Bank of Malta Act, the Bank may act as banker to credit and financial institutions. Accordingly, the Bank offers deposit and credit facilities to the banking sector. It also manages the local payments and settlements systems.

Deposit and Credit Facilities

The Central Bank offers deposit facilities in Maltese lira and in foreign currency to the domestic credit and financial institutions. The credit institutions, in turn, use these balances at the Central Bank to satisfy the reserve requirements imposed on them by the Bank, to settle inter-bank transactions and to carry out their daily operations in the domestic financial markets.

Domestic banks are also eligible for short-term credit from the Central Bank. This they can obtain either through the discount window or by way of loans backed by collateral. The operation of these lending facilities is discussed in more detail in Chapter 1 of Part II in this Report.

Payments System

The Central Bank is a key player in the domestic payments system. In fact, all inter-bank transactions are settled through the accounts held at the Central Bank by the other banks. The Bank also maintains settlement accounts for the Malta Stock Exchange to enable brokers to settle trades in securities that are listed on the local capital market.

The Central Bank accepts payment instructions from credit institutions, generally via SWIFT. During 1999 the number of inter-bank transactions totalled 13,071, while their value rose by 77% to Lm 3,054 million. The Bank also manages the Malta Clearing House through which cheques are settled. In 1999, the volume of cheques processed continued to increase, surpassing 7 million. The value of these cheques amounted to Lm2,390 million, up by 8.9% from the previous year's level.

As from April 1999, the process of the cheque clearing was changed from a net to a gross settlement basis. This means that, instead of settling net balances at the end of the clearing as previously, each bank now pays the full amount of the cheques drawn on it but negotiated by other banks. This change contributed to the increase in the volume of inter-bank transactions, which are settled through the Bank's real time gross settlement system via SWIFT.

3.2 Currency Operations

As issuer of the currency, the Central Bank must ensure that the supply of currency notes and coins is at all times sufficient to meet demand. The Bank is also responsible for the regular examination of notes and coins returned to it to see that they are still fit for circulation and for ensuring that counterfeit notes and coins are quickly detected.

3.2.1 Note and Coin Issue

At the end of 1999 the total stock of currency notes and coins in issue amounted to Lm418.5 million, an increase of 7.4% when compared to the previous year.

The stock of currency notes circulating outside the Central Bank stood at Lm402 million at the end of December, up by Lm 28.2 million from a year earlier. This increase reflected a higher value of notes issued

Table 3.1

CURRENCY NOTES AND COINS ISSUED BY AND PAID INTO THE CENTRAL BANK OF MALTA IN 1999

Lm thousands

	Notes and Coins			Currency Notes & Coins Issued and Outstanding[1]	Monthly % Change
	Issued	Paid-In	Net Issue		
January	6,524	15,985	-9,461	380,045	-2.43
February	9,852	9,853	-1	380,083	0.00
March	15,934	9,347	6,587	386,633	1.73
April	12,825	12,126	699	387,332	0.18
May	15,065	10,520	4,545	391,877	1.17
June	15,306	9,485	5,821	397,699	1.49
July	14,671	14,714	-43	397,656	-0.01
August	12,903	12,641	262	397,917	0.07
September	12,796	13,119	-323	397,594	-0.08
October	11,780	14,001	-2,221	395,372	-0.56
November	13,904	12,491	1,413	396,785	0.36
December	29,226	7,526	21,700	418,485	5.47
1999	**170,786**	**141,808**	**28,978**	**418,485**	**7.44***
1998	159,681	154,831	4,850	389,506	1.26*

[1] Includes Currency in Circulation and Currency held by Banking System.

* Annual percentage change.

coupled with a lower value of notes paid into the Bank. Of the total value of notes issued, 64.8% consisted of re-issued notes, while the remainder 35.2% were notes in mint condition.

Chart 3.1 shows the composition of the stock of currency notes outstanding at the end of 1999. During the year, the importance of the Lm10 note increased further, despite the fact that the 3rd series Lm10 note was withdrawn completely from circulation. The Lm10 note represented 64.5% of the value of notes outstanding at year end. Meanwhile, the share of the Lm20 note in the total value of notes outstanding fell to 27%. The Lm5 and Lm2 notes maintained a stable share.

At the end of 1999 the value of the outstanding stock of coins amounted to Lm16.5 million, 5% more than at the end of the previous year. The total value of coins issued exceeded the value of coins returned to the Bank by Lm0.8 million. The shares of the different coin denominations in the total, however, remained largely unaltered. As Chart 3.2 shows, the Lm1 coin maintained the highest share, 30.2%.

The demand for currency notes and coins continued

CHART 3.1 COMPOSITION OF THE LM402 MILLION IN CURRENCY NOTES ISSUED AND OUTSTANDING IN 1999

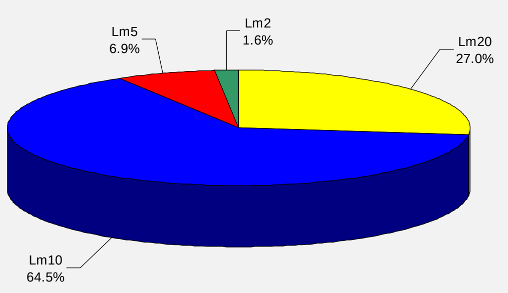


CHART 3.2 COMPOSITION OF THE LM16.5 MILLION IN COINS ISSUED AND OUTSTANDING IN 1999

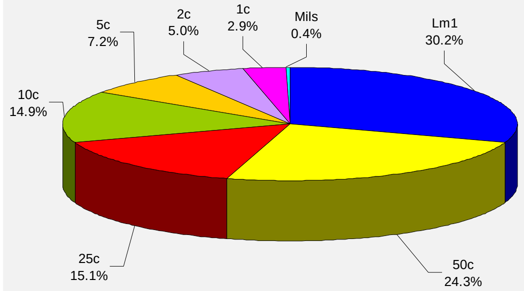
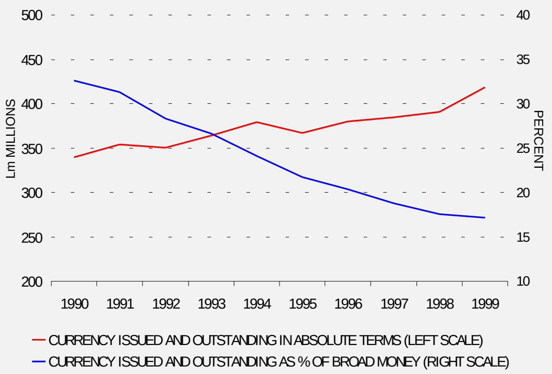


CHART 3.3 CURRENCY ISSUED AND OUTSTANDING



to exhibit the usual seasonal pattern, as Table 3.1 indicates. In January there was a drop of Lm9.5 million, as credit institutions disposed of excess currency holdings accumulated during the festive season. In December, on the other hand, there was a significant increase in the demand for notes and coins. Apart from the usual seasonal factor, this also reflected the precautionary build up of cash by the banks towards the end of the year on account of the Millenium change.

Chart 3.3 illustrates the trend followed by currency in issue over the last decade, both in absolute terms and as a percentage of broad money. This shows that whereas the absolute level of currency in issue increased more sharply in 1999, its share in broad money continued to decline, albeit at a slower pace than previously.

During 1999, the Currency Examination Room of the Bank's Issues Office examined a total of 15.8 million notes. Of these, 11.1 million were found fit for re-issue, while the other 4.7 million were found to be in poor condition and were consequently destroyed. The total number of coins examined during 1999 amounted to 5.6 million.

3.2.2 Commemorative Coins

In December 1999 the Central Bank issued a silver coin to commemorate the three-hundredth anniversary of the death of the painter Mattia Preti. 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 U.K. It has a finesse of 0.925 silver, a diameter of 38.61mm and weighs 28.28 grams. It has a legal tender value of Lm5, and is subject to a minting limit of 5,000. The reverse side of the coin depicts a self-portrait of Mattia Preti and a drawing of St John the Baptist, a detail from one of his works. The obverse side shows the coat of arms of Malta and the year of issue.

3.2.3 Anti-Counterfeit Measures

During the year, the Central Bank continued to monitor closely all incidents of counterfeit currency. In December, in order to increase public awareness of the anti-counterfeit features of the currency, the Bank issued illustrative posters and brochures to be displayed in all bank branches.

Box 2:
Payments and Settlements System in Malta

A payments and settlements system may be defined as a group of institutions and a set of instruments and procedures used to facilitate the circulation of money in an economy. Clearly, the existence of a properly functioning payments system is crucial both to the efficient functioning of a market economy and to its management, particularly though monetary policy.

According to a survey carried out by the Central Bank, **payments by cheque** still accounted for about 74% of the value of retail payments in Malta in 1999. This translates into some 11 million cheques – or 53% of the instruments exchanged - annually, of which **7** million, valued at Lm2,390 million, are cleared through the payments system. The significant share of the market that the cheque occupies, in volume terms, has forced the pace of development of the domestic payments system to the point that there now exists a virtually dematerialised cheque clearing system in which cheques are no longer returned to the payer, but are "truncated" at (or kept by) the paying bank. Items are handled, from the point of presentation to the point of payment, only in electronic form. Settlement for the cheque clearing takes place in real time (that is instantaneously) through the respective banks' operating accounts at the Central Bank of Malta.

Rapid progress has also been made in the use of **other forms of payment**, such as direct debits and direct credits. The number of debit/credit cards in Malta has reached 250,000. The continued expansion in the use of the plastic card, both in its credit and in its debit card form, has contributed to greater flexibility in the way retail payments are handled. A network of 120 Automated Teller Machines (ATMs) and 3,600 Electronic Point of Sale Machines (EPOs) and home banking products give bank customers direct access to accounts with all domestic banks operating in Malta. Both the volume and the value of transactions effected through ATMs and EPOS now run into millions.

The value of **cross border payments**, that is payments from and to abroad, transacted by the local banking system in **1999** amounted to some Lm 2,400 million, more or less equally distributed between inward and outward transfers. This figure is equivalent to 170% of Malta's nominal GDP, reflecting the high degree of openness of the Maltese economy.

All inter-bank Maltese liri transfers in respect of **money market transactions**, **foreign exchange deals** or other **inter-bank settlements** are made in real time through the Central Bank of Malta. These large value payments number around 100 per day, and in 1999 their value reached Lm3,054 million. The volumes that pass through the payments system in respect of money market transactions associated with monetary operations amounts to Lm1,800 million, equivalent to around 120% of GDP.

Settlement of transactions involving sales and purchases of securities quoted on the **Malta Stock Exchange** is also carried out through a clearing account at the Central Bank, where daily business is netted on behalf of the licensed brokers. The volume of business transacted through the Stock Exchange account generates about 100 deals daily.

4. Internal Management

4.1 Administration

4.1.1 The Governor and Board of Directors

On October 1, 1999 Mr M C Bonello was appointed Governor of the Central Bank for a period of two years, replacing Mr E Ellul whose term of office expired on September 30. Earlier in the year, Mr D A Pullicino was appointed Deputy Governor for a period of five years with effect from July 1, 1999. Mr Pullicino was previously Deputy General Manager responsible for the Bank's International Markets Division.

At the end of 1999 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 held 22 sittings during the year.

4.1.2 Management

The Executive Management Committee is responsible for all decisions on the Bank's internal management and administration. During 1999 the Committee, which is composed of the Governor (as Chairman), the Deputy Governor and the five Deputy General Managers of the Bank, met on a regular basis to discuss management issues and to implement administrative decisions made by the Committee itself or by the Board of Directors. The Committee held 47 meetings during the year.

Mr J V Laspina, General Manager of the Bank, retired on September 30, 1999 on reaching pensionable age. Following the appointment of the Deputy Governor and the retirement of the General Manager a re-structuring of certain divisions within the Bank was undertaken. Thus the departments and offices responsible for domestic and foreign financial market operations were merged into a single division, which was renamed the Financial Markets Division, while the Correspondent Banking Office, which deals with the Bank's relations with international banks was placed directly under the responsibility of the Deputy Governor. At the same time, the Security Department was allocated to the Resource Management Division while the Issues Office was transferred to the Finance and Banking Division. The Research Management Division and the Banking Supervision and Audit Division were left unchanged.

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 1999 Mr E Ellul, then Governor, attended the Annual Meeting of the European Bank for Reconstruction and Development (EBRD) in London. Later in the month he attended the Spring Meetings of the International Monetary Fund (IMF) and the World Bank, which were held in Washington DC.

In May the Governor led a Central Bank delegation consisting of senior management officials to the European Central Bank (ECB) in Frankfurt for a one-day familiarisation visit. The visit was related to the Central Bank's preparations for EU accession. In June Mr Ellul attended the Central Bank Governors' Symposium hosted by the Bank of England and the 69th Annual General Meeting of the Bank for International Settlements (BIS) in Basle.

In September the Deputy Governor, Mr D A Pullicino, who is Malta's Alternate Governor on the IMF's Board of Governors, attended the joint Annual Meetings of the IMF and the World Bank in Washington DC. Mr Pullicino was accompanied by Mr A Lupi, a director of the Bank. In November the new Governor, Mr M C Bonello, attended a seminar for central bank governors of Euro-zone states and EU accession countries organised by the European Central Bank in Helsinki. During the seminar Mr Bonello presented a paper on the development of Malta's money market.

4.2 Human Resources

The full-time staff complement of the Central Bank at the end of 1999 stood at 307, two more than at the end of 1998. In addition, the Bank had in its employment 18 employees on a part-time basis. During the year a member of the executive staff passed away while in the service of the Bank.

Three Trainee Research Officers, one Legal Officer and seven clerks were recruited during the year. As in previous years, the Bank also offered temporary employment under the student-sponsorship scheme to four students pursuing studies in banking and related subjects at the University of Malta and the Paolino Vassallo Upper Lyceum.

4.2.1 Training and Development

The Bank continued to organise extensive training programmes for its staff during the year. These included both in-house and external courses in Malta and overseas.

A total of sixteen in-house training courses were organised, most of which focused on the new accounting system installed at the Bank on April 1, 1999. Several courses, including two on the Bank's new Library Management System, were related to computer training. Other courses covered such areas as management and supervisory development, cashier duties and effective report writing techniques. A total of 267 employees attended the in-house training programme. Apart from this, the Bank sponsored two clerks to follow full-time courses in Law and Information Technology at the University of Malta.

During the year the Bank, in conjunction with Caritas – Malta, also launched an Employee Assistance Programme. This was intended to help employees identify, control and find solutions to personal problems. The launching of the programme was preceded by an awareness session, which was attended by the Bank's senior and middle management.

The Bank also hosted a training session on 'Business Objects' organised by the international software company CITIL. Apart from officials of the Central Bank of Malta, representatives from Rabo Bank Istanbul and FBME Cyprus also attended the session.

A total of 87 employees also participated in external seminars and courses organised by a number of local institutions. The topics covered included issues related to management, industrial relations, economic development and information technology. Thirty-two employees attended specialised courses and conferences organised by foreign central banks - including the Bank of England, the Banque de France, the Federal Reserve Bank of New York and the Swiss National Bank. The topics covered included monetary and economic analysis, economic modelling, banking supervision, accounting and auditing techniques, financial stability, security and risk management, the functions and operations of the European System of Central Banks, the payments system and note printing and distribution.

In the last quarter of the year, an executive from the Bank's Economics Department was given the opportunity to work with the European Commission in Brussels on an attachment basis. The attachment took place at the unit responsible for *Monetary Affairs of the Euro Area and other Member States, ERM II*, which is a part of Directorate General, Economic and Financial Affairs, within the Commission.

4.2.2 Academic and Professional Courses

At the end of the year 26 employees were benefiting from the Bank's Study Scheme, which was launched in 1998. The Scheme provides financial support to members of the staff who wish to pursue professional studies on their own initiative.

During 1999 an executive from the Human Resources Department successfully completed his post-graduate studies and obtained a degree in Business Administration from Henley Management College, while an executive from Compliance Office was awarded a post-graduate degree in Management from the University of East Anglia. In addition, two employees obtained the dual qualification leading to the award of the BSc Honours degree in Financial Services and the ACIB Diploma, while another staff member obtained a degree in Theology and Human Studies from the University of Malta. Two other staff members obtained a Diploma in Social Studies (Industrial Relations) from the University of Malta, while seven others obtained the Banking Certificate issued by the Chartered Institute of Bankers - Malta.

At the end of 1999, 56 members of staff were pursuing studies on a part-time basis, either through distance learning or by attending courses offered by local professional bodies or the University of Malta. Among these were two employees who were following post-graduate courses and 23 employees who were following courses leading to various diplomas. Another 31 employees were following first degree programmes offered by the Chartered Institute of Bankers, the Malta Institute of Accountants and other professional bodies.

4.2.3 Gender Equality

The Bank continued to attach great importance to issues related to gender equality. With a view to providing equal opportunities for both male and female staff, the Bank introduced a reduced-hours working schedule, thereby enabling employees having children under four years of age to cope better with their family and work commitments.

At the end of 1999 female employees constituted 33.1% of the Bank's full-time staff complement. During the year there was a substantial increase in the number of female employees participating in training and development activities. Thus 50% of all staff members engaged in part-time self-development programmes during 1999 were female.

4.2.4 Collective Agreements with Trade Unions

During the year the Bank renewed its agreements with the unions representing clerical employees and non-clerical employees. Both agreements remain valid until December 31, 2001.

4.3 Premises

Work related to the refurbishment of the foyer at the main Central Bank building commenced in mid-January and was completed in September 1999. During the refurbishment process every effort was made to ensure consistency between the new design and the original surroundings.

The refurbished foyer now houses, in appropriate displays, two collections: one of numismatic coins and another of currency notes that had been in circulation in Malta since 1914. The display also includes all the commemorative coins issued by the Bank.

4.4 Information Technology

During the first half of 1999 the activities of the Bank focused on the upgrading of hardware and the adaptation of procedures necessary for the implementation of the Bank's new accounting system, Flexcube. The latter resulted in a transition from a proprietary to an open operating system.

The Bank also conducted a re-engineering exercise so as to optimise the capacity and efficiency of the new system. The replacement of the IBIS accounting system by Flexcube significantly reduced the number of operations required for the input of a single transaction, eliminated the need for a number of manual operations and provided users with a real time system. A major advantage was the integration of Reuters and SWIFT on the same accounting platform, thus generating SWIFT messages in straight-through-processing mode.

During the second half of the year, the Bank proceeded with the development of software applications to complement the new system. New applications were developed for the Banking Office, Administration Office and Money and Capital Markets Offices. In the later part of the year, much activity centred on the preparation of a Y2K contingency plan.

4.5 Risk Management and Audit

The task of the Bank's Risk Management Unit is to identify, gauge and analyse all potential risks arising from internal and external sources relevant to the Bank. Upon the finalisation of a Year 2000 compliance strategy in March 1999, the efforts of the Unit focused on Year 2000 contingency planning and testing.

Detailed process-centric contingency plans were drawn up, in conjunction with the various offices, and upon endorsement by the Board of Directors, these were subsequently tested. The Unit also collaborated with Challenge 2000 and the Department of Civil Protection in the drawing up of a National Y2K Contingency Plan.

In accordance with an Executive Management Committee decision calling for the institution of the appropriate internal controls to improve risk management, the Unit also embarked on an exercise aimed at overhauling the Bank's Standing Instructions. This was necessitated by the procedures resulting from the implementation of the Bank's new accounting system.

The Bank also continued to ensure that high standards of accountability were maintained throughout the organisation through the application of comprehensive internal audit procedures. To this end, the Audit Department carried out a detailed evaluation of the Bank's control processes with a view to mitigating risk and ensuring the highest standards of efficiency.

The Audit Department also conducted a number of additional investigations on a one-off basis so as to ensure a more comprehensive evaluation of procedures in view of the far-reaching changes that occurred in 1999. These included the advent of the euro, the introduction of the new accounting system and the Bank's Y2K compliance planning. Office processes were automated further, thereby enhancing the Department's overall flexibility and providing it with easy access to all the information required for the satisfactory completion of its investigations.

4.6 Information Services

4.6.1 Awareness Campaigns

During the year, the Bank, in collaboration with the media, brought a number of issues to the attention of the public. Among these were matters related to the banking and financial system, including decisions taken by the Bank's Monetary Policy Council, money laundering and the risks posed by fraudulent financial schemes.

4.6.2 Website

In 1999 the Central Bank of Malta launched its own website, *www.centralbankmalta.com*, displaying information related to the Bank and the services it offers. The site includes information about the Bank's history and its functions, the national currency, exchange rates, the money market and financial legislation. It also displays press releases and statistical releases issued by the Bank, together with the Bank's Annual Report and Quarterly Review.

4.6.3 Publications

As in past years the Bank continued to provide an independent analysis of economic and financial developments in Malta and abroad through the publication of the four issues of its Quarterly Review. The Reviews included a number of specialised articles on economic and financial topics - such as funded pension schemes, current account sustainability and harmonised indices of consumer prices.

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, 1998. The Report also included a comprehensive analysis of economic and financial developments during that year.

Throughout the year, the Bank continued to publish data on monetary aggregates and their determinants. These monthly statistical releases included figures on the money supply, the external reserves and domestic credit, together with a brief commentary on the latest developments. The Bank also continued to publish a weekly report on developments in the money market.

4.6.4 Library

As the main source of information on banking, finance and economic matters in Malta, the library of the Central Bank continued to be used by various organisations, including government departments, authorities and agencies, credit and financial institutions and private firms as well as the Bank's staff. The general public, particularly those engaged in research work, were also regular users of the library's facilities. In August 1999, following an extensive exercise to identify its present and future requirements, a modern integrated system, called Olib7, was installed in the Bank's library.

During the year the library also continued to develop its collection of publications on CD-ROM with the addition of the Laws of Malta and Justis, a publication that includes all European Union legislation. The library also subscribed to an increasing number of journals and periodicals.

The library also continued to maintain and update its comprehensive newspaper clippings service, by monitoring a wide selection of local and foreign newspapers, and compiling the most important news items in a weekly digest for internal circulation.

Meanwhile, 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 were also updated and maintained in a separate depository adjacent to the library.

4.7 Social, Cultural and Educational Activities

During 1999, as in previous years, the Bank organised various activities of a social, cultural and educational nature. As part of the commemorative festivities of its 31st anniversary, the Bank organised the customary concert of classical music, which was held at the Mediterranean Conference Centre during the month of April.

In October the Bank held a three-day regional workshop on financial sector reform for central bankers from countries that have applied for membership of the European Union. The workshop, which was entitled *Financial Sector Reform – Preparing for EU Membership*, was attended by delegates from the central banks of twelve applicant countries including Malta. The delegates discussed their respective experiences regarding institutional reform and market restructuring within the financial sector in preparation for EU membership. The workshop was organised with the assistance of the European Central Bank and the central banks of France and Ireland, all of which provided facilitators.

Earlier in the year, the Bank also hosted a two-day conference for the Offshore Group of Banking Supervisors. The conference was organised in conjunction with the Malta Financial Services Centre.

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

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

5. Relations with International Institutions

As in previous years, the Central Bank, was actively involved, during 1999, in all matters related to Malta's membership of international institutions. These institutions include the International Monetary Fund (IMF), the International Bank for Reconstruction and Development (IBRD) or World Bank, the Multilateral Investment Guarantee Agency (MIGA) - an affiliate of the World Bank group - and the European Bank for Reconstruction and Development (EBRD). The Minister of Finance is the Governor for Malta on the Board of Governors of the IBRD, the MIGA and the EBRD, while the Governor of the Central Bank is the Governor for Malta on the Board of Governors of the IMF and the Alternate Governor on the Board of Governors of the EBRD.

The Central Bank has regular contacts with the Bank for International Settlements (BIS), particularly on matters related to banking supervision. Although the Bank is not a member of this institution the Governor of the Central Bank attends the Annual Meeting of the BIS where the Bank has observer status.

The Central Bank is also involved in matters related to Malta's obligations under the World Trade Organisation (WTO) Agreement, especially those connected with the liberalisation of financial services and capital movements. In this regard the Bank participated in a working group on WTO issues established by the Ministry of Foreign Affairs.

Following the re-activation of Malta's application to join the European Union in September 1998, the Central Bank also became actively involved in the EU screening process. The Bank also took a number of initiatives to strengthen its relationship with various European central banks, including the European Central Bank (ECB). These included the workshop on financial sector reform mentioned in the previous chapter of this Report.

5.1 International Monetary Fund (IMF)

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

During 1999, as a result of the Eleventh General Review of Quotas that had been approved by Fund members in 1997, Malta's quota in the Fund rose from SDR67.5 million to SDR102.0 million. The Bank completed all the procedures related to the quota increase early in the year and effected payment by the end of the first quarter. As a result, Malta's reserve position with the IMF rose by Lm6.0 million to Lm22.8 million (or SDR40.2 million). The IMF's holdings of Maltese currency also rose, by Lm15.9 million, to stand at Lm35.0 million at the end of the year.

As regards transactions in SDRs, the Central Bank effected net payments of SDR21.9 million (about Lm11.7 million) during 1999. Part of this amount was in settlement of the quota increase while the remainder was related to the operations of the Fund's SDR Department. Consequently, Malta's total holdings of SDRs at the end of 1999 stood at SDR22.5 million (or Lm12.7 million) compared with SDR44.4 million (Lm23.6 million) at the end of 1998.

As part of its support for the IMF's Heavily Indebted Poor Countries Initiative, Malta contributed a grant of SDR0.7 million (about Lm0.4 million) - which was the amount that had accumulated in its favour in the Fund's Second Special Contingent Account (SCA-2). The SCA-2 consists of deposits held with the Fund by members in creditor position, like Malta. These balances may be transferred back to the Fund with the consent of the individual member countries concerned.

Under Article IV of the Fund's Articles of Agreement, the IMF exercises surveillance over its members' exchange rate policies and, for this purpose, bilateral discussions with individual country members are held regularly. In the case of Malta bilateral discussions are held every two years. During these consultations, an IMF staff team visits the country, collects economic and financial information, and discusses with senior officials from both the public and private sectors the country's economic developments and policies. An Article IV Consultation Mission visited Malta in March and had meetings with the Minister of Finance, the Minister of Economic Services, the Governor of the Central Bank and senior officials of the Bank and various Ministries. The Mission also had meetings with representatives of the private and parastatal sectors, the commercial banks and the trade unions.

In its efforts to strengthen the international financial system and promote transparency, the IMF's Executive Board, in the first half of the year, launched a pilot project under which member countries would voluntarily release the staff reports prepared by Fund mission teams at the conclusion of Article IV consultations. Malta was among the first group of countries that agreed to participate in this project. Consequently, the IMF Staff Report on Malta, which was prepared following the visit of the Fund's Article IV Consultation Mission team in March, was released to the media in July.

Over the year, the Central Bank also continued to receive technical assistance from the IMF. A technical mission from the Fund's Monetary and Exchange Affairs Department visited Malta in February to advise the Monetary Authorities on monetary operations and the implementation of a book-entry system for short-term government securities. Another technical mission, this time from the Fund's Statistics Department, visited Malta at the end of May to advise the Bank on balance-of-payments compilation and methodology.

The Governor of the Central Bank attended the Spring Meetings of the Interim and Development Committees of the IMF and the IBRD in April. In September, the Minister of Finance and the Deputy Governor of the Central Bank led a delegation to the 54th Annual Meetings of the World Bank and the IMF, which were held in Washington D.C.

During the Annual Meetings, the Interim Committee, which is the IMF's principal advisory body, adopted the Code of Good Practices on Transparency in Monetary and Financial Policies and recognised the need for further actions to strengthen governance at both national and international levels. The Code, which is expected to be finalised in the early part of 2000, was discussed with member countries at a series of regional seminars organised by the IMF's Monetary and Exchange Affairs Department. The regional seminar for European countries was held in Basle in the third week of November. Senior officials from the Central Bank and the Malta Financial Services Centre participated in the seminar.

5.2 World Bank (IBRD)

The Central Bank continued to follow developments at the World Bank and to advise and assist the Ministry of Finance on various matters related thereto. In this regard the Bank prepared background information for the Ministry on a number of resolutions proposed by the World Bank's Executive Board which necessitated the approval of member countries.

During the year experts from the World Bank visited Malta on a number of occasions to advise the Government on reforms in the pensions system and on a privatisation strategy.

As agent of the Government, the Central Bank is also responsible for arranging any payments to the IBRD with regard to capital subscriptions. No such payments were effected during 1999.

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.

The Central Bank continued to liaise with the Ministry of Finance on issues related to the EBRD. Here too the Central Bank supplied 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.

A Maltese delegation attended the Eighth Annual General Meeting of the EBRD, which was held in London during the month of April. This was led by the Governor of the Central Bank and included the Permanent Secretary at the Ministry of Finance.

5.4 European Union (EU)

The Bank participated actively in the screening process that the European Commission conducted vis-à-vis Malta as a prerequisite to negotiations leading to accession to the European Union. The Central Bank carried out an examination of a number of chapters of the *acquis communautaire* related to economic and financial issues. These included banking services, capital movements, money laundering, payments systems and Economic and Monetary Union (EMU). Senior management officials of the Bank, led by the Deputy Governor, then participated in three screening sessions which were held at the EU Commission's headquarters in Brussels in the last three months of the year. These sessions related to the Free Movement of Services, the Free Movement of Capital and EMU. The Bank was also represented by a senior official at the screening session on Statistics.

In November the Governor of the Central Bank attended a conference in Helsinki organised by the European Central Bank for central bank governors from Euro zone and EU pre-accession countries. The purpose of the conference was to discuss the preparations that were necessary in the financial sector for EU membership and, at a later stage, for participation in EMU.

Internally the Bank strengthened its structure to focus more actively on issues related to EU membership and EMU, with five main areas being identified for further study. These included EU Banking Directives, the Payments System, the Liberalisation of Capital Controls, Financial Statistics and European Monetary Operations. The Bank also established an Awareness and Documentation Unit to keep management and staff informed of EU developments and the accession process. A Steering Committee made up of senior management officials was set up to co-ordinate all matters relating to the involvement of the Central Bank in the EU accession process and membership of the EMU. On a number of occasions during the year, members of the Bank's Steering Committee attended meetings of the Malta-EU Steering and Action Committee (MEUSAC).

Meanwhile, an EU working group for banks that had been set up in previous years in conjunction with the local banks met regularly during the year to discuss and implement EU directives in the banking field. The Bank also appointed an EU desk officer to liaise with the Ministry of Finance and other government bodies on matters related to the European Union and accession thereto.

Part III

FINANCIAL STATEMENTS

FOR THE YEAR ENDED

31 DECEMBER 1999