# Central Bank of Malta

# THIRTY-FIRST ANNUAL REPORT

# AND

# STATEMENT OF ACCOUNTS

# 1998

The Annual Report is prepared and issued by:
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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 1998)

Mr Emanuel Ellul
Governor

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

**Executive Management Committee**
(As at 31st December 1998)

**Governor**
(Mr Emanuel Ellul)
*Chairman*

**General Manager**
(Mr Joseph V Laspina)

**Deputy General Manager**
Resource Management
(Mr John Agius)

**Deputy General Manager**
Research Management
(Mr Alfred Demarco)

**Deputy General Manager**
Finance and Banking
(Mr Godfrey Huber)

**Deputy General Manger**
International Markets
(Mr David A Pullicino)

**Deputy General Manager**
Advisor to Governor
(Mr Rene G Saliba)

**Deputy General Manager**
Banking Supervision and Audit
(Mr Herbert Zammit Laferla)

**Monetary Policy Council**
(As at 31st December 1998)

**Governor**
(Mr Emanuel Ellul)
*Chairman*

**Director**
Mr Alfred F Lupi

**Director**
Prof Edward Scicluna

**Director**
Mr Saviour Falzon

**General Manager**
(Mr Joseph V Laspina)

**Deputy General Manager**
Research Management
(Mr Alfred Demarco)

**Deputy General Manager**
International Markets
(Mr David A Pullicino)

**Deputy General Manager**
Advisor to Governor
(Mr Rene G Saliba)

**Deputy General Manager**
Banking Supervision and Audit
(Mr Herbert Zammit Laferla)

**Investments Policy Committee**
(As at 31st December 1998)

**Governor**
(Mr Emanuel Ellul)
*Chairman*

**General Manager**
(Mr Joseph V Laspina)

**Deputy General Manager**
Finance and Banking
(Mr Godfrey Huber)

**Deputy General Manger**
International Markets
(Mr David A Pullicino)

**Deputy General Manager**
Advisor to Governor
(Mr Rene G Saliba)
*Observer*

**Manager**
Economics Department
(Mr Anton Caruana Galizia)

**Manager**
Investments & Reserves
(Mr Saviour Briffa)

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* Mr Peter Baldacchino was director until November 14, 1998. Mr Saviour Falzon was appointed director on November 15, 1998.

# THE BOARD OF DIRECTORS

(As at 31st December 1998)

*Left to right:*

Mr A F Lupi (Director), Mr H Zammit Laferla (Secretary), Mr E Ellul (Governor and Chairman), Mr S Falzon (Director), Prof E Scicluna (Director)

# Organisation of the Central Bank of Malta

(showing the different departments and offices in the Bank)

- Governor
  Mr Emanuel Ellul
  - Deputy General Manager
    Advisor to Governor
    Mr Rene G Saliba
  - General Manager
    Mr Joseph V Laspina
    - Deputy General Manager
      International Markets
      Mr David A Pullicino
      - Investments
      - Correspondent Banking
    - Deputy General Manager
      Resource Management
      Mr John Agius
      - Human Resources
      - Administration
      - Information Technology
    - Deputy General Manager
      Research Management
      Mr Alfred Demarco
      - Balance of Payments
        *Exchange Control,*
        *Data Compilation*
      - Economics
        *Research and Analysis,*
        *Statistics*
      - Information Services
        *Records Management Services,*
        *Library,*
        *Governor's Office*
    - 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*
        *Sett. & Communications*
      - Banking Office
        *Operations*
        *Payments & Services*
    - Security
    - Money and Capital Markets
    - Open Market Operations
    - Issues

December 1998

# LETTER OF TRANSMITTAL

CENTRAL BANK OF MALTA
VALLETTA

30th March 1999

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 1998, and a report on the Bank's operations during that year.

Yours sincerely
EMANUEL ELLUL
Governor

# Contents

# Governor's Statement

## *Overview of the Economy*

The Maltese economy is approaching a critical juncture. The possibilities of fiscally-driven economic growth through domestic demand expansion appear now to be exhausted, as the structural components of the fiscal and external current account deficits are threatening to undermine the economy's long term viability. Sustainable and durable economic growth henceforth hinges entirely on the efficient and effective use of the economy's limited resources, especially its human capital skills, for the production of goods and services enjoying foreign demand. This, at a time of a significant international drive towards globalisation and the attendant expectations of increased efficiency and competition. The task that faces Malta in its liberalisation drive, and particularly in its path towards EU membership are a reflection of this.

This is a scenario of challenges and significant opportunities, indicating that the healthy performance of the Maltese economy over the past few years in terms of income growth can be improved even further through the implementation of proper structural reform policies. It also forms the fundamental background against which the performance of the Maltese economy in recent years, and indeed in 1998, can be analysed.

A number of encouraging economic results were obtained in 1998. The economy continued to grow, albeit at a slower pace than in previous years. The country's real economic growth in 1998, estimated at just under 3%, compares well with that of its main trading partners. Underlying this growth was a strong expansion in exports coupled with a subdued domestic demand. The unemployment rate increased marginally - though at 5.1%, it still remained far below the rates prevailing in most of Malta's trading partners.

Inflation dropped significantly in 1998, falling to 2.4%. This was in line with the declining trend in inflation in Malta's main trading partner countries. Indeed, Malta's underlying inflation, that is the rate of inflation adjusted for the effects of changes in indirect taxes, was, by the end of the year, estimated to be no higher than imported inflation. This indicates that domestic inflationary pressures had been brought under control.

As a result of the developments in domestic and export demand that affected GDP growth, the external deficit narrowed significantly in the course of the year, although it remained around 4% of GDP. Inflows of foreign capital led to an increase in the country's net foreign assets, which contributed substantially to the growth in the money supply during the year.

The country's macroeconomic performance during 1998 was however marred by a significant expansion in the fiscal deficit – which rose to a level equivalent to 11.7% of GDP. This in part reflected an adjustment in the statistics aimed at better gauging the economic impact of fiscal activities. However, it was also partly the result of a core structural deficit that had built up over the years, which is likely to cause further strains in the future in view of demographic developments. The Government is fully committed to address this problem, and has formulated a six-year strategy aimed at bringing down the fiscal deficit to a range of 3%-4% of GDP. It is essential that the momentum to redress the deficit is maintained vigorously and with the necessary flexibility to respond to changing circumstances.

The pattern of economic growth in 1998 deserves further analysis. Domestic demand continued to grow, but at a weak pace. The slower rate of growth may have reflected cyclical factors, as well as uncertainty regarding the political situation and economic policies. The slowdown in domestic demand growth in turn resulted in a marginal rise in unemployment and no doubt constrained the growth of incomes. But it also allowed inflation to ease, and relieved some, though by no means all, of the pressures on the current account of the balance of payments. The situation, however, needs to be closely monitored because it is probable that domestic demand will rebound strongly in response to a change in cyclical conditions.

The expansion in exports that took place in 1998 was encouraging, with both tourism and manufacturing displaying remarkable resilience. A concern in this respect, however, is Malta's vulnerability in terms of its strong dependence on a small number of key exporting activities. These sectors were indeed the main driving force behind the rise in exports during 1998 – but their performance was largely conditioned by a number of fortuitous, but not necessarily lasting, favourable circumstances. The drop in the international price of oil was another fortunate development that helped Malta's balance of payments during 1998.

It is thus clear that, in spite of a number of encouraging economic indicators and the slowdown in domestic demand, structural fiscal and external deficits persisted during 1998. These deficits resulted mainly from inefficiencies in the use of the country's resources. On the external front, it is clear that the country's demand for imports remains fundamentally larger than the exports it can offer in return. On the fiscal front, the demand for goods, services and income provided by the public sector by far exceeds the amount and productivity of the resources that the economy is currently devoting towards this function. As fiscal injections fuel the demand for imports, the fiscal imbalance is a primary contributor to the external deficit.

In a situation of persistent underlying deficits in the fiscal and external sectors, the Central Bank maintained a cautious monetary policy stance during 1998. In influencing short-term interest rates through its weekly repo auctions, the Bank sought to prevent an unduly large upsurge in domestic demand, as it considered the fiscal deficit to be generating enough pressure in that respect. The Bank pursued this policy so as to contain the external deficit, whose persistence threatens the stability of the exchange rate peg of the Maltese lira. In an economy as open as Malta's, the exchange rate peg is the final objective of monetary policy, as it links domestic inflation to that prevailing in the country's main trading partners, and thus promotes exports and foreign direct investment.

Thus, while refraining from effecting marked increases in short-term interest rates because of the sluggishness of domestic demand and in view of the cushion provided by the high level of its external reserves, the Central Bank kept back from cutting repo rates during 1998.The relatively tight monetary policy stance and the declining international inflationary pressures impacted positively on domestic inflationary expectations. This contributed to a pronounced investor demand for longer-term securities, which in turn led to a significant reduction in capital market yields in Malta. The latter also reflected the drop in interest rates abroad.

## *Outlook and Policy Stance*

A number of developments in external and domestic demand are expected to condition the development of the Maltese economy during 1999.

Domestic demand is on balance expected to recover moderately, as work on a number of capital projects, with their attendant multiplier effects, commences. Furthermore, signs of increased business optimism are emerging from the latest business perceptions surveys conducted by the Bank. This optimism may in part reflect an expected cyclical upturn in demand, conditioned perhaps by the dissipation of consumer uncertainty. Weighing against these factors is the planned tightening of the fiscal stance, with the fiscal deficit expected to narrow to around 9% of GDP.

As regards external demand, there are indications that the positive performance of 1998 will be sustained. The major manufacturing exporters and operators in the tourism industry on the Island generally report a positive outlook, but other manufacturing businesses may be affected by a slowdown in Malta's main trading partners. In 1999, both exporting and locally-oriented firms will continue to gear up for the challenges posed by globalisation and Malta's prospective membership in the EU. This may involve a rise in exports and sales for some industries, and the need for restructuring in others.

Taking all these considerations – and the fiscal measures announced in the latest Budget – into account, the Bank expects real GDP growth in 1999 to accelerate to just over 3%. The unemployment rate is expected to decline somewhat, as domestic demand recovers and export activity remains generally sustained. The rate of inflation may rise temporarily, mainly reflecting the changes in indirect taxation announced in the latest Budget. To some extent, inflation may also rise in response to the recovery in domestic demand, though this may be offset by a further drop in imported inflation.

Based on Ministry of Finance projections, the fiscal deficit is expected to drop to 9% of GDP, or 5% of GDP if privatisation receipts are included with revenue. The Government expects to realise substantial efficiency gains to obtain these results. On the other hand, the external deficit may widen somewhat as import demand recovers in response to the increase in domestic activity. The change in the relative price of imports resulting from the replacement of Customs and Excise Tariffs by Value Added Taxation in January 1999 may also contribute to the widening of the external deficit.

From a medium term perspective, the sustainable development of the Maltese economy depends crucially on the attainment of the objectives of the Government's six-year strategy aimed at containing the fiscal deficit. Equally important is the attainment of higher economic efficiency levels through the restructuring of industry to strengthen its international competitiveness and through the privatisation of public sector activities. It is important not to view the latter merely as schemes to generate revenue for the exchequer.

Within this scenario of economic adjustment and reform, the Central Bank of Malta will continue to closely assess domestic and international economic and financial developments. Its interest rate and exchange rate policies will continue to be aimed at ensuring price and balance of payments stability, so as to achieve sustainable economic growth and high employment levels on a durable basis. Developments in the international environment, in particular where these concern Malta's relations with the EU, will also continue to be monitored closely.

## *Central Bank Operations*

During 1998, the Central Bank continued to pursue its policy aim of price stability by maintaining the exchange rate peg for the Maltese lira. The basket of currencies to which the Maltese lira was pegged continued to be made up of the ECU, the US dollar and sterling. In December, in the light of the imminent introduction of the euro, the Bank announced that the composition of the currency basket would be revised accordingly - in a manner which would be as neutral as possible.

The Bank continued to use a variety of tools to maintain the exchange rate peg. Notably, the Bank intervened in the foreign exchange market and conducted open market operations to influence short-term interest rates, so as to keep these within the limits established by the Bank's Monetary Policy Council. During 1998, the Monetary Policy Council raised interest rates twice, so as to narrow the spread between the Bank's injection and absorption rates and to tighten the monetary policy stance gradually. The manner in which open market operations were conducted was revised during the year. In February, the Bank discontinued auctions of reverse repos and began auctioning term deposits to absorb liquidity instead. Towards the end of the year, the use of swaps was streamlined.

The Bank continued to operate in the market for government securities, acting as a market maker in the market for government stocks and Treasury bills. The Bank continued to refrain from participating in the primary market for Treasury bills, but bought stocks on the primary market in order to fulfil its market-making role. The Central Bank is carrying out this market-making function in order to support the development of liquid domestic financial markets, but it aims to encourage other players in the market to take on a greater role in this area.

As in previous years, the Government did not make use of the overdraft facility with the Central Bank. Nevertheless, I would like to repeat the Bank's view that the amendments to the Central Bank of Malta Act that abolish this facility should be brought into effect as soon as possible.

The Bank remained responsible for promoting a sound financial structure and an orderly capital market in Malta. It also retained its responsibilities as the Competent Authority appointed in terms of the Banking Act, 1994 and the Financial Institutions Act, 1994. In this capacity, the Bank issued licences to two credit institutions and one financial institution during the year. In addition, the Bank continued to introduce further capital requirements as part of the phased implementation of the Capital Adequacy Directive. It continued to supervise credit and financial institutions according to its remit through a combination of on-site and off-site inspections. The Bank ensured that credit institutions continued to maintain healthy levels of capital and liquidity.

During the year, the Bank undertook extensive preparations for the introduction of the euro. These preparations mainly involved its foreign exchange trading systems. The Bank also began the process of implementing a new accounting system and continued to work to ensure that its information technology framework was fully able to meet the requirements imposed by the onset of the year 2000.

I am pleased to report that this year, too, the Bank's financial performance was satisfactory. Furthermore, the presentation of the Bank's financial statements included in this report has been upgraded to improve disclosure, giving more information than before on the Bank's activities. During 1998, the Bank made net profits amounting to Lm30.7 million, compared with Lm25.1 million in 1997. Finally, on behalf of the Board of Directors, I would like to thank all the staff of the Bank for their dedication and hard work, without which this performance would not have been possible.

EMANUEL ELLUL

# Part I

# FINANCIAL AND ECONOMIC DEVELOPMENTS

# 1. The International Environment

## 1.1 The World Economy

The world economy slowed down considerably in 1998. In fact, global growth was expected to slow to 2.2% - down from 4.2% in 1997. This weak performance was mainly attributable to the repercussions of the Southeast Asian economic and financial crisis that broke out in July 1997 and to the Russian crisis which escalated with Russia's defaulting on its debt repayments in August 1998.

The contagion effects from the Southeast Asian crisis extended to both the advanced and the developing countries during the year. In fact, the industrial sectors in most OECD countries were hit hardly by steep decreases in exports to the affected countries. Despite its little direct trade links with Asia, even Latin America was adversely affected by the crisis, owing partly to the impact on commodity prices and partly to the rounds of currency devaluations that gave Southeast Asia a competitive advantage. International economic and financial conditions deteriorated considerably during the summer, as recessions deepened in many Asian emerging market economies and Japan, while Russia's financial crisis created concerns about debt-repayment default. Negative spillovers were felt in world stock markets, while commodity prices – particularly oil prices – which were already weak, dropped further. Private financial flows to emerging markets effectively dried up, while concerns about a global credit crunch intensified in view of a broader increase in risk aversion among investors. In the later months of the year, several industrial countries and a number of emerging economies implemented a number of policy measures, particularly monetary-policy easing, in order to respond to these problems. This helped to restore calm in financial markets. Nevertheless, while the danger of a global recession seemed to recede, the supply of funds to most emerging market economies was still tight, and conditions in financial markets remained fragile.

The economic performance of the **advanced industrial countries** as a group deteriorated considerably during the year, mainly on account of the global economic

**Table 1.1**
**INTERNATIONAL ECONOMIC INDICATORS**
***Percentage change from previous period***

| Country | Real GDP % Change | | | Inflation (Consumer Prices) % Change | | | Current Account Balances US$ billions | | |
|---|---|---|---|---|---|---|---|---|---|
| | 1996 | 1997 | 1998[1] | 1996 | 1997 | 1998[1] | 1996 | 1997 | 1998[1] |
| Canada | 1.2 | 3.8 | 2.8 | 1.6 | 1.4 | 1.2 | 3 | -9 | -13 |
| United States | 3.4 | 3.9 | 3.9[2] | 2.9 | 2.3 | 1.6 | -135 | -155 | -233[2] |
| Japan | 5.0 | 1.4 | -2.8 | 0.1 | 1.7 | 0.4 | 66 | 94 | 128 |
| France | 1.6 | 2.3 | 3.0 | 2.0 | 1.2 | 0.7 | 21 | 39 | 31 |
| Germany | 1.3 | 2.2 | 2.7 | 1.5 | 1.8 | 1.0 | -14 | -4 | 3 |
| Italy | 0.7 | 1.5 | 1.3 | 3.9 | 1.7 | 1.7 | 41 | 34 | 29 |
| United Kingdom | 2.6 | 3.5 | 2.6 | 2.9 | 2.8 | 2.6 | -3 | 7 | -7 |
| Advanced Countries | 3.2 | 3.2 | 2.0 | 2.4 | 2.1 | 1.6 | 35 | 72 | 44 |
| Developing Countries | 6.5 | 5.7 | 2.8 | 14.1 | 9.2 | 10.2 | -74 | -66 | -95 |
| Countries in Transition[3] | -1.0 | 1.9 | -0.8 | 41.4 | 27.9 | 21.0 | -18 | -25 | -21 |

[1] Forecasts.
[2] U.S. Commerce Department.
[3] Includes countries of Central and Eastern Europe and the former USSR.

*SOURCE: IMF,* ***World Economic Outlook and International Capital Markets Interim Assessment*** *(December 1998)* and financial woes, and their combined GDP growth was expected to slow down to 2%, 1.2 percentage points less than in 1997. The inflationary environment, however, remained remarkably subdued in practically all these countries throughout 1998. During the early months of the year, economic indicators pointed towards sustained growth in the U.S., lower growth in the U.K., continued recovery in continental Europe and stagnant conditions in Japan. However, while the U.S. economy remained resilient, the U.K. slowdown persisted, Japan's economic problems deepened and the recovery in continental Europe came to a halt as the year progressed. Moreover, the adjustment processes triggered by the financial crisis produced a sharp widening of current account imbalances among the major industrial countries. In fact, the U.S. suffered a marked deterioration in its current account, as it absorbed much of the improvement in emerging Asia's trade balance, whereas Japan's external surplus widened further and Euroland's external position remained in large surplus. In the later months of the year, central banks in North America and Western Europe eased monetary policy in response to weakening growth prospects. Concerns about excessive tightness in credit markets prevailed in the U.S., while in Euroland, attention focused on the need for convergence of short-term interest rates before the launch of EMU on January 1, 1999 amid a re-emerging economic slowdown. Among the industrial countries, Japan stood out as the economy with the weakest growth performance for a decade and the only one in recession, having suffered five successive quarters of output decline since late 1997.

Economic growth in the **developing countries** slowed down sharply in 1998, with the combined GDP growth of these countries expected to fall to 2.8%, from 5.7% in 1997. This slowdown mainly stemmed from the fact that developing countries in all regions were adversely affected, even if to varying degrees, by the Asian crisis. By the spring, the impact of the crisis had begun to spread to Latin America via declining commodity prices. Later, the exchange and equity markets of several developing countries also came under pressure. Asia experienced larger-than-expected declines in consumption and investment owing to loss of confidence, widespread deflation of asset values, heavy business-debt burdens and large capital outflows. The latter, in turn, brought about a significant tightening of financing opportunities, forcing many firms into bankruptcy. On the other hand, until the Russian crisis erupted in August, most developing countries in the Western Hemisphere had weathered the crisis reasonably well, benefiting from the sound economic policies pursued during the past decade. As the Russian crisis took its toll, however, financial-market pressures intensified even in this region – reflecting increased fear of devaluation and default. During the later months of the year, the Asian financial markets seemed to have stabilised owing to monetary-policy easing in Korea, Thailand, Indonesia and Malaysia - as well as the successful maintenance of exchange rate regimes in China and Hong Kong. Subsequently, however, attention focused on Brazil, whose currency came under pressure on account of the country's unsustainable fiscal situation and its weakened external competitiveness. In response, the Brazilian central bank raised domestic interest rates sharply in a bid to slow the pace of capital outflows from the country.

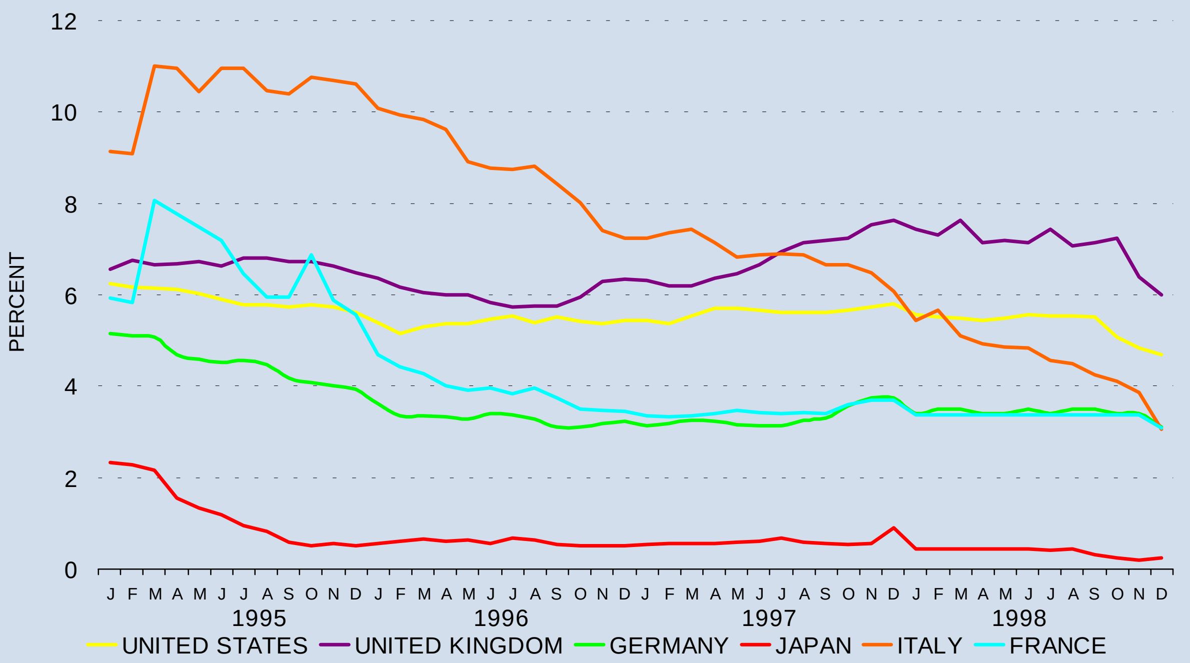
Meanwhile, the economies of the **countries in transition** registered a contraction in their combined GDP of 0.8%, as against a growth rate of 1.9% recorded in the previous year. This took place mainly on account of spillovers from the Asian crisis and from Russia's problems. The countries in transition felt the repercussions of the crisis in emerging markets unevenly. Countries like the Czech Republic and Hungary, which had taken resolute action to curb fiscal and external imbalances, were in a much stronger position to confront the turmoil than countries that still had unsustainably large budget deficits – like Moldova, Ukraine and, especially, Russia. The latter, in particular, suffered from severe fiscal problems, a distorted structure of expenditures with payment arrears and significant weaknesses in its institutional arrangements. In this context, a liquidity crisis erupted in Russia in the spring, and on August 17, despite substantial assistance from the IMF, the Russian authorities announced a de facto devaluation of the rouble, a unilateral restructuring of rouble-denominated public debt, and a 90-day moratorium on foreign credit repayments. Although external developments, including the Asian crisis and the associated weakness of energy prices, contributed to Russia's difficulties, domestic policy shortcomings were more pertinent. The Russian crisis had a particularly large impact on Ukraine and other economies, which still had close trade and financial linkages with Russia.

Economic growth in the **United States** continued at a remarkably strong pace for the eighth consecutive year in 1998, with GDP growing at a preliminary 3.9% during the year, same as in 1997 and up from 3.4% in 1996. Record low unemployment, a budget surplus, low interest rates, soaring stock-market gains and cheap imports combined to provide an almost optimal environment for spending. In fact, American consumers continued their three-year spending spree during 1998, and retail sales rose by 5.1%, following a gain of 4.3% in 1997. In contrast, the household savings rate rose only 0.5% during the year - the weakest savings performance since the Great Depression. Housing and construction remained unusually buoyant, reflecting the low interest-rate environment, which kept housing affordable and enabled the refinancing of mortgages. Business investment also continued to rise notably during the year, contributing to increased productivity and adding to industrial capacity. As a result, overall demand in the U.S. economy expanded by more than 3.5% – the third straight year of above-trend growth. At the same time, the international financial turmoil and the rounds of currency devaluations in Asia brought about cheaper import prices. These helped to contain inflation, which dropped to a 12-year low of 1.6% in the year to December 1998. Strong service-sector growth offset weakness in the manufacturing sector, which registered a decline in exports, largely on account of fading overseas markets in Asia and other struggling economies. These, in turn, brought about a marked deterioration in the U.S. trade deficit, which hit a record high of U.S.$168.59 billion in 1998.

In contrast, **Japan** fell into its worst recession in five decades and remained mired in this state throughout 1998. The Japanese economic scenario was characterised by falling capital markets, banks burdened with bad loans, very low inflation and record-high unemployment, which reached 4.1% from 3.4% in 1997. Japanese firms were forced to abandon their traditional paternalistic role towards employees and to shed excess workers. Business sales and profits worsened significantly, as personal spending and industrial output declined consistently. The Japanese economy received support mainly from massive government spending and from exports. On its part, the Japanese Government announced further economic stimulus packages during the year. Nevertheless, these measures failed to drag the economy out of its prolonged slump. The latest package, announced in mid-November, though the largest ever, failed to convince the markets that it could invigorate domestic spending, or even that it could be implemented in full. Shrinking domestic demand, as well as a sharp fall in oil and raw materials prices, brought about a huge drop in imports, which outpaced declines in exports and pushed Japan's current account surplus to a record 15.86 trillion yen, up 38.7% from 1997. However, towards the end of the year, some positive signals began to emerge. Consumer spending stopped falling, while the number of corporate bankruptcies fell in October and November compared with the same months a year before.

In the **European Union** countries, the IMF's forecast for GDP growth in 1998 was revised down to 2.8%, from an earlier forecast of 2.9%, in view of the deterioration in global economic trends. Economic recovery in continental Europe gained substantial ground during the first half of 1998, when it was supported by strong export growth, robust domestic demand and a tame inflationary climate. Nevertheless, structural labour market rigidities kept unemployment stubbornly high. In the summer, however, domestic demand began to replace net exports as the principal engine of growth in most of continental Europe. France, and to a lesser extent Germany, started to suffer from declining net exports as a result of the global financial turmoil, and this slowed down these countries' economic recovery. German business confidence weakened, while the Italian economic

**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

recovery, which had been particularly fragile, came to a halt mainly due to a sharp drop in net exports and slack domestic demand. The U.K. economy registered a lower-than-expected pace of growth practically through the whole year in response to a declining overall demand, and its GDP growth for 1998 was estimated to fall to 2.6%, from 3.5% in 1997. This was mainly due to the strong pound, which drove up the relative cost of U.K. services abroad. The problems in Asia also depressed British exports, while greater competition from cheap imports and weaker domestic growth, in turn, started to dent domestic demand. Although the U.K. labour market remained tight, the employment data were in line with a weakening economy. Nevertheless, the service sector, the principal motor of economic growth in Britain, proved quite resilient in the face of the general economic slowdown.

During the year, the transition to the **single European currency** was completed relatively smoothly. On March 25, the European Commission recommended that eleven E.U. countries had met the qualification criteria to join the economic and monetary union (EMU) in January 1999. On May 1, the European Council formally accepted this recommendation and decided that the Euro-11 currencies were to enter EMU at the central rates within the ERM of the European Monetary System prevailing at that time. The European Central Bank (ECB), which is to manage the monetary policy of Euroland, was inaugurated on June 30, with price stability as its paramount goal. On October 13, the ECB announced that its Governing Council had adopted a flexible three-pillared monetary-policy strategy based on an explicit medium-term inflation target, a money supply growth reference value and a mix of other indicators. The Euro-11 short-term interest rates gradually converged towards the level prevailing in the core European countries. Indeed, the central banks of the relevant countries reduced their official interest rates to 3% in December. On December 31, the E.U. finance ministers announced definitive rates for converting the currencies of the Euro-11 into the new single currency, the euro. This marked the end of the ECU, which was convertible on a one-for-one basis with the euro.

## 1.2 Interest Rates and Exchange Rates

**Short-term interest rates** during 1998 fluctuated in line with developments in inflation and underlying economic conditions – although in the case of the Euro-11 countries, market expectations ahead of the launch of EMU were another important factor. Accordingly, rates in Germany and France remained practically stable, while in Italy they tended to decline through most of the year. In the U.K., short-term interest rates rose in March and July, then they remained relatively stable until October. Thenceforth, they followed a declining trend until the end of the year. U.S. short-term money-market interest rates remained virtually unchanged until August but then headed downwards in line with the Federal Reserve's monetary policy easing. In Japan, short-term interest rates fluctuated thinly throughout the year.

In the **United States**, money-market interest rates remained practically unchanged until August, reflecting the Federal Reserve's neutral interest-rate policy stance. This stance was adopted in view of the low inflationary environment and buoyant economic activity in the U.S. as well as the uncertainties stemming from the global financial turmoil. Between September and December, however, the Federal Reserve cut the Federal funds rate three times in order to prevent a credit crunch and fend off severe financial market stress. As a consequence, short-term interest rates fell during these months. Nevertheless, short-term interest rates generally tended to stay slightly above the Federal funds rate throughout 1998.

Meanwhile, **Japanese** money-market interest rates tended to fluctuate about the Bank of Japan's discount rate, which, in view of the stagnant state of the Japanese economy and the low inflationary climate, was kept unchanged at the record low level of 0.5% throughout the year. On September 9, the Bank of Japan even cut its target for the overnight money-market interest rate to 0.25%, from just below 0.5%, as the economic situation in Japan deteriorated further.

**German** money-market interest rates were generally stable above the Bundesbank's repo rate, which was kept unchanged at 3.3% until November - within a context of very mute inflation, subdued economic growth and stubbornly high unemployment. On December 3, the Bundesbank and the Bank of France led an unexpected co-ordinated cut in the interest rates of all EMU countries in order to restore faltering confidence among consumers and businesses and

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

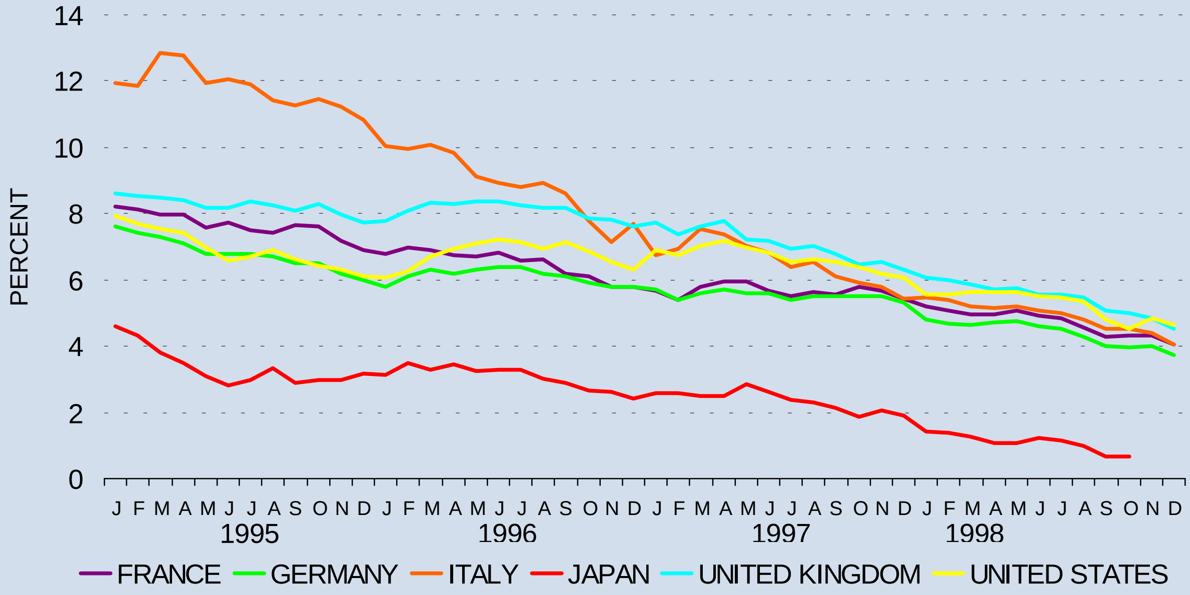
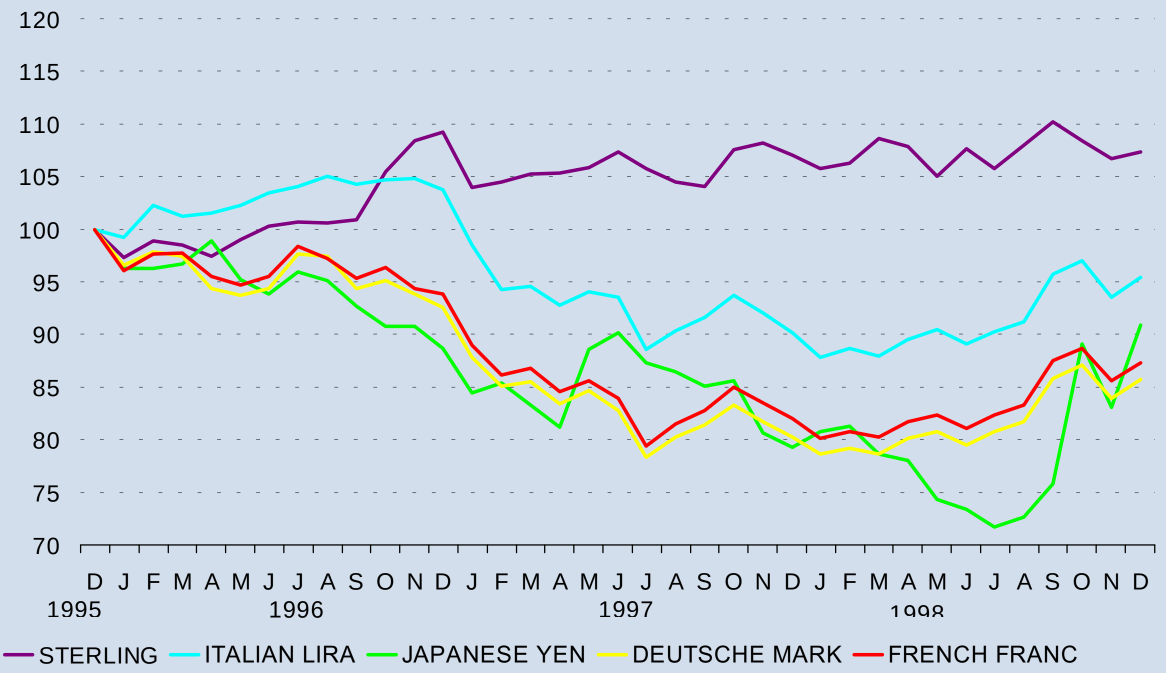


**CHART 1.3 EXCHANGE-RATE MOVEMENTS OF SELECTED CURRENCIES AGAINST THE US DOLLAR**
(INDEX OF END-OF-MONTH RATES, END-1995 = 100)




boost growth and investment. All the central banks in the euro zone, except the Bank of Italy, lowered their official rates to 3%. Consequently, German short-term rates fell in December.

In the **United Kingdom**, money-market interest rates flactuated slightly above official rates during the first quarter of 1998. Afterwards, money-market rates fluctuated below official rates practically throughout the rest of the year. Money-market rates rose in July, following an increase in the Bank of England's repo rate, which was raised by 0.25% to 7.5% in June. This took place in response to the rising trend in wage inflation. The Bank of England reduced its repo rate three times during the last quarter of 1998, against a backdrop of a slowing economy and a tame inflationary scenario, and U.K. money-market interest rates tended to decline in line with the repo-rate reductions.

In **Italy**, money-market interest rates fluctuated thinly above the Bank of Italy's discount rate, which stood at 5.5%, until March. Afterwards, money market interest rates fell in response to a cut in Italy's official interest rates on April 21. Money-market rates fluctuated thinly between May and September, but below the level of the official discount rate. On its part, the Bank of Italy reduced its discount rate three times during the fourth quarter of 1998 – against a background of a slowdown in Italian economic growth, a subdued inflationary environment and on euro-zone rate convergence considerations. Consequently, Italian money-market rates fell more sharply during the last quarter of 1998.

**Long-term interest rates** in the major advanced economies fluctuated according to inflation expectations and, in a number of countries, developments in short-term rates. Hence, long-term interest rates generally continued to follow a downward trend throughout 1998 – falling to their lowest levels for many years in several countries owing to the remarkably tame inflationary environment. In the summer, a global flight to quality by investors brought about further declines in long-term interest rates on public-sector debt instruments – in many cases to levels not seen in more than 30 years – while, in contrast, stock-market prices fell notably. Long-term interest rates in Germany, France and Italy stood below U.S. and U.K. rates. The lowest

**Table 1.2**
**AVERAGE EXCHANGE RATES OF FIVE MAJOR CURRENCIES AGAINST THE US DOLLAR - 1998**

| | Ffr | DM | Stg[1] | Lit | Yen |
|---|---|---|---|---|---|
| January | 6.0807 | 1.8162 | 1.6355 | 1787.8 | 129.5 |
| February | 6.0789 | 1.8137 | 1.6404 | 1789.6 | 125.9 |
| March | 6.1161 | 1.8245 | 1.6589 | 1796.4 | 128.6 |
| April | 6.0803 | 1.8141 | 1.6730 | 1792.2 | 131.9 |
| May | 5.9487 | 1.7739 | 1.6377 | 1749.5 | 135.0 |
| June | 6.0032 | 1.7902 | 1.6483 | 1763.9 | 140.5 |
| July | 6.0273 | 1.7978 | 1.6449 | 1772.4 | 140.6 |
| August | 5.9944 | 1.7888 | 1.6332 | 1764.3 | 144.7 |
| September | 5.7123 | 1.7037 | 1.6813 | 1683.3 | 134.8 |
| October | 5.4979 | 1.6396 | 1.6942 | 1622.0 | 121.3 |
| November | 5.6378 | 1.6814 | 1.6616 | 1663.9 | 120.4 |
| December | 5.5950 | 1.6684 | 1.6721 | 1652.0 | 117.1 |
| Average for the year | 5.8977 | 1.7594 | 1.6568 | 1736.4 | 130.9 |
| Closing rate on 31.12.98 | 5.6283 | 1.6783 | 1.6626 | 1661.7 | 113.3 |
| Closing rate on 31.12.97 | 5.9915 | 1.7915 | 1.6571 | 1759.3 | 129.9 |
| High for the year | 6.2133 | 1.8540 | 1.7141 | 1828.2 | 147.0 |
| | (Apr. 02) | (Apr. 02) | (Oct. 09) | (Apr. 02) | (Aug. 11) |
| Low for the year | 5.4075 | 1.6133 | 1.6127 | 1596.2 | 113.4 |
| | (Oct. 16) | (Oct. 08) | (Aug. 17) | (Oct. 08) | (Dec. 31) |
| Percentage appreciation (+)/depreciation (-) of the currency vs the dollar from closing rate on 31.12.97 to closing rate on 31.12.98 | 6.0 | 6.2 | 0.6 | 5.2 | 9.6 |

[1] US dollars per pound sterling.

long-term interest rates featured in Japan, however, where they reflected the exceptionally easy monetary-policy stance taken by the Bank of Japan. But Japanese long-term interest rates rose sharply towards the end of the year, when it became apparent that the Japanese Government's borrowing requirement for 1998 was going to be larger than in 1997.

During 1998, the **foreign exchange market** was characterised by two contrasting features: on the one hand, substantial fluctuations took place among the major currencies, mainly due to the impact of the global financial turmoil, while, on the other hand, there was relative stability among the euro-zone currencies. The U.S. dollar continued to appreciate against other major currencies until around mid-year. Subsequently, however, the dollar tended to depreciate against a number of major trading currencies. In the second half of the year, the euro-zone currencies tended to fluctuate closely about their respective central parity rates with the Deutschemark ahead of the launch of EMU.

The U.S. dollar started the year on a strong footing and continued to register gains against all the other major currencies, except the pound sterling. This reflected market optimism about short-term prospects for the U.S. economy and the perception that the dollar was a safe haven from the Southeast Asian financial turmoil. Against the Japanese yen, the dollar opened the new year at Y132.3 – the highest level since mid-1992 – and generally continued to appreciate against that currency. The yen was depressed by Japanese political uncertainty and the stagnant economic situation as well as by the market's perception that Japan's efforts to revive its economy were inadequate. Against the Deutschemark, the dollar tended to register notable gains, mainly on account of Germany's weaker economic fundamentals, German profit-taking against the Japanese yen, and U.S. - German interest-rate differentials. In contrast, the dollar suffered losses against the pound sterling – as the latter, besides gaining a safe-haven status, was bolstered by prospects of an increase in U.K. interest rates.

In April, the dollar tended to weaken against the continental European currencies on account of the record high U.S. trade deficit and a shift in market sentiment in favour of the Deutschemark on the back of positive prospects for economic recovery in continental Europe. But the dollar strengthened almost continuously against the yen, as the Japanese currency was negatively affected by the Asian financial crisis and the weak economic data that ensued from several countries in the region. In June, Moody's downgrading of some of Japan's large construction companies to junk bond status helped push the yen to as low as Y146.75 to the dollar – its lowest point since September 1990.

In early July, the continuing financial crisis in Russia dominated trade and supported the dollar – which was considered to be a safe haven against the crisis. Subsequently, however, the dollar registered losses against both sterling and the Deutschemark on account of the expanding U.S. trade deficit. The pound was supported by high U.K. interest rates, reduced expectations of imminent rate rises in Euroland and concerns over Russia. Towards the end of July, the dollar recouped most of its losses against the pound as several large U.S. investors, including hedge funds, changed their long-term views of the U.K. economy. In fact, the dollar extended its gains against sterling until mid-August, as prospects for the U.K. economy dimmed. Later, however, the dollar and the continental European currencies lost ground against the pound as investors decided that the U.K.'s economic slowdown was of minor significance compared with Russia's crisis. Against the Japanese yen, the dollar tended to strengthen until around mid-August, as the prospect of a slow pace of economic reform in Japan and the publication of further bad economic data continued to depress the Japanese currency.

The dollar strengthened against the Deutschemark through most of August on rumours regarding financial turmoil in Russia and following the rouble devaluation. Towards the end of August, however, the dollar lost some of its safe haven status owing to the significant decrease in the value of financial assets on Wall Street as investors feared that the Russian crisis could infect Latin America. The U.S. currency also suffered from talk of a probable Federal Reserve interest rate cut in a bid to save the world from recession.

In September, the dollar suffered considerable losses from the near-collapse of LTCM hedge fund. Political uncertainty in Washington, prospective interest rate cuts in the U.S. and economic woes in the rest of the world – especially in Latin America – depressed the dollar further. The dollar lost most of its gains against the Japanese yen, as hedge funds bought the latter currency in order to repay the yen they had used to buy emerging market assets in previous years. Moreover, Japanese investors probably repatriated capital in connection with LTCM hedge fund. The US currency weakened further in October, as investors sold dollars and sterling for euro-zone currencies in view of the protection that the Euroland economy was expected to provide against the global financial turmoil. During the first two weeks of October, the dollar suffered sharp losses against the Japanese yen, which appreciated significantly against all other major currencies as investors sold dollars for yen in order to cover short positions in the latter currency. At this stage, the yen was also helped by an agreement between the Japanese Government and opposition parties over the recapitalisation of the Japanese banking system, which boosted the Japanese equity market. After around mid-October, however, a firmer U.S. stock market, and the probability of a broader softening of interest rates across the euro zone, bolstered the dollar on the international currency markets. Nevertheless, in December, renewed declines in U.S. equity prices and fresh rumours about a probable devaluation of the Brazilian real dragged the U.S. dollar lower against the other major currencies. As a result, the dollar ended the year notably weaker against the yen and the continental European currencies when compared with end-1997 levels.

### 1.3 Commodities and Precious Metals

The prices of **base metals** declined steadily throughout 1998, ending the year 17.4% down from end-1997 levels. Essentially, this was a direct consequence of the global financial turmoil, which depressed demand and created excess supplies of various base metals. Mining companies thus suffered financial losses on most of the copper, aluminium and nickel they sold. Copper prices ended the year around their 11 ½-year lows in view of expectations that the world copper surplus was about to swell to over 300,000 tonnes by the end of the year. Excess stocks of aluminium piled up in Japanese warehouses, as recession hit the country's construction and car industries. In August, nickel prices dipped to US$4,000 a tonne, their lowest level for over eleven years, as the Asian financial crisis dampened demand for stainless steel, the main use for nickel. Russia's financial woes further intensified the slump in the metal markets. As the Russian economy slowed down, it tried to boost its already large exports of many metals. Selling by investment funds pushed copper, aluminium and nickel down further on the London Metal Exchange on fears that higher Russian exports would add to oversupply. In contrast, production problems lifted tin prices – though these were still far below their level before the 1985 crash.

During 1998, the **oil** markets were smothered by a large stock overhang as a result of a collapse in demand from Asia, an unusually warm 1997-98 winter, rising Iraqi exports and a badly-timed lifting of OPEC's output ceiling in 1997. Moreover, technology, competition, new discoveries and the post-Cold War peace contributed to make a finite resource seem as if it were a renewable commodity. Additionally, according to the International Energy Agency, producers' indiscipline allowed world petroleum stocks to rise by a million barrels a day. In contrast, average oil demand grew by just 550,000 barrels to 74.3 million barrels per day during 1998. Towards the end of the year, although OPEC producers were generally complying with agreed cuts in production, the size of these cuts was not enough to curb excess supply. Hence, on November 24, world oil prices sank to new 12-year lows of $11.13, as the U.N. Security Council renewed the Iraq oil-for-food plan for another six months. Adjusted for inflation, this was the lowest price since the oil embargo of 1973. After some fluctuations, oil prices slipped further on December 21, after Iraq's exports survived a four-day military onslaught without disruption, leaving glutted markets threatening new lows. As a result, the price of oil ended the year at US$10.44 per barrel, or 37.4% down from the December 1997 level.

**Food** prices declined through most of 1998 – mainly as a consequence of the economic and financial turmoil in Southeast Asia and Russia. However, prices tended to rise towards the end of the year, mainly on the back of adverse weather conditions. American grain prices were under pressure for several months in the face of a record soyabean crop, the second-biggest maize crop ever, and the biggest wheat harvest of the decade. Meanwhile, the demand for animal feed dropped notably, owing to the mild winter for 1997-1998 and the economic slowdown in Southeast Asia. During autumn 1998, however, grain prices began to exhibit a very modest recovery due to a sales-delay by U.S. farmers and an announcement of a U.S. food aid programme to Russia. Sugar prices tended to decline to ten-year lows through the year to September, as Brazil, the world's second-biggest sugar producer, harvested a record crop while demand fell. Nevertheless, sugar prices rebounded slightly in the last quarter on the back of news that the U.S. was about to reduce its sugar import quota. Coffee prices tended to fluctuate during the year. In the early months, prices rose, as fears of a shortage of arabica bean ahead of the new Brazilian crop in May brought buyers onto the market. Moreover, coffee output around the world had been hit by the El Nino weather pattern, which brought drought to Colombia and Indonesia and floods to Mexico, Central America and Kenya. Afterwards, coffee prices tended to weaken in anticipation of a bumper crop in Brazil. Towards the end of the year, however, the price of arabica bean rose significantly on expectations of short supply, as coffee-growing regions in Central America were devastated by disasters, particularly Hurricane Mitch. Hence, on balance, food prices ended the year 18.9% down from end-1997 levels.

Meanwhile, prices of **non-food agricultural commodities** also tended to follow a downward trend through most of 1998. The prices of tropical products like natural rubber fell sharply following the rounds of currency devaluations and economic slowdown in Southeast Asian countries. Prices of both Australian wool and cotton, on balance, followed a declining trend, owing to a slump in demand from Asia and Russia as well as stiff competition from cheaper synthetic substitutes. Despite a booming market for new homes, timber prices in America dropped heavily during the year, as demand was adversely affected by the Asian crisis. In the European Union, commercial forestry faced a potential crisis in large areas of woodland following a sharp increase in cheap imports and a growing oversupply of timber. This, in turn, depressed selling prices for pulpwood – one of the main components for paper and board production. However, the price-index of non-food agricultural commodities went up slightly towards the end of the year as various countries intervened in order to support prices. As a result, prices of non-food agricultural commodities at the end of the year were, on balance, down by 9.0% from December 1997 levels.

**Gold** prices continued to follow a downward trend throughout 1998. Bullion prices dropped in mid-January in view of concerns that central banks were set to continue to reduce their gold reserves in favour of more liquid investment instruments. Subsequently, however, bullion surged, as investment funds bought gold in order to cover short positions. After some fluctuations the price of gold registered notable gains as it was supported by prospects for reduced supply pressure from central banks, light producer hedging, a weaker U.S. dollar and positive technical signals. However, gold prices fell almost consistently in May and were quite volatile in June, as investor demand for hard assets remained sluggish due to bullish expectations for financial assets and low inflation. In June, the European Central Bank's Council reached a consensus that between 10% and 15% of the Bank's reserves were set to be in gold. After some fluctuations, the price of gold dropped, mainly on account of a strengthening of the U.S. dollar against the Japanese yen and a statement by the ECB president in which no mention was made of a freeze on gold sales by European central banks. The price of gold fell further, to 19-year lows, in August, following the Russian financial crisis and the depreciation of the currencies of gold producer countries. In September, however, the price of bullion tended to rise, supported by a combination of factors linked to the bailout of LTCM hedge fund, U.S. dollar weakness, declining global equity markets and the prospect of U.S. monetary-policy easing. Nevertheless, after some fluctuations, the price of gold resumed its downward trend in December, because bullion appeared to be losing its clout as a hedge against political insecurity. On December 18, the Swiss parliament voted to sever the Swiss franc's peg to gold, the first step in paving the way for the country's central bank to sell its excess gold reserves. This re-ignited concerns about massive gold sales by central banks, which depressed bullion further. As a result, the price of gold ended the year at US$287.35 per ounce, down by 1% from the US$290.15 per ounce at which it had ended 1997.

# 2. The Domestic Economy

Central Bank estimates show that Malta's rate of real economic expansion declined further to 2.8% in 1998. This was in part attributable to the sustained weakness of domestic demand and a smaller contribution to growth by the external sector. Nevertheless, GDP growth remained largely export-led. The weakness in domestic demand led to a slight increase in unemployment, which averaged 4.9% during 1998. Retail price inflation fell by over half a percentage point to 2.4% by the end of the year, with the decline in part reflecting lower imported inflation and in part the lowering of utility rates in the latest Budget, which was backdated to November 1997.

The export-oriented sectors of the economy continued to provide the main stimulus to growth, with manufacturing industry, especially the electronics sector, performing strongly, thus boosting both employment income and profits. In the tourism sector, arrivals reached record levels, but revenue directly generated by the tourism industry grew at a slower pace than in 1997. At the same time, the performance of the locally-oriented sectors, particularly that of the construction industry and the distributive trades, remained generally weak. This was reflected in a decline in both employment income and profits generated by these sectors.

## 2.1 Aggregate Demand

The Bank's estimates of GDP and its main expenditure components for the year are presented in Table 2.1. The Table also gives the GDP data relating to the previous four years. The Bank, however, has adjusted the official real GDP data for these years by deflating nominal inventory changes with the implicit deflator for net final expenditure – in line with the internationally accepted practice. The results, presented in the Table, show that while the Maltese economy has continued to expand, the rate of growth peaked in 1995 and declined in each of the following three years.

### *2.1.1 Consumption Expenditure*

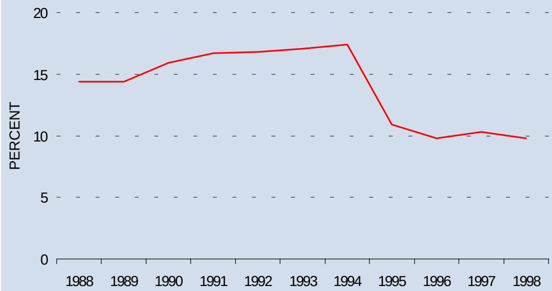
During the year under review, private consumption expenditure at current market prices is estimated to have expanded at a slightly slower rate than in 1997. Furthermore, since retail price inflation was somewhat higher than in the previous year, consumption expenditure in real terms is estimated to have slowed down further during the year reviewed.

The slowdown in consumption expenditure was partly attributable to slower growth in household disposable income, which is estimated to have grown by 4.4% in 1998, compared to the 5.6% growth recorded in 1997. This in turn partly reflected slower growth in the average number of the gainfully occupied, where the increase was around two-thirds of that recorded in 1997.

The fact that consumption expenditure outpaced growth in household disposable income implies a drop in the household savings rate. In fact, in 1998, the latter is estimated to have declined by half a percentage point to 9.8%, as Chart 2.1 shows.

Government consumption in nominal terms accelerated somewhat, rising by 7.8% in 1998 after having expanded by 1.8% in 1997. This acceleration in government consumption, which was reflected in a widening of the fiscal deficit, was largely attributable to the payment of wage arrears to government employees following the conclusion of the collective

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



## Table 2.1
## GDP BY CATEGORY OF EXPENDITURE

*Lm millions*

| | 1994 | 1995 | 1996 | 1997 | 1998[1] |
|---|---|---|---|---|---|
| AT CURRENT MARKET PRICES | | | | | |
| Consumers' Expenditure | 608.3 | 700.4 | 764.9 | 803.1 | 840.0 |
| Government Current Expenditure | 209.5 | 235.2 | 259.8 | 264.4 | 285.1 |
| Gross Fixed Capital Formation | 305.4 | 365.2 | 345.3 | 325.5 | 330.0 |
| Inventory Changes | 10.0 | 1.2 | -1.4 | -2.8 | 5.1 |
| **Domestic Absorbtion** | **1,133.2** | **1,302.0** | **1,368.6** | **1,390.2** | **1,460.2** |
| Exports of Goods & Services | 994.4 | 1,074.7 | 1,045.6 | 1,096.3 | 1,181.6 |
| Imports of Goods & Services | 1,099.0 | 1,231.2 | 1,212.8 | 1,204.5 | 1,254.6 |
| **Balance of Trade in Goods & Services** | **-104.6** | **-156.5** | **-167.2** | **-108.2** | **-73.0** |
| **GROSS DOMESTIC PRODUCT** | **1,028.5** | **1,145.5** | **1,201.4** | **1,282.0** | **1,387.2** |
| AT CONSTANT 1973 PRICES | | | | | |
| Consumers' Expenditure | 246.5 | 272.5 | 293.4 | 295.9 | 298.1 |
| Government Current Expenditure | 88.4 | 95.9 | 104.0 | 102.4 | 104.0 |
| Gross Fixed Capital Formation | 99.6 | 117.3 | 112.9 | 103.7 | 102.7 |
| Inventory Changes[2] | 10.0 | 1.2 | -0.6 | 0.0 | 1.9 |
| **Domestic Absorbtion** | **444.5** | **486.9** | **509.7** | **502.0** | **506.7** |
| Exports of Goods & Services | 342.9 | 361.3 | 337.0 | 347.6 | 365.3 |
| Imports of Goods & Services | 314.0 | 345.5 | 323.7 | 311.0 | 318.3 |
| **Balance of Trade in Goods & Services** | **28.9** | **15.8** | **13.3** | **36.6** | **47.0** |
| **GROSS DOMESTIC PRODUCT** | **473.3** | **502.8** | **523.0** | **538.6** | **553.7** |
| **YEAR-ON-YEAR PERCENTAGE CHANGE** | | | | | |
| AT CURRENT MARKET PRICES | | | | | |
| Consumers' Expenditure | 8.3 | 15.1 | 9.5 | 5.0 | 4.6 |
| Government Current Expenditure | 10.9 | 12.3 | 10.5 | 1.8 | 7.8 |
| Gross Fixed Capital Formation | 10.3 | 19.6 | -5.4 | -5.7 | 1.4 |
| Inventory Changes[3] | 0.7 | -0.9 | -0.2 | -0.1 | 0.6 |
| **Domestc Absorbtion** | **9.9** | **14.9** | **5.1** | **1.6** | **5.0** |
| Exports of Goods & Services | 10.9 | 8.1 | -2.7 | 4.8 | 7.8 |
| Imports of Goods & Services | 11.3 | 12.0 | -1.5 | -0.7 | 4.2 |
| **Balance of Trade in Goods & Services[3]** | **-1.5** | **-5.0** | **-0.9** | **4.9** | **2.7** |
| **GROSS DOMESTIC PRODUCT** | **9.4** | **11.4** | **4.9** | **6.7** | **8.2** |
| AT CONSTANT 1973 PRICES | | | | | |
| Consumers' Expenditure | 2.3 | 10.5 | 7.7 | 0.9 | 0.7 |
| Government Current Expenditure | 6.4 | 8.5 | 8.4 | -1.5 | 1.6 |
| Gross Fixed Capital Formation | 8.5 | 17.8 | -3.8 | -8.1 | -1.0 |
| Inventory Changes[3] | 1.4 | -1.9 | -0.2 | 0.1 | 0.4 |
| **Domestic Absorption** | **5.9** | **9.5** | **4.8** | **-1.5** | **0.9** |
| Exports of Goods & Services | 7.1 | 5.4 | -6.7 | 3.1 | 5.1 |
| Imports of Goods & Services | 7.5 | 10.0 | -6.3 | -3.9 | 2.3 |
| **Balance of Trade in Goods & Services[3]** | **0.2** | **-2.8** | **-0.5** | **4.5** | **1.9** |
| **GROSS DOMESTIC PRODUCT** | **5.7** | **6.2** | **4.2** | **3.0** | **2.8** |

[1] Central Bank of Malta estimates.
[2] Deflated with the implicit Net Final Expenditure deflator.
[3] Annual changes are expressed as a percentage of the previous year's GDP.

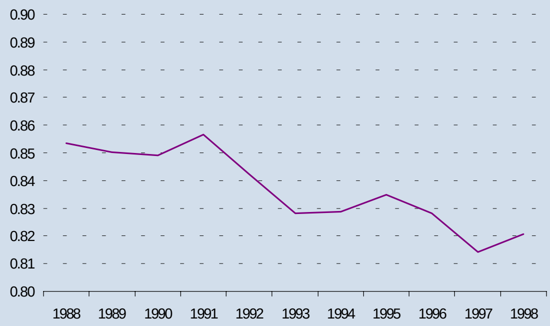
*SOURCE: Economic Planning Division,* ***Economic Survey*** agreement between the Government and the unions during the fourth quarter of 1998. This more than offset the effects of the reduction in public sector employment during the course of the year. In fact, government consumption in real terms expanded by only 1.6%, which implies that a significant proportion of the 7.8% nominal growth was attributable to higher unit labour costs.

### *2.1.2 Gross Fixed Capital Formation*

The downward trend in gross fixed capital formation observed since 1996 continued during 1998. In fact, despite the 1.4% increase in nominal terms, investment in real terms is estimated to have declined by 1% during the year under review. As Table 2.1 shows, however, this drop was significantly smaller than that recorded in 1997.

The decline in real investment in part reflected the further slowdown of the construction industry during the year. This, in turn, reflected lower capital outlays by public sector enterprises and the government. In fact, work on Terminal II of the Malta Freeport Corporation was completed during the year, while that on the new hospital at Tal-Qroqq slowed down.

CHART 2.2 TERMS OF TRADE*




Besides, the uncertain political situation that developed in the course of the year undoubtedly kept some investment expenditure plans in abeyance.

### *2.1.3 The External Balance*

The improvement in the external trade balance noted in 1997 continued during 1998. As Table 2.1 shows, the negative balance on the goods and services account in the balance of payments is estimated to have contracted by a further Lm35 million during the year under review, following a contraction of about Lm59 million in the previous year. The improvement in the trade balance in nominal terms was also reflected in a favourable trade balance in real terms. This was

**Table 2.2**
**CONTRIBUTION TO REAL GDP GROWTH BY THE VALUE ADDED COMPONENTS OF EXPENDITURE[1]**

*Percent*

| | 1994 | 1995 | 1996 | 1997 | 1998[2] |
|---|---|---|---|---|---|
| **AT CONSTANT 1973 PRICES** | | | | | |
| Consumers' Expenditure | 0.1 | 4.0 | 3.7 | 0.7 | 0.4 |
| Government Current Expenditure | 1.3 | 1.6 | 1.6 | -0.3 | 0.3 |
| Gross Fixed Capital Formation | 0.6 | 2.4 | 0.4 | -0.9 | -0.1 |
| Inventory Changes[3] | -0.9 | 0.5 | -0.2 | 0.1 | 0.4 |
| Export of Goods & Services | 2.0 | 0.7 | -1.3 | 3.4 | 1.8 |
| **Gross Domestic Product** | **3.1** | **9.2** | **4.2** | **3.0** | **2.8** |

[1] The Table shows contributions of demand components net of their import content. Imports have been distributed in accordance with balance of payments data. The estimated import content was then deducted from each component of aggregate demand. This was done by deducting imports of consumer goods and services from Consumers' Expenditure and imports of capital goods from Gross Fixed Capital Formation. Imports of industrial supplies were distributed between Consumers' Expenditure and Exports in proportion to their values (after deducting imports of Consumer Goods and Consumers' Expenditure). However, the effects of VAT in 1994 and 1995 were taken into account in the computation of the distribution of imports for these two periods. The changes in the resultant values are then shown as a percent of the previous year's GDP.
[2] Central Bank of Malta estimates.
[3] Deflated with the implicit Net Final Expenditure deflator.

partly attributable to a shift in the terms of trade in Malta's favour, as Chart 2.2 shows.

The improvement in the external balance was entirely attributable to a strong growth in exports, since imports, both in nominal and real terms, increased again, following two successive years of decline.

The increase in exports was primarily attributable to the strong performance of exports of manufactured goods, particularly by the machinery sub-sector. This, in turn, mainly reflected the upgrading of its product line by a large firm in the sector, which boosted the value of its output and, together with a decline in the international price of oil, resulted in an improvement in Malta's terms of trade. Transportation (particularly passenger carriage) and other services also contributed to the growth in exports, though gross earnings from tourism, i.e. expenditure by tourists on accommodation and other goods and services provided locally, were only marginally up from the 1997 level.

### *2.1.4 Sources of Real GDP Growth*

The data presented in Table 2.1 indicate that economic expansion during 1998 was export led. This can be seen even more clearly from Table 2.2, however. In this Table, changes in each component of aggregate demand are expressed as a proportion of the previous year's GDP, so that the sum of these percentage changes equals the GDP growth rate. Furthermore, the data presented in the Table are expressed in real terms, so as to eliminate the effects of price changes, while the import content of each component is deducted to reflect its true contribution to domestic value added. The results confirm that during 1998 GDP growth was underpinned by the strong performance of exports. The contribution of consumption expenditure to growth declined further during 1998 and was well below that recorded in 1995 and 1996, while the contribution of investment remained negative.

The decline in real gross fixed capital formation for the second consecutive year indicates that productive capacity contracted further during 1998, and this could restrict future output growth. However, the decline in investment, especially in plant and equipment, was less pronounced than in the previous year. This, together with a reported rebound in imports of capital goods during the last two months of the year, could indicate a recovery in investment and in the potential for further economic growth in 1999.

## 2.2 The Labour Market

Labour market developments during 1998 were consistent with the slowdown in output growth noted earlier. Thus, labour supply growth slowed down further, while the number of the gainfully occupied declined during the year. As a result, the unemployment rate rose from 4.6% in 1997 to 4.9% in 1998. However, it must be pointed out that the 1998 data are not strictly comparable to the data for previous years - because they exclude student-workers employed for less than twenty hours per week. If the 1997 data were to be adjusted to take this factor into account, the number of the gainfully occupied for 1998 would show an increase of about 225, and the unemployment rate would accordingly be 0.2, rather than 0.3 percentage points higher than in 1997.

As Table 2.3 shows, the labour supply increased by a mere 0.1% during 1998 - though this would rise to 0.4% if the above-mentioned change in the statistics were to be taken into account. Nevertheless, this

**Table 2.3**
**LABOUR MARKET: MAIN INDICATORS**
*Number of Persons*

| | January-December Average | |
|---|---|---|
| | 1997 | 1998 |
| Labour Supply | 143,946 | 144,054 |
| Males | 104,801 | 104,534 |
| Females | 39,145 | 39,520 |
| Registered Unemployed | 6,675 | 7,060 |
| Males | 5,609 | 6,062 |
| Females | 1,066 | 998 |
| Unemployment Rate (%) | 4.6 | 4.9 |
| Gainfully Occupied | 137,270 | 136,995 |

*SOURCE: Employment and Training Corporation* growth would still be lower than the 1.2% increase recorded in 1997. Demographic developments – particularly the decline in the male working age population – were the main factor behind the slowdown in labour supply growth. In fact, the supply of males on the labour market started to decline in 1998, while that of females increased further. However, the growing popularity of part-time employment was another factor contributing to the decline in the size of the labour force[1].

As mentioned earlier, the decline in the number of the gainfully occupied, shown in Table 2.3, was entirely attributable to the exclusion of student-workers from the employment figures. Nevertheless, even if allowance were to be made for this factor, the increase in the number of the gainfully occupied during 1998 would still be smaller, both in absolute and in percentage terms, than that recorded in 1997. This is to be expected, given the continued deceleration of economic growth.

A positive development in the labour market during 1998 was that private sector employment grew at a

## Table 2.4
## GAINFULLY OCCUPIED BY SECTOR
***Number of persons***

| | Jan.-Dec. 1997 Average | | | Percent of Gainfully Occupied | Jan.-Dec. 1998 Average | | | Percent of Gainfully Occupied |
|---|---|---|---|---|---|---|---|---|
| | Public | Private | Total | | Public | Private | Total | |
| **i. Direct Production** | **3,612** | **37,448** | **41,060** | **29.9** | **3,489** | **37,447** | **40,936** | **29.9** |
| including | | | | | | | | |
| Footwear and Clothing | 0 | 4,141 | 4,141 | 3.0 | 0 | 3,954 | 3,954 | 2.9 |
| Construction | 527 | 5,752 | 6,279 | 4.6 | 480 | 5,563 | 6,043 | 4.4 |
| Electronics, Appliances & | 0 | 4,786 | 4,786 | 3.5 | 0 | 5,076 | 5,076 | 3.7 |
| Food | 41 | 3,234 | 3,275 | 2.4 | 34 | 3,228 | 3,262 | 2.4 |
| Agriculture[1] | 0 | 2,536 | 2,536 | 1.8 | 0 | 2,558 | 2,558 | 1.9 |
| Transport Equipment[2] | 843 | 2,186 | 3,029 | 2.2 | 845 | 2,117 | 2,962 | 2.2 |
| Other[3] | 2,201 | 14,813 | 17,014 | 12.4 | 2,130 | 14,951 | 17,081 | 12.5 |
| **ii. Market Services** | **14,432** | **44,721** | **59,153** | **43.1** | **14,255** | **45,217** | **59,472** | **43.4** |
| including | | | | | | | | |
| Wholesale and Retail | 15 | 15,297 | 15,312 | 11.2 | 15 | 15,322 | 15,337 | 11.2 |
| Hotel and Catering | 370 | 8,737 | 9,107 | 6.6 | 371 | 8,750 | 9,122 | 6.7 |
| Community and Business | 3,706 | 9,550 | 13,256 | 9.7 | 3,748 | 9,478 | 13,227 | 9.7 |
| Transport | 2,188 | 5,401 | 7,589 | 5.5 | 2,165 | 5,327 | 7,492 | 5.5 |
| Malta Drydocks | 3,281 | 0 | 3,281 | 2.4 | 3,142 | 0 | 3,142 | 2.3 |
| Banks & Financial Institutions | 2,104 | 1,733 | 3,837 | 2.8 | 2,162 | 1,805 | 3,966 | 2.9 |
| Other | 2,768 | 4,003 | 6,771 | 4.9 | 2,652 | 4,535 | 7,187 | 5.2 |
| **iii. Temporarily Employed** | **4,283** | **512** | **4,795** | **3.5** | **3,885** | **595** | **4,480** | **3.3** |
| including | | | | | | | | |
| Apprentices and Trainees | 569 | 512 | 1,081 | 0.8 | 656 | 595 | 1,251 | 0.9 |
| Pupil workers | 3,087 | 0 | 3,087 | 2.2 | 3,201 | 0 | 3,201 | 2.3 |
| Student workers | 627 | 0 | 627 | 0.5 | 28 | 0 | 28 | 0.0 |
| **iv. Government[4]** | **32,260** | **0** | **32,260** | **23.5** | **32,107** | **0** | **32,107** | **23.4** |
| **Gainfully Occupied** | **54,587** | **82,681** | **137,268** | **100.0** | **53,736** | **83,259** | **136,995** | **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*

[1] Since workers in part-time employment, even those holding a part-time job as their primary job, are not included in the labour force.

# Box 1: Government Employment

Table 1 gives a breakdown, by Ministry and grade, of government employment as at the end of September 1998. The Table distinguishes between six occupational categories. The “Senior Officials and Managers” category comprises the grades ranging from Scale 1 to Scale 5 given in the Budget Estimates for 1999 published by the Ministry of Finance. The “Professionals” grade covers Scales 6 to 9, while the “Technicians and Associate professions” grade covers Scale 10 to Scale 13. “Clerks and Trades Workers” covers Scales 14 to 16, while “Elementary Occupations” represents Scales 17 to 20. These classifications are in accordance with the International Standard Classification of Occupations published by the International Labour Office (ILO).

The Table shows that clerical and trades workers represented the largest share (32.2%) of government employment. The Ministry for Home Affairs employed around 20% of these, mainly as police officers, while the Health Department employed over 15%, mainly as health assistants and paramedic or nursing aides. The “Technicians and Associate Professionals” category represents the second largest group of government employees. Teachers employed by the Ministry of Education accounted for around 40% of this category, while another 20% were nurses employed by the Ministry of Health. But the “Elementary Occupations” category, which comprises unskilled workers, such as messengers, labourers, watchman, drivers, etc. was the third largest occupational group, representing around one quarter of civil service employees. Around one-third of these were employed by the Ministry for the Environment, in activities related to public works and cleansing. Another 30% were placed, almost in equal proportions, with the Ministry of Education and the Ministry for Gozo.

**Table 1**
**GOVERNMENT CIVIL SERVICE EMPLOYEES, BY MINISTRY AND GRADE**
***(as at 30 September 1998)***

| Department/Ministry | Grades | | | | | | |
|---|---|---|---|---|---|---|---|
| | Senior Officials and Managers | Professionals | Technicians and Associate Professionals | Clerks and Trades Workers | Elementary Occupations | Part-Timers/ Contract Workers | **Totals** |
| Office of the Prime Minister | 64 | 60 | 225 | 391 | 339 | 192 | **1,271** |
| Ministry for Social Policy | 12 | 138 | 304 | 822 | 436 | 260 | **1,972** |
| Ministry of Education | 38 | 519 | 3,305 | 1,357 | 1,136 | 1,364 | **7,719** |
| Ministry of Finance | 30 | 86 | 476 | 710 | 195 | 28 | **1,525** |
| Ministry for the Environment | 18 | 67 | 465 | 1,184 | 2,453 | 48 | **4,235** |
| Ministry for Home Affairs | 41 | 97 | 414 | 1,898 | 111 | 23 | **2,584** |
| Ministry of Agriculture and Fisheries | 7 | 25 | 133 | 319 | 491 | 59 | **1,034** |
| Ministry for Gozo | 12 | 109 | 668 | 880 | 1,234 | 240 | **3,143** |
| Ministry of Health | 170 | 520 | 1,674 | 1,506 | 796 | 0 | **4,666** |
| Others | 41 | 80 | 214 | 407 | 314 | 245 | **1,301** |
| **Total** | **433** | **1,701** | **7,878** | **9,474** | **7,505** | **2,459** | **29,450** |

*Source: Estimates 1999, Ministry of Finance* faster rate than in the previous year, while public sector employment shrunk at a more rapid pace. At the same time, temporary employment, after the 1997 data are adjusted, expanded at a slightly slower rate during 1998.

Growth in private sector employment was basically attributable to a further increase in employment in the market services sector. At the same time, however, the downward trend in employment in private direct production observed over the past years was halted. In fact, as Table 2.4 shows, average employment in private direct production during 1998 remained practically unchanged at the 1997 level. While the construction industry continued to shed jobs, the manufacturing and agricultural sectors increased their labour force, thus compensating for the lower demand for labour by the construction industry.

Overall, employment in manufacturing increased by around 170 during 1998. Within the manufacturing sector, employment in the electronics industry, in particular, continued to expand, adding on almost another 300 placements, or around three times the growth recorded in 1997. In contrast, employment in the footwear and clothing industry continued to decline, so that its share in total employment fell below 3%.

Employment in market services continued to expand, although the increase – of around 500 - was around half as great as that recorded in 1997. Employment in the wholesale and retail trades, which accounts for around one third of total private sector employment in market services, rose by a mere 25, compared to the increase of around 100 recorded in 1997. Similarly, the increase in employment in hotels and catering establishments during 1998 was marginal, as against the increase of almost 400 in 1997- when two new five-star hotels were opened. Meanwhile, the community and business and the transport sectors recorded lower levels of employment, largely reflecting the lull in domestic demand. In contrast, employment in financial services recorded a 4.2% growth, reflecting mainly the expansion of the international banking sector in Malta.

At the same time, public sector employment declined further, and at a faster pace during 1998. As Table 2.4 shows, employment in government departments and security services was down by about 150 from the previous year's level, while employment in public sector corporations or state-owned companies was down by about 300.

The decline in full-time employment during 1998 was in part compensated for by an 8.4% growth in part-

**Table 2.5**
**PART-TIME EMPLOYMENT**
*Number of Persons*

| | Average for January - December | | |
|---|---|---|---|
| | 1996 | 1997 | 1998 |
| **Part-Time employees holding full-time jobs** | **12,260** | **14,029** | **15,415** |
| Males | 9,834 | 10,959 | 11,765 |
| Single Females | 1,643 | 2,003 | 2,346 |
| Married Females | 783 | 1,067 | 1,304 |
| **Part-Time employment as a primary job** | **11,333** | **12,608** | **13,447** |
| Males | 4,393 | 4,905 | 5,268 |
| Single Females | 2,436 | 2,603 | 2,765 |
| Married Females | 4,504 | 5,100 | 5,414 |
| **Total part-time employment** | **23,595** | **26,637** | **28,862** |
| Males | 14,227 | 15,864 | 17,033 |
| Single Females | 4,078 | 4,606 | 5,111 |
| Married Females | 5,290 | 6,167 | 6,718 |

*SOURCE: Employment and Training Corporation* time employment. In fact, although this was a less rapid rate of growth than was recorded in 1997, the increase of 2,225 part-time employees was still significant. The slower growth in part-time employment during 1998 was equally attributable to those who also held full-time jobs and those who had a part-time job as their primary job. The number of part-timers who also hold a full time job grew by almost 1,400 during 1998, and of these nearly 60% were males. At the same time, the number of those holding a part-time job as their primary job increased by 839. In this case, females accounted for around 57% of the increase.

### *2.2.1 Unemployment*

During 1998 the rate of unemployment averaged 4.9%, which is 0.3 percentage points higher than in 1997. This increase was mainly attributable to deficient demand, especially by the construction industry. Even the demand for labour by the market services sector was relatively weak during 1998. In contrast, manufacturing firms, particularly those engaged in export-oriented activity, increased their employment levels, thus helping to contain the growth in unemployment.

An analysis of the distribution of the unemployed by duration of registration, age and gender as at the end of December 1998 illustrated in Chart 2.3, shows that around 86% of the unemployed were males. Thus, the share of males in the unemployment pool rose for the second consecutive year. This mainly reflected the loss of jobs in the construction industry, which is largely a male-dominated occupation. In contrast, the number of unemployed females at the end of 1998 was down by almost 100 from the end-1997 level.

The share of those aged over thirty years in the unemployed was higher in 1998 than in 1997. The 30-49 age group, in particular was up by over 200, while those aged over 50 also increased further. On the other hand, the increase in youth unemployment noted in 1996 and 1997 was halted in 1998, when the number of the unemployed aged less than thirty remained at the 1997 level, as can be seen from the Chart.

As regards the distribution of the unemployed by duration of registration, long-term unemployment increased further during 1998, as the Chart shows, and its share in total unemployment rose to 45.1% from 43.8% a year earlier. Short-term unemployment

CHART2.3 INCREASE IN REGISTERED UNEMPLOYED BY DURATION, AGE AND GENDER
(YEAR TO DECEMBER 1998)

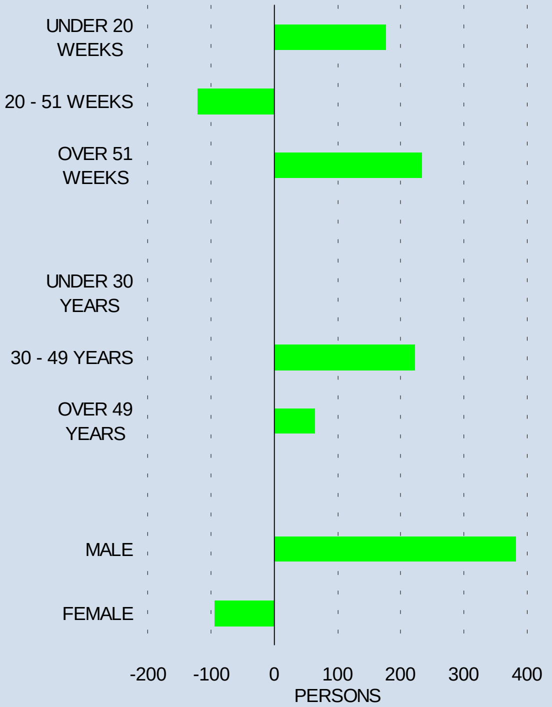
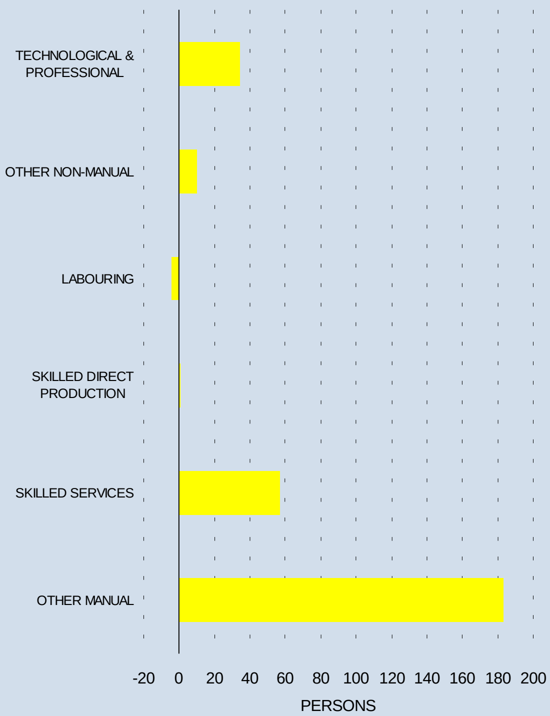



CHART2.4 INCREASE IN REGISTERED UNEMPLOYED BY TYPE OF SKILL
(YEAR TO SEPTEMBER 1998)




SOURCE: ECONOMIC PLANNING DIVISION, E

also increased during 1998, after the substantial drop recorded in the previous year, so that the number of those registering for less than 20 weeks returned to the level prevailing at the end of 1996.

Meanwhile, an analysis of the distribution of the unemployed by occupational skills, for which data are available only up to the end of September, shows that most of the increase in the number of those registering for work during 1998 came from among the unskilled. As Chart 2.4 shows, however, the number of these registering for work in the skilled services category also went up - though the bulk of these were manual workers. Thus around 80% of the increase in the unemployed were manual workers, pushing up the share of unemployed manual workers in the total unemployed to almost 77%.

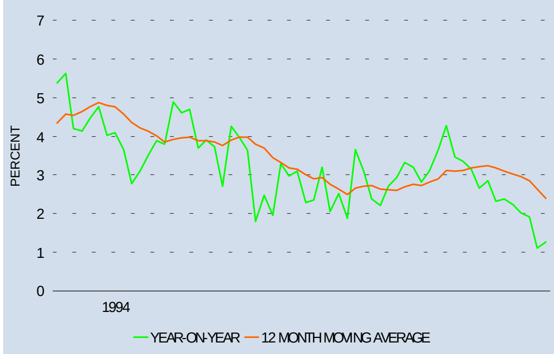
The developments highlighted above indicate that structural unemployment is increasing. This is borne out by the fact that during 1998 the age structure of the unemployed shifted towards older age categories and included a greater proportion of unskilled manual workers. Given that the sectors that are increasing their labour complement are mainly the services and the electronics industries, the increase in unemployed older-aged manual workers is likely to create a mismatch of skills between labour demand and supply. Although this could be partly remedied by re-training programmes, employers are generally more willing to recruit younger people - because the expected return on investment in their training is perceived to be greater.

## 2.3 Prices and Wages

### *2.3.1 Retail Prices*

The downward trend in retail price inflation in evidence since 1994, resumed during 1998, after the temporary rise in 1997. In reality, the rise in inflation during 1997 was principally attributable to tax and other related measures announced in the 1997 budget in January of that year, and the 1998 budget presented in November 1997. Similarly, the drop in inflation during 1998 was in part attributable to the downward revision of utility rates, which was backdated to November 1997. This had the effect of reducing the rate of

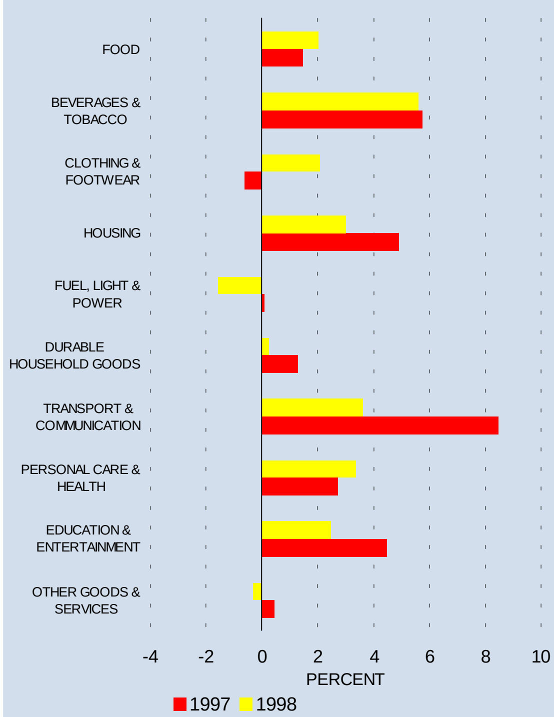
CHART 2.5 RETAIL PRICE INFLATION




inflation by about one percentage point, so that the average rate of inflation for 1998 fell to 2.4% from 3.1% a year earlier, as can be seen from Chart 2.5.

Apart from the revision in utility rates, other factors contributing to decline in inflation during 1998 were the continued slowdown in domestic demand and a decline in imported inflation. In fact, the slowdown in domestic demand, and the resulting increase in unemployment, also led to lower wage pressures during 1998. At the same time, it was estimated that imported inflation declined by almost half a percentage point during the year under review.

CHART 2.6 INFLATION RATES OF COMMODITY SECTIONS IN THE RPI



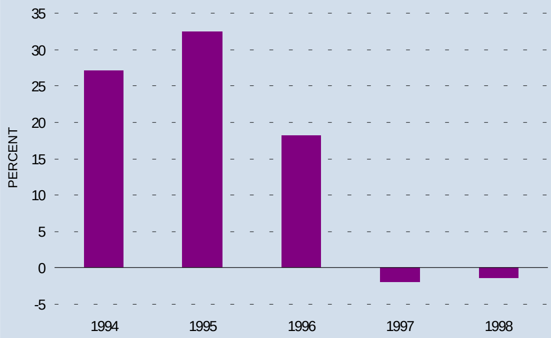
The drop in imported inflation mainly stemmed from lower inflation in Malta's main trading partner countries, though exchange rate movements also contributed. As for the tax increases announced in the Budget for 1999, it should be noted that although the increase in the excise tax on cigarettes and the rise in price of petrol were effective as from November, they were not taken into account in the readings of the RPI for November or December. Nevertheless, these would have had a minimal effect, of about 0.04 percentage points, on the measured average rate of inflation for 1998.

As Chart 2.6 shows, the decline in the rate of inflation during 1998 was reflected in several of the sub-indices that make up the RPI. Furthermore, those sub-indices that recorded a drop in inflation accounted for almost 54% of the weight in the RPI.

As can be seen from the Chart, the Fuel, Light and Power index recorded a negative rate of inflation of 1.6% during 1998, implying that the items whose prices are measured by this index actually became cheaper in 1998. However, it was the transport and communications index that recorded the sharpest deceleration, as the rate of inflation in this sub-index declined by almost 5 percentage points to 3.6%. Nevertheless, this was still around one percentage point higher than the rate of price increase recorded by this index in 1996. Thus, the drop in inflation in the transport and communications sub-index during 1998 was mainly due to the exceptional jump in the index in 1997 - as a result of the rise in price of petrol and the increase in motor-vehicle registration and licence fees that came into effect in that year.

As can be seen from the Chart, the three commodity groups that recorded a faster rate of increase in prices during 1998 were the food, clothing, and personal care and health indices. The combined weight of these sub-indices in the RPI is about 46%, but food and personal care and health tend to be rather price inelastic and represent a substantial proportion of the expenditure of low-income groups and pensioners. As the Chart shows, food prices were, on average, 2% higher in 1998 than in 1997 - although movements

CHART 2.7 AVERAGE PRICE INFLATION OF DWELLINGS




SOURCE: ESTATE AGENTS, THE SUNDAY TIMES, THE TIMES OF MALTA

in food prices, to a large extent, reflect developments in the supply of fresh food items. Furthermore it is worth noting that, at 2%, the rate of inflation in food prices in 1998, though higher than in 1997, was still well below the rates recorded between 1993 and 1996, which ranged from 3.3% to 5.3%. Similarly, despite the acceleration in the rate of increase of prices of personal care and health items, the rate of inflation of this sub-index during 1998 was somewhat lower than the 4%-5% rate recorded in the 1993-1996 period.

### *2.3.2 Real Estate Prices*

Developments in real estate prices are a useful indicator not only of activity in the construction industry but also of the strength of domestic demand. In fact, a booming property market tends to boost consumption expenditure, partly because of the wealth effect. Chart 2.7 illustrates the percentage change in the average asking price of dwellings (including finished terraced houses and flats and maisonettes in shell-form). The Chart shows that, following the sharp increases in prices observed during 1994 and 1995, a slowdown was noted in 1996 - and by the following year, asking prices of dwellings were actually declining.

CHART 2.8 ADVERTISED REAL ESTATE PRICES*

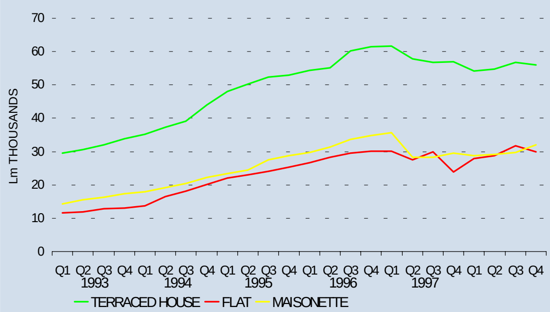


CHART 2.9 RATIO OF AVERAGE PRICES OF DWELLINGS TO THE AVERAGE WAGE*

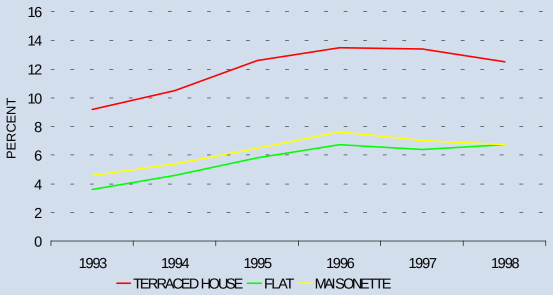
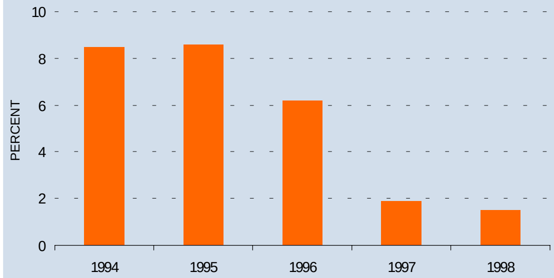



CHART 2.10 ANNUAL INCREASE IN AVERAGE WAGES*




* COMPUTED AS TOTAL WAGES AND SALARIES EARNED, DIVIDED BY THE GAINFULLY OCCUPIED POPULATION EXCLUDING THE SELF-EMPLOYED
DATA FOR 1998 ARE CENTRAL BANK OF MALTA ESTIMATES
SOURCE: ECONOMIC PLANNING, ECONOMIC SURVEY

These developments in real estate prices reflect the slowdown in both domestic demand and in activity in the construction sector during the last three years. However, it is worth noting that the average rate of increase in real estate prices in 1994 and 1995 was clearly unsustainable - as the number of completed dwellings was by far outstripping demand.

Chart 2.8 illustrates movements in the average price of the three types of dwelling units between 1993 and 1998. From the Chart one can observe that the price for each category of dwelling generally followed the same trend, with prices peaking towards the end of 1996 and following a stable to downward path thereafter. The same trend can also be discerned in Chart 2.9, where average property prices are expressed as a ratio of the annual average income from employment per employee. The Chart shows that by 1998 the average price of a finished terraced house was twelve-and-a-half times the average annual wage, while that of a flat and a maisonette in shell form was 6.7 times the average wage.

### *2.3.3 Wages*

Wage inflation eased further during 1998. This can be seen from Chart 2.10, which shows the percentage change in average income from employment per employee. As the Chart shows, the slowdown in wage inflation has been in evidence since 1996, despite the acceleration in nominal GDP growth. In fact, nominal GDP growth was higher than wage inflation during both 1997 and 1998, indicating that labour's share in total value added at factor cost declined during these two years.

Indications of lower wage inflation can also be discerned from the Central Bank's estimates of the average weekly wage based on data from collective agreements – which are presented in Table 2.6. It should be borne in mind, however, that these estimates exclude overtime pay, production bonuses, social security benefits and allowances and other income in kind, which together with wages make up the total compensation to labour. Furthermore, they ignore developments in non-unionised sectors. Thus, they are not strictly comparable to the data illustrated in Chart 2.10.

The Bank's estimates nevertheless indicate that the wages, both including and excluding the cost of living adjustment, grew at a slower pace in 1997 and 1998, though the deceleration appears less marked than that indicated by Chart 2.10. Furthermore, the average weekly wage growth during 1997 and 1998, as estimated by the Central Bank, was higher than the average rate of inflation during these two years, implying that wages continued to grow in real terms. This contrasts somewhat with the result presented in Chart 2.10. The difference may indicate, however, that unionised workers were able to secure better conditions than workers in non-unionised sectors. Furthermore, a substantial proportion of the collective agreements from which the Central Bank computed the average wage, were concluded with public sector organisations and the Government. Hence, the estimates based on these collective agreements could indicate that, during the last two years, public sector wages rose more rapidly than those in the private sector.

From Table 2.6, it can be seen that the wages of all

**Table 2.6**

**ESTIMATED AVERAGE WEEKLY WAGE RATES[1]**

***Amounts in Maltese Liri***

| | 1996 | 1997 | 1998 | 1999 |
|---|---|---|---|---|
| **Unskilled** | | | | |
| Minimum | 51.05 | 53.94 | 55.64 | 56.35 |
| Maximum | 59.93 | 62.86 | 65.15 | 65.98 |
| Spread | 8.88 | 8.92 | 9.51 | 9.62 |
| Average | 54.61 | 57.51 | 59.44 | 60.20 |
| Percentage change in Average | 6.1% | 5.3% | 3.4% | 1.3% |
| **Skilled** | | | | |
| Minimum | 62.59 | 65.86 | 67.88 | 68.60 |
| Maximum | 74.26 | 78.51 | 80.75 | 81.60 |
| Spread | 11.68 | 12.66 | 12.86 | 13.00 |
| Average | 67.26 | 70.92 | 73.03 | 73.80 |
| Percentage change in Average | 4.6% | 5.4% | 3.0% | 1.1% |
| **Clerical** | | | | |
| Minimum | 60.48 | 63.75 | 66.57 | 67.38 |
| Maximum | 83.69 | 86.55 | 88.77 | 89.59 |
| Spread | 23.21 | 22.80 | 22.19 | 22.20 |
| Average | 69.77 | 72.87 | 75.45 | 76.26 |
| Percentage change in Average | 5.2% | 4.4% | 3.5% | 1.1% |
| **Administration[2]** | | | | |
| Minimum | 99.78 | 102.74 | 104.97 | 105.43 |
| Maximum | 146.90 | 151.03 | 155.24 | 155.77 |
| Spread | 47.12 | 48.29 | 50.27 | 50.33 |
| Average | 118.63 | 122.06 | 125.07 | 125.57 |
| Percentage change in Average | 2.1% | 2.9% | 2.5% | 0.4% |
| Average Wage across categories | 65.27 | 68.50 | 70.68 | 71.44 |
| Percentage change | 5.0% | 5.0% | 3.2% | 1.1% |
| Average Wage including COLA[3] | 78.27 | 83.25 | 86.93 | 89.44 |
| Percentage change | 7.0% | 6.4% | 4.4% | 2.9% |

[1] The table shows Central Bank estimates based on data regarding collective agreements 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.

[3] Some negotiated increases were exclusive of cost of living adjustments.

four employee categories grew at a slower rate in 1998. Furthermore, the difference in the percentage growth in wages among these four groups narrowed somewhat, ranging from 2.5% for the managerial grade to 3.5% for the clerical grades. Thus, the difference between the wages of middle management and those of the other three categories narrowed further during 1998.

The indications are that wage inflation will ease further in 1999, when the average negotiated wage increase is projected at just 1.1%. This rises to just under 3% if the cost of living adjustment is taken into account. However, this projection largely reflects the effects of the collective agreement for civil service employees concluded at the end of 1998. Thus, it is likely to be revised upwards as further agreements are concluded during the year.

## 2.4 Sectoral Analysis

### *2.4.1 Manufacturing*

The first nine months of 1998 witnessed a positive turnaround in the performance of the manufacturing

**Table 2.7**
**MANUFACTURING SECTOR: MAIN INDICATORS[1]**

| | January-September | | | % Change | | |
|---|---|---|---|---|---|---|
| | 1996 | 1997 | 1998[2] | 1996 | 1997 | 1998[2] |
| Gross Sales (Lm million) | 556.3 | 556.6 | 620.7 | -4.6 | 0.1 | 11.5 |
| Exports (Lm million) | 410.6 | 402.4 | 466.6 | -6.5 | -2.0 | 16.0 |
| Domestic Sales (Lm million) | 145.8 | 154.2 | 154.1 | 1.2 | 5.8 | -0.1 |
| Share of Manufacturing exports in Total Exorts of goods and services (%) | 52.8 | 49.0 | 52.5 | - | - | - |
| Value Added at factor cost (Lm million) | 184.0 | 181.0 | 208.0 | 3.4 | -1.6 | 14.9 |
| Manufacturing Value Added as a share of GDP at factor cost (%) | 23.4 | 22.2 | 23.2 | - | - | - |
| Average Employment for January-September | 29,891 | 29,215 | 29,308 | -1.2 | -2.3 | 0.3 |
| Average Manufacturing Employment as a share of gainfully occupied (%) | 21.8 | 21.3 | 21.4 | - | - | - |
| Net Investment (Lm million) | 31.1 | 17.0 | 15.3 | 1.6 | -45.4 | -9.9 |
| Net Investment per employee (Lm) | 1,443.8 | 817.6 | 741.6 | 5.5 | -43.4 | -9.3 |

[1] All data, save for that relating to employment, is based on a survey of large firms, excluding Malta Shipbuilding Co Ltd. Employment data refers to the entire manufacturing sector.
[2] Provisional.

*SOURCE: Economic Planning Division,* ***Economic Survey*** *; Employment and Training Corporation*

sector. Turnover by large manufacturing firms surged by 11.5% during the period - following a drop in the comparable period of 1996 and no growth in 1997. However, the data on manufacturing activity were greatly influenced by developments in the machinery sub-sector, whose turnover accounted for just over half of total sales by manufacturing industry in 1998. As explained above, the introduction of a new and more sophisticated product line by a leading firm in the machinery sub-sector boosted both the value of the imported inputs required for the firm's production and its local value added. As for the remaining sub-sectors of manufacturing industry, these recorded a 1.3% increase in turnover during the first three quarters of 1998. Although this rate of increase was around half a percentage point lower than that recorded in the same period of the previous year, it was entirely attributable to higher exports - whereas domestic sales had underpinned the rise in turnover recorded in 1997.

As can be seen from Table 2.7, turnover in the manufacturing sector in 1998 was completely underpinned by higher export sales, while domestically oriented activity largely mirrored the continued slowdown in domestic demand. Turnover by the machinery sector was up by 24% during the first nine months of 1998, following a drop of almost 2% in the same period of the previous year. This increase was entirely attributable to higher export sales by the leading firm in the machinery sub-sector though other smaller firms in this sector also reported positive results. Moreover, other sectors of manufacturing also contributed to the growth in exports, together increasing their foreign sales by 2% in 1998, following a 0.6% drop recorded in the previous year. This increase was mainly attributable to the leather and rubber sectors and the chemical industry.

The impact of the increase in export turnover by the manufacturing sector during the first nine months of 1998 was also reflected in the employment data. In fact, as can be seen from Table 2.7, the period witnessed a turnaround in average employment in manufacturing, which rose by almost 100. This increase was mainly linked to the performance of the

**Table 2.8**
**SHARES OF EXPORT SALES**
**GENERATED BY SECTOR OF MANUFACTURING ACTIVITY[1]**

*Percent*

| | January-September | | | |
|---|---|---|---|---|
| | 1995 | 1996 | 1997 | 1998[2] |
| **Export Sales (Lm millions)** | **439.1** | **410.6** | **402.4** | **466.6** |
| Food, Beverages & Tobacco | 0.9 | 1.8 | 2.0 | 1.6 |
| Textiles, Clothing & Footwear | 11.8 | 13.8 | 14.4 | 12.3 |
| Wood and Furniture | 0.1 | 0.1 | 0.3 | 0.1 |
| Paper and Printing | 3.4 | 4.1 | 2.7 | 2.3 |
| Machinery | 67.9 | 62.4 | 61.9 | 66.5 |
| Rubber and Leather | 3.1 | 3.1 | 3.4 | 3.4 |
| Chemicals | 2.9 | 3.6 | 3.5 | 3.2 |
| Non-Metals | 0.2 | 0.2 | 0.3 | 0.3 |
| Metals | 1.1 | 1.1 | 1.4 | 1.1 |
| Transport | 0.3 | 0.7 | 0.9 | 0.8 |
| Miscellaneous | 8.3 | 9.1 | 9.3 | 8.4 |

[1] Based on a survey of large manufacturing firms, excluding Malta Shipbuilding Co. Ltd.
[2] Provisional.

*SOURCE: Economic Planning Division,* ***Economic Survey***

machinery sub-sector, though some other sectors also contributed.

Value added by the manufacturing sector during the first nine months of 1998 was up by almost 15% from the previous year's level. Thus, the contribution of manufacturing to GDP at factor cost rose by around one percentage point to 23.2% during the period. The growth in the sector's value added was primarily attributable to higher profits, which were up by around

**Table 2.9**
**EMPLOYMENT IN LARGE MANUFACTURING FIRMS[1]**

| | January-September | | | | | |
|---|---|---|---|---|---|---|
| | 1996 | | 1997 | | 1998[2] | |
| | Persons | % Share | Persons | % Share | Persons | % Share |
| **Employment** | | | | | | |
| Food, Beverages & Tobacco | 3,151 | 14.6 | 2,979 | 14.3 | 2,901 | 14.1 |
| Textiles, Clothing & Footwear | 4,764 | 22.1 | 4,453 | 21.4 | 4,285 | 20.8 |
| Wood and Furniture | 1,085 | 5.0 | 1,015 | 4.9 | 1,073 | 5.2 |
| Paper and Printing | 1,663 | 7.7 | 1,472 | 7.1 | 1,469 | 7.1 |
| Machinery | 3,520 | 16.3 | 3,781 | 18.2 | 4,027 | 19.5 |
| Rubber and Leather | 1,204 | 5.6 | 1,239 | 6.0 | 1,366 | 6.6 |
| Chemicals | 1,435 | 6.7 | 1,464 | 7.0 | 1,496 | 7.3 |
| Non-Metals | 922 | 4.3 | 820 | 3.9 | 772 | 3.7 |
| Metals | 1,143 | 5.3 | 1,041 | 5.0 | 876 | 4.2 |
| Transport | 275 | 1.3 | 251 | 1.2 | 244 | 1.2 |
| Miscellaneous | 2,393 | 11.1 | 2,252 | 10.8 | 2,109 | 10.2 |
| Total | 21,556 | 100.0 | 20,768 | 100.0 | 20,618 | 100.0 |

[1] Based on a survey of large manufacturing firms, excluding Malta Shipbuilding Co. Ltd.
[2] Provisional.

*SOURCE: Economic Planning Division,* ***Economic Survey.***

**Table 2.10**

**NET INVESTMENT IN LARGE FIRMS**[1]

| | January-September | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 1995 | | 1996 | | 1997 | | 1998 | |
| | Lm000s | % Share | Lm000s | % Share | Lm000s | % Share | Lm000s | % Share |
| **Net Investment** | | | | | | | | |
| Food, Beverages & Tobacco | 4,785 | 15.6 | 3,993 | 12.8 | 1,686 | 9.9 | 1,124 | 7.4 |
| Textiles, Clothing & | 1,254 | 4.1 | 1,009 | 3.2 | 706 | 4.2 | 616 | 4.0 |
| Wood and Furniture | 90 | 0.3 | 45 | 0.1 | 40 | 0.2 | 85 | 0.6 |
| Paper and Printing | 1,525 | 5.0 | 256 | 0.8 | 793 | 4.7 | 996 | 6.5 |
| Machinery | 18,402 | 60.1 | 22,764 | 73.1 | 10,429 | 61.4 | 9,310 | 60.9 |
| Rubber and Leather | 53 | 0.2 | 311 | 1.0 | 486 | 2.9 | 646 | 4.2 |
| Chemicals | 615 | 2.0 | 706 | 2.3 | 1,138 | 6.7 | 714 | 4.7 |
| Non-Metals | 423 | 1.4 | 65 | 0.2 | 40 | 0.2 | 43 | 0.3 |
| Metals | 221 | 0.7 | 318 | 1.0 | 634 | 3.7 | 217 | 1.4 |
| Transport | 253 | 0.8 | 13 | - | 11 | 0.1 | 10 | 0.1 |
| Miscellaneous | 3,007 | 9.8 | 1,642 | 5.3 | 1,015 | 6.0 | 1,529 | 10.0 |
| Total | 30,628 | 100.0 | 31,122 | 100.0 | 16,979 | 100.0 | 15,291 | 100.0 |

[1] Based on a survey of large manufacturing firms, excluding Malta Shipbuilding Co. Ltd.

[2] Provisional.

*SOURCE: Economic Planning Division,* ***Economic Survey***

25% during the first nine months of 1998, following a 2% drop in the comparable period of 1997. As a result, profitability in manufacturing industry is estimated to have increased to about 10% of total turnover. The developments in the machinery sub-sector highlighted earlier were largely responsible for the overall increase in the manufacturing sector's profits though reduced losses by the shipbuilding and ship-repair industry also contributed. Income from employment in manufacturing also increased during the period, rising by almost 8% from the previous year's level, and in contrast with the 1.4% drop recorded a year earlier.

Table 2.7 clearly shows that the local manufacturing sector has become increasingly geared to export-oriented activity, as the share of export sales in total manufacturing turnover has risen to over 75%. This development mainly reflected the vigorous growth of the electronics industry, whose sales now accounts for around two-thirds of total exports of manufactured goods, as can be inferred from Table 2.8. Nevertheless, the steady growth in the share of other export-oriented industries, such as rubber and leather and chemicals, in total employment in manufacturing (see Table 2.9), indicates that the trend is more broadly based.

Despite the positive developments in terms of turnover, employment and value added by manufacturing, net investment in the sector during the first nine months of the year declined further in1998. In fact, as Table 2.10 shows, net investment in large manufacturing firms was down by almost 10% from the previous year's level during the period. However, aggregate data on investment in a small economy like Malta are likely to be highly influenced by the investment decisions of the larger firms. In fact, a major investment programme undertaken by a particular firm in recent years had a substantial impact on investment in those years. With the completion of this investment in 1997, the aggregate data for investment in the following year has shown a drop.

Thus, during the first nine months of 1998, investment by the machinery sector was down by around Lm1 million from the previous year's level. As Table 2.10 shows, however, in 1995 and 1996, this sector had invested heavily. Even in 1997, the leading firm in the sector undertook significant investment expenditure

**Table 2.11**
**TOURIST ARRIVALS BY NATIONALITY**

| Nationality | January-December | | Change | | % share in total arrivals January-December | |
|---|---|---|---|---|---|---|
| | 1997 | 1998 | Persons | Percent | 1997 | 1998 |
| Austria | 17,913 | 23,741 | 5,828 | 32.5 | 1.6 | 2.0 |
| Belgium | 25,567 | 25,146 | -421 | -1.6 | 2.3 | 2.1 |
| France | 62,457 | 72,512 | 10,055 | 16.1 | 5.6 | 6.1 |
| Germany | 193,020 | 203,199 | 10,179 | 5.3 | 17.4 | 17.2 |
| Italy | 90,190 | 90,558 | 368 | 0.4 | 8.1 | 7.7 |
| Libya | 39,289 | 37,509 | -1,780 | -4.5 | 3.5 | 3.2 |
| Netherlands | 52,238 | 56,534 | 4,296 | 8.2 | 4.7 | 4.8 |
| Scandinavia | 33,576 | 35,414 | 1,838 | 5.5 | 3.0 | 3.0 |
| Switzerland | 17,924 | 24,776 | 6,852 | 38.2 | 1.6 | 2.1 |
| United Kingdom | 436,899 | 448,763 | 11,864 | 2.7 | 39.3 | 38.0 |
| Others | 142,088 | 164,088 | 22,000 | 15.5 | 12.8 | 13.9 |
| **Total** | **1,111,161** | **1,182,240** | **71,079** | **6.4** | **100.0** | **100.0** |

*SOURCE: Central Office of Statistics*

in connection with the introduction of the new product line referred to earlier. Similarly, the drop in investment in the chemicals sector in 1998, shown in the Table, followed the construction of a plant producing pesticides in 1997. In fact, net investment by this sector during 1998 was in line with that recorded in 1996. At the same time, the paper and printing and the rubber and leather sub-sectors recorded growth in investment during 1998. But this followed relatively low levels of investment in these sectors in the previous year.

***2.4.2 Tourism***

In many respects, the performance of the tourism industry during 1998 remained positive. Tourist arrivals reached a record high of almost 1.2 million, as growth in the number of tourists visiting Malta accelerated by a percentage point to 6.4%. Even the number of cruise passengers visiting the island continued to increase at a double-digit rate during the year. Nevertheless, data on the number of days stayed by tourists during the first half of the year show that these were up only marginally (by 0.6%) from the previous year's level – indicating that visitors were, on average, staying for shorter periods. This was in fact reflected in gross earnings by the industry, which increased by less than 2% from the previous year's level.

The sustained growth in the number of tourist arrivals was underpinned by a number of factors. The growth rates recorded in a number of markets mainly reflected the economic situation of the source countries, since this obviously influences out-bound tourism from these countries. For example, the marked growth in arrivals from France and Germany reflected the higher rates of economic expansion in these countries. By contrast, slower economic growth in the UK and Italy led to a slower growth in arrivals from these two markets. Another factor that influences tourism, particularly the more price-sensitive markets, is exchange rate developments. In this regard, the slower growth in arrivals from the UK also partly reflected the fact that sterling's appreciation against the Maltese lira was significantly less marked in 1998 than in the previous year. More aggressive marketing efforts and increased flight capacity to some destinations also contributed to the increase in tourist arrivals. Competition from other destinations, however, remains stiff, and the monopoly power of foreign tour operators maintains the pressure on local operators to keep prices competitive.

Table 2.11 gives a breakdown of tourist arrivals by

**Table 2.12**
**CHOICE OF TOURIST ACCOMODATION 1997/1998 (January-June period)**
*Number of bednights stayed, by nationality and by category*

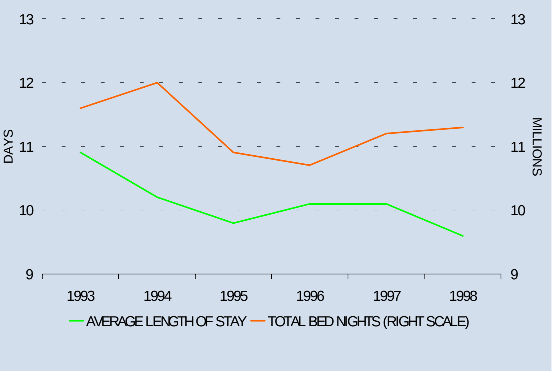
| | HOTELS | | | | | Guest Houses | Complexes | Other | Total |
|---|---|---|---|---|---|---|---|---|---|
| | 5-Star | 4-Star | 3-Star | 2-Star | 1-Star | | | | |
| **UK** | | | | | | | | | |
| 1998 | 63,383 | 588,415 | 309,561 | 81,879 | 724 | 7,209 | 585,196 | 415,669 | 2,052,036 |
| 1997 | 40,643 | 535,377 | 326,245 | 87,492 | 602 | 4,786 | 532,155 | 416,586 | 1,943,886 |
| %Change | 56.0 | 9.9 | -5.1 | 6.4 | 20.3 | 50.6 | 10.0 | -0.2 | 5.6 |
| **Germany** | | | | | | | | | |
| 1998 | 51,112 | 301,446 | 126,211 | 14,339 | 591 | 4,698 | 133,946 | 169,007 | 801,350 |
| 1997 | 39,670 | 290,952 | 209,233 | 106,305 | 529 | 7,219 | 127,272 | 178,502 | 959,682 |
| %Change | 28.8 | 3.6 | -39.7 | -86.5 | 11.7 | -34.9 | 5.2 | -5.3 | -16.5 |
| **Italy** | | | | | | | | | |
| 1998 | 42,773 | 53,356 | 39,244 | 4,486 | 390 | 827 | 25,580 | 84,100 | 250,766 |
| 1997 | 24,779 | 51,185 | 38,908 | 7,568 | 201 | 1,555 | 18,337 | 86,086 | 228,619 |
| %Change | 72.6 | 4.2 | 0.9 | -40.7 | 94.0 | -46.8 | 39.5 | -2.3 | 9.7 |
| **France** | | | | | | | | | |
| 1998 | 18,115 | 81,698 | 29,855 | 13,085 | 434 | 1,153 | 63,677 | 37,660 | 245,677 |
| 1997 | 12,982 | 70,819 | 34,311 | 3,746 | 69 | 902 | 56,129 | 37,813 | 216,771 |
| %Change | 39.5 | 15.4 | -13.0 | 249.3 | 529.0 | 27.8 | 13.4 | -0.4 | 13.3 |
| **Other** | | | | | | | | | |
| 1998 | 126,226 | 258,916 | 123,360 | 28,411 | 2,607 | 8,759 | 269,705 | 394,678 | 1,212,652 |
| 1997 | 74,273 | 233,175 | 106,371 | 29,063 | 1,685 | 8,584 | 254,857 | 477,977 | 1,185,985 |
| %Change | 69.9 | 11.0 | 16.0 | -2.2 | 54.7 | 2.0 | 5.8 | -17.4 | 2.2 |
| **Total** | | | | | | | | | |
| 1998 | 301,609 | 1,283,831 | 628,231 | 142,200 | 4,746 | 22,646 | 1,078,104 | 1,101,114 | 4,562,481 |
| 1997 | 192,347 | 1,181,508 | 715,068 | 234,174 | 3,086 | 23,046 | 988,750 | 1,196,964 | 4,534,943 |
| % Change | 56.8 | 8.7 | -12.1 | -39.3 | 53.8 | -1.7 | 9.0 | -8.0 | 0.6 |

*SOURCE: National Tourism Organization - Malta*

nationality during 1997 and 1998. The Table clearly shows that virtually all major markets registered growth, in terms of arrivals, during 1998. Around 45% of the increase in the number of incoming tourists was, however, more or less evenly distributed between the UK, France and Germany. Nevertheless, the increase in arrivals from the UK was only about one-third of that recorded in 1997, and occurred entirely during the first half of the year. In fact, the number of British tourists declined marginally both during the third and during the final quarter of the year. These developments are in part explained by the depreciation of sterling and the slowdown in the UK economy during the second half of the year. In contrast, the growth in arrivals from Germany, which was more marked than in 1997, took place entirely during the second half of the year. This was mainly attributable to a change in the marketing strategy of a leading German tour operator, which in 1998 was aimed at distributing arrivals more evenly throughout the year, rather than concentrating them in one quarter, as in 1997. Arrivals from France rose by more than 16% during 1998. This increase was partly attributable to the introduction of charter flights to Malta by a French airline as from April, though more intensive marketing efforts also contributed.

Other source markets, which contributed notably to the growth in tourist arrivals during 1998, were the Swiss, the Austrian and Dutch markets. Together, these accounted for almost a quarter of the overall increase and gained a percentage point in market share. However, the performance of these three markets varied over the course of the year. On the one

CHART 2.11 AVERAGE LENGTH OF STAY* AND TOTAL TOURIST BED NIGHTS*




hand, arrivals from Netherlands and Switzerland increased steadily from one quarter to another; on the other hand, the bulk of the increase in arrivals from Austria occurred during the shoulder months and towards the end of the year.

As Table 2.11 shows, the countries grouped under the "others" category added on another 22,000 tourists during 1998, thus topping up their market share by a full percentage point to just under 14%. The North American and Russian markets accounted for almost a quarter of this increase, while the Republic of Ireland contributed another 15%. Strong gains were also recorded in arrivals from Japan.

A more revealing indicator of the performance of the tourism industry than arrivals is the number of days stayed by tourists. A rising number of arrivals could well be accompanied by a drop in the industry's earnings if tourists started taking shorter holidays. The latest available data on the number of days stayed by visitors to Malta, however, relate to the first half of 1998. The data, reproduced in Table 2.12 clearly show that despite a 3.7% increase in the number of arrivals, the number of days stayed during the period was up by only 0.6%. This implies that the average visitor's length of stay during the first six months of the year fell to 8.9 days, from 9.2 days in the comparable period of the previous year. In fact, Central Bank estimates, illustrated in Chart 2.11 show that, for 1998 as a whole, the number of days stayed went up by about 1.2%, with the average length of stay declining by around half a day to 9.6 days. Thus, given the number of available beds, the occupancy rate is estimated to have declined to 67.9% in 1998 from 68.2% in 1997.

Table 2.12 also gives a breakdown of the number of days stayed by category of accommodation and nationality of tourists during the first half of 1997 and 1998. This shows that the number of days stayed by tourists from Malta's two largest source markets, the UK and Germany, largely reflected the number of arrivals from these markets. In fact, the average British and German visitor's length of stay remained virtually unchanged from the previous year's level. On the other hand, the growth in tourist arrivals from France and the countries grouped under the "others" category significantly outstripped the growth in the number of days stayed by visitors from these source markets, implying a drop in their average length of stay. In contrast, while arrivals from Italy remained virtually at the 1997 level, the number of days stayed by Italian tourists went up by nearly 10%, implying an increase in their average length of stay by around half a day to 7.6 days.

Table 2.12 also shows that the shift towards the upper end of the accommodation category spectrum, noted in 1997, continued during 1998. Thus, the combined share of bednights stayed in 4- and 5-star hotels in the total number of bednights stayed during the first half of 1998 rose to 34.7%, from 30.3% a year earlier. This partly reflected the increase in bed-capacity in the upper accommodation category as a result of the completion of two new 5-star hotels early in 1997. 1998 represented the first full year of operation for these two hotels. Besides, during 1998, two 4-star hotels added a further 400 beds to their existing capacity.

The performance of the tourism industry in terms of revenue generated was less positive in 1998 than in 1997. In fact, estimates for 1998 show that gross earnings from tourism were up by only about 1.8% from the previous year's level. This is not surprising, given that the number of days stayed increased only marginally during 1998. Besides, cruise passenger arrivals, which had risen by 57,400 in 1997, rose by only 17,400 in 1998. Another factor contributing to the relatively slow growth in earnings from tourism was the downward pressure on accommodation rates, even at the upper end of the accommodation spectrum,

**Table 2.13**
**CONSTRUCTION ACTIVITY INDICATORS**

| | January-September | | |
|---|---|---|---|
| | 1996 | 1997 | 1998 |
| **Sales (Lm million) of which:** | **87.4** | **87.3** | **83.1** |
| Private Sector | 44.6 | 47.7 | 45.6 |
| Public Sector | 42.8 | 39.6 | 37.5 |
| Value Added (Lm millions) | 27.0 | 29.1 | 28.5 |
| Share of value added in GDP (%) | 3.4 | 3.6 | 3.2 |
| Employment (Average for January-December - No. of persons) | 6,584 | 6,279 | 6,043 |
| Share in gainfully occupied (%) | 4.8 | 4.6 | 4.4 |

*SOURCE: Economic Planning Division,* ***Economic Survey***

exerted by excess capacity.

Growth in the number of tourist arrivals, however, certainly contributed to the increase in revenue from passenger carriage generated by the national airline. In fact, this was estimated to have increased by about 6% to Lm63.4 million in 1998. If one were to add this to the figure for gross earnings from tourism, which refers to expenditure on goods and services by tourists during their stay in Malta, then total revenue generated by tourism in 1998 would rise to about Lm317.6 million, up from Lm309.5 million in 1997. With the import content of tourism expenditure being estimated at around 35%, the net contribution of the industry to nominal GDP in 1998 would be around 15%.

The number of tourists expected to visit Malta during 1999 is expected to increase further, as indicated by the increase in number of bookings. However, differences in performance of major individual markets are likely to emerge during the year. Thus, as a result of the current slowdown of the UK economy and a possibly weaker pound sterling, the strong growth in arrivals from the UK observed over the past two years is not expected to continue during 1999. Indeed, a contraction in the number of arrivals from the UK can be anticipated. This is expected to be outweighed by the performance of some of the major continental European markets, especially Germany. In fact, the increase in the number of German bookings for 1999 seems to confirm this. However, flight capacity constraints could well provide a cap for growth in this market. Gains are also anticipated in the French market, as a leading French tour operator has launched a holiday brochure dedicated to Malta and will be increasing flight capacity during 1999.

### *2.4.3 Construction*

The main indicators relating to construction activity, which are presented in Table 2.13, mostly cover the first nine months of the year. Unfortunately, data relating to the number of approved building permits in terms of floor space area were not available for 1998. But the data presented in the Table clearly indicate a negative performance by the construction industry during the year reviewed. During the first nine months of the year, turnover by the industry declined by nearly 5%, after it had managed to maintain the level of sales of the previous year in 1997. The drop in turnover during 1998 was attributable to a Lm2.1 million fall in sales to both the private and public sector, as the Table shows. The drop in sales to the private sector was in sharp contrast with the 7% increase recorded in 1997 - though this largely reflected the completion of two new hotels early in that year. On the other hand, the drop in sales to the public sector largely reflected the cut in government capital expenditure during 1998.

The decline in the value of turnover by the construction industry was mirrored in its value added at factor cost, which fell by around 2% during the first nine months of 1998. This also led to a drop in the sector's share in total value added, which fell to 3.2% of GDP, from 3.6% in 1997. The drop in value added by the construction industry during 1998 was attributable both to lower income from employment and to lower profits. The employment income component declined for the second consecutive year, in line with the continued decline in employment in the sector. The drop in the profits component, however, contrasted with the increase recorded in the previous year - though the latter was entirely linked to the completion of the above-mentioned hotels, the profit on which was realised in 1997.

**2.5 Outlook for 1999**

Central Bank projections on the performance of the Maltese economy, which are discussed in more detail in Box 2 at the end of this chapter, indicate that real GDP growth is expected to rise to the 3% to 3.5% range in 1999. Growth is expected to be aided by a more stable environment and the commencement of a number of infrastructural projects that were postponed in the previous year. The latter, in particular, should revive the construction industry and have some spillover effects on domestic demand generally. The contribution of exports to economic growth should also remain substantial, despite the expected weakness in demand in the Euro-zone economies. Furthermore, as the outlook for the US economy remains positive, the strong performance of the local electronics industry should be sustained during the coming year. There are also indications that the performance of the tourism industry will remain positive, with arrivals increasing further, although flight capacity constraints could restrict growth.

On the negative side, however, the recovery in domestic demand, together with the still significant fiscal impulse, are likely to rekindle pressures on prices and on the current account of the balance of payments. Thus, retail price inflation may be expected to rise again towards the 3% mark. This increase in inflation will in part stem from the expected one-time jump in the RPI resulting from the re-introduction of VAT, and in part from the other measures announced in the November 1998 budget. On the other hand, imported inflation is expected to remain low, and possibly even to decline further, as inflation in Europe is likely to remain well under control, while exchange rate movements should also make imports cheaper. Meanwhile, the rise in unemployment during 1998, as well as efforts to maintain price competitiveness, should also dampen upward pressures on wages.

The expected recovery in domestic demand during 1999, especially in the construction sector, should help to increase employment, although the construction industry is becoming increasingly less labour intensive. The expected positive performance of the electronics industry and of the tourism sector are also likely to boost employment. On the other hand, the need to create a more competitive environment, partly in view of the preparations ahead of negotiations for EU membership, and to restructure manufacturing industry and other sectors of the economy, becomes ever more pressing, and this could lead to some job losses in some sectors. As a result, unemployment during 1999 is expected to remain around the 5% mark.

# Box 2:
# Medium Term Projections for the Maltese Economy

*This article reviews the principal macroeconomic developments in the Maltese economy during 1997 and 1998, and attempts to analyse the expected trends during the period up to the year 2004. The analysis is conducted using a purposely-adapted version of the Central Bank of Malta's structural macro-econometric model of the economy. The objective of this exercise is to assess the sustainability of the expected future development of the Maltese economy given the present policy stance and the conditions likely to impinge on the economy in the medium term.*

**The Model**

The Central Bank's macro-econometric model of the Maltese economy has been described in past issues of the Bank's Quarterly Review[1]. Since then, the model has been updated in the light of the latest data and economic developments. For the purposes of this exercise, the model has been simplified, linearilised, and expressed in reduced form. This procedure has sacrificed some of the complexity of the model's simulation capabilities in exchange for improved tractability and has thus enhanced its forecasting characteristics. The general features of the revised model, however, remain those of the original one.

The core of the model used in this exercise is the determination of real GDP through behavioural equations for its expenditure components. Private consumption depends essentially on real disposable income, while public consumption is determined primarily by government employment, which is exogenous. Investment expenditure is influenced by a measure of permanent demand, and generates productive capacity. Discrepancies between total demand and total output yielded by the productive capacity are reflected in changes in inventories. Export demand is determined by productive capacity, foreign demand, and the real exchange rate. Import expenditure responds to domestic demand and the real effective exchange rate, the latter taking into account the effects of import duties.

The central price variable in the model is the consumer price. It is determined from a supply-side approach as a weighted average of import prices and domestic unit labour costs. Import prices reflect foreign prices adjusted by exchange rate movements, all of which are exogenous. The domestic unit labour costs are the change in wage costs net of exogenous productivity improvements. Other price variables in the model are based on the consumer price. Wages are determined by an equation featuring prices, demand and productive capacity. Therefore, domestic inflation would rise above imported inflation if increases in demand are not matched by higher productivity or productive capacity that would restrain the increase in unit labour costs.

Real expenditure and price variables are combined to produce the fiscal and balance of payments sectors of the model. In the fiscal sector, exogenous tax rates are applied to appropriate tax bases to generate government revenue. Government expenditure depends on public consumption and on transfer payments, with the latter developing in line with inflation and exogenous demographic factors. Capital expenditure is determined exogenously. In the balance of payments sector, the current price value of the goods and services balance on the external current account is derived by setting off imports against exports using the relative real expenditure and price variables.

**Developments During 1997 and 1998**

This analysis is centred around six principal macro-

[1] See Cordina G, "A Structural Econometric Model of the Maltese Economy", Central Bank of Malta Quarterly Review, September 1996 and December 1996.

**Table 1**
**MACROECONOMIC INDICATORS**

| | 1997 | 1998 |
|---|---|---|
| Real GDP growth | 3.0% | 2.8% |
| Nominal GDP growth | 6.7% | 8.2% |
| Unemployment rate | 5.0% | 5.1% |
| Inflation rate | 3.1% | 2.7% |
| Fiscal Borrowing Req. (Lm millions) | 128.8 | 163.2 |
| Fiscal Borrowing Req. (% of GDP) | 10.1% | 11.7% |
| External Goods and Services (Lm millions) | -108.0 | -73.1 |
| External Goods and Services (% of GDP) | -8.4% | -5.3% |

economic variables that most usually fall under scrutiny - namely, the real and nominal GDP, the rates of unemployment and inflation, and the "twin deficits" – i.e. the fiscal balance and the external goods and services trade balance. The latter two are also analysed in terms of their share in GDP. Table 1 details the development of these variables in 1997 and 1998.

Real GDP growth is estimated to have slowed down to around 2.8% in 1998, from 3% in 1997. This primarily reflected weaker growth in domestic private consumption, as exports increased strongly during the year. In spite of the slower real GDP growth, the increase in nominal GDP accelerated during the year, on account of more rapid price increases in the manufacturing export sector. Reflecting the weak domestic demand, the unemployment rate remained relatively stable at just over 5%. The inflation rate dropped by 0.7 percentage points to 2.4%, reflecting the state of domestic demand as well as lower imported inflation. The fiscal deficit continued to widen in 1998, as expenditure rose at a steady rate while revenue decreased somewhat. The development of domestic demand, as well as the timing of the collection of revenue arrears, significantly affected the fiscal deficit figure for 1998. The external goods and services balance remained in deficit, albeit this narrowed in view of a substantial increase in exports of electronic goods, a drop in the price of oil imports, and the weakness of domestic demand.

**Bases for the Projections**

The estimates of the economic performance during 1998 are used as the base for the forecasts covering the period 1999 to 2004. The principal premises and assumptions on which these projections are based are the following:

i. The main measures presented in the fiscal Budget for 1999 are implemented. These include the re-introduction of Value Added Taxation (VAT) in place of the Customs and Excise Tariff (CET) system, the increase in employees' National Insurance contribution rates to 9% in 1999 and 10% in 2000, changes in a number of other indirect taxes[2], and efficiency gains in public sector operations.

ii. Capital expenditure by Government develops as indicated in projections recently issued by the Ministry of Finance[3].

iii. Government wages develop in line with the provisions of the 1998 Civil Service collective agreement.

iv. Government employment remains constant at the 1998 level.

v. Social security benefits develop in line with average wages and demographic factors.

vi. The stance of fiscal policy remains otherwise

[2] For an analysis of the expected economic effects of these measures see "The Budget Estimates for 1999: An Analysis of the Government's Budgetary Operations", Central Bank of Malta Quarterly Review, December 1998.

[3] "Consolidated Account Structure: Trends and Projections 1985-2004", Ministry of Finance, Malta, November 1998.

unchanged during the period covered by the projections. The same applies to interest rate and exchange rate policies.

vii. The average inflation in Malta's main trading partners fluctuates closely around 1.7% per annum, while real demand growth in these countries averages 2% per annum.

viii. The productivity of the resources employed in the Maltese economy improves by 1% per annum. This assumption is deemed reasonable in view of the state of development in Malta and the recent performance of the economy.

ix. The increase in the labour supply fluctuates closely around an average of 1.5% per annum.

x. An autonomous increase in private investment of an order of between Lm10-15 million takes place each year during the forecast period. This is presumed to reflect the various capital projects that are expected to be undertaken during the period.

The projections discussed below depend to a considerable extent on each of these premises and assumptions, and are likely to be significantly altered if any of them are changed. It is important to note that the projections do not make any allowance for the development of significant new export ventures, except for those created by the capital projects being envisaged. The projections also assume no changes in Malta's relations with the EU.

**The Projections**

*Real GDP growth* is expected to accelerate to around 3.3% in 1999, to peak at 3.6% in 2000, and to gradually moderate to around 3.2% thereafter, as Chart 1 shows. These projections reflect the expected developments in domestic demand and export activity during the forecast period.

On the basis of information available at present, export activity is expected to continue growing at a sustained rate in 1999. The prospects for the larger exporting firms are generally positive for the year. Export activity should be further stimulated in later years by the creation of productive capacity arising out of the capital projects that are expected to be undertaken. On the other hand, it should be pointed out that the uncertainty inherent in forecasting exports increases significantly with time, due to the dependence of the country's exports on a few major exporters and the difficulties in assessing the likely effects of the envisaged industrial restructuring on smaller operators.

Domestic demand is expected to recover in the latter half of 1999 and to remain generally sustained for most of the forecast period. This is a reflection of the undertaking of the capital projects and their multiplier effects, together with cyclical demand factors that would tend to reverse the slowdown observed between 1996 and the first part of 1999. Playing against these factors is a projected slower growth in government expenditure, particularly of a capital nature.

On balance, however, sustained export activity and stronger domestic demand are both expected to contribute to a real economic growth rate in excess of 3% per annum throughout the forecast period.

*Nominal GDP growth* is more or less expected to develop in line with real GDP growth, as shown in Chart 2. This result reflects the fact that the increase in the implicit GDP deflator can - on the basis of information available at present - be expected to remain stable at around 2.5%. The only exception to this is 1999, when a deceleration in nominal GDP growth is expected as a number of exceptional developments in prices - particularly those relating to exports and imports - that took place in 1998 are not expected to be repeated. This effect is however offset by the increase in the price of domestic value added generated by the switch in the indirect tax system from CET to VAT.

The recovery in GDP growth, underpinned by a stronger domestic demand, is expected to produce a gradual but steady drop in the *unemployment rate* between 1999 and 2002, as Chart 3 shows. While government employment is, by assumption, retained at a constant level, private sector employment is projected to grow by an average of 2% per annum between 1999 and 2002. This is lower than the projected growth of real GDP, indicating the assumed increase in productivity as well as the contribution of capital investment to output generation. On the assumption that the labour supply grows by around 1.5% per annum, the unemployment rate is projected to drop by over one half of a percentage point to 4.4% by the year 2002. Meanwhile, in the context of a tightening market for labour, the private sector wage rate is projected to rise by an average of 5.6% per annum up to that year. These wage pressures, combined with slower output growth, are thus expected to contribute to an increase in the unemployment rate to 4.7% during the two years to 2004.

The projection for retail *price inflation* is strongly conditioned by the assumptions regarding imported inflation, as well as by the demand process through which the model produces an estimate for domestically-generated inflation. Price inflation is projected at 3.1% in 1999, as Chart 4 shows. This rise in inflation reflects the estimated effects of the increase in a number of indirect taxes announced in the budget for that year, as well as the replacement of the CET system by VAT that is expected, on a net basis, to somewhat increase the average rate of indirect taxation. It also reflects, to a limited extent, the effects of the recovery in domestic demand, although these are projected to impact more strongly on inflation in later years. After 1999, inflation is projected to ease, as the one-off effects of the increases in indirect taxation dissipate, and to stabilise at around 2.5% by the end of the forecast period. This stability in inflation reflects contrasting trends in imported inflation, which for most of the time is assumed to be declining, and which at no time exceeds 2%, and domestic inflation, which is expected to accelerate moderately on account of a recovery in domestic demand reflecting, in part, the persistent, if weakening, fiscal pressures. The model's projections thus indicate that, because of domestic demand pressures and the low rate of unemployment, domestic inflation in the medium term is expected to remain somewhat higher than that prevailing in Malta's trading partners. This could have negative repercussions on Malta's international price competitiveness in the longer term.

On the basis of the current stance of fiscal policy and the projected growth of the economy, the *fiscal deficit* is expected to drop from almost 12% of GDP in 1998 to just over 5% of GDP by the year 2004, as shown in Chart 5. Although declining, the fiscal deficit is thus projected to have a significant impact on the Maltese economy throughout the forecast period, stimulating domestic demand, imports, and inflation.

On the basis of the projected nominal growth of incomes, direct tax revenue is projected to increase by an average of 9% per annum between 1998 and 2004. An important assumption implicit in this result is that income tax brackets determining the progressiveness of the direct tax system remain unchanged in spite of a 6% average annual increase in personal income during the period. This effectively means that the average rate of direct taxation is construed to rise by 3 percentage points over the period. Indirect taxes, on the other hand, are presumed to bear a more proportional relationship with expenditure, such that their projected growth is somewhat lower, at an average of 7% per annum.

Meanwhile, social security expenditure is projected to be the main contributor to the increase in fiscal outlays, growing at an average annual rate of 7% between 1998 and 2004. Other important contributors to expenditure growth are projected to be interest payments and public consumption. The assumed exogenous development of government capital expenditure features a gradual decline in outlays from Lm97 million in 1998 to just over Lm78 million in 2004. This is in line with the projections published by the Ministry of Finance.

The *goods and services deficit on the current account of the balance of payments* is expected to deteriorate in 1999 and to improve gradually in later years. The latter development is very much in line with the projected development of the fiscal deficit. As Chart 6 shows, the external goods and services

# MEDIUM TERM PROJECTIONS FOR MAIN MACROECONOMIC INDICATORS

CHART 1 REAL GDP GROWTH

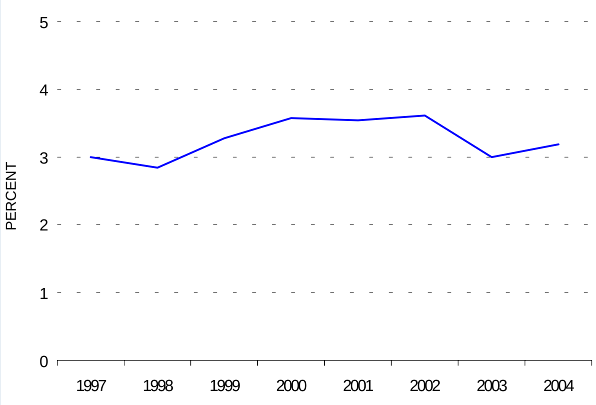



CHART 2 NOMINAL GDP GROWTH

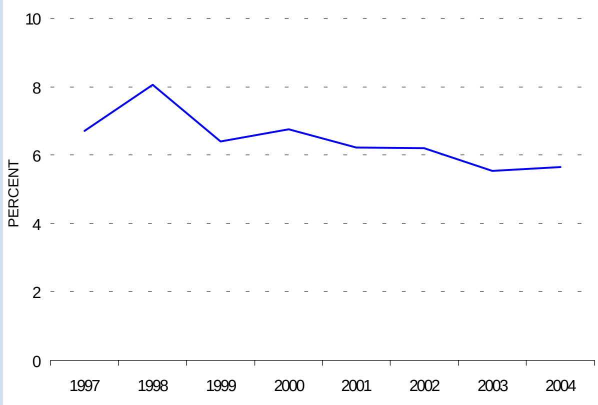



CHART 3 UNEMPLOYMENT RATE

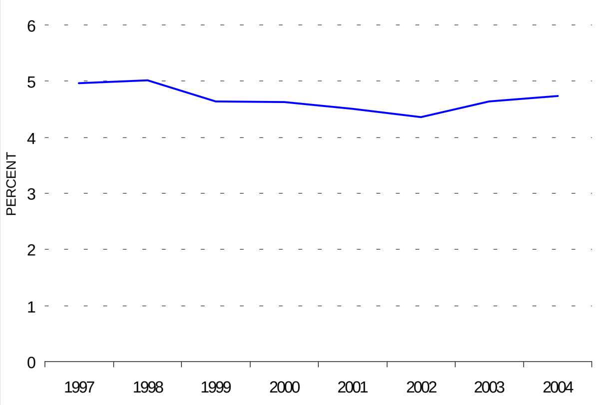



CHART 4 INFLATION RATE

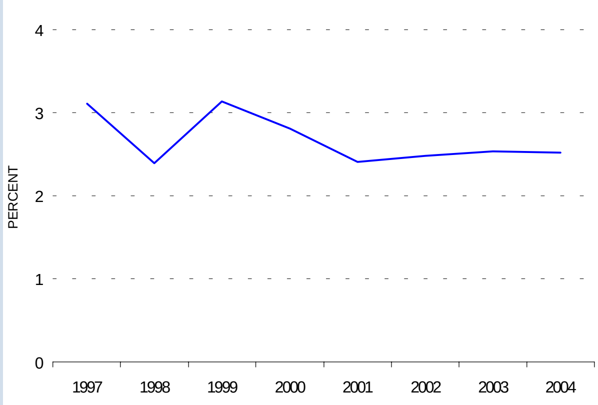



CHART 5 FISCAL DEFICIT TO GDP RATIO

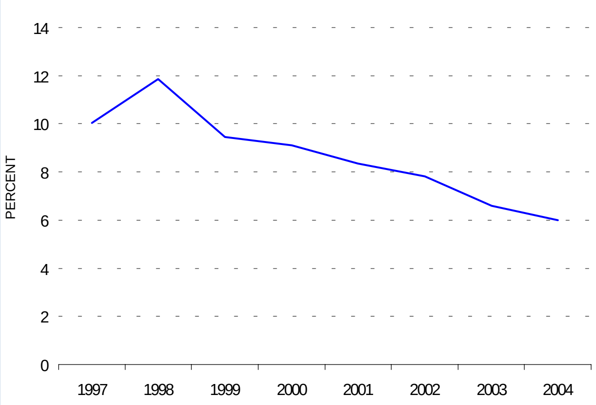
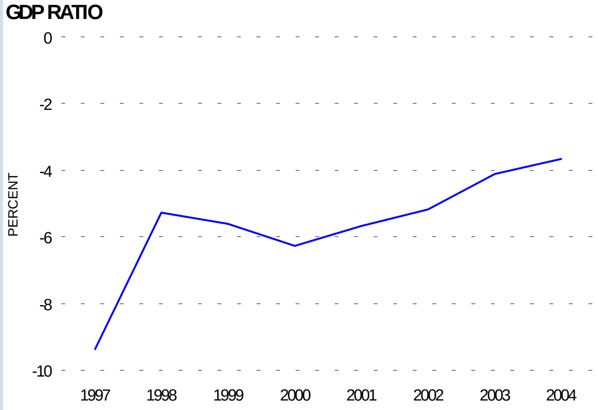



CHART 6 EXTERNAL GOODS & SERVICES TRADE BALANCE TO GDP RATIO



trade deficit is nevertheless projected to remain significant throughout the forecast period, ending at around 4% of GDP by 2004.

The deterioration in the external goods and services deficit to around 6% of GDP in 1999 reflects the fact that although export growth is expected to remain sustained in that year, the increase in imports is projected to be even stronger. The latter is expected to result out of a recovery in domestic demand in the second half of the year, as discussed above, as well as from the increased attractiveness of import prices engendered by the switch from the CET system to VAT. The growth of imports is projected to continue outstripping that of exports in 2000, when expenditure on a number of capital projects is expected to be in full swing. Thereafter, the growth in imports is expected to decelerate, and to actually fall short of that of exports, which would by then be positively influenced by the creation of new productive capacity. This would lead to the gradual improvement in the external goods and services trade balance shown in Chart 6. The narrowing of the external deficit is prevented from being even more pronounced by the persistence of the fiscal deficit, that will boost import demand, and by the prevalence of relatively high domestic price and wage inflation, that will adversely affect Malta's international price competitiveness.

**Conclusion**

The economic situation in 1998 was characterised by slower economic growth, a substantial fiscal deficit and the persistence of an imbalance on external trade in goods and services. The latter occurred in spite of favourable developments in exports and in the price of oil imports, and of a marked slowdown in domestic demand. The large twin deficits highlight the structural inefficiencies in the Maltese economy that are not sustainable in the long term.

In 1999, export growth is expected to be maintained, while domestic demand is expected to recover in the second half of the year. The fiscal deficit is expected to remain at around 9% of GDP, while the external goods and services account on the balance of payments is expected to deteriorate to 5.6% of GDP. Medium-term forecasts on a six-year horizon indicate that it is possible for the economy to sustain a real growth rate of around 3.5%, an unemployment rate of under 5% and inflation of around 2.5%. However, the decline in the fiscal deficit is seen as being only gradual, as the deficit is projected to remain at around 5% of GDP by 2004. This is expected to continue fuelling persistent outflows on the current account of the balance of payments, which could become unsustainable in the longer term.

Thus, while these projections allow for a continued growth of the Maltese economy in the medium term, with moderate rates of unemployment and inflation, they also indicate that, if the economy is to continue to develop along a sustainable path in future, a number of policy measures and structural adjustments will be necessary to improve the country's export performance and the efficiency of its fiscal operations.

# 3. The Balance of Payments and the Maltese Lira

## 3.1 The Balance of Payments based on Banking Transactions

An analysis of transactions between residents and non-residents effected through the local banking system indicates that, during 1998, the deficit on the current account of Malta's balance of payments contracted further, while the net inflow on capital transactions by the non-financial sectors was larger than in 1997. Thus, the overall net outflow on Malta's balance of payments was considerably smaller than that recorded in 1997.

The contraction in net current account outflows was attributable both to a drop in the merchandise trade deficit and to higher net receipts from services and investment income. The larger net capital inflow was due to higher receipts from the sale of shares overseas and lower outflows on the direct and portfolio investment accounts.

### *3.1.1 Merchandise Trade*

The shortfall on **merchandise trade** transactions narrowed by Lm18.5 million from that registered in 1997. This contraction was due to a Lm14.9 million rise in export proceeds and a Lm5.4 million decline in import payments. The increase in receipts and the decline in payments in respect of merchandise trade were, however, partly offset by an increase in net outlays on freight and insurance. It should be noted that, during the year under review, export proceeds were boosted by exceptional receipts, amounting to nearly Lm13.0 million, in respect of the export of vessels built in Malta in previous years. However, most of the main exporting sectors did register an increase in earnings. This was, however, partly offset by a decline in revenues from the re-export of fuel as

**Table 3.1**
**BALANCE OF PAYMENTS BASED ON BANKING TRANSACTIONS[1]**

*Lm millions*

| | 1996 | 1997 | 1998 |
|---|---|---|---|
| **MERCHANDISE TRADE BALANCE** | **-350.2** | **-361.1** | **-342.6** |
| (including shipbuilding, freight and insurance) | | | |
| **SERVICES (Net)** | **171.6** | **206.4** | **240.1** |
| of which: | | | |
| Transportation (other than freight and insurance) | 36.8 | 49.3 | 75.1 |
| Travel | 120.1 | 143.7 | 146.3 |
| Other services | 14.6 | 13.5 | 18.8 |
| **BALANCE ON GOODS AND SERVICES** | **-178.7** | **-154.7** | **-102.4** |
| **INVESTMENT INCOME (Net)** | **36.4** | **33.1** | **47.8** |
| of which international banking institutions | 3.1 | 11.4 | 6.4 |
| **BALANCE ON GOODS, SERVICES & INCOME** | **-142.2** | **-121.6** | **-54.6** |
| **UNREQUITED TRANSFERS (Net)** | **38.1** | **33.3** | **27.2** |
| **CURRENT ACCOUNT BALANCE** | **-104.1** | **-88.3** | **-27.5** |
| **NET CAPITAL FLOWS (non-monetary sector)** | **46.2** | **3.9** | **22.7** |
| **OVERALL BALANCE** | **-57.9** | **-84.5** | **-4.7** |

[1] Provisional. Compiled from data based on transactions effected through the local banking system. The coverage is different from that of the Central Office of Statistics (COS) which records all transactions on an accrual basis, and which would thus cover offsetting arrangements.

a result of the drop in the price of oil on international markets. The drop in oil prices was also primarily responsible for the decline in import payments, as it resulted from lower outlays on fuel imports. However, a decline in payments for various other categories of imports, including alimentary products, electronic goods and transport equipment, also contributed. The drop in payments for imports of transport equipment was due to a payment for an exceptional item in 1997. Meanwhile, import payments in respect of plastic and chemical products, telecommunications equipment, textiles, pharmaceuticals and motor vehicles registered an increase.

### *3.1.2 Services and Income*

When compared with 1997, net receipts from **services** were up by Lm33.7 million in 1998, mostly as a result of bigger surpluses on transportation and other services, though net receipts from travel also rose slightly.

Net inflows from **transportation** were up by Lm25.8 million. The rise in net receipts on the transportation account reflected higher revenues from passenger carriage, ship repair and other activities in this sector - such as transhipment, charter hire and bunkering. Cumulatively, gross revenues from transportation activities were up by Lm32.0 million, or 39.1%, whereas gross payments rose by only Lm6.2 million, or 19.0%.

When compared with 1997, net receipts on the **travel** account were up by Lm2.6 million. Gross receipts from travel rose by Lm4.2 million, or 2%, while gross payments were up by Lm1.6 million, or 2.2%. Although the increase in travel receipts was not as significant as the increase in tourist arrivals, it should be borne in mind that earnings in respect of hotel accommodation in the first three months of 1997 reflected the higher rate of expenditure tax prior to the replacement of VAT by CET in April of that year. It is also probable that the tourism earnings figures for 1997 included substantial volumes of accumulated sterling and dollar holdings that were converted into Maltese liri in view of the sudden appreciation of these currencies on the foreign exchange markets at the time. A probable decline in the average price of hotel accommodation and in the average length of stay of incoming tourists may also have contributed to lower earnings from tourism in 1998.

Net inflows from '**other services'** were up by Lm5.3 million, when compared with 1997. This was attributable to an increase in gross receipts, which more than offset the higher payments on this account. Nearly all the sub-components of this account registered an increase in revenues. In particular, higher proceeds were registered from catering and professional services, insurance and labour income. These helped to offset higher outflows on professional and other miscellaneous services.

The decline in the merchandise trade deficit, coupled with the increase in the surplus on services, resulted in a decline of Lm52.3 million in the net outflow on **goods and services**, when compared with that registered in 1997.

Net receipts from **investment income** rose by Lm14.7 million when compared with 1997. This was mostly due to an increase in dividends received by an international bank and a decline in dividends paid by local subsidiaries to their foreign parent companies. These two factors together more than offset a decline in net interest earnings from abroad. International banks operating in Malta registered sharply higher volumes of both interest receipts and payments. However, the net investment income of such institutions - which are licensed to transact business solely with non-residents, and which, therefore, have a limited impact on the Maltese economy - declined when compared with 1997.

### *3.1.3 Transfers*

The surplus on **unrequited transfers** was down by Lm6.1 million from the previous year's level as a result of lower inflows from grants and from the other components of this account. It should be recalled, however, that in 1997, net receipts from current transfers were boosted by exceptional inflows, probably as a result of exchange rate factors. To a large extent, these inflows did not repeat themselves in 1998. Furthermore, in 1998, inflows by way of grants were down by Lm1.5 million from their level in 1997.

As a result of these developments, the net outflow on **current account** transactions during 1998 amounted to Lm27.5 million. This was Lm60.8 million less than the net current account outflow recorded in 1997.

### *3.1.4 Capital Flows*[2]

Net **capital inflows** rose from Lm3.9 million in 1997 to Lm22.7 million in 1998. This was due to inflows from the proceeds of overseas sales of shares in Maltacom plc and lower levels of both direct and portfolio investment abroad by residents of Malta. It should be recalled, however, that in 1997 there were substantial direct investment outflows, both by way of overseas investment by residents and by way of repatriation of capital by non-residents. Inflows by way of loans from overseas were up by Lm8.3 million in 1998, while outflows by way of loan repayments rose by Lm32.7 million. Most of these inflows and outflows were in respect of overseas borrowing by non-financial public sector institutions.

### *3.1.5 Overall Balance and Reserves*

The **overall net outflow** from balance-of-payments transactions in 1998 amounted to Lm4.7 million. This was considerably smaller than the net outflow of Lm84.5 million registered in 1997. On the other hand, there was an increase, of nearly Lm120.0 million, in the **net foreign assets of the banking system**. The discrepancy between the net outflow on balance-of-payments transactions and the increase in the net foreign asset position of the banking system was mainly due to accounting adjustments, such as the revaluation of foreign asset portfolios and the re-classification of certain liabilities as equity by international banks (discussed elsewhere in this Report).

## 3.2 The Balance of Payments on an Accrual Basis

What follows is an analysis of the balance of payments on an accrual basis, as estimated by the Central Bank of Malta, using official data where these were available. The coverage is more comprehensive than with the cash-based method, since the latter covers only transactions that are effected through the local banking system[3]. The classification of certain items may also differ between the two systems[4].

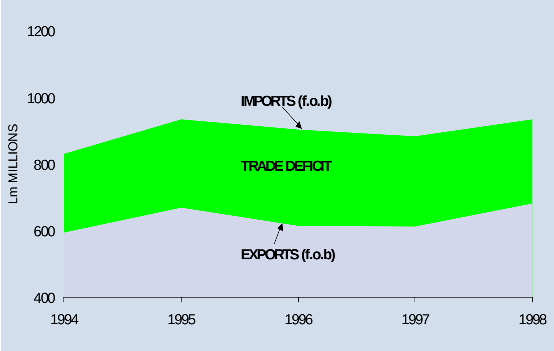
As Table 3.2 indicates, the deficit on the current account of the balance of payments in 1998 is estimated to have contracted by Lm14.3 million from its 1997 level. This was due to a decline in the merchandise trade deficit and an increase in the surplus on services - which together outweighed the effect of a reversal in net investment income.

### *3.2.1 Merchandise Trade*

The **merchandise trade** deficit is estimated to have contracted by Lm19.0 million during 1998. This contraction in the trade gap was attributable to an increase of Lm68.7 million in merchandise exports, which more than offset a Lm49.7 million increase in imports.

The increase in merchandise exports was mainly attributable to those industries that manufacture

CHART 3.1 MERCHANDISE EXPORTS AND IMPORTS




[2] The balance of payments based on banking transactions excludes all capital transactions effected by the monetary sector. This enables the reconciliation of the balance with changes in the net foreign assets of the banking system.

[3] The method based on banking transactions does not capture transactions such as those settled through overseas bank accounts or offsetting transactions. Furthermore, this method only captures transactions at the point of payment, and not when the actual asset or liability is created.

[4] For instance, merchandise exports as reported in the accrual-based compilation include ship repair activities, whereas in the balance of payments based on banking transactions these are included under 'other transportation'.

**Table 3.2**
**BALANCE OF PAYMENTS ON AN ACCRUAL BASIS**

*Lm millions*

| | 1997[1] January-December | | 1998[2] January-December | |
|---|---|---|---|---|
| | Credit | Debit | Credit | Debit |
| **CURRENT ACCOUNT BALANCE** | | **75.2** | | **60.9** |
| **Goods and Services Balance** | | **108.3** | | **73.0** |
| **Merchandise Trade Balance** | | **271.3** | | **252.3** |
| Merchandise f.o.b. (including ship building and repairing) | 612.8 | 884.1 | 681.5 | 933.8 |
| **Services Balance (net)** | **163.0** | | **179.3** | |
| Shipment | 27.6 | 96.1 | 31.1 | 102.2 |
| Other transportation | 109.5 | 54.1 | 113.3 | 54.6 |
| Travel | 249.8 | 73.6 | 254.2 | 75.2 |
| Other services | | | | |
| Official | 8.6 | 10.8 | 8.7 | 11.8 |
| Private | 87.9 | 85.8 | 92.8 | 77.0 |
| **Investment Income (net)**[3] | **7.4** | | | **15.6** |
| Dividends, Reinvested Earnings, Interest, Other | 134.6 | 127.2 | 192.7 | 208.3 |
| **Unrequited Transfers (net)** | **25.7** | | **27.7** | |
| Private | 26.6 | 12.4 | 22.8 | 5.6 |
| Official | 14.4 | 2.9 | 14.4 | 3.9 |
| **FINANCIAL ACCOUNT BALANCE (Net)** | **43.3** | | **47.3** | |
| Direct investment | 24.8 | | 116.2 | |
| Portfolio investment | 42.4 | | | 36.0 |
| Other investment | | 21.3 | 31.1 | |
| Reserve assets | | 2.6 | | 64.0 |
| **Statistical discrepancy**[4] | **31.9** | | **13.6** | |

[1] Provisional Central Office of Statistics data.
[2] Central Bank of Malta estimates from preliminary data.
[3] Net investment income of international banking institutions amounted to Lm4.8 million in 1997 and Lm18 million in 1998.
[4] Represents the difference between the Current Account Balance and the Financial Account Balance.

machinery and transport equipment - which constitute, by far, the country's most significant export sector. This increase mainly reflected the performance, in terms of both volume and value added, of the electronics industry. It does not take into account vessels built in Malta in earlier years and referred to in statistics on merchandise trade published by the Central Office of Statistics. For balance-of-payments purposes, these vessels were accounted for as exports gradually, over the years, as they were built and invoiced. The other exporting sectors registered a mixed performance, but, overall, no significant developments were recorded. On the other hand, there was a notable drop from the previous year's level in re-exports. This was mainly due to the re-export of a vessel in 1997, which boosted the re-exports figure for that year.

As regards imports, only 'industrial supplies' registered a significant increase. As a result, the percentage share of industrial imports in total imports increased by 2.2 percentage points when compared with 1997. Almost the entire increase in imports of industrial supplies was attributable to the 'machinery and transport equipment' sector - in particular the electronics industry. This reflected the increase in the industry's exporting activity. Imports of consumer goods registered a decline both in absolute terms and in their percentage share of total imports. Part of this decline was due to lower outlays on fuel, and reflected

CHART 3.2 DISTRIBUTION OF IMPORTS BY DESTINATION

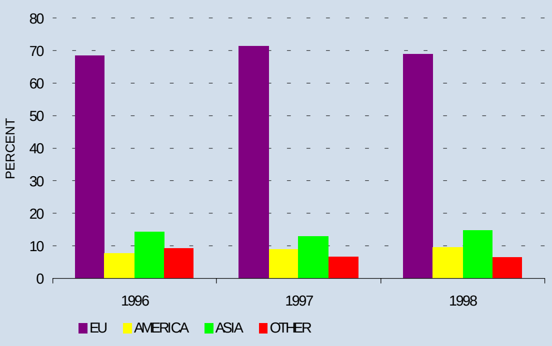
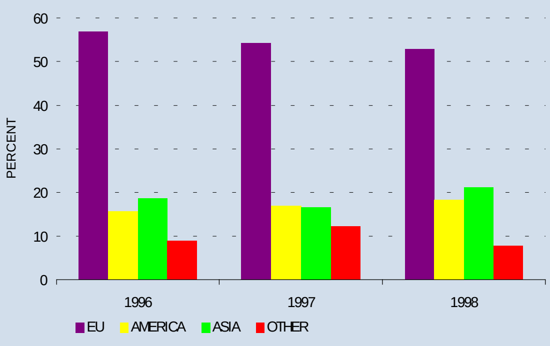



CHART 3.3 DISTRIBUTION OF EXPORTS BY DESTINATION




the drop in the price of oil on the international markets. Imports of capital goods increased slightly in absolute terms, but their percentage share in total imports fell marginally.

**Direction of Trade**

As Charts 3.2 and 3.3 indicate, there were no substantial changes in the pattern of Malta's trading relationships during 1998. The European Union remained Malta's foremost trading partner, despite a slight decline in its relative importance when compared with 1997. In fact, the share of EU imports in the country's total imports declined by 2.4 percentage points to 69%, while the share of exports to the EU in Malta's total exports fell by 1.5 percentage points to 52.8%. On the other hand, the percentage share of imports from the American and Asian continents rose by 0.6 and 2 percentage points respectively. Imports from the American continent in 1998 made up 9.6% of total imports, while imports from Asia accounted for nearly 15%. The percentage share of exports to countries in these two continents also grew, mostly as a result of the increase in exports of electronic components, which are predominantly destined for the North American and Asian markets. The share of exports to the American continent in Malta's total exports, in fact, rose by 1.5 percentage points to 18.4%, while the share of exports to Asia rose by 4.5 percentage points to 21.1%.

### *3.2.2 Services*

The surplus on **services** is estimated to have risen by Lm16.3 million over that registered in 1997. This increase was attributable solely to an increase in gross revenues, as total payments were virtually unchanged from the 1997 level. In fact, gross inflows from services are estimated to have risen by Lm16.7 million during 1998.

Of these, Lm3.8 million were due to higher receipts from **transportation** - as a result of higher inflows from passenger carriage, port services and charter operations. These more than offset a drop in the value of ship stores and bunker fuel supplied to non-residents as a result of the significant decline in oil prices during the year. Gross outflows on transportation are estimated to have remained almost unchanged from the previous year's level, giving rise to an increase in the net inflow on this account.

Net receipts from **travel** are also estimated to have increased, by Lm2.8 million, as higher gross receipts from tourism more than offset an increase in payments by residents travelling abroad. The most significant increase, however, was attributable to net receipts from **other private services**, which are estimated to have risen by Lm13.7 million when compared with 1997. This was due to higher inflows and, especially, lower outflows on most sub-components of this account. These included, among others, insurance, communications and labour income. On the other hand, it is estimated that there was an increase of Lm2.6 million in the net outflow on **shipment** and a rise of nearly Lm1 million in net outflows on **official services**.

As a result of the decline in the merchandise trade deficit and the increase in the surplus of services, the deficit on **goods and services**, at Lm73.0 million, is estimated to have fallen by Lm35.3 million from the level registered in 1997.

### *3.2.3 Investment Income and Transfers*

It is estimated that there were net **investment income** outflows amounting to Lm15.6 million in 1998, compared with net inflows of Lm7.4 million in 1997. This was mainly due to higher interest payments abroad by public sector organisations and an increase in dividend payments by local subsidiaries to their parent companies abroad. The latter included dividends re-invested in Malta and others which were not effected through the local banking system. There was also a decline in net investment income from abroad received by the banking sector.

Net inflows by way of **unrequited transfers** are estimated to have risen by Lm2.0 million. The rise was mainly attributable to lower payments on the private component of this account. Net transfers from official sources are estimated to have declined slightly as a result of an increase in outflows.

### *3.2.4 Financial flows*[5]

Preliminary data indicate that in 1998 there was a net **financial inflow** amounting to Lm47.3 million. This inflow was up by Lm4.0 million when compared with the net financial inflow recorded in 1997 – with the increase being attributable to a rise in net inflows by way of direct investment and of borrowing from overseas.

In fact, net **direct investment** inflows rose by Lm91.4 million when compared with 1997. This was mainly attributable to higher levels of capital inputs in the form of loans and other capital contributions advanced to international banks operating in Malta by their parents overseas. Furthermore, there was also an increase in the level of dividends re-invested by non-resident companies in their local subsidiaries.

Part of the increase in direct investment inflows was mirrored in the net outflow of Lm36.0 million registered on the **portfolio investment** account. This outflow contrasted sharply with the net inflow of Lm42.4 million that was registered on this account in 1997, and was primarily due to movements in the foreign asset portfolio of the banking sector. The latter, in fact, increased its investment in debt and other securities. These outflows more than offset the influx of funds from the sale of Maltacom shares overseas.

The portfolio investment outflow was also reflected in the net inflow on the **other investment** account, which was also in contrast with the outflow on the latter account recorded in 1997. The inflow in 1998 was mainly the result of net borrowing from overseas by both the banking sector and non-financial public sector organisations. However, developments associated with trade credit arrangements also resulted in an increase in liabilities to non-residents.

In 1998, there was an increase of Lm64.0 million in the **reserve assets** (i.e. the official reserves) of the monetary authorities, on an accrual basis. This increase was larger - by Lm61.4 million – than that recorded in 1997. This figure for the change in reserves differs slightly from that given in other sections of this Report on account of revaluation adjustments.

### 3.3 Foreign Equity Investment in Malta

According to data available at the Central Bank of Malta and the Registrar of Companies at the Malta Financial Services Centre, 62 new companies with non-resident shareholding were established in Malta in 1998[6]. Table 3.3 gives a breakdown of these companies by economic category and source country of foreign shareholding. The total authorised share capital of these new companies amounted to Lm14.0 million, of which Lm1.9 million was paid up. Total non-resident paid-up capital amounted to Lm0.8 million, or 42.1% of the total. Both the number of companies with non-resident participation and the total value of non-resident paid-up capital were higher when compared with the previous year. When

[5] The balance of payments on an accrual basis includes movements in the net foreign assets position of banking and financial institutions, whereas the methodology based on banking transactions excludes them.

[6] This figure excludes: (1) companies with at least 80% non-resident shareholding established for the purpose of owning vessels registered under the Merchant Shipping Act, 1973; (2) offshore companies (including banks) registered with the Malta Financial Services Centre, and (3) international trading companies (including banks) owned entirely by non-resident shareholders (with the possible exception of one share) and transacting solely with non-residents.

**Table 3.3**
**SOURCE OF NON-RESIDENT PAID-UP CAPITAL - 1998**

*Lm*

| Source | Manufacturing | Services | Totals |
|---|---|---|---|
| UK | 47,722 | 162,079 | 209,801 |
| Germany | 54,999 | 11,500 | 66,499 |
| Italy | 15,550 | 19,450 | 35,000 |
| France | 0 | 58,750 | 58,750 |
| Other Europe | 18,051 | 52,041 | 70,092 |
| US | 8,000 | 111,831 | 119,831 |
| Libya | 0 | 7,049 | 7,049 |
| Other Foreign | 2,500 | 150,695 | 153,195 |
| Offshore/Nominee | 31,040 | 0 | 31,040 |
| International Trading Companies | 46,078 | 16,400 | 62,478 |
| **Total Non Resident Paid-Up Capital** | **223,940** | **589,795** | **813,735** |
| **Number of Companies** | **29** | **33** | **62** |

analysing such data, however, it is important to keep in mind that the inflow of non-resident share capital shown in the Table is only a minor component of non-resident direct investment in Malta. The latter also includes items such as re-invested earnings, inputs in the form of expertise and technology, and credit to local subsidiaries from their parents overseas.

Twenty-nine of the new companies with non-resident participation were manufacturing companies. Of these, 20 were in the machinery sector. The remaining 9 companies were spread over various sub-sectors of manufacturing, including the metal, the printing and the construction materials industries. The total paid-up equity capital from non-resident sources in these newly established manufacturing companies amounted to Lm0.2 million, or 27.5% of total equity capital paid-up by non-residents.

In the services sector, 33 new companies involving non-resident participation were set up in 1998. These accounted for nearly Lm0.6 million, or 72.5% of total equity capital paid-up by non-residents. These companies were established to undertake various activities within the services sector, including catering and tourism, management consultancy, fund management, bunkering, insurance and information technology services.

The most important source country for new equity capital in 1998 was the U.K., which accounted for 25.8% of the total. The second most important single source country was the U.S., which contributed another 14.7% of total foreign paid-up equity investment.

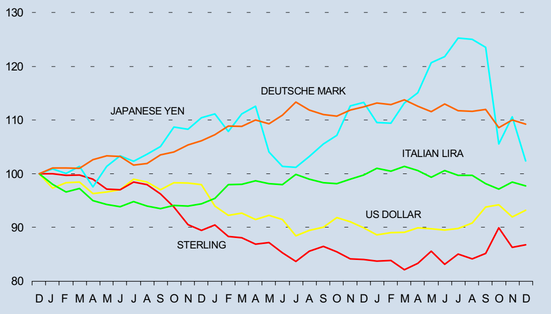
During 1998, there were 19 applications from local companies to increase their share capital from non-resident sources. This investment amounted to Lm2.7 million. Furthermore, there were share transfers, with a value of Lm2.4 million, from non-residents to residents, as well as share transfers with a value of Lm0.3 million from residents to non-residents.

### 3.4 The Maltese Lira

During 1998, the Maltese lira[7] regained some of the ground it had lost against the US dollar and the pound sterling during 1997. At the same time, it declined in value against the continental European currencies and, especially, the Japanese yen, as these currencies posted gains in the international foreign exchange markets.

[7] Until December 31, 1998 the exchange rate of the Maltese lira was determined on the basis of a basket of currencies comprising the ECU, the US dollar and the pound sterling. As from January 1, 1999, the Euro replaced the ECU in the Maltese lira basket.

**CHART 3.4 EXCHANGE RATE MOVEMENTS OF THE MALTESE LIRA AGAINST SELECTED CURRENCIES**
(INDEX OF END-OF-MONTH RATES, END-1995 = 100)




The Maltese lira rose by 4.5% against the **US dollar** over the year. Most of the gains were registered in the final four months of the year, as in the preceding eight months the US$/Lm rate was generally stable. The Maltese lira's lowest level for the year vis-à-vis the dollar, US$2.50, was recorded on April 3, while its highest quotation, US$2.73, was recorded on October 8. Subsequently, the lira lost ground versus the dollar, to end the year at US$2.66.

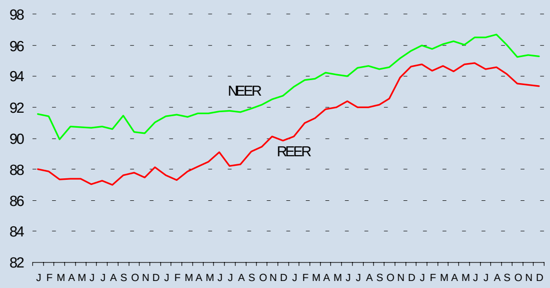
The lira also ended the year higher vis-à-vis the pound **sterling**, against which it rose by 3.2%. During the first three months of 1998 the Maltese lira continued to lose ground against sterling, and on April 3 it dipped to Stg1.50. This level was slightly below the lowest level registered in 1997 and was the lowest level touched by the Stg/Lm rate since 1983. Subsequently, however, the lira began to appreciate steadily against the pound, reaching a peak of Stg1.61 on November 4. Thereafter, the Stg/Lm rate remained stable, ending the year at Stg1.59.

Meanwhile, during 1998, the Maltese lira lost considerable ground against the continental European currencies, as these firmed prior to the introduction of the euro. Against the **Deutsche mark**, the lira fell by 2.9%, mostly during the final four months of the

## Table 3.4
## EXCHANGE RATES OF THE MALTESE LIRA AGAINST SELECTED MAJOR CURRENCIES FOR 1998

| | US$ | DM | Stg | Lit | Yen |
|---|---|---|---|---|---|
| Monthly Averages: | | | | | |
| January | 2.5230 | 4.5830 | 1.5428 | 4511.0 | 326.5 |
| February | 2.5258 | 4.5819 | 1.5396 | 4521.0 | 317.9 |
| March | 2.5238 | 4.6059 | 1.5210 | 4535.3 | 324.8 |
| April | 2.5358 | 4.6010 | 1.5163 | 4545.1 | 334.5 |
| May | 2.5554 | 4.5329 | 1.5607 | 4470.2 | 344.9 |
| June | 2.5468 | 4.5602 | 1.5443 | 4492.9 | 357.2 |
| July | 2.5392 | 4.5653 | 1.5444 | 4500.8 | 357.2 |
| August | 2.5425 | 4.5476 | 1.5571 | 4486.1 | 367.9 |
| September | 2.6297 | 4.4768 | 1.5641 | 4423.5 | 354.6 |
| October | 2.6908 | 4.4109 | 1.5882 | 4364.1 | 325.7 |
| November | 2.6413 | 4.4410 | 1.5896 | 4394.9 | 317.9 |
| December | 2.6557 | 4.4319 | 1.5887 | 4388.5 | 310.9 |
| Average for 1998 | 2.5758 | 4.5282 | 1.5547 | 4469.4 | 336.7 |
| Average for 1997 | 2.5921 | 4.4900 | 1.5825 | 4410.8 | 313.5 |
| % change 1998/1997 | -0.6 | 0.9 | -1.8 | 1.3 | 7.4 |
| Closing rate on 31.12.98 | 2.6642 | 4.4376 | 1.5904 | 4393.9 | 299.7 |
| Closing rate on 31.12.97 | 2.5497 | 4.5682 | 1.5411 | 4485.9 | 331.8 |
| % change 1998/1997 | 4.5 | -2.9 | 3.2 | -2.1 | -9.7 |
| High for the year | 2.7303 | 4.6462 | 1.6073 | 4581.6 | 374.6 |
| | (Oct. 08) | (Apr. 02) | (Nov. 04) | (Apr. 02) | (Aug. 11) |
| Low for the year | 2.5029 | 4.3799 | 1.4995 | 4334.6 | 299.7 |
| | (Apr. 03) | (Oct. 07) | (Apr. 02) | (Oct. 07) | (Dec. 31) |

CHART 3.5 REAL AND NOMINAL EFFECTIVE EXCHANGE RAT
INDICES FOR THE MALTESE LIRA*
(1990 = 100)




year. In fact, the DM/Lm rate continued on an upward trend during the first quarter, until it reached a high of DM4.65 on April 2. Subsequently, however, the lira started its decline against the mark, dipping to DM4.38 on October 7. Despite a subsequent recovery, the lira ended the year at DM4.44.

The Maltese unit also lost ground against the **Italian lira**. The trend of the Lit/Lm rate was virtually identical to that of the DM/Lm rate - in view of exchange rate convergence in Europe ahead of European Monetary Union. In fact, the highest and lowest levels of the Maltese lira against both the mark and the Italian lira coincided in 1998. At the end of the year, the Lit/Lm rate stood at Lit4393.9, which implied a decline of 2.1% from its end-1997 quotation.

However, the Maltese lira registered its most significant loss against the **Japanese yen**, which gained 9.7% against the Maltese unit during 1998. The trend of the lira against the yen was once again inconsistent, as it was throughout 1997, reflecting the erratic behaviour of the yen on the international markets and the uncertainty that characterised economic developments in the Far East during the year. In the first two months of the year, the Yen/Lm rate moved on a downward trend, but subsequently it reversed its direction and headed higher, until it reached a high of Y374.6 on August 11. After a short period of consolidation, the Yen/Lm rate fell sharply in October and continued to move within a relatively narrow range until the end of the year, when it closed at Y299.7, its lowest level for the year.

As shown in Table 3.4, the Maltese lira, on average, remained stable vis-à-vis the US dollar and the Deutsche mark during 1998. Its average value was slightly higher in terms of the Italian lira and slightly lower in terms of sterling when compared with 1997. On the other hand, the lira, on average, was considerably stronger against the yen when compared with the previous year.

Chart 3.5 shows the trend of the Maltese lira in terms of its **Nominal Effective Exchange Rate (NEER) index**[8] and of its **Real Effective Exchange Rate (REER) index**[9] as compiled by the Central Bank of Malta.

The average level of the NEER index for the Maltese lira rose to 95.98 in 1998, from 94.36 in 1997. This indicates that, on the basis of exchange rate movements, Malta's competitive position deteriorated during the year. As the Chart shows, the trend of the NEER index was mildly upward almost throughout the first six months of 1998, but this trend was reversed later in the year, especially during the last quarter. This drop in the index was due to the fact that the Maltese lira was depreciating against the currencies of its major trading partners on the European continent. The index stood at 95.29 in December, down from 95.65 a year earlier.

The average level of the REER index also rose during the year, when compared with its average level in the previous twelve months. In fact, it rose to 94.27 in 1998 from 92.16 in 1997. Like the NEER index, the REER index continued to rise slowly till mid-year, but subsequently retreated steadily during the second half of the year, to end at 93.35. This level was nearly 1.4% below its end-1997 value. The steeper drop in the REER index, when compared with the NEER index, was attributable to the fact that the average rate of inflation in Malta during 1998 was lower than the average inflation rate of competitor countries.

[8] The NEER index is based on a trade-weighted average of changes in the exchange rate of the lira against the currencies of Malta's major competitor countries, including its trading partners. A fall in the index represents a depreciation of the lira's average exchange rate, and vice-versa.

[9] The REER index is derived by adjusting the NEER index for relative movements in consumer prices. A fall in the index implies a gain in Malta's external competitiveness and vice-versa.

# 4. Government Finance

The structural pressures which contributed to the significant rise in the fiscal deficit over the preceding two years remained in evidence in 1998, when the deficit stood at 11.8% of GDP. As a result of the introduction, by the Government, of a six-year programme aimed at putting government finances on a sustainable growth path, however, the fiscal deficit is projected to decline to around 9% of GDP in 1999.

## 4.1 Fiscal Activities During 1998

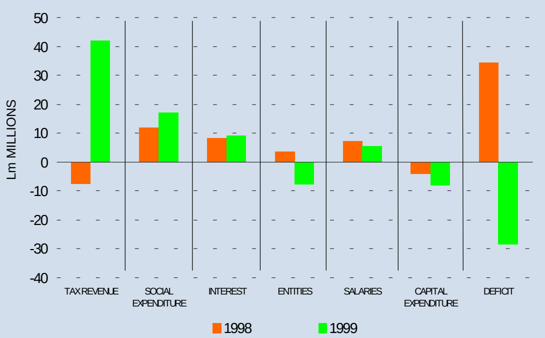
Developments in government finances during 1998 were marked by a steady increase in expenditure and a slight drop in revenue. The higher government expenditure may, in turn, be squarely attributed to structurally-ingrained factors – particularly those connected with the social security system. In fact, higher expenditure on social security, which in 1998 reflected developments in the number of beneficiaries as well as the effects of past policy measures, was mainly responsible for the overall increase in total government expenditure during the year. Expenditure on personal emoluments also increased significantly, reflecting mainly the increases in public sector wage rates. Interest payments were another important contributor to the rise in government expenditure, indicating the high level of government debt - which was estimated at 55.2% of GDP at the end of 1998. In contrast, government revenue declined somewhat in 1998, in spite of the fact that the economy continued to expand. This drop was mainly due to a shortfall in tax revenues, as the latter were adversely affected by the timing of the receipt of tax arrears and by the change of the indirect tax system as from July 1997. Thus, as can be seen from Chart 4.1, it was higher outlays on social expenditure, interest payments, and personal emoluments which were the main factors behind the widening of the fiscal deficit, although a drop in tax revenue and increased contributions to public entities also contributed.

As a result of these developments, the fiscal deficit in 1998 reached Lm163.2 million, equivalent to 11.8% of GDP. This was Lm34.4 million higher than the level posted in 1997, with the deterioration being in good part due to the fact that the primary balance of the fiscal account turned from a surplus of almost Lm7 million to a deficit in excess of Lm23 million, as Table 4.1 shows.

### *4.1.1 Revenue*

As Table 4.1 also shows, government ordinary revenue dropped slightly, to Lm452.1 million, or 32.6% of GDP, in 1998. This mainly resulted from lower receipts from **direct taxation**, which took place in spite of the fact that nominal GDP, which is the tax base for direct taxation, increased at an average rate of 6.5% over the past few years. The timing of the collection of tax arrears was the primary factor behind the drop in direct tax revenue in 1998, particularly in view of a large settlement of tax arrears by a parastatal entity late in 1997. Allowing for this factor, it is estimated that revenue from direct taxation would have increased by some 3% in 1998. It should be mentioned that this was the first full year that the Final Settlement System of collecting tax on wage income was in place. However, possibly due to the low rate of new employment generation during the year, this system did not result in a significant increase in tax revenues. The growth in direct tax revenue in 1998 may also have been negatively affected by the fact that the main source of income growth in recent years was the export sector – whose corporate profits are generally taxed at a lower rate than domestically-oriented

CHART 4.1 CHANGES IN SELECTED GOVERNMENT REVENUE AND EXPENDITURE ITEMS



## Table 4.1
## GOVERNMENT BUDGETARY OPERATIONS[1]

*Lm millions*

| | 1997 | | 1998 | | 1999 | |
|---|---|---|---|---|---|---|
| **Ordinary Revenue** | | **456.7** | | **452.1** | | **493.0** |
| *(as % of GDP)* | | *(35.6)* | | *(32.6)* | | *(33.3)* |
| *of which:* | | | | | | |
| Direct Tax[2] | 205.4 | | 198.7 | | 220.6 | |
| *(as % of GDP)* | *(16.0)* | | *(14.3)* | | *(15.0)* | |
| Indirect Tax[2] | 182.1 | | 181.3 | | 201.5 | |
| *(as % of private consumption)* | *(22.7)* | | *(21.6)* | | *(22.3)* | |
| Central Bank Profits | 22.2 | | 24.1 | | 30.0 | |
| Other Revenue | 47.0 | | 47.6 | | 40.5 | |
| **Recurrent Expenditure** | | **449.9** | | **475.4** | | **486.6** |
| *of which:* | | | | | | |
| Social Security[2,3] | 183.5 | | 195.5 | | 212.7 | |
| Personal Emoluments | 157.9 | | 165.1 | | 170.8 | |
| Contribution to Entities | 35.0 | | 38.6 | | 30.7 | |
| Other | 73.5 | | 76.2 | | 72.4 | |
| **Primary Balance** | | **6.8** | | **-23.7** | | **6.0** |
| Interest Payments | | 32.2 | | 40.6 | | 49.7 |
| **Capital Expenditure** | | **103.4** | | **99.4** | | **91.4** |
| *of which:* | | | | | | |
| Asset Formation | 47.8 | | 56.5 | | 54.2 | |
| Subventions | 55.6 | | 42.9 | | 37.2 | |
| **Fiscal Deficit** | | **128.8** | | **163.2** | | **134.6** |
| (as % of GDP) | | *(10.0)* | | *(11.8)* | | *(9.1)* |
| *Financed by:* | | | | | | |
| Domestic Borrowing[4] | 119.6 | | 102.8 | | 89.1 | |
| Foreign Borrowing[4] | -0.8 | | -3.7 | | -0.3 | |
| Sales of Assets | 0.1 | | 35.3 | | 60.0 | |
| Grants | 9.8 | | 10.0 | | 11.0 | |
| Sinking Funds of Converted loans | 0.0 | | 0.0 | | 8.0 | |
| Total Financing | | 128.7 | | 144.4 | | 167.8 |

[1] Data for 1998 are revised estimates, and for 1999 are estimates issued by the Ministry of Finance. In 1998, the accounting practices used in the computation of the fiscal deficit were revised by the Ministry of Finance, mainly so as to exclude transactions of a non-recurrent nature from ordinary revenue and recurrent expenditure, and to provide a better coverage of all Government activities. For a more detailed explanation of these changes, see "The Budget Estimates for 1999: An Analysis of the Government's Budgetary Operations", Central Bank of Malta Quarterly Review, December 1998.

[2] Government contributions to the social security account are excluded from both direct tax revenue and recurrent expenditure.

[3] Includes social security benefits, family and social welfare, care of the elderly, and treasury pensions.

[4] Net of repayments and transfers to sinking funds.

Figures may not add up due to rounding.

SOURCE: Ministry of Finance, Central Bank of Malta estimates

activities.

The yield from **indirect taxation** also dropped marginally in 1998 - to Lm181.3 million, as Table 4.1 shows. This in part reflected the slow growth in consumption expenditure - which is the main base for this tax source – during the year. In particular, the imported content of consumption expenditure, which carried a larger burden of indirect taxation under the Customs and Excise Tariffs (CET) system , appears to have declined during the year. Even when calculated as a proportion of consumption expenditure, indirect taxation contracted by 0.8 percentage points to 21.6% in 1998. This decline was in part attributable to the switch from Value Added Taxation (VAT) to the CET system half-way through 1997, which led to a drop in the average rate of indirect taxation on consumption expenditure, especially on domestically-produced goods and services.

The other main components of government revenue remained generally stable or increased somewhat during 1998, as Table 4.1 shows. However, drops were registered in respect of dividends from investments, mainly due to lower dividends from government shareholdings in banks, and in revenues from civil aviation, as responsibility for the latter, with the related revenues and expenditures, was passed on to a public corporation, the Malta International Airport.

### *4.1.2 Expenditure*

During 1998, recurrent expenditure rose by Lm25.5 million (or 5.7%) to stand at Lm475.4 million. Interest payments rose by a further Lm8.4 million (or 26%) to Lm40.6 million. On the other hand, capital expenditure dropped by some Lm4 million, primarily due to the fact that in 1997, under the heading of capital expenditure, an exceptional and significant loan had been advanced to a public sector corporation to enable it to settle outstanding tax payments.

Close to one-half of the increase in **recurrent expenditure** was attributable to higher outlays on social security, which during 1998 rose by Lm12 million (6.5%). The increase in social security expenditure reflected two principal factors. The first was the steady increase in the number of beneficiaries. In fact, data published by the Ministry of Finance reveal that the average number of beneficiaries of certain types of pensions had increased by around 800 persons (1.6%) per year over the past ten years. The second factor was, the various social policy initiatives taken over the years. These measures had the effect not only of pushing up the level of current and future expenditure flows, but also of augmenting the number of eligible beneficiaries who, for equity reasons, were entitled to payments of arrears. In this way, per-capita expenditure per beneficiary is estimated to have increased by over 8% per annum during the past 10 years. In the absence of policy changes, it is likely that social expenditure will continue to increase steadily in the coming years, with the rate of growth becoming more pronounced as the population ages.

Another major item contributing to the increase in recurrent expenditure in 1998 was personal emoluments. These rose by 4.6% to Lm165.1 million – mainly as a result of the payment of wage arrears following the conclusion of the new Civil Service collective agreement between the Government and the unions. Contributions to parastatal entities were also up, by close to Lm4 million. This was mainly on account of higher subsidies being paid to the Water Services Corporation.

The Lm8.4 million increase in payments of interest on government debt in 1998 reflected mainly the interest payable on new stocks issued in that year, as well as the payment, for the first time, of a full year's interest on stocks issued in 1997. The average coupon rate on stocks issued in the last two years – when a total of Lm311 worth of stocks was issued - was between 7.2% and 7.4%. Interest paid on local short-term borrowing and on foreign borrowing was virtually unchanged from the previous year's level.

Behind the Lm4 million drop in **capital expenditure** in 1998 was a Lm12.7 million decline in subventions – which, as Table 4.1 shows, more than offset an increase in outlays on capital formation. This reflected a Lm21.3 million decline in subventions to the ship-repair and ship-building sector, which in the previous year had been allocated a substantial advance. This was partly offset by new capital expenditure in other areas, most notably the restructuring of industry, towards which Lm6.9 million were allocated in 1998, and the construction of the Gozo ferries, which absorbed some Lm5.5 million. Capital expenditure by the Department of Corporate Services (which, among other things, is responsible for oil exploration) rose by some Lm2.3 million in 1998. Other major areas of capital expenditure were education, health, roads and construction projects, incentives for direct foreign investment in manufacturing, the promotion of tourism, and the development of the Malta Freeport. Expenditure in these areas, however, showed little change from that registered in 1997.

## 4.2 Fiscal Activities planned for 1999

In the Budget for 1999, the Government announced a six-year programme aimed at bringing the fiscal deficit down to around 4% of GDP by the year 2004. Within this framework, the major fiscal policy measures announced for 1999 were the following:

- Value Added Tax (VAT) was to be re-introduced from the beginning of the year to replace the Customs and Excise Tariffs (CET) system;
- Indirect taxes on cigarettes and petrol were increased, while those on kerosene were to be reduced;
- The employees' social security contribution rate was to be raised by two-thirds of a percentage point to 9% in 1999 and by a further percentage point in the year 2000.

It is projected that these measures, coupled with efficiency gains that are expected to be achieved in the collection of revenue and the management of expenditure, should reduce the fiscal deficit to Lm134.6 million in 1999, or just over 9% of GDP[10]. As Table 4.1 shows, the projected Lm28.6 million contraction in the fiscal deficit should be reflected in the primary balance, which should register a small surplus compared with a deficit of over Lm23 million in 1998. Furthermore, as Chart 4.1 indicates, the contraction in the deficit is in part expected to result from a Lm40 million increase in tax revenue. Over two-thirds of this, however, will be absorbed by higher social security spending, interest costs and salary payments. This implies that over one half of the projected decline in the fiscal deficit will have to be attained by a reduction in capital expenditure and by a drop in recurrent contributions to public entities.

On the revenue side, government is projecting an 11% increase in receipts from direct taxation. This is in part expected to accrue out of higher National Insurance contributions following the increase in national insurance rates announced in the Budget and the normal growth in the tax base. However, it is probable that the increase in direct tax revenue in 1999 is expected to accrue in part out of increased efficiency in tax collection. Revenue from indirect taxation is expected to increase by 11.1%, likewise as a result of a combination of higher indirect taxes, the expected growth in the tax base and enhanced efficiency in tax collection. Meanwhile, the transfer of profits from the Central Bank of Malta is expected to increase by Lm6 million. This should in part offset an expected Lm7.5 million decline in other revenues, primarily due to the transfer of responsibilities for civil aviation from the Government to the Malta International Airport.

At 2.4%, the growth in recurrent expenditure projected for 1999 is under one half of that registered in 1998. In line with the provisions of the Civil Service collective agreement concluded in 1998, the increase in personal emoluments in 1999 is to be somewhat smaller than that registered in 1998. More importantly, recurrent contributions to public entities are to decline by almost Lm8 million, in anticipation of improved efficiency in the production and distribution of water by the Water Services Corporation. Capital expenditure is also expected to decline by Lm8 million, mainly on account of an expected drop in subventions to the shipbuilding and ship-repair sector.

It thus appears evident that the planned reduction in the fiscal deficit will depend, to a large extent, on enhanced efficiency in revenue collection and in the operations of government and public sector entities.

### 4.3 Government Financing Operations

In 1997, over 90% of the fiscal deficit had been financed by domestic borrowing, with the remainder being almost entirely financed through foreign grants. As Table 4.1 shows, the sale of assets contributed more significantly to the financing of the fiscal deficit in 1998. In fact, over Lm35 million, or just over one-fifth of the fiscal deficit, was raised by Government through such sales. While the sale of public assets as a means of raising finance may be preferable to the issue of debt - as the latter carries a future interest rate cost - it should be borne in mind that such sales may entail a loss of revenue to Government in the future in the form of profits foregone on such assets. Furthermore,

[10] For an analysis of the expected economic effects of these measures see "The Budget Estimates for 1999: An Analysis of the Government's Budgetary Operations", Central Bank of Malta Quarterly Review, December 1998.

the sale of assets is not a source of finance that can be sustained indefinitely in the future.

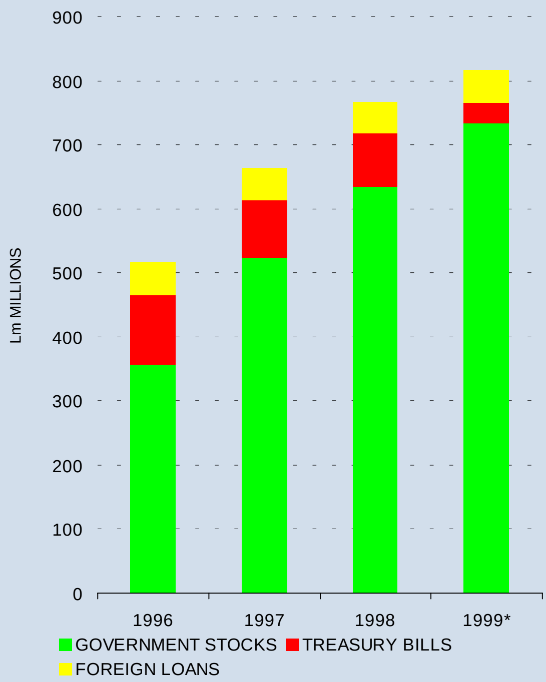
Meanwhile, domestic borrowing declined by around Lm16 million in 1998, while receipts by way of foreign grants were unchanged from the previous year's level. As Table 4.1 also indicates, the total financing obtained in 1998 fell short of the deficit reported for that year. This situation , however, should be reversed in 1999.

In 1999, receipts from the sale of assets are expected to play an even more important role in government's financing operations, being estimated at close to one half of the fiscal deficit. This should enable domestic borrowing to be kept to a lower level than in 1998. In fact, borrowing from domestic sources is projected at Lm89.1 million in 1999. Government is to obtain a further Lm11 million by way of foreign loans, and Lm8 million from the liquidation of sinking funds of converted loans.

### 4.4 The Government Debt Position

In 1998, the stock of government debt rose markedly for the second year in succession, reflecting the further expansion of the fiscal deficit. In fact, the total stock of government debt rose steadily from Lm516.8 million in 1996 to Lm663.8 million in 1997 and Lm765.7 million in 1998, as Chart 4.2 illustrates. As a percentage of GDP, this represents a progression from 43% in 1996 to 52% in 1997 and 55% in 1998. In 1999, total government debt as a percentage of GDP is projected to rise further - to just over 58% of GDP. This ratio may thus exceed the 60% level in the following year. (*A more detailed analysis of trends and developments in public sector debt is made on page 68 of this Report)*

CHART 4.2 GOVERNEMENT DEBT POSITION (GROSS)
(DEBT OUTSTANDING AT END OF PERIOD)




* PROJECTIONS ISSUED BY THE MINISTRY OF FINANCE.
SOURCE: THE TREASURY, CBM DATA

# Box 3:
# Developments in Public Sector Debt

In recent years, the Maltese public sector has borrowed heavily. Thus, between 1993 and 1998, gross public sector debt doubled as both the government and non-financial public institutions (NFPIs)[1] were net borrowers. During the period, government debt increased more rapidly than debt incurred by NFPIs, leading to a pronounced increase in the ratio of gross government debt to GDP. However, whereas the government borrowed entirely from local sources, the NFPIs often preferred to borrow abroad. Nevertheless, the ratio of public sector external debt to GDP remained low.

In the analysis that follows, the public sector includes both the central government and the NFPIs. Institutions that form part of the financial sector, including the Central Bank of Malta, have been excluded from this analysis. These institutions hold a significant proportion of the local debt issued by the government and they have a substantial net foreign asset position. The analysis ignores non-financial assets and liabilities, as well as any claims government may have against public sector enterprises and vice-versa. The government's future obligations with respect to pensions and other welfare benefits, as well as any future revenues, are not taken into account. Finally, this analysis includes measures of gross debt and net debt. The net debt measure acknowledges that the public sector holds financial assets, such as bank deposits and sinking funds.

This brief report also examines the external debt of the public sector, which rose over the period as NPFIs financed a substantial part of their expenditure by borrowing abroad.

The increase in the external debt of the public sector is partly a counterpart to the deficit on the current account of its balance of payments that Malta registered each year between 1993 and 1998. A deficit on the current account must be financed by capital inflows, which can take place either through the depletion of existing foreign assets or through borrowing from abroad. International borrowing can offer advantages to both parties involved: investments in Malta may yield higher returns to international investors; at the same time, Maltese borrowers may raise funds at rates of interest which are lower than domestic rates. However, borrowing abroad raises the problem of debt service in foreign currency, with the attendant exchange rate risk. At the level of the firm, the investments financed by overseas borrowing must generate sufficient returns to repay the foreign lender. At the national level, the country must either run a surplus on its current account or attract new capital inflows in order to repay the external debt as it matures. Otherwise it will have to run down its official reserves.

**Public Sector Debt**

Between 1993 and 1998, Malta's gross public sector debt doubled, rising from Lm602.2 million to Lm1,260.8 million, as Table 1 shows. Public sector debt increased in each year during the period, with the annual growth rate reaching 23.2% in 1994, fluctuating during the following three years, and dropping to 9.4% in 1998. Net debt also doubled during the period, rising from Lm546.4 million to Lm1,171.5 million. Annual developments in net debt mirrored those in gross debt, implying that there were no significant changes in the public sector's holdings of financial assets.

Most of the debt of the public sector was financed locally. At the end of 1998, the total external debt of the public sector stood at Lm300.1 million. The share of external debt in the total, which stood at 30.7% at the end of 1993, rose to 36.8% in 1994, before dropping steadily to 23.8% at the end of 1998.

[1] NFPIs are those institutions that are subject to control by government. Control is defined as the ability to determine corporate policy.

During the same period, the external public sector debt to GDP ratio rose from 19.7% in 1993 to 26.6% in 1994, before dropping gradually to 21.6% in 1998.

As the external debt of the public sector increased, so did its external debt service costs. In fact, between 1993 and 1997, the costs of servicing the external debt of the public sector had already risen from Lm14.4 million to Lm41 million. Then, in 1998, the repayment of a large foreign loan by a NFPI, which was financed by additional borrowing abroad, raised the total external debt service cost to Lm77.8 million. Interest on the external debt alone doubled during the period, rising to Lm18.9 million, as Table 2 shows. As the Table also shows, the ratio of external debt service costs to exports of goods and services rose from 1.6% in 1993 to over 3.7% in 1997 and to 6.6% in 1998. On average, between 1993 and 1998, external debt service costs accounted for 3.6% of Malta's annual receipts from exports of goods and services and 3.2% of its GDP.

**Government**

The stock of government debt outstanding rose continuously during the period, reflecting an annual succession of government budget deficits. The budget deficit, or surplus, is the difference between the government's income and expenditure during a period of time. Budget deficits may be financed either through seigniorage (i.e. creating money by borrowing from the central bank), or by selling assets, or by borrowing on domestic or international markets. But excessive money creation generates inflation and pressures on the balance of payments, and there are limits to the number of assets the government can sell. Therefore, budget deficits generally lead to an increase in the stock of debt outstanding.

The government's gross debt rose from Lm305 million in 1993 to Lm765.8 million in 1998. The steady increase in the stock of government debt is shown in Chart 1. On average, government debt rose by 20.4% annually

**Table 1**
**PUBLIC SECTOR DEBT OUTSTANDING**
*(Excluding Financial Institutions)*

*Lm thousands*

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998[1] |
|---|---|---|---|---|---|---|
| **Government** | | | | | | |
| Treasury bills | 30,000 | 30,000 | 71,406 | 108,935 | 89,980 | 83,987 |
| Malta Government Stocks | 224,552 | 253,252 | 285,952 | 356,119 | 523,369 | 633,369 |
| Foreign loans | 50,480 | 56,264 | 53,433 | 51,789 | 50,449 | 48,446 |
| **Gross Government Debt** | **305,032** | **339,516** | **410,791** | **516,843** | **663,798** | **765,802** |
| Deposits with CBM | 2,437 | 1,725 | 20,194 | 22,785 | 24,503 | 35,667 |
| Sinking Funds | 30,401 | 31,770 | 21,895 | 10,817 | 11,217 | 12,055 |
| Deposits with other banks | 2,704 | 2,211 | 6,744 | 8,952 | 10,000 | 11,839 |
| **Net Government Debt** | **269,490** | **303,810** | **361,958** | **474,289** | **618,078** | **706,241** |
| **Non-Financial Public Institutions** | | | | | | |
| Domestic Loans | 162,908 | 185,205 | 234,014 | 249,505 | 257,314 | 243,266 |
| Foreign Loans | 134,254 | 216,971 | 199,525 | 213,202 | 230,869 | 251,687 |
| **Gross Debt of the NFPIs** | **297,162** | **402,176** | **433,539** | **462,707** | **488,183** | **494,953** |
| Bank Deposits[2] | 20,254 | 23,963 | 24,214 | 26,691 | 30,148 | 29,648 |
| **Net Debt of the NFPIs** | **276,908** | **378,213** | **409,325** | **436,016** | **458,035** | **465,305** |
| **Total Debt (Gross)** | **602,194** | **741,692** | **844,330** | **979,550** | **1,151,981** | **1,260,755** |
| **Total Debt (Net)** | **546,398** | **682,023** | **771,283** | **910,305** | **1,076,113** | **1,171,546** |

[1] Provisional.
[2] Deposits with banks exclude deposits held with the CBM, and any deposits held abroad.

*SOURCE: The Treasury, Non-Financial Public Institutions, Central Bank of Malta* during the period. Government debt grew fastest during 1996 and 1997, when it expanded by 25.8% and 28.4% respectively. As the Chart also shows, net government debt tracked gross debt closely, as there was little change in the government's holdings of financial assets during the period.

The stock of government debt increased more rapidly than nominal GDP over the period. In fact, as Chart 2 shows, the ratio of gross government debt to GDP rose from 32.5% at the end of 1993 to an estimated 55.2% at the end of 1998.

Most of the increase in government debt resulted from domestic borrowing, through issues of Treasury bills and government stocks. In 1995, Parliament raised the limit on **Treasury bills** in issue from Lm30 million to Lm100 million, and in the following year it raised it again to Lm200 million, where it stands today. The increase in the limit on bills outstanding was related to the abolition of the government overdraft facility with the Central Bank[2]. Between 1993 and 1998, Treasury bills in issue rose by Lm54 million, peaking at Lm108.9 million in 1996, before dropping to Lm84 million at the end of 1998. In absolute terms, the government borrowed to an even greater extent by issuing stocks. Thus, the value of **government stocks** outstanding climbed from Lm224.6 million in 1993 to Lm633.4 million in 1998. By the end of 1998, government stocks accounted for 82.7% of gross government debt, up from 73.6% in 1993.

In 1998, the government's **external debt** stood at Lm48.4 million. In fact, as Table 1 shows, after 1994 government external debt fell steadily, and the share of external debt in gross government debt dropped from 16.5% in 1993 to 6.3% in 1998. The government's external debt is owed mainly to other governments and to official multilateral agencies such as the European Investment Bank. Commercial bank loans constitute only a small proportion of the total.

Chart 3 shows the maturity pattern of the government's outstanding debt. As the Chart indicates, foreign debt levels are low, and the maturity of official external debt is fairly evenly distributed. In the case of local debt, however, more than half is due to mature within the next five years.

The preponderance of local debt in total government debt is also evident in Chart 4, which shows that almost all government debt outstanding is denominated in Maltese liri. A small proportion of the government's debt is denominated in foreign currencies, mainly in Italian lire and euro, with the remainder being contracted in a number of major currencies including the US dollar, the Japanese yen and the German mark.

The increase in government debt during the period was also reflected in higher debt service costs. Annual debt service costs, which include interest payments and contributions to sinking funds, rose from Lm18.6 million in 1993 to Lm62.2 million in 1998. Most of the increase in debt service costs reflected the rapid build-up of domestic debt. In fact, interest payments on domestic debt more than tripled during the period, increasing particularly rapidly during 1997 and 1998. Capital repayments (i.e.

CHART 1 GOVERNMENT DEBT OUTSTANDING

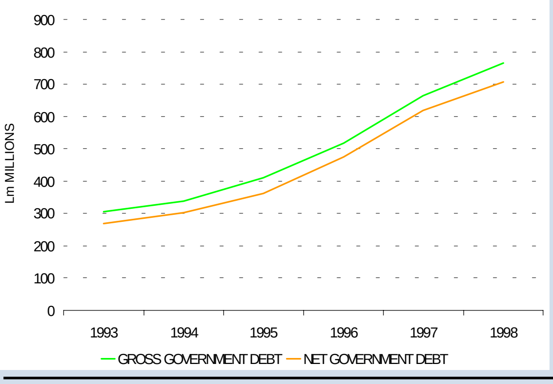
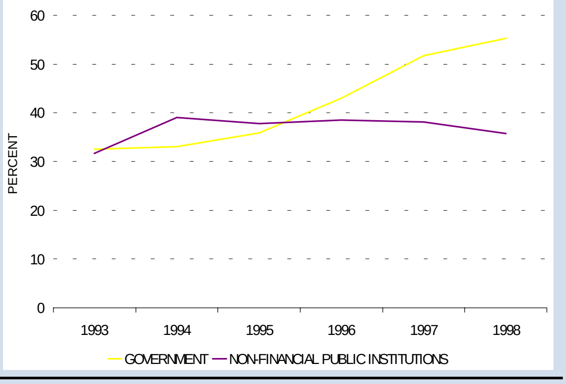



CHART 2 GROSS DEBT : GDP




[2] Although this facility has still not been formally abolished, the government has not used it since 1995.

## Table 2
## DEBT SERVICING COSTS

*Lm thousands*

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998[1] |
|---|---|---|---|---|---|---|
| **Government Debt Servicing Costs** | **18,625** | **23,356** | **24,702** | **30,849** | **45,988** | **62,217** |
| of which: | | | | | | |
| **Domestic** | **13,337** | **17,049** | **19,267** | **24,500** | **39,903** | **56,463** |
| Interest Payments | 11,661 | 14,602 | 16,805 | 20,818 | 30,435 | 39,295 |
| Capital Repayments | 1,676 | 2,447 | 2,462 | 3,682 | 9,467 | 17,168 |
| **External** | **5,288** | **6,307** | **5,435** | **6,349** | **6,085** | **5,754** |
| Interest Payments | 1,895 | 1,912 | 2,048 | 1,812 | 1,780 | 2,152 |
| Capital Repayments[2] | 3,393 | 4,395 | 3,387 | 4,537 | 4,305 | 3,602 |
| **NFPIs Debt Servicing Costs[3]** | **9,125** | **19,403** | **31,627** | **30,025** | **34,956** | **72,057[5]** |
| of which: | | | | | | |
| **External** | **9,125** | **19,403** | **31,627** | **30,025** | **34,956** | **72,057[5]** |
| Interest Payments | 6,994 | 9,385 | 12,509 | 12,101 | 15,269 | 16,758 |
| Capital Repayments[4] | 2,131 | 10,018 | 19,118 | 17,924 | 19,687 | 55,299 |
| Memo Item: Early refinancing of a loan | - | - | - | - | - | 75,622 |
| ***Ratios*** | | | | | | |
| ***External Debt Service/GDP (%)*** | ***1.53*** | ***2.50*** | ***3.24*** | ***3.03*** | ***3.20*** | ***5.61[5]*** |
| ***External Debt Service/Exports of Goods and Services (%)*** | ***1.61*** | ***2.59*** | ***3.45*** | ***3.48*** | ***3.74*** | ***6.59[5]*** |

[1] Provisional.
[2] Mainly contributions to Sinking Funds.
[3] Domestic debt servicing costs of NFPIs are not available.
[4] Figures for 1998 include the repayment of a major loan by one corporation.
[5] Excluding amounts in respect of early refinancing of a loan.

*Source: Ministry of Finance, CBM Estimates*

contributions to sinking funds) also rose sharply during the period, especially during the last two years, as Table 2 shows. At the same time, the costs of servicing the government's external debt remained relatively low, as the level of its external debt remained contained.

### Non-Financial Public Institutions

The increase in government debt during the period was accompanied by a smaller rise in the gross debt of NFPIs. As Table 1 shows, this increased from Lm297.2 million in 1993 to Lm495 million in 1998, implying an average annual growth rate of 11.3%

CHART 3 GOVERNMENT DEBT BY MATURITY
(OUTSTANDING AS AT END DECEMBER 1998)

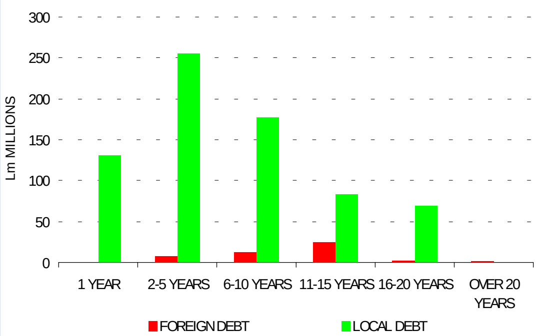



CHART 4 GOVERNMENT DEBT BY CURRENCY
(OUTSTANDING AS AT END DECEMBER 1998)

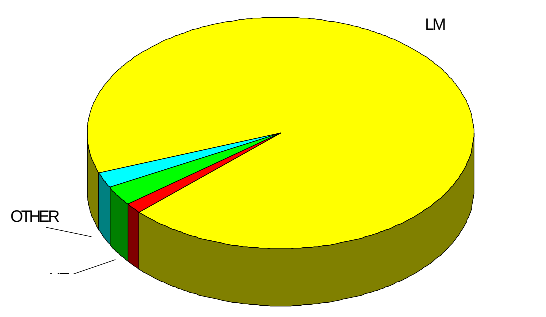
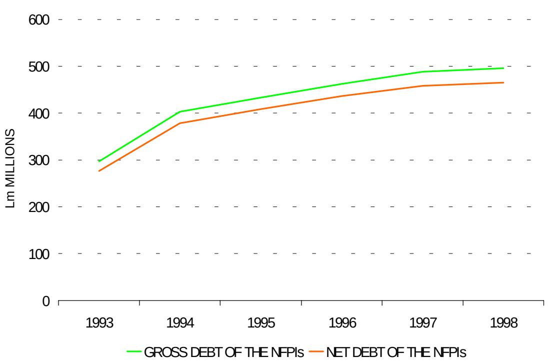


CHART 5 NON-FINANCIAL PUBLIC INSTITUTIONS' DEBT




during the period. The annual rate of growth of the debt of NFPIs peaked at 35.3% during 1994, when one corporation borrowed substantially on the international capital market. The sharp increase in the debt of the NFPIs in 1994 and the slower growth after that is illustrated in Chart 5. The Chart also shows that these institutions' net debt moved closely in line with their gross debt.

Both domestic loans and foreign borrowing by NFPIs increased during the period. Domestic loans to these institutions, which consist of credit facilities provided by the banking system, rose by Lm80.4 million between 1993 and 1998. However, the rate of growth of credit to these institutions peaked at 26.4% during 1995 and decelerated steadily after that. Indeed, bank credit to NFPIs decreased by 5.5% during 1998.

In contrast with the government, NFPIs made greater use of foreign borrowing during the period, often with the backing of a government guarantee. The NFPIs' foreign debt amounted to Lm251.7 million at the end of 1998, after having increased by Lm117.4 million, or 87.5%, during the period under review. As a result, the share of external debt in the total debt of the institutions rose from 45.2% in 1993 to 50.9% in 1998. Unlike government external debt, the external debt of the NFPIs is owed mainly to commercial lenders. Moreover, as Chart 6 shows, although a substantial proportion of this debt will mature in the long term, more than one-third of it is due within five years. Most of this debt is denominated in US dollars, as Chart 7 shows.

Heavy external borrowing by the NFPIs led to a parallel increase in the costs incurred to service their debt[3]. The NFPIs' external debt service costs tripled between 1993 and 1997, as capital repayments rose rapidly. Moreover, in 1998, the repayment of the loan mentioned earlier boosted external debt service costs for that year considerably. Even excluding capital repayments, interest charges on the external debt of the NFPIs more than doubled, rising to Lm16.8 million in 1998, as Table 2 shows.

**Conclusion**

This brief analysis has described the rapid growth in the debt of the public sector between 1993 and 1998. Gross government debt increased sharply, both in absolute terms and as a proportion of GDP. Debt contracted by NFPIs grew more slowly, although, unlike government, these institutions borrowed substantially from abroad. Debt service costs, including those relating to servicing the external debt, rose considerably during the period. The ratio of external debt service costs to GDP and to exports of goods and services also increased.

CHART 6 NFPIs EXTERNAL DEBT BY MATURITY
(OUTSTANDING AS AT END DECEMBER 1998)

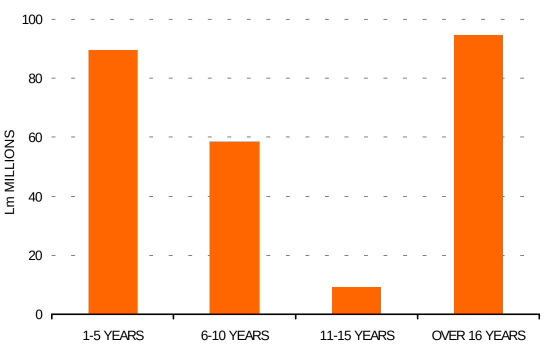
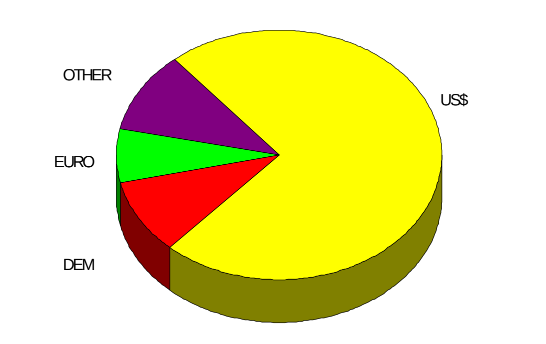



CHART 7 NFPIs EXTERNAL DEBT BY CURRENCY
(OUTSTANDING AS AT DECEMBER 1998)




[3] Data on the domestic debt servicing costs of NFPIs are not available.

The increase in government debt has led to growing debt service costs, and has placed upward pressure on domestic interest rates. Stabilising the level of government debt will require the government to run budget surpluses equivalent to the interest costs on the existing debt. On the other hand, stabilising the ratio of debt to GDP will require that the rate of growth of GDP be equal to the rate of growth of the debt - which will, in turn, depend on the size of the budget deficit and the rate of interest on the outstanding debt stock.

To a limited extent, altering the composition of the debt may lower debt service costs. Raising finance by issuing fewer stocks and more Treasury bills may help in this respect. In view of the drop in interest rates abroad and the current low level of external debt, borrowing abroad may also seem to be a feasible proposition. However, an increase in external debt may have an immediate negative impact on Malta's credit rating. In the longer-term, the country will have to generate surpluses on the current account of the balance of payments to service such debt.

This analysis has also pointed out that public sector institutions are exposed to exchange rate risk. This is because, whereas the Maltese lira is largely pegged to the euro, these institutions' foreign debt is mainly contracted in US dollars. Moreover, the fact that a substantial part of the debt will mature within five years leaves these institutions exposed to increases in international interest rates or any adverse movements in investor sentiment. While hedging can reduce these exposures, it is also important to pursue monetary and fiscal policies that are consistent with the exchange rate peg and, in particular, to achieve a sustainable balance of payments position.

# 5. Monetary and Financial Developments

During 1998, the rate of growth of broad money continued to slow down. Domestic credit remained the principal determinant of monetary expansion, but the rate of growth of credit also decelerated. In contrast, and in part because of a one-off accounting adjustment, the net foreign assets of the banking system recovered somewhat. The issue of a substantial amount of government stock on the primary market in July had a major impact on monetary developments and on financial markets during the year.

A marginal tightening of the Central Bank's monetary policy stance led to an increase in short-term interest rates during the first half of the year. In the capital market, however, robust demand for government stocks drove down long-term interest rates significantly in the later part of the year. Activity in the equity market continued to increase and share prices rose considerably.

## 5.1 The Monetary Base

The monetary base, or M0, is a measure of the Central Bank's monetary liabilities that comprises currency in issue and the banks' deposits with the Central Bank. During 1998, the monetary base, whose movements over the last three years are illustrated in Chart 5.1, expanded by Lm19.5 million to Lm504.7 million. However, the annual rate of growth of the monetary base slowed down, dropping from 7.3% in 1997 to 4% in 1998. During the year, as the Chart indicates, M0 fluctuated widely, largely reflecting changes in banks' deposits with the Central Bank. Currency in issue, which is the larger component of the monetary base, was more stable.

## 5.2 Broad Money and its Components

**Broad money**, or M3, is made up of currency in circulation and residents' deposits with the banking system. During 1998, broad money expanded by Lm173 million to Lm2,220 million. This was a smaller increase in absolute terms than those recorded during 1996 and 1997. Thus, the annual rate of growth of broad money continued to slow down, dropping from 9.6% in December 1997 to 8.5% at the end of 1998. As Chart 5.2 shows, the annual rate of growth of broad money accelerated at the beginning of the year, but dropped in July, when government stocks were issued on the primary market. Broad money growth then recovered during the third quarter, before slowing down gradually during the final quarter of the year.

**Narrow money**, or M1, comprises currency in circulation and demand deposits, which are the more liquid components of broad money. During 1998, narrow money expanded by Lm41.1 million, or 8.6%. As Table 5.1 shows, this was a more rapid rate of growth than those recorded in 1996 and 1997. The annual rate of growth of M1 accelerated during the first three quarters of the year, reaching a peak of 12.5% in September, before decelerating towards the end of the year.

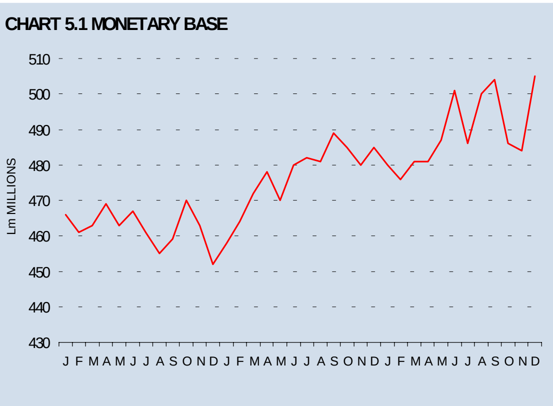


CHART 5.1 MONETARY BASE

**Table 5.1**
**MAIN MONETARY AGGREGATES**

*Lm millions*

| | 1995 | | 1996 | | 1997 | | 1998 | |
|---|---|---|---|---|---|---|---|---|
| | Amount | % Change | Amount | % Change | Amount | % Change | Amount | % Change |
| **Broad Money** | **1,691.4** | **7.7** | **1,868.3** | **10.5** | **2,047.0** | **9.6** | **2,220.0** | **8.5** |
| of which: | | | | | | | | |
| **Narrow Money** | **436.8** | **-5.8** | **454.1** | **4.0** | **479.9** | **5.7** | **521.0** | **8.6** |
| Currency in Circulation | 351.8 | -3.9 | 362.1 | 2.9 | 363.8 | 0.5 | 368.1 | 1.2 |
| Demand Deposits | 85.0 | -13.0 | 92.0 | 8.3 | 116.1 | 26.2 | 152.9 | 31.7 |
| **Quasi-Money** | **1,254.6** | **13.4** | **1,414.2** | **12.7** | **1,567.1** | **10.8** | **1,699.0** | **8.4** |
| Savings Deposits | 510.8 | 10.5 | 537.3 | 5.2 | 574.1 | 6.9 | 585.1 | 1.9 |
| Time Deposits | 743.8 | 15.4 | 876.9 | 17.9 | 993.0 | 13.2 | 1,113.8 | 12.2 |
| **Foreign currency components of broad money**[1] | **156.0** | **26.9** | **173.1** | **11.0** | **182.7** | **5.5** | **192.2** | **5.2** |
| Demand | 5.5 | + | 3.4 | -39.0 | 7.4 | + | 8.9 | 20.4 |
| Savings | 89.7 | 15.0 | 102.4 | 14.1 | 111.6 | 9.0 | 107.3 | -3.8 |
| Time | 60.8 | 40.3 | 67.4 | 10.8 | 63.7 | -5.5 | 76.0 | 19.3 |

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

Vigorous growth in demand deposits continued to drive the rapid expansion in narrow money. In fact, demand deposits, which had risen by 26.2% during 1997, expanded by a further Lm36.8 million, or 31.7%, during 1998. Demand deposits held by the personal sector accounted for most of this growth, but deposits held by private firms also increased significantly. Demand deposits increased strongly throughout most of the year, probably in response to the increase in interest rates offered on them that took place towards the end of 1997. However, the rate of growth of demand deposits slowed down somewhat during the final quarter of the year.

In contrast, currency in circulation, which is the larger component of narrow money, continued to expand moderately. During 1998, currency in circulation increased by Lm4.3 million, with the annual rate of growth picking up slightly, to 1.2%. Nevertheless, as the private sector continued to favour other means of payment, the share of currency in circulation in broad money continued to fall, dropping by over one percentage point to 16.6%. Currency in circulation dropped during the first quarter, in line with the normal seasonal pattern, recovered during the second and third quarters, and fell slightly during the final quarter of the year.

**Quasi-money** – which includes savings and time deposits – continued to account for most of broad money growth. During 1998, quasi-money expanded by Lm131.9 million, or 8.4%. This was a smaller increase in absolute terms than those recorded during the previous two years. Consequently, the annual rate of growth of quasi-money continued to decelerate, as Chart 5.2 shows.

Savings deposits expanded modestly, adding on Lm11 million, or 1.9%, during the year. With demand deposits offering higher rates of interest than before, and with short-term fixed deposits also being available, the relative attraction of savings deposits continued to wane. Savings deposits decreased during the first quarter and recovered partially during the second quarter. Savings deposits then fell sharply in July, when government stocks were issued on the primary market, but recovered strongly in August. They rose sharply again in December, when annual interest was credited to savings accounts. Whereas savings deposits held by households continued to grow, those held by private firms and public sector corporations contracted. Furthermore, as Table 5.1 indicates, deposits denominated in Maltese liri accounted for all the increase in such deposits during the year, as savings deposits denominated in foreign currencies contracted by 3.8%.

Time deposits remained the most important component of broad money in 1998. They rose steadily during most of the year, expanding by Lm120.9 million, and thus accounting for more than two-thirds of the increase in broad money. Nevertheless, as Table 5.1 shows, the annual rate of growth of time deposits slowed down, dropping from 13.2% in 1997 to 12.2% during the year under review. Deposits belonging to households accounted for almost all the increase in time deposits during the year, although time deposits held by private firms and public sector corporations also increased. As in the past two years, the largest increase in absolute terms took place in deposits with a maturity of one year, but deposits with a shorter term to maturity and those with a term to maturity of five years or more increased at a more rapid rate. In contrast with the fall recorded in 1997, time deposits denominated in foreign currency expanded vigorously during 1998, rising by Lm12.3 million, or 19.3%, mainly because of an increase in foreign currency time deposits belonging to public sector corporations.

### 5.3 Determinants of Monetary Expansion

During 1998, domestic credit continued to be the principal determinant of monetary growth. However, in contrast with the previous three years, an increase in the net foreign assets of the banking system also contributed to monetary expansion. Not all the increase in the banking system's net foreign assets was reflected in monetary growth, since a large part of it mirrored an increase in the banks' non-monetary liabilities.

**Domestic credit** expanded by Lm183.5 million, or 11.2%, to Lm1,828.2 million, as can be seen in Table 5.2. Nevertheless, the annual rate of growth of domestic credit, which is shown in Chart 5.3, decelerated gradually during the year, as bank claims on the government and on the private and parastatal sectors increased at a slower pace than in 1997.

During 1998, the Government continued to finance its borrowing requirement largely by selling securities to the banking system. However, during the year, it also sold stocks to the non-bank private sector and raised funds by selling part of its equity stake in Maltacom

CHART 5.3 DOMESTIC CREDIT
(PERCENTAGE CHANGES ON YEAR EARLIER)

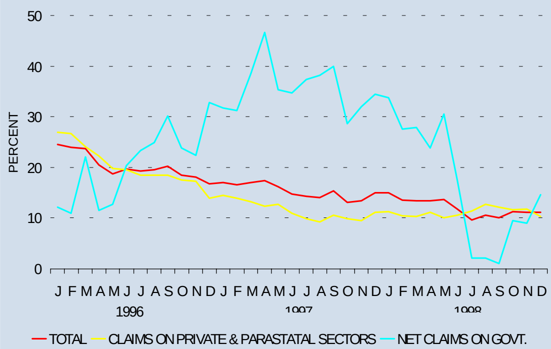



**Table 5.2**
**DETERMINANTS OF MONETARY EXPANSION**

*Lm millions*

| | 1995 | | 1996 | | 1997 | | 1998 | |
|---|---|---|---|---|---|---|---|---|
| | Amount | % Change | Amount | % Change | Amount | % Change | Amount | % Change |
| **Broad Money** | **1,691.4** | **7.7** | **1,868.3** | **10.5** | **2,047.0** | **9.6** | **2,220.0** | **8.5** |
| **Domestic Credit** | **1,224.8** | **26.6** | **1,429.6** | **16.7** | **1,644.7** | **15.1** | **1,828.2** | **11.2** |
| Net Claims on Government | 179.9 | 19.4 | 239.1 | 32.9 | 321.5 | 34.5 | 368.4 | 14.6 |
| Claims on private and parastatal sectors | 1,044.9 | 28.0 | 1,190.5 | 13.9 | 1,323.3 | 11.2 | 1,459.8 | 10.3 |
| **Net Foreign Assets** | **812.9** | **-7.4** | **754.1** | **-7.2** | **735.2** | **-2.5** | **855.2** | **16.3** |
| Monetary Authorities | 580.7 | -15.9 | 554.1 | -4.6 | 561.7 | 1.4 | 625.8 | 11.4 |
| All Banking Institutions | 232.2 | 24.1 | 200.0 | -13.9 | 173.5 | -13.2 | 229.4 | 32.2 |
| *Less* | | | | | | | | |
| **Other Items (Net)** | **346.3** | **26.2** | **315.4** | **-8.9** | **332.9** | **5.6** | **463.4** | **39.2** |

**Table 5.3**
**DISTRIBUTION OF CREDIT**[1]

| | 1997 | | | 1998 | | |
|---|---|---|---|---|---|---|
| | Amount Lm000s | Annual Growth (%) | Share of Total (%) | Amount Lm000s | Annual Growth (%) | Share of Total (%) |
| Energy and Water | 98,105 | 12.9 | 7.5 | 106,900 | 9.0 | 7.6 |
| Agriculture & Fisheries | 11,218 | -5.2 | 0.9 | 11,106 | -1.0 | 0.8 |
| Manufacturing, Shiprepair/Build | 213,443 | 0.3 | 16.4 | 204,640 | -4.1 | 14.5 |
| Building & Construction | 72,254 | -2.7 | 5.6 | 82,571 | 14.3 | 5.8 |
| Tourism | 174,543 | 29.9 | 13.4 | 190,872 | 9.4 | 13.5 |
| Wholesale and Retail | 228,737 | 7.6 | 17.6 | 250,736 | 9.6 | 17.7 |
| Personal | 251,623 | 17.8 | 19.3 | 292,109 | 16.1 | 20.6 |
| Transport, Storage & Comm. | 78,667 | -2.3 | 6.0 | 84,609 | 7.6 | 6.0 |
| Other Services | 56,499 | 17.6 | 4.3 | 62,708 | 11.0 | 4.4 |
| All Other | 116,660 | 18.8 | 9.0 | 128,474 | 10.1 | 9.1 |
| **Total Local Lending**[2] | **1,301,749** | **11.0** | **100.0** | **1,414,733** | **8.7** | **100.0** |
| **Public Sector**[3] | **257,314** | **3.1** | **19.8** | **243,266** | **-5.5** | **17.2** |
| **Private Sector** | **1,044,435** | **13.1** | **80.2** | **1,171,467** | **12.2** | **82.8** |

[1] By all banking institutions. Includes bills discounted and excludes inter-bank advances and credit to government.
[2] Includes lending by International Banking Institutions licensed under the MFSC Act 1994, for which sectoral distribution is not available.
[3] Publicly owned and/or controlled entities.

plc. Thus, whereas during 1997 the banking system's **net claims on government** had risen by 34.5%, during 1998 they expanded by 14.6%. As Chart 5.3 shows, the annual rate of growth of the banking system's net claims on government decreased gradually during the first half of the year before falling sharply during the third quarter, when the issue of government stocks on the primary market boosted the Treasury's deposits with the Central Bank. The banking system's net claims on government picked up during the final quarter, however, as the Treasury ran down bank deposits and resumed issues of bills. As in the previous year, an increase in government stocks held by the deposit money banks accounted for all the growth in bank claims on government during 1998.

Growth in **claims on the private and parastatal sectors** continued to account for most of the increase in domestic credit during the year under review. In fact, during 1998, these claims expanded by Lm136.6 million. Nevertheless, the annual rate of growth of bank claims on the private and parastatal sectors, which had peaked most recently early in 1996, continued to slow down, dropping to 10.3% in December 1998, as Chart 5.3 illustrates.

The slowdown in claims on the private and parastatal sectors was the result of less rapid growth in bank loans and advances, their predominant component. As Table 5.3 shows, whereas total loans and advances, including bills discounted, had increased by 11% during 1997, they expanded by 8.7% during 1998. As the Table also shows, loans to public sector enterprises, which had expanded slightly during 1997, contracted by 5.5% during the year under review. Meanwhile, lending to the private sector expanded less rapidly than in the previous year, with the annual growth rate falling from 13.1% in 1997 to 12.2% in 1998.

The annual growth rates of credit to various categories of borrower, which are also shown in Table 5.3, generally slowed down during the year. Thus, for example, credit to the manufacturing sector contracted and lending to the tourism sector slowed down sharply. Moreover, although the annual rate of growth of credit to the personal sector remained high, it was lower than that recorded during 1997. In contrast with this general trend, credit to the construction industry recovered and the rate of growth of credit to the wholesale and retail trades picked up slightly.

Credit to manufacturing industry, which had barely increased during 1997, fell by Lm8.8 million, or 4.1%, during 1998. This was mainly because bank credit to the shipyards and to the electronics sub-sector declined. Moreover, although credit to the tourism industry rose significantly in absolute terms, the annual rate of growth of such credit slowed down sharply, dropping from 29.9% in 1997 to 9.4% in 1998. In fact, during 1998, credit to finance the acquisition and upgrading of tourist facilities declined, while credit for the construction of new facilities grew at a slower pace than in 1997.

Credit to households accounted for the largest single share of the increase in bank lending during the year. In fact, during 1998, lending to the personal sector expanded by Lm40.5 million, or more than one-third of the total annual increase in local lending. More than half of this credit financed the acquisition or construction of housing. Although the annual growth rate of credit to the sector remained high, it continued to slow down, dropping from 17.8% in 1997 to 16.1% in 1998.

In contrast, bank lending to the wholesale and retail trades, which had slowed down during 1997, picked up during 1998, rising by Lm22 million, or 9.6%. Credit to the construction industry, which had contracted during 1997, recovered strongly during 1998, rising by Lm10.3 million, or 14.3%.

After having fallen for three consecutive years, the **net foreign assets** of the banking system expanded by Lm120 million, or 16.3%, to Lm855.2 million during 1998. This recovery in the banking system's net foreign assets partly reflected a lower deficit on the current account of the balance of payments and higher capital inflows. However, more than half the increase was the result of a change in the accounting treatment of certain categories of capital reported by international banks that was carried out in January. This increase had no impact on monetary aggregates but was reflected in a rise in "other items (net)".

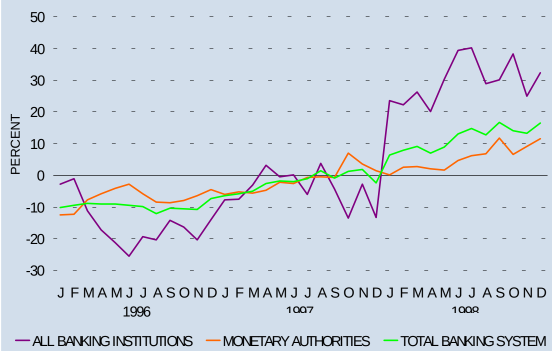
The net foreign assets of the monetary authorities, which mainly consist of the Central Bank's external reserves, expanded steadily during 1998. After a small rise recorded during 1997, the net foreign assets of the monetary authorities rose by Lm64.1 million, or 11.4%, during 1998. The increase in the Bank's external reserves took place largely in the second and third quarters of the year, and was mainly the result of capital inflows connected with the sale of Maltacom shares abroad and a positive balance on bilateral trade arrangements. The Bank also made substantial net purchases of foreign exchange from the rest of the banking system during the year, particularly in December.

The net foreign assets of the rest of the banking system, which had fallen both in 1996 and in 1997, increased by Lm55.8 million, or 32.2%, during 1998. The entire rise was accounted for by a rise in the net foreign assets of the international banks. In contrast, the net foreign assets of the deposit money banks continued to fall, contracting by Lm37 million, or 12.3%. The drop took place entirely during the final quarter, when these banks sold foreign assets to the Central Bank to invest in the domestic capital market. The net foreign assets of the international banks expanded by Lm92.8 million, or 69.7%, during 1998. As stated earlier, and as can be seen in Chart 5.4, almost all the increase took place in January, when around Lm70 million worth of capital grants from shareholders of these institutions were no longer classified as foreign liabilities, but as equity.

**5.4 The Money Market**

Short-term securities, usually defined as those with a maturity of less than one year, are traded in the money market. The Central Bank uses open market operations

CHART 5.4 NET FOREIGN ASSETS
(PERCENTAGE CHANGES ON A YEAR EARLIER)



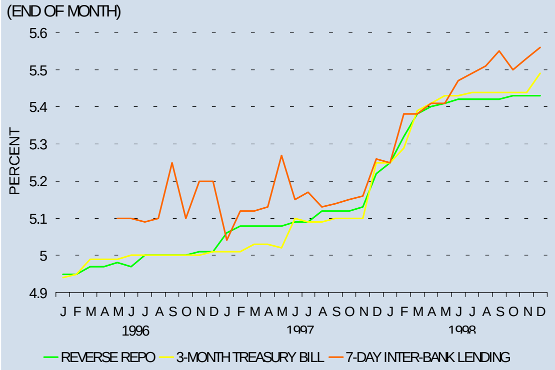
to affect liquidity in the money market and, hence, to influence short-term interest rates.

Money market **interest rates** rose marginally during 1998 as the Central Bank tightened its monetary policy stance slightly in February and April. As a result, whereas the repo rate remained unchanged at 5.5% throughout the year, the reverse repo rate rose from 5.22% in December 1997 to 5.43% in December 1998. The primary market yield on three-month Treasury bills shadowed the reverse repo rate closely, as Chart 5.5 shows, ending the year at 5.49%. During the same period, the average seven-day inter-bank lending rate rose from 5.26% to 5.56%, rising above the repo rate during the second half of the year.

During the year, the Central Bank continued to influence conditions in the money market using a combination of repos, reverse repos, term deposit auctions and foreign exchange swaps to inject or absorb liquidity temporarily from the banking system. The conduct of these open market operations is described in more detail in another Chapter of this Report.

On balance, during 1998, the Bank injected liquidity into the banking system. In fact, during 1998, the Bank carried out **repo** auctions, temporarily injecting an aggregate of Lm241.3 million. In contrast, during 1997, it had only injected Lm54.2 million in this way. Repos were mainly carried out during the third quarter, when banks borrowed funds to be able to participate in the primary market for government stocks. On the other hand, whereas during 1997 the Bank had temporarily absorbed an aggregate of

CHART 5.5 MONEY MARKET INTEREST RATES
(END OF MONTH)




Lm349 million from the banking system through reverse repos, during 1998 it absorbed Lm173 million through a combination of **reverse repos** and **term deposits**.

To a lesser extent, the Bank also influenced domestic liquidity through foreign exchange **swaps**. The Bank carried out swaps worth Lm48.1 million during 1998, compared with the Lm60.7 million worth that were carried out during 1997. Through these swaps the Bank injected liquidity temporarily into the banking system by buying foreign exchange against Maltese liri. Nevertheless, as not all maturing swaps were renewed, the value of outstanding swaps fell.

The Treasury continued to issue bills, with maturities ranging from one month to one year, to finance its expenditure during 1998. However, the amount of bills issued dropped from Lm332.2 million in 1997 to Lm249.5 million in 1998. During 1998, bills worth Lm255.8 million matured. **Treasury bill** issues remained steady during the first two quarters of the year, but they dropped during the third quarter – as the Treasury received the proceeds from the sale of Maltacom shares and the issue of government stocks. Treasury bill issues then picked up again during final quarter of the year. As in 1997, most of the bills issued were bought by Malta Government Sinking Funds (MGSF), which subscribed to 74% of the total. The deposit money banks bought 17.8% of the bills issued, with other investors taking up the remainder. As in previous years, the Central Bank did not participate in the primary Treasury bill market.

As a result of lower activity in the primary Treasury bill market, secondary market turnover dropped from Lm468.6 million in 1997 to Lm402.2 million during 1998. The Central Bank remained active in the secondary Treasury bill market, although to a lesser extent than in the previous year. Whereas during 1998 the Bank made purchases and sales worth Lm116.3 million and Lm79 million respectively, during 1997 it had bought Lm268.4 million worth of bills and sold Lm147.6 million worth. However, secondary market transactions that did not involve the Central Bank almost quadrupled during 1998,

**Table 5.4**
**ALLOCATION OF PRIMARY MARKET ISSUES OF GOVERNMENT STOCKS DURING 1998**

*Lm thousands*

| Stock | Amount Issued | Allocation: Banking System | Allocation: Non-Bank Private Sector |
|---|---|---|---|
| 7.2% MGS 2008 (I)[1] | 10,000 | 9,326 | 674 |
| 6.8% MGS 2004 (II) | 25,852 | 22,324 | 3,528 |
| 7.2% MGS 2008 (II) | 30,000 | 22,242 | 7,758 |
| 7.8% MGS 2018 | 70,000 | 36,339 | 33,661 |
| 6.15% MGS 2001 (V)[1] | 17,600 | 16,787 | 813 |
| 6.15% MGS 2001 (V) - 2nd Tranche[1] | 5,000 | 5,000 | - |
| **Total** | **158,452** | **112,018** | **46,434** |

[1] Conversion Stock.

*SOURCE: The Treasury*

rising to Lm206.9 million. The MGSF acted as the principal dealer in this market, in which the Treasury itself was also active.

### 5.5 The Capital Market

Debt securities with a maturity of more than one year and equities are traded in the capital market. During 1998, developments in the capital market were characterised by the partial privatisation of Maltacom plc and the substantial issue of government stocks in July. The growth of collective investment schemes continued to support activity on the Malta Stock Exchange. Falling interest rates abroad may have contributed to increased demand for domestic financial instruments, leading to higher asset prices and lower yields. Furthermore, the Exchange switched to daily trading in May, increasing the liquidity of listed financial instruments.

There were two major issues on the primary capital market during 1998. In June, the Government sold 40% of its equity holding in Maltacom, offering 17.2 million shares for sale on the domestic market and a similar amount of shares in the form of global depository receipts internationally. An additional 3 million shares were offered directly to the Maltacom Employee Foundation. The shares were sold at a price of 90 cents each and were subsequently traded on the Malta Stock Exchange and on the London Stock Exchange.

In July, the Government issued Lm125.9 million worth of **stocks** on the primary market. As Table 5.4 shows, the stocks were issued with maturities of six, ten and

**Table 5.5**
**TURNOVER OF GOVERNMENT STOCKS IN THE SECONDARY MARKET**

*Lm thousands*

| | Total Stocks 1996 | Total Stocks 1997 | Total Stocks 1998 |
|---|---|---|---|
| Purchases to CBM portfolio[1] | 2,881 | 19,640 | 8,034 |
| Sales from CBM portfolio | 16,011 | 60,082 | 63,793 |
| Other Deals[2] | 1,683 | 32,123 | 40,237 |
| Total | 20,575 | 111,844 | 112,064 |

[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*

**Table 5.6**
**THE EQUITY MARKET**

| Listed Company | Turnover Lm000s | | Number of Shares | | End of Year Price (Lm) | | Average Price (Lm) | |
|---|---|---|---|---|---|---|---|---|
| | 1997 | 1998 | 1997 | 1998 | 1997 | 1998 | 1997 | 1998 |
| Bank of Valletta | 3,210 | 5,792 | 2,403,583 | 3,806,414 | 1.34 | 1.70 | 1.34 | 1.52 |
| Mid Med Bank | 1,360 | 1,863 | 834,614 | 1,029,986 | 1.69 | 2.10 | 1.64 | 1.81 |
| Lombard Bank | 369 | 3,162 | 241,292 | 1,515,763 | 1.65 | 2.38 | 1.54 | 2.09 |
| Middle Sea Insurance | 2,673 | 2,984 | 2,101,336 | 2,254,563 | 1.30 | 1.61 | 1.17 | 1.32 |
| Farsons | 107 | 77 | 229,979 | 145,957 | 0.43 | 0.52 | 0.49 | 0.53 |
| Suncrest[1] | 230 | 203 | 316,483 | 346,147 | 0.68 | 0.59 | 0.71 | 0.59 |
| Maltacom[2] | - | 6,887 | - | 8,067,383 | - | 0.90 | - | 0.85 |
| Total | 7,949 | 20,968 | - | - | - | - | - | - |

[1] Listed on 16 April 1997.
[2] Listed on 22 June 1998.

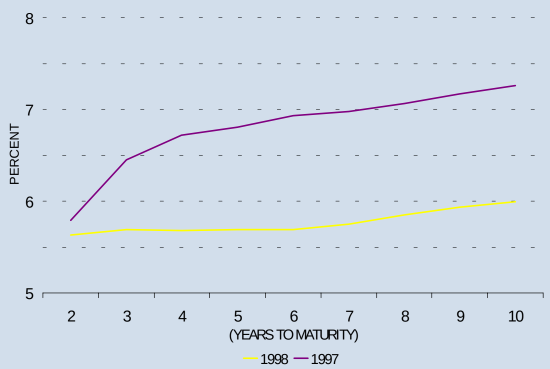
twenty years and coupon rates ranging from 6.8% to 7.8%. This was the first time that the Government issued bonds with a term to maturity exceeding fifteen years. As the Table also shows, the banking system took up Lm80.9 million of the stocks issued, with the non-bank private sector taking up Lm44.9 million. The Central Bank subscribed to Lm27.6 million of stocks – solely in order to fulfil its role as market maker. Apart from this issue, the Government issued a total of Lm32.6 million in conversion stocks to roll over maturing debt securities.

Turnover in government stocks on the secondary market increased marginally during the year. As in 1997, most transactions in the secondary market involved the Central Bank, which continued to perform the role of market maker, as no other institution was in a position to take on this function. The Bank made heavy net sales to satisfy demand, as Table 5.5 shows. However, the value of sales that did not involve the Central Bank continued to rise, increasing by 25.3% to Lm40.2 million. More than one-fifth of the total turnover in the secondary market was accounted for by trading in the 7.8% MGS 2018 I, which was issued in July. The 7.2% MGS 2008 II, the 6.8% MGS 2004 II, and the 7% 2003 II were also heavily traded. Activity in the secondary market rose considerably during the second half of the year, after the newly issued stocks were listed on the Malta Stock Exchange.

Falling interest rates abroad increased investor interest in the domestic capital market during the year. In turn, the strong demand for government stocks pushed up bond prices and lowered yields, as Chart 5.6 shows. For example, the average yield on ten-year government stocks dropped from 7.26% in December 1997 to 5.99% in December 1998. Similarly, the yield on the twenty-year stock, which is not shown in the Chart, dropped from 7.8% in July 1998 to 6.86% in December. Downward pressure on yields was strongest during the final quarter of the year.

The private sector did not issue any long-term debt on the domestic capital market during 1998. The value of listed **corporate bonds**, including preference shares, traded on the secondary market increased by 9.7% to Lm1.6 million. Trading activity focused mainly on Mid-Med Bank 7.25% Loan Stock.

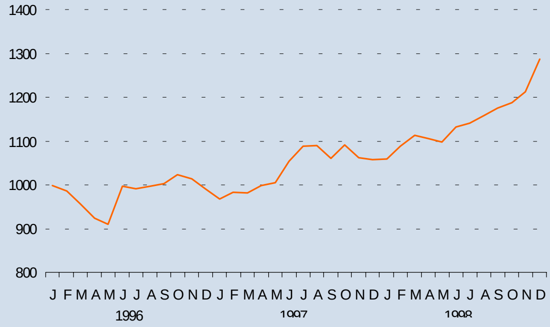
CHART 5.6 YIELD CURVES



Activity in the **equity market** continued to expand vigorously during 1998. The value of shares traded almost tripled during the year, rising to Lm21 million, from Lm7.9 million during 1997. As can be seen in Table 5.6, trading in Maltacom shares, which were listed in June, accounted for almost one-third of this activity.

Share prices generally rose considerably during the year, boosted by strong demand. The index of share prices compiled by the Malta Stock Exchange, which had moved up by 6.8% during 1997, rose by 21.8% during 1998. After rising moderately during the first quarter, share prices dropped in April and

CHART 5.7 STOCK EXCHANGE SHARE INDEX
(END OF MONTH)




May, as Chart 5.7 shows. However, they bounced back during the second half of the year, rising sharply during the final quarter.

# Box 4:
# Changes to the Presentation of the Central Bank of Malta's Balance Sheet and Monetary Aggregates

This year, the Central Bank has revised the presentation of its financial statements to enhance disclosure and to comply with International Accounting Standards in so far as they are appropriate to a central bank - as amplified in the Notes to the Financial Statements. The financial statements that are published in this Report are presented in the new format, which differs significantly from the previous one in a number of ways. As a result of these changes, reported external assets and deposits have increased, while other assets and other liabilities have decreased.

The principal differences in the balance sheet are described briefly below.

***Assets***

- The Central Bank's **external reserves** are now shown gross. Thus, a reserve against changes in the value of external assets, which was previously netted from external reserves, is now shown on the liabilities side of the balance sheet with capital and reserves. The external reserves also include foreign assets backing customers' foreign currency deposits, which were previously shown under other assets.

- **Other assets** now exclude securities and deposits in foreign currency held on behalf of customers, which are being shown with external reserves. Financial conventions, which were formerly included with other assets, are now being shown as an off-balance-sheet item. Furthermore, accrued income is now being shown separately on the face of the balance sheet.

- Tangible **fixed assets** are being shown on the balance sheet for the first time.

***Liabilities***

- **Deposits** now include foreign currency deposits belonging to government and other customers that were previously netted against external reserves.

- **Other liabilities** now exclude a number of items that are shown elsewhere. The profit and loss balance, as well as interest payable and deferred income, is now being shown separately. Customers' deposits in foreign currency are now incorporated with the relevant category of deposits. Provisions for risks and contingencies are transferred to capital and reserves, whereas financial conventions are now shown as off-balance-sheet items.

- **Capital and reserves** now include the reserve against changes in the value of external assets, as well as provisions for risks and contingencies.

These accounting adjustments will result in changes in monetary aggregates and their determinants. First, the increase in the reported external reserves will significantly raise the net foreign assets of the monetary authorities and, hence, those of the banking system as a whole. Second, the increase in reported deposits will raise monetary aggregates, including broad money, although the impact of this change is likely to be small. Third, the increase in deposits belonging to government will reduce net claims on government and, consequently, domestic credit. Finally, the changes to other assets and other liabilities will also have an impact on "other items (net)". These adjustments have not been taken into account in the data and analysis presented in the main body of this Report.

# 6. The Banking System

The banking sector continued to expand during 1998, with the international banking sector, in particular, growing most rapidly. The deposit money banks' total assets, which were funded mainly by residents' deposits and foreign borrowing, increased at a faster pace than in 1997. The deposit money banks' profits before tax also increased, while their capital and liquidity levels remained robust. The activity of the other banking institutions also increased moderately, following the decline registered in the previous year.

## 6.1 The Deposit Money Banks

The aggregate balance sheet of the deposit money banks expanded at a faster pace during 1998. After having risen by 9.8% during 1997, their aggregate balance sheet expanded by Lm295 million, or 12.5%, during 1998, as Table 6.1 shows. This expansion was mainly financed by growth in residents' deposits, but borrowing from non-residents also contributed significantly. The funds raised were mainly channelled into local lending and investment in government securities.

### *6.1.1 Liabilities*

**Residents' deposits** remained the principal source of funds for the deposit money banks, accounting for over half of the total increase in their liabilities. During 1998, residents' deposits with these banks expanded by Lm157.6 million, or 9.4%, compared with an 11.7% increase recorded during 1997.

Almost the entire increase took place in deposits denominated in Maltese liri, as deposits denominated in foreign currencies[11] rose by just Lm2.5 million, or 1.5%, to Lm170.4 million during the year. In fact, a drop in corporate foreign currency deposits with the deposit money banks almost completely offset an increase in foreign currency deposits held by public sector enterprises, while households' deposits in foreign currency remained stable. With international interest rates falling during the year, foreign currency deposits were less attractive to savers.

Deposits owned by the personal sector accounted for almost all the increase in deposits with the deposit

**Table 6.1**
**DEPOSIT MONEY BANKS' BALANCE SHEET**

*Lm thousands*

| | 1996 | | 1997 | | 1998 | |
|---|---|---|---|---|---|---|
| | Amount | % Change | Amount | % Change | Amount | % Change |
| **LIABILITIES** | | | | | | |
| Deposits | 1,496,743 | 12.5 | 1,672,335 | 11.7 | 1,829,888 | 9.4 |
| Demand | 87,248 | 10.1 | 110,486 | 26.6 | 145,973 | 32.1 |
| Savings | 538,177 | 5.4 | 574,352 | 6.7 | 581,875 | 1.3 |
| Time | 871,318 | 17.6 | 987,497 | 13.3 | 1,102,040 | 11.6 |
| Foreign Liabilities | 229,597 | 18.7 | 226,806 | -1.2 | 305,527 | 34.7 |
| Other Domestic Liabilities | 319,900 | 18.4 | 339,765 | 6.2 | 395,919 | 16.5 |
| Capital and Reserves | 96,090 | 10.7 | 112,694 | 17.3 | 115,258 | 2.3 |
| **ASSETS** | | | | | | |
| Cash and deposits with CBM | 96,777 | -3.8 | 125,183 | 29.4 | 140,172 | 12.0 |
| Foreign Assets | 588,571 | 5.6 | 534,756 | -9.1 | 575,077 | 7.5 |
| Loans and Advances | 1,079,552 | 15.0 | 1,205,349 | 11.7 | 1,324,629 | 9.9 |
| Local Investments | 263,194 | 12.3 | 365,333 | 38.8 | 477,853 | 30.8 |
| Fixed and Other Assets | 114,236 | 128.7 | 120,979 | 5.9 | 128,861 | 6.5 |
| **Total Assets/Liabilities** | **2,142,330** | **13.9** | **2,351,600** | **9.8** | **2,646,592** | **12.5** |

[11] Including external Maltese liri.

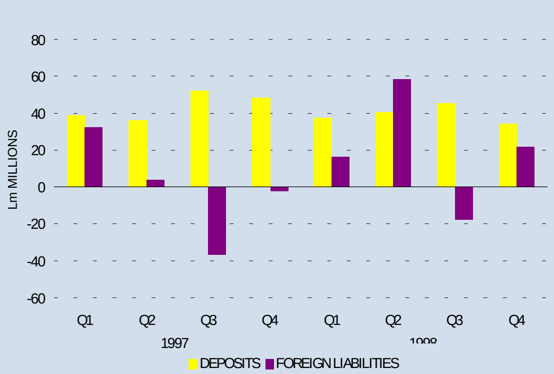
money banks. In fact, personal sector deposits expanded by Lm150.5 million, or 10.6%, during the year, with time deposits accounting for most of the increase. Corporate deposits and deposits belonging to government also increased during the year, rising by Lm9.7 million and Lm1.8 million respectively. Meanwhile, deposits owned by public sector enterprises contracted slightly. Bearer deposits, which include both savings and time deposits, continued their trend decline, dropping by Lm3.4 million to Lm34.2 million.

Deposits held with the deposit money banks account for almost all residents' deposits with the banking system. Consequently, the analysis on the type of deposit that follows mirrors the analysis of monetary aggregates carried out earlier in this Report.

Following the rapid expansion recorded during 1997, demand deposits continued to increase strongly. During 1998, demand deposits expanded by Lm35.5 million, with the annual rate of growth accelerating from 26.6% to 32.1%. Demand deposits increased most rapidly during the second and third quarters, but remained stable during the final quarter of the year. In contrast, savings deposits expanded moderately, rising by just Lm7.5 million, or 1.3%, over the year. Savings deposits fell considerably during the first quarter, but recovered during the second. They were stable during the third quarter and rose during the final quarter of the year. Most of the increase in residents' deposits took place in time deposits, which expanded by Lm114.5 million during 1998. Apart from a small fall in October, time deposits increased throughout the year. Nevertheless, the annual rate of growth of these deposits continued to slow down, dropping from 13.3% in 1997 to 11.6% in 1998.

During the year, the deposit money banks took advantage of falling interest rates overseas to increase their borrowings from non-residents. Thus, their **foreign liabilities**, which had decreased by 1.2% during 1997, increased by Lm78.7 million, or 34.7%, during 1998. The banks' foreign liabilities fluctuated widely during the year, rising during the first and second quarters, falling in the third and recovering during the final quarter, as Chart 6.1 shows. Liabilities to non-resident banks – including one large syndicated loan – increased by Lm35 million. At the same time, repos with non-residents rose by Lm44.2 million.

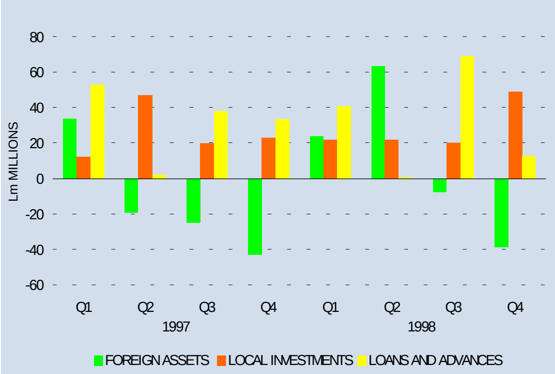
CHART 6.1 QUARTERLY CHANGES IN DEPOSIT MONEY BANKS' LIABILITIES




The deposit money banks' **other liabilities** increased more rapidly during 1998, rising by Lm56.2 million, or 16.5%, compared with a 6.2% rise recorded during 1997. Other liabilities include deposits due to the banks' subsidiaries, debentures and subordinated loan stock, certain categories of shareholders' funds and accrued interest expenses. Deposits due to the deposit money banks' international subsidiaries – the largest single component of their other liabilities – expanded by Lm11.1 million to Lm227.5 million during the year, despite falling during the final quarter. At the same time, various types of shareholders' funds, including reserves, provisions and current profits, also increased. Reserves alone rose by Lm11.3 million, with around half this increase reflecting the reclassification of revaluation reserves and other reserves that were added to other liabilities in April. To a lesser extent, the increase in the deposit money banks' other liabilities also reflected the use of new instruments to raise funds. One bank began to issue certificates of deposit during the year, another issued subordinated loan stock, and a third engaged in domestic repos.

The deposit money banks' **capital and reserves** include paid-up share capital, retained earnings, share premiums and capital reserves. During 1998, the banks' capital and reserves increased by Lm2.6 million, or 2.3%. This was a smaller rise than the 17.3% increase recorded during 1997, partly because certain

CHART 6.2 QUARTERLY CHANGES IN DEPOSIT MONEY BANKS' ASSETS




categories of reserves were included with other liabilities, as explained earlier.

### *6.1.2 Assets*

The deposit money banks' **reserves**, which mainly consist of deposits held with the Central Bank[12], increased by Lm15 million, or 12%, during 1998. The increase followed a 29.4% rise recorded during 1997. Reserves, which are the most liquid category of the banks' assets, fluctuated widely in the course of the year. They rose during the first and second quarters, particularly in June, but fell sharply in July, when government stocks were issued on the primary market. The banks' reserves then recovered during the rest of the third quarter and during the final quarter of the year.

In contrast with the previous year, when they had contracted by 9.1%, the deposit money banks' **foreign assets** expanded by Lm40.3 million, or 7.5%, during 1998. As can be seen in Charts 6.1 and 6.2, the banks' foreign assets moved broadly in line with their foreign liabilities during the first nine months of 1998, increasing during the first half of the year, and falling during the third quarter. During the final quarter of the year, however, the banks responded to falling interest rates abroad by selling foreign assets, using the proceeds to buy domestic securities. The composition of the banks' foreign asset portfolio also changed during the year, particularly as they reduced their holdings of securities issued by foreign governments and bought securities issued by other non-residents.

**Loans and advances to residents**[13], which remained the deposit money banks' largest single category of assets, continued to increase at a decreasing pace. Following an increase of 15% during 1996 and one of 11.7% during 1997, loans and advances rose by Lm119.3 million, or 9.9%, during 1998. During the first and third quarters, the deposit money banks' loans and advances increased substantially, mainly because of half-yearly interest charges. Otherwise, credit growth was slow, particularly during the second quarter.

In contrast with the slowdown in credit growth, the deposit money banks' **local investments** continued to increase vigorously. During 1998, the banks' local investments, which mainly consist of holdings of government stocks, rose by Lm112.5 million, or 30.8%. The banks built up their holdings of local investments steadily during the first three quarters of the year, but did so more rapidly during the final quarter. All categories of local investments increased, with holdings of government stocks, in particular, rising by Lm86.6 million.

The deposit money banks' **other assets** include premises and equipment, interest receivable and equity investments in other banks and financial institutions. During 1998, the banks' other assets grew by Lm7.9 million, or 6.5%, fluctuating in the course of the year according to changes in interest receivable. During the year, the deposit money banks' equity investments in their subsidiaries increased considerably.

### *6.1.3 Performance*

The deposit money banks made aggregate **profits before tax** of Lm25.6 million during 1998[14]. In contrast with the previous year, when the banks' profits fell, these rose by Lm2.4 million, or 10.1%, during the year reviewed. This improved performance, which took place despite slower growth in interest income, was the result of a recovery in non-interest income and slower growth in expenditure. Net interest income

[12] Most of the banks' deposits with the Central Bank are required reserves, i.e. reserves they are obliged to hold with the Bank.
[13] Including discounted bills.
[14] Data on the banks' profit and loss statements refer to the calendar year.

**Table 6.2**
**DEPOSIT MONEY BANKS - AGGREGATE PROFIT AND LOSS**

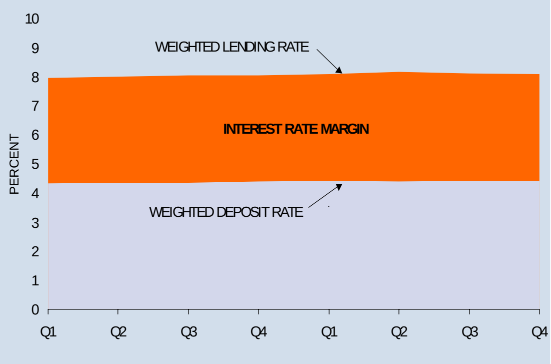
*Lm thousands*

| | 1996 | 1997 | 1998 |
|---|---|---|---|
| **TOTAL INCOME** | **146,083** | **166,290** | **182,665** |
| Interest Income | 127,354 | 149,800 | 164,545 |
| Non-Interest Income | 18,729 | 16,490 | 18,120 |
| **TOTAL EXPENDITURE** | **120,850** | **143,053** | **157,071** |
| Total interest expense payable | 81,824 | 97,421 | 111,019 |
| Operating Expenditure | 33,460 | 40,476 | 41,845 |
| Wages | 22,022 | 24,410 | 24,618 |
| Expenses of premises | 5,505 | 6,310 | 7,378 |
| Other | 5,933 | 9,756 | 9,849 |
| Provisions | 5,566 | 5,156 | 4,207 |
| Net interest income | 45,530 | 52,379 | 53,526 |
| **Profit (loss) on activities before tax** | **25,233** | **23,237** | **25,594** |

rose less rapidly during the year, indicating that margins were tighter.

The deposit money banks' **total income**, which is shown in Table 6.2, rose by Lm16.4 million, or 9.8%, during 1998. Interest continued to be the principal source of the banks' income, rising by Lm14.7 million, or 9.8%. Nevertheless, this was a slower rate of growth than those recorded during the previous two years. In line with the relatively slow growth in the banks' foreign assets, and with interest rates abroad falling, foreign interest earned decreased during the year. This drop was offset by an increase in interest income on local government securities and on loans and advances to residents. As Chart 6.3 shows, the average bank lending rate only rose marginally during the year - from 8% in December 1997 to 8.1% in December 1998. Therefore, higher income from loans and advances largely reflected the expansion in the deposit money banks' lending portfolio.

CHART 6.3 DEPOSIT MONEY BANKS' INTEREST RATE MARGIN

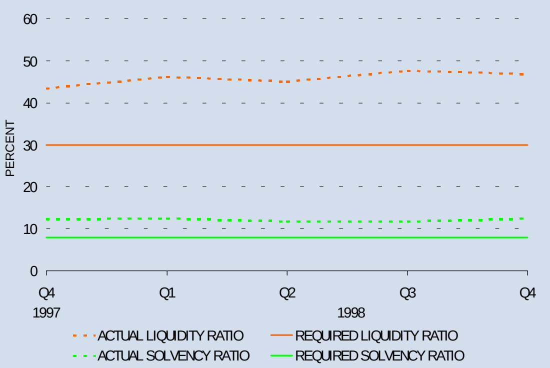



Non-interest income earned by the deposit money banks, which had dropped by 12% during 1997, recovered during 1998. As can be inferred from Table 6.2, the banks' non-interest income rose by Lm1.6 million, or 9.9%, during the year. Non-interest income increased as a result of higher fees and commissions as well as capital gains on foreign exchange and on trading investments.

The deposit money banks' **expenditure** increased more slowly during 1998, particularly since their operating expenses were contained. The banks' total expenditure rose by Lm14 million, or 9.8%, around half the rate of growth recorded during 1997. Interest expense, which accounts for most of the deposit money banks' expenditure, continued to increase, albeit at a slower pace than that recorded during the previous year. Interest expense increased by Lm13.6 million, or 14%, during 1998, compared with a 19.1% rise recorded during 1997. Interest paid on residents' deposits accounted for most of this expense, with interest paid on current accounts rising rapidly. At the same time, the deposit money banks' operating expenses, which had risen by 21% during 1997, rose more slowly during 1998. The banks' operating expenses increased by Lm1.4 million, or 3.4%, as wages, the major component, rose minimally.

The deposit money banks continued to maintain healthy levels of capital and liquidity during 1998.

CHART 6.4 LIQUIDITY AND SOLVENCY RATIOS




Their **capital adequacy ratio**[15] remained well above the statutory minimum of 8%, rising from 12.3% in December 1997 to 12.5% in December 1998. The method of computing this ratio changed slightly during the year, as additional features of the Capital Adequacy Directive issued by the Central Bank were implemented.

The deposit money banks' **liquidity ratio**, which measures the ratio of their liquid assets to their net short-term liabilities, increased during 1998. As can be seen in Chart 6.4, the banks' liquidity ratio increased from 43.5% at the end of 1997 to 46.9% at the end of 1998. The banks' holdings of liquid assets[16] rose by Lm70.7 million during the year, while their net short-term liabilities, which mainly include deposits, expanded by Lm62.6 million. Increased holdings of marketable debt securities accounted for almost all the rise in the banks' liquid asset holdings.

## 6.2 International Banks

The locally based international banks are licensed under Maltese law to conduct banking business with non-residents. The aggregate balance sheet of the international banks, which is shown in Table 6.3, continued to grow at an accelerating pace during 1998, as one new bank began to operate during the year and other banks increased their business. Whereas the total assets of these institutions had risen by Lm373.5 million, or 55.9%, during 1997, they expanded by Lm855.3 million, or 82.1%, to Lm1,897.2 million during the year under review.

Liabilities to non-residents constitute the main source of funds for the international banks. During 1998, these banks' **foreign liabilities** increased by Lm740.6 million, or 77.9%. Except for a relatively small fall in September, and despite the reclassification of a substantial amount of capital grants received by the international banks in January, their foreign liabilities expanded steadily during the year. Deposits belonging

**Table 6.3**
**INTERNATIONAL BANKING INSTITUTIONS' BALANCE SHEET**

*Lm thousands*

| | 1997 | 1998 |
|---|---|---|
| **LIABILITIES** | | |
| Demand | 2,068 | 2,866 |
| Savings | 5,757 | 7,712 |
| Time | 7,080 | 11,292 |
| Total Resident Deposits | 14,905 | 21,870 |
| Foreign Liabilities | 950,186 | 1,690,832 |
| Capital and Reserves | 63,912 | 161,866 |
| Other Liabilities | 12,881 | 22,598 |
| **ASSETS** | | |
| Cash and Money at call | 867 | 1,236 |
| Foreign Assets | 817,949 | 1,657,915 |
| Loans to Residents | 598 | 996 |
| Local Investments | 217,221 | 231,290 |
| Other Assets | 5,249 | 5,729 |
| **Total Assets/Liabilities** | **1,041,884** | **1,897,166** |

[15] Midland Bank plc, which is not incorporated in Malta, is not included in the computation.
[16] Liquid assets include cash and deposits with the Central Bank, inter-bank deposits, Treasury bills and marketable debt securities.

to non-residents, which account for most of these liabilities, rose by Lm488.4 million to Lm1,023.4 million during 1998. At the same time, balances due to banks abroad, the other major source of funds for these banks, doubled to Lm622.3 million.

As the Table shows, during 1998 the **capital and reserves** of the international banks climbed from Lm63.9 million to Lm161.9 million. This increase was mainly the result of an accounting adjustment carried out in January, when around Lm70 million worth of capital grants from their parent institutions were classified as part of their equity and no longer as foreign liabilities of the international banks. However, the international banks' reserves also increased – by Lm16.8 million – during the year.

To a limited extent, the international banks are permitted to carry on banking business with certain categories of resident, including international trading companies and foreign nationals who are permanent residents in Malta. Thus, **residents' deposits**, which had grown by Lm2.1 million during 1997, expanded by Lm7 million during 1998.

In the main, the funds raised by the international banks were re-invested abroad. Thus, the international banks' **foreign assets** doubled during 1998, rising by Lm840 million to Lm1,657.9 million. The three main categories of these banks' claims on non-residents all increased during the year. Claims on banks abroad increased tenfold, rising from Lm47 million to Lm482.1 million, reflecting the fact that most international banks operating in Malta are branches or subsidiaries of banks already operating abroad. The international banks' holdings of securities issued by non-residents also increased considerably, expanding by Lm234 million to Lm538.4 million. On the other hand, loans and advances to non-residents, the international banks' largest single asset item, increased more slowly, ending the year at Lm606.4 million compared with Lm447.1 million at the end of 1997.

The international banks' **local investments** consist almost entirely of assets held with deposit money banks by their international subsidiaries. The latter, which had risen by 7.7% during 1997, expanded by 7.3% during 1998. During the final quarter of the year, the international banks' claims on the deposit money banks decreased. Their loans to residents, however, increased marginally during the year.

### 6.3 Other Banking Institutions

The other banking institutions sector includes one credit institution that specialises in housing finance and three financial institutions. Two of these financial institutions focus on investment banking activity. Three of the institutions included in the sector are subsidiaries of deposit money banks. During 1998, the consolidated balance sheet of these institutions resumed growth after having contracted during 1997. Following a fall of 1.8% in 1997, the total assets of the

**Table 6.4**
**OTHER BANKING INSTITUTIONS' BALANCE SHEET**

*Lm thousands*

| | 1997 | 1998 |
|---|---|---|
| **LIABILITIES** | | |
| Debentures | 60,000 | 60,000 |
| Borrowing from Banks | 67,904 | 74,600 |
| Other Liabilities | 8,389 | 13,844 |
| Capital and Reserves | 21,414 | 22,846 |
| **ASSETS** | | |
| Cash and deposits with CBM | 94 | 321 |
| Foreign Assets | 7,047 | 7,030 |
| Claims on Government | 842 | 5,794 |
| Claims on Private and Parastatal Sectors | 142,170 | 150,313 |
| Other Assets | 7,554 | 7,832 |
| **Total Assets/Liabilities** | **157,707** | **171,290** |

sector expanded by Lm13.6 million, or 8.6%, as Table 6.4 shows.

**Borrowings from banks** remained the primary source of funds for these institutions. These liabilities, which include funds raised on the inter-bank market, recovered after having fallen during the previous year. Following a 10.2% drop during 1997, borrowings from banks by the other banking institutions increased by Lm6.7 million, or 9.9%, during 1998. During the year, these institutions' **other liabilities** expanded by Lm5.5 million to Lm13.8 million, with most of the increase taking place in residents' savings and time deposits. At the same time, the other banking institutions' **capital and reserves** rose by Lm1.4 million, or 6.7%, mainly as a result of higher retained earnings.

The funds raised in this way were principally used by the other banking institutions to grant loans to the private sector and to invest in government securities. Thus, their **claims on the private and parastatal sectors**, which are the most important category of assets held by these banks, and which had contracted by 4.9% in 1997, increased by Lm8.1 million, or 5.7%, during 1998. Almost all the increase in these claims took place in loans and advances to the personal sector. During 1998, the institutions' **claims on government** rose from Lm0.8 million to Lm5.8 million as a result of additional investments in Treasury bills and government stocks.

# *Part II*

# CENTRAL BANK POLICIES,

# OPERATIONS AND ACTIVITIES

# 1. Monetary and Exchange Rate Policy

## 1.1 Policy Overview

The Central Bank of Malta is responsible for the conduct of monetary policy in Malta. It also plays an important role in the formulation of exchange rate policy. The objectives of monetary policy are laid down in the Central Bank of Malta Act, which binds the Bank to "promote the orderly and balanced 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 Central Bank has identified the maintenance of domestic price stability as the principal aim of monetary policy, since this is necessary to promote sustainable growth in employment and incomes and to maintain the external value of the currency. During 1998, the Bank continued to pursue this goal by means of an exchange rate peg for the Maltese lira. The objective of maintaining an exchange rate peg is to link Malta's inflation to the inflation rates prevailing in its main trading partners. The peg also acts as a discipline to contain domestic price pressures. Furthermore, exchange rate stability is very important for an economy so dependent on international trade flows, and helps to promote foreign investment.

During 1998, the Maltese lira continued to be pegged to a basket of currencies that reflected the pattern of Malta's international trade in goods and services. The currency basket included the ECU, the US dollar and sterling, with weights of 64.8%, 21.7% and 13.5% respectively at the end of the year. In December 1998, the Central Bank announced that the composition of the currency basket would be revised to take into account the introduction of the euro in 1999. As from the beginning of 1999, the basket would be made up of the euro, the US dollar and sterling, with weights of 56.8%, 21.6% and 21.6% respectively. This ensured that the change in the currency basket necessitated by the launching of the euro was as neutral as possible. In particular, the weight of the pound sterling had to be increased in order to maintain its effective weight – including that implicit in its representation in the ECU in the previous basket – unchanged.

To maintain the exchange rate peg, the Central Bank stands ready to buy and sell foreign exchange at the rate determined by the basket and by the movements of the various currencies on the foreign exchange markets. Apart from intervening in the foreign exchange market, however, the Central Bank uses a wide variety of tools, including interest rates and, to a lesser extent, controls on capital movements to support the exchange rate. A tighter monetary policy stance, as indicated by an increase in short-term interest rates, lowers pressure on the exchange rate by dampening consumption and, hence, the demand for imports. Furthermore, a tighter monetary policy stance encourages the net inflow of capital into the economy. By restraining domestic demand, it also curbs domestically-generated inflation.

The Bank's Monetary Policy Council is responsible for formulating monetary policy and, in particular, for establishing official interest rates. The Council is chaired by the Governor and made up of the other members of the Board of Directors and senior Bank officials. During 1998, the Council met twelve times, generally on the last Thursday of the month.

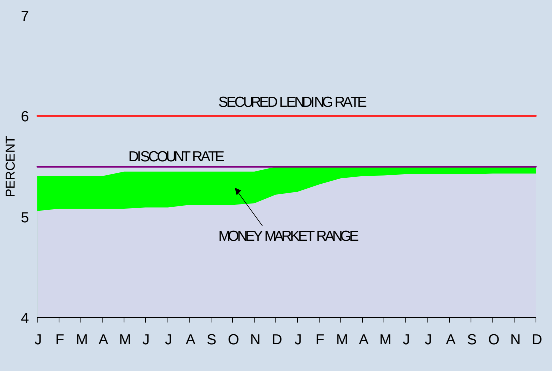
During 1998, the Council changed the repo band twice: to tighten its monetary policy stance and to reduce the difference between the Bank's injection rate and its absorption rate, as Chart 1.1 shows. In February, the absorption rate band was raised from 5.2% - 5.3% to 5.3% - 5.4%, while the injection rate band was left unchanged. In April, the Monetary Policy Council instituted a central intervention rate of 5.45%, with a band of five basis points on either side.

## 1.2 The Tools of Monetary Policy

### *1.2.1 Open Market Operations*

During 1998, the Central Bank continued to use open

CHART 1.1 DEVELOPMENTS IN OFFICIAL INTEREST RATES




market operations to influence liquidity in the banking system and, hence, the level of short-term interest rates. Open market operations were principally carried out using repos, reverse repos and auctions of term deposits in Maltese liri. To a lesser extent, however, the Bank also used foreign exchange swaps to inject liquidity temporarily into the banking system.

In a repo, the Central Bank injects liquidity into the banking system by buying securities from a bank, subject to an agreement to re-sell the securities after one week. The difference between the purchase price and the selling price is the repo rate, which is the implicit interest rate that the Bank charges for making funds available in this way. In a reverse repo, the Bank absorbs liquidity from the banking system by selling securities to a bank, subject to an agreement to buy them back a week later. The Bank pays interest on the funds absorbed in this way. In February, the Bank switched from reverse repos to seven-day term deposits to absorb liquidity from the rest of the banking system. Thus, the Bank dispensed with the need to sell securities when absorbing liquidity. These open market operations were carried out through weekly auctions involving the Bank and the credit institutions.

In conducting open market operations, the Bank responded to shifts in liquidity in the banking system so as to keep money market interest rates at the desired level. Thus, the interest rates that the Bank applied when injecting or absorbing funds through open market operations fluctuated within the band determined by the Monetary Policy Council. In contrast with previous years, when the Central Bank largely absorbed funds from the banking system, during 1998 the Bank used open market operations to inject liquidity into the system. In fact, during the year, the Bank injected an aggregate of Lm241.3 million through repo auctions, compared with an aggregate of Lm54.2 million in 1997. Most repos were carried out in the third quarter, when the banks were particularly short of funds. During the year, the Bank also absorbed an aggregate of Lm173 million through reverse repos and term deposit auctions. In contrast, during 1997, the Bank had absorbed Lm349 million worth of funds in this way.

During 1998, the Central Bank carried out swaps worth Lm48.1 million with domestic banks. In these swaps, the Bank injected liquidity temporarily by buying foreign exchange from the banking system, with the transaction being reversed at a stipulated rate after an agreed period of time. The value of swap transactions was lower than that recorded in 1997, when swaps worth Lm60.7 million were carried out. Towards the end of the year, the Bank streamlined its operations in the swap market, conducting swaps with a standard maturity of two weeks only. Interest rates charged on swaps were generally higher than the repo rate.

### *1.2.2 Lending Facilities*

The Central Bank of Malta Act stipulates that the Bank may discount Treasury bills and other eligible financial instruments to inject liquidity into the financial system. This facility – the discount window – was not activated during 1998. The Bank's discount rate remained unchanged at 5.5% throughout the year.

The Bank may also grant banks and financial institutions short-term loans and advances secured by assets pledged with it. In February, the Bank reviewed this facility, amending the limits placed on individual institutions' access to it and introducing a tiered interest rate structure. One credit institution made use of this standing loan facility during the year, borrowing funds overnight at 6%.

### *1.2.3 Reserve Requirements*

The Central Bank continued to oblige banks to maintain deposits with it equivalent to 5% of their own deposit liabilities. Reserve requirements continued to be held on a monthly averaging basis; that is, banks were allowed to draw on their reserve deposits during part of the maintenance period as long as they then held sufficient excess balances to meet the reserve requirement on average during the period. As in 1997, the Central Bank paid interest on balances held with it as required reserves at an unchanged rate of 2.7%.

### 1.3 Managing the External Reserves

The Central Bank of Malta Act requires the Bank to maintain external reserves in proportion to its currency and deposit liabilities. During 1998, the required ratio of reserves to currency and deposit liabilities, which is established by the Minister of Finance, remained unchanged at 60%. In line with this legal obligation, and in order to be able to intervene in the foreign exchange market, the Bank continued to manage a sizeable portfolio of foreign assets during the year.

Policies related to the management of the Bank's portfolio of external reserves are established by the Bank's Investment Policy Committee. The Committee, which meets every month, is chaired by the Governor and includes senior officials from the Bank. Part of the Central Bank's external reserves portfolio consists of liquid assets, to enable the Bank to intervene in the foreign exchange market as and when necessary. The remainder is managed with a view to generating income, while keeping risk to a minimum. In this respect, the Bank has established limits on exposures to individual counter-parties that are monitored daily. Most of the Bank's external reserves are held in the form of deposits with top-rated foreign banks and securities issued by first-class borrowers. In addition, the Bank holds gold, Special Drawing Rights and claims on the International Monetary Fund. During the year, the Bank reviewed its investment practices in the light of the prospective introduction of the euro at the beginning of 1999.

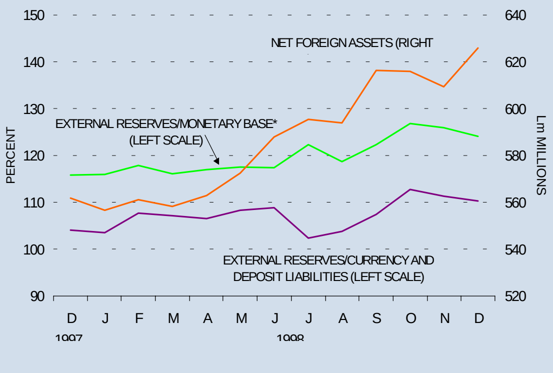
During the year, the Central Bank continued to trade in the spot and forward market for foreign exchange against Maltese liri with credit and financial institutions. The Bank traded with local credit and financial institutions in three major currencies: the US dollar, the German mark and sterling, in amounts greater than Lm150,000. The Bank published opening exchange rates daily and quoted real-time rates throughout the day on Reuters service. The Bank continued to monitor developments in the foreign exchange market closely, maintaining strong links with credit institutions' trading desks. Credit institutions continued to report details of their transactions in the foreign exchange market daily to the Bank.

During 1998, the Bank carried out 28 spot purchases of foreign exchange from credit and financial institutions. The value of these purchases rose from Lm19 million in 1997 to Lm50 million, as deposit money banks sold foreign assets to invest in the domestic financial markets. At the same time, the Bank carried out 129 spot sales for a value of Lm21 million, compared with spot sales worth Lm28 million in 1997. The Bank also deals in foreign exchange in the forward market. Swaps, which involve a spot transaction and a forward commitment, have already been discussed. In addition, during 1998, forward contracts with banks worth Lm15 million matured.

Since July 1997, when the CET Act was introduced, the Bank has imported gold for use by local manufacturers. During 1998, the Bank sold 1,405 kilos of gold grain to local manufacturers for a value of Lm5.2 million.

The net foreign assets of the monetary authorities increased during 1998, partly as a result of income earned on the Bank's foreign asset portfolio, and partly on account of other developments on the balance of payments. In particular, banks sold a substantial part of their foreign currency reserves to the Central Bank for Maltese liri, as Maltese lira assets offered relatively high interest rates. As Chart 1.2 shows, the net foreign assets of the monetary authorities, which include funds held on behalf of customers, increased from Lm561.7 million at the end

CHART 1.2 THE CENTRAL BANK'S FOREIGN ASSETS




of 1997 to Lm625.8 million at the end of 1998[17]. As the Chart indicates, most of the increase took place during the second half of the year.

The Chart also shows the ratio of the Bank's external reserves to its currency and deposit liabilities, which remained above 100% throughout the year. After ending 1997 at 104%, it dropped to 102.4% in July, when the sale of government stocks on the primary market led to an increase in government deposits. However, towards the end of the year, this ratio increased in line with the expansion in the Bank's external reserves and reached 110.2% in December. The ratio between the net foreign assets of the monetary authorities and the monetary base, which is the other ratio shown in the Chart, also increased during the year, rising from 116% in December 1997 to 124% in December 1998.

## 1.4 Money and Capital Markets

The Central Bank's open market operations are designed to influence liquidity in the banking system and short-term interest rates. In addition to these open market operations, the Bank also acts as market maker in the markets for government securities, so as to enhance liquidity in these markets.

As in 1997, during 1998, the Central Bank refrained from participating in the primary market for Treasury bills. Nevertheless, during the year, the Bank was actively involved in the secondary Treasury bill market as market maker, buying and selling bills to meet the market's needs. As the Government reduced the use of Treasury bills to finance its borrowing requirement, activity on the secondary bill market dropped. Thus, during 1998, the Bank bought Lm116.3 million worth of Treasury bills, compared with Lm268.4 million during 1997. The value of Central Bank sales of bills also decreased, dropping from Lm147.6 million in 1997 to Lm79 million during 1998. The interest rates quoted by the Bank in the secondary Treasury bill market varied in line with the Bank's intervention rates.

The Central Bank also continued to make a market in government stocks. As such, it sought to increase the liquidity of the market by selling stocks from its trading portfolio to meet demand and by buying stocks whenever supply was not taken up by other participants in the secondary market.

During 1998, the Bank subscribed to Lm29 million worth of government stocks on the primary market, or 18.3% of the total issued. This was a slightly higher share than that taken up in 1997, when the Bank bought 17.2% of the stocks issued. Most of these purchases were made in July, although the Bank also bought small amounts of conversion stocks that were issued in June and September. The Bank did not underwrite any of the stocks issued.

Activity in the secondary market for government stocks increased during the year reviewed. Nevertheless, turnover in the secondary market for government stocks involving the Central Bank fell from Lm79.7 million in 1997 to Lm70.1 million in 1998. As in the previous year, the Bank was a heavy net seller of stocks, making purchases and sales worth Lm7.8 million and Lm62.2 million respectively. The Bank also dealt in Lm1.5 million worth of stocks as agent for ecclesiastical entities, selling from the stock acquired under the Church-State Agreement. There were no secondary deals outside the trading floor of the Exchange involving the Bank.

Prices and yields in the capital market were market driven, with the Bank's broker adjusting the prices

[17] As explained elsewhere in this Report, the Central Bank's accounting policies were reviewed during the year, and a number of accounting adjustments were carried out, which raised the level of the Bank's reported external reserves. The figures reported on here do not take these accounting adjustments into consideration.

quoted by the Bank along the yield curve in response to market pressures.

### 1.5 Administration of Exchange Controls

The Central Bank remained responsible for administering the remaining exchange controls as the agent of the Government in terms of the Exchange Control Act. The Bank also continued to maintain records of certain transactions between residents and non-residents for statistical purposes, even though these transactions no longer require the Bank's approval. During August 1998, an Exchange Control circular (No 10) was issued to clarify the Central Bank's policy regarding transactions in Maltese lira between credit institutions and non-resident banks. Towards the end of the year, another Exchange Control Circular (No 9) was amended in order to explain procedures regarding overseas borrowing by local credit institutions and lending by such institutions in foreign currency.

In November 1998, a number of liberalisation measures, which were to take effect at the beginning of 1999, were announced. The annual foreign direct investment allowance for companies was doubled to Lm300,000, while the annual portfolio investment allowance applicable to persons and non-financial entities was raised from Lm5,000 to Lm8,000. Moreover, the period within which exporters may retain their earnings in foreign currency in accounts with domestic credit institutions was extended from four to six months.

The total value of remittances overseas by residents sanctioned by the Bank's Exchange Control Department halved to just over Lm42 million in 1998, as Table 1.1 shows. These funds included drop shipments, purchases of foreign currency by importers who personally export funds to buy goods and services abroad, and purchases of foreign currency for portfolio investment purposes. The latter

**Table 1.1**
**VALUE OF TRANSACTIONS PROCESSED BY THE EXCHANGE CONTROL DEPARTMENT OF THE CENTRAL BANK**

*Lm millions*

| | 1997 | 1998 |
|---|---|---|
| Remittances of funds overseas | 81.3 | 42.2 |
| of which: | | |
| Investments in foreign currency | 4.3 | 5.2 |
| Payments of insurance premiums | 9.5 | 7.3 |
| Borrowing by local companies owned by non-residents: | | |
| From domestic banks | 8.1 | 6.8 |
| From foreign shareholders | 3.3 | 0.4 |
| Borrowing by resident companies from overseas lenders | 41.9 | 93.2* |
| Borrowing by resident persons from overseas lenders | 1.1 | 0.2 |
| Borrowing by non-residents from domestic banks | 3.0 | 0.3 |
| of which: | | |
| Borrowing for the purchase of residential property in Malta | 0.1 | 0.2 |
| Equity investment in new companies with non-resident participation | | |
| Paid-up Share Capital | 4.2 | 3.0 |
| of which: | | |
| Non-resident Capital | 0.7 | 1.4 |
| Increase in paid-up share capital of companies with non-resident participation | 4.3 | 5.7 |
| Transfers of shares from residents to non-residents | 0.3 | 0.3 |
| Transfers of shares from non-residents to residents | 6.1 | 2.5 |
| Direct investment overseas by residents | 7.3 | 7.2 |

* Includes (1) Loan by Mid Med from Council of Europe Social Development Fund (US$ 25,292,000) for onlending to small/medium enterprises. (2) Loan by BOV from West Deutschebank (XEU 70,000,000).

NB The definition of residency used in the compilation of this data is that given by the Exchange Control Act.

are shown separately in the Table. The Bank also continued to approve applications for loans between residents and non-residents, equity investments in Malta by non-residents, and direct investment by residents abroad. Within this category of transactions, there was a substantial increase in borrowing by resident institutions from overseas lenders in 1998. This increase was in good part explained by foreign loans obtained by domestic banks.

**1.6 Economic Information and Analysis**

In order to enable the Central Bank to conduct Malta's monetary policy effectively and to fulfil its statutory role as adviser to the Government on economic and financial matters, the Bank continued to monitor and analyse economic and financial developments both in Malta and abroad.

The task of compiling and analysing the relevant statistical information is carried out in the Bank's Economics department. In fact, during the year, the Economics department continued to provide the Bank's Monetary Policy Council and its Investments Policy Committee with comprehensive statistical tables and analytical reports on the latest economic and financial developments prior to their respective monthly meetings.

Similarly, the Bank, through its Economics department, provided the Government's Central Office of Statistics and its Economic Planning Division with reports and statistics on monetary and exchange rate developments. Money and banking statistics were also regularly supplied to the International Monetary Fund (IMF) and/or the World Bank.

Information on economic and financial developments was also communicated to the general public through the Bank's regular publications – namely, its *Quarterly Review*, its *Annual Report*, and the monthly *Statistical Release on Monetary Aggregates and their Determinants* - as well as through one-off publications, such as the pamphlet about the euro which the Bank published in November in collaboration with the Malta Commercial Banks Association.

During 1998, the task of compiling government finance statistics and reporting on these to the IMF was undertaken by the Central Bank. After completing the necessary research, and with the assistance of an IMF mission that visited Malta for the purpose, the Bank implemented the relevant methodological changes required to bring the compilation of these statistics fully in line with the IMF Government Finance Statistics Manual. Another task taken over from the Ministry of Finance during the year was that of reporting on the external debt of the public sector to the World Bank.

During 1998, the Economics department continued to broaden and update its statistical coverage of public sector debt. Such data, which were reported to the World Bank, included central government and parastatal debt, both domestic and foreign. Furthermore, during the year, the Bank, in collaboration with the Malta Financial Services Centre (MFSC), started collecting data on collective investment schemes. This was considered necessary to ensure that the Bank had a complete picture of what was happening in the local financial system.

The Bank, in collaboration with the Central Office of Statistics, also continued to enhance the coverage, accuracy and timeliness of Malta's balance-of-payments statistics and to ensure that these conformed with the latest IMF guidelines. Statements for the reconciliation of credit institutions' net foreign assets data with balance-of-payments statistics were redesigned in order to cater for new types of transactions and financial instruments. In order to strengthen further its sources of information, the Bank held several meetings with top management representatives from the credit institutions. During these meetings, particular statistical concepts and issues were discussed. Where necessary, the Bank also extended this type of assistance to those enterprises that were included in the respondents' list of the balance-of-payments surveys.

To supplement its database, the Bank continued to make use of the services of a private marketing agency to conduct a regular survey of business perceptions on its behalf. The Survey was carried out on a quarterly basis and an analysis of its results was published in the Bank's Quarterly Review. During the year, the Bank also continued to update its two econometric models of the Maltese economy. A spreadsheet version of one of these models was also developed. A description of one of the models was also published in a prestigious international journal on economic and financial modelling.

During the year, the Bank participated in a number of forums involved in economic analysis both in Malta and abroad. In Malta, the Bank was represented on the Statistics Board and on the Forum for a Better Economy. At the international level, the Bank presented one of its models of the Maltese economy at an international conference on econometric modelling organised by the European Economic and Financial Centre which was held in Vienna.

# 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. The Central Bank is also the Competent Authority appointed in terms of the Banking Act, 1994 and the Financial Institutions Act, 1994. Moreover, the Bank is responsible for examining the affairs of the Malta Stock Exchange and its members in terms of the Malta Stock Exchange Act.

The Joint Banking Committee, set up in terms of the Banking Act, is responsible for formulating banking regulatory and supervisory policy and monitoring the soundness of the banking system. The Committee is chaired by the Governor and includes four other Central Bank officials, two representing the Bank in its role as Competent Authority and two representing the Bank as the institution responsible for monetary policy. During 1998, the Committee met seven times to discuss regulatory policy and approve amendments to Directives issued under the Banking Act and the Financial Institutions Act.

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

## 2.1 Policy Developments

During 1998, following approval by the Joint Banking Committee, the Central Bank amended the Banking Directives on licensing, large exposures, solvency, liquidity and statutory returns. Furthermore, the Bank introduced new capital requirements in respect of various types of market risks, including position risk, settlement risk and underwriting risk. Further capital requirements in respect of other categories of market risks are expected to be introduced early in 1999. As a result, the Capital Adequacy Directive would be fully implemented.

In April, the Minister of Finance issued regulations governing bank representative offices in Malta[1]. Subsequently, the Central Bank, as the Competent Authority, published a notice to guide prospective applicants on the prevailing policy regarding the establishment of representative offices by foreign banks in Malta.

## 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 Central Bank is responsible for licensing credit and financial institutions. Licensing procedures and requirements are set out in Directives issued by the Central Bank in terms of the relevant laws. The basic requirements, which include minimum levels of own funds and the requirement that shareholders and managers be "fit and proper" persons, are based on international norms, including standards laid down by the Bank for International Settlements (BIS).

During 1998, the Central Bank licensed two credit institutions and one financial institution. In April, a licence was issued to Euro Change Company Ltd to carry out the business of a financial institution by issuing and administering means of payment and by carrying out foreign exchange transactions. In September, Disbank Malta Ltd, a subsidiary of a Turkish credit institution, was licensed to carry on the business of banking in foreign currency with non-residents. In October, the Central Bank issued a licence to EGS Bank, a Turkish bank, to operate through a branch from Malta. This bank was also licensed to undertake banking business from Malta in foreign currency with non-residents. A list of credit and financial institutions licensed to operate in Malta as at the end of 1998 is shown in Box 5.

During the year, the licences granted to two financial institutions were amended, extending the range of activities they were permitted to carry out. No licences

[18] See Legal Notice 113 of 1998.

## Box 5:
## Banks and Financial Institutions Licensed to Operate in Malta*

**Credit Institutions Licensed under the Banking Act (1994)**

| | |
|---|---|
| APS Bank Ltd[1] | Investkredit International Bank Ltd[2] |
| Austrian Raiffeisen Malta Bank plc[2,4] | Izola Bank Ltd[2] |
| Bank of Valletta plc[1] | Lohombus Bank Ltd |
| Demirbank T.A.S.[2,3] | Lombard Bank Malta plc[1] |
| Disbank Malta Ltd[2,4] | Midland Bank plc[1,3] |
| EGS Bank[2,3] | Mid-Med Bank plc[1] |
| First International Merchant Bank Ltd | Turkiye Garanti Bankasi AS[2,3] |

**Financial Institutions Licensed under the Financial Institutions Act (1994)**

| | |
|---|---|
| All Financial Services Ltd | Mid-Med Finance Ltd |
| Britannia Financial Services Ltd | PDK Finanical Services Ltd |
| Collins Exchange Bureau Ltd | Thomas Cook Financial Services Malta Ltd |
| Cremona Exchange Bureau Ltd | Valletta Investment Bank Ltd |
| Euro Change Company Ltd | W&J Coppini & Co |
| Fexco (Malta) Ltd | |

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

| | |
|---|---|
| Bank of Valletta International Ltd[2] | Mid-Med Bank (Overseas) Ltd[2] |
| Erste Bank (Malta) Ltd[2,4,5] | Volksbank Malta Ltd[2,4] |

* As at 31 December 1998
[1] Deposit money bank
[2] Licensed to operate with non-residents
[3] Licensed to operate as a branch
[4] Subsidiary of foreign bank
[5] 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.

were restricted or revoked.

### 2.3 Supervision of Credit and Financial Institutions

The Central Bank is responsible for supervising licensed credit and financial institutions in its role as the Competent Authority appointed in terms of the Banking Act and the Financial Institutions Act. The Bank continued to supervise credit and financial institutions through a combination of on-site inspections and off-site analysis. In this way, the Bank ensured that licensed institutions complied with the provisions of the relevant legislation and that they managed risk appropriately.

On-site examinations are based on visits to licensed institutions by teams of inspectors. During 1998, 13 inspectors held appointment in terms of the relevant legislation. During the year, they carried out eleven on-site inspections. The focus of their examinations ranged from the assessment of market-related risks and banks' lending portfolios and asset quality to internal audit functions and other internal controls. The inspection programme also included reviews of local branches and subsidiaries of foreign-owned institutions. The inspectors' reports on their findings were transmitted to the credit and financial institutions concerned.

The Central Bank also supervises credit and financial institutions through the analysis of periodic returns that they are legally obliged to file with it. This information allows supervisors to assess a number of indicators of bank soundness, including capital adequacy, liquidity and exposure to risk. During 1998, the Bank introduced surveys tailored to monitor particular risks and to evaluate the level of awareness and management of certain risks.

As part of the supervisory process, the Central Bank communicates with the external auditors of credit and financial institutions. The Bank evaluates external auditors' management letters and any replies to them. The Bank also maintains close relations with the foreign supervisory authorities of credit institutions operating in Malta that have their head offices or parent companies abroad.

**2.4 Other Activities**

The Central Bank monitored the activity of the Malta Stock Exchange through contacts with the Exchange itself and discussions in the Regulatory Co-ordination Forum. In addition, the Bank continued to be represented on the Council of the Exchange.

The Central Bank continued to play an important role in the fight against money laundering. In this respect, through the Prevention of Money Laundering Joint Committee, the Bank participated in discussions held with the banks, the police, the Malta Financial Services Centre and the Attorney General's Office. Training on money laundering was given to all the Bank's staff. In September 1998, evaluators from the Council of Europe reviewed the measures taken by the Maltese authorities in this area. Their assessment, which was generally positive, was discussed and accepted at the plenary session of the Council of Europe Select Committee of Experts on the Evaluation of Money Laundering. A senior Central Bank official from the Banking Supervision and Compliance Department also formed part of Select Committee teams evaluating two other member countries.

The Central Bank continued to ensure that banks and financial institutions would be in a position to avoid information technology problems associated with the year 2000. It continues to follow and monitor progress made by all licensed institutions in this regard. Working closely with the institutions concerned, the Bank compiled a "Year 2000" database on local credit and financial institutions in line with the requirements of the Basle Committee.

The Bank also monitored licensed institutions to ensure that the introduction of the euro would not expose them to excessive risks and that they would be able to provide facilities in euro.

In line with its responsibilities for ensuring the soundness of the financial system, the Central Bank, during the course of the year, issued several public warnings about the dangers posed by foreign solicitations for participation in financial scams and pyramid schemes.

# 3. Banking and Currency Operations

## 3.1 Banking Operations

The Central Bank of Malta is the banker to the Government and to the domestic banking system. In this capacity, the Bank continued to provide a range of banking facilities to government departments, public sector corporations and credit and financial institutions. In addition, a limited range of facilities was provided to the Bank's own staff. The Bank also advises the Government and public sector corporations on financial matters.

### *3.1.1 Banker to the Public Sector*

As banker to the Government in terms of the Central Bank of Malta Act, the Bank accepts deposits and maintains accounts for the Government and for a number of public sector corporations. The Bank also provides the Government and public corporations with foreign exchange and money transmission services, including the execution of payments by means of cheques, electronic transfers or direct credits.

**Deposit and Credit Facilities**

During 1998, the Central Bank continued to maintain deposits in Maltese liri and in foreign currency for the Treasury and other government departments, for Malta Government Sinking Funds and for public sector corporations. The Bank continued to offer a variety of interest-bearing deposits, including demand and time deposit facilities, to these customers.

During 1998, the Government continued to refrain from using the ways and means facility – although the amendment to the Central Bank of Malta Act that terminates the use of the facility had still not been brought into effect.

**Payments Services**

The Bank also continued to cash cheques drawn on the Central Bank and issued by government departments. During 1998, the number of cheques cashed fell by 8% to 2.3 million as the Government made greater use of the direct credit system and certain payments were incorporated into salary cheques. However, the value of cheques drawn on the Central Bank also dropped – by 21.3% to Lm434.6 million. This fall partly mirrored the drop in the number of cheques processed, but it may also have reflected fluctuations in the timing of government payments.

In an effort to reduce the costs associated with processing cheques, the Bank encouraged the more widespread use of the direct credit system, whereby various government payments are made directly to the payee's personal account with local credit institutions. In December, this system, which continues to be implemented on a voluntary basis, began to cater for payments of old age pensions. During 1998, the value of government payments, including salaries, pensions and social security benefits, that were credited in this way rose by 19.2% to Lm57.7 million.

**Foreign Exchange**

The Bank continued to offer the Government and public sector corporations a wide range of foreign exchange services in a number of currencies. The Bank continued to carry out transactions supported by documents, such as letters of credit, inward/outward bills for collection, inward transfers and guarantees. The Bank also carried out other transfers, by SWIFT or by bank draft, and provided foreign exchange to members of government delegations travelling abroad. The value of foreign currency receipts processed on behalf of government departments and public sector corporations rose from Lm19.6 million in 1997 to Lm52.5 million in 1998. At the same time, the value of foreign currency payments made on their behalf dropped from Lm108.1 million to Lm75.4 million.

During 1998, the Bank stopped entering into forward contracts in foreign exchange with the Government or public sector corporations. This decision was taken to facilitate the development of the foreign exchange market by giving credit and financial institutions a more active role in the market.

**Other Services**

The Central Bank continued to effect payments in connection with the Government's external debt obligations. During 1998, repayments of principal amounted to Lm4 million, while interest payments on external debt totalled Lm1.8 million. Repayments of principal are made from sinking funds established by the Government specifically for this purpose. During the year reviewed, the Government transferred Lm4.7 million to these sinking funds.

The Bank continued to administer banking arrangements in connection with trade between Malta and Libya. According to these arrangements, the Bank settles the balance outstanding on trade in goods and services between the two countries on a quarterly basis.

The Central Bank continued to administer the Foreign Pensions Subsidy Scheme on behalf of the Government. Maltese nationals who receive a government pension in foreign currency from the United Kingdom, the United States, Canada and Australia are entitled to a means-tested subsidy on this pension to compensate for exchange rate fluctuations. During 1998, payments under the scheme amounted to Lm36,202, compared with Lm44,902 in 1997.

***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. During 1998, the Bank continued to offer the banks deposit and credit facilities. In addition, it continued to play a crucial role in the local payments and settlements systems.

**Deposit and Credit Facilities**

The Central Bank offered domestic credit and financial institutions deposit facilities in Maltese lira and foreign currency. The credit institutions continued to make use of their balances with the Bank to settle inter-bank payments and to carry out their daily operations in domestic financial markets. In addition, the credit institutions continued to hold required reserves on deposit with the Bank, in accordance with the Central Bank of Malta Act. The Bank paid interest on reserve requirements at 2.7% per annum. No interest was paid on excess balances.

The domestic credit institutions remained eligible for short-term credits either through the discount window or in the form of collateralised loans. The operation of these lending facilities is discussed in more detail in another Chapter of this Report.

**The Payments System**

The Central Bank is a key player in the Maltese payments system, since settlement of all inter-bank payments takes place on the domestic banks' accounts with it. In addition, the Central Bank maintains settlement accounts for the Malta Stock Exchange to enable brokers to settle trades in listed securities on the local capital market.

The Central Bank accepts payment instructions from credit institutions, generally via SWIFT. These payments are settled manually, on a gross basis, upon receipt. During 1998, 10,091 inter-bank transactions were settled in this way, compared with 7,606 during 1997. At the same time, the value of these transactions rose from Lm961 million in 1997 to Lm1,730.2 million. This increase in the number and value of inter-bank transactions reflected higher activity in the wholesale inter-bank market. In fact, 85% of the transactions by value during 1998 involved payments worth more than Lm0.5 million.

The Bank also manages the Malta Clearing House, through which cheques are settled. The number of cheques presented at the clearing house dropped slightly during 1998. However, the value of cheques negotiated increased from Lm2,132.3 million to Lm2,194.2 million. These amounts are settled daily on a net basis through the banks' accounts with the Central Bank.

**Table 3.1**

**CURRENCY NOTES AND COINS ISSUED BY AND PAID INTO THE CENTRAL BANK OF MALTA IN 1998**

*Lm thousands*

| | Notes and Coins | | | Currency Notes and Coins Issued and Outstanding[1] | Monthly % Change |
|---|---|---|---|---|---|
| | Issued | Paid-In | Net Issue | | |
| January | 11,017 | 21,663 | -10,646 | 374,009 | -2.77 |
| February | 12,807 | 12,986 | -179 | 373,830 | -0.05 |
| March | 15,624 | 12,844 | 2,780 | 376,610 | 0.74 |
| April | 17,644 | 13,221 | 4,423 | 381,033 | 1.17 |
| May | 14,940 | 16,669 | -1,729 | 379,304 | -0.45 |
| June | 16,077 | 12,847 | 3,230 | 382,534 | 0.85 |
| July | 12,701 | 12,720 | -19 | 382,515 | -0.01 |
| August | 11,351 | 9,755 | 1,596 | 384,111 | 0.42 |
| September | 13,080 | 9,590 | 3,490 | 387,601 | 0.91 |
| October | 10,251 | 12,874 | -2,623 | 384,978 | -0.68 |
| November | 9,205 | 12,408 | -3,203 | 381,775 | -0.83 |
| December | 14,986 | 7,255 | 7,731 | 389,506 | 2.03 |
| **1998** | 159,683 | 154,832 | 4,851 | 389,506 | 1.26 |
| **1997** | 177,692 | 173,284 | 4,408 | 384,655 | 1.16 |

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

Note: Percentage changes may not add up due to rounding.

**3.2 Currency Operations**

As issuer of the currency, the Central Bank remained responsible for all the functions related to the issue and re-issue of currency notes and coins, including commemorative coins. The Bank also remained active in ensuring that counterfeit notes and coins were detected.

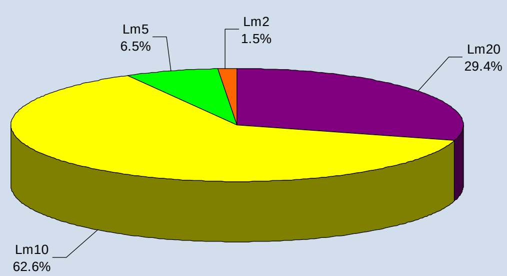
***3.2.1 Note and Coin Issue***

At the end of 1998, the total value of currency notes and coins in issue amounted to Lm389.5 million, or 1.3% more than at the end of 1997.

The total value of notes in issue amounted to Lm373.8 million, up by 1.1% from the value at the end of the preceding year. However, there was a decline in both the value of notes issued and in the value of notes paid into the Bank when compared with the previous year. Of the total value of notes issued, 70.7% consisted of re-issued notes, while 29.3% were notes in mint condition.

As Chart 3.1 shows, the Lm10 note remained the most widely used currency note. By the end of 1998, it had increased its percentage share in the value of the note circulation to 62.6%, from 59.4% a year earlier – in spite of the fact that the Lm10 note of the 2nd Series ceased to be exchangeable on January 15. Meanwhile, the Lm20 note lost more of its share and, by the end of the year, accounted for 29.4% of the value of currency notes in issue. The share of the Lm5 and Lm2 notes also declined slightly when compared with

**CHART 3.1 COMPOSITION OF CURRENCY NOTES ISSUED AND OUTSTANDING - 1998**




TOTAL VALUE OF NOTES Lm 373.8m

CHART 3.2 COMPOSITION OF CURRENCY COINS ISSUED AND OUTSTANDING - 1998

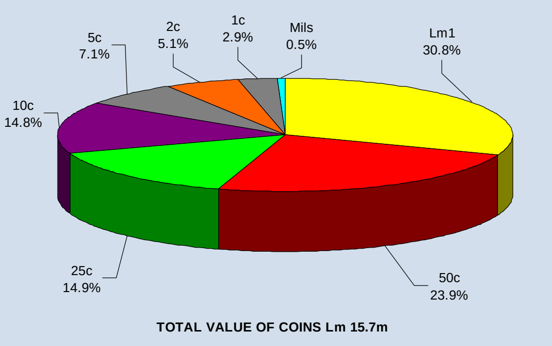
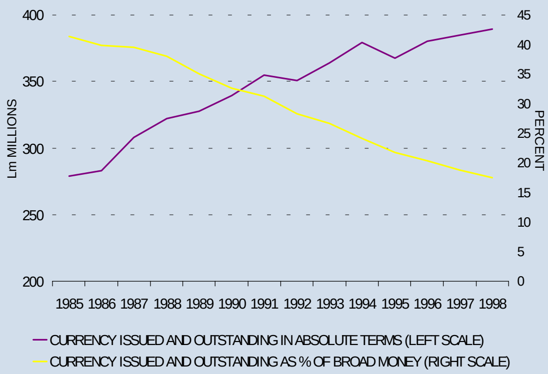



CHART 3.3 CURRENCY ISSUED AND OUTSTANDING




the preceding year. This may have been due to the de-monetisation of the 4th Series of the Lm5 and Lm2 notes on June 15.

The total value of coins issued and outstanding at the end of 1998 amounted to Lm15.7 million, or 6.1% higher than in 1997. The total value of coins issued by the Bank exceeded the value of coins paid into the Bank by Lm0.9 million. The share of the Lm1 coin in the total value of coins in circulation dropped marginally, to 30.8%. Nevertheless, it remained the highest of all the coin denominations.

The demand for currency notes and coins in 1998 generally followed the usual seasonal patterns. In January there was a drop of Lm10.6 million as credit institutions disposed of excess holdings accumulated during the festive season. Another seasonal decline occurred in November, prior to the Christmas period. As in previous years, this was reversed in December, when there was a Lm7.7 million increase in currency in issue. Another substantial increase was recorded in April, during the Easter period. On the other hand, the increase in demand normally associated with the peak tourist season was dampened as a result of the sale of Maltacom shares and the issue of government bonds in June.

Chart 3.3 shows the trend followed by currency in issue, both in absolute terms and as a percentage of broad money, since 1985. The chart clearly shows that, although the absolute level of currency in issue continued to increase, it has done so at a declining rate. Furthermore, as a percentage of broad money, it has declined steadily.

During 1998, the Currency Examination Room of the Issues Office examined a total of 17.8 million notes. Of the total notes examined, 12.4 million were found fit for re-issue, while 5.4 million were deemed unfit and, consequently, were destroyed. The total number of coins examined during 1998 amounted to 4.9 million.

### *3.2.2 Numismatic Coins*

The Central Bank issued two commemorative coins during 1998. The first was issued in April, on the occasion of the Central Bank's 30th Anniversary. The coin, which was struck at the Royal Mint in the U.K., has a legal tender value in Malta of Lm5, is of proof condition and is subject to a mintage limit of 1,500. It has a finesse of 0.925 silver, a diameter of 38.61 millimetres and weighs 28.28 grams. The coin was designed by Maltese artist Noel Galea Bason. The obverse shows the coat-of-arms of the Republic of Malta and the year of issue, while the reverse shows a pyramid structure symbolising financial solidity and the strength of the Maltese banking system. The reverse also bears the coat-of-arms of the Central Bank and an inscription which reads "30 Anniversarju Bank Centrali ta' Malta 1968-1998".

The second coin was issued in August to commemorate the bi-centenary of the uprising of the Maltese against the French. The silver coin, which is legal tender in Malta for the value of Lm5, was struck at the Royal Mint in the U.K. and is subject to a mintage limit of 5,000. It has a finesse of 0.925, a diameter of 38.61 millimetres and weighs 28.28 grams.

This coin was also designed by Noel Galea Bason. The obverse shows the coat-of-arms of the Republic of Malta and the year of issue. The reverse shows the design of the gold medal, bearing the legend "Patria Liberata", which was presented by Sir Alexander Ball to the Maltese leaders of the uprising.

### *3.2.3 Anti-Counterfeit Measures*

During the year, the Bank continued to monitor closely all incidents involving counterfeit currency. The Bank also continued to organise courses for handlers of cash, such as employees in banks and financial institutions, as well as members of the police force, to help them identify counterfeit currency.

# 4. Internal Management

## 4.1 Administration

### *4.1.1 The Governor and Board of Directors*

At the end of 1998, the Board of Directors of the Central Bank was composed of Mr E Ellul, Governor and Chairman of the Board, together with Professor E Scicluna, Mr A F Lupi and Mr S Falzon as members. Mr H Zammit Laferla was Secretary to the Board. The Board held 24 sittings during the year.

Mr A F Lupi was appointed Director for a period of two years with effect from January 21, 1998, replacing Mr R Cachia Carurana, whose term of office expired on January 20,1998. Mr S Falzon was appointed Director for a period of two years with effect from November 15, 1998, replacing Mr P J Baldacchino, whose term of appointment lapsed on November 14, 1998. Professor E Scicluna, whose term had also lapsed on November 14, was re-appointed to serve as Director for two years, also with effect from November 15.

### *4.1.2 Management*

The Executive Management Committee remained the organ responsible for most of the decisions related to the Bank's internal management and administration. In 1998, this Committee, which is made up of the Governor (as Chairman), the General Manager, and the Deputy General Managers of the Bank, met on a regular basis to discuss management procedures and new policies, as well as to implement administrative decisions taken by the Committee itself or by the Board of Directors.

The restructuring of the Bank's organisational set-up, which had commenced in 1996 with the ultimate aim of rationalising management structures, continued in 1998. During the year, the Banking Supervision Department, the Compliance Office, the Audit Department and the Risk Management Unit were grouped within the Banking Supervision and Audit Division. The Banking Office and Financial Control Department were grouped within the Finance and Banking Division.

### *4.1.3 Official Representation Overseas*

During the year, members of the Board and senior management officials represented the Bank at various official gatherings overseas. In April, the Governor, accompanied by Mr A Demarco, Deputy General Manager Research Management, attended the Spring Meetings of the International Monetary Fund (IMF) and the World Bank in Washington DC. The following month, the Governor, accompanied by his advisor, Mr R G Saliba, attended the Annual Meeting of European Bank for Reconstruction and Development (EBRD), which was held in Kiev. In June, the Governor participated in the Commonwealth Central Bank Governors' Meeting in London and attended the Annual General Meeting of the Bank for International Settlements (BIS) held in Basle during the same month. Mr H Zammit Laferla, Deputy General Manager Banking Supervision and Audit accompanied the Governor on this occasion. In October, the Governor of the Bank attended the joint Annual Meetings of the International Monetary Fund (IMF) and the World Bank in Washington DC. On this visit the Governor was accompanied by Mr P J Baldacchino, a Director of the Bank, and by Mr A Demarco, Deputy General Manager Research Management.

## 4.2 Human Resources

The full-time staff complement of the Central Bank at the end of 1998 stood at 305. In addition, the Bank employed one trainee and a further 18 employees on a part-time basis. During 1998, 14 new members of staff were recruited at the clerical level. The Bank also offered temporary employment under its student-sponsorship scheme to 10 students pursuing banking and related studies at the University of Malta and the Paolino Vassallo Upper Lyceum.

### *4.2.1 Training and Development*

As in previous years, the Bank continued to give considerable importance to staff training, and its human resource development programme featured among its top priorities during the year. The Programme included courses organised in-house by the Bank itself, as well as external courses organised by both local and foreign organisations.

During 1998, 28 different in-house training courses were organised by the Bank's Training Section. These ranged from job and computer-related training to more general developmental courses. The areas covered in these training programmes included, among others, management, supervisory and clerical development, the prevention of money laundering, the review of financial statements, financial mathematics and anti-counterfeit measures. Particular emphasis was made to familiarise staff members with software applications and the Bank's new core accounting system. Another important initiative was the "Ready for Euro" course organised in conjunction with the SWIFT User Group. The objective of this course was to give participants a good understanding of the impact of the euro on SWIFT operations.

During February and March the Bank held four seminars on the Bank's Strategic Direction for all clerical and executive members of staff. The aim of these seminars was to examine the role of the respective divisions within the Bank's overall corporate strategy. A one-day development programme for the Bank's non-clerical staff, designed to examine their role in the Bank's present and future objectives and to discuss the aspect of teamwork, was also held.

A total of 99 members of staff were given the opportunity to develop their abilities by participating in courses, conferences and seminars organised in Malta by various local bodies. The subjects covered included issues relating to management, finance, economics and information technology.

Thirty-six staff members were sent on specialised courses of training or conferences organised by foreign institutions. These included the Bank of England, the Banque de France, the Swiss National Bank and the Federal Reserve Bank of New York. The subjects covered by these courses included the management of external reserves, banking supervision techniques, monetary policy, internal auditing procedures, European Monetary Union and the management of change.

### *4.2.2 Academic and Professional Courses*

The Bank continued to upgrade its development support programme with a view to encouraging staff members to pursue self-development opportunities. This the Bank did by offering staff incentives and providing them with assistance to undergo academic and professional training, both locally and overseas. In this regard, during 1998, the Bank launched a Study Scheme to replace its Graduate Study and Examination Grant Schemes. At the end of the year, 12 staff members were benefiting from assistance under this Scheme. During 1998, a senior member of the staff successfully completed his post-graduate studies and obtained a Master's degree in Business Administration from Henley Management College of the UK. Another staff member, from the Bank's Compliance Office, completed a post-graduate course at the University of Malta, obtaining a Master's degree in Financial Services. Two other members of the staff were conferred with the Chartered Institute of Bankers (ACIB) diploma, while eleven others obtained the Institute's Malta Banking Certificate. One member of the staff obtained the Institute for the Management of Information Systems (IMIS) Graduate Diploma, while two other staff members obtained the IMIS Higher Diploma. Another staff member obtained a diploma in Management Studies from the University of Malta.

At the end of the year, 27 members of the Bank's staff were pursuing graduate or postgraduate studies on a part-time basis, either through distance learning or by following courses held by local professional bodies or the University of Malta. Another 27 employees were following part-time courses leading to diplomas issued by the Chartered Institute of Bankers and other institutions.

### *4.2.3 Governor's Award*

In 1998, the Governor's Award, which is intended to recognise effort, initiative and excellence among staff members, was awarded to Mr Gordon Cordina, an executive in the Bank's Economics and Research Department.

#### *4.2.4 International Exchange Scheme for Young Bankers*

During the year the Bank participated in the International Exchange Scheme for Young Bankers. This scheme involves the exchange of young employees in banks from different countries. In 1998 a staff member in the clerical grade at the Central Bank was sent for two weeks on attachment under this scheme to National Westminster Bank plc in Cardiff, UK. In exchange, an official from NatWest Bank was offered a two-week attachment at the Central Bank of Malta.

#### *4.2.5 Gender Equality*

Gender equality continued to be given due importance, and the Bank's internal committee set up for this purpose continued to maintain a close working relationship with the Department for Women's Rights in order to keep itself informed of developments in this area.

At the end of 1998, female staff members constituted 32.6% of the Bank's total full-time staff complement. Furthermore, during the year, notable efforts were made to increase female participation in courses of training organised by the Bank. In fact, there was a considerable increase in the proportion of female staff members sent on external courses, both locally and overseas. An increase was also registered in the proportion of female staff members involved in self-development programmes on a part-time basis.

### 4.3 Premises

During 1998, the final arrangements for the refurbishment of the foyer of the main Central Bank building were concluded. Works are scheduled to be completed in 1999.

### 4.4 Information Technology

The main development relating to the application of information technology within the Bank during 1998 were the preparations for the implementation of a new accounting system due to come into operation in 1999. This project was initiated in July, with the Business Process re-engineering. This involved an exercise in which the Bank's analysts, together with an external consultant, reviewed the entire operations of the Bank and made proposals for the implementation of changes in processing methods in order to be compatible with the new system. The first phase of the implementation programme was completed in December. This phase included a product walkthrough, a database design for the new system, end-user training and mock conversion of customer balances – as well as training on the use of the related report writing software.

In-house developments included the writing of different systems for the Bank's various departments. These included systems for the Banking Office, the Investments Office and the Exchange Control Department. Another development was the introduction of a document imaging system for Records Management Services. A corporate messaging system, giving the Bank a centralised system for the transmission and receipt of faxes and internal e-mail, was also introduced. Meanwhile, the Bank continued with the exercise of ensuring that its entire information technology framework is geared to meet the requirements imposed by the onset of the year 2000.

### 4.5 Risk Management and Audit

In 1998, the Risk Management Unit continued to identify, gauge and analyse all possible risks which the Bank can face from internal and external sources. The major issue that was dealt with during the year was the Year 2000 problem, which the Bank identified as a high-risk item. Through its representation on the Bank's Year 2000 Task Force, the Unit was assigned the responsibility to co-ordinate all compliance efforts in connection with this problem. Other activities of the Unit during 1998 included its involvement in the implementation of the Bank's new accounting system and the continuation of the risk evaluation exercise in respect of the various departments of the Bank.

The Bank also continued to ensure that high standards of accountability were maintained within the entire organisation through the application of comprehensive internal audit procedures by its Audit Department in line with the approved audit plan. In 1998, the Department took further measures to ensure that it could handle the increasingly sophisticated operational environment brought about by developments in information technology, as well as local and international financial conditions. The Bank also started to implement the recommendations set forth by an Audit Review Committee which was established by the Board of Directors to review internal audit procedures.

## 4.6 Information Services

### *4.6.1 Awareness Campaigns*

During the year, the Bank, in co-operation with the various media of communication, brought a number of issues to the attention of the public. These included the imminent introduction of the euro, cases of counterfeit currency in circulation and warnings on illegal or unauthorised financial operations.

### *4.6.2 Publications*

As in past years, the Bank published four issues of its Quarterly Review, which provided a continuous analysis of economic and financial developments in Malta and abroad. The Review also included an analysis of the results of the quarterly Business Perceptions Surveys conducted by the Bank, as well as articles on selected topics of an economic and financial nature. These included an article on the VAR econometric model of the Maltese economy used by the Bank's Economics Department for economic forecasting and another on inflation and the cost of living. The texts of the speeches delivered by the Governor of the Bank on a number of occasions during the year, as well as those delivered by various speakers at the Bank's 30th Anniversary Conference, were also published in the Quarterly Review.

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 31 December 1997. The Report also contained a comprehensive analysis of developments in the economic and financial sphere during that year.

In 1998, the Bank continued to publish data on monetary aggregates and their determinants on a monthly basis. These monthly releases included figures on the money supply, the external reserves and domestic credit and were accompanied by a short commentary on the latest developments. The data published are consistent with the concepts, definitions, and classifications recommended by the International Monetary Fund.

In order to prepare the Maltese public for the introduction of the euro on January 1, 1999, the Central Bank, in collaboration with the Malta Commercial Banks' Association, published a leaflet entitled "The European Monetary Union and You" in both an English and a Maltese version. This publication was intended to give an overview of European Monetary Union, the significance and scope of the euro and its effects on the Maltese financial system.

The Bank also continued to publish a weekly money market report in the local press.

### *4.6.3 Library*

Being the main source of information on economic and financial matters, the Bank's library continued to be widely used by the Bank's staff, by the staff of other public sector bodies and by the general public, particularly students involved in research work.

During 1998, the library continued to be upgraded with new acquisitions of books, periodicals, and other specialised documentation related to the Bank's functions and operations. A number of publications were also replaced by updated versions. Furthermore, the library continued to develop its collection of publications on CD-ROM and to use its Internet facilities to gain access to research data. It also maintained its comprehensive newspaper clippings service by monitoring both local and overseas newspapers. The most relevant items of news continued to be published in the form of a weekly digest for internal distribution.

The separate depository in the Governor's Office, which was set up in 1997, continued to be updated with the latest publications issued by international organisations, such as the IMF, the World Bank Group, the EBRD and certain EU institutions.

**4.7 Social, Cultural and Educational Activities**

As in previous years, the Bank, in 1998, organised a number of activities of a social, cultural and educational nature. Among the most significant of these activities were those held in April to commemorate the Bank's 30th anniversary. These included an international conference on "The Management of Monetary and Exchange Rate Policies", which involved the participation of representatives from some of the world's major central banks. The anniversary celebrations also included a Thanksgiving Mass at St John's Co-Cathedral and the customary concert of classical music held at the Mediterranean Conference Centre.

During the year, the Bank was honoured by visits from the then Prime Minister, the Hon Dr A Sant, and by His Grace the Archbishop of Malta, Mgr J Mercieca. The Bank also hosted the delegation from the Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures of the Council of Europe which visited Malta in September.

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 to them the role and functions of the Central Bank in the Maltese economy.

The Bank also participated in the Careers Convention Exhibition in March and in the Business and Finance Fair in September.

As in previous years, the Central Bank provided assistance to a number of organisations involved in philanthropic work. Arrangements were also made in collaboration with the health authorities for staff members to donate blood on a number of occasions. The Bank also continued to support its Staff Social Club, which, on its part, organised a number of social, cultural and philanthropic activities.

# Box 6:
# Year 2000 Compliance Statement

The Central Bank of Malta fully acknowledges the utmost importance of assessing how the information provided by any of its systems could be affected by the Year 2000 problem, and the risk inherent in these not being Year 2000 compliant.

The issue has been addressed by the Bank through the establishment of a specialist Year 2000 Task Force which for the past two years has had the task of analysing all areas of the Bank's business with a view to identifying where it was not compliant. The Central Bank of Malta is now in a position to confirm that all its critical systems are in fact, or will be, Year 2000 compliant at the time of publication of this Report and that the Bank's Executive Management Committee is satisfied that no foreseeable risks remain in respect of its core business operations.

Certification regarding Y2K compliance has been obtained from most external entities that the Central Bank of Malta works with. At the same time, the Bank is satisfied that those entities that have not yet confirmed compliance, do not present any significant risk to its critical operations. Where it has identified that such non-certification may affect the Bank's business in some way, contingency plans are being put in place.

The Central Bank of Malta recognises its responsibilities – as the Competent Authority appointed in terms of the Banking Act, 1994 and the Financial Institutions Act, 1994 – to regulate and supervise credit and financial institutions in Malta in addressing the Year 2000 problem accordingly. In this respect, the Banking Supervision and Compliance Department of the Central Bank of Malta has launched a thorough programme to ensure that all locally registered institutions are adequately addressing the Year 2000 problem. The progress of these institutions in achieving Year 2000 compliance is being closely monitored through detailed plans and timetables on the work required to be undertaken.

# 5. Relations with International Financial Institutions

The Central Bank continued to advise the Government on matters related to Malta's membership of international financial 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 Governor of the Central Bank also represents the Central Bank at the Annual Meeting of the Bank for International Settlements (BIS), where the Bank has observer status.

## 1.1 International Monetary Fund (IMF)

As the institution representing the Government at the IMF, the Central Bank was responsible for voting, in consultation with the Minister of Finance, on issues proposed by the IMF's Executive Board. As no transactions took place in connection with the Fund's quarterly operational budgets, Malta's reserve position with the IMF remained unchanged at Lm16.8 million (or SDR31.6 million) during the year. Conversely, the IMF's holdings of Maltese currency rose by about Lm0.1 million over the year, to stand at Lm19.1 million at the end of December.

The Central Bank continued to participate in the operations of the Fund's SDR Department. In this regard, the Bank effected payments of SDR0.5 million (about Lm0.3 million) and received approximately SDR2.9 million (about Lm1.5 million) in exchange for convertible currencies during the year. As a result of these transactions, Malta's total holdings of SDRs stood at SDR44.4 million (or Lm23.6 million) at the end of 1998, which was SDR2.6 million more than at the end of the previous year.

Over the year, the Central Bank continued to receive technical assistance from the IMF. An economic consultant visited Malta on two occasions. On his second visit, in November, the consultant advised the Ministry of Finance during the preparation of the budget. In June, the Fund also sent a technical assistance mission to advise the Bank on issues related to the compilation of government finance statistics.

The Governor of the Central Bank, accompanied by a senior Bank official, attended the Spring Meetings of the Interim and Development Committees of the IMF and the IBRD in April. In October, the Minister of Finance and the Governor of the Central Bank led a delegation to the Annual Meetings of the World Bank and the IMF, which were held in Washington D.C.

During the year, the members of the Fund's Interim Committee renewed their support for the amendment of the IMF Articles of Agreement so as to provide for the orderly liberalisation of capital movements. They also agreed to explore ways to strengthen the Fund's capacity to provide effective contingent finance to help countries pursuing sound policies maintain stability in the face of difficult global financial conditions. The Committee also endorsed proposals to strengthen the IMF's Special Data Dissemination Standard (SDDS) and called for accelerating work on improving systems for reporting external debt. The Committee asked the IMF Executive Board to study further the use of market-based mechanisms to cope with the risk of sudden changes in investor sentiment leading to financial crises. It called on the IMF to develop its surveillance activities and to complete its work to deal with the operational implications of EMU. The IMF adopted a Code of Good Practices on Fiscal Transparency – Declaration on Principles to serve as a guide to help member countries strengthen fiscal transparency.

### 5.2 World Bank (IBRD)

The Ministry of Finance is responsible for almost all areas of Malta's relationship with the IBRD. Nevertheless, the Central Bank continued to follow developments at the World Bank and to advise the Ministry of Finance on resolutions and other matters related to it. Moreover, as agent of the Government, the Central Bank remained responsible for arranging any payments to the IBRD with regard to capital subscriptions. However, no such payments were effected during 1998. In November, a World Bank technical mission was in Malta to advise the Minister of Finance on fiscal issues, particularly the re-introduction of the VAT system.

During the year, the World Bank continued to register notable progress in implementing the Debt Initiative for Heavily Indebted Poor Countries (HIPC). Member countries encouraged the World Bank to work closely with the World Trade Organisation (WTO), UNCTAD, and other interested parties in building poor countries' capacity to prepare for a new global trade round. The Board of Governors of the World Bank approved a general increase, amounting to US$850 million, in the capital of its Multilateral Investment Guarantee Agency (MIGA) and agreed to transfer US$150 million to MIGA by way of a grant to help it acquire a sustainable capital structure for the medium- to long-term.

### 5.3 European Bank for Reconstruction and Development (EBRD)

The Central Bank continued to advise the Ministry of Finance on issues related to the European Bank for Reconstruction and Development (EBRD). The EBRD was established in 1991 to assist the former communist countries of Central and Eastern Europe, as well as the countries of the Former Soviet Union, in their transition towards open market-oriented economies, and to promote private and entrepreneurial initiative in these countries.

In May, the Governor of the Central Bank led a delegation that attended the Seventh Annual General Meeting of the EBRD, which was held in Kiev, Ukraine. During the Meeting, the Board of Governors of the Bank discussed ways to continue to improve the investment climate in its countries of operation in order to attract additional capital inflows into the region. In this regard, Governors emphasised the need to strengthen the region's financial systems and to maintain macroeconomic stability in the transition countries so as to prevent a crisis similar to the one that erupted in Southeast Asia in 1997. Governors also discussed the role that the EBRD could play to facilitate the accession to the European Union of the transition countries that had applied for membership. Finally, the Board discussed ways to cope with the significant increase in demand for the EBRD's financing.

# *Part III*

# FINANCIAL STATEMENTS

# FOR THE YEAR ENDED

# 31 DECEMBER 1998

# Directors' report

The directors present their report and the audited financial statements of the Bank for the year ended 31 December 1998.

**Principal activities and review of operations**

The Central Bank's Mission and Objectives are set out on page 3. The Governor's Statement on pages 12 to 15 and the Bank's Policies, Operations and Activities on pages 91 to 114 give a detailed account of the Bank's activities and operations during 1998.

**Presentation of the financial statements**

These financial statements have been prepared so as to give a true and fair view of the state of affairs of the Bank as at 31 December 1998, and of its profit and cashflows for the year to that date. The Board of Directors has over the past years become increasingly aware of the need to change the presentation of the Bank's financial statements in the interest of greater public disclosure and in order to improve their qualitative characteristics. This year's financial statements have therefore been prepared in compliance with International Accounting Standards issued by the International Accounting Standards Committee in so far as these standards are appropriate to a central bank and applicable in terms of the Central Bank of Malta Act, 1967.

**Financial results**

The Bank's financial statements for the year ended 31 December 1998 are set out on pages 121 to 135 and disclose an operating profit of Lm30.7 million (1997 - Lm25.1 million). The Bank has this year changed its accounting policy on tangible fixed assets, which were in earlier years expensed in the year of acquisition. The Bank has instated the net book value of its tangible fixed assets at 1 January 1998 giving rise to an adjustment of Lm4.8 million which has been credited to the profit and loss account in accordance with International Accounting Standards. After setting aside Lm0.5 million (1997 - Lm1 million) to the Reserves for Risks and Contingencies, the residual profit payable to Government amounts to Lm30.2 million (1997 - Lm24.1 million).

# **Directors' report** - continued

**Board of Directors**

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

Mr Emanuel Ellul (Governor)
Mr Alfred F Lupi (appointed on 21 January 1998)
Mr Saviour Falzon (appointed on 15 November 1998)
Prof Edward Scicluna (re-appointed on 15 November 1998 )
Mr Richard Cachia Caruana (whose term expired on 20 January 1998)
Mr Peter Baldacchino (whose term expired on 14 November 1998)

Mr Herbert Zammit Laferla is the Secretary to the Board.

**Auditors**

MSD & Co and PricewaterhouseCoopers have signified their willingness to continue in office.

By order of the Board

| | |
|---|---|
| E Ellul<br>Governor | A F Lupi<br>Director |

Valletta
Malta

4 March 1999

# Statement of directors' responsibilities in respect of the financial statements

The Central Bank of Malta is governed by the provisions of the Central Bank of Malta Act, 1967. The Bank has also chosen to comply with International Accounting Standards, modified as set out in note 1(a) to the financial statements to take cognisance of the role of a central bank. The Board of Directors is responsible for ensuring that these financial statements give a true and fair view, on the basis referred to above, of the state of affairs of the Bank as at 31 December 1998, and of the profit and cash flows for the year to that date. The Board of Directors is also responsible for ensuring that the financial statements are drawn up in accordance with the requirements of the Central Bank of Malta Act, 1967.

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

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

# Report of the auditors

We have audited the financial statements set out on pages 121 to 135. As described in the statement of directors' responsibilities on page 118, these financial statements are the responsibility of the Bank's Board of Directors. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements give a true and fair view of the financial position of the Bank at 31 December 1998 and its profit and cash flows for the year then ended, in accordance with the basis of preparation set out in note 1(a) on page 124, and comply with the Central Bank of Malta Act, 1967.

MSD & Co
Malta

4 March 1999

PRICEWATERHOUSECOOPERS
Malta

4 March 1999

# Profit and loss account

| | Notes | 1998 Lm'000 | 1997 Lm'000 |
|---|---|---|---|
| **Result on operations** | 3 | **25,912** | 25,093 |
| Effect of change in accounting policy on tangible fixed assets | 4 | **4,770** | - |
| **Profit for the year** | | **30,682** | 25,093 |
| Transfer to reserves for risks and contingencies | 22 | **(500)** | (1,000) |
| **Payable to the Government of Malta in terms of Section 24(4) of the Central Bank of Malta Act, 1967** | | **30,182** | 24,093 |

# Balance sheet

| | Notes | 1998 Lm'000 | 1997 Lm'000 |
|---|---|---|---|
| **Assets** | | | |
| Cash and bank balances | 5 | **19,655** | 14,220 |
| Gold | | **688** | 1,311 |
| Placements with banks | 6 | **394,500** | 373,475 |
| Investment securities | 7 | **173,344** | 156,730 |
| International Monetary Fund | 8 | **40,429** | 38,912 |
| Other foreign currency assets | 9 | **11,357** | 1,534 |
| Total external assets | | **639,973** | 586,182 |
| Treasury bills | 10 | **16,937** | 22,735 |
| Domestic debt securities | 11 | **17,385** | 46,428 |
| Other assets | 12 | **27,275** | 27,905 |
| Tangible fixed assets | 13 | **5,233** | - |
| Prepayments and accrued income | | **8,188** | 7,803 |
| **Total assets** | | **714,991** | 691,053 |
| **Liabilities and equity** | | | |
| Liabilities | | | |
| Notes and coins in circulation | 14 | **390,912** | 384,655 |
| Deposits by: | | | |
| Banks | 15 | **115,195** | 100,511 |
| Government | 16 | **48,189** | 36,459 |
| Others | 17 | **13,367** | 18,932 |
| Profit for the year payable to Government | | **30,182** | 24,093 |
| Foreign liabilities | 18 | - | 5,736 |
| Other liabilities | 19 | **22,078** | 26,450 |
| Accruals and deferred income | | **2,018** | 1,667 |
| | | **621,941** | 598,503 |
| Capital and reserves | | | |
| Capital | 20 | **5,000** | 5,000 |
| General reserve fund | 21 | **23,000** | 23,000 |
| Special reserve fund | 21 | **13,000** | 13,000 |
| Reserves for risks and contingencies | 22 | **52,050** | 51,550 |
| | | **93,050** | 92,550 |
| **Total liabilities and equity** | | **714,991** | 691,053 |

The financial statements on pages 121 to 135 were approved by the Board of Directors on 4 March 1999 and were signed on its behalf by:

| | | |
|---|---|---|
| E Ellul<br>Governor | G Huber<br>Deputy General Manager<br>Finance and Banking | R Filletti<br>Financial Controller |

# Cash flow statement

| | Note | **1998 Lm'000** | 1997 Lm'000 |
|---|---|---|---|
| **Cash flows from operating activities** | | | |
| Result on operations | | **25,912** | 25,093 |
| Increase in interest receivable | | **(385)** | (463) |
| Increase in interest payable and accrued expenses | | **351** | 915 |
| Depreciation | | **315** | - |
| Amortisation of discounts and premiums on securities | | **(205)** | (252) |
| Profit on sale of securities | | **(1,828)** | (661) |
| Operating profit before changes in operating assets/liabilities | | **24,160** | 24,632 |
| **Net changes in operating assets and liabilities** | | | |
| Placements with banks | | **(33,093)** | 3,977 |
| Other foreign exchange assets | | **(897)** | 811 |
| Treasury bills | | **18,255** | (12,358) |
| Dealing securities | | **30,361** | 30,595 |
| Other assets | | **630** | (874) |
| Deposits | | **24,937** | 28,061 |
| Other liabilities | | **(4,372)** | (19,150) |
| Net cash inflow from operating activities | | **59,981** | 55,694 |
| **Cash flows from investing activities** | | | |
| Purchase of investment securities | | **(54,335)** | (108,816) |
| Proceeds from the sale of investment securities | | **38,436** | 73,271 |
| Purchase of tangible fixed assets | | **(778)** | - |
| Net cash utilised in investing activities | | **(16,677)** | (35,545) |
| **Cash flows from financing activities** | | | |
| Net movement in currency in issue | | **6,257** | 4,409 |
| Payment to the Government under Section 24(4) of the Central Bank of Malta Act, 1967 | | **(24,093)** | (22,204) |
| Net cash utilised in financing activities | | **(17,836)** | (17,795) |
| **Increase in cash and cash equivalents** | | **25,468** | 2,354 |
| Cash and cash equivalents at 1 January | | **246,792** | 244,438 |
| **Cash and cash equivalents at 31 December** | 23 | **272,260** | 246,792 |

# Notes to the financial statements

**1. Accounting policies**

***(a) Basis of preparation of financial statements***

These financial statements have been drawn up so as to give a true and fair view of the state of affairs of the Bank and its profit and cash flows. They have been prepared in accordance with the requirements of International Accounting Standards issued by the International Accounting Standards Committee in so far as they are appropriate to a central bank and applicable in terms of the Central Bank of Malta Act, 1967, as amplified below.

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

The financial statements have been prepared on the historical cost basis of accounting. The basis of preparation outlined above has been adopted by the Bank for the first time this year and has necessitated, in a number of areas, the reclassification of comparative figures.

***(b) Gold***

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

***(c) Investment securities***

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

***(d) International Monetary Fund***

The International Monetary Fund Reserve Tranche Position and Special Drawing Rights are shown at the prevailing representative rate for the Maltese lira of SDR1.8796 to Lm1 as quoted by the Fund at the close of business on 31 December 1998.

The International Monetary Fund Maltese lira holdings, including the Non-Interest Bearing Notes, are revalued against the SDR at the representative rate for the Maltese lira quoted by the Fund at 31 December 1998. Adjustments on revaluations of the International Monetary Fund holdings are reflected in the corresponding asset - Currency Subscription.

***(e) Government securities held for dealing purposes***

Government securities held for dealing purposes are stated at the lower of cost and market value. Up to the year ended 31 December 1997, it was the policy of the Bank to carry Malta Government Stocks held for dealing purposes at the Bank's bid prices. The effect of this change in policy is not material and it was not considered necessary to restate previous year's figures.

***(f) Treasury and other eligible bills***

Treasury and other eligible bills are stated at cost plus accrued interest.

***(g) Tangible fixed assets***

Up to the year ended 31 December 1997, it was the policy of the Bank to write off all capital expenditure incurred on land, buildings, leasehold improvements, plant and equipment, furniture and vehicles in the year of acquisition.

As part of the process of drawing up financial statements which comply with International Accounting Standards to the extent considered appropriate to a central bank (see note (a) above), the Bank has this year introduced the following changes:

(a) The Bank has introduced into its accounting records, with effect from 1 January 1998, the net book value of its tangible fixed assets at that date, computed by reference to their historical cost and applying the rate of depreciation outlined below.

(b) During the financial year, all capital expenditure incurred was capitalised and a depreciation charge for the year computed applying the rates set out below.

The depreciation rates adopted by the Bank are applied on a straight line basis so as to write off the cost of an asset over its estimated useful life. The annual rates used for this purpose are:

| | |
|---|---|
| Long-term leasehold property | Nil |
| Computer equipment and other fixed assets | 5 - 25% |

Owing to the Bank's policy of continuous refurbishment of long-term leasehold property, no depreciation is provided on the buildings element; this depreciation charge would, in any event, be immaterial. Long term leases are defined as those having a remaining term of more than 50 years.

***(h) Bad and doubtful debts***

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

***(i) Foreign currency translation***

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

***(j) Leases***

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

***(k) Sale and repurchase agreements***

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

***(l) Derivative financial instruments***

Derivative financial instruments, including forward foreign exchange contracts and currency swaps, are carried at their fair value in assets when favourable to the Bank and in liabilities when unfavourable to the Bank. The fair value of foreign exchange derivative contracts represents the unrealised gain or loss on revaluation of the contracts to year end rates of exchange.

Gains and losses on derivative instruments used in dealing activities are included in the profit and loss account as they arise. Gains and losses on other derivative financial instruments used for hedging purposes are deferred and recognised as income or expense on the same basis as the corresponding expense or income on the hedged position.

The Bank's criteria for a derivative instrument to be classified as a hedge include:

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

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

**2. External reserve ratio**

The ratio of external assets to notes and coins issued, excluding coins issued for numismatic purposes, and deposit liabilities is 113% (1997: 107%). The minimum ratio established by the Minister of Finance on the recommendation of the Board of the Central Bank of Malta in accordance with Section 19(2) of the Central Bank of Malta Act, 1967 is 60%.

**3. Result on operations**

The result on operations is stated after charging:

| | **1998** | 1997 |
|---|---|---|
| | **Lm'000** | Lm'000 |
| Fees and salaries: | | |
| Directors' remuneration | **26** | 42 |
| Staff costs | **2,322** | 2,207 |
| Depreciation | **315** | - |
| Auditors' remuneration | **12** | 12 |

**4. Effect of change in accounting policy on tangible fixed assets**

As explained in note 1(g), the Bank has this year changed its accounting policy on tangible fixed assets, which in earlier years had been fully expensed in the year of purchase.

The Bank has accordingly introduced into its accounting records, with effect from 1 January 1998, the net book value of its tangible fixed assets at that date, giving rise to an adjustment of Lm4,770,000. This adjustment has been credited to the profit and loss account, in accordance with International Accounting Standard 8, avoiding the need of restating comparative figures.

Had this policy been adopted in 1997, the profit for that year would have increased by Lm126,000, being the difference between capital expenditure expensed during the year (Lm286,000) and the depreciation charge (Lm160,000) which would have resulted.

**5. Cash and bank balances**

| | 1998 Lm'000 | 1997 Lm'000 |
|---|---|---|
| Cash in hand | **326** | 291 |
| Bank balances - repayable on call and at short notice | **19,329** | 13,929 |
| | **19,655** | 14,220 |

**6. Placements with banks**

| | 1998 Lm'000 | 1997 Lm'000 |
|---|---|---|
| By remaining maturity | | |
| - One year or less but over three months | **83,295** | 30,502 |
| - Three months or less but over one month | **150,951** | 32,845 |
| - One month or less | **160,254** | 310,128 |
| | **394,500** | 373,475 |

**7. Investment securities**

| | 1998 Lm'000 | 1997 Lm'000 |
|---|---|---|
| By remaining maturity | | |
| - Over five years | **85,189** | 77,644 |
| - Five years or less but over one year | **69,404** | 71,360 |
| - One year or less but over three months | **16,110** | 7,726 |
| - Three months or less | **2,641** | - |
| | **173,344** | 156,730 |

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

**8. International Monetary Fund**

| | 1998 Lm'000 | 1997 Lm'000 |
|---|---|---|
| Reserve Tranche Position | **16,826** | 16,732 |
| Special Drawing Rights | **23,603** | 22,180 |
| | **40,429** | 38,912 |

Malta's membership subscription to the International Monetary Fund amounts to SDR67,500,000 (1997: SDR67,500,000).

The Bank's position with the International Monetary Fund at 31 December 1998 is reflected in the balance sheet as follows:

(a) Reserve Tranche Position included above is equivalent to SDR31,625,171. This amount is a

**8. International Monetary Fund** - continued

claim on the International Monetary Fund and represents the difference between the quota of SDR67,500,000 and the Fund's Maltese lira holdings.

(b) Special Drawing Rights included above are equivalent to SDR44,364,875. These represent the Special Drawing Rights allocated to Malta amounting to SDR11,288,000, to which a corresponding liability exists in the form of a restricted demand deposit of the Government of Malta included under "Other deposits" (see note 17), together with other Special Drawing Rights acquired in accordance with International Monetary Fund requirements and procedures. Special Drawing Rights allocated to Malta cannot be withdrawn unless such advice is received from the Fund. Other Special Drawing Rights have no specified maturity.

(c) Currency Subscription included with "Other assets" (see note 12) is stated at Lm19,086,417 and represents the balance of the quota paid in Maltese liri. A corresponding liability exists in the form of Non-Interest Bearing Notes of Lm18,989,000 or SDR35,691,724, and IMF current accounts of Lm97,417 or SDR183,105.

## 9. Other foreign currency assets

| | **1998 Lm'000** | 1997 Lm'000 |
|---|---|---|
| Amounts receivable under banking arrangements | | |
| - Repayable within three months | **4,135** | - |
| - Repayable on demand | **5,685** | - |
| | **9,820** | - |
| Others | **1,537** | 1,534 |
| | **11,357** | 1,534 |

## 10. Treasury bills

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

| | **1998 Lm'000** | 1997 Lm'000 |
|---|---|---|
| By remaining maturity | | |
| - One year or less but over three months | **66** | 8,080 |
| - Three months or less but over one month | **7,890** | 11,885 |
| - One month or less | **8,981** | 2,770 |
| | **16,937** | 22,735 |

## 11. Domestic debt securities

| | **1998 Lm'000** | 1997 Lm'000 |
|---|---|---|
| Malta Government Stocks held for investment purposes | **-** | 31,371 |
| Malta Government Stocks held for dealing purposes | **7,385** | 5,057 |
| Other securities held for investment purposes | **10,000** | 10,000 |
| | **17,385** | 46,428 |

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

**11. Domestic debt securities** - continued

Amounts include:

| | **1998 Lm'000** | 1997 Lm'000 |
|---|---|---|
| By remaining maturity | | |
| - Over five years | **1,031** | 8,808 |
| - Five years or less but over one year | **15,015** | 32,680 |
| - One year or less | **1,339** | 4,940 |
| | **17,385** | 46,428 |

**12. Other assets**

| | **1998 Lm'000** | 1997 Lm'000 |
|---|---|---|
| International Monetary Fund Currency Subscription | **19,086** | 18,988 |
| Securities held under agreements to resell | **4,000** | - |
| Derivative financial instruments | **747** | 1,177 |
| Others | **3,442** | 7,740 |
| | **27,275** | 27,905 |

The contracted local currency amounts of the derivative financial instruments outstanding at 31 December 1998, consisting of forward foreign exchange contracts and currency swaps, amounted to Lm96,544,000 (1997: Lm114,685,000).

**13. Tangible fixed assets**

| | Leasehold land & buildings Lm'000 | Others Lm'000 | Total Lm'000 |
|---|---|---|---|
| Net Book Value at 1 January | 4,279 | 491 | 4,770 |
| Additions | 37 | 741 | 778 |
| Depreciation for the year | - | (315) | (315) |
| **Net Book Value at 31 December** | **4,316** | **917** | **5,233** |
| Cost | 4,316 | 3,184 | 7,500 |
| Accumulated depreciation | - | (2,267) | (2,267) |
| **Net Book Value at 31 December** | **4,316** | **917** | **5,233** |

**14. Notes and coins in circulation**

| | **1998 Lm'000** | 1997 Lm'000 |
|---|---|---|
| Notes | **375,210** | 369,830 |
| Coins | **15,702** | 14,825 |
| | **390,912** | 384,655 |

## 15. Bank deposits

| | **1998** **Lm'000** | 1997 Lm'000 |
|---|---|---|
| Reserve deposits held in terms of Section 37 of the Central Bank of Malta Act, 1967 | **109,122** | 101,236 |
| Call accounts - repayable on demand | **6,073** | (725) |
| | **115,195** | 100,511 |

Amounts include:

| | | |
|---|---|---|
| By currency | | |
| Maltese liri | **114,914** | 100,363 |
| Foreign | **281** | 148 |
| | **115,195** | 100,511 |

## 16. Government deposits

Amounts include:

| | **1998** **Lm'000** | 1997 Lm'000 |
|---|---|---|
| By currency | | |
| Maltese liri | **35,923** | 24,759 |
| Foreign | **12,266** | 11,700 |
| | **48,189** | 36,459 |
| By remaining maturity | | |
| - Over five years | **1,243** | 1,268 |
| - Five years or less but over one year | **7,776** | 7,077 |
| - One year or less but over three months | **12,378** | 2,494 |
| - Three months or less | **7,400** | 122 |
| | **28,797** | 10,961 |
| Repayable on demand | **19,392** | 25,498 |
| | **48,189** | 36,459 |

## 17. Other deposits

| | **1998** **Lm'000** | 1997 Lm'000 |
|---|---|---|
| Public Sector Corporations and similar entities: | | |
| - Repayable within three months | **1,098** | 1,078 |
| - Repayable on demand | **6,205** | 11,815 |
| | **7,303** | 12,893 |
| International Monetary Fund SDR allocation | **6,006** | 5,974 |
| Other entities: | | |
| - Repayable on demand | **58** | 65 |
| | **13,367** | 18,932 |

**17. Other deposits** - continued

Amounts include:

| | **1998** **Lm'000** | 1997 Lm'000 |
|---|---|---|
| By currency | | |
| Maltese liri | **4,649** | 4,611 |
| Foreign | **8,718** | 14,321 |
| | **13,367** | 18,932 |

**18. Foreign liabilities**

| | **1998** **Lm'000** | 1997 Lm'000 |
|---|---|---|
| Amounts payable under banking arrangements | | |
| - Repayable within three months | **-** | 5,433 |
| - Repayable on demand | - | 303 |
| | **-** | 5,736 |

**19. Other liabilities**

| | **1998** **Lm'000** | 1997 Lm'000 |
|---|---|---|
| International Monetary Fund Non-Interest Bearing Notes | **18,989** | 18,887 |
| Securities sold under sale and repurchase agreements | **1,000** | 1,000 |
| Others | **2,089** | 6,563 |
| | **22,078** | 26,450 |

**20. Capital**

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

**21. Reserve funds**

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

**22. Reserves for risks and contingencies**

| | **1998** **Lm'000** | 1997 Lm'000 |
|---|---|---|
| Balance at 1 January | **51,550** | 50,550 |
| Transfer from profit in terms of Section 24(4) of the Central Bank of Malta Act, 1967 | **500** | 1,000 |
| Balance at 31 December | **52,050** | 51,550 |

## 22. Reserves for risks and contingencies - continued

Reserves for risks and contingencies are maintained in terms of Section 24 of the Central Bank of Malta Act, 1967 to cover the broad range of risks to which the Bank is exposed. The major risks in this regard arise from: potential losses which could result from pursuing monetary policy objectives, movements in market values of the Bank's holdings of domestic and foreign securities and other investments, potential losses arising from support of the financial system in the Bank's role as a lender of last resort, and other non-insured losses. The Board of Directors determines each year the amount to be transferred to or from such reserves taking into account the factors described above.

## 23. Cash and cash equivalents

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

| | **1998** | 1997 |
|---|---|---|
| | **Lm'000** | Lm'000 |
| Cash and bank balances | **19,655** | 14,220 |
| Treasury bills maturing within three months | **12,457** | - |
| Placements with banks maturing within three months | **273,854** | 285,922 |
| Other foreign currency assets maturing within three months | **9,820** | - |
| Deposits maturing within three months | **(43,526)** | (47,614) |
| Foreign liabilities maturing within three months | - | (5,736) |
| | **272,260** | 246,792 |

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

## 24. Financial instruments

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

### *Credit risk*

The Bank has in place internal control structures to assess and monitor credit exposures and risk thresholds. Funds are placed with, and derivative instruments are entered with, financial institutions having a first class credit rating. The Bank invests only in first class quality paper and does not engage in derivative trading for speculative purposes.

### *Currency risk*

Investments denominated in foreign currency are held in a mix of currencies which reflects, in the main part, their respective weighting in the Maltese lira basket. As a result, exposure to currency risk is managed within controlled parameters.

**24. Financial instruments** - continued

***Currency risk*** - continued

At 31 December, the Bank's net foreign currency holdings, including amounts arising under derivative financial instruments, were in the following currencies:

| | **1998** | 1997 |
|---|---|---|
| | **%** | % |
| USD | **21.39** | 22.85 |
| GBP | **21.19** | 21.92 |
| EURO currencies | **55.51** | 53.31 |
| Others | **1.91** | 1.92 |
| | **100.00** | 100.00 |

***Fair values of financial assets and liabilities***

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

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

| | **Carrying value** | | **Market value** | |
|---|---|---|---|---|
| | **1998** | 1997 | **1998** | 1997 |
| | **Lm'000** | Lm'000 | **Lm'000** | Lm'000 |
| Foreign currency investment securities | **173,344** | 156,730 | **186,459** | 164,668 |
| Malta Government Stocks held for dealing and investment purposes | **7,385** | 36,428 | **7,388** | 36,445 |
| | **180,729** | 193,158 | **193,847** | 201,113 |

**25. Contingent liabilities and commitments**

| | **1998** | 1997 |
|---|---|---|
| | **Lm'000** | Lm'000 |
| **Contingent liabilities** | | |
| Guarantees and letters of credit | **26,393** | 30,995 |
| **Commitments** | | |
| Repayment of foreign loans received by the Bank on behalf of the Government under Financial Conventions | **23,693** | 25,557 |
| **Total** | **50,086** | 56,552 |
| By remaining maturity: | | |
| Guarantees and letters of credit | | |
| - Over five years | **-** | 3,165 |
| - Five years or less but over one year | **16,335** | 14,646 |
| - One year or less but over three months | **328** | 7,710 |
| - Three months or less | **9,730** | 5,474 |
| | **26,393** | 30,995 |

**25. Contingent liabilities and commitments** - continued

Foreign loans received by the Bank on behalf of the Government under Financial Conventions and repayable in due course from funds to be made available by Government

| | **1998** | 1997 |
|---|---|---|
| | **Lm'000** | Lm'000 |
| - Over five years | **13,238** | 15,456 |
| - Five years or less but over one year | **8,836** | 8,280 |
| - One year or less but over three months | **1,525** | 1,724 |
| - Three months or less | **94** | 97 |
| | **23,693** | 25,557 |

**26. Related parties**

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

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

**27. General**

***(i) Demonetised currency notes***

On 15 June 1998, in accordance with Section 42(4) of the Central Bank of Malta Act, 1967, notice was given in the Government Gazette that the Lm5 and Lm2 4th Series currency notes having a value of Lm1,363,030 and Lm539,296 respectively were demonetised. Up to 31 December 1998, an amount of Lm459,125 of the Lm5 4th Series currency notes and Lm36,444 of the Lm2 4th Series currency notes were claimed by the public. In accordance with Section 42(6) of the Central Bank of Malta Act, the balance of the above demonetised currency notes not claimed by the public after one year from date of demonetisation will be recognised as profits of the Bank.

Claims made after the expiry of one year following the end of the period established in the notice of demonetisation, but not later than ten years after the end of that period, are charged against profits of the Bank in the year such claims are made. During 1998 such claims amounted to Lm412,340 (1997: Lm321,885).

After the expiry of ten years from notice of demonetisation, demonetised currency notes are not redeemed by the Central Bank of Malta. During 1998, the Lm10 2nd Series currency notes reached the ten year expiry period. The amount unpresented of this currency note was Lm382,130.

At 31 December 1998, the value of unpresented demonetised currency notes amounted to Lm3,531,715 (1997: Lm2,919,428).

**27. General** - continued

***(ii) Average number of employees***

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

| | **1998 Number** | 1997 Number |
|---|---|---|
| General and Deputy General Managers | **7** | 7 |
| Heads and Executives | **68** | 62 |
| Supervisory and clerical staff | **192** | 186 |
| Non-clerical staff | **55** | 57 |
| | **322** | 312 |

***(iii) Assets held in custody***

At 31 December 1998, assets held in custody by the Bank in terms of the Insurance Business Act amounted to Lm27,344,000 (1997: Lm25,393,000).