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The new Governor, Dr Chr. Christodoulou



Chr. Christodoulou
Governor

Dr Christodoulos Christodoulou holds a PhD in Law from the University of Wales and Bachelor's degrees in Law and Political Sciences from the Universities of Thassaloniki and Athens, respectively, in Greece, as well as a teaching diploma from the Pedagogical Academy of Cyprus.

Between 1964 and 1968 Dr Christodoulou worked in the Publications Section of the Press and Information Office and from 1968 until 1972 as a senior officer in the House of Representatives. In 1972 he was appointed to the post of Director of the Government Printing Office in which he served until February 1985. In March 1985 he was appointed to the post of Permanent Secretary at the Ministry of Labour and Social Insurance where he served until June 1989. In the same month he was transferred to the Ministry of Agriculture and Natural Resources where he served until November 1994 when he was appointed Minister of Finance.

Dr Christodoulou's other duties and activities have included the chairmanship of a number of semi-public organisations, such as the Human Resource Development Authority, the Cyprus Productivity Centre, the Agricultural Insurance Organisation, the Committee for the Protection of the Environment, the Agricultural Research and Extension Council, as well as many other committees. Dr Christodoulou represented Cyprus on the governing bodies of the International Labour Office (ILO), the Food and Agricultural Organisation (FAO) and the World Food Council (WFC).

In November 1994, Dr Christodoulou was appointed Minister of Finance, a post he held until March 1999 when he was appointed Minister of Interior. On 2 May 2002 he was appointed Governor of the Central Bank of Cyprus.

As Minister of Finance he represented Cyprus at annual conferences of the World Bank and the International Monetary Fund and the annual meetings of the Finance Ministers of the Commonwealth and numerous other international economic conferences. As Minister of Interior he participated in many international conferences and meetings concerning planning issues and the protection of Cyprus's architectural heritage, as well as issues regarding migration, civil defence, harmonisation with the *acquis communautaire*, etc. He has written numerous articles and reports and has lectured on industrial relations, economic and legal issues.

Dr Christodoulou is married and has a daughter.

1. Introduction by the Governor

The year 2002 was a landmark in the evolution of the Central Bank of Cyprus, as a result of the enactment of new legislation re-defining its functions and operations. On the basis of the new Central Bank of Cyprus Law and the pertinent amendments in the Constitution of the Republic, the Central Bank has acquired complete independence and a legal framework, overall consistent with the *acquis communautaire* and, in particular, with the relevant provisions of the Treaty Establishing the European Community and the Statute of the European System of Central Banks and the European Central Bank. The primary objective of the Bank remains that of ensuring price stability, as clearly provided by the *acquis*.

Apart from safeguarding all the main elements of central bank independence, i.e. institutional and financial independence, as well as the personal independence of the members of its decision-making bodies, the new Law has terminated the access of the public sector to the monetary authority for the purpose of direct borrowing. Within the framework of the Bank's institutional independence, the Governor may attend the meetings of the Council of Ministers and its competent committees as well as Parliamentary committee meetings, when issues pertaining to the competencies of the Central Bank are discussed. The Governor also addresses to Parliament annually, a report on monetary policy. Furthermore, under the new Law, the Monetary Policy Committee, which previously functioned on an advisory basis, has been upgraded and

assigned the task of defining and implementing monetary and credit policy.

The aforesaid changes to the Bank's legal status and operational framework came into effect two months after the change at its helm. In May 2002, I was appointed by the President of the Republic of Cyprus as the new Governor, in succession to Mr Afxentis Afxentiou, who ably served as Governor for an uninterrupted period of 20 years. Immediately after my appointment, a series of organisational and administrative changes relating to various aspects of the Bank's tasks were initiated, thus establishing a new approach on the way the Bank operates.

Among the first measures I introduced was the implementation of an Internal Communications Plan, with a view to improving communication between members of staff at all levels and keeping them informed on all current matters. A programme of regular meetings between the Governor and senior Bank staff was also established. As a means of achieving the strategic objectives of the Bank, emphasis has been given to the setting of targets in conjunction with spelled-out time schedules. In this respect, each division is expected to set targets in line with the current policy of the Bank and all the senior staff must be actively involved in their formulation and implementation. As far as the organisational structure is concerned, an important change is that the Personnel and Administration Section, the Information Technology Department and the Internal Auditor Department are now directly reporting to the

Governor. The Governor also handles directly matters which are of a legal nature, within the broader competence and policy of the Bank, as well as matters related to security, budgeting, publicity and public relations. The Economic Research and Management Services Division has been renamed as the Economic Research and Statistics Division, being composed of the two respective departments. In the area of budgeting, the continuous monitoring of the Bank's income and expenditure and the systematic examination of the divergence between budgeted and actual income and expenditure have been introduced, together with the regular briefing on these matters of the Governor, the Board of Directors and the Governor's Committee.

In the area of financial supervision, at the initiative of the Central Bank, a Memorandum of Understanding has been signed with effect the 1 January 2003 between the Central Bank, the Securities and Exchange Commission and the Insurance Companies Control Service. The main purpose of the Memorandum is to provide for the continuous cooperation of the three supervisory authorities, so that the supervision of the financial sector becomes more effective. The Memorandum is also intended to address problems arising from the fragmentation of the supervision and regulation of the financial sector. Furthermore, as has already been announced, it is expected that the Memorandum will be adopted by the supervisory authority of the Co-operative Credit Institutions. The resultant coordination and cooperation of the various supervisory bodies in the field of financial services is, accordingly, aligned with the policy of the European Union aiming at the greater har-

monisation of rules and procedures relating to the regulation and supervision of financial services in each member state.

As regards developments in the banking sector during the year under review, it is noted that the implementation of a prudent policy aimed at restoring to health the balance sheets of banks and overcoming the serious problems resulting from the lax lending policy during the stock market bubble of 1999 was actively sought by the Central Bank. In addition, I would like to note with satisfaction the fact that banks responded positively to our recommendation to refrain from paying dividends in 2002. The non-payment of dividends, which aimed at increasing the capital base of the banks and improving their capital adequacy ratio, was not popular, especially in the light of the poor performance of the stock market during the year under review. Despite the improvement already observed, our banking institutions are still facing difficulties which, apart from the unfavourable repercussions of the stock market crisis during 1999-2001, are connected with the problems brought about by the intense competition, the reductions in interest rates and concomitant lower profitability. Due to these considerations, as well as their high operating costs, Cypriot banks are obliged to continue with the necessary, but at the same time difficult task of rationalisation and of improving their profitability and financial strength. The Central Bank will continue to encourage and support these efforts which have to be combined with structural changes as well as operational and administrative modernisation. The banking sector constitutes an essential pillar of Cyprus's economic development and its

financial strength is an important prerequisite for successfully meeting the challenge of the island's accession to the European Union.

In November 2002, following the careful examination by the Governor and senior staff of the Annan Plan for the solution of the Cyprus problem, a report was submitted to the President of the Republic, detailing the Bank's views regarding the Plan's provisions for the structure and functions of the Central Bank. New reports were prepared and presented by the Governor to both the former and current Presidents of the Republic regarding the provisions of the two revised Annan Plans, relating to the Central Bank and their repercussions for the Cyprus economy.

As far as economic developments are concerned, it is noted that economic activity in 2002 was subdued. Gross domestic product (GDP) in real terms grew by 2,0%, compared with 4,1% in the previous year. This slowdown, which was in line with the unfavourable economic climate prevailing in the world economy during the year under review, was mainly the result of the negative performance of the tourism sector and the slowdown in private consumption. Inflation during 2002 reached 2,8%, compared with 2,0% during the previous year, reflecting mainly the increase in Value Added Tax (VAT) and other consumption taxes. In the labour market, the number of registered unemployed as a percentage of the economically active population increased from 3,0% in 2001 to 3,2% during the year under review, reflecting the slowdown in the growth of GDP. The significant fall in tourist

arrivals and associated revenues, the expenditure for the purchase of aircraft by the national carrier, Cyprus Airways, as well as the increase in defence expenditure, resulted in the further widening of the current account deficit, which is estimated to have reached 5,3% of GDP in 2002.

According to provisional figures prepared by the Ministry of Finance, the fiscal deficit in 2002 increased to £215,7 million or 3,5% of GDP, compared with £166,5 million or 2,8% of GDP in 2001 and the budgeted figure of 2,4%. This was mainly the result of the negative repercussions of the tax reform introduced in the middle of the year under review, as well as the slowdown in the economy. It is also important to note those factors which had a negative impact on the fiscal deficit. These include, as repeatedly stressed by the Central Bank, the incorrect assessment of revenue and expenditure during the formulation of the tax reform, as well as the failure to achieve the required fiscal consolidation and discipline.

In the monetary sector, the international political developments, combined with the widely expected worldwide economic recovery and the underlying domestic inflationary pressures, prompted the Central Bank to adopt a cautious stance during the largest part of 2002. In December of the year under review, the Bank, after taking into account the increased spread between Cypriot and European official interest rates, the weakened and faltering international economic recovery, as well as dampened domestic inflationary pressures, decided to reduce the marginal lending facility rate (Lombard rate) by one-half (0,5) of a percentage point, from

5,50% to 5,00%. As regards the monetary aggregates, the rate of increase in the money supply recorded a slowdown, reaching 10,3%. A deceleration was also recorded by credit to the private sector which grew by 8,0%, compared with an increase of 12,3% in 2001. During the year under review, the banking system exhibited conditions of excess liquidity, with the result that the Central Bank had to intervene continuously in the money market through deposit collection auctions, absorbing, on average, liquidity to the tune of €314,3 million per month, bearing the concomitant cost.

The military conflict in Iraq is expected to have a negative impact on the recovery of the world economy and, as a result of the envisaged negative impact on tourist arrivals, on the growth of the domestic economy, which in 2003 is forecast to be lower than in 2002. Unemployment in 2003 is expected to register a further small increase. Following the increases in VAT and other consumption taxes and the cumulative impact of the Cost of Living Allowance (COLA), inflation is forecast to accelerate and reach around 4,5%.

The current account deficit is anticipated to improve slightly in 2003 and not to exceed 5,0% of GDP. The expected small improvement in the current account deficit is based on the working assumptions that defence expenditure in 2003 will be reduced significantly and Cyprus Airways will not purchase any aircraft. The economic slowdown, which is expected to continue in 2003, will have an adverse impact on public finances, thus resulting in a further increase of the fiscal deficit, and an even greater divergence from the fiscal deficit estimate incorporated in the

Pre-accession Economic Programme which Cyprus submitted to the European Union in 2002.

Finally, I want to underline that during 2002, the unfavourable international conditions with their inevitable serious domestic repercussions, together with the domestic developments, have worsened economic conditions in Cyprus, with a particularly unfavourable impact on public finances. Although the Cyprus economy is expected to experience difficulties and problems during 2003, I am confident that it will be able to recover and continue its upward course. Our economy has strong and healthy foundations as well as many comparative advantages which should be highlighted and exploited with realistic and prudent policies. It would be a mistake to be complacent or to undertake only a superficial assessment of the economy and the challenges it faces. What is required is a drastic reduction of the non-productive public expenditures and a significant increase in public revenues. Although these measures are likely to be unpopular, they are necessary in order to satisfy Cyprus's commitments as regards meeting the Maastricht criteria, entering the Exchange Rate Mechanism II upon accession to the European Union, and overall, achieving nominal and real convergence, which will pave the way for Cyprus's entry in the euro-zone without delay.

I would like, in conclusion, to express my warm thanks to the members of the Board of Directors and the members of the Monetary Policy Committee for their valuable contribution and assistance. I would also like to express my gratitude to all the Bank's staff

for their dedication, diligence and support of our efforts towards achieving the objectives of the Bank. My thanks are also extended to Mr H. Akhniotis, who retired on 30 November 2002 from the post of Chief Senior Manager after a long and successful service at the Bank. Mr Akhniotis continues to serve the Bank as an Advisor to the Governor and member of the Monetary Policy Committee.



Christodoulos Christodoulou
Governor, Central Bank of Cyprus

2. Management and organisation of the Bank

(31 December 2002)

2.1 Board of Directors



**Chr.
Christodoulou**
Governor, Chairman



C. Tsielepis



Chr. Theocli



C. Damtsas



Ph. Zachariades



E. Hadjizacharias

Costas Tsielepis: Managing Partner and founder of an accounting firm. He has been a member of the Board of Directors of the Bank since 1983.

Chrysostomos Theocli: Company consultant and member of the Board of Directors in a number of companies. Former partner in an accounting firm. He has been a member of the Board of Directors of the Bank since 1988.

Constantinos Damtsas: Managing Director in a private company. Member of the Industrial Disputes Court. Member of the Board of Directors of private and public companies, semi-government and professional organisations. He has been a member of the Board of Directors of the Bank since 1990.

Phlios Zachariades: General Manager of an insurance company. President of the Association of Insurance Companies and member of the Insurance Advisory Committee. Vice-President of the Cyprus Employers and Industrialists Federation. He has been a member of the Board of Directors of the Bank since 1993.

Eleftherios Hadjizacharias: Partner in an accounting firm since 1984. He has been a member of the Board of Directors of the Bank since 1999.

2.2 Monetary Policy Committee



**Chr.
Christodoulou**
Governor, Chairman



H. Akhniotis



A. Philippou



A. Malaos



A. Matsis



Chr. Pissarides

Haralambos Akhniotis: Chief Senior Manager, Economic Research and Management Services Division, Central Bank of Cyprus until 30 November 2002. He has been a member of the Monetary Policy Committee since November 2000.

Andreas Philippou: Chief Senior Manager, Banking Supervision and Regulation Division, Central Bank of Cyprus. He has been a member of the Monetary Policy Committee since November 2000.

Antonis Malaos: Director of the European Institute of Cyprus and former Permanent Secretary of the Ministry of Finance and the Ministry of Justice. He has been a member of the Monetary Policy Committee since November 2000.

Andreas Matsis: Entrepreneur. President of the Famagusta Chamber of Commerce and Industry. He has been a member of the Monetary Policy Committee since November 2000.

Christophoros Pissarides: Professor of Economics, London School of Economics and Political Science. He has been a member of the Monetary Policy Committee since November 2000.

2.3 Senior Management Team (Governor's Committee)



**Chr.
Christodoulou**
Governor, Chairman



H. Akhniotis
Chief Senior Manager
Economic Research and
Management Services
Division



A. Philippou
Chief Senior Manager
Banking Supervision and
Regulation Division



S. Stavrou
Senior Manager
International Division



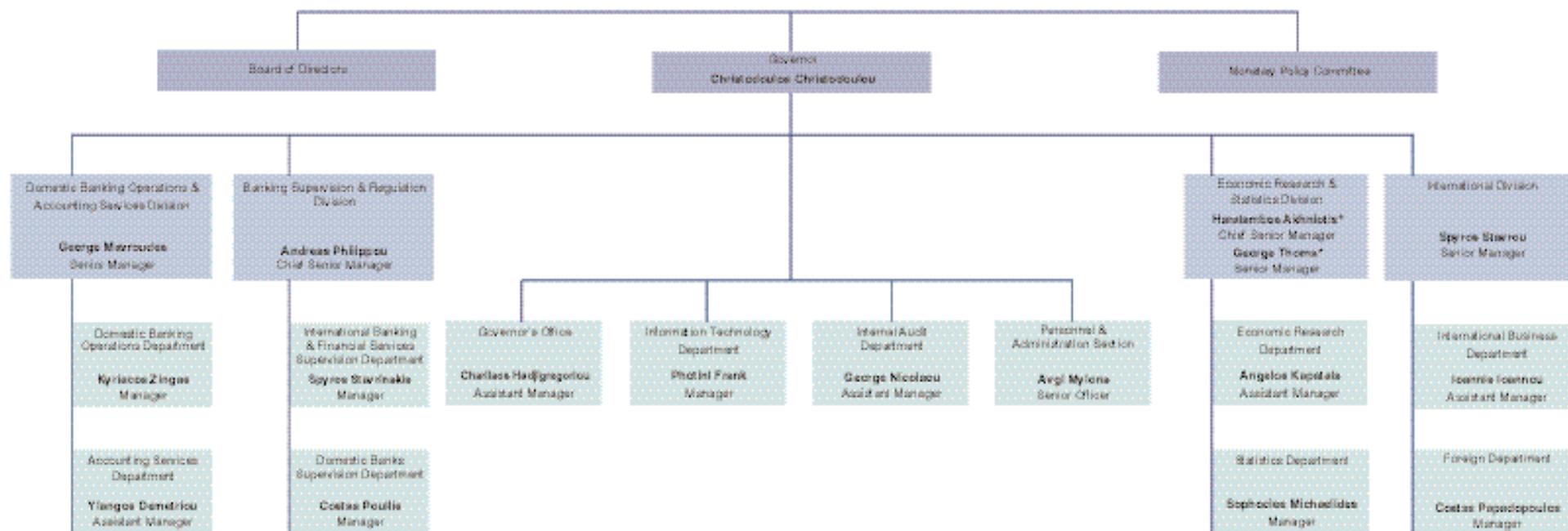
G. Mavroudes
Senior Manager
Domestic Banking
Operations and Accounting
Services Division



G. Thoma
Senior Manager
Economic Research
and Statistics Division

Note: Mr H. Akhniotis retired on 30 November 2002 and the Economic Research and Management Services Division was renamed the Economic Research and Statistics Division with Dr G. Thoma as its head.

2.4 Organisational and Management Structure



* On 1 December 2002, the Economic Research and Management Services Division was renamed the Economic Research and Statistics Division. Dr G. Thomas took over the management of the Division from Mr H. Akhridis after his retirement on 30 November 2002.

3. The economy in 2002

3.1 Economic developments

Overview

According to provisional figures prepared by the Statistical Service, the Cyprus economy exhibited a slowdown during 2002, with gross domestic product (GDP) increasing by 2,2% in real terms, compared with 4,1% in 2001. Foreign demand fell significantly compared with 2001, mainly as a result of the adverse developments in the tourism sector following the events of 11 September 2001, the worldwide economic downturn and the fall in exports. Domestic demand displayed a small deceleration due to the fall in the rate of growth of public and private consumption, whereas the rate of growth of gross capital formation exhibited an acceleration. On the supply side, the services sectors registered a significant slowdown, due mainly to the aforementioned decline in tourism, whereas the performance of the secondary sectors was relatively better, as a result of the improvement in the construction sector since 2001.

The rate of inflation reached 2,8% in 2002, compared with 2,0% in the previous year, reflecting mainly the acceleration observed in the prices of domestic industrial products and the increase in the prices of services, which were mainly due to the increase in value added tax (VAT) and other consumption taxes from July 2002. As regards the labour market, the number of registered unemployed as a proportion of the economically active population increased from 3,0% in 2001 to 3,2% during the year under review, reflecting the slowdown observed in the rate of growth of GDP.

Supply

The secondary sectors of the economy exhibited a moderate improvement, as indicated by the increase in their rate of growth in real terms. This performance occurred despite the continuous stagnation in the manufacturing sector, as well as the slowdown in the sector of electricity, gas and water, and was due to the healthy performance of the construction sector. More specifically, value added in the manufacturing sector fell by 0,3% in real terms during 2002, which reflects the chronic structural problems faced by the sector. The poor performance of the manufacturing sector was also reflected in the volume index of manufacturing production, which fell by 2,6% in 2002, compared with a decline of 2,0% in the previous year. As regards the construction sector, an increase of 4,2% was observed, compared with a fall of 2,7% in 2001. The positive performance registered by this sector during 2002 was clearly reflected in the increase recorded by the volume and value indices of building permits, as well as the increase in the local sales of cement, and was the result of the significant increase in the construction of housing by the private sector.

The services sectors exhibited an overall slowdown, registering an increase of 2,0% in real terms, compared with a rise of 4,8% in 2001. Most of the sub-sectors of services experienced a decline or slowdown. More specifically, the sector of financial intermediation displayed a marginal increase of 0,9%, compared with a rise of 4,4% in the previous year, reflecting, mainly, the continued subdued performance of the stock market as well as the overall slowdown in the economy. The hotels and restaurants sector registered a

Gross Domestic Product by economic activity

£ million

Economic activity	At current market prices				At constant 1995 prices			
	1999	2000	2001	2002 (prov.)	1999	2000	2001	2002 (prov.)
Primary sectors	218,7	216,1	243,5	267,0	221,4	211,0	224,6	237,2
Agriculture, hunting and forestry	191,4	187,8	214,7	236,2	193,7	178,1	191,5	202,6
Fishing	12,4	11,4	11,4	11,8	12,4	15,8	15,9	16,2
Mining and quarrying	14,9	16,9	17,4	19,0	15,3	17,1	17,2	18,4
Secondary sectors	998,9	1.048,7	1.102,2	1.152,3	895,9	908,3	917,3	938,5
Manufacturing	532,8	560,5	581,7	593,9	476,6	487,8	477,6	476,2
Electricity, gas and water supply	94,9	114,2	123,1	128,1	101,7	109,9	120,7	130,0
Construction	371,2	374,0	397,4	430,3	317,6	310,6	319,0	332,3
Tertiary sectors	3.623,0	3.995,4	4.257,9	4.403,2	3.193,6	3.414,1	3.579,5	3.650,7
Wholesale and retail trade	626,6	681,4	720,7	752,6	574,9	603,5	626,6	638,9
Hotels and restaurants	442,5	503,0	544,7	506,9	406,7	446,9	464,8	432,1
Transport, storage and communication	446,6	494,5	557,8	569,6	420,9	477,5	527,1	549,9
Financial intermediation	345,6	392,8	391,6	386,6	268,8	293,1	306,0	308,9
Real estate, renting and business activities	677,0	738,9	781,1	842,2	600,6	632,0	659,6	693,1
Public administration and defence	446,4	485,6	515,2	543,8	381,9	395,7	406,8	416,6
Education	247,5	270,6	289,8	313,4	205,0	212,8	220,4	228,4
Health and social work	172,4	186,4	199,2	211,9	141,6	146,2	150,7	155,0
Other community, social and personal services	194,6	215,6	227,3	242,7	169,4	179,8	187,0	194,3
Private households with employed persons	23,8	26,6	30,5	33,5	23,8	26,6	30,5	33,5
Total Gross Value Added	4.840,6	5.260,2	5.603,6	5.822,4	4.310,9	4.533,4	4.721,4	4.826,4
Less: Imputed bank service charges	188,8	223,0	265,2	244,6	168,1	192,2	223,5	202,7
Plus: Value Added Tax and import duties	378,4	474,6	541,6	615,0	458,3	497,7	541,5	527,9
Gross Domestic Product at market prices	5.030,2	5.511,8	5.880,0	6.192,9	4.601,1	4.838,9	5.039,4	5.151,6

Gross Domestic Product by category of expenditure

£ million

Category of expenditure	At current market prices				At constant 1995 prices			
	1999	2000	2001	2002 (prov.)	1999	2000	2001	2002 (prov.)
Private final consumption expenditure	3.316,3	3.764,1	3.999,4	4.224,1	3.063,6	3.313,3	3.480,2	3.563,4
Government final consumption expenditure	860,3	913,3	1.038,2	1.097,1	747,3	748,7	835,1	861,4
Gross capital formation	984,9	1.092,8	1.077,8	1.229,7	908,8	983,4	948,6	1.047,9
Increase in stocks	75,0	124,3	60,0	72,3	68,1	108,0	51,0	59,6
Gross fixed capital formation	909,9	968,5	1.017,8	1.157,4	840,7	875,4	897,6	988,3
Total domestic demand	5.161,5	5.770,2	6.115,4	6.550,9	4.719,7	5.045,4	5.263,9	5.472,7
Exports of goods and services	2.236,8	2.554,9	2.751,7	2.642,7	2.036,3	2.225,9	2.315,4	2.200,7
Less: Imports of goods and services	2.387,2	2.868,6	3.031,2	3.003,1	2.246,5	2.475,7	2.571,4	2.497,6
Statistical discrepancy	19,1	55,3	44,1	2,3	91,6	43,3	31,5	-24,2
Gross Domestic Product at market prices		5.030,2	5.511,8	5.880,0	6.192,9	4.601,1	4.838,9	5.039,4
5.151,6								
Plus: Net factor income from abroad	17,6	18,7	11,6	12,2	13,3	9,0	11,0	12,0

fall of 7,0% during 2002, compared with a rise of 4,0% in the previous year, due mainly to the fall in tourist arrivals. There was also a slowdown in the wholesale and retail trade sector, reflecting the slowdown in private consumption. In contrast, the real estate, renting and business activities sector improved, reflecting the increase in the Land Registry's revenues derived from the transfer of land ownership fees. This was the result of a buoyant real estate market in 2002 which, to a large extent, was related to the positive performance of the construction sector during the year under review.

Demand

The rate of growth of domestic demand reached 4,0% during 2002, compared with a

rise of 4,3% in 2001. This slowdown can be explained mainly by the fall in the growth rate of both private and public consumption, in real terms, to 2,4% and 3,1%, respectively, compared with 5,0% and 11,5%, respectively, in the previous year. The increase of 1,0% displayed by the volume index of retail sales, compared with a rise of 5,9% in the previous year, is indicative of the slowdown in private consumption during 2002. A restraining factor on the deceleration of domestic demand in 2002, was the significant rise of 10,5% in gross fixed capital formation, which was mainly due to the purchase of two new aircraft by Cyprus Airways and a cruise ship by a private company, as well as the increase in construction activity. Foreign demand displayed a fall of 5,0%,

compared with a rise of 4,0% in 2001, mainly as a result of a significant decline in tourist arrivals.

Inflation, productivity and the labour market

The rate of inflation during 2002 reached 2,8%, compared with 2,0% in 2001. This acceleration was primarily due to the acceleration in the prices of local industrial products and services, resulting mainly from the increase in VAT and other excise taxes in July 2002. However, the continued fall in the prices of imported motor vehicles since July 2002, due to the fall in excise taxes, as well

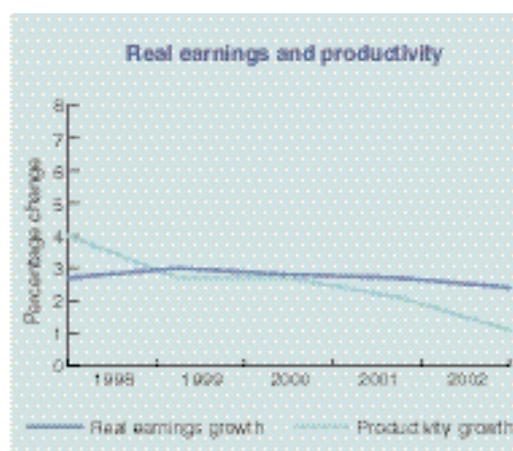


as the slowdown in economic activity, constrained, to a large extent, the rise in inflation.

More analytically, the price index of local goods grew by 4,4% in 2002, compared with a rise of 1,3% in 2001. This acceleration was due to the significant rise in the price of local industrial non-oil products, as well as the large acceleration in the price of fuel. This was mainly the result of the increases in VAT and excise taxes on petroleum products, as the prices of crude oil remained, on average, at the same level as in 2001. In contrast, the prices of local agricultural goods registered a

marked deceleration mainly due to the prevailing favourable weather conditions, while the price of electricity fell, as in 2001. As regards the price index of imported goods, there was a fall of 1,7% in 2002, compared with a rise of 0,5% in 2001, reflecting the significant fall in the prices of motor vehicles, as mentioned above. However, the prices of services recorded a slightly accelerated increase of 3,7%, due to price increases in the sectors of education, and recreation and culture, as well as other services. It is worth mentioning that the acceleration in the prices of services was held back significantly by the large fall in the prices of telecommunication services.

The growth in labour productivity registered a deceleration, increasing by 1,1%, compared with a rise of 2,1% in the previous year. This was the result of the deceleration in the rate of growth of GDP during 2002, combined with the rise of 1,1% in employment during the year under review. It should also be noted that during 2002, earnings grew by 2,4% in real terms which was higher than productivity growth.



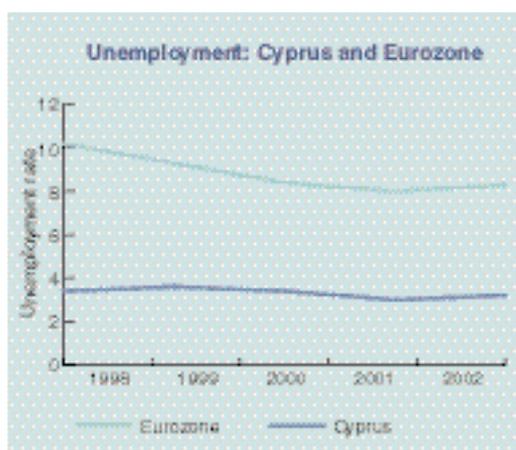
In the labour market, unemployment increased by 10,6% in 2002, compared with a

Consumer Price Index by economic origin

annual percentage change

				Weights
	2000	2001	2002	1998=100
General Consumer Price Index	4,1	2,0	2,8	100,0
Local goods	7,2	1,3	4,4	36,7
Agricultural	9,0	4,5	1,8	7,9
Industrial	4,5	0,8	5,6	27,3
Industrial, non-oil	2,5	0,1	4,6	22,9
Fuel and gas	14,9	4,0	10,6	4,4
Electricity	36,0	-3,2	-2,3	1,5
Imported goods	2,1	0,5	-1,7	22,2
Motor vehicles	3,8	0,6	-5,1	9,4
Other imported goods	0,9	0,4	0,9	12,8
Services	2,5	3,4	3,7	41,1

fall of 12,7% in 2001, while as a proportion of the economically active population it rose to 3,2%, compared with 3,0% the previous year. The rising trend in unemployment began in November 2001 and it coincides with the slowdown in economic activity during 2002.



Public finances

The fiscal deficit in 2002 increased to £215,7 million, compared with £166,5 million in 2001, reaching 3,5% of GDP, compared with

2,8% in the previous year, exceeding for the first time since 1999 the level prescribed by the relevant Maastricht convergence criterion. The rate of growth of public revenue decelerated significantly to 5,3%, compared with 11,1% in 2001. Deceleration was also exhibited by public expenditure which grew by 7,1%, compared with a rise of 11,1% during the previous year.

As far as expenditure is concerned, current expenditure displayed a deceleration, whereas capital expenditure exhibited a small acceleration. More specifically, out of current expenditure, current transfers, interest payments and social pensions registered a deceleration, while subsidies fell due to the abolition of subsidies on oil products. In contrast, social insurance fund payments as well as wages and salaries recorded an acceleration. As regards capital expenditure, there was a large increase in investment, while capital transfers exhibited a fall.

Public revenue and expenditure

£ million

	1999	2000	2001	2002 (prov.)
Total revenue and grants	1.590,9	1.865,6	2.073,2	2.182,3
Direct taxes	494,0	558,1	659,4	639,8
Income tax	334,0	373,9	482,8	460,8
Indirect taxes	562,8	653,6	722,0	803,2
Value Added Tax	236,1	296,6	344,7	403,8
Excise taxes	128,5	160,7	178,4	198,7
Import duties	56,5	62,6	73,6	72,5
Social security fund contributions	226,8	244,0	278,0	300,5
Other revenue	306,4	407,4	411,3	436,1
Foreign grants	0,9	2,5	2,5	2,7
Total expenditure and net lending	1.792,3	2.016,0	2.239,7	2.398,0
Current expenditure	1.594,9	1.789,8	2.006,0	2.170,1
Goods and services	688,0	747,3	870,1	972,2
Wages and salaries	482,7	526,3	559,7	604,5
Current transfers	288,7	322,6	374,0	425,3
Social pensions	21,1	24,3	25,7	26,9
Social security fund payments	273,0	304,2	318,8	337,6
Subsidies	39,0	79,5	91,1	64,2
Interest payments	285,0	311,8	330,0	344,0
Capital expenditure	192,8	215,8	217,2	219,0
Investment	131,1	153,2	155,6	170,7
Capital transfers	61,8	62,5	61,7	48,3
Net lending	4,6	10,4	16,5	8,9
Fiscal surplus (+)/deficit(-)	-201,4	-150,4	-166,5	-215,7
Fiscal surplus (+)/deficit(-) as a percentage of GDP (%)	-4,0	-2,7	-2,8	-3,5

Public debt⁽¹⁾

£ million

	1999	2000	2001	2002 (prov.)
Domestic debt	3.826,9	4.187,4	4.725,1	5.230,4
Long-term debt	1.013,5	1.175,4	1.580,5	2.714,8
Development stocks	862,8	1.012,6	1.368,1	1.528,9
Central Bank	77,5	75,8	70,0	7,9
Deposit money banks	173,5	253,1	695,2	938,9
Private sector	611,3	683,2	602,5	581,6
Sinking funds	0,0	0,0	0,0	0,0
Social security funds ⁽²⁾	0,5	0,5	0,5	0,5
Savings bonds	20,0	19,8	20,0	16,5
Central Bank	0,8	1,9	3,1	0,0
Private sector	19,2	17,9	16,9	16,5
Savings certificates	18,0	23,8	45,7	53,6
Private sector	18,0	23,8	45,7	53,6
Others	112,8	119,2	146,7	1.115,8
Central Bank	0,0	0,0	0,0	961,1
Local authority loans	112,8	119,2	146,7	154,7
Short-term debt	2.813,4	3.012,0	3.144,6	2.515,6
Treasury bills	2.435,8	2.426,6	2.605,9	2.538,6
Central Bank	75,1	205,8	179,6	7,9
Deposit money banks	791,2	627,9	689,2	490,3
Private sector	16,1	-12,2	28,7	70,3
Sinking funds	-266,2	-394,8	-507,7	-476,9
Social security funds ⁽²⁾	1.819,6	2.000,0	2.216,2	2.447,0
Central Bank advances	377,6	585,4	538,7	-23,0
Foreign debt	855,4	825,6	765,3	849,5
Short-term liabilities of the Central Bank to the IMF	4,8	4,8	4,8	4,8
Long-term loans	223,4	249,1	180,8	152,3
Medium-term loans (EMTN)	515,9	515,9	515,9	674,8
Short-term loans (ECP)	111,4	55,8	63,9	17,7
Total public debt	4.682,4	5.012,9	5.490,4	6.079,9
Net public debt (excluding intragovernmental and short-term liabilities of the Central Bank to the IMF)	2.857,5	3.007,7	3.268,9	3.627,7

1) There may be discrepancies between the various aggregates prepared by the Ministry of Finance and the equivalent aggregates referred to by the Central Bank in other parts of this report. This is due to differences in methodologies and definitions.

2) Intragovernmental debt.

As far as total revenue is concerned, there was a large deceleration in tax revenues. Reflecting, in part, the subdued economic activity in 2002, direct tax revenue fell, whereas revenue from indirect taxes accelerated compared with 2001. More specifically, a fall was observed in income tax, whereas revenues from VAT and excise taxes accelerated due to the increase in the rate of VAT and excise taxes in July 2002. However, revenues from import duties fell.

The fiscal deficit in 2002 was financed from both domestic and external sources. Specifically, net domestic borrowing reached £166,6 million, whereas net external borrowing amounted £49,0 million. Domestic borrowing emanated from commercial banks, in the form of treasury bills and development stocks, as well as from the non-bank private sector.

In conjunction with the increase in the fiscal deficit during 2002, net public debt, excluding intragovernmental debt, increased to 58,6% of GDP, compared with 55,7% in 2001, but still remained within the limits set by the relevant Maastricht criterion.

Balance of payments

During 2002, the current account deficit expanded, reaching £327,4 million or 5,3% of GDP, compared with 4,2% of GDP in 2001. More specifically, as far as the trade account is concerned, total exports and total imports of goods exhibited a fall of 18,8% and 1,7%, respectively, resulting in the deterioration of the trade deficit¹, which reached £1.974,6 million or 32,0% of GDP. The main development in services was the 10,3% fall in tourist arrivals, which was mainly the result of the events of 11 September 2001

and the unfavourable economic climate prevailing internationally during 2002. The current account deficit was financed mainly from direct investment and external borrowing by the public and private sectors.

It should be noted that as of 2000, the presentation of the balance of payments statistics by the Central Bank is based on a new methodology, stipulated by the Statistical Office of the European Communities (Eurostat), which in turn is based on the methodology developed by the International Monetary Fund. The new statistical presentation requires more analytical data than previously and thus the Central Bank has developed a new system of data collection and compilation for the balance of payments which provides detailed monthly data since 2002. The new system is based on statistical information provided by the commercial banks concerning their transactions with non-residents, either for their own account or for the account of their resident customers (settlements - based system), and is complemented with sample surveys and direct reporting by certain categories of residents. The adoption of the new data collection system has improved the compilation procedure, especially as regards the export of services.

Furthermore, as of 2002, the compilation of statistics has been applied in accordance with the new residency definition used by the International Monetary Fund and the European Union. According to the new definition, both natural persons who reside in Cyprus for more than one year and legal persons who operate from, and have a physical presence in Cyprus, are considered to be residents. As a consequence of the adoption of this new definition, international business

1. The trade deficit is calculated as the difference between total exports (f.o.b.) and total imports (c.i.f.).

Balance of payments

£ million

	2001			2002 (prov.)		
	Credit	Debit	Net	Credit	Debit	Net
Current account	3.178,5	3.432,6	-254,0	3.254,5	3.582,0	-327,4
Goods, services and income	3.146,8	3.414,8	-267,9	3.130,5	3.495,9	-365,5
Goods and services	2.784,2	3.030,5	-246,2	2.876,6	3.268,0	-391,4
Goods	628,0	2.268,3	-1.640,2	510,2	2.236,3	-1.726,1
Services	2.156,2	762,2	1.394,0	2.366,4	1.031,7	1.334,7
Transport	277,4	373,2	-95,8	344,7	456,0	-111,3
Sea transport	58,1	234,3	-176,2	131,8	311,8	-180,0
<i>Passenger</i>	16,4	0,0	16,4	9,5	1,1	8,3
<i>Freight</i>	7,4	226,8	-219,5	16,5	178,6	-162,2
<i>Supporting, auxiliary and other services</i>	34,4	7,5	26,9	105,9	132,0	-26,2
Air transport	219,3	138,9	80,4	212,9	144,2	68,8
<i>Passenger</i>	118,5	90,2	28,3	129,9	46,0	83,9
<i>Freight</i>	12,0	0,0	12,0	11,1	61,7	-50,6
<i>Supporting, auxiliary and other services</i>	88,8	48,7	40,2	72,0	36,5	35,5
Travel	1.290,0	275,0	1.015,0	1.160,3	286,0	874,3
Communications services	19,5	12,8	6,7	15,8	24,3	-8,5
Construction services	0,0	0,0	0,0	43,0	4,0	39,0
Insurance services	0,0	39,5	-39,5	24,0	15,0	9,0
Financial services and renting	0,0	0,0	0,0	74,0	24,0	50,0
Design and information services	0,0	0,0	0,0	10,0	3,8	6,2
Royalties and licence fees	0,0	13,0	-13,0	1,0	11,5	-10,5
Other business services	393,6	31,3	362,3	503,8	148,4	355,4
Personal, cultural and recreational services	0,2	2,8	-2,6	6,6	6,8	-0,2
Government services, n.i.e.	175,5	14,6	160,9	183,2	52,0	131,2
Income	362,6	384,3	-21,7	253,9	228,0	25,9
Remuneration of employees	50,0	51,1	-1,1	20,3	26,5	-6,2
Investment income	312,6	333,2	-20,6	233,6	201,5	32,1
<i>Of which:</i>						
<i>Reinvested earnings</i>	38,0	12,0	26,0	21,0	-0,1	21,1
Current transfers	31,7	17,8	13,9	124,1	86,0	38,0
General government	14,7	0,0	14,7	5,9	0,8	5,0
Other sectors	17,0	17,8	-0,8	118,2	85,2	33,0
Capital and financial account	1.316,5	1.166,4	150,1	1.299,3	996,5	302,8
Financial account	1.316,5	1.166,4	150,1	1.299,3	996,5	302,8
Direct investment	105,0	140,0	-35,0	131,7	36,5	95,2
<i>By Cypriot residents abroad</i>	0,0	140,0	-140,0	0,0	36,5	-36,5
<i>By non-residents in Cyprus</i>	105,0	0,0	105,0	131,7	0,0	131,7
Portfolio investment	337,0	285,0	52,0	115,5	653,1	-537,6
<i>Assets</i>	0,0	285,0	-285,0	0,0	653,1	-653,1
<i>Liabilities</i>	337,0	0,0	337,0	115,5	0,0	115,5
<i>Derivatives</i>	0,0	0,0	0,0	0,0	31,1	-31,1
Other investment	874,5	347,6	526,9	1.052,1	30,3	1.021,8
<i>Assets</i>	0,0	347,6	-347,6	1.052,1	0,0	1.052,1
<i>Liabilities</i>	874,5	0,0	874,5	0,0	30,3	-30,3
Reserve assets	0,0	393,8	-393,8	0,0	245,5	-245,5
Net errors and omissions			103,9			24,6

Notes:

(1) The adoption of the new methodology for compiling data through the banking system in 2002 has improved the collection of statistics, especially as regards the export of services.

(2) In 2002, a new definition of "resident" was adopted consistent with the methodology of the IMF and EU.

companies (IBCs) with a physical presence in Cyprus are now considered as residents rather than non-residents, as was previously the case.

Trade balance

The main development in the balance of trade during 2002 was the significant fall in imports destined for re-exports and an almost

corresponding fall in re-exports. Furthermore, imports for home consumption exhibited a significant deceleration due to the slowdown in domestic economic activity during the year under review, while a small decline in domestic exports was observed.

More analytically, total imports recorded a small decrease of 1,7% in 2002, in contrast

Imports (c.i.f.) by economic origin

£ million

	2000	2001	2002 (prov.)	% change	
				2001/2000	2002/2001 (prov.)
Consumer goods	569,6	617,7	651,7	8,4	5,5
Non-durable	308,7	338,1	358,4	9,5	6,0
Semi-durable	157,4	170,4	180,1	8,3	5,7
Durable	103,5	109,2	113,1	5,5	3,6
Intermediate inputs	675,1	710,3	719,5	5,2	1,3
Agriculture	42,0	42,2	43,5	0,3	3,0
Construction and mining	110,4	120,7	134,0	9,4	11,0
Manufacturing	398,8	421,8	426,9	5,8	1,2
Transport, storage and communications	44,9	29,4	23,2	-34,6	-21,0
Other	79,0	96,2	92,1	21,7	-4,3
Capital goods	237,1	258,3	243,3	8,9	-5,8
Agriculture	8,8	8,8	8,4	0,7	-4,1
Construction and mining	15,7	20,6	20,6	31,3	-0,2
Manufacturing	67,0	69,6	61,6	4,0	-11,5
Transport, storage and communications	43,8	52,3	46,8	19,3	-10,6
Other	101,9	107,0	105,9	5,0	-1,0
Transport equipment and parts	186,4	226,6	283,3	21,6	25,0
Motor vehicles	74,9	94,6	98,3	26,3	3,9
Spare parts	53,3	61,3	61,8	15,1	0,8
Aircraft and parts	0,8	0,6	42,7		
Fuels and lubricants	269,3	266,1	226,2	-1,2	-15,0
Unclassified	31,1	97,9	134,0		
Imports (c.i.f.) for home consumption	1.968,7	2.176,8	2.257,9	6,9	3,7
Imports destined for re-export	433,3	351,9	227,0	-18,8	-35,5
Total imports	2.401,9	2.528,7	2.484,8	2,4	-1,7
Non-oil civil imports for home consumption	1.668,0	1.813,0	1.885,5	8,7	4,0

Note: The figures for imports are based on available data covering the first ten months of 2002.

to an increase of 2,4% in the previous year. The main reason for this decrease was the 35,5% fall in imports destined for re-exports. The decline in total imports would have been greater if the additional increase in imports of military equipment amounting to £30,1 million and the purchase of aircraft by

Cyprus Airways valued at £42,5 million are excluded. Non-oil civil imports for home consumption registered a significant deceleration, with an increase of 4,0%, compared with a rise of 8,7% in 2001.

A detailed analysis of imports for home con-

Exports (f.o.b.) by economic origin

£ million

	2000	2001	2002 (prov.)	% change	
				2001/2000	2002/2001 (prov.)
Agricultural products (raw)	34,4	43,8	36,2	27,4	-17,4
Of which:					
Potatoes	12,3	17,5	10,7	42,3	-39,1
Other fresh vegetables, frozen or dried	3,2	4,2	4,0	42,3	-5,6
Citrus fruit	12,8	14,7	18,3	14,8	24,8
Minerals and industrial products of mineral origin	12,4	11,6	10,3	-6,3	-11,3
Industrial products of agricultural origin	28,2	28,0	33,6	-0,7	20,0
Halloumi cheese	7,6	7,7	11,6	1,3	50,0
Preserved fruit	1,5	0,9	0,9	-40,0	4,5
Fruit and vegetable juices	3,5	4,1	4,8	17,1	17,1
Beer	1,0	1,0	0,9	0,0	-10,3
Wines	6,2	5,3	5,5	-14,5	3,6
Industrial products of manufacturing origin	148,8	150,5	142,4	1,1	-5,4
Cigarettes	16,2	10,8	4,6	-33,3	-57,5
Cement	10,8	8,4	10,1	-22,2	20,7
Pharmaceutical products	30,9	39,4	43,9	27,5	11,3
Articles of paper	4,8	6,0	5,6	25,0	-5,9
Clothing	22,5	19,7	16,1	-12,4	-18,3
Footwear	6,1	3,8	2,9	-37,7	-23,9
Furniture	7,9	6,8	6,0	-13,9	-11,5
Unclassified	0,0	0,1	0,1		
Total domestic exports	224,0	233,9	222,5	4,5	-4,9
Re-exports	299,6	337,0	246,0	12,5	-27,0
Goods procured in ports by carriers (shipstores)	68,3	57,1	41,7	-16,4	-27,0
Total exports	591,9	628,0	510,2	6,1	-18,8

Note: The figures for exports are based on available data covering the first ten months of 2002.

sumption reveals that in 2002 there was a deceleration in imports of consumer goods, which increased by 5,5%, compared with an 8,4% increase in 2001. A slowdown was recorded by imports of intermediate goods and raw materials which exhibited a deceleration, rising by 1,3%, compared with a growth rate of 5,2% in 2001. Imports of capital goods recorded a fall of 5,8%, compared with an increase of 8,9% in the previous year. This decline was, in part, due to a correction following the significant increase in the two previous years and reflects the subdued economic activity during 2002. In contrast, a significant increase of about 25,0% was observed in imports of transport equipment and spare parts which is due to the purchase of two aircraft by Cyprus Airways. The first aircraft, valued at £22,4 million, was bought in May and the second, valued at £20,1 million, was bought in July. Excluding this purchase, the rate of growth of imported transport equipment and parts registered a deceleration and reached only 6,4%, compared with an increase of 21,6% in 2001.

Total exports recorded a fall during 2002, due mainly to the fall in re-exports, which, in part, is related to the slowdown in worldwide economic activity during the year under review. Specifically, total exports exhibited a fall of 18,8%, compared with an increase of 6,1% recorded in 2001, whereas re-exports registered a significant fall of 27,0%, compared with an increase of 12,5% in the previous year.

All categories of domestic exports recorded a decline during 2002, with the exception of exports of industrial products of agricultural origin which registered a significant increase, due to the increase in exports of halloumi cheese, meat and fruit. Exports of

industrial products exhibited a fall, even though pharmaceutical products recorded a rise.

Services

The surplus in services is estimated to have reached £1.334,7 million in 2002, compared with £1.394,0 million in 2001. This reduction was due mainly to the fall in revenue from tourism and the concomitant reduction in the surplus of travel services. More analytically, in 2002, revenue from tourism, which is the main source of foreign exchange inflows, decreased by 11,0%, due to the events of 11 September 2001 and the resulting impact on world travel, as well as the slowdown in the world economy that prevailed during 2002.

Despite the adverse international environment, the international business sector, which is the second largest source of foreign exchange inflows, and is included in the category of "other business services", displayed an increase of 13,1% in 2002, compared with a rise of 9,9% in 2001. The higher growth rate of earnings from this sector, however, reflects the improved collection of data.

As far as other categories of services are concerned, the transport account registered a deficit of £111,3 million in 2002, compared with a deficit of £95,8 million in 2001. This was due to the fall in tourist arrivals and the slowdown in international trade. More analytically, sea transport showed a deficit of £180,0 million in 2002, compared with a deficit of £176,2 million in 2001, while the surplus of £80,4 million registered in the air transport sector in 2001 decreased to £68,8 million in 2002. As regards the telecommunications sector, the net outflows reached £8,5 million in 2002, compared to net

inflows of £6,7 million in 2001. This development is mainly due to the extensive use of mobile phones by Cypriots travelling abroad, and to the increase in international calls, following reductions in telephone charges. It should, however, be noted that the apparent improvement in many categories of services was mainly due to the better collection of data.

Income

The income account recorded a surplus of £25,9 million in 2002, compared with a £21,7 million deficit in 2001. The improvement in the income account was mainly due to the increase in investment income which exhibited a net inflow of £32,1 million in 2002, compared to net outflows of £20,6 million in 2001. This was partly the result of the reduction in interest rates and its impact on interest receipts and, to a larger extent, on interest payments.

As regards income from labour, a significant reduction in remuneration payments and, to a larger extent, revenue, was observed. This development was mainly due to the adoption of a new definition of residency, according to which all foreign workers working in Cyprus for more than one year are considered to be residents as of 2002. Similarly, the same applies to all Cypriots working abroad for more than one year, in which case they are not considered to be Cypriot residents as of 2002.

Current transfers

The current transfers surplus increased to £38,0 million in 2002, compared with £13,9 million in 2001. This development is mainly due to inflows from Cypriots working abroad and the inflows from Cypriot emigrants who returned to Cyprus.

Financial and capital account transactions

The financial account registered a surplus of £302,8 million during 2002, compared with a surplus of £150,1 million in 2001.

In particular, as a result of the increase of direct investment by non-residents in Cyprus and the fall of direct investment by residents abroad, foreign direct investment recorded a net inflow of £95,2 million in 2002, compared with a net inflow of £35,0 million in 2001. As regards portfolio investment, an outflow of £537,6 million was exhibited in 2002, compared with an inflow of £52,0 million in 2001. This development was the result of investment in foreign bonds by domestic banks and international banking units.

In the category of other investment, a significant net inflow was displayed, mainly as a result of the sizeable reduction in net assets of residents, including international business companies, amounting to £1.052,0 million. This decline in assets resulted from the significant reduction in foreign placements by banks, mainly international banking units .

International reserves

Reflecting the developments in the financial and capital account transactions, official international reserves increased significantly to £1.734,9 million in 2002, compared with £1.558,4 million in 2001. The coverage provided by official reserves at the end of 2002 with respect to total imports (cif) increased from 8,2 months in 2001 to 9,3 months in 2002.

Exchange rates

During 2002, the Cyprus pound recorded very small movements against the euro. According to the existing exchange rate pol-

icy framework, the fluctuation margins of the Cypriot currency are $\pm 15,0\%$ from the central parity, in line with the Exchange Rate Mechanism II (ERM II).

Reflecting the significant strengthening of the euro against the other international currencies during 2002, especially during the last quarter, the Cyprus pound strengthened against the pound sterling, the US dollar and the Japanese yen by 1,3%, 5,7% and 8,7%, respectively.

3.2 Monetary policy and monetary developments

Monetary policy

Monetary policy in Cyprus in 2002 was exercised in a difficult international and domestic environment, resulting to a large extent from the terrorist attacks on 11 September 2001.

Following the economic downturn which was observed worldwide in 2001, the forecasts of analysts for 2002 were based on the assumption of a recovery in the major economies. Despite the forecasts, and even though most of 2002 did indeed indicate a partial recovery, the revival faltered towards the end of the year. Specifically, the downturn in the main stock markets of the USA, Europe and Asia continued. In Latin America, the economies of Argentina and Venezuela suffered due to internal unrest, causing further regional repercussions. Both consumer and business confidence continued to be subdued worldwide, whereas, at the same time, the high prices of property and oil exerted a further adverse impact on international economic activity.

The Cyprus economy did not remain unaffected by these international developments. The rate of growth of GDP fell from 4,1% in

2001 to 2,0% in 2002, due mainly to the slowdown in domestic consumption and investment activity, as well as the fall in exports of goods and services. This was also reflected in the slowdown observed in the growth rate of credit to the private sector. In parallel, the stock market continued its downturn during 2002.

The change in the Central Bank's stance towards a more relaxed monetary policy began in the second half of 2001 and was the result of the international downturn. Specifically, the implications of this slowdown on the domestic economy, the continued fall in share prices and the increased inflow of foreign exchange, were the main factors that led the Bank to proceed with three equal reductions in the base rate, each reduction being one-half (0,5) of a percentage point.

The improved outlook which the economic indicators exhibited towards the end of 2001, led to a cautious optimism for an economic recovery in 2002. The international recovery, even though uncertain, continued during the major part of 2002, while concerns emerged about a possible increase in inflation worldwide. As a result, the period of relaxed monetary policy was considered to have come to an end. Most central banks maintained a cautious stance during this period, avoiding any change in their policies regarding interest rates. On the domestic front, in view of the higher inflation, as well as the fact that economic activity, despite the decline in tourist arrivals, compared favourably with economic activity worldwide, the Central Bank maintained its interest rates unchanged.

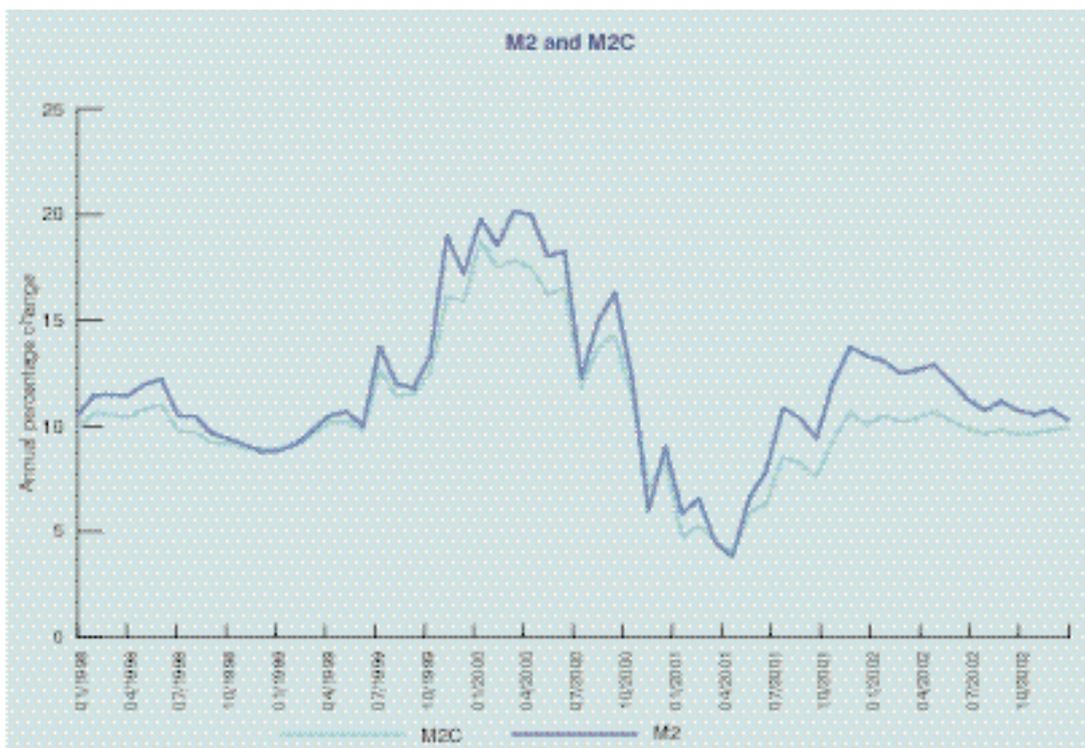
Domestic inflationary pressures played a significant role for the Central Bank's decisions

regarding monetary policy. The unstable international political developments led to forecasts of high oil prices and, more generally, inflationary pressures which were also fuelled by domestic factors such as the increase in indirect taxes which was due to come into effect in July 2002. Furthermore, the granting of wage increases in various sectors of the economy, together with an increase in personal disposable income resulting from the impending tax reform, as well as the increase in liquidity through the net repayment of government securities, fuelled inflationary pressures. Despite the fact that the impact of excess bank liquidity on inflation and the current account deficit was mitigated by the subdued demand for loans to the private sector, there was a risk of increasing inflationary pressures, had the low demand for credit been reversed. Furthermore, the strengthening of the euro and, as a consequence, the Cyprus pound against the dollar and sterling, partly kept

domestic inflationary pressures in check.

During the last quarter of 2002, the worldwide economic recovery was subdued, as a result of the uncertainty prevailing in geopolitical developments. The weakened international recovery, in combination with continued uncertainty, restrained consumption and investment expenditure and increased unemployment, led the US Federal Reserve to reduce its key official rate by one-half (0,5) of a percentage point. The European Central Bank (ECB), prompted by similar concerns, proceeded on 5 December 2002 with an equal reduction in its interest rates, resulting in a widened spread between Cypriot and European key official rates. These developments, combined with the small decline in domestic inflation in October and November, and the continued subdued economic activity, strengthened the arguments for a reduction in interest rates.

Taking into account the above considera-



tions, the Central Bank of Cyprus decided on 13 December 2002 to reduce the marginal lending facility rate (Lombard) by one-half (0,5) of a percentage point, i.e. to 5,00%. At the same time the Bank also decided to keep the deposit facility rate unchanged at 2,50%.

Monetary developments

Monetary and credit developments

After its acceleration in 2001, the rate of growth of total money supply slowed down to 10,3% in December 2002, compared with a rise of 13,3% a year earlier. The rate of growth of money supply in 2002, including the Co-operative Credit Institutions (M2C)², displayed an even larger slowdown, reaching 9,9%. The deceleration registered by total liquidity was mainly the result of a slowdown in quasi-money.

In 2002, narrow money supply (M1), which consists of notes and coins in circulation and demand deposits, recorded a rise of 2,4% or £24,8 million, compared with an increase of 1,1% or £10,9 million in 2001. Quasi-money exhibited a more restrained slowdown, which was reflected in all its components. Specifically, savings deposits increased by 8,9%, compared with a rise of 9,7% in 2001, reaching £19,6 million. The rate of growth of time deposits showed a deceleration, falling from 15,1% or £764,2 million in 2001 to 12,4% or £724,9 million in 2002, whereas the foreign currency deposits of Cypriot residents registered a fall of 2,3%, in contrast to an increase of 28,3% in the previous year.

The slowdown in the growth of total money supply (M2) in 2002 reflects the reduction in claims on the private and public sectors and

Total money supply

£ thousand

	End of period balances		Change		
	2002	2001	2002	2002	
				1st half	2nd half
Money supply (M1)	1.037.186	10.931	24.777	-79.071	103.848
Currency in circulation	392.844	23.269	36.319	9.136	27.183
Demand deposits	626.584	-14.411	-21.292	-89.124	67.832
Foreign currency demand deposits of Cypriot residents	17.758	2.073	9.750	917	8.833
Quasi-money	7.126.757	859.094	736.540	255.497	481.043
Savings deposits	239.485	19.489	19.621	1.955	17.666
Time deposits	6.553.853	764.226	724.859	279.526	445.333
Foreign currency deposits of Cypriot residents	333.419	75.379	-7.940	-25.984	18.044
Total money supply (M2)	8.163.943	870.025	761.317	176.426	584.891

2. A detailed description of the M2C aggregate can be found in the Monetary Policy Report, January 2003.

net foreign assets. Specifically, the annual rate of growth of loans to the government reached 17,1%, compared with 29,6% in 2001. In absolute terms, lending to the public sector increased by £254,3 million in 2002, compared with an increase of £339,0 million in the previous year. Adjusted for the impact of net government borrowing from abroad, the net lending of banks to the public sector showed an increase of £315,5 million, compared with an increase of £273,9 million in the previous year.

Net foreign assets fell by £78,5 million, compared with an increase of £165,0 million in 2001, thus contributing to the slowdown of total money supply. Excluding the impact of government external borrowing, foreign assets exhibited outflows of £139,7 million in 2002. In contrast, a net injection of liquidity amounting to £2,8 million was effected by transactions in unclassified items during the year under review, compared with an absorption of liquidity of £438,1 million in 2001.

Factors affecting total money supply

£ thousand

	End of period balances		Change		
	2002	2001	2002	2002	
				1st half	2nd half
Net foreign assets	483.660	165.034	-78.498	-94.496	15.998
Official (net)	1.689.963	393.418	186.800	47.712	139.088
All banks (net)	-1.242.803	-228.819	-272.903	-148.007	-124.896
IMF reserve position	36.500	435	7.605	5.799	1.806
Claims on private sector	7.902.852	804.095	582.780	342.425	240.355
By all banks	7.902.852	804.834	582.780	342.425	240.355
By monetary authorities	0	-739	0	0	0
Claims on public sector	1.738.309	338.985	254.256	-40.382	294.638
Central government	1.778.429	334.231	266.429	-36.507	302.936
Advances and loans	1.030.870	116.968	460.821	183.171	277.650
Securities, treasury bills, etc.	1.413.827	325.893	-153.713	-92.787	-60.926
Government deposits ⁽¹⁾	-666.268	-108.630	-40.679	-126.891	86.212
Government agencies ⁽²⁾	-3.620	5.189	-4.568	1.924	-6.492
Advances and loans	71	222	-6.900	-2.053	-4.847
Deposits ⁽¹⁾	-3.691	4.967	2.332	3.977	-1.645
IMF reserve position	-36.500	-435	-7.605	-5.799	-1.806
Unclassified items	-1.960.878	-438.089	2.779	-31.121	33.900
Total money supply	8.163.943	870.025	761.317	176.426	584.891

(1) A negative sign indicates an increase and no sign indicates a decrease.

(2) These consist of the Vine Products Commission and the Cyprus Grain Commission.

Bank credit by sector

£ thousand

	End of period balances		Change		Share (%) ⁽¹⁾	
	2001	2002	2001	2002	2001	2002
Public institutions and corporations ⁽²⁾	231.144	248.504	57.127	17.360	6,4	2,8
Agriculture	119.786	112.853	2.312	-6.933	0,3	-1,1
Mining	27.817	26.988	4.508	-829	0,5	-0,1
Manufacturing	538.339	560.721	32.766	22.382	3,7	3,6
Transport and communications	119.300	136.284	24.599	16.984	2,8	2,7
Foreign and domestic trade	1.503.788	1.615.045	173.441	111.257	19,6	17,7
Building and construction	1.061.092	1.197.772	153.454	136.680	17,3	21,7
Tourism	761.890	818.811	147.418	56.921	16,6	9,0
Personal and professional loans	3.280.199	3.557.901	295.038	277.702	33,3	44,1
Bills discounted:						
Local	4.780	3.929	-3.190	-851	-0,4	-0,1
Foreign	3.768	3.323	-1.318	-445	-0,1	-0,1
Total	7.651.903	8.282.131	886.155	630.228	100,0	100,0

(1) Refers to the change in credit.

(2) Includes government loans.

The slowdown in the rate of growth of claims on the private sector and the continued excess liquidity in the banking system, were the dominant features in the monetary field during 2002. The annual growth of bank lending fell to 8,0% in 2002, compared with 12,3% in the previous year. This slowdown was due to the decline in the demand for loans and, more generally, the subdued economic activity, as well as stricter bank policies for the assessment of loan applications.

An analysis of bank lending by sector of economic activity indicates that in 2002 personal and professional loans, construction, and foreign and domestic trade, absorbed the largest proportion of new credit, reaching 44,1%, 21,7% and 17,7%, respectively. As regards foreign currency loans to Cypriots, there was a significant slowdown in 2002 compared with the previous year. Cypriots

also showed an increased preference for foreign currencies other than the euro. Specifically, foreign currency borrowing was effected increasingly in dollars, Swiss francs and yen, with the result that lending in euros was restricted to about 60,0% of new foreign currency loans, compared with 80,0% in the previous year.

Co-operative Credit Institutions

As far as the Co-operative Credit Institutions (CCIs) are concerned, their deposits accounted for 33,3% of total deposits, compared with 32,4% in the previous year. The remaining market share of 66,7% in 2002 and 67,6% in 2001 was accounted for by the commercial banks. In 2002, deposits in CCIs grew by 13,0%, compared with an increase of 10,2% in 2001, whereas the growth of local currency deposits in banks grew by 8,4% and 10,2%, respectively.

Co-operative Credit Institutions

End of period	Total deposits		Total loans	
	Value £'000	% change over previous year	Value £'000	% change over previous year
1982	197.140	25,5	151.768	28,7
1983	238.427	20,9	195.631	28,9
1984	290.078	21,7	237.634	21,5
1985	340.476	17,4	299.122	25,9
1986	401.169	17,8	357.395	19,5
1987	493.196	22,9	425.482	19,1
1988	615.953	24,9	521.264	22,5
1989	745.554	21,0	647.119	24,1
1990	902.861	21,1	787.950	21,8
1991	1.055.808	16,9	936.967	18,9
1992	1.230.315	16,5	1.108.023	18,3
1993	1.417.260	15,2	1.270.431	14,7
1994	1.608.417	13,5	1.452.322	14,3
1995	1.802.002	12,0	1.651.945	13,7
1996	1.976.253	9,7	1.838.032	11,3
1997	2.188.198	10,7	1.991.267	8,3
1998	2.416.375	10,4	2.132.803	7,1
1999	2.570.687	6,4	2.410.214	13,0
2000	2.821.560	9,8	2.483.933	3,1
2001	3.109.080	10,2	2.519.097	1,4
2002 (prov.)	3.513.030	13,0	2.672.080	6,1

The loans granted by the CCIs in 2002 expanded by 6,1% compared with an increase of 1,4% in the previous year. Despite the aforementioned acceleration and the slowdown exhibited in bank lending, loans by the CCIs as a proportion of total loans fell marginally, reaching 24,4% compared with 24,8% in the previous year.

The money market

Government securities

The government financed a large part of its

borrowing requirements with loans from the Central Bank and from abroad. This resulted in net repayments of government securities, which totalled £16,9 million, in contrast to net sales of £528,4 million in the previous year, thus contributing to excess bank liquidity in 2002. Specifically, the proportion of acceptance of offers for government securities through auction, i.e. the ratio of the value of securities actually sold to the total value of securities offered for sale, fluctuated at around 49,4%, whereas the ratio of the value of securities sold to the total value of bids

was even lower at 34,7%. It is worth noting that during the period April to December, the government conducted only one auction for 3-month treasury bills whereas no auctions were conducted for 1-year treasury bills for the periods May-June and October-December.

Interest rates

During 2002, the Central Bank, in the context of its anti-inflationary policy, intervened in the money market through deposit accep-

tance auctions (depos) and absorbed a monthly average of £314,3 million of liquidity, compared with a monthly average of £86,8 million during the second half of 2001. It should be noted that during the first five months of 2001, repos were auctioned. As already mentioned, the base lending rate remained unchanged during most of the year under review, with only one reduction of one-half (0,5) of a percentage point on 13 December. In particular, the marginal lending facility rate (Lombard rate) remained at

Interest rates

percent per annum

Period	Main refinancing operations		Treasury bills		Development stocks			
	Repos	Rev. Repos/ Depos	13 weeks	52 weeks	2 years	5 years	10 years	15 years
2001 January	6,50	-	6,03	6,45	-	7,46	7,68	-
February	6,25	-	6,10	6,56	-	7,43	7,70	-
March	6,41	-	6,09	6,61	-	7,49	7,59	-
April	-	-	6,14	6,63	6,75	7,49	7,72	-
May	-	-	6,14	6,60	6,74	7,44	7,72	-
June	-	5,39	5,49	6,45	6,71	7,36	-	-
July	-	5,39	-	6,28	6,57	7,26	7,57	-
August	-	5,06	-	6,10	-	-	-	-
September	-	4,60	-	5,50	-	-	-	-
October	-	4,08	-	-	5,20	5,70	-	6,47
November	-	3,88	-	-	-	-	-	-
December	-	3,75	-	-	4,70	5,04	-	-
2002 January	-	3,82	4,00	4,25	4,54	4,99	-	-
February	-	3,78	4,00	4,21	4,58	5,02	5,37	-
March	-	3,76	4,00	4,22	-	5,06	-	-
April	-	3,91	-	4,50	4,65	5,08	-	5,59
May	-	3,96	-	-	-	-	-	-
June	-	3,91	-	-	-	-	-	-
July	-	3,93	4,08	4,38	4,56	5,10	-	-
August	-	3,91	-	4,28	4,54	5,11	-	-
September	-	3,99	-	4,28	4,53	5,10	-	-
October	-	3,98	-	-	4,49	5,09	5,36	5,60
November	-	3,98	-	-	-	-	-	-
December	-	3,95	-	-	-	-	-	-

Bank interest rates

percent per annum

	Lending rates ^{(1), (2)}					Deposit rates ^{(1), (3)}		
	Business overdraft within limits	Business secured loans	Personal secured loans	Housing loans secured by life insurance policy	Credit cards	Current accounts	3 month notice over £5.000	1 year fixed over £5.000
2001 January	7,92	7,92	8,95	8,67	10,50	2,00	5,25	6,50
February	7,92	7,92	8,95	8,67	10,50	2,00	5,25	6,50
March	7,92	7,92	8,95	8,67	10,50	2,00	5,25	6,50
April	7,92	7,92	8,95	8,67	10,50	2,00	5,25	6,50
May	7,92	7,92	8,95	8,67	10,50	2,00	5,25	6,50
June	7,92	7,92	8,95	8,67	10,50	2,00	5,25	6,50
July	7,92	7,92	8,95	8,67	10,50	2,00	5,25	6,50
August	7,42	7,42	8,45	8,17	10,17	1,50	4,75	6,00
September	6,92	6,92	7,95	7,67	9,67	1,00	4,25	5,42
October	6,92	6,92	7,95	7,67	9,67	1,00	4,25	5,42
November	6,42	6,42	7,45	7,17	9,00	0,50	3,75	4,92
December	7,12	7,12	7,95	7,00	9,00	0,90	4,00	4,94
2002 January	7,12	7,12	8,03	7,00	10,00	0,92	4,00	4,95
February	7,12	7,12	8,12	7,08	10,50	0,93	4,03	4,95
March	6,78	7,13	7,90	7,15	10,50	0,93	4,03	4,79
April	6,78	7,13	7,90	7,15	10,50	0,93	4,03	4,79
May	6,78	7,13	7,90	7,15	10,50	0,93	4,03	4,79
June	6,98	7,16	7,90	7,15	10,50	0,93	4,42	4,85
July	6,98	7,16	7,90	7,15	10,50	0,93	4,42	4,85
August	6,98	7,16	7,90	7,21	10,50	0,83	4,42	4,85
September	6,98	7,16	7,90	7,21	10,50	0,84	4,37	4,88
October	7,15	7,33	7,90	7,21	10,50	0,84	4,37	4,88
November	7,15	7,33	7,90	7,21	10,50	0,83	4,40	4,84
December	6,98	6,88	7,52	6,78	10,33	0,66	3,80	4,56

(1) Reported as at end of month.

(2) For the period January 2001 to November 2001, data refer to the average of the minimum rates charged on each loan category, as reported by the three largest banks. From December 2001, data refer to the average of the representative rates charged on each loan category, as defined by the three largest banks.

(3) Data refer to the average of the representative interest rates offered on each deposit category, as defined by the three largest banks.

5,50% until November, compared with 4,25% in the eurozone during the first 11 months, whereas on 13 December it was reduced to 5,00%, compared with 3,75%, the equivalent rate in the euros system. Consequently, the rates for all types of loans remained stable until and including November, whereas they fell in December.

As regards the overnight deposit facility rate, this remained stable at 2,50% throughout the year, compared with 2,25% and 1,75% prevailing in the eurozone during the period January - November and December 2002, respectively.

As can be seen from the table titled "Bank

interest rates”, the deposit and lending rates of commercial banks remained stable for the first 11 months of the year under review and exhibited a fall during December, reflecting the trend of the base rate, in other words of

the marginal lending facility rate, as set by the Central Bank. Indicatively, in December 2002 the rate of interest on 3-month time deposits was 3,80%, whereas the lending rate for secured business loans was 6,88%.

4. Functions of the Bank

4.1 The role of the Central Bank in the process of accession of Cyprus to the European Union

In a historical meeting held in Copenhagen on 12 and 13 December 2002 concerning the enlargement of the European Union, the European Council decided to accept Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia as members of the European Union on 1 May 2004. On 9 April 2003, the European Council is due to approve the Accession Treaty, which will be signed in Athens on 16 April 2003.

Of special importance for Cyprus's accession was the report of the European Commission on the island's progress. The report, which was published on 9 October 2002, gives a very positive assessment of Cyprus's progress towards harmonisation and its ability to fulfil its commitments towards the EU.

The Central Bank of Cyprus played, and is still playing, an important role in the process of harmonisation, especially in the areas of free movement of capital, banking services and economic and monetary union. The Central Bank participates actively in the co-ordination mechanisms of the Cypriot authorities and in meetings and collaboration with the European Commission. Below is a summary description of the harmonisation measures taken by the Central Bank in the areas of its competency during 2002, as well as the measures expected to be taken for the completion of the harmonisation process in each sector, in accordance with the action plan which has been prepared.

Free movement of capital

The progress of the third and final phase of the abolition of exchange control restrictions, which was formulated by the Central Bank in collaboration with other competent authorities during the course of the accession negotiations, is at an advanced stage of completion.

In March 2002, liberalisations were introduced allowing Cypriot residents to undertake portfolio investments abroad and deposit funds in overseas banks. Specifically, natural persons who are at least 18 years of age were allowed to transfer abroad up to £20,000 annually, either for the purchase of securities listed on stock exchanges in EU countries or for the purchase of units of undertakings for collective investments in transferable securities (UCITS) which fulfil EU requirements. Alternatively, part or all of this amount could be deposited with banks abroad. In September 2002, the aforementioned amount was raised to £50,000. At the same time, the limits for certain personal capital movements (i.e. gifts, inheritances and migration allowance) were also increased. The requirement to notify the Central Bank prior to the export of capital for direct investments abroad was abolished, except in cases where the expected foreign exchange cost of the investment exceeds £5,0 million annually. Furthermore, the procedures for the handling of international transactions were simplified through the issue of new Central Bank directives to banks.

For the completion of the liberalisation of the movement of capital, the Central Bank prepared a draft law titled the Movement of Capital Law of 2003, which is aimed at

repealing the Exchange Control Law and ensuring the free movement of capital in accordance with the *acquis communautaire*. The draft law is expected to be enacted in 2003, with the proviso that it comes into force on the date of Cyprus's accession to the EU.

During the pre-accession period, the gradual abolition of exchange control restrictions will continue with the issue of directives by the Central Bank based on the existing Exchange Control Law. Specifically, the Central Bank intends to adopt a set of important harmonisation measures during 2003, which will abolish most of the remaining exchange control restrictions, with the exception of certain potentially volatile or destabilising capital flows which will be liberalised upon the island's accession to the EU.

On 1 January 2002, in line with the gradual abolition of exchange control restrictions, a new system for the collection and compilation of statistics for the balance of payments was introduced. This new system replaced exchange controls as a source of information and is able to produce statistics consistent with the requirements of the EU.

As regards the prevention of the use of the financial system for money laundering, which is an important part of the chapter in the negotiations for the free movement of capital, Cypriot legislation is aligned with the *acquis*. Furthermore, the administrative institutions and mechanisms for the effective application of the legislation also function satisfactorily. During the course of 2002, the Central Bank issued new guidance notes in its role as the supervisory authority under the Prevention and Suppression of Money Laundering Activities Law of 1996, with the

aim of further strengthening the measures to combat money laundering. Specifically, on 29 March 2002, the Central Bank issued a guidance note to all banks, setting out stricter procedures for the identification of the beneficial owners/controllers of corporate customers, "client accounts" opened by professional intermediaries (lawyers, accountants, stockbrokers and other intermediaries), as well as politically exposed persons. On 11 October 2002, the Central Bank issued a guidance note to all legal and natural persons authorised under the Exchange Control Law to offer money transmission services, for the purpose of introducing procedures to combat money laundering, similar to the procedures prevalent in other financial institutions.

Regarding payment systems, in January 2003, the Settlement Finality in Payment and Securities Settlement Systems Law of 2003 (8(1)/2003), which was drafted by the Central Bank of Cyprus, was passed by the House of Representatives. This Law, which is intended to transpose the relevant EU directive (98/26/EC), comes into effect immediately upon Cyprus's accession to the EU. With the passing of this Law, the legal harmonisation of payment systems with the *acquis* has been almost completed.

Banking services

In the banking sector, the rules, policy and practice of the Central Bank have been aligned with the directives of the EU.

In 2002, the Central Bank, with the aim of full harmonisation of the legal framework which governs banking services in Cyprus, prepared a draft law containing amendments to the Banking Law. In particular, the draft law provides for the adoption of the single licence principle, so that upon accession

banking institutions from EU member states will be able to establish branches in Cyprus, or to offer banking services in Cyprus, without requiring a licence from the Central Bank of Cyprus. The draft law also contains a provision that, on joining the EU, the Central Bank will no longer take into consideration the criterion of economic need for the purpose of granting licences for banking services. The vetting of the legislation by the Law Office of the Republic will be completed by the beginning of 2003. Furthermore, the Central Bank prepared amendments to the regulations on the deposit protection scheme, so that it covers deposits in other currencies apart from the Cyprus pound, as required by the relevant EU directive (94/19/EC). The amendment regulations, as well as the legislation for the amendment of the Banking Law, are expected to receive parliamentary approval by June 2003.

In December 2002, a new Central Bank directive was issued for the capital adequacy of banks, which fully reflects the provisions of the relevant EU directive (93/6/EEC), as well as the directive on contractual netting arrangements, which adopts the relevant provisions of EU directive 2000/12/EC. The two new directives will take effect on 1 January 2003.

Apart from the above, the EU directive relating to electronic money institutions (2000/46/EC) is the only directive in the field of banking which has yet to be transposed, although there are currently no such institutions in Cyprus. The Central Bank has prepared draft legislation which adopts the provisions of this directive and is expected to be enacted by the end of 2003.

Economic and monetary union

As regards economic and monetary union, harmonisation with the *acquis* was completed on 5 July 2002, with the entry into force of the Central Bank of Cyprus Law of 2002 (138(I)/2002) and the Fourth Amendment of the Constitution Law of 2002 (104(I)/2002). This legislation ensures the independence of the Central Bank of Cyprus and achieves compatibility with the relevant provisions of the Treaty Establishing the European Community and the Statute of the European System of Central Banks and of the European Central Bank. Specifically, the new Central Bank of Cyprus Law ensures the independence of the Central Bank, prohibits the direct financing of the public sector by the Bank and stipulates that the primary objective of the Bank is to ensure price stability.

During 2002, the Central Bank contributed to the annual revision of the pre-accession economic programme of Cyprus for the period 2001 - 2005, which was submitted to the European Commission within the framework of the pre-accession fiscal surveillance procedure.

Completion of Cyprus's accession to the EU

The harmonisation measures which have been adopted by the Central Bank and the other competent authorities in all the chapters of the *acquis*, combined with the island's macroeconomic stability, establish strong foundations for Cyprus's accession to the EU, as well as the island's subsequent participation in the eurozone without any undue delay.

The Copenhagen decision on Cyprus's

accession to the EU should not, however, lead to complacency. The efforts of the Central Bank and other competent authorities for the completion of the legal harmonisation and the effective implementation of the *acquis* will continue, so that Cyprus can fulfil the commitments it undertook during the negotiations. The European Commission continues to monitor the work towards the island's accession and the orderly keeping of Cyprus's commitments, as with the other candidate countries. The Commission's delegation is due to visit Cyprus in January 2003, in order to prepare its first monitoring report after the Copenhagen European Council. The Commission's final report, covering all

aspects of the *acquis*, is expected in November 2003.

4.2 Monetary policy operations

Open market operations

As has already been mentioned, the primary objective of the Central Bank of Cyprus is to ensure price stability and, without prejudice to this primary objective, to support the general economic policy of the government. In order to achieve its monetary policy objectives, the Central Bank has at its disposal a set of monetary policy instruments through which it regulates the supply of money and credit. On 1 January 2001, the Central Bank

Open market operations

£ million, monthly averages

	Repos(+)/Reverse Repos, Depos (-)	Marginal Lending Facility	Deposit Facility
2001 January	10,2	8,6	3,9
February	49,5	0,5	12,5
March	16,3	5,0	2,9
April	0,0	18,2	0,3
May	0,0	28,5	1,0
June	-26,4	0,0	57,9
July	-92,2	1,2	9,2
August	-58,7	0,5	39,3
September	-95,0	0,0	58,7
October	-104,7	2,3	19,4
November	-118,5	2,3	13,3
December	-111,9	3,6	8,3
2002 January	-174,3	0,8	16,4
February	-131,1	0,6	14,5
March	-189,9	3,3	24,8
April	-267,7	3,4	17,6
May	-287,6	1,0	11,2
June	-366,9	0,6	26,0
July	-405,2	1,5	41,5
August	-427,1	1,9	21,9
September	-392,3	8,6	2,2
October	-332,6	0,3	10,5
November	-385,3	0,6	4,7
December	-412,0	0,0	36,2

set the base lending rate for all banks equal to the rate on its marginal lending facility. This formal linkage will continue for a transitional period until experience of the new system is acquired. A margin over the base rate is applied by the commercial banks according to the risk and the creditworthiness of the client.

More specifically, the Central Bank, in pursuing its monetary policy objectives, has the following instruments available:

Main refinancing operations allotted through tenders

Since 1 January 1996, main refinancing operations allotted through tenders have replaced the liquidity ratio as the main instrument of monetary management.

Reverse transactions based on a repurchase agreement

Liquidity-providing (absorbing) operations are executed in the form of reverse transactions based on a repurchase agreement, whereby the Central Bank buys (sells) government securities from (to) the commercial banks against collateral [repos (reverse repos)]. Reverse transactions take place whenever the Central Bank deems appropriate and their duration is up to 15 days.

Auctions for the acceptance of deposits

In October 2001, the Central Bank introduced a new liquidity-absorbing operation, the auctions for the acceptance of deposits from the commercial banks. During these operations, the Central Bank accepts deposits from the commercial banks for any period of time determined by the Central Bank. In the case of interest rate tenders, the Central Bank announces a maximum interest

rate for accepting deposits as well as the total amount of deposits to be accepted. In the case of volume tenders, the Central Bank announces a fixed interest rate for accepting deposits whereas the total amount of deposits to be accepted is announced by the Bank after the submission of tenders.

Standing facilities

Marginal lending facility

A marginal lending facility was introduced on 1 January 1996, the interest rate of which is intended to provide the upper end of the overnight money market interest rates. A change in the facility's interest rate is used to signal a change in the stance of monetary policy. Credit granted to banks under the marginal lending facility is made available on an overnight basis and government securities are used as collateral. There is no limit on the amount of funds made available under this facility as long as there are sufficient underlying eligible assets. However, the Central Bank reserves the right to restrict access to this facility if excessive use risks jeopardising its monetary policy objectives.

Deposit facility

The Central Bank also offers to commercial banks a deposit facility for placing their short-term surplus funds at the end of the day. The interest rate on this facility is intended to provide, under normal circumstances, the floor for the overnight money market interest rates.

Minimum reserves

In 1995 the liquidity ratio was abolished and, as of 1 January 1996, a proportion equal to 20,0% of the average weekly deposits of banks was "frozen". This frozen stock consists of treasury bill holdings which are auto-

matically renewable and bear a fixed interest rate of 6,00% per annum. The frozen stock of treasury bills will be phased out gradually.

A proportion equal to 7,0% of the average weekly bank deposits during the first three weeks of December 1995, was transferred to a new reserve account. The reserve account is the only operational account of the commercial banks with the Central Bank and a reserve ratio of 6,5% is currently applicable.

The average actual reserve holdings of commercial banks are remunerated at an interest rate directly linked to the marginal lending facility rate, which is determined by the Central Bank. Excess reserve holdings over the maintenance period are not remunerated.

4.3 Regulation and supervision of the banking sector

Under the Central Bank of Cyprus Law of 2002 and the Banking Law of 1997, the Central Bank of Cyprus is the competent authority for the supervision of banks, which includes the granting of a licence to carry on banking business. The main objective of supervision is to preserve the stability of the banking system, minimise systemic risk, and retain public confidence in the banking system. Supervision also aims at protecting depositors.

The Central Bank of Cyprus supervises domestic banks, international banking units as well as representative offices of foreign banks.

Today, 14 domestic banks operate in Cyprus, out of which 11 are commercial banks and 3 are specialised financial institutions. Moreover, 30 international banking units and 2

representative offices of foreign banks operate from within Cyprus.

Domestic banking sector

During 2002, the domestic banking system was, as in all countries, adversely affected by the recession in the world economy. Moreover, it was negatively affected as a result of the reduction in interest rates, the prolonged fall in share prices as well as the decline in tourist arrivals. As a consequence of the above, the operating profits of domestic banks remained at about the same level as in 2001, while the quality of their lending portfolio deteriorated, creating the need for increased provision for bad and doubtful debts. Banks also incurred increased losses due to the diminution in the value of investments in stock exchange securities. Moreover, the fact that many bank customers did not repay loans granted for the purchase of shares on the expectation that these would be written off free of charge, also contributed to the banks' poor performance.

It should be stressed that despite the temporary weaknesses referred to above, the domestic banks remain sound and are capable of successfully managing the present unfavourable conditions. Furthermore, the excellent quality of human resources they employ, the up-to-date technology at their disposal, the containment of losses due to the fall in share prices, and the expected recovery of the Cyprus economy, as well as the containment of their operating expenses, are expected to contribute positively to their long-term prospects.

The expansion of Cypriot banks abroad provides opportunities for market penetration in far larger markets and thus for

further growth and greater profits. One should bear in mind that the banking market in Cyprus is small and almost saturated. In addition, the experiences acquired by domestic banks as a result of their exposure to the external competitive environment, will enable them to successfully meet the challenge of greater competition in the domestic market.

However, expansion abroad, which is mainly in Greece, creates the need for increased capital funds which are required to finance growth. In order to ensure a smooth growth path, the Central Bank of Cyprus believes that, when expanding abroad, banks should adopt a gradual approach and should proceed only after a thorough study of market conditions, as well as their ability to operate efficiently, so that their overseas operations continue to contribute substantially to their profitability.

International banking sector

The international banking sector has also been adversely affected by the worldwide economic recession and the reduction in interest rates of the major international currencies. Nevertheless, the impact of the above factors on the financial results of international banks has been less severe compared with domestic banks, owing to the ability of the former to specialise and concentrate in the niche markets of Eastern Europe and the Middle East.

The tax reform of July 2002 has changed the preferential tax environment in which international banks have been operating since 1982. As from 1 January 2006, all international banking units (IBUs) operating from within Cyprus will be subject to the same tax rate as domestic banks. Those IBUs

which were already established and operating in Cyprus on 31 December 2001 were given the option of either being taxed at the new tax rate as from 1 January 2003, whilst at the same time acquiring the right to engage in commercial activities with Cypriot residents, or to continue being taxed at a lower rate until the end of 2005, but without the right to transact business with Cypriot residents. All IBUs which were operating on 31 December 2001, have opted for the latter choice.

Initial indications show that the tax reform has not been a deterrent to the establishment of new IBUs. During 2002, the Central Bank of Cyprus granted two new licences for the establishment of IBUs. Cyprus's well known non-tax advantages in conjunction with the new prospects created by accession to the European Union, are important factors which have contributed towards the ongoing presence of IBUs in Cyprus and which continue to generate interest for the establishment of new international banks.

Co-operation with other domestic and foreign supervisory authorities

The supervision of the financial sector has been strengthened with the signing of a Memorandum of Understanding between the Central Bank of Cyprus, the Securities and Exchange Commission and the Insurance Companies Control Service. The Memorandum of Understanding was signed in October 2002 and will become effective as of 1 January 2003. The signing of the Memorandum has paved the way for the ongoing co-operation among the three regulatory authorities, which will render the monitoring of the financial sector even more effective. The Memorandum is based on the provisions of the legislation in force which

allow the competent regulatory authorities to co-operate and exchange information between them with a view to discharging their functions and responsibilities in a more effective manner.

During 2002, the Central Bank of Cyprus reinforced its supervisory and regulatory relations with a number of central banks and supervisory/regulatory authorities in countries whose banks and other financial institutions have an active presence in Cyprus, by signing a number of memoranda of understanding. This practice is in accordance with the relevant recommendation of the Basle Committee on Banking Supervision, which aims at strengthening the supervision of cross-border activities of banking institutions. In particular, memoranda of understanding have been signed with the Central Bank of Romania, the Czech Securities Commission, the Federal Commission for the Securities Market of Russia, the Securities Commission of Lithuania and the Securities Commission of Greece. The Central Bank of Cyprus is also currently negotiating the signing of ten other memoranda with foreign supervisory and regulatory authorities.

Regulation and supervision

The Central Bank of Cyprus, in exercising its supervisory role, is guided by the recommendations of the Basle Committee on Banking Supervision and the regulatory rules of the European Union. In this context, various directives have been issued to all banking institutions that have a presence in Cyprus, both domestic and international, for the purposes of prudential supervision.

The Central Bank has prepared a draft law amending the Banking Law that is currently

in force. The new law is expected to be enacted during 2003. The purpose of the proposed amendments is to fully harmonise the existing legislation with the *acquis communautaire*.

Moreover, a deposit protection scheme has been established under the auspices of the Central Bank, which is aimed mainly at the protection of small depositors, in accordance with the requirements of the European Union. The Central Bank is also the competent authority for the implementation of the provisions of the Law for the Prevention and Suppression of Money Laundering Activities as well as of various international financial sanctions.

The Central Bank uses two methods for the supervision of banking institutions which complement each other and which are deployed in a co-ordinated manner: (a) on-site examinations aimed at evaluating the financial condition of banks as well as their future prospects; and (b) the off-site monitoring of banks' performance through the analysis of various periodic prudential returns submitted to the Central Bank covering an extensive range of operations.

4.4 Payment and settlement systems

Payment systems are very important for the economy, as smooth and orderly economic development depends on the existence of an efficient and safe means of effecting payments.

The Central Bank attaches great importance to payment systems because, in addition to their contribution to the smooth functioning of the economy, they constitute an important

factor in maintaining financial stability, as they are the means through which economic disturbances are transmitted from one economic sector to another.

The substantial increase of activity in the financial markets, coupled with the rapid advances in technology, have brought to the surface the safety and effectiveness aspects concerning the operation of payment systems and have increased further their significance. For all these reasons, particular importance has been assigned to the existence of the required legal framework governing payment systems and also the necessary infrastructure for their orderly, safe and effective operation.

Legal framework

The role of the Central Bank in the area of payment systems, as envisaged by the *acquis communautaire*, has been defined under the Central Bank of Cyprus Law of 2002. In particular, section 6(2)(e) of the Law specifies as one of the main responsibilities of the Central Bank, the promotion, regulation and oversight of the smooth operation of payment and settlement systems. Furthermore, in accordance with section 48 of the Law, the Central Bank may administer, participate in or become a member of any payment and settlement system and may, through an announcement in the Official Gazette of the Republic, place under its oversight any payment and settlement system that operates in the Republic. In addition, the Central Bank is empowered to issue directives regulating the functions and the operating procedures of the systems under its supervision.

Within the framework of harmonisation with the *acquis*, the provisions of EU Directive 98/26/EC on Settlement Finality have been

incorporated in a law enacted by the House of Representatives and published in the Official Gazette of the Republic on 31 January 2003 (8(I)/2003). This Law specifies that the Central Bank is the competent authority empowered to designate the payment systems that fall within the scope of its provisions. The EU directive and the aforementioned Law achieve three basic objectives with regard to the payment systems, even in the case where insolvency proceedings have been initiated against any participant in the system.

These objectives are the following:

- (a) the irrevocability of the instructions for payment and of netting;
- (b) the obligations of each and every participant in the system to provide collateral in the form of liquid funds and/or securities with a view to fulfilling their obligations to the system;
- (c) the possibility for immediate liquidation of the collateral for the purpose for which it has been pledged.

In addition, Law 8(I)/2003 gives the Central Bank the right of access to any information that the Bank may deem necessary in the exercise of its responsibilities and the power to impose administrative fines on any participant for non-compliance.

Payment systems operating in Cyprus

There are five payment and securities settlement systems operating in Cyprus at present: The Large Value Credit Transfers System (LVCTS), the Cyprus Clearing House for cheques, the payment cards settlement system (JCC Multipack), the

retail credit transfers system (JCC Transfer) and the Cyprus Stock Exchange System. These systems are described in detail in the report of the ECB “Payment and securities settlement systems in accession countries” issued in August 2002.³

The Central Bank operates the Large Value Credit Transfers System and also the Cyprus Clearing House for cheques.

All systems operating currently in Cyprus were evaluated by the ECB in June 2002 and were found to be very satisfactory for the purpose of EU accession. Within the context of the evaluation, some recommendations have been made for the improvement of the infrastructure, which the Central Bank has already implemented or is in the process of doing so.

The role of the Bank

In order to respond to the new responsibilities of the Bank, as determined by the legislation and in line with the ECB recommendations, the Accounting Services Department was reorganised during the year to create two distinct sections with regard to payment systems. One section is responsible for the functioning of the payment systems that are operated by the Bank and the other section is responsible for the general oversight of payment systems operating in Cyprus. The Bank is in the final stages of issuing a document elaborating the Bank’s payment systems oversight policy, which will become public after its approval by the Board.

Other developments

In an effort to increase confidence in the use

of cheques as a safe means of payment, the Central Bank will, as of 1 February 2003, put into operation the Central Information Register for the Issuers of Dishonoured Cheques (CIR).⁴ The CIR will operate under directives to be issued jointly by the Governor of the Central Bank and the Commissioner of Co-operative Institutions and Co-operative Development.

In addition, with a view to improving the efficiency in cheque clearing, the Central Bank has prepared a draft law amending the Bills of Exchange Law, which will allow electronic presentation of cheques for payment (cheque truncation). The draft law will be submitted to the House of Representatives at the beginning of 2003.

4.5 Currency in circulation

The accession of Cyprus to the European Union in May 2004 and the policy objective of participating in the Economic and Monetary Union and adopting the euro the soonest possible, have been decisive factors in setting the priorities concerning currency and related matters. The contemplated quality upgrading of Cypriot banknotes and coins has been abandoned, while all plans for new issues and the incorporation of enhanced security features in banknotes, which are in any case of a high quality, have been put aside. All efforts have focused on maintaining on the one hand the quality of banknotes in circulation and, on the other hand, adequate stocks to meet any increase in demand for currency as well as replacing the unfit banknotes, which are withdrawn from circulation. The replenishment of stocks is effected through international tenders.

3. The report can be downloaded from the ECB website (www.ecb.int) or accessed via the Bank’s website (www.centralbank.gov.cy).

4. Further information about the CIR and the full text of the directives can be found on the Bank’s website.

During the period 1996-2001, the average annual increase in the total value of banknotes in circulation was 7,6%, while in 2002 there was an increase of 9,4%. In the case of coins in circulation, the average annual increase in their total value during the period 1996-2001 was 7,7%, compared with an increase of 6,3% in 2002. The currency in circulation as at 31 December 2002, and comparative figures for 2001, are shown in the table titled "Currency in circulation".

With respect to the introduction of the euro, the efforts of the Central Bank have focused on two objectives: first, to facilitate the smooth introduction of the euro in Cyprus and second, to establish the required infrastructure and adopt the necessary measures for harmonisation with the relevant *acquis*. As regards the first objective, the Bank, with the cooperation of the National Bank of Belgium, has prepared and carried out a campaign to acquaint the public with the euro and to fully inform bank officials and members of other organisations about

this matter. The Bank has also arranged the receipt and distribution of the first euro banknotes in Cyprus, to meet the needs of travellers.

The Central Bank has also moved speedily with regard to harmonisation measures and the required infrastructure. The Bank has prepared a draft law transposing into Cypriot legislation all the relevant EU and ECB directives on currency counterfeiting. After legal vetting, the draft law will be submitted to the House of Representatives for approval and will take effect as from the day of accession. The Bank has also issued a new directive on the exchange of mutilated and damaged banknotes, which is in full conformity with the provisions of the respective directive of the ECB.

Regarding the necessary infrastructure for the registration and analysis of counterfeit euro currency, the Bank follows the directives of the ECB. The required systems and procedures concerning this matter will be ready before accession to the EU.

Currency in circulation

£ thousand, end of period balances

Denomination	2001		2002		Increase/(Decrease)	
	Value	%	Value	%	Value	%
£20	145.029	35,4	179.571	40,1	34.542	4,7
£10	196.422	48,0	197.141	44,0	719	(4,0)
£5	17.748	4,3	18.320	4,1	572	(0,2)
£1	18.569	4,6	19.247	4,3	678	(0,3)
Coins	31.460	7,7	33.441	7,5	1.981	(0,2)
Total	409.228	100,0	447.720	100,0	38.492	

4.6 Issue of government securities

In accordance with the provisions of the Central Bank of Cyprus Law, the Bank is responsible for the administration of the public debt, including the issue of securities. This task is performed within the framework of arrangements made between the Bank and the Ministry of Finance and in accordance with laws and regulations pertaining to government borrowing through the issue of

liberalisation and modernisation of the financial sector, most government securities have been issued through auctions, allowing interest rates to reflect prevailing market conditions.

Government registered development stocks (GRDS) were issued for the first time in 1969. In the case of GRDS of 5 and 10-year duration, the auction method was first used in 1997, whereas for the 2 and 15-year GRDS, the method was first used in 2000

GRDS issued in 2002

£ million

Type of bond	Issues		Maturities
	No. of Issues ⁽²⁾	Amount	Amount
2-year ⁽¹⁾	10	207,6	71,0
3-year	12	88,9	53,0
5-year ⁽¹⁾	11	199,5	216,6
10-year ⁽¹⁾	2	3,7	-
15-year ⁽¹⁾	2	7,8	-
Total		507,5	340,6

(1) Through auction.

(2) In the case of 5, 10 and 15-year GRDS, the number refers to tranche issues.

securities (government registered development stock, treasury bills, savings certificates and savings bonds). The operational and administrative matters regarding the issue and sale of securities, keeping the holders' register, payment of interest, redemption of securities, savings bonds draws and all other related matters, are carried out by the Central Bank of Cyprus.

The first government securities, issued at the end of the 1960s, aimed at encouraging domestic savings and the non-inflationary financing of budget deficits. Since the beginning of 1996, within the framework of

and 2001, respectively. GRDS issues carried out by the Central Bank during 2002, are shown in the table titled "GRDS issued in 2002".

The weighted average yield for each type of stock issued through auction during 2001 and 2002 is shown in the table titled "Weighted average yield of GRDS".

The weighted average yield of the last issues in 2002 (15 October 2002), was 4,49% for the 2-year GRDS, while for the tranche issues of 5, 10 and 15-year GRDS the yields were 5,09%, 5,36% and 5,60%, respectively.

The decrease of the weighted average yield

for all types of GRDS during 2002, reflects mainly the reduction of the key official interest rates of the Central Bank and the conditions of excess liquidity prevailing during 2002.

GRDS issued through auction are listed and traded on the Cyprus Stock Exchange. According to the terms of issue, the Central Bank may intervene in the secondary market, if it deems it necessary, in order to maintain orderly market conditions.

Weighted average yield of GRDS				
%				
Year	2-year	5-year	10-year	15-year
2001	6,42	7,01	7,65	6,47
2002	4,55	5,06	5,37	5,59

In December 2002, the House of Representatives approved the Loan (Development) (Amendments) Regulations of 2002, which regulate, inter alia, the registration of GRDS for joint holders in the alternative form “or”. The purpose of these amendments is to meet investors’ requirements and also follow market trends.

The Central Bank also issues for and on behalf of the Government of the Republic of Cyprus, treasury bills (TBs) with 13 and 52-week duration. TBs of 13-week duration are issued either through auction or at fixed prices. The latter are issued in order to meet the investment needs of Government Funds administered by the Central Bank and the investment of frozen deposits maintained by banks with the Central Bank. TBs with 52-week duration are issued only through auction. Auctions usually take place every second and fourth Wednesday of the month.

TBs of 52-week duration are listed on the Cyprus Stock Exchange, whereas for the 13-week TBs there is no secondary market.

The total nominal value of TBs outstanding as at 31 December 2002 was £3.056,7 million compared with £3.189,0 million as at 31 December 2001. The Government Funds administered by the Central Bank, were holding TBs amounting to £2.422,4 million as at 31 December 2002, while banks were holding £293,5 million frozen TBs (which are gradually being released) and £328,1 million TBs issued through auction. The Central Bank was holding TBs with a total value of £7,6 million as a result of discounting, whereas other investors were holding TBs amounting to £5,1 million.

The weighted average yield of TBs issued through auction during 2001 and 2002 is shown in the table titled “Weighted average yield of TBs.”

The weighted average yield of the last issue of TBs with 13-week duration carried out in 2002 was 4,08% (24 July 2002), whereas for TBs with 52-week duration the yield was 4,28% (4 September 2002).

Weighted average yield of TBs		
%		
Year	13-week	52-week
2001	6,05	6,50
2002	4,01	4,32

Government borrowing in the form of savings certificates (SCs) continued with the issue of the Fifth Series, bearing an interest rate of 4,65% and having a repayment period of five years. Sales of SCs during 2002

Total amounts of investment instruments

£ million

As at	TBs	GRDS					SCs	SBs	Total
		2-year	3-year	5-year	10-year	15-year			
31 Dec. 2001	3.149,8	195,0	198,0	775,4	193,8	4,1	46,4	21,3	4.583,8
31 Dec. 2002	3.060,5	349,6	209,8	760,3	197,5	11,8	55,0	16,5	4.661,0

amounted to £10,3 million compared with £23,3 million during 2001. The total amount of all series of SCs outstanding as at 31 December 2002 was £55,0 million, an increase of £8,6 million over the amount outstanding as at 31 December 2001.

Regarding government borrowing through the issue of savings bonds (SBs), it was decided during 2002, in consultation with the Ministry of Finance, to postpone the issue of a new series and to terminate the policy of extending the redemption period of matured SBs. Exempted from this arrangement are the SBs of series 1-12, issued before 1974.

The outstanding amounts of all investment products as at 31 December 2001 and 2002 are presented in the table titled "Total amount of investment instruments".

4.7 Management of international reserves

In accordance with the provisions of the Central Bank of Cyprus Law of 2002, the basic functions of the Bank include the holding, safeguarding and management of the official international reserves which, as at 31 December 2002, stood at £1.734,9 million, compared with £1.558,4 million as at the end of 2001. The increase was mainly due to net foreign currency inflows, interest

received, and foreign exchange rate movements against the Cyprus pound.

The basic objectives of the Bank's management of international reserves are the safety of these reserves, the main-tenance of their value and the maintenance of sufficient liquidity to satisfy various needs, as and when they fall due. Subject to the fulfilment of these objectives, the management of the Bank's reserves aims at maximising return.

The currency distribution of international reserves takes into account mainly the flows of receipts and payments for goods and services by currency, and the country's external debt servicing obligations. During 2002, the international reserves were held mostly in euros and dollars and, to a lesser extent, in sterling, Swiss francs and yen. The Central Bank also maintains a small part of its reserves in the form of gold bullion.

The international reserves are invested in approved instruments according to the Bank's investment policy by undertaking authorised types of transactions with approved banks or other financial institutions as well as investment services organisations.

Interest rate risk is controlled by setting modified duration and monitoring it to

ensure that it is kept within an allowed specified margin. There is also an additional restriction in that investment in securities whose remaining life to maturity exceeds five years, is not allowed.

Credit risk is contained and controlled at various levels. It is standard practice for maximum investment limits to be prescribed by country, bank nationality, foreign counterparty and supranational organisation or other institution.

In order to maximise the return from gold reserves, part of the Bank's holdings is invested in gold swap agreements.

The present framework for the implementation of the Bank's reserves management policy works very well. The ultimate objective of the Bank is the continuous upgrading of its processes and its successful adaptation to new developments.

4.8 Management of public external debt

The Bank, in accordance with the provisions of section 51(c) of the Central Bank of Cyprus Law of 2002, is responsible for the management of the public debt. In this respect, the management of the public external debt includes the finding of foreign financing sources, the comparative evaluation of financing proposals, the negotiation of relevant agreements, the recording and servicing of the debt and the monitoring and management of the various risks.

In managing the external public debt, the main objective of the Central Bank is the achievement of the following objectives:

(a) the securing of smooth cover of the

government's external financing needs through regular and continued access to the various segments of the international financial markets;

- (b) the minimisation of the cost of the public external debt, subject to the prevailing conditions in the international markets and acceptable exchange and interest rate risk levels;
- (c) the achievement of a balanced and more extended maturity structure of the debt so as to avoid a heavy bunching of maturing debt which could potentially increase abruptly the fiscal burden and/or make the refinancing of the debt more difficult and/or less favourable than if such a refinancing was effected under more normal conditions.

The total public external debt increased from £806,9 million at the end of 2001 to £847,8 million at the end of 2002, primarily due to new net foreign borrowing through the Euro Medium Term Note Programme (EMTN).

The main source of external financing for the government continues to be the EMTN programme. In particular, the raising of funds under this programme constitutes 79,7% of total public external debt. The remainder of the public borrowing in foreign currency is achieved through the issue of Euro Commercial Paper (ECP) (2,3%), from loans from the Council of Europe Development Bank (12,4%), and loans from the European Investment Bank (4,4%).

Principal repayments amounting to £207,2 million and interest payments amounting to £38,2 million were effected for the servicing of the public external debt during 2002.

On 12 February 2002, a eurobond issue amounting to €550 million was placed with

institutional investors at an interest rate corresponding to 41 basis points above the Euro Interbank Offered Rate (Euribor). The eurobond, which has a 10-year maturity and an annual coupon of 5,50%, is the biggest bond ever issued by the Republic of Cyprus.

Lead-managers of the issue were Credit Suisse First Boston and Deutsche Bank whilst the group of co-arrangers consisted of the following banks: ABN AMRO, Alpha Bank, BNP Paribas, Bayerische Landesbank, DePfa Bank, HSBC, JP Morgan, Merrill Lynch, Morgan Stanley, National Bank of Greece and UBS Warburg.

The eurobond issue was very successful as demonstrated by big demand shown by a wide range of foreign investors. The issue was oversubscribed twice. It was as a result of this high demand that it was decided to increase the issue to the aforementioned amount of €550 million, which was the maximum amount of borrowing stipulated in the relevant approval of the House of Representatives. A strong interest and participation in the issue was recorded from large institutional investors such as mutual funds, pension funds, banks, insurance companies, etc., from 12 countries, with the greatest interest emanating from institutions in Germany and The Netherlands.

4.9 Developments in the international business sector

The most significant development in the international business sector during 2002 was the new tax legislation passed by the House of Representatives in July and which is due to come into effect on 1 January 2003.

Under the new tax regime there will be a

single rate of corporation tax (10%) for all companies, either local companies or international business companies (IBCs). IBCs are currently subject to 4,25% corporation tax and local companies 20%-25% (according to their taxable income). The new tax legislation also provides for a windfall tax of 5% for chargeable income in excess of €1,0 million, which will be collected for the years 2003 and 2004.

Those IBCs which were registered in Cyprus prior to 1 January 2002 and which had, and continue to have, an income exclusively outside Cyprus, can opt to maintain their existing tax status (i.e. 4,25%) until the end of 2005.

New company registrations in 2002 fell by 21,2%. This fall cannot be attributed entirely to the new tax regime since the latter is not due to come into effect until 1 January 2003. It is also important to note that the new rate of corporation tax is still the lowest in the European Union and hence is unlikely to have acted as a disincentive to foreign investors wishing to locate in Cyprus. It is most likely that the decline in registrations was largely the result of the slowdown in the European economies which are the main source of company registrations.

Despite the fall in company registrations, the gross foreign exchange revenue generated by the international business sector is estimated to have increased from €283,0 million in 2001 to €320,2 million in 2002, representing a rise of 13,1%.

The next major development in the international business sector will be the abolition of the Exchange Control Law upon accession to the EU. This will have a direct impact on the role of the Central Bank.

Under the Exchange Control Law, all IBCs need to submit an application to the Central Bank prior to setting up their operations in Cyprus. With the pending abolition of the law, all foreign investors from the European Union will be able to set up a business in Cyprus without the Central Bank's approval.

Despite the recent tax reform, the prospects for Cyprus as an international business centre look promising. Tax experts agree that the new tax regime is in many ways more beneficial to foreign investors than the previous regime. These experts are confident that Cyprus can continue to be promoted as an ideal jurisdiction for tax planning, especially in the context of the island's 32 double tax treaties covering 40 countries.

4.10 Statistics

Monetary policy in the euro area is formulated on the basis of statistics, which are collected and transmitted to the ECB and the Eurostat by the national central banks of the member countries in accordance with strict standards and deadlines. In view of the country's accession to the EU, the Central Bank of Cyprus is obliged to ensure that monetary and financial statistics as well as statistics on the balance of payments and other related matters are fully harmonised with ECB requirements as from 1 May 2004. The fulfilment of this obligation is facilitated by the new Central Bank of Cyprus Law that came into effect in July 2002. Sections 63 and 64 empower the Bank to collect statistical data for the purposes of the Law. Within this context, the Economic Research and Management Services Division was reorganised in December 2002 and renamed the Economic Research and Statistics Division (ER & SD). The newly established

Statistics Department within the ER & SD has been divided into three sections. The duties and responsibilities of each section are outlined below:

Money and Banking Statistics Section

The Money and Banking Statistics Section (MBSS) is responsible for the collection, compilation and dissemination of statistics concerning monetary aggregates, interest rates, as well as the issue of securities (except shares). The MBSS is in the process of implementing new money and banking statistics systems leading to full harmonisation with the requirements of the ECB, Eurostat, the IMF and the Bank for International Settlements (BIS). During the process of harmonisation, priority is being given to the implementation of:

- (a) ECB Regulation ECB/2001/13, concerning the consolidated balance sheet of the monetary financial institutions sector;
- (b) ECB Regulation ECB/2001/18, concerning statistical data on interest rates applied by monetary financial institutions to deposits and loans of households and non-financial corporations;
- (c) the ECB Guideline ECB/2002/5, concerning certain statistical reporting requirements in the field of money and banking statistics.

In accordance with the ECB's harmonisation programme for the accession countries, the MBSS has compiled the Monetary Financial Institutions (MFI) list, which includes all domestic banks and international banking units as well as the Co-operative Credit Institutions operating in Cyprus. The MFI

list is revised on a regular basis and is published by the ECB. The MBSS has also contributed the chapter on Cyprus in the ECB publication entitled “Bond Markets and Long-term Interest Rates in the Accession Countries”, and in the ECB methodological manual entitled “Money, Banking and Financial Statistics in the Accession Countries”. Moreover, the MBSS is co-operating with the Statistical Service of the Republic regarding the compilation of financial accounts as well as the classification of institutional units into institutional sectors, in accordance with the European System of Accounts (ESA 95).

Balance of Payments and International Investment Position Section

Statistical data in the field of balance of payments and international investment position are collected and compiled by the Balance of Payments and International Investment Position Section (BOP & IIPS). Given the gradual dismantling of exchange control restrictions and the resultant loss of this source of statistical information, the Central Bank has developed a new system for the collection and compilation of balance of payments and international investment position statistics. The new system is based on the methodology recommended by the IMF in its fifth edition of the Balance of Payments Manual (BPM5), which has also been adopted by the EU, and complies with the additional requirements and level of detail specified by Eurostat and the ECB.

In accordance with the new methodology, the presentation of both the current account and the former capital account has changed. The former invisible account is now clearly divided into three sections: services, income

and current transfers. As a reflection of the growing importance of services, the component list of services transactions has been expanded. In parallel, the former capital account (capital movements) has been divided into the new capital account and the financial account. The financial account includes most of the items that were included in the former capital account, while the new capital account includes only capital transfers (debt forgiveness, migrants’ transfers and other transfers) and the acquisition/disposal of non-produced, non-financial assets. The financial account is further divided into four functional categories: direct investment, portfolio investment, other investment (which includes mainly loans/credits, currency and deposits) and reserve assets (which cover only the reserves held by the monetary authorities). The new presentation requires much more detailed data than the previous format.

The new balance of payments collection system has been in operation since 1 January 2002. It is based on transaction-by-transaction reporting by banks for all transactions carried out between residents and non-residents. A series of data is reported for each transaction, on the basis of which breakdowns by type of operation, geographical region, resident institutional sector, etc. are compiled. Balance of payments statistics are produced annually, quarterly and monthly. Surveys and direct reporting by certain categories of residents complement the new system.

Under the new system, as of 1 January 2002, balance of payments statistics are compiled on the basis of the new definition of residency, which is specified in the BPM5. In accordance with the new definition, natural

persons are considered to be residents of a country when they reside (or intend to reside) for more than a year in the country, while legal entities are considered to be residents when they have a physical presence in the country. Statistics produced by the BOP&IIPS are submitted to Eurostat, the ECB and the IMF on a regular basis and are also published on the Bank's website.

General Economic Statistics Section

In the context of a more efficient allocation of the work undertaken as a result of commitments vis-à-vis the ECB, Eurostat, the IMF, etc., the Central Bank has established within the Statistics Department the General Economic Statistics Section (GESS). The new section is responsible for the effective management and monitoring of statistical data/indicators concerning important economic areas which fall outside the scope of both the MBSS and the BOP&IIPS. In particular, the GESS is responsible for the collection, processing and dissemination of statistical data concerning:

- (a) external debt (in co-operation with the BOP&IIPS);
- (b) international reserves;
- (c) long-term economic indicators;
- (d) short-term economic indicators;
- (e) the "Special Data Dissemination Standard" (SDDS) of the IMF,
- (f) the setting up of a data bank, in co-operation with the other sections of the Statistics Department.

The GESS is expected to be fully staffed and operational by the end of 2003.

4.11 Management services

Information technology

During 2002, the Bank continued its efforts

to achieve its long-standing goal of improving efficiency and effectiveness through the redesign and automation of its systems by utilising the latest technology.

During this period emphasis was given to projects which strengthen the infrastructure, such as the upgrading of the Bank's network and the services provided through it. At the same time, applications continued to be developed in-house, which resulted in the enlargement of the Bank's Central Production Database. The ongoing administration of the Database ensures the integrity, availability and confidentiality of the stored information.

The information technology projects carried out in 2002 were as follows:

Infrastructure projects

Internet services upgrade

The Bank's network underwent a major redesign in order to implement a security architecture. The aim was to control network traffic to and from the Bank and to support the Bank's Internet usage policy. Following the successful completion of its redesign, the Bank's network was connected to the Internet.

Within this framework, a Security Policy for the Bank's Information was formulated and guidelines were issued for safeguarding computing equipment and services. To increase staff awareness on these guidelines, as well as security issues in general, presentations were given to the members of staff.

Database servers upgrade

The Bank's database servers and software were upgraded not only to enable the Bank to

enhance the availability of information but also to improve the efficiency of information access. In addition, the Bank's development server and development tools were also upgraded.

Office Automation software upgrade

The latest version of Office Automation software was deployed throughout the Bank and new revised guidelines were issued to staff who, in addition, underwent training in order to better comprehend the new features and exploit the potential of the latest version.

Connection with the European System of Central Banks Electronic Mail System

The infrastructure for the CebaMail system, which provides for the secure and direct exchange of electronic messages within the European System of Central Banks, was set up. Users were issued with guidelines and were also trained on the system's functionality.

System development projects

Balance of payments system

Based on the specifications of the ECB and the Eurostat, the phased development and implementation of the balance of payments system continued with the collection and processing of large volumes of electronic data and the production of new reports.

Transfers and issuing of cheques in foreign currency

The above sub-system, part of the Documentary Credits and Bills for Collection Section System, involving the handling of incoming and outgoing transfers and the issuing of cheques in foreign currency, was developed and implemented.

Accounting system

The accounting system was upgraded to the

latest revised version which offers improved security features and flexibility.

Staff payroll, leave of absence and loans system

The development of the new system for the Bank's staff, which specifically handles the submission and processing of the staff's leave of absence, the submission and processing of staff loan requests and the calculation of staff payroll, was completed.

The implementation of the leave of absence and loans parts of the system has been completed, while the payroll part will be completed by the spring of 2003.

Savings bonds system

The system for recording redeemed and drawn savings bonds was upgraded with the introduction of the latest technology in scanning and document recognition.

Dealing system

A new dealing system was developed offering enhanced security and added flexibility. Implementation is expected by early 2003.

Large value payment system

The system's analysis for the processing of large value payment transactions concluded in Cyprus pounds between the banks was completed. The goal of this system is to provide for better management of credit risk which banks are exposed to, and the harmonisation with EU directives.

It was originally decided to create a state-of-the-art system which could, in the future, be easily integrated with the payment system in use among the member states of the

eurozone, known as TARGET. During the last quarter of 2002, the ECB chose to re-evaluate the TARGET system, thus the development of the system was halted temporarily by the Bank until the latest developments are assessed.

The management of the prudential returns of international banking units.

The system was upgraded so as to support the new structure of the prudential returns as directed by the EU and also to allow these returns to be submitted electronically by international banking units operating from within Cyprus.

Central Information Register for the Issuers of Dishonoured Cheques

Within the framework of the Banking Law, the Central Bank of Cyprus will be setting up a Central Information Register for the Issuers of Dishonoured Cheques. For this purpose an automated system will be introduced, its main features being the flexibility, security and integrity of stored data, as well as its acceptance by the banks and co-operative credit institutions which contribute to its operation. The system is due to become operational on 1 February 2003.

New website

The Bank proceeded to publish on the Internet its upgraded website, featuring a completely new design and structure with new services and an enriched content.

Through its web pages, the Bank seeks to establish an attractive Internet presence so as to strengthen its existing relationships and collaborations, entice new visitors and constitute a source of valid and timely information for visitors, associates and other researchers.

The Bank's website can be found at www.centralbank.gov.cy

Priority for 2003 will be the carrying out of ECB work based on its suggested project plans. At the same time, efforts will be directed towards more effective management and strengthening of security, with special emphasis on the completion of the contingency plans by all the Bank's divisions on the basis of the installed technical infrastructure and the continuous monitoring of the security architecture set up by the Bank.

Human resources

Staff numbers

At the end of 2002, the Bank employed a total of 287 persons. During the year, 26 persons joined the Bank and 5 left due to retirement. Of the new staff, 10 were university graduates with Master's degrees in the areas of economics, finance and computer science. Sixteen of the newly recruited employees were employed in support and clerical positions.

Gender equality

The Bank is an equal opportunity employer and, therefore, a strong supporter of gender equality issues. During 2002, female staff members continued to have an important role in the Bank's operations and made up 57% of the total staff number. In addition, the Bank has adopted an equal opportunity policy on staff benefit issues like equal pay, medical and pension rights and equal opportunity rights for career advancement.

Training and development

The Bank's management gives high priority to the recruitment and development of skilled

and academically qualified staff. The Bank's training policy takes into consideration a number of issues such as the Bank's overall strategy and goals, the divisions' specific objectives, the continuous changes in the economic environment (EU accession) and the staff's personal needs.

The Bank's staff training and development strategy for 2002 included employee participation in various professional seminars conducted either in-house or by local independent service providers or by national central banks or European Union institutions.

Internal communications

The Bank's general communications strategy was among the top priorities for 2002. The establishment of the Internal Communications Plan, both on the horizontal and vertical levels, has been achieved through regular, formal and informal, meetings aimed at the sharing of knowledge and the exchange of ideas and information.

In general, the Bank welcomes and encourages staff to express their opinion in a constructive and professional manner. This allows for the improvement, upgrading and advancement of the Bank's current practices.

Trade union relations

The Bank is a strong supporter of social dialogue between the social partners.

Community involvement

The Bank attaches great importance to its contribution to society, which focuses on: a) the Bank's commitment to enhance knowledge through contributions to educational institutions promoting research work in areas relevant to the Bank's

operations; and b) the Bank's support to charities and non-profit organisations, as well as to health and community-related programmes.

Human resource strategy and philosophy

Human capital is the most important asset of any institution. The new economic environment that will develop during the next few years with Cyprus's accession to the EU requires a well trained, highly skilled and professional staff. The main goal of the human resource service is to strategically address all areas related to human resource management within the Bank's general environment with a view to fully utilising the Bank's human capital.

The human resource strategy of the Bank will mainly target areas such as recruitment procedures, employee training and development needs, and employee performance appraisal systems.

Premises and security

In the autumn of 1994, the offices of the Central Bank of Cyprus were transferred to new purpose built premises located at 80 Kennedy Avenue in Nicosia. The Bank's Technical Services Section has done its best to maintain the building in good operational condition so that the working environment for the staff is pleasant and thus conducive to productive work.

The new building has conference rooms as well as an auditorium with more than 100 seats, which satisfy the needs of the Bank for the organisation of seminars, lectures and conferences.

During the design stage of the building,

particular attention was given to security. In this connection, the security standards prevailing in other European central banks were taken into consideration. The building is divided into three basic levels: the ground level with the banking hall, to which members of the public have free access; the office spaces, to which members of staff and, following certain control procedures during their entrance, members of the public have access; and the security areas and strongroom where access is restricted to a limited number of personnel, in accordance with the Bank's prevailing security regulations.

The security management system has been recently upgraded with new software and computers. The new equipment has been integrated into the existing security system, making its operation more efficient and user

friendly. The upgrading of the building management system is also in progress. New equipment and software will replace the existing set-up in order to improve the efficiency and performance of the system.

During 2002, all small power and lighting installations in the Bank were connected to standby generators. These generators can now provide electricity to all the small power and lighting installations of the building in case of general mains power failure.

The Bank has appointed mechanical and electrical consultants to prepare specifications and plans for the upgrading of the air conditioning system. Based on these specifications and plans, tenders were invited from Cypriot contractors. The tender procedures have been completed and work is in progress.

FINANCIAL STATEMENTS
for the year ended 31 December 2002

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31 DECEMBER 2002

	Notes	2002 £'000	2001 £'000
Interest Income	2	80.499	95.716
Interest Expense	3	67.140	76.031
Net Interest Income		13.359	19.685
Other Operating Income	4	7.448	9.319
Total Operating Income		20.807	29.004
Administrative Expenses - Staff	5.1	7.339	6.883
- Other	5.2	2.297	2.194
Depreciation	6	845	1.373
Operating Expenses	7	610	1.318
Provisions	8	3.318	2.871
Total Expenses and Provisions		14.409	14.639
Net Profit		6.398	14.365

APPROPRIATION ACCOUNT

	2002 £'000	2001 £'000
Appropriation of the Net Profit in accordance with section 59 of the Central Bank of Cyprus Law 2002:	6.398	14.365
General Reserve (20% of Net Profit)	1.280	
Consolidated Fund of the Republic	5.118	14.365

The notes on pages 58-66 form part of these accounts.

BALANCE SHEET AS AT 31 DECEMBER 2002

	Notes	2002 £'000	2001 £'000
Assets			
Foreign Reserves	9	1.697.687	1.528.760
Local Investments		67.800	194.685
Treasury Bills	10.1	7.587	122.908
Government Securities	10.2	60.213	71.777
Loans and Advances		961.106	530.693
Government and Government Agencies		961.074	530.660
Banks		32	33
Fixed Assets	6	10.457	10.884
Other Assets	11	47.435	31.553
Total Assets		2.784.485	2.296.575
Liabilities			
Currency in Circulation		447.670	409.227
Notes		414.229	377.794
Coins		33.441	31.433
Deposits	12	2.063.240	1.483.226
Banks		1.451.116	934.268
Government		61.749	35.862
Government Agencies and Public Corporations		68.847	1.080
Sinking Funds		477.800	508.137
Insurance Companies		1.991	1.738
International Organisations		1.737	2.141
Other Credit Balances	13	70.694	136.860
Special Accounts for the Revaluation of Gold and Net Assets/Liabilities in Foreign Currencies	14	171.601	237.262
Capital and Reserves		31.280	30.000
Capital		15.000	15.000
General Reserve Fund		16.280	15.000
Total Liabilities		2.784.485	2.296.575

The notes on pages 58-66 form part of these accounts.

NOTES TO THE FINANCIAL STATEMENTS

1. Accounting policies

Form of presentation of the financial statements

The financial statements have been prepared in accordance with the Central Bank of Cyprus Law of 2002 (the Law) with the exception of the provision of section 57(2) which refers to the obligation of the Bank to apply the accounting principles determined by the European Central Bank (ECB). The provision for the immediate application of the accounting principles of the ECB was added by the House of Representatives during the discussion process of the draft Law. This provision cannot currently be adopted as it requires the development or acquisition of complicated systems which would have to be adapted to the needs of the Bank, and would also require the training of personnel. Furthermore, the ECB does not require the adoption of these accounting principles before our joining the Eurosystem. In December 2002, the Central Bank prepared an amendment to the Law that will overcome the problems unduly created by the provision of section 57(2).

The historical cost accounting convention has been followed, except for the valuation of financial items as set out below.

Valuation of foreign currency balances

Foreign currency balances are translated into Cyprus pounds using the mid-market closing exchange rates ruling at the balance sheet date. Exchange rate differences arising from the translation of foreign currencies into Cyprus pounds are transferred to revaluation reserves in accordance with section 57(2) of the Law.

Securities

Securities, which are included in foreign reserves and local investments, are stated at cost adjusted for the amortization of premium or discount which is effected on a straight line basis over the period to maturity plus accrued interest.

Bullion

Bullion is shown in foreign reserves at the lower of: (a) the average of the gold prices recorded at the two daily London fixings during the six months prior to the balance sheet date; and (b) the average price at the two London fixings on the penultimate working day of the period. The difference between valuation and book value is transferred to a revaluation reserve in accordance with section 57(2) of the Law.

Fixed assets

Land is stated at acquisition cost and is not depreciated. The Bank's building is stated at construction cost including preliminary expenses which are connected with the construction.

Buildings, furniture, equipment and motor vehicles are depreciated on a straight line basis over their estimated useful life.

Currency in circulation

Currency in circulation is recognised as a liability which comprises the face value of Cyprus legal tender banknotes and coins and excludes coins issued for commemorative or numismatic purposes. Coins issued for commemorative or numismatic purposes are deemed not to be in ordinary circulation and are included in the balance sheet under other credit balances at face value less value of precious metal content up to the corresponding face value.

Income and expense recognition

Foreign currency income and expenses are converted to Cyprus pounds using mid-market exchange rates ruling on the respective conversion date.

Interest or other income or expense arising with the effluxion of time is recognised in the profit and loss account on an accruals basis.

Capital gains or losses on realisation of securities or other financial investments are recognised in the period in which they are realised.

The expense of printing of banknotes, minting of coins and purchases of stationery is written off to the profit and loss account in the year that it is defrayed.

2. Interest income

	2002	2001
	£'000	£'000
Income from foreign reserves	50.451	61.342
Income from local investments:		
Treasury bills	1.788	6.081
Government and Government guaranteed stocks	4.515	4.914
	6.303	10.995
Income from loans and advances:		
Credit facilities to the Government and Government agencies	23.387	22.245
Credit facilities to banks	103	816
Loans to staff and other loans	255	318
	23.745	23.379
Total	80.499	95.716

3. Interest expense

	2002 £'000	2001 £'000
Interest on foreign currency liabilities	6.932	16.448
Interest on Cyprus pound deposit liabilities and other accounts:		
Banks' deposits	37.478	32.746
Sinking funds	22.629	26.733
Insurance companies deposits and other accounts	101	104
	60.208	59.583
Total	67.140	76.031

4. Other operating income

Other operating income includes net profit on foreign exchange transactions (excluding gains arising from exchange rate fluctuations), capital gains on the sale of foreign securities, money received as reimbursement of bank supervision expenses, fees received by the Bank as Trustee under the Insurance Companies Laws 1984 - 2001 and miscellaneous income.

5. Administrative expenses

5.1 Staff

The average number of staff employed on a full time basis was 287 (2001: 279). Staff costs comprised the following:

	2002 £'000	2001 £'000
Salaries	1.886	1.828
Cost of living allowance	4.226	3.923
Bank's social insurance and other contributions	977	891
Other allowances	101	107
Staff training	149	134
Total	7.339	6.883

5.2 Other

Other administrative expenses include telecommunications expenses, insurance and maintenance of buildings and equipment, stationery, utility expenses, expenses incurred in connection with the promotion of Cyprus as an international business centre and miscellaneous expenses.

6. Fixed assets

	Land and Buildings £'000	Furniture and Equipment £'000	Motor Vehicles £'000	Total £'000
Cost				
As at 1 January 2002	12.060	5.339	179	17.578
Additions		418		418
Disposals		(7)		(7)
As at 31 December 2002	12.060	5.750	179	17.989
Depreciation				
As at 1 January 2002	2.632	3.935	127	6.694
Provision	329	494	22	845
Disposals		(7)		(7)
As at 31 December 2002	2.961	4.422	149	7.532
Net Book Value				
As at 31 December 2002	9.099	1.328	30	10.457
As at 31 December 2001	9.428	1.404	52	10.884

The cost of land is £1.201.500.

7. Operating expenses

Operating expenses include expenses for printing of notes and minting of coins totalling £513.000 (2001: £1.260.000).

8. Provisions

Provisions refer to obligations arising from employment pension benefits as follows:

	2002	2001
	£'000	£'000
Current service cost	1.254	817
Interest on pension fund obligation	1.901	1.886
Past service cost	163	168
Total	3.318	2.871

9. Foreign reserves

Foreign reserves are composed of foreign currency deposits and foreign securities including accrued interest, special drawing rights and gold.

10. Local investments

10.1 Treasury bills

The amount of investment in treasury bills as at 31 December 2002 represents treasury bills purchased in the secondary market from non-government organisations. The balance for 2001 includes £115.699.000 for treasury bills purchased from the Government in order to finance its short term liquidity requirements. This practice ceased on 5 July 2002, in accordance with the provisions of the Law which prohibits the Central Bank from providing finance to the Government.

10.2 Government securities

	2002 £'000	2001 £'000
Government registered stock	59.146	69.337
Savings bonds	1.067	2.440
Total	60.213	71.777

11. Other assets

	2002 £'000	2001 £'000
Cheques in process of collection	21.833	14.344
Interest on administered funds	0	6.432
Loans to staff	10.677	10.490
Interest receivable	14.535	0
Other accounts	390	287
Total	47.435	31.553

Interest receivable relates to the long term loan to the Government.

12. Deposits

	2002 £'000	2001 £'000
Banks	1.451.116	934.268
Minimum reserve	511.111	466.341
Other Cyprus pound deposits	615.585	248.064
Foreign currency accounts	324.420	219.863
Government sight accounts	61.749	35.862
Government agencies and public corporations	68.847	1.080
Sinking funds	477.800	508.137
Government foreign debt	302	15.912
Government registered stock	468.483	481.240
Savings bonds	8.427	10.454
Government guaranteed stock	588	531
Insurance companies	1.991	1.738
International organisations	1.737	2.141
Total	2.063.240	1.483.226

13. Other credit balances

	2002 £'000	2001 £'000
Appropriation account	5.118	14.365
Provision for staff pension scheme	31.323	29.129
Matured, unredeemed savings bonds	6.948	4.897
Unclaimed drawn savings bonds	1.626	1.671
Demonetised notes and coins	3.387	3.392
Accrued interest payable	466	1.225
Special drawing rights allocation by the International Monetary Fund	14.493	15.948
Administered funds	0	60.791
Other accounts	7.333	5.442
Total	70.694	136.860

14. Special accounts for the revaluation of gold and net assets/liabilities in foreign currencies

These accounts were created and maintained in compliance with section 57(2) of the Law. The movement of revaluation accounts is summarised as follows:

	Gold £'000	Foreign Currencies £'000	Total £'000
Balance as at 1/1/2002	74.700	162.562	237.262
Revaluation adjustments for the year ended 31/12/2002	(1.459)	(64.202)	(65.661)
Balance 31/12/2002	73.241	98.360	171.601

15. Retirement benefits

The Bank operates an unfunded pension scheme which provides benefits that are based on the employees' final pensionable salary. Employees' contributions are made only in respect of widows and orphans benefits. The pensionable service liability is computed at regular intervals by independent qualified actuaries. The latest actuarial valuation was carried out as at 31 December 2001 and revealed a past service deficiency of £2.654.000 at the valuation date.

The amounts recognised in the balance sheet are as follows:

	2002 £'000	2001 £'000
Present value of unfunded obligation	33.977	31.783
Unrecognised past service deficiency	2.491	2.654
Recognised past service deficiency	163	-
Net liability in balance sheet	31.323	29.129

On the basis of recommendations from the actuaries the unrecognised past service deficiency will be provided by the Bank with a contribution of 3% of members' annual salaries over the average remaining working lifetime of employees as at the date of the actuarial valuation which has been estimated at 21 years. Pension payments for 2002, as in previous years, were charged directly to the pension scheme provision account.

16. Contingent liabilities

A court decision was issued relating to the action brought against the Bank by architects who participated in the design of the Bank's building whereby the claimants were awarded damages of £152.198,73 plus interest from 29 November 1996, plus expenses. The Bank has appealed against the decision. Accordingly, no provision is made in these financial statements.

17. Government funds administered by the Central Bank of Cyprus

The deficiency of interest earned by the above funds for 2001 by comparison to the guaranteed interest was £11.249.000 (£6.211.000 in 2001). According to an agreement with the Ministry of Finance, the above amount is charged to the Consolidated Fund of the Republic and was therefore not recognised as a charge to the profit and loss account.

REPORT OF THE AUDITOR GENERAL OF THE REPUBLIC TO THE BOARD OF DIRECTORS OF THE CENTRAL BANK OF CYPRUS

I have audited the financial statements on pages 56 to 66 and have obtained all the information and explanations I considered necessary. These financial statements are the responsibility of the management of the Bank. My responsibility is to express an opinion on these financial statements, based on my audit.

I conducted my audit in accordance with the International Standards on Auditing. These Standards require that I 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 management as well as evaluating the overall financial statements presentation. I believe that my audit provides a reasonable basis for my opinion.

In my opinion proper books of account have been kept and the financial statements, which are in agreement therewith, give a true and fair view of the state of affairs of the Central Bank of Cyprus at 31 December 2002 and of its surplus for the year then ended in accordance with the practice followed by central banks and the provisions of the Central Bank of Cyprus Law 2002 with the exception of provision 57(2) of the Law as stated in note (1) of the financial statements.

CHRYSTALLA GEORGHADJI
Auditor General of the Republic

Nicosia, 9 May 2003