

## 1. Introduction by the Governor

The year 2003 was the first during which the Central Bank of Cyprus operated in accordance with the provisions of the *Central Bank of Cyprus Law*, which had been enacted in July 2002. On the basis of this law and the relevant amendment to the Constitution, the Central Bank has gained full independence, which is consistent with the provisions of the Treaty establishing the European Community as well as the Statute of the European System of Central Banks and of the European Central Bank. The year 2003 also coincided with the 40th anniversary of the Bank's establishment, which was celebrated with various events, including a relevant and interesting lecture by Nicholas Garganas, Governor of the Bank of Greece, entitled "The accession to the European exchange rate mechanism and the euro zone centre: lessons from Greece's experience". The lecture was attended by the President of the Republic and about 1.000 guests.

Undoubtedly, the most historical moment for Cyprus in 2003 was the signing of the Treaty Concerning the Accession of our country together with nine other countries to the European Union in Athens, on 16 April 2003. The signing of the Treaty was the crowning achievement of lengthy and intensive efforts by the Republic of Cyprus in which the Central Bank had an active and substantial role. The lengthy process, which began 14 years ago when Cyprus first submitted its application for membership, will come to an end on 1 May 2004.

Shortly after the signing of the Treaty, the President of the European Central Bank (ECB) invited the Central Bank of Cyprus as well as the central banks of the other nine

accessing countries, to commence attending, as observers, the meetings of the ECB's General Council and the committees of the European System of Central Banks (ESCB), in order to prepare for their participation as full and equal members from 1 May 2004. In this context, I attended three meetings of the ECB's General Council on 26 June, 18 September and 18 December 2003, intervening actively and constructively in the discussion of vital issues concerning the European Union (EU) and the accessing countries.

During 2003, the Central Bank of Cyprus participated in the meetings of the committees of the ESCB and the EU. Due to the limited resources of our small central bank, our representatives to the ESCB and other EU bodies need to be specialists in several fields. Despite the high cost in terms of financial and human resources, the Central Bank will continue to do its utmost to accomplish the difficult and very important work it has undertaken.

In order to prepare the Bank's participation in the ESCB as well as in other bodies and activities of the EU, in June 2003 the Bank established the European Affairs Unit (EAU) which reports directly to the Governor. The EAU assists the Governor in preparing for the meetings of the ECB's General Council and coordinates the Central Bank's participation in the numerous committees of the ESCB and the EU. The contribution of the EAU to this aspect of the Bank's work has proven to be very significant.

Following accession, neither the Government nor the Central Bank of Cyprus will have the luxury to be complacent since both will need

to deal with the challenges and obligations associated with full membership of the European Union. The most important among these challenges concerns our accession to the Exchange Rate Mechanism II (ERM II) and the fulfilment of the criteria for the adoption of the euro.

On 1 May 2004, Cyprus and nine other countries will join the EU as member states with a derogation regarding Economic and Monetary Union (EMU). The new members are committed to adopting the euro as their currency in the future, if they satisfy the convergence criteria as stipulated in the Maastricht Treaty. It has already been declared that Cyprus intends to apply to join ERM II as soon as possible following accession to the EU. The earliest possible date for adopting the euro as the national currency is 1 January 2007. On the basis of this target, the EU, the ECB and other relevant parties will, toward the end of 2006, conduct an assessment in order to agree whether Cyprus has met and will continue to fulfill the nominal Maastricht criteria. Specifically:

1. The fiscal deficit as a percentage of GDP must not exceed 3% and, in order for it to be considered sustainable, the projected annual deficits for the medium-term should also be below 3%. Our fiscal deficit as a percentage of GDP fluctuated around 6% in 2003, compared with 3,6% in the previous year.
2. The public debt in terms of market prices (excluding intragovernmental debt) should not exceed 60% of GDP. Any member state whose public debt exceeds this limit will have to prove that this percentage is being steadily reduced at a satisfactory rate. Cyprus's public debt

reached 63,6% at the end of 2003, compared with 59,3% at the end of the previous year.

3. The average annual rate of inflation should not exceed by more than 1,5 percentage points the average inflation rate of the three member states with the lowest inflation rates. In 2003, the average annual rate of inflation in Cyprus was 4,1% while the relevant convergence criterion was 2,8%.
4. The average nominal long-term rate of interest should not exceed by more than 2 percentage points the average rate of the three member states with the most stable price levels. In December 2003, the yield on 10-year government bonds was 4,9%, while the relevant convergence criterion was 6,3%.
5. The Cyprus pound should exhibit stability by not fluctuating by more than  $\pm 15\%$  from its central parity against the euro throughout the period of its membership of ERM II.

The application to join ERM II may be submitted jointly by Cyprus's Minister of Finance and the Governor of the Central Bank or by other EU members. As part of the procedure for joining ERM II, the central exchange rate parity of the Cyprus pound against the euro and the width of the fluctuation band will have to be agreed by all the parties involved. After joining ERM II, Cyprus will have to treat its exchange rate policy as a matter of common interest to all members of the eurosystem and thus avoid unilateral or competitive devaluation of the pound. If during its participation in ERM II Cyprus satisfies the nominal Maastricht cri-

teria and achieves real convergence with the economies of the eurozone, then on 1 January 2007 it will be allowed to adopt the euro as its national currency.

The aim of joining ERM II can be successfully achieved if there is satisfactory coordination and cooperation among all the competent authorities as well as firm insistence on the set target. It is reiterated that, in order to adopt the euro by 2007, the fiscal deficit will have to be maintained at a level below 3% in 2005. For this to be considered sustainable, the projected deficit in the medium-term will have to be below 3% as well. Public finances have to improve drastically in order to meet the fiscal criteria for joining the euro but also in order to improve the effectiveness of monetary policy. During this critical period, domestic inflationary pressures have to be avoided and, thus, wage settlements have to be in line with productivity. In the new environment of free capital movements, which will begin on 1 May 2004, the aforesaid conditions will have to prevail in order to enable the Central Bank to secure monetary stability and to deal with unusually large capital inflows or outflows through combinations of interest and exchange rate policies.

During the year under review, special emphasis was given to the upgrading and reform of operations and methods employed by the Bank to achieve its aims. Among the successful arrangements I introduced, were the quarterly meetings of the Bank's managerial staff under my chairmanship during which policy issues, administrative matters and the implementation of decisions were discussed. Similar meetings were held regularly within every division and department under the chairmanship of the Senior Manager and Manager, respectively.

Every four months, I conferred with the Bank's representatives on the committees of the ESCB and EU in order to discuss topics such as preparations for the ECB General Council meeting, the procedure and prospects for joining ERM II, macroeconomic developments, etc.

Moreover, almost every week, I chaired the Governor's Committee, consisting of the Governor's Advisor and the five Senior Managers. At its regular meetings, the Governor's Committee examined, in accordance with the guidelines and decisions of the Board of Directors and the Monetary Policy Committee, issues which affect the Bank's daily operations as well as its short and medium-term plans.

I also initiated biannual meetings with the Presidents/Chief Executives of commercial banks under my chairmanship at the Central Bank. These meetings have proven to be very important because they cover serious issues such as the current state and future prospects of the banking sector, the capital base and capital adequacy of banks, the assessment and projection of risks, supervision and regulation, expansion overseas, etc.

During the year under review, and in the context of the Bank's organisational restructuring, a fifth division, named the Management Services Division, was created. This division includes the Information Technology Department, the Human Resource and Administration Section and the Security and Technical Support Section.

All of the aforementioned changes and improvements contributed to an increase in collective participation in the formulation and implementation of policy objectives and

the achievement of the Bank's strategic aims, within the specified time schedules.

During 2003, the low rates of economic growth in Cyprus and worldwide affected the domestic banking system negatively. The stagnation of the local economy, together with the outstanding loans used for the purchase of shares, prevented commercial banks from improving the quality of their loan portfolios and forced them to increase their provisions for bad loans compared with 2002. The Central Bank directive regulating the suspension of interest payments, which came into effect on 1 January 2003, also affected negatively the net revenue of domestic banks during the year under review. In addition to the Iraq war and the fall in tourist arrivals, banks were also negatively affected by the under-performance of the stock market and the reductions in key interest rates in Cyprus and abroad.

Despite the negative economic environment described above, Cypriot domestic banks strengthened their capital base and enhanced their credibility and confidence to deal successfully with negative market conditions. The Central Bank played an important role in this positive development by persuading banks to strengthen their capital base, to make appropriate provisions for bad and doubtful debts and to better manage their loan portfolios over the short-term. This firm and consistent policy has already borne fruit, primarily with the re-establishment of trust in the banking system's potential and prospects. The pending accession of Cyprus to the EU is not expected to create serious problems for the domestic banks, which have the strength and ability to successfully face increased competition.

The deposits and loans of domestic banks

abroad, especially in Greece, continued their upward trend as a result of the expansion of their branch network. However, overseas expansion creates the need for increases in capital funds, which are necessary for the financing of operations. For this reason, during 2003 banks strengthened their capital base significantly through the issue of hybrid capital instruments and subordinated loan capital.

An important development in the area of financial supervision was the implementation of the Memorandum of Understanding between the Central Bank, the Securities and Exchange Commission and the Insurance Companies' Control Service as of 1 January 2003. In November 2003, the Co-operative Societies Supervision and Development Authority also signed the Memorandum. The basic aim of this Memorandum is the systematic and on-going cooperation between the competent regulatory authorities so as to successfully confront problems arising from the splitting-up of responsibilities for the supervision and regulation of the financial sector. In this way, the coordination and collaboration among the institutions that supervise the provision of financial services in Cyprus, has been fully aligned with the EU requirement for the greatest possible uniformity regarding the regulation and supervision of financial services in every member state.

During the year under review, the Central Bank issued a number of directives to the banks and proceeded with the preparation of laws which fully align the statutory framework for banking supervision with its equivalent in the EU. Specifically, the Central Bank promoted the revision of the supervisory framework on capital adequacy in accor-

dance with the European Commission framework and the New Basel Accord which is due to be implemented at the end of 2006. On the Central Bank's initiative, working groups consisting of specialist staff from the banking sector will undertake the realisation of the entire project on the basis of a predetermined timetable, which is compatible with the EU equivalent.

During 2003, the Central Bank took the first steps towards the development of a comprehensive framework for macroprudential analysis, thus complying with the recommendations and requirements of the ECB and the International Monetary Fund. The macroprudential analysis used by the Central Bank aims at identifying, assessing and monitoring the vulnerable points and systemic weaknesses of the banking sector so that appropriate measures for the protection of financial stability can be taken promptly.

It is important to stress that the Central Bank's participation in the ESCB has increased its obligations regarding the production and distribution of statistics, in line with the harmonised technical norms. The formulation of economic and monetary policy at a national and EU level, as well as the assessment of Cyprus's preparedness for the adoption of the euro, require timely and reliable statistical data. In EU member states, the responsibility for the production and distribution of statistical data is divided between the national central banks and the national statistical services on the basis of formal agreements. The Central Bank of Cyprus and the Ministry of Finance (the latter being responsible for the Cyprus Statistical Service) have agreed to sign a Protocol in order to regulate their cooperation, along the same lines.

An important step toward the harmonisation of money and banking statistics was the issue by the Central Bank of a directive to monetary financial institutions (MFIs) regarding the grouping of institutional units into institutional sectors in accordance with the European System of Accounts (ESA95). The directive was issued in July 2003 together with an electronic archive, in the form of a CD, which is revised regularly by the Central Bank with the aim of facilitating MFIs to classify electronically their clients into sectors and sub-sectors in accordance with ESA95. In this context, the Money and Banking Statistics Section organised a number of seminars in order to inform MFIs about the new system under development, which uses their consolidated financial statements for the collection of statistics.

The preparation of quarterly and annual balance of payments statistics continued in accordance with EU and international standards through the electronic data collection and compilation system that was initially implemented in 2002. In 2003, a complete statement of Cyprus's international investment position was compiled for the first time. This statement portrays the financial assets and liabilities of residents of Cyprus vis-à-vis non-residents at the end of 2002.

In 2003, the Central Bank, which is responsible for administering the *Exchange Control Law*, proceeded with the further lifting of exchange control restrictions as well as the simplification of administrative procedures, on the basis of the *acquis communautaire*. Furthermore, the Central Bank drafted the *Capital Movement Law, 115(1)/2003*, which provides, *inter alia*, for the abolition of the *Exchange Control Law* as of 1 May 2004.

In order to protect the currency, including the euro, from counterfeiting the Central Bank prepared a draft law entitled the *Currency (Counterfeiting and Related Matters) Law* which fully harmonises Cyprus's legislative framework with the *acquis communautaire*. The House of Representatives is expected to enact the law in the first quarter of 2004.

The Bank gives high priority to the development of its human resources and to the use of information technology. In this context, the Central Bank's staff participated in most of the training seminars organised by the ECB and other central banks in the ESCB. The Bank also worked toward the implementation of ESCB guidelines regarding information technology and the upgrading of the security systems of its building.

During the year under review, the Governor, together with Bank officials and foreign experts, continued to examine the Annan Plan for the solution of the Cyprus problem. New documents and reports were prepared and submitted by the Governor to the President of the Republic concerning those provisions of the revised Annan Plan which concern either the Central Bank or the Cyprus economy.

Despite its numerous functions, the Central Bank's primary goal remains the maintenance of price stability within the framework of the Government's general economic policy. The achievement of this goal requires up-to-date knowledge of economic facts, timely diagnosis of economic developments and the implementation of appropriate policies by the monetary authority.

In 2003 Cyprus's real GDP grew by about 2%, the same as in 2002. The observed stag-

nation should be viewed in the context of the general state of the global economy as well as the downward trend in the tourist industry, which were negatively affected by the Iraq war.

As a result of increased government expenditure and the tax reforms of July 2002, the fiscal deficit increased to about 6% of GDP in 2003, compared with 3,6% in the previous year.

The increase in VAT from 10% in January 2002 to 13% in July 2002 and, finally, to 15% in January 2003, was one of the main reasons why the retail price index increased by 4,1% in 2003, compared with 2,8% in the previous year. The number of registered unemployed as a percentage of the economically active population increased to 3,5% in 2003, from 3,1% in the previous year.

The stagnation of economic growth caused the current account deficit to stabilise at about 4,4% of GDP in 2003, compared with 5,4% in the previous year. The improvement in the current account was partly due to a fall in the import of military equipment.

During 2003, the ECB reduced its key interest rate by 75 basis points, whereas the US Federal Reserve reduced its key rate by 25 basis points. The Central Bank of Cyprus, bearing in mind the specific circumstances of the domestic economy and the actions of other monetary authorities, proceeded on 4 April 2003 with the reduction of its key interest rate by 50 basis points. Contradictory indicators, such as a stagnant real growth rate, a wider fiscal deficit, higher inflationary pressures, a greater number of unemployed, a virtually unchanged current account deficit as well as higher expectations

for a revival in international economic activity following the end of the war in Iraq, led the Central Bank to adopt a cautionary stance. It thus maintained its interest rates unchanged for the remainder of 2003.

In 2004 it is expected that there will be a revival in the international economy. The growth rate of the Cyprus economy is projected to reach 4%, as a result of the improvement in tourist arrivals and the Olympic Games in Athens. During 2004, the inflation rate is expected to fall due to a weakening of the effects of VAT increases, while the unemployment situation may improve slightly.

If the above projections are confirmed, the current account deficit may remain below 3% of GDP in 2004. The expected improvement in the current account deficit is related to the expected increase in tourist arrivals as well as the expected reduction in defence expenditure. The revival of economic growth will positively affect public finances. During 2004, it is estimated that the fiscal deficit will fall to 4% of GDP, a rate that is above the relevant Maastricht convergence criterion.

Before I conclude this introduction, I consider it important to stress once again that what is required is a drastic fall in unproductive public expenditure and a significant increase in state revenue. Although the required measures are likely to be unpopular and accompanied by political cost, they are necessary in order to satisfy the Maastricht criteria, allow us to enter into ERM II and thus adopt the euro as our national currency as soon as possible. It is also important to stress that, despite the unfavourable international conditions with their inevitable domestic repercus-

sions, especially with regard to public finances, the Cyprus economy remains basically healthy, with strong foundations and many comparative advantages which should be exploited and strengthened with bold and prudent policies.

In conclusion, I would like 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 efforts towards achieving the objectives of the Bank. Warm thanks are extended to Costas Tsielepis and Chrysostomos Theocli who retired from the Board of Directors. Their long tenure on the Board was carried out with great zeal and goodwill. Thanks are also extended to Andreas Philippou who retired from his post as Chief Senior Manager on 30 March 2003, after a long and successful service with the Bank.



Christodoulos Christodoulou  
Governor, Central Bank of Cyprus

## 2. Management and Organisation of the Bank

### 2.1 Board of Directors



**Chr. Christodoulou**  
Governor, Chairman



**C. Damsas**



**Ph. Zachariades**



**E. Hadjizacharias**



**A. Galanos**



**Z. Katsourides**



**C. Tsielepis**



**Chr. Theocli**

**Constantinos Damsas:** Managing Director of a private company. Member of the Industrial Disputes Court. Vice-president of the Cyprus Chamber of Commerce and Industry and Member of the Board of Directors of private and public companies, semi-government and professional organisations. He has been a member of the Bank's Board of Directors since April 1990.

**Philios 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 Bank's Board of Directors since November 1993.

**Eleftherios Hadjizacharias:** Member of the Institute of Chartered Accountants in England and Wales, and partner in an accounting firm since 1984. Member of the Board of the Institute of Certified Public Accountants. He has been a member of the Bank's Board of Directors since June 1999.

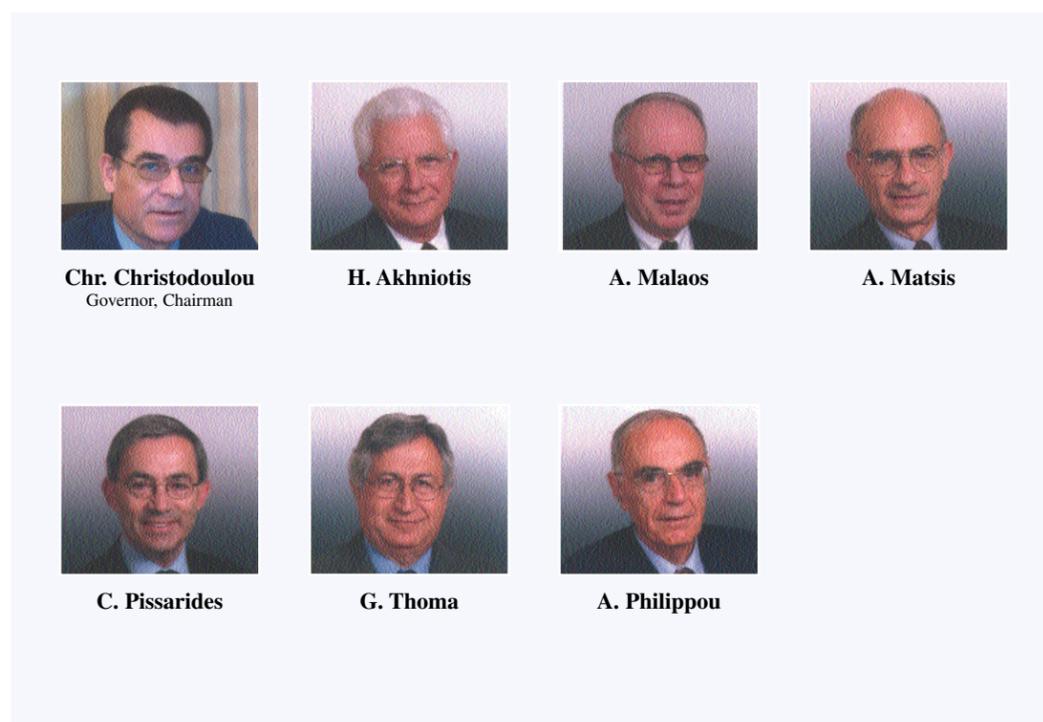
**Alexis Galanos:** Ex-President of the House of Representatives. Member of the Board of Directors of the Central Bank of Cyprus from July 1974 to May 1979. He was re-appointed as a member of the Bank's Board of Directors in November 2003.

**Zenon Katsourides:** Ship owner and Managing Director of a shipping company. Member of the Cyprus Shipping Council, Companion of the Nautical Institute and President of the Apocalypse Historical Research Society. He previously served as Advisor to the President of the Republic on Maritime Affairs, as member of the Board of Directors of the Central Bank of Cyprus, and Principal of the Baltic Exchange. He was re-appointed as a member of the Bank's Board of Directors in December 2003.

**Costas Tsielepis:** Member of the Institute of Chartered Accounts in England and Wales, Managing Partner and co-founder of an accounting firm. He served as a member of the Bank's Board of Directors from July 1983 to July of 2003.

**Chrysostomos Theocli:** Company consultant and member of the Board of Directors in a number of companies. Former partner in an accounting firm. He served as a member of the Bank's Board of Directors from December 1988 to November of 2003.

## 2.2 Monetary Policy Committee



**Haralambos Akhniotis:** Advisor to the Governor and formerly Chief Senior Manager of the Economic Research and Management Services Division at the 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.

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

**George Thoma:** Senior Manager, Economic Research and Statistics Division, Central Bank of Cyprus. He has been a member of the Monetary Policy Committee since April 2003.

**Andreas Philippou:** Chief Senior Manager of the Banking Supervision and Regulation Division at the Central Bank of Cyprus until March 2003. He served as a member of the Monetary Policy Committee from November 2000 to April 2003.

## 2.3 Senior Management Team



**Chr. Christodoulou**  
Governor, Chairman



**H. Akhniotis**  
Advisor to  
the Governor



**S. Stavrou**  
Senior Manager  
Management Services  
Division



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



**G. Thoma**  
Senior Manager  
Economic Research and  
Statistics Division

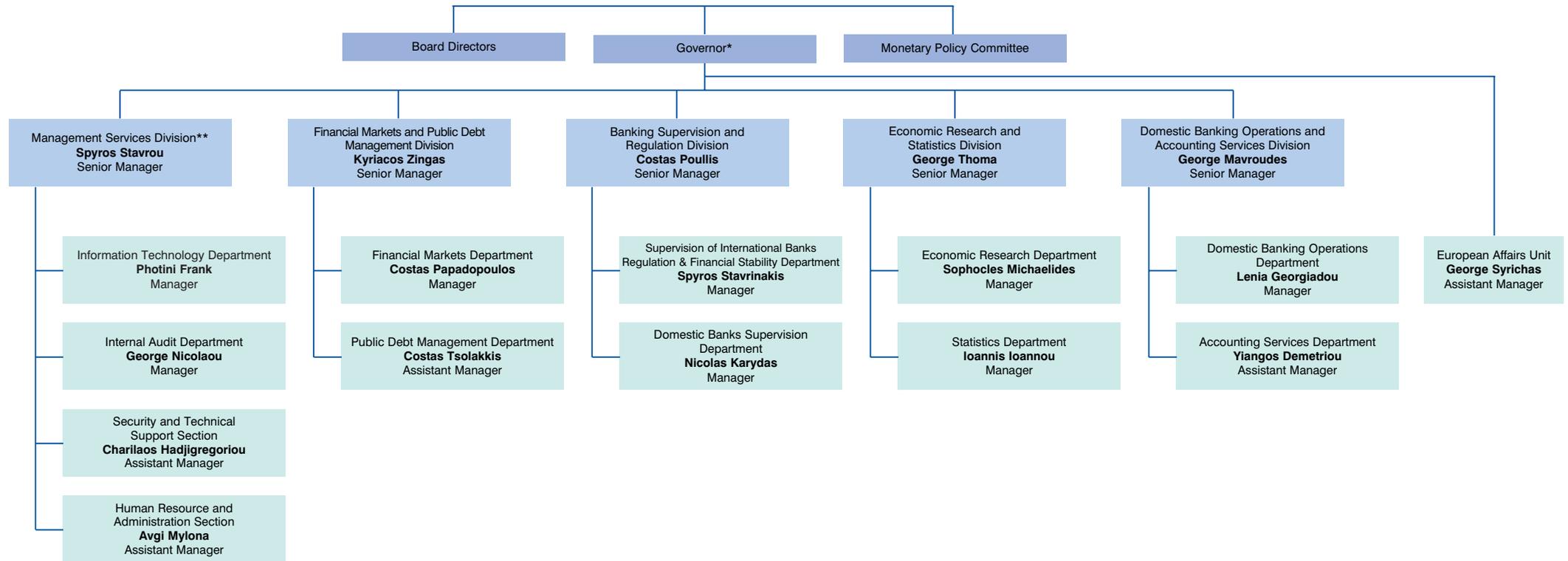


**C. Poullis**  
Senior Manager  
Banking Supervision and  
Regulation Division



**K. Zingas**  
Senior Manager  
Financial Markets and  
Public Debt Management  
Division

## 2.4 Organisation Chart - December 2003



\* European and budgeting issues are addressed directly by the Governor

\*\* This includes the Library

## 3. The economy in 2003

### 3.1 Economic developments

#### Overview

According to provisional figures from the Cyprus Statistical Service (Cystat), real GDP grew by 2% in 2003, the same as in 2002. During the year under review, foreign demand declined further as a result of the continuing fall in tourism. Domestic demand decelerated, reflecting the fall in the growth rate of public consumption and the decline in gross capital formation. On the supply side, despite the unfavourable conditions prevailing in tourism, the services sector registered a small increase as real estate, renting and business activities exhibited significant growth. The secondary sector experienced a slowdown as a result of the downturn in manufacturing, electricity, gas and water and, to a lesser extent, in construction activities.

The rate of inflation reached 4,1% in 2003 compared with 2,8% in the previous year. This acceleration was mainly due to the rises in VAT and excises, which increased the prices of domestic industrial non-oil products, fuel and gas, electricity and, to a smaller degree, services. As regards the labour market, the number of registered unemployed as a proportion of the economically active population reached 3,5% in 2003 compared with 3,1% in 2002, reflecting the sluggish economic activity in 2003.

#### Supply

The economy's secondary sectors experienced a general slowdown caused by the continuing downturn in manufacturing and the deceleration of the electricity, gas

and water sector. More specifically, value added in manufacturing fell by 2% in real terms during 2003, reflecting structural problems inherent in this sector. The fall in the manufacturing production volume index reflected the poor performance of the manufacturing sector in 2003. In contrast, the construction sector grew by 4% in real terms, compared with 4,5% in the previous year. The positive performance of this sector for a third consecutive year was reflected in the increases in the volume and value of building permits as well as in the sales of cement resulting from the significant increase in private housing construction.

The services sector grew by 2,1% in real terms compared with 1,8% in the previous year. Most of the service sub-sectors experienced deceleration. The financial intermediation sector experienced only a marginal increase of 0,3% in 2003 reflecting the continued sluggish performance of the stock market and the overall subdued economic activity. Hotels and restaurants registered a drop of 3,9% during 2003, compared with a fall of 7% the previous year, mirroring the continuing decline in tourist arrivals. During 2003 there was also a slowdown in the wholesale and retail trade sector, which was reflected in the retail sales volume index. In contrast, real estate, renting and business activities remained buoyant as a result of the positive performance of the construction sector during the year under review.

#### Demand

Domestic demand expanded by 2% in real terms during 2003, compared with 4,9% during 2002. The slowdown was mainly

## Gross Domestic Product by economic activity

£ million

Economic activity	At current market prices				At constant 1995 prices			
	2000	2001	2002	2003 (prov.)	2000	2001	2002	2003 (prov.)
<b>Primary sectors</b>	<b>216,1</b>	<b>240,7</b>	<b>257,6</b>	<b>280,4</b>	<b>211,0</b>	<b>218,5</b>	<b>230,6</b>	<b>234,3</b>
Agriculture, hunting and forestry	187,8	211,9	226,8	246,0	178,1	185,4	196,0	198,9
Fishing	11,4	11,4	11,8	12,8	15,8	15,9	16,2	16,5
Mining and quarrying	16,9	17,4	19,0	21,6	17,1	17,2	18,4	18,9
<b>Secondary sectors</b>	<b>1.059,2</b>	<b>1.115,2</b>	<b>1.163,7</b>	<b>1.227,5</b>	<b>915,4</b>	<b>926,9</b>	<b>943,5</b>	<b>957,2</b>
Manufacturing	560,5	574,1	577,4	575,5	487,8	477,6	467,1	457,8
Electricity, gas and water supply	114,2	123,1	128,1	147,9	109,9	119,7	131,9	141,1
Construction	384,5	418,0	458,2	504,1	317,7	329,6	344,5	358,3
<b>Tertiary sectors</b>	<b>3.998,4</b>	<b>4.247,4</b>	<b>4.402,1</b>	<b>4.690,6</b>	<b>3.392,7</b>	<b>3.554,3</b>	<b>3.619,2</b>	<b>3.695,8</b>
Wholesale and retail trade	681,4	730,9	756,4	782,1	603,5	635,6	642,1	645,3
Hotels and restaurants	503,0	544,7	509,2	500,4	446,9	461,6	429,3	412,6
Transport, storage and communication	494,5	542,9	530,6	549,6	477,5	516,7	534,7	548,1
Financial intermediation	392,8	373,7	374,7	384,8	290,6	296,4	297,4	298,3
Real estate, renting and business activities	738,9	794,3	859,5	941,3	632,0	666,5	701,3	738,1
Public administration and defence	488,6	510,9	551,1	624,5	382,0	393,6	403,8	415,9
Education	268,9	290,6	316,8	354,9	208,1	216,1	223,3	231,5
Health and social work	186,9	199,3	223,6	248,6	144,5	148,0	154,2	160,7
Other community, social and personal services	215,6	227,3	241,6	261,2	179,8	187,0	194,5	202,1
Private households with employed persons	27,8	32,8	38,6	43,2	27,8	32,8	38,6	43,2
<b>Total Gross Value Added</b>	<b>5.273,7</b>	<b>5.603,3</b>	<b>5.823,4</b>	<b>6.198,5</b>	<b>4.519,1</b>	<b>4.699,7</b>	<b>4.793,3</b>	<b>4.887,3</b>
Less: Imputed bank service charges	223,0	265,2	272,6	306,9	191,1	222,5	201,3	205,0
Plus: Value Added Tax and import duties	474,6	538,8	610,2	672,2	500,0	543,9	531,0	545,0
<b>Gross Domestic Product at market prices</b>	<b>5.525,3</b>	<b>5.876,9</b>	<b>6.161,0</b>	<b>6.563,8</b>	<b>4.828,0</b>	<b>5.021,1</b>	<b>5.123,0</b>	<b>5.227,3</b>

caused by the fall in the real growth rate of public consumption to 3,5% in 2003, compared with 8,5% in the previous year.

Gross fixed capital formation registered a decrease of 6,6% in 2003, compared with an increase of 10,6% in 2002. The increase

## Gross Domestic Product by category of expenditure

£ million

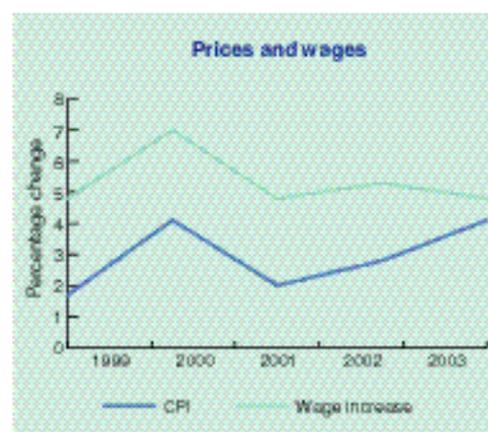
Category of expenditure	At current market prices				At constant 1995 prices			
	2000	2001	2002	2003 (prov.)	2000	2001	2002	2003 (prov.)
Private final consumption expenditure	3.764,1	4.011,6	4.208,6	4.562,7	3.313,3	3.466,9	3.552,5	3.701,4
Government final consumption expenditure	911,01	1.027,6	1.137,0	1.235,4	746,7	824,7	894,6	925,7
Gross capital formation	1.106,0	1.097,7	1.241,4	1.224,5	995,2	962,7	1.064,9	994,6
Increase in stocks	124,3	60,0	72,3	89,6	108,0	51,0	59,6	70,6
Gross fixed capital formation	981,7	1.037,7	1.169,1	1.134,9	887,2	911,7	1.005,3	924,0
<b>Total domestic demand</b>	<b>5.781,1</b>	<b>6.136,9</b>	<b>6.587,0</b>	<b>7.022,6</b>	<b>5.055,2</b>	<b>5.254,3</b>	<b>5.512,0</b>	<b>5.621,7</b>
Exports of goods and services	3.137,0	3.359,4	3.189,6	3.079,0	2.724,1	2.815,6	2.671,4	2.501,2
Less: Imports of goods and services	3.425,8	3.619,5	3.637,3	3.547,7	2.953,3	3.064,8	3.111,5	2.976,0
Statistical discrepancy	33,0	0,1	21,7	9,9	2,0	16,0	51,1	80,4
<b>Gross Domestic Product at market prices</b>	<b>5.525,3</b>	<b>5.876,9</b>	<b>6.161,0</b>	<b>6.563,8</b>	<b>4.828,0</b>	<b>5.021,1</b>	<b>5.123,0</b>	<b>5.227,3</b>
Plus: Net factor income from abroad	60,4	61,6	61,7	63,7	52,8	52,6	51,3	50,7
<b>Gross National Product at market prices</b>	<b>5.585,7</b>	<b>5.938,5</b>	<b>6.222,7</b>	<b>6.627,5</b>	<b>4.880,8</b>	<b>5.073,7</b>	<b>5.174,3</b>	<b>5.278,0</b>

during 2002 was the result of the purchase of two new aircraft by Cyprus Airways and a cruise ship by a private company. During 2003, private consumption registered an improvement because of the higher consumption of services and despite the lower retail sales, measured by the retail sales volume index. As a result of the decline in tourist arrivals and the sluggish world economy, foreign demand registered a fall of 6,4% in 2003 compared with a rise of 5,1% in 2002.

### Inflation, productivity and the labour market

The inflation rate was 4,1% in 2003 compared with 2,8% in 2002. The acceleration resulted from higher prices for

domestic products and services, caused by increases in indirect taxes including VAT and



excises. Specifically, the standard rate of VAT was raised from 10% in January 2002 to 13% in July 2002 and to 15% in January

### Consumer Price Index by economic origin

annual percentage change

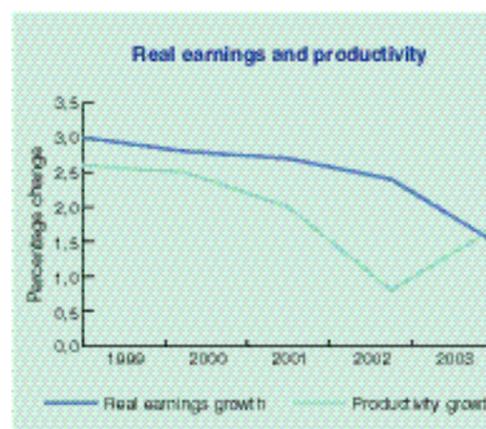
	2001	2002	2003	Weights 1998=100
<b>General Consumer Price Index</b>	<b>2,0</b>	<b>2,8</b>	<b>4,1</b>	<b>100,0</b>
<b>Local goods</b>	<b>1,3</b>	<b>4,3</b>	<b>7,3</b>	<b>36,7</b>
Agricultural	4,5	1,8	4,5	7,9
Industrial	0,8	5,6	7,9	27,2
Industrial, non-oil	0,1	4,6	6,5	22,9
Fuel and gas	4,0	10,6	14,2	4,3
Electricity	-3,2	-2,3	10,2	1,5
<b>Imported goods</b>	<b>0,5</b>	<b>-1,7</b>	<b>-2,4</b>	<b>22,2</b>
Motor vehicles	0,6	-5,1	-8,3	9,4
Other imported goods	0,4	0,9	1,8	12,8
<b>Services</b>	<b>3,4</b>	<b>3,7</b>	<b>4,4</b>	<b>41,1</b>

2003. The acceleration in the inflation rate was constrained by the reduction of excises on motor vehicles in July 2002 and November 2003, as well as by the strengthening of the Cyprus pound against other currencies.

More analytically, the prices of domestic products grew by 7,3% in 2003 compared with 4,3% in 2002. This acceleration was mainly due to higher prices for domestic industrial non-oil products, fuel and electricity, emanating from the increases in the standard VAT rate and excises on petrol. The price of agricultural products also rose at a higher rate during the year under review. On the other hand, imported goods were cheaper by 2,4% in 2003, compared with 1,7% in 2002. The price of services increased by 4,4%, mainly due to the rise in the standard rate of VAT.

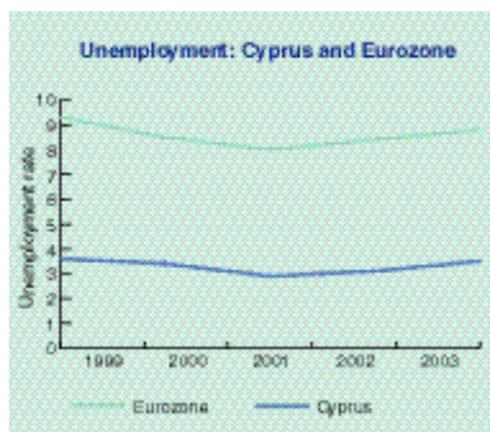
According to provisional Cystat figures, productivity, defined as the ratio of value

added to gainful employment, grew by 1,7% in 2003 compared with 0,8% in the previous year. This improvement, coupled with the small increase in employment, caused real GDP to grow by 2% in 2003. It should also be noted that, during the year under review,



real earnings grew by 1,5% and thus remained below the productivity growth rate.

The number of registered unemployed increased by 13,3% in 2003 compared with



10,6% in 2002. The number of registered unemployed as a proportion of the economically active population climbed to 3,5% in 2003 from 3,1% in the previous year. The rising trend of unemployment, which began in 2001, reflects the continuing slowdown in economic activity.

#### Public finances

The fiscal deficit as a proportion of GDP reached 6% in 2003 compared with 3,6% in 2002, exceeding the corresponding Maastricht criterion for the second consecutive year. While public revenue grew by 10,6% in 2003, compared with 5,4% during the previous year, public expenditure grew by 15,4% in 2003, compared with 7,4% during the previous year.

During the year under review, current and capital public expenditure accelerated, rising by 16,6% and 8,3%, respectively. The increase in current expenditure was mainly due to the significant acceleration of civil service wages and salaries. The increases in the basic salaries of civil servants agreed for the years 2001 and 2002 were paid to them retroactively in 2003. Current transfers also increased by £45 million in respect of child benefits and £45 million in respect of pensions. Payments in respect of interest also

accelerated. In contrast, there was a reduction in social security payments and subsidies. As far as capital expenditure is concerned, there was an increase in capital transfers while fixed investment fell.

The higher increase of tax revenue in 2003 as compared with 2002 was due to higher indirect taxes. More specifically, revenue from VAT grew at an accelerating pace due to the rises in the standard rate of VAT in July 2002 and January 2003. Revenue from excises also increased. During the period under review, revenue from direct taxes, particularly income tax, fell as a result of subdued economic activity and the tax reforms introduced in July 2002. Revenue from import duties also declined due to lower domestic demand.

The fiscal deficit in 2003 was financed from domestic and external sources. Net domestic borrowing rose to £227,8 million, whereas net external borrowing expanded to £130,3 million. Domestic borrowing from the banks and the private sector was in the form of treasury bills and development stocks.

The public debt, net of intragovernmental debt, reached 63,6% of GDP in 2003, compared with 59,4% in 2002, thus exceeding the corresponding Maastricht criterion. Domestic debt, including intragovernmental debt, rose by 13,6% to reach £5.944,5 million in 2003, compared with £5.233,1 million the year before. External debt rose by 10,6% to reach £939,8 million in 2003 compared with £849,5 million in the previous year.

#### Balance of payments

According to balance of payments data for the first nine months of 2003, the current

## Public revenue and expenditure

£ million

	2000	2001	2002	2003 (prov.)
<b>Total revenue and grants</b>	<b>1.865,6</b>	<b>2.073,2</b>	<b>2.185,8</b>	<b>2.418,5</b>
<b>Direct taxes</b>	<b>558,1</b>	<b>659,4</b>	<b>647,7</b>	<b>641,0</b>
Income tax	373,9	482,8	465,2	455,6
<b>Indirect taxes</b>	<b>653,6</b>	<b>722,0</b>	<b>808,9</b>	<b>973,6</b>
Value Added Tax	296,6	344,7	405,8	513,0
Excise duties	160,7	178,4	199,9	247,7
Import duties	62,6	73,6	73,5	72,5
<b>Social security fund contributions</b>	<b>244,0</b>	<b>278,0</b>	<b>303,4</b>	<b>360,6</b>
<b>Other revenue</b>	<b>407,4</b>	<b>411,3</b>	<b>422,9</b>	<b>441,4</b>
<b>Foreign grants</b>	<b>2,5</b>	<b>2,5</b>	<b>2,8</b>	<b>2,0</b>
<b>Total expenditure and net lending</b>	<b>2.016,0</b>	<b>2.239,7</b>	<b>2.405,8</b>	<b>2.776,5</b>
<b>Current expenditure</b>	<b>1.789,8</b>	<b>2.006,0</b>	<b>2.167,9</b>	<b>2.527,1</b>
Goods and services	747,3	870,1	964,2	1.108,6
Wages and salaries	526,3	559,7	598,5	724,6
Current transfers	322,6	370,0	455,7	609,4
Social pensions	24,3	25,7	26,9	29,6
Social security fund payments	304,2	319,2	354,1	387,1
Subsidies	79,5	91,1	62,9	61,0
Interest payments	311,8	330,0	304,2	331,5
<b>Capital expenditure</b>	<b>215,8</b>	<b>217,2</b>	<b>230,2</b>	<b>249,4</b>
Investment	153,2	155,6	173,0	186,9
Capital transfers	62,5	61,7	57,2	62,5
<b>Net lending</b>	<b>10,4</b>	<b>16,5</b>	<b>7,7</b>	<b>0,0</b>
<b>Fiscal surplus (+)/deficit(-)</b>	<b>-150,4</b>	<b>-166,5</b>	<b>-220,0</b>	<b>-358,0</b>
<b>Fiscal surplus(+)/deficit(-) as a percentage of GDP</b>	<b>-2,7</b>	<b>-2,8</b>	<b>-3,6</b>	<b>-5,4</b>

**Public debt<sup>(1)</sup>**

£ million

	2000	2001	2002	2003 (prov.)
<b>Domestic debt</b>	<b>4.187,4</b>	<b>5.232,8</b>	<b>5.233,1</b>	<b>5.944,5</b>
<b>Long-term debt</b>	<b>1.175,4</b>	<b>1.580,5</b>	<b>2.714,8</b>	<b>3.032,2</b>
<b>Development stocks</b>	<b>1.012,6</b>	<b>1.368,1</b>	<b>1.528,9</b>	<b>1.848,4</b>
Central Bank	75,8	70,0	53,7	53,7
Deposit money banks	253,1	695,2	938,9	1.132,3
Private sector	683,2	602,5	535,8	661,9
Sinking funds	0,0	0,0	0,0	0,0
Social security funds <sup>(2)</sup>	0,5	0,5	0,5	0,5
<b>Saving bonds</b>	<b>19,8</b>	<b>20,0</b>	<b>16,5</b>	<b>12,5</b>
Central Bank	1,9	3,1	0,0	0,0
Private sector	17,9	16,9	16,5	12,5
<b>Savings certificates</b>	<b>23,8</b>	<b>45,7</b>	<b>53,6</b>	<b>49,6</b>
Private sector	23,8	45,7	53,6	49,6
<b>Others</b>	<b>119,2</b>	<b>146,7</b>	<b>1.115,8</b>	<b>1.121,8</b>
Central Bank	0,0	0,0	961,1	961,1
Local authority loans	119,2	146,7	154,7	160,7
<b>Short-term debt</b>	<b>3.012,0</b>	<b>3.652,30</b>	<b>2.518,3</b>	<b>2.912,2</b>
<b>Treasury bills</b>	<b>2.426,6</b>	<b>3.113,60</b>	<b>2.518,3</b>	<b>2.912,2</b>
Central Bank	205,8	179,6	7,9	7,9
Deposit money banks	627,9	689,2	533,8	733,8
Private sector	-12,2	28,7	52,5	72,9
Sinking funds	-394,8	0,0	-476,9	-548,3
Social security funds <sup>(2)</sup>	2.000,0	2.216,2	2.401,0	2.646,0
<b>Central Bank advances</b>	<b>585,4</b>	<b>538,7</b>	<b>0,0</b>	<b>0,0</b>
<b>Foreign debt</b>	<b>825,6</b>	<b>765,3</b>	<b>849,5</b>	<b>939,8</b>
<b>Short-term liabilities of the Central Bank to the IMF</b>	<b>4,8</b>	<b>4,8</b>	<b>4,8</b>	<b>4,8</b>
<b>Long-term loans</b>	<b>249,1</b>	<b>180,8</b>	<b>152,3</b>	<b>242,5</b>
<b>Medium-term loans (EMTN)</b>	<b>515,9</b>	<b>515,9</b>	<b>674,8</b>	<b>674,8</b>
<b>Short-term loans (ECP)</b>	<b>55,8</b>	<b>63,9</b>	<b>17,7</b>	<b>17,7</b>
<b>Total public debt</b>	<b>5.012,9</b>	<b>5.998,10</b>	<b>6.082,6</b>	<b>6.884,2</b>
<b>Net public debt (excluding intragovernmental and short-term liabilities of the Central Bank to the IMF)</b>	<b>3.007,7</b>	<b>3.776,60</b>	<b>3.676,3</b>	<b>4.233,0</b>

(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.

account deficit reached £291 million or 4,4% of GDP during the year under review, compared with £330,9 million or 5,4% of GDP in 2002. This favourable development emanated from a significant improvement of the trade account. Specifically, total exports and total imports of goods fell by 6,7% and 7,4%, respectively. As a result, the trade deficit narrowed to 24,3% of GDP in 2003 compared with 28,2% of GDP in 2002. In contrast the services, income and current transfers account deteriorated during the year under review. Tourist arrivals declined by 4,8% mainly due to the impact of the Iraq war, the threats of international terrorists and the subdued economic climate prevailing internationally during 2003. The current account deficit was financed from direct investment and external borrowing by the public and private sectors.

Since 2002 balance of payments statistics have been compiled by the Central Bank in accordance with the methodology of the Statistical Service of the European Community (Eurostat). For the time being, the new system provides quarterly data based on monthly figures collected by banks regarding their transactions with non-residents, either for their own account or for the account of their resident customers (settlements-based system). The Central Bank supplements this information with sample surveys and direct reports from various categories of residents. Due to the implementation of the aforementioned system, the collection of statistical data has improved, especially with regard to the export of services. Since 2002 the compilation of statistics has been in line with the definition of “resident”, as defined by the International Monetary Fund and the European Union. This term refers to natural

persons who reside in Cyprus for more than one year and to legal persons who operate from and have a physical presence in Cyprus. Since the adoption of this new definition, international business companies (IBCs) with more than one year physical presence in Cyprus are considered resident rather than non-resident, as had been previously the case.

#### **Trade balance**

During 2003 there was a significant fall in imports destined for re-export and an almost corresponding fall in re-exports. In parallel, imports for home consumption showed a significant reduction due to the general slowdown in domestic economic activity. During the year under review, domestic exports declined due to the subdued economic conditions prevailing internationally.

Total imports registered a decline of 7,4% in 2003, compared with a fall of 1,7% in the previous year. Imports for home consumption, excluding imports of oil related products and military equipment registered a fall of 2,3% in 2003 compared with a rise of 3,8% in 2002. Imports of consumer goods registered a decrease of 0,5% in 2003 compared with an increase of 3,9% in 2002. Imports of intermediate goods and raw materials registered a marginal increase of 0,1% in 2003 compared with a rise of 0,8% in 2002.

Imports of capital goods increased by 5,7% in 2003 compared with 6% during the previous year. Imports of transportation equipment and spare parts (excluding aircraft) increased by 4,4% in 2003 compared with 5,5% in 2002. It is worth noting that, despite the increase in price of

## Balance of payments<sup>(1)(2)</sup>

£ million

	2002			2003 (prov.)		
	Credit	Debit	Net	Credit	Debit	Net
<b>Current account</b>	<b>3.676,7</b>	<b>4.007,6</b>	<b>-330,9</b>	<b>3.589,1</b>	<b>3.880,4</b>	<b>-291,3</b>
<b>Goods, services and income</b>	<b>3.537,3</b>	<b>3.908,3</b>	<b>-371,0</b>	<b>3.449,1</b>	<b>3.796,0</b>	<b>-346,9</b>
<b>Goods and services</b>	<b>3.226,5</b>	<b>3.632,6</b>	<b>-406,0</b>	<b>3.231,6</b>	<b>3.531,0</b>	<b>-299,4</b>
<b>Goods</b>	<b>514,4</b>	<b>2.253,4</b>	<b>-1.739,0</b>	<b>476,8</b>	<b>2.071,4</b>	<b>-1.594,6</b>
<b>Services</b>	<b>2.712,1</b>	<b>1.379,2</b>	<b>1.333,0</b>	<b>2.754,8</b>	<b>1.459,6</b>	<b>1.295,2</b>
Transport	528,3	538,2	-9,9	647,1	655,1	-8,0
Sea transport	269,0	377,2	-108,3	376,6	414,9	-38,3
Air transport	259,4	161,0	98,4	220,5	185,2	35,3
Other transport	0,0	0,0	0,0	50,0	55,0	-5,0
Travel	1.156,8	319,0	837,9	1.038,9	319,0	719,9
Communication services	22,3	39,2	-16,8	19,0	35,2	-16,2
Construction services	47,6	4,3	43,3	66,6	10,0	56,6
Insurance services	17,1	19,2	-2,1	14,5	20,1	-5,6
Financial services and renting	91,3	40,0	51,3	82,2	30,0	52,2
Design and information services	140,6	131,9	8,7	42,2	19,8	22,4
Royalties and licence fees	1,5	9,3	-7,8	7,0	9,8	-2,8
Other business services	521,8	205,2	316,6	652,3	287,3	365,0
Personal, cultural and recreational services	8,9	8,1	0,7	5,0	10,5	-5,5
Government services, n.i.e.	175,9	64,7	111,1	180,0	62,8	117,2
<b>Income</b>	<b>310,7</b>	<b>275,7</b>	<b>35,0</b>	<b>217,5</b>	<b>265,0</b>	<b>-47,5</b>
Remuneration of employees	8,7	29,7	-21,0	6,0	11,0	-5,0
<b>Current transfers</b>	<b>139,5</b>	<b>99,3</b>	<b>40,1</b>	<b>140,0</b>	<b>84,4</b>	<b>55,6</b>
<b>Capital and financial account</b>			<b>300,3</b>			<b>221,4</b>
<b>Capital and financial account</b>	<b>13,6</b>	<b>16,7</b>	<b>-3,1</b>	<b>10,6</b>	<b>9,2</b>	<b>1,4</b>
<b>Financial account</b>			<b>303,4</b>			<b>220,0</b>
Direct investment			187,5			150,0
By Cypriot residents abroad			-176,4			-200,0
By non-residents in Cyprus			364,0			350,0
Portfolio investment			-277,7			-100,0
Assets			-397,4			-300,0
Liabilities			119,7			200,0
Derivatives			-31,1			-30,0
Other investments			661,7			-100,0
Assets			1.318,3			-700,0
Liabilities			-656,6			600,0
Reserve assets			-237,0			300,0
<b>Net errors and omissions</b>			<b>30,6</b>			<b>69,9</b>

### 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.

crude oil internationally, the value of imports of oil related products decreased mainly due to the weakening of the dollar against the Cyprus pound.

Total exports registered a fall of 6,7% in 2003, compared with a decrease of 18,6% in 2002. Domestic exports declined by 7,2% in 2003, compared with 5,1% in the previous year. Exports of pharmaceuticals and

clothing were particularly hit as a result of the stagnation of economic activity worldwide during the year under review. Agricultural exports were the only category of domestic exports which expanded during 2003.

### Services, income and current transfers

The surplus of the services, income and

#### Imports (cif) by economic origin

£ million

	2001	2002	2003	% change	
				2002/2001	2003/2002
<b>Consumer goods</b>	<b>617,7</b>	<b>641,6</b>	<b>638,2</b>	<b>3,9</b>	<b>-0,5</b>
Non-durable	338,1	351,0	356,8	3,8	1,7
Semi-durable	170,4	178,0	172,6	4,5	-3,0
Durable	109,2	112,6	108,7	3,1	-3,5
<b>Intermediate inputs</b>	<b>710,3</b>	<b>715,8</b>	<b>716,4</b>	<b>0,8</b>	<b>0,1</b>
Agriculture	42,2	43,3	41,2	2,6	-4,8
Construction and mining	120,7	135,9	154,9	12,6	14,0
Manufacturing	421,8	419,3	416,8	-0,6	-0,6
Transport, storage and communications	29,4	26,2	23,3	-10,9	-11,1
Other	96,2	91,1	80,2	-5,3	-12,0
<b>Capital goods</b>	<b>258,3</b>	<b>242,8</b>	<b>256,6</b>	<b>-6,0</b>	<b>5,7</b>
Agriculture	8,8	8,6	7,5	-2,3	-12,8
Construction and mining	20,6	21,2	23,8	2,9	12,3
Manufacturing	69,6	60,0	61,0	-13,8	1,7
Transport, storage and communications	52,3	45,8	62,4	-12,4	36,2
Other	107,0	107,3	101,8	0,3	-5,1
<b>Transport equipment and parts</b>	<b>226,6</b>	<b>281,5</b>	<b>228,3</b>	<b>24,2</b>	<b>-18,9</b>
Motor vehicles	153,7	160,1	149,8	4,2	-6,4
Spare parts	61,3	66,3	66,3	8,2	0,0
Aircraft and parts	0,6	42,7	0,2		
<b>Fuels and lubricants</b>	<b>266,1</b>	<b>240,4</b>	<b>162,5</b>		
<b>Unclassified</b>	<b>97,9</b>	<b>134,3</b>	<b>92,1</b>		
Imports (cif) for home consumption	<b>2.176,8</b>	<b>2.256,4</b>	<b>2.094,0</b>	<b>3,7</b>	<b>-7,2</b>
Imports destined for re-export	351,9	230,2	220,2	-34,6	-4,3
<b>Total imports</b>	<b>2.528,7</b>	<b>2.486,6</b>	<b>2.314,2</b>	<b>-1,7</b>	<b>-6,9</b>
Non-oil civil imports for home consumption	<b>1.813,0</b>	<b>1.882,1</b>	<b>1.839,5</b>	<b>3,8</b>	<b>-2,3</b>

*Note: The figures for imports are based on available data covering the first ten months of 2003.*

## Exports (fob) by economic origin

£ million

	2001	2002	2003	% change	
				2002/2001	2003/2002
<b>Agricultural products (raw)</b>	43,8	36,9	43,6	-15,8	18,2
Of which:					
Potatoes	17,5	11,1	15,1		
Other fresh vegetables, frozen or dried	4,2	3,8	4,4		
Citrus fruit	14,7	18,3	19,0		
<b>Minerals and industrial products of mineral origin</b>	<b>11,6</b>	<b>10,5</b>	<b>9,8</b>	<b>-9,5</b>	<b>-6,7</b>
<b>Industrial products of agricultural origin</b>	<b>28,0</b>	<b>32,9</b>	<b>32,7</b>	<b>17,5</b>	<b>-0,6</b>
Halloumi cheese	7,7	10,9	10,5		
Preserved fruit	0,9	0,9	0,4		
Fruit and vegetable juices	4,1	4,7	4,4		
Beer	1,0	0,9	0,6		
Wines	5,3	5,1	6,1		
<b>Industrial products of manufacturing origin:</b>	<b>150,5</b>	<b>141,6</b>	<b>119,9</b>	<b>-5,9</b>	<b>-15,3</b>
Cigarettes	10,8	4,5	6,8		
Cement	8,4	8,8	9,1		
Pharmaceutical products	39,4	43,1	38,7	9,4	-10,2
Articles of paper	6,0	5,5	5,6		
Clothing	19,7	16,0	9,8		
Footwear	3,8	3,2	1,4		
Furniture	6,8	6,0	4,2		
<b>Unclassified</b>	<b>0,1</b>	<b>0,0</b>	<b>0,0</b>		
<b>Total domestic exports</b>	<b>233,9</b>	<b>221,9</b>	<b>205,9</b>	<b>-5,1</b>	<b>-7,2</b>
Re-exports	337,0	247,1	224,5	-26,7	-9,1
Goods procured in ports by carriers (shipstores)	57,1	42,3	46,4	-25,9	9,6
<b>Total exports</b>	<b>628,0</b>	<b>511,3</b>	<b>476,8</b>	<b>-18,6</b>	<b>-6,7</b>

*Note: The figures for exports are based on available data covering the first ten months of 2003.*

current transfers account dropped to £1.303,3 million in 2003 from £1.408,1 in 2002. This was due to the 10,4% decrease in revenue from tourism in 2003, compared with the 11% drop in the previous year. The travel industry is Cyprus's major source of

foreign exchange inflows. Its decline for the second consecutive year was due to the uncertain conditions prevailing internationally such as the war in Iraq and the threats of international terrorism which affected the tourist industry internationally.

In contrast to other categories of services, there was an improvement in the transport account. During 2003 the improvement of the other business services account by 15% was partly due to better collection of statistical data.

The widening of the incomes account deficit to £47,5 million from £35 million in 2002 was caused by a reduction of revenues from financial investments and labour services.

#### Financial and capital account transactions

The financial account registered a surplus of £221,4 million in 2003, compared with a surplus of £303,3 million in 2002. In particular, direct investments recorded a net inflow of £150 million in 2003 compared with a net inflow of £187,5 million in 2002. As regards portfolio investment, an outflow of £100 million took place in 2003 compared with an outflow of £277,7 million in 2002. In the category of other investment, a net outflow of £100 million occurred in 2003

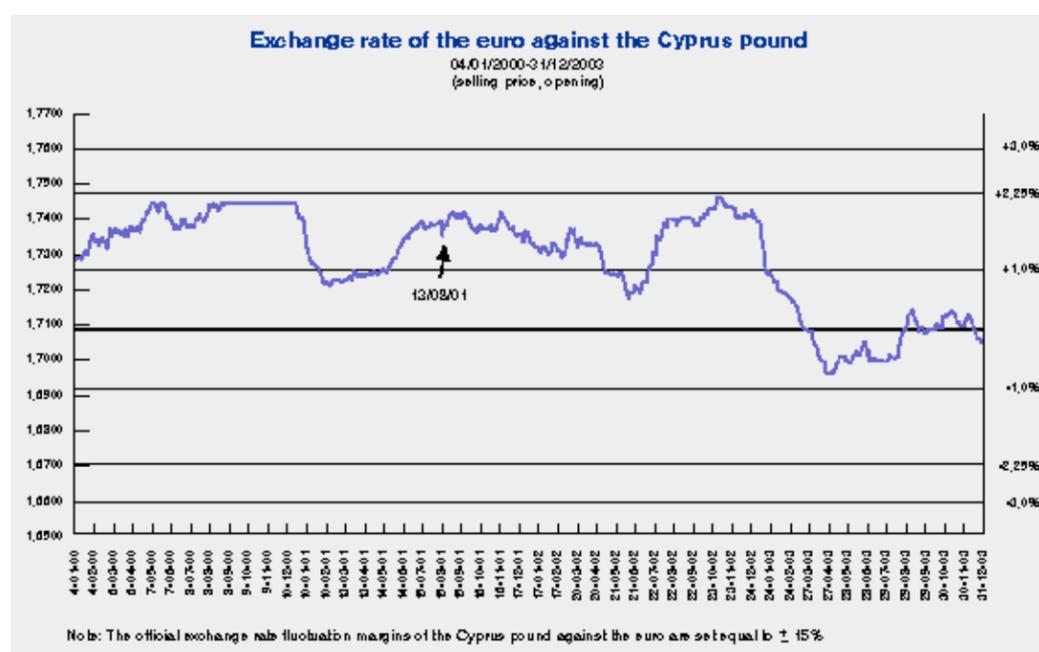
compared with an inflow of £661,7 million in 2002.

#### International reserves

Reflecting the subdued economic conditions prevailing globally, which affected Cyprus's external transactions negatively, official international reserves decreased to £1.560,3 million in 2003, compared with £1.734,9 million in 2002. The coverage provided by official international reserves in respect of total imports (cif), amounted to 9,6 months in 2003 compared with 9,8 months in 2002.

#### Exchange rates

During 2003 the Cyprus pound displayed very small fluctuations against the euro, reaching €1,7054 on 31 December 2003 (opening selling price) compared with €1,7390 on 31 December 2002. According to the present exchange rate policy framework, the fluctuation margins of the Cypriot currency are set at  $\pm 15\%$  of the central parity, which is in line with Exchange Rate Mechanism II. During 2003, as in previous



years, the Cyprus pound fluctuated against the euro within  $\pm 2,25\%$  of its central parity. The fluctuations of the Cyprus pound against international currencies were affected by developments in foreign exchange markets but remained within the foreign exchange policy framework. During 2003 there was a significant weakening of the dollar against the euro and sterling and, to a smaller degree, against the yen. On 31 December 2003, the dollar reached 1,26 per euro which was its lowest rate since the euro was first introduced in January 1999. Sterling also strengthened against the dollar reaching US\$1,78 on 31 December 2003, the highest rate during the last 10 years.

The main reason for the weakening of the dollar was the significant increase of the US fiscal deficit. This development led to an increase of the US current account deficit, which is expected to reach 5% of GDP in

2003. Reflecting the fluctuations of international currencies, the Cyprus pound strengthened significantly against the dollar reaching US\$2,15 on 31 December 2003, compared with US\$1,83 on the first working day of the same year. During the same period the Cyprus pound also strengthened against sterling reaching ST£1,21 on 31 December 2003, compared with ST£1,14 on the first working day of the same year.

### 3.2 Monetary policy and monetary developments

#### Monetary policy

During most of 2003 the war in Iraq dominated the international scene as a result of the uncertain and pessimistic climate that was, in part, created by the impact on the price of oil. The fluctuations in the price of oil generated expectations of weak growth worldwide. During the year under review, the ECB cut its



official interest rates by a total of 75 basis points, the Bank of England by 50 basis points while the Federal Reserve System by 25 basis points. It is noted that the Bank of England was the only one of the aforementioned central banks that eventually decided to raise its official rate by 25 basis points in November.

Following the ECB's decision to cut its official rates and given the uncertainties created by the war in Iraq, the Monetary Policy Committee of the Central Bank of Cyprus also cut its official rates by 50 basis points at an extraordinary meeting in April. The decision was based on the expectation that the war was going to last longer than had originally been assessed as a result of which projections for world economic growth were revised downwards. The hopes for econom-

ic recovery following the end of the war, in conjunction with the relatively high rate of domestic inflation as well as the large budget and current account deficits, led the Central Bank to adopt a cautious stance until the end of the year.

## Monetary and financial developments

### Monetary developments

The growth rate of the total money supply (M2), excluding deposits with Co-operative Credit Institutions, decelerated further, falling to 4% in December 2003, compared with 10,3% in December 2002. According to provisional data, the growth rate of the total money supply (M2C), including deposits with Co-operative Credit Institutions, fell to 5,1% in 2003 as compared with 9,7% in the previous year.

<b>Total money supply</b>					
<i>£ thousand</i>					
	End of period balances	Change			
		2002	2003	2003	
	2003			1st half	2nd half
<b>Money supply (M1)</b>	<b>1.373.265</b>	<b>26.354</b>	<b>334.502</b>	<b>50.462</b>	<b>284.040</b>
Currency in circulation	467.238	36.319	74.394	14.377	60.017
Demand deposits	862.043	-19.715	233.882	31.767	202.115
Foreign currency demand deposits of Cypriot residents	43.984	9.750	26.226	4.318	21.908
<b>Quasi-money</b>	<b>7.117.827</b>	<b>736.187</b>	<b>-8.577</b>	<b>-100.483</b>	<b>91.906</b>
Savings deposits	294.590	19.624	55.102	14.616	40.486
Time deposits	6.440.004	724.503	-113.493	-142.959	29.466
Foreign currency deposits of Cypriot residents	383.233	-7.940	49.814	27.860	21.954
<b>Total money supply (M2)</b>	<b>8.491.092</b>	<b>762.541</b>	<b>325.925</b>	<b>-50.021</b>	<b>375.946</b>

## Factors affecting total money supply

£ thousand

	End of period balances		Change		
	2003	2002	2003	2003	
				1st half	2st half
<b>Net foreign assets</b>	<b>814.870</b>	<b>-78.498</b>	<b>331.210</b>	<b>-301.851</b>	<b>633.061</b>
Official (net)	1.553.653	186.800	-136.310	-331.108	194.798
All banks (net)	-785.103	-272.903	457.700	20.992	436.708
IMF reserve position	46.320	7.605	9.820	8.265	1.555
<b>Claims on private sector</b>	<b>8.303.587</b>	<b>584.034</b>	<b>399.481</b>	<b>265.890</b>	<b>133.591</b>
By all banks	8.303.587	584.034	399.481	265.890	133.591
By monetary authorities	0	0	0	0	0
<b>Claims on public sector</b>	<b>1.906.635</b>	<b>254.256</b>	<b>168.326</b>	<b>163.226</b>	<b>5.100</b>
Central government	1.956.390	266.429	177.961	171.207	6.754
Advances and loans	1.049.965	460.821	19.095	14.132	4.963
Securities, treasury bills, etc.	1.730.491	-153.713	316.664	224.189	92.475
Government deposits <sup>(1)</sup>	-824.066	-40.679	-157.798	-67.114	-90.684
Government agencies <sup>(2)</sup>	-3.435	-4.568	185	284	-99
Advances and loans	23	-6.900	-48	-47	-1
Deposits <sup>(1)</sup>	-3.458	2.332	233	331	-98
IMF reserve position	-46.320	-7.605	-9.820	-8.265	-1.555
<b>Unclassified items</b>	<b>-2.534.000</b>	<b>2.749</b>	<b>-573.092</b>	<b>-177.286</b>	<b>-395.806</b>
<b>Total money supply</b>	<b>8.491.092</b>	<b>762.541</b>	<b>325.925</b>	<b>-50.021</b>	<b>375.946</b>

(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.

The main factor affecting the growth of M2 was the considerable slowdown in credit to both the private and the public sectors. Specifically, claims on the private sector grew by 5,1% or £399,5 million in 2003,

compared with 8% or £584 million in the previous year. Credit to the public sector rose by 9,7% or £168,3 million, compared with 17,1% or £254,3 million in 2002. The slowdown in credit to the private sector can be

## Bank credit by sector

£ thousand

	End of period balances		Change		Share (%) <sup>(1)</sup>	
	2002	2003	2002	2003	2002	2003
Public institutions and corporations <sup>(2)</sup>	248.504	267.830	17.360	19.326	2,7	4,8
Agriculture	112.853	112.331	-6.933	-522	-1,1	-0,1
Mining	26.988	29.528	-829	2.540	-0,1	0,6
Manufacturing	560.721	540.972	22.382	-19.749	3,5	-4,9
Transport and communications	136.284	133.776	16.984	-2.508	2,7	-0,6
Foreign and domestic trade	1.615.045	1.639.828	111.257	24.783	17,6	6,2
Building and construction	1.197.772	1.376.023	136.680	178.251	21,6	44,5
Tourism	818.811	836.510	56.921	17.699	9,0	4,4
Personal and professional loans						
Bills discounted:	3.559.155	3.739.738	278.956	180.583	44,2	45,1
Local	3.929	4.081	-851	152	-0,1	0,0
Foreign	3.323	3.187	-445	-136	-0,1	0,0
<b>Total</b>	<b>8.283.385</b>	<b>8.683.804</b>	<b>631.482</b>	<b>400.419</b>	<b>100,0</b>	<b>100,0</b>

(1) Refers to the change in credit.

(2) Includes government loans.

attributed to the subdued economic activity and to stricter bank policies regarding the assessment of loan applications. In contrast to the above, net foreign assets rose significantly by £331,2 million in 2003, compared with a decrease of £78,5 million in 2002. The observed increase was mainly due to the issue of loan capital by some banks. The decline in unclassified items, due to the combination of higher net foreign assets with higher provisions for bad debts, restrained the growth of M2 during the year under review.

As regards the components of M2, the narrow money supply (M1), which consists of currency in circulation and demand deposits, rose by 32,2% or £334,5 million in 2003, compared with 2,6% or £26,4 million in 2002. This development was due to the fact

that currency in circulation more than doubled while demand deposits increased significantly following a switch from time deposits. The depositors' preference for short-term deposits is attributed to the banks' imposition of penalties in cases of insufficient notice on withdrawals from time deposits. Furthermore, due to low real interest rates, investors searched for higher returns in the property market. In order to take advantage of opportunities in the property market investors kept their funds in liquid form. Consequently, during the year under review time deposits decreased by £113,5 million or 1,7% while demand deposits rose by £233,9 million or 37,2%. In contrast, during the previous year, time deposits increased by 12,4% while demand deposits fell by 3%. Both savings deposits and Cypriot resident foreign currency

deposits increased but not sufficiently to reverse the significant fall in quasi-money during 2003.

An analysis of bank lending by sector of economic activity indicates that in 2003 personal and professional loans, as well as construction, absorbed the largest proportion of new credit, reaching 45,1% and 44,5%, of the total respectively, compared with 44,2% and 21,6% in the previous year.

Regarding foreign currency lending to

Cypriots, the euro was the preferred currency of borrowers accounting for 70,5% of loans, while dollar loans accounted for 9,3% of the total. The respective proportions for 2002 were 64,1% and 15,4%. Most of the change in these proportions was due to the appreciation of the euro against the dollar during the period under review.

#### **Co-operative Credit Institutions**

In 2003, there was an increase in both deposits with and loans from Co-Operative Credit Institutions (CCIs) leading to an

End of period	Total deposits		Total loans	
	Value £'000	% change over previous year	Value £'000	% change over previous year
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	3.513.363	13,0	2.670.250	6,0
2003 (prov.)	3.939.968	12,1	2.901.026	8,6

## 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
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	-	-	-	-	-	-
2003 January	-	3,70	-	3,89	4,08	4,58	4,83	5,08
February	-	3,69	-	3,84	4,07	4,55	-	-
March	-	3,72	-	3,80	-	-	-	-
April	-	3,62	-	-	3,68	4,36	4,63	4,62
May	-	3,45	-	-	3,69	4,37	-	-
June	-	3,39	-	3,60	3,67	4,39	4,59	4,62
July	-	3,34	3,51	3,63	3,69	4,45	-	-
August	-	3,28	-	3,64	3,69	4,48	-	-
September	-	3,41	-	-	-	-	-	-
October	-	3,44	-	3,60	3,79	4,50	4,75	4,90
November	-	3,35	-	3,58	3,90	4,56	-	-
December	-	3,00	-	3,68	3,99	4,68	-	-

improvement in their market share vis-à-vis the commercial banks. According to provisional data, domestic currency deposits with CCIs amounted to 36,9% of total deposits in 2003 compared with 33,3% in the previous year while the respective shares of commercial banks were 63,1% and 66,7%. Excluding the deposits of CCIs with the Co-operative Central Bank, the growth rate of CCI deposits declined to 12,1% in 2003 compared with 13% in 2002. The growth rate of domestic currency deposits with the commercial banks fell to 4,3% in 2003 from 8,4% the previous year.

The loans granted by CCIs in 2003 expanded by 8,6%, compared with 6% in 2002. The proportion of loans by CCIs in the total amount of loans granted also rose to 25,5%, compared with 24,4% in the previous year.

### **The money market**

#### **Bank liquidity**

In the money market, there was an increase in the net sales of government securities worth £392,9 million during the year under review, as compared with net repayments worth £16,9 million in 2002. This develop-

## Bank interest rates

percent per annum

	Lending rates					Deposit rates		
	Business overdraft with 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
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
2003 January	7,40	7,32	7,70	6,78	10,50	0,71	3,85	4,43
February	7,22	7,21	7,70	6,78	10,50	0,65	3,84	4,40
March	7,23	7,22	7,70	6,78	10,50	0,68	3,85	4,37
April	6,77	6,74	7,13	6,18	10,50	0,45	3,33	3,68
May	6,66	6,68	7,10	6,18	10,50	0,45	3,34	3,64
June	6,76	6,72	7,20	6,18	10,50	0,45	3,33	3,60
July	6,97	6,98	7,40	6,30	10,50	0,42	3,34	3,57
August	6,92	6,90	7,40	6,30	10,50	0,40	3,34	3,55
September	6,92	6,90	7,40	6,30	10,50	0,46	3,34	3,52
October	6,92	6,90	7,53	6,30	10,50	0,44	3,35	3,50
November	6,92	6,90	7,53	6,30	10,50	0,42	3,35	3,48
December	6,92	6,90	7,53	6,30	10,50	0,44	3,35	3,45

Note: The interest rates are reported as at end of month and refer to the average for each respective category, as indicated by the three largest banks.

ment increased government deposits with the Central Bank and consequently led to a dampening of surplus liquidity during 2003. The fall in the Central Bank's net foreign assets also played a role in the reduction of excess liquidity in the money market. Specifically, the monthly average of net foreign assets amounted to £1.156,6 million in 2003 compared with £1.485,2 million in 2002. Currency in circulation also rose, reaching a monthly average of £446,1 mil-

lion in 2003 from £398,3 million in the previous year. The Central Bank, in the context of its anti-inflationary policy, intervened in the money market through auctions for the acceptance of deposits (depos) and absorbed a monthly average of £190,8 million in 2003, compared with a monthly average of £314,3 million in 2002.

### Interest rates

As already mentioned, the marginal lending

facility rate remained unchanged during most of 2003, with only one reduction of 50 basis points in April. Specifically, the marginal lending facility rate was 5% until March and was reduced to 4,5% in April, remaining at this level until the end of the year. The respective interest rate of the euro area was 3,75% for the period January to March. This was reduced to 3,5% for the period March to June and then reduced again to 3% for the period June to December 2003. The domestic overnight deposit facility rate remained at 2,5% throughout the year. In the euro area, the respective rate was 1,75%

from January to March, 1,5% from March to June and 1% for the period June to December 2003. The overnight domestic inter-bank deposit rate decreased considerably owing both to surplus liquidity conditions and the reduction in the official rate in April. The average overnight rate was 3,31% in December 2003, compared with 3,52% in December 2002.

The bank lending and deposit rates were stable during the first three months of the year under review but fell in April, reflecting the trend of the official rate.

## 4. Functions of the Bank

### 4.1 The Central Bank and Cyprus's accession to the European Union

The Central Bank has made an important contribution to Cyprus's efforts to join the European Union (EU). These efforts led to the signing in Athens, on 16 April 2003, of the Treaty Concerning the Accession of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia and the Republic of Slovakia to the EU. Throughout 2003, the Central Bank continued to work for the timely completion of the harmonisation process with the *acquis communautaire* in its areas of competence.

Immediately after the signing of the Treaty of Accession and following an invitation by the ECB, the Central Bank of Cyprus and the central banks of the other acceding countries began to attend the meetings of the ECB General Council and the ESCB committees as observers. The purpose of their attendance was to prepare for their smooth integration into the ESCB as full members on 1 May 2004. In this context, the Governor of the Central Bank, Christodoulos Christodoulou, attended the meetings of the ECB General Council on 26 June, 18 September and 18 December 2003, and participated in the discussion of vital issues. In parallel, about 30 Central Bank officials attended the meetings of ESCB committees and subcommittees, regularly.

#### European Affairs Unit

In June 2003, the Bank established the

European Affairs Unit, which reports directly to the Governor, in order to facilitate the Central Bank's participation in the ESCB and the other bodies and activities of the EU. The Unit's functions include assisting the Governor's preparation for the ECB General Council meetings and coordinating the Central Bank's participation in ESCB and other EU committees. The coordinating function of the Unit is especially necessary for important policy issues where two or more Central Bank divisions are involved. The Unit is also responsible for the coordination of the Central Bank's harmonisation programme with the *acquis communautaire*.

#### Harmonisation with the *acquis*

The European Commission's comprehensive monitoring report on Cyprus's preparations for membership, which was issued in November 2003, reaffirmed that Cyprus has reached a high level of alignment with the *acquis* in most policy areas. The topics in the Central Bank's sphere of competence were classified by the European Commission among those for which harmonisation has been completed or is at an advanced stage and only minor issues remain, which will be resolved by the time of Cyprus's accession to the EU. This positive assessment was the result of the effective work carried out by the Central Bank. The harmonisation measures taken by the Central Bank during 2003, as well as the measures to be taken for the completion of harmonisation in each area, are discussed below.

#### Banking services

In the banking sector, the rules, policy and practice of the Central Bank have been aligned with the relevant EU directives with only secondary issues still pending.

The *Banking (Amendment) Law, 119(I)/2003*, was enacted by the House of Representatives in July 2003 for the purpose of full harmonisation with the relevant part of the *acquis*, particularly Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions as amended by Directive 2000/28/EC. This law includes, *inter alia*, provisions for the following:

- abolition of the economic need criterion;
- the establishment of branches or the provision of cross-border banking services by banks authorised by other EU member states (“single passport”);
- criteria for the fitness and propriety of bank directors, chief executive officers and managers;
- the power of the Central Bank to exchange information with other supervisory authorities;
- the prescription of a time limit for the refusal of a bank licence;
- the amendment of the rules on large exposures;
- the exercise of consolidated supervision.

The provisions concerning the economic need criterion and the “single passport” will enter into force on the date of Cyprus’s accession to the EU, while the other provisions of the law entered into force on 25 July 2003.

In July 2003, the House of Representatives also approved the Establishment and Operation of the Deposit Protection Scheme (Amendment) (No. 2) Regulations (P.I. 637/2003), which aim at ensuring full alignment with EU Directive 94/19/EC. In accordance with the new regulations, the deposit protection scheme (which at present

covers only deposits in Cyprus pounds) will be extended to include deposits in all the currencies of EU member states, upon Cyprus’s accession to the Union.

In November 2003, the Central Bank amended its 1999 directive on the layout and contents of the annual accounts of banks to incorporate the provisions of EU Directive 2001/65/EC on valuation rules. In addition, the Central Bank issued to banks the European Commission’s Recommendation 2000/408/EC concerning the disclosure of information on financial instruments and other items.

As regards EU Directive 2000/46/EC on electronic money institutions, the Central Bank prepared a draft law for its transposition and the bill is expected to be submitted to the House of Representatives in early 2004. In 2003 the Central Bank also prepared a draft law to transpose EU Directive 2001/24/EC on the reorganisation and winding up of credit institutions, since member states must implement this directive by 5 May 2004.

Furthermore, the Central Bank prepared a draft directive to banks for the transposition of EU Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate. The Central Bank directive is expected to enter into force by August 2004.

In addition, in December 2003 the Central Bank issued a circular to banks concerning EU Regulation (EC) No 2560/2001 on cross-border payments in euro, which will be directly applicable in Cyprus as from the date of accession. The circular invites banks

to take all appropriate measures to comply with the Regulation as from 1 May 2004.

During 2003, the Central Bank also took preparatory measures with regard to the reform of the existing regulatory regime for capital adequacy in accordance with the forthcoming revision of the corresponding EU framework, which is expected to come into effect at the end of 2006. The new framework, which will regulate the capital requirements of credit institutions and investment firms at the EU level, aims at bringing the EU rules on capital adequacy into line with the New Basel Capital Accord (this is expected to come into effect at the same time as the relevant EU directive). In this connection, the Central Bank took the initiative to set up working groups of experts from the banking sector. These working groups will be responsible for the implementation of the whole project, on the basis of a predetermined timetable consistent with that of the EU.

#### **Free movement of capital**

On 10 July 2003, the House of Representatives enacted a new law entitled the *Capital Movement Law, 115(I)/2003*. This law, which will come into effect on the date of Cyprus's accession to the EU, will abolish the *Exchange Control Law* and ensure the freedom of capital movements, in accordance with the *acquis communautaire*. During the pre-accession period, the gradual abolition of exchange controls is effected through the issue of administrative acts by the Central Bank, under the *Exchange Control Law*.

With the entry into force of the *Capital Movement Law* on 1 May 2004, there will be no restrictions on capital movements and

payments to and from Cyprus, with certain exceptions provided by the Treaty establishing the European Community and the Treaty of Accession. In this context, *Law 115(I)/2003* provides, *inter alia*, for safeguard measures in accordance with the Treaty establishing the European Community (for instance, in case of a sudden crisis in the balance of payments prior to the adoption of the euro by Cyprus) and provides for other measures with regard to non-EU countries taken by the Council of the EU (in the context of the common foreign and security policy). The law also provides for the maintenance of certain existing restrictions concerning direct investments in Cyprus from third countries, while it reaffirms that direct investments in Cyprus by residents of EU member states are free from restrictions. However, for a five-year transitional period stipulated in the Treaty of Accession, the acquisition of secondary residences in Cyprus by non-Cypriot EU nationals will remain subject to the District Officer's approval under the *Immovable Property Acquisition (Aliens) Laws*.

The gradual abolition of exchange control restrictions continued during 2003, in the context of the three-phase plan formulated by the Central Bank in collaboration with other competent authorities during the accession negotiations. In August 2003, the Central Bank lifted a substantial number of exchange control restrictions by issuing directives under the *Exchange Control Law*. Specifically, the Central Bank abolished the 50% ceiling on the participation of non-residents in the share capital of domestic banks listed on the Cyprus Stock Exchange. The abolition of this ceiling is without prejudice to the provisions of other relevant laws, particularly section 17(1) of the *Banking Law*,

by virtue of which the Central Bank's prior approval is required for the acquisition of 10% or more of a bank's share capital. The Central Bank also abolished the remaining quantitative limits and procedural requirements with regard to the following capital movements:

- (a) transfer abroad by non-residents of the proceeds from the sale of securities listed on the Cyprus Stock Exchange;
- (b) transfer abroad by non-residents of the proceeds from the sale of real estate in Cyprus that was not acquired by payment in foreign exchange;
- (c) prepayments for imports;
- (d) gifts and endowments, inheritances and transfers of emigrants' funds;
- (e) cash withdrawals abroad through credit or debit cards held by residents.

At the same time, the Central Bank simplified further the procedures applicable to current transactions. Specifically, the Central Bank abolished all indicative limits over which the verification of genuineness by the Bank was required. Furthermore, direct investments abroad by residents of Cyprus were fully liberalised. Specifically, since 5 August 2003, direct investment projects necessitating the transfer of funds in excess of £5 million per year no longer have to be referred to the Central Bank.

The exchange control restrictions on investments from EU member states were virtually abolished in January 2000, while certain administrative requirements for prior notification of the Central Bank remained in place. The Central Bank abolished these requirements with the issue of the Exchange Control (Exemption of European Union Residents) Order of May 2003 (P.I. 394/2003). By virtue

of this Order, EU residents (natural and legal persons) are fully exempted from the provisions of the *Exchange Control Law* concerning the establishment of companies and the acquisition or transfer of securities in Cyprus. Following the issue of the aforementioned Order, EU residents may establish companies or acquire existing companies, wholly or partly, without any exchange control formalities, in the same manner as Cypriots. However, direct investments by EU residents are still subject to a number of restrictions under other specific laws for certain sectors of economic activity, particularly electricity supply, tertiary education, radio and television stations, travel agencies and acquisition of real estate. The relevant laws have been amended or replaced by new laws, in line with the *acquis*, which will come into full effect on 1 May 2004.

Given the liberalisation measures implemented in 2003, the remaining exchange control restrictions concern mainly:

- (a) short-term foreign borrowing by residents;
- (b) loans in Cyprus pounds to non-residents;
- (c) the free conversion of Cyprus pounds into foreign currency by residents;
- (d) the maintenance of deposits with banks abroad;
- (e) portfolio investment (above the currently applicable limit of £50,000 per year for natural persons) by residents (other than banks and insurance companies, which are already free); and
- (f) the purchase of secondary residences abroad (above the limit of £200,000 per resident family).

The abolition of the remaining exchange control restrictions will be completed by the

time of Cyprus's accession to the EU, at the latest.

### **Payment systems**

With regard to payment systems (which are included in the accession negotiations chapter on the free movement of capital), harmonisation with the *acquis communautaire* has been almost completed.

In January 2003, the *Settlement Finality in Payment and Securities Settlements Systems Law, 8(I)/2003*, which was drafted by the Central Bank, was enacted by the House of Representatives with a provision for entry into force upon accession. This law transposes the provisions of EU Directive 98/26/EC (more information is given in section 4.4 of this Report).

In 2003 the transposition of EU Directive 97/5/EC on cross-border credit transfers was completed. Specifically, the directive regulating the provision of international money transmittance services (P.I. 659/2003), which was issued by the Central Bank under section 48 of the *Central Bank of Cyprus Law, 2002* and entered into force on 1 September 2003, requires *inter alia* the companies offering such services to comply with the directive on cross-border credit transfers, in the same manner as banks. As regards banks, the provisions of the EU Directive on cross-border credit transfers were transposed through the issue of a Central Bank directive to banks on 30 November 2000, under the *Banking Law*.

With the aim of implementing the European Commission's Recommendation concerning transactions by electronic payment instruments, and in particular the relationship between issuer and holder (97/489/EC), the Central Bank issued a draft directive on

transactions by electronic payment instruments to banks for comments. In the light of the comments received, the Central Bank finalised the text of the directive, which is expected to be issued under the *Banking Law* in the first quarter of 2004. It should be noted that some of the provisions of Recommendation 97/489/EC have already been transposed into national legislation. Specifically, the *Consumer Credit Law, 39(I)/2001*, covers several of the provisions of Recommendation 97/489/EC with respect to credit cards, in particular the provisions concerning the liability of a credit card holder in case of loss or theft, the transparency of the terms of transactions and the settlement of disputes.

Furthermore, in 2003 the Central Bank prepared a draft law entitled the *Financial Collateral Arrangements Law, 2004*, which transposes the provisions of EU Directive 2002/47/EC of June 2002. The draft law sets out the regime applicable to financial collateral arrangements in order to protect the validity of these arrangements, thereby contributing to the efficient operation of the financial market, as well as to the stability of the financial system. The new law is expected to be enacted in the first quarter of 2004 and come into force on the date of Cyprus's accession to the EU.

### **Prevention of the use of the financial system for money laundering**

During 2003, the Central Bank, in its capacity as the supervisory authority under the *Prevention and Suppression of Money Laundering Activities Law*, issued new guidance notes to banks and other institutions under its supervision for the implementation of even stricter procedures for the prevention of money laundering (more information is given in section 4.3 of this Report).

An important development in this area was the enactment of the *Prevention and Suppression of Money Laundering Activities (Amendment) Law, 118(I)/2003*, which transposes the second EU Directive on the prevention of the use of the financial system for the purpose of money laundering (2001/97/EC). *Law 118(I)/2003*, which entered into force on 25 July 2003, imposes on accountants, auditors and tax advisors, as well as lawyers when engaged in the activities specified in Directive 2001/97/EC, the obligation to take the preventive measures against money laundering specified in the principal law, which are also applicable to banks and other financial institutions. The law also lays down the required additional measures for the identification of customers who request the establishment of business relationships or the execution of transactions without being physically present (“non-face to face” operations). In addition to these harmonised provisions, *Law 118(I)/2003* empowers the supervisory authorities, including the Central Bank, to impose administrative fines of up to €3.000 on persons falling under their supervision who fail to comply with their obligations for the implementation of preventive measures against money laundering. As an exception, the competent supervisory authorities for lawyers and auditors, namely the Cyprus Bar Council and the Institute of Certified Public Accountants of Cyprus, respectively, shall refer lawyers and auditors to their respective professional disciplinary bodies.

#### **Protection of the euro against counterfeiting**

In 2003 the Central Bank prepared a draft law entitled the *Currency (Counterfeiting and Related Matters) Law*, which streamlines

and modernises the existing *Currency Law* and brings about harmonisation with the relevant *acquis communautaire* (Council Framework Decision 2000/383/JHA, as amended by Framework Decision 2001/888/JHA, Framework Decision 2001/887/JHA, and Regulations (EC) No 1338/2001 and 1339/2001). The draft law is expected to be enacted in the first quarter of 2004.

The Central Bank had consultations with the Ministry of Justice and Public Order, in order to comply with the requirements of EU Regulation (EC) No 1338/2001 concerning the designation of a competent national authority for gathering and analysing technical and statistical data relating to counterfeit banknotes and coins. The consultations resulted in an agreement to designate the Police Forensic Science Laboratory as the National Analysis Centre and the Coin National Analysis Centre.

#### **Economic and monetary union**

Since July 2002, Cyprus has met the commitments and requirements arising from the accession negotiations in the area of economic and monetary union. These requirements, which primarily concern the independence of the Central Bank and the prohibition of the financing of the public sector by the Bank, were fulfilled by virtue of the *Central Bank of Cyprus Law* and the amendments to the Constitution of the Republic of Cyprus, which came into effect on 5 July 2002.

Having met its commitments in this area, the Central Bank proceeded in 2003 with the gradual preparation for the adoption of the euro. In particular, the Central Bank began to prepare for Cyprus’s participation in the Exchange Rate Mechanism II (ERM II).

Both the Central Bank and the government aim to join ERM II immediately after accession to the EU and to adopt the euro after the two-year participation in ERM II.

#### 4.2 Monetary policy instruments

The primary objective of the Central Bank of Cyprus is to ensure price stability and, without prejudice to this objective, to support the general economic policy of the government. In order to achieve the monetary policy objectives in general and, in particular to regulate the supply of money and credit in the

economy, the Central Bank has at its disposal a number of monetary policy instruments.

#### Open market operations

The main refinancing operations allotted through tenders are the main operations which have replaced the liquidity ratio. They are liquidity-providing (or-absorbing) reverse transactions applicable on the basis of repurchase agreements, whereby the Central Bank buys (or sells) government securities from (or to) the counterparties against collateral (repos or reverse repos). Such transactions, whose duration is up to

#### Monetary policy instruments

£ millions, period averages

Period	Open market operations	Standing facilities		Minimum reserves
	Repos(+)/Reverse Repos, Acceptance of deposits(-)	Marginal lending facility	Deposit facility	Minimum required reserves
2002 January	-174,3	0,8	16,4	470,4
February	-131,1	0,6	14,5	485,3
March	-189,9	3,3	24,8	486,3
April	-267,7	3,4	17,6	487,9
May	-287,6	1,0	11,2	490,2
June	-366,9	0,6	26,0	492,8
July	-405,2	1,5	41,5	494,8
August	-427,1	1,9	21,9	500,9
September	-392,3	8,6	2,2	506,2
October	-332,6	0,3	10,5	508,2
November	-385,3	0,6	4,7	509,0
December	-412,0	0,0	36,2	512,4
2003 January	-438,9	3,5	29,3	521,5
February	-325,0	0,4	32,4	533,1
March	-308,5	10,3	11,1	535,4
April	-210,4	0,2	14,7	531,9
May	-152,3	3,2	13,4	529,7
June	-136,7	1,6	9,9	526,1
July	-117,7	0,0	27,6	525,1
August	-146,8	0,0	24,0	525,1
September	-174,5	2,6	14,0	527,4
October	-123,6	0,3	23,0	529,2
November	-107,7	0,6	31,2	527,4
December	-47,4	4,8	17,8	528,2

15 days, take place whenever the Central Bank deems appropriate.

In addition, the Central Bank invites the counterparties to submit tenders for the acceptance of deposits in order to reduce (absorb) their excess liquidity. The duration of such operations is determined by the Central Bank. In the case of interest rate tenders, the Bank announces the maximum interest rate and the total amount of deposits to be accepted. In the case of volume tenders, the Bank announces the 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. In 2003, the Central Bank absorbed on a monthly average basis £190,8 million of liquidity through the auctions for the acceptance of deposits. This compares with £314,3 million in 2002.

#### **Standing facilities**

The interest rate on the marginal lending facility is intended to provide the upper end of the overnight money market interest rates. A change in the interest rate on this facility signals a change in the monetary policy stance. Credit granted to banks under the marginal lending facility is made available on an overnight basis. Government securities, acquired through auctions, 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. The Central Bank reserves the right to restrict access to this facility should its excessive use jeopardise the monetary policy objectives. In 2003 the monthly average amount borrowed by the banks through this facility was £2,3 million, compared with £1,9 million in 2002.

The counterparties may deposit their short-term surplus funds at the Central Bank at the end of each day. The interest rate on the deposit facility is intended to provide the floor for the overnight money market interest rates. In 2003 the monthly average amount deposited by the banks through this facility was £20,7 million, compared with £19 million in 2002.

#### **Minimum reserves**

On 1 January 1996, the liquidity ratio was abolished and a proportion equal to 20% of the average weekly deposits was “frozen”. This “frozen” stock consists of treasury bills which are renewed automatically and bear a fixed interest rate of 6% per annum. The Central Bank has been gradually releasing the stock which will be phased out by the beginning of 2005.

A proportion equal to 7% of the average weekly deposits during the first three weeks of December 1995 was transferred to a reserve account. The reserve account is the only operational account of the commercial banks with the Central Bank. A reserve ratio of 6,5% is currently in effect. Commercial banks earn interest on the average holding of their reserve account at a rate linked to the marginal lending facility rate, which is determined by the Central Bank. Over the maintenance periods, reserves in excess of the required are not remunerated. In 2003, the monthly average minimum required reserves amounted to £528,3 million, compared with £495,4 million in 2002.

### **4.3 Regulation and supervision of the banking sector**

Under the *Central Bank of Cyprus Law, 2002* and the *Banking Law, 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 system. Supervision also aims at protecting depositors.

The Central Bank supervises domestic banks, international banking units (formerly referred to as “offshore banks”) as well as representative offices of foreign banks. Of the 14 domestic banks operating in Cyprus, 11 are commercial banks and 3 are specialised financial institutions. There are also 29 international banking units and one representative office of a foreign bank operating from within Cyprus.

In exercising its supervisory role, the Central Bank is guided by the recommendations of the Basel Committee on Banking Supervision and the regulatory rules of the European Union. In this context, various directives have been issued to all banking institutions (domestic and international) that have a presence in Cyprus, for the purposes of prudential supervision. In order to supervise banking institutions, the Central Bank uses two complementary methods in a coordinated manner. Specifically, the Central Bank:

- (a) Monitors, off-site, the performance of banks through various prudential returns covering an extensive range of their operations;
- (b) Examines, on-site, the financial condition of banks and evaluates their future prospects at the time of the examination.

On-site examinations focus on management and administration, internal audit, risk management framework (credit risk, interest rate risk, foreign exchange risk, etc), profitability/performance, adequacy of provisions for doubtful debts as well as compliance with the rules and directives of the Central Bank.

#### **Developments in the regulatory framework for banking supervision**

During 2003, an important development in the field of banking supervision was the enactment of the *Banking (Amendment) Law, 2003* for the purposes of full harmonisation of banking legislation with the *acquis communautaire*. Also of importance was the approval of new regulations regarding the Deposit Protection Scheme. In accordance with the relevant EU directive, these regulations extended coverage to deposits in EU currencies upon Cyprus’s accession.

Since 1 January 2003 more stringent criteria with respect to the suspension of the recognition of interest have been implemented. The time period beyond which interest is to be suspended for credit facilities in arrears or limits in excess, provided that there is no adequate tangible security, was originally set at nine months. In October 2003, the Central Bank amended the relevant directive, reducing the time period beyond which interest will be suspended from nine to six months with effect from 1 January 2004. This time period will gradually be reduced to three months, irrespective of the existence of tangible security, in line with international practice.

As regards the prevention of money laundering, in February 2003 the Central Bank issued a new guidance note under the

*Prevention and Suppression of Money Laundering Activities Law, 1996*. The note deals with the identification of the principal/ultimate beneficial owners of “old customer accounts”. In accordance with the same law, a number of new guidance notes were issued with the aim of implementing additional monitoring procedures for business relations and transactions with persons from countries designated by the Financial Action Task Force as “non-cooperative” in the fight against money laundering. In July 2003, the *Prevention and Suppression of Money Laundering Activities (Amendment) Law* was enacted by the House of Representatives with the intention of transposing the EU’s second money laundering Directive on the prevention of the use of the financial system for the purpose of money laundering.

In the course of fighting terrorism, the Central Bank issued circulars to banks requiring the freezing of funds belonging to individuals designated by the United Nations Sanctions Committee Against Terrorism and the European Union as being associated with terrorist organisations. In the same context, a number of circulars were issued requesting banks to take all necessary measures for the implementation of United Nations resolutions and common positions of the Council of the European Union which impose financial sanctions against Iraq, the Democratic Republic of Congo, Rwanda, Sudan, Myanmar and Afghanistan (Taliban).

#### **Domestic banking sector**

During 2003, the domestic banking system was adversely affected by the prolonged recession in the world economy as well as the slowdown of the Cyprus economy. Moreover, the reduction of interest rates, the

continuing war in Iraq, the decline in tourist arrivals and the underperformance of the stock market also had a negative impact on the banking system.

The slowdown of the economy in conjunction with the ongoing uncertainty regarding the settlement of loans granted for the purchase of shares prevented the improvement in the quality of the loan portfolio of banks. These developments rendered necessary increased provisions for bad and doubtful debts compared with 2002. Furthermore, the application of the Central Bank directive on the suspension of the recognition of interest on non-performing loans as from 1 January 2003 had a negative effect on the net interest income of domestic banks for the whole of 2003. This negative impact was counterbalanced by increases in net interest margins and by the expansion of their operations. The inability of banks to contain their operating costs adversely affected their financial results for 2003. As regards the losses arising from the fall in the value of stock market investments, these were substantially reduced in relation to 2002.

Despite the negative picture presented above, Cyprus’s domestic banks remain sound, backed by a strong capital base and are capable of successfully managing the present unfavourable market conditions. Furthermore, the excellent quality of human resources, the know-how and up-to-date technology at their disposal, the increased range of products and services offered, the continuous efforts to reduce their operating costs, the reduction of losses suffered due to the collapse of the stock market, as well as the anticipated revival of the Cyprus and the world economies are expected to contribute positively to the long-term prospects of

banks. In addition, the forthcoming accession of Cyprus to the EU is not expected to create serious problems for the banks because they have the strength and ability to compete successfully.

During 2003, the overseas operations of domestic banks, particularly in Greece, grew considerably through the expansion of their branch network and the volume of their loans and deposits. The expansion of Cypriot banks abroad enables them to be less dependent on the small and saturated Cyprus market and provides opportunities for further growth and improved profits. As a result of reduced dependence on the Cyprus market, banks succeeded in containing their business risk. In addition, the exposure to the external competitive environment enables them to meet successfully the challenge of greater competition in the domestic market.

However, expansion abroad creates the need for increased capital funds which are required to finance the growth of their operations. For this reason, during 2003 banks considerably strengthened their capital base through the issue of hybrid capital instruments and subordinated loan capital. The Central Bank believes that in order to ensure a smooth growth path when expanding abroad, banks should adopt a gradual approach and should proceed only after a thorough study of market conditions. The long-term goal is that overseas operations should continue to have a positive and increasing contribution to the financial results of banks.

#### **International banking sector**

During 2003, the performance of the international banking sector, whose transactions have been historically carried out with non-residents and without foreign exchange

restrictions, exhibited some improvement in relation to the previous year, despite the slow rate of recovery of the world economy and the reduction in interest rates of the major international currencies. The total assets of international banking units (IBUs) recorded a small increase, primarily reflected in balances with banks and other financial institutions, while total lending registered a decline. In contrast, total deposits did not register a significant change, remaining at the same level as in 2002. The financial results of IBUs showed an improvement compared with the previous year.

The tax regime which governs the operations of IBUs has changed radically since the implementation of new tax legislation on 1 January 2003. In accordance with the new legislation, there is no longer a distinction between domestic banks and IBUs. With the exception of those IBUs which had been operating in Cyprus on 31 December 2001 and which have been granted a transitional period until 31 December 2005, all domestic banks and IBUs are subject to the same rate of corporation tax, i.e. 10%. Those IBUs which were already established and operating in Cyprus on 31 December 2001 were given the choice of either being taxed at the new rate as from 1 January 2003 whilst at the same time acquiring the right to engage in commercial activities with Cypriot residents, or continuing to be taxed at the lower rate until the end of December 2005 on condition of not being allowed to transact business with Cypriot residents. All eligible IBUs opted for the latter. As of 1 January 2006 all IBUs operating from within Cyprus will be subject to the same tax rate as domestic banks.

It is worth mentioning that those IBUs which have been operating in Cyprus in the form of

a branch and which had been exempted from taxation in accordance with the previous tax regime, have been obliged to pay income tax at the rate of 4,25% as from 1 January 2003. This enables them to maintain their special tax status during the transitional period. The tax reforms have not, so far, led to a scaling down of IBU operations and have not adversely affected interest in the establishment of new IBUs, thus reflecting Cyprus's non-tax advantages as well as its international recognition as a reputable regional financial centre.

It should also be mentioned that following Cyprus's accession to the EU more business opportunities are expected to arise, especially for banks coming from countries outside the EU. By establishing their presence in Cyprus, foreign banks can serve as a bridge between their home countries and the European Union, to the benefit of both sides. In this context, it is worth mentioning that in 2003 the Central Bank granted a licence to Kazkommertsbank of Kazakhstan to establish an IBU. Other foreign banks have also expressed an interest in establishing IBUs in Cyprus and more licences are expected to be granted in the near future.

The tax reforms, in conjunction with the imminent abolition of the *Exchange Control Law*, which will allow Cypriot residents to maintain deposits in foreign currencies with domestic banks or IBUs as well as to borrow in foreign currency on a short-term basis, will lead to the end of "ring-fencing" hitherto applied to IBUs and to the convergence of the domestic and international banking sectors as from 1 January 2006.

#### **Financial stability**

During 2003, the Central Bank took the first

steps towards the development of a comprehensive framework for macroprudential analysis, with the purpose of safeguarding further the stability of the financial system and complying with the recommendations and requirements of the ECB and the IMF. Macroprudential analysis aims at assessing and monitoring the soundness and vulnerability of the banking sector so that any systemic weakness which could threaten the stability of the financial system can be identified early and acted upon. The framework relies on a number of indicators which, combined with other data on the macroeconomic and financial environment, are intended to capture significant build-ups of risk exposure within the banking system, potential disturbances emerging from outside the system, and channels of contagion through which difficulties at one institution might spread to others. The Central Bank has asked all banking institutions to submit in the first half of 2004 banking sector data requested by the ECB. During the second half of 2004, the Central Bank will complete the collection of all banking sector data required for the conduct of macroprudential analysis, while the collection of data regarding the other sectors of the financial system will begin.

#### **Cooperation with other domestic and foreign supervisory authorities**

As from 1 January 2003, the Memorandum of Understanding that was signed in 2002 by the Central Bank of Cyprus, the Securities and Exchange Commission and the Insurance Companies' Control Service has become effective. The signing of the Memorandum has received positive comments from the European Union as it has paved the way for a substantial and on-going cooperation between the competent regulatory authorities of the financial sector, render-

ing its monitoring more effective and leading to a more uniform approach to regulation. An important development in November 2003 was the signing of the above Memorandum by the Service for the Supervision and Development of Co-operative Societies, which further reinforces the effectiveness of financial regulation.

During 2003, the Central Bank reinforced its bilateral relations by signing Memoranda of Understanding with a number of foreign central banks, supervisory and regulatory authorities of countries whose banks and other financial institutions have an active presence in Cyprus. This practice is in accordance with the relevant recommendation of the Basel Committee on Banking Supervision, which aims at strengthening the supervision of cross-border activities of banking institutions. Memoranda of Understanding were signed with the Financial and Capital Market Commission of the Republic of Latvia, the National Bank of Slovakia, the Bank of Tanzania and the Central Bank of Jordan. The Central Bank is currently negotiating Memoranda with three other foreign supervisory and regulatory authorities.

#### **4.4 Payment and settlement systems**

The smooth and orderly development of the economy depends on the existence of efficient and safe means of effecting payments. In addition to this, payment systems 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 financial market activity coupled with the rapid advances in

technology have brought to the surface the security and efficiency aspects of payment systems and have highlighted their significance.

For the above reasons, great importance has been assigned to the establishment of the required legal framework governing payment systems and the necessary infrastructure for their orderly, safe and efficient operation.

The need for close cooperation between the Central Bank and the banking community in the field of payment systems is considered very significant for safeguarding the timely and effective response to developments. To this end, the Central Bank has proceeded with the setting up of a Payments Committee consisting of commercial banks, the Association of Cyprus Commercial Banks and the Office of the Commissioner for the Supervision and Development of Co-operative Societies. The role of this Committee is to act as a consultant to the Central Bank and as a coordinator for the banking community.

#### **Legal framework**

The role of the Central Bank in the area of payment systems, as envisaged by the *acquis communautaire*, is stipulated in the *Central Bank of Cyprus Law*. In particular, section 6(2)(e) states 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, 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 communautaire*, the provisions of EU Directive 98/26/EC on settlement finality have been incorporated in the *Settlement Finality in Payment Systems and in Securities Settlement Systems Law, 2003* which comes into force on 1 May 2004. This law stipulates that the Central Bank is the competent authority empowered to designate the payment systems that fall within the scope of its provisions. As in the EU directive, the aforementioned law achieves three basic objectives with regard to the payment systems that fall under its provisions, even in the case where insolvency proceedings have been initiated against any participant in the system. These objectives are the :

- irrevocability of the instructions for payment and of netting;
- 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;
- possibility for immediate liquidation of the collateral for the purpose for which it has been pledged.

In addition, the law 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 in Cyprus**

Five payment and securities settlement systems currently operate in Cyprus: 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 European Central Bank titled "Payment and securities settlement systems in accession countries" issued in August 2002. The Central Bank operates the LVCTS and the Cyprus Clearing House.

Following agreement with the Cyprus Stock Exchange, arrangements are under way for the transfer of the cash settlement of stock exchange transactions to the Central Bank. This is expected to be completed around the middle of 2004 and will contribute to the improvement of the credibility and the security of the cash settlement of exchange transactions, as this will be effected in Central Bank money.

All systems currently operating in Cyprus were evaluated by the ECB in June 2002 and were found to be very satisfactory for the purpose of accession to the EU. Within the context of the evaluation, several recommendations were 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 Central Bank**

In order to fulfil its new responsibilities, as determined by legislation and ECB recommendations, the Bank has placed payment systems under the responsibility of two independent units within the Accounting Services Department. One of the units is responsible for the operation of payment systems operated by the Bank while the other has the overall responsibility for the oversight of systems

operating in Cyprus. The Bank is in the final stage 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 order to increase confidence in cheques as a safe means of payment, the Central Bank set up the Central Information Registry for the Issuers of Dishonoured Cheques (CIR) in 1 February 2003. The CIR operates under directives issued jointly by the Governor of the Central Bank and the Commissioner for the Supervision and Development of Co-operative Societies. More information about the CIR and the full text of the joint directives is available on the Bank's website ([www.centralbank.gov.cy](http://www.centralbank.gov.cy)).

In addition, with a view to improving cheque clearing, the Central Bank drafted a law that was passed by the House of Representatives in July 2003 (*Law 96(I)/2003*). This law, which amends the *Bills of Exchange Law*, authorises the Central Bank to provide the rules and conditions that govern the electronic presentation of cheques for payment (cheque truncation). The Central Bank, in cooperation with the commercial banks, is currently working out the operational framework that will enable the application of the law.

In order to promote the implementation of Council Regulation 2560/2001 regarding cross border credit transfers in euro, the Central Bank, in cooperation with the banks, introduced the IBAN standard (International Bank Account Number). The Cyprus IBAN has already been registered with the European Committee of Banking Standards and, as of 31 March 2004, all banks will have to comply with the standard.

#### 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, were the decisive factors in setting the priorities concerning currency and related matters during 2003. For the second consecutive year, the contemplated quality upgrading of Cypriot banknotes and coins was suspended. As a consequence, all plans for new issues and the enhancement of banknote security features, which are in any case of a very high quality, were deferred. Since 2002, all efforts have focused on maintaining, on the one hand, the quality of banknotes in circulation and, on the other, adequate stocks to meet any increase in demand for currency, as well as replacing the unfit banknotes, which are withdrawn from circulation for destruction. In this connection, the Bank has placed orders for all denominations of notes and coins to cover the needs for the period up to the end of 2006.

The total value of banknotes in circulation increased by 18,5% during the year under review compared with 9,4% in 2002. It is noted that the average annual increase for 1996-2001 was 7,6%. In the case of coins in circulation, there was an increase of 8,6% in 2003 compared with 6,3% in 2002. It is noted that the average annual increase during 1996-2001 was 7,7%. Currency in circulation as at 31 December 2003 and comparative figures for 2002, are shown in the table entitled "Currency in circulation".

The Central Bank continued its efforts toward the introduction of the euro by establishing the required infrastructure and adopting the necessary measures for harmonisa-

## Currency in circulation

£ thousand, end of period balances

	2002		2003		Increase/(Decrease)	
	Value	%	Value	%	Value	%
<b>1. Banknotes</b>						
Denomination						
£20	179.571	40,1	204.421	38,8	24.850	(1,3)
£10	197.141	44,0	246.475	46,7	49.334	2,7
£5	18.320	4,1	19.255	3,7	935	(0,4)
£1	19.247	4,3	20.811	3,9	1.564	(0,4)
<b>Sub-total</b>	<b>414.279</b>	<b>92,5</b>	<b>490.962</b>	<b>93,1</b>	<b>76.683</b>	<b>-</b>
<b>2. Coins</b>						
50 cents	13.596	3,0	14.788	2,8	1.192	(0,2)
20 cents	9.210	2,1	10.042	1,9	832	(0,2)
10 cents	4.772	1,1	5.204	1,0	432	(0,1)
5 cents	3.623	0,8	3.891	0,7	268	(0,1)
2 cents	1.410	0,3	1.488	0,3	78	-
1 cent	830	0,2	890	0,2	60	-
<b>Sub-total</b>	<b>33.441</b>	<b>7,5</b>	<b>36.303</b>	<b>6,9</b>	<b>2.862</b>	<b>-</b>
<b>Total</b>	<b>447.720</b>	<b>100,0</b>	<b>527.265</b>	<b>100,0</b>	<b>79.545</b>	<b>-</b>

tion with the *acquis*. Concerning other harmonisation measures, the Central Bank prepared a draft law transposing into Cyprus legislation all the relevant EU and ECB directives on currency counterfeiting and related matters. The law will soon be submitted to the House of Representatives for enactment. As regards the necessary infrastructure for the registration and analysis of counterfeit euro currency, the Bank has adopted the relevant ECB directives. The required systems and procedures will be implemented before Cyprus's accession to the EU.

### 4.6 Management of international reserves

According to the *Central Bank of Cyprus Law, 2002*, the basic functions of the Bank include the holding, safeguarding and man-

agement of official international reserves.

The basic objectives of the Bank's management of its international reserves are the safety of these reserves, the maintenance of their value and the availability of sufficient liquidity in order 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 official international reserves amounted to £1.607,3 million at the end of 2003, compared with £1.734,9 million at the end of 2002. The fall in reserves reflects the net result of net foreign currency outflow, interest received on foreign currency reserves and the movement of reserve currencies exchange rates against the Cyprus pound.

The currency distribution of international reserves mainly takes into account the flows of goods and services by currency and the country's external debt servicing obligations. During 2003, the international reserves were mostly held 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.

The Central Bank controls interest rate risk by setting modified duration and monitoring it to ensure that it is kept within an allowed specified margin. Within this context, investment in securities whose remaining life to maturity exceeds five years is not allowed. Credit risk is contained and controlled at va-

rious 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 reserve management policy has yielded very satisfactory results. The ultimate objective of the Bank is the continuous upgrading of its processes and its successful adaptation to new developments.

#### 4.7 Management of public debt in local currency

The issue of government securities is carried out within the framework of arrangements made between the Bank and the Ministry of Finance, in accordance with laws and regulations pertaining to government borrowing and entails the issue of government registered development stocks, treasury bills, savings certificates and savings bonds.

#### GRDS issued in 2003

£ million

Type of Bond	Issues		Maturities
	No. of Issues <sup>(2)</sup>	Amount	Amount
2-year <sup>(1)</sup>	17	179,7	142,0
3-year	9	59,7	52,0
5-year <sup>(1)</sup>	17	501,0	146,6
10-year <sup>(1)</sup>	4	6,2	-
15-year <sup>(1)</sup>	4	11,5	-
<b>Total</b>		<b>758,1</b>	<b>340,6</b>

(1) Through auction.

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

Operational and administrative matters regarding the issue and sale of securities, the keeping of holders' register, payment of interest, redemption of securities, savings bonds draws and all other related matters, are carried out by the Central Bank.

**Weighted average yield of GRDS**  
%

Year	2-year	5-year	10-year	15-year
<b>2002</b>	4,55	5,06	5,37	5,59
<b>2003</b>	3,89	4,49	4,78	4,95

The first government securities, issued at the end of the 1960s, were intended to encourage domestic savings and the non-inflationary financing of budget deficits. Since 1996, within the framework 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 auction method was first used in 2000 and 2001, respectively. GRDS issues carried out by the Central Bank during 2003 are shown in the table titled "GRDS issued in 2003", where the maturities during the same year are also stated.

The weighted average yield for each type of stock issued through auction during 2002 and 2003 is shown in the table titled "Weighted average yield of GRDS".

The weighted average yield of the December

in 2003 issue, was 3,99% for the 2-year GRDS, while for the tranche issues of 5, 10 and 15-year GRDS the yields were 4,68%, 4,75% and 4,90%, respectively.

The decrease of the weighted average yield for all types of GRDS during 2003 reflects mainly the reduction of the key official interest rates of the Central Bank and the conditions of excess liquidity prevailing during 2003.

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, to maintain orderly market conditions. The Central Bank, after consultation with the Ministry of Finance, has decided to transfer the stockholders' Register, whose GRDS are listed on the Cyprus Stock Exchange, to the Central Depository and Central Registry. This will result in the dematerialisation of the certificates issued for GRDS.

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 and are listed on the Cyprus Stock Exchange. For the 13-week TBs there is no secondary market. The Central Bank, after consultation with the Ministry of Finance, has decided to transfer the stockholders' Register whose TBs are listed on the Cyprus

### 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. 2002	3.060,5	349,6	209,8	760,3	197,5	11,8	55,0	16,5	<b>4.661,0</b>
31 Dec. 200	3.183,8	387,3	217,6	1.114,6	203,7	23,3	69,9	13,5	<b>5.213,7</b>

Stock Exchange. This will result in the dematerialisation of the certificates issued for TBs.

The total nominal value of TBs outstanding as at 31 December 2003 was £3.183,8 million compared with £3.056,7 million as at 31 December 2002. The Government Funds administered by the Central Bank were holding TBs amounting to £2.591,1 million as at 31 December 2003, while banks were holding £195,6 million frozen TBs (which are gradually being released) and £395,7 million TBs issued through auction. The Central Bank was holding TBs with a total value of £0,1 million as a result of discounting, whereas other investors were holding TBs amounting to £1,3 million.

The weighted average yield of TBs issued through auction during 2002 and 2003 is shown in the table titled "Weighted average yield of TBs".

The weighted average yield of the last issue

#### Weighted average yield of TBs

%		
Year	13-week	52-week
<b>2002</b>	4,01	4,32
<b>2003</b>	3,51	3,72

of TBs with 13-week duration carried out in 2003 was 3,51% (July 2003) whereas for TBs with 52-week duration the yield was 3,68% (December 2003).

Government borrowing in the form of savings certificates (SCs) continued with the issue of the Sixth Series, bearing an interest rate of 4,15% and having a repayment period of five years. Sales of SCs during 2003 amounted to £17,9 million compared with £10,3 million during 2002. The total amount of all series of SCs outstanding as at 31 December 2003 was £69,9 million, an increase of £14,9 million over the amount outstanding as at 31 December 2002.

Regarding government borrowing through the issue of savings bonds (SBs), it was decided during 2002, after consultation with the Ministry of Finance, to postpone the issue of a new series.

The outstanding amounts of all investment products as at 31 December 2002 and 2003 are presented in the table titled "Total amounts of investment instruments".

#### 4.8 Management of public debt in foreign currency

The management of the public external debt includes the:

- sourcing of foreign financing,
- comparative evaluation of financing proposals,
- negotiation of relevant agreements,
- recording and servicing of the debt and
- monitoring and management of the various risks.

In managing the external public debt, the main objectives of the Central Bank are the following:

- 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;
- the minimization 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;
- 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.

The total public external debt increased to £1.077,1 million at the end of 2003 from £847,8 million at the end of 2002. The increase was due to the drawdown of loans from the European Investment Bank and the Council of Europe Development Bank for the construction of development projects.

The notes issued under the Euro Medium Term Note Programme (EMTN) are the main source of the government's external finan-

cing. The amount due at the end of 2003 from notes issued under the above Programme represented 64,2% of the total public external debt as against 79,7% at the end of 2002. Other main sources of financing are the Council of Europe Development Bank with 13,4%, the European Investment Bank with 11,1% and the Euro Commercial Paper Programme (ECP) with 10,4%. The percentages at the end of 2002 were 12,4%, 4,4% and 2,3%, respectively.

The proportion between short-term and long-term external debt at the end of 2003 was 11% and 89%, respectively, compared with 4% and 96%, respectively, at the end of 2002. At the end of 2002, short-term external debt consisted mostly of issues under the ECP Programme.

During the year under review, 96% of the public external debt was denominated in euro followed by 2% in yen and 1% in dollars, as against 92%, 3% and 3%, respectively, at the end of 2002.

The fixed and floating interest rate proportions of the external debt were 72% and 28%, respectively, at the end of 2003, compared with 89% and 11%, respectively, at the end of 2002.

The weighted average life and the weighted average interest rate of the external debt were 6,67 years and 4,69% at the end of 2003 compared with 6,66 years and 5,11% at the end of 2002.

For the servicing of the public external debt, principal repayments amounting to £13,9 million and interest payments amounting to £42,5 million were effected during 2003 as against £207,8 million and £38,2 million, respectively, during 2002.

#### 4.9 Developments in the international business sector

The most significant development in the international business sector was the implementation of new tax legislation which came into effect on 1 January 2003. Under the new tax regime, all companies pay the same rate of corporation tax which is 10%. This is in contrast to the previous tax regime under which local companies were taxed at either 20% or 25% (depending on their income) whereas international business companies (IBCs), whose activities were exclusively outside Cyprus, were taxed at 4,25%.

Another important development in the international business sector was the Exchange Control (Exemption of European Union Residents) Order issued by the Central Bank on 30 May 2003. Under this Order, EU residents are exempt from the obligations and restrictions regarding the acquisition of, or transfer of shares to, Cypriot companies, imposed by the *Exchange Control Law*. As a result of this order, residents of EU member states wishing to set up businesses in Cyprus have been free to do so without exchange control restrictions or any involvement by the Central Bank since June 2003.

The combination of the aforementioned developments means that, as far as EU residents are concerned, there is no longer a distinction between local companies and IBCs. However, those IBCs which were registered in Cyprus prior to 1 January 2002 and which derived income exclusively outside Cyprus, were given the option of maintaining their old tax status (i.e. 4,25%) until the end of 2005.

During 2003, the number of Central Bank permits for the registration of IBCs fell by 33,1%. This was partly the result of the slow-down in the European economies, which are the main source of company registrations, and partly because of the changes in the tax regime. Another contributing factor was the lack of statistics for companies from the EU, which no longer require a Central Bank permit to operate in Cyprus.

The gross foreign exchange revenue generated by the international business sector is estimated to have risen to £391 million in 2003 from £320 million in 2002, representing an increase of 22,2%.

#### 4.10 Statistics

The Central Bank's participation in the ESCB has increased the requirements and obligations in the area of statistics since the central banks of member states are expected to report regularly a large amount of data to the ECB. This statistical information should be produced in accordance with harmonised standards. Reliable statistics are of paramount importance for economic policy in general and monetary policy in particular at both the national and EU level. In addition, the convergence reports, which will assess Cyprus's preparedness to adopt the euro, require specific statistical data.

During 2003 the Statistics Department produced the required statistics and transmitted them to the Statistical Service of Cyprus (Cystat), the ECB, Eurostat, the IMF and other local and international organisations. At the same time, the Statistics Department proceeded with the preparation for the additional obligations emanating from the island's accession to the EU on 1 May 2004

and, subsequently, from the expected participation of Cyprus in the euro area. Since May 2003, Statistics Department officers have participated as observers in the ESCB Statistics Committee and in the working groups reporting to it.

The Statistics Department is divided into two sections: the Money and Banking Statistics Section (MBSS) and the Balance of Payments and General Economic Statistics Section (BPGESS). The MBSS is responsible for money and banking statistics and financial accounts, as well as statistics for interest rates, securities issues, structural indicators and other related issues. The BPGESS is responsible for balance of payments and international investment position statistics, government finance statistics and general economic statistics. The main developments in 2003 for each field are described below.

#### **Money and banking statistics**

In view of Cyprus's EU membership and given the commitment to a speedy accession to the euro area, the MBSS is currently working on the necessary harmonisation of money and banking statistics and financial accounts with the requirements of the ECB and Eurostat. The MBSS is also responsible for ensuring compliance with the statistical requirements of other international organisations, such as the IMF and the BIS. Due to Cyprus's accession to the EU in May 2004, priority was given to the implementation of the Regulations and Guidelines listed below:

- Regulation ECB/2001/13, concerning the consolidated balance sheet of monetary financial institutions (MFIs);
- Regulation ECB/2001/18, concerning statistical data on interest rates applied

by MFIs to deposits and loans vis-à-vis households and non-financial corporations;

- Guideline ECB/2003/2, concerning certain statistical reporting requirements of the ECB and the procedures for reporting by the national central banks of statistical information in the field of money and banking statistics;
- Guideline ECB/2002/7 on the statistical reporting requirements of the ECB in the field of quarterly financial accounts.

In order to ensure full compliance with ECB requirements, new harmonised statistical systems for the collection and compilation of statistics are in the process of being developed and implemented. The ECB monitors the progress achieved closely. MBSS officers participated in the relevant working groups of the ECB and Eurostat as well as in special seminars organised by the ECB for the preparation of acceding countries in the field of money and banking statistics.

In the course of 2003, the MBSS organised seminars in order to prepare and inform MFIs of the new system for the collection and compilation of money and banking statistics, in accordance with the requirements of the ECB and other international organisations.

In July 2003, the MBSS issued a Directive on the Classification of Institutional Units into Institutional Sectors and Sub-sectors in Accordance with the European System of Accounts (ESA 95) to all MFIs. This was in the context of the implementation of Regulation ECB/2001/13 concerning the consolidated balance sheet of the MFI sector. This classification is an important step in the harmonisation process because it provides

the statistical infrastructure for the implementation of most of the requirements of the ECB and other international organisations.

An Electronic Register of Institutional Units accompanied the aforementioned Directive. The Register is maintained and updated regularly by the MBSS with the aim of facilitating MFIs to electronically identify and classify their customers into the ESA 95 sectors and sub-sectors. ECB officials commented favourably regarding the Directive and expressed interest in other possible uses of the Register.

Following the implementation of the aforementioned Directive, the MBSS continued to work on the implementation of Regulation ECB/2001/13 concerning the consolidated balance sheet of the MFI sector and Guideline ECB/2003/2 concerning certain statistical reporting requirements of the ECB in the field of money and banking statistics. In this context, the MBSS concentrated on the preparation of the first drafts of the reporting scheme for the new MFI balance sheet, which will be used as the basis for discussion with all interested parties before implementation by MFIs.

During the year under review, the MBSS participated in the compilation and maintenance of the list of MFIs in the accession countries. The list provides the reporting population for money and banking statistics. The list, which includes all local and international banking units and the co-operative credit and savings societies, is regularly updated according to the timetable provided by the ECB. On 1 May 2004, the MFI list of the accession countries will be merged with the MFI list of the EU and published on the ECB's website. In this connection, the Central Bank adopted

the N13 production system, which provides the technical infrastructure for the efficient and reliable bilateral exchange of information between the ECB and the national central banks concerning the MFI sector.

The MBSS also contributed to the revision of the ECB publication "Bond Markets and Long-term Interest Rates in EU Accession Countries, October 2003". This publication focuses on the activity and liquidity of the bond market and provides an overview of the structure of the capital market. The publication is available in English on the ECB website. Based on the results of this report and following consultations with the Ministry of Finance, the ECB and Eurostat, the ten-year Development Stock has been selected for Cyprus's assessment with the fourth Maastricht criterion, which concerns the convergence of long-term interest rates. It was also agreed with the ECB that, for the time being, this assessment would be based on the primary market yield, until the secondary market develops sufficiently. The Ministry of Finance committed itself to the development of the secondary market and the regular issue of ten-year Development Stock. The necessary decisions were taken by the Ministry of Finance and an Advisory Committee was established, with the participation of the Central Bank, for the development of the secondary market. The MBSS submits on a regular basis all relevant data to the ECB. As from 1 May 2004 these data will be published on the ECB website.

In the area of financial accounts, the MBSS worked closely with Cystat, which has the primary responsibility for the compilation of the annual financial accounts. In the course of 2003, the MBSS provided Cystat with all the available statistical data falling within the

competence of the Central Bank which are necessary for the compilation of the first preliminary set of annual financial accounts, covering the period 1995-2002. Moreover, the MBSS started preliminary work for the implementation of Guideline ECB/2002/7 concerning the quarterly financial accounts.

The MBSS is also responsible for the collection, compilation and dissemination to both internal and external users of monthly data concerning monetary aggregates, bank interest rates, money market and capital market interest rates, as well as data for securities issues.

#### **Balance of payments and international investment position**

In view of Cyprus's accession to the EU, balance of payments statistics have become particularly important. They are also important in the context of the assessment of the conditions for the adoption of the euro.

During 2003, the Central Bank continued to produce quarterly and annual balance of payments statistics, in accordance with EU and international standards, through the new data collection and compilation system that was initially implemented in 2002. A brief description of the new system and the methods applied by the Central Bank of Cyprus is given in the ECB's publication "Accession countries balance of payments/international investment position statistical methods", which was updated in May 2003. This publication is available on the ECB website.

A significant improvement in 2003 was the compilation, for the first time, of a complete statement of Cyprus's international investment position. The statement gives the financial assets and liabilities of Cypriot residents

vis-à-vis non-residents at the end of 2002. In particular, direct investment positions, which were missing from the international investment position statements for previous years (1999-2001), were recorded for the first time, with accumulation of flows used as an approximation. The assets and liabilities concerning portfolio and other investments of international banking units operating in Cyprus were also added. These banking units are considered as resident for statistical purposes, in line with international methodological standards.

The Coordinated Portfolio Investment Survey (CPIS) is one of the main sources of international investment position data. It is conducted by the Central Bank of Cyprus and the central banks of many other countries, under the auspices of the IMF. Following its successful participation in the 2001 CPIS, the Central Bank decided to continue the survey on an annual basis.

During 2003 the Central Bank carried out the CPIS survey for 2002. In this connection, the BPGESS collected data on the value of equity and debt securities issued by non-residents and held by residents as at 31 December 2002. Data were collected on a security-by-security basis, while the results of the survey were disseminated in aggregate form, by type of security and by country of issuer. The survey covered domestic banks and international banking units operating in Cyprus, all domestic and international insurance companies, all public investment companies and all resident financial and non-financial international business companies having an office in Cyprus. In 2003 the survey was extended to cover direct investment by the aforementioned respondents in addition to portfolio investment.

In parallel, the BPGESS continued to work towards the enhancement of the quality of balance of payments and international investment statistics. An important step in this direction is the development of direct reporting by selected enterprises to complement the data collected from banks and other sources, since many international transactions are performed without the intermediation of domestic banks. In 2003 the BPGESS began to draft new questionnaires and instructions for direct reporting.

On 27 June 2003, following the abolition of exchange controls on direct investment in and from Cyprus, and the resultant loss of this source of data, the Central Bank issued a directive to lawyers and accountants concerning the submission of a statistical declaration for every case of direct foreign investment in Cyprus by their clients. Simultaneously, the Central Bank issued a directive to domestic banks requesting the submission of a statistical declaration for every new direct investment abroad by a resident client.

#### **General economic and government finance statistics**

The Unit for General Economic Statistics deals with general economic statistics (GES) and government finance statistics (GFS) as defined by the ECB. GES cover primary and secondary convergence statistics as well as a wide range of other macroeconomic statistics needed for economic and monetary policy analysis.

For the purposes of the convergence reports, the ECB requests specific secondary series directly from national central banks. These series include consumer price indices (CPI), harmonised indices of consumer prices

(HICP) excluding net indirect taxes, proxies for unit labour costs (if the latter are not available from standard national accounts sources), data on residential property prices and projections of the elderly dependency ratio. Accessing countries central banks (ACCBs) have been requested to provide methodological information and available data for these statistics.

The ECB assesses the submitted GES by taking into account the availability, timeliness, reliability and international comparability of the data. The statistical standards for GES are identical for euro area and non-euro area EU countries. As a consequence, after accession significant efforts and improvements will be needed to meet these standards.

The responsibilities and obligations of national central banks with regard to GFS are described in the relevant ECB Guideline which, when adopted, will form an integral part of Community Law.

The annual GFS data provided by the acceding countries are considered an important input for the future ESCB annual public finance reports. The data are also important for the forthcoming convergence reports and the note on fiscal developments in the acceding countries that will be presented to the ECB's Monetary Policy Committee in 2004. The GFS covers the following:

- main categories of government revenue and expenditure (current and capital);
- revenue sub-categories like direct taxes, indirect taxes, sales and capital taxes;
- expenditure sub-categories like compensation of employees, intermediate consumption, interest, current transfers, investment and capital transfers;

- deficit/surplus with a breakdown by government sub-sector, providing primary deficit/surplus separately;
- general government debt, changes in debt and the breakdown of general government debt by financial instrument sub-sector, original maturity and currency (national currency, euro and other);
- transactions in main financial assets held by the general government.

During the second half of 2003, the Central Bank submitted annual GFS to the ECB for the period 1998-2001. The ECB assessed the quality, completeness and timeliness of the transmitted data in its quality report of October 2003 and in its first progress report of November 2003. The ECB commented that Cyprus complies reasonably well with the minimum requirements, even though improvements are warranted in the timeliness of submissions and quality of data.

The ECB participated in the Eurostat mission to Cyprus on excessive deficit procedure (EDP) which took place in February 2004. During this mission, the ECB assessed the quality of GFS once more. During 2004, the Central Bank is expected to transmit to the ECB a complete set of harmonised GFS for the period 1991-2003. The Unit for GES collaborates closely with the Ministry of Finance and Cystat in order to create an electronic system for the compilation, processing and transmission of statistical data to the ECB.

The Unit for GES is also responsible for collecting, processing and dissemination of statistical data concerning the following:

- external debt;
- international reserves;
- short-term economic indicators;

- the “Special Data Dissemination Standard” of the IMF;
- the establishment of a data bank.

#### 4.11 Information technology

During 2003 the priorities of the Information Technology Department were the correct and timely preparation of ESCB information technology projects, the adoption and implementation of the policies and principles approved by the ECB General Council and the complete alignment with ECB requirements. In this context, the IT Department sustained the security of the Bank’s information technology environment, completed the disaster-recovery and contingency plans for critical automated functions and continued the redesign and automation of the Bank’s functions utilising the latest technology. The information technology projects carried out in 2003 were:

##### A. Projects of the ESCB

###### **Infrastructure projects**

The IT Department actively participated in the Information Technology Committee of the ESCB as well as in its four working groups where infrastructure projects were discussed and finalised. The objective of these projects is to create a secure and reliable connection between the member and acceding central banks and the platform upon which all common applications will run. Based upon the agreed project plan, the expected completion period for the infrastructure projects is within the first half of 2004.

###### **Application projects**

*Electronic data-exchange / data statistics:* A system was developed and implemented which handles the exchange of statistical

information between the Bank and organisations within the European Union. The information received is incorporated into the Bank's Database System and is available for statistical and economic research.

*N13:* A new system was developed which maintains information on MFIs operating in the European Union. A study of Eligible Assets with similar handling of information was carried out.

*Balance of payments system:* Development continued with the creation of new reports, based on specifications drawn up by the European Union, on sectors of the Cyprus economy. These reports are submitted at regular intervals.

## **B. Systems development projects**

### **Implemented systems**

*Central Information Registry for Dishonoured Cheques (CIR):* The system was implemented on 1 February 2003 and is functioning reliably and securely. It has been fully accepted by all the banks and co-operative credit institutions which actively contribute to its smooth operation.

*Payroll system:* The new payroll system was completed and implemented. Its objective was to upgrade the services provided and to redistribute responsibilities among the relevant departments for a more effective and independent execution of the required tasks.

*Remote trading with the Cyprus Stock Exchange (CSE):* This system allows the Bank to monitor transactions remotely and intervene, if necessary, in the secondary market for government bonds on the CSE.

*Library system:* A new library system was developed and implemented which offers, in

addition to the straightforward management of book and periodical inventories, several other capabilities such as online updating and retrieval of book and periodical details, electronic borrowing and reservation, and purchase of new books.

*Timekeeping system:* A time-recording and monitoring system for the time consumed and the work carried out by the Domestic Bank Supervision Department was implemented for the purpose of pricing.

### **Systems under development**

*International Bank Account Number (IBAN):* New specifications were drawn up for the modifications needed to the Bank's systems for the introduction of the International Bank Account Number by April 2004.

*SWIFT:* An investigation was carried out for the upgrading and further automation by means of straight through processing of transmitting and receiving SWIFT messages.

*Management of reserves:* An ad hoc committee investigated alternative solutions for the introduction of a system which will cover all the future needs for the management of reserves whilst being able to satisfy the requirements of the ECB.

*Payment system:* Following the decision of the ECB to proceed with the creation of a common cross-border payment system, the Bank has modified its project specifications accordingly. The existing Local Fund Transfers system will be upgraded by September 2004 so as to satisfy the minimum set criteria.

*Transfer of the Government Bonds Register to the Central Registry and Central*

*Depository of the CSE:* As a result of the decision to transfer the Government Bonds Register of the issues listed on the CSE to the CSE Central Registry, new procedures and regulations have been created. A system was developed with the objective of exchanging the Holders' Registers with the CSE as well as the administration of dividend and maturity payments.

#### **Goals for 2004**

Priority will, again, be given to projects of the ESCB. In parallel with these projects, implementation of new Internet services and an integrated document management system are planned, as well as the completion of projects started in 2003.

#### **4.12 Human resources**

The new challenges brought about by Cyprus's EU accession and the Bank's role in the financial system demand a new approach to human resource management. The Bank's human resource strategy for 2003 focused on the:

- continuous development and effective utilisation of the Bank's human capital;
- effective implementation of the Bank's appraisal system;
- updating of the Central Bank of Cyprus Employees' (Schemes of Service) Regulations.

#### **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, divisional / departmental needs, the continuous changes and challenges of the

emerging business landscape, as well as the staff's personal needs. The Bank's staff training and development strategy for 2003 included the following:

- The design and implementation of a Training Needs Analysis project. The project's main goal was to identify the major training needs and areas of development of the Bank's staff.
- Employee participation in various professional seminars conducted either in-house or by local independent service providers or by other European central banks and EU institutions.

#### **Administration**

The Human Resource and Administration Section has the overall responsibility for organising various functions including public relations events.

#### **Trade union**

The Bank is a strong supporter of dialogue with its social partners. During the year under review, the 2002 - 2004 Collective Agreement was signed between the Bank and the staff's trade union.

#### **Community involvement**

The Bank's policy remained the same as in previous years and it continues to consider its contribution to society as of prime importance. This policy focuses on the Bank's:

- commitment to enhance knowledge through contributions to educational institutions which promote research in areas relevant to the Bank's operations;
- support to charities and non-profit organisations, as well as to health and community related programs.

#### 4.13 Premises and security

The Security and Technical Support Section is responsible for maintaining the building and keeping all the installations in an excellent operational condition so that working conditions for the staff are pleasant and conducive to productive work.

During 2003, the upgrading of the air conditioning system was completed in line with the relevant specifications and drawings that were prepared by specialist consultants. At the same time, a new standby generator was installed for the air conditioning system so that it can operate even if the electricity supply is temporarily cut. Work is in progress for the extension of the parking areas both for the staff and the general public as well as

for the installation of iron fencing on the Bank's west site which is at present used as a garden.

The Building Management System has been upgraded with new software and computers, thus improving its efficiency and performance. A review of the existing security arrangements is also in progress. The review is taking into account the security requirements set by the ECB, the obligations resulting from the accession of the Bank to the ESCB on 1 May 2004 and the expected adoption of the euro by 2007. In this context, the Central Bank has proceeded with the installation of new security systems and has begun reviewing the whole of the Bank's security procedures.

**5 . F I N A N C I A L   S T A T E M E N T S**  
for the year ended 31 December 2003

**PROFIT AND LOSS ACCOUNT  
FOR THE YEAR ENDED 31 DECEMBER 2003**

	Notes	2003 £'000	2002 £'000
Interest Income	2	<b>66.460</b>	80.499
Interest Expense	3	<b>52.310</b>	67.140
Net Interest Income		<b>14.150</b>	13.359
Other Operating Income	4	<b>3.915</b>	7.448
Total Operating Income		<b>18.065</b>	20.807
Administrative Expenses - Staff	5.1	<b>8.016</b>	7.339
- Other	5.2	<b>2.192</b>	2.297
Depreciation	6	<b>2.469</b>	845
Operating Expenses	7	<b>506</b>	610
Other Charges	8	<b>3.673</b>	3.318
Total Expenses and Provisions		<b>16.856</b>	14.409
Net Profit		<b>1.209</b>	6.398

**APPROPRIATION ACCOUNT**

	2003 £'000	2002 £'000
Appropriation of the Net Profit in accordance with section 59 of the <i>Central Bank of Cyprus Laws, 2002 and 2003</i> :	<b>1.209</b>	6.398
General Reserve (20% of Net Profit)	<b>242</b>	1.280
Consolidated Fund of the Republic	<b>967</b>	5.118

The notes on pages 64-71 form part of these accounts.

**BALANCE SHEET**  
**AS AT 31 DECEMBER 2003**

	Notes	2003 £'000	2002 £'000
<b>Assets</b>			
<b>Foreign Reserves</b>	9	<b>1.560.297</b>	1.697.687
<b>Local Investments</b>		<b>53.602</b>	67.800
Treasury Bills	10.1	<b>93</b>	7.587
Government Securities	10.2	<b>53.509</b>	60.213
<b>Loans and Advances</b>		<b>969.106</b>	961.106
Government		<b>961.074</b>	961.074
Banks		<b>8.032</b>	32
<b>Fixed Assets</b>	6	<b>8.770</b>	10.457
<b>Other Assets</b>	11	<b>43.020</b>	47.435
<b>Total Assets</b>		<b>2.634.795</b>	2.784.485
<b>Liabilities</b>			
<b>Currency in Circulation</b>		<b>527.264</b>	447.670
Notes		<b>490.958</b>	414.229
Coins		<b>36.306</b>	33.441
<b>Deposits</b>	12	<b>1.848.949</b>	2.063.240
Banks		<b>1.090.664</b>	1.451.116
Government		<b>158.296</b>	61.749
Government Agencies and Public Corporations		<b>46.991</b>	68.847
Sinking Funds		<b>548.978</b>	477.800
Insurance Companies		<b>997</b>	1.991
International Organisations		<b>3.023</b>	1.737
<b>Other Credit Balances</b>	13	<b>63.574</b>	70.694
<b>Special Accounts for the Revaluation of Gold and Net Assets/Liabilities in Foreign Currencies</b>	14	<b>163.486</b>	171.601
<b>Capital and Reserves</b>		<b>31.522</b>	31.280
Capital		<b>15.000</b>	15.000
General Reserve Fund		<b>16.522</b>	16.280
<b>Total Liabilities</b>		<b>2.634.795</b>	2.784.485

The notes on pages 64-71 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 Laws, 2002 and 2003* (the law).

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 exchange rates prevailing on the balance sheet date. Exchange rate differences arising from the conversion 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 mid-market price of the London fixing at the balance sheet date. 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 is comprised of 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 into 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 banknotes, minting coins and purchasing stationery is written off to the profit and loss account in the year that it is defrayed.

## 2. Interest income

	2003 £'000	2002 £'000
Income from foreign reserves	33.894	50.451
Income from local investments:		
Treasury bills	404	1.788
Government stocks	3.231	4.515
	3.635	6.303
Income from loans and advances:		
Credit facilities to the Government and Government agencies	28.595	23.387
Credit facilities to banks	109	103
Loans to staff and other loans	227	255
	28.931	23.745
<b>Total</b>	<b>66.460</b>	<b>80.499</b>

Interest income from foreign reserves for 2003 is reduced by £520.000, an amount that represents interest expense for the year on gold swaps. The corresponding figure for 2002 was £935.000 and is included in interest expense.

## 3. Interest expense

	2003 £'000	2002 £'000
Interest on foreign currency liabilities	5.769	6.932
Interest on Cyprus pound deposit liabilities and other accounts:		
Banks' deposits	30.769	37.478
Sinking funds	15.691	22.629
Insurance companies' deposits and other accounts	81	101
	46.541	60.208
<b>Total</b>	<b>52.310</b>	<b>67.140</b>

#### 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 and miscellaneous income.

#### 5. Administrative expenses

##### 5.1 Staff

The average number of staff employed on a full-time basis was 311 (2002: 287). Staff costs comprised the following:

	2003 £'000	2002 £'000
Salaries	1,977	1,886
Cost of living allowance	4,600	4,226
Special Constables	226	0
Bank's social insurance and other contributions	1,026	977
Other allowances	114	101
Staff training	73	149
<b>Total</b>	<b>8,016</b>	7,339

The salaries of Special Constables for 2002 (£201,000) are included under other administrative expenses.

##### 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
<b>Cost</b>				
As at 1 January 2003	12.060	5.750	179	17.989
Additions	135	655		790
Disposals		(18)		(18)
As at 31 December 2003	12.195	6.387	179	18.761
<b>Depreciation</b>				
As at 1 January 2003	2.961	4.424	149	7.534
Prior year adjustment	948	551	18	1.517
Provision	491	449	12	952
Disposals		(12)		(12)
As at 31 December 2003	4.400	5.412	179	9.991
<b>Net Book Value</b>				
<b>As at 31 December 2003</b>	<b>7.795</b>	<b>975</b>	<b>0</b>	<b>8.770</b>
As at 31 December 2002	9.099	1.328	30	10.457

The cost of land is £1.201.500.

The prior year adjustment is the result of the change in the estimated economic useful life of the buildings from 33 years to 25 years and of computers, software and motor vehicles from 5 years to 4 years. In addition, fixed assets which cost less than £6.000 are fully written off in the year of purchase.

The above changes were made after the approval of the Board of Directors and are in agreement with the Guideline of the European Central Bank on the Legal Framework for reporting in the European System of Central Banks (ECB/2002/10).

## 7. Operating expenses

Operating expenses include expenses for printing notes and minting coins totalling £409.000 (2002: £513.000).

## 8. Provisions

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

	2003 £'000	2002 £'000
Current service cost	1.425	1.254
Interest on pension fund obligation	2.063	1.901
Past service cost	185	163
<b>Total</b>	<b>3.673</b>	<b>3.318</b>

## 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 2003 represents treasury bills purchased in the secondary market from non-government organisations.

### 10.2 Government securities

	2003 £'000	2002 £'000
Government: Registered stock	53.499	59.146
Savings bonds	10	1.067
<b>Total</b>	<b>53.509</b>	<b>60.213</b>

## 11. Other assets

	2003 £'000	2002 £'000
Cheques in process of collection	16.552	21.833
Loans to staff	11.173	10.677
Interest receivable	14.298	14.535
Other accounts	997	390
<b>Total</b>	<b>43.020</b>	<b>47.435</b>

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

## 12. Deposits

	2003 £'000	2002 £'000
Banks	1.090.664	1.451.116
Minimum reserve	644.171	511.111
Other Cyprus pound deposits	120.500	615.585
Foreign currency accounts	325.993	324.420
Government sight accounts	158.296	61.749
Government agencies and public corporations	46.991	68.847
Sinking funds	548.978	477.800
Government foreign debt	710	302
Government registered stock	540.168	468.483
Savings bonds	7.467	8.427
Government guaranteed stock	633	588
Insurance companies	997	1.991
International organisations	3.023	1.737
<b>Total</b>	<b>1.848.949</b>	<b>2.063.240</b>

### 13. Other credit balances

	2003 £'000	2002 £'000
Appropriation account	967	5.118
Provision for staff pension scheme	34.392	31.323
Matured and unredeemed savings bonds	4.072	6.948
Unclaimed drawn savings bonds	1.357	1.626
Demonetised notes and coins	3.378	3.387
Accrued interest payable	410	466
Special Drawing Rights allocation by the International Monetary Fund	13.511	14.493
Other accounts	5.487	7.333
<b>Total</b>	<b>63.574</b>	<b>70.694</b>

### 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 1/1/2003	73.241	98.360	171.601
Revaluation adjustments for the year ended 31/12/2003	9.596	(17.711)	(8.115)
<b>Balance as at 31/12/2003</b>	<b>82.837</b>	<b>80.649</b>	<b>163.486</b>

### 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. 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 their average remaining working lifetime as at the date of the actuarial valuation, which has been estimated at 21 years.

The amount recognised in the balance sheet is £348.000 (2002 : £163.000) and the present value of the obligation is as follows:

	<b>2003</b>	2002
	<b>£'000</b>	£'000
Present value of unfunded obligation	<b>36.698</b>	33.814
Unrecognised past service deficiency	<b>2.306</b>	2.491
Net liability in balance sheet	<b>34.392</b>	31.323

As in previous years, pension payments for 2003 were charged directly to the pension scheme provision account.

#### **16. Government funds administered by the Central Bank of Cyprus**

The deficiency of interest earned by the above funds for 2001 compared with the guaranteed interest was £8.293.000 (£11.249.000 in 2002). 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 61 to 71 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 2003 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 Laws, 2002 and 2003*.

**CHRYSTALLA GEORGHADJI**  
*Auditor General of the Republic*

Nicosia, 7 April 2004