CENTRAL BANK OF CYPRUS

ANNUAL REPORT

2004

NICOSIA - CYPRUS

CONTENTS

The Governor
Dr Christodoulos C. Christodoulou

Dr Christodoulos Christodoulou was born in Avgorou, Famagusta District, in April 1939. He is married and has one daughter and one granddaughter.

Dr Christodoulou holds a Ph.D. in Law from the University of Wales and Bachelor's degrees in Law and Political Sciences from the Universities of Thessaloniki and Athens, Greece, respectively. He is also a graduate of the Pedagogical Academy of Cyprus.

Dr Christodoulou served as a primary school teacher for a short period of time before joining the Press and Information Office in 1964. In 1968 he was appointed as senior officer in the House of Representatives, where he served until 1972 when he was appointed Director of the Government Printing Office. In March 1985, he was appointed to the post of Permanent Secretary at the Ministry of Labour and Social Insurance where he served until June, 1989, when he was transferred to the Ministry of Agriculture and Natural Resources, where he served as Permanent Secretary until November, 1994.

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

Dr Christodoulou's other duties and activities have included, *inter alia,* the chairmanship of a number of semi-public organisations, such as the Human Resource Development Authority, the Higher Technical Institute, the Cyprus Productivity Centre and the Agricultural Insurance Organisation. Dr Christodoulou has represented Cyprus on the governing bodies of the International Labour Office (ILO), the Food and Agricultural Organisation (FAO) and the World Food Council (WFC). He has also participated in many conferences and seminars abroad.

Dr Christodoulou has contributed to the political, social and cultural life of Cyprus. He participated in the 1955 - 59 struggle for the island's independence and was interned without trial as a political detainee. Dr Christodoulou has published numerous articles and studies and has lectured on labour, economic and legal matters.

1. Introduction by the Governor

The Central Bank made an important contribution to the efforts that led to Cyprus's accession to the EU on 1 May 2004. Since this date the Central Bank has been a full member of the ESCB, and the Governor, Christodoulos Christodoulou, has been participating in the General Council of the ECB as a full and equal member. In parallel, about 40 Bank officials are members of the ESCB committees and working groups, which facilitate the decision making process. In addition, representatives of the Central Bank participate in various other EU committees, which assist the Council of the EU and the European Commission. Notwithstanding its small size, the Central Bank of Cyprus participates constructively in the functions of the ESCB and the aforementioned EU committees.

During 2004 the Central Bank gave special emphasis to the timely adoption of the *acquis communautaire*, specifically in the areas of banking services, capital movements and payment systems. Upon Cyprus's accession to the EU, harmonisation with the relevant *acquis* was completed with the entry into force of a series of legal acts which had been prepared by the Central Bank. Due to the dynamic and constantly evolving nature of the *acquis*, harmonisation is a continuing process.

In the context of the adoption of the *acquis communautaire,* an important financial sector reform was the abolition of the remaining exchange restrictions after a process of gradual liberalisation of capital movements. The *Capital Movement Law 115(I)2003,* which entered into force on the date of Cyprus's accession to the EU, repealed the *Exchange Control Law*, thus ensuring freedom of capital movements in accordance with the *acquis*. The liberalisation of capital movements allows a more rational allocation of financial resources, strengthens competition and enhances Cyprus's financial integration with the other EU countries.

As regards the banking sector, the Central Bank of Cyprus, in exercising its supervisory role, issued a number of directives to banks, prepared bills for the necessary amendments of the *Banking Law* and proposed other legislation for the timely harmonisation of the regulatory framework governing the operation and supervision of banking institutions with the *acquis* and best international practices.

Furthermore, the Central Bank took measures for the revision of the existing supervisory framework of capital adequacy, in line with the "New Capital Accord" of the Basel Committee on Banking Supervision, which was finalised in June 2004, and the European Commission's proposal for the amendment of the relevant EU directives. The proposed new EU directive is expected to enter into force in all the member states at the end of 2006. Taking into consideration the complexity of the new framework and the need for its prompt implementation, the Central Bank advised banks to compare their internal procedures and practices with the requirements of the new capital adequacy framework, in order to take appropriate measures for its adoption. Moreover, the Central Bank asked banks to provide information with regard to the final approach they intend to adopt in relation to credit risk and operational risk. In parallel, the Central Bank started studying the national discretions and options included in the proposed EU directive, in order to finalise its policy in relation to this matter.

During 2004 additional measures were taken in the field of depositor and investor protection, in accordance with the relevant EU directives. On 1 May 2004, the Deposit Protection Scheme was extended to include the currencies of the EU. The Investment Protection Scheme for Customers of Banks was also established at the same time. As regards legal convergence, the reports of the ECB and the European Commission confirm that Cypriot legislation fulfils the condition of central bank independence, which is of vital importance, but does not yet anticipate the legal integration of the Central Bank of Cyprus in the Eurosystem. Aiming at achieving legal convergence well before the issue of the next convergence reports in 2006, the Central Bank has began to work for the necessary changes in the *Central Bank of Cyprus Laws.*

Having contributed to the historic event of our country's accession to the EU, the Central Bank is now focused on the next landmark in Cyprus's European integration - the successful adoption of the euro. In accordance with the Treaty of Accession, Cyprus and the other new member states participate in the Economic and Monetary Union as member states with a derogation. This implies that our country has to fulfil all the necessary conditions for the adoption of the euro, within a reasonable time. More specifically, Cyprus has to strive to meet the convergence criteria (known as the Maastricht criteria), which refer to inflation, the fiscal situation, exchange rate stability and long-term interest rates. In addition to the fulfilment of these criteria, the successful adoption of the euro requires a high degree of real convergence of the Cypriot economy with the euro area economy (i.e. high per capita income and similar structural characteristics). Moreover substantial technical preparation is necessary for the changeover from the Cyprus pound to the euro.

The stated policy objective of both the Central Bank and the government of Cyprus is the adoption of the euro as early as possible. In this context, on 29 December 2004 the Council of Ministers approved an action plan for Cyprus's participation in ERM II, which was prepared by the Central Bank in cooperation with the Ministry of Finance. On the same date, the Council of Ministers also approved the strategic action plan for the introduction of the euro in Cyprus. The plan was prepared by the Central Bank and the Ministry of Finance, which bear the main responsibility for its implementation. The Central Bank has already started the technical preparation for the introduction of euro notes and coins.

In October 2004 the ECB and the European Commission, respectively, issued their first convergence reports assessing Cyprus and the other new member states (together with Sweden) with respect to the fulfilment of the conditions for the adoption of the euro. According to these reports, Cyprus fulfils the inflation and interest rate criteria but does not yet meet the fiscal criterion (because it has an excessive deficit as determined by a decision of the EU Council) and the exchange rate criterion (since it does not yet participate in ERM II).

Upon EU accession, the European Commission placed Cyprus under the Excessive Deficit Procedure because it did not fully comply with the Maastricht criteria concerning the fiscal deficit and the public debt. Throughout the year under review, the Central Bank emphasised its commitment to the earliest possible participation in ERM II, stressing the need for the consolidation of public finances. In May 2004 Cyprus submitted its first Convergence Programme for the period 2004-2007 and updated it in December so as to cover the period 2005-2008. Within this context, the government announced a number of fiscal consolidation measures which have, to a large extent, been implemented. Consequently, in December 2004 the European Commission issued a recommendation to ECOFIN to put in abeyance the Excessive Deficit Procedure. Having been convinced that Cyprus had taken effective action toward compliance, ECOFIN adopted the Commission's recommendation in January 2005. In this connection, I wish to reiterate that fiscal consolidation and fulfilment of the relevant convergence criteria is an absolute necessity, since our accession to the eurozone will safeguard the long-term sustainability and prosperity of the Cyprus economy. The Central Bank will continue to play a leading part in promoting the policies and regulations which will safeguard Cyprus's economic future within Europe.

As regards the international banking sector, the implementation of the *Capital Movement Law 115(I)/2003* as from the date of Cyprus's accession to the EU, in conjunction with the tax reforms of 2002, have created new conditions with regard to the international banking units which operate in Cyprus today. These banking institutions, with the exception of those which have been granted a transitional period until 1 January 2006, are free to offer the full range of banking services to the island's residents. As regards applications for the establishment of new banks in Cyprus, the Central Bank is currently working on a new framework for the granting of banking business licenses which will not distinguish between domestic banks and international banking units.

In the domain of macro-prudential analysis, which aims at monitoring and assessing the soundness and vulnerabilities of financial institutions so that any systemic weakness which could threaten the stability of the above sector can be identified early and acted upon, the Central Bank submitted the first set of consolidated data for the Cyprus banking system to the ECB. Within the above framework, the Central Bank is also participating in the Coordinated Compilation Exercise for Financial Soundness Indicators, which takes place under the auspices of the International Monetary Fund.

In the context of the Memorandum of Understanding signed by the supervisory authorities of the financial sector, which became effective in 2003, the Central Bank of Cyprus, the Cyprus Securities and Exchange Commission and the Insurance Companies' Control Service of the Ministry of Finance jointly prepared a draft Bill which provides for the establishment and operation of an institution (Financial Ombudsman) for the out-of-court settlement of disputes of a financial nature between consumers and financial firms (including banks) with a view to ensuring the interests of consumers.

An important development in the field of cooperation with foreign supervisory authorities, is the participation of the Central Bank of Cyprus in the Committee of European Banking Supervisors (CEBS) which took up its duties on 1 January 2004. The purpose of the CEBS is to advise the European Commission on supervisory and regulatory issues with regard to the banking sector. The Central Bank also participates in the context of the ESCB in the Banking Supervision Committee (BSC). The purpose of the BSC is to monitor and assess developments in the EU banking and financial sectors from a financial system perspective, to analyse the impact of regulatory and supervisory requirements on financial system stability and structures and to promote cooperation and exchange of information between central banks and supervisory authorities on issues of common interest.

It is noted that the overall performance of the domestic banking system displayed signs of improvement in 2004 compared with 2003. The gradual recovery of the Cyprus and the world economies, the increase in interest rates locally and internationally, the remedial measures that banks have taken as well as the further expansion of their operations in Greece were amongst the factors which had a positive impact on the profitability of the domestic banking institutions. The recent accession of Cyprus to the EU is expected to bring about significant changes in the overall functioning and the regulatory environment of the domestic banking system.

The management of the local banking institutions have acknowledged the rapidly changing demands of the new era and have gradually commenced to adjust to them. Significant investments have been made in the fields of technology and computerised systems, which increase productivity and facilitate better utilization of resources as well as improved risk management by banks. Furthermore, the significant efforts made under pressure from the Central Bank to increase tangible security and to improve collection procedures regarding debts in arrear enabled these institutions to improve the quality of their loan portfolios. An additional positive development during the year under review was the banks' success in containing their operating costs and reducing their cost-to-income ratios. As a result, the domestic banking institutions returned to profitability and now face the future with renewed optimism. In 2004 the Central Bank consented, for the first time in three years, to the granting of dividends by commercial banks. Nevertheless, despite the favourable developments outlined above, the level of non-performing loans remains high. The Central Bank will continue to encourage the commercial banks to adopt better practices regarding the evaluation and approval of loans as well as regarding the follow-up and collection of overdue debts.

The Central Bank attaches great importance to payment systems and the need for close cooperation with the banking community in safeguarding the timely and effective response to developments in this area. To this end, the Central Bank has proceeded to set up a Payments Committee with the participation of all relevant parties. The usefulness of this Committee, as well as the considerable improvement it has brought in the exchange of information and coordination between the parties involved, have been evident from the first year of its operation.

Within the framework of harmonisation with the *acquis communautaire*, EU Directive 98/26/EC on Settlement Finality has been incorporated in the *Settlement Finality in Payment Systems and in Securities Settlement Systems Law 8(I)/2003,* which came into force on 1 May 2004. This law specifies that the Central Bank is the competent authority for designating the payment systems that fall within the scope of the law. Consequently, the Bank has designated the Large Value Credit Transfers System operated by the Bank and the Central Depository / Central Registry of the Cyprus Stock Exchange as payment systems.

With the aim of applying the provisions of Regulation 2560/2001 of the European Parliament and of the Council, relating to cross-border payments in euro, the Bank, in cooperation with the banking industry, implemented the IBAN standard (International Bank Account Number) on 1 April 2004. The transposition into law of the provisions of EU Directives 2000/46/EC and 2002/47/EC relating to the provision of electronic money services and financial collateral arrangements was completed during 2004. The *Electronic Money Institutions Law 86(I)/2004* regulates the operation and supervision of institutions providing such services, while the *Provision of Financial Collateral Law 43(I)/2004* aims to safeguard the integrity of such agreements.

In its continued efforts to reduce the number of dishonoured cheques, the Central Bank widened the range of application of the provisions of the Central Information Registry for the Issuers of Dishonoured Cheques (CIR). In February 2004 the definition of a cheque was amended in the *Banking Law (1997 to 2004)* and the Governor of the Central Bank with the Commissioner of Cooperative Societies' Supervision and Development Authority, issued a joint directive (ΚΔΠ 105/2004) in order to enable the registration of issuers of dishonoured post-dated cheques in the CIR.

In order to reduce the use of cheques as a means of payment, the Bank, in cooperation with the Government, has undertaken the development of a system for government transfers. With the use of this system, the beneficiaries of government payments (including pensions, grants, etc) will be able to receive payments directly in a nominated bank account instead of being paid by cheque. This system, which is expected to be ready for implementation within the first quarter of 2005, will contribute to safer and more efficient government payments.

The Central Bank's obligations towards the ESCB and Eurostat in the area of statistics have increased substantially following full membership of the EU. The Central Bank produces and distributes statistical information in accordance with the methodology and standards of the ECB and Eurostat. The data produced by the Statistics Department is used at the national level for the formulation and implementation of monetary and economic policy, and at the community level for the evaluation of the preparedness of Cyprus for the adoption of the euro. The production of timely and reliable statistics is an obligation of all member-states of the EU. The preparation of these statistics is, jointly or separately, carried out by the national central bank and the national statistical service of each country. In the case of Cyprus, a Memorandum of Understanding is being drafted which is expected to be signed within 2005 for better coordination between the two organisations.

The harmonisation of money and banking statistics with ECB Regulations continued at an intensive pace, in line with preparations for accession to the euro area. During 2004 the Statistics Department completed the reporting forms of the directive concerning the new MFIs balance sheet. At the design stage extensive consultations were held within and outside the Central Bank in order to incorporate the requirements of all data users in the new reporting scheme. The new balance sheet directive will be implemented during 2005 by all MFIs operating in Cyprus, including Cooperative Credit and Savings Societies, comprising a total of 406 reporting agents. The new balance sheet is based, to a large extent, on the statistical infrastructure provided by the "Directive on the Classification of Institutional Units into Institutional Sectors and Sub-Sectors in accordance with the European System of Accounts", issued by the Statistics Department and implemented by MFIs in 2003.

During 2004 the Central Bank continued to compile and submit monthly, quarterly and annual balance of payments statistics as well as the "international reserves template" in accordance with community and international requirements. In parallel, the Central Bank continued to compile and submit the complete statement of Cyprus's international investment position. An important step in 2004 was the development of a new system for the compilation of balance of payments and international investment statistics. The new system is based on direct reporting by selected enterprises to complement the data collected from banks and other sources.

In anticipation of Cyprus's accession to the eurozone in the near future, no further upgrading of the security features of the national currency was pursued. In any case, banknotes issued by the Central Bank bear advanced security features and their credibility remains high. During 2004 the quantity of banknotes authenticated and sorted increased by 42% compared with the previous year. In order to protect the euro against counterfeiting, the Bank acquired access to the Counterfeit Monitoring System, the central database containing technical and statistical information on counterfeit euro notes and coins.

Real GDP grew by 3,7% in 2004 compared with 1,9% in 2003. This acceleration reflects the significant expansion of private consumption and gross capital formation, which are the main components of domestic demand. The fiscal deficit was contained to 4,2% of GDP compared with 6,3% of GDP in the previous year. This improvement reflects the increase in public revenue, due to the acceleration of GDP growth, as well as the deceleration in public expenditure.

The rate of inflation reached 2,3% in 2004 compared with 4,1% in the previous year. This deceleration was mainly due to the dissipation of the impact of the increase of VAT from 10% to 13% in July 2002 and from 13% to 15% in January 2003, as well as the reduction in excises on motor vehicles implemented in November 2003. The deceleration in the rate of inflation was achieved despite the increase in the international price of crude oil during the second half of the year. In the labour market, the number of registered unemployed as a proportion of the economically active population reached 3,6% in 2004 compared with 3,5% in 2003.

The acceleration in economic activity, particularly domestic demand, led to a current account deficit of 5,8% of GDP in 2004 compared with 3% of GDP in the previous year. Other external factors, such as the increase in the international price of oil as well as the reduction in excises on most categories of motor vehicles, also contributed to the deterioration of the current account deficit. In particular, car imports increased by around 50%.

The Cyprus economy is expected to exhibit further recovery during 2005, reflecting, among other factors, the expected rebound in tourism. More specifically, it is estimated that real GDP will increase by 4%. Inflation is expected to hover at around 2,5%, provided that the international price of oil remains at the levels of 2003, while the unemployment rate is expected to show a small improvement and fluctuate at around 3,5%, reflecting the rebound in economic activity. The current account deficit is also expected to improve and hover at around 4,5%, mainly due to the reduction in car imports.

With the exception of the ECB, the major monetary authorities abandoned loose monetary policies in 2004. The US Federal Reserve raised its federal funds rate on five occasions, by 25 basis points on each occasion, while the Bank of England raised its repo rate four times, by 25 basis points each time. At the end of 2004, the federal funds rate stood at 2,25% and UK repo rate rate at 4,75%. The US monetary authority raised interest rates because of inflationary pressures and the twin deficits. Inflationary pressures became more pronounced as a result of the weakening dollar, the continued increase in private consumption and the decrease in saving, in conjunction with fast economic growth. The Bank of England raised its repo rate mainly in response to the combination of rising property prices and steady economic growth. In contrast, the ECB decided that a wait-and-see stance was the appropriate policy for 2004 because of the strong euro as well as low inflation and steady growth.

In Cyprus, domestic credit and, consequently, total money supply expanded at an accelerated pace. Foreign currency loans and deposits also increased. In the money market, surplus bank liquidity prevailed, albeit reduced, compared with the previous year. During most of 2004, the Central Bank intervened, using acceptance of deposits (depos) in order to absorb the excess bank liquidity.

Domestic monetary developments were marked by the rise in the marginal lending facility rate by 100 basis points to 5,50% in April 2004. The Central Bank increased the official rate in response to unfounded rumours regarding devaluation of the Cyprus pound. This move sent a strong signal in favour of the local currency in the light of the political uncertainty arising from the April referendum on the Annan Plan. Also, in view of the abolition of exchange controls on 1 May 2004, this increase was a precautionary measure against possible capital outflows. The rise in interest rates encouraged capital inflows and, thus, strengthened public confidence in the Cyprus pound.

The Bank accords 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 security systems.

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 introduced were the quarterly meetings of the Bank's managerial staff under the Governor's chairmanship, during which policy issues, administrative matters and the implementation of decisions were discussed. Every four months, I also 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 and the five Senior Managers. At its regular weekly meetings, the Governor's Committee examined numerous issues affecting the Bank's daily operations as well as its short and medium-term objectives in accordance with the guidelines and decisions of the Board of Directors and the Monetary Policy Committee. The Board of Directors and the Monetary Policy Committee convened once a month and carried out their assigned tasks concerning the governance of the Bank and the conduct of monetary policy, respectively.

The biannual meetings between the Governor of the Central Bank and the presidents/chief executives of commercial banks have proved very productive and significant. These meetings 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, the Governor, together with Bank officials and foreign experts, participated in the discussion, analysis and evaluation of the Annan Plan for the solution of the Cyprus problem. In the light of the April referendum, 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 timely diagnosis of economic developments and the implementation of appropriate policies by the monetary authority.

Neither the Government nor the Central Bank of Cyprus can afford the luxury of complacency because full membership of the European Union entails many challenges and obligations. The most important among these concerns our participation in ERM II and the fulfilment of the criteria for the adoption of the euro. The goal of joining ERM II can be successfully achieved if there is satisfactory coordination and cooperation among all the discipline, the continuation of the unions' cooperative stance and the avoidance of excessive politicisation of sensitive economic issues. I wish to stress the last point because in a few months we will be entering the campaign period for the upcoming parliamentary elections. We all have to remain conscious of the very rigorous criteria our country will have to meet regarding its nominal and real convergence with the EU. Satisfying exorbitant demands is not conducive to the fulfilment of these criteria.

I also believe that priority should be given to the design and implementation of economic policies which will ensure our county's continued prosperity by taking into account its competitive advantages. These policies should also encompass world and local developments, advances in production methods and best business practices as well as the qualitative improvement of services, which is our country's most important sector.

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 the Bank's staff for their dedication, diligence and efforts towards achieving the objectives of the Bank. Thanks are due to Constantine Dampsas for his long and successful service on the Board of Directors. Finally, I wish to express once again my sincere condolences to the family of the late Antonis Malaos, who served as member of the Board of Directors and the Monetary Policy Committee with great dedication and professionalism.

Christodoulos Christodoulou
Governor, Central Bank of Cyprus

2. Management and Organisation of the Bank

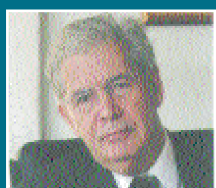
2.1 Board of Directors

Chr. Christodoulou
Governor, Chairman

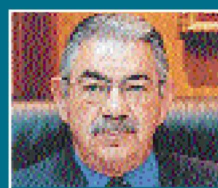
C. Damtsas

Ph. Zachariades

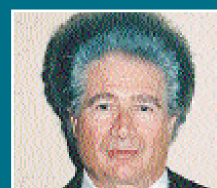
E. Hadjizacharias



A. Galanos



Z. Katsourides



S. Araouzos

Constantinos Damtsas: Managing Director of a private company. Member of the Industrial Disputes Court. Vice-president of the Cyprus Chamber of Commerce and Industry and a member of the board of directors of private and public companies, semi-government and professional organisations. He served as a member of the Bank's Board of Directors between April 1990 and April 2004.

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 & 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 Adviser to the President of the Republic on Maritime Affairs, a 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.

Spyros Araouzos: Partner and Director of a number of private companies. He has been Spain's Honorary Consul General in Cyprus since 1968. He previously served as Chairman of the Board of Directors of the Cyprus Petroleum Refinery for five years, as a member of the Board of Directors of Cyprus Airways and as a member of the Board of Directors of the Central Bank of Cyprus from 1979 - 1989. He was re-appointed as a member of the Bank's Board of Directors in July 2004.

2.2 Monetary Policy Committee

Chr. Christodoulou
Governor

H. Akhniotis

A. Malaos

A. Matsis

C. Pissarides

G. Thoma

Haralambos Akhniotis: Adviser to the Governor and formerly Chief Senior Manager of the Economic Research and Management Services Division of the Central Bank of Cyprus. He has been a member of the Monetary Policy Committee since November 2000.

Antonis Malaos: Served as Permanent Secretary of the Ministry of Finance and the Ministry of Justice as well as Director of the European Institute of Cyprus. He also served on the Bank's Board of Directors and subsequently became a member of the Monetary Policy Committee. Antonis Malaos passed away on 3 January 2005.

Andreas Matsis: Entrepreneur and 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.

2.3 Senior Management Team

Chr. Christodoulou
Governor

H. Akhniotis
Adviser to
the Governor

S. Stavrou
Senior Manager
Management Services
Division

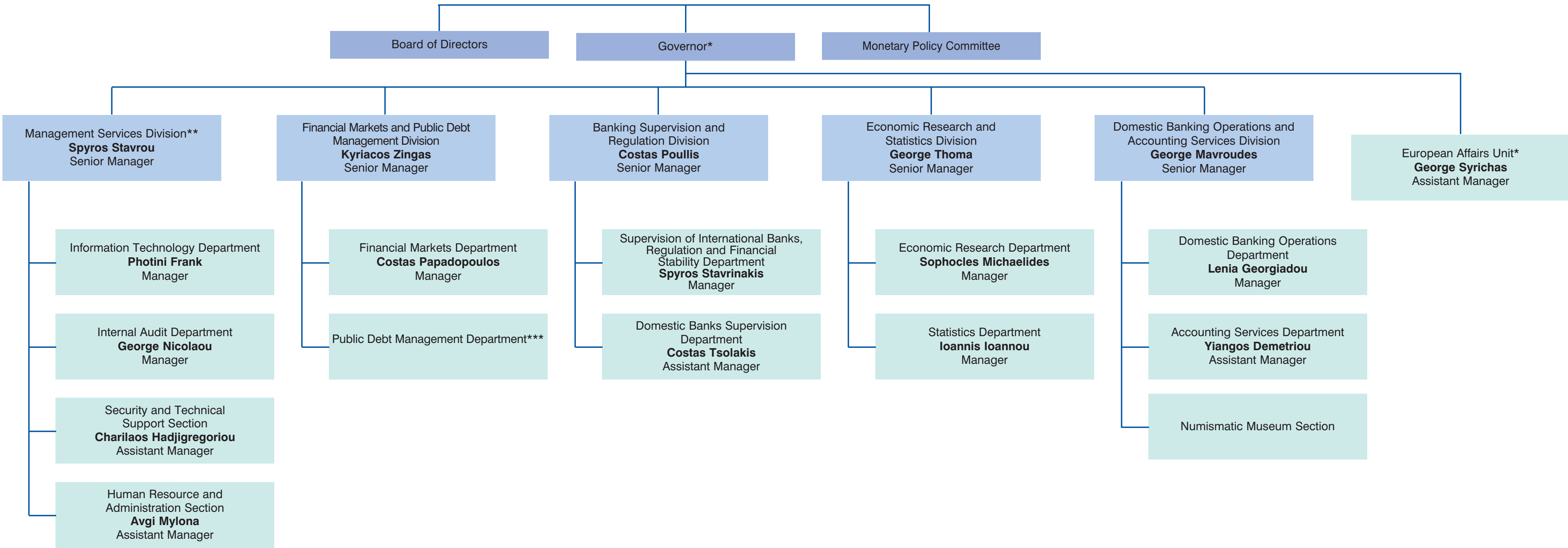
G. Mavroudes
Senior Manager
Domestic Banking
Operations and
Accounting Services
Division

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 Organisational Chart - December 2004



* The Governor deals directly with budget issues. He is also directly responsible for the European Affairs Unit.

** This includes the Library.

*** The proposed Exchange Bureau and Other Transactions Section will operate under this Department.

3. The economy in 2004

3.1 Economic developments

Overview

Real GDP grew by 3,7% in 2004 compared with 1,9% in 2003. During the year under review, foreign demand increased as a result of favourable developments in the services sector excluding tourism. Domestic demand accelerated, reflecting the large increases in private consumption and gross capital formation. On the supply side, despite the unfavourable conditions prevailing in tourism, the services sector improved as the sub-sectors of wholesale and retail trade, financial intermediation and transport and communications exhibited significant growth. The secondary sector experienced a slowdown as a result of the deceleration in manufacturing and electricity, gas and water.

The inflation rate reached 2,3% in 2004 compared with 4,1% in the previous year. This deceleration was mainly due to the dissipation of the impact of the VAT increase, from 10% to 13% in July 2002 and from 13% to 15% in January 2003, as well as the reduction in excise taxes on motor vehicles implemented in November 2003. In the labour market, the number of registered unemployed as a proportion of the economically active population reached 3,6% in 2004, compared with 3,5% in 2003.

Supply

The economy's secondary sectors experienced a general slowdown caused by the downturn in the manufacturing and the electricity, gas and water sectors. A marginal deceleration was also registered by the construction industry. More specifically, the construction sector grew by 5,2% in real terms, compared with 5,3% in the previous year. The positive performance of this sector for a fourth consecutive year was reflected in the number of building permits as well as the volume of cement sales. Value added in manufacturing rose by 0,3% in real terms during 2004, compared with an increase of 2,5% in the previous year. The fall in the manufacturing volume index reflected the termination of the operation of the Cyprus Oil Refinery in May 2004.

The UN Human Development Index (HDI)

GDP data do not provide a precise picture of the welfare of a country's people. For some years now, economists have attempted to find the extent to which non-monetary indicators correlate with GDP data in portraying relative living standards. In 1990 the United Nations Development Program introduced the Human Development Index (HDI) which combines, in addition to GDP (measured in purchasing parity terms), indicators of health (longevity measured by life expectancy at birth) and education (years of schooling and adult literacy) as a more comprehensive measure of welfare development than GDP data alone.

According to the 2004 HDI, which was based on 2002 data, Cyprus is ranked 30th among 177 UN-member countries, and 18th among the EU member states.

The services sector displayed an overall acceleration during 2004. More specifically, the wholesale and retail sector experienced a real increase of 4,8% in 2004 compared with

Gross Domestic Product by economic activity
£ million

Economic activity	At constant 1995 prices 2001	2002	2003	2004 (prov.)
Primary sectors	**216,6**	**222,4**	**233,4**	**233,0**
Agriculture, hunting and forestry	185,4	188,7	199,3	198,3
Fishing	15,9	16,2	15,9	15,8
Mining and quarrying	15,3	17,5	18,2	18,9
Secondary sectors	**927,0**	**962,3**	**1001,1**	**1024,2**
Manufacturing	482,2	485,5	497,7	499,2
Electricity, gas and water supply	119,7	135,5	144,0	146,9
Construction	325,1	341,3	359,3	378,1
Tertiary sectors	**3.759,5**	**3.822,7**	**3.868,1**	**4.036,4**
Wholesale and retail trade	640,5	654,4	629,6	660,0
Hotels and restaurants	486,8	451,9	433,0	421,0
Transport, storage and communications	512,1	527,5	530,8	577,9
Financial intermediation	305,5	305,9	302,9	340,5
Real estate, renting and business activities	815,3	852,3	892,6	920,4
Public administration and defence	396,4	411,1	429,6	438,2
Education	222,2	227,9	238,7	247,4
Health and social work	152,8	156,2	163,8	169,4
Other community, social and personal services	194,6	197,6	203,1	212,6
Private households with employed persons	33,2	37,9	44,0	49,0
Total Gross Value Added	**4.903,1**	**5.007,3**	**5.102,5**	**5.293,6**
Less: Imputed bank service charges	222,5	224,4	219,0	233,6
Plus: Value Added Tax and import duties	517,0	524,3	524,9	550,4
Gross Domestic Product at market prices	**5.197,6**	**5.307,2**	**5.408,4**	**5.610,4**

a decrease of 3,8% in the previous year, reflecting the acceleration in private consumption expenditure. During the year under review the financial intermediation sector also grew significantly, reflecting the rebound of banking activities. In addition, real estate, renting and business activities remained buoyant as a result of the construction sector's positive performance. On the other hand, hotels and restaurants registered a drop of 2,8% in 2004, compared with a fall of 4,2% in the previous year.

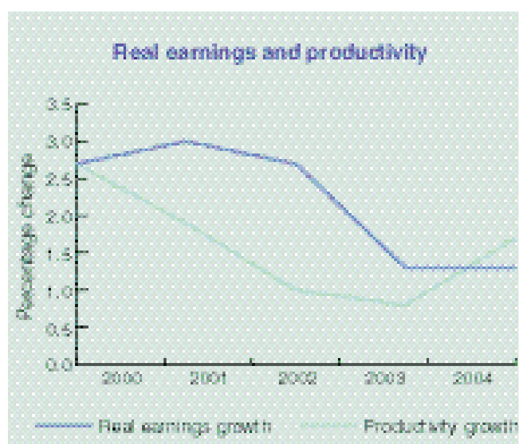
Demand

Domestic demand accelerated in real terms during 2004. This was mainly caused by the increase in the growth rate of private consumption to 6,1% compared with 1,9% the year before. This development reflects the significant increase in the demand for durables, largely due to the reduction in excises on cars in November 2003. Gross fixed capital formation registered an increase of 19,3% in 2004 compared with an increase of 1,8% in 2003, as a result of higher investment demand for construction, machinery and equipment. In contrast, public consumption declined, mainly due to lower defence spending. Foreign demand registered an increase of 3,1% in 2004 compared with a fall of 0,3% in 2003.

Inflation, productivity and the labour market

The inflation rate fell to 2,3% in 2004 from 4,1% in 2003. This deceleration reflects the dissipation of the impact of the VAT increases in 2002 and 2003 as well as the reduction of excises on motor vehicles in November 2003. In contrast, the increase in the international price of crude oil led to higher inflation than initially expected.

More analytically, the prices of domestic products grew by 5% in 2004 compared with 7,3% in 2003. This deceleration was mainly due to lower price increases for domestic industrial non-oil products, electricity and agricultural products. At the same time, imported goods were cheaper by 5,6% in 2004 compared with 2,4% in 2003 mainly due to the aforementioned reduction in motor vehicle taxes. The cost of services rose by 3,2% compared with 4,4% in 2003, reflecting the price deceleration in the health, recreation and culture sectors, as well as restaurants and hotels, while prices actually fell in the transport and communications sectors.



Productivity, defined as the ratio of value added to gainful employment, grew by 2% in

Gross Domestic Product by category of expenditure

£ million

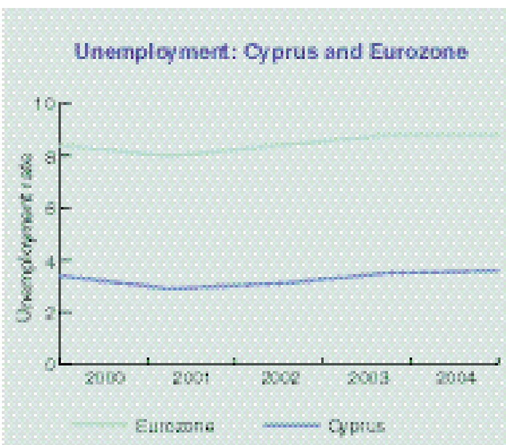
Category of expenditure	At constant 1995 prices 2001	2002	2003	2004 (prov.)
Private final consumption expenditure	3.423,6	3.474,3	3.539,7	3.755,9
Government final consumption expenditure	857,0	919,7	966,2	911,0
Gross capital formation	887,2	1.017,6	1.004,0	1.198,3
Increase in stocks	-28,3	28,4	30,1	132,7
Gross fixed capital formation	915,5	989,2	973,9	1.065,6
Total domestic demand	**5.167,7**	**5.411,6**	**5.509,9**	**5.865,2**
Exports of goods and services	2.867,9	2.719,0	2.711,2	2.796,3
Less: Imports of goods and services	2.838,2	2.823,4	2.812,7	3.051,1
Gross Domestic Product at market prices	**5.197,6**	**5.307,2**	**5.408,4**	**5.610,4**
Plus: Net factor income from abroad	-288,0	-228,6	-157,4	-157,8
Gross National Product at market prices	**4.909,5**	**5.078,6**	**5.251,0**	**5.452,6**

Consumer Price Index by economic origin

annual percentage change

	2002	2003	2004	Weights 1998=100
General Consumer Price Index	**2,8**	**4,1**	**2,3**	**100,0**
Local goods	**4,3**	**7,3**	**5,0**	**36,7**
Agricultural	1,8	4,5	3,3	7,9
Industrial	5,6	7,9	6,1	27,2
Industrial, non-oil	4,6	6,5	3,4	22,9
Fuel and gas	10,6	14,2	17,2	4,3
Electricity	-2,3	10,2	-3,1	1,5
Imported goods	**-1,7**	**-2,4**	**-5,6**	**22,2**
Motor vehicles	-5,1	-8,3	-13,7	9,4
Other imported goods	0,9	1,8	-0,4	12,8
Services	**3,7**	**4,4**	**3,2**	**41,1**

2004 compared with 0,8% in the previous year. This improvement, coupled with the small increase in employment of 1,7%, caused real GDP to grow by 3,7% in 2004. It should also be noted that during the year under review, real earnings grew by 1,3% and thus remained below the productivity growth rate. The number of registered unemployed increased by 5,8% in 2004, compared with 13,3% in 2003. The number of registered unemployed as a proportion of the economically active population climbed to 3,6% in 2004 from 3,5% in the previous year. It is also worth mentioning that, according to the labour force survey, the unemployment rate reached 4,3% in 2004, compared with 4,1% in 2003.



Public finances

According to preliminary calculations by Cystat, the fiscal deficit of the general government sector was significantly reduced in 2004 compared with 2003. Specifically, the deficit was 4,2% of GDP compared with 6,3% in the previous year, thus exceeding for the third consecutive year the 3% Maastricht criterion. Public revenue rose by 7,7% compared with 15,8% in 2003, while public expenditure increased marginally by 2,7% compared with the significant increase of 19,6% in 2003. Current expenditure increased slightly by 7% mainly due to the significant reduction of subsidies by 12,7% and of defence expenditure by 50,4%. As far as wages and salaries are concerned, the recorded increase was 7,8%. Capital expenditure recorded a significant reduction of 25,2% which was due to a change in the definition of this item during 2004.

During the year under review a significant increase in tax revenue was recorded due, in part, to the economic recovery. Specifically, income from direct taxation rose by 8,8%, mainly due to the 16% increase in revenues from corporate taxation and the 20% increase in revenues from capital gains tax. The indirect taxes recorded an increase of 6,8%, mainly due to the widening of the tax base and the continuing effect of higher excises during the year under review. Public revenue was also enhanced by the allocation of £20 million from the proceeds of the tax amnesty which came into effect in September 2004.

During 2004 the budget deficit, which in absolute terms reached £306,3 million, was mainly financed by foreign borrowing. More specifically, during the year under review, European Medium Term Notes (EMTN) worth €500 million constituted 78,4% of total external borrowing. As far as domestic issues of government bonds and development stocks are concerned, the government borrowed £100,1 million from the non-banking sector and repaid £131,6 million to the commercial banks.

The net public debt, excluding the intragovernmental debt, reached 71,9% of GDP, compared with 69,8% in 2003, thus continuing to be above the limit of the

Public revenue and expenditure

£ million

	2001	2002	2003	2004 (prov.)
Total revenue and grants	**2.083,7**	**2.125,1**	**2.408,0**	**2.627,7**
Direct taxes	**659,4**	**641,7**	**582,0**	**633,3**
Income taxes	482,8	461,2	386,9	442,8
Indirect taxes	**722,0**	**799,3**	**1.046,4**	**1.117,9**
Value Added Tax	344,7	403,8	548,9	606,5
Excise duties	178,4	198,9	282,2	330,9
Import duties	73,6	72,5	62,3	35,6
Social security fund contributions	**278,0**	**303,4**	**322,3**	**398,2**
Other revenue	**421,8**	**377,9**	**452,1**	**400,9**
Foreign grants	**2,5**	**2,8**	**5,3**	**77,4**
Total expenditure and net lending	**2.213,1**	**2.398,6**	**2.824,3**	**2.934,0**
Current expenditure	**1.995,9**	**2.166,4**	**2.518,9**	**2.705,8**
Goods and services (including unallocable)	300,4	358,3	355,6	251,7
Wages and salaries	559,4	600,5	726,8	783,8
Current transfers	370,0	457,7	595,4	762,0
Social pensions	25,7	26,9	27,4	28,2
Social security fund payments	319,2	355,1	395,9	453,4
Subsidies	91,1	63,9	90,9	79,4
Interest payments	330,0	304,2	327,0	347,3
Capital expenditure	**217,2**	**232,2**	**305,3**	**228,3**
Investment	155,6	174,0	218,8	228,3
Capital transfers	61,6	58,2	86,6	0,0
Surplus(+)/deficit(-) of Local Authorities	**-9,3**	**-8,4**	**-11,5**	**-9,1**
Other readjustments	0,0	-2,0	0,1	9,1
Fiscal surplus (+)/deficit(-)	**-138,7**	**-283,9**	**-427,7**	**-306,3**
Fiscal surplus (+)/deficit(-) as a percentage of GDP (%)	**-2,3**	**-4,5**	**-6,3**	**-4,2**

Public debt(1)

£ million

	2001	2002	2003	2004 (prov.)
Domestic debt	**5.232,8**	**5.710,0**	**6.295,5**	**6.559,4**
Long-term debt	**1.580,5**	**2.714,8**	**3.151,1**	**3.380,4**
Development stocks	**1.368,1**	**1.528,9**	**1.946,5**	**2.168,3**
Central Bank	70,0	53,7	52,4	86,2
Deposit money banks	695,2	938,9	1.096,1	1.205,3
Private sector	602,5	535,8	797,5	876,4
Sinking funds	0,0	0,0	0,0	0,0
Social security funds(2)	0,5	0,5	0,5	0,5
Savings bonds	**20,0**	**16,5**	**13,5**	**10,5**
Central Bank	3,1	0,0	0,0	0,0
Private sector	16,9	16,5	13,5	10,5
Savings certificates	**45,7**	**53,6**	**69,3**	**73,9**
Private sector	45,7	53,6	69,3	73,9
Others	**146,7**	**1.115,8**	**1.121,8**	**1.127,8**
Central Bank	0,0	961,1	961,1	961,1
Local authority loans	146,7	154,7	160,7	166,7
Short-term debt	**3.652,3**	**2.995,2**	**3.144,4**	**3.179,0**
Treasury bills	**3.113,6**	**2.995,2**	**3.144,4**	**3.179,0**
Central Bank	179,6	7,9	0,1	0,0
Deposit money banks	689,2	533,8	574,4	404,6
Private sector	28,7	52,5	-38,6	1,1
Sinking funds	0,0	0,0	0,0	0,0
Social security funds(2)	2.216,2	2.401,0	2.608,5	2.773,3
Central Bank advances	**538,7**	**0,0**	**0,0**	**0,0**
Foreign debt	**765,3**	**849,5**	**1.063,9**	**1.422,7**
Short-term liabilities of the Central Bank to the IMF	**4,8**	**4,8**	**4,8**	**4,8**
Long-term loans	**180,8**	**152,3**	**273,4**	**328,9**
Medium-term loans (EMTN)	**515,9**	**674,8**	**674,8**	**974,5**
Short-term loans (ECP)	**63,9**	**17,7**	**111,0**	**114,5**
Total public debt	**5.998,1**	**6.559,5**	**7.359,4**	**7.982,1**
Net public debt (excluding intragovernmental and short-term liabilities of the Central Bank to the IMF)	**3.776,6**	**4.153,3**	**4.745,7**	**5.203,6**

(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.

respective Maastricht criterion. Domestic debt, including intragovernmental debt, reached £6.559,4 million or 90,7% of GDP, compared with £6.295,5 million or 92,6% of GDP in the previous year. Simultaneously, the foreign debt (including the medium term borrowing through EMTN worth £974,5 million) reached £1.422,7 million or 19,7% of GDP compared with £1.063,9 million or 15,6% of GDP in 2003. The recorded increase of 44,4% in the EMTN compared with 2003 is due to the aforementioned EMTN worth €500 million.

During 2004 Cyprus continued not fulfilling the fiscal convergence criteria of the Maastricht Treaty and, as a result, on 1 May 2004 Cyprus was placed under the EU's Excessive Deficit Procedure (EDP). As a result, the government set as target the improvement of the fiscal situation and announced a package of fiscal measures which were included in the Convergence Programmes. These Programmes were submitted to the EU in May for the period 2003-2007 and in December for the period 2004-2008. According to the latter Programme, the deficit of the general government sector was expected to be reduced to 4,8% of GDP in 2004. However, the final figure 2004 was 4,2%. According to Ministry of Finance projections the fiscal deficit is expected to be further reduced to 2,9%, 1,7%, 1,5% and 0,9% from 2005 until 2008. The debt of the general government sector, which reached 71,9% of GDP in 2004, is expected to follow a descending path from 2005 until 2008 falling by stages to 71,9%, 69,2%, 65,7% and 58,1% of GDP, respectively. In December 2004, after positively evaluating the implementation of the fiscal consolidation measures, the European Commission proposed to put the EDP in abeyance. The proposal was approved by ECOFIN in January 2005.

Balance of payments

According to the data available for the first ten months of 2004, the current account deficit is expected to have reached £418,8 million or 5,8% of GDP in 2004 compared with £205 million or 3% of GDP in 2003. The widening of the current account deficit was mainly the result of the deterioration in the trade balance and services income and transfers balance. As far as the trade balance is concerned, total exports of goods (fob) and total imports of goods (fob) reported increases of 11,2% and 15,6%, respectively. As a consequence, the trade deficit reached 26,2% of GDP in 2004 compared with 23,8% in 2003.

A notable increase was reported in car imports, as a result of the reduction in import duties in November 2003. Furthermore, a marked increase was reported in the value of oil imports in the second half of the year, due to higher oil prices internationally. As far as services are concerned, there was a marked increase in the number of Cypriots travelling abroad, mainly due to the Olympic Games in Athens. Cypriots also took advantage of the cheaper air fares available in 2004. The current account deficit was financed mainly from foreign direct investment and foreign and domestic borrowing by the public and private sectors.

Since 2002 balance of payments statistics have been compiled by the Central Bank in accordance with the Eurostat methodology. The 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 new system, the collection of statistical data has improved, especially with regard to the export of services. Since 2002 the compilation of balance of payments statistics has been based on the International Monetary Fund and the European Union definition of "resident". 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) which have had a physical presence in Cyprus of more than one year are considered resident.

Trade balance

The main development in the trade balance in 2004 was the significant increase in the total imports of goods. Total exports of goods also increased in 2004, but to a lesser extent. More specifically, total imports rose by 16,3% in 2004, compared with a fall of 6,9% in 2003. Total imports of consumer goods reported an 8,4% increase in 2004, compared with a 0,5% decrease in 2003. Total imports of intermediate inputs rose by 14% in 2004, compared with a 0,1% rise in the previous year. Total imports of capital goods increased by 19,4% in 2004, compared with 5,7% in 2003. Imports of transport equipment and parts registered an increase of 50% in 2004, compared with a decrease of 18,9% in 2003. During the year under review the value of oil imports rose significantly as a result of the increase in the price of oil.

As far as the total export of goods is concerned there was a 15,6% increase in 2004, compared with a 6,7% decrease in 2003.

Services, income and transfers

The surplus in the services, income and transfers account reached £1.472,8 million in 2004, compared with £1.412,1 million in 2003. The improvement was mainly the result of higher export of services. More specifically, significant increases were reported in the category "other business services" which registered an 11,7% increase and in the category "computer and information services" which increased by 248,4%. During 2004 the travel account surplus reported a decrease relative to 2003. Revenue from tourism declined by 3% in 2004, compared with 10,4% in 2003. Nevertheless, a pilot study undertaken by Cystat has shown that revenue arising from the running expenses of holiday homes owned by tourists staying in Cyprus for less than a year, were not fully captured by the current survey. Preliminary data suggest that these expenses are close to £60 million for 2004. Expenditure related to the purchase of tourism services from abroad increased in 2004, as a result of a decrease in air fares and the Olympic Games hosted in Athens.

The income account reported a deficit of £246 million in 2004, compared with £198,1 million in 2003. The deterioration is mainly due to the decrease of revenue from the compensation of employees.

The financial and capital account

The financial account registered a surplus of £456,9 million in 2004, compared with £210 million in 2003. More specifically, foreign direct investment reported a net inflow of £302 million in 2004, compared with a net

Balance of payments

£ million

	2003 (prov.)			2004 (est.)		
	Credit	Debit	Net	Credit	Debit	Net
Current account	**3.658,2**	**3.863,2**	**205,0**	**3.983,8**	**4.402,6**	**-418,8**
Goods, services and income	**3.460,9**	**3.739,4**	**278,5**	**3.705,8**	**4.207,9**	**-502,1**
Goods and services	**3.210,3**	**3.290,6**	**-80,3**	**3.426,6**	**3.682,7**	**-256,1**
Goods	**494,1**	**2,111,2**	**-1.617,1**	**549,4**	**2.441,0**	**-1.891,5**
Services	**2.716,2**	**1.179,4**	**1.536,8**	**2.877,2**	**1.241,7**	**1.635,4**
Transport	631,2	571,9	59,3	677,7	525,2	152,5
Sea transport	397,2	373,7	23,5	500,4	309,9	190,4
Air transport	231,2	179,6	51,6	168,5	205,4	-36,9
Other transport	2,8	18,6	-15.8	8,8	9,9	-1,1
Travel	1.073,7	325,7	748,0	1.054,4	377,2	677,2
Communication services	25,5	36,5	-11,0	16,5	36,6	-20,1
Construction services	79,3	7,6	71,7	68,4	6,9	61,5
Insurance services	17,6	25,9	-8,3	20,9	33,3	-12,4
Financial services and renting	97,0	23,4	73,7	105,4	51,2	54,2
Computer and information services	47,7	19,1	28,7	115,3	15,3	100,0
Royalties and licence fees	7,8	20,0	-12,2	8,3	25,0	-16,7
Other business services	543,2	62,3	480,8	642,5	105,6	536,9
Personal, cultural and recreational services	5,1	11,5	-6,4	11,6	22,7	-11,1
Government services, n.i.e.	188,0	75,4	112,6	156,3	42,8	113,5
Income	**250,6**	**448,8**	**-198,1**	**279,2**	**525,1**	**-246,0**
Current transfers	**197,3**	**123,8**	**73,4**	**278,0**	**194,7**	**83,3**
Capital and financial account			**210,0**			**465,9**
Capital account	**21,3**	**10,8**	**10,4**	**86,7**	**27,2**	**59,5**
Financial account			**199,6**			**406,4**
Direct investment			251,9			302,0
By Cypriot residents abroad			-271,1			-273,1
By non-residents in Cyprus			523,0			575,2
Portfolio investment			147,5			90,3
Assets			-253,8			-861,9
Liabilities			401,3			952,2
Derivatives			8,6			-17,6
Other investments			-319,6			211,0
Assets			-1.252,2			-937,4
Liabilities			932,2			1.148,4
Reserve assets			111,2			-179,3
Net errors and omissions			**-5,0**			**-47,2**

Source: Central Bank of Cyprus and Cystat.

inflow of £251,9 million in 2003. As far as portfolio investment is concerned a net inflow of £90,3 million was registered in 2004, compared with £147,5 million in 2003. In the category of "other investment" a net inflow of £211 million was registered in 2004, compared with a net outflow of £319,6 million in 2003.

International reserves

Official international reserves reached £1.750,5 million at the end of 2004, compared with £1.607,3 million at the end of 2003. The coverage of total imports of goods by official reserves was equal to 7,9 months in 2004 compared with 8,7 months in 2003.

Exchange rates

In December 2004 the Cyprus pound appreciated relative to the euro reaching €1,7255 compared with €1,7087 in December 2003. In August 2001 the fluctuation margins of the pound relative to the euro were unilaterally increased to ±15%, in line with the corresponding ERM II margins. During 2004 the fluctuations of the Cyprus pound relative to the euro were within the narrow band of ±2,25%, as in previous years.

The cross rates of the Cyprus pound relative to other currencies were formulated by developments in international exchange rate markets. During the year under review the dollar registered a significant depreciation relative to the euro, sterling and, to a lesser extent, the yen. In December 2004 the dollar reached $1,34 per euro which was its lowest value since January 1999, when the euro was first launched. The same path was followed by the dollar relative to sterling reaching $1,93 per sterling in December 2004, the highest value during the last ten years. The dollar's decline was the result of investors' negative sentiment vis-à-vis the twin deficits.

In line with the euro, the Cyprus pound reported a significant appreciation relative to the dollar reaching $2,31 per Cyprus pound in December 2004, compared with $2,10 in December 2003. From the beginning of the

Imports (cif) by economic origin

£ million

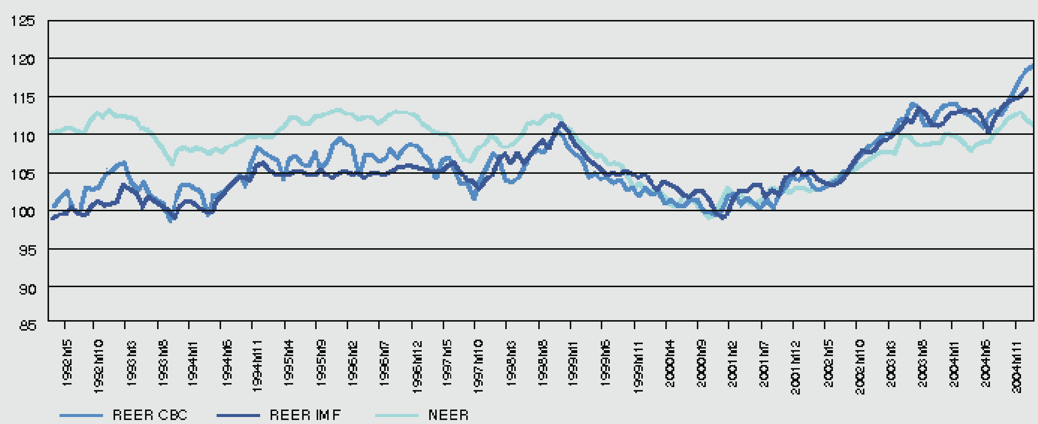
				% change	
	2002	2003	2004	2003/2002	2004/2003
Consumer goods	**713,6**	**667,7**	**724,0**	**-0,5**	**8,4**
Intermediate inputs - raw materials	**725,0**	**727,2**	**829.0**	**0,1**	**14,0**
Capital goods	**246,8**	**263,4**	**314,4**	**5,7**	**19,4**
Transport equipment and parts	**397,2**	**326,8**	**490,4**	**-18,9**	**50,0**
Fuels and lubricants	**269,7**	**226,8**	**283,5**		
Unclassified	**134,3**	**92,1**	**38,0**		
Total imports	**2.486,6**	**2.304,0**	**2.679,3**	**-6,9**	**16,3**

Source: Cystat

Exchange rate of the Cyprus pound against the euro

Note: The official exchange rate fluctuation margins of the Cyprus pound against the euro are set equal to ±15%

Real Effective Exchange Rate index of the Cyprus pound (IMF weight)
(Base year 2000=100)



year the Cyprus pound depreciated relative to sterling reaching ST£1,13 - ST£1,16 in the summer months. From September a significant appreciation was reported reaching ST£1,20 per Cyprus pound towards the end of 2004.

3.2 Monetary policy and developments

Monetary policy

In 2004 the major monetary authorities, with the exception of the ECB, ceased pursuing loose monetary policies. The ECB decided to adopt a wait and see stance as the appropriate policy for the euro area due to the low growth and steady inflation associated with the strong euro. In the light of mounting twin deficits, the continued rise in consumption expenditures and the concurrent decrease in household savings, as well as the rise in property prices, the US Federal Reserve raised the Federal Funds rate five times, by 25 basis points each time. The Bank of England raised the repo rate four times, by 25 basis points on each occasion, mainly as a result of rising UK property prices in conjunction with steady economic growth.

The Central Bank of Cyprus maintained a cautionary stance, with only one rise in the marginal lending facility rate by 100 basis points to 5,50% in April 2004. The increase in the official rate came as a direct response to the unfounded rumours regarding an impending devaluation of the Cyprus pound. It sent a strong signal of support for the local currency in the light of capital outflows that resulted from political uncertainty surrounding the referendum on the Annan Plan. Also, in view of the imminent removal of capital controls after 1 May 2004, this rise was a precautionary measure against possible additional outflows. The decision to increase interest rates contributed towards the strengthening of public confidence in the Cyprus pound and the reversal of capital outflows.

Monetary developments

The annual growth of money supply, including the Co-operative Credit Institutions (M2C) rose by 6,8%, compared with 5,6% in the previous year. Total money supply (M2) grew at an annual rate of 5,6% in December 2004, compared with 4% in December 2003.

The main factors that contributed to the rise in M2 were the strong credit growth and the increase in foreign assets. Specifically, credit to the private sector rose by 6,5% or £536,2 million in 2004, compared with 5% or £397,9 million in the previous year. Credit to the public sector fell by 6% or £113,7 million in 2004, compared with an increase of 9,8% or £169,9 million in 2003. The growth in claims to the private sector is attributed to the revival of economic activity and is especially reflected in the construction and personal-professional loans. Net foreign assets rose significantly by £317,5 million in 2004, compared with a rise of £352,2 million in 2003. This development was primarily due to the €500 million EMTN issue in July 2004.

As regards the components of M2, the narrow monetary aggregate M1, which consists of currency in circulation and demand deposits, increased by 10,6% or £146,6 million in 2004, compared with a rise of 32,6% or £338,3 million in 2003. This development is attributed to the slowdown in currency in circulation and, more importantly, to the marked increase in time deposits in local currency during 2004. This latter development was the result of the increased preference for time deposits, a reversal of the trend observed in the previous year. In April, the rise in interest rates augmented public confidence in the Cyprus pound and affected positively the demand for quasi-money in local currency. Specifically, time deposits rose by 1,5% while demand deposits rose by 6,4%. The respective figures for 2003 were a decrease of 1,7% in time deposits and a rise in demand deposits of 37,8%. In addition, both time and demand deposits in foreign currency held by Cypriot residents exhibited significant increases. This development had been anticipated since

Total money supply

£ thousand

	End of period balances	Change			
				2004	
	2004	2003	2004	1st half	2nd half
Money supply (M1)	**1.523.695**	**338.339**	**146.593**	**15.220**	**131.373**
Currency in circulation	513.752	74.393	46.515	6.287	40.228
Demand deposits	921.319	237.720	55.438	-38.574	94.012
Foreign currency demand deposits of Cypriot residents	88.624	26.226	44.640	47.507	-2.867
Quasi-money	**7.448.050**	**-9.360**	**331.006**	**318.610**	**12.396**
Savings deposits	319.645	55.102	25.055	14.032	11.023
Time deposits	6.534.831	-114.289	95.623	124.016	-28.393
Foreign currency deposits of Cypriot residents	593.574	49.827	210.328	180.562	29.766
Total money supply (M2)	8.971.745	328.979	477.599	333.830	143.769

Factors affecting total money supply

£ thousand

	End of period balances	Change			
				2004	
	2004	2003	2004	1st half	2nd half
Net foreign assets	**1.153.310**	**352.164**	**317.486**	**89.523**	**227.963**
Official (net)	1.711.488	-136.312	157.837	29.969	127.868
All banks (net)	-589.382	478.656	174.765	68.105	106.660
IMF reserve position	31.204	9.820	-15.116	-8.551	-6.565
Claims on private sector	**8.838.151**	**397.893**	**536.152**	**325.726**	**210.426**
By all banks	8.838.151	397.893	536.152	325.726	210.426
By monetary authorities	0	0	0	0	0
Claims on public sector	**1.794.577**	**169.944**	**-113.676**	**85.054**	**-198.730**
Central government	1.835.535	178.520	-121.414	81.753	-203.167
Advances and loans	1.071.438	19.095	21.473	7.364	14.109
Securities, treasury bills, etc.	1.693.015	316.271	-37.083	34.021	-71.104
Government deposits(1)	-928.918	-156.846	-105.804	40.368	-146.172
Government agencies(2)	-9.754	1.244	-7.378	-5.250	-2.128
Advances and loans	23	-48	0	-3	3
Deposits(1)	-9.777	1.292	-7.378	-5.247	-2.131
IMF reserve position	-31.204	-9.820	15.116	8.551	6.565
Unclassified items	**-2.814.293**	**-591.022**	**-262.363**	**-166.473**	**-95.890**
Total money supply	**8.971.745**	**328.979**	**477.599**	**333.830**	**143.769**

(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.

Cypriots enjoyed the opportunity of owning deposits in foreign currency without restrictions after 1 May 2004. The rise in Cypriots' foreign currency deposits also affected quasi-money positively.

In 2004 bank credit analysis shows that most sectors had net debt repayments. In contrast, the personal-professional loans and construction sectors continued to take up the largest share of net credit, absorbing 74,1% and 32,7%, respectively, compared with 50,4% and 45,1% in the previous year. It is noted that in 2004 about 34,5% of new personal-professional loans were used for house purchases, compared with 62,5% in 2003. The decrease may be partly attributed to the Central Bank directive issued in November 2003 requiring banks to supply credit only up to 70% of the value of the property held as collateral.

Regarding borrowing in foreign currencies, loans denominated in euro remained the first

Bank credit by sector

£ thousand

	End of period balances		Change		Share (%)[1]	
	2003	2004	2003	2004	2003	2004
Public institutions and corporations[2]	267.830	279.963	19.326	12.133	4,8	1,9
Agriculture	111.572	116.799	-1.281	5.227	-0,3	0,8
Mining	29.528	27.239	2.540	-2.289	0,6	-0,3
Manufacturing	540.162	524.179	-20.559	-15.983	-5,1	-2,5
Transport and communications	133.776	106.975	-2.508	-26.801	-0,6	-4,1
Foreign and domestic trade	1.604.835	1.561.703	-10.210	-43.132	-2,6	-6,7
Building and construction	1.377.888	1.588.418	180.116	210.530	45,1	32,7
Tourism	849.508	878.537	30.697	29.029	7,7	4,5
Personal and professional loans	3.760.400	4.237.621	201.245	477.221	50,4	74,1
Bills discounted:						
Local	4.081	2,987	152	-1.094	0,0	-0,2
Foreign	3.187	2.024	-136	-1.163	0,0	-0,2
Total	**8.682.767**	**9.326.445**	**399.382**	**643.678**	**100,0**	**100,0**

(1) Refers to the change in credit. *(2) Includes government loans.*

Co-operative Credit Institutions

	Total deposits		Total loans	
End of period	Value £'000	% change over previous year	Value £'000	% change over previous year
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	3.985.863	13,4	2.947.042	10,4
2004 (prov.)	4.245.433	6,5	3.279.538	11,3

preference of residents, thus absorbing 69,7% of the total while loans denominated in dollars absorbed 8,4% of the total loans in foreign currency at the end of 2004. The respective figures in the previous year were 70,5% and 9,3%.

Co-operative Credit Institutions

During 2004 Co-operative Credit Institutions (CCIs) exhibited larger increases in their deposits and loans in local currency, compared with the commercial banks, thus improving their market share. According to preliminary figures, at the end of 2004, deposits with CCIs amounted to 37% of total local currency deposits, compared with 36,2% in the previous year. Commercial banks shares amounted to 63% and 63,8%, respectively. Deposits with CCIs grew by 6,5% in 2004, compared with a rise of 13,4% in 2003, while Cyprus pound deposits with commercial banks, excluding CCIs' deposits with the Co-operative Central Bank, grew by 2,8% in 2004, compared with a decrease of 1,2% in the previous year.

As regards borrowing, preliminary data show that CCI loans grew by 11,3% in 2004, compared with a rise of 10,4% in the

Interest rates

percent per annum

	Open market operations		Treasury bills		Development stocks			
Period	Repos	Rev. repos/ Acceptance of deposits	13 weeks	52 weeks	2 years	5 years	10 years	15 years
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	-	-
2004 January	-	3,36	3,56	3,87	4,37	4,70	-	-
February	-	3,47	-	-	4,53	5,10	5,17	5,56
March	-	3,44	3,70	4,30	4,79	-	-	-
April	-	3,30	3,96	4,43	5,01	5,50	-	-
May	-	-	-	-	-	-	-	-
June	-	-	4,74	5,27	5,81	6,36	6,58	7,05
July	-	4,38	-	-	5,70	6,54	-	-
August	-	4,36	4,70	5,19	5,60	6,48	-	-
September	-	4,27	-	5,14	5,25	6,29	-	-
October	-	4,20	-	-	-	-	-	-
November	-	4,24	4,62	5,09	5,24	6,22	6,27	-
December	-	-	-	-	-	6,21	6,26	-

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
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
2004 January	6,92	6,90	7,53	6,30	10,50	0,44	3,35	3,43
February	6,92	6,90	7,53	6,30	10,50	0,45	3,35	3,42
March	6,92	6,90	7,53	6,30	10,50	0,44	3,35	3,43
April	6,92	6,90	7,53	6,30	10,50	0,42	3,35	3,40
May	7,92	7,90	8,53	7,30	11,50	0,69	4,41	3,88
June	7,92	7,90	8,53	7,30	11,50	0,66	4,42	4,04
July	7,92	7,90	8,53	7,30	11,50	0,66	4,43	4,08
August	7,92	7,90	8,53	7,30	11,50	0,67	4,61	4,11
September	7,92	7,92	8,55	7,30	11,50	0,66	4,44	4,14
October	7,92	7,92	8,55	7,30	11,50	0,66	4,44	4,18
November	7,92	7,92	8,55	7,30	11,50	0,64	4,44	4,21
December	7,92	7,92	8,55	7,30	11,50	0,63	4,44	4,21

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.

previous year. The CCI share of total local currency loans rose to 29% in 2004, compared with 28% in the previous year.

Bank liquidity

In the money market, excess bank liquidity conditions prevailed, albeit lower when compared with 2003. The increase in government deposits with the Central Bank mainly emanated from the €500 million EMTN issue in July 2004. The 2% minimum reserve maintenance ratio on foreign currency deposits introduced on 1 May, also contributed towards a reduction of excess bank liquidity. An additional factor that absorbed surplus funds was the rise in circulating currency, which averaged £514,1 million per month in 2004 as compared with £446,1 million per month in 2003. In contrast, the increase in the Central Bank's average monthly net foreign assets, from £1.156,6 million in 2003 to £1.274,9 million in 2004, added to excess bank liquidity. In pursuit of its anti-inflationary policy the

Central Bank continued to intervene in the money market using auctions for the acceptance of deposits (depos) absorbing, on average, £94,4 million per month in 2004, compared with £190,8 million per month in 2003. It is noted that in May, June and from mid-November until the end of the year, balanced bank liquidity conditions prevailed.

Interest rates

As already mentioned, the marginal lending facility rate remained unchanged during most of 2004, with only one rise by one percentage point in April. Specifically, the rate remained at 4,5% until 30 April and was then raised to 5,5%, staying at this level until the end of the year. The respective interest rate in the euro area remained unaltered at 3% for the whole year. The overnight deposit facility rate followed the same course as the marginal lending rate, rising from 2,5% to 3,5% on 30 April and staying at this level until the end of 2004. In contrast, in the euro area the respective interest rate remained unchanged at 1% during the whole year. The domestic overnight interbank rate increased on average because of the fall in excess liquidity and the rise in the official interest rate in April. The average interbank rate reached 3,92% in 2004, compared with 3,35% in 2003.

Both deposit and lending rates of commercial banks remained stable during the first four months of the year and rose during April, reflecting the rise in official Central Bank rates.

Regarding government securities, there was a rise in all yields compared with the previous year, due to the increase in the Central Bank's official rates. In spite of this, towards the end of the year there was a downward trend in yields on all securities. Detailed analysis regarding the interest rates of government securities is provided in section 4.7.

4. Functions of the Bank

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

With Cyprus's accession to the European Union on 1 May 2004, the Central Bank of Cyprus became a full member of the ESCB. Since EU accession the Governor, Christodoulos Christodoulou, has been participating in the General Council of the ECB as a full and equal member and about 40 Central Bank officials have become members of the ESCB committees and working groups. During the year prior to Cyprus's accession, the Governor and other officials of the Central Bank attended the relevant meetings as observers, thus facilitating the Bank's smooth integration into the ESCB.

Representatives of the Central Bank also participate in various other committees and working groups of the EU, which assist the Council and the European Commission. Notwithstanding its small size, the Central Bank participates effectively and constructively in the functions of the ESCB and the aforementioned EU committees.

The European Affairs Unit (EAU) of the Bank undertakes the coordination necessary for the Bank's successful participation and fulfilment of its obligations vis-à-vis the EU. The participation of the EAU in the editorial group for the ECB's convergence report, which was issued in October 2004, is noteworthy as well as the Unit's contribution with respect to the issues addressed by the General Council of the ECB. The EAU continued to coordinate the Bank's programme for harmonisation with the *acquis communautaire*, especially during the first four months of 2004, and provided the European Commission and the Office of the Harmonisation Coordinator of the Republic of Cyprus with relevant information.

Harmonisation with the *acquis*

The harmonisation with the *acquis communautaire* in the Central Bank's area of competence was completed upon Cyprus's accession to the EU, with the entry into force of a series of legal acts. Several of these acts were adopted in 2003, while others were adopted in the first months of 2004. Because of the dynamic nature of the *acquis* and its constant evolution, harmonisation is a continuing process.

Banking services

The Central Bank, in exercising its supervisory powers, gives special emphasis to the timely adaptation of the regulatory framework for the operation and supervision of banking institutions in accordance with the *acquis.*

In April 2004 the House of Representatives enacted the *Banking (Amendment) (No. 2) Law 151(I)/2004* in order to transpose the provisions of EU Directive 2001/24/EC, which introduces the principle of mutual recognition by the EU member states with regard to the reorganisation measures or winding up proceedings adopted by the home country of credit institutions, in case these run into difficulties. *Law 151(I)/2004* provides that the reorganisation measures or winding up proceedings adopted in respect of any bank which operates under a banking business licence granted to it by the Central Bank, including its branches in another member state, are governed by the laws of Cyprus. Conversely, the reorganisation measures or winding up proceedings adopted in respect of a bank incorporated in another member state will also be recognised and implemented with regard to its branches operating in Cyprus. Reorganisation measures are defined as measures which are intended to preserve or restore the financial situation of a bank and which could affect creditors and/or other persons' pre-existing rights, including the measures prescribed in the *Companies Law*, which are taken under the supervision of the Central Bank of Cyprus. Moreover, *Law 151(I)/2004* ensures equal treatment of a bank's creditors and strengthens further the power of the Central Bank to cooperate and exchange information with other supervisory authorities.

In April 2004 the House of Representatives also enacted the *Electronic Money Institutions Law 86(I)/2004* for the purpose of harmonisation with EU Directive 2000/46/EC. *Law 86(I)/2004* defines electronic money and specifies the requirements that an electronic money institution must fulfil in order to pursue its business. Moreover, it allows electronic institutions authorised in other EU member states freedom of establishment and provision of cross-border services in Cyprus. The aforementioned law sets the regulatory framework for electronic money institutions, specifies the "fit and proper" criteria for the directors of such institutions and empowers the Central Bank to exchange information with other competent supervisory authorities.

On 1 May 2004 the provisions of the *Banking Laws* (particularly *Law 119(I)/2003)* allowing freedom of establishment and cross-border provision of banking services by banks authorised in other EU member states, entered into force. Conversely, banks incorporated in Cyprus are free to establish branches in another member state and/or provide cross-border services in other member states. In July 2004 the Central Bank issued a "Policy statement and guidelines on the establishment and cross-border provision of services in the Republic of Cyprus by a credit institution incorporated in another member state of the EU". This statement includes the terms and conditions for the conduct of banking business by such credit institutions as well as details with regard to the procedure that must be followed. In this context, one bank from the UK and one from Greece currently operate in Cyprus in the form of a branch without a banking licence from the Central Bank. In addition, during 2004 banks from ten member states notified the Central Bank of their wish to offer cross-border banking services in Cyprus.

Furthermore, in June 2004 the Central Bank issued a new directive on the monitoring and control of exposures to individual borrowers or bank directors and their connected persons, replacing the directive which had been issued in September 2002. The new directive incorporates fully the amendments of the *Banking Law* with regard to exposures (prior to the amendment introduced in 2003 for the purpose of harmonisation with Directive 2000/12/EC, the *Banking Law* referred to credit facilities only) and sets out, in detail, the types of exposures exempted from the limits prescribed in the law.

In addition, the Central Bank drafted a directive transposing EU Directive 2002/87/EC on the supplementary supervision of financial conglomerates, which is expected to enter into force in January 2005. The term "financial conglomerates" refers to banks, investment firms as well as insurance undertakings. The directive's main purposes are:

- the supervision of capital adequacy at the conglomerate level;

- the monitoring and control of risk concentration at the level of the conglomerate and intragroup transactions;

- the cooperation between authorities involved in the sectoral supervision of financial firms belonging to a financial conglomerate.

In October 2004 the House of Representatives enacted the *Banking (Amendment) (No. 4) Law 235(I)/2004,* which incorporates those parts of Directive 2002/87/EC which concern banks that do not belong to financial conglomerates, in order to ensure equivalent supervision with banks that do belong to such conglomerates.

Taking into account the developments concerning the revision of the EU framework on capital adequacy, the Central Bank advised banks to proceed with the conduct of a gap analysis between the existing internal procedures and practices used and the requirements of the new capital adequacy framework. This will enable banks to decide on the actions that need to be taken for purposes of adaptation to the new framework and to proceed with appropriate measures. More specifically, the gap analysis is expected to assist banks to better assess the existing capabilities of their own internal credit risk and operational risk management systems, the availability of quantitative and qualitative data as well as their own information technology and internal control systems in comparison with the requirements of the proposed EU directive.

Moreover, the Central Bank invited banks to provide information with regard to the final approach that they intend to adopt in relation to credit and operational risks. Banks operating in Cyprus as subsidiaries of foreign banks were also asked to inform the Central Bank with regard to the approach which would be followed by their parent banks.

In parallel, the Central Bank began studying the national discretions and options included in the proposed EU directive, in order to formulate its policy in relation to this matter.

Furthermore, during 2004 additional measures were taken in the field of depositor and investor protection. As from 1 May 2004, the Deposit Protection Scheme, which had been in operation since September 2000, has been extended to include all EU currencies, in line with Directive 94/19/EC. Accordingly, all foreign banks (subsidiaries and branches) operating in Cyprus as international banking units (formerly known as "offshore banks") have become members of the Scheme. Branches of domestic banks operating in other member states of the EU have also become members of the Scheme. The deposits of the existing Cyprus branches of banks incorporated in other member states (Greece, the UK and France) are covered by the corresponding schemes of their countries of incorporation, in accordance with the provisions of Directive 94/19/EC.

The New Capital Accord of the Basel Committee on Banking Supervision and the revision of the EU framework for the capital adequacy of credit institutions

The New Capital Accord of the Basel Committee on Banking Supervision, which revised the existing framework on capital adequacy, was finalised on 26 June 2004. In parallel with the work carried out by the Basel Committee, the European Commission has taken measures for the revision of the corresponding regulatory framework in the EU. In July 2004 the Commission submitted a proposal for recasting Directive 2000/12/EC, concerning the taking up and pursuit of the business of credit institutions, and Directive 93/6/EEC, on the capital adequacy of investment firms and credit institutions, in order to incorporate the new international framework on capital adequacy while taking into account the specific features of the EU. In contrast to the New Capital Accord, which is primarily addressed to large international banks of the G-10, the proposal of the European Commission will apply to the full range of credit institutions and investment firms in the EU.

The new framework aims at ensuring the closest possible alignment between regulatory and economic capital, reinforcing financial stability and promoting the competitiveness of the EU's financial sector. Credit institutions with healthy portfolios and effective risk management systems are rewarded, and this provides incentives for the modernisation and upgrading of the banks' risk management systems. The proposed EU directive is expected to enter into force at the end of 2006. In contrast to the present framework, which does not take into account the specific risk profile of each bank, the new one allows the use of three alternative approaches for the calculation of capital requirements against credit and operational risks, which escalate from the most simple to the most advanced. The simple and intermediate approaches will be available for adoption by banking institutions by the end of 2006 (however, banks could still opt to apply the current rules until the end of 2007), while the most advanced approaches will be available from the end of 2007. The proposal includes a number of national discretions and options that may be implemented according to the specific conditions pertaining in each EU member state.

The Deposit Protection Scheme aims primarily at protecting small depositors by paying compensation in case the deposits of a member bank are rendered unavailable. Certain categories of deposits such as those of insurance companies and other institutional investors are excluded from the payment of compensation. The amount of compensation is set at 90% of the total deposits of each depositor, up to a maximum of the equivalent of €20.000 in Cyprus pounds or in the currency of the EU member state in which the deposit is denominated.

With regard to investor protection, in April 2004 the House of Representatives approved the Regulations on the Establishment and Operation of the Investment Protection Scheme for Customers of Banks (ΚΔΠ 530/2004). These regulations were issued under the *Investment Firms Laws* for purposes of harmonisation with EU Directive 97/9/EC. The purposes of the Investment Protection Scheme for customers of banks are to:

- protect investors/clients of banks, by paying compensation in case a member bank fails, for reasons related to its financial circumstances;

- return to its covered clients funds owed to them in the context of the provision by the said member of investment services; and/or;

- hand over to the covered clients financial instruments which belong to them and which the bank holds, manages or keeps on their account.

The Scheme does not cover institutional or professional investors. The level of compensation provided to the eligible investors/clients of member banks amounts to the equivalent of €20.000 in Cyprus pounds and applies to the investor's aggregate claims against a member bank, irrespective of the number of accounts, the currency and the location of the provision of the service.

Free movement of capital

The abolition of exchange controls was completed in accordance with the *acquis communautaire* upon Cyprus's accession to the EU. Cyprus had adopted a gradual approach for the removal of restrictions in the past few years. As a result, the exchange restrictions that remained on the eve of accession concerned mainly the following capital movements:

- short-term borrowing in foreign currency by residents of Cyprus;
- loans in Cyprus pounds to non-residents;
- maintenance of deposits with banks abroad;
- portfolio investment abroad (above the previously applicable limit of £50.000 per year for natural persons) by residents (other than banks and insurance companies, which were already free to carry out such investments);
- purchase of secondary residences abroad (above the limit of £200.000 per resident family);
- generally, free conversion of Cyprus pounds into foreign currency by residents;
- forward exchange contracts with non-residents that did not involve the purchase of goods and services from Cyprus.

The aforementioned restrictions were abolished on 1 May 2004 through the entry into force of the *Capital Movement Law*

115(I)/2003, an important framework law enacted by the House of Representatives in July 2003. *Law 115(I)/2003* repeals the *Exchange Control Law* (which dated from colonial times) and ensures the freedom of capital movements, with certain exceptions provided by the *acquis*.

More specifically, *Law 115(I)/2003* includes provisions for safeguard measures in accordance with the Treaty establishing the European Community (for instance, in case of a sudden crisis in Cyprus's balance of payments prior to the adoption of the euro) and for restrictions vis-à-vis non-EU countries pursuant to a relevant decision of the Council of the EU in the context of the common foreign and security policy. *Law 115(I)/2003* also provides for the maintenance of certain restrictions concerning direct investments in Cyprus from non-EU countries.

In October 2004 the Council of Ministers decided to abolish the restrictions on direct investments from non-EU countries provided by the *Capital Movement Law*. However, the restrictions with regard to non-EU investors that are imposed by other laws continue to apply. These restrictions concern direct investments from non-EU countries in a number of sectors including real estate, radio and television broadcasting, tertiary education, the distribution of newspapers and magazines, travel agencies, construction, as well as the ownership of merchant ships and fishing vessels.

As regards direct investments in Cyprus from EU counties, the restrictions in the aforementioned sectors were abolished upon Cyprus's accession to the EU, when the relevant harmonising legislation came into full effect. Restrictions on non-Cypriot EU nationals remain only with respect to the acquisition of secondary residences in Cyprus for a five-year transitional period specified in the Accession Treaty. More specifically, in accordance with the *Immovable Property Acquisition (Aliens) Laws,* non-Cypriot EU nationals still need the District Officer's approval to acquire a secondary residence, while they may freely acquire real estate for any other purpose, under the same conditions that apply to Cypriot nationals.

Payment systems

The legislative adjustment to the *acquis communautaire* for payment systems was completed on the date of Cyprus's accession to the EU. In particular, on 1 May 2004 the *Settlement Finality in Payment and Securities Settlements Systems Law 8(I)/2003,* which transposes the provisions of Community Directive 98/26/EC, came into force. On the same date, the *Financial Collateral Arrangements Law 43(I)/2004,* which transposes the provisions of Directive 2002/47/EC, also came into force. More information on the purpose, provisions and implementation of these two laws is given in section 4.4 of this report.

In April 2004 the Central Bank directive to banks on transactions effected by electronic payment instruments came into effect. The directive was issued in February 2004 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). Electronic payment instruments comprise mainly credit or debit cards, electronic money cards and the means that allow phone and home banking. The Central Bank directive sets out rules on the transparency of the conditions for the issue and use of electronic payment instruments, and specifies the obligations and liabilities of the banks (issuers) and the holders of these instruments. The provisions limiting the holder's liability in case of loss or theft of the electronic payment instrument are particularly important.

In addition, the directive on electronic payment instruments provides for the establishment of a mechanism for an out-of-court procedure for the settlement of disputes for matters outside the competence of the Competition and Protection of Consumers Service of the Ministry of Commerce, Industry and Tourism under the *Consumer Credit Law 39(I)/2001*. Pursuant to this provision, the Committee for the Investigation of Disputes concerning transactions effected by electronic payment instruments was established under the auspices of the Central Bank. Since the Competition and Protection of Consumers Service is responsible for consumer complaints with regard to credit cards, the newly established committee will investigate cases concerning disputes arising from the use of such cards by legal persons or the use of electronic payment instruments other than credit cards by natural or legal persons.

As regards the implementation of the EU directive on cross-border credit transfers (97/5/EC), on 1 May 2004 the provisions of the corresponding Central Bank directive concerning customer compensation (in case of delay) and refund (in case of non-performance) came into force. The other provisions of the directive have been in force since April 2001.

Another important Community legal act concerning payment systems is Regulation (EC) No 2560/2001 on cross-border payments in euro, according to which the charges levied by banks or other institutions for payments up to €12.500 from one EU member state to another must be the same as those for payments within the member state. Regulation 2560/2001 also provides for the facilitation of cross-border transfers by the use of the IBAN (international bank account number) and BIC (bank identifier code). Regulation 2560/2001 – like other Community regulations – became directly applicable in Cyprus as of the date of accession to the EU.

Furthermore, the Central Bank is planning its connection with TARGET 2 (Trans-European Automated Real Time Gross Settlement Express Transfer System). Connection will begin upon Cyprus's entry into the euro area, since it is necessary for the execution of the single monetary policy operations.

Protection of the euro against counterfeiting

The *Currency (Counterfeiting and Other Related Matters) Law 110(I)/2004,* entered into force in April 2004. This law streamlines and modernizes the national legislation on currency and brings about harmonisation with the relevant *acquis* (Council Framework Decision 2000/383/JHA as amended by Framework Decision 2001/888/JHA, Decision 2001/887/JHA and Regulations (EC) No 1338/2001 and 1339/2001). In order to implement Article 6 of Regulation 1338/2001, the Central Bank issued a directive to banks under *Law 110(I)/2004* in July 2004, specifying the procedure for the surrender to the competent authorities of banknotes and coins that are known or believed to be counterfeit.

The competent national authorities for the implementation of Regulation 1338/2001 were appointed by the Council of Ministers. Specifically, the Central Bank and the Police Forensic Science Laboratory were designated as the competent authorities for identifying counterfeit banknotes and coins, while the Police Forensic Science Laboratory was designated as the National Analysis Centre and the Coin National Analysis Centre.

Participation in the Economic and Monetary Union

In accordance with the Treaty of Accession, Cyprus and the other nine countries that acceded to the EU on 1 May 2004 participate in EMU as member states with a derogation. This implies that Cyprus has to strive to fulfill all the conditions for the adoption of the euro, within a reasonable time. In particular, Cyprus has to meet the convergence criteria (known as the Maastricht criteria), which refer to inflation, the fiscal situation, exchange rate stability and long-term interest rates. In addition to the fulfillment of these criteria, the successful adoption of the euro requires a high degree of real convergence of the Cyprus economy with the euro area. Moreover, substantial technical preparation is necessary for the changeover from the Cyprus pound to the euro.

The policy objective of the Central Bank and the government of Cyprus is the adoption of the euro as early as possible. On 19 October 2004 the Council of Ministers took the political decision for Cyprus's participation in ERM II as soon as possible and authorised the Minister of Finance to begin, in cooperation with the Central Bank, the appropriate procedures. On 29 December 2004 the Council of Ministers approved the strategic action plan for the introduction of the euro in Cyprus. The action plan was prepared by the Central Bank and the Ministry of Finance, which bear the main responsibility for its implementation. The Central Bank, specifically the Domestic Banking Operations Department, has already started the technical preparation for the introduction of euro notes and coins.

In October 2004 the ECB and the European Commission issued their first convergence reports assessing Cyprus and the other new member states (together with Sweden) with respect to the fulfillment of the conditions for the adoption of the euro. The convergence reports examined whether each country with a derogation had achieved a high degree of sustainable convergence, on the basis of the aforementioned convergence criteria (also taking into account a series of other factors, such as the situation of the current account of the balance of payments). The reports also assessed legal convergence, that is the compatibility of national legislation with the Treaty establishing the European Community (particularly Articles 108 and 109 of the Treaty and the Statute of the ESCB and of the ECB).

According to the 2004 convergence reports, Cyprus fulfils the inflation and interest rate criteria, but does not meet the fiscal criterion because it has an excessive deficit (as determined by a decision of the EU Council), and the exchange rate criterion, since it does not yet participate in ERM II. It is worth noting that none of the 11 countries examined in these convergence reports fulfils

Cyprus's economic indicators in relation to the convergence criteria

	Inflation[1] (%)	Government budgetary position		Exchange rate	Long-term interest rate[2] (%)
		General government deficit (% GDP)	Debt (% GDP)	ERM II participation	
Reference period	2004	2004	2004	2003-2004	2004
Indicator for Cyprus	1,9	4,2	71,9		5,8
Fulfilment of convergence criterion	Yes	No	No	No (because of non-) participation in ERM II)	Yes
Reference value	2,2	3	60		6,3
Definition of convergence criterion - calculation of reference value	Average rate of inflation of the three best performing EU member states in terms of price stability +1,5 (Finland: 0,1 Denmark: 0,9 Sweden: 1,0)			Respecting the normal fluctuation margins provided for by the exchange rate mechanism for at least two years without severe tensions, in particular without devaluation against the currency of any other EU member state.	Average nominal long-term interest rate of the three best performing EU member states in terms of price stability +2 (Finland: 4,1 Denmark: 4,3 Sweden: 4,4)

Sources: Eurostat and ECB.
(1) Increase in the 12-month average of the HICP over the previous 12-month average.
(2) Average of nominal long-term interest rates over a 12-month period.

the exchange rate criterion, and none has as yet achieved the required legal convergence.

As regards legal convergence, the reports of the ECB and the European Commission confirmed that Cypriot legislation fulfils the condition of central bank independence, which is of vital importance, but does not yet anticipate the legal integration of the Central Bank into the Eurosystem. Certain provisions of the *Central Bank of Cyprus Law* need to be adjusted prior to Cyprus's entry into the euro area. In particular, the provisions that need to be adjusted refer to the following areas, in which the ECB will exercise its powers:

- definition and implementation of monetary policy;
- monetary policy instruments;
- issue of banknotes and coins;
- foreign reserve management;
- conduct and formulation of exchange rate policy;

- appointment of independent external auditors;
- accounting principles for the Bank's financial statements.

With the aim of achieving legal convergence well before the issue of the next convergence reports, the Central Bank has begun working on the necessary changes to the *Central Bank of Cyprus Law.*

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 this and in particular to regulate the supply of money and credit, the Central Bank has at its disposal a set of monetary policy instruments.

Open market operations

Open market operations have replaced the liquidity ratio. They are liquidity providing (or absorbing) reverse transactions based on repurchase agreements, whereby the Central Bank buys (or sells) government securities from (or to) the counterparties (repos or reverse repos). Such transactions take place whenever the Central Bank deems it appropriate and their duration is up to 15 days.

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. During 2004 conditions of excess liquidity prevailed and as a result the Central Bank absorbed through auctions for the acceptance of deposits, liquidity amounting to a monthly average of £94,4 million, compared with £190,8 million in 2003.

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 monetary policy objectives. The monthly average amount borrowed by the banks through this facility was £1,7 million in 2004, compared with £2,3 million in 2003.

The counterparties may deposit their short-term surplus funds with 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. The monthly average amount deposited by the banks through this facility was £28,1 million in 2004, compared with £20,7 million in 2003.

Monetary policy instruments

£ million, period averages

Period		Open market operations	Standing facilities		Minimum reserves
		Repos(+)/Reverse Repos, Acceptance of deposits(-)	Marginal lending facility	Deposit facility	Minimum required reserves
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
2004	January	-151,9	0,0	55,4	529,0
	February	-169,0	0,0	22,2	544,6
	March	-140,3	2,2	17,4	548,5
	April	-93,3	0,7	29,7	549,9
	May	0,0	6,0	8,0	636,4
	June	0,0	0,0	32,9	633,1
	July	-61,2	0,0	42,1	636,4
	August	-151,6	0,0	44,5	639,8
	September	-162,7	2,0	31,9	641,8
	October	-121,1	0,0	24,3	641,8
	November	-82,2	0,0	15,8	639,8
	December	0,0	10,0	12,9	639,7

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 for liabilities in Cyprus pounds. Since 1 May 2004, minimum reserve holdings are also required for liabilities in foreign currency and a respective reserve ratio of 2% is applied. The average holdings of commercial banks on their reserve accounts earn interest at a rate which is directly linked to the official interest rates of the Central Bank. Over the maintenance periods, reserves in excess of the required are not remunerated. The monthly average minimum required reserves increased to £606,7 million in 2004, compared with £528,3 million in 2003, mainly due to the aforementioned introduction of minimum reserves for liabilities in foreign currency.

4.3 Regulation and supervision of the banking sector

Under the *Central Bank of Cyprus Law 38(I)/2002* and the *Banking Law 66(I)/1997,* both as subsequently amended, the Central Bank is the competent authority for the supervision of banks having, *inter alia,* the power to grant a licence to carry on banking business. The Central Bank plays a particularly important role in the new environment created by Cyprus's accession to the EU. Banks operate in a more competitive environment than in the past which could lead to excessive risk taking. The main objective of supervision is to preserve the stability of the financial sector, minimise systemic risk and retain public confidence in the banking system. Supervision also aims to protect depositors.

The Central Bank supervises domestic banks, international banking units (IBUs, formerly known as "offshore banks") as well as representative offices of foreign banks. There are currently 14 domestic banks, 29 IBUs and 1 representative office of a foreign bank operating in Cyprus.

The Central Bank, in exercising its supervisory role, is guided by the recommendations of the Basel Committee on Banking Supervision and the regulatory rules of the EU which promote the adoption of best practices. In this context, various directives regarding prudential supervision have been issued to all banking institutions both domestic and international, that have a presence in Cyprus.

The Central Bank applies two methods for the supervision of banking institutions which complement each other and are performed in a coordinated manner: (a) off-site monitoring of banks' performance through the analysis of various periodic prudential returns submitted to the Central Bank, covering an extensive range of their operations; and (b) on-site examinations, the aim of which are to evaluate the financial condition of a bank as well as its future prospects at the time of the examination. On-site examinations focus on the following areas: 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 of Cyprus.

Developments in the regulatory framework for banking supervision

In 2004, in addition to the statutory measures taken for the purpose of harmonising Cyprus's regulatory framework of banking supervision with the EU equivalent (as described in section 4.1 of this report), the Central Bank issued a number of circulars and directives for the purpose of improving the regulatory framework in accordance with international practice and requirements.

As from 1 January 2004, more stringent criteria with respect to the suspension of the recognition of interest have been implemented. The time period beyond which interest will be suspended for credit facilities in arrears or limits in excess, provided that there is no adequate tangible security, has been reduced from nine to six months. In December 2004, the Central Bank reduced further the time period beyond which interest will be suspended, from six months to 90 days ("the 90 days rule"), with effect from 1 January 2006. In the near future, the Central Bank is planning to reissue the directive which will include an obligation for the suspension of interest irrespective of the existence of tangible security, in line with international practice and the provisions of the proposed EU directive on capital adequacy.

As regards the prevention and suppression of money laundering, in November 2004 the Central Bank reissued its Guidance Note, previously issued in 1999, on the prevention of the use of the banking system for money laundering. The revised Guidance Note takes into account the:

(i) amendment of the *Prevention and Suppression of Money Laundering Activities Law 61(I)/1996,* enacted in July 2003, for the purpose of harmonising Cyprus's legislation with EU Directive 2001/97/EC;
(ii) revised Recommendations for combating money laundering issued by the Financial Action Task Force (FATF) on money laundering in June 2003;
(iii) FATF's Special Recommendations on terrorist financing issued in October 2001;
(iv) recommendations included in the paper on "Customer due diligence for banks" issued in October 2001 by the Basel Committee on Banking Supervision.

The new Guidance Note consolidates into one single document the previous Guidance Note of November 1999 with all its amendments and supplements issued thereafter, while introducing additional requirements for the adoption of measures and implementation of procedures by banks for the prevention of money laundering. Specifically, it places upon banks an obligation for the development of customer acceptance policy, renewal of customers' identification data on a regular basis, prohibition of secret, anonymous, numbered accounts and accounts in fictitious names, as well as an obligation for ensuring identification data on customers' accounts and records.

Moreover, it provides for an obligation for the construction of customers' business profiles and the installation of appropriate computerised risk management systems for verifying whether a customer constitutes a "Politically Exposed Person". It also provides for the assessment of customer identification and due diligence procedures employed by professional intermediaries and third parties for the acceptance of customer identification performed by the said persons when they introduce customers to the bank.

In addition to the above, the Guidance Note renders obligatory the provision of full details on the ordering customer in all messages for fund transfers in excess of U$1.000 performed by electronic means and the introduction and implementation of adequate information management systems for the purpose of the on-going monitoring of customers' accounts and transactions.

In the course of fighting terrorism, the Central Bank continued to issue 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.

Domestic banking sector

The overall performance of the domestic banking system displayed signs of improvement in 2004. The gradual recovery of both the Cyprus and world economies, the increase in domestic and international interest rates, the remedial measures taken by banks as well as the further expansion of their operations in Greece, were among the factors which had a positive impact on the profitability of domestic banking institutions.

The recent accession of Cyprus to the European Union is expected to bring about significant changes in the overall functioning of the domestic banking system. Competition is expected to become even more intense and the regulations that govern the operations of banks will become stricter, especially as a result of the new Basel Accord. In addition, banks will need to implement stricter transparency and corporate governance rules as prescribed by the directives of the EU.

The management of the local banking institutions have acknowledged the rapidly changing demands of the new era, and have gradually commenced to adjust to them. Significant investments have been made in the fields of technology and computerized systems, which increase productivity and facilitate better utilization of resources as well as improved risk management. Furthermore, the significant efforts made by banks, under pressure from the Central Bank, to improve collection procedures of debts in arrear and to increase tangible security held, have resulted in the improvement of the quality of their loan portfolios.

Despite the above efforts, the uncertainty regarding the settlement of loans granted for the purchase of shares and the sluggish performance of certain sectors of the economy such as tourism, manufacturing and financial services, have rendered necessary the need for significant provisions for bad and doubtful debts. Furthermore, higher net interest margins have counterbalanced, to a large extent, the adverse effects of the application of stricter rules, introduced by the Central Bank on 1 January 2004 with regard to the reduction in the period for the suspension of the recognition of interest on non-performing loans from nine to six months. A positive development during 2004 was the containment of the growth of operating costs which, in turn, led to a decrease in the cost to income ratio. As a result of the above, the domestic banking institutions returned to profitability and are now in a position to face the future with renewed optimism. Nevertheless, despite the favourable developments outlined above, the level of non-performing loans remains high compared with the levels prevailing internationally.

It is expected that the impact of EU accession on the Cyprus economy will be positive in the long-term. The need to accelerate the process of modernization and restructuring of the economy, which emanates from the island's membership of the EU, is expected to promote better conditions for financial stability. A direct consequence of such a development will be the decrease in the level of uncertainty among businessmen which, in turn, is expected to result in enhanced investment activity. The soundness of the domestic banking institutions as well as their strong capital base will allow them to be in a position to succefully manage the increased demands of the new era. The banks' excellent human resources, know-how and up-to-date technology, the increased range of products and services and the continuous efforts to contain operating costs all augur well for their future success. The Central Bank has played an important role in the maintenance of the soundness of commercial banks by insisting on the implementation of its recommendations regarding the strengthening of their capital base through the improvement of their loan portfolio and credit risk management procedures, as well as the resolution of all pending issues relating to doubtful loans.

During 2004 the overseas operations of Cypriot banks, particularly in Greece, grew considerably through the expansion of their branch network and the volume of their loans and deposits. Furthermore, the operations of these banks in Australia exhibited growth. The expansion of Cypriot banks abroad enables them to be less dependent on the relatively small Cyprus market, provides opportunities for further growth and improved profits and reduces business risk through geographical diversification. In addition, the exposure to the external competitive environment enables Cypriot banks to meet successfully the forthcoming challenge of increased competition in the domestic market. The systems of internal control which the banks have put in place contribute to the complete and timely measurement as well as monitoring of the risks that are undertaken.

The expansion abroad creates the need for increased capital funds which are required to finance the growth of their operations. During 2004 banks strengthened further their capital base through the issue of hybrid capital instruments and non-convertible loan stock. The Central Bank believes that in order to ensure the success of their overseas expansion, 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 2004 the international banking sector continued to exhibit a positive performance. The total assets of IBUs recorded an increase, as compared with 2003, which primarily reflects the increase in operations of the largest banks operating in Cyprus. At the same time, the financial results of IBUs show an improvement compared with the previous year.

The abolition of the *Exchange Control Law* following the implementation of the *Capital Movement Law 115(I)/2003* as from the date of Cyprus's accession to the EU, in conjunction with the tax reforms of 2002, have created new conditions with regard to IBUs which operate in Cyprus. Those IBUs which are already subject to the 10% tax rate because they were licensed after 31 December 2001, are free to offer a full range of banking services to permanent residents of Cyprus. Those IBUs which had been operating in Cyprus on 31 December 2001 and which elected to continue being taxed at the preferential rate of 4,25% until 31 December 2005, are obliged to deal exclusively with non-residents of Cyprus. As from 1 January 2006 all IBUs will be subject to the same tax rate as domestic banks.

With the exception of those applications concerning branches of banks incorporated in EU member states, for which the principle of the "single passport" applies, applications for the conduct of banking business will be examined under a new framework which will not distinguish between domestic banks and IBUs. The new framework is at the final stage of processing and is expected to enter into force soon.

Financial stability

The Central Bank of Cyprus aims at setting up the necessary infrastructure for regular monitoring and analysis of the stability of the financial system by developing macro-prudential analysis, stress testing, structural analysis of the banking sector, an early warning system for banking crises and a framework for financial crisis management. With regard to macro-prudential analysis, which aims at monitoring and assessing the soundness and vulnerabilities of the financial system so that any systemic weakness which could threaten stability can be identified early and acted upon, the Central Bank submitted the first set of cross-border and cross-sector consolidated data for the banking system to the European Central Bank in July 2004. Apart from the submission of banking data to the ECB, the above information constitutes the main data source for the conduct of macro-prudential analysis for the banking sector.

During 2005 the Central Bank will continue with the collection of data with regard to the other sectors of the financial system, while the computerisation of the data collection, storage and processing required for the conduct of macro-prudential analysis is expected to be finalised.

Within the above framework, the Central Bank is currently participating in the Coordinated Compilation Exercise for Financial Soundness Indicators (FSIs), which takes place under the auspices of the IMF and is expected to be finalised by the end of 2006. The above exercise aims at:

- developing the various countries' capacity to compile FSIs, which are considered very important for the surveillance of their financial systems;
- promoting cross-country comparability of FSIs;
- coordinating efforts by national authorities to compile FSIs;
- allowing the IMF to publish FSIs for each country compiled under the exercise in order to increase transparency and strengthen market discipline.

The FSIs to be compiled by the Central Bank will cover all sectors of the financial system (banking sector, non-bank financial sector, corporate sector, household sector and real estate sector).

During 2004 a national Financial Stability and Crisis Management Committee was established which comprises of high-level representatives of all the regulatory authorities in the financial sector and the Ministry of Finance. This Committee constitutes a consultative forum for the discussion and overview of various issues regarding the management and resolution of financial crises and aims, *inter alia,* at developing a national contingency plan on financial crisis management and performing periodic crisis simulation exercises.

Cooperation with other domestic and foreign supervisory authorities

In the context of the Memorandum of Understanding signed by Cyprus's financial supervisory authorities, which became effective in 2003, the Central Bank of Cyprus, the Cyprus Securities and Exchange Commission and the Insurance Companies' Control Service of the Ministry of Finance jointly prepared a draft Bill which provides for the establishment and operation of an institution (Financial Ombudsman) for the out-of-court settlement of disputes of a financial nature. The draft Bill, which was prepared in accordance with the European Commission's Recommendation 98/257/EC, has already been sent to the Ministry of Finance which in turn will submit it to the Law Office of the Republic for legal vetting. Subsequently, it will be submitted to the Council of Ministers and finally to the House of Representatives for enactment into law.

The objective of the Financial Ombudsman is to settle out-of-court disputes between consumers and financial firms (including banks) in an efficient, fair and appropriate manner, implementing transparent, fast and effective procedures with a view to ensuring the interests of consumers.

In the field of cooperation with foreign supervisory authorities, as from the date of Cyprus's accession to the EU, the Central Bank has been actively participating in the Committee of European Banking Supervisors (CEBS) as well as in the Committee's working groups. The main aims of the CEBS, which took up its duties on 1 January 2004, are to:

- advise the European Commission on supervisory and regulatory issues concerning the banking sector;
- contribute to the consistent application of Community directives as well as the convergence of member states' supervisory practices throughout the Community.

In the context of the ESCB, the Central Bank also participates in the Banking Supervision Committee (BSC) and its two working groups. The main aims of the BSC are to monitor and assess developments in the EU banking and financial sectors from a financial stability perspective, to analyse the impact of regulatory and supervisory requirements on financial system stability and structure and to promote cooperation and exchange of information between central banks and supervisory authorities on issues of common interest.

During 2004 the Central Bank continued to give special emphasis to the development of bilateral relations by entering into negotiations for the signing of memoranda of understanding with a number of foreign central banks and supervisory/regulatory authorities of countries whose banks and/or 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.

4.4 Payment and settlement systems

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

The Central Bank attaches great importance to payment systems because, in addition to their contribution to the smooth functioning of the economy, they constitute an important factor in maintaining financial stability, as they are the means through which economic disturbances are transmitted from one economic sector to another. The substantial increase of activity in the financial markets coupled with the rapid advances in technology have brought to the surface the safety and efficiency aspects concerning the operation of payment systems and have further increased their significance.

For all these reasons, particular importance has been assigned to the existence of the required legal framework governing payment systems and also the necessary infrastructure for their orderly, safe and efficient operation.

The need for close cooperation between the Central Bank and the banking community in the field of payment systems is considered of great importance in the safeguarding of the timely and effective response to developments, whether these are connected to EU membership or not. To this end, the Central Bank set up a Payments Committee, made up of the commercial banks, the Association of Cyprus Commercial Banks and the Co-operative Societies' Supervision and Development Authority. The role of this Committee is to consult with the Central Bank and coordinate with the banking community.

The usefulness of this Committee, as well as the considerable improvement it has brought in the exchange of information, communication and coordination between the parties involved, have been evident from the first year of its operation.

Legal framework

The Central Bank's role in the area of payment systems, as envisaged by the *acquis communautaire,* is determined by the *Central Bank of Cyprus Law 139(I)/2002, as subsequently ammended.* In particular, article 6(2)(e) determines 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 article 48 of the same law, the Central Bank may administer, participate in or become a member of any payment and settlement system and may, through an announcement in the Official Gazette of the Republic, place under its oversight any payment and settlement system that operates in the Republic. In addition, the Central Bank is empowered to issue directives regulating the functions and the operating procedures of the systems under its supervision.

Within the framework of harmonisation with the *acquis,* the provisions of the EU Directive 98/26/EC on Settlement Finality have been incorporated in the *Settlement Finality in Payment Systems and in Securities Settlement Systems Law 8(I)/2003,* which came into force on 1 May 2004. This law determines that the Central Bank is the competent authority empowered to designate the payment systems that fall within the scope of the provisions of the law. As with 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:

(a) irrevocability of payment instructions and of netting arrangements;

(b) obligation of each and every participant in the system to provide collateral in the form of liquid funds and/or securities with a view to fulfilling their obligations to the system;
(c) 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 as well as the power to impose administrative fines on any participant for non-compliance.

In the context of its legal responsibilities, the Bank has designated as systems falling under the provisions of the law, the Large Value Credit Transfers System operated by the Bank and the Central Depository / Central Registry of the Cyprus Stock Exchange.

EU membership has triggered the application in Cyprus of the provisions of Regulation 2560/2001 of the European Parliament and of the Council, relating to cross-border payments in euro. With the aim of applying the provisions of the Regulation, the Bank has, in cooperation with the banking industry, prepared a manual for the implementation of the IBAN standard. The Cyprus IBAN, which has been registered with the ECBS (European Committee for Banking Standards), has been adopted by all domestic banking institutions as from 1 April 2004.

Following the recommendation of both the ECB and the European Payments Council, the IBAN has been adopted for all bank accounts and not only for those that are used for payments in euro. For the time being the IBAN is not being used for local transfers of funds but the decision has been taken for its gradual application to such transactions.

The transposition into law of the provisions of EU Directives 2000/46/EC and 2002/47/EC, relating to electronic money services and financial collateral arrangements, was completed during 2004 and prior to EU accession. The *Electronic Money Institutions Law 86(I)/2004* regulates the operation and supervision of institutions providing such services while the *Provision of Financial Collateral Law 43(I)/2004* aims to safeguard the integrity of such agreements with a view to ensuring the efficient operation of financial markets and the maintenance of financial stability.

The Central Bank directive regarding transactions by electronic payment instruments was put in force on 1 April 2004. This directive was part of the harmonisation process with the *acquis* and its purpose is the application of the provisions of the EU Recommendation 97/489/EC concerning the use of electronic payments instruments and, in particular, the relationship between the issuer and the holder.

During 2004 the Bank continued with the examination of applications for licensing in accordance with the provisions of the Central Bank directive which regulates the provision of intermediary services in money transfers (ΚΔΠ659/203). The purpose of this directive is the regulation of a sector that is not, as yet, regulated on a European level, as well as the safeguarding of the transferors and beneficiaries involved in money transfers through the medium of such service providers.

Payment systems in Cyprus

There are five payment and securities settlement systems operating in Cyprus at present: The Large Value Credit Transfers System (LVCTS), the Cyprus Clearing House for cheques, the payment cards clearing and settlement system, the retail credit transfers system (JCC Transfer) and the Cyprus Stock Exchange settlement system. These systems are described in detail in the ECB's report titled "Payment and securities settlement systems in accession countries" issued in August 2002 (www.ecb.int). The Central Bank operates the Large Value Credit Transfers System and the Cyprus Clearing House for cheques.

All the systems currently operating in Cyprus were evaluated by the ECB in June 2002 and were found to be very satisfactory for the purpose of EU accession. Within the context of the evaluation, some recommendations 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 respond to its new responsibilities, as determined by the legislation and in line with ECB recommendations, the Bank has placed payment systems under the responsibility of two independent Units within the Accounting Services Department. One of these Units is responsible for the operation of payment systems operated by the Bank while the other Unit has the overall responsibility for the oversight of all systems operating in Cyprus.

Other developments

In February 2003 the Central Information Registry for Issuers of Dishonoured Cheques (CIR) was put into operation by the Central Bank in order to deal effectively with the problem of dishonoured cheques. In February 2004, the definition of a cheque was amended both in the *Banking Law 66(I)/1997* and the joint Directive of the Governor of the Central Bank of Cyprus and the Commissioner of Cooperative Societes' Supervision and Development Authority (ΚΔΠ105/2004) in order to enable the registration of issuers of dishonoured postdated cheques in the CIR. Furthermore, in June 2004 the joint Directive was amended (ΚΔΠ617/2004) with the removal of the two year minimum period that a registered person had to remain in the Register in order to encourage the timely settlement of dishonoured cheques. Following the amendment, the CIR Management Committee may examine applications from registered persons for their removal from the Register provided at least 12 months have elapsed from the proven settlement of all registered dishonoured cheques.

During 2004 four separate projects relating to payment systems were initiated, which are at different stages of completion:

(i) *Government Transfers System.*
The Bank, in the context of an initiative to reduce the use of cheques as a means of payment, and in cooperation with the Government, has undertaken the development of a system for Government transfers. This system will enable the beneficiaries of Government payments (including pensions, grants, etc) to receive payments directly in a nominated bank account instead of being paid by cheque. This will

contribute to safer and more efficient government payments.

(ii) *Participation in the JCCTransfer system.* The necessary software is under development which will enable the Bank to become a member of the retail payment system operated by JCC Payment Systems Ltd.

Both systems under (i) and (ii) above, are expected to be ready for implementation within the first quarter of 2005.

(iii) *EU transfer system TARGET and TARGET2.* The expected entry of Cyprus into the eurozone and the adoption of the euro presupposes, among other things, the connection of the Bank and the Cyprus banking system with TARGET. This system, which deals only with transfers in euro, started operating in its current configuration in January 1999, and consists of the interconnected real-time payment systems of the 12 eurozone countries, Denmark, Sweden, UK and the ECB.

Plans for the enhancement of TARGET have been under consideration since its inception. These plans are now materialising with the development of a new system, known as TARGET2, which is being developed jointly by the central banks of Germany, France and Italy. It is estimated that the new system will be in place and operational on 1 January 2007. The Bank has appointed a working group for the coordination of all necessary internal actions in preparation for the connection with TARGET2, as well as the coordination, through the Consultative Payments Committee, of the actions that will need to be undertaken by the banking sector. In line with the political decision for adoption of the euro the soonest possible, the actions of the Bank have two directions:

(i) the timely and orderly preparation for the connection with TARGET2;
(ii) the adoption of the fall-back solution in case TARGET2 is not ready when Cyprus joins the eurozone, in which case the Bank will have to join the existing TARGET system.

The actions which relate to the above two distinct projects are quite complicated as they encompass legal, technical and operational matters that have to be dealt with within strict time limits determined by the ESCB. The management of the Bank is following closely developments in this important area and is briefed regularly.

4.5 Currency in circulation

In view of Cyprus's anticipated entry into the euroarea in the near future, no further upgrading of the security features of banknotes was pursued during 2004. In any case, banknotes issued by the Central Bank contain advanced security features and their credibility remains high. The processing (authentication and sorting) of used banknotes for reissue was intensified with a view to maintaining the high quality of notes in circulation. In 2004 the quantity of banknotes authenticated and sorted increased by 42%.

Furthermore, in response to the continuous increase of the currency in circulation and the need to maintain sufficient reserves, the

Bank proceeded with the procurement of additional quantities of banknotes.

In 2004 the total value of currency in circulation increased by 8,5% compared with an increase of 17,8% in 2003. The annual average rate of increase recorded during the period 1998-2002 was 7,9%.

The increase in banknotes was confined to the 20 pound note. In 2004 the value of banknotes in circulation increased by 8,6% compared with an increase of 18,5% in 2003, while the annual average rate of increase during the period of 1998-2002 was 8%. The increase in the value of coins in circulation slowed down to 6,7% in 2004, compared with an increase of 8,6% in 2003, while the annual average rate of increase of coins in circulation during the period 1998-2002 was 7,7%. Analytical data on currency in circulation as at the end of 2004 and 2003 are shown in the table titled "Currency in Circulation".

On the occasion of Cyprus's accession to the EU, collector coins depicting "Triton", a sea god, trumpeting the birth of Aphrodite, were issued. It was also decided to proceed with the issue of a new collector coin depicting the indigenous seal known as "monachus - monachus''.

Preparing for the changeover to the euro

In anticipation of Cyprus's participation in ERM II and, later, in the euroarea, the Central Bank has started preparing for the smooth transition to the new currency.

Currency in circulation

£ thousand, end of period balances

	2003		2004		% Change 2004/2003
Banknotes	Value	Share	Value	Share	%
Value		%		%	
£20	204.420,6	38,8	249.051,4	43,5	21,8
£10	246.475,0	46,7	241.998,0	42,3	-1,8
£5	19.254,5	3,7	19.989,3	3,5	3,8
£1	20.811,4	3,9	22.229,3	3,9	6,8
Sub-total	**490.961,4**	**93,1**	**533.268,0**	**93,2**	**8,6**
Coins					
50 cent	14.788,3	2,8	15.771,8	2,8	6,7
20 cent	10.041,5	1,9	10.772,8	1,9	7,3
10 cent	5.204,1	1,0	5.573,9	1,0	7,1
5 cent	3.890,5	0,7	4.156,2	0,7	6,8
2 cent	1.487,7	0,3	1.548,1	0,3	4,1
1 cent	890,4	0,2	929,4	0,2	4,4
Sub-total	**36.302,7**	**6,9**	**38.752,1**	**6,8**	**6,7**
Total	**527.264,1**	**100,0**	**572.020,2**	**100,0**	**8,5**

An overall strategic plan for the introduction of the euro has been prepared and preliminary decisions have been taken regarding the changeover. Estimates have also been made concerning the volume of euro notes and coins that will be required to replace the national currency. Moreover, the Domestic Banking Operations Department participates in several committees and working groups of the ECB and the European Commission, from which valuable experience and knowledge is acquired on the various aspects of the changeover.

With regard to the protection of the euro against counterfeiting, the Central Bank has acquired access to the Counterfeit Monitoring System, the central database containing technical and statistical information on counterfeiting, concerning euro notes and coins. Data on euro counterfeits found in Cyprus are recorded in the system.

4.6 Management of international reserves and the domestic foreign exchange market

International reserves management

According to the *Central Bank of Cyprus Law 138(I)2002 as subsequently amended,* one of the basic functions of the Bank is the holding, safeguarding and management of the official international reserves as well as the execution of transactions in currency and gold. These reserves consist of foreign currency and gold held by the Bank and foreign exchange held by the public sector.

The Bank's main objectives in managing the international reserves include the safety and maintenance of their value, and the availability of sufficient liquidity in order to satisfy various needs. Subject to the fulfilment of these objectives, the Bank manages the international reserves with the aim of maximising their return.

At the end of 2004, the official international reserves amounted to £1.749,3 million compared with £1.607,3 million at the end of 2003. The change in the level of reserves came about mainly as a result of net foreign currency inflows, interest and other income as well as from the movement of exchange rates against the Cyprus pound.

The Bank decides the currency distribution of international reserves by taking into consideration the country's flows of goods and services by currency as well as the external debt servicing obligations. During 2004 the Bank's international reserves were mostly held in euros and dollars and, to a lesser extent, in sterling, Swiss francs and yen. The Bank also maintains a small part of its reserves in the form of gold bullion. In order to maximise the return from gold reserves, part of these are employed in gold swap transactions.

According to the Bank's investment policy, the international reserves are invested in approved instruments by executing authorised types of transactions with approved counterparties, such as banks or other financial institutions, as well as with investment services organisations.

The maintenance of international reserves necessitates monitoring and controlling various types of risk. Currency risk is controlled by setting a fluctuation margin around the approved limit for each currency. The currency composition of reserves is based on the Bank's net international reserves.

Interest rate risk is controlled by setting and monitoring the modified duration of the reserves currency portfolio and by permitting a specific maximum deviation margin. In addition, the remaining life to maturity of securities held in the portfolio should not exceed five years.

Credit risk is monitored and controlled at various levels. In this respect, maximum limits are set by country, bank nationality and foreign counterparty, as well as by supranational or other organisation. With a view to improving the methodology for selecting and determining maximum counterparty limits, the Bank revised its practices in 2004 by aligning them with those of the ECB.

In addition to implementing new practices for selecting and determining maximum limits per counterparty, the Bank, with a view to controlling the risks associated with holding international reserves more effectively, has, in cooperation with the World Bank, adopted a new system for portfolio analysis and management.

In order to achieve a smooth and secure reserves management operation, the execution and settlement of foreign currency transactions is carried out separately from dealing. The SWIFT system was upgraded in 2004, while further improvements are under way in the dealing and settlements areas so as to increase efficiency and minimise operational risks.

By the continuous upgrading of processes and the successful adaptation to new developments, the Bank's international reserves management policy has yielded very satisfactory results.

Domestic foreign exchange market

In accordance with the *Central Bank of Cyprus Law 138(I)/2002 as subsequently amended* and within the framework of exercising the foreign exchange policy, the Bank may determine and announce the buying and selling rates of major currencies against the Cyprus pound at which it is prepared to transact.

Within the above framework, the Bank closely monitors the domestic foreign exchange market. It also participates in the inter-bank market and is prepared to intervene, in order to contribute to the smooth functioning of the market and to foster reasonable exchange rates that uphold the stability of the Cyprus pound. Furthermore, the Bank is responsible for organising the daily fixing session, where official exchange rates of the Cyprus pound are determined with the participation of commercial banks.

In April 2004, with the aim of preparing for participation in ERM II, the Bank adopted a new quotation method for the exchange rate of the Cyprus pound against foreign currencies. According to this method, the exchange rate is stated in terms of the units of Cyprus pounds that correspond to one unit of foreign currency.

4.7 Management of public debt

The Bank, in its capacity as the Government's banker and agent for financial matters is, *inter alia,* the administrator of public debt, including the issue of government securities. Within this framework, the Bank takes all necessary actions for satisfying the financing needs of the Government and for managing the debt.

The issue of government securities and the management of public debt are carried out within the framework of agreements entered into by the Bank and the Ministry of Finance. Operational and administrative matters are the sole responsibility of the Central Bank.

Public debt in local currency

The Government's financing needs in local currency are satisfied through issues, carried out by the Central Bank, of treasury bills of 13 and 52-week duration, government registered development stocks of 2, 3, 5, 10 and 15-year duration and savings certificates of 5-year duration. The financing of the government through the issue of savings bonds has been terminated.

Treasury bills (TBs) of 13-week duration are issued either at fixed prices (for the investment of Government Funds administered by the Bank and for the investment of frozen deposits maintained by banks with the Central Bank) or through auctions. TBs with 52-week duration are issued only through auction and are listed on the Cyprus Stock Exchange. For 13-week TBs there is no secondary market.

The total nominal value of TBs outstanding as at 31 December 2004 was £3.225,1 million compared with £3.183,8 million as at 31 December 2003. The Government Funds administered by the Central Bank were holding TBs amounting to £2.786,9 million as at 31 December 2004, while banks were holding £97,8 million frozen TBs (which were released on 1 January 2005) and £339,3 million TBs issued through auction. Other investors were holding TBs amounting to £1,1 million.

The weighted average yield of TBs issued through auction during 2003 and 2004 is shown in the table titled "Weighted average yield of TBs".

The weighted average yield of the last issue of TBs in 2004 (November) with 13-week duration was 4,62% whereas for TBs with 52-week duration the yield was 5,09%.

Weighted average yield of TBs

%

Year	13-week	52-week
2003	3,51	3,72
2004	3,87	4,43

Government registered development stocks (GRDS) of 2, 5, 10 and 15-year duration are issued through auction whereas GRDS of 3-year duration are issued at par and are offered only to natural persons. The issue of government securities through the auction method allows lending rates to reflect market conditions.

GRDS issues carried out by the Central Bank during 2004 are shown in the table titled "GRDS issued in 2004", where the maturities during the same year are also stated.

The weighted average yield for each type of stock issued through auction during 2003 and 2004 is shown in the table titled "Weighted average yield of GRDS".

The weighted average yield of the last issue in 2004 was 5,24% (November) for the 2-year GRDS and 6,26% (December) for the 10-year GRDS while for the tranche issues of 5 and 15-year GRDS the yields were

Weighted average yield of GRDS
%

Year	2-year	5-year	10-year	15-year
2003	3,89	4,49	4,78	4,95
2004	5,35	5,87	6,23	6,54

6,21% (December) and 7,05% (June), respectively.

Compared with 2003, the increase of the weighted average yield for all types of GRDS, reflects mainly the increase in official interest rates during 2004.

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 to maintain orderly market conditions, if it is deemed necessary.

As from August 2003, following an amendment to the relevant legislation, GRDS may be registered in the name of joint holders in the form "or".

The Bank and the Ministry of Finance are currently considering the introduction of primary dealers as well as other changes, including the dematerialisation of titles, aimed at improving and developing further the GRDS secondary market. These measures are expected to lead to the improvement of the terms for financing of the public sector.

Government borrowing in the form of savings certificates (SCs) continued with the issue of the Seventh Series, bearing an interest rate of 5,65% and having a repayment period of five years. Sales of SCs amounted to £28,5 million in 2004 compared with £17,9 million during 2003. The total amount of all SCs series outstanding as at 31 December 2004 was £76 million, an increase of £6,1 million over the amount outstanding as at 31 December 2003. As from July 2004, SCs may be registered in the name of joint holders in the form "or", following amendment of the legislation governing the issue of SCs.

GRDS issued in 2004
£ million

Type of bond	Issues		Maturities
	No. of Issues[2]	Amount	Amount
2-year[1]	10	232,6	207,5
3-year	12	118,1	69,0
5-year[1]	12	283,6	179,9
10-year[1]	4	37,5	-
15-year[1]	2	6,4	-
Total		**678,2**	**456,4**

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

Total amounts of investment instruments

£ million

As at	TBs	GRDS 2-year	GRDS 3-year	GRDS 5-year	GRDS 10-year	GRDS 15-year	SCs	SBs	**Total**
31 Dec. 2003	3.183,8	387,3	217,6	1.114,6	203,7	23,3	69,9	13,5	**5.213,7**
31 Dec. 2004	3.225,1	412,3	266,7	1.218,4	241,2	29,7	76,0	10,5	**5.479,9**

Regarding government borrowing through the issue of savings bonds (SBs), it was decided, after consultation with the Ministry of Finance, to postpone the issue of a new series. During 2004 it was also decided to terminate the extension of the repayment period of SBs.

The outstanding amounts of all the above borrowing investments as at 31 December 2003 and 2004 are presented in the table titled "Total amounts of investment instruments".

Public debt in foreign currency

The management of the public external debt includes the sourcing of foreign finance, evaluation of financing proposals, negotiation of relevant agreements, recording and servicing of the debt and monitoring and management of the associated risks.

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

- 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;

- 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 or make the refinancing of the debt more difficult or less favourable.

The total public external debt increased from £1.077 million at the end of 2003 to £1.411 million at the end of 2004. The increase is mainly due to new net foreign borrowing through the Euro Medium Term Note (EMTN) Programme and the drawdown of loans from the European Investment Bank for development projects.

The notes issued under EMTN continue to be the main source of the government's external financing. The amount due from notes issued under the above Programme represented 69% of the total public external debt at the end of 2004, compared with 64% at the end of 2003. Other main sources of financing are the European Investment Bank with 13%, the Council of Europe Development Bank with 9%, and the Euro Commercial Paper (ECP) Programme with

8%. The percentages at the end of 2003 were 11% 13% and 11%, respectively.

The proportion of short-term and long-term external debt was 9% and 91% at the end of 2004, respectively, compared with 11% and 89%, respectively, at the end of 2003. At the end of 2004, short-term external debt consisted mostly of issues under the ECP.

Ninety-seven percent of the public external debt is denominated in euro while the yen and the dollar account for about 1% each.

The percentages of the external debt with fixed and floating interest rates were 84% and 16% at the end of 2004, compared with 72% and 28%, respectively, at the end of 2003.

The weighted average life and the weighted average interest rate of the external debt were 6,81 years and 4,58% at the end of 2004, compared with 6,67 years and 4,69% respectively at the end of 2003.

For the servicing of the public external debt, principal repayments amounting to £10,4 million and payments of interest amounting to £45,2 million were effected during 2004, as against £13,9 million and £42,5 million, respectively, during 2003.

On 15 July 2004 a eurobond amounting to €500 million was placed with institutional investors at an interest rate corresponding to 12 basis points above mid-swaps. The eurobond has a ten year maturity and an annual coupon of 4,375%.

Credit Suisse First Boston and UBS Ltd were the lead managers of the issue. The group of co-managers consisted of the following banks: Alpha Bank, Bank of Cyprus, Bayerische Hyp-und Vereinsbank AG, Bayerische Landesbank, Cyprus Popular Bank, Deutsche PostBank AG, Dexia Capital Markets, Eurohypo AG, Goldman Sachs Intl., Kommunalkredit International Bank and National Bank of Greece.

The issue was a great success. The bond was oversubscribed almost three times due to the huge demand showed by a wide range of foreign investors. Large institutional investors such as banks, asset management organisations, insurance companies, etc, from 16 countries, but primarily from Germany, Switzerland and Austria, showed a strong interest and participated in the issue.

4.8 Developments in the international business and direct investment sector

The coming into force of the *Capital Movement Law 115(I)/2003* together with Cyprus's accession to the EU on 1 May 2004, signalled the end of Central Bank responsibility for the international business companies (IBCs) and foreign direct investment sectors. In accordance with the provisions of the new legislation, the Ministry of Finance became the competent authority for Cyprus's promotion as an international business centre as well as for the approval of foreign direct investments in Cyprus. However, the Minister of Finance delegated for a limited period of time, the responsibility for foreign direct investment permits to the Bank.

The Bank's role was finally terminated by the Council of Ministers' decision on 30 September 2004 to abolish all restrictions regarding foreign direct investments in

Cyprus, with effect 1 October 2004. This significant development ended the distinction between local companies and IBCs registered in Cyprus prior to 1 May 2004, thus putting both types of companies on an equal footing. Irrespective of this and the implementation of a uniform 10% rate of corporation tax on 1 January 2003, IBCs which were registered in Cyprus prior to 1 January 2002 and which derive their income exclusively outside Cyprus, retain the option of maintaining their old tax status of 4,25% until the end of 2005.

The contribution of the IBC sector to the Cyprus economy has been remarkable. It is estimated that it accounts for over 6% of GDP and offers direct employment to over 3.100 Cypriots, about one third of whom are university graduates. The Bank, having played a leading role in the sector's development, appreciates the magnitude of its economic importance, especially at a time when the Cyprus economy appears to have limited investment opportunities. Hence, the Bank considers important for the sector to be maintained and enhanced further. For this purpose the Central Bank has suggested the formation of an independent investment promotion agency with exclusive responsibility for the coordination of Cyprus's promotion as an international business centre.

4.9 Statistics

The Central Bank's membership of the ESCB means that the production and dissemination of statistical information are subject to the requirements of the ECB. The statistical data sent to the ECB are, *inter alia,* necessary for evaluating Cyprus's preparedness for the adoption of the euro. At the national level, the data are valuable for the formulation and implementation of monetary and economic policy.

During the year under review, the Statistics Department continued to compile and produce statistics according to the requirements and specifications of the ECB, the IMF and Eurostat. Efforts are being intensified for the further enrichment and improvement of data and for the fulfilment of demands by the EU and other international organisations. In this connection, the Statistics Department cooperates closely with the Statistical Service of Cyprus (Cystat).

Money and banking statistics and financial accounts

Following Cyprus's accession to the EU, and given the commitment for a speedy accession to the euro area, the timely harmonisation of money and banking statistics as well as the compilation of financial accounts is a Central Bank priority. The ECB and Eurostat carry through the various tasks falling within these areas of responsibility by organising regular meetings of the relevant working groups, where the Statistics Department is represented. The ECB monitors the progress achieved through the Statistics Committee, which is responsible for these working groups. In this context, the statistics departments of the EU member states operate as representatives of the ECB, collecting and compiling the statistics which are essential for the functioning of the ESCB and for the monitoring of the convergence criteria required for the accession of the new member states to the euro area.

The harmonisation of the money and banking statistics with the relevant Regulations of the ECB continues at an intensive pace. The design and preparation of the Directive for the New Balance Sheet of the Monetary Financial Institutions (MFIs) was the most important project pursued during the year. The Directive will be implemented by all MFIs operating in Cyprus, including the Co-operative Credit Institutions, comprising a total of 406 reporting agents.

The New Balance Sheet was constructed, to a large extent, on the basis of the statistical infrastructure provided by the "Directive on the Classification of Institutional Units into Institutional Sectors and Sub-sectors in accordance with the European System of Accounts (ESA 95)", issued in July 2003 and implemented by all MFIs. This directive as well as the accompanying Electronic Register of Institutional Units are being revised in order to incorporate some additional requirements which arose during the design of the New Balance Sheet.

The New Balance Sheet incorporates all ECB requirements and fulfils the statistical and supervisory needs of the Central Bank of Cyprus and other users. This was achieved through intensive consultations with internal and external data users. There was also an exchange of views with the MFIs regarding the drafts of the New Balance Sheet. In this connection, all reporting forms have now been prepared, while the compilation of a set of definitions and instructions for completion is currently under way aiming at the implementation of the Directive in 2005.

The Statistics Department worked closely with the Bank's Information Technology (IT) Department on the design of the system for the direct electronic submission of the New Balance Sheet data from the MFIs. In parallel, the mechanism for the compilation and checking of the data before they are disseminated to the ECB and other users, was examined. In this connection, the Statistics Department together with the IT Department invited the representatives of the MFIs to a seminar, with a view to providing information on the new system and exchanging views regarding its implementation.

Further to the aforementioned work, the Statistics Department was involved in the discussion concerning methodological issues arising mainly from the MFIs balance sheet, such as the classification of certain items, the treatment of new bank products, as well as the impact of the implementation of the new International Accounting Standards on the valuation of loans and deposits. The Department also worked on the compilation of Financial Sector Structural Statistical Indicators which were requested by Eurostat via Cystat. At the moment, only partial data have been compiled but the production of these data will be expanded during the course of 2005. Similar requirements of the ECB will also be covered.

Apart from the production and dissemination of balance sheet data regarding the MFIs sector, the ECB has similar requirements concerning the Other Financial Intermediaries (OFIs) sector which excludes the insurance corporations and pension funds. The OFIs sector includes investment funds of all types, mutual funds and other collective investment schemes, securities and derivatives dealers on own account, financial corporations engaged in lending (such as financial leasing, hire purchase and factoring) as well as financial vehicle corporations created to be holders of securitised assets.

The ECB in cooperation with the National Central Banks have started the preparatory work which will lead to a new Regulation concerning the collection of statistical balance sheet information from organisations included in this sector. Regarding the identification of institutional units falling within the OFIs sector, the Statistics Department has prepared and submitted to the ECB a preliminary list of investment funds operating in Cyprus. Furthermore, the Statistics Department has conducted a survey in order to identify the companies which should be included in this sector, with a view to defining its size and sub-categories.

In addition to the aforegoing, the ECB has decided, as from 2005, to incorporate payment systems statistics in the general context of money and banking statistics. This is the result of an initiative aimed at the improvement of definitions as well as the collection and dissemination of payment systems statistics.

The Statistics Department is also involved in the compilation and dissemination of data concerning bond issues and yields. This is a very important task since, as stated in Article 121 of the Treaty establishing the European Union, the convergence of long-term interest rates is one of the criteria for assessing a country's preparedness for joining the euro area. Interest rates should be measured on the basis of long-term government bonds or comparable securities. In this connection, the ten-year Development Stock has been selected for assessing Cyprus's convergence with the long-term interest rate criterion. It has been agreed that, until the secondary market develops sufficiently, this assessment will be based on the primary market yield. Since 1 May 2004, all relevant data have been published on the ECB website. Information regarding the ten-year Development Stock is submitted by the Central Bank to the ECB on a daily basis, via the electronic system GESMES/TS. Furthermore, data regarding all government bonds are disseminated on a regular basis.

During 2004 the Statistics Department contributed to the preparation of the ECB publication "Bond Markets and Long-Term Interest Rates in Non-Euro Area Member States of the European Union and in Accession Countries". This publication provides an overview of the bond market's structure and focuses on the activities of primary and secondary markets. It also provides information regarding the liquidity and interest rates in the secondary market. The ECB is working closely with all the member states of the EU with the aim of expanding and upgrading this publication in 2005.

During the year under review, the list of MFIs, which includes all local and international banking units and the co-operative credit institutions, was updated according to the ECB timetable. Since 1 May 2004, the list of MFIs in the new member states has been merged with that of the 15 EU members and is published on the ECB website which is updated on a regular basis. According to the new ECB guidelines, the MFI list is now updated on an ad-hoc basis meaning that any changes in the list are reported to the ECB as and when they occur. In this connection, the Central Bank adopted the "N13 Data Exchange 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.

Since September 2004, the Statistics Department has been contributing to the monthly updating of the ECB's Green Book. This publication provides an overview of the main developments concerning money, finance and macroeconomics in the non-euro area member states. The Green Book is included in the briefing material for each meeting of the Governing Council.

Data concerning monetary aggregates, Central Bank, commercial bank, money market and capital market interest rates, as well as data on securities issues, are also dispatched to the ECB via the electronic system GESMES/TS on a monthly basis. A table presenting the main interest rates applied by MFIs to deposits and loans is submitted to the Monetary Policy Committee before each meeting. In addition, data concerning foreign exchange reserves, exchange rates, interest rates and monetary aggregates are dispatched to the IMF via the electronic system "Integrated Correspondence System", on a monthly basis. This dataset is included in the IMF's "International Financial Statistics". Data regarding the banking system of Cyprus are dispatched to the Bank for International Settlements on a quarterly basis.

During 2004 the Statistics Department continued working with Cystat on the first set of annual Financial Accounts (FA) for the period 1995-2003. The Statistics Department supplied Cystat with all relevant data regarding the Central Bank and domestic banks as well as government securities in accordance with the ESA 95 methodology.

In parallel, the Department started working on the implementation of Guideline ECB/2002/7 and its forthcoming amendment concerning quarterly FA data. The amended Guideline will cover the following sectors: non-financial corporations, MFIs, other financial intermediaries, financial auxiliaries, insurance corporations and pension funds, general government and its subsectors, households and non-profit institutions serving households and the non-residents sector. All requirements for annual and quarterly FA concerning the MFIs have been incorporated in the New MFI Balance Sheet. Moreover, the work for the use of currently existing data sources for the remaining institutional sectors is in progress.

During 2005 the Statistics Department is planning to further utilise currently existing data sources and to conduct additional surveys in order to cover all sectors and financial instruments required by Guideline ECB/2002/7 and its forthcoming amendment. Priority will be given to the implementation of Regulation EC 501/2004 on quarterly FA for general government, in cooperation with Cystat and the Ministry of Finance. The exact arrangements and responsibilities of each institution are expected to be defined in the context of the Memorandum of Understanding which is under preparation.

Balance of payments and international investment position

Cyprus's accession to the EU, combined with the aim of joining ERM II, has focused attention on the balance of payments statistics, since developments in the current account constitute a secondary criterion for the adoption of the euro.

An important development during 2004 was the compilation of monthly balance of payments statistics and their transmission to the ECB, as well as the compilation and regular submission of the "international reserves template", in accordance with the IMF's manual. Moreover, the quarterly and annual balance of payments data were disseminated in accordance with community and international requirements.

In parallel, in 2004 the Department compiled Cyprus's international investment position concerning the financial assets and liabilities of Cypriot residents. The Coordinated Portfolio Investment Survey (CPIS) conducted by the Central Bank of Cyprus and the central banks of other countries under the aegis of the IMF, is one of the main sources of international investment position data. A basic innovation concerning CPIS, in view of the dismantling of exchange control restrictions, was the use of the security-by-security indirect approach. In particular, a large number of custodians and fund managers were asked to report on the portfolio holdings of their resident natural-person customers.

In the context of the revision of the 1995 - 2003 national accounts by Cystat in accordance with ESA 95, the Statistics Department estimated past balance of payments data consistent with the BPM5 residency definition. The revised time series includes annual balance of payments data for the years 1995 - 2001, as well as quarterly data for 2001.

In 2004, following the complete abolition of exchange controls, the Central Bank issued a directive to lawyers and accountants concerning their obligation for the submission of a statistical declaration for every case of foreign direct investment in Cyprus by their clients.

During 2004 a new system for the collection and compilation of statistical data for the balance of payments and the international investment position of Cyprus was designed. The new system is based on the direct collection of financial data from resident entities, especially those who have significant cross-border transactions with non-residents. This will supplement the existing system of data collection from domestic banks.

The necessary infrastructure has been created, while the various analytical questionnaires and instructions as to how to fill them, have been provisionally completed. The system will include information on direct and portfolio investments, financial derivatives and other financial claims and liabilities of residents vis-à-vis non-residents. The entities to be included in the survey have been selected from all areas of business activity on the basis of the volume of their transactions with non-residents. The data will be submitted every three months with the ultimate aim of a monthly collection.

The application of the new "Direct Reporting" system is scheduled to be launched with the completion and operation of the Centralised Securities Database (CSDB) at the ECB. This is due to the fact that the ECB requires that portfolio investments be collected and recorded on a security-by-security basis, the details of which will be drawn from the CSDB.

General economic and government finance statistics

The Statistics Department deals, *inter alia,* 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.

The Orange Book, produced by the ECB for every Governing Council meeting, includes non-harmonised GES indicators specified by the ECB separately for each country. Since September 2004, the Department has been transmiting monthly time series data for the period 1999 - 2004 for inclusion in the Orange Book. The time series cover five indicators: the consumer price index (CPI), core CPI, unemployment, unemployment rate and job vacancies.

Additionally, the following statistics were transmitted to the ECB in 2004:

- data for GDP at constant prices for the period 1996 - 2000 and for the population in 2001 with the purpose of computing Cyprus's contribution to the ECB share capital;
- statement listing the monthly working days of the 11 year period 1995 - 2005, as well as a statement showing details regarding public holidays and their weights in the economy with respect to the ECB working days calculation methodology;
- the release dates during the period August 2004 - January 2005 of 18 specific GES indicators;
- the annual structural indicators for housing for the period 1980 - 2003.

Since September 2004, the Department dispatches to the ECB the Green Book regarding monthly summaries of economic developments.

In April 2004 and September 2004 the annual GFS statistics were also transmitted to the ECB. In accordance with the ECB requirements, a complete set of harmonised GFS statistics for the period 1995 - 2004 must be submitted in 2005. The Statistics Department is working in close collaboration with the Ministry of Finance and Cystat for the purpose of accomplishing the timely and complete transmission of the GFS data to the ECB.

In accordance with the Excessive Deficit Procedure, Cyprus, like all the other EU member states, must transmit to Eurostat through Cystat, data for the government general deficit and debt twice a year, on 1 March and 1 September. In parallel, the same data must be transmitted by NCBs to the ECB for the purpose of evaluating compliance with the relevant Maastricht criteria.

In June 2004 the ten new member states, as well as Sweden, transmitted data to the ECB in order to be evaluated for compliance with the various convergence requirements of the European Union. The second and third progress reports of the ECB for the statistical preparedness of the non-euro area member states were issued in June and December 2004, respectively.

With respect to the GES, some data, especially for residential property prices and the CPI net of indirect taxes, are still unavailable, which is common to all the countries under evaluation. As far as the GFS is concerned, the submission of the time series data for the period 1995 - 1997 as well as the completion of the missing time series data for the period 1998 - 2003 are still pending.

4.10 Management services

Information technology

During 2004, ESCB information technology projects and, generally, the Bank's alignment with ECB requirements received first priority. At the same time, particular attention was paid to reinforcing security, upgrading infrastructure as well as redesigning and automating the Bank's functions.

The ESCB information technology projects completed during this period include the installation of the:

- CoreNet infrastructure which connects the EU national central banks with the ECB;
- ESCB-Net platform which allows the operation of ESCB information technology systems;
- TeleConference system.

The Cebamail system, which is used for the secure exchange of electronic messages, was upgraded. Systems that were already in operation were moved on to the ESCB-Net platform following the technical and security requirements of the ESCB. The IT Department adopted the ESCB information systems security policy for all ESCB systems used by the Bank and continued the systematic monitoring and improvement of the Bank's information security. As far as infrastructure is concerned, there was an upgrade of the office automation environment, the Bank's internal network and the SWIFT message exchange. Finally, the infrastructure for exchanging encrypted files with commercial banks, government departments and other Bank associates was created.

In terms of systems development, the IT department continued with the redesign and automation of several of the Bank's functions. Specifically, the system for processing the reports submitted by international banking units was completed and the international method for coding bank accounts, known as IBAN, was adopted. In addition, a new method of calculating exchange rates was implemented, as well as a system for recording the working time for staff in the Domestic Banks Supervision Department. A number of systems are in the phase of user acceptance, namely the settlement system for large value payments in Cyprus pounds, the small payments system known as JCC transfers, and the Government payments system. The development of the currency administration system is well in progress.

In the area of statistical systems, the Bank's commitments for submitting statistical data to the ECB and Eurostat have increased considerably as a result of the country's accession to the EU. In particular, the Electronic Registry of Institutional Units classified in accordance with ESA 95 was implemented and there was a necessary revision of the balance of payments system, the N13 monetary financial institutions system, the N13 eligible assets system and the electronic data exchange application, known as EDX/DS.

An electronic document management system has been gradually implemented during the year with the aim of safeguarding the confidentiality and the efficient management of the Bank's documents. The system applies a uniform method of organising the Bank's documents and facilitates their fast and flexible retrieval by authorised personnel. The first phase of implementation covered ESCB and EU documents, and the system will be gradually extended to include the rest of the Bank's documents, with confidential documents having first priority.

In 2005 priority will again be given to ESCB information technology projects and preparations for joining the eurozone. There are also plans to upgrade the systems development environment, expand the use of cryptography for the exchange of information and, finally, to further upgrade and utilise management information.

Human resource and administration issues

During 2004 the Bank's human resource policy focused on facilitating the staff's training in the field of economics as well as in technical matters related to the Bank's operations. Staff were also given the opportunity to familiarise themselves with the EU and the ECB's regulatory environment. In this connection, the Bank encouraged the staff's participation in various professional seminars, conducted either in-house or by local independent consultants or by other European central banks and EU institutions.

Furthermore, as a full member of the ESCB the Bank has undertaken the responsibility of distributing to the public the following ECB publications both in English and Greek:

- ECB Annual Report
- Convergence Report
- Quarterly Bulletin
- General Documentation

Regarding trade union issues, and taking into consideration the Bank's commitment to promoting a dialogue with its social partners, the negotiation procedure for the renewal of the Collective Agreement was initiated.

Premises and security

The Security and Technical Support Section maintains the building and the installations of the Bank so that conditions for the staff are pleasant and conducive to productive work. The installation of a new standby generator was completed so that the air conditioning system can operate even if the electricity supply is temporarily disrupted. The extension of the parking areas for the staff as well as the installation of iron fencing on the Bank's west site were also completed.

A review of the existing security arrangements is in progress. The review is taking into account the security specifications stipulated by the ECB, the Bank's membership in the ESCB from 1 May 2004, as well as our expected participation in ERM II.

5. FINANCIAL STATEMENTS

for the year ended 31 December 2004

PROFIT AND LOSS ACCOUNT
FOR THE YEAR ENDED 31 DECEMBER 2004

	Notes	**2004**	2003
		£'000	£'000
Interest Income	2	**66.713**	66.460
Interest Expense	3	**56.586**	52.310
Net Interest Income		**10.127**	14.150
Other Operating Income	4	**2.589**	3.915
Total Operating Income		**12.716**	18.065
Administrative Expenses - Staff	5.1	**8.585**	8.016
- Other	5.2	**2.309**	2.192
Depreciation	6	**990**	2.469
Operating Expenses	7	**1.230**	506
Provisions	8	**3.905**	3.673
Total Expenses and Provisions		**17.019**	16.856
Loss / Profit for the year		**(4.303)**	1.209
Provisions no longer required	9	**5.500**	-
Net profit		**1.197**	1.209

APPROPRIATION ACCOUNT

	2004	2003
	£'000	£'000
Appropriation of the Net Profit in accordance with section 59 of the Central Bank of Cyprus Laws, 2002 and 2003:	**1.197**	1.209
General Reserve (20% of Net Profit)	**239**	242
Consolidated Fund of the Republic	**958**	967

The notes on pages 72-78 form part of these accounts.

BALANCE SHEET
FOR THE YEAR ENDED 31 DECEMBER 2004

	Notes	2004	2003
		£'000	£'000
ASSETS			
Foreign Reserves	10	**1.717.324**	1.560.297
Local Investment		**87.387**	53.602
Treasury Bills		**0**	93
Government Securities	11	**87.387**	53.509
Loans and Advances		**961.106**	969.106
Government and Govt. Agencies		**961.074**	961.074
Banks		**32**	8.032
Fixed Assets	6	**8.768**	8.770
Other Assets	12	**47.346**	43.020
Total assets		**2.821.931**	2.634.795
LIABILITIES			
Currency in Circulation		**572.020**	527.264
Notes		**533.268**	490.958
Coins		**38.752**	36.306
Deposits	13	**2.031.963**	1.848.949
Banks		**1.120.600**	1.090.664
Government		**168.289**	158.296
Govt. Agencies and Public Corporations		**138.587**	46.991
Sinking Funds		**561.735**	548.978
Insurance Companies		**829**	997
International Organisations		**41.923**	3.023
Other Credit Balances	14	**65.403**	63.574
Special Accounts for the Revaluation of Gold and Net Assets/Liabilities in Foreign Currencies	15	**120.784**	163.486
Capital and Reserves		**31.761**	31.522
Capital		**15.000**	15.000
General Reserve Fund		**16.761**	16.522
Total Liabilities		**2.821.931**	2.634.795

08.04.2005

Christodoulos Christodoulou
Governor

The notes on pages 72-78 form part of these accounts.

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.

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.

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

	2004 £'000	2003 £'000
Income from foreign reserves	**34.167**	33.894
Income from local investments:		
Treasury bills	**1**	404
Government stocks	**3.202**	3.231
	3.203	3.635
Income from loans and advances:		
Credit facilities to the Government and Government agencies	**28.793**	28.595
Credit facilities to banks	**284**	109
Loans to staff and other loans	**266**	227
	29.343	28.931
Total	**66.713**	66.460

3. Interest expense

	2004 £'000	2003 £'000
Interest on foreign currency liabilities	**7.609**	5.769
Interest on Cyprus pound deposit liabilities and other accounts:		
Banks' deposits	**33.476**	30.769
Sinking funds	**15.445**	15.691
Insurance companies' deposits and other accounts	**56**	81
	48.977	46.541
Total	**56.586**	52.310

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 314 (2003: 311). Staff costs comprised the following:

	2004 **£'000**	2003 £'000
Salaries	**2.076**	2.032
Cost of living allowance	**5.026**	4.731
Bank's social insurance and other contributions	**1.122**	1.046
Other allowances	**271**	134
Staff training	**90**	73
Total	**8.585**	8.016

5.2 Other

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

6. Fixed assets

	Land and Buildings £'000	Furniture and Equipment £'000	Motor Vehicles £'000	Total £'000
Cost				
As at 1 January 2004	12.195	6.387	179	18.761
Additions	398	589	3	990
Disposals		(231)		(231)
As at 31 December 2004	12.593	6.745	182	19.520
Depreciation				
As at 1 January 2004	4.400	5.412	179	9.991
Provision	467	520	3	990
Disposals		(229)		(229)
As at 31 December 2004	4.867	5.703	182	10.752
Net Book Value				
As at 31 December 2004	**7.726**	**1.042**	**0**	**8.768**
As at 31 December 2003	7.795	975	0	8.770

The cost of land is £1.201.500.

7. Operating expenses

Operating expenses include expenses for printing notes and minting coins totalling £1.127.000 (2003: £409.000).

8. Provisions

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

	2004 **£'000**	2003 £'000
Current service cost	**1.459**	1.425
Interest on pension fund obligation	**2.256**	2.063
Past service cost	**190**	185
Total	**3.905**	3.673

9. Provisions no longer required

The amount of £5,5m consists of a provision of £3,4m which was created over the period 1967-1982 by transfers from the bank's profits, and a reserve of £2,1m which was created as a result of the revaluations of the Bank's foreign assets and liabilities, following the change in currency parities in November, 1967. The purpose of these provisions was to cover future fluctuations in parities. Since such fluctuations are covered by special accounts for the revaluation of assets/liabilities in foreign currencies, it was considered that these provisions are no longer required.

10. Foreign reserves

Foreign reserves are composed of foreign currency deposits and foreign securities including accrued interest, Special Drawing Rights and gold.

11. Local investments - Government securities

The amount of investment in government securities as at 31 December 2004 represents government securities purchased in the secondary market from non-government organisations.

	2004 **£'000**	2003 £'000
Government: Registered stock	**87.377**	53.499
Savings bonds	**10**	10
Total	**87.387**	53.509

12. Other assets

	2004 **£'000**	2003 £'000
Cheques in process of collection	**20.118**	16.552
Loans to staff	**11.825**	11.173
Interest receivable on Government long-term loan	**14.259**	14.298
Participation in ECB's Capital	**297**	-
Other accounts	**847**	997
Total	**47.346**	43.020

Participation in the Capital of the European Central Bank (ECB)

On 1 May 2004 Cyprus joined the European Union and consequently Central Bank of Cyprus (CBC) became a member of the European System of Central Banks (ESCB). In accordance with Article 28 of the Statute of the ESCB and the ECB, the CBC became a subscriber of the capital of the ECB. Subscriptions depend on shares which are fixed in accordance with Article 29.3 of the ESCB Statute and which must be adjusted every five years. The share of CBC in the ECB's capital is 0,13% and was calculated in accordance with Article 29 of the Statute of the ESCB, on the basis of population and GDP data provided by the European Commission. As Cyprus does not participate in the euro area, the transitional provisions of Article 48 of the Statute apply. Consequently, CBC was required to pay-up a minimal contribution of 7% of its subscribed capital to the ECB upon entry to the ESCB on 1 May 2004 amounting to EUR 506.385, or £297.000.

13. Deposits

	2004 **£'000**	2003 £'000
Banks	**1.120.600**	1.090.664
Minimum reserve	**640.264**	644.171
Other Cyprus pound deposits	**175.634**	120.500
Foreign currency accounts	**304.702**	325.993
Government sight accounts	**168.289**	158.296
Government agencies and public corporations	**138.587**	46.991
Sinking funds	**561.735**	548.978
Government foreign debt	**717**	710
Government registered stock	**554.046**	540.168
Savings bonds	**6.273**	7.467
Government guaranteed stock	**699**	633
Insurance companies	**829**	997
International organisations	**41.923**	3.023
Total	**2.031.963**	1.848.949

14. Other credit balances

	2004 £'000	2003 £'000
Appropriation account	**958**	967
Provision for staff pension scheme	**37.400**	34.392
Matured, unredeemed savings bonds	**2.702**	4.072
Unclaimed drawn savings bonds	**1.330**	1.357
Demonetised notes and coins	**1.373**	3.378
Accrued interest payable	**648**	410
Special Drawing Rights allocation by the International Monetary Fund	**12.979**	13.511
Other accounts	**8.013**	5.487
Total	**65.403**	63.574

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

The movement of revaluation accounts is summarised as follows:

	Gold £'000	Foreign Currencies £'000	Total £'000
Balance as at 1/1/2004	82.837	80.649	163.486
Provisions no longer required that were transferred to P&L A/c		(5.500)	(5.500)
Revaluation adjustments for the year ended 31/12/2004	(4.518)	(32.684)	(37.202)
Balance as at 31/12/2004	**78.319**	**42.465**	**120.784**

16. 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 £538.000 (2003: £348.000) and the present value of the obligation is as follows:

	2004 **£'000**	2003 £'000
Present value of obligation	**39.516**	36.698
Unrecognised past service deficiency	**(2.116)**	(2.306)
Net liability in balance sheet	**37.400**	34.392

As in previous years, pension payments for 2004, were charged directly to the pension scheme provision account.

17. Government funds administered by the Central Bank of Cyprus

The deficiency of interest earned by the above funds for 2004 compared to the guaranteed interest was £19.365.000 (£8.293.000 in 2003). 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 70 to 78 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 2004 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.*

CHRYSTALLA GEORGHADJI
Auditor General of the Republic

Nicosia, 8 April 2005

6. Abbreviations

BSC	Banking Supervision Committee
CCIs	Co-operative Credit Institutions
CEBS	Committee of European Banking Supervisors
CIR	Central Information Registry for the Issuers of Dishonoured Cheques
CPI	Consumer Price Index
CPIS	Coordinated Portfolio Investment Survey
CSDB	Centralised Securities Database
Cystat	Statistical Service of the Republic of Cyprus
EAU	European Affairs Unit
ECB	European Central Bank
ECOFIN	EU Council of Finance Ministers
ECP	Euro Commercial Paper
EDP	Excessive Deficit Procedure
EFC	Economic and Financial Committee
EMTN	European Medium Term Note
EMU	Economic and Monetary Union
ERM II	Exchange Rate Mechanism II
ESA 95	European System of Accounts 1995
ESCB	European System of Central Banks
EU	European Union
Eurostat	Statistical Office of the European Communities
FA	Financial Accounts
FSIs	Financial Soundness Indicators
GES	General Economic Statistics
GFS	General Finance Statistics
GDP	Gross Domestic Product
GRDS	Government Registered Development Stocks
HDI	Human Development Index
IBAN	International Bank Account Number
IBCs	International Business Companies
IBUs	International Banking Units
IMF	International Monetary Fund
MFIs	Monetary Financial Institutions
NCBs	National Central Banks
OFIs	Other Financial Intermediaries
SBs	Savings Bonds
SCs	Savings Certificates
TARGET	Trans-European Automated Real-time Gross-settlement Express Transfer system
TBs	Treasury Bills