

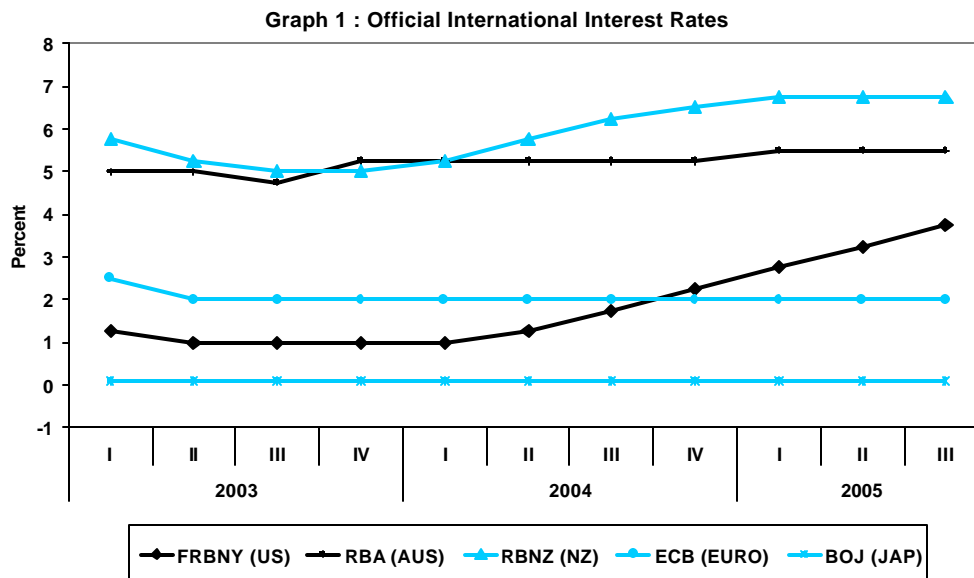
II. OVERVIEW OF ECONOMIC DEVELOPMENTS DURING THE THIRD QUARTER OF 2005.

a. The World Economy

The world economy continued to expand at a good pace during the September quarter of 2005. In addition to ongoing strong growth in the US, the economic situation in Japan has improved markedly since the start of the year. High commodity prices and expansionary financial conditions continued to support solid growth in other emerging economies. However, the euro area remained a key area of weakness in the global economy, weighed down by low confidence and high unemployment.

The US economy maintained its robust expansion into the second half of 2005, posting growth of 0.9 percent in the September quarter and 4.1 percent over the year, driven by ongoing strong consumption growth. While the effects of hurricanes Katrina and Rita had resulted in some near-term weakness in the US economy, its underlying momentum remained strong. In the medium term, reconstruction activity should contribute to growth. Labour market conditions remained firm in the first part of the September quarter, and the unemployment rate fell steadily to 4.9 percent in the month of August. However, the displacement of workers by Hurricanes Katrina and Rita had resulted in some weaker labour market indicators. Similarly, headline CPI inflation rose to 4.7 percent over the year to September, as petrol prices spiked following disruptions to production and refining caused by the hurricanes. The persistence of high-energy prices and the pick-up in growth of labour costs, to 4.3 percent over the year to the September quarter, pointed to ongoing inflationary pressure.

In its two meetings in the September quarter, the US Federal Open Market Committee (FOMC) raised the Fed funds target rate from 3.25 percent to 3.50 percent and then to 3.75 percent. Market expectations of future tightening had fluctuated due to uncertainty caused by the two Hurricanes. However, after it became clear that the Federal Reserve did not expect any ongoing threat to economic growth, the market once again priced in more tightening. (See Graph 1.)



In Australia, the favourable global economic environment during the September quarter helped support growth of the economy at a time when domestic factors have had a modest dampening effect on household spending. Nevertheless, growth in household incomes and spending continued to be supported by strong growth in employment and real wages, and by the recent tax cuts. Other

than the household sector, business investment spending had been expanding due to the high level of commodity prices, which had stimulated investment in the mining sector and in resource-related manufacturing and infrastructure projects.

In the September quarter, the Reserve Bank of Australia took the view that the economic situation and growth in demand and output remained solid, but had eased back from the peaks seen in recent years. While underlying inflation had been forecasted to rise modestly over the year ahead, inflationary trends overall were expected to remain consistent with the target over the medium term. As a result, the RBA decided to hold the cash rate unchanged, pending any further information on prices that prompt a reassessment of the inflation outlook.

New Zealand economic growth eased from the rapid pace of 2004, but still remained firm. Households have enjoyed continuing income growth and have been spending on consumption goods and housing. Employment growth was strong over the September quarter, and the unemployment rate fell to 3.4 percent. Supported by rising incomes, there was significantly more retail spending during the September quarter. However, the merchandise trade deficit widened in the September quarter, pointing to a negative contribution to GDP from the external sector and an increase in the current account deficit. Inflation increased to 3.4 percent in September, mainly as a result of higher petrol prices and ongoing increases in housing costs.

In the two interest rate reviews of the Reserve Bank of New Zealand (RBNZ) in the September quarter, the official cash rate was left unchanged at 6.75 percent, noting that the economy had shown signs of softening. However, the RBNZ's expectation of further monetary tightening may still prove necessary to ensure inflation is kept within the 3 percent band over the medium term.

In other parts of the world, indicators in the Euro-zone suggested household consumption remained subdued in the September quarter, with consumers pessimistic about prospects for recovery. However, there are tentative signs that the labour market is improving with the unemployment rate in the Euro area dropping to 8.6 percent in the September quarter. Recent data for business sector and industrial production also picked up in the September quarter.

The European Central Bank (ECB) left its policy rate unchanged at 2 percent during the quarter under review. Comments from ECB officials highlighted growing concerns on the effect of inflationary expectations of high oil prices. Consequently, markets have factored in the possibility of a 25 basis points increase in the policy rate early in 2006.

The pace of growth of the UK economy slowed down, as the cooling housing market dampened consumer spending while external demand eased. Preliminary data suggested GDP growth was 0.4 percent in the September quarter, to be 1.6 percent over the year. This slowdown was reflected in the labour market with the unemployment rate up to 2.8 percent in September from 2.6 percent at the start of 2005.

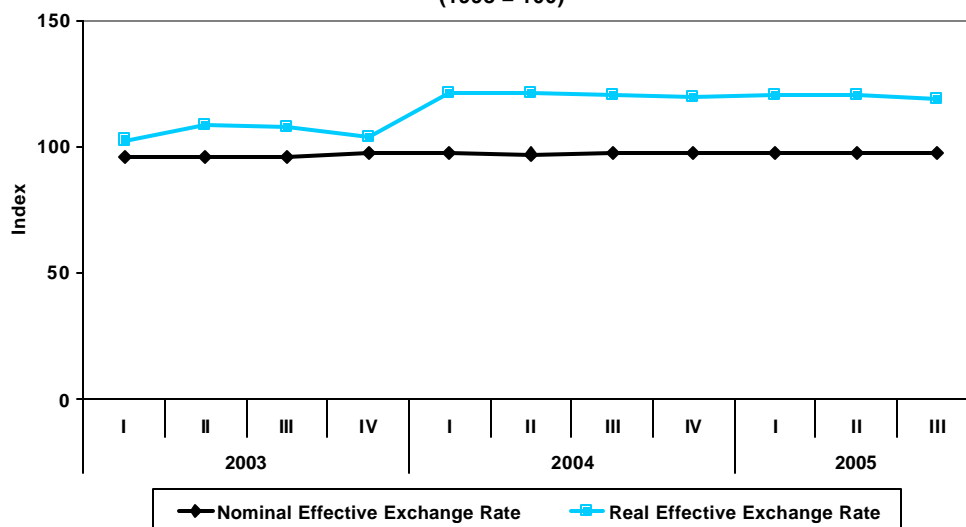
For the Bank of England, it reduced its official cash rate by 0.25 percent to 4.50 percent in one of its three reviews in the September quarter. The Monetary Policy Committee concluded that the slackening in the pressure of demand on supply capacity should lead to some moderation in inflation. As a result, the Committee judged that a decrease in the repo rate was necessary to keep Consumer Price Index inflation on track to meet the target in the medium term.

The Japanese economy continued to show strength and confidence as shown earlier in the second quarter of 2005. Employment continued to expand at a solid pace, up by ½ percent over the year to end September, while the unemployment rate was at its lowest level in around seven years at 4.2 percent. Similarly, like the majority of Central Banks during the quarter under review, the Bank of Japan did not change its monetary policy stance, with the economy experiencing only

moderate economic growth. However, some market participants have interpreted recent Bank of Japan comments that deflation may end next year as a signal that it may soon start to move away from the easing policy.

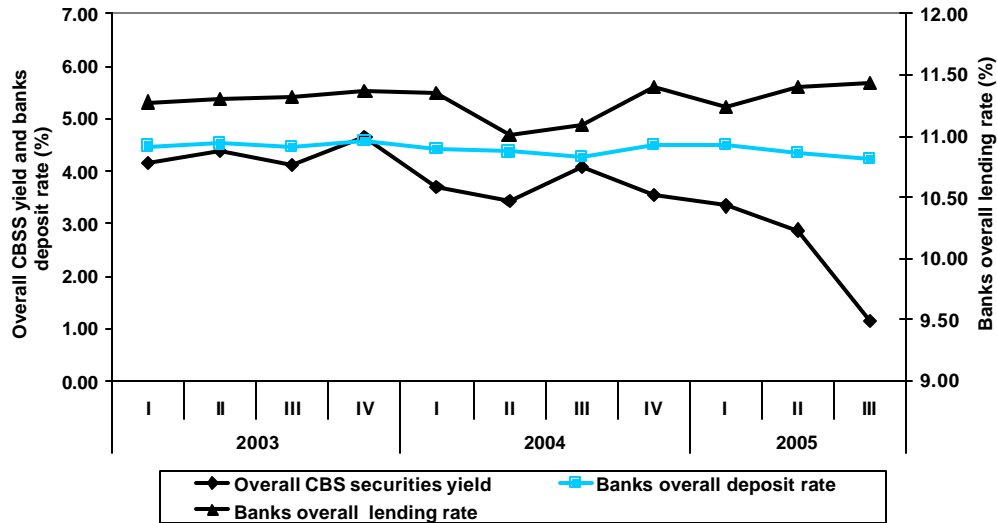
During the quarter under review, the US dollar held its ground earlier before starting to lose some momentum due to the threat posed by the aftermath of Hurricanes Katrina and Rita on the US economy. Similarly, as the US dollar weakened against the currencies of Samoa’s trading partners, this in effect led to an appreciation of the Tala against the US dollar, Australian dollar and the Fijian dollar but depreciated against the New Zealand dollar and the Euro. As a result, the value of the Tala in terms of its nominal index showed a slight appreciation of 0.07 percent in the third quarter of 2005. Furthermore, since price rises in Samoa were less than the price rises of our major trading partners, the real effective exchange rate of the Tala fell 0.96 percent. (See Graph 2.)

**Graph 2 : Trade Weighted Exchange Rate Index
(1998 = 100)**



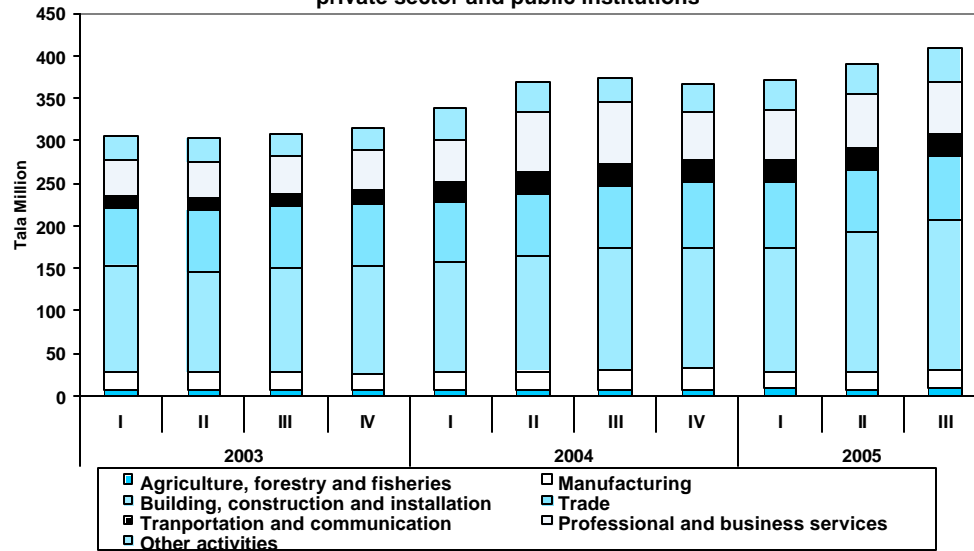
The Samoan Government’s financial operations in the September 2005 quarter closed with an overall budget surplus of \$3.1 million. This overall surplus was mainly due to a drop in Government spending (down \$60.6 million) which more than outweighed a \$49.4 million reduction in total Government revenue and external grants. On the other hand, monetary policy tightened in the quarter under review to contain the potentially large balance of payments deficit forecast for the fiscal year 2005/06. In implementing that policy stance, the level of the banks’ excess liquidity fell to \$40.2 million from \$49.2 million in the previous quarter. At that level, however, excess liquidity was still plentiful, with the weighted average interest rate on Central Bank securities consequently declining to 1.16 percent from 2.88 percent in the previous quarter. In the event, the weighted average commercial bank deposit rate fell 13 points to 4.29 percent. On the other hand, the average lending rate remained at 11.41 percent, sustained by a strong demand for loans. (See Graph 3.)

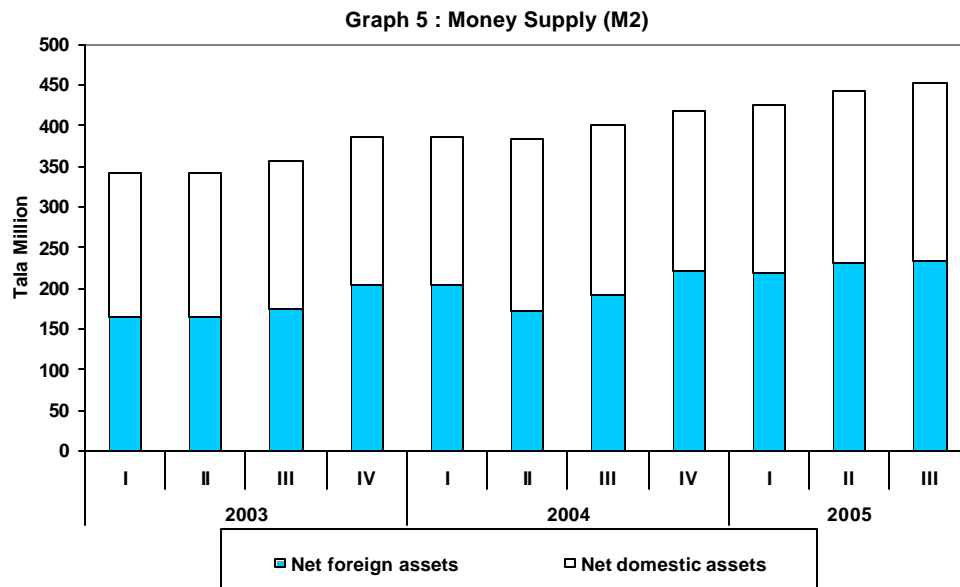
Graph 3 : Overall yield on CBS securities and commercial banks interest rates



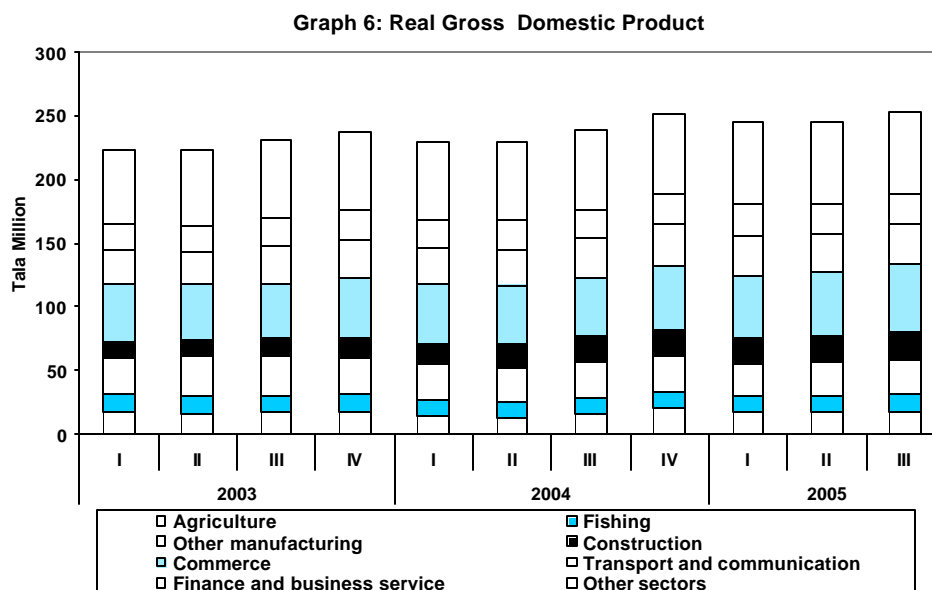
Domestic credit rose in the September quarter of 2005. In particular, bank credit to the private sector went up \$17.1 million, on the back of an \$18.0 million increase in the previous quarter. (See Graph 4.) The hike in private sector credit largely went to the “Building, construction, installation and purchase of land” sector (up \$12.9 million) and the “Trade” sector (up \$2.8 million). Increased credit together with a 1 percent gain in net inflow of foreign funds saw total money supply (M2) expand 2 percent in the third quarter of 2005. (See Graph 5.)

Graph 4 : Commercial banks credit to the private sector and public institutions



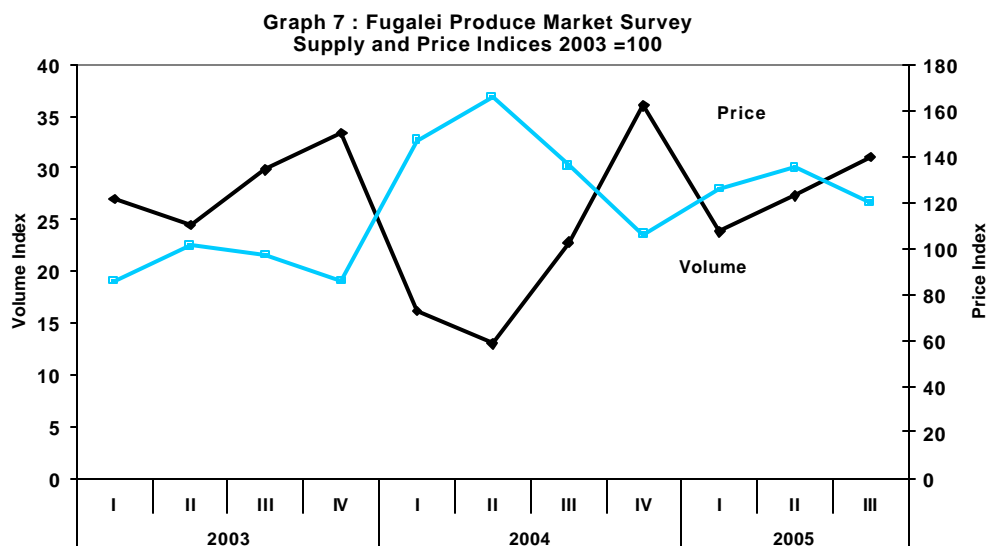


According to the national accounts figures compiled by the Ministry of Finance, the economy grew 3.6 percent in real terms in the quarter under review in line with normal seasonal trends where economic activity tends to pick up towards the end of the year. (See Graph 6.) Significant growth was recorded for the “Hotels and restaurants” sector, which jumped 11 percent and the “Construction” sector climbed 10 percent to a level 13 percent higher than the same quarter of 2004. The “Electricity and water” sector rose 9 percent in the quarter under review and the “Commerce” sector increased 7 percent to a level 14 percent higher than the September quarter of the year before. The “Agriculture” sector, which accounts for about 7 percent of total value -added, grew 4 percent after a 2 percent hike in the previous quarter, and was 12 percent higher than in the September 2004 quarter as production recovered from Cyclone Heta. The “Other manufacturing” sector, which includes the production of automotive wire harnesses for export, rose 2 percent in the quarter under review and that of “Transport and communication”, “Public administration”, “Finance and business service” and “Ownership of dwellings” each recorded a gain of 1 percent in the quarter under review.

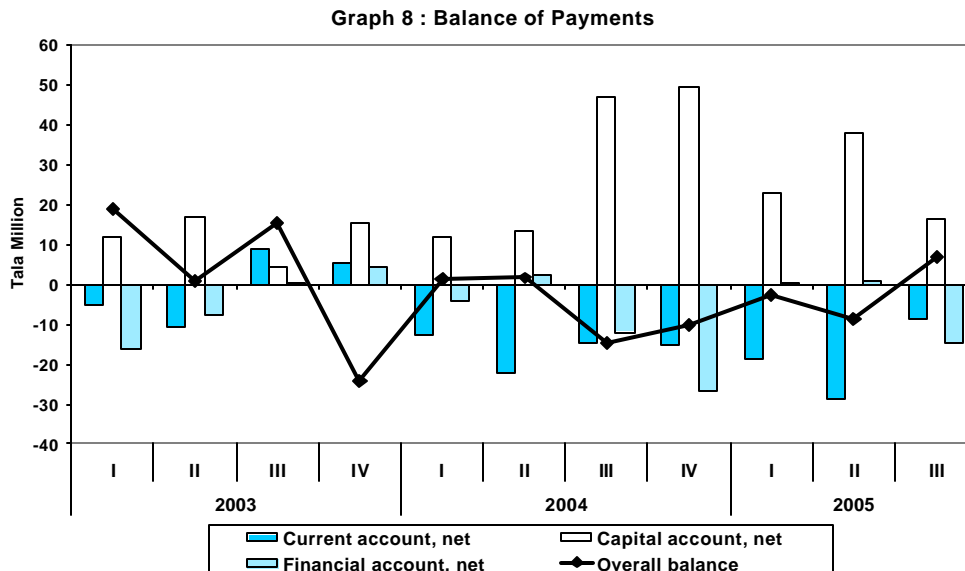


In line with normal cyclical patterns, the production of industrial products in the September quarter of 2005 slipped 1 percent but was 2 percent higher than the same quarter of 2004. Beverages production dropped in the third quarter of 2005 with soft drinks declining by 16 percent and that of beer falling 3 percent. Food production, on the other hand, improved with ice cream up 55 percent, corned meat leapt 15 percent and that of coconut cream increased 10 percent. With the pick up in construction activity in the quarter under review, the production of building materials expanded in the quarter under review. The output of paints and timber rose 8 percent and 9 percent respectively and those of ready-mix cement and concrete blocks climbed 6 percent and 21 percent in that order. Despite an improvement in overall agricultural production, there was a marked drop in the export of agricultural commodities such as nonu products, taro and coconut based products (coconut cream and desiccated coconut). In addition, the output of the fishing industry, which is the mainstay of the export sector, fell following a remarkable recovery in the previous quarter.

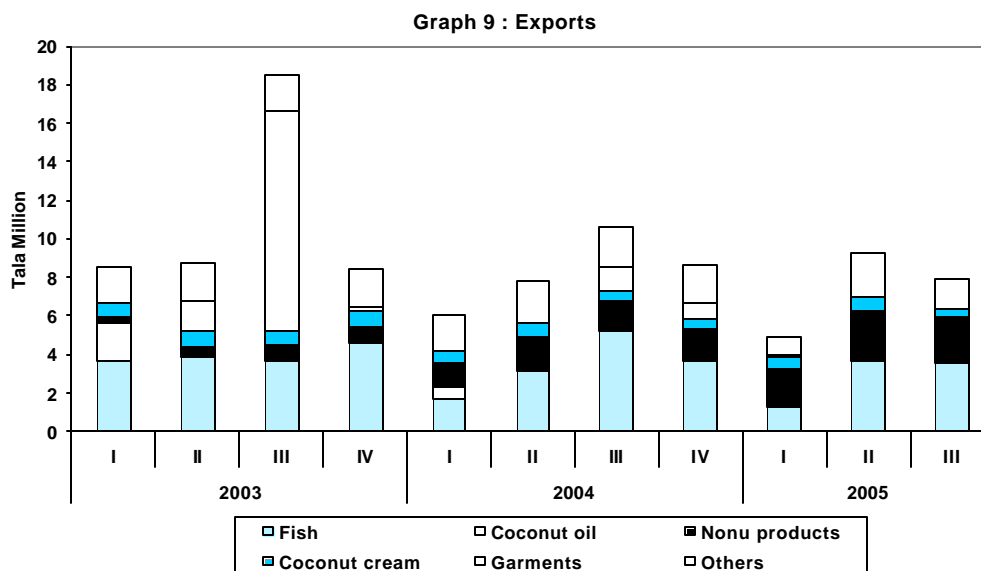
The supply of agricultural produce to the Fugalei Market leapt 15 percent following a large decline in the previous quarter. However, increased demand for agricultural goods led to higher prices (up 7 percent) especially for taamu. This is the normal trend for the Market during the third quarter as farmers gear up for the end of year festivities. (See Graph 7.) Most of the selected commodities recorded significant gains particularly those for taro palagi, taamu, head cabbage, Chinese cabbage and cucumber.



On the external sector, the balance of payments recorded a gross outflow of \$7.1 million in reserve assets in the September 2005 quarter, mainly attributed to a lower capital account surplus despite a drop in the current account deficit, which was largely financed by a net inflow of \$16.3 million in the financial account. (See Graph 8.) Consequently, gross official reserve assets fell to a level that was sufficient to cover 5.5 months of imports of goods, which was lower than the 5.9 months in the previous quarter and 6.0 months in the same quarter the previous year.

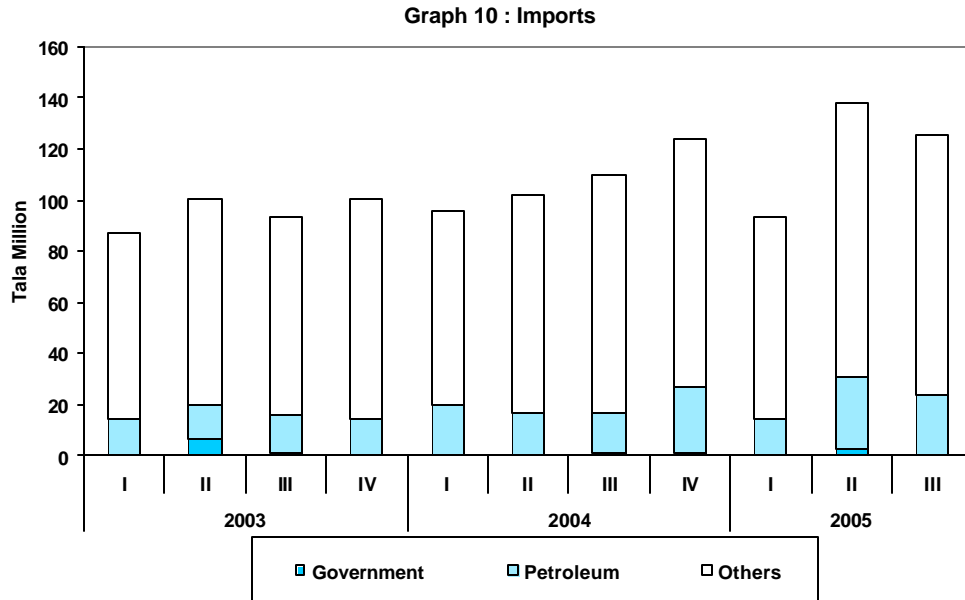


The foreign trade deficit fell to \$117.2 million due to a \$12.5 million decline in imports despite a small drop in export earnings. (See Graph 9.) The hefty decrease in total imports was due to a drop of \$5.0 million each in petroleum and non-petroleum private sector imports. Government imports declined \$2.2 million after a large one off import item in the previous quarter. For exports, a drop of 42 percent in the volume of coconut cream exports coupled with a 4 percent decline in its export price saw its total value shrink by 45 percent or \$304 thousand in the quarter under review. Export revenue from beer shrank 41 percent as a result of a 42 percent decrease in its volume despite a 1 percent gain in its international price. Fish exports fell 3 percent or \$97 thousand reflecting 1 percent and 2 percent reductions in its volume and price respectively. The value of nonu juice exports declined 6 percent as a result of a similar drop in its volume despite an unchanged export price. Revenue from taro and nonu fruits also fell in the quarter by 27 percent and 19 percent respectively reflecting decreases in both their volumes and prices. Likewise, desiccated coconut export earnings halved to \$81 thousand due to a 51 percent drop in its volume. Garment exports resumed in the quarter under review with shipments valued at \$198 thousand.



The third quarter of 2005 again saw the average spot price for crude oil going up 18 percent to \$59.98 per barrel with some industry analysts predicting that oil prices would likely ease in the

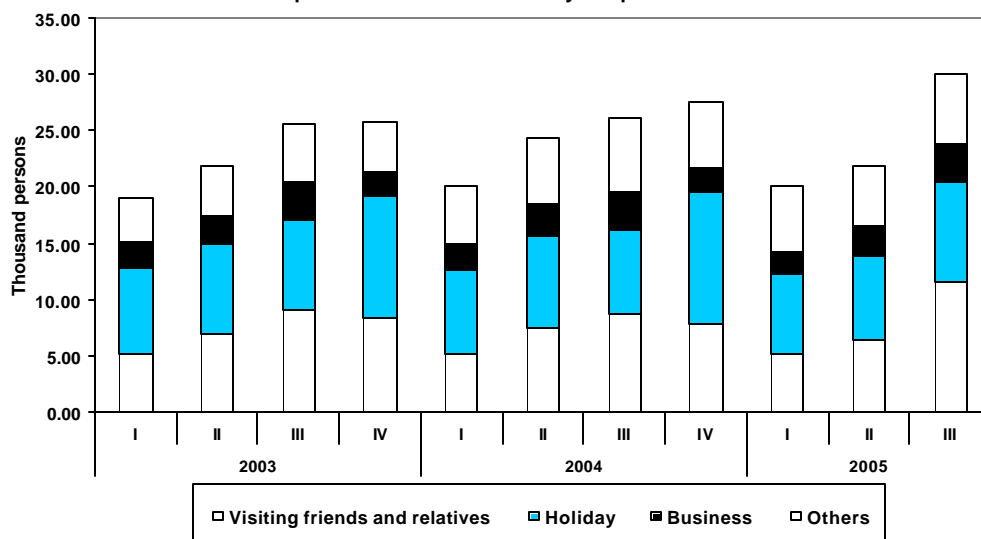
next quarter with the expected recovery in the US crude oil inventory from disruptions caused by hurricanes late in the quarter. (See Graph 10.)



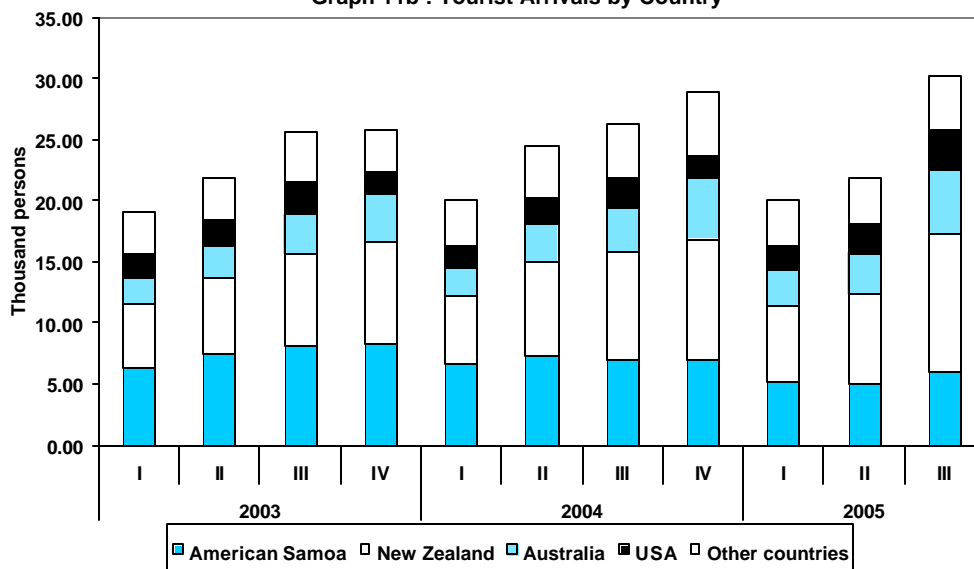
With the Teuila Festival, Methodist Annual Conference as well as sports tournaments (Pacific Tri-nations and South Pacific Island Nations Touch Rugby Tournament) held in the quarter under review, total tourist arrivals jumped 38 percent to 30.2 thousand persons. As usual, those visiting friends and family accounted for 38 percent of total tourist arrivals. Those who were here on holiday followed with a ratio of 30 percent, down from 35 percent in the previous quarter while those who were here on ‘business’ decreased to 11 percent from 12 percent in the second quarter of 2005. Visitors who were here for ‘sports’ purposes edged up to 2 percent from 1 percent while those who were here for ‘other’ purposes fell to 19 percent from 23 percent. (See Graph 11a and 11b.)

Since the majority of those visiting friends and family are from New Zealand, that country’s share rose to 37 percent from 33 percent while that of American Samoa fell to 20 percent from 22 percent in the previous quarter. The proportion of tourists from Australia increased to 18 percent from 16 percent while those visiting from the USA remained unchanged at 11 percent. Likewise, visitors from the UK, Germany and other European countries were unchanged at 2 percent, 1 percent and 1 percent in that order.

Graph 11a : Tourist Arrivals by Purpose of Visit

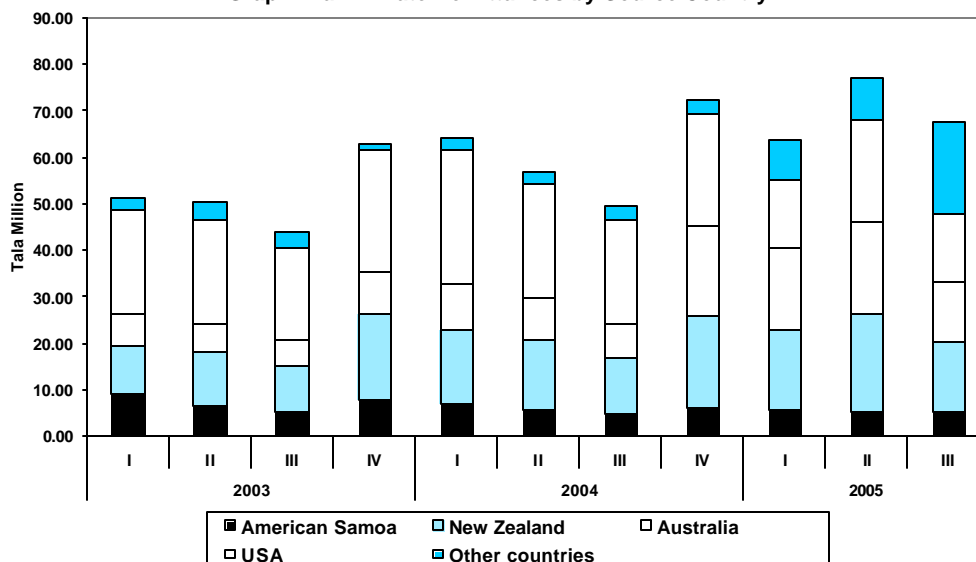


Graph 11b : Tourist Arrivals by Country

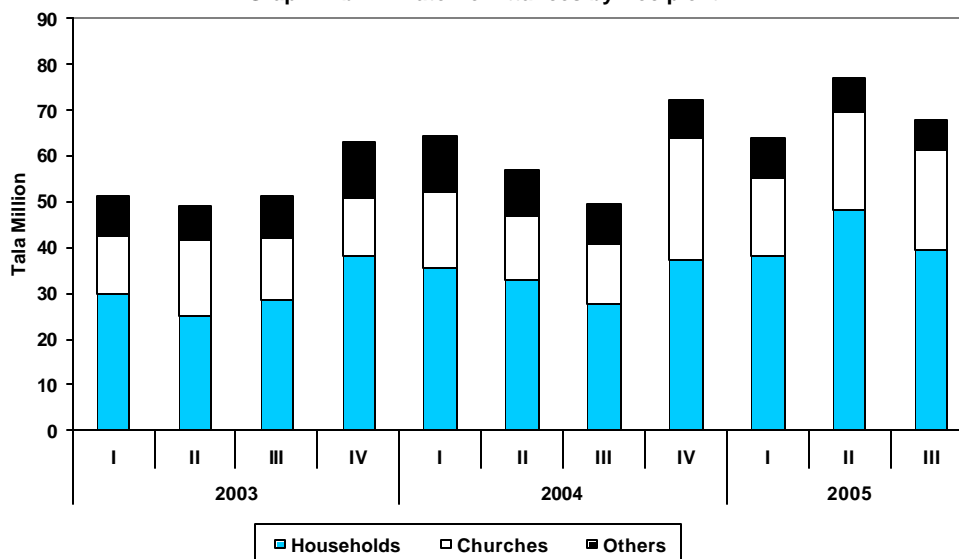


The net inflow of private remittances in the quarter under review fell 18 percent, largely reflecting lower remittances for households while funds for charitable organizations (mostly churches) recorded a 7 percent rise. As shown in Table E-7, the main sources of private remittances were the USA and New Zealand with shares of 22 percent each. Fiji’s share jumped to 20 percent from 7 percent reflecting funds for a major construction project for a church being remitted through that country. Australia’s share fell to 19 percent from 26 percent while American Samoa edged up to 8 percent from 7 percent. (See Graph 12a.) Funds for supporting families and individuals accounted for the bulk of private remittances (58 percent) followed by funds for religious organizations and non-government schools (33 percent). (See Graph 12b.)

Graph 12a : Private Remittances by Source Country



Graph 12b : Private Remittances by Recipient

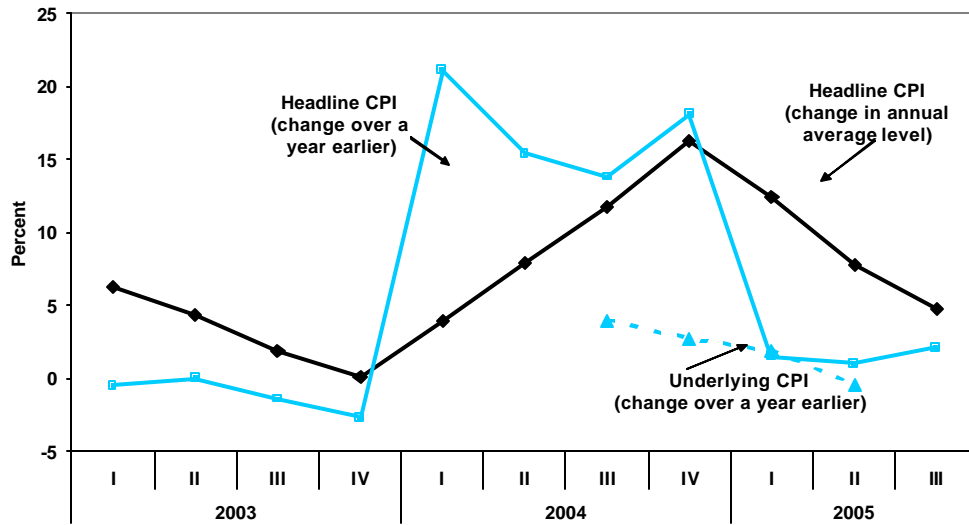


The capital account of the balance of payments recorded a net surplus of \$16.2 million, which was down from a very large surplus of \$37.9 million in the previous quarter. Official grants received by Government dropped 55 percent after a significant portion of the grants was received in the previous quarter for the construction of major sporting facilities in preparations for the 2007 South Pacific Games. In the financial account, which is a record of the flow of non-reserve assets and liabilities, there was a large net inflow of funds of \$14.7 million, compared to a net outflow of \$0.9 million from the previous quarter.

The average level of consumer prices edged up 0.2 percent in the September quarter of 2005 to a level 1.1 percent higher than in the same quarter a year earlier. (See Graph 13.) The marginal rise in the headline Consumer Price Index (CPI) during the quarter mainly reflected an increase in local housing and household goods in light of the recent price hike for gas. The local component of transport and communications increased 1 percent due to higher airfares while the imported component of the CPI rose 1.9 percent in light of higher prices for construction materials and petroleum products. As expected, the headline rate of inflation, on an annual average basis, declined to 4.7 percent at end September 2005 from 7.8 percent at end June 2005 and 11.7 percent

at end September 2004. The underlying rate of inflation, on the other hand, was much lower at 1.4 percent.

**Graph 13 : Consumer Price Index
(March 2004 = 100)**



III. PRUDENTIAL SUPERVISION

For the quarter ended 30 September 2005, the banking system maintained its good performance, recording moderate growth of assets and maintaining adequate level of capital comfortably above the Central Bank's minimum requirement of 15.0 percent.

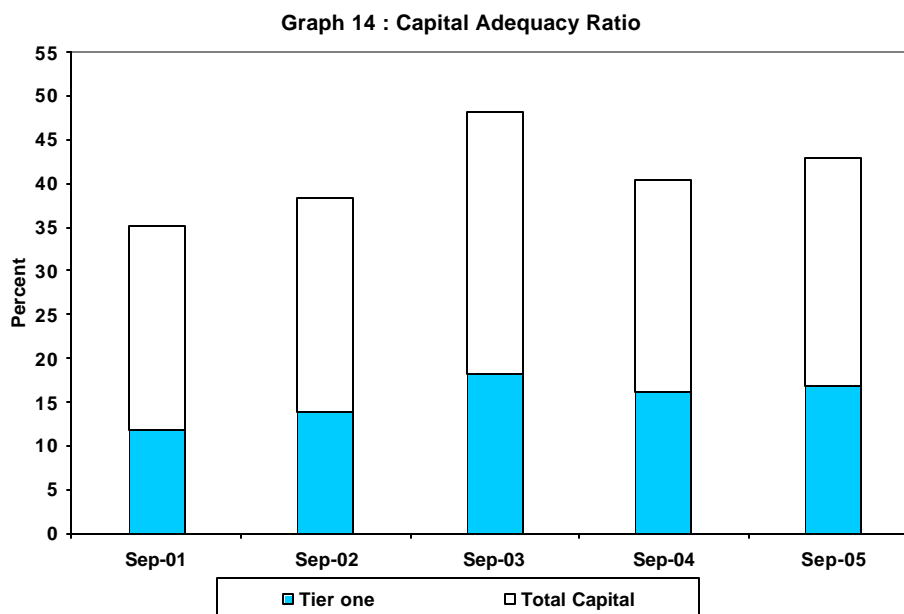
The commercial banks assets combined at \$599.1 million, reflected an increase of 1.3 percent in the September quarter and indicated an annual growth of 7.6 percent (\$42.3 million) when compared to the same time a year earlier. The composition of the commercial banks assets comprised mainly of loans and advances of \$412.8 million (68.9 percent of total assets), cash reserves and deposits with the Central Bank and other banks combined at \$148.2 million (24.7 percent) and fixed assets of \$56.5 million (9.4 percent) respectively.

Total loans and advances of \$412.8 million increased by 5.1 percent (\$20.0 million) at the end of the quarter and further went up by 9.2 percent (\$34.9 million) over the same time in the previous year. The growth in loans and advances was attributed mainly to loans to private businesses and households.

Total deposit liabilities of \$476.5 million increased 1.9 percent (\$9.0 million) as a result of a strong increase in domestic demand and savings deposits which more than offset the decline in time deposits. At this level, total deposit liabilities registered an annual growth rate of 9.2 percent (\$40.0 million) when compared to the same period a year earlier.

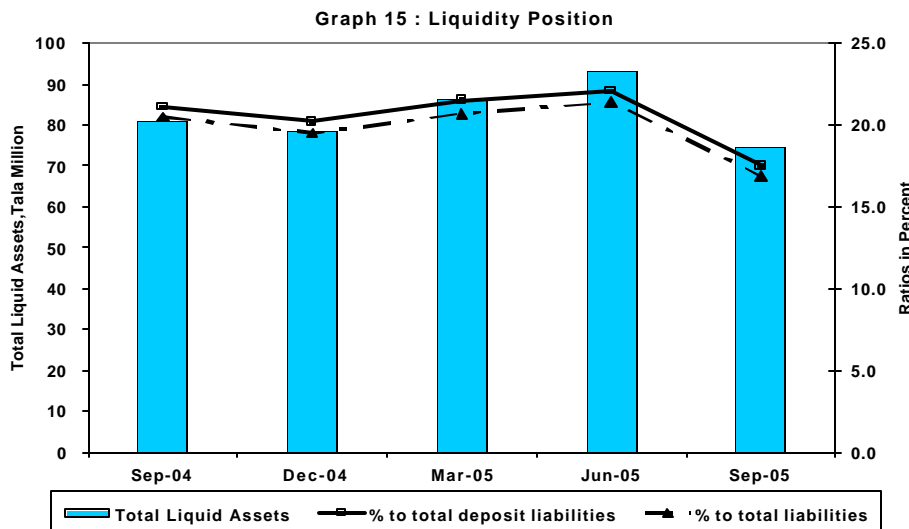
At \$79.3 million, total contingent and off-balance sheet items increased by \$4.5 million over the previous quarter, due mainly to increases in trade related items (letter of credits) of \$8.3 million and unmatured foreign exchange contracts of \$35.2 million.

The banking system remained strongly capitalized at \$101.8 million, up from \$99.8 million the previous quarter largely reflecting the banks profitable performance throughout the period. In proportion to total risk weighted assets, capital adequacy ratio dropped by 1.1 percent to 25.9 percent. Tier 1 capital recorded a 16.9 percent ratio, a decrease of 2.2 percent over the June quarter. (See Graph 14.)



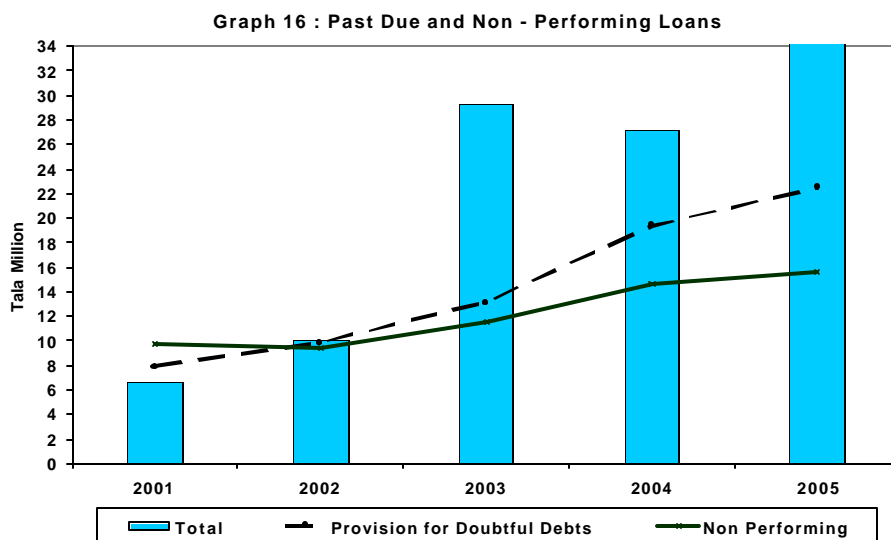
All the banks complied with the Central Bank's minimum capital adequacy requirement (15.0 percent) at the end of the quarter.

In terms of liquidity, the banking system experienced a marked decrease in the level of liquid assets by 19.7 percentage (\$18.3 million) over the previous quarter. Total liquid assets stood at \$74.7 million, equivalent to 17.5 percent of total domestic deposit liabilities. On an annual basis, the overall level of liquidity dropped by \$6.0 million respectively. The Central Bank Securities of \$26.9 million, made up 36.0 percent of total liquid assets at the end of the quarter. (See Graph 15.)

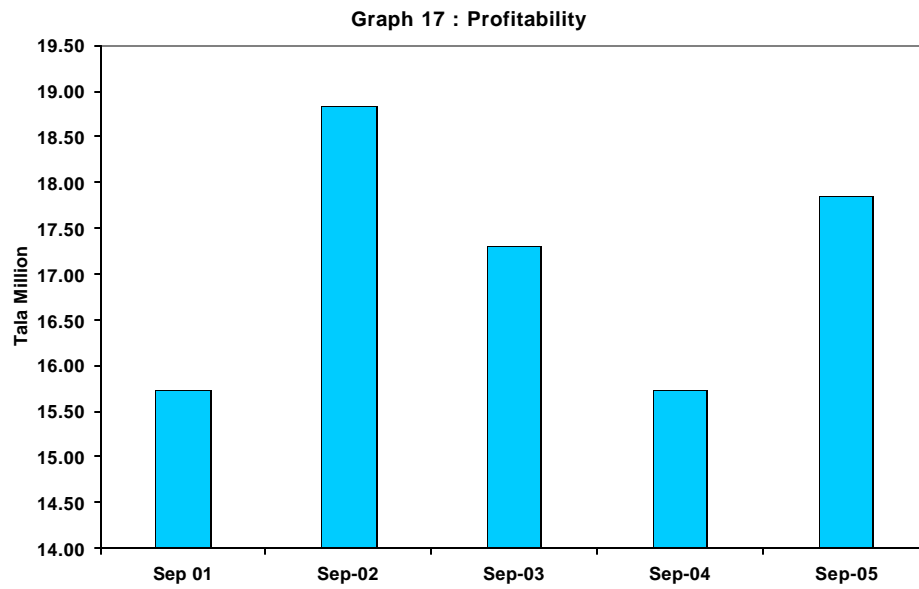


The combined foreign assets of the commercial banks amounted to \$63.2 million (10.6 percent of total assets) as compared to total foreign liabilities of \$56.3 million. At these levels, it showed a net long exposure position of around \$7.0 million or 6.9 percent of total capital.

Total non-performing loans stood at \$22.5 million, reflecting an increase of 10.9 percent (\$2.2 million) over the previous quarter. As compared to the prior year, it rose further by 16.1 percent (\$3.1 million). The Central Bank maintains a close monitoring of banks level of arrearages and non-performing loans and continues to consult with the banks about such trends which, among others, would require them to be extra vigilant in their approaches towards asset quality and underwriting adequate provisions to cover for possible write-offs of non-performing assets from their books while efforts to expedite recoveries are pursued. (See Graph 16).



At a combined figure of \$24.9 million, the banking system’s pre tax profit level increased by 11.8 percent in the quarter under review when compared to the same period the year before. (See Graph 17.)



For the period under review, total operating expenses represented 65.7 percent of total income, more or less the same level achieved in the previous year. The banks also continued to achieve good earnings from their non-interest earning activities such as commission, fees and charges and foreign exchange gains.
