

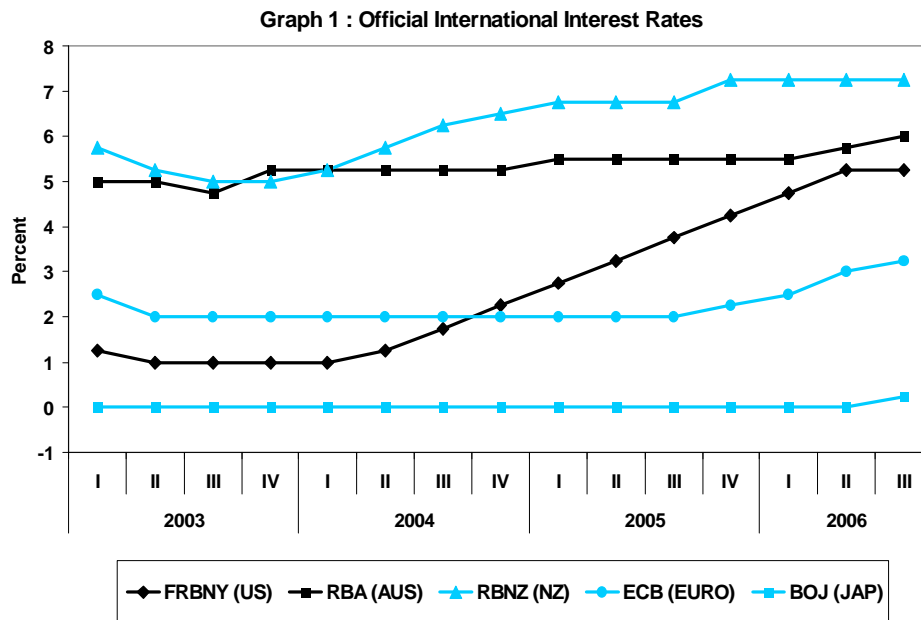
II. OVERVIEW OF ECONOMIC DEVELOPMENTS DURING THE THIRD QUARTER OF 2006.

a. The World Economy

The world economy continued to expand in the September quarter of 2006. While strong economic conditions generally prevailed in other parts of the world, growth in the United States had moderated. Significant improvements in conditions in the Euro area were again noted while the expansion in Japan continued. Strong growth rates were also seen in a range of emerging economies in Asia and elsewhere. Overall, the global expansion remained broadly based, and observers generally expect it to remain robust in the face of the moderate slowing now underway in the United States.

The US economy’s real GDP increased at an annual rate of 1.6 percent in the third quarter of 2006, compared to a reported 2.6 percent in the second quarter. The recent slowing mainly reflected the downturn in residential investment, which fell by almost 8 percent over the year to the September quarter. The softening of conditions in the housing market weakened consumer spending and eased growth in households’ wealth. The unemployment rate continued to fall, to be at a five-year low of 4.7 percent in the September quarter. Conditions for business investment remained favourable, although business sentiment was well down from peaks on most measures; it is at levels that have traditionally been associated with a moderate expansion in activity. Core inflation dropped to an annualized 2.7 percent in the September quarter. Headline inflation has also dropped significantly from 3.8 percent over the year to August to 2.1 percent in September.

In its two meetings in the September quarter, the Federal Open Market Committee (FOMC) decided to keep the Fed funds interest rate unchanged at 5.25 percent. In doing so, the Federal Reserve indicated at a continuation of moderate economic growth partly reflecting a cooling of the housing market. (See Graph 1.)



The Australian economic growth in the third quarter of 2006 was led by domestic spending and supported by the effect of the rising terms of trade. Notably, the improvement in Australia’s trade deficit was due to strong export growth. The unemployment rate came in at 4.7 percent in the September quarter compared to 4.9 percent of the previous quarter. Measures of consumer price inflation reflect these pressures, as consumer prices rose by 0.9 percent in the September quarter and by 3.9 percent over the year.

In the September quarter, the Reserve Bank of Australia decided to increase interest rates by 25 basis points, to 6.0 percent. The Board's assessment, based on the gradual increase in underlying inflation this year, and the wider background of above-average global growth and strong domestic demand, was that the underlying inflation in the period ahead was likely to exceed previous forecasts.

Growth in the New Zealand economy remained relatively subdued in the September quarter. Nevertheless, the labour market remained tight, with the unemployment rate close to record lows during the quarter under review. Although consumer confidence picked up, it was still below its long run average and growth in retail sales remained relatively soft in August, at 2.8 percent in year-end terms. Similarly, business confidence remained well below the long-run average. Consumer prices increased by 0.7 percent in the September quarter, but the annual CPI fell to 3.5 in the same quarter from 4.0 percent in the June quarter.

In its two meetings in the September quarter, the Reserve Bank of New Zealand decided to hold its official cash rate at 7.25 percent as recent economic activity has been weaker and clearly showing signs of easing.

The Euro area continued to show strength in the September quarter as industrial production grew solidly, increasing by 5.1 percent over the year to August. Measures of business sentiment remained at high levels. The unemployment rate declined from 8.5 percent to 7.8 percent over the year to September. Strong external demand appeared to have been a factor behind the positive business sentiment in the Euro area, although year-end growth in exports had softened.

The European Central Bank (ECB) in its September quarter interest rate review added another 0.25 percent, raising interest rates from 3.0 percent to 3.25 percent. Economic growth in the euro area has strengthened, and the ECB continued to see some upside risks to the inflation outlook. The market expects further rate increases next year.

Economic growth in the United Kingdom picked up further in the September quarter, with GDP expanding by 2.8 percent over the year. Consumption spending recovered solidly, supported by rising house prices and above-average levels of consumer sentiment. Employment has been growing moderately, but this has been outstripped by a significant expansion in the labour force due to immigration and increased participation by female and older workers.

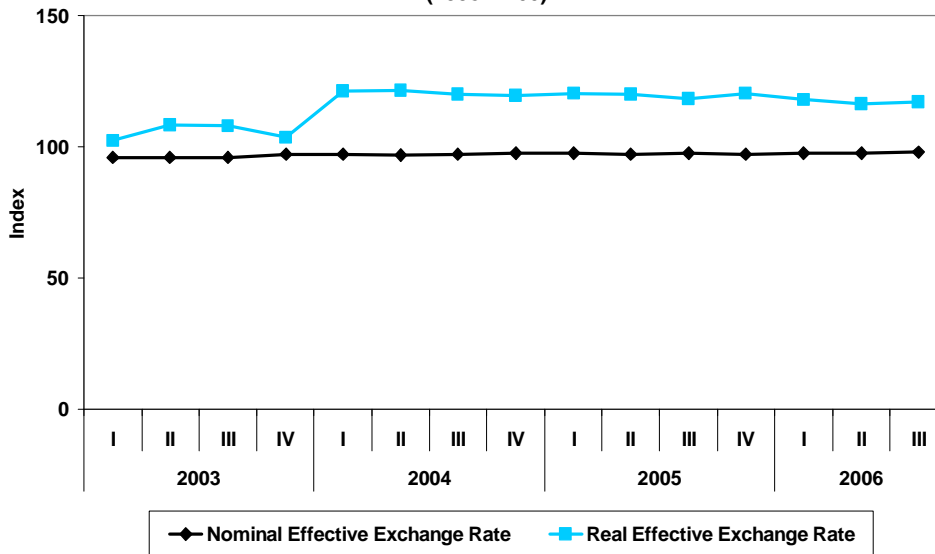
With inflation pressures building up in recent months, the Bank of England decided to raise its official cash rate by 0.25 percent to 4.75 percent in the September quarter. The Monetary Policy Committee concluded that the raise was necessary to bring CPI inflation back to the target in the medium term.

The economic expansion in Japan continued in the September quarter. Year-ended growth in industrial production remained solid at around 5 percent and capacity utilisation remained high. In the September quarter Tankan survey, business conditions were reported at their highest level in 15 years and the unemployment rate was around an eight-year low at 4.2 percent. Following its July meeting, the Bank of Japan (BoJ) announced a raise to the short-term interest rate to 0.25 percent as the operating target for monetary policy. Markets expect the next tightening by the BoJ to be in early 2007.

During the quarter under review, the US dollar had a mixed performance against the currencies of our major trading partners with its performance largely dependent on the slowing US economy. Otherwise, against the currencies of our major trading partners, the Tala appreciated against all the currencies in the basket with the exception of the New Zealand dollar. The value of the Tala in terms of its nominal index showed an appreciation of 0.10 percent in the third quarter of 2006.

Furthermore, since price rises in Samoa were higher than the price rises of our major trading partners and coupled with the appreciation of the Tala in nominal terms, the real effective exchange rate of the Tala rose 0.82 percent. (See Graph 2.)

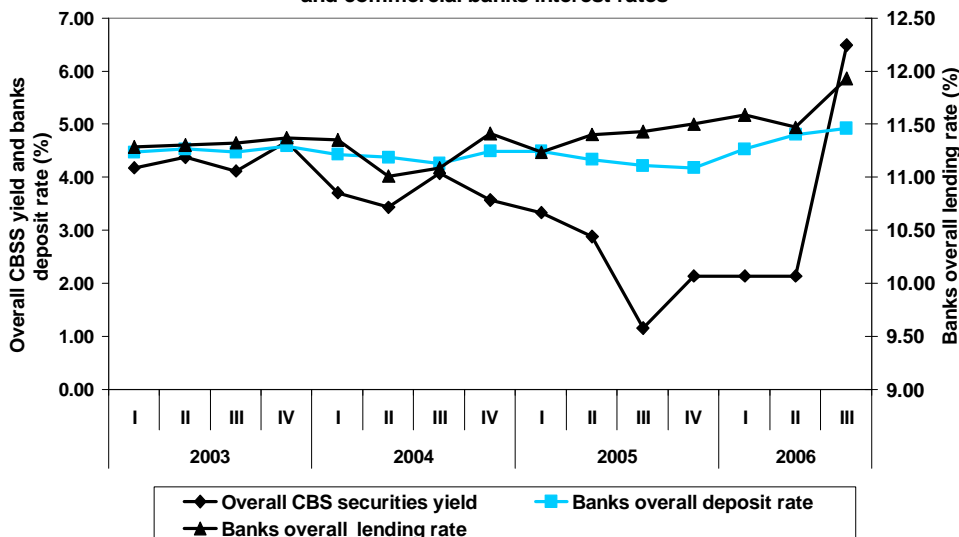
**Graph 2 : Trade Weighted Exchange Rate Index
(1998 = 100)**



b. The Samoan Economy

Government’s financial operations recorded a further overall cash surplus of \$1.4 million in the third quarter of 2006, complimenting the current tightened monetary policy stance adopted by the Central Bank. Consequently, the level of official interest rates rose to 6.50 percent from 2.14 percent at end June 2006, pushing up the overall level of commercial bank deposit and lending rates by 13 points to 4.93 percent and 46 points to 11.93 percent respectively at end September 2006. (See Graph 3.)

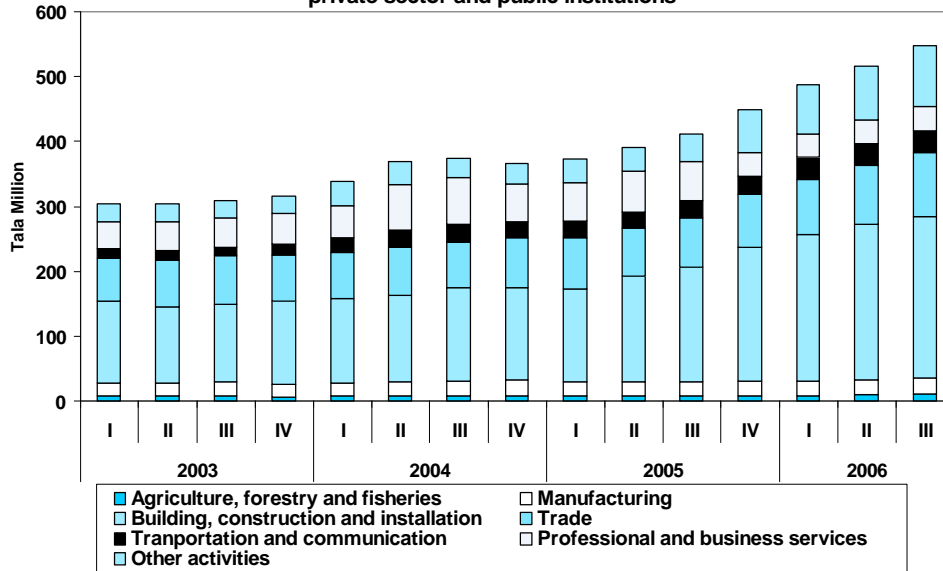
Graph 3 : Overall yield on CBS securities and commercial banks interest rates



Despite the increase in interest rates, very strong demand saw bank credit grow strongly exerting pressure on commercial bank liquidity. The growth momentum of credit continued on the back of strong demand for loans by the private sector and Government enterprises. Bank credit to the private sector and public institutions combined expanded \$25.1 million to \$544.5 million in the

September quarter of 2006, much higher than the \$22.5 million increase to \$415.8 million in the same period a year earlier. More commercial bank loans were extended to most sectors of the economy, particularly “Building and constructions” (up 3 percent), “Trade” (up 8 percent), “Agriculture” (up 30 percent), “Professional and business services” (up 6 percent), “Manufacturing” (up 5 percent) and “Other activities” (up 5 percent). (See Graph 4.)

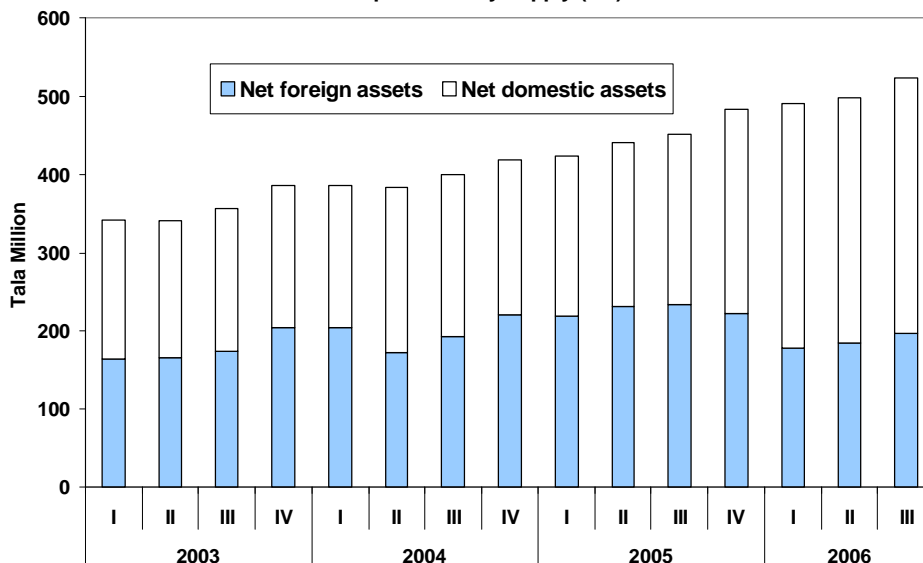
Graph 4 : Commercial banks credit to the private sector and public institutions



Consequent to the strong growth of credit, total commercial bank liquidity fell \$11.9 million (or 37 percent) from the second quarter of 2006. In particular, commercial banks’ excess reserves and cash holdings fell 44 percent to \$10.2 million and 35 percent to \$9.1 million respectively at end September 2006. At these levels, total liquidity and its various components were well below their corresponding levels last year.

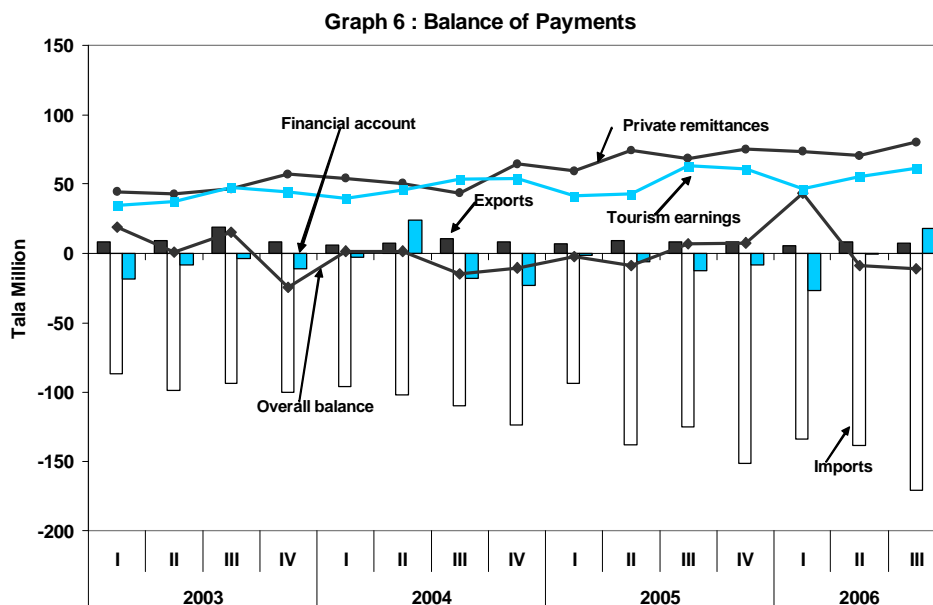
On the external sector, high levels of private remittances and inflows in the capital and financial accounts saw the balance of payments record an overall surplus, pushing up the level of gross official reserves by \$10.7 million in the three months to September 2006. The inflow of foreign funds combined with increased domestic credit to raise total money supply (M2) 5 percent to \$523.3 million, a level that was 16 percent higher than September 2005. (See Graph 5.)

Graph 5 : Money supply (M2)



Private remittances of \$80.7 million in the quarter under review were 15 percent higher than in the preceding quarter, reflecting the steady economic growth in the main source countries - USA, Australia and New Zealand - and the increased number of money transfer businesses locally and overseas. Over the previous quarter, tourism earnings were likewise 11 percent higher, driven by increases in both tourist arrivals and average tourist expenditures. Like the previous quarter, those who were here visiting friends and relatives dominated tourist arrivals during the quarter, followed by those on holidays.

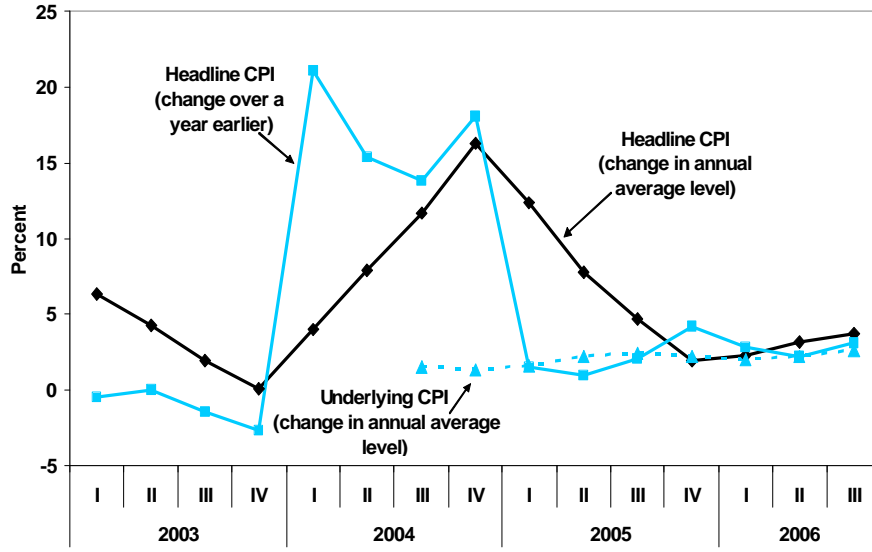
Total export earnings declined 5 percent to \$7.6 million in the September quarter of 2006, and were also 6 percent lower than the same quarter last year. Most of the major export commodities fell during the period under review, particularly nonu juice and beer which plunged more than four times and 51 percent from their respective levels in the June quarter. The recovery from a low catch since the beginning of the year led fish exports to continue to account for the bulk of export revenue, increasing its contribution to 74 percent from 56 percent in the previous quarter. Imports, on the other hand, increased by a significant 20 percent (\$27.8 million) to \$166.2 million from the preceding quarter, reflecting strong demand by both Government and the private sector. The resulting merchandise trade deficit therefore widened substantially by a further 22 percent in the quarter under review. (See Graph 6.)



The overall surplus in the balance of payments in the third quarter saw the level of gross official reserves recover from its low level in the second quarter. However, as a result of the continued strong rise in imports, the import cover of official reserves remained unchanged at 3.9 months at end September 2006 as it was at end June 2006 but lower than the 5.5 months at end September 2005. The low level of import cover, which is slightly below the benchmark target of 4.0 months, is therefore being monitored very closely.

On prices, favourable developments in the agriculture sector helped ease some of the pressure on inflation as the economy braced itself for the planned increase in the VAGST rate in October 2006. The volume of agricultural produce available at the Fugalei Market increased 6 percent in the three months to end September 2006, driving down the overall prices at the Market by 18 percent. Consequently, the annual rate, both the headline and underlying inflation rates, which started to trend upwards in February 2006, stabilized at 3.7 percent and 2.6 percent respectively in September 2006. Inflation in the coming months is, however, likely to rise due mainly to the increase in the VAGST rate in October. (See Graph 7).

Graph 7 : Consumer Price Index
(March 2004 = 100)



III. PRUDENTIAL SUPERVISION

For the quarter ended 30 September 2006, the banking system recorded a moderate growth of assets against liabilities whilst maintaining an adequate level of capital comfortably above the Central Bank's minimum requirement of 15.0 percent.

However, the overall liquidity level continued to slide at an undesirable pace and thus maintaining its lowest level when compared to the past five years against a record growth in loans and advances now reaching \$563 million at the end of the quarter.

At \$700.6 million, the commercial banks combined assets reflected an increase of 1.5 percent (\$10.2 million) in the September quarter and indicated an annual growth of 16.9 percent (\$101.5 million) when compared to the same time a year earlier. The composition of the commercial banks assets comprised mainly of loans and advances of \$562.9 million (80.3 percent of total assets), cash reserves and deposits with the Central Bank and other banks combined at \$94.4 million (13.5 percent) and fixed assets of \$45.9 million (6.5 percent) respectively.

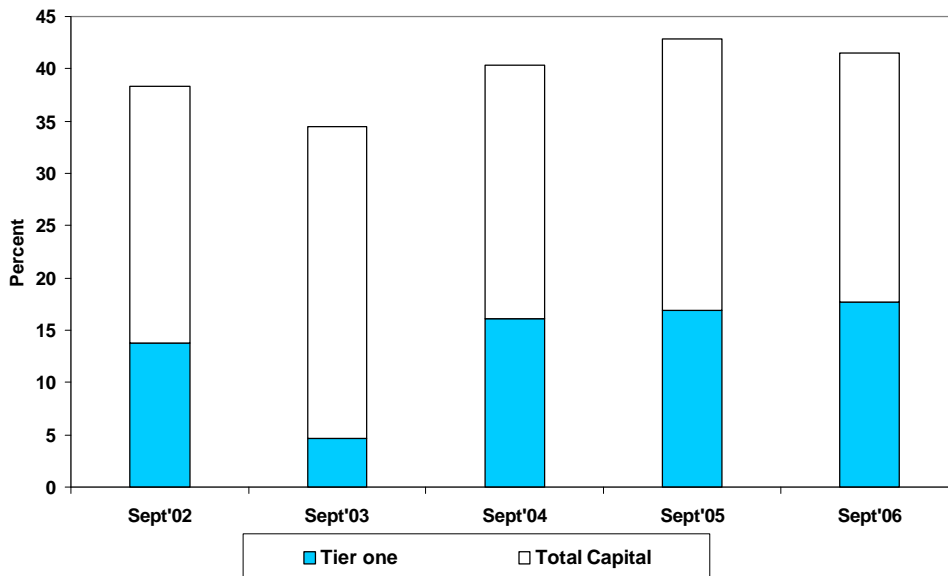
Total loans and advances of \$563 million increased further by 4.2 percent (\$22.9 million) at the end of the quarter, reflecting a substantial increase of 36.4 percent (\$150.1 million) over the same time a year earlier. The relatively strong growth in loans and advances was attributed mainly to loans and advances to private businesses and households, as well as to the Government.

There was some improvement shown in the level of deposit liabilities over the quarter, up 2.0 percent (\$10.6 million) from \$530.8 million. At this level, total deposit liabilities recorded an annual growth rate of 13.6 percent (\$64.9 million) when compared to the same period in the previous year. Time deposits (\$291.1 million) represents 41.6 percent of total deposits, demand deposits (\$182.3 million) accounted for 26.0 percent while savings deposits (\$68.0 million) made up 9.7 percent of total deposits.

Total contingent and off-balance sheet items rose by 7.2 percent (\$5.8 million) to \$86.2 million over the previous quarter, due mainly to increase in the banks commitments in the form of direct credit substitutes.

The banking system remained strongly capitalized at \$121.7 million, recording a further increase of 6.2 percent (\$7.2 million) over the previous quarter. This was due mainly to the banks profitable performance throughout the period. In relation to the overall level of risk weighted assets, the capital adequacy ratio edged up from 23.4 percent to 23.8 percent. Tier 1 capital of 17.7 percent recorded a decrease of 0.8 percent over the June 2006 quarter. (See Graph 8.)

Graph 8 : Capital Adequacy Ratio

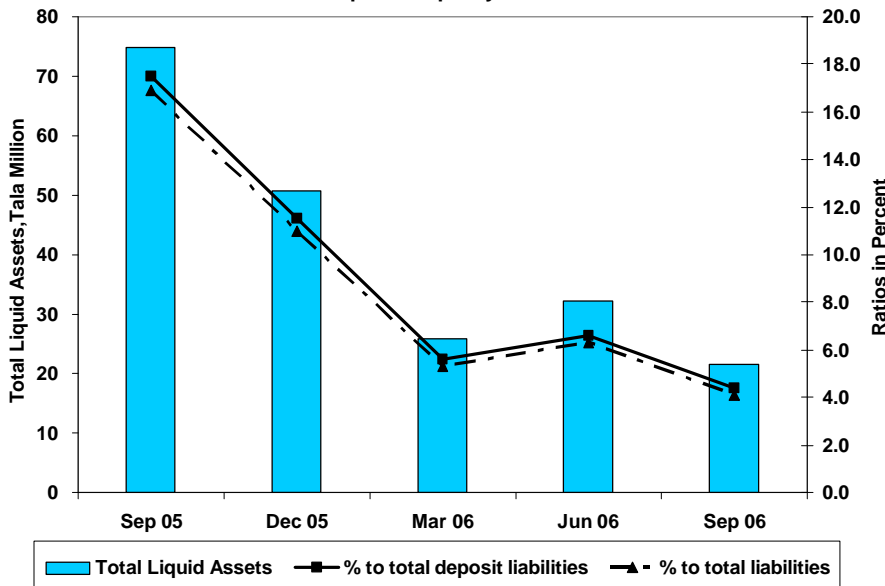


All the banks complied with the Central Bank’s minimum capital adequacy requirement (15.0 percent) at the end of the quarter.

The banking system continued to experience a rundown in the level of liquid assets, dropping further by 32.8 percent (\$10.6 million) over the previous quarter. This is a significant drop of 71.1 percent (\$53.1 million) when compared with the same time a year earlier, mainly due to the banks’ strong lending activities over the recent periods.

At \$21.6 million, total liquid assets is still at a low of 4.4 percent of total domestic deposit liabilities. The Central Bank Securities of \$1.0 million made up 4.6 percent of total liquid assets at the end of the quarter. (See Graph 9)

Graph 9 : Liquidity Position



At its Meeting on 27 October 2006, the Central Bank’s Board of Directors approved, in pursuant to Section 34 of the Central Bank of Samoa Act 1984, the reduction of the Statutory Reserve Deposit (SRD) ratio from 4.8 percent to 3.5 percent effective on the commercial banks’ total deposit liabilities for the month of September 2006. This change shall effectively release more

funds to the commercial banks to help ease the current pressure on the tight liquidity conditions experienced by the banking system.

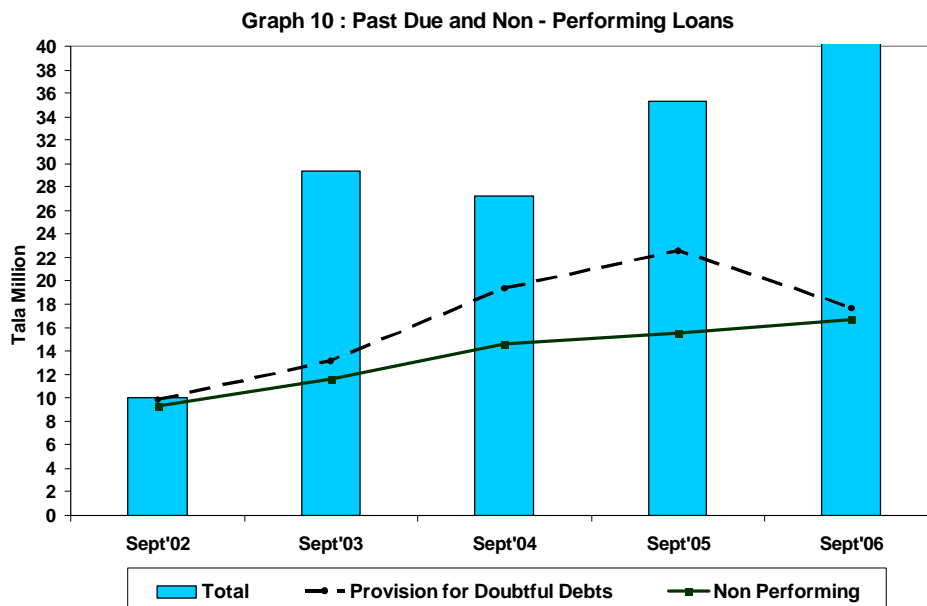
It is expected that the tight liquidity conditions will improve in the next six months. Thus, this policy change is made on a temporary basis and the SRD ratio will revert to the initial requirement of 4.8 percent of total deposit liabilities at the end of the six months period.

In making this policy change, the Central Bank has advised the commercial banks to be more vigilant in managing their liquidity positions to better suit their business strategies and cover the various financial risks that they plan to undertake by ensuring to set aside ample reserves to meet their daily financial obligations. At the same time, the commercial banks are still required to adhere to the Central Bank's current restrictive monetary policy stance for the present financial year.

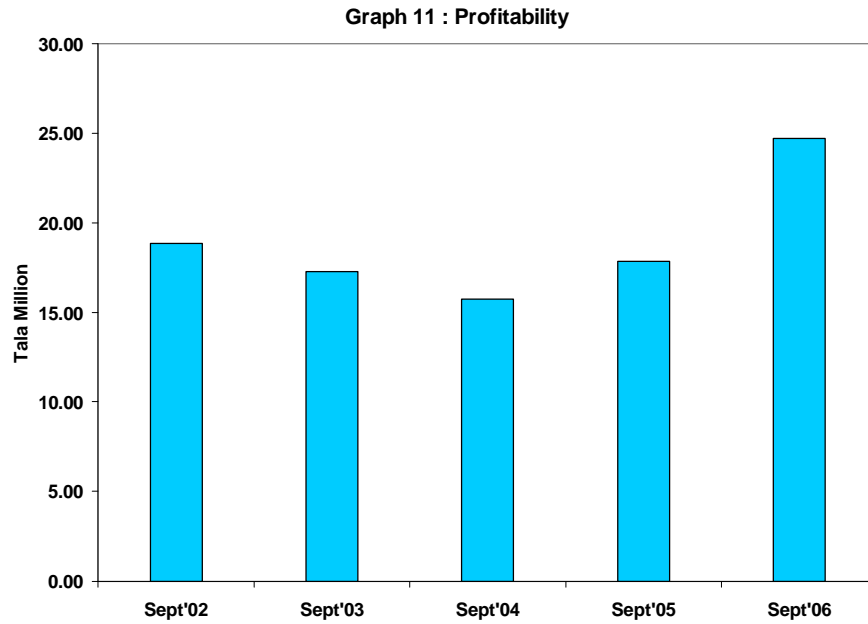
The combined foreign assets of the commercial banks amounted to \$54.7 million as compared to total foreign liabilities of \$52.1 million. At these levels, it showed a net long exposure position of around \$4.3 million or 3.5 percent of total capital.

Total non-performing loans dropped favorably by 22.6 percent (\$5.1 million) to \$17.6 million over the previous quarter. As compared to the prior year, it reduced further by 21.7 percent (\$4.9 million) respectively. In relation thereto, a total provision for bad and doubtful debts of \$16.7 million provides a 94.8 percent buffer against possible loan losses that may derive from non-performing loans. As a proportion of total loans and advances, total provision stood at 3.0 percent respectively.

The Central Bank continues to monitor closely the banks performances towards reducing their levels of arrearages and non-performing loans, which require them to be extra vigilant in their approaches towards asset quality. Equally important, is the need for the banks to ensure that adequate provisions are being provided to cover for such problem loans while recovery efforts are pursued. (See Graph 10).



At a combined figure of \$34.7 million, the banking system's pre tax profit level increased by 39.4 percent when compared to the same period a year earlier. Total net profit after tax therefore amounted to \$24.7 million, up markedly from \$17.9 million recorded a year earlier. At this level, return on average networth and assets stood at 22.8 percent and 3.8 percent respectively. (See Graph 11).



For the period under review, total operating expenses represented 60.6 percent of total income, an improved level of efficiency for the banking system when compared to the same time a year earlier. Furthermore, the banks also continued to achieve good earnings from their non-interest earning activities such as commission, fees and charges and foreign exchange gains.
