

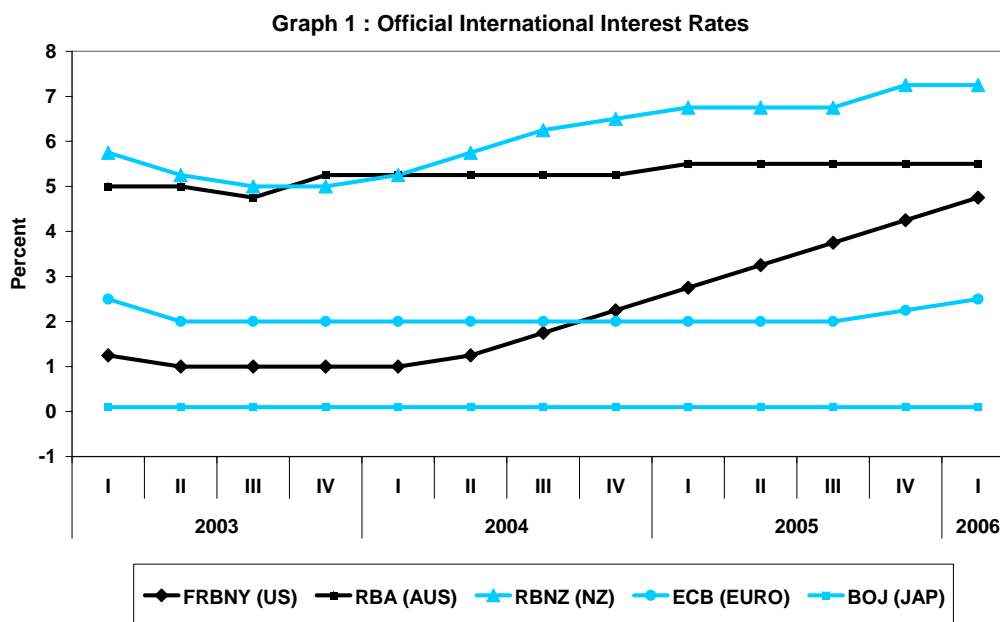
II. OVERVIEW OF ECONOMIC DEVELOPMENTS DURING THE FIRST QUARTER OF 2006.

a. The World Economy

The global economy continued to expand in the March quarter of 2006. Economic growth in both the United States and Asia-Pacific countries, the two main engines of global activity, increased in the first quarter of 2006. The economic recovery in Japan also gained strength. Strong growth was also evident in other emerging markets, and conditions remained supportive of recovery in the euro area.

The US economy started 2006 with solid momentum, with real GDP expanding by 1.2 percent in the quarter, to be 3.5 percent higher over the year. The strong expansion in real GDP was driven by domestic demand from strong growth in personal consumption expenditure and business investment spending. Net exports continued to be a drag on growth, with strong export growth outpaced by import growth. Thus the US current account deficit was 6.2 percent of GDP in the March quarter. On the other hand, inflation remained moderate with core CPI inflation around 2 percent in March. Nonetheless, with the economy operating at a high level of capacity utilisation and ongoing strength in energy and other commodity prices, the US Federal Reserve continued to tighten monetary policy.

In its two meetings in the March quarter, the US Federal Open Market Committee (FOMC) decided to raise the Fed funds target rate from 4.25 percent to 4.50 percent and then to 4.75 percent. With US interest rates now at more normal levels, the policy statement, however, continued to highlight upside risks to inflation and signalled that some further policy firming may be required. (See Graph 1.)



The Australian economy continued to benefit from favourable international conditions due to the increases in commodity prices. The annualised growth rate of the Australian economy up to end March 2006 was 4.7 percent, above its long-term trend of 3.8 percent. The unemployment rate edged up to 5.3 percent in early 2006, but then returned to a 30-year low of 5.0 percent in March. Consumer prices in the March quarter were higher than expected, with the CPI rising 0.9 percent in the quarter and 3.0 percent over the year.

In the March quarter, the Reserve Bank of Australia continued to hold interest rates at 5.50 percent. While the Board had adopted this stance since March of 2005, the RBA will continue to monitor developments and make policy adjustments as required to promote sustainable economic growth with low inflation.

The New Zealand economic growth in early 2006 continued to slow as was evident towards the end of 2005. Most indicators pointed to a period of weak growth during 2006 as the lagged impacts of the previous high level of the exchange rate, past interest rate increases as well as the more recent high petrol prices and falls in New Zealand's terms of trade, all acted to constrain growth.

In its two meetings in the March quarter, the Reserve Bank of New Zealand decided to hold its official cash rate at 7.25 percent as recent data confirmed the view that economic growth was slowing.

The euro area at the start of 2006 displayed buoyant business sentiment and improved consumer confidence. Corporate profitability has increased further and investment growth has remained relatively strong. Given continued strength in external demand, merchandise exports picked up further, increasing by 13 percent over the year to February. Industrial production also picked up, increasing by 3.2 percent over the year to February.

The European Central Bank (ECB) in its March quarter interest rate review added another 0.25 percentage points, raising interest rates from 2.25 percent to 2.50 percent. The Bank announcement expressed confidence in the region's recovery in output growth and concern over the upside risks to price stability.

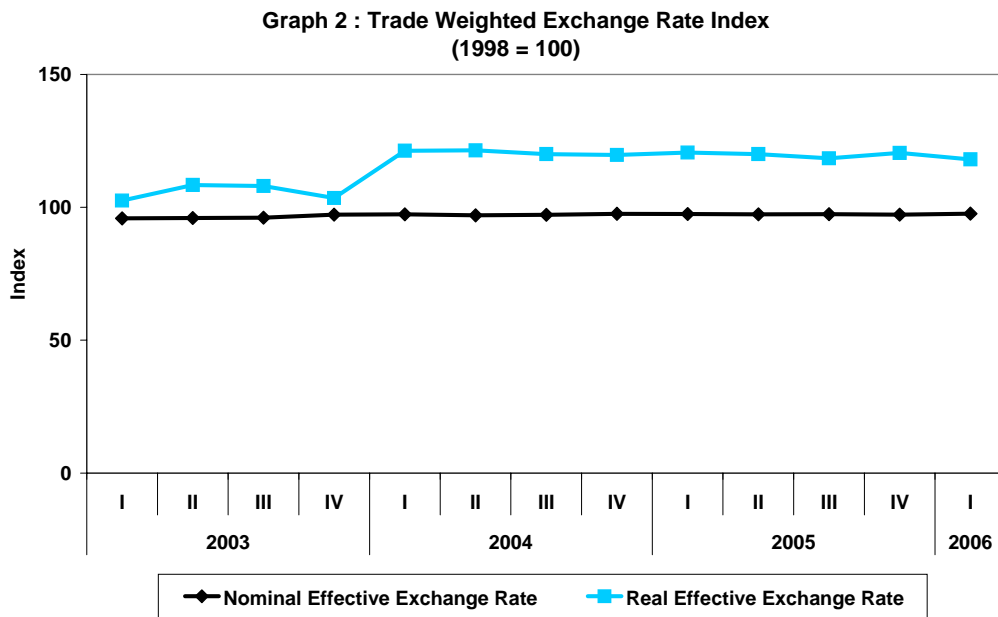
According to preliminary estimates for the United Kingdom, the quarterly growth rate of real GDP in the first quarter of 2006 is 0.6 percent, unchanged from the previous quarter. Given weak retail sales data, household consumption is estimated to have softened in the first three months of 2006. The unemployment rate continued to increase, reaching 5.1 percent on average to February 2006.

With inflation pressures remaining subdued, the Bank of England decided to hold its official cash rate at 4.50 percent in all of its three reviews in the March quarter. The Monetary Policy Committee concluded that the pipeline inflation pressures in the United Kingdom were modest, and it seems likely that inflation would fall below the 2 percent target in the medium term.

The Japanese economic recovery continued to build, with the rise in consumer prices seen in early 2006, suggesting that the economy has emerged from its extended period of deflation. In the March quarter, industrial production increased 3 percent over the year and merchandise exports were 18 percent higher, boosted by the global ITC recovery. Machinery orders remained on an upward trend in early 2006, and investment intentions were again revised upwards in the March quarter Tankan survey. In this context, following its March meeting, the Bank of Japan announced the end of the quantitative easing policy and returned to using the short-term interest rate as the operating target for monetary policy. However, the change in policy framework is expected to have little immediate effect on economic activity, with the short-term interest rate remaining at zero for the time being.

During the quarter under review, the US dollar weakened earlier before recovering some of its ground towards the end of the quarter. This was a result of two interest rate hikes by the US central bank earlier in the year which restored confidence in the US dollar. The slight recovery of the US dollar against the currencies of Samoa's trading partners led to an appreciation of the Tala against the New Zealand dollar and the Fijian dollar but weakened against the US dollar, Australian dollar and the Euro. The value of the Tala in terms of its nominal index showed an

appreciation of 0.41 percent in the first quarter of 2006. Furthermore, since price rises in Samoa were less in contrast with the price rises of our major trading partners, the real effective exchange rate of the Tala fell 1.98 percent. (See Graph 2.)

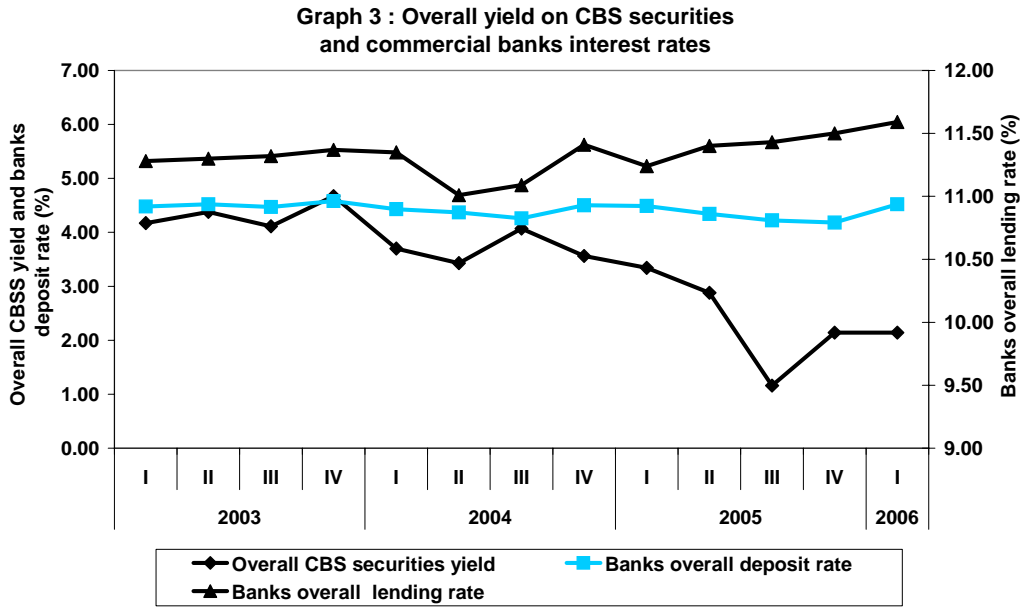


b. The Samoan Economy

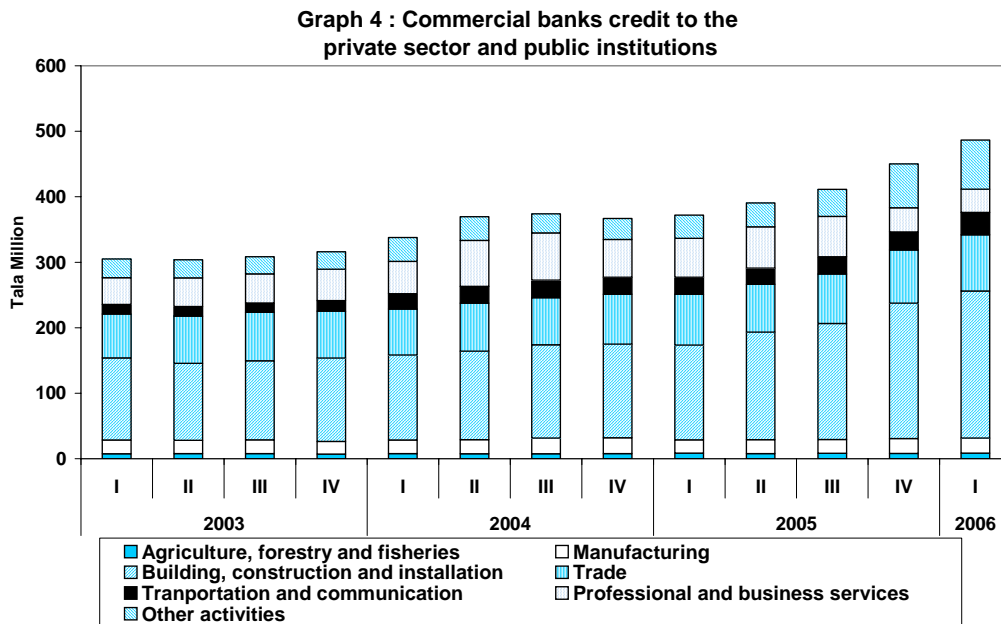
In Samoa, the expansionary impact of the Government's financial operations on the domestic economy during the first quarter of 2006 was partly moderated by the continuation of tight monetary policy. Government's financial operations in the quarter under review closed with a quarterly cash deficit of \$24.2 million vis-à-vis the monetary system, the highest level since the third quarter of 2003. The cash deficit saw Government's accounts with the banking system, falling into the red zone by \$11.0 million in the March 2006 quarter, while Government's deposits with the Central Bank were reduced by \$5.5 million. These were partially offset by a \$1.6 million improvement in Government's foreign exchange holdings. Contributing to the substantial decrease in Government's net position with the monetary system were the settlement by Government of some of the national airline's external debts, the ongoing infrastructural preparations for the 2007 South Pacific Games, the urgently needed repair and reconstruction of infrastructure that was badly damaged by very heavy flooding in February 2006 and the completion of outstanding projects prior to the completion of Government's five year term in March 2006.

With the huge outflow of international liquidity following the settlement of some of Polynesian Airlines external debts by Government, monetary policy, by necessity, remained tightened in the quarter under review to safeguard the level of official foreign exchange reserves. In the March 2006 quarter, therefore, the level of the banks' excess liquidity edged further down to \$13.9 million, its lowest level since end June 2000. That level of excess liquidity was below the \$15.0 million level that was considered comfortable for the banking system to maintain at all times. Combining the holdings of CBS securities with holdings of excess liquidity, total commercial bank liquidity at the end of the March 2006 quarter fell \$21.9 million to \$14.4 million. The sharp reduction in total liquidity, particularly the very low level of excess liquidity in the banking system, did not warrant any new issue of CBS securities during the quarter under review. The tight liquidity conditions in the quarter under review saw the weighted average commercial bank deposit rate increasing 29 points to 4.46 percent as the banks competed for more funds to meet the unprecedented strong demand for loans, pushing up slightly the weighted average lending rate by 6 points to 11.58 percent. The rise in commercial bank interest rates was considered minimal especially given the exceptionally tight level of liquidity and strong demand for loans. In the

process, the commercial banks' interest rate spread narrowed 23 points to 7.12 percent. (See Graph 3.)

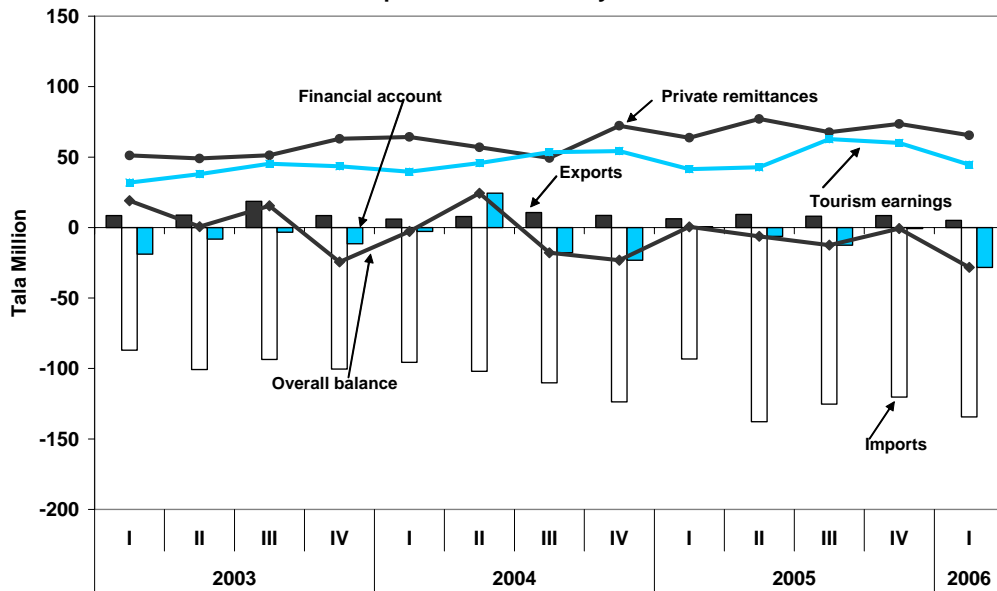


Together with the strong growth in credit to the private sector, the financing of Government's cash deficit vis-à-vis the monetary system saw total domestic credit expand \$55.8 million or 15 percent in the March 2006 quarter. In particular, bank credit to the private sector rose \$32.7 million or 7 percent to \$471.8 million in the quarter under review. Fueling real economic growth in the first quarter was a sharp rise in loans to the "Building" sector (up \$23.9 million) as well as significant increases in loans to the "Transportation" sector (up \$4.8 million) and the "Trade" sector (up \$4.3 million). (See Graph 4.)



The cash deficit in the budget, which was partly attributed to the settlement of some of Polynesian Airline's external debts, combined with a seasonal reduction in exports, private remittances and tourism earnings, to drive the balance of payments into a substantial quarterly overall deficit of \$43.5 million. (See Graph 5.)

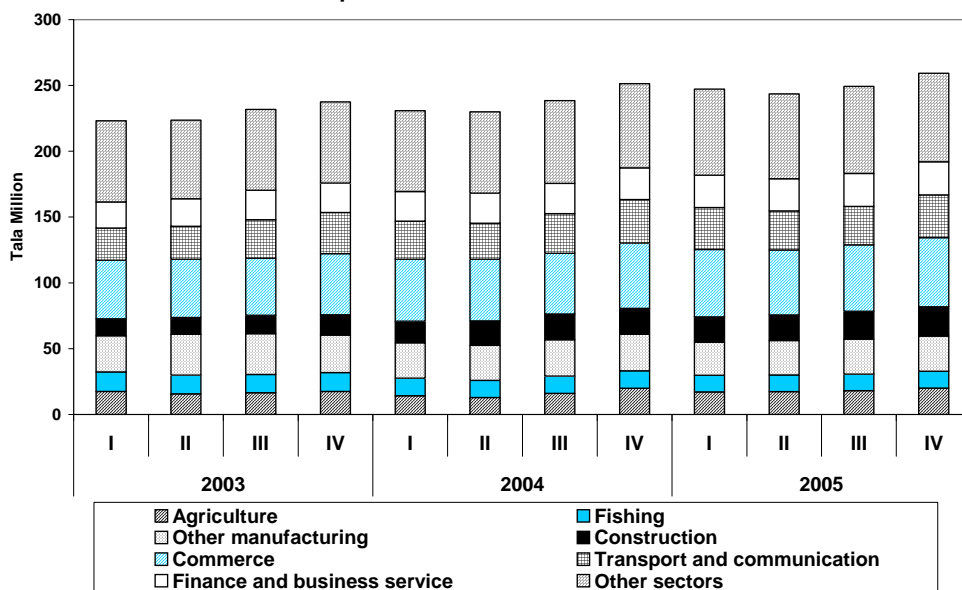
Graph 5 : Balance of Payments



Exports fell 40 percent to \$5.1 million due to reductions in almost all major export products. Private remittances went down 7 percent to \$62.3 million and tourism earnings decreased 26 percent to \$44.5 million. Imports typically fell in the quarter under review, going down 11 percent to \$134.4 million mainly as a result of reductions in non-petroleum imports (down \$17.4 million) and petroleum imports (down \$3.2 million). The overall deficit in the balance of payments pulled down the level of official international reserves to \$208.3 million. At this level, official reserves at the end of March 2006 was sufficient to finance 3.7 months of imports which was substantially lower than the 5.1 months at the end of December 2005.

On the real sector, national accounts figures for the March 2006 quarter are not yet available. However, the latest indicators suggest that after discounting the usual seasonal decline following the hype associated with the end of year festivities in the December 2005 quarter, the economy grew in real terms, boosted by the continued strong growths in the construction sector, the transport sector, commerce sector and the agriculture sector. (See Graph 6.)

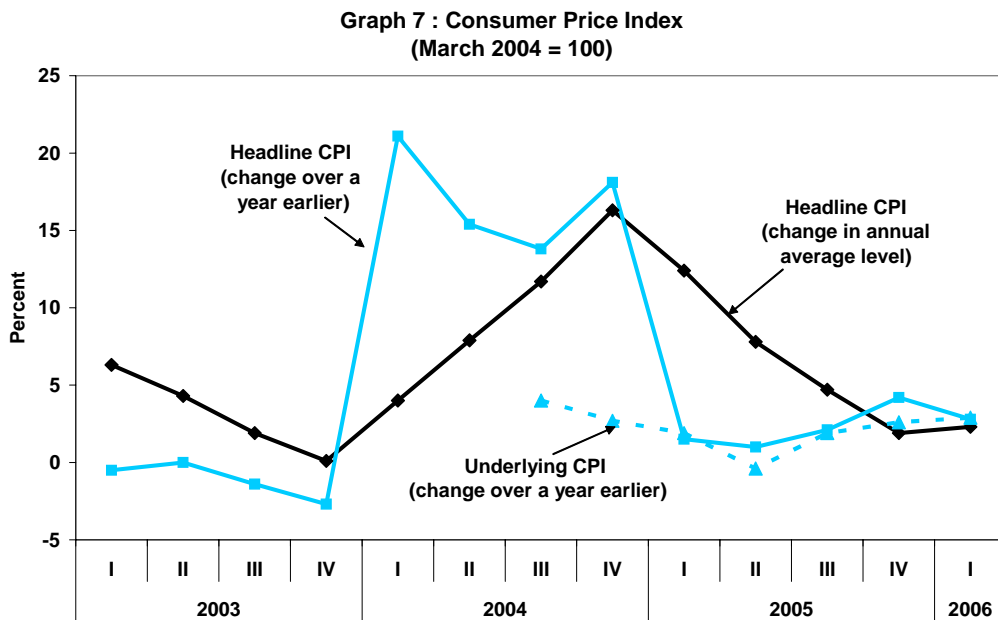
Graph 6: Real Gross Domestic Product



Real economic growth was predominantly driven by the ongoing construction of facilities for the 2007 South Pacific Games, repair and reconstruction of infrastructure that was badly damaged by

very heavy flooding in February 2006, construction of the Development Bank Headquarters, the construction of some large private sector buildings and the completion of outstanding infrastructure projects. On the agriculture sector, the overall level of supplies to the Fugalei Market fell 32 percent and the overall price level increased 21 percent, a trend that was typical of this quarter every year.

On inflation, the headline Consumer Price Index (CPI) registered an increase (up 0.1 percent) in the March 2006 quarter. The marginal rise in the CPI was caused by a 0.4 percent increase in the local component, partially offset by a 0.1 percent fall in the imported component. A rise in the local food sub index (up 0.8 percent), which includes the price of fresh fish, accounted for the increase in the local component whereas a reduction of 1.5 percent in the “Clothing and Footwear” and the “Imported food” sub indices accounted mainly for the fall in the import component. Compared with a year ago, the headline CPI at end March 2006 was 2.8 percent higher. Consequently, the annual headline inflation rate rose to 2.3 percent at the end of the quarter under review from 1.9 percent at end December 2005. However, leaving aside the prices of the officially regulated items and the highly volatile prices of seasonal commodities, the underlying annual inflation rate at the end of March 2006 was 1.6 percent, up from 1.3 percent in December 2005. (See Graph 7.)



Given that the level of international reserves has fallen below the minimum comfortable level of 4.0 months imports and that inflation is rising, monetary policy will remain tight in the foreseeable future to safeguard reserves and minimize inflation.

III. PRUDENTIAL SUPERVISION

At the end of the March 2006 quarter, the banking system achieved a marked growth in assets, underpinned by a relatively strong rundown in the level of liquidity, largely as a result of banks capitalizing on their contingency commitments with their customers.

At this point, the overall liquidity has recorded its lowest level over the past five years against a record growth in loans and advances now reaching over the \$500 million mark at the end of the quarter. Naturally, such growth has brought about positive results, which among others, reflected on the banks improved profitability that shall continue to support their capital base for their ongoing financial activities.

At \$653.3 million, the commercial banks combined assets reflected an increase of 5.0 percent (\$31.2 million) in the March quarter and indicated an annual growth of 14.8 percent (\$84.5 million) when compared to the same time a year earlier. The composition of the commercial banks assets comprised mainly of loans and advances of \$512.3 million (78.4 percent of total assets), cash reserves and deposits with the Central Bank and other banks combined at \$99.5 million (15.2 percent) and fixed assets of \$45.3 million (6.9 percent) respectively.

Total loans and advances of \$512.3 million increased markedly by 11.3 percent (\$51.9 million) at the end of the quarter and showed a substantial increase of 35.0 percent (\$132.7 million) over the same time in the previous year. The strong growth in loans and advances was attributed mainly to loans to private businesses and households and Government.

There was a strong increase in domestic time deposits which more than offset the decline in savings deposits and resulted in an overall increase in deposit liabilities of 4.2 percent (\$20.8 million) over the previous quarter. At this level, total deposit liabilities registered an annual growth rate of 14.8 percent (\$66.1 million) when compared to the same period a year earlier.

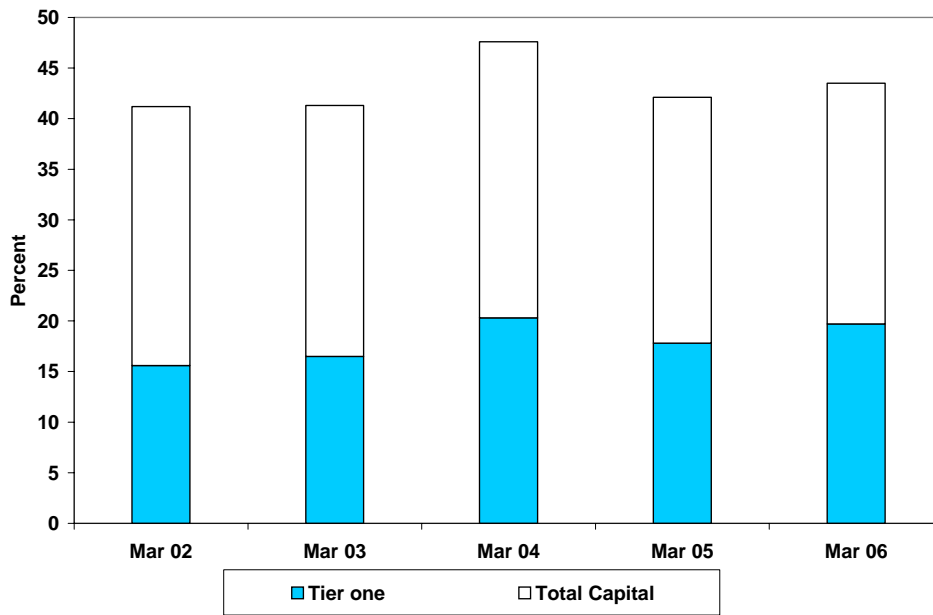
Total contingent and off-balance sheet items decreased dramatically by 29.5 percent (\$26.6 million) to \$63.5 million over the previous quarter, due mainly to reductions in trade related items (letter of credits) of \$2.3 million and unused credit commitments of \$24.3 million respectively.

The banking system remained strongly capitalized at \$108.5 million, recording an increase of 6.5 percent (\$6.6 million) over the previous quarter, due mainly to the banks profitable performance throughout the period. In relation to the overall level of risk weighted assets, the capital adequacy ratio dropped slightly by 0.3 percent to 23.8 percent. Tier 1 capital of 19.7 percent recorded a decrease of 0.9 percent over the December 2005 quarter. (See Graph 8.)

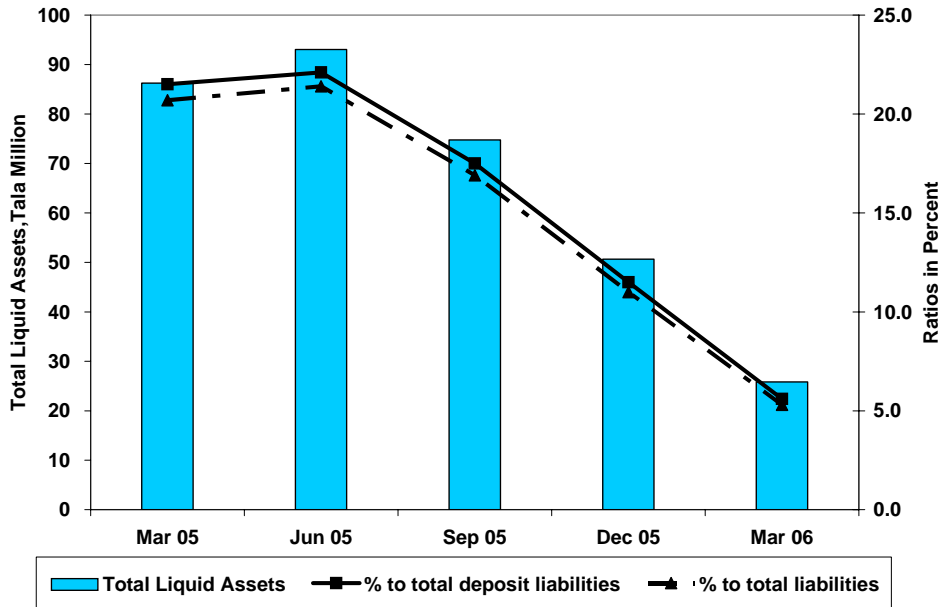
All the banks complied with the Central Bank's minimum capital adequacy requirement (15.0 percent) at the end of the quarter.

The banking system experienced a significant decrease in the level of liquid assets by 49.0 percent (\$24.8 million) over the quarter, reflecting a significant drop of 70.0 percent (\$60.4 million) over the past twelve months. This was due mainly to the strong lending activities of banks during the quarter. Total liquid assets stood at \$25.8 million, equivalent to 5.6 percent of total domestic deposit liabilities. The Central Bank Securities of \$0.5 million made up 1.9 percent of total liquid assets at the end of the quarter. (See Graph 9.)

Graph 8 : Capital Adequacy Ratio



Graph 9 : Liquidity Position

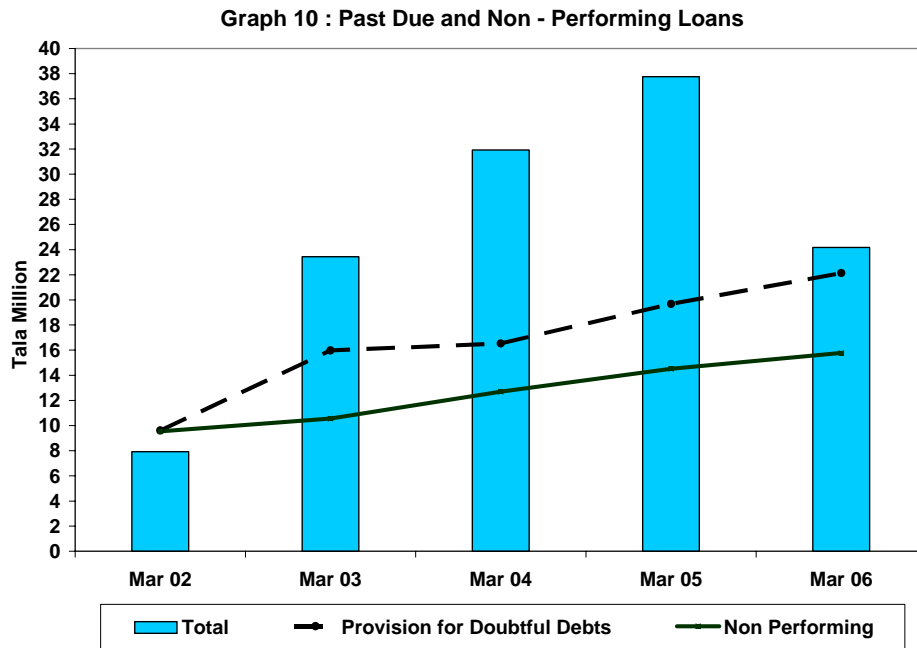


The combined foreign assets of the commercial banks amounted to \$61.1 million as compared to total foreign liabilities of \$58.0 million. At these levels, it showed a net long exposure position of around \$3.2 million or 2.9 percent of total capital.

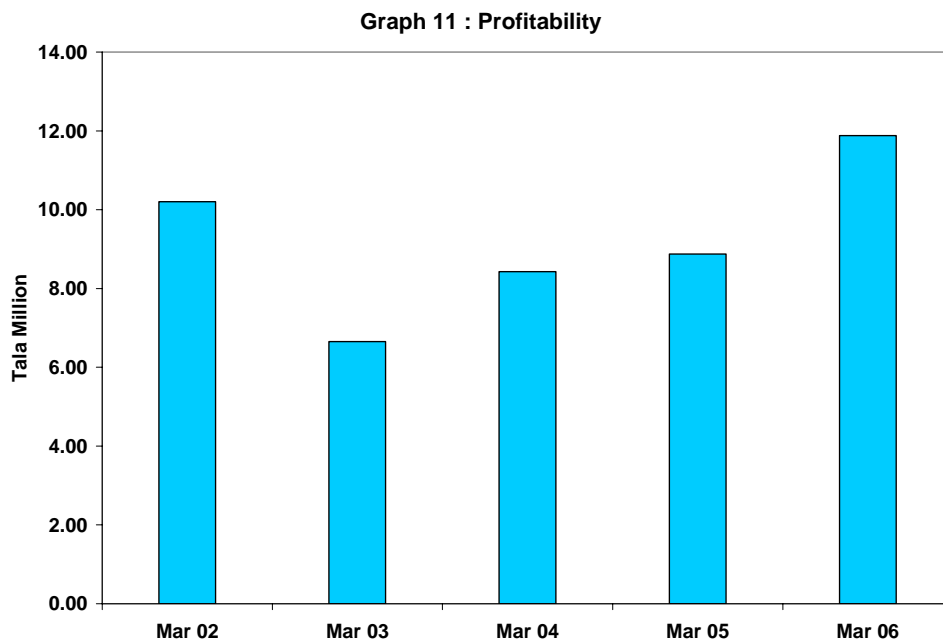
Total non-performing loans deteriorated further by 9.5 percent (\$1.9 million) to \$22.1 million over the previous quarter. As compared to the prior year, it rose further by 12.5 percent (\$2.5 million) respectively. In relation thereto, a total amount of \$2.2 million has been expensed as losses in relation to loans and advances that have been recognized as bad debts, an unfavourable upward trend from \$1.7 million recorded in the same time a year earlier.

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 \$16.6 million, the banking system’s pre tax profit level increased by 33.4 percent in the quarter under review when compared to the same period a year earlier. Total net profit after tax therefore amounted to \$11.9 million, up markedly from \$8.9 million recorded a year earlier. At this level, return on average networth and assets stood at 11.8 percent and 1.9 percent respectively. (See Graph 11.)



For the period under review, total operating expenses represented 65.8 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.
