

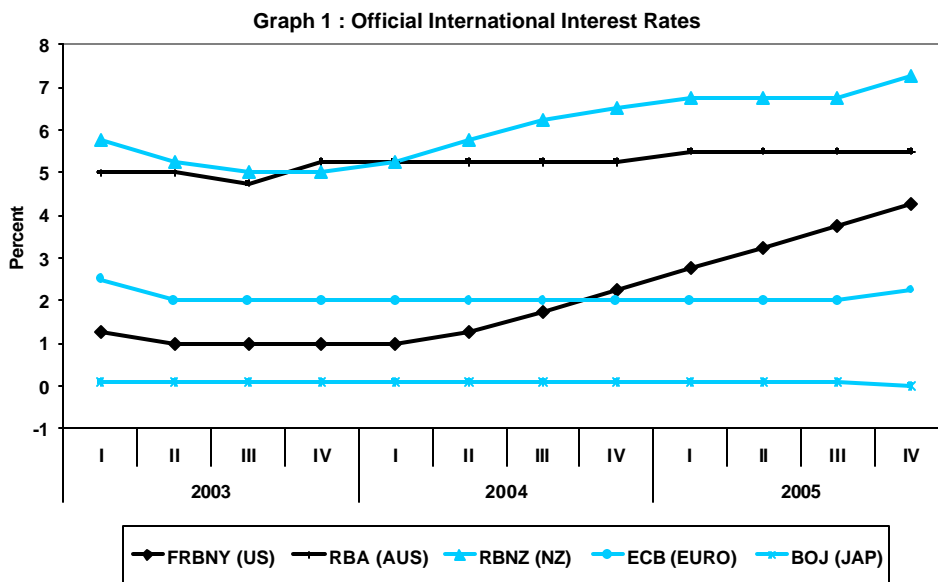
## II. OVERVIEW OF ECONOMIC DEVELOPMENTS DURING THE FOURTH QUARTER OF 2005.

### a. The World Economy

The world economy continued to expand at a solid pace in the December quarter of 2005. The US economy remained sturdy, despite the drop in fourth quarter growth while economic improvement in Japan firmed as demand in the global information technology sector began to recover. In addition, after a disappointing performance in recent years, growth in the euro area appears to be strengthening. In other emerging economies, high commodity prices and expansionary financial conditions continued to support solid growth.

The US economy posted above trend growth in 2005, with real GDP expanding by 3.5 percent. The quarterly growth rate fell to 0.3 percent in the December quarter. However, recent indicators suggested that the earlier hurricanes and spike in retail petrol prices had little lasting impact on the US economy. Labour market conditions remained firm in the December quarter, and the unemployment rate registered 4.7 percent at the end of the year. At 4.7 percent, the unemployment rate is at a 4 ½ -year low, and forward indicators suggest continued strong employment growth. After peaking at 4.7 percent in September, year-ended headline CPI inflation declined to 3.4 percent in December, as petrol prices fell back following the hurricanes.

In its two meetings in the December quarter, the Federal Open Market Committee (FOMC) decided to raise the Fed funds target from 3.75 percent to 4.0 percent and then to 4.25 percent. With US interest rates now at more normal levels, the Fed will soon pause in the current tightening cycle to assess whether incoming data about the economic cycle and inflation warrant a tighter stance in monetary policy settings. (See Graph 1.)



The annual rate of growth in Australia in 2005 was 2.6 percent, the fourth consecutive quarter of annual growth below 3 percent. The labour market remained tight, with unemployment rate still hovering around 30 year lows. Employment growth stalled over the past three months, with the annual rate falling to 2.3 percent in December from the August peak of 4.2 percent. Consumer prices increased 0.5 percent in the December quarter and 2.8 percent over the past year. The annual figure was boosted by rising fuel prices, while underlying inflation measures have remained broadly stable at around 2.5 percent.

In the December quarter, the Reserve Bank of Australia (RBA) continued to hold interest rates at 5.50 percent. While the RBA has adopted this stance since March of 2005, it took the view that international forces continued to influence the Australian economy, namely the global expansion and rising commodity prices.

New Zealand economic growth has continued to slow. Data at the end of 2005 supported further indications that the slow down in the New Zealand economy has yet to come to a halt. This slowdown in the fourth quarter included low retail sales, low business confidence, weak export performance, slowing employment growth and declining investment intentions. The GDP for the December quarter contracted 0.1 percent, compared to the increase forecast of 2.0 percent. The current account deficit for 2005 of \$13.7 billion was also the worst ratio in relation to GDP of 9 percent since 1986 when it was also 8.9 percent. While economic growth has slowed, inflation concerns remain with consumer prices rising 0.7 percent in the December quarter and 3.2 percent over the year.

In its two meetings in the December quarter, the Reserve Bank of New Zealand decided to raise the official cash rate from 6.75 percent to 7.0 percent and then to 7.25 percent, citing concerns about a lack of spare capacity in the economy and associated inflation pressures.

Despite the improvement in the Euro-zone business sector, household consumption remained subdued. Euro-wide retail sales growth was just 0.7 percent over the year to December, weighed down by weak wage growth. Nonetheless, the euro area unemployment rate has fallen to 8.4 percent, from a peak of 8.9 percent, and consumer sentiment has increased to around long-run average levels in December for the first time in more than three years.

The European Central Bank (ECB) made its first policy tightening in the December quarter, raising interest rates by 0.25 percent to 2.25 percent. The Bank noted that the increased pace of activity could begin to put pressure on inflation and create concerns about the rapid rate of money supply growth.

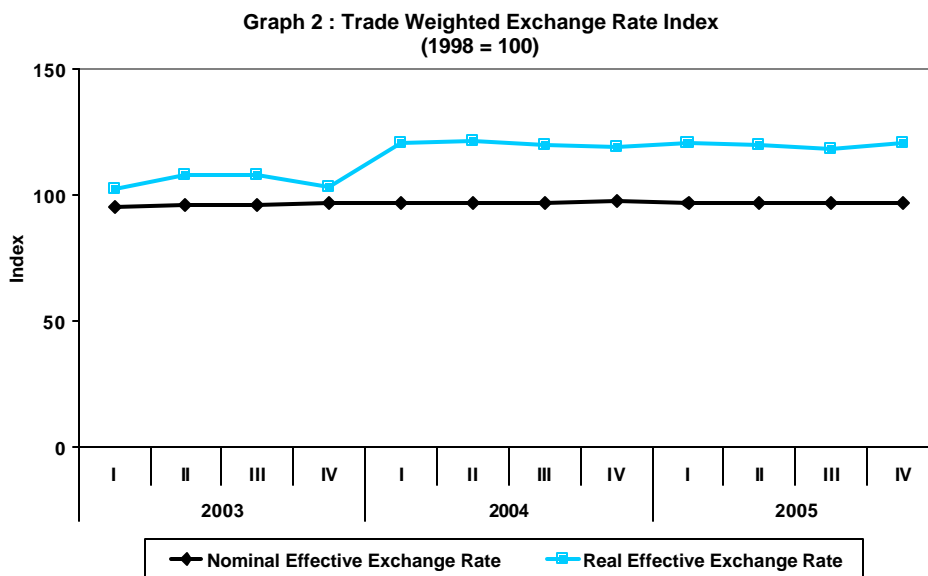
The pace of growth of the UK economy remained relatively subdued, but appeared to have stabilised. GDP grew 0.6 percent in the December quarter and by 1.7 percent over the year. Strong profitability and increased external demand have supported activity in the business sector. However, inflation pressures remain subdued, with average earnings growth slowing to 3.4 percent over the year to November and underlying inflation running at 1.2 percent over the year to December.

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 December quarter. The Monetary Policy Committee concluded that the pipeline inflation pressures in the United Kingdom were easing with output price inflation moving lower. Therefore this argument implied that the CPI inflation was likely to undershoot the 2 percent target in the medium term.

The Japanese economy continued to show recovery at the end of 2005. More timely data showed industrial production and machinery orders rose in the December quarter. Merchandise export volumes increased by 10 percent over the year to December. In addition, business conditions reported by the Tankan survey in the December quarter were at their highest levels in 10 years. On the interest rate front, policy interest rates in Japan have been zero for more than five years now. Part of the Bank of Japan's monetary policy has been to provide unusually large amount of liquidity to banks and the recent policy debate has revolved around when this policy will end, given that the financial system is now in better health and that economic recovery has taken hold. However, markets expected that this would occur in the coming months, but that the more important step of beginning to raise interest rates is not expected to occur in 2006.

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During the quarter under review, the US dollar continued the appreciation that had been occurring since the start of the 2005. This came about due to the ongoing tightening of monetary policy and better economic data on the US economy. The slight recovery of the US dollar against the currencies of Samoa's trading partners in effect led to an appreciation of the Tala against the New Zealand dollar, Australian dollar, Euro and the Fiji dollar with the exception of the US dollar. Since the weight of the US dollar in the basket outweighs those of other currencies, the value of the Tala in terms of its nominal index showed a depreciation of 0.17 percent in the fourth quarter of 2005. Furthermore, since price rises in Samoa is less than the price rises of our major trading partners, the real effective exchange rate of the Tala rose 1.75 percent.

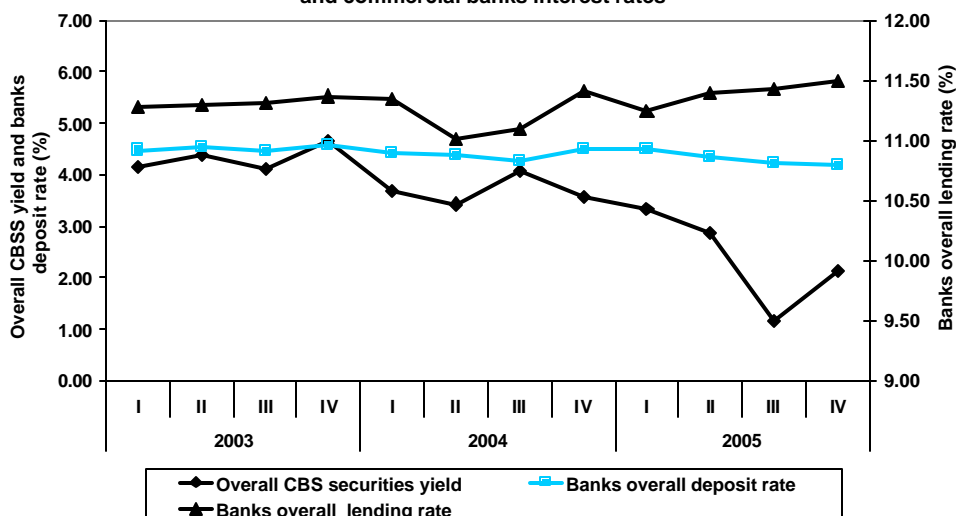


## b. The Samoan Economy

On the domestic front, monetary policy continued with its tightening stance in the December quarter which saw official interest rates rise from the previous quarter. Government's fiscal position, on the other hand, was expansionary as the quarter closed with an overall budget deficit of \$7.2 million and a larger \$10.0 million cash deficit.

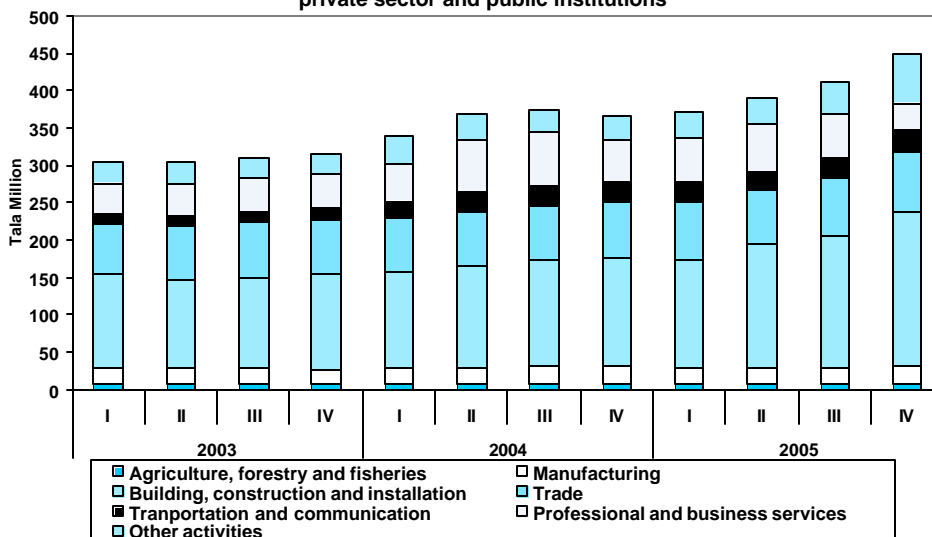
In line with the contractionary impetus of monetary policy, the official interest rate rose to 2.14 percent at end December 2005 from 1.16 percent at end September, as excess reserves of the commercial banks plunged to an average of \$25 million from \$40.3 million in the previous quarter. The commercial banks' weighted average lending rate likewise increased 1 percentage point to 11.52 percent while the weighted average deposit rate declined further to 4.17 percent. (See Graph 3).

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

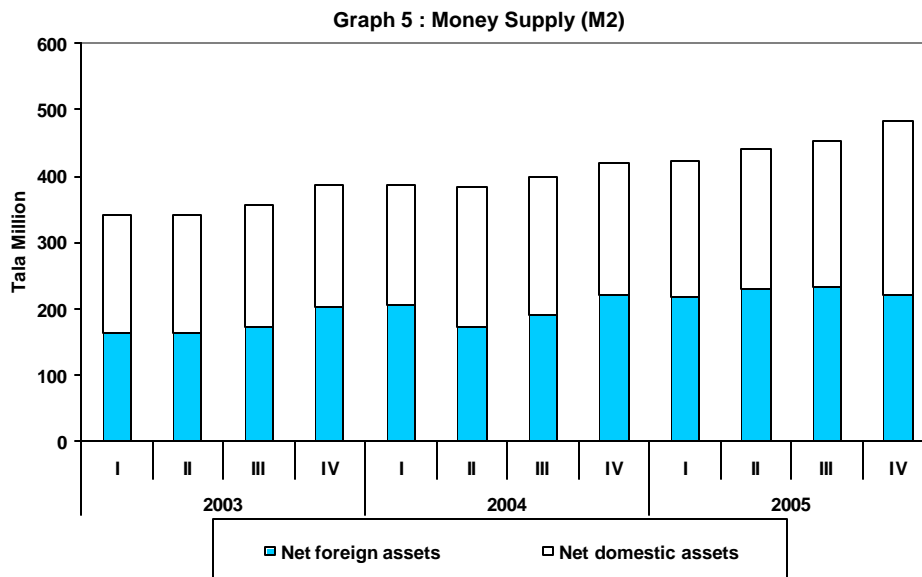


Despite the increase in the average lending rate, commercial bank credit to the private sector and public institutions rose 10 percent and 11 percent respectively. (See Graph 4). Most of this increase was absorbed by the “Building and construction”, with some channeled to the “Manufacturing” and “Other activities” sectors.

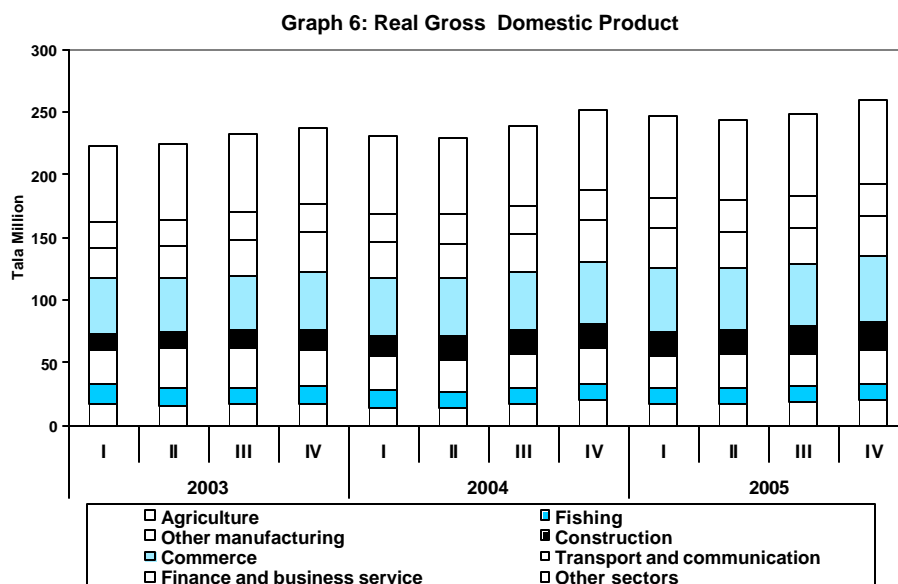
Graph 4 : Commercial banks credit to the private sector and public institutions



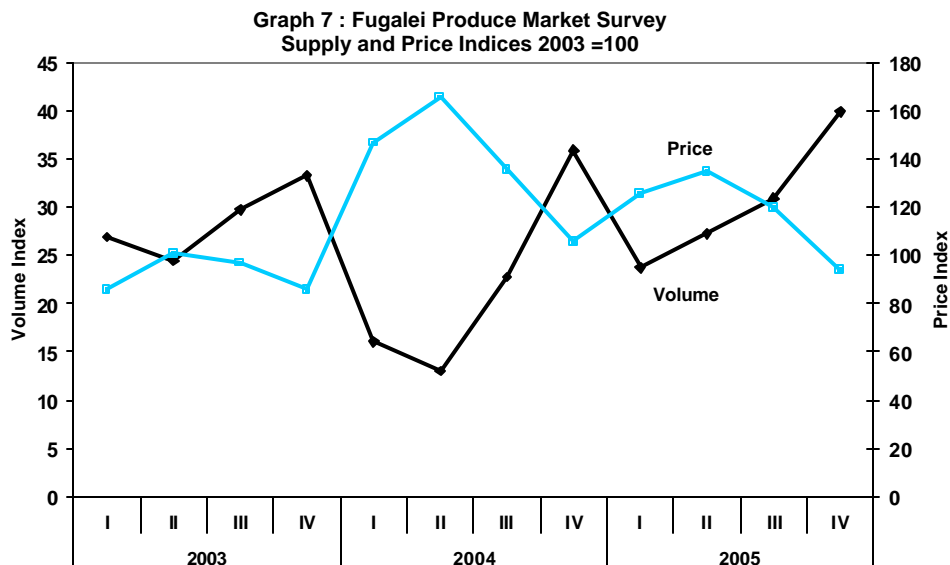
This expansion in bank credit, coupled with the reduction in net deposits of the Government, more than offset the net outflow of foreign funds during the quarter. As a result, total money supply (M2) grew 7 percent, reflecting increases in all of its components. (See Graph 5.)



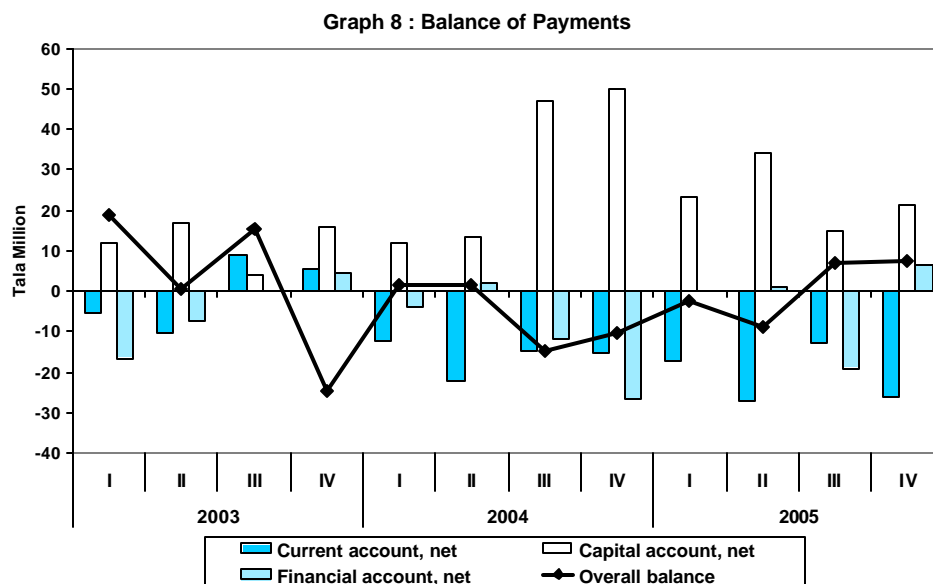
Preliminary national account figures showed that the economy grew by 4 percent in the December quarter, to record an annual growth rate of 5.1 percent for 2005. Most sectors of the economy performed well over the year, with the “agriculture” and “transport and communication” sectors posting the largest growths of 11 percent each. This high level of output in the agriculture sector reflected the strong recovery of farms and plantations around the country from damages caused by cyclone Heta in early 2004. The “construction” industry recorded the second largest growth of 5 percent, followed by “food and beverages”, “hotels and restaurants” and “commerce” at 4 percent each. Smaller increases were recorded for “public administration”, “fishing”, “other manufacturing” and “finance and business services” while “electricity and water” declined slightly. (See Graph 6.)



The supply of agricultural produce to the Fugalei Market expanded by a further 29 percent during the fourth quarter of 2005, following a 14 percent increase in the previous quarter. As a result, average prices at the Market fell 22 percent after declining 11 percent in the preceding three months. Most of the commodities surveyed recorded significant increases in supply, particularly banana, taro and some vegetables. (See Graph 7.)



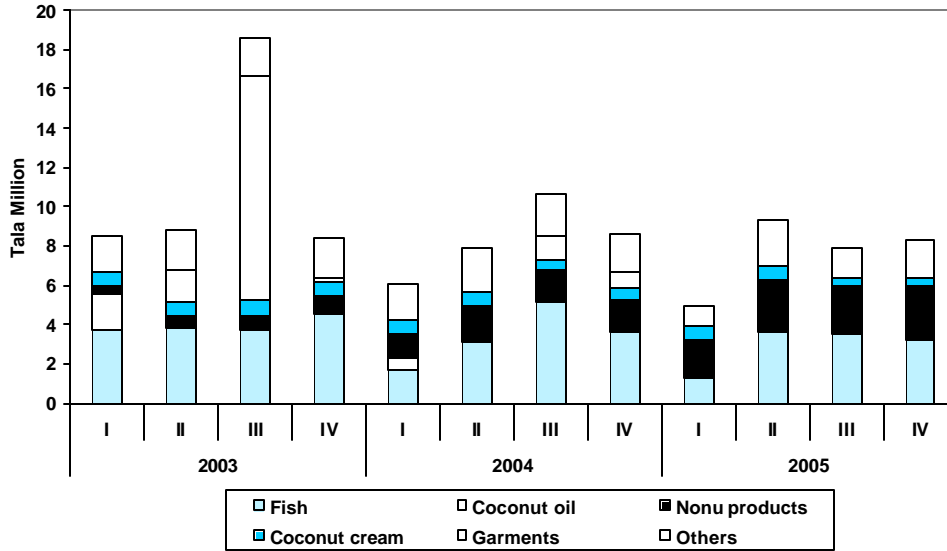
On the external sector, the balance of payments recorded a larger overall deficit of \$7.6 million, up from \$7.1 million in the previous quarter. This deficit was attributed almost entirely to a deterioration in the current account balance which offset net inflows in the capital account. The widening of the current account deficit during the quarter was due entirely to a worsened trade balance. (See Graph 8).



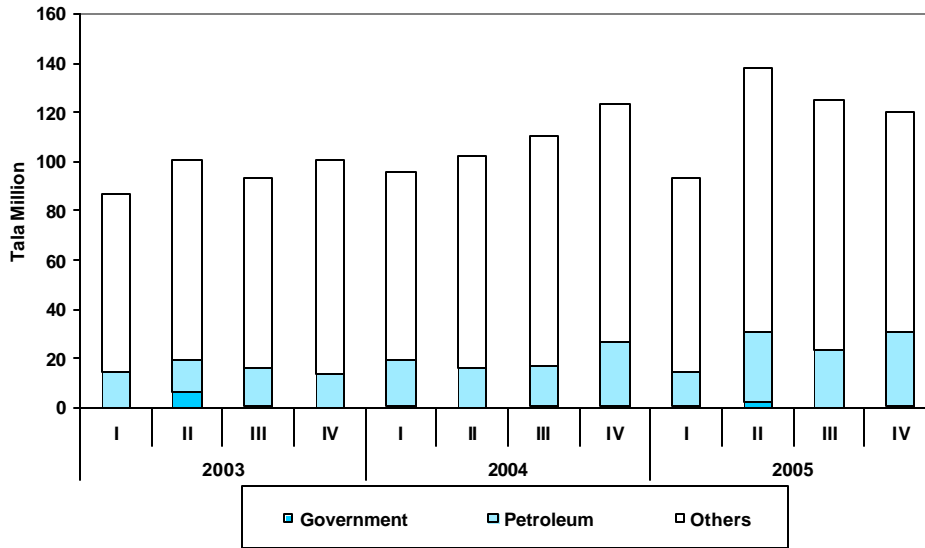
On the back of robust domestic demand, the total value of imports grew by a further 21 percent in the December quarter, to be 22 percent higher than the same quarter in the preceding year. Imports by the Government have been the fastest growing component (rose more than triple) during the quarter, reflecting largely the one-off factors such as imports of construction materials for the Aquatic Centre. Petroleum and non-petroleum imports of the private sector increased by 31 percent and 18 percent respectively.

By comparison, exports rose 4 percent in the December quarter, but were 3 percent lower than the December quarter of 2004. Rises in the three months to end December 2005 included nonu juice (up 17 percent), beer (64 percent) and coconut cream (13 percent) but fresh fish and garments fell by 10 percent and 56 percent respectively. (See Graphs 9 and 10).

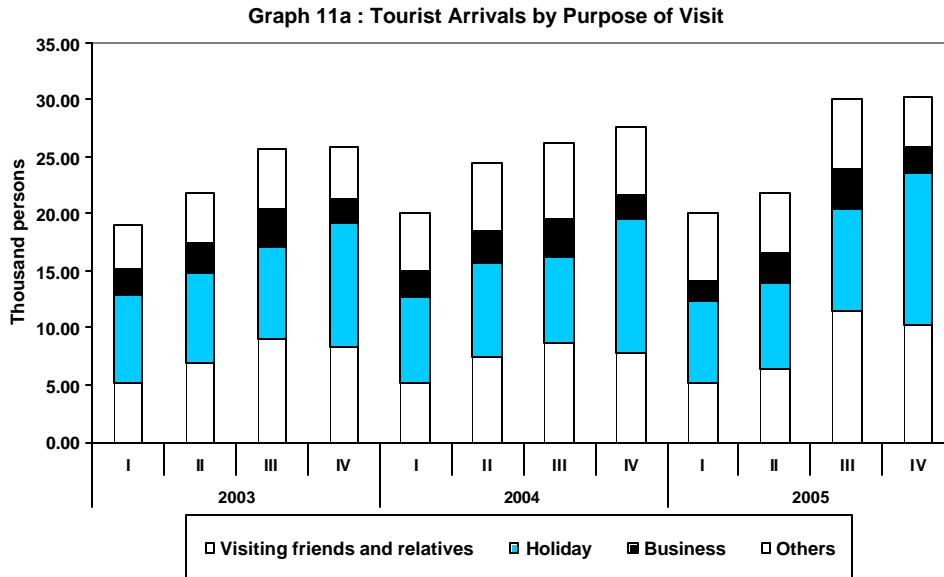
Graph 9 : Exports



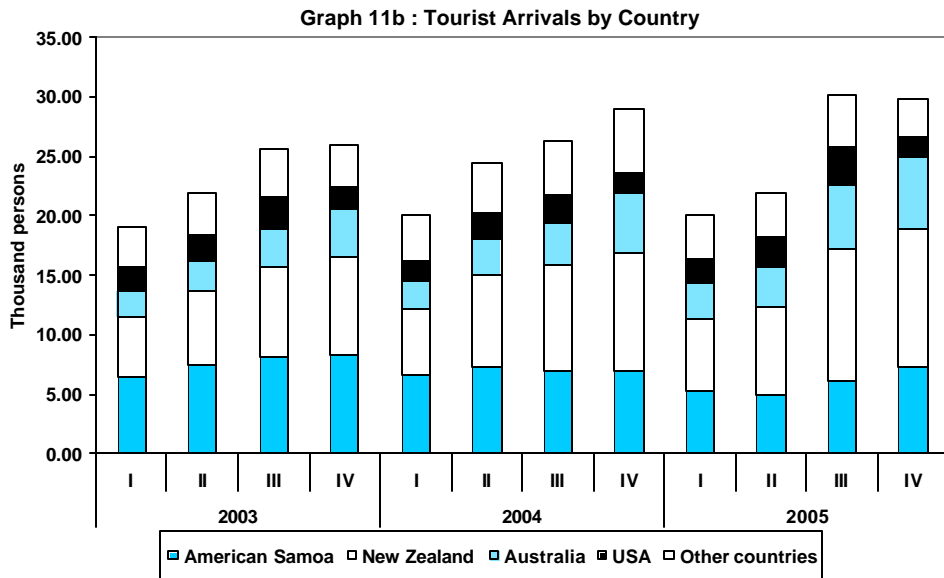
Graph 10 : Imports



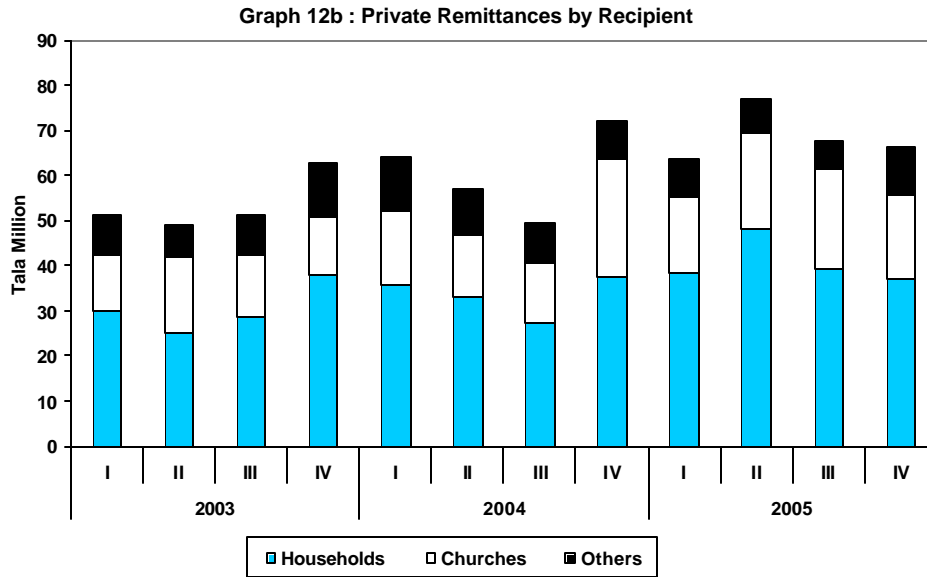
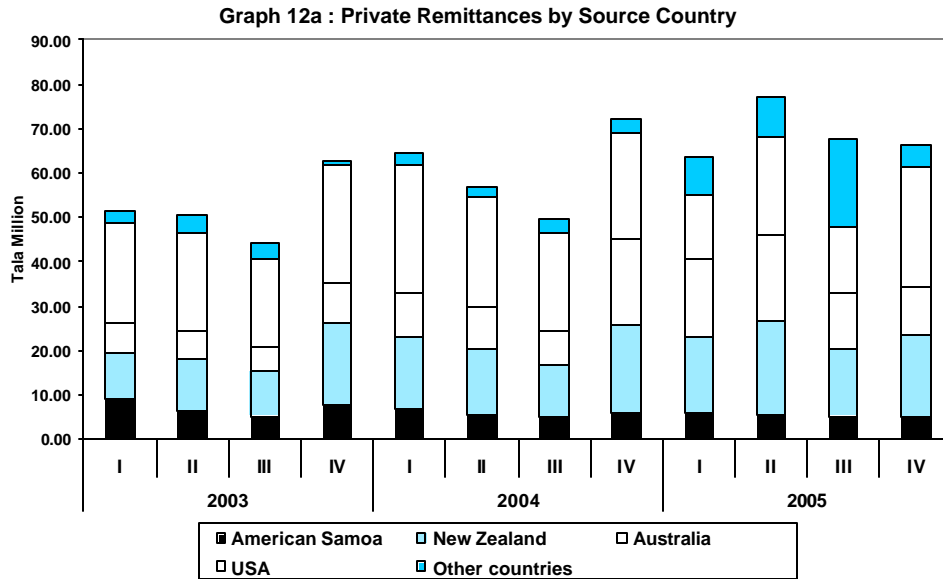
The tourism industry was atypically weak in the fourth quarter of 2005, as tourism earnings declined 4 percent to \$60.1 million during the quarter, following a significant increase in the September quarter. This fall was driven by the decline in both tourist arrivals and average tourist expenditures. Those who were here on holidays dominated tourist arrivals during the quarter, followed by those visiting friends and relatives. (See Graph 11a).



As usual, most of the visitors came from New Zealand, accounting for 39 percent of total arrivals. American Samoa was the second largest source market with a share of 24 percent, followed by Australia and USA with shares of 20 percent and 6 percent respectively. (See Graph 11b).

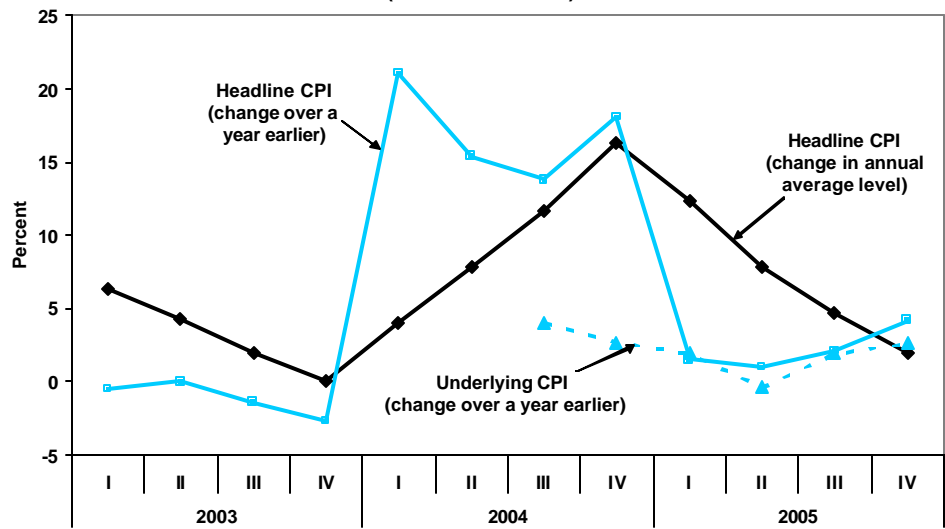


The net inflow of private remittances rebounded in the December quarter, rising by 6 percent to \$65.6 million. USA was the largest source of private remittances with its share surging to 41 percent from 22 percent in the previous quarter. New Zealand, which was the leading source in the preceding quarter, followed with a share of 28 percent while the contributions from Australia and American Samoa declined to 17 percent and 8 percent in that order. Funds for supporting families and individuals continued to account for the bulk of private remittances despite the decline in its share to 56 percent from 58 percent in the September quarter. (See Graphs 12a and 12b).



On prices, the annual ‘headline’ inflation rate as given by the Consumer Price Index (CPI) slowed down to 1.9 percent in the fourth quarter of 2005 from 4.7 percent in the third quarter. This decline reflected mostly the fall in local food prices, particularly the local agricultural produce, offsetting increases in local transport costs and the emerging demand pressures from other sectors particularly the construction industry. The annual ‘underlying’ inflation rate, on the other hand, was 1.3 percent, down slightly from 1.5 percent in September 2005. (See Graph 13).

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



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### III. PRUDENTIAL SUPERVISION

For the quarter ended 31 December 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 banks total assets combined at \$622.2 million reflected an increase of 3.9 percent in the December quarter 2005. On an annual basis, total assets grew 10.6 percent (\$59.8 million). The composition of the commercial banks assets comprised largely of loans and advances of \$460.3 million (74.0 percent of total assets), cash reserves and deposits with the Central Bank and other banks combined at \$121.5 million (19.5 percent) and fixed assets of \$55.9 million (9.0 percent).

Total loans and advances of \$460.3 million increased by 11.5 percent (\$47.5 million) at the end of the quarter and further went up by 24.4 percent (\$90.3 million) over the same time a year earlier.

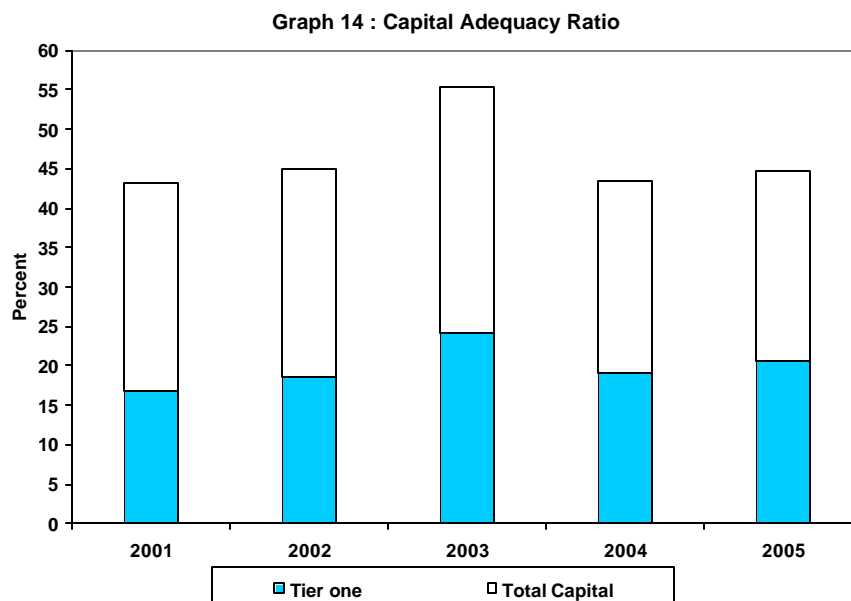
The growth in loans and advances was attributed mainly to loans to private businesses and households.

Total deposit liabilities of \$490.9 million increased 3.0 percent (\$14.4 million) at the end of the quarter 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 11.5 percent (\$50.6 million) when compared to the same period a year earlier.

At \$90.1 million, total contingent and off-balance sheet items increased \$13.5 million over the previous quarter, due mainly to increases in transaction related items of \$2.3 million and unused credit commitments of \$17.1 million.

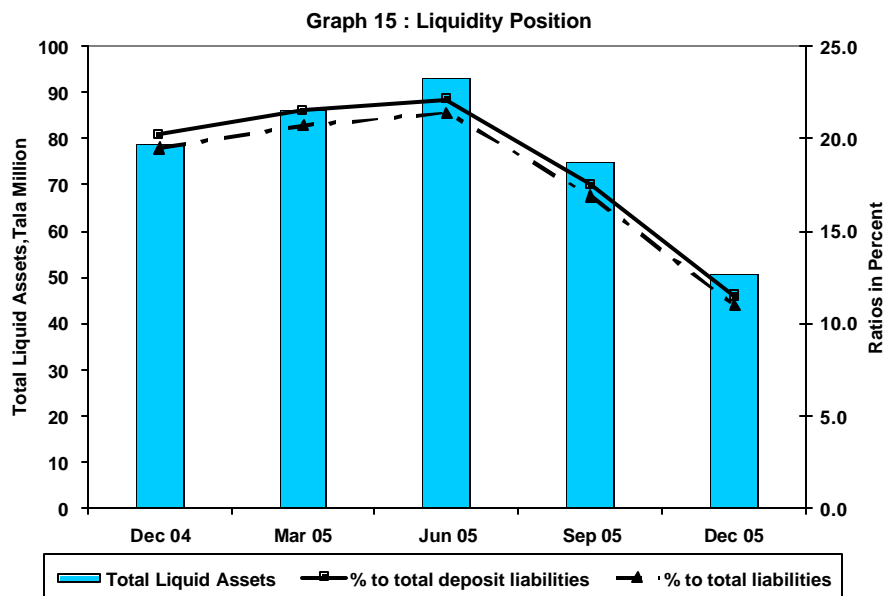
Total capital of the banking system remained strong at \$101.9 million, slightly increased by 0.1 percent over the previous quarter. Among others, this largely reflected banks profitable performance throughout the period, contributing to an annual growth of \$3.4 million of capital funds.

In proportion to total risk weighted assets, capital adequacy dropped by 1.8 percent to 24.1 percent. Tier 1 capital recorded a 20.6 percent ratio, an increase of 3.7 percent over the September 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.

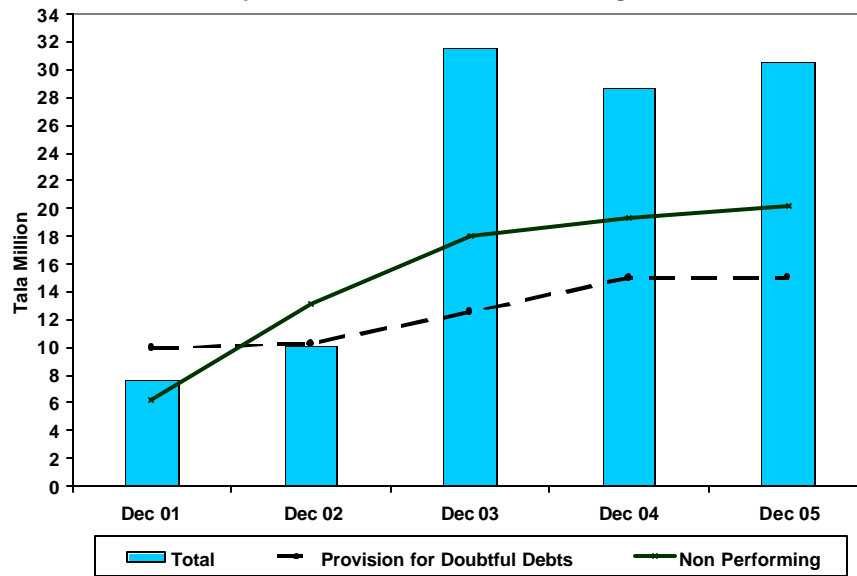
The banking system liquidity revealed a decrease of 32.2 percentage (\$24.1 million) compared to the previous quarter. Total liquid assets stood at \$50.6million, equivalent to 11.5 percent of total domestic deposit liabilities. On an annual basis, liquid assets dropped \$28.0 million, about 11.0 percent of total deposit liabilities. Central Bank Securities of \$21.9 million, made up 43.2 percent of total liquid assets at the end of the quarter. (See Graph 15.)



The combined foreign assets of commercial banks totaled \$46.8 million (7.5 percent of total assets) as compared to total foreign liabilities of \$41.4 million. At these levels, it showed a combined net exposure long position of around \$5.6 million or 5.5 percent of total capital.

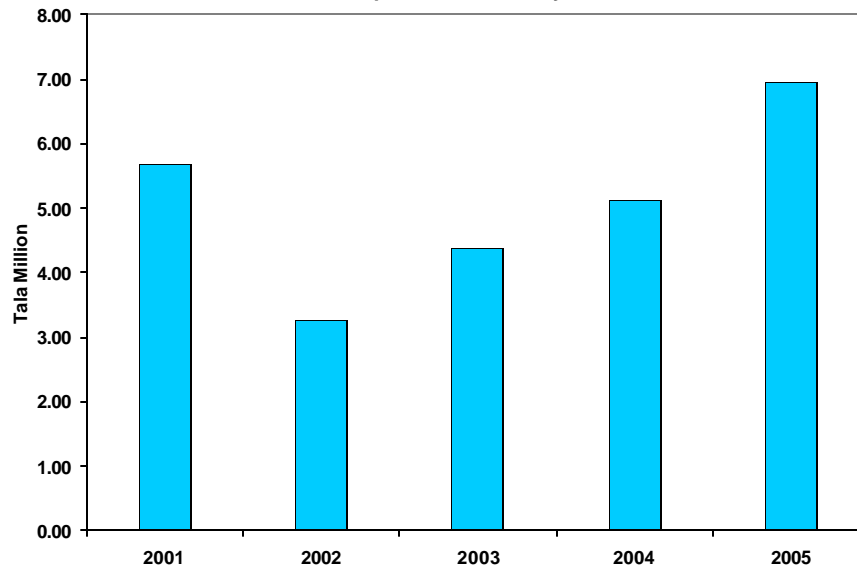
Total non-performing loans stood at \$20.2 million, reflecting a decrease of 10.2 percent (\$2.3 million) over the previous quarter. As compared to the prior year, it recorded an increase of 4.4 percent (\$0.9 million). The Central Bank maintains a close monitoring of banks level of arrearages and non-performing loans and consulting 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.)

Graph 16 : Past Due and Non - Performing Loans



At a combined figure of \$9.7 million, the banking system’s pre tax profit level increased by 35.2 percent in the quarter under review when compared to the same period the year before. (See Graph 17.)

Graph 17 : Profitability



For the period under review, total operating expenses represented 70.2 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.

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#### **IV. UPDATED MACRO-ECONOMIC FORECASTS AND MONETARY POLICY FOR THE FISCAL YEAR ENDING JUNE 2006**

At its Meeting on 24 February 2006, the Central Bank Board discussed the update of the macro economic outlook and monetary policy stance for the remaining part of financial year 2005/06.

The revised forecasts for the financial year 2005/2006 replaced the original forecasts that was endorsed by the Board in August 2005. The revisions were based on the actual and estimated national accounts, balance of payments, prices and monetary statistics up to end January 2006.

The outlook for the world economy changed little from what was expected six months ago in the original forecasts. The main drivers were the Chinese and US economies with security concerns and increased demand for oil impacting adversely on international oil prices. Moreover, in the US, the devastating impact of the two major hurricanes on oil production in that country at the end of 2005 fanned the oil price inflation further. All in all, the world economic growth was still expected at around 4.4 percent in 2005/06 with inflation still expected to hover around 2.1 percent.

On the domestic economy, the Bank's baseline forecasts in August 2005 indicated that the expansionary fiscal stance and a continuation of an accommodative monetary policy stance would see real economic growth of about 5 percent, boosted by the ongoing strong growth in the construction sector and the increased net inflow of private remittances and tourism earnings. Unfortunately, the balance of payments was expected to record a substantial \$50 million overall deficit, which would lower the level of official reserves to 4.2 months of imports of goods at the end of June 2006. The headline annual rate of inflation was anticipated to decline to 1.7 percent in January 2006, rising to 3.4 percent at the end of June 2006. Similarly, the underlying rate of inflation was projected to increase steadily to 3.7 percent, on a point-to-point basis, from negative 0.8 percent in July 2005.

The large balance of payments deficit forecast under the baseline scenario was a matter of great concern, as it would lead to a substantial reduction in official reserves. Consequently, to safeguard international reserves and sustain macro-economic stability in 2005/06, monetary policy was tightened.

Monetary policy in 2005/06 has therefore been aimed at slowing down the growth rate of bank credit to the private sector. This, together with the expected Government Budget deficit and outflow of funds, would see the growth of money supply (M2) slow down. In the event, real economic growth would be expected to slow down from 5.0 percent under the base case scenario to around 4 percent under the program scenario while the annual inflation rate was expected to be reduced from close to 4.0 percent in the base case scenario to the target of 3.0 percent in the program scenario.

Reflecting the need to tighten monetary policy, the level of the commercial banks' excess reserves was consistently reduced from \$36 million at the end of August 2005 to \$23 million at the end of January 2006. Consequently, the overall official interest rate rose steadily from 1.41 percent in August 2005 to 2.14 percent in January 2006. In contrast, however, the average commercial bank lending rate took time to respond to the reduction in liquidity and the steady rise in official interest rates, increasing rather slowly from 11.39 percent in August 2005 to 11.50 percent in December 2005. The slow response of credit interest rates to official interest rates, in part, reflected the greatly increased competition for market share in the financial system, with finance companies becoming more and more prominent.

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On the fiscal side, Government completed the first six months of 2005/06 with a cash deficit of \$1.8 million. Preparations for the issue of long term Government Bonds were well under way with the first issue attracting a very cautious response from the market.

In the six months to end December 2005, bank credit to the private sector rose 15 percent (\$55.8 million) compared with the target of 6 percent (\$22.3 million). On the other hand, a higher than expected accumulation in the monetary system's capital and reserves saw the level of net domestic assets only 1 percent short of expectation. Net foreign assets fell, but not by as much as expected reflecting the uncertainty surrounding the timing of large overseas payments related to the Polynesian Airlines merger with Virgin Blue Airlines and the flow of funds associated with large construction projects, namely the Development Bank Headquarters. In the event, total money supply (M2) grew 10 percent.

The end result was that the economy grew 5 percent in real terms in the six months to end December 2005, stronger than the expected growth rate of 4.4 percent. On the other hand, the balance of payments recorded an overall deficit of \$14.7 million, which was much in line with expectations. The output of the export sector so far has been disappointing with fish, garments and coconut products not performing to expectations. Headline inflation declined as expected. However, at 1.8 percent at the end of January 2006, headline inflation was slightly higher than the forecast rate of 1.5 percent. Similarly, the underlying inflation rate, on a point-to-point basis, rose to 3.3 percent at the end of January 2006, which was higher than the expected rate of 2.9 percent.

#### *Monetary policy stance in the second half of 2005/06*

The latest available information up to January 2006 indicated that growth was running faster than expected. This, coupled with disruption to agricultural production and some construction activities due to the exceptionally heavy downpours early in February 2006, would see the annualized headline and underlying inflation rates rise to 4.6 percent and 2.9 percent in June 2006. In addition, the balance of payments was expected to record an overall deficit of \$18.8 million in the second half of the financial year.

The revised forecasts indicated that the faster real economic growth rate was impacting adversely on international reserves and on inflation. Given that outlook, the tightened monetary policy stance was set to continue in the remaining half of 2005/06.

In the event, the real GDP growth rate for 2005/06 was revised up from 4.0 percent in the original forecast to 5.0 percent in the revised forecasts while the expected headline and underlying inflation rates were pushed up from 3.0 percent and 3.5 percent respectively to 4.6 percent and 5.0 percent in that order. In addition, the forecast overall balance of payments deficit for the financial year 2005/06 was increased from \$30.0 million to \$34.0 million.

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