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

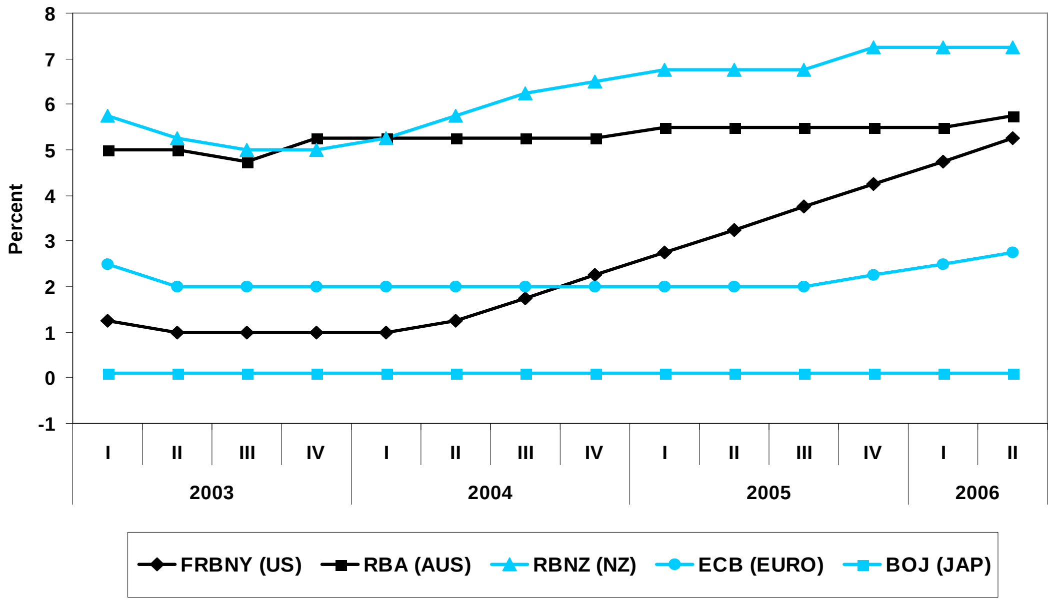
a. The World Economy

The world economy continued to grow in the June quarter of 2006. Economic growth in the United States remained solid although it has slowed in recent months. Japan's economic expansion was increasingly robust. Strong growth was also evident in the rest of East Asia and other emerging markets and the economic recovery in the euro area is progressing though at a moderate pace.

The US economy's real GDP growth slowed to 0.6 per cent in the June quarter and 2.5 per cent over the year, compared to a reported 5.6 percent for the previous quarter. While consumption has slowed compared to recent years, the strength in labour market has helped to support household spending. The unemployment rate continued to fall, to be at a five-year low of 4.6 percent in June. Growth in business investment moderated in the June quarter, to be 0.7 per cent for the quarter, and growth in core capital goods orders also slowed. Energy price increases pushed headline inflation up to 4.3 percent over the year to June, and core inflation picked up to 2.6 percent, its fastest pace in over four years.

In its two meetings in the June quarter, the Federal Open Market Committee (FOMC) decided to raise the Fed funds target from 4.75 percent to 5.0 percent and then to 5.25 percent The Federal Reserve has indicated that further rate rises depended on the economic outlook in the months ahead. However, the market has significantly increased its assessment of the probability that the US central bank will pause at its next meeting. (See Graph 1.)

Graph 1 : Official International Interest Rates



The Australian economic growth in the second quarter of 2006 continued to be supported by favourable international economic conditions. Employment posted strong gains in the June quarter with an increase of 2.2 percent. This saw the unemployment rate drop to 4.9 percent in the June quarter compared to 5.0 percent in the previous quarter. Consumer prices in the June quarter were higher with the CPI rising by 1.6 percent in the quarter and by 4.0 percent over the year.

In the June quarter 2006, the Reserve Bank of Australia Board decided to increase interest rates by 25 basis points, to 5.75 percent. The Board has adopted this stance as data on producer and consumer prices for the quarter under review indicated that these domestic and international developments had been accompanied by stronger inflationary pressures.

Data released in the June quarter suggest domestic demand in the New Zealand economy remained relatively subdued, and consumer and business confidence measures have been weak. While aggregate output was broadly in line with expectations, inflationary pressure was greater than predicted. Annual consumer price index (CPI) inflation increased to 4.0 percent in the June quarter as a result of a 1.5 percent quarterly increase with higher oil prices as a major contributor.

In its two meetings in the June 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 than projected in the March Policy Statement.

Business conditions during the June quarter remained buoyant in the euro area. Positive sentiment in the business sector stemmed from strong external demand, with merchandise exports increased by 12 percent over the year to June 2006. Industrial production continued to expand by almost 5 percent over the year to May.

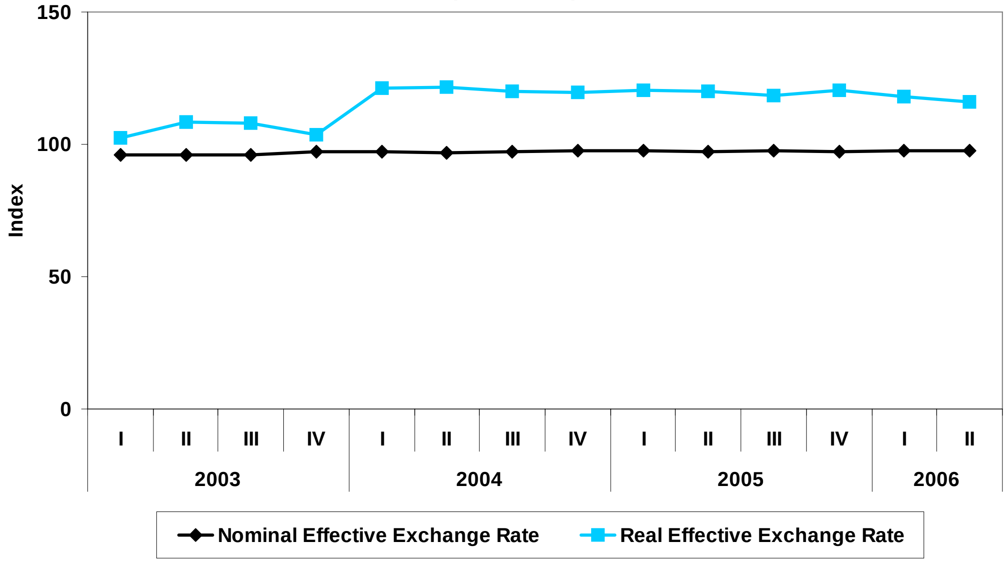
The European Central Bank (ECB) in its June quarter interest rate review added another 0.25 percent, raising interest rates from 2.50 percent to 2.75 percent. With the economic recovery in Europe continuing and with inflation above 2 percent, the market expects further rate increases later this year.

Economic growth in the United Kingdom continued to recover in the June quarter 2006, and was 2.6 percent over the year. Growth has been led by the consumer sector. Consumer sentiment remained above its long-run average and house price growth continued to recover, although the unemployment rate increased in the June quarter.

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 June quarter. The Monetary Policy Committee concluded that the domestic generated inflation pressures in the United Kingdom remained weak and it seems likely that inflation would fall below the 2 percent target in the medium term.

The economic expansion in Japan continued in the June quarter. Year-ended growth in industrial production remained solid at around 4 percent and the ongoing global information technology recovery continued to underpin strong merchandise export growth of 15 percent over the year. Furthermore, consumer prices continued to record modest annual increases, providing further evidence that the deflation period has ended. Following its June meeting, the Bank of Japan announced the return to the short-term interest rate as the operating target for monetary policy. However, short-term interest rate in Japan still remained at zero for the time being.

During the quarter under review, the US dollar weakened against a well bid Australian dollar and the Euro but had a mixed performance against the New Zealand dollar. Against the currencies of our major trading partners, the Tala appreciated against the New Zealand and the US dollar but weakened against the Australian dollar, Fiji dollar and the Euro. The value of the Tala in terms of its nominal index showed an appreciation of 0.10 percent in the second quarter of 2006. Furthermore, since price rises in Samoa is less than in contrast with the price increases of our major trading partners, the real effective exchange rate of the Tala fell 1.74 percent. (See Graph 2.)



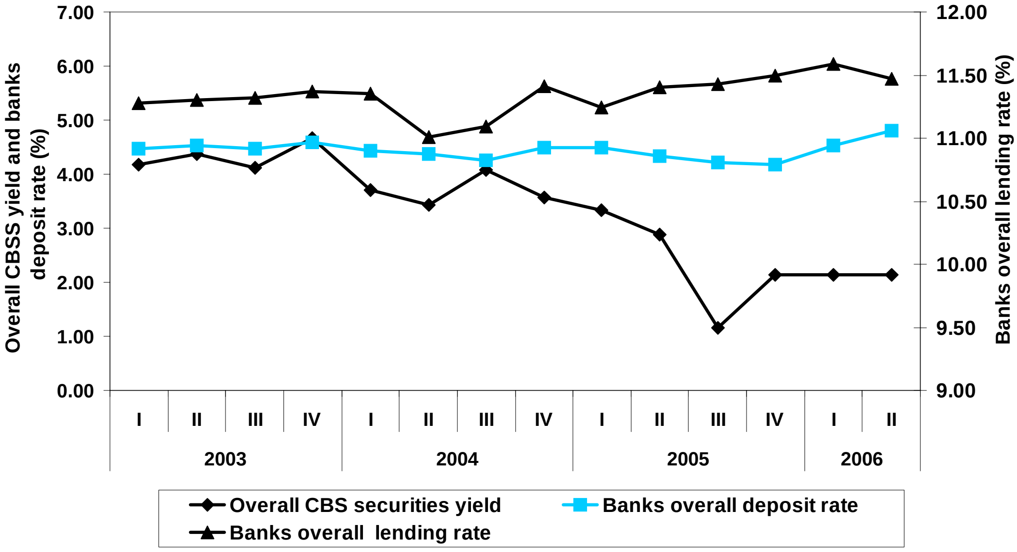
b. The Samoan Economy

As part of Government's initiative to curb its large fiscal expenditure and attain a more balanced budget, its financial operations in the second quarter of 2006 closed with a quarterly cash surplus of $16.0 million vis-à-vis the monetary system, following a cash deficit of $24.2 million in the previous quarter. With the bulk of Government's repayments of the national airline's external debts made in the first quarter of 2006, Government was able to consolidate its position with the banking system, up $11.6 million in the June 2006 quarter compared to a hefty overdraft of $20.3 million in the previous quarter. Government's deposits with the Central Bank also rose by $3.4 million to $45.5 million. These were further aided by a $1.0 million jump in Government's foreign exchange holdings.

In light of the eroding foreign reserves as a result of strong economic growth so far, monetary policy remained tightened in the quarter under review in order to ease the demand for loans and raise interest rates to boost the supply of liquidity to the financial system. Total net foreign assets recovered 4 percent or $6.3 million to $184.6 million, led primarily by a $6.9 million improvement in Central Bank reserves while commercial banks' net foreign assets continued to slide.

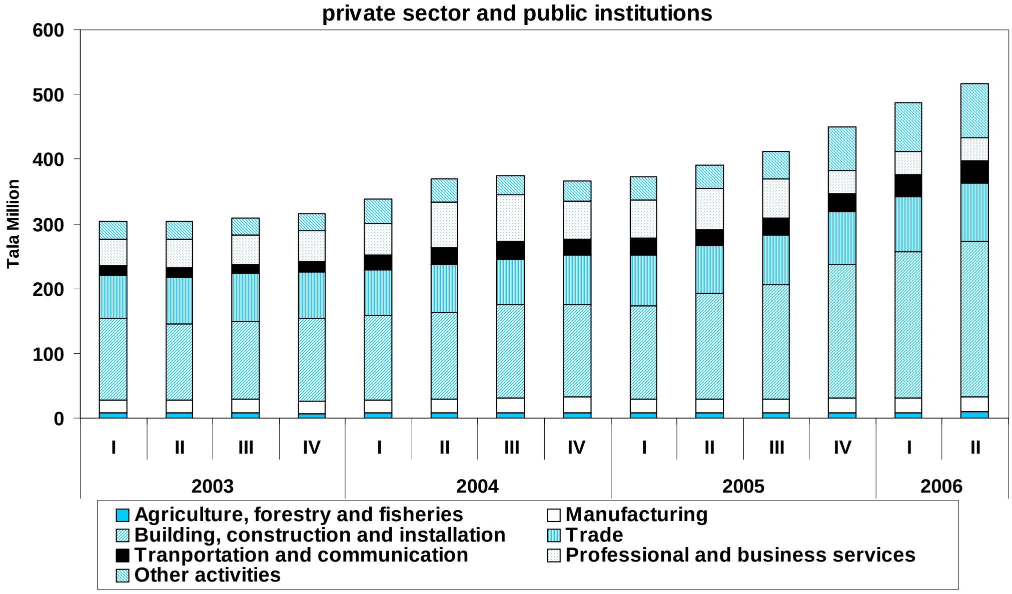
Although it rose substantially in the last few days of June 2006 to $18.2 million, through out much of June 2006 quarter, the level of excess liquidity hovered below the $15.0 million level considered comfortable for the banking system to maintain at all times. Consequently, no CBS security was issued during the quarter under review. This left the overall official interest rate unchanged at 2.14 percent. On the other hand, the weighted average lending rate of the commercial banks fell by 6 points to 11.52 percent while the tight liquidity conditions in the quarter under review saw the weighted average commercial bank deposit rate increasing 28 points to 4.74 percent as the banks competed for more funds to meet the unprecedented strong demand for loans. In the process, the commercial banks' interest rate spread narrowed 34 points to 6.78 percent. (See Graph 3.)

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



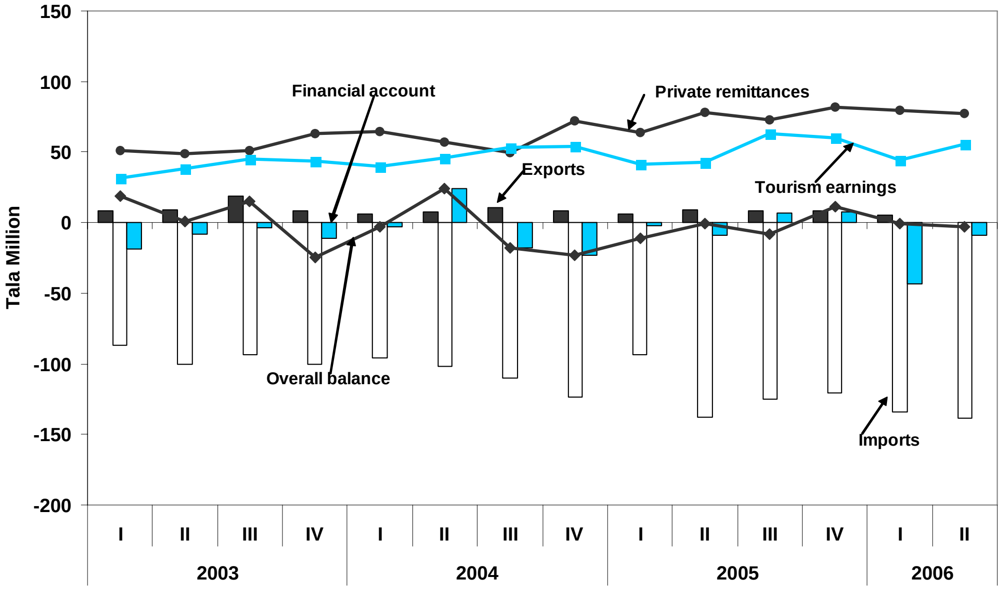
Despite the contractionary monetary policy stance, very strong domestic demand saw total domestic credit rise $14.0 million or 3 percent in the quarter under review. This reflected a $21.4 million growth in private sector lending to $490.9 million. Fueling real economic growth in the first quarter was a sharp rise in loans to the "Building" sector (up $16.7 million) as well as increases in loans to the "Trade" sector (up $3.9 million) and the "Transportation" sector (up $1.5 million). (See Graph 4.)

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



The cash surplus in the Government budget coupled with a seasonal rebound in exports and tourism earnings led to an overall balance of payments surplus of $8.5 million. This was a welcomed relief as it was in stark contrast to the overall deficit of $44.1 million in the previous quarter. (See Graph 5.)

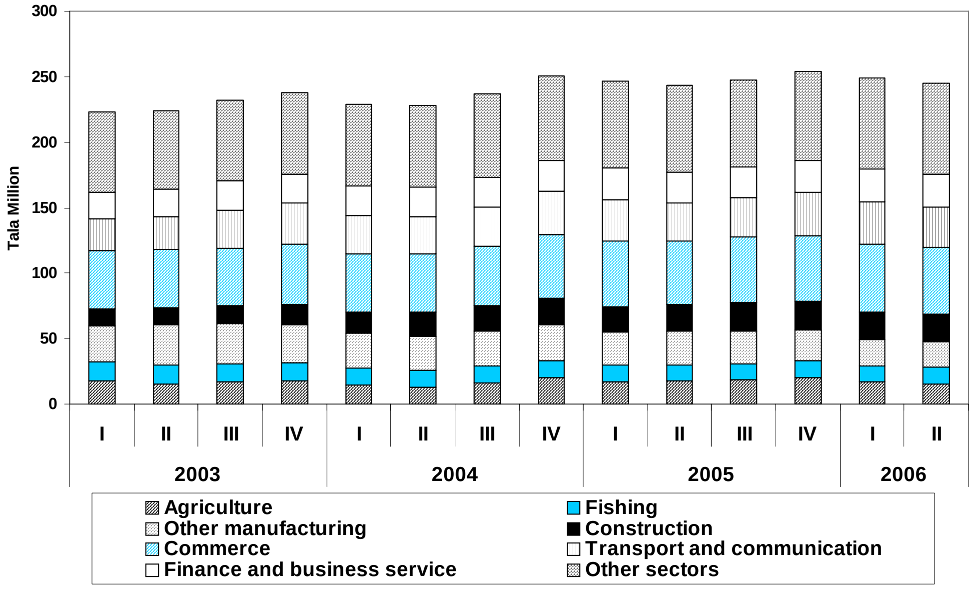
Graph 5 : Balance of Payments



Tourism earnings increased 18 percent or $8.6 million following a seasonal decline of 23 percent in the previous quarter. Exports jumped 58 percent to $8.0 million due to a major recovery in fish and nonu fruit exports. On the other hand, private remittances went down 4 percent to $70.3 million for the second quarter in a row. Imports rose 3 percent or $4.1 million to $138.5 million mainly as a result of the increase in non-petroleum imports (up $10.3 million) offsetting declines in Government imports (down $3.8 million) and petroleum imports (down $2.4 million). The overall surplus in the balance of payments saw the level of gross official international reserves rise to $179.1 million in the June 2006 quarter. At this level, official reserves were sufficient to finance 3.9 months of imports, up slightly from 3.7 months at the end of March 2006.

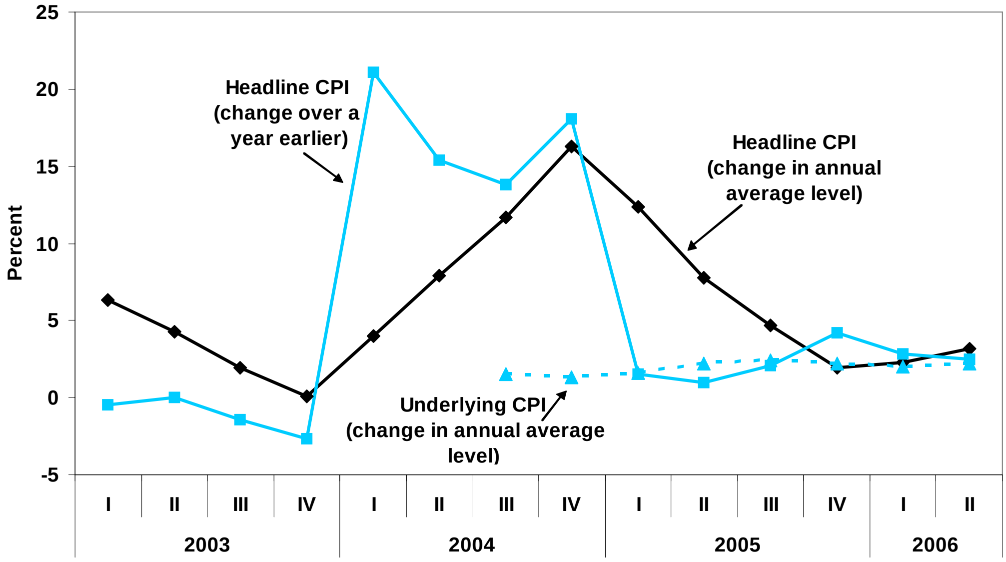
On the real sector, the economy contracted by 1.8 percent in real terms largely due to reductions in the transport sector, the agriculture sector, the other manufacturing sector and to a lesser extent the food and beverages manufacturing sector. On the agriculture sector, the overall level of supplies to the Fugalei Market fell 13 percent which saw the whole sector down 9 percent. However, growth was recorded in fisheries sector as well as the electricity and water sector, up 4 percent and 3 percent respectively. The construction sector was virtually unchanged (up 0.2 percent). (See Graph 6.)

Graph 6: Real Gross Domestic Product



On inflation, the headline Consumer Price Index (CPI) registered a drop (down 0.2 percent) in the June 2006 quarter. The marginal decrease in the CPI was caused by a 0.7 percent decline in the local component, partially offset by a 0.5 percent hike in the imported component. A drop of 6.4 percent in local 'Transport and communication' index and a 1.9 percent decrease in imported 'Food' index were responsible for the decline in the 'All Items' index. A 15.5 percent hike was recorded for the imported 'Transport and communication' index reflecting the soaring crude oil prices. However, when compared with a year ago, the headline CPI at end June 2006 was 2.2 percent higher. The annual headline inflation rate however, fell to 3.2 percent at the end of the quarter under review from 7.8 percent at end June 2005. And, leaving aside the prices of the officially regulated items and the highly volatile prices of seasonal commodities, the underlying (or core) annual inflation rate of 2.2 percent at the end of June 2006 was the same as it was at the end of June 2005 but was up from 1.6 percent at end March 2006. (See Graph 7.)

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



Given that the level of international reserves had fallen below the minimum target level of 4.0 months imports and that inflation is on a rising trend, monetary policy will remain tightened in the foreseeable future.

III. PRUDENTIAL SUPERVISION

At the end of June 2006 quarter, the banking system continued to record steady growth in assets although at a much slower pace than the previous months. Such trend is expected in the period ahead as banks strategically undertake measures to improve the current low level of liquidity available in the financial system.

At $690.5 million, the commercial banks combined assets reflected an increase of 5.7 percent ($37.0 million) in the June quarter, indicating an annual growth of 16.7 percent ($98.9 million) when compared to the same time a year earlier. The composition of the commercial banks assets comprised mainly of loans and advances of $540.1 million (78.2 percent of total assets), cash reserves and deposits with the Central Bank and other banks combined at $108.4 million (15.7 percent) and fixed assets of $46.6 million (6.7 percent) respectively.

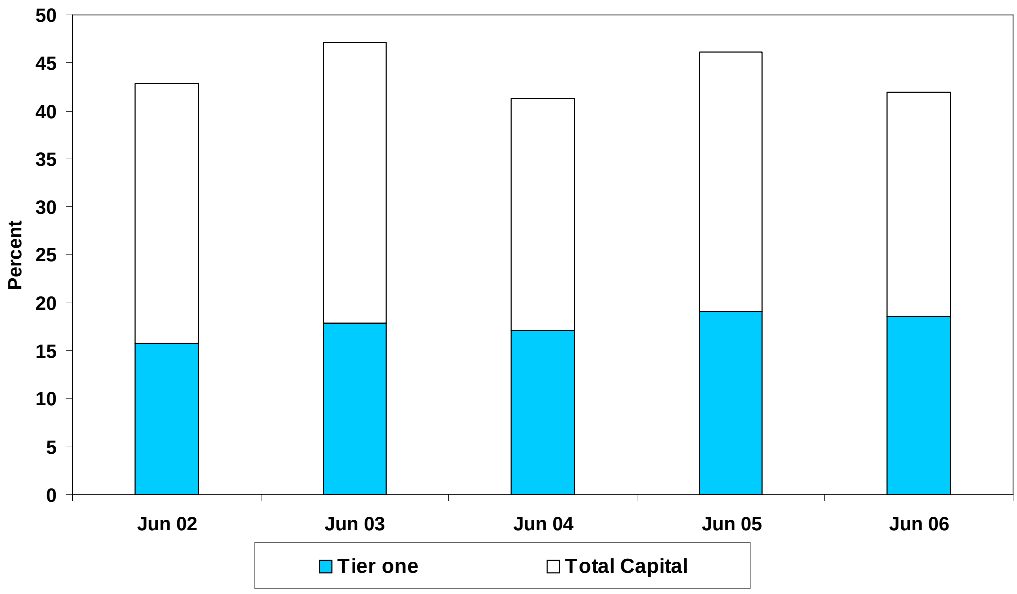
Total loans and advances of $540.1 million recorded another marked increase of 5.4 percent ($27.8 million) at the end of the quarter, showing a substantial increase of 37.5 percent ($147.3 million) over the same time in the previous year.

There was a noticeable increase in deposit liabilities over the quarter by 3.7 percent ($19.1 million). At this level, total deposit liabilities registered an annual growth rate of 13.5 percent ($63.3 million) when compared to the same period a year earlier. Time deposits ($291.4 million) represents 54.8 percent of total deposits, demand deposits ($175.1 million) accounted for 32.9 percent while savings deposits ($64.3 million) made up 12.1 percent of total deposits.

Total contingent and off-balance sheet items also increased by 26.5 percent ($16.9 million) to $80.4 million over the previous quarter. The major movements in these accounts reflect a significant rise in unused credit commitments, up by 85.6 percent ($18.6 million) which more than offset the decline in unmatured foreign exchange contacts, documentary L/Cs and direct credit substitutes.

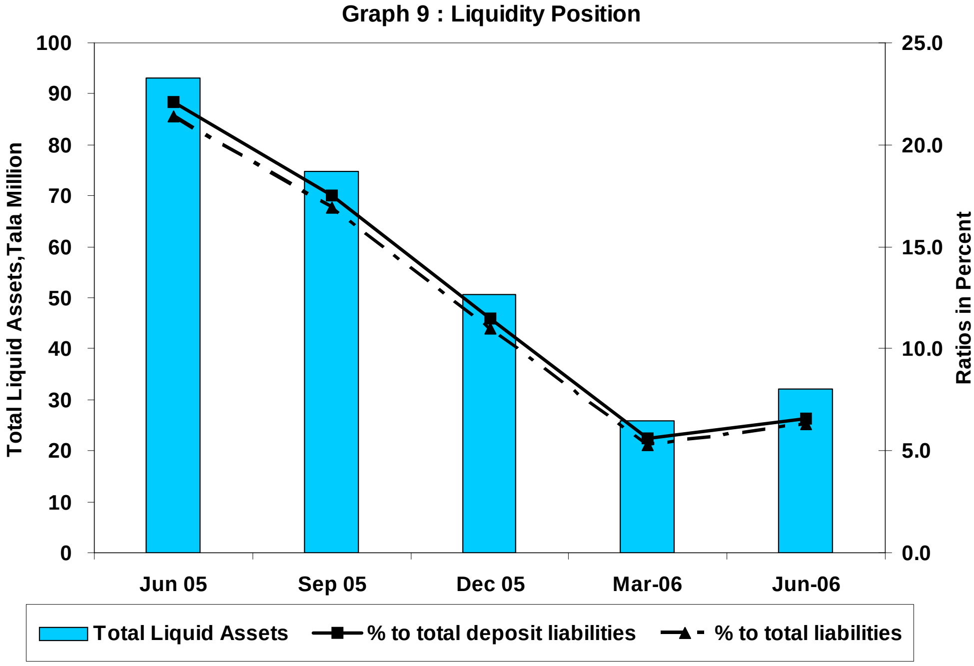
The banking system remained strongly capitalized at $114.6 million at the end of June 2006, recording an increase of 5.6 percent ($6.0 million) over the previous quarter, due mainly to the banks profitable performance throughout the period. In relation to the overall level of risk weighted assets, the capital adequacy ratio dropped from 27.0 percent to 23.4 percent respectively. Tier 1 capital of 18.5 percent edged down by 0.6 percent over the March 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 June quarter.

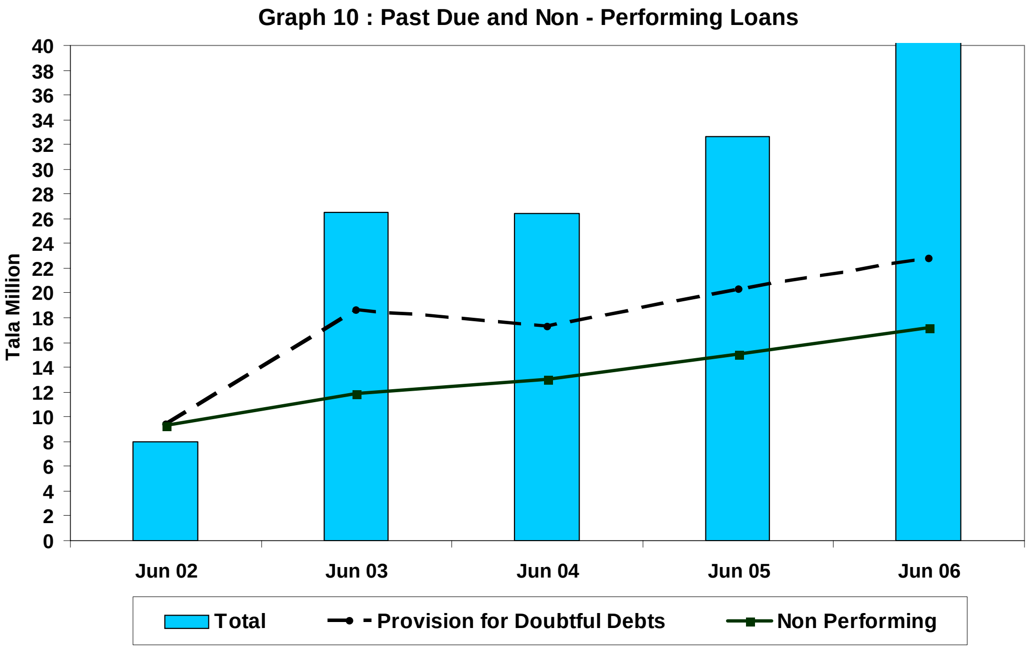
During the June 2006 quarter, the banking system showed a slight improvement in the level of liquid assets which rose 24.6 percent ($6.3 million) to $32.2 million over the previous quarter and registered a drop of 65.4 percent ($60.8 million) over the past twelve months. The main cause for such movement reflected banks strong lending activities during the period.



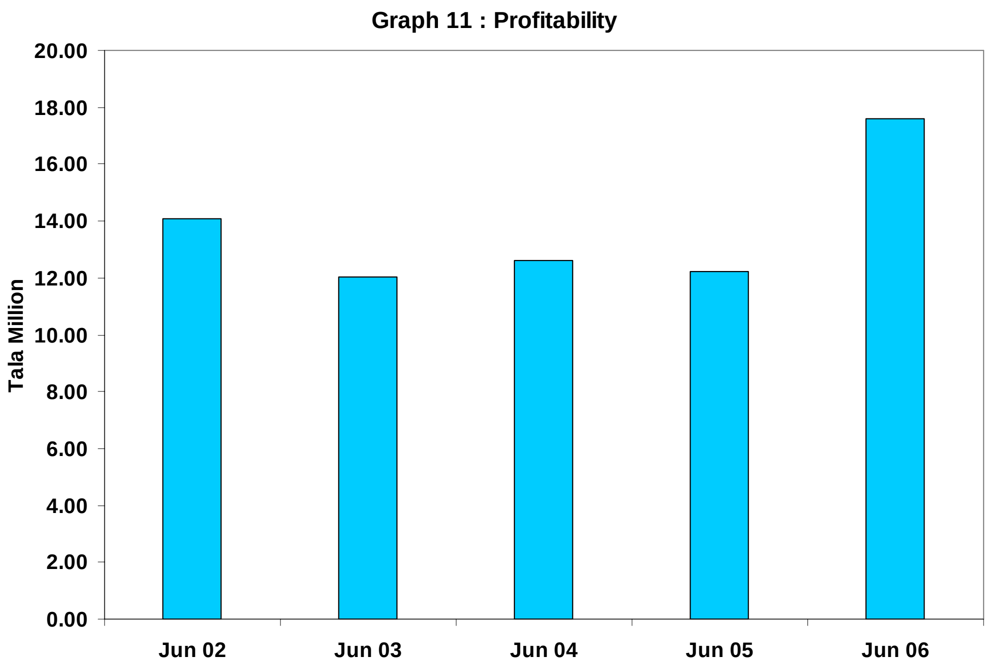
The combined foreign assets of the commercial banks amounted to $62.8 million as compared to total foreign liabilities of $58.5 million at end June 2006. At these levels, it showed a net long exposure position of around $5.0 million or 4.4 percent of total capital. (See Graph 9.)

Total non-performing loans edged up by 2.8 percent ($0.6 million) to $22.8 million over the previous quarter. As compared to the prior year, it rose further by 12.2 percent ($2.5 million) respectively. In relation thereto, total provision for bad and doubtful debts of $17.2 million provides a 75.4 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 3.2 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 $24.7 million, the banking system's pre tax profit level increased by 44.3 percent in the quarter under review when compared to the same period a year earlier. Total net profit after tax amounted to $17.6 million, up markedly from $12.2 million recorded a year earlier. At this level, return on average networth and assets stood at 16.9 percent and 2.7 percent respectively. (See Graph 11).



For the period under review, total operating expenses represented 60.3 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.
