

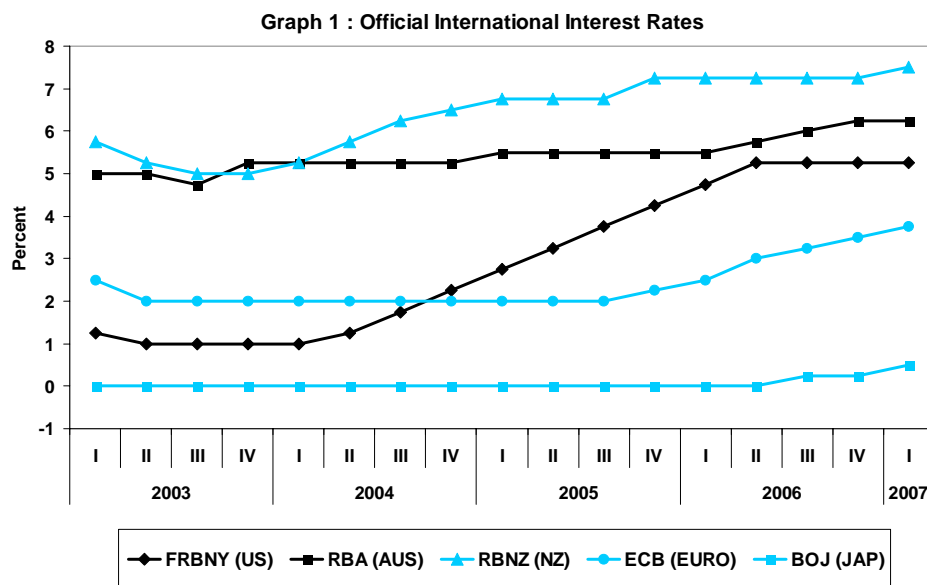
## II. OVERVIEW OF ECONOMIC DEVELOPMENTS DURING THE FIRST QUARTER OF 2007.

### a. The World Economy

The world economy continued to grow at a firm pace in the first quarter of 2007. The expansion was broad based with an upturn in Europe and Japan. However, weaker growth is expected for the major developed countries, mainly reflecting a slowdown in the United States. Most forecasters are expecting that a slowdown in the United States should be reasonably temporary and that the current slowdown in the housing sector will not spread too much to other sectors or countries.

Growth in the US economy slowed in the first quarter, due to a downturn in the housing construction and auto-related sector. Real GDP increased by 0.3 percent in the March quarter, and by 2.1 percent over the year. Activity in the US housing market continued to weaken in early 2007. Residential investment fell by 4.6 per cent in the quarter under review and by 17 per cent over the year and is expected to decline further. However, household consumption rose by 0.9 per cent in the March quarter and by 3.4 percent over the year. Business investments also increased in the March quarter, to be 3.2 per cent higher over the year. CPI inflation picked up a little to be 2.8 per cent over the year to March after slowing down in the second half of 2006. Over the same period, core inflation eased to 2.5 per cent.

In its two meetings in the March quarter, the Federal Open Market Committee (FOMC) continued to keep the Fed funds interest rate unchanged at 5.25 percent. Recent indicators have been mixed and the adjustment in the housing sector is ongoing. Nevertheless, the US economy seems likely to continue to expand at a sluggish pace over coming quarters.



The Australian economy performed strongly in the first quarter of 2007. Output growth picked up accompanied by continued strength in incomes and falling unemployment. The Australian economy grew by 1.6 per cent in the March quarter and by 3.8 per cent over the year. Likewise, production of goods and services increased 1.3 per cent in the quarter and 3.2 per cent over the year. The unemployment rate fell to 4.3 per cent in the same quarter. Despite the strength in demand and activity, the evidence from producer and consumer price indices is that inflation moderated in the March quarter. The Consumer price index rose 0.1 per cent in the quarter under review, which was a slight increase from 0.1 per cent in the previous quarter.

In the March quarter, the Reserve Bank of Australia decided to keep interest rates unchanged at 6.25 percent. The Reserve Bank's decision was based on prices available at the time which suggested that inflation was running at a lower rate than previously expected.

The New Zealand economy recorded a growth of around 1.0 per cent in the March quarter of 2007 with a strong contribution from private consumption growth. Employment growth was surprisingly high and labour force participation increased. The unemployment rate rose slightly in the March quarter (from 3.7 percent to 3.8 percent), due to a large increase in the participation rate. Labour income growth was again recorded at a high level which supported record retail sales growth in the March quarter. The annual consumer price inflation rate held steady at 2.5 per cent in the March quarter, and at the time the Reserve Bank of New Zealand's measures of underlying inflation were running at higher rates.

In the March quarter, the Reserve Bank of New Zealand decided to raise its official cash rate by 25 basis points to 7.50 percent, citing concerns about the recent pick-up in domestic demand.

The euro area continued to expand into the first quarter of 2007 and remains solid and broad based. The euro area growth was recorded at 1.6 per cent in the first quarter of 2007. Household consumption expenditure increased 1.0 per cent and 3.3 percent over the year. The unemployment rate declined to 7.1 percent in March from a peak of 8.9 percent in mid 2004. Headline inflation in the euro area has been steady at just below the ECB's per cent band of 0-2 per cent. Core inflation continued to trend upward, to be 1.9 per cent over the year ended in March.

The European Central Bank (ECB) in its March quarter interest rate reviews hiked only once by 0.25 basis points to take the ECB rate to 3.75 per cent. The ECB noted that the risks to inflation remained on the upside in the euro area.

Growth in the United Kingdom was solid in the March quarter, with GDP rising by 0.7 percent. Household spending and buoyant business investment continued to lead demand growth. In the period under review, consumption had been supported by increases in house prices and a tight labour market. Headline inflation rose to 3.1 per cent in March, above the Bank of England's target range.

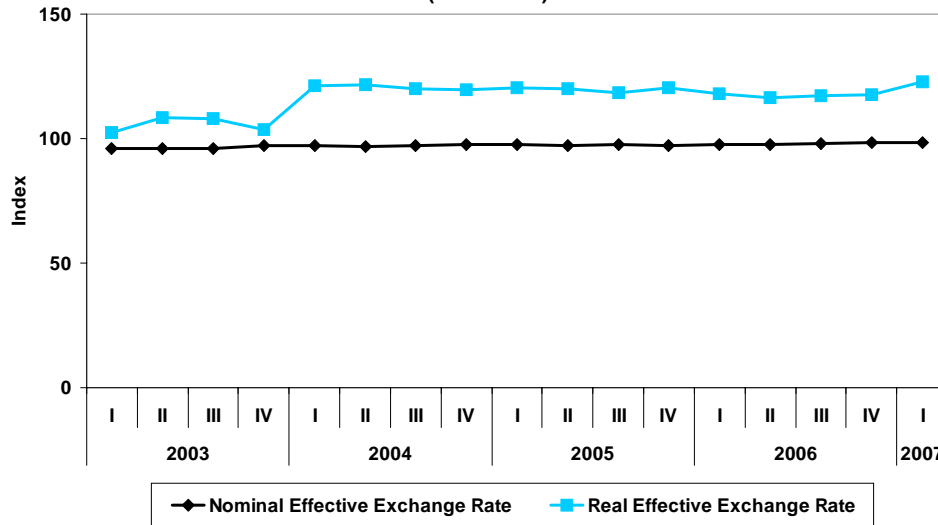
In the March quarter, the Bank of England decided to raise its official cash rate by 0.25 percent to 5.25 per cent from 5.0 percent. The Monetary Policy Committee concluded that the raise was necessary to bring CPI inflation back to the target in the medium term.

The expansion in Japan steadily continued into the period under review, while inflation remained subdued. Growth in consumption had been supported by the conditions in the labour market, while the unemployment rate was at an 8-year low of 4.0 per cent in March 2007 and surveyed employment indicators suggest the outlook remains positive. The March Tankan survey pointed to a favourable short-term outlook for the Japanese economy. During the March quarter meetings, the Bank of Japan decided to raise its short-term interest rate by 0.25 per cent to 0.50 percent as the operating target for monetary policy.

During the quarter under review, the US dollar continued to depreciate against most major currencies. The main factor which weighed on the US dollar over the period had been a reassessment of growth prospects in the US. Against the currencies of our major trading partners, the Tala depreciated against all the currencies in the basket with the exception of the US dollar. The value of the Tala in terms of its nominal index showed an appreciation of 0.15 percent in the first quarter of 2007. Furthermore, since price rises in Samoa have been 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 4.43 percent.

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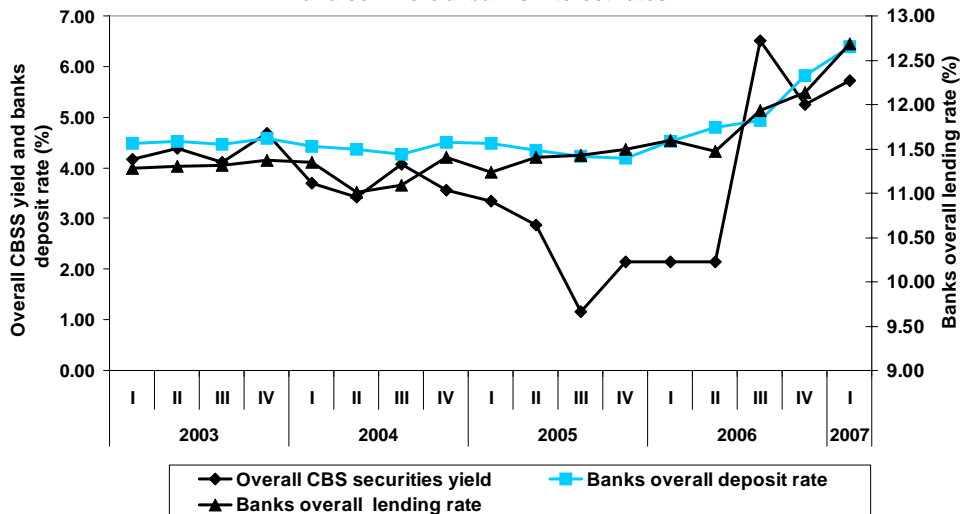
Graph 2 : Trade Weighted Exchange Rate Index  
(1998 = 100)



(b) The Samoan Economy

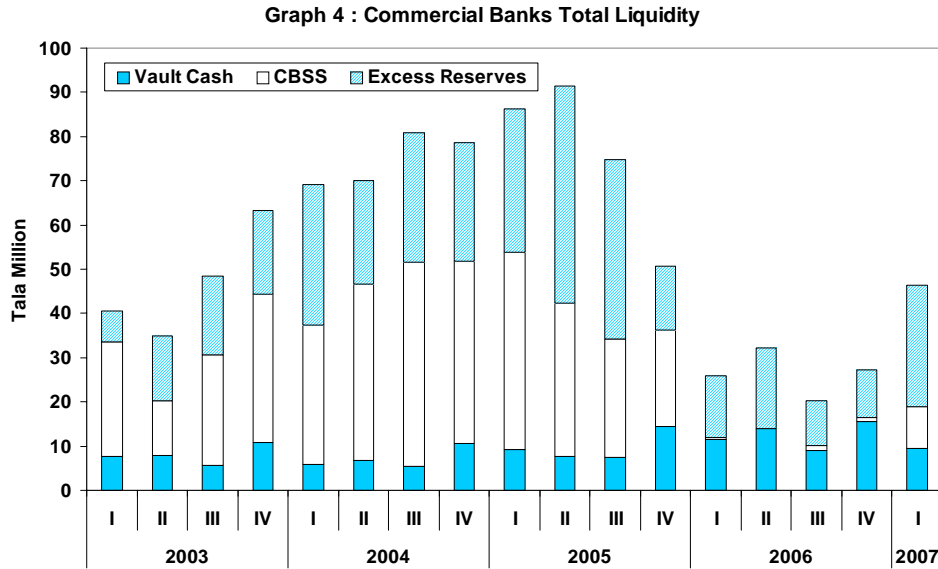
Government’s financial operations vis-à-vis the monetary system registered a cash deficit of \$12.1 million in the first quarter of 2007, following cash surpluses in the previous three quarters. Contributing largely to the substantial decline in Government’s net deposits with the monetary system were the ongoing infrastructural preparations for the 2007 South Pacific Games and some external debt servicing during the quarter. This expansionary impact of Government’s financial operation on the domestic economy was moderated by the continuation of tight monetary policy which saw the average level of interest rates pick up from the previous quarter. The overall level of official interest rates rose to 5.73 percent from 5.25 percent in the previous quarter, pushing up the average level of commercial bank lending and deposit rates by 55 points and 57 points to 12.69 percent and 6.40 percent respectively at end March 2007. (See Graph 3.)

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

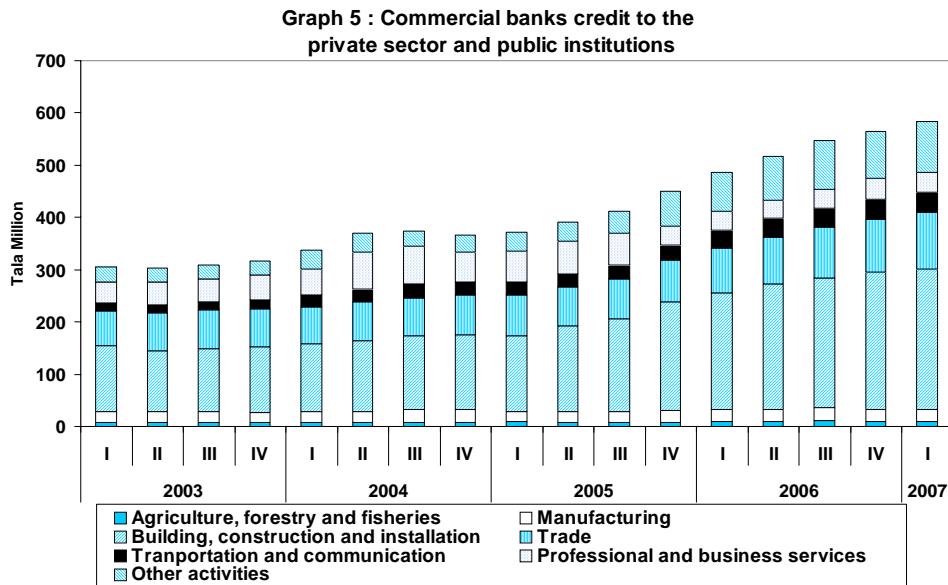


Reflecting the higher weighted average deposit rates offered by commercial banks and maintaining the Statutory Reserve Deposit (SRD) ratio at 3.5 percent, total commercial bank liquidity (comprised of holdings of CBS securities, excess reserves and cash holdings) improved strongly by a further 70 percent to \$46.3 million in the March quarter of 2007. Excess reserves of the commercial banks almost doubled the level in the preceding quarter to total \$27.4 million,

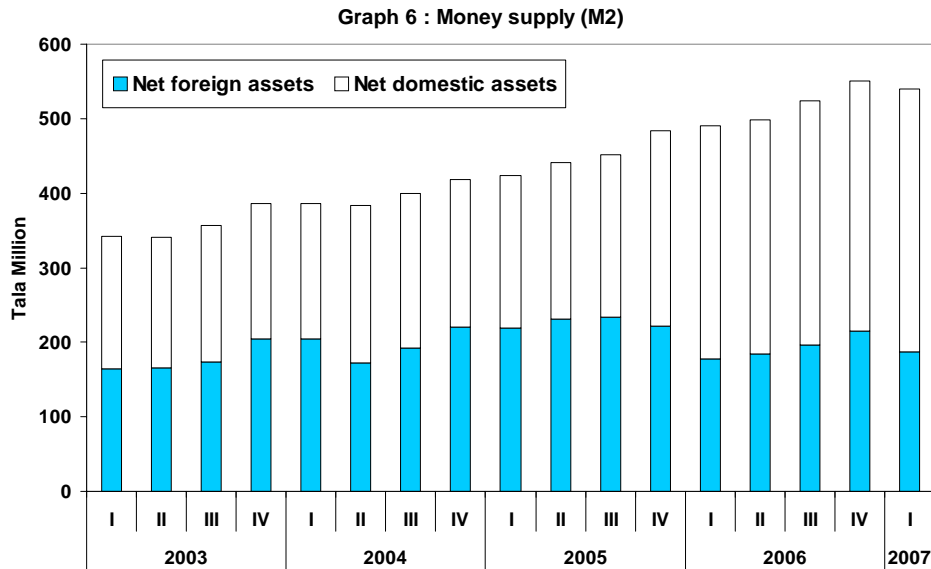
which was significantly higher than the \$15 million level that was considered comfortable for the banking system to keep at all times. (See Graph 4.)



Despite the increased lending rates, bank lending to the private sector and public institutions combined strengthened by a further \$19.4 million to \$584.3 million. In particular, loans to the private sector jumped \$18.5 million to \$555.4 million, which saw the “building, construction and installation,” “trade” and “other activities” sectors absorb most of the increased bank credit, like in the previous quarter. On an annual average basis, however, the rate of growth of credit decelerated to 27 percent at end March 2007 from 29 percent at end December 2006, a rate of growth that was very much in line with Central Bank expectations. (See Graph 5.)

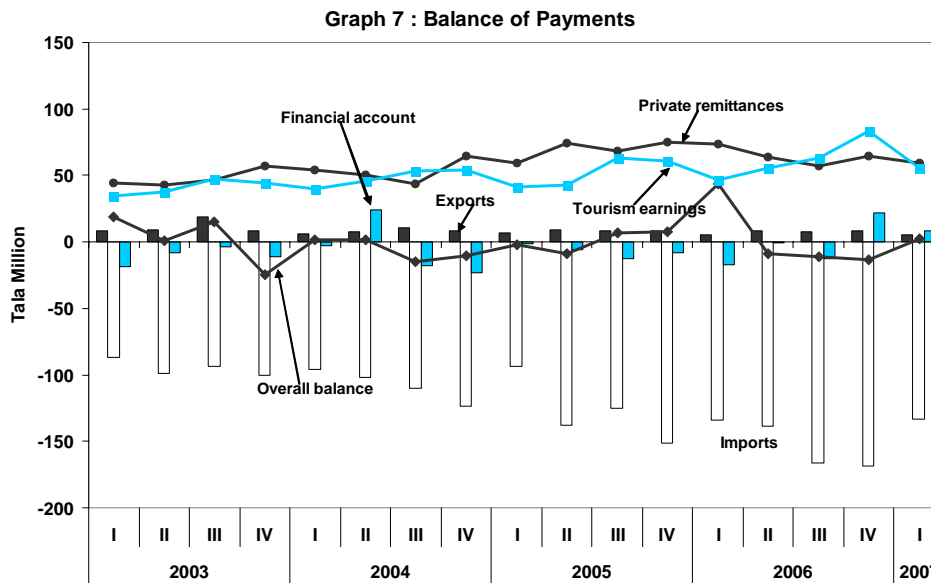


The higher level of bank credit, together with the decline in net deposits of Government with the monetary system raised the level of net domestic assets by \$17.4 million to \$352.3 million in the March 2007 quarter. On the contrary, net foreign assets seasonally declined by a significant \$28.1 million, reducing total money supply (M2) to \$539.8 million. (See Graph 6.)



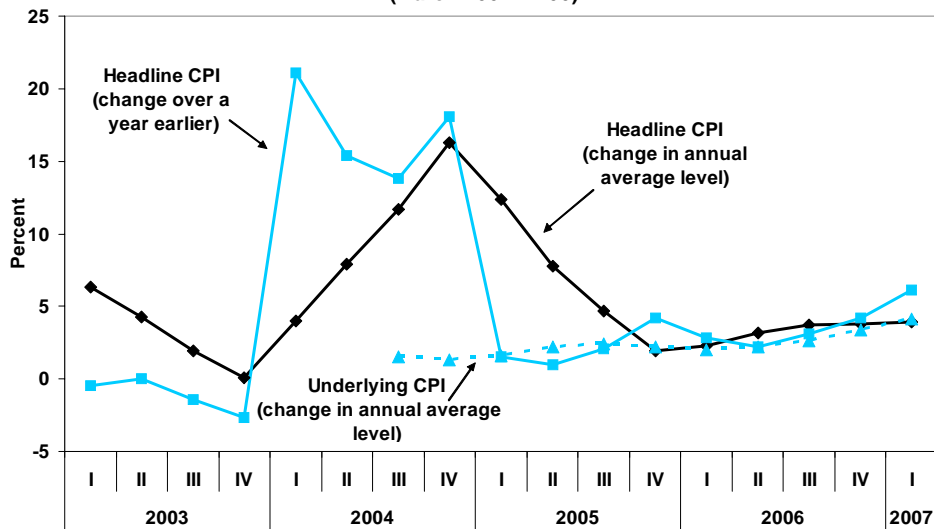
On the external sector, the merchandise trade deficit narrowed by a notable \$32.4 million to \$128.2 million; the lowest quarterly deficit since the September quarter of 2005. This improvement in the trade balance, which more than outweighed the seasonal decline in tourism earnings and private remittances, reduced the current account deficit to \$28.9 million during the quarter. The capital account and the financial account, on the other hand, however recorded significant outflows driving the balance of payments into a deficit of \$2.2 million from a surplus of \$13.4 million in the December 2006 quarter. Consequently, the level of official international reserves declined slightly to \$201.6 million at end March 2007; a level sufficient to cover 4.0 months of imports which was higher than the import cover of 3.7 months in the same period last year.

The reduction in the trade deficit was due entirely to a decline (of \$35.3 million) in imports offsetting a (\$2.8 million) fall in exports. Petroleum imports and in particular, other private sector imports, which dropped \$2.9 million and \$37.9 million respectively, were responsible for the lower level of imports in the quarter under review. In contrast, Government imports picked up strongly by \$5.6 million to \$8.8 million, reflecting largely imports of stationeries by the Ministry of Education. The decline in exports, on the other hand, was due to a fall in earnings from most of the major export commodities, particularly fresh fish which tumbled 58 percent during the quarter.

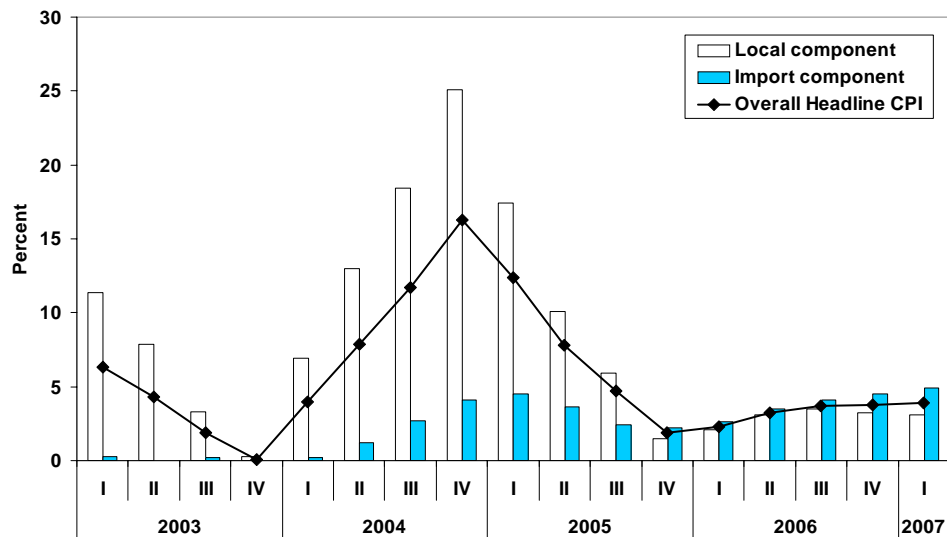


On inflation, the headline Consumer Price Index (CPI) registered a 2.7 percent increase in the first quarter of 2007; on top of a 2.9 percent increase in the preceding quarter. The rise in the CPI during the quarter under review was due largely to a 5.1 percent increase in the local component of the CPI, reflecting the higher prices for local food items, (especially for agricultural produce) and the new Government regulated prices for electricity and cigarettes which became effective in February 2007. The “imported goods” component also contributed with a 0.2 percent increase as the prices for imported food items rose 1.3 percent during the quarter. In the event, the annual headline inflation rate continued with its upward trend, edging up to 3.9 percent from 3.8 percent in the previous quarter and was higher than the 2.3 percent at end March 2006. Extracting the prices of the officially regulated items and the highly volatile prices of seasonal commodities, the annual underlying inflation rate similarly rose further to 4.1 percent at end March 2007 from 3.4 percent at end December 2006 and 1.6 percent at end March 2006.

Graph 8a : Consumer Price Index  
(March 2004 = 100)



Graph 8b : Headline Consumer Price Index



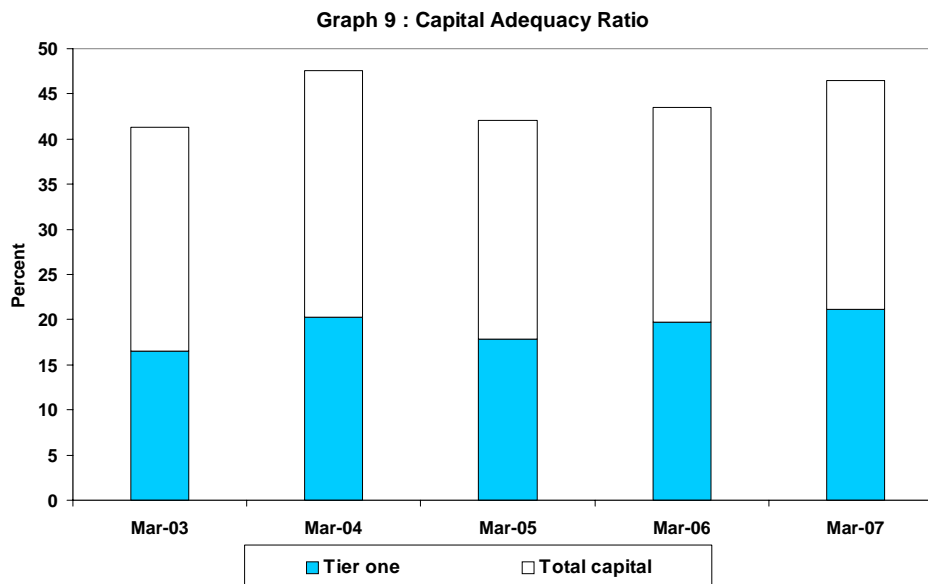
### III. PRUDENTIAL SUPERVISION

At \$759.8 million, the commercial banks combined assets increased further by 4.1 percent (\$30.2 million) in the March quarter 2007 and indicated an annual growth of 16.3 percent (\$106.3 million) when compared to the same time in 2006. The composition of the commercial banks assets comprised mainly of loans and advances of \$605.1 million (79.6 percent of total assets), cash reserves and deposits with the Central Bank and other banks combined at \$112.1 million (14.7 percent) and fixed assets of \$48.1 million (6.3 percent) respectively.

The overall level of loans and advances of \$605.1 million increased by 4.1 percent (\$23.8 million) at the end of the quarter and further increased by 18.1 percent (\$92.8 million) over the same time a year earlier. In the meantime, deposit liabilities of \$570.9 million rose 2.3 percent (\$12.6 million) over the previous quarter, recording an annual growth rate of 11.6 percent (\$59.3 million) respectively. Time deposits (\$331.3 million) represents 58.0 percent of total deposits, demand deposits (\$175.5 million) accounted for 30.7 percent while savings deposits (\$64.1 million) made up 11.2 percent of total deposit liabilities.

Total contingent and off-balance sheet items reduced by 12.4 percent (\$12.2 million) to \$85.8 million over the previous quarter, due mainly to decreases in unused credit commitments and unmatured foreign exchange contracts.

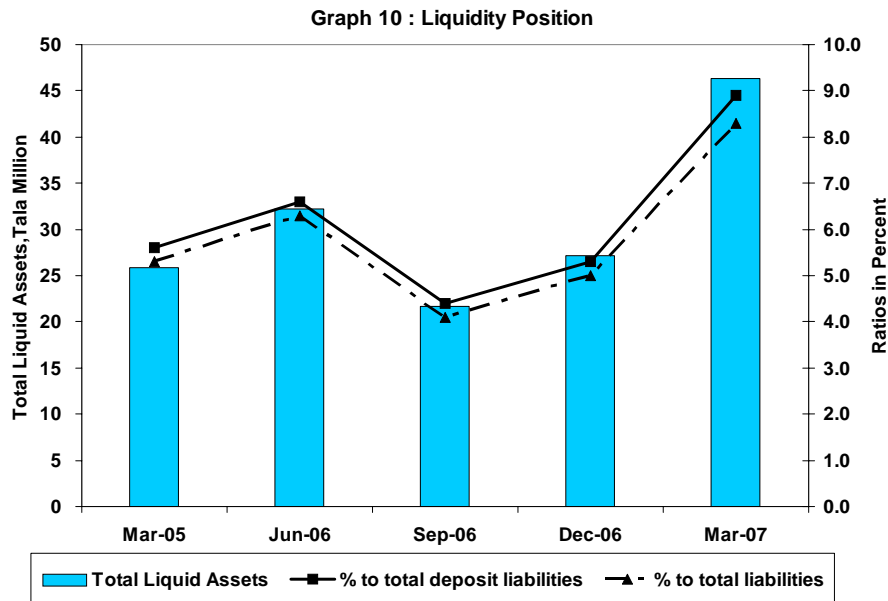
The banking system remained strongly capitalized at \$135.8 million, revealing an increase of 4.8 percent (\$6.2 million) over the previous quarter due mainly to the banks profitable performance throughout the period. In relation to the overall level of risk weighted assets, the capital adequacy ratio edge up from 24.4 percent to 24.9 percent. Tier 1 capital of 21.2 percent dropped by 0.2 percent over the December 2006 quarter. (See Graph 9.)



All the banks complied with the Central Bank's minimum capital adequacy requirement (15.0 percent) at the end of the quarter except one bank recorded at 14.7 percent.

The banking system also recorded an improvement in the level of liquid assets by 70.4 percent (\$19.1 million) over the previous quarter and further increased by 79.3 percent (\$20.5 million) when compared to the past twelve months level.

Total liquid assets stood at \$46.3 million, equivalent to 8.9 percent of total domestic deposit liabilities. The Central Bank Securities of \$9.4 million made up 20.3 percent of total liquid assets at the end of the quarter. (See Graph 10.)

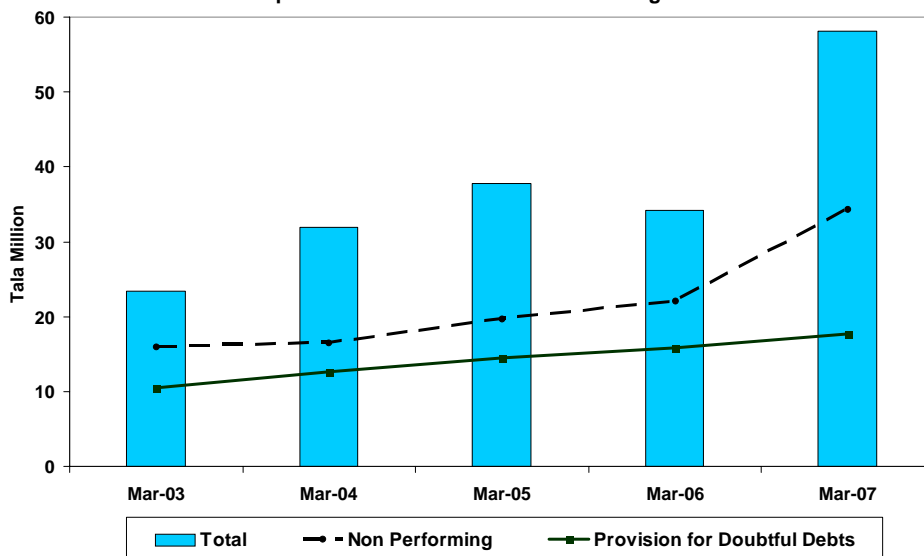


The combined foreign assets of the commercial banks amounted to \$73.2 million as compared to total foreign liabilities of \$76.4 million. At these levels, it showed a net short exposure position of around \$6.4 million or 4.7 percent of total capital.

Total past due loans however, deteriorated further with an increase of 48.6 percent (\$11.2 million) in non-performing loans now reaching \$34.3 million. As compared to the prior year, non performing loans rose markedly by 54.9 percent or \$12.2 million. Total provision for bad and doubtful debts of \$17.7 million provides a 51.7 percent buffer against possible losses that may derive from non-performing loans. As a proportion of total loans and advances, total provision stood at 2.9 percent respectively.

The Central Bank continues to monitor closely the banks performances towards reducing their levels of arrearages and non-performing loans, emphasizing the need 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 11).

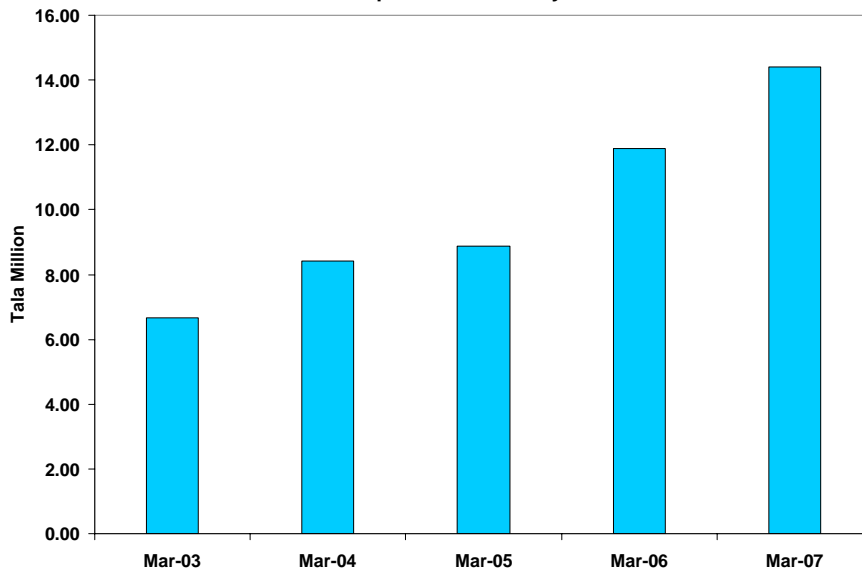
Graph 11 : Past Due and Non - Performing Loans



At a combined figure of \$20.4 million, the banking system’s pre tax profit level increased by 22.5 percent in the quarter under review when compared to the same period a year earlier.

Total net profit after tax amounted to \$14.4 million, increased from \$11.9 million recorded a year earlier. At this level, return on average networth and assets stood at 11.9 percent and 2.0 percent respectively. (See Graph 12).

Graph 12 : Profitability



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#### IV. CBS GOVERNOR'S OPENING ADDRESS FOR THE SECOND SOUTH PACIFIC COURSE ON CENTRAL BANKING 5-8 MARCH 2007

Ladies and Gentlemen

##### (A) Introduction

I am pleased to be able to welcome all our overseas guests to Samoa, and more particularly to the Central Bank of Samoa. Welcome also to the local participants. It is both an honor and a privilege for us to host this Training Course here in Apia. This is the second Course on Central Banking for the Pacific Region to be conducted by the Bank of England's Centre for Central Banking Studies, in collaboration with PFTAC. I thank both these Organisations, the International Monetary Fund and the Reserve Bank of New Zealand for this valuable training opportunity provided to the Pacific Islands central bankers as well as other bankers and Government finance officials. I would also like to thank the Asian Development Bank for the financial assistance which made it possible for most overseas participants to be here this week.

Before I start on the official part of my Opening Address, I would first like to provide a bit of free commercial, particularly to our visitors from abroad. As you will have noticed already, we have a beautiful country. It is peaceful, green and clean. Our people are friendly and, apart from the occasional downpours, we have a very warm sunny climate. We have beautiful beaches and many historical sites which unfortunately, given your tight schedule, you will not have enough time to see. But, may be some time in the future you will be able to come back perhaps with your families for a holiday and spend a longer time with us. Of course our friends from Tonga, Vanuatu, Fiji and the other island countries will probably say that they have better beaches and historical sites than us. But my answer to that is 'Samoa is still the best kept secret' and we are also 'the Heart of Polynesia'. Anyway, enough on Tourism.,

According to many reports published by several International Financial Organisations, 'Capacity constraint' is one of the key problems responsible for the relatively poor economic performances of many Pacific Island countries. Because, no matter how sound a country's economic policies are, if you do not have the qualified people to implement them, then these policies are doomed to fail.

Outward migration is one of the main reasons attributed to the problem of capacity constraint. The second reason is the lack of appropriate training opportunities. Granted, that there are several training courses being conducted by the various organisations inside and outside of the Pacific region. But what is lacking is more specialised and more focused training on issues relevant to the functions of the different Ministries and Corporations of Government.

Although the topics to be covered this week are more directly relevant to central bankers, they are also useful for the commercial and development bankers, as well as Ministry of Finance officials. Because, understanding the objectives of monetary policy and the basic tools used by central bankers to conduct monetary policy will assist these other entities in implementing complementary policy decisions. I again commend the initiative, especially by PFTAC and the Centre for Central Banking Studies, to conduct these central banking courses in the Pacific Region.

I have often been asked by the Governors of the other Pacific Island countries' central banks as to why the Samoan economy has continued to perform relatively well over the past many years. My response has been, 'consistency in the decision making process plus having a Government and people who have the courage and commitment to implement appropriate policy reforms, not only in the public sector but also in the financial sector'. On many occasions, tough and unpopular

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decisions, even sacrifices, are required to be made. But as long as the reform objectives are clear and the long term benefits are understood, then the chances of success are high. Ongoing consultation with the private sector and non Government organizations is vital. In any case, having a stable political and economic environment are very crucial ingredients.

**(B) Samoan Economy**

On the Samoan economy, the early eighties was a very critical period for us, as we faced numerous socio, economic and political problems. On the political front, things were very unstable. At one stage, we had three different Prime Ministers in one year, preceded by a 3 months public servants industrial strike. The economy was in real bad shape. For the five years to 1984, our average GDP growth rate was negative 2%. Inflation rates were extremely high and in double digits, registering 33% in 1980 and declining to 16.4% in 1983. Our foreign exchange reserves were negative \$28.5 million in 1982 and negative \$16.5 million in 1984. On interest rates, lending rates reached an unprecedented high of 20% in 1983.

At the same time, the Government spent much more than what it was earning, resulting in fiscal deficits well in excess of 5% of GDP. Unemployment was high with public servants taking a very casual 'laid back' attitude with their work, resulting in a lot of time-consuming processes and unnecessary red tapes.

In view of the abovementioned socio economic problems, the Government decided to introduce a program of reform initiatives to put the economy back on track.

**(C) The Reforms**

The first major reform was the strengthening of monetary and exchange rate policy formulation through the establishment of the Central Bank of Samoa in May 1984. This paved the way for later reforms, particularly the changing of the exchange rate peg from the New Zealand dollar to a trade weighted basket of currencies in 1985, the liberalization of the financial system in 1998 and the licensing of foreign exchange dealers and money transfers.

There were also major reforms in the taxation area, especially with the introduction of the 'value added goods and services tax' in 1994. Import tariffs and corporate and personal income taxes were also reduced.

On the Government budget, key reforms included the introduction of output based budgeting in 1996. This provided the basis for moving the focus more to performance. At the same time, the size of the public service was reduced. State-owned enterprises were made to be more accountable and transparent by employing best practices in their operations and management.

A key objective of the reform program was recognizing and developing the private sector as the engine of economic growth, which therefore necessitated creating an enabling environment to facilitate increased activity in the private sector. Some of the key strategies that were accordingly implemented included tariff and tax reductions, removal of exchange controls, the abolition of credit and interest rate ceilings, and the issue of two new banking licences. These latter reforms allowed more funds to be made available at competitive rates for private sector investment and development.

**(D) The Achievements**

The major achievements resulting from the above reforms included positive rates of GDP growth since 1994. In fact, for the ten year period to 2005, our average annual growth rate was 4.2%. This is in contrast to the negative growth rates recorded prior to 1994. In the same period, the inflation rate was contained at an average of around 4% per annum, while our foreign exchange reserves continued to trend upwards averaging around 4.5 months of import cover.

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On Government spending, the budget recorded surpluses from the mid 90's. However, the need for large infrastructural investments resulted in small manageable budget deficits from 2000 to 2005.

**(E) Monetary Policy**

As regards the conduct of monetary policy, the main policy instrument currently used by the Central Bank of Samoa, since the economy was liberalized in 1998, is Central Bank securities. These Securities are issued on a weekly basis, through a tender process. The volume of securities issued is dependent on the level of free liquidity in the financial system, taking into account the Central Bank's monetary policy stance at the time.

As we have learned recently, this policy instrument (i.e. Central Bank Securities) is only effective if there is ample free liquidity in the system. However, the question arises as to what one can do in a situation where monetary policy needs to be tightened to slowdown demand and reduce the pressure on prices and foreign exchange reserves, but there are no buyers of Central Bank Securities because there is insufficient free liquidity in the financial system. In our case, we used a non-economic instrument called 'moral suasion'. Through ongoing consultations with the stakeholders in the financial system, commercial banks' interest rates were made to rise, despite the absence of Central Bank Securities.

The above confirms the importance of what I have said earlier about the value of regular consultation with the stakeholders. As long as the stakeholders understand the implications and consequences of certain actions, or otherwise, then they would be receptive to some elements of moral suasion.

**(F) Conclusion**

In concluding, I would like to say that I shall be very interested to learn, during the course of this week, of the experiences of the other countries, as well as from our overseas experts, as regards other possible options for the conduct of monetary policy in small island countries.

In any case, the Course Agenda contains several very important issues pertaining to the conduct of monetary policy. They are all very interesting topics and I encourage all participants to utilize the Resource personnel well, in addition to learning from your other colleagues.

And remember, 'It is not what you learn, but it is how you use what you learn that is important.'

I wish you all the very best over the next few days.

Soifua.

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