

## II. OVERVIEW OF ECONOMIC DEVELOPMENTS DURING THE FOURTH QUARTER OF 2008

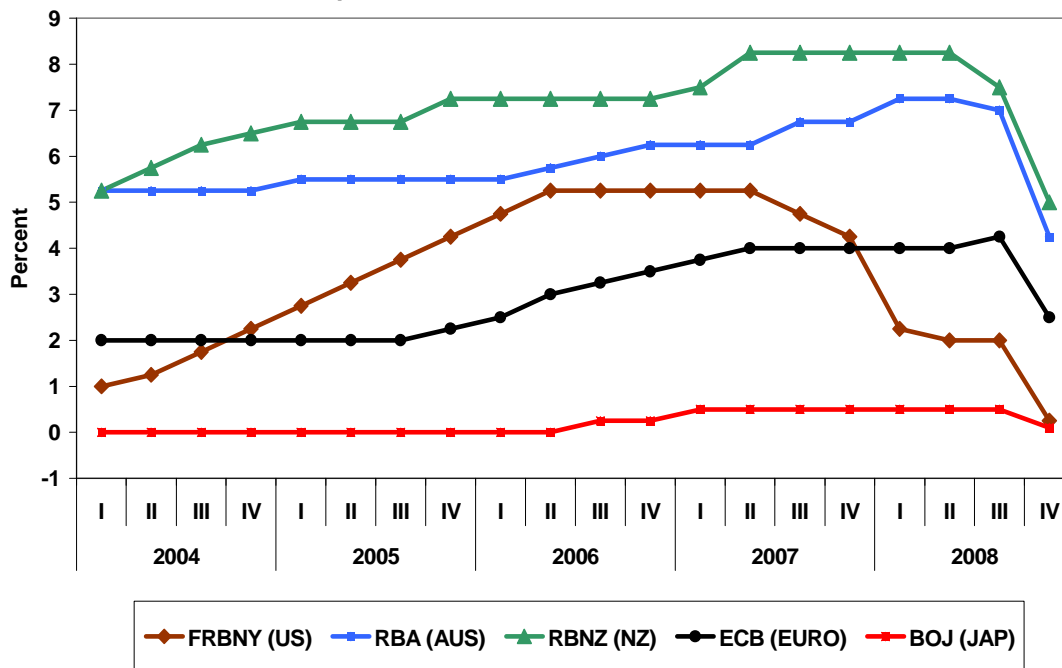
### a. The World Economy

For most major economies, the December quarter of 2008 was yet another period of contraction as growth in the global economy took on a significant downturn and the world’s largest economies, often labelled the engines of growth, remained entangled in a web of financial and economic problems. Economic growth rates in the US, Japan, the UK, Europe, Australia and New Zealand were all negative in the quarter under review. As inflation rates came off their highs in the quarter under review, efforts to stave off the deepening downturn became a vital concern and as a result, Reserve Banks across the globe slashed their monetary policy rates in magnitudes of 50 to 150 basis points.

The United States economy contracted at an annual rate of 6.2 percent in the final quarter of 2008 after contracting only 0.5 percent in the previous quarter. The deeper downturn in the December quarter was led by the sharp fall in exports, continuing decline in consumer spending, ongoing weakness in the housing sector, coupled with the larger reduction in business investment. In the labour market, the US unemployment rate rose to 6.9 percent from 6.1 percent in the previous quarter. Households’ income over the three months period also fell, led by the increase in job losses and the fall in asset prices, hence the continued decline in consumer spending. But, in spite of all the economic gloom, there was one upside to the downturn and that was the notable drop in the US economy’s inflation rate, from 4.9 percent in June to only 0.1 percent in the month of December.

Against the backdrop of sluggish demand, retreating oil prices and benign inflation levels, the Fed finally reacted to the rapidly deteriorating economy by slashing 175 basis points off the Federal funds rate in the December quarter, to a target range of zero to 0.25 percent. (See Graph 1.)

Graph 1 : Official International Interest Rates



In the December quarter, the Australian economy contracted 0.1 percent from the previous quarter. However, on an annual basis, the growth rate was positive at only 0.6 percent, preceded by 1.9 percent growth in the June quarter. Australia’s GDP fell mainly because of the decline in

manufacturing, property and business services as well as declining wholesale trade. Positive contributions to growth came through the agriculture, forestry and fishery sectors. In the labour market, Australia's unemployment rate rose to 4.5 percent from 4.3 percent in the third quarter. Nevertheless, retail sales rose slightly as wages and salaries increased by a small margin and consumer sentiment was slightly more positive. Australia's annual inflation rate fell to 3.7 percent from 5.0 percent in the previous quarter as commodities and oil prices fell during the December quarter.

As price pressures eased and the downside risks to growth became increasingly threatening, the Reserve Bank of Australia slashed a total of 275 basis points from its 7.0 percent cash rate to 4.25 percent in the quarter under review.

For New Zealand, the economy's growth in the fourth quarter contracted 0.9 percent from the previous quarter. On an annual basis, the economy contracted 1.9 percent in the quarter under review. The labour market continued to weaken as the unemployment rate rose to 4.6 percent from 4.2 percent in the previous quarter. The housing market was also weaker as issued building permits continued to fall and house prices fell for three consecutive months. Retail activity also continued on a downtrend as sales fell an annual 1.5 percent in the fourth quarter of 2008. Price pressures also eased from its highs as the inflation rate in the Kiwi economy fell from 5.1 percent in the June quarter to 3.4 percent in the quarter under review.

After months of maintaining the highest official interest rate among the industrialised economies, the onset of the financial markets crises and the rising downside risks to growth saw the Reserve Bank of New Zealand joining the global race among Reserve banks to lower their key interest rates. The Reserve Bank of New Zealand reduced their OCR by 250 basis points to 5.0 percent in the December quarter of 2008.

In the Euro area, the economy contracted at an annualised rate of 1.3 percent after expanding only 0.6 percent in the third quarter. Economic activity continued to slow down as industrial production declined for a second consecutive quarter, retail sales were also negative for a second straight quarter and international trade, slumped further from the previous quarter's levels. Overall sentiment for businesses across all sectors including consumers indicated increased pessimism towards the state of the economy. In the jobs market, the unemployment rate in Europe rose to 7.9 percent from 7.6 percent. Europe's inflation rate trekked lower to 2.3 percent in the quarter under review from 3.8 percent in the third quarter.

Against the backdrop of easing price pressures and rapidly deteriorating economic fundamentals, the European Central Bank joined in the global race to lower interest rates. Over the December quarter, the European Central Bank reduced the repo rate by a total of 175 basis points to 2.5 percent.

The United Kingdom's economy contracted at an annual rate of 1.9 percent in the fourth quarter of 2008 after slowing only 0.5 percent in the previous quarter. The negative growth rate is attributed to the marked decline in activity in the manufacturing and services industries, coupled with the continued slump in the housing market. With lower income compared to previous quarters, consumer expenditure fell over the quarter under review and retail sales fell 0.8 percent from the previous quarter. The labour market in the United Kingdom is similarly weak as in other economies and its unemployment rate rose to 6.3 percent from 6.1 percent. Price pressures in the UK subsided as the inflation rate fell to 3.9 percent from 4.8 percent in the third quarter.

In the December quarter, the Bank of England slashed its official interest rate by the most points than any other Reserve bank within the three months period. The Bank of England sliced off 300 basis points from its official interest rate to 2.0 percent.

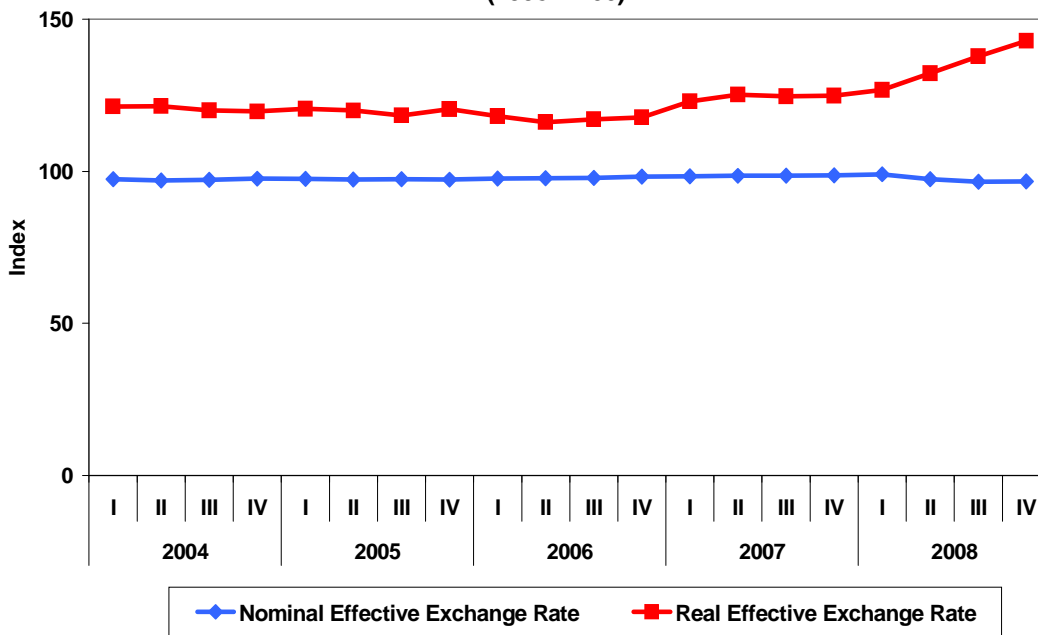
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The Japanese economy contracted at an annual rate of 4.6 percent after previously contracting only 0.2 percent in the previous quarter. Business sentiment continued to worsen as a larger proportion of respondents to the Tankan survey expected not so favourable business conditions in the fourth quarter. The unemployment rate in Japan was slightly lower in the December quarter, as it dropped from 4.1 percent in the previous quarter to 4.0 percent. Inflation in Japan eased to 1.0 percent in the quarter under review, from 2.2 percent in the previous quarter. During the last quarter of 2008, deteriorating economic activity led the Bank of Japan to lower its official interest rate by 40 basis points to 0.1 percent and it maintains the lowest interest rate among the industrialised countries.

In the currency markets, the US dollar was clearly on an uptrend against most of the major economies, save the Yen. Despite the deterioration in the global economy, the US dollar was largely supported by the safe haven appeal of its US Treasuries. Likewise, the Yen appreciated in the fourth quarter, supported by its appeal as another safe haven currency. For the Tala, these meant a reversal of previous gains into a period of decline against the US dollar and the Yen, while appreciating against the currencies of New Zealand, Australia, the EU and Great Britain.

In terms of the Tala’s nominal index, the overall value of the Samoan currency against the currency basket appreciated 0.2 percent in the quarter under review. In real terms, the real effective exchange rate indicated that the Tala appreciated by 3.66 percent, down from 4.27 percent in the previous quarter due to the nominal depreciation of the Tala against the US dollar. Nevertheless, the real effective exchange rate was still high, thus indicating that prices in Samoa continued to rise faster than those of our major trading partners. (See Graph 2.)

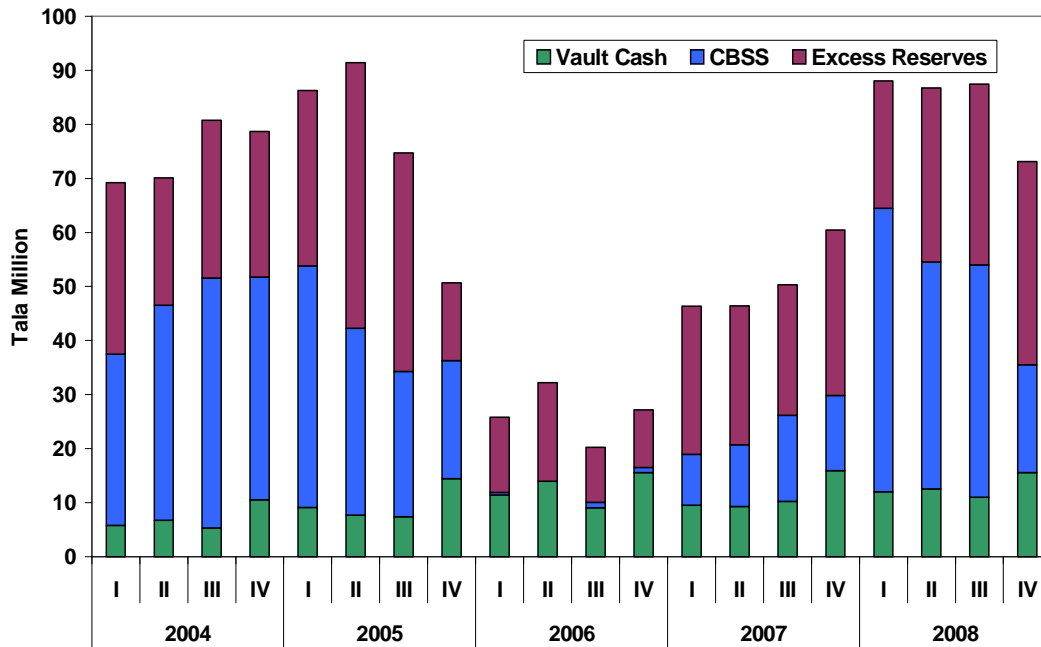
**Graph 2 : Trade Weighted Exchange Rate Index  
(1998 = 100)**



**b. The Domestic Economy**

Total commercial bank liquidity in the quarter under review contracted by a significant 16 percent (\$14.0 million) after a slight increase in the previous quarter. This notable reduction in liquidity was mainly due to a 53 percent (\$22.7 million) drop in investments in CBS securities despite improvements in cash holdings and excess reserves of \$4.6 million and \$4.1 million respectively. (See Graph 3.)

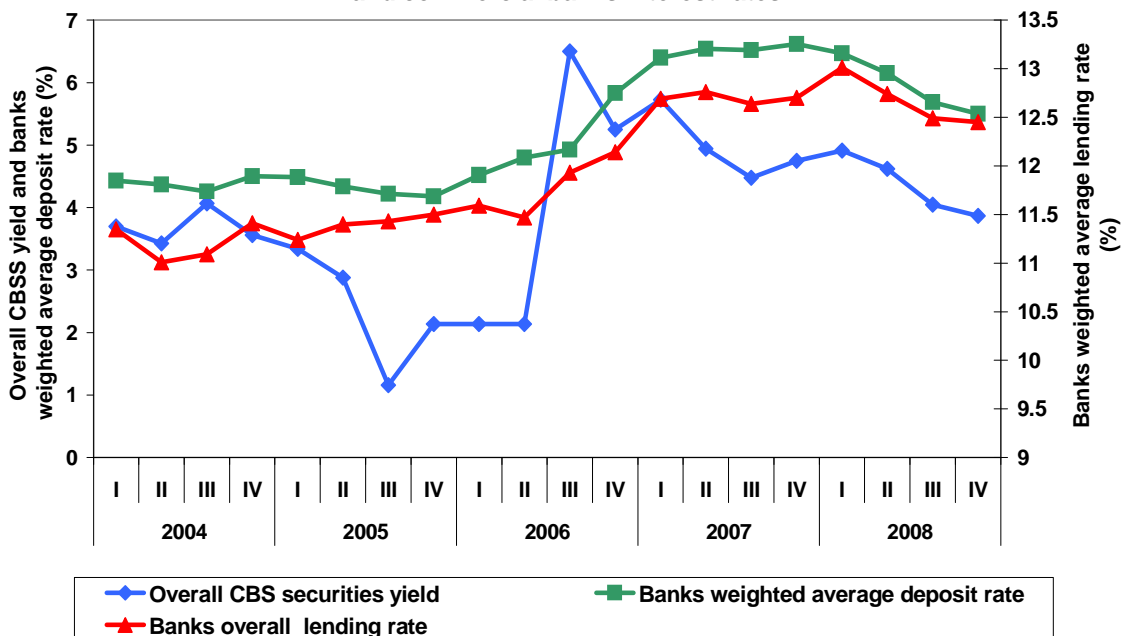
Graph 3 : Commercial Banks Total Liquidity



The Government’s financial operations in the December quarter registered a quarterly cash surplus of \$3.7 million in contrast to a cash deficit of \$4.3 million in the preceding quarter. This accumulation of Government funds reflected a slowdown in fiscal spending during the quarter

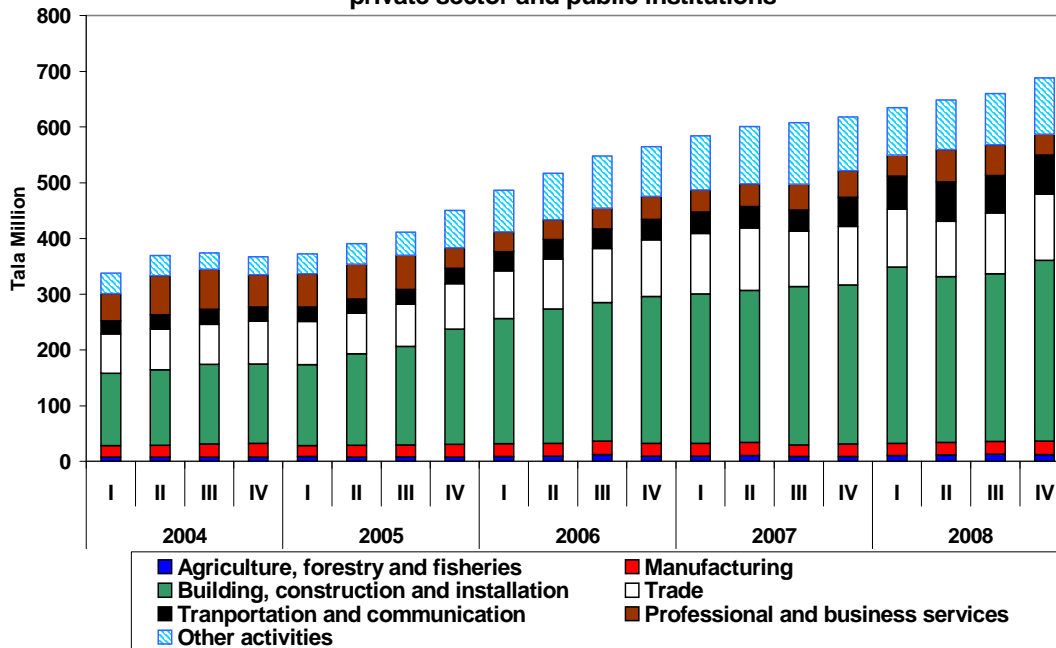
In line with the easing of the Bank’s monetary policy stance, interest rates fell in the final quarter of 2008. The overall weighted average official interest rate decreased to 3.87 percent at end December 2008 from 4.05 percent at end September. Commercial bank interest rates followed suit with both the weighted average lending and deposit rates declining by 4 points and 19 points to 12.45 percent and 5.50 percent respectively in the same period. In the event, the commercial bank’s interest rate spread edged up to 6.95 percent from 6.80 percent in the preceding quarter. (See Graph 4.)

Graph 4 : Overall yield on CBS securities and commercial banks interest rates



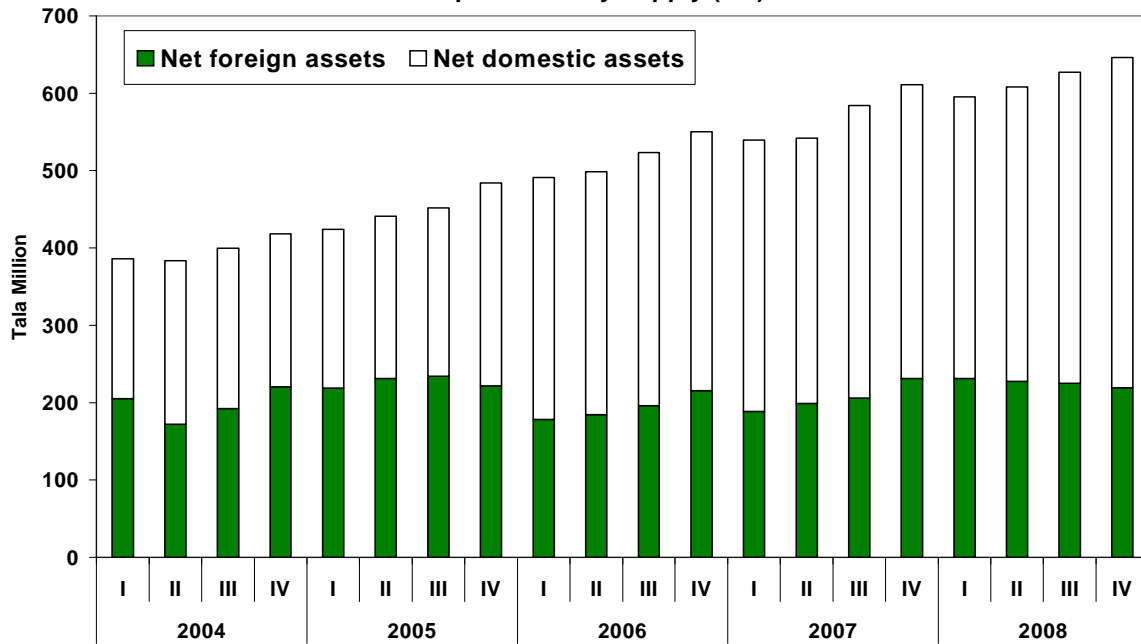
With the lower cost of borrowing, bank credit to the private sector and public institutions combined expanded by \$28.1 million to \$691.4 million, notably higher than the \$11.6 million rise in the previous quarter. Private sector credit, which rose 4 percent (\$25.5 million) to \$614.2 million was absorbed mainly by the “Building and construction” (up \$23.4 million), “Trade” (up \$9.5 million), “Transportation and communication” (up \$2.5 million) and “Other activities” (up \$8.4 million) sectors while “Professional and business services” tumbled \$17.4 million during the quarter under review. On an annual average basis, the rate of growth of bank credit picked up to 6.7 percent for the first time since October 2006, from 5.7 percent at end September 2008. (See Graph 5.)

**Graph 5 : Commercial banks credit to the private sector and public institutions**



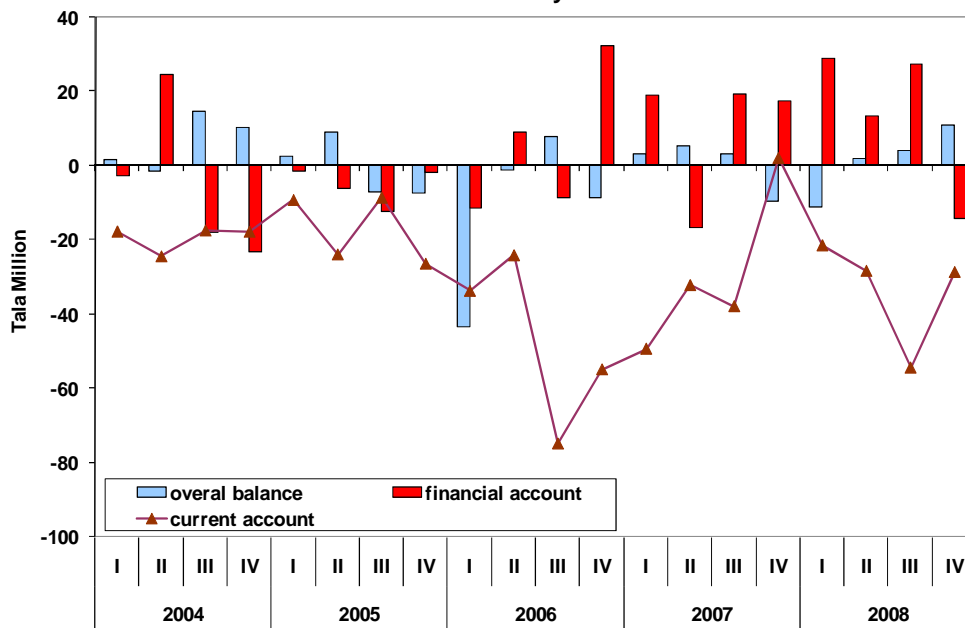
This higher level of bank credit pushed up net domestic assets by 6 percent, raising the level of money supply (M2) by 3 percent (\$19.1 million) in the fourth quarter of 2008, despite a 3 percent (\$6.1 million) fall in net foreign assets. However, the annual growth of M2 decelerated to 8.7 percent from 10.1 percent in September 2008 and 10.5 percent in December 2007. (See Graph 6.)

Graph 6 : Money supply (M2)

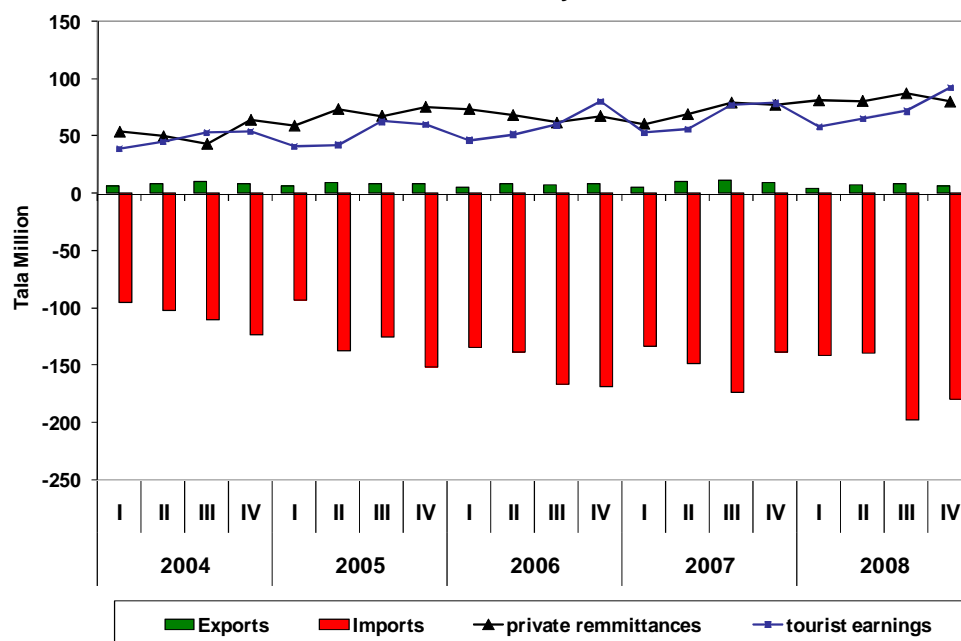


On the balance of payments, an overall deficit of \$10.7 million was recorded in the December 2008 quarter due to outflows in both the current account and, to a lesser extent, the financial account. (See Graph 7a.) The current account deficit, albeit much smaller than in the previous quarter, was due largely to a high level of imports and a drop of 8 percent in private remittances which offset gains from tourism earnings during the quarter. (See Graph 7b.)

Graph 7a  
Balance of Payments



Graph 7b  
Balance of Payments



All categories of imports declined in the December 2008 quarter, with private sector imports virtually unchanged (down \$0.2 million) from the preceding quarter, reflecting largely weakened demand for consumer goods, motor vehicles and construction materials. Similarly, petroleum and Government imports shrank 26 percent (\$15.0 million) and 39 percent (\$3.7 million) respectively in the period under review.

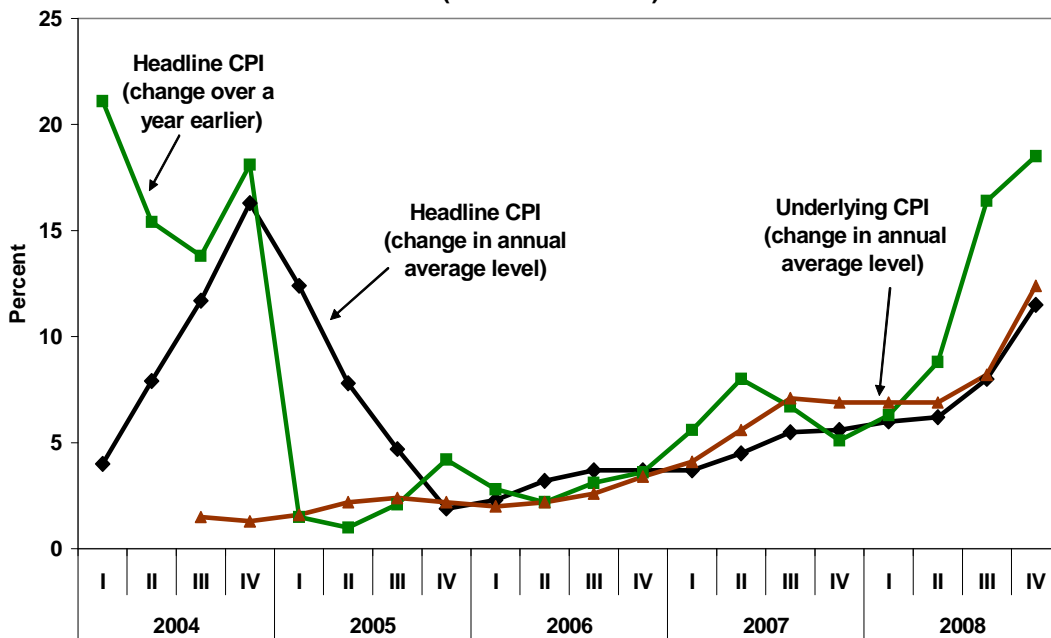
Total export earnings, likewise, fell 14 percent (\$1.1 million) in the fourth quarter of 2008 to \$6.7 million mainly due to a \$1.3 million drop in re-exports despite a \$0.2 million increase in domestic exports. A strong rebound in nonu juice exports coupled with increases in fish, coconut oil, taro and nonu fruit pushed up domestic exports, offsetting reductions in other major export commodities such as beer, coconut cream and nonu juice in the quarter under review.

Tourism earnings increased 28 percent (or \$20.2 million) in the December quarter of 2008, following a 6 percent increase in tourist arrivals and a 22 percent hike in average expenditure in light of increased consumer prices as well as a seasonal rise in spending during the festive season. Like the previous quarter, the majority of tourists that visited Samoa in the last quarter of 2008 were from New Zealand (43 percent), Australia (21 percent) and American Samoa (19 percent). Most of the tourists were here to visit friends and relatives (45 percent) and those who were here for holiday (42 percent). Gross private remittances, as well, fell 9 percent (\$8.8 million) due to a 35 percent drop in remittances for charitable organizations and a 2 percent decline for households.

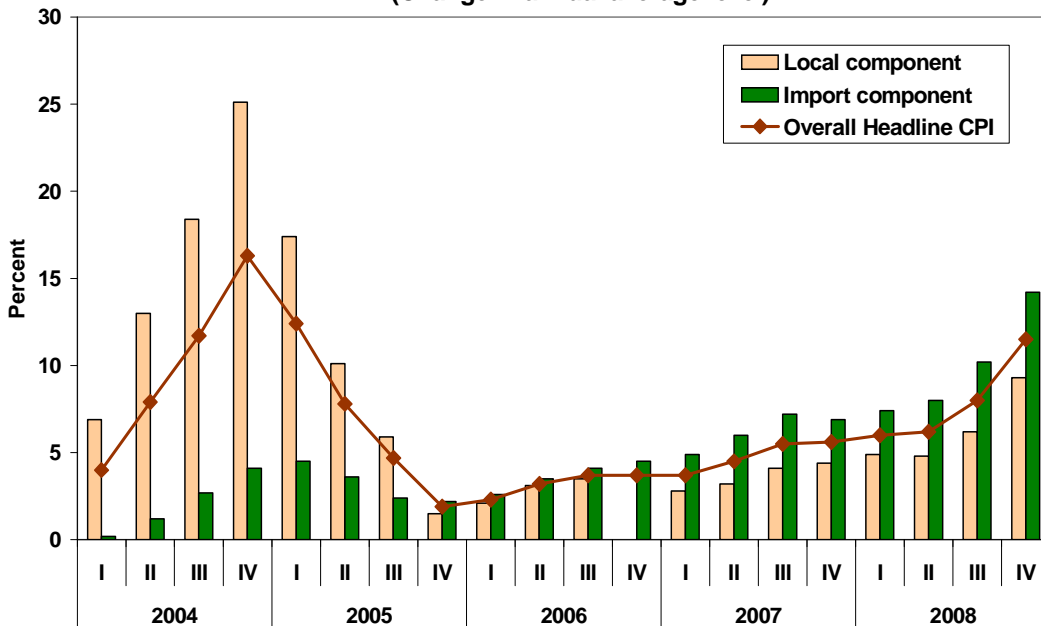
On prices, the average level of consumer prices rose 4.4 percent in the December quarter, to a level 18.6 percent higher than in the same quarter a year earlier. (See Graph 8a.) The higher headline Consumer Price Index (CPI) reflected increased prices in all categories except for the "Transport & Communications" and "Housing and Household Operation" sub-groups. Contributing the most to the higher headline CPI were the 8.7 percent, 3.1 percent and 1.9 percent increases in the "Food", "Clothing & Footwear" and "Alcohol and Tobacco" subgroups. These sub-indices were largely influenced to a large extent, by external factors, with the import component of the CPI rising by 4.9 percent combined with an increase of 3.9 percent in its local component. The "Food" sub-index rose 8.7 percent reflecting hikes of 10.4 percent and 6.1 percent in both its imported and local components respectively. Local "Transport & Communications" rose 6.8 percent reflecting the upward revision in boat fares which was

effective in December 2008 but was offset by a 13.9 percent drop in its import component as petroleum prices eased in the quarter under review. Lower gas prices saw the “Housing and Household Operation” sub-index fall in the quarter under review while an increase in the price of beer contributed to an overall hike in the “Alcohol and Tobacco” sub-index. Consequently, on an annual average basis, the headline rate of inflation increased to 11.5 percent at end December 2008 from 8.0 percent at end September 2008 and 5.6 percent at end December 2007. The annual average underlying inflation rate also rose to 12.4 percent in the last quarter of 2008 from 8.2 percent and 6.9 percent in September 2008 and December 2007 quarters respectively. (See Graph 8b.)

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



**Graph 8b : Headline Consumer Price Index  
(Change in annual average level)**



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### III. PRUDENTIAL SUPERVISION

For the quarter ended 31 December 2008, the banking system continued to grow in terms of total assets against the upward trend in liabilities. Capital adequacy remained comfortably above the Central Bank's minimum requirement of 15.0 percent as banks' profitability improved steadily.

At \$919.9 million, the commercial banks combined assets reflected an increase of 1.9 percent (\$16.8 million) in the December quarter and indicated an annual growth of 10.9 percent (\$90.7 million) when compared to the same time a year earlier. The composition of the commercial banks assets comprised mainly of loans and advances of \$714.8 million (77.7 percent of total assets), cash reserves and deposits with the Central Bank and other banks combined at \$147.5 million (16.0 percent) and fixed assets of \$54.6 million (5.9 percent) respectively.

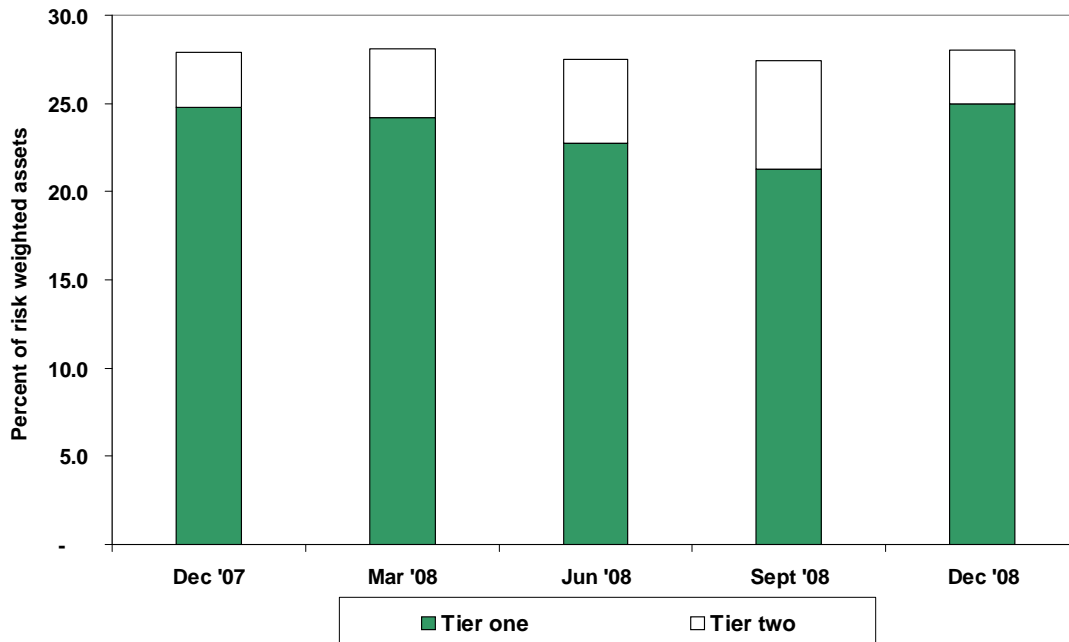
Total loans and advances of \$714.8 million grew by 4.7 percent (\$31.8 million) at the end of the quarter and further rose by 11.7 percent (\$74.9 million) over the same time a year earlier. Loans to private businesses and non-financial public enterprises dominated the growth in loans and advances for the quarter.

Total deposit liabilities showed an increase of 2.3 percent (\$15.7 million) over the previous quarter and recorded an annual growth rate of 11.0 percent (\$68.7 million) respectively. Time deposits (\$426.5 million) represents 61.3 percent of total deposits, demand deposits (\$196.6 million) accounted for 28.3 percent while savings deposits (\$72.1 million) made up 10.4 percent of total deposit liabilities.

Total contingent and off-balance sheet items dropped by 21.1 percent (\$28.9 million) to \$107.9 million over the previous quarter, due mainly to decreases in unmatured foreign exchange contracts and unused credit commitments.

The banking system remained strongly capitalized at \$176.6 million, revealing an increase of 6.6 percent (\$10.9 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 went up from 27.4 percent to 28.0 percent. Tier 1 capital of 25.0 percent increased by 3.7 percent over the September 2008 quarter. (See Graph 9.)

**Graph 9 : Capital Adequacy Ratio**



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

The level of liquid assets dropped markedly by 16.0 percent (\$14.0) to \$73.1 million over the previous quarter, largely reflecting the reduction in Central Bank Securities. On an annual basis, the banking system's overall liquidity level improved by 20.9 percent (\$12.6 million) when compared to the same time a year earlier. At this level, it represents 11.7 percent of total domestic deposit liabilities.

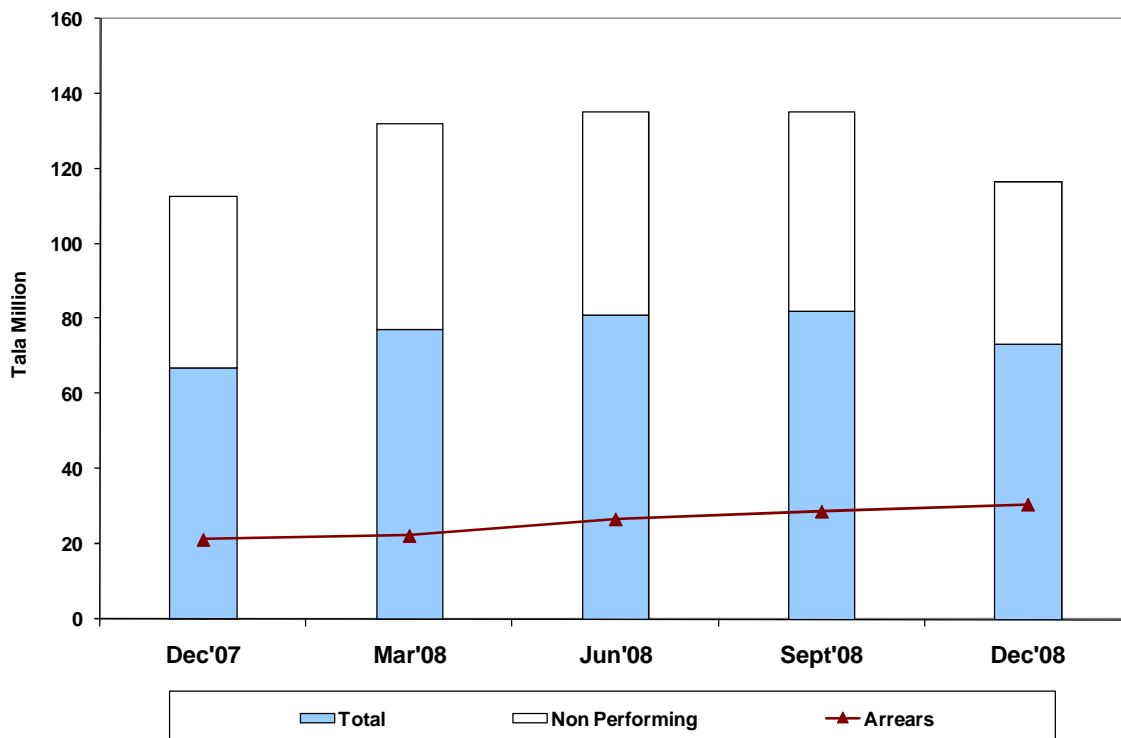
To date, total Central Bank Securities of \$19.9 million dropped significantly by 53.3 percent (\$22.7 million) at the end of the quarter.

The combined foreign assets of the commercial banks amounted to \$114.9 million as compared to total foreign liabilities of \$95.8 million. At these levels, it showed a net long exposure position of around \$19.1 million or 10.8 percent of total capital.

The overall level of problem loans recorded a marked decrease of 19.4 percent (\$10.4 million) to \$42.9 million. As compared to the prior year, the level of non performing loans registered a decrease of \$2.8 million respectively. In relation thereto, total provision for bad and doubtful debts of \$30.1 million provides a 70.0 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 4.2 percent respectively.

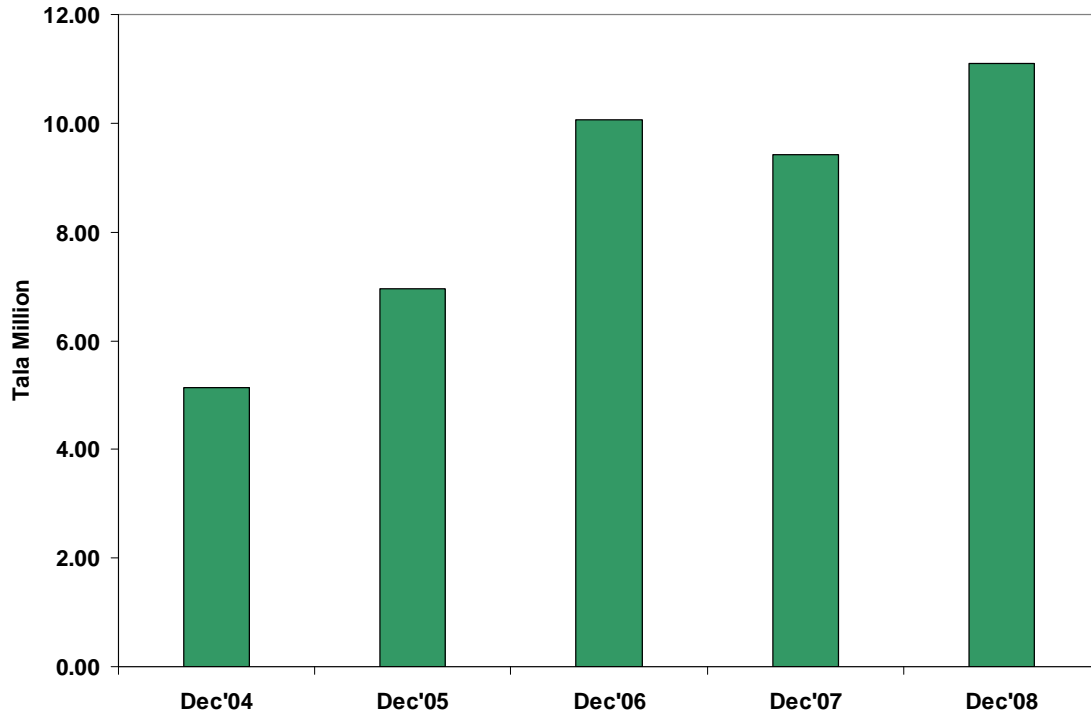
The Central Bank continues to monitor closely the banks performances towards reducing their levels of arrearages and non-performing loans, which require them to be extra vigilant in their approaches towards asset quality. Equally important, is the need for the banks to ensure that adequate provisions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

**Graph 10 : Past Due and Non-Performing Loans**



At a combined figure of \$15.2 million, the banking system's pre tax profit level increased by 17.8 percent when compared to the same period a year earlier. Total net profit after tax amounted to \$11.1 million, up from \$9.4 million recorded a year earlier. At this level, return on average networth and assets stood at 7.0 percent and 1.3 percent respectively. (See Graph 11).

**Graph 11 : 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. Furthermore, the banks continued to achieve good earnings from their non-interest earning activities such as commission, fees and charges and foreign exchange profit.

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**IV. PRESS RELEASE****ECONOMIC DEVELOPMENTS IN THE FIRST SIX MONTHS AND MONETARY POLICY FOR THE SECOND HALF OF 2008/09.**

At its Meeting on Friday 30 January 2009, the Board of Directors of the Central Bank of Samoa decided for monetary policy to be eased some more in order to stimulate further private sector development and growth. The Board's decision was based on current and latest trends in the global and domestic economies.

Since the outbreak of the financial crisis in September 2008, the world economy has deteriorated rapidly into its worst economic performance since World War II. Despite extreme measures taken by governments and central banks around the world, most industrialized countries are now in recession. Although economic analysts around the world saw the world economy heading downwards in 2008 and 2009, they did not expect to see economic conditions deteriorating enormously and as rapidly as they have been since September 2008. As the financial fallout deepened worldwide, the IMF has continued to revise downward its world economic forecasts in the last quarter of 2008. Last week, in its *January 2009 World Economic Outlook Update*, the IMF again scaled down its forecasts for 2009 and 2010, with global growth expected to fall from 3.4 percent in 2008 to only ½ a percent in 2009, the lowest since World War II. Unemployment rates in the developed world worsened with those for the US, Australia and New Zealand (Samoa's main trading partners) now at 7.2 percent (11.1 million), 4.5 percent (501,000) and 4.6 percent (105,000) respectively.

Fiscal and monetary policies worldwide were swiftly reversed from tight to dramatically expansionary stances in the six months to end December 2008. This policy direction is expected to continue as countries try to unlock their credit markets and to revive their ailing economies. The global economy is projected by the IMF to recover gradually with a 3.0 percent growth rate in 2010. Official interest rates have fallen sharply with those for the US and Japan nearing zero and those elsewhere in the world also heading down. Australian and New Zealand official interest rates now stand at 3.25 percent and 3.50 percent respectively. As we reported last time, the good news for Samoa is that the global recession has dampened demand for oil, driving down the prices of petroleum products overseas and in Samoa. However, in January 2009, OPEC decided to halt the downward spiraling of international oil prices by agreeing to substantially cut supply by a record 2.2 million barrels a day. The downside of the global deterioration is that the weak demand and increased unemployment overseas will impact adversely on Samoa's export sector, tourism and private remittances – Samoa's main sources of foreign exchange.

For Samoa, after recording consistently high real growth rates in the previous five years, the economy is expected to decline by 1.3 percent in the current financial year as the adverse impact of the global downturn start to show up in Samoa's economic statistics. The external sector has continued to absorb the adverse impact of the financial crisis, exacerbated by a relatively subdued fiscal outturn. Consequently, the balance of payments recorded an overall deficit in the first six months of 2008/09. For the financial year 2008/09 as a whole, the Bank's balance of payments forecast has been revised to post an overall deficit, driving down our international reserves to 4.3 months of goods from 5.1 months in the last financial year.

In the first six months of 2008/2009, exports were substantially lower (down 30 percent), the largest decline for the same period in the last five years. Although some improvement is expected in the six months to end June 2009, the total value of exports in 2008/2009 is projected to be lower than in 2007/08.

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The tourism sector did remarkably well in the first half of 2008/2009. While tourist arrival numbers were slightly lower than in the SPG-impacted first half of 2007/2008, tourism revenues in the first half of the current financial year were 13 percent higher reflecting the significant increase in domestic prices. Arrival numbers are, however, expected to decline in the second half of 2008/09 as the global meltdown start to impact adversely on travel to Samoa. Private remittances grew 5 percent in the first six months of 2008/2009 (when compared to the same period of 2007/2008). But, given the worldwide recession and growing unemployment in advanced economies, the inflow of private remittances is expected to slowdown in the second half of 2008/2009.

Inflation remained high with the headline inflation rate reaching 11.5 percent at end December 2008, well above the long term target of 3.0 percent. However, as currently witnessed throughout the world, countries have chosen to pursue economic growth rather than to curtail inflation. Domestically, there are signs that suggest that the deflationary process which is currently taking place around the globe is finally reaching Samoa. What this means is that as domestic demand weakens and agriculture production improves, the significant price hikes that were seen in the first half of 2008/09 are expected to cease and be replaced by much smaller price rises or outright price reductions in the six months to end June 2009.

The growth of private sector credit in the first half of 2008/09 has not been as strong as anticipated. In fact, it remained well below the growth rates for the previous two financial years. To encourage stronger growth in lending activities, interest rates need to be reduced further. ***And, to help achieve this objective, the CBS Board has agreed for the Central Bank's lending rate to the commercial banks to be reduced from 7.8 percent to 5.0 percent, effective from Monday 2 February 2009.*** Furthermore, the term for such lending has been increased from 7 days to 30 days. At the moment, loans are secured by Central Bank securities. For the future, the range of collateral instruments will be extended to other acceptable assets.

In line with the need to boost lending and investment in the domestic economy, as well as the need to ease the pressure on international reserves, the Bank has also discouraged the outflow of foreign exchange for investment overseas.

This monetary policy stance will be reviewed when Government's Budget for fiscal year 2009/2010 is finalized in June 2009. Meanwhile, the Central Bank has asked the commercial banks to play their part to ensure that the cost of funds are competitive to facilitate private sector development and economic growth. The general public, particularly the business community, is also urged to do all they can to assist in steering the economy away from its current unfavorable trend.

**CENTRAL BANK OF SAMOA**  
**2<sup>nd</sup> February 2009**

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