



***CENTRAL BANK OF SAMOA***



**MONETARY POLICY STATEMENT  
FOR THE FINANCIAL YEAR 2006/2007**

**APIA  
September 2006**

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## **1. INTRODUCTION**

In line with Government's emphasis on transparency and accountability, Monetary Policy Statements (MPS) serve as the main vehicle to communicate and explain to the public the key monetary policy objectives and targets that would be pursued by the Central Bank in the year ahead. As well, these Statements are issued in accordance with the Central Bank's Corporate Plan and the latest of Government's Strategy For The Development of Samoa. The main objective of the Central Bank's monetary policy is to promote sustainable real economic growth by maintaining price stability and international reserves viability. This is the sixth Monetary Policy Statement issued by the Central Bank of Samoa.

The Central Bank has defined price stability as an inflation rate consistent with those of Samoa's main trading partners. The annual rates of inflation for Samoa's main trading partners currently average around 3.0 percent and this is the target that the Central Bank normally aims to achieve and maintain each year. However, there are times when changes to prices are beyond the realms of monetary policy, indeed beyond the control of the Central Bank. This was the case in recent years where the sharp and continually increasing international price of crude oil combined with the adverse effects of natural disasters such as cyclone Heta in January 2004 to drive up the prices of petroleum products and local food. During such periods, attention is focused more on the underlying or core inflation rate.

Samoa is a small open economy with total merchandise trade alone representing around 60 percent of nominal GDP. In the event, it is very important that Samoa maintains a sufficient level of international reserves to withstand large unforeseeable economic shocks. Under present circumstances, the Central Bank considers a level of gross official international reserves, equivalent to no less than 4.0 months of

imports of goods, as adequate for maintaining the country's long-term international viability.

On the exchange rate, the main objective of the Central Bank's policy is to ensure that the value of the Tala is such that local exports remain competitive in overseas markets whilst at the same time minimizing imported inflation. While there is no specific target level for the nominal effective exchange rate (NEER) and real effective exchange rate (REER) of the Tala, a real appreciation is not encouraged as this could have an adverse effect on the international competitiveness of the local export industry.

## **2. EXECUTIVE SUMMARY**

As anticipated, the financial year 2005/06 was a challenging year for monetary policy. Especially with liquidity conditions tightening under pressure from a dramatic outturn in Government's financial operations, coupled with an enormous growth in demand for credit by the private sector and public institutions consequent to the economy growing much faster than anticipated.

As outlined in the Bank's original and revised macro-economic forecasts for 2005/06, the consequence of a rapidly growing economy was realized in 2005/06. Although actual national accounts figures are not yet available, the economy was estimated to have grown 4.6 percent in real terms in 2005/06, with the result of running down domestic liquidity as well as international reserves. In the event, the balance of payments registered a large overall deficit of \$49 million, pushing the level of international reserves down to the benchmark 4.0 months of imports cover. Furthermore, the underlying annual rate of inflation breached the 3.0 percent target rate, registering at 3.2 percent at end June 2006. In the process, the liquidity position of the commercial banks came under enormous pressure, whereas interest rates edged up

only marginally, hardly sufficient to attract new money or deter the strong demand for credit. (See Table 1.)

<b>Table 1</b>				
<b>Selected Domestic Economic Indicators</b>				
Fiscal year to end June	2003/04	2004/05	2005/06	2006/07 Forecast
(Percentage change over the previous year)				
<b>Real sector</b>				
Nominal GDP	8.8	10.1	6.7	4.6
Real GDP	3.3	5.4	4.6	3.1
<b>Prices</b>				
Headline Consumer Price Index (annual average)	7.9	7.8	3.2	3.6
Underlying Consumer Price Index (annual average)			2.2	2.2
Implicit GDP Deflator (annual average)	5.4	4.4	2.4	1.4
<b>Monetary aggregates</b>				
Net foreign assets (annual average)	7.1	12.5	-2.3	-8.5
Government's net monetary position (end of period)	-17.8	22.9	-10.9	-1.9
Bank credit to private sector				
Annual average	10.5	12.1	21.3	12.4
End period	17.1	6.8	28.2	2.1
Money Supply, M2				
Annual average	11.4	10.8	14.0	6.6
End period	12.7	15.0	13.0	5.6
<b>Exchange rate</b>				
Nominal Exchange Rate	1.12	0.49	0.11	na
Real Exchange Rate	4.87	5.74	-1.51	na
<b>International reserves</b>				
Gross International Official Reserves (Tala million)	191.74	228.27	179.08	186.89
Gross International Official Reserves (Months of imports)	5.9	5.9	3.9	4.1
<b>Weighted average interest rates</b>				
	(End of period, percent p.a.)			
CBS 14 days Securities	2.22	2.22	-	-
CBS 28 days Securities	3.21	3.20	-	5.25 (1)
CBS 56 days Securities	4.30	4.23	-	6.00 (1)
CBS 91 days Securities	4.90	4.92	-	-
CBS 182 days Securities	-	-	-	-
CBS 365 days Securities	-	-	-	-
CBS Securities overall weighted average yield (annual average)	4.0	3.5	1.9	2.1 (1)
Commercial bank deposits	4.4	4.3	4.8	4.8 (1)
Commercial bank credit	11.0	11.0	11.5	11.5 (1)
Commercial bank interest rate spread	6.6	6.7	6.7	6.7 (1)
Source: Central Bank of Samoa				
(1) Interest rate as at end July 2006				








In fiscal year 2006/07, Central Bank forecasts indicate that liquidity conditions would ease up a little, following the tight situation experienced in the second half of 2005/06. Much of the liquidity easing

will come from the Government Budget for 2006/07 and a net inflow of foreign exchange. In the event, the economy is expected to grow by about 3.0 percent in real terms, compliments of the ongoing construction of buildings, grounds and facilities for the 2007 South Pacific Games, continuation of Government's infrastructural developments and the second installment of the approved increase for public servants salaries and wages. On the external side, international reserves are expected to improve from the level at end June 2006 with the balance of payments forecast to return an overall surplus in the 2006/07 fiscal year. With much of Polynesian Airlines external debt situation dealt with in 2005/06, the main unknown for 2006/07 is the proposed investments in the telecommunications sector for improved and expanded cellular phone coverage. Inflation is a concern, as the approved increase in public servants salaries and wages and projected real economic growth are expected to exert upward pressure on domestic prices.

In order to safeguard international reserves and contain inflationary pressures, monetary policy will remain tightened in 2006/07. Tightening monetary policy will see the growth of private sector credit almost halved from a record 21 percent in 2005/06 to 12 percent in 2006/07. As a result, money supply (M2) growth rate would slow down from an annual growth rate of 14 percent in 2005/06 to 7 percent in 2006/07.

### **3. WORLD ECONOMY**

Continuing its above-average growth, the world economy registered real economic growth of 4.9 percent in 2005/06 surpassing the forecast of 4.3 percent while world inflation was 2.3 percent exceeding expectations of 1.9 percent. (See Table 2.) With increases in real economic growth noted around the world, the macroeconomic policy setting was generally contractionary as most countries had to combat increased inflationary pressures. On the exchange rate front, the US dollar was again weighed down against most of the major currencies.

<b>Table 2</b>				
<b>Selected World Economic Indicators</b>				
Fiscal year to end June	2003/04	2004/05	2005/06	2006/07 Forecast
	(Percent)			
Real growth rate	4.3	4.7	4.9	4.8
Inflation rate	1.8	1.9	2.3	2.0
Official international interest rates,	(End of period, percent p.a.)			
US Federal Reserve	1.25	3.25	5.25	5.25  (1)
Reserve Bank of Australia	5.25	5.50	5.75	6.00  (2)
Reserve Bank of New Zealand	5.75	6.75	7.25	7.25  (3)
Bank of Japan	0.10	0.10	0.10	0.25  (4)
Bank of England	4.50	4.75	4.50	4.75  (5)
European Central Bank	2.00	2.00	2.75	3.00  (5)
Reserve Bank of Fiji Notes, 91 days	1.75	1.75	2.25	4.25  (6)
Source: IMF and reserve banks' publications and information releases.				
(1) Interest rate as at 08th August 2006				
(2) Interest rate as at 02nd August 2006				
(3) Interest rate as at 27th July 2006				
(4) Interest rate as at 14th July 2006				
(5) Interest rate as at 03rd August 2006				
(6) Interest rate as at 28th July 2006				

For the fiscal year 2006/07, the world economy was forecast by the IMF in its April 2006 World Economic Outlook (WEO) to continue to expand at a pace of 4.8 percent with world inflation anticipated to remain close to 2.0 percent. The economic expansion was expected to be driven by strong growth in China and India with projected growth rates of 9.3 and 7.2 percent respectively while the key players of the world economy, the United States, Euro area and Japan are envisaged to contribute also to this global economic expansion with forecast growth rates of 3.4, 2.0 and 2.5 percent respectively.

Prospects for the global economy therefore appear sound, although the risk profile contains more downside than up. Global inflation pressure is rising as demand for oil continues to push up oil prices. This is the main threat to global economic growth and it is expected to remain high, volatile and within the US\$60-US\$80 per barrel range with stronger projections that it will mostly trade around the US\$70 per barrel mark.

For the US economy, real GDP growth slowed to 0.6 per cent in the June quarter to be 3.5 per cent over the year as demand started to respond to increases in interest rates over the past couple of years, the recent slowing in the housing market and high energy prices. The unemployment rate, however, continued to fall, going down to a five-year low of 4.6 percent in June 2006 quarter while the trade deficit was steady at 5.9 per cent of GDP. Energy price increases pushed headline inflation up 4.3 percent over the year to June 2006 and core inflation picked up to 2.6 per cent. The Fed funds rate was continually raised by 25bps, standing at 5.25 percent at the end of August 2006.

Growth in the US economy is expected to moderate going into 2006-07. The outlook for business investment is favourable with capacity utilisation high, profits continuing to grow strongly and business sentiment remaining at a healthy level. The tightening in the US Fed funds rate is expected to halt in the near future with widely expected forecasts that it would not exceed the 6.0 percent mark, while the US dollar would again continue its weak run against most of the major currencies. The IMF WEO forecasts the US economy to grow 3.4 percent with an inflation forecast of 2.9 percent by end 2006/07.

The Australian economy continued to grow at a good pace recently, with GDP expanding by around 3.0 per cent over the year to the March 2006 quarter, driven mostly by domestic spending. Employment posted strong gains in the June 2006 quarter, and business surveys have continued to report strong trading conditions for the economy overall. Business credit has also continued to expand at a fast pace, reflecting favourable business conditions and rapid expansion in investment spending. Household demand has also increased, accompanied by signs of firmer conditions in the housing market. The combination of rising world commodity prices, strong domestic demand and tight capacity has contributed to increase pressure on consumer and producer prices. These inflation pressures resulted in the Reserve Bank of Australia



(RBA) recently increasing the cash rate in its tightening cycle. The RBA cash rate stood at 6.0 percent at end August 2006.

The IMF forecasts the Australian economy to grow 3.0 percent in 2006/07, with an inflation rate of 2.8 percent. The household sectors' strong demand for finance, coupled with high fuel prices, will have the RBA keeping a keen eye on inflation. At most, one more increase before the end of 2006 is expected in the RBA's extended tightening cycle given the evidence of stronger domestic conditions and mounting inflationary pressures.

The New Zealand economy slowed down in 2005/06 with domestic demand on the wane after being the main flag-bearer for growth over the past few years. Real GDP rose 0.7 percent in the March 2006 quarter taking the annual growth rate to 2.2 percent. The trend in retail sales is now effectively flat, the annual inflation rate has lifted to 3.3 percent with little respite expected in the near term. Consumer confidence has fallen to a six year low. The Reserve Bank of New Zealand's official cash rate stood at 7.25 percent at the end of August 2006, which is the highest of the developed economies.

A protracted period of slow growth is envisaged for the New Zealand economy. The key theme shaping slow growth is the Reserve Bank having a lingering period of tighter monetary policy as it looks to contain inflationary pressures. Consumer spending will continue to be held hostage by tight monetary policy, a slowing housing market and elevated debt levels. The combined impact of higher petrol prices, past interest rate hikes, and a slowing housing market will ensure that economic growth remains weak throughout 2006. The IMF forecasts the New Zealand economy to grow only 1.5 percent in 2006/07 with inflation at 3.0 percent.

The Japanese economy registered a real GDP increase of 0.8 percent in the March quarter to be 3.5 percent higher over the year with growth

broadly based across domestic private demand and the export sector. Conditions in the household sector have continued to strengthen with consumption increasing by 2.4 per cent over the year to the March 2006 quarter. Consumer sentiment also remains strong, helped by a further improvement of the labour market. Business activity remains robust with industrial production rising just over 3.0 percent on an annual basis in the second quarter. The Bank of Japan (BoJ) let go of its quantitative monetary policy methods earlier in the year and has recently increased its overnight call rate to 0.25 percent.

The IMF estimates the Japanese economy to grow 2.5 percent in 2006/07 with an inflation forecast of 0.5 percent. Japan's economic expansion is looking increasingly robust supported by a favourable investment outlook with machinery orders continuing to trend upwards, and capacity utilisation rates for both the manufacturing and non-manufacturing sectors at high levels. In addition there is a positive sentiment about future employment conditions. With more growth expected, the Bank of Japan is expected to be on the tightening cycle.

Economic activity has strengthened in the Euro area. The March 2006 quarter GDP rose by 0.6 and 2 percent over the year led by household spending. The unemployment rate fell to 8 percent, helping to lift aggregate household incomes and consumer sentiment. Inflationary pressures have built up owing largely to higher fuel prices amidst concern that liquidity conditions remain overly accommodative. Headline inflation at 2.5 percent is above the European Central Bank's (ECB) 2 percent reference rate, although core inflation has been lower at around 1½ percent. The ECB embarked on its tightening cycle in monetary policy in December 2005 and has raised rates by 25bps every 3 months to reach 3.0 percent on 3 August 2006.

The Euro economy is expected by the IMF to reach only 2.0 percent growth for 2006/07 and inflation of 2.2 percent. The ECB views

monetary policy to remain accommodative and expects that on the basis of their current assumptions some further tightening will be required.

## 4. DOMESTIC ECONOMY IN 2005/06

### 4.1 Policy Developments

A substantial expansionary **fiscal policy** was pursued in 2005/06 with a Government Budget deficit of \$44.3 million approved by Parliament in June 2005. The 2005/06 Government Budget contained substantial items of expenditures with very little matching increase in Government revenue. The large overall Budget deficit was expected to be funded mainly by the issuance of \$26.5 million long term Government Bonds (with maturities of between 5 and 15 years) and external soft term loan disbursements of \$32 million. (See Table 3.)

During the period	2003/04	2004/05	2005/06 Budget	2006/07 Budget
Total Revenue and Grants	318.4	524.4	358.1	461.6
Total Revenue	251.4	283.0	286.3	363.1
Tax	224.1	242.2	249.7	317.9
Non-tax	27.3	40.9	36.6	45.2
External Grants	67.0	241.4	71.8	98.5
Total Expenditure	332.4	521.4	402.4	476.6
Current Expenditure	208.0	236.6	272.8	339.8
Development Expenditure	93.5	263.8	104.7	131.7
Net Lending (1)	30.9	21.0	25.0	5.1
Overall Surplus / Deficit (-)	-14.0	3.1	-44.3	-15.1
Financing	14.0	-3.1	44.3	15.1
External Financing	13.0	15.8	19.5	17.8
Disbursements	26.5	27.6	32.9	33.3
Amortisation	13.5	11.8	13.4	15.5
Domestic Financing	1.0	-18.9	24.8	-2.7
Monetary system	0.0	-19.0	0.0	0.0
Other	1.0	0.1	24.8	-2.7

Source: Ministry of Finance

The largest items of expenditures were for the construction of venues and sporting facilities for the 2007 South Pacific Games, the construction of joint campus buildings for the National University of Samoa and Samoa Polytechnic, the first of the three tranches of the public sector salaries and wages increase, and payment by Government of contractual obligations of Polynesian Airlines following the national carrier's merger with the Virgin Blue Airline.

Given the expansionary stance of fiscal policy in 2005/06, Central Bank forecasts for the year ending June 2006 showed that the ensuing strong economic growth would put official reserves and inflation under pressure. To maintain macro-economic stability therefore, **monetary policy** was tightened in 2005/06. The intention was to slow down real economic growth from 5.0 percent under the base case scenario to around 4 percent under the program scenario and to reduce the expected annual inflation rate from close to 4.0 percent in the base case scenario to the target benchmark of 3.0 percent.

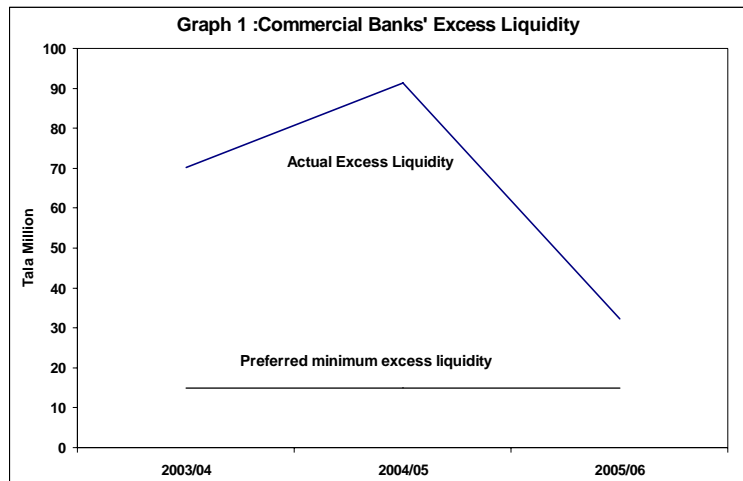
On the monetary side, actual figures for 2005/06 showed that net domestic assets (NDA) rose 49 percent (\$104 million), on the back of a drop in Government's net position vis-à-vis the monetary system (down 13 percent or \$13 million) and a dramatic rise in credit to the private sector and public institutions combined (up 32 percent or \$126 million). Much of this rise in credit flowed out to finance a rapid growth in imports as well as to settle debt obligations for Polynesian Airlines. Consequently, a large overall deficit in the balance of payments was recorded in 2005/06, which saw the level of official foreign reserves decline \$49 million.

During the financial year under review, the commercial banks level of excess liquidity (which is largely the basis for further credit growth) declined steadily from \$49 million in June 2005 to \$12 million at the end of May 2006, twenty percent below the benchmark level of \$15 million, before an inflow of foreign exchange in June 2006 saw it

crawling back up to \$18 million. (See Table 4 and Graph 1.) In contrast to the sharply reduced level of excess liquidity, interest rates crept up only marginally during the year, hardly enough to attract more liquidity or to stem the excessive demand for credit.

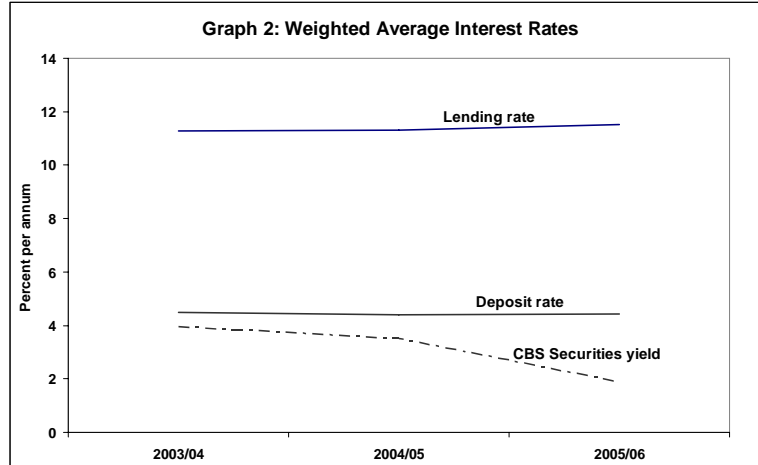
End of Period	2003/04	2004/05	2005/06
Cash on hand	6.80	7.68	13.99
Exchange Settlement Account (1)	23.58	49.17	18.20
Central Bank of Samoa Securities (CBSS)	39.71	34.58	0.00
<b>Total</b>	<b>70.09</b>	<b>91.43</b>	<b>32.19</b>

Source: Central Bank of Samoa  
Exchange Settlement Account (ESA) with the Central Bank. ESA represents the commercial banks' excess reserves / liquidity.



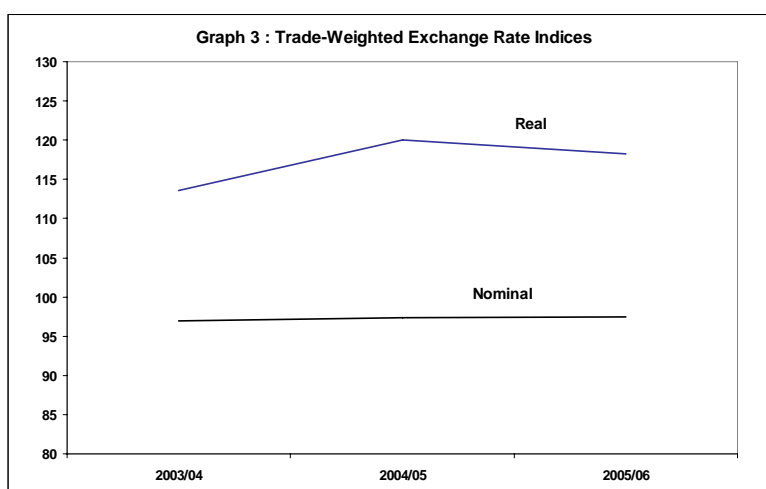
With excess liquidity being so low, no CBS security was issued in the last half of the financial year 2005/06. Consequently, the weighted average level of official interest rates fell from 2.88 percent at end June 2005 to 2.14 percent at end December 2006 and remained at that rate

throughout the second half of the fiscal year 2005/06. On the other hand, the commercial banks' weighted average interest rate on loans snailed up from 11.40 percent at end June 2005 to 11.47 percent at the end of June 2006 while the rate for deposits edged up from 4.34 percent to 4.80 percent. (See Graph 2.)



In fiscal year 2005-06, the nominal effective **exchange rate** (NEER) of the Tala appreciated 0.11 percent on an annual average basis against the currencies in its exchange rate basket. On the other hand, it depreciated 1.51 percent in real effective terms (REER) reflecting the lower inflation rate in Samoa compared to those of our major trading partners. (See Graph 3.)

There were no changes to the Central Bank's **Exchange Control Regulations** during the 2005\06 fiscal year but a number of money transfer business licenses were issued, further facilitating the inflow of private remittances.



## 4.2. Macro-economic performance

As expected, available figures showed that the economy grew strongly in 2005/06 led by strong public and private sector construction activities and further expansion in tourism earnings, private remittances and grants from abroad. Unfortunately, and as anticipated, this strong economic growth was achieved much at the expense of the external sector, with the balance of payments recording one of the largest overall deficits, pushing down the level of international reserves to the minimum target level of 4.0 months imports at end June 2006. In addition, inflation, which declined in the first half of the fiscal year under review, started to crawl back up in the second half reflecting strong demand pressures and the continued rise in international oil prices.

### 4.2.1 *Real sector*

Actual national accounts figures for the second half of 2005/06 are not yet available but estimates showed that, on the back of a 5.4 percent growth rate in 2004/05, real gross domestic product grew by a further

4.6 percent in 2005/2006. Continuing on much the same trend as seen in 2004/05, real economic growth in 2005/06 was driven by growths in the commerce, construction, public administration, finance and business services, agriculture, electricity and water, transport and communication and personal and other services. (See Table 5.)

During the period	2003/04	2004/05	2005/06 Estimated	2006/07 Estimated
Agriculture	61.2	70.6	74.4	76.1
Fishing	54.5	51.8	51.2	51.5
Food & Beverage manufacturing	30.9	32.8	33.6	34.1
Other manufacturing	113.1	106.5	104.6	105.6
Construction	64.2	78.1	85.2	87.7
Electricity and water	41.8	42.9	45.3	46.7
Commerce	183.7	196.2	210.4	220.3
Hotels, restaurants	24.6	26.4	27.9	29.1
Transport, Communication	116.9	124.6	128.2	134.5
Public administration	76.9	81.2	86.8	89.4
Finance and business service	89.9	96.3	101.8	103.9
Less: Enterprise share of FISIM (1)	-13.5	-14.2	-14.8	-15.1
Ownership of dwellings	34.2	34.9	35.8	36.6
Personal and other service	51.4	52.9	54.6	56.3
<b>Total</b>	<b>929.8</b>	<b>980.4</b>	<b>1,025.0</b>	<b>1,056.7</b>
Annual percent change	3.3	5.4	4.6	3.1
Implicit GDP deflator	107.0	111.7	114.0	115.6
Annual percent change	5.4	4.4	2.1	1.4
Source: Ministry of Finance				
(1) FISIM : Financial Intermediary Services Imputed				

Agriculture appeared to be returning to prominence again, with output growing for the second year in a row, expanding 5 percent in 2005/06. This reflected the continued success of replanting efforts to restore production following Cyclone Heta in 2004. Most of the stable food items such as taro, banana and taamu as well as vegetables registered strong increases in supplies to the main produce market at Fugalei. There is still very little sign of the fishing industry progressing any further with output of the sector slipping 1 percent after some improvement in the previous financial year. The industry continued to experience low catch rates as a consequence of prolonged unfavourable

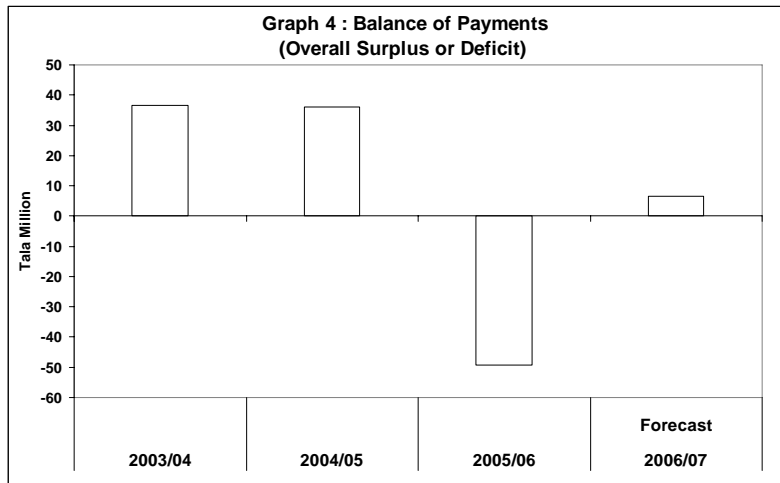


weather conditions. The output of the construction sector, the driving force underlying the continued strong growth in the country in recent years, expanded 9 percent in 2005/06 spearheaded by the construction of the Development Bank of Samoa (DBS) Headquarters, aid funded projects such as the NUS/Polytechnic joint campus at Le Papaigalagala and some large private sector buildings. Feeding off the growth in other sectors of the economy, the commerce sector recorded the largest increase in output, expanding 7 percent in 2005/06 reflecting a busy year for wholesaling and retailing activities. Similarly, the output of the transport and communication sector, which is closely associated with activities in the construction sector, recorded a 3 percent growth reflecting the heavy reliance of construction projects on the transportation of building materials to construction sites. The communication sector also experienced some growth in activity with the diversification of SamoaTel services to include their Home Zone wireless telephone providing coverage for rural areas and development of new telephone cards. Increased tourist arrivals saw hotel and restaurant activities grow 6 percent and the finance and business service sector rising 6 percent supported by a very strong growth of credit in the financial system. The value-added by the public administration sector rose 7 percent in 2005/06 reflecting the expansion in Government expenditure. Also boosted by growth in other major sectors was the output of 'electricity and water', which went up 3 percent while 'personal & other services' and 'ownership of dwelling' rose 4 percent and 3 percent respectively. The output of food and beverage manufacturing improved 2 percent, driven by strong demand for beer in the local and overseas markets. On the down side, the output of "Other manufactured" items fell 2 percent reflecting a drop in export processing services by Yasaki and uncertainties facing the Pacific Cashmere garment factory following the recent changes to US garment and textile imports regime.

### 4.2.2 Balance of payments

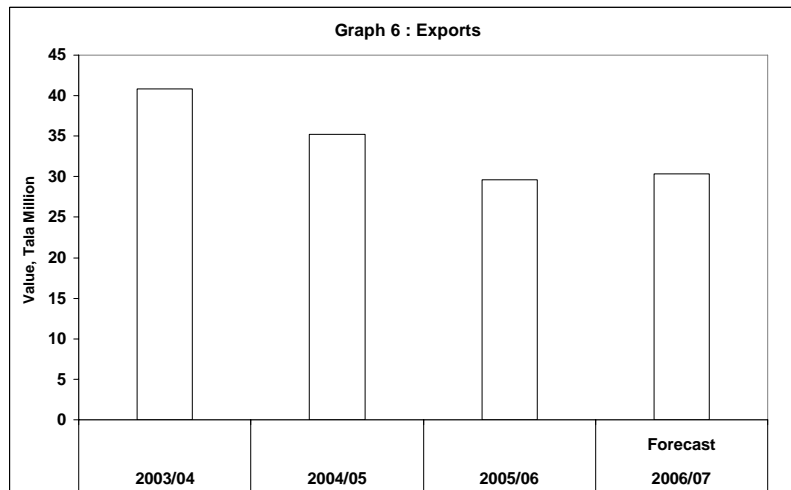
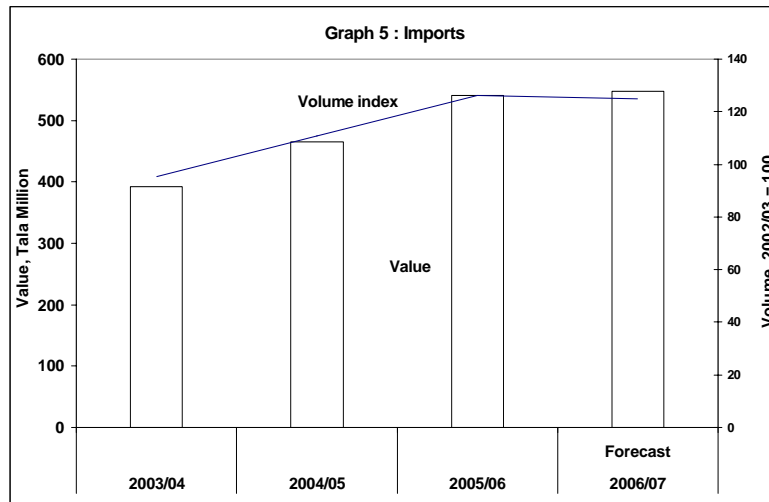
The balance of payments registered a large overall deficit of \$49 million in 2005/2006, much in line with projections, and was in stark contrast to the surplus of \$36.2 million in the previous financial year. (See Table 6 and Graph 4.) The overall deficit, which resulted in a dramatic reduction in the level of official international reserves, was largely due to a record merchandise trade deficit, the settlement of substantial external debt obligations for Polynesian Airlines and some overseas dividend repatriations for foreign owned companies.

<b>Table 6</b>			
<b>Balance of Payments</b>			
(Amounts in Tala Million)			
During the period	2004/05	2005/06	2006/07 Forecast
A. Current Account Balance	-82.5	-80.1	-67.9
Merchandise Trade Balance	-429.8	-519.9	-517.8
Exports	35.2	29.6	30.4
Imports	-465.0	-549.5	-548.2
Services, net	100.3	162.8	171.3
Income, net	-22.1	-14.1	-14.4
Current Transfers, net	269.1	291.1	293.0
Private transfers	230.1	286.9	291.2
Official transfers	39.0	4.2	1.8
B. Capital Account Balance	148.0	79.4	133.8
Official Grants	143.6	71.8	93.5
Other	4.4	7.6	40.3
C. Financial Account Balance	-34.2	-48.4	-59.4
Direct Investment	4.1	-11.1	-0.7
Portfolio Investment	0.8	-0.3	-0.3
Other Investment	-39.2	-37.0	-58.4
D. Reserve Assets	-36.2	49.5	-6.5
E. Net Errors & omissions	4.9	-0.4	0.0
Source: Central Bank of Samoa			



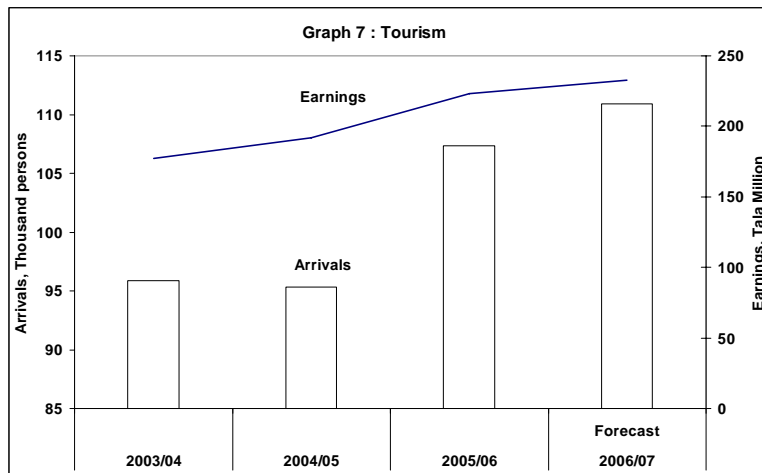
The stronger than targeted real economic growth and continued rise in oil prices saw the total value of imports for the year as a whole expand 12 percent, with significant increases recorded in all major categories of imports. A 50 percent surge in the average import price of petroleum products saw the volume of petroleum imports fall 19 percent. As a result, the total value of petroleum imports rose 22 percent in 2005/06. Non-petroleum private sector imports went up 15 percent on account of a 9 percent increase in the average unit value and a 6 percent increase in volume. Direct imports by Government leapt 64 percent with its volume growing 55 percent and average unit value going up 9 percent. (See Graph 5.)

As expected, the total value of exports fell in 2005/06, going down 16 percent to \$30 million. The fall largely reflected the anticipated reduction in earnings from fish, coconut cream, taro and nonu fruit. (See Graph 6.) With exports not being able to keep up with the growth in imports, the trade deficit widened 19 percent to reach its highest level ever. Nevertheless, a strong growth in private remittances and tourism earnings saw the current account deficit narrow slightly to \$78.7 million.



Tourism earnings in 2005/2006 amounted to \$219.6 million, 15 percent higher than in the previous financial year, compliments of a 13 percent hike in tourists arrivals and a 2 percent rise in average tourist spending. (See Graph 7.) The increase in total tourist arrivals was due mainly to significant increases in visitors from Australia and New Zealand,

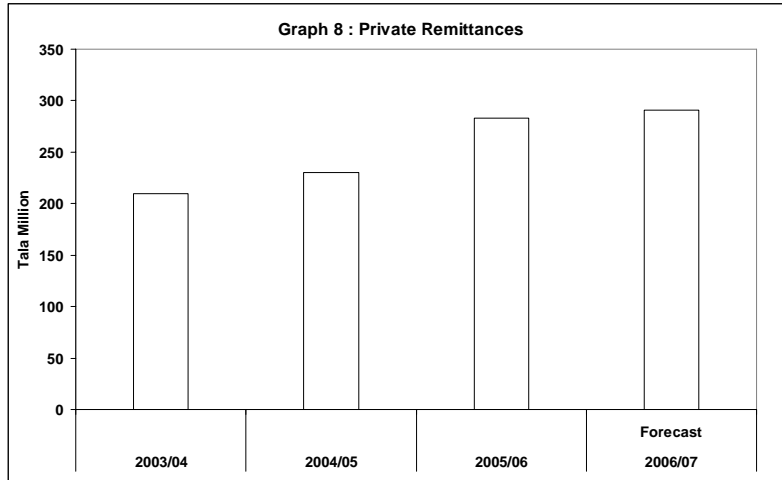
American Samoa and the USA, boosted by successful overseas tourism promotions and competitive airfares between Samoa and the major tourism markets.



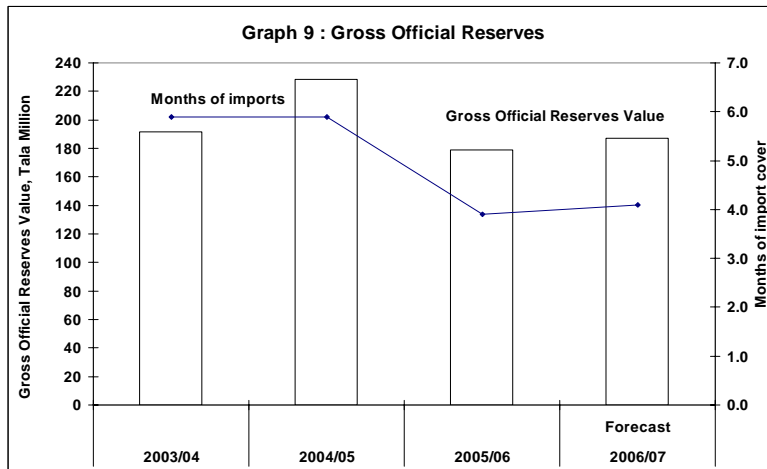
Current transfers (official and private) expanded 7 percent or \$18.2 million to \$287.3 million reflecting a 23 percent rise in private transfers, more than offsetting a large drop in current official transfers as foreign aid fell back to historical levels in 2005/06. The hike in private transfers was due to a 38 percent (\$56.0 million) jump in household remittances despite a 4 percent drop in remittances for charitable organizations, which reflected the winding down of inflows following the completion of some large construction projects in 2004/05. (See Graph 8.)

After some heavy inflows in 2004/05, a large reduction in project grants saw the capital account surplus fall significantly to \$79.3 million from \$148.0 million in 2004/05 which was associated with the intensive implementation of major projects for the 2007 South Pacific Games, renovation of various Government schools and the start of the NUS/Polytechnic joint campus. On the financial account, the items that had a dominant impact were the investment by Government in the

newly merged airline Polynesian Blue and settlement of large external debt obligations for Polynesian Airlines.



All in all, the large overall deficit in the balance of payments saw the level of gross official reserves falling to 4.0 months of imports at the end of June 2006 from 5.9 months at the end of June 2005. (See Graph 9.)



### 4.2.3 Prices

By and large, price movements were tame during the first half of the financial year, gradually rising in the last half. After the devastation by Cyclone Heta in January 2004, a recovery in the production of local food items helped ease the pressure on consumer prices, outweighing the inflationary impact of increased transport costs (bus and taxi fares) that came into effect in October 2005.

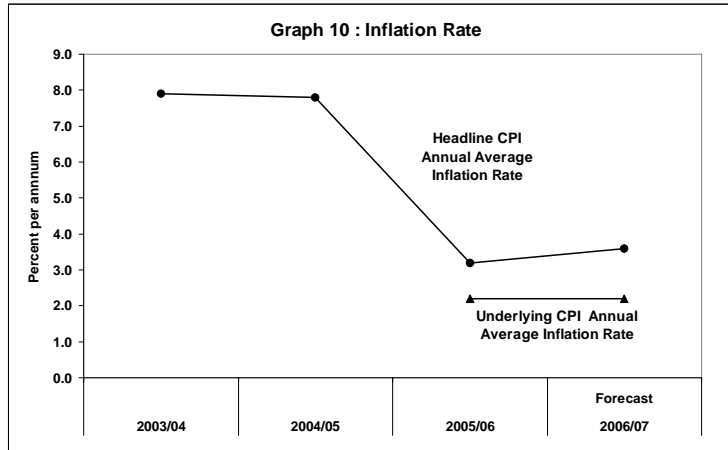
In the fiscal year under review, the overall price level at the Fugalei Market decreased 13 percent as agricultural produce returned to more normal levels with a 12 percent increase in overall volume. This, together with some improvement in bottom and reef fish catches over the year, contributed to a lower growth rate in local food prices which, on an annual average basis, went up 1.0 percent in the year to end June 2006 compared to a 13.9 percent increase in the year to end June 2005. These domestic factors helped offset the pass-through effects of volatile international oil prices with a new record high of \$74 USD per barrel on April 20<sup>th</sup> 2006. This saw local transport costs (bus and taxi fares) being adjusted up by 25 percent in October 2005 from the levels that were last reviewed in 2002.

In the event, the annual rate of headline inflation, which decreased from 7.8 percent in June 2005 to 1.8 percent in January 2006, rose steadily reaching 3.2 percent in June 2006. (See Table 7 and Graph 10.)

After extracting the influence of extreme movements in the prices of volatile consumer items, the underlying consumer prices also trended upwards in the last five months of 2005/06. With demand pressure much stronger than a year earlier, the annual underlying inflation rate (on an annual average basis) initially dropped from around 2.0 percent at end June 2005 to 1.3 percent at end December 2006 then rose steadily reaching 2.2 percent at end June 2006.

**Table 7**  
**Consumer Price Index**  
(March 2004 = 100)

Fiscal year to end June	2003/04	2004/05	2005/06	2006/07 Forecast
<b>A. Headline Inflation</b> (12 months average percent change)				
<b>Description</b>				
All Groups	7.9	7.8	3.2	3.6
Food	12.9	10.9	2.2	4.0
Clothing and Footwear	-3.0	-6.3	-7.3	0.2
Housing and Household Operations	-0.1	3.9	6.1	3.3
Transport and Communication	1.3	3.8	10.1	2.5
Alcohol and Tobacco	2.7	-0.1	1.2	4.7
Miscellaneous	1.2	0.7	0.4	1.1
Import Component	1.2	3.6	3.5	3.5
Local Component	13.0	10.1	3.1	3.6
<b>B. Underlying Inflation (1)</b>				
		year on year end percent change	12 months average percent change	
<b>Description</b>				
All Groups		-0.4	2.2	2.2
Food		-0.7	3.0	2.4
Clothing and Footwear		-8.1	-7.3	0.2
Housing and Household Operations		3.1	1.5	2.0
Transport and Communication		0.9	1.4	4.5
Miscellaneous		1.3	0.9	1.6
Import Component		-1.5	1.9	1.4
Local Component		3.1	3.0	4.4
Source: Statistical Services Division, Ministry of Finance				
(1) The historical series for this new index started in August 2003.				





## **5. DOMESTIC ECONOMIC OUTLOOK FOR 2006/07**

### **5.1 Government Budget**

The 2006/07 Government Budget is again an expansionary one although the overall deficit is not as large as the 2005/06 Budget. The main areas of focus are the completion of the sporting facilities for the 2007 South Pacific Games, the second installment of the approved increase in public sector salaries and wages as well as the implementation of projects listed in the 2005-2007 Strategy for the Development of Samoa. Total expenditure is therefore set to increase 18 percent from the 2005/06 Budget. To fund the budgeted increase in expenditures, some revenue measures are set to be implemented. The main ones are a 250 basis points increase in the VAGST rate from 12.5 percent to 15.0 percent and an increase in the excise tax on soft drinks, alcoholic beverages and tobacco. Together with the new revenue measures, total domestic revenues is expected to rise 27 percent, further supported by a 37 percent increase in external grants.

The increase in total revenues and grants are, however, not sufficient to meet the rise in total expenditures for the financial year. Consequently, an overall Budget deficit of \$15 million is expected in 2006/07, to be financed entirely from external soft term loans. The deficit is equivalent to around 3 percent of GDP. Given that the liquidity position of the financial system is expected to remain within a tight range in 2006/07, the external borrowing by Government would help ease the pressure on private sector credit.

### **5.2 Real sector**

The key factors that will influence the real rate of growth in 2006/07 are the expansionary fiscal policy which is largely focused on the completion of sporting facilities for the 2007 South Pacific Games, the continuation of Government's infrastructural developments, the

completion the DBS Headquarters, construction of other public sector buildings, the anticipated continued rise in oil prices, further strengthening in tourism activities and private remittances. Although liquidity is expected to improve, the level of excess funds is likely to hover marginally above the tight conditions of 2005/06. This would mean that interest rates will rise to encourage more financial savings as well as to ease demand and ultimately the growth rate of bank credit in 2006/07.

In the event, GDP is expected to grow by about 3 percent in real terms in 2006/07, down from 4.6 percent in 2005/06. Growth is forecast to be led by activities in the commerce sector, the largest sector of the economy, (up 5 percent), transport and communications (up 5 percent), the construction sector (up 3 percent), electricity and water (up 3 percent) and hotels and restaurants (up 4 percent).

### **5.3 Balance of payments**

Given the expected continuation of relatively tight liquidity conditions and the consequent reduction in bank credit to the private sector and public institutions, the underlying growth rate of imports is anticipated to slow down from the very high level seen in 2005/06. With oil prices envisaged to rise further, the volume of petroleum imports is expected to decline again in 2006/07 as the local community rationalizes its petroleum usage and consumption. Incidentally, with the price of petroleum products set to rise by 11 percent, the volume of petroleum imports is expected to fall by about 10 percent leaving the total value of petroleum products at slightly below the 2005/06 level. In much the same trend, the volume of private sector imports is expected to slip slightly but an increase of a little over 2 percent in import prices is expected to result in the total value of private sector imports rising 2 percent in 2006/07. The growth rate of direct Government imports is expected to remain negligible in 2006/07. Overall, therefore, the total value of imports is expected to increase slightly in 2006/07.

Tourism is again expected to make a further positive contribution to the balance of payments in 2006/07. Tourist arrivals are forecast to grow further in light of more regional sporting activities that are scheduled to be held in Samoa such as the international and regional championships for weightlifting, archery and athletics as well as the resurrection of the Samoa Games. Chinese tourists may also start to explore Samoa in line with the Chinese Government's recent offer to boost the number of Chinese visitors to Pacific Island countries. Inflation will see the prices of most commodities that are consumed by tourists such as hotel room rates, car rentals and transportation rise in the coming year. As a result, total tourism earnings is expected to rise 6 percent (about \$13 million) to \$233 million.

The export of automotive wire harnesses by Yasaki is expected to improve 8 percent and the export of telecommunications services are also anticipated to increase thereby making a further positive contribution to foreign exchange earnings in 2006/07. On the outflow side, the repatriation of profits by some foreign companies operating in Samoa and the planned debt service payments by Government are expected to result in a net outflow of foreign exchange in the income account.

The inflow of current transfers is forecast to rise slightly (by 2 percent) in 2006/07 with household transfers expected to improve by 4 percent in light of the growth of the money transfer and money exchange businesses, the increasing number of emigrants under the NZ quota and continued strong economies of the main source countries NZ, Australia and USA. On the other hand, funds for 'charitable organizations' are expected to slow down following the completion of some very large church projects in 2004/05 and 2005/06.

From the Government's Budget estimate for 2006/07, project grants are expected to rise to \$93.5 million together with a loan write-off of \$33 million by the Chinese Government. Much of Polynesian Airlines' debt

obligations were settled in 2005/06, with an amount of \$4.0 million remaining to be paid in the first half of 2006/07. There are no other major financial transactions expected in 2006/07. Commercial bank foreign exchange holdings are expected to consolidate as Government eases down on the draw down of its commercial bank accounts in 2006/07. Net Government disbursements of foreign loans are expected to amount to \$17.8 million.

All in all, therefore, the balance of payments is expected to record an overall surplus of about \$7 million in 2006/07, maintaining gross official reserves at the equivalent of 4 months of imports. There are, however, large investments in the telecommunications sector that have not been factored into the forecasts which could drive the balance of payments into deficit in 2006/07. Figures on this project are yet to be confirmed.

## **5.4 Prices**

### **5.4.1 *Headline inflation***

#### ***Import component***

The import component of the headline CPI is expected to grow 4.5 percent in the twelve months ending June 2007, reflecting both external and local inflationary pressures. A combination of domestic factors (a 2.5 percent increase in the VAGST tax rate to 15.0 percent in October 2006 and a real economic growth of 3.1 percent stimulating strong local demand pressure) and external factors (inflationary pressures from source countries - New Zealand and Australia – as well as high international commodity prices particularly for oil) are expected to influence prices of imported goods in 2006/07. In terms of commodities, those that are most likely to be affected are those in the “Transport and Communication” sub-index (mainly petroleum and diesel) as a 14.0 percent increase is anticipated over the year with the international oil markets remaining volatile. Speculative activities (by

economic agents predicting a barrel of oil to surpass \$100 USD in the next few years) and increased world-wide demand exceeding stretched supplies from source countries<sup>1</sup> are some of the contributing factors to the continued volatility, which Samoa, being a small open economy, will be most vulnerable to. Imported food prices is also predicted to increase over the year, with a 4.1 percent rise expected following an upward inflationary assessment in source countries (particularly New Zealand and Australia) in combination with strong local demand growth. Other commodities forecast to increase their prices in the year ending June 2007 are building materials and household items, as reflected by a 4.0 percent expansion in the “Housing and Household Operations” sub-group. This increased outlook is due to more construction projects (particularly the completion of the SPG complex facilities at Tuanaimato and the DBS building as well as other private constructions) expected in the next few months placing demand pressure on required materials. On an annual average basis, imported inflation is estimated at 3.5 percent at end June 2007, similar to that at end June 2006.

#### ***Local component***

In 2006/07, a 6.9 percent increase in the local component of the headline CPI is expected with domestic factors mainly responsible for this upward assessment. The payment of the second tranche of the approved increase in public sector salaries and wages in July 2006, increased VAGST rate in October 2006 (from 12.5 percent to 15.0 percent) combine with a 3.1 percent real growth in the economy to put upward pressure on prices over the financial year under review. Local produce prices are expected to be affected with a 13.0 percent increase projected, driven by demand pressures. A 4.1 percent increase in prices of alcohol and tobacco items is expected following the increased excise tax for such items (in July 2006 for alcohol and Pocket Edition tobacco and in February 2007 for Pall Mall cigarettes). And, based on the

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<sup>1</sup>The Middle East remains a hotspot, particularly Iran, which has been in the political spotlight in recent months with its nuclear program being hotly disputed by USA.

expected growth in real GDP in the fiscal year ending June 2007, increased consumer demand will put pressure on prices in other commodities as reflected by 3.6 percent, 3.0 percent and 1.0 percent increases respectively in the “Housing and Household Operations”, “Transport and Communication” and “Miscellaneous” sub-groups. Therefore, on an annual average basis, the domestic component of the CPI is envisaged to increase to 3.6 percent at end June 2007 from 3.1 percent at end June 2006, driven mainly by an 8.0 percent increase in local food prices over the year, up from a 1.0 percent rise at end June 2006.

### ***All Items***

Overall, therefore, the combination of strong demand growth in the domestic economy, high international oil prices and solid global economic conditions are expected underpin inflationary trends in 2006/07. Adding to these pressures will be the second tranche increase in public sector salaries and wages growth and the 2.5 percent increase in the VAGST rate in October 2006. Commodities that will be profoundly affected by these changes are food, alcohol and tobacco items. All in all, the annual headline inflation rate is projected to fluctuate over the first few months of 2006/07 before rising steadily to reach 3.6 percent in June 2007 from 3.2 percent at end June 2006.

## ***5.4.2 Underlying inflation***

### ***Import Component***

It is anticipated that in the twelve months to June 2007, the import component of the underlying CPI will increase 3.7 percent, on the back of strong demand conditions. This outlook reflects the upward pressure on inflation stemming from the pick up in labour costs as well as the price effects of real growth in the economy. Mainly reflecting this upward assessment will be a 4.1 percent increase in imported food prices as inflationary pressures in source countries (that of Australia and

New Zealand) are expected to increase slightly over the next few months. Demand for building materials for the various construction projects is expected to continue, exerting upward pressure on their prices, and contributing to a 3.5 percent expansion anticipated in the “Housing and Household Operations” sub-group. On an annual average basis, therefore, imported inflation for the underlying CPI is projected at 1.4 percent at end June 2007, lower than the 1.9 percent at end June 2006.

***Local Component***

A 4.0 percent increase in the local component of the underlying CPI is projected for the next twelve months ending June 2007, based on an underlying 4.6 percent growth in local food prices, a 4.0 percent rise in prices for housing and household items (such as paint, timber and toiletries). Therefore, on an annual average basis, the domestic underlying CPI is estimated to rise to 4.4 percent in 2006/07, an increase from 3.0 percent in 2005/06.

***All Items***

The combination of real growth in the economy and increased public sector salaries and wages are expected to further strengthen domestic demand in the 2006/07 fiscal year, consequently pushing up underlying consumer prices. In the event, the underlying or core inflation will, on an annual average basis, again increase by another 2.2 percent in 2006/07.

**6. MONETARY POLICY STANCE FOR 2006/07**

Given the expansionary stance of fiscal policy, expected further expansion in the tourism sector and inflow of private remittances, the domestic economy is forecast to grow 3 percent in real terms. On the external side, the balance of payments is anticipated to record an overall surplus, maintaining the level of international reserves at around the minimum target level of 4 months imports coverage. Headline inflation

is expected to rise up to 3.6 percent while the core or underlying inflation is anticipated to register another 2.2 percent rise.

Overall, therefore, the outlook for 2006/07 is likely to be much better than 2005/06 although the expected outcomes barely stay within the benchmark levels. The main areas of concern are the stagnant export performance as well as the continued increase in international oil prices putting pressure on domestic inflation and international reserves. The expected surplus in the balance of payments is small, leaving not much room for any relaxation of monetary policy settings. Details on pipeline investments in the telecommunications sector are not yet known but are understood to be substantial, which could easily drive the balance of payments into deficit.

All in all, therefore, monetary policy will remain tightened in 2006/07 to safeguard macro-economic stability whilst at the same time generating some positive real economic growth for the financial year. Some improvement is likely in liquidity of the financial system although it is still expected to remain relatively constrained. Market interest rates are therefore anticipated to rise in order to attract more liquidity by encouraging more financial savings and to restrain the demand for credit.

In 2006/07, therefore, the annual average growth rate of bank credit to the private sector is targeted to slow down from a record 21 percent in 2005/06 to 12 percent. Together with the approved Government Budget deficit and the expected net inflow of funds from abroad, the annual average growth rate of money supply (M2) is anticipated to slow down from 14 percent in 2005/06, the highest rate of growth since the 2000/01 financial year, to 7 percent in 2006/07. (See Table 8.)



<b>Table 8</b>				
<b>Monetary Survey</b>				
<b>(Amounts in Tala million)</b>				
<b>End of Period</b>	<b>2003/04</b>	<b>2004/05</b>	<b>2005/06</b>	<b>2006/07 Forecast</b>
<b>A. Determinants of Money Supply</b>				
Net Foreign Assets	172.1	231.3	184.6	194.8
Net Domestic Assets	211.5	209.9	313.9	333.3
Government's Net Position	-81.6	-100.3	-89.3	-90.1
Bank credit to private sector	358.5	383.0	490.9	501.1
Bank credit to public institutions	13.4	10.3	28.5	31.0
Others, net	-78.9	-83.1	-116.2	-108.7
<b>B. Money Supply (M2)</b>				
Narrow Money	112.6	132.8	145.2	156.0
Currency Outside banks	28.4	30.7	37.0	38.4
Demand Deposits	84.2	102.1	108.2	117.6
Quasi-money	271.0	308.4	353.4	372.1
Savings deposits	49.4	55.8	64.3	67.6
Time deposits	209.4	239.5	269.4	286.7
Foreign Currency Deposits of Residents	12.2	13.1	19.7	17.8
Source: Central Bank of Samoa				

This monetary policy stance will be reviewed after six months.

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