CENTRAL BANK OF SAMOA

MONETARY POLICY STATEMENT

FOR THE FINANCIAL YEAR 2005/2006

APIA

September 2005

CONTENTS

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 main 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 for 2003–2005 and Government's Strategy For The Development of Samoa for 2005-2007. 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 fifth 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 the past two to three financial years where the sharp and continually increasing international price of crude oil combined with the adverse effects of Cyclone Heta in January 2004 to drive up the prices of petroleum products and local food.

Given that Samoa is a very small open economy with total merchandise trade alone representing around 60 percent of nominal GDP, it is therefore very important that Samoa maintains a sufficient level of international reserves to withstand large unforeseeable economic shocks. The Central Bank considers a level of gross official international reserves, equivalent to no less than 4.5 months of imports of goods, as adequate for maintaining the country's long-term international viability.

2. EXECUTIVE SUMMARY

The world economy is forecast by the latest IMF World Economic Outlook (WEO) to continue to expand in 2005/06, albeit at a subdued pace of 4.3 percent, driven mainly by strong growth in China and to a lesser extent, the United States. Inflation, on the other hand, remains moderate with IMF forecast pointing to 1.90 percent in 2005/06. Growth in the economies of Samoa's closest trading partners - Australia and New Zealand - are also expected to slow down with forecasts for 2005/06 of 2.9 percent (from 3.2 percent in 2004/05) and 2.7 percent (from 5.0 percent in 2004/05) respectively.

Worldwide, interest rates look set to trend upwards with the official rate in the US expected to reach 4.0 percent by the end of the year while the US dollar is expected to weaken further against most of the other major world currencies. Crude oil prices are expected to remain high and volatile, but the IMF says that fears of this resulting in a hike in world inflation and a disruption to the world economic expansion remain low. Recently, oil prices rose above the USD $70 per barrel mark, but the IMF WEO forecasts crude oil prices to average around USD $54 per barrel for the remainder of 2005 before falling back somewhat in 2006.

In the financial year 2004/05, domestic fiscal and monetary policies were focused on facilitating an expeditious recovery from Cyclone Heta, which struck the country in January 2004, and to boost real economic growth. Accordingly, the Bank continued to focus on driving down official interest rates throughout the year. On the other hand, fiscal policy was tighter than expected, with the Government Budget for the financial year 2004/05 closing with a large overall surplus.

As expected, the macro-economic results for 2004/05 were remarkable. The economy grew in real terms by 5.6 percent, headline inflation continued to decline reaching 7.8 percent at the end of June 2005 and the level of official international reserves grew by a substantial $36.2 million to $228.6 million.

In fiscal year 2005/06, assuming that monetary policy settings were to remain relaxed, the economy would continue heading upwards with real GDP likely to grow by 5.0 percent, boosted by a continued upswing in construction activities, tourism and private remittances. Unfortunately, the expected strong growth in the economy would come at a time when large overseas payments are due to be made following the merger between Polynesian Airlines and Virgin Blue and increased public sector salaries and wages. This, as a result, will see the balance of payments record a very large overall deficit of $50 million and inflation to exceed the target of 3.0 percent.

Whilst inflation is not so much of a worry, the anticipated substantial overall deficit in the balance of payments is expected to reduce the level of official reserves to 4.1 months of imports. To safeguard the country's foreign exchange reserves and to ensure that the macro-economic environment remain on a stable and sustainable footing, the growth in aggregate demand needs to be softened by implementing some gradual tightening in monetary policy in 2005/06. A tightening in monetary policy will see real GDP growth slowing down to around 4.0 percent in 2005/06 instead of 5.0 percent (if monetary policy are to continue being relaxed). The slower economic growth rate would help contain the demand for imports, thus reducing the expected overall balance of payments deficit from $50 million to $30 million. In addition, inflation would also fall from over 3 percent to the preferred target rate of 3.0 percent.

Tightening monetary policy will see the growth of private sector credit decline from around 14 percent (were monetary policy to remain accommodative) to around 12 percent. As a result, money supply (M2) growth rate would slow down from 12 percent (under a no-policy-change environment) to 10 percent (under a slightly tightened monetary policy environment).

3. WORLD ECONOMY

The world economy performed exceptionally well in 2004/05, overshooting the forecasts for economic growth and world inflation. World economic growth grew at an impressive 4.7 percent versus the forecast of 3.3 percent as world inflation of 1.9 percent also surpassed the forecast of 1.4 percent. (See Table 1.)

Table 1
Selected World Economic Indicators

Fiscal year to end June	2002/03	2003/04	2004/05	2005/06 Forecast	
		(Percent)			
Real growth rate	3.1	4.3	4.7	4.3	
Inflation rate	1.7	1.8	1.9	1.9	
Official international interest rates,		(End of period, percent p.a.)			
US Federal Reserve	1.00	1.25	3.25	3.50	(1)
Reserve Bank of Australia	4.75	5.25	5.50	5.50	(2)
Reserve Bank of New Zealand	5.25	6.75	6.75	6.75	(3)
Bank of Japan	0.15	0.10	0.10	0.10	(1)
Bank of England	3.75	4.50	4.75	4.50	(4)
European Central Bank	2.00	2.00	2.00	2.00	(5)
Reserve Bank of Fiji Notes, 91 days	1.25	1.75	1.75	1.75	(6)

Source: IMF and reserve banks' publications and information releases.
(1) Interest rate as at 9th August 2005
(2) Interest rate as at 6th September 2005
(3) Interest rate as at 28th July 2005
(4) Interest rate as at 4th August 2005
(5) Interest rate as at 1st September 2005
(6) Interest rate as at 26th August 2005

Macroeconomic policy setting around the world was generally contractionary as inflationary pressures became more prevalent.

On the exchange rate front, most of the major currencies were generally stronger against the US dollar as it continued to be pressured by the massive US current account deficit.

Driving the global expansion and surpassing the forecast figures, was a combined effort from China and the US economy. Both have been leading the front on economic expansion and are also expected to continue the lead, pushing up the global economy by 4.3 percent in 2005/06. Risks to this outlook remain in the form of US dollar weakness, continued high oil prices and heightened geo-political uncertainty. The world inflation rate, on the other hand, is expected to remain at a moderate level of 1.9 percent for 2005/2006.

For the US economy, real GDP increased by 0.8 percent in the June quarter, to be 3.6 percent higher over the year. This was attributed to the improvement in various economic settings such as firm labour market conditions, further increases in household wealth, a recovery in consumer confidence, and an increase in consumption and investment. The US current account deficit reached 6.4 percent of GDP in the March quarter while inflation, on the other hand, was well contained despite an increase in unit labour costs and persistent high oil prices. The Fed funds rate was tightened 25 basis points every policy meeting since mid 2004 and currently stands at 3.50 percent.

The outlook for the US economy looks positive despite the recent damages incurred from Hurricane Katrina's wrath. At least 20 oil rigs and platforms in the Gulf of Mexico have been reported missing and as a result the US emergency oil reserves have been opened up. Despite the extensive damage caused on the economy and the resulting effects on oil supplies, growth could be hurt but overall it is not expected to halt economic expansion. Policy stimulus is expected to remain strong as US monetary conditions remain very accommodative. However, the Federal Reserve Bank of New York is expected to keep on removing policy stimulus at a measured pace while the US dollar will continue its weak run against most of the major currencies. The IMF forecasts the US economy to grow 3.6 percent with an inflation forecast of 2.6 percent by end 2005/06.

The Australian economy remained steady in 2004/05. Despite strong investment to alleviate supply bottlenecks, there were still areas of infrastructure and labour market constraints. On the inflation front, inflation fell safely within the Reserve Bank of Australia's (RBA) 2-3 percent target band at 2.4 percent in the year to the March quarter of 2005. A strong AUD and adverse weather effects put pressure on farm output while business credit appeared robust implying that investment remained firm.

The IMF forecasts the Australian economy to grow 2.9 percent with an inflation rate of 2.7 percent in 2005/06. The case for a tightening in monetary policy is fast disappearing as there is increasing evidence of domestic demand cooling, the housing market slowing and building activity coming off its highs. Thus, the RBA's target cash rate currently at 5.50 percent looks set to hold at that level in the medium term. The massive gains in coal and iron ore contract prices are also expected to result in a sustained rise in the Terms of Trade for the Australian economy.

The New Zealand economy performed brilliantly in 2004 with a growth rate of 5.0 percent. It then tapered off to a mere 2.5 percent pace in early 2005 as economic prospects have been curtailed on the supply side by capacity constraints and on the demand side by tighter monetary conditions. Unemployment stood at a record 3.9 percent, activity within the housing sector was moderate, retail sales remained solid, residential building consent issuance dropped and export revenues were disappointing in recent months.

Going forward, the New Zealand economy will find support from the expansionary fiscal policy, infrastructure investment and solid income growth. Monetary policy settings will remain at 6.75 percent or go higher until the full effects of the tightening will be more widely felt throughout the economy before it recedes back to a more neutral level. The New Zealand dollar is projected to head lower while productivity growth will continue to improve. The IMF forecasts the New Zealand economy to grow only 2.7 percent by end 2005/06 with inflation at 2.9 percent.

The Japanese economy after encountering a mild recession last year, bounced back smartly in the first part of 2005 with a real GDP growth of 1.2 percent in the March quarter. This outcome was underpinned by a pick up in domestic spending. Other domestic economic conditions that supported the pick up in economic growth included ongoing employment growth, strong retail sales and consequently corporate profitability gains, a rise in business confidence and increased spending plans.

The IMF estimates the Japanese economy to grow 1.4 percent by end 2005/06. More pro-growth factors are expected to follow, including moderate growth rates in industrial production, increase consumer spending and healthier banking sector balance sheets.

In the Euro area, growth remained subdued with a 0.5 percent rise in the March 2005 quarter that translated into only 1.4 percent growth in the year to the March quarter. Measures of business and consumer confidence eased, and consumer spending remained weak weighed down by soft labour market conditions and high energy prices. Other contributors to the Euro-area's poor performance despite a very accommodative monetary policy stance of 2.0 percent included, a muted household sector weighed down by low confidence and a sluggish labour market, disappointing export figures and a strong Euro.

The Euro economy is expected by the IMF to achieve only 2.0 percent growth for 2005/06 and inflation of 1.8 percent. Given the Euro areas economic woes, monetary policy is expected to either remain at 2.0 percent or go lower.

4. DOMESTIC ECONOMY IN 2004/2005

4.1 Monetary policy and conditions

In the financial year 2004/05, fiscal policy was again focused on boosting real economic growth. Growth was expected to be led by the booming construction sector, large inflows of foreign aid, private remittances and further expansion in the tourism sector. With the expected recovery in the world economy, the balance of payments was forecast to generate an overall surplus despite the anticipated sharp rise in imports of goods and services. Headline inflation was expected to continue to feel the aftermath of Cyclone Heta, rising to 17 percent in December 2004 before eventually declining to 8 percent at the end of the financial year, with the underlying rate of inflation forecast to register at around 2 or 3 percent.

In the event, monetary policy was focused on supporting fiscal policy in boosting real economic growth in 2004/05. In pursuing that monetary policy stance, interest rates were encouraged to remain or fall further from their prevailing levels. This, as a result, was expected to push up bank credit to the private sector and money supply in 2004/05.

Actual figures on Government's financial operations in 2004/05 are not yet available but monetary data showed that Government closed the financial year with an overall cash surplus of $19 million. This turned out to be far better than an overall deficit that was approved for the 2004/05 Government Budget of $9 million. The Budget surplus soaked up some of the surplus liquidity in the financial system. (See Table 2.)

Table 2
Financial Operations of Government
(Amounts in Tala Million)

During the period	2002/03	2003/04	2004/05 Budget	2005/06 Budget
Total Revenue and Grants	303.5	318.4	524.4	358.1
Total Revenue	229.3	251.4	283.0	286.3
Tax	206.5	224.1	242.2	249.7
Non-tax	22.8	27.3	40.9	36.6
External Grants	74.2	67.0	241.4	71.8
Total Expenditure	309.1	332.4	521.4	402.4
Current Expenditure	202.2	208.0	236.6	272.8
Development Expenditure	86.9	93.5	263.8	104.7
Net Lending (1)	20.0	30.9	21.0	25.0
Overall Surplus / Deficit (-)	-5.6	-14.0	3.1	-44.3
Financing	5.6	14.0	-3.1	44.3
External Financing	4.8	13.0	15.8	19.5
Disbursements	16.6	26.5	27.6	32.9
Amortisation	11.8	13.5	11.8	13.4
Domestic Financing	0.8	1.0	-18.9	24.8
Monetary system	-6.2	0.0	-19.0	0.0
Other	7.0	1.0	0.1	24.8

Source: Ministry of Finance

On the monetary side, an overall surplus in the balance of payments in 2004/05 saw the level of net foreign assets (NFA) rise 35 percent ($59 million) on a point-to-point basis, much higher than expected. On the other hand, net domestic assets (NDA) declined 0.9 percent ($1.8 million), 8 percent ($17.4 million) lower than projected. With rehabilitation activities following Cyclone Heta, coupled with construction activities relating to tourism, education and sports development, private sector credit expanded 7 percent (or $24.5 million). This was, however, lower than the 9 percent ($30.6 million) increase anticipated for the same period. In the event, M2 grew by a significant 14 percent (or $57.6 million) in contrast to a 7 percent ($28.5 million) growth projected for end June 2005 (on and end-year on end-year basis). (See Table 3.)

Table 3
Selected Domestic Economic Indicators

Fiscal year to end June	2002/03	2003/04	2004/05	2005/06 Forecast	
	(Percentage change over the previous year)				
Real sector					
Nominal GDP	6.5	8.6	8.8	6.1	
Real GDP	1.8	3.0	5.6	3.8	
Prices					
Headline Consumer Price Index (annual average)	4.3	7.9	7.8	3.0	
Underlying Consumer Price Index (year-on-year)			-0.4	3.5	
Implicit GDP Deflator (annual average)	4.6	5.5	3.1	2.2	
Monetary aggregates					
Net foreign assets (annual average)	0.2	7.1	12.5	3.0	
Government's net monetary position (end of period)	6.7	-17.8	22.9	-6.3	
Bank credit to private sector					
Annual average	10.7	12.8	12.1	12.4	
End period	11.4	17.1	6.8	14.0	
Money Supply, M2					
Annual average	8.3	11.5	10.8	10.1	
End period	6.6	12.7	15.0	8.5	
Exchange rate					
Nominal Exchange Rate	2.21	1.03	0.40	na	
Real Exchange Rate	-1.96	12.02	1.17	na	
International reserves					
Gross International Official Reserves (Tala million)	142.35	178.78	228.57	198.98	
Gross International Official Reserves (Months of imports)	4.0	5.0	5.7	4.8	
Weighted average interest rates	(End of period, percent p.a.)				
CBS 14 days Securities	2.29	2.22	2.22	0.5	(1)
CBS 28 days Securities	3.15	3.21	3.20	0.9	(1)
CBS 56 days Securities	3.62	4.30	4.23	1.20	(1)
CBS 91 days Securities	5.15	4.90	4.92	1.54	(1)
CBS 182 days Securities	6.69	-	-	-	
CBS 365 days Securities	6.90	-	-	-	
CBS Securities overall weighted average yield (annual average)	4.3	4.0	3.5	-	
Commercial bank deposits	4.5	4.4	4.3	4.3	(2)
Commercial bank credit	11.3	11.0	11.0	11.4	(2)
Commercial bank interest rate spread	6.8	6.6	6.7	7.1	(2)

Source: Central Bank of Samoa
(1) Interest rate as at end August 2005
(2) Interest rate as at end July 2005

In effect, the commercial banks level of excess liquidity rose steadily from $23.6 million in June 2004 to close the fiscal year in June 2005 at $49.2 million. This resulted in reducing the level of official interest rates exerting pressure on the commercial banks' lending and deposit rates. The overall weighted average interest rate on CBS securities dropped to 2.9 percent in June 2005 from 3.4 percent in June 2004. At the same time, the commercial banks' weighted average interest rates for lending remained at 11.29 percent at end June 2005 while that of deposits fell to 4.39 percent from 4.48 percent at end June 2004.

On an annual average basis, therefore, excess liquidity in the financial system during 2004/05 was at a level of about $30 million, as Government's net deposits with the monetary system improved 7 percent. This saw private sector credit surge at an annual average rate of 12 percent due to the high demand from the construction industry. With NFA expanding substantially during the year, money supply (M2) rose significantly by 11 percent in the period under review. (See Table 4.)

Table 4
Monetary Survey
(Amounts in Tala million)

End of Period	2002/03	2003/04	2004/05	2005/06 Forecast
A. Determinants of Money Supply				
Net Foreign Assets	165.5	172.1	231.3	199.1
Net Domestic Assets	175.0	211.5	209.9	279.7
Government's Net Position	-99.2	-81.6	-100.3	-100.2
Bank credit to private sector	306.1	358.5	383.0	436.6
Bank credit to public institutions	30.2	13.4	10.3	9.7
Others, net	-62.1	-78.9	-83.1	-66.2
B. Money Supply (M2)	340.4	383.6	441.2	478.9
Narrow Money	93.8	112.6	132.8	138.1
Currency Outside banks	26.2	28.4	30.7	37.7
Demand Deposits	67.6	84.2	102.1	100.4
Quasi-money	246.6	271.0	308.4	340.8
Savings deposits	45.5	49.4	55.8	62.0
Time deposits	184.8	209.4	239.5	250.1
Foreign Currency Deposits of Residents	16.3	12.2	13.1	28.7

Source: Central Bank of Samoa

In nominal terms, the Tala appreciated 0.36 percent in the year to end June 2005, easing somewhat the pressure on imported inflation. And, there were no changes to the Central Bank's Exchange Control Regulations during the fiscal year under review.

4.2 Macro-economic performance

Available figures show that the economy performed extremely well in 2004/05. Real GDP grew much stronger than expected, led by strong public and private sector construction activities and further growth in tourism earnings, private remittances and grants from abroad. On the external sector, the balance of payments recorded an overall surplus despite a sharp increase in imports of goods and services, pushing up the level of international reserves above the minimum target level of 4 months imports. Headline inflation remained high but declined steadily throughout the year reflecting the pass through impact of Cyclone Heta and international oil prices. However, leaving aside the unavoidable impact of Heta and internationally induced oil price rises, the underlying rate of inflation subsided continuously.

4.2.1 Real sector

Gross domestic product for 2004/2005 increased 5.6 percent in real terms reflecting strong growths in the "Construction", "Transport and communication", "Agriculture, finance and business services" and "Commerce" sectors, with some improvements in "Fishing", "Public administration" and "Hotels and restaurants". (See Table 5.)

During the year, the agriculture sector rebounded 12 percent reversing the declining trend over the past eight years. This reflected the increases in the production of most agricultural commodities particularly taro, banana and taamu following the intensive replanting and rehabilitation efforts to recover from Cyclone Heta as well as notable improvements in the production of export commodities such as nonu and coconut products.

Table 5
Real Gross Domestic Product by Industry
(At 2002 prices. Amounts in Tala million)

During the period	**2002/03**	**2003/04**	**2004/05**	**2005/06 Forecast**
Agrculture	64.9	61.9	69.6	73.8
Fishing	63.3	55.3	58.6	61.4
Food & Beverage manufacturing	29.4	30.0	29.9	31.3
Other manufacturing	114.9	113.2	109.3	110.6
Construction	52.2	64.1	77.6	80.9
Electricity and water	42.2	44.6	42.9	45.0
Commerce	179.4	181.7	186.7	196.1
Hotels, restaurants	21.5	24.0	25.8	26.5
Transport, Communication	107.6	116.2	125.9	131.2
Public administration	73.0	76.9	80.4	83.6
Finance and business service	81.3	90.1	96.7	101.6
Less: Enterprise share of FISIM (1)	-12.6	-13.6	-14.2	-15.1
Ownership of dwellings	33.5	34.2	34.9	35.6
Personal and other serivce	49.7	53.3	52.9	53.5
Total	900.3	927.2	977.1	1,016.1
Annual percent change	1.8	3.0	5.4	4.0
Implicit GDP deflator	101.5	107.1	110.4	112.8
Annual percent change	4.6	5.5	3.1	2.2

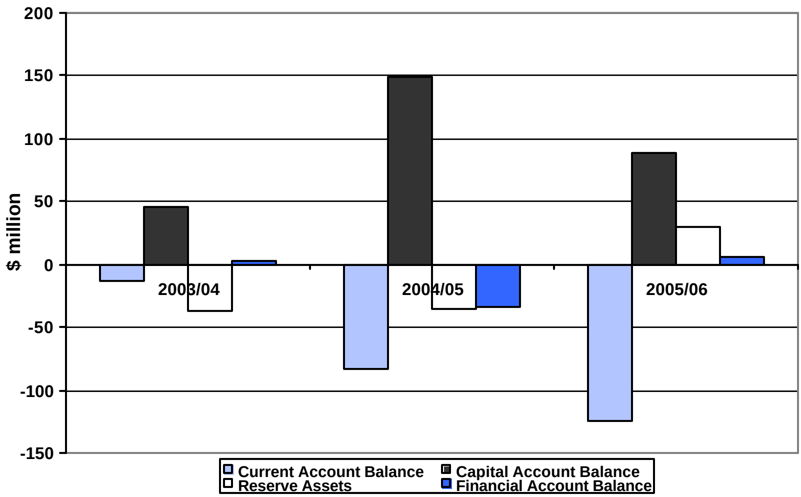
Source: Ministry of Finance
(1) FISIM : Financial Intermediary Services Imputed

The fishing industry recovered 6 percent in the year under review. The construction sector recorded a major boost in 2004/05 reflecting large projects such as the SamoaTel Headquarters, Aggie Grey's Faleolo Resort, Aqua centre, Taumeasina Hotel, the LDS Temple and Church, the NUS / Polytechnic joint campus buildings and other major private sector works (including the Mackenzie Company's Headquarters at Fugalei). Likewise, the transport sector, which is closely associated with the construction sector, also recorded a 10 percent improvement reflecting the strong linkage between the two sectors. "Communication services" also expanded with the opening of the new SamoaTel Headquarters. Additionally, the "Finance and business service" sector increased 7 percent while the "Commerce" sector rose 3 percent following on from strong growth in previous years. "Hotels and restaurants" increased 9 percent due to higher numbers of visitors to the country. "Electricity and water" grew 3 percent reflecting the completion of new water pipes around the rural areas while "Personal and other services" and "Ownership of dwellings" each rose 2 percent.

4.2.2 Balance of payments

The balance of payments in 2004/05 registered an overall surplus of $36 million, marginally down from the overall surplus of $37 million in the previous year. (See Graph 1.)

Graph 1 : Balance of Payments



The overall surplus in 2004/05 was due to substantial capital inflows, which managed to offset a hefty increase in the current account deficit and large financial outflows. (See Table 6.)

Table 6
Balance of Payments
(Amounts in Tala Million)

During the period	2003/04	2004/05	2005/06 Forecast
A. Current Account Balance	-12.8	-82.5	-124.9
Merchandise Trade Balance	-350.9	-429.8	-461.0
Exports	40.8	35.2	39.0
Imports	-391.8	-465.0	-500.0
Services, net	119.8	100.3	94.4
Income, net	-1.0	-22.1	-20.5
Current Transfers, net	219.3	269.1	262.1
Private transfers	211.1	230.1	243.2
Official transfers	8.2	39.0	18.9
B. Capital Account Balance	45.4	148.0	89.1
Official Grants	52.9	143.6	79.1
Other	-7.4	4.4	9.9
C. Financial Account Balance	2.8	-34.2	6.3
Direct Investment	-0.3	4.1	-0.5
Portfolio Investment	-1.4	0.8	0.9
Other Investment	4.5	-39.2	5.9
D. Reserve Assets	-36.6	-36.2	29.6
E. Net Errors & omissions	1.2	4.9	0.0

Source: Central Bank of Samoa

The current account deficit widened significantly due to a 23 percent increase in the merchandise trade deficit, a 16 percent drop in net earnings from services and a large jump in net outflow of income. Total imports for the year as a whole rose 19 percent due to gains in all categories of imports with non-petroleum private sector imports up 16 percent, petroleum imports up 31 percent and Government imports leaping to $4 million. Total exports, however, fell 14 percent due mainly to lower proceeds from garments and coconut cream.

Tourism earnings amounted to $192 million, 8 percent higher than in 2003/04 as a result of strong average tourist expenditure in 2004/2005 despite a slight drop in arrivals. The decline in total arrivals was due to a 21 percent fall in visitors from American Samoa, which offset gains in arrivals from New Zealand, Australia and the USA. “Other services” recorded a net outflow of $73 million reflecting large payments for services such as transportation (freight and airfares), technical services (TA’s) and telecommunication services while earnings from export processing rose 12 percent in the year under review.

There was a hefty net outflow of $22 million in the Income Account in 2004/05 compared to a net outflow of only $1 million in 2003/2004 as a result of large dividend payments by the ANZ Bank and the British American Tobacco Company and other foreign owed companies.

Current transfers expanded 23 percent or $50 million to $269 million reflecting a 9 percent rise in private remittances and a huge increase in current official transfers from $8 million in 2003/04 to $39 million in 2004/05. The hike in private remittances was due to a 45 percent jump in funds for ‘charitable organisations’, compliments of the large LDS projects at Pesega (Temple and Church).

The capital account surplus surged to $148 million in view of substantial project grants received by Government for the construction of the South Pacific Games 2007 sports facilities, renovation of various Government schools, the start of the NUS/Polytechnic joint campus and other extensions and projects. On private capital transactions, a $10 million inflow was recorded reflecting the commencement of the Taumeasina Hotel project.

4.2.3 Prices

With both domestic and external pressure affecting the economy in 2004, the subsequent inflationary trend was unfavourable in the first half of the 2004/05 fiscal year before it eventually slowed down in the latter half as a recovery in the agricultural and fisheries sectors started to exert downward pressure on prices. (See Table 7.)

Table 7
Consumer Price Index
(March 2004 = 100)

Fiscal year to end June	2002/03	2003/04	2004/05	2005/06 Forecast
A. Headline Inflation (12 months average percent change)				
Description				
All Groups	4.3	7.9	7.8	3.0
Food	4.3	12.9	10.9	2.0
Clothing and Footwear	-1.5	-3.0	-6.3	-5.5
Housing and Household Operations	1.9	-0.1	3.9	7.9
Transport and Communication	4.5	1.3	3.8	7.0
Alcohol and Tobacco	14.1	2.7	-0.1	1.4
Miscellaneous	2.8	1.2	0.7	1.0
Import Component	2.9	2.1	3.6	3.1
Local Component	7.9	13.0	10.1	3.0
B. Underlying Inflation (1) (Year end on year end percent change)				
Description				
All Groups			-0.4	3.5
Food			-0.7	3.9
Clothing and Footwear			-8.1	-1.2
Housing and Household Operations			3.1	3.0
Transport and Communication			0.9	1.8
Miscellaneous			1.3	2.2
Import Component			-1.5	4.2
Local Component			3.1	1.1

Source: Statistical Services Division, Ministry of Finance
(1) The historical series for this new index started in August 2003.

Following the devastation of Cyclone Heta in early January 2004 on agricultural production, the consequent rise in local food prices was unrelenting throughout the year, with the first half of the fiscal year under review recording a 32 percent increase in the overall price level for the Fugalei Market. However, with the recovery in supplies of agricultural produce back to their pre-cyclone levels, as well as the steady improvement in fish catches from lingering El-Nino effects, overall consumer prices subsided in the second half of 2004/05. These domestic factors partially outweighed the pass-through effects of volatile international oil prices (reaching a new record high of USD $70 per barrel following the onslaught of Hurricane Katrina in the US) and the increased electricity rates and natural gas prices (in May 2005).

In the event, the annual rate of headline inflation, which accelerated to a high of 16.3 percent in December 2004, decreased steadily to 7.8 percent in June 2005.

5. DOMESTIC ECONOMIC OUTLOOK FOR 2005/2006

The latest Central Bank forecasts indicate that the stability of the macro-economic environment would be at risk if monetary policy remained eased. With real GDP expected to continue to grow strong in 2005/06, aggregate demand is anticipated to grow a little too fast for comfort, risking a sharp reduction in international reserves and a rate of inflation that would slightly exceed the preferred target rate of 3.0 percent. To ease the pressure on the foreign reserves and inflation, real GDP, which on current trends would continue to grow almost as strong as in the last financial year, needs to be slowed down a bit in 2005/06. Given that an expansionary fiscal policy has been approved, softer growth in private sector investment and consumption is required which therefore calls for some tightening in monetary policy in the next twelve months.

5.1 Government

The 2005/06 Government Budget contains substantial items of expenditures with virtually no matching increase in Government revenue except for a 50 percent dividend payout policy across all state-owned enterprises. Therefore a large overall Budget deficit is expected in 2005/06, 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.

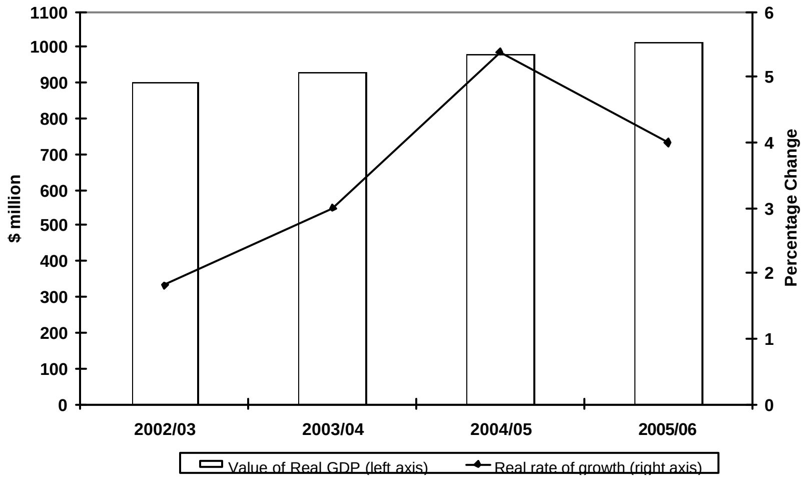
The largest items of expenditures are for the construction of venues and sporting facilities for the 2007 South Pacific Games, the construction of the campus buildings for the National University and Polytechnic, the first of the three tranches of the public sector salaries and wages increase and payment by Government of contractual obligations of Polynesian Airlines following the national carrier's merger with the Virgin Blue Airline. Consequently, the Budget is expected to record an overall deficit of $59.3 million, equivalent to about 4.2 percent of GDP. The large budget deficit is expected to stimulate further real economic growth in 2005/06.

The following sections describe the outlook for real growth, the external sector and inflation in 2005/06 under the assumptions of tightened monetary conditions.

5.2 Real sector

Real GDP is expected to grow about 4.0 percent in 2005/06, with all the productive sectors of the economy expected to expand. (See Graph 2.)

Graph 2 : Real Gross Domestic Product



Total output of the agriculture sector is expected to improve 6 percent and, on current trends, the fishing industry is expected to rebound by at least 5 percent as cooler weather conditions that are ideal for tuna stock are predicted to persist throughout the first half of 2005/06. Food and beverage manufacturing is estimated to expand by 5 percent led by growth in beverage production as well as the resumption of desiccated coconut production. Despite the completion of major LDS construction projects and Aggie Grey's Faleolo Resort, the construction sector is expected to expand further by reflecting the construction of the DBS building, two new sports gymnasiums, a new CCCS building and NPF property developments. The output of the "Electricity and water" sector is expected to increase in view of demand pressures for these services from the growing economy. A new water supply project will be funded under the Government Budget for 2005/06. The "Transport and communication" sector is expected to grow further, tagging along to the expansion in the construction sector. The "Hotels and restaurants" sector is also expected to improve further reflecting a likely increase in tourist arrival numbers, complimented by the opening of the new Aggie Grey's Faleolo Resort and additional smaller scale tourism facilities. The "Commerce" sector is again expected to increase further, picky backing on the growth of other sectors of the economy as well as the recent substantial salary and wages increase for the public sector employees. The finance and business services sector is also estimated to grow following the expected strong expansion of the financial system.

5.3 Balance of payments

The growth in real GDP and further increase in petroleum prices worldwide are expected to push up the total value of imports to $500.0 million. Export earnings, on the other hand, are expected to rebound 13 percent, spearheaded by the buoyant outlook for nonu products, a cyclical improvement in the fishing industry as the warm El-Niño oceanic temperature recedes, and increases in the exports of taro, beer, coconut cream and desiccated coconut.

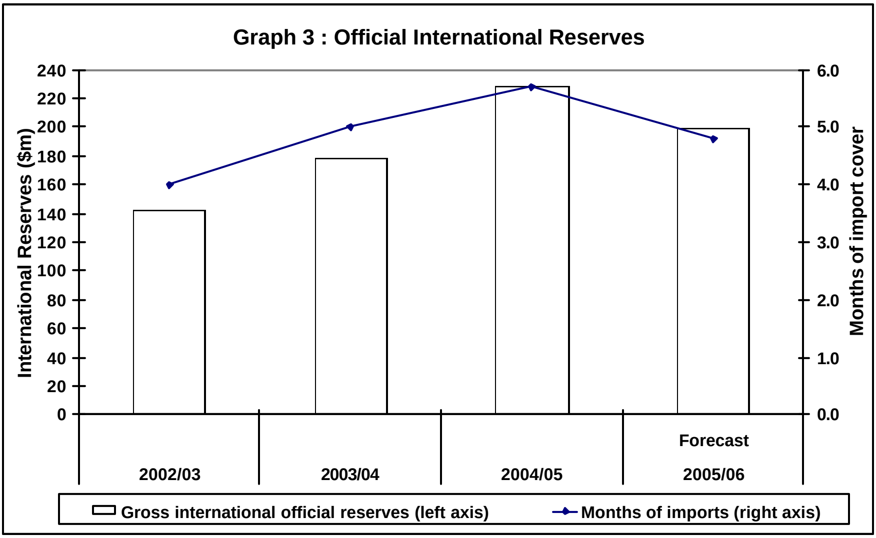
Tourist arrivals, which fell slightly in 2004/05 are expected to improve in 2005/06 in line with the current upward trend in Pacific tourism and benefits of low airfares to and from Samoa through the Polynesian Blue Airline merger. The prices of commodities and services that are normally consumed by tourists such as hotel accommodation, car rentals and transportation are expected to rise in the coming financial year as the private sector is pressured to offer pay rates that are compatible with those in the public sector. As a result, total earnings from tourism is expected to grow in 2005/06. Total revenue from the export of automotive wire harnesses is also expected to improve in the year to end June 2006 in view of the anticipated favourable outlook for the Australian economy which is the main market for these products. Overseas payments for “Other” services are forecast to increase, with substantial payments expected for construction activities (DBS building) and transportation and telecommunication services. Substantial dividend payments are scheduled to be made by some private foreign owed companies operating in Samoa.

The overall net inflow of current transfers is expected to contract slightly as a result of lower official transfers expected in the Government Budget estimates for 2005/06. Family and personal remittances, however, are expected to rise 10 percent in light of the continuing strong growth in the main source countries (USA, Australia and New Zealand), facilitated by the increased number of money transfer and foreign exchange businesses in the country. A reduction is expected in funds to be received by ‘charitable organisations’ following the completion of the LDS Temple.

The Government Budget for 2005/06 expects the level of project grants to return to more normal levels after large inflows were received in 2004/05 for some major projects such as the Chinese funded Aqua-centre complex and the Japanese funded NUS/Polytechnic joint campus. With the ongoing construction of the Taumeasina Hotel, net inflows of private capital is expected to increase as well in 2005/06.

On the financial account, large financial outflows are expected in 2005/06. In particular, the financing of the DBS Headquarters, payment by Polynesian Airlines of penalty fees for returning its remaining aircraft before due date, severing other international servicing contracts and the settling of the airlines spare parts account in New Zealand. On the other hand, a $32.0 million loan disbursement is expected by Government and loan proceeds of $24 million are expected by DBS from the European Investment Bank.

Overall, therefore, the balance of payments is expected to record a deficit of around $30 million in 2005/06. Together with the expected high level of imports, the resulting reduction in official reserves is expected to reduce the international reserves import coverage to 4.8 months of imports from 5.9 months at end June 2005. (See Graph 3.)



5.4 Prices

5.4.1 Headline inflation

Headline inflation is expected to be driven up by the high level of petroleum prices as well as the prices of local non-food items.

Import component

The import component is envisaged to increase by about 4.9 percent in the fiscal year to end June 2006 due largely to an anticipated growth in the "Transport and Communication" sub-index as well as a projected surge in the "Housing and Household Operations" sub-group. The expansion in the "Transport and Communication" sub-index over the year to June 2006 reflects the impact on domestic economy of the continued volatility in the international oil markets as renewed conflicts in source countries[1], intense speculative activity (with economic commentators predicting a barrel of oil to surpass $100 USD at the end of the year), growing world-wide demand especially in China intensify and the devastating impact of Hurricane Katrina on oil production in the USA. Being a small open economy, Samoa is vulnerable to the continuing volatility in oil prices. Increased demand pressure from the large number of construction projects around the country (including the DBS Headquarters, SPG sporting facilities, NPF property development and other private sector construction) will push up the level of the "Housing and Household Operations" sub-group by about 7.3 percent. The imported "Food" sub-group is also projected to increase over the year to end June 2006 as demand increases combined with a resurging US dollar (which will

[1] Major source countries in turmoil include those in Iraq, Saudi Arabia, Nigeria and Russia to name a few.

see the prices of poultry items such as chicken leg quarters becoming more expensive).

On an annual average basis, the import component of the CPI is projected to rise by about 3.1 percent in the year to end June 2006. This projected increase, is attributed to a potential rise in the level of the imported "Food" sub-group (which accounts for 66 percent of the overall import component of the headline CPI).

Local component

In 2005/06, a 2.8 percent increase is expected in the local component of the headline CPI, driven mainly by the expected strong demand for local food produce, partially neutralized by the return of agriculture production to its normal supply level. The local "Food" sub-index is expected to grow by about 3.5 percent in the year to end June 2006. A 5.0 percent expansion is also expected in the local "Transport and Communication" sub-group, reflecting the pass-through effects of volatile international oil prices on local transport costs, with taxi and bus fares expected to rise dramatically. And, based on the expected growth in real GDP in 2005/06, increased consumer demand will exert upward pressure on prices for other consumer goods and services, with an increase of up to 4.0 percent in the "Housing and Household Operations" and 1.0 percent and 2.0 percent respectively for the "Miscellaneous" and "Alcohol and Tobacco" sub-indices. Overall, on an annual average basis, the local component of the CPI is envisaged to rise by 3.0 percent in 2005/06.

All Items

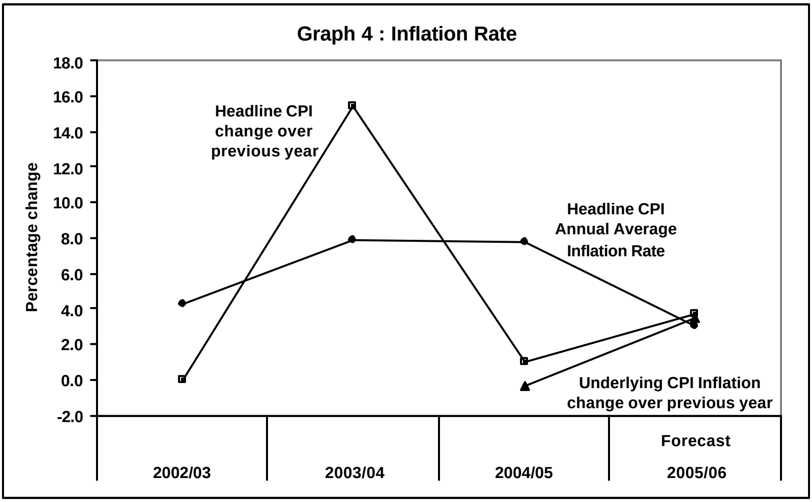
The "Food" sub-group is expected to increase by about 3.8 percent, largely driven by increased demand for both local and imported food items. The "Housing and Household Operations" sub-index is projected to expand 5.8 percent in 2005/06, mainly due to the expected strong growth in its import component as well as a smaller increase in its local component, both reflecting increasing demand from a number of construction activities around the country. Another significant contributor to the overall CPI is the "Transport and Communication" sub-index which is expected to grow strongly as both its import and local component increase by significant percentages, as a consequence of the continuing instability in the international oil market. The overall "Clothing and Footwear" sub-group is estimated to remain unchanged in the next eleven months as cheap supplies from source countries (namely in China) is expected to be offset by increased local consumer demand following the recent increase in July 2005 of salaries and wages increases in the public sector.

On an annual average basis, the recovery in agricultural production to normal supply levels is expected to contain some of the strong upward pressure on prices in 2005/06. In the event, the headline annual rate of inflation is projected to continue to decline reaching 1.5 percent in January 2006 before rising slowly to reach 3.0 percent in June 2006. (See Graph 4.)

5.4.2 Underlying inflation

Import Component

It is anticipated that all the sub-groups of the import component of the underlying CPI (with the exception of "Clothing and Footwear") will record expansions in 2005/06, predominantly on the back of increased pressure from consumer demand.



The expected strong growth in the economy and the recent increase in the salaries and wages of the public sector, will drive up the imported "Food" sub-group, along with increases in the imported "Housing and Household Operations", "Miscellaneous" and "Transport and Communications" sub-indices. As a result, the underlying import component is expected to rise 4.2 percent (on a year-end-on-year-end basis) at end June 2006 after falling 0.8 percent in the year to end July 2005.

Local Component

In the year to end June 2005, the domestic component of inflation (on a year-end-on-year-end basis) is expected to decrease by about 1.1 percent by end June 2006. This downward trend reflects an expected slide in prices of items in the local "Food" sub-group. All other sub-groups, in particular "Housing and Household Operations", "Transport and Communication" and "Miscellaneous" are projected to grow due to the expected growth in aggregate demand.

All Items
Overall, therefore, the core (underlying) inflation rate is expected to steadily begin increasing to reach 3.5 percent at end June 2006 (on a year-end-on-year-end basis) as consumer demand pressure intensifies.

6. MONETARY POLICY STANCE

A continuation of relaxed monetary policy in the light of a substantially expansionary fiscal policy outlook for 2005/06 and the anticipated increase in net inflows of private remittances and tourism earnings will see aggregate demand grow unsustainably strong in the next twelve months, pushing real economic growth to above 5 percent. Unfortunately, this expected rapid growth in demand will put undue pressure on the balance of payments with a potentially large overall deficit. The end result would be a sharp reduction in the level of official reserves to 4.1 months of imports for the year to end of June 2006. Furthermore, the headline annual rate of inflation, which is anticipated to decline to 1.7 percent in January 2006, would rise again reaching 3.4 percent at the end of June 2006. Similarly, the underlying rate of inflation would increase steadily reaching 3.7 percent, on a point-to-point basis, after falling 0.8 percent in the twelve months to end July 2005.
The expected large balance of payments deficit, under a relaxed monetary policy environment leading to a substantial reduction in official reserves is a matter of concern to the Board of the Central Bank. To safeguard international reserves and sustain macro-economic stability, therefore, some tightening in monetary policy is called for in 2005/06.

The tightened monetary policy stance should see the growth rate of bank credit to the private sector reduced from 14 percent (under a no policy change environment) to 12 percent. This, together with a reduced outflow of foreign reserves, should see the growth of money supply (M2) slow down from 12 percent (under a no policy change environment) to 10 percent in 2005/06.

This monetary policy stance will be reviewed when data for the first half of 2005/06 (i.e six months to end December 2005) become available.
