# RESERVE BANK OF FIJI

## QUARTERLY REVIEW

### March 2006

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# QUARTERLY REVIEW OF THE ECONOMY & FINANCIAL CONDITIONS

# OVERVIEW

International economic and financial conditions gained momentum in the March quarter, with the economic expansion becoming broader based. The US remains the main engine of growth and this has been further complemented by the buoyant economic activity in China, India and Russia.

The International Monetary Fund (IMF) estimated that the global economy expanded by 4.8 percent in 2005, up from the previous projection of 4.3 percent.

For 2006, world growth is now projected at 4.9 percent, before easing to 4.7 percent in 2007. A few risks, however, could derail the envisaged expansion. These include continued high and volatile crude oil prices, the potential risks of an Avian Flu pandemic outbreak and escalating geo-political tensions and terrorism threats.

Globally, monetary policy remained on a tightening bias with the US and the Euro-zone raising their policy interest rates over the quarter. Furthermore, deflationary pressures in Japan continued to ease, encouraging the view that policy accommodation may be removed in the year ahead. Monetary policy in Australia and New Zealand, on the other hand, was neutral.

The growth outlook for most of our major trading partners is optimistic particularly for the US, Australia, Japan and the Euro-zone. However, New Zealand's economic growth is projected to slow.

Over the March quarter, international financial markets recorded mixed performance. The equity markets rallied, while bond prices generally fell. On exchange rates, the US dollar strengthened against the Aussie and the Kiwi dollars, but weakened against the Yen and the Euro.

Locally, revised growth projections indicate that the economy is estimated to have expanded by 1.5 percent in 2005. The following sectors were expected to have led last year's growth: building and construction, wholesale & retail trade, hotels & restaurants and finance, insurance, real estate & business services.

For 2006, an improved growth of 2.7 percent is being anticipated. The transport & communications; agriculture, forestry, fishing & subsistence; and community, social & personal services sectors are expected to be the main drivers of growth this year.

On a sectoral basis, overall economic performance during the review period was generally positive.

Partial indicators of consumer spending, including net Value Added Tax (VAT) collections, indicate that consumption remained firm into the first quarter of the year. In addition, currency in circulation and lending for consumption purposes also showed healthy growth over the same period. Consumption activity is also being supported by rising incomes.

The tourism industry continued its robust performance as latest official statistics indicate a new record for visitor arrivals in 2005. In the years ahead, growth in the tourism industry will be supported by increased room inventory and a rise in inbound flights.

Investment levels also noted a gradual pick up, supported by buoyant activities in the building and construction sector. In addition, output in the copra, fishing, timber and electricity industries rose on an annual basis during the review quarter.

In contrast, production in the mining & quarrying and clothing & footwear sectors remained weak.

Inflation moderated during the quarter. The headline measure stood at 2.0 percent in March, while the underlying measure, the trimmed mean, was 1.1 percent. In the approaching quarter, inflationary pressures are expected to emanate from external factors, namely, higher energy prices and a relatively stronger US dollar. However, lower inflation on the domestic front is likely to cushion the impact to some extent. Thus, the 2006 year-end inflation rate is projected at 3.5 percent.

Labour market conditions improved over the review quarter as suggested by partial indicators. Moreover, anecdotal evidence from various surveys indicates employment conditions may continue to improve over the year.

Government's fiscal position slightly deteriorated in 2005. The underlying fiscal deficit for 2005 is currently estimated at $168.2 million or 3.6 percent of GDP, as opposed to the underlying deficit of $146.6 million (3.3 percent of GDP) recorded for 2004.

On the external front, latest accrual trade data showed that cumulative to February, merchandise exports fell by around 27 percent while imports rose by around 7 percent, thus widening the trade deficit.

Foreign reserves at the end of March were $794 million, sufficient to cover 3.4 months of import payments of goods.

Following the 50 basis point hike in October, the Reserve Bank raised its policy indicator rate by a further 100 basis points in February 2006 to 3.25 percent. In implementing this recent change, the Bank noted that the environment had not changed since the previous policy decision. Consumption was still strong supported by strong credit growth and oil prices remained high, factors which contributed to a growing imports bill. The Bank considered this trend unsustainable given the continuing underperformance of the exports sector. This led to the further interest rate rise to reign in the credit expansion and protect Fiji's overall macroeconomic stability.

In March 2006, the Bank raised the Statutory Reserve Deposit ratio (SRD) for commercial banks from 5 percent to 7 percent, effective 8 May. The minimum lending rate was also increased from 50 to 100 basis points above the policy indicator rate.

The Bank will continue to monitor developments in the economy in the coming months and align monetary policy accordingly.

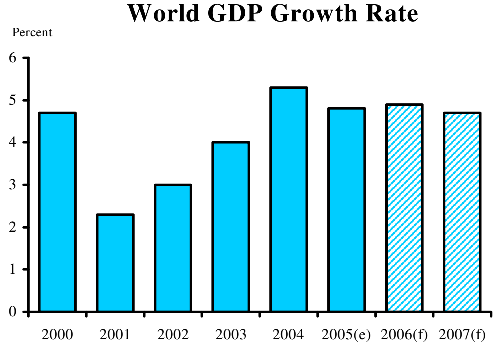
# THE INTERNATIONAL ECONOMY

## International Economic Conditions

International economic and financial conditions gained momentum in the March quarter, with the economic expansion becoming broader based (Graph 1). The US remains the main engine of growth; the Japanese expansion is also well established, together with signs of more sustained recovery in the Euro-area. This has been further complemented by the buoyant economic activity in China, India and Russia.

Graph 1

**World GDP Growth Rate**




Source: IMF World Economic Outlook - April 2006

The International Monetary Fund (IMF) estimated that the global economy expanded by 4.8 percent last year, up from the previous projection of 4.3 percent. The upward revision reflected stronger-than-expected economic activity in the latter half of last year, despite the higher crude oil prices and natural disasters. For 2006, world growth is now projected at 4.9 percent, before easing to 4.7 percent in 2007. Growth this year remains positive, supported by the solid performance of emerging and developing economies, particularly led by the upbeat activity in China and India.

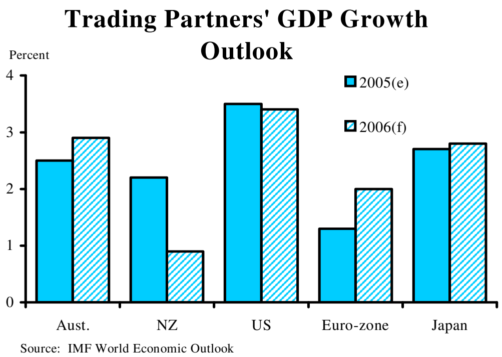
While the global economic conditions remain buoyant, a few risks could derail the envisaged expansion. Firstly, continued high and volatile crude oil prices could lead to further interest rate hikes, which could disrupt the current growth momentum. Secondly, while the potential risks of an Avian Flu pandemic outbreak are impossible to assess with certainty, a worse-case scenario could have extremely high human and economic costs. Finally, geo-political tensions and terrorism threats remain an undermining factor to growth prospects.

Internationally, monetary policy remained on a tightening basis, with the US and the Euro-zone raising their policy interest rates over the quarter. Furthermore, Japan may be able to remove policy accommodation in the year ahead as deflationary pressures continued to ease. Monetary policy in Australia and New Zealand, on the other hand, was neutral.

Over the March quarter, international financial markets recorded mixed performance. The equity markets rallied, while bond prices generally fell. On exchange rates, the US dollar strengthened against the Aussie and the Kiwi dollar, but weakened against the Yen and the Euro.

The growth outlook for most of our major trading partners is optimistic. (Graph 2). Consistent with robust domestic demand, growing exports and high business investment, the economic outlook remains positive for Australia, the US, Japan and the Euro-zone. However, New Zealand's economic growth is projected to slow, due to weak domestic demand.

Graph 2




Economic growth in **Australia** rose at a faster pace of 0.5 percent in the December quarter, following a revised 0.3 percent growth during the previous quarter. The pick-up in growth was led by increased business investment.

Economic activity over the March quarter was generally positive. Consumer and business confidence rose in March, amid declining fuel prices and optimism that the central bank would not raise interest rates this year. Moreover, retail sales rose in January, as consumers increased spending at department and clothing stores.

However, the trade deficit widened in January, while the unemployment rate rose to its highest level in more than a year.

The Reserve Bank of Australia (RBA) kept its key interest rate unchanged at 5.5 percent during the quarter, after inflationary pressures remained subdued.

The economy is anticipated to expand by 2.9 percent this year, after a 2.5 percent growth in 2005. Consumer prices are expected to increase by 2.8 percent this year, only marginally higher than the 2.7 percent in 2005 and within the RBA's target band of 2-3 percent.

**New Zealand's** economy fell by 0.1 percent in the fourth quarter, after a revised 0.1 percent growth in the third quarter. Weaker growth was due to high interest rates, which curbed investment growth, while a stronger currency restrained exports.

Economic indicators were generally weak in the current quarter. Business confidence fell to a 15-year low in February, while the annual trade deficit widened, led by rising imports. Manufacturing also slumped in January.

In line with the restrained economic outlook and amid expectations that inflationary pressures will be contained in the medium term, the Reserve Bank of New Zealand (RBNZ) left its key interest rate at 7.25 percent during the quarter.

Looking ahead, economic growth is forecast to slow to 0.9 percent this year, after an estimated 2.2 percent growth in 2005. Year-end inflation is expected to increase to 3.1 percent in 2006, from the previous-year's estimate of 3.0 percent.

Growth in the **US** economy was at a slower rate of 0.4 percent in the fourth quarter, after a 1.0 percent growth in the previous quarter. The slowdown in growth emanated from declines in personal consumption, corporate investment and exports.

Economic indicators for the current quarter were cautiously optimistic. The jobless rate fell to a 4-year low in January, while manufacturing expanded. Moreover, industrial production rebounded in February and the services industry accelerated during the same month.

However, on a negative note, the trade deficit widened in January, as imports surged. Moreover, retail sales and consumer confidence fell in February. An index of US leading indicators also fell during the same month.

The Federal Reserve raised its key interest rate by 25 basis points each in January and March, prompted by expected inflationary pressures stemming from higher energy prices.

The economy is expected to grow by 3.4 percent this year, only slightly lower than the 3.5 percent growth estimated for 2005. Inflation is anticipated to slow to 3.2 percent this year, after an estimated 3.4 percent last year.

**Euro-zone** economic growth expanded at a slower pace of 0.3 percent during the December quarter, after a revised 0.7 percent growth in the September quarter. Growth slowed during the fourth quarter due to falling household consumption and weaker net exports.

Economic indicators over the review quarter were encouraging. In February, Euro-zone manufacturing expanded, consistent with increasing exports.

Furthermore, the Euro-zone's two major economies, Germany and France, also reported positive results during the quarter. German investor confidence rose to a 2-year high in January, while consumer confidence also surged during the same month. In France, retail sales rose in February, while consumer spending and industrial production gained momentum in January.

The European Central Bank (ECB) increased its benchmark interest rate by 25 basis points to 2.50 percent in the March quarter, to restrain inflation as economic growth accelerated.

The Euro-zone economy is forecast to expand by 2.0 percent this year, after an estimated 1.3 percent growth last year. Year-end inflation for 2006 is forecast at 2.1 percent, following an estimated 2.2 percent in 2005.

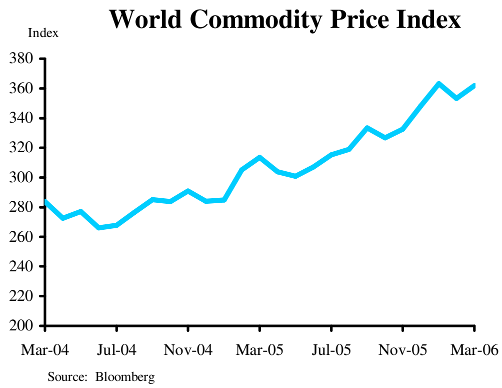
The **Japanese** economy grew at a faster pace of 1.3 percent in the fourth quarter, after a revised 0.2 percent growth in the previous quarter, driven by domestic demand and rising exports.

Latest indicators were also largely positive. Japanese consumer confidence surged to a 14½-year high in January, on improving job prospects and wages. In addition, retail sales rose in January, while industrial production expanded. The services industry also expanded during the same month.

This year, the Japanese economy is anticipated to expand by 2.8 percent, compared to 2.7 percent estimated for 2005. There is cautious optimism that after five years, Japan's deflation fighting policies may be relaxed. Inflation is forecast at 0.3 percent, after an estimated -0.3 percent last year.

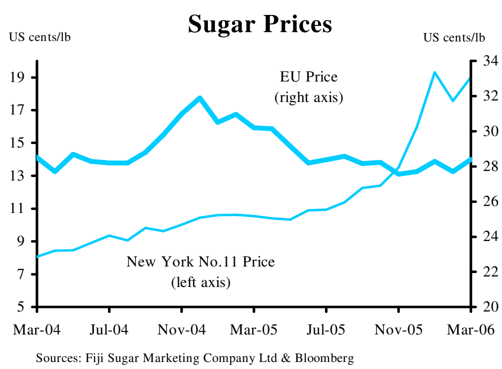
**World commodity prices** rose by around 4.0 percent over the March quarter, mainly underpinned by the surge in sugar and gold prices (Graph 3).

Graph 3




Over the March quarter, **world market sugar prices** rose by around 19 percent, reaching a historical high of US20.46 cents per pound in early February (Graph 4). The sugar prices increased in the quarter, driven by a decline in supply from Brazil and Australia.[1]

Graph 4




Consequently, sugar prices are anticipated to remain above US15 cents per pound, in line with lower anticipated supplies into the world market.

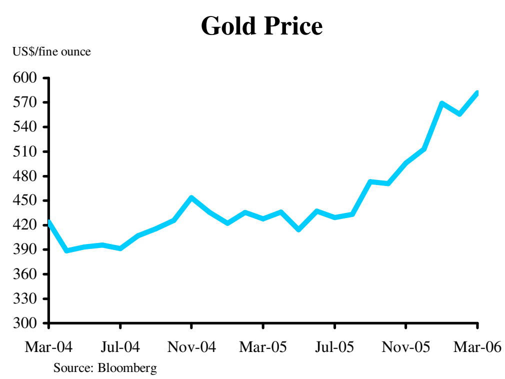
At the end of March, the European Union (EU) sugar price was around US28 cents per pound. Over the quarter, the EU sugar price rose slightly, reflecting a stronger Euro against the US dollar.

**Gold prices** rose by around 14 percent over the March quarter, reaching a historical high of US$584 per fine ounce at the end of March (Graph 5). In January, gold prices rose after a decline in the US dollar against the euro increased demand from European investors. In addition, the outperformance of gold to other assets such as stocks and bonds also lured investors.

However, the price of gold declined in the second month of the quarter, after a decline in oil prices eased speculation of inflationary pressures, thus reducing demand for the metal as a hedge against inflation.

Nevertheless, gold prices rallied again in March, after a rise in the price of crude oil and US homes spurred inflation concerns, thus fuelling interest in the precious metal once more.

Graph 5




In the coming months, gold prices are expected to remain high (above US$500 per fine ounce). Possible inflationary pressures,

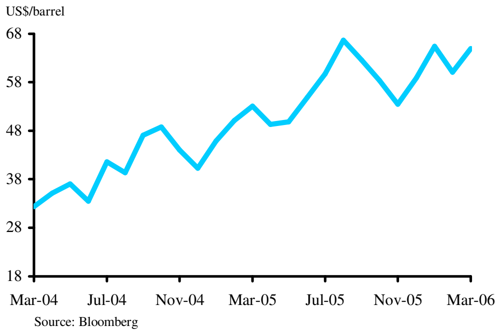
[1] Brazil, the world's largest producer, may direct more of its production towards ethanol, after a surge in gasoline prices increased demand for an alternative-fuel source. For Australia, lower supply resulted from Cyclone Larry that destroyed an estimated 10 percent of sugar cane production in Australia in mid March.

emanating from high crude oil prices and ongoing terrorism concerns are anticipated to maintain the high demand for the precious metal, as a safe haven investment.

At the end of March, the **Brent crude oil price** was around US$65 per barrel, an increase of 10 percent compared to the end of December 2005 (Graph 6).

Graph 6

**Crude Oil Price**




Crude oil prices rose in the first month of the quarter, reaching a new historical high of US$66.29, on concerns that the escalating tension over Iran's nuclear program,[2] and the continued militant attacks in Nigeria[3], may affect oil shipments from the Middle East. However, prices declined in February after signs that Iran's nuclear standoff would not lead to a reduction in oil supply from the fourth-biggest producer, which eased supply constraint concerns.

Nonetheless, prices continued its rising trend later in the quarter, after concerns that rising demand for gasoline and extended refinery maintenance in the US may erode supplies before the summer driving season.

In the months ahead, crude oil prices are anticipated to remain high (above US$60 per barrel), on expectations that higher energy demand from the US and China and the escalating tensions in Iran and Nigeria which could lead to lower supplies, may result in demand exceeding crude oil supplies in the world market.

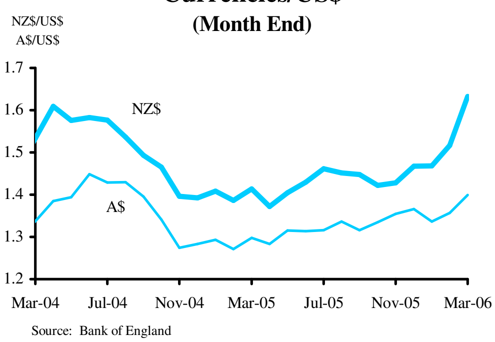
## International Financial Markets

Over the March quarter, the US dollar strengthened against the Aussie and the Kiwi dollars, whereas it weakened against the Yen and the Euro.

During the quarter, the Australian and the New Zealand currencies generally weakened against the US dollar (Graph 7).

Graph 7

**Exchange Rate - Selected Currencies/US$**
**(Month End)**




In January, the Aussie dollar strengthened against the US dollar, after rising prices of metals that the country exports, increased demand for the currency.

However, the Aussie dollar weakened against the US dollar during the last two months of the quarter, after investors'

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[2] Europe and the US are trying to stop Iran from going ahead with its plans to resume research on uranium reprocessing. The Iranians, on the other hand, are going ahead with their nuclear program. United Nations Security Council sanctions could limit the investment that Iran needs to pump more oil, thus leading to a huge decline in oil supplies.

[3] In Nigeria, the fifth-biggest source of US oil imports in October and the sixth-biggest OPEC producer in December, Port Harcourt was attacked by an armed gang who exchanged fire with local security forces.

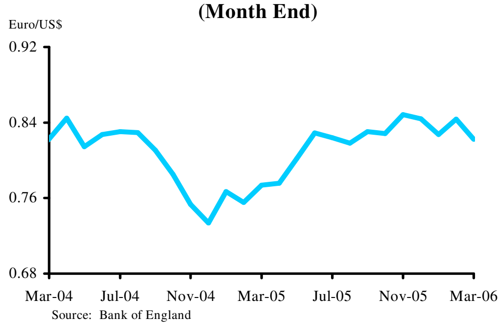
appetite for Aussie dollar denominated financial assets declined, as interest rates stayed unchanged, while US borrowing costs continued to rise.

The Kiwi dollar weakened during the quarter, amid speculation that slowing economic growth may prompt an interest rate cut this year, reducing demand for Kiwi dollar-denominated assets and hence the currency.

The Euro generally strengthened against the Greenback over the first quarter (Graph 8). The rise in the Euro was on speculation that the ECB had more interest rate increases in store which lured investors into Euro-denominated assets and thus the currency. However, there was some momentary softening of the Euro in February, after speculations that the US Federal Reserve will keep raising interest rates, prompted investors to demand more US denominated assets.

Graph 8

**Exchange Rate - Euro/US$**
**(Month End)**

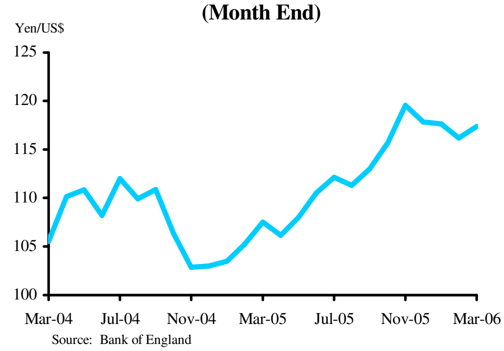



The Yen also generally strengthened over the quarter against the US dollar (Graph 9). The Yen appreciated in the first two months of the quarter, on speculation that the Bank of Japan will soon end its five-year deflation-fighting policy and raise interest rates, thus boosting the appeal of Yen denominated assets.

However, the Yen weakened in the last month of the quarter, after the Bank of Japan's announcement to keep interest rates at zero percent, prompted investors to switch from Yen-denominated assets to other higher yielding assets.

Graph 9

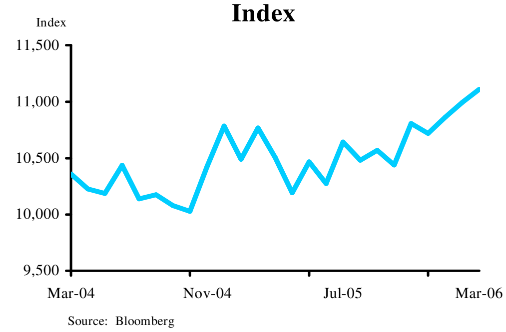
**Exchange Rate - Yen/US$**
**(Month End)**




Equity prices generally rose over the March quarter. In the three months to March, the Dow Jones Industrial Average Index rose by around 4 percent (Graph 10). The Dow rose throughout the quarter, as the outlook for corporate earnings improved, luring investors into US equities.

Graph 10

**Dow Jones Industrial Average Index**

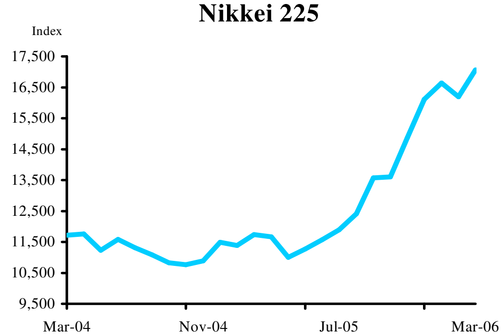



The Nikkei 225 Stock Average Index rallied by around 6 percent (Graph 11) over the quarter. In January, the Japanese index rose, after improved profit expectations led by technological companies, lured investors into equities. However, the Nikkei fell modestly in February, after a weaker US dollar against the Yen undermined profit expectations for Japanese exporters, thus decreasing the appeal of Japanese stocks.

The Nikkei rallied again in the last month of the quarter, after optimism of rising consumer demand in the economy boosted company earnings, consequently prompting investors demand for stocks.

Graph 11

**Nikkei 225**

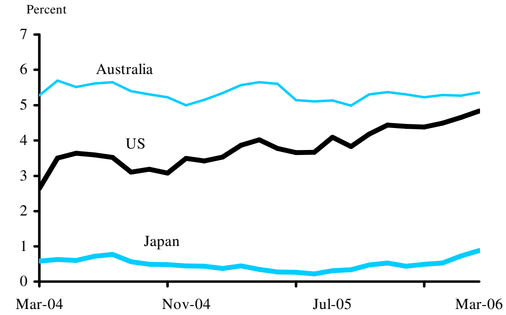



Source: Bloomberg

Over the March quarter, 10-year bond yields for the US, Japan and Australia generally rose (Graph 12).

Graph 12

**Ten-Year Bond Yields**




Source: Bloomberg

US bond yields rose in the three months to March, after expectations of strong economic growth and consequently inflationary pressures, reduced the appeal of the inflation-sensitive debt asset.

Japanese bond yields rose during the March quarter, after a gain in stocks prompted investors to move away from bonds and into equities.

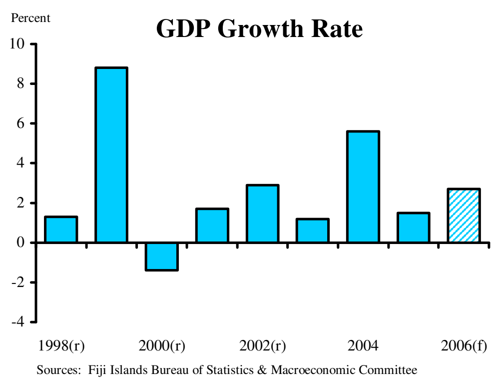
Over the three months to March, Australian bond yields rose, after generally positive economic activity during the quarter lured investors away from Aussie bonds into other assets.

# THE DOMESTIC ECONOMY

## Domestic Economic Conditions

Domestically, revised growth projections indicate that the economy is estimated to have expanded by 1.5 percent in 2005 (Graph 13). The building and construction sector; followed by the wholesale & retail trade and hotels & restaurants, and finance, insurance, real estate & business services sectors are expected to have led last year's growth. For this year, slightly better growth of 2.7 percent is anticipated. The transport & communications; agriculture, forestry, fishing & subsistence; and community, social & personal services sectors are expected to be the main drivers of growth this year.

Graph 13



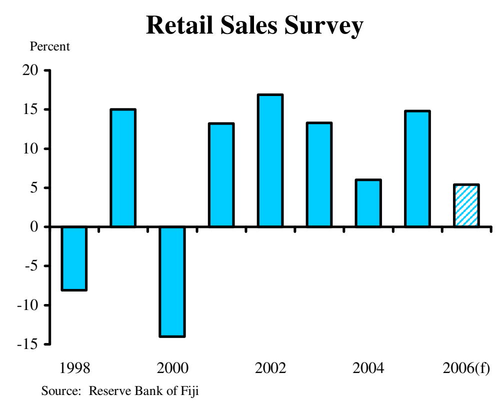

## Consumer Spending

Partial indicators of **consumer spending** indicate that consumption remained firm in the first quarter of the year.

Cumulative to March, net Value Added Tax (VAT) from domestic collections increased by around 13 percent over the same period last year. In addition, currency in circulation and lending for consumption purposes also showed healthy growth over the same period. Consumption activity is also being supported by rising incomes, as evident by the growth in Pay As You Earn tax receipts, which grew by 11 percent on an annual basis in the first 3 months of the year.

Looking ahead, the results of the Reserve Bank's December 2005 Retail Sales Survey indicate that growth in retail sales will likely slow in 2006 to around 5 percent, from a strong growth of around 15 percent estimated for 2005 (Graph 14).

Graph 14




The expansion in retail sales for 2006 is expected to be largely underpinned by better sales of goods in the building materials & hardware, food, drinks & tobacco, other duty free retailing, motorcars & other transport equipment, household goods & appliances, restaurants, and pharmaceutical &

chemicals categories.

The slowdown in retail sales this year could be a result of a combination of factors, including the introduction of import excise duties on consumer durables in the 2006 National Budget, continuing high oil prices and monetary policy tightening by the Reserve Bank of Fiji beginning late last year.

## Production

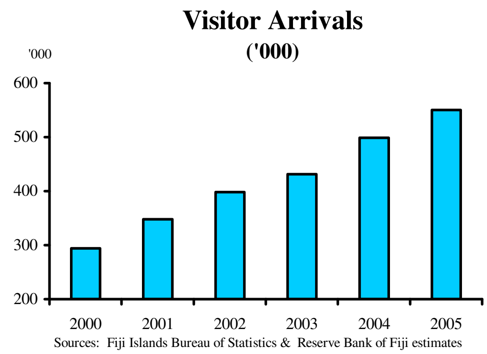
On a sectoral basis, overall economic performance during the review period was generally positive.

The tourism industry continued its robust performance as latest official statistics indicate a new record for visitor arrivals in 2005. Investment levels also showed a gradual pick up, supported by buoyant activity in the building and construction sector. In addition, output in the copra, fishing, timber and electricity industries rose, on an annual basis, during the review quarter.

In contrast, production in the mining & quarrying and clothing and footwear sectors remained weak.

The **tourism** industry performed exceptionally well, in terms of visitor arrivals, for 2005. According to provisional data from the Fiji Islands Bureau of Statistics (FIBOS), visitor arrivals in 2005 totalled almost 550,000, representing an annual increase of 10 percent (Graph 15). The Fiji Islands Visitors Bureau (FIVB) expects visitor arrivals of around 576,000 this year, an increase of around 5 percent over last year's level. Visitor arrivals in 2007 and 2008 are anticipated to be approximately 610,000 and 658,000, respectively.

Graph 15




In terms of industry developments, this year is especially promising for the tourism industry in that room inventory has significantly increased as a result of the Sofitel Fiji Resort & Spa, Marriot Fiji Resort & Spa and Navutu Stars Hotel opening for business. The Naviti Resort also recently completed its $15 million renovation.

According to the FIVB, these new resorts/hotels would add about 1,500 new rooms to inventory. Moreover, construction work at other resorts including the Marriot Fiji Resort & Spa in Momi, the Intercontinental Fiji Resort in Natadola and the Hilton Fiji Beach Resort and Spa, and renovations to existing hotels, would increase room inventory further.

In addition, Air Pacific Limited recently announced its intention to increase inbound flights from Christchurch, Auckland, Brisbane, Los Angeles and also commence regular flights from Kiribati. The company has acquired an additional aircraft to ensure that Fiji has adequate seat capacity to meet the projected growth in visitor arrivals. Air Pacific also has plans to commence domestic flights by mid-2006, particularly to areas not frequented by tourists due to transportation problems.

Production in the **clothing and footwear** industry was subdued in the year to February. Total garment exports in the first two months (on an accrual basis) totalled around $16.9 million, denoting a strong decline of 48 percent over the 2005 level.

The local garment manufacturers are still awaiting the decision of the Australian Government on the proposed reduction of the rules of origin criteria under SPARTECA from the current 35 percent to 15 percent. This reduction of the local area content criteria to 15 percent is expected to provide some relief to the ailing industry.

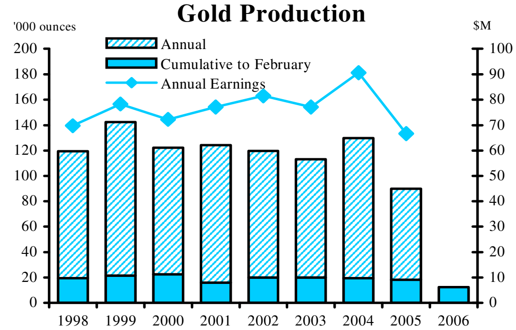
In February, a trade mission to New Zealand was launched to promote Fiji's garment industry to wholesalers and fashion designers particularly in Auckland, Wellington and Christchurch. The mission was led by the Fiji Islands Trade and Investment Bureau and included five major garment manufacturers from Fiji. Early indications from the mission are that New Zealand manufacturers have expressed interest in outsourcing part of their production to Fiji, which is capable of handling smaller orders with a faster turnaround time, compared with countries like China.

Output in the **mining and quarrying** sector remained weak during the review period. Cumulative to February 2006, total gold production amounted to almost 12,400 ounces, around 32 percent lower than the corresponding period in 2005 (Graph 16).

According to Emperor Gold Mining Company Limited (EGM), the decline in production is a result of lower quality of ore extracted at the mines coupled with industrial problems.

Graph 16

**Gold Production**



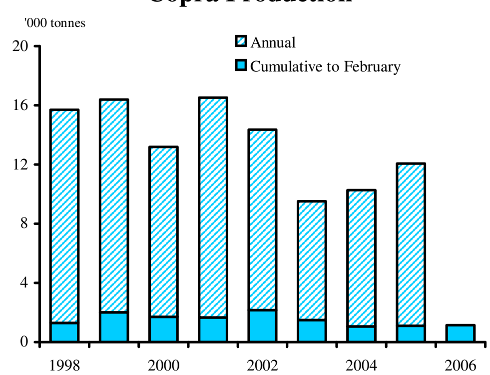

Source: Emperor Gold Mining Company Limited

In line with weak production, earnings from gold exports were also lower by 8 percent on an annual basis during the review period.

The **copra** industry recorded a favourable performance in the year to February. During the first two months, copra production amounted to around 1,100 tonnes (Graph 17), representing an increase of around 4 percent on an annual basis.

Graph 17

**Copra Production**




Source: Coconut Industry Development Authority

The minimum mill gate price of copra

remained unchanged at $500 per tonne. As at February, Government's subsidy towards the mill gate price was $101.02 per tonne.

**Electricity** production also held up well during the review period. Cumulative to February, total electricity generated equalled 127 million kilowatt hours (kwh), an increase of around 7 percent over the corresponding period last year.

The Fiji Electricity Authority, as part of continued investment in electricity infrastructure, recently commissioned $26 million worth of generators. This investment is expected to increase power generation capacity on Viti Levu. The Authority highlighted that while other renewable resources were being developed, the above investment was necessary for the reliability of the nation's power system.

Output in the **fishing** industry improved marginally, on an annual basis, in 2005. Annual trade statistics suggest that total fish export earnings totalled $82.9 million, a 1.8 percent rise over 2004.

In addition, annual **timber** export receipts for 2005 totalled $45.1 million, 7.2 percent higher than in 2004.

In terms of development in the mahogany industry, the Fiji Hardwood Corporation Limited is in the process of securing funding to finance a necessary upgrade to the company's sawmill and to improve sawn timber production. The company is optimistic in successfully implementing downstream value adding approaches to its processing and manufacturing facilities, once funding is secured.

Government also recently endorsed the signing of a Memorandum of Understanding between the Ministry of Fisheries and Forests and Tropik Woods Limited on the construction of a sawmill and chipmill at Wairiki, Bua. This development would complement the port construction in Wairiki, Bua that is currently underway, and reflects Government's effort to promote economic development in the North.

Activities in the **building and construction** sector are estimated to have reached a peak in 2005. Latest data from the FIBOS revealed that the total value of work put-in-place last year totalled around $271 million. This represents a significant increase of around 70 percent over 2004 levels. By categories, the total value of work put-in-place by the private and public sectors rose by 100 percent and 11 percent, respectively.

After recording strong growth last year, the building and construction sector is anticipated to grow at a slower pace of around 2 percent this year. This growth is expected to be largely underpinned by private sector construction activities. Apart from the major ongoing tourism projects, work is still in progress at the Great Council of Chiefs Complex, the Kadavu Provincial House, Mid City Plaza, FIRCA Head Office development, Maritime & Ports Authority of Fiji, Airports Fiji Limited and the Rewa Bridge.

In line with the robust performance of the building and construction sector, partial indicators also suggest a steady growth in **investment**. Cumulative to February 2006, imports of investment type goods rose by 22 percent on an annual basis. Lending to private individuals for housing purposes and to the construction sector also continued to increase.

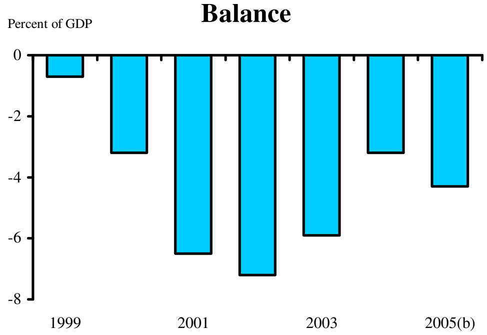
## Public Finance

Government's fiscal position slightly deteriorated in 2005, compared to the fiscal outcome in 2004. The underlying fiscal deficit for 2005 is currently estimated at $168.2 million or 3.6 percent of GDP, as opposed to the underlying deficit of $146.6 million (3.3 percent of GDP) recorded for 2004 (Graph 18). This compares favourably with a deficit of $203.5 million (or 4.4 percent of GDP) earlier estimated for 2005.

Underpinning the 2005 fiscal outturn was a 4.8 percent increase in expenditures, which more than offset a 3.4 percent increase in revenue collections. Capital expenditure declined by 2.6 percent, on an annual basis, last year. Compared with the 2005 budgeted levels, revenue collections rose marginally, while expenditures declined by 2.7 percent, on an annual basis.

Graph 18

**Government Fiscal Underlying Balance**




Source: Ministry of Finance

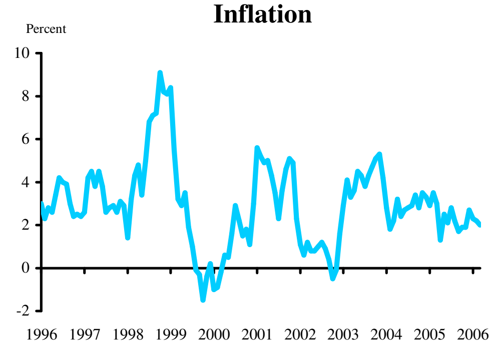
For this year, Government's underlying deficit is projected at around $232.0 million, equivalent to 4.7 percent of GDP.

## Inflation

Inflation stood at 2.0 percent in March, compared with 2.7 percent recorded in December (Graph 19). Consumer prices fell by around 0.6 percent on a quarterly basis. This was a result of lower costs of heating & lighting, transport and food items. Lower prices of heating & lighting and transport were due to the reduction in domestic fuel prices in early March. Conversely, during the quarter, higher prices were recorded in housing, services, clothing & footwear, durable household goods, alcoholic drinks & tobacco and miscellaneous items. The upward movement in prices of these items was primarily owing to the changes in import and excise duties announced in the 2006 Budget announcement.

Graph 19

**Inflation**




Source: Fiji Islands Bureau of Statistics

The underlying measure of inflation, the trimmed mean, was 1.1 percent in March, down from 1.2 percent recorded in December.

Looking ahead, inflationary pressures are expected to emanate from external factors, namely, higher energy prices and a relatively stronger US dollar. However, lower domestic inflation is likely to cushion the impact to some extent. Thus, the 2006 year-end inflation forecast is projected at 3.5 percent.

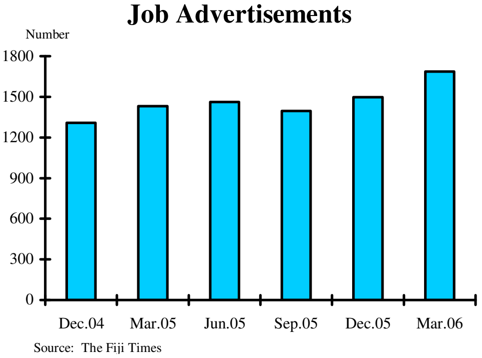
## Labour Market

Labour market conditions improved over the year as suggested by partial indicators. In the March quarter, around 4,200 individuals were registered with the Fiji Islands Revenue & Customs Authority (FIRCA), an increase of around 9 percent over the corresponding period last year. The community, social & personal services sector recorded the largest number of new taxpayers followed by the finance, insurance, real estate & business services; manufacturing; wholesale, retail trade, restaurants & hotel; transport, storage & communications and construction sectors.

Moreover, recruitment intentions are also on the rise. The Reserve Bank's March Survey of Job Advertisements reported an annual increase of 18 percent (Graph 20). The finance, insurance, real estate & business services sector recorded the most number of advertised positions. This was followed by the community, social & personal services; wholesale & restaurants & hotels; transport and construction sectors.

Graph 20

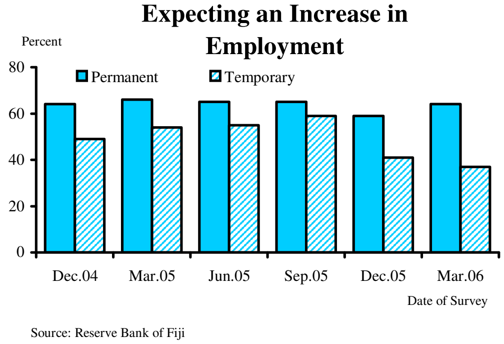
**Job Advertisements**




Similarly, the recent Reserve Bank's Fiji Employers Federation (FEF) Expectations survey revealed that a net of around 64 percent and 37 percent of respondents expect an increase in permanent and temporary employment, respectively. This compares favourably against the last survey where 59 percent and 41 percent of respondents, anticipated increases in the permanent and temporary categories, respectively (Graph 21).

Graph 21

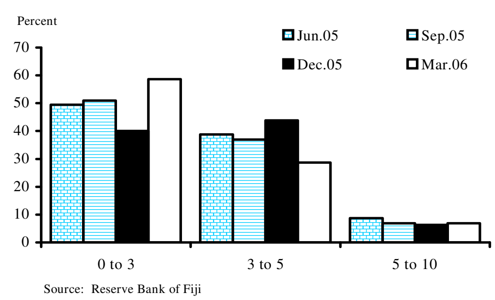
**Net Proportion of Respondents Expecting an Increase in Employment**




Wages growth is expected to be modest in the medium term (Graph 22). The FEF Expectations survey revealed that a net of 89 percent of respondents expect wage levels to rise in the coming months.

Graph 22

**Proportion of Respondents Expecting Wages to Increase**




Around 85 percent of the respondents

anticipate wages to rise between 0-5 percent, while the remaining 4 percent expect a rise between the 5-10 percent range.

## The External Sector

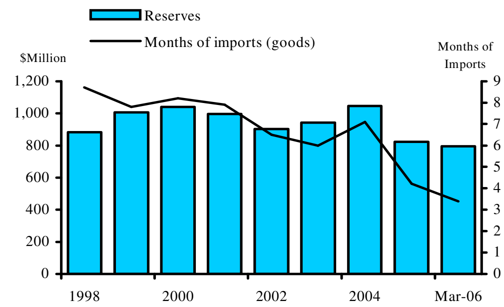
On the external front, latest accrual trade data showed that cumulative to February, merchandise exports fell by around 27 percent, compared with a growth of around 12 percent in the same period last year. The decline in receipts was largely attributed to lower earnings from garments, timber, sugar, textiles, yarn & fabrics, footwear & headgear, fish, other exports, mineral water and fruits & vegetables and re-exports, which more than offset higher earnings from gold and yaqona.

In the same period, merchandise imports rose by around 7 percent, compared with a growth of around 5 percent in the corresponding period in 2005. The increase in import payments was due to higher payments for intermediate goods (4.3 percent) and investment goods (3.4 percent), which more than offset lower payments for consumption goods (-1.1 percent). The rise in intermediate goods was largely due to higher outlays for mineral fuels and crude materials, which more than offset the lower payments for oils & fats, while the growth in import payments of investment goods was due to increased machinery & transport equipment and chemicals outlays. The fall in import payments for consumption goods was largely attributed to declines in miscellaneous manufactured articles, manufactured goods and beverage & tobacco expenditures which more than offset higher outlays for food, and miscellaneous transactions.

Foreign reserves at the end of March were around $794 million, sufficient to cover 3.4 months of import payments of goods (Graph 23).

Graph 23

**Gross Foreign Reserves**



Source: Reserve Bank of Fiji

## Domestic Financial Conditions

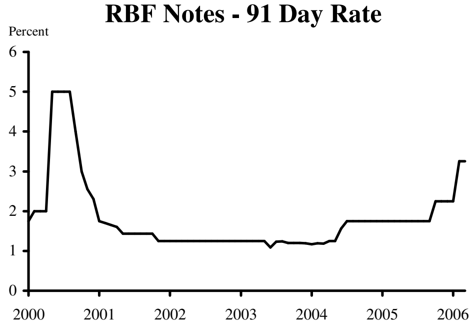
### Money Markets

Activity in the inter-bank market slowed considerably as demand for funds in the March quarter fell to $15.8 million from $373.3 million in the December quarter. The marked slowdown in inter-bank trading largely reflected sufficient liquidity held by commercial banks arising mainly from a fall in RBF Notes outstanding. The weighted average inter-bank rate at the end of the review quarter was 4.24 percent.

The Reserve Bank's monetary policy continued to be on a tightening bias during the review period. On 23 February 2006, the Bank raised its policy indicator rate by 100 basis points from 2.25 percent to 3.25 percent (Graph 24). The interest rate hike was taken in order to curb domestic demand pressures arising from strong credit growth and rising imports.

Graph 24

**RBF Notes - 91 Day Rate**




Source: Reserve Bank of Fiji

As part of open market operations, around $15.5 million worth of RBF Notes were allotted during the January to March period, compared with $86.0 million issued in the preceding quarter. The yield on RBF Notes during the review period averaged 2.41 percent.

Issues of Treasury Bills dominated the money market during the March quarter. The Government raised $131.2 million through short-term papers to rollover maturing debt as well as to finance the higher revised budget deficit. Yields on all maturities continued to rise steeply during the review period.

## Capital Markets

Government also issued bonds worth $45.8 million during the January to March period compared with $105.6 million issued in the December quarter of 2005. The maturities offered were from 3 to 15 years, with weighted average yields ranging from 4.12 percent to 7.68 percent.

The Fiji Development Bank is the only statutory corporation that raised bonds, to the value of $11 million during the quarter.

In the secondary market for bonds, there were 6 trades during the March quarter, totalling $0.7 million. This compares with the 56 trades amounting to $35.5 million recorded in the previous quarter.

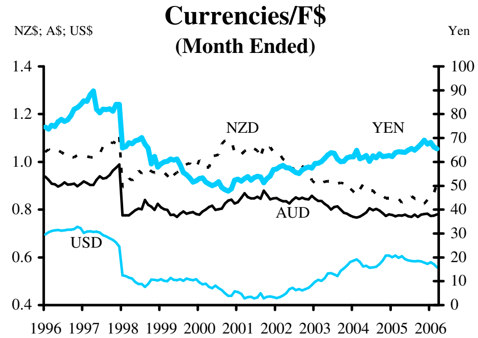
## Foreign Exchange Markets

Bilateral movements in exchange rates during the March quarter show that the Fiji dollar strengthened against the New Zealand dollar (8.2%), while the domestic currency weakened against the Euro (5.2%), Japanese Yen (3.1%), the US (2.7%) and the Australian (0.3%) dollars compared with the end of the December quarter (Graph 25).

Graph 25

**Exchange Rates - Selected Currencies/F$**

**(Month Ended)**

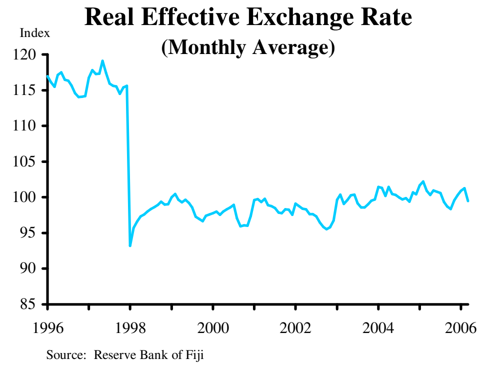



Source: Reserve Bank of Fiji

The Nominal Effective Exchange Rate (NEER) Index, which reflects aggregate exchange rate movements between the Fiji dollar and currencies of Fiji's major trading partner countries, fell marginally over the quarter, indicating a depreciation of the Fiji dollar against the basket of currencies.

During the same period, the Real Effective Exchange Rate (REER) Index of the Fiji dollar, which adjusts the NEER for inflation differentials across Fiji's major trading partners also fell, implying an improvement in our competitiveness externally (Graph 26).

Graph 26

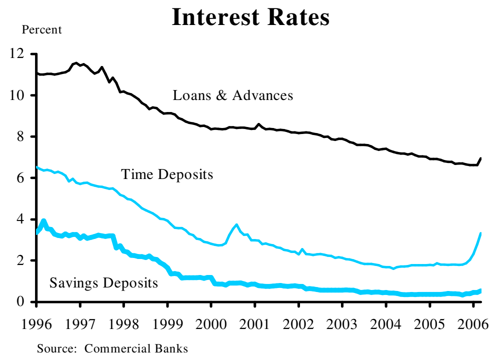



## Financial Intermediaries

Latest movements in commercial bank interest rates generally reveal an upward trend. As at March 2006, the savings and time deposit rates rose by 14 basis points and 140 basis points to 0.54 percent and 3.33 percent respectively, compared with the previous quarter (Graph 27).

However, the weighted average lending rate on commercial bank outstanding loans also rose, by 31 basis points to 6.94 percent during the same period.

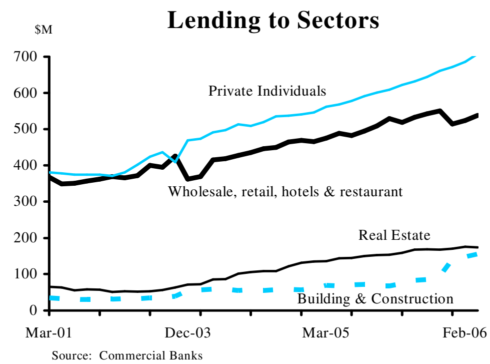
Graph 27




In addition, compared with the end of the previous quarter, the weighted average lending rate extended by Licensed Credit Institutions (LCIs)[5] declined by 44 basis points to 10.84 percent, while the interest rate on outstanding time deposits increased from 4.06 percent to 4.22 percent at the end of March.

Monetary aggregates remained buoyant during the review period. In the year to March, the value of loans outstanding in the banking system rose by 25.9 percent. This was spurred largely by higher lending to private individuals, building & construction, wholesale, retail, hotels & restaurants and the real estate sectors (Graph 28).

Graph 28




In contrast, commercial bank lending to the public enterprise, and central and local government sectors declined during the same period.

Total outstanding loans and advances by LCIs, rose by 23.1 percent in the year to March, underpinned mainly by higher lending to private individuals and the real estate sector.

5 LCI's include Merchant Finance Investment Company Limited, Credit Corporation (Fiji) Limited and Home Finance Company Limited.

## Banking Industry Quarterly Condition Report – December 2005

### Overview - Commercial Banks

The overall condition of the banking industry over the December quarter remained satisfactory.

All banks' **total assets** expanded by 5.4 percent over the quarter to $2.9 billion, driven by continued growth in 3 main lending sectors – private individuals, wholesale/retail and building and construction. On the **liabilities** side, deposits grew by 5.0 percent to $2.6 billion, mainly from private sector business entities, central Government and public enterprises.

**Capital adequacy** ratios were maintained above the minimum requirement of 8.0 percent, at an average of 12.0 percent.

**Asset Quality** remained satisfactory as impaired assets declined and past due loans over 3 months decreased. Total provisions to total loans stood at 1.6 percent.

**Management** performance is rated satisfactory in view of the satisfactory or strong performance in most other CAMEL[6] components. Minor deficiencies are deemed correctible during the normal course of operations.

**Earnings** for all banks were satisfactory with a 4.4 percent growth in pre-tax profits to $28.4 million, which continues to surpass prior quarter profits. Interest spreads increased slightly, led by increased returns on earning assets, and the efficiency ratio improved to 47.5 percent.

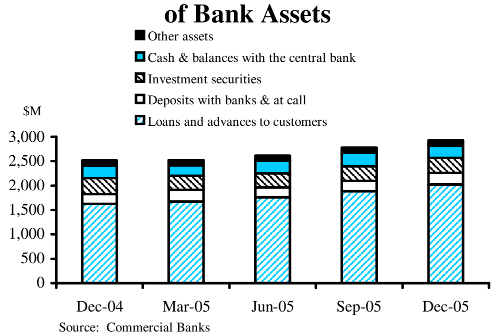
**Liquidity** is rated marginal as short term liabilities are increasing at a faster rate than liquid assets.

### Balance Sheet

Combined assets of banks grew over the quarter by 5.4 percent to $2.9 billion and up by 16.3 percent over the year (Graph 29). This expansion was mainly the result of an increase in loans and advances.

Graph 29

**Structural Change and Growth of Bank Assets**

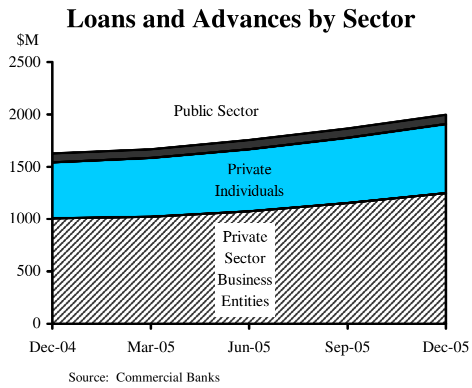



Loans and advances expanded over the quarter by 7.3 percent or $141.0 million to $2.1 billion. Sectors contributing to this growth were private individuals ($39.1 million), wholesale, retail, hotels and restaurants ($32.7 million) and building and construction ($19.1 million). Most other sectors also showed growth. Lending to private individuals was mainly for housing (Graph 30).

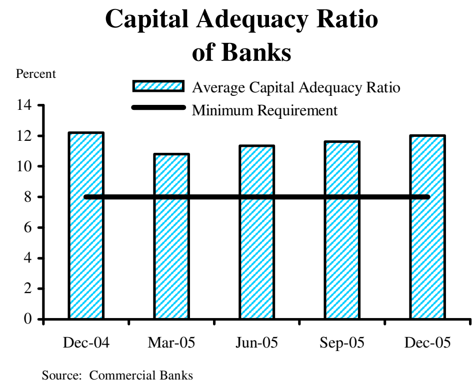
Over the year, the increases were comparable. The annual loan growth was 23.9 percent.

[6] CAMEL refers to Capital Adequacy, Asset Quality, Management, Earnings and Liquidity.

Graph 30




Graph 31




On the liabilities side, deposits increased by 5.0 percent or $123.0 million to $2.6 billion. The increase was from private sector business entities ($53.6 million) and central Government ($50.0 million) who held mainly demand deposits and public enterprises ($26.4 million) who held mainly time deposits. Private individuals increased by $5.4 million generally for savings deposits.

## Capital Adequacy

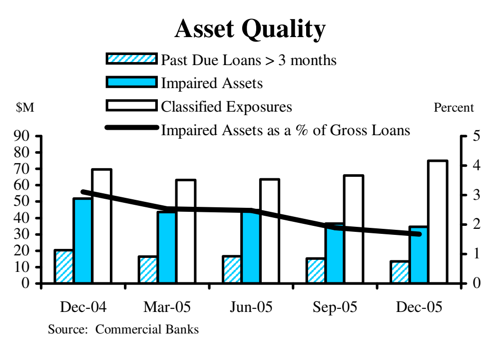
Banks continued to maintain strong capital levels with a combined *capital adequacy* ratio of 12.0 percent (Graph 31). The ratio increased by 60 basis points over the quarter. Total risk assets increased by 5.6 percent and capital rose by 9.3 percent.

A year on year comparison however, showed that the ratio declined by 21 basis points - total risk assets increased by 19.2 percent and capital by 17.2 percent.

## Asset Quality

The asset quality of banks remained satisfactory during the quarter. While there was an increase in the level of classified exposures, the level of impaired assets and past due loans (above 3 months), registered declines (Graph 32).

Graph 32



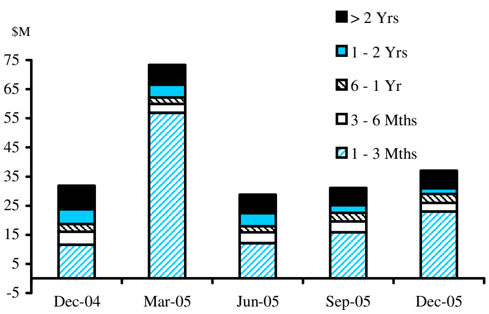

Total impaired assets at the end of December 2005 were $34.6 million and classified exposures were $74.9 million and represented 1.7 percent and 3.6 percent of total loans and advances, respectively.

Over the quarter, impaired assets declined by 5.2 percent or $1.9 million and classified exposures grew by 13.7 percent or $9.0 million. The increase in classified exposures was the result of an increase in substandard accounts, by $11.7 million.

Past due loans increased by $5.3 million to $36.3 million (Graph 33). Past due loans over 3 months decreased over the quarter by $1.7 million. Past due loans as a percent of total loans and advances, was 1.8 percent.

Graph 33

**Past Due Status**




Source: Commercial Banks

Problem loans by sector are concentrated within private individuals (27.0 percent), wholesale/retail (24.1 percent) mining and quarrying (22.7 percent) and manufacturing (14.3 percent). Housing for private individuals makes up 20.8 percent of total problem loans.

At the end of 2005, banks held $33.9 million worth of provisioning, or 1.6 percent of total loans and advances. This is a decline of $5.0 million and also a decline in coverage of 38 basis points.

Both general and specific provisions decreased, by $3.0 million (to $20.3 million) and $2.0 million (to $13.6 million), respectively.

## Earnings

The combined banks' earnings were satisfactory during the quarter with a 4.4 percent growth in before tax profits to $28.4 million. This profit level continues to surpass the prior year's profits.

Growth in profits over the quarter was due to an increase in interest income. Interest income growth was led by growth in interest from "other" sources, business loans, deposits with banks and housing loans.

Annualised returns on assets remained at 4.0 percent.

## Aggregate Banks' Income Statement

| | Dec-04 | Sep-05 (r) | Dec-05 | % Change | |
|---|---|---|---|---|---|
| | | $M | | Over Qtr | Over Year |
| Interest Income | 33.8 | 36.5 | 40.3 | 10.4 | 19.2 |
| Interest Expense | 4.6 | 5.5 | 5.8 | 5.5 | 26.1 |
| **Net interest income** | 29.2 | 31.0 | 34.5 | 11.3 | 18.2 |
| *Add:* **Non interest income** | 20.6 | 27.1 | 21.8 | (19.6) | 5.8 |
| Income from overseas exchange transactions | 8.2 | 9.5 | 8.8 | (7.4) | 7.3 |
| Commission | 2.7 | 2.6 | 2.5 | (3.8) | (7.4) |
| Fee Charges | 9.2 | 11.7 | 10.5 | (10.3) | 14.1 |
| Other income | 0.5 | 3.2 | 0.0 | (99.8) | (99.1) |
| *Equals* | | | | | |
| **Total operating income** | 49.8 | 58.1 | 56.3 | (3.1) | 13.1 |
| *Less:* Operating expenses | 22.7 | 29.0 | 26.7 | (7.9) | 17.6 |
| *Less:* Bad Debts & provisions | 2.5 | 1.9 | 1.1 | (42.1) | (56.0) |
| *Equals:* | | | | | |
| **Profit before tax** | 24.5 | 27.2 | 28.4 | 4.4 | 15.9 |
| *Less:* Tax | 7.1 | 8.4 | 8.1 | (3.6) | 14.1 |
| *Add Extra ordinary items* | 1.8 | - | - | - | (100.0) |
| *Equals:* | | | | | |
| **Net profit after tax** | 19.2 | 18.7 | 20.4 | 9.1 | 6.3 |

Source: Commercial Banks

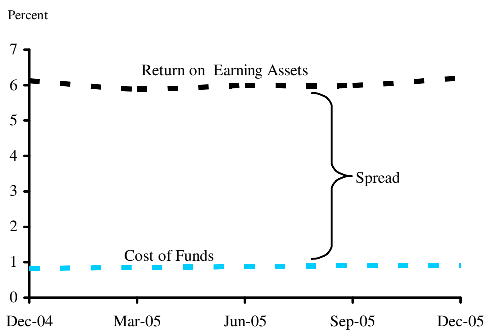
Note: (r) : revised.

## Interest Margin and Spread

The combined banks' interest spread increased over the quarter to 5.3 percent. Returns on earning assets grew slightly over the quarter, by 20 basis points (Graph 34). The cost of funds also increased, by a basis point.

Graph 34

**Margins and Spreads**




Source: Commercial Banks

## Efficiency

The efficiency ratio (operating costs to operating income) of banks improved by 2.4 percentage points to 47.5 percent, after recording an increase last quarter. Banks also recorded an improvement during the same period last year.

## Liquidity and Funding

For the quarter ended 31 December 2005, the combined banks' liquidity position was considered marginal.

Of the total loan portfolio, short term loans and advances represent 32.2 percent. This will add to liquid asset levels in the short term.

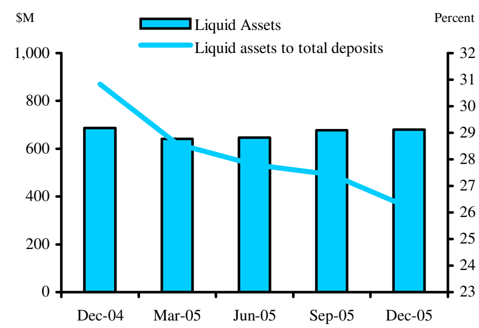
Liquid asset levels increased over the quarter by $1.7 million to $679.5 million. However, its coverage over short term liabilities[7] dropped.

The ratio of liquid assets to short term liabilities was 39.8 percent for the quarter, decreasing by 2.5 percentage points from the previous quarter. Other liquidity ratios also show this decline (Graph 35).

Contributing to the increase in short term liabilities is the build up of large deposits, which have previously shown large variances. Banks need to build up their stock of less volatile funding. The 15 largest depositors of all banks represented 21.2 percent of total deposits at the end of the quarter.

Graph 35

**Liquid Assets to Total Deposits**




Source: Commercial Banks

## Electronic Banking

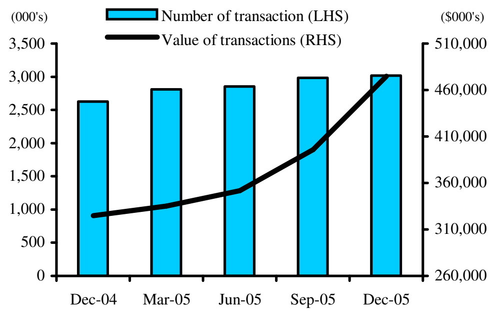
Bank customers kept up their use of electronic banking facilities during the December quarter (Graph 36).

ATM and EFTPOS machines recorded 3.0 million transactions during the quarter, a slight improvement from the previous quarter. The value of this quarter's transactions rose by 19.9 percent to $474.7 million.

[7] Term deposits maturing in less than 12 months plus demand deposits.

Graph 36

**ATM & EFTPOS Transactions**



Source: Commercial Banks

## Overview - Credit Institutions

Overall, credit institutions continued their satisfactory performance during the December quarter. Aggregated assets increased by 4.2 percent. This increase was due mainly to growth in loans.

**Capital adequacy** remained strong. Credit institutions' capital adequacy ratio was 23.7 percent as at quarter end, compared to the minimum requirement of 10.0 percent.

Credit institutions' **asset quality** continues to be rated marginal. Impaired assets declined to $14.4 million and represented 5.1 percent of total loans. Adequate provisions were maintained.

**Earnings** were satisfactory. Net profit after tax increased by 61.5 percent over the quarter, mainly due to the reduction in interest expense and bad debts and provisions. When compared to the same period last year, after tax profits increased by 23.5 percent.

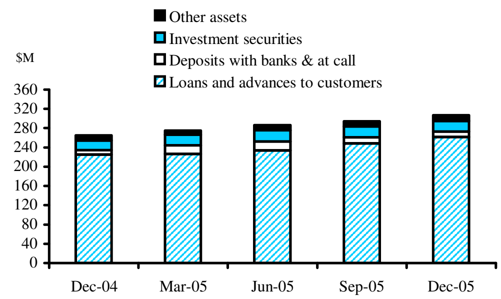
**Liquidity** is considered satisfactory with the stable sources of funds and standby funding arrangements that credit institutions have in place. Liquid funds held by credit institutions, however, declined over the quarter.

## Balance Sheet

The combined assets of credit institutions grew over the quarter by 4.2 percent to $306.5 million, up by 15.8 percent over the year (Graph 37).

Graph 37

**Structural Change and Growth in Credit Institutions' Assets**



Source: Credit Institutions

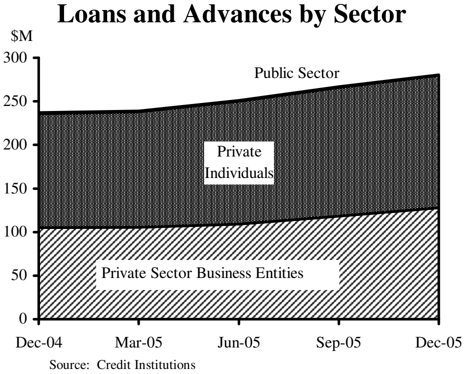
This expansion was mainly the result of an increase in loans and advances.

Loans and advances expanded over the quarter by 5.4 percent ($13.6 million) to $261.8 million, as lending for all institutions increased. New loans approved increased over the quarter, by 8.9 percent (10.5 percent last quarter) to $15.6 million.

New loans issued during the quarter were mainly to the following five sectors: private individuals, transport and storage, real estate, wholesale, retail, hotels and restaurants and building and construction (Graph 38).

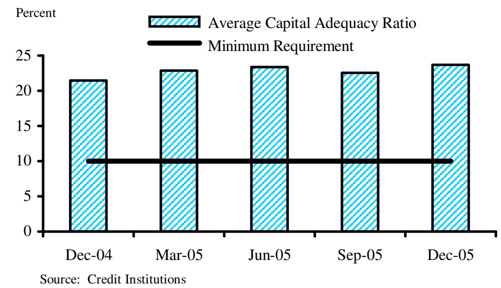
Graph 38

**Loans and Advances by Sector**




Graph 39

**Capital Adequacy Ratio of Credit Institutions**




Funding this growth on the liabilities side was an increase in borrowings from parent companies, up by 9.5 percent to $93.9 million.

Term deposits increased over the quarter by 0.8 percent to $151.7 million and grew by 16.2 percent from December 2004. This is due to a continuous increase in deposits.

## Capital Adequacy

The minimum capital adequacy requirement for credit institutions is 10.0 percent of their risk-weighted assets. The current ratio is 23.7 percent (Graph 39). While rated strong, this was a 116 basis points increase over the quarter. This increase was caused by strong earnings over the quarter.

Total risk weighted assets increased by 2.3 percent and capital increased by 7.6 percent. A year-on-year comparison showed that the ratio increased by 224 basis points – total risk weighted assets increased by 19.5 percent and capital by 32.0 percent.

Credit institutions are expected to remain well capitalised.

## Asset Quality

Asset quality recorded improvements over the quarter with falling past due levels and classified exposures (Graph 40).

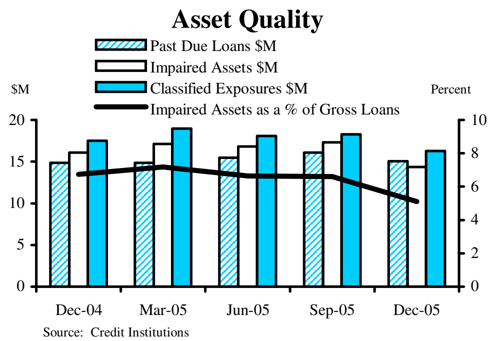
Classified exposures decreased by 10.9 percent to $16.3 million, following decreases in the substandard and doubtful categories. As at quarter end, substandard and doubtful accounts declined to $3.0 million and $2.0 million, respectively. Loss accounts increased slightly to $11.2 million.

Over the quarter, impaired assets declined to $14.4 million from $17.3 million in the September quarter. Impaired assets and classified exposures registered declines over the quarter.

With the fall in classified exposures for accounts classified substandard and doubtful, specific provisions decreased by 11.0 percent to $5.8 million. General provisions continued to steadily increase for all credit institutions, with a 4.6 percent increase to $8.8 million. General coverage has been consistent, remaining within 3 percent.

In spite of the positive changes, credit institutions' asset quality has been rated marginal. The rating has been influenced by several large and long outstanding non-performing loans.

Graph 40




## Earnings

Profitability of credit institutions was $4.2 million compared to $2.6 million in the preceding quarter and $3.4 million in the same period last year.

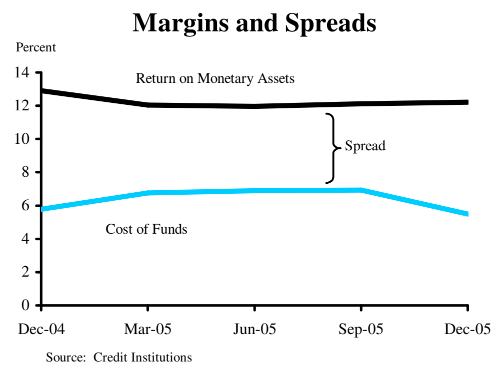
### Aggregate Credit Institutions' Income Statement

| | Dec-04 | Sep -05 | Dec-05 | % Change Over Qtr | % Change Over Dec-04 |
|---|---|---|---|---|---|
| | | $M | | | |
| Interest Income | 8.0 | 8.5 | 8.8 | 3.5 | 10.0 |
| Interest Expense | 1.9 | 2.5 | 2.1 | (16.0) | 10.5 |
| **Net interest income** | 6.1 | 6.0 | 6.7 | 11.7 | 9.8 |
| *Add:* **Non interest income** | 0.6 | 0.9 | 0.9 | - | 50.0 |
| Commission | 0.1 | 0.1 | 0.1 | - | - |
| Fee Charges | 0.8 | 0.6 | 0.7 | - | (12.5) |
| Other income | -0.2 | 0.2 | 0.2 | - | (200.0) |
| *Equals* | | | | | |
| **Total operating income** | 6.7 | 6.8 | 7.7 | 13.2 | 14.9 |
| *Less:* Operating expenses | 2.1 | 3.0 | 2.5 | (16.7) | 19.1 |
| *Less:* Bad Debts & provisions | 0.4 | 0.6 | 0.2 | (66.7) | (50.0) |
| *Equals:* | | | | | |
| **Profit before tax** | 4.2 | 3.3 | 5.0 | 51.5 | 19.1 |
| *Less:* Tax | 0.9 | 0.7 | 0.8 | 14.3 | (11.1) |
| *Add Extra ordinary items* | - | - | - | - | - |
| *Equals:* | | | | | |
| **Net profit after tax** | 3.4 | 2.6 | 4.2 | 61.5 | 23.5 |

Source: Credit Institutions

Interest income recorded an increase over the quarter of 3.5 percent while interest expenses recorded a 20.0 percent decrease (Graph 41). The increase in interest income is attributed to higher lending activity, while the decrease in interest expense can be attributed to the decline in interest paid on deposits.

Graph 41




Operating expenses show a 16.7 percent decline over the quarter, mainly caused by the reduction in other expenses by 81.4 percent.

Return-on-equity showed a 310 basis point increase to 9.9 percent while return-on-assets rose 54 basis points to 1.7 percent.

The earnings indicators have improved over the quarter, indicative of a *satisfactory* earnings position for credit institutions.

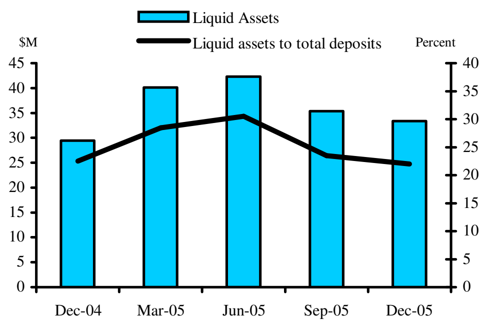
## Liquidity

Credit institutions' liquid funds decreased by 5.7 percent over the quarter to $33.4 million (Graph 42). The decline is attributed to increased loan funding needs (5.4 percent) which were not fully sourced from term deposits growth (0.8 percent) thus the decline in liquid assets. As a percentage of funding, liquid assets decreased by 1.5 percentage points to 22.0 percent.

The total 15 largest depositors for credit institutions constituted $62.0 million representing 184.5 percent of liquid assets.

Graph 42

**Liquid Assets to Total Deposits**




Source: Credit Institutions

The maturity profile of credit institutions' loans and deposits reveal a negative mismatch amount of $21.9 million occurring in the short term.

In this regard, the level of liquid assets available to cover volatile liabilities and mismatches in crisis situations is considered marginal. This liquidity risk is, however, mitigated by stable funding sources for existing borrowings, and stand-by arrangements with banks and parent companies.

## Insurance Industry Quarterly Condition Report – September 2005

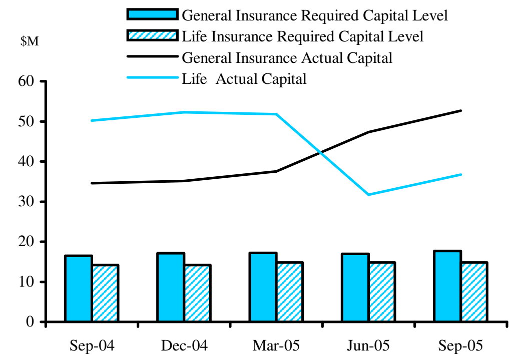
### Overview of Insurance Industry Performance

The performance of the insurance industry based on "**CARAMELS**[8]", the new reporting insurance supervision methodology, continued to improve in the third quarter of 2005. This was evident in the growth of the insurance industry solvency, assets, liabilities and profitability indicators.

For quarter ended September 2005, the **capital** base for the insurance industry was assessed as satisfactory. Total capital available for the industry was $89.4 million, well above the required capital level of $32.6 million (Graph 43).

Graph 43

**Insurance Industry Actual Capital & Required Capital Levels**




Source: Insurance Companies

The main contribution to this growth came from general insurers' admissible assets which grew by 35.2 percent. The growth in assets was driven mainly by increased investments.

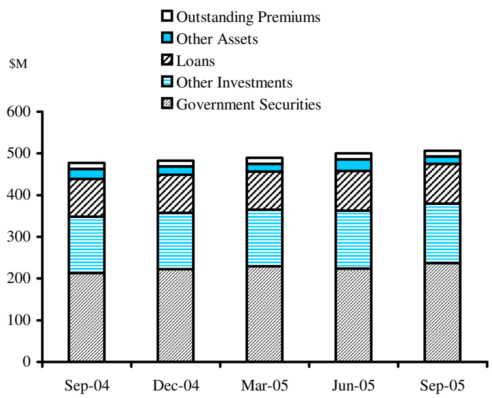
Combined insurers' **assets** rose by 6.0 percent to $700.3 million. The growth was driven by both the life and general sectors with life insurers accounting for 72.0 percent of total industry assets.

[8] **"CARAMELS"** stands for: Capital, Assets, Reinsurance, Actuarial Liabilities, Management, Earnings, Liquidity and Subsidiaries.

Total life insurance assets grew by 6.0 percent in 2005 to reach $506.5 million (2004: $477.0 million). The asset distribution pattern remained largely unchanged over the year (Graph 44).

Graph 44

**Distribution of Assets for Life Insurance Companies**




Source: Insurance Companies

Investment in government securities continued to dominate the asset base of life insurers at $237.0 million or 46.8 percent of total assets, an increase over the year by 11.0 percent. This is followed by policyholder loans of $93.2 million and property at $61.4 million, representing 18.4 percent and 12.1 percent of total assets respectively. Of total loans, $0.1 million was unsecured.

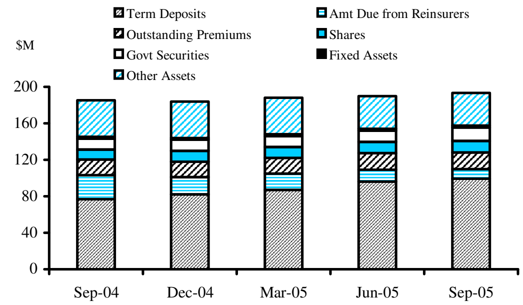
Total assets of the general insurers were at $193.8 million in September, up by 5.0 percent over a year ago and 2.0 percent from the previous quarter.

The majority of the assets continued to be tied up in investments, comprising of 69.7 percent of the general industry assets ($135.1 million). Bank deposits accounted for the largest percentage of investments at $99.3 million (73.5 percent of total investments) compared to $77.4 million in 2004.

The other major assets include outstanding premiums, amounts due from reinsurers, government securities, shares in related persons and cash on hand (Graph 45).

Graph 45

**Distribution of Assets for General Insurance Companies**




Source: Insurance Companies

All insurers satisfactorily complied with the **reinsurance** requirements indicating that they can safely call on their reinsurers should they unexpectedly face very large claims.

The insurance industry recorded a growth of 4.0 percent in combined life and general insurer **liabilities** (excluding shareholders funds) to reach $582.8 million. This was underpinned by growth in the life insurers' balance of revenue account which continues to form the bulk of insurance industry liabilities at $434.5 million (96.1 percent of total liabilities).

**Management** is assessed to be satisfactory with adequate processes and practices in place. However, some areas of improvement have been noted and these will be reviewed during future on-site visits.

There was a marginal reduction in combined industry **earnings** by 2.0 percent to $44.3 million for the quarter ended September 2005. However, the industry's overall after tax surplus was reported at $9.7 million, a 3.0 percent increase from what was recorded in September 2004. The surpluses were mainly contributed by the general insurers with total revenue increasing as a result of writing more business, coupled with a reduction in expenses and growth in investment income.

The **liquidity** position is considered satisfactory with the bulk of assets concentrated in bank deposits and government securities.

**Subsidiaries** of insurance companies are currently assessed to pose no major risk.

**Insurance Brokers**

Net profit after tax for insurance brokers decreased by 10.0 percent to $1.4 million for the quarter ended 30 September 2005. The reduction was a direct result of the decline in total revenue by 16.0 percent.

For the quarter under review, the Insurance Broking Account balance stood at $3.9 million compared to $4.5 million in the corresponding period of 2004.

The Reserve Bank approved 83 offshore applications with premium remittances of $4.1 million in the September 2005 quarter, compared to 72 applications worth $5.0 million approved in the same quarter in 2004.

## For the Record

# PRINTING OF FIJI'S NEW CURRENCY NOTES

*Statement by Governor, Mr. S Narube, 10 February 2006.*

The Reserve Bank of Fiji today signed an agreement for the printing of a series of new design Fiji banknotes with De La Rue International Limited of United Kingdom. The agreement was signed by the Governor of the Reserve Bank of Fiji, Mr. Savenaca Narube and De La Rue's Regional Manager, Mr. Tim Jones. De La Rue has been printing Fiji's currency banknotes since 1914.

The Governor said that 9 reputable banknote printers were invited to indicate their interest through an Expression of Interest (EOI). The 4 printers that responded to the EOI were invited to tender. They submitted tenders by the close of tender on 30 November, 2005. The 4 companies were Canadian Banknote Company, Canada, De La Rue International Limited, United Kingdom, Giesecke & Devrient GmBH, Germany and Francois-Charles Oberthur, France.

The Governor said that, "The overall quality and presentation of all the tenders received was extremely competitive and comprehensive particularly the inclusion of new banknote security features."

The Governor said that, "He considers this new currency design as an important milestone for the Reserve Bank of Fiji. In this review, we have been able to improve banknote durability and upgraded security and recognition features of the banknotes."

The Governor said, "A $100 note will be introduced for the first time."

The Governor also announced that the new design banknotes will feature images of local people, flora and fauna, culture and tradition, industrial and economic activity and the portrait of Her Majesty Queen Elizabeth II will be retained. He thanked the Design Committee for its work. The Committee was chaired by Mr. Kanti Tappoo, a member of the Reserve Bank Board and the other members were Ms. Sagale Buadromo, Mr. Ikbal Jannif *OF*, Mr. Radike Qereqeretabua *OF*, and Dr. Dick Watling.

The Governor was pleased to announce that the new design banknotes will also include a visually impaired feature which was arrived at through discussions with various interest groups. The banknotes will vary in size lengthwise with the highest denomination $100 being the existing standard note size and will reduce consistently at a standard size towards the smaller denomination.

The new banknotes will be issued in 2007.

## For the Record

## FINANCIAL TRANSACTION REPORTING ACT

*Statement by Governor, Mr. S Narube, 13 February 2006.*

The Reserve Bank of Fiji has been delegated with the responsibility to implement the new Financial Transactions Reporting (FTR) Act following a delegation of powers, functions and duties of the Minister for Justice, provided under the FTR Act, to the Governor of the Reserve Bank of Fiji.

All provisions of the FTR Act – excluding those relating to the imposition of $10,000 threshold reporting for cash, electronic funds transfer and cross-border currency transactions – came into effect on January 2006.

The Act effectively imposes and regulates customer due diligence, suspicious transaction reporting, monitoring of customers' transactions, record keeping and other obligations of financial institutions, which includes commercial banks, foreign exchange dealers, non-bank financial institutions and designated non-financial businesses and professionals such as real estate agents, lawyers and accountants.

The Act establishes a Financial Intelligence Unit (FIU) as Fiji's national and autonomous agency responsible for carrying out wide ranging functions, duties and powers. In line with the delegation of powers, the Director of the FIU will be responsible to the Governor, when performing his duties and functions.

The Governor of the Reserve Bank of Fiji, Mr. Savenaca Narube, said that he was pleased with the decision of the Government to locate the FIU under the Reserve Bank, highlighting that the work of the FIU will complement the functions of the Bank, which is to ensure that the integrity and stability of the financial system is maintained in Fiji. He added that the FIU will develop appropriate regulations and guidelines and will also provide awareness and training on the FTR Act.

For further information on the FTR Act please contact Mr. Razim Buksh of the FIU on telephone 322 3216 or email razim@rbf.gov.fj.

## For the Record

# RESERVE BANK RAISES OFFICIAL INTEREST RATE

*Statement by Governor, Mr. S Narube, 24 February 2006.*

The Reserve Bank of Fiji Board, at its monthly meeting yesterday, decided to raise the official interest rate from 2.25 percent to 3.25 percent.

The decision was made after reviewing economic conditions since the last interest rate hike in October 2005. The Board noted that the current monetary policy stance was still accommodative. Recent economic data suggests that consumer demand continues to increase, supported by strong credit growth.

The rising consumer credit is of some concern. International oil prices remain high.

The Board noted that these factors are adding to our growing imports bill. This trend is not sustainable given the lacklustre performance of our exports industry. A small open economy which is driven by consumption is unsustainable. Therefore, the Board deemed it necessary to take a further measure to reign in the credit expansion for the protection of our overall macroeconomic stability.

In pursuing this policy option, the Board recognises that investment activity has been on the rise with several major investment projects nearing completion and a few more starting up this year. These developments will certainly provide a stronger base for Fiji's economy in the medium term. However, the Board also notes, that it will take some time before these projects will get off the ground and begin to realise gains for the Fiji economy.

The Bank's twin objectives of low inflation and maintaining an adequate level of foreign reserves remain intact. Inflation was 2.3 percent in January and official foreign reserve levels stood at $850.1 million as at 23 February 2006, sufficient to cover 4.0 months of imports of goods. Nevertheless, the Board regards its policy decision as a proactive response to protect these two objectives.

The Reserve Bank will continue to monitor developments in the coming months and align monetary policy accordingly.

## For the Record

# RESERVE BANK IMPLEMENTS FURTHER TIGHTENING MEASURES

*Statement by Governor, Mr. S Narube, 24 March 2006.*

The Reserve Bank of Fiji Board approved at its monthly meeting yesterday to further tighten monetary policy to supplement the increase in interest rates announced in February.

The Governor of the Reserve Bank and Chairman of the Board, Mr. Savenaca Narube, said that, "The Board has taken the following measures to tighten liquidity and to allow a more conducive environment for better flow through of its interest rate increases.

- **Statutory Reserve Deposit (SRD):** Effective from 8 May 2006, the ratio will be increased from 5 percent to 7 percent of all licensed commercial banks' deposits and similar liabilities; and

- **Minimum Lending Rate (MLR):** Effective from 8 May 2006, the margin between the official indicator rate and the MLR will be increased from 50 basis points to 100 basis points. Hence, the current MLR will now rise from 3.75 percent to 4.25 percent."

The Governor stressed that "In taking this decision, the Reserve Bank noted that commercial banks' credit continues to grow at a buoyant rate which is far beyond the rate of economic growth and inflation. Such a rate of credit expansion therefore cannot be supported by the increase in real national incomes and is contributing to excessive rise in indebtedness.

At the same time, this high credit growth directly contributes to higher demand for imports at a time when our exports are not performing. It is therefore necessary for the Bank to tighten liquidity which will assist in the execution of its monetary policy."

The RBF will continue to monitor the situation closely and introduce further measures when necessary.

# ECONOMICS ASSOCIATION OF FIJI PRESENTATION: ASSESSING SUSTAINABILITY OF FIJI'S PUBLIC DEBT

The Economics Association of Fiji held its first Forum on Tuesday, 28 February. The theme for the first meeting of 2006 was 'Assessing the Sustainability of Fiji's Public Debt'. Dr Mahendra Reddy, an Associate Professor at the University of the South Pacific presented a paper on the subject. The session was chaired by Mr Paula Uluinaceva, the CEO of Ministry of Finance and National Planning. A non-technical summary of Dr Reddy's paper is provided below.[1]

## A. Introduction

Governments' role can generally be categorised into the following four categories, (i) provision of public good; (ii) redistribution of income; (iii) provision of social safety nets; and, (iv) the stabilisation of the economy. To undertake these roles, governments need finance. Hence, they table annual budgets outlining their expenditure outlays and revenue levels and sources. When the expenditure demands are equal to the revenue projections, it is said that the budget is balanced and that the government is neutral. That is, its influence on the economy has been neither expansionary nor contractionary. However, contrary to the refrain of some (classical) economists, a balanced budget may not necessarily be good. A balanced budget undoubtedly implies that debt levels are stable and provides some level of expenditure discipline. However, a balanced budget may, in fact, be restrictive in some ways and may lead to depression. This is particularly true for developing countries in their early stages of development when the government needs to play a major role in leading growth and investment. Similarly, a surplus budget is also generally regarded as being restrictive in its effects on the economy, and may be inflationary. On the other hand, a deficit budget could either be restrictive or have a positive effect on the economy, depending on how the instruments of the budgetary policy are handled. These instruments include expenditure, taxation, borrowing and debt repayment.

Prolonged and rising deficit can be costly and is directly related to debt level and thus policy makers often debate on fiscal adjustment.[2] Therefore, deficit and debt reduction are twin targets of any government.

Deficit and debt reduction becomes an issue once the two are beyond sustainable limits. That is, it may be difficult to repay it. The issue of sustainability has received increasing attention from economists and policy makers in recent years. The concept of sustainability has three important elements. First government needs enough resources to ensure its ability to carry out its functions. In this case sustainability analysis determines whether a current fiscal policy can be maintained in the longer run. The second element deals with the implications for other macroeconomic variables, thus has a direct effect on economic growth. The third element relates to the issue of affordability. The

[1] The full paper can be obtained by contacting the author at reddy_m@usp.ac.fj.

[2] Fiscal adjustment is defined as a change in the primary deficit above a given threshold.

goal of policy makers should be to ensure that the cost of debt is in line with a jurisdiction's economic and fiscal base. Historical data on the world economy reveal that after the World War I, Germany, Poland, Austria and Hungry were in major fiscal crises with unprecedented levels of public debt coupled with very high inflation levels. In the longer run, rising debt levels and poor economic performance could tarnish government credibility and thus private investors would be unwilling to hold government bonds and securities.

In this paper, we explore some of the key indicators of sustainability of debt and extend the analysis utilizing advance time series methodology to examine if Fiji's debt level is indeed on a sustainable path. Studies in this area have been carried out in the past. Previous studies conclude that Fiji's budget deficit is sustainable.

## B. Economic Performance, Revenue, Deficit and Debt

*Economic Performance*

The Fiji government's fiscal position has been under scrutiny in recent time because of the economy's poor performance. The real GDP growth rate of the economy over the last decade has been below the potential growth rate for developing country standards. Apart from a real growth of 9.2% in 1999, all other years' performance have been disappointing. The high growth rate of GDP in 1999 is not anything extraordinary. Instead, it demonstrates the recovery of the economy to its trend growth line after the effects of drought. The poor economic performance is supported by low investment levels and higher import growth rates than export growth rate in most of the years. Despite these shortcomings, inflation levels, however, have been moderate and foreign reserves position has been stable (Table 1).

Table 1: Selected indicators of Fiji's Economy

| Year | Real GDP Growth Rate | Investment as % of GDP | Inflation (%) | Export Growth Rate (%) | Import Growth Rate (%) | Foreign Reserve Position (Months equivalent) |
|---|---|---|---|---|---|---|
| 1994 | 5.1 | 12.0 | 1.2 | 19.5 | 5.4 | 4.3 |
| 1995 | 2.5 | 12.5 | 2.2 | 5.1 | 2.0 | 3.8 |
| 1996 | 4.7 | 10.0 | 2.4 | 20.1 | 10.4 | 4.8 |
| 1997 | -2.3 | 10.2 | 2.9 | -14.8 | 0.6* | 5.1 |
| 1998 | 1.2 | 14.7 | 8.1 | 13.4 | 3.0 | 4.8 |
| 1999 | 9.2 | 13.8 | 0.2 | 18.1 | 24.0* | 6.4 |
| 2000 | -2.8 | 11.5 | 3.0 | 3.6 | -1.3 | 5.6 |
| 2001 | 2.7 | 13.7 | 2.3 | -1.6 | 2.9* | 6.1 |
| 2002 | 4.3 | - | 1.6 | -2.4 | 8.0* | 5.6 |
| 2003 | 3.0 | - | 4.2 | 6.6 | 13.4* | 4.6 |
| 2004 | 4.1 | - | 3.3 | -7.7 | -0.4* | 4.0 |

Source: RBF Quarterly Report, September, 2005.

*Budget Deficit*

The low growth rates of the economy have an implication on the public debt via its effect on government revenue. With low growth rates, lack of will to restrain expenditure and with poor financial management, it is expected that budget deficits will widen. While government have always been successful in having a revenue surplus,[3] its inability to cover the capital expenditure as well, have led to a widening budget deficit. The budget deficit in 1994 was F$106.3m which steadily increased to F$307m in 2004. This figure in absolute sense has no meaning. In relative terms, as a percent of GDP, it has been mostly higher than 4%, the sustainable limit. This could be a cause of anxiety.

*Deficit Financing*

Deficits can be financed either by raising taxes or borrowing. Raising taxes are not a preferred option due to its inevitable implications on investment and it is also not a politically desirable move. Despite

[3] Revenue surplus refers to excess of operating revenue over operating capital.

that, the rate of Value Added Tax (VAT) was raised by 25% (from 10% to 12.5%) in 2003 to partially fund the deficit. On the other hand, the easiest option is to borrow, which results in debt creation. Rising debt levels, if not checked by a growing economy, could pose several problems. Fiji's public debt level has been rising steadily. In 1994, the national debt was F$981.9m and in 2004, F$2280.3m. There was a sharp increase in debt level between the 1995-97 period which was followed by a sharp decline. This sharp abrupt decline was due to the sale of ATH shares for which most of the proceeds was channelled towards the repayment of debt.

*Sustainability Indicators*

The debt created has mostly been borrowed from domestic sources. Currently around 90% of the debt is owed to domestic sources, the majority of which to the Fiji National Provident Fund. There are obvious benefits from this, in particular, the debt servicing expenditure remains in the domestic economy rather then moving out of the country. Furthermore, exchange rate risks are also minimized. However, since our exchange rate is fixed, this may not be much of a concern. The downside to excessive borrowing from domestic market is that it will undermine private sector borrowing. Higher borrowing in the domestic market can push up interest rates thus affecting the cost of borrowing. Fiji's financial sector is not that competitive and not very deep. The other problem with domestic borrowing is that, generally, lenders in the domestic market are less stringent than the external sources. Therefore, borrowing is seen as easy option to any fiscal pressure, thus raising debt levels.

An indicator of sustainability of the public debt is the ratio of the rate of interest and rate of growth of the economy. Perusal of secondary data on these two variables indicates that the rates of interest are higher than the rates of growth of GDP. This implies that the debt to GDP ratio will rise. The actual data on debt to GDP ratio does depict this picture (Table 2). Furthermore, the ratio is also above the sustainable limit of 40%.

Table 2: Government Expenditure, Revenue, Deficit and Debt Level, 1994-2004.

| Year | Government Expenditure (F$m) | Government Revenue (F$m) | Budget Deficit (F$m) | Deficit as a % of GDP | Debt (F$m) | Debt as % of GDP | Debt service as % of Exp | Interest Payment as a % of Debt Service |
|---|---|---|---|---|---|---|---|---|
| 1994 | 804.1 | 697.8 | 106.3 | 4.0 | 981.9 | 42.8 | 17.3 | 50.9 |
| 1995 | 801.1 | 718.9 | 82.2 | 3.0 | 1001.8 | 42.2 | 18.4 | 52.1 |
| 1996 | 948.6 | 743.3 | 205.1 | 6.9 | 1133.5 | 44.0 | 14.4 | 56.0 |
| 1997 | 1082 | 803.5 | 278.6 | 9.3 | 1356.3 | 52.8 | 20.1 | 55.5 |
| 1998 | 1230.3 | 1141.2 | 89.1 | 2.7 | 1306.2 | 46.8 | 36.3 | 31.4 |
| 1999 | 1204.1 | 1004.5 | 199.6 | 5.3 | 1355.2 | 41.8 | 24.0 | 34.1 |
| 2000 | 1141.6 | 911 | 230.6 | 6.6 | 1433.9 | 47.0 | 17.2 | 44.8 |
| 2001 | 1253.7 | 900.5 | 353.2 | 9.6 | 1680.0 | 52.5 | 17.0 | 48.4 |
| 2002 | 1382.5 | 1038.8 | 343.7 | 8.7 | 1893.9 | 55.0 | 19.0 | 46.6 |
| 2003 | 1447.9 | 1066.3 | 381.6 | 9.0 | 2133.4 | 58.3 | 18.6 | 47.1 |
| 2004 | 1479.1 | 1172.1 | 307.0 | 6.8 | 2280.3 | 58.3 | 23.5 | 43.2 |

Source: Reserve Bank of Fiji, September 2005 Quarterly Report, 2006.

The rising debt level has absorbed a significant proportion of government finances in servicing it. Over one fifth of the expenditure is channelled towards debt servicing and close to 50% of it is interest payments only. Such a high debt-servicing requirement is a tax on investment and thus leads to weakening of incentives to invest. Furthermore, since a significant proportion of the borrowings are done in the foreign market, outward transfers to creditors for debt servicing impose a disincentive to investment and growth in the debtor economies because part of the returns to investment are taken away from the domestic economy in the form of payments to foreign creditors. This issue of a debt as a tax on investment or disincentive to investment leads to the question of sustainability. The sustainability of a particular level of debt relies on how the government revenue and expenditure series are related.[4]

## E. Concluding Remarks

Rising public debt for developing countries is not a new phenomenon. However, when the debt level rises beyond the overall size of the economy, sustaining it in the longer run can become an issue. In this paper, the sustainability of Fiji's public debt is examined using the public expenditure and public revenue series. Utilising data for the period 1970-2004 and allowing for a structural break in 1987, the results from time series analysis reveal that Fiji's public debt borders on unsustainable limits.

[4] The author then uses econometric tools to assess if Fiji's debt is on a sustainable path.