



RESERVE BANK OF FIJI

MONETARY POLICY STATEMENT
DECEMBER 2007



Our Vision Leading Fiji to Economic Success

Our Mission

- Enhance our role in the development of the economy
- Provide proactive and sound advice to government
- Develop an internationally reputable financial system
- Conduct monetary policy to foster economic growth
- Disseminate timely and quality information
- Recruit, develop and retain a professional team

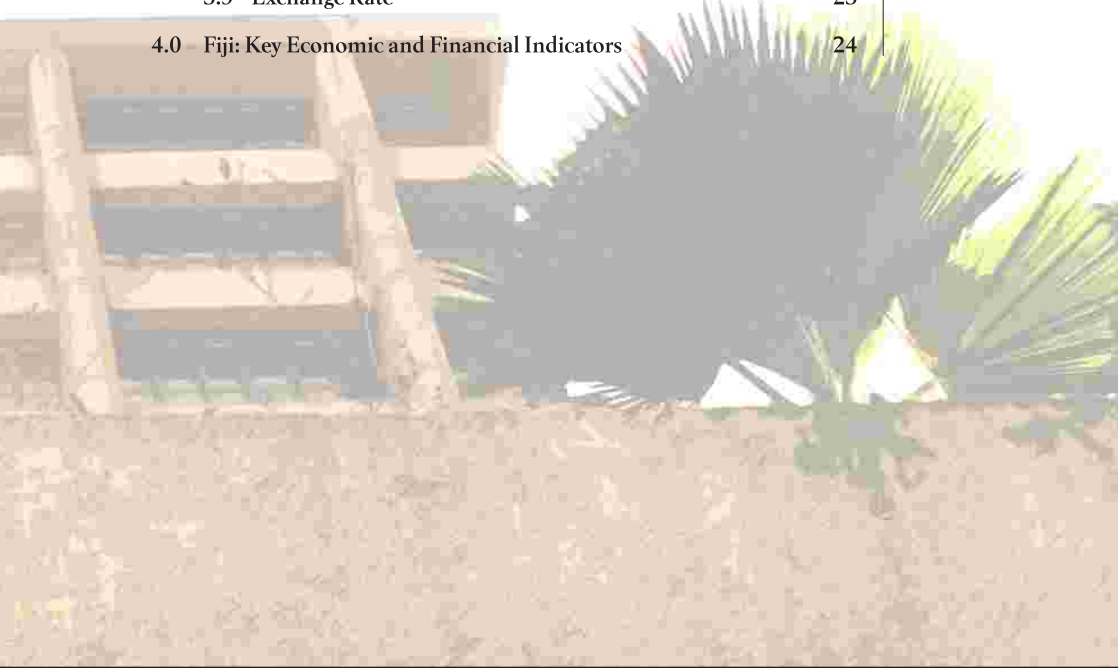
Our Values

- Professionalism in the execution of our duties
- Respect for our colleagues
- Integrity in our dealings
- Dynamism in addressing our customers' needs
- Excellence in everything



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1.0 Executive Summary

The conduct of monetary policy by the Reserve Bank continues to be guided by the twin objectives of *maintaining an adequate level of foreign reserves* and *keeping inflation low*. The policies implemented to date have, to some degree, had the desired effect of curbing excessive credit growth, slowing imports and relieving pressures on Fiji's foreign exchange holdings. As a result, the monetary policy objectives have continued to remain intact. At the end of November, inflation was 4.0 percent while the foreign reserves level of \$919.9 million was sufficient to cover 4.1 months of imports of goods.

The Fiji economy is now expected to contract by 3.9 percent this year and recover to growth of 2.2 percent in 2008. The outturn for 2007 is largely influenced by a contraction in most of Fiji's major sectors, while the recovery next year is anticipated to be driven mainly by the agriculture, forestry, fishing & subsistence; manufacturing; transport & communication; wholesale & retail trade, hotels & restaurants; electricity & water and building & construction sectors.

The current account is projected to remain in a deficit this year underpinned mainly by a large trade deficit. Cumulative to September this year, the trade account registered a deficit of around \$1.2 billion, an improvement of 18.9 percent when compared with the same period last year. The outcome was mainly due to a slowdown in import growth and a slight upturn on the exports front. Despite the present deceleration in imports, the trade imbalance is still substantial, as exports continue to perform well below their potential.

In view, therefore, of the pressures on foreign reserves, the Reserve Bank has continued to adopt a monetary policy tightening bias. To this effect, the policy indicator rate was raised to 4.25 percent in June 2006 and a credit ceiling together with exchange control measures were introduced and have been in place since December last year.

Looking ahead, the pressure on our Balance of Payments (BOP) position is likely to continue as long as the export sectors' performance remains subdued. The Reserve Bank will continue to monitor economic developments closely and devise policies to maintain macroeconomic stability and preserve Fiji's financial position.

2.0 Monetary Policy Discussions

2.1 Monetary Policy Issues

The Fiji economy is estimated to have expanded by 3.6 percent in 2006, underpinned by growth in the finance, insurance, real estate & business services; wholesale & retail trade and hotels & restaurants; manufacturing; building & construction; community, social & personal services and electricity & water sectors.

For 2007, the economy is forecast to contract by 3.9 percent. The projected contraction is largely underpinned by a decline in the community, social & personal services sector as a result of lower Government expenditure this year. In addition, the completion of several large construction projects and the decline in tourist arrivals mean that the building & construction and wholesale & retail trade, hotels & restaurants and transport & communication sectors are also expected to drive this year's economic decline. In addition, activity within the financial, insurance, real estate & business services sector has also been subdued. Furthermore, while Westech Gold Fiji Limited (WGFL) has taken over the operations at the Vatukoula mine, no gold production is envisaged for 2007.

Recent economic data support the weak economic outlook for 2007. The Business Expectation Surveys (BES) conducted by the Bank in June indicate below average trading conditions for the economy in the short and medium-term. Consumption activity has also remained weak as suggested by the performance of partial indicators. Net Value Added Tax (VAT) collections, cumulative to October 2007 were lower by 8.0 percent on an annual basis, while lending for consumption purposes and currency in circulation also slowed.

Latest partial indicators also suggest a subdued investment outlook for this year. Cumulative to September, imports of investment type goods declined by around 15.4 percent on an annual basis, while lending for investment purposes and to private individuals for housing purposes, slowed. This outcome was largely consistent with the weak short-term outlook for investment in plant & machinery and building expressed in the June 2007 BES. However, sentiment for the medium-term suggests some pick-up in investment intentions. Investment is expected to improve in 2008 in line with the modest economic growth anticipated next year.

On the external position, the current account deficit improved in the second quarter of 2007 amounting to around \$218.3 million (-3.4% of GDP), following a deficit of \$250.1 million in the previous quarter. The improvement in the current account deficit was due to a lower trade deficit and higher surpluses in the services and transfers accounts. Additionally, the capital account recorded a surplus of \$5.0 million in the same period, an improvement from the \$4.1 million surplus in the March quarter, driven largely by higher capital inflows. However, by the end of this year the current account deficit is expected to widen to 19.6 percent (-\$1,089m) of GDP. A capital account deficit of 0.1 percent (-\$4.1m) of GDP is also expected. Reflecting these figures, the BOP deficit is projected to widen to close to 1.0 percent of GDP this year.

In line with the subdued economic activity in the real sector, the growth in monetary and credit aggregates continued to slow in the year to October. The annual growth in broad money slowed to 18.1 percent at the end of October this year, down from 19.8 percent at end 2006. The growth in the review period was driven by increases in demand and savings deposits and currency in circulation. Time deposits, however, have been declining on a monthly basis suggesting a shift from time to demand deposits as term deposits mature.

During the same period, domestic credit growth decelerated to 6.9 percent from 25.4 percent in the same period last year. A slowdown in private sector credit largely influenced this outcome as it has consistently fallen from the beginning of this year. The slowdown in private sector credit growth is in turn due to subdued commercial bank lending, with the annual growth rate falling from 21.4 percent at the end of 2006 to 5.4 percent at the end of October.

Liquidity in the banking system has been building up steadily over the past few months. Bank demand deposits rose from \$82 million at the end of May to \$320.2 million at the end of November. The outturn reflects inflows of foreign reserves, redemptions of RBF Notes and other securities, Government drawdowns of the international bond proceeds and Government borrowing through the ways & means facility.

Interest rates have declined markedly as liquidity levels have increased. Commercial bank lending and deposit rates have fallen consistently since the beginning of the year and stood at 8.62 and 2.32 percent respectively in October. Interest rates on money and capital market securities have also fallen during this

period.

On the fiscal front, as per revised estimates released in the 2008 National Budget, Government is projected to achieve a surplus of \$22.4 million in 2007, equivalent to 0.4 percent of GDP. This expected outcome is underpinned by estimated annual declines of 14.2 percent in expenditure and 2.0 percent in revenue. This compares with a net deficit of \$157.2 million (equivalent to 2.9 percent of GDP) achieved in 2006.

2.2 Monetary Policy Stance

The conduct of monetary policy in Fiji focuses on the Reserve Bank's twin objectives of safeguarding the foreign reserves position and keeping inflation low.

Aside from the contracting economy, the credit ceiling put in place at the end of last year continues to be a key factor in containing excessive credit growth, slowing import growth and relieving pressures on foreign reserves. The policy objectives of low inflation and an adequate level of foreign reserves remained intact in the review period. In the year to November, inflation was 4.0 percent while foreign reserves were \$919.9 million, adequate to cover 4.1 months of imports of goods.

More recently, the Reserve Bank reduced the statutory reserve deposit (SRD) requirements of commercial banks from 7 to 6 percent in May this year. This policy initiative injected liquidity into the system and contributed to the decline in interest rates which has been underway since March of this year. In view of better-than-expected foreign reserves levels, certain conditions for non-resident businesses and individuals to borrow domestically were adjusted. Additionally, there were relaxations to various criteria attached to the utilisation of the Export Finance Facility (EFF) to enable more exporters to have access to the facility.¹ Collectively, these policies should contribute to creating an environment that is conducive to investment and growth.

Although imports are currently slowing, exports are still performing below potential. Against this backdrop, pressures on foreign reserves remain. Therefore, despite inflation being projected to be around 3.5 percent and foreign reserves forecast to be around \$917.5 million at the end of the year, sufficient to cover 4.1 months of imports of goods only, the Reserve Bank's monetary policy will continue to be aimed largely at preserving the BOP position.

¹ The EFF is a scheme whereby the Reserve Bank provides funds to the commercial banks and the Fiji Development Bank for onlending to exporters. The scheme was introduced in 1983 and is designed to assist the export sector by ensuring the availability of credit at relatively low interest rates.

3.0 Developments and Expectations

3.1 International Developments

The world economy is expected to grow by 5.2 percent this year after growing by an estimated 5.4 percent in 2006. Global economic and financial conditions remain upbeat with great optimism for this year's outlook.

China continues to be the engine for world growth, helped by emerging markets such as India and Russia. These three economies have to some extent emerged onto the international scene as significant contributors to global growth. World growth is also supported by above-trend performance in the Euro area and Japan, where domestic demand is driving the expansion. The US is currently affected by the subprime mortgage market crisis and its effect on other sectors of the economy.

The **US economy** is expected to slow to a 1.9 percent growth this year, after a strong growth of 2.9 percent in 2006. Albeit increases in net exports and business investment, the slowdown is led by slow growth in private consumption in the face of rising gasoline prices and residential investment which continued to exert a significant drag on the growth of service industries and manufacturing activities. Recent data, however, have painted a weaker picture of the US economy going forward, reflecting in part the impact of recent turmoil in financial markets.

Latest economic indicators showed generally a mixed performance. While the service industries were buoyant and there was a general rise in retail sales in October, consumer confidence fell in November, to the lowest level in a year. Furthermore, the subprime mortgage market crisis in July this year has created more problems for the US economy. In light of this, the Federal Reserve lowered its benchmark interest rate in September this year by 50 basis points to 4.75 percent. The rate was then lowered further by 25 basis points to 4.50 percent in October and further lowered by another 25 basis points to 4.25 percent in December to prevent the housing slump and credit squeeze from undoing the six-year expansion.

The **Australian economy** is forecast to grow by a robust 4.4 percent this year, following a growth of 2.7 percent last year, supported by business investment,

rising exports and household consumption. Recent economic indicators over the third quarter suggest that the country's 16 years of expansion will be sustained. Building approvals continue to improve while both retail sales and business confidence were strong on growing jobs and rising wages and exports. The jobless rate was unchanged at a 33-year low of 4.3 percent as Australian employers hired almost twice as many extra workers, fearing a labour shortage may drive wages higher.

Furthermore, consumer confidence also rose in the third quarter despite a rise in interest rates, while an index of leading economic indicators also rose at the fastest rate in three months in September, signalling the nation's expansion may gather pace. The Reserve Bank of Australia (RBA) raised its benchmark interest rate in July to 6.5 percent, to curb inflation and to cool the biggest surge in lending since 1989. The RBA again raised its interest rate to an 11-year high of 6.75 percent in November to quell inflation sparked by an accelerating domestic economy and increases in fuel and food costs and sparked speculation of another increase after it was expected that inflation will exceed its target. However, in December, the RBA left its benchmark interest rate at 6.75 percent articulating that the credit market turmoil may contain inflation and slow global economic growth thus driving down the nation's currency as investors bet the bank will hold off raising interest rates early next year.

Economic growth in **New Zealand** is expected to pick up to 2.8 percent this year, when compared to a 1.6 percent growth in 2006. The growth is expected to be driven by anticipated increases in business investment and despite some recent signs of slowing, household consumption. Recent indicators showed that the manufacturing industry expanded in October as companies received new orders in the lead-up to Christmas. Retail sales rose in September, buoyed by higher fuel prices, while spending on furniture and clothing slowed because of higher borrowing costs.

On the downside, business confidence fell from a six-month high in November, led by declining residential housing markets. This supported signs that the current high interest rates have started to impact domestic demand, weakening the prospect of another increase in borrowing costs. The Reserve Bank of New Zealand (RBNZ) raised the key interest rate by 25 basis points to 8.25 percent in July, after a falling currency and rising prices for commodity exports was expected to fan inflation. No further changes were made by the RBNZ to the

key interest rate from then to date, although increased prices for oil and food is expected to stoke inflation.

The **Japanese** economy is forecast to grow by 2.0 percent supported by private consumption and industrial production. This compared with growth of 2.2 percent in 2006. More recent data has also revealed that Japan's consumer confidence declined in October, to a three year low, as consumers were discouraged by declining wages and financial market turmoil. Weak confidence was reflected in the Japanese index of leading economic indicators, which fell to the lowest level in a decade, signalling growth may stall. Nevertheless, industrial production rose in October, to a record, underscoring the economy's reliance on exports as demand at home waned. Also, retail sales rose in October, at the fastest pace in more than a year, as consumers bought new-model cars and record gas prices increased revenue at filling stations. The Bank of Japan kept its benchmark interest rate at 0.5 percent throughout the year, on concerns that unstable global financial markets could derail their economic growth.

Euro-zone economic growth is expected to fall to 2.5 percent this year, from 2.8 percent growth in 2006. Growth is expected to be supported by industrial production. Euro zone exports is expected to be affected by weakening external demand, and the strength of the Euro is likely to weigh on export prospects of Euro-zone countries lacking a sufficient cushion in competitiveness (including France, Portugal, and Spain). Recent data provide mixed signals about the likely growth performance of Euro-zone economies in the coming quarters, as the recent financial market turbulence and weaker growth in the United States are pointing to a likely slowdown.

Latest economic indicators suggested some slowing in the Euro zone area although the performances of the two largest economies, Germany and France, were mixed. Overall European investor confidence fell in November, to the lowest level in almost two years, as a surging euro and rising oil prices, together with the US housing slump, will dampen economic growth. On a positive note, German business confidence rose in November, suggesting companies are coping with the high oil prices and the euro's appreciation. Industrial production also increased in September, led by construction and energy. However, German consumer confidence fell in November, to the lowest level in almost two years, as soaring energy and food prices sapped households' spending power. Retail sales also fell in October. French business confidence increased in November,

led by rising orders and manufacturers' greater optimism about production in their own companies while consumer confidence fell in November, to a 17-month low, hurt by faster inflation and a nine-day public transport strike. The European Central Bank kept its benchmark interest rate unchanged at a six year high of 4.0 percent in November and December, as policy makers weigh signs of slowing economic growth against the threat of accelerating inflation.

Crude oil prices have shown an increasing trend this year. Over recent weeks, prices have risen to new historical highs of above US\$90 per barrel. This compares to the 2006 high of US\$79 per barrel recorded in early August last year. Concerns of strong demand and possible disruptions to supply have placed large upward pressure on oil prices this year. Adding to the pressure is the US subprime mortgage market crisis that began in July this year. Due to the crisis, the US dollar depreciated sharply to near a record low against the Euro, enhancing the appeal of commodities such as oil as an alternative investment and driving their prices up.

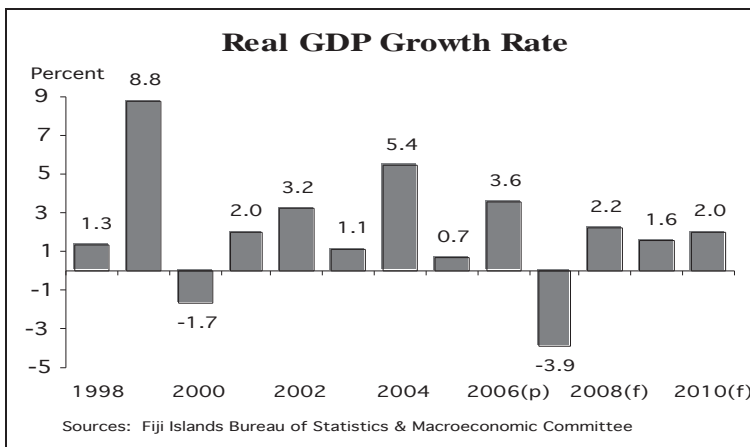
World market sugar prices have been stable at around US12.00 cents this year, after rising to a peak of around US19.00 cents in the first quarter of last year. Prices fell early this year on speculation of increased production from Brazil and India. However, prices have started rising marginally lately as a surge in energy costs enhanced the appeal of ethanol made from cane in Brazil.

3.2 Domestic Economic Conditions

Fiji's domestic economy grew by 3.6 percent in 2006, compared with growth of 0.7 percent in 2005. This favourable growth was led by the finance, insurance, real estate & business services; wholesale & retail trade, hotels & restaurants; manufacturing; building & construction; community, social & personal services and electricity & water sectors. The mining & quarrying, transport & communication and agriculture, forestry, fishing & subsistence sectors, however, were a drag on the economy.

This year, the economy is forecast to decline by 3.9 percent largely as a result of lower Government spending reflected in a decline in the community, social & personal services sector and lower construction activity in the building & construction sector. Other sectors envisaged to also decline are the wholesale & retail trade, hotels & restaurants; finance, insurance, real estate & business services; mining & quarrying; transport & communication; agriculture, forestry, fishing & subsistence and manufacturing.

Graph 1



Fiji's economy is expected to turn-around in 2008 with an envisaged growth of 2.2 percent. An expected improvement in tourist arrivals and its positive stimulus on the manufacturing; transport & communication; wholesale & retail trade, hotels & restaurants sectors, is forecast to drive growth next year. In addition, the agriculture, forestry, fishing & subsistence; electricity & water and building & construction sectors are projected to contribute positively to growth in 2008.

For 2009 and 2010, growth is envisaged at 1.6 percent and 2.0 percent, respectively. The manufacturing; agriculture, forestry, fishing & subsistence; transport & communication and wholesale & retail trade, hotels & restaurants sectors are forecast to underpin growth in these years.

3.3 Sectoral Developments

In line with the larger contraction now anticipated for 2007, partial indicators of domestic demand suggest that consumer confidence has weakened. In the year to October, net VAT collections amounted to around \$370.2 million, representing an annual decline of 8.0 percent. In addition, lending for consumption purposes and currency in circulation also noted a slowdown. However, Pay As You Earn (PAYE) collections (a partial indicator of household incomes) registered a marginal growth of 0.7 percent cumulative to October, much lower than the 17.0 percent growth recorded in the same period last year.

Investment activity is also expected to under-perform this year, as suggested by the performance of partial indicators. The value of capital work put-in-place by both the private and the public sector registered strong declines in the first six months of the year which substantiates the anticipated contraction in the building & construction sector this year. In addition, imports of investment type goods fell by an annual 15.4 percent cumulative to September. Lending for investment purposes (includes lending to the building & construction and real estate sectors) and to private individuals for housing purposes, also slowed in the year to October. However, investment is expected to pick up next year as suggested by improvements in business sentiment. According to the June 2007 BES results, the medium-term sentiment for investment activity (both plant & machinery and buildings) improved, in comparison with the previous survey.

Generally, sectoral performances remained weak in the review period. According to provisional data from the Fiji Islands Bureau of Statistics, cumulative to October, visitor arrivals totalled 446,305, representing an annual decline of 4.6 percent. Nonetheless, the provisional outcome of over 446,000 visitors was better than projections by 3.8 percent. Cumulative to June, tourism earnings declined by an annual rate of 9.0 percent. As per the categories of tourism earnings, business-related earnings in the first six months of the year fell by an annualised 8.6 percent, while earnings under the personal category declined by 9.0 percent.

In terms of visitor arrivals, cumulative to June, the 239,680 visitors that came to Fiji in the first six months of the year were lower by 5.1 percent on an annual basis, over the corresponding period in 2006. Looking specifically at categories, tourists that came for business in the review period were lower by 4.2 percent

annually and visitors that came for personal reasons declined by 5.2 percent, annually. The visiting friends and relatives (VFR) category also recorded an annualised 4.9 percent fall. As a ratio, the total VFR category accounted for 7.9 percent of all visitors in the first two quarters of this year, unchanged from the corresponding 2006 period.

The performance of the cane and sugar industries in the review period has been subdued. Cumulative to October 2007, around 2.2 million tonnes of cane was crushed to produce 216,346 tonnes of sugar. This represents a decline of 9.1 percent and 11.2 percent in cane and sugar production over the comparable period in 2006, respectively. The cane and sugar industries are forecast to contract by 13.0 percent this year as a result of the floods (mainly in the Northern & Western Division) and the drought conditions faced earlier this year.

The building & construction sector also registered a noticeable poor performance, cumulative to Quarter 2 of 2007. Around \$113.4 million worth of work was put-in-place up to the June quarter this year, representing an annual decline of 27.2 percent. By categories, the value of work put-in-place by the private and public sectors declined on an annual basis, by 25.9 percent (to \$92.5m) and 32.6 percent (to \$20.9m), respectively. The building & construction sector is forecast to contract by 14.8 percent this year due to the completion of major projects and with work on certain large projects being on hold for nearly half the year.

The textile, clothing & footwear industry's performance in the review period was also weak, as total export earnings registered marginal growth in the year to September. Textile, clothing & footwear export earnings amounted to around \$79.7 million cumulative to September, representing an annual increase of 0.5 percent.

3.4 Balance of Payments

The current account deficit improved in the second quarter of 2007, amounting to around \$218.3 million (-3.4% of GDP), following a deficit of \$250.1 million in the previous quarter. The improvement in the current account deficit was due to a lower trade deficit and higher surpluses in the services and transfers accounts.

The capital account recorded a surplus of \$5.0 million in the same period, an improvement from the surplus of \$4.1 million in quarter 1, driven largely by higher capital inflows.

The financial account (excluding reserve assets) also recorded a surplus during the review period, led by an increase in foreign investment into Fiji, mainly due to an improvement in direct and other investments.

The improvement in the financial account (excluding reserve assets) resulted in the overall BOP recording a surplus of around \$90.0 million in the second quarter.² The improvement in the current account deficit and the higher capital account surplus would have also contributed to this.

Cumulative to September this year, the trade deficit narrowed by 18.9 percent after widening by 33.8 percent over the same period last year. The outcome was largely influenced by a 11.0 percent decline in imports to around \$2.1 billion and a 2.7 percent increase in exports that totalled \$0.9 billion thus giving a trade deficit of around \$1.2 billion. This compares with around \$2.3 billion imports and around \$0.8 billion worth of exports in the same period in 2006, when the trade deficit was around \$1.5 billion.

In the first nine months of the year, merchandise imports declined by around 11.0 percent to \$2.1 billion. This compares with a growth of around 19.7 percent in the corresponding period in 2006. All categories of imports declined with the main drivers being investment goods (4.5 percent) such as machinery & electrical equipment and chemicals; intermediate goods (4.1 percent) which was led by mineral fuels and crude materials; and consumption goods (2.4 percent) mainly consisting of manufactured goods, miscellaneous manufactured

² BOP data released by the FIBOS is up to quarter 2, 2007.

articles, food and beverages & tobacco. Excluding mineral fuels, imports declined by 10.5 percent compared to a 12.4 percent growth in the same period last year.

During the same period, merchandise exports rose by around 2.7 percent, compared with an increase of around 0.9 percent in the corresponding period last year. Domestic exports increased by 5.2 percent compared to a decline of 3.5 percent in the same period last year. Excluding re-exports of mineral fuels, exports rose by around 6.0 percent cumulative to September 2007, compared to around 1.8 percent decline in the same period in 2006.

Leading the increase in domestic receipts were other domestic exports, mineral water, timber, sugar, fruits & vegetables, uncooked pasta, garments, flour and fish. These more than offset the declines recorded in sectors such as re-exports, molasses, corned meat of bovine animals, sweet biscuits and footwear & headgear. With imports at \$2.1 billion and exports at a mere \$0.9 billion for the first nine months of this year, the resulting trade deficit of \$1.2 billion remains a concern.

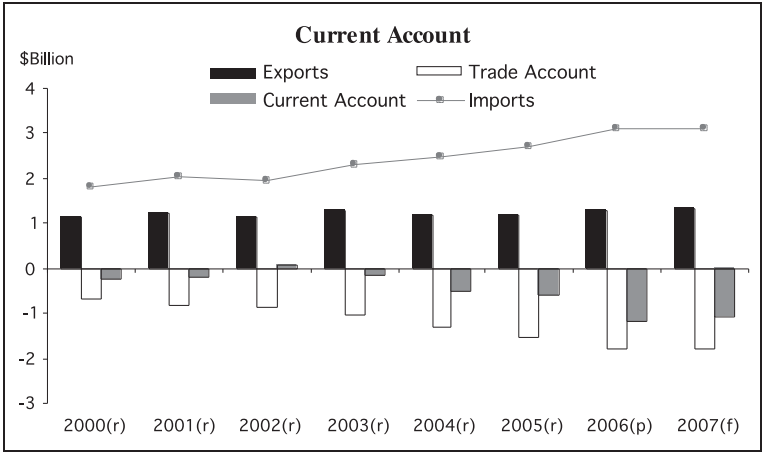
This year, exports (excluding aircraft) are forecast to rise by 2.7 percent. Mineral water, garments and other domestic exports are expected to lead the forecast growth. These are anticipated to more than offset expected declines in earnings from re-exports, timber and fish, with no gold production expected. Imports (excluding aircraft) on the other hand, are projected to decline by 5.1 percent. In particular, imports of machinery & transport equipment, manufactured goods, mineral fuels, miscellaneous manufactured goods and crude materials are all expected to decline.

The current account deficit is expected to widen in 2007 to 19.6 percent of GDP. However the magnitude of the current account deficit is likely to be considerably less, given the large surplus net errors and omissions figure, equivalent to 17.5 percent of GDP, which indicates unaccounted inflows. The larger current account deficit reflects lower services surpluses. A capital account deficit is also forecast, at 0.1 percent of GDP, reflecting higher capital transfer outflows, mainly in the form of migrant transfers and non residents' transfer of funds on departure from Fiji. Reflecting these figures, the overall BOP deficit is projected to widen to close to 1.0 percent of GDP this year.

Although imports have slowed to some extent, and exports have grown, the trade deficit remains considerably high, underpinning the significant current

account deficit. This situation continues to place pressures on Fiji's foreign reserves. However, gross foreign reserves were at adequate levels at the end of November 2007, at \$919.9 million, sufficient to cover 4.1 months of imports of goods. This compares to around \$879.9 million of foreign reserves sufficient to cover 3.7 months of imports of goods in December last year.

Graph 2



3.5 Fiscal Operations Of the Government

In the 2008 National Budget, Government's cashflow data indicates a fiscal surplus of \$22.4 million for 2007, equivalent to 0.4 percent of GDP. This outcome is underpinned by estimated annual declines of 14.2 percent in expenditure and 2.0 percent in revenue.

The annual decline in revenue is underpinned by a 2.1 percent fall in direct tax collections, while the lower annual expenditure is attributed mainly to a 42.4 percent reduction in investment payments.

Operating payments fell on an annual basis by 9.4 percent and within that, personal payments declined by an annualised 9.7 percent.

For 2008, Government expenditure is expected to increase by 19.4 percent, which is estimated to more than offset the 8.1 percent projected rise in annual revenue. The fiscal deficit for next year is projected at 2.0 percent of GDP.

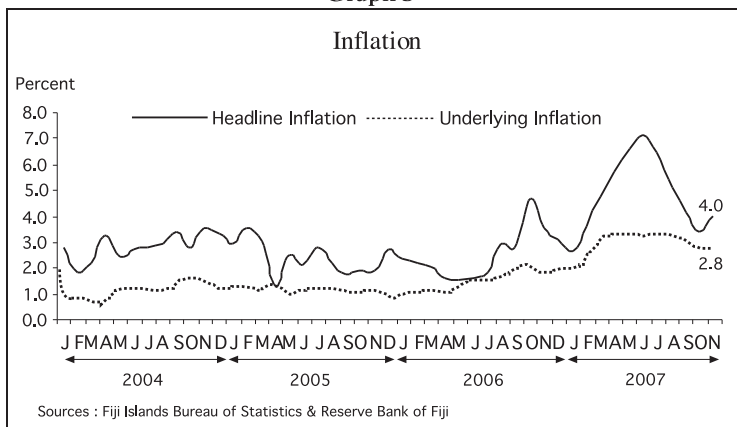
Government's outstanding debt for this year is estimated at \$2,803.4 million, equivalent to 50.3 percent of GDP. This compares with the 2006 estimated debt level of \$2,863.1 million, equivalent to 52.2 percent of GDP.

For 2008, Government debt is projected at \$2,919.9 million (50.1% of GDP).

3.6 Inflation

Inflation followed a rising trend during the first six months of the year, largely underpinned by significant increases in prices of market produce and other food items (Graph 3). On the domestic front, flash flood occurrences earlier in the year triggered supply shortages of fruits and vegetables, and at the same time the limited local supply was further constrained by an increase in exports to overseas markets. On the international front, higher prices of imported dairy and wheat-related products also had flow-on effects to other down-the-line products such as milk, cheese and bread. These factors contributed to the rise in inflation to around 7.1 percent by June 2007.

Graph 3



However, in July, inflationary pressures began to ease and the earlier up-trend reversed. The quick turnaround in price pressures was largely owed to improvements in the supply of volatile market items, as well as an easing in export demand for fruits and vegetables. In addition, the structural adjustment in September which reduced the percentage mark up of import, wholesale and retail prices of basic food items administered by the Prices and Incomes Board also lowered consumer prices.

In the approaching months, upward price pressures emanating from the external front are expected to remain. Crude oil prices are currently hovering around

the US\$90 per barrel mark³ and could filter into higher domestic fuel prices in the final quarter of the year. The recent rise in average trading partner inflation to 2.2 percent from 2.0 percent, may also feed into imported prices. Nevertheless, these upward pressures are expected to be mitigated by lower domestic inflation and a relatively weaker US dollar. Incorporating all these factors, the year end forecast, was revised down to 3.5 percent from 7.0 percent in July.

In the medium term, inflationary pressures are likely to ease next year given the slowdown in wages and income growth, coupled with the weak economic recovery expected next year. Thus, year-end inflation for 2008 is projected at around 2.5 percent.

However, potential risks to the inflation forecast are, *inter alia*:

Externally:

- Significant volatility and unanticipated increases/decreases in international crude oil prices; and
- Adverse currency movements.

Domestically:

- Natural disasters and adverse weather conditions that could cause supply shortages;
- Changes in import duties and tax rates that may be instituted by Government; and
- Structural changes in prices administered by the Prices and Incomes Board.

³Based on Brent crude oil prices.

3.7 Labour Market

The labour market continues to exhibit spare capacity and weak hiring intentions across certain sectors, in line with the current economic contraction. Cumulative to November, around 5,700 jobs were advertised, representing an annualised decline of around 5.8 percent. Employment prospects were lower mainly in the finance, insurance, real estate & business services; construction; electricity & water; mining & quarrying; wholesale & retail trade, restaurants & hotels and transport, storage & communication based companies.

Nevertheless, some improvement in market expectations has been noted recently. An analysis of the results of the September Reserve Bank's Fiji Employer's Federation Expectations Survey seemed to show a slight glimpse of optimism in the labour market, when compared to the results of the December 2006 survey. While this may foreshadow higher employment levels in the future, it is still too early to signal any significant and immediate change in the current weakness in the labour market. Unless there is a quick rebound in investment and business conditions, labour market conditions are expected to remain relatively weak.

3.8 Monetary and Financial Market Developments

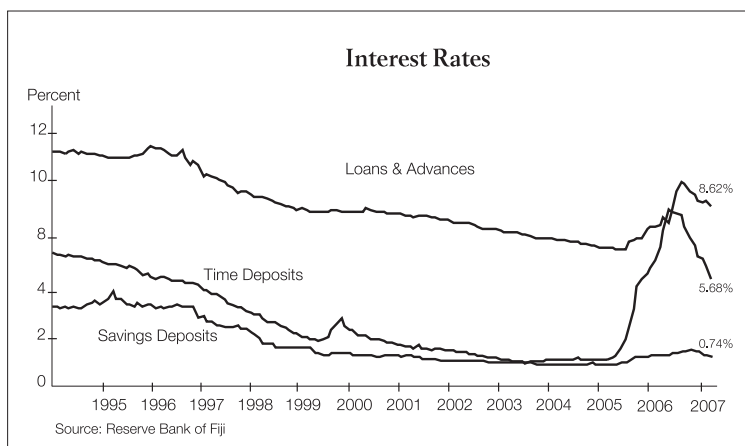
The policy indicator rate was maintained at 4.25 percent as the Bank continued to adopt a tightening stance in the second half of this year. The policies implemented over the past two years have been effective in curbing excessive credit growth, slowing imports and relieving the pressures on foreign reserves. Notably, the underlying weakness in economic activity has also been a contributing factor to the deceleration in import growth. However with exports still performing below its potential, a pick up in imports could exacerbate the trade deficit and place added pressure on our reserves position.

In June, the Reserve Bank, has relaxed exchange control measures to facilitate trade payments and assist importers in meeting their overseas commitments. The Bank also amended the terms of the Export Finance Facility to enable more exporters to access the facility. In order to encourage investment lending, the Reserve Bank reduced the commercial banks' SRD ratio from 7 percent to 6 percent in May. This resulted in increased liquidity in the system and placed downwards pressure on interest rates.

Liquidity reached a record high in the third quarter of this year, at around \$285.0 million. This was a significant expansion from the \$39.0 million prevailing in the corresponding period last year. The outturn reflects the combined influence of inflows of foreign reserves, redemption of RBF Notes and other securities, as well as Government's drawdown of the international bond proceeds and Government borrowing through the ways & means facility. As liquidity rose, it has eased pressure on interest rates.

Interest rates have generally trended downwards since March this year (see Graph 4). In October, the commercial banks' weighted average lending rate was down by 122 basis points, compared with the end of the March quarter. During the same period, the savings deposit rate fell by 24 basis points to 0.74 percent while the time deposit rate decreased by 305 basis points to 5.68 percent. Similarly, interest rates on new loans by credit institutions and some time deposit rates also decreased during this period.

Graph 4



Additionally, the commercial banks' new lending rate has fallen by 298 basis points to 8.56 percent in October, compared with the end of March. During the same period, the new time deposit rate fell from 8.38 percent to around 2.93 percent. Additionally, the weighted average outstanding time deposit rate declined from 8.73 percent to around 5.68 percent.

In line with interest rate developments in the banking sector, interest rates also fell in the money and capital markets. In November, the yield on 91 Day T-Bills fell by 983 basis points to 0.17 percent from 10.0 percent in the corresponding period last year. There were issues of 3, 5, 7, 10 and 15-year Government bonds in September, with weighted average interest rates of 3.0, 6.0, 6.5, 6.73 and 6.83 percent, respectively.

Broad money supply rose by 18.1 percent to \$3.4 billion, largely due to increases in demand deposits in October this year. During this period, demand and savings deposits rose by 67.0 and 4.6 percent, to \$1.3 billion and \$0.6 billion, respectively.

Domestic credit growth continued to slow in the wake of the credit ceiling implementation. The strong annual double-digit growth rate has fallen to 6.9 percent in October, compared to 23.6 percent at the end of last year. The

deceleration in credit was similar across the private and government sectors, except for statutory authorities.

Private sector credit rose by 5.8 percent in October, lower than the 23.7 percent in December of 2006, fuelled by higher commercial bank lending to private individuals and other major sectors such as wholesale & retail trade, manufacturing, real estate and building & construction.

The majority of advances to private individuals were for housing purposes. Outstanding lending for housing purposes totaled around \$632.1 million at the end of October, accounting for 81 percent of total loans to private individuals and 25.5 percent of total outstanding loans in the banking system.

The developments in lending have been in line with the Reserve Bank's expectation. Following the Reserve Bank's monetary policy tightening measures and the credit ceiling towards the end of last year, a significant slowdown in credit has been observed. The annual growth in commercial bank credit slowed to 5.4 percent by the end of October, down from a high of 29.0 percent in May 2006 and 21.4 percent in December of last year. On a monthly basis, credit growth has averaged around 0.2 percent in the last ten months of this year.

The monetary policy tightening bias together with the credit ceiling is expected to keep credit growth low in the months ahead.

3.9 Exchange Rate

Movements in the exchange rate at the end of November, compared with end last year, showed that the Fiji dollar had strengthened against the US dollar but weakened against the Euro, Australian and New Zealand dollars and the Yen. The same result was obtained when compared with the exchange rate prevailing at the beginning of this year. Recently, the US dollar has been weakening against the major currencies, underpinned by the financial crisis in the United States subprime⁴ mortgage market.

The Fiji dollar has risen by 7.5 percent against the US dollar increasing from US\$0.6009 at the end of 2006 to US\$0.6460 at the end of November this year. The general appreciation of the Fiji dollar was also reflected in the rise of the Nominal Effective Exchange Rate (NEER) by 0.2 percent at the end of November. During the same period, the Real Effective Exchange Rate Index (REER) of the Fiji dollar, which adjusts the NEER for inflation differentials across Fiji's major trading partners, also rose by 1.8 percent, implying a deterioration in Fiji's competitiveness externally.

⁴ The practice of making loans to borrowers who do not qualify for the best market interest rates because of their deficient credit history. Subprime lending is also called B-paper, near prime or second chance lending.

Fiji: Key Economic and Financial Indicators

Table 1

INDICATOR (\$M)	2003	2004	2005	2006	Oct-07
Broad Money Supply	1,980.5	2,185.7	2,513.8	3,012.3	3352.1
Domestic Credit	1,662.9	1,871.2	2,368.6	2,927.6	3018.0
Private Sector Credit	1,326.4	1,565.8	1,949.3	2,411.5	2,468.0
Net Credit to Government	236.4	178.1	277.5	356.1	316.4
Net Foreign Assets	1,326.4	1,565.8	1,949.3	2,411.5	2468.0

Table 2

INTEREST RATES	2003	2004	2005	2006	Oct-07
RBF Policy Indicator Rate	1.25	1.75	2.25	4.25	4.25
Lending Rate	7.39	7.03	6.63	7.89	8.62
New Lending Rate	7.92	6.91	6.62	9.75	8.56
Time Deposit Rate	1.70	1.77	2.03	9.05	5.68
New Time Deposit Rate	0.76	1.43	2.23	12.41	2.93
Savings Deposit Rate	0.45	0.36	0.40	0.84	0.74
Credit Growth	17.7	19.3	22.8	21.4	5.4

Table 3

INDICATOR	2004	2005	2006	2007
CONSUMER PRICE INDEX (Annual % changes)				
Headline	3.3	2.7	3.1	3.5
Trimmed mean	1.6	1.2	1.9	-
BALANCE OF PAYMENTS (F\$M)				
Current Account	-520.6	-575.9	-1154.7	-1089.4
Financial Account	129.1	185.8	596.2	116.3
Overall balance	-102.1	223.2	-57.5	36.8
Gross Int. Reserve	1045.6	822.4	879.9	917.5
Import Cover (Goods)	5.6	4.0	3.7	4.1
FISCAL OPERATIONS OF THE GOVERNMENT				
Underlying Deficit (F\$M)	146.6	168.2	185.2	-22.4
% of GDP	3.3	3.5	3.4	-0.4
GROSS DOMESTIC PRODUCT (Annual % growth)				
Real GDP	5.4	0.7	3.6	-3.9
Nominal GDP	7.7	6.0	9.4	1.6



The Great double-hulled, ocean-going canoes (drua) of the ancient Fijians were remarkable craft capable of long voyages. The Tagaga (Pronounced “Tanganga”) or masthead, was crucial for holding in place the sails, woven from the leaves of the pandanus tree. It was the Tagaga which enabled the navigators to keep their drua sailing towards their destinations.

For the Reserve Bank of Fiji, a logo based on the Tagaga masthead, symbolises the Bank’s role in contributing towards a sure and steady course for Fiji’s economy.

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Reserve Bank of Fiji

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