RESERVE BANK OF FIJI

Monetary Policy Statement

November 2008

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Statement by the Governor

The world is in the middle of the deepest financial crisis since the Great Depression. The magnitude of the crisis is astounding and continues to unfold on a daily basis. The economic impact of the global financial crisis will further weaken our economy and growth prospects may likely be revised downward as we enter the New Year.

Following a decline of 6.6 percent last year, we expect the economy to grow by 1.2 percent this year.

The global financial crisis has come at a time when our balance of payments was already under pressure from the lacklustre performance of our exports, and the hikes in oil and food prices. The crisis is expected to adversely affect our exports, tourism, remittances and foreign investment. In addition to reducing our growth potential, these will also exert considerable pressure on our balance of payments.

Our foreign reserves have fallen steadily during the course of the year. Nevertheless, due to the tight monetary policy stance that we have adopted since December 2006 and the fall in domestic demand, foreign reserves remain at adequate levels. At the end of November, reserves were around $832 million, sufficient to cover 3.1 months of imports of goods.

On the upside, oil prices have fallen dramatically, easing inflationary pressures. Consequently, inflation has since fallen from a 20-year high of 9.8 percent. The primary cause of inflation is the supply factors from abroad. Therefore, there is little role that monetary policy can play in addressing these temporary factors. Inflation has begun to decline and we expect it to ease further to 7.5 percent by the end of December and moderate to 4.5 percent at the end of 2009. We should, however, guard against inflation filtering through to demand for higher wages and creating a cyclic and more permanent rise in prices.

The primary focus of monetary policy in the medium term will continue to be on protecting our foreign reserves position. The credit ceiling remains the key instrument in alleviating the pressure on foreign reserves by dampening credit to non-priority sectors, particularly for consumption activity.

In a climate of low economic growth and a weak balance of payments, the proper mix of fiscal and monetary policy is important. While monetary policy is aimed at financial stability, fiscal policy has moved to promote growth and investment through the incentives announced in the National Budget recently. Due to these measures, growth is expected to consolidate and increase to 2.4 percent in 2009.

Monetary policy, while remaining focused on external stability, will also play its part in promoting growth and investment. Exceptions over the credit ceiling are allowed for investment-related lending and the recent upsurge in credit for this purpose augurs well for economic growth. Certain exchange controls have also been relaxed to spur investment. The lending rate has also declined and it is the lowest in the region including Australia and New Zealand.

I believe that this macroeconomic policy mix is sustainable and appropriate for Fiji in our combined effort to preserve financial stability but at the same time lift economic growth.

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Savenaca Narube

Governor

Monetary Policy Assessment and Key Issues

Overview

Global economic conditions were dominated by the unravelling of the financial crisis, as the major industrialised countries entered into recession and growth of emerging economies slowed. The International Monetary Fund (IMF) projects that the world economy will be in recession in 2009, with growth at 2.2 percent, compared to the estimate of 3.7 percent for this year. Except for Australia, our major trading partners are in recession. These developments are anticipated to adversely affect Fiji's growth, trade and balance of payments (BOP) outcomes in the New Year.

Fiji's economy is anticipated to expand by 1.2 percent this year and grow further by 2.4 percent in 2009. Consumption and investment remain subdued although Government's fiscal expansionary position should drive economic activity next year. The trade deficit, however, continues to deteriorate.

Inflation has eased from a 20-year high of 9.8 percent in September to 7.7 percent in November. This is in line with the remarkable fall in international oil prices in recent months. Lower prevailing crude oil prices are also expected to mitigate recent announcements in terms of the higher Fiji Electricity Authority's (FEA) fuel surcharge and duty changes listed in the 2009 National Budget. As such, the inflation forecast remains unchanged at 7.5 percent. Inflation is projected to moderate to 4.5 percent in 2009.

The outcome in foreign reserves reflects ongoing pressure on the BOP position. During the year, foreign reserves fell by $127 million to $832 million (worth around 3.1 months of imports), at the end of November. The persistent trade deficit is anticipated to continue to exert pressure on foreign reserves levels in the year ahead. The repercussions of the global financial crisis pose major downside risks. Fiscal policy measures targeted at alleviating the pressure on the BOP are largely expected to come to fruition in the medium to long term.

Monetary policy continues to focus on safeguarding the foreign reserves position. The credit ceiling has been largely effective in dampening credit. However, lending for investment purposes have been allowed to grow and this is anticipated to support growth prospects. Selective exchange controls have also been relaxed to entice foreign investment.

Given that foreign reserves will continue to be under pressure in 2009, monetary policy remains vigilant in protecting Fiji's external position.

Macroeconomic Assessment with Key Outcomes

The credit crunch or liquidity crisis that first erupted with the United States (US) sub-prime mortgage collapse in mid-2007 entered a deeper phase in September, unfolding into a global financial crisis. Regarded as the most severe shock since the Great Depression of the 1930s, the impact has been felt across the global financial system.

Intensifying solvency concerns have badly shaken confidence, pushing the global financial system to the brink of meltdown, leading to emergency resolutions in major advanced economies. Stock markets across the globe have fallen significantly and money and credit markets have frozen, causing severe stress in financial systems and resulting in the failure of several large financial institutions in the US and Europe.

The global financial crisis has crippled business and consumer confidence in most of the advanced economies, with many entering recession. Emerging market economies like China and India have also posted slower growth projections. Consequently, the IMF made several downward revisions to world growth, particularly for 2009. The latest projections indicate that the global economy is forecast to expand by 3.7 percent this year and enter into recession next year, with an expected growth of 2.2 percent.

Given the gravity of the crisis, unprecedented fiscal stimulus packages were announced and there was rapid easing of monetary policies worldwide, geared to injecting liquidity to unfreeze international financial markets. Major industrialised countries also coordinated policy responses, while countries of the Group of 20 (G-20) and Asia-Pacific Economic Cooperation (APEC) held summits to discuss concrete ways to deal with the current crisis, as well as prevent similar crises from occurring in the future.

The US economy has been hit hard by the crisis and according to the National Bureau of Economic Research, entered into recession in December 2007. American stock markets fell to the lowest level since 2003, unemployment rose to the highest level in 24 years, while business and consumer confidence remain low. Growth projections have been successively lowered and expectations are that the economy will grow by 1.4 percent this year, before contracting by 0.7 percent in 2009.

Contagion effects from the global financial crisis have also seen Fiji's other major trading partners, New Zealand, Japan and the Euro-zone, enter into recession. New Zealand is projected to grow marginally (0.7%) this year before picking up slightly (1.5%) in 2009. On the other hand, Japan and the Euro-zone are forecast to expand by 0.5 and 1.2 percent, respectively, before contracting in 2009, by 0.2 and 0.5 percent, respectively. Australia has so far staved off a major economic contraction, although its growth projections have been lowered to 2.4 percent for 2008 and 1.8 percent next year.

The global financial crisis, through its effect on Fiji's major trading partners, has far reaching negative consequences for Fiji's economic growth prospects, as well as for trade and the balance of payments. Given that Fiji is a small and open economy and reliant on external trade in goods and services, recessions in four of the five major trading partners does not bode well for overall domestic economic conditions. The adverse international economic conditions compound an already weak situation of low growth and ongoing pressure on the balance of payments.

Economic growth projections have been revised twice during the year. Official estimates indicate that the economy contracted by 6.6 percent in 2007 (Graph 1), compared to the earlier estimate of 4.4 percent. This year, growth is forecast at 1.2 percent, a downward revision from the earlier projection of 1.7 percent. The amendment was largely a result of poor performances of the sugar and gold sectors, coupled with restrained Government expenditure. The latter follows Government's strategy to consolidate its fiscal position in the last 2 years.

On a positive note, the fiscal expansionary policy stance announced in the Government's 2009 National Budget augurs well for growth in

2009. Mainly as a result of the budgeted fiscal stimulus, the economy is forecast to expand by 2.4 percent, up from the previous projection of 1.4 percent. Positive performances are also expected from agriculture, tourism and manufacturing. Nevertheless, there are serious downside risks from the fallout of the global financial crisis. Given that the crisis continues to unravel, a better assessment on the impact on Fiji's economy will be made early next year.

Graph 1

Real GDP Growth Rate

Sources: Fiji Islands Bureau of Statistics & Macroeconomic Committee

Although Government unveiled several investment and export initiatives in its 2009 National Budget, the benefits of these measures are likely to be reaped over the medium to long term. Consequently, as Government reverts to consolidate its position post-2009, with ongoing lacklustre performance of traditional sectors, growth is anticipated to be low for the ensuing years. It is expected that the economy will expand by 1.9 and 1.5 percent in 2010 and 2011, respectively.

Although partial indicators of **consumer spending** are mixed, it is likely that retail activity remains soft, given low income levels. Proxy indicators for income such as newly registered taxpayers and personal remittances recorded a 10.0 and 21.9 percent annual decline, in October and August, respectively. Moreover, Pay As You Earn collections fell by 2.2 percent in September.

Furthermore, even though Net Value Added Tax collections and imports of consumer items rose over the year by 2.7 and 22.7 percent, respectively, in September, this was likely a result of higher prices than a reflection of increased retail spending. On the other hand, lending for consumption purposes have recently trended up, growing by 11.3 percent in October. However, this is underpinned by base-related effects and growth is expected to moderate in the year ahead, given the prevailing credit ceiling.

On a positive note, visitor arrivals rose by 9.6 percent over the year to October. Moreover, the recent Budget announcement to maintain the income tax threshold at $15,000 and higher recruitment intentions indicated in the October Job Advertisements Survey may raise consumption into the new year.

Overall, **investment** activity remains sluggish, despite some pockets of optimism. Anecdotal evidence on the construction sector and upcoming projects signal subdued activity, albeit some pick up expected for next year. However, lending for investment purposes has recently strengthened, growing by 16.5 percent over the year to October. This also coincides with higher annual import payments (16.4%) for investment-type goods.

Government announced numerous investment incentives in its 2009 National Budget in the form of tax holidays, and duty concessions for capital equipment, amongst others. These measures, however, are anticipated to raise investment in the medium to long term. For the short term, investors continue to take a cautious approach to new project decisions, likely influenced by issues regarding political stability.

In its 2009 National Budget, **Government** revealed that it is expected to record a deficit of 3.0 percent of gross domestic product (GDP). Both revenue and expenditure is budgeted to increase. Total revenue collections are expected to rise by 6.0 percent, while total expenditure is envisaged to expand by 14.8 percent. In particular, Government has raised the allocation for capital construction by 26.2 percent – the highest allotment in 8 years. Government has planned several infrastructure projects related to the upgrading of roads, water, sewerage schemes and maintenance/upgrade of buildings. By providing the necessary infrastructure, Government aims to stimulate private sector investment, particularly in under-developed regions like Vanua Levu. This bodes well for investment in the medium to long term.

At the same time, Government has budgeted for an increase in operating expenditure, which should fuel consumption activity. A major component of operating expenditures is the wages and salaries of Government workers. Consequently, a rise in their incomes should encourage retail spending.

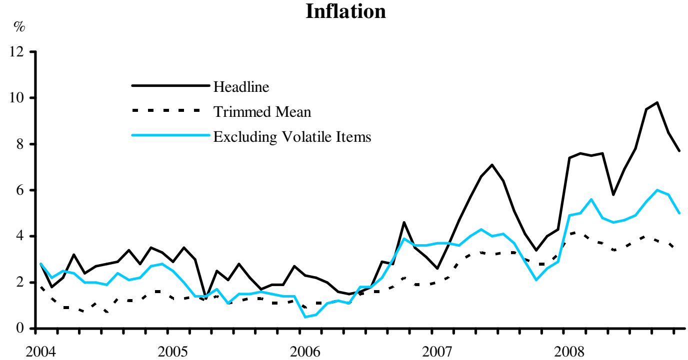
Cumulative to September, the **trade** deficit deteriorated to $1.5 billion from $1.2 billion in the comparable period last year. Export receipts (excluding aircraft) rose by 22.4 percent, compared to 2.7 percent a year ago, largely underpinned by re-exports, sugar, fish, gold and timber. This outcome is consistent with the annual forecast of 17.9 percent. Import payments (excluding aircraft) expanded by 26.0 percent, compared to 10.6 percent in 2007, led by a broad-based increase in outlays for imports. On an annual basis, imports are projected to expand by 21.8 percent. Although export earnings have recorded strong growth, imports have recorded equivalent increases. Consequently, the trade deficit continues to persist, which does not augur well for foreign reserves levels.

Inflation Outcomes and Outlook

Consumer prices generally rose over the year (Graph 2), climbing to a 20-year high of 9.8 percent in September, led by higher food and fuel prices. Higher import prices for food and fuel reflected external supply side constraints and the on-going global energy crisis. Moreover, in July, the Consumer Price Index (CPI) base was officially revised from 1993 to 2005, leading to changes in the coverage and weights of goods and services in the CPI basket. Consequently, the food, transport and heating & lighting categories now record the largest combined weight of over 64 percent. As such, movements in food and fuel prices drive inflation even more than before.

Graph 2

Inflation



Sources: Reserve Bank of Fiji & Fiji Islands Bureau of Statistics

Nevertheless, consumer prices eased to 7.7 percent in November, driven by lower fuel prices, as international oil prices plunged from its peak of US$146 per barrel in July, reeling from the repercussions of the global financial crisis. In the middle of the year, expectations were that oil prices would continue to surge, underpinned by high demand, supply constraints and other geo-political factors.

However, as the international financial crisis took a sharp downward turn in September, there were immediate concerns that demand for oil would decelerate as the major industrialised countries contracted and emerging economies slowed. Predictions of a global recession also added downward pressure on oil prices, which have plummeted sharply. Since its peak in July, crude oil prices fell by around US$100 in the space of 4 months to the lowest level in about 3½ years. These developments have undoubtedly eased domestic inflationary pressures.

Movements in underlying inflation, measured by the trimmed mean[1], was less volatile, rising by 3.3 percent in November. On the other hand, the CPI excluding volatile items tracked the movements of headline inflation, surging to 6.0 percent in September before dropping to 5.0 percent in November.

Looking at the sources of inflation, imported inflation trended largely in tandem with headline inflation (Graph 3). Imported inflation

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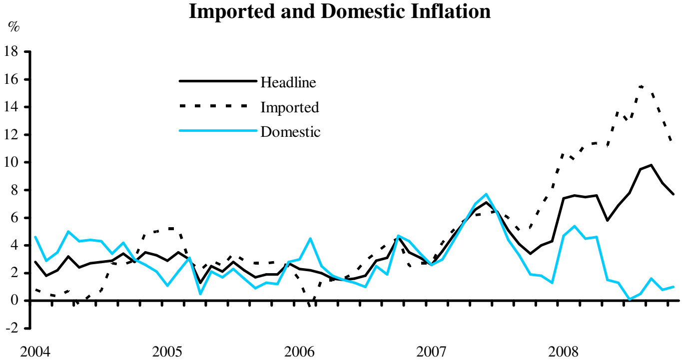
[1] The trimmed mean is calculated by removing 15 percent of the lowest and highest price changes and then computing the mean of the remaining price changes.

peaked at 15.5 percent in August before easing in November to 11.1 percent. Food and fuel prices continue to be the major contributors to the movements in import prices. Although global wheat prices have fallen since the beginning of the year, prices have remained high due to lags in the transmission to domestic wholesale prices. International wheat and other similar food prices have also eased on account of lower expected global demand, a consequence of the global financial crisis, as well as improved supply conditions.

Graph 3

Imported and Domestic Inflation



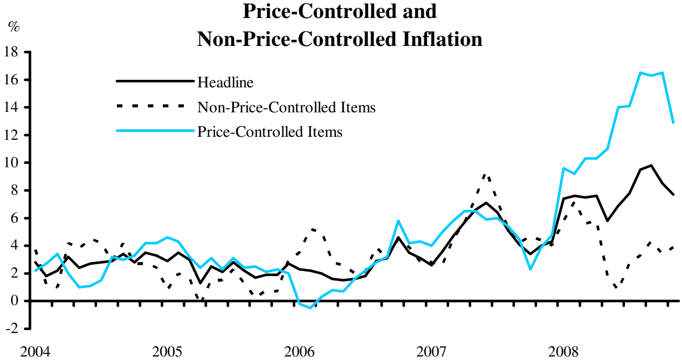
Sources: Reserve Bank of Fiji & Fiji Islands Bureau of Statistics

On domestic inflation, prices of locally produced goods and services generally fell throughout the year, registering at 1.0 percent in November. The fall was underpinned by the gradual restoration of the supply of market items, following earlier disruptions caused by Cyclone Gene in February.

Inflation movements can also be tracked via changes in prices of price-controlled and non-price-controlled items (Graph 4). Following revisions to the CPI base, price-controlled items now total around 52 percent of the total weight in the CPI basket, while non-price-controlled items make up the rest of the basket. Price-controlled items have continued to soar throughout the year, rising to 12.9 percent in November. This reflects the higher food and fuel prices, compared to a year ago. In contrast, prices of deregulated items initially fell during the first half of the year, before picking up in the latter months. The initial fall was consistent with the recovery of the supply of certain market items following Cyclone Gene. However, prices trended up as the second-round effects of rising energy costs filtered through.

Graph 4

Price-Controlled and Non-Price-Controlled Inflation

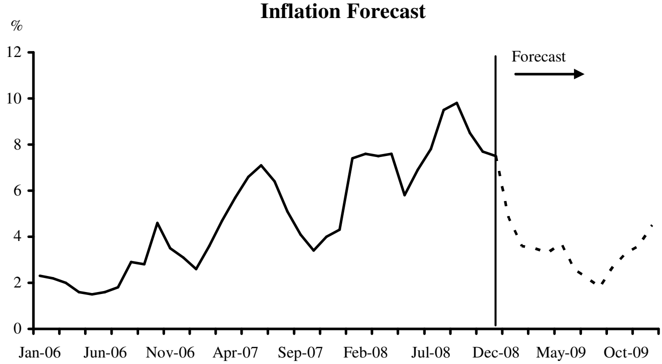


Sources: Reserve Bank of Fiji & Fiji Islands Bureau of Statistics

The **outlook for inflation** for the year-end remains unchanged at 7.5 percent (Graph 5). The recent announcement of an increase in FEA's electricity fuel surcharge, coupled with the various changes to import duties that Government listed in the 2009 National Budget are expected to be largely offset by the fall in oil prices. Furthermore, given that developments in international oil prices are transmitted to domestic prices with a lag of two months, the prevailing low crude oil prices are anticipated to see inflation ease further in the New Year. In addition, wages growth is expected to be minimal, given subdued labour market conditions, in line with the relatively low economic growth outlook.

Graph 5

Inflation Forecast



Source: Reserve Bank of Fiji

Inflation is forecast to ease to 4.5 percent by the end of 2009. The risks to this forecast include:

External:

- Stronger-than-anticipated world demand;
- Significant and unanticipated increase/decrease in international crude oil and food prices;

- Adverse currency movements; and
- Any other adverse external shock such as natural disasters.

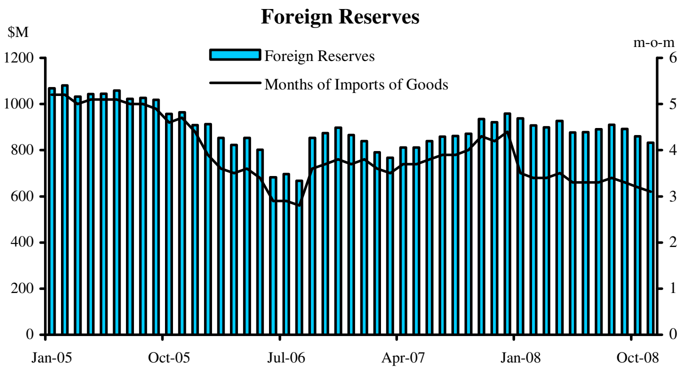
Domestic:

- Natural disasters;
- Changes in import duties and tax rates; and
- Wage growth beyond expectations.

Foreign Reserves Outcomes and Outlook

Official foreign reserves remained under pressure during the year. Foreign reserves have fallen to $832 million at the end of November, from $959 million recorded in December 2007 (Graph 6). The current level of foreign reserves is equivalent to around 3.1 months of imports of goods.

Graph 6



Source: Reserve Bank of Fiji

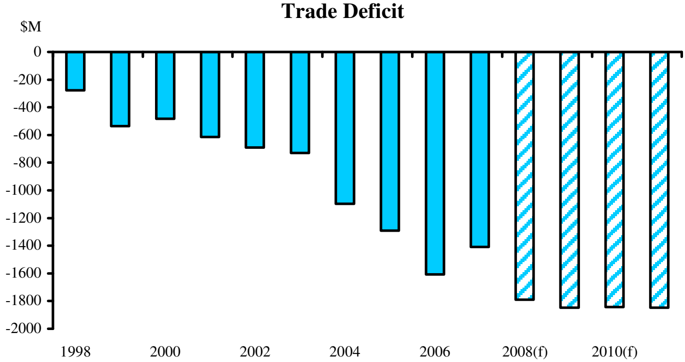
The pressure on reserves levels continue to stem from the significant trade deficit, forecast at $1.8 billion or 30 percent of GDP for 2008 (Graph 7). This compares with a revised trade imbalance of $1.4 billion for 2007 (around 26% of GDP).

Tourism receipts, personal remittances, and other services and transfer inflows are insufficient to offset the trade deficit. Consequently, the current account deficit is projected at around 21 percent of GDP for 2008. As the surplus in the capital and financial account is not enough to finance the current account deficit, foreign reserves continue to be drawn on to meet the BOP shortfall.

Moreover, the repercussions of the global financial crisis pose major downside risks for Fiji's external position. As discussed earlier, while Government has announced several measures to mitigate BOP pressures, the benefits are predicted to be reaped in the medium to long term. Consequently, risks to the BOP position remain in the short term.

Graph 7

Trade Deficit



Sources: Reserve Bank of Fiji & Macroeconomic Committee

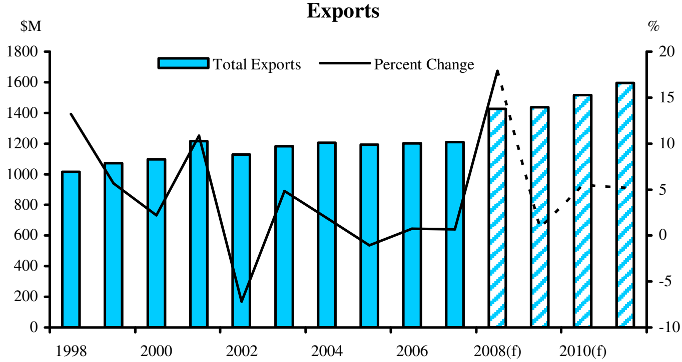
This year, total **export earnings** (excluding aircraft) are expected to expand by 17.9 percent (Graph 8), mainly driven by sugar, gold, mineral water, fish and timber, offsetting lower receipts from fruits & vegetables and textiles.

Exports (excluding aircraft) are forecast to slow to a growth of 0.8

percent in 2009, led by lower expected income from sugar, gold, re-exports, mineral water, fish and other domestic exports. For 2010 and 2011, it is expected that the growth in total exports (excluding aircraft) will average around 5 percent.

Graph 8

Exports



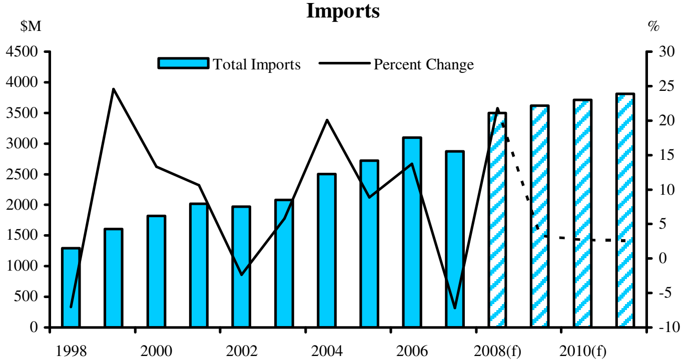
Sources: Reserve Bank of Fiji & Macroeconomic Committee

While exports are forecast to expand in the coming years, these gains are muted by expectations that **import** payments are also projected to increase. Following the decline in import outlays in 2007, imports are forecast to rebound this year to record a 21.8 percent growth (Graph 9), underpinned by a broad-based increase in payments for intermediate, investment and consumer goods. High international fuel and food prices have contributed to these increases, and to a lesser extent, a small recovery in domestic demand.

Next year, the growth in imports (excluding aircraft) is anticipated to ease to 3.3 percent, consistent with the expected fall in oil and food prices. The fall in import prices is projected to largely offset a pick up in domestic demand. In the following years (2010 and 2011), imports growth are forecast to remain subdued at close to 3.0 percent.

Graph 9

Imports



Sources: Reserve Bank of Fiji & Macroeconomic Committee

It is important to note that given the upward trend in imports over the years and in particular, the surge in imports this year, more foreign reserves are now needed to cover a month of imports of goods than before. This compounds the pressure on foreign reserves levels.

Tourism earnings recovered during the course of 2008 and are forecast to be around $754 million, an annual increase of 10 percent. Next year, tourism receipts are projected to expand by 5.1 percent, in line with higher expected visitor arrivals. Government has almost doubled the grant to the Fiji Islands Visitors Bureau (to be called Tourism Fiji from January 2009) in their planned Budget for the New

Year. This allotment is timely given that the industry faces major challenges in dealing with lower external demand for tourism, as Fiji's major trading partners have recently plunged into recession, a consequence of the global financial crisis.

Personal remittances continue to fall since reaching a peak in 2006. This year, remittances are forecast to decline further by 9.8 percent to $231 million and remain at around this level in the years ahead. Adverse exchange rate movements and weakening international labour conditions, following the global financial crisis, are expected to place downward pressure on inward remittances.

The overall consequence for the **foreign reserves outlook** is that the trade deficit and hence, the BOP deficit, is not expected to improve in the short term. Risks continue to weigh heavily on the downside and pressures on foreign reserves are likely to mount in the New Year.

In Government's efforts to address balance of payments pressures, the measures announced in the 2009 Budget aim to raise Fiji's export potential, while advocating import substitution policies and encouraging less reliance on mineral fuels. These initiatives are expected to affect the trade position in the medium to long term – both exports and imports are expected to rise. The increase in imports is anticipated to largely parallel the higher demand for capital goods, as investment activity picks up. In the short term, however, there is some concern over the dampening effect of the export duty levied on fish and timber exports, and the implementation of the water resource tax.

The impact of the global financial crisis is also a major downside risk to trade and Fiji's external position in 2009. Fiji's commodity exports will be affected as external demand falls. Hence, demand-driven exports, such as tourism, water and garments are likely to slow down. Tourism, in particular, is anticipated to be under threat from the fallout of the global financial crisis. With most of Fiji's major trading partners in recession, cutbacks on personal travel are likely. Personal remittances are also likely to decline further, as labour market conditions abroad deteriorate, leaving less money to send back home.

As with exports, the impact on imports will depend on exchange rate movements relative to our major trading partners, coupled with the type of imports out of the source markets, as well as considering the increase in import duty announced in the 2009 Budget. On balance, it is likely that the trade balance may worsen, adding pressure to an already weak BOP position.

Monetary Policy Decisions

During the course of the year, monetary policy continued to focus on developments in foreign reserves and inflation. Given that inflationary pressures originated from external economic forces, monetary policy was primarily focused on safeguarding foreign reserves.

The credit ceiling remained the key instrument of monetary policy, aimed at dampening credit for consumption purposes. At the same time, allowances are made for investment-related lending so as to stimulate domestic economic activity.

Lending for consumption purposes trended up during the year, rising by 11.3 percent at the end of October. However, the recent uptick is on account of the lower base recorded in the comparable period a year ago, rather than a signal of a sustained increase in consumption lending. Also, while imports of consumption goods have registered strong growth in the year to September (22.7%), it reflects the high food prices compared with a year ago, more than an increase in domestic demand for retail items. It is expected that the growth in credit for consumption and imports will moderate in the year ahead.

On a positive note, lending for investment gathered momentum since the middle of this year, rising by 16.5 percent in October. Since the implementation of the credit ceiling (until 21st November 2008), the

Reserve Bank has granted special loan approvals of $356 million, with approximately 44 percent going to the building & construction sector.

Furthermore, with prevailing excess liquidity, the commercial banks' weighted average lending rate continued to fall, registering at 7.78 percent in October. This should further boost lending for investment purposes.

To encourage foreign investment, the Reserve Bank relaxed the criteria on local borrowing by non-resident individuals. Exchange control guidelines were also amended in line with Government's introduction of a category for permanent resident status for former Fiji residents. These changes were aimed at encouraging former Fiji residents to return and contribute to the economy.

The gradual recovery in the economy also witnessed the relaxation of selected exchange controls. Delegated approval limits were raised for prepayment of imports, credit and debit card payments, travel, and other various payments.

Next year, inflation is expected to ease, while the pressure on foreign reserves is anticipated to continue. Therefore, monetary policy will continue to focus on protecting Fiji's external position.