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Statement by the Governor

The safeguarding of the twin objectives of monetary policy have been challenging in the first 5 months of the year. Under a modest economic recovery expected this year, inflation has risen, while foreign reserves remain under pressure. At the end of May, inflation was 5.8 percent, while foreign reserves were $878 million, around 3.8 months of imports of goods.

A comprehensive monetary policy review was conducted in April. We decided to retain the credit ceiling to address the risks to our projections on exports and the rise in oil prices. The credit ceiling is not constraining investment. Provisions are made for commercial banks to exceed their ceiling to lend to priority sectors, particularly related to investment and to small and micro enterprises.

With the ceiling in place, we have allowed liquidity to build up, which has led to a general fall in interest rates. The lower interest rates will offer some support to investment. In addition, we have relaxed certain exchange control policies related to non-resident borrowing. This relaxation should encourage much-needed foreign investment into the country.

We have revised the year-end 2008 inflation forecast up to 7.5 percent from 5.0 percent. This revision is a reflection of the persistent high international prices for crude oil and wheat, as well as higher expected inflation outcomes from our major trading partners.

Monetary policy is already tight and there is little that monetary policy can do to ease inflationary pressures. However, to help keep imported prices down, we have allowed commercial banks to enter into forward foreign exchange contracts with local importers of rice, wheat, flour, edible oils, and milk/milk powder to hedge against future price increases.

In the months ahead, monetary policy will continue to safeguard our twin objectives.

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Savenaca Narube

<u>Governor</u>

Monetary Policy Assessment and Key Issues

Overview

Globally, there is growing evidence that the world economy is slowing, underpinned by the repercussions of the United States (US) sub-prime mortgage crisis, as well as soaring crude oil and commodity prices. World economic growth is projected at 3.7 percent this year, compared to 4.9 percent in 2007. In addition, key macroeconomic data indicate an economic slowdown for all our major trading partners.

For Fiji, the economy is anticipated to rebound and grow by 1.7 percent this year from a contraction of 4.4 percent last year. Current economic conditions continue to be weak. Investment is generally subdued, with low private business sentiment, manifesting in sluggish labour market conditions. Consequently, consumer spending is restrained.

Against this backdrop, a comprehensive review of the current monetary policy package was conducted in April. The policy package was aimed particularly at safeguarding our foreign reserves levels by the implementation of a credit ceiling, as well as maintaining tight exchange controls. Given that inflationary pressures in 2007 stemmed from global supply constraints, there was little that monetary policy could do.

The main outcome from the review was that the current policy package was having its desired effect. At the end of December, foreign reserves were around $959 million, sufficient to cover 4.4 months of imports of goods. Inflation at the end of 2007 was 4.3 percent.

The continuation of the credit ceiling was deemed appropriate as it maintained a cap particularly on lending for consumption purposes, which have been spurring imports of consumption goods, negatively impacting reserves levels. Furthermore, banks are allowed to exceed the ceiling but only for lending to priority sectors, particularly related to investment. Therefore, the credit ceiling simultaneously restrains credit to non-priority sectors, but channels funds to investment activities. Interest rates have also fallen as a result of the Bank's decision to allow liquidity to rise, which should further support priority sector lending.

Looking ahead, the pressure on foreign reserves is unlikely to abate in the near term. Recent macroeconomic projections indicate that while exports are anticipated to post some gains into the following years, the import bill is still expected to remain significant, owing to higher fuel prices, as well as an anticipated pick up in demand as the economy recovers. As a result, the trade imbalance is projected to continue to exert pressure on foreign reserves levels. This is the main reason for the continuation of the current policy package.

However, the recent stability of foreign reserves levels has allowed the relaxation of exchange control guidelines on local borrowing by non-residents. The Bank is mindful of the need to raise investment for long term economic sustainability and will continue to review its policies to ensure that incentives for investment are in place to support the economic recovery, where viable.

In the first few months of 2008, public attention was invariably on rising domestic prices, hard hit by soaring global fuel, food and dairy prices. Inflation has been above 7.0 percent for four consecutive months since January. However, at the end of May, inflation was 5.8 percent, partly due to the higher base in May last year when inflation was 6.6 percent. The lower inflation outcome was also due to some improvement in the local supply of vegetables and root crops. Foreign reserves have held up well, registering $878 million in May, about 3.8 months of imports of goods.

The factors leading to the current high domestic inflation outcomes stem largely from the global supply constraints in the market for oil, food and dairy products. Oil prices have recently surpassed US$130 per barrel, reflecting the excess demand over supply, particularly from China and other emerging economies, supply disruptions in oil-producing nations and amidst continued geo-political tensions in the Middle East. This has filtered into our oil-dependent economy in the form of higher fuel prices, higher transportation charges and higher overall energy costs.

The higher prices for international food and dairy products are also mainly a result of supply shortages brought on by adverse weather conditions, particularly the drought in Australia, and the trend towards bio-fuels by industrialised countries in the face of higher oil prices. These factors are contributing to the global shortage, which has seen food and dairy prices escalate. Local prices of milk, bread and rice, amongst others, have increased significantly in recent months.

The prevailing high prices for global crude oil and wheat has led to the upward revision to the 2008 year-end inflation forecast. Inflation is now forecast at 7.5 percent, up from the previous projection of 5.0 percent. Higher anticipated inflation outcomes of our major trading partners are also underpinning the upward revision.

Given that the factors underlying these price increases are due to global supply shortages, monetary policy is unable to directly influence and temper these increases. However, to mitigate the impact, the Bank in mid-May relaxed parts of its Forward Foreign

Exchange Cover Facility – commercial banks can now enter into forward foreign exchange contracts with local importers of rice, wheat, flour, edible oils and milk/milk powder to hedge against future price increases. This measure, alongside the fiscal measures put in place (removal of duty on certain items and the increase in the tax threshold) should assist the public during these trying times.

In the months ahead, monetary policy will continue to focus on safeguarding its dual objectives of maintaining an adequate level of foreign reserves and ensuring low inflation. The Bank recognises the weak state of the economy with low growth prospects, high inflation and continued pressure on foreign reserves. It will continue to be proactive in its policies to ensure a balanced and orderly economic recovery.

Macroeconomic Assessment with Key Outcomes

Internationally, the repercussions of the US sub-prime mortgage crisis have led the International Monetary Fund (IMF) to downgrade world economic growth twice, in January and April, to 3.7 percent. Global growth prospects have also been lowered due to soaring crude oil and commodity prices. Rising inflation is now a growing global concern. As such, the central banks of our major trading partner countries have left their respective key interest rates unchanged to contain inflationary pressures.

The risks to world growth are firmly on the downside, given the possibility that the international financial strain could deepen. Other risks include continuing inflation worries, especially in the wake of increasing commodity prices.

This year's growth projection for the US was also revised down to 1.3 percent amidst fears of a recession. US business and consumer sentiment are at extremely low levels, as economic conditions worsen from the financial market crisis. Similarly, the growth momentum of Fiji's other major trading partners has receded – Australia's economy is anticipated to slow to 3.2 percent in 2008 due to higher interest rates, tight credit conditions and the global slowdown.

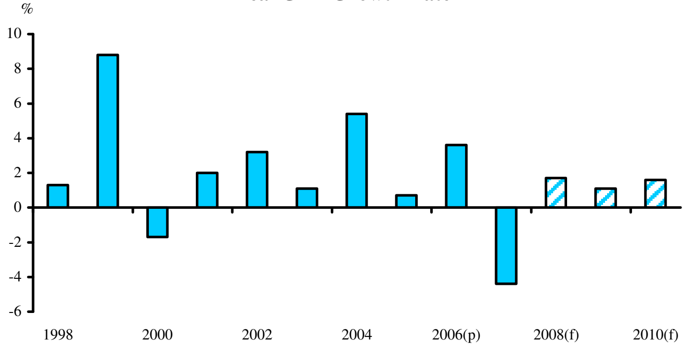
New Zealand's economic growth is projected at 1.6 percent, much lower than the 3.0 percent recorded last year, following declines in household consumption and investment. The Japanese economy is expected to slow to 1.3 percent in 2008, underpinned by lower private and industrial production. Economic activity in the Euro-zone is also forecast to decelerate to 1.5 percent this year, driven by a slowdown in investment and private consumption.

The global economic slowdown, particularly developments in our major trading partner countries, does not bode well for Fiji's economy. In particular, demand for our exports of goods and services are anticipated to be adversely affected by these developments. This exacerbates the current situation where exports are performing below potential.

Domestically, **economic growth** prospects have been revised downwards from earlier projections. Fiji's economy is estimated to have contracted by 4.4 percent in 2007, compared to the 3.9 percent decline projected in October last year (Graph 1). Economic growth for 2008 is now forecast at 1.7 percent, down from the 2.2 percent announced in October last year.

Graph 1

Real GDP Growth Rate



Sources: Fiji Islands Bureau of Statistics & Macroeconomic Committee

The downward revisions are led mainly by developments in the sugar industry. In 2007, the industry was adversely affected by various natural disasters, including flash floods and drought, as well as mill disruptions. This year the sugar industry was negatively impacted by Cyclone Gene and the industry stakeholders have also expressed pessimism on production levels.

Moreover, while the repercussions of the 2006 political crisis have largely been incorporated in earlier forecasts, lower-than-expected investor sentiment has led to further downward revisions, particularly for the building & construction sector. Business sentiment is anticipated to be more flat and prolonged than earlier forecast. Lastly, particularly for 2008, lower-than-anticipated Government expenditure is projected to lower growth outcomes.

While an economic recovery is still expected in the next 2 years, it is lower than earlier projected. The economy is forecast to grow by 1.1 percent in 2009 and 1.6 percent in 2010. Furthermore, it may take more than three years for the economy to reach output levels of 2006.

Consumption spending remains weak, evident by partial indicators – credit extended for consumption purposes has slowed considerably to 4.7 percent in April from 6.1 percent recorded a year ago. Income levels are likely to be lower, contributing to subdued consumer spending, as proxy indicators like newly registered taxpayers and personal remittances registered a decline of 13.0 percent and 33.4 percent in the year to March and February, respectively.

Some indicators, such as Net Value Added Tax collections and imports of consumption goods, suggest a pick-up in spending in the early months of the year. However, these may be explained by a price effect resulting from high local and imported inflation. On a positive note, Pay As You Earn collections have risen to 1.7 percent in the year to March and if this trend continues, this is expected to support consumer spending.

The upward movement of the income tax threshold will have a similar positive impact on consumption. Also, recruitment intentions, as indicated in the March Job Advertisements Survey, have improved, while the better-than-expected outturn in visitor arrivals in April (14% higher than last year), augurs well for a pick up in consumer spending in the months ahead.

Investment conditions also remain weak, as indicators suggest that investment decisions continue to be on hold. The cumulative annual growth rate of commercial banks' investment lending slowed to 6.3 percent in April in comparison to a growth of around 30 percent a year ago. In addition, imports of investment goods this year are lower than last year's levels as chemicals and machinery and transport equipment, major inputs for building and construction, continue to wane. Moreover, while the number of jobs advertised rose by around 14 percent over the year to March, it is difficult to apportion this increase between rising business optimism and vacancies left by the emigration of skilled workers. On balance, it is likely that business confidence remains depressed.

Cashflow data reveal that **Government** posted a deficit of 1.3 percent of GDP for 2007, lower than the revised 2006 deficit of 2.9 percent of GDP. Total revenue collections were marginally higher than levels collected in 2006, while total expenditure fell by around 6 percent. Over the year, current spending fell by around 4 percent, while capital outlays declined by around 15 percent. This outturn reinforces the downward revisions made to growth estimates for 2007, given the influence that Government expenditure has on the economy. This is also consistent with the decline in credit to Government in 2007, reflecting the lower domestic financing requirement. For 2008, Government is anticipated to record a deficit of 1.9 percent of GDP, which should provide some growth stimulus.

The merchandise **trade** deficit deteriorated further – cumulative to March the trade imbalance worsened to $418 million from $409 million a year ago. Export earnings rose by around 27 percent, compared with a decline of around 8 percent in 2007, driven mainly by re-exports, sugar, mineral water and fish. On the other hand, import payments rose by around 11 percent, compared with a decline of 6 percent last year, led by higher outlays for intermediate and consumption goods.

Inflation Outcomes and Outlook

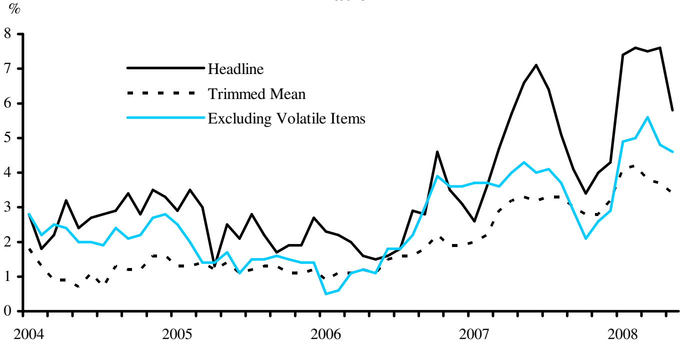
The year-end inflation rate for 2007 was 4.3 percent, higher than the 3.1 percent recorded in 2006. The increase was mainly driven by higher food and oil prices.

Although there was a reduction in the percentage mark-up allowed by the Prices and Incomes Board in September and a fall in the electricity surcharge in December, these were more-than-offset by the second round effects of soaring oil and food prices.

In the first four months of 2008, consumer prices have risen significantly, peaking at a 10-year high of 7.6 percent in April (Graph 2). Soaring global oil prices filtering through via domestic fuel prices, transportation costs and electricity surcharges underpinned the notable increase in consumer prices. Moreover, food prices are persistently high on the back of rising costs of wheat, dairy and cereal products caused by droughts in Australia. This has led to an increase in prices of their respective down-the-line products. However, at the end of May, inflation slowed to 5.8 percent. This is partly attributed to base-related effects and a decline in food prices as a result of local supply restoration of some vegetables and root crops.

Graph 2

Inflation



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

Underlying inflation, measured by the trimmed mean[1], has risen to 3.4 percent compared to 3.2 percent at the end of last year. The Consumer Price Index (CPI) excluding volatile items, another measure of underlying inflation, has also surged to 4.6 percent in May. In line with rising headline inflation, underlying inflation has also been trending upwards.

Many factors have contributed to the higher crude oil prices since the second half of 2007. These include the robust growth in oil demand in major emerging economies, such as Brazil, China and India, as well as strong demand for energy in mature economies, like the US, Europe and Japan. In addition, the weakness of the US dollar has increased financial market speculation and made oil cheaper for other currency holders, thus raising the demand for oil.

[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.

At the same time, several constraints have emerged on the supply side. These include geo-political concerns in the Middle East, which have raised questions about the stability of supply. The major concern over oil supplies is from Nigeria, following ongoing political tensions and the sabotage of major oil pipelines. There is also limited spare supply capacity by the Organisation of Petroleum Exporting Countries (OPEC) and the weak supply performance of non-OPEC oil producing countries. These developments are happening against a backdrop of dwindling refinery capacities and breakdowns.

While some of these factors are largely temporary, continued growth in demand (especially from the emerging economies) and market speculation, attributed to the weakening US dollar, could see oil prices continue to escalate. Oil prices recently peaked at slightly over US$130 per barrel.

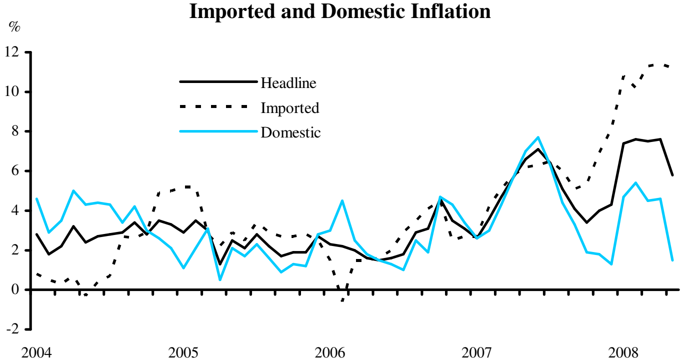
Moreover, prices for wheat, dairy and rice have also soared. Much of this increase is due to supply constraints, a consequence of the drought in Australia, as well as production declines in the US. The US is the largest producer of wheat and its production has been affected by unfavourable weather conditions. The higher wheat prices have affected dairy prices, as wheat serves as food for cattle. In addition, industrialised countries have started producing bio-fuels, in the face of the high oil prices, which has also contributed to the increase in food prices.

Inflation can also be studied from an imported and domestic inflation viewpoint. In the CPI basket, around 45 percent of the items are imported as final or intermediate goods. The other 55 percent is produced domestically. These include goods and services such as market produce, housing rental, services and fees.

Imported inflation in May was 11.2 percent, a significant increase from 2.7 percent and 8.1 percent at the end of 2006 and 2007, respectively (Graph 3). Inflation pressures from imported items continue to influence domestic prices due to episodes of droughts in Australia which have raised the prices of imported dairy and wheat products.

Graph 3

Imported and Domestic Inflation



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

Additionally, the stronger Australian dollar is also placing some upward pressure on prices of imported goods. This is despite the changes in import and excise duties in the 2008 National Budget, which was expected to ease inflation.

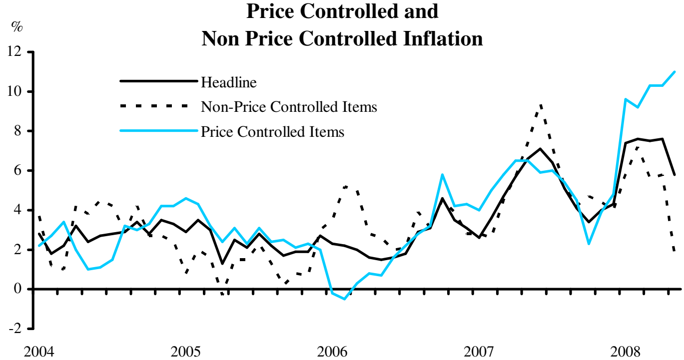
On the domestic front, the increases in prices of locally produced goods and services have risen from 1.3 percent at the end of 2007 to 4.6 percent in April before slowing to 1.5 percent in May. Food prices have contributed significantly to the domestic inflation rate of 5.8 percent in May, largely owing to the exorbitant prices of vegetables and root crops over the year. Supply shortages following Cyclone Gene and expensive fertiliser, together with costly transportation charges, have contributed to this outturn.

Movements in the inflation rate also reflect changes in prices of price-controlled and non-price controlled items. Price controlled items total around 49 percent of the total weight in the CPI basket, while non-price controlled items make up the rest of the basket. Price controlled inflation rose to 11.0 percent in May from 4.3 percent in 2006 and 4.8 percent last year (Graph 4). The increase reflects a rise in prices of selected regulated items arising from higher import costs of sharps, petrol, flour and powdered milk. On the domestic front, charges for bus fares (by 10%), taxi flag fall rates (by 50%) and rent for private dwellings increased. The approval for the increase in bus fares and taxi flag fall rates were based on increasing global oil prices.

On the other hand, prices of deregulated items have fallen from 2.8 and 4.0 percent at the end of 2006 and 2007, respectively to 1.8 percent in May. This was mainly led by lower prices of some non-regulated food items (beans, carrots, cucumbers, tomatoes).

Graph 4

Price Controlled and Non Price Controlled Inflation



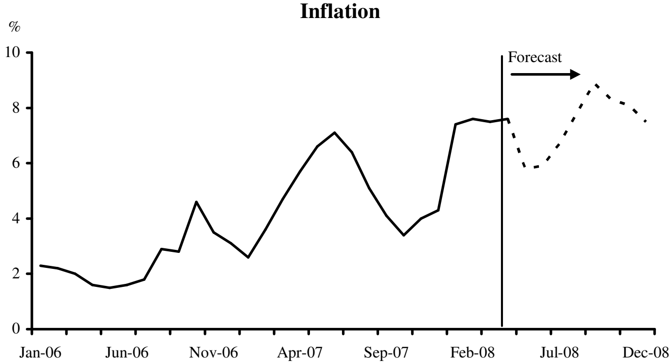
Sources: Reserve Bank of Fiji & Fiji Islands Bureau of Statistics

The **outlook is for inflation** to rise in the short term before stabilising at modest levels in the medium term. The inflation forecast for this year has been revised upwards to 7.5 percent from 5.0 percent projected earlier. Upside risks exerted by higher crude oil and wheat prices, as well as expectations of higher inflation outcomes for our trading partners underpinned this revision.

Despite a weak economic performance in 2007-2008, prices have risen to the highest level in a decade. This increase is principally attributed to the persistent and volatile global energy and wheat prices. Exorbitant prices of crude oil have passed on to transport costs and electricity surcharges, while higher wheat costs have been reflected in rising prices of flour and sharps and down-the-line products such as bread and breakfast crackers. Moreover, the cost of rice has been increasing and is expected to remain high in the coming months.

Graph 5

Inflation



Source: Reserve Bank of Fiji

The potential risks to the above inflation forecast include the following:

External:

- 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.

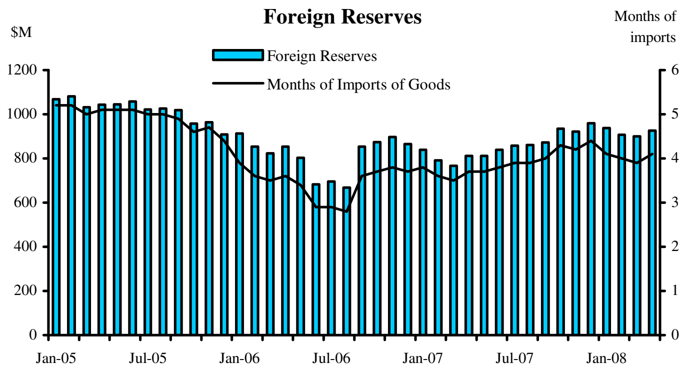
Domestic:

- Natural disasters;
- Changes in import duties and tax rates;
- Revision of the CPI basket based on the 2002 Household Income & Expenditure Survey; and
- Wage growth beyond expectations.

Foreign Reserves Outcomes and Outlook

Official foreign reserves levels have been under pressure for some time now. Looking at the last 3 years, the foreign reserves level at the end of 2004 was around $1,097 million – this fell to $668 million in August 2006 (Graph 6). Several policies were implemented to bolster foreign reserves and by the end of 2007, reserves recovered to $959 million, equivalent to around 4.4 months of imports of goods.

Graph 6

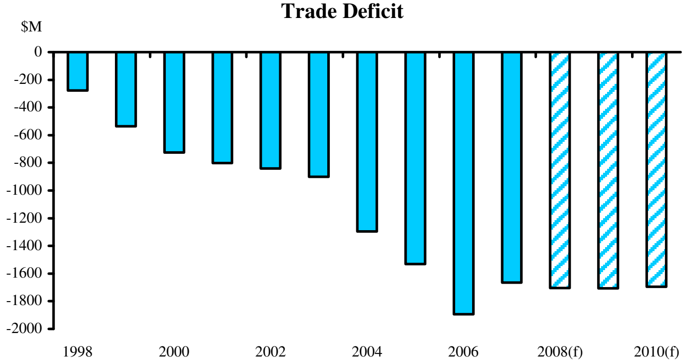


Source: Reserve Bank of Fiji

Developments in the Balance of Payments (BOP) underpin the movements in foreign reserves. The pressure on foreign reserves stems largely from the extremely wide trade deficit, around $1.7 billion or 30 percent of GDP for 2007 (Graph 7). The surplus in the services account (from tourism receipts), and positive balance on current transfers (led by remittances), falls short of the trade and net income deficit. Hence, the current account deficit for 2007 is quite significant at around 23 percent of GDP. The surplus in the capital and financial account is also unable to offset the current account deficit. Consequently, foreign reserves are constantly drawn down to meet the BOP deficit.

Graph 7

Trade Deficit



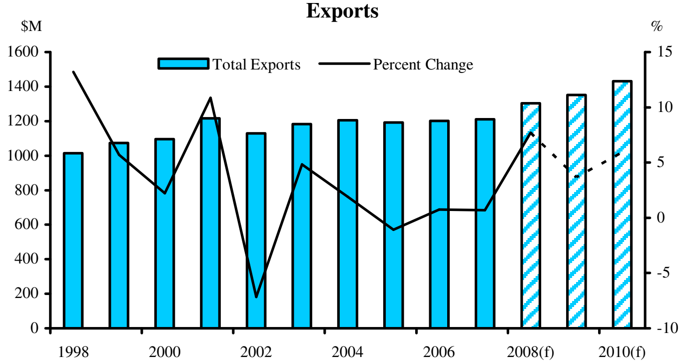
Sources: Reserve Bank of Fiji & Macroeconomic Committee

Like many small developing countries, Fiji has a relatively narrow export base. Fiji's domestic **exports** are largely made up of traditional commodities like sugar, timber, gold and fish. Non-traditional exports, like garments, emerged in the early 90s but have recently waned, due to the cessation of preferential access to major markets. More recently, mineral water exports have featured prominently as a major foreign exchange earner. Overall, though, exports have been performing below potential.

In 2007, exports rose by around 0.7 percent, compared with an increase of around 0.8 percent in 2006 (Graph 8). Leading the increase in receipts were other domestic exports, mineral water, re-exports, timber, fish, fruits & vegetables, sweet biscuits, flour and uncooked pasta. These more than offset the declines recorded in exports of gold, sugar, molasses and corned meat of bovine animals and coral & similar materials.

Graph 8

Exports



Sources: Reserve Bank of Fiji & Macroeconomic Committee

This year, exports are forecast to grow at a higher pace of 7.7 percent driven by gold, re-exports, mineral water, fish and timber. This is expected to offset the negative contributions from sugar, other domestic exports and garments.

Exports growth is projected to slow to 3.7 percent in 2009 – gold, other domestic exports, mineral water and fish being the main drivers. Nevertheless exports are forecast to pick up (5.9%) in 2010 led by sugar, re-exports, other domestic exports, gold and mineral water.

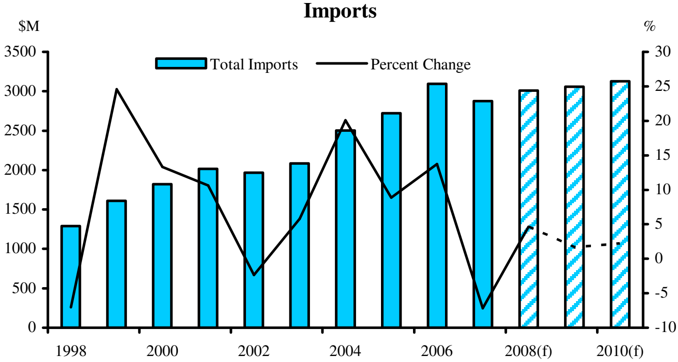
Fiji's **imports** performance is largely influenced by strong domestic activity and demand, trade reforms such as tariff/duties reduction, international commodity prices, amongst others. Goods imported into Fiji are divided into three broad categories; consumption, investment and intermediate goods.

Looking at the average over the past 10 years, 46 percent of total imports were consumption goods, of which imports of manufactured goods are the largest portion. Investment goods made up 30 percent of total imports, with machinery and transport equipment being the largest component – a sharp increase in this sector was noted between 2004 and 2006. This reflects relatively higher imports of road vehicles, general and specialised industrial machinery, and telecom and sound equipment. On the other hand, total imports of intermediate goods amounted to around 24 percent of total goods imports. Clearly, mineral fuel is the major component of intermediate goods, showing a significant increase over the years, mainly reflecting higher international oil prices.

In 2007, total imports (excluding aircraft) declined by 7.2 percent, compared with an increase of 13.7 percent in 2006, reflecting the weak economic conditions (Graph 9). The slow down in imports growth was broad based and was led by the decline in imports of investment goods (4.0%), attributed to lower payments for machinery transport equipment and chemicals. The decline in intermediate goods (2.0%) was attributed to mineral fuels and crude materials. The decline in payments for consumption (1.5%) goods was led by manufactured goods, miscellaneous manufactured articles and beverages & tobacco. Excluding mineral fuels, imports declined by 8.1 percent compared to 8.5 percent growth in 2006.

Graph 9

Imports



Sources: Reserve Bank of Fiji & Macroeconomic Committee

Imports are forecast to grow by 4.6 percent in 2008 and moderate to a growth of 1.7 percent in 2009 and 2.2 percent in 2010. These projections mirror developments in the growth outlook, particularly domestic demand.

Tourism earnings and personal remittances account for the two major foreign exchange earners. However, these earnings have been negatively impacted by the 2006 political crisis.

In 2007, tourism earnings are estimated to have fallen to $686 million, mainly as a result of the repercussions of the coup in December 2006. The decline in earnings is consistent with the lower visitor arrivals estimated for the year. For 2008, earnings are expected to increase by around 5.9 percent to $726 million, and gradually thereafter to $756 million in 2009 and $811 million in 2010. These projections mirror the expected recovery in visitor arrivals, assuming a modest growth. So far this year, visitor arrivals have been above forecasts and could surpass projections, which has a positive impact on tourism earnings.

In 2007, remittances fell by around 20 percent to $256 million. This is possibly due to various reasons such as the cautious stance taken by remitters following the political events of December 2006, a strong Fiji dollar against those of the remitting countries, expiry of contracts for Fiji personnel serving abroad etc. For the years ahead (2008-2010), personal remittances are expected to remain flat at $256 million.

The **foreign reserves outlook** mirrors developments in the BOP. Looking at the latest projections, the trade imbalance is still anticipated to persist – while exports are anticipated to post some recovery, imports growth is forecast to remain strong. Tourism earnings and remittances are anticipated to mitigate the trade deficit to some extent – tourism earnings are expected to recover quite rapidly and reach new highs by 2010 although remittances flows are forecast to remain relatively flat.

Therefore, with the high trade deficit projected to continue into the years ahead, the pressure on foreign reserves is expected to remain. The current monetary policy package in place, particularly the credit ceiling, will ensure that the growth recovery is not on the back of consumption, as this will spur imports of consumption goods, weighing on reserves levels. Outcomes on foreign reserves and changes to key predictive variables will continue to be monitored to ensure that reserves levels are safeguarded.

Monetary Policy Decisions

Monetary policy judgements are guided foremost by the outcomes and outlook in our twin objectives – to ensure low inflation and maintain an adequate level of foreign reserves. Inflation has risen, underpinned by supply constraints, mostly internationally and to a lesser extent, locally. Monetary policy is unfortunately unable to dampen these inflationary pressures. Instead, monetary policies have concentrated on safeguarding foreign reserves, which has been under pressure for some time now. A comprehensive monetary policy review was conducted in April, which set the basis for our monetary policy decisions.

Given the grave concerns on the outlook for foreign reserves, particularly in the aftermath of the December 2006 political crisis, the Reserve Bank decided to put aside its market based approach to implementing monetary policy and instead adopt a pragmatic strategy that is more effective in such a crisis situation. This is in the form of the credit ceiling.

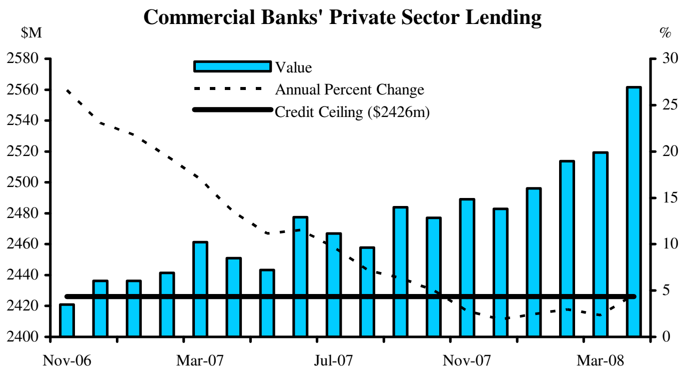
The credit ceiling was used to address the extremely strong level of credit growth, which averaged around 25 percent in 2006. In particular, credit for consumption purposes grew robustly over this period, which fuelled imports of consumption goods, widening the trade deficit and straining reserves levels.

The credit ceiling limited lending by commercial banks to levels prevailing at the end of November 2006. This ceiling ensures that credit, particularly for consumption, is restricted so as to dampen import demand for consumption goods, ultimately alleviating the pressure on foreign reserves. However, provisions are made for commercial banks to exceed their ceiling and lend to priority sectors.

Looking at outcomes in 2007, the credit ceiling has had its desired effects – the annual growth rate of total lending by commercial banks slowed to around 2 percent in December 2007 from 21 percent in December 2006. Importantly, lending for consumption purposes slowed to 0.04 percent from 11 percent in the same review period. Mirroring these credit developments, merchandise imports have fallen. Accrual data indicate that merchandise imports fell by 7.2 percent in 2007, led by a broad based decline in investment, consumption and intermediate goods. The decline in imports can be attributed to the overall downturn in economic activity in 2007, a consequence of the political crisis, as well as from the monetary policy measures. Foreign reserves also stabilised by the end of 2007 at around $959 million.

This year, the decision to maintain the credit ceiling was based on the outlook on foreign reserves, which is still expected to remain under pressure, as well as ensuring that the credit ceiling was not unnecessarily restricting investment. In this regard, since its inception, commercial banks have been allowed to extend credit beyond their limits for priority sectors. Lending for investment is particularly encouraged. Since the imposition of the credit ceiling (until 28th May 2008), the Reserve Bank has granted special loan approvals of $228.6 million. Almost 52 percent of the special approvals were designated for building & construction purposes. In fact, total commercial bank credit, which accounts for these special approvals, have been above the ceiling (Graph 10).

Graph 10



Source: Reserve Bank of Fiji

Moreover, given the high level of liquidity in the system, interest rates have fallen. Commercial bank’s weighted average interest rate on lending has fallen to 8.01 percent in April, from 9.73 percent a year ago. This augurs well for future investment lending.

Thus, while the credit ceiling works towards safeguarding foreign reserves, it also provides an additional lever to steer credit to areas that continue to support growth in the medium term. Nevertheless, overall demand for credit remains subdued given the weak economic climate.

In line with the concerns on foreign reserves, exchange controls have been relatively tight in the past year. However, given that foreign reserves have held up well so far this year, certain exchange control policies were relaxed. Local borrowing guidelines for non-resident companies and individuals were relaxed given the need to raise investment to support long term economic growth.

The specific changes to this policy include raising the maximum local financing percentage by 10 percent, depending on non-resident ownership. For 51-70 percent non-resident ownership, the maximum local financing percentage was increased to 85 percent from 75. For 71-90 percent non-resident ownership, the maximum local financing was raised to 75 percent from 65. For 91-100 percent non-resident ownership, the maximum local financing was increased to 60 percent from 50.

The 2008 year-end inflation forecast was revised up to 7.5 percent from 5.0 percent. To mitigate the impact of current high inflation outcomes, the Bank relaxed parts of its Forward Foreign Exchange Cover Facility. Commercial banks can now enter into forward foreign exchange contracts with local importers of rice, wheat, flour, edible oils and milk/milk powder to hedge against future price increases. This measure, alongside the fiscal measures put in place (removal of duty on certain items and the increase in the tax threshold) should assist the public during this high inflation episode. Specifically, it is hoped that the policy will reduce the import costs on these food items, the benefits of which will be passed on to consumers.

In the months ahead, the priority for monetary policy will be to closely monitor foreign reserves levels and inflation outcomes. Changes to any policy will be guided by outcomes in these dual objectives, balanced with the need to stimulate growth, where viable. On this note, while monetary policy will make every effort to implement policies that will stimulate growth, its overriding concern is to protect its twin objectives. Safeguarding these objectives is critical in building a strong foundation for sustainable growth in the long term.