RESERVE BANK OF FIJI

QUARTERLY REVIEW

September 2006

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OVERVIEW

Prospects for a stronger global economy firmed during the September quarter, with the International Monetary Fund (IMF) raising its world growth forecast for 2006 to 5.1 percent, from 4.9 percent projected earlier in the year. Solid expansions from the US economy, Japan, the Euro-zone and key emerging markets were the underlying sources of optimism.

On balance, risks to this year's forecast growth performance remain. Whilst crude oil prices have fallen somewhat, the levels are still high and could possibly spiral upwards over the coming months, on the back of strong demand. Furthermore, geo-political tensions and terrorism threats continue.

Fiji's major trading partners' growth scenario is encouraging. The US, Australian, Japanese and Euro-zone economies are anticipated to grow, driven by rising exports, domestic demand and business investment. However, New Zealand's growth forecast is for moderate economic expansion, underpinned by anticipated sluggish consumer spending.

To combat potential pressures on inflation, some central banks raised their official interest rates. In particular, Australia, Japan and the Euro-zone tightened monetary policy during the review quarter.

In the international financial markets, equities generally rose, while bond markets recorded a mixed performance. The US dollar weakened against all of Fiji's major trading partner currencies, except for the Yen.

Domestically, partial and forward-looking indicators assessed during the September quarter showed a firmer positive outlook for Fiji's growth this year, which is forecast at 3.6 percent.

Domestic demand strengthened further during the September quarter. Higher Value Added Tax collections, a faster pace in growth of consumption-related imports, relatively excessive commercial bank lending for consumption and somewhat firmer labour market conditions all support resilience in consumer spending. Investment spending also continues to be buoyant, largely observed through increased lending for investment purposes and greater imports of investment-related goods. Survey results also confirm optimism in general business conditions and investment plans into the short and medium term.

On the production side, the pattern of economic growth across the real sector is mixed. Whilst the tourism, electricity, fisheries and building & construction sectors performed well during the review period, weak performances recorded by the sugar and cane, garments, timber and mining industries continue to weigh negatively on economic growth. Looking ahead, no major significant change in the industry-specific outlook is anticipated.

In the year to September, inflation was 2.8 percent, while the underlying measure, the trimmed mean, was 1.8 percent. Looking ahead, the approved electricity fuel surcharge made effective in October will have an impact on the inflation outlook. The year-end inflation forecast however,

remains at around 3.5 percent.

Employment conditions improved during the review quarter. The number of registered taxpayers with the Fiji Islands Revenue & Customs Authority (FIRCA), a partial indicator of employment, rose in the first nine months. Forward looking survey results, in particular the Bank's September Survey of Job Advertisements and the Fiji Employers Federation's (FEF) Survey both showed optimism in hiring intentions over the last quarter of the year and into the medium term. Wage growth is anticipated to be modest in the medium term.

The fiscal sector anticipates a budgeted underlying deficit of $232 million or 4.7 percent of GDP for 2006. In August, Cabinet approved a redeployment of $58.3 million from the existing budget to meet Government's extra budgetary demands for 2006, principally for Cost of Living Adjustment commitments. Furthermore, Government made its first ever global bond offering of US$150 million in September, with a coupon rate of 6.875 percent. Funds are expected to be channelled towards financing investment-related projects. Total Government outstanding debt is forecast at 52.2 percent at the end of 2006.

On the external front, Overseas Exchange Trade (OET) data showed that merchandise exports, cumulative to August, fell by around 12 percent over the year. This was due to lower receipts from sugar, ginger, fish, mineral water, textiles, clothing & footwear and other re-exports. Merchandise imports on the other hand, rose by around 9 percent, driven by higher demand for all categories of import goods.

Foreign reserves at the end of September were around $817 million, sufficient to cover 3.4 months of import payments of goods.

The Reserve Bank's monetary policy stance remained unchanged during the third quarter, with the target interest rate on 91 day RBF Notes maintained at 4.75 percent. However, the impact of monetary policy tightening measures implemented during the first half of the year continued to filter through. The weighted average lending rate on commercial bank outstanding loans rose to 7.65 percent at the end of August. Likewise, savings and time deposit rates both continued to rise.

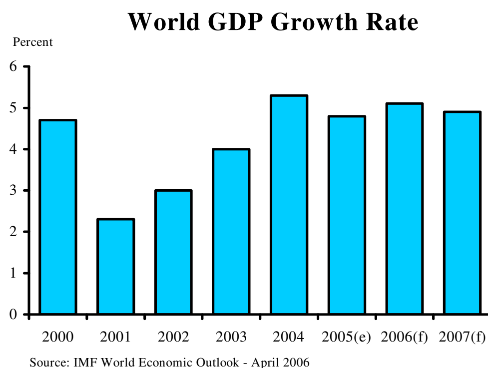
THE INTERNATIONAL ECONOMY

International Economic Conditions

World economic and financial conditions remained buoyant in the third quarter, with economic performances in most regions meeting or exceeding expectations. Growth was particularly strong in the US and Japan, while activity in the Euro area gathered pace. Emerging markets also grew rapidly, especially China, and low income countries maintained an impressive growth performance, helped by strong commodity prices. Consequently, the IMF has revised its projection for this year's global economic growth to 5.1 percent, from 4.9 percent envisaged earlier in the year (Graph 1). Growth is expected to moderate to 4.9 percent in 2007.

Graph 1[1]

World GDP Growth Rate



Source: IMF World Economic Outlook - April 2006

Nevertheless, downside risks could hinder this optimistic global growth outlook. Foremost, despite the recent downward movement in international crude oil prices, risks still remain. Crude oil prices could rebound over the coming months, on the back of strong demand or supply reductions by the Organisation of Petroleum Exporting Countries (OPEC).

Consequently, inflationary pressures could intensify, prompting further monetary policy tightening, which could derail the current pace of growth. Finally, geo-political tensions and terrorism threats could also slow global economic growth prospects.

In response to the inflationary pressures, some central banks increased their official interest rates. In particular, Australia, Japan and the Euro-zone tightened monetary policy during the review quarter.

Over the September quarter, in the international financial markets, equities generally rose, while bond markets recorded a mixed performance. The US dollar weakened against all our major trading partner currencies except for the Yen.

Of our major trading partners, economic performance for Australia, the US, Euro-zone and the Japanese economies remain encouraging, buoyed by rising exports, domestic demand and business investment. However, New Zealand's economic growth is expected to moderate, underpinned by an anticipated slowdown in consumer spending (Graph 2).

[1] Note: (e) - estimate, (f) - forecast.

Graph 2

The **Australian** economy grew at a modest pace of 0.3 percent in the June quarter, following a 0.7 percent growth during the previous quarter. The slow down in growth was led by a decline in consumer spending, depletion of stockpiles by companies as well as sluggish business spending.

Recent indicators showed mixed economic trends during the review quarter. An index of leading economic indicators surged in July, while retail sales gained in August. Moreover, manufacturing activity expanded and the unemployment rate fell in July.

However, business confidence dropped in July, after rising fuel prices and higher interest rates raised companies' operational costs.

In response to rising inflationary pressures stemming from higher energy prices, the Reserve Bank of Australia (RBA) raised its benchmark interest rate by 25 basis points to 6 percent in August.

The economy is forecast to grow by 3.1 percent this year, following 2.5 percent growth in 2005. Consumer prices are expected to increase to 3.5 percent this year, higher than the 2.7 percent in 2005, outside the RBA's target band of 2-3 percent.

New Zealand's economy expanded by 0.5 percent in the second quarter of 2006, falling marginally from the 0.7 percent growth recorded in the first quarter, led by weak consumption.

Recent indicators show subdued activity over the current quarter. Business confidence fell to a five-month low in August amid speculation that the rising cost of imported gasoline and machinery will support inflation and reduce profits. Moreover, the annual trade deficit widened in July after imports rose to an eight-month high.

Consistent with strong inflationary pressures, the Reserve Bank of New Zealand (RBNZ) maintained its key interest rate at a high of 7.25 percent during the third quarter.

For this year, the economy is forecast to slow to 1.3 percent, after a 2.3 percent growth in 2005. The year-end inflation is expected to increase to 3.8 percent in 2006, from the 3.0 percent recorded in 2005.

US economic growth decelerated to 0.6 percent in the second quarter, after a strong start with an expansion of 1.4 percent in the first quarter. The slowdown in economic activity resulted from a cut back in expenditure by enterprises and consumers and a slowdown in business investment.

Recent data showed that economic performance was generally mixed during the third quarter. Retail sales rose in July, while manufacturing also picked up in the same month. Moreover, job growth picked up in August, while falling gasoline prices pushed consumer confidence to a 5-month high in September.

However, on a negative note, an index of leading economic indicators dropped in July and the services sector slowed as well. Moreover, consumer spending fell to a 9-month low in August.

The Federal Reserve maintained the benchmark interest rate unchanged at 5.25 percent during the review quarter.

The economy is expected to grow by 3.4 percent this year, slightly higher than the 3.2 percent growth in 2005. Inflation is anticipated to be at 3.6 percent, from 3.4 percent recorded in 2005.

The **Euro-zone** economy grew by 0.9 percent during the second quarter, after a revised 0.8 percent growth in the previous quarter. The upbeat economic performance was led by rising exports, domestic demand and business investment.

Latest indicators show that economic performance continues to strengthen. The Euro-region's services industry expanded in August, while consumer confidence rose to a 5-year high in September.

Furthermore, the Euro-zone's two major economies, Germany and France also reported positive results. German business confidence rose in August, while the unemployment rate was at a 2-year low in September. Moreover the French unemployment rate also fell to a 4½ year low in July, while business confidence rose in the same month.

The European Central Bank (ECB) raised its benchmark interest rate to 3.0 percent in August, to rein in inflation.

The Euro-zone economy is forecast to expand by 2.4 percent this year, following an expansion of 1.3 percent in 2005. Year-end inflation for 2006 is forecast at 2.3 percent, compared with 2.2 percent recorded last year.

Japan's economic growth slowed from 0.5 percent in the first quarter to a more subdued 0.3 percent in the second quarter, led by weaker external demand and public investment.

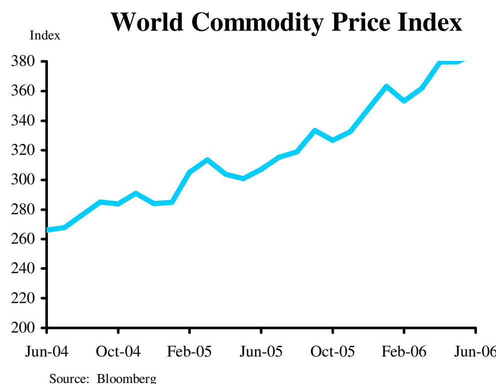
Nevertheless, recent data signals positive economic activity during the September quarter. Consumer confidence rose in July, while retail sales and exports increased in August. Moreover, the jobless rate also fell in August to an 18-year low.

The Bank of Japan finally ended its zero interest rate policy by raising its key interest rate to 0.25 percent in July.

For this year, Japan's economy is forecast to grow by 2.7 percent, compared to 2.6 percent in 2005. Inflation is forecast at 0.3 percent, after recording -0.6 percent last year.

World commodity prices fell by around 4.0 percent over the third quarter, mainly underpinned by declines in crude oil, sugar and gold prices (Graph 3).

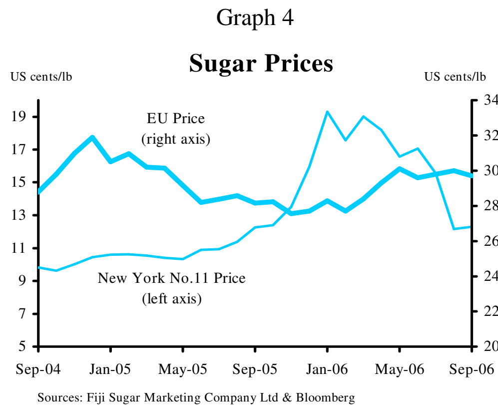
Graph 3



Over the September quarter, **world market sugar prices** fell by around 28 percent (Graph 4). The world sugar prices fell throughout the quarter, on concerns that supply may outstrip demand[2].

Graph 4

Sugar Prices



In the months ahead, prices are expected to remain low (around US11-12 cents), on anticipation of excess supply.

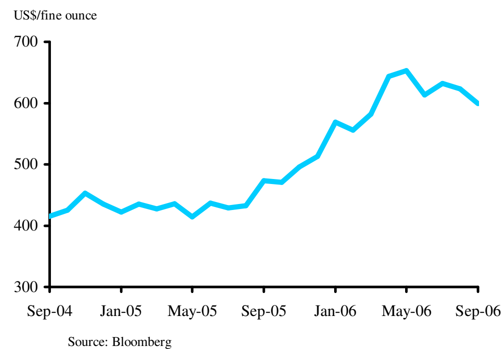
At the end of September, the European Union (EU) sugar price was around US30 cents per pound, having risen slightly over the quarter, due to a stronger Euro against the US dollar.

Gold prices fell by around 2 percent over the September quarter (Graph 5). Gold prices rallied in July, after investors bought the metal as a hedge against inflation, as geo-political tension in the Middle East drove crude oil prices up.

However, gold prices fell in the last two months of the quarter, after a slump in oil prices diminished the metal's appeal as a hedge against inflation.

Graph 5

Gold Price

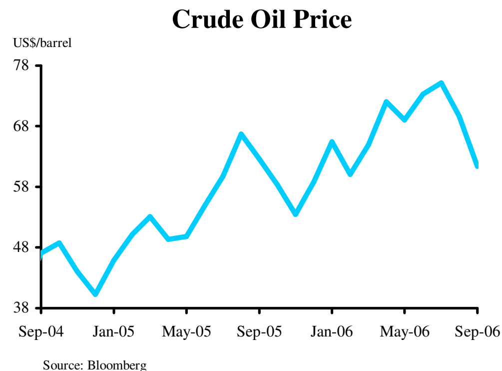


In the coming months, declining inflationary expectations emanating from crude oil prices is anticipated to reduce gold's appeal, thus keeping prices below US$600 per fine ounce.

At the end of September, the **Brent crude oil price** was around US$61 per barrel, a decline of around 16 percent when compared to the price recorded at the end of June (Graph 6).

Graph 6

Crude Oil Price



Crude oil prices rose in July, as concerns mounted that geo-political tension in the Middle East and violence in Nigeria will restrain crude oil supplies.

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[2] Brazil is expected to produce 29.2 million tons of sugar this year, up by 10 percent from last year. India, the world's biggest sugar consumer, is expected to increase exports, as farmers take advantage of prices that are higher on the international market than domestically. Also, India, the world's second-biggest sugar-cane grower, started crushing cane three weeks early. A 62 percent jump in raw sugar prices last year had spurred sugar cane farmers to plant more crop. Sugar mills in India have started crushing earlier than usual because of a record crop.

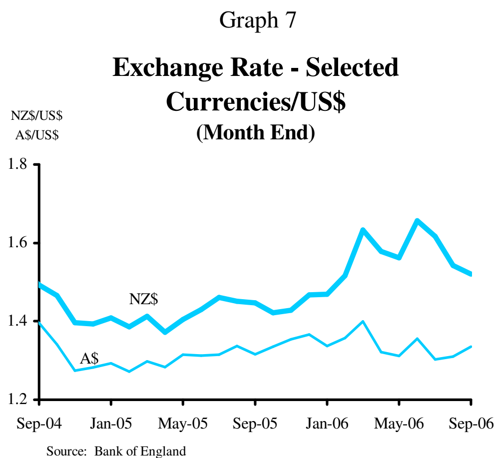
However, crude oil prices fell in the latter months of the quarter, after rising to a new historical high of US$79 per barrel in early August, following a surprise increase in US gasoline stocks, coupled with speculation that Saudi Arabia, the world's largest oil producer, has not agreed to participate in any output cut by OPEC[3].

Looking ahead, concerns of strong global demand are expected to maintain upward pressure on crude oil prices.

International Financial Markets

Over the third quarter, the US dollar weakened against all of Fiji's major trading partner currencies except for the Japanese Yen (Graph 7).

Graph 7



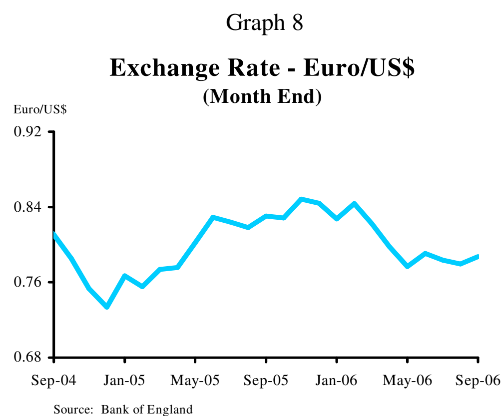
The Kiwi dollar strengthened against the Greenback throughout the quarter, buoyed by demands for higher-yielding NZ bonds and expectations that the RBNZ will not reduce its key interest rate anytime soon.

The Australian dollar, however, strengthened against the US dollar in the first month of the quarter, after demand for Australian commodity exports rose, increasing demand for the Aussie currency.

The Aussie then weakened against the Greenback in the following months, after reports that the Australian economy grew at the slowest pace in three years in the second quarter reduced the appeal of Aussie dollar denominated assets.

The Euro generally strengthened against the Greenback over the third quarter (Graph 8). The Euro appreciated in the first two months of the quarter, after speculation of rapid economic growth in the region prompted investors to demand more Euro-denominated assets. However, the Euro declined in September, after reports of positive economic indicators emanating from the US lured investors into US dollar denominated assets and the currency.

Graph 8



The Yen generally weakened over the quarter against the US dollar (Graph 9).

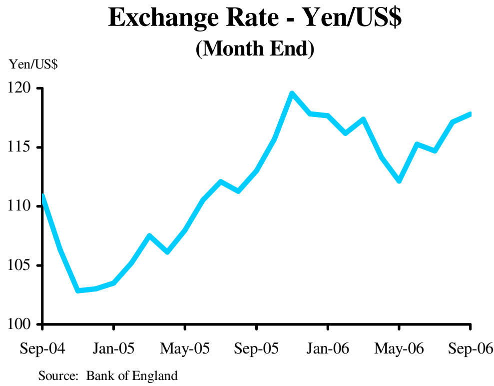
Initially, the Yen gained in the first month of the quarter, after the Bank of Japan (BOJ)

[3] OPEC, the producer of 40 percent of the world's oil, is wanting to cut "about 1 million barrels a day" of output to prop up oil prices (maintain it around US$60/barrel), which have lost almost a quarter of their value in recent months.

raised interest rates for the first time since 2000, thus boosting the appeal of Yen-denominated assets.

However, the Yen weakened in the latter months, as the weak consumer prices outlook dimmed prospects of an interest rate raise by the BOJ, thus reducing the appeal of Yen-denominated assets.

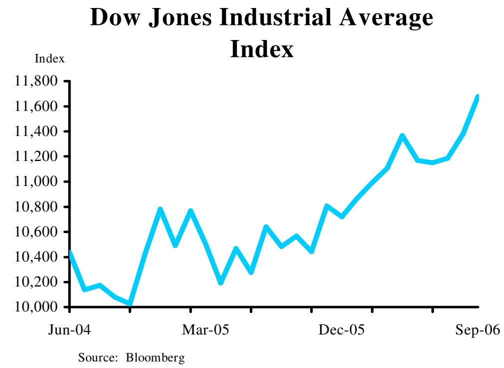
Graph 9



World equity prices increased during the September quarter, when compared to the June quarter.

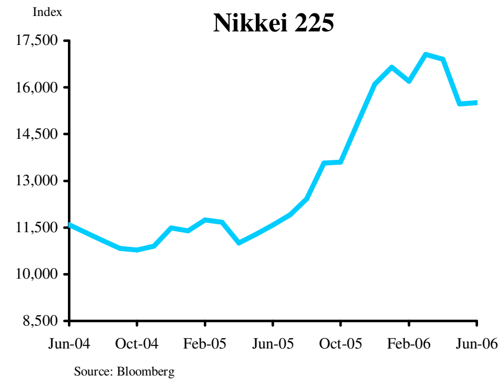
Over the three months to September, the Dow Jones Industrial Average Index rose by around 5.0 percent (Graph 10), after falling oil prices and speculation that the US Federal Reserve may not raise interest rates this year[4] improved companies' profit outlook, thus increasing demand for stocks.

Graph 10



The Nikkei 225 Stock Average Index rose by around 4 percent (Graph 11) over the quarter, after encouraging economic data increased optimism of the Japanese economy, thus increasing demand for stocks.

Graph 11



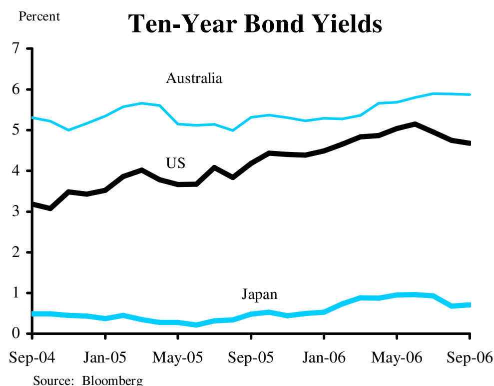
Over the September quarter, 10-year bond yields for the US and Japan fell, while Australian bond yields generally rose (Graph 12).

US bond yields fell over the three months to September, after speculation that the US Federal Reserve may not increase the key interest rate, added to expectations that

[4] Falling oil prices and relatively slower economic growth in the second quarter added to speculation that the US Federal Reserve may not increase its benchmark interest rate further this year.

inflation[5] is contained and boosted demand for inflation-sensitive government bonds.

Graph 12



Australian bond yields rose in the third quarter, after expectations of faster economic growth prompted investors to switch from bonds to stocks.

Japanese bond yields fell during the first two months of the September quarter, after speculation that the central banks in Japan and the US will keep interest rates on hold amid signs of slowing inflation, increased demand for bonds. However, yields rebounded in September, after an increase in stocks lured investors away from bonds.

[5] Inflation erodes the real return on fixed income securities such as bonds.

THE DOMESTIC ECONOMY

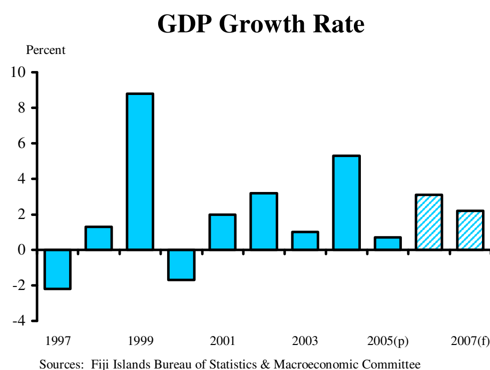
Domestic Economic Conditions

On balance, the domestic economy performed well during the review period, despite weaknesses in certain industries. Overall, the economy is anticipated to expand by 3.6 percent this year, before slowing to a growth of 2.0 percent in 2007 (Graph 13).

The encouraging outlook for 2006 is underpinned by better prospects in the community, social & personal services; building & construction; transport & communication and agriculture, forestry, fisheries & subsistence sectors. Positive developments in these sectors are expected to more than offset the negative contributions stemming from the mining & quarrying sector, and the textiles, clothing & footwear industry.

Graph 13

GDP Growth Rate



Consumer Spending

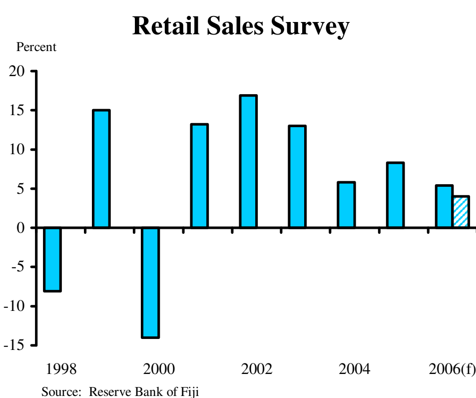
The robust performance of partial indicators suggest that **consumer spending** remained firm during the January to August period.

In the year to August, Value Added Tax (VAT) collections from domestic activities[6] noted a buoyant 12 percent growth over the comparable period last year. Furthermore, lending for consumption purposes rose and imports of consumption goods grew further. Firm labour market conditions and growing incomes continued to underpin domestic demand during the review period.

The results of the Reserve Bank's June 2006 **Retail Sales** Survey indicated that gross retail sales is expected to increase by around 4.0 percent this year. This is relatively lower than the 5.4 percent growth in retail sales anticipated for 2006 in the December 2005 survey (Graph 14).

Graph 14

Retail Sales Survey



The projected growth for this year is largely underpinned by healthy sales prospects in the food, drinks & tobacco, other duty free retailing, motor cars,

[6] There are 3 broad categories of VAT collections. These include import VAT, cash collections and Government collections.

entertainment, footwear, household goods & appliances and restaurants categories. However, retailers have indicated that no growth in sales is expected from the pharmaceuticals & chemicals and clothing & textiles categories, while the building materials & hardware and jewellery categories are expecting a decline in sales this year.

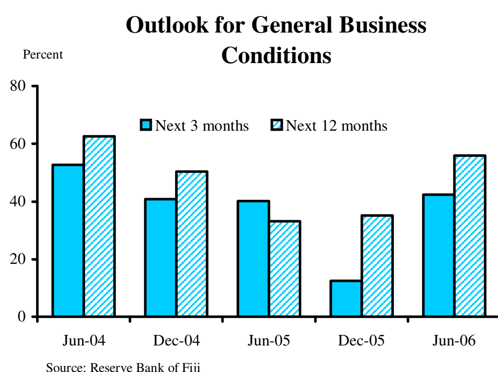
In addition, the monetary policy tightening measures implemented by the Reserve Bank earlier this year is a possible reason for the relatively slower growth in forecast sales, relative to the previous survey.

Business Expectations Survey

The Reserve Bank of Fiji also conducted its latest **Business Expectations** Survey (BES) in June. The survey results signal relatively encouraging prospects for general business conditions in the short-term, with a net[7] 42 percent of respondents estimating business to pick up in the review quarter (Graph 15).

Graph 15

Outlook for General Business Conditions



The manufacturing, tourism, building & construction, wholesale & retail trade, transport and real estate sectors/ industries drove this optimism.

Similarly, sentiments for the medium-term outlook for general business conditions also improved by around 21 percentage points. A net 56 percent of respondents were optimistic about the general business outlook for the next 12 months, with the communication, insurance, manufacturing, real estate and wholesale & retail trade sector/industries dominating the favourable sentiment.

Production

On a sectoral basis, mixed performances were noted during the review quarter. The tourism, electricity, fisheries and building & construction sectors registered favourable growth. However, weak performances were noted for the cane & sugar, textile, clothing & footwear, timber and mining & quarrying sectors.

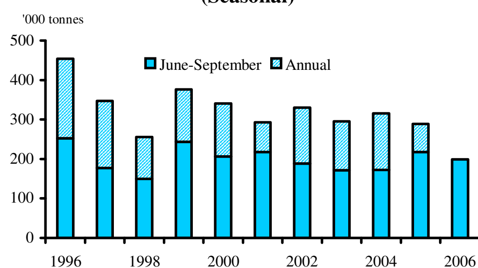
The **cane & sugar** industries continued to perform poorly into the third quarter of the year. Mill reports from the Fiji Sugar Corporation Limited (FSC) indicate that around 2 million tonnes of sugarcane was crushed during the first 4 months of the harvesting season. This represented a decline of 5.9 percent on an annual basis. Consistent with the poor harvest thus far, sugar production totalled 199,000 tonnes, around 8.6 percent lower than the level recorded over the previous comparable period (Graph 16).

The relatively subdued performance by the industries was due largely to unfavourable weather conditions earlier in the year, mill breakdowns and land tenure issues hindering cane supply to the mills.

[7] Net is calculated by subtracting the number of respondents expecting a decrease from the number of respondents expecting an increase.

Graph 16

Sugar Production
(Seasonal)



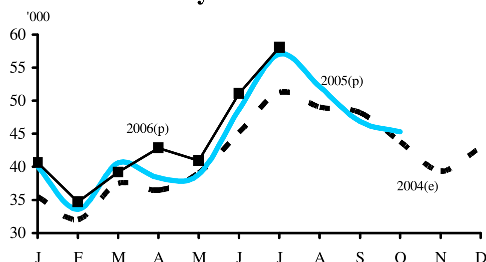
Sources: Fiji Sugar Corporation Ltd & Fiji Islands Bureau of Statistics

On a more positive note, under the anticipated restructure program, FSC is expected to complete mill upgrades before the commencement of the 2007 crushing season.

The **tourism** industry grew at a slow pace during the review period (Graph 17). According to provisional data from the Fiji Islands Bureau of Statistics (FIBOS), visitor arrivals (exclusive of sea arrivals) during the first seven months of this year totalled 307,498, 3.5 percent higher than the comparable period in the previous year.

Graph 17

Monthly Visitor Arrivals



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

For this year, the Fiji Visitors Bureau envisages visitor arrivals to be around 576,000, an increase of around 5 percent over last year's level. This suggests that arrivals may pick up pace in the remaining months of the year.

The marginal growth in arrivals was reflected in a similar growth in hotel turnover in the first half of the year, which grew by around 2.0 percent over the corresponding period last year.

As anticipated, output in the **textiles, clothing and footwear** industry remained depressed during the review period. In the year to July, textiles, clothing and footwear export earnings totalled $61 million, representing a decline of around 32 percent. A similar level of contraction (29.4 percent) was also noted in the second quarter Industrial Production Index for garments and footwear index.

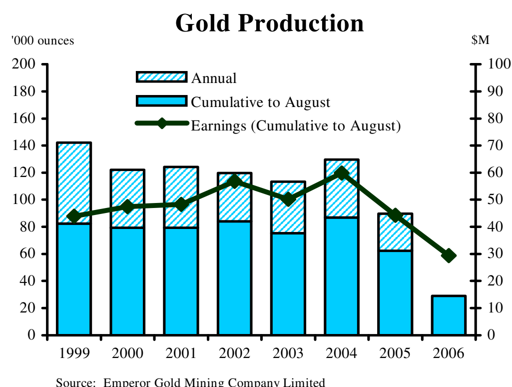
In related developments, the Fiji Government has accepted the terms and conditions of the Australian Government on the reduction of the Minimum Local Area Content from 35 percent to 25 percent. However, the reduction is to be carried out no earlier than January 2008 and would be conditional on the establishment of a credible audit and compliance system, improvements in productivity in Fiji's Textile, Clothing and Footwear industry, and that more manufacturers engage in the training opportunities under the Structural Adjustment Package. Wool and wool blend fabrics remain excluded from the scheme.

Performance of the **mining and quarrying** sector remained subdued during the quarter. Cumulative to August this year, total gold output amounted to almost 29,000 ounces, 53 percent lower than the corresponding period in 2005 (Graph 18). According to industry

sources, poor production resulted largely from mining disruptions due to the restructure program being undertaken at the mill.

Graph 18

Gold Production



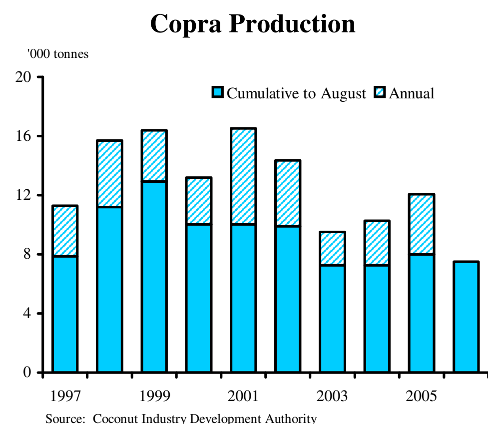
Source: Emperor Gold Mining Company Limited

In line with production and downward trending international gold prices, total export earnings also declined on an annual basis by 34 percent to $29 million.

Output in the **copra** industry also continued to remain weak during the review period. Cumulative to August, copra production totalled around 7,500 tonnes (Graph 19), representing a decline of 6 percent over the corresponding 2005 level.

Graph 19

Copra Production



Source: Coconut Industry Development Authority

Industry liaison indicates that poor production is mainly emanating from copra farmers switching to production of other cash crops, such as yaqona and fresh vegetables. The rising cost of transportation, fuelled by the high crude oil prices, is also a contributing factor.

In August, the minimum mill gate price of copra remained unchanged at $500 per tonne. Government's subsidy towards the mill gate price was $83.45 per tonne.

Electricity generation continues to hold up well. During January to September, total electricity generated by the Fiji Electricity Authority (FEA) was around 557 megawatt hours (Mwh), an increase of 9.8 percent over the same period last year. Growth in electricity generation has been maintained around this level for sometime now, suggesting a steady growth in economic activity.

Owing to the rising fuel costs, the FEA has invested in the development of renewable energy sources, such as the Butoni Wind Farm and intends to conduct research on alternative fuels apart from diesel. In addition, the Commerce Commission has authorised FEA a fuel surcharge up to 4.97 cents per kilowatt hour (kWh) that would become effective on 15 November 2006. In addition, to assist low income earners, the Commission has agreed that for domestic users, no fuel surcharge will be applied for residential customers consuming 75kWh or less per month. However, for those residential customers consuming above 75kWh and up to 125kWh per month, a 50 percent reduction in the maximum fuel surcharge will be applied (i.e. 3.25 cents per kWh). All consumers consuming above the 125kWh per month supplied by FEA, will pay the maximum

fuel surcharge. An incentive program has also been introduced where discounts will be offered by FEA for reductions in electricity usage.

Furthermore, with Tropik Woods Industries Limited[8] and FSC moving towards renewable power generation,[9] increased generation of electricity could be expected in the future.

The **fishing** industry is estimated to have performed well in the first 7 months of the year. Trade data for the January to July period indicates that total fish export receipts amounted to around $54 million, representing a 10.5 percent increase over the corresponding period last year.

Export earnings data suggest that the performance of the **timber** industry was subdued during the review period. Cumulative to July, timber export receipts were around $17 million, 38 percent lower than the corresponding period in 2005.

The **building and construction** sector continues to maintain its buoyant performance this year. According to the Building and Construction Survey Report released by the FIBOS, a total of $156 million worth of construction work has been realised in the year to June. This represents a strong increase of around 34 percent on an annual basis.

By categories, the value of work put-in-place by the private sector rose significantly by around 38 percent (to $125m), followed by the public sector recording an increase of 19 percent (to $31m).

Moreover, tourism projects are still driving the robust activity in the construction sector. These include continuing construction work at the JW Marriot Resort & Spa at Momi Bay, First Landing Resort, Hilton Fiji Beach Resort and Spa, Natadola Beach Hotel (which will be known as Inter-Continental Resort Fiji), the Radisson Denarau and the Ritz Carlton.

Other notable projects still ongoing include construction work at the Carpenters Tower, FNPF/Tappoo Retail Outlet, Mid-City Plaza, Great Council of Chiefs complex and FIRCA's new Headquarters.

Coupled with the strong performance of the building & construction sector, other partial indicators suggest a steady pick up in **investment** during the review period.

For instance, in the year to August, OET data show that imports of investment type goods increased by 17 percent on an annual basis. Lending to private individuals for housing purposes and to the construction sector also remained strong. Against this backdrop, it is envisaged that investment will likely be around 18 percent of GDP this year. While this is an improvement over the previous estimate of 17 percent of GDP, still much more needs to be done to meet Government's investment target of 25 percent of GDP.

Public Finance

On the **fiscal side**, in August, Cabinet approved a redeployment of a total sum of $58.3 million from the existing budget to

[8] Tropik Woods Industries Limited launched a $23 million renewable power generation project on 13 October 2006 in Lautoka.

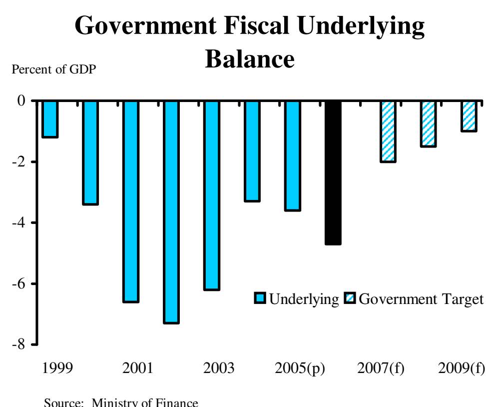
[9] The target date for FSC's cogeneration project to come on line is September 2007 i.e. 3 months after the completion of the mill upgrade programme.

meet extra budgetary requirements of the Government. The largest portion of the redeployment is expected to meet Government's Cost of Living Adjustment (COLA) commitments.

In addition, as per the Strategic Policy Statement,[10] it is anticipated that the 2007 budget strategy will propose a fiscal framework that ensures that Government continues on the path of fiscal consolidation in the medium term 2007 – 2009.

According to the Statement, Government has set a deficit target of 2.0 percent of GDP for 2007, which it intends to progressively reduce to 1.5 percent of GDP in 2008 and to 1.0 percent of GDP in 2009 (Graph 20). The underlying deficit for this year is still budgeted at $232 million, or 4.7 percent of GDP.

Graph 20



In an attempt to finance its budget deficit and in particular fund capital projects, Government made its first ever bond issue in the international capital market in September this year. The issue size was US$150 million and tenor was 5 years. The bonds were priced with a coupon rate of 6.875 percent. The proceeds of the issue will be used to meet the Government's 2007 budget deficit requirements and, in particular, to finance its capital projects.

Total outstanding **Government debt** continued to expand during the first 9 months of the year. At the end of September this year, total Government debt totalled around $2,572 million, or around 52.7 percent of GDP.

As per the Strategic Policy Statement, the underlying focus of the Government's fiscal policy over the medium term is to constrain the growth in levels of Government debt, whilst supporting investment, exports (growth) and essential services.

For 2006 – 2008, Government projects its debt to increase slightly from 52.2 percent of GDP this year to 52.8 percent of GDP in 2007, before falling to 50.3 percent in 2008.

Inflation

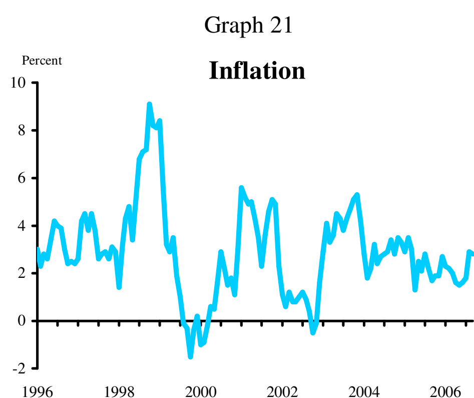
In the year to September, inflation stood at 2.8 percent compared with 1.6 percent recorded for June (Graph 21). Over the quarter, consumer prices picked up by around 1.0 percent. This was largely due to higher costs of transport, heating & lighting, miscellaneous items, durable household goods, housing, clothing & footwear and food items. Prices of alcoholic drinks & tobacco declined, while charges for services remained unchanged.

The higher prices of transport and heating & lighting in particular, were largely

[10] As required under Section 12 of the Finance Management Act of 2004, this statement presents Government's strategic policy framework for the 2007 Budget.

underpinned by the hike in domestic fuel prices in July and September, while the high costs of housing emanated greatly from an increase in costs of repair items. The rise in prices of miscellaneous items, durable household goods and clothing & footwear on the other hand, could be attributed to the flow on effects of the changes in import duty since November last year. Conversely, higher food prices were largely due to increases in prices of basic food items such as edible oil, wheat products and some market items. On the other hand, lower costs for alcoholic drinks & tobacco emanated from lower prices for alcohol and cigarettes.

Graph 21



The underlying measure of inflation, the trimmed mean, was 1.8 percent in September, up from 1.5 percent in the last quarter.

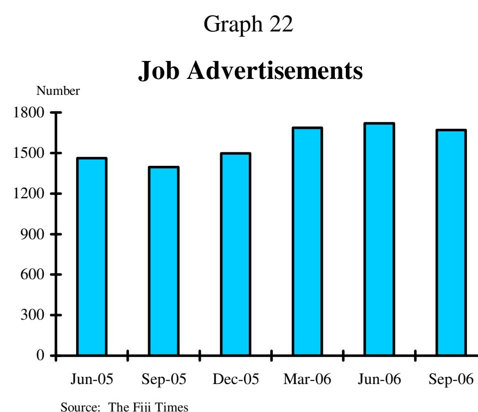
Looking ahead, upward pressure on prices is likely to remain, emanating from the approved electricity fuel surcharge which comes into effect in October. This is expected to be further fuelled by our high average trading partner inflation which stood at 3.2 percent as of September. The year-end inflation for 2006 nonetheless, remains at around 3.5 percent.

Labour Market

Employment conditions are improving as revealed by partial indicators as well as survey data. Cumulative to September, around 6,400 taxpayers were registered with FIRCA, representing an annual increase of around 16 percent. The highest number of new taxpayers so far have been registered in the community, social & personal services sector followed by the wholesale, retail trade, restaurants & hotel; finance, insurance, real estate & business services; manufacturing; transport, storage & communications and construction sectors.

The Reserve Bank's September Survey of Job Advertisements recorded an annualised rise of around 20 percent (Graph 22). Recruitment intentions were largely noted in the wholesale, retail trade, restaurants & hotels; community, social & personal services; transport, storage & communication; construction and finance, insurance, real estate & business services sectors.

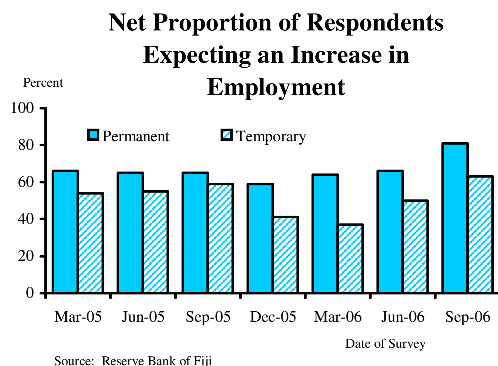
Graph 22



The Reserve Bank's Fiji Employers Federation (FEF) Expectations survey conducted in September showed that a net of around 81 percent and 63 percent

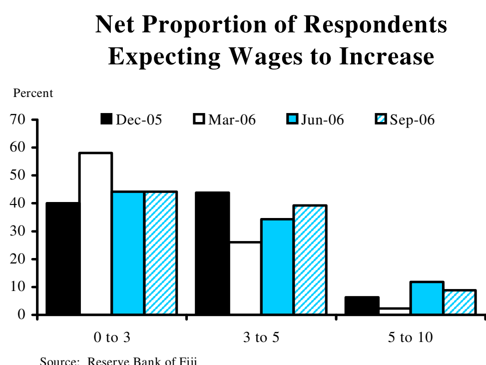
of respondents expect an increase in permanent and temporary employment, respectively. Employment prospects have improved in case of both temporary and permanent employment over the June survey (Graph 23).

Graph 23



Wages growth is expected to be modest in the medium term (Graph 24). The FEF Expectations survey revealed that a net of 92 percent of respondents expect wage levels to rise in the approaching months. Around 83 percent of the respondents anticipate wages to rise by between 0-5 percent, while 9 percent expect a rise between the 5-10 percent range.

Graph 24



The External Sector

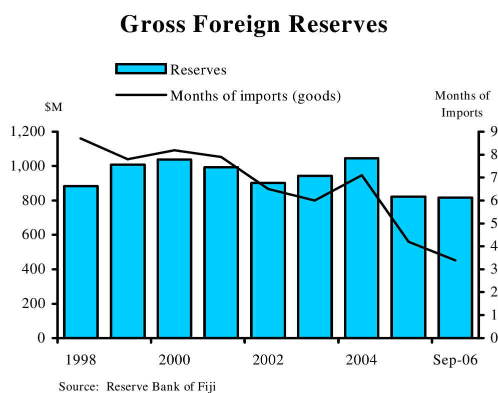
Latest OET data shows that cumulative to August this year, merchandise exports fell by 12.3 percent, compared with a decline of 17.4 percent in the corresponding period in 2005. The decline in earnings was due to lower receipts from sugar, ginger, fish, mineral water, textiles, clothing & footwear, and other re-exports, which more than offset the higher inflows from gold, other exports, copra, timber, and re-exports of mineral fuels.

During the same period, merchandise imports rose by around 9.3 percent, compared to a growth of around 12.3 percent in the corresponding period in 2005. The increase in import payments was due to higher payments for all; investment goods (4.0%), consumption goods (3.5%) and intermediate goods (1.7%). The higher payment for investment goods was largely made up of increases in imports of machinery & electrical equipment and chemicals, while the growth in consumption goods was largely attributed to the increase in payments for duty free goods, transport equipment, food, beverage & tobacco. The increase in payments for intermediate goods was underpinned by mineral fuels, raw materials and textiles, clothing & footwear.

Foreign reserves at the end of September were around $817 million, sufficient to cover 3.4 months of import payments of goods (Graph 25).

Graph 25

Gross Foreign Reserves



Source: Reserve Bank of Fiji

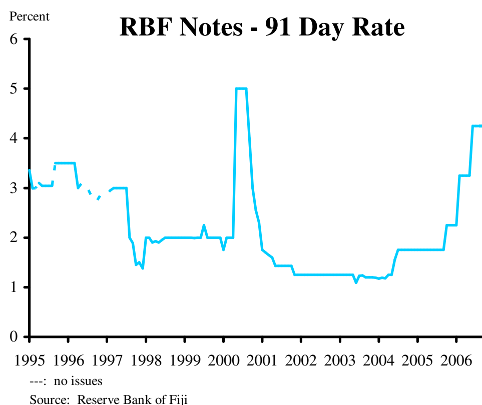
Domestic Financial Conditions

Money Markets

The demand for inter-bank funds increased during the September quarter, reflecting tight liquidity conditions in the market. Total inter-bank turnover rose to $645.8 million from $635.9 million recorded in the June quarter. The weighted average inter-bank rate at the end of September was 5.23 percent (Graph 26).

Graph 26

RBF Notes - 91 Day Rate



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Source: Reserve Bank of Fiji

On open market operations, around $2.2 million worth of RBF Notes were allotted during the July to September period, $12.3 million lower than the June quarter value. The outcome was largely a result of more attractive rates offered on other securities in the money market. The yield on the RBF Notes during the review period averaged 4.25 percent.

Issues of Treasury Bills dominated activity in the money market during the September quarter. The Government raised $175.4 million through short-term papers to rollover maturing debt, as well as, finance the higher revised budget deficit. In line with the notable increase in Treasury Bills issued, yields on the majority of the maturities continued to rise steeply.

Capital Markets

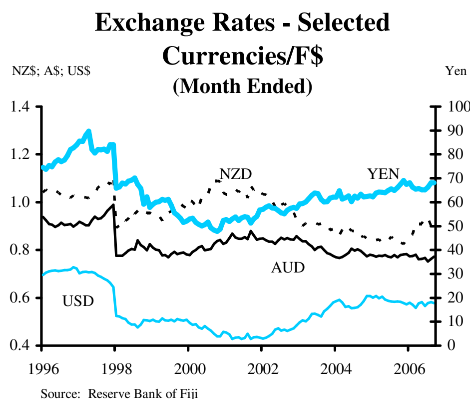
Government issued bonds worth $81.3 million during the third quarter, around $68.2 million lower than the June quarter value. The maturities offered ranged from 3 to 15 years, with weighted average yields between 8.80 percent and 10.35 percent.

Statutory Corporations also issued bonds during the review period. The Fiji Development Bank and Housing Authority raised bonds worth $22.8 million and $10.0 million respectively.

Foreign Exchange Markets

Relative to the June quarter, bilateral movements in exchange rates reveal that during the September quarter, the Fiji dollar strengthened against the Japanese Yen (4.5%), US dollar (2.3%), Euro (1.8%) and Australian dollar (0.7%) while the domestic currency weakened against the New Zealand dollar (6.1%) (Graph 27).

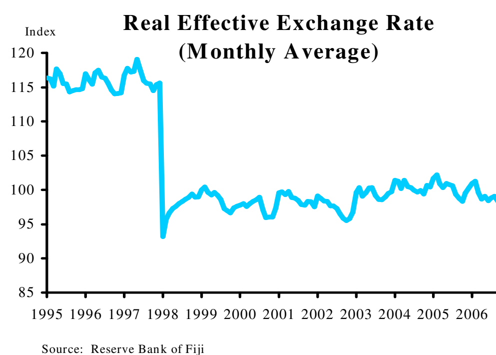
Graph 27



The Nominal Effective Exchange Rate Index (NEER), which reflects aggregate exchange rate movements between the Fiji dollar and the currencies of Fiji's major trading partners, rose marginally over the quarter, indicating an appreciation of the Fiji dollar against the basket of currencies.

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, fell implying an improvement in our competitiveness externally (Graph 28).

Graph 28

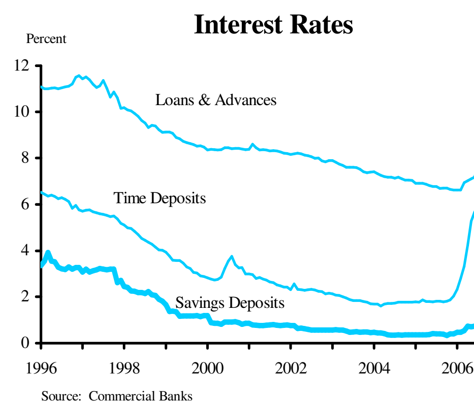


Financial Intermediaries

Interest rates continued to rise into the third quarter. As at end-September, the savings and time deposit rates of commercial banks rose over the June quarter by 7 basis points and 98 basis points to 0.80 percent and 6.63 percent, respectively (Graph 29).

Furthermore, the weighted average lending rate on outstanding loans also increased, reaching 7.69 percent during the same period.

Graph 29



Licensed Credit Institutions (LCIs)[11] also showed similar trends during the review quarter. The weighted average lending rate rose by 67 basis points to 11.46 percent, while the interest rate on time deposits increased from 6.02 percent to 7.0 percent at the end of September.

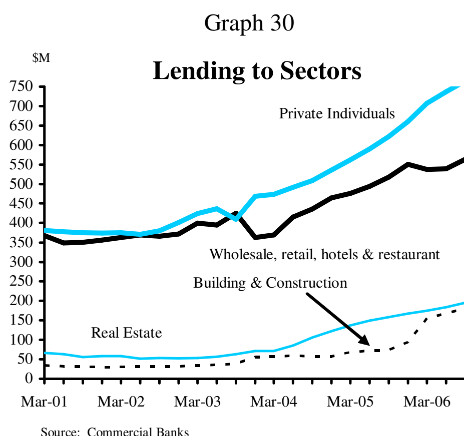
Monetary aggregates continued to strengthen, although the growth rate has slowed. In September, money supply (M2) rose by an annual growth rate of 15.0 percent after recording average growth rates of 18.6 percent and 17.1 percent in the second and first quarter of 2006, respectively. The sustained monetary expansion reflects largely a

[11] LCIs' include Merchant Finance Investment Company Limited, Credit Corporation (Fiji) Limited and Home Finance Company Limited.

stronger accumulation of time deposits relative to demand deposits, as interest rates on the former continue to be quite lucrative. Time deposits rose by an annual growth rate of 60.6 percent in September.

Commercial banks' credit growth, since peaking in May at 29 percent, has continued to slow, falling to 24.8 percent at the end of September. An overall slowdown in credit growth, albeit small, is noted in September for the consumption-related sectors and also in lending to private individuals for housing purposes (which accounts for around 81 percent of total lending to private individuals) (Graph 30).

Graph 30



Lending by LCIs also slowed in September. The annual growth rate of loans was 17.6 percent, compared to a growth of 21.1 percent in the year to June.

Banking Industry Quarterly Condition Report – June 2006

Overview – Commercial Banks

The **overall** condition of the banking industry remained ***satisfactory*** in the June quarter**,** as total assets' growth was recorded against a strong capital position, improved asset quality and satisfactory earnings. Liquidity was strained during the quarter, but the industry managed its cash flow adequately.

Total assets grew by 19.9 percent over the year to $3.1 billion fuelled by loan growth. On the **liabilities** side, total deposits increased by 1.4 percent or $37.7 million over the quarter and 16.3 percent over the year to $2.7 billion.

The **capital adequacy** ratio of all banks was above the minimum prudential requirement of 8.0 percent, and the overall banking industry recorded a ***strong ratio*** of 12.0 percent.

Asset quality remained ***satisfactory*** as classified assets declined by $1.7 million to $48.3 million. Past due levels decreased slightly by $0.6 million and general provisions were raised by 27.5 percent over the quarter.

Management is rated ***satisfactory*** in view of the satisfactory or strong performance in most other operations of the banking industry.

Earnings were assessed to be ***satisfactory***. Combined pre-tax quarterly profits declined slightly to $32.3 million (March: $32.6m). Interest expense for the quarter increased by 115.9 percent, but growth in both interest income and non interest income cushioned the impact on operating income.

Liquidity remains ***marginal***. Liquidity ratios dropped over the quarter as all banks successfully met the two percentage point increase in Statutory Reserve Deposit (SRD) required by the Reserve Bank. Liquidity is expected to remain marginal in the next few quarters as banks

continue to make adjustments to meet the impact of the tightening monetary policy.

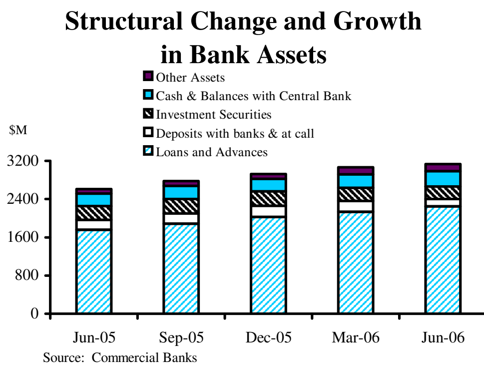
Balance Sheet

As at June 2006, the banking industry's total assets stood at $3.1 billion. This grew by 2.2 percent over the quarter and 19.9 percent over the year fuelled by the growing loan portfolio of individual institutions (Graph 31).

The quarterly growth rate continued its slowdown from the previous quarters. A growth rate of 3.7 percent was recorded in the corresponding quarter last year. On an annual basis growth also slowed, compared to the annual growth rate of 21.6 percent to the end of March 2006.

Graph 31

Structural Change and Growth in Bank Assets



Source: Commercial Banks

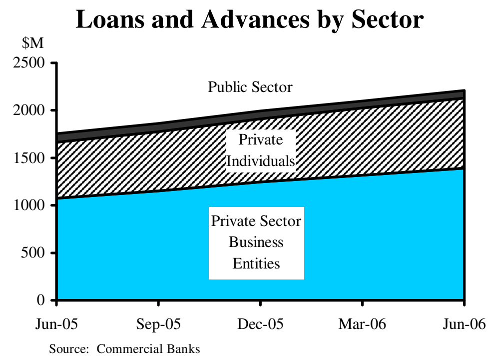
Loans and advances expanded over the quarter by 5.5 percent ($120.8m) to $2.2 billion (Graph 32). Quarterly loan growth slowed over the last 2 quarters (March: 5.4%) compared to a growth rate of 7.4 percent in December and 6.7 percent in September 2005. However, it still increased compared with 5.2 percent growth in the June 2005 quarter.

The increase in loans over the quarter was mainly driven by a $29.7 million increase in lending to Private Individuals. However growth to this sector has slowed to 4.2 percent compared to 7.0 percent in the previous quarter. The wholesale/retail sector recorded a slight increment by $1.0 million or 0.2 percent over the quarter compared to a much higher increase of $44.5 million over the year.

Among the high priority sectors, large increments were recorded in manufacturing (+$18m) and building and construction (+$12m). All the other sectors recorded minor growth with the exception of the agricultural and mining sectors which recorded slight declines.

Graph 32

Loans and Advances by Sector



Source: Commercial Banks

While the loan portfolio grew other asset categories reported reductions, investments (-$19.5m), deposits with banks and at call (-$69.7m) and cash and settlement account (-$13.7m). These liquid assets were utilised to fund the increase in SRD requirement (+$56.9m) and partly to fund the loan growth.

Total deposits increased by 1.4 percent ($37.7m) over the quarter to $2.7 billion. On a yearly basis this increased by 16.3 percent. The rising interest rates over the quarter saw a shift of deposits from demand (-$36.5m) to the time category (+$80.8m). A major decline of $99.3 million was noted in foreign currency time

deposits, while local time deposits of private sector business entities and Non-Bank Financial Institutions' (NBFIs) rose $107.6 million and $85.5 million respectively.

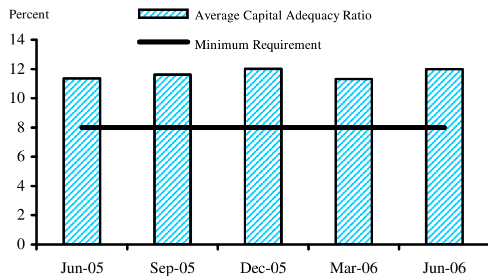
Capital Adequacy

As at June 2006, the industry recorded a strong 12 percent capital adequacy ratio (Graph 33). This compares to 11.3 percent recorded in the March quarter and 11.4 percent in June 2005.

The ratio improved by 70 basis points over the quarter mainly due to a faster rate of growth in total capital (+10.5%) than the risk weighted assets (+4.3%).

Graph 33

Capital Adequacy Ratio of Banks



Growth in total capital was due to a strong increase (+$64.0m) in unappropriated profits under Tier 2[12] capital, while the growth in risk assets (+$88.1m) mainly stemmed from higher lending in the 100 percent risk weighted category.

The Banking Industry is expected to continue to be well capitalised on the back of consistent earnings and minimal deterioration in asset quality.

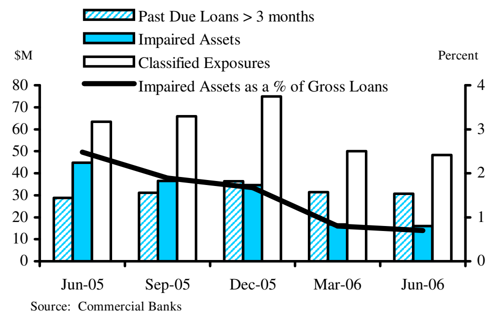
Asset Quality

Overall, the asset quality of banks was assessed to be satisfactory. This slightly improved in the June quarter following a further decline of 3.4 percent ($1.7m) in the level of classified exposures to $48.3 million (Graph 34).

Banks reported mixed movements for the quarter with one bank recording a $5.3 million decline in classified loans caused by a reduction in debt of one of their major classified loans, while another bank recorded a $2.5 million increase.

Graph 34

Asset Quality



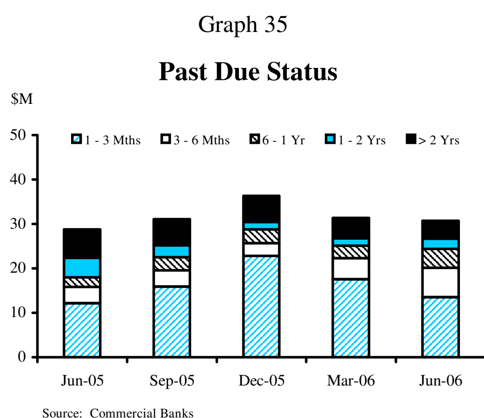
Out of the industry-wide $48.3 million in classified loans, $16.1 million was considered impaired. Total impaired loans reduced by $0.7 million over the quarter and represented 0.7 percent of gross loans and advances.

Past due loans dropped slightly by $0.6 million over the quarter to $30.7 million (Graph 35). The decline stemmed mainly from a $4.0 million decrease in the 1-3 months category, with one bank accounting for the bulk of the change.

[12] Supplementary capital comprising items which exhibit some but not all characteristics of capital, such as unaudited profits, revaluation reserves and general provisions for doubtful debts.

Graph 35

Past Due Status



Source: Commercial Banks

Problem loans of the banks are concentrated in the private individuals sector (44.1%) led by problem housing loans which make up 35.6 percent of all problem loans. The mining and quarrying sector represents 26.8 percent, wholesale/retail 10.1 percent and manufacturing sector 2.5 percent.

As at June 2006, banks held $37.5 million in provisions for doubtful debts. This increased by $5.1 million or 15.9 percent in the June quarter as banks increased general provisions to brace against the rise in interest rates and its possible impact on asset quality.

General provisions coverage of gross loans and advances has increased to 1.3 percent from 1.1 percent in March and 1.2 percent in June 2005.

Corresponding to the decline in impaired assets, specific provisions declined by $1.2 million over the quarter and accounted for 51.7 percent of total impaired assets.

The current level of classified and past due loans is considered moderate and the level of impaired assets is considered low. The current asset quality position does not pose a major threat to the earnings and capital position of the banking industry. However, with the effects of the monetary policy tightenings filtering through, the volume of classified loans is expected to rise in the next few quarters.

Banks are expected to increase their general provisions against a possible deterioration in asset quality.

Earnings

The combined banks' e*arnings* were assessed to be *satisfactory.* The Banking industry earned before-tax profits of $32.3 million over the quarter, a small decline on the $32.6 million earned in the previous quarter. However, it exceeded the level earned in the June quarter last year.

Following the increase in interest rates on deposits offered by banks, interest expenses recorded a dramatic increment of 115.9 percent over the quarter. This however, did not cause an equally dramatic impact on the overall profitability as the interest income and non interest income contributed positively to cushion the impact on operating income of banks. On the other hand, Banks also managed to slightly reduce operating expenses over the quarter through reductions in personnel expenses.

Banks' Income Statement

	Jun 05	Mar 06	Jun 06	% Change	
		$M		Over Qtr	Over Yr
Interest Income	35.0	42.2	48.2	14.4	38.0
Interest Expense	5.1	6.5	14.0	115.9	175.2
Net interest income	29.9	35.7	34.2	-4.1	14.6
Add: **Non interest income**	22.2	23.0	23.3	1.2	4.8
Income from overseas exchange transactions	7.9	8.8	9.0	2.6	13.3
Commission	2.0	4.3	3.1	-27.1	57.2
Fee Charges	11.0	9.8	11.1	13.7	1.2
Other income	1.4	0.2	0.1	-58.2	-93.2
Total operating income	52.1	58.7	57.5	-2.0	10.4
Less: Operating expenses	23.3	26.3	26.0	-0.9	11.7
Less: Bad Debts & provisions	2.2	-0.2	-0.9	358.3	-138.4
Equals:					
Profit before tax	26.6	32.6	32.3	-0.8	21.8
Less: Tax	6.9	10.2	7.3	-28.2	7.1
Add Extra ordinary items	0	0	0	-	-
Equals:					
Net profit after tax	19.7	22.4	25.0	11.6	26.9

Source: Commercial Banks

Banks also wrote back $0.9 million of bad debts and provisions expenses over the quarter as a result of improvements in asset quality. This also contributed positively to pre tax profits.

Despite a reduction in the level of pre-tax profits in the June quarter, reduced tax allocation by two banks meant there was an overall increase in after tax profits, when compared to the March quarter.

As a result of the reduction in pre-tax profits, the pre-tax return on assets (annualised) of the Banking industry reduced to 4.2 percent from 4.4 percent in the previous quarter. Similarly, the return on equity reduced to 55.7 percent from 58.9 percent in the previous quarter.

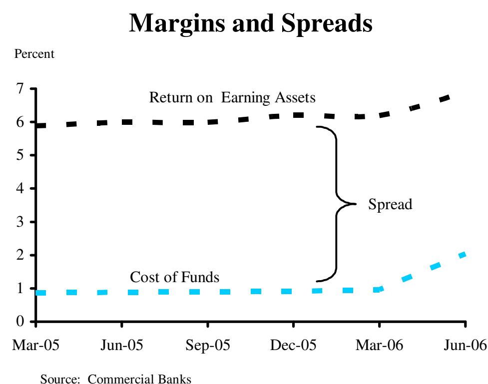
Banks will continue to record satisfactory earnings over the coming quarters driven in particular by higher interest income. However, interest expenses are also expected to remain high for at least another year as banks continue to pay high interest rates on deposits to bolster their liquidity positions.

Interest Margin and Spread

Both the return on earning assets and the cost of funds for the banking industry accelerated in the June quarter (Graph 36). The cost of funds doubled from 1.0 percent in the March quarter to 2.0 percent. This was caused by competition for deposits in a bid to accumulate funds to meet the increased SRD requirement, which was raised from 5 percent to 7 percent, in May this year.

Graph 36

Margins and Spreads



Source: Commercial Banks

As the cost of funds rose, banks increased their lending rates to transfer part of the cost to their customers. As a result, the yield on earning assets also increased in the June quarter (from 6.2 percent in March to 6.9 percent in June).

Despite efforts by banks to maintain their margin, the cost of funds rose at a much

faster rate than the yield on earning assets, causing a contraction in the overall spread by 40 basis points (from 5.2 percent in March to 4.9 percent in June).

With the further 100 basis points increase in the monetary policy indicator rate at the end of June 2006, banks may further raise their lending rates in the next few quarters.

Efficiency

The efficiency ratio of banks (operating costs-to-operating income) deteriorated over the quarter to 45.3 percent from 44.8 percent in March 2006 and 44.7 percent in June 2005. The slight deterioration was a result of decreased operating income, caused by rising interest expenses.

Liquidity and Funding

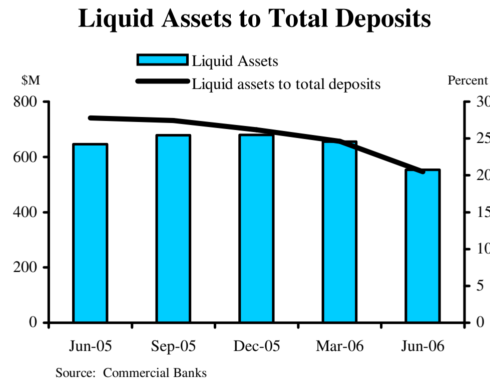
The liquidity position for banks continues to remain *marginal*. However, all banks successfully managed to accumulate the additional $56.9 million required to meet the increase in SRD.

The level of liquid assets dropped significantly over the quarter by $102.8 million to $552.5 million. On an annual comparison, it dropped by $93.3 million. This was mainly a result of banks setting aside funds to meet the increased SRD requirement in May 2006.

Due to the fall in the level of liquid assets, the ratio of liquid assets-to-total assets reduced to 17.7 percent from 21.4 percent in March. The liquid assets-to-deposits ratio also declined to 20.5 percent from 24.6 percent in March (Graph 37).

Graph 37

Liquid Assets to Total Deposits



Source: Commercial Banks

As at June, the 15 largest depositors of the industry represented 21.6 percent of the total deposits.

The maturity mismatch analysis shows positive inflows for the less than 1 month category, however, it reflects negative outflows of $335.0 million within the next 12 months. This is a reflection of the concentration in short term deposits while inflows from loans and advances are over the long term. These outflows can be met by the liquid assets held by banks

The refinancing of a large account over the quarter widened the uneven distribution of liquidity among the banks. While one bank became flushed with liquidity and held 77.7 percent of total Bank Demand Deposits at the central bank at the end of the quarter, another struggled to meet its day to day liquidity requirements. Inter-bank borrowing activity increased. The distribution of liquidity is expected to even out in the long term.

Generally, all banks managed their cash flow satisfactorily and weathered the

imposed SRD increase. Liquidity is expected to remain marginal in the next few quarters as banks try to absorb the impact of the monetary policy tightening.

Overview – Credit Institutions

Credit institutions on a consolidated basis continued their ***satisfactory*** performance during the quarter. Combined assets growth was generally driven by credit institutions' deposits placed with banks, and loans and advances.

The combined credit institutions' **capital adequacy** ratio remained ***strong*** at 22.8 percent.

Asset quality continues to be rated ***marginal*** with an increase in the level of past dues by $5.7 million in the 1-3 months category and expansion in classified exposures by $1.4 million to $19.9 million. Provisions were raised by $0.9 million.

Earnings are considered ***satisfactory*** despite a fall in earnings ratios.

Notwithstanding an improvement in all liquidity ratios, based on individual institutions' ratings **liquidity** of credit institutions is still assessed to be ***marginal.***

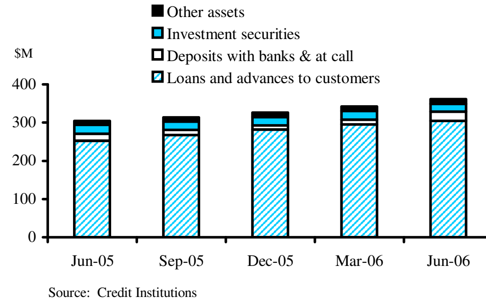
Balance Sheet

Credit institutions' assets grew at a faster rate this quarter, compared to the first quarter of 2006. Current total assets were $339.5 million, up by 5.6 percent over the quarter and by 18.6 percent over the year.

The growth was generally driven by credit institutions' deposits with banks (Graph 38) and loans and advances (Graph 39). Deposits with banks increased by 93.3 percent ($11.9m) over the quarter, and by 29.7 percent over the year. The increase came as term deposits from one institution's parent company pushed up total deposits at a faster rate than the growth in loans.

Graph 38

Structural Change and Growth in Credit Institutions' Assets

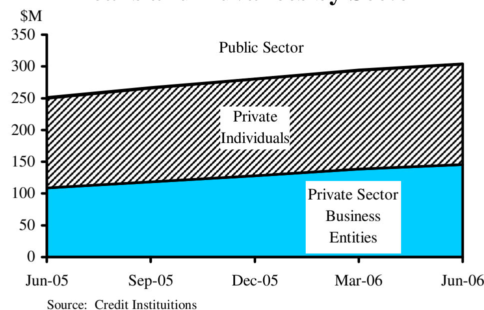


Source: Credit Institutions

Loans and advances grew by 3.2 percent over the quarter and 20.7 percent over the year to $304.3 million. The growth generally slowed over the quarter when compared to growth of 4.8 percent in the March quarter and 5.1 percent in December

Graph 39

Loans and Advances by Sector



Source: Credit Instituitions

New loans and advances disbursed over the quarter were generally at a lower level than March 2006 and the same period in 2005. Total new loans disbursed came to

$35.9 million compared to $44.6 million in March 2006 and $38.2 million in June 2005.

The top 5 sectors lent to during the quarter were:

- private individuals – housing (+23.2%);
- real estate (+18.1%);
- transport & storage (+15.6%);
- private individuals – personal transport (+13.0%); and
- building & construction (+6.7%).

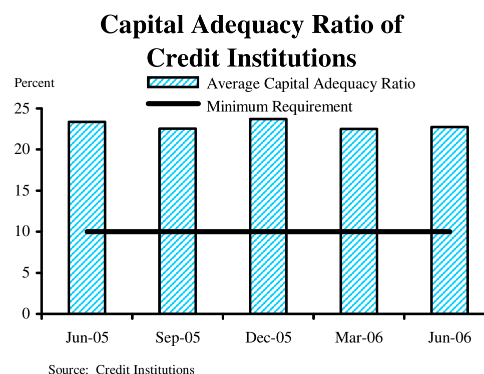
This was generally the same as for the last quarter. Most reflected the high priority lending sectors, with the exception of private individual's personal transport. The trend, compared to the same period last year, shows movement away from low priority lending sectors such as private individual's loans for personal transport (less was disbursed in the current quarter) and private individual's loans for other reasons apart from housing and personal transport.

On the funding side, notable movements were recorded for term deposits and amounts owing to holding company. Term deposits were up 21.4 percent to $168.3 million at the end of June. Amounts owing to parent company decreased by $15.2 million as one credit institution repaid its maturing debenture loans.

Capital Adequacy

Credit institutions remained well capitalised for the June 2006 quarter. The combined credit institutions' capital adequacy ratio was 22.8 percent (Graph 40) which was generally the same level recorded in the last quarter, but dropping slightly from the same period in 2005 by 60 basis points.

Graph 40

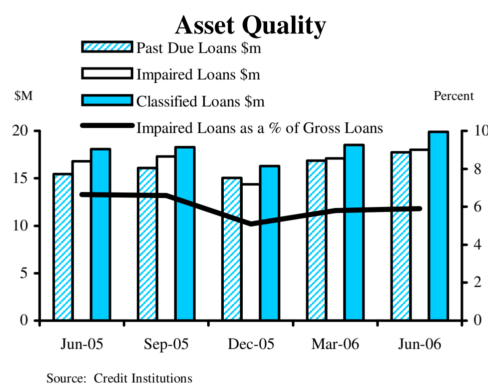


On an individual basis, all credit institutions were above the 10 percent requirement. Credit institutions are expected to remain well capitalised in the coming quarters.

Asset Quality

Credit institutions' asset quality continued to be rated as *marginal* with an increase in classified loans and the level of past dues (Graph 41). This was also evident in the increase of the ratio of classified loans to gross loans and past due loans to gross loans.

Graph 41



Classified loans increased by a further 7.5 percent to $19.9 million. The increase arose out of an increase in doubtful (11.8%) and loss accounts (11.7%).

Past due loans greater than 3 months continued to grow over the quarter, by 5.2 percent to $17.7 million. The majority of these accounts are past due over 2 years.

The ratio of classified loans to gross loans continued to increase, to 6.5 percent, representing a 26 basis points rise over the last quarter. Similarly the ratio of past due loans greater than 3 months to total loans was up by 11 basis points to 5.8 percent. The ratio of weighted classified assets (the level of classified loans expected to turn bad) to tier 1 capital and general provisions has improved[13] over the years from around 47 percent in June 2001 to 29.0 percent in June of this year.

Bad loan coverage[14] deteriorated by 50 basis points to 3.2 percent, and this is considered a marginal position, while good loan coverage[15] improved 10 basis points to 3.3 percent.

Earnings

Credit institutions' earnings are considered *satisfactory* despite a fall in earnings ratios.

[13] Shows credit institutions' resilience to an expected level of bad loans. The lower the ratio, the better the ability to withstand shocks to asset quality.

[14] Specific Provisions to classified exposures.

[15] General Provisions to net loans.

Credit Institutions' Income Statement

	Jun 05	Mar 06	Jun 06	% Change	
		$M		Over Qtr	Over Yr
Interest Income	8.1	9.0	9.3	2.8	14.2
Interest Expense	2.4	2.6	2.7	6.7	11.9
Net interest income	5.7	6.4	6.5	1.2	15.2
Add: **Non interest income**	0.7	1.1	0.8	-28.0	11.7
Commission	0.1	0.1	0.1	18.4	54.7
Fee Charges	0.2	0.4	0.4	-0.7	78.5
Other income	0.4	0.5	0.2	-59.3	-41.4
Total operating income	6.4	7.5	7.3	-3.0	14.8
Less: Operating expenses	4.2	2.7	3.2	19.7	-24.5
Less: Bad Debts & provisions	0.5	0.6	1.0	70.6	95.5
Equals:					
Profit before tax	1.6	4.2	3.1	-27.8	92.3
Less: Tax	1.1	0.7	0.5	-32.5	-56.2
Add Extra ordinary items	0.0	0.0	0.0	0.0	0.0
Equals:					
Net profit after tax	0.5	3.5	2.6	-26.9	399.6

Source: Credit Institutions

Interest income from loans led the increase in income over the quarter while interest paid for funds led the increase in interest expense over the quarter.

Bad debts and provisions increased by 70.6 percent to $1.0 million. This impacted all three credit institutions.

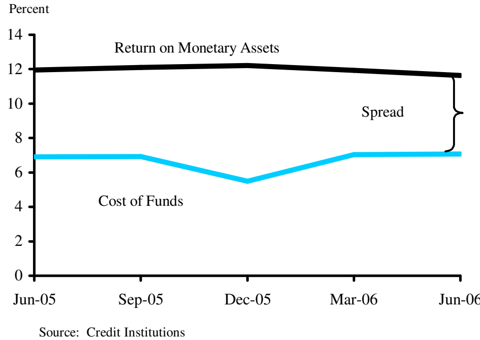
Return on assets before tax declined 170 basis points to 3.7 percent, and returns on assets after tax also declined, by 139 basis points, to 3.1 percent. Similarly, returns on equity dropped 807 basis points to 18.8 percent over the quarter.

Credit institutions' efficiency as measured by the ratio of operating expenses to operating income also deteriorated to 43.7 percent owing to an increase in personnel and other expenses.

Credit institution's cost of funds began to show the signs of tightening liquidity with the interest spread contracting over the quarter (Graph 42). While the return on monetary assets declined (11.6 percent from 11.9 percent) the cost of funds increased to 7.1 percent from 7.0 percent in March.

Graph 42

Margins and Spreads



Credit institutions' spread is expected to come under pressure as a portion of their loan portfolio is tied up with fixed interest rates. As such, while their returns on monetary assets would show a slight increase with increases in variable rates, their cost of funds would continue to rise as they would be compelled to raise interest rates on deposits to compete with the banks.

Liquidity

Credit institutions' liquidity was assessed as *marginal* based on individual institutions' ratings.

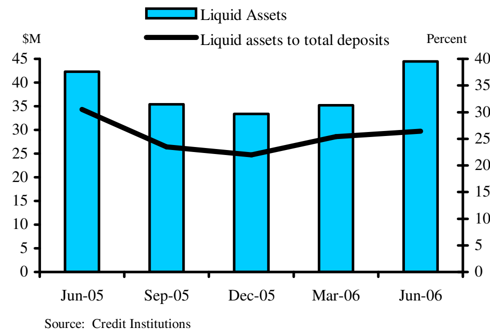
Liquid assets increased by 26.4 percent to $44.5 million owing to the increase in deposits with Banks, mainly by two institutions (Graph 43). Liquid assets relative to short term deposits improved to 42.4 percent while as a percent of total borrowings, the ratio declined over the year to 26.2 percent.

Liquid assets as a percentage of total liabilities improved to 12.9 percent from 10.5 percent recorded for March 2006. Loans to deposits decreased to 180.8 percent from 212.6 percent in March. This ratio still remains high and reflects credit institutions utilisation of funding from sources other than deposits to fund loan growth.

The combined deposits of the 15 largest depositors stood at $76.4 million, increasing by 104.8 percent over the quarter. As a result, liquid assets coverage of the 15 largest depositors deteriorated over the quarter from 94.5 percent in March to 58.3 percent.

Graph 43

Liquid Assets to Total Deposits



The combined maturity profile for credit institutions shows a negative mismatch of $28.7 million within the next 12 months compared to a negative mismatch of $31.9 million in the March quarter. The outflows can, however, be covered by the liquid assets held by credit institutions.

Insurance Industry Quarterly Condition Report – March 2006

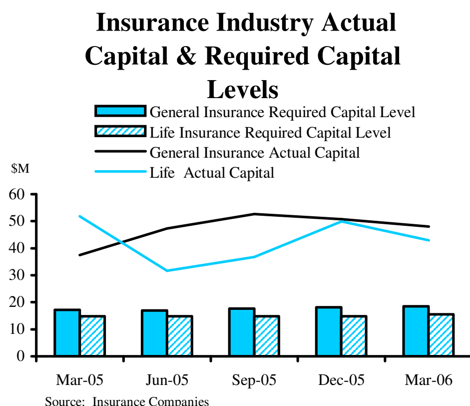
The insurance industry's performance was assessed to be satisfactory for the March

quarter of 2006 based on "**CARAMELS**[16]".

The total **capital** available for the insurance industry was $90.8 million, up by 4 percent from the corresponding quarter of 2005, against a required capital of $34.0 million (Graph 44). The main contribution to this growth was an increase in the admissible assets of general insurers by 31 percent.

Graph 44

Insurance Industry Actual Capital & Required Capital Levels



Source: Insurance Companies

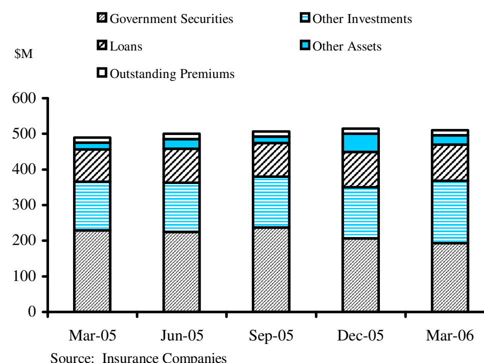
Combined insurers' **assets** recorded a growth of 7.0 percent over the year to reach $726.7 million. The growth was driven by both the life and general sectors with life insurers accounting for 70.2 percent of the total industry assets.

Total assets of the life industry grew marginally to reach $510.4 million at the end of March 2006. The growth was attributed by the increase in bank deposits to $30.9 million, secured loans to $100.0 million and cash on hand to $10.4 million.

The asset composition of insurers remained unchanged over the past twelve months (Graph 45). Investments continued to comprise a major portion of life insurer assets and accounted for 72.2 percent of total assets. The bulk of the life insurers' investment portfolio is made up of government securities and properties at $193.4 million and $61.6 million respectively.

Graph 45

Distribution of Assets for Life Insurance Companies



Source: Insurance Companies

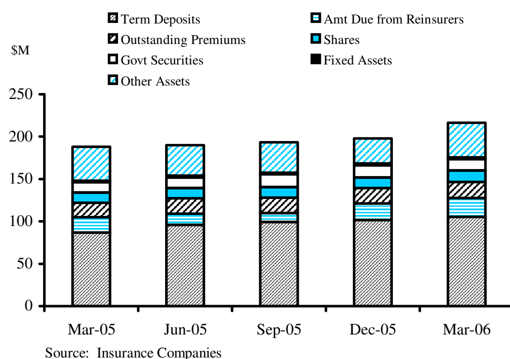
The general insurer's total assets grew by 15 percent over the year to $216.3 million compared to $188.1 million in March 2005.

During the year, general insurers continued to pursue active investment management strategies, resulting in lower cash holdings and larger investment portfolios (Graph 46). Total investment holdings rose by $21.0 million to $139.4 million, up by 18 percent from 2005, to command more than half of the allocations of general insurance assets (64.0 percent of total assets).

[16] **"CARAMELS"** stands for: **C**apital, **A**ssets, **R**einsurance, **A**ctuarial Liabilities, **M**anagement, **E**arnings, **L**iquidity and **S**ubsidiaries, a new reporting insurance supervision methodology.

Graph 46

Distribution of Assets for General Insurance Companies



Source: Insurance Companies

Of this amount, investments in bank deposits increased further to $105.5 million, accounting for 48.0 percent of total assets (2005: $87.3mor 46.0%).

Cash and deposit holdings totalled $116.8 million. The other major assets include outstanding premiums, amounts due from reinsurers, government securities, shares in related persons and cash on hand.

All insurers satisfactorily complied with the **reinsurance** requirements.

Total **liabilities** recorded a growth of 9.0 percent to $618.0 million compared to $569.0 million in the same quarter of 2005. This was underpinned by growth in the life insurers' balance of revenue account which continued to form the bulk of insurance industry liabilities at $442.5 million (95.8% of total liabilities).

Management is assessed to be satisfactory with adequate processes and practices in place. Some areas of improvement have been noted from recent on-site examinations and these are currently being addressed by the respective institutions.

For the quarter ended March 2006, the industry reported an overall **after tax surplus** of $9.6 million, a 27 percent reduction on the 2005 performance. Major contributions to the reduction were the drop in investment income and the rise in expenses.

The industry's **liquidity** position is considered satisfactory. The bulk of the assets are held as bank deposits and government securities and these can be easily liquidated to meet short term liabilities.

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

Insurance Brokers

The total earnings of insurance brokers for the quarter ended March 2006, marginally increased to $2.7 million when compared to the corresponding period of 2005. Total expenses increased by 3 percent to $1.7 million resulting in a profit after tax of $1.0 million.

The Insurance Broking Account Balance stood at $3.9 million compared to $4.5 million in the corresponding period of 2005.

The Reserve Bank of Fiji continues to process and approve offshore applications by brokers and individuals. There were 116 applications processed in the March 2006 quarter amounting to $8.9 million compared to 85 applications worth $4.6 million approved in the March 2005 quarter. The increase was due to both the increase in number of placements and amounts remitted for transport (aviation) and marine classes of insurance.

For the Record

GOVERNOR MR. SAVENACA NARUBE'S STATEMENT ABOUT THE FIJI ECONOMY

Statement by the Governor of the Reserve Bank of Fiji, 28 July 2006

The Reserve Bank of Fiji has a mandate under its Act to:

- Protect macroeconomic stability
  - Low inflation
  - Adequate foreign reserves

Inflation is under control despite the high oil prices because:

- The fixed exchange rate is serving as an anchor on prices
- Wage demands are moderate
- There is good inflation management in major trading partners
- There are good supply conditions of local market produce like dalo, local vegetables

Foreign reserves are adequate at this time but we are concerned about the future because:

- Commodity exports like sugar, garments, agriculture, forestry and fishing are
- seriously underperforming - this is a structural issue not a competitiveness issue
- Import demand is buoyant funded by remittances and domestic credit
- Remittances are funded from offshore so impact on foreign reserves is neutral
- Import funding by domestic credit is a direct drain on foreign reserves
- Hence the need to dampen domestic credit

Interest rate is the major instrument of central banks to dampen credit demand.

The Reserve Bank of Fiji has now used interest rates to slow down credit then spending and in turn imports. The Bank has been proactive as it takes time to translate the increase to spending and imports.

Unfortunately interest rates affect all forms of expenditure which includes investment and consumption.

To offset this, the Reserve Bank has issued guidelines on priority lending to commercial banks. This hopefully will help continue to support investment.

Central banks around the world use interest rate and lately they have been raising interest rates.

- US raised rates sometimes more than 4 times a year and is now over 5 percent
- New Zealand and Australia have done the same and their official rate is close to 6 percent
- Bank of Japan has raised rate for the first time in many years
- Reserve Bank of India has recently raised rates to over 5 percent

Fiji's official rate is only 4.25 percent which is relatively low.

To lessen the need to raise interest rate further fiscal policy should support monetary policy:

- Government to put in measures that discourage consumption imports
- Government to reduce take home pay
- Fiscal deficit to be reduced

Reforms must be accelerated immediately to lift commodity exports.

The Reserve Bank is confident that if these are done the situation will become sustainable within two years.

For the Record

REVISED ECONOMIC PROJECTIONS

Statement by the Governor of the Reserve Bank of Fiji, 10 August 2006

The Chairman of the Macroeconomic Policy Committee and Governor of the Reserve Bank of Fiji, Mr Savenaca Narube, today announced a slightly better economic growth projection for 2006.

According to Mr Narube, improved prospects from certain industries have contributed to an upward revision to the economic growth forecast for this year, to 3.1 percent from 2.7 percent projected in April. Although the manufacturing; electricity & water and the mining & quarrying sectors are now expected to register weaker performance, the transport & communication; agriculture, forestry, fisheries & subsistence; and the finance, insurance, real estate & business services sectors are anticipated to record improved performances.

The Chairman added that, "The real GDP growth projection for 2007 remains intact at the earlier level of 2.2 percent, but the growth for 2008, has been slightly downgraded to 2.8 percent. Overall, Fiji's economy is expected to grow at an average rate of 2.7 percent annually in the medium term, compared with an average annual growth of 2.4 percent over the last 5 years".

Inflation was 1.6 percent at the end of June.

On the external front, Mr Narube explained that, "In 2006 total exports (excluding aircraft) are envisaged to record a slower growth of 6.6 percent, compared with an earlier projection of 9.3 percent.

The downward revision arose from weaker-than-expected exports of garments, timber, gold and other domestic export items, which more than offset the positive contributions from re-exports, fish and the sugar industries".

In contrast, the Governor stated that, "Total imports (excluding aircraft) are projected to grow faster than earlier forecast. For 2006, total imports are now expected to register a growth of 17.5 percent, with higher payments for mineral fuels, machinery & transport equipment, chemicals and food items anticipated to fuel the imports bill. Unfortunately, the situation is being exacerbated by rising oil prices, which has risen from an average of US$55 per barrel in 2005 to around US$75 currently. It is commendable that the Government has pursued a National Exports Strategy Design initiative to explore opportunities to raise the level of exports".

The next revision of these forecasts will be announced at the Budget address in early November.

For the Record

SECURITY FEATURES FOR FIJI'S NEW DESIGN CURRENCY NOTES

Statement by the Governor of the Reserve Bank of Fiji, 22 September 2006

The Reserve Bank of Fiji will be issuing a new series of currency notes early in 2007. The notes will have improved security features, and these features were introduced to the press on Friday 22nd September at the Reserve Bank building.

Many of the features which have become familiar to the public will remain the same or similar (raised printing; very small text visible only with a magnifier; anti-photocopier and scanner line patterns; closely registered images *etc.*) or in improved form. Holograms carrying the same images as at present will remain on the F$20 and 50 denominations. The F$10 will carry *Kaleidoscope*™, a metallic foil overprinted such that an effect of movement is achieved when the note is angled.

The security threads will appear to the unaided eye just as they do in the current note series. The thread will appear as a series of shiny dashes on the surface of the paper and these will become a solid line when held against the light. The thread will carry text: 'RBF' plus the Reserve Bank logo, as per the current notes.

The thread will not now be fluorescent when illuminated with an ultraviolet light; instead the fluorescence will appear as a design elsewhere on the note, in two colours. These two fluorescent colours will both appear to be the same colour in normal light.

The Fijian effigy will remain as the watermark. It will however be accompanied by a bright numeral within the paper which will indicate the denomination of the note.

The new F$100 denomination will carry a brand new security feature called *Optiks*™ which is a very wide security tape (more than five times wider than the threads on the other denominations).

This will appear as an aperture on the front of the note, effectively producing a clear 'window' in the note. The tape will carry an image of typical Fijian emblems.

INFLATION REPORT AUGUST 2006

Executive Summary

The 2006 year-end inflation projection remains unchanged at 3.5 percent. The anticipated second-round effects of the build-up in oil prices over the past 2 years have not been fully reflected in consumer prices due to price regulations in the transport and utilities sectors. Furthermore, strong and consistent monetary policy tightening measures taken by the central banks of our major trading partners, have kept our imported inflation relatively in-check. The weaker price of market items has been another contributing factor. Domestic employment and wage growth are expected to be in line with the economic growth forecasts for the year, thus having minimal effects in terms of inflationary pressures for this year. The recent series of wage increments awarded to the civil service will most likely feed into prices in the coming year.

The inflation forecast for 2007 is expected to be around 4.0 percent, given that crude oil futures are hovering above US$75 per barrel and expectations that trading partner inflation will remain high in the coming year. In 2008, inflationary pressures are expected to ease to 3.5 percent, against the backdrop of lower trading partner inflation owing to a slightly weaker global economy and anticipated steadiness in international crude oil prices.

INTRODUCTION

The 2006 year-end inflation projection remains unchanged at 3.5 percent. This is underpinned by several factors. Firstly, the anticipated second-round effects of high domestic fuel prices have not fed through to other consumer prices, largely due to price controls. Secondly, imported inflation on average, has been relatively lower than last year, kept in-check by increases in interest rates by central banks abroad. Finally, prices of market items, on average, have fallen during the first six months of the year, contrary to our expectation. In 2007, inflation is expected to be around 4.0 percent and for 2008, year-end inflation stands at 3.5 percent.

This report is made up of seven sections. Section 1 briefly examines the purpose of the inflation report, while section 2 focuses on Fiji's inflation process. Section 3 covers inflation performance, while section 4 looks at inflation prospects. Inflation expectations and inflation outlook are highlighted in sections 5 and 6, respectively. Section 7 concludes the report.

1.0 PURPOSE OF THE REPORT

The RBF Inflation Report serves two purposes. Firstly, it intends to provide a comprehensive and forward-looking assessment on inflation to assist in the conduct of monetary policy. Secondly, it formalises the inflation forecasts and raises awareness about the inflation forecasting process. The report is prepared semi-annually, in February and August, to coincide with the two inflation forecasting rounds conducted every year.

2.0 FIJI'S INFLATION PROCESS

Against a backdrop of rising and volatile global oil prices and the ensuing impact on global inflation, Fiji continues to enjoy

relatively low inflation. In fact, inflation over the past decade averaged about 3.0 percent annually, very close to rates experienced by most of our trading partners. The low and stable rates of inflation can be attributed to our fixed exchange rate regime. Given that Fiji is a small open economy, about three quarters of our inflation is caused by foreign factors. This exchange rate arrangement has provided an excellent nominal anchor for inflation. Of course, the fact that all our trading partners explicitly or implicitly target inflation augurs well for Fiji.

2.1 Inflation Model

The model used to forecast inflation is based on a conventional mark-up model. It assumes that firms price their products by adding a margin to the cost of their inputs. The mark-up is assumed to be constant in the long run, but may vary in the short run. The costs of production included in the model typically includes unit labour costs and import prices.

The results suggest the following (in isolation):

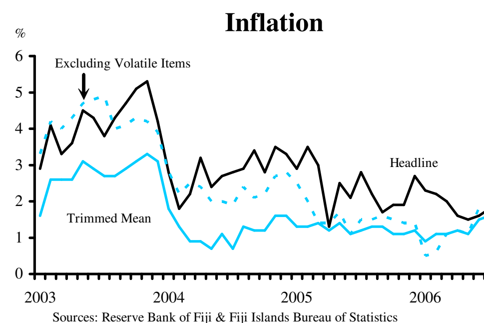
- A 1 percent increase in import prices causes inflation to rise by 0.73 percent, of which, 0.21 percent is reflected in the same year.
- A 1 percent increase in unit labour cost (or 1% rise in wages without a subsequent rise in output) causes inflation to rise by 0.20 percent, the following year and beyond.
- A 1 percent contraction in output gap causes a 0.18 percent rise in inflation in the following year.

3.0 INFLATION PERFORMANCE

Inflation during the last six months remained largely subdued, ranging from 1.5 percent to 2.2 percent (Graph 1). Underlying inflation, measured by the trimmed mean method, was also low, hovering between 1.1 and 1.6 percent. Another measure of underlying inflation, the Consumer Price Index (CPI) excluding volatile items, ranged from 0.6 to 1.8 percent during the same period. The fluctuations in headline inflation have largely been influenced by the movements in prices of items in the consumer basket that are seasonal in nature.

Graph 1

Inflation

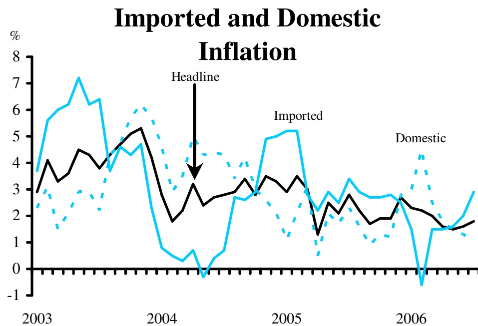


An additional measure of inflation is calculated by separating imported inflation from domestic inflation (Graph 2). In the CPI basket, around 45.0 percent of the items are imported as final or as intermediate goods. The other 55.0 percent is produced domestically. These include goods and services such as market items, housing rental, services and fees.

During the last six months, imported inflation ranged between -0.6 to 2.9 percent while inflation from domestically produced goods and services ranged between 1.0 to 4.5 percent. Average imported inflation for the six months to July moreover, rose marginally by approximately 0.2 percent, when compared with the preceding period. This could be attributed to the abating effects of import and excise duties with the removal

of VAT from certain items since early this year. The pick up in imported inflation towards the end of the review period nevertheless, has been due to the high prices of imported goods, in particular prices of items in the transport and heating & lighting categories, which have been influenced by higher crude oil prices.

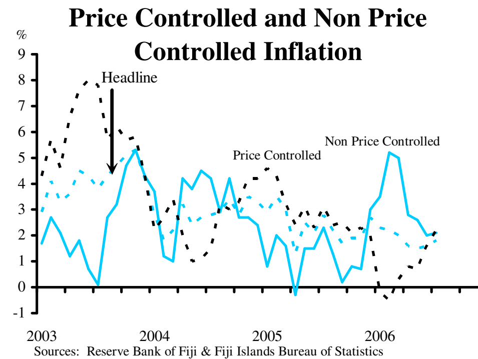
Graph 2



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

Movements in the inflation rate also reflect changes in prices of price-controlled and non-price controlled items. Price controlled items aggregate to around 49.0 percent of the total weight in the CPI basket, while non-price controlled items make up the rest of the basket. Inflation from price controlled items has ranged between -0.5 to 2.2 percent from February to July this year. The increases in costs of transport and heating & lighting have underpinned the movements in prices of price controlled items during the review period. For the same period, prices of items that fall under the deregulated market increased with a bit more volatility. As a result, headline inflation picked up towards the end of the review period.

Graph 3



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

4.0 INFLATION PROSPECTS

The inflation outlook can be ascertained by understudying the expected trends in domestic and external factors that impact consumer prices in Fiji.

4.1 Domestic Factors Affecting Inflation

Domestic factors influencing inflation are the **degree of spare capacity** in the economy and **unit labour costs**, which is a function of wage growth and productivity. Sometimes, movements in prices of administered goods and services and changes in tax and tariff rates can also cause a one-off change in the inflation rate.

4.1.1 Employment

Employment conditions during the first half of 2006 have made a rebound compared to the deceleration experienced during the comparable period last year. This outturn is evidenced by partial indicators such as the various RBF surveys as well as new taxpayer registrations with the Fiji Islands Revenue

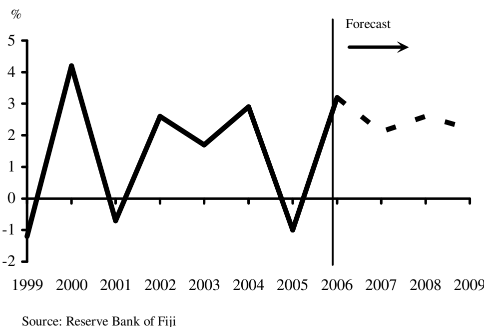
& Customs Authority (FIRCA). Cumulative to July, newly registered taxpayers have risen by around 15.0 percent to around 5,900 over the comparable period in 2005.

In the remaining months of the year, employment prospects are anticipated to remain optimistic, despite the redundancy of 61 employees of Post Fiji Limited in July, the result of an internal restructure of the organisation. The favourable outlook is largely attributable to the higher recruitment intentions indicated in the June Job Advertisements survey and the Fiji Employers Federation (FEF) Expectations survey.

The graph below provides forecasts of formal sector employment (Graph 4). These projections are internal estimates based on the Reserve Bank's FEF survey, industry liaison and an internal labour market model.

Graph 4

Formal Sector Employment Growth Rates



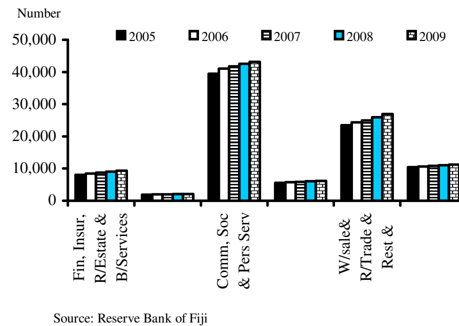
In 2006, the level of formal sector employment[1] is expected to grow by 3.2 percent, led by the finance, insurance, real estate & business services; agriculture, forestry & fishing; community, social & personal services; construction and wholesale, retail trade & restaurants & hotels related firms Graph 5).

In 2007, formal sector employment is estimated to grow by 2.1 percent, according to in-house estimates and partial indicators of employment and survey data. The finance, insurance, real estate & business services; wholesale, retail trade & restaurants & hotels; manufacturing; agriculture, forestry & fishing; transport storage & communication; and construction based industries are expected to underpin this rise.

The projected expansion in employment levels is principally accredited to the upbeat and emerging Information and Communication Technology (ICT) industry, together with the thriving tourism industry which is giving added impetus to its linked industries (wholesale & retail trade, construction and transport).

Graph 5

Employment Levels in Major Sectors 2005-2009



The medium-term outlook for 2008 and 2009 remains firm. Employment is projected to grow by around 2.6 percent and 2.2 percent in 2008 and 2009, respectively. This is generally in line with growth prospects for these years.

[1] Formal sector or paid employment refers to wage and salary earners.

In terms of informal sector employment[2], it is assumed that around 60 percent of the labour force in Fiji is employed under this arrangement. For 2006, approximately 249,000 people are expected to be employed by the informal sector based on in-house estimates. This represents an increase of around 2.8 percent over the year. Similarly, in 2007, it is anticipated that informal sector employment will again rise by about 2.8 percent.

4.1.2 Wages

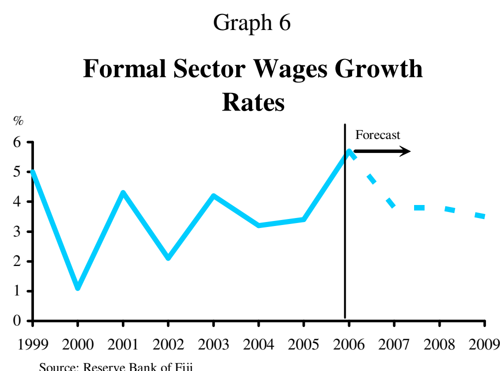
Wage settlements in Fiji are based on a combination of Cost of Living Adjustment (COLA) and performance based increments, or either one of the two. In 2005, formal sector wages were estimated to have increased, on average, by 3.5 percent, close to the average increment registered in the previous year (Graph 6).

Wages growth for 2006 is expected to be around 5.7 percent primarily due to several payments to civil servants, the largest group employed under the community, social & personal services sector. The State paid out 3.0 percent merit-based increment to civil servants in February, while another (estimated) 3.0 percent in June was given as part of the arrears from the 'Galanchini Award' approved in October last year. Moreover, in August, civil servants are expected to be paid another 2.0 percent merit increase for 2004, as well as a further increase of a 4.0 percent COLA in December for 2005, as agreed to in the Industrial Relations Framework. The civil service would have received an estimated 12.0 percent pay rise by the end of this year.

On the private sector front, hotel workers will continue to receive their agreed annual increase of 5.0 percent until 2007, while workers in the transport, storage & communication; finance, insurance, real estate & business services and construction sectors are anticipated to receive increments based on a combination of COLA and merit increases of around 5.0 percent, on average.

Graph 6

Formal Sector Wages Growth Rates



Source: Reserve Bank of Fiji

In 2007, wages growth is expected to ease to 3.8 percent. It is assumed that the public sector will receive 4.0 percent COLA based pay increment for 2006 and 2.0 percent based on the Performance Management System (PMS) for 2003. Hotel workers will continue to enjoy a further 5.0 percent increment and the higher demand for finance sector workers is likely to raise their wage increments in the medium term.

In the medium term, wage growth is expected to be moderate, largely corresponding to employment levels and the forecast pace of economic activity. It is anticipated that wages will rise by around 3.8 percent in 2008 and 3.5 percent in 2009.

[2] Characterised by small-scale activities that are normally semi-organised and use simple labour-intensive technology. Activities are predominantly unregulated by virtue of the non-registration of most activities under formal authorities and workers typically are without formal qualifications.

With regards to the informal sector, wages for such workers depend on the type of employment that they are engaged in. In many cases, wages are dependent on the seasonal nature of employment, the demand for respective commodities, the type and quantity of products and profitability. Given the above factors, informal sector wages are highly volatile and difficult to forecast.

4.1.3 Output Gap

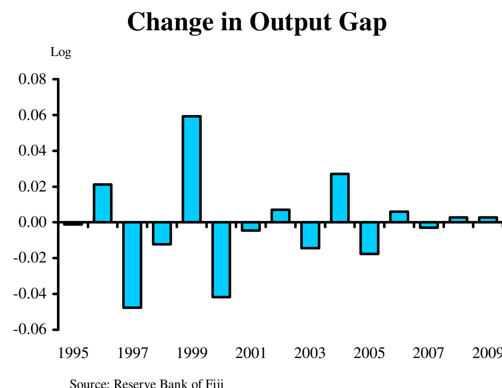
The output gap measures the difference between actual GDP and its potential. Generally, it is difficult to measure the output gap precisely. However, for the purpose of forecasting inflation, a basic econometric tool, the Hodrick-Prescott filter is used to estimate potential GDP.[3] This filter runs regressions on actual GDP level and constructs a trend line. Graph 7 depicts the change in output gap (positive values reflect stronger demand, while negative values reflect weaker demand).

The estimated output gap for Fiji in 2006 illustrates that the performance of the economy is expected to be better than the 2005 level since economic growth is anticipated to grow slightly above its potential this year. The optimistic result for 2006 is attributed to the revised GDP forecast which shows that for 2006, the economy is projected to grow by 3.1 percent after contracting by 0.7 percent in 2005. Hence, it is assumed that price pressures emanating from this front are likely to be reflected next year (as per the inflation mark-up model).

For 2007, the performance of the economy is expected to be below potential, as economic growth is likely to ease to 2.2 percent. Spare capacity in 2007 may assist in easing price pressures in 2008.

Graph 7

Change in Output Gap



4.1.4 Other Domestic Factors

Apart from the above mentioned factors, the CPI is also subject to seasonal variations. Prices of primary produce can fluctuate due to variations in supply, as a result of seasonal changes, adverse weather conditions, pest and disease outbreaks etc. Market items account for 11.0 percent of the CPI basket and are often subjected to large price swings (Graph 8).

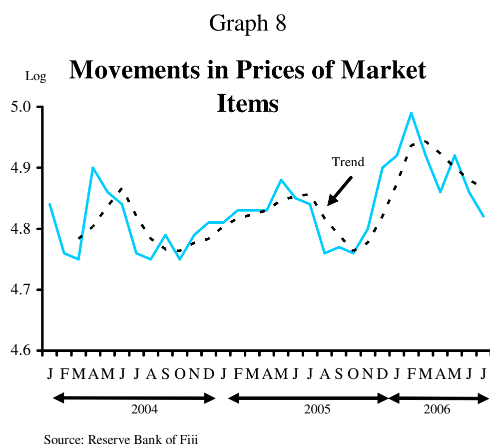
During the February-July period of 2006, prices of primary produce, classified as market items in the CPI basket, were lower compared to the same period in 2005. In the earlier projection, prices of market items were anticipated to rise by around 6.0 percent based on past trends and poor weather conditions experienced earlier in the year. However, prices of market items on average, actually eased in the first six months of the year. The fall in prices of primary produce in the first half of the year may be due to the fact that

[3] The limitations of the Hodrick-Prescott filter includes changes in weight affecting the responsiveness of potential output to movements in actual output. Also, it involves arbitrary choices of the business cycle frequency and the smoothing parameter. It neglects structural breaks, regime shifts and there is inadequate treatment of non-stationary dynamics.

supply was consistent with demand, underpinned by a cyclone-free period.

Graph 8

Movements in Prices of Market Items



Source: Reserve Bank of Fiji

In fact, market item prices are relatively lower than their 3-year average trend, and will probably remain low for the coming months except for December, the festive season.

4.2 External Factors

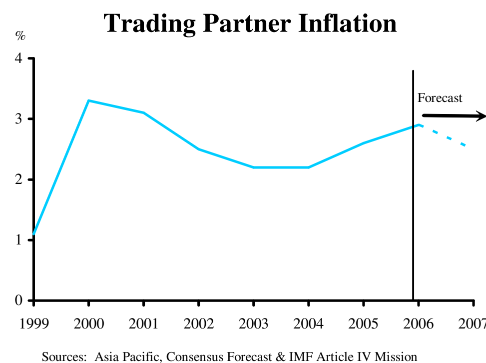
External factors affecting Fiji's domestic inflation generally filter through the domestic economy through **import prices**. Forecasts of import prices are based on trading partner inflation, international crude oil prices and movements in the exchange rate.

4.2.1 Trading Partner Inflation[4]

Fiji's average trading partner inflation as at July this year, stood at 2.9 percent. Almost all of the central banks of our trading partner countries have taken a tightening monetary policy stance in light of the high and volatile crude oil prices that they have been faced with (Graph 9).

Graph 9

Trading Partner Inflation



Sources: Asia Pacific, Consensus Forecast & IMF Article IV Mission

Inflation forecasts for Fiji's major trading partners have picked up since February this year. United States and New Zealand's inflation forecasts for 2006 are at their highest, at 3.4 percent. The forecast for Australia is currently at 3.1 percent. This is followed by the inflation forecast for the Euro zone at 2.2 percent and Japan at 0.6 percent.

The persistently high and volatile international crude oil prices remain a threat to global inflation.

4.2.2 International Crude Oil Prices

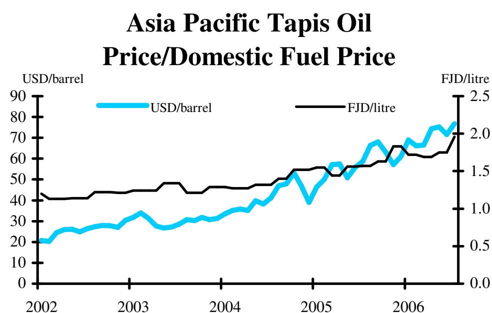
International crude oil prices registered consistent increases in the first half of this year. This subsequently placed upward pressure on the prices of domestic fuel towards the later months of the review period. In fact, Brent crude oil prices in July had risen to an average of around US$74 per barrel, up from the US$60 per barrel average in February. Unresolved geo-political tensions in the Middle East continue to underpin the high and volatile nature of global oil prices. Looking ahead, futures prices for Brent crude oil are hovering around the US$76 to US$78 per barrel mark.

[4] Trading partner inflation forecast is sourced from the monthly Consensus Forecast, Asia Pacific Consensus Forecast and 2004 IMF Article IV Mission Report.

Tapis crude oil prices[5] continued to follow the general movements of Brent crude oil prices in the first half of the year. Monthly averages from February to May showed a general increase in the average price from US$66 to US$75 per barrel mark (Graph 10). Prices dropped in June before picking up again in July towards the US$77 per barrel mark. While there is no futures market for Tapis, it is expected to customarily track Brent crude oil prices.

Graph 10

Asia Pacific Tapis Oil Price/Domestic Fuel Price



Sources: Bloomberg and Prices & Incomes Board

In terms of domestic fuel prices, four price changes[6] have been implemented within the review period by the Prices & Incomes Board (PIB), reflecting the volatility in the international crude oil prices. In the year to July, domestic fuel prices have increased by an annualised rate of 21.0 percent. In the months ahead, domestic fuel prices are expected to increase marginally in line with PIB's regular review of domestic fuel prices, based on the Tapis oil price movements.

The impact of high crude oil prices on inflation will also depend on the movements in the US dollar. A weaker US dollar will cushion the impact of higher crude oil prices on inflation while a strengthening would worsen the situation.

4.2.3 Exchange Rates

Given that around two thirds of our import payments are made in US dollars, movements in the USD/FJD bilateral exchange rate will have implications on consumer prices.

Graph 11 illustrates the movements in the US dollar vis-à-vis the Fiji dollar for the previous year up to July of this year. Towards the end of 2005, the US dollar generally appreciated against the Fiji dollar. Likewise, during the first six months of this year, the US dollar appreciated slightly against the Fiji dollar. The appreciation has largely been underpinned by interest rate hikes by the Federal Reserve, making US dollar denominated assets more attractive.

Looking ahead, the US dollar is expected to further strengthen against the Fiji dollar based on possibly further interest rate hikes by the Federal Reserve, given persisting inflationary pressures from the soaring global oil prices.

Graph 11

USD/FJD

Source: Reserve Bank of Fiji

Other currencies within the Fiji dollar exchange rate basket could also have an impact on future import prices in the

[5] The PIB uses this price to set domestic fuel prices.
[6] The weighted average changes for the domestic fuel price hikes were 8.0 percent fall in January, 1.0 percent fall in March, 3.0 percent increase in May and 12.0 percent in July.

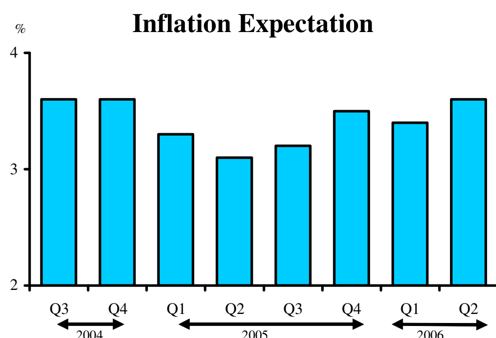
coming year. However, it is expected that the overall impact of these developments may be marginal, due to the off-setting effects of the various currency movements in our exchange rate basket.

5.0 INFLATION EXPECTATIONS

This section briefly looks at the market's expectations on inflation, by analysing the inflation expectations index. This index is based on the Bank's FEF survey on business expectations, particularly in capturing firms' views on the near-term inflation outlook.

According to the June 2006 FEF Expectations survey, on average, firms anticipate inflation to be around 3.6 percent in the next twelve months, compared to 3.4 percent recorded in the March survey of this year (Graph 12).[7] The anticipated increase in inflation expectations may be owing to the recent increases in domestic fuel prices.

Graph 12



Furthermore, expectations on wages are also modest, with the majority of firms surveyed anticipating wage increases to fall within the 0.0-5.0 percent range over the next twelve months.

5.1 Asset Prices

Housing market activity, as per the June survey data have shown some signs of slowdown. Property prices moreover, have shown varied performance. Whilst property prices in general remains at high levels when compared to 2004, prices in the second quarter of this year showed marginal decreases over the corresponding period last year. This could be attributed to a slowdown in demand for properties arising from the higher cost of borrowing, given the recent interest rate hikes and difficulty in sourcing finance.

Looking ahead, property prices are likely to ease further as interest rate hikes implemented early this year gradually take full effect. The passing of the Real Estate Bill, which is hoped to bring about better regulation of the property market via licensing requirements for real estate agents and sales person(s), prohibition to charging excessive commission and compliance with various other regulations, may also put downward pressure on prices.

6.0 INFLATION OUTLOOK 2006 - 2008

The inflation outlook for the medium-term remains modest.

The 2006 year-end inflation forecast remains unchanged at 3.5 percent. This is attributed to the second-round effects of higher domestic fuel prices not being passed on to other consumer prices simply because of price controls. The pass-through of domestic fuel prices to transportation costs have been minimal because of concessions given to the bus

[7] Inflation expectation comprises the upper quartile of the 4 different ranges of inflation expectations (0-3, 4-5, 6-7, 8-10) provided to firms in the FEF survey. The response is then weighted.

and taxi operators to compensate for declining submissions by these operators to increase bus and taxi fares (Graph 13).

Furthermore, the average imported inflation during the February to July period this year has been around 1.5 percent compared to 3.2 percent recorded in 2005, thus supporting subdued domestic prices as well. The monetary tightening decisions of the central banks of our trading partners have kept our imported inflation largely in-check.

In addition, the prices of market items, unlike previous years, have fallen by an annualised rate of 1.5 percent during the review period. During the February forecast round, these prices were anticipated to rise by at least 6.0 percent, mainly based on past trends and poor weather conditions experienced early in the year.

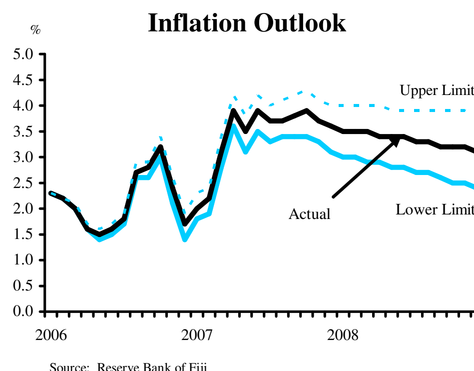
Moreover, the removal of VAT from basic items in the CPI basket at the beginning of this year resulted in a structural shift downwards in consumer prices. In regards to domestic employment and wage growth, they are expected to be in line with the economic growth forecasts for this year.

For 2007, inflation is expected to pick up slightly, on the back of improved economic activity in 2006. The above potential performance of the economy in 2006 may exert inflationary pressures in 2007. Also, the effects of the VAT removal this year would be abated. Moreover, the high and volatile crude oil prices, higher trading partner inflation and the expected 2006 COLA payout coupled with dampening domestic demand following the interest rate increase by the Bank have been taken into consideration.

Incorporating these factors, the year-end inflation for 2007 is projected at 4.0 percent.

Graph 13

Inflation Outlook



Source: Reserve Bank of Fiji

For 2008, inflationary pressures are expected to ease to 3.5 percent against the backdrop of lower trading partner inflation owing to an expected weaker global economy and anticipated steadiness in global crude oil prices.

6.1 Risks

The upper and lower limits in Graph 13 are expected to cater for most of the unanticipated shocks.[8] However, the inflation rate may fall well outside the band, if shocks are very large and persistent. The potential risks to the above inflation forecast include the following:

External:

- Stronger than anticipated world demand;
- Unanticipated increase/decrease in international crude oil prices;
- Adverse currency movements; and

[8] The upper and lower limits are uncertainty factors. These are derived from the inflation model and are adjusted in line with deviation between the forecast and actual, over the 5-year period.

- Any other adverse external shock such as natural disasters.

Domestic:
The current forecast does not include the possibility of other factors influencing the inflation rate in the future. These factors include:

- Natural disasters;
- Extreme one-off price shocks;
- Changes in import duties and tax rates; and
- Revision of the CPI basket based on the 2002 Household Income & Expenditure Survey.

7.0 CONCLUSION

The year-end inflation forecast for 2006 remains at 3.5 percent while for 2007, the inflation outlook stands at 4.0 percent. For 2008, the year-end inflation is anticipated to ease to 3.5 percent, stemming from expected lower trading partner inflation and stable global crude oil prices.

The next assessment will be in January 2007. However, the Inflation Report, which will include the medium term forecast, will be produced in February.