- If the full payments for the restructuring of Polynesian Airlines are made in 2005, this will lower gross reserves from the current level of 4 months of imports to about 3½ months of imports. Thus, the reserve level at end-2005 would stay broadly unchanged from the end-2004 level. While a higher reserve coverage ratio is desirable, the payments do not significantly undermine Samoa's reserve position.
- The budget also announced that about 2½ percent of GDP of the deficit target would be financed domestically (through issuance of treasury bonds of 5, 10 and 15 year maturities). However, given the level of excess liquidity in the banking system as discussed in the staff report (paragraph 8), which currently stands at about 4 percent of GDP, the impact of this on interest rates is likely to be minimal.
- Excluding the reform costs for the restructuring of Polynesian Airlines, the 2005/06 budget deficit target becomes 1½ percentof GDP. This compares with about ¼ percent of GDP recommended by the staff (excluding restructuring costs for the airline the staff tentatively included in its recommendation). The inflation and growth impact of the higher deficit (about 1 percent of GDP) is likely to be small, especially if a significant part of the wage increase leaks into imports. However, this implies that there would be a non-negligible impact on the balance of payments, reinforcing the staff's concerns and strengthening the case for monetary tightening as recommended in the staff appraisal (paragraph 40).

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IMF Executive Board Concludes 2005 Article IV Consultation with Samoa

On June 17, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Samoa.[1]

Background

Samoa embarked upon a remarkable economic transformation in the mid-1990s and has transformed itself into one of the best managed economies in the Pacific Island region over the last decade. The economy registered solid growth, low inflation, improved public finances and international reserve levels, and outperformed comparator countries both within and outside the region. Samoa also made significant progress toward the Millennium Development Goals (MDG). Political stability, close consultation with stakeholders, and extensive efforts to foster a broad consensus for reform have been integral to the program's steady implementation and success.

Despite this notable progress, overall macroeconomic performance weakened in recent years, the export base remains narrow (mainly fish, automotive parts, and tourism), and the economy remains vulnerable to external shocks. There are still substantial reforms which need to be tackled to consolidate the gains made over the last decade and boost Samoa's long-term growth prospects.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Although growth has slowed down from levels attained through 2000/01, economic activity has started to pick up. Real GDP growth increased to 3½ percent in 2003/04 from about 1¾ percent in 2002/03. The slowdown in the manufacturing sector, poor performance of the fishing sector and cyclone Heta's damages in January 2004 (which hit hard the agriculture sector), was more than offset by the robust growth in the services and construction sectors. Growth is projected to be 3 percent for 2004/05. Inflation (year-on-year) rose to double digits in 2004 following cyclone Heta's impact on food prices, but has declined in recent months and is expected to turn negative by the end of 2004/05. Inflation (12 months average) is projected to be about 7½ percent in 2004/05. The trade deficit widened in both 2003/04 and 2004/05 reflecting sluggish export growth, and high import growth which was driven by the boom in the construction sector. Structural weaknesses rather than exchange rate competitiveness, have led to the weak export performance.

Real GDP growth is projected at 3 percent in 2005/06 underpinned by robust growth in the services and construction sectors. Agriculture is expected to recover slowly, while improvements in the fishing sector remain uncertain. Headline inflation (12 months average) is projected to decline to 3 percent in 2005/06. The current account deficit (excluding official transfers) is projected at about 13 percent of GDP in 2005/06 due to continued weak export growth and the increase in construction-related imports.

The fiscal deficit outturn of 0.9 percent of GDP for 2003/04 was lower than budget (1½ percent of GDP). Although revenues were slightly below budget in 2003/04, this was more than offset by continued expenditure restraint. The 2004/05 budget targets a deficit of 0.9 percent of GDP. At end December 2004, the government's fiscal position recorded a deficit of about ½ percent of GDP based on preliminary 2004/05 mid-year figures. The forthcoming 2005/06 budget is likely to face a number of domestic pressures most notably the strong calls for a large wage increase in the public sector. The costs of restructuring Polynesian Airlines are also likely to impose a significant burden on the forthcoming 2005/06 budget. The staff proposes that the fiscal deficit be contained at 0.9 percent of GDP for the forthcoming 2005/06 budget given the need to gradually reduce the debt level. Prudent wage policy is crucial to achieving this deficit target.

Executive Board Assessment

Executive Directors commended the authorities for good macroeconomic management and for continued efforts to undertake structural reforms. They welcomed the recent pickup in growth and the decline in inflation following a significant increase in 2004 that largely reflected the impact of cyclone Heta on food prices. Directors considered that over the medium term, Samoa's economic prospects remain favorable, provided that macroeconomic stability is maintained and structural reforms are deepened to facilitate private sector development.

Directors emphasized that maintaining fiscal discipline will be essential to further reducing public indebtedness and enhancing Samoa's flexibility to respond to external shocks. In this regard, Directors expressed concern about the increased deficit target in the 2005/06 budget to about 4 percent of GDP from about 0.9 percent of GDP in 2004/05. The increase reflects to a large extent the costs allocated for the restructuring of Polynesian Airlines, but also a large

public sector wage increase. Directors welcomed the progress made toward the restructuring of Polynesian Airlines, and stressed that further progress needs to be made toward its comprehensive restructuring. With regard to the wage increase, they noted risks for both macroeconomic stability and the government's economic reform program, and urged the authorities to follow a prudent wage policy in future budgets. They welcomed the planned phase in of the wage increase over three years, and the authorities' consideration of a performance-based system in lieu of automatic wage increases in the future. Directors emphasized that expenditure restraint would allow the public debt to GDP ratio—which remains high by regional standards—to decline gradually over the medium term.

Directors encouraged the authorities to continue their efforts toward strengthening tax administration, and in particular to establish a Large Taxpayer Unit and to modernize the 1974 income tax legislation. Directors also noted that a better rationalization of expenditures would enable a reorientation of spending toward the education, health, and infrastructure sectors, which are crucial for medium-term growth. Directors welcomed the authorities' plans to include a medium-term budget framework in the 2006/07 budget.

Directors considered that Samoa's adjustable peg exchange rate regime has served well as a nominal anchor. They agreed that the policy of periodically making small adjustments in the value of the tala has struck an appropriate balance between maintaining competitiveness and preserving the exchange rate peg's role as an anchor for inflation. Directors also welcomed the authorities' intention to tighten monetary policy in view of the potential balance of payments pressures that could arise from the large budget deficit in 2005/06.

Directors commended the Central Bank of Samoa for the recent measures taken to strengthen the supervision framework. They noted that the approval of the international banking bill, which requires all offshore banks to establish a physical presence in Samoa, will enhance the development of the financial sector. Directors welcomed the progress made in strengthening Samoa's framework for Anti-Money Laundering and Combating the Financing of Terrorism. Directors commended the authorities' interest in improving the investment guidelines of the National Provident Fund (NPF). They noted that given its high level of nonperforming loans, which reflects increasing activity in non-core functions, there is a need to strengthen the NPF's supervisory framework. Directors noted that a financially-sound pension fund will be needed to deal with the fiscal pressures that can arise when the population ages.

Directors acknowledged the progress made in a number of key areas of structural reform, such as civil service reform, telecommunications sector liberalization, and WTO accession talks. They welcomed the authorities' commitment to implement the reforms outlined in the Strategy for the Development of Samoa. They emphasized that it is important for Samoa to continue to move forward its public sector reform agenda and tackle impediments to private sector development. In particular, they noted that deeper reforms of state-owned enterprises and land reform are important to enhance private sector development. This will require enacting and implementing the Companies Act and its supporting legislation, and engaging in consultations with the public to build an institutional framework for an efficient lease market for communal

land. Directors commended the authorities' plan to encourage investment in tourism, where Samoa has a comparative advantage.

Directors noted that Samoa has made important progress in strengthening the reporting of economic statistics, and welcomed its adoption of the IMF's General Data Dissemination System (GDDS). Nevertheless, they encouraged the authorities to improve the quality and timeliness of fiscal data and the disclosure of assumptions and risks in the annual budget.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.