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French Polynesia (Overseas Country of)

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ISSUER CREDIT RATING	
French Polynesia (Overseas Country of)	
Issuer Credit Rating	BBB+/Negative/--
Issuer credit rating history:	
July 18, 2006	BBB+
Sept. 5, 2000	A-

Major Rating Factors

Strengths:

- Very solid financial support from the Republic of France
- Strong tax flexibility, though this is hampered by Polynesia's social and political climate
- Satisfactory financial performance and moderate financial requirements
- Modest direct debt by international standards

Weaknesses:

- Political instability and consequent lack of medium-term visibility on finances
- Weak management with little control over significant off-balance-sheet exposures
- Structurally dependent and vulnerable economy
- Highly rigid operating expenditures and structurally high infrastructure needs

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Rationale

The rating on the Overseas Country of French Polynesia primarily reflects the very strong financial support from the Republic of France (AAA/Stable/A-1+) that props up Polynesia's economy. The rating is also underpinned by strong revenue autonomy, satisfactory financial performance, and moderate debt by international standards. The rating remains constrained by the persistence of an uncertain political situation and subsequent absence of visibility on the country's finances; Polynesia's structurally dependent and vulnerable economy; growing rigidities on operating costs; and weakened management capacities. In addition, significant off-balance-sheet exposure to Air Tahiti Nui (ATN)--which has been badly hit by rising oil prices--and the social security system, weigh negatively on the ratings.

Net of budgetary changes and onetime items, Polynesia posted a 11% operating margin in

2005, comparable with 2004 though weaker than pre-2002. Thanks to sizable capital grants, the overseas country entirely self-financed its investment program and reduced its direct debt burden to a moderate 58% of operating revenues (or 13% of GDP) in 2005. Standard & Poor's Ratings Services estimates consolidated debt to be about 87% of total revenues.

The continued fraught political and social climate in Polynesia raises questions over the government's commitment to budgetary discipline and hampers the country's tax flexibility. The country is increasingly exposed to slippages in transfers to satellites or in social expenditures and to shortfalls in state transfers, failing the renewal of some agreements. Although the final terms of a reform of the social security financing system will result from ongoing negotiations with unions, we have no visibility on how this will affect Polynesia's finances.

Situated in the Pacific Ocean, Polynesia is handicapped by its small size, and young and growing population. Massive and continued state transfers sustain Polynesia's economy, which generates--notably through tourism--only about one-third of the income needed to support its standard of living, one of the highest in the South Pacific area. The evolution of the economy is structurally bound to that of state transfers and other external factors.

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Outlook

The negative outlook reflects our concern that the continued unstable political and social situation might prevent Polynesia from implementing a clear financial strategy, and have negative knock-on effects on the performance of the overseas country's public finances, leading to a structural deterioration in credit fundamentals.

If continued political and social instability result in further deterioration in Polynesia's self-financing capacity and material slippage in debt levels, the ratings could come under pressure.

Conversely, the outlook could be revised to stable if the overseas country succeeds in implementing its reform while maintaining satisfactory budgetary performance, and upgrades its management capabilities in order to provide better medium-term visibility on its finances, including those of its satellites.

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Comparative Analysis

Among local and regional governments Polynesia's closest peers are the French Region of La Réunion (BBB+/Stable/--) and the Canadian Province of Prince Edward Island (A/Stable/A-1). Compared with these peers Polynesia has a much higher level of political autonomy, including its own tax regime, social security system, and local public sector. Like La Réunion, Polynesia's economy is largely dependent on external consumption and subsidies from the French state. Polynesia is less wealthy than Prince Edward Island.

Polynesia's government is interventionist and actively supports the local economy through large subsidies to the private sector; a heavy capital investment plan partly financed by the French state; and, specifically, the development of ATN. In Prince Edward Island state support may be as strong as that enjoyed by Polynesia, but it takes the form of equalization transfers and payments to the social and health care system. Similarly, La Réunion receives large social transfers to compensate for its below-average wealth and tense unemployment situation. From a financial perspective, Polynesia's higher investment level translates into greater financing requirements than those of Prince Edward Island, although they are in line with La Réunion's projections for the coming years. Polynesia's direct debt, standing at 58% of operating revenues at year-end 2005, also compares favorably with that of its Canadian peer (106% in 2005) or with La Réunion's near-term projections. On the other hand, Polynesia has greater contingent liabilities than either of these two peers.

Polynesia's creditworthiness is also similar to that of certain sovereign islands rated by

Standard & Poor's, such as the Cook Islands (BB-/Positive/B) and The Commonwealth of The Bahamas (A-/Stable/A-2). All three economies are characterized by their moderate size and dependency on tourism, making them sensitive to international economic conditions, and all were markedly hindered by the U.S. economic slowdown in 2002. Polynesia and the Bahamas are wealthier and enjoy similar levels of GDP per capita. Among their credit strengths is a close political relationship with their respective sovereigns. The Cook Islands also enjoy special ties with New Zealand (AA+/Stable/A-1+). Unlike Polynesia, however, the Cook Islands and the Bahamas do not benefit from financial aid, which explains why they posted higher debt levels as a percentage of GDP (48% and 21.4%, respectively) than Polynesia (12.7%) in 2005. Defense, justice, and external relations remain the mainland governments' prerogatives for all three peers.

Table 1 Overseas Country of French Polynesia 2005 Peer Comparison

	Overseas Country of French Polynesia	Region of La Réunion	Province of Prince Edward Island	Montserrat	Cook Islands
Issuer credit rating*	BBB+/Negative/--	BBB+/Stable/--	A/Stable/A-1	BBB-/Stable/A-3	BB-/Positive/B
Sovereign	Republic of France	Republic of France	Canada	United Kingdom	Cook Islands
Sovereign rating	AAA/Stable/A-1+	AAA/Stable/A-1+	AAA/Stable/A-1+	AAA/Stable/A-1+	BB-/Positive/B
Status	Overseas country	Overseas region	Province	Overseas territory	Independent association with New Zealand
Currency	French Pacific franc	Euro	Canadian dollar	Eastern Caribbean dollar	New Zealand dollar
Degree of dependency on the sovereign/state support	Strong	Large social transfers	Social and equalization transfers	High financial dependence	N/A
Key economic sectors	Public sector, tourism, pearls	Public sector, tourism	Agriculture	Construction, public sector	Tourism, public sector
Population	252,900¶	764,600¶	1,378,644§	4,700¶	13,200¶
GDP (mil. US$)	3,851	12,037	3,559§	41.9§	187.5¶
GDP per capita (US$)	14,682	15,702	22,126§	9,260§	13,996¶
General government debt/GDP (%)	12.7¶	1.1¶	28.5¶	10.0§	41.2§
General government fiscal balance/GDP (%)	0.0¶	(0.2)¶	(0.7)	5.1§	4.0¶
Budgetary revenues coming from the sovereign level (as a % of revenues)	17.4¶	27.6	40.4	46.4§	N.A.
Unemployment rate (%)	11.7	31.9¶	11.3§	N.A.	N.A.

Data for year ended Dec. 31, 2003, unless otherwise stated. *Ratings as at July 28, 2006. ¶2005 figures. §2004 figures. N/A--Not applicable.

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System Support And Predictability

Significant autonomy strengthened in 2004

Polynesia was a French colony until 1946, when it became a French overseas territory with its own local parliament. Since the mid-1980s it has gradually gained more autonomy than France's other overseas departments and regions, carrying broader responsibilities and wielding greater taxing power. In February 2004, Polynesia's bylaws were amended, and the territory became a "pays d'outre mer" (overseas country). The overriding effect of this has been to give more weight to local parliamentary decisions, particularly those pertaining to civil, labor, and property rights. In practice, the Polynesian assembly votes in the country's budget and laws, provided such laws respect the French constitution. It also elects and can dismiss the president of the country; a source of instability in the absence of a strong parliamentary majority.

Within this framework, Polynesia is a kind of hybrid. It is a local government endowed with sovereign-like powers, notably on taxes and duties, and sovereign-like responsibilities including labor rights, economy, employment, education, health, and social care, none of which local governments in France assume.

The social security system principally provides pensions and health insurance under three different regimes financed by different mixes of social contributions from citizens and companies, income tax (CST), and state and overseas country contributions. Representatives of the labor unions, employers, the state, and the country govern these regimes under the umbrella of the Caisse de Prévoyance Sociale (CPS), for which the country is ultimately responsible.

Polynesian municipalities have limited jurisdiction and no taxing power since they are subject to ex ante supervision. They assume responsibilities on behalf of the overseas country (water and waste treatment, for example), and derive most of their resources from Polynesia's inter-municipal equalization fund (FIP), which is funded by the state and the country up to, in the 2006 budget, 17% of the country's tax proceeds. The current Polynesian government has agreed to gradually increase this, to 25% by 2009, which will add rigidity to the country's expenses. The implementation of the planned reform, by which municipalities would gain autonomy and be supervised ex post like their mainland counterparts, has been delayed at the mayors' request.

Strong financial support from the French state

The French state has consistently and heavily supported its overseas territories financially. The most important overseas-specific schemes benefiting Polynesia are:

- State civil servants benefit from high wages and pensions (approximately twice those of their mainland counterparts) that account for the majority of Polynesia's cash inflows (see chart) and fuel the Polynesian consumption-driven economy.
- The "Pons" and "Girardin" laws allow private investors--notably in hotels and resorts--to benefit from tax exemptions representing up to 70% of their investments. This amounted to €0.42 billion/French Pacific franc (CFP) 50 billion loss of revenues in France's 2006 budget for Polynesia. The laws are complemented by a similar tax exemption scheme supported by Polynesia, which represented a CFP11 billion loss of revenues in the country's 2006 budget.

In addition to these national policies in favor of French overseas territories, France provides Polynesia with specific forms of financial support, including:

- Compensation for the loss of nuclear activities. Following the termination of nuclear testing, the French government has committed to injecting the equivalent amount of money into the local economy to help Polynesia refocus and develop its economic autonomy. Consequently, the country has received CFP18 billion per year since 1993. This annual subsidy, initially agreed for a 10-year period, was extended indefinitely under the form of a new grant, "Dotation Globale de Développement Economique" (DGDE), by a new convention signed in 2002. The French state reduced the flexibility Polynesia presumably had on this revenue by capping at 20%, from 2008, the share of this resource available to fund employment-related operating expenses. This amendment to the convention follows a rejection by the country's audit board of the country's initial budget for 2006, which accounted about one-half of the DGDE income as operating revenues.

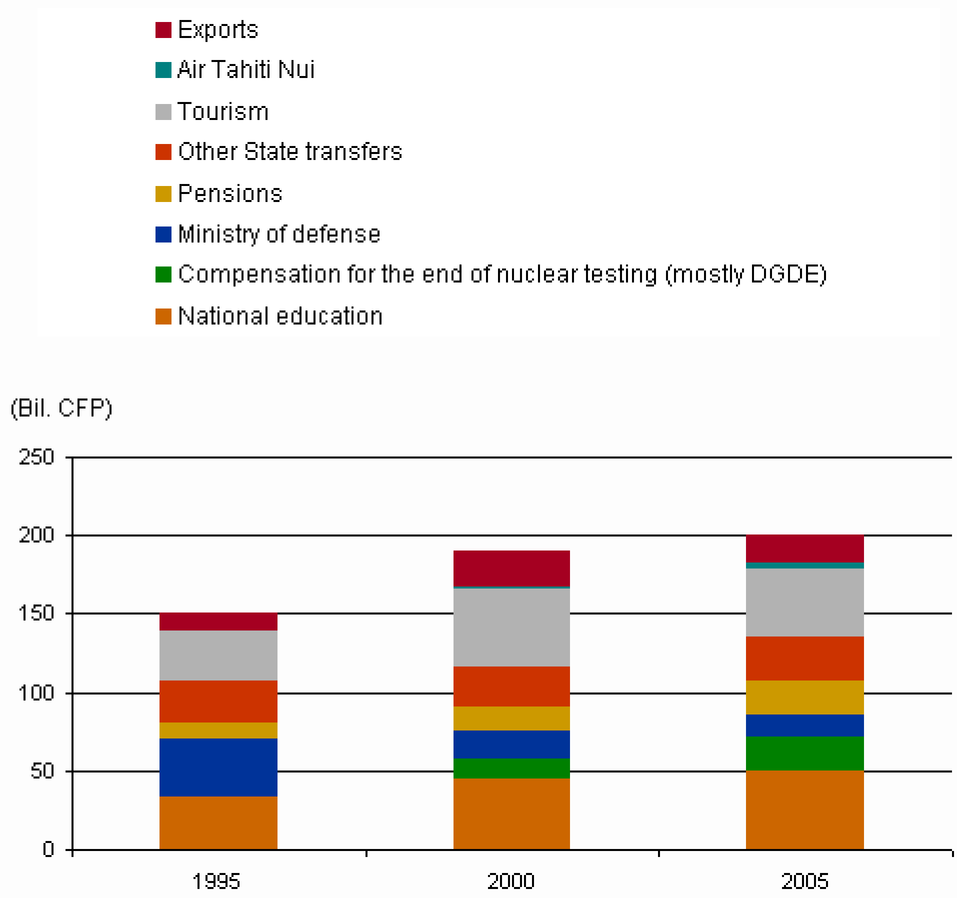
A development contract, under which, the state and Polynesia have agreed to co-finance certain investments on a 50/50 basis. The initial 2000-2003 plan of CFP40 billion was extended by one year through to the end of 2004. Failing a renewal, Polynesia is to lose about CFP5 billion in capital revenue annually.

While the country is fully responsible for education, the state directly assumes the bulk of the cost--CFP50 billion in 2004--directly through the payment of teachers' wages, and indirectly through small transfers to the country's budget.

Under the solidarity/health convention, the state also contributes to the funding of the health and social care for which the country is responsible, through transfers amounting to almost CFP4 billion per year to the country's and CPS' budgets. The agreement, ending at year-end 2003, has not yet been renewed, resulting, in 2004, in a CFP0.9 billion shortfall for CPS, compensated by the country.

Overall, France spends about €1.26 billion per year on Polynesia (2004 figures excluding state tax exemptions; 4% higher than in 2003), which corresponded to 30% of local GDP in 2004 and approximately 70% of Polynesia's external resources (the balance mostly came from tourism and exports; see chart).

Overseas Country of French Polynesia Evolution Of External Resources



CPF--French Pacific franc. DGDE--Dotation Globale de Développement Economique.

Polynesia receives far fewer social transfers than other French overseas departments, because it has its own social security system. However, within the framework of the EU program for the economic development of overseas countries, Polynesia will receive €10.4 million to finance water treatment projects over 2006-2008.

Financial support may erode in the future

Financial support from the French state has never been questioned and was even reinforced at the dawn of the century by Polynesia's then president, Gaston Flosse, an ally of the UMP, the French political party currently in power. The vast majority of Polynesians want their future to remain with France, ensuring the financial support necessary to prop up a country that generates only about one-third of the income needed to support its high standard of living. This is the price France is willing to pay to maintain its strategic presence in the Pacific area and continue to be a global power.

We rule out any sharp and brutal decline in France's very strong financial support of Polynesia, which underpins the overseas country's credit strength. However, the following factors hamper visibility and may blunt the French state's financial support of Polynesia in the future, notably in 2007 after Jacques Chirac's mandate ends and general elections are held in France:

Polynesia's president Oscar Temaru has held office since 2004. Contradicting the opinion of the majority, he has reiterated calls for independence from France, which he describes as Polynesia's colonial master, and has consequently received three official reprimands from the high commissioner representing the state in Polynesia. This has poisoned his relationships with the French state, and hampers his powers of negotiation. On the occasion of his first visit to Paris in June 2006, Mr. Temaru claimed for the payment of transfers outstanding under previous agreements amounting to CFP6.2 billion, and urged a renewal of the development contract (and of the solidarity/health convention), but he did not show up for a meeting with Mr. Chirac. Failing renewals, state transfers are budgeted to decrease in the country's 2006 budget to 17% of total revenues, from 19% in the 2005 budget.

French members of parliament (MPs) closely scrutinize the overseas tax exemption and civil servant special wage and pension regimes. They increasingly question the socio-economic benefit of these; constraints on public finances are increasing, leading the state to scale down its expenditures, including those in favor of mainland local governments.

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Economy

Geography and demographic growth structurally pressure the country's expenditures

Polynesia is an archipelago made of mountainous islands and atolls spread over an area as large as Western Europe. The islands are in the Pacific Ocean but a long way from America, Japan, and Australia. Long distances inflate the cost of goods imported. Polynesia is vulnerable to tsunamis and rising oceans.

Underpinned by strong natural growth, Polynesia's population has increased markedly over the past decades and is expected to exceed 300,000 by 2020 (see table 2). This trend, which is decelerating, however, increases land demands and costs in the already densely populated Society Islands, where the population is concentrated. Population growth also infers significant education, housing, employment, transport, and infrastructure needs, for which the country is responsible. The provision of public services in remote and sparsely populated islands is expensive.

Table 2 Overseas Country of French Polynesia Demographic Evolution									
	Polynesia			France (excluding overseas France)			Region of La Réunion		
Number of inhabitants (2003)	245,800			59,625,000			753,600		
Actual population growth 1990-2003 (%)	18*			5.4			26.5		
Estimated population growth 2003-2010 (%)	15¶			2.4			10.5		
Estimated population growth 2003-2030 (%)	11§			3.9			36.5		
Age structure	Under 19 years	20-59 years	Over 60 years	Under 19 years	20-59 years	Over 60 years	Under 19 years	20-59 years	Over 60 years
As a % of total	41	52	7	25	54	21	36	54	10

(1999)									
*1992-2002. ¶2002-2012. §2002-2022. Sources: Te Autaeaeraa project, Standard & Poor's, Insee.									

The youth of Polynesia's population (49% under the age of 26) will, however, translate into a rapid ramp-up in those of working age in the next decade, pressuring the labor market and employment and social care expenditures. Strong family networks and a significant underground economy should mitigate the social impact of this trend in the absence of unemployment benefits, however. Positively, pensions are not yet an issue, given the low proportion of elderly people in the population.

Huge public funding has driven economic development

The start of nuclear testing in the Pacific in the 1960s deeply transformed the once traditional society and self-sufficient economy of Polynesia. Military activities, the construction of infrastructure, and the purchasing power of an extensive--and highly paid--military and civil administration drove economic development. With GDP per capita of about €16,390 in 2003, comparable to that of New Zealand, Polynesia is one the wealthiest islands of the South Pacific area; its population enjoys a relatively high standard of living and a good level of basic infrastructure for health care, education, and transport.

The growing population, with increased purchasing power, has led Polynesia's economic growth to exceed the national average over the past decade and has boosted the country's tax revenues. Driven by household and public sector spending, employment has been vigorous; salaried employment increased by 48% but the population only by 19% over 1995-2005. This translates into modest unemployment, estimated at 11.7% in 2002, compared with other French overseas regions (31.9% in La Réunion in 2005, against 9.8% in France). As reflected by a rise in private services employment over the past decade, strong internal demand has fostered the development of private businesses, notably trade, which employs 15% of the Polynesian salaried workforce. The harbor of Papeete is Polynesia' s economic hub.

The public sector remains predominant in the socio-economic balances of Polynesia. However:

- State transfers account for a fairly stable two-thirds of external resources, to the volume of which GDP is directly correlated as admitted by officials (GDP=2.6x external resources).
- High salaries for French public servants inflate the wage structure of the whole extensive public sector, as locally employed public servants expect the same rate (see table 3). This translates into huge disparities in wages and attractiveness between the public and the private sector, and contributes to significant social inequalities (20%-30% of the population is estimated to live under the poverty threshold). Though high wages help keep the local economy stable, they also ensure an artificially inflated costenvironment, with high prices for almost everything.
- Semi-public companies and other satellites enjoy de facto monopoly situations in business areas such as telecommunications, preventing private companies from developing.

Table 3 Overseas Country of French Polynesia Employment And Wage Distribution By Sector		
	Salaried employment as a % of total employment	Average yearly wage (CFP)
Agriculture and fishing (%)	4.1	141,000
Industry and energy (%)	7.7	232,000
Building and public works (%)	9.9	166,000
Transport and telecoms (%)	8.8	270,000

Hotels and catering (%)	10.5	154,000
Commercial services (%)	18.1	251,000
Trade (%)	15.4	209,000
Domestic services (%)	3.1	54,000
Administration (%)	22.4	281,000
Country	N/A	293,000
Municipalities	N/A	197,000
Public entities and companies	N/A	357,000
Local state civil servants	N/A	345,000
CFP--French Pacific franc. N/A--Not applicable. Sources: Te Autaeaeraa Project; Caisse de Prévoyance Sociale.		

Economy remains structurally dependent and vulnerable

Artificially inflated prices are all the more high since Polynesia imports almost all of the goods it uses. The country has very few natural resources, but has developed a limited substitution industry to meet local demand, which accounts for 8% of salaried employment. Increases in oil prices, a major component of the shipping costs on very long distances, inflate the price of imports and have equally dried up the country's energy equalization fund reserves.

Following the cessation of nuclear testing in the mid-90s, financial compensations from the state have helped local authorities refocus the Polynesian economy on activities such as tourism, cultured-pearl production, and fishing, with the aim of decreasing the country's dependence on external resources.

Tourism has become the mainstay of the private sector in Polynesia, contributing up to 25% of external resources and directly employing 10% of the country's workforce. The country's role has been key, with massive tax exemptions prompting the construction of new resorts and the development of ATN's transportation capacities. The country's initial target of attracting 300,000 visitors in 2007 and 500,000 per year by 2015, was overoptimistic, however (see chart). Polynesia's competitiveness remains constrained by high prices, while service quality is hampered by its low attractiveness to employees of the private sector. Tourism is correlated with economic cycles and is linked to CFP exchange rates, particularly against Japanese yen and U.S. dollars. The French Pacific franc is pegged to the euro. Tourism is also vulnerable to natural or public health catastrophes such as that experienced by La Réunion in 2006. Unless France provides exceptional support, such a crisis would be much more severe for Polynesia than it was for La Réunion, as Polynesia does not come under the French social security system umbrella.

Cultured pearls represent about 80% of total exported goods, which account for approximately 8% of Polynesia's resources. This business is also exposed to economic cycles and to exchange rates. Exports are slowly recovering, following a severe crisis that was primarily due to an increase in volumes to the detriment of quality. The semi-industrial fishing industry is also in crisis, primarily because of diminishing resources and competition from more efficient foreign fleets.

Economic prospects remain dull

The economy significantly slowed in 2004, as reflected by an increase in turnover of just 1.6%, against 6.2% the year before. A decrease in public works has particularly affected the construction sector (10% of the workforce), which expanded rapidly in recent years fuelled by the construction of public and private tax-exempted investments. Energy price rises, recent increases in the minimum wage, uncertainties related to reforms of social security financing, and continued political turmoil weigh on the prospects of Polynesian companies.

On a positive note, employment and household consumption have proven resilient and successive increases in the minimum wage should sustain growth. Tourism is also showing early signs of more robust growth. In the longer term, the evolution of the economy will remain closely tied to that of state transfers, and to other external factors.

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Management Capacity And Institutional Legitimacy

Continued fraught political and social climate hampers reforms and budgetary discipline

As a result of by-elections Mr. Temaru returned to power in 2005, after a four-month stint between June and October 2004. It was the third change of leadership in less than one year, and followed months of wrangling between Mr. Temaru and his long-time opponent, Mr. Flosse, who before 2004 had ruled Polynesia for almost two decades.

Mr. Temaru's presidency remains insecure; vote catching and influence peddling are strongly entrenched in the political habits of the country. In April 2006, the local assembly elected a new speaker reflecting the emergence of a new "pro-autonomy" platform contradicting the one-seat majority coalition that had previously elected Mr. Temaru as the president of Polynesia. Mr. Temaru had to reshuffle his cabinet and include three MPs, previously members of the opposition, to regain a majority coalition.

This confused situation in a kind of endless pre-election environment raises questions over the government's commitment to budgetary discipline, and hampers its ability to use its tax flexibility.

The government's priorities are reflected in its landmark Te Autaeaeraa (solidarity) project, which principally aims to:

- Grow the revenues and purchasing power of working and middle class households through gradual increases in wages (7% annually over the next three years), with low-paid workers benefiting proportionally more;
- Improve the competitiveness of private companies by significantly decreasing their wage-based social contributions in order to foster employment growth and compensate for increased wages; and
- Improve social protection and ensure the long-term balance of social regimes through increases in CST--a progressive direct income tax based not only on wages but also on pensions and financial income--and consumption-based taxes.

The government implemented a first increase in the minimum wage at year-end 2005. But, facing general strikes that partially blocked the capital city and its harbor at year-end 2005, the government had to suspend an increase in alcohol and tobacco taxes and, more importantly, in CST, which unions had refused. While the terms and conditions of the reform will come about as a result of bargaining with unions, we have no visibility on how the Te Autaearaa project will impact the finances of the country or those of CPS, for which the country is ultimately liable.

Management capacity weak overall

In recently released reports that mostly cover 1998-2004, Polynesia's audit board highlights significant weaknesses in the country's budgetary processes and, more globally, in the administration's management; weaknesses that are principally due to the lack of reporting and monitoring tools and to Polynesia's particular political culture. These weaknesses made possible the "prise illégale d'intérêts" of which former president Mr. Flosse was recently convicted by Tahiti's criminal court. Insufficiencies include:

- Loose control on operating expenses, including transfers to satellites and associations; a contingent source of risk and of inflation in the country's expenditures.
- Multiyear investment planning has become a political communication tool. The

- subsequent huge stock of commitments can result in a budgetary impasse while the gap between budgeting and low execution leads to irrelevant debt recourse.
- The difficulties in forecasting tax revenues based on the absence of preliminary impact studies--notably for the Flosse exemption scheme that eventually "cost" CFP14 billion in 2004, against CFP8 billion budgeted--the insufficient monitoring of tax bases and weak recovery on tax receivables.

The audit board called for regulatory and organizational reform, which the vice president in charge of finances has committed himself to enforcing. He has set in motion a thorough clean up of existing programs and dramatic changes in the investment process, and has merged four tourism-related satellites into one. We also view positively, although we recognize that they are challenging, the vice president's objectives of:

- Abiding by a French department-like GAAP from the 2007 budget;
- Presenting accounts consolidating the country's ancillary budgets and its numerous public entities, which benefit from a statutory ultimate guarantee from the country on all their financial obligations; and
- Working out the country's financial projections.

Upgrading the budgetary process and tools will be key to improving the forecasting, planning, piloting, and controlling capacities of Polynesia's management, and eventually enabling the government to maintain sound finances.

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Financial Flexibility

High tax flexibility is constrained by political and economic cost

The country's revenue flexibility is very strong. Polynesia has almost full autonomy on tax setting, which accounted for 85% of operating revenues in 2005. Taxes are relatively low (see table 4). The country is free to adjust the rates on all taxes, implement or reduce various tax exemptions, and levy new taxes, within limits set by the French constitution.

Overseas Country of French Polynesia Tax Pressure As A % Of GDP					
	Polynesia			Republic of France	EU
	2005	2002	1992	2005	2005
Indirect tax	15.5	14.1	11.4	12.0	12.0
Of which country*	14.5	13.4	N.A.	N.A.	N.A.
Direct tax (including CST income tax)	5.4	5.0	3.5	14.5	15.5
Of which country*	4.1	3.5	N.A.	N.A.	N.A.
Social security contributions	12.1	10.1	6.9	17.4	12.8
Total tax presssure	33.0	29.2	21.8	43.9	40.3
Source: Te Autaeaeraa Project. *As reflected in the principal budgets.					

This flexibility on the country's taxes is, however, constrained by the government's willingness to improve the purchasing power of the low to middle classes, as shown by the Te Autaeaeraa project and its planned changes to the social security financing mix. Flexibility is further hampered by the current social climate, marked by repeated strikes and workers' demands for lower prices and taxes; notably on oil, to soften the impact of recent price surges. Tax rises might also weaken Polynesia's competitiveness as a tourist destination and harm domestic consumption, which is the main driver of the country's revenue growth.

In 2006 the government did, however, implement some selective rises among its 35 taxes, and introduce some others into the principal budget; these latter represented a total of CFP2 billion and were levied by EPAP and EGT, two public entities that had accumulated significant surpluses. The government may find additional room for maneuver with the public entities whose earmarked taxes levied increased from CFP3.8 billion in 2000 to CFP7.5 billion in 2003. Yet, the leverage on tax revenues will decrease since the country's contribution to FIP, which is based on the tax revenues in the country's principal budget, is to gradually increase. The government may also increase its revenues through better tax collection and recovery.

The country increasingly relies on indirect taxes (78% of operating revenues in 2005), including duty on imported goods (31% of total indirect taxes) and VAT (53%). The strengthening of the euro and oil price hikes positively affected Polynesia's import taxes, which increased by 13% in 2005. They also, though, affected private companies' earnings; revenues from corporate income tax have trended steadily downward since 2003, although this has also been driven by the government's tax exemption policies. All in all, tax revenues increased by 6.4% in 2005, including onetime proceeds of CFP2.5 billion stemming from a change in the country's method of calculating fines.

Operating expenditures: increasingly rigid and under pressure

Polynesia's geographic, economic, and demographic profiles structurally confer little flexibility to the country's budget, on both the investment and operating sides.

Personnel expenses, interest, and transfers to other budgets together account for 80% of Polynesia's operating expenses, making them very rigid.

The Polynesian administration is responsible for setting the wages of its 5,200 employees. Historically, these have mirrored those of France's civil servants, contributing to the size of the country's personnel cost base, which accounts for nearly 30% of operating expenditures. After the 2005 integration of the 300 security personnel who had not been on the payroll during the previous presidency, the government has frozen its headcount. Personnel expenses grew on average 6% annually in the past five years, growth likely to resume following the wage increases built into the Te Autaeaeraa project. Polynesian companies were able to recoup wage-related losses through lowered social contributions, an avenue not open to the country.

Transfers, which are mostly dedicated to health and social care, employment, training, and economic development, are barely modifiable and potentially inflationary expenses. They include:

- Transfers to municipalities through FIP that are set to represent, in 2009, 25% of tax revenues, up from 15% in 2005. This will reinforce the budget's rigidity; all the more since FIP has never paid the country back when actual tax proceeds were lower than budgeted. In turn, municipalities are no longer likely to be granted discretionary subsidies.

- Transfers to CPS, representing about 14% of operating expenses. The Te Autaeaeraa project is supposed to alleviate the country's contribution to social regimes, as shown by a budgeted 13% decrease in 2006. However, there is a risk that Polynesia will pay the potentially large difference between the project plans and what will result from negotiations with unions.

- Other health- and social care-related transfers include those to hospitals. There is a new hospital currently under construction, the operating cost and potential cost slippage of which are uncertain. Organization is poor, and the country has difficulty retaining nursing personnel (turnover exceeds 50% annually).

- Transfers to equalization funds, notably for oil products or local products such as vanilla, depend on external factors and can be very volatile. This was illustrated by a CFP6 billion transfer, budgeted to balance the country's energy hydrocarbon fund, which ran out of reserves following the oil price surge.

Transfers to satellites endowed with a public mission by the country (excluding CPS) and representing approximately 15% of operating expenses nearly doubled between 1999 and 2003, primarily because increasing numbers of such entities avoid wage limits and strict control. Streamlining these entities is one of the main sources of savings for the country, together with overheads, discretionary subsidies, and presidency-related expenses.

Heavy infrastructure needs

Capital investments represent between 25% and 30% of Polynesia's total annual expenditures. The technical ceiling, based on the capacities of the administration and construction sector, is estimated at CFP35 billion. The largest project under construction is a new 365-bed hospital for a total cost of CFP37 billion scheduled to be completed in 2007.

Polynesia has investment flexibility, as its difficulty lies more in carrying out planned investments. However, in the longer term, substantial infrastructure needs in terms of transportation--including a new harbor in Farateera for a cost of more than CFP100 billion, or a light train to alleviate congestion in Papeete for CFP100 billion--water and waste treatment, health care, and subsidized housing will maintain pressure on the region's investment expenses, while the municipalities have limited resources.

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Budgetary Performance

Satisfactory budgetary performance, increasingly exposed to deterioration

Polynesia's operating margin and balance after borrowings are volatile, highlighting management's weak forecasting and piloting capacities in an economic environment that is difficult to predict.

The overseas country's operating margin increased to 18.3% in 2005, from 10.8% in 2004, reflecting higher than expected tax revenues, a good grasp on personnel expenses, and the nonimplementation of some costly social measures. The increase was, though, mainly due to the allocation of 50% of DGDE to operating revenues that the audit board eventually invalidated in the country's 2006 budget. Net of these DGDE resources and onetime tax proceeds of CFP2.5 billion, the country's 2005 operating margin stood at 11% of operating revenues, a level comparable to that of 2004 but weaker than pre-2002.

Thanks to sizable capital grants, the country was able to entirely self-finance its investment program in 2005, and posted a moderate surplus before debt repayment of 0.5% of total revenues at year-end 2005, versus a small deficit of 2.7% in 2004.

Although we do not expect investment expenses to exceed CFP35 billion annually, Polynesia's financial requirements will principally depend on the local and international economic conditions that drive its tax earnings, and on management's ability to control costs and use its flexibility to finance the shortfalls in state transfers and deviations in operating expenses to which it is increasingly exposed.

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Liquidity And Debt Management

Most tax revenues are collected by the local state representative and then transferred to the country's treasury on a regular basis, providing Polynesia with a comfortable cash cushion over the year. However, weak receivables and payables management and delays in state transfers hamper cash flow predictability and cash optimization, particularly as cash is not pooled and managed with that of the satellites. Polynesia's cash position is secured by its so far unused short-term credit facilities (CFP2.1 billion) and by its revolving long-term credit lines.

Polynesia's debt management is prudent; 48% of debt is at fixed rates, and it has no short-term debt or foreign currency risk. The average interest rate at year-end 2005 stood at 4.2%, which is moderate in light of an average maturity of nine years.

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Debt Burden

Large and potentially growing tax-supported debt

Polynesia's direct debt decreased slightly to 58% of operating revenues at year-end 2005, or a fairly low three years of operating margin. As a percentage of GDP, direct debt remains modest, accounting for approximately 13% in 2005. Including the tax-supported and guaranteed debt linked to heavily subsidized public companies (mainly ATN and housing companies), Polynesia's public sector debt is high, accounting for about 87% of total revenues according to Standard & Poor's estimates.

Near-term debt trends will depend on the new government's investment policy and its ability to keep a satisfactory capacity for self-financing. Future debt accumulation will be a crucial element for the rating.

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Contingent Liabilities

Large public sector with increased airline activities

Polynesia has 30 public entities in various economic sectors including postal and port services, hospitals, social security, housing, culture, and tourism. These entities rely either fully or largely on subsidies from the overseas country's budget. Most are small and have no debt, apart from rising--but still very moderate--debt for hospitals and social housing. Some of them experience occasional liquidity stress.

Polynesia has majority stakes in several companies, some of which are also largely subsidized. The most important are Socredo and ATN. The former is a local bank in which the overseas country owns a 50% share, the other 50% being held by the Agence Française de Développement (AAA/Stable/A-1+), which is negotiating with BRED - Banque Populaire (--/--/A-1+) the sale of some of its stake as part of a refocusing on its core missions. In addition to retail banking activities, Socredo serves as a vehicle for improving the local economy, lending money to developing economic sectors.

ATN is a semipublic airline in which French Polynesia has a 61.4% share, with the remainder belonging to local private enterprises. Created in 1996 as the cornerstone of Polynesia's economic development strategy, the airline has gradually developed since 1998 and now operates five aircraft, providing connections to the U.S. (Los Angeles and New York), Japan, New Zealand, and Australia.

ATN posted heavy losses in its start-up years, calling for several subsidies and recapitalization measures. French Polynesia injected CFP6.5 billion into the company over 2001-2003. ATN met its breakeven objective in 2003 but was badly hurt by oil price surges, which led to a CFP2 billion deficit in 2005. Thanks to a thorough restructuring plan and a new recapitalization, which has not been so far budgeted by the country, management expects to narrow this deficit to CFP1 billion in 2006. The new breakeven objective should be met in 2007, as planned, thanks to current bookings, which exceed forecasts. In addition, ATN now enjoys a major source of flexibility with an unrealized capital gain representing about $30 million, as it is free to sell the first plane it acquired for a very low price thanks to an overseas France tax exemption scheme. However, ATN remains fragile and without support would not survive a crisis such as the epidemic that took place in La Réunion, or a further rise in oil prices.

ATN's leverage ratio is high, standing at 107% at year-end 2004, down from 151% in 2003. ATN's debt--guaranteed by Polynesia--decreased to CFP5.9 billion at year-end 2005, from its CFP8.6 billion peak in 2003. We will continue to monitor closely Polynesia's exposure to ATN.

Table 5 Overseas Country of French Polynesia Financial Statistics									
	--Year ended Dec. 31--								
(Mil. CFP)	2006b	2005e	2005b	2004	2004b	2003	2002	2001	2000
Operating revenues	116,563	116,549	112,840	104,036	103,671	104,584	93,347	94,428	89,820
Operating balance	12,869	21,291	10,755	11,217	13,516	20,344	10,078	17,567	21,180
Operating balance (% of operating revenues)	11.0	18.3	9.5	10.8	13.0	19.5	10.8	18.6	23.6
Balance after capital expenditures (capex)	(9,325)	587	(4,914)	(3,326)	(6,140)	3,992	(16,723)	(3,316)	(201)
Balance after capex (% of total revenues)	(7.5)	0.5	(4.0)	(2.7)	(5.1)	3.2	(17.1)	(3.3)	(0.2)
Balance after debt repayment and onlending	(17,725)	(7,324)	(13,904)	(13,298)	(15,000)	(5,036)	(24,912)	(10,569)	(7,253)
Balance after debt repayment and onlending (% of total revenues)	(14.2)	(5.7)	(11.2)	(10.9)	(12.5)	(4.1)	(25.5)	(10.5)	(7.6)
Balance after borrowings	(3,725)	(124)	96	(1,860)	0	6,616	(10,602)	1,188	4,711
Balance after borrowings (% of total revenues)	(3.0)	(0.1)	0.1	(1.5)	0.0	5.4	(10.8)	1.2	4.9
Total revenues (% of GDP)	N.A.	24.0	23.4	23.8	23.4	24.9	20.4	22.0	21.5
Modifiable revenues (% of operating revenues)	84.8	80.2	79.8	84.2	84.8	85.2	82.6	82.2	82.3
Capex (% of total expenditures)	22.9	25.1	21.1	25.8	28.5	29.4	27.3	26.0	28.5
Operating revenue growth (%)	0.0	12.0	8.5	(0.5)	(0.9)	12.0	(1.1)	5.1	8.2
Operating expenditure growth (%)	8.9	2.6	10.0	10.2	7.0	1.2	8.3	12.0	6.5
Direct debt (debt outstanding at year end)	73,024	67,424	N.A.	68,135	N.A.	66,669	64,046	57,925	53,421
Direct debt (% of operating revenues)	62.7	57.9	N.A.	65.5	N.A.	63.8	68.6	61.3	59.5
Direct debt (% of GDP)	N.A.	12.7	N.A.	13.3	N.A.	13.4	13.4	12.7	12.0
Tax-supported debt (% of total revenues)	58.4	61.5	N.A.	87.7	N.A.	82.3	95.0	78.9	74.5
Interest (% of operating revenues)	2.1	1.5	2.3	2.0	2.6	2.1	2.5	2.7	3.2
Debt service (% of total revenues)	8.7	7.6	9.3	9.9	9.7	9.1	10.8	9.7	10.4

b--Budgeted. e--Estimated. CFP--French Pacific franc. N.A.--Not available.

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French Polynesia (Overseas Country of)

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ISSUER CREDIT RATING	
French Polynesia (Overseas Country of)	
Issuer Credit Rating	BBB+/Negative/--
Issuer credit rating history:	
July 18, 2006	BBB+
Sept. 5, 2000	A-

Major Rating Factors

Strengths:

- Very solid financial support from the Republic of France
- Strong tax flexibility, though this is hampered by Polynesia's social and political climate
- Satisfactory financial performance and moderate financial requirements
- Modest direct debt by international standards

Weaknesses:

- Political instability and consequent lack of medium-term visibility on finances
- Weak management with little control over significant off-balance-sheet exposures
- Structurally dependent and vulnerable economy

Highly rigid operating expenditures and structurally high infrastructure needs

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Rationale

The rating on the Overseas Country of French Polynesia primarily reflects the very strong financial support from the Republic of France (AAA/Stable/A-1+) that props up Polynesia's economy. The rating is also underpinned by strong revenue autonomy, satisfactory financial performance, and moderate debt by international standards. The rating remains constrained by the persistence of an uncertain political situation and subsequent absence of visibility on the country's finances; Polynesia's structurally dependent and vulnerable economy; growing rigidities on operating costs; and weakened management capacities. In addition, significant off-balance-sheet exposure to Air Tahiti Nui (ATN)--which has been badly hit by rising oil prices--and the social security system, weigh negatively on the ratings.

Net of budgetary changes and onetime items, Polynesia posted a 11% operating margin in 2005, comparable with 2004 though weaker than pre-2002. Thanks to sizable capital grants, the overseas country entirely self-financed its investment program and reduced its direct debt burden to a moderate 58% of operating revenues (or 13% of GDP) in 2005. Standard & Poor's Ratings Services estimates consolidated debt to be about 87% of total revenues.

The continued fraught political and social climate in Polynesia raises questions over the government's commitment to budgetary discipline and hampers the country's tax flexibility. The country is increasingly exposed to slippages in transfers to satellites or in social expenditures and to shortfalls in state transfers, failing the renewal of some agreements. Although the final terms of a reform of the social security financing system will result from ongoing negotiations with unions, we have no visibility on how this will affect Polynesia's finances.

Situated in the Pacific Ocean, Polynesia is handicapped by its small size, and young and growing population. Massive and continued state transfers sustain Polynesia's economy, which generates--notably through tourism--only about one-third of the income needed to support its standard of living, one of the highest in the South Pacific area. The evolution of the economy is structurally bound to that of state transfers and other external factors.

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Outlook

The negative outlook reflects our concern that the continued unstable political and social situation might prevent Polynesia from implementing a clear financial strategy, and have negative knock-on effects on the performance of the overseas country's public finances, leading to a structural deterioration in credit fundamentals.

If continued political and social instability result in further deterioration in Polynesia's self-financing capacity and material slippage in debt levels, the ratings could come under pressure.

Conversely, the outlook could be revised to stable if the overseas country succeeds in implementing its reform while maintaining satisfactory budgetary performance, and upgrades its management capabilities in order to provide better medium-term visibility on its finances, including those of its satellites.

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Comparative Analysis

Among local and regional governments Polynesia's closest peers are the French Region of La Réunion (BBB+/Stable/--) and the Canadian Province of Prince Edward Island (A/Stable/A-1). Compared with these peers Polynesia has a much higher level of political autonomy, including its own tax regime, social security system, and local public sector. Like La Réunion, Polynesia's economy is largely dependent on external consumption and subsidies from the

French state. Polynesia is less wealthy than Prince Edward Island.

Polynesia's government is interventionist and actively supports the local economy through large subsidies to the private sector; a heavy capital investment plan partly financed by the French state; and, specifically, the development of ATN. In Prince Edward Island state support may be as strong as that enjoyed by Polynesia, but it takes the form of equalization transfers and payments to the social and health care system. Similarly, La Réunion receives large social transfers to compensate for its below-average wealth and tense unemployment situation. From a financial perspective, Polynesia's higher investment level translates into greater financing requirements than those of Prince Edward Island, although they are in line with La Réunion's projections for the coming years. Polynesia's direct debt, standing at 58% of operating revenues at year-end 2005, also compares favorably with that of its Canadian peer (106% in 2005) or with La Réunion's near-term projections. On the other hand, Polynesia has greater contingent liabilities than either of these two peers.

Polynesia's creditworthiness is also similar to that of certain sovereign islands rated by Standard & Poor's, such as the Cook Islands (BB-/Positive/B) and The Commonwealth of The Bahamas (A-/Stable/A-2). All three economies are characterized by their moderate size and dependency on tourism, making them sensitive to international economic conditions, and all were markedly hindered by the U.S. economic slowdown in 2002. Polynesia and the Bahamas are wealthier and enjoy similar levels of GDP per capita. Among their credit strengths is a close political relationship with their respective sovereigns. The Cook Islands also enjoy special ties with New Zealand (AA+/Stable/A-1+). Unlike Polynesia, however, the Cook Islands and the Bahamas do not benefit from financial aid, which explains why they posted higher debt levels as a percentage of GDP (48% and 21.4%, respectively) than Polynesia (12.7%) in 2005. Defense, justice, and external relations remain the mainland governments' prerogatives for all three peers.

Table 1 Overseas Country of French Polynesia 2005 Peer Comparison

	Overseas Country of French Polynesia	Region of La Réunion	Province of Prince Edward Island	Montserrat	Cook Islands
Issuer credit rating*	BBB+/Negative/--	BBB+/Stable/--	A/Stable/A-1	BBB-/Stable/A-3	BB-/Positive/B
Sovereign	Republic of France	Republic of France	Canada	United Kingdom	Cook Islands
Sovereign rating	AAA/Stable/A-1+	AAA/Stable/A-1+	AAA/Stable/A-1+	AAA/Stable/A-1+	BB-/Positive/B
Status	Overseas country	Overseas region	Province	Overseas territory	Independent association with New Zealand
Currency	French Pacific franc	Euro	Canadian dollar	Eastern Caribbean dollar	New Zealand dollar
Degree of dependency on the sovereign/state support	Strong	Large social transfers	Social and equalization transfers	High financial dependence	N/A
Key economic sectors	Public sector, tourism, pearls	Public sector, tourism	Agriculture	Construction, public sector	Tourism, public sector
Population	252,900¶	764,600¶	1,378,644§	4,700¶	13,200¶
GDP (mil. US$)	3,851	12,037	3,559§	41.9§	187.5¶
GDP per capita (US$)	14,682	15,702	22,126§	9,260§	13,996¶
General government debt/GDP (%)	12.7¶	1.1¶	28.5¶	10.0§	41.2§
General government fiscal balance/GDP (%)	0.0¶	(0.2)¶	(0.7)	5.1§	4.0¶
Budgetary	17.4¶	27.6	40.4	46.4§	N.A.

revenues coming from the sovereign level (as a % of revenues)					
Unemployment rate (%)	11.7	31.9¶	11.3§	N.A.	N.A.
Data for year ended Dec. 31, 2003, unless otherwise stated. *Ratings as at July 28, 2006. ¶2005 figures. §2004 figures. N/A--Not applicable.					

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System Support And Predictability

Significant autonomy strengthened in 2004

Polynesia was a French colony until 1946, when it became a French overseas territory with its own local parliament. Since the mid-1980s it has gradually gained more autonomy than France's other overseas departments and regions, carrying broader responsibilities and wielding greater taxing power. In February 2004, Polynesia's bylaws were amended, and the territory became a "pays d'outre mer" (overseas country). The overriding effect of this has been to give more weight to local parliamentary decisions, particularly those pertaining to civil, labor, and property rights. In practice, the Polynesian assembly votes in the country's budget and laws, provided such laws respect the French constitution. It also elects and can dismiss the president of the country; a source of instability in the absence of a strong parliamentary majority.

Within this framework, Polynesia is a kind of hybrid. It is a local government endowed with sovereign-like powers, notably on taxes and duties, and sovereign-like responsibilities including labor rights, economy, employment, education, health, and social care, none of which local governments in France assume.

The social security system principally provides pensions and health insurance under three different regimes financed by different mixes of social contributions from citizens and companies, income tax (CST), and state and overseas country contributions. Representatives of the labor unions, employers, the state, and the country govern these regimes under the umbrella of the Caisse de Prévoyance Sociale (CPS), for which the country is ultimately responsible.

Polynesian municipalities have limited jurisdiction and no taxing power since they are subject to ex ante supervision. They assume responsibilities on behalf of the overseas country (water and waste treatment, for example), and derive most of their resources from Polynesia's inter-municipal equalization fund (FIP), which is funded by the state and the country up to, in the 2006 budget, 17% of the country's tax proceeds. The current Polynesian government has agreed to gradually increase this, to 25% by 2009, which will add rigidity to the country's expenses. The implementation of the planned reform, by which municipalities would gain autonomy and be supervised ex post like their mainland counterparts, has been delayed at the mayors' request.

Strong financial support from the French state

The French state has consistently and heavily supported its overseas territories financially. The most important overseas-specific schemes benefiting Polynesia are:

- State civil servants benefit from high wages and pensions (approximately twice those of their mainland counterparts) that account for the majority of Polynesia's cash inflows (see chart) and fuel the Polynesian consumption-driven economy.
- The "Pons" and "Girardin" laws allow private investors--notably in hotels and resorts--to benefit from tax exemptions representing up to 70% of their investments. This amounted to €0.42 billion/French Pacific franc (CFP) 50 billion loss of revenues in France's 2006 budget for Polynesia. The laws are complemented by a similar tax exemption scheme supported by Polynesia, which represented a CFP11 billion loss of revenues in the country's 2006 budget.

In addition to these national policies in favor of French overseas territories, France provides Polynesia with specific forms of financial support, including:

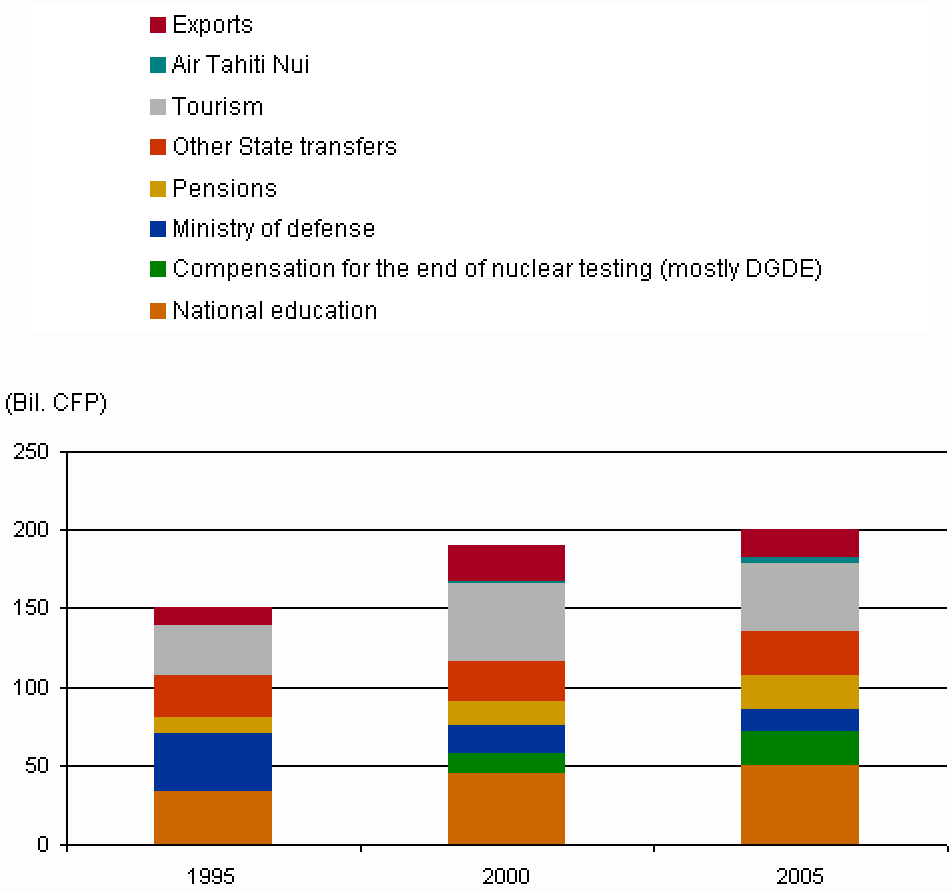
- Compensation for the loss of nuclear activities. Following the termination of nuclear testing, the French government has committed to injecting the equivalent amount of money into the local economy to help Polynesia refocus and develop its economic autonomy. Consequently, the country has received CFP18 billion per year since 1993. This annual subsidy, initially agreed for a 10-year period, was extended indefinitely under the form of a new grant, "Dotation Globale de Développement Economique" (DGDE), by a new convention signed in 2002. The French state reduced the flexibility Polynesia presumably had on this revenue by capping at 20%, from 2008, the share of this resource available to fund employment-related operating expenses. This amendment to the convention follows a rejection by the country's audit board of the country's initial budget for 2006, which accounted about one-half of the DGDE income as operating revenues.

- A development contract, under which, the state and Polynesia have agreed to co-finance certain investments on a 50/50 basis. The initial 2000-2003 plan of CFP40 billion was extended by one year through to the end of 2004. Failing a renewal, Polynesia is to lose about CFP5 billion in capital revenue annually.
- While the country is fully responsible for education, the state directly assumes the bulk of the cost--CFP50 billion in 2004--directly through the payment of teachers' wages, and indirectly through small transfers to the country's budget.

Under the solidarity/health convention, the state also contributes to the funding of the health and social care for which the country is responsible, through transfers amounting to almost CFP4 billion per year to the country's and CPS' budgets. The agreement, ending at year-end 2003, has not yet been renewed, resulting, in 2004, in a CFP0.9 billion shortfall for CPS, compensated by the country.

Overall, France spends about €1.26 billion per year on Polynesia (2004 figures excluding state tax exemptions; 4% higher than in 2003), which corresponded to 30% of local GDP in 2004 and approximately 70% of Polynesia's external resources (the balance mostly came from tourism and exports; see chart).

Overseas Country of French Polynesia Evolution Of External Resources



CPF--French Pacific franc. DGDE--Dotation Globale de Développement Economique.

Polynesia receives far fewer social transfers than other French overseas departments, because it has its own social security system. However, within the framework of the EU program for the economic development of overseas countries, Polynesia will receive €10.4 million to finance water treatment projects over 2006-2008.

Financial support may erode in the future

Financial support from the French state has never been questioned and was even reinforced at the dawn of the century by Polynesia's then president, Gaston Flosse, an ally of the UMP, the French political party currently in power. The vast majority of Polynesians want their future to remain with France, ensuring the financial support necessary to prop up a country that generates only about one-third of the income needed to support its high standard of living. This is the price France is willing to pay to maintain its strategic presence in the Pacific area and continue to be a global power.

We rule out any sharp and brutal decline in France's very strong financial support of Polynesia, which underpins the overseas country's credit strength. However, the following factors hamper visibility and may blunt the French state's financial support of Polynesia in the future, notably in 2007 after Jacques Chirac's mandate ends and general elections are held in France:

Polynesia's president Oscar Temaru has held office since 2004. Contradicting the opinion of the majority, he has reiterated calls for independence from France, which he describes as Polynesia's colonial master, and has consequently received three official reprimands from the high commissioner representing the state in Polynesia. This has poisoned his relationships with the French state, and hampers his powers of negotiation. On the occasion of his first visit to Paris in June 2006, Mr. Temaru claimed for the payment of transfers outstanding under previous agreements amounting to CFP6.2 billion, and urged a renewal of the development contract (and of the solidarity/health convention), but he did not show up for a meeting with Mr. Chirac. Failing renewals, state transfers are budgeted to decrease in the country's 2006 budget to 17% of total revenues, from 19% in the 2005 budget.

French members of parliament (MPs) closely scrutinize the overseas tax exemption and civil servant special wage and pension regimes. They increasingly question the socio-economic benefit of these; constraints on public finances are increasing, leading the state to scale down its expenditures, including those in favor of mainland local governments.

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Economy

Geography and demographic growth structurally pressure the country's expenditures

Polynesia is an archipelago made of mountainous islands and atolls spread over an area as large as Western Europe. The islands are in the Pacific Ocean but a long way from America, Japan, and Australia. Long distances inflate the cost of goods imported. Polynesia is vulnerable to tsunamis and rising oceans.

Underpinned by strong natural growth, Polynesia's population has increased markedly over the past decades and is expected to exceed 300,000 by 2020 (see table 2). This trend, which is decelerating, however, increases land demands and costs in the already densely populated Society Islands, where the population is concentrated. Population growth also infers significant education, housing, employment, transport, and infrastructure needs, for which the country is responsible. The provision of public services in remote and sparsely populated islands is expensive.

Table 2 Overseas Country of French Polynesia Demographic Evolution									
	Polynesia			France (excluding overseas France)			Region of La Réunion		
Number of inhabitants (2003)	245,800			59,625,000			753,600		
Actual population growth 1990-2003 (%)	18*			5.4			26.5		
Estimated population growth 2003-2010 (%)	15¶			2.4			10.5		
Estimated population growth 2003-2030 (%)	11§			3.9			36.5		
Age structure	Under 19 years	20-59 years	Over 60 years	Under 19 years	20-59 years	Over 60 years	Under 19 years	20-59 years	Over 60 years
As a % of total	41	52	7	25	54	21	36	54	10

(1999)										
*1992-2002. ¶2002-2012. §2002-2022. Sources: Te Autaeaeraa project, Standard & Poor's, Insee.										

The youth of Polynesia's population (49% under the age of 26) will, however, translate into a rapid ramp-up in those of working age in the next decade, pressuring the labor market and employment and social care expenditures. Strong family networks and a significant underground economy should mitigate the social impact of this trend in the absence of unemployment benefits, however. Positively, pensions are not yet an issue, given the low proportion of elderly people in the population.

Huge public funding has driven economic development

The start of nuclear testing in the Pacific in the 1960s deeply transformed the once traditional society and self-sufficient economy of Polynesia. Military activities, the construction of infrastructure, and the purchasing power of an extensive--and highly paid--military and civil administration drove economic development. With GDP per capita of about €16,390 in 2003, comparable to that of New Zealand, Polynesia is one the wealthiest islands of the South Pacific area; its population enjoys a relatively high standard of living and a good level of basic infrastructure for health care, education, and transport.

The growing population, with increased purchasing power, has led Polynesia's economic growth to exceed the national average over the past decade and has boosted the country's tax revenues. Driven by household and public sector spending, employment has been vigorous; salaried employment increased by 48% but the population only by 19% over 1995-2005. This translates into modest unemployment, estimated at 11.7% in 2002, compared with other French overseas regions (31.9% in La Réunion in 2005, against 9.8% in France). As reflected by a rise in private services employment over the past decade, strong internal demand has fostered the development of private businesses, notably trade, which employs 15% of the Polynesian salaried workforce. The harbor of Papeete is Polynesia' s economic hub.

The public sector remains predominant in the socio-economic balances of Polynesia. However:

- State transfers account for a fairly stable two-thirds of external resources, to the volume of which GDP is directly correlated as admitted by officials (GDP=2.6x external resources).
- High salaries for French public servants inflate the wage structure of the whole extensive public sector, as locally employed public servants expect the same rate (see table 3). This translates into huge disparities in wages and attractiveness between the public and the private sector, and contributes to significant social inequalities (20%-30% of the population is estimated to live under the poverty threshold). Though high wages help keep the local economy stable, they also ensure an artificially inflated costenvironment, with high prices for almost everything.
- Semi-public companies and other satellites enjoy de facto monopoly situations in business areas such as telecommunications, preventing private companies from developing.

Table 3 Overseas Country of French Polynesia Employment And Wage Distribution By Sector		
	Salaried employment as a % of total employment	Average yearly wage (CFP)
Agriculture and fishing (%)	4.1	141,000
Industry and energy (%)	7.7	232,000
Building and public works (%)	9.9	166,000
Transport and telecoms (%)	8.8	270,000

Hotels and catering (%)	10.5	154,000
Commercial services (%)	18.1	251,000
Trade (%)	15.4	209,000
Domestic services (%)	3.1	54,000
Administration (%)	22.4	281,000
Country	N/A	293,000
Municipalities	N/A	197,000
Public entities and companies	N/A	357,000
Local state civil servants	N/A	345,000
CFP--French Pacific franc. N/A--Not applicable. Sources: Te Autaeaeraa Project; Caisse de Prévoyance Sociale.		

Economy remains structurally dependent and vulnerable

Artificially inflated prices are all the more high since Polynesia imports almost all of the goods it uses. The country has very few natural resources, but has developed a limited substitution industry to meet local demand, which accounts for 8% of salaried employment. Increases in oil prices, a major component of the shipping costs on very long distances, inflate the price of imports and have equally dried up the country's energy equalization fund reserves.

Following the cessation of nuclear testing in the mid-90s, financial compensations from the state have helped local authorities refocus the Polynesian economy on activities such as tourism, cultured-pearl production, and fishing, with the aim of decreasing the country's dependence on external resources.

Tourism has become the mainstay of the private sector in Polynesia, contributing up to 25% of external resources and directly employing 10% of the country's workforce. The country's role has been key, with massive tax exemptions prompting the construction of new resorts and the development of ATN's transportation capacities. The country's initial target of attracting 300,000 visitors in 2007 and 500,000 per year by 2015, was overoptimistic, however (see chart). Polynesia's competitiveness remains constrained by high prices, while service quality is hampered by its low attractiveness to employees of the private sector. Tourism is correlated with economic cycles and is linked to CFP exchange rates, particularly against Japanese yen and U.S. dollars. The French Pacific franc is pegged to the euro. Tourism is also vulnerable to natural or public health catastrophes such as that experienced by La Réunion in 2006. Unless France provides exceptional support, such a crisis would be much more severe for Polynesia than it was for La Réunion, as Polynesia does not come under the French social security system umbrella.

Cultured pearls represent about 80% of total exported goods, which account for approximately 8% of Polynesia's resources. This business is also exposed to economic cycles and to exchange rates. Exports are slowly recovering, following a severe crisis that was primarily due to an increase in volumes to the detriment of quality. The semi-industrial fishing industry is also in crisis, primarily because of diminishing resources and competition from more efficient foreign fleets.

Economic prospects remain dull

The economy significantly slowed in 2004, as reflected by an increase in turnover of just 1.6%, against 6.2% the year before. A decrease in public works has particularly affected the construction sector (10% of the workforce), which expanded rapidly in recent years fuelled by the construction of public and private tax-exempted investments. Energy price rises, recent increases in the minimum wage, uncertainties related to reforms of social security financing, and continued political turmoil weigh on the prospects of Polynesian companies.

On a positive note, employment and household consumption have proven resilient and successive increases in the minimum wage should sustain growth. Tourism is also showing early signs of more robust growth. In the longer term, the evolution of the economy will remain closely tied to that of state transfers, and to other external factors.

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Management Capacity And Institutional Legitimacy

Continued fraught political and social climate hampers reforms and budgetary discipline

As a result of by-elections Mr. Temaru returned to power in 2005, after a four-month stint between June and October 2004. It was the third change of leadership in less than one year, and followed months of wrangling between Mr. Temaru and his long-time opponent, Mr. Flosse, who before 2004 had ruled Polynesia for almost two decades.

Mr. Temaru's presidency remains insecure; vote catching and influence peddling are strongly entrenched in the political habits of the country. In April 2006, the local assembly elected a new speaker reflecting the emergence of a new "pro-autonomy" platform contradicting the one-seat majority coalition that had previously elected Mr. Temaru as the president of Polynesia. Mr. Temaru had to reshuffle his cabinet and include three MPs, previously members of the opposition, to regain a majority coalition.

This confused situation in a kind of endless pre-election environment raises questions over the government's commitment to budgetary discipline, and hampers its ability to use its tax flexibility.

The government's priorities are reflected in its landmark Te Autaeaeraa (solidarity) project, which principally aims to:

- Grow the revenues and purchasing power of working and middle class households through gradual increases in wages (7% annually over the next three years), with low-paid workers benefiting proportionally more;
- Improve the competitiveness of private companies by significantly decreasing their wage-based social contributions in order to foster employment growth and compensate for increased wages; and
- Improve social protection and ensure the long-term balance of social regimes through increases in CST--a progressive direct income tax based not only on wages but also on pensions and financial income--and consumption-based taxes.

The government implemented a first increase in the minimum wage at year-end 2005. But, facing general strikes that partially blocked the capital city and its harbor at year-end 2005, the government had to suspend an increase in alcohol and tobacco taxes and, more importantly, in CST, which unions had refused. While the terms and conditions of the reform will come about as a result of bargaining with unions, we have no visibility on how the Te Autaearaa project will impact the finances of the country or those of CPS, for which the country is ultimately liable.

Management capacity weak overall

In recently released reports that mostly cover 1998-2004, Polynesia's audit board highlights significant weaknesses in the country's budgetary processes and, more globally, in the administration's management; weaknesses that are principally due to the lack of reporting and monitoring tools and to Polynesia's particular political culture. These weaknesses made possible the "prise illégale d'intérêts" of which former president Mr. Flosse was recently convicted by Tahiti's criminal court. Insufficiencies include:

- Loose control on operating expenses, including transfers to satellites and associations; a contingent source of risk and of inflation in the country's expenditures.
- Multiyear investment planning has become a political communication tool. The

subsequent huge stock of commitments can result in a budgetary impasse while the gap between budgeting and low execution leads to irrelevant debt recourse.

The difficulties in forecasting tax revenues based on the absence of preliminary impact studies--notably for the Flosse exemption scheme that eventually "cost" CFP14 billion in 2004, against CFP8 billion budgeted--the insufficient monitoring of tax bases and weak recovery on tax receivables.

The audit board called for regulatory and organizational reform, which the vice president in charge of finances has committed himself to enforcing. He has set in motion a thorough clean up of existing programs and dramatic changes in the investment process, and has merged four tourism-related satellites into one. We also view positively, although we recognize that they are challenging, the vice president's objectives of:

- Abiding by a French department-like GAAP from the 2007 budget;
- Presenting accounts consolidating the country's ancillary budgets and its numerous public entities, which benefit from a statutory ultimate guarantee from the country on all their financial obligations; and
- Working out the country's financial projections.

Upgrading the budgetary process and tools will be key to improving the forecasting, planning, piloting, and controlling capacities of Polynesia's management, and eventually enabling the government to maintain sound finances.

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Financial Flexibility

High tax flexibility is constrained by political and economic cost

The country's revenue flexibility is very strong. Polynesia has almost full autonomy on tax setting, which accounted for 85% of operating revenues in 2005. Taxes are relatively low (see table 4). The country is free to adjust the rates on all taxes, implement or reduce various tax exemptions, and levy new taxes, within limits set by the French constitution.

Overseas Country of French Polynesia Tax Pressure As A % Of GDP					
	Polynesia			Republic of France	EU
	2005	2002	1992	2005	2005
Indirect tax	15.5	14.1	11.4	12.0	12.0
Of which country*	14.5	13.4	N.A.	N.A.	N.A.
Direct tax (including CST income tax)	5.4	5.0	3.5	14.5	15.5
Of which country*	4.1	3.5	N.A.	N.A.	N.A.
Social security contributions	12.1	10.1	6.9	17.4	12.8
Total tax presssure	33.0	29.2	21.8	43.9	40.3
Source: Te Autaeaeraa Project. *As reflected in the principal budgets.					

This flexibility on the country's taxes is, however, constrained by the government's willingness to improve the purchasing power of the low to middle classes, as shown by the Te Autaeaeraa project and its planned changes to the social security financing mix. Flexibility is further hampered by the current social climate, marked by repeated strikes and workers' demands for lower prices and taxes; notably on oil, to soften the impact of recent price surges. Tax rises might also weaken Polynesia's competitiveness as a tourist destination and harm domestic consumption, which is the main driver of the country's revenue growth.

In 2006 the government did, however, implement some selective rises among its 35 taxes, and introduce some others into the principal budget; these latter represented a total of CFP2 billion and were levied by EPAP and EGT, two public entities that had accumulated significant surpluses. The government may find additional room for maneuver with the public entities whose earmarked taxes levied increased from CFP3.8 billion in 2000 to CFP7.5 billion in 2003. Yet, the leverage on tax revenues will decrease since the country's contribution to FIP, which is based on the tax revenues in the country's principal budget, is to gradually increase. The government may also increase its revenues through better tax collection and recovery.

The country increasingly relies on indirect taxes (78% of operating revenues in 2005), including duty on imported goods (31% of total indirect taxes) and VAT (53%). The strengthening of the euro and oil price hikes positively affected Polynesia's import taxes, which increased by 13% in 2005. They also, though, affected private companies' earnings; revenues from corporate income tax have trended steadily downward since 2003, although this has also been driven by the government's tax exemption policies. All in all, tax revenues increased by 6.4% in 2005, including onetime proceeds of CFP2.5 billion stemming from a change in the country's method of calculating fines.

Operating expenditures: increasingly rigid and under pressure

Polynesia's geographic, economic, and demographic profiles structurally confer little flexibility to the country's budget, on both the investment and operating sides.

Personnel expenses, interest, and transfers to other budgets together account for 80% of Polynesia's operating expenses, making them very rigid.

The Polynesian administration is responsible for setting the wages of its 5,200 employees. Historically, these have mirrored those of France's civil servants, contributing to the size of the country's personnel cost base, which accounts for nearly 30% of operating expenditures. After the 2005 integration of the 300 security personnel who had not been on the payroll during the previous presidency, the government has frozen its headcount. Personnel expenses grew on average 6% annually in the past five years, growth likely to resume following the wage increases built into the Te Autaeaeraa project. Polynesian companies were able to recoup wage-related losses through lowered social contributions, an avenue not open to the country.

Transfers, which are mostly dedicated to health and social care, employment, training, and economic development, are barely modifiable and potentially inflationary expenses. They include:

- Transfers to municipalities through FIP that are set to represent, in 2009, 25% of tax revenues, up from 15% in 2005. This will reinforce the budget's rigidity; all the more since FIP has never paid the country back when actual tax proceeds were lower than budgeted. In turn, municipalities are no longer likely to be granted discretionary subsidies.

- Transfers to CPS, representing about 14% of operating expenses. The Te Autaeaeraa project is supposed to alleviate the country's contribution to social regimes, as shown by a budgeted 13% decrease in 2006. However, there is a risk that Polynesia will pay the potentially large difference between the project plans and what will result from negotiations with unions.

- Other health- and social care-related transfers include those to hospitals. There is a new hospital currently under construction, the operating cost and potential cost slippage of which are uncertain. Organization is poor, and the country has difficulty retaining nursing personnel (turnover exceeds 50% annually).

- Transfers to equalization funds, notably for oil products or local products such as vanilla, depend on external factors and can be very volatile. This was illustrated by a CFP6 billion transfer, budgeted to balance the country's energy hydrocarbon fund, which ran out of reserves following the oil price surge.

Transfers to satellites endowed with a public mission by the country (excluding CPS) and representing approximately 15% of operating expenses nearly doubled between 1999 and 2003, primarily because increasing numbers of such entities avoid wage limits and strict control. Streamlining these entities is one of the main sources of savings for the country, together with overheads, discretionary subsidies, and presidency-related expenses.

Heavy infrastructure needs

Capital investments represent between 25% and 30% of Polynesia's total annual expenditures. The technical ceiling, based on the capacities of the administration and construction sector, is estimated at CFP35 billion. The largest project under construction is a new 365-bed hospital for a total cost of CFP37 billion scheduled to be completed in 2007.

Polynesia has investment flexibility, as its difficulty lies more in carrying out planned investments. However, in the longer term, substantial infrastructure needs in terms of transportation--including a new harbor in Farateera for a cost of more than CFP100 billion, or a light train to alleviate congestion in Papeete for CFP100 billion--water and waste treatment, health care, and subsidized housing will maintain pressure on the region's investment expenses, while the municipalities have limited resources.

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Budgetary Performance

Satisfactory budgetary performance, increasingly exposed to deterioration

Polynesia's operating margin and balance after borrowings are volatile, highlighting management's weak forecasting and piloting capacities in an economic environment that is difficult to predict.

The overseas country's operating margin increased to 18.3% in 2005, from 10.8% in 2004, reflecting higher than expected tax revenues, a good grasp on personnel expenses, and the nonimplementation of some costly social measures. The increase was, though, mainly due to the allocation of 50% of DGDE to operating revenues that the audit board eventually invalidated in the country's 2006 budget. Net of these DGDE resources and onetime tax proceeds of CFP2.5 billion, the country's 2005 operating margin stood at 11% of operating revenues, a level comparable to that of 2004 but weaker than pre-2002.

Thanks to sizable capital grants, the country was able to entirely self-finance its investment program in 2005, and posted a moderate surplus before debt repayment of 0.5% of total revenues at year-end 2005, versus a small deficit of 2.7% in 2004.

Although we do not expect investment expenses to exceed CFP35 billion annually, Polynesia's financial requirements will principally depend on the local and international economic conditions that drive its tax earnings, and on management's ability to control costs and use its flexibility to finance the shortfalls in state transfers and deviations in operating expenses to which it is increasingly exposed.

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Liquidity And Debt Management

Most tax revenues are collected by the local state representative and then transferred to the country's treasury on a regular basis, providing Polynesia with a comfortable cash cushion over the year. However, weak receivables and payables management and delays in state transfers hamper cash flow predictability and cash optimization, particularly as cash is not pooled and managed with that of the satellites. Polynesia's cash position is secured by its so far unused short-term credit facilities (CFP2.1 billion) and by its revolving long-term credit lines.

Polynesia's debt management is prudent; 48% of debt is at fixed rates, and it has no short-term debt or foreign currency risk. The average interest rate at year-end 2005 stood at 4.2%, which is moderate in light of an average maturity of nine years.

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Debt Burden

Large and potentially growing tax-supported debt

Polynesia's direct debt decreased slightly to 58% of operating revenues at year-end 2005, or a fairly low three years of operating margin. As a percentage of GDP, direct debt remains modest, accounting for approximately 13% in 2005. Including the tax-supported and guaranteed debt linked to heavily subsidized public companies (mainly ATN and housing companies), Polynesia's public sector debt is high, accounting for about 87% of total revenues according to Standard & Poor's estimates.

Near-term debt trends will depend on the new government's investment policy and its ability to keep a satisfactory capacity for self-financing. Future debt accumulation will be a crucial element for the rating.

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Contingent Liabilities

Large public sector with increased airline activities

Polynesia has 30 public entities in various economic sectors including postal and port services, hospitals, social security, housing, culture, and tourism. These entities rely either fully or largely on subsidies from the overseas country's budget. Most are small and have no debt, apart from rising--but still very moderate--debt for hospitals and social housing. Some of them experience occasional liquidity stress.

Polynesia has majority stakes in several companies, some of which are also largely subsidized. The most important are Socredo and ATN. The former is a local bank in which the overseas country owns a 50% share, the other 50% being held by the Agence Française de Développement (AAA/Stable/A-1+), which is negotiating with BRED - Banque Populaire (--/--/A-1+) the sale of some of its stake as part of a refocusing on its core missions. In addition to retail banking activities, Socredo serves as a vehicle for improving the local economy, lending money to developing economic sectors.

ATN is a semipublic airline in which French Polynesia has a 61.4% share, with the remainder belonging to local private enterprises. Created in 1996 as the cornerstone of Polynesia's economic development strategy, the airline has gradually developed since 1998 and now operates five aircraft, providing connections to the U.S. (Los Angeles and New York), Japan, New Zealand, and Australia.

ATN posted heavy losses in its start-up years, calling for several subsidies and recapitalization measures. French Polynesia injected CFP6.5 billion into the company over 2001-2003. ATN met its breakeven objective in 2003 but was badly hurt by oil price surges, which led to a CFP2 billion deficit in 2005. Thanks to a thorough restructuring plan and a new recapitalization, which has not been so far budgeted by the country, management expects to narrow this deficit to CFP1 billion in 2006. The new breakeven objective should be met in 2007, as planned, thanks to current bookings, which exceed forecasts. In addition, ATN now enjoys a major source of flexibility with an unrealized capital gain representing about $30 million, as it is free to sell the first plane it acquired for a very low price thanks to an overseas France tax exemption scheme. However, ATN remains fragile and without support would not survive a crisis such as the epidemic that took place in La Réunion, or a further rise in oil prices.

ATN's leverage ratio is high, standing at 107% at year-end 2004, down from 151% in 2003. ATN's debt--guaranteed by Polynesia--decreased to CFP5.9 billion at year-end 2005, from its CFP8.6 billion peak in 2003. We will continue to monitor closely Polynesia's exposure to ATN.

Table 5 Overseas Country of French Polynesia Financial Statistics									
	--Year ended Dec. 31--								
(Mil. CFP)	2006b	2005e	2005b	2004	2004b	2003	2002	2001	2000
Operating revenues	116,563	116,549	112,840	104,036	103,671	104,584	93,347	94,428	89,820
Operating balance	12,869	21,291	10,755	11,217	13,516	20,344	10,078	17,567	21,180
Operating balance (% of operating revenues)	11.0	18.3	9.5	10.8	13.0	19.5	10.8	18.6	23.6
Balance after capital expenditures (capex)	(9,325)	587	(4,914)	(3,326)	(6,140)	3,992	(16,723)	(3,316)	(201)
Balance after capex (% of total revenues)	(7.5)	0.5	(4.0)	(2.7)	(5.1)	3.2	(17.1)	(3.3)	(0.2)
Balance after debt repayment and onlending	(17,725)	(7,324)	(13,904)	(13,298)	(15,000)	(5,036)	(24,912)	(10,569)	(7,253)
Balance after debt repayment and onlending (% of total revenues)	(14.2)	(5.7)	(11.2)	(10.9)	(12.5)	(4.1)	(25.5)	(10.5)	(7.6)
Balance after borrowings	(3,725)	(124)	96	(1,860)	0	6,616	(10,602)	1,188	4,711
Balance after borrowings (% of total revenues)	(3.0)	(0.1)	0.1	(1.5)	0.0	5.4	(10.8)	1.2	4.9
Total revenues (% of GDP)	N.A.	24.0	23.4	23.8	23.4	24.9	20.4	22.0	21.5
Modifiable revenues (% of operating revenues)	84.8	80.2	79.8	84.2	84.8	85.2	82.6	82.2	82.3
Capex (% of total expenditures)	22.9	25.1	21.1	25.8	28.5	29.4	27.3	26.0	28.5
Operating revenue growth (%)	0.0	12.0	8.5	(0.5)	(0.9)	12.0	(1.1)	5.1	8.2
Operating expenditure growth (%)	8.9	2.6	10.0	10.2	7.0	1.2	8.3	12.0	6.5
Direct debt (debt outstanding at year end)	73,024	67,424	N.A.	68,135	N.A.	66,669	64,046	57,925	53,421
Direct debt (% of operating revenues)	62.7	57.9	N.A.	65.5	N.A.	63.8	68.6	61.3	59.5
Direct debt (% of GDP)	N.A.	12.7	N.A.	13.3	N.A.	13.4	13.4	12.7	12.0
Tax-supported debt (% of total revenues)	58.4	61.5	N.A.	87.7	N.A.	82.3	95.0	78.9	74.5
Interest (% of operating revenues)	2.1	1.5	2.3	2.0	2.6	2.1	2.5	2.7	3.2
Debt service (% of total revenues)	8.7	7.6	9.3	9.9	9.7	9.1	10.8	9.7	10.4

b--Budgeted. e--Estimated. CFP--French Pacific franc. N.A.--Not available.

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