

**MONETARY POLICY STANCE FOR 2003.**

**1. Introduction**

This Monetary Policy Statement is the first to be issued by the Central Bank of Solomon Islands to the public. The aim of doing so is first to inform the general public of the outlook for monetary developments in 2003 and secondly to ensure the Bank is more accountable and transparent in the discharge of its mandate and responsibilities.

In deciding the stance of monetary policy for 2003, the Central Bank has considered developments and projections in the global economy, domestic economic conditions, the balance of payments, and fiscal operations of the government with particular attention to their possible impacts on monetary aggregates and prices. These are summarized as follows.

**2. Review of Recent Economic Developments**

Provisional estimates based on data available to the Bank indicate Solomon Islands economy has relatively improved in 2002. Although the data showed a further contraction of 2.5% (i.e. -2.5% real GDP growth), this was much lower than the declines of 14.0% and 9.0% recorded in 2000 and 2001 respectively. The relative improvement in 2002 reflected both external and domestic factors.

The global economy remained resilient in 2002 and ended with a growth of 2.8% despite weaknesses in certain areas during the year. This had impacted positively on Solomon Islands economy in two ways. First, it led to a general rise in average prices of major export commodities. Secondly, it raised growth prospects of Solomon Islands major trading partners. As a result they were able to buy more from the country, thus increasing the country's total export receipts.

Earlier, the IMF has forecasted a continued growth in the global economy of 3.3% for 2003. Recent global developments, however, suggest that this would not be given the unusually high degree of uncertainty across the globe as a result of the Iraq war. Already industrial production and consumption are low in most advanced countries with investment plans currently on hold. These, together with the recent surge in oil prices could undermine the global recovery.

Domestically, provisional data on economic activity have also shown positive developments during the year especially in the export sector. The growth came mainly from the cocoa and fishery sectors. The rise in cocoa production, in a way, reflected the general improvement in the security situation on Guadalcanal.

However, with only about 50% of the country's production capacity being utilized, it is crucial that all stakeholders take corrective action to address impediments that constrain growth in the economy and contribute towards the recovery process. Both log and copra production, on the other hand, fell during the year. It is estimated, however, that production in both commodities will increase in 2003.

The resumption of domestic economic activities and relatively favorable global conditions had positive impacts on the balance of payments (BOP) during the year. At the beginning of the year, reserves came under severe pressures and fell to as low as \$80 million. But this rebounded during the third and fourth quarters so that by end December 2002, the level of reserves were \$128 million or equivalent to about a month worth of import cover. The rise in reserves was due partly due to Exim loan inflows, tighter exchange controls, export growth and the depreciation of the Solomon Island dollar. The level of reserves is forecasted to rise further in 2003 given the positive outlook for export growth and increased inflows from development partners during the year. Once reserves reach comfortable levels to a target of about three months of import cover, the current exchange control and exchange rate regimes would be reviewed.

Although total revenues surpassed budget estimates, the government ended with a deficit of about \$200 million in 2002, higher than in the previous year. This performance was largely due to increased expenditures, particularly unbudgeted items, which more than offsets the rise in revenue. The non-servicing of both external and domestic debt arrears and the long delay in salary payments were key fiscal issues during the year. These remain key concerns for government to sort out in 2003.

In view of delayed economic activities in early 2002, the emphasis of monetary and credit policy was to provide for growth while ensuring there is no emergence of inflationary pressures. Accordingly the Bank continued its policy of managing domestic liquidity through open market operations despite the withdrawal of major players. The monetary policy stance took into account the then low level of economic activity, level of external reserves, the government's budget stance and more importantly the delay in implementing the government reform programs.

Monetary conditions remained relatively depressed in early 2002. Broad money fell in the first six months due to declines in all components of money supply, except time deposits, which showed a marginal increase. By year-end, all forms of money had risen, resulting in a 5% growth in broad money supply. The rise also reflected the increase in net foreign assets during the period. The commercial banks remained very liquid during the year. Data in the first quarter of 2003 showed a continued growth, albeit at a low pace, in all monetary aggregates, except total domestic credit, which fell during the period.

In a highly open economy like Solomon Islands with very little sources of credit financing, the rise in surplus liquidity normally poses a threat on the level of external reserves. The Bank, however, does not see this as a major concern at present as overall demand for credit remained relatively weak. Nevertheless, changes in the surplus liquidity position still warrant a close review to ensure appropriate actions are taken should this threat resurface in the months ahead.

### **3. Economic Forecasts**

Given the above developments and based on data available so far, the Bank has forecasted a marginal improvement in economic activity in 2003 despite a relative weak and uncertain global outlook. This assumes that the law and order would improve, increased production of major export commodities, and government implements its reform programs and maintains a balanced budget throughout the year.

On the external front, the export sector is forecasted to remain relatively firm in 2003 and increase to more than \$500 million. The improvement in the security situation and speedy implementation of governments reform programs should also attract more donor funding. Although increased activity would fuel import demand, it is expected that this would remain relatively low, especially if the current Iraq war boosted oil prices higher.

The balance of payments outcome is expected to positively impact on the financial sector during the year. As a result money supply is expected to increase further, reversing the declining trend seen in the previous two years. Total domestic credit is also forecasted to marginally increase reflecting an expected increase in private sector economic activities. At the same time it is important that credit growth is also closely monitored to ensure that this does not unnecessarily put pressures on external reserves, result in inflation and therefore erode external competitiveness. The government's budget, however, is not expected to contribute towards monetary growth in 2003.

### **4. 2003 Monetary Policy Stance**

Despite the improvement in economic activity, the Bank believes, however, that the underlying situation remains fragile and any positive developments gained so far could easily be reversed if the security situation remains unsolved and the implementation of government reforms are prolonged. In view of the financial sector's weaknesses, the Bank takes the stance that it will maintain its current monetary policy stance and continue to foster conditions 'conducive to the orderly and balanced economic development of Solomon Islands'. This requires close monitoring of all indicators such as changes in the exchange rates, external reserves, money and credit aggregates, prudent implementation of governments 2003 budget, level of donor assistance inflows, and developments in the global economy to help it determined any change in policy direction it might want to take.

The economy has contracted significantly since 2000, and it is important that the recovery process is supported with appropriate policies. Specifically, the Bank's monetary policy objectives for 2003 are:

- First, continue to foster conditions conducive for economic growth by capping inflationary pressures, and
- Secondly, continue to rebuild the reserves level through private sector led growth.

### **Conduct of Monetary Policy**

Based on the above two concerns, the Bank would continue to act indirectly through its influence on money market conditions as the issuer of reserve money through three policy instruments as follows:

#### **(i) Open Market Operations (OMO)**

Although OMO activities fell sharply since the withdrawal of commercial banks, the Central Bank would continue to use OMO as the key instrument for signaling its monetary policy stance and influence liquidity in the financial system, or where appropriate issue its own financial instruments or use its regulatory powers.

#### **(ii) Exchange controls**

Secondly, although export growth is forecasted to impact positively on external reserves, this would not be sufficient to raise reserves to the desired level of about three months of import cover. The Bank would maintain the current exchange controls and only gradually liberalized once macroeconomic conditions have stabilized.

#### **(iii) Exchange rate policy**

To ensure exports remain competitive and cap any possible pressures on reserves, the Bank would maintain the current exchange rate policy of protecting the external reserves and would review the policy once the level of external reserves rise to comfortable levels and stabilize.