CENTRAL BANK OF SOLOMON ISLANDS

2004 MONETARY POLICY STANCE STATEMENT

Issued by Governor of the Central Bank of Solomon Islands

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Honiara
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Box 1.

OBJECTIVES OF THE CENTRAL BANK

The principal objects of the Central Bank shall be:

(a) to regulate the issue, supply, availability and international exchange of money;
(b) to advise the Government on banking and monetary matters;
(c) to promote monetary stability;
(d) to supervise and regulate banking business;
(e) to promote a sound financial structure; and
(f) to foster financial conditions conducive to the orderly and balance economic development of Solomon Islands.

CBSI ACT, Section 4, [CAP.49]

Box 2.

In pursuing monetary policy, and in line with the key policy guidelines, the Central Bank shall continue to ensure that economic and financial conditions remain conducive to enable private sector led growth activities. For a small and highly open economy like Solomon Islands, conducive economic and financial environment conditions require:

(a) a sustainable balance of payments position to enable a rise in the level of external reserves sufficient to six months of import cover;
(b) providing certainty for private sector businesses in terms of access to domestic financial resources to plan for long-term investment and hence growth;
(c) maintaining price stability and minimizing volatility and price distortions. Price stability inevitably requires, amongst other things improving confidence in the local currency and management of the economy.

The Central Bank believes that these key objectives if achieved would potentially lead to a more stable macroeconomic environment.

EXECUTIVE SUMMARY

The economic performance in 2003 was encouraging. The positive developments in the global economy, combined with improved law and order, increased donor inflows and private sector resilience, resulted in the following:

- Real GDP growth of 3.8%;
- Improvement in government finances and hence better delivery of health and educational services;
- A rise in official external reserves to unprecedented level of around $271 million, equivalent to 4.9 months of import cover;
- Declining trend in average lending rates, and
- Growth in private sector lending.
- Declining inflation rate

The Central Bank expects further improvements in economic conditions in 2004. The Bank expects the global economy to remain firm, the Regional Assistance Mission to Solomon Islands (RAMSI) to stay and ensure the current security situation persists, increased donor inflows, government adheres to budget and there is political stability in 2004. Based on these assumptions, the Bank projects the following outcomes for 2004.

- Real GDP growth - 4.0%
- Annual inflation - less than 10.0%
- Private sector credit growth - 25.0%
- Credit to government (net) - -21.0%
- Increase in external reserves - 46.0%

The major risks in achieving the above targets remain with any severe adverse developments in the global economy, particularly SI major trading partner economies, sudden shift in law and order situation, extent of implementing government projects, reforms and hence expected donor inflows.

2004 MONETARY POLICY STANCE STATEMENT
APRIL 2004

This Monetary Policy Statement is the second to be issued by the Central Bank of Solomon Islands to the media. There are two aims of doing so. The first is to inform the public, both local and overseas, of the outlook for monetary developments in 2004. The second is to ensure the Bank is more accountable and transparent in deciding the key monetary policy objectives to be pursued during the year.

Introduction

The Central Bank of Solomon Islands (CBSI) is responsible for formulating and implementing monetary policy in the country. The Banks Board does this important task at the beginning of each year in line with the policy guidelines laid out in the Central Bank Act (Section 4, CAP 49) as cited in Box 1 above. In pursuing these objectives, the Bank is also mindful of the broad policy objectives of increased employment, relatively stable prices and sustainable economic growth. These broad objectives are normally achieved by using appropriate fiscal and monetary policies although it is acknowledged the attainment of these policy objectives are sometimes not mutually compatible.

The Bank believes that monetary policy (MP) can help achieve the above three broad objectives by focusing on three major policy objectives. The first is to ensure there are adequate reserves to augment the recovery process. The second is to maintain stable financial conditions friendly to private sector-led growth, and thirdly maintain the value of money by reducing inflation. The Bank believes that in the long term, the reduction in inflation is the principal way in which MP can meaningfully contribute to form a sound basis for long-term growth in Solomon Islands.

The Monetary Policy Statement is presented in two parts. The first covers economic developments in 2003 and projected outcomes in 2004. The seconds sets out the rationale for the monetary policy stance for 2004 and the conduct of monetary policy during the year.

1. Economic Developments

In designing monetary policy for 2004, the Central Bank considers both actual and projected developments in seven main areas with particular attention to their impacts on monetary aggregates and inflation. These are summarized as follows.

1.1 The World Economy

According to the latest World Economic Outlook, released in September 2003, the IMF expected global growth to be 3.2% in 2003, marginally higher than 3.0% in 2002 The growth reflected the quick end to the US-led war on Iraq, the waning of

SARS problems and easing of macroeconomic policies in major economies around the world.

In the US, optimism about the recovery has increased with September quarterly GDP showing very strong growth across all major sectors. The Japanese economy also showed signs of growth during the year driven mainly by a rise in net exports and investments. However, there is concern that the Yen appreciation may hamper export growth. Other industrialized economies, and the Euro zone are expected to grow modestly. There was also growth in other market economies in Asia, reflecting improvements in the US economy and continued strong growth in China.[1] Growth in both Australia and New Zealand are also estimated to outpace the outcomes in 2002. This would reflect the rise in stock prices, building approvals, and consumer spending in the case of Australia and positive impacts associated with the booming migrant population in the case of New Zealand.

Global inflation currently remains very low. In major economies, inflation was projected below 2.0% in 2003 and to fall further to 1.3% in 2004, the lowest in 30 years. Average inflation in developing countries is also forecast to fall to 5.0%, from 6.0% in 2003.

2004 Projections

Recent data suggest that growth in the global economy would rise further to 4.6% in 2004, relatively higher than earlier projected. The global recovery reflects expected recovery in most regions due to reduced geopolitical uncertainties, continued supportive macroeconomic conditions in major economies and the expected decline in average oil prices. The U.S would lead the recovery with growth projected at 4.6% for 2004. In Asia (including Japan) growth is expected to rebound, boosted by continued policy easing and robust growth in China. The return of SARs in China and emergence of the bird flu crisis through out Asia poses a threat to this expectation. A higher growth of 1.9% is also forecast for the Euro-zone during the year. Solomon Islands economy should benefit from the global recovery, especially from growth in Asia.

1.2 Domestic Economic Activity

Solomon Islands real gross domestic product (GDP) grew by 3.8% in 2003, compared to an earlier estimate of 1.3% by the Central Bank. This was a significant improvement compared to negative growth rates in the previous four years. The economy showed signs of recovery early in the year, but it was the arrival of the Regional Assistance Mission to Solomon Islands (RAMSI) in late July that boosted the recovery process further. The strong performance was due primarily to relatively better global economic conditions, the significant improvement in the law and order situation, increased donor inflows, and the resilience of the productive and private sector. In the real sector, there were significant increases in the production of all major export commodities. The benefits were widespread given the fact that nearly 80% of the population is involved in one way or

[1] China is becoming an increasing important player in the Asian region.

the other in export related activities.

2004 Projections

Real GDP is forecast to grow further at 4.0% in 2004 with growth projected in all major sectors during the year. The agriculture, forestry and fisheries sectors are all expected to contribute positively reflecting the strengthening of the global economy, and continuous improvements in the security situation, and expected rise in the production of all major export commodities.

However, in the medium-term, prospects for sustained recovery in the economy will depend on the rehabilitation of both SIPL and Gold Ridge projects, developments of new mineral and non-mineral projects, improvement of infrastructure development and maintenance of existing infrastructures, continuation of structural reforms, maintenance of law and order; and political and financial stability.

1.3 Inflation

The annual inflation was 10.1% in 2003, compared to 9.4% in 2002. On a monthly basis, however, inflation continued to decline. For example, in January inflation was 15.5% but declined to 4.1% in December. The fall in domestic food prices due to improved supply of fresh fruits and vegetables to the Honiara markets, gradual decline from the very high oil prices experienced in late 2002 and early 2003, and relative stability in the exchange rate in the latter half of 2003 contributed to the declining trend in inflation in 2003.

2004 Projections

The Bank expects annual inflation to remain relatively stable at less than 10% in 2004. This assumes that the exchange rate would remain relatively stable, and that average oil prices would trend downward as supply improves globally. In addition, the improvement in law and order should help maintain the supply of fresh fruits and vegetables to the Honiara market. This should help keep inflation down as food accounts for almost 50% of the CPI. The risk, however, is that as the economy strengthens, inflation could rise if production does not keep pace with increased demand. Already inflation increased to 5.4% in February, up from 4.1% in December last year. Any further depreciation of the exchange rate, particularly against the Australian dollar, would also result in a rise in the price of imported items and therefore put upward pressures on the overall inflation rate.

1.4 Balance of Payments

The balance of payments recorded an overall surplus of $140.6 million, much higher than the surplus in 2002 and deficits in the previous two years. The surplus reflected positive developments in both the current and capital accounts, with the former recording a surplus of $39.9 million, and the latter a surplus of $140.6 million. The current account surplus reflected higher export receipts, and net inflows in both private and official current transfers. The surplus in the capital and financial accounts was mainly due to the rise in capital transfers. As a result, the level of external reserves rose to

$271.1 million, from $130.4 million in 2002. This level of reserves represents about 4.9 months of imports of goods and services. However, taking into account the level of government external debt arrears and pending foreign exchange applications at the end of 2003, the reserve cover would have declined to less than three months.

2004 Projections

The recovery in the external sector is forecast to remain firm in 2004, with total exports rising to $650 million from $557 million in 2003. This, combined with the expected rise in donor inflows, should result in an overall surplus of $125 million. Although there will be a rise in import payments, driven by increased private sector lending, there should be sufficient reserves to facilitate the recovery process given the expected rise in donor assistance during the year. In any case, much of the growth in imports is expected to be financed by donor inflows.

There is concern, however, that the volume of un-used credit limits, which amounted to $50.6 million in February, may adversely affect reserves if these are used to finance imports. The Bank will continue to closely monitor the un-used credit limits and path of economic activity in the months ahead and take necessary actions to ensure economic conditions remain conducive (in terms of sufficient foreign reserves) to support the ‘private sector led’ recovery process.

1.5 Exchange Rates

The Solomon Islands dollar (SBD) was kept relatively stable against the US dollar during the year. This not only reflected the need to instill financial and business confidence, but also the rise in donor inflows, and growth in exports during the year. As a result the SBD depreciated marginally by 10.6% against the US$, less compared to the movement in 2002 (27.9%). The average movements (depreciations) against other major currencies were relatively large compared to movements in 2002. This was mainly due to weakening of the US dollar against these currencies in the foreign exchange market.

The US dollar is forecast to remain relatively weak against other major currencies in 2004. To minimize the SBD exchange rate against these other currencies, and thereby impacts on inflation, appropriate actions will be taken against the US dollar should its downward movement against other currencies persists.

1.6 Fiscal Operations

Available data on the government’s fiscal operations to December 2003 showed an overall deficit of $77.7 million[2], compared to $302.6 million in 2002. The lower deficit was due to the fall in expenditures and rise in both tax and non-tax revenue.

Total domestic revenues rose to $373.4 million or 44.5% over budget estimates, but this was not sufficient to offset the increase in payroll and

[2] Based on the accrual system.

other charges.[3] This resulted in a recurrent deficit of $81.8 million. Based on the cash accounting system, government had reported a cash surplus of $37.5 million for 2003. However, this underscored difficulties in governments fiscal operations, particularly in the first half, which led to an increase in official debt arrears of $80.6 million at the end of the year. Government finances have now stabilized after RAMSI instituted controls. This positive development is very encouraging and is expected to continue in 2004.

The government serviced $40.9 million in debts during the year. While the stock of domestic debts has remained relative unchanged, the volume of external debts has increased due to exchange rate movements. Consequently, the stock of total debts rose to $1,602 million. Since RAMSI's arrival, payment of other creditors has also started and is expected to continue in 2004. This should enhance private sector activities and further reduce the government's debt burden.

2004 National Budget

The SIG budget[4] passed in December 2003 was a balance budget. Its key objective is to improve government finances, and achieve macroeconomic stability by consolidating fiscal adjustments begun in late 2003. This should help provide the conditions necessary for promoting sustainable economic growth. The budget strategy recognizes current economic conditions confronting SI economy. The budget has no new revenue measures but aims to strengthen existing revenue measures and improve expenditure controls by:

- Tightening controls to eliminate overruns on salaries,
- Removing ghost workers on the payroll,
- Adhering to budget allocations, and
- Freezing new recruitment

However, government fiscal operations are projected to end with an overall deficit of $14 million, lower than in 2003. The projected outcome mainly reflected the slow pace of implementing the development budget. As a result, government would not receive all budgeted related donor inflows, including the budgeted $17 million in external loans for the year. In addition, it is expected that government would still end up with debt arrears even if all ADB, World Bank and Exim loan dues for the year were paid.

1.7 Monetary Developments

The monetary growth, which began towards the end of 2002 continued in 2003, and resulted in a 25.4% growth in broad money supply. As a result, all components of money has increased; currency by 12.2%, demand deposits (44.7%), time deposits (24.3%), and savings deposits by 0.1%. The growth in money supply was driven almost entirely by the rise in net foreign assets during the year.

Total private sector credit reversed the sluggish growth in the previous

[3] Most were expended in the first six months before RAMSI instituted controls in the third quarter

[4] The Development component was later revised from about $700 million to just $282.9 million in March 2004.

years and rose 25.4% in 2003. This growth, however, was mainly due to a rise in over draft facilities with very little in new loans. This resulted in the rise in excess liquidity within the system. However, continued improvements in demand for private credit should reduce some of this excess liquidity in 2004.
The weighted average deposit rate slightly increased to 0.77% in 2003 compared to 0.61% in 2002, while the weighted average lending rate fell to 15.53% from 15.62% in 2002. As a result, the interest rate margin fell to 14.66%. With the decline in average inflation during the year, it is obvious that there have been positive real returns on lending while savers have been receiving negative real returns on their deposits as the average weighted deposit rate is far below the average inflation rate.

The Central Bank continued to utilize its Open Market Operation (OMO) instruments to manage liquidity. However, two key problems restricted the effectiveness of this instrument during the year. First, most major players decided not to take part in OMO activities. Second, the amount was restricted to just $30 million due to expenditure implications on government's finances. This also contributed towards the reduction in the interest rates on Treasury bills during the year. Nevertheless, these remained relatively higher than commercial banks average deposit rates.

2. 2004 MONETARY POLICY

The Central Bank acknowledges that to sustain the recovery process, it is crucial that all arms of macroeconomic policies, including monetary policy are implemented in a coordinated manner. In the long run, however, monetary policy cannot directly influence the growth rate of real variables such as real GDP, investment and employment. Experience from other countries showed that attempts to do so would only result in a rise in inflation and therefore costs the economy in terms of less efficient resource allocations and unequal distribution of incomes. The Central Bank believes, therefore, that the best monetary policy can contribute in a small and highly open economy like Solomon Islands is to ensure that economic and financial conditions remain 'conducive to the orderly and balanced economic development of Solomon Islands'. This requires the close monitoring of all indicators such as changes in the exchange rates, external reserves, money and credit aggregates, prudent implementation of governments 2004 budget, level of donor assistance inflows, and developments in the global economy.

The Bank believes that positive developments experienced in the second half of 2003 offer the best opportunity to rehabilitate the SI economy. Given the normalization of the security situation, restoration of law enforcement agencies and expected donor support into efforts to re-grow the economy, it is crucial that this window of opportunity is grasped. To achieve this, it is crucial that the recovery process is supported with appropriate policies.

On the monetary front, three major macroeconomic policy objectives will determine the conduct of monetary policy in 2004 and in the short to medium terms:

- First, to enhance economic activities and hence through private sector access to domestic financial resources,
- Second, to sustain the BOP position and gradually build the level of external reserves to more than five months of import cover, and
- Third, to maintain price stability and hence annual inflation to single digits.

In terms of priority, the primary objective of monetary policy is to ensure there is adequate liquidity that would respond adequately to the needs of the private sector as the economy picks up pace. This objective will be pursued without prejudice to an adequate level of foreign reserves while ensuring against upward pressures on the level of inflation. Should maintenance of this policy undermine the external reserves, policy actions will shift to defending the external reserves.

Conduct of Monetary Policy

Based on the above three policy concerns, the Bank continues to act indirectly through its influence on money market conditions as the issuer of reserve money. The Bank shall do this through three policy instruments as follows:

(i) Open Market Operations (OMO)

Although OMO activities are currently ineffective, the Bank will continue to use this as its key instrument for signaling its monetary policy stance and influencing liquidity in the financial system. However, assuming that by the second quarter of 2004 SIG has reached a comprehensive debt compromise[5], whereby all SIG Debt [including SIG Advances with CBSI] become respectable income earning assets again, a substantial part of SIG Advances with the CBSI could be "converted" into Treasury Bills. This would help address the liquidity problem that currently overhangs the market.

(ii) Liquid Asset Ration (LAR)

In the event that increased credit fuels downward pressure on external reserves, the Central Bank will resort to administrative controls and raise the liquid assets ratio (LAR) from 7.5% to a more appropriate level.

(ii) Liquidity Management Measures

These are mechanisms introduced primarily to absorb excess liquidity in the banking system. One such measure introduced earlier was the Statutory Reserve Deposit (SRD), whereby commercial banks were asked to freeze a certain portion of their deposit liabilities.

In the past, the Bank has also resorted to its BOKOLO bill instrument. This option, however, is currently not possible due to budgetary constraints.

[5] SIG is yet to reach a compromise with holders of Restructuring Bonds, Treasury Bonds and Development Bonds. It is expected that a similar approach would be taken to deal SIG advances at the Central Bank.

(iv) Imposition of Credit Limits

The remaining and best option, albeit administrative, is to impose (tradable) credit limits on the commercial banks. The Bank sees this as the best option should the current overhang threatens the external reserves as commercial banks start lending more resolutely than in the past 3 years. In terms of the CBSI Act [CAP 49]], the Bank would to require banks to seek CBSI approval for new lending. A notice would become effective 30 days after publication in the Official Gazette. Banks would be asked to supply details of any existing un-drawn commitments including unused overdraft limits that could be added to the limits provided the banks agree to refrain from new lending from the date of the advice from CBSI.

However, there is a major weakness in granting credit limits to commercial banks. Evidence in other countries showed that the use of credit limits tend to be bias towards certain clients and sectors in the economy. This could happen in Solomon Islands.

Policy Actions already taken.

Following the rise in foreign exchange reserves, and in view of expected further reserve growth in the months ahead, the Bank has also reviewed all exchange controls imposed since June 2000 in March 2004. This resulted in three major policy changes. First, the delegated limit on all outward payments was raised to $25,000 from $5,000. Second, the Central Bank raised the overnight limit to commercial banks to $3 million from $2 million. Third, the Bank reversed its previous policy not to participa te in the foreign exchange market and resumed participation in the foreign exchange market. These policy changes became effective as of 5th April 2004. These changes should enhance private sector activities and hence economic growth.

The Central Bank will closely monitor economic developments in the months ahead, particularly changes in the exchange rates, external reserves, money and credit aggregates, prudent implementation of governments 2004 budget, level of donor assistance inflows, developments in the global economy and take appropriate policy action using the best available instrument when the need arises.

Central Bank
8th April 2004