



MONETARY POLICY STANCE FOR 2005.

(MEDIA RELEASE)

Introduction

This Monetary Policy Statement is the third 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 2005 and secondly to ensure the Bank is accountable and transparent in the discharge of its mandate and responsibilities.

In deciding the stance of monetary policy for 2005, the Central Bank has considered developments and projections in the global economy, domestic economic conditions, the balance of payments outlook, and fiscal operations of the government with particular attention to their possible impacts on monetary aggregates and prices. These are summarized as follows.

1. Review of Recent Economic Developments

Provisional estimates based on data available to the Bank indicate that the Solomon Islands economy performed strongly in 2004. Real GDP grew by 5.5% during the year. The improvement, which continued the general recovery process which begun late 2003 reflected both external and domestic factors.

The global economy remained resilient in 2004 and ended with a growth of 5.1% 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. The likelihood of further positive growth in the global economy in 2005 is good news to Solomon Islands, particularly growth in the East Asian region. But it is also important that existing impediments that hinder SI from responding adequately to increased demand for our export markets are addressed if the country is to benefit fully from the global growth.

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 forestry and copra sectors. The rise in copra 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 cocoa and fish production, on the other hand, fell during the year. It is estimated, however, that production in both commodities will increase in 2005.

The resumption of domestic economic activities, relatively favorable global conditions and continued donors support had a positive impact on the balance of payments (BOP) during the year. At the beginning of the year, reserves were \$280.4 million. But this increased during the subsequent months to end at \$592.8 million in December. This is equivalent to about seven months of imports of goods and non-factor services. The rise in reserves was due largely to continued donor support and export growth. The level of reserves, however, is forecast to slightly decline by \$30.3 million in 2005 in view of expected increase in imports and relatively lower export receipts. The Bank relaxed its exchange controls in April 2004 and further relaxation is expected in 2005 in view of positive developments in the economy. The Solomon Islands dollar has remained relatively stable against the Australian dollar and other major trading currencies since March 2004. So the exchange rate policy to hold steady against the US dollar has had a moderating effect on inflation during the year. Inflation in March 2005 further declined to 5.0% and to 4.5% in April.

Available data on fiscal operations by the national government showed an overall surplus of \$102.6 million, reversing the series of deficits since 2000. The improvement was attributable to a rise in revenue, continued donor support and stringent expenditure controls at the Ministry of Finance. In terms of expenditures, payroll accounted for 34.3% of expenditures during the period while government debt arrears rose by \$12.4 million in 2004.

Monetary conditions remained relatively depressed in early 2004. 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 19% growth in broad money supply. The rise mainly reflected positive outcome in the balance of payments, which led to a significant rise in net foreign assets during the period. The commercial banks remained very liquid during the year. Data in the first quarter of 2005, showed a continued growth in the monetary aggregates, especially in private sector credit. Net lending to government, on the other hand is expected to increase as government draws down its balances within the system to finance its 2005 budget deficit.

Monetary policy remained relatively inactive in 2004 although the emphasis of monetary and credit policy was to provide for growth while ensuring there was 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.

In a highly open economy like Solomon Islands with very little sources of credit financing, the rise in surplus liquidity poses a threat on the level of external reserves. In the first four months of 2005, the level of liquidity has steadily declined reflecting the rise in private sector lending. At the same time, reserves have also fallen slightly. The Bank will monitor closely changes in the surplus liquidity position and ensure appropriate actions are taken should this threat develop further in the months ahead.

2. Economic Forecasts

Given the above developments and based on data available so far, the Bank has forecast a further real GDP growth of 4.0% for 2005. This assumes that the law and order situation remains stable, there is increased production of major export commodities, that government implements its reform programs and sticks to its budget throughout the year, and donors remain committed to the country.

On the external front, the export sector is forecast to decline in 2005 reflecting expected reduction in log exports. The improvement in the security situation and speedy implementation of government's reform programs should also attract more donor funding. Although increased activity would fuel import demand, it is expected that international fuel prices should fall from recent highs.

The balance of payments could impact on the financial sector during the year. Money supply is expected to increase further, reflecting expected growth in private sector lending. It is important that credit growth is also closely monitored to ensure that this does not unnecessarily put pressure on external reserves, result in inflation and therefore erode external competitiveness. The government's budget, is expected to contribute towards monetary growth in 2005 through the use of its \$80 million savings last year.

3. 2005 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 were to deteriorate and the implementation of government reforms are prolonged. The Bank 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 2005 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 emerged from significant contraction since 2000, and it is important that the recovery process is supported with appropriate policies. Specifically, the Bank's monetary policy objectives for 2005 are:

- First, continue to foster conditions conducive for economic growth by capping inflationary pressures, and
- Secondly, continue to maintain appropriate level of reserves whilst encouraging private sector led growth.

4. Conduct of Monetary Policy

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

(i) Open Market Operations (OMO)

Although OMO activities fell sharply since the withdrawal of some players 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. The Central Bank could consider the issue of its own financial instruments or use its regulatory powers should events deem it necessary.

(ii) Exchange controls

In view of positive developments in the economy, and need to sustain the growth process, all existing exchange controls would be reviewed upwards. The Bank will closely monitor developments in the months ahead and review these controls if the need arises.

(iii) Exchange rate policy

To ensure exports remain competitive and cap any possible inflationary pressures, the Bank would maintain the current exchange rate policy of stabilizing against the US dollar and would review the policy when the need arises.

Central Bank of Solomon Islands
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