CENTRAL BANK of SOLOMON ISLANDS

MONETARY POLICY STANCE 2007

HONIARA
JUNE 2007

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Monetary Policy Stance 2007

The following paper outlines the Central Bank of Solomon Islands' monetary policy stance for 2007. The first three sections provide a summary of domestic and international developments in 2006, and expectations for 2007. The fourth section outlines the major policy goals and strategies for the year ahead.

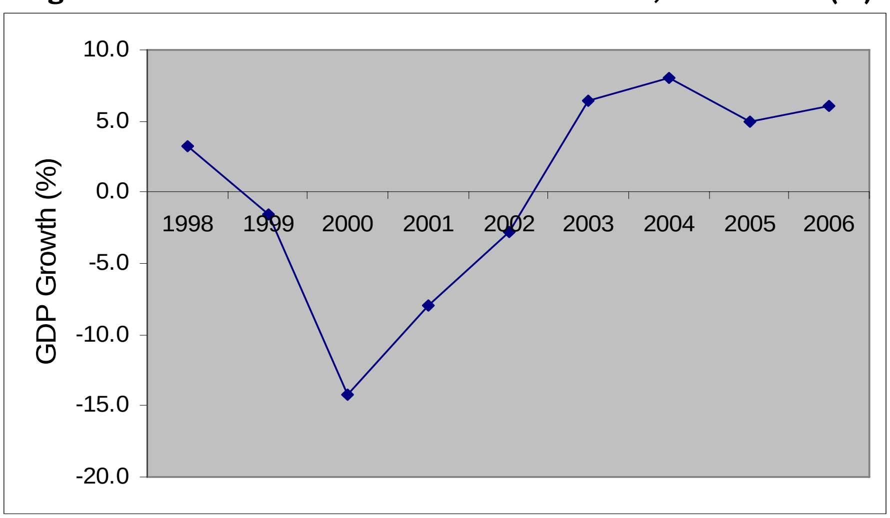
1. Domestic economic developments in 2006

2006 was an expansionary year for the Solomon Islands, with many of the key monetary economic indicators rising significantly, and GDP growth also impressively high at over 6%. The following is a summary of the main trends observed over the past year.

1.1. GDP

Positive GDP growth in the previous three years was followed by real GDP growth of 6.1% in 2006, according to provisional results. Low growth in agriculture of 2.3% was a result of a large decline in copra and cocoa production. The commencement of significant palm oil production mid-way through the year helped to bolster sector growth.

Figure 1. GDP Growth in the Solomon Islands, 1998-2006 (%)



Fishing production and logging, representing 5.1% and 14.1% of GDP in 2006 respectively, were both important contributors to the high growth, increasing by 25% and 6.3% respectively. Growth in 'other services' (which includes government spending on health, education etc) was also high at 6.5%, and was an important factor as this category makes up over 20% of GDP. Finally, extremely large growth rates were recorded in the construction sector (33.5%) and in transport and communications (27.9%), though these two categories do not contribute a large share to value-added.

1.2. Employment

Labour market conditions during the year were vibrant, reflecting positive developments in both the private and public sectors. The total public service workforce at the end of 2006 was 10,315 people, compared with 9,668 at the end of 2005. This increase of 647 employees continues the recruitment policy the Government has pursued since 2004. Nevertheless, the Government managed to fill less than half of the budgeted 1,351 posts. Cumbersome recruitment procedures and a scarcity of appropriately-qualified individuals were the main obstacles to further expansion.

Employment indicators from the Solomon Islands National Provident Fund (SINPF) showed a growth in total employment. The number of active workers, defined as those who have made contributions in the last 12 months, increased from 25,856 individuals at the end of 2005 to 29,890 individuals by the end of 2006, an increase of 4,034 employees. Similarly, total registered members (including retirees and redundant) rose by 2,922 contributors (4.6%) over the previous year to 66,045 in 2006. In accordance with the Industry Standard and Classification by industry (ISIC), the net increase was accounted for mainly by real estate & business services (24%), forestry (21%), retail & wholesale (11.3%), manufacturing (7%), transport & communication (6%), hotels & restaurants 4.3%, construction 4%, and 3.7% from health & social welfare services. The number of employers registered with SINPF also rose from 1,364 to 1,470 employers, owing to compliance measures taken by SINPF and the rise in small businesses.

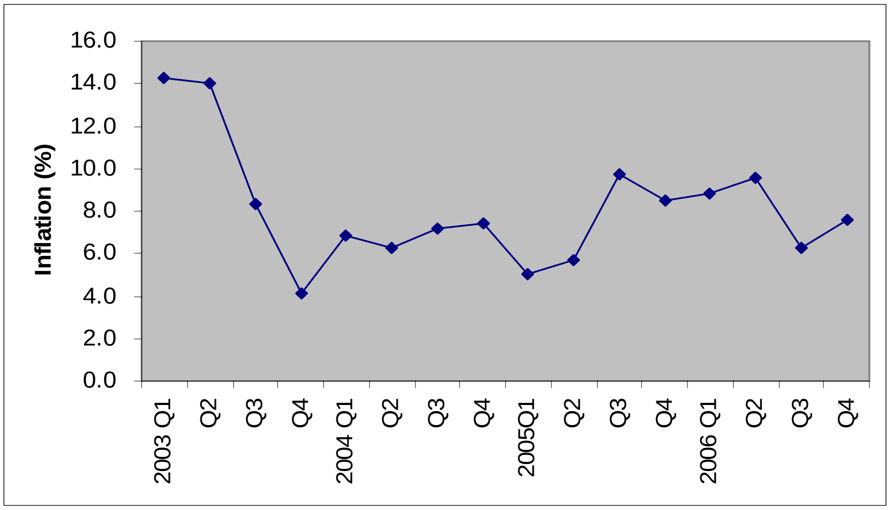
1.3. Inflation

Inflation decreased significantly in 2006, according to the Honiara Consumer Price Index. Annual inflation in 2006 was 7.6% (3-month moving average) compared with 8.5% in 2005.

The fall was due mainly to inflation on domestic items which fell to 6.6%, from 9.6% in 2005. On the other hand, inflation on imported items rose to 8.9% in 2006, compared to 6.2% in 2005 (3-month moving average). High oil prices were an important factor in the high inflation for imported items, as was a weakening of the Solomon Island Dollar against several trading partners.

During the course of 2006 CBSI closely monitored the price-level situation. This level of inflation remained within the boundaries that CBSI deems acceptable given the current situation of post-crisis recovery in the Solomon Islands economy.

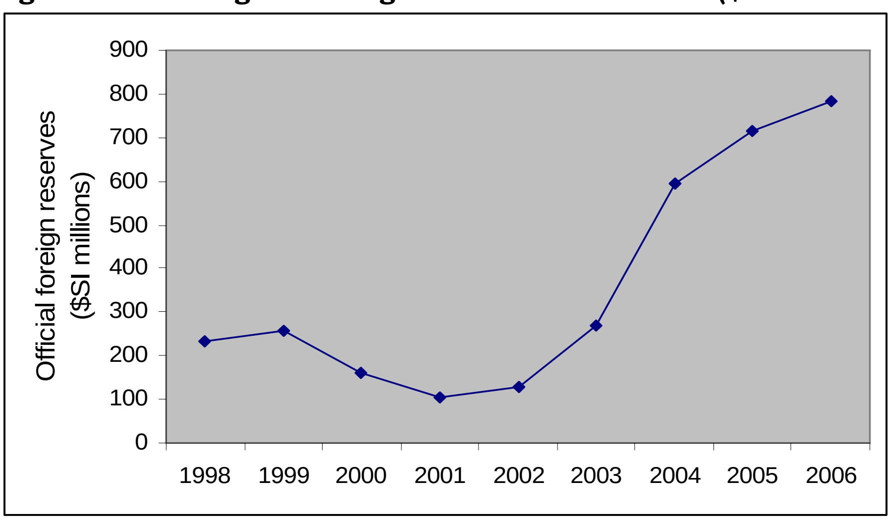
Figure 2. Inflation (%) 2003-2004 (3-month moving average)



1.4. Foreign reserves

The Solomon Islands is heavily reliant on imports for many basic goods so maintaining an adequate level of official foreign reserves is a key policy aim of the Central Bank. In 2006 foreign reserves rose by $66.0 million to $782.9 million, equivalent to 4.4 months of import cover (of goods and non-factor services).

Figure 3. Official gross foreign reserves* 1998-2006 ($SI millions)



* The data in this graph refers to official foreign reserves at year-end

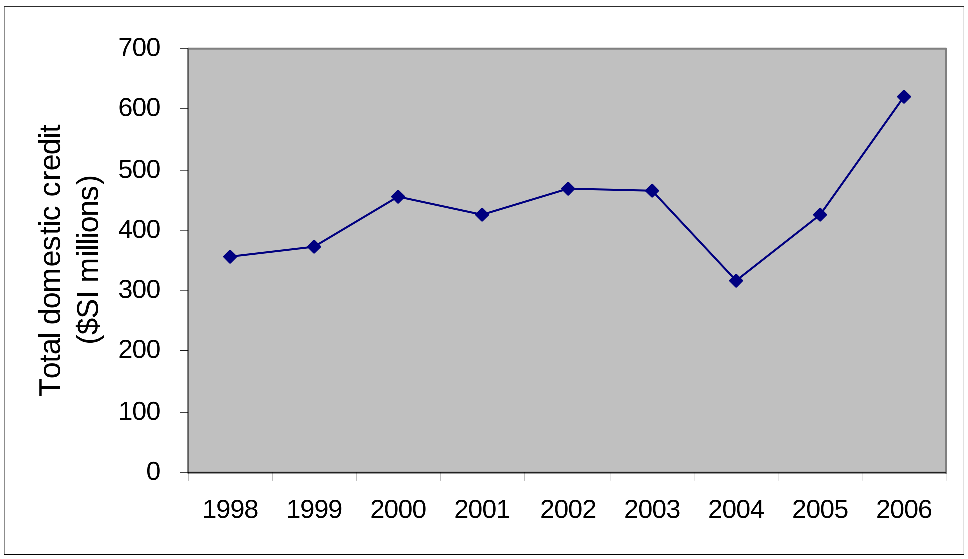
However, the Solomon Islands continues to experience a large trade deficit. In 2006, according to CBSI figures, the deficit was over $480 million. The positive balance of payments results recorded in the past few years are accounted for by the large inflows of aid assistance from overseas donors. Exchange rate developments have also positively helped sustain reserves, as reserves held in other currencies than the USD have increased in value due to their appreciation with respect to the USD.

Given the positive foreign reserves performance and the ample import cover this provides, CBSI action to protect foreign reserves was not needed in 2006.

1.5. Domestic credit

Total domestic credit in the economy expanded by a huge amount in 2006, increasing by 45.9% during the course of the year to $621 million. Driving this increase was a 62.5% growth in credit to the private sector, which rose to $632.3 million. This dramatic increase in lending was the result of increasing investment opportunities in the country, and in particular improved commercial bank confidence in the stability of the economic and political environment. Net credit to government decreased in 2006, falling from $36.4 million to minus $11.2 million, due to improved fiscal discipline on the part of the Solomon Islands Government.

Figure 4. Total domestic credit* 1998-2006 ($SI millions)

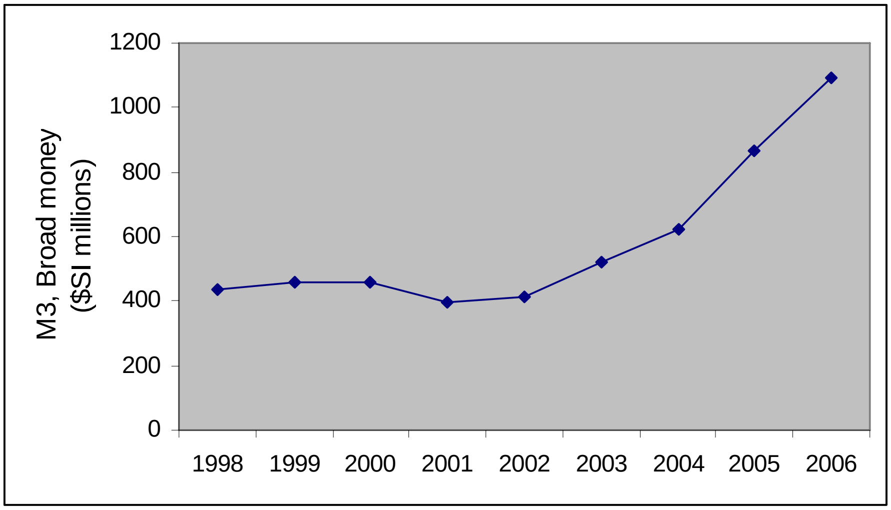


* The data in this graph refers to total domestic credit at year-end

1.6. Money supply

Money supply grew rapidly in 2006, with broad money (M3) growing by 26.4% to $1091.6 million by the end of the year. The most significant changes included 36.6% growth in demand deposits to $521.6 million, 16.1% growth in currency in circulation to $177.6 million and 19.1% growth in quasi-money (savings and time deposits) to $388.1 million. The huge increase in credit to the private sector was the main factor behind money supply expansion, although an increase in net foreign assets was also a factor. On the other hand, fiscal discipline during the year and the build-up of government finance surpluses helped to contain growth in the money supply and therefore reduce inflationary pressures.

Figure 5. Money supply 1998-2006 (broad money*, $SI millions)

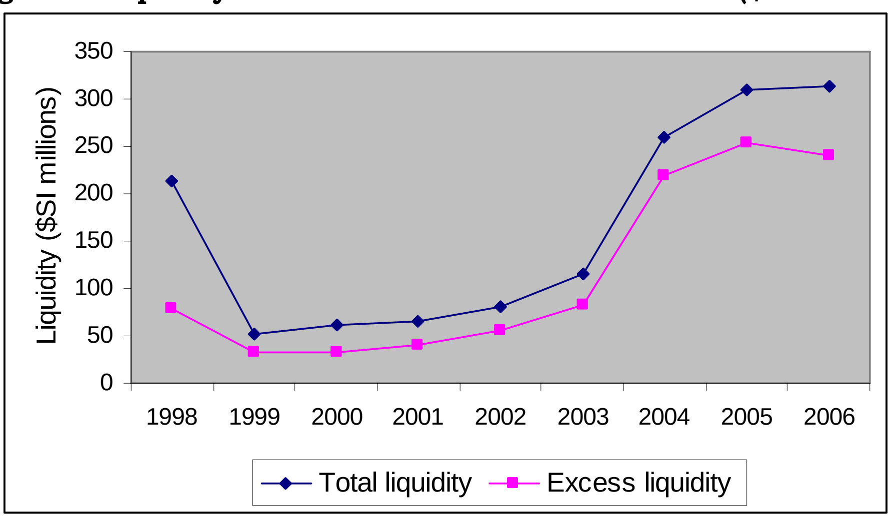


* The data in this graph refers to M3, broad money, at year-end

1.7. Liquidity

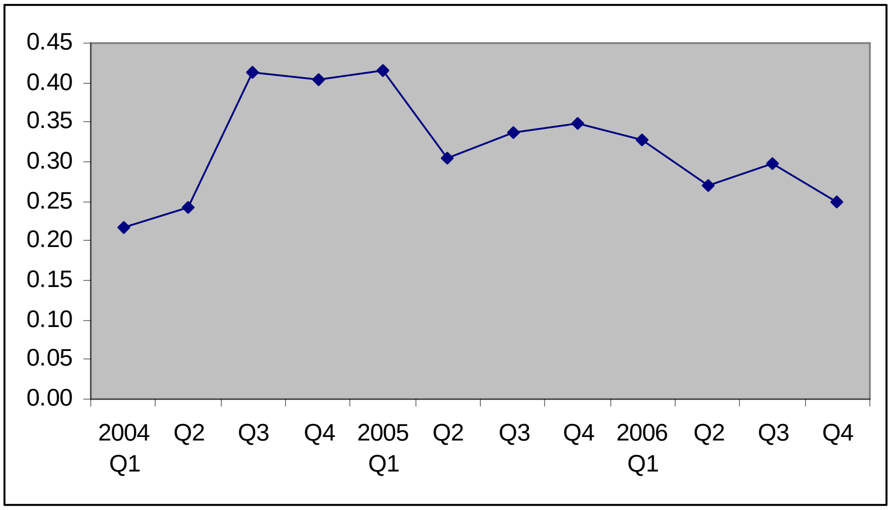
Total liquidity in the system increased slightly in 2006, reaching $313.0 million at the end of the year compared with $309.5 million at the end of 2005. Excess liquidity declined slightly over the same period, falling from $254.6 million at the end of 2005 to $240.0 million by December 2006 (see Figure 6). As a share of total deposits, excess liquidity also declined in 2006, declining to a quarter of total deposits by the end of the year, from over a third at the beginning (see Figure 7).

Figure 6. Liquidity* in the Solomon Islands 1998-2006 ($SI millions)



* The data in this graph refers to liquidity at year-end

Figure 7. Ratio of excess liquidity to total deposits, 2004-2006



Nevertheless, the level of excess liquidity in the banking system remains very high, and the Bank has been closely monitoring the situation as this presents a risk for future inflation and downward pressure on the level of official foreign reserves. The fall in excess liquidity despite a large expansion in domestic credit is partly explained by the rise in required reserves in 2006, due to the growing value of deposits. The tightening of fiscal spending also helped to limit liquidity growth, with SIG building up balances with CBSI. In particular, the reduction in excess liquidity is explained by leakages from the system in terms of rising payments for imports and transfers.

1.8. Interest rates

According to 2006 indicative interest rates obtained from the commercial banks, average interest rates on deposits remained unchanged from 2005 at 0.9%. Meanwhile, average interest rates on loans and overdrafts decreased to 14.0% from 14.5% in 2005, and therefore the (indicative) interest rate margin decreased by 0.5 percentage points to 13.5%. In contrast, average 'actual' interest rates calculated from the balance sheets and assets and liabilities of the commercial banks show that the margin between rates on deposits and those on loans in fact increased in 2006, rising to 13.7% from 13.2% in 2005, due to a fall in the average rate on deposits. More importantly, the average interest rate received on earning assets by the commercial banks increased by 1.5 percentage points to 12.4% in 2006. This, combined with the fall in rates on average rates on deposits caused an increase in the interest rate spread to 11.2%, compared with 9.2% in 2005 (see Table 1 below).

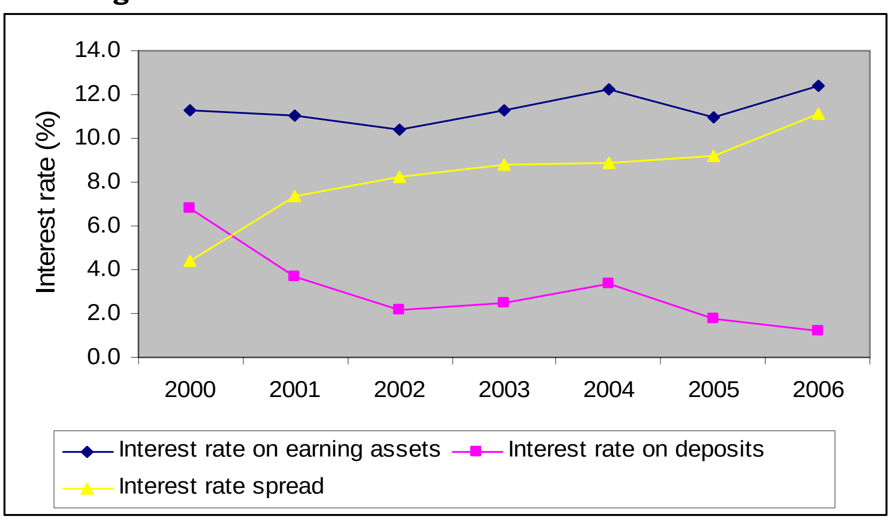
The low rates on deposits that have persisted over the last five years are in large part caused by the high and escalating levels of excess liquidity over the same period; with such large surplus funds available, there is no need for the commercial banks to offer higher interest rates in order to attract more funds from depositors. One reason for the higher return on total earning assets in 2006 is that the proportion of lower-yield SIG bonds in commercial banks' portfolios has decreased. Another reason is that in 2006 interest rates on restructured bonds was 1% higher as a result of improved revenue performance.

Table 1. Indicative and 'actual' interest rates, 2000-2006

	2000	2001	2002	2003	2004	2005	2006
Average 'indicative' rate on deposits (%)	2.9	1.2	0.9	1.1	1.2	0.9	0.9
Average 'indicative' rate on loans and overdrafts (%)	15.1	15.2	15.6	15.4	14.7	14.5	14.0
'Indicative' IRM (%)[1]	**12.2**	**14.0**	**14.7**	**14.3**	**13.5**	**13.6**	**13.1**
'Actual' interest rate on deposits (%)	6.8	3.7	2.1	2.5	3.4	1.7	1.2
'Actual' interest rate on loans and overdrafts (%)	14.8	13.8	14.5	15.5	17.5	14.9	14.9
'Actual' IRM (%)[2]	**8.0**	**10.1**	**12.4**	**13.0**	**14.1**	**13.2**	**13.7**
'Actual interest rate on interest-earning assets (%)	11.3	11.0	10.4	11.3	12.2	10.9	12.4
Interest rate spread (%)[3]	**4.5**	**7.3**	**8.3**	**8.8**	**8.8**	**9.2**	**11.2**

[1] 'Indicative' interest rate margin (IRM) is the difference between the average indicative rate on loans and the average indicative rate on deposits
[2] 'Actual' IRM is the difference between the average return on loans and the average interest rate paid on deposits
[3] Interest rate spread is the difference between the average return on earning assets and the average interest rate paid on deposits

Figure 8. Average 'actual' interest rates in the Solomon Islands 2000-2006 (%)



1.9. Exchange rate

In 2006 CBSI maintained its policy of determining the value of the Solomon Islands Dollar (SBD) from a basket of currencies with which the country trades. In particular, though, the SBD is closely related to the USD, the currency in which the country's major exports and imports are valued. Throughout 2006 the SBD remained stable against the USD, depreciating just slightly from SBD7.58 per USD in December 2005 to SBD7.63 at the end of 2006. In 2006, the USD depreciated against the currencies of the Solomon Islands' other major trading partners, causing the SBD to also depreciate against those currencies. In particular, the SBD weakened between the end of 2005 and end 2006 from SBD5.62 to SBD6.0 per AUD, from SBD13.23 to SBD14.99 per GBP and from SBD8.98 to SBD10.09 against the Euro.

2. International economic developments in 2006 and projections for 2007

The world economy grew strongly by 5.4% in 2006. This reflected positive growth in almost all regions. The US economy grew by 3.3% in the course of the year, a similar rate to 2005. Meanwhile, growth in the Euro area reached its highest level for six years, averaging 2.6%. In Asia, a region with significant trade links with the Solomon Islands, growth continued to remain very strong. GDP growth in the 'Emerging Asia' group of countries[1] improved slightly from 2005 to average 9.0% for 2006, in particular influenced by the continued success of China and India which grew by a remarkable 10.7% and 9.1% respectively.

In the Oceania region, the Australian economy, one of the key powerhouses in the region and a major trading partner of Solomon Islands, experienced a slight slowdown in growth to 2.4% from 3.0% in 2005. This in part was an effect of the severe drought that suppressed agricultural production. New Zealand also experienced sluggish growth of 1.5%, down from 2.2% in 2005. In contrast, positive GDP growth results were experienced by all of the Solomon Islands immediate Pacific island neighbours. Papua New Guinea continued to build on an upward trend in recent years to achieve 3.7% growth, while Fiji reversed the stagnation of 2005 to achieve 3.2% growth (compared to an estimated 0.7% in 2005). Vanuatu experienced lower growth than the high of 6.8% in 2005, but still enjoyed an expansion of 5.5% in 2006.

Robust world growth was achieved despite the surge in the price of oil to a high in August 2006, generating concern over inflation pressures and threatening household spending. The decline in oil prices in the second half of the year helped to reduce these problems, and also contributed to buoyant financial market conditions.

The outlook for 2007 remains positive with global real GDP growth forecast to fall only slightly compared with 2006 growth, as governments attempt to limit inflationary and oil price pressures. US economic growth is projected to slow down to 2.2% in 2007 as the housing market cools, dampening

[1] 'Emerging Asia' countries refers to China, India, Hong Kong SAR, Korea, Singapore, Taiwan, Indonesia, Malaysia, the Philippines, Thailand and Vietnam

private consumption and residential investments. Growth in the EU is expected to fall slightly to 2.3% in 2007, reflecting the possibility of currency appreciations that would weaken exports. Within the Japanese economy, real GDP growth is projected to grow at 2.3% in 2007, with expectations that household income growth will increase amidst the expansion. Finally, in China vibrant growth is expected to continue with further 10% growth forecast for 2007, reflecting the continued robust demand, although there is concern about its reliance on fixed asset investment.

Despite rapid economic growth over the past four years, there is a growing concern over large global imbalances especially on current deficits, as well as the potential for heightened protectionist measures in the face of the stalemate over the Doha Round. There has also been a need to balance domestic demand growth in advanced economies and ensuring that developing economies reduce potentials for difficulties in utilizing capacity. Nonetheless, policy interest rates will likely loosen in 2007, as inflation drops in the advanced economies in response to the earlier tightening of rates in 2006 to taper the global expansion.

Oil price forecasts for 2007 predict a slight decrease compared with 2006, but are nevertheless expected to remain high. Robust world economic growth, in particular in oil-intensive emerging economies such as China and India, will maintain the high level of demand for oil in 2007. On the supply-side, geopolitical tensions in the Middle East is a significant threat to supply capacity and remain a source of price volatility. Supply problems in other oil-producing countries such as Nigeria and Venezuela could also lead to capacity constraints and further push up prices.

3. Domestic macroeconomic outlook for 2007

In this section forecasts for the key macroeconomic and monetary variables in 2007 are presented. In addition, issues with the potential to affect the relevant variables are also identified. The April 2nd Tsunami, though devastating in terms of the cost to individuals affected, is expected to have a negligible effect on economic growth in 2007.

3.1. GDP growth

GDP growth is expected to rise even higher in 2007. Strong growth is expected in agriculture, with palm oil production in particular likely to increase markedly. Logging production will be a major driver behind growth and is forecast to increase by approximately 12.5% compared with 2005. Fishing output, however, is expected to decrease this year as a result of a reduced number of fishing vessels in use by the largest company. Overall, the CBSI estimate for GDP growth is 6.3% for 2007[2].

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[2] The IMF Article IV Mission's estimate is 5.4% growth for GDP in 2007

GDP growth in the Solomon Islands, where the economy depends heavily on a small number of primary commodities, is very sensitive to a number of external variables, including international commodity prices and weather conditions.

3.2. Inflation

Inflation is expected to remain within the single-digit boundary currently deemed acceptable by CBSI. Nevertheless, experience in recent years has shown that inflation in the Solomon Islands is highly variable, and CBSI will have to monitor price levels closely. The following factors are likely to contribute towards inflation in 2007.

Growth in domestic credit, and the upward pressure this exerts on the money supply, would be a major source of price inflation. Continued increases in private sector credit are expected in 2007, but should domestic lending exceed estimates there may be additional pressures on inflation of which CBSI must be wary. The increased spending outlined in the SIG 2007 budget is another factor that could potentially contribute to inflation.

The international price of oil has a major influence on prices in the Solomon Islands, in particular because transport costs are a large component in the prices of imported goods, and to a lesser extent in the price of domestic goods such as food which are transported to Honiara from the provinces. Oil prices have fallen since the exceptionally high levels witnessed in the first half of 2006, and according to the World Bank are expected to continue to decline moderately in 2007. Nevertheless, with limited spare supply capacity, international oil prices remain extremely vulnerable to shocks such as supply side disruptions and financial speculation.

The BSP takeover of NBSI is another factor that may have a small contribution towards inflation should it lead to an increase in spending and upward pressure on prices. The sale will result in a significant portion of the large capital build up in NBSI over the past few years being distributed to NPF, Health and Education Trusts and NBSI employees. This is expected to add $60 million to the money supply. Given the very low rates of return on deposits, NBSI employees may spend significant portions of their share, contributing to demand side inflation.

3.3. Foreign reserves

Gross foreign reserves in 2007 are forecast to grow again from the current levels, and are estimated to increase by approximately $80 million over the course of the year to around $865 million. This will mainly be the outcome of continued strong inflows from donors as well as positive growth in agriculture and logging which will help to improve export receipts. Substantial inward investment by Gold Ridge will also contribute to upward movement in gross foreign reserves. CBSI will also monitor a number of factors that may decrease reserves. First, the start of offshore investment by NPF will have an impact, although careful management on the part of CBSI will ensure foreign reserves do not deteriorate excessively. Likewise, the takeover of NBSI may have a small negative effect, if large amounts of the capital share paid to employees are spent on imported goods such as cars. Changes in the exchange rate may also affect the level of reserves measured in USD and SBD, as the Solomon Islands holds significant reserves in other currencies (particularly AUD, Euro and GBP), which are currently at historically high levels in relation to the USD.

The import cover provided by foreign reserves tends to fluctuate more widely than foreign reserve levels. Although an increase in foreign reserves is predicted this year, it is anticipated that imports (of goods and services) will also increase and import cover is not expected to increase significantly. Changes in the quantity and price of oil imports, which make up a significant component of import payments, may also have unforeseen effects on import cover.

3.4. Domestic credit and money supply

Total domestic credit is forecast to rise to around $780 million during 2007, an increase of 25% from the level at year-end 2006. Private sector credit is also estimated to increase by around 25% over the year to $790 million, on the back of positive investment opportunities and improving commercial bank confidence. Loans made available by the commercial banks for victims of the Tsunami may also contribute to increases in domestic credit, though the effect is expected to be relatively small. Net credit to government is expected to remain approximately unchanged at around minus $10 million.

This predicted increase in domestic credit will be the driving force behind a large expected increase in money supply in 2007. Broad money (M3) is forecast to increase by approximately 20% to $1,300 million by the end of the year. The increase will predominantly be seen in demand deposits, predicted to increase by over 25% to $660 million. Time deposits, savings deposits and currency in circulation are also expected to increase, but by smaller proportions.

4. Monetary policy in 2007

The stated objectives of the Central Bank of Solomon Islands are to achieve sustained and stable economic growth, a high level of employment, stability in the purchasing power of the local currency, and a viable balance of payments position. In order of priority, the following are the main policy objectives of CBSI in 2007:

1. Guard against excessive inflation
2. Maintain the adequacy of official foreign reserves
3. Improve interest rates on deposits and reduce the high levels of excess liquidity in the banking system

4.1 Policy Goal 1: Guard against excessive inflation

A moderate level of inflation is acceptable in creating the stable economic environment and desirable investment climate that is necessary for generating economic growth. As in 2006, maintaining a level of inflation below 10% per annum will be the primary policy aim for CBSI in 2007. Inflation this year is forecast to remain within this boundary, at about 8%, therefore no pre-emptive policy measures will need to be taken. However, the highly variable nature of inflation in the Solomon Islands means that CBSI will have to closely monitor price levels, and take action should upward movements prove undesirably high.

In the event of inflation rising to undesirable levels in the course of 2007, the Central Bank will consider a number of measures to restrict liquidity and credit expansion, including adjusting the Liquid Asset Requirement (LAR) and implementing credit controls.

4.2 Policy Goal 2: Maintain an adequate level of official foreign reserves

In 2007 CBSI will seek to maintain the official foreign reserves at a level that is equivalent to at least three months of expected imports of goods and services. As outlined in section three above, CBSI expects foreign reserves to expand in 2007 and it is unlikely that precautionary measures will be necessary to protect them. Nevertheless, CBSI will continue to closely monitor official foreign reserves and will take action if these fall below the target levels of import cover. Restricting liquidity and credit expansion through the LAR and credit controls are amongst available policy tools

4.3 Policy Goal 3: Improve interest rates on deposits and reduce the high levels of excess liquidity in the banking system

In 2007, CBSI will take direct measures targeted at addressing the structural problem of high levels of excess liquidity in the banking system that has persisted in recent years. This will consist of two main policies:

a. Establishing long-term deposit facilities for financial institutions
b. Permitting NPF to engage in some overseas investment

This policy goal represents a positive first-step towards the possibility of CBSI, in the medium-term, engaging in market operations to influence liquidity and interest rates. In the more immediate future, a positive upward effect on deposit interest rates is also expected.

The two policies will be implemented in small incremental steps to reduce the risks of undesirable shocks to the banking system, and will involve consultation with the commercial banks and NPF.

As excess liquidity in the financial system is reduced the Central Bank will pay careful attention to short term fluctuations in overall liquidity. These can arise when quarterly and annual taxes are paid and when large volume, high value, fuel imports arrive and are paid for. Commercial banks will have access to Central Bank short term deposit and advances “standing facilities” that will ensure banks are not faced with short term liquidity problems. Borrowing costs for short term advances will reflect commercial banks’ lending rates. The Central Bank expects that the inter-bank market will deal with shortfalls that are encountered by an individual bank as opposed to those shortfalls caused by system wide outflows.

4.4 Other monetary policies for 2007

Exchange rate policy in 2007 will continue with the conventional peg system, focusing on maintaining relative stability against the USD. As stated above, CBSI will keep the **Liquid Asset Requirement (LAR)** at 7.5% in 2007, unless adverse developments transpire in terms of inflation and/or official foreign reserves. In 2007 CBSI will consider extending the LAR obligation to Credit Corporation.

The rapid expansion in private sector credit over the last year, which is forecast to continue in 2007, will also be closely monitored by CBSI to ensure that the **quality of loans** does not deteriorate to the degree that the stability of the financial system is at risk. At present, non-performing loans represent an extremely small share of total loans, at less than 1%. Nevertheless, the fact that many of these loans are new loans calls for particular diligence on the part of CBSI to double-check the quality of loans. In particular, CBSI will monitor the housing market and house prices and rentals alongside the expansion of private sector personal lending, as housing is a major component of this category (62% of total personal lending).

The Central Bank applauds the initiatives in the past year to bring financial services to the rural areas and specially welcomes the Government’s “Bottom Up” support to the ANZ that will further extend mobile banking and bring more ATMs to the provinces. The Bank of the South Pacific’s (BSP) acquisition of the NBSI will bring much expertise to rural banking and the Central Bank has high expectations of the benefits that will undoubtedly accrue to rural dwellers from BSP’s presence.

In addition, to support the development of small businesses in the Solomon Islands, the Central Bank has revived the **Small Business Finance Scheme** which has fallen out of practice in recent years. This will be undertaken in partnership with the commercial banks and the Solomon Island Government, the latter providing a $10 million loan as backing for the scheme. The scheme has a distinct focus on lending that will enhance the economic growth in rural areas.

Central Bank of Solomon Islands
June, 2007