CENTRAL BANK OF SOLOMON ISLANDS

MONETARY POLICY STATEMENT
MARCH 2016

Central Bank of Solomon Islands
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1 Overview

The global economy registered lower growth in 2015. This was driven mainly by a weakened emerging and developing economy. The rebalancing in China away from investment to consumption continued to weigh down on global demand and suppressed commodity prices which in turn had dampening effects on commodity economies. Activities in the advanced economies on the other hand picked up slightly and were due in part to improved growths from the US economy, euro area and Japan. The growth in the euro area and Japan was supported mainly by easing monetary policies and lower oil prices, especially for countries that are net oil importers. In the US, the Federal Reserve started to tighten monetary policy in 2015 following years of accommodative policy.

Solomon Islands major trading partners slowed down in 2015 with China recording 6.9%, the lowest level of growth seen in several years. Despite a strong third quarter, the Australia economy posted a below trend growth of 2.5% in year to September 2015. New Zealand GDP also recorded a positive growth in 2015 in spite of weak commodity prices affecting its diary industry.

Global inflationary pressures rose in the second half of 2015 due to currency depreciations and supply side constraints. However, price developments in Solomon Islands major trading partners remained low and were largely influenced by weak commodity prices and low input costs, combined with spare capacities. Headline inflation in Australia moderated to 1.7%. In China, inflation rose marginally to 1.6% from 1.5% a year ago. In New Zealand, inflation remained low at 0.1%.

The domestic economy recovered in the second half of 2015 to post an overall growth of 2.9%. Forestry sector, boosted by unprecedented high output combined with the depreciation of the local currency against the US dollar, was the lead driver behind the positive outturn. The other major contributors were wholesale and retail trade, manufacturing, construction, and government spending. On the downside, agriculture, fisheries, and mining and quarrying recorded declines to contribute negatively to the overall growth in 2015.

The CBSI's production index, an anecdotal data measuring activities in the major commodities sector, bounced back by 10% against the first half year to a second half year average of 86. Higher than expected log output was the major driver behind the improvement in the production index supported by increased activities in fisheries, and copra and coconut oil. Palm oil, cocoa and mineral on the other hand contracted with the latter two commodities recording consecutive half yearly declines.

Investment activities picked up in the second half of 2015. Partial indicators from the Foreign Investment Division showed increases in the number of approved foreign direct investment applications particularly in retail and wholesale, and tourism sectors. Partial indicators from the balance of payments survey also showed foreign investors made investments from retained earnings during the year.

Labour market conditions improved modestly in 2015. Anecdotal evidence from CBSI's industry consultations indicated new job opportunities were created in tourism, manufacturing and construction sectors. However, the average number of people[1] that were contributing to the Solomon Islands National Provident Fund in the five months to November dropped by 1% to 55,171 people against the average contributors in the preceding six months. Despite the weaker second half, average contributors in 2015 increased by 4.5% against the preceding year.

The balance of payments of the country deteriorated in the second half of 2015 to a deficit position of $277 million, owing to the large negative outcome in the third quarter. The outturn reflected weak developments in the primary income, services income and financial accounts. Consequently foreign reserves declined to $4,190 million in December after a strong surge in the first half year to $4,390 million in June. Merchandise trade balance on the other hand recovered in the second half, driven by export receipts which improved by 16% to , million on the back of robust log export volumes to outpace import payments which grew by 6% to $1,732 million.

The trade weighted index, which reflects the movement of the currency basket, depreciated by 3.6% to 109.4 in the six months to December following the 5.5% depreciation in the first half of 2015. The consecutive half yearly depreciations were the result of the strengthening of the US dollar against all major currencies. The weak SBD leads to an improvement in the competitiveness of local exports. Bilateral exchange rate movements throughout the year showed SBD weakening against the USD but appreciated against most other currencies including AUD and NZD.

[1] Active and slow active contributors

Broad money recorded a higher growth of 9.0% in the second half to $4,180 million. This is a growth of 15% year-on-year. The growth was attributed to reserve money which grew by 8% against June to $2,257 million in December. The increase represents movements in currency in circulation and bank deposits which increased by 16.2% and 3.7% to $740 million and $1,511 million respectively.

Credit growth consolidated in the second half of 2015, up by 10% to $1,988 million with most of the lending injected into consumption, manufacturing, communication, transportation, construction and tourism sectors. Comparing to December 2014, credit to private sector rose by 17%.

Weighted average lending rates declined from 10.6% in June to 10.1% in December. This reflected subdued rates in agriculture, non-residents, personal loans and transport sectors. Meanwhile, weighted average deposit rates remained low just above zero percent.

The current Government registered a fiscal deficit of $503 million in the second half of 2015 compared to $297 million surplus in year to June. The turnaround reflected the slow budget implementation phase in the four months up to April. Revenue collection increased by 9% against the first half year to $1,681 million. Expenditure on the other hand rose sharply by 75% against year to June outcome to $2,183 million.

Inflation rate swung sharply from a negative 4.8% in June 2015 to 2.9% in December 2015. This reflects sustained inflationary pressures seen across the entire consumption basket in the second half. However more pronounced increases came from food, housing and utilities, and transport and communication categories. Domestic inflation climbed up from a low of negative 6.8% in June to 3.5% in December. To a lesser extent, imported inflation rose from minus 1.1% over the six months to 2.0% in December 2015. While the stronger USD may exert pressures on imported prices, this was somewhat cushioned by the marked decline in oil prices and appreciation of the SBD against the AUD and NZD. Core inflation, which excludes volatile and regulated prices, also paced up to 3.7% from 1.3% in June.

On the economic outlook, the global economy is expected to pick up in 2016 and 2017. While commodity prices are anticipated to remain low, there could be a bottoming out in the prices of some commodities. However, near term downside risks could stem from developments in China, low commodity prices and ongoing geopolitical tensions.

Medium term projection for the domestic economy is also on the upside. The local economy projects growth to remain the same in 2016 but stronger in 2017 at 3.2%. All other sectors are expected to grow positively except for agriculture, forestry and mineral sectors that are assumed to provide neutral contributions in 2016 due to weak commodity prices and lower output volumes.

2 International Developments

2.1 Global Economic Growth

The global economy is estimated to have grown by 3.1%[2] in 2015 compared to 3.4% growth in 2014. This followed a further downward revision by 0.2 percentage points over the second half of the year reflecting a further slowdown in the performance of emerging market economies while growth in advanced economies remained modest. Low commodity prices also kept growth subdued for many commodity based economies.

Growth in advanced economies is estimated to have picked up slightly to 1.9% in 2015 compared to 1.8% in 2014, a downward revision of 0.2 percentage points from the July forecast. The pickup in growth was primarily driven by growth in the euro area and Japan which was each estimated to have gained 0.6 percentage points compared to the preceding year. The euro area benefited from strong private consumption over the year owing to low oil prices, a weak euro and loose monetary policy. Similarly, Japan's growth through the year was attributed to low oil prices and a strengthening in consumer confidence. Meanwhile, the United States saw an uptick of 0.1 percentage points to estimated growth of 2.5% in 2015. Nonetheless, other advanced economies, such as the UK and Canada, did not perform as strongly as initially expected and this lead to downward revision from projections in July.

Growth in emerging market and developing economies is estimated to have reduced to 4.0% in 2015 compared to 4.6% in 2014 and a downward revision of 0.2 percentage points since July. By and large, the fall in growth year on year stemmed from a

[2] All statistics in this section obtained from IMF World Economic Outlook, January 2016 Update unless otherwise stated.

0.4 percentage point contraction in growth in China. However, the downward revision in growth estimates between the first and second half of the year was due to precipitous falls in growth estimates for Russia and Brazil whose economies contracted by negative 3.7% and negative 3.8% respectively. The growth of 6.9% recorded for China in 2015, while in line with government targets, was the slowest rate seen since 1990. As the world's second largest economy, this slowdown had far reaching effects on global growth. Meanwhile, economic growth in India remained strong at 7.3%, a positive prospect for Solomon Islands as a new market for Solomon Islands logs.

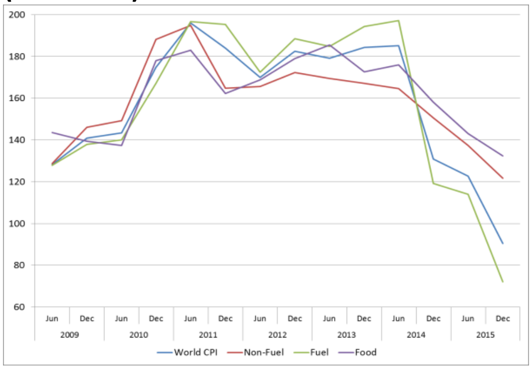
Closer to home, the Australian economy managed to post growth of 2.5%[3], down from 2.8% in 2014, despite the steep falls in commodity prices, and the slowdown in China, its main trading partner. However, economic activity was cushioned by a weakened Australian dollar and low production costs, which made Australian exports competitive in global markets. Similarly, the performance of the New Zealand economy remained relatively strong, despite low commodity prices putting a strain on the dairy industry. This growth was primarily driven by the service industry and manufacturing. As for the Pacific Island countries and small states, growth was estimated at 3.6% in 2015, a slight improvement from 3.5% in 2014.

2.2 International Commodity Prices

Global commodity prices, as indicated by the World Commodity Price Index (CPI), continued on their downward trajectory, reaching lows that have not been seen since 2005. The index saw a significant fall of 26% from June 2015 to reach 90 points on the index in December. This is in comparison to a more moderate 6% fall recorded between December 2014 and June 2015, and represents a 31% fall year on year. Driving this fall over the second half of 2015 were falls across all price indices with the fuel index falling by 37% to 72 while the non-fuel price index fell 12% to 122 in December. Contributing heavily towards the fall in the fuel index was a 41% plunge in the crude oil price index from 115 to a low of 69 by December, the lowest point recorded on the index since June 2004. This completely reversed the slight gains made in the first half of the year when the index picked up by 1%. Moreover, recent data shows that prices have continued to fall going into 2016. The Tapis crude oil price, the most relevant fuel price for Solomon Islands, fell 20% between June and December 2015 to reach a monthly average price of US$39 per barrel, a low not seen since June 2004.

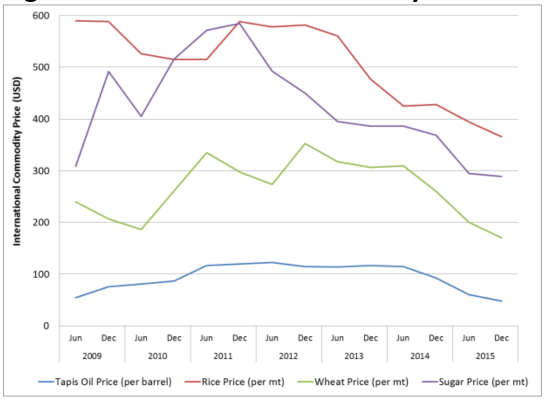
International food prices, as indicated by the IMF food price index, fell by 8% between June and December 2015 to reach 132, the lowest level since December 2008. This fall was driven by declines in price indices across the board. More importantly for the Solomon Islands, there was a general fall in the average prices of rice, wheat and sugar between the first and second half of 2015 by 7%, 15% and 2% respectively. Over the second half of 2015 rice fell to an average price of US$366 per ton, wheat fell to US$171 per ton while sugar reached US$289 per ton.

Figure 1: Commodity and Food Price Indices (2005=100)



Source: IMF Commodity Price Indices, retrieved Mar 2016

Figure 2: International Commodity Prices



Source: IMF Commodity Prices and Bloomberg Database, Mar 2016

2.3 Global Inflation

Global inflation rates picked up slightly over the second half of 2015. Some of the inflationary pressure stemmed from currency depreciations, especially in countries such as Brazil, Russia and Venezuela that faced economic stress due to low commodity prices. Additionally, however, spill overs from higher food prices due to the El Nino weather cycle also exerted some upward pressure on prices in some regions. Moreover, the base effect of low oil prices on inflation began to wear off as the year drew to a close.

[3] Reserve Bank of Australia, retrieved from http://www.rba.gov.au/snapshots/economy-snapshot/ [Feb 2016]

Headline inflation in advanced economies remained subdued in the second half of the year, mostly reflecting the continued declines in the price of oil. Consequently, this meant that core inflation remained below most central banks' inflation objectives. Meanwhile, in emerging market economies, lower commodity prices contributed to cushioning headline inflation from rising. However, sizable currency depreciations led to offsets on the upside in some economies such as Russia.

For Solomon Islands' major trading partners, inflation remained subdued. Inflation for China was recorded at 1.6% in December 2015, a slight increase from 1.5% at the end of 2014. Turning to Solomon Islands neighbours, inflation in Australia moderated to 1.7%[4] while inflation in New Zealand fell to 0.1%[5]. Likewise, the preliminary average inflation rate for the Pacific Islands also fell to 0.3% compared to the 2.4% registered in the December quarter of 2014.

3 Domestic Economic Developments

3.1 Monetary Conditions

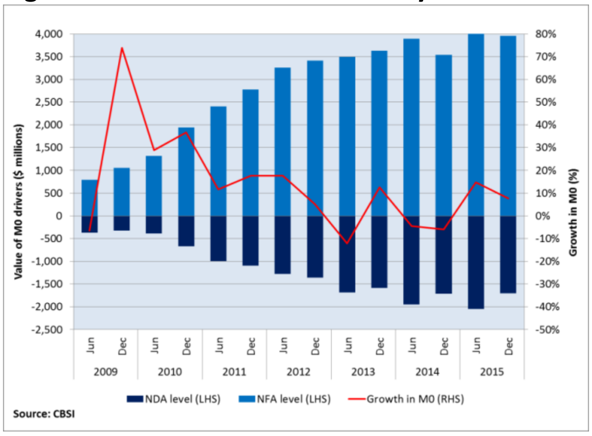
3.1.1 Reserve Money

In the second half of 2015, reserve money (M0) continued on the upward trajectory started in the first half of the year, picking up by a further 8% to $2,257 million. These increases reversed the losses observed in 2014 to reach levels even higher than had been recorded two years prior. Driving this increase in reserve money was an improvement in net domestic assets (NDA) over the half year by 17% to liabilities of $1,698 million from liabilities of $2,050 million, which outweighed the 5% reduction in net foreign assets (NFA) to $3,960 million.

The fall in CBSI NFA was primarily the result of a fall in gross foreign reserves by 4.5% to $4,190 million over the review period. This was due to a fall in transactional inflows, particularly from donors, and an increase in import and foreign loan repayments. Meanwhile, the improvement in NDA stemmed from an improvement in domestic credit, in particular, a considerable fall in liabilities to central government. Net credit to government fell 32% from $1,641 million in June down to $1,115 million by December while net credit to other depository corporations (ODCs) increased by $90 million to liabilities of $712 million over the six months to December.

Components of reserve money saw increases across the board in the second half of 2015. Currency in circulation saw a considerable jump of 16% to $740 million by December compared to the 3% fall recorded in the first half of the year. Meanwhile, CBSI liabilities to ODCs saw a more modest increase of 4% to $1,511 million compared to the 25% jump recorded in June. These liabilities to ODCs were made up of $264 million in cash reserve requirements (CRR) and $1,247 million in other deposits held by commercial banks in the call accounts with CBSI.

Figure 3: Drivers of Reserve Money



Source: CBSI

3.1.2 Money Supply

Broad money (M3) followed a similar trend to that of reserve money in the second half of 2015. Total money supply in the economy increased a further 9% to $4,180 million in December, an increase of 15% year on year. The main driver of this expansion in broad money was a significant increase in NDA from net liabilities of $474 million in June to net assets of $59 million by the end of the year. This movement far outweighed the 4% fall in NFA to $4,129 million. The improvement in NDA was driven by a rise in credit to private sector by 10% coupled with an improvement in net credit to central government by 26% to $1,352 million. Meanwhile, movements in the key components of broad money showed increases for all components. Currency in circulation saw an increase of 19% to $655 million, while demand deposits rose by 9% to $2,617 million and time and savings deposits by 3% to $908 million.

[4] Reserve Bank of Australia, retrieved from www.rba.gov.au/inflation/measures-cpi.html [Feb 2016]
[5] Reserve Bank of New Zealand, retrieved from www.rbnz.govt.nz/monetary-policy/inflation [Feb 2016]

Figure 4: Drivers of Broad Money

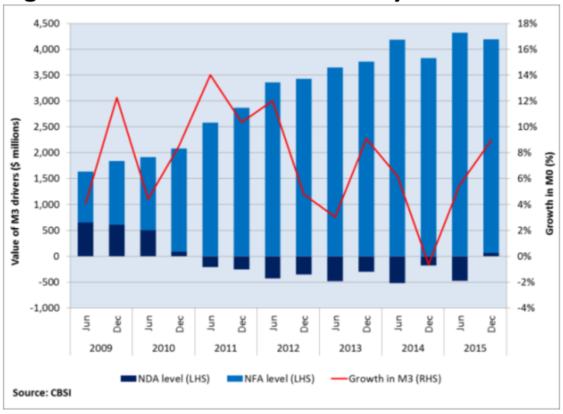
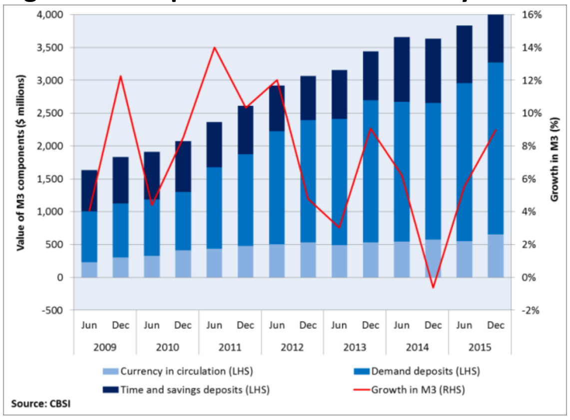


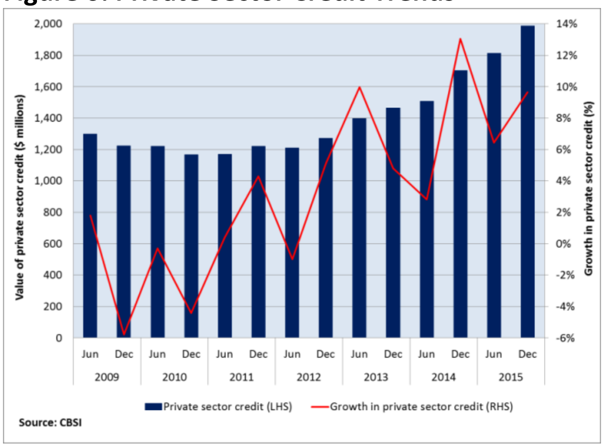
Figure 5: Components of Broad Money



3.1.3 Credit conditions

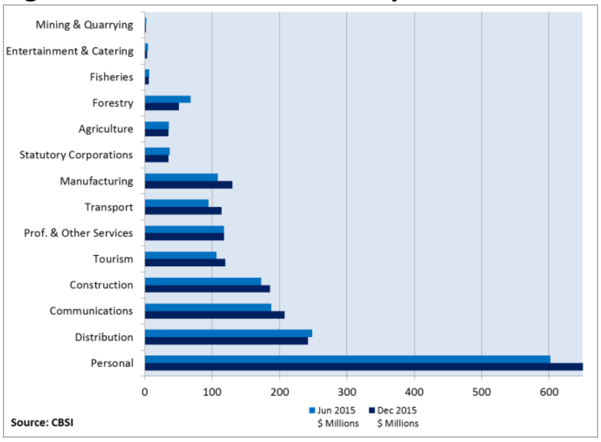
Credit to private sector recorded strong growth over the second half of 2015 of 10% to $1,988 million by December. This represented growth of 17% year on year. Driving this growth was an increase in credit to other non-financial corporations by $107 million to $1,308 million, aided by an increase in credit to individual residents by $68 million to $672 million. Loans accounted for the majority of total lending with 90.4%, followed by overdrafts with 8.9% and lease financing at 0.7%.

Figure 6: Private Sector Credit Trends



Over the second half of 2015, personal loans increased by $107 million to reach $709 million. Other sectors that recorded significant gains were manufacturing which gained $22 million to reach $130 million, communications gained $20 million to $208 million, transport was up $19 million to $114 million, while construction and tourism each increased by $13 million to $189 million and $120 million respectively. Loans to professional and other services remained flat while loans to the distribution sector fell by $6 million to $243 million. The remaining sectors saw losses of between $1 million to $2 million.

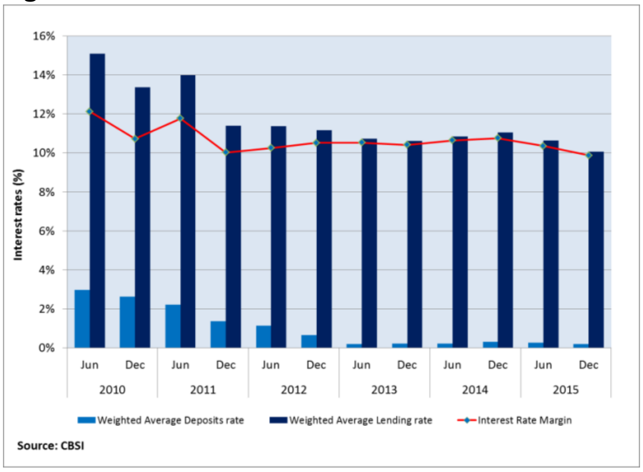
Figure 7: Private Sector Credit by Sectors



3.1.4 Interest Rates

Weighted average deposit rates fell by 8 basis points between June and December to reach 0.19%. Following the same trend, average lending rates fell by 56 basis points to 10.07% which led to interest rate margins for the banking sector to fall to 9.88% in December compared to 10.36% in June. Sectors that exhibited the greatest falls in weighted average lending rates were agriculture which fell from 13.84% in June to 10.48% in December, loans to non-residents, which fell from 17.42% to 15.21%, personal loans from 12.73% to 10.91%, and transportation which fell from 11.09% to 9.94%. Lending rates to fisheries, on the other hand, increased from 9.38% to 11.06% while other sectors recorded smaller movements. The lowest weighted average lending rate was for the communications sector at 6.33%.

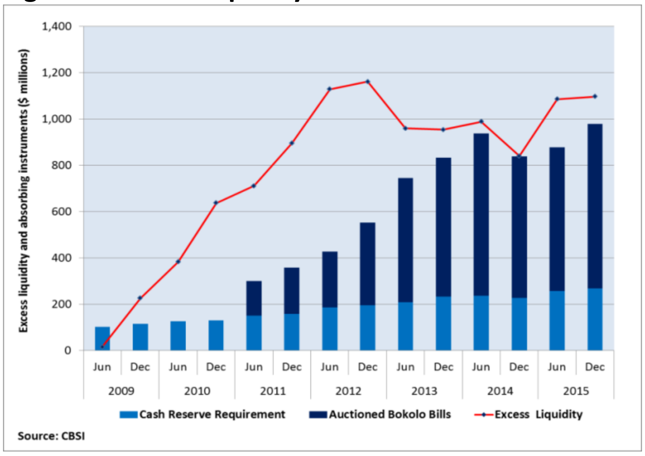
Figure 8: Interest Rate Trends



3.1.5 Liquidity

Total liquidity in the banking system continued on its upward trend, increasing by 3% over the second half of 2015 to reach $1,504 million in December. Similarly, excess liquidity increased by 1% to $1,097 million, a 31% increase year on year. These movements were primarily driven by a drawdown on central government deposits at CBSI to meet fiscal payment obligations in the second half of the year. The net position of central government fell from net liabilities of $1,565 million in June to net liabilities of $1,072 million in December.

Figure 9: Excess Liquidity



3.1.6 Bokolo Bills and Treasury Bills

The stock of Bokolo bills floated was maintained at $710 million throughout the second half of 2015. By the end of the year, the stock of Bokolo bills issued to ODCs had reached full subscription at $710 million with some oversubscription observed towards the end of the year. This meant $710 million of free liquidity was absorbed from the system by the end of the year. Nonetheless, the weighted average interest rate remained at 0.62% over the six months to December. Meanwhile, the cap on SIG backed treasury bills remained unchanged at $40 million. Weighted interest rates for the Treasury bills varied for the different maturities but remained unchanged from June with the 56 days earning 0.34%, 91 days earning 0.46% and the 182 days earning 1.15%.

3.2 External Conditions

The Solomon Islands external position in the second half of 2015 weakened as opposed to the strong performance observed in the first half of the year. The downturn was driven mainly by the deterioration in the capital and financial account which outweighed the improvement in the current account. The deterioration in the capital and financial account stemmed mainly from a large deficit in the financial account that outweighed the surplus in the capital account during the six months to December. In contrast, the improvement in the current account was mainly triggered by a surge in trade surplus.

Despite the weak performance in the second half year, the overall balance of payment position (BOP) in 2015 registered a surplus of $395 million from $9 million surplus in 2014. The favourable outturn was primarily driven by a widening surplus in the secondary income and capital and financial accounts. This was mainly associated with increases in receipts from donor inflows, export receipts and foreign investments during the year.

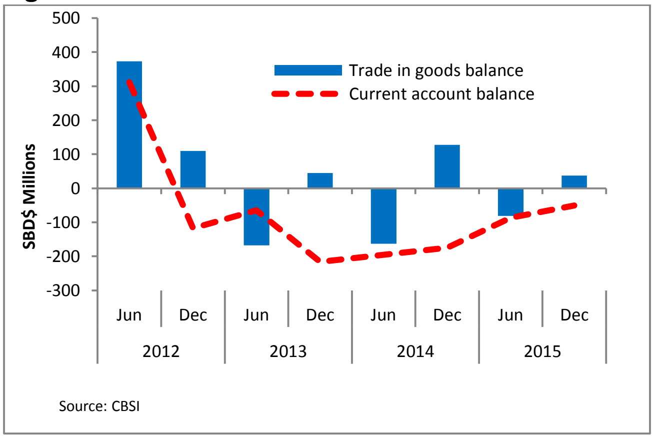
3.2.1 Current Accounts

The current account, narrowed to a deficit of $50 million in the second half of 2015 from $86 million deficit in the first half year. The improvement was chiefly promoted by gains in the trade in goods balance with a large reduction in the primary account deficit. This outweighed the deterioration in the trade in services and secondary income accounts over the period.

The trade in goods account recorded a surplus of $37 million in the second half of 2015 reversing the $81 million deficit recorded in the first half year. The favourable trade position was predominantly driven by an increase in export receipts by 14% to $1,769 million relative to a lesser growth of 5% in imports to $1,732 million. Higher export earnings in logs, fish, and copra largely explained the positive outturn during the period. On imports, the slight rise was due to an increase in food imports, crude materials, machinery and equipment and miscellaneous goods. Meanwhile, fuel import payments showed a decline reflecting the lower prices over the six months to December.

On the primary income account, the reduction in the deficit to $60 million from $86 million in the first half year was triggered by increasing inflows from fishing licenses, equity and investment fund shares and interests from reserve assets. On the other hand, the service account worsened to a deficit of $315 million associated mainly with high outflows in business and government services during the period. The secondary income, although it remained positive, saw a decrease in the surplus by 21% to $288 million due to a decline in both transfer inflows to the general government and the private sector during the latter six months of 2015.

Figure 10: Trade and Current Account Balances



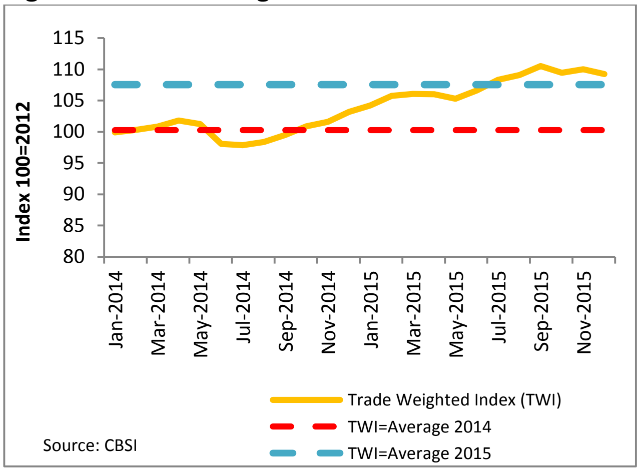
3.2.2 Capital and Financial Account

The capital and financial accounts posted a deficit of $106 million in the second half year from a surplus of $689 million in the first six months of 2015. The negative outcome stemmed largely from deterioration in both the capital and financial accounts during the period. The capital account registered a smaller surplus of $134 million from a $300 million surplus in the first half year, reflecting the significant drop in capital transfer to the general government during the period. Similarly, the financial account worsened to a deficit of $240 million from a $389 million surplus in the first half year. The deterioration was largely related to a large outflow in foreign direct investment, equity, and reinvested earnings including external loan repayments by private companies.

3.2.3 Exchange Rate

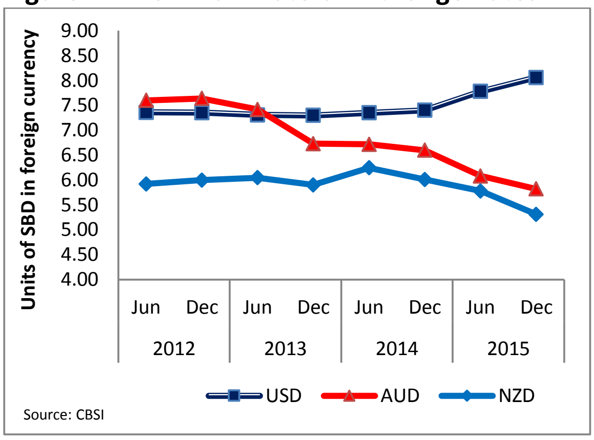
Solomon Islands maintained the exchange rate policy of pegging the SBD against a basket of invoicing currencies throughout 2015. In the six months to December, the trade weighted index[6] (TWI) increased by 4% to 109.4 on average compared to the TWI of 106 in the first half of 2015. Similarly, year on year averages showed that the TWI rose by 7% to 107 in 2015 from trade index of 100 in 2014 (see Figure 11).

Figure 11: Trade Weighted Index



The movement in the TWI was largely influenced by the strengthening of the SBD against the Australia dollar (AUD) by 4% to $5.82 per AUD in the second half year. The SBD also strengthened against the New Zealand dollar (NZD) by 8% to $5.31 per NZD. This in turn benefited importers trading in these currencies during the period.

Figure 12: Nominal Bilateral Exchange Rates



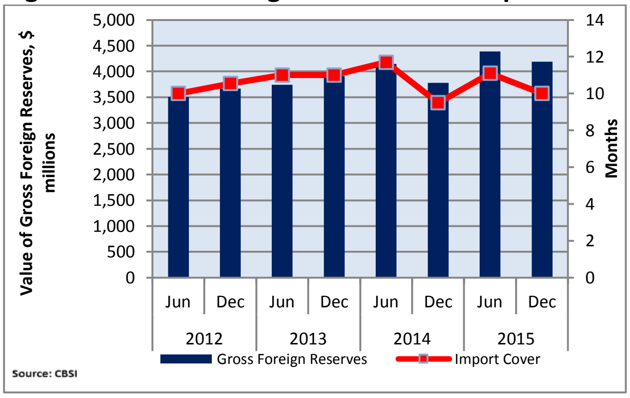
The Solomon Islands real effective exchange rate appreciated slightly on average by 2.1% to an index of 148.4 over the second half of 2015. The appreciation suggested that Solomon Islands exports were becoming less competitive internationally in the second half of 2015.

[6] Measures the movement of the SBD against the basket of currencies

3.2.4 Reserves

Gross foreign reserves dropped by 4.5% to $4190 million at the end of December 2015 following strong growth of 16% in the six months to June 2015. The deceleration was mainly triggered by a $292 million fall in transaction inflows, largely from donor inflows as reflected in the secondary income and capital account. Increases in import payments and repayment of foreign loans also contributed to the reduction in gross foreign reserves during the period. The level of gross foreign reserves was sufficient to cover 10 months of imports of goods and services, lower than the 11.1 months import cover at the end of June 2015. Year-on- year, however, gross foreign reserves were 5% higher than in 2014.

Figure 13: Gross Foreign Reserves and Import Cover



3.3 Domestic Conditions

Key indicators on domestic economic activities showed improvement in the second half of 2015. Production and manufacturing activities performed strongly in the six months to December compared to the weak performance in the first half year. Similarly, other key indicators including, transport and communication, foreign direct investment, wholesale and retail activities and energy demands also strengthened over the period. Meanwhile, employment, tourism and construction activities contracted during the second half year period.

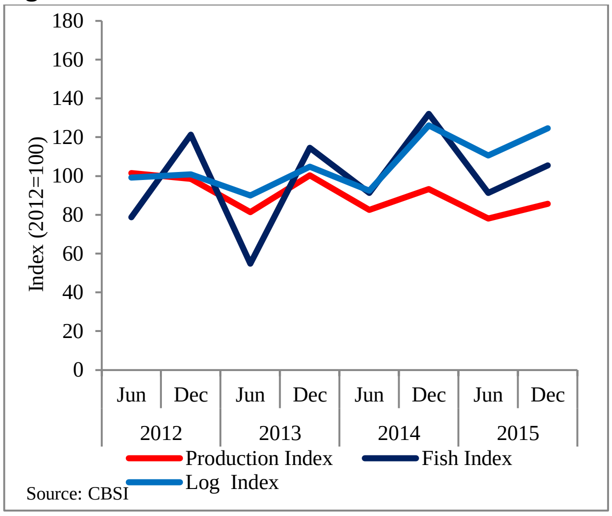
3.3.1 Economic Growth

In 2015, the domestic economy is estimated to have expanded by 2.9%, higher than the 2.0% growth recorded in 2014. Underpinning the 2015 growth outcome was the robust activities in the forestry, manufacturing, transport, communication, and construction sectors. In contrast, the agriculture and the mining sectors saw contractions that hampered growth during the year.

3.3.2 Production

Domestic economic activities picked up in the second half of 2015. This was reflected in the CBSI production index which rose over the first half year by 10% to 86 index points in the latter half. Driving this positive outturn were higher outputs in logs, fish catch and copra which more than offset the decline in palm oil and cocoa. Log production increased by 13% to 1,215 million cubic meters over July to December 2015 owing to an exceptionally strong harvest in the December quarter. Over the same period, fish catch rose 16% to 15,505 tons driven by favourable output in the third quarter whilst copra increased marginally by 0.5% to 8,725 tons. Conversely, palm oil productions, after a strong performance in the first half year, dropped 11% to 15,334 tons in the second half year. Driving the fall in the palm oil productions was the significant decline in contracted palm oil export prices during the period. Similarly, cocoa despite the increase in the contracted cocoa export price fell considerably by 39% to 1721 tons in the second six months of 2015.

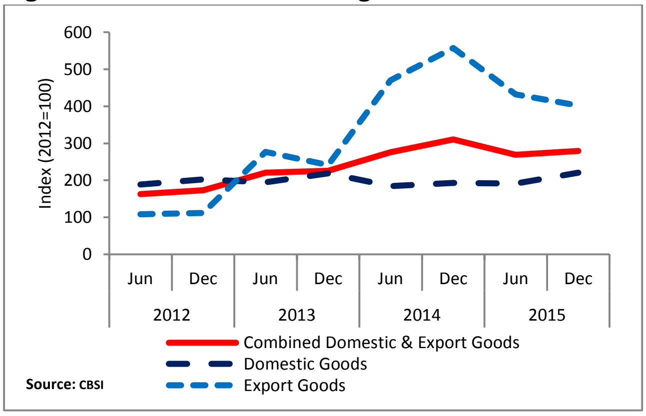
Figure 14: CBSI Production Index



3.3.3 Manufacturing

Domestic demand conditions, as measured by the CBSI manufacturing index, showed an improvement of 4% to 279 points in the second half of 2015. Growth was driven mainly by manufactured goods destined for domestic markets that rose by 15% to 221 points. The rise in manufactured goods for domestic markets came from an increase in manufactured canned fish, alcohol and tobacco during the period. The increase in alcohol and tobacco was ascribed to the establishment of the new brewery and tobacco factories in the second half of 2015. In contrast, the manufactured goods for export markets contracted by 7% to 402 points driven by the decline in loin fish and manufactured biscuits during the period.

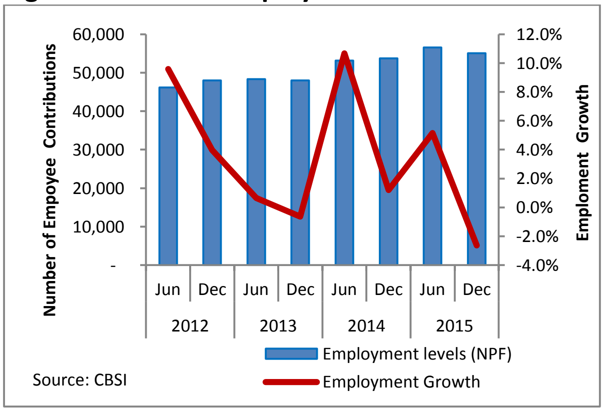
Figure 15: CBSI Manufacturing Index



3.3.4 Employment

Employment indicators showed labour market conditions slowed in the six months to December 2015. The number of employee contributors to the Solomon Islands National Provident Fund (SINPF) showed a 3% fall to 55,073 in the second half year as opposed to the higher number of contributors of 56,556 in the first six months. The outcome mainly came from slow active contributors falling 17% to 8,165 whilst active contributors increase by 2% over the second six months. However, year-on-year showed SINPF contributors increased moderately by 4% to 55,438 in 2015.

Figure 16: Formal Employment in Solomon Islands



Source: SINPF & CBSI

Similarly, employment indicators from the CBSI job advertisement survey also showed a fall by 9% to 740 vacancies in the second half of 2015. In terms of vacancies by industry, employment vacancies in the administration and support services accounted for the highest with 31%. This was followed by public administration and defence consisting of 20% and education sector with 12%. The remaining sectors accounted for 37% during the second half of 2015.

3.3.5 Foreign direct investment

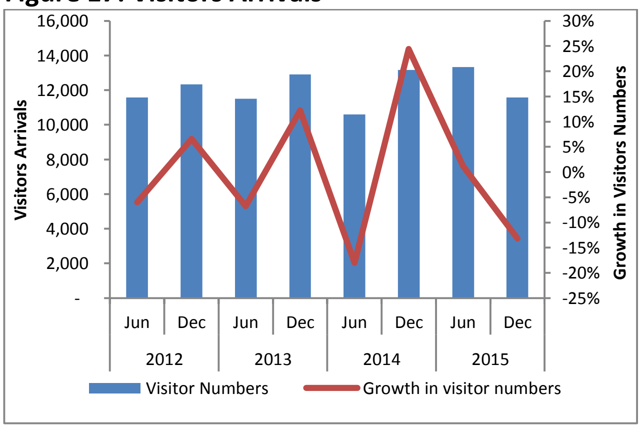
Investment conditions remained buoyant in the latter six months of 2015 with approved foreign direct investment (FDI) applications by the Foreign Investment Division rising by 10% to 113. FDI applications also increased by 14% (year-on-year), following positive growths in both the first and second half of the year. The favourable outcome in the latter six months was mainly due to an increase in applications by retail and wholesale by 31% to 46 applications, tourism by 83% to 11 applications and other services which went up by 59% to 35 applications. In terms of share, retail and wholesale service, tourism, and other services accounted for the majority of applications with 92 applications. The remaining 21 applications were for fisheries, minerals, forestry, construction, transport, and energy sectors.

3.3.6 Tourism

Tourism activities, measured by the number of visitors arriving in the country, slowed further in the second half of 2015 to 11,583. The outcome was mainly due to zero visitors arriving by sea in the second half of the year as opposed to the 3,376 visitors arriving by sea in the first half. This more than outweighed the 16% increase from visitors arriving by air during the review period. Despite the slow growth in the second half year, year-on-year comparison saw total visitors arriving rise by 5% to 24, 920 on account of strong marketing promotion by the Solomon Islands Visitor Bureau, the Government and Solomon Airlines during the year.

Australia continues to be the main visitor market, accounting for 45% of total visitors in the second half of the year followed by other Asian countries, New Zealand, United States, Fiji, and Papua New Guinea. Meanwhile, the average length of visitors' stay days in the second half year remained unchanged at 13 days as in the first six months of 2015.

Figure 17: Visitors Arrivals

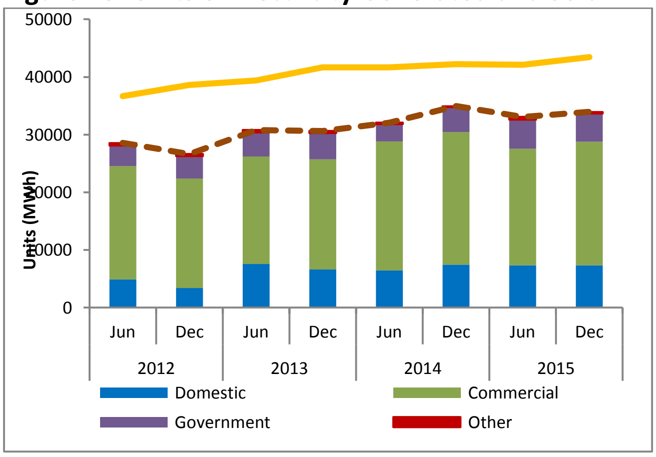


Source: SINSO & CBSI

3.3.7 Energy

Energy demand grew slightly in the second half of 2015 as opposed to the marginal fall of 0.4% in the first half of the year. Total energy, as reflected by electricity generated increased by 3% to 43,470 Megawatt hours (MWh) during the period. Consequently, units of electricity sold rose by 3% to 33,947 MWh. This was driven by increases in sales to commercial industries rising by 6% to 21,394 MWh and domestic consumers increasing by 0.3% to 7,346 MWh during the latter six months. Conversely, units sold to government and other categories dropped by 2% and 42%, respectively. Year-on-year also saw electricity generated rising to 85,563 MWh in 2015, an increase of 2% over 2014.

Figure 18: Units of Electricity Generated and Sold



Source: SIEA

3.3.8 Retail and wholesale

Domestic consumption, as reflected by retail and wholesale activities, improved in the last six months to December 2015. A partial indicator, import payments for food and beverages, showed a 13% increase to $444 million and accounted for 54% of the total imports during the second half year. Another partial indicator, foreign direct investment applications to the retail and wholesale sector followed a similar trend with a considerable increase of 31% to 46 applications in the last six months of 2015. Conversely, credit issued by commercial banks to the distribution sector slipped 2% to $243 million. The decline mainly came from loans issued specifically for the retail and wholesale category which fell slightly by 1.7% to $219 million.

3.3.9 Transport

Activities in the transport sector as indicated by various indicators improved in the second six months of 2015. Loans issued by commercial banks to transport sector rose 20% to $xxx million in December. Similarly other partial indicators, including FDI inflows to transport services recorded in the BOP, increased substantially to $122 million from $86 million in the first half year.

3.3.10 Communication

Activities in the communication sector were buoyant in the second half year. This reflected increases in the two telecommunication operators' internet and mobile usages by 10% and 24% respectively in the second half of 2015. Loans issued by the banking sector to the communication sector also increased by 11% against June to $208 million in December.

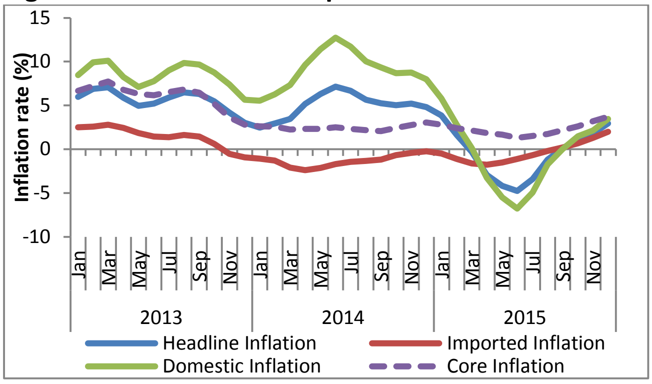
3.3.11 Construction

Construction activities, slowed further in the six months to December. Building permits in Honiara, a partial indicator for construction activities, maintained the downward trajectory during the second half year. The Honiara City Council issued 98 permits in July to December 2015, 11% lower than the 110 permits issued in the preceding six months. The reduction came largely from decreases in all the building permit categories issued during the second half year. Permits to residential applicants fell by 4% to 53, industrial permits down by 20% to 20 and other permits dropped by 17% to 25. The decline in permits issued came primarily in the third quarter of 2015 and more than offset the increase in the fourth quarter. However the estimated value of all the permits increased and was driven by the surge in the value of commercial and industrial activity to $248 million from $59 million in the first half year. Similarly, commercial bank loans to the construction sector increased further by 7% to $244 million in the second half year.

3.4 Inflation

Headline inflation, after reaching its lowest point in June at minus 4.8% trended upward to reach 2.9% at the end of December 2015. The acceleration in headline inflation in July to December can be ascribed to a pickup in both imported and domestic inflation. Domestic inflation, which reflects domestic price movements rose considerably to 3.5% in December from minus 6.8% in June. Similarly, imported inflation, which represents imported price movements, rose to 2.0% in December from minus 1.1% in June 2015. The core inflation also showed a measured increase to 3.7% in December from 1.3% in June. This expansion is primarily due to a considerable rise in food from 1.1% in June to 4.5% in December 2015.

Figure 19: Inflation Developments



Source: SINSO & CBSI

In terms of the drivers of the upward trend in the Honiara Retail Price Index (HRPI), the rise to 2.9% in December was explained mainly by increases in drinks and tobacco rising from minus 11.8% in June to 26% in December and food from minus 9.1% to 1.3%. By component, of the overall 2.9% inflation, food accounted for the largest proportion at 1.2%, followed by housing and utilities with 0.7%, and transport and communication contributing 0.4%. Other headline inflation components contributed the remaining 0.6%.

The domestic inflation component remained the dominant driver of the overall headline inflation in December. Similar to headline inflation, much of the acceleration in the domestic inflation component can be attributed to faster growth in drinks and tobacco, food, housing and utilities, transport and communication and recreation, health and other services. By component, of the 3.5% in domestic inflation, food account for the bulk with 1.3%, followed by housing and utilities at 1.1%, transport and communication representing 0.5%, and drinks and tobacco contributing 0.3%. The remaining 0.5% was attributed to lesser increase in clothing and footwear, household operation and recreational health and other services.

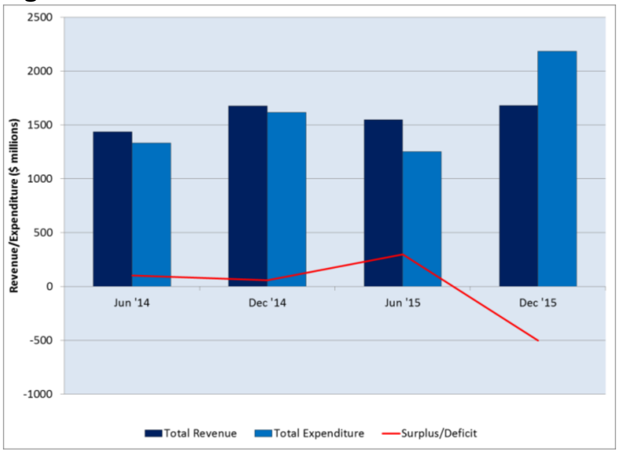
Meanwhile, the acceleration in imported inflation to 2.0% in December was mainly driven by a surge in food from 1.6% in June to 6.6% in December. This was followed by increase in miscellaneous items from 1.5% to 3.4% and recreational health and other services increasing to 11% from 10.8% in June. Other imported items account for the remaining acceleration in the imported inflation. Of the 2.0% in imported inflation, food represented largest proportion with 1.0% in the last six months, followed by housing and utilities at 0.26%, and transport and communication at 0.24%. The rest of the imported inflation components made up the remaining 0.5%.

Compared to 2014, headline inflation of 2.9% in 2015 is lower than 4.8% in 2014. This was driven mainly by the domestic component which reduced substantially from 8% in the prior year to 3.5%. The deceleration in the domestic inflation mainly reflected the declines in food, housing and utilities, and household operations categories during the year. Conversely, imported inflation increased to 2% in 2015 from minus 0.2% at the end of 2014. This was driven by notable increases in food, recreational, health and other services and miscellaneous items during the year.

3.5 Fiscal Conditions

The 2015 fiscal year got off to a slow start due to the late passage of the national budget in April 2015. However, fiscal operations gained momentum in the second half of the year with preliminary figures showing a deficit of $503 million compared to the surplus of $297 million recorded over the first half of 2015. This outturn in the second half of the year followed mounting pressure on the government to expend the development budget which resulted in expenditure rising faster than revenue collections.

Figure 20: Fiscal Performances in 2014-2015

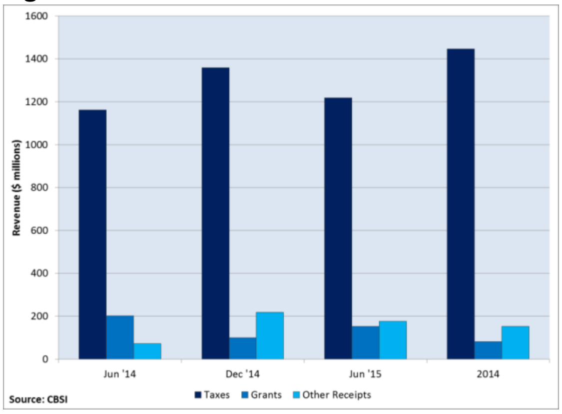


Source: MoFT

3.5.1 Revenue

Revenue collection over the second half of 2015 totalled $1,681 million, a 9% increase against the first half of the year but still 5% below budget. This surge in revenue was driven by an increase in tax receipts by 4% to $1,447 million while grant receipts and non-tax revenue saw declines. Nonetheless, revenue collections remained flat when compared to the same six month period in 2014.

Figure 21: Fiscal Revenue Collection



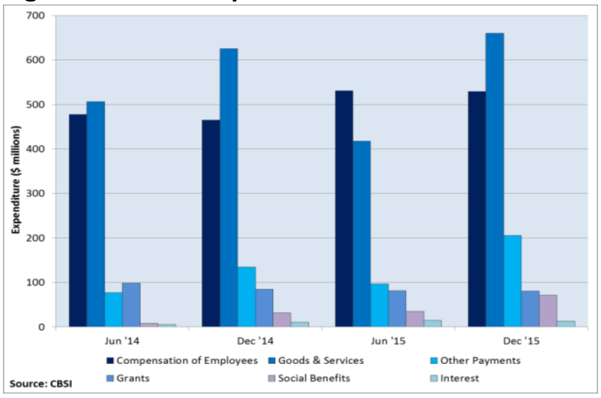
Between the first and second half of the 2015, tax collections increased by 19% to $1,447 million, 10% above budget and 7% higher than the same period in 2014. Tax collections accounted for 86% of revenue in the second half of the year, higher than the 79% of the first half. Driving the positive upturn was an increase in collections from all tax categories with the exception of a marginal fall in tax on property. The greatest increase coming from a 30% rise in tax on income, profits and capital gains to $545 million, as well as an 16% increase in tax on international trade and transactions to $586 million. These tax movements also underscored a shift towards greater reliance on tax collections for revenue in the face of the slowdown in donor funding.

Grant receipts were down by close to half between the first and second half of 2015. Donor funding reduced from $152 million in the six months to June to $81 million in the six months to December. While this represented a 74% shortfall on the budget, however, the decrease from the same period a year prior was a much smaller 18%. The decrease compared to the first half of 2015 represented a drop in contributions from both foreign governments and international organisations with recurrent grants accounting for the bulk of the funding. Grants from international organisations fell to just $2 million in the second half of the year compared to $42 million in the first half, most of which came in the first quarter. Meanwhile, other non-tax revenue fell from $176 million to $153 million between the first and second half of the year, primarily driven by falls in property income, but still 6% above budget.

3.5.2 Expenditure

Expenditure over the second half of 2015 came to $2,183 million, representing a 75% increase in spending over the first half of 2015. The amount expended was essentially equal to the budgeted amount for the period with the underspending on recurrent expenses offset by additional spending on fixed assets. Recurrent spending in the latter six months of 2015 amounted to $1,580 million, a 34% increase on recurrent spending in the first half of the year and 6% under budget.

Figure 22: Fiscal Expenditure

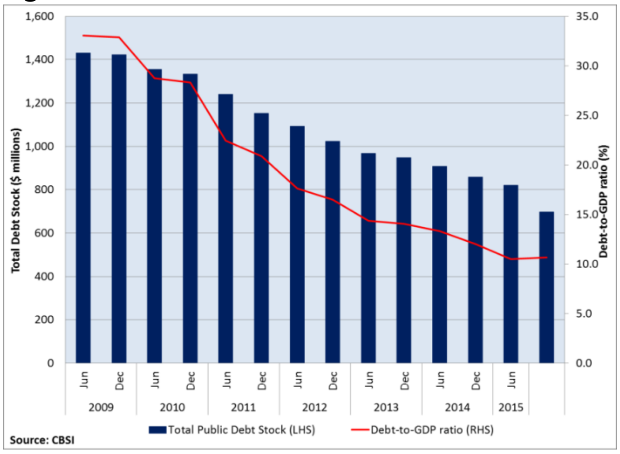


Spending on compensation of employees, which accounted for a third of total expenditure, remained relatively flat between the first and second half of 2015 at $530 million, albeit 4% under budget. Meanwhile, purchases of goods and services increased by 58% over the first half year to $660 million, although still 15% under budget. However, the share of total expenditure decreased by 3 percentage points to 30%. Other areas of recurrent expenditure that saw increases in the second half of 2015 were social benefit payments and other payments which both more than doubled to $72 million and $206 million respectively.

3.5.3 Public Debt Stock

At the end of 2015, the public debt stock had fallen to $697 million, 15% lower than the $820 million in June of the same year and 19% lower than in December 2014. A large contributor to this fall was a one-off debt repayment to domestic creditors made in the December quarter which helped domestic debt fall from $154 million down to $43 million. As such, external debt accounted for 94% of total debt in December 2015 at $655 million, a 2% fall in debt stock since June. During the review period, debt repayments totalled $138 million of which $132 million was principle repayments, and $6 million in interest payments. Moreover, the debt-to-GDP ratio fell to 9% representing an improvement in debt sustainability indicators for Solomon Islands.

Figure 23: Public Debt Trends



4 Economic Outlook

4.1 Global Outlook

According to the IMF World Economic Update January 2016 issue, global economic activity projects to expand by 3.4% in 2016 and 3.6% in 2017. The higher growth projections reflect modest improvements in the advanced economies and the positive turnaround in emerging market and developing economies. However, growth projections were revised downward from the October 2015 projections.

Growth in advanced economies is expected to rise by 2.1% in 2016 – 2017 with the US, euro area and Japan all expecting positive outlooks. Meanwhile emerging market and developing economies anticipates higher growth projections of 4.3% and 4.7% for 2016 and 2017, respectively. The anticipated pick up comes on the back of improvements from Brazil, Russia and some Middle East countries. However, downside risks to global growth remain and could emanate from the further slowdown and rebalancing in the Chinese economy, weak energy and commodity prices, and the gradual tightening of the US monetary policy.

Global inflation projections point to rising inflationary pressures in the near term. This is consistent with tight monetary conditions in the US, appreciation of the US currency against other major currencies, and supply side constraints. In the advanced economies, inflation is expected to rise to 1.1% and 1.7% in 2016 and 2017, respectively. Inflation in the emerging market and developing economies is projected to rise gradually to 5.6% in 2016 and 5.9% in 2017. While oil prices and non-fuel prices are expected to remain low, signs of these prices bottoming out in 2016 are on the horizon.

Interest rates in the United States are expected to rise further in 2016 in line with the planned intention of the Federal Reserve Bank to tighten monetary policy. This raises expectations that demand for the US dollar would rise making the USD stronger against all other major currencies.

4.2 Domestic Outlook

Medium term prospects show the economy would remain positive with growth rate averaging at 3.15% over 2016-2018. In the near term, growth in 2016 is projected to level off at 2.9% and rising to 3.1% in 2017. The major driving sectors are construction, manufacturing, hotel and restaurants, and public spending. Despite increasing capacity in the fisheries sector, contribution from the primary industries to growth in 2016 declines substantially following neutral contributions that are anticipated from forestry and agriculture.

Planned public and private sector investments are expected to pick up and generate activities in the near term and provide a basis for long term growth. However risk uncertainties could stem from any sizable decline in logging activities given the protracted weak demand from China, and a sudden upswing in energy prices.

Inflationary pressures at the back end of 2015 are expected to continue in 2016 though at a decelerating rate. Headline inflation, which reaches 3.2% in January 2016, is projected to remain within the 3%-5% range. Lower oil prices mainly in the first half combined with favourable movements by the SBD against AUD and NZD are expected to dampen imported food inflation and provide buffers against shocks from an appreciating USD. Upside risks to inflation include tight domestic supply conditions and higher than expected depreciation in the SBD against the USD.

The balance of payments position of the country projects near to medium term surpluses despite persistent current account deficits projected for 2016 - 2018. The BOP surpluses are predominantly driven by capital inflows mainly from donors combined with retained earnings from foreign investors. As a share of GDP, the bop surplus is expected to drop from 4.8% in 2015 to levels below 2% in the subsequent years.

The trade position[7] of the country over the next three years is expected to remain in deficit. The projected

[7] Trade balance for goods and services

trade deficit averages at minus 7.5% of GDP over 2016-2018, slightly lower than 7.9% in 2015. This reflects falls in both exports and imports of goods and services. On merchandise trade as a share of GDP, exports and imports are anticipated to average around 39% and 40% respectively over the medium term.

The exchange rate regime of pegging to a basket of currencies would continue in the medium term. The bilateral movements between the USD against the other major currencies could well determine the forecasted trend of the basket hence the local currency. If the current projection of a stronger USD continues to hold, then the trade weighted index is likely to show a marginal depreciation in 2016.

Credit growth is expected to remain above trend at 14% to levels just below $2.3 billion in line with the expansion in domestic activities. Money supply, also expected to rise, but a slower rate of 10% in 2016. Weighted interest rates are expected to maintain the gradual decline seen in recent years as lenders outcompetes each other. Current excess liquidity conditions are expected to be prevalent in the coming years and will continue to distort monetary conditions, a major hindrance to the establishment of an effective monetary policy transmission mechanism.

The central government projects an expansionary budget in the medium term mainly to grow the economy and address the development needs of the country. Overall deficit as a share of GDP widens by one percentage point against 2015 to minus 8.0% in 2016 before narrowing to 4.2% in 2018. The projected deficit reflects a strong growth mainly in capital expenditure. Capital expenditure as a share of GDP is expected to rise strongly in 2016 and 2017 to 14.5% and 15.8% from 11.2% in 2015. The budget shortfall is likely to be financed from SIG deposits with CBSI. Within the fiscal space, donor assistance is assumed to continue particularly in the services and infrastructure sectors.

The fiscal deficit is likely to be temporary as budget financing options are quite limited. The current option of financing the deficit from savings is not sustainable. Government borrowing is also an option but the debt management strategy requires any form of borrowing must be for capital projects.

5 Monetary Policy Stance

Inflationary pressures have risen in recent months but are expected to subside towards the end of 2016 to within 3%-5%. Pressures from a stronger USD should be countered by other invoicing currencies that are expected to weaken against the USD thus against SBD. The price of oil, which is expected to remain low especially in the first half of 2016, should also provide an additional buffer. With this development, there is still ample policy space for the economy to expand without generating inflationary pressures beyond desirable levels.

There will be no changes to the current exchange rate policy regime which pegs the SBD against a currency basket. As part of the Central Bank's plan to disseminate more economic information to the market, the performance of the currency basket over time can be observed through the trade weighted index published on the CBSI website and in various reports.

The Central Bank will continue to support open market operations over the next six months. The securities market, which is currently limited to Bokolo bills issuance and SIG Treasury bills, will be reviewed as part of the drive to deepen financial sector development and strengthen the monetary policy framework.

In the foreign exchange market space, the Central Bank will explore facilities it can transact with the commercial banks to help deepen the foreign exchange market and improve the management of liquidity conditions in the banking system going forward.

Given the recent economic developments and the macroeconomic outlook, the Central Bank of Solomon Islands will maintain an accommodative monetary policy stance over the course of the next six months. This compliments the expansionary policy of the Government which aims at growing the economy and addressing the development needs of the country. The Bank will however continue to assess economic and financial developments in the immediate future and is prepared to take appropriate actions if required.