Central Bank of the
Solomon Islands

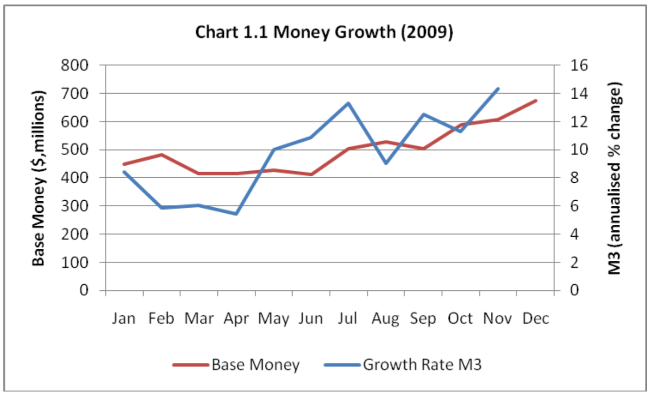
Monetary Policy Statement: March 2010

1.Money and Financial Markets

1.1 Money and Monetary Policy

Across the last 6 months of 2009 and into 2010 the Central Bank has operated an expansionary monetary policy, allowing reserve money to increase by 85% up to the end of February. The objective of this policy has been to boost the supply of money in the economy and ease the constraints on commercial lending, which has fallen as the economy has slumped (discussed in section 3). Monetary loosening in an attempt to boost nominal demand in the economy and prevent inflation from undershooting.

The increase in M0 was achieved by allowing net foreign assets to increase, through unsterilised capital inflows. Between June and December the Bank increased net foreign asset holdings by almost 32%, with only 8% of this total offset through security issuance. This rapid increase in reserve money has translated into large increases in free liquidity in the market, which has over doubled since June.



This expansionary policy has succeeded in boosting the supply of money in the economy. The growth rate of broad money, as measured by M3, has risen from an rate of 5.4% per annum in May to above 14% in December.

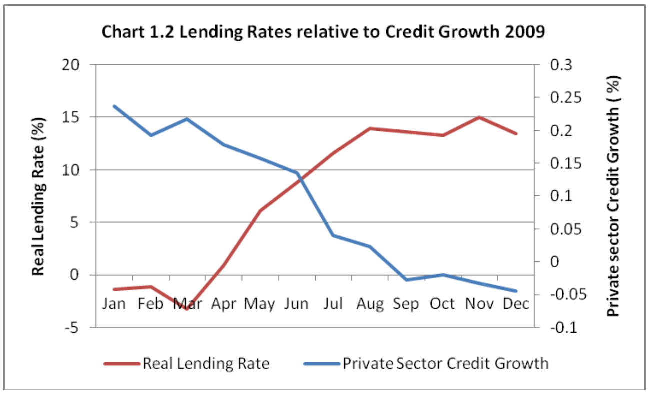
This risen in broad money has in large part stemmed from rises in currency outside the banking system. This growth is important as it means monetary policy actions have fed through into the real economy, and not simply been contained by the financial sector.

1.2 Bank and Credit Conditions

Despite the rise in non-performing loans across 2009, the banking sector in Solomon Islands remains well capitalised and stable. The effects of the worldwide financial crisis and the poor performance of the domestic economy in the year have however impacted strongly on the financial sector. Of greatest concern to the MPC was the fall in the growth rate in credit and particular the 7.4% fall in private sector credit witnessed in the 6 months to November 2009.

Despite this fall nominal lending rates have remained reasonably static across the period whilst real lending rates have rocketed. This is though to be a result of an increased level of risk aversion amongst the commercial banks, which is also indicated by the 14% fall in leveraging across the year. Falls in the levels of private sector credit may however not only be a result of decreases supply of credit from the commercial banks but may also be attributable to decreases in the demand for credit by companies hit by the downturn in the economy.

December saw a modest recovery in lending as credit to the private sector grew by 1.5% and real interest rates fell by nearly 12%. Despite the indications from preliminary data that indicate credit saw a further contraction in January 2010, it is anticipated that with expansionary monetary policy, high levels of liquidity in the system and falling levels of real interest rates, lending will begin to grow again across the next few months.

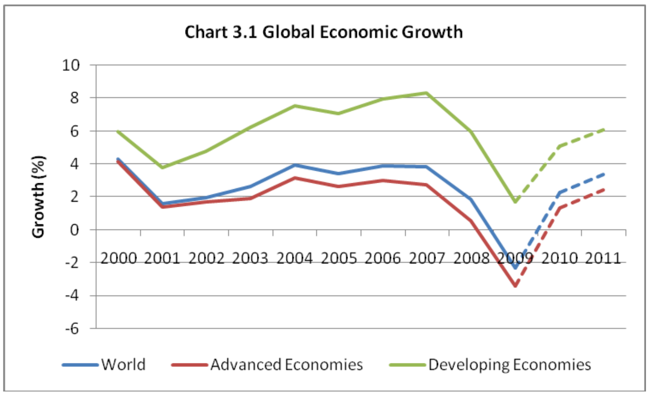


The high levels of liquidity and falling levels of credit have alleviated the funding difficulties the sector was facing in early 2009. In response to this deposit rates fell in the second half of the year, with nominal rates decreasing by around 28% between July and December. This has increased the interest rate margin to around 12.8 percentage points. Real deposit rates have fallen from their July peak, but remain far higher than witnessed in 2008.

2. International Economic Conditions

2.1 International Growth

The world economy struggled in 2009 experiencing its first contraction since World War II, as global output fell by around 0.8%. Leading this recession were the advanced economies, many of whom saw large contractions. The US economy shrank by 2.5% across 2009, the Euro area by 3.9% and Japan by around 5.3%. The only major industrial nation not to enter recession was Australia, though even there growth was limited to 0.7%. Our other large economic neighbor New Zealand fared poorly, shrinking by around 2.2% across the year.



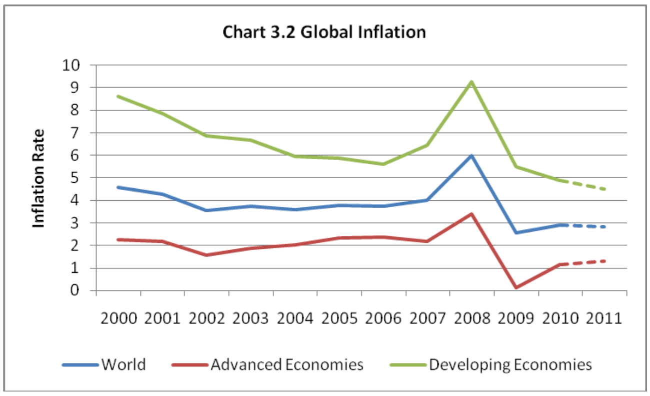
The emerging and developing economies of the world fared better in 2009, seeing on average an expansion of around 2.1%. This group is however highly heterogeneous and the performance of individual economies was highly varied. China, Solomon Islands' most significant trading partner, expanded 8.1% across the year whilst the Russian economy was hit badly by the global economic crisis and saw a 9% fall in its GDP.

The worldwide economic recovery has been highly unbalanced and whilst some nations have experienced a buoyant return to growth in the last half of 2009 continuing into 2010, other countries remain in recession. It is anticipated that the recovery will hold in 2010 and the global economy will continue to grow. The risk of a 'double-dip' recession still persists but appears increasingly less likely.

The global return to growth however remains fragile. A premature exit from fiscal stimulus packages, before economies become self sustaining, could see a reversal in fortunes. The continuing weaknesses of financial systems in many countries remains a large downside risk. Whilst worldwide banks are becoming less dependent on central bank funding their is still the possibility of further write downs and there is a need to rebuild capital. The stubbornly high rate of unemployment also threatens growth in many industrialised economies.The greatest threat however stems from the high level of sovereign debt accumulated by many countries. It is hoped that the current debt crisis in Greece can be quickly rectified and the threat contagion averted. Greece does however provide a warning of the precarious situation many countries find themselves in and the delicate nature of global growth at the start of 2010.

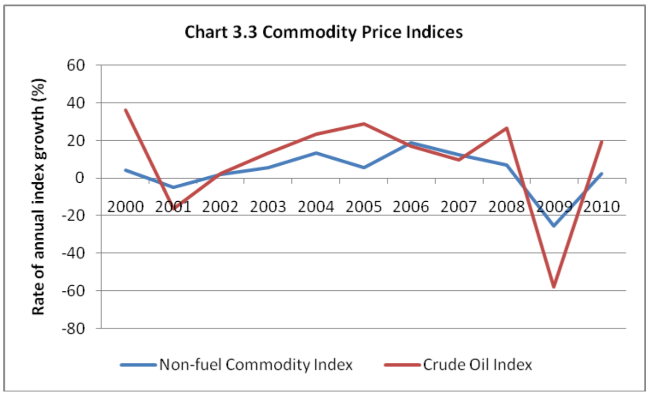
2.2 Global Inflation and Commodity Prices

The collapse in growth during 2009 proved a powerful disinflationary force. Average global inflation for the year fell from 6% in 2008 to only 2.5%. This fall was mainly brought about by the stagnation in prices across advanced economies, where inflation averaged only 0.1%. Many of these industrialised nations experienced bouts of deflation across the year, with prices falling by 0.4% in the United States and by 1.1% in Japan. Australia, a major source of Solomon Island retail imports, saw prices rise across the year, but at a rate of only 1.6%.



Developing and emerging countries on average saw far higher rates of inflation than the advanced economies, but this had also moderated a great deal since 2008, falling over 3 percentage points to 5.2%. Inflation rates were far from uniform amongst this group, with prices falling in China by 0.06% and rising in Russia by 12.3%.

It is anticipated that global inflation will see some increase in 2010 but will remain relatively low across the year. Unused capacity remains very high, with the output gap for industrial nations being around -4% of GDP at the end of 2009 and unemployment in these countries remaining above 8%. Although confidence has improved at the start of 2010 it remains subdued and inflationary expectations in the majority of countries remain anchored at low levels.

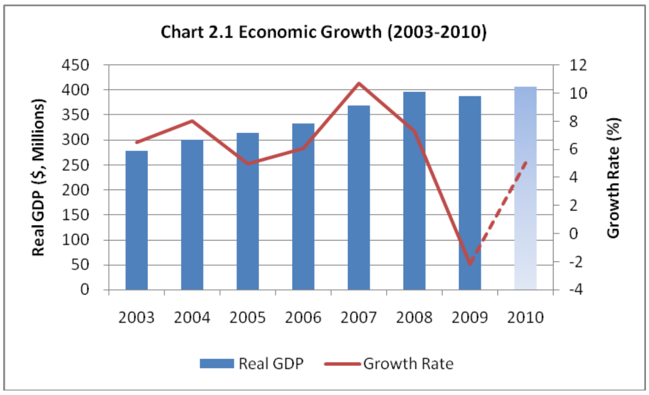


The major worldwide inflationary risk remains a commodity price spike. Commodity prices have rebounded strongly since the economic crash, rising with renewed demand from Asia. It is likely that commodity prices will experience further price rises across the medium term but continued economic weakness across a great portion of the world will continue to provide a dampener.

3. Domestic Economic Conditions

3.1 Domestic Output

2009 was a poor year for the Solomon Islands economy as real GDP fell by around 2.2%. This contraction was a result of declines in the major exporting industries, hit by the global declines in growth and trade. Output from the logging sector, which contributed around 11% of value added in the year, declined by around 31%. Production from the fishing industry fell by 24%, and copra fell 36.5% although both these industries began to rally towards the end of the year. Cocoa and palm oil both provided slight upsides to the disappointing economic performance in 2009, growing 13% and 15% respectively.



It is hoped that with continued growth from cocoa, palm oil and fish and a return to growth for the copra industry the economy will see a return to growth in 2010. It is hoped that this will be further aided by the introduction of competition to the telecommunication industry in mid-2010. The Bank is therefore anticipating 5% growth in real GDP across the year.

The major threat to this comes from the logging industry which, although anticipated to make a limited recovery early in the year, is in terminal decline. It is not anticipated that mining will make any contribution to the economy in 2010.

3.2 Government Spending

Government spending remains a large and important part of the Solomon Islands' economy. Fiscal constraints and a commitment to the Honiara club agreement meant that the government was forced into retrenchment measures during 2009 and spending reduced 1.5%. With a return to growth projected in 2010 and additional help pledged from the donor community government has budgeted for a 17% rise in spending. Any changes to these spending plans following the election, due in mid-2010, could have significant impacts on growth and inflation projections.

3.3 Labour Market Conditions

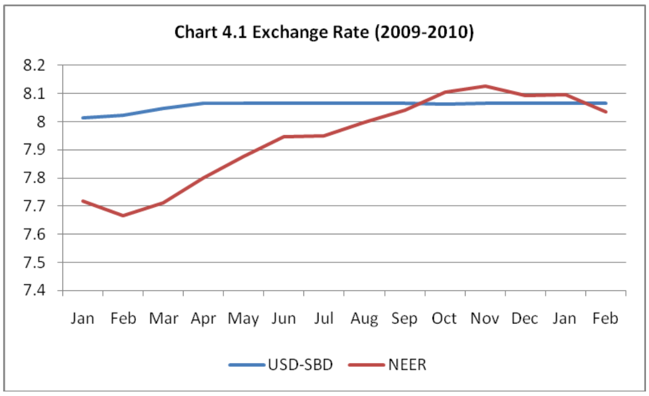
Public sector employment increased by only 4% in 2009. This was due to a freeze on 'non-essential' recruitment by the government across the year, with the majority of those employed being doctors and teachers. Data calculated from NPF membership indicates that private sector employment grew by less that 1% in 2009. Given the high rate of population growth and the increasing rate of urbanisation this would indicate a degree of loosening in the labour market and this is supported by estimates made concerning the rate of unemployment in Honiara.

4. Exchange Rate & Foreign Reserves

4.1 Exchange Rates

The Solomon Islands dollar maintained has maintained its policy of pegging to the US dollar although its was allowed the currency to devalue by around 4% across the last 12 months.

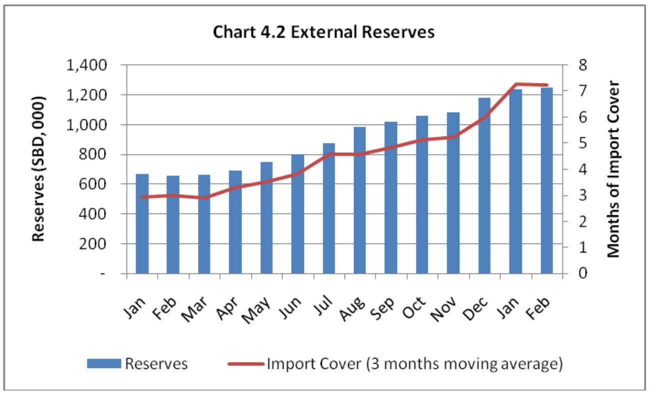
This policy has generated a steep appreciation of the nominal effective exchange rate. This has been undertaken to help curb the high level of inflation in the country at the start of the year. This policy has been a success, helping to achieve needed disinflation without damaging the level of reserves.



Loosening of monetary policy has meant a depreciation of the nominal effective rate, which has been falling since November. The Bank does not feel this depreciation poses a substantial risk to inflation at this time, as discussed in section 5.

4.2 Foreign Reserves

External reserves have seen a rapid and sustained rise since March 2009, increasing 88% across this short period. Reserves now stand above $1.2 million or 7.2 months of import cover. This has been a success for the Bank as reserves had fallen below the policy minimum target of 3 months import cover.



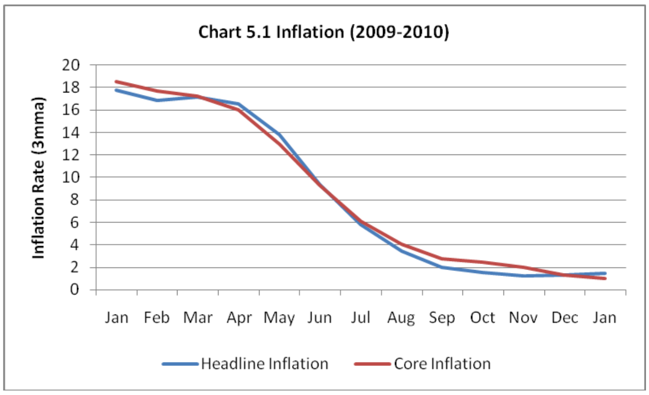
This increase in reserves has occurred despite the large structural trade deficit and worsening current account deficit that has hit the economy. Large capital inflows from investment and large levels of donor support have been instrumental in increasing the reserves as was the large allocation of special drawing rights made to the Solomon Islands by the IMF.

The Bank is currently anticipating a slight fall in the level of reserves in the middle of 2010, mainly due to increasing trade payments. The Bank does not however foresee large or rapid diminution of reserve levels across 2010. The ability of reserves to cover forward imports is anticipated to fall slightly through the year as import volumes rebound, but not however by a dramatic margin.

5. Prices and Inflation

5.1 Inflation

At 1.5%, headline inflation as measured by the Honiara retail price index is currently both low and stable. Reducing the rate of inflation to a level more in concordance with monetary policy goals was a major success for the Bank in 2009.



Inflation fell in the first half of the year in large part due to the rising value of the Solomon Islands dollar combining with the falling international price of commodities. Domestically the tight monetary policy implemented by the Bank also relieved inflationary pressures in the economy.

As inflation fell the Bank loosened monetary policy so as to prevent undershooting of inflation and stabilise it at a low level. The Bank achieved this by increasing reserve money in the economy.

The short run inflationary outlook remains promising as upward pressure on prices remains low. Underlying inflation is very low at 1%, excess capacity remains high and whilst both the nominal effective exchange rate and the real interest rate are falling they remain at high levels. The major threat to the maintenance of price stability remains commodity import prices.

In the medium term increases in domestic economic activity and increased activity in international commodity markets may see the price level begin to creep upwards and whilst the high levels of liquidity in the market are not felt to pose a threat to stability in the short run the Bank will intervene if this generates inflationary pressures in the future.

Monetary Policy Stance

The Central Bank of Solomon Islands currently intends to pursue a moderately accommodative strategy. Conditions in the economy remain tight and with both price rises and inflationary pressures low the Bank will continue to maintain an underlying stance of monetary easing.

The MPC has based this decision on a number of factors. Inflation has been brought in to line with Bank targets and at this point is very low. The Bank does not envisage a rapid return to high levels of inflation in the long run, given the weaknesses in both the domestic and global economies. Reserve levels are high and the Bank does not perceive any major threat to their level across the short to medium run. The Bank therefore feels easing to be appropriate at this time.

The Bank will however be vigilant in monitoring possible inflationary developments in the economy and stands ready to moderate the degree of accommodativeness were the conditions to alter. In particular the Bank stands ready to wind down the liquidity position if this becomes a threat to price stability. The ample level of liquidity already present in the market also means that moves to loosen by the Bank will not be aggressive at this time but could become more expansionary if market conditions see further deterioration.