Monetary Policy Statement

March 2011

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1. International Developments

1.1 Financial Market Conditions

Despite the strengthening global economic outlook, the global financial outlook is still plagued by a certain degree of vulnerability. A two-speed economic recovery has led to differing financial vulnerabilities in advanced and emerging economies.

The European sovereign debt crisis which unfolded in early 2010 and resulted in the EU-IMF bailouts for Greece and later Ireland has heightened the market's reaction to perceived debt sustainability amongst many advanced economies. Initial worries of contagion effects to other major world economies has been subdued as 2010 saw spill-over effects contained to the Euro Area and the positive response of world markets following the bail-out that was coordinated in response to the Greek crisis and later the Irish crisis. The concern, however, is that following unprecedented amounts of monetary stimulus in many advanced economies and the experience of EU countries has left these economies with unsustainable levels of fiscal debt which threatens to undermine their financial stability if these lead to rising borrowing costs.

With the maintenance of low interest rates in advanced economies and the existence of positive returns in many emerging economies, the last quarter of 2010 and the first quarter of 2011 have seen a pick-up in capital inflows to emerging economies. These threaten the financial stability of these economies to the extent that they may fuel asset price bubbles and unsustainable credit expansion. These economies will need to be vigilant for signs of over-heating.

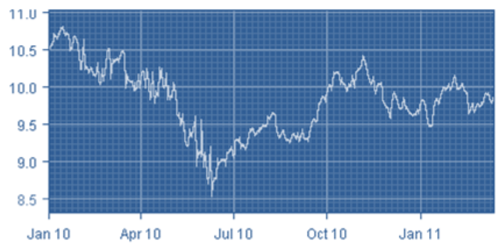
1.2 Foreign Exchange Market

Across the final quarter of 2010 and the initial quarter of 2011, the Solomon Islands dollar (SBD) saw an overall improvement in its position against the Euro, the Japanese Yen and the New Zealand dollar. The position against the Australian dollar over the same period witnessed a very slight overall depreciation. This reverses the trend witnessed in the last monetary policy statement where the position of the SBD was deteriorating against these four currencies.

Figure 1.1: Exchange Rates against SBD*

(a) SBD/AUD

(b) SBD/EUR



(c) SBD/JPY

(d) SBD/NZD

*OANDA bid rates

Source: The Economist

In January this year, the Central Bank Board via the Bank's Monetary Policy Committee (MPC) resolved that in light of unprecedentedly high levels of foreign reserves coupled with low inflation, it would pursue exchange rate flexibility in order to re-align the value of the Solomon Islands dollar (SBD) with the trade weighted basket of currencies. Moreover, this flexibility should be able to cushion the anticipated rapid increase in imported fuel and food prices that have the potential to trigger inflation.

Following the Japanese earthquake and tsunami, the Japanese Yen overshot to ¥76.25 per US dollar, its highest level since WWII. An initial need to raise money for repair and reconstruction saw the unwinding of carry trades[1], but with this resulting in a rising Yen and hence a reduction in the profitability of such trades, further unwinding has been witnessed and further threatened to appreciate the currency. Such a highly valued Yen threatened to undermine Japanese financial stability and the economic recovery following the disaster. On 18th March, The G-7 nations acted jointly to intervene in the currency market in order to bring the Yen back to a sustainable level. With the Bank of Japan's action to provide emergency liquidity to the money market, the Yen is expected to weaken across 2011. As a counterpart, the unwinding of carry trades saw a sell-off of Australian dollars, with the AUD falling to 97.35 US cents. The AUD has rebounded, such that the effect on the currency proved to be temporary.

1.3 International Economic Conditions

Global economic recovery has continued across the final quarter of 2010 and the first quarter of 2011. However, the existence of a two-speed recovery has been accentuated. Emerging economies have been experiencing strong recoveries supported by buoyant private consumption, strong terms of trade and resurgent inflows of private capital. In advanced economies, the recovery has been stronger than expected but hampered by persistent high-unemployment rates and restrained levels of private consumption. The two speed recovery has led to the need for contrasting policy responses in the two types of economies.

Advanced economies, amidst persistent economic fragility have maintained interest rates at record lows and in some cases have approved additional measures of monetary stimulus. New Zealand, in the face of the earthquake in February 2011, further acted to support economic activity through expansionary monetary policy. The recent earthquake in Japan has also led the Bank of Japan to pursue an expansionary policy with a total of ¥37 trillion being pumped into the money market as the Bank of Japan aims to subdue panic of the economic impact of the disaster.

Due to the maintenance of strong growth rates prior to the financial crisis, resurgent capital inflows and strong terms-of-trade for commodity exports, emerging countries are now experiencing output levels close to capacity. The resultant rise in prices has led to contractionary monetary policies to curb excessive credit growth and asset price bubbles.

Recent political turbulences in the Middle East and North Africa have led to rising oil prices. In addition, global commodity prices have been increasing due to weather related disruptions to global production and in the case of cocoa; world supply has been affected by continued political tensions in the Ivory Coast, the world's largest producer of cocoa. Moreover, these rises have been underpinned by rising global demand but slow adjustments in supply. These weather and politically related supply shocks will push prices up in the short term, with food prices expected to

[1] Carry trades refer to the strategy of selling low-yielding currencies (such as the Yen) to fund the purchase of higher yielding currencies (such as the AUD)

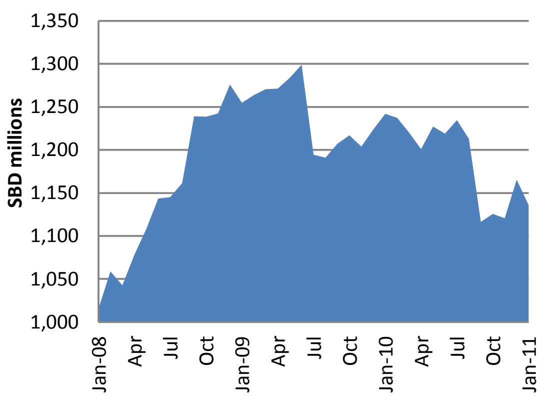
peak in mid-2011, but excess demand may persist supporting higher prices in the long-term. Such rising commodity prices will further fuel inflationary pressure in emerging economies that will require the authorities to further tighten monetary policy.

2. Domestic Developments

2.1 Domestic Financial Developments

Despite some monthly volatility, credit to the private sector increased by 4.4% across the fourth quarter of 2010, driven by the 4% increase witnessed in December (see Figure 2.1). This increase, however, has not marked the end of the overall downwards trend since early 2009, with credit to the private sector experiencing a 2.5% decline between December 2010 and January 2011.

Figure 2.1: Private Sector Credit

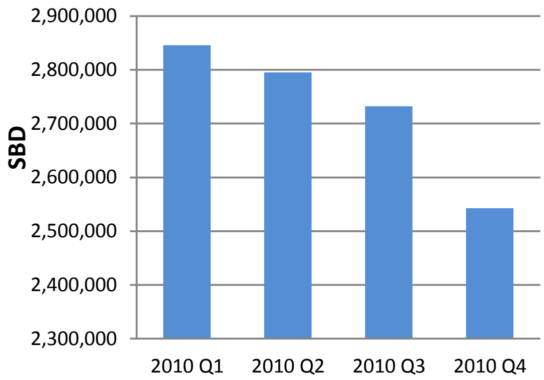


Source: Central Bank of Solomon Islands

Total stock of loans in 2010 followed a steadily declining trend (see Figure 2.2). However, excluding two large repayments in September 2010 by borrowers holding a substantial value in loans, total loans witnessed a marginal 1% increase in the third quarter of 2010 but still a 6.7% decrease between the third and final quarter despite the pick-up in economic activity across the latter part of the year suggesting a continued conservatism towards borrowing and lending.

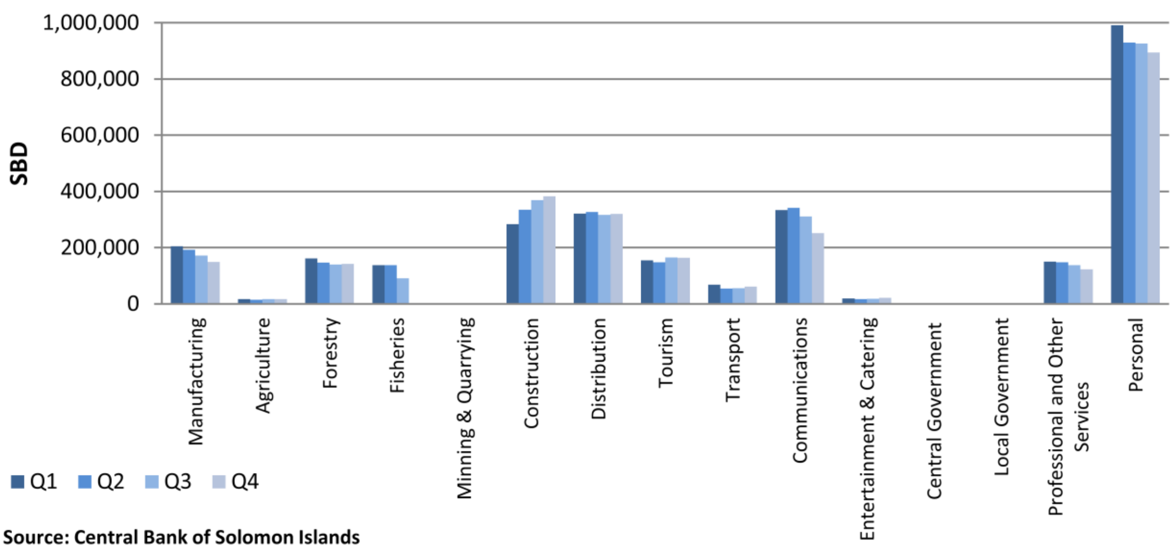
Looking at total value of loans by sector, only the construction, tourism, mining and quarrying and the entertainment and catering sectors saw increases in the quantity of loans held by the sector across 2010. Personal loans witnessed a 9.8% decline across 2010 and the manufacturing sector witnessed a 27.5% fall in total value of loans across 2010 (see Figure 2.3).

Figure 2.2: Total Value of Loans



Source: Central Bank of Solomon Islands

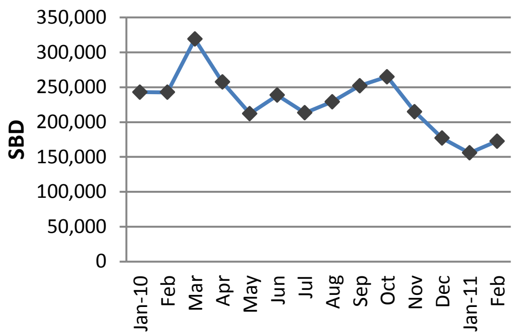
Figure 2.3: Total Value of Loans by Sector



Source: Central Bank of Solomon Islands

Approved loans across 2010 followed a similar, overall, downwards trend. The value of loans approved in January 2011 was 35% below the figure recorded in January 2010, in line with continued conservatism in lending and borrowing. However, the quantity of loans approved in February 2011 went up by 10.8% from the January figure, which may represent the transformation of strong economic activity in the latter part of 2010 into renewed confidence in borrowing and lending. If so, this may signal a pick-up in credit to the private sector in the coming months (see Figure 2.4).

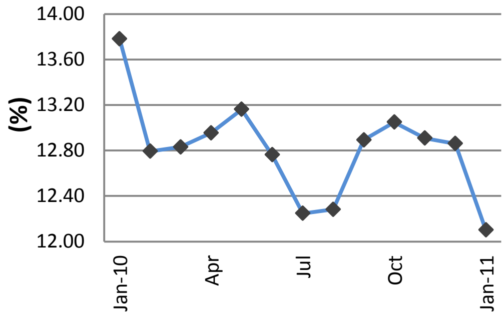
Figure 2.4: Total Value of Approved Loans[a]



Source: Central Bank of Solomon Islands
[a]commercial bank undrawn commitments used as an estimate for approved loans

Average real lending rates have shown a fair amount of month-to-month volatility but have showed an overall 11.5% decline since the beginning of 2010 (see Figure 2.5). In line with this reduction in the cost of credit, we would anticipate that this would soon start to translate into increased demand for credit. The pick-up in approved loans may signal the start of these declining real rates feeding through into demand. Real deposit rates declined marginally in the final quarter of 2010, but witnessed a 35% decline between December and January due to a pick-up in inflation in January, giving little incentive for increased saving. Overall, real interest rate margins have been declining since August 2010, however, they remain high by regional standards.

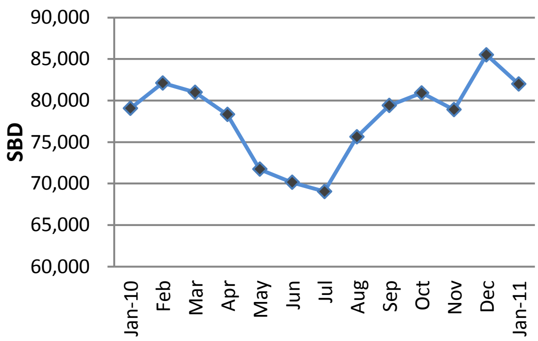
Figure 2.5: Weighted Average Real Lending Rate (%)



Source: Central Bank of Solomon Islands

Overall, the number of non-performing loans increased by 1.3% across the fourth quarter of 2010, with non-performing loans classified as loans with payment arrears of 90 days or more[2] (see Figure 2.6). The number of non-performing loans recorded in January 2011 was 4.1% below the December figure. Overall, the January 2011 figure represents a 3.7% increase on the January 2010 figure and across 2010 non-performing loans as a proportion of total loans has averaged about 8.5%, as such; the level of non-performing loans is not expected to represent a downside risk to banks' balance sheets and is not expected to represent a restraint on lending.

Figure 2.6: Non-Performing Loans[a]



Source: CBSI
[a] payment arrears > 90 days

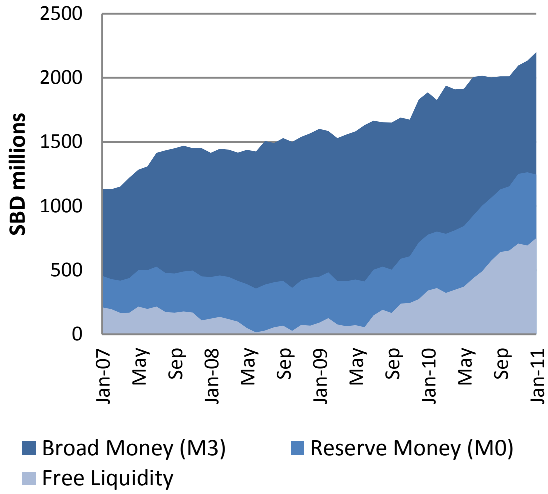
[2]Classification based on the new prudential guideline.

Total domestic credit, witnessed a significant 22.3% decline in the final quarter of 2010. This resulted from an increase in net credit to Government, so that net credit to Government went from $36.2 million to $315.5 million across the quarter on the back of increased Government deposits held at the Central Bank.

Reserve money (M0) increased by 11.9% across the final quarter of 2010, with free liquidity increasing by 7.9% over the same period (see Figure 2.7). In January 2011, free liquidity went up by 8.5%.

Broad money (M3) went up by 6.1% across the final quarter of 2010. Additionally, this represents an increase of 10.9% compared to the corresponding quarter in 2009 (see Figure 2.7).This increase is in line with the 4.4% increase in private sector credit across the same period. However, the restrained growth in private sector credit does not explain the majority of the rise in M3; instead, monetary growth is being driven by large external inflows rather than domestic demand with a significant impact following the large inflow of aid in the final quarter of 2010.

Figure 2.7: Reserve Money, Free Liquidity and Broad Money

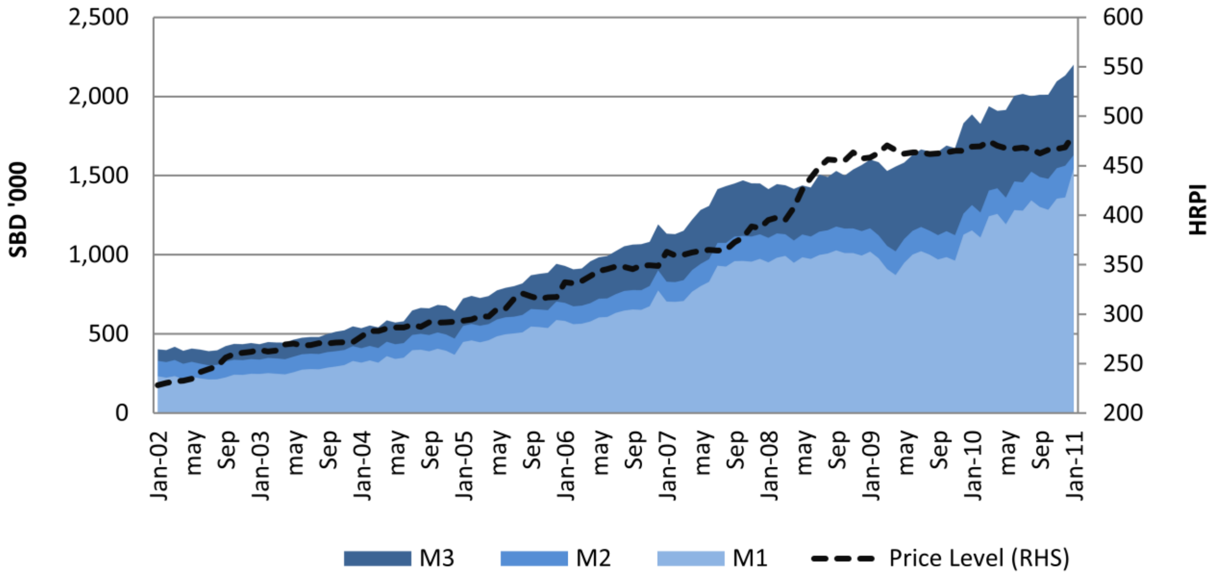


Source: Central Bank of Solomon Islands

Box 1: The Relationship between the Money Supply and Inflation

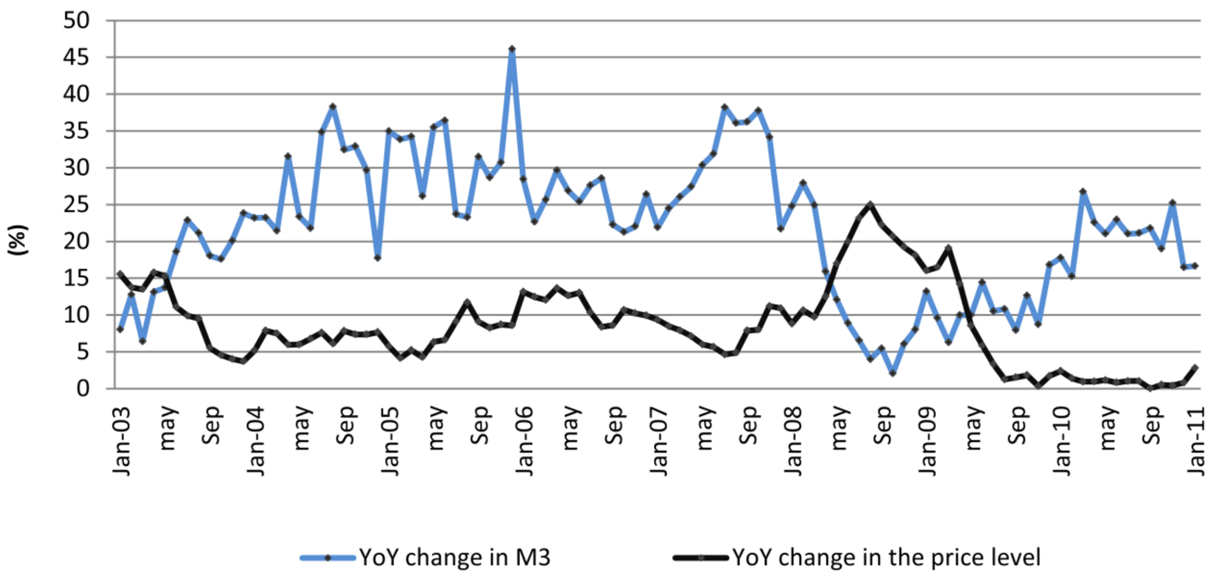
The money supply has been increasing steadily since 2002, with the price level following the rate of increase in M3 fairly closely until the first quarter of 2008 (see Graph 1). However, since 2008, there has been a breakdown in the close relationship between the two variables, with inflation, at first increasing whilst the money supply decreased and then decreasing as the money supply increased (see Graph 2). Nevertheless, the breakdown in the fairly close relationship is not considered to represent a breakdown in the relationship altogether, but rather an increase in the lag with which a change in the money supply affects inflation as well as reflecting the greater effect that external pressures are having on inflation.

Graph 1: M1, M2, M3 and the HRPI Price Level



Source: Central bank of Solomon Islands

Graph 2: Change in M3 against Change in the Price Level



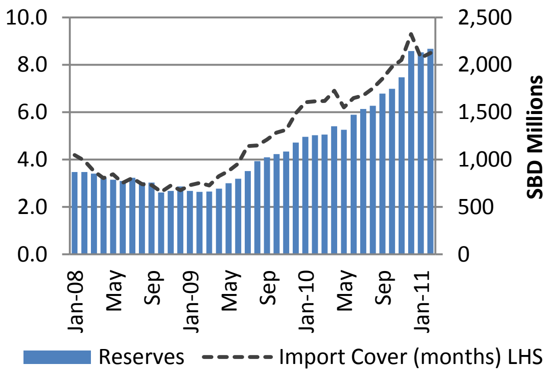
Source: Central Bank of Solomon Islands

2.2 Domestic Economic Conditions

2.2.1 External Sector

External reserves in the final quarter of 2010 surged by 26.5% to $2,143.8 million as a result of the large aid inflow from the European Union (EU) received in December 2010. In January 2011, total external reserves went down slightly to $2,112.4 million, but then went up slightly by 2.6%in February to $2167.4 million. The level at February 2011 represented 8.5 months of import cover (see Figure 2.8). Indeed, reserves have exceeded 4 months of import cover since mid-2009. As such, the level of reserves is not a major worry for the Central Bank.

Figure 2.8: Reserves and Import Cover

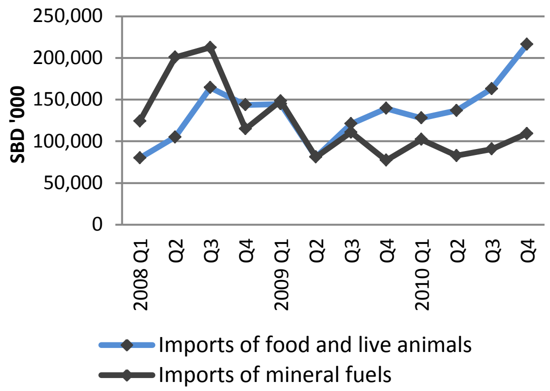


Source: Central Bank of Solomon Islands

Across the final quarter of 2010, the trade deficit worsened from a deficit of $196.5 million to a deficit of $321.7 million due to a surge in the value of imports which outweighed the increase in exports. The value of imports in the last quarter of 2010, surged by 29.9% to $873.8 million on the back of an 83% surge in the value of imports of 'machinery and transport equipment' during the quarter, the majority of which was imported by Gold Ridge. In January, the trade deficit widened to $168.2 million from the $76.2 million deficit in the previous month, mainly owing to a large fall in exports. Notably this came from a 57.5% and 54% decline in log and fish exports respectively. However, the trade balance improved in February 2011 by a narrowing of the deficit to $4.7 million following a rise in exports and a slowdown in imports.

The value of food imports has been rising across 2010 and represented 19.6% of total imports. The value of fuel imports, has been rising since the third quarter of 2010 and made up 14.2% of total imports (see Figure 2.9). Rising food and fuel prices are expected to see the value of these imports rise in the short-term, however, the rate at which this rise occurs should be subdued by the alignment of the SBD.

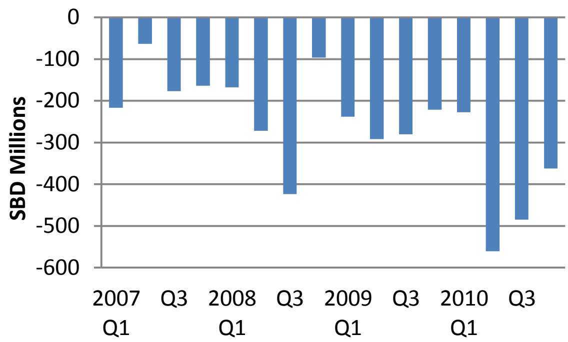
Figure 2.9: Imports of Food and Fuel



Source: Central Bank of Solomon Islands

In the last quarter of 2010, overall, the current account saw a significant improvement from a deficit of $485.6 million to $367.8 million (see Figure 2.10).

Figure 2.10: Current Account Balance



Source: Central Bank of Solomon Islands

This improvement comes on the back of a strengthening in the position of the primary income balance, secondary income balance and the trade in services balance which outweighed the deterioration in the trade deficit witnessed in the final quarter. Secondary income credit was boosted by a large inflow of aid from the EU in December 2010.

2.2.2Domestic Output

Real GDP registered a rise of 7.2% in 2010 amidst stronger than expected economic activity in the second half of the year. In the final quarter of 2010, the overall production index increased by 6.8% reflecting increased production in copra, fish and logging. Global commodity prices, except for fish and cocoa, increased across the final quarter.

Copra production showed a 41% increase across the final quarter, log exports recorded a marginal 4% increase, fish catch registered a 26% increase, cocoa production saw a 13% decline and palm oil production witnessed a fall.

Across the first two months of 2011, log production recorded a significant fall in January but then a strong 75% (MoM) increase to 163,015 cubic meters in February. This figure represented an increase of 117% compared to February 2010 figures.

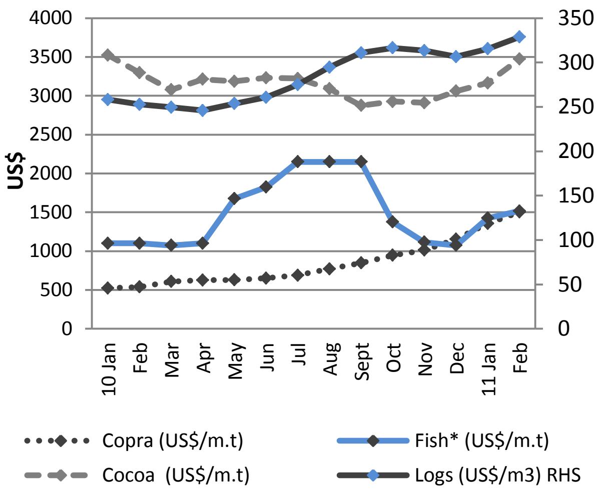
Cocoa production registered a 63% (MoM) decline in January and a marginal 3.2% increase in February. Typically, the beginning of the year is the low production period for cocoa.

Copra production declined by 16% (MoM) in January, but picked-up in February with a 32.5% (MoM) increase.

Fish catch in January rose 9% (MoM) but witnessed a 25.9% (MoM) decline in February. Fish catch is greatly affected by weather conditions and the decline seen at the end of 2010 and in February 2011 are attributed to unfavourable weather conditions.

Turning to global prices for Solomon Islands exports, copra prices have been rising across 2010 on the back of strong demand for alternative fuels which supports the demand for coconut oil and its primary inputs. Log prices have also risen steadily in 2010, this steady rise is attributed to steady growth in global demand, especially from China.

Figure 2.11: Global Commodity Prices



Source: Central Bank of Solomon Islands

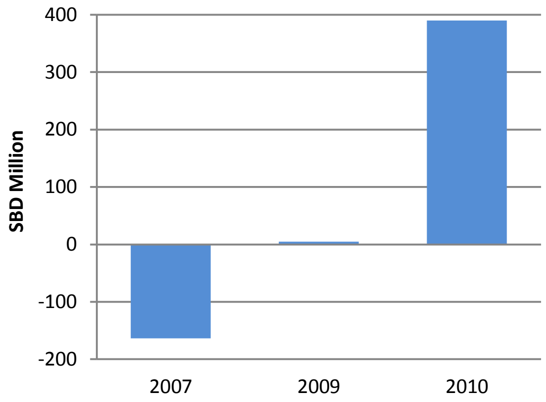
Cocoa prices have witnessed more volatility than other commodity prices across 2010. Recent political unrest, however, in the Ivory Coast is expected to be behind the rising prices for cocoa witnessed since September 2010 (see Figure 2.11).

In the near-term, commodity prices, in general, are expected to continue rising. These rises will, in turn, support rising domestic production for these commodities. March, however, has seen a reduction in domestic prices for copra, which has been explained to be in line with an expected fall in global copra prices following uncertainties in the world market stemming from the Middle East crisis.

2.2.3 Government Spending

The overall fiscal position in 2010 registered a surplus of $389.7 million, which hugely surpasses the $4.9 million surplus recorded in 2009 (see Figure 2.12). The overall surplus is attributed to a large increase in donor grants in 2010, most significantly, a one-off grant from the EU received in December 2010. However, excluding donor grants, the overall fiscal position still recorded a significant surplus of $195 million which reflects improved tax collection and the imposition of spending restraints during the year.

Figure 2.12: Overall Fiscal Position



Source: Central Bank of Solomon Islands

Although, Government expenditure, overall, was below budget in 2010, this is due to the non-implementation of 25% of Government funded projects and the imposition of a 35% reservation on spending at the beginning of the year. Such reservations were put in place to reduce unbudgeted spending and over-budget spending by ministries. In particular, payroll spending increased by 19.3% to $563 million in 2010, 13.8% above budget. The over-budget spending is attributed to unbudgeted payroll spending and comes despite a freeze on recruitment in 2010. Payroll spending is expected to increase by 4.3% in 2011.

2.2.4 Labour Market Conditions

According to NPF figures, used as proxy for employment, the number of active workers increased by 33.7% across 2010 from 30,747 to 41,096. In support of this, total private sector PAYE collected by the Government was recorded at $194.6 million in 2010, 36.8% above 2009 collection. This increase will, to some extent, represent higher contributions as employees progress into higher tax brackets but also an increase in contributions from new workers entering the labour force in 2010. As for the public sector, the total number of public sector employees increased from 13,281 in 2009 to 13,547, an increase of 2% which was subdued on the back of a freeze in public sector recruitment.

2.2.5 Investment

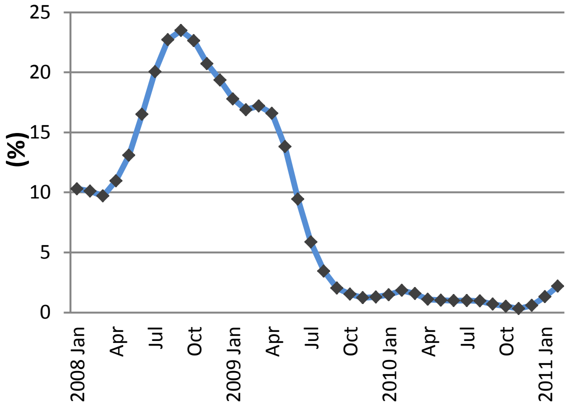
With commercial banks facing subdued investment opportunities in personal lending, the emphasis is expected to be in larger business investments especially in the telecommunications sector with the possibility of a new telecommunication provider entering the market and continued investment by the other players in the market expected to represent investment opportunities in the near term.

The National Provident Fund represents a further investment source in the economy, with the institution investing in private sector projects. In 2010, this included a large refinancing deal with a major company in the manufacturing sector. In 2011, the institution extended a further $6 million loan bringing its total investment in private sector business to $80 million.

2.2.6 Prices

Inflation as measured by the Honiara Retail Price Index (HRPI) has been following a downward trend since March 2009 (see Figure 2.13).

Figure 2.13: Headline Inflation (3mma)



Source: Central Bank of Solomon Islands

In November 2010, headline inflation as measured by the three-month-moving average (3mma) reached a low of 0.3%.It rebounded to 0.6% in December and reached 2.2% in February2011, signalling the end of the extended downward trend. This reversal is in line with higher global fuel and commodity prices which have already fed through into domestic prices.

3. Macroeconomic Outlook

Rising global food and oil prices represent a downside risk to growth, although the negative effect on disposable income is expected to be mitigated, to a certain extent, by the alignment of the SBD which will make imports relatively less expensive. The flexibility in the local currency will act to cushion the economy against external shocks.

In the short-term, following the commencement of operations at Gold Ridge Mine and on the back of strong general economic activity, demand for oil is expected to increase across 2011. This, and higher oil prices are expected to impact the trade in goods balance negatively, nevertheless a reduction in the value of 'machinery and transport equipment' expected now that refurbishment of the Mine is nearing completion should lessen the negative impact, with an expected overall improvement in the trade balance in 2011. In the longer-term, as Gold Ridge steps up production, large volumes of gold exports are expected to further improve the trade in goods balance, which will exceed increased imports which are expected in the medium term on the back of the alignment of the SBD, with a surplus anticipated in 2012.

The broad money supply is still increasing at a sustainable rate and is not considered to represent a significant risk to inflation in the short-term with continued conservatism in both borrowing and lending in the domestic market.

Inflation is still at low levels although, upward pressure in the form of rising global food and fuel prices are expected to push up prices in the medium-term. The rate of inflation, however, is expected to be subdued by the alignment of the SBD.

The Central Bank currently anticipates a steady rise in the price level across 2011, with a projected annual inflation rate of 5.0% in 2011. The level of reserves is expected to remain high in the near term and represent adequate import cover.

4. Monetary Policy Stance

In light of the aforementioned developments, and with signs of robust economic growth and expected inflationary pressure, the Central Bank of Solomon Islands will pursue a moderate contractionary monetary policy to contain the anticipated increase in inflation to single digit levels.

The main inflationary pressures come from external price rises raising import costs and feeding through into domestic prices. The alignment of the SBD will, for now, act to subdue these external pressures.

On the domestic side, M3 is growing at a sustainable rate and the Bank is monitoring its growth closely. In the short-term, it is not expected to represent a risk to inflation.

The Central Bank of Solomon Islands will continue to monitor local macroeconomic conditions in conjunction with developments in the global economy and stands ready to act should circumstances necessitate it to do so.