CENTRAL BANK OF SOLOMON ISLANDS

Monetary Policy Statement

March 2013

PO Box 634, Honiara, Solomon Islands   Tel: (677) 21791   Fax: (677) 23513   www.cbsi.com.

Table of Contents

List of Figures and Tables

1. Overview of 2012

International economic conditions continued to be marred by the deepening recessions observed in periphery economies within the euro area, coupled with only modest growth performances in the US. Persistently weak economic activity in advanced economies continues to impact other regions across the globe, resulting in lower global economic output for 2012 than in 2011. Latest estimates from the IMF World Economic Outlook Update published in January 2013 revealed that the global economy expanded by 3.2% in 2012, a slight revision downwards from the earlier forecast of 3.5%. However, the resilience of the emerging and developing economies has been the principal source impelling global growth into positive territory.

Global inflation slowed in 2012 influenced by lower commodity prices and weakening global demand. Despite **international commodity prices** retreating by 2.3% over the year, international food prices have remained elevated and have yet to return to levels witnessed before the 2011 historical peak. Oil prices, on the other hand, observed a slight increase in 2012. In particular, the Tapis oil price registered a 1% increase on last year[1].

In the domestic economy, **money aggregates** displayed further expansion during the second half of 2012. The chief proponent of growth was attributed to Net Foreign Assets (NFA) of the Central Bank, a similar picture to the first half of the year. Money supply growth was also driven by an improvement in Net Domestic Assets (NDA) of the banking system, which reflected faster growth in private sector credit and a drawdown in government deposits over the same period. Free liquidity growth, on the other hand, slowed between June and December, mainly caused by the increase in issued Bokolo bills stock.

The balance of payments remained buoyant notwithstanding the weaker performance in the final quarter 2012; gross foreign reserves continued to accumulate during the second half of 2012 leading to amelioration in the import cover, which reached 10.5 months in December 2012. Improvements in trade in services and the capital account, together with strong revaluation gains, helped to offset weaker positions in goods trade and the primary and secondary income accounts.

Economic activity in the domestic economy, as measured by real GDP, expanded by 4.8% in 2012. Annual growth was supported by forestry, mining, fishing as well as the manufacturing, construction and other services sectors during the year. However, agricultural industry, namely cocoa and copra production remained weak during the second half of 2012.

In the second half of the year, production of all major export commodities declined with the exception of the robust accomplishments in the logging and fishing sectors. In other sectors of the economy, sustained growth occurred in tourism, manufacturing, construction, retail and wholesale, and utilities sectors.

The Government recorded a **budget surplus** of $59 million, a significant fall from $353 million budget surplus registered in 2011. However, the Government records a fiscal deficit when budget support from donors is

[1] Tapis oil is used as a pricing benchmark in Singapore where Solomon Islands import most of its fuel.

excluded. The reduction in the budget surplus was ascribed to a significant proportion of the 2011 allocated donor funds unspent during the year. This declining surplus was also a result of improved budget expenditure planning. Total government expenditure, a potential source of inflationary pressure, increased by 27% compared to 2011 of which the majority was expended during the second half of the year, driven by increases in both development and recurrent expenditure

Domestic annual inflation, as measured by the 12 months moving average, displayed a slowdown in the growth of average prices, from 7.4% in 2011 to 5.9% in 2012. Headline inflation, which detects more recent price changes and is measured by the 3 months moving average, also witnessed a retreat. By December 2012, the 3mma stood at 4.6%. In both measures, this was caused by a slowdown in both domestic and imported inflation components. Furthermore, elevated domestic inflation, however, was the primary driver of higher prices in both measures.

2. International Economic Development

A continued weakening in external demand, coupled with slower global inflation rates as a direct result of a softening in global non-energy commodity prices have been the main international developments over the past 12 months. This, in turn, has attributed to both the containment of domestic inflation in Solomon Islands whilst also dampening economic activity in 2012.

2.1 Global Economic Activity

In January 2013, the International Monetary Fund (IMF) revised estimates showed global growth slowing to a below trend pace of 3.2% in 2012 compared to 3.9% in 2011. Much of the growth was driven mainly by resilience in the emerging and developing economies supported by modest growth in the United States (US).The forecast for global growth in 2013 is 3.5%.

While the recent pick-up in the US economy and robust performance witnessed in the emerging and developing economies generated some positive impact on global growth, the gains were not sufficient to offset the contractions experienced in the euro area and Japan. As a result, the advanced economies and the emerging and developing economies as a whole grew at a slower pace of 1.3% and 5.5%, respectively in 2012.

Latest indicators showed that the US economy expanded at 2.3% in 2012 while the euro area, dragged down by the periphery economies, contracted by 0.4%. The modest growth expansion in US was, by large, supported by improved domestic consumption following a moderate pick-up in employment and better housing market conditions during the second half of the year.

The developing Asian economies remained the main driver within the emerging and developing economies, growing at 6.6%, spurred mainly by China's fortitude of 7.8%. Closer to home, growth estimates for New Zealand and Australia, although positive, remained subdued; New Zealand grew by 2.2% in 2012 while Australia's economy expanded by 3.5% in 2012.

2.2 International commodity prices

Global commodity prices, based on the IMF estimates, indicated a modest decline of 2.6% in 2012 compared to 2011. Excluding energy prices, global commodity prices fell by 9.8% over the same period.

High international food prices continued to persist in spite of a slight decline observed in 2012. This was attributed mainly to short term supply constraints. As indicated by the Food Price Index published by the United Nation's Food and Agriculture Organisation, food prices, although falling by 7%, in 2012 following its historical peak in 2011, have yet to return to those pre-2011 levels.

Similarly, fuel prices remained strong, albeit witnessing a gradual weakening since its record high in March 2012 as the global economic slowdown leads to reduced demand. Over the course of the year, the Tapis oil price, the most relevant fuel price for Solomon Islands, remained high for 2012 averaging US 118 per barrel, decreasing marginally by 1% on 2011 monthly average price.

2.3 Global inflation

According to the IMF January 2013 World Economic Outlook Update, headline inflation in the advanced economies declined from 2.7% in 2011 to a record low of 2.0% in 2012. Following a similar trend, inflation in the emerging and developing economies slowed to 6.1% in 2012 from 7.2%. The decline in global inflation in 2012 largely reflects the drop in non-energy commodity prices.

In terms of Solomon Islands major trading partners, that is, China, Australia, and New Zealand, inflation rates are also expected to remain low. Inflation for China stood at 3.0% on average in 2012 while Australia recorded an inflation rate of 2.0% over the same period, remaining within its target range of 2%-3%. Similarly, average inflation in New Zealand was confirmed at 1.9% in 2012 and also within its target range of 1%-3%.

3. Domestic Economic Developments

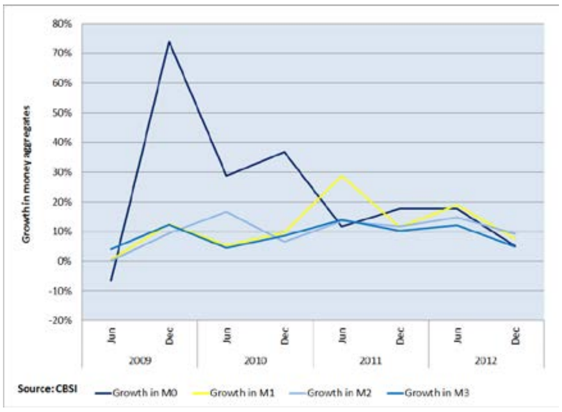
The domestic economy witnessed a slowing down of economic growth and inflation over 2012. Money aggregates continued to expand albeit at a slower rate. The expansion in money supply was fuelled by sustained increases in gross foreign reserves, rising private sector credit, positive employment outcomes, robust growth in government spending, and improved real sector conditions in majority of sectors. This was partially offset by enhanced efforts to curb free liquidity through the issue of larger volumes of central bank bills. The current and capital account balance remained favourable over the year despite deteriorating in the final quarter. Government recorded a budget surplus of $59 million in 2012.

3.1 Monetary Conditions

Growth in monetary aggregates, although slowing, continued to expand over the second half of 2012. Similar to the first half of the year, growth continues to be driven by improvements in Net Foreign Assets (NFA) of the Central Bank. A slight narrowing in Net Domestic Assets (NDA) of the banking system also explained positive movements in total money supply. In turn, growth in private sector credit and a drawdown in government deposits were behind the improved NDA position. Free liquidity also slowed between June and December, mainly caused by the increase in issued Bokolo bills stock.

Reserve money (M0) continued to increase across the second half of the year albeit at a slower rate. By December 2012, M0 stood at $2,054 million, a 5% increase on the first half of 2012, significantly slower than the 18% expansion exhibited during the first six months of this year (see Figure 3.1.1).

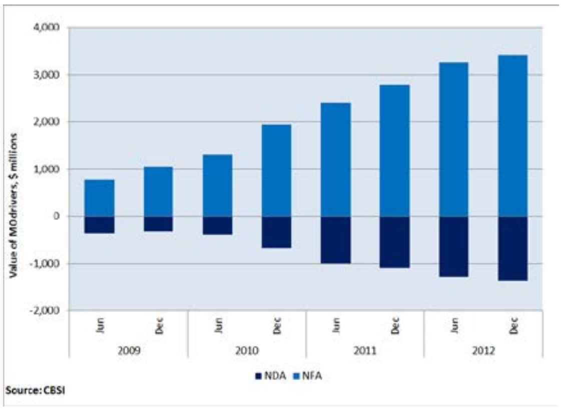
Figure 3.1.1: Growth rates in Monetary Aggregates



Growth continues to be driven by the accumulation of NFA of the Central Bank despite continued increase in the negative position of net domestic assets (NDA) of the Central Bank. The expansion in NFA was attributed to increases in gross foreign reserves over the period, while worsening in NDA originated from the drawdown in government deposits and an increase in capital accounts.

In spite of NFA having expanded at a slower rate of 5% across the second half of 2012 compared to the growth in NDA of 12% over the same period, in value terms, growth in the former outstripped that of the latter, leading to a net increase in M0. As of December 2012, NFA of the Central Bank had increased to $3,486 million whilst NDA of the Central Bank had deteriorated to a minus $1,431 million.

Figure 3.1.2: Drivers of M0

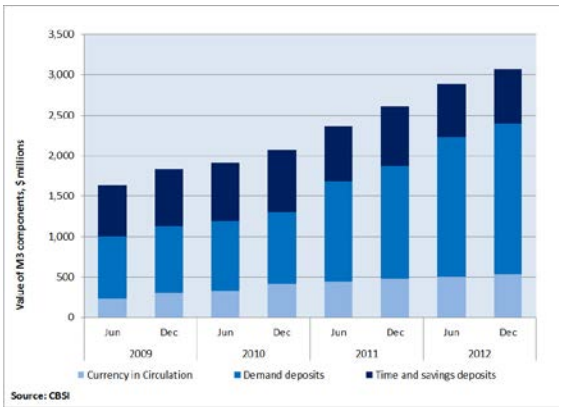


Other money aggregate also experienced growth in the second half of the year (see Figure 3.1.1). Both M1 and M2 expanded but at a slower rate than in the first half. M1 an M2 money aggregates grew by 8% and 9% to reach $2,396 million and $2,484 million respectively.

Broad money supply (M3), which measures the total supply of money in the economy, followed a similar growth path to M0. M3 increased by 5% to $3,065 million as of December 2012, a considerable slowdown from the 12% growth rate exhibited in the first half of the year. The rise in M3 was mainly attributed to 2% expansion in net foreign assets of the banking system. Meanwhile, money supply growth was also supported by a slight narrowing of NDA of the banking system from $427 million to $425 million over the same period. This was mainly driven by a drawdown of government deposits from the banking system together with modest private sector credit growth.

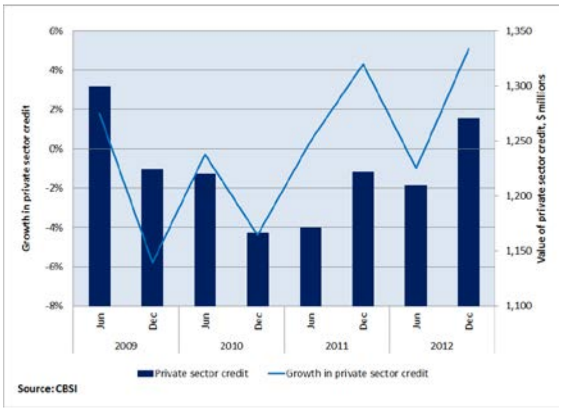
The growth in M3 varied by component. Currency in circulation mirrored a trend akin to that of the first half of 2012, expanding by 6%, while the increase in demand deposits eased from 24% in June 2012 to 5% in December 2012. Growth in other deposits, that is, time and savings deposits, the other component of M3, declined by 4% over the same period, slightly slower than the 5% decline displayed in the first half of 2012.

Figure 3.1.3: Components of M3



From June 2012 to December 2012, private sector credit expanded by 5% to reach $1,271 million with fluctuation over the period (see Figure 3.1.4).

Figure 3.1.4: Private Sector Credit Growth



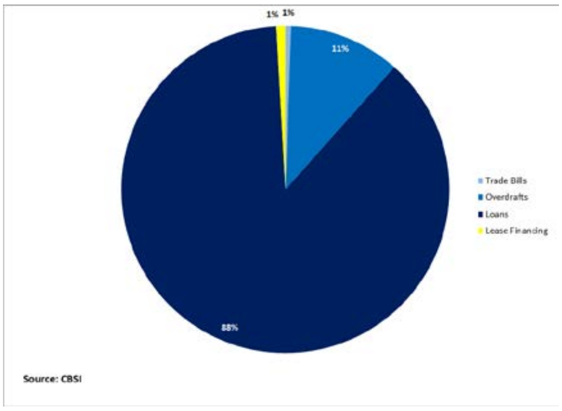
Credit from other depository corporations (ODCs)[2] grew by 8%[3]. Excluding trade bills, a form of very short term credit available mainly to logging exporters, private sector credit had increased by 10%.

[2] ODCs consist of the major commercial banks and Credit Corporation.

[3] This excludes both interest payments and credit unions payments.

Growth in credit was derived primarily from an increase in loans, which grew by 20% from $911 million in June 2012 to reach $1,094 million by December 2012. This was marginally dampened by declines in the other major forms of credit, namely overdrafts, lease financing and trade bills. As of December 2012, loans and overdrafts accounted for 88% and 11% of total private sector credit from ODCs respectively, while lease finance and trade finance accounted for the remainder.

Figure 3.1.5: Private sector credit by credit type, December 2012



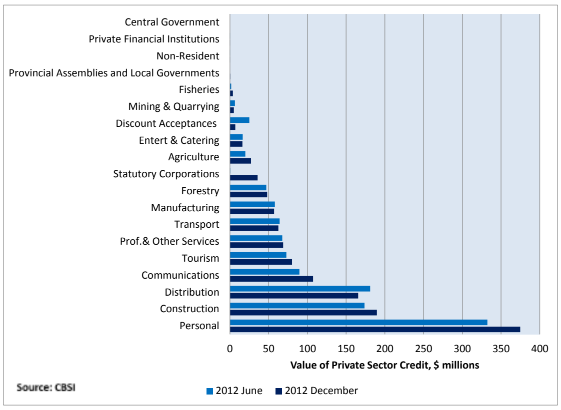
Compared to June 2012, the sectoral profile of private sector credit (see Figure 3.1.6) remained the same for the largest recipients; the personal, distribution, communication and construction sectors continued to dominate, accounting for two thirds of total credit from ODCs in December 2012.

In growth terms, the sector recording the largest increase was the personal sector, which observed a 13% increase in credit (equivalent to $42 million) between June 2012 and December 2012.

Communications, tourism and construction sectors all continued to show robust growth in access to credit while fishing and agriculture benefited both from noteworthy increases; credit in agriculture rose from $20 million to $27 million whilst the fisheries industry witness an expansion from $2 million to $4 million. Conversely, the distribution sector observed the largest decline in credit of 9%, equivalent to $16 million during the second half of 2012. Transport and mining and quarrying sectors also exhibited a reduction in credit, falling by 3% and 21% respectively, although the latter from a relatively small base.

In terms of other trends in credit growth, there was a significant rise in credit attributed to the public sector, namely statutory corporations, which increased from $370,000 to nearly $36 million over the same period. This reflects the 5 year loan from the Bank of the South Pacific (BSP) to Solomon Airlines for the payment of the new Dash 8 aircraft, which commenced in November 2012.

Figure 3.1.6: Credit from ODCs to private and public sectors

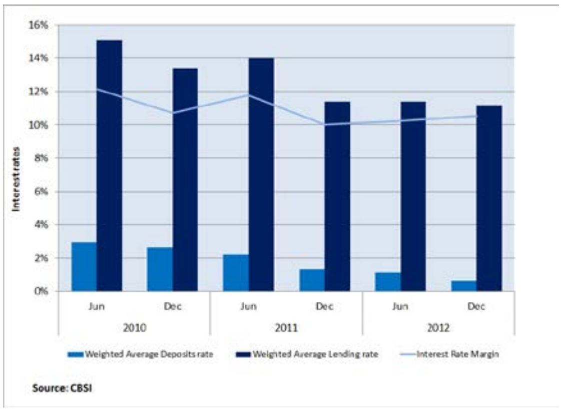


The weighted average lending rate on commercial and personal loans has fallen every month with the exception of October 2012. Over the second half of 2012, the weighted average lending rate declined from 11.4% in June to 11.17% in December, partly explaining the increase in private sector credit growth. The decrease over the period was ascribed to a reduction in lending rates to private financial institutions, mining and quarrying, and communications sectors. The uptick in October, however, was mainly explained by the rising loan rates to the non-residents sector and statutory corporations.

Meanwhile, the weighted average deposit rate continued to decline to 0.65% by the end of the year from 1.13% in June 2012. The fall mainly reflected a significant decline in deposit rates offered on time deposits (see Figure 3.1.5). Between June 2012 and December 2012, commercial banks increased deposit rates for time deposit accounts bearing 1-3 months while reducing rates across all other time deposit accounts.

Overall, due to the marginal increase in average lending rates and decline in deposit rates, the interest rate margin widened from 10.3% at end June to 10.5% at the end of December 2012.

Figure 3.1.7: Weighted Average Deposit and Lending rates

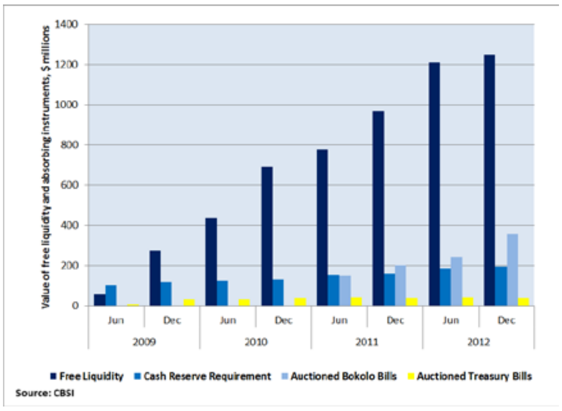


Over the same period, the growth in free liquidity, the Central Bank's measure of excess of cash reserve holdings needed to meet depositors' requirements of withdrawals on demand, decelerated significantly to 3% by December 2012, growing slower than reserve money growth. With cash reserve requirements maintained at 7.5% of total deposit liabilities, the slowdown in the growth of free liquidity from 25% in June was mostly attributed to recent moves by CBSI to increase the floated stock of auctioned Bokolo bills in an attempt to meet existing excess demand. By December 2012, free liquidity stood at $1,251 million.

The floated monthly stock of Bokolo bills increased from $240 million in the first half of the year to reach $500 million by December 2012. Despite the weighted average yield (WAY) offered falling from 0.81% in June 2012 to 0.47% in December (see Figure 3.1.2), stock of Bokolo bills issued over the same period increased from $240 million to $356 million.

CBSI continued to facilitate the auctioning of government Treasury bills on behalf of the Government in 2012[4]. Unlike the trend of the Bokolo bills stock, the cap on Treasury bills remained unchanged at $40 million despite the robust demand. This led to the sustained decline in Treasury bill rates; WAY fell from 1.13%, 1.14%, and 0.9% in June 2012 to 0.36%, 0.34%, and 0.22% in December 2012 for bills with a 56 day, 91 day and 182 day maturities respectively.

Figure 3.1.8: Free Liquidity and Liquidity Absorbing Instruments



[4] Despite treasury bills providing some support in tackling free liquidity, CBSI does not control the volume or interest rate for treasury bills. It merely provides an administrative function. It is, therefore, not a monetary policy instrument of CBSI.

3.2 External Conditions

Balance of payments indicators remained resilient despite weakening in the final quarter of the year. The current account recorded a deficit of $12 million by year end caused by a weakening in goods trade and the primary and secondary income accounts. The capital account balance continued to improve reaching $677 million by the end of 2012. The balance of payments was also supported by revaluation gains. Gross foreign reserves continued to grow together with positive movements in the import cover.

Current and capital account balances

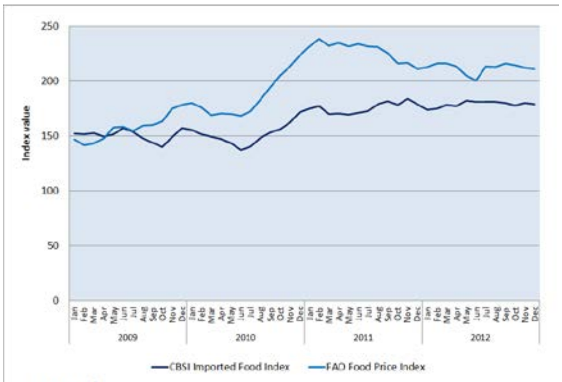
Mirroring the improvements made in 2011, the current and capital account continued to perform well albeit a worsening in the current account in the second half of 2012. Despite earlier surpluses in the year, the current account recorded a deficit of $12 million by the end of 2012. The deterioration was attributed to weaker outcomes in the goods, primary and secondary income accounts during the final quarter of 2012 in spite of continued improvement in the trade in services account. On the contra side, the capital account continued to increase its original surplus of $260 million to reach $677 million by year end, driven by donor aid inflows.

Total imports and import prices

Total imports augmented in value by 20% over the second half of the year compared to the first half. This was equivalent to $1,758 million as of December 2012. Fuel and food imports, the largest components of imports in Solomon Islands, increased by 12% and 32% respectively between June 2012 and December 2012. Fuel imports reached $445 million while food imports stood at $389 million.

After exhibiting a fall in food prices earlier in the ear, the FAO food price index witnessed an increase of 5% in the last six months of 2012. Contrary to this, imported food prices, measured by the CBSI Imported Food Price Index, have marginally declined by 1% over the same period. Rice, which makes up the largest component of the index, observed a decline in prices by 7% between June and December 2012. This was partially offset by price gains in the second largest component, wheat, which increased by 26% over the same period to December 2012.

Figure 3.2.1: FAO Food Price Index and CBSI Imported Food Price Index



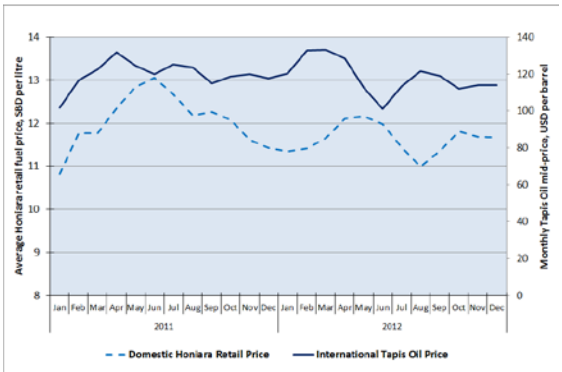
Source: CBSI and FAO

In terms of imported fuel prices, Tapis oil prices were 9% higher by year-end compared to June 2012 and stood at USD 114 per barrel by December 2012. However, the average oil price for the first half of the year was around $123 per barrel whilst only averaging $115 per barrel during the second half of 2012. Furthermore, Tapis oil prices have been falling in the final months of the year partly reversing the surge in prices in the third quarter.

Mirroring the softening in the Tapis oil price in the second half of 2012, average domestic fuel prices in Honiara marginally fell by 2.4%

to $11.49 per litre during the second six months compared to $11.78 per litre in the preceding first six months. The fall reflected marginal declines in the price of diesel and petrol during the period. Similarly, annual comparisons also indicated a moderate decline of 3.60% to $11.64 per litre in 2012 from $12.07 per litre in 2011 driven mainly by fall in diesel, petrol and kerosene prices. However, the Honiara fuel price level despite the weakening is still above the pre-euro crisis price of $9.27 per litre on average in 2010.

Figure 3.2.2: International and domestic fuel prices



Source: CBSI and Bloomberg

This implies that despite the downward price pressures witnessed in the major import components of the country, import payments continued to increase unabated, mainly due to larger import volumes.

Total exports and export prices

The value of exports increased by 1% to reach $1,824 million in the second half of 2012 compared to first half. Together with the first half of the year, total annual exports stood at $3,628 million for 2012. The marginal increase in exports in the second half was a result of significant gains in fish and log product receipts offsetting deterioration in mineral, agricultural, and re-exports receipts.

Downward movements in international prices of the country's major export commodities dampened growth in export receipts. With the exception of gold and cocoa prices, international prices of all major exports commodities observed declines during the second half of the year compared to the first half. The international price of gold has increased 5% from USD 1,599 per ounce in June 2012 to USD 1,685 by December 2012. Similar in magnitude, the international and domestic prices of cocoa increased by 6% on the first half of 2012. Both commodities, however, have experienced a weakening in prices over the final quarter of 2012, dampening earlier price gains made in the previous quarters.

The international price of logs declined 2% across the second half of 2012 to USD 355 per cubic metre, following a 7% decline in the first half of the year. Over the same period, international fish prices, although strengthening in third quarter of 2012, observed a retreat in the final quarter of the year. Hence, international fish prices were 15% lower at the end of the year compared to June 2012.

International prices for palm oil and copra have also significantly deteriorated since the first half of the year with palm oil and copra prices falling by 22% and 26% respectively between June and December. Domestic copra prices followed suit, falling by 32% by the end of the second half of the year.

As a result of weakening prices in export commodities and rising volumes in imports, particularly in the final quarter, the trade in goods balance witnessed deterioration from a surplus in the trade in goods balance of $313 million in the first half of the year to a surplus of $33 million in the second half of 2012. This reversed the trend of recent years, which exhibited an improvement to the trade in goods balance in the second half of the year.

In the final month of the year, the trade in goods balance recorded a trade deficit of $1 million in December 2012.

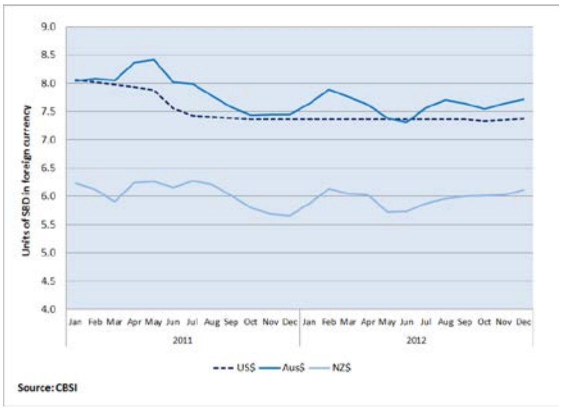
Exchange rates

As discussed in the October 2012 Monetary Policy Statement, CBSI announced a change in exchange rate policy. As of 1st October 2012, the exchange rate moved from pegging the local currency from the USD to an invoice-weighted basket of currencies. The change in policy was founded upon the precept of price stability by allowing greater flexibility to absorb global commodity price movements. However, in order to prevent large fluctuations in the exchange rate, thereby protecting exporters and gross foreign reserves from large movements, CBSI has capped the exchange rate to move only within a ±1% margin around the base rate.

The new invoice basket still places the greatest importance on the US Dollar (USD), which accounts for 58% of the total weight. The AUD constitutes the second largest weighting at 32%. The remaining weightings comprise of the New Zealand Dollar (NZD) at 5%, the Japanese Yen (JPY) at 3% and the Pound Sterling (GBP) at 2%.

As a direct result of this action, the SBD observed an initial appreciation in subsequent months from the previous fixed rate of 7.36 SBD per USD. By December 2012, the SBD remained stable having only depreciated by 0.1% compared to June 2012[5]. Against other major trading partner currencies[6], the SBD significantly depreciated against both the AUD and the NZD falling by 5.6% and 6.7% respectively over the second half of the year. Both the AUD and NZD observed similar exchange rate movements to that of the USD since the change in exchange rate policy.

Figure 3.2.3: Monthly exchange rates of major trading partners



Effective exchange rates measure a currency against a basket of its major trading partner currencies and indicate a country's relative competitiveness against their trading partners[7]. The Solomon Islands' nominal effective exchange rate (NEER), a trade-weighted exchange rate, observed depreciation of 2% between June 2012 and December 2012. This reflected the movement of the SBD against the basket of currencies, in particular the USD and the AUD, the two main invoicing currencies in trade. Meanwhile, the real effective exchange rate (REER), which adjusts the NEER with inflation, witnessed a depreciation of 5% against the tradable currencies over the same period. This suggests that Solomon Islands exports were more competitive in the second half of 2012 compared to the first half of the year.

Reserves

Gross foreign reserves continued to strengthen over the second half of the year

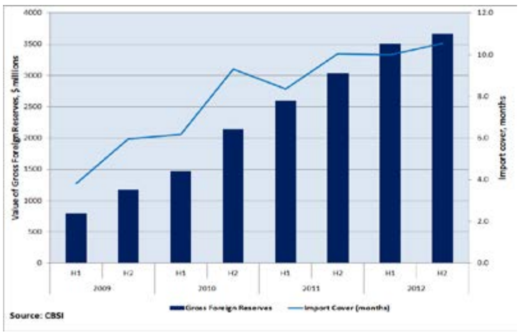
[5] Monthly exchange rates are estimated as an average of daily exchange rates.
[6] Major trading partners as defined by the list comprising of the invoice-weighted basket.
[7] Baseline year =2005

reaching $3,668 million by December 2012, a 4% rise on June 2012 levels. This was on the back of a 16% rise observed in the first half of the year. Despite inflows decreasing by 56% from June to December and outflows increasing by 30%, growth in reserves was attributed to inflows of donor capital grants, export and services receipts particularly from fishing revenues and income on reserve assets.

However, the final quarter of the year saw reserves come under pressure, as net reserve flows posted a deficit of $45 million from a surplus of $98 million in the third quarter. This originated from declining trade-related inflows accompanied by a rise in outflows associated with trade and dividend repatriation payments, and government debt servicing. A positive outcome for the second half of 2012 was observed primarily owing to a foreign exchange revaluation gain, which alleviated the deterioration in reserves flows.

As a result of the above, the level of reserves as of December 2012 was equivalent to 10.5 months of import of goods and services, a slight improvement from the 10.0 months of import cover observed in June 2012. Excluding IMF and donor inflows, the import cover remains robust at 10.1 months, providing a comfortable buffer to facilitate trade for Solomon Islands, a country heavily dependent on imports.

Figure 3.2.4: Gross Foreign Reserves and Import Cover



3.3 Domestic Conditions

The economy continued to expand in 2012 by 4.8% in real terms. Earlier MPS estimates for real GDP of 4.4% was revised upward following stronger performances in non-agricultural sectors.

Real GDP growth was supported by including sustained growth in tourism, manufacturing, construction, retail and wholesale, and utilities as well as rising employment, which reflected positive developments in other sectors of the economy together with increased donor and Government expenditure.

Production of major export commodities

In spite of the CBSI production index increasing by 5% between June and December, production in all major export commodities, declined across the second half of the year against first half of 2012 with the exception of fish and log production that grew by 54% and 2% respectively. As a result, the annual production index contracted by 3% to 116.

Copra and cocoa production were weaker than expected in the second half of the year. Copra production fell 25% to 10,925 metric tons across the second half of the year, continuing the declining trend witnessed during the first half of 2011. Declining production came on the back of weakening international prices along with more copra farmers shifting to coconut oil processing during the year. Cocoa production also declined by 15% to 2,225 metric tons over the same period, ending the year with a 25% decline to 4,838 metric tons.

Across the second half of the year, all palm products also contracted with palm oil and palm kernel oil falling 3% to 15,665 metric tons and 9% to 1,612 metric tons respectively against first half of 2012 owing to weakening international prices. Mineral production, notably gold also fell considerably by 32% to 27,488 tons during the second half of the year against the first. However, on annual basis gold production rose significantly to 67,819 ounces (oz) in 2012 from 51,054 oz year before.

Employment

As in the first half of the year, labour market conditions continued to improve in the second half of 2012. Employment indicators, based on National Provident Fund (NPF) contributors[8], showed modest growth in the labour market, adding an estimated 3% to reach 47,740 workers at end of 2012 from 46,342 workers at end June 2012. This emanated from relatively high levels of public sector-related construction activity, notably donor funded public projects and firm labour demand in the primary industry and public health sector. Increases in public sector and private sector recruitment along with high expenditure on government payroll also helped to explain the improved labour market conditions.

In line with the positive development in both the public and private sectors, the CBSI Vacancy Survey indicated a further expansion of 18% to 843 vacancies across the second half of 2012, following the 25% vacancy increase in the preceding first six months. The acceleration stemmed from increase in public sector vacancies, non-government Organisation (NGO) vacancies and private sector vacancies, notably primary industries, tourism, housing, transport and communication sectors.

Tourism

The tourism industry, as indicated by the visitor arrivals in the country, rose by 13% to 13,097 visitors in the second six months of 2012, following the 14% rise in the previous first six months. This resulted to end year visitors' arrivals rising by 8%, driven mainly by surge in participants attending the Festival of the Pacific Arts (FOPA) in July, along with the Royal Visit, which promoted Solomon Islands internationally. The ongoing infrastructure developments also helped improved the tourism industry.

Manufacturing

Manufacturing output, as measured by the CBSI manufacturing index, rose by 8% to 202 points in the second half of 2012, extending the 14% growth in the first half of the year. The upward trend reflected strong demand for locally manufactured goods such as food, drinks, alcohol and tobacco as well as manufactured export items, notably processed canned tuna fish. New foreign direct investment (FDI) applications to the manufacturing sector also indicated an increase with 4 applications noted in the second half of the year from 3 applications in the first half of 2012. This resulted to year end applications to the manufacturing sector rising by 4% against 2011 levels.

Electricity

Electricity production during the second half of the year recorded 38617 Megawatt hours (MWh), an upturn of 5% against the previous first six months of 2012. On the other hand,

[8] Defined as the total of active and slow active contributors.

electricity consumption fell by 7% to 26,635 Mwh over the same period, mirroring the annual decline. The decline was mainly driven by fall in domestic consumption falling by 31%, other consumption 10% and commercial/industrial consumption down by 3% which more than offset the 10% rise in government consumption.

Retail and Wholesale

Trading activity in the retail and wholesale sectors, as measured by food, beverages, and tobacco imports remained strong in the second half of the year. Total imports for food, beverages, and tobacco over the period, increased by 26% compared to the first half of 2012. The rise in food import values more than offset the slowdown in beverage and tobacco imports to observe an overall increase.

Other measures of activity in the sector witnessed a slowdown. Total stock of credit to the retail and wholesale sectors declined by 9% to $166 million by end of December 2012 from $181 million at the end of June. The decline in credit reflected a 7% drop in short-term lending for wholesale and retail. Furthermore, foreign investment applications to retail and whole sale sector also registered an 11% decline to 16 applications during the second half of 2012 against the first half of the year.

Foreign Direct Investment

New FDI applications in the second half of the year declined considerably, falling by 30% to 69 applications from that of 99 applications in the first half of 2012. In value terms, FDI was significantly higher, worth $631 million, more than that of $179 million recorded in the first half of the year. On an annual basis, FDI applications rose 7% to 168 applications in 2012. Investment applications in other services remained the largest recipient with a share of 30%, followed by wholesale and retail accounting for 20% and forestry applications totalling 17% of total applications.

Construction

Imports of basic manufactures, a proxy for the inputs needed for construction, grew by 20% in the second half of 2012 following a decline of 21% drop in the first half. Other measures for the industry were also looking positive; building permits increased to 55 permits (worth $44 million) throughout the second half of 2012, extending the 49 permits issued in the first half. The upturn follows an increase in the number of permits issued for commercial and industrial related activities.

3.4 Fiscal conditions

By the end of 2012, preliminary figures showed the Government recorded a budget surplus of $59 million and a corresponding recurrent surplus of $353 million. However, the government would record a budget deficit if budget support from donors is excluded. Furthermore, government expenditure, as a driver for increases in aggregate demand and therefore inflationary pressure, observed an increase in both recurrent expenditure and development expenditure during the second half of 2012. Development spending, in particular, doubled over the same period propelled by the completion of SIG funded development projects and a significant increase in donor funded development expenditure.

Recurrent expenditure, including budgetary support, rose to $1175 million across the second half of 2012, an increase of 14%

against the first half of the year. The upturn reflected increased spending on payroll, budgetary support and debt servicing.

Payroll spending throughout the second half of the year rose 6% to $358 million from $338 million in the first half of 2012. This reflected rising wages and salaries of government employees and increased recruitment during the period. Budgetary support spending also increased significantly to $171 million across the second half of the year, an upturn of $94 million from $77 million in the first half. The large increase was driven by increased spending on grants and capital expenditure, mainly within the health and education sectors.

Development expenditure almost doubled during the second half of 2012 from $214 million in June 2012 to $462 million in December 2012. Donor funded development spending increased by $82 million to reach $95 million while SIG funded development spending rose by $166 million to stand at $368 million. Similar to previous years, the surge in both SIG funded and donor funded development spending the latter half of 2012 can be attributed to the utilisation of allocated funds before year end as well as lower spending in the first half as ministries await for the passing of the annual budget.

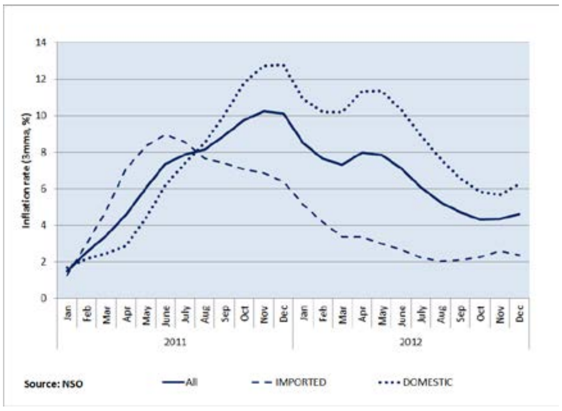
Similarly, debt servicing across the second six months of the year rose 8% to $79 million from $73 million in the first six months of 2012, which in turn, stemmed from increases in government advance payment to reduce the stock of restructured bonds in the banking system.

3.5 Inflation

Since the last MPC meeting in October, headline inflation, measured by a 3 months moving average (3mma) and has the ability to detect current price pressures, has continued to ease (see Figure 3.5.1). In August, headline inflation stood at 5.3%, slowing to 4.6% by December despite the slight uptick over the final quarter of the year. The slowdown exhibited during the second half of the year was mainly driven by deceleration in domestic inflation from 7.3% in August to 6.3% in December. Imported inflation, although witnessing a slight pickup from 2.0% to 2.4% in the same period, remained relatively low, helping to offset domestic inflation.

The lower imported inflation over the second six months of the year was largely driven by declining prices for imported items including food, drinks and tobacco and transport and communication services. Similarly, the reduced domestic inflation across the second half stemmed from lower domestic prices for food, notably rice and flour, drinks and tobacco, clothing and footwear, housing and utilities, and household operations.

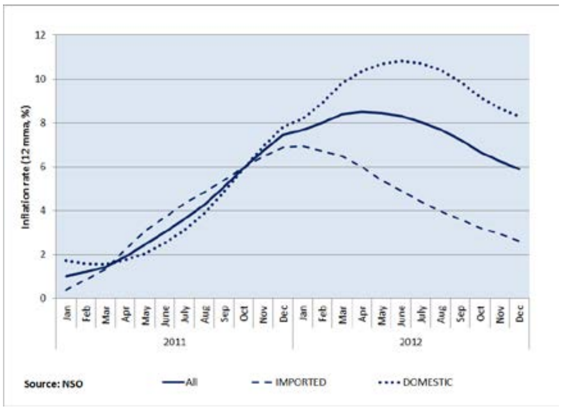
Figure 3.5.1: Headline Inflation (3mma)



The annual inflation rate, measured by the 12 months moving average (12mma) that takes account of and adjusts temporary price shocks, has also slowed from 7.4% in 2011 to 5.9% in 2012, reflecting the retreat in both domestic and imported inflation that occurred in the second half of the year. Imported inflation slowed mainly due to declining prices in transport and communications whilst domestic inflation decelerated on the back of slower growth in food prices and a levelling off in transport and communication prices. However, domestic inflation continued to be elevated by stubbornly fast growth in housing and utility prices.

The 12mma measure remains within the inflation range of 5%-7% that was forecasted in the October 2012 MPS statement.

Figure 3.5.2: Annual Inflation (12mma)



4. Outlook for 2013

Tables 1 and 2 provide a summary of the key monetary and credit aggregates together with macroeconomic indicators that help us to assess the outlook for the economy in 2013 and the likely impact on inflation.

International economic conditions are cautiously set to improve. Based on the presuppositions that the US concludes an agreement of a medium-term fiscal consolidation and an improvement in the financial conditions in the euro area, the IMF forecasts global growth to marginally increase by 3.5% in 2013, albeit a downward revision from its previous forecast of 3.9%. In the absence of these restorative policy interventions, the forecasted growth outcome for the global economy is likely to lower.

Emerging and developing economies are projected to continue to drive the global economy's expansion. Emerging Asian economies are forecast to lead the way, growing by 7.1% in 2013. Similarly, the Asia-Pacific region is set to recover to 7.9% in 2013 driven by domestic demand.

In contrast to this, advanced economies are forecast to have another disappointing year of growth ahead; growth is anticipated at 1.4% in 2013, a similar pace to that of 2012. More specifically, growth projections for US in 2013 will remain cautiously subdued at 2.0% amidst the impending threat of the fiscal cliff to economic recovery. Furthermore, the euro area is set to contract by 0.2% as low confidence and problems in the financial sector continue to loom.

In terms of the country's main trading partners, China is expected to pick up in 2013, growing by 8.2% in 2013 on the back of continued macroeconomic policy easing, improved confidence and solid domestic consumption. Closer to home, growth estimates for New Zealand and Australia, although positive, remained subdued. New Zealand is projected to observe an expansion of 3.0% in 2013. Australia's economy is expected to slow to 2.8% in 2013 as the boom in the mining industry diminishes.

Global commodity prices based on IMF estimates indicated energy prices rising by a marginal increase of 1% in 2012 but expected to decline by 5.1% in 2013. Excluding energy prices, global commodity prices are expected to continue declining by 3% in 2013. The IMF anticipates a moderation in prices of key food crops predicated on assumption that there are no major additional disruptions to supply. However, the first months of 2013 have seen an uptick in oil prices and major food import prices in rice and wheat alert to some caution although this is expected to be temporary.

Global inflation is expected to continue falling in 2013 on the back of lower commodity prices. According to the IMF's January 2013 World Economic Outlook Update, headline inflation in the advanced economies declined from 2.7% in 2011 to a record low of 2.0% in 2012. Following a similar trend, inflation in the emerging economies and developing economies slowed to 6.1% in 2012 from 7.2%.

Closer to home, China is forecasted to exhibit similar inflation estimates as 2012 at 3% while Australia's average inflation is estimated to rise from 2.0% in 2012 to 2.6% in 2013. Similarly, average inflation in New Zealand is estimated to slightly increase from 1.9% in 2012 to 2.4% in 2013.

However, persistent elevation of global food and fuel prices may pose an upside risk to the global inflation outlook whilst weaker global demand is likely to provide an offsetting effect.

In the domestic economy, **economic growth** is anticipated to drop from 4.8% in 2012 to 4.0% in 2013. It should be noted that as the logging sector continues to level off and gold production is forecast to decline, the composition of growth has shifted. Expansion in the economy for 2013 is expected from another strong performance in the fishing industry reflecting increased productivity in the sector. Growth will also be attributed to the communications sector from the anticipated construction of new telecommunication towers by both BeMobile and Telekom. Agricultural commodities are also forecast to generate a more robust outturn in 2013 reflecting continued success in palm oil and a better year for cocoa and copra production, subject to favourable climatic conditions. Prospects for the manufacturing industry are also looking promising for 2013.

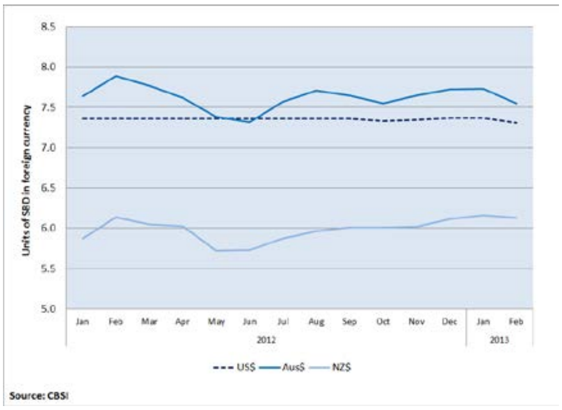
Money aggregates will expand in line with growth in the economy albeit at a slower rate. A more restrained growth in gross foreign reserves will bolster growth in the monetary base. However, this will be partially offset by the new level of Bokolo Bills averaging $500 million per month in 2013 compared to $328 million in 2012. As a result, free liquidity is expected to slightly contract this year.

Furthermore, there is a potential upside risk as private sector credit is forecast to increase by 8% in 2013, in line with growth in the economy. However, although this is key source of growth in M3, forecasts for broad money growth seem more subdued than previous years, suggesting this is unlikely to be a major source of inflationary pressure if forecasts materialise.

The balance of payments is anticipated to deteriorate on the back of a worsening trade balance, weakening in the primary account and decline in the capital account. A current account deficit is projected as export receipts slow amidst lower gold production and lower prices for copra and palm oil. The primary account is anticipated to observe a significant increase in the outflow of dividend payments. As a result, the current and capital account balance is forecast to produce a "net lending" balance of $215 million. However, gross foreign reserves are expected to further accumulate over the year improving the import cover to 11.9 months in 2013.

Latest monthly nominal **exchange rates** have recorded a slight appreciation in the SBD compared to both the USD and AUD whilst observing no substantial change in the NZD. Between December 2012 and February 2013, the SBD has appreciated by 1% to 7.31 SBD per USD and by 2% to 7.55 SBD per AUD (see graph below). Assuming all other factors are constant, import prices become cheaper leading to an easing in inflationary pressure from imported goods but upward price pressures from increased demand. Furthermore, all other things being equal and exporters being price takers, export receipts are also likely to fall when converted into national currency with the likely effect of dampening the domestic demand from lower earnings. The net impact of a currency appreciation on the trade balance and the wider economy will depend on responsiveness to price changes and the value and volume of goods traded.

Figure 4.1.1: 2013 Nominal Exchange Rates



For 2013, the Government is forecasting a **budget surplus** of $0.7 million of which government expenditure projected to increase by 25% to $3,606 million compared to 2012. This increase in fiscal expenditure is likely to contribute to some upside pressures as this spending is released into the economy. From 2009 to 2012, between 44% and 47% of total government expenditure was disbursed in the first half of the year. This suggests that although historically, less is spent in the first six months of the fiscal year, inflationary pressure is likely to occur from this additional expenditure.

Based on a range of CBSI inflation models, **inflation in Solomon Islands** is estimated to fall within the range of 4% to 6% with imported inflation levelling off from 3% in 2012 to around 2-3% in 2013 while the domestic component looks to retreat from 9% in 2012 to around 7%-8%. This is in line with the World Bank forecasts of a slightly softer outlook for imported commodity prices during the year. However, new proposed tax policies regarding tobacco products are likely to be passed on to the consumer resulting in further upward inflationary pressure.

Upward inflationary pressures are likely to originate from, robust growth in government spending, improved real sector conditions and positive employment outcomes. However, downside price pressures to the outlook for inflation are likely to be attributed to larger volumes of central bank bills curbing free liquidity and any slight appreciation in the local currency.

5.0 Monetary Policy Stance

Given the forecasts in the key monetary and credit aggregates together with the macroeconomic indicators outlined in the previous section, a softening in international commodity prices, particularly in the food and fuel prices, would be a major factor behind inflation remaining within the 5% to 7% for 2013. However, the economy may exhibit upward pressure from the planned rise in public expenditure, foreign direct investment, improved economic growth prospects and positive employment prospects.

The Board endorsed an unchanged monetary policy stance, with the view that if the macroeconomic conditions alter, this stance may need to be altered before the next MPC meeting. In this instance, an unchanged policy stance is defined as no alterations to the current operations of the Central Bank's key monetary policy instruments. These are outlined in the Table 5.1 below. The Central Bank will continue to monitor economic developments in the next six months and remains ready to take remedial action whenever necessary.

Table 5.1: Monetary Policy Instruments

Instrument	Description	Actions taken since previous MPS	Actions proposed for the current MPS
Exchange rate	The Solomon Bokolo Dollar is now linked to a invoice-basket of goods that is free to fluctuate within a ±1% margin	A managed float (within a ±1% margin)	Maintain the managed float (within a ±1% margin)
Open market operations - Bokolo bills	Bokolo bills are Central Bank backed securities denominated in Solomon Island Dollars with a 28 day maturity.	The monthly stock has increased from $320 million in October to $500 million in December, resulting in a monthly average floated stock of $328 million over 2012.	Maintain the floated stock at $500 million per month.
Cash Reserve Requirement	The Cash Reserve Requirement is set as an amount determinable by multiplying the average level of deposit liabilities for the previous maintenance period by the reserve ratio. Operationally, the average level of deposit liabilities shall be calculated by averaging the stated deposit liabilities in each Weekly Statement of Assets and Liabilities received in the previous maintenance period. The CBSI shall establish the reserve ratio applicable to deposit liabilities.	The Cash Reserve Requirement remained at 7.5%	Maintain the Cash Reserve Requirement at 7.5%