



# MONETARY POLICY STATEMENT

October 2010

**CENTRAL BANK OF SOLOMON ISLANDS**

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# 1. Financial Market Conditions

## 1.1. International Developments

2010 has seen the continuation of global economic recovery. Nevertheless, volatility in financial and currency markets has been evident across 2010.

Credit growth is rising again in many emerging countries. In advanced economies, bank lending has not seen a tightening. Due to continued economic uncertainty, however, banking systems are still vulnerable to confidence shocks.

Of concern in the last Monetary Policy Statement was the debt crisis suffered by Greece in the second quarter of 2010 and the threat that such a crisis posed to global economic stability. Following the announcement of a support package by the European Union and the International Monetary Fund, such fears have been eased although there still remains concerns regarding how some European governments will respond to sovereign vulnerabilities alongside actions to support economic growth.

## 1.2. Foreign Exchange Market

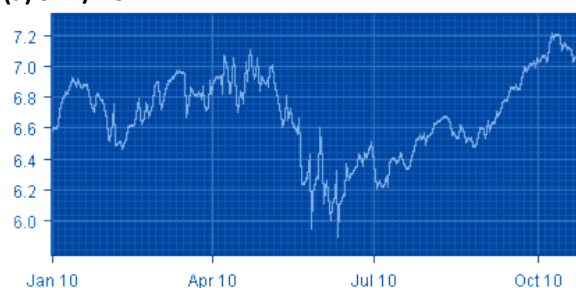
During 2010, a weakening of the U.S. dollar against other major currencies has been witnessed although its value has varied greatly over this period.

Volatility in the value of the Australian dollar was witnessed in 2010. Despite it being weakened in the second quarter of

2010, overall, the Australian dollar has strengthened against the Solomon Island dollar since mid 2010 (figure 1.1(a)).

**Figure 1.1: Exchange Rates against SBD\$\***

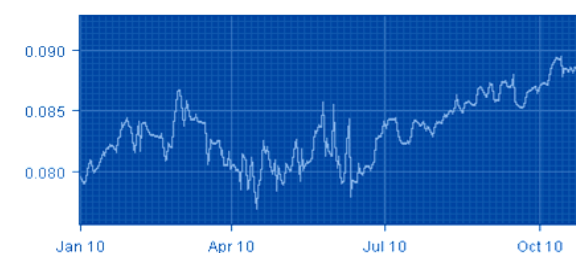
**(a) SBD/AUD**



**(b) SBD/EUR**



**(c) SBD/JPY**



**(d) SBD/NZD**



\*OANDA bid rates

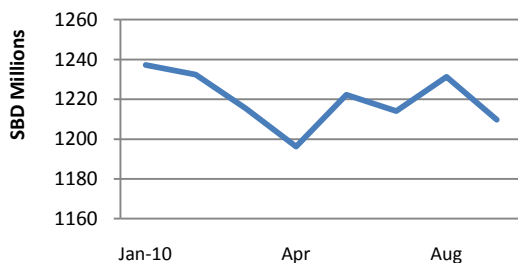
Source: The Economist

The position of the Solomon Island dollar against the Euro strengthened in early 2010 but since the second quarter its position against the Euro has weakened (figure 1.1 (b)). During 2010, the position of the Solomon Island dollar against the Japanese Yen has weakened (figure 1.1(c)). Against the New Zealand dollar, overall, across 2010 the position of the Solomon Island dollar has weakened but by only a marginal amount (figure 1.1(d)).

### 1.3. Domestic Developments

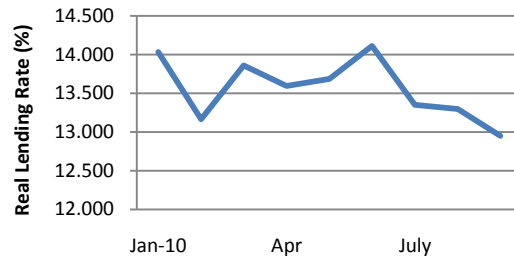
Of greatest concern in the previous Monetary Policy Statement was the fall in the growth rate in credit and in particular the fall in private sector credit witnessed in the last half of 2009. Credit to the private sector, overall, has declined during 2010 although the quantity of credit supplied to the private sector on a monthly basis has varied greatly over the period, with a dip in credit extended during the second quarter (figure 1.2). This has been in spite of falling real lending rates across 2010 (figure 1.3).

**Figure 1.2: Credit to Private Sector**



Source: CBSI

**Figure 1.3: Real Lending Rates**



Source: CBSI

Total domestic credit has fallen by 4 percent to \$1117.4 million since the end of the first quarter. This reflects the overall falls in credit to the private sector and to the Government over the same period. Net credit to Government also, however, saw some volatility with a rise in the second quarter of 2010 and then a decline in July and August.

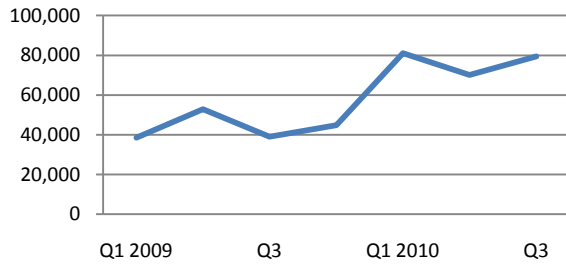
Risk aversion in the banking sector as estimated by average leverage ratios shows continued uncertainty in the banking sector. Average leverage ratios<sup>1</sup> rose by 14 percent from 2009 to 2010 perhaps indicating reduced risk aversion by commercial banks. However, between the first and second quarters of 2010, leverage ratios have fallen by 3 percent perhaps reflecting continued uncertainty in the banking sector.

Overall, the fall in credit to the private sector may represent a lack of demand for credit from the private sector indicating low consumer confidence but is most probably more attributable to an unwillingness to supply credit on behalf of the banking sector amid continued economic uncertainty in global and domestic markets.

<sup>1</sup> CBSI figures – equity to average assets

The number of non-performing loans has continued to increase in 2010, although at a slower pace than seen in 2009 (figure 1.4).

**Figure 1.4: Non-Performing Loans\***

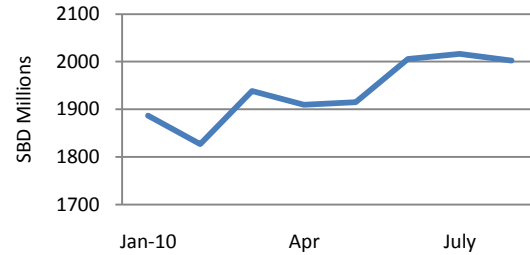


Source: CBSI  
\*90+ day arrears

Reserve money (M0) increased by 44 percent across the second and third quarters of 2010 to \$1127 million. This increase in M0 has translated into large increases in free liquidity in the market which has increased by 99 percent over the same period. Despite this significant increase in liquidity, increases in private credit have been subdued.

The supply of money in the economy as measured by broad money (M3) has increased by 3.3 percent since the end of the first quarter (figure 1.5).

**Figure 1.5: Broad Money (M3)**



Source: CBSI

## 2. International Economic Developments

Global economic recovery has continued to strengthen in the second and third quarters of 2010. According to IMF figures, global activity is forecast to expand by 4.8 percent in 2010 and 4.2 percent in 2011. Advanced economies, worst hit by the recession have seen growth reach 3.2 percent during the first half of 2010 due to low consumer confidence and reduced incomes and wealth restraining spending. Emerging economies in contrast have seen strong household spending and growth of 8 percent.

Recovery has continued in the U.S. although unemployment remains high and consumer confidence remains low. Output is expected to increase by 2.6 percent in 2010 and then 2.3 percent in 2011.

Economic growth in the trading partners of the Solomon Islands has continued.

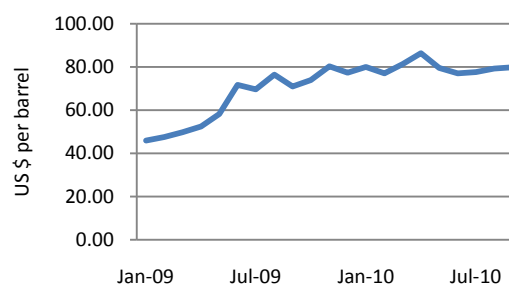
Economic activity in Australia has remained robust during 2010. Consumer and business confidence remains high and should lead to continued growth in economic activity. In China, following major fiscal stimulus and a large expansion of credit, continued growth in economic activity is expected. According to IMF figures economic output in China is expected to increase by 10.5 percent in 2010 and 9.6 percent in 2011.

The collapse in growth during 2009 proved a powerful disinflationary force and across 2010 inflation rates have remained low.

Core inflation in advanced economies has remained at low levels due to weak domestic demand, excess capacity and continued high unemployment. Emerging economies, less affected by the financial crisis, are operating at closer to full capacity and have therefore seen greater inflationary pressure, most notably in India and China. Australia expects inflation to be slightly above 3 percent over 2010, notably higher than other advanced economies.

Commodity prices have rebounded strongly since the economic crash and have continued to do so in 2010. Increased demand from China alongside significant production cuts (oil) and weather related factors restricting supply of some agricultural commodities has led to higher prices. Oil prices have been rising steadily since the beginning of 2009 (figure 2.1).

**Figure 2.1: Tapis Oil Spot Price**



Source: Energy Information Administration

### 3. Domestic Economic Conditions

#### 3.1. External Sector

The Solomon Islands dollar has continued to be pegged against the US dollar.

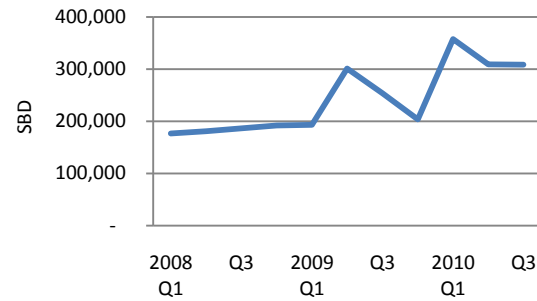
2009 saw a rapid increase in foreign reserves. Since the beginning of 2010, reserves have continued to increase although at a slower rate than seen in 2009. Reserves now stand at SBD\$1.7 billion, an increase of 37 percent since the beginning of the year. The reserves now stand at 7.4 months of import cover compared to the 6.5 months of import cover seen at the end of the first quarter of 2010.

2010 has seen a continued increase in the trade deficit and the current account deficit. Over the first half of 2010, the trade deficit has increased by 62 percent.

Foreign direct investment has seen an increasing trend since 2008. In 2010, following a peak in foreign direct investment in the first quarter of 2010, investment has remained around the same level across the second and third quarter of 2010 (figure 3.1).

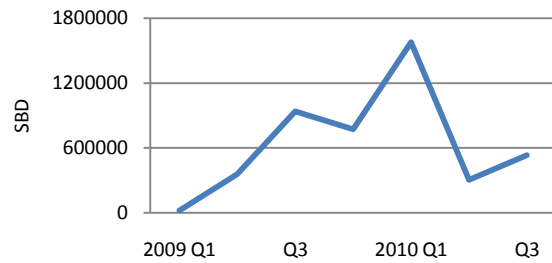
Registration of new foreign companies in Solomon Islands has increased by 75 percent between the second and third quarters of 2010. Overall, however, there has been a 66 percent reduction in the registration of new foreign companies in Solomon Islands since the first quarter of 2010 (figure 3.2).

**Figure 3.1: Foreign Direct Investment**



Source: CBSI

**Figure 3.2: Registration of Foreign Companies**



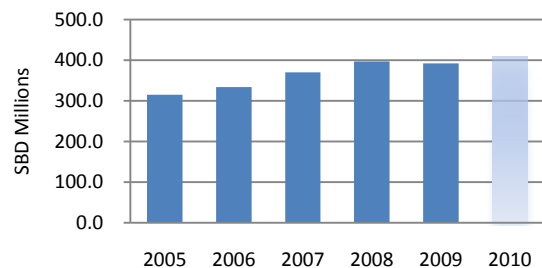
Source: CBSI

#### 3.2. Domestic Output

Following the decline seen in 2009, real GDP is expected to rise by 4 percent by the end of 2010 (figure 3.3).

This increase is driven by rises in the agricultural and forestry industries which represent the largest contributors to GDP in the Solomon Islands.

**Figure 3.3: Real GDP\***

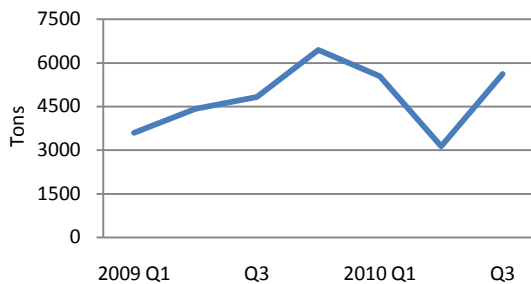


Source: CBSI

\*2010 figure is forecasted figure from CBSI

The third largest contributor to GDP is fishing. Output in this industry is expected to fall by 9 percent by the end of 2010. The second quarter of 2010 saw a fall in the quantities caught: a consequence of a temporary suspension of the cannery. Data for the third quarter of 2010 shows an 80 percent increase in the catch compared to the second quarter. And a slight increase of 1.5 percent compared to the first quarter of 2010 (figure 3.4).

**Figure 3.4: Fish Catch**

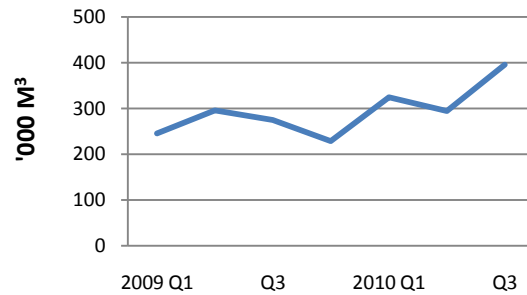


Source: CBSI

Transport and Communication, although still a small contributor to GDP, are expected to increase by 17 percent jointly by the end of 2010 signalling an expansion of these industries (perhaps stemming from the introduction of competition in the telecommunication industry in mid 2010).

Following a decline in 2009, logging production is expected to rise by 13 percent by the end of 2010. Since the end of the first quarter, logging industry output has risen by 22 percent (figure 3.5).

**Figure 3.5: Logging Industry Output**



Source: CBSI

The components driving the rise in the value of the agricultural sector are a 6 percent rise in cocoa production over the last half of 2010. This offsets the declines in production in both the production of palm oil and copra over the last half of the year of 10 percent and 1 percent respectively. In aggregate, the Production Index signals a rise in production of 30 percent over the last half of 2010.

Due to supply shortages in copra, prices are expected to remain high. Prices for cocoa and palm oil are expected to continue rising in the medium term.

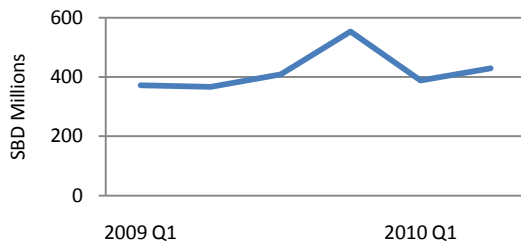
### 3.3. Government Spending

Government spending represents an important part of the Solomon Island economy.

Preliminary figures show that total government expenditure increased by 10 percent across the first and second quarter of 2010 to \$430 million (figure 3.6).



**Figure 3.6: Total Government Expenditure**

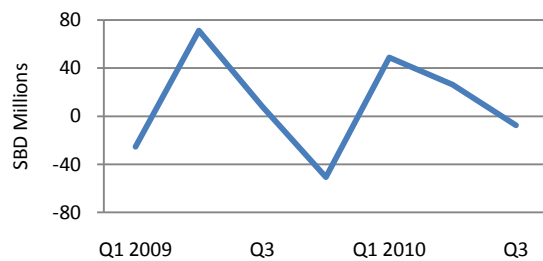


Source: CBSI

Preliminary figures for the fiscal position of the Government at September 2010 show a quarterly deficit of \$7.6 million, a worsening of the fiscal position of the government since the second quarter of 2010 (figure 3.7).

The long-term trend however, has seen a steady improvement of the government fiscal position with a move to an overall surplus in 2009 of \$3.3 million from a \$152.8 million deficit in 2008 reflecting efforts by the Government to increase revenue and contain spending.

**Figure 3.7: Government Fiscal Position (Quarterly)**



Source: CBSI

Recent reductions in spending restrictions in the majority of government ministries in the form of reduced restrictions on essential spending are expected to result in

increased government expenditure in the short-term.

### 3.4. Labour Market Conditions

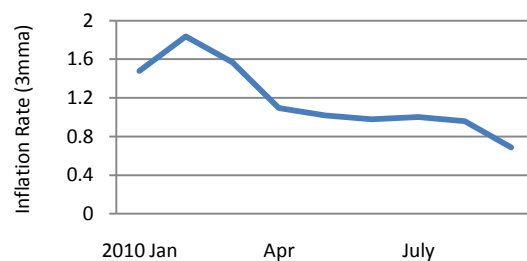
2009 saw an increase in public sector employment of 9 percent against 2008 levels. Figures for 2010 show that the number of posts filled in the public sector are currently below 2009 levels but further increases in numbers are expected so it will remain to be seen whether by the end of 2010 there will be a net increase or decrease in public sector employment.

Data for the third quarter of 2010 showing NPF membership which is currently used as a proxy for employment levels shows an increase of 62 percent in membership rates over the past year. This contrasts to the decline in membership rates seen in 2009.

### 3.5. Prices

At 0.7 percent (3mma) in September 2010, headline inflation as measured by the Honiara Retail Price Index (HRPI) is low and stable. After a slight increase in the first quarter of 2010, headline inflation has maintained a downward trend through the rest of 2010 (figure 3.8).

**Figure 3.8: Headline Inflation**



Source: CBSI

The feeling at the time of the last Monetary Policy Statement was that inflation had reached its lowest point and would start to climb during 2010. The figures for 2010 do not support this belief and the Bank is concerned that the HRPI figures may not be adequately capturing recent developments in prices.

## 4. Macroeconomic Outlook

Global economic recovery has continued through 2010, with economic activity expected to increase by 4.8 percent by the end of 2010 and a slightly lower increase of 4.2 percent in 2011 (IMF figures).

These global economic growth figures are driven by robust economic growth rates forecast for emerging and developing economies rather than the still constrained growth rates predicted for advanced economies. In terms of trading partners for the Solomon Islands, a notable exception from this last group is Australia where increases in economic activity are expected to remain above rates for other advanced economies.

Continued rises in commodity prices are expected in the medium-term due to increased demand from China alongside significant production cuts and weather related factors affecting the supply of many commodities. Prices for copra, cocoa and palm oil are expected to continue rising. Rising oil prices are expected to feed directly through into domestic price increases.

Domestic economic activity is expected to rise by 4 percent by the end of 2010, driven by increases in the domestic agricultural and forestry industries. Increased domestic government spending is expected in the short-term due to the lifting of restrictions on essential spending in the majority of government ministries.

## Monetary Policy Stance

Inflation is currently low and stable and at this point upside risks to inflation are not of immediate concern to the Bank. The Bank projects that in the short term inflation will remain low. Also, the level of reserves is expected to remain at comfortable levels, at least in the short to medium term.

Against this background, the Central Bank of Solomon Islands currently intends to maintain a moderate accommodative monetary position.

There is the realisation, however, that rising commodity prices and rising import costs will represent inflationary pressures in the economy and thus the Bank will be vigilant in monitoring inflationary developments in the economy and stands ready to tighten monetary policy if needed. In particular rapid rises in credit growth and significant changes in the fiscal position will be monitored to determine upside risk to inflation.