CENTRAL BANK OF SOLOMON ISLANDS

MONETARY POLICY STATEMENT

September 2014

Central Bank of Solomon Islands
P. O. Box 634, Honiara, Solomon Islands. Tel: (677) 21791

Table of Contents

List of Figures

Table

1.0 OVERVIEW

Growth for the global economy has been revised downward in 2014, weighed down by the weak first quarter. According to the IMF World Economic Outlook in July, growth forecast for 2014 shaved off 0.3 percentage points to 3.4% from the previous April forecast of 3.7%. However, world output showed recovery in the second quarter supported by renewed domestic demand, fiscal consolidation and accommodative monetary policies in major economies. Projected growth for the euro area is still on course. Growth in the emerging market and developing economies was downgraded but remain high at 4.6%. Capital inflows, stable exchange rates and equity prices are the underpinning drivers behind growth in this region. However, risks remained with negative geopolitical fallouts in Ukraine and the Middle East could impact negatively on oil prices and the global growth.

Initial projections at the beginning of the year as published in the March Monetary Policy Stance (MPS) pointed to a strong year with growth pitched at 3.7%. However, the April flash flood changed the economic landscape of the local economy with growth prospects for 2014 downgraded to 0.9%. Major transport infrastructures in Honiara and Guadalcanal were badly affected causing temporary downtimes to business activities across different sectors and huge revenue losses. The flood provided the final stroke for Gold Ridge Mining Limited, who had already incurred financial losses prior to the flood because of low gold prices, to cease production. This not only created a huge revenue gap for the government and the export sector but also dampened activities in the dependent sectors.

However, quicker than expected recovery in the agriculture sector towards the end of the second quarter, vibrant fisheries sector, robust communication sector and construction activities that was supported by post flood rehabilitation works from the government and development partners, have helped to revive and boost the domestic economy and support the small but positive growth. Even the year to date performance from the logging sector points to a more modest fall year on year than initially anticipated during the March MPS, implying a lesser drag on the economy this year.

Monetary growth slowed down in the six months up to June 2014 as growth in the net foreign assets (NFA) was cushioned by increases in Bokolo bills; cash reserve requirement, and accumulating Government deposits in the financial system. Credit growth also decelerated from the 5% rise in the preceding six months to a marginal increase of 3% to $1506 million. The sectors recording positive growth in lending during the first half of 2014 were communications, distribution, professional and other services, and personal. In correspondence with the movements in the above monetary aggregates, liquidity levels in the financial system was more or less contained in the first half of the year with excess liquidity in June posting a negligible growth of 1% against December 2013 to $977 million. However, recent data in August points to rising liquidity levels due to temporary under subscriptions in the Bokolo bills market.

External sector developments improved relative to the second half of 2013. Gross foreign reserves improved by 6% against December 2013 to $4148 million in June 2014. Much of the increase came from donor inflows that were received for government projects including the post flood rehabilitation projects. The current account balance, though in deficit still, improved from the deficit in the preceding six months and was attributed to surpluses in the BOP primary and secondary income accounts. Total exports in the first six months of 2014 declined by 11% against the preceding six months to $1538 million, around the same level as the first half of 2013. Total imports on the other hand dropped by a lesser fall of 3% against the first half of 2013 to $1653 million. Compared to the preceding six months, imports fell by 2%.

Exchange rate developments up to June 2014 showed the Solomon Islands dollar depreciated against all major currencies except for the AUD and Japanese yen. Against Solomon Islands heavily traded currencies, the SBD appreciated by 0.3% to $6.72 per AUD but weakened against the USD by 0.7% to $7.36. The Central Bank has maintained the peg against the basket of currencies arrangement and continues to monitor developments in the major trading currencies.

Preliminary data showed the Government registered a fiscal deficit in the first half of 2014 in the tune of $153 million. The negative outcome was attributed largely to revenue shocks in the second quarter which caused total revenue to fall against budget by 20% to $1435 million. However, year on year comparisons showed local revenue increased by 6% to $1281 million while recurrent expenditure was up by 23% to $1300 million. Debt sustainability indicators for Solomon Islands remain within comfortable levels as the Government continued to honour its debt obligations in the first half of the year.

Inflationary pressures built up immediately after the flood as a result of domestic supply constraints. This caused the headline inflation to temporarily overshoot CBSI's projected inflation band for 2014 of 4% to 6%. Headline inflation peaked at 7.2% in June and was attributed mainly to domestic factors. Domestic inflation rose quite significantly from 5.7% in December to 12.7% in June. Local food component of the CPI basket was the dominant driver, followed by housing & utilities, transport & communication, and drinks & tobacco. Imported inflation rose negligibly from minus 1.9% in December 2013 to minus 1.7%. Excluding the volatile and regulated items, underlying inflation for Solomon Islands as measured by core inflation remained low at 2.5% in June.

2.0 INTERNATIONAL ECONOMIC DEVELOPMENTS

2.1 Global Economic Growth

Since the March 2014 *Monetary Policy Statement (MPS)*, global economic conditions appear to have strengthened, as the transitory factors that weighed on growth earlier in the year receded. Following the weak first quarter and a less optimistic outlook for several other emerging markets, the International Monetary Fund (IMF) world economic outlook (WEO) in July 2014 downgraded its global growth projections for 2014 by 0.3% to 3.4% from its April forecast of 3.7%. Growth is expected to be supported by a global rebound in output from the second quarter of 2014 as the temporary weaknesses of the first quarter retreated with policies already responding to weaker growth from other larger economies. However, downside risks to the outlook remain. This include heightened geopolitical risks over the Ukraine crisis and Iraq and its impact on oil prices and trade flow, the lack of robust momentum in advanced economies and sluggish growth in the euro zone.

In the advanced economies, growth rebounded in the June quarter with a projection of 1.8% in 2014, down from April's forecast of 2.2% but still above the 1.3% in 2013. Growth in this region continues to be sustained by moderating fiscal consolidation and highly accommodative monetary policy. In the United States (US), the growth momentum built in the second half of 2013 weakened notably in the first quarter of 2014, associated with inclement weather, but growth is expected to pick up going forward. Growth is now projected to rebound to 1.7% in 2014, compared to 2013, aided by solid growth in both manufacturing and services despite the weak residential construction outlook.

In Japan, growth is projected to be higher at 1.6% in 2014 following the strong performance in the economy, in particular consumption and business investment in the March quarter. However, the pace of growth is quite uncertain given the volatility in economic activity witnessed recently in the June quarter. In the euro zone, growth has strengthened modestly to 1.1% in 2014 following the gradual recovery of economic activity in the March quarter. This is slightly below April's forecast of 1.2% as growth remains uneven across the region. In the United Kingdom, economic recovery picked up since mid-2013, with GDP expanding by 3.2% over the year to the June quarter[1].

In emerging market and developing economies growth is now projected to decline to 4.6% in 2014 from 4.7% in 2013. The slight fall was mainly due to weaker than projected growth originating from both weaker demand, notably from the US and China, and softer domestic demand, with frailer investment growth. Nevertheless, growth in this region is driven mainly by the recovery in capital flows, stabilised exchange rates and equity prices. China, Solomon Islands major trading partner strengthened in the June quarter, with GDP rising by 2.0% to an annualised growth of 7.5%. Year-end growth projections for 2014, however, expect it to only reach 7.4%, slightly below April's forecast of 7.5% due to the weak first quarter. Growth is expected to be supported by limited and targeted policy measures that support activity in the second half of the year. Other major emerging market economies including Brazil, Russia and South Africa also marked down growth projections for 2014.

[1] IMF World Economic Outlook, 24 July 2014.

Growth in the East Asia and the Pacific region over the first half of 2014 has slowed from the strong pace since late 2013. Growth in consumption and retail sales has eased across the East Asia region and output has fallen in Thailand amid ongoing political tensions. Closer to home, overall growth of Solomon Islands other trading partners, Australia and New Zealand showed mixed performances. In New Zealand, GDP has grown at an above-average pace over the past year, buoyed by strong growth in exports, domestic demand and reconstruction following the Canterbury earthquakes. In Australia, the Reserve Bank of Australia has downgraded its growth forecast to 2.5% in 2014, down from the previous forecast of 2.7% in May[2] and growth of 3.3% in the March quarter. This followed from subdued growth in export volumes, mining investment, retail sales volumes, consumption and domestic demand during the first quarter. However, growth is expected to strengthen in the third quarter, aided by improved businesses and a spike in retailer confidence.

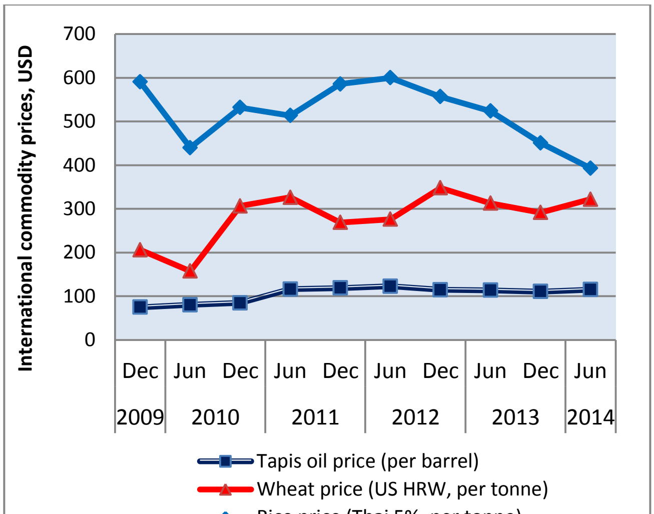
2.2 International Commodity Prices and global inflation

International commodity prices as measured by the World Commodity Price Index (WCPI) will remain at high levels by historical standards, but face downward pressure and great variation across commodities. The WCPI although remained high and unchanged from the previous six months of 2013 declined by 2% in the month of July from the previous month. Drivers of the deceleration came from fuel prices falling by 3% during the month.

International oil prices, indicated by the World Bank's average crude oil price increased a little by 2.5% to US$106 per barrel over the June quarter in response to geopolitical concerns in the Middle East. However, crude oil prices fell in July by 3% to US$105 per barrel from US$108 per barrel in June with year-end projections to reach US$106 per barrel on average. Given the recent developments on global oil demand and supply, oil prices could drift down more than anticipated if the global demand recovery is slower than expected. Conversely, if further disruptions occur on the supply side in Iraq (and surrounding states) or other oil-exporting countries, oil prices may go above the projected level. Consistent with the global oil price, Tapis the main imported fuel for Solomon Islands also increased by 1% to US$116 per barrel in the June quarter from US$114 per barrel in the previous quarter. But in July, Tapis oil price fell noticeably to US$108 per barrel and most recently down further to US$106 per barrel[3] in the first week of September (see Figure 2.2.1).

International agriculture food prices, one of the key components of the international commodity prices, are also expected to decline in 2014 despite the strengthening global demand. Sourced from the Food and Agriculture Organisation's (FAO) price index, international food price index rose to 208 in June from 206 in December, but fell to a six month low to 204 in July. Sharp declines in grains and dairy quotations pushed down the FAO Food Price Index to its lowest level since January 2014[4].

Figure 2.2.1: International prices of major imports of the Solomon Islands



Source:CBSI

More specifically, prices of major imported food types for Solomon Islands, particularly rice and wheat are expected to fall in the rice and wheat prices. Rice prices[5] have fallen since mid-2013 reaching US$393 per ton in the June quarter, down from the first quarter averages of US$443 per ton. More recently in July 2014, rice prices increased to US$422 per ton following the geopolitical tensions around Ukraine and the dry weather in some agricultural producing countries, including the United States and Brazil. However, it is expected that the favourable stocks situation and the expected abundant harvest this year,

[2] Reserve Bank of Australia; http://www.theaustralian.com.au/business/economics/reserve/bank.on 18 August 2014.

[3] Source, Bloomberg

[4] Food and Agriculture Organisation of the United Nations

[5] Thai 5% rice prices, World Bank Commodities price data, 4 August 2014.

for grains, are likely to keep prices below the levels of 2013. Although wheat prices increased in the June quarter to US$322 per ton on average from the declining trend witnessed since June quarter 2013, they have recently fallen in the month of July by 8% to US$280 per ton[6].

Price pressure is rising in many advanced economies outside Europe with inflation expected to rise to 1.6% in 2014 from 1.4% in 2013. In the US, inflation rose from 1.4% in the March quarter to 2.1% in May 2014 on account of higher domestic demand as the recovery gained momentum. Despite higher inflation, the policy stance of central banks in this region remained accommodative with policy interest rates at or near zero. In contrast, inflation in the emerging and developing economies was expected to ease to 5.4% in 2014 from 5.9% in 2013.

For Solomon Islands major trading partner, China, inflation rose by 0.10% to an annualised 2.42% in July. In Australia, inflation rose to 3.0% in the June quarter encroaching on the upper end of the RBA's target range of 2% to 3%. This was mainly driven by stronger tradable inflation, owing in large part to the gradual pass-through of the depreciation of the exchange rate since early 2013[7]. In New Zealand, inflation has been relatively stable with prices rising by 1.6% in the year to June 2014 quarter. Half of the latest annual increase came from housing and household utilities reflecting the higher prices for electricity, housing rentals and newly built houses excluding land.

3.0 DOMESTIC ECONOMIC DEVELOPMENTS

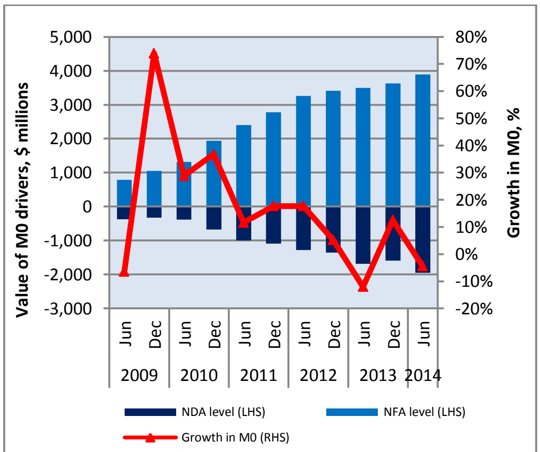
3.1 Monetary Conditions

Monetary growth slowed down in the first half of 2014 compared to the second half of 2013. The slowdown was aided by various factors including sterilisation activities in the Bokolo bills market and accumulating Government deposits in the financial system, which cushioned increases in net foreign assets (NFA). Credit growth during the first half of 2014 also decelerated against December 2013 and was partly due to economic uncertainties arising from the flash flood in April. As a result of the above developments, excess liquidity was contained at the same growth level as in the second half of 2013.

Reserve money

Reserve money in June 2014 declined by 4% against December 2013 to $1943 million, a sharp turnaround from the stronger growth of 13% in the second half of 2013 (see Figure 3.1.1). The negative growth in reserve money against December 2013 was influenced by developments in the CBSI's net domestic assets (NDA), which deteriorated by 23% to minus $1945 million. Meanwhile, CBSI's NFA rose by 7% to $3892 million.

Fig 3.1.1: Drivers of Reserve Money



Source: CBSI

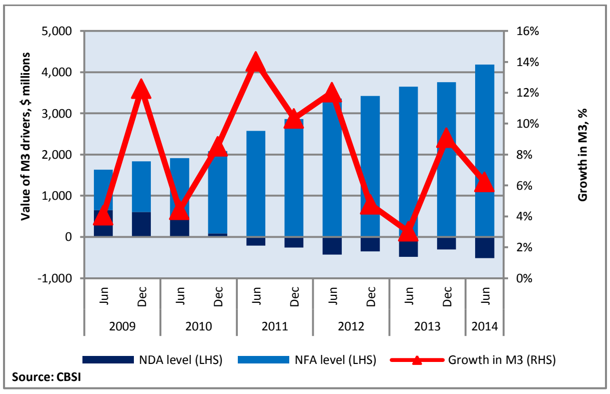
Underlining the deterioration in the CBSI NDA was the persistent build up in government deposits at the CBSI and the additional sterilisation in the Bokolo bills market. Two major components of the NDA, net credit to Government and net credit to other depository corporations, moved by $132 million and $195 million over the six months to June to minus $1317 million and minus $700 million respectively. In terms of the NFA, the substantial influx of donor inflows in the aftermath of the April flash flood was the major reason behind the 7% surge in CBSI NFA. However, the inability of the Government to utilise the donor funds resulted in much of these funds accumulating in the financial system as reflected in CBSI NDA.

Components of reserve money showed mixed movements. Currency in circulation increased just above 1% to $611 million. However, this was outweighed by liabilities CBSI has with other depository corporations which increased by 7% to $1326 million. This comprised of $237 million in cash reserve requirement and other liabilities at $1089 million.

[6] US Hard Red Winter (HRW) wheat prices

[7] Reserve Bank of Australia, Monetary Policy Stance, August 2014.

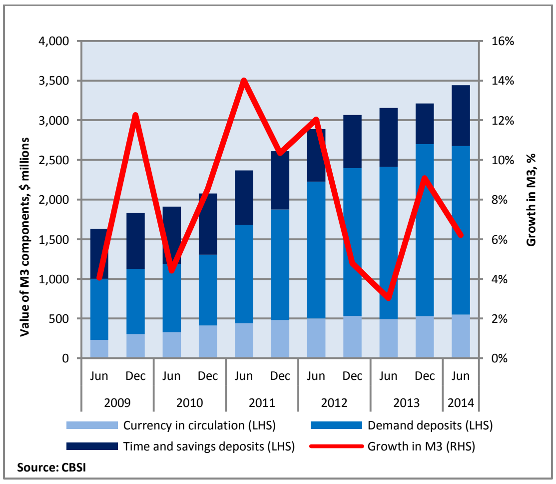
Fig 3.1.2: Drivers of Broad Money (M3)



Source: CBSI

The above developments led to a decelerated half year growth by broad money supply (M3) of 6% across the half year to $3657 million, compared to a much higher growth of 9% in the preceding half year (see Figure 3.1.2). Underlining the 6% growth in M3 were private sector credit that influences movement in the NDA of other depository corporations and influx of donor flows, particularly in the second quarter, and trade inflows. The movements in key M3 components were mixed. Demand deposits fell by 2% to $2128 million over the six months to June. However, the fall in demand deposits was counteracted by currency in circulation and time deposits which increased by 3% and 79% to $548 million and $767 million, respectively (see Figure 3.1.3).

Fig 3.1.3: Components of Broad Money (M3)

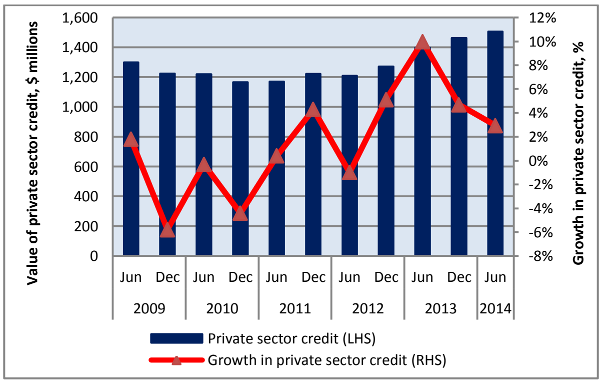


Source: CBSI

Credit Conditions

Credit growth decelerated further in the first half of 2014. Private sector credit as at June 2014 rose 3% or $43 million against December 2013 to $1506 million, following a 5% growth in the preceding six months (see Figure 3.1.4). The slower growth reflected subdued lending activities from other depository corporations in the second quarter which could only account for 15% of the half yearly lending. Comparing to December 2013, total lending from ODCs rose by 2.4% to $1475 million. Loans accounted for the majority of total lending with 87.9% followed by overdrafts with 11.6% and lease financing at 0.5%.

Fig 3.1.4: Private sector credit trends



The sectors that recorded large credit movements in the six months to June were communications with $38 million to $177 million, distribution up $28 million to $240 million, professional & other services rose by $18 million to $85 million, and personal that increased by $10 million $482 million (see Table 3.1.1). On the other hand, sectors whose loan balances recording significant declines were construction with $19 million to $162 million, forestry sector by $18 million to $22 million, and agriculture down by $7 million to $35 million. Under the personal loan, housing loan for residential homes accounted for 54%.

Table 3.1.1: Private sector credit by sectors

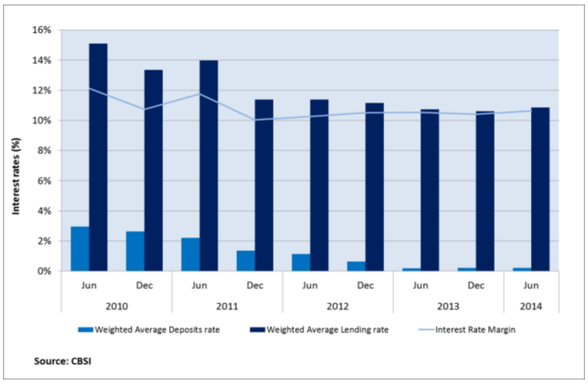
	Jun 2012 $ Millions	Dec 2012 $ Millions	Jun 2013 $ Millions	Dec 2013 $ Millions	Jun 2014 $ Millions	Change over Jun 2013 and Dec 2013 $ millions	Change over Dec 2013 and Jun 2014 $ millions
Personal	332	375	416	472	482	56	10
Distribution	181	166	200	212	240	12	28
Construction	174	190	192	182	162	-10	-19
Communications	90	107	159	140	177	-19	38
Tourism	73	80	74	103	101	30	-2
Professional and Other Se	68	69	68	67	85	-1	18
Transport	64	63	68	72	75	4	3
Manufacturing	58	57	56	54	50	-1	-4
Statutory Corporations	0	36	38	32	31	-6	-1
Agriculture	20	27	33	42	35	9	-7
Forestry	47	48	26	40	22	14	-18
Bills Receivable	25	7	22	4	0	-18	-4
Fisheries	2	4	19	3	4	-16	1
Entertainment and Caterin	17	16	16	12	8	-4	-5
Non-Resident	0	0	0	0	1	0	1
Mining and Quarrying	6	5	0	0	1	0	1
Private Financial Institutio	0	0	0	5	0	5	-5
Provincial Assemblies and	0	0	0	0	0	0	0
Central Government	0	0	0	0	0	0	0

Source: CBSI

Interest rates

Weighted average deposit rates in June 2014 was 0.21% while average lending rates increased marginally by 16 basis points to 10.88% (see Figure 3.1.5). This caused the interest rate margin for the banking industry to rise to 10.67% from 10.62% in December 2013. According to the sectoral weighted average lending rates in June, both communication and statutory corporations' categories recorded the lowest weighted average lending rates at 6.9%. The other categories that recorded single digit lending rates were tourism at 9.1%, 'professional & other services' with 9.7% and construction at 9.8%. All the other sectors recorded double digit weighted lending rates that ranged between 10.3% in distribution and 15.1% in forestry.

Fig 3.1.5: Interest rate trends



In June, the least minimum lending rate charged on any borrower across the different categories was 5.2% in the professional and other services category. Mining and Quarrying recorded the highest rate at 27%. Within the personal sector, the lending rates charged in June ranged between 7.4% and 26.4%.

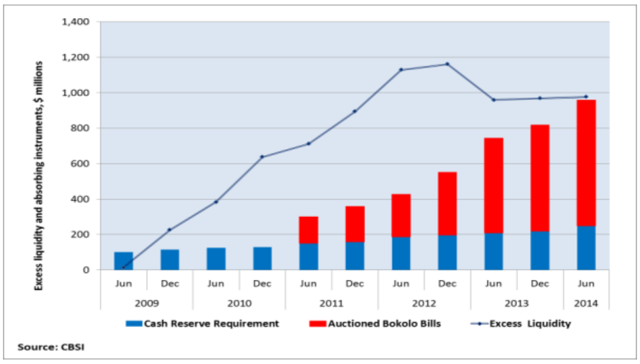
Liquidity

Liquidity in the financial system rose by 1% over the first half of 2014 to $1078 million and was consistent with trends in the NFA, which were directly related to post flood rehabilitation assistance from development partners. As a result, excess liquidity grew insignificantly at the same pace of 1% to $977 million. The growth was sterilised in part by the Bokolo bills coupled with the persistent accumulation of SIG deposits. The latest data in August showed excess liquidity temporarily jumped up due to under subscriptions in the Bokolo bills market but that was reversed in September.

Bokolo bills

The level of Bokolo bills issued was ramped up in the first quarter of 2014 to $710 million from $600 million in December 2013 and remained there in line with the CBSI monetary policy statement in March. Over those six months, Bokolo bills weighted interest rate rose from 0.56% in December 2013 to 0.60% in June 2014. The cap on SIG backed Treasury bills remained unchanged at $40 million. Total stock of Treasury bills in June 2014 stood at $35 million as opposed to $33 million in December last year. Weighted interest rates for the Treasury bills varied for the different maturities with the 56 days earning yields of 0.135%, 0.13% for 91 days and the 182 days bill earning 1.01%.

Fig 3.1.6: Excess liquidity



3.2 External Conditions

The Solomon Islands external position in the first half of 2014 improved further from the second half of 2013 with the level of gross foreign reserves accumulating to $4148 million. This favourable outcome was driven mainly by high surplus in both the primary and secondary income accounts with donor cash inflows being the main driver in the latter. This more than offsets the deficits in the trade in goods and services accounts leading to a massive reduction in the current account deficit. The high surplus in the capital account associated with high donor inflows for government public projects and rehabilitations also attributed to the favourable external position. As a result, the current and the capital accounts registered a higher surplus in the first half of 2014 compared to the preceding six months of 2013.

Current Account and capital Account

Year to June 2014 saw the current account narrowed markedly to a deficit of $42 million from $246 million deficit in the second half of 2013. However, the deficit was fully financed by inward capital transfers and foreign direct investment leading to the accumulation of foreign reserves in the first half of 2014. Meanwhile, the significant reduction in the current account deficit largely came from higher surplus in the primary income and secondary income accounts with net inflows of $152 million and $356 million, respectively. The acceleration in the primary income surplus was mainly due to higher inflow from both investment income and other primary income. As for the secondary income, the surplus emanates from transfers to both general government and private sector funding for government budget and assistance to the

April flood victims. Transfers to the general government, mainly donor cash inflows, rose considerably to $415 million in the first half year from $296 million in the second half year of 2013.

In contrast, the trade in goods account moved from a surplus of $45 million in the second half of 2013 to a high deficit of $115 million across the first half of 2014. The services account also registered a deficit of $400 million in the first six months, following the $496 million deficit in the preceding half year of 2013. The deficit in the services account was mainly associated with higher service outflow of $828 million relative to low service inflow of $429 million during the period. A sharp fall in transport and travel service receipts, particularly in the March quarter of 2014, pushed down services inflows in the first half year. As a result, the trade in goods and services account widen further to a deficit of $515 million from $452 million deficit in the second half of 2013.

In trade in goods account, the deterioration in the first six months of 2014 came from higher import payments of $1653 million relative to lower export receipts of $1538 million. Drivers of the lower export receipts stemmed from a significant fall in mineral, which fell by 41% to $176 million from $298 million in the preceding half year. The drastic fall was associated with the closure of the mining operations that reduced mineral productions and consequently gold export receipts. Fish exports also fell by 27% to $220 million from a strong growth of 99% to $301 million in the second half of 2013. Other exports also registered a strong decline, falling by 78% to $13 million from $58 million while log receipts recorded a lesser fall of 7% to $768 million from $822 million in the second half of 2013. On the upside, copra earnings rose significantly by more than two fold to $58 million from $25 million, cocoa exports up by 15% to $43 million, palm oil rose by 29% to $147 million from $114 million, and timber exports went up by 6% to $38 million during the period.

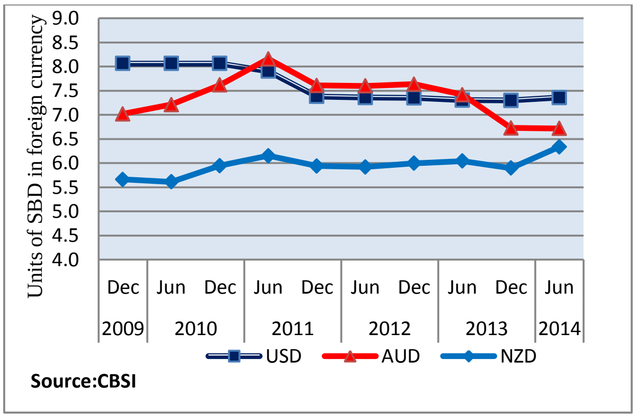
Total imports, although showed a marginal 3% fall over the previous six months remained high and was driven by food and live animal, beverages and tobacco and crude materials. Food and live animal increased by 4.4% to $398 million, beverages and tobacco up by 2% to $31 million and crude materials went up to $24 million from $6 million. Conversely, in the first half of 2014, fuel fell by 5% to $416 million, animal, vegetable and oil slide by 27% to $7.3 million, chemicals down by 16% to $104 million, basic manufacturer decelerate by 3% to $25 million, machinery and transport slowed by 4% to $465 million and miscellaneous items came down by 6% to $116 million.

The capital account remained firm with a surplus of $306 million following the $265 million surplus in the past six months. The higher surplus was aided entirely by an increase in capital transfer receipts by donors to the general government for major capital projects including the post flood rehabilitation projects. Consequently, the current and capital accounts overall recorded a net lending (surplus) of $264 million in the first half of 2014, compared to the $18 million surplus in the second half year of 2013.

Exchange Rate

The Solomon Islands real effective exchange rate (REER) appreciated by 3% in the first six months of 2014, extending the 3% appreciation in the second half of 2013. This was mainly driven by the appreciation of the Solomon Islands nominal effective exchange rate (NEER) which remained firm at an index of 92 as in the second half of 2013. In particular, the appreciation was largely due to the strengthening of the Solomon Islands dollar (SBD) against the nominal bilateral exchange rate of the Australian dollar (AUD), the second main trade invoicing currency. The relatively higher inflation rate in Solomon Island in comparison to its trading partner countries in part also contributed to the appreciation of the REER. This means the higher REER indicated a loss in Solomon Islands international competitiveness during the period.

Figure 3.2.1: Nominal Bilateral Exchange Rates

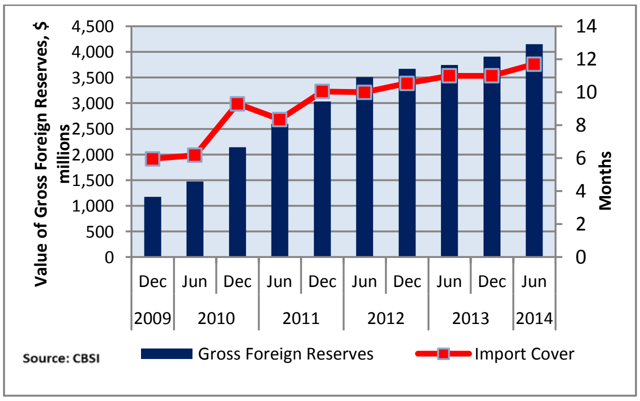


On the nominal bilateral exchange rate, the SBD on average depreciated by 0.7% against the United States dollar to $7.36 per USD compared to the average of the second half of 2013. Against the AUD, however, the SBD appreciated by 0.1% to $6.72 per AUD, and by 2.14% against the Japanese yen to $7.17 per 100JPY. Meanwhile, the SBD depreciated against the British pound by 6.0% to $12.25 per GBP, against the Euro by 2.9% to $10.06 per EUR, and against the New Zealand dollar by 5.4% to $6.34 per NZD.

Reserves

The gross foreign reserves remained high and accumulated further in the first half of 2014 to $4148 million, 6% up from $3,909 million at the end of December 2013. The build-up resulted from net inflow of $191 million driven by the increase in both donor cash and capital inflows, particularly in the second quarter of 2014. This was reflected in the surplus secondary income and capital accounts. Revaluation gains of $9 million in the second quarter also contributed to the growth in foreign reserves. This level of reserves was sufficient to cover 11.7 months of import of goods and services (see Figure 3.2.2).

Figure 3.2.2: Gross Foreign Reserves



3.3 Domestic Conditions

Recent economic indicators suggest that growth is expected to pick up moderately in 2014 following the weaker than expected growth projections in the post April's flood. Despite the gradual recovery, growth is expected to still be lower than the growth forecast of 3.7% presented earlier in the March 2014 MPS. As expected, the sharp fall in mineral production as a result of the closure of the mining operations from the April's flash flood weigh heavily on growth. Nonetheless, the rebound in the flood related output disruptions, in particular agriculture commodities in the first half of 2014 attributed to the higher revised growth forecast. Expected improvement in fisheries and other leading indicators including employment, manufacturing, investments, construction and retail and wholesale activities should also help support growth in 2014.

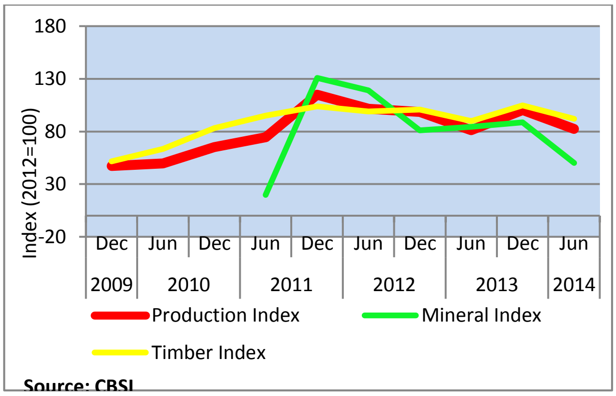
Economic Growth

Real GDP growth is expected to be a little stronger than growth projections made earlier in the post April's flood but still tracking below the initial growth forecast published in the March MPS. The slight growth follows from a quick turnaround in May from the flood stricken commodities, including signs of strengthening in other leading indicators. Real GDP growth is projected to be a little higher than the previous April's forecast of 0.9% but still well below the 3.2% level in 2013 and 3.7% projections in the March MPS. Growth is expected to be supported by favourable performances in agriculture and fisheries rising by 6% and 14%, respectively. Indicators of investment and consumer sentiment have also improved noticeably since the start of 2014. A pick up in housing investment and construction is also underway, supported by expected increase in private sector lending and donor capital flows.

Production

Domestic economic activities, measured by the CBSI production index, slowed down in the first half of 2014, reversing the strong performance witnessed in the second half of 2013. The index fell by 19% to 82 points from 102 points in the previous six months of 2013. This was dragged down by the weak first quarter of 2014 and in part to a drastic fall in gold production in the second quarter, as a result of the closure of the mining operations following the April flash flood. Gold and silver productions fell by 36% and 18%, respectively in the first six months of 2014. Contraction in fish catch by 20% to 13,407 tons and log output by 12% to 900,000 cubic meters over the second half of 2013 also attributed to the decline (see Figure 3.3.1).

Figure 3.3.1: CBSI Production Index



Aside from the reductions in log, mineral and fish, the production of other commodities, in particular agriculture commodities increased in comparison to the second half of 2013. Palm oil and its bi-products despite the drastic fall in the second quarter of 2014 from the April flash flood increased in the first half of 2014 with crude palm oil rising by 10% to 17,464 tons. Copra also demonstrated a strong performance, rising by 40% to 10,719 tons, on the back of favourable domestic copra prices during the period. Likewise, cocoa rose further by 5% to 2,514 tons attributed to sustained increases in both international and domestic prices during the period. Growth is also underway in most of the key commodities as indicated by recent available data in year to July 2014. Except for mineral, year to July 2014 productions for all key commodities increased over the same period last year.

Employment

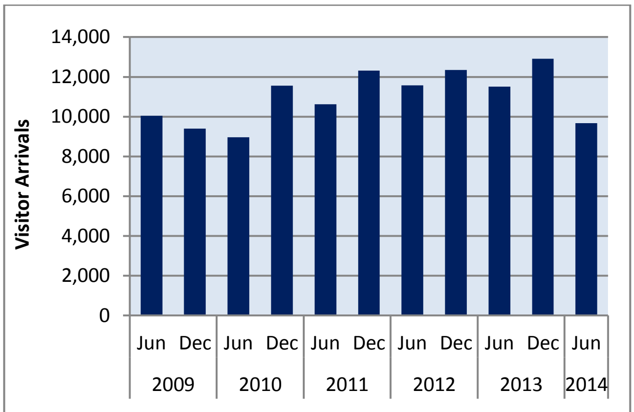
Labour market conditions, as proxied by the number of Solomon Island National Provident Fund (SINPF) contributors, improved in the first six months of 2014, after a mild fall in the last six months of 2013. The average number of contributors went up by 11% to 53,160 from 48,034 in the second half of 2013. Both active and slow contributors accredited to the growth. Active contributors recorded an increase of 10% to 44,575 and slow active contributors, rose by 17% to 8,585 during the first half of 2014. Compared to the corresponding period in 2013, the average number of contributors also went up by 10% in the first six months of 2014. The increase was driven mainly by active contributors associated with new contributors joining the SINPF during the period.

Partial employment indicators from the CBSI Job advertisement survey showed similar movement rising by 16% to 870 vacancies across the first half year of 2014. About 67% of the total job advertisements were recorded in the first quarter of 2014 consistent with the improvement in economic activity since the second half last year. By industry, employment vacancies in the education industry have continued to exhibit a strong upward trend with the bulk of employment vacancies growth of 21% in this sector. This followed by gains in the public administration and defence with 16% and administration and support service at 15%.

Tourism

The tourism industry, as measured by visitor arrivals contracted in the first half year, reversing the strong performance in the last six months of 2013. Total visitor arrivals fell by 25% to 9679, driven by a 21% fall in travellers in the first quarter of 2014. The cumulative falls in arrivals by 17% in April followed by 3% in May as an indirect consequence of the April flood in part also contributed to the overall decline in the visitor arrivals in the first half of 2014. Consistent with the economy's recovery, a significant rebound in travellers was noticeable in June, rising by 33% which resulted to a 3% growth in the second quarter. However, this growth was insufficient to offset the falls in the first quarter. The average length of stay for tourists also fell to 15 days in the first six months of 2014 as opposed to 17 days in the previous six months.

Figure 3.3.2 Visitors Arrivals



Source: CBSI and NSO

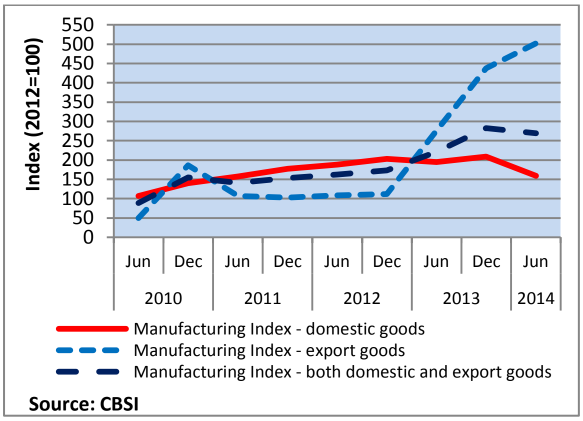
In terms of visitor's origins, Australian travellers fell by 26% to account for much of the fall in the reviewed period. The fall was further aggravated by a 6% deceleration in other Asian countries, the second highest accounting for 13% of total visitor arrivals. Meanwhile visitors from Papua New Guinea represented 7% of the total arrivals, dropped by 44%.

Other indicators including approved foreign direct investment applications to the tourism sector and inflows from business and private travels registered in the Balance of Payment (BOP) also indicated declines of 44% and 27%, respectively during the first six months of 2014.

Manufacturing

The manufacturing industry, measured by the CBSI manufacturing index improved further, rising by 22% to 276 points over the first half of 2014. Growth was mainly driven by manufactured products destined for exports despite the fall in products for the domestic market. The rise in manufactured products for exports is reflected in the export component of the index, which rose considerably by 95% to 470 points from 241 points in the last six months of 2013. The increase was buoyed by a surge in manufactured fish production for exports during the first six months of 2014. In contrast, the manufactured products destined for the domestic market dropped by 16% to 184 points in the first half year. The fall owed to declines in alcohol, soft drinks, biscuits and fish production for domestic consumption. Commercial bank loans issued to the manufacturing sector also exhibited a fall by 8% over the first quarter of 2014.

Figure 3.3.3: CBSI Manufacturing Index



Energy

Following growth in the second half of 2013, energy demand also rose over the first half of 2014, consistent with growth in the domestic economy. Total energy demand as reflected in the electricity generated rose mildly by 0.04% to 41,683 Megawatt hour (MWh) against the 41,668 MWh in the previous six months of 2013. Consequently, unit of electricity sold rose by 5% to 32,077 MWh over the first half year. This was driven by increase in sales to commercial industries, rising by 17% to 22,337 MWh during the period. Conversely, electricity for domestic consumers fell by 2% to 6,466 MWh in the first half year. Similarly, units sold to government and other categories fell by 35% and 23%, respectively during the period.

Retail and wholesale

Retail and wholesale activities, reflecting consumer demand sustained further growth to improve in the first half of 2014 as indicated by partial indicators for this sector. Credit issued by commercial banks to distribution sector rose by a further 13% to $240 million, following a 6% increase in the second half of 2013. Drivers mainly came from loans issued specifically for retailers and wholesalers category, which rose by 9% to $200 million over the first half of 2014. Other indicators of conditions in the retail and whole sale sector also showed improvement. This includes approved FDI application to the wholesale and retail sector which moved higher by 10% to 23 applications from 21 applications in the second half of 2013. Import on food and beverages goods recorded in the BOP also increased by 4% and 2%, respectively reflecting consumption growth during the first half of 2014.

Foreign Direct Investment

Investment in the country remained buoyant in the year to June 2014 period, as business confidence strengthened. The Foreign Investment Division approved 108 foreign applications, 7% up from the preceding half year, with an estimated value of $2008 million. The increase in foreign investment in the first half year reflected strong investment growth in forestry rising by 125%, mining up by 70%, transport higher by 25% and wholesale and retail increasing by 10%. Another partial indictor FDI inflows recorded in the BOP also indicated similar movement. FDI income mainly from equity and investment fund shares rose by 2% to $557 million from $546 million in the second six months of 2013.

Construction

Partial indicators for construction activities showed mixed performances but overall growth remains positive in this sector in the first half of 2014. Building permits, a partial indicator for construction activities, points to a slowdown particularly in the first quarter of 2014, after a strong growth in the second half of 2013. Year to June 2014 building permits issued by Honiara City Council declined by 8% to 77 permits against the 84 permits issued in the last six months of 2013. The biggest fall came from residential permits falling by 17% to 39 permits. In contrast, other permits went up by 6% to 18 permits while permits issued to commercial buildings remained unchanged as in the preceding second half of 2013. Building permits however, rebounded strongly in the second quarter of 2014 rising by 48% although this was insufficient to offset the fall in the first quarter of 2014. The overturn in the second quarter mainly reflected the re-constructions and rehabilitation work on buildings, bridges, and roads that were severely damaged during the April flood.

Another partial indicator, loans issued by commercial banks to the construction sector, also fell by 11% to $162 million across the first six months of 2014. However, month-on-month movements indicated a pickup in construction activities with loans to construction sector, rising by 4% in June after falling since early this year. Personnel loans issued by commercial banks to residential buildings also increased significantly by 45% to $262 million in the first half of 2014 from $181 million in the last six months of 2013. The increase reflected new personnel loans to residential buildings as well as in part from reclassifications' related issues during the period.

Transport and Communication

Transport and communication activities as indicated by various indicators for this sector showed improvement in the first half of 2014. Partial indicators from loans issued by commercial banks to transport and communication sectors increased by 19% to $253 million against the $212 million recorded in the second half of 2013. The rise came from increase in loans allotted to both transport and communication sectors, rising by 4% to $75 million and 27% to $177 million, respectively over the first half of 2014. Another partial indicator from approved FDI applications to transport and communication sectors also point to a positive growth. Approved FDI applications for this sector moved a little higher to 5 applications in the first half of 2014 from 4 applications in the second half of 2013. Inflows to telecommunication services, recorded in the BOP also indicated a positive growth, rising by 25% in the first half of 2014. Conversely, inflows to transportation services dropped 27% against the preceding six months of 2013. This reflected a fall in the visitors' arrival in the first half year.

3.4 Fiscal Conditions

Preliminary figures from the Ministry of Finance and Treasury showed a half year deficit[8] of $153 million. The negative outcome came as a result of large capital expenditure and weaker revenue during the half year. In response to the revenue disruptions, the Government revised local revenue estimates for 2014 downward. Donors on the other hand are looking at providing more funds mostly towards post flood rehabilitation projects.

Revenue

Year to June revenue collections totalled $1435 million, a 20% fall against budget and 19% against the second half of 2013. The weak performance was attributed mainly to revenue disruptions caused by the April flash flood. The closure of Gold Ridge Mining Limited (GRML) in particular created a revenue gap in government finances that is quite difficult to replace in the near term.

However, comparing against the same period in 2013, overall revenue collection was marginally higher by 1%. Local revenue improved by 6% on the back of a year-on-year growth of 76% in non-tax revenue to $72 million supported by Customs and Excise Division (CED) revenue that rose 7% to $408 million and Inland Revenue Division (IRD) collections which also improved year on year by 1% to $790 million.

Export duties which include log duty recorded a surprise increase against budget by 10% to $221 million. Of the total, log duty alone accounted for $204 million while duties from non-log exports accounted for the remaining $17 million. Meanwhile, excise duty fell slightly below budget to $78 million. Import duties also registered a budget shortfall of 21% to $98 million respectively. Comparing to the first half of 2013, all CED categories showed improvements except for import duties. The latter was consistent with expectations that import demand particularly for oil and machineries would subside in the post flood period after Gold Ridge ceased operation.

Revenue collections from IRD weakened against budget and the preceding half year due to broad based declines across most IRD categories. Company tax and withholding tax dropped against the same period in 2013 by 4% and 25% to $114 million and $84 million respectively. These sharp contractions were expected in view of the business losses caused by the April flood. While public sector PAYE easily surpassed budget by 8% to $50 million, private sector PAYE fell against budget by 16% to $134 million. Goods tax was up negligibly against budget to $331 million. Sales tax also strengthened against budget by 32% to $40 million. Revenue from licensing and stamp duty were $7 million and $5 million respectively.

Non-tax revenue dropped against budget by 32% to $84 million. However, it improved by 76% against the

[8] This deficit is smaller than MoFT published deficit because CBSI excludes principle repayment on debt from recurrent expenditure in accordance with the GFS 2001 Manual.

same period a year ago as some fishing licenses were received in the first half of this year.

Capital grants from development partners fell against budget and the first half of 2013 to $153 million. Most of these grants were received in the second quarter of this year and were associated with the post flood rehabilitation phase.

Expenditure

Year to June expenditure[9] stood at $1588 million compared to the half year original budget of $1740 million. This reflected a general underspending across all expenditure categories. Recurrent expenditure in the six months to June was $1300 million, 6% down against budget but was higher than the two halves of 2013.

Payroll expenditure up to June stood at $411 million, 3% down against the second half of 2013 but 15% higher year on year. Other charges overran budget and the first half of 2013 by 16% and 5% respectively to $729 million due to a surge in post flood related expenditures. Interest payments on public debt amounted to $7 million of which $2 million went towards external debt and $5 million on domestic debt. Budget support as at June was at $153 million.

Capital expenditure shrunk by more than half against the previous six months to $288 million. The marked contraction was due to high development expenditure in the final quarter of 2013. Comparing to budget, development expenditure declined by 20%.

Public Debt Stock

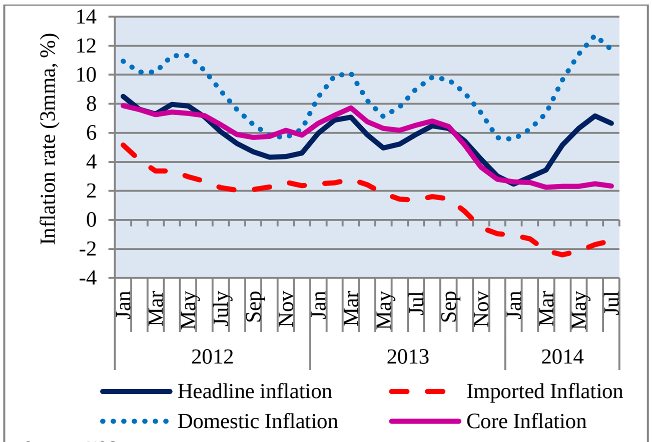
Public debt stock in June 2014 fell by 4% against December 2013 to $908 million. The decline stemmed from debt repayments the government made on both domestic and external debt obligations. Of the outstanding debt balance, external debt accounted for $716 million and domestic debt $192 million. During the reviewed period, debt repayments totalled $46 million of which $39 million went to principle repayments and just above $7 million on interest payments.

Debt sustainability indicators for Solomon Islands remained within acceptably low thresholds. Debt to GDP ratio fell to 13% as of June 2014 from 14% in December 2013. With the low debt to GDP ratio, future assistance from multilateral development partners such as ADB and the World Bank will not be provided solely as 100% grant assistance but will comprise of a loan component as well. As such, there is a risk that the debt to GDP ratio could rise again if borrowing is not prudently managed.

3.5 Inflation

The headline inflation rate as measured by the three months moving average (3MMA) rose markedly to 7.2% by end of June from 3.0% in December 2013. The increase was a direct consequence of the April flood and was considered as a temporary shock. It does not represent the underlying pressures in the economy but is more representative of fruit and vegetable prices in the local market. Month-on-month inflation showed easing pressures after the spike in April with latest inflation for July 2014 even now falling to 6.7% from the 7.2% in June (see Figure 3.5.1).

Figure 3.5.1: Headline Inflation (3mma)



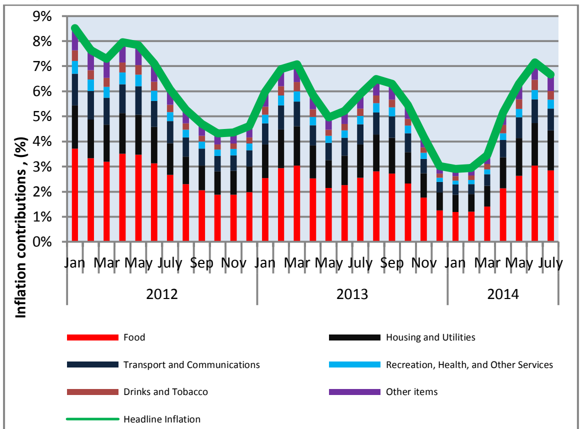
Source: NSO

Nonetheless, the increase in headline inflation can be ascribed to a spike in domestic inflation which more than offsets the falling imported price reflected by the negative imported inflation rate. The domestic inflation component, which reflects domestic price movements rose considerably to 12.7% at the end of June 2014 from 5.7% in December 2013. The surge in the domestic inflation is the highest rate in around two years, and contrast with the declining in domestic prices seen over most of that period. Meanwhile imported inflation, which represents imported price movements, remained subdued at minus 1.7% at the end of June compared to minus 0.9% in December 2013.

[9] This excludes principle repayments on external and domestic debts.

In terms of the drivers of the upward trend in the Honiara Retail Price Index (HRPI), the rise to 7.2% in June was explained mainly by increase in drinks and tobacco rising from 10.7% in December to 35.0% in June. This followed by increase in housing and utilities from 5.9% to 9.8%, food from 1.2% to 6.1% and recreation health and other services rising to 4.3% from minus 2.4% in December 2013. By component, of the overall 7.2% inflation, food accounted for the largest proportion at 3.04%, followed by housing and utilities with 1.7% and transport and communication contributing 0.93%. Drinks and tobacco, clothing and footwear, household operations, recreational health and other services and miscellaneous items explained the remaining 1.5% (see Figure 3.5.2).

Figure 3.5.2 Headline inflation Contributions



Source: CBSI

The domestic inflation component remained the dominant driver of the overall headline inflation in June. Similar to headline inflation, much of the acceleration in the domestic inflation component can be attributed to faster growth in drinks and tobacco, food, housing and utilities, clothing and footwear and recreational health and other services. Conversely, household operations and transport and communication decelerated in June. Of the 12.7% in domestic inflation, food account for the bulk with 5.0%, followed by housing and utilities at 3.8%, transport and communication representing 1.7% and drinks and tobacco contributing 1.1%. The remaining 1.1% was attributed to lesser increase in clothing and footwear, household operation and recreational health and other services. As expected, the latest available data for July saw domestic inflation easing to 11.7% from the previous month.

Meanwhile, the subdued growth in imported inflation at minus 1.7% in June was mainly driven by contraction in food to minus 4.0%, clothing and footwear down to 1.6% from 10.6% and household operations falling to 1.5% from 5.2% in December 2013. Other imported items account for the remaining deceleration in the imported inflation. Of the minus 1.7% inflation, food accounted for the highest fall with minus 0.8%, followed by transport and communication, and clothing and utilities at minus 0.2% each. Other imported items account for the remaining fall at minus 0.1% each in June.

Despite rising headline inflation, the underlying or core inflation remained unchanged at 2.5% as in December 2013.

4.0: MACROECONOMIC OUTLOOK

External Outlook

According to the IMF economic outlook, global growth projection for 2014 shaved off 0.3 percentage points from the April WEO projection to 3.4% with the sluggish first quarter performance a drag on annual growth.

The downgrade was largely attributed to adverse developments in the advanced economies particularly in US economy. Growth for the US economy has been revised downward to 1.7% from the 2.8% forecast in April. Larger than anticipated credit overhang and harsh winter conditions were the major drivers behind the downgrading projection. However growth in the US economy is expected to recover strongly by 3.0% in the following year. The Euro area maintained the positive outlook for 2014 with growth pitching at 1.1%. This reflected more broad-based growth for at least the major economies. The growth is expected to strengthen further to 1.5% in 2015. The Japanese economy strengthened since the previous WEO in April with a growth of 1.6%. This is expected to decelerate to 1.1% in 2015 due to unplanned winding of fiscal stimulus.

Prospects for Solomon Islands major trading partners remain positive. Growth in China is expected to be around the Government’s target rate of 7.5%, supported mainly by the urbanisation process and the Government’s reform program that could stimulate domestic demand. With annual economic growth in coming years expected to hover around 7%, future demand for forestry products from Solomon Islands will likely to remain strong.

Closer to home, the Australian economy is projected to grow below trend until 2015 when the economy is expected to transit from a mining led growth to a more broad based growth. Weak performance from the resource sector could possibly lead to a depreciating Australian dollar with exchange rate implications for Solomon Islands. New Zealand projected growth to moderate from 3.5% in 2014 to just above 2% in the medium term. The moderate growth is expected to be supported by a more broad-based and self-sustaining domestic demand.

Price developments are mixed in the different economic regions. In the advanced economies, 2014 inflation projection has been revised upward to 1.6%. However, inflation in the emerging market and developing economies could ease to 5.4% in 2014 and 5.3% in 2015. Inflation outlook for major trading partners are set to be contained within their respective targets, benefiting from soft food and energy prices. However, upside risks such as the instability in Russia and Ukraine coupled with that in the Middle East may adversely push oil prices, and hence inflationary pressures, upward.

Domestic Outlook

Recent data to August points to a growth that is slightly higher than the 0.9% CBSI initially anticipated immediately after the April flood. The growth projection is supported by the quick turnaround in agriculture, robust fisheries sector, pick up in communication and construction activities combined with post rehabilitation activities from the government in partnership with the development partners. Year to July data showed the drag on growth from the logging sector is projected to be much smaller now than previously anticipated. However, risks to this projection could come from a much weaker performance from logging sector in the second half and global oil price shocks.

Reserve money and overall money supply are projected to rise further by December 2014. The increases are expected to be driven by growth in net foreign asset, possible ramp up in public expenditure in the second half year, and rebounding growth in credit to private sector. With the entrance of the fourth bank in the middle of 2014, the Central Bank is anticipating this to stir competitions in the industry and fuel movements in some of the key monetary aggregates. Based on these projections and the Central Banks limited capacity to sterilise additional liquidity, the banking system could see liquidity levels increasing further by end year.

The overall balance of payments position is expected to trend favourably in the second half of 2014. Reserves are projected to grow by 8% against December 2013 to $4239 million, driven mainly by capital inflows from developments partners. However, there are some BOP components that are likely to worsen in the second half and into 2015. The current account deficit is expected to worsen this year given the sharp deterioration in the export sector and ongoing deficit in service and income accounts. With mineral exports out of the picture in the near term, the trade account deficit is expected to deteriorate from 2% of GDP in 2013 to 6% by end year and 8% in 2015.

The exchange rate policy of the CBSI remains unchanged. The local dollar is still pegged to a basket of currencies that is dominated by the major trading currencies. Exchange rate market developments indicated the Australian dollar may continue to depreciate as commodity prices remain soft. USD on the other hand was projected to appreciate in the second half year.

Recent price developments in July pointed to a slowdown in inflationary pressure after headline inflation peaked at 7.2% in June. This is consistent with expectations that the second quarter pressures were transitory and likely to subside as supply constraints are removed and market production in Guadalcanal and Honiara normalises. However, CBSI inflation models projected headline inflation to be on the upside of the 4% - 6% range projected for 2014. Imported inflation is expected to remain deflationary as food and energy prices remain weak. Domestic inflation on the other hand is anticipated to retreat to levels below the double digit in the near term. Possible risks to easing inflationary pressures are expected from sudden spike in global oil prices, another domestic supply shock, and adverse volatilities in the exchange rate.

The fiscal landscape has changed dramatically in the wake of the April flash flood. Contrary to the earlier projections of a balanced budget for this year, the Government is now expecting a fiscal deficit of around $165 million. Despite the contraction in local revenue, overall fiscal revenue for 2014 has been revised upward by 2% against the original budget to $3577 million. The increase is driven mainly by grants and budget support that is projected to increase by 30% to $866 million. On the other hand, the expenditure budget is also raised by 6% against the original budget to $3742 million. This is to cater for large expenditures that will be incurred in the second half including post flood rehabilitation projects.

5.0 MONETARY POLICY STANCE

The CBSI Act 2012 states that price stability is the primary mandate of the CBSI. To effectively perform this role, the Bank has over the years built required infrastructures to strengthen the effectiveness of monetary policy and to harmonise its coordination with other important policies such as exchange rate and fiscal policy.

The exchange rate, an important price in the local economy, has been the most effective tool to arrest inflation in the country so far. In the past six months, the Central Bank maintained the exchange rate arrangement of pegging the local currency to a basket of currencies and this will continue going forward. Looking ahead, the Central Bank will closely monitor exchange rate developments particularly for Solomon Islands major trading partners and allow the local currency to move in tandem with the basket of trading currencies within slightly wider margins to minimise possible exchange rate misalignments over the next six months.

The shallow structure of the financial system combined with high levels of excess liquidity that was largely driven by net capital inflows render the monetary policy to become ineffective. Removal of the structural liquidity has cost implications on the central bank balance sheet. In 2014, the CBSI used two policy instruments to stifle growth in excess liquidity. These are the cash reserve requirement, which required the commercial banks to hold 7.5% of total deposit liabilities with the CBSI; and the Bokolo bills that are issued to commercial banks on a fortnightly basis.

In June 2014, the CBSI removed $249 million in cash reserve requirement (CRR) and $710 million in Bokolo bills. Recent data in August 2014 showed the CRR volume grew in correspondence with deposit liabilities to $240 million. However, temporary under subscription in the Bokolo bills market led to a spike in excess liquidity to $1375 million in August but was reversed in September. Looking ahead over the next six months, the Bank will maintain auctioned Bokolo bills volume at $710 million per month and the cash reserve requirement ratio at 7.5%.

Various CBSI inflation models projected headline inflation for 2014 to be on the upside of the 4% - 6% range stated in the previous MPS in March. Unanticipated inflationary pressures in the second quarter, which was mainly flood related, are expected to dissipate in the second half of the year. Supporting this are easing prices for imported food and energy items. Recent data in July showed domestic supply shocks have been restored to some extent and points to an easing domestic index. The CBSI acknowledges that the recent supply shock pressures are well beyond CBSI influence. However, the CBSI encourages farmers and businesses to raise productivity levels to improve overall output.

The current and projected developments showed the SI economy performs below potential and there is still policy space on the inflationary front to accommodate further increases in aggregate demand. To assist the country recover from the effects of the flood, the CBSI would adopt an accommodative monetary policy over the next six months by reviewing policies and regulations within its means to foster investment and support private sector activities. This entails reviewing of the exchange rate margins, exchange control policies and ways to facilitate productive lending.

The CBSI will, however, continue to monitor key economic aggregates including price developments and will act whenever necessary to ensure that prices are stable and macroeconomic fundamentals are supportive of a balanced growth.