CENTRAL BANK OF SOLOMON ISLANDS

MONETARY POLICY STATEMENT
MARCH 2017

P. O. Box 634, Honiara, Solomon Islands. Tel (+677) 21791

Table of Contents

List of Figures

List of Tables

1 Overview

The global economy is estimated to have grown by 3.1% in 2016 on the back of positive performances from the advanced economies including the United States which rallied in the second half of the year combined with higher than anticipated growths from Japan, Germany, France, Spain and United Kingdom. China, which is a major driver behind growth in the emerging and developing economies continued to provide support to the positive near to medium term global economic outlook.

While Australia and New Zealand, Solomon Islands major trading partners, recorded positive growths in 2016, the former yielded a weaker than anticipated growth due to reduced mining investment and subdued activities in the construction sector. The latter however benefited from favourable demographic shifts and firmer activities in construction, tourism and an accommodative monetary policy.

Price trends in 2016 were mixed with commodity prices showing relative pick-ups while prices of major food items remain suppressed yielding a net benefit for the Solomon Islands economy. The uptick in commodity prices boosted export earnings for local commodity exporters. On the contrary, falling international food prices lowered inflationary pressures for consumers. However, energy price upticks towards end year signalled upward pressures on both consumer prices and production costs are mounting.

The domestic economy is estimated to record a slightly higher growth of 3.5%, 30 basis points higher than what was previously projected in September 2016. The growth was driven by buoyant activities in logging and agriculture sectors that gained from firm commodity prices combined with public infrastructure investments that were heavily aided by donor support. All other sectors except for mining and fisheries sectors, contributed positively to the favourable outturn in 2016.

The monetary aggregates expanded further during the second half of 2016. Money supply recorded another similar sized growth as the first half in July to December. Credit to private sector picked up further with distribution, construction, personal, transport, tourism, communications and manufacturing as the lead drivers. Interest rate remained stable throughout the second half except for the sudden spike in the month of December.

The external conditions weakened in the six months to December 2016 due to a widening current account deficit. While capital and financial account consolidated the growth in the first half with a further growth, the gains were not adequate to offset the deterioration in the current account. This subsequently led to the slight decline in gross external reserves by 0.3% against June to $4,210 million in December.

According to the CBSI trade weighted index, the currency basket appreciated by 1.2% in the second half of 2016, continuing the 0.8% appreciation in year to June. This movement was driven largely by the stronger USD which outpaced movements in all other major currencies in the basket. While the half yearly average value of the SBD showed an appreciation against the USD in both halves of 2016, the local currency depreciated against the AUD and the NZD.

The government registered another fiscal deficit, albeit smaller, in the second half of 2016. This resulted from a much bigger fall in expenditure than revenue. As a share of GDP, expenditure contracted to 23% from 26% in year to June. Over the same period, revenue shrunk by two percentage points to 21%. On an upside though, the government continued to receive both direct and indirect donor support throughout the year.

Inflationary pressures were easing notably in the third quarter due to downward movements in both imported and domestic components. The fall in the imported index was attributed to several factors including falling energy prices, softening of food prices in line with international food price trends combined with local competition, and excess supply of vegetables and fruits at the market.

The near to medium term outlook for the Solomon Islands economy is projected to remain positive. This is based on these key underlying assumptions that planned infrastructure programs remain on track over the medium term, donor assistance continues, logging activities in 2017 remains the same as in 2016, credit to private sector remains buoyant as new entrants in the financial space are established, and prices of tradeable commodities continue to be favourable. There is however some downside risks to the near to medium term growth projection. These include a faster than anticipated increase in oil prices, unfavourable shocks to commodity prices, and an unanticipated decline in global demand for local logs.

2 International Economic Developments

The global economic growth is estimated to grow by 3.1%[1] in 2016, broadly in line with mid-year update in 2016. The global growth although slightly lower than initial forecast, is expected to be supported by diverged growth outcome in different country groups. Supporting the global growth were firm activities in the United States, against weaker performance in the first half of the year. Although mixed outcome in the emerging and developing economies, China holds strong growth while Latin American countries in recession. Meanwhile, growth in the Euro area is projected to have picked up from initial estimate despite a much slower growth than a year prior.

Growth outlook for the global economy is forecast to grow 3.4% in 2017 and 3.6% for 2018. This outcome is underpinned by firming oil prices, anticipated global spill overs from United States policy mix and new administration, China's anticipated policy stimulus, and a more balanced risk in the medium term. However negative risk in the near term growth may affect global growth under the uncertainty around policy outcome of the US economy and likely impact on the rest of the world.

Growth in the advanced economy is projected to remain moderate at 1.6%, consistent with previous forecast, however slightly below initial estimates by 30 basis points and 50 points below year-on-year. This stemmed from initial weaker exports in the US and dampening private consumption in Japan in the first quarter of 2016. On the upside, a more stabled growth is forecasted in the recent update and is expected to be fuelled from strong pick up in the US economy aided by sizable appreciation in the USD dollar since the November election and its associated fiscal stimulus package. Prominent downside risks, however exists around the US administration and policies in migration and protectionism agenda, that might affected our major trading partners such as China and the Euro area in the medium term growth. Consequently, the effect of the strengthening USD dollar resulted in our local currency depreciating against the USD in 2016 and sluggish demand of our round log from China particularly towards the end of 2016.

The Japanese economy is expected to pick up to 0.9%, following an estimated growth of 0.5% in the previous update. This was 40 basis points above initial forecast and against previous year. Supporting this recovery was a more coordinated growth measure which enhanced private consumption. This is expected cushion effect of anticipated downside risk of uncertainty, moderate appreciation of the Yen and somewhat mixed global performances. The appreciation of the Japanese yen resulted in the weakening of the local currency against the yen seen in 2016.

Growth projections for the Euro area remain same as in the September outlook at 1.7%. Although, this was an upward revision from the initial forecast done at the beginning of the year, 2016 saw a much weaker growth against the preceding year. The level of output in a number of advanced economies and in particular the Euro area remained below potential output as there were spare capacities as the brunt of the Brexit started to kick in. Meanwhile, the upward revision in the Euro area relative to the initial forecast came from stronger than expected growth in Germany, France and Spain. Spain and the United Kingdom remained stronger than initially expected due to high domestic demand than expected in the aftermath of the Brexit. This saw an upward revision in the level of output in the United Kingdom by 20 basis points to 2.0%.

In the emerging and developing economies, growth was revised slightly down against previous outlook, following two quarters of stabled growth records of 4.2%. Growth in 2016 is estimated to have grown at 4.1%, slightly higher than 4% recorded a year ago and is expected to grow further in 2017and 2018 to 4.5% and 4.8% respectively. Despite the downward revision, emerging economies continued to support global growth. GDP growth in China has been stronger than earlier anticipated. As a result, growth for 2016 was revised up by 0.1 percentage point to 6.7% albeit lower than growth of 6.9% recorded for 2015. Supporting this outcome were accommodative macroeconomic policies and reliance on policy stimulus measures which China currently embarking on. Notwithstanding this, slow progress in addressing corporate debt and pressure on capital outflows weighted on growth in the medium term to slow down. The direct impact of the U.K referendum is likely to be limited in light of China's low trade and financial exposure to the United Kingdom. However, high and rising debt coupled with excess capacity in some sectors, remain a risk to the medium-term outlook for growth in China. Economic performance in India is expected to slow down a little by 0.1percentage point to 6.6% in 2016 and increase to 7.2% in 2017 and 7.7% the following

[1] All statistics in this section obtained from IMF World Economic Outlook, January 2017 Update unless otherwise stated.

year. The downgraded position in 2016 was primarily due to the temporary negative consumption shock emanated from cash shortage and payment disruptions resulted from recent currency note withdrawals. However, the effect is expected to soon dissipate in the medium term. A positive prospect for Solomon Islands as a market destination for Solomon Islands logs.

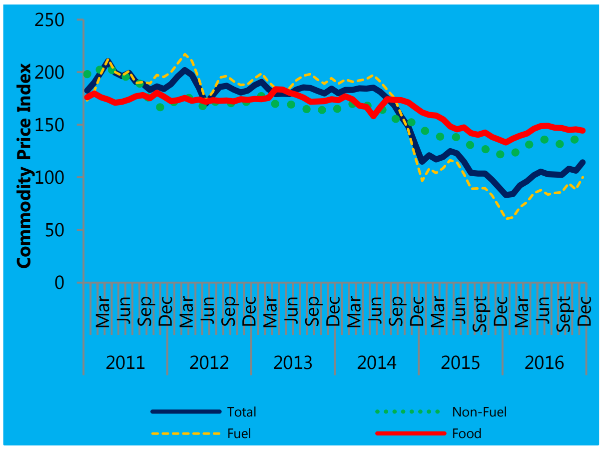
Growth projections for the country's closest major trading partners, Australia and New Zealand, showed mixed results in the recent outlook. The Australian [2] economic growth was downgraded to 1.8%, following a more optimistic growth of 3% forecasted in the September outlook. Driving this were weaker-than-expected developments in the construction industry exacerbated by bad weather condition and disruption of coal supply, and reduced mining investment. The current pick up in commodity prices were considered temporary and unlikely to increase domestic demand and higher investment in Australia. However, for the periods ahead, growth is expected to pick up to 2.5% and above, on the back of reduced impact from falling mining investment, the ramping up of liquefied natural gas (LNG) exports and strong demand in dwelling investments. As for New Zealand, economic growth is estimated to strengthen at 3.5% and is forecast to average around this level over the next two years. The positive outturn reflected strong growth in net migration, construction, tourism and high working age population, together with an accommodative monetary policy.

2.1 International Commodity Prices

After considerable price declines in 2015, the IMF's commodity price index experienced a comparatively lesser fall of 11% in 2016 to 99 index points. This represents a bottoming out of prices during the year, as both oil and non-commodity prices reached the floor and started to pick up towards the end of the year. The fuel price index in particular dropped by 17% to 81 points during the year. However, by December 2016, the decision by oil producers to curtail supply had seen a steady rise in oil prices that is expected to push up the fuel price index by 16% in 2017 to 94 points. Moreover, tapis fuel price, the key benchmark indicator for Solomon Islands' fuel imports has witnessed similar trends with a 16% fall in 2016 to US$45 per barrel and is expecting higher prices in 2017. Likewise, the non-fuel price index also fell by 3% to 130 in 2016 and is projected to rise by 1% in 2017 to 131, a likely positive prospect for local commodity exporters.

[2] http://www.rba.gov.au/publications/smp/2017/Feb/

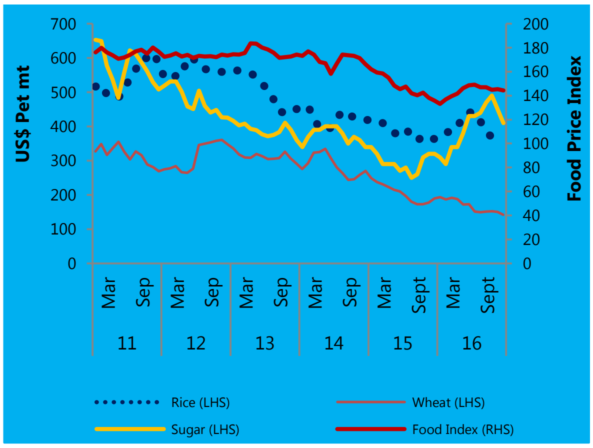
Figure 1: Commodity and Food Price Indices (2005=100)



Source: IMF

Average international food price, as indicated by the IMF food price index (see Figure 1) declined by 3% to reach 144 points by end of December 2016, following a 13% decline recorded a year ago. This outcome was driven mainly by falls in wheat price, chicken, beef and milk that more than offset price pickups in rice and sugar against the previous year. More important for the Solomon Islands, the fall in food price could be short lived as prices of the mostly consumed food items in the Solomon Islands, such as rice and sugar rebounded 3% to US$396 per ton, and by 35% to US$398 per ton respectively.

Figure 2: International Food Price Indices 2011-2016



Source: IMF

2.2 Global Inflation

Global inflation edged up by 12 basis points from the previous year to an average 2.9% in 2016. This is attributed to the rebound in oil prices, the pickup in headline inflation in advanced economies and the firming of prices in China. With the marked upturn in oil prices due to supply-side cuts and the pickup in commodity prices, inflationary pressures are expected to further strengthen in 2017.

The upward inflationary trend in advanced economies to 0.8% during 2016 was attributed to the relative impact of weaker currencies in the UK and the EU, and continued reduction of their negative output gaps with the exception of a stronger hold in the US currency. By 2017, consumer prices in these economies will further strengthen but still be within inflation targets. On the other hand, inflationary pressures in emerging and developing economies continued to ease in 2016. This reflects the diverse nature of these economies with some experiencing the effects of stronger commodity prices, while others, the lingering deflationary pressures from past currency appreciations.

Consumer prices in China have moved up to 2.1% in 2016 and will rise to 2.3% in 2017 amid reductions in excess capacity and higher oil prices. In Australia, inflation had eased in 2016 to 1.3% but is also expected to rise in 2017 to 2.1%. Meanwhile, the consumer price index in New Zealand rose in 2016 to 0.7% and is further expected to reach 1.6% in 2017. Across the Pacific Islands, average inflation for the region including Solomon Islands indicates declining prices to -1.5% due to persistently low inflation in most economies except for Fiji; however this is expected to turn around in 2017.

3 Domestic Economic Development

3.1 Monetary Conditions

Monetary conditions improved in July to December 2016, consolidating the gains made earlier in the year. Money supply increased further on the back of continuous growth in credit to private sector and the drawing down of fiscal savings at CBSI to finance government expenditure. The weighted interest rate margin however picked up in the second half particularly in the month of December. However, lending rates in major borrowing sectors remained in single digit.

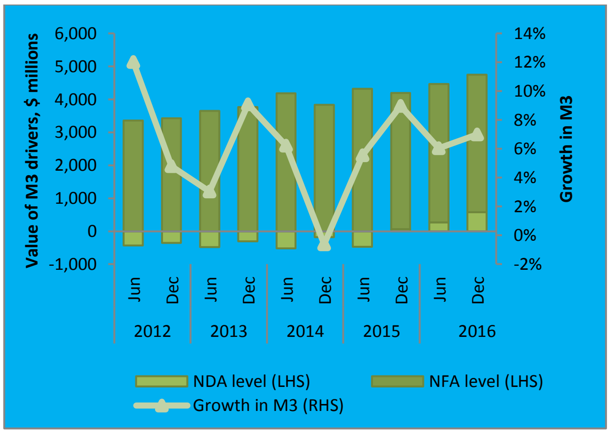
3.1.1 Reserve Money

Reserve money gained momentum in the six months to December by recording a 10% increase against June 2016 to $2,583 million, reversing the declining trend that was seen since December 2015. The recent outcome was attributed to the 14% growth in CBSI NDA that rose 14% to minus $1,429 million as a result of consistent drawdowns in government deposits to meet budget financing gaps. The CBSI net foreign assets also grew during the same period though negligibly to $4018 million.

3.1.2 Money Supply

Money supply grew at a steady pace in both halves of 2016. Between June and December, money supply went up by 7% to $4,742 million in December following a 6% growth in year to June. The monetary growth reflected increases in both net foreign assets (NFA) and net domestic assets (NDA) of the depository corporations (see Figure 3). The latter was driven mainly by credit to private sector and net credit to non-financial public sector which rose against June 2016 by 8% ($158 million) and 18% ($224 million) to $2,229 million and minus $1,037 million respectively.

Figure 3: Drivers of Money Supply



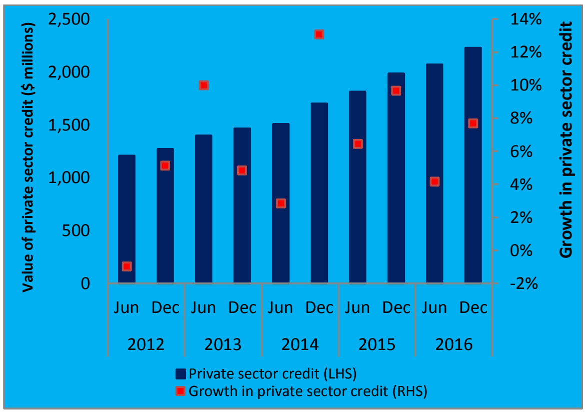
Source: CBSI

Of the overall money supply, 59% were held as transferrable deposits, 26% in other deposits while currency in circulation accounted for the remainder.

3.1.3 Credit Conditions

Credit growth gained momentum in the second half of 2016 after a much slower growth earlier in the year. The strong pick up in July to December was consistent with trends in the past two years. As depicted in Figure 4, total credit issued to the private sector went up to $2,229 million, 8% against June 2016 and 12% against the previous year. About ninety percent of the credit was represented by loans, nine percentage points above twelve months ago. Distribution, construction, personal, transport, tourism, communications and manufacturing were the key driving sectors behind credit growth in the review period.

Figure 4: Credit to Private Sector

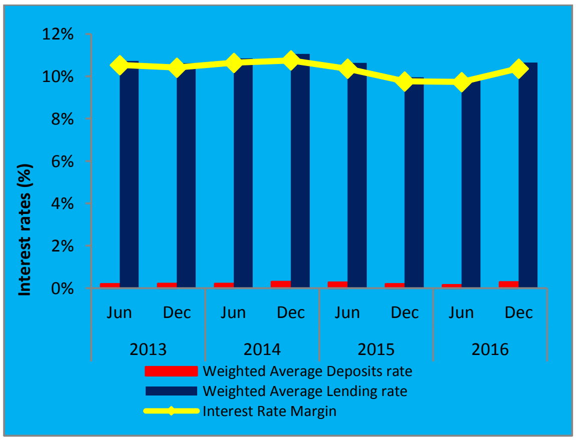


Source: CBSI

3.1.4 Interest Rate Trends

Interest rates had increased in the second half of 2016. The weighted average interest rate for all deposits moved upward by 15 basis points from 0.14% in the six months to June to 0.29% in the second half of 2016. During the same period, the weighted average interest rate for loans and advances rose by 79 basis points to 10.66% (see Figure 5). As a consequence, the weighted interest rate margin hiked by 64 basis points to 10.37% over the same period. Much of the increase in weighted average interest rate for loans and advances were recorded in December 2016.

Figure 5: Interest rate trends



Source: CBSI

Available data from the banking system revealed that certain sectors were accorded lower risks than others. This was evidenced in Table 1 when sectors like manufacturing, construction, distribution, tourism, transportation, statutory corporations, and professional and other services recorded lower weighted average lending rates within single digits over the recent two years. However, productive sectors such as agriculture, fisheries, mining & quarrying, forestry and all other sectors were considered as higher risks thus leading them to receiving double digit lending rates over the same period.

Table 1: Half Yearly Weighted Average Lending Rates

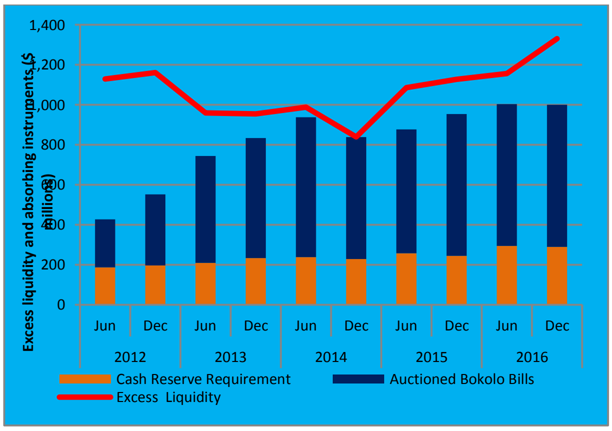
Sectors	2015H1	2015H2	2016H1	2016H2
Manufacturing	8.23%	8.34%	7.85%	7.84%
Agriculture	17.41%	10.50%	9.03%	11.39%
Forestry	13.40%	9.16%	9.28%	10.78%
Fisheries	15.83%	14.19%	16.76%	18.75%
Mining & Quarrying	18.33%	21.79%	17.08%	17.08%
Construction	9.75%	9.60%	8.97%	8.80%
Distribution	11.81%	9.52%	9.17%	9.72%
Tourism	8.40%	8.17%	7.93%	8.23%
Transportation	10.58%	9.61%	9.13%	9.93%
Communications	14.67%	4.82%	16.89%	14.50%
Entertainment & Catering	9.77%	10.56%	9.82%	11.14%
Central Government	22.00%	21.79%	20.13%	19.99%
Provincial Assemblies & Local Governments	22.00%	32.91%	13.67%	16.35%
Statutory Corporations	7.11%	6.83%	6.90%	7.03%
Private Financial Institutions	14.67%	21.79%	19.50%	19.06%
Professional & Other Services	7.92%	8.28%	7.74%	8.23%
Personal	15.05%	14.17%	13.73%	13.96%
Non-Residents	14.33%	7.74%	16.41%	8.60%

Source: ODCs and CBSI

3.1.5 Liquidity Levels

Growth in liquidity levels not only remained positive but gathered pace between July and December. This came in spite of growth in credit to private sector and was fuelled partly by fiscal injections together with rising capital inflows. As shown in Figure 6, excess liquidity jumped up by 15% to $1,330 million after a smaller growth of 3% in June.

Figure 6: Liquidity levels



Source: CBSI

The CBSI continued to absorb liquidity from the commercial banks through the use of both direct and indirect policy instruments. An average of $289 million was absorbed from the commercial banks through the cash reserve requirement. The CRR is still maintained at 7.5% of deposit liabilities.

The CBSI had also increased the volume of Bokolo bills that was auctioned each fortnight to $375 million in August 2016, an increase of $40 million above the stock level that was sustained from July 2015 to July 2016. Over subscriptions had increased during the second half of 2016 to a monthly average of $192 million compared to $166 million in the first half. While this indicates excess appetite from the commercial banks, the same sentiment was shared by participants in the treasury bills. Interest rate for the bokolo bills remained unchanged at 0.62%, the same as in previous years.

The treasury bills CBSI administered on behalf of the Government was still capped at $40 million. However the government had begun to utilise this facility to meet short term financing needs of the government. Interest rate for the 56 days and 91 days treasury bills remained the same throughout the year at 0.34% and 0.46% respectively while the 182 days interest rate was sustained at 1.12% since May 2016.

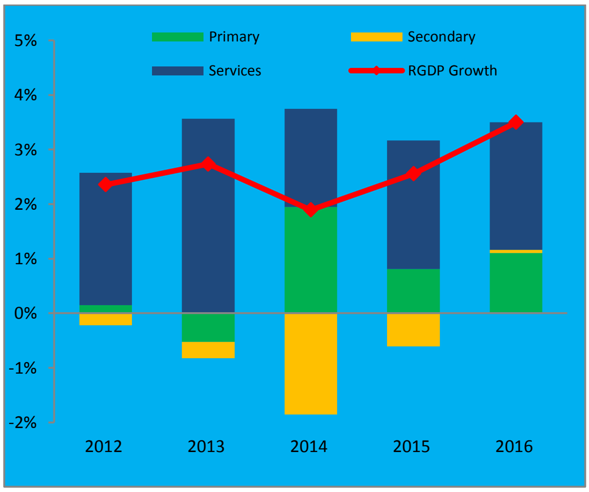
3.2 Domestic Conditions

3.2.1 Economic Growth

The CBSI has revised its 2016 growth estimates for the Solomon Islands economy in March 2017. Available preliminary data showed the local economy expanded by 3.5% in 2016, 30 basis points higher than the previous estimate. In terms of contribution to the estimated overall growth for 2016, Figure 7 showed services sector contributed 2.3%, followed by primary sector with 1.1%, while industry sector accounted for the remaining 0.1%.

The gains in the primary sector were associated with higher outputs in the logging and agricultural sectors. In addition to the commodity price gains, the weaker SBD particularly against the USD led to exchange rate gains as well. Construction, manufacturing, wholesale retail, hotel and restaurants, and public expenditures were the other major drivers behind the positive outcome.

Figure 7: Contribution to Real GDP growth

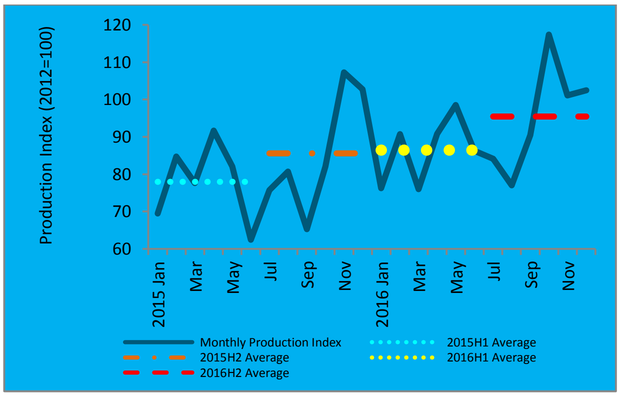


Source: SINSO & CBSI

3.2.2 Production

The commodities sector performed strongly in the second half of 2016, reflecting strong recovery across all major commodities in the third quarter. As shown in Figure 8, the average production index for July to December 2016 improved by 10% to 95 against the six months prior. The half yearly growth was largely driven by round logs, fish catch and copra whose average indexes improved by 16%, 61% and 14% respectively.

Figure 8: Half Yearly Production Index

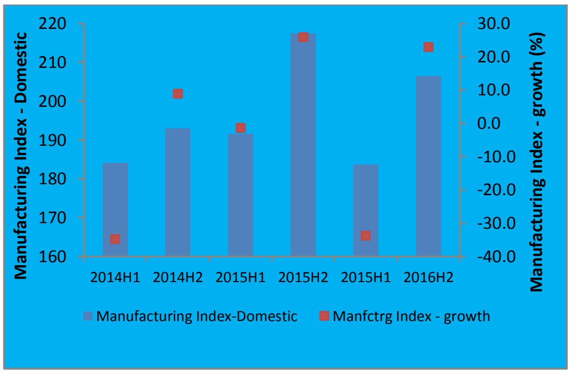


Source: CBSI

3.2.3 Manufacturing

The manufacturing index as a proxy for domestic demand bounced back after a weak performance in the first half of the year. The index for goods that were manufactured purposely for the domestic market improved by 22% from 184 six months ago to 206 (see Figure 9). This sentiment was generally shared by the manufacturing companies that were captured in the index. Loans to the manufacturing sector picked up 4.8% against June to $130 million in December, reversing a similar sized decline in year to June. Anecdotal data also pointed to a broadening in the manufacturing base with a growing number of investors venturing into activities such as water bottling, bakeries, and so forth.

Figure 9 Manufacturing Index Trend

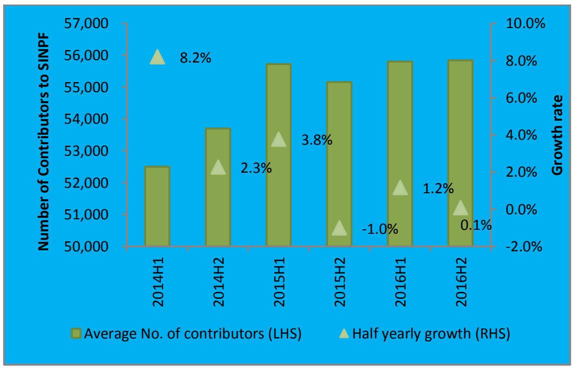


Source: CBSI

3.2.4 Employment

Labour market conditions were more or less the same as in the first half of the year. The number of workers that were actively contributing to the Solomon Islands National Provident Fund rose insignificantly by 0.1% to 55,844 people (see Figure 10). Latest employment numbers from the public sector showed an annual increase of 2.3% (or 371 people) to 16,599 by December 2016. Teachers accounted for 63% of the newly filled positions. December 2016.

Figure 10: Average number of Contributors to SINPF



Source: SINPF & CBSI

3.2.5 Foreign Direct Investment

The Foreign Investment Division reported a total of 119 applications were received in the second half of 2016 compared to 91 applications in the six months prior. Most of the applicants expressed interests in wholesale/retail (42) followed by construction (12), forestry (10), consultancy, (8) and mining (7).

3.2.6 Tourism

Preliminary data showed visitor arrivals picked up further in the second half of 2016 to 18,654 visitors. This benefited from increases in both air and sea arrivals which rose by 8% to 11562 and 11% to 7,092 visitors respectively. Another proxy for tourism i.e. loans issued to tourism sector, consolidated the 8% growth in June 2016 with a further growth of 10% to $142 million. The growth was most notable in the months of September to November.

3.2.7 Energy

Energy demand from domestic households and commercial industrial users declined in the second half of 2016, reversing the trend seen since a year ago. As a consequence, overall energy demanded dropped by 3.4% to 35,198 megawatt hour (MwH). Anecdotal evidences showed a number of commercial industrial customers used alternative energy sources such as standby generators with some households relying on solar energy. Energy demand from the government however went up negligibly by 0.5% to 5,300 MwH.

3.2.8 Retail & Wholesale

Wholesale and retail activities increased further in 2016. Lending to the distribution sector jumped up by 28% ($105 million) over the year to $348 million. Of the total increase, $77 million were disbursed in the second half of the year. Food imports, another proxy indicator, also trended upward by 14% against year to June total to $512 million.

Anecdotal FDI data from the Foreign Investment Board revealed the wholesale and retail sector attracted the highest number of FDI applications. Wholesalers have started to decentralise their businesses away from Honiara to the provinces most notably in the Western province.

3.2.9 Transport

Transport sector as measured by the cargo of volume handled by Solomon Islands Ports Authority improved in the second half following the completion of a second international wharf at Honiara. Anecdotal data from Solomon Airlines showed total passenger numbers from July to December increased by 28% on year to June total.

3.2.10 Communication

The communication sector recorded another improvement, though smaller when compared to activities up to June. Growth momentum in internet usage slowed to 15%, following a stronger growth of 39% in the previous six months. However, over the same period, mobile usage reversed the 21% decline in the previous six months by recording a stronger growth of 27%. Credit to the communication sector grew marginally by 1.3% in the six months to December after a notable decline of 16% six months prior.

3.2.11 Construction

Construction activities continued to remain robust. The Honiara Town Council building permit records showed a total of 120 permits were issued in the second half of 2016. This is an increase of 15% against the previous six months. More than half of the permits were issued for residences while 20% were issued to commercial and industrial buildings. The remaining 20% were issued for things other than for residential and commercial properties. The estimated value of the building permits was $450 million, of which residential and commercial/industrial represented 12% and 87% respectively.

Other proxy indicators for construction showed buoyancy. Lending to construction sector, another proxy indicator for construction activities, indicated strong borrowing from the construction sector with an increase of 13% ($36 million) against June 2016 to $317 million. This continued the 15% ($37 million) growth in the first half of the year to $281 million. Consistent with the strong borrowing, basic manufactures imports rebounded by 24% to $315 million after slumping by 12% six months back. The positive turnaround was also indicative of firmer demand for construction materials.

3.3 External Conditions

Conditions in the external sector cooled in the second half of the year after the positive outturn in the period from January to June 2016. The marked deterioration of the current account deficit to minus 4% of GDP from minus 1% of GDP was primarily responsible for the lower surplus in the Balance of Payments (BOP) position. On the other hand, the 'capital and financial' account improved to 4% of GDP from 3% of GDP in the first half of the year as donor and private sector investments continued to be injected into the economy.

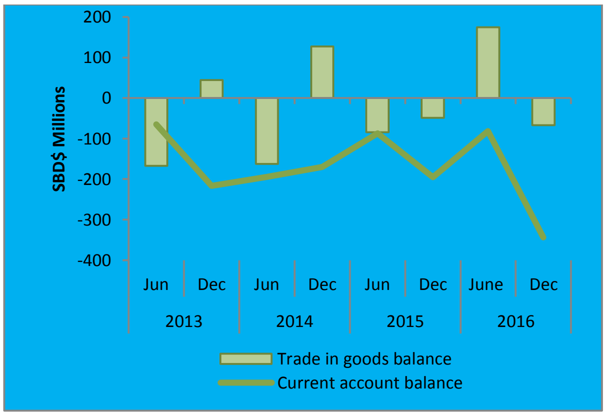
On an annual basis that corresponds with the result in the last six months of the year, the surplus in the BOP position for 2016 shrunk to 1% of GDP from 5% of GDP in the year prior. This emanated from a worsening current account and a slowdown in the inflows from the capital and financial accounts during the full course of the year. Reflecting the measured outcome, the country's gross foreign reserves witnessed only marginal growth at the end of 2016.

3.3.1 Current Accounts

The current account weakened to a deficit of $344 million in the period from July to December 2016 compared to the smaller revised deficit of $82 million in the previous period (see Figure 11). This was driven by the reversal in the trade in goods outcome, a widening of the services deficit, and the fall in the secondary income surplus. In contrast, the deficit in primary income improved during the review period.

Trade in goods returned to a deficit of $67 million in the second half of 2016 after the surplus of $175 million in the first half of the year. Despite a small rise in exports across most commodities except for palm oil, a boom in imports especially from food, fuel and machine contributed to the result. Similarly, the trade in services deficit worsened to $385 million from $341 million on the back of a higher rise in transport payments that offset a relative improvement in travel services. Meanwhile, the surplus in secondary income slid by 7% to $241 million in spite of a rise in donor-funded cash grants to the government. This was attributed to a rise in outward remittances by foreign workers in the country and a decrease in transfers by Non-Government Organizations.

Figure 11: Trade and Current Account Balances



Source: CBSI

On the other hand, the deficit in primary income narrowed to $133 million from $174 million in the last six months of 2016. Contributing to this outcome was the improvement in the interest income received on the country's reserve assets and a drop in dividends sent overseas by foreign companies. Nonetheless, as a developing economy receiving foreign direct investments, the county's primary income account apart from 2013 has witnessed structural deficits that are in part the returns on investment by investors for their capital injections into the economy.

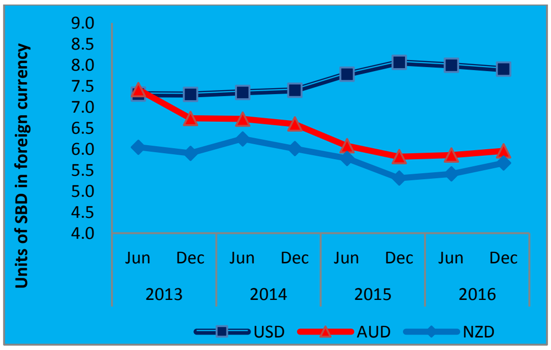
3.3.2 Capital and Financial Account

The 'capital and financial' account expanded in the second half of 2016 with a surplus of $132 million compared to a surplus of $215 million in the January to June 2016 period. The positive developments stemmed from improvements on the surpluses in both the capital and financial accounts. In particular, the financial account jumped to a surplus of $132 million from a $26 million surplus that reflected the growths in inward foreign direct investment and external loans during the reference period. Meanwhile, the capital account rose by 23% to $234 million, continuing the growth witnessed in the first half of the year. Donor supported capital projects notably on road infrastructure and educational facilities accounted for the positive development.

3.3.3 Exchange Rate

The country's Real Effective Exchange Rate (REER) depreciated by 3.5% to an average index of 146.3 in the months from July to December 2016. This came about following the slight 0.1% fall in the Nominal Effective Exchange Rate (NEER) to an average index of 100.8 and takes into account the previously high consumer price index levels in the Solomon Islands. Moreover, a weaker REER implies that the country's exports were relatively more competitive during the reference period.

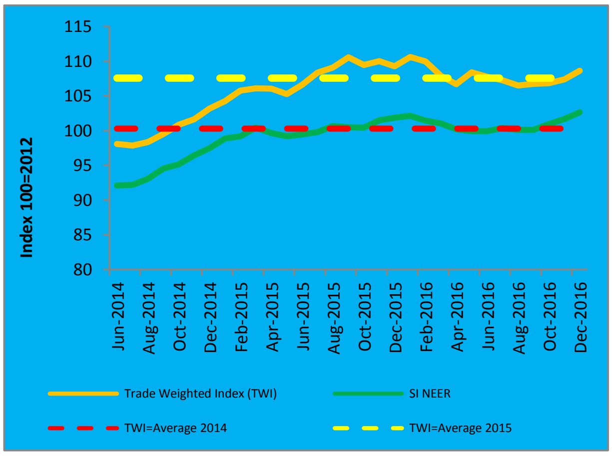
Figure 12: Nominal Bilateral Exchange Rates



Source: CBSI

Aside from minor operational changes, CBSI maintained its exchange rate policy of pegging the Solomon Islands dollar to an invoice-weighted basket of major tradable currencies during the review period. This has proved beneficial with reduced volatility and enhanced certainty in the market. Accordingly, the SBD strengthened by 1.2% against exchange rate Trade-Weighted Index (TWI) to 107.2 (see Figure 13). This reflected the SBD's movements against the USD during the second half of the year. It notably went up by 1.1% against the US Dollar to $7.90 per USD which had benefited importers with USD-dominated trade invoices. However, the SBD depreciated against the Australian dollar by 1.7% to $5.96 per AUD, and by 4.8% against the New Zealand dollar to $5.67 per NZD in the last six months of 2016 (see Figure 12).

Figure 13: Trade Weighted Index

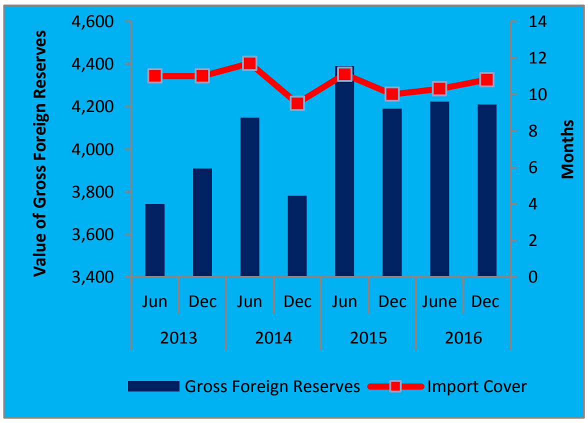


Source: CBSI

3.3.4 Reserves

As evident in the slower BOP outcome during the second half of the year, the gross foreign reserves slightly decreased by 0.3% to $4,210 million at end December 2016. The fall was attributed to the lower inflows particularly from fishing licences and a rise in trade services payments during the period. Likewise, compared to the reserves of $4,190 million in December 2015, this stock of reserves was barely up by 0.5%. Consequently, the level of gross foreign reserves was equivalent to 10.8 months of imports of goods and services (see Figure 14).

Figure 14: Gross Foreign Reserves

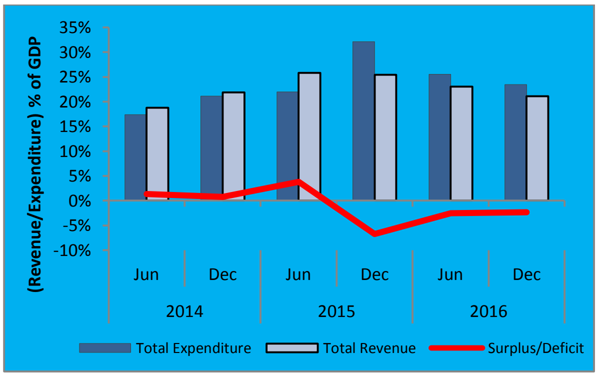


Source: CBSI

3.4 Fiscal Conditions

The country's fiscal position, while running a deficit for the past three half-year periods, slightly eased in the last six months of 2016 with a fiscal deficit of 2% of GDP (see Figure 15). This compares to the 3% of GDP deficit in the first half of 2016 and is also a relative improvement to the 7% of GDP deficit in the same period one year ago. The half year outcome emanated from the slowdown in revenue to 21% of GDP from 23% of GDP in the first half of the year. In light of the revenue gaps, and with government continuing its expansionary fiscal policy, overall spending was more restrained in the second half of the year. Expenditure slid to 23% of GDP from 26% of GDP in the previous period, and was also below the budget. Going forward, government will continue to moderate spending, while enhancing collections to limit the deterioration of its fiscal reserves.

Figure 15: Half Yearly Fiscal Performance 2014-2016

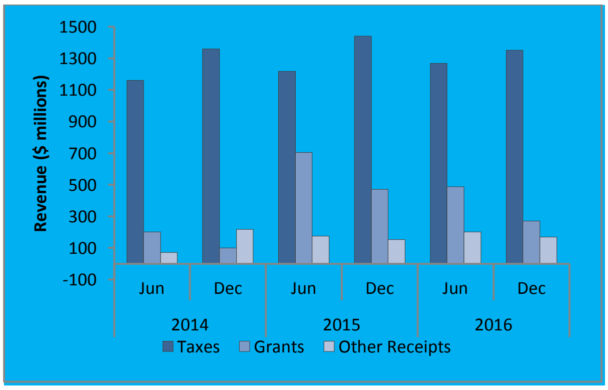


Source: MoFT & CBSI

3.4.1 Revenue

Government revenue collected in the last six months of 2016 went down by 8% to $1,746 million. This was 3% below the budget, and was also 13% lower than the same period last year. Despite a rise in taxes, the decline in the second half of the year emanated from lower grants and other revenue received by the government.

Figure 16: Fiscal Revenue Collection



Source: MoFT & CBSI

Grants directly[3] received by the government plunged from $487 million in the first half of the year to $271 million in the last six months of 2016 (see Figure 16). Notably, there were falls in both budget support and capital projects supported by donors during the period. Meanwhile, other government revenue declined 16% to $170 million on the back of a decrease in property income which exceeded the rise in the sale of goods and services. In terms of total revenue, other government revenue accounted for 9% and grants accounted for 15% during the reference period.

Meanwhile, consolidated tax revenue during the period between July and December 2016 totalled $1,351 million. This was higher by 7% against the first half of the year but was 13% below the same period in 2015 and 2% under the budget. Driving this positive outcome was the growth in individual and company taxes, goods and services taxes, and, export and import duties after the marked fall in the first six months of the year. Taxes comprised 75% of total revenue and in spite of the moderate increase, could not remedy the gap left by the fall in grants and non-tax revenues and ultimately finance expenditure.

3.4.2 Expenditure

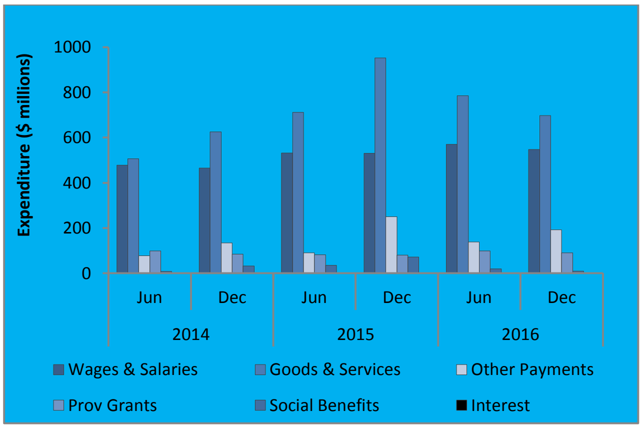
Government spending went down by 8% to $1,993 million in the second half of the year. Compared to the previous period one year ago, this was lower by 24% and was also 9% below the budget. Government's tapering off total expenditure, while implementing its expansionary fiscal policy, corresponds with the drop in revenue and the reduction in its reserves. The slowdown was witnessed in both recurrent and development expenditures.

Recurrent outlays which represents 77% of total expenditure, slid by 5% to $1,540 million. In spite of the fall, this was 9% higher than the budget. Most recurrent categories fell during the period between July and December 2016 (see Figure 17). This included a sizable drop in the procurement of goods and services, along with falls in wages and salaries, long service and contractual benefits, and provincial grants. On the other hand, other expenses rose considerably during the period on the back of increases in funding towards constituency scholarships, churches and other

[3] This only incorporates grants appropriated through the government consolidated accounts. Non-appropriated grants are expended directly by donors in agreement with the government.

rural projects. To sustain its financial resources, government must continue to control and spend within its budget.

Figure 17: Fiscal Expenditure



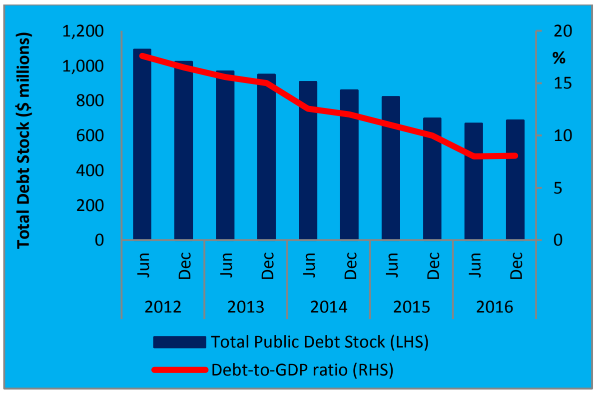
Source: MoFT & CBSI

Similarly, capital expenditure went down by 19% to $452 million and was significantly below the budget by 43% in the six months to December 2016. The outrun was attributed to the decline in funding towards road and bridge infrastructure, office complexes, and rural housing projects. Capital expenditure meanwhile accounted for 23% of government expenses, and as % of GDP has trended downward from 9% the same period one year ago, to 7% in the first of half of 2016 and 5% in the last six months of the year. This suggests that government in light of financial constraints has limited spending on the capital, and concentrated more on the recurrent side.

3.4.3 Public Debt Stock

Government debt stock rose by 3% to $686 million at end December 2016 from $669 million at end June 2016 (see Figure 18). This was the first increase in decades related to the disbursement of new external debt provided by multilateral lenders and more than exceeded debt servicing payments. As such, external debt stock also grew by 3% to $643 million and accounts for 94% of the country's debt. In contrast, domestic debt went down by 3% to $43 million during the period. Meanwhile, total debt servicing rose by 4% to $34 million in the six months to December 2016. This outcome emanated from the jump in external debt repayments that offset minor declines in the interest repayments of Treasury bill related domestic debt. In terms of total debt servicing, principal external debt repayments wholly accounted for 87% of debt servicing, while interest repayments comprised 13%. With the consistent debt servicing, the country continues to enjoy a healthy debt sustainability indicator of debt at 8% of GDP.

Figure 18: Public Debt Trends



Source: CBSI

3.5 Inflation Development

Headline inflation plummeted to negative territory at minus 2.8% by end of 2016 from 2.9% recorded at the end of the previous year and a peak of 4.1% in April 2016 (See Figure 19). The deceleration was attributed to declines in both domestic and imported inflation during the year.

Domestic inflation which reflects domestic price movements eased from 4.3% in the first half of the year to minus 1.8% by end of December 2016. Likewise, imported inflation plummeted from 0.5% in June quarter to be followed by series of price deflations since July 2016 to reaching minus 4.6% by the end of the year.

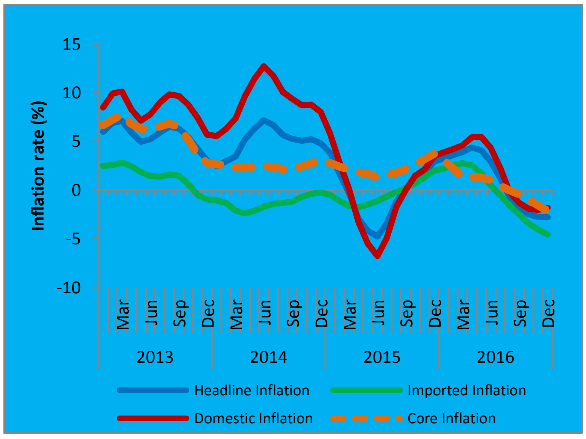
The fall in domestic component was mainly driven by price declines in the food category, drinks and tobacco, and housing and utilities during the year. The index for drinks and tobacco recorded the largest fall, contracting from 15.6% in June to minus 1.3% in December. This was followed by the food index which dropped from 7.3% in the second quarter to minus 4.2% on the back of excess food supplies from local farmers and cheaper imported substitutes. The housing and utilities index fell from minus 1.1% to minus 2.1% at the end of 2016. These deflations more than offset the moderate inflation in transport and communication while other components remained stabled.

Similarly, the decline in imported index which represents imported price movements, largely driven by significant fall in food indices from 2.2% to minus 5.3%, followed by household operations easing from minus 1.3% to minus 6.3%; clothing and footwear indices from minus 1% to minus 2.3% while miscellaneous category plunged from minus 1.2% to minus 16.2% at the end of the year.

Disaggregating the overall inflation of minus 2.8%, food remained the largest contributor accounting for minus 1.1%. This reflected the slowdown in food prices for both local and imported food categories, particularly during the second half of the year. Housing and utilities accounted for minus 0.7%, transport and communication represented minus 0.4% while all the other categories accounted for the remaining minus 0.6%.

In terms of the overall inflation development for 2016, Solomon Islands recorded negative inflation (deflation) in two separates episodes, in particular in the second and third quarter of 2015 and the second half of 2016. This reflected combined results from low imported food prices, and the fact that the drag on effect of the supply shock that hits the country in 2014 started to dissipate and therefore disappears from the headline inflation calculations. Consequently, the headline inflation fell below zero at minus 0.7% in August and sustained below zero for the fifth consecutive months up to December where it registered its lowest point at minus 2.8%.

Figure 19: Inflation Developments



Source: SINSO & CBSI

Moreover, core inflation recorded negative inflation (deflation) for the first time in trend records in the third quarter of 2016 and remained subdued from 1% in June to minus 2.2% by end of the year. This implies that price movements in non-food and non-energy categories recorded price declines during the year.

4 Economic Outlook

4.1 Global Outlook

The global economy is projected to grow by 3.1% in 2016 from 3.2% in 2015 according to the IMF's World Economic Outlook January 2017 Update. In spite of this slower growth in 2016, a buoyant growth of 3.4% is forecast for 2017 bolstered by accommodative monetary policies, more robust fiscal policies and the pick-up in oil and commodity prices. Moreover, in the medium term, global growth is expected to trend upward to 3.6% in 2018.

Economic activity in the advanced economies is projected to slowly improve to 1.9% in 2017 and 2.0% in 2018. This is underscored by more robust growth projections in the United States due to an expected fiscal stimulus and near full employment conditions. Growth in the emerging and developing economies led by China meanwhile, are expected to primarily drive global growth with a forecast growth of 4.5% in 2017 and 4.8% in 2018. However, risks remain that could weigh down growth, including a slowdown in China, less inclusive and more protectionist policies, tighter financial conditions, and geopolitical issues.

Global inflation is expected to rise in the medium term to 2.8% in 2017 – 18. Contributing to this projection is the upturn in oil and commodity prices. Moreover, inflation in advanced economies is forecast to pick up strongly to 1.7% in 2017 and 1.9% in 2018. This will come on the back of reductions in their negative output gaps and the impact of weaker currencies aside from the USD. However, consumer prices in emerging market and developing economies are expected to ease to 4.4% in 2017 and 4.2% in 2018 due to the diverse nature of these economies, with firming Chinese prices on one side, and others, the effects of past appreciations.

In terms of the outlook on global investment income, US interest rates have moved upward as the US Federal Reserve hiked rates due to a firmer US economy. Accordingly, the London Interbank Offered Rate projects US rates to jump to 1.7% in 2017 and rise to 2.8% in 2018. This monetary tightening would ultimately lead to a stronger US dollar as investors shift capital to the US markets.

4.2 Domestic Outlook

Growth prospects for the Solomon Islands economy remain positive with an average medium term projection of 3.4% between 2017 and 2019. Moreover, growth is forecast to rise to 3.6% in 2017 from the modest 3.5% in 2016. Drivers contributing to this near term outlook will come from the agriculture, fishing, construction, transport and financial sectors. On the downside, forestry is expected to level off along with public spending due to government's fiscal challenges.

Negative risks also persist on this forecast horizon including a more severe fall in the forestry sector that could have a contagion effect on the public sector and other parts of the economy such as wholesale and retail. Additionally, a stronger US dollar, steep increases in global oil prices and other external shocks such as a Chinese slowdown could also affect the economy.

After the easing of consumer prices in 2016, inflation in 2017 is projected to pick up albeit at a slower pace. Headline inflation, while at a deflation of 2.7% in January 2017 is trending up and forecast to reach the 1% – 3% range in 2017. The rebound in oil prices and the strengthening US dollar will drive this projection, although counteracted by the competition in key imported food like rice, slower government spending, and possible appreciations against the AUD and NZD.

The Balance of Payments' near to medium term projection expects moderate to lower surpluses between 2017 and 2019. This is based on continued foreign exchange inflows from foreign direct investment companies and donors, higher imports for major capital projects, and modest export levels. As a percentage of GDP, the BOP surplus is projected to fall from 1.9% in 2017 to 1.4% in 2019.

Moreover, trade in goods and services are forecast to remain in deficit over the medium term, with a deficit of 8.1% of GDP in 2017 rising to a deficit of 8.6% in 2019. The projection is based on steeper falls in exports that offset the declines in imports over the period. This due to the expected reduction in exported goods from 39% of GDP to 36% of GDP between 2017 and 2019.

On the fiscal front, government maintained its expansionary fiscal policy in 2017 with a $4.1 billion budget to implement its key development programmes. As a percentage of GDP, the fiscal deficit balance is projected at 5.6% in 2017, the same share as 2016 but then rising to 5.8% in 2018. Meanwhile, recurrent expenditure, while rising in 2017 to 32% of GDP is expected to remain at the same ratio into 2018. Capital expenditure is also expected to rise to 14% of GDP in 2017 but then taper off to 13% of GDP in 2018. To finance the deficits, government is expected to utilize its fiscal reserves. However, with recent falls in government revenue against the budget these reserves would not be sustainable in the medium term, and government would need to beef up its collection capacity, control spending or put in place a balanced budget.

5 Monetary Policy Stance

Given the macroeconomic projections that inflation would remain low in the near to medium term, the Central Bank will continue with the accommodative monetary policy stance in the next six months.