CENTRAL BANK OF SOLOMON ISLANDS

MONETARY POLICY STATEMENT

September 2018

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1 Overview

The global economy remained buoyant with growth for 2018 and 2019 pegged at 3.9%. This firm outcome will be driven by strong demand, a conducive financial environment and gradual normalization of monetary policy in the US. In contrast, growth in the EU, UK and Japan slowed reflecting weaker investment and conditions. Nonetheless, growth in the emerging and developing economies continues to be robust, particularly from the Asian region. While growth in the China has moderated, its economy remains resilient and continues to fuel demand in the region and the Solomon Islands.

Over the first half of 2018, global oil prices picked up, reflecting supply-side fundamentals in the market. Although these prices are expected to moderate over the medium term as suppliers increase production. Meanwhile, global inflation rose over the period in line with the expansion in oil prices. The outturn for core inflation in advanced economies has been mixed, with core inflation in the US close to their target but lower in the euro area and Japan. While in emerging markets, core inflation has trended upward due to weakening currencies and the impact of fuel prices.

Economic activity in the Solomon Islands gathered momentum in the first half of 2018 with growth for the year projected at 3.5%. This is an upward revision of 10 basis points from the March 2018 Monetary Policy Statement and emanated from the favourable developments in logs, palm oil, fish and construction. In contrast, other commodities, particularly copra and cocoa, and manufacturing outturns declined during the period.

Monetary conditions, while positive, moderated with slower growth over the period. Broad money rose 3% on the back of a surge in net foreign assets. Accordingly, this has led to an increase in liquidity levels in the banking system, and ultimately the continued expansion of excess liquidity. Meanwhile, credit to private sector also grew by 3% with key sectors driving growth being construction, distribution, transport and manufacturing.

The external sector improved markedly over the six months to June 2018 with a growing balance of surplus driven by the turnaround in the current account. Strong results in the trade in goods, particularly from the surge in exports, and donor grants in the secondary income account drove the positive current account. Meanwhile, the capital and financial account slowed due to a deterioration in the financial account inflows, particularly related to FDI flows, currency and deposits, and reinvested earnings. The favourable external position accordingly led to an 8% growth in the country's gross foreign reserves.

Government's fiscal balance recovered to a surplus position in the first half of the year after running a deficit over the past two six month periods. This positive outturn was primarily due a reduction in expenditure on the back of the delay in passage of the 2018 national budget, as both recurrent and development spending declined. Meanwhile, total revenue slightly decreased compared to the last six months on the back of a slowdown in grants and non-tax revenue. On the other hand, tax revenue grew over the period. Government's debt stock also remained comfortable at 10% of GDP.

While headline inflation rose to 2.4% in June 2018 against 1.8% in December 2018, inflationary pressures during the current six-month period peaked at 4.0% in March 2018. These movements stems from the growth and later moderation in food, household and utilities and fuel prices. Moreover, commodity and weather related factors are expected to continue drive inflation developments during the year. Meanwhile, core inflation remained relatively stable and marginally grew to 1.1% from 0.7% in in December 2018.

Growth prospects for the near to medium term remains buoyant. The Solomon Islands economy is expected to improve from the 3.5% in 2018 to 3.8% in 2019, as key development projects get underway and favourable conditions in fisheries, construction, wholesale retail and other services drive growth. However, downside risks remain, particularly related to natural resource sustainability, fiscal pressures and global trade shocks. Meanwhile, inflation is expected to be contained within the 2% - 4% range in 2018 and at 3% - 5% over the medium term.

2 International Economic Developments

Global economic performance remained firm in 2018 broadly in line with the previous forecast. Solid growth of 3.9% is projected for 2018 and 2019[1] supported by favourable financial conditions, firm domestic demand and investments resulted in part from the United States (US) expansionary policy. Nevertheless, growth expansions have peaked in some major economies as potential downside risk is mounting. The balance of risk is more on the down side as geopolitical uncertainty, rising trade tension and uneven growth could put pressure on the growth path.

Growth in the advanced economies is expected to be above trend at 2.4% before moderating to 2.2% in 2019. The forecast for 2018 is a slight downward revision of 10 basis points, largely reflecting moderations in the euro area and Japan that were subsequently above-potential for several quarters. Growth prospects for the United States is broadly on tract in the near-term with growth projected at 2.9% in 2018 and 2.7% for 2019. Supporting this growth path are the substantial fiscal stimulus, robust private final demand, stronger domestic demand and solid gains in the labour market creating above potential output and lowering of unemployment.

On the other hand, growth in the Euro area, a key export destination for Solomon Islands fish, palm oil and coconut oil products was lowered by 20 basis points slowed to 2.2% and is expected to recede further to 1.9% in 2019. The clouded outlook reflected weaker economic sentiments, coupled with uncertain political and trade relationships between major trading partners, in particular within the Eurozone. Additionally growth in the United Kingdom was revised downward by 20 basis points to 1.4% on the back of slower investment and economic activities due to uncertainties over post-BREXIT negotiations. The growth forecast for Japan is also downgraded to 1.0%, due to weak private consumption and investment.

For the emerging market and developing economies (EMDE), growth is projected to remain unchanged at 4.9% broadly in line with the previous update. Uneven growth is becoming profound in the EMDE reflecting combined influences of several fundamentals such as the increase in oil prices, domestic political and policy uncertainty and sentiment shifts due to escalating trade tensions. Supporting growth are firm financial conditions and increased oil prices in oil producing countries despite the underlying differentiation across countries in terms of economic fundamental and political uncertainty. Emerging and Developing Asia is expected to remain firm at 6.5% supported by

[1] All statistics in this section obtained from the International Monetary Fund (IMF) World Economic Outlook, July 2018, unless otherwise stated.

robust economic sentiments in the ASEAN-5[2] regions.

In China, economic activities softened in Q2 ahead of the new trade tariffs. With some elements of resilience, growth is forecasted to remain at 6.6% for 2018 broadly on tract with the previous forecast. Despite that, growth is expected to moderate to 6.4% in 2019 as the impact of the trade war unfolds. Meanwhile the Chinese authorities are taking qualitative and quantitative measures to avoid the material slowdown by easing fiscal policy and ensuring investment. Conditions in China ultimately have a direct impact on Solomon Islands, as China is the key market destination for round logs. Another log export destination, India is expected a slow-down by 10 basis points to 7.3% on the back of moderate domestic demand in contrast to the initial expectation on strong growth from the good and services tax regime and currency initiatives.

Growth in our neighbouring trading countries, Australia and New Zealand showed mixed movements, with Australia remaining on tract whilst the New Zealand economy moderated. Supporting the solid growth momentum, the Australian economy is forecasted to firm up at 2.9% in the second quarter supported by accommodative domestic monetary policy and positive international outlook. GDP growth is projected to rise above 3% beyond 2019[3]. As for New Zealand, economic growth has softened to 2.7% despite improved global conditions, strong population growth and low interest rates. Growth was held down by falling business confidence, continued softness in the housing market, slow down in service, construction and other temporary factors.

2.1 Commodity prices

Based on available data, commodity prices had generally picked up reflecting supply shortfalls in oil whilst food prices relatively moderate against the previous update.

The surge in global oil prices have predominantly dictated all other commodities through its direct, first and second round effect on other commodities such as tradable goods and manufacturing products. However, prices are expected to slow down to USD$59 per barrel in the next 4-5 years as the OPEC[4] and non-OPEC oil producers agreed to increase oil production and the US shale production.

2.2 Global inflation

Global headline inflation has increased slightly to 3.5% since the beginning of the year driven by higher energy prices as earlier projected. Consequently, core inflation (excluding fuel and food prices) is close to the inflation target in most advanced economies including the United States. In the United States, inflation is expected to increase to 3%, an upward revision from the previous update. The pick up could be more than expected on the back of increasing domestic demand from tax cuts and fiscal stimulus.

However, core inflation was below target for other advanced economies such as in the euro area and Japan. In the short to medium term, inflationary pressure is expected to increase as spare capacity continues to be absorbed.

Core inflation in the emerging markets have also increased driven in part by the pass though effects from currency depreciation for some countries while second-round effects of higher fuel prices for some countries.

[2] Indonesia, Malaysia, Philippines, Thailand, Vietnam
[3] Reserve Bank of Australia (RBA) Monetary Policy Statement (MPS) Aug 2018
[4] Organisation of Petroleum Exporting Countries

On the regional front, inflation outcomes in Australia were consistent with previous headline inflation forecast of 2.1% with a core inflation[5] of 2%. These reflected spare capacity in the economy associated with low wage rates. In New Zealand, inflation gradually picked up to 2% as a result of increase in tradable inflation, and the pass through of high fuel prices as the dampening effect of past low inflation disappears[6].

3 Domestic Economy

3.1 Monetary Conditions

Key monetary aggregates moderated slightly in the first half of the year in contrast to the pickup seen in the second half of 2017. Reserve money (M0), narrow money (M1) and broad money (M3) have all eased against the last six months in 2017. Meanwhile, liquidity continued to increase while private sector credit remained firm.

3.1.1 Reserve Money

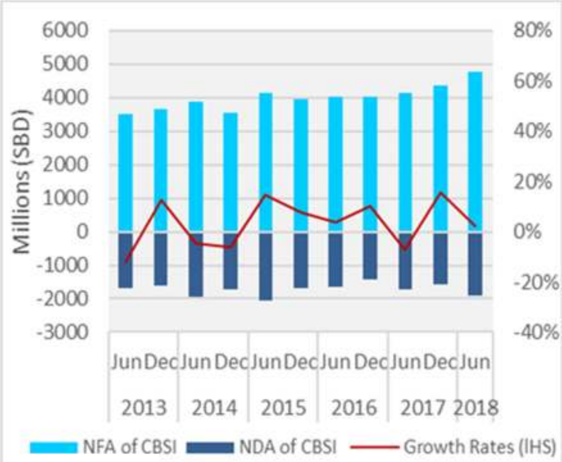
Reserve money grew at a slower pace of 2% to $2,836 million across the first six months of 2018 compared to the 15% growth posted in the second half of 2017. The growth against December 2017 was driven mainly by an increase in Other Depository Corporations (ODCs) call accounts by 6% to $1,983 million. Conversely, currency in inactive circulation declined by 5% to $848 million. On the asset side, the slower growth reflected gains in Net Foreign Assets (NFAs) by 9% to $4,760 million along with deterioration in CBSI's net domestic assets (NDA) by 21% to minus $ 1,918 million. The widening of NDA came mainly from a build-up in government deposits during the review period.

3.1.2 Money Supply

Consistent with the trend in reserve money, broad money (M3) growth eased to 3% from 6% in the latter half of 2017, standing at $5,077 million by June 2018. The growth against December 2017 mirrored a rise in narrow money by 7% to $3,907 million, driven by a 10% growth in transferrable deposits to $3,119 million. In contrast, other deposits (time and savings) fell by 7% to $1,169 million across the review period.

On the sources of M3 growth, an increase in NFA by 8% to $4,955 million underpinned the growth over the last six months. In contrast, NDA fell by more than half the amount recorded in December 2017 to $165 million. This outturn was driven by a 12% decline in Net Domestic Credit (NDC) to $1,011 million, driven by an increase in government deposits during the review period. A 2% reduction in capital accounts to $956 million combined with a 14% decrease in other items net also contributed to the decline in NDC.

Figure 1: Drivers of Money Supply



Source: CBSI

[5] RBA MPS Aug 2018

[6] Reserve Bank of New Zealand Monetary Policy Stance Aug 2018.

3.1.3 Domestic Credit

Private Sector Credit (PSC) grew at a slower rate across the first half of 2018, despite higher liquidity both at the institutional and system-wide level. PSC grew by 3% growth to $2,440 million compared to 6% growth posted in the second half of 2017. Loans issued by ODCs which increased by 3% to $2,390 million was the key driver of credit growth. The main sectors supporting this marginal credit growth in the six months up to June 2018 include construction, distribution, transport and manufacturing. On the other hand, personal, communication, tourism recorded declines during the review period.

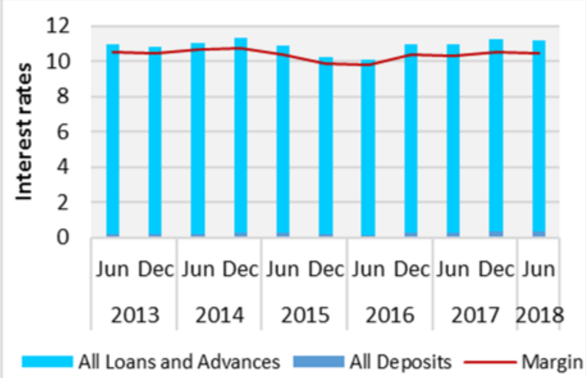
Figure 2: Private Sector Credit

Source: CBSI

3.1.4 Interest Rate Trends

The interest rate margin narrowed to 10.49% across the first six months of 2018 from 10.52% in the latter half of 2017. This result stemmed from the decline in the indicative weighted average interest rates on loans. Lending rates fell by six basis points to 10.84% and outweighed the decrease in deposit rates by two basis points to 0.35%. The fall in lending rates reflected broad based reductions across the major sectors.

Figure 3: Interest Rate Trends

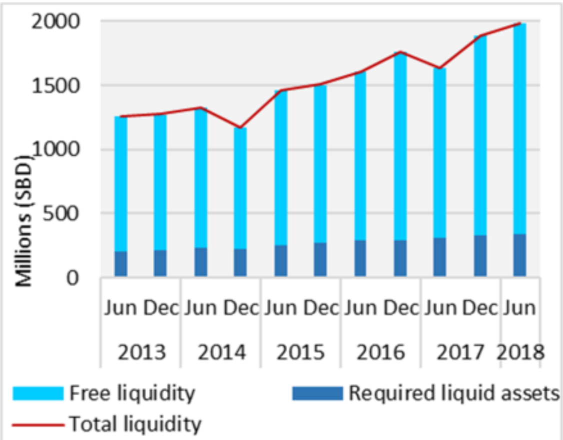


Source: CBSI

3.1.5 Liquidity Levels

Liquidity levels in the banking system continued to grow across the first six months of 2018, building on from the growth in the second half of 2017. Excess liquidity grew further by 5% to $1,467 million in June 2018 against December 2017. This was driven largely by CBSI's net foreign assets and currency in circulation. The stock of Bokolo bills floated by CBSI remain capped at $750 million at end June 2018 with the interest rate remained unchanged at 0.62%. Additionally, the SIG treasury bills remained capped at $40 million with interest rate for 56 days and 91 days maintained at 0.34% and 0.46% respectively.

Figure 4: Liquidity Levels



Source: CBSI

3.2 Domestic Conditions

Domestic economic activities firmed up in the first half of 2018 following the strong performance in the second half of 2017. Key indicators for production, construction, communication and wholesale and retail sectors performed strongly in the first half of the year. In contrast, energy, investment activities and tourism sectors eased over the period while the manufacturing sector showed mixed outcomes in the last six months.

3.2.1 Economic Growth

The domestic economy is projected to record a slightly higher growth than the March 2018 MPS projection. CBSI growth forecast for 2018 has been revised slightly upwards to 3.5%, 10 basis points higher than the initial projection of 3.4%. Underpinning the outcome were strong performances in the forestry sector, palm oil industry and coupled with the sustained growth in the fishing, wholesale retail, construction, transport, communication and financial intermediation sectors. Disaggregating the overall growth forecast for 2018 by broad sectors, the services sector is projected to contribute 2.5%, while the primary and secondary sectors are expected to contribute 0.8% and 0.5% respectively.

3.2.2 Production Index

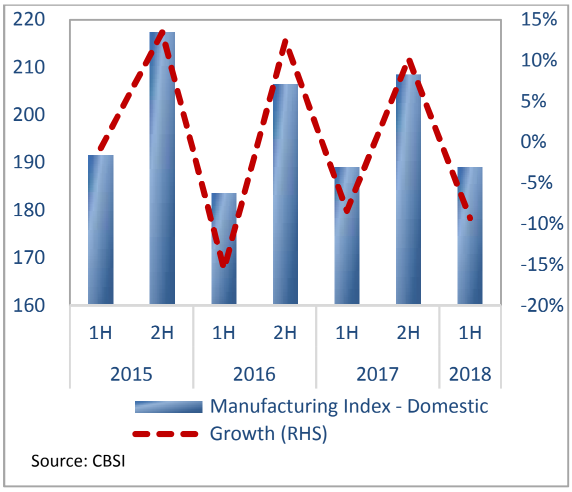
Domestic production activities expanded further in the first half of 2018 as reflected in the improvement of the CBSI production index by 5% to 106 index points from 101 points in December 2017(See Figure 5). The outcome stemmed from the robust performances in four of the major export commodities with log output increasing by 2% to 1,472 million cubic metres, fish catch rising by 18% to 19,040 metric tons while crude palm oil and palm kernel output growing by 42% to 21,135 metric tons and by 36% to 2,147 metric tons respectively. In contrast, copra and cocoa output weakened over the first half year of 2018.

Figure 5: Half Yearly Production Index

3.2.3 Manufacturing

Manufacturing activities decelerated in the first half of 2018 by 2% to an average 288 points on the back of a slowdown in outturns for domestic consumption. The domestic component contracted by 9% to 189 points (see Figure 6) and was attributed to the fall in alcohol and soft drinks by 19%, canned tuna by 8% and biscuits by 2%. In contrast, goods destined for exports improved further by 6% reflecting sustained demand for the country's tuna products in the overseas market. Meanwhile, loans to the manufacturing sector grew further by 16% to $163 million by the end of June 2018 and 21% higher than the corresponding period in 2017.

Figure 6: Manufacturing Index Trend



3.2.4 Employment

The number of Solomon Islands National Provident Fund (SINPF) contributors, a proxy for labour market conditions, showed negligible improvements during the first half of 2018. The average number of contributors[7] increased by 2% to 56,672 contributors from 55,788 contributors at the end of December 2017. This outcome was driven by the slight pickup in the number of active contributors over the period by 2% to 48,493 contributors.

3.2.5 Other Sectors

Other economic indicators showed mixed movement in the first half of 2018. Sectors that had shown a relatively improved performance were transport, communication, construction and wholesale and retail services. Lending to transport and newly registered vehicles as indicators of transport sector grew by 13% to $164 million and by 3% to 1,375 vehicles respectively. Similarly, the communication sector strengthened further with internet usage surged by 40%, mobile usage by 13% and 2% increase in fixed lines.

Meanwhile, the construction sector continued to expand in the first six months of 2018 with approved building permits rising by 7% to 162 permits, particularly related to residential and commercial approvals. Performance in the wholesale and retail activities remained robust as evident in the outcome of several partial indicators. Lending to wholesale retail went up by 9% to $462 million with employment captured under this sector also increased by 8%. Moreover, the sector continued to dominate foreign direct investment applications approved in the first half of 2018, recording 53 applicants this period albeit a shortfall of 9 applicants against the previous period.

On the other hand, weak performance showed in the energy, foreign investments and tourism sectors. Electricity generation wanned by 3% to 47,400 Megawatt hours (MWh) reversing the 5% growth recorded six months ago. Nevertheless, total units sold remained stable at 37,797 MWh and units wasted continued to decelerate reflecting improved internal controls and monitoring. While, the number of foreign investment applications received in the first half of 2018 declined by 9% to 97 applications, with a vast majority coming from wholesale retail, other services and construction. Performance in the tourism sector weakened by 28% in the six months leading to June 2018 to 15,013 arrivals from a 23% growth recorded in second half of 2017. This reflected the normalization after the rise in sea arrivals and the major events such as the RAMSI farewell and the 75th Anniversary of the Guadalcanal landings in the second half of 2017.

3.3 External Conditions

The performance of the external sector improved markedly in the first half of 2018 with a higher balance of payments (BOP) surplus compared to the last six months of 2017. Driving this outcome was the turnaround in the current account from a 2% of GDP deficit to a surplus of 5% of GDP. Meanwhile, the surplus in the ‘capital and financial’ account remained at 4% of GDP despite a reduction in financial liabilities and foreign direct investments (FDI). Accordingly, the positive half-year result saw further growth in the country’s gross foreign reserves at the end of June 2018.

3.3.1 Current Accounts

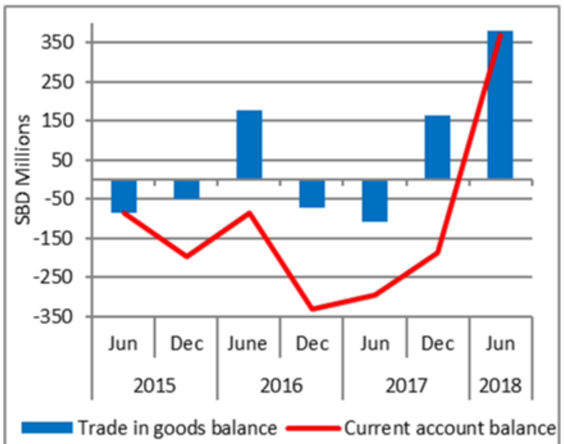
The current account improved markedly from a $188 million deficit in the last half of 2017 to

[7] Active and Slow active categories

reach $369 million surplus in the first half of 2018. This reflected strong outturns in the goods and secondary income surplus and an improvement in primary income and services deficit.

Trade in goods improved to a surplus of $380 million in the year to June 2018 compared to a surplus of $164 million in the months from July to December 2017. The upturn was attributed to the increase in exports, particularly from forestry, palm oil and re-exports amidst a fall in imports from food machineries, beverages and chemicals. Moreover, the narrowing of the trade in services deficit from $332 million to $221 million was aided by the surge in transport and travel receipts while payments in transport, travel and other services recorded falls.

Figure 7: Trade and Current Account Balances



Source: CBSI

Also on the positive trend, the secondary income increased to a surplus of $232 million in the first half of 2018 from a surplus of $123 million in the second half of 2017. This came on the back of an upswing in donor funded aid in cash and technical assistance inflows despite an increase in outward remittances by foreign workers in the country. Similarly, the primary income deficit narrowed from $143 million to $22 million due to a surge in receipts from fishing licenses and a decline in profits repatriated by foreign direct investment companies over the period.

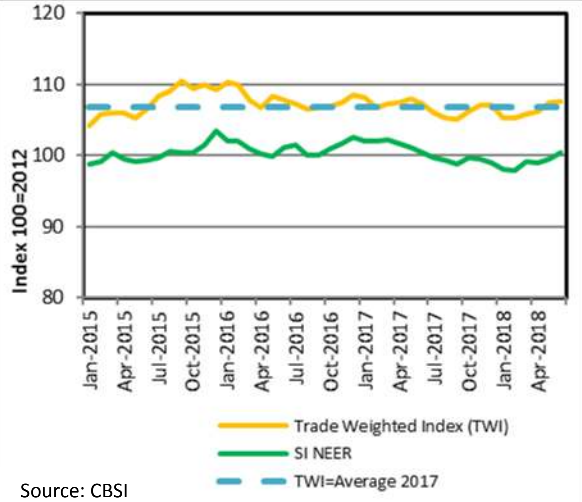
3.3.2 Capital and Financial Account

The surplus in the 'capital and financial' account fell by 15% from $405 million in the last six months of 2017 to $344 million in the period from January to June 2018. This outcome was driven primarily by the fall in financial account inflows from $193 million to $101 million. This downturn was attributed to the decreases in inward foreign direct investments and in currency and deposit liabilities coupled with the negative reinvested earnings of foreign companies in the country. Meanwhile the capital account surplus grew by 15% to $243 million reflecting donor funded capital projects in the review period.

3.3.3 Exchange Rate

The Real Effective Exchange Rate (REER) strengthened by 5.4% to an index of 152.7 in the first half of 2018 implying that the country's exports were less competitive. This outcome stemmed from the appreciation of the Nominal Effective Exchange Rate (NEER) by 1.5% to an average index of 100.5. Meanwhile, on an annualized basis, the REER and NEER in June 2018 had also both appreciated by 2.4% and 0.1% respectively against June 2017.

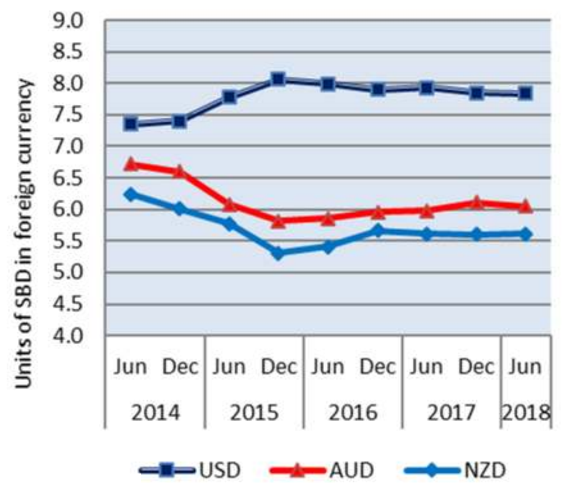
Figure 8: Trade Weighted Index



Source: CBSI

During the first six months of 2018, CBSI maintained its exchange rate policy of pegging the local currency to an invoice-weighted basket of major global currencies. Evidently, the SBD marginally weakened by 0.27% against the Trade-Weighted Index (TWI) to an average index of 107.1, and by 0.12% against the first half of 2017. In the six months leading to June 2018, the SBD appreciated against both the USD and AUD by 0.1% to an average $7.84 per USD and by 1.0% to an average $6.05 per AUD respectively. On the other hand, it depreciated by 0.3% against the New Zealand Dollar (NZD) to $5.62 per NZD.

Figure 9: Nominal Bilateral Exchange Rates

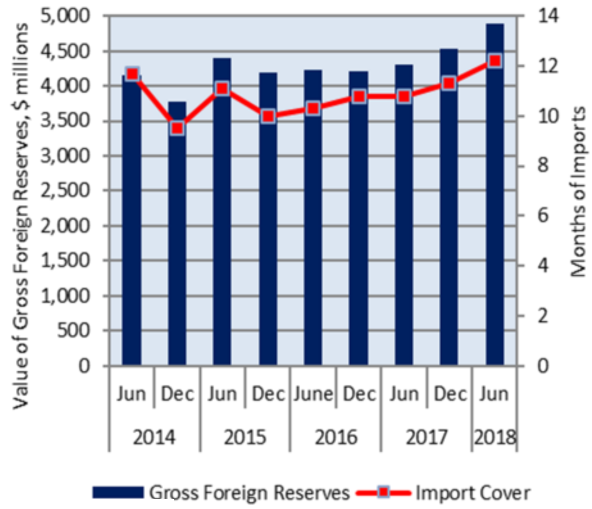


Source: CBSI

3.3.4 Reserves

The positive BOP performance during the first six months of 2018 consequently improved the country's gross foreign reserves by 8% to $4,897 million. This was due to a larger rise in inflows particularly from donor grants and fishing licences amidst declines in outflow payments. On an annualized basis, this level of reserves surpassed the same period last year by 14%. Accordingly, this level of reserves approximately represented 12.2 months of imports of goods and services.

Figure 10: Gross Foreign Reserves



Source: CBSI

3.4 Fiscal Conditions

The government's fiscal position improved in the first six months of 2018 to a surplus of $305 million against a deficit of $122 million in the second half of 2017. The fiscal surplus resulted from a sizeable decline in expenditure outlays during the review period that emanated from the delay in passage of the 2018 national budget in the first four months of the year. Government revenue also slowed down during the first half of 2018 reflecting weak revenue collections during the period. Meanwhile, the Government's debt position stood at $956 million at the end of June 2018, equivalent to 10% of GDP.

3.4.1 Revenue

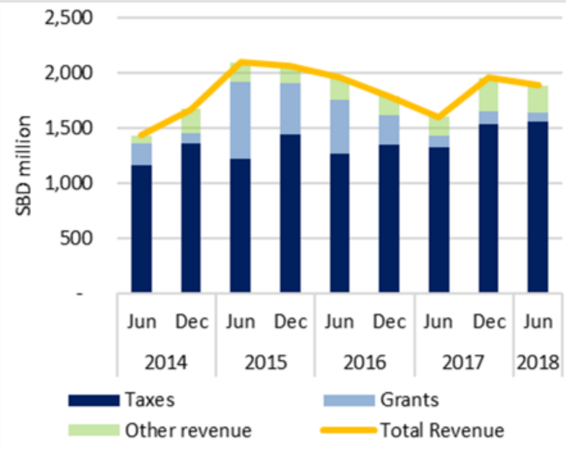
Total revenue collected by the government in year to June 2018 fell below budget by 2% to $1,886 million, and was 4% below revenue collected in the last six months of 2017. This weak performance was driven by the decline in donor grants and non-tax revenue, which outweighed the slight pickup in tax revenue during the period. However, year-on-year comparison saw a 17% growth in total revenue.

Grants received from donor partners to finance the recurrent budget, fell markedly by 27% to $82 million in the first half of 2018. This outcome was 47% below the half-yearly budget and 19% lower against the corresponding period one year ago. Non-tax revenue, which accounted for 13% of total revenue in the year to June period plunged by 21% to $240 million. Reflected the low proceeds from fishing licences over the reference period. However, year-on-year comparison, non-tax receipts were up by 34%.

Tax revenue collected in the year to June went up slightly by 2% to $1,563 million. This outturn was 4% above the budget and 18% higher than the corresponding period in 2017. This positive outcome came mainly from tax on international trade and transactions, which increased by 12% to $543 million on the back of higher receipts from log exports. The 7% growth in tax on properties to $19 million also contributed to this outcome. On the other hand, tax on income, profits and capital gains edged down by 4% to $523 million while tax on goods and services fell by 3% to $503 million.

In terms of revenue share, tax receipts accounted for 83%; non-tax revenue contributed 13% while donor grants accounted for the remaining 4% for the review period.

Figure 11: Fiscal Revenue



Source: CBSI

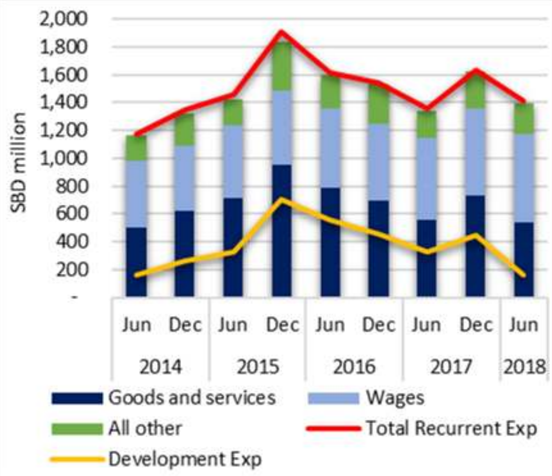
3.4.2 Expenditure

Total government expenditure fell short by 21% against the budget to $1,581 million in the six months to June 2018, and 6% below the corresponding period in 2017. The fall came from both recurrent and development expenditures. This outcome was expected due to the trending effects where government spending normally slowed in the first half of the year. The government's delay in passing the national budget during the first four months of 2018 also contributed to this outcome. Despite the expenditure shortfall, spending on most expenditure categories remained relatively high compared to the year to June of 2017. Moreover, government's spending is cyclically expected to pick up strongly in the second half of the year.

Recurrent spending, which accounted for 90% of total expenditure, dropped by 13% in the year to June 2018 to $1,417 million. This was 17% below the half-yearly budget, but 4% above the same period a year ago. The general slowdown in government expenses reflected the tight spending on goods and services during the reference period, falling by 27% to $536 million, and a 29% decline in other expenses to $116 million coupled with the slight drop in interest payments and subsidies. Meanwhile, government spending on wages and salaries, grant transfers and social benefits recorded growth over the review period.

Capital expenditure in the first half of 2018 amounted to $163 million, a significant downturn from $434 million in the preceding six months. This was significantly below budget by 47% and 50% lower than the corresponding period in 2017. This result came mainly from spending cuts across all categories during the period including buildings and structures, machinery and equipment and other fixed assets. In terms of share, development expenditure accounted for only 10% of total government outlays during the first half of the year.

Figure 12: Fiscal Expenditure

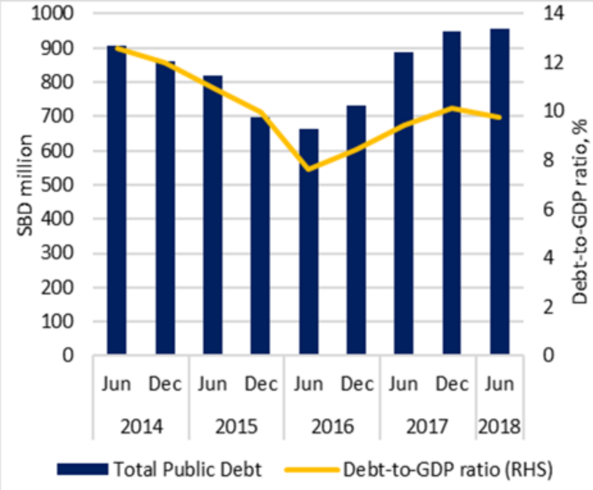


Source: CBSI

3.4.3 Central Government debt

Total Central Government debt increased further to $956 million at the end of June 2018, a 1% growth from $949 million in December 2017 and 8% higher than the corresponding period a year prior. The upturn in public debt stemmed mainly from the loan disbursement by multilateral financial institutions. Of the total debt stock, external debt represented 80% ($689 million) while domestic debt accounted for the remaining 20% ($195 million). Meanwhile, total debt repayment dropped by 10% to $31 million during the period compared to $35 million repaid in the last six months of 2017. By components, $19 million (60%) was for principle repayments and $12 million (40%) went for interest payments. As an indicator for the country's level of debt sustainability, the debt-to-GDP ratio remained at 10% of GDP at the end of June 2018.

Figure 13: Public Debt Trends



Source: CBSI

3.5 Inflation Developments

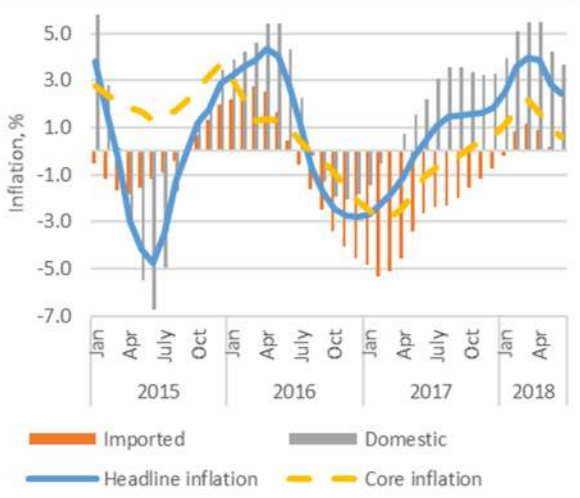
Headline inflation started to pick up in the first three months of the year reaching a peak of 4.0% in March 2018 compared to 1.8% in December 2017. By June, this inflationary pressure had moderated to 2.4% due to slowdowns in both domestic and imported inflation. However compared to the same period last year, inflation was lower at 0.5% in June 2017. Broad categories contributing to the June result was food with 1%, followed by housing and utilities at 0.6%, transport and communications with 0.3%, and drinks and tobacco and recreation at 0.2% each, whilst all the other categories accounted for the remaining 0.2%.

Compared to December 2017, domestic inflation increased by 0.4 percentage points to 3.7% in June 2018. Driving this result was food prices, particularly seasonal market produce, which rose by 0.8 percentage points to 2.2%. Similarly, transport and communication categories picked up by 0.3 percentage point to 2.4%, and household operations rose by 0.1 percentage point to 0.6%. Meanwhile, all other categories moderated over the first half of the year.

Imported inflation have also inched up from -0.8% in December 2017 to 0.1% in June 2018, albeit at a relatively moderate level compared to 1.2% in the first quarter of this year. The uptick in imported inflation reflected the turnaround in prices across broad categories except for clothing and footwear. Food inflation improved by 10 basis points to minus 1.4%, housing utilities increased by 20 basis points to 2%, transport and communication edged up by 3.2 percentage points to 4.8%, and household operation rising by 1.4 percentage points to minus 0.2%.

Meanwhile, core inflation grew to 4% in March 2018 from 0.7% in December 2017 before moderating to 1.1% in June.

Figure 14: Inflation Developments



Source: CBSI

4 Domestic Economic Outlook

While growth is expected to moderate in 2018, it is projected to firm up over the medium term as major pipeline investments come on stream. However, due to the narrow economic base, the potential for downside risks over the horizon outweighs upside risks such as high commodity prices and favourable global conditions.

Economic growth for 2018 is revised upward by 10 basis points to 3.5% on the back of stronger than expected output in the logging sector against the zero growth initially expected and favourable outcomes in the palm oil industry. Additionally positive performance in services sector, particularly wholesale & retail and transport & storage aided the upward revision.

Over the medium term the output remains positive, anchored by projected strong growth in the construction sector, wholesale and retail, transport & storage and financial services. Growth in the medium term is expected to increase to 3.8% in 2019 and 3.9% in 2020 considering the roll out of big ticket projects such as the submarine cable, Tina Hydro and the Pacific Games.

On the other hand, downside risks may take a toll on growth and other macroeconomic fundamentals. Uncertainty surrounding the sustained fiscal pressures, logging sector sustainability issues and the possible negative impact of China's trade war with the USA may weigh on growth in the domestic economy. Over the medium term, the lack of a broad commodity base and the potential for an adverse impact on fisheries and agriculture due to Solomon Islands' possible graduation from least developing country status could affect the economy.

Inflationary pressures are contained and expected to remain within an acceptable band of 2-4% in 2018 and 3-5% over the medium term forecast horizon. The moderate level of inflation is expected on the back of slowdown in both the domestic and imported inflation and in particular food components. Inflation volatilities are expected to continue as international fuel prices continued to increase, commodity prices and changing weather patterns. Underlying inflation is expected to move between 1%-3% over the medium term.

Given the comfortable level of inflation and growth aspirations, there is still spare capacity to accommodate any upward inflationary pressures.

The external conditions are projected to improve further to a balance of payment surplus in 2018, with a narrowed current account deficit and increased capital and financial account. However marginal deficits in the overall balance are projected for 2019-2020 reflecting higher imports for planned major projects by the Government in the medium term. These associated current account deficits are expected to be funded by donor inflows, foreign borrowings and other investments. The external reserves are expected to adequately cover 11 months of imports of goods and services in the medium term.

5 Monetary Policy Stance

Considering the spare capacity in inflation developments, the moderation in growth in 2018, along with the country's growth aspirations and stable macroeconomic conditions, the CBSI will maintain the accommodative monetary policy stance for the next six months. Nevertheless, appropriate measures will be considered in the event of adverse shocks that might affect the local economy.