CENTRAL BANK of SOLOMON ISLANDS

P.O. BOX 634, Honiara, Solomon Islands

Year to May Macroeconomic Update

<u>Governor's Statement</u>

July 9, 2021

Wednesday this week marked the 43rd Independence Day of our beloved Solomon Islands. The journey of nationhood has not been smooth riding. Economically, our country has gone through myriad of challenges. This morning, I'd like to provide a brief economic update on our economy following the covid19 pandemic and what lies ahead.

Before I do that, let me briefly touch on the global economy.

The global economy is projected to recover by 6% in 2021 following the recession in 2020. This is owed to large economies' fiscal and monetary policy support and rapid vaccinations. Commodity prices are also expected to remain robust throughout 2021 and 2022 in line with the anticipated economic recovery. These growth prospects, however, remain highly uncertain as well as uneven due to the new virus mutations, vaccine availability and the efficacy of policies.

The domestic economy entered a recession in 2020 with an economic growth of minus 4.3%. **(**Put it differently, the economy contracted by 4.3%). **This year we are projecting a recovery of a 1.5% growth** on the back of key national infrastructure projects and recovery of some sectors such as the fishing and agriculture.

Over the medium term (2022 – 2025), growth is expected to average at 3.5%, with high growth rates concentrated in 2022 to 2023 of around 5% and 6%. This will come mainly from the anticipated booming construction activities for the Pacific Games and other key national projects such as Tina Hydro. Despite this positive outlook, risks are skewed to the downside and remain highly uncertain.

In terms of Labour market conditions, it has been modest, with considerably slow hiring across sectors. In particular, employment in the construction sector as indicated by the SINPF contributions (as proxy for employment) was relatively low and vacancies advertisements were also slow. The services sector, particularly the transport sector remained subdued due to continued border closure and weakened exports. There is also an employment freeze across the public sector except for certain priority positions.

With regards to prices, Inflation trajectory has been low over the years and remain so throughout 2020 and into the first half of this year. The latest figure we have is for April 2021, recording at minus 1.4% from minus 1.8% in December 2020. The slight increase was driven mainly by the pick-up in oil prices combined with continued weak demand in the economy. Inflation is expected to improve to 3.0% by year end.

The external trade deficit widened in the first five months up to May 2021, with a 15% fall in exports while imports dropped by 10%. Most export commodities, in particular round logs slowed down as expected. Weaker domestic demand also had had a negative impact on import consumption.

In terms of exchange rate, the Solomon Islands dollar (SBD) had remained stable against the Trade weighted basket index, with a small upward movement of 1.22% in June. Accordingly, the US dollar (the internationally convertible currency) remained stabled against the local currency. The Solomon Islands exchange rate regime is that of a managed pegged to a basket of currency.

Despite the negative growth and the slowdown in the economy, the country's Gross foreign reserves remained high and well above our three months minimum threshold. By June, our foreign reserves sit at $5.488 billion, equivalent to 13.9 months of import cover. These high reserves are driven largely by donor inflows. Thanks to our donors.

The outlook for the overall balance of payments in 2021 is expected to remain at a smaller surplus from a projected widening trade deficit. Nonetheless, capital and financial inflows are anticipated to increase, resulting in a slight build-up in the foreign reserves. Over the medium term, the continuation of the key pipeline infrastructure projects means the current account deficit would widen further from high capital imports, although this will be financed by donor capital grants and FDI in the capital and financial accounts.

Despite the challenges posed by COVID-19, the financial sector continued to remain stable and profitable, though reduced. **Monetary conditions** were broadly sustained with monetary aggregates expected to increase in 2021 and beyond, in tandem with the medium-term growth forecast. Both reserve money (M0) and broad money (M3) are forecasted to increase moderately over the medium term. P**rivate sector credit** is projected to increase but at a modest pace whilst liquidity levels are expected to remain high in line with the current expansionary monetary stance employed by CBSI. On this note, the Central Bank will continue to work closely with and support the Government as the country moves into the recovery phase.

That said, let me briefly say something on the fiscal front. At the outset, let me acknowledge and congratulate the Government for its steadfast containment measures implemented to cushion the country against the COVID-19 pandemic. The strict measures put up by the Government have indeed contained community transmission. Well done Government. However, It's not yet over until it's over!

On the economic front, the containment measures have had a toll on Government finances. The impact of the pandemic put a strain on government finances. The late passage of the 2021 government budget in April constrained the use of fiscal policy to boost domestic activities in the five months to May 2021.

Tax revenue collections remained broadly weak reflecting the prevailing depressed economic conditions. **Non-tax revenue,** particularly from fishing license fees, were significantly lower than expected. These, combined with fewer grant receipts in the five months to May 2021, weakened overall revenue collections.

On the expenditure side, spending pressures are mounting. With domestic revenue collections remaining subdued and budget support disbursement delayed, this has subsequently led to cash flow challenges and in turn, payment rationing. If this trend persists into the second half of 2021, the fiscal deficit of 3% of GDP envisaged in this year's budget could widen further.

This calls for a closer scrutiny and warrant more on priority spending, the need for increased budget support or additional borrowing to finance the development budget. Better still, more targeted priorities should focus on short term policies during the recovery phase. The medium to long term policies should follow later on towards the end of the recovery phase. In short, perhaps the government could come up with a proper expenditure switching and expenditure reducing policy.

Support from our development partners are duly acknowledged. Going forward, further closer collaboration between government and development partners on mutually agreed principles would be welcoming.

Two immediate risks in the fiscal side we are envisaging are:

(i) depletion of fiscal buffers (cash reserves), and
(ii) the potential adverse knock-on effect from government's non-payment of service providers to our financial system.

Fiscal buffers have eroded in recent years, limiting the Government's ability to respond timely and effectively to the ever-present risks of climate induced shocks and economic shocks. Furthermore, late payments of service providers most of whom have mortgages (or loans) with the financial institutions leads to building up of non-performing loans, which could potentially destabilize the financial system if it becomes systemic.

Over the medium term, fiscal pressures are expected to remain abound. More social services and physical infrastructures will be needed to sustain the country's growing population. With fiscal position continuing to deteriorate and the economy growing at a slower pace, this could potentially lead to more debt financing. Although the nation takes pride in hosting the 2023 Pacific Games, it is a commitment that could put huge pressure on government finances if not managed well. In essence, fiscal discipline and continued donor support remain crucial to ensure fiscal sustainability over the medium term. **Government's outstanding debt** balance as May 2021 rose to $1,621 million (or 13% of GDP) from $1,450 million in December 2020. The increase stem from the new loan obtained from JICA. Government debt is expected to rise once planned domestic borrowing to finance SIG's budget shortfall eventuated. Although the debt-to-GDP ratio remain low, this will increase once the funding for Tina Hydro kicks in. If the funds are spent and managed well for infrastructure purposes, the returns from these projects should be able to more than offset the level debts.

On the policy front, the Central Bank will continue to consolidate economic recovery efforts, strengthen supervisory oversight, financial inclusion initiatives, and reduce business red tapes. Some institutional processes (including that of the Government) that hinders financial institutions from proactively involved in lending requires streamlining through digitization.

As part of supporting the Government to promote businesses to recover, the Central Bank has relaxed some of its capital control, this became effective as of yesterday, Thursday 8th July.

Later this 3rd quarter, the Central Bank will introduce an export finance facility to support small exporters once the export finance facility guidelines are finalized. The CBSI is also encouraged to note the renewed domestic confidence in the Government's security papers and stands ready to absorb any government bonds that bondholders would like to offload for liquidity or some other reasons.

Once again, I wish to reiterate that the Central Bank will work closely with the Government to recover the economy. As an agent of the Government, we are here to provide economic and financial advice to Government.

Finally, lately there has been so many fast money-making schemes popping up in and around Honiara. I'd like to advice our good people, don't fall into such schemes. You will end up losing your hard-earned savings from such schemes. Reiterating our recent press release regarding the new currency (i.e. *SolYork* currency), there is no such thing. The only legal tender in the country is the Solomon dollar. People should stay away from such undertaking.

Thank you very much.

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Appendix

May YTD 2021 Macroeconomic Outcome

			Domestic Macroeconomic Indicators					
Sectors	**Indicators**	**Unit**	**2019**	**2020**	**Annual change**	**YTD May 20**	**YTD May 21**	**YTD change**
Domestic	Economic Growth	%	1.2	-4.3	▼-5.5	-4.3 (annual)	1.0 - 1.5 (annual)	▲5.3
	Production Index	Index= 100	98	80	▼-18%	81	77	▼-4%
	Round logs - natural + plantation	000 m3	2,626	2,319	▼-12%	1,040	969	▼-7%
	Copra	tons	8,055	11,768	▲46%	4,779	5,301	▲11%
	Fish Catch	tons	40,859	24,435	▼-40%	8,725	9,998	▲15%
	Cocoa	tons	4,335	4,320	▼0%	1,283	847	▼-34%
	Palm Oil	tons	41,279	40,365	▼-2%	17,726	13,425	▼-24%
	SINPF contributions	count	60,643	57,028	▼-6%	57,028 (Dec)	55,949	▼-2%
External	Trade Balance (Net Exports)	$m SBD	-298	-300	▼-1%	-159	-211	▲32%
	Export	$m SBD	3,765	3,275	▼-13%	1,337	1,130	▼-15%
	Import	$m SBD	4,063	3,576	▼-12%	1,496	1,340	▼-10%
	Gross Foreign Reserves (FOREX)	$m SBD	4,706	5,315	▲13%	5,315 (Dec)	5,488	▲3.3%
	Import cover	months	11.9	13.3	▲1.4	13.3	13.9	▲0.6
Fiscal	Fiscal Balance	$m SBD	-202	-307	▼-52%	-51	-105	▼-108%
	Gov't Revenue	$m SBD	3,633	3,800	▲5%	1,426	1,116	▼-22%
	Gov't Expenditure	$m SBD	3,834	4,108	▲7%	1,477	1,202	▼-19%
	SIG Debt	$m SBD	1,074	1,450	▲35%	1,450 (Dec)	1,621	▲12%
	External	$m SBD	801	999	▲25%	999	1,168	▲17%
	Domestic	$m SBD	273	452	▲66%	452	453	▲0%
Money	Reserve Money (M0)	$m SBD	2,852	3,509	▲23%	3,509 (Dec)	3,557	▲1%
	Broad Money (M3)	$m SBD	5,082	5,418	▲7%	5,418 (Dec)	5,624	▲4%
	Liquidity	$m SBD	1,921	2,510	▲31%	2,510	2,410	▼-4%
	Private Sector Credit (PSC)	$m SBD	2,553	2,489	▼-3%	2,513	2,567	▲2%
Prices	Headline Inflation	%	2.8	-1.8	▼-4.6	-1.8 (Dec)	-1.4 (Apr)	▲0.4
	CBSI Monthly Price Index (MPI)	Index= 100	100.0	97.4	▼-3%	106	102	▼-4%
	Exchange rate - USD	SBD per USD	8.17	8.22	▲1%	8.28	8.00	▼-3%
	Exchange rate - AUD	SBD per AUD	5.68	5.66	▼0%	5.39	6.18	▲15%
	Exchange rate - NZD	SBD per NZD	5.39	5.34	▼-1%	5.16	5.75	▲11%
	Interest rate - 28 days Bokolo Bills	%	0.54	0.47	▼-0.1	0.35	0.19	▼-0.2
	Interest rate - 91 days Treasury Bills	%	0.49	0.49	▬0.0	0.49	0.49	▬0.0
	Crude oil	US$/bbl	66	41	▼-39%	41	63	▲53%

Source: Central Bank of Solomon Islands; External Sources: Treasury, Customs, Statistic, & World Bank