CENTRAL BANK OF SOLOMON ISLANDS

MONETARY POLICY STANCE FOR 2006.

(MEDIA RELEASE)

Introduction

This is the fourth Monetary Policy Statement to be issued by the Central Bank of Solomon Islands to the public. Its aims are two fold: first, the Bank wishes to inform the public of recent economic developments in 2005 and the outlook for 2006, and secondly to broadly outline likely monetary policy actions to be taken by the Bank in 2006. This public statement is issued as part of ensuring accountability and transparency in the discharge of the Bank's mandate and responsibilities.

The monetary policy stance for 2006 was formulated in light of developments and projections in both global and domestic economic conditions. In the domestic economy, attention was given to developments and projections of the balance of payments and fiscal operations and their possible impacts on monetary aggregates and prices. These are summarized below:

1.0 Recent Economic Developments

Based on provisional data available to the Bank, it is estimated that the Solomon Islands economy grew further in 2005. Real gross domestic product [RGDP] grew by 5% during the year compared to a revised 8% in 2004. This growth reflected favourable external and domestic outcomes.

Growth in the global economy in 2005 remained high at 4.3% as a result of strong performances in the major leading economies, such as the US, Japan and China. This had a positive impact on the Solomon Islands economy especially through stable commodity prices and export growth during the year. On the downside, however, high fuel prices resulted in a dramatic rise in import payments.

Provisional data on domestic economic activities indicate positive developments in 2005 both in the production and the export sectors. In the production sector, most major commodities recorded increases, which led to a 4.7% rise in the overall production index. In the export sector, export receipts rose by 7.0% which partly contributed towards growth in the external reserves at year-end. To ensure this momentum continues, all stakeholders in the economy need to take necessary actions in addressing impediments, weaknesses, and constraints that undermine the economic recovery process.

The resilience of the private sector, positive global conditions and continued donor support were the major factors for the positive outcome in the balance of payments (BOP) during the year. Accordingly, external reserves rose by 20%, to over 6 months of import cover. With the improved situation, the Bank relaxed exchange controls during the year. The Solomon Islands dollar remained relatively stable against the major trading currencies during 2005 as a result of the Bank's policy of stabilizing the Solomon Islands dollar [SBD] against the US dollar during the year. This policy had a moderating effect on inflation during the year and would likely continue in 2006.

On fiscal operations, available data show an accrued deficit of $32.8 million in 2005, a turn around from a surplus of $99.2 million in 2004. Despite this outcome, monthly collections were above budget estimates during the year. The robust revenue collections reflected donor assistance and compliance with collection mechanisms put in place. Total government revenues (including grants) were $832.4 million, of which, locally generated revenues represented 75.2%. The impact on government revenues from the recent Honiara riots is anticipated to be insignificant. Government expenditures increased by 41.4% to $865.2 million, of which payroll costs accounted for 25.8%. Debts servicing rose by 15.4% to $78.1 million in 2005, with further settlement of domestic arrears and trade creditors anticipated in 2006.

Developments in monetary conditions in 2005 were influenced by favourable developments in the external sector and growth in credit to the private sector. The former increased by 22.6% and the latter by 63.1%. Consequently money supply (M3) rose by 38.9% to $863.7 million. Net credit to government declined during the period due to government's build up of its deposits in the banking system. The excess liquidity overhang persisted during the year.

Monetary policy in 2005 targeted price stability and especially efforts to mitigate the negative impact of the excess liquidity overhang in the economy. High liquidity poses threats to the country's foreign reserves, so the Bank will continue to closely monitor changes in the surplus liquidity position and if necessary, take appropriate remedial actions.

2.0 Forecasts for 2006

Based on the above developments and available data to date, the Bank has forecast real GDP to grow further in 2006 by around 5%. However, this is based on the assumption that the law and order situation continues to be stable. Furthermore, this assumes that the impact from the recent destruction in Honiara would be insignificant and that production of major commodities continues to be firm, government remains committed to implementing its reform programs and donor assistance to the country continues. The rebuilding of damaged properties will have positive impact on the construction sector, create job opportunities and contribute to economic activity.

The 2006 growth prospects for the global economy and in particular the Asian economies, remain positive. This is good news for the Solomon Islands. However, in order for the economy to benefit from the gains in the global economy, it is crucial that decisive action is taken to address existing impediments that constrain the economy's growth potentials. Special attention should be given to possible adverse effects emanating from the recent Honiara riots and destruction of properties. These need to be comprehensively addressed so the domestic economy can benefit fully from the global growth and positive developments in the country.

On the external front, the export sector is projected to increase in 2006 despite the recent riots. It appears that apart from the RIPEL fires, the export sector was not affected by the recent disturbances. In addition, palm oil production is expected to come on stream in the second half of the year. And although imports will also increase, driven by high oil prices and strong domestic demand, the balance of payments is expected to record another surplus in 2006.

Money supply is expected to increase further, as a result of growth in net foreign assets and private sector lending. This is likely to cause further increase in liquidity that could exert upward pressure on domestic inflation and downward pressure on the external reserves. The Bank expects to maintain the policy of managing domestic liquidity through open market operations and as a new strategy consider NPF investing a portion of its excess funds overseas.

3.0 2006 Monetary Policy Stance

The improvement in economic activity in 2005 provided a positive basis for further growth in 2006. However, the recent riots in Honiara would impact adversely on investor confidence as they have heightened future security risks to both businesses and individuals. The Bank therefore believes that the underlying situation remains fragile and the gains to date from the recent economic recovery process can be easily reversed.

In light of all this, the Bank's monetary policy stance in 2006 was designed to continue fostering economic conditions required for orderly and balanced economic development of the country. This being its primary goal, the Bank will continue to closely monitor developments in the main macroeconomic indicators namely the exchange rate, inflation, external reserves, money supply and credit aggregates and will take appropriate action if and when necessary.

To this end, the following key macroeconomic objectives will underpin monetary policy actions in the short to medium term:

i. To maintain price stability and keep inflation to single digits;
ii. To sustain the level of external reserves at above five months of import cover: three (3) months cover is considered to be the danger level;
iii. To encourage greater private sector access to credit particularly in the rural areas.

4.0 Conduct of Monetary Policy

In implementing the foregoing monetary policy stance, the Bank will apply the following instruments:

(a) <u>NPF Investment Option</u>

This is not a normal monetary policy instrument. However, the Bank will consider National Provident Fund proposals to invest a portion of its funds overseas as a means of reducing excess liquidity in the banking system. The amounts and timing will be determined in line with the level of the external reserves.

(b) Open Market Operation

Despite a history of being an ineffective tool, the Bank still sees the importance of this instrument in the conduct of monetary policy and the influence it has on liquidity management. The Bank would issue its own debt instrument and may use statutory powers should events deem it necessary.

(c) **Exchange Control**

For the purpose of enhancing and maintaining positive developments in the economy, the Bank will continue to review all existing exchange controls with the view of further relaxation if the situation allows.

(d) Exchange Rate Policy

In ensuring the export sector remains competitive and inflationary pressures are capped, the Bank will maintain the current exchange rate policy of stabilizing against the US dollar. However, should the need arise the Bank will review this policy.

Central Bank of Solomon Islands
2nd May 2006.