CENTRAL BANK of SOLOMON ISLANDS

MONETARY POLICY STANCE 2008

HONIARA
April 2008

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Monetary Policy Stance 2008

The Central Bank of Solomon Islands (CBSI) faces a challenging economic environment in 2008, with inflation rising and the import cover of reserves trending downwards. The following paper outlines the CBSI monetary policy stance for 2008. The first section provides a summary of the main monetary and economic developments in 2007, while section two presents the forecasts of key variables for 2008. The third section outlines the monetary policy strategy for the year ahead, describing how CBSI intends to achieve its stated objectives of maintaining price stability, adequate foreign reserves, and thereby creating a suitable environment for economic growth and development in Solomon Islands.

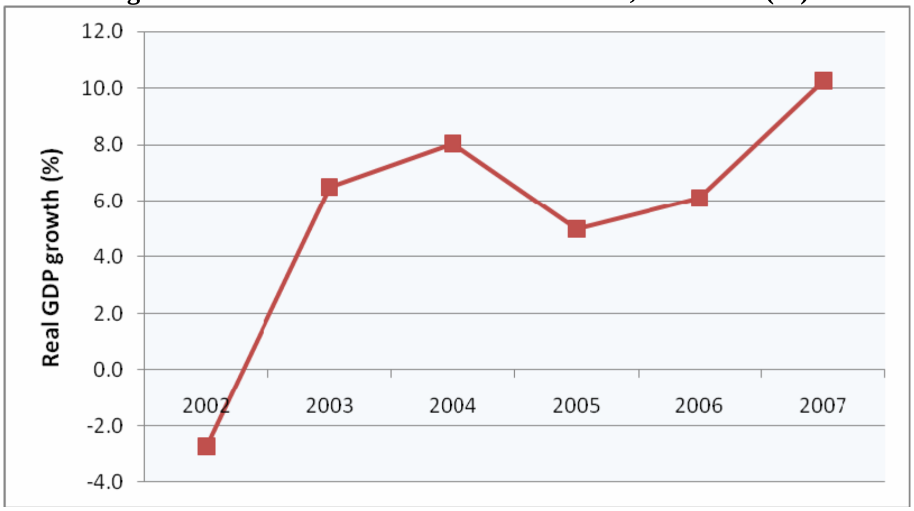
1. Economic developments in 2007

2007 was another expansionary year for Solomon Islands. Economic growth reached a 15-year high of 10.3%, and private sector lending and money supply increased rapidly. In another positive development, excess liquidity fell by over $80 million. Familiar problems, however, remained. The BoP surplus was dependent on large aid inflows, and the trade deficit widened further this year. Foreign reserves increased, but import cover fell during the year. Most worryingly for CBSI, inflation was recorded at 10% in 2007, in large part a result of the soaring international price of oil.

1.1. GDP

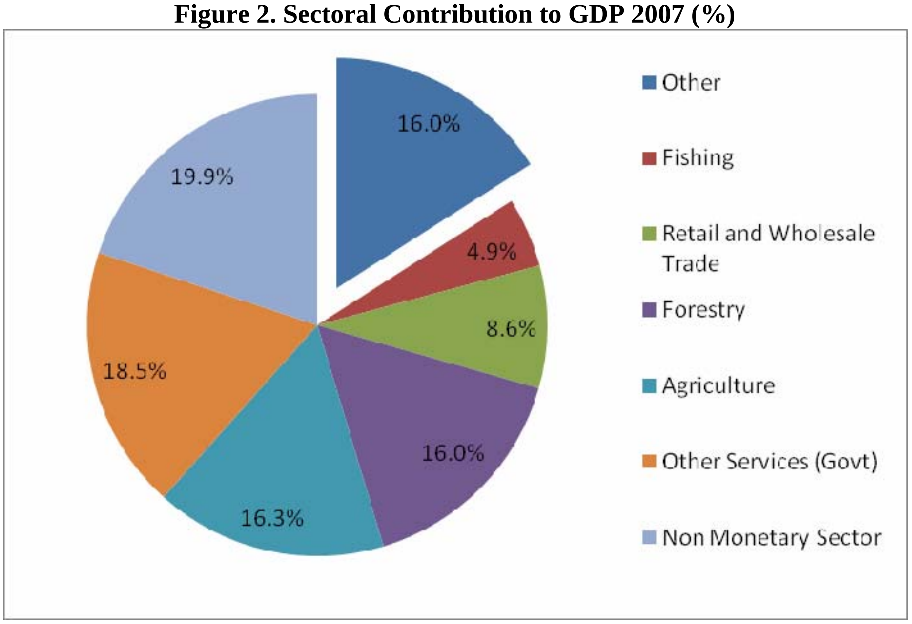
Real GDP growth in Solomon Islands was an impressive 10.3% in 2007 (figure 1), a significant increase on 2006 and the highest annual growth in the economy for 15 years. Positive outcomes in a number of sectors contributed to this outcome, but the largest factor was the massive expansion in logging activities during the year. The forestry sector represents 16.0% of total GDP (figure 2), and export of round logs increased by 24.5% in 2007. While providing a welcome boost in terms of foreign exchange inflows and other income generating activities in the country, this rate of output is completely unsustainable. The expansion of logging this year has brought closer the imminent decline of the forestry sector, now forecast to begin as early as 2010, and which is of serious concern for the country. Non-logging growth in 2007 is estimated at 6.4%.

Figure 1. GDP Growth in the Solomon Islands, 2002-2007 (%)



The most positive development in GDP in 2007 was the strong performance of the agriculture sector. Agricultural production (not including subsistence) represents 16.3% of total GDP, and overall the sector grew by 21.2% in 2007. Most striking was the huge increase in production of palm oil products, with output increasing almost threefold compared with 2006 (though production only began in May 2006). Cocoa production was also very positive in 2007, increasing by 16.8% despite adverse weather conditions, while copra production increased even more by 21.2%, largely stimulated by the soaring price of copra and coconut oil on international markets.

Figure 2. Sectoral Contribution to GDP 2007 (%)



Fishing, the other major productive sector in the country representing 4.9% of GDP, experienced a significant decline in 2007, with a sectoral contraction of 15.1%. Total catch fell by 28%, with both major companies experiencing a reduction in catch due to poor fishing conditions and a reduction in the fishing fleet.

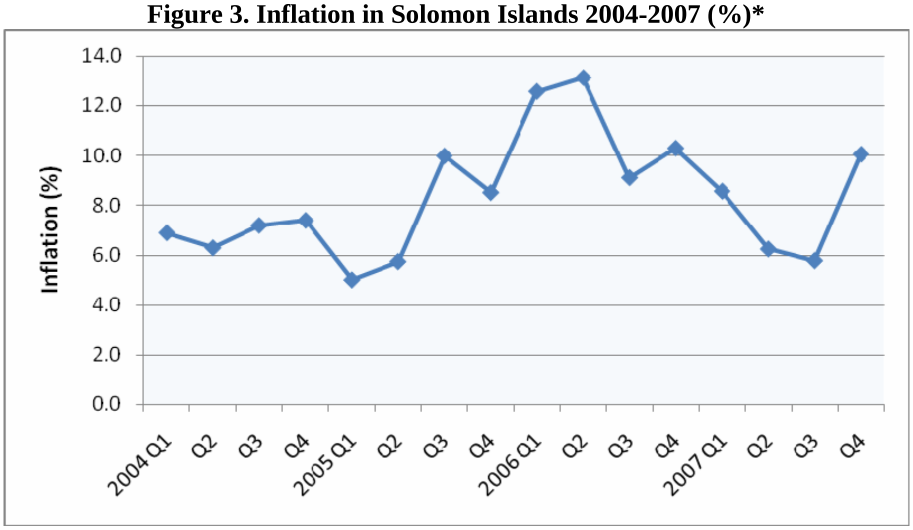
Other significant contributors to GDP growth in 2007 were: the retail and wholesale sector (8.6% of total GDP) which expanded by 6.5%; the construction sector (1.5% of GDP) which expanded by an estimated 34%; and the transport and communication sector (5.2% of GDP) which grew by 20.5%.

1.2. Inflation

In the third quarter of 2007 the Department of Statistics introduced newly-adjusted inflation figures for the period Q4 2005 onwards, based on the re-weighted consumption basket. According to these latest figures, inflation has been considerably higher in recent years than was indicated in the old inflation index. In 2006, for example inflation was recorded at 10.3%, compared with 7.6% according to the previous price index[1].

Inflation in 2007 was recorded at 10.0%, a slight decrease from 10.3% in 2006. Inflation in the price of domestic items (representing 58% of the consumption basket) was 10.1% and inflation in imported items was 10.0%. Inflation fluctuated widely in the course of the year, and was high at the beginning and the end of the year due to annual price increases by certain companies (most notably utilities companies) and high consumer demand during the Christmas holiday period (Figure 3).

Figure 3. Inflation in Solomon Islands 2004-2007 (%)*



* Inflation measures in Solomon Islands are based on the Honiara retail price index

The rising international price of oil in 2007 has been a major source of inflation in the price of both domestic and imported items in Solomon Islands, with the price increasing from US$58 per barrel at the end of 2006 to US$91 at the end of 2007. This has resulted in an increase in the cost of

[1] Inflation refers to the annual 3-month moving average, unless otherwise specified

fuel imports directly, and increases in the price of both domestic and imported items through the effect on input costs (in particular SIEA and SIWA) and freight costs. Other factors that contributed to high inflation in 2007 were: the huge expansion in domestic demand related to expanding domestic credit and money supply; exchange rate depreciation of the Solomon dollar against certain foreign currencies; and inflation in international food prices, most notably rice and wheat.

1.3. BoP and Foreign reserves

In 2007 gross foreign reserves rose by $122.7 million to $905.6 million. Of this increase, $73.4 million was the result of a BoP surplus while an estimated $50 million was due to revaluation gains. By the end of February 2008, however, reserves had fallen to $847.8 million. The BoP surplus was again dependent on large inflows of foreign aid, though the growth in logging helped boost export receipts.

In recent years, and in 2007 in particular, imports of goods and services have been increasing rapidly (Figure 4). As a result, the import cover provided by reserves fell from 4.6 months at the end of 2006 to 3.9 months at the end of 2007. By the end of February 2008 import cover was down to 3.6 months (Figure 5). Though this level remains sufficient at present, this downward trend is a concern for CBSI.

Figure 4. Imports, exports and the trade balance 2006-2007

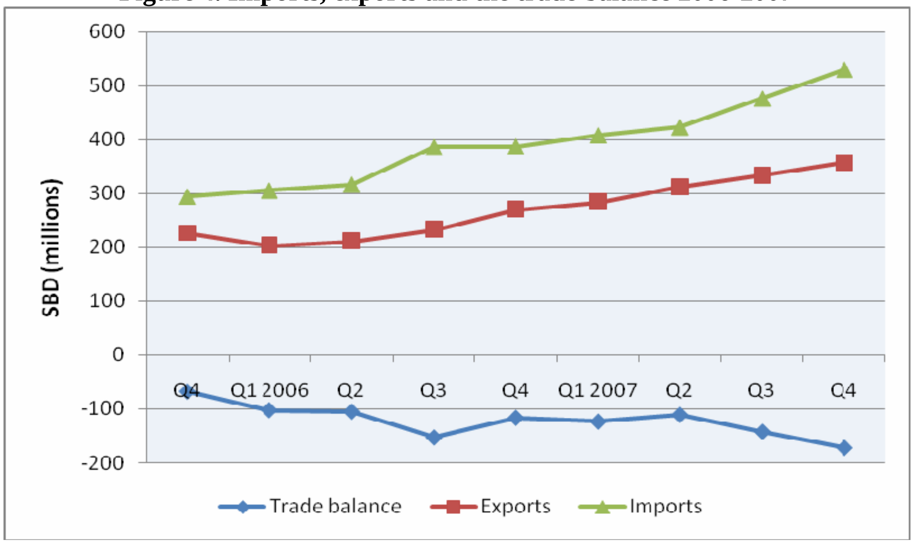
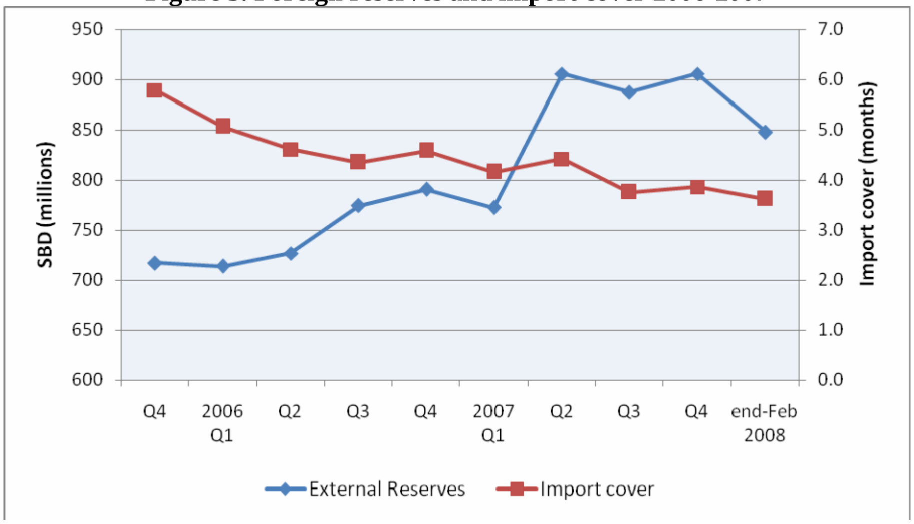


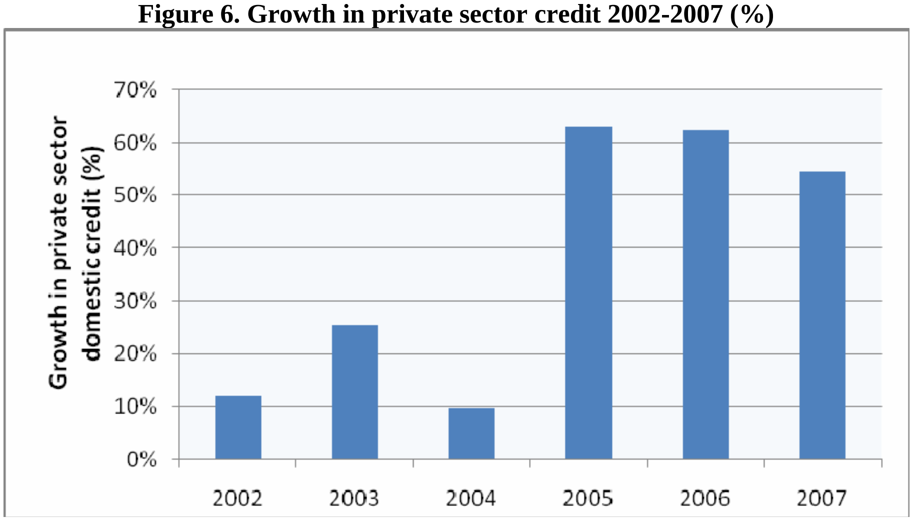
Figure 5. Foreign reserves and import cover 2006-2007



1.4. Domestic credit

Total domestic credit continued its remarkable expansion in 2007, increasing by 54% in the course of the year to $957.5 million, though this growth was marginally less than in 2005 and 2006. As in the previous two years, this expansion was entirely due to rapid growth in private sector credit. While net credit to government fell by $8.2 million to minus $19.4 million, private sector credit increased by $344.6 million (55%) over the level at the end of 2006 (Figure 6). These huge increases in private sector credit since 2005 reflect a growing confidence in the investment climate in the country.

Figure 6. Growth in private sector credit 2002-2007 (%)



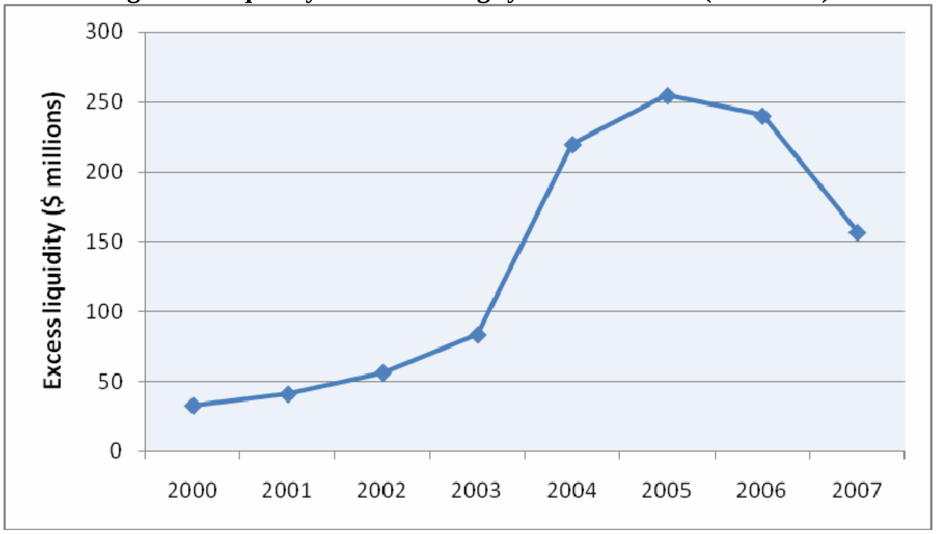
1.5. Money supply

Money supply expanded significantly in 2007 with broad money (M3) increasing by 24.5% to $1,352 million by the end of the year, though growth this year was slightly lower than money growth of 25.7% in 2006 and 28% in 2005. The huge increase in credit to the private sector was the main factor behind this rise, though the increase in net foreign assets as a result of the BoP surplus was also a factor. On the other hand, continued fiscal discipline during the year (and consequently the slight build-up of government deposits) helped to contain growth in money supply and therefore reduce inflationary pressures.

1.6. Liquidity and interest rates

In 2007 CBSI began implementing measures to tackle excess liquidity, through allowing $100 million in overseas payments by NPF. Largely as a result of this policy, total liquidity fell by $69.8 million during the year, to $243.2 million, while excess liquidity fell by $83.5 million to $156.6 million (Figure 7). This is a positive first step towards bringing excess liquidity down to a manageable level, and enabling CBSI to utilise market-based policy instruments to implement monetary policy in the future. Nevertheless, excess liquidity remains very high. Interest rates on deposits increased slightly from 1.2% at the end of 2006 to 1.6% by the end of 2007, but remain very low. Further steps will be necessary in 2008 in order to influence interest rates and to mitigate excessive inflation pressures in the country.

Figure 7. Liquidity in the banking system 2000-2007 ($ millions)



1.7. Exchange rates

The Solomon Islands dollar remained stable against the US dollar in 2007, depreciating by just 0.8% from $7.63 per USD at the end of 2006 to $7.66 at the end of 2007. Given that over 95% of exports revenue (and the most important import items) are traded in US dollars, this policy of maintaining stability against the USD was intended to promote Solomon Islands businesses and protect rural incomes. However, depreciation of the USD against most other major international currencies led to a similar depreciation of the SBD against these currencies. Thus, the SBD depreciated by: 11% against the AUD; 3.3% against the GBP; 5.8% against the Japanese Yen; and 10.7% against the Euro.

2. Macroeconomic outlook for 2008

Forecasts for 2008 suggest a challenging year ahead for the Central Bank. GDP growth is expected to fall somewhat to an estimated 6%, while foreign reserves are expected to remain stagnant, suggesting import cover will continue to slowly decline. Crucially, government is planning to increase expenditure significantly in 2008 which, combined with continued increases in private sector lending, will lead to an excessive increase in money supply and very high inflation. Firm intervention by CBSI is likely to be necessary in 2008, in order to avoid excessive inflationary pressures.

2.1 GDP growth

Real GDP growth is expected to fall in 2008, though will remain high at a forecasted 6%. The agriculture sector is again expected to experience growth, with palm oil products and cocoa production in particular expected to rise. Fishing output is expected to bounce back from the poor performance in 2007, with improved vessel capacity suggesting catch volumes will improve and cannery processing also expected to expand further with the completion of a new storage facility. The commencement of production at Gold Ridge is now not expected until at least the second quarter of 2009, so mining output will not play a role in GDP growth this year. However, fiscal expenditure is expected to be significantly higher in the coming year, and therefore growth in the public sector ('other services') is likely to again be a significant contributor to GDP in 2008.

Significantly, the GDP forecast of 6% in 2008 is based on the assumption that forestry sector output will remain at the same level this year as in 2007. There is great uncertainty about logging volumes this year, however, as information flows are minimal and output is highly variable and difficult to predict. License approval remains high, and logging companies are also increasingly returning to areas of re-forest, suggesting there is still potential for further growth this year at least. On the other hand, the Ministry of Forestry reported a marked increase in smaller size logs being exported, indicating companies are beginning to struggle to find appropriate areas to fell. Given this uncertainty, it is useful to provide a forecast for a number of different logging scenarios. If the logging sector declines by 5% then overall GDP growth is forecast at just over 5%, while stable output in 2008 gives a forecast of 6%. On the other hand, if logging output rises by 5% this year the forecast for GDP growth rises to 6.8%, and logging growth of 10% and

15% gives a GDP growth forecast of 7.6% and 8.4% respectively. The best estimate, given the data available, is for a small increase in logging of between 0% and 5%.

2.2 Inflation

Dampening rising inflation will be a major challenge for CBSI in 2008, as inflationary pressures are expected to continue this year.

In particular, the international price of oil has continued to rise in the first months of the year, with the global credit crisis and stock market uncertainty contributing to these increases. The likely economic slowdown in the US (and therefore other economies) could lead to reduced demand for oil and therefore some easing of price increases, but prices are expected to remain high in 2008. Price increases in the main food commodities such as rice and wheat are also likely to continue, though the government's policy to abolish goods tax on rice should help to reduce inflationary pressures on this important food item. The continued depreciation of the US dollar against other major international currencies would also contribute to inflation in Solomon Islands.

Inflationary pressures from domestic sources will also remain high. Most notably, the government plans a significant increase in expenditure in 2008, in particular relating to development funding, which will only partially be offset by increased revenue. A large rise in net credit to government will contribute to domestic demand and inflationary pressures. With excess liquidity in the economy remaining high, domestic lending is expected to also increase rapidly, leading to an expansion in money supply, domestic demand and putting additional pressure on prices.

2.3 Foreign reserves and import cover

CBSI forecast foreign reserves to remain stable in 2008 at around $900 million by the end of the year. On the positive side, foreign exchange inflows are expected to remain high, with both logging receipts and aid inflows forecast to remain at a similar level to 2007. Large capital inflows related to Gold Ridge may also begin towards the end of the year, though these will largely be used to import machinery.

On the other hand, foreign exchange outflows are expected to increase significantly. Imports of goods have been rising rapidly for a number of years, and this trend is set to continue in 2008. Continued increases in the price of fuel will increase import payments directly as fuel represents around 25% of total imports, and also indirectly as freight costs increase. NPF payments overseas of $50 million are expected in the first half of the year ($20 million of which was invested in January), further reducing foreign reserves. Finally, the government's plans to greatly increase expenditure will also lead to outflows of foreign exchange, as it is likely that significant amounts of this funding will be used to purchase goods and services overseas.

With foreign reserves expected to remain unchanged but imports forecast to increase significantly, a further fall in import cover of reserves is forecasted for 2008. By the end of the year, reserve cover is forecast to fall to 3.2 months.

2.4 Domestic credit

Domestic credit is expected to rise considerably in 2008, and in the event that inflation rises to unacceptable levels, limiting this expansion will be a key challenge for CBSI.

In previous years, the build-up of government deposits has helped to constrain the expansion of domestic credit in the face of a rapid increase in private sector lending. In 2008, however, government expects revenue to increase by around 10% to $1.38 billion, whereas expenditure is forecast to rise to $1.55 billion. This suggests a deficit of over $160 million in 2008, which is expected to be financed by using up its past deposits with the banking system. Given the difficulty government has had in previous years in implementing planned development projects, CBSI estimate that the draw down in deposits will be lower than $160 million. Nevertheless, such a large increase in net credit to government is a significant change from falls in the previous five years, and will have a big impact on money supply.

Private sector credit increased by 55% in 2007, and though this was slightly lower than in the previous two years, another large expansion in lending is forecast for 2008 in the absence of CBSI policy action. Excess liquidity remains high at over $150 million, and demand for loans is still strong.

2.5 Money supply

Large increases in both net credit to government and private sector credit have serious implications for money supply and inflation in Solomon Islands. Assuming private sector credit increases by 40% in 2008, a fairly conservative estimate given the growth witnessed in the last three years, money supply is forecast to grow by around 33%. With economic growth lower than last year, and even assuming monetisation is as high as 10%, the growth in money supply suggests inflation could rise higher than the current level of 10% in 2008.

3. Monetary policy stance in 2008

The stated objectives of the Central Bank of Solomon Islands are to achieve sustained and stable economic growth, a high level of employment, stability in the purchasing power of the local currency, and a viable Balance of Payments position. In order to achieve these objectives, the following three policy goals will be prioritised by CBSI in 2008:

1. Guard against excessive inflation
2. Maintain the adequacy of official foreign reserves
3. Improve interest rates on deposits (subsidiary objective)

3.1. Policy Goal 1: Guard against excessive inflation

Inflation levels in the upper single digits have been considered acceptable in Solomon Islands in the post-conflict period. High donor aid flows and the large expansion in domestic credit as the country gets back on its feet have led to strong domestic demand and therefore inflationary pressures. CBSI considers inflation in the upper single digits tolerable in 2008.

The new inflation figures revealed by the re-weighted consumer price index, however, have shown inflation of 10% in 2007, and inflation as high as 13.7% in the course of 2006. With inflationary pressures set to continue in 2008, CBSI intends to employ a number of policy measures to attempt to control inflation. The main policy will focus on tackling the high excess liquidity in the banking system, as a means of reducing money supply growth and domestic demand. It is hoped this will be sufficient to contain inflation below the double digit level, though alternative measures may also be necessary in order to contain inflation. In particular, should inflation rise above 10% for three consecutive months, emergency measures to reduce inflation are likely to be necessary.

a) Tackling excess liquidity

The issue of excess liquidity, its underlying causes and consequences in terms of inflation, interest rates, and monetary policy tools was the focus of an Economics Department discussion paper[2]. Excess liquidity fell significantly in 2007 but remains high, and is likely to increase again in 2008 unless further action is taken. Although the impact on inflation will not be instantaneous, CBSI has decided that tackling excess liquidity is a crucial step towards controlling inflation. The policy will also help to increase deposit interest rates in the country.

Central Bank long-term deposit facilities (or securities) and an expansion of government securities are the most appropriate means of tackling excess liquidity in the country. Expanding the market for government securities is desirable in the long-run, and CBSI will begin talks immediately with the

[2] See report entitled 'Tackling Excess Liquidity in Solomon Islands', available on the CBSI website

Ministry of Finance and Treasury regarding this possibility. However, this development will require discussions over a period of time, and is unlikely to materialize before 2009. For this reason Central Bank deposit facilities will be the main mechanism for tackling excess liquidity this year. This mechanism was proposed in the MPS 2007, but the implementation was delayed while the impact of NPF overseas investment on liquidity was observed.

CBSI will also establish short-term lending and short term deposit facilities for use by financial institutions, though these are unlikely to be utilised in 2008. Once excess liquidity has been sufficiently decreased these would form a necessary part of the open market operations that would enable CBSI to effectively manage liquidity and therefore interest rates. Rates of interests on loans would be set to ensure commercial banks could not use short term standing facilities to finance credit expansion.

While long-term deposit facilities will be the most important means for tackling excess liquidity, CBSI will also consider reintroducing Bokolo Bills in 2008. Bokolo Bills will only be introduced after long-term deposit facilities have been implemented, as their scale, and therefore scope to reduce liquidity, will be limited.

CBSI will also begin discussion with government regarding an expansion of the market for government securities. At present the total value of Treasury Bills is limited to a rolling stock of $30 million in auction Treasury Bills, making monetary policy through open market operations redundant. Increasing the volume of long-term Treasury Bills would help to reduce excess liquidity and offers the potential for a secondary market and therefore open market operations.

b) Adjusting the Liquid Asset Requirement

In the event that inflation rises above 10% for three consecutive months (based on the three month moving average), it may be necessary for CBSI to raise the Liquid Asset Requirement (LAR) above the current level of 7.5%. This would be done in gradual incremental stages to reduce the destabilising impact on the financial system. Nevertheless, those commercial banks with very low levels of excess liquidity would be disproportionately affected by such a measure.

c) Limiting commercial bank credit expansion

If reducing excess liquidity is not sufficient to bring down inflation in 2008, CBSI will consider directly limiting the credit expansion of the commercial banks and thereby dampening domestic demand. A first step would be informal discussions and a request to slow down the pace of approvals for personal and housing loans. If they do not respond, a formal instruction to cease lending could be issued. If this still has no effect, formal credit ceilings could be imposed.

d) ***Exchange Rate Policy***

Exchange rate policy also plays an important role in limiting inflation, and CBSI will again aim to maintain stability against the US dollar in 2008. A comprehensive review of exchange rate policy will be the subject of technical assistance in the first half of 2008, and CBSI does not intend to implement a shift in policy until this has been completed.

3.2. Policy Goal 2: Maintain an adequate level of official foreign reserves

As in previous years, in 2008 CBSI will seek to maintain official foreign reserves at a level that is equivalent to at least 3 months of forecasted imports of goods and services. Exchange rate policy will be crucial in achieving this. Since over 95% of Solomon Islands exports are purchased in US dollars, CBSI will aim to ensure stability against that currency in 2008.

As stated above, import cover is expected to remain above the threshold level in 2008, but forecast to fall slightly to 3.2 months of cover. CBSI will continue to monitor the level closely, and will consider a number of policy measures in the event that reserves drops below the threshold level. Adjusting the LAR and limiting commercial bank lending are two possible measures, as described above. If further action is necessary, CBSI would consider allowing the exchange rate to take the strain, helping to limit imports and boost exports. As a last resort, CBSI would be able to instruct NPF to repatriate overseas investment.

3.3. Policy Goal 3: Improve interest rates on deposits

Measures to tackle excess liquidity in 2008 are expected to have an impact on deposit interest rates in Solomon Islands. The decrease in excess liquidity in 2007 by over $80 million was probably the major factor behind the improvement of interest rates by 40 basis points in the course of the year.

The main benefits of higher deposit rates are likely to be felt mainly by NPF, as a player with a vast volume of funds in the system. However, the very high value of currency in circulation in Solomon Islands relative to other countries in the region, suggests there are significant sources of alternative funds commercial banks could tap into by offering more attractive deposit rates to individual savers.