Monetary Policy Statement

March 2012

CENTRAL BANK OF SOLOMON ISLANDS

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1. Overview

The global economy recorded positive growth in 2011 though slightly lower than the expected levels. The positive growth was driven by emerging economies supported by higher than anticipated recoveries in the US and Japanese economies. However downside risks in the second half came mainly from the continued uncertainties in the Euro Area.

In the domestic economy, movements in monetary aggregates continue to be dominated by movements in net domestic assets and net foreign assets of the Central Bank of Solomon Islands. Liquidity in the banking system continued to increase across the period, although at a slower rate than the first half of the year. The pace of growth of private sector credit picked up in the second half of the year although this reflects an increase in the extension of very short-term credit to one sector of the economy rather than more general longer-term extensions of credit.

Balance of payments indicators suggest stronger external conditions in the second half of the year, with a movement to a positive position in the current account in the final quarter. FDI is recorded as marginally more robust across the second half of the year while aid inflows are recorded as stronger in the first half of the year. The level of reserves at the end of February 2012 reached the equivalent of 10.6 months of import cover, which the Central Bank of Solomon Islands considers a comfortable level of reserves.

Retail sales continued to remain strong in the second half of the year reflecting domestic incomes supported by strong external trade rather than rising levels of credit to households[1]. Disposable incomes increased as a result of a general wage price increase across the sectors in the second half of 2011 and are set to increase further from the raising of the minimum PAYE threshold which came into effect in January 2012. Employment had shown relative growths in some sectors during the second half of the year.

Domestic business conditions indicate sustained activity in the construction, manufacturing, retail & wholesale and tourism sectors. This favourable outcome primarily reflects positive external conditions supporting domestic demand, continued foreign investments and donor spending in the second half of the year.

Fiscal conditions improved further across the final six months of the year such that at year-end a significant $184 million surplus (excluding donor support) had been recorded. This outcome is consistent with the accumulation of deposits by the Government across the year. Government debt levels are almost at ‘green light’ status as outlined in the Honiara Club Agreement which opens up the possibility of future credit extension by the Government.

Headline inflation peaked in November 2011 at 10.2%. The imported component of inflation was declining across the second half of the year but was counteracted by the rising domestic component until the final months of the year where the domestic component reached a peak of 12.8%. The latest figure for headline inflation for January 2012 stands at 8.5%.

[1] Retail sales reflect sales in the manufacturing sector

2. International Economic Developments

Despite relative optimism concerning the economic recovery, global economic activity began to falter towards the end of 2011. This set-back in the recovery has resulted in revised-down estimates for growth in the coming year reflecting continued uncertainties in the Euro Area and the impact of economic and fiscal policies pursued in 2011. Growth rates in emerging economies, despite the downward revision remain robust to drive world growth.

Economic Growth

Advanced economies including, the United States, United Kingdom and the Euro Area witnessed promising signs of growth at the start of 2011. This marginal improvement, at the beginning of the year, came on the back of the resilience of global trade following the financial crisis and the pursuit of expansionary monetary policy with interest rates remaining at historical lows and further monetary stimulus measures to support economic activity.

The second half of the year, in contrast, was characterised by less promising signs of economic recovery as fiscal austerity measures coupled with continued trends in the reduction of private sector and household debt began to take effect, despite additional monetary stimulus measures. Throughout the year, significant volatility in financial markets has prevailed in relation to the on-going European Debt Crisis which further acted to dampen confidence in many economies during the year. The exception has been the United States where growth in the second half of the year was still recorded as positive, with the economy benefiting from a delay to implement fiscal austerity measures whilst the private sector and households continue to decrease debt levels. In the December quarter, the US economy recorded an uptick in personal consumption.

The performance of emerging economies in 2011, like the year before, was more robust than that seen in advanced economies. In the first half of 2011, as in 2010, the resilience of global trade following the financial crisis supported economic activity. The existence of historically high commodity prices also supported economic activity in terms of higher export revenue, but squeezed incomes as domestic prices rose. With fears that many of these economies were over-heating, many monetary policy authorities took steps to tighten monetary policy during the first half of the year.

In the second half of the year, as these measures began to take effect on subduing domestic demand, so did the impact on global trade of the fiscal tightening in many advanced economies. As domestic prices eased, the action then was to loosen monetary policy again to support domestic economic activity going forward.

Looking specifically at the performance of Solomon Islands' main trading partners, growth has been fairly robust. Australia, New Zealand and China were estimated to have grown by 1.8%, 2.0% and 9.2% respectively in 2011.

2012 Growth Forecast

Estimates for global growth in 2012, released by the International Monetary Fund (IMF) have been revised downwards to 3.3% as many economies were performing lower than anticipated towards the end of 2011 amidst continued uncertainty over the European Debt Crisis[2]. Developed economies are expected to grow by a muted 1.2% in 2012 as fiscal austerity measures continue to take effect and amidst continued trends for the reduction of debt by the private sector and households. Again, emerging economies are estimated to

[2] IMF World Economic Outlook - January 24, 2012

lead global growth with an estimate of real growth in economic output of 5.4% in 2012. The outlook for economic growth of Solomon Islands main trading partners in 2012 remains fairly robust at 3.3%, 3.8% and 8.2% for Australia, New Zealand and China respectively.

Inflation

Average inflation in advanced economies during 2011 was estimated by the IMF at 2.7% reflecting high international price pressures at the beginning of the year despite spare capacity in these economies and well anchored inflation expectations. Average inflation in emerging economies is estimated to have been 7.2% reflecting international price pressures across the beginning of the year and resilient external demand.

Commodity prices at the start of 2011 were at historically high levels. International food prices declined across the year due to improving supply conditions and slowing global demand. The food index published by the United Nation's Food and Agriculture Organization (UN FAO) indicates that food prices increased by 8% during the first half of the year and then weakened by 10% across the second half of the year. Fuel prices, in contrast, remained strong in the face of supply disruptions. The average price of Brent Crude Oil was recorded at US$111 in 2011, 39% above the average price of US$80 recorded in 2010.

2012 Inflation Forecast

Average inflation in 2012 is expected to fall to 1.6% in advanced economies due to ample spare capacity, well-anchored inflation expectations and sluggish economic activity. Average inflation in emerging economies is expected to average 6.2% due to a weakening in economic activity combined with easing global non-fuel commodity prices. However, the path of international fuel prices in 2012 adds considerable uncertainty to inflation prospects in these economies.

Looking at inflation in major trading partners of the Solomon Islands, average inflation is expected to ease in 2012 on the back of easing global commodity prices and slower global trade expectations. Inflation in Australia was recorded at 3.5% in 2011 and expected to be 3.3% in 2012, average inflation in New Zealand was estimated at 4.4% in 2011 and forecasted to be 2.7% in 2012 and in China, average inflation was estimated at 5.5% in 2011 and expected to be 3.3% in 2012[3].

[3] IMF World Economic Outlook – January 24, 2012 for China estimates and IMF World Economic Outlook – September 21,2011 for Australia and New Zealand estimates

3. Domestic Economic Developments

3.1 Monetary Conditions

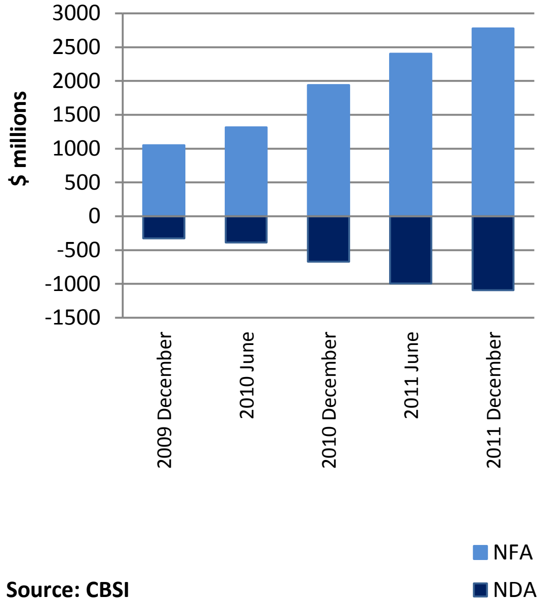
Movements in monetary aggregates continued to be dominated by the movement in net domestic assets and net foreign assets of the Central Bank of Solomon Islands (CBSI). The pace of growth of private sector credit picked up in the second half of the year although this reflects an increase in the extension of very short-term credit to one sector of the economy rather than more general longer-term extensions of credit.

Reserve money (M0) was recorded at $1,660 million at the end of 2011, an increase of 18% across the final half of the year. The increase in M0 reflects a 16% increase in the net foreign assets (NFA) of CBSI and a 10% increase in the net domestic assets (NDA) of CBSI (see Figure 3.1.1). In January, M0 grew marginally by 0.2% to reach $1,663 million reflecting an 11% rise in NFA of CBSI which was almost entirely counteracted by the 28% increase in NDA of CBSI.

The movement in NDA of CBSI across the final half of 2011 reflects a 30% rise in net credit to government (NCG) due to the accumulation of deposits by the Government which more than overshadowed the 12% increase in the negative position of net credit to other depository corporations (ODCs) across the final six months of the year (see Figure 3.1.2). In January, NCG increased by a further 3% across the month, although this was overshadowed by a 42% increase in net credit to financial corporations and a 50% increase in net credit to ODCs.

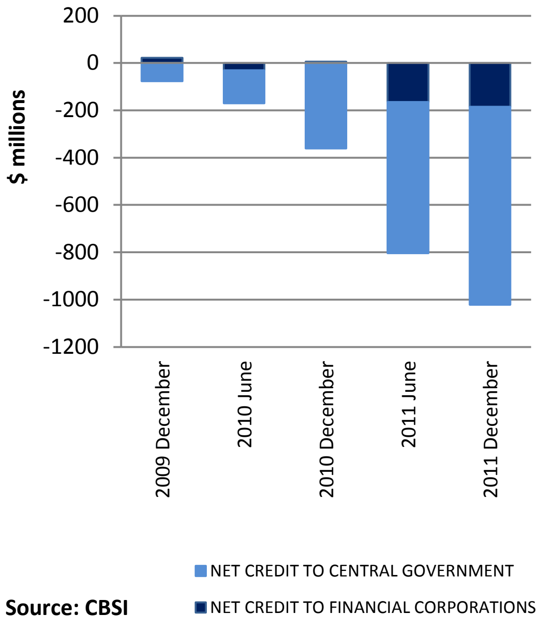
Correspondingly, liquidity in the banking system increased by 18% across the final half of the year to $1,659 million. In January, free liquidity remained flat mirroring the rise in M0, at $1,663 million.

Figure 3.1.1: Drivers of M0



Source: CBSI

Figure 3.1.2: Components of CBSI NDA



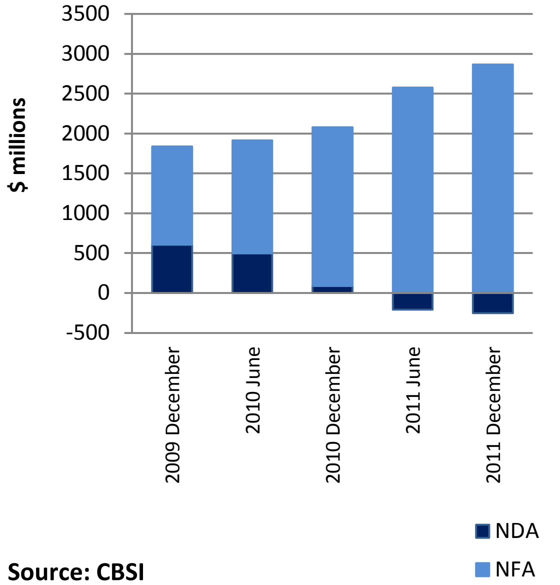
Source: CBSI

Total money supply (M3) at end-December 2011 was recorded at $2,610 million, an increase of 10% across the second half of the year. This was a slower rate when compared against the first half of the year where M3 grew by 14%.

In terms of the components of M3, across the first half of 2011, narrow money increased by 29% compared to 12% across the second half of the year driven by movements in transferable deposits held by ODCs.

Looking at the drivers of M3, the deceleration in M3 reflected a slower pace of increase of NFA of the banking system in the second half of the year and a larger increase in the negative position of NDA in the banking system dominated by movements in the NFA and NDA of CBSI (see Figure 3.1.3).

Figure 3.1.3: Drivers of M3



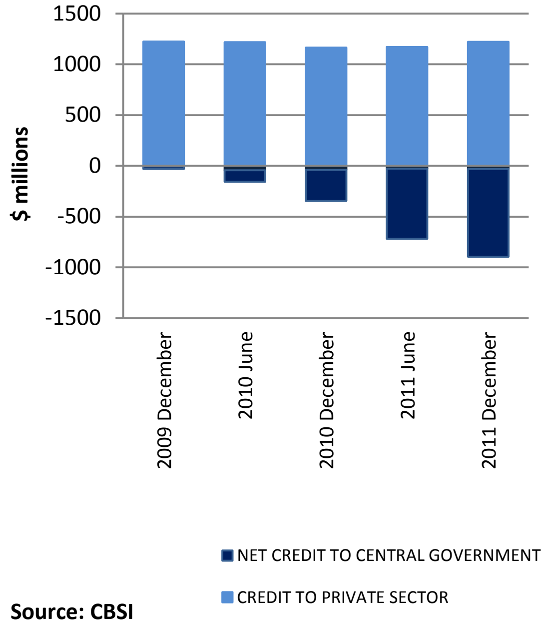
Source: CBSI

Across the first half of the year, NFA of the whole banking system increased by 29% in line with stronger overall aid inflows and trade receipts in the first half of the year. Whilst across the last six months of the year, the rise was fairly muted in comparison at just 11% (see Figure 3.1.3).

Across the second half of the year the negative position of NDA of the banking system increased by 22% from minus $208 million to minus $254 million reflecting a build-up of deposits by the Government, which acted to counteract a marginal increase in private sector credit (see Figure 3.1.4).

Private sector credit recorded an increase of just 0.4% across the first half of the year and a more robust 4% across the second half of the year. Reflected in these growth rates, however, was a pick-up in very short-term lending associated with activities in the forestry sector rather than more general longer-term credit. Subtracting this shorter-term lending, private sector credit declined by 0.4% across the first half of the year and grew by a muted 2.7% across the second half of the year.

Figure 3.1.4: Components of Banking System NDA



Source: CBSI

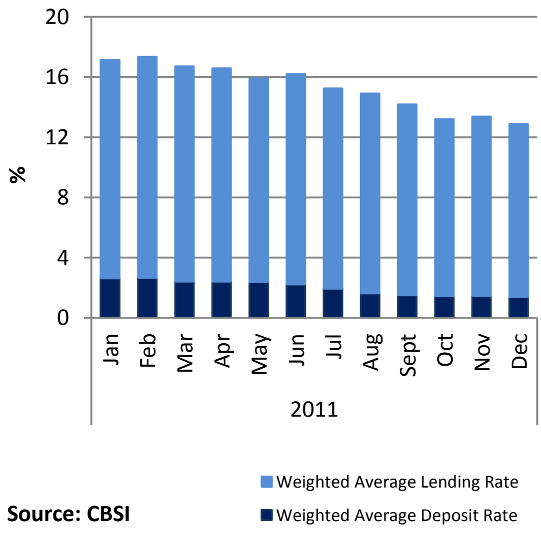
The weighted average lending rate offered on commercial and personal loans was recorded at 11.5% by the end of the year, a substantial reduction in the nominal lending rate when compared against the weighted average of 13.9% recorded at mid-2011. This contrasted against an increase in the weighted average lending rate across the first half of the year (see Figure 3.1.5).

The weighted average deposit rate recorded at the end of the year also declined from 1.9% at end-June to 1.4% reflecting a reduced desire to attract deposits with liquidity at high levels (see Figure 3.1.5).

Overall, due to the significant fall in average lending rates, the interest rate margin narrowed from 11.4% at end-June to 10.2% by the end of the year. However, the maintenance of a large margin reflects not just the reduced desire to attract deposits but, to a lesser extent, the mechanism used by financial institutions to preserve profits by lowering the interest expense of deposits as profits from lending activities decline.

In real terms, deposit rates remain negative which erodes the purchasing power of savings. Lending rates, in real terms have fallen from 12.73% at the end of 2010 to 1.30% by the end of 2011 indicating the sharp decline in the real cost of borrowing across the year due to falling nominal lending rates and an increasing rate of headline inflation in the second half of the year.

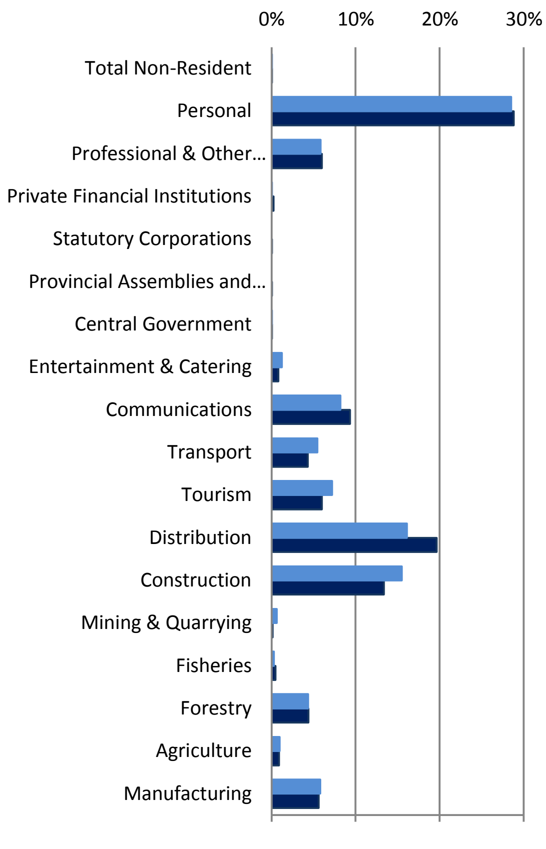
Figure 3.1.5: Weighted Average Deposit and Lending Rates



Source: CBSI

Although private sector credit remains fairly stagnant, some sectors across the second half of 2011 increased their proportion of total credit held whilst others saw a decrease in the proportion of total credit held. Sectors that saw an increase in their credit shares include the transport, tourism and construction sectors. As for those that saw a decline were the personal, communications and distribution sectors (see Figure 3.1.6).

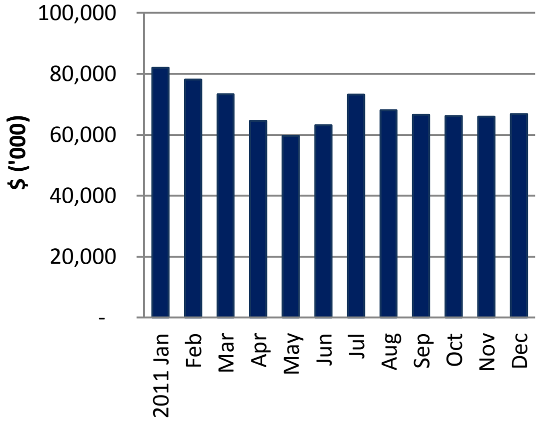
Figure 3.1.6: Sectoral Distribution of Credit



Source: CBSI

The total value of non-performing loans (NPLs) in the financial system declined across 2011 from $82 million in January to $67 million by the end of the year (see Figure 3.1.7). The fall was due mainly to NPLs that were restructured as performing loans again and one off settlements of large NPLs.

Figure 3.1.7: Total Value of NPLs in the Financial System



Source: CBSI

Looking at the value of NPLs for a sector against total credit in that sector allows us to gauge the relative riskiness of lending to some sectors compared to others. NPLs in the personal sector represent 6.2% of credit in the sector which is below the 9.3% average for all sectors. Average lending rates, however, offered for loans to the personal sector remain above average lending rates for most other sectors.

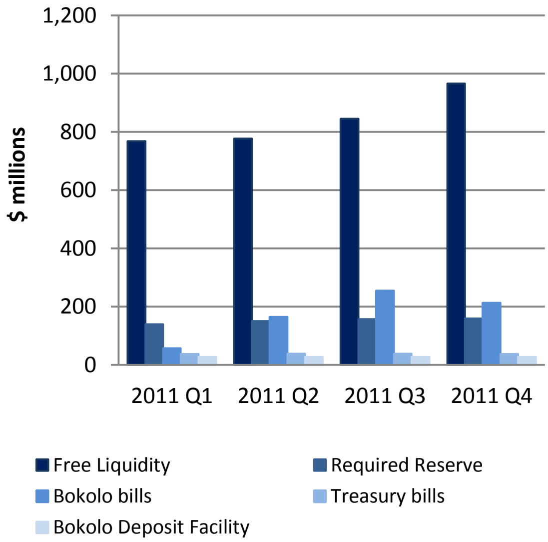
In response to the need to develop the securities market, CBSI issued Bokolo bills in the first quarter of 2011. This was continued across the second half of 2011. At end-February 2012 the total stock of Bokolo bills held stood at $213 million and the weighted average yield (WAY) offered at 0.95% (see Figure 3.1.8).

Although the Treasury bills facility is not a tool of monetary policy, liquidity can further be constrained via the Government's actions to accept offers on Treasury bills. However, the stock of Treasury bills accepted by the Government remained largely unchanged during 2011, averaging $39 million. At mid-March 2012, the stock of Treasury bills stood at $38 million and the WAY offered on bills with maturities of 56-, 91- and 182-days stood at 1.90%, 2.30% and 2.55% respectively.

The level of the reserve ratio relating to the cash reserve requirement (CRR) set by the Monetary Policy Committee (MPC) remained unchanged in the second half of the year at 7.5% (see Figure 3.1.8).

The increase in the stock of Bokolo bills held resulted in this instrument extracting a higher portion of liquidity from the banking system than the CRR by the end of the year and acted to help moderate the rate of growth of free liquidity in the banking system in the second half of 2011 (see Figure 3.1.8).

Figure 3.1.8: Free Liquidity and Liquidity Absorbing Instruments



Source: CBSI

3.2 External Conditions

Balance of payments indicators suggest stronger external conditions in the second half of the year, with a movement to a positive position in the current account in the final quarter resulting from an increased value of exports and increases in services and primary income receipts.

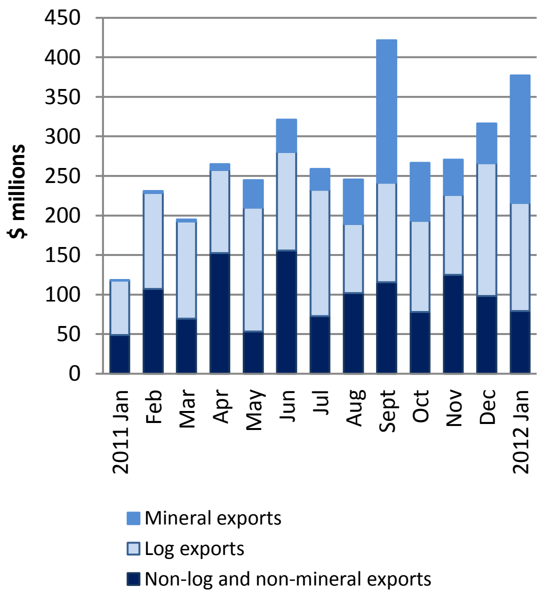
FDI was recorded as marginally more robust across the second half of the year while aid inflows were recorded as stronger in the first half of the year. The level of reserves at the

end of the year reached the equivalent of 10 months and latest data indicates is at a level equivalent to 10.6 months of import cover at February 2012. This level of reserves is considered to be a comfortable level.

Total value of exports (f.o.b) across the first half of the year totalled $1,375 million. Across the second half of the year, the value of total exports reached $1,779 million. This aggregate figure indicates a favourable overall export performance in the second half of the year; however, the value of exports was significantly boosted by mineral exports which began in April, with exports scaling up across the second half of the year.

Subtracting mineral exports, the total value of exports was $1,287 million in the first half of the year and slightly higher in the second half of the year at $1,349 million, driven primarily by a higher value of log exports in the second half of the year (see Figure 3.2.1).

Figure 3.2.1: Log Exports, Mineral Exports and Non-Log & Non-Mineral Exports



Source: CBSI

Copra & coconut oil exports recorded a higher value of exports across the first half of the year, reflecting higher production and higher international prices for these commodities. Palm oil & kernel oil exports also recorded higher export values across the first half of the year despite lower production than in the latter half of the year, reflecting higher international prices for these commodities at the beginning of the year.

Copra production was stronger across the first half of the year, with total production reaching 20,037 tons. Production slowed down in the last six months of 2011 to 15,243 tons. This performance reflects the sensitivity of domestic prices offered to farmers when international prices change which then determines production. Latest data for January 2012 indicates monthly production reached 2,144 tons, which is below the 2,716 tons recorded a year ago.

The average international price of copra fell in the second half of the year to US$954 per ton, compared to US$1,361 per ton in the first six months of the year. Domestic export prices reported by Solomon Island exporters averaged US$934 per ton in the first half of the year and fell to US$650 per ton in the second half. In February 2012, the domestic export price was US$696 per ton compared to an international price of US$945 per ton. Average prices offered to farmers averaged $5.79 per kg in the first half of the year and following the trend in domestic contract prices, plunged to $3.17 per kg in the second half of the year. In February 2012, the domestic price had recovered slightly to $3.90 per kg.

Crude palm oil and palm kernel oil production totalled 17,296 tons across the first half of the year, this increased to 17,832 tons across the second half of the year.

The international price for palm kernel oil, averaged US$2,003 per ton in the first half of the year, declining to US$1,295 per ton in the second half of the year. The average price reported by domestic exporters for palm kernel oil averaged US$1,932 per ton in the first half of the year and US$1,421 in the second half of the year indicating that the sharp decline in global prices was not entirely reflected in domestic export prices.

The international price of crude palm oil, averaged US$1,199 per ton in the first half of the year and US$1,052 per ton in the second half of the year. Domestic export prices for crude palm oil, averaged US$1,277 per ton in the first half of the year and US$1,140 in the second half of the year.

The strong production in the second half of the year reflects the increased incentives given by exceptionally high prices at the beginning of the year with crops determined early in the year before collection during July-September. The weakening in the international price, although substantial from the highs at the beginning of the year still remain at levels over US$1,000 per ton and the decline was not fully reflected in the domestic export prices recorded in the second half of the year, which for palm kernel oil and crude palm oil exceeded international prices.

Year to February 2012 indicates palm oil and palm kernel oil production reached 4,977 tons compared to 5,109 tons a year ago. The domestic export price for palm kernel oil is recorded at US$1,425 at end-February 2012, above the international price of US$1,362 per ton. The domestic export price of crude palm oil was US$1,110 at end-February 2012, above the US$1,106 per ton international price.

Log & timber exports and cocoa exports record marginally better activities in the last six months of the year compared to the first half of the year with total export values of $757 million versus $700 million and $62 million versus $58 million respectively.

Log production across the first six months of the year totalled 924,471 m^3. Across the second half of the year, however, total production was recorded at 1,013,000 m^3. This increase in production resulted from sustained global demand for logs and higher average international log prices. Latest year to February data indicates that production continues to reach exceptional levels at 330,713 m^3 as opposed to 256,035 m^3. Across the first six months of the year, the international price of logs averaged US$343 per m^3, but increased in the second half of the year to US$427 per m^3. At February 2012, the international log price stood at US$375 per m^3.

The value of mineral exports surged from $88 million in the first half of the year to $430 million across the last six months of the year due to the scaling up of gold mining activity in the country and this outcome contributed significantly to the overall better export outcome across the second half of the year.

Production of cocoa and fish catch fared better in the second half of the year.

Cocoa production across the first half of 2011 totalled 2,785 tons against the 3,351 tons in the second half of the year. Primarily, this increased production reflects ongoing assistance in the sector by the Cocoa Livelihoods Improvement Program (CLIP) and the Ministry of Agriculture that led to the rehabilitation of some old plantations. To a lesser extent, this level of production in the second half of the year again reflects increased incentive stemming from the very high international price of cocoa at the beginning of the year.

The average international price of cocoa was US$3,209 per ton in the first half of the year and declined to US$2,752 per ton in the second half of the year. Average domestic export prices, exhibited a less dramatic fall with an average of GBP1,714 per ton reported for the first half of the year and GBP1,571 per ton in the second half of the year. Average domestic prices offered to farmers fell sharply, however, from an average of $17.17 per kg in the first six months of the year to $14.33 per kg in the latter half of the year.

Fish catch in the first six months of the year at 10,146 tons, was significantly lower than the 18,049 tons in the latter half. This positive jump in production reflects favourable fishing conditions as well as the increase in average international fish prices from US$1,609 per ton in the first half of the year to US$1,916 per ton in the second half of the year. Latest data available for January indicates a monthly catch of 1,266 tons, below the 1,910 tons recorded in the corresponding month of 2011.

In terms of imports, the total value of imports (f.o.b) across the first half of the year was recorded at $1,426 million, whilst across the second half of the year this increased to $1,719 million reflecting a significant jump in the value of 'food and live animals' imports, 'animals and vegetable oil and fats' imports, 'beverage and tobacco' imports and mineral fuel imports. The increase in all four categories was attributed not just to an increased volume of imports but also to higher import prices.

The CBSI Imported Food Price Index indicates global food prices remained high in 2011 and increased 3% in the second half of the year, contributing to higher imports costs.

International fuel prices for the Pacific region recorded an average price of USD119 per barrel across the second half of the year, compared to an average of USD116 per barrel across the first half of the year, further contributing to higher import costs across the second half of the year[4].

CBSI balance of payments data indicates a higher level of aid inflows across the first six months of the year compared to the final six months of the year. Inflows of FDI, in contrast, are recorded as marginally stronger in the second half of the year.

A total of 70 FDI applications were recorded across the first six months of 2011, with 25 of these for investment in the forestry sector, 9 applications each for investment in the mining and wholesale sectors, 7 for the tourism sector and 4 for the construction sector[5].

Across the last six months of 2011, 87 FDI applications were recorded. Of these 87 applications, 20 were for applications to investment in other services, 16 were for investment in the wholesale sector, 16 for the forestry sector, 7 each for the mining and the transport and communication sectors and 5 for the construction sector.

Overall, the position of the current account improved across the second half of the year from a negative position at end-June of $57 million to a positive position of $96 million by the end of the year following on from a similar improvement across the first half of the year.

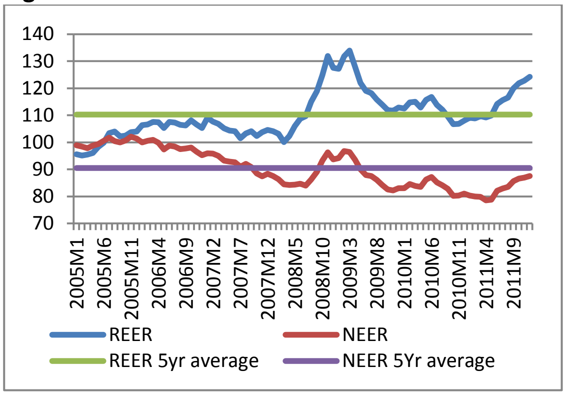
In the first half of 2011, CBSI implemented a gradual appreciation of the SBD in order to bring the SBD back into line with a trade-weighted basket of foreign currencies and a one-off 5% appreciation in June to counteract high international commodity prices at the beginning of the year, such that the SBD

[4] Bloomberg Asia-Pacific Tapis Crude Oil Spot Price
[5] FDI applications are reported by the Foreign Investment Division of the Ministry of Commerce, Employment and Industries. The proportion of applications that result in actual investment are not reported.

appreciated by 6.3% against the USD across the first six months of 2011. With a continuation of the gradual appreciation across the third quarter of 2011, overall, the SBD appreciated by 2.6% against the USD in the second half of the year.

The 5% appreciation of the SBD in June 2011 also led to a gradual rise in the real effective exchange rate (REER). At December 2011, REER was 13% higher than its five year average, suggesting a worsening of Solomon Islands export competitiveness (see Figure 3.2.2). However, the fact that Solomon Islands exporters are price-takers in the global markets means the stronger SBD will have less effect on the demand for the country's exports. The most notable adverse effect was the falling trade receipts that local exporters receive in terms of the domestic currency, which may translate into a fall in local prices for commodities like copra and cocoa.

Figure 3.2.2: NEER and REER



The SBD:AUD cross-rate is a major contributor to import costs faced by domestic importers. Across the first five months of the year (January to May) the SBD depreciated by 6%, significantly increasing import costs across the beginning of the year. Across the final half of the year, however, the SBD appreciated continually each month so that across the final six months of the year the currency appreciated by 5% against the AUD.

Against other currencies, the SBD depreciated by 4% against the NZD in the first half of the year and then depreciated by 4% across the second half of the year; against the GBP the SBD appreciated by 4% and 7% across the first and second half of the year respectively; and against the EUR, the SBD depreciated slightly by 0.4% across the first half of the year and then substantially, by 13% across the final half of the year.

Gross foreign reserves at end-June stood at $2,599 million, a 21% increase across the first six months of the year, equivalent to 9.3 months of import cover. By end-December total reserves increased by 17% to $3,033 million, equivalent to 10 months of import cover. At end-Feb 2012 reserves was recorded at $3,269 million equivalent to 10.6 months of import cover: a level considered as comfortable for the country.

3.3 Domestic Demand

Retail sales continued to remain strong in the second half of the year reflecting, primarily, domestic incomes supported by strong external trade rather than rising levels of credit to households.

Increased disposable income for some workers resulting from the increase in the minimum PAYE threshold at the beginning of the year and wage price increases awarded to private and public sector workers at the end of 2011 will likely add to domestic price pressures. Employment growth remains muted across the second half of the year.

Retail sales continued to remain strong in the second half of the year and major businesses in the sector reporting lower than desired levels of inventory[6]. Strong domestic demand

[6] Retail sales data reflect sales in the manufacturing sector

reflects positive external conditions which have acted to support incomes through higher trade receipts.

Total credit extended for personal loans and overdrafts remained flat, increasing marginally by 1% from $307 million at end-June to $310 million by end-December.

From January 2012, the Government implemented a rise in the minimum PAYE tax threshold increasing the tax-free allowance of workers from $7,800 per annum to $15,080 per annum. The resulting rise in disposable income could represent an upward risk to inflation. The extent to which this spending will impact headline inflation will depend on whether the tax saving is reflected in higher consumers purchases or higher savings.

Employment growth as estimated by SINPF contributors for all sectors, increased marginally by 2% between end-June and end-December.

Annual consultations carried out by CBSI with many major businesses and organisations revealed that the majority of wage increases for employees earning above the minimum wage were based on internal appraisal procedures and indicated an average wage increase of 6% awarded towards the end of 2011.

Preliminary estimates suggest a muted rise in Solomon Islands Government (SIG) employment by end-2011[7]. Towards the end of 2011, a 4% cost of living adjustment (COLA) to be backdated to January 2011 was agreed for all public sector workers. This lump-sum of backdated payments was paid to workers in December 2011.

[7] Based on preliminary established and non-established employment figures as quoted in the Government's 2012 Establishment Report.

3.4 Business Conditions

Domestic business conditions indicate sustained activity in the construction, manufacturing, retail & wholesale and tourism sectors. This favourable outcome primarily reflects positive external conditions supporting domestic demand, continued foreign investments and donor spending in the second half of the year.

Manufacturing

The CBSI manufacturing index increased from an average of 135 points in 2010 to 195 points in 2011. This strong performance in the manufacturing sector reflects sustained domestic demand during the year.

Total value of credit held by the manufacturing sector increased 5% from $60 million at end-June to $63 million by end-December. Total Solomon Islands National Provident Fund (SINPF) contributors from the manufacturing sector increased 2% from 11,884 contributors at end-June to 12,120 contributors by end-December. In terms of FDI applications, a total of 4 FDI applications were received for manufacturing sector against zero applications in the first six months of the year.

Retail/Wholesale

The total value of credit held by the retail & wholesale sector declined from $209 million at end-June to $176 million by end-December. This decline in credit reflects a significant decline in short-term lending for wholesale activities and a decline in longer-term lending for retail activities. These declines outweighed a slight increase in short-term credit for retail activities and an increase in longer-term lending for wholesale activities.

The number of FDI applications for investment in the sector increased from 9 applications in the first half of the year to 16 applications across the final six months of the year. The conclusion from these differing indicators is that foreign investment rather than domestic investment is behind the growth in this sector. In terms of employment, SINPF contributions relating to retail trade increased 2% from 8,225 contributors at end-June to 8,348 contributors at end-December. NPF contributors relating to wholesale trade, however, decreased by 1% from 1,823 contributors at end-June to 1,803 contributors by end-December.

Many businesses in the sector report stagnant domestic demand although this may be resulting from the increased number of competitors driving down the number of customers per business. With the increasing competition many businesses including large wholesalers diversified into different business areas.

Construction

Across the first six months of 2011, a total of 95 building permits were granted by Honiara Town Council, with the majority (48) of these permits extended for residential building requests and 32 requests extended for commercial/industrial applications. Across the last six months of the year, a total of 106 building permits were granted, with 54 extended to residential applications and 33 extended for commercial/industrial projects.

Total credit held by the construction sector increased strongly from $143 million at end-June to $167 million by end-December. SINPF contributions relating to the construction sector increased 4% from 2,431 contributors at end-June to 2,515 contributors by end-December. Overall, the above indicators signalled strong growth in the construction sector.

Solomon Islands Government (SIG) and donor spending on capital projects totalled $379 million by the end of 2011, 6% above total development spending in 2010. The majority of projects were infrastructure related projects. Government and donor spending were linked to major commercial and industrial construction projects which were not reflected in the Honiara-based building permit data.

Tourism

Visitor arrivals data indicates a 16% increase from 10,624 visitors to 12,317 visitors in the second half of 2011[8]. This significant boost to visitor numbers in the second half of the year reflects to a large degree a seasonal pattern of greater number of visitors in the second half of the year. Compared against the final half of 2010, total visitors in the second half of 2011 increased by 7%.

The total value of credit held by the tourism sector increased from $64 million at end-June to $78 million by end-December reflecting borrowing mainly by large hotels. A total of 7 FDI applications indicated interests to invest in the tourism sector in the first half of the year and 5 in the second half of the year.

Total number of SINPF contributors relating to employees employed by hotels increased only marginally by 1% from 2,073 contributors at end-June to 2,090 contributors at end-December.

3.5 Fiscal Conditions

Fiscal conditions improved further across the second half of the year such that by the end of the year a significant $184 million surplus (excluding donor support) had been recorded. This outcome was consistent with the accumulation of deposits by the Government across the year. Government

[8] Visitor arrivals data reflects ‘arrivals by air’ and excludes ‘arrivals by sea’.

debt levels are almost at 'green light' status as outlined in the Honiara Club Agreement which opens up the possibility of future credit extension by the Government. However the government does not foresee any form of borrowing in the near term even if debt levels reach 'green light'.

In 2011, year-to-June Government revenue (excluding donor support) totalled $1,007m, 15% above budget estimates boosted by high international prices for exports and rising trade volumes. By the end of the year, total Government revenue (excluding donor support) was recorded at $2,233 million, 2% above revised budget estimates. As a proportion of GDP, this level of revenue stood at 40%, compared to 37% in 2010.

At the end of the first half of the year, total Government spending (excluding donor support) was recorded at $845 million, 2% above budget estimates. At end-December, total spending (excluding donor support) is recorded at $2,048 million, 1% below revised budget estimates. This level of spending as a proportion of GDP is equivalent to 37%, compared to 33% in 2010[9].

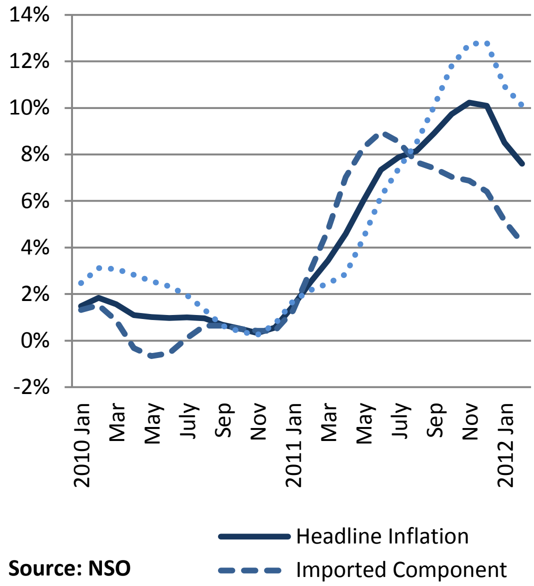
Overall, a budget surplus of $184 million is recorded at the end of 2011. This fiscal performance supports the trend evident in the monetary aggregates of a significant accumulation of Government deposits across the year.

The Government continued its commitment to debt servicing in the second half of the year such that spending on debt servicing came in on budget by the end of the year. By the end of 2011, the total debt stock of the Government stood at $1,153 million, 21% of GDP[10].

3.6 Costs and Prices

Headline inflation peaked in November 2011 at 10.2% and at end-February was recorded at 7.6%. The imported component of inflation was declining across the second half of the year but was negated by the rising domestic component until the final months of the year where the domestic component peaked at 12.8%.

Figure 3.6.1: Headline Inflation



Source: NSO

Headline inflation as measured by the three-month-moving-average peaked in November at 10.2%. Across the last six months of the year, the pace of inflation slowed to an average monthly increase of 0.3% compared to an average monthly increase of 1.2% across the first six months of the year (see Figure 3.6.1).

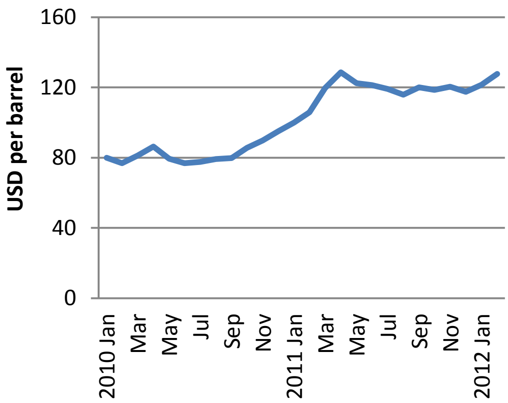
[9] All ratios of Government data against GDP use CBSI 2010 and 2011 GDP estimates.

[10] A debt-to-GDP ratio of 20% will represent the reaching of 'green light' status under the terms of the Honiara Club Agreement. This status reflects the level of debt at which the Government can recommence obtaining external and domestic credit. A debt strategy review has been started in anticipation of reaching this status in 2012.

The imported component of headline inflation peaked in June at 9.0% and across the final six months of the year and January 2011 has slowed to record a rate of 5.2% in January.

Following the large increases in Tapis crude oil prices across the second half of 2010, Tapis prices peaked in May 2011 at US$129 per barrel and then declined to US$116 per barrel by August 2011. From August, however, the price of Tapis increased to US$118 per barrel at the end of the year. Recent developments in the Middle-East at the end of 2011/beginning of 2012 threatens to push global fuel prices back to levels on a par with those seen early in 2011. At end-Feb, the Tapis crude oil spot price increased significantly to US$128 per barrel (see Figure 3.6.2).

Figure 3.6.2: Tapis Crude Oil Spot Price

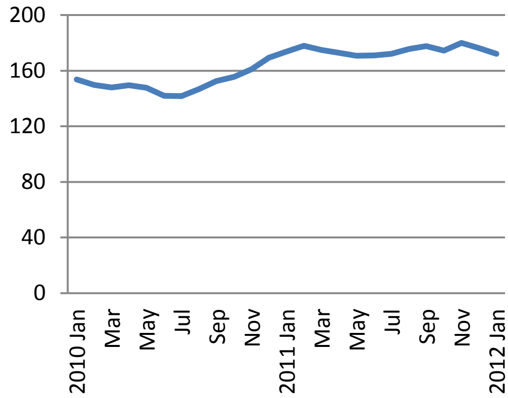


Source: Bloomberg

International commodity prices also surged across the second half of 2010. The CBSI Imported Food Price Index which follows global commodity prices reflected in the HCPI imported food sub-component increased overall across 2010, reaching 178 in February 2011. The index stayed at these elevated levels across the whole year, dipping slightly during the middle of the year but finishing the year at 176. The latest figure for Jan 2012 shows a fairly substantial drop to 172 as global commodity prices ease following the reversal of many supply-side restrictions encountered in 2011 (see Figure 3.6.3). IMF estimates that global food prices will continue to ease in 2012.

In line with these international price movements, the peak of 9.0% reached by the imported component in June was driven by the pass-through of high global fuel and non-fuel commodity prices. Across the second half of the year the imported component declined to reach 6.4% by the end of the year on the back of declining non-fuel commodity prices and to a lesser extent the effects of the 5% appreciation in the SBD in June which acted to further cushion domestic prices against the maintained high global fuel prices.

Figure 3.6.3: CBSI Imported Food Price Index



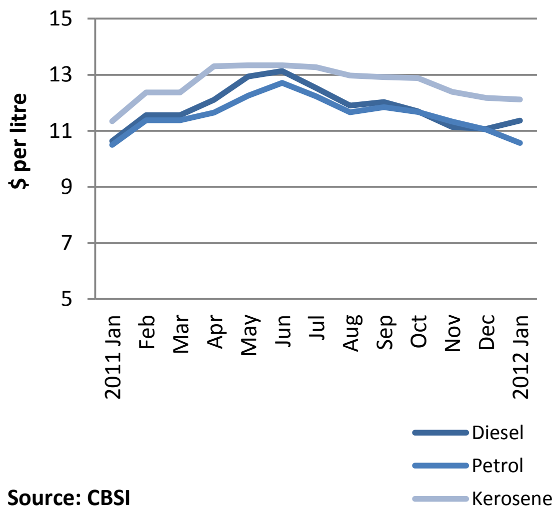
Source: CBSI

Fuel prices captured in the imported component of inflation, which are sensitive to international price movements and exchange rate movements saw prices rise in the first half of the year in line with international price pressure and then declined in the second half of the year indicating that savings from the 5% appreciation were passed on to consumers (see Figure 3.6.4)[11].

[11] Domestic fuel prices are regulated in the domestic economy and reviewed on a monthly basis. Due to the transparency of the pricing formula it is easy to see that international price

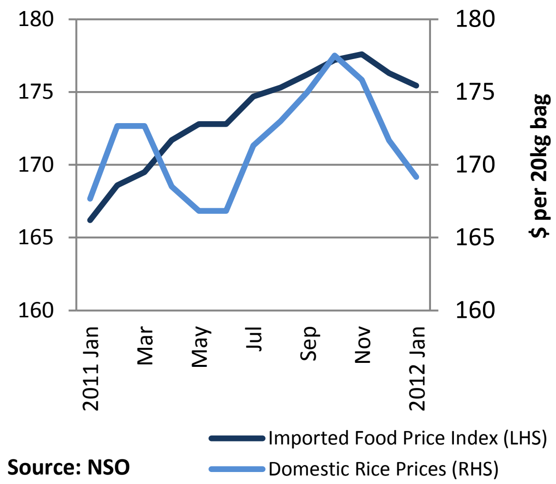
The HCPI imported food sub-component showed that imported food prices rose across the year until November reflecting strong international prices. This showed little evidence that the 5% appreciation cushioned prices, reflecting a reluctance to pass on savings to consumers.

Figure 3.6.4: Honiara Fuel Prices



Source: CBSI

Figure 3.6.5: HCPI Imported Food Price Index and Domestic Rice Prices



Source: NSO

In the final month of the year and the first month of 2012, however, imported food prices began to fall. The fall was driven by declines in rice prices (see Figure 3.6.5). Although rice prices are also regulated in the domestic economy there is a weaker relationship between their prices and international price and exchange rate movements. Indications from retailers were that rice prices were considerably influenced by domestic supply conditions.

The domestic component of headline inflation continued to increase across 2011, rising from 1.7% in January to 12.8% by December. Again, however, the largest month-on-month gains were witnessed across the first half of the year with the average month-on-month change in domestic inflation recorded at 1.2% compared with an average of 0.6% across the final months of the year.

The trend in the domestic component of headline inflation is driven by the close relationship between the imported and domestic components of inflation. Developments in the imported component of inflation are estimated to impact quickly on the domestic component due to second-round effects filtering almost immediately into domestic prices. For instance, it was estimated that rising transportation costs resulting from high fuel prices were passed on quickly to other domestic prices. In line with this, the domestic component of inflation increased until it reached a peak of 12.8% in November/December 2011.

In January, market prices for many vegetables saw an increase most likely reflecting supply shortages of produce due to bad weather at the beginning of the year. These were counteracted, however, by a decline in rice prices. Prices of market produce should decline as supply restrictions correct themselves over the next few months.

and exchange rate movements will impact the price of fuel.

4. Outlook

Real GDP growth in 2012 is preliminary forecasted by CBSI to be 5.5%, with a significant portion of the slow-down in real GDP growth reflecting no growth in the forestry sector in 2012 and more modest growth in the other sectors, mainly in the agriculture sector. On an upside, the key driving sectors expected to generate the 5.5% growth are mining, transport and telecommunications, construction and fisheries.

Subtracting the effects of new commercial mining activity which does not greatly impact monetary aggregates, the slowdown in export oriented sectors is expected to result in a further decline in the rate of accumulation of NFA and a corresponding decline in the rate of increase of liquidity in the banking system. Domestic incomes are also likely to moderate in light of slowing external trade receipts.

Domestic price pressures stemming from rising private sector credit are likely to remain subdued across the first half of 2012 as financial institutions remain cautious in their lending practices. CBSI anticipates growth in private sector credit to remain at the levels seen in the second half of 2011 as commercial banks continue to try to attract borrowers through lower lending rates but constrained by the aforementioned caution in the market.

Immediate upside risks to domestic prices include increases in domestic food prices following recent heavy rain destroying crops and hampering the transportation of market produce to commercial centres. These price pressures are likely to be temporary as prices decline in line with supply side corrections.

Additional price pressures stem from the general wage increase across the private and public sectors in 2011 and the raising of the PAYE minimum threshold in January 2012.

Furthermore, Government spending as outlined in the 2012 budget is expected to increase and could contribute to domestic inflationary pressures. Looking at the level of recurrent expenditure as a proportion of GDP the ratio is expected to increase from 33% in 2011 to 36% in 2012[12]. The level of aid inflows and foreign direct investment are not expected to represent a significant risk to inflation in the near term in the anticipation that levels in 2012 will be below those seen in 2010/2011.

On the external side, the greatest immediate upside risk to imported inflation remains high international oil prices. With Tapis oil prices at US$128 and continued uncertainty regarding global supply, CBSI conservatively estimates that Tapis oil prices will remain on average above US$120 per barrel across the first six months of 2012.

Downside pressure on imported inflation could stem from falling global non-fuel commodity prices although the extent to which these act to dampen inflation will be determined by the extent that savings are passed onto consumers by importers. Additionally, non-fuel commodity prices are at risk of maintaining current high levels if global fuel price pressures feed-through into these prices. In this respect, if domestic importers believe that present falls in non-fuel commodity prices are temporary, savings are unlikely to be passed on to consumers.

Overall, in line with the forecasts of the imported and domestic sub-components inflation (on a year-on-year basis) is expected to average in the range of 5.0% - 7.0% in 2012.

[12] CBSI estimates of 2011 GDP and 2012 forecasted GDP are used in the calculation.

5. Monetary Policy Statement

Subtracting the effects of new commercial mining activity, external conditions for the country are expected to moderate over the next six months due to weaker commodity prices and slowing global demand. This is expected to result in a weakening in the rate of accumulation in net foreign assets in the banking system and moderating levels of free liquidity in the system. Movements in credit to the private sector are expected to continue in line with the restrained increases seen in the second half of 2011. These downside pressures to domestic inflation are expected to counteract upside pressures in the form of an anticipated expansionary fiscal stance and increases in disposable incomes through the raising of the minimum PAYE threshold and public sector wage increases.

On the imported side, global fuel price pressures are expected to represent immediate upside risks to inflation, whilst a downside pressure stemming from falling non-fuel commodity prices may take time to feed-through and may start to trend upwards if global fuel price pressures feed through into these commodity prices.

In line with these domestic and external price pressures, average year-on-year inflation is expected to average in the range of 5.0% - 7.0% in 2012.

Further upward pressures can result from higher than anticipated increases in global fuel prices and non-fuel commodity prices or a pick-up in domestic demand pressures stemming from increases in private sector credit.

In view of the recent analysis on inflation, the Central Bank will pursue a moderate monetary policy stance that maintains price stability in the next six months. The Central Bank will continue to monitor economic developments and stand ready to act should economic developments require.