CENTRAL BANK OF SOLOMON ISLANDS

MONETARY POLICY STATEMENT
MARCH 2015

Central Bank of Solomon Islands
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1.0 OVERVIEW

The global economy expanded by 3.3% in 2014, the same growth level as in the previous year. However, growth diverged across the major economic regions. While the United States (US) rebounded stronger than expected to be the major driver behind global growth, the euro area crept out of the negative zone to register a marginal growth of 0.8%. On Solomon Islands major trading partners, growth remained positive. In China, growth was still strongly positive but exhibited a downward trend to 7.4%. Australia and New Zealand remained strong across 2014 with respective growths of 2.7% and 3.3%. While the falling oil prices had a dampening effect on growth in oil producing countries, activities in net oil importing countries including Solomon Islands were boosted by this price development. Consistent with the fall in oil and food prices, inflation in these three major trading partners recorded declines during the year.

The Solomon Islands economy rebounded strongly in the second half of 2014 after a weaker first half to record an annual growth of 2.0%, 1.1 percentage points higher than the projected growth in April 2014. The positive turnaround came on the back of favourable export prices, coupled with robust activities in key sectors.

Leading indicators showed primary commodities improved remarkably in the six months to December 2014 despite the closure of Gold Ridge Mining Limited. Large increases in the volumes of round log exports combined with robust fisheries exports were the major contributors to this positive turnaround in the second half of 2014. On a half yearly basis, the Central Bank of Solomon Islands (CBSI) production index (2012=100) jumped up by 13% to 93 points. Despite that, the second half of 2014 was understandably weaker than the previous year because of the closure of the Gold Ridge mine since April.

Other partial indicators pointed to mixed movements in the second half of 2014. Domestic demand conditions, as proxied by the manufacturing index, showed some recovery. Labour market indicators also showed an overall growth for the year, despite a relatively weaker second half.

The balance of payments position deteriorated in the second half of 2014 despite a narrow current account deficit. The overall position weakened as a result of large capital outflows in the fourth quarter which subsequently contributed to the fall in gross foreign reserves to $3,875 million at end December. The current account balance narrowed from a deficit of $226 million in the first half of 2014 to a deficit of $193 million in the second half of 2014. However, trade in goods account reversed the first half deficit to post a $125 million surplus. Exports rose significantly in the second half to $1,841 million to outweigh imports of around $1,715 million. The strong growth in export receipts was driven mainly by increasing export volumes combined with the depreciation of the local currency against the United States dollar (USD). Imports on the other hand benefited from the large fall in oil prices which to a large extent have cushioned the effects of the appreciating USD.

Following the previous Monetary Policy Statement in September, the CBSI reviewed the exchange rate policy in October to make it more accommodative by pegging the local currency to a basket comprised of major trading partners' currencies. The CBSI also removed the tight exchange rate margins such that major trading partners' currencies within the exchange rate basket were able to adjust fully against each other to determine the value of the local currency. As such, the value of the local currency depreciated by 4.6% against the USD but appreciated strongly against the Australian dollar (AUD) and New Zealand dollar (NZD). These movements in the final quarter would benefit both the exporters and imports. Exporters that traded in USD were receiving more in terms of the local currency while local importers that traded in other currencies such as AUD and NZD would buy imported goods cheaply.

Following the flood in April, the Government revised its 2014 budget to accommodate unexpected expenditure pressures and falling revenue mostly from the mineral industry. The Government however managed to record a fiscal surplus of $129 million by the end of the year due to the non-implementation of some planned projects, a huge increase in export duty from logs and surprise increases in non-tax revenue particularly from the fisheries sector.

Monetary conditions were moderately slower in the second half of 2014. The CBSI monetary base or reserve money dropped further by 6% after a 4% fall in the six months to June. The subdued movement was attributed to a contraction in CBSI's net foreign assets by 9% to $3,540 million to outstrip the 12% movement in net domestic assets to minus $1,708 million. The decline was consistent with falls in the gross foreign reserves that was partly influenced by leakages in the capital account combined with revaluation losses incurred over the course of the year.

Overall money supply fell negligibly by 1% in the second half year to $3,634 million, although credit to private sector expanded by 13% to $1,703 million. To a large extent, the slight contraction in money supply reflected reductions on the banking system's net foreign assets. The credit growth on the other hand was attributed to a couple of factors including competition from the new bank entrant for market share, renewed lending to the personal sector, and financing of large infrastructure projects. Weighted average lending and deposit rates increased in the second half of the year. This led to a 7 basis points rise in the weighted interest rate margin over the six months to December to 10.71%, owing to a higher increase in lending rates as compared to the increase in deposit rates.

Inflationary pressures that were building up temporarily in the second quarter as a result of supply shocks relating to the April flooding began to subside in July. Reflecting output and price corrections at the Honiara market in the second half, the local price index dropped from 12.7% in June to 8.0% in December. This, combined with subdued imported inflation, effectively dragged down headline inflation from a peak of 7.2% in June to 4.8% in December. Despite a sharp depreciation in the local currency against the USD, imported inflation was contained below zero percent. This could be attributed to the falling oil and food prices as well as appreciations of the local currency against AUD and NZD.

2.0 INTERNATIONAL DEVELOPMENTS

Global Economic Growth

Global growth remained subdued in the second half of 2014 as downside risks to global growth persisted. Despite these risks, however, including geopolitical tensions around the world, the slowing down of growth in emerging market economies, and weak economic activity in the euro zone, some economies rebounded from the slow start early in the year. The global economy is estimated to have grown by 3.3%[1] by the end of 2014, 0.1 percentage points lower than was projected in the July 2014 IMF World Economic Outlook (WEO) Update. This growth was characterised by divergence in growth across countries as the United States (US) continued to pick up in the second half of 2014 while China slowed down, Japan wavered, and Europe continued to slip. Another key feature of the second half of 2014 was the plummeting of the oil price with crude oil prices alone falling more than 50% by December, compared to June 2014.

The growth estimate for advanced economies was maintained at 1.8% by the end of 2014, as in the July forecast. This was 0.5 percentage points higher than the growth rate of 1.3% recorded for 2013. Of the major economies, the US was the quickest to recover from the contraction experienced in the first half of 2014. By year end, the country had registered a growth rate of 2.4%, 0.7 percentage points higher than had been projected in July. The United Kingdom also helped shore up growth amongst the advanced economies registering annualised growth of 2.6% as the labour market healed and accommodative monetary policy was implemented.

In the euro area, growth remained subdued in the second half of 2014, closing at 0.8% at year end. This was nonetheless an improvement from the 0.5% that had been forecast in July, and a complete reversal of the negative 0.5% growth recorded in 2013. Despite weak investment and declining inflation in the region, Germany and Spain helped to bolster growth. Meanwhile, Japan fell into recession during the third quarter of 2014, achieving annualised growth of only 0.1% by year end, a substantial contraction from the 1.6% forecast in July. Despite increased infrastructure spending in the country, private domestic demand failed to accelerate as expected, particularly after the increase in the consumption tax rate was introduced in April.

Growth in emerging market and developing economies was estimated at 4.4% at the end of 2014, a marginal fall of 0.1 percentage points from the July forecast. This, however, was a somewhat reduced pace from the 4.7% recorded in 2013. Contributing to this reduction was China as it continued on its path of gradual deceleration posting a growth rate of 7.4%, 0.4 percentage points lower than a year prior. Growth in India increased 0.4 percentage points from the July forecast to reach 5.8% by year end, supported by the boost to terms of trade from lower oil prices. Russia also continued to be plagued by the effects of geopolitical tensions, which were further compounded by the fall in oil prices. The impact of lower oil prices, as well as other commodity prices, has also been felt by several emerging and developing commodity exporters as these take their toll on terms of trade and real incomes.

In the East Asia Pacific region, growth remained subdued in the second half of 2014, this despite a sharp acceleration noted in the second quarter. Aside from the deceleration in China, the ASEAN-5[2] also saw a contraction in growth. Closer to home, growth in Australia and New Zealand, Solomon Islands' other major trading partners, remained solid through to the end of 2014. By the end of the year, growth estimates for both countries had been revised up from the July projections to 2.7% for Australia and 3.3% for New Zealand. For the former, this was buoyed by a notable improvement in resource export volumes, while the latter saw stronger private consumption and fixed investment, as well as an improving external sector.

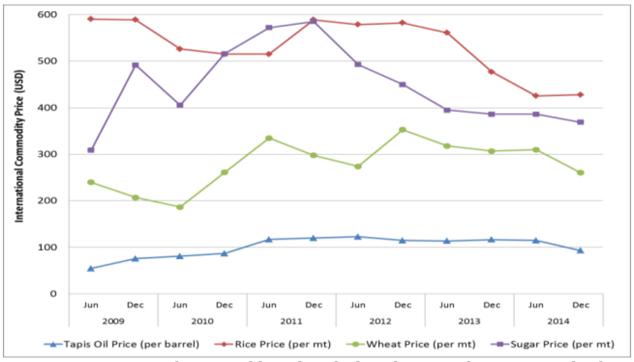
[1] All statistics in this section obtained from IMF World Economic Outlook, Jan 2015 unless otherwise stated.

[2] The ASEAN-5 comprise Indonesia, Malaysia, Philippines, Singapore, and Thailand

International Commodity Prices

Global commodity prices, as indicated by the World Commodity Price Index (CPI), plunged 30% by December, compared to June 2014, to reach 130 on the index. This drastic fall was primarily driven by the drop in fuel prices whose index plummeted 39% over the same period to reach 119. Crude oil prices alone fell more than 50% with the Brent crude oil price reaching a monthly average of US$62 per barrel. The Tapis crude oil price, the most relevant fuel price for the Solomon Islands, also followed suit by falling 43% to reach a monthly average price of US$66 per barrel in December. Looking forward, it is not clear how long these depressed fuel prices will persist, but they are likely to remain subdued compared to prices seen in recent years. The non-fuel index also experienced a contraction by December, compared to June 2014, but this was a more modest decline of 9%.

Figure 1: International Commodity prices



Source: GEM Commodities World Bank and Bloomberg Database, retrieved Feb 2015

International food prices, as indicated by the Food Price Index[3], experienced a 7% decline between the first and second half of 2014 to reach an average of 194 on the index. This fall was driven by declines in the price indices of cereals, dairy, vegetable oils, and sugar during the year with global markets for most foodstuffs characterised by abundant supply and reduced uncertainty. More importantly for Solomon Islands, the average prices[4] of wheat and sugar both fell between the first and second half of the year by 16% and 5% respectively to reach US$260 per ton and US$369 per ton. The price of rice rose marginally by 0.7% to reach US$428 per ton. Going forward, the market for these commodities is expected to remain relatively stable through 2015.

Global Inflation

Global inflation remained relatively steady in 2014 but it is expected that the lower oil prices observed in the latter half of 2014 will temporarily reduce global inflation. The impact across countries will vary significantly, depending on the importance of oil on consumer baskets, exchange rate developments, and other price regulations. Nonetheless, the pass-through to headline inflation in most cases is expected to be modest.[5]

In advanced economies, inflation[6] generally remained below central banks' policy targets. Inflation in the US slowed to its lowest level in six years averaging 0.8% in December while in the euro area, inflation expectations continued to decline. Similarly, inflation in Japan is expected to remain subdued, once the effects of the sales tax boost are removed, to hover around the 1% mark. Meanwhile, the lower oil prices are expected to alleviate inflation pressure in many emerging market and developing economies.

For Solomon Islands' major trading partners, inflation was on the decline in the second half of 2014. In China, annualised inflation fell 0.4 percentage points from July to reach 2% in December 2014, and appears likely to continue on a downward trend. Australia saw annual average inflation drop to 2.5% in the fourth quarter reflecting lower prices for transport, resulting from lower oil prices, as well as healthcare. In New Zealand, annual headline inflation reached 0.8% in the last quarter of 2014, falling below the Reserve Bank of New Zealand's 1%-3% target range. However, inflation is projected to increase in 2015 to reach an average of 1.8%.

3.0 DOMESTIC ECONOMIC DEVELOPMENTS

3.1 Monetary Conditions

Reserve Money

In December 2014, reserve money (M0) declined by 6% against June 2014 to reach $1,828 million. This was in addition to the decline already observed in the first half of the year, bringing the total year-on-year drop to 10%. The decline in reserve money was due to a fall in CBSI's net foreign assets (NFA) by 9% to $3,540 million in the second half year million (see Figure 2). However, this outpaced the improvement in CBSI's net domestic assets (NDA) by 12% to minus $1,708 million over the same period.

The decrease in the CBSI NFA position was primarily due to a decline in gross foreign reserves by 9% to $3784 in December, compared to June 2014. This drop was primarily driven by revaluation loses, as well as some financing of the current account. On the other hand, the improvement in CBSI NDA was attributed to an increase in net domestic credit following a rise in claims by the central government. Net credit to government fell marginally to liabilities of $1,280

[3] FAO Food Price Index obtained at www.fao.org/worldfoodsituation/foodpricesindex/en/ - accessed Feb 2015

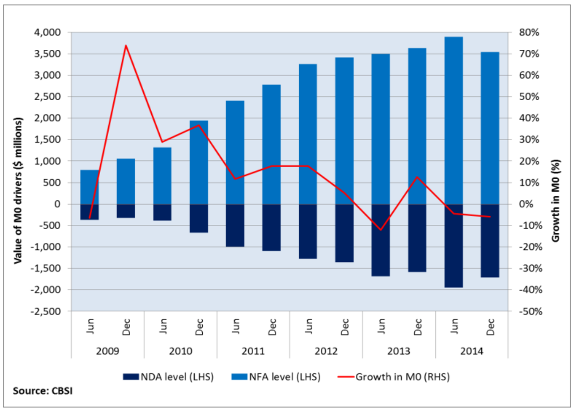
[4] Global Economic Monitor (GEM) Commodities prices, World Bank Group, retrieved Feb 2015

[5] Global Economic Prospects, January 2015, World Bank

[6] All inflation data in this section is obtained from: www.focus-economics.com/economic-indicator/inflation-rate - accessed Feb 2015

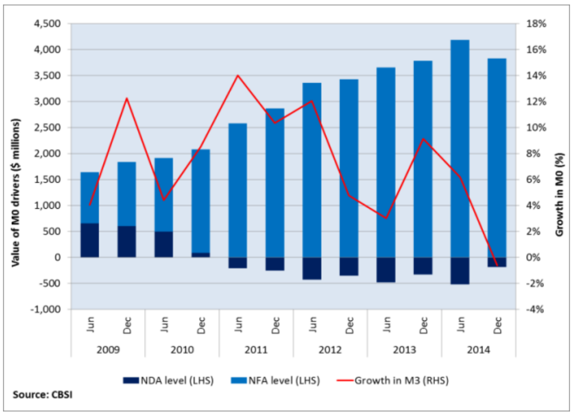
million while net credit to other depositor corporations (ODCs) fell by $124 million to liabilities of $575 million over the six months to December.

Figure 1: Drivers of Reserve Money



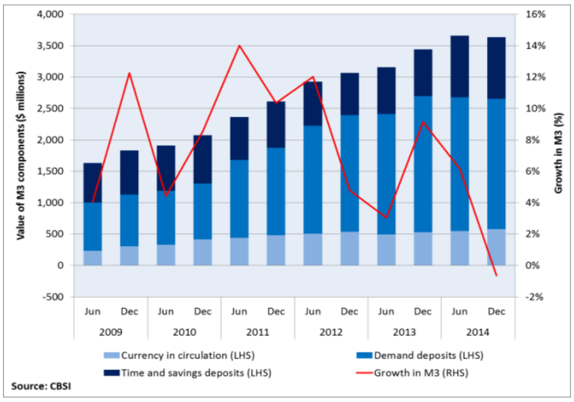
Components of reserve money continued to show mixed movements in the second half of 2014. While currency in circulation saw an 8% increase to $658 million over the six months to December 2014, this was outweighed by CBSI liabilities to ODCs which increased 12% to $1,165 million over the same period. These liabilities to ODCs were comprised of $239 million in cash reserve requirements (CRR) and other deposits commercial banks held in their call accounts with CBSI at $926 million.

Figure 2: Drivers of Broad Money



Broad money (M3) followed a similar trend to that of reserve money over the second half of 2014, although more moderately so. Total money supply in the economy fell by 1% to $3,634 million in December, but this was still 6% higher than a year prior (See Figure 4). This minor contraction in M3 stemmed from a contraction in NFA of $358 million to $3,827 which outweighed an improvement in NDA by $334 million to minus $183 million (see Figure 3). The movements in key components of M3 were mixed. While demand deposits fell 2% to $2,078 million in the six months to December 2014, currency in circulation increased 5% to $545 million, and time and savings deposits remained flat at $981 million.

Figure 3: Components of Broad Money



Credit Conditions

Following two consecutive decelerations since June 2013, credit growth accelerated by 13% in the second half of 2014. Credit to private sector increased to $1,703 million in December 2014 from $1,506 million in June (see Figure 5). This growth was primarily driven by the establishment of a new ODC in the second half of the year. Loans accounted for the majority of total lending with 89.7%, followed by overdrafts with 9.8% and finally lease financing at 0.5%.

Figure 4: Private Sector Credit Trends

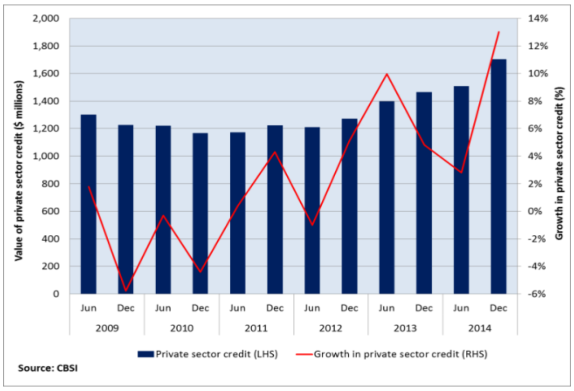
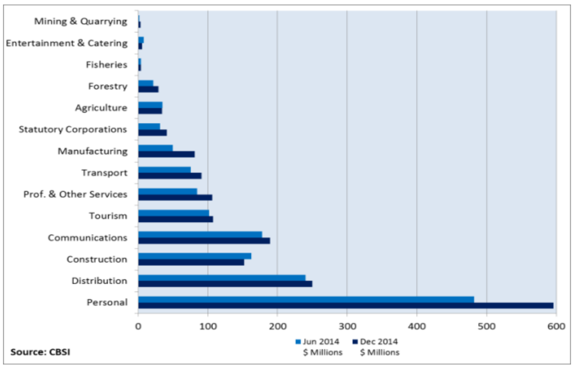


Figure 5: Private Sector Credit by Sectors



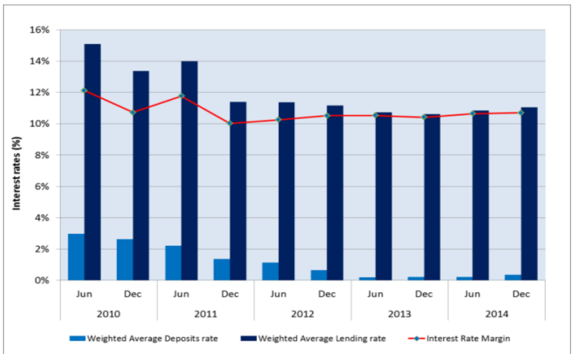
The sectors that recorded large credit movements in the second half of 2014 were personal loans which increased by $114 million to $596 million, manufacturing gained $31 million to reach $81 million, and professional & other services up $22 million to $106 million (see Figure 6). Of the personal loans, housing loans for residential homes accounted for 49%. On the other hand, the only sector that experienced a significant decline over the same period was construction which shrunk by $11 million to $152 million.

Interest Rates

Weighted average deposit rates stood at 0.35% in December 2014, up 14 basis points from June. Following the same trend, average lending rates increased by 21 basis points to 11.06%. This caused the interest rate margin for the banking sector to rise to 10.71% from 10.64% over the same period (see Figure 7). According to the sectoral weighted average lending rates in December 2014, the communication sector recorded the lowest weighted average lending rate at 6.78%, a drop of 13 basis points from June. Transportation and manufacturing also experienced significant drops in their lending rates of 2.55 and 1.91 percentage points respectively to 9.84% and 9.40%. Other sectors that recorded single digit lending rates were construction and tourism. All other sectors recorded double digit lending rates ranging from 10.09% in fisheries to 18.96% in forestry.

In December 2014, the professional and other services category recorded both the lowest and the highest lending rate charged on any borrowing across the different categories with a range of 5.39% to 29.63%. Within the personal lending sector, rates charged in December ranged from 9.80% to 22.09%.

Figure 6: Interest Rate Trends

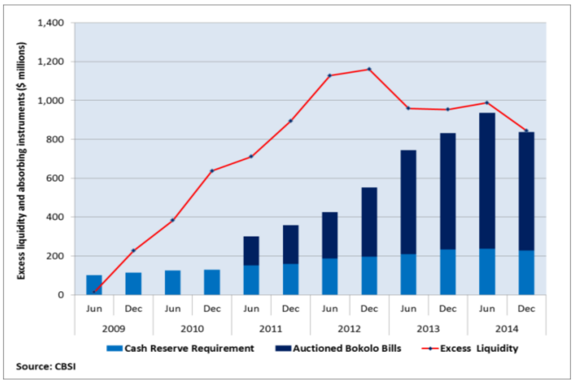


Source: CBSI

Liquidity

Total liquidity in the banking system fell 11% by December, compared to June 2014, to $1,174 million. This came after a peak of $1,615 was reached in August following under subscription in the Bokolo bills market in that month. Excess liquidity followed a similar trend falling 15% in the six months to December to $844 million (see Figure 8). Contributing to this fall was the build-up of government deposits combined with the fall in CBSI's NFA. To further help reduce excess liquidity, CBSI continued to issue Bokolo bills.

Figure 7: Excess Liquidity



Source: CBSI

Bokolo Bills

The level of Bokolo bills issued was maintained at $710 million throughout the second half of 2014. By December, the stock of ODCs' Bokolo bills held by CBSI stood at $610 million following some under subscription over the six months period. Throughout this period, the weighted average interest rate was maintained at 0.61%.

The cap on SIG backed Treasury bills remained unchanged at $40 million. Total stock of Treasury bills in December 2014 stood at $37 million compared to $35 million in June. Weighted interest rates for the Treasury bills varied for the different maturities with the 56 days earning 0.30%, 91 days earning 0.48% and the 182 days earning 1.24%.

3.2 External Conditions

The Solomon Islands external position in the second half of 2014 weakened as opposed to the strong performance observed in the first half of the year. The downturn was driven mainly by the deterioration in the capital account, associated with significant capital outflows and a drop in gross foreign reserves during the period. This counteracted the improvement in the current account gained from the significant trade export surplus in the six months to December. The strong growth in exports in the second half year was led by the gradual recovery of the economy and monetary accommodations. This growth was further supported by the depreciation of the Solomon Island dollar (SBD) against the United States dollar (USD), which in turn boosted export competitiveness during the period.

Current and Capital Accounts

The second half of 2014 saw the current account narrowed to a deficit of $193 million from a revised deficit of $226 million in the first half year. This outcome was triggered by trade in goods account posting a $125 million surplus compared to $125 million deficit in the first six months to June. The reduction in trade in services account deficit to $355 million from a deficit of $506 million in the preceding half year also contributed to the improvement in the current account. Conversely, the primary and secondary income accounts deteriorated in the second half year with the former expanding to $113 million deficit and the latter dropping to $150 million surplus from $460 million surplus in the first half of 2014. The high deficit in the primary income account is primarily due to higher outflows in investment income and compensation of employees. Meanwhile, the lower surplus in the secondary income account stemmed from a decline in general government transfers as a result of falls in both cash grants and technical assistance.

The significant turnaround in trade in goods account in the six months to December was driven mainly by stronger exports reaching $1841 million relative to weaker imports which were contained at $1715 million during the period. Higher earnings in logs, copra, fish, and cocoa largely explained the positive outturn in exports. Logs rose considerably by 46% to $1162 million from a 4% fall in the preceding half of 2014. The strong growth in log exports in the second half year was aided by higher export volumes, and accounted for 59% of total log exports in 2014. Driven by better prices and volumes, fish exports went up by 66% to $286 million, a significant reversal from the 46% decline in the preceding six months to June. Despite the lower production, cocoa earnings increased by 46% to $59 million, on account of higher contracted export prices during the second half year. In contrast, copra, timber, and palm oil exports dropped in the second half year reflecting lower production and prices during the period. Copra fell by 27% to $42 million, timber down 34% to $25 million and palm kernel oil dropped 39% to $90 million. Minerals also fell drastically by 80% to $34 million in the second half of 2014, following the closure of the only gold mine in the country.

The 3% growth in imports came from increase payments in machinery and transport equipment which went up by 9% to $518 million. The growth was also supported by growth in food and live animals which rose by 9% to $433 million, basic manufactures 8% to $281 million, chemicals 4% to $108 million, beverages and tobacco 16% to $37 million and animal, vegetable and oil fat up 36% to $10 million. A smaller increase in miscellaneous imports by 2% to $119 million also contributed to growth in imports. Nevertheless, the decline in fuel import payments by 16% to $353 million from $425 million in the preceding six months helped contribute to the slower growth in imports during the period.

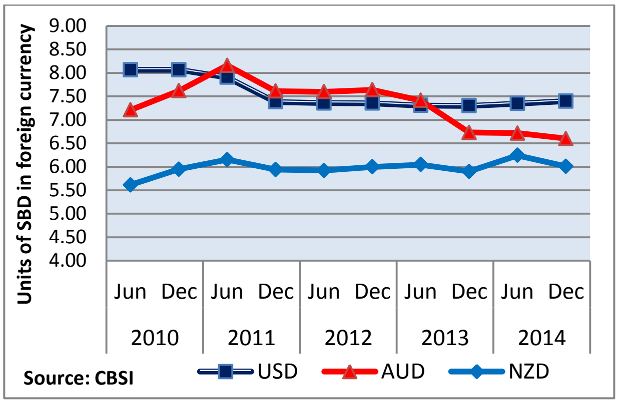
On the capital account, the decline by 35% to $195 million surplus from $305 million surplus in the first half of 2014 was driven mainly by the decline in donor inflows for capital projects. This fall primarily stemmed from a significant drop in investment cash grants, relating to government capital projects, and technical assistants. Capital investment grants dropped 40% to $141 million from $235 million in the first half of 2014 whilst technical assistants fell by 95% to $1 million from $5 million in the preceding half year. The decline in capital donor in kind by 17% to $53 million in the second six months of 2014 also contributed to the lower capital surplus during the period.

Exchange Rate

The Solomon Islands real effective exchange rate (REER) appreciated further by 4% to an index of 146 in the six months to December. This was triggered by the appreciation of the country's nominal effective exchange rate (NEER) coupled with higher domestic inflation relative to trading partners' inflation. The NEER appreciated by 3% to an index of 95 from an index of 92 in the preceding first six months of 2014. The appreciation was largely influenced by the strengthening of the SBD against the nominal bilateral exchange rate of the Australian dollar by 1.8% to $6.60 per AUD in the second half year. The AUD is the second main trade invoicing currency after USD in Solomon Islands and this in turn benefited importers trading in this currency during the period.

Meanwhile, the weakening of the SBD against the United States dollar by 1.03% to $7.40 per USD (see Figure 9) benefited exporters as a result of the exchange rate policy review in the fourth quarter of 2014. Similarly, year-on-year in December 2014 also saw the SBD depreciating strongly against the USD by 4% to $7.67 per USD from $7.29 per USD in December 2013.

Figure 8: Nominal Bilateral Exchange Rates



On the nominal bilateral exchange rate of the other trading currencies, the SBD in the second half of 2014 appreciated against the British pound by 2% to $12.03 per pound. The SBD also appreciated against the

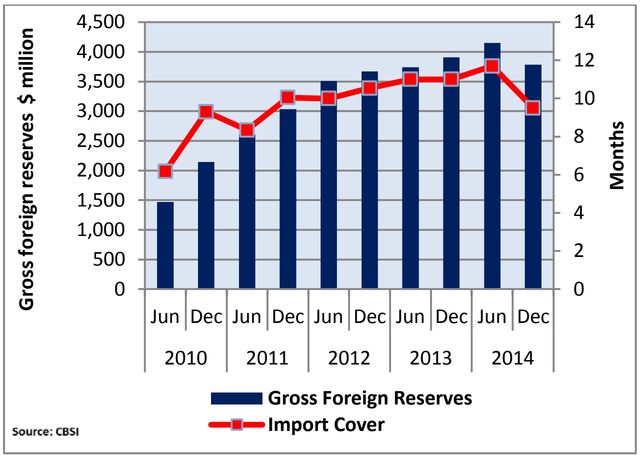
Japanese Yen by 5% to $6.82 per 100JPY, against the New Zealand dollar by 4% to $6.01 per NZD and against the Euro by 5% to $9.53 per EURO.

In terms of exchange rate policy development, the Central Bank in the final quarter of 2014 removed the exchange rate band and further expanded the exchange rate margins. This is mainly to improve trading activities in the foreign exchange markets following the move to an accommodative monetary policy stance in September 2014.

Reserves

Gross foreign reserves, after spiking in June to $4,148 million dropped rapidly by $367 million to $3,784 million at the end of December (see Figure 10). Consequently, this level of gross foreign reserves now only covers 9.5 months import for goods and services as opposed to the 11.7 months of import cover at the end of June.

Figure 9: Gross Foreign Reserves



The deceleration in gross foreign reserves was mainly triggered by the revaluation losses, falls in donor inflows and large payments during the second half of the year. Revaluation resulted in a loss of $109 million compared to the $6 million gain in the preceding six months to June. Donor inflows to the government dropped by $104 million from significant gains in the first half of 2014. High outflows of $537 million, associated with significant trade payments and other large overseas payments also contributed to the decline in gross foreign reserves in the last six months of 2014.

3.3 Domestic Conditions

Partial indicators on domestic activities show tentative signs of improved conditions in the second half of 2014. Production and manufacturing activities performed strongly as the economy recovers and domestic demand picks up. Other key indicators including, tourism, and transport and communication also showed signs of improvement as demand for services improved during the period. Consumption and construction activities also increased in the second half year, but grew at relatively moderate rates. Conversely, investment activities slowed in the second half year following the slow growth in the economy.

Economic Growth

As predicted in the September MPS, the gradual recovery of economic activity continued in the second half of 2014 with annual gross domestic product (GDP) expanding moderately at 2.0%. Growth was above the post April flood projection of 0.9%, but still below the revised growth of 2.8% in 2013. The recovery during the second half of the year was driven by domestic activities with noticeable pick up in production and manufacturing, while continuing under-execution of public development funds weighed on growth. Fisheries and forestry, driving production in the second half of the year, picked up strongly to be above the levels of the first half of 2014.

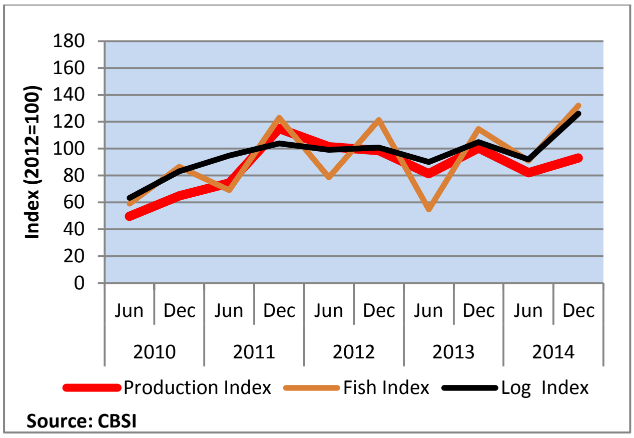
A range of indicators also suggest that tourism, transport and communication sectors grew strongly in the second half year. However, other partial indicators including retail and wholesale activities, construction and employment moderated over the same period. Consistent with the recovery and monetary accommodations, net exports made a significant contribution to growth in the second half year. This partly reflects the depreciation of the SBD against the USD with exports becoming more competitive during the period.

Production

Domestic economic activities picked up in the second half of 2014, following the weak performance in the previous six months. This is reflected in the CBSI production index which rose over the first half year by 13% to 93 index points in the latter half (see Figure 11). Driving this positive outturn was higher output in fish catch and logs which more than offset the decline in the agricultural commodities in the second half of the year. Fish catch increased by 45% (5,983 tons) to 19,389 tons over July to December 2014 owing to better international fish price and increase in fishing days. Over the same period, log production rose to 1,229 million cubic meters, despite the drop in price, an increase of 37% or 329,000 cubic meters from the first half year.

Conversely, copra productions after a strong performance in the first half year dropped 6% to 8022 tons in the second half. Similarly, palm oil fell 7% (1176 tons) to 16,288 tons while cocoa slid by 11% (269 tons) to 2,245 tons in the second six months of 2014. Driving the fall in copra and palm oil productions were the significant decline in contracted export prices for both commodities.

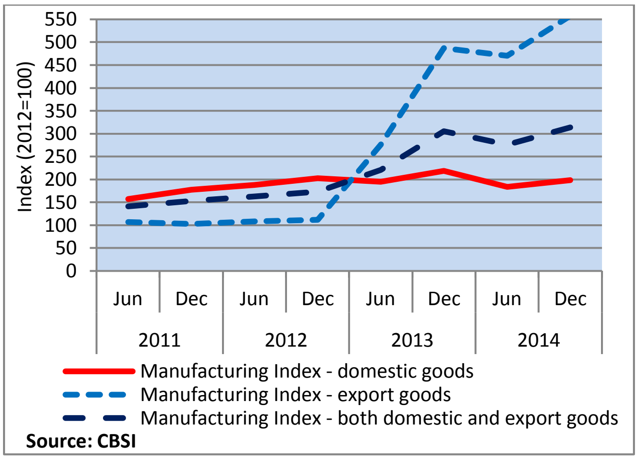
Figure 10: CBSI Production Index



Manufacturing

Domestic demand conditions, measured by the CBSI manufacturing index showed an improvement of 7% to 198 points in the second half of 2014 (see Figure 12). This is in contrast to a revised fall of 16% in the preceding half. Growth was driven mainly by manufactured goods destined for both exports and domestic markets that rose by 13% to 476 points and 13% to 314 points, respectively. The rise in manufactured goods for exports came from an increase in manufactured fish for exports. Meanwhile, the increase in alcohol and tobacco was ascribed to growth in manufactured goods for domestic markets in the second half year. Strong demand for manufactured goods came in the third quarter, but decelerated in the fourth quarter. This followed from the conservative approach taken by most consumers during the national general election in November.[7]

Figure 11: CBSI Manufacturing Index



Employment

Partial indicators showed labour market conditions remained positive in July to December 2014. The average number of contributors to the Solomon Islands National Provident Fund (SINPF) showed a 2% increase to 53,696 in the second half year, although much slower than the 11% increase in the preceding half. The increase mainly came from active contributors rising 9% to 47,246 in the second half year.

Employment indicators from the CBSI job advertisement survey also showed similar movements rising by 16% to 1,011 vacancies in the second half of 2014. About 64% of the total job advertisements were recorded in the last quarter of 2014 consistent with the economic recovery in the second half of the year. By industry, employment vacancies in the administration and support services account for the bulk of employment vacancies with 26%. This followed by employment vacancies in the education industry, accounting for 24% and professional and technical activities with 17%.

Foreign direct investment

Investment activities in July to December slowed, opposing the strong performance in the first six months to June. The Foreign Investment Division approved 82 applications, 26 applications down from the preceding half year, with an estimated value of $412 million. The decline in foreign investment applications in the second half year reflected low investment growth in mining, other services, retail and wholesale, and forestry. Approved applications received by the mining sector fell by 65%, other services down by 48%, retail and wholesale slid by 30% and forestry came down by 11% during the second half year.

Tourism

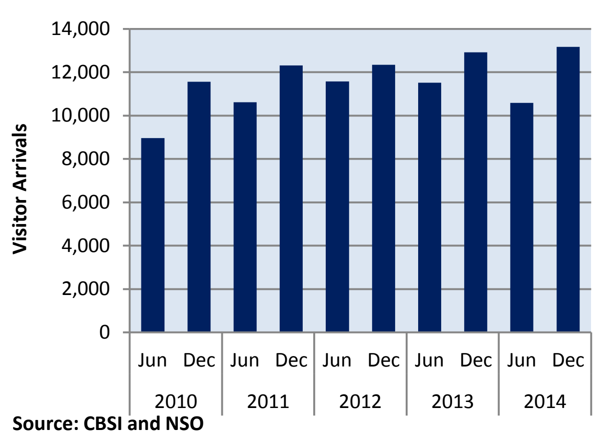
Tourism activities, measured by the number of visitors arriving in the country picked up strongly in the second half of 2014. Total arrivals by both air and sea showed a significant turnaround rising by 24% to 13,178 from a 17% fall in the first half (see Figure 13). Of the total, travellers by air account for the majority at 10,391 and sea travellers the remaining 2,787. The decline in the first half year followed from the negative media reports of the unprecedented floods that struck Honiara and Guadalcanal in April. Meanwhile, the uptick in the second half year, consistent with the recovery was noticeable in the third quarter, rising by 51% over the second quarter. By proportion, the third quarter accounts for 59% of the total travellers in the second half year. This more than outweighed the fall of 31% in the fourth quarter. The decline was a direct consequence of the prolong impasse between the Solomon Islands Government and the Fiji Government. Meanwhile, the average length of stay in the second six months was 16 days, a little longer than the 15 days in the prior six months.

In terms of visitor origins, Australian travellers' accounts for 48% of total visitors arriving in the

[7] 2015 CBSI Annual Industry Consultations

second half of 2014, a 12% increase to 4,821 compared to the first half of the year. The second highest number of travellers originates from the Asia region representing 8%, followed by travellers from New Zealand and Papua New Guinea with 6% each during the period.

Figure 12: Visitors Arrivals



Source: CBSI and NSO

Energy

Energy demand, consistent with the recovery, grew a little stronger in the second half of 2014. Total energy, as reflected in the electricity generated, increased by 1% to 42,247 Megawatt hours (MWh) against the 41,683 MWh in the preceding half year. Consequently, unit of electricity sold rose by 4% to 33,326 MWh. This was driven by increases in sales to commercial industries rising by 3% to 22,992 MWh and domestic consumers increasing by 15% to 7446 MWh during the period. Conversely, units sold to government and other categories dropped by 9% and 43%, respectively.

Retail and wholesale

Domestic consumption, as reflected by retail and wholesale activities, grew slowly in the second half year. Credit issued by commercial banks to the distribution sector rose by 4% to $250 million, considerably slower than the 13% rise in the first six months to June. Growth mainly came from loans issued specifically for retail and wholesale category which rose by 15% to $141 million. Another partial indicator, import on food and beverages goods recorded in the balance of payment also showed similar trend. Food imports increased 9% while beverages went up by 16% from July to December 2014. Conversely, foreign direct investment application to the retail and wholesale sector dropped by 30% to 16 applications in the second half year from 23 applications in the first six months. The mixed movements ended sectoral growth in the retail and wholesale sector with 2.3% in 2014, a little slower than the 3.7% growth in 2013.

Transport and communication

Activities in the transport and communication sector improved in the last six months to register a sectoral growth of 10.4% in 2014, with higher growth coming from communication. Partial indicators from loans issued by commercial banks to transport and communication sectors rose by 11% to $280 million in December from $253 million in the preceding six months to June. The rise came from increase in loans both to transport which rose by 20% to $91 million and communication up by 7% to $189 million. In the communication sector, the main mobile and internet usage indicators also showed similar trend with both rising by 29% each during the second half year. Similarly, FDI inflows to transport services recorded in the BOP showed an increase of 11%. Other partial indicators, including FDI applications to the transport and communication sectors, remained unchanged at 5 applications during the period.

Construction

Construction activities, as indicated by various timely indicators, showed improvement in the second half of 2014. Building permits, a partial indicator for construction activities, showed a significant reversal in the latter six months of 2014. The Honiara City Council issued 110 permits in July to December 2014 as opposed to 77 permits issued in year to June 2014. Growth was driven by increases in permits to all categories namely residential, industrial and other permits, with 65 permits coming from residential alone during the period. The spike in permits issued was noticeable in the third quarter. This mainly reflects the major construction projects in the pipeline that are expected to start in 2015. Partial indicators from FDI applications to construction sector also showed similar trend rising to 4 applications in the second half year from 3 applications in the prior first six months of 2014. Conversely, commercial bank loans to this sector dropped by 4% in July to December 2014. This brings a sectorial annual growth of 1.2% in 2014 as opposed to the much stronger growth of 11% in 2013.

3.4 Fiscal Conditions

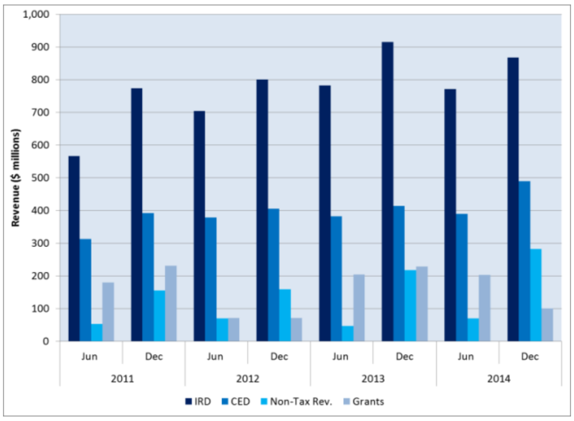
Preliminary figures show a surplus of $92 million, a considerable improvement from the initially expected half year deficit of $153 million. Despite being confronted with large unbudgeted spending pressures in the first half of the year as a result of the April floods, the redeployment of allocated funds for post-flood reconstruction and rehabilitation helped buoy the final outturn.

Revenue

Revenue collection from July to December 2014 totalled $1,739 million, a 21% increase against the first half of the year, and 6% above budget. This increase was driven primarily by an increase in tax revenue as the recovery in the economy post-flood was quicker than anticipated, and there was an increase in compliance efforts. However, compared to the same period in 2013, overall revenue collection was 2% lower.

Local revenue increased by 33% in the second half of 2014 to $1,638 million from $1,281 million in the first half. This was driven by a significant increase in non-tax revenue which shot up to $282 million over the six months to December, compared to the $84 million collected over the first six months of the year. This increase stemmed mostly from increased collections from overseas fishing licences which went up almost five-fold compared to the first half of the year to $159 million. This accounted for 56% of total collections from non-tax revenue. Similarly, collections from the Customs and Excise Duty (CED) and Inland Revenue Division (IRD) also went up between the first and second half of 2014 by 20% and 10% respectively to $489 million and $867 million (see Figure 14).

Figure 13: Major Sources of Fiscal Revenue



Timber and log duty collections accounted for 58% of total CED collections at $282 million, a 38% increase over collections in the first half. Other export and excise duty categories contributed 17% to total collections, while import duty contributed 25% at $121 million in the six months to December 2014. Both import and export duty collections were above budget in the second half of the year by 25% and 46% respectively.

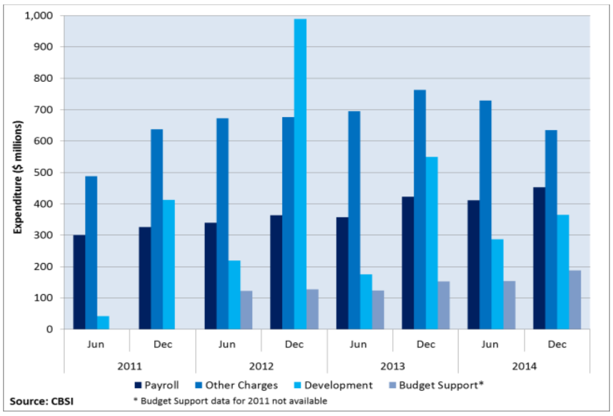
Revenue collections from IRD strengthened by 12% in the second half of the year against the budget. Leading the increase were dividend withholding tax, company notice tax and customs goods tax, each respectively adding $27 million, $21 million and $20 million to the total. While public sector Pay As You Earn (PAYE) tax increased by 8% to $54 million, private sector PAYE fell 1% to $132 million. Overall goods tax was up 5% to $338 million, while stamp duty almost doubled to $9 million. Revenue from sales tax fell short of the budget by 13%, but it also increased 13% from the first half of the year to $46 million.

Grants from development partners fell further still in the six months to December 2014 compared to the preceding half year to June. The 35% reduction to $100 million was mostly driven by a drop in funding from Australia Aid in the second half of the year. This was due to underspending of funds that had already been disbursed to SIG in the first half of the year such that subsequent tranches had to be withheld until these funds had been utilised. Furthermore, funding cuts were announced across the Australia Aid budget in general in 2014, but it is not yet clear what effect these will have on the Solomon Islands budget. As such, most of the funding received in the second half of the year came from New Zealand Aid and Papua New Guinea, the sum of whose contributions made up 78% of total grant funding in the six months to December.

Expenditure

Expenditure[8] over the second half of 2014 came to $1,647 million, 16% under budget. This reflected underspending in the purchase of goods and services and the purchase of non-financial assets which fell short by 14% and 41% respectively. Recurrent expenditure in the six months to December was $1,282 million which was 16% under budget but 1% lower than recurrent spending in the first half of the year.

Figure 14: Fiscal Expenditure



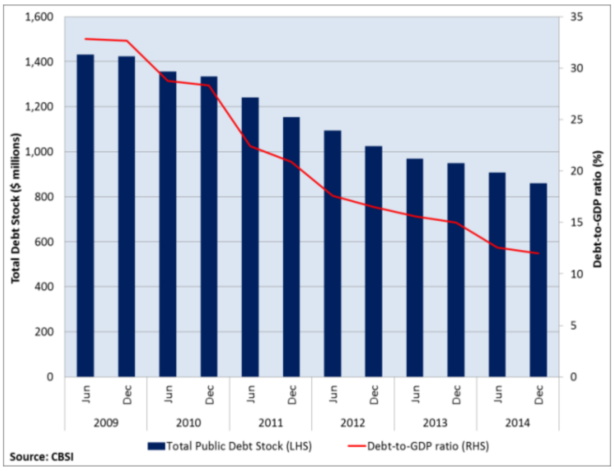
Payroll expenditure in the six months to December 2014 stood at $452 million, 10% higher than the first half of the year and 2% above budget (see Figure 15). Meanwhile, other charges were under budget in the second half of the year by 14%, while interest payments remained broadly unchanged at $7 million. Of these interest payments, $5 million went to external debt, while $2 million was on domestic debt. Budget support in the six months to December 2014 stood at $188 million while development spending went up 27% from the first half of the year to $365 million.

[8] This excludes principle repayments on external and domestic debt.

Public Debt Stock

Public debt stock in December 2014 fell by 5% against June to $859 million (see Figure 16). The decline stemmed from debt repayments the government made on both domestic and external debt obligations. Of the outstanding debt balance, external debt accounted for $685 million and domestic debt $174 million. During the review period, debt repayments totalled $47 million, up 3% from June. Of these repayments, $39 million went to principle repayments while the remaining $8 million was interest payments.

Figure 15: Public Debt Sustainability Indicator



Debt sustainability indicators for Solomon Islands remained within acceptably low thresholds. Debt to GDP ratio fell to 12% from 13% in June 2014. With the low debt to GDP ratio, future assistance from multilateral development partners such as Asian Development Bank and the World Bank will not be provided solely as 100% grant assistance but will comprise of a loan component as well. As such, there is a risk that the debt to GDP ratio could rise again if borrowing is not prudently managed.

3.5 Inflation

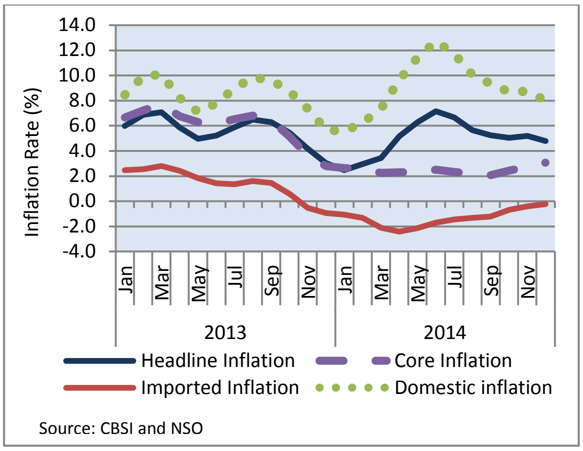
Inflationary pressures in the country remained contained in the second half year. Year-end headline inflation, as measured by the three months moving average (3MM), as at December 2014 reached 4.8% (see Figure 17). This is well below the temporary 7.2% inflation spike in June that resulted from the floods, and is also within the Bank's inflation forecast range of 4%-6% for 2014. Imported inflation for the same period also remained subdued at minus 0.2%, owing to lower trading partners' inflation and the appreciation of the SBD against the AUD and NZD. Nonetheless, the deceleration in headline inflation was largely triggered by the considerable fall in the domestic inflation component to 8.0% at the end of December 2014 from a peak of 12.7% in June. The fall in domestic inflation is consistent with improved supply conditions after flood related disruptions to fruit and vegetable crops earlier in April.

In terms of the drivers of the downward trend in the Honiara Retail Price Index (HRPI), the fall to 4.8% in December was owed mainly to the drastic decline in prices of drinks and tobacco declining from 35% in June to 8% in December. This was followed by a deceleration in prices of food from 5.8% to 4.2%, clothing and footwear from 4.5% to 3.5%, housing and utilities from 9.8% to 9.2% and transport and communication from 1.7% to minus 1% in December. By component, of the overall 4.8% inflation, food and housing and utilities accounted for 3.14% with food representing the largest proportion at 1.98% and the latter at 1.16%. Other headline inflation components including drinks and tobacco, clothing and footwear, household operations, transport and communications, recreational health and other services and miscellaneous items accounted for the remaining 1.66%.

The domestic inflation component, although it remained high, was the dominant driver of the decline of the overall headline inflation in December. Similar to headline inflation, much of the deceleration in the domestic inflation came from prices of drinks and tobacco falling from 34.8% to 8.4%, food from 16% to 8.4%, transport and communication from 2.4% to 0.1% and housing and utilities from 12.6% to 11%. Of the 8% in domestic inflation, food, housing and utilities and transport and communication accounted for 6.6%. Food prices accounted for 3.0%, the largest proportion, whilst housing and utilities and transport and communication represented 2.5% and 1.1%, respectively. The remaining 1.44% came from drinks and tobacco, clothing and footwear, recreational health, and other services and miscellaneous items.

Subdued growth in imported inflation, which has been in negative territory since November 2013, also contributed to the decline in headline inflation in December. Imported inflation, although it inched a little from minus 1.7% in June, remained negative at minus 0.2% in December. This outcome mainly arose from prices in transport and communication which fell to minus 2.8% in December from 0.5% in June. Food, and recreational health and other services which stayed on at minus 0.1% and minus 0.3%, respectively also contributed to the subdued growth. Of the minus 0.2%, food represented the largest proportion with minus 0.1% in the second half year. The rest of the imported inflation components including drinks and tobacco, clothing and footwear, housing and utilities, household operations, transport and communication, recreational, health and other services and miscellaneous items accounting for the remaining minus 0.1%. Meanwhile, the underlying or core inflation increased slightly to 2.7% in December from 2.5% in June 2014.

Figure 16: Inflation Measures



4.0 OUTLOOK

Global Economic Outlook

The global economy is expected to record further growth in 2015. Activities in advanced economies are likely to be boosted by falling oil prices as most of these economies are net oil importers. The stronger than anticipated recovery in the US economy led to an appreciation of the USD against all other major currencies including the AUD.

Solomon Islands major trading partners are expected to record positive growth in 2015, though at different magnitudes. China, which grew by 7.4% in 2014, projects economic growth to fall to levels below 7%, owing to weak sentiments in the property market. In Australia, economic growth is expected to be within a range of 2.25-3.25 percent in 2015 and to pick up further in subsequent years to reach 4.25% in June 2017. While consumption remains subdued and resource exports are anticipated to slowdown, the impetus from low oil prices and the weak Australian dollar are expected to outweigh the negative shocks and drive economic growth. New Zealand also anticipated much higher growth levels in the near to medium term. In 2015, New Zealand projects growth above 3%.

Consistent with falling commodity prices and the more subdued near term outlook from the product and labour markets, which outweighed upward pressure from a weakening AUD, headline inflation in Australia is projected to hover below the target inflation range of 2-3%. However, it is expected to rise to within the target range in subsequent years. In New Zealand, inflation would trough at zero percent in early 2015 before climbing gradually in the medium term to the target range of 2-3% by 2017.

Domestic Economic Outlook

The projections on key domestic macroeconomic indicators are based on some key assumptions. Oil prices, after falling further in the first quarter of 2015, could track upwards later in the year, but are expected to remain low year-on-year.

The domestic economy is estimated to consolidate the recovery in the second half of 2014 with a higher growth of 3.3% projected in 2015. All major sectors are anticipated to contribute to the overall growth, with the exception of mineral and forestry. Mineral will remain subdued as the Gold Ridge mine is unlikely to reopen in 2015, while the forestry sector is anticipated to subside after a strong second half in 2014. Also offering support to overall growth is the planned expansionary budget of the incoming Democratic Coalition for Change government.

Consistent with commodity price developments in the global economy, prices for key domestic exports are projected to decline in 2015 to point to a worsening terms of trade for Solomon Islands. To some extent, a weaker local currency against the USD would help cushion the fall in export prices. Exports are projected to decline in 2015 to 39% of GDP while imports are likely to rise to 49% of GDP, despite low oil prices. Imports are expected to be driven by anticipated strong demand from the private sector in unison with the expansionary fiscal policy.

Private sector credit is expected to track upward in 2015. Industry consultations indicated that there is still appetite for credit growth within the lending institution. The establishment of the Credit Bureau in Solomon Islands may also provide some stimuli to lending activities in the domestic market, especially to local Solomon Islanders. Credit could be even higher if the Government's plan to revive the Development Bank of Solomon Islands eventuates in 2015. Structural liquidity levels in the banking system are expected to remain high in 2015, though drop was noted in the fourth quarter of 2014.

The $4.1 billion budget of the Government is anticipated to provide stimuli to domestic activities across the different sectors. The budget will be financed from local revenue sources, funds from aid donors and budget savings that accumulated over the years. The planned fiscal deficit of $470 million represents 5% of GDP as opposed to a 1.6% surplus in 2014. Capital expenditure is budgeted to increase from 7% of GDP in 2014 to 13% in 2015.

The continued strengthening of the USD against other currencies in the global market is expected to have some bearing on the direction of the invoice weight index of the basket of currencies that ultimately determines the value of the local currency. The invoice weighted index, which has stabilised since the previous monetary policy statement, is expected to appreciate in 2015 given the external developments. This could result in the SBD appreciating further against AUD and NZD while remaining weak against USD.

Inflationary pressures have eased since the previous monetary policy statement, driven mainly by the local component which was largely influenced by improved supply conditions. This trend is expected to continue in 2015 on the back of falling oil prices, which would cushion upward pressures from the depreciating value of the SBD against USD. Other factors that would assist in containing import pressures are declining food prices and the expected strengthening of the invoice weighted index of the currency basket vis-à-vis AUD and NZD.

Headline inflation is projected to move within a lower inflation range of 3-5 percent compared to 4-6 percent in the prior years. Low oil prices are expected to dampen inflation through a first round effect in fuel prices in the transport index and second round effect through lower input cost for firms and farmers that are producing goods for household consumption. However, the speed and pass-through effects could not be determined the government policy and the current government

Core inflation, which excludes prices of volatile items such as fuel and market products and regulated goods such as Solomon Blue tuna, rice and other goods, showed a general increase since the previous statement. Data from the National Statistics Office points to food, utilities, and others as the underlying drivers. Core inflation is projected to peak at less than 3% in 2015 before subsiding in the medium term.

5.0 MONETARY POLICY STANCE

With the inflation rate anticipated to remain low in 2015, the Central Bank plans to undertake policy actions that would create a macroeconomic environment that enhances monetary policy implementation. Creating the right environment for effective macroeconomic management is an essential step that can yield greater and sustained long term macroeconomic benefits to the country.

The volume of idle liquidity that is available in the banking system has prevented monetary policy from being used as an effective tool to conduct macroeconomic management. In this regard, the Bank plans to use monetary and exchange rate policy instruments to gradually drain excess liquidity. This exercise is not expected to discourage lending activities by the commercial banks as there will still be sufficient funds within the system to finance credit to private sector.

Direct monetary policy instruments are the least preferred means to address the liquidity overhang. However, recognising that the Central Bank has limited options, CBSI plans to cautiously use both direct and indirect policy instruments to gradually drain excess liquidity. The cash reserve requirement ratio that currently stands at 7.5% of commercial banks deposit liabilities could be raised in the course of the next six months. While this policy may have different effects on the liquidity levels of individual banks, the banking industry is likely to benefit as this encourages and facilitates the interbank market to become active. Commercial banks that are short of liquidity will have to use the interbank window to address their short term liquidities. The interbank market is effectively non-existent for various reasons including the liquidity overhang.

Having aligned the value of the local currency to a basket of currencies, the Bank plans to introduce new products into the foreign exchange market to gradually siphon excess liquidity from the financial system. At the same time, this facility provides an opportunity to deepen the foreign exchange market in the domestic economy. Over the course of the year, the CBSI will introduce a foreign exchange SWAP facility to transact with the commercial banks.

The Central Bank will continue to conduct open market operations in the domestic securities market. The Bokolo Bills that CBSI issues to commercial banks each month will continue to roll over at $710 million. Complimenting this is the SIG backed Treasury Bills which the Central Bank administers on behalf of the Government. The Treasury Bills will remain capped at $40 million. Weighted interest rates for these facilities are expected to remain low due to budgetary considerations.

The Central Bank anticipates that these measures will drive down liquidity levels, diversify investment options in the domestic market, deepen the foreign exchange market, encourage the domestic interbank market to become active, and ultimately create an environment in which monetary policy can be effectively used as a tool for macroeconomic management.

In view of the foregoing macroeconomic assessments and to complement the Government's broad based economic development goals, the Central Bank will maintain its accommodative monetary policy stance with a particular bias towards addressing the excess liquidity in the banking system to create an enabling environment that improves monetary policy implementation, financial deepening and efficient allocation of financial resources in the medium term. At the same time, the Central Bank will remain vigilant and will take necessary adjustments as and when the need arises.