



Monetary Policy Statement

October 2011

CENTRAL BANK OF SOLOMON ISLANDS

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1. Overview

Projected growth for the Solomon Islands economy in 2011 has been revised up to 8.2% (from an initial projection of 7.2%). This follows better than expected export activity in the first half of 2011 due to sustained global demand and high global prices for Solomon Island exports. Inflationary pressures stemming from rising global food and fuel prices have subsided to a large degree.

The value of export commodities across the first half of 2011 greatly surpassed expectations. The exceptional outcome stems both from sustained global demand for Solomon Islands exports and sustained historically high global prices for Solomon Islands exports. Additionally, the commencement of gold production in the second quarter has contributed to the buoyant exports seen across the second and third quarters of the year.

Economic activity in other sectors remains buoyant, and an overall positive outlook for the economy across the second half of the year is ensued. Manufacturing activity in the first nine months of the year has been strong and positive signs of buoyant activity in the transport, tourism and construction sectors have been witnessed across the first half of the year.

This buoyant activity in the domestic economy continued despite subdued growth in private sector credit, with much activity being funded by foreign direct investment the growth of which is expected to remain positive across the last quarter of the year. Labour and government activity remain favourable but not at levels that indicate inflationary concern.

Broad money has continued to grow at strong rates across the second and third quarters of 2011. Reserve money and free liquidity continue to grow strongly too, although the pace of growth of these aggregates has been weakening across 2011.

Headline inflation has been steadily increasing since the beginning of the year due to the pass-through effects of the rising international food and fuel prices witnessed across the last months of 2010 and the early months of 2011. External inflationary pressures have now subsided as reflected in the peak of the international price component of headline inflation in June 2011.

Core inflation has started to pick-up but the pace of acceleration is subdued and core inflation remains significantly below headline inflation.

2. International Economic Conditions

Since the publication of the last monetary policy statement, the global economic outlook has deteriorated. Although there remains evidence of a “two-speed” recovery with emerging economies continuing to fare better than advanced economies, the outlook for many advanced economies has worsened amidst signs of a continued struggle to support growth. For many emerging economies the outlook has improved slightly with reduced inflationary pressures stemming from weakening global commodity prices.

The on-going European Debt Crisis continues to provide uncertainty for global financial markets. Initial hopes that the crisis would be confined to the worst affected European Countries following EU-IMF support no longer hold. Continued efforts to restrain the impact on global financial markets has been witnessed but significant uncertainty persists due to political tensions surrounding the bail-out mechanism for struggling EU member countries. Austerity measures undertaken by the worst affected member states have had little effect on calming financial markets due to continued scepticism that such efforts can truly rectify unsustainable debt situations. As such, uncertainty regarding the operation of the Euro currency in its present form persists.

The stalemate encountered whilst trying to lift the US government debt ceiling in August 2011 contributed additional uncertainty to already jittery global financial markets. Actions eventually taken by the government succeeded in calming the markets to a large extent, although the underlying issue of unsustainable government budgets remain largely unaddressed.

Growth in advanced economies for 2011 has been downgraded to 1.6% from 2.2% from previous estimates, according to the IMF’s latest (September) World Economic Outlook.

In emerging economies, fears of persistent over-heating have somewhat softened. In general, after reaching a peak earlier in the year, global commodity prices have declined, providing some

relief to emerging economies that are experiencing rising inflation. With continued uncertainty regarding the global economic outlook, many emerging economies have chosen lately to keep monetary policy unchanged.

Estimates for growth in emerging and developing economies in 2011, were revised from 6.6% by the IMF in June 2011, to 6.4% in September.

Closer to home, inflationary pressures in Australia has subsided to a small degree and despite continued strong activity in the mining sector, other sectors of the economy are showing signs of moderating activity. Monetary policy remained unchanged following the latest announcement by the Reserve Bank.

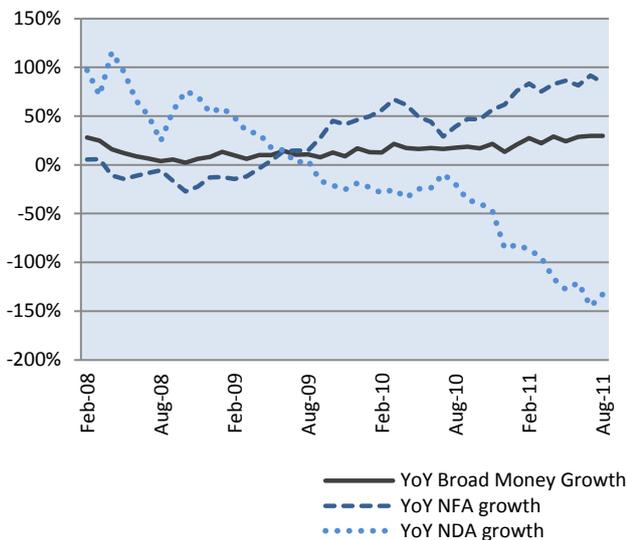
In China, signs that the economy is over-heating have subsided but considerable uncertainty regarding the impact an economic downturn in Europe and the US could have on China’s economy remains. Inflation has remained worryingly high across the year, rising by 6.5% in July, although earlier pressures from rising global food prices have somewhat softened. In response, the Peoples Bank of China has tightened monetary policy by raising the reserve requirements over the past months. The IMF has lately (September) revised their growth estimate for China to 9.5% for 2011, a negative 0.1 percentage point revision from their June estimate.

3. Domestic Economic Conditions

3.1 Monetary Conditions

Broad money reached \$2,523.3 million in August 2011, a 30% increase from the same month of 2010. Across the first eight months of 2011 broad money grew by an average of 26% (see Figure 2.1). The increase in broad money has been largely driven by external inflows such as export receipts, donor funds and FDI, as reflected in the continued strong growth in net foreign assets. This strong growth in NFA, however, has been counteracted to a large extent by the build-up of government deposits across the same period as indicated by the increased rate of decline in net domestic assets.

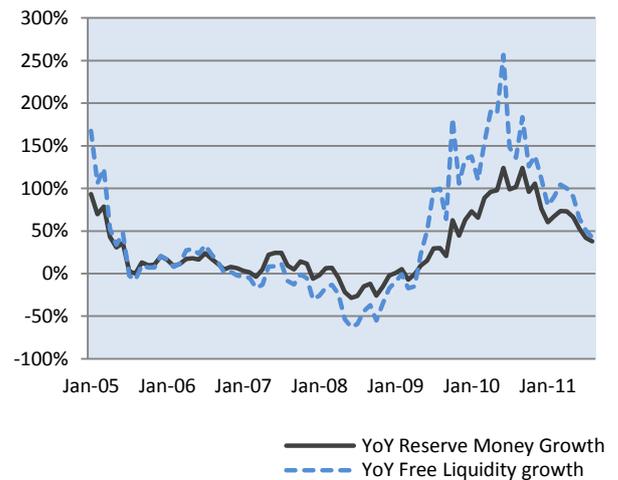
Figure 3.1.1: Broad Money and Determinants



Source: Central Bank of Solomon Islands

Reserve money (M0) reached \$1,466.8 million in August 2011, 38% up against the same month a year ago. The rate of growth of reserve money has been slowing since December 2010 due to the increasing rate of build-up of government deposits across the same period. Consequently, the rate of growth of free liquidity has also been slowing since December 2010. The average growth rate of reserve money across the first nine months of the year is 78%, in August the growth rate was 42% indicating the extent to which the growth rate has declined (see Figure 3.1.2).

Figure 3.1.2: Growth of Reserve Money and Free Liquidity



Source: Central Bank of Solomon Islands

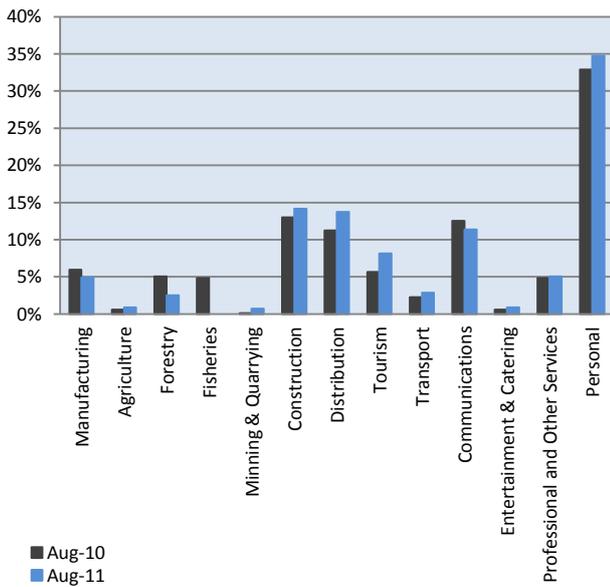
Despite the continued positive growth in free liquidity, private sector credit reached \$1,174.7 million in August 2011, down 3% from the level recorded in August 2010. The growth rate for private sector credit has been negative since the beginning of the year.

Total value of loan stock recorded in August 2011 is 7% below the total value of loan stock recorded in the same month a year ago. However, this reflects a large fall in the value of total loans for commercial and personal activities between the second and third quarters of 2010.

In the last eight months, the total value of commercial and personal loans has increased by 3%. The rise reflects increases in the total value of loans to the Agriculture (7%), construction (3%), distribution (9%), tourism (23%), communication (13%) and entertainment & catering (5%) sectors which act to marginally outweigh falls in other sectors.

Data on the sectoral distribution of loans indicates marginal increases in the total share of loan stock held by the mining and quarrying, construction, distribution, tourism, transport and personal sectors. On the other hand, there were declines in the proportion of total value of loan stock held by the forestry, fisheries, and communications sectors (see Figure 3.1.3).

Figure 3.1.3: Sectoral Distribution of Total Loan Stock

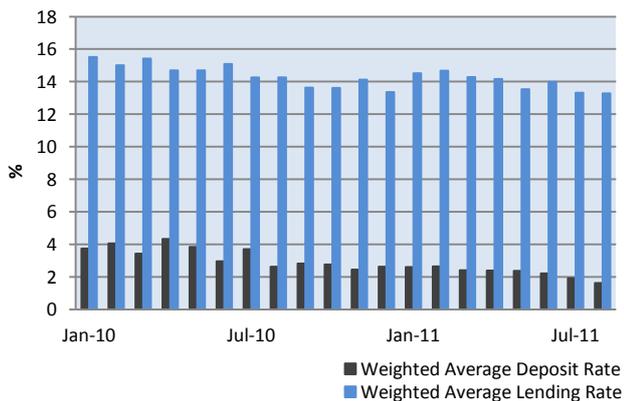


Source: Central Bank of Solomon Islands

The weighted average lending rate offered on commercial and personal loans stood at 13.3% in August 2011, down from the 14.5% average lending rate witnessed in January 2011. The weighted average deposit rate was 1.6% in August, a decline when compared against the 2.6% offered at the end of 2010 (see Figure 3.1.4)

Overall, across the first eight months of the year, the interest rate margin has narrowed marginally from 11.9% in January to 11.7% in August.

Figure 3.1.4: Average Deposit and Lending Rates



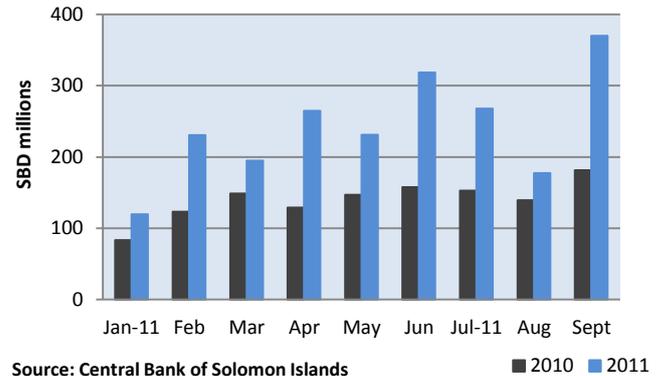
Source: Central Bank of Solomon Islands

In terms of real interest rates, real deposit rates have been negative since March 2011 due to the rising inflation witnessed since the beginning of the year. Real lending rates have been falling since November 2011 to reach 5% in August 2011.

3.2 External Conditions

Growth in total value of exports has been exceptionally strong across the first half of 2011 with the percentage change of total value of exports on a year earlier averaging 70% for the first nine months of the year (see Figure 3.2.1).

Figure 3.2.1: Value of Exports



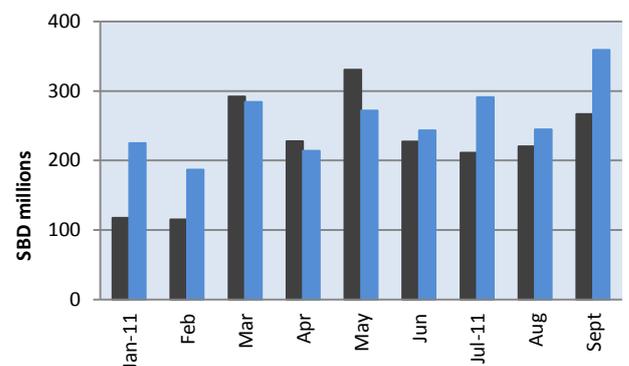
Source: Central Bank of Solomon Islands

■ 2010 ■ 2011

In September, the percentage change of total export value a year earlier jumped 104% on the back of buoyant log exports and the up-scale of gold exports which acted to counteract declines in agricultural exports. Due to mineral exports, the YoY growth in export value will remain strong across the last quarter of 2011 despite weakening international prices for agricultural exports.

YoY growth in the value of imports was positive in the first two months of the year as high global commodity prices impacted the cost of imports. High global prices are thought to have dampened domestic demand for imports reflected by negative growth in import value across the third quarter. Since June, however, we have seen a return to positive growth in import value with a significant jump in September (see Figure 3.2.2).

Figure 3.2.2: Value of Imports



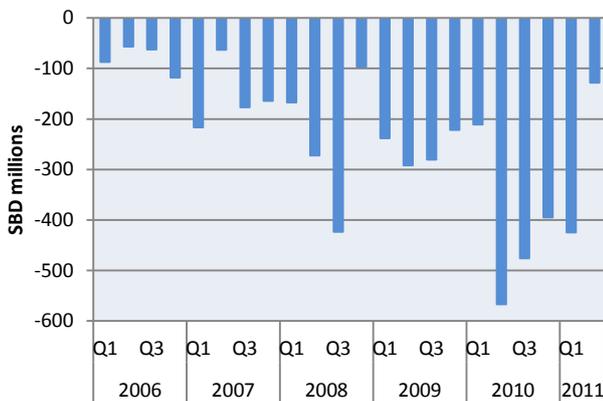
Source: Central Bank of Solomon Islands

■ 2010 ■ 2011

The strong increases in “crude material (excluding fuels)”, “chemical” and “machinery and transport equipment” imports reflects the commencement of operation at the country’s largest gold mine and continued strong foreign direct investment (FDI) in the forestry, mining and wholesale/retail sectors. The effect of the 5% appreciation may have also contributed to the moderate increase in the value of imports, especially “food and live animals” and “animals, vegetable oils and fats” imports.

Overall, the current account witnessed a significant improvement in the second quarter of 2011, primarily due to a surplus recorded in the trade in goods balance. Improvements in the primary and secondary income balances also contributed (see figure 3.2.3).

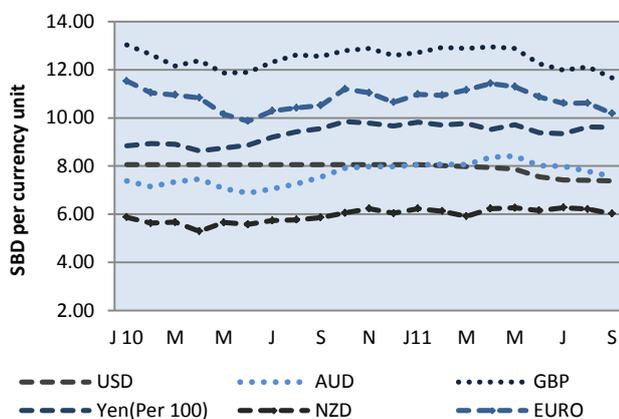
Figure 3.2.3: Current Account Balance



Source: Central Bank of Solomon Islands

Across the first nine months of the year, the SBD has appreciated against the currencies of all major trading partners.

Figure 3.2.4: Exchange Rates

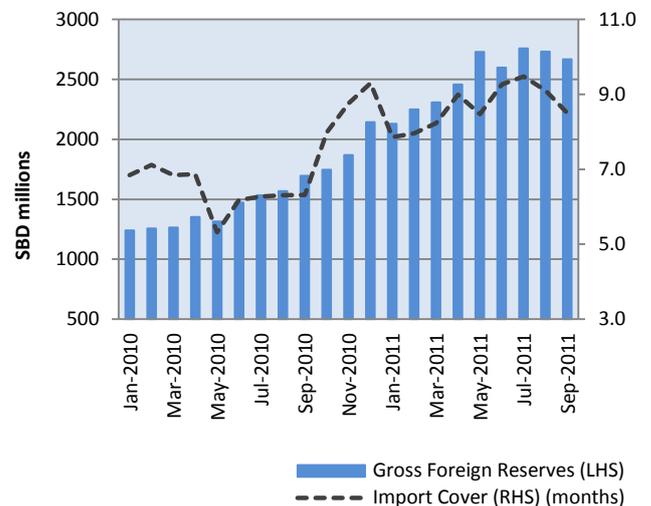


Source: Central Bank of Solomon Islands

In line with the managed appreciation of the Solomon Islands dollar (SBD), the domestic currency has appreciated by 8% against the US dollar since the beginning of 2011. Accordingly, across the same period, the SBD has also appreciated by 6% against the AUD, 8% against the GBP, 2% against the Yen, 7% against the Euro and 3% against the NZD (see Figure 3.2.4).

Gross foreign reserves slid by 2.6% in September to \$2,667 million on the back of foreign exchange losses and rises in foreign exchange payments (see Figure 3.2.5). This level of foreign reserves represents a comfortable 8.5 months of import cover. As such the level of reserves is not of concern for the Central Bank.

Figure 3.2.5: Foreign Reserves and Import Cover



Source: Central Bank of Solomon Islands

Production of all commodities for export has been strong across the first three quarters of 2011 driven by historically high world prices and favourable production conditions.

Log production recorded 1.438 million m³ for the first nine months of the year, up 42% against the same months of 2010 and surpassing the total volume of production recorded for 2010.

Total copra production recorded for the first eight months of 2011 totalled 24,796 tonnes, a 79% increase on the production recorded across the same period of 2010.

Fish production recorded from January to September 2011 totalled 20,240 tonnes, a 42% increase on total production recorded across the same period of 2010.

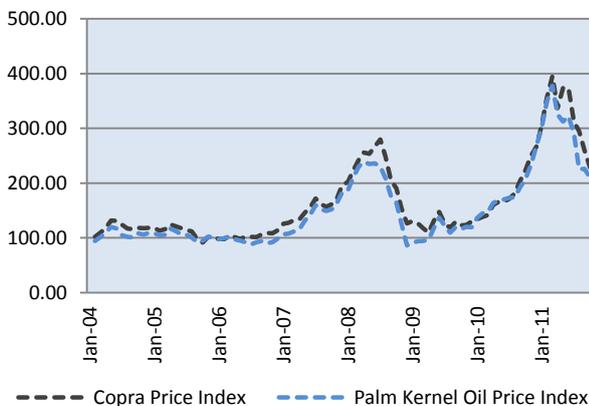
The volume of cocoa exports recorded in the first eight months of the year totalled 4,468 tonnes, a 21% increase on the volume of exports recorded across the same months of last year.

Total palm oil production from January to August is recorded at 23,596 tonnes, a 5.4% increase on the production volume recorded over the same period of 2010.

Gold exports commenced in April 2011, following the re-commencement of operations at the country's largest mine. Total gold exports to September stood at 26,688 ounces.

World price of copra and palm kernel oil saw substantial increases towards the end of 2010 reaching a peak of US\$1,503 and US\$2,296 in February 2011 respectively (see Figure 3.2.5). Since February, overall, the world price of copra and palm kernel oil have declined but prices are expected to remain at historically high levels in the short-term as tightness in global supply of these commodities is expected to continue and even intensify.

Figure 3.2.5: Copra and Palm Oil Price Indices



Source: Central Bank of Solomon Islands

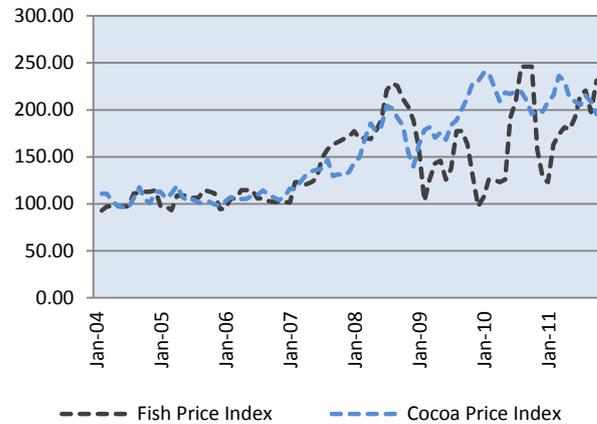
World price of cocoa and fish on the other hand, did not follow the same pattern of steady increases as copra and palm oil prices at the end of 2010 (see Figure 3.2.6).

World price of fish has been volatile since mid-2008, but overall follows an increasing trend. World fish prices are expected to continue on an upwards trend due to anticipated steady growth in demand with some degree of volatility in prices.

World price of cocoa has had an overall flat trend since mid-2009 and has suffered from a fair degree

of price uncertainty due to various supply disruptions. The international price for cocoa is expected to decline marginally across the second half of 2011.

Figure 3.2.6: World Fish and Cocoa Price Indices



Source: Central Bank of Solomon Islands

World price of logs and gold, in contrast, have yet to peak (see Figure 3.2.7).

World price of gold reached US\$1,771 per ounce in September 2011 driven by continued growth in demand for this "safe asset" amidst global economic uncertainties. The world price of gold is expected to continue rising driven by increasing demand due to continued uncertainty in the short-term global economic outlook.

The world price of logs has been steadily increasing due to strong demand and constrained supply due to adverse weather conditions, both are expected to ease by the end of the year. In line with this expectation, the world price of logs is expected to peak before the end of the year although remain at historically high levels in the short to medium term.

Figure 3.2.7: World Log and Gold Price Indices



Source: Central Bank of Solomon Islands

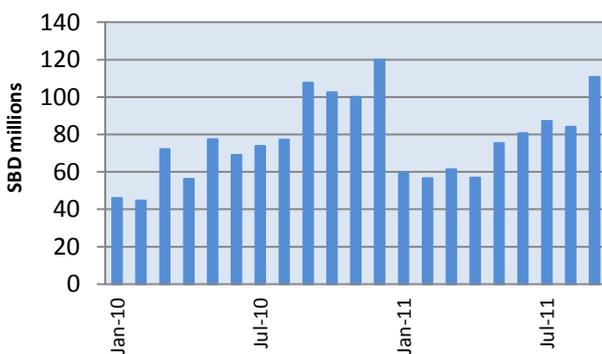
3.3 Domestic Demand

Across the first seven months of 2011, 119 building permits were granted, 20% below the 148 permits extended across the same months of 2010.

This overall decline in building permits granted was witnessed in all building categories. There were 62 building permits granted for construction of residential buildings in the first seven months of 2011 compared to 64 granted in the same period of 2010. Permits granted for the construction of commercial buildings was down from 55 last year to 38 in the first seven months of this year. Permits granted for "other" construction totalled 19 in the first seven months of the year, compared to the 29 granted over the same months of 2010.

The YoY growth rate of the value of imports for private consumption¹ was strong across the first quarter of the year due to rising global food prices at the beginning of the year. Across the second quarter the growth rate of imports for private consumption dipped as high world prices may have constrained demand. In recent months the growth rate of imports for private consumption has returned to positive values on the back of a pick-up in demand as a result of a strengthening local currency at end-June 2011 although the growth is subdued when compared to growth in the value of total exports (see Figure 3.3.1).

Figure 3.3.1: Imports for Private Consumption



Source: Central Bank of Solomon Islands

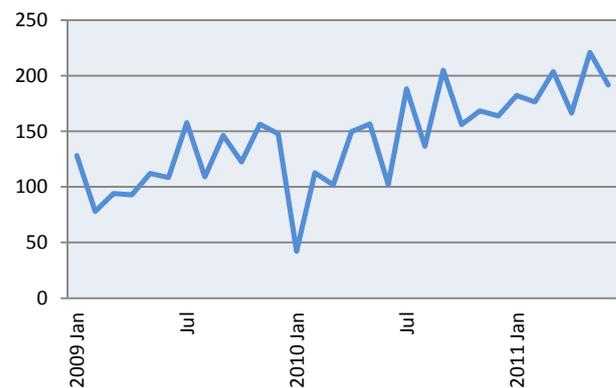
3.4 Business Conditions

According to the CBSI Business Expectations Survey overall business conditions across the first half of 2011 compared to 2010 were "neutral", with

positive outcomes seen in the agricultural, fisheries, construction and transport and telecommunications sectors.

CBSI's manufacturing index² shows a continuation of the upwards trend in production across the first six months of the year (see figure 3.3.2). Additionally, results from the CBSI Business Expectations Survey for the manufacturing sector indicated favourable conditions for the second half of 2011 so the expectation is for this upward trend

Figure 3.3.2: Monthly Manufacturing Index



Source: Central Bank of Solomon Islands

to continue in the next few months.

FDI registrations in 2011 have been strong. The total value of FDI registrations in the third quarter of 2011 records a value of \$706 million, a 33% increase on the value of registrations recorded in the corresponding period of 2010. In terms of numbers, 41 FDI registrations were recorded for the third quarter of the year, compared with 33 recorded for the third quarter of 2010. Across the whole year, sectors recording the greatest value of FDI registrations have been by far the forestry and mining sectors. Other sectors with significant registered FDI quantities are the transport, "wholesale and retail" and construction sectors.

Further encouraging evidence of healthy domestic activity in the tourism and "wholesale and retail" sectors comes from the 23% and 9% increases in the value of total loans held by each sector respectively across the first eight months of the year. Additionally, strong activity in the tourism sector is further supported by the data on visitor arrivals. The first two quarters of 2011 record a total of 10,624 visitors, a 19% increase on the first two quarters of 2010.

¹ Food and drink imports

² The CBSI Manufacturing Index captures manufacturing activity in the food manufacturing sector

3.5 Fiscal Conditions

Government revenue across the first seven months of the year totalled \$1,469.0 million, 61% higher than the corresponding period of 2010 and exceeding budget estimates by 23.7%. The favourable position stems notably from buoyant log duty collection and goods tax collection.

Government expenditure across the first seven months of the year totalled \$1,102.5 million, a 10% increase against the corresponding period of 2010 and 8% below budget estimates. This restrained spending came in spite of 1.9% above budget payroll spending and was mostly due the 66% below budget spending on development projects.

Consequently an overall surplus of \$93.2 million is recorded across the first seven months of the year which has contributed to the steady build-up of government deposits since the start of the year.

3.6 Labour Market

Employment growth as estimated by NPF membership contributions and PAYE contributions remains positive.

NPF member contribution figures, used as a proxy for employment data, recorded active contributors at 43,367 in June 2011, a 10% increase on the number recorded in June 2010.

The value of total PAYE collected in July 2011 is recorded at \$18.8 million, a 25.6% increase on the value of PAYE collected in the corresponding month of 2010. The average growth rate of total value of PAYE collected across the first seven months of 2011 is 34%.

Forward looking indicators in the form of the CBSI Vacancy Survey indicates a pick-up in vacancies, however, private sector vacancies remain below public sector vacancies and many advertised positions are thought to represent replacement of existing vacant positions rather than additional positions. The August 2011 CBSI Business Expectations Survey indicates an overall "adequate" staffing levels for the next six months, suggesting that private sector hires will remain subdued across the second half of 2011.

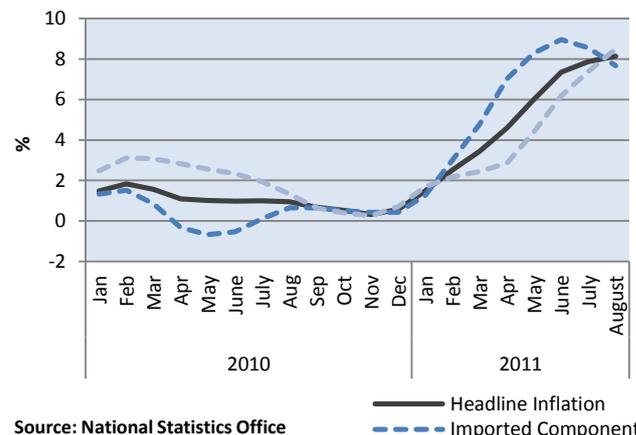
3.7 Costs and Prices

Headline inflation as measured by the three-month-moving average has been steadily rising since the beginning of the year, reaching 8.2% in August 2011.

The imported component of headline inflation increased across the first six months of the year, reaching a peak of 9.0% in June 2011. Since then, the imported component of inflation has eased reaching 7.7% in August.

The domestic component of inflation, in contrast, has been subdued across the first five months of the year. Since June, however, the domestic component of headline inflation has picked-up indicating demand pressures in the domestic economy (see Figure 3.7.1).

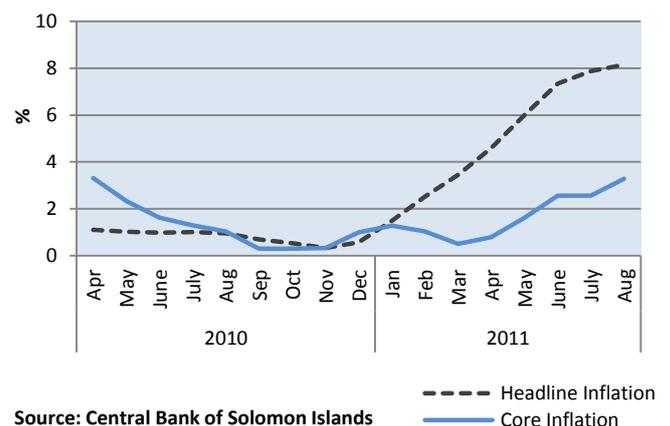
Figure 3.7.1: Headline Inflation



Source: National Statistics Office

In August, core inflation reached 3.3%, up from 2.6% in July suggesting that core inflation is picking-up although is still subdued and significantly below headline inflation (see Figure 3.7.2).

Figure 3.7.2: Core Inflation



Source: Central Bank of Solomon Islands

Imported price pressures have eased since June 2011 due to falling global commodity prices. Global fuel prices peaked in April 2011 at US\$129 a barrel and have since fallen to US\$120 a barrel in September (see Figure 3.7.3).

Figure 3.7.3: Tapis Oil (Singapore)



Source: US Energy Information Administration

Imported food price pressures have also eased with international food prices reaching a peak in February after rapid rises across the second half of 2010 (see Figure 3.7.3).

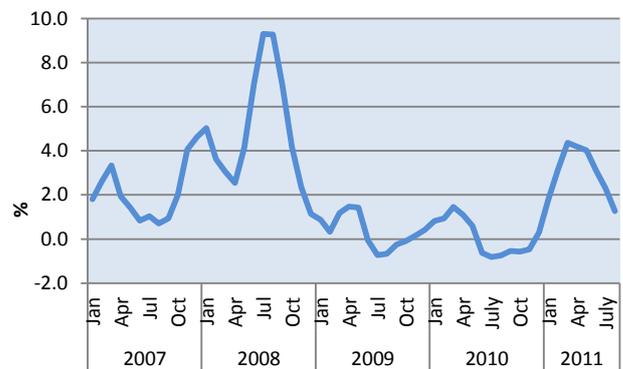
Figure 3.7.3: CBSI Imported Food Price Index



Source: Central Bank of Solomon Islands

Although headline inflation is still rising, it is a measure of long-run inflation and indicates what has happened to inflation compared to last year. Therefore, it is also important to consider shorter-run measures of inflation. By considering inflation today against inflation last month (the month-on-month measure) can show a volatile inflation story. It is best to consider average inflation across the last three months against the average inflation of the previous three months (the quarter-on-quarter measure of inflation). This QoQ measure indicates that the rate of inflation has been easing since March 2011 (see Figure 3.7.4).

Figure 3.7.4: Quarter on Quarter Change in Inflation



Source: National Statistics Office

4. Outlook

Broad money is expected to continue to grow although the pace of growth is expected to weaken. Reserve money and free liquidity are expected to continue to grow although at continued declining rates as already witnessed across the first half of the year.

Private sector credit in contrast is expected to remain subdued although may register low positive growth rates by the end of the year.

Exports are expected to remain strong across the final quarter of 2011 as a consequence of the scaling up of gold exports which will counteract the declining value of other exports as world commodity prices weaken. Domestic demand for imports is expected to increase resulting in higher values of imported goods. Strong demand for machinery and transport equipment is expected on the back of strong FDI registrations for the forestry and mining sectors whilst imports for private consumption are expected to increase at a lesser rate. Pressure on external reserves will increase across the final quarter of 2011 as a consequence of expected higher foreign exchange payments as well as further foreign exchange losses although will be counteracted to a large extent by the inflow of anticipated donor funds such that the level of reserves is not expected to be a concern.

Domestic activity in the manufacturing sector is expected to remain buoyant on the back of a positive outlook for the sector recorded in the CBSI Business Expectations Survey. The wholesale and retail, construction, transport and tourism sectors are also expected to perform well across the final quarter of the year on the back of increased FDI registrations and increased total value of loans for these sectors.

Fiscal conditions are expected to remain subdued with restrained spending and buoyant revenues expected to continue across the second half of the year reflecting continued strong log revenues and revenue from goods tax.

Employment opportunities are expected to increase marginally across the last few months of the year and into the first quarter of 2012.

Headline inflation is expected to continue to increase across the second half of 2011 although the rate of increase is expected to slow down. Due to the easing of external price pressures the imported component of inflation is expected to ease further although increasing domestic price pressures are expected across the last few months of the year as demand stays steady. Headline inflation is expected to average 6.6% across 2011 (a slight upward revision when compared against the 6% estimate in the March 2011 Monetary Policy Statement).

Core inflation is also expected to increase across the second half of the year although at a slower pace than headline inflation.

5. Monetary Policy Stance

In light of the latest analysis regarding inflationary pressures, the Central Bank of Solomon Islands will maintain a moderately contractionary monetary policy stance for the next six months.

Inflation will be closely monitored and further actions will be taken accordingly. In this regard, core Inflation shall be monitored closely in order to identify signs of accelerating inflation. Additionally, private sector credit remains under close observation for any signs that demand for credit may be increasing.

The Central Bank of Solomon Islands will act to counteract any adversary movements in inflation and/or foreign reserves.
