Monetary Policy Statement

October 2012

CENTRAL BANK OF SOLOMON ISLANDS

PO Box 634, Honiara, Solomon Islands   Tel: (677) 21791   Fax: (677) 23513   www.cbsi.com.sb

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1. Overview

The global economy is set to grow by 3.5% in 2012, albeit a slight downward revision from previous IMF estimates. Growth continues to be driven primarily by the emerging economies with some growth from the US. However, persistent weak economic performance in the Euro area is dampening the positive growth from other regions.

In the domestic economy, changes in money aggregates throughout the first half of 2012 remain heavily influenced by increases in reserve money. This has been driven by further build-up of net foreign assets (NFA) of the Central Bank of Solomon Islands (CBSI) whilst net domestic assets deteriorated over the same period. Liquidity increased by around 25% over the first half of 2012, again, primarily powered by increases in reserve money. Private sector credit from commercial banks and credit unions has decreased slightly by 1% over the same period. Growth in credit from overdrafts, lease financing and loans has been negated by falls in the value of trade bills and loans from credit unions.

The balance of payments turned positive in the first half of 2012 despite a negative trade balance in the second quarter. The positive outcome was attributed to donor inflows over the period and large trade surplus in the first quarter. The level of foreign reserves at the end of June 2012 was equivalent to 10 months of import cover, a slight reduction from the February 2012 cover. The CBSI still considers this to be an adequate level of reserves and remains in accordance with IMF recommendations.

Domestic business conditions improved in several of the major sectors including manufacturing, retail and wholesale, telecommunications and tourism. Some of this growth can be attributed to the Festival of Pacific Arts [FOPA], which took place in July 2012 as well as continued foreign direct investment, donor spending, and government spending. Conversely, electricity production and electricity consumption both fell across the same period, whilst the construction industry (measured by employment in construction) experienced a substantial decline. However, overall employment grew by 8% across the first half of 2012 compared to the second half of 2011.

Fiscal conditions for the first half of the year showed a recurrent surplus of $153 million. Recurrent expenditure (inclusive of donor budgetary support) increased by 16% in the first six months of 2012 compared to the previous six months. Government spending on goods and services and budgetary support were the primary causes for this increase, accounting for 71% and 27% of the increase in value, respectively. SIG development expenditure in the first half of 2012 amounted to $214 million. This excludes projects that were financed by donor partners.

Government debt levels are now at ‘green light’ status as outlined in the Honiara Club Agreement, which enabled Government to, once again, borrow externally.

Economic activity in the domestic economy, as measured by real GDP, is expected to expand by 4.4% in 2012, fuelled by strong performances in forestry, mineral, manufacturing, finance, transport, communication and fisheries sectors. This is coupled with high government spending and donor support. Expectations are for growth in 2013 to slow down to 3.7%.

With the exception of April where inflation took a slight rebound, headline inflation (as measured by a 3 months moving average) has been gradually falling since the recent peak in November 2011. Domestic component continues to be the main driver of inflation since April this year with food prices and housing and utilities categories featuring prominently. The latest figures for August 2012 showed headline inflation at 5.3% and is expected to be in the range of 5%-7% for this year. Inflation forecasts for 2013 are estimated to average around 6%. Lower economic growth forecasts for 2013 will help to dampen domestic inflationary pressures.

2. International Economic Developments

International economic conditions remain weak, despite optimism of strengthening global activity at the beginning of the year. Following weakening financial conditions and deteriorating growth prospects across the second half of 2011, global conditions were thought to be recovering with the emergence of positive economic indicators for the emerging economies and to a lesser extent, the US, at the beginning of the year. However, indicators have not maintained consistency indicating that the recovery is still fragile.

IMF figures for global growth in 2012 were revised down marginally in July 2012 to 3.5%. Continued downside risks stem from the unresolved Euro debt crisis, although better policies have mitigated some risks, and from continued fiscal consolidation that continue to impact developing economies and this will represent a risk to external demand for emerging economies.

The US, was seen as leading the recovery at the beginning of the year with a delay to implement fiscal austerity measures but economic activity has proven fragile across the beginning of the year. Latest indicators, however, support the view that the US is on a moderate growth path and should achieve growth of 2.0% this year.

The Euro area saw a deterioration of activity across the first half of the year with measure of fiscal consolidation and low levels of confidence related to the unresolved Euro debt crisis. The Euro area is expected to record a negative 0.3% growth this year. This negative growth, however, reflects a divergence in the strengths of Euro area countries with Italy and Spain expected to record growth rates of -1.9% and -1.5% respectively whilst Germany and France are expected to achieve growth rates of 1.0% and 0.3% respectively. Continued fiscal consolidation in many of the Euro area countries as well as banking sector problems in Spain have been behind the negative growth in the Euro area.

Emerging economies are expected to grow by 5.6% in 2012, supported by expansionary monetary policies which will support domestic demand in the second half of the year. The second quarter of 2012, saw emerging economies benefiting from the increased financial market confidence that followed actions taken by the European Central Bank to extend its longer-term refinancing operations.

China saw a growth of 7.6% over the second quarter of 2012, a further slowdown in economic activity, the sixth consecutive quarter of weakening growth. IMF estimates from July anticipated a 7.8% growth for China across 2012.

Global commodity food prices, as measured by the CBSI Imported Food Price Index[1], have risen across the first half of the year from the floor reached in January 2012 and have remained around the levels seen in 2011 since May 2012 (see Figure 2.1.1).

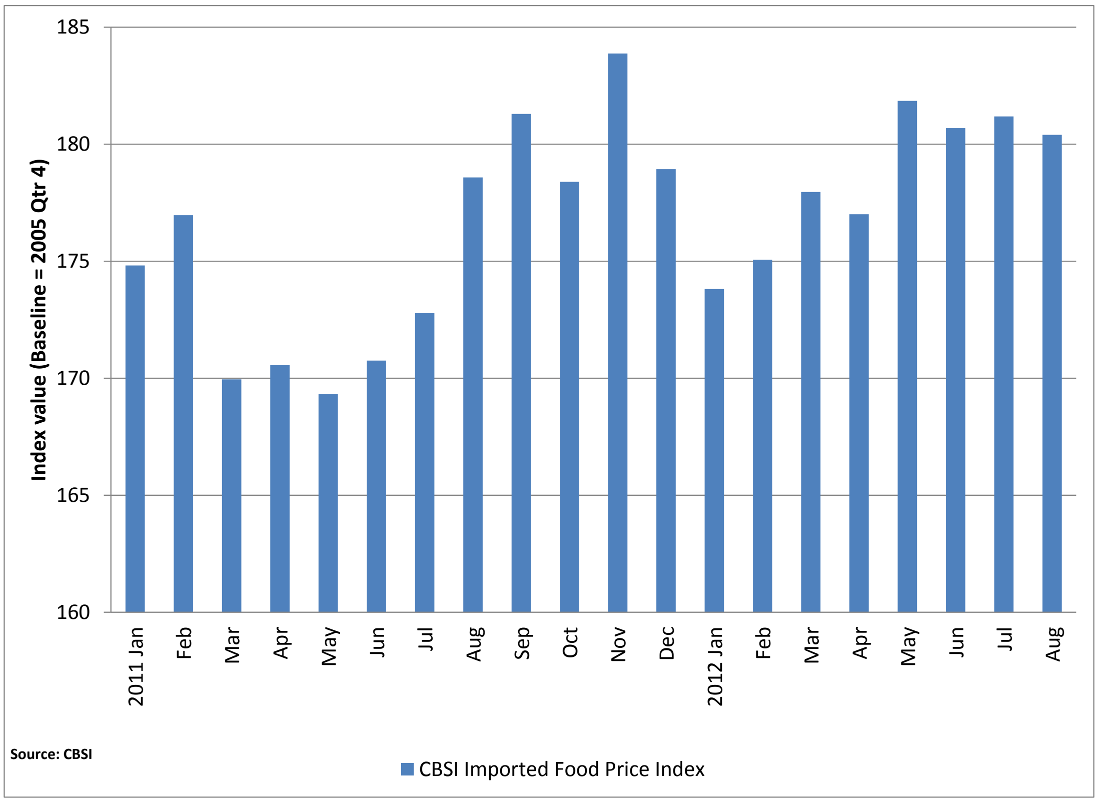

Figure 2.1.1: CBSI Imported Food Price Index

[1] The CBSI Imported Food Price Index is a composite index measuring the international price changes of the following food types: Rice (Thai 5%), Wheat (US HRW), Sugar (World), Palm Oil (Malaysia), Poultry (Japan), Beef (Oceania), Coffee (Robusta, New York), Milk Powder (Oceania). The baseline is Q4 2005.

2012 and 2013 Inflation outlook

According to the IMF, global consumer prices are expected to ease in 2012 on the back of weak commodity prices and subdued global demand. Headline inflation is expected to drop to 3-3.5% in 2012-2013 from 4.5% at the end of 2011. The drop in overall inflation mirrored movements in the inflation of advanced economies as well as emerging and developing economies that slipped from 2.7% and 7.2% to 2.0% and 6.3% respectively. Energy prices fell slightly during the year as indicated by the energy index which dropped by 0.3%. Non-energy commodity prices also dropped by 9.3%.

Inflation in Solomon Islands main trading partners has eased since the beginning of the year. In emerging economies, this has allowed central banks to take steps to ease monetary policy in order to support growth. Australia in particular recorded an annual inflation of around 2% in September. This remains within Reserve Bank of Australia (RBA)'s long term target band of 2% -3%.

Global inflation is projected to fall further in 2013. Average inflation for advanced economies is expected to ease further to 1.6% while that for emerging and developing economies are expected to fall to 5.6%. Both energy and non-energy prices are forecasted to drop across 2013. The abatement of oil price risks in recent months reflected changes in market conditions and geopolitical risks. The improvement in oil production particularly from Saudi Arabia coupled with weakening demand formed the basis for expected low oil prices in 2013.

Inflation in major trading partners is expected to fall further in 2013. In Australia, the RBA expects inflation in the near term to be within their target range of 2%-3%. Inflation in New Zealand for next year is expected to be maintained within the 1%-3% range while that for China is expected at 4.2%.

3. Domestic Economic Developments

3.1 Monetary Conditions

Developments in monetary aggregates continued to improve across the first half of the year driven by significant improvement in NFA of the Central Bank. Private sector credit after picking up in the second half of 2011 declined marginally at the end of the first half of 2012. This reflects a relatively large decline in the extension of very short-term credit by the commercial banks. Loans from credit unions also fell but negligibly.

Reserve money continued to increase across the first six months of the year due to continued build-up on NFA and despite continued increase in the negative position of net domestic assets (NDA). NFA increased 17% across the first six months of the year, following on from the 16% increase across the second half of 2011. NDA of the Central Bank deteriorated to a minus $1,278 million from minus $1,093 million at the end of 2011, reflecting the build-up of Government deposits at the Central Bank (see Figure 3.1.1).

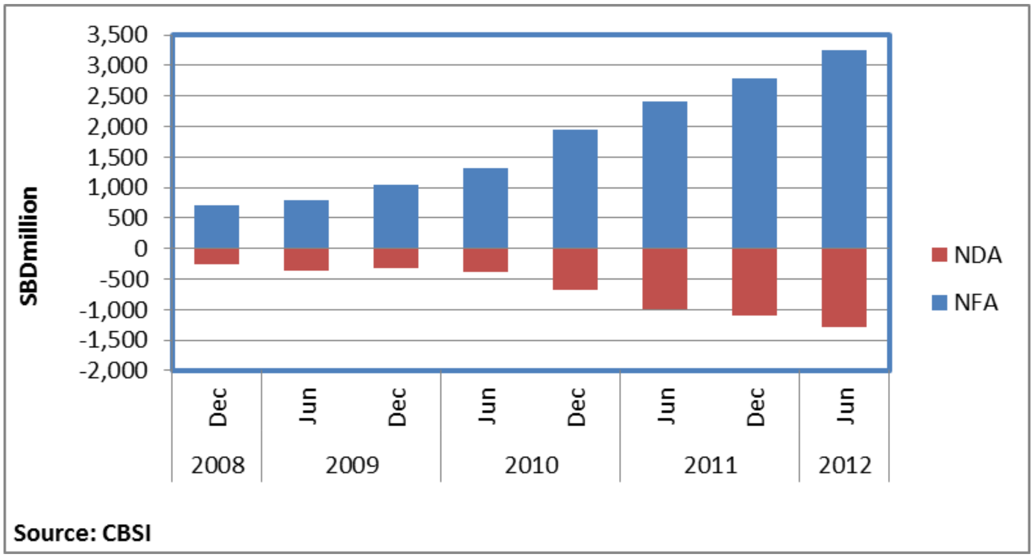

Figure 3.1.1- Drivers of M0

Free liquidity increased further by 26% to $1,212 million by the end of June as a result of the increase in reserve money. The stock of Bokolo bills remained unchanged since the end of 2011 at $240 million with the weighted average yield (WAY) offered remaining at 0.95% since March (see Figure 3.1.2).

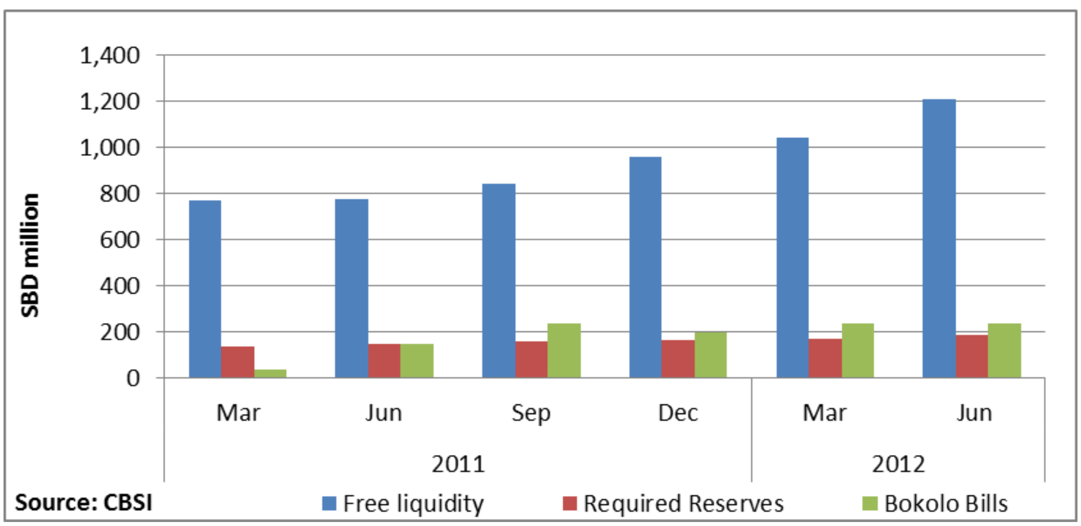

Figure 3.1.2: Free Liquidity and Liquidity Absorbing Instruments

Following the trend in reserve money, the total money supply increased by 11% to $2,889 million in the first half of 2012. This reflected a 5% increase in currency in circulation and a

24% increase in demand deposits coupled with a 10% decline in time and saving deposits (see Figure 3.1.3).

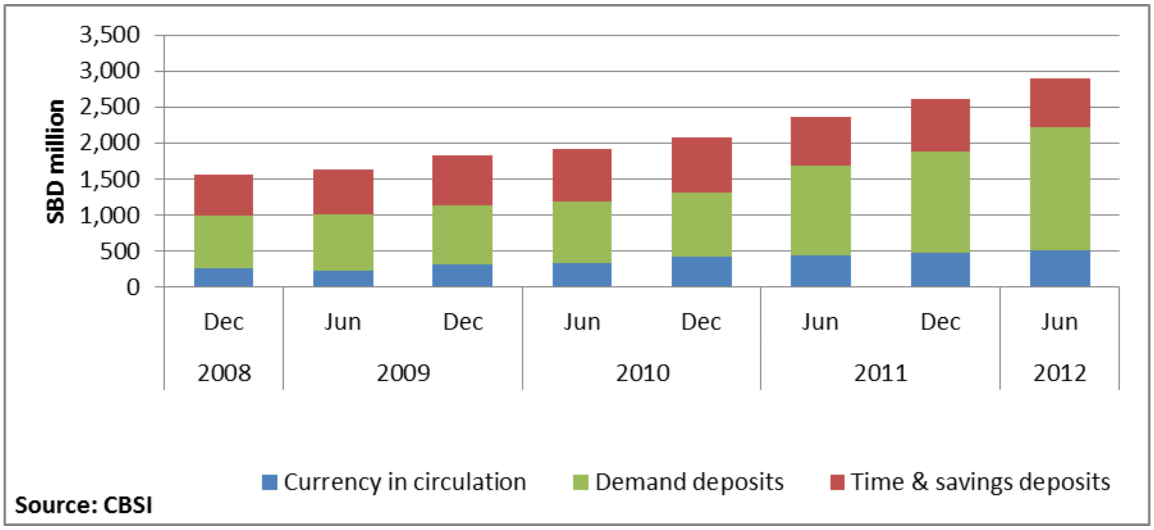

Figure 3.1.3: Components of M3

From December 2011 to June 2012, private sector credit from other depository corporations[2] (ODCs) recorded a slight decrease of 1%. Over this period, private sector credit fluctuated although recent months have shown small falls followed by a small pick-up in June, (see Figure 3.1.4).

Detailed analysis of the breakdown of loan types of the factors driving the change in lending is twofold. Some forms of credit demonstrated growth. Loans from commercial banks, which account for around 75% of all credit from commercial banks, increased marginally, growing at around 1%. Overdrafts, which account for over 10% of all credit, grew by 11% whilst growth in lease financing exceeded 25%. Lease financing accounted for around 6% of all private sector credit.

This growth was cancelled out by the sharp decline in the value of trade bills and, to a lesser extent, loans from credit unions during the period. As of June 2012, the value of trade bills and loans from credit unions fell by nearly 70% and 8% respectively, compared to December 2011. This was driven by a relatively large influx of trade bill credit in December. However, trade bills and loans from credit unions account for only 2% and 3% respectively of all private sector credit from commercial banks, reflected the marginal fall in overall private sector credit. Excluding trade bills, a form of very short term loans, private sector credit grew increased by 3.9%

[2] Comprises of the three commercial banks, Credit Corporation of Solomon Islands and credit unions.

The major sectors recording the largest value growth in their loans over this period included personal, agriculture, distribution, construction and transport.

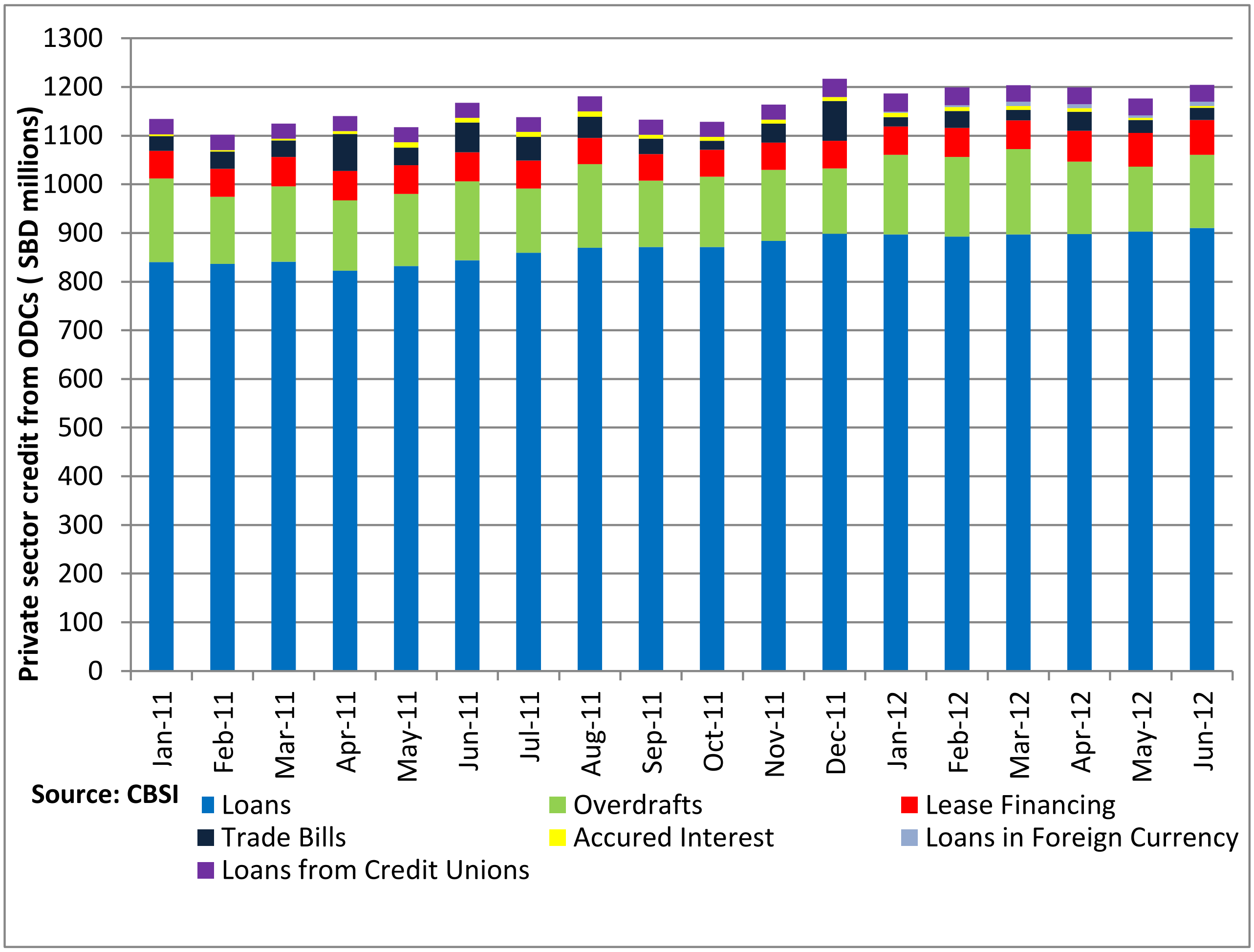

Figure 3.1.4: Private Sector Credit Growth

The weighted average lending rate on commercial and personal loans fell to 10.2% at the end of the first quarter due to temporary promotional offers but has picked up again to 11.4% in the second quarter, the same rate as at end 2011. The rise was due to a slight increase in lending rates in the distribution, central government and personal loans categories. Meanwhile, the weighted average deposit rate continued to decline to 1.1% by end June from 1.4% at end 2011. The fall mainly reflected a significant decline in deposit rates on demand and time deposits (see Figure 3.1.5).

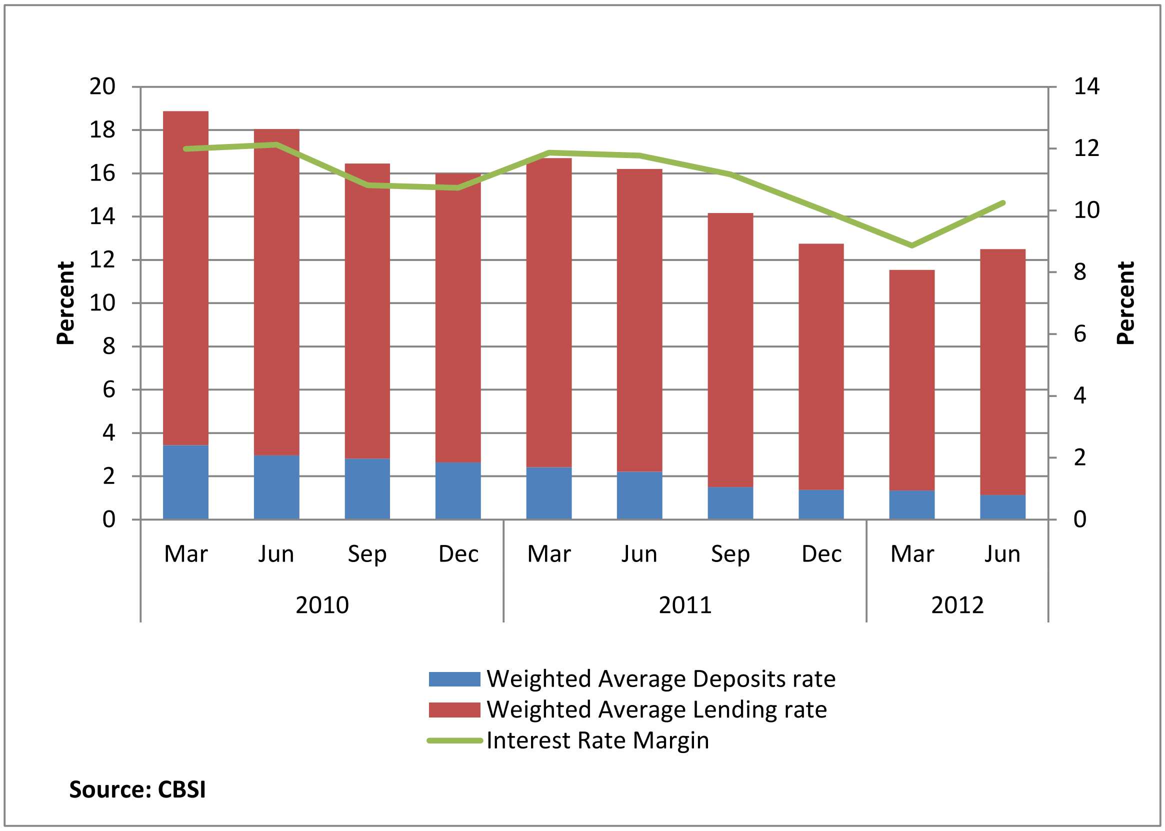

Figure 3.1.5: Weighted Average Deposit and Lending rates

Overall, due to the marginal increase in average lending rates and decline in deposit rates, the interest rate margin widened to 10.3% at end June from 10% at end December 2011. The interest rate margin dipped in the first quarter of 2012 due to a fall in commercial lending rates; temporary promotional offers left average lending rates at 10.2 % but by the end of the second quarter, this had picked up again to 11.4%, the same rate as end 2011. Commercial deposit rates have continued to decline falling to 1.1% by end June from 1.4% at end 2011.

The cap on Treasury bills remained at $40 million, despite high demand for Treasury bills. The stock of Treasury bills in August stood at $39 million and the WAY offered on bills with maturities of 56, 91 and 182 days were 1.13%, 1.14% and 0.9% respectively. Treasury bill rates have continued to decline.

3.2 External Conditions

Balance of payments indicators showed weaker external conditions in the second quarter of 2012 after a strong performance in the first quarter. This came on the heels of a significant deficit in the goods trade, services and primary income accounts with weakening export receipts driving the negative trade performance. Despite this, the overall current account across the first six months of the year registered a significant surplus, which stemmed from high donor inflows and exports in the first quarter.

Foreign direct investment inflows increased across the first half of the year with majority of investments in the “other” categories followed by retail and wholesale. The level of external reserves at the end of June quarter reached 10 months of import cover slightly down from the February 2012 position of 10.5 months. The level of reserves is considered to be comfortable.

The value of imports increased by 22% in the second quarter of 2012 compared to the same quarter of 2011, reflecting increased imports of machinery & transport equipment and increased food imports related to FOPA demand.

Tapis oil prices peaked in March 2012 at USD134 per barrel before declining to USD104 per barrel in June. Latest monthly data for August 2012 indicated that oil prices were rising again and back at USD118 per barrel.

The value of exports peaked in the first quarter of the year, driven by all major commodities with the exception of copra and cocoa exports. The second quarter saw a weakening of all exports against the first quarter, except for cocoa with the start of cropping period.. This resulted in a trade deficit in the second quarter.

However, there was an overall current account surplus of $170 million across the first six months of the year driven by donor inflows in the secondary income account and trade in goods surplus in the first quarter of 2012.

Exchange rates

As of June 2012, the SBD remained pegged against the USD at 7.36 SBD per USD compared to December 2011[3]. Against other major currencies, the SBD appreciated significantly by 5% against the Euro, 2% each against the Japanese Yen (JPY) and Australian Dollar (AUD) and 1% against the Pound Sterling (STG). However, the SBD depreciated marginally by 1% against the New Zealand Dollar (NZD) over the same period.

As of 1st October 2012, CBSI announced a move to peg the local currency to an invoice-based basket of currencies. In order to avoid large fluctuations in the exchange rate, the Bank has

[3] Monthly exchange rates are estimated as an average of daily exchange rates.

capped the exchange rate to move only within a plus or minus one percent margin around the base rate. Figure 3.2.1 provides data of the major currency components found in the new-invoice basket of currencies. Latest data up to September 2012 shows that there has been a depreciation in both the AUD and the NZD in recent months from June 2012 although there was a reversal in the AUD in September. The SBD-US Dollar rate remained at 7.36 SBD for 1 USD until end September.

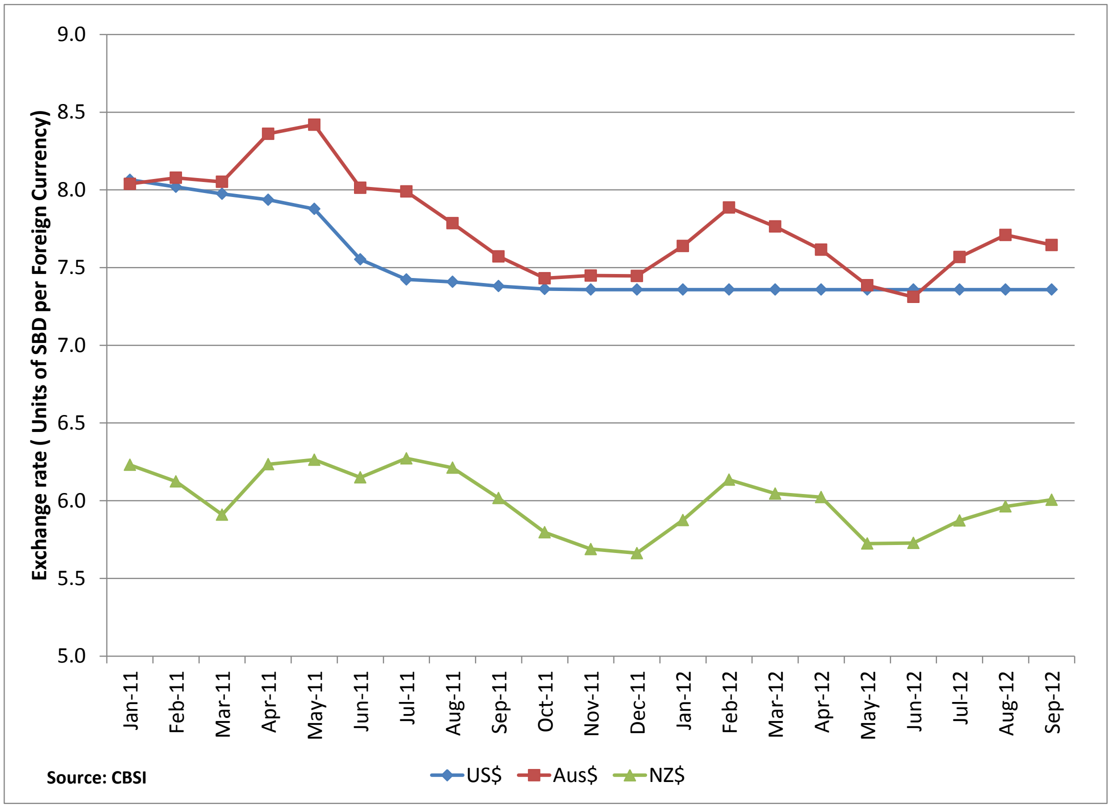

Figure 3.2.1: Monthly exchange rates of major trading partners

Reserves

Gross foreign reserves were recorded at $3,662 million (a 20% increase) in August 2012 against $3,034 million in December 2011. Donor funds represented 47% of the inflows responsible for the build-up of reserves at $324 million across the first six months of the year whilst trade and services receipts represented 42% of the inflows at $292 million. Donor funds in the last half of 2011 was $169 million (24% of total inflows), trade & services receipts was $352 million (50% of total inflows) the remaining inflow was IMF two tranches and fishing licenses. At the end of June 2012, the import cover was equivalent to 10 months, a slight reduction from the February 2012 cover. However, this is sufficiently above the recommended 3 months benchmark.

Commodity prices

The international price of logs declined 7% across the first half of the year to USD362 per cubic metre, following a 7% decline across the final half of 2011. Latest prices for August 2012 indicate a further drop to USD355 per cubic metre. Declining prices are reflective of the weakening economic activity in China, the major importer of Solomon Islands logs.

In the first six months of the year, the international price of gold fell by 3% from USD1,642 per ounce in December 2011 to USD1,599 in June 2012. Latest data, however, indicate that the global price reached a floor of USD1,594 in July and rebounded by 2% to USD1,630 by the end of August 2012.

The international copra price fell by 27% across the first half of 2012, continuing on from the 18% fall across the second half of 2011. Copra prices are now at half of the peak price reached in February 2011. Domestic copra prices have followed the trend in international prices, although the increases and declines have been more subdued.

During the first half of 2012, the international price of palm oil fell by 3%, following a 9% decline in the second half of 2011. Latest data indicates a rise in prices in July but a fall back to mid-year levels in August with the price back at USD995 per ton.

The international price of cocoa increased by 3%, following a 27% fall in prices over the last six months of 2011. Latest data indicates that global prices have continued to increase, rising to USD2,512 per ton by end-August. The improvement in international prices reflects tight supply conditions in global markets. Domestic cocoa export prices fell 24% across the first half of the year. Latest contract price data, however, indicates that prices have rebounded 2% month on month in August reversing earlier falls and taking the average contract price back to levels seen at end 2011.

3.3 Domestic Conditions

Production

Mid-year production of all major export commodities were above mid-year production levels a year ago except for copra and cocoa which have struggled with weakening world prices and less favourable weather conditions. Cocoa industry analysis suggested that the cocoa cropping period will be low due to heavy rainfall affecting the flowering period at the beginning of the year. Compared to the first half of 2011, cocoa productions fell by 17% to 2,567 tons in the first half of 2012.

Copra production continues to suffer from high sensitivity to global price movements. Copra production reached 15,309 tons across the first half of the year against 15,243 tons in the second half of 2011 but against the same period last year, production fell by 24%. At the end of the second quarter of 2012, copra productions fell significantly by 29% to 6,356 tons from the first quarter as domestic prices continued to deteriorate in line with weak world prices.

Employment

Employment indicators showed labour market conditions improved in 2012. Employment growth based on SINPF contributors increased strongly across the first half of 2012, registering an 8% growth from 43,014 at end-2011 to 46,342 at June 2012. This was in contrast to a 1% decline in active contributors across the second half of 2011.

The increase could be attributed to recruitments both in the private and public sectors. Government payroll has also increased to $450 million against a prorata budget of $437 million, possibly indicating increases in wages and the size of the workforce.

The CBSI Vacancy Survey saw a 25% increase in vacancies across the first six months of the year, reflecting increases in NGO vacancies, public sector vacancies and vacancies in the wholesale & retail sector.

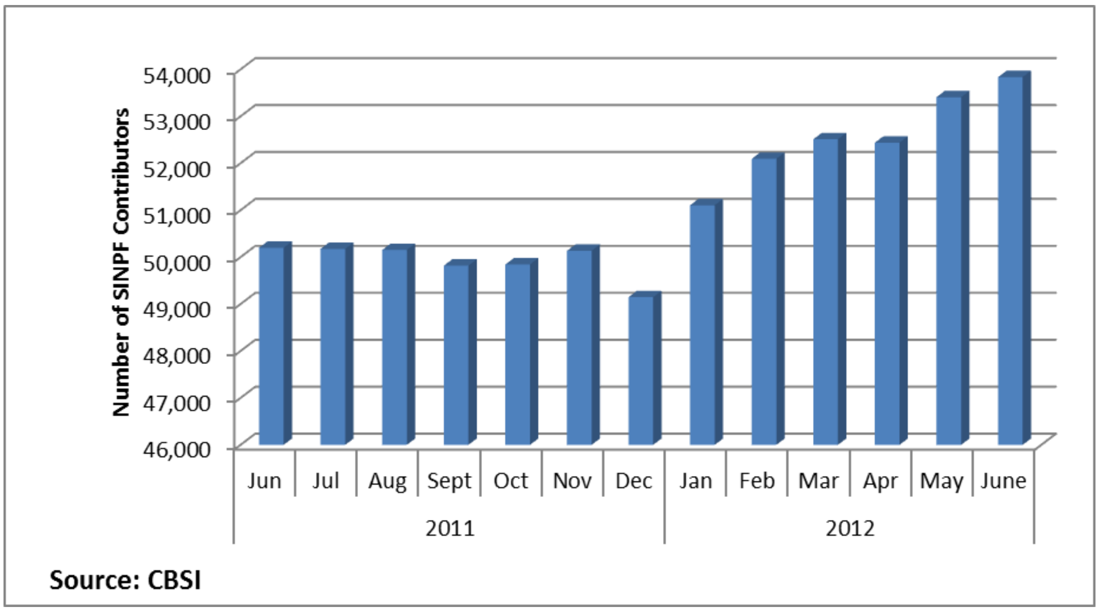

Figure 3.3.1: Employment

Tourism

The FOPA saw a surge in visitors' arrivals in June 2012, as participants arrived in time for the start of the Festival in July. The number of visitors recorded, doubled against the same month a year ago (see Figure 3.3.2). Visitor arrivals data indicated a 14% rise in the first half of the year, and a 26% increase in arrivals data against same month a year ago.

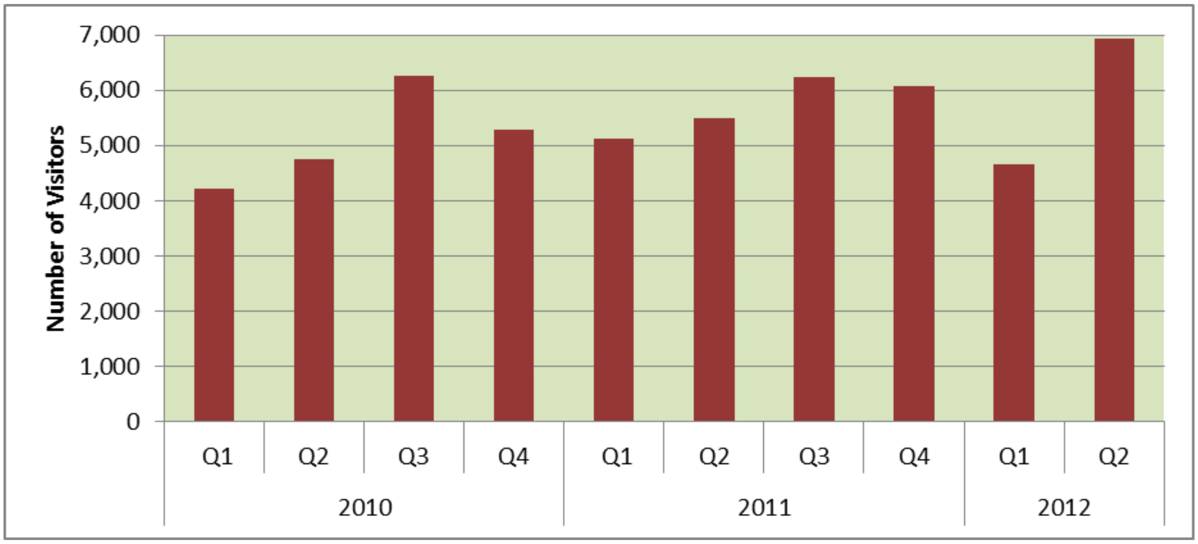

Figure 3.3.2: Visitors Arrivals

Manufacturing

Manufacturing output increased by 12% across the first six months of the year, continuing on from the 14% growth in the second half of 2011[4]. Manufacturing output is reflective of domestic demand conditions in the economy with output keeping up with demand and low inventory levels. Applications for foreign direct investment relating to the manufacturing sector saw 3 applications during the first half of 2012, a slight fall from the 4 applications recorded in the second half of 2011. Total stock of credit associated with the manufacturing sector fell 8% against the end of 2011.

Electricity Production

Electricity production fell by 3% during the first half of the year compared to the last half of 2011 but remained almost unchanged against the same period a year ago. Electricity consumption also fell by 9% in the first six months of 2012. Most of the decline is attributed to a fall in domestic consumption of 35%, a drop in ‘other’ categories of 27%, and reduced

[4] CBSI Manufacturing Index reflects production of food items, tobacco and alcoholic beverages

government consumption of 7%. Consumption in the commercial/industrial category remained unchanged in the same period.

Retail and Wholesale

The total value of credit held by the retail & wholesale sector increased to $181 million by the end of June from $176 million at the end of December 2011. The increase in credit reflected a significant increase in short-term lending for wholesale and retail and an increase in longer-term lending for retail. The latest available data at end July suggested further strong growth in total credit to retail and wholesale to $186 million with short-term credit accounting for the larger proportion.

Foreign Direct Investment

A total of 99 foreign direct investment (FDI) applications were recorded since the beginning of 2012, a 14% increase from the 87 applications recorded in the second half of 2011. The majority of applications (35) were for investment in "other" services[5], followed by 18 applications each for the wholesale and retail sector and the forestry sector.

Construction

Throughout the first half of 2012, 49 building permits were extended, a significant reduction when compared against the 95 permits issued across the first half of 2011 and the 106 issued in the second half of 2011. These figures, however, do not fully reflect conditions in the construction sector. Latest sectoral analysis of NPF contributions, used as a proxy for employment suggests that construction employment increased by 10% across the first quarter of the year. This represented a pick-up in employment in the sector following quarter-on-quarter growth of 1% and 3% in the two preceding quarters. Total stock of credit associated with the construction sector increased by 3% from the end of 2011.

3.5 Fiscal Conditions

Recurrent expenditure, including budgetary support, increased to $1,029 million for the first half of 2012, a 16% increase against the last half of 2011. Increased recurrent expenditure primarily reflected higher spending on government goods and services and budgetary support spending. Payroll spending across the first half of the year was $338 million compared to $311 million in the first half of 2011. Spending on government goods and services was $541 million, compared to $435 million in the first half of 2011 and $447 million in the second half of 2011.

[5] Other sectors refers to FDI applications to sectors other than agriculture, mining, forestry, fisheries, tourism, manufacturing, construction, wholesale and retail, consultancy, electrical and transport.

Budget support in the first half of 2012 was $76 million compared against $172 million in the first half of 2011. Spending is expected to rise in the second half of each year as Government ministries moved to complete all spending allocated for the year.

Debt servicing reached $73 million for the first six months of 2012, with a record $52 million for the second quarter. This was due to advance repayment of restructured bonds reflecting continued efforts to reduce the stock of restructured bonds in the banking system.

Development spending fell to $214 million over the first six months of 2012 from $316 million in the previous six months again due to higher spending in the latter in order to complete spending allocated for the year. SIG funded development expenditure decreased to $201 million at the first half of 2012 compared to $266 million in the second half of 2011.

3.6 Inflation

Headline inflation eased in 2012 to 5.3% in August after it peaked in November 2011 at 10.2%. The slowdown was driven mainly by the imported component that continues to trend downward to 2.0%% in August. However, the domestic component has hovered around 10% since the end of 2011. Only in recent months have there been signs of easing with September domestic inflation standing at 7.4%. As a result, overall inflation was sustained above 7% over the second quarter (see Figure 3.6.1).

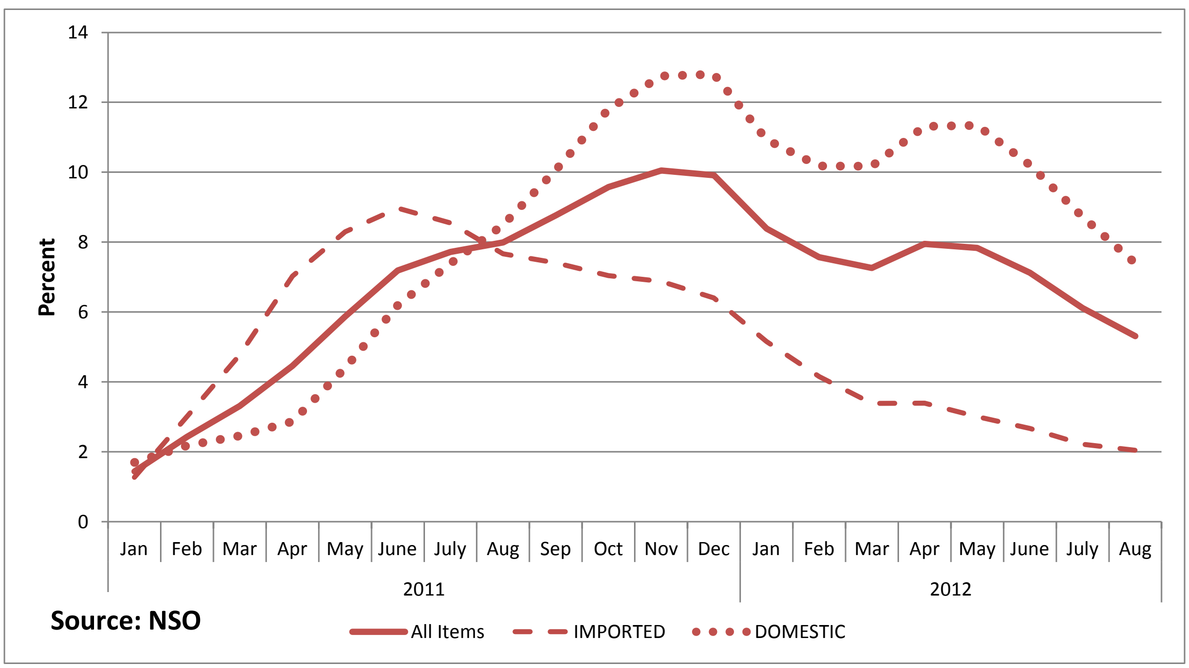

Figure 3.6.1: Headline Inflation

In March, the Central Bank projected inflation to be within a range of 5-7%. The 12 months moving average showed inflation overshot the range in April but since then, inflation momentum slowed down across the second half of 2012. The inflationary pressure in the first half is partly attributed to the brief increase in oil prices that in turn fed into other retail items. Local retail prices for fuel soared to almost $12 per litre in May but moderated to $11.50 by mid-year. The latest data in August suggested local retail price for diesel was comparatively lower than the peak level in 2011.

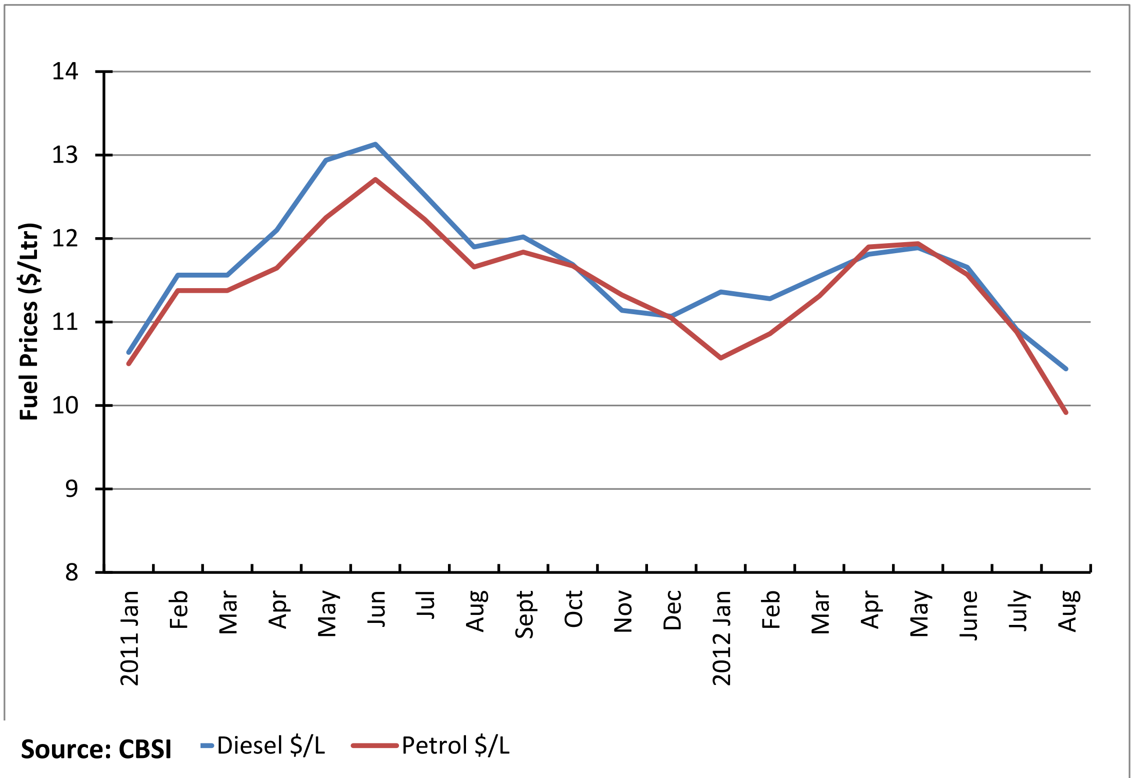

Figure 3.6.2: Retail Fuel Prices in Honiara

According to the CBSI inflation forecasting univariate model, inflation is projected to average 6.5% for the current year. By December 2012, inflation is expected to stand at 5.4%. This is within the range projected March 2012 and also in line with other indicators such as the CBSI Imported Food Index, which slowed down in July after it increased by 4% across the half year. According to IMF projections, commodity prices are expected to fall. This implies that imported inflation would pose no immediate risk to price stability. Domestic food prices and housing and utilities which sustained domestic inflation at elevated levels in the first half of the year also eased. Unless oil prices picked up suddenly, inflation is expected to be within the upper limit of the projected inflation of 7%.

The move to peg the local currency to a basket of currencies allows for greater flexibility for the SBD to appreciate and depreciate in line with market forces. However, the Bank has taken the decision to cap the exchange rate to move only within a plus or minus one percent margin around the base rate to contain inflation, curbing any opportunity in large exchange rate movements that may be harmful to the economy, whilst reaping the benefits from greater flexibility.

4.0 Outlook

Economic activity is expected to grow by 4.4% in 2012, broadly in line with the growth projections in March of 5.5%. The revised forecast incorporates recent international developments that impacted negatively on the tradable sector in particular agricultural commodities such as copra and cocoa. The growth was driven by the logging, mineral, manufacturing, finance, transport, communication and fisheries sectors. High Government expenditure and strong donor support also contributed to the growth.

Meanwhile, growth projection for 2013 was expected to slow down to 3.7% as forestry and mineral sectors level off next year. Agriculture activities could also stall as a result of weak global prices. On the upside, growth in production for cocoa and fish have been revised upward with improved outlook for fish coming from anticipated scaling up of canned and loin fish and fish catch with better prices. Other drivers of 2013 growth are expected to come from manufacturing, electricity consumption, retail and wholesale activities, and the services sector.

Domestic income is projected to remain moderate in 2012 and 2013 following the slowdown in export and services oriented sectors (excluding mining) and lower external trade receipts in the second quarter of 2012. As a result, the trade balance has been revised downward to $147m in 2012, with a projected trade deficit of $181 million in 2013 in anticipation of imports growing faster than exports. The relatively low export inflows are likely to dampen the rate of accumulation of NFA and a corresponding decline in the rate of increase of liquidity in the banking system. Foreign reserves are also projected downward by 2% in 2012 from the initial growth forecast in March which would also have an impact on NFA. However, foreign reserves are expected to grow by 10% in 2013 in anticipation of continued high donor inflows.

With restrained private sector credit across the first half of the year and a slight uptick in lending rates in the second quarter, domestic price pressures are likely to remain subdued in 2012 and into 2013. On the upside risk, the strong growth in employment and government payroll across the first half of the year suggest strong labour demand could contribute to price pressures. The higher government spending on goods and services across the first half of the year with higher development spending in the second quarter could also contribute to domestic inflationary pressure. In addition, high level of aid inflows and foreign direct investment as witnessed across the first half of the year are also expected to represent an upside risk to inflation in the medium term if left unsterilized.

With the exception of April 2012, headline inflation has been declining since the November 2011 peak. Latest data for August 2012 recorded inflation at 5.3%.

The imported component of inflation has continued to fall reaching 2% in August. This remains counteracted by the persistently higher domestic inflation. Only in recent months have there been signs of domestic inflation retreating to growth below 10%.

CBSI inflation projections for the rest of 2012 still stand in the range of 5%-7% with estimates for year-end to be around 5.4% in December. The average for the year is estimated to stand at 6.5%. Inflation for 2013 is estimated to be around 6% assuming downward pressure from falling global food prices and with Tapis oil prices expected to follow 2012 trends.

Inflation may increase going into 2013 if global food prices reverse their current trend or through rising fuel prices, which have been volatile in recent months. Further upward pressure may also arise under the backdrop of increasing Government and donor spending, high levels of liquidity and domestic supply side constraints.

5.0 Monetary Policy Stance

Recent developments showed commodity prices have fallen and will remain weak at least for the next six months. Therefore there is no immediate pressure on inflation from the imported component. On the other hand, the domestic component was the chief reason why overall inflation remained at around 8% in the first half of the year. Improved private sector performance supported by government related expenditures contributed to the strong domestic demand. The increase of private sector credit from loans, overdrafts and lease financing may also lead to some upward pressure in the coming months.

Inflation is expected to continue its downward trend in the remaining months of this year to between 5%-7%. This is still considered appropriate at the current growth levels.

Recommendation for the Board

1. The Board to note the developments in the first half of 2012 and the forecasted outlook for the next six months.
2. The Board to endorse a neutral monetary policy stance.