CENTRAL BANK OF SOLOMON ISLANDS

MONETARY POLICY STATEMENT
SEPTEMBER 2015

Central Bank of Solomon Islands
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1.0 OVERVIEW

The world economy continued to expand in the first half of 2015 but at a slower pace than initially anticipated. Economic growth for 2015 is projected at 3.3%, down slightly from the 3.5% projected in the IMF World Economic Outlook April publication. The downward revision represented slowdowns in emerging economies and sluggish recovery in the advanced economies. Weak commodity prices, depreciating emerging market currencies, weaker capital inflows, and financial market volatilities were the key underpinnings behind the revision.

Solomon Islands' major trading partners' recorded positive growths in recent quarters despite downside risks. The Chinese economy picked up 7% in June 2015 with more fiscal and monetary space for the authorities to conduct accommodative policies. Likewise Australia experienced a slower growth of 2.5% so far this year on the back of low commodity prices compounded by subdued domestic demand. New Zealand projects a higher growth of 2.9% for 2015 with the impetus coming from migration, construction activities and robust labour income. Inflation in trading partners however remained within central bank targets.

Domestic economic activities in the first half showed mixed performances. Forestry recorded a surprise increase in year to June supported by agriculture and solid construction activities. Fisheries sector was slightly higher than the corresponding period last year. However, partial indicators including production index and manufacturing index were weakly. While declining commodity prices may be regarded as a huge disincentive, this was somewhat cushioned by the depreciation in SBD particularly against USD.

Economic growth for 2015 is expected to remain positive at 3.2%. Growth is expected to be driven mainly by the services sectors supported by fisheries and upbeat in public expenditure in the second half. The underlying assumptions however are subjected to downside risks such as deteriorating commodity prices; exchange rate volatilities; slow implementation of public investment; and weak domestic demand conditions.

Investment activities remained unbalanced with most of the foreign direct investment (FDI) channelled into a few selected sectors. Logging, mineral, retail and wholesale, and construction continued to be featured as the main beneficiaries of FDI applications. Public investments so far in 2015 particularly on large infrastructure projects are ongoing but are still low by recent years' standards and this was associated mainly with the government's slow budget process. However public investment is anticipated to rise substantially in the second half in line with the government's planned programs for the year.

The Balance of Payments position of the country improved in the first half of 2015, reversing the deteriorating trend in the second half of 2014. Gross foreign reserves rallied by 16% against December 2014 to $4,390 million in June this year. The strong external position was driven mainly by the combined surpluses in the current, capital and financial accounts which outweighed the year to June trade deficit of $390 million. The deteriorating trade position reflected the fall in merchandise exports and growth in merchandise imports.

The Central Bank of Solomon Islands (CBSI) still maintains the exchange rate policy of pegging the local currency (SBD) to a basket of invoicing currencies. Over the six months to June 2015, the trade weighted index of the currency basket moved by 3% to 106.8 as a consequence of the stronger USD. While the local currency weakened against the USD to the benefit of exporters, at the same time the SBD appreciated against other currencies. Hence, AUD and NZD denominated imports were becoming relatively cheaper. The exchange rate trend is expected to continue in the second half and puts further upward pressure on the domestic trade weighted index.

Monetary aggregates rose in the first half of 2015 in contrast to the slump in the half year to December 2014. Broad money (M3) grew by 5.5% to $3,836 million to reverse the negative growth of 0.6% in December. M1 and M2 also recorded positive growths of 11.5% and 11% to $2957 million and $3,101 million respectively.

Credit expansion slowed down to 6.4% compared to the higher half year growth of 13% in December 2014 with total credit in June standing at $1,813 million. While credit growth may have contributed positively to the overall monetary expansion, this was somewhat offsetted by commercial bank deposits held with CBSI which accumulated by 25% over the half year to drive monetary base by 15%. Large donor and trade inflows through the Central Bank in the first half were the chief drivers behind the expansion in monetary base.

Interest rate declined slightly during the period with the weighted interest rate margin shaving off 22 basis points over the half year to 10.1%. The margin was derived from a weighted lending rate of 10.6% and a weighted deposit rate of 0.5%. Interest rate for the 91 days Treasury bills fell by 2 basis points to 0.46%. On the other hand, the interest rate on the 28 days CBSI

Bokolo bills rose negligibly by 1 basis point to 0.62%. Meanwhile the interest rate on the Government's 10 years amortised bonds remained at 3%.

The Government recorded a year to June surplus of $300 million compared to $60 million in the prior six months. The higher surplus was explained by a sharper contraction in expenditure than revenue. Expenditure fell 23% against December 2014 to $1,247 million while revenue collections dropped by 7.7% to $1,547 million. The low expenditure outturn was attributable to the delayed enactment of the 2015 Appropriation Act to April this year. Public debt declined further to $820 million in June from $859 million in December with most of the principle repayments made in the second quarter.

Inflationary pressures fell much sharper than previously anticipated with headline inflation decelerating into negative territory since March this year. The deflationary situation represented persistent weak prices in the import and domestic components. Energy prices in the consumption basket slumped by more than 20% year on year while average food prices at the Honiara Central Market plunged by more than 30% relative to post April flood prices in 2014. Meanwhile core inflation dropped by 2.4 percentage points against December to 1.7% in June, implying that the deflation is temporary and not broad based. Other measures of inflation have shown signs of a bottoming out already. While the appreciation of the local currency against AUD and NZD are regarded as possible sources of deflation, there has been little evidence that these benefits are passed through to prices at the shops in Honiara.

2.0 INTERNATIONAL DEVELOPMENTS

Global Economic Growth

Global growth saw a downward revision following a subdued performance over the first half of 2015 to 3.3%[1] from 3.5% in the IMF World Economic Outlook (WEO) January Update. This downgrade projects growth to be slower than the 3.4% recorded in 2014. Following weaker than initially estimated growth in the first quarter, advanced economies continued on their gradual pickup, supported by favourable financial conditions and continued low fuel prices. Meanwhile, the slowdown in emerging market and developing economies also persisted. As downside risks from China and the Eurozone increased, the world economy is expected to grow at its weakest pace since the global financial crisis.

Growth projections for advanced economies have been moderated to 2.1% in 2015, down 0.3 percentage points from January estimates but still higher than the 1.8% growth for 2014. For the second year running, output contracted sharply in the first quarter of the year, particularly in the United States which faced another harsh winter and a reduction in capital expenditure for the oil sector. With a substantial downward revision of 1.1 percentage points in its growth prospects for the year from 3.6% down to 2.5%, the United States accounted for the bulk of the overall moderation for advanced economies. Nonetheless, fundamentals in the country remain strong, including labour market conditions and easy financial conditions. Other countries contributing to the downward revision included Canada downgraded 0.8 percentage points to 1.5% growth for 2015, and the United Kingdom down 0.3 percentage points to 2.4% growth.

Growth in the euro area continues with its gradual pickup with growth estimates for 2015 revised upwards by 0.3 percentage points to 1.5%. Aside from Greece where economic and political developments over the first half of the year took a downturn, most other euro area economies received upward revisions in growth projections. Of particular note was Spain where estimates were raised by 1.1 percentage points to 3.1% growth, and Germany where growth is now estimated at 1.6% for 2015, up 0.3 percentage points. These developments follow a general recovery in domestic demand in the region. Similarly, Japan saw a modest increase in growth projections of 0.2 percentage points to 0.8% growth. This followed stronger than expected growth in the first quarter, supported by increased capital investment despite consumption remaining sluggish.

Growth projections in emerging market and developing economies received a marginal downgrade of 0.1 percentage points to 4.2% growth in 2015, a slower rate compared to the 4.6% recorded in 2014. In addition to the planned slowdown in China, the moderated growth rate reflects the impact of softer commodity prices as well as tighter external fiscal conditions, particularly for oil exporters. With China being the world's second largest economy, the slowdown in growth from 7.4% in 2014 to a projected 6.8% in 2015, albeit unchanged from estimates made in January, accounts for much of the region's reduced growth prospects. This was compounded by lacklustre performance by other countries in the region with Russia entering a period of contraction over the first half of the year as a result of international sanctions, low oil prices, and high inflation. Following a pickup

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

in industrial production, however, India was one of the few countries to get an upward revision on its growth prospects for 2015 by 1.2 percentage points to 7.5%.

In the East Asia Pacific region, an easing in growth is anticipated in 2015 despite the region being expected to benefit from lower oil prices. This slowdown is expected to stem from tighter fiscal policy in some countries in the region, as well as softer commodity prices taking their toll on commodity exporting countries. In addition to the easing in China's growth, projections for the ASEAN-5[2] region have been downgraded since the beginning of the year by 0.5 percentage points to 4.7% growth. Contributing to these lowered growth expectations was a slowdown in Malaysia following the introduction of a goods and services tax (GST) in April, as well as moderated growth in Thailand and Indonesia.

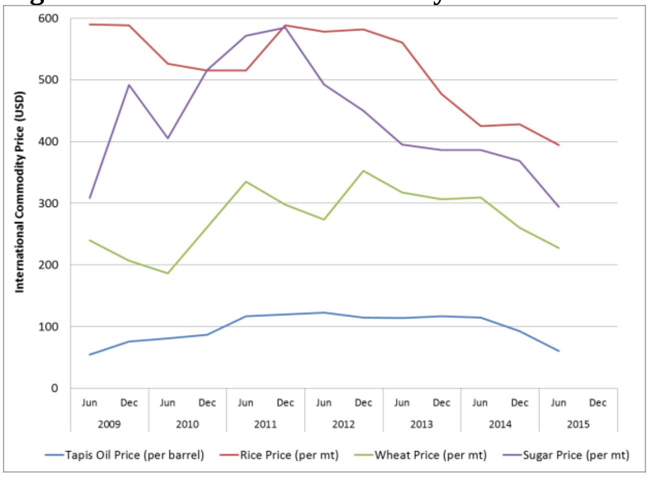
Growth in Australia and New Zealand, two of Solomon Islands' major trading partners, saw an easing over the first half of 2015. In Australia growth slowed further given continued soft commodity prices, high household debt and poor domestic demand. The economy is forecast to grow at a rate of 2.5%[3] in 2015. Similarly, New Zealand saw poor performances in the agriculture and mining sectors, as well as a weakening in both business and consumer confidence. Nonetheless, growth is expected to be around trend at 2.9% in 2015, supported by high migration, robust construction activity and solid labour income growth.

International Commodity Prices

Global commodity prices, as indicated by the World Commodity Price Index (CPI), continued on their downward trajectory, albeit at a more moderate pace. A 6% fall was recorded over the first half of 2015 to reach 123 on the index. This is in comparison to a 30% fall between June and December 2014. Contributing to this drop in the first half of the year was a fall in both fuel and non-fuel price indices of 4% and 9% to 114 and 137 respectively. Nonetheless, the fall in the fuel index was considerably more moderate than was observed in the second half of 2014 when it plummeted 40% to 119. In January 2015, Brent crude oil prices reached a low of US$48 per barrel before increasing gradually to approximately the same level as observed at the end of 2014 of US$62 per barrel in June. The Tapis crude oil price, the most relevant fuel price for the Solomon Islands, followed similar movements to the Brent to reach an average monthly price of US$65 per barrel in June.

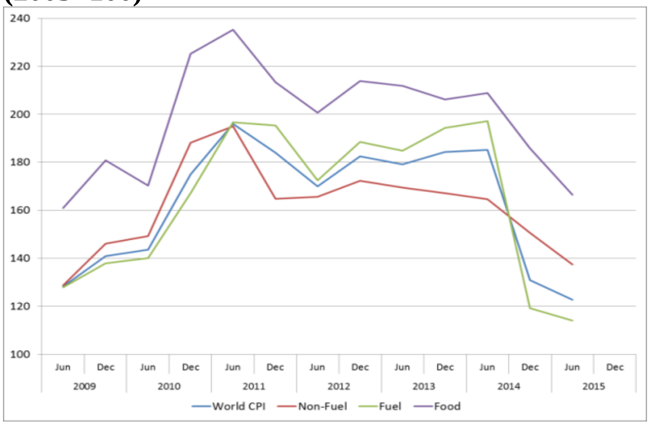
International food prices, as indicated by the Food Price Index[4], fell by 23 points on the index between the second half of 2014 and the first half of 2015 to reach an average of 171. This level represented the lowest half-yearly average value since the first half of 2010. This fall was driven by declines in price indices across the board for sugar, meat, dairy, cereals and oils. More importantly for the Solomon Islands, there was a general fall in the average prices of rice, wheat and sugar between the second half of 2014 and the first half of 2015 by 8%, 13% and 20% respectively. Over the first half of 2015 rice fell to an average price of US$394 per ton, wheat fell to US$227 per ton while sugar reached US$294 per ton.

Figure 1: International Commodity Prices



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

Figure 2: Commodity and Food Price Indices (2005=100)



Source: IMF Commodity Price Indices and FAO Food Price Index, retrieved Sept 2015

Global Inflation

Global inflation remained relatively low over the first half of 2015 in line with the falling commodity prices and low oil prices, but was generally below the inflation objectives of most economies. Furthermore,

[2] The Association of Southeast Asian Nations - 5 comprise Indonesia, Malaysia, Philippines, Singapore, and Thailand.
[3] Source: Reserve Bank of Australia, Statement on Monetary Policy August 2015

[4] FAO Food Price Index obtained at www.fao.org/worldfoodsituation - accessed September 2015

the transition to lower commodity prices and weaker currencies has had diverging inflationary consequences. While oil importing countries with fixed exchange rates, such as Solomon Islands, have seen headline inflation slowing down, many oil exporting countries with flexible exchange rates have seen a pickup in inflation. Nonetheless, core inflation has remained relatively stable.[5]

In advanced economies, inflation is projected to bottom out in 2015. In the United States, inflation saw modest increases over the first half of 2015 and is expected to average 1.3% for the year. Euro area inflation also saw some recovery as the months progressed, but will likely remain low through the year. Meanwhile, inflation in Japan continued to ease over the first half of 2015 as the effects of the sales tax boost from last year continue to dissipate. The Bank of Japan expects core inflation to be between 0.2% and 1.2% in the fiscal year ending March 2016. On the other hand, projections in emerging market and developing economies show inflation picking up as some countries experience exchange rate depreciations.

For Solomon Islands' major trading partners, inflation eased over the first quarter before starting a moderate pickup in the second quarter. In China, inflation averaged approximately 1.5% over the first half of 2015, and is expected to register a rate at about that level for 2015 compared to the 2.0% of the previous year. Meanwhile, Australia started the year with 1.3% inflation in the first quarter, dipping to an almost three year low, before picking up slightly to 1.5% in the second quarter. Inflation is expected to remain relatively low with a projection of 1.8% annual inflation compared to 2.5% in 2014. Similarly, inflation in New Zealand remained subdued after registering a marginal pick up over the first half of the year. It is expected to reach 1.1% for 2015 compared to the 1.2% recorded in 2014.

3.0 DOMESTIC ECONOMIC DEVELOPMENTS

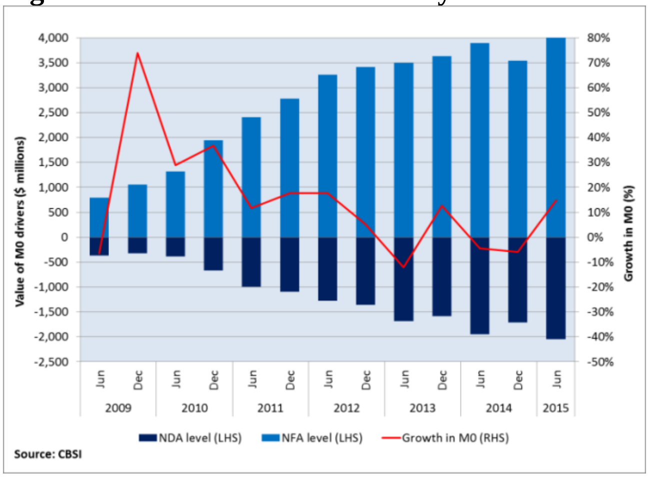
3.1 Monetary Conditions

Reserve Money

In June 2015, reserve money (M0) picked up by 15% against December 2014 to reach $2,097 million, bucking the declining trend observed since June 2014. This level of M0 also represented a total year-on-year increase of 8%. The increase in reserve money was due to a rise in CBSI's net foreign assets (NFA) by 17% to $4,152 million over the first half year which outpaced the deterioration in CBSI's net domestic assets (NDA) by 20% to minus $2,050 million over the same period.

The improvement in the CBSI NFA position was stemmed from an increase in gross foreign reserves by 16% to $4,390 million in June 2015, compared to December 2014. This increase was primarily driven by net transaction inflows, largely from donor inflows. On the other hand, the deterioration in CBSI NDA was attributed to an increase in net domestic credit following an increase in liabilities to central government. Net credit to government saw a considerable increase of 24% to liabilities of $1,585 million while net credit to other depositor corporations (ODCs) increased by $47 million to liabilities of $622 million over the six months to June.

Figure 3: Drivers of Reserve Money



Components of reserve money showed mixed movements in the first half of 2015. While currency in circulation saw a 3% decrease to $637 million over the six months to June, this was outweighed by a 25% increase in CBSI liabilities to ODCs to $1,457 million over the same period. These liabilities to ODCs were comprised of $257 million in cash reserve requirements (CRR) and other deposits commercial banks held in their call accounts with CBSI at $1200 million.

Broad money (M3) followed a similar trend to that of reserve money over the first half of 2015. Total money supply in the economy increased by 6% to $3,836 million in June, an increase of 5% year on year. This expansion in M3 followed from an increase in NFA by 13% to $4,318 million which outweighed deterioration in NDA by $292 million to minus $474 million. The movements in key components of M3 were mixed. While demand deposits rose 16% to $2,405 million in the six months to June 2015, currency in circulation fell 4% to $552 million, and time and savings deposits fell 10% to $879 million.

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

Figure 4: Drivers of Broad Money

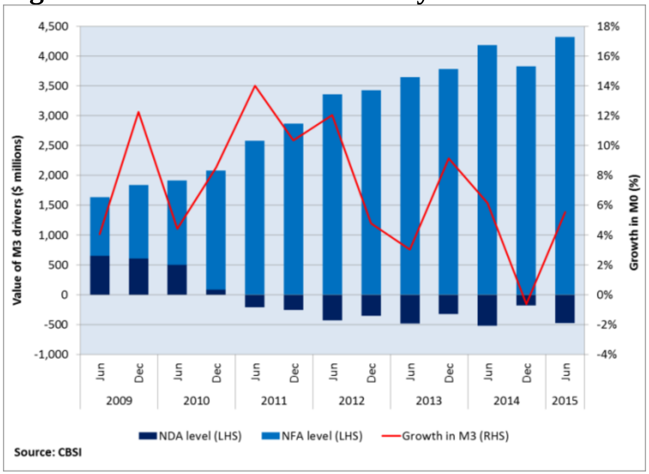


Figure 6: Private Sector Credit Trends

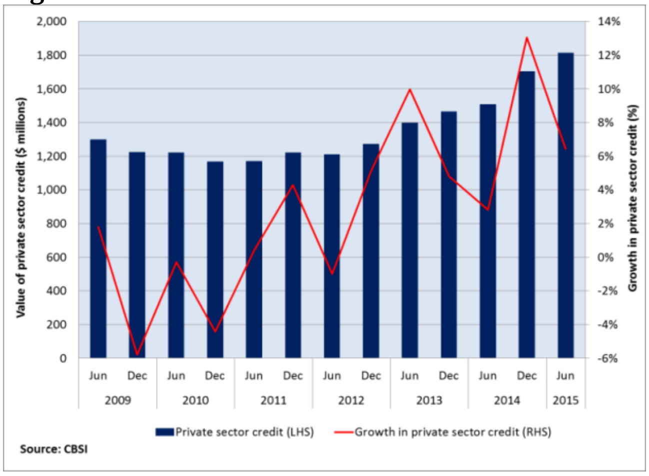


Figure 5: Components of Broad Money

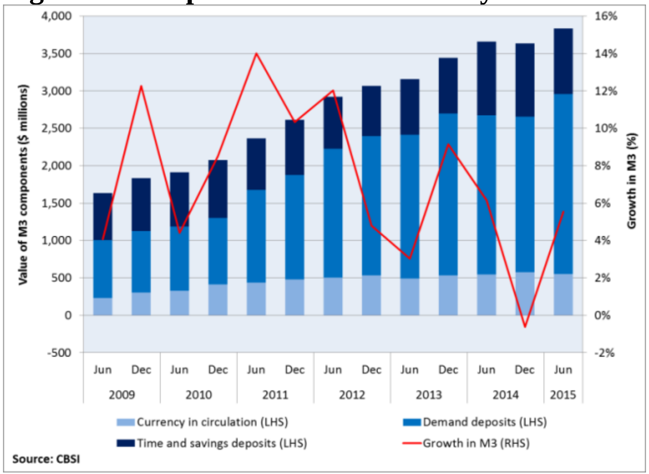
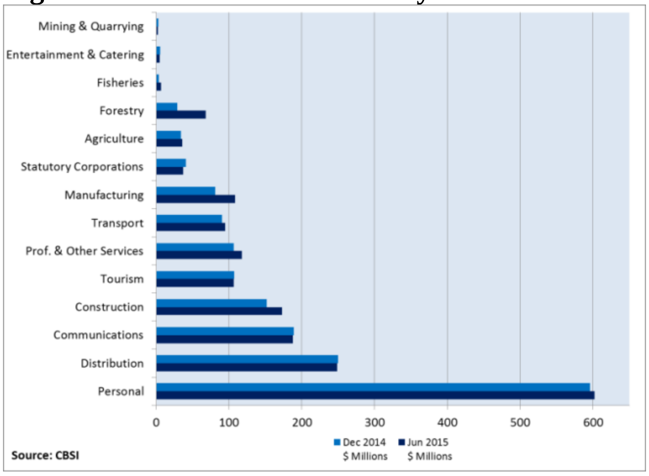


Figure 7: Private Sector Credit by Sectors



Credit Conditions

Following a sharp acceleration in growth over the second half of 2014, credit growth decelerated slightly to grow at 6% in the first half of 2015. Credit to private sector increased to $1,813 million in June 2015 from $1,703 million in December of the previous year. This growth was primarily driven by credit allotted to other non-financial corporations while credit to individual residents remained constant. Loans accounted for the majority of total lending with 89.1%, followed by overdrafts with 10.2% and finally lease financing at 0.7%.

The sectors that recorded large credit movements in the first half of 2015 were forestry loans which increased by $39 million to $68 million, manufacturing gaining $27 million to reach $109 million, construction up $21 million to $173 million, and professional & other services increasing $12 million to $118 million. Movements in the remaining categories were marginal including personal loans increasing by $6 million and statutory corporations falling by $4 million.

Interest Rates

Weighted average deposit rates stood at 0.27% in June, down 3 basis points from December 2014. Following the same trend, average lending rates fell by 43 basis points to 10.63%. This caused the interest rate margin for the banking sector to fall to 10.36% from 10.75% over the same period. According to the sectoral weighted average lending rates in June, the communications sector recorded the lowest weighted average lending rate at 6.29%, a drop of 49 basis points from December 2014. The statutory corporations sector also recorded relatively low lending rate at 6.75%, exhibiting a drop of 78 basis points. Lending rates to non-residents and entertainment & catering sectors also experienced significant drops of 3.40 and 3.08 percentage points to 17.40% and 9.79% respectively.

Liquidity

Total liquidity in the banking system saw a 3% increase over the first six months of 2015, compared to December 2014, to reach $1,206 million. Excess liquidity followed a similar trend increasing 2% over the same period to $1,091 million. Contributing to this increase was the build-up of CBSI’s NFA.

Figure 8: Interest Rate Trends

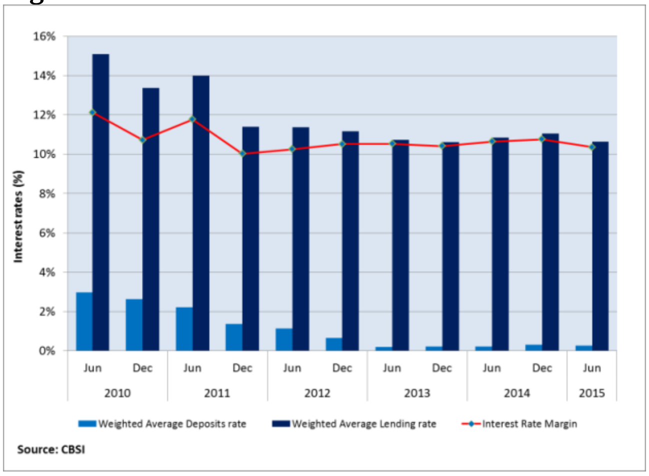
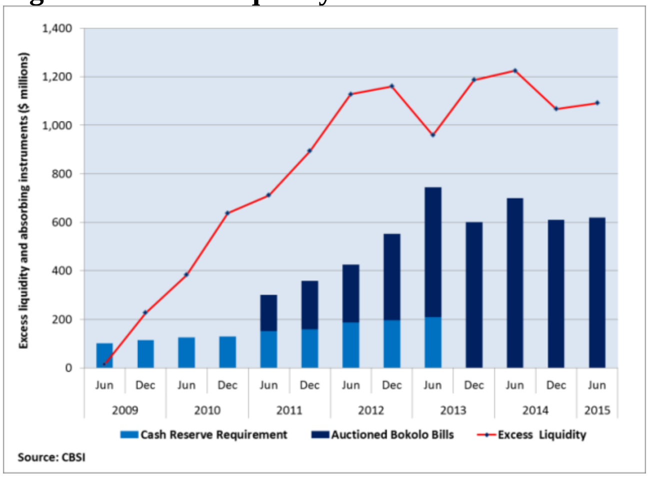


Figure 9: Excess Liquidity



Bokolo Bills and Treasury Bills

The level of Bokolo bills issued was maintained at $710 million throughout the first half of 2015. By June, the stock of ODCs' Bokolo bills held by CBSI stood at $620 million following some under subscription over the six months period. The weighted average interest rate saw a slight increase to 0.62% from 0.61% in December. Meanwhile, the cap on SIG backed Treasury bills remained unchanged at $40 million. Weighted interest rates for the Treasury bills varied for the different maturities with the 56 days earning 0.34%, 91 days earning 0.46% and the 182 days earning 1.15%.

3.2 External Conditions

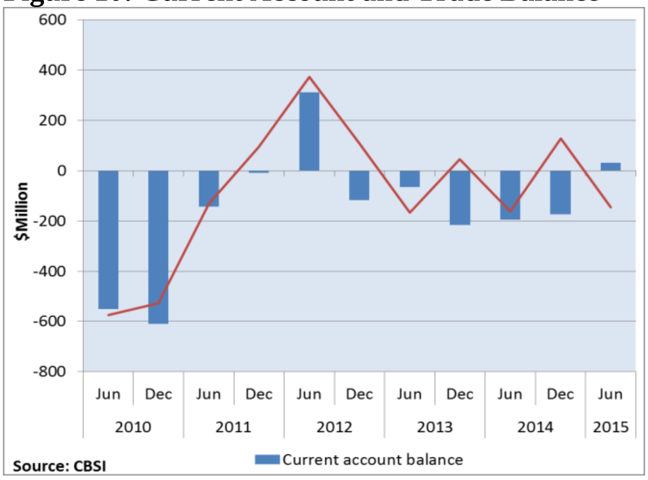
The Solomon Islands external position in the first six months of 2015 strengthened as opposed to the weak performance observed in the second half of 2014. The upsurge was mainly driven by a widening surplus in the current and capital accounts, associated with significant donor inflows. The expansion in the financial account surplus stemmed from increasing financial assets as foreign reserves accumulated, which also contributed to the favourable external position. This counteracted the deterioration in the trade account which saw a significant increase in the trade gap in the year to June 2015.

Current and Capital Accounts

The current account, following persistent deficits since the second half of 2012, registered a surplus of $31 million in the first half of 2015. The turnaround was primarily driven by a positive outturn in the second quarter with the current account registering a surplus of $72 million which outweighed the $40 million deficit registered in the first quarter. The outcome stemmed from a significant expansion in the secondary account from $141 million surplus in the second half of 2014 to $465 million surplus in the first half of 2015. This was largely due to significant donor funds originated from high inflows to the general government and depository taking corporations. Similarly, the significant deficit reduction in the primary income and services accounts was also attributed to the positive outcome in the current account in the first half year of 2015.

Conversely, the trade in goods account deteriorated in the first half of 2015 to $144 million deficit, overturning the $128 million surplus recorded in the second half of 2014. The widening trade gap was primarily due to a fall in exports by 14% to $1590 million relative to a slight increase of 1% in imports to $1735 million. Lower earnings in log, fish, copra, cocoa, and minerals associated with low export prices explained the negative outcome. This more than offsets the increase in palm oil, timber and other exports which went up by 21%, 35% and almost tripling to $41 million, respectively.

Figure 10: Current Account and Trade Balance



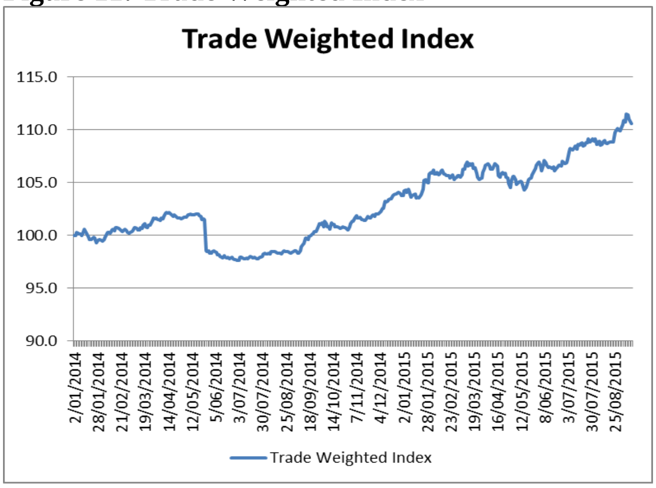
The 1% growth in imports came from rising payments in machinery and transport equipment which went up by 21% to $627 million. The outcome was mainly related to capital imports for the seaport facilities in the second quarter. Import growth was also supported by high payment in miscellaneous goods which rose by 21% to $145 million and animal, vegetable and oil fat which rose by 29% to $13 million. Meanwhile, import payments on food, fuel, beverages and tobacco and chemicals fell during the first half of 2015. The decline in food and fuel import values, particularly in the first quarter reflected lower prices during the period.

Similarly, the capital and financial accounts, posted an increasing surplus of $652 million in the first half year from $159 million surplus in the second six months of 2014. The upsurge stemmed primarily from significant increases in both the capital and financial accounts with surpluses of $287 million and $364 million, respectively. The rise in the capital account predominantly reflected capital inflows to fund various government capital projects in the energy and health sectors, including the international sea port facility and donor funds toward the national transport fund. Meanwhile the increase in the financial account was largely related to sizeable increase in financial assets to $550 million supported by the accumulation in reserve assets over the first half year. As a result, the current and capital accounts surplus widen to $319 million in the first half year compared to $42 million surplus in the latter six months of 2014.

Exchange Rate

In terms of exchange rate policy developments, Solomon Islands maintained the managed exchange rate regime implemented in December 2014 over the first half of 2015. This had allowed the local currency to move along with the invoiced basket of currencies reducing the average fluctuations of the domestic currency vis-à-vis other currencies in the basket. Mirroring the appreciation of the SI nominal effective exchange rate (NEER), the trade weighted index (TWI) increased by 3.0% to 106.8, as opposed to an increase of 6.2% in the second half of 2014. Latest data showed the index was at 110 at the end of August.

Figure 11: Trade Weighted Index

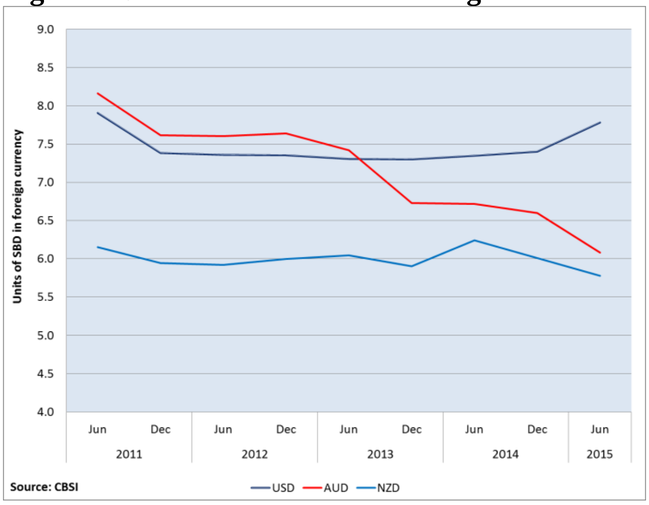


The Solomon Islands real effective exchange rate (REER) remained stable with the index for the six months to June 2015 averaging at 145. The NEER index on the other hand rose by 5% to 99 from 95 in the second half of 2014.

The appreciation of the Solomon Islands NEER indicated that Solomon Islands dollar (SBD) strengthened against the invoiced basket of currencies. The appreciation was largely influenced by the strengthening of the SBD against the Australian dollar by 8% to $6.08 per AUD in the first half year. The SBD also strengthened against other major currencies including the New Zealand dollar, the Japanese Yen, Pound Sterling and Euro. This in turn benefited importers trading in these currencies during the period. In terms of currency composition, USD and AUD the two main trade invoicing currency made up 82% of the total foreign exchange transactions in the first half of 2015, with USD accounting for 69%.

Meanwhile, the SBD depreciated against the United States dollar by 5% to $7.78 per USD in the first half year. Similarly, year-on-year figures saw the SBD depreciating strongly against the USD by 7% to $7.85 per USD in June 2015 from $7.31 per USD in June 2014.

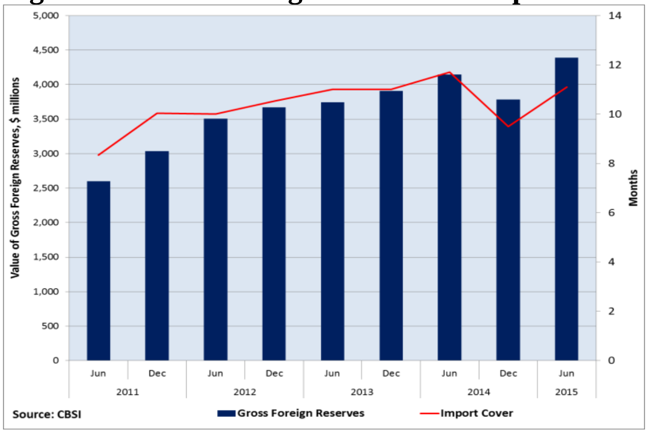
Figure 12: Nominal Bilateral Exchange Rates



Reserves

Gross foreign reserves, after dipping to $3,875 million in December 2014 rebounded strongly by 16% to $4,390 million at the end of June 2015. The acceleration was mainly triggered by net transaction inflows of $666 million over the period, largely from donor inflows as reflected in the secondary income and capital account. This level of gross foreign reserves was sufficient to cover 11.1 months import for goods and services, an increase from the 9.5 months of import cover at the end of December 2014.

Figure 13: Gross Foreign Reserves & Import Cover



3.3 Domestic Conditions

Partial indicators on domestic economic activities showed a mixed performance in the first six months to June 2015 following the improved conditions in the second half of 2014. Production and manufacturing activities performed weakly in the first half of the year. Similarly, other key indicators including, tourism, construction, wholesale and retail activities, consumption and energy demand also eased over the period. Meanwhile, transport and communication and foreign investment activities performed strongly, surpassing the relatively moderate growths in the last six months of 2014.

Economic Growth

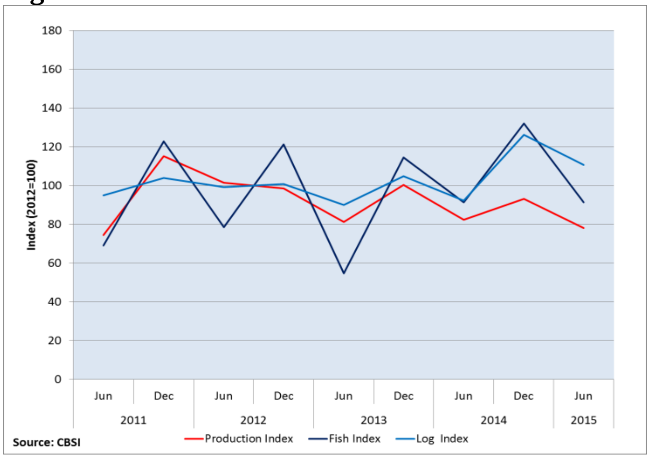
Consistent with the recovery, growth is projected at 3.2% in 2015; a slight downward revision from the 3.3% projected in the March 2015 Monetary Policy Statement (MPS). Growth in 2015 is expected to be driven mainly by stronger growth from transport and communication, construction, utilities sectors and fisheries. Forestry sector is expected to weaken in the second half.

Production

Domestic production activities eased in the first half of 2015, following a strong performance in the last six months of 2014. This is reflected in the CBSI's production index which decelerated over the first half year by 17% to 78 index points. However, latest monthly production index data showed some pickup with year to July productions surpassing the same level last year. Meanwhile, the contraction in year to June productions was attributed to declines in two of the major export commodities with fish catch plunging 31% to 13,413 tons whilst logs fell by 12% to 1,077 million cubic meters. The weak performance was attributed to prolonged unfavourable weather conditions over the first half year with subdued international prices. Besides, the latest monthly data for fish and log already showed a pickup in July with the latter rising by 11% to 159,636 cubic meters while the former went up by 3% to 2061 metric tonne.

Conversely, production in agricultural commodities improved during the period. Copra production went up by 3% to 8248 tons, palm oil up 6% to 17,245 tons while cocoa rose by 10% to 2,463 tons over the first six months of 2015. On prices, the average contracted export and domestic prices for agricultural commodities deteriorated over the first half of 2015. Contracted export prices in year to June for copra fell by 0.4%, cocoa down by 1.4% and palm oil dropped by 12%. Similarly, for the same period, domestic prices for copra and cocoa slid by 1.5% and 1.1% respectively.

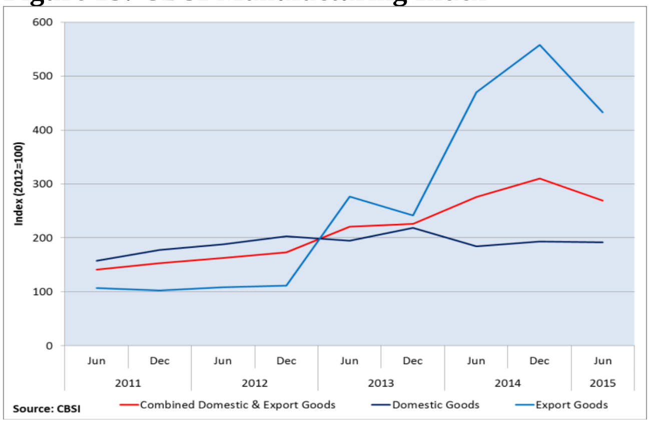
Figure 14: CBSI Production Index



Manufacturing

Domestic demand conditions, measured by the CBSI manufacturing index saw a contraction of 13% to 269 points in the first half of 2015 from 310 points in the second half of 2014. The weak performance primarily resulted from a fall in manufactured goods destined for export by 22% to 433 points as well as a marginal fall in goods for domestic markets by 0.7% to 192 points. The fall in manufactured goods for exports came from decline in manufactured fish, in particular loin and canned tuna for exports. Meanwhile, the fall in alcohol and tobacco was attributed to a decline in manufactured goods for domestic markets in the first half year.

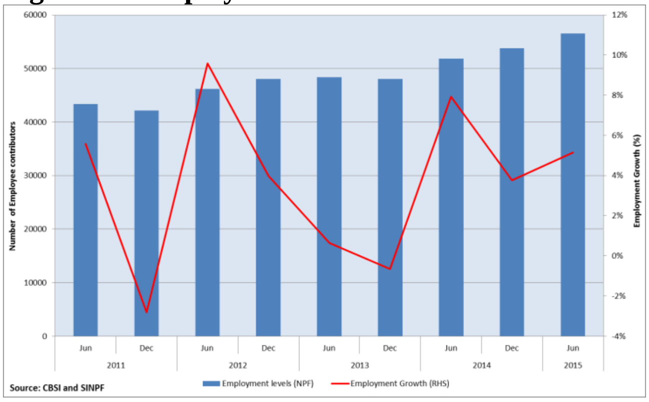
Figure 15: CBSI Manufacturing Index



Employment

Partial indicators showed labour market conditions improved further in the first six months of 2015. The average number of contributors to the Solomon Islands National Provident Fund (SINPF) showed a 5% increase to 56,566 in the first half year, much faster than the 1% increase in the preceding half year. The increase mainly came from slow active contributors rising 64% to 10,386 whilst active contributors fell slightly by 3% to 46,180.

Figure 16: Employment



Employment indicators from the CBSI job advertisement survey showed a slowdown by 19% to 817 vacancies in the first half of 2015. In terms of vacancies by industry, employment vacancies in the administration and support services accounted for the highest with 26% (210 vacancies). This was followed by public administration and defence consisting of 25% (205 vacancies) and education sector with 21% (173 vacancies). The remaining sectors accounted for 28% (229 vacancies) during the year to June.

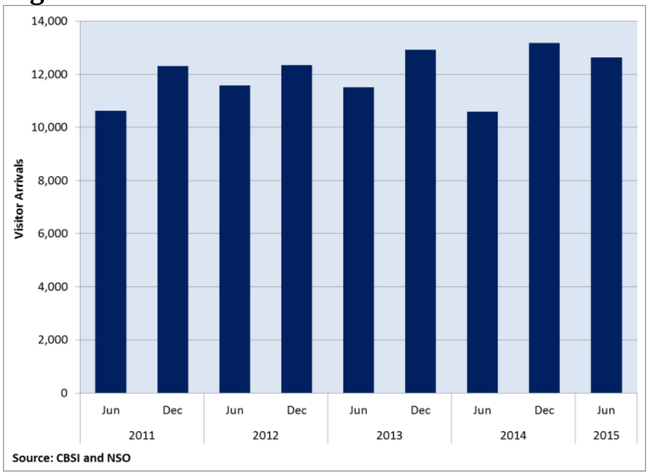
Foreign direct investment

Investment activities as indicated by the number of foreign investment applications rose 26% to 103 applications in the first half of 2015 from 82 applications in the last six months of 2014. The approved applications for the first half were estimated at a value of $1,006 million, up 62% from the preceding six months period. In terms of application by sector, retail and wholesale services accounted for the majority of applications with 35 applications. This was followed by other services comprising of 22 applications, mining with 11 applications, forestry 10 applications, construction 7 applications, and tourism with 6 applications. The remaining 12 applications were for fisheries, agriculture, manufacturing, transport and consultancy.

Tourism

Tourism activities, measured by the number of visitors arriving in the country slowed in the first half of 2015, following a strong performance in the last six months of 2014. Total arrivals by both air and sea, eased by 4% to 12,632 in the first six months compared to 13,178 in the second half of 2014. The fall came from visitors arriving by air dropping by 11% to 9,256. This more than outweighed the increase in sea arrivals from 2,787 to 3,376 during the first half year. The average length of stay for the visitors remained at 16 days in year to June.

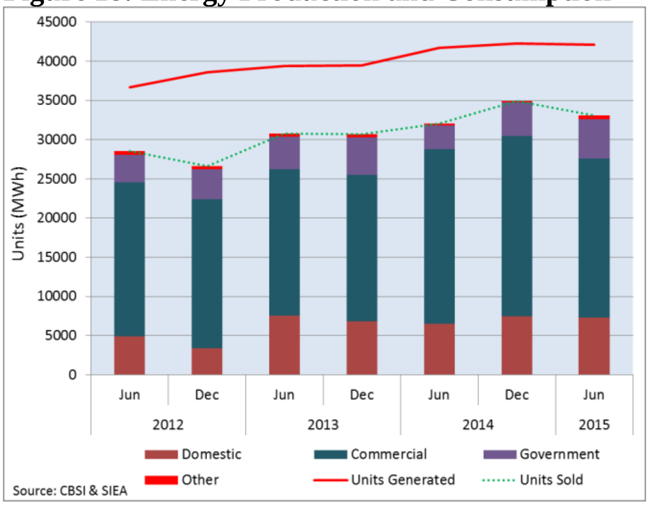
Figure 17: Visitors Arrival



Energy

Energy demand as reflected in the electricity generated eased marginally by 0.4% to 42,093 Megawatt hours (MWh) in the first half of 2015 from 42,247 MWh in the second half of 2014. Similarly, units of electricity sold fell by 5% to 33,067 MWh. This was driven a by fall in sales to commercial industries by 12% to 20,235 MWh and domestic consumers by 1.7% to 7,322 MWh during the period. Conversely, units sold to government rose by 16% to 5,045 MWh and other clients went up to 464 MWh from 162 MWh in the second half of 2014.

Figure 18: Energy Production and Consumption



Retail and wholesale

Domestic consumption, as reflected by retail and wholesale activities, eased marginally in year to June 2015. Credit issued by commercial banks to the distribution sector slipped 0.6% to $248 million. The decline mainly came from loans issued specifically for the retail and wholesale category which fell slightly by

0.2% to $224 million. Another partial indicator, import on food and beverages goods recorded in the balance of payment also showed a similar trend. Food imports dropped by 12% while beverages came down by 16%. Conversely, foreign direct investment application to the retail and wholesale sector rose considerably to 35 applications in the first half year from 16 applications in the second last six months of 2014.

Transport and communication

Activities in the transport and communication sector as indicated by partial indicators picked up in the first six months of 2015. Loans issued by commercial banks to transport and communication sectors rose 1% to $283 million in June from $278 million in the last six months of 2014. The rise mainly came from an increase in loans to transport which rose by 5% to $95 million whilst communication came down slightly by 1% to $188 million. Other partial indicators, including FDI inflows to transport services recorded in the BOP, remained unchanged at $81 million while inflows to communication went up by 29% to $18 million. Similarly FDI applications for both sectors dropped to 4 applications from 5 applications in the preceding half year.

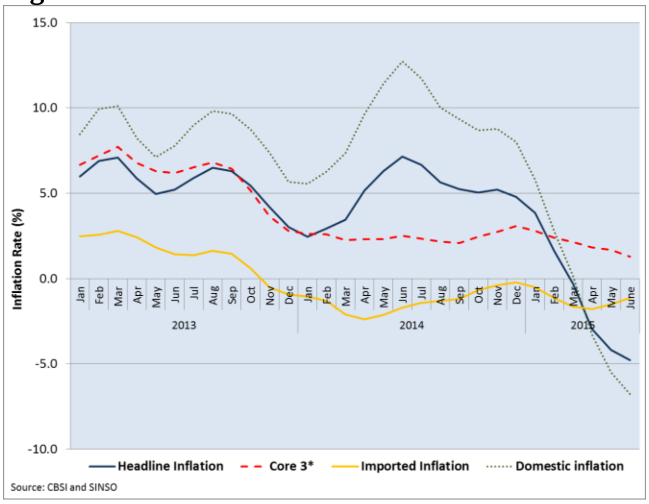
Construction

Construction activities, as indicated by various indicators, slowed in the first six months to June. Building permits in Honiara, a partial indicator for construction activities, saw a reversal during the first half year. The Honiara City Council issued 110 permits in January to June 2015 as opposed to 136 permits issued in the latter six months of 2014. The reduction came largely from decreases in permits to residential applicants by 32% to 55 while industrial permits went down by 4% to 25. The drop in permits issued came primarily in the first quarter of 2015 and more than offset the increase in the second quarter. Conversely other permits went up by 3% to 30 during the period. In terms of value of total permits, this fell by 55% to $99.5 million, driven by decline in the value of residential and commercial and industrial.

3.5 Inflation

Inflationary pressures in the country remained subdued in the first six months of 2015. Headline inflation, as measured by the three months moving average (3MM), as at end June 2015 reached a deflation of 4.8%, opposing the 4.8% inflation recorded in December. This is well below the Bank’s March inflation forecast range of 3%-5% for 2015. However, the latest monthly data for July showed inflation picking up to minus 3.8%. The deceleration in headline inflation in year to June was largely triggered by a considerable fall in the domestic inflation component to minus 6.8% from 8.0% in December 2014. The fall in domestic inflation was a result of a plunge in the food prices to minus 17.4% in June from 8.4% in December. Imported inflation also remained subdued at minus 1.1% over the same period, owing to low inflation in trading partner countries and the appreciation of the SBD against the AUD and NZD during the period.

Figure 19: Headline and Core Inflation

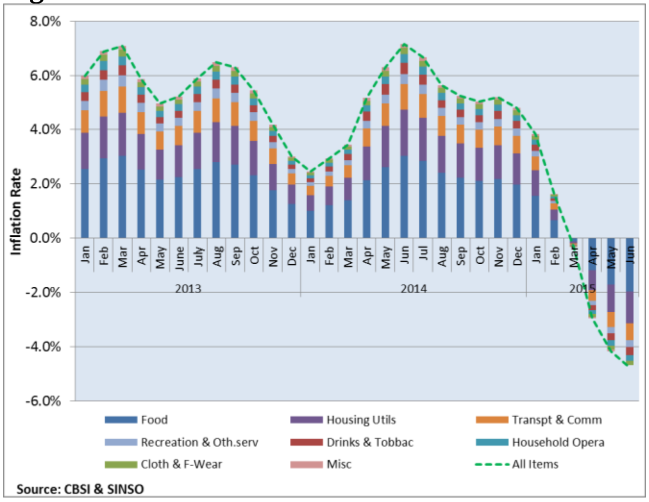


*excl. volatile, controlled & excise items

In terms of the drivers of the downward trend in the Honiara Retail Price Index (HRPI), the fall to minus 4.8% in June owed mainly to the drastic weakening in prices of drinks and tobacco declining from 7.9% in December 2014 to minus 11.1% in June 2015. This was followed by a deceleration in prices of food from 4.2% to minus 9.1%, housing and utilities from 9.2% and transport and communication from minus 1% to minus 2.9% for both categories. By component, of the overall minus 4.8% inflation, food and housing and utilities accounted for minus 3.1% with food representing the largest proportion at minus 1.9% and the latter at minus 1.2%. Other headline inflation components including drinks and tobacco, clothing and footwear, household operations, recreational health and other services and miscellaneous items together contributed the remaining minus 1.64%.

Similar to headline inflation, much of the deceleration in domestic inflation came from food falling to minus 17.4%, drinks and tobacco down to minus 12.4% and housing utilities to minus 1.7%. Of the minus 6.8% in domestic inflation, food, housing and utilities and transport and communication accounted for a combined minus 5.5%. Food prices accounted for minus 2.6%, the largest proportion, whilst housing and utilities and transport and communication represented minus 2.1% and minus 0.9%, respectively. The remaining minus 1.25% came from drinks and tobacco, clothing and footwear, recreational health, and other services and miscellaneous items.

Figure 20: Contributors to Inflation



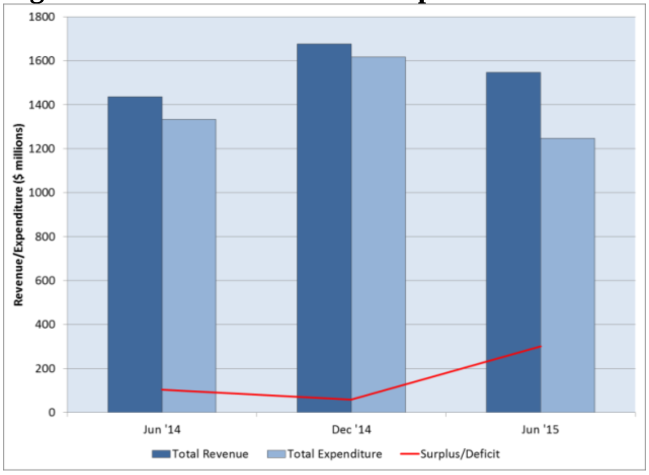
The persistent deflation in the imported component since the second half of 2013 also contributed to the decline in headline inflation in June 2015. Imported inflation fell further to minus 1.1% from minus 0.2% in December. This was associated with significant deterioration in transport and communication which fell to minus 13.6% in June from minus 2.8% in December and housing and utilities which decline to minus 7.7% from 2.4%. Of the minus 1.1%, food represented the largest proportion with minus 0.5% in the first six months. This was followed by housing and utilities and transport and communication dropping to minus 0.15% and minus 0.14%, respectively. The rest of the imported inflation components including drinks and tobacco, clothing and footwear, household operations, recreational, health and other services and miscellaneous items made up the remaining minus 0.3%.

Nonetheless, underlying or core inflation showed a measured decline to 1.7% in June from 3.1% in December 2014. This deceleration is primarily due to a considerable fall in housing and utilities from 9.2% in December to minus 0.7% in June.

3.4 Fiscal Conditions

Preliminary figures show a surplus of $300 million over the first six months of 2015, considerably greater than the $60 million surplus observed in the second half of 2014. This excess in the surplus stemmed from low spending over the first half of the year, with close to no capital expenditure recorded in the first quarter of the year. Prior to the budget being passed in April, expenditure was kept to a minimum.

Figure 21: Total Revenue and Expenditure



Revenue

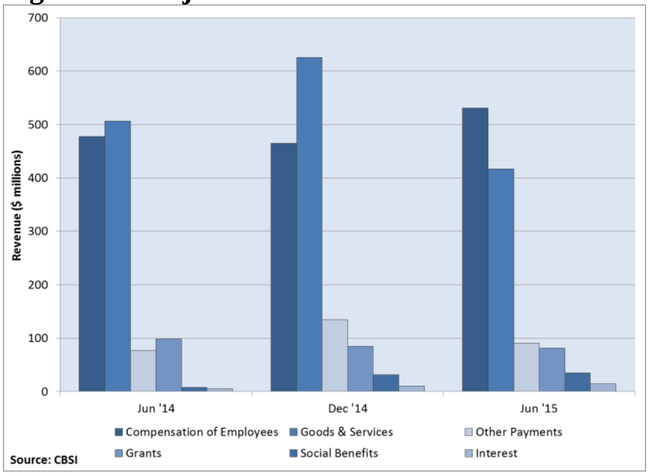
Revenue collection over the first half of 2015 totalled $1,547 million, an 8% decrease against the second half of the 2014, and 12% below budget. This decrease was driven primarily by a fall in both tax and non-tax receipts which outweighed the increase in grant receipts over the period. However, compared to the same period in 2014, overall revenue collection fell 8%.

Tax receipts, which constituted 79% of total revenue, fell by 10% against the second half of 2014 to $1,219 million. This figure was 3% lower than budgeted for the period, but still a 5% increase from the same period a year prior. This fall was a result of reductions in most tax categories with tax on international trade and transactions falling 11% to $506 million, tax on income, profits and capital gains falling 8% to $418 million and tax on goods and services falling 13% to $279. Meanwhile, tax on property recorded the only increase of $5 million to $16 million.

Non-tax revenue recorded a fall of $42 million to $176 million, contributing 11% of total revenue. Nonetheless, this was still 27% above budget and 11% higher than the same period last year. Driving this fall was a fall in property income and sales of goods and services by 21% and 15% to $140 million and $35 million respectively. Moreover, overseas fishery licence fees and receipts from sale of treasury bonds fell by $46 million and $44 million respectively.

Grant receipts, primarily in the form of budget support, contributed 10% to total revenue and registered an increase from $99 million in the second half of 2014 to $152 million over the six months to June 2015. The main donor contributors over the review period were New Zealand Aid with $66 million, Australia Aid with $43 million, and the World Health Organisation with $41 million.

Figure 22: Major Sources of Fiscal Revenue

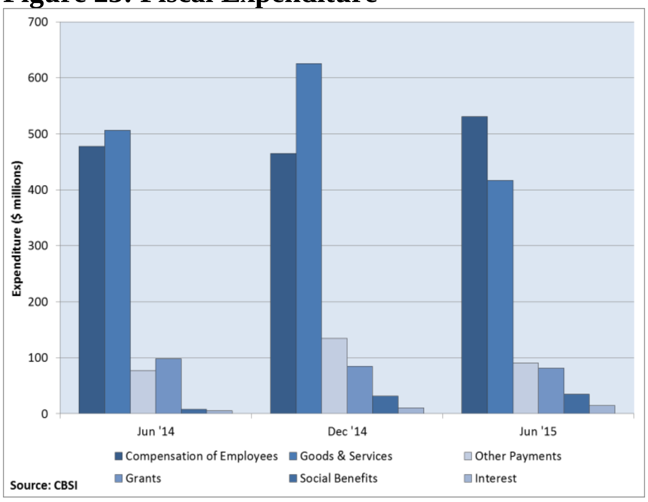


Expenditure

Expenditure over the first half of 2015 came to $1,247 million, less than half the amount in the budget. In particular, while recurrent spending fell by 13% between the second half of 2014 and the first half of 2015 to $1,171 million, capital spending plunged 71% to $76 million. These contractions in expenditure largely stemmed from the slow start from the first quarter of the year as the budget awaited approval.

In terms of recurrent spending, purchase of goods and services saw the biggest contraction falling from $626 million to $417 million over the period, followed by other payments from $135 million to $91 million. Grant payments to other government agencies also decreased marginally by $4 million to $81 million. On the other hand, compensation of employees increased by 14% to $531 million. Interest payments and social benefit payments also went up by $4 million and $3 million to $15 million and $35 million respectively. Meanwhile, driving the fall in capital spending was a $188 million fall in spending on fixed assets to $70 million, largely due to a fall in spending on buildings and structures.

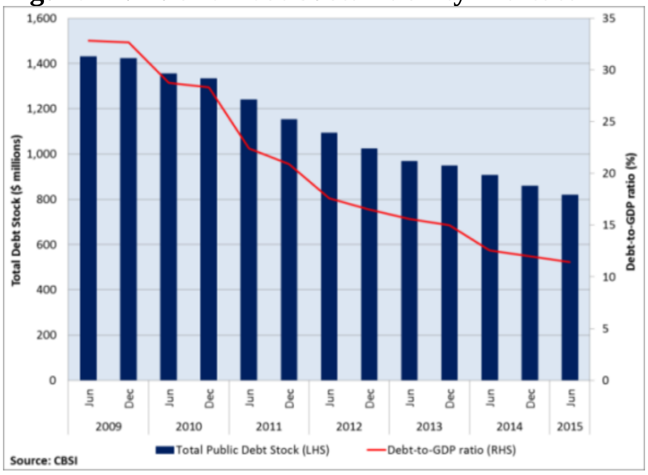
Figure 23: Fiscal Expenditure



Public Debt Stock

Public debt stock in June had fallen by 5% against December 2014 to $820 million. 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 $666 million and domestic debt $154 million. During the review period, debt repayments totalled $48.5 million, up 6% from the second half of 2014. Of these repayments, $43 million went to principle repayments while the remaining $5.5 million was interest payments. Meanwhile, debt sustainability indicators for Solomon Islands remained within acceptably low thresholds with the debt to GDP ratio falling to 11% from 12% in December 2014.

Figure 24: Public Debt Sustainability Indicator



4.0 Economic Outlook

External Outlook

The global economic growth prospect for 2016 is projected to strengthen to 3.8%[6] from the estimated 3.5% this year. Growth in advanced economies is projected to rise to 2.4% in 2016 from an estimate of 2.1% in 2015 driven by solid consumption and investment in US, improvements in productivity and capital formation in Japan, and economic recovery in the euro area staying broadly on track. Growth in emerging market and developing economies is expected to pick up to 4.7% in 2016 following the slowdown in 2015. This is anticipated to result from a rebound in activity in a number of distressed economies in Africa, Middle East and Eastern Europe that had been facing geopolitical factors.

Broadly in line with global economic growth prospects, Solomon Islands major trading partners in 2016 are expecting growth to remain positive, albeit at

[6] All statistics in this global outlook section is obtained from The IMF World Economic Outlook, April and July 2015 updates.

different paces. China's economic growth is expected to slow further to 6.3% in 2016 from the 6.8% estimate in 2015, as anticipated from continued slower investment particularly in real estate. Similarly, a slowdown is expected in New Zealand easing to 2.7% in 2016 from 2.9% estimate in 2015 as a partial result of the slowdown in China which is the major importer of New Zealand's dairy products. Meanwhile, Australia is expecting growth to rise above 3% in 2016 and through the medium term in anticipation of strong resource exports, accommodative monetary policy, and rising confidence.

As the effect of lower oil prices on general consumer prices fades, inflation in advanced and developing economies are expected to pick up slightly to 1-2%. However, inflation in emerging and developing economies is forecast to trend downward slightly, although at stable rates around 4-5% with commodity prices projected to remain relatively low across most categories. Inflation in Australia and New Zealand is forecast to pick up softly though expected to be within their target band of 2-3%.

Domestic outlook

Growth in the domestic economy was revised downward from 3.3% in the first half of 2015 to 3.2% in the second half of the year. The slowdown reflected weaker than expected mid-year actuals across several sectors. Nonetheless, the sectors that are expected to drive the economy in 2015 are fishing, manufacturing, construction, and transport and communications sectors. The anticipated increase in public expenditure in the second half of the year could also contribute to overall growth.

Headline inflation has rebounded as expected from minus 4.8% in June to minus 1.2% in August. This trend is expected to rise to the lower end of the March forecasted range of 3% - 5% by December 2015. The resurgence reflects renewed upward pressures from the domestic components of inflation together with energy prices in the imported component. Further upside risk is expected to come from the strong USD. Nonetheless, core inflation is expected to be at an average of 2% at the end of 2015.

The Solomon Islands current account deficit is estimated at 5% of GDP by end of 2015, almost the same level as in 2014. The recent estimate has been revised down from 9% of GDP in the last monetary policy stance following higher than expected receipts on round log exports and donor inflows in the first half of 2015. The surplus in capital and financial account is estimated at 7% of GDP, higher than the deficit in current account. Consequently, official foreign reserves are estimated to rise by 5% and will be sufficient to cover 10 months of imports.

The current account deficit for 2016 is forecast to worsen to 7% of GDP as a result of a growing deficit in net exports of goods and services. Import demand is expected to increase on the back of higher domestic consumption, as well as public and private capital investment. Exports would improve slightly from 2015 driven mainly by the agriculture and fisheries export commodities on higher production and relatively steady world prices for palm oil, copra, cocoa and fish. The weak SBD particularly against USD is also an added boost to export receipts. However, forestry exports are forecast to trend downwards owing to adverse supply and demand with slower growth prospects in China, the main importer of Solomon Islands' timber products.

Meanwhile surplus in the capital and financial account in 2016 is forecast to expand to 10% of GDP driven by anticipated donor inflows for capital infrastructure developments towards the transport, energy and communication sectors. These capital projects are expected to attract higher imports that would be reflected in the current account. Some receipts are also expected on foreign investments in the services, manufacturing, and mining prospecting sectors.

The exchange rate policy of the CBSI remains unchanged with the local dollar pegged to a basket of currencies that is dominated by the major trading currencies. The US dollar has been strengthening following positive economic performance in the US and analysts expect the US dollar to remain strong going forward into 2016. Conversely, analysts point to a depreciating trend of the Australian dollar on the back of strong US dollar as commodity prices continue to soften and concern on the slowing Chinese economy. These developments could see a further depreciation in the SBD against the USD while appreciating against the AUD.

Reserve money and overall money supply are expected to pick up further in the remaining half of 2015, in line with the growth level in the first half. The increases are expected to be driven by growth in CBSI's net foreign assets and possible rise in public expenditure in the second half. Given recent macroeconomic conditions, the Central Bank does not envisage a further increase in the level of Bokolo bills available for tender and the cash reserve requirement. Following this, excess liquidity is expected to increase by 23% by the end of 2015 following a contraction of 24% in 2014 as a result of exceptionally low levels in December. Furthermore, private sector credit is projected to continue growing, albeit slightly lower than the 16% performance of 2014 with projections of 10% and 9.8% in 2015 and 2016, respectively.

Following a delay in the adoption of the 2015 national budget, fiscal activity remained relatively subdued during the first six months of the year despite projected budget spending of $4.1 billion for the fiscal year. The moderate outcome was reflected in year-to-July results showing only $1.6 billion having been expended. Nonetheless, the Government is expected to ramp up spending over the remainder of the year, but is unlikely to achieve the full extent of the 2015 budget. Based on this assumption, the Government could be seeing a smaller deficit in December than the budgeted deficit of $462 million.

5.0 Monetary Policy Stance

The CBSI conducts open market operations through the 28 days Bokolo bills which are issued on a fortnightly basis. Currently CBSI floats $710 million per month with a take up volume that averages below the $710 million per month, but has picked up in recent auctions. The CBSI also administered the SIG Treasury bills, which remains capped at $40 million. This facility has been used sparingly by the Government to meet short term financing needs on previous occasions.

Using the cash reserve requirement (CRR), which currently obligates each commercial bank to maintain the equivalent of 7.5% of their respective deposit liabilities with CBSI, the Central Bank has at its disposal a direct instrument to influence money supply. Going forward, the CRR ratio will be reviewed by the MPC and the Central Bank Board on a quarterly basis and any adjustments will be announced by the Governor.

Exchange rate policy remains another important policy tool for the Bank given the country's openness and pass through inflationary effects. The Bank will continue to maintain the peg against the currency basket and ensure that the trade weighted index is stable, even as some currency volatility is observed in various international currencies including the USD and AUD. Economic stakeholders can monitor the performance of the currency basket from the trade weighted index that is published on the CBSI website. Furthermore, the Central Bank is exploring the option of engaging in Repo transactions with commercial banks in order to address structural liquidity.

Given the recent economic developments and near term macro projections, the Central Bank maintains its accommodative monetary policy stance in support of economic growth. The Central Bank will also work with the Government on key financial sector reforms to encourage financial deepening and financial inclusion.

The CBSI will continue to monitor economic developments and take appropriate action as and when necessary to achieve the intermediate targets including maintaining an adequate level of reserves, stable exchange rate basket and stable prices.