CENTRAL BANK OF SOLOMON ISLANDS

MONETARY POLICY STATEMENT
SEPTEMBER 2016

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1 Economic Overview

Global economic conditions in 2016 remain positive despite heightened risks. The global economy has been projected to grow by 3.1% in 2016, a downward revision of 10 basis points from the March forecast. The downward revision came as a result of the Brexit referendum which raises economic uncertainty compounded geopolitical tensions happening around the globe. Advanced economies are projected to grow by 1.8%, down from an earlier projection of 1.9% on the back of positive performances from the US and Japanese economies. Euro area is forecasted to grow by 1.6% in 2016. Growth projection for the emerging and developing economies remains unchanged at 4.1%. China, an important trading partner for Solomon Islands, has revised growth upward by 10 basis points to 6.6%. Australia and New Zealand are projecting growth to moderate to 3% and 2.5% respectively.

Commodity prices as measured by the world commodity price index have broadly risen against the previous year, reflecting increases in both food and non-food categories. Tapis oil price trended upward in recent months to US$49.98 per barrel but is comparatively lower than the average price of US$54.44 in 2015. Meanwhile, prices of rice and sugar moved upward while the price of wheat subdued.

Global inflation is relatively weak and remains within central banks' target range. More importantly, Solomon Islands major trading partners such as China, Australia and New Zealand have recorded low inflation levels.

On the domestic economy, economic growth for 2016 is projected to rise slightly by 30 basis points against the previous March forecast to 3.2%. Year to date performances from forestry, agriculture, wholesale and trade, transportation, and construction sectors are on the upside and projected as the major drivers behind growth this year. Contribution from the government remains positive but lower than anticipated due to weak revenue collection that affects spending plans.

Monetary developments pointed to subdued growth against the previous half year. Reserve money expanded by 3% over the six months to June to $2,344 million as opposed to a 7.6% growth in December 2015. Broad money also increased by 6% to $4,432 million, in line with marginal credit growth, net external inflows and drawdown of government deposits.

Credit grew by 4% in year to June to $2070 million compared to the 10% growth in the second half of 2015. The sectors that recorded large increases were construction, distribution, forestry, tourism, and transportation. Interest rate margin declined further in June to 9.18%, indicative of growing banking competition and slight improvements in risk conditions.

The commodities sector recovered in the six months to June, boosted by a rebound in logging activities in the second quarter combined with buoyant performances in palm oil and coconut oil as well as an uptick in commodity prices that cushioned falls in copra and cocoa volumes.

Proxy indicators for construction, communication and tourism were upbeat pointing to another strong year. This is consistent with energy demands both from households and businesses that have been steadily growing. Labour market conditions improved slightly, reversing the slump in the second half of last year. However, manufacturing slowed down following falls in the domestic component.

External conditions improved markedly in the first half of 2016 from a balance of payments deficit of $267 million in the preceding half year to $62 million surplus, owing to remarkable improvements in the capital and financial account that outweighed the widening current account deficit. Foreign reserves, which picked up by 1% against December 2015 to $4,223 million in June, was equivalent to 10.3 months of imports. The positive outcome was attributed to rising inflows and a fall in outflow payments.

Exchange rate developments as measured by the trade weighted index showed the local currency (SBD) had appreciated since December 2015. This was largely influenced by adverse global exchange rate developments that drove other major currencies to weaken against USD.

The fiscal sector performed weakly against budget. Shortfalls in revenue collection had affected spending plans in 2016. In the six months to June 2016, the government recorded a deficit of $216 million, half of the deficit anticipated for the year. However, revenue and expenditure were slightly higher than the same period in 2015.

Public debt declined further to $669 million, a fall of 18% year on year and 4% against December 2015. Following repayments made in the first half of 2016, external debt dropped to $625 million while domestic debt which comprised mainly of treasury bills stood at $44 million.

The global economy is envisaged to remain positive over the period 2016-2018 despite risks that heightened as a consequence of economic and financial uncertainties. Oil price, which had risen in recent months is not expected to reach the price levels in 2015 and may continue to support activities in oil importing countries.

Near to medium term growth projection for the domestic economy remains positive at around the trend rate of 3%. While contribution from forestry is expected to decline in the medium term, activities in the mineral sector are expected to pick up over the coming years with associated construction phase expected to kick in a bit earlier. Public investments in major capital infrastructures such as roads, wharves and bridges are also expected to contribute to growth by enhancing productivity in the medium to long term.

2 International Economic Developments

Global Economic Growth

The global economy was forecasted to grow by 3.1%[1] in 2016, broadly in line with 2015 economic growth. The global growth although slightly lower than previous forecast, is expected to be supported by slight improvements to few emerging markets in the first half of the year. Relative to its April forecast, the downward revision of 0.1 percentage point reflected sizable uncertainty still unfolding from the UK referendum known as the Brexit. Pertaining to the recent IMF update, key assumptions behind the revised growth consisted of; gradual reduction in uncertainty, optimal negotiation outcomes between European Union and the United Kingdom, no major financial disruption and limited political fallout from the referendum.

Growth in the advanced economy is expected to remain lacklustre as a result of growing uncertainties emanating in the aftermath of the Brexit vote. Growth was revised downward by 10 basis points to 1.8%. The United Kingdom itself showed largest revision of 0.2 percentage points in 2016 and one percentage point in 2017 as unfolding effects of the fallout are likely to materialise in 2017. Likewise, growth in the United States was downgraded to 2.2% in 2016. This outcome reflected weakened business strength and waned manufacturing investments resulted from low oil and gas prices. Furthermore, weak external demand, exchange rate appreciation and somewhat tighter financial conditions weigh heavily on recovery in the US economy. Growth for Japan is expected to slow further from 0.6% previously forecasted to 0.3% in June 2016. This reflected weaker domestic demand resulted from increase in consumption tax and appreciation of Japanese yen.

The euro area economy grew at an above-trend rate to record 1.6% in the first half of 2016, although heightened uncertainty following the outcome of the United Kingdom's referendum could dampen output growth in the period ahead. The brunt of the impact of Brexit is not expected to materialise in the euro area in 2016 as negotiations are expected to drag on for a period of 2 years. As a result, growth for 2017 was forecasted to decline by 0.2 percentage points to 1.4%.

In the emerging and developing economies, growth is expected to remain unchanged relative to April 2016 outlook at 4.1%, slightly higher than 2015 and grow further in 2017 to 4.6%. These emerging economies continued to support global growth. The Chinese economy is recovering with improved near term outlook on the back of policy support that strengthens domestic demand. The effect of the U.K referendum on China is likely to be limited in light of China's low trade and financial exposure to the United Kingdom. On the other hand, India economic growth was expected to slow down a little by 0.1 percentage point reflecting a more sluggish investment recovery but trends above 2015 growth due to strong consumption growth.

Turning to the country's closest major trading partners, Australia and New Zealand expected moderate growths in 2016 of 3% and 2.5% respectively. This growth is supported by strong net immigration, construction, tourism, accommodative monetary policy, robust private consumption and fixed investment. These outweighed the weak exports, arising from low commodities prices, subdued demand and an appreciation of the New Zealand dollar. Growth for 2017 is forecasted to grow by 2.6%.

International Commodity Prices

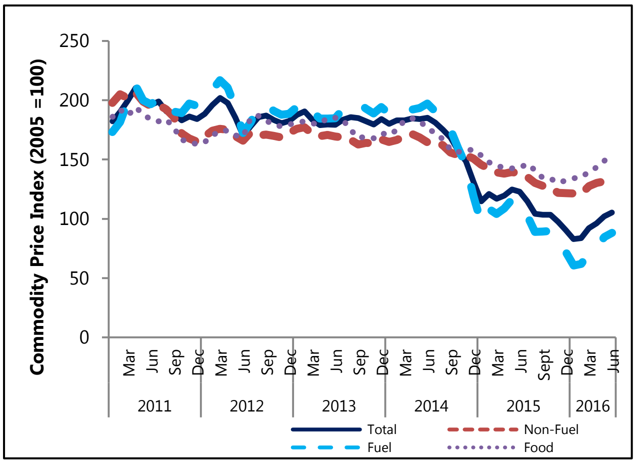
According to the World Commodity Price Index[2], global commodity prices rebounded since end of the first quarter. Price index now went up by 16% to 105 point against the final quarter of previous year and 12% above year-on-year. Driving these were increases across all price indices with food price index rising by 17% to 155 points, food and beverage index went up by 15% against December 2015 while non-food rose by 11% to 135 points.

[1] All statistics in this section obtained from IMF World Economic Outlook, July 2016 Update unless otherwise stated.

[2] *http://www.indexmundi.com/commodities/?commodity=commodity-price-index&months=300*

Likewise Tapis oil price that Solomon Islands normally paid for oil imports, has been picking up gradually since the beginning of the year, up by 7% to US$47 per barrel against December 2015 levels. However, year-on-year still showed 25% below same period a year ago.

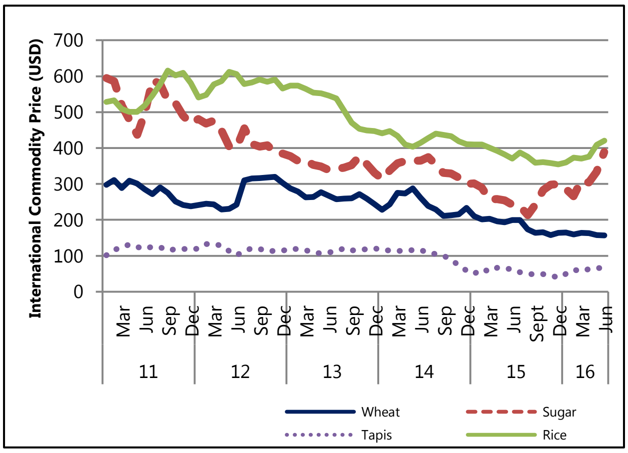
Figure 1: Commodity and Food Price Indices



Source: IMF

International food prices, as indicated by the IMF food price index, increased sizably by 17% in the first half of 2016 to reach 155 points in June 2016. This increase was driven by price indices rising across the board. More important for the Solomon Islands were the surges in the average prices of rice and sugar relative to the final quarter of 2015 by 19% and 30% respectively to more than offset the fall in average price of wheat by 4%. Over the first half of 2016, rice price went up to an average price of US$420 per ton while sugar surged by 30% to US$388 per ton. Meanwhile wheat price fell by 4% to US$156 per ton against December quarter of previous year.

Figure 2: International Commodity Prices



Source: IMF

Global Inflation

Global inflation remained low in the first half of 2016 reflecting sluggish demand and eased economic prospects in most advanced economies[3]. Inflation in the major advanced economies remains below their respective central banks' target inflation rates. Contributing to the decline are longer term market based inflation expectations in the United States and euro area which coincided with the decline in oil prices in recent past months.

For Solomon Islands' major trading partners, inflation still moderated. China's inflation rate remained low at 1.8% reflecting weak general consumption and rebalancing, despite positive prospect in infrastructure investment and credit growth for the rest of the year. Inflation in Australia[4] fell further to 1.0% by June 2016, broadly in line with May monetary policy statement. Reflecting this, were general weaknesses in labour market conditions and pressures on cost margins over the first half of the year. Similarly, inflation in New Zealand remains around historically low levels of 0.4%[5] reflecting downward pressures from subdued underlying inflationary pressures from energy prices and modest nominal wage growth.

3 Domestic Economic Developments

Monetary Conditions

Monetary conditions eased in the first half of 2016 relative to the preceding half year. Key monetary aggregates such as reserve money and broad money supply grew at slower rates. Credit growth also slowed down. Interest rate margin dropped owing possibly to growing competition in the banking sector.

Reserve Money

Reserve money rose by 3.8% in the six months to June 2016 to $2,344 million compared to the 7.6% increase in December 2015. The growth was underlined by increases in both CBSI net foreign assets and net domestic assets. Of the total reserve money, currency in circulation represented 32%, required reserves at 13%, and Other liabilities to ODCs at 55%.

Money Supply

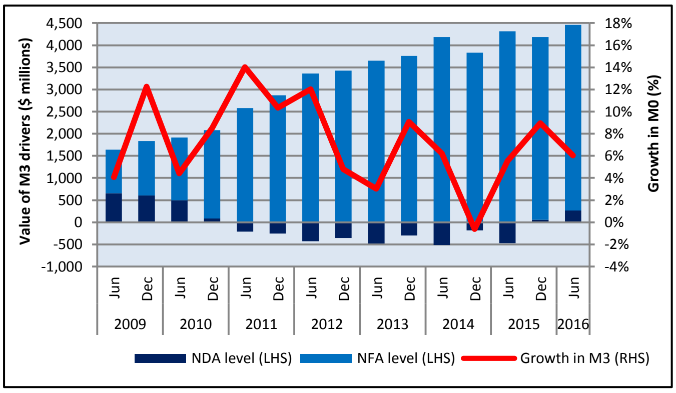
Broad money continued to expand albeit at a slower pace of 6% against December to $4432 million. The deceleration mirrored similar movements in key components such as liabilities to the government and credit to private sector. The increase was primarily

[3] http://www.rba.gov.au/publications/smp/2016/aug/
[4] http://www.rba.gov.au/snapshots/economy-snapshot/
[5] Reserve Bank of New Zealand, retrieved from www.rbnz.govt.nz/monetary-policy/inflation [August 2016]

driven by net domestic assets which rose by almost fourfold to $269 million and in part to a 1.5% increase in net foreign assets to $4189 million. In June, the banking sector's net foreign asset totalled $4,189 million and net domestic assets at $269 million.

Transferrable deposits as a ratio of broad money increased its share from 62.6% in December 2015 to 63.8% in June 2016. This implies that a large number of people are holding money in its liquid form. The other components of broad money such as currency in circulation and other deposits recorded marginal declines to 15.1% and 21.0% respectively.

Figure 3: Money Supply

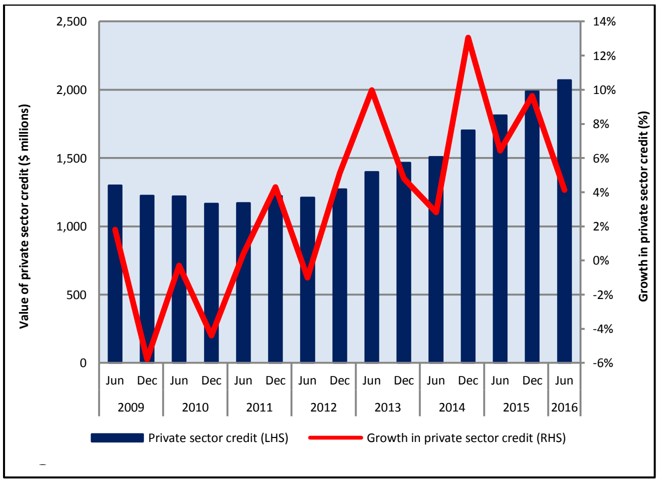


Source: CBSI

Credit Conditions

Credit to private sector in year to June continued to show an increase but at a much slower pace than the previous six months. Total credit rose by 4% against December to $2070 million, slowing from the 10% growth in the second half of 2015. Key sectors that benefited most from the increase were construction, distribution, forestry, tourism, and transportation. On the other hand, personal, communications, and manufacturing were among the other sectors that recorded huge declines.

Figure 4: Credit to Private Sector



Source: CBSI

Loans category which accounted for 89% of total credit grew by only 2.7% to $1,820 million, a relatively weaker growth against 11% in the second half of 2015. Overdrafts, which represented 10% of total loans, gained 17% against December to $204 million while lease financing rose 23% to $16 million.

Interest Rates

Interest rates declined in the first half of 2016. Deposit rates dropped by 4 basis points against December to 0.15% while lending rates fell by 88 basis points to 9.18%. As a result of these movements, weighted average interest rate margin declined by 7 basis points to 9.18%. Sectors that recorded marginal declines in their lending rates were professional and other services, distribution, construction, agriculture and tourism. Sectors that registered increases by more than one percentage point were non-residents, fisheries, personal, and mining and quarrying.

Liquidity

Liquidity conditions showed modest growth in year to June. Free liquidity rose by 3% to $1,310 million in the six months to June, a slowdown from the 6% increase in the second half of 2015. The weak growth in liquidity levels was expected in view of modest growth in credit to private sector and drawdown in government deposits from other depository corporations. Cash reserve requirement which remained at 7.5% of total deposits removed $293 million from the liquidity system, an increase of $30 million from December 2015.

Open Market Operations

Open market operation activities were sustained at the same level and also contributed to the slower growth. Auctioned bokolo bills volume was maintained at $710 million as in the second half of 2015 while the volume of issued Treasury bills remained below the $40 million cap. Weighted average interest rate for bokolo bills remained at 0.62%. Interest rates for the 56 days and 91 days treasury bills remained the same at 0.34% and 0.46% since April 2015. However interest rate for the 182 days Treasury bill fell by three basis points against December to 1.12%.

External Conditions

External sector conditions in the Solomon Islands improved markedly in the first half of 2016 compared to the sluggish performance in the previous period. This was due to the positive flows in the capital and financial account and offset the deterioration in the current account during the reference period. Moreover, the external sector result over the previous three six-month periods also closely tracks with the movements of the capital and financial account. This reflects the inflow and the importance of overseas donors and private investment funds for the economy.

The upturn in the external sector position in the year to June 2016 to surplus 1% of GDP from deficit 3% of GDP in the July to December 2015 period is evident from the favourable trends in the balance of payments transactions. In particular, the trade in goods witnessed an improvement from deficit 1% of GDP to surplus 1% of GDP during the period. The donor-funded capital account also advanced to 2.1% of GDP from 1.6% of GDP. While, the financial account associated with foreign direct investment activities posted a surplus of 1% of GDP in the first six months of the year as opposed to a deficit of 2% of GDP in the last six months of 2015.

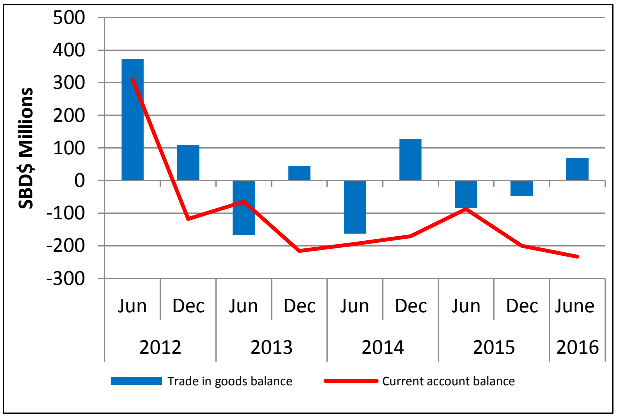
Current Accounts

The current account deficit widened to $234 million in the year to June 2016 from $200 million in the last half of 2015. This negative movement primarily stemmed from the widening of the trade in services deficit and the large deficit in primary income. Additionally, the decrease in the secondary income surplus also contributed to the outcome. On the other hand, the trade in goods posted a surplus turnaround not witnessed since the second half of 2014.

The trade in services deficit worsened from $333 million to $468 million in the first six months of 2016 on the back of higher payments related to transport and travel services. Primary income, while relatively improving from a deficit of $108 million in the last six months of 2015 to a deficit of $101 million in the reference period was still significantly high compared to the same period one year ago. The large deficit emanated from the fall in inflows from fishing licences and the sizeable outflows associated with reinvested earnings and dividend payments of foreign companies. Meanwhile, secondary income went down by 8% to $265 million in the year to June 2016 compared to the previous six months. This was mainly due to the fall in donor-funded cash grants to government and a rise in outflows by foreign workers in the country.

In contrast, trade in goods upturned to a surplus of $70 million in the first half of the year compared to a deficit of $47 million in the last half of the previous year. This positive outcome came on the back of a larger fall in imports by 14% to $1,571 million that offset a decline in exports by 8% to $1,641 million. The decrease in imports stemmed from the reduction in payments for machineries, fuel, miscellaneous goods and basic manufactures. On the other hand, the drop in exports came from the fall in receipts for fish and forestry products that counteracted a rise in agricultural products such as palm oil, cocoa and copra.

Figure 5: Trade and Current Account Balances



Source: CBSI

Capital and Financial Account

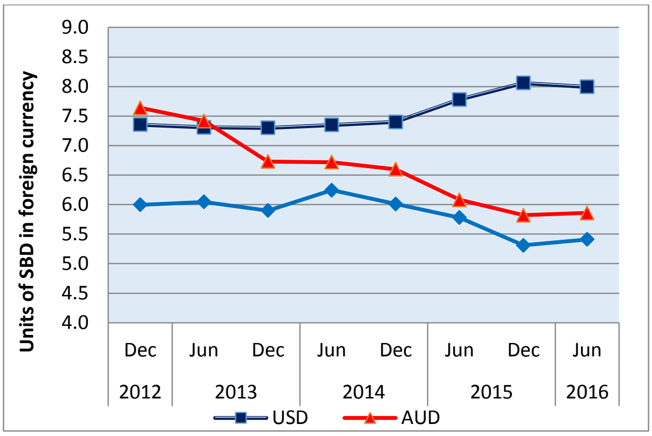
The capital and financial account registered a surplus of $258 million in the first half of 2016 compared to a deficit of $21 million in the last half of 2015. This positive result reflected the significant growths in both the capital account surplus and a turnaround in the financial account. The capital account surplus rose from $134 million to $183 million on the back of a rise in non-appropriated donor-funded infrastructure capital projects that were completed during the period. While, the financial account improved to a surplus of $76 million from a deficit of $155 million due to a rise in direct investments and a relative improvement in other investments.

The improvement in direct investment from a deficit of $89 million to a surplus of $120 million came from the increase in inward foreign direct investments associated with reinvested earnings and an uptake in external debt by foreign enterprises from their parent companies. Deficits in Other investments narrowed from $65 million in the last half of 2015 to $44 million in the first six months of 2016. This was associated with the reduction in other investment liabilities as private companies serviced their loans during the reference period.

Exchange Rate

The inflation-based real effective exchange rate (REER) strengthened on average by 3.7% to an index of 154.0 during the first six months of 2016. While, the nominal effective exchange rate (NEER) on average remained the same at an index of 101.1, the REER appreciation reflected the relatively higher inflation in the Solomon Islands. This suggests that the country's exports were relatively less competitive against its trading partners during the period.

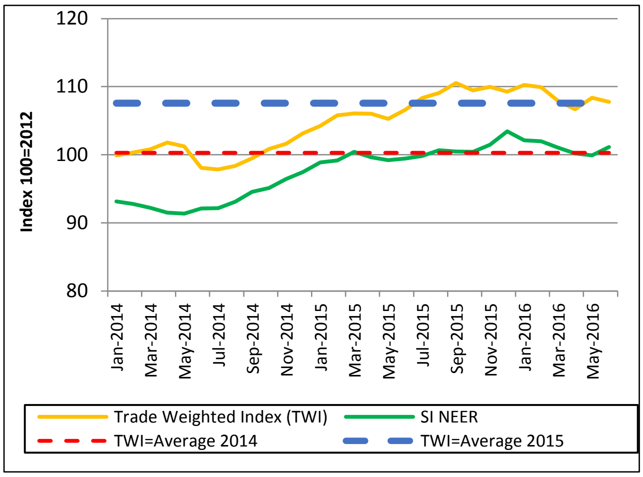
Figure 6: Nominal Bilateral Exchange Rates



Source: CBSI

Meanwhile, the movements of the SBD against the invoiced basket of currencies during the period resulted in the invoice-trade-weighted index (TWI) to appreciate by 0.9% to an index of 108.5 in the year to June. This reflected the strengthening of the SBD against the United States dollar (USD) and the British Pound (GBP). The SBD appreciated by 0.8% against the USD to $7.99 per USD and by 7.7% against the GBP to $11.45 per GBP in the aftermath of the Brexit vote. However, against the Australian dollar, the SBD went down by 0.6% to $5.86 per AUD and against the New Zealand dollar by 1.9% to $5.54 per NZD during the first half of 2016.

Figure 7: Trade Weighted Index

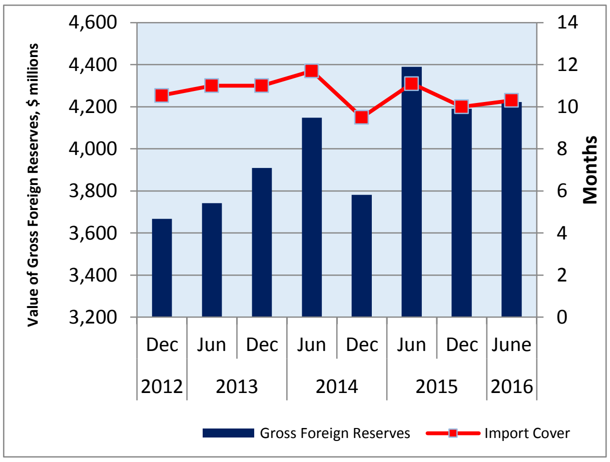


Source: CBSI

Reserves

Solomon Islands gross foreign reserves rose by 1% to $4,223 million at end June 2016 and reversed the 4.5% decline to $4,190 million at the end of December 2015. This positive outcome was mainly from the 5% increase in transaction inflows to $1,392 million, along with the 17% fall in transaction outflows to $1,338 million. The upturn in inflows was associated with the rise in donor receipts channelled through CBSI, export receipts and Central Bank interest income on its investments while the fall in outflows was related to the fall in import payments. Accordingly, this level of gross foreign reserves was equivalent to 10.3 months of import cover, relatively higher than the import cover of 10.0 months at the end of December 2015.

Figure 8: Gross Foreign Reserves



Source: CBSI

Domestic Conditions

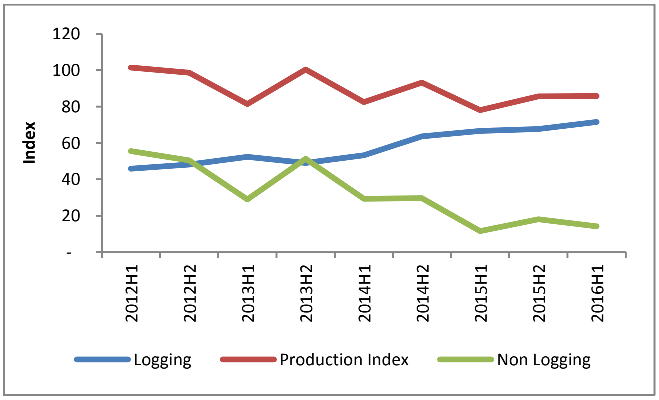
Economic Growth

The domestic economy is projected to record a higher growth than the March projection. Growth for 2016 has been revised upward by thirty basis points to 3.2%, reflecting growths in the major categories. According to the revised projections, primary sectors is expected to rise by 1.5%, industry sectors up by 4.5% and services sector up by 3.9%. While the growth in primary and services sectors are lower than the previous year, industry sectors bounced back from the negative growth in 2015.

Production

The productive sector of the economy recovered in the second quarter after a slow start to the year. The turnaround stemmed from a rebound in logging activities combined with robust production in palm oil and coconut oil. Other agricultural commodities such as copra and coconut oil were weak. The CBSI production index that measures activities in the commodities sector of the economy rose marginally to 85.8 points from 85.6 points in December 2015. However the production index in the first half of 2016 was 10% higher than the corresponding period in 2015.

Figure 9: Production Index (2012=100)



Source: CBSI

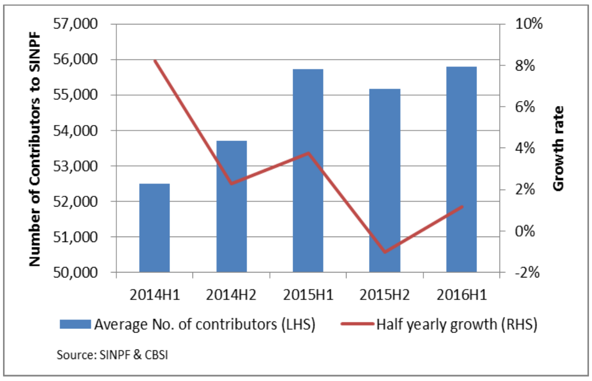
Manufacturing

Manufacturing activities slowed down in the first half of the year. This was primarily driven by the domestic component of the manufacturing sector which contracted to outweigh gains made by the export component. The overall manufacturing index dropped by 5% against December to 263 points in June. The weak outturn was attributed largely to supply constraints.

Employment

Labour market conditions improved in the first half of 2016 after a decline in the second half of last year. Labour market indicators from the Solomon Islands National Provident Fund showed the half yearly average number of contributing members[6] rose marginally by 1% to 55,799 contributors (see Figure 6). During the first half of 2016, June recorded the lowest number of contributors at 54,554 while April was the peak month with 56,364 contributors.

Figure 10: SINPF Contributors



Foreign Direct Investment

According to the Foreign Investment Board, a total of ninety one foreign direct investment applications were received in the first half of 2016, a drop of 19% against the second half of 2015. The fall mirrored reductions in FDI applications for the following sectors; other services, wholesale and retail, tourism, and mining. About two thirds of the FDI applicants had intentions to invest in Honiara, followed by Western, Guadalcanal, and Malaita provinces at 9%, 5%, and 4% respectively.

Tourism

Activities in the tourism sector fared above trend. Visitor arrivals in year to June increased markedly by 26% against the second half of 2016 to 9,572 visitors. The arrival numbers were boosted mainly by increases in the number of cruise boats that visited the country. The number of air visitors on the other hand had fallen against the latter half of 2015 but was higher against the corresponding period a year ago.

Energy

Units of electricity generated in the first half of 2016 rose by 7.8% to 46,870 Megawatt Hour, following a 3.3% growth in the preceding half year. Units of electricity sold also trended upward as a result of a strong general demand across all major categories. The growing demand for electricity was in part due to the lower electricity tariff, strong compliance measures that led to a reduction in illegal connections, and a general increase in economic activities. While business houses, which consumed 61% of total units sold, recorded a gradual increase of 4% to 22,301 MwH, units used by domestic households grew exponentially by 18% against the second half of 2015 to 8,701 MwH.

Retail and Wholesale

Retail and wholesale sector remained buoyant in year to June 2016. Food and beverages import payments, a partial indicator for retail and wholesale, grew by 8% against the preceding half year to $478 million from $444 million in the previous half year. Loans issued to distribution, another partial indicator, also went up by 12% to $271 million.

Transport

The transport sector improved but at a slower pace than the previous year. Anecdotal data from the banking sector showed lending to transport sector increased by 5% to $120 million. The lower growth could also be partly due to management issues at the Honiara International Port. On an upside though, Honiara International Port are slowly returning to normalcy since the middle of 2016. This should boost activities at the sea port again. Immediate benefits to the economy from ongoing investments under the National Transport Fund would be minimal but it

[6] Active and slow active contributors are members whose funds have been received by SINPF at least within the previous six to twelve months.

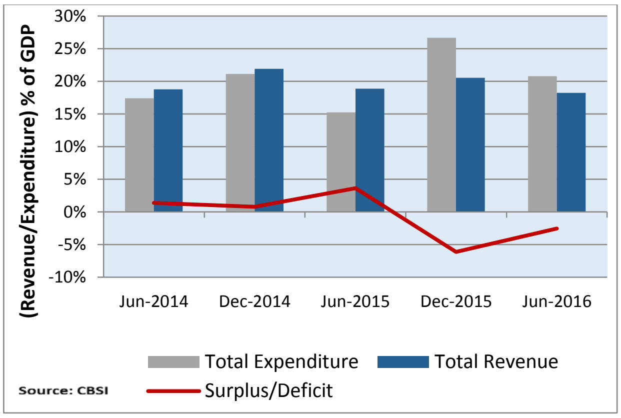
should be a big boost to productivity in the medium term.

Communication
According to GDP projections, the communication sector is projected to grow by 2% in 2016. This is expected in light of the amount of investment communication companies invested over the recent years. However loans issued to communication sector dropped substantially by 16% against December 2015 to $175 million, indicating strong financial position of the communication companies to reduce their debts by such a substantial margin.

Construction
Construction activities remained buoyant in the first half of 2015. This reflects continued investment in public infrastructures and private sector undertakings. Anecdotal data from Other Depository Corporations showed lending to the construction sector rose by $59 million over the year to June to $587 million. The international wharf that was completed early this year was one of the major undertakings in recent years. The upgrading of the Kukum highway in Honiara that commences in the third quarter is another major project whose benefit would become more pronounced in later years through increased productivity.

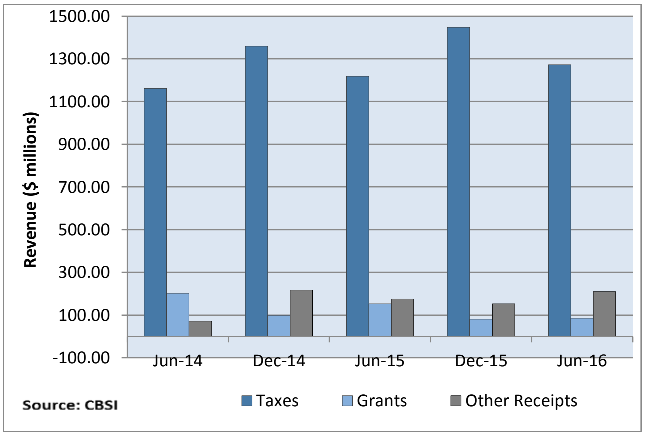
Fiscal Conditions
Fiscal conditions did not meet expectations and remained on the downward trend into the first six months of the year. The fiscal position posted a deficit of 2.5% of GDP that was 50% below the projected budget of deficit 5.0% of GDP. This was due to the fall in total revenue to 18% of GDP from the budget of 20% of GDP. While this was a relative improvement when compared against the deficit of 6% of GDP in the last six months of 2015, the weak revenue performance during the period means government's fiscal activities have been placed under pressure. Accordingly, total expenditure also went down against the budget of 25% of GDP to 21% of GDP in the year to June 2016. The deterioration in fiscal performance contrasts strongly with the surplus outcome of 4% of GDP in the same period one year ago.

Figure 11: Fiscal Performance 2014-2016



Revenue
Total revenue collected by government was below the budget by 10% to $1,567 million, and was also 7% less than the receipts in the last half of 2015. This downturn was primarily due to the fall in tax receipts that countered a rise in grant receipts and non-tax revenues.

Figure 12: Fiscal Revenue Collection



Tax revenue in the year to June 2016 went down by 12% to $1,272 million. Although, this was up 4% compared to the same period in 2015, it was 8% below the budget. The share of tax in the current period accounted for 81% of total revenue, a fall from 86% in the previous period but higher than the 79% share in the same period last year. Other than a 4% rise in property taxes to $14 million, the downturn in taxes during the period was triggered by the fall in taxes on income, goods and services, and international trade. Income tax went down by 16% to $456 million, goods and services tax by 13% to $263 million and taxes on international trade by 8% to $538 million.

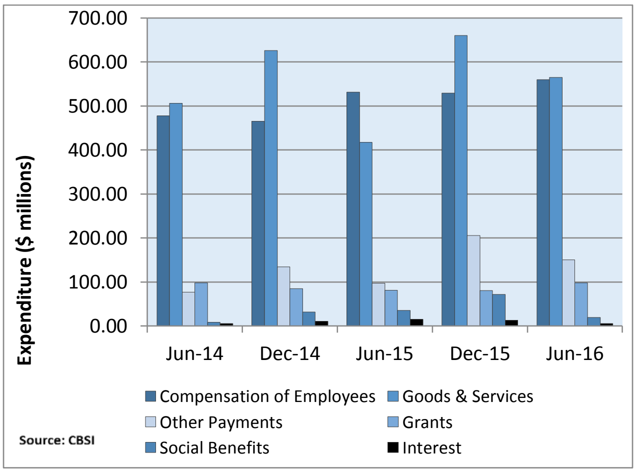
Meanwhile, grants to government in the first half of 2016 rose by 6% to $86 million. Compared to the same period in the previous year however, this was a fall of 44% and 63% below the budget. Most of the inflows during the reference period came from bilateral donors to finance activities in the recurrent budget, although none was appropriated for the development budget. Non-Tax revenue, which accounted for 13% of total revenue also increased in the January to June 2016 period by 37% to $210 million. This outturn was 50% above budget and 19% higher than the previous year. The positive result was due to property income that markedly rose by 51% to $138 million and income from the sale of goods and services by 3% to $63 million.

Expenditure

Total expenditure in the first six months of 2016 fell by 18% against the budget to $1,784 million and was also 18% lower than the previous reference period. However, it was 43% higher compared to the same period in 2015. The budget shortfall came from both recurrent and development expenditures. With the apparent slowdown in revenue collected and in spite of the first half year fall, spending on most expenditure categories remained relatively high compared to the previous year. As such, spending may likely be tightened to reduce any further pressures on fiscal balances in forthcoming periods.

Recurrent expenses which accounted for 78% of total expenditure went down by 12% to $1,394 million. Compared to the same period in 2015 however, this was higher by 18%. The fall in recurrent expenditures came from most expense categories. Use of goods and services, which account for a third of total expenses declined by 14% to $565 million and was 32% below budget. Other expenses decreased by 27% to $150 million, and social benefits slid from $72 million to $19 million. On the other hand, compensation of employees came to $560 million, representing a 6% increase and amounting to 31% of total expenditure and was 1% above budget. Meanwhile, grants rose by 18% to $95 million that was related to supporting the education, provincial government and tourism sectors.

Figure 13: Fiscal Expenditure

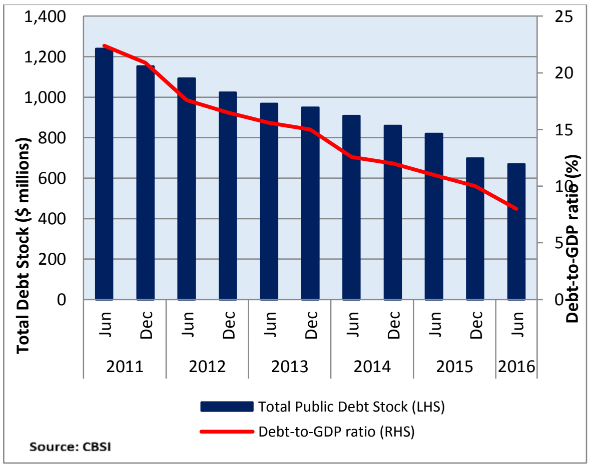


The development expenditure meanwhile slid by 35% to $390 million in the year to June 2016. Compared to the same period last year, this was a four-fold increase due to the delayed rollout of the 2015 budget. It was also below the budget by 18% and the lower revenue collection experienced in the first half of 2016 delayed implementation of a variety of capital projects. The lower growth in development expenditure during the period mainly came from the drop in building projects by 39% to $215 million and from machinery and equipment by 30% to $153 million.

Public Debt Stock

The public debt stock continued to trend downward with a 4% decline to $669 million at end June 2016 and against the first half of 2015, an 18% fall. This result reflected the 5% decrease in external debt to $625 million, which represents 93% of total debt. In contrast, domestic debt rose by 2% to $44 million after the significant one-off debt repayment in the previous period. Accordingly, debt servicing dropped from $138 million in the last half of 2015 to $37 million in the reference period. By share, almost all the debt servicing in the first six months of the year was for external debt repayments, compared to the share of 19% external debt and 81% domestic debt servicing in the previous period. By component, $31 million or 83% was for principal repayments and $6 million was for interest payments. As an indicator of the country's improving levels of debt sustainability, the debt to GDP ratio fell to 8% from 10% of GDP in the previous period.

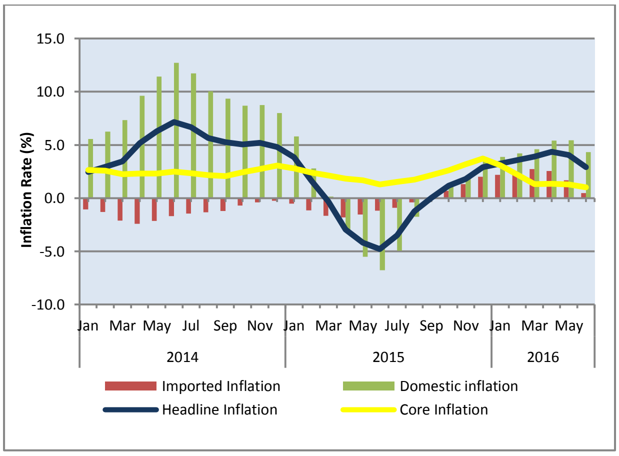
Figure 14: Public Debt Trends



Inflation

Headline inflation as measured by the 3mma settled at 2.9% in June, the same level as recorded in December quarter of 2015. Despite that, Inflation development in the first half of 2016 went through two episodes. The first quarter recorded an increasing trend but reverted in the second quarter resulted in movements evened out to record 2.9% in June. The period of uptick in the first six months was driven by domestic Inflation surging by 4.3% while the slowdown in June was attributed to falls in imported inflation by 0.5%. Similarly, core inflation eased considerably to 1% compared to 3.7% recorded at end of December quarter of 2015.

Figure 15: Inflation Developments



Source: CBSI

In terms of contributions to the overall headline inflation, food accounted for the highest proportion with 1.2%, followed by housing utilities representing 0.7%, transport and communication contributing 0.4%, drinks and tobacco and recreation each accounting 0.2% while the remaining categories each contributed 0.1%.

Imported inflation plays a key role in keeping the overall inflation rate for June 2016 stabled relative to December quarter. Against the end of previous year, the imported inflation moderated to 0.5% from 2% in December and peak at 2.7% by the end of March quarter. Driving this fall was a general slowdown in food inflation falling significantly to 2.2% from 6.6% six months ago. Meanwhile, other categories have all contributed to the fall except for housing utilities that has increased relative to December quarter. Of the 0.5% in imported inflation, food accounted for 0.2% while the rest of the categories each negligibly contributing less than 0.1% inflation.

Domestic Inflation on the other hand depicted an uptick by 4.3% in June compared to 3.5% in the final quarter of the previous year, albeit lower against March quarter. Inflationary pressures stemmed from food inflation rising by 7.3% in June 2016, against minus 2.6% in December reflecting low supply coming from market produce. Meanwhile all other categories moderated over the first half of the year. In terms of contributions to the domestic inflation of 4.3%, food represented largest proportion with 1.6%, followed by housing and utilities with 1.3%, and transport and communication accounting for 0.6%. The rest of the domestic inflation components made up the remaining 0.8%.

4 Economic Outlook

According to the IMF World Economic Outlook July 2016, near term baseline forecasts showed the global economy is projected to grow by 3.1% in 2016 and may improve to 3.4% in 2017. This positive growth is underpinned by the emerging market and developing economies that projects growth to rise from 4.1% in 2016 to 4.6% in 2017.

Economic projection for advanced economies pointed to a similar sized growth for both 2016 and 2017 of 1.8%. While most of the advanced economies are expected to slowdown in 2017, the US economy is projected to grow by 2.5% in 2017 from 2.2% in 2016. The macroeconomic effect of the Brexit vote are not fully realised in 2016 and are expected to unwind fully in subsequent years. This therefore raises economic and financial uncertainties around the globe.

The IMF projects inflation to move in opposite direction across the major economic blocs. The advanced economies are expected to see an inflation hike both in 2016 and 2017 to 0.7% and 1.6% respectively. Inflation in emerging market and developing economies on the other hand softened to 4.4% in 2017. Despite the mixed movements, inflation rates are considered to be within the different countries' Central Banks targets.

According to the London Interbank offered rate, interest rates on US dollar deposits could continue to trend upward to 1.2% in 2017. In contrast, offered rates on Euro and Japanese Yen deposits are expected to remain below zero percent in 2016 through to 2017.

The outlook for the domestic economy, based on the most recent preliminary data in the eight months to August 2016, remains positive. Surprise increases in the primary sector particularly in forestry and to some extent agriculture and fisheries sectors contributed to the slight upward revision from the March 2016 growth projection of 2.9% to 3.2%. Broad positive outcomes anticipated across the industry and services sector are also expected to contribute to the upward revision. Oil price which ticked upward in recent months still remain below last year's oil prices and is expected to support economic activities.

Price pressures are projected to ease further in the second half of 2016, pushing inflation rate below the initial March 2016 projected range of 3%-5% for 2016. The dramatic deceleration in inflation rate is likely to be driven by imported inflation which counteracted upward pressures from the domestic index. Favourable movements in the local currency against key trading currencies such as AUD and NZD combined with downward revisions in administered prices are in part contributing to the falling inflation rate. However over the medium term, inflation may pick up again in line with global projections that international food prices may increase further in 2017 and 2018. The domestic component is assumed to behave closely to seasonal patterns in the previous years. Core inflation is projected to hover around the 3% mark in 2016-2018 after excluding volatile items.

The Balance of Payments position of the country is expected to remain positive in the near to medium term though smaller. The BOP surplus is associated with assumptions that capital and financial account would continue to record surpluses that outweighs persistently smaller current account deficits.

The Central Bank will continue to issue bokolo bills in line with its 2016 budget. The CBSI noted that with the current excess liquidity levels in the financial system, actions by CBSI to incrementally raise the bokolo bills stock will still leave more than adequate levels of liquidity for lending purposes. In this regard, the Central Bank has made a commitment to support lending policies that promote private sector credit growth with a particular focus on micro small medium enterprises.

There are no anticipated changes to the current exchange rate regime which pegs the local currency to a basket of currencies. However with the volatilities in the global exchange rate market, the CBSI will continue to monitor the performance of the local currency vis-à-vis the major trading currencies and may take necessary actions to ensure any negative repercussions on the local economy are minimised.

The central government’s 2016 budget portrayed an expansionary fiscal policy in the near to medium term. However, relatively weak revenue performance against budget in the eight months to August is more likely to affect planned spending for the rest of the year. So far, the government has financed the budget shortfall from its deposits in the banking system. Budget financing from savings could not be sustained in the medium term. In light of the medium term fiscal situation and the low debt to GDP ratio, the national government is expected to borrow some funds to finance planned infrastructure projects.

5 Monetary Policy Stance

Given the macroeconomic projections that inflationary pressures would ease further in 2016 and may remain weak despite an anticipated increase in the medium term, the CBSI will continue to conduct an accommodative monetary policy stance over the next six months. The Bank will closely monitor economic and financial developments and may take necessary measures if required.