CENTRAL BANK OF SOLOMON ISLANDS

MONETARY POLICY STATEMENT
March 2018

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Table of Contents

List of Figures

1 Overview

The world economy experienced robust growth of 3.7% in 2017 buoyed by upside results from the advanced economies particularly from strong investment and improved consumer confidence in the United States and the Euro zone. Moreover, demand-driven results were also evident in emerging Asia and Europe. The favourable conditions are expected to extend into 2018 with global growth projected to pick up to 3.9% driven by the impacts of the US tax cuts and an upward movement in trade and manufacturing activities.
Growth in Solomon Islands' key trading partners was mixed over the year. China's economy continued to expand by 6.8% amidst supply-side reforms and policy easing. While, New Zealand benefiting from supportive fiscal policy is estimated to have grown by 3.5%. In contrast, adverse weather in the first part of the year that hampered production tapered Australia's GDP growth at 2.2% in 2017 against the 3.0% in the previous year.

Broad-based growth in prices for both fuel and non-fuel commodity prices during the year saw an upward movement in overall global commodity prices. Fuel prices increased markedly during the year, and has resulted in upward inflationary pressures and a rise in the costs of production. Similarly, rising global food prices has translated into an uptick in the local prices. On the other hand, the measured growth in other commodity prices benefited some of the country's major export sectors.

The Solomon Islands economy rallied in the second half of the year with growth revised upward by 30 basis points from the September 2017 Monetary Policy Statement (MPS) to 3.7% for 2017. Key productive commodities, such as logging and fisheries boosted activities over the last six months period, along with contributions from the construction, wholesale & retail, and the transport & storage sectors during the year. These movements negated the sluggish conditions in agriculture and the public sector.

In line with economic conditions, the monetary aggregates trended upward in the last six months of 2017. Broad money recovered from the falls in the first half of the year and grew 6%, while credit to the private sector picked up from the 1% in the year to June to rise by 6% in the last half of the year. Sectors contributing to the credit growth were forestry, construction, distribution, transport, tourism and manufacturing.

The external sector performed strongly in the June to December period of 2017 on the back of a much reduced current account deficit. Driving the favourable current account flows were export-led growth in the goods account and travel related recepts in the services account. These developments were aid by the growth in the capital and financial account surplus over the reference period. Consequently, the foreign reserves improved across the six-month period and against the previous year.

Meanwhile, the Solomon Islands dollar (SBD) experienced a turnaround against the basket of tradable currencies. After a 0.3% depreciation in the year to June, the Trade Weighted Index (TWI) strengthened by 1.2% in the last six months of 2017. This movement closely matches the downward movement of the United States dollar against the SBD. The local currency also appreciated against the New Zealand dollar, as opposed to the deprecation against the Australian dollar through the whole year.

Government's fiscal deficit widened in the last six months of the year as expenditure expanded more than the growth in revenue. Expenditure soared from 18% of GDP in the year to June to 23% of GDP in the last half of 2017. Meanwhile, revenue only increased from 17% to 21% of GDP over the reference period. This expansive fiscal stance ultimately lead to a depletion of government's available savings in the banking system.

As anticipated in the September 2017 MPS, inflationary pressures became more pronounced in the July to December period of the year. Driving this uptick in consumer prices were the rise in food, household operations and the fuel-led transport and communications. Moreover, stronger global oil prices and supply side conditions affecting local food has seen prices continuing to trend upward into early 2018.

In the near to medium term, the forecast for the domestic economy remains positive albeit on the downside. In 2018, growth is projected to moderate to 3.4% to account for the anticipated slow down in log output and likely effects of the constrained fiscal outlook. In the medium term, growth is expected to pick up on the back of fishing, manufacturing, construction and other services. However, there are some downside risks that could impair the near and medium term outlook. These include global volatility from tighter monetary policy, higher than expected oil and imported food prices and adverse weather conditions that could affect production and local prices.

2 International Economic Developments

Global economic conditions strengthened in 2017 to 3.7%. Driving this buoyant growth was rebound in the advanced economies along with the emerging economies in Europe and Asia. This is an upward revision by 20 basis points from the previous update and is forecasted to gain momentum at 3.9% in 2018 and 2019[1]. Supporting this outlook is the sustained pick up in trade and manufacturing activities coupled with increasing market confidence, recovery in commodity prices and higher demand from the US tax cuts. These drivers are expected to enable growth in the emerging and developing economies.

Risks to the global forecast are broadly on a balanced path, however may remain prevalent to the downside over the medium term. On the upside, the rebound in economic conditions could be stronger than expected in the medium term as the positive spinoffs reinforce each other. On the downside, financial market corrections might adversely affect asset values and dampen confidence.

Growth has been stronger than expected and remain above potential for major advanced economies. It is projected to expand at 2.3%, an upward revision of 0.1 percentage point from the 2.2% growth forecasted in the previous update. This is largely because of favourable monetary and fiscal policies in most of these countries. Robust growth in Japan, Germany, Korea, United States and the Euro area have all contributed to this upward revision.

Growth in the United States is projected to grow at 2.3% in 2017 from 2.1% projected in the previous update. The upward revision is supported by positive investment responses resulting from recently approved tax policy changes. The improvement in retail and industrial sales relatively to the previous quarter emanated from the fiscal stimulus undertaken in the later part of the year.

Growth in the Euro area a key export destination for Solomon Islands fish and palm oil, is forecasted to rise to 2.4%, an upward revision of 0.3 percentage points on the back of strong domestic and external demand buoyed by strong consumer confidence. Supporting the positive growth outlook in the fourth quarter is resilient labour conditions, optimistic sentiments and a healthier global market. Similarly, growth in Japan continued to gain traction and is projected to have grown at 1.8% in 2017 doubling the 0.9% growth recorded in 2016.

Meanwhile, growth in the United Kingdom is estimated to remain at 1.7%, a slower outcome than had initially expected after the 2016 Brexit referendum. The outcome reflected slower than expected growth that emanated from weaker private consumption and lower household real income in the UK over the second half of the year.

The emerging market and developing economies, which accounted for over half of the world growth sustained momentum from the previous year and are forecasted to grow at 4.7% in 2017. This outcome reflected stronger external demand particularly from the Euro area and favourable financing conditions.

Growth in China, Solomon Islands largest export destination for round log exports continued to grow solidly in 2017. Growth is projected to expand to 6.8% from 6.7% in the earlier update reflecting supply side reforms and policy easing in the first half of 2017. Growth is however, expected to slow in 2018 as authorities seek to contain risks from elevated debt levels. As for India, another export destination for Solomon Islands round log exports, growth has been revised down to 6.7% in the final quarter, 0.4% percentage points below the 2016 performance on the back of slower than expected growth in consumption spending.

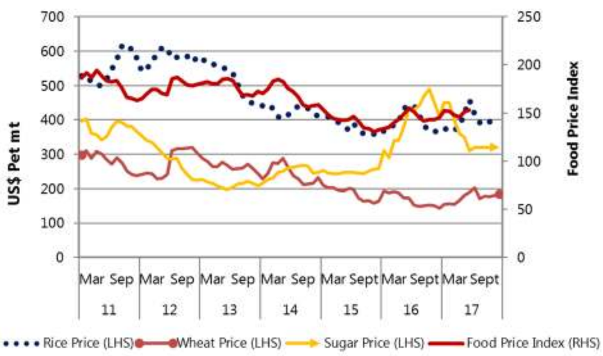
Growth in Solomon Islands' other major trading partners saw a mixed outcome. Conditions in the Australian economy slowed and growth is estimated at 2.2% for 2017, below the 3.0% in 2016. This came on the back of weather related disruptions to production in the first half of the year. While, GDP in New Zealand is estimated to have expanded by 3.5% amidst productive restocking and supportive fiscal policy actions. This optimistic outturn is expected to strengthen over the next three years, underpinned by accommodative monetary policy, a high terms of trade, government spending and population growth.

[1] All statistics in this section obtained from International Monetary Fund (IMF) World Economic Outlook, January 2018 unless otherwise stated.

2.1 International Commodity Prices

International commodity prices, as measured by the IMF's World Commodity Price Index (WCPI) rebounded by 3% to 110 basis points from 107 basis points in the previous update and 11% above year on year. The outcome was driven by the pickup in both fuel prices and non-fuel commodity prices against the previous update and the previous year. Fuel prices rose by 15% to 93 index points compared to 81 index points in 2016 and non-fuel commodity prices reverted by 7% against the previous year to reach 188 index points. Consistent with the movement in global fuel price, tapis crude oil price, the main imported fuel for Solomon Islands, rebounded by 8% to reach an average price of US$56 per barrel reversing the 4% slowdown in 2016 and 6% firmer than the previous update.

Figure 1: Commodity and Food Price Indices (2005=100)



Source: IMF Commodity Price

Average international food prices, as measured by the World Bank's Price Indexes that measure food prices hedged up slightly by 4% to 150 index points in 2017 from a revised 144 points in 2016. The outcome reflected average price increases for most of the commodities. For the whole of 2017, major imported food items for Solomon Islands namely rice and wheat have recorded price increases of 1% to US $399 per ton and 5% to US $174 per ton respectively whilst sugar registered a price fall of 11% to US$354 per ton.

2.2 Global Inflation

Inflation started to pick up slightly after remaining subdued in the recent periods. The price pressure is supported by the rebound in fuel and commodity prices relative to 2016. Inflation is expected to rise by 0.4 percentage points to 3.3% on the global economy with the advanced economy rallying up to 1.7%. This is dictated by increases in United States and Japan's core inflation as spare capacity has diminished further. Some pick-up in inflation is expected over the next year or two as market indicators of inflation expectations have all trended upwards. However, core and wage inflation in advanced economies remained weak and inflation for the Euro area remained stabled. As for the United Kingdom, inflation has picked up strongly from 0.7% in 2016 to 2.6% due to the depreciation of the pound following the Brexit vote. As a result, real wage fallen sharply causing slow consumption and tight labour market.

In the emerging and developing economies, headline and core inflation picked up slightly in the second half of 2017 following some periods of slowdown in the beginning of the year. On an annual basis, inflation is 0.1% percentage point below the previous year to 4.4% in 2017. Much of this is attributed to softer commodity prices particularly in the first half of the year although prices started to pick up in recent months. Inflation in China rose a little over the past few quarters, partly driven by higher fuel prices. Core inflation has edged higher since early 2016 and has been supported by upstream price pressures and continued policy accommodation. However, headline inflation remained below the authorities' upper bound of 3 per cent in 2017.

Meanwhile, inflation in Australia stood at 1.9% slightly above 1.8% in the previous forecast driven by prices of fuel and fruits, which tend to be volatile and an increase in excise tax on tobacco. This level is considered consistent and still within the country's inflation target of 2-3%2 for the medium term. As for New Zealand, the annual inflation in December was lower than expected at 1.6% due to weakness in manufactured goods prices. However, headline CPI is expected to fluctuate over the coming years and within the banks forecasted rate of 2-3%.

3 Domestic Economic Developments

3.1 Monetary Conditions

Key monetary aggregates recovered in the second half of 2017 reversing the broad-based contractions witnessed during the first half. Growth in reserve money (M0), narrow money (M1), broad money (M3), total liquidity and private sector credit though

[2] Retrieved from https://www.rba.gov.au/inflation/inflation-target.html.

slow continued expanding across the final half of 2017.

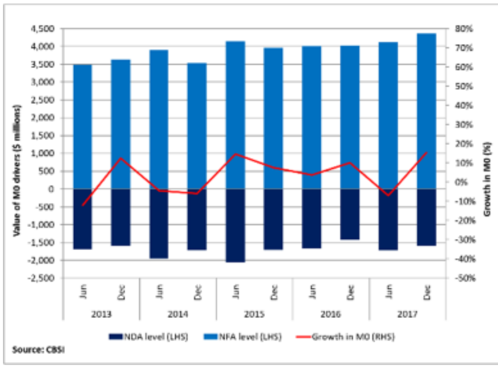
3.1.1 Reserve Money

Reserve money rebounded across the final part of the year increasing from $2,405 million in the first half of the year to $2,777 million by year end. The upturn in M0 was owed to the surge in both the net foreign assets (NFA) and net domestic assets (NDA) of CBSI by $234 million and $138 million respectively to $4,366 million and minus $1,583 million respectively at the end of December 2017. The increase in circulation and ODCs' call accounts during the same period also contributed to this positive outcome.

3.1.2 Money Supply

Similarly, broad money (M3) rose 6% to $4,908 million over the second half of 2017, following a 2% fall in the preceding half year. This increase reflected broad-based recovery across all components of M3 with currency in circulation, demand deposits and time and savings deposits rallying by 15% to $821 million, 4% to $2,827 million and 6% to $1,260 million respectively over the first half of 2017. In addition, the growth in M3 was also driven by a 5% and 19% expansion respectively in NFA and NDA of the banking system over the review period.

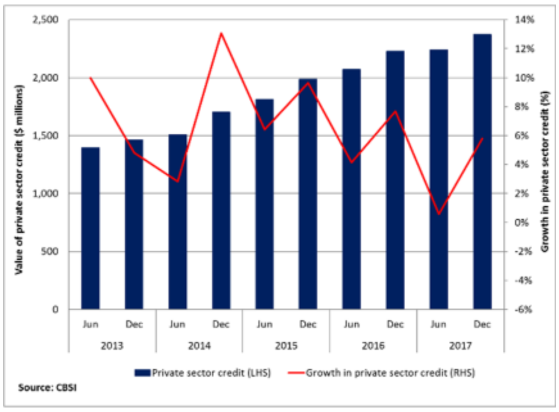
Figure 2: Drivers of Money Supply



3.1.3 Credit Conditions

Credit growth firmed up in the second half of 2017 with credit to private sector expanding by 6% to $2,372 million against a 1% growth posted earlier. Loans dominated the majority of lending accounting for about 89%, followed by overdrafts with 10% and lease financing 0.5%. Sectors contributing to credit growth in the second half include forestry, construction, distribution, transport, tourism and manufacturing. In contrast, agriculture, fisheries, personal and communications recorded declines across the second half.

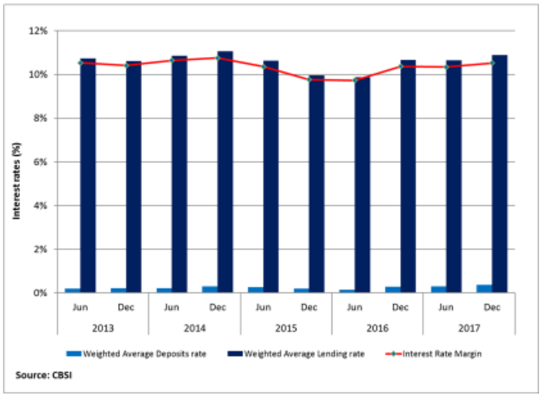
Figure 3: Credit to Private Sector



3.1.4 Interest Rate Trends

The interest rate margin picked up to 10.52% in the second half of 2017 reversing the decline recorded in the first half. The growth came on the back of higher indicative weighted average lending rates that grew from 10.65% in June 2017 to 10.89% in December 2017 and a narrow increase in the indicative weighted average deposit rate. Increased lending rates to fisheries, mining and quarrying, agriculture and the distribution sectors explained the increase.

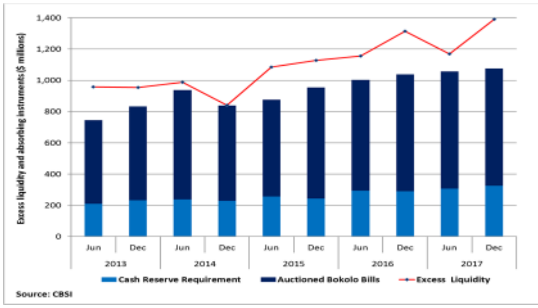
Figure 4: Interest rate trends



3.1.5 Liquidity Levels

Liquidity levels in the banking system rebounded across July to December 2017 after falling in the preceding half year. The growth in liquidity was driven largely by CBSI's NFA and currency in circulation, with much of the increase prevalent in the second half of 2017. In response to this, excess liquidity grew further by 19% to $1,392 million in December against an 11% fall in June 2017. In December 2017, the stock of Bokolo bills floated by CBSI remain capped at $750 million. Bokolo bills interest rate remained unchanged at 0.62% for the whole of 2017. Additionally, the SIG treasury bills administered by CBSI remained capped at $40 million for 2017 with interest rate for 56 days and 91 days maintained at 0.34% and 0.46% respectively from 2016.

Figure 5: Liquidity levels



3.2 Domestic Conditions

Domestic economic activities improved in the second part of the year. Key indicators such as production, manufacturing, construction, retail and wholesale, tourism and the balance of payments all performed strongly.

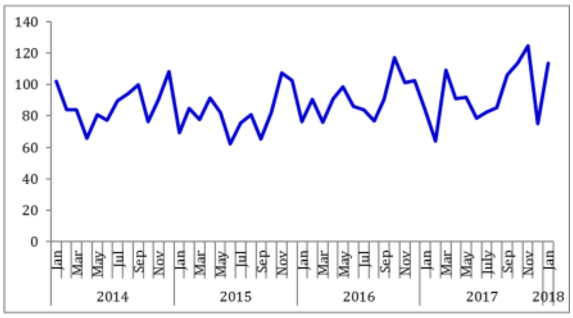
3.2.1 Economic Growth

With the pickup in economic activities in the second half of 2017, the Gross Domestic production (GDP) has been revised upward to 3.7%, 20 basis points higher than the 3.5% predicted earlier in the September 2017 MPS. Underpinning the favourable outcome were gains from logging, construction, financial intermediaries, transport and storages, hotels and restaurants, and, wholesale and retail trades which negated the fall in public sector performance during the period.

3.2.2 Production Index

The production sector rebounded in the second half of 2017with the CBSI production index rising by 13% over the previous period to 98 index points. This came on the higher outturn in logging, copra and fish which outweigh the fall in crude palm oil and cocoa. Log production also outperformed the previous period by 19% to 1,449 cubic metres. Fish catch surged by 3% to 14,870 tons and copra output rose by 47% to 14,987 tons in the period of July to December 2017, following increases in their international prices. Crude palm oil, on the other hand, fell by 26% against the first six months of 2017 to 14,899 tons partly due to the effects of the rhinoceros beetle infestation. Likewise, cocoa dropped by 11% to 1,870 tons and was attributed to the decline in the contracted export price for cocoa.

Figure 6: Half Yearly Production Index

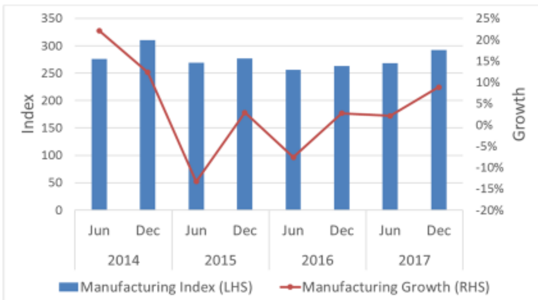


Source: CBSI

3.2.3 Manufacturing

The manufacturing index strengthened by 9% in the last six months of 2017 to 292 points. This was consistent with the robust growth posted in the previous half of 2017. The outcome was evident in goods manufactured for both the export and the local markets, which edged up by 9% to 469 points and by 10% to 208 points, respectively. The improvement in manufactured fish for export largely backed the outturn in manufactured goods for the export index whilst the increases in beverages which negated the declined in tobacco drove the outcome for locally consumed goods. This result is expected following the seasonal increase in demand for alcohol during the festive season. Consistent with the improvement in the domestic demand conditions, loans to the manufacturing sector continued to increase and grew by 2% to $140 million during the period.

Figure 7: Manufacturing Index Trend



Source: CBSI

3.2.4 Energy

Energy output, as represented in the electricity generated, accelerated by 5% to 48,643 Megawatt hours (MWh) against the 46,175 MWh recorded in the first six months of 2017. Accordingly, the overall electricity sold rose by 4% to 37,803 MWh, following the 3% upsurge in the preceding first half of 2017. The 7% upturn in electricity sales to commercial industries to 24,134 MWh along with the 1% rise in electricity sales to the domestic households to 8,134 MWh largely explained the half-yearly growth in energy demand. While the electricity consumed by the government fell by 1% during the period to 5,535 MWh.

3.2.5 Employment

Labour market conditions weakened in the second half of 2017, subsequent to minor growth in the previous period. The partial indicators reveal a 1% fall in the average number of contributors to the Islands National Provident Fund (SINPF) to 55,788 in the July to December from 56,450 contributors recorded in the previous six months to June 2017. The marginal fall came following a 13% drop to 7,358 in slow active contributors which more than offset a 1% rise to 48,429 in the active contributors. Compared to the corresponding period of 2016, the average number of contributors slipped by just 0.3%.

3.2.6 Foreign Direct Investment

The number of foreign investments application as a proxy for Foreign Direct Investment (FDI) continued to fall in July to December 2017. The Foreign Investment Division (FID) reported a 3% fall in the number of applications received to 107 applications against the 110 applications received in the previous six months of 2017. Of the total applications, wholesales and retails constituted bulk of the applications at 58%, followed by consultancies with 18%, mining and transport accounted for 6% each, construction 5% and the remaining 7% was shared between manufacturing and agriculture.

3.2.7 Retail and Wholesale

Wholesale and retail activities improved in the second six months of 2017 from mixed result posted in the last six months of 2017. The positive outcome was pronounced across all the partial indicators with lending to the distribution sector rising by 7% to $425 million from $396 million. While, import of foods and beverages trended upwards by 21% over January to June 2017 to $510 million. Anecdotal FDI data from the Foreign Investment Board indicate the wholesale and retail sector continued to maintain the biggest proportion of FDI applications, although the number of applications declined to 62 applications in the second half of 2017 from 64 applications in the first six months.

3.2.8 Tourism

Visitor's arrivals grew by 23% to 20,828 in July to December 2017, following a 13% fall in the previous half-year period. It was also 6% higher compared to the same period a year ago. The improvement against the last period was attributed to a 27% increase in visitors arrival by air to 14,403 and a 14% rise in visitors arrivals by sea to 6,425. Meanwhile, the average length of stay edged up slightly to 13 days in the current period from previous 12 days. Lending to the tourism sector as a partial indicator rose by 28% to $187 million.

3.2.9 Transport

Transport activities showed an improvement in the second half of 2017, after a slow down in the previous period. Loans to the transport sector strengthened to $145 million in the second half of 2017 from $116 million in the first half 2017. Vehicle registrations another proxy for transport activities improved by 9% against June 2017 to 1,333 newly registered vehicles as reported by the Inland Revenue Division (IRD).

3.2.10 Communication

Communication sector expanded further in the second six months of 2017 with internet usage increase by 27% from 21% in the last six months of 2017. Similarly, mobile usages grew from 8% in the previous period to 14% in July to December 2017. Conversely, lending to the communication sector continue to fall this period, decreasing by 3% to $164 million compared to the first half of 2017.

3.2.11 Construction

Construction activities strengthened further during July to December 2017 after recording a slower growth in the first six months of 2017. The building permits issued by the Honiara City Council (HCC) rose by 23% in the six months to December 2017 to 152 permits. The favourable outcome was obvious across all the permits categories with permit to residential building rising by 10% to 62 permits, others not elsewhere classified rose by 46% to 51 permits and industries increased by 23% to 32 permits. Likewise, the value of building permits improved dramatically to $372 million in the second six months of 2017 from $106 million in the preceding six months of 2017.

Other proxy indicators also recorded a strong growth during the period. Lending to the construction sector, as proxy for construction activities, went up by 14% this period to $387 million, following a 7% upturn in the previous period. Basic manufactures imports, on the other hand, declined by 6% to $293 million and was 7% down against the similar period of 2016.

3.3 External Conditions

The external sector maintained the positive momentum in the first six months of 2017 into the second half of the year. This came from the improvement in the current account and an increase in the surplus in the capital and financial account. Moreover, continuing the trend on an annual basis, the sector expanded to a surplus representing 2% of GDP for 2017 from a surplus of 1% of GDP in 2016. Again, the buoyant outcome emanated from a reduction in the current account deficit. Accordingly, the developments lead to a robust growth of the country's gross foreign reserves for the year.

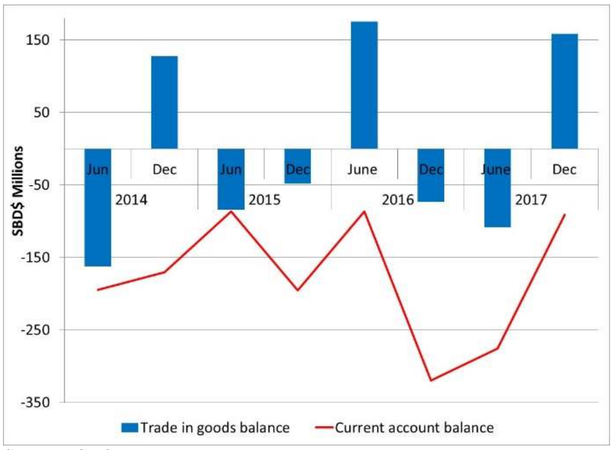
3.3.1 Current Accounts

For the last six months of 2017, the current account deficit declined considerably from $275 in the first half of the year to $91 million (see figure 11). This positive movement was due to a positive turnaround in the goods account and a reduction in the deficit of the services account. However, there were decelerating movements in the primary income and secondary income accounts over the reference period.

The trade in goods account surged to a surplus of $158 million in the last half of the year from the deficit of $109 million in the January to June period of 2017. Primarily contributing to this phenomenal performance was the 26% jump in exports to $2,060 million that more than offset a 9% increase in imports to $1,902 million. The upturn in exports stemmed from the broad-based growth in all major commodities except for palm oil, while the rise in imports came from the payments for food, fuel and machines. Similarly, the services deficit improved to $247 million from $356 million specifically due to tourism related inflows.

However, the primary income deficit deteriorated on account of a rise in direct investment income outflows and a decline in fishing licences over the July to December period of the year. Meanwhile, the fall in the secondary income surplus to $122 million from $290 million reflected the slow down in donor grant disbursements after a surge in the first half of the year. This counterweighed the pick up in personal and worker's remittance transfers over the reference period.

Figure 8: Trade and Current Account Balances



Source: CBSI

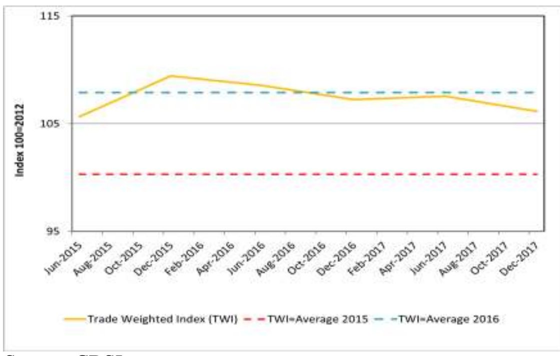
3.3.2 Capital and Financial Account

The surplus in the 'capital and financial' account widened in the last six months of the year by 4% to $311 million in the year from June to December 2017. Primarily driving this result was the surge in the financial account from $41 million in the previous period to $98 million at the end of the year. The improvement in the account stemmed from the growth in FDI related equity and reinvestment earning inflows and a reduction in the other investment outflows. In contrast, the capital account surplus slid by 18% to $212 million over the reference period due to higher capital grant inflows by donors in the first half of the year.

3.3.3 Exchange Rate

In line with prevailing conditions, the Bank's exchange rate policy of pegging the Solomon Islands dollar (SBD) to an invoice-weighted basket of trading currencies, as represented by the Trade Weighted Index (TWI) was maintained. Accordingly, the SBD strengthened against the TWI by 1.3% to an average 106.2 points in the year between July to December 2017 (see figure 11).

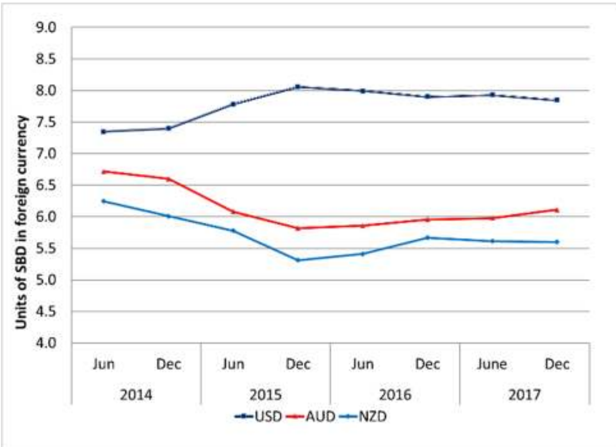
Figure 9: Trade Weighted Index



Source: CBSI

The upward movement in the TWI reflects the SBD's 1% appreciation against the United States dollar (USD), the key currency in the basket to $7.85 per USD and the New Zealand dollar by 0.3% to $5.60 per NZD. However, the local currency depreciated by 2.2% to $6.11 per AUD over the last six months of 2017. Meanwhile, the Real Effective Exchange Rate (REER) depreciated by 3.1% to an average index of 145.6 with the variance between the TWI and REER reflecting the inflation differentials between the country and its trading partners. The softer REER implies that exports were more competitive during the period.

Figure 10: Nominal Bilateral Exchange Rates

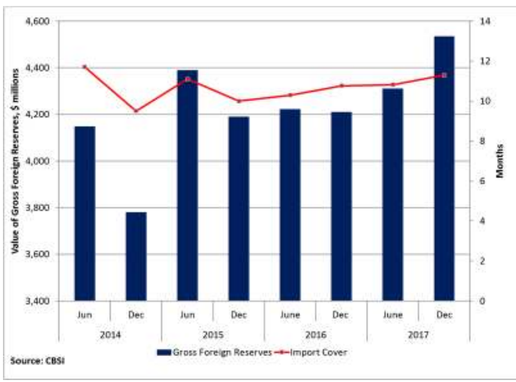


Source: CBSI

3.3.4 Reserves

The country's gross foreign reserves grew by 5% to $4,535 million at end of the year compared to June. This expansion reflects the positive outturn in the BOP and was directly attributed to export and donor related inflows. Compared to the previous year, the level of reserves was higher by 8% and provides a comfortable buffer for the country's trading needs. Consequently, this external reserve position represents more than 11.3 months of imports of goods and services.

Figure 11: Gross Foreign Reserves



3.4 Fiscal Conditions

The government widened the fiscal deficit to $132 million in the last six months of 2017 against the $103 million deficit recorded in the first part of the year. This outcome stemmed from a higher increase in expenditure which more than offset the rise in revenue collected during the review period. Meanwhile, since the second half of 2015 the government has been drawing down its savings in the banking system to finance these deficits.

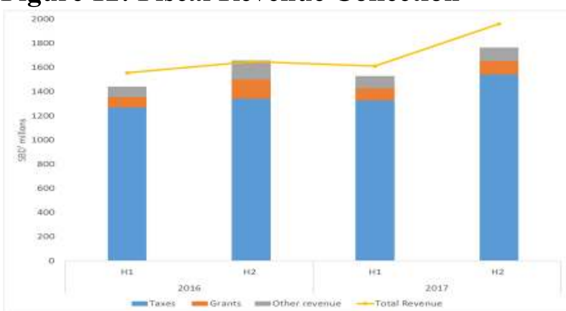
3.4.1 Revenue

Total revenue collected rose by 22% in the months from July to December 2017 to $1,960 million. The increase in overall revenue against the previous six months of 2017 was noticeable in tax revenue, nontax and aid received during the period. Meanwhile, disaggregating revenue by major contributors, tax made up 79% of the total revenue, nontax with 16% and grants accounted for the remaining 6%.

Tax increased by 16% to $1,540 million during the reference period. Driving the outturn was a 14% rise in goods and services tax to $520 million, 25% increase in tax on international trade to $483 million and a 12% improvement to $518 million in income and profit tax. Similarly, nontax revenue rose to $306 million in July to December 2017 from $185 million in January to June 2017, reflecting increases in proceeds from overseas fishing licenses in the third quarter of 2017.

Grants also recorded a growth of 11% to $113 million in the six months to December 2017. Of the total grants, recurrent grants which accounted for 35%, fell to $39 million from $100 million in the first six months of 2017. Capital grants, which contributed 65%, rose to $74 million from $1 million. Meanwhile, against the corresponding period of 2016, grants extended from donors, was 29% lower.

Figure 12: Fiscal Revenue Collection



Source: CBSI

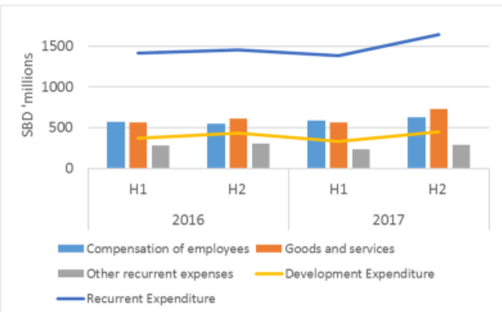
3.4.2 Expenditure

The Government's total outlays soared by 22% in the six months to December 2017 to $2,090 million. This outcome was expected following the trending effects where government spending picks up in the second half of the year. However, this was 11% under the budget but 11% higher when compared with the same period a year ago.

Recurrent expenditure, which accounted for 79% of the total expenditure, rose by 19% in the six months to December 2017 to $1,642 million, but 8% down against the half yearly budget. A 30% surge in consumption expenses to $738 million and 6% upturn in compensation of employees to $586 million were the major drivers behind the growth in recurrent spending. All other payments also registered some growth during the period.

Capital expenditure, representing 21% of the total Government outlays, fell by 21% against the half yearly budget to $449 million. However this was 36% higher than the last six months to June 2017. The outcome came about following increased spending on acquisition of non-residential building, roads and bridges, ships, and other equipment whilst the spending on acquisition of residential buildings drop during the period.

Figure 13: Fiscal Expenditure

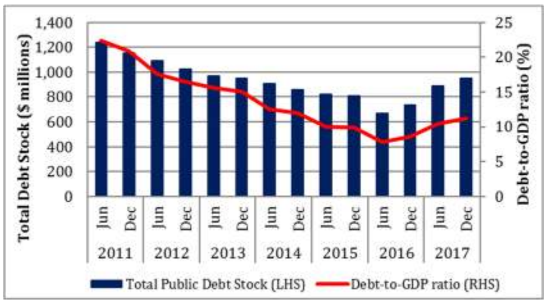


Source: CBSI

3.4.3 Public Debt Stock

Total Central Government debt outstanding continued to rise by 7% to $950 million. The marked increase emanated from loan disbursements of $64 million, although, the government also serviced its debt totalling $31 million during the period. In terms of the composition of debt stock, external debt stock shared 80% of the total debt stock whilst the domestic debt constituted 20%. Consequently, total debt outstanding, as a share of GDP rose to 11% at the end of December 2017 from 10% at the end of June 2017.

Figure 14: Public Debt Trends



Source: CBSI

3.5 Inflation Developments

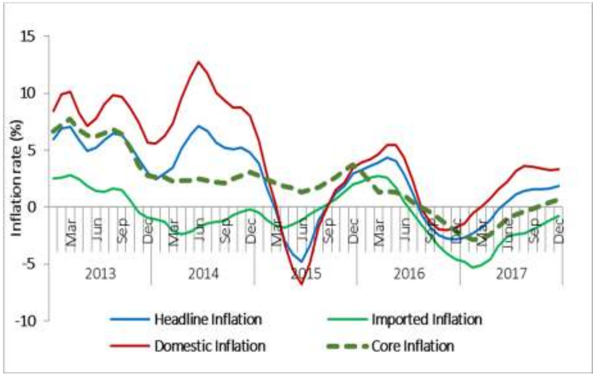
Inflationary pressures in the country picked up in the second half of 2017 following the subdued outcome recorded in the last six months of 2017. Headline inflation rose to 1.8% at end of December 2017 from 0.5% posted in June 2017. The acceleration in the headline inflation in July to December 2017 emanated largely from an increase in both the domestic and imported components of inflation. Moreover, the outlook for 2018 is for inflation to further increase as evident by the 2.5% headline inflation for January 2018.

In terms of the 2017 outturn, the increase in domestic inflation to 3.3% in December 2017 from 2.2% in the June 2017 was largely driven by rise in food indices to 1.5% in December from 0.7%. This was followed by an upsurge in housing and utilities from 0.1% in June to 3.8% in December 2017. On the other hand, drinks and tobacco dropped to 11.6% in December from 16.0% in June 2017 and transports and communication fell to 2.1% from 2.3% in the previous period. By domestic contributors, food made up 1.1%, housing and utilities represented 1.0%, transport and communication 0.5%, drinks and tobacco 0.4%, recreations, health and other services contributed 0.2% and clothing and footwear, and household operations accounted for 0.1% each.

Driving the growth in imported inflation was the food index, which rose to minus 1.5% over June from minus 3.0%, housing and utilities to 1.8% from minus 0.3%, and clothing and footwear from minus 1.1% to 0.7%. Similarly, household operations improved from minus 6% to minus 1.6% and miscellaneous items with the largest price surge to minus 7.4% from 19.4% in June 2017. Transports and communication, in contrast, dropped to 1.7% in December from 4.4% at the end of June 2017. By imported contribution, food constituted the bulk of the imported inflation at minus 0.4%, housing and utilities contributed minus 0.1%, transport and communication minus 0.09%, household operation 0.07%, clothing and footwear, and recreational health and other services, both shared 0.05% each, miscellaneous items represented 0.03% and the rest was accounted for by drinks and tobacco.

Core inflation improved further from minus 1% recorded in June 2017 to 0.7% at end of December 2017. This denotes that prices movements in non-food and non-energy categories registered price increases during the reviewed period.

Figure 15: Inflation Developments



Source: CBSI

4 Domestic Economic Outlook

In the near to medium term, the forecast for the domestic economy remains positive albeit on the downside. In 2018, growth is projected to moderate and then pick up in the medium term. However, there are also downside risks on the forecast horizon that could impair the near and medium term outlook.

Economic growth for 2018 is marked downward to 3.4% from 3.8% on the back of zero growth in logging and dampening effects of contractionary fiscal policy. Regardless of the slow growth, this outlook is on par with previous estimate six months ago and set to be driven by the expected increase in activities from the fishing, construction, manufacturing, wholesale and retail and transport and storage sectors.

Over the medium term, the outlook remains positive with a broad range of possible growth between 3%-4% in 2018 to 2021. Positive contributions from agriculture, fisheries, mineral, construction, wholesale and retail, manufacturing, transport and storage and financial intermediation are expected to offset the zero to declining growth in the logging sector.

Conversely, downside risks may weigh down growth. These risks include global volatility from tighter monetary policy and potential trade wars, higher than expected oil and imported food prices and adverse weather conditions. Alternatively, in the absence of the expected risks, the growth outlook will remain stronger than expected in the previous forecast.

Inflationary pressure are expected to gather pace in 2018 to 2021 as fuel prices rebounded and imported prices started to pick up in the global economy. Inflation is projected to hover around 2%-5% in 2018 and 2019. Underpinning the price pressure are newly approved tariff on administered items such as fuel, alcohol and cigarettes. Inflation volatilities are anticipated to continue on the back of movements in commodity prices, energy sources and changing weather patterns. Core inflation is expected to move between 2%-3% over the medium term. Given the more controlled levels of inflation, there is still policy scope to accommodate any upward inflationary pressures.

On the external front, balance of payment surpluses are projected for the 2018-2020 period despite anticipated deficits in the current account for the next three years. The deficit current account is expected to be financed by donor inflows, foreign borrowings and other investments. The external reserves are expected to be at a comfortable level of 11 months of import cover in 2018 to 2020.

5 Monetary Policy Stance

Given the recent developments and forecasted macroeconomic conditions, the CBSI will continue with the accommodative monetary policy over the next six months but will consider taking appropriate measures should there be any large adverse macroeconomic shocks to the domestic economy.