CENTRAL BANK OF SOLOMON ISLANDS

MONETARY POLICY STATEMENT
September 2017

P. O. Box 634, Honiara, Solomon Islands. Tel (+677) 21791

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1 Overview

Global growth is projected to rally by 3.5% in 2017 based on favourable activities in both the advanced economies and the emerging and developing economies. Driving the outlook for the advanced economies was the better than expected outturns from Germany, France, and Japan. This offset the downward movement from the sluggish output and uncertainties in the United States. While, a more robust China, along with India are projected to lead the buoyant growth in the emerging and developing economies.

Closer to the Solomon Islands, growth in Australia and New Zealand is expected to remain positive in 2017. Despite initial temporary shocks, stronger retail activity and business conditions is anticipated to further boost growth in Australia. Meanwhile, conducive fiscal and monetary policies, and improved terms of trade will contribute to the growth outlook in New Zealand.

In spite of earlier expectations for higher energy and lower food prices in the six months to June 2017, subdued oil prices continued to weigh down global commodity prices. Global food prices in contrast trended upward with prices for major Solomon Islands food imports such as rice and wheat picking up over the period. Accordingly, the depressed fuel prices will taper imported inflation expectations in the country, support the reduction of production costs and benefit consumers.

Meanwhile, domestic output in the Solomon Islands eased in the period from January to June 2017. This came on the back of sluggish manufacturing outturns and weaker production from all commodities except for crude palm oil and copra. Slowdowns in tourism, transport and investment activities also contributed to the result. On the other hand, there was modest performance from the construction, communication, wholesale and retail, and the energy sectors.

The monetary aggregates, particularly reserve money and broad money also trended downwards against the last half of 2016, although they were higher against the same period last year. Credit to private sector growth tapered off compared to the previous six and twelve month periods. Contributing to the marginal increase were personal, distribution, construction, communications, tourism, manufacturing and transport. While, the fall in lending interest rates at end June 2017 came from the forestry, government, entertainment and personal sectors.

In the six months to June 2017, the external sector recovered in the on the back of a reduction in the current account deficit, particularly from a rise in donor-funded current grants. This outturn was made against a reduction in the capital and capital account surplus that stemmed from the decline in foreign investments and financial liabilities. Accordingly, the country's gross foreign reserves rose by 2% to $4,311 at end of the period.

The exchange rate's trade weighted index depreciated by 0.27% in the first half of 2017 against the last six months of 2016, although this was stronger against the same period in 2016. The half-year outcome stemmed from SBD's fall against the USD and AUD, the two primary currencies in the invoice-weighted basket. On the other hand, the local currency strengthened against the NZD during the period.

Fiscal performance in the first half of 2017 was below budget expectation. Both revenue and expenditure fell against budget by 16.8% and 16.7% to $1,608 million and $1725 million, respectively. This resulted in the government recording a fiscal deficit of $117 million. The deficit was financed mainly from previous year's savings and borrowings. Public debt trended upward to $880 million by June as the government started issuing development bonds domestically. The first development bond issuance was in March 2017 which totalled $150 million.

Inflation developments turned around in the six months to June. From a subdued minus 2.8% in December 2016, headline inflation picked up to 0.5% in June 2017. This reflected the upward movement in both the domestic and imported indices, particularly in terms of food that outweighed lower fuel prices.

Over the medium term, CBSI projects the economy to maintain positive growth. Although growth in 2017 has been marked down to 3.4% following slightly weaker than expected performances in forestry, agriculture and fiscal sectors, the outlook in 2018-2020 are more optimistic. Overall growth is expected to average around 4.0% with agriculture, fishing, mining, construction, wholesale and retail, manufacturing, transport and storage, financial intermediation and public sector as the major driver. However, risks are tilted to the downside especially if key projects in the mineral and energy sectors do not take off as planned and if commodity prices are subdued.

2 International Economic Developments

Global economic growth continued to strengthen in the first half of 2017 supported by the improvement in economic activities from large and developing economies and some advanced economies. Global economic growth is forecasted to expand to 3.5% in 2017, an upward revision from 3.4% in the March 2017 Monetary Policy Statement (MPS) while projected growth for 2018 is expected to remain at 3.6%, consistent with the previous MPS statement.[1] Underpinning this outlook is the sustained pick up in trade and manufacturing activities coupled with increasing market confidence and the recovery in commodity prices, enabling growth to gain momentum in emerging and developing economies.

However, several downside risks to the outlook over the medium term include: continued policy uncertainties following the post-Brexit negotiations and the United States' (US's) fiscal policies, financial tensions from China's strong credit growth and control of US's monetary policy, inward looking policies and increased geopolitical tensions. Therefore, it is imperative that policies aimed at addressing these challenges should focus on strengthening the growth momentum through fiscal, monetary and structural policies, ensuring more inclusive growth, promoting global cooperation and making growth resilient and balanced.

[1] All statistics in this section obtained from International Monetary Fund (IMF) World Economic Outlook, July 2017 unless otherwise stated.

Growth in advanced economies is projected to grow at 2% in 2017, a slight upward revision from earlier forecasts of 1.9%. This is largely driven by higher growth outturns in the Euro countries including Germany, France, Italy, and Spain, extending to Canada and Japan. Contrary to this positive growth outcomes, the US's growth forecasts for 2017 and 2018 were revised downward to level off at 2.1 % for both years from previous forecast of 2.3% and 2.5% respectively. These revisions reflected weaker growth outturns in the first half of the year along with the uncertainty surrounding US's fiscal policy, which contributed to a depreciation in the US dollar against major currencies. Likewise, lower revision for 2018 was based on the assumption of less expansionary fiscal policy given the uncertainty in timing and nature surrounding the US's fiscal policy.

Growth projections for the Euro region, a key export market for Solomon Islands fish and palm oil, recorded stronger growth for most countries including France, Germany, Italy, and Spain resulting in an overall growth forecast of 1.9% for 2017, an upward revision from 1.6% in early 2017. The outlook was supported by higher growth than expected along with positive growth revisions for late 2016 and stronger than anticipated momentum in domestic demand in early 2017. Meanwhile, growth forecasts for the United Kingdom was revised to 1.7%, an upward revision from earlier forecasts of 1.5%, much of which reflected firmer growth and resilience in spending after the June 2016 referendum. Similarly, growth forecasts for Japan was revised upward to 1.3% from the 0.9% forecasted earlier, largely driven by increased private consumption, investment and exports in the first half of the year.

In emerging and developing economies, growth is envisaged to pick up in 2017 to 4.6%, a slight upward revision from earlier forecasts of 4.5%, with growth rising from 4.3% in 2016 to 4.8% in 2018. The outlook is underpinned by improving conditions in large commodity exporting economies following the recovery in commodity prices. Growth in China, Solomon Islands' largest export destination for round log exports is projected at 6.7%, in line with earlier 2017 forecasts, much of which reflect solid growth momentum backed by policy easing and supply-side reforms. In India, growth projections is forecasted to remain at initial projections of 7.2% in 2017 and 7.7% in 2018, primarily driven by higher government spending and data revisions in late 2016 coupled with strong consumption that showed growth momentum in the first part of the year. The positive growth in India is a prospect for Solomon Islands as a market destination for the country's logs.

Moving to the country's closest trading partners, growth in Australia and New Zealand was consistent with earlier projections albeit slower than growth in the first part of 2017 than anticipated due to several temporary factors. Growth in Australia is envisaged to pick up in the second quarter against the 1.1% growth registered in December 2016, underpinned by improved business conditions and stronger retail sales. Moreover, growth is forecasted to reach 3% in first half of 2018 as recovery from the drag from mining investment siphons and ramp-up in resource exports continues.[2] However, a potential risk to Australia's recovery in growth is the appreciation of the Australian dollar, which has appreciated by 5% on a trade-weighted basis and by 7% against the US dollar

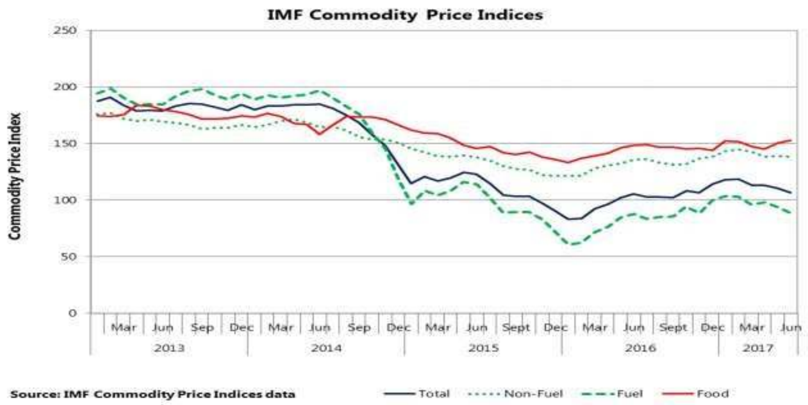
[2] Source: Reserve Bank of Australia, Statement on Monetary Policy August 2017.

and is expected to appreciate further causing slower pick-up in economic activity. As for New Zealand, growth is expected to improve, with annual growth averaging 3.4% over the next two years. The outlook is supported by accommodative monetary policy, strong population growth, higher terms of trade and fiscal stimulus outlined in the Budget 2017.[3]

2.1 International Commodity Prices

International commodity prices, as measured by the IMF's World Commodity Price Index (WCPI) have declined by 7% to 107 basis points against December 2016 and 1% above year on year. The outcome was largely driven by the fall in fuel price in the first half of the year by 12% to 88 index points in June 2017. This outweighed the price pick up in food and beverage of 6% against December 2016. Meanwhile, non-fuel commodity prices fell by a marginal 0.1% against the end of 2016. Consistent with the movement in global fuel price, tapis crude oil price, the main imported fuel for Solomon Islands, also recorded price fall of 14% to reach an average monthly price of US $48 per barrel in June 2017 compared to the US $56 per barrel at the end of 2016.

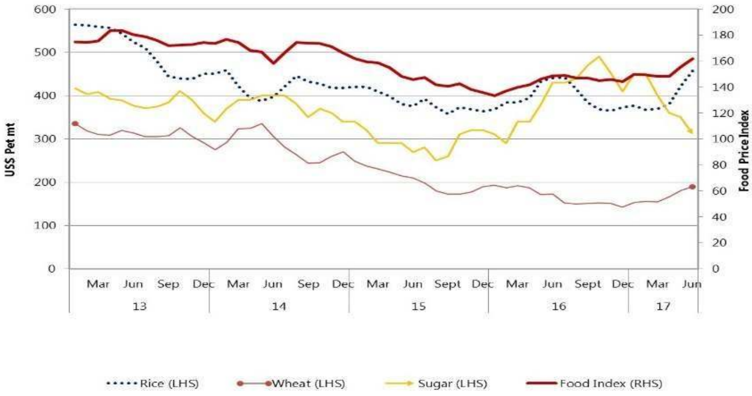
Figure 1: Commodity and Food Price Indices (2005=100)



The average international food price, as measured by the World Bank's Commodities Price Indices have increased by 12% to reach 162 index points in June 2017. The outcome reflected average price increases for most of the commodities. For the first half of 2017, major imported food items for Solomon Islands namely rice and wheat have recorded price increases of 23% to US $458 per ton and 34% to US $190 per ton respectively whilst sugar registered price fall of 24% to US $310 per ton against December 2016 price levels.

[3] Source: Reserve Bank of New Zealand, Monetary Policy Statement August 2017.

Figure 2: International Food Price Indices 2011-2017



Source: World Bank Food Price Indices

2.2 Global Inflation

Global inflation was consistent with earlier projections and remained subdued for the first half of 2017. Inflation in advanced economies and emerging market and developing economies were revised downward from the start of the year to 1.9% from 2.0% and 4.5% from 4.7% respectively. Much of which reflected lower oil prices due to pick-up in oil supply and robust inventory levels in the US.

In terms of Solomon Islands major trading partners, inflation in China stabilized and is forecasted to lower to 2.0% in 2017 following oversupply of key food items: pork and vegetables over past months and lower fuel prices.[4] Australia's inflation for the June quarter inflation remained consistent with earlier projections and is forecasted to rise to 2% over the second quarter of 2017, increasing marginally thereafter. While its headline inflation is projected to rise slowly between 2% and 3% over the forecast period[5]. As for New Zealand, annual CPI eased in the June quarter recording 1.7%, lower than the previous update, however is expected to be volatile over the next year whilst headline inflation is forecasted to drop following expected falls in fuel and food prices.[6] Meanwhile, the preliminary average inflation rate for several Pacific Island Countries (PIC) including Solomon Islands rose to 2.3% compared to the 1.4[7]% registered in December 2016, largely reflecting positive inflation rates for all PIC except for Kiribati, however, prices are expected to pick up in 2017 .

3 Domestic Economic Development

3.1 Monetary Conditions

Monetary conditions slowed in the first half of 2017 after recording gains in the second half of 2016. The weakened outcome reflected an easing in key monetary aggregates such as reserve money and broad money

[4] Source: Asian Development Outlook Supplement. July 2017.
[5] Source: Reserve Bank of Australia, Statement on Monetary Policy August 2017.
[6] Source: Reserve Bank of New Zealand, Monetary Policy Statement August 2017.
[7] 2016 Data for Q4 for 7 PICs as sourced from IMF.

across the first six months of 2017. The rate of growth of credit as well as the weighted interest rate margin also slowed compared to the second half of 2016.

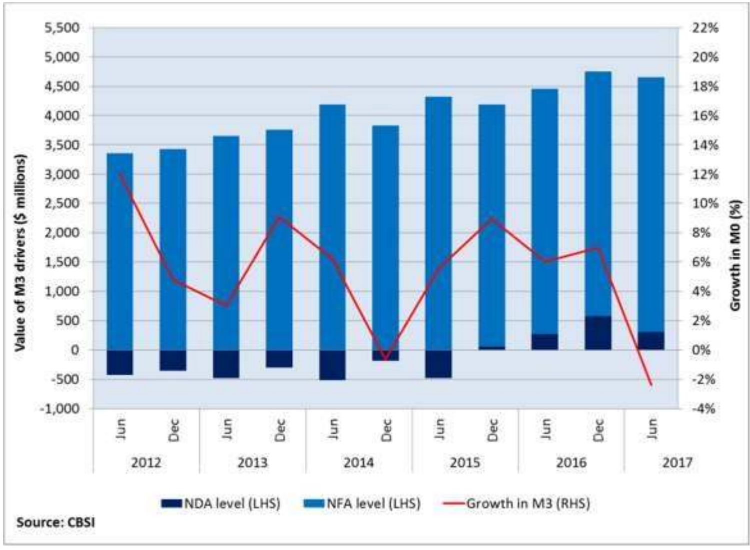
3.1.1 Reserve Money

After registering broad-based growths in July to December 2016, reserve money contracted across the first six months of 2017; falling by 7% to $2,405 million from $2,583 in December 2016. This negative growth against December 2016 was primarily attributed to a 20% deterioration in CBSI's net domestic assets (NDA) to minus $ 1,721 million, owing largely to the build -up in government deposits at CBSI during the period. Twin reductions in currency in circulation and ODCs' call accounts during the same period also contributed to this fall.

3.1.2 Money Supply

Broad money followed a similar trend to that of reserve money over the first half of 2017. Total money supply fell by 2% to $4,630 million compared to a 7% growth recorded in the preceding half year. The fall came on the back of a broad-based decline across all components of broad money with currency in circulation, demand deposits and time and savings deposits dropping by 4% to $714 million, 2% to $2,725 million and 3% to $1,190 million respectively over the first half of 2017.

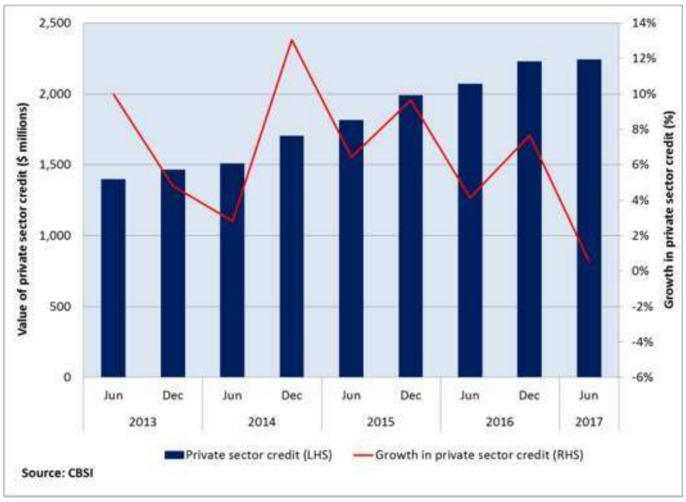
A similar movement was mirrored in net domestic assets (NDA) of the depository corporations which decreased by $267 million to $307 million in June, outweighing an improvement of $172 million to $4,345 million in net foreign assets (NFA) at the end of the review period. Driving the decline in NDA was an 18% decrease in net domestic credit (NDC) to $978 million coupled with a 13% drop in other items net to $235 million. **Figure 3: Drivers of Money Supply**



3.1.3 Credit Conditions

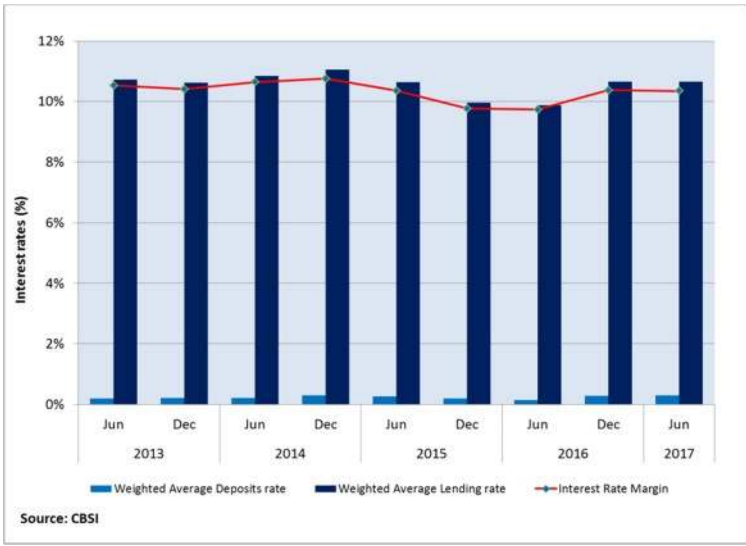
Credit growth grew at a slower rate across the first half of 2017. Between December 2016 and June 2017, credit to private sector recorded a 1% growth to $2,241 million compared to an 8% growth posted earlier. Loans dominated the majority of lending accounting for about 89%. The main sectors supporting this marginal credit growth in the six months up to June 2017 include construction, forestry, distribution, communications, tourism and manufacturing. On the other hand, transport, personal and communications recorded declines in contrast to positive growths in the preceding half year.

Figure 4: Credit to Private Sector



3.1.4 Interest Rate Trends

Interest rates declined in the first half of 2017 reversing the growth registered in the preceding six months. The dip in interest rate reflected a fall in lending rates from 10.66% in the second half of 2016 to 10.65% in first half of 2017. Deposit rates on the other hand, moved upward from 0.29% to 0.30% during the review period. As a result of these movements, the weighted interest rate margin dropped from 10.37% to 10.35% by end June 2017. Sectors that witnessed marginal declines in their lending rates over the review period include forestry, provincial assemblies and local government, entertainment and catering and personal whilst sectors that posted increases in their lending rates include mostly the productive sectors such as agriculture and fisheries. **Figure 5: Interest rate trends**

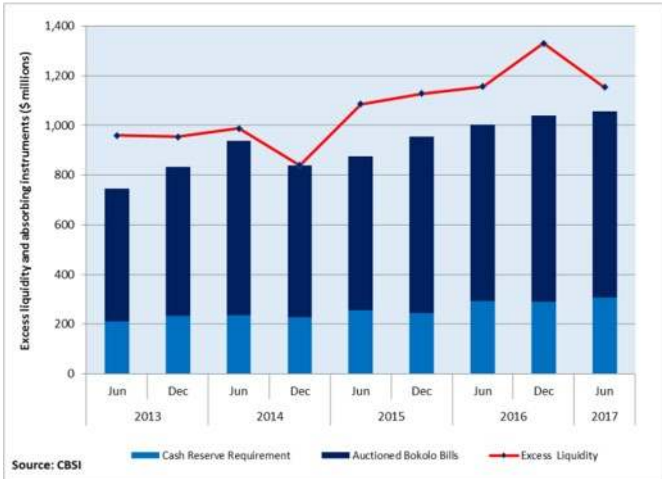


3.1.5 Liquidity Levels

Liquidity levels in the banking system fell across the six months to June 2017 benefitting in part from modest growth in private sector credit and persistent build-up in government deposits from other depository corporations. Correspondingly, excess liquidity contracted by 13% to $1,153 million following a 15% growth in December 2016. The contraction in excess liquidity was partly driven by the $150 million SIG development bond SINPF purchased in March 2017.

The stock of Bokolo bills floated was maintained at $750 million throughout the final half of 2016 through to the first half of 2017 suggesting that $750 million of free liquidity was absorbed from the system by end -June 2017. Bokolo bills interest rate remained unchanged at 0.62% from the previous years. The SIG treasury bills remained capped at $40 million with interest rate for 56 days and 91 days staying the same throughout the years at 0.34% and 0.46% respectively.

Figure 6: Liquidity levels



3.2 Domestic Conditions

Domestic economic activities, as measured by partial indicators, eased in the first six months to June 2017 following the strong performance in the second half of 2016. Production and manufacturing index performed weakly in the first half of the year. Similarly, other key indicators including tourism, transport and investment activities also eased over the period. Meanwhile, construction, communication, wholesale and retail activities and energy demand improved moderately compared to last six months of 2016.

3.2.1 Economic Growth

The CBSI growth forecast for 2017 has revised downwards to 3.4%, 20 basis points lower than the 3.6% projected in March 2017. Slower growth in 2017 is expected to be driven mainly by projected slowdown in forestry sector and weak performance in the public sector. However, expected growth in fishing, construction, wholesale and retail, transport and storage sectors and financial intermediation will continue to sustain growth in 2017. Disaggregating the overall growth forecast for 2017 by broad sectors, services sector is projected to contribute 2.4% while the secondary and primary sectors are expected to contribute 0.5% and 0.4%, respectively.

3.2.2 Production Index

Domestic production activities eased in the first half of 2017, following a strong performance in the last six months of 2016. This is reflected in the CBSI production index, which decelerated over the first half year by 9% to 87 index points (see Figure 7). This outcome was driven mainly by weak performances in three of the major export commodities with cocoa production plummeted by 20% to 1,757 tons, log output fell by 14% to 1,215 million cubic metres while fish catch dropped by 3% to 14,483 tons. In contrast, crude palm oil and copra output recorded growth over the first half year of 2017.

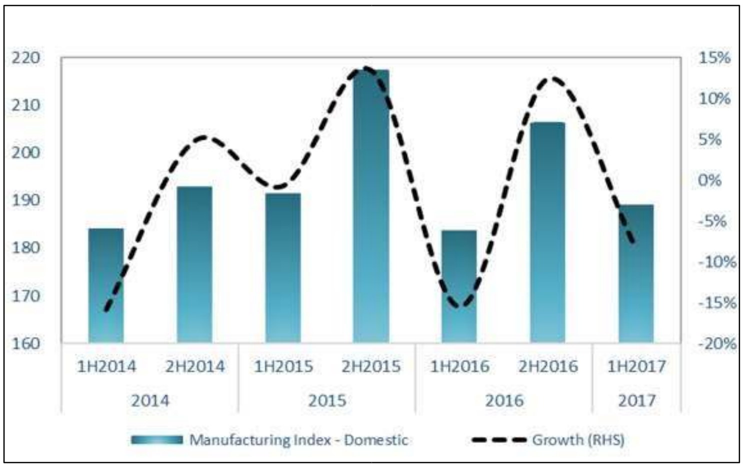
Figure 7: Half Yearly Production Index

Source: CBSI

3.2.3 Manufacturing

Domestic demand conditions weakened over the first half of 2017, reversing the strong growth in the second half of 2016. The CBSI manufacturing index for goods destined for the domestic market, as a proxy for domestic demand contracted by 8% to 189 points from 206 points in the preceding six months (see Figure 8). The weak performance was attributed to the fall in the index for alcohol and soft drinks, and biscuits, falling by 17% and 12% respectively. Despite the fall, loans to the manufacturing sector increased further by 3% to $134 million by end of June 2017, and 8% higher than the corresponding period in 2016. This is consistent with the anecdotal data that pointed to a broadening in the manufacturing base with a growing number of investors venturing into activities such as water bottling, bakeries and so forth.

Figure 8: Manufacturing Index Trend

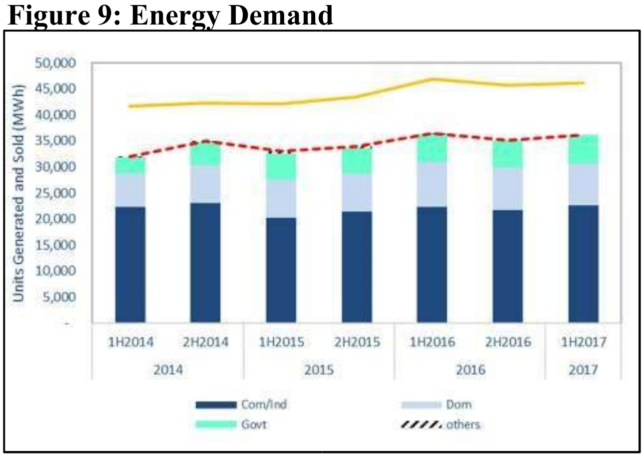


Source: CBSI

3.2.4 Energy

Energy demand as reflected in the electricity generated improved moderately by 1% to 46,175 Megawatt hours (MWh) in the first half of 2017 from 45,680 MWh in the second half of 2016. As a result, total electricity sold increased by 3% to 36,227 MWh during the period, reversing the 3% fall in the second half of 2016. This was driven by the increase in electricity sales to the government and commercial and industrial customers, rising by 5% and 4% to 5,565 MWh and 22,581 MWh, respectively. Meanwhile, energy demand from domestic customers declined negligibly by 0.4% to 8,081 MWh

Figure 9: Energy Demand



Source: CBSI & Solomon Power

3.2.5 Employment

The number of Solomon Islands National Provident Fund (SINPF) contributors, as a partial indicator for labour market conditions, showed slight improvements during the first half of 2017. The average number of contributors[7] for this period increased slightly by 1% to 56,450 contributors from 55,820 contributors in the previous six months to December 2016. This reflected the slight pickup in the number of active and slow active

[7] Active and Slow active categories

contributors over the period, by 1% and 2% respectively. Against the corresponding period in 2016, the average number of contributors also increased by 1%.

3.2.6 Foreign Direct Investment

Investment activities as indicated by the number for foreign investment applications slowed during the first half year of 2017. The total number of applications received by the Foreign Investment Division (FID) fell by 8% to 110 applications compared to 119 applications in the six months prior. In terms of applications by sectors, wholesale and retail sector still accounted for the largest share with 64 applications, followed by the 'other services' category with 22 applications, transport and communication received 7 applications, manufacturing sector recorded 6 applications, while the remaining sectors received either less than five applications or zero application during the period.

3.2.7 Retail and Wholesale

Domestic consumption, as reflected by the wholesale and retail activities, showed mixed outcomes during the first six months to June 2017. Commercial banks' lending to the distribution sector rose by 14% to $396 million following a 28% increase in the six months to December 2016. Similarly, anecdotal data from Foreign Investment Division (FID) revealed that the wholesale and retail sector continued to dominate the number of FDI applications. The foreign direct investment applications to the wholesale and retail sector rose considerably to a record of 64 applications in the first half year from 42 applications in the previous six months.

Conversely, other proxy indicators showed weak performance during the period. Food imports dropped by 38% to $320 million, reversing the 14% increase in the preceding six months while imports of beverage and tobacco products declined by 13% to $25 million.

3.2.8 Tourism

Tourism activities, measured by the number of visitors arriving in the country slowed down in the first half of 2017. Total arrivals by both air and sea, declined by 14% to 16,748 arrivals from 19,568 arrivals in the last six months of 2016. This outcome reflected the declines in both air and sea arrivals falling by 9% to 11,307 arrivals and 24% to 5,420 visitors respectively. The average length of stay for air visitors remained at 13 days in year to June. Loans to the tourism sector, another proxy for tourism activities, saw a moderate increase of 2% to $145 million, following a 10% growth in the second half of 2016.

3.2.9 Transport

Activities in the transport and storage sector, as reflected by partial indicators, slowed in the first half year of 2017. Lending to the transport and storage sector fell by 15% to $116 million, reversing the upward trend since the second half of 2012. The total number of new vehicle registrations, another partial indicator reported by the Inland Revenue Division (IRD) declined further by 8% to 1,224 new registered vehicles against 1,329 vehicles recorded over the last six months of 2016.

3.2.10 Communication

The communication sector, as measured by proxy indicators remained buoyant over the six first months to June 2017. Internet usage recorded another increase of 21% following a 39% increase in the six months prior. Growth momentum in mobile usage slowed to 8% after a stronger growth of 29% recorded in the second last half of 2016. These outcomes reflected the ongoing promotional and marketing activities by the two telecommunication operators during the period. Meanwhile, credit issued by the commercial banks to the communication sector slipped 4% to $170 million from $177 million in the second half of 2016.

3.2.11 Construction

Construction activities as indicated by partial indicators showed slight improvements in the first six months to June. The total approved building permits issued by the Honiara City Council (HCC) during the period went up by 3% to 124 permits following a 15% increase in the preceding six months. Of the total permits issued, 63 permits were issued for residences, ‘others’ category comprised of 35 permits while 26 permits were granted for commercial and industrial buildings. Compared to the corresponding period in 2016, the total approved building permits issued was 19% higher. In contrast, the estimated value of the approved permits dropped to $106 million compared to $451 million in the preceding six months, driven by the decline in the value of commercial and industrial buildings.

Other proxy indicators for construction remained buoyant. Lending to construction sector, another useful indicator to measure construction activities increased further during the first half year of 2017 by 7% to $338 million. This continued the 13% growth in the second half of 2016 to $317 million. Imports of basic manufactures slid by 1% to $311 million in the first half year, however, this was 7% higher than the corresponding period a year ago.

3.3 External Conditions

The performance of the external sector markedly improved in first half of 2017 with a larger balance of payments (BOP) surplus compared to the last six months of 2016. Driving this outcome was the reduction in the current account deficit from 7% of GDP to 4% of GDP. However during the period, the surplus in the ‘capital and financial’ account narrowed to 5% of GDP from 12% of GDP on the back of a reduction in financial liabilities and foreign direct investments (FDI). Accordingly, the positive half-year result saw further growth in the country’s gross foreign reserves at end June 2017.

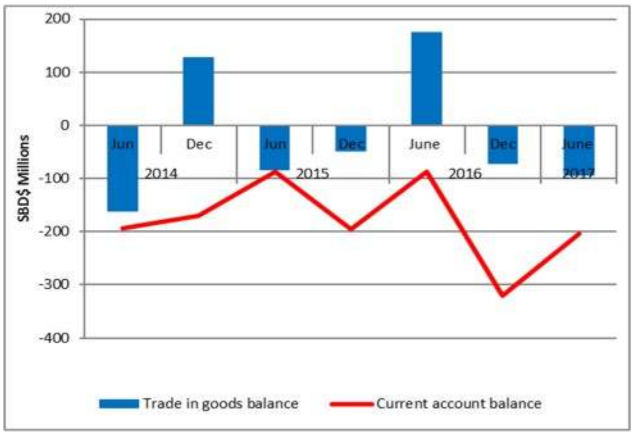
3.3.1 Current Accounts

The structural deficit in the current account waned from $320 million in the last half of 2016 to $204 million in the first half of 2017. This reflected the rise in the secondary income surplus and a reduction in primary income deficit. However, the outturn was offset by the expansion of the deficits in both the trade in goods and trade in services over the six-month period.

Trade in goods deteriorated to a deficit of $95 million in the year to June 2017 compared to a smaller deficit of $73 million in the months from July to December 2016. The downturn was attributed to the decline in exports, particularly from forestry, fisheries and copra amidst a lesser fall in imports from food, basic manufactures and beverages. Moreover, the widening of the trade in services deficit from $346 million to $359 million stemmed from the surge in travel and other services payments that counterweighed a reduction in transport payments.

Meanwhile, secondary income increased to a surplus of $342 million in the first half of 2017 from a surplus of $255 million in the last half of 2016. This came on the back of an upswing in donor funded aid in cash and technical assistance inflows against a fall in outward remittances by foreign workers in the country. Similarly, the primary income deficit narrowed from $156 million to $92 million due to a surge in receipts from fishing licenses and a decline in profits repatriated by foreign direct investment companies over the period.

Figure 10: Trade and Current Account Balances



Source: CBSI

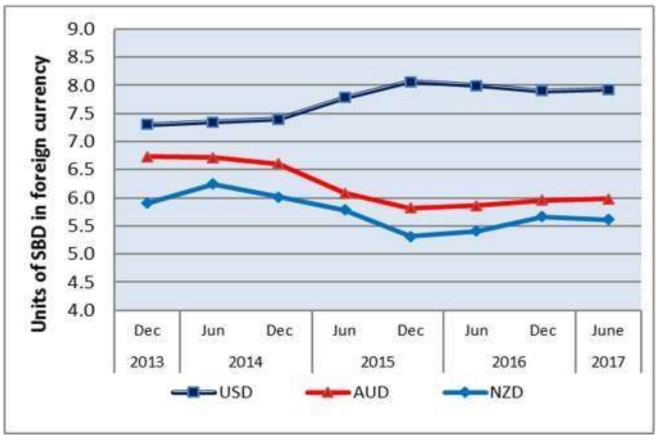
3.3.2 Capital and Financial Account

The surplus in the 'capital and financial' account more than halved from $528 million in the last six months of 2016 to $234 million in the period from January to June 2017. Primarily driving the outcome was the fall in financial account inflows from $298 million to $48 million. This downturn was attributed to the decreases in inward foreign direct investments and in currency and deposit liabilities that offset the rise in reinvested earnings of foreign companies in the country. In addition, the 20% decrease to $187 million in the capital account surplus, particularly after the influx of donor funded capital projects in the previous period contributed to the reduced outturn in the capital and financial account.

3.3.3 Exchange Rate

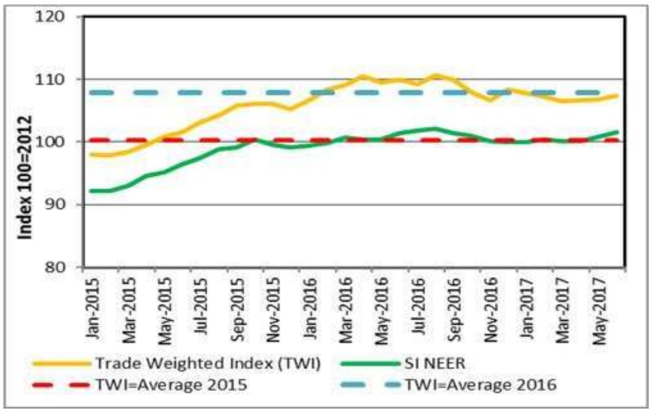
The Real Effective Exchange Rate (REER) weakened by 2.2% to an index of 144.4 in the first half of 2017 and implying that the country's exports were more competitive. This outcome stems from the depreciation of the Nominal Effective Exchange Rate (NEER) by 4.1% to an average index of 99.3. The movement in the NEER reflects the fall of the Solomon Islands dollar against the country's key tradable currencies. Meanwhile, on an annualized basis, the REER and NEER in June 2017 had also both depreciated by 3% and 0.6% respectively against June 2016.

Figure 11: Nominal Bilateral Exchange Rates



Source: CBSI

During the first six months of 2017, CBSI maintained its exchange rate policy of pegging the local currency to an invoice-weighted basket of major global currencies. This is in concurrence with the Bank's accommodative monetary policy stance and ensures stability within the foreign exchange market. Evidently, the SBD marginally weakened by 0.27% against the exchange rate basket, the Trade-Weighted Index (TWI) to an average index of 107.5, although stronger by 1.2% against the first half of 2016. Driving the movement against the last half of 2016 was SBD's depreciation against the United States Dollar (USD) and the Australian Dollar (AUD), the two key currencies in the basket. In the period from January to June 2017, the SBD fell against both against the former and latter by 0.3% to an average $7.93 per USD and an average $5.98 per AUD respectively. On the other hand, it appreciated by 0.9% against the New Zealand Dollar (NZD) to $5.59 per NZD. **Figure 12: Trade Weighted Index**

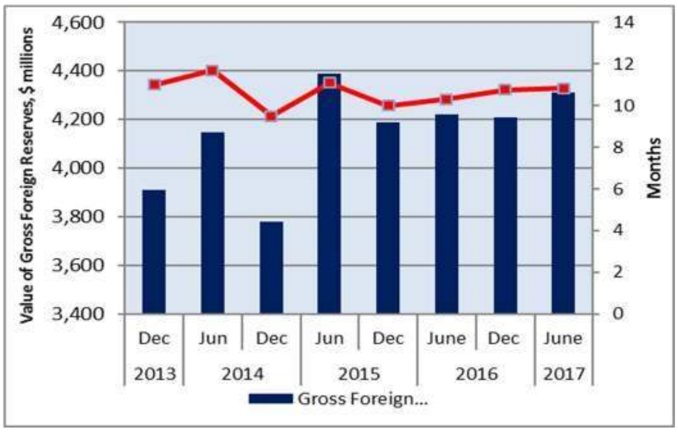


Source: CBSI

3.3.4 Reserves

The positive BOP performance during the first six months of 2017 was reflected in the 2% increase in the country's gross foreign reserves to $4,311 million. This was due to larger rise in inflows particularly from donor grants and fishing licences amidst a decline in outflow payments. On an annualized basis, this level of reserves also rose by 2% against $4,223 million in June 2016. Accordingly, this level of reserves approximately represents 10.8 months of imports of goods and services.

Figure 13: Gross Foreign Reserves



Source: CBSI

3.4 Fiscal Conditions

The government recorded a fiscal deficit of $117 million in the first six months of 2017. Although the negative outturn was expected, the size of the first half deficit was smaller than budget expectations but relatively higher than the same period a year ago. The deficit came as a result of high expenditure outlays and weaker than expected revenue outturn during the period. To a large extent, the government continued to finance its deficit from the government's previous years' savings in the banking system. Comparing to budget, both revenue and expenditure outturns for year to June tracked below their respective budgets due to an overly optimistic budget.

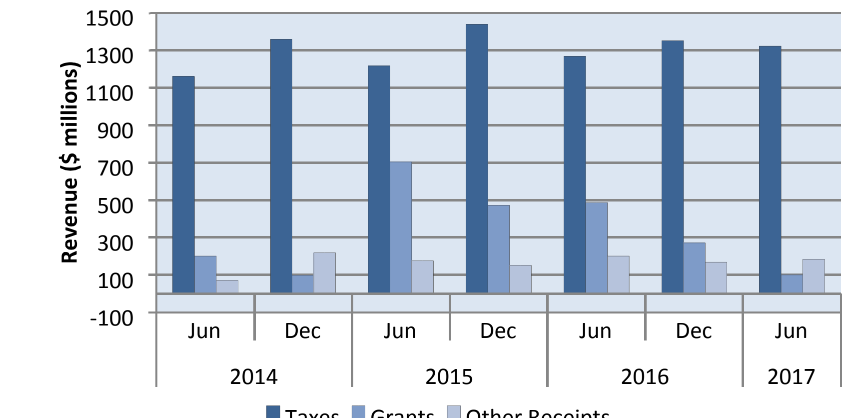
3.4.1 Revenue

Total revenue and grants received in year to June fell against budget by 16.8% to $1,608 million. This reflected budget shortfalls in all three broad revenue categories namely taxes, non-tax, and grants. Taxes which represented 82% of total revenue fell by 11.6% against budget to $1,322 million. Non tax, which accounted for 14% of overall revenue, fell against budget by 34.2% to $185 million. Similarly, grants received in the six months to June fell by 35.4% against budget to $101 million.

Despite the weak performance against budget, revenue collection in the first half of 2017 improved by 3% against the corresponding period in 2016. Tax revenue gained 4% to $1,322 million, driven mainly by taxes on goods and services which rose by 10.5% ($44 million) to $458 million. Other forms of taxes also recorded yearon-year growths though very marginal. Taxes on income, profits and capital gains improved by 1.3% to $459 million and taxes on international trade went up negligibly by 0.2% to $388 million. Non tax also picked up 4% to $185 million. Fishing licenses that were received in the second quarter was a major factor behind the stronger year on year outturn in non-tax. Similarly, grants which accounted for 6.3% of total revenue rose by 18% against the same period in the previous year to $101 million. Of the non-tax revenue, property income accounted for 72% and sales of goods and services 28%.

Grants received from development partners in year to June fell by 35% against budget to $101 million. The grants were purposely for budget support. About 80% of the grants were received in the second quarter while 19% in the first quarter. Comparing to the same period a year ago, grants went up by 18%.

Figure 14: Fiscal Revenue Collection



Source: CBSI

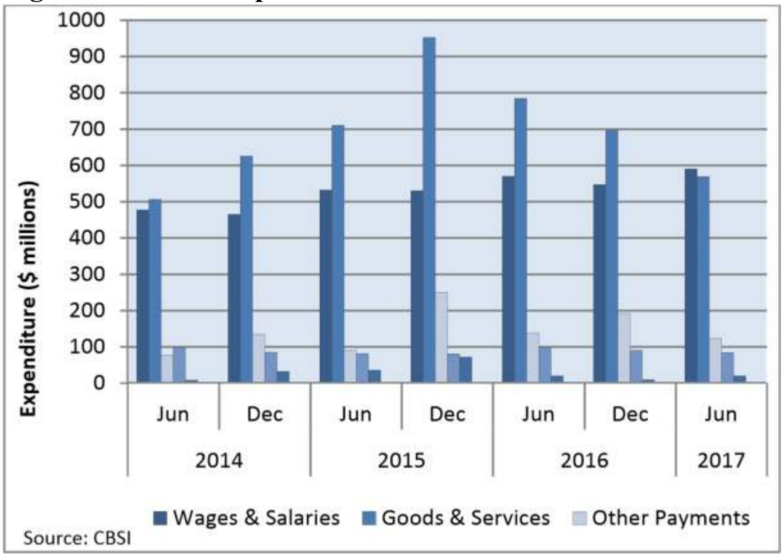
3.4.2 Expenditure

Expenditure outlays in the six months to June 2017 declined against budget by 16.7% to $1,725 million. This was a fall of 3% year-on-year. The weak expenditure outturn was in part constrained by unanticipated revenue shortfalls against budget. Of the total expenditure, around 81% ($1,393 million) was expended on recurrent operations and 19% ($332 million) on capital expenditure.

Recurrent expenditure fell below budget by 11% to $1,393 million. The shortfall was driven mainly by other charges which fell by 20% to $803 million. The main categories under other charges that recorded significant shortfalls were ‘use of goods and services’ category, other expenses, and grants which declined by 20%, 24% and 11% to $569 million, $124 million and $84 million respectively. Compensation of employees on the other hand overran budget by 3.6% to $590 million, due in part to one-off lumpy allowances that were paid in the first half of the year. Against the previous year, ‘compensation of employees’ strengthened by 4%.

Capital expenditure in the six months to June amounted to $332 million. This was below budget and the similar period in 2016 by 34% and 11%, respectively. As a share of overall expenditures, capital expenditure up to June 2017 trended downward to 19.1% from a slightly higher share of 21.1% in the corresponding half year in 2016. The ratio indicates capital expenditure was given lesser priority in terms of resourcing than recurrent expenditure in the first half of 2017.

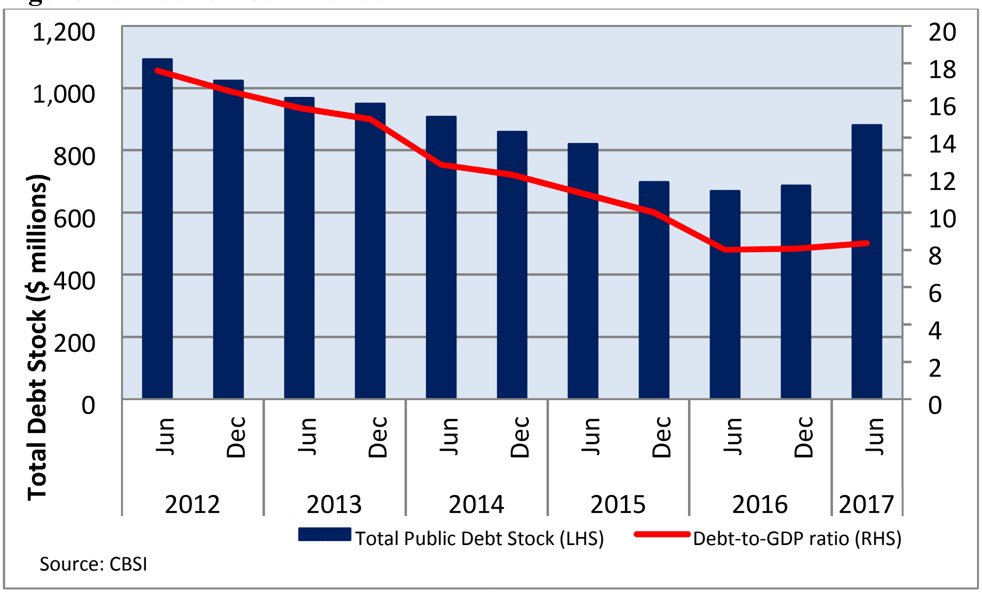
Figure 15: Fiscal Expenditure



3.4.3 Public Debt Stock

The Central Government debt increased to $880 million in June 2017 from $669 million in December 2016. The 31.5% increase was driven in large part by the development bonds the government started issuing in March 2017 to finance key pipeline projects such as the fibre optic cable and to a lesser extent factored by loan components from multilateral donors such as ADB. Of the total debt stock, external debt accounted for 78.4% ($690 million) while domestic debt represented 11.6% (or $190 million). Debt repayments also declined by 17% against that in the first half of 2016 to $24 million of which 99.3% were for external repayments and 0.7% for domestic repayments. Of the debt repayments, principal repayments accounted for 83% as opposed to 17% in interest payments.

Figure 16: Public Debt Trends



3.5 Inflation Developments

Inflationary pressures in the country remained subdued in the first six months of 2017. Headline inflation as measured by the three months moving average (3MMA) turned positive to 0.5% in June from minus 2.8% in December 2016, after a series of price deflations since August 2016. The positive outturn reflected price pickups in both domestic and imported inflation over the first half of the year. This was largely driven by price rises in the food component from minus 4.7% in December 2016 to minus 0.9% in June and positive 0.5% in July.

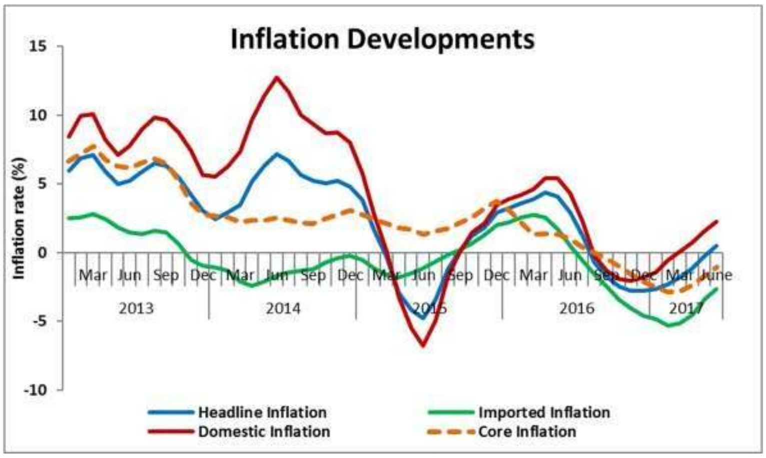
Of the overall headline inflation of 0.5%, food component contributed 0.2%, followed by housing utilities and transport and communications at 0.1% each whilst all the other categories accounted for the remaining 1%.

Domestic inflation, which captures local price movements rose to 2.2% in June 2017, from minus 1.8% in December 2016. Driving this positive outcome, were price increments in major categories namely the food category from minus 4.2% to 0.7% in June, followed by housing and utilities with prices surging from minus 2.1% to 0.1% in June. The largest price increase emanated from the drinks and tobacco category, which accelerated from minus 1.3% to 16% in June, while a negligible price increase was recorded for household operations, improving from minus 0.3% to 0.1% in June. These outweighed the price falls in the transport and communications category from 3.5% to 2.3% and the clothing and footwear category from 0% to minus 9.5% in June. In terms of contributions to domestic inflation, food accounted for the largest component with 0.8%, followed by housing and utilities accounting for 0.7%. Meanwhile, transport and communications contributed 0.3%, drinks and tobacco represented 0.2% whilst the remaining categories accounted for the remaining 0.2% Imported inflation, which reflects price movements in imported goods increased to minus 2.6% in June 2017, from minus 4.6% in December 2016. This was driven by price pickups in the food, transport and communications, clothing and footwear and household operations categories, offsetting the price falls in housing and utilities, recreation health and other services and miscellaneous items during the first half of the year. The largest price increase came from the transport and communications category from minus 5% to 4.4% in June 2017, followed by food component from minus 5.3% to minus 3.0%; and clothing and footwear category from minus 2.3% to minus 1.1% at the end of June. Of the overall imported inflation, food accounted for minus 1.3% followed by housing and utilities, and transport and communications categories at 0.3% each. Household operations, clothing and footwear, and recreation categories represented minus 0.2% each whilst the other categories accounted for the remaining 0.2%.

In terms of inflation development for Solomon Islands as at June 2017, headline inflation emerged from a negative trough after 10 months of consecutive deflation, reaching a nadir of minus 2.8% in December 2016 before rebounding on an upward trend to reach 0.5% in June. Headline inflation for July reached 1.1% and is expected to increase thereafter for the second half of 2017 (See figure 18).

Core inflation, which excludes volatile and regulated items improved to minus 1% in June 2017, from minus 2.2% in December 2016. Price movements in core inflation reached its lowest point at minus 2.8% in April before rebounding to minus 1% in June. The outcome was attributed to the gradual pick-up in prices for food, housing utilities, household operations and clothing and footwear for the first half of the year (See figure 18).

Figure 17: Inflation Developments



Source: CBSI

4 Domestic Economic outlook

The CBSI has reviewed it's near to medium term economic growth projections for the domestic economy. Economic growth for 2017 is marked down to 3.4%, 10 basis points down against the preliminary projection in March. This followed revisions to some of the underlining key assumptions behind the March forecast. Logging output, which was initially expected to remain at the same level as 2016, is projected to fall by 4% year-on-year due to unfavourable weather conditions in the first half of the year. Similarly, contribution from the agriculture sector is expected to be much lower than initially anticipated following weak performances from palm oil and cocoa.

Over the medium term, economic growth is expected to average at 4.0% in 2018-2020. Positive contributions from agriculture, fishing, mining, construction, wholesale and retail, manufacturing, transport and storage, financial intermediation and public sectors are expected to outweigh moderate declines from the logging sector. However, risks to the medium term growth projection are tilted to the downside if planned projects in the mineral and energy sectors are delayed and weak commodity prices.

Inflationary pressures are expected to pick up in the remaining months of 2017 and may push overall inflation upper level of the 3%-5% range by end year. Inflation volatilities are expected to continue on the back of movements in commodity prices particularly from food and energy sources as well as from unfavourable weather patterns. Over the medium term, external pressures are also expected from price and exchange rate developments in major trading partners. The stronger AUD may drive prices of goods imported from Australia upward. While core inflation is still within negative zone, it is projected to come out of the negative zone in the final quarter of 2017. Domestic demand pressures are expected to remain subdued as credit growth expected to grow moderately in 2017 and 2018. Given the low levels of inflation, there is still policy scope to accommodate any upward inflationary pressures.

Liquidity conditions is expected to fall in the near to medium term. This is however not expected to drive domestic demand and inflationary pressures. The main assumption behind the contraction in liquidity level is associated with the government plans to borrow from domestic agents to finance key pipeline projects in the energy and communication sector.

The external sector is projected to record a balance of payments surplus in 2017 and 2018 despite anticipated deficits in the current account. The current account deficits are envisaged to be financed mainly by donor inflows and foreign borrowing. However, external reserves are expected to remain comfortably at 10 months of import cover in 2017 and 2018.

The Central Bank maintains the exchange rate regime that pegs the local currency to a currency basket. The currency basket is expected to support the local dollar cushion against volatilities in the global market. The central bank will continue to monitor the exchange rate markets and takes appropriate actions deem necessary.

According to the Solomon Islands 2017 Budget Strategy and Outlook document, the central government is expected to incur a budget deficit in 2017-2019. The deficit is expected to be financed from domestic savings and through borrowings. The deficits are expected in light of the pipeline infrastructure projects the government embarks to achieve over the near to medium term.

5 Monetary Policy Stance

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.