CENTRAL BANK OF SOLOMON ISLANDS

MONETARY POLICY STATEMENT
March 2021

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1 Overview

Recent vaccine approvals and strong policy support in few large economies led to an upward revision for global growth in the IMF's January World Economic Outlook (WEO) update for 2021. The global economy is projected to grow 5.5% in 2021, an upward revision of 0.3 percentage point relative to the 2020 October WEO forecast. Stronger than expected momentum on average in the second half of 2020 also led to an improved revision of global growth for 2020 with growth projected at a 0.9 percentage point higher than earlier forecasted in September.

Nonetheless, outturns in the real economy in the second half of 2020 witnessed broad contractions across most productive commodities, foreign investment applications and building permits aside from manufacturing and communication.

Monetary conditions on the other hand, were firm reflecting the expansionary monetary policy taken by CBSI to cushion the fallout in the pandemic and to stimulate the economy. Expansions were noted in all key aggregates of the monetary sector.

The Balance of Payments (BoP) deficit improved to a smaller deficit of $7 million in the second half of 2020 on account of significant surplus in the first half of 2020 coupled with the IMF credit support under Covid-19 response measures. Accordingly, the country's gross foreign reserves marginally grew by 1% year to December 2020 representing 13 months of import cover.

The government's overall fiscal deficit widened in the last six months of the year as expenditures grew more than the expansion in revenue. To a larger extent, this reflected Covid-19 related containment and economic recovery measures as the government's response to the pandemic.

Headline inflation remained subdued in line with weak economic activity in 2020 falling to -1.8% in December from 5.7% in June. Core inflation consequently declined to -1.4% in December from 1.2% in June.

Overall, these weak economic activities in the economy translated into a recession in real GDP in 2020. Real GDP growth was downgraded to -4.3% relative to the -3.9% earlier forecasted. The revision reflected weaker than expected outturns in the final quarter of 2020 as well as overall for the year. As a result, growth for 2021 is projected to slow to 1.5% compared to 2% previously expected.

Over the medium, real GDP is forecast to grow on average by 3.5% in line with the anticipated roll out of big infrastructure projects while it is expected to dip in 2024 as engagements in construction activities eases. Moreover, there is considerable uncertainty to this near to medium term outlook as any delays to these growth assumptions could easily hamper growth.

2 International Economic Developments

Following the stronger rebound in economic activity seen across most advanced and emerging market economies in in the second half of 2020, global growth for 2021 is expected to recover to 5.5%, up from -3.5% in 2020[1]. Supporting this recovery momentum, which is expected to materialise later in the year is the mass roll-out of vaccines coupled with additional policy support measures in a few large economies. Whilst large uncertainties prevail, downside risks to this outlook include renewed waves of Covid19 infections and new variants of the virus that could dampen these recovery prospects.

Growth in advanced economies rebounded in later 2020 reflecting the various fiscal support measures provided by governments in these economies and their central banks to households and firms. This pick-up in economic activity were more notable in the Euro area and USA. On the other hand, growth in the UK moderated in 2020. Growth prospects for 2021 in advanced economies remain mixed. Where some economies are expected to recover strongly in 2021 following the stronger growth momentum in the second half of the 2020 backed by policy support measures as in

[1] IMF World Economic Outlook January 2021

the case of Japan and USA. Other economies particularly, the UK and Euro Area, are expected to recover moderately. In the Euro area, this reflects the easing of activity towards the end of 2020 due to rising infections and renewed lockdowns which is expected to continue into early 2021.

As for **emerging market economies**, economic activity also picked up in 2020 and is projected surge to above pre-pandemic levels. Unlike other economies, positive growth was recorded for China in 2020 and is expected to grow to 8.1% in 2021. This comes on the back of effective containment measures; dynamic public investment response and central bank liquidity support, which have encouraged strong recovery.

Growth in our regional trading partners, recovered at a faster pace than expected in the second half of 2020. In Australia, growth is expected to recuperate strongly from -2% at the end of December 2020 to 3.5% in 2021 as the recovery continues into 2021-2022.[2] As for New Zealand, economic activity is expected to remain around pre-Covid19 levels until late 2021. Thereafter, growth is expected to accelerate from late 2022. [3]

2.1 Global Inflation

Inflation remained muted across 2020 for advanced and emerging market economies and is expected to remain subdued over 2021-2022. In advanced economies, inflation is forecasted to rise from 0.7% in 2020 to 1.3% in 2021, remaining well below the Central Banks target of 1.5%. Meanwhile, inflation in emerging markets and developing economies is estimated at 5% in 2020 and is projected to moderate to 4.2% in 2021, which is lower than the historical average of the group.

On the regional front, inflation outcomes in Australia and New Zealand remained low throughout 2020. Inflation movements in Australia were volatile in 2020 largely due to the impact responses to Covid19 and fluctuations in fuel prices. As such headline inflation eased from 1.4% in the September quarter to 0.9% in December quarter. This outcome was slightly higher than expected as some prices of components that were affected by the pandemic related policies increased more than expected. Meanwhile, in New Zealand, the recovery in economic activity for the second half of 2020 led to higher than expected inflation, reaching 1.4% at the end of December 2020. Some of this increase reflected disruptions to global supply chains. Moreover, this outcome remains slightly below the 1-3% medium-term target range until mid-2022.[4]

2.2 Global commodity prices

Based on the latest available data, the IMF's commodity price index increased further by 16% to 125 index points in the December quarter. This outcome reflected positive increases across major commodities during the quarter. The energy index surged by 31%, food index grew by 9% and non-fuel index increased by 8% over the quarter. Meanwhile, the tapis fuel price[5] fell by 3% to an average of US $43 per barrel at the end of December from US$45 per barrel in the previous quarter[6]. Against the same period a year ago, tapis fuel prices have fallen substantially by 37%.

3 Domestic Economic Developments

3.1 Monetary Conditions

Monetary conditions recovered in the second half of 2020, 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 have continued expanding but at a slower pace across the last six months of 2020.

3.1.1 Reserve Money

Reserve money (M0) growth firmed in the second half of 2020 by 23% to $3,509 million compared to a slower growth of 0.2% recorded in the first six months. The growth against June 2020 was driven by increases in both the currency in circulation by 20% to $1,095 million and Other Depository Corporations (ODCs) call accounts by 24% to $2,409 million respectively. On the sources side, this growth is reflected in the uptick in the Net Foreign Assets (NFA) by 1% to $5,029 million combined with the reduction in the CBSI's net

[2] RBA Monetary Policy Statement February 2021

[3] RBNZ Monetary Policy Statement February 2021.

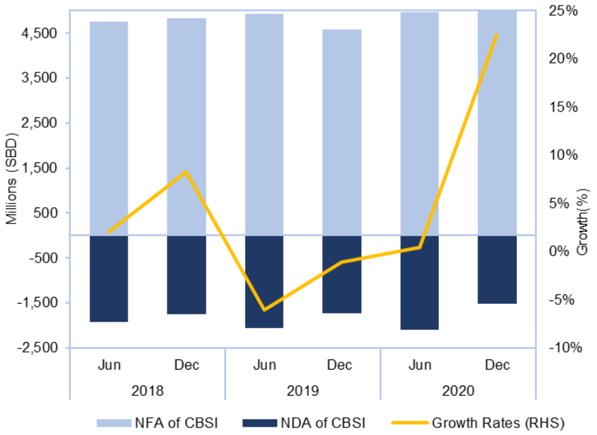
[4] Reserve Bank of New Zealand Monetary Policy Statement February 2021.

[5] The main imported fuel for the Solomon Islands

[6] Bloomberg

domestic assets (NDA) by 28% to minus $1,514 million.

Figure 1: Drivers of Reserve Money



Source:CBSI

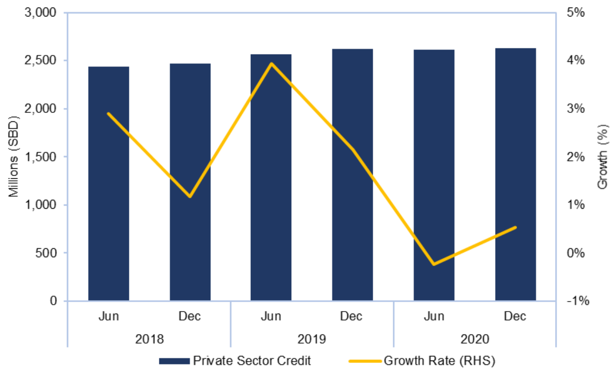
3.1.2 Money Supply

Broad money (M3) grew by 7% to $5,418 million in the second half of 2020, after a 0.3% fall in the first half. This outcome mirrored an increase in narrow money (M1) outweighing the fall in other deposits. On the sources side, this growth was supported by the growth in both NDA and NFA of the banking system; the former from minus $209 million to $80 million and the latter by 1% to $5,393 million.

3.1.3 Credit Conditions

Private Sector Credit (PSC) growth marginally surged by 1% to $2,629 million in the second half of 2020 against a fall of 0.2% in the first half. The growth mirrored an increase in ODC's credit lending by 1% to $2,613 million. Major sectors contributing to the increase were construction, agriculture, forestry, and professional and other services. In contrast, fisheries, entertainment, and catering, private financial institution, and the manufacturing sector declined across the second half.

Figure 2: Credit to Private Sector



Source:CBSI

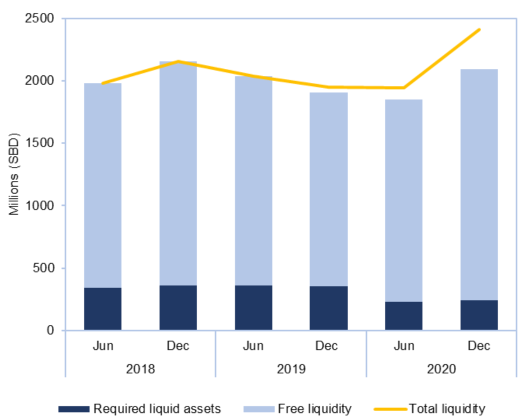
3.1.4 Interest Rate Trends

The ODCs' interest rate margin narrowed to 9.73% in December 2020 from 10.33% in June 2020, reflecting a decline in the indicative weighted average lending rates from 10.80% in June 2020 to 10.30% in December 2020 whilst, the indicative weighted average deposit rate increased from 0.47% to 0.57% over the same period. Declined lending rates to distribution, tourism, transportation, communication, entertainment and catering, manufacturing, and personal sectors explained the fall.

3.1.5 Liquidity Levels

Liquidity levels in the banking system rebounded across the second half of 2020 by 8% to $2,403 million after a decline of 0.2% in the first half. The surge in liquidity was driven by an increase in CBSI's NFA combined with the deterioration in the CBSI's NDA. Hence, both free liquidity and excess liquidity plunged by 14% to $1,850 million and 15% to $1,660 million respectively during the same period.

Figure 3: Liquidity levels



Source:CBSI

3.1.6 Open Market Operations

The level of Bokolo Bills issued had declined in the second half of 2020. The stock of Bokolo Bills held by the ODCs stood at $430 million at the end of December 2020 against $660 million in June 2020. This reflected the expansionary monetary policy action taken by the Bank to mitigate the impact of Covid-19 in the financial system. Throughout the same period, the interest rate (WAY) declined to 0.29% from 0.56%. The stock of treasury bills issued recorded $87.7 million by end of December 2020 with a lesser amount left before reaching the threshold of $100 million. The interest rates offered for 91% days remained unchanged at 0.49% as of December 2020. However, interest rates for both 182 days and 365 days dropped to 1.07% and 1.95% from 1.11% and 1.96% respectively.

3.2 Domestic Conditions

Domestic economic activities remained weak in the second half of 2020 as Covid-19 continues to have profound societal and economic impacts in the economy. The impact of the containment measures led to significant effects across the economy resulting in most households and businesses pulling back on activity. As a result, weaker than expected outturns were evident across key sectors in the economy.

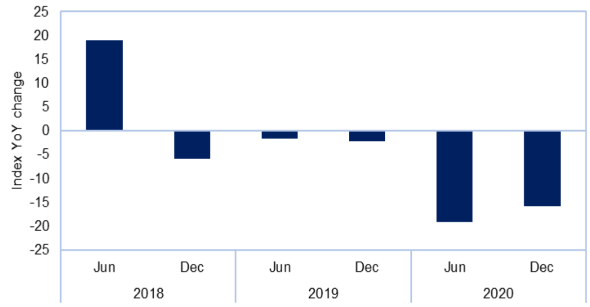
3.2.1 Economic Growth

The revised real GDP growth estimate for 2020 dipped further than earlier forecasted in the September 2020 Monetary Policy Stance (MPS). The economy is estimated to contract to minus 4.3% in 2020 from minus 3.9% estimated in September. The derail demand in the global market, uncertainty calamity amidst Covid19 importation into the quarantines, and unfavourable fishing conditions are key drivers for this revision.

3.2.2 Production Index

Domestic economic activity in the second half of 2020 contracted further with the CBSI Production index declining by another 15 points to an index of 77.

Figure 4: Half Yearly Production Index



Compared to the same period in 2019, round logs dropped 17%s, fish catch by 31%, crude palm oil by 2%, and cocoa by 19%. These commodities make up around 90% of the country's merchandise exports. The negative outcome was attributable to weak global demand, fall in export prices, and constraint in domestic supply-side factors.

3.2.3 Manufacturing

The manufacturing sector in the second half of 2020 picked up by 22% to an index of 282. However, compared to year ago, the index dropped by 10% reflecting under capacity due to two key factors. First, the weak demand in the economy affecting sales and production, and secondly, the negative supply-side factors particularly with the lower fish catch into the tuna processing.

3.2.4 Other Sectors

Other indicators of the economy have mixed outcomes in the second half of 2020. Communications almost doubled to an index of 500 due to higher internet usage, and imports of food and beverages as an indicator for the wholesale and retail trade picked up by 8%. Private sector credit stayed around the same as in the first half reflecting less incentive to invest given the uncertain Covid19 environment. On the downside, foreign investment applications fell 45%, building permits in the capital city dropped 30%, and cement imports declined by 27% indicating lower investments and constructions. No tourist arrived in the second half of 2020 as governmental mandates and restrictions limited movements.

3.2.5 Employment

The labour market conditions remained weak in the second half of 2020 as a result of the economic fall out of the Covid19 pandemic. SINPF members' contribution dropped further by 4% to 57,028 (active and slow active) contributors. This is a loss of over 2,500 contributors in the second half of the year as the economy experienced the full impact of the Covid19 pandemic and containment measures. The sectors that were largely affected were accommodations, constructions, and transport. The number of vacancy advertisements on print media went up strongly by 67% in the second half indicating a positive outlook for the labour market. However, this increase is largely driven by the public sector and given weak tax collection and expenditure controls, actual recruitments may be delayed to 2022 subject to passage of the 2021 national budget at the end of March 2021.

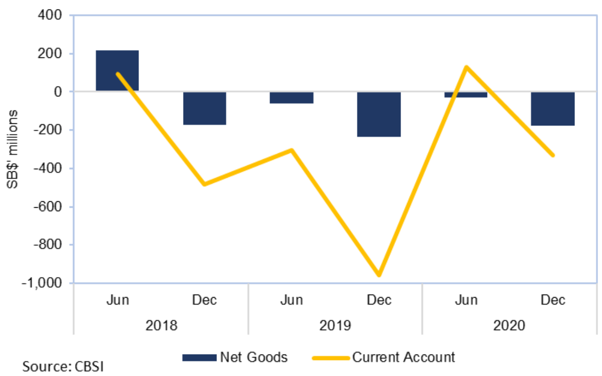
3.3 External Conditions

The Balance of Payments (BoP) position posted an overall deficit of $7 million in the second half of the 2020, down from a $203 million surplus in the first half. This outcome was driven by the dramatic swing in the current account to a deficit level from the surplus witnessed in the first half amid the weak global demand. With the significant surplus in the first half, and the IMF credit support under the Covid19 pandemic, the BoP position in annual terms resulted in an overall surplus of 3% of GDP.

3.3.1 Current Accounts

The current account balance deteriorated to a deficit of -$333 million (3% of GDP) in the second half of 2020 reversing the surplus balance of $129 million (1% of GDP) in the first half. Widening deficit in trade in goods and services, higher dividend payments and decreased donor grant transfers contributed to the outcome.

Figure 5: Trade and Current Account Balances



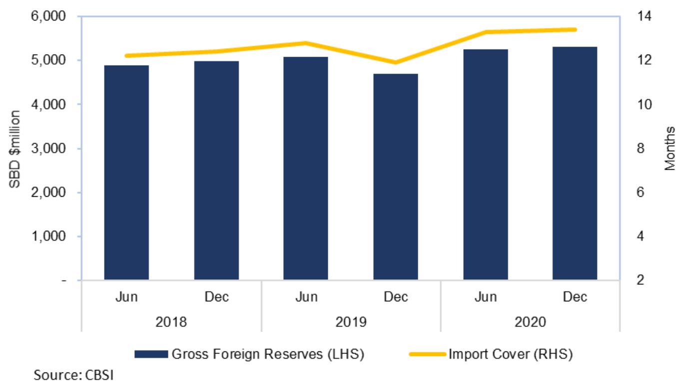
3.3.2 Capital and Financial Account

On the contra side, the 'capital and financial' account surplus improved significantly to 4% of GDP in the second half of 2020 from 1% of GDP in the first half. This reflected the increase in donor capital grants towards Covid19 infrastructure support to the country and government external loan disbursments from ADB and World Bank.

3.3.3 Foreign Reserves

The Gross foreign reserves in the second half grew marginally by 1% to $5,315 million driven mainly by revaluation gains from strengthening of the SBD against the USD which offset the minimal BoP deficit. This level of reserves is equivalent to cover 13.4 months of imports.

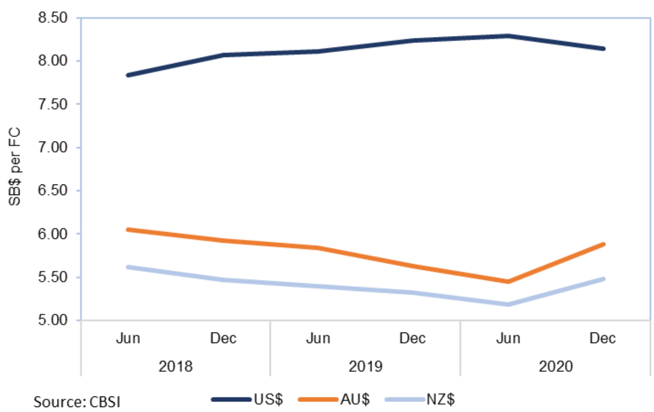
Figure 6: Gross Foreign Reserves



3.3.4 Exchange Rate

In terms of global currency movement, the Solomon Islands dollar (SBD) appreciate by 4.1% against the Trade Weighted Basket to an index of 109.2. This corresponds to the SBD strengthen against the USD by 1.7% to $8.14 per USD. On the other hand, the SBD depreciated against the Australian dollar and New Zealand dollar by 8.0% to $5.88 per AUD and 5.7% to $5.48 per NZD respectively.

Figure 7: Nominal Bilateral Exchange Rates



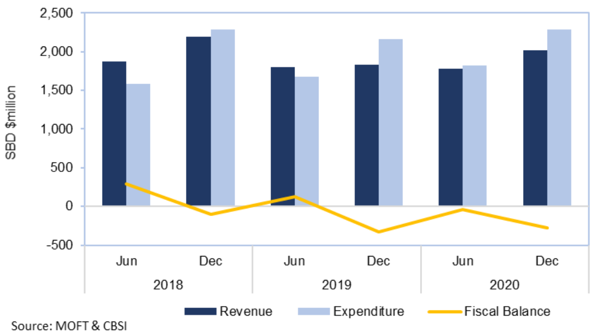
The country's Nominal Effective Exchange Rate depreciated by 2.5% to 114.7. While the Real Effective Exchange Rate appreciated by 0.4%

during the period, reflecting the inflation differentials with the trading partners.

3.4 Fiscal Conditions

The fiscal position recorded a wider overall deficit of $273 million in the second half of 2020 compared to a narrower deficit of $32 million in the first six months. On an annual basis, the total fiscal deficit recorded in 2020 is equivalent to 2.5% of GDP. This outcome mirrored larger increase in expenditure, relating to Covid19 containment and economy recovery measures, relative to the donor-driven increase in total revenue. Meanwhile, the Central government's debt stock increased further by 11% to $1,364 million in the second of 2020, equivalent to 11% of GDP

Figure 8: Fiscal Balance



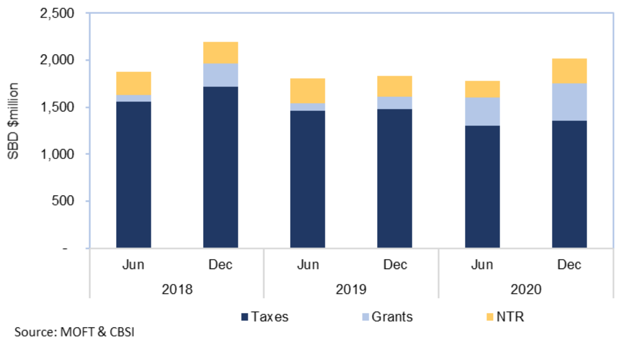
Source: MOFT & CBSI

3.4.1 Revenue

Total revenue firmed up by 13% to $2,015 million in the last six months of 2020 supported by strong tax and non-tax collections and increased grant receipts related to Covid19. This level was 10% higher than the same period in 2019 but 4% below the budget.

Tax receipts rose by 4% to $1,355 million in the second half of 2020, driven by increases in income tax and tax on goods and services. However, compared to the same period in 2019, tax revenue was lower by 8% and by 12% against the budget. Non-tax revenue surged by 42% to $262 million supported by improved collections on fishing license fees in the latter half of 2020. This was 22% higher year-on-year and 2% above the budget. Grant receipts grew markedly to $398 from $299 million in the first half of 2020 mainly donor support related to Covid19. This nearly doubled the amount received in the period in 2019 and 27% above the budget.

Figure 9: Fiscal Revenue Collection

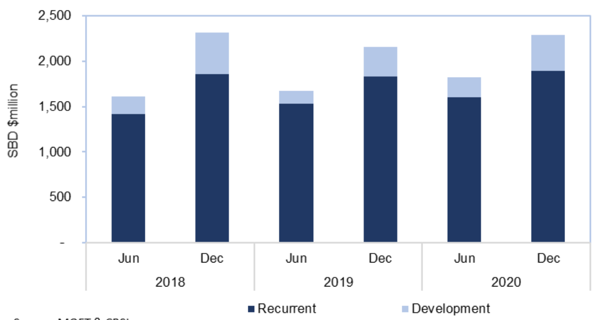


Source: MOFT & CBSI

3.4.2 Expenditure

Total expenditure expanded by 26% to $2,289 million in the second half of 2020 reflecting Covid19 containment and stimulus spending. Compared to the budget, expenditure was 3% lower but 6% higher year-on-year. Recurrent expense, which accounted for over 80% of total expenditure, increased by 18% to $1,890 million against the first six months of 2020. Increases in goods and services, grants and 'other' spending largely underpinned the growth in expense. Conversely, payroll spending was contained in the second half relative to the first of 2020. Meanwhile, capital spending almost doubled to $399 million relative to the first six months driven by spending on building and structures. This level was 2% higher than the budget and 21% higher than the same period in 2019.

Figure 10: Fiscal Expenditure



Source: MOFT & CBSI

3.4.3 Public Debt Stock

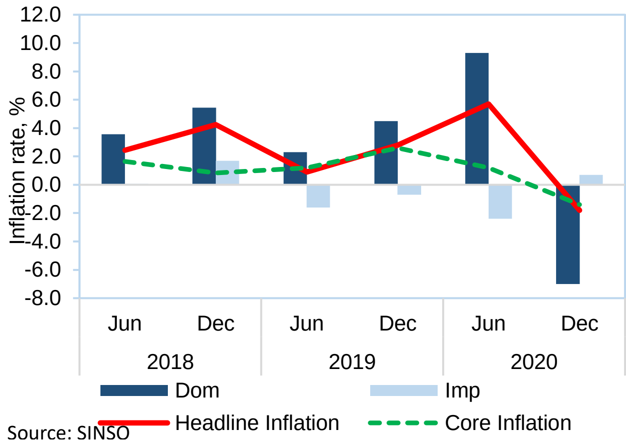
The Central Government debt stock rose by 11% to $1,364 million in the second half of 2020 driven by increases in both domestic and external debt. External debt increased by 16% to $972 million reflecting additional loans disbursement from ADB and the World Bank. Domestic debt increased by 2% to $392 million underpinned by additional bonds issued to state owned enterprises in the latter half of 2020. By proportion; external debt's share of total debt at the end of December 2020 rose to 71% from 69% in June 2020 while the share of domestic debt declined to 29% from 31%.

3.5 Inflation Developments

Inflation in the second half fell considerably due to combined weak domestic demand, excess supply of local crops and betel nuts, and relatively lower crude oil prices. Headline inflation declined from 5.7% in June to minus 1.8% in December driven mainly by the significant drop in domestic items from 9.3% in June to minus 7.0% in December. The fall in the price of betel nuts, and market root crops and vegetables had been the major factor driving this downturn. The relaxation of Covid-19 health measures particularly with the opening of betel nut markets in Honiara had seen the price of betel nuts nose-dived due to consistent supply from peak levels observed in the first half. Covid-19 relief measures by Solomon Power to keep electricity tariff at minimum levels also contributed to easing inflation.

On the other hand, imported items increased from minus 2.4% in June to 0.7% in December following the rebound in crude oil and food prices in the second half, although crude oil price was relatively lower than pre-pandemic levels. Core inflation dropped to minus 1.4% in December from 1.2% in June in line with depressed demand in the second half of 2020.

Figure 11: Inflation Developments



Source: SINSO

4 Domestic Economic Outlook

4.1 Real Economy

The real GDP growth is forecasted to a slower recover of 1.5% in 2021 following a contraction of minus 4.3% in 2020. Pick up is expected in the fisheries and constructions of major national projects such as the Pacific Games that would have spill over benefit to the service sectors. Moreover, prospects for vaccines roll out in the second quarter of 2021 would add confidence and certainty for business activities to return to normalcy. Globally, the IMF forecasted a rebound of 5.5% in 2021 adding momentum demand on export commodities. However, on the downside, the delay in the passage of the 2021 national budget to end March 2021 mean a downtime of implementation during the year. The gradual decline in logging – a major source of national income is a source of concern. In a very short-term outlook for the first half of this year reopening of the borders for tourism activities is unlikely. Besides, business perceptions are pointing to a status quo indicating operations and outcome will be around the same as in the second half of 2020.

The forecast over the medium term (2022 – 2025) is broadly unchanged to projections in the September 2020 Monetary Policy Stance. The bank is anticipating growth to pick up to an average of 3.5% with high growth concentrated in 2022 to 2023 between 5% and 6% from booming construction activities for the Pacific Games and other national projects. Given this construction driven growth, post-games in 2024 would be more challenging as growth would drop considerably to around 1% when infrastructures and facilities are completed. Strategic policies to rekindle growth on non-construction activities from 2024 to 2025 is paramount to ensure growth keeps pace with the annual population growth rate of 2.7%.

4.2 Fiscal

With the slower economic recovery anticipated this year, the outlook for the fiscal sector remains bleak. On the revenue front, the depressed economic conditions may weigh on domestic revenue mobilisation efforts. More budget support or additional borrowing will be required to fill likely revenue shortfalls in 2021. On the expenditure side, the government aims to limit recurrent spending and increase budget allocations to development spending in line with the theme of the government's policy redirection. With the anticipated slowdown in domestic revenue collections and the need to support economic recovery, the fiscal deficit is expected to widen to around 3% of GDP in 2021 compared to the fiscal deficit of 2% of GDP posted in 2020.

Budget risks

Two immediate risks to the fiscal outlook are (a); the current level government's cash reserves and (b) overly optimistic forecast on donor budget support. With the government's cash reserves just above the IMF's $300 million minimum cash reserve, there is tendency for additional debt financing in 2021. On budget support, the fiscal deficit could rise higher than 3% of GDP without donor support. Since the 2021 budget is heavily dependent on donor support, effective dialogue with donor partners is required to avoid committing the government to additional borrowing if the forecast tuns out too optimistic.

4.3 External

The outlook for the external sector in 2021 is expected to remain positive despite a projected widening current account deficit on the back of higher imports for major capital projects. Nonetheless, capital and financial inflows are anticipated to increase resulting in a reduced BOP surplus and a slight build up in the foreign reserves. Over the medium term, the continuation of the key pipeline infrastructure projects means the current account deficit would widened further from high capital imports, although this will be financed by donor capital grants and FDI in the capital and financial accounts.

4.4 Monetary

Developments in key monetary aggregates are expected to increase in 2021 and beyond, consistent with the medium-term growth forecast. Reserve money, narrow money, and broad money are forecasted to increase moderately over the medium term. Growth in private sector credit is projected to pick up but at a modest pace. Thus, excess liquidity is estimated to increase further with the anticipated expansionary fiscal policies over the medium-term. However, there are downside risks to the medium-term outlook that hinged on the unfavourable conditions in the external sector and the fiscal policy's financing mix.

4.5 Inflation

Inflation at end of 2020 fell to the negative territory at minus 1.8% and core inflation at minus 1.4%. Pass through effect from lower world price for crude oil combined with weak demand in the economy amid the Covid-19 pandemic had been the key determinants of this negative inflation.

In the next six months to June 2021, inflation is projected to remain negative at around minus 1.6%. The continued depressed demand to the first of half the year is anticipated to drive down inflation but with some counteracting upward pressures on vegetables, fish and betel nut prices as the country enters into the wet season cycle through to April. Inflation is projected to pick up to around 3% towards end of 2021 as world commodity prices particularly, crude oil is projected to pick up to pre-pandemic levels.

5 Monetary Policy Stance

1. **Recommendation:**
   With the projected rebound in global growth and corresponding pace of modest recovery expected for the domestic economy, along with low inflation and amidst high uncertainty, the CBSI will maintain an expansionary monetary policy stance for the next six months to ensure the momentum to recovery in economic and financial activity is supported. However, should the situation change, the Bank shall take appropriate actions accordingly.