CENTRAL BANK OF SOLOMON ISLANDS

MONETARY POLICY STATEMENT
September 2021

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1 Overview

Continued delays in vaccine access, the extent of mutation scenarios and changes in policy support led to a revision in the growth compositions of advanced and emerging markets and developing economies in the IMF's July 2021 World Economic Outlook (WEO) Update. Global growth projection remained unchanged at 6% from the previous outlook but with equal offsetting revisions by a marked downgrade in emerging market and developing economies growth projections for 2021 compared to an upward revision in the projection for advanced economies.

Global commodity prices remained robust in line with strengthening global recovery coupled with strong food and oil prices from the first half whilst global inflation was contained on the back of temporary pandemic-related developments and transitory supply-demand mismatches.

Economic conditions in the Solomon Islands remained subdued in the first six months of the year building on from lacklustre conditions in the second half of 2020. Broad-based contractions remained across most sectors of the economy apart from manufacturing.

Against this backdrop, key monetary aggregates slowed during the period with broad money and private sector credit declining by 0.4% and 1% respectively. Conversely, reserve money and liquidity both grew by 2% each reflecting improved reserves in the first half of 2021.

Accordingly, deteriorations in both the fiscal and current account deficits widened over the period to 3% and minus 6% of GDP respectively reflecting weak economic activities and wanning exports amid high imports. As a result, headline inflation remained muted in the first half of the year.

In light of these developments, real GDP in 2021 is downgraded to 0.4% from 1.5% reflecting weaker-than-expected outturns in most sectors in the economy. Over the medium term, real GDP is forecasted to grow at an average of 3% on account of planned key national projects in the pipeline.

However, risks to this outlook are tilted to the downside. Prolonged COVID-19 and delayed pick-ups to growth assumptions would quickly hamper growth.

2 International Economic Developments

The global economy is projected to recover firmly in 2021 from the contraction in 2020, although with diverge growth path across economies. According to the IMF's latest July WEO 2021 update, global growth outlook for 2021 is forecasted at 6%[1] driven largely by the advanced economies uptick in fiscal support and vaccination programs. In 2022, global growth is forecasted to ease to 4.9%. Meanwhile, the risks are downside and the growth prospects remain uncertain given the rise in the contagious delta variant virus coupled with slower vaccine rollout especially in developing economies.

Growth prospects in advanced economies are on track at 5.6% in 2021 and 4.4% in 2022 propelled by a faster pace of vaccines rollouts and additional fiscal support. The outlook for

[1] All statistics in this section are obtained from the International Monetary Fund (IMF) World Economic Outlook July 2021 update, unless otherwise stated.

the US economy is relatively stronger compared to the other advanced countries due to additional support on boosting infrastructure investments.

In emerging market and developing economies, growth for 2021 is expected at 6.3% and is projected to moderate to 5.0% in 2022. Meanwhile, growth in Southeast Asian countries has been revised downwards due to renewed lockdowns and travel restrictions from the delta variant virus. Also, vaccinations administered is around 1% for low-income countries, and only 11% for emerging economies compared to 35% for advanced economies. This gap is the 'fault line' to economic recovery according to the IMF. Moreover, the Chinese economy is expected to grow by 8.1% in 2021 from the increase in public investments and fiscal support.

On the regional front, the Australian and New Zealand economies have continued on their economic recovery trajectories in the March quarter of 2021 following a recorded a fall in unemployment and a positive quarterly growth of 1.1% and 1.6%, respectively. Both economies are expected to rebound firmly in 2021 and ease into 2022 supported by accommodative fiscal and monetary policy. Growth in Australia is expected to recover to 5.3% in 2021 and moderate to 3.0% in 2022, stronger than earlier projections. Similarly, New Zealand is expected to grow by 4% in 2021 before slowing down to 3.2% in 2022.

2.1 Global Commodity Prices

Global commodity prices have rebounded accompanied by the global recovery. The IMF's Commodity Price Index further rose by 15% to an index of 162 in the June quarter driven by upward movements in both energy index by 20% and non-fuel index by 10%. Consistent with the energy index, the tapis fuel price in the June quarter picked up strongly by 13% to the pre-pandemic level of US$70 per barrel. The global commodity prices are forecasted to remain strong in 2021 following the surge in the first half of the year.

2.2 Global Inflation

Global inflation is expected to pick up although contained from 3.2% in 2020 to 3.5% in 2021 in line with the global economic recovery and surge in global commodity prices. In advanced economies, inflation in 2021 is expected to pick up by 0.9 percentage points to 1.6% before remaining stable at 1.7% in 2022. Meanwhile, inflation in emerging market and developing economies is expected to rise from 5.1% in 2020 to 5.4% in 2021 and ease to 4.7% in 2022.

In Australia and New Zealand, inflation has surged in the June quarter of 2021. Australia's CPI rose by 3.3%[2] in June 2021 quarter from 1.1% in the March 2021 quarter with a notable price rise in automotive fuel. Similarly, in New Zealand, CPI increased to 3.3%[3] in the June 2021 quarter from 1.5% in March 2021 quarter driven by food and petrol. Partly accounting for this surge were revisions in the annual calculation against the low inflation in June 2020 quarter following the COVID-19 impact. Meanwhile, the forecasts for average consumer prices in 2021 compared to 2020 for Australia is expected to increase by 0.8

3 Domestic Economic Developments

3.1 Monetary Conditions

Monetary conditions in the first half of 2021 aligned with slower economic performance. Reserve money (M0) grew at a slower rate while narrow money (M1), broad money (M3), and private sector credit (PSC) saw a downward trend during the first six months of 2021. Meanwhile, total liquidity continued to increase while Other Depository Corporations' (ODCs) interest rate margin further widened during the period.

3.1.1 Reserve Money

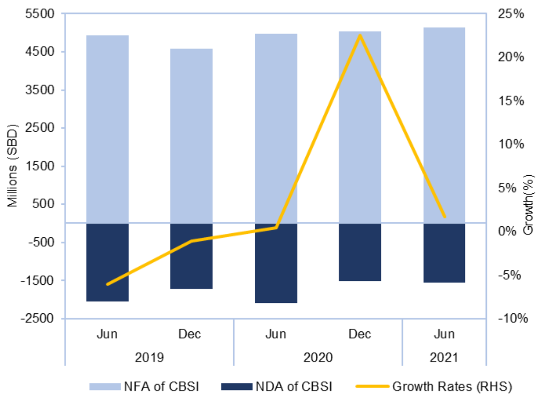
Reserve money (M0) growth continued to increase in the first half of 2021 by 2% to

[2] Australia Bureau of Statistics

[3] Statistics New Zealand

$3,567 million following a 23% growth recorded in previous period. The growth against December 2020 was driven by increases in both currency in circulation by 1% to $1,103 million and ODCs' call balances held at CBSI by 2% to $2,461 million. On the sources side, this growth mirrored the rise in CBSI's net foreign asset (NFA) by 2% to $5,137 million along with the increase in the CBSI's net domestic asset (NDA) by 3% to minus $1,564 million.

Figure 1: Drivers of Reserve Money



Source:CBSI

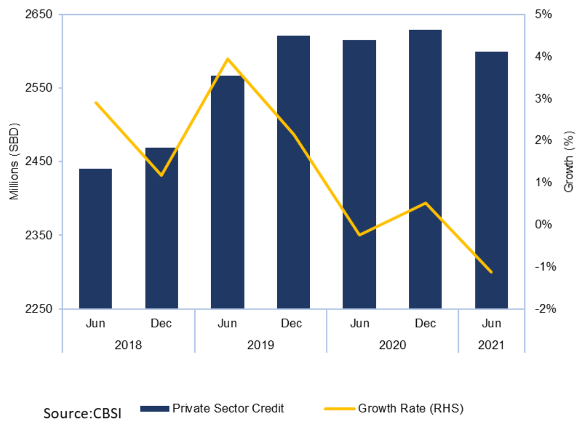
3.1.2 Money Supply

Broad money declined marginally by 0.4% to $5,398 million in the first half of 2021, after a 7% growth posted in the previous period. This fall reflected the increase in other deposits outweighing the fall in M1. On the sources side, the 1% fall in the NFA of the banking system to $5,353 million supported the fall in M3 during the period. Meanwhile, the NDA of the banking system increased by 24% to $100 million.

3.1.3 Credit Conditions

Private sector credit growth fell slightly by 1% to $2,599 million in the first half of 2021 against a 1% increase in the previous period. The fall mirrored the 1% decline in ODCs' lending to $2,583 million. Key sectors contributing to this fall were the construction, fisheries, forestry, communication, private institution, and professional and other services sectors. However, agriculture, distribution, tourism, transport, entertainment and catering, and personal sectors increased in the first half.

Figure 2: Credit to Private Sector



Source:CBSI

3.1.4 Interest Rate Trends

The ODCs' interest rate margin widened to 9.93% in June 2021 from 9.73% in December 2020, resulting from an increase in the indicative weighted average lending rates from 10.30% in December 2020 to 10.41% in June 2021. In contrast, the indicative weighted average deposit rate decreased from 0.57% to 0.48 % over the same period. This was attributed to the decrease in lending rates to the forestry, fisheries, construction, communication, and person sectors.

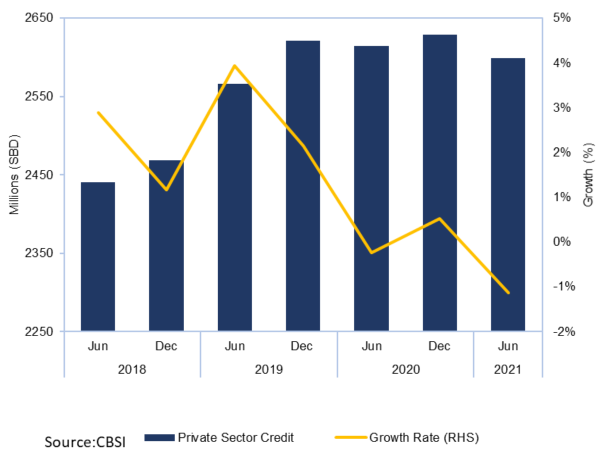
3.1.5 Open Market Operations

The stock of Bokolo Bills issued in the first half of 2021 remained at $430 million as in the previous period. This reflected CBSI's expansionary monetary policy stance which aimed to lessen the impact of COVID-19 on the financial system. During the same period, the interest rate (WAY) declined to 0.10% from 0.35%. The stock of treasury bills issued recorded $89.3 million by end of June 2021 with limited space left before reaching the $100 million cap. Thus, the interest rate offered for 91-days remained unchanged at 0.49% as of June 2021. Interest rates for 182-days and 365-days both declined to 1.05% and 1.92% respectively.

3.1.6 Liquidity Levels

Total liquidity levels in the banking system increased by 2% to $2,461 million in June 2021, following a 24% increase recorded in December 2020. This outcome was driven mainly by an increase in CBSI's NFA. Hence, free liquidity and excess liquidity increased by 2% each to $2,215 million and $2,020 million respectively during the same period.

Figure 3: Liquidity levels



3.2 Domestic Conditions

Domestic economic activities remained muted in the first half of 2021. This outcome reflected the persistent impact of the Covid-19, extended travel restrictions coupled with the prolonged disruptions to the domestic economic activities. This weaker outturn was seen across broad sectors of the economy except for the manufacturing and construction sectors.

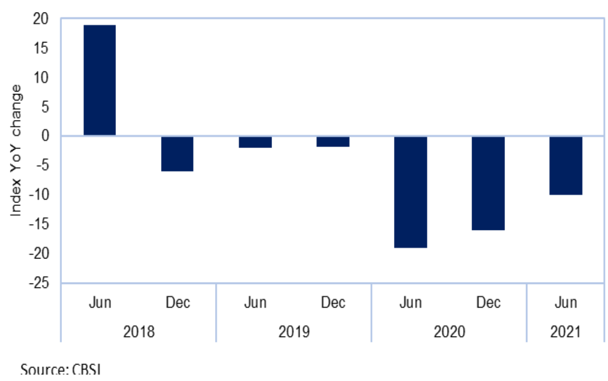
3.2.1 Economic Growth

Following the slower economic performance in the first half, economic growth projection for 2021 was revised down to 0.4% from the 1.5% earlier projected in the March 2021 Monetary Policy Statement (MPS). A notable fall was seen in the agriculture sector, particularly for palm oil and cocoa – the two high valued products.

3.2.2 Production Index

The production index dwindled by 12 points to an index of 76 in the first half of 2021 compared to the same period in 2020 (see Figure 4). The decline is driven by a fall in round logs, palm oil, and cocoa which offset the increased production in fish catch, copra and coconut oil.

Figure 4: Half Yearly Production Index



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3.2.3 Manufacturing

The manufacturing sector remained firm in the first six months of 2021. Compared to the first half in 2020, the manufacturing index strengthened by 25% to 289 index points and was 2% higher than the second half of 2020. This positive outcome was attributed to stronger outturn in tuna processing on the back of improved fish catch.

3.2.4 Other Sectors

Other indicators of the economy in the first half remained subdued. Energy production, imported food, import of cement, and FDI applications all showed a fall compared to the second half of 2020. Private sector credit was also broadly the same from the second half of 2020. These indicators portrayed the slow-down in economic activity in the first half of 2021.

3.2.5 Employment

Employment using SINPF member's contributions as proxy waned further by 2% to 55,776 (active and slow active) contributors. This reflected recruitment freezes by employers opting to maintain the same level of workers to sustain operations amid the uncertainty of the COVID-19. However, the number of vacancy advertisements in print media showed an uptick in demand in the labour market as 784 job vacancies[4] were advertised in the first half mainly from state-owned enterprises and international businesses.

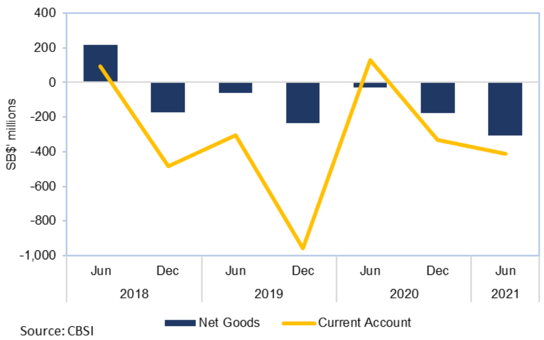
3.3 External Conditions

The Balance of Payments (BOP) position rebounded to a surplus at 1.3% of GDP ($171 million) in the first half of 2021 from a revised deficit of minus 0.02% of GDP (minus $3 million) in the second half of 2020. This outcome reflected the improvement of the capital and financial accounts amidst a widening current account deficit. Accordingly, the gross foreign reserves surged over the period.

3.3.1 Current Accounts

The current account balance widened to a deficit of $411 million from $333 million in the second half of 2020. This outcome was underpinned by the sizable expansion in the trade in goods deficit and a contraction in the primary income surplus.

Figure 5: Trade and Current Account Balances



Source: CBSI

Supporting the trade deficit outturn was the significant increase in imports particularly from machines, basic manufactures and fuel imports. Meanwhile, exports increased slightly on the back of upturns in copra, coconut oil, minerals and other exports. The narrowed primary income surplus resulted from the slowdown in fishing license receipts. In contrast, the services deficit was reduced as spending on public goods and services declined while secondary income surplus surged from higher donor grants received.

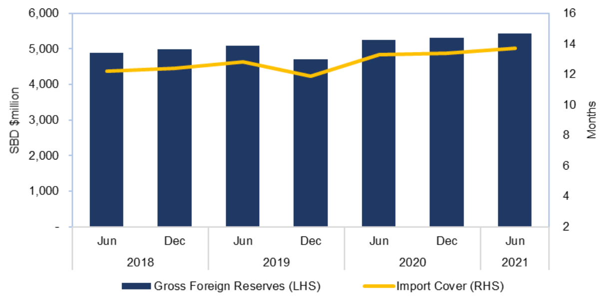
3.3.2 Capital and Financial Account

On the contra side, the capital and financial account surplus surged by 22% to $542 million due to the increase in financial account inflows reflecting the substantial rise in government loans over the period.

3.3.3 Foreign Reserves

The Gross foreign reserves increased by 2% to $5,427 million at the end of June 2021 following the improved capital and financial account balance surplus, driven mainly by inflows from capital grants and financial inflows. This level of reserves is equivalent to around 13.7 months of import cover.

Figure 6: Gross Foreign Reserves



Source: CBSI

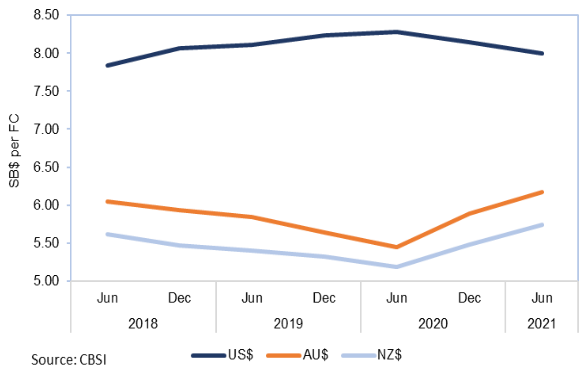
3.3.4 Exchange Rate

Global currency movements particularly the weakening of the US dollar led to the appreciation of the Solomon Islands dollar (SBD) by 2.8% against the Trade Weighted Basket to 106.1 points. Against the key bilateral currencies, the SBD appreciated against the USD by 1.8% to $8.00 per USD. On the other hand, the SBD depreciated against the Australian dollar and New Zealand dollar by -4.7% to $6.17 per AUD and by 4.5% to $5.72 per NZD respectively.

The country's Nominal Effective Exchange Rate depreciated by 1.2% to an index of 113.3. Moreover, the Real Effective Exchange Rate on average depreciated by 4.4% during the period, reflecting the inflation differentials between the country and its trading partners

[4] Sourced from Pasifiki HR

Figure 7: Nominal Bilateral Exchange Rates



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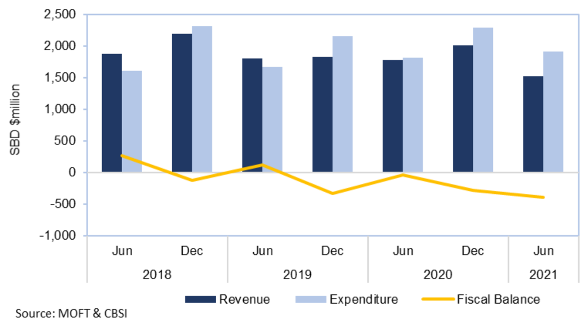
3.4 Fiscal Conditions

The fiscal year got off to a slower start with the 2021 national budget delayed until April. This rendered fiscal policy less effective, than otherwise, in supporting economic recovery. The prevailing depressed economic conditions affected revenue mobilisation and budget implementation in the first half of 2021. By June 2021, the fiscal position deteriorated to a $382 million deficit, 3% of GDP, up from the deficit of 2% of GDP recorded in the second half of 2020.

Figure 8: Fiscal Balance

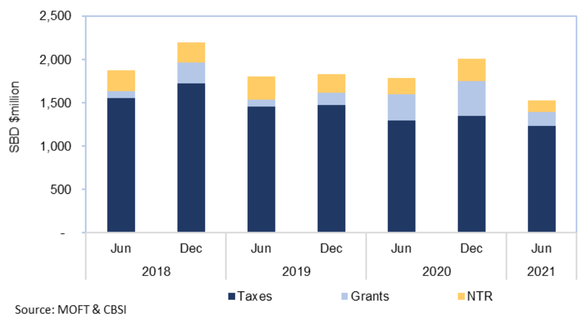


This mirrored declines in both revenue collections and expenditure across the first six months. Meanwhile, the government's debt stock rose to $1,609 million, 11% higher than at the end of December 2020, equivalent to 13% of GDP

3.4.1 Revenue

Total revenue declined by 24% to $1,530 million in the first half of 2021, reflecting weaker collections on all revenue categories. This level was 14% lower than in 2020 and 17% below the budget.

Figure 9: Fiscal Revenue Collection

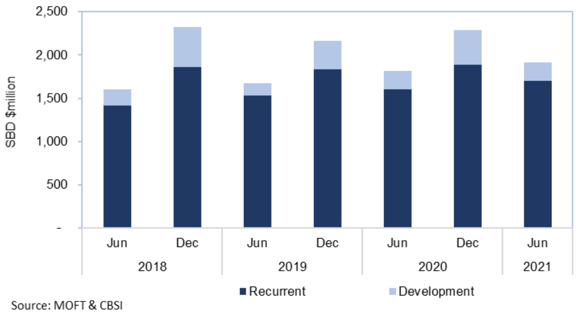


Tax revenue fell by 9% to $1,239 million against the prior six months reflecting declines in all tax categories. Taxes on trade fell by 7% to $501 million, driven by both import and export duties, the latter due to fewer round logs receipts. Income and profit tax shrank by 15% to $416 million attributing to lower company and personal taxes. Goods and services tax declined by 2% to $303 million and property tax by 2% to $19 million. On a year-on-year basis, tax revenue fell by 5% and down by 4% against the budget. **Non-tax revenue** dropped to $131 million, half the receipts in the prior six months and was due to lesser fishing fees collected. Meanwhile, **donor support** fell to $160 million from $398 million relative to the second half of 2020

3.4.2 Expenditure

Total expenditure fell by 16% to $1,912 million against the second half of 2020, driven by both recurrent and development spending. This level of spending was 13% below the budget although 5% higher than in 2020.

Figure 10: Fiscal Expenditure



Source: MOFT & CBSI

Recurrent expense shrunk by 10% to $1,701 million underpinned by reductions in major spending categories. Operational costs declined by 8% to $1,448 million. This stemmed from a decline in the purchase of goods and services by 19% to $705 million despite an increase in payroll by 5% to $743 million. Transfers and other benefits fell by 20% to $237 million owing to fewer grant and social benefit payments, and other expenses. Development spending fell to $211 million, 47% less than in the prior six months, consistent with the slower revenue outturn and delayed budget execution.

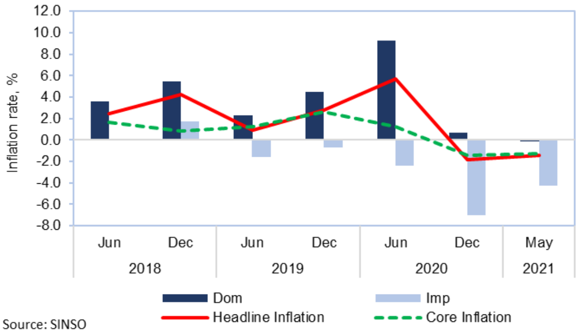
3.4.3 Public Debt Stock

The Central Government's debt stock rose to $1,609 million reflecting new loan disbursement in the first six months to June 2021. The external debt rose by 16% to $1,155 million, following the $183 million loan disbursement from JICA. The domestic component edged slightly higher by 1% to $454 million sustained by the additional treasury bills issued. Debt serving in the first six months totalled to $37 million, $21 million in principal repayment on external loans and $16 million on interest charges, paid on both domestic and external loans.

3.5 Inflation Developments

Inflation in the first six months of the year remained subdued at negative numbers although it has started to rebound given the uptick in world commodity prices. Headline inflation in June 2021 compared to December 2020 increased by 30 basis points to minus 1.5% a faster upswing than earlier anticipated in the March 2021 MPS.

Figure 11: Inflation Development



Source: SINSO

Imported inflation increased to minus 2.2% in June from minus 7% in December 2020 reflecting the surge in fuel prices. Domestic inflation on the other hand eased from 0.7% to minus 1.1% following the decline in prices of fish, seafood and alcoholic beverages. Accordingly, core inflation improved to minus 1.1% in June from minus 1.5% in December 2020.

CBSI price monitor through the year to August saw petrol price in Honiara pump stations increased by 37%, LNG gas by 8%, and electricity tariff minimally by 1%. Meanwhile, rice prices dropped by 8% due to increased competition from several importers

4 Domestic Economic Outlook

4.1 Real Economy

The bank has revised down its economic growth outlook for 2021 and the medium term due to the prolonged impact of the pandemic following the rise of the newly contagious delta variant. Despite global economic recovery and rebound in commodity prices, the supply side factors to productions posed challenges to capitalise on these opportunities.

The economic outlook in 2021 is projected to slow to 0.4%, a downward revision from the modest recovery of 1.5% in the March 2021

MPS. This came largely from the agriculture sector, in particular, palm oil and cocoa productions which are expected to fall reversing their earlier forecasted growths. Climate change variations that were not foreseen affected their yields. Besides, indicators in the first half across sectors were relatively slower as well which indicated a prolonged effect of the Covid-19 pandemic. The delayed passage of the 2021 national budget for four months also decelerates the anticipated modest recovery. The responses from the Business Perception Survey also showed bleak outcomes on businesses sales and profits.

The delta variant posed new threats in the second half of 2021 and the government has imposed strict measures on incoming travels from countries affected by the variant. Vaccination despite being rolled out in March still attracts very low coverage from the population at large. The smaller recovery in 2021 would be mainly from fishing, manufacturing, and construction of national projects such as the commencement of the sports stadium funded by China. Fast-tracking national projects are crucial to support economic activity and growth. Otherwise, a much slower outlook could have implications for government tax revenues and employment. A lower business turnover would lead to lower tax, and businesses/organisations facing limited cash flow may resort to an employment freeze in the labour market, thus impacting on the labour market.

In the medium term, two-phased growth is predicted. In 2022 and 2023, growth is anticipated between 2% to 3% from a construction-led growth largely funded by donors and other commercial buildings. Meanwhile, the value-added from construction national projects depends on the extent of local labour recruitments and the use of local content materials and services. Once these constructions activities are heavily capital intensive then that can hamper these higher growths forecast as most of the materials are already anticipated to be imported. In 2024 and 2025 growth is forecasted to average around 2% and the onus is on policymakers to ensure growth is sustained once these big constructions activities are completed. During these two-phased growth episodes, agriculture, fishing, manufacturing, transport, finance, and business services are projected to be the mainstay of the economy. It is therefore vital that these sectors are supported with a conducive environment and infrastructure to drive the economy forward.

However, these baseline growth forecasts are based on no community transmission of COVID-19 and lockdowns.

4.2 Fiscal

The economic distress is affecting revenue mobilisation and budget implementation. Revenue collections have weakened whilst spending, although restrained remain elevated, exerting huge pressure on government finances. The cash position fell below $300 million in June, the minimum cover for three months of spending. With fewer reserves to draw on, payment rationing and a build-up in deferred payments ensued. If this trend persists into the second half of the year, the financing gap could widen further. To ease the pressure and stabilise government finance, additional donor support, expenditure restraints, particularly on nonessential items, and short-term borrowing are warranted. The latter necessitates raising the annual borrowing limit above the current ceiling of $350 million to allow for short-term borrowing if required.

The slower-than-anticipated economic recovery seen in the first half of the year points to a gloomy fiscal outlook. Tax revenues are expected to remain subdued in 2021 amid high spending pressures. With fiscal buffers stretched thin, the ability to respond swiftly to immediate risks could severely be limited. Besides climate-related risks, a potential outbreak of the covid-19 delta variant lurking next door, in Fiji and PNG, could be disastrous on government finances and the broader economy. Delayed payments to service providers, particularly those with mortgages, could lead to increases in non-performing loans, a potential risk to financial system stability.

Over the medium term, fiscal risks remain to abound. Across the country, both social services and infrastructures are deteriorating. With the country's population growing fast, demand for these essential services will further strain government finances. These investment needs are overwhelming and donor support will be required. Preparations for the 2023 Pacific Games present added fiscal pressures, pre and post-game. With the economy growing below potential and the fiscal position continuing to deteriorate, these pressures could see debt rise faster than otherwise in the near to medium term. At the outset, two potential issues deserve attention. First, persistently higher short-term borrowing to finance recurrent expenses could crowd out investment. Second, as the debt level increases, it may affect the government's creditworthiness. Markets tend to charge higher risk premiums on less creditworthy borrowers, thereby raising the cost of borrowing.

4.3 External

The outlook for the external sector in 2021 is principally favourable. This is due to the considerable donor support for the country's Covid-19 response and the major projects currently underway. The BOP surplus is expected to remain in surplus excluding any IMF policy finance during the year. If new SDR allocation comes into effect it will further boost the buffer for BOP needs to a comfortable level during this pandemic period. However, over the medium term, the rollout of the key pipeline infrastructure projects means a widening of the current account deficit with high capital imports, although this will be financed invariably by the capital and financial accounts.

4.4 Monetary

In line with the medium-term growth forecast, developments in the key monetary aggregates are expected to grow moderately in 2021 and beyond. Reserve money, narrow money, and broad money are forecasted to grow modestly over the medium term. Private sector credit is projected to fall but at a slower space. Meanwhile, excess liquidity is projected to increase further with the anticipated expansionary fiscal policies over the medium term. However, unfavourable conditions and uncertainties in the external sector and fiscal policy's financing mix are the downside risk to the medium-term outlook.

4.5 Inflation

The headline inflation for the next six months to December 2021 is forecasted to be contained at 3% and core inflation at 2.2%. This is broadly unchanged from the March 2021 MPS with the main factor is cost-push inflation from pickup in world commodity prices to pre-pandemic levels.

It is anticipated that crude oil prices will drive up transport costs and pass-through effect to other consumer items especially housing and energy. Rice price is forecasted to slow down although with some offsets expected from the proposed government imposing sugary tax once become effective. The negative inflation is therefore anticipated to revert to positive territory in the third quarter of 2021. CBSI price monitor of selected items through to August already saw this surge particularly with petrol prices (see subsection 3.5).

In 2022, headline inflation is forecasted between 3% and 4%, and core inflation between 2% and 3% on the broad assumptions of a moderate rise in world commodity prices, positive domestic economic growth, and government price control to repressed unsubstantiated price mark-ups in regulated consumer items.

5 Monetary Policy Stance

1. **Recommendation:**
   In light of these weaker than expected outcomes, a slower-than-expected projected recovery amid high uncertainties and with inflation expected to be contained, CBSI will adopt an accomodative monetary policy stance for the next six months to support the economy as it gathers momentum to recover. The CBSI will however, continue to attentively monitor key economic data in hand and take appropriate actions accordingly.