MONETARY POLICY STATEMENT

September 2023

CENTRAL BANK OF SOLOMON ISLANDS

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1. Overview

Global recovery continued but, is slowing as inflation risks and financial markets repricing challenges persist. Global growth is projected to fall from 3.5% in 2022 to 3% in both 2023 and 2024 with bulk of this slowdown concentrated in advanced economies while growth estimates for the emerging market and developing economies (EMDEs) remained broadly stable as in 2022.

Global food and oil prices fell markedly from their 2022 peaks although food prices remain elevated. The build-up of gas inventories in Europe and weaker-than-expected demand in China together with the normalization of supply chains contributed to this downward trend.

The domestic economy recorded mixed outcomes in the first six months of 2023 amid weaker than expected outturns mainly from agriculture, manufacturing, construction and the energy sector whilst mining on the other hand, posted exceptional growth over the period. Labour market conditions softened this period along with declines in advertised vacancies.

Monetary conditions varied in the first half as shown by key monetary indicators with reserve money (M0), narrow money (M1), private sector credit (PSC), and excess liquidity all registering growths in the previous six months while broad money (M3) conversely weakened. Moreover, interest rate margins of Other Depository Corporations (ODCs) edged down during the reviewed period.

The country's external position improved in the six months to June compared to the second six months of 2022. The favourable outcome reflected a reduced current account deficit which negated the decline in both the capital and financial account surplus. As a result, gross foreign reserve elevated in the reviewed period.

The fiscal environment deteriorated further in the first six months of 2023 following mounting spending pressures amid lower revenue collections. This led to further widening of the fiscal deficit to $551 million in the first half compared to the prior six months of 2022. Meanwhile, the central government debt stock increased substantially owed to the incurrence of new debt.

Headline inflation (3mma) eased to 5.5% in May 2023 from 9.5% recorded in December 2022 reflecting falling imported fuel prices and the pass-through effects on the energy and transport prices in the first half.

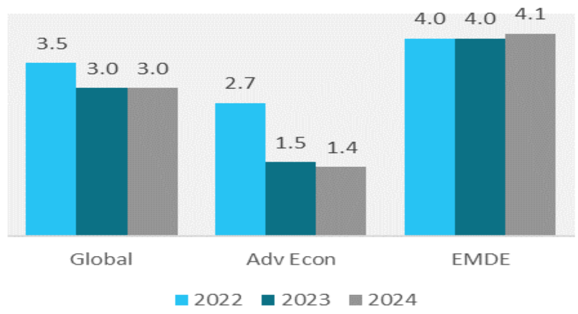
Against this backdrop, real domestic growth has been revised downwards to 2.4% from 2.7% projected in March 2023, primarily reflecting weaker-than-expected outcomes in agriculture, fishing and logging.

Risk to this growth outlook is skewed downward as vulnerability to natural disasters, poor infrastructure and transport system, limited fiscal buffers, and political uncertainty ahead of the 2024 National General Elections (NGEs) cloud the horizon. Globally, the Russian invasion of Ukraine, geopolitical tensions, and global financial turmoils may pose global growth challenges. Meanwhile on the upside, the country continued to benefit from heavy donor support with upgrades of key infrastructure developments and increased labour participation in the labor mobility scheme.

2. International Economic Developments

Global growth is estimated to slow from 3.5%[1] in 2022 to 3% in 2023 and 2024 as monetary policy tightening continues to weigh on economic activities, especially in advanced economies (see Figure 1) while growth in emerging markets and developing economies (EMDEs) is projected to be broadly stable at 4%.

Figure 1: Global Economic Growth



Source: IMF

[1] All statistics in this section are obtained from the IMF WEO July 2023 Update, unless otherwise stated.

Global growth in 2023 has been revised up by 0.2 percentage points from the April forecast, mirroring resilience in the services sector during the first quarter. However, growth is still below the historical average of 3.8% as forces that hinder growth in 2022 such as high levels of inflation and tight access to credit continued to persist.

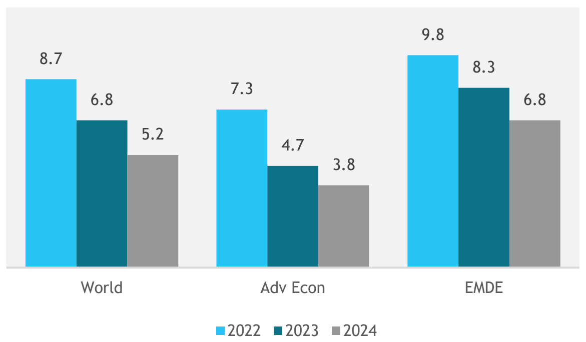
The risks to this outlook have moderated with immediate concerns on the banking turbulence easing and COVID-19 no longer a health emergency. However, the risks are skewed down by the continual war in Ukraine, geopolitical tensions, persistence in core inflation, higher debt distress, and China's contracting real estate. These could hamper global trade and investments.

On the regional front, the 2023 growth path for Australia and New Zealand is also forecasted to be relatively low between 1% and 2% reflecting tighter monetary conditions amid inflation forecast above the target level.

The global commodity prices have continued to abate in the first half of 2023 reflecting the fall in the IMF primary commodity price index from 193 points to 155 points. Energy prices dropped by 42% reversing the surge in prices in 2022, however, food prices increased slightly by 1%.

Global inflation is expected to slowly fall in 2023 and further ease in 2024 from the peak in 2022 as most central banks are prioritizing taming inflation (see Figure 2). Despite this gradual reduction, the underlying inflation remained persistently above central banks' inflation targets and the risks to the inflation outlook are high should there be further intensification of the war in Ukraine and any supply shocks due to weather variation.

Figure 2: Global Inflation



Source: IMF

3. Domestic Economic Development

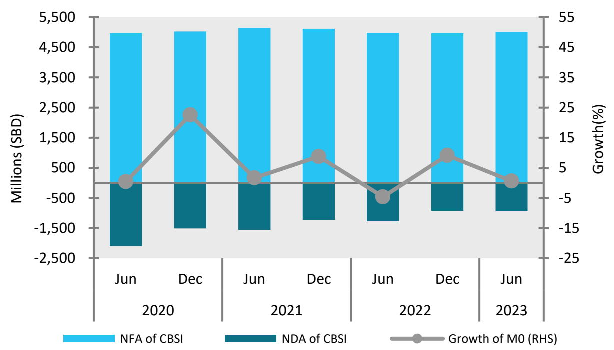
3.1. Monetary Conditions

Monetary conditions during the first half of 2023 saw varied changes in key monetary indicators. Reserve money (M0), narrow money (M1), private sector credit (PSC) and excess liquidity all saw growth. However, broad money (M3) experienced a decline. Additionally, interest rate margins for Other Depository Corporations (ODCs) decreased further during the reviewed period.

3.1.1. Reserve Money

Reserve money (M0) experienced a 1% increase, reaching $4,061 million in the first half of 2023. This followed a significant 9% rise recorded in December 2022. The growth seen in the first half of 2023 was evident in the increase of the ODCs' call balances, which went up by 2% to $2,823 million. However, there was a 4% decrease in currency in circulation, reducing to $1,231 million. On the sources' side, this increment in reserve money was influenced by a 1% rise in both the NFA and NDA of CBSI to $5,005 million and $937 million respectively.

Figure 3: Drivers of Reserve Money (M0)



Source: CBSI

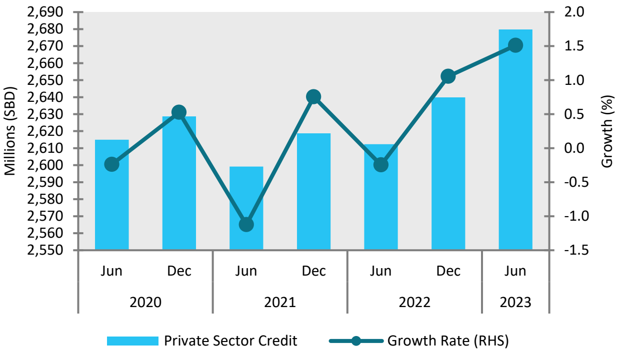
3.1.2. Money Supply

Broad money supply (M3) decreased by 2% to reach a total of $5,687 million in the first half of 2023, reversing an 8% increase recorded in the second half of 2022. The reduction in M3 was primarily influenced by decreases in M1 and other deposits, both falling by 2% to $4,642 million and $1,045 million, respectively. On the sources' side, the decline in the NFA of the banking system by 1% to $5,239 million, along with the fall in the NDA from $608 million to $492 million, contributed to this outcome.

3.1.3. Credit Conditions

The banking system experienced a slight 2% increase in total lending to the private sector to $2,680 million in the first half of 2023.

Figure 4: Credit to Private Sector



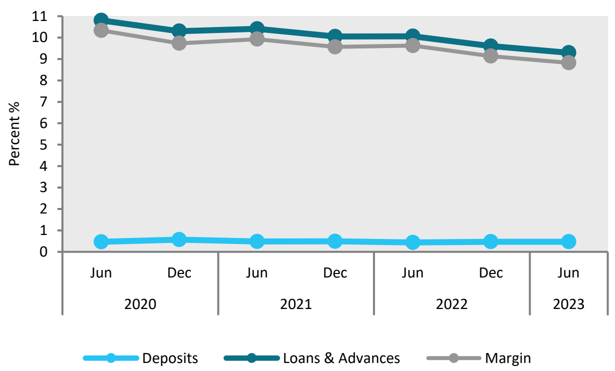
Source: CBSI

The rise in lending to the private sector was mainly driven by an increase of 1% in ODCs lending, reaching $2,658 million. Notably, the growth was supported by key sectors such as personal, distribution, manufacturing, agriculture, and fisheries. However, sectors like, transport, tourism, professional and other services, communication, and entertainment & catering saw a decline in the same period.

3.1.4. Interest Rates

In the first half of 2023, the ODCs' interest rate margin narrowed further to 8.8 % compared to 9.1% in December 2022. This was due to a decrease in the indicative weighted average (IWA) lending rates, which dropped from 9.60% in December 2022 to 9.20 % in June 2023. The decline in lending rates was primarily influenced by lower rates in sectors such as manufacturing, agriculture, fisheries, distribution, private financial institution, and personal. Meanwhile, the IWA deposit rates remained unchanged at 0.47% as in December 2022.

Figure 5: Interest Rates



Source: CBSI

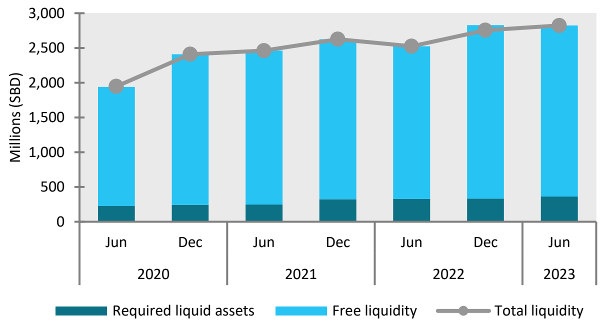
3.1.5. Open Market Operations

The weighted average interest rate for the Bokolo bills remained unchanged at 0.24% in June 2023 from December 2022. However, the stock of Bokolo bills issued remained at $430 during the first half of 2023, indicating the Central Bank's effort to support the financial system and mitigate the impact of external shocks. On the other hand, the stock of treasury bills issued rose to $133 million in June 2023, up from $93 million in December 2022. Thus, the weighted interest rates for 91 days rose to 0.50% from 0.49%, 182 days to 1.77% from 0.97%, and 365 days to 2.10% from 1.84%, respectively.

3.1.6. Liquidity Levels

The overall liquidity in the banking system grew by 2% to $2,823 million in the first half of 2023 following a significant rise of 9% in December 2022.

Figure 6: Liquidity



Source: CBSI

The upsurge was attributed to the increase in the Central Bank's NFA mainly driven by a rise in inflow receipts. Consequently, both free liquidity and excess liquidity saw growth, rising by 2% to $2,461 million and 0.4% to $2,099 million during the same period.

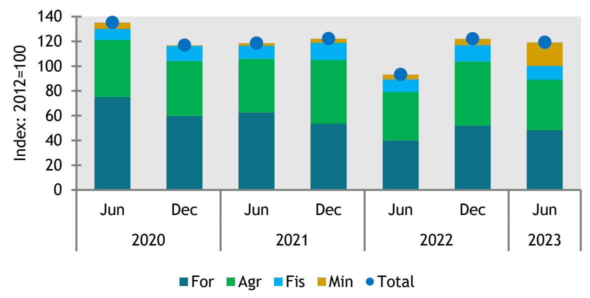
3.2. Domestic Conditions

Domestic activities in the first half showed mixed outcomes amid weaker-than-expected outturns in the first half of this year. Furthermore, government preparations and infrastructure developments geared towards the hosting of the Pacific Games in November 2023 continued, limiting other activities and programs in other Ministries to make way for Pacific Games priorities. Moreover, businesses, offices, and residents in Honiara have been severely impacted over the last two months by power disruptions due to mechanical issues with Solomon Power's gensets, resulting in added costs and increased revenue losses. Together, these mixed outcomes have implications for growth projections as initial growth was forecasted to be broad.

3.2.1. Production Index

The production index in the first half of 2023 declined against the second half of 2022 by 3 points to an index of 119.

Figure 7: Production Index



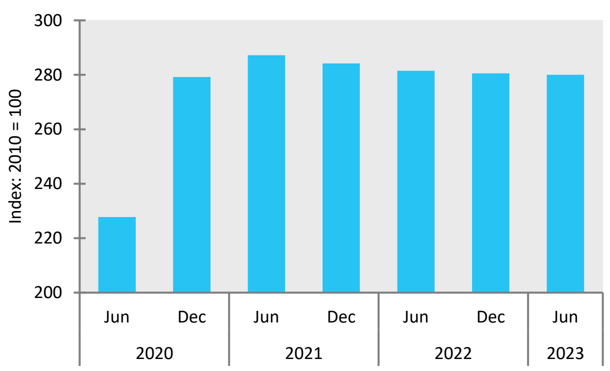
Source: CBSI

A significant fall was seen in agriculture (11 points), followed by logging (4 points), and fishing (2 points). In contrast, mining substantially expanded (14 points) with higher gold exports from Gold Ridge Mining. On a year-on-year basis, the production index was up by 26 points, a basis for economic recovery in 2023.

3.2.2. Manufacturing

Manufacturing index in the first half fell by 1 point to an index of 280. Driving this outcome is a downturn in manufacturing products for domestic consumption outweighing gains in manufactured goods for exports in the first half.

Figure 8: Manufacturing Index



Source: CBSI

3.2.3. Other Sectors

Provisional numbers for total visitors' arrival increased by 18% to 7,900 visitors from 6,688 arrivals. Air arrivals rose by 3% whilst 5 international cruise ships arrived in Honiara in the first half. Cement imports, a proxy indicator for investment slowed considerably indicating sport stadiums constructions earmarked for the Pacific Games were in the final completion stage. Several public infrastructure constructions also continued in the capital and in the provinces supported by donors and Solomon Islands Road and Aviation Project (SIRAP) initiative.

The business perception survey conducted by CBSI in July 2023 showed businesses recorded a favorable outcome in their profitability and revenue turnovers in the first half. The outlook in the second half for business profitability and their perception of the overall economy is favorable and optimistic. This suggests that there is confidence in business activities in the next six months.

3.2.4. Employment

The labor market remained soft with SINPF's number of contributions (active and slow active) showing only a minimal uptick of 0.3% to 55,379 contributions largely from the mining sector.

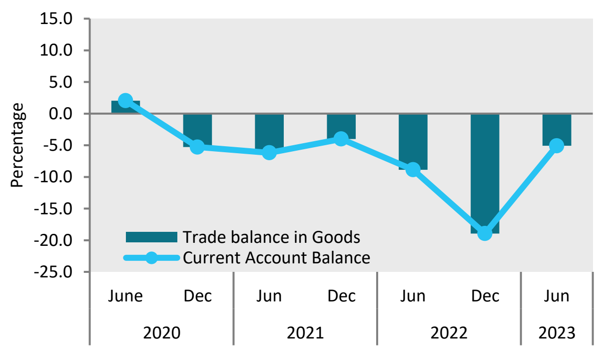
3.3. External Conditions

The Balance of Payment (BOP) position recorded a surplus over the first six months of 2023 equivalent to 1.9% of GDP ($126 million), improving from minus 2.7% of GDP (-$171 million) in the second half of 2022. This positive outcome emanated from the sizeable reduction in the current account deficit which outweighed the reduced surplus in the capital and financial account. As a result, the level of gross foreign reserves grew by 2% to $5,582 million over the period.

3.3.1. Current Accounts

The current account deficit narrowed significantly to minus 5.1% of GDP (-$335 million) during the first half of 2023 from minus 18.9% of GDP (-$1,178 million) in the preceding six months. This was driven by the reduced deficit in the trade in goods and services accounts combined with the increased surplus in the primary income.

Figure 9: Trade and Current Account



Source: CBSI

The deficit in trade in goods narrowed significantly to minus 4.7% of GDP (-$313 million) over the first six months to June 2023 from minus 17.3% of GDP (-$1,075 million) in the preceding period. This favorable performance was driven by the surge in exports rising by 29% to $1,907 million combined with the decline in imports by 13% to $2,219 million. The growth in exports was mainly attributed to the strong pick up in mineral receipts which increased by four folds to $573 million and gains in fish exports, both underpinned by higher production and favorable international prices, and palm oil exports. These outweighed the decline across all other export commodities during the review period. Meanwhile, the fall in imports emanated from the reduction across all import categories, particularly food, beverages and tobacco, vegetable oils, and fuel reflecting easing commodity prices internationally, and chemicals, basic manufactures and crude materials due to the near completion of the sporting facilities and infrastructures for the 2023 Pacific Games.

The deficit in trade in services narrowed to minus 7.4% of GDP (-$490 million) during the first six months of 2023 from minus 11.1% of GDP (-$689 million) in the preceding six months. This outcome was attributed to higher receipts for transport, travel and all other services reflecting the recovery in economic activities and positive spillovers from the 2023 Pacific Games preparations.

The primary income surplus increased to 1.2% of GDP ($77 million) over the first half of the year from 0.8% of GDP ($48 million) in the second half of 2022. This stemmed from the surge in receipts from fishing licenses which outweighed the reduction in compensation of employees and higher outflow on investment income during the review period. On the other hand, the secondary income surplus shrank to 5.9% of GDP ($391 million) from 8.7% of GDP ($539 million) due to lower donor cash grants and technical assistance received which outweighed the increase in inward remittances over the period.

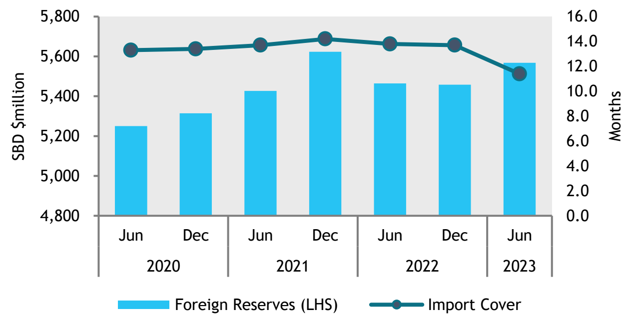
3.3.2. Capital and Financial Accounts

The capital and financial account surplus contracted to 12.5% of GDP ($601 million) over the first six months to June 2023 against the previous period. This was attributed to the slowdown in donor capital inflows as most of the key infrastructure projects relating to the 2023 Pacific Games are near completion. The reduction in net foreign direct investment (FDI) reflecting lower reinvested earnings and debt instruments also contributed to this outcome.

3.3.3. Foreign Reserves

The gross foreign reserves edged higher by 2% to $5,582 million at the end of June 2023. This was driven by the net inflow of $125 million in transactions following the improvement in the current account balance during the first six months of the year. This level of reserves is sufficient to cover 11.4 months of imports of goods and services.

Figure 10: Gross Foreign Reserves

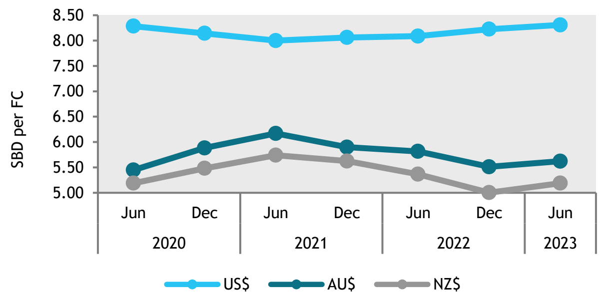


Source: CBSI

3.3.4. Exchange Rate

Global currency movements particularly the weakening of the US dollar has led to the appreciation of the Solomon Islands dollar (SBD) by 16 basis points against the Trade Weighted basket to 114.2 points. Against the key bilateral currencies, the SBD depreciated against the US dollar by 1% to $8.31 per USD. Similarly, it weakened against the Australian dollar (AUD) and New Zealand dollar (NZD) by 2% to $5.62 per AUD and 4% to $5.19 per NZD, respectively.

Figure 11: Nominal Bilateral Exchange Rates



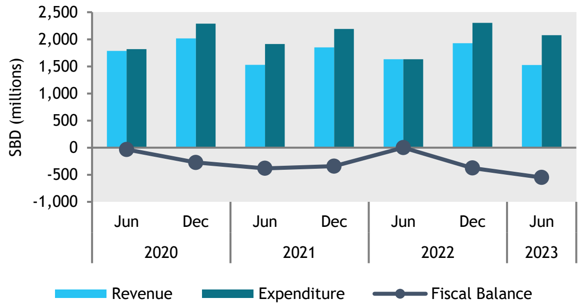
Source: CBSI

The country's Nominal Effective Exchange Rate (NEER) on average depreciated by 3% to 119.7 index points. Similarly, the Real Effective Exchange Rate (REER) depreciated by 4% to 132.9 points reflecting inflation differentials between Solomon Islands and its trading partners over the review period.

3.4. Fiscal Conditions

Fiscal conditions in the first six months of 2023 were very gloomy, owing to slower revenue collection combined with the mounting spending pressures on key Government priorities for 2023. Hence, the government registered a wider deficit of $551 million in the first half of 2023 compared to a deficit of $374 million recorded in the last six months of 2022.

Figure 12: Fiscal Balance



Source: MOFT and CBSI

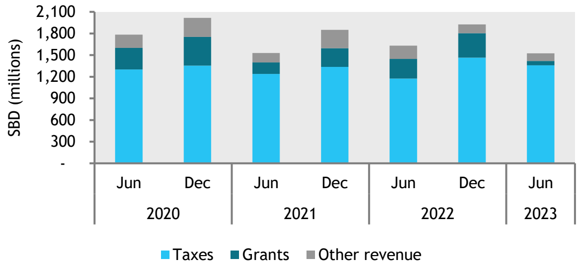
At the same time, the central government debt stock outstanding increased further following new loan disbursements for pacific game related projects such as roads, water supply and sanitation and issuance of development bonds to fund the lingering effects of Covid-19.

3.4.1. Revenue

Total revenue slowed in the first six months of 2023, dropping by 21% to $1,526 million (13% of GDP) and was 6% lower than the same period in 2022. The slower economic activities and late disbursement of grants from donor partners were the drivers behind the fall in revenue collected for the first half of 2023.

Tax revenue contracted by 7% in the six months to June to $1,358 million, reversing the 2% growth recorded in the six months to December 2022. The subdued outcome was noted for all the tax categorises with tax on income falling by 10% to $481 million, goods and services tax fell by 13% to $325 million and international trade tax edged down by 2% to $552 million. Grants received from donors dwindled to $61 million against the $339 million received in the last six months of 2022. The unfavourable outcome was attributed to slower disbursement of grants in the first half of 2023. Non-tax revenue collected from other ministries declined by 12% to $107 million following lower fishing revenue collected during the period.

Figure 13: Government Revenue

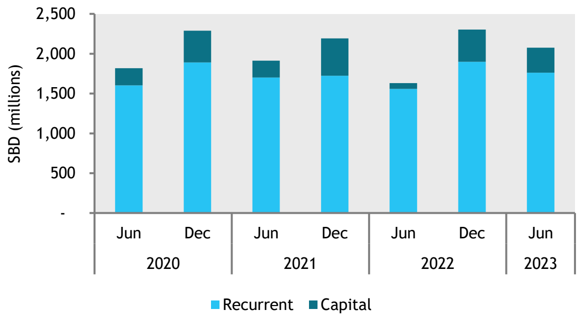


Source: MOFT and CBSI

3.4.2. Expenditure

Total government expenditure contracted by 10% in the first half of 2023 to $2,076 million, equivalent to 17% of GDP. However, this expenditure level was 2% higher than the corresponding period of 2022. The decline in total expenditure was obvious in both the recurrent and capital expenditure.

Figure 14: Government Expenditure



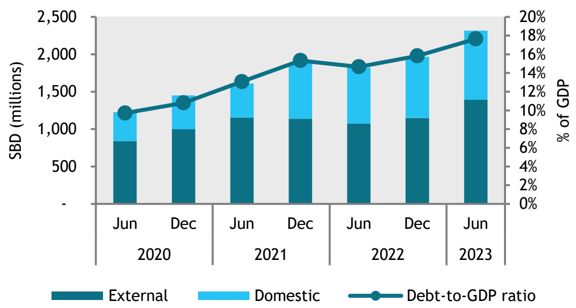
Source: MOFT and CBSI

The 7% downturn in recurrent expenses to $1,761 million in the first half of 2023 emanated from the decline in payroll by 8% to $780 million, purchase of goods and services by 16% to $651 million and interest spending by 3% to $21 million. In contrast, benefits and grants spending increased by 21% to $309 million during January to June 2023. Similarly, Government expenditure on capital projects went down by 22% to $315 million in first six months of this year, but higher than the same period twelve months ago by $243 million.

3.4.3. Central Government Debt Stock

Total central government debt stock grew by 11% in the first six months of 2023 to $2,316 million, equivalent to 19% of the country's total output. The increase was reflected in both the external and domestic debt stock.

Figure 15: Government Debt



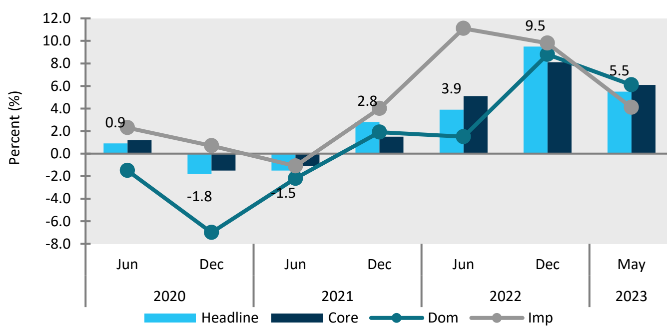
Source: MOFT and CBSI

External debt balance increased by 10% to $1,392 million, owing to additional debt disbursement of $143 million for water supply and sanitation, and road projects in preparation for the 2023 Pacific Game. Similarly, domestic debt stock went up by 13% to $924 million on account of issuance of development bond worth $58 million and auctioned treasury bills of $101 million during the period to assist government in mitigating the lingering effects of Covid-19 on the economy.

3.5 Inflation Development

The headline inflation (annual change of 3 months moving average) decelerated in May 2023 to 5.5% from 9.5% in December 2022.

Figure 16: Inflation



Source: SINSO and CBSI

This outcome reflected a moderate reduction in imported fuel prices and the pass-through effect on energy and transport in the domestic economy. The major drivers of inflation were food, transport, and housing utilities & energy.

Core inflation (excluding price control, excise, and volatile items) also declined to 6.1% in May from 8.1% in December 2022. Despite the gradual easing of core inflation, it is relatively at high levels implicated by sticky downward in prices in the local market.

4. Domestic Economic Outlook

4.1. Real Economy

As initially anticipated, an economic recovery is projected in 2023 with a new growth path to the medium term from the economic contraction in 2020-2022 following the pandemic and social-political upheaval. In 2023, growth is forecasted to rebound to 2.4%, a slight downward revision from the initial forecast of 2.7%.

A smaller downward adjustment in the economic growth forecast considered (i) a fall in agricultural production particularly palm oil, copra, and cocoa in the first half; (ii) lower than initially projected for the annual increase in fish catch which also factored downtime in fishing boats; (iii) reduction in the forecasted increase in annual government spending due to constraints in domestic revenue; and (iv) business disruptions due to power rationing for at least 3 months beginning in May. In contrast, mining and forestry productions were higher than expected, and with added catalysts from the preparations and hosting of the Pacific Games in November, this should drive some momentum of recovery. The July 2023 business perception survey also showed an optimistic outlook for the second half of 2023.

The drivers of growth are expected from mining, manufacturing, services, and to some extent fishing and forestry. However, this baseline forecast is fragile as any disruptions to production and consumption or capacity constraints on government spending may have implications for economic growth.

Over the medium term, moderate growth is anticipated at around 2.1% (same as initially projected) as the economy is expected to return to pre-pandemic levels and recuperate to its potential capacity. This considers the optimistic global growth but conservatively weighs the domestic challenges of the cost of doing business and the risks ahead.

The downside risks to the outlook are vulnerability to natural disasters or climate variations, inefficient transport system, poor infrastructure, limited fiscal buffer in the event of losses, and political uncertainty ahead of the 2024 national elections. Externally, Russia's war in Ukraine, geopolitical tensions, and global financial shocks may pose global growth challenges. Meanwhile, on the upside, donors are continuing to support the country in infrastructure upgrades and expansion of labor mobility schemes. In addition, the capacity to host other regional sports events could potentially drive growth over the medium term.

4.2. Fiscal

Following the gloomy fiscal condition in the first half of 2023, a wider deficit of 9% of GDP is expected in 2023 from 3% in 2022, in line with government's two key prioritises, the Pacific Games (PG) and the National General Election (NGE). Given the high uncertainty for the macroeconomic outlook and budgetary outlook, risks are tilted to the downside, with fiscal issues expected to persist amid inadequate government cash reserves, slower revenue collection and increasing debt levels. Short-term policy actions such as reduction of exemptions, expenditure controls and strengthening of tax compliance can help mitigate fiscal pressures over the short-to-medium term.

Over the medium term (2024-2028), the deficit is expected to return to 5% of GDP as initially estimated, owing to a projected increase in expenditure amid an anticipated slower rise in revenue collection. As such, it is feasible for the government to develop a credible risk-based fiscal framework to promote macroeconomic policies, reduce debt vulnerabilities and build up buffer to handle any shock in the future.

4.3. External

The outlook for external sector is favorable with the current account deficit anticipating to improve in 2023 with the expected expansion in the mining and fishing sectors, and the growth in the trade in services supported by the positive spillovers from the 2023 Pacific Games preparations. In contrast, the capital and financial account surplus is projected to diminish due to the anticipated decline in capital and construction related FDI inflows as majority of the infrastructure projects related to the Pacific Games are near completion. As a result, the gross foreign reserves are forecasted to decline though remaining at sufficient levels.

Over the medium term, the external sector outlook remains favorable given the expected gains in the mining sector, ongoing donor support towards infrastructure developments and inward remittances. However, the downside risks to this outlook remain firm with the projected slowdown in the forestry sector, climate change impacts on domestic output, and uncertainties associated with the on-going Ukraine-Russian war.

4.4. Monetary

In 2023, there is an expectation of moderate growth in key monetary aggregates, including reserve money, broad money, and private-sector credit. This growth is anticipated due to the projected recovery and the support of fiscal policies. As a result, excess liquidity is also predicted to increase. Looking ahead into the medium-term, the forecast indicates continued growth in reserve money, broad money, private sector credit, and excess liquidity, inline with the positive economic growth expectations. However, there are uncertainties and risks in the external sector that could potentially pose challenges to the medium-term forecast.

4.5. Inflation Outlook

The headline inflation in June 2023 is estimated at 4.2%, 1.2 percentage points lower than 5.4% that was projected in the March 2023 Monetary Policy Statement due to a faster-than-anticipated decline in fuel price which passed through to domestic transport and utility prices. This is expected to continue in the next six months.

With the faster fall in inflation in the first half, inflation is projected to fall to 1.3% in December 2023, lower than the 3% projected in March 2023 Monetary Policy Statement. However, this is an episode of a low inflation rate in an environment with a very high level of price index. The current higher price index level came from a surge in inflation in the second half of 2022 and that has already reached the top plateau. In that, the rate at which the price level would be rising is anticipated to be smaller, reflected in the predicted low inflation. Meanwhile, due to the current high price level, households may still face some constraints in their purchasing power.

The core inflation is estimated at 5.3% in June before gradually declining to around 2.6% at the end of the year, two-fold higher than the projected headline inflation. This mirrored sticky downward prices implying higher input costs for businesses along the supply chain associated with logistics, shipping, ports, and storage. The deteriorating road conditions and infrastructures also increased the costs of repairs and maintenance of vehicles for transporting goods which are embedded into the final selling price of consumer goods.

The risks to the outlook are higher with the uncertainty in the global market, war, and financial turmoil may increase costs along the supply chain. A particular concern is the importation of rice as the current lower global supply may continue to lift rice prices. There are also risks to the shallow local market once the supply of local food unmatched the demand at the height of the influx of visiting contingent during the Pacific Games.

The Bank anticipates inflation in 2024 to be normalized between 2% and 3% although the medium-term horizon is highly uncertain, particularly with shocks to the supply side factors such as local weather patterns or world prices.

5. Monetary Policy Stance

With the projected recovery in global growth, rebounding domestic demand from the PGs, amid elevated levels of price index in the economy, CBSI will continue to maintain a tightening monetary policy stance for the next six months to ensure that inflation is actually easing. CBSI will continue to monitor incoming data and act accordingly if needed.