Central Bank of the
Solomon Islands

Monetary Policy Statement: May 2009

Please direct questions or comments relating to this paper to the Chief Manager, Economics, Research and Statistics Department

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A Message from the Governor

2008 proved to be a challenging but successful year for the Solomon Islands economy. The nation continued to experience steady growth founded upon continued peace and stability. Despite this, Solomon Islands remains the poorest in the region and still much work is left to be done.

The strong growth was however heavily dependant on unsustainable logging and a world economy that began to falter. By the end of 2008 the global slowdown had already started to damage our economy. The ability of the nation to export was compromised as demand, especially from Asian economies, evaporated. The impressive gains made in the agricultural sector throughout the year looked under threat as world agricultural prices plummeted and there were strong indications of emerging weaknesses developing in the domestic economy. Looking ahead with trepidation, 2009 could prove a tough year for both the global economy and the Solomon Islands. Some economic analysts feel that the world economy may turn round by the end of the year and governments around the world have been far from passive in dealing with the crisis, launching a series of fiscal stimulation packages and bank bail-out packages. It is hoped that these policies will be instrumental in turning around the world economy. It would not however be appropriate for Solomon Islands to implement such a program at this juncture as the cost would be prohibitive, it would encumber the nation with further debts and provide very little boost to the economy given the supply constraints of the economy and the dependence on foreign demand.

Early 2008 (prior to the crisis) had seen high worldwide levels of inflation and the Solomon Islands was badly impacted by this trend. The Central Bank of Solomon Islands was active during 2008 tightening monetary policy throughout the year in an attempt to reign in these rapid rises in the price level. Such inflation has a damaging effect on the economy reducing the purchasing power and so living standards of many in the population and undermining the basis for long run economic growth in the economy. The Bank responded to the challenge by introducing the Bokolo deposit facility, releasing Central Bank securities in an attempt to gain control through market operations and by tightening the liquid asset ratio.

In 2009 through continued effort and research the Bank will strive to promote greater stability in the market and provide the basis for a healthy, growing economy. Throughout 2009 we hope to bring in policies that will create stability in prices and of our financial system. A combination of improvements in the country's underlying economic fundamentals and appropriate policy responses are essential if the economy is to counter inflation, promote and sustain growth (despite the worldwide economic turmoil) and foster the conditions for high and stable growth in the long run.

Denton H Rarawa

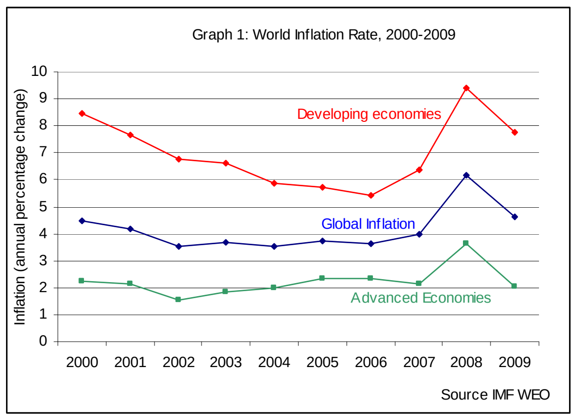
Governor

International Economy

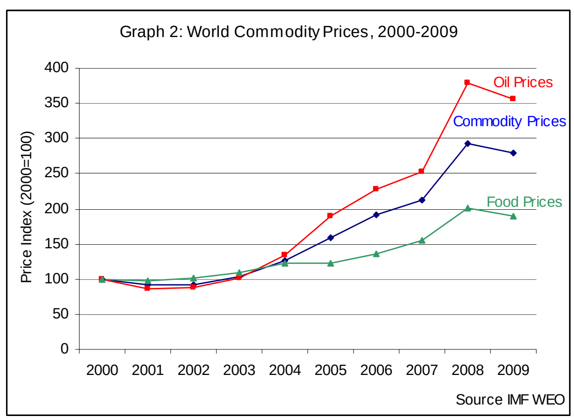
2008 was a bleak year for the global economy. The first part of the year saw a rapid escalation of world prices stoked by a commodities price boom and asset price bubbles developing across many industrialised nations. The final quarter of the year witnessed weaknesses, which had developed in the US financial sector in late 2007, escalate and spread into a global financial crisis. In September the major US investment bank Lehman Brothers became the first major casualty of the crisis. Since this point it has been joined by several other major US and European financial institutions that have collapsed or come near to collapse, as the global financial system was pushed close to breaking point. Financial market breakdown has led to a weakening of real economic conditions as confidence evaporates, credit lines breakdown and risk aversion soars. As this paper is written it is predicted that around 65% of the world's economies are in recession the greatest number since 1960 and the IMF has warned that this recession may be both deep and prolonged.

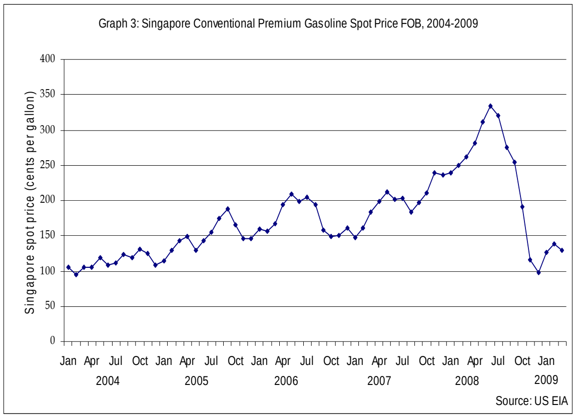
Global Inflation

Global inflation accelerated throughout 2008. Whilst 2007 had seen inflation average only 2% amongst the OECD, by the third quarter of 2008 this rate exceeded 4%, with inflation being led by the US with 4.9% and the UK 5%. This inflation was generated by an upward surge of prices in global commodity markets and rising asset price bubbles in many major economies. Inflation amongst developing nations was even higher and by the middle of the year over half of all developing nations had an inflation rate exceeding ten percent.

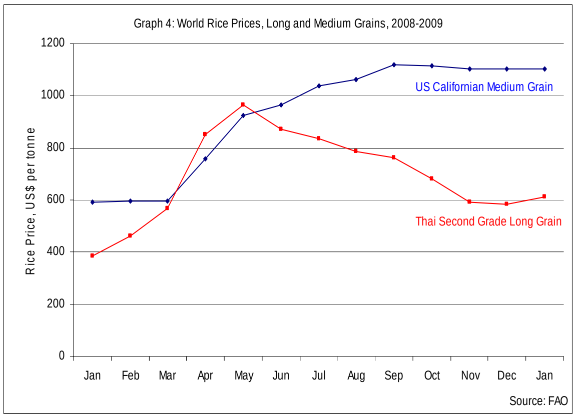


The global boom in the commodity price was caused by a range of factors. One major driver has been the strong growth of the world economy and in particular the expansion of developing nations. The economic progress that many low income countries have experienced has often been based around highly commodity intensive industrialisation. Oil markets have felt demand pressures as fuel imports to major developing nations, especially in Asia, have risen to sustain and grow their expanding export industries and infrastructure development programs. In 2003 China overtook Japan as the world's second largest consumer of oil and since then has increased its demand by around 15% a year. Supply side factors have also been important in driving up crude prices. Concerns over the limits to spare capacity amongst oil producers and instability in key regions such as in Pakistan and Nigeria has helped drive up prices. The combination of these demand pull and cost push factors conspired to send the price of oil above $100 a barrel at the end of 2007 and to a record high of $147 in July 2008.





Food price rises were the other major driver of global inflation. Food prices increased as rapidly increasing demand from developing nations outpaced increases in capacity. There were also pressures due to shortfalls in agricultural output caused by poor weather conditions in a large range of producers in both 2006 and 2007. The high price of oil pushed up food prices as the cost of transport and fertilizer both increased and caused land to be converted to the production of bio-fuels in response to both prices and concerns over fuel security. Supply shortfalls led to many exporting nations enforcing export bans and quotas on food products to ensure sufficient domestic stocks were maintained and this also created pressure on world prices. In the 12 months to March 2008 world wheat prices jumped 120% and average world rice prices rose by 74% across the same period. The World Bank has predicted that high fuel and food prices pushed between 130 and 155 million people into poverty in 2008.



One impact of the global economic crisis has been to arrest this high global inflation. Global oil prices have tumbled in the wake of falling global demand and a large range of commodity, industrial and asset prices have tumbled as consumer confidence falters and household incomes fall. Despite production cutbacks by OPEC and other producers the price of oil has fallen 60% from its high in 2008 and the IMF has slashed its prediction for baseline oil prices in 2009 to $50 per barrel. Aggregate food prices have seen falls due to reducing oil prices and weakening demand combined with rebounding production in many countries. Price falls have not however been encountered universally. Medium grain rice prices for example, which are an important food source across the pacific, have remained obstinately high due to the continued drought in Australia decimating the harvest and the continuation of export bans enforced by China and Egypt in response to their own poor harvests.

The IMF is predicting world inflation to average only 2.5% in 2009, its lowest level for over 30 years. Advanced economies are anticipated to experience deflation across the year with prices falling by around 0.2%. The mean inflation rate amongst developing countries is expected to fall to around 5.7% in 2009, with a further decline expected in 2010.

Global Growth

Both the World Bank and the IMF are both predicting their first recorded falls in world output. The World Bank's projection of a 1.7% contraction in 2009 is a large downward revision from earlier forecasts as the scale of the global economic crisis becomes clear. The IMF is predicting a marginally less severe decline of 1.3%. This global recession is led by the industrialised nations who the IMF predicts will decline by around 3.8% in 2009. Of these economies the United Sates is predicted to decline by around 2.4%, Japan by 5.3% and the Euro Area by around 2.7%. Nor does this represent the most pessimistic of predictions; the European commission for example is estimating the Euro Area will decline by 4% in 2009. Amongst developing nations the IMF is predicting growth to slow to just 1.6%, down from the 6.1% growth experienced in 2008. This figure is also inflated by China and India who although hit hard by the crisis will continue to grow at a predicted 6.5% and 4% respectively. Outside these two emerging giants the World Bank has predicted the remaining low income countries will on average stagnate, with mean growth for 2009 and estimated 0%. On the prospects for the longer term the IMF has warned that not only is this recession deep but that it could also be prolonged in nature due to the synchronization of the downturn across many countries. The World Bank and many countries individually offer a more upbeat analysis hinting at a slow recovery in 2010, although this estimate is prefaced by a long series of potential downside shocks.

Asia has been hit hard by the global economic crisis despite its minimal exposure to toxic assets. Growth in emerging Asia had been built around highly decentralized, regionally integrated production networks generating manufactured goods for export. The cutbacks in consumer spending in Asia's target markets in the US and Europe has meant that demand for these products has evaporated. The cross-border production chains meant that there has been widespread contagion, with problems being rapidly transmitted across the region. In the final quarter of 2008 China saw its biggest decline in exports for a decade as recorded levels slumped to 2.8% below third quarter levels for 2007 whilst South Korea saw a 17.4% fall across the same period. Despite the insulating effect that the large reserves many Asian economies accumulated following the East Asian crisis many countries in the area recorded poor results in the last quarter of 2008 and are predicted to suffer a decline in 2009. South Korea for example experienced a quarter on quarter decline of around 20% in the fourth quarter of 2008 and Taiwan experiencing a decline of over 25% for the same period. All of our trading partners in Asia are likely to be well below trend growth in 2009.

For other important partners to the Solomon Islands this could also prove a difficult year. The Australian economy did not fare as badly as many other industrialised nations in 2008 yet still witness a 0.5% contraction in the final quarter of the year. This is the first shrinkage the Australian economy has experienced in eight years. Falling price and demand for commodities have hit the economy badly, especially the mining sector. The dependence of the Australian financial system on offshore wholesale funding has meant that although it did not face the same exposure to toxic assets that plagued many other developed countries; it has been vulnerable to crisis in international financial market. The pronounced softening in the Australia housing market has also generated problems for the banking sector. The Australian unemployment rate began a worrying rise towards the end of the year. New Zealand is also suffering from falling exports and weak domestic confidence and so the Reserve Bank of New Zealand has downgraded its growth forecast to -0.8% for 2009.

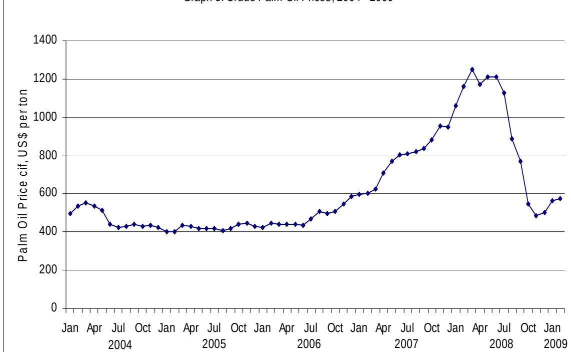
Global Policy Response

The global policy response to the economic crisis has been monetary easing and Keynesian fiscal spending. In the last quarter of 2008 central banks around the world began to loosen their monetary policy in light of the reduction in global inflationary pressures and in order to bolster weakening growth. Conventional policies have been used as numerous central banks have slashed their policy rates and injected liquidity into the system. Since December the US federal funds rate has stood at just one half of a percent. Since March both the deposit rate of the ECB and the base rate of the Bank of England also stand at only half a percent. As these approaches have proved insufficient a range of unconventional monetary policy tools have been employed, for example many banks including the Federal Reserve and the Bank of England have undertaken quantitative easing. Countries have accompanied monetary actions with complimentary expansionary fiscal policy. In the US, China and South Korea for example discretionary fiscal easing measures have passed 2% of GDP whilst in Europe and Japan they now exceed 1%. It is hoped that the full effects of these policies will be felt in 2009. The US federal spending bill to counter the financial crisis approached US$1 trillion, China's economic stimulus package amounted to around US$568 billion and added to these are the Canadian package of US$ 40 billion and a huge range of other countries with their own packages. Many countries have also moved to shore up their financial systems such as the UK which has already granted two financial bail out packages worth a total of £550 billion. The multilateral response to the crisis was outlined in the G20 meeting in London and a range of worldwide solutions are proposed, for example a huge strengthening of the International Monetary Fund.

Commodity Prices

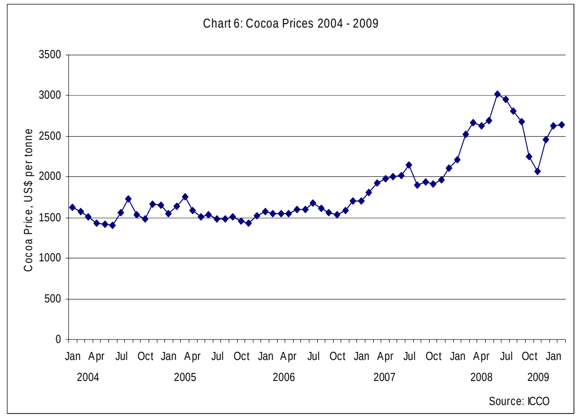
As it is too small as an economy or an exporter to influence global prices the Solomon Islands must play the role of a price taker in world markets. As an open economy movements in the price of traded goods are very important to the economy. World commodity prices saw huge volatility in 2008. During the first three quarters of the year they skyrocketed to record highs only to crash down again with the onset of the financial crisis, in some cases to below the point at which they started the year. Up until the third quarter of 2008 the world had been witnessing a commodity boom. This boom saw an upward trend in average commodity

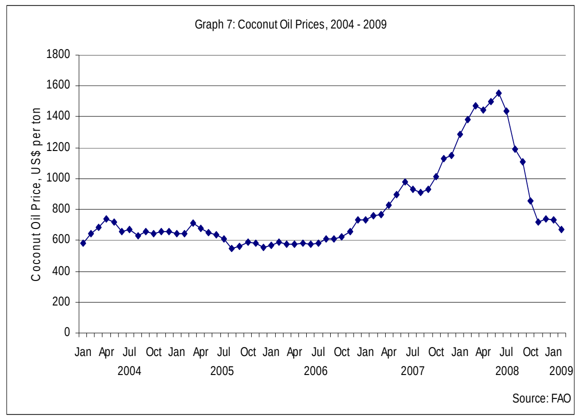
Graph 5: Crude Palm Oil Prices, 2004 - 2009



Source: FAO

prices that was both longer and larger than any other commodity price boom experienced since 1900. Rapid and sustained global economic growth had generated an upward surge in demand for primary goods and this had been met with a sluggish supply side response driving world prices increasingly higher in what was deemed a 'super-cycle'. Many analysts even believed that the new high prices did not represent the upswing of a cycle but signaled a structural shift in the underlying price of primary goods. The absorption of the Soviet block had hidden a build up in underlying demand for commodities and by around the year 2000 when these economies had been fully integrated into the global market it was discovered that the rate of exploration and investment had not been adequate to sustain production at a level necessary to meet supply. This in turn drove up agricultural prices as bio-fuels were pushed as an alternative to fossil fuels and the high price of fuel and fertilizer increasing the cost of production. This was compounded by poor global harvests, for example in Australia.





The falling levels of global growth have reduced commodity prices worldwide and should keep them subdued in the medium term. In the longer term it is hoped that increased efficiency, especially in China, could help prevent fuel and mineral prices rocketing again whilst strong productivity growth, the opening up of new land and slower population growth may be able to keep food prices in check. Any sustained drive for bio-fuels still remains an upside risk for global food prices as does continuation of poor weather in major producers, for example the continuation of the drought which has so damaged Australia's agricultural output.

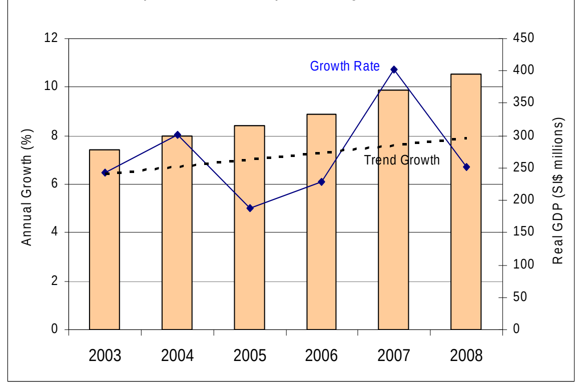
For the Solomon Islands this presents benefits on the import side. The total fuel bill should be reduced in the near term, as should food prices, although crucially at the moment not medium grain rice. The export side looks far less healthy however given the new global situation. Prices for palm oil have for example fallen dramatically since their peak, as have coconut products. Fish and cocoa have seen declines but these have not been so dramatic. In logging movements in price have not been as dramatic as the reduction in quantity demanded and excess supply to the market may be an issue. Mineral prices, for a range of products, are well below their peak, with the exception of gold, which would begin to impact upon the Solomon Islands if production were to recommence.

Domestic Economy

Economic Growth

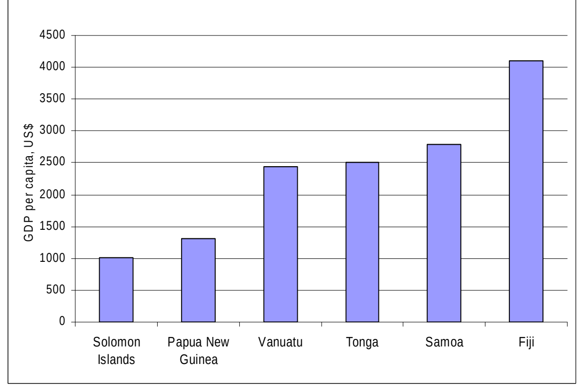
Real economic growth in the Solomon Islands during 2008 remained robust at 6.8%, as the economy continued the sustained growth it has experienced since the return to stability. This result is below both the 10.7% growth recorded in 2007 and the trend growth rate of the economy in the post-tension period but is above the average growth rate in the region. This slowdown was generated by declines in the rate of growth across many of the productive sectors of the economy. Nominal growth in the economy was around 25%.

Graph 8: Solomon Islands post tension growth, 2003-2008



Using a predicted population growth rate of 2.8% real GDP per capita in 2008 increased by around 3%. Despite six years of strong growth in the economy the Solomon Island's remains the poorest in the region, with GDP per capita of around SB$ 7803 (US$1019).

Graph 9: GDP per capita Pacific, 2008

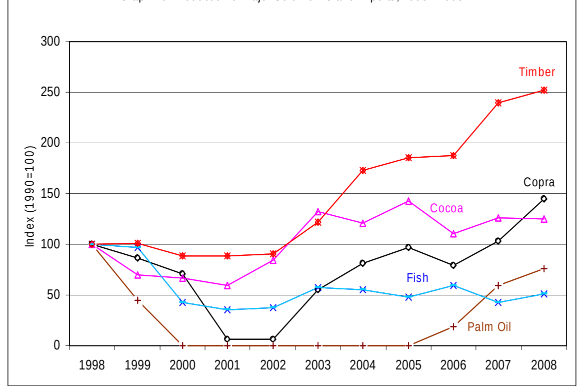


Agriculture

The agricultural sector experienced the strongest sectoral growth in 2008, growing by 14% to $68.8 million. Agriculture contributed 17.4% of GDP.

Copra saw a 40% rise in production as farmers responded strongly to world prices. This meant that 2008 witnessed record levels of copra production for the Solomon Islands. Transportation bottlenecks associated with the infrequency of shipping to the provinces constrained the ability to export copra from many areas and it is believed that were these issues to be adequately addressed the level of production could be further increased. It is however unlikely that these supply chain shortcomings could be fully addressed in 2009 nor is it likely that copra plantations will begin function again throughout the year. It is therefore likely that the level of production will not see a great increase in the year. It is indeed possible that the large fall in copra prices will generate a sharp decline in copra production as many farmers only harvest nuts when prices are high or they are in desperate need of cash. First quarter results for 2009 support this hypothesis given that production is 39% lower than first quarter production in 2008. This result could however be generated by the flooding that has hit the country rather than a production response to the high elasticity of supply. Given that large increases in production are unlikely during 2009 it seems probable that the real value of copra produced will fall due to low world prices.

Graph 10: Production of Major Solomon Island Exports, 1998 - 2008



Palm oil also saw strong output growth in 2008 increasing by 28% across the year. This was an expected development given the expansion plans for palm products in the country. The high value added by the product was however aided by record prices for palm oils, driven by demand for both the edible oil and increasing world demand for bio-fuels. Palm oil has still not attained the levels of output witnessed prior to the tensions with output only reaching 75% of 1998 levels. Output of palm oil products should increase in 2009 however prices are likely to be at a far lower level than experienced in 2008 meaning the value of palm oil products may fall in 2009. First quarter 2009 production of crude palm oil was 19.6% higher than recorded in 2008.

The contribution of cocoa to GDP also increased in 2008 but this was solely the product of high international prices. Cocoa production saw a fall from its 2007 level due to adverse weather conditions in 2008, but it is hoped that with better weather conditions that the 2009 cocoa harvest could be improved. Despite the severe weather conditions affecting the Solomon Islands in the first three months of the year cocoa production saw a year on year first quarter increase in 2009.

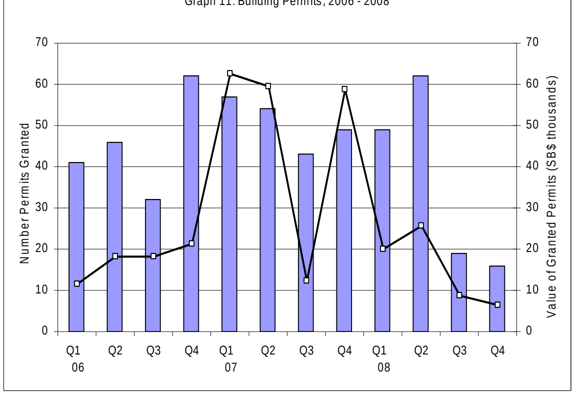
Forestry

Forestry saw record production levels in 2008 with 1.5 million cubic meters being exported. This accounted for 16% of Solomon Island's GDP. The rate of growth in output slowed from the previous year, yet still rose by 5%. This slowdown was a key cause of the slowing rate of growth of the Solomon Islands economy in 2008. The rate of logging experienced in 2008 is far above a level that could be deemed sustainable. The global economic crisis has severely compromised the ability of the Solomon Islands to export logs. The slowdown in Asia and in particular China has reduced their demand for logs and has resulted in slowing harvesting in the Solomon Islands. Only 250 thousand cubic meters were exported in the first quarter of the year and preliminary indications are that second quarter results will not show a great improvement. Were the trend displayed in the first quarter continued annual production levels would be only two thirds of those in 2008 and this lower volume would earn a lower price. As the economy still remains reliant on the logging industry for both growth and to earn foreign currency, a large fall in the value of the forestry sector could severely harm economic growth, export receipts and government revenues.

Construction

The construction industry saw strong growth of 9% across the year but this represented an acute slowdown from the 43% growth experienced in 2007. The first half of the year saw large increases in both the number and value of issued building permits Issues peaked for the year in the second quarter of the year with 62 applications granted. This growth was largely driven by continued high demand for housing in Honiara The final half of the year saw a rapid decline with the third and fourth quarters both witnessing issue levels well below not only the first half of the year but below average. This could be interpreted as a lessening of confidence in the economy towards the end of the year, as construction is often taken as a leading indicator.

Graph 11: Building Permits, 2006 - 2008



Other Sectors

Other major exporting sectors of the economy saw mixed results throughout the year. The fisheries sector saw strong growth with the total annual catch increasing by around 20%. This result was greatly aided by favorable weather conditions throughout the year. Fish cannery operations however saw a 37% fall in output through the year. The first quarter of 2009 has posted poor results due to poor weather conditions.

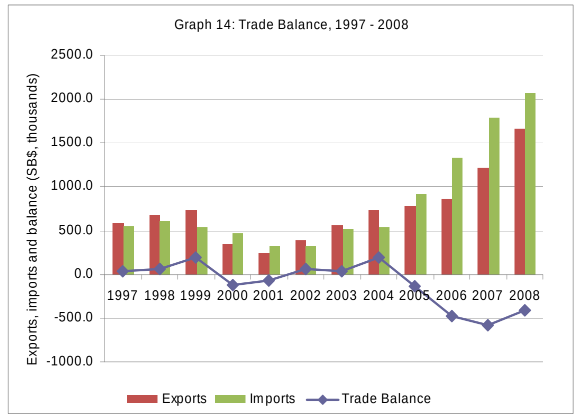
Gold mining did also not commence in 2008 and it is now unlikely that any extraction will occur until 2010. The Ministry of Mines granted 56 prospecting licenses across the year but although this is promising for future development in the Solomon Islands it can be assumed any project stemming from this work would be a long way off. Tourism also saw strong growth in the year with visitor numbers growing by 45% to 22,023.

Government Sector

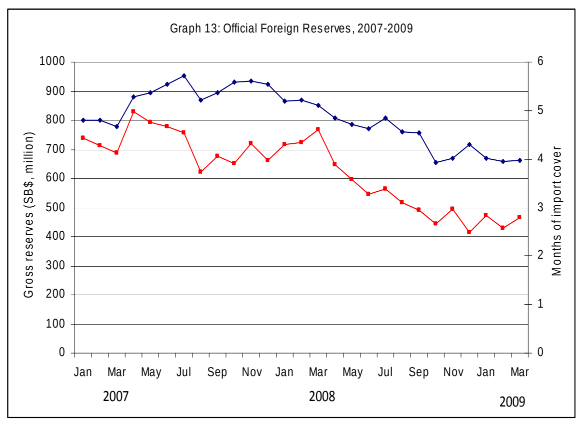
The Government played an important role in the economy in 2008 spending around $1526 million. Of this total $1208 million was recurrent expenditure and $319 million was development spending. Both these totals were under the figure that government budgeted. Government revenues in 2008 totaled $1566 million with $1372 million being raised locally and $194 million coming from grants to the Government. The government budget for 2009 anticipated spending of just under $2000 million. Of this $1600 million is accounted for by recurrent spending and $400 million in development spending. The global crisis however has meant that government are already factoring in reductions to this total declaring that non-payroll recurrent expenditures are to be reduced by 10% from budgeted totals.

External Balances

The trade balance saw an improvement in 2008 as the rate of export growth exceeded the growth in imports. Despite this the trade account still registered a deficit of $406.4 million for the year. The improvement in the trade balance can be attributed to strong revenue gains by major export commodities, generated both by high world prices and by a good harvest. Logging, which currently contributes just under 60% of all export earnings, saw a 20% rise in revenues. Agricultural products also experience a buoyant year due to both good harvests and high world prices. Copra exports over doubled in value in 2008 whilst oil palm products rose over 60% and copra over doubled. Global price inflation also had a strong impact on imports however with the import bill for fuel rising by 21% and for food rising by 42% for the year. The overall balance of payments position for 2008 saw a deficit of $120 million. This was caused by the current account deficit of $578.9 million outweighing the capital account surplus of $507.2 million.

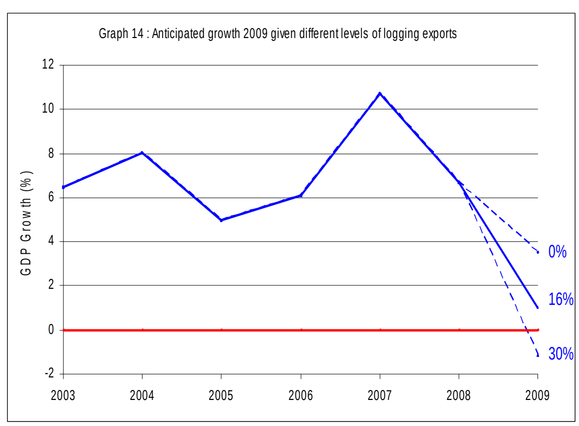


External reserves have seen a steady decline since their peak in June 2007. September 2008 saw reserves fall below the Bank's minimum desired level of three month of import cover and they continued to fall. Early 2009 has seen the gross levels of reserves stabilise and import cover has risen due to a declining import payments. Reserves must be monitored closely in the coming months and remain a major concern for the Bank.



Expectations for 2009

The fate of the Solomon Islands economy in 2009 remains highly unclear. At this point the Solomon Islands economy is highly linked through both trade and aid to the rest of the world and as such its fortunes are highly linked to the uncertain future of the world economy. Original estimates predicted a 16% decline in logging exports this year which would have reduced the rate of growth in the economy to a predicted 1.2%. The decline in logging experienced in the first quarter of the year has been more extreme than this preliminary estimate envisaged. Were the decline in the first quarter to be echoed in the remainder of the year then the decline in the logging sector would be around 30% and given this we predict that the economy would shrink by around 1.5%. Such a precipitous decline in logging would have implications beyond a



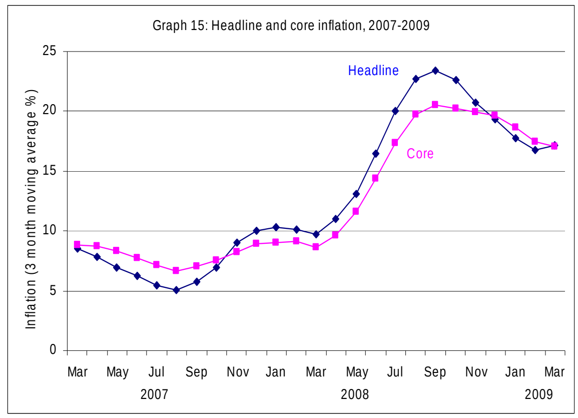
decline in GDP with government revenues being badly hit and further retrenchment from the government becoming a necessity. Without action the balance of trade could see a large decline and reserves could dwindle further. This will be alleviated somewhat by the weakening in demand for imported goods but this can not completely absorb the change as vital and price inelastic imports, in particular food and fuel, will not allow for full adjustment.

Any strong recovery from China in the latter part of the year, which has been forecast by more optimistic analysts, could generate far more promising results in the economy. The commencement of large scale mining activities or stronger than estimated growth in agriculture or other sectors of the economy could also alleviate any decline. Structural reform in the economy and donor led labour intensive projects may also help avoid an economic downturn in the country.

Price & Monetary Developments

Inflation

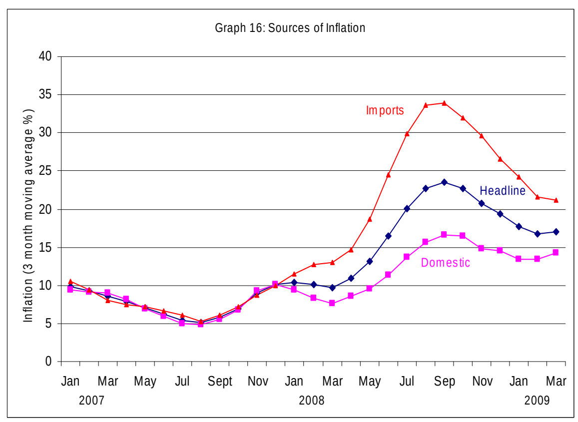
The inflation rate in the economy was a major worry during 2008. The average rate of inflation for the year was 16.6% with September providing the greatest rise in prices at 23.5%. Core inflation averaged 15% for the year also reached a maximum in September, of 20.6%.



Graph 15: Headline and core inflation, 2007-2009

Inflation was mainly driven by imported goods which saw average price rises of 23.4% across the period and a peak rise of 33.8% in September 2008. Fuel prices in particular saw large rises that also had second round effects on the economy increasing for example bus and electricity prices. The price of imported rice was also an important driver of price rises in 2008 and remains an inflationary force into the first quarter of 2009.

Core inflation is a measure of rises in the price level that excludes certain items that face high price volatility. This is done in order to capture underlying movements in the price level and to strip out transitory jumps which although affect the prices people pay should not elicit a monetary policy response. This is because monetary policy acts with a time-lag and volatile items may convince us to act in error. If short run price movements in volatile items convince us to take action by them time our policy has an impact the influence of the volatile items has dissipated and our monetary policy will miss its target.

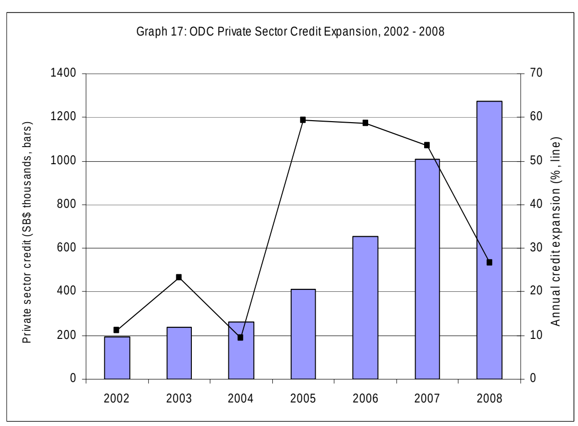


Graph 16: Sources of Inflation

Since September the inflation rate has been falling mainly as a result of declines in the world price of oil. This declining trend has continued into the first quarter of 2009 although March saw an upturn in the headline rate of inflation. This increase was related to increasing prices of local market produce caused by supply problems relating to the extreme weather conditions experienced in the country and we believe to be transient as core inflation continues to decline

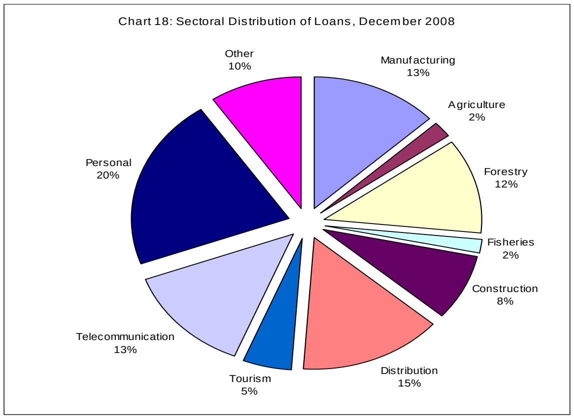
Monetary Aggregates

Credit expansion saw a large fall in its rate of growth in 2008 down to only 27%. This can partly be attributed to the slowing rate of growth in the economy and the high existing stock of loans but also is the result of monetary tightening during the year.



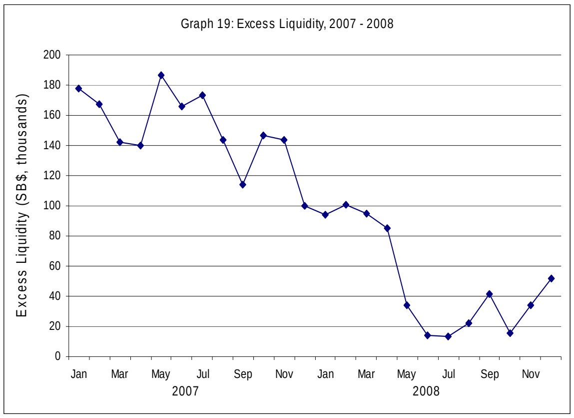
Graph 17: ODC Private Sector Credit Expansion, 2002 - 2008

The sectoral distribution of loans saw little change between 2008 and 2009. The forestry sector saw a 2 percentage point fall in its share of total loans as the rate of growth in loans to the forestry sector declined. Personal loans grew as a percentage of total private sector loans by almost 1 percentage points as the housing boom in Honiara continued. This was also the cause of the 45% increase in loans to construction companies. Agriculture saw a 98% year on year increase in loan volumes yet it still remained a very small proportion of total private sector lending.



Broad money grew by around 10% across 2008. This represented a slowdown from the 28% rate of growth in M3 experienced in 2007. M1 witnessed rapid expansion in 2007 expanding by 59% but in 2008 this was constricted to only 0.5% across the year.

A great deal of focus was given in the 2008 monetary policy stance to reducing the level of excess liquidity in the country. This policy was successfully achieved across the year as average monthly excess liquidity in 2008 was around 61% lower than had been experienced in 2009.

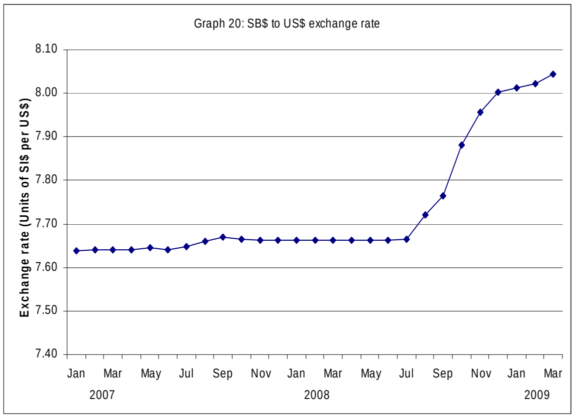


Reducing excess liquidity was prioritised as a goal in the 2008 monetary policy stance due to the belief that excess liquidity is inflationary through its effect on the behavior of commercial banks.

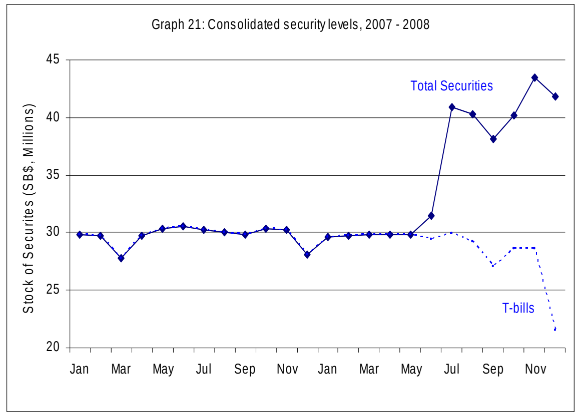
It is important to note that the definition of excess liquidity has been changed compared to that used in the 2008 monetary policy stance as an attempt has been made to remove reserves held for payment system liquidity of for precautionary motives. This does not make a substantive difference to trends, however, acting in most cases as simply a shifter.

Exchange Rate

The Solomon Islands continued its peg to a basket in the first months of 2008. Through to July this relationship stayed stable but following this the Solomon Islands has seen frequent downward movements The Solomon dollar saw a fall against the US dollar due to the rapid strengthening of the US dollar against other major currencies and in particular other investment currencies. The movement in the US dollar was one major cause in the fall of the value of the Solomon Island’s official reserve levels as revaluation effects of currency movements took their toll on the value of non US dollar denominated holdings. It is hoped that movements in the exchange rate will help protect the reserves.



Monetary Policy Actions and Securities Market



In order to combat the high levels of inflation in the economy the Bank tightened monetary policy during 2008. This was done in two distinct ways. The first was to remove till cash from the definition of liquidity in the liquidity asset ration. This measure is a de facto increase in the required reserves that the commercial banks must hold. The motives for doing this and the effect that this measure had are explored in greater length in the included information box.

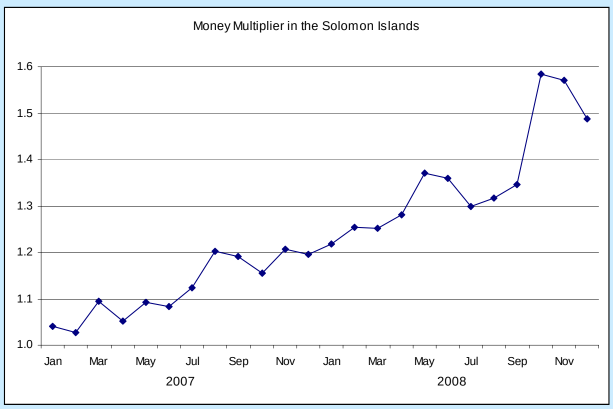
Other measures taken by the Bank to absorb excess liquidity in 2008 involved the use of standing facilities and securities. A new standing facility, the Bokolo deposit facility, was introduced and this was successful in removing $11 million from the market between June and July 2008. The other measure the Bank took was to issue its own securities the Bokolo bills. The sales of these securities from October onwards further helped to drain excess liquidity from the system. The Bank was therefore able to withdraw liquidity from the system over the course of 2008 despite problems in the t-bills market.

Information Box: Money Multiplier

Fractional reserve banking is the system whereby commercial banks can issue an amount of loans backed only by a proportion of this amount held within their reserves. Commercial banks are able to do this as at any one time only a proportion of their deposits are drawn upon and the held reserves are usually enough to meet these obligations. If at any time the bank is short in meeting its payments it can borrow the money for a short period of time from either other banks or from the central bank, which normally will lend to banks when no one else can or will, in its role as 'lender of last resort.' This fractional banking system means that money is not only created by the release of currency by the central bank or the appropriate authority, but it is also created by financial intermediaries making loans. Banks can therefore create money limited only by their need to hold reserves for purposes of meeting their obligations and in many countries, such as the Solomon Islands, to meet legal requirements.

This means the money supply in an economy is many times the level of actual currency. Imagine there is only one bank in the economy. Person A takes $100 in currency to the bank and deposits it. The bank must hold $10 of this money but can then lend out $90. Person B borrows the $90 and so it becomes a deposit in his account. Of this $90 the bank again holds $10 and lends out $80 and the cycle continues. This means that the original $100 has generated $550 worth of money. This is called the money multiplier. The money multiplier is the link between the currency that the central bank issues, so called high powered money, and the money in use, broad money.

The money multiplier is determined by a number of factors, the level of banking technology, the trust in the currency and in the banks and also the actions of the central bank. In raising the level of required reserves in November 2008 the Central Bank of the Solomon Islands acting to reduce the money multiplier as we believed it would help reduce the level of inflation in the economy. The Bank has calculated and estimate of the money multiplier in the Solomon Islands which is shown below. The line sees an upward trend through the period generated by advances in the banking sector. The downturn since October provides some evidence that The Bank's intervention, to raise the LAR, succeed in reducing the multiplier. It will however take more time to asses if this had the desired impact on inflation.



Monetary Policy Stance 2009

In response to the international environment, domestic economic conditions and in line with the Central Bank of the Solomon Islands Act the Bank will follow the following priorities in 2009:

1. The Bank will act to reduce and stabilize the level of inflation
2. The Bank will act to protect and preserve the level of official foreign reserves
3. The Bank will act to ensure the stability and robustness of the financial system

Reducing and stabilizing the level of inflation

During 2008 the price level rose at a rate felt by the Bank to be unacceptably high. In response to this the Bank tightened its monetary policy. The subsequent fall in international prices has acted to lower the rate of inflation in the Solomon Islands economy yet it still remains above a level the bank would deem conducive to stability and long run growth in the economy. At present core inflation in the economy is decreasing and it is believed that the upturn in headline inflation is a transitory reaction to the flooding experienced in the Islands. It is the opinion of the Bank however that to loosen monetary policy due to this declining trend would be premature with the rate of headline and core inflation above 17. The Bank will continue to monitor the price level and will intervene where necessary to benefit the economy.

Protecting the level of official foreign reserves

The current level of reserves is below the Bank's desired level of sufficient to cover the predicted next three months of imports. As the rate of reserves is already below target the desire of the Bank must strive to bring it above this level. In the worst scenario we must act to prevent a further dwindling of the reserves. To achieve this goal the Bank proposes to keep monetary policy tight. It is hoped that this can prevent a hemorrhaging of reserves. If this were to prove unsuccessful then the Bank may have to consider pursuing different courses of action in the future. The Bank is proposing a level of reserves equivalent to 2 months import cover at which point more extreme measures may be required. In the longer term the bank will hope to work with the government to develop and implement structural reforms in the economy that may help to rebalance the current trade deficit.

Ensuring the stability and Robustness of the financial system

The global financial system was severely tested in 2008 and some of the procedures in place to supervise and regulate financial systems around the world were found severely wanting. Whilst the financial system of the Solomon Islands is secure and has not fallen prey to the problems of other markets, especially more complex ones, it seems an appropriate juncture to review our procedures in this field and to reinforce any area we feel weak. In 2009 therefore the bank intends to further improve the system currently in place. Revised prudential guidelines will be completed and enforced governing capital adequacy, asset quality, liquidity management, large credit exposures and external audit requirements. A new prudential guideline has been formulated for foreign currency open positions. By strengthening prudential guidelines, bank reporting standards and by increasing the range and detail of analysis conducted on this data the Bank hopes to ensure the continued stability of the financial system of the Solomon Islands.