CENTRAL BANK OF SOLOMON ISLANDS

MONETARY POLICY STATEMENT
September 2019

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1 Overview

The protracted trade tensions and continued global market uncertainty has led to global growth for 2019 to be revised down by 10 basis points to 3.2%. Growth in emerging markets has slowed, particularly in China and this has been mirrored likewise in Australia and New Zealand with subdued demand and sluggish conditions.

Moreover, global commodity prices have weakened on the back of this muted global activity, plus lower supply side influences amongst oil producers. Similarly, global inflation continued to soften, as major economies attempt to support growth through more accommodative policies.

Economic conditions in the Solomon Islands were subdued in the first half of the year. This was driven by the deterioration in forestry and agriculture production. There were also weaker manufacturing outturns, along with lower FDI and visitor arrivals. As such, real GDP growth for 2019 has been downgraded by 1% to 2.7%.

Reflecting the softer conditions, the monetary aggregates eased during the period. Reserve money, broad money and liquidity slid 6%, 2% and 6% respectively. Nonetheless, private sector credit remained firm and grew 5%, driven by lending to construction, distribution, personal and transport.

Meanwhile, the external sector improved with a reduction in the current account deficit, as imports waned and offset a smaller fall in exports. Although, the capital and financial account surplus declined with lower foreign investment flows. Moreover, global turbulence saw a stronger USD rise against the SBD and other tradable currencies.

On the fiscal front, less first half year spending saw a build up of cash reserves and a surplus position for government. However, revenue from taxes particularly logs and donor grants declined across the board, aside from a pick- up in fishing licences.

Consumer prices eased during the period from 4.2% at year end 2018 to 1% in May 2020.This outturn represented weaker oil and imported prices, and slow domestic demand amidst soft conditions. Core inflation likewise eased during the period.

Looking towards 2020, growth in the local economy is projected to improve by 3.7% as key infrastructure projects start construction or commence operations such as the submarine cable. Over the medium term, growth will strengthen, although risks are abound, particularly if the projects are delayed, or there is a rapid fall in the already declining logs and if there is slower than expected commodity prices.

The outlook for the other sectors is mixed. While fiscal sustainability will be an issue with the drawdown in logs amidst no significant new revenue, and the current account deficit is expected to widen, monetary conditions are expected to remain positive. Similarly, the inflation is forecast to be contained below the 5% mark.

2 International Economic Developments

Global growth in 2019 has been downgraded to 3.2%[1], 10 basis points below the IMF's April WEO forecast. The revised projection comes on the back of escalating United States (US)-China trade and technology tensions and continued uncertainties surrounding the Brexit. In 2020, global growth is expected to improve to 3.5%. However, this growth is precarious and based on the assumption that currently stressed emerging market and developing economies stabilise and there is progress towards resolving trade policy differences.

Growth forecasts for advanced economies is projected at 1.9%, reflecting stronger than expected growth performance in the first quarter of 2019. The outcome was driven by stronger inventory build-up although going forward, weaker growth momentum is anticipated for countries relying on external demand. In 2020, consistent with earlier projections, growth in advanced economies is forecasted to slow to 1.7% as the effects of the fiscal stimulus taper off in the US coupled with weak productivity growth and aging demographics that dampen long-run growth prospects.

In emerging markets and developing economies, growth is expected to grow at 4.1% in 2019 before

[1] All statistics in this section are obtained from the International Monetary Fund (IMF) World Economic Outlook, July 2019, unless otherwise stated.

rising to 4.7% in 2020. In China, growth is expected to slow, reflecting in part higher tariffs imposed by the US in May, while India and Brazil expect weaker domestic demand. Meanwhile, for commodity exporters, supply disruptions in Russia and Chile and sanctions in Iran have also led to downward expectations despite the near-term improvements in the outlook for oil prices.

Turning to the country's closest major trading partners, growth in Australia and New Zealand have also eased, mirroring the weaker global conditions. Growth in the New Zealand economy has weakened with annual GDP growth recorded at 2.5% in March 2019[2], reflecting weaker performances across indicators for growth coupled with subdued house price inflation and low business confidence restraining domestic demand. Similarly, growth in the Australian economy is projected to ease to 2.5% at the end of 2019 and reach 2.75% over 2020[3]. The weaker outcome reflected prolonged subdued private sector demand coupled with soft conditions in the housing market and investments, and slower mining activity.

2.1 International Commodity Prices

Based on latest available data, the IMF's commodity price index declined by 4% in June 2019 against the previous quarter reflecting prolonged weaker commodity prices following subdued global activity coupled with supply influences in the case of oil prices (affected by civil strife in Venezuela and Libya, and US sanctions on Iran). As such, the energy and petroleum index have also declined by 11% and 6% respectively, while non-fuel index rebounded by 3% against the prior quarter. Consistent with the global oil price fall, tapis crude oil, the main imported fuel for Solomon Islands fell by 7% to an average of US $68.50 per barrel at the end of June 2019 compared to an average of US $73.3 per barrel registered in the previous quarter.

2.2 Global Inflation

Global inflation continued to soften in the first half of 2019, reflecting weaker than anticipated global activity across advanced and emerging markets. Similarly, core inflation has remained below target. As such, central banks are pursuing accommodative policies to support their economies. In advanced economies, inflation is forecasted to moderate to 1.6% in 2019 from 2% in 2018 before rebounding to 2% in 2020. Meanwhile, inflation in emerging market and developing economies is projected at 4.8% in 2019 and will ease to 4.7% in 2020.

On the regional front, inflation outcomes in Australia remained low, 1.6% in June and 1.3% in March, well below its inflation target range of 2%-3% on average. This reflected the weaker demand conditions[3]. In New Zealand, annual headline inflation picked up to 1.7% at the end of the June quarter from 1.5% in the March quarter although still below its 2% target. The subdued inflation reflects lower imported inflation and is expected to remain below the 2% target mid-point throughout 2019 and into 2020[2].

3 Domestic Economic Developments

3.1 Monetary Conditions

Monetary conditions eased amidst slower economic performance across the first six months of 2019. Reserve money (M0), broad money (M3) and total liquidity contracted as private sector credit (PSC) growth firmed up and fiscal policy tightened.

3.1.1 Reserve Money

Reserve money dropped by 6% to $2,885 million in the first half of 2019. The decline against December 2018 mirrored reductions in both other depository corporations' (ODCs) call accounts and currency in circulation by 6% to $2,036 million and 7% to $844 million respectively.

On the asset side, this result mirrored the widening of the net domestic assets (NDA) by 17% to minus $2,049 million despite gains in net foreign assets (NFA) by 2% to $4,940 million. Increases in net domestic credit (NDC) by 14% to minus $2,016 million and capital accounts from $130 million to $222 million underpinned the deterioration in the NDA.

[2] Reserve Bank of New Zealand Monetary Policy Statement August 2019.

[3] Reserve Bank of Australia Monetary on Policy Statement August 2019.

Figure 1: Drivers of Reserve Money

Source: CBSI

3.1.2 Money Supply

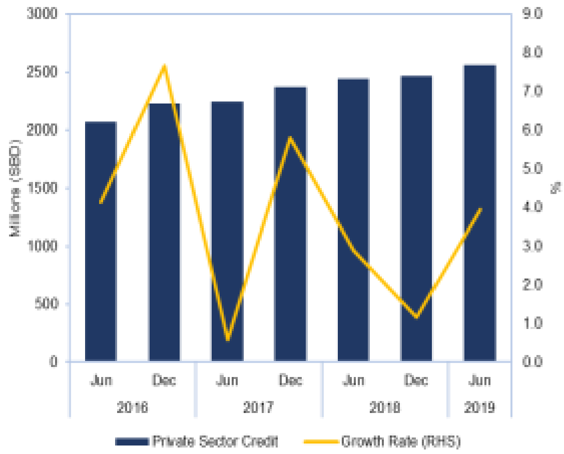
Broad money (M3) declined by 2% to $5,133 million against December 2018. The outturn was driven by decreases in both narrow money (M1) and other deposits; the former by 1% to $3,906 million and the latter by 6% to $1,228 million.

On the sources of M3 growth, the decline stemmed from deterioration in NDA; from $240 million in December 2018 to $27 million. The outcome was attributed largely to NDC which fell by 12% to $1,070 million, reflecting the build-up in government deposits over the last six months as fiscal policy tightened. An increase in capital accounts by 7% to $1,236 million also contributed to the decline in NDA. Meanwhile, NFA widened by 2% to $5,167 million on the back of expansions in both the CBSI and ODC NFA positions.

3.1.3 Credit Conditions

Private Sector Credit (PSC) growth meanwhile firmed up by 4% to $2,566 million in the first six months of 2019. This outturn was driven mainly by an upturn in ODC lending by 4% to $2,554 million. The major sectors supporting the growth included personal, construction, distribution, transport and professional and other services. Conversely, credit issued to the communication, tourism and manufacturing declined over the same period.

Figure 2: Credit to Private Sector

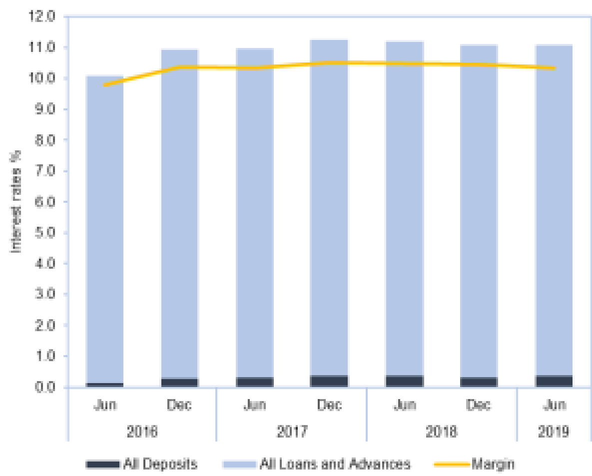


Source: CBSI

3.1.4 Interest Rate Trends

The interest rate margin narrowed to 10.37% in the first half of 2019 from 10.48% in the prior six months. This largely reflected the narrowing of the average weighted lending rates by seven percentage points to 10.72%. The fall in lending rates mirrored reductions across most of the major credit recipient sectors. Likewise, the weighted average deposit rate widened to 0.35% from 0.30% in December 2018.

Figure 3: Interest rate trends

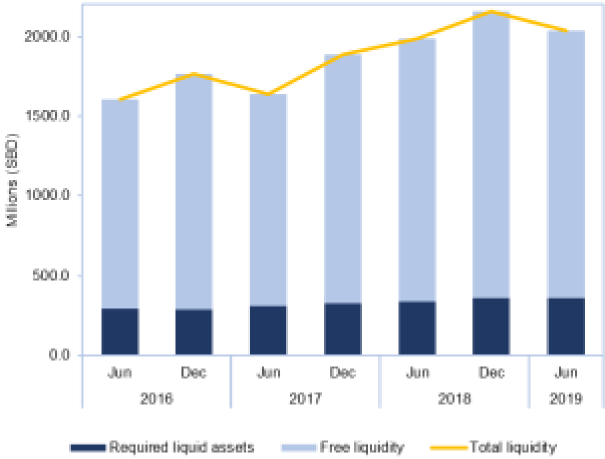


Source: CBSI

3.1.5 Liquidity Levels

Liquidity levels in the banking system dropped by 6% to $2,038 million, from a record $2,158 million posted in December 2018. This mirrored the deterioration in the CBSI's NDA position largely driven by government savings accumulated across the first six months. This saw both excess and free liquidity declining by 7% to $1,491 million and $1,678 million respectively.

Figure 4: Liquidity levels



Source: CBSI

The stock of Bokolo Bills floated by CBSI remain capped at $750 million across the first half of 2019 although the interest rate narrowed to 0.56% from 0.59% in December 2018. Meanwhile, the stock of treasury bills issued stood at $83 million in June, with less borrowing space left before hitting the new $100 million threshold. The interest rate for 182 days remain unchanged at 1.12%. However, the interest rate for 91 days widened to 0.49% from 0.48% whilst that for 365 days narrowed to 1.98% from to 2% in December 2018.

3.2 Domestic Conditions

Domestic economic activities weakened considerably following subdued performances from the primary sector, manufacturing and tourism. On the other hand, there was some pick up in communication, utilities and financial services over the period.

3.2.1 Economic Growth

Growth projection for 2019 has been revised down to 2.7% from the earlier forecast of 3.7% in March. This slower than expected growth is largely driven by fall in production in the forestry sector and agricultural cash crops in the first half of the year. These two sectors comprised a significant share of the economy.

3.2.2 Production Index

Domestic production activity contracted in the first half of 2019 with the production index declining to 107 points from 110 points. This was mainly driven by the negative performance in the forestry and agriculture sectors.

Output levels dropped in the first half of 2019 against the same period in 2018 – with round logs by 6%, palm oil by 5%, cocoa by 55%, coconut oil by 33%, and copra more than a three-fold cut. This negative result was attributable to a combination of domestic supply-side factors, weaker external demand, and declining world commodity prices. Meanwhile, the fisheries sector remained firm as expected with fish catch up by 11% compared to the first six- month period in 2018.

Figure 5: Half Yearly Production Index

Source: CBSI

3.2.3 Manufacturing

The manufacturing index dropped to 270 points in the first half of the year compared to 288 points in the same period last year. This was mainly driven by lower manufacturing for domestic consumption and suggests weaker domestic demand over the period.

Figure 6: Manufacturing Index Trend

Source: CBSI

Over the year to June 2019, the manufacturing index for domestic consumption declined by 15% to 161 point compared to the same period last year. This reflected lower output for beverages and tobacco. Meanwhile, the manufacturing index for exports slightly rose by 1% year-on-year to 500 points that is associated with an uptick in the manufacturing of tuna products for export following the higher fish catch.

Similarly, loans to the manufacturing sector declined by 18% year-on-year and 10% compared to the previous six months to a position of $134 million. Nonetheless, seasonally manufacturing output is usually relatively low in the first half of the year. With this additional financing capacity and seasonal manufacturing patterns, it is anticipated that activity will pick up in the second half of 2019.

3.2.4 Employment

SINPF member contributions, which is a proxy for labour market conditions grew by an additional 974 (active and slow active) contributors over the first half of 2019 to a total of 59,710 contributors. Compared to end June of 2018, this was an increase of 2%. However, job vacancies tallied from the newspapers recorded a fall of 15% to 310 advertisements during the period.

3.2.5 Other Sectors

Meanwhile, there was mixed performance in the other key sectors in the first half of 2019.

Electricity generation increased by 4% to 49 million Kilowatt-hour (KWH) in the first half of the year against the same period of 2018. Correspondingly, units sold to households and commercial entities increased by 3% to 9 million KWH and 4% to 25 million KWH respectively against the same period last year. This reflects sustained momentum in the use of energy that is associated with economic activities.

Closely associated with the energy usage, the communication index for the first half increased by 7% against the same period in 2018, and 11% against the second of 2018 to an index of 198 points. This reflects a substantial growth in internet usage by 16% and mobile usage by 2%.

Commercial bank lending also increased by 4% over the first six months where the bulk of the loans apart from fisheries were for construction, distribution, and transport indicating positive activity in these sectors. Personal loans also increased suggesting higher household investments.

Meanwhile, provisional visitors' arrival dropped in the first half of 2019 by 22% to 13,823 visitors as arrival by both air and sea dropped over the six months. The number of FDI applicants in the first half also dropped by 42% to 62 applicants. The fall was seen across all the sectors and provinces.

3.3 External Conditions

The Balance of Payments (BOP) surplus improved in the first half of the year to $78 million compared to $48 million in December 2018. This result stems from the improvement in the current account deficit, amidst a relative fall in the capital and financial account surplus. Accordingly, the gross foreign reserves slightly improved over the period.

3.3.1 Current Accounts

The current account relatively improved to a deficit of $327 million from a $567 million deficit in the second half period of 2018. A significant reduction in the trade in goods deficit to $5 million from $175 million, and a turn around in the primary income to a surplus of $24 million from a $217 million deficit contributed to the outcome.

The trade in goods outturn was due to the significant 9% fall in imports to $2,090 million, particularly from machines, food and fuel. Meanwhile, exports slid by 2% to $2,085 million on the back of declines in copra, palm oil, bauxite and fish export values.

In contrast, the services deficit deteriorated to $400 million from $334 million as visitor numbers declined. While, secondary income tumbled to $54 million from $159 million as less donor cash grants were received during the period.

Figure 7: Trade and Current Account Balances

Source: CBSI

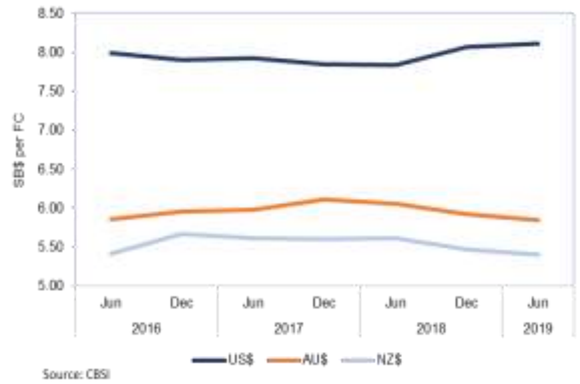
3.3.2 Capital and Financial Account

On the contra side, the 'capital and financial' account surplus went down by 20% to $282 million. This was due to the 5% fall in donor capital grants to $248 million, and net financial account decreasing to $34 million from $92 million. The outcome in the capital account is associated with lower donor capital activity, while in the financial account due to the fall in foreign investment inflows and debt repayments.

3.3.3 Exchange Rate

Global currency movements particularly the strengthening US dollar (USD) led to the Solomon Islands dollar (SBD) falling by 0.9% against the Trade Weighted Basket to 110.3 points. Against the key bilateral currencies, the SBD slid against the USD by 0.6% to $8.11 per USD. On the other hand, the SBD appreciated against both the Australian and New Zealand dollars by 1.4% to $5.84 per AUD and 1.3% to $5.40 per NZD respectively.

Figure 8: Nominal Bilateral Exchange Rates

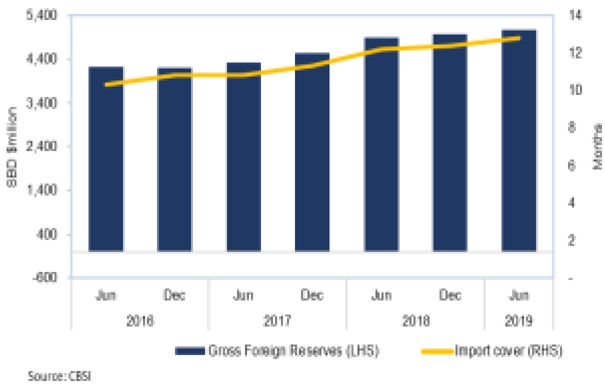


Due to stronger countervailing effect of the USD, the country's Nominal Effective Exchange Rate accordingly went down by 0.3%. Although the Real Effective Exchange Rate on average appreciated by 2.6% during the period, reflecting the inflation differentials between the country and its trading partners.

3.3.4 Foreign Reserves

Due to the relative improvements in the current account, along with foreign exchange revaluation gains, the gross foreign reserves increased by 2% to $5,082 million at end June 2019. This level of reserves is equivalent to around 12.8 months of import cover.

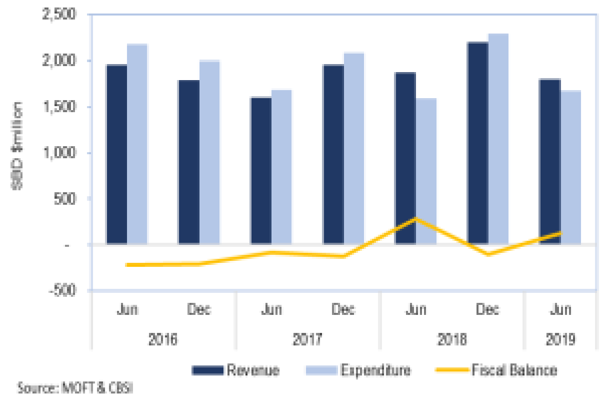
Figure 9: Gross Foreign Reserves



3.4 Fiscal Conditions

The government recorded a fiscal surplus of $129 million in the first half of 2019 against a deficit of $96 million in the second half of 2018. This outcome was somewhat expected due to the government being in caretaker-mode with no major capital expenditure before the April 2019 general elections. As such, the government built up its reserves in the banking system. Although, compared to the pro-rata budget, both revenue and expenditure outturns tracked below their year to June budget.

Figure 10: Fiscal Balance



3.4.1 Revenue

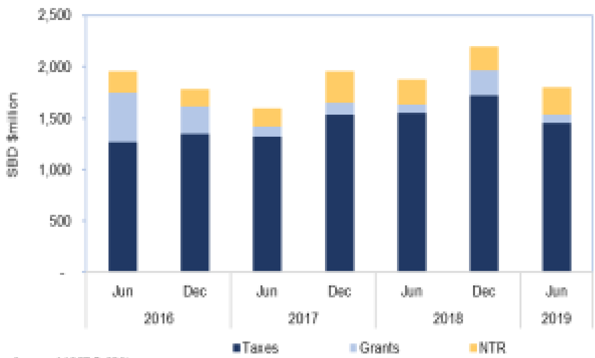
Total revenue and grants collected in year to June 2019 fell below budget by 10% to $1,803 million, and was 18% lower than the last six months of 2018. This weaker performance reflected the declines in tax revenue and grant assistance received, which outweighs the slight increase in non-tax revenue during the review period. Against the same period last year, total revenue receipts was down by 3%.

Tax revenue collected in the first six months of the year contracted by 15% to $1,462 million. This negative outturn reflected weaker collection across all tax categories during the review period. Tax on goods and services plunged by 22% to $476 million, tax on income and profits edged lower by 13% to $476 million and tax on international trade fell by 10% to $490 million. The latter driven by lower receipts from round log exports, while tax on property shrank from $23 million to $20 million during the period.

Grant assistance received from donor partners fell drastically by 68% to $78 million during the six months to June. On the other hand, non-tax revenue rose by 14% to $263 million in the first half of the year. This increase reflected higher proceeds from fishing licences fees received during the period.

In terms of share, tax revenue accounted for 81% of total revenue, non-tax receipts contributed 15%, while grant assistance accounted for the remaining 4% during the review period.

Figure 11: Fiscal Revenue Collection



Source: MOFT & CBSI

3.4.2 Expenditure

Total government's outlays plunged by 27% to $1,674 million during the first six months of 2019, and fell below the annual budget by 20%. However, total government's expenditure was 6% higher when compared to the same period in 2018.

Recurrent expenditure, which accounted for 93% of total outlays, fell by 17% to $1,551 million. This was mainly driven by a 21% reduction in spending on goods and services to $695 million and a 65% decline in other expenses to $60 million. Weaker spending on compensation of employees, subsidies and social benefits also contributed to this outcome. Based on year-on-year comparison, recurrent expenditures were 10% higher.

Figure 12: Fiscal Expenditure

Source: MOFT & CBSI

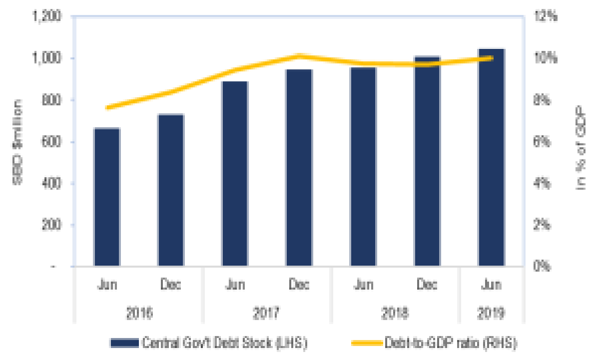
Capital expenditure, which comprised 7% of total outlays, declined sharply by 73% to $123 million. This was significantly lower by 36% against the same period last year. The negative outcome reflected lower spending during the caretaker mode of government before the elections, particularly on acquisition of residential and non-residential buildings, roads, bridges and wharves, machinery and equipment and land purchases.

3.4.3 Public Debt Stock

Central Government's debt balance increased by 3% to $1,043 million at the end of June 2019. The increase in government's debt stock emanated from the upturn in auction treasury bills issued combined with the foreign exchange rate movements during the review period. By composition, external debt accounted for 74% ($777 million) while domestic debt represented the remaining 26% ($266 million).

Meanwhile, debt repayments increased by 28% to $31 million compared to $24 million repaid in the last six months of 2018. Of the total debt repayment, $21 million was for principle repayment and $10 million was on interest repayments. As a debt sustainability indicator, the country's debt-to-GDP ratio remained at 10%.

Figure 13: Public Debt Trends



Source: MOFT & CBSI

3.5 Inflation Developments

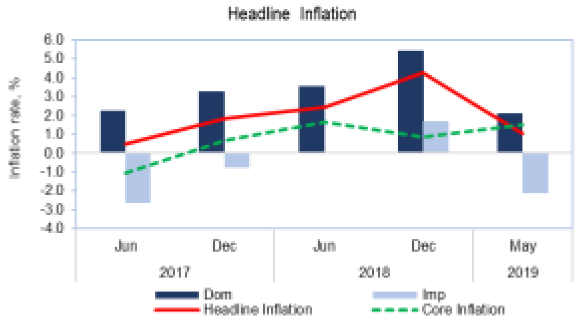
The headline inflation report for June 2019 was not available at the time of this reporting. This inflation assessment is based on the first five months of the year where data was available.

Inflationary pressures in the country eased over the first five months of the year, reversing the upward trend recorded in the second half of 2018. Headline inflation reached 0.5% in April 2019 compared to 4.2% in December 2018. By May 2019, consumer prices picked up slightly to 1%. The slowdown in headline inflation reflected the price declines in both domestic and imported inflation during the review period. Compared to the same period in 2018, headline inflation was 1.8 percentage points lower.

Domestic inflation, which measures the price of domestically produced goods, dropped to 2.1% in May 2019 from 5.4% in December 2018, and 2 percentage points below the corresponding period a year prior. This outcome was underpinned by sustained price drops across major categories such as food, alcoholic beverages and tobacco, transport and education.

Similarly, imported inflation slowed down during the first four months of 2019, falling from 1.7% in December 2018 to minus 2.8% in April 2019, and picked up slightly to minus 2.2% in May 2019. The downturn in imported inflation was mainly driven by the slowdown in fuel-related transport and housing utilities. This outweighed the rise in the price of imported food, clothing, household operations and miscellaneous categories. Compared to the corresponding period last year, imported inflation was 2.6 percentage points lower.

Figure 14: Inflation Developments



Source: SINSO & CBSI

Meanwhile, core inflation grew to 1.7% in March 2019 from 0.8% in December 2018 before moderating to 1.5% in May. This reflected the price increase in non-food and non-fuel categories during the review period.

4 Domestic Economic Outlook

4.1 Real Economy

The economic growth for 2019 is forecast to be slower than expected at 2.7%, 1 percentage point lower than projected in the March MPS. Externally on the demand side, this is underpinned by weak global commodity prices and muted global growth. Domestically, on the supply side, production has been lower than projected based on the low outturns in first half of the year. These underlying assumptions contribute to slower growth.

Given the downward revision in 2019, growth in 2020 is projected to pick up to 3.7%. This is in line with a scenario of a rebound in global growth and commodity prices. As such, in the primary sector, CBSI is expecting the agriculture cash crops to revert to positive growth, although a downward risk could be the lingering effects of the coconut rhinoceros beetle pest. Fishing is expected to remain buoyant in anticipation of the full utilisation of the fishing boats. While, the forestry sector is expected to gradually slow down with the implementation of the government's forestry sustainability policy initiative.

The secondary and services sectors are forecasted to remain firm with an assumption of a jump in the communication sector once the submarine cable goes online and boosts internet services. Construction from donor infrastructure funded projects are also expected to continue, while 'wholesale and retail' and manufacturing will remain buoyant.

Over the medium term, the growth forecast is expected to pick up further to 4.0% in anticipation of the construction of the pacific games facilities and the Tina Hydro project, resumption of the Gold Ridge Mining, and a positive growth in all other sectors except for forestry that is assumed to gradually decline.

However, risks to the medium-term growth projections are tilted to the downside if planned projects in the mineral and energy sectors are deferred, a faster decline than expected in round logs, and a slower pick up in commodity prices. Moreover, heightened fiscal risks with respect to revenue and expenditure pressures could also dampen growth.

4.2 Fiscal

With respect to the near to medium fiscal outlook, the anticipated gradual decline in logging will see a fall in government revenue. New revenue measures such as a tax on rice and other expected tax reforms are envisaged to partially fill the gap from logging.

On the expenditure side, the pressure on the government to maintain social services given the growing population and to build large infrastructures such as for the pacific games suggests a tendency for fiscal deficits that would need to be financed through either debt and/or donor support.

4.3 External

Moreover, the outlook for the balance of payments is for a widening of the current account deficits due to higher capital imports associated with the construction for the planned major projects. This is anticipated to be fully financed by the surplus capital and financial account as government infrastructure projects are donor-funded and private imports are largely through FDI. As a result, the balance of payments is forecasting a surplus position but at a reduced rate. The gross foreign reserves going forward is therefore anticipated to remain at sufficient levels.

4.4 Monetary

Meanwhile, monetary conditions are expected to remain positive in the medium term as earlier projected, and in line with economic growth conditions. Reserve money and broad money are projected to grow moderately. Private sector credit is forecasted to trend up but at a slower pace and accordingly, excess liquidity is anticipated to trend upward.

4.5 Inflation

While headline inflation has eased in the first half of the year, and domestic inflation is expected to be stable for the rest of the year (barring any bad weather), imported inflation is expected to swing upwards. This comes on the heels of the government revenue measure to tax rice as of September 2019. Overall, headline inflation in 2019 is estimated to be contained at an annual average of around 1.6% and approximately 2.1% for the year ending December.

In 2020 headline inflation is preliminary projected to rise to 3.2%, within the acceptable band of 3% - 5%. This is due to demand-side factors on both the domestic and external fronts, particularly higher imported food prices, although fuel prices are anticipated to remain stable.

There also risks to inflation over the horizon. Any global geopolitical shocks poses external downside risks to the forecast. Additionally, a predominant downside domestic risk is climatic conditions that could disrupt supply and push up the prices of domestic food at the market. Meanwhile, a potential upside risk is that persistently weak fiscal spending could lead to softer demand and thereafter subdued inflation outcomes.

5 Monetary Policy Stance

Given the subdued conditions in the first six months and the slower economic forecast for 2019, CBSI has adopted an accommodative monetary policy stance for the next six months. The change from the previous moderate tightening stance in March, reflects the easing inflationary pressures thus far, the projection for relatively modest inflation for remaining part of the year, and the desire to further support growth in the economy. However, should there be any other macroeconomic shocks, the Bank shall consider taking appropriate action.