CENTRAL BANK OF SOLOMON ISLANDS

MONETARY POLICY STATEMENT
March 2022

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1 Overview

Global recovery continued but at a moderate pace as multiple challenges weigh on growth. Global growth projection was revised down to 4.4%, 0.5 percentage point lower for 2022[1] than previously forecasted in October 2021. This downward revision reflected forecast downgrades for the United States and Chinese economies. For the US, this owed to a smaller fiscal package than previously anticipated combined with anticipated early withdrawal of monetary policy whilst with China, continued stress in the property market and a weaker-than-expected recovery in private consumption induced the downgrade.

Global food and oil prices remained elevated in the second half of 2021 owed to on-going supply chain disruptions, bottlenecks in transportation of goods and high energy prices continuing into 2022. Moreover, elevated price pressures are expected to persist for longer for both advanced and emerging market economies over 2022 but are expected to subside in 2023. Global commodity prices are expected to moderate in 2022.

The domestic economy showed subdued conditions in the second half of 2021. This reflected sluggish economic activities owed to on-going pandemic impacts as well as the adverse economic impacts of the November riot that pushed the economy back into recession at the close of 2021. This saw uneven falls across most sectors in the economy led by falls in the production and manufacturing indexes. On the other hand, mixed outcomes were recorded in other sectors.

Key monetary aggregates improved in the second half of 2021 with reserve money and excess liquidity increasing in line with the growth in reserves during the year. Narrow money (M1) and broad money(M3) also rose however, private sector credit declined further continuing the fall recorded from the first half.

The Balance of Payments (BOP) position remained positive over the second half of the year reflecting surpluses in the capital and financial accounts during the year. Despite these gains, a wider current account deficit was recorded over the period on account of weakening trade in goods and services. Nonetheless, gross foreign reserves rose over the period reflecting the new allocation of Special drawing rights (SDR) by IMF during the year.

The government recorded another fiscal deficit of $261 million in the last six months of 2021 against the $382 million deficit recorded in the first six months to June. This reflected increases in both revenue and expenditure over the period. The government’s debt stock rose to $1,609 million, equivalent to 13% of GDP by end 2021.

Headline inflation in November 2021 (latest available) reached 2.0% from -1.5% in June. This outcome reflected the increases in both imported and domestic components of inflation owed to rising food and fuel prices in the second half of the year.

Given these developments, real GDP for 2021 is revised down to -0.6% reflecting on-going subdued economic activities amid on-going pandemic impacts. With the onset of the Covid-19 transmission, growth for 2022 is expected to deteriorate further to -7.3% and is expected to linger into 2023. Heightened uncertainties and rising risks cloud this outlook.

2 International Economic Developments

Global growth for 2022 is forecasted to moderate to 4.4%2 from 5.9% in 2021. This weaker outlook stems from the spread of the new COVID-19 Omicron variant amid the diverging growth paths across economies. The resurgence of highly infectious COVID-19 Omicron has resulted in imposed mobility restrictions and financial markets volatility. Risks to the global outlook are tilted downside marked by the scarring effects of the COVID-19, geopolitical tensions namely the Ukraine conflict, climate change-related disasters, and broad-based higher inflation than anticipated.

Growth in advanced economies in 2022 is projected to decline to 3.9% from 5% in 2021 reflecting the

[1] IMF’s January 2022 World Economic Outlook (WEO) Update.

[2] All statistics in this section are obtained from the IMF WEO July 2021 updates, unless otherwise stated.

resurgence of COVID-19 across advanced countries in particular Europe, supply chain disruptions, and reduced fiscal support. Similarly, in Emerging Markets and Developing Economies (EMDEs), growth is anticipated to decelerate to 4.8% in 2022 from 6.5% in 2021, This is largely driven by the Chinese economy, which marked the third year of slower growth, with new restrictions to contain the Omicron variant, amidst its zero-COVID policy. This is expected to retrench property investments and slower consumption.

On the regional front, growth prospect for Australia is at 4.1% about the same as in 2021 supported by strong household spending and an upswing in investments. However, the pandemic remains the source of uncertainty. In New Zealand, growth outlook is expected to ease to 3.3% from 5% in 2021 from weakened business and consumer confidence as the score of COVID-19 cases resurface towards the end of 2021.

2.1 Global Commodity Prices

Global commodity prices continued to rise in the second half of 2021 although at a diminishing pace compared to the first half of the year. The IMF's commodity prices rose by 16% to an index of 187 in December 2021 marked by a sizeable 41% increase in energy prices and an 18% increase in tapis oil price to US$82 per bbl. Meanwhile, food prices rose slightly by 4%. The global commodity price is forecasted to stabilize moderately in 2022 as prices reach pre-pandemic levels.

2.2 Global Inflation

The global inflation picked up strongly in the fourth quarter of 2021 following the new wave of COVID-19 Omicron variant inducing supply-chain disruptions. Inflation in 2021 for advanced economies grew to 3.1% from 0.7% and EMDEs to 5.7% from 5.1%, driven by the sharp rise in energy prices. In 2022, fuel and natural gas are expected to increase moderately, which would drive inflation to remain high with advanced economies projected at 3.9% and EMDEs at 5.9%. Higher inflation poses challenges for monetary and fiscal policy to trade-off between curbing higher inflation and strengthening the weaker economy. In the United States, monetary policy is expected to be less accommodative following the soaring inflation in December 2021.

Similar to the United States, inflation outlook for Australia and New Zealand in 2022 is expected to fluctuate above their target range of 2 to 3 percent and 1 to 3 percent, respectively. Australian inflation rose more than expected to 3.5% in December 2021 and is forecasted at 3.75%[3] in mid-2022 from strong demand in housing constructions and durable goods. In New Zealand, inflation is projected at around 5%[4] before easing towards end of 2022 due to higher fuel and capacity constraints.

3 Domestic Economic Developments

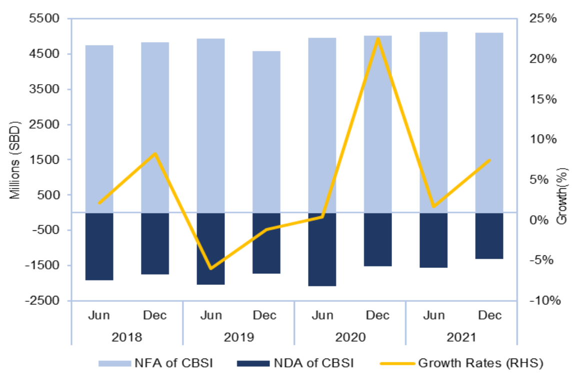
3.1 Monetary Conditions

Monetary conditions in the second half of 2021 saw growth in reserve money (M0), narrow money (M1) and broad money(M3). Whilst, growth in private sector credit recorded a downturn in the second half of the year. Total liquidity in the banking system continued to increase while Other Depository Corporations' (ODCs) interest rate margin narrowed during the period.

3.1.1 Reserve Money

Reserve money(M0) growth continued to increase by 7% to $3,833 million in the second half of 2021 following a 2% growth posted in the first six months of 2021. The growth against June 2021 reflected increased in both the currency in circulation and other depository corporations' (ODCs) call balances both by 16% to $1,274 million and $2,550 million respectively. On the sources side, this growth mirrored the narrowing of the net domestic assets (NDA) by 16% to minus $1,309 million despite a 0.5% fall in net foreign assets (NFA) to $5,112 million.

Figure 1: Drivers of Reserve Money



Source:CBSI

[3] RBA, MPS, February 2022

[4] RBNZ, MPS, November 2021

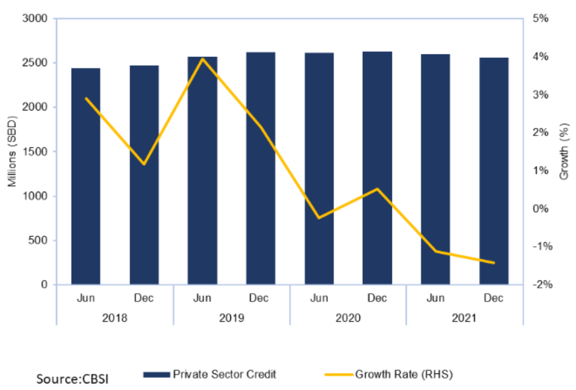
3.1.2 Money Supply

Broad money(M3) increased by 6% to $5,709 million in the second half of 2021, after a 0.4% fall recorded in the first half of 2021. This was driven by increases in narrow money (M1) by 2% to $4,441 million and other deposits by 3% to $1,091 million respectively. On the sources side, the increase in NDA of the banking system by 1% to $100 million supported the growth in M3 during the period. Hence, NFA of the banking system declined by 0.3% to $5,337 million.

3.1.3 Credit Conditions

Private sector credit (PSC) decreased marginally by 1% to $2,562 million in the second half of 2021 following a 1% decline in the previous period. The downturn was driven mainly by a fall in ODCs' lending by 1% to $2,544 million. The major sectors that contributed to the fall included construction, tourism distribution, transport, and professional and other services. Meanwhile, credit to personal, communication, and manufacturing sectors increased over the same period.

Figure 2: Credit to Private Sector



3.1.4 Interest Rate Trends

The ODCs' interest rate margin narrowed to 9.5% in December 2021 from 9.9% posted in June 2021. This resulted from a fall in the indicative weighted average lending rates from 10.41% in June 2021 to 10.04% in December 2021. This reflected the decline in the lending rates to forestry, tourism, communication, transportation, and entertainment & catering services. Meanwhile, the weighted average deposits increased from 0.48% in June 2021 to 0.55% in December 2021.

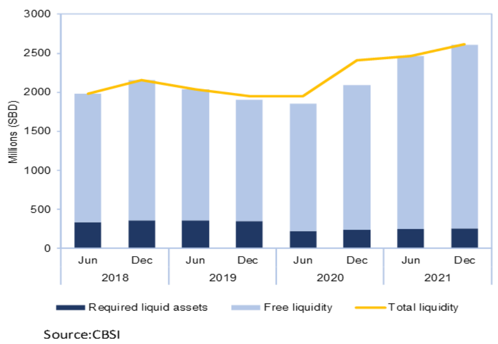
3.1.5 Open Market Operations

The stock of Bokolo Bills issued in the second half of 2021 remained capped at $430 million in line with CBSI's expansionary monetary policy stance to lower the impact of COVID-19 on the financial system. During the same period, the weighted average interest rate for Bokolo Bills declined to 0.10% in December 2021 from 0.18% posted in June 2021. The stock of treasury bills issued recorded $92.8 million by end of December 2021, almost reaching its maximum limit of $100 million. Therefore, the weighted interest rate offered for 91-days remained unchanged at 0.49% as of June 2021. Whilst, weighted interest rates for 182-days both declined to 0.99% and 1.89% respectively.

3.1.6 Liquidity Levels

Total liquidity levels in the banking system firmed up by 6% to $2,609 million in December 2021, from $2,461 million recorded in June 2021. This upturn mirrored the narrowing of the CBSI's NDA position largely driven by reduction of government deposits in the last six months. This resulted in a 7% increase in excess liquidity to $ $2,159 million whilst free liquidity rose by 6% to $2,355 million over the same period.

Figure 3: Liquidity levels



3.2 Domestic Conditions

Domestic economic activities remained subdued in the second half of the 2021 following the weaker growth outturn recorded in the first half the year. This outcome was seen across broad sectors of the economy. Driving the slow-down in economic activity was the sustained impact of COVID-19 on the economy coupled with the Honiara Riots in late November which led to the closure and loss of businesses in Honiara particularly in the wholesale and retail sector.

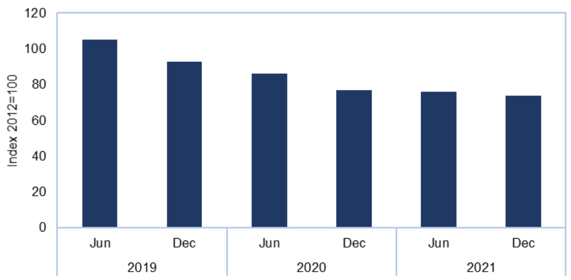
3.2.1 Economic Growth

The economy is estimated to grow at -0.6% in 2021 following the protracted impact of COVID-19 on the economy and the three days of Rioting in Honiara. Moreover, this growth is an improvement from the -4.3% growth estimate in 2020, reflecting growth in the construction sector on the back of major national projects that is expected to drive the economy in the near term.

3.2.2 Production Index

The production index remained muted in second half of 2021, declining by 3 points to an index of 76 basis point. The fall in logging industry during the period outweighed the gains from the fishing, palm oil, copra and coconut oil industries.

Figure 4: Half Yearly Production Index



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3.2.3 Manufacturing

The CBSI manufacturing index waned by 11% to 257 points in the second half of 2021 reversing the strong performance witnessed in the first half of the year. The weaker outturn stemmed from the fall in tobacco production in the fourth quarter of 2021 due to the Honiara Riot which disrupted production of tobacco output. On the other hand, tuna processing specifically loin production strengthened due to improved fish catch during the third and fourth quarters of 2021.

3.2.4 Other Sectors

Other indicators of the economy in the second half of 2021 recorded mixed outcomes following subdued movements earlier. Energy production, construction, communication and the retail and wholesale sectors recorded positive outturns in activity from subdued outcomes in the first half of the year. In contrast, FDI fell further owing to no new investments during this period.

3.2.5 Employment

Activities in the labour market recorded another 2% fall in the second six months of 2021 to 55,573 (active and slow active) contributors, using SINPF members contribution as a proxy for employment. This outcome reflected the continuous recruitment freeze by the public sector and some private companies due to the uncertainties created by the Covid-19. Similarly, the number of vacancy advertisements in print media also dropped to 561 job vacancies in 2021 from 785 job vacancies recorded in 2020.

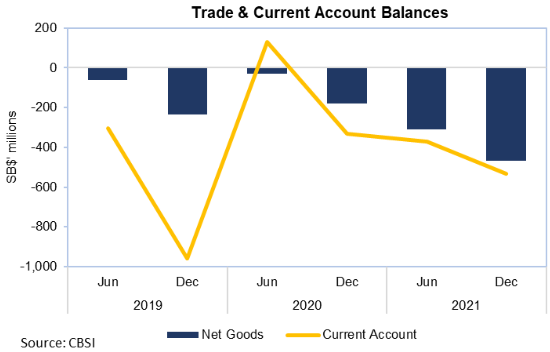
3.3 External Conditions

The Balance of Payments (BOP) position posted a surplus of $212 million in the second half of the year from a revised $171 million surplus in June 2021. This came from a surplus in the capital and financial account amidst a wider current account deficit. Accordingly, the gross foreign reserves increased over the period.

3.3.1 Current Accounts

The current account deteriorated to a deficit of $535 million from a revised $369 million deficit in the first six months of 2021. This reflected the significant weakening in the trade in goods and services to $469 million and $540 million deficits respectively, despite the rise in the primary and secondary income surpluses.

Figure 5: Trade and Current Account Balances



Source: CBSI

The broader deficit in the trade in goods was driven by the increase in all major import categories expect for animal vegetation and oil fats. Goods import grew by 20% to $2,056 million. Similarly, exports receipts also increased over the period by 13% to $1,587 million, although inadequate to offset the outflows. The trade in service balance deteriorated to $540 million deficit from $455 million reflecting higher service payments. Meanwhile, donor related secondary income increased by 15% to $359 million and primary income recorded a surplus of $115 million driven by the compensation of employees.

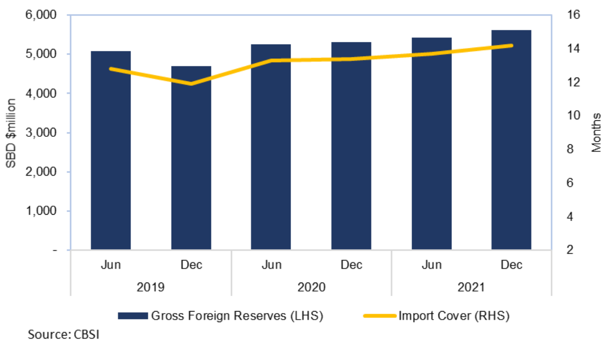
3.3.2 Capital and Financial Account

On the contra side, the 'capital and financial' account recorded a surplus of $759 million from $790 million in the first half of the year. This fall come on the back of lower donor capital grants to $183 million, while net financial account increased by 19% to $577 million. The outcome in the capital account is associated with slower donor capital projects, while in the financial account is due to the surge in other investment inflows in the second half of the year.

3.3.3 Foreign Reserves

Despite the deterioration in the current account balance, the gross foreign reserves increased by 3% to $5,617 million at end December 2021. This reflected the new allocation of Special drawing rights (SDR) by IMF for BOP needs. This level of foreign reserves is equivalent to around 14.2 months of import cover.

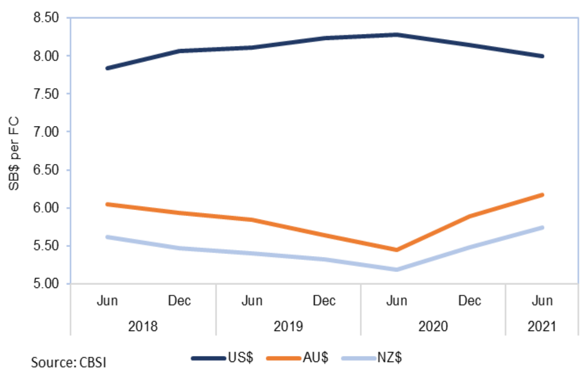
Figure 6: Gross Foreign Reserves



3.3.4 Exchange Rate

Global currency movements particularly the strengthening of the US dollar (USD) led to the Solomon Islands dollar (SBD) falling by 2% against the Trade Weighted Basket to 108.6 points. Against the key bilateral currencies, the SBD depreciated against the USD by 1% to $8.06 per USD. On the other hand, the SBD appreciated against the Australian dollar and New Zealand dollar by 4% to $5.90 per AUD and 2% to $5.63 per NZD respectively.

Figure 7: Nominal Bilateral Exchange Rates

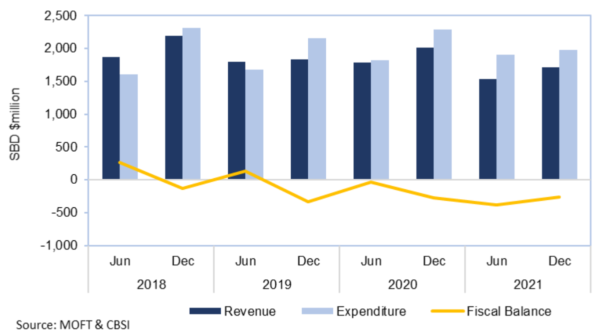


The country's Nominal Effective Exchange Rate appreciated by 2.5% to an index of 116.2. Conversely, the Real Effective Exchange Rate on average depreciated by 1.3% during the period, reflecting the inflation differentials between the country and its trading partners.

3.4 Fiscal Conditions

The second half of 2021 was quite a turbulent period. Rioting and burning of business properties and a vote motion of the no confidence that followed it, added to an already depressed economic environment. This has resulted in revenue losses to the government, particularly from the notable tax payers whose businesses have fallen victim to the ransacking and arson. By December 2021, the government recorded another fiscal deficit of $261 million, lower than the $382 million deficit recorded in the first six months to June.

Figure 8: Fiscal Balance

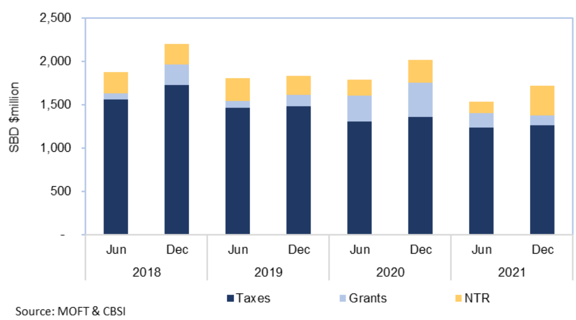


Meanwhile, the government's debt stock rose to $1,609 million, 11% higher than at the end of December 2020, equivalent to 13% of GDP.

3.4.1 Revenue

Total revenue firmed up by 12% to $1,720 million against the first six months of 2021. This reflected favourable collections on both other revenues and tax collections. However, this level was 15% lower than the same period in 2020.

Figure 9: Fiscal Revenue Collection



Tax revenue rose by 2% to $1,262 million against the prior six months. This outturn stemmed from increases in income and profit taxes and GST; the former by 8% to $450 million and the latter by 26% to $381 million. Conversely, taxes on international trade fell by nearly 20% to $403 million. However, tax revenue was 7% lower year-on-year. **Non-tax revenue** expanded to $341 million from $131 million in the prior six months, and up by 30% year-on-year reflecting higher fishing fee receipts in the second half of 2021. Meanwhile, donor support fell by 27% to $117 million relative to the prior six months to June. Similarly, donor support fell to $160 million from $398 million relative to the first of 2021.

3.4.2 Expenditure

Total expenditure increased by 4% to $1,981 million against the second half of 2020, but was 13% lower than in 2020. This reflected capital spending which surged by nearly 80% to $375 million, largely underpinned by the spending on fixed assets.

Figure 10: Fiscal Expenditure

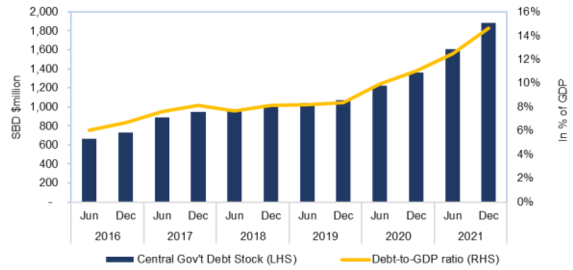
Source: MOFT & CBSI

On the contra side, recurrent expense fell by 6% to $1,606 million driven by reductions in both payroll and other charges despite an increase in benefits and transfers recorded in the second half of 2021.

3.4.3 Central Government Debt Stock

The Central Government's debt stock rose by 17% to $1,886 million in second half of 2021, 30% higher than in 2020. Relative to the prior six months, the increase stemmed from the domestic debt component which surged by 65% to $748 million.

Figure 9: Central Government Debt



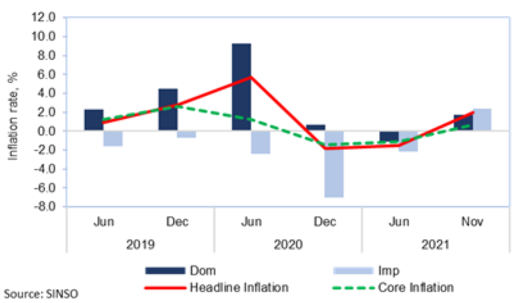
Source: MOFT & CBSI

This mirrored the issuing of additional domestic bonds: $60 million each to SINPF and SIPA; $50 million to POB and $120 million reissued to CBSI in the secondary market. However, the external debt edged lower by 1% to $1,138 million. Meanwhile, total debt servicing costs increased notably to $102 million in the second half of 2021; $94 million in principal repayment and $8 million on interest charges. The principal component comprised of $73 million repaid on domestic debts, mainly matured T-bills, and $21 million on external debt. Interest charges included $3 million on domestic debt and $5 million on external debt.

3.5 Inflation Developments

Inflation in the second half of 2021 rebounded out from deflationary levels following the uptick in world commodity prices, particularly, the surge in fuel prices. Headline inflation in November 2021 (latest available) ascended to 2.0% from -1.5% in June. This outcome reflected the increase in imported and domestic components, rising to 2.4% and 1.7% respectively (see chart Figure 11). By composition, transport contributed more than half of the upward inflation due to the increase in crude oil, followed by housing & utilities from the pass-through effect in the surge in fuel price and to a lesser extent a food basket.

Figure 11: Inflation Development



Source: SINSO

Similarly, core (or underlying) inflation emerged from -1.1% in June to 0.7% in November in line with economic activities. CBSI price monitor of selected items in Honiara at end of 2021 rose to 103 points from 97 points in June. Fuel in pump stations rose by 17%, rice (solrice 40lb) grew by 16%, LNG gas and electricity tariff increased by 11% each.

4 Domestic Economic Outlook

4.1 Real Economy

CBSI expects economic growth to contract further by -7.3% in 2022 and does not expect economic activity to recover for at least a year due to on-going COVID-19 response measures, weak economic activities, and lockdown and curfew effects that resulted in shutdown of non-essential businesses and activities. Broad-based contractions are expected across the construction, manufacturing, wholesale and retail, hotel & restaurants, transport and storage, agriculture and forestry.

Under this baseline, real output and the effects Pacific Games hosting and policy response will see growth moderating from -7.3% to -1.5% in 2023 led by a rebound in the services sector.

Alternatively, a moderate economic contraction of -6.8% is expected in 2022 if containment measures are eased and border restrictions are lifted in July 2022 as announced with significant fiscal and monetary policies support. This baseline assumes that in-bound travellers will drive growth and its associated spill over effects in the economy.

Over the medium term 2024-2025, the economy is expected to bottom out from recession and rebound at an average growth of 1.5% on the back of steady progress on testing, treatments and vaccination rates and thereby the subsequent reopening of international borders. Drivers contributing to this outlook will be anticipated recoveries from construction, manufacturing, retail & wholesale, agriculture fishing and public administration.

However, considerable risks of pandemic uncertainties, supply-demand mismatches, weak demand from our trading partners, high inflation, debt and climate change vulnerabilities surrounds these forecasts and if materialize will weigh sharply on this projected partial recovery.

4.2 Fiscal

The sluggish economic growth in recent years has weakened domestic revenue mobilisation while spending remained elevated. This has led to erosion of fiscal buffers, widening fiscal deficit and a rapid increase in government borrowing. These structural frailties are being reinforced by the negative impacts of the covid-19 pandemic. With economic growth forecasts in 2022 further downgraded following the community transmission, efforts to stabilise government finances will not eventuate sooner as the fight to contain the virus takes centre stage.

Financing and policy responses. Tax revenues are expected to remain subdued in 2022. More donor support will be needed to fill an expected financing gap of around 5% of GDP this year. Beside covid-19 related spending, other impending spending pressures include outstanding student allowances, both at national and various regional university institutions, additional allowances for frontline staff, Pacific Games funding commitment and anticipated stimulus spending in the aftermath of covid-19. Additional resources will be needed to provincial governments strengthen their health systems and capacity to respond to potential widespread outbreak.

The near-term fiscal outlook hingers on the generosity of donors. Without fiscal consolidation, the government may struggle to meet an annual financing gap as large as $1 billion if donor support falls. The annual borrowing limit of around $300-$400 million provides some headroom to cushion the financing gap. The trade-off between fiscal consolidation and deficit financing. In this pandemic period, fiscal consolidation, could choke off near-term growth, adding to social tensions. Deficit financing through borrowing may use up resources needed for productive investment post covid-19. Both policy choices, although necessary, could set the economy down a vicious path of low growth and high debt if not set right. Therefore, a well-thought-policy helps to minimize the unintended impacts of these policy responses. Over the medium term, it is imperative to set expenditure in line with domestic revenue collection capacities to restore fiscal sustainability.

Covid-19 policy response. Mapping the policy responses to be employed during the different phases of the current pandemic is crucial. Beside the immediate actions to save lives and livelihoods, authorities must now begin to consider post covid-19 recovery plans to help the economy quickly regain its foot and longer-term measures to rebuild a more resilient, inclusive and greener post-COVID-19 economy. However, as the pandemic persists, these phases may overlap. Policymakers could confront the challenge of trying to boost the economy while also dealing with potentially repeated outbreaks. Given the challenging fiscal setting, tackling these competing needs may be demanding, even with or without well-crafted policy responses.

4.3 External

The forecast for balance of payments is for a contracted current account deficit on account of slower imports of goods and services and FDI inflows in 2022. Although, this is anticipated to be partially financed by the surplus capital and financial accounts, this will not be sufficient to offset the anticipated deficit over the medium term. As a result, the balance of payments projects a wider current account deficit position over the next three years and slightly weaker gross foreign reserves going forward.

4.4 Monetary

The developments in the key monetary aggregates are expected to grow moderately in 2022 and beyond in line with the medium -term growth forecast. Reserve money, narrow money, and broad money are forecasted to grow moderately over the medium term. Growth in private sector credit is projected to fall but at a slower space. Nevertheless, excess liquidity is projected to increase further with the anticipated negative growth forecast along with the expansionary fiscal policies over the medium term. Downside risks to this outlook include any unfavourable developments in the external sector and fiscal sectors.

4.5 Inflation

The headline inflation is estimated at 2.5% in December 2021, and is below the September MPS forecast of 3.0% as crude oil prices somehow eased in September and October than was forecasted. In the next six months, inflation is projected to rise to 3.0% in June 2022, and 3.2% end of 2022. Core inflation is projected to fall between 3% and 4% in 2022 on the back of supply-side constraints and international commodity price effect on core consumer items outweighing the weaker demand effect from the recession expected for the year.

On the global commodity prices, the World Bank Group forecasted rice and crude oil prices in 2022 to rise moderately compared to the surge seen in 2021. This is anticipated to drive up imported inflation.

In the domestic market, the flow-through impact of the Honiara Riot in November 2021 and the COVID-19 community outbreak in Honiara in January 2022 is expected to disrupt supply and hike in prices, especially for food items, in the first quarter of 2022. The forecast assumes that by the second quarter, prices would be relatively stable as health measures are assumed to be relaxed in balancing business activities and virus containment. The government price control and weaker economic growth in 2022 are anticipated to repress shortage induced price rise during the year.

Risks to this inflation outlook are twofold. First, the persistence in the size of supply disruptions is imperative to price hikes and may warrant higher price hikes than projected. Second, imported inflation is sensitive to world crude oil and food prices, therefore, any global shocks to the commodity prices may potentially increase prices beyond the inflation outlook.

5 Monetary Policy Stance

1. **Recommendation:**
   In light of the on-going high uncertainties around the pandemic evolution and projected recession for 2022 amid significant downside risks, CBSI has resolved to maintain an expansionary monetary stance to further support recovery during the recession. Furthermore, inflation is expected to be contained within a 3%-4% desired range. CBSI remain agile to take appropriate actions accordingly as the situation warrant.