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Solomon Islands: 2011 Article IV Consultation, Third Review Under the Standby Credit Facility, and Request for Arrangement Under the Standby Credit Facility—Staff Report; Staff Supplements; Public Information Notice and Press Releases; and Statement by the Executive Director for Solomon Islands

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2011 Article IV consultation with Solomon Islands and the third review under the Standby Credit Facility, and request for arrangement under the Standby Credit Facility, the following documents have been released and are included in this package:

- The staff report for the combined 2011 Article IV Consultation, third review under the Standby Credit Facility, and request for arrangement under the Standby Credit Facility, prepared by a staff team of the IMF, following discussions that ended on October 12, 2011, with the officials of Solomon Islands on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 8, 2011. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- Joint IMF/World Bank Debt Sustainability Analysis 2011
- A staff supplement of November 18, 2011 updating information on recent economic developments.
- A Public Information Notice (PIN) and Press Release, summarizing the views of the Executive Board as expressed during its November 23, 2011, discussion of the staff report on issues related to the Article IV consultation and the IMF arrangement, respectively.
- A Press release.
- Statement by the Executive Director for Solomon Islands

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Solomon Islands*
Memorandum of Economic and Financial Policies by the authorities of Solomon Islands*
Technical Memorandum of Understanding*
Selected Issues Paper

*Also included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

SOLOMON ISLANDS

Staff Report for the 2011 Article IV Consultation, Third Review Under the Standby Credit Facility, and Request for Arrangement Under the Standby Credit Facility

Prepared by the Asia and Pacific Department in Consultation with Other Departments

Approved by Hoe Ee Khor and Dominique Desruelle

November 8, 2011

Key Issues

Context and outlook. Solomon Islands' economy has rebounded from the 2008–09 global financial crisis. An 18-month Standby Credit Facility (SCF) was approved in June 2010 and succeeded in restoring macroeconomic and financial stability. A strong commodity-based recovery is underway led by demand for logging from emerging Asia, particularly in China. Reserve buffers have been rebuilt. However, progress toward reducing poverty has been limited. Growth remains concentrated in the commodity sector with limited spill-over to the rest of the economy. The near-term prospects remain favorable, but downside near-term risks have increased with the uncertainty in the global outlook.

Focus. The mission focused on the policy mix that could help the country strengthen its resilience to external shocks by building policy buffers and achieve sustainable and inclusive growth.

Medium-term agenda. In the medium term, economic prospects are contingent on the implementation of a critical mass of structural reforms:

- A new resource taxation regime is key to reap the benefits from natural resource wealth and ensure that the government receives a fair share of mining revenue. Reforms of mining legislation should be a key part of a broader set of measures to improve the investment climate and the regulatory framework.
- The quality of public spending on education, health and infrastructure also needs to be strengthened to lift long-term growth potential.

Program discussions. The authorities are requesting a precautionary SCF arrangement. The precautionary SCF arrangement would build on the SCF-supported program that expires in early December 2011 and should be instrumental in anchoring the policy agenda going forward.

Data provision has some shortcoming, but is broadly adequate for surveillance. Significant progress has been made in the timeliness of core macroeconomic data since the 2009 Article IV.

Team. Discussions took place in Honiara during September 29–October 12. The team comprised Ms. Tumbarello (head), Messrs. Feridhanusetyawan and Peiris, and Ms. Lin (all APD). Mr. Khor (APD) and Ms. Hunter (OED) joined the policy meetings. Mr. Bulman (World Bank) joined the Article IV discussions. The mission met with Deputy Prime Minister Manasseh Maelanga, Minister of Finance Gordon Darcy Lilo, Minister of Development Planning and Aid Coordination Snyder Rini, Minister of Public Service Rick Houenipwela, Governor of the Central Bank Denton Rarawa, other senior officials, financial institutions, private sector representatives, and development partners.

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Annex

Appendix

I. The Setting

1. **Solomon Islands is a small open economy vulnerable to external demand shocks and terms of trade volatility**. The country's main exports are timber and, more recently, gold. Tourism accounts for less than 2 percent of GDP. The mineral sector has the potential to become one of the main drivers of growth, if the appropriate policies are implemented as logging stocks are expected to be exhausted later in this decade. Food and fuel account for about 40 percent of total imports. Overall, the trade and production structures make the economy extremely vulnerable to swings in commodity prices. The country relies heavily on foreign aid to finance its external and internal imbalances.

2. **While the economy has rebounded from the global crisis thanks to strong political commitments to sound macroeconomic management, current gains from high growth rates will prove transitory if progress in structural reform lags**. Bolstering resilience to shocks and adopting a more inclusive-growth model remain top priorities. One key challenge is to ensure that the forthcoming mineral wealth spills over to the rest of the economy; another is to create jobs in the non-mineral sector. Addressing these challenges will speed up progress toward achieving the Millennium Development Goals (MDGs) targets, which are currently lagging behind.

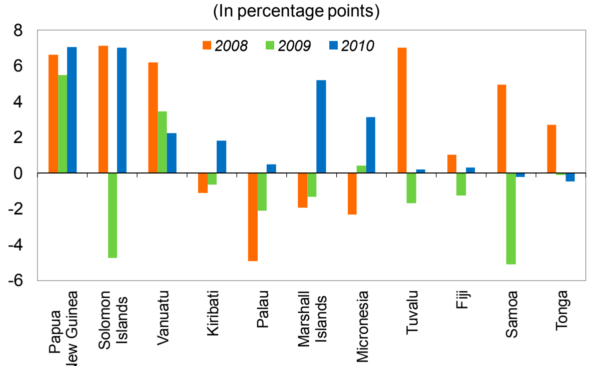
3. **Against this background, the 2011 Article IV discussions tackled both near- and longer-term policy issues**. A special focus was on the policy mix that could help the country strengthen its resilience to external shocks by building policy buffers and achieve sustainable and inclusive growth. In the medium term, economic prospects are contingent on the implementation of a critical mass of structural reforms. A new resource taxation regime is key to reap the benefits from natural resource wealth and ensure that the government receives a fair share of mining revenue. Reforms of the mining legislations should be a key part of a broader set of measures to improve the investment climate and the regulatory framework to attract foreign investment. The quality of public spending on education, health and infrastructure also needs to be strengthened to lift long-term growth potential. The authorities are requesting a precautionary Standby Credit Facility (SCF) arrangement. The precautionary SCF arrangement would build on the SCF-supported program that expires in early December 2011 and should be instrumental in anchoring the policy agenda going forward. Given the strong balance of payment position, no disbursement is envisaged under the baseline scenario. However, downside risks to the outlook have increased.

II. Recent Developments and Outlook

From Crisis to Recovery

4. **Solomon Islands' economy has rebounded strongly from the 2008–09 global financial crisis.** Growth contracted by nearly 5 percent in 2009 driven by a drop in commodity exports, mainly logging. International reserves were depleted. By early 2010, the government had run out of cash and accumulated large domestic arrears.

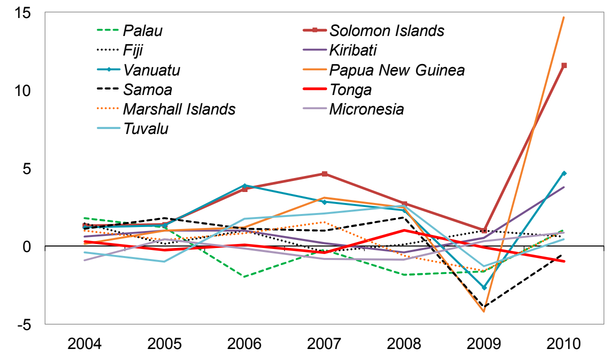
Pacific Island Countries: Real GDP Growth
(In percentage points)



Sources: Country authorities; and IMF staff estimates.

An 18-month SCF arrangement was approved in June 2010. The program succeeded in restoring macroeconomic and financial stability, catalyzing donor support, and promoting structural reforms. Strong demand for logging from emerging Asia, particularly in China, and favorable terms of trade triggered an unexpected surge in logging production in 2010 and growth rebounded to 7 percent. Like Papua New Guinea which has benefitted from high global commodity prices, the relative growth performance of Solomon Islands has improved over the last two years compared to the other Pacific island countries.

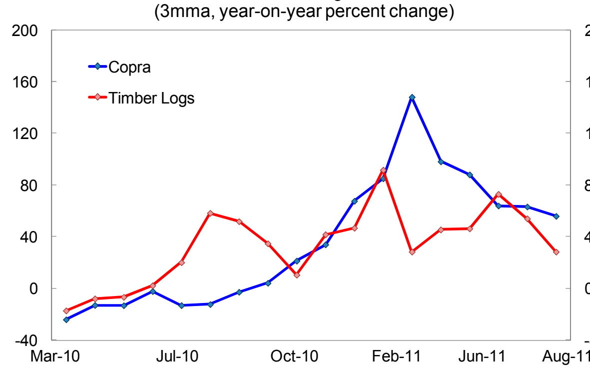
Pacific Island Countries: Relative Growth Performance
(Real GDP growth relative to regional median, in percent)



Source: IMF staff estimates.

5. **A strong commodity-based recovery is underway**. Log production surprised on the upside and jumped by 40 percent year-on-year (y/y) in the first eight months of 2011, close to a historical high. This reflected investments of new logging companies, re-entry logging (the harvesting of native stands in areas previously logged and where trees have not re-grown fully), and strong log prices following the earthquake and tsunami in Japan in March, which triggered a surge in demand for logs to build temporary housing. Production of copra has also increased by 80 percent (y/y) during January-August 2011. The redeveloped Gold Ridge mine which started its operations in April 2011 has also supported the current expansion. Leading indicators of annual GDP growth suggest that activity will be exceptionally high in 2011 with growth reaching over 9 percent. Anecdotal evidence indicates that private sector activity in the retail and construction sectors has picked up, as the recovery gained traction, but credit growth has remained sluggish as these activities, in particular retail, appear to be self-financed and mining investment is financed offshore.

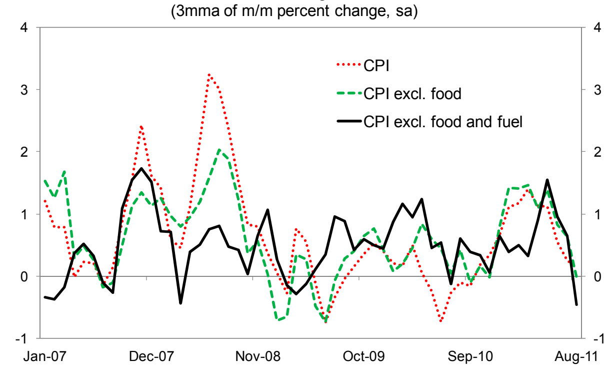
Solomon Islands: Production by Major Commodities
Mar. 2010 - Aug. 2011
(3mma, year-on-year percent change)



Sources: Country authorities ; and IMF staff estimates.

6. **Inflation pressures are dissipating.** After falling to 1 percent (y/y) in 2010, inflation increased to 8.7 percent (y/y) in August 2011 reflecting base effects and the pass-through of global energy and food prices. However, the latest reading of month-on-month (m/m) data through August suggests a sustained downward momentum. Both headline and core inflation (excluding food and fuel) are edging down helped by the revaluation of the domestic currency in June and the decline in fuel prices

Solomon Islands: CPI Inflation
Jan. 2007–Aug. 2011
(3mma of m/m percent change, sa)

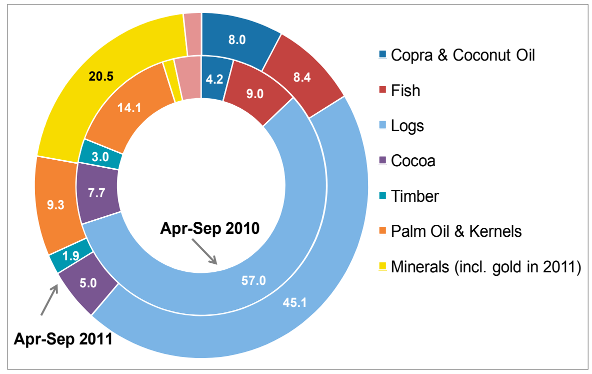


Sources: Country authorities; and IMF staff estimates.

since mid-year, with headline inflation reaching almost a negative territory on an m/m basis.

7. **Reserve buffers have been rebuilt and Solomon Islands' external position continues to be strong.** The trade balance shifted from deficit to surplus during April–September 2011 for the first time since 2004, driven by exceptionally strong gold exports and logging. As a result, the balance of payment position improved, supported by large FDI and aid flows. Gross international reserves increased to US$355 million (6 months imports) in June 2011 from less than US$100 million in mid-2009 (Figure 1, Tables 1 and 2).

Solomon Islands: Exports of Goods
(In percent of total exports)



Sources: Country authorities; and IMF staff estimates.

Solomon Islands: Millennium Development Goals (MDGs) Progress

MDG 1. Eradicate extreme poverty and hunger. Halve between 1990 and 2015 the proportion of people whose income is less than $1 per day.	Mixed
MDG 2. Achieve Universal Primary Education.	Mixed
MDG 3. Promote gender equality and empowerment Eliminate gender disparities in primary and secondary education.	Off track
MDG 4. Reduce child (Under 5) mortality by two thirds	Off track
MDG 5. Improve maternal health Reduce maternal mortality by three quarters.	Off track
MDG 6. Reverse the spread of HIV/AIDS, malaria and TB	Mixed
MDG 7. Ensure environmental sustainability Integrate principles of sustainable development into country policies.	Off track

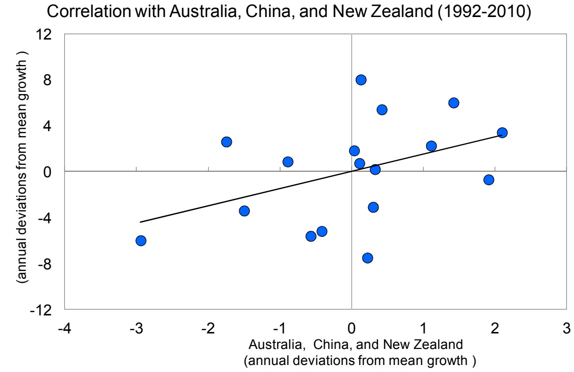
Source: 2011 Pacific Regional MDG Tracking Report, Pacific Islands Forum Secretariat.

8. **However, progress toward reducing poverty has been limited.** Despite strong growth, the recovery is uneven and growth remains concentrated in the commodity sector with limited spill-over to the rest of the economy. The spike in food and fuel prices in 2008 has undermined past gains in poverty reduction. As a result, most of the MDGs are unlikely to be met by 2015.[1]

Outlook, Spillovers and Risks

9. **Under the baseline scenario Solomon Islands' near-term economic prospects remain favorable.** Real GDP growth is projected at 6 percent in 2012 with gold production (from the Gold Ridge mine) taking over from logging as a main driver of growth. The still positive outlook for fast-growing emerging Asia, especially China, will continue to support activity. Inflation is likely to decrease to around 5¼ percent down from 7 percent in 2011, as commodity prices stabilize. The balance of payment position would also remain strong with gross international reserves projected at 6½ months of imports at end-2011 and 2012. Under the baseline scenario, staff does not envisage any disbursement under the proposed precautionary SCF arrangement.

Solomon Islands: Real GDP Growth
Correlation with Australia, China, and New Zealand (1992-2010)



Sources: Country authorities; and IMF staff calculations.

10. **The still favorable outlook for Australia, New Zealand and China should have positive spillovers on Solomon Islands**. China accounts

[1] The incidence of poverty is high in Solomon Islands. The latest analysis on poverty based on the 2005-06 household income and expenditure data suggest that almost 25 percent of the population is below (the basic need) poverty line.

for 50 percent of Solomon Islands' total exports, and Australia and New Zealand are the largest providers of aid. Staff analysis suggests a positive correlation between growth in Australia, New Zealand and China, and Solomon Islands over the last twenty years. In addition, the planned increase in Australia's and New Zealand's bilateral official development assistance over the next few years should continue to support growth. Strong linkages with Papua New Guinea—a booming economy—through financial channels and labor market mobility should also benefit Solomon Islands' growth prospects.

11. **However, the near-term risks to the baseline scenario are tilted to the downside, given the deterioration of the external outlook.** On the downside, a key near-term risk is that global recovery stalls because of the current global turmoil in Europe or Asian growth falters, lowering commodity prices and thus exports of logs and gold—Solomon Islands' key commodity exports. On the domestic front, the fluid political coalition could slow down the implementation of structural reforms affecting negatively the outlook. On the upside, activity in the logging and mining sectors could be larger than expected should Asian economies remain resilient to the current global turmoil.

12. **Downward scenario.** If near-term external downside risks were to materialize, contagion would occur through a sharp contraction in FDI and demand for commodities from Asia, and a deterioration of the terms of trade. Staff estimates suggest that a 20 percent decline in gold and log prices in 2012–13 compared to the baseline, a sharp drop in logging exports, and delays in gold production would lower GDP growth by around 4 percentage points and double the size of the current account deficit in 2012. Under this downward scenario, one would envisage a disbursement under the proposed SCF arrangement of US$8.2 million in order to maintain international reserves on average at 4 months of imports of goods and non-factor services during 2012–13.

Solomon Islands: Baseline and Downside Scenarios

	2011		2012		2013	
	Baseline	Downside 1/	Baseline	Downside 1/	Baseline	Downside 1/
Real GDP growth (in percent)	9.3	8.8	6.0	2.0	4.0	3.2
Current account balance (in percent of GDP)	-11.6	-14.0	-12.7	-26.9	-15.6	-28.1
Logs export (in percent of GDP)	22.3	22.2	13.7	4.5	9.7	2.8
Gold export (in percent of GDP)	10.8	8.9	19.3	13.0	20.6	15.4
Financing (in millions of U.S. dollars)	-88.8	-85.8	-25.0	122.0	10.4	47.2
Change in gross reserves (- = increase)	-98.7	-98.5	-24.9	116.6	10.5	47.3
IMF 2/	10.0	12.7	-0.1	5.4	-0.1	-0.1
Gross official foreign reserves (in millions of U.S. dollars)	364.6	364.3	389.5	247.7	379.0	200.4
In months of next year's imports of GNFS	6.5	6.9	6.4	4.4	5.8	3.4
Overall fiscal balance (in percent of GDP)	3.6	3.4	1.3	0.1	0.2	0.0

1/ Assumes a 20 percent decline in log and gold prices in 2011-13 compared to the baseline scenario, a 40 percent decline in log production in 2012 and 30 percent decline in 2013, and delays in gold production during 2012-13.
2/ The downside scenario reflects the disbursements under the successor Standby Credit Facility of 50 percent of quota in total (US$8.2 million).

13. **Over the medium term, achieving more inclusive growth would be critical for social cohesion and to ensure a sustainable growth path.** Over the medium term, growth will remain around 4 percent. This lower trajectory reflects the projected decline in logging production and a leveling off in contribution of gold activity. The outlook for the medium term depends on the scope and speed of the government's reform agenda. The upside risk to the medium-term growth outlook stems from stronger-than-anticipated activity in the mining sector (e.g., gold and nickel) if structural reforms are well implemented leading to an improvement of the business environment and more FDI. Nonetheless, mining is a more capital intensive activity than logging. In order for mining wealth to spill over to the rest of

the economy, the government will have to step up the implementation of structural reforms that promote private sector growth and broaden the economy's base, thereby creating employment opportunities in other sectors that are more labor intensive.

Authorities' Views

14. **The authorities broadly agreed with staff on the outlook and balance of risks**. They were concerned about the potential impact on Solomon Islands' economy of a significant disruption of global growth. They considered the downside risks to the outlook as mainly external and noted that there is no scope for complacency. However, they viewed the underlying growth momentum as still favorable, with inflation expected to moderate and reserves remaining at a healthy level. They shared staff's views that under the baseline scenario there would not be any disbursement under the precautionary SCF given their current strong balance of payment position.

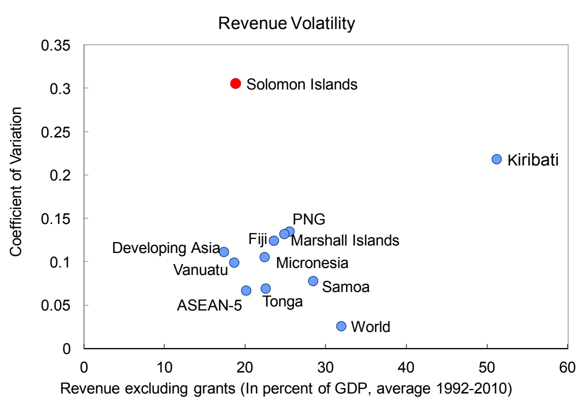
III. Enhancing Resilience to Shocks and Building Policy Buffers—The Near-Term Macroeconomic Policy Mix

15. **The pillars of the successor SCF-supported program include strengthening the fiscal framework, improving monetary operations, maintaining a strong foreign exchange position, and containing financial sector risks** (MEFP Section II). Preserving the strong external and fiscal positions and strengthening fiscal management remain top priorities. Increasing the capacity of the public sector including through coordination with the donor community is also important to deliver services and implement investment projects. To address medium-term challenges, the program also focuses on reforms to raise non-logging revenue, including from mineral resources, develop multiyear budgeting, and resume concessional borrowing. In addition, the program will also aim at preserving monetary stability, reforming the National Provident Fund, and improving access to finance for the private sector.

A. Fiscal Policy

Background

16. **The fiscal position has improved as a result of strong commodity revenues, financial support from donors and better fiscal management**. The revenue base is large, but volatile due to its dependency on commodity prices. Yet, the fiscal position has strengthened under the SCF-supported program and fiscal buffers have been rebuilt (Figure 2, Table 3). The government fiscal surplus reached over 6 percent of GDP in 2010 against 2½ percent of GDP targeted under the program. The cash balance increased from almost zero in the first quarter of 2010 to around SI$260 million at end of the year and reached more than SI$300 million in June 2011—equivalent to two months of recurrent spending. Public debt has declined from 60 percent of GDP in 2005 to less than 30 percent in 2010 (Table 4). The improvement in the fiscal position reflected stronger-than-anticipated revenue from logging as the recovery



Source: IMF staff estimates.

gained traction together with strong improvements in tax compliance and tax arrears collection. However, the non-commodity fiscal balance provides a more nuanced picture of the underlying fiscal position and shows a small deterioration in 2010. Recurrent spending was also kept under control despite some cost pressures from national elections and additional wage bills. Finally, the strong program implementation under the SCF catalyzed large disbursements of donor support, particularly from the EU, that contributed to the buildup in the fiscal cash balance. The authorities are expected to submit the 2011 supplemental budget and the 2012 budget to parliament in late November.

17. **Preliminary data for 2011 suggest that the fiscal position has strengthened further in recent months thanks to stronger-than-anticipated logging revenues and buoyant non-logging revenues.** The increase in taxes on goods and services reflects a further strengthening in tax collections and stronger consumer confidence, consistent with the ongoing recovery. Strong revenue performance up to August suggests that the program targets for the rest of the year could be achieved comfortably even if the authorities pass a 2011 supplementary budget of up to 1 percent of GDP later this year.

Staff's Views

18. **In discussing the forthcoming 2012 budget, the mission stressed that the key challenge is to build policy buffers in a way that reinforces efforts to implement growth-enhancing and poverty-reducing reforms.** In particular, it raised the following points:

- *Preserving the cash balance.* To anchor fiscal plans in the near term, the authorities should maintain the cash balance at no less than two months of recurrent spending in 2011 and 2012.

- *Strengthening domestic revenues.* This can be achieved by rationalizing tax structures. The mission urged the authorities to continue applying the full market price for log exports with an automatic quarterly adjustment. In light of the expected decline in logging revenue starting in 2012, the ongoing efforts to raise revenues by strengthening tax administration and customs, and broadening the tax base should be stepped up.

- *Boosting priority spending.* As the recovery proceeds, the authorities should strike a balance between preserving strong fiscal buffers and increasing spending on critical infrastructure and social priorities, such as health and education. While stronger-than-anticipated revenues compared to the budget should be partly saved to maintain the fiscal buffers at a comfortable level to deal with future shocks, a scaling up of critical infrastructure investment and social priority expenditure would be important to make meaningful progress toward the attainment of the MGDs and achieving inclusive growth.[2] However, the pace of spending will need to be calibrated, taking into account capacity constraints. The authorities should continue to limit the growth of nonessential recurrent

[2] The authorities are still working toward reconciling the data on spending on health and education. An indicative floor on this priority spending will be set during the first program review once the tracking mechanism is in place.

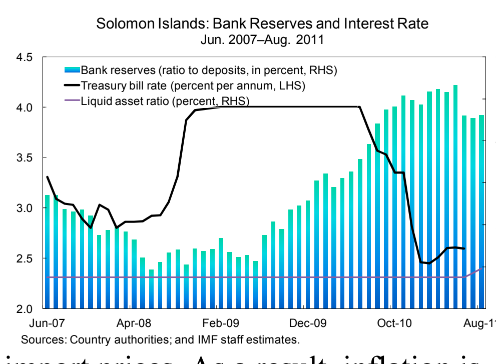
spending in order to create the necessary fiscal space for critical development spending. In particular large wage/benefits increases and transfers to local constituencies should be resisted. The mission stressed the importance of strengthening the management and transparency of government-funded development budget, including the National Transport Fund (NTF), and saving unspent budgetary resources to contribute to the NTF.

Authorities' Views and Plans

19. **The authorities' views and plans are outlined in the MEFP** (¶6). The authorities reiterated their commitment to strengthening the fiscal position and to maintaining the government cash balance at no less than two months of recurrent spending. They indicated that the over-performance of the cash balance carried over from 2010–11, the buoyancy of tax collection, and windfall mining revenue could create additional fiscal space in 2012. While they stressed the need to increase spending on infrastructure, health and education to lift potential growth and spread the benefits more widely, they added that the low absorptive capacity may constrain the pace of spending. Yet they are committed to keeping spending on health and education at no less than 32 percent of the government-funded recurrent budget and to increasing infrastructure spending by doubling the contribution to the NTF. The authorities indicated they are currently working on the reconciliation of data on health and education spending, including spending financed by donor budget support. Progress has been made in improving the timely reporting of priority spending by the Ministry of Health and Ministry of Education. In light of the limited absorptive capacity, they indicated their intention to use any additional fiscal surplus arising from buoyant revenues to retire domestic and/or external debt, if positive revenue surprises materialize. To improve the quality of spending and strengthen public financial management, the authorities will revise budget presentation from input line items to functional/output items. They will also seek assistance from development partners to strengthen procurement and internal audit processes to reduce leakages that affect public service delivery.

B. Monetary and Exchange Rate Policies

Background



20. **Monetary conditions have remained accommodative over the past two years, but the authorities have appropriately started to mop up excess liquidity.** The improved balance of payment position, supported by strong terms of trade, allowed the Central Bank of Solomon Islands (CBSI) to let the currency appreciate by 7 percent against the U.S. dollar from March 2011 to August 2011 to help curb inflation pressures stemming from rising fuel and food import prices. As a result, inflation is on a downward trend. However, the rapid increase in international reserves led to a large accumulation of banks' excess reserves in 2010–11 because of a limited sterilization capacity. Early this year the central bank resumed auctioning its short-term paper (28-day Bokolo bills) following the introduction of new auction guidelines. As a result, excess liquidity has stabilized, albeit at a very high level, while interest rates have remained low. If a

downside scenario were to materialize, the authorities have space to slow down monetary tightening.

21. **Yet there are no signs of a pickup in private credit** (Table 5). Private sector credit growth has remained negative reflecting delays in the execution of donor-funded projects, the still nascent recovery in private investment, and a tightening in banks' lending standards.

Staff's Views

22. **The monetary and exchange rate policies over the past few months have helped anchor inflation expectations and are appropriate**. Staff analysis showed that while the monetary transmission mechanism is currently weak partly because of the excess liquidity in the system, the pass-through of exchange rate changes to headline inflation has been rapid and nearly complete. Thus, the recent nominal exchange rate appreciation has helped contain imported inflation and was on the mark.[3] Given the uncertainty surrounding the global outlook, subdued credit growth and the benign outlook for inflation, the current setting remains appropriate.

23. **However, if the recovery remains on track and inflation pressures start to re-emerge, monetary tightening would be warranted**. The CBSI should stand ready to tighten its policy by raising the reserve requirement and scaling up open market operations should the large overhang in excess reserves in the banking system lead to rapid credit growth or demand-led inflationary pressures. The exchange rate should continue to be managed in a flexible manner in order to provide a buffer against external shocks. Should the government decide to retire domestic debt, close coordination between the Central Bank and the Ministry of Finance would be critical to ensure that the injection of liquidity into the private sector does not lead to excessive credit growth. To increase the effectiveness of monetary policy, the amendments to the CBSI Act would be critical because they would strengthen its operational autonomy and transparency, including by improving its communication with the public.

Authorities' Views

24. **The Governor of the CBSI emphasized that monetary and exchange rate policies will continue to be geared toward maintaining price and external stability** (MEFP ¶8). The Central Bank will monitor credit developments closely and tighten monetary policy should the banks start to expand credit aggressively. Excess liquidity will continue to be mopped up using Bokolo bills while the cash reserve requirement will be used in the unlikely event of a credit boom. The Governor indicated that the exchange rate will be managed using a pragmatic approach and adjusted as needed. He also noted that while the CBSI's decision to let domestic currency appreciate in June has helped reduce inflationary pressures, the benefits of lower import prices have not been fully passed through to domestic consumers by traders who have increased their margins. Yet, the objective of reducing average inflation to

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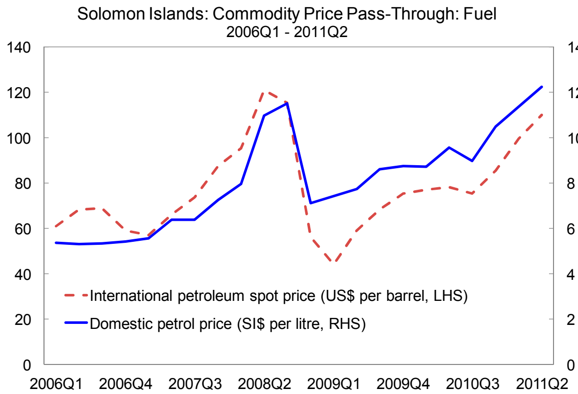
[3] See Selected Issues paper by S. Peiris, "Inflation Dynamics and Monetary Transmission Mechanism in Solomon Islands" and Box 1.

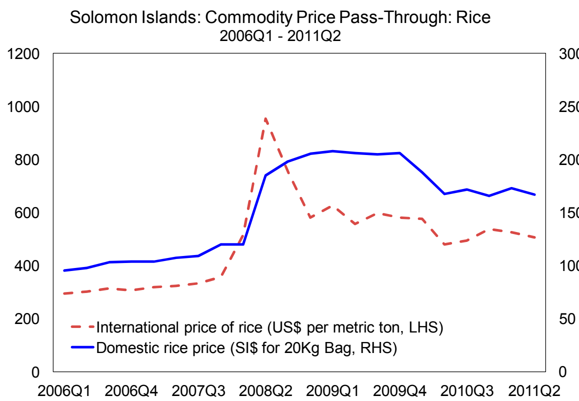
Box 1. Global Commodity Prices, Exchange Rate Pass-through and the Monetary Transmission Mechanism[1]

Inflation dynamics in Solomon Islands is highly dependent on global commodity prices as confirmed by graphic analysis. Food accounts for 43 percent of the consumer price index (CPI), nearly half of which is imported. An increase in international fuel prices historically has resulted in an equal increase in domestic prices, with a few months lag. Over the last decade, food and fuel imports represented, on average, 40 percent of total imports.



Sources: Country authorities; and IMF staff estimates.

Staff's econometric analysis suggests that the exchange rate could be a useful tool to control imported inflation and absorb external shocks. A more flexible use of the exchange rate would also provide greater scope for monetary policy to be focused on domestic price stability.



Sources: Country authorities; and IMF staff estimates.

- **The exchange rate pass-through to the imported component of the CPI is nearly complete within a year** (i.e., a-one percent depreciation in the exchange rate raises the imported component of consumer prices by 0.98 percent within 10 months). Econometric tests suggest that the exchange rate determines the imported component of the CPI; and, in turn, the import price index determines the domestic consumer price index and not vice-versa.

- **The analysis of the transmission of external and monetary shocks to inflation suggests that the monetary transmission mechanism is currently weak**. External shocks, particularly global fuel prices, explain a large share of the variation in headline inflation, both directly and indirectly through second-round effects. The impact of monetary shocks on headline inflation is weak regardless of the monetary variable considered (broad money, reserve money, interest rates, or domestic credit), probably reflecting the excess liquidity in the banking system and structural impediments to access to credit due to difficulties in using land as collateral. The strong influence of the imported component of CPI on headline inflation and the weak monetary transmission mechanism suggest a greater role for the exchange rate in affecting inflation than monetary policy.

[1] Prepared by Shanaka J. Peiris.

around 6 percent in 2011 is broadly on track. The CBSI officials reported that sluggish credit growth reflects not only the absence of bankable projects but also on the high lending rates and tightening of lending standards. The recent decision of commercial banks to lower the lending rate by 2 percentage points could help stimulate private credit growth, but officials agreed with staff that a credit boom is unlikely. CBSI officials also indicated that should the government decide to prepay debt, they would prefer the retirement of external debt because it would help reduce liquidity in the banking system.

IV. POLICIES FOR SUSTAINABLE AND INCLUSIVE GROWTH

Background

25. ***Medium-term policy challenges.*** One key issue Solomon Islands faces over the medium term is to ensure that the forthcoming mineral wealth spills over to the rest of the economy. This will entail two main policy challenges: first, how to manage the potentially large mineral revenues from the mining sector and secure resources to finance its economic development going forward, without jeopardizing debt sustainability; and, second, how to foster private sector development. Investors' growing interest and investment in the resource sector—especially mining—is expected to underpin the medium-term growth prospects for Solomon Islands. Sound management of the expected mineral revenues could potentially provide the resources for financing development, thereby creating jobs, raising household incomes and reducing poverty. But it brings with it challenges to which polices will need to respond. Development grants will gradually decline (in terms of GDP) over the medium term as the Regional Assistance Mission to Solomon Islands (RAMSI), which started in 2003, will scale down its operations beginning in 2013.

26. ***Authorities' medium-term policy agenda.*** The authorities have formulated an update of the Medium-term Fiscal Strategy for 2010–15 in August 2010.[4] The strategy does not only cover fiscal and tax reform issues but it also contains a blueprint for structural reforms to support private sector development. In addition, the authorities have launched a comprehensive National Development Strategy (NDS) on structural reforms in September 2011. The overarching theme of the NDS is to build better lives for all Solomon Islanders by focusing on poverty alleviation and achievement of the MDGs, providing access to quality health care and education (Box 2). In addition, the authorities have also developed a strategy together with the donor community under the Core Economic Working Group (CEWG)—a government donors partnership. The CEWG reform program is based on three pillars: public financial management, budget reform, and economic growth. The medium-term growth strategy outlined in the MEFP aims at maintaining macroeconomic stability and reducing the costs of doing business by improving the business climate and land tenure-security. On strengthening the fiscal framework, the authorities' new plans include developing a multi-year budget framework next year, in time for the 2013 budget.

[4] www.mof.gov.sb/.../Medium_Term_Fiscal_Strategy_2010-2015.sflb.ashx.

Box 2. Solomon Islands: National Development Strategy (NDS) 2011–21[1]

In September 2011, the government launched the NDS with an overarching objective of alleviating poverty and helping the attainment of the MDGs.

The NDS has eight development objectives:

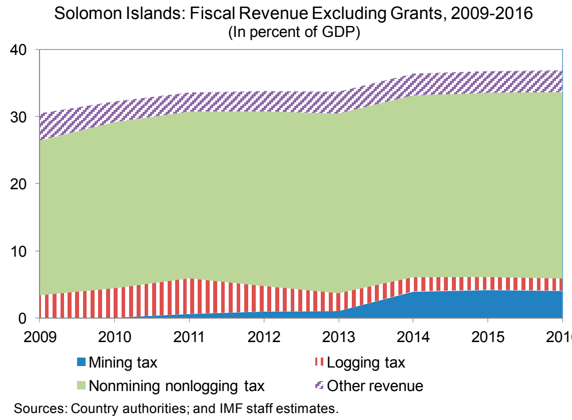
1. *Alleviating poverty*: Develop and implement programs to alleviate poverty; improve equity in social service provision; manage the rate of population growth; and promote and foster national unity and sustainable peace.
2. *Supporting the vulnerable group*: Establish a social security system; support people with disability; provide food security; protect and develop the interests and rights of children; promote the development of youth; and improve gender equality and opportunities for women.
3. *Ensuring access to quality health care*: Provide quality health service, including by ensuring adequate supply of medicine; building and maintaining health infrastructure; and promoting healthy diets.
4. *Ensuring access to quality education*: Promote effective implementation of the National Education Action Plan and the Education Sector Framework; prepare and implement education infrastructure development plan; and ensure that the education and training systems develop skills required for the labor market.
5. *Increasing economic growth and equitably distributing employment*: support private sector led growth; increase opportunities for trade; increase opportunities for employment; develop economic growth centers; and promote sustainable use of natural resources.
6. *Developing physical infrastructure and utilities*: Improve water supply and sanitation; ensure availability and efficient use of energy; develop efficient and cost effective communication services; develop air services and infrastructures; rehabilitate road infrastructure; and improve local transport services.
7. *Responding to climate change and managing the environment:* Mainstream climate change into national development planning; promote a holistic and sustainable approach to natural resources management; and develop measures to manage and reduce natural disaster risks.
8. *Improving governance and law and order*: Improve standards of governance and service delivery by public servants; increase effectiveness, reliability, and efficiency of electoral processes; strengthen the provincial government; promote a safe, secure, and stable living environment; strengthen the capacity of legal system; and improve border security.

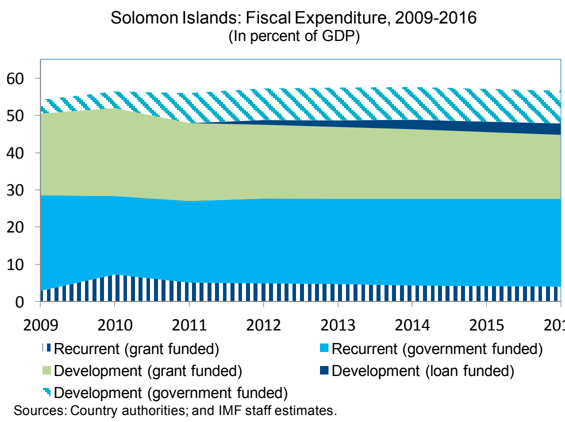
[1] Prepared by Tubagus Feridhanusetyawan.

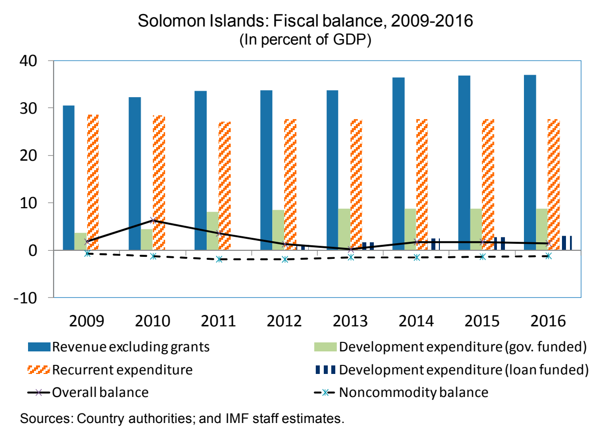
A. Managing the Mineral Wealth Over the Medium Term—Fiscal Policy and Tax Reform

Staff's Views

27. **Prudent management of natural resources is critical to replace revenue from logging.** The mission suggested the following policy measures:







- *Implementing the resource tax regime legislation would help sustain fiscal revenue*. Tax reform can play a key role in allowing Solomon Islands to take full advantage of the strong prospects in the mining sector. The authorities should finalize the amendments to tax legislation and implement the new resource taxation regime in line with FAD recommendations. As a critical first step, the authorities should enforce the Gold Ridge mining agreement to ensure that revenues from gold, particularly corporate and additional profits taxes are collected effectively. Mining revenue (from the Gold Ridge mine) is expected to remain modest at 1 percent of GDP during 2011–12. Under the current WEO commodity assumptions, staff estimates that mining revenue could amount to around 4 percent of GDP in the medium term, replacing revenue from the declining logging industry. Staff's sensitivity analysis suggests that if gold prices were to decline by 25 percent from the current WEO price baseline, mining revenue would still amount to 2–3 percent of GDP.[5]

- *Strengthening the medium-term fiscal framework by adopting fiscal responsibility provisions would help maintain fiscal sustainability*. The mission praised the authorities for reforming the Public Finance Act to incorporate fiscal responsibility provisions that include commitments to developing medium-term budget strategy, maintaining appropriate level of cash balance, management and use of public funds, and

[5] See Selected Issues paper by T. Feridhanusetyawan, "Managing Mineral Resources in Solomon Islands."

promoting budget transparency and accountability. Staff urged the authorities to adopt these provisions by end-2012.

- *Developing a multi-year budget framework would also provide more fiscal discipline*. Realistic fiscal plans in line with the objectives of the NDS would be more easily designed and fiscal sustainability safeguarded.

- *Targeting the non-commodity fiscal balance as opposed to the cash balance starting in 2014 would help anchor fiscal plans over the medium term, as mining taxes become a large source of government revenue.* This rule would help moderate pro-cyclical fiscal policies driven by volatile revenues and support the economy during downturns. It would also ensure a more sustainable use of exhaustible resources.

- *Resuming concessional borrowing after completing the Honiara Club Agreement review would be key to tap resources to finance development needs going forward.* The improved fiscal position and the favorable revenue prospects provide scope for resuming concessional borrowing. Public debt has declined from about 60 percent of GDP in 2005 to below 30 percent at end-2010 under the framework of the Honiara Club Agreement (HCA) which allows the country to receive only grants, not loans. The authorities are currently developing a new debt strategy and reviewing the HCA framework to facilitate access to external borrowing on concessional terms. Preliminary Debt Sustainability Analysis (DSA) results indicate that Solomon Islands will remain at a moderate risk of debt distress, even after transitioning to concessional borrowing.

Authorities' Views

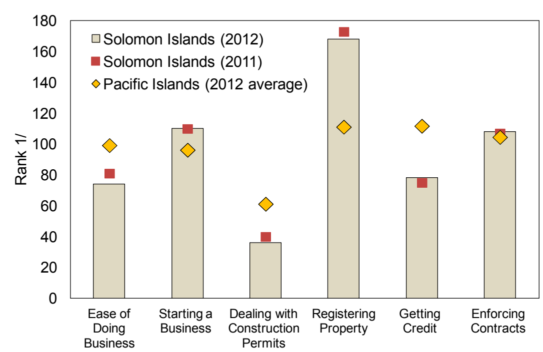
28. **The authorities agreed that strengthening the management of natural resources is key over the medium-term** (MEFP ¶7). They also indicated that the new plan of developing a multi-year budget framework should also help from a political economy point of view, particularly in containing spending pressures in the near term. The multi-year budget framework will help build consensus on the appropriate sequencing of development projects and calibrate better the pace of development spending taking into account capacity constraints.

B. Structural Reforms to Support Private Sector Growth

Background

29. **The business environment has improved in recent years, but private sector continues to face several barriers.** According to the 2012 World Bank's *Doing Business Report*, Solomon Islands ranks better than most Pacific island countries on the overall ease of doing business index, having climbed seven places since last year to rank 74th. However, procedures for starting a business and registering property are more cumbersome than in other Pacific islands.

Pacific Island Countries: Business Climate Indicators



Source: World Bank Doing Business (2012 Doing Business Report).
1/ Higher rank indicates more costly.

30. **The authorities have implemented several reforms since the 2009 Article IV consultation.** The government made starting a business easier by implementing an online registration, it made registering property faster by separating the land registry from the business and movable property registries, and it strengthened investor protections by increasing shareholder access to corporate information and adopted a new law that simplified insolvency proceedings.

31. **The momentum for state-owned-enterprise (SOE) reforms seems finally to have gained traction.** In 2007, Parliament passed the SOE Act which was promulgated in 2009. Since then, the authorities have liberalized the telecommunication system and the rice sector by terminating the government monopolies. As a result the calling costs have been reduced by 50 percent, and the price of rice has declined too. The authorities also plan to resolve the cross arrears between water and electricity companies to improve service delivery.

Staff's Views

32. **The authorities' ongoing efforts to support private sector development have proved to be effective and should continue.** Achieving sustainable, inclusive and broad-based growth will require further implementation of structural reforms. These include: (i) reforming mining legislations to develop a stable and transparent regulatory regime to attract foreign investment; (ii) instituting a "one-stop shop" to ease procedures for opening a business; (iii) streamlining land title registration and transfer of ownership to ease access to credit, improving collateral recovery and supporting private sector investment; and, (iv) and exploring options for small business financial schemes (Section VI).

33. **The SOE reforms underway with the assistance of the Asian Development Bank (AsDB) and the World Bank are critical.** Urgent reforms are still needed in public utilities, such as water and electricity. Reforming the SOEs would also reduce the drain on the budget and the contingent liabilities, and create more space for social spending.

34. **The NDS is an important step toward a comprehensive poverty reduction and growth strategy over the next ten years**. Going forward, the strategy could benefit from an appropriate sequencing of policy actions; it should also include costing and prioritization of projects, and articulate the linkages between spending, growth and poverty reduction. It is also critical to incorporate an underlying macroeconomic framework with the assistance of development partners and to provide prudent financing mix to ensure long-term debt sustainability.

Authorities' Views

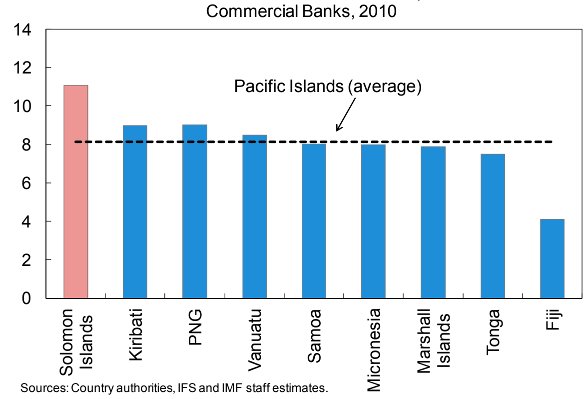
35. **The authorities agreed that a shift to a more inclusive growth model hinges on a vibrant private sector, as reported in the medium term fiscal strategy and on the NDS with a special focus on mining, agriculture, tourism, and fishing** (MEFP ¶7, 12, 13). With regard to mining, they noted that the reform of mining legislation and participating with the Extractive Industry Transparency Initiative (EITI) should foster the development of the private sector. On SOE reforms, they agreed to resolve cross arrears between the water and the electricity companies and undertake tariff reform for water charges. They also stressed that one impediment to private sector growth is the country's vulnerability to climate change,

in particular the absence of climate change-proof infrastructure, and the impact of income on rural areas. The authorities are planning on developing an adaptation and migration strategy with the help of development partners to mitigate the adverse impact on the most vulnerable.

V. SAFEGUARDING FINANCIAL SECTOR STABILITY

Background

Pacific Island Countries: Interest Rate Spreads of Commercial Banks, 2010



Sources: Country authorities, IFS and IMF staff estimates.

36. **Solomon Islands' financial sector has a simple structure but it has structural impediments that limit access to credit by small business and households.** It consists of three major foreign commercial banks (ANZ, Westpac and Bank of South Pacific), a non-bank financial institution (Credit Corporation Solomon Islands Limited) and a saving and retirement fund—the National Provident Fund (NPF), a systematically important financial institution with a large share of its assets held as deposits in the banking system (Box 3). On-site examinations on the NPF conducted by Australian Prudential Regulatory Authority (APRA) suggest that weaknesses remain in the governance and financial performance of the NPF. Access to finance by the private sector is expensive and constrained by customary land practices which limit the use of land as collateral, especially in rural areas. Lack of financial reporting and the single borrower limit also constrain access to credit. Banks have complained that commercially viable projects are few while the size of their loans is constrained by the single borrower limit, which explains why credit growth has been sluggish. The interest rate spread is above the Pacific island average, although in October commercial banks reduced lending rates by 2 percentage points. The private sector has regularly complained about high banking charges and fees.

37. **The authorities have tried to bolster financial intermediation.** The CBSI had established a small business finance scheme a few years ago that provides a partial risk guarantee to banks that lend to small private sector businesses. More recently, Credit Corporation has been recently active in expanding credit to small and medium enterprises (SMEs) and using the Secured Transactions Act of 2008. However, the scale of these operations remains small. Mobile banking is likely to be introduced in 2012 using cellular phones. This financial innovation may compensate for the closing of a few bank branches for lack of economic viability.

Staff's Views

Solomon Islands: Core Financial Soundness Indicators 1/

	2008	2009	2010 /2				2011	
			Mar.	Jun.	Sep.	Dec.	Mar.	Jun.
Capital adequacy:								
Regulated capital to risk-weighted assets	22.6	22.0	17.1	13.9	19.3	23.5	19.8	21.1
Nonperforming loans, net of provisions to capital	6.6	8.5	15.7	12.5	13.1	14.4	11.4	8.6
Asset quality:								
Nonperforming loans to total gross loans 2/	2.7	3.8	7.0	6.1	7.6	8.3	7.2	6.1
Earnings and profitability:								
Return on average assets	6.7	6.0	5.4	5.2	4.8	4.9	2.9	6.6
Return on average equity	43.0	34.4	33.2	31.1	28.1	28.5	15.9	36.1
Net interest income to gross income	50.2	52.6	48.3	48.1	47.7	43.9	47.8	46.5
Noninterest expenses to gross income	34.3	37.5	39.8	40.0	41.9	42.0	52.3	49.7
Liquidity:								
Liquid assets to total assets (liquid asset ratio)	20.7	33.5	37.8	41.0	47.8	47.8	51.8	54.4
Liquid assets to short-term liabilities	38.3	67.4	57.7	61.9	74.4	72.8	79.4	82.3

Source: Central Bank of Solomon Islands.

1/ Commercial banks only, as of end-period.

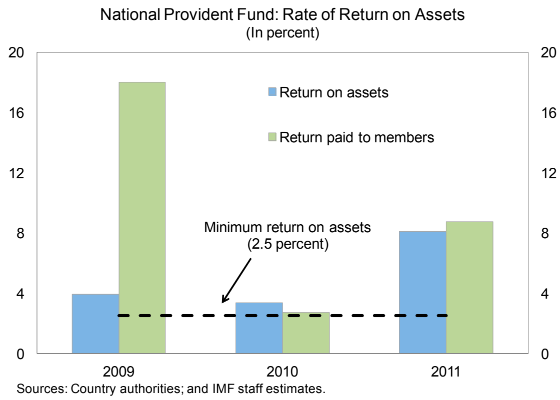
2/ Revised data for 2010 reflecting on-site bank examinations.

38. **The banking system is sound, adequately capitalized and highly profitable but some challenges remain**. The ratio of nonperforming loans (NPLs) to total outstanding loans moderated from 8.3 percent at end-2010 to 6.1 percent at end-June 2011. On-site examination of major banks conducted by the CBSI with IMF TA has revealed weaknesses in accounting and classification, due to the

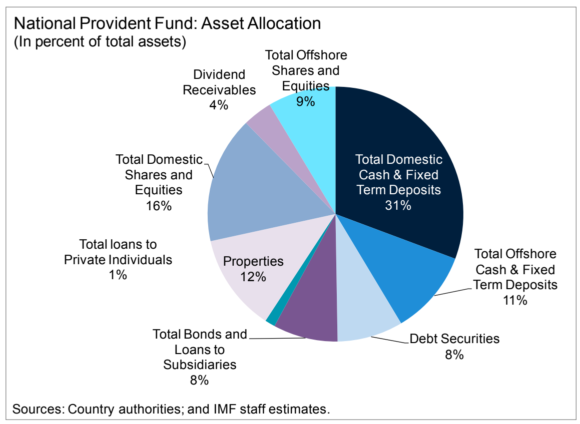
Box 3. Solomon Islands: The National Provident Fund[1]

The National Provident Fund Act (NPF) is Solomon Islands' only pension fund and the largest pool of financial savings. It provides the only retirement income scheme in the country.

- The NPF was established in 1973 as a defined-contribution pension scheme. Employers contribute for a minimum of 7½ percent of the employees' salary and employees pay 5 percent. The minimum yearly rate of return guaranteed is 2½ percent. Members can withdraw their full savings at age 50 (lump-sum payment) and are allowed to use se their fund balances as collateral for bank loans up to two-thirds of their account balance at any time before then.



- Member contributions (total liabilities of the fund) have grown at double-digit rates over the last couple of years suggesting strong employment growth in the formal sector. As of June 2011, total assets amounted to about SI$ 1.27 billion or 20 percent of GDP. The NPF's balance sheet is growing fast but its investment portfolio is largely invested in short-term liquid assets with low returns. While the NPF is allowed to invest up to 30 percent of its assets off-shore, only about 20 percent is currently overseas. About one third of the portfolio is held in cash and fixed deposits in the domestic banking system. The NPF is by far the largest depositor in all three major banks.



- The requirement for the NPF to declare the annual return to members before the finalization of the audited accounts could result in an unsustainable drawdown of the Fund's reserves. As a result, the return paid to members has not always reflected the return on assets of the Fund. In addition, the lack of a domestic secondary market for equity and debt instruments makes it difficult to value higher risk equity stakes and real estate investments which are valued at cost. The politicization of investment decisions in the past also has resulted in poor investments and non-performing loans, some of which have been recently restructured.

[1] Prepared by Shanaka J. Peiris.

treatment of offshore balances, including transactions with their parent institutions which has resulted in a significant downward revision of capital in 2010. However, recent data (mid-October) suggest that all banks are above their minimum capital requirement following the implementation of remedial actions specified by the CBSI.

39. **Progress continues to be made in improving operations and financial performance of the NPF.** This occurred through better management of information systems and restructuring of non-performing loans in 2010, although the long-term sustainability of the NPF and ensuring that benefits to its members are maximized would require a reform of the NPF Act. Reforming the NPF Act based on the approved reform plan and APRA on-site examination is a priority in order to safeguard and enhance the value of its members' assets over the long run. Cabinet approval of the drafting instructions for the amendments to the NPF has been delayed due to the unavailability of expected TA (program benchmark) and the need for wider consultations among stakeholders to strengthen ownership of the reform. This benchmark is now expected to be met by June 2012. The authorities' ongoing efforts to improve access to credit are appropriately focused. The mission suggested taking further steps such as an expanding micro-credit scheme, as done in other Pacific island economies, with the help of development partners.

40. **The supervisory and regulatory framework of the financial system will need to be further strengthened**. Supported by Fund TA, the CBSI will need to continue to strengthen its effectiveness by obtaining Cabinet approval of the amendments to the CBSI Act (program benchmark) and enhance its supervisory capacity through both on-site examinations and off-site monitoring as part of a move from a regulatory approach that focuses on compliance of financial institutions with laws and rules to a framework that identifies risks in the financial system as a whole, from a macro-prudential perspective. These examinations will need to be followed up by steadfastly enforcing corrective actions that are identified and conducting stress tests of the banking system to identify vulnerabilities going forward.

Authorities' Views

41. **Officials broadly shared staff's views on the financial sector and requested additional IMF TA on strengthening the supervisory and regulatory framework** (MEFP ¶9-11). They agreed that the amendments to the CBSI Act will strengthen the effectiveness of monetary policy operations and supervisory activities. The Financial Institutions Act of 1990 will also be amended to reflect structural changes in the financial system and the latest international best practices. The CBSI will request IMF technical assistance for this purpose. The authorities remain committed to reforming the NPF and improving access to finance. The officials shared staff's views that improving NPF's governance and investment performance would be essential to provide adequate retirement income and maintain financial stability. In this regard, they plan to seek Cabinet approval of the drafting instructions to amend the NPF Act by end-June 2012 to reduce political influence on investment decisions and maximize returns on its investments. To facilitate large project financing, the prudential guideline on the single borrower limits will be revised by end-2011 as recommended by PFTAC TA. To improve financial access by households and small enterprises, the authorities aim at streamlining land title registration and transfer of

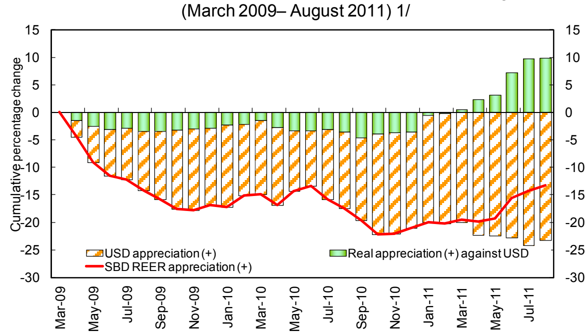
ownership to facilitate the use of land as collateral. They also plan to explore ways to revamp the use of the small business finance scheme administrated by the CBSI.

VI. Addressing External Competitiveness and Safeguarding External Stability

Background

42. **The exchange rate arrangement is currently classified as an "other managed arrangement."**[6] The REER has depreciated by 13 percent as of August 2011 from its peak in March 2009. This reflects the U.S. dollar depreciation of around 23 percent in real terms against other currencies in the basket as well as the Solomon Islands dollar appreciation vis-à-vis the U.S. dollar of 10 percent in real terms over this time period. The REER appears to be in line with its estimated equilibrium level (Box 4). However, the current account balance deficit widened to 30 percent of GDP in 2010, well above the historical average of 15 percent, driven by imports of machinery and transport equipments related to the revival of the Gold Ridge mine. High fuel prices also took a toll on the import bill. In 2011, the current account deficit is expected to narrow to about 12 percent of GDP reflecting strong growth in commodity exports, especially gold and logs. Looking ahead, the current account deficit should stabilize at 12–13 percent of GDP, as the exploitation of Gold Ridge mine continues to boost mineral exports while mining-related imports of machinery and transport decline after the initial sunk cost investment.

Solomon Islands: Decomposition of the Real Effective Exchange Rate (March 2009– August 2011) 1/



Source: IMF staff estimates.

1/ Real appreciation of the Solomon Islands dollar against the U.S. dollar, and real appreciation of the U.S. dollar against other currencies in the basket.

Staff's Views

43. **The current exchange rate regime has provided a strong nominal anchor and remains appropriate.** While the current regime has served Solomon Islands well, the exchange rate policy should continue to be managed in a flexible manner. This would provide a buffer against external vulnerability given the economy's large exposure to commodity prices. Staff welcomed the authorities' decision to adjust the NIR targets upward by around US$60 million for the remainder of program given the recent over-performance and to further reduce vulnerability to external shocks. The reserve coverage of 6½ months of imports (7½ months excluding mining-related imports) is in line with the optimal reserves coverage for low-income countries.[7] While model-based staff's analysis suggests that the real effective exchange rate is in line with its medium-terms fundamentals, a further

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[6] Solomon Islands accepted the obligations under Article VIII, Sections 2(a), 3, and 4 in 1979 and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions.

[7] The optimal reserve coverage for fragile states ranges from three months of imports under flexible exchange rate regimes to less than eight months of imports under fixed exchange regimes.

Box 4. Solomon Islands: Exchange Rate Assessment[1]

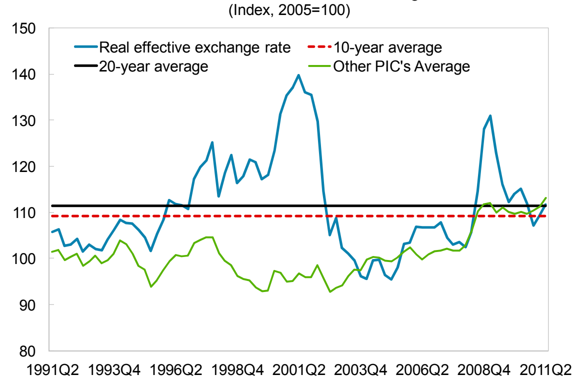
Simple metrics such as long-term averages and model-based estimates suggest that Solomon Islands' exchange rate is broadly in line with its medium-term fundamentals.

- **The real effective exchange rate** is currently in line with its 20-year average and only 2 percent above its 10-year average.

- **According to the macroeconomic balance approach** the equilibrium current account deficit, or norm, over the medium term is about 14 percent of GDP. The projected current account deficits over the medium term are broadly in line this norm, implying no misalignment. However, the estimates are subject to considerable uncertainty, as shown by the wide range of the confidence intervals. This approach determines the change in the real effective exchange rate that is needed to close the gap between the underlying current account balance (i.e., staff projections) and its equilibrium level (i.e., norm). The explanatory variables include fiscal balance, economic growth, foreign aid and demographics. All variables are measured in deviation from the average of the trading partners.

- **According to the equilibrium real exchange rate approach**, the real exchange rate is also broadly in line with its medium-term fundamentals. The model explains the equilibrium REER based on projections on the terms of trade, relative productivity, and relative government consumption.

Solomon Islands: Real Effective Exchange Rate
(Index, 2005=100)



Sources: INS; and IMF staff estimates.

Exchange Rate Assessment: Baseline Results (In percent)			
	Current Account/GDP		REER
	Norm	Projection 1/	Overvaluation
Macroeconomic balance 2/	-13.9	-13.2	-2.0
Equilibrium real exchange rate 3/	...	...	2.7

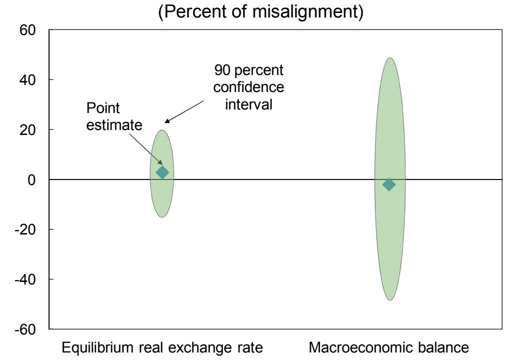
Source: IMF staff estimates.

1/ Staff projection of the underlying CA/GDP during 2012-16.

2/ Based on semi-elasticity of CA/GDP with respect to the REER of -0.37.

3/ Overvaluation is assessed relative to Q2 2011.

Solomon Islands: Equilibrium Real Exchange Rate Estimates
(Percent of misalignment)



Source: IMF staff estimates.

[1] Prepared by Huidan Lin.

improvement in the business environment would help improve competitiveness based on institutional indicators (Section V).

44. **Current account deficits in the lower-double digits over the medium term are likely to be manageable as they are driven by investment to increase export capacity.** For instance, the investment in the mining sector is expected to be financed by foreign direct investments. Going forward, while resuming concessional borrowing after completing the Honiara Club Agreement is important to tap resources to finance large development needs, such as the hydro power project, this borrowing should still be prudent to safeguard external stability. The joint IMF-World Bank DSA shows that the debt distress remains at a moderate risk level, even after transitioning toward external concessional loans, if borrowing remains on check.

Authorities' Views

45. **The authorities concurred with staff's assessment on the exchange rate and external stability**. They noted that the relatively high current account deficits over the medium-term should be sustainable because they will be financed mostly with non-debt-creating inflows.

VII. PROGRAM DISCUSSIONS

46. **Current arrangement.** The current SCF-supported program remains on track, with strong performance on the quantitative targets and notwithstanding delays in implementing some of the program benchmarks. All end-June performance criteria were met with large margins owing to larger-than-expected logging production, while government spending has been broadly in line with the program (MEFP Table 1). A few program benchmarks are being implemented with some delays, partly because of capacity constraints (MEFP Table 2).

47. **Modalities of successor arrangement.** Staff agreed with the authorities that a 12-month precautionary SCF for SDR5.2 million (equivalent of 50 percent quota) would be the appropriate modality in light of the current strong external position and favorable medium-term prospect. The successor arrangement would help consolidate the macro improvements made during the current SCF and take significant steps toward strengthening economic institutions and structural policies. It would be a building block in implementing an ambitious medium-term structural reform agenda. All of these will give greater confidence about the medium-term stability of Solomon Islands' economic policies and boost its resilience to external shocks. The SCF would be monitored through semi-annual reviews, quantitative targets, and structural benchmarks (Table 6, and MEFP Tables 1 and 2). The target for the government cash balance is specified as end-of-period stock rather than cumulative changes from the beginning of the year to strengthen program monitoring and reporting, and to make the 2012 targets independent from the end-2011 outcome. The benchmarks for 2012 include the amendment of tax legislation on exemption, implementation of new resource tax regime, reforms of public finance act, completion of Honiara Club Agreement review, improving the budget presentation, and amendments to NPF Act. If purchases under the precautionary arrangement were made, annual repayment to the Fund would amount to less than one percent of exports of goods and services (Table 7).

An update of the Safeguards Assessment of the CBSI is expected to be completed by the time of the first review of the successor arrangement.

48. **Financing.** Large donors' financing is in the pipeline from Australia and New Zealand (around US$40 million per year), the AsDB (US$7–14 million per year during 2012–14 to finance infrastructure and transports projects in the form of both budget support and loans), the World Bank (US$2 million in budget support in 2012 and other future disbursements in the form of grants and loans including to finance Tina River hydro project), and the EU (US$4–7 million per year in budget support). The AsDB has recently approved the second tranche of its budget support (US$5 million). Disbursements from development partners hinge on the continuation and good implementation of a Fund-supported program. The development partner community is very active in Solomon Islands. In 2003, after a period of social unrest, the Solomon Islands government requested assistance from Pacific island countries, which is being delivered through the Regional Assistance Mission to Solomon Islands (RAMSI). Australia's and New Zealand's bilateral aid program, which covers sectors not included in the RAMSI mandate, focuses on health and education. The World Bank is taking the lead on Public Expenditure Review. The AsDB's support focuses on structural reforms to support private sector development by providing TA on state-owned-enterprise (SOE) reform and on microfinance and credit. The Fund will continue to take the lead on banking supervision (through PFTAC), tax reforms to manage the forthcoming mining revenue in the medium term, public financial management and fiscal responsibility provisions to improve budget transparency and accountability. Development partners coordinate closely to avoid duplications in the work program.

49. **Risks.** The risks to the program stem from possible delays in the 2012 budget, political instability, and capacity constraints. However, the strong implementation and success of the current program provides a good indication that program ownership is strong and likely to continue. The first review of the successor arrangement is expected to take place in April 2012.

VIII. Staff Appraisal

50. **Solomon Islands' economy has rebounded from the 2008–09 global financial crisis and a strong commodity-based recovery is underway.** The economy has benefited from the implementation of the government's economic reform program supported by SCF arrangement approved in June 2010 due to strong political commitment to rebuilding fiscal and financial buffers and sound macroeconomic management that triggered donors' support. Reserves have been rebuilt and fiscal health has improved.

51. **Despite a still positive near-term outlook, several challenges remain**. The economy remains extremely vulnerable to swings in commodity prices and external demand shocks, and the risks to the global outlook have increased with potential spillovers to Solomon Islands. Logging—the main source of growth in recent years—is expected to decline and be exhausted during the current decade. So far, growth has remained concentrated in the commodity sector, mainly logging, with limited spillovers to the rest of the economy. The mineral sector has the potential to become the main driver of growth, but several reforms need to be implemented to ensure that the country as a whole benefits from its mineral wealth. Continued high growth alone may not be sufficient to address social

imbalances and policy measures are necessary to make growth more inclusive and to make progress toward the achievements of the MDGs which are currently out of reach. The government's National Development Strategy is an important step toward a comprehensive poverty reduction and growth strategy over the next few years. Going forward, the strategy would benefit from a more detailed implementation plan that includes costing and prioritization of projects, and a further articulation of the linkages between spending, growth and poverty reduction.

52. **Bolstering resilience to shocks and adopting a more inclusive growth model remain top priorities**. This will imply continuing rebuilding policy buffers, a scaling up of critical infrastructure investment and spending in health and education, and structural reforms (such as a new resource tax regime and new mining legislation) that would help boost investors' confidence and ensure sustainable growth. However, the pace of spending will need to be calibrated taking into account capacity constraints to avoid waste. Measures to foster private sector development such as streamlining land title registration and transfer of ownership to ease access to credit and improve collateral recovery are also urgently needed to ensure a more broad-based growth. A precautionary SCF would build on the previous SCF program that expires in early December 2011 and should be instrumental in anchoring the policy agenda, going forward.

53. **Preserving a strong fiscal position and strengthening the medium-term fiscal framework would ensure fiscal sustainability**. Staff welcomes the authorities' commitment to strike a balance between maintaining a strong fiscal buffers and increasing spending on critical infrastructure and social priorities. In the medium-term, resuming concessional borrowing to secure financing for development needs, managing resources revenue, anchoring fiscal policy on non-commodity fiscal balance, and adopting fiscal responsibility provisions would be critical to maintain fiscal sustainability. The mission strongly supported the authorities' plan of moving toward a multi-year budget framework later next year. Casting budget decisions in a multi-year perspective will help the authorities design realistic fiscal plans and build consensus on the appropriate sequencing of development projects.

54. **The monetary stance and the exchange rate policy over the past few months have helped anchor inflation expectations and are currently appropriate.** However, if the recovery remains on track and rapid credit growth re-emerges monetary tightening would be warranted.

55. **Financial and external stability are not at risk.** The banking system remains profitable and adequately capitalized. The supervisory and regulatory framework will need to be strengthened. The exchange rate is broadly in line with fundamentals. While resuming concessional borrowing after completing the Honiara Club Agreement is important to tap resources to finance large development needs, this borrowing should still be prudent to ensure external stability as analyzed in the joint IMF-World Bank DSA.

56. **The quality of macroeconomic data should continue to be improved**. The authorities should continue the ongoing progress to implement PFTAC recommendations on the compilation and dissemination of economic data.

57. **Based on the strong program performance, staff recommends the completion of the third and final review of the current SCF-supported program**. The authorities'

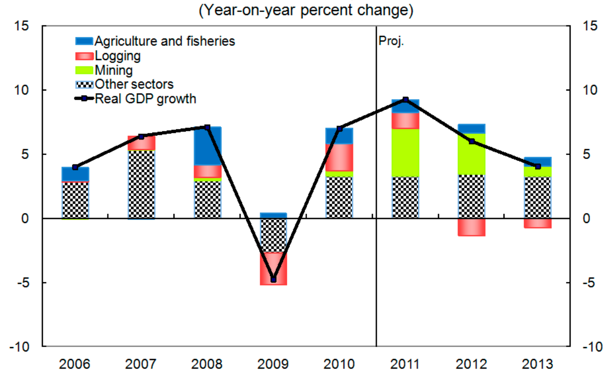
reform program going forward is also well focused. Therefore, staff recommends the approval of the authorities' request for a successor arrangement in the form of a precautionary SCF arrangement (SDR5.2 million). The current SCF arrangement will expire as soon as the last disbursement is made in the coming days. Because a member cannot have two arrangements effective at the same time under the PRGT Instrument, a draft proposed decision approving the new SCF arrangement will be circulated to the Board for adoption after the current SCF arrangement has expired.

58. **It is recommended that the next Article IV consultation take place on a 24-month cycle**. This recommendation is in accordance with the Decision on Article IV Consultation Cycles (Decision No. 14747-(10/96) (9/28/2010), http://www.imf.org/external/pp/longres.aspx?id=4515.

Figure 1. Solomon Islands: Macroeconomic Developments and Outlook

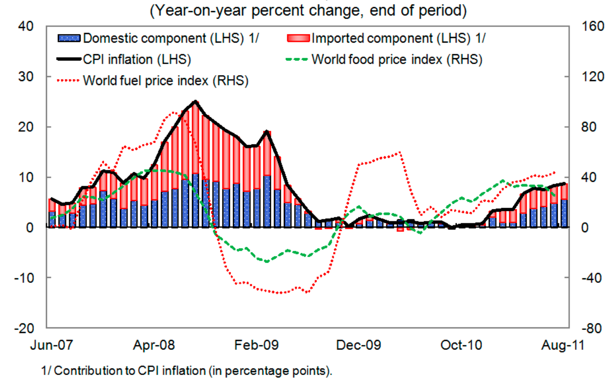
The economic recovery has been driven by logging and mining, although logging is expected to decline over the medium term.

Sources of Growth, 2006–13
(Year-on-year percent change)



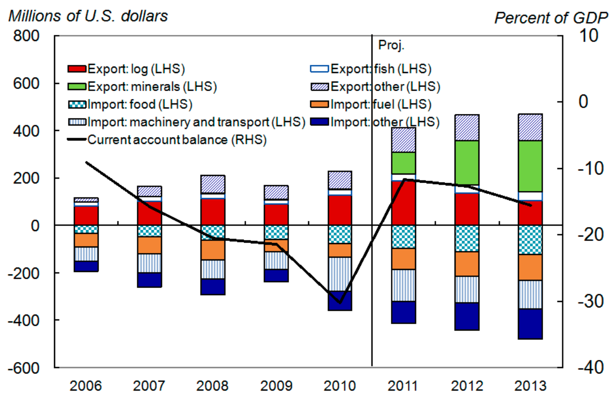
World food and fuel prices have contributed to higher inflation although pressures are now dissipating.

Contributions to Inflation, Jun. 2007–Jun. 2011
(Year-on-year percent change, end of period)



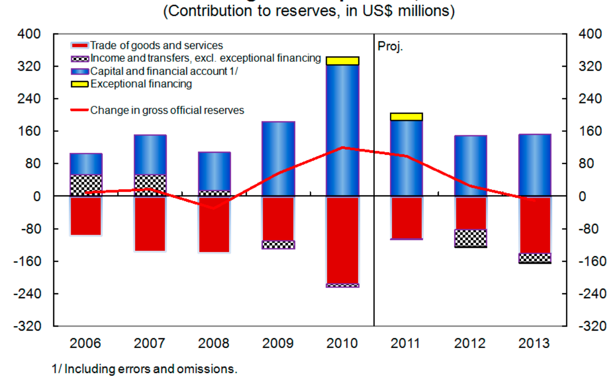
Logs and mineral exports have contributed to narrowing the current account despite robust import growth...

Current Account Balance and Trade, 2006–13



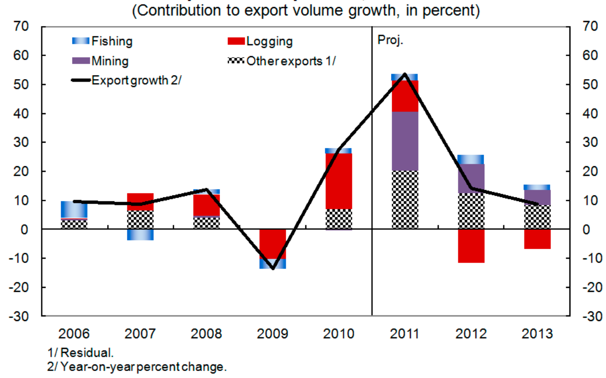
… and reserves continue to build up driven by donor grants and FDI.

Reserve Change Decomposition, 2006–13
(Contribution to reserves, in US$ millions)



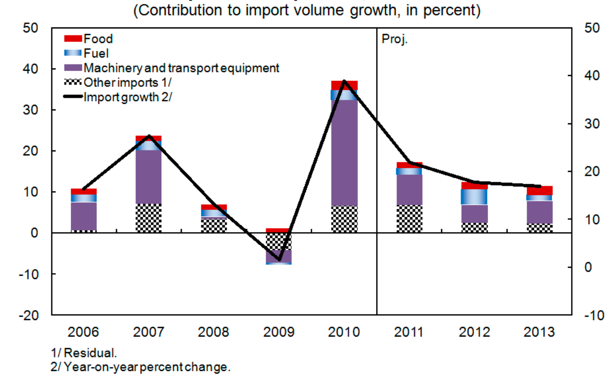
Export volume has been strong driven by log and mineral exports, although log exports are to decline down the road…

Export Developments, 2006–13
(Contribution to export volume growth, in percent)



…and import volume is likely to decline as Gold Ridge mine is now operational and ready for full scale production.

Import Developments, 2006–13
(Contribution to import volume growth, in percent)

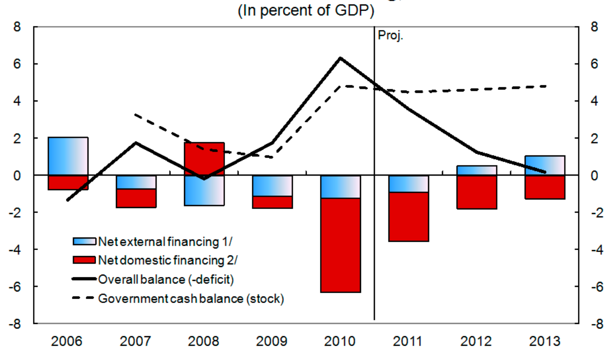


Sources: Data provided by the Solomon Islands authorities; and IMF staff estimates and projections.

Solomon Islands: Macroeconomic Developments and Outlook (concluded)

Fiscal over-performance has been strong, contributing to a large increase in the cash balance.

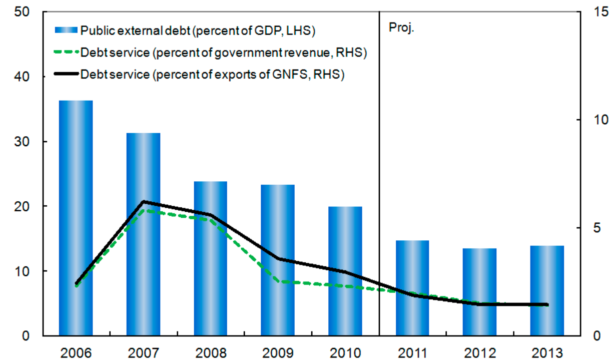
Fiscal Balance and Financing, 2006–13
(In percent of GDP)



1/ Between 2005–07, includes debt forgiveness.
2/ Includes privatization receipts.

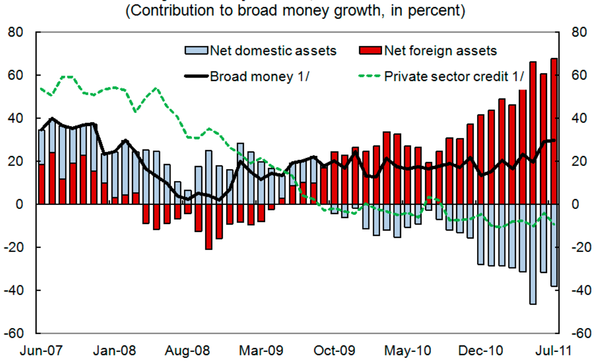
Public external debt has declined and is expected to remain sustainable over the medium term.

Public External Debt, 2006–13



Rapid increase in reserve position has contributed to strong money growth…

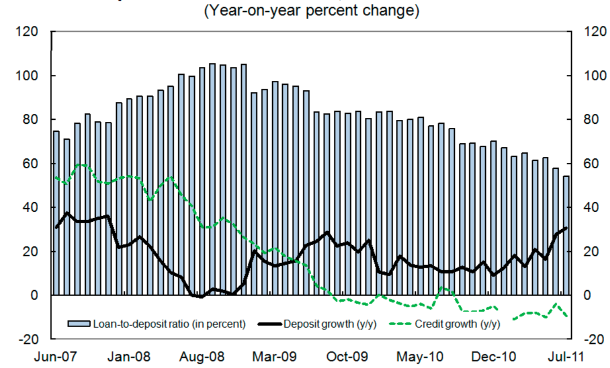
Monetary Developments, Jun. 2007—Jul. 2011
(Contribution to broad money growth, in percent)



1/ Year-on-year percent change.

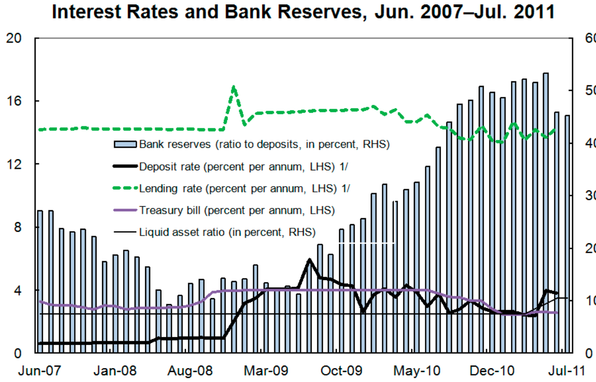
…while private sector credit growth has been sluggish leading to a decline in loan-deposit ratio.

Deposit and Credit Growth, Jun. 2007–Jul. 2011
(Year-on-year percent change)



The recent increase in CBSI's bills has helped stabilize banks' excess liquidity albeit at a high level.

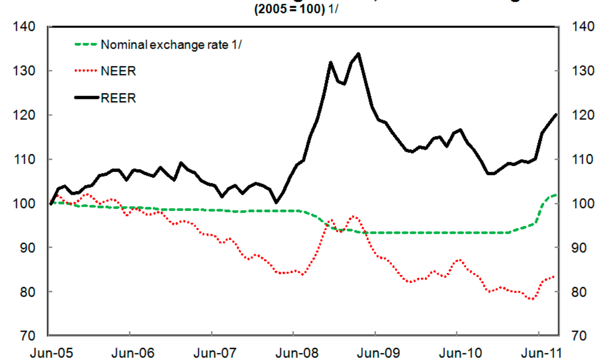
Interest Rates and Bank Reserves, Jun. 2007–Jul. 2011



1/ Weighted average rate of the commercial banks.

The real effective exchange rate has recently increased due to the currency appreciation which has reduced inflationary pressures.

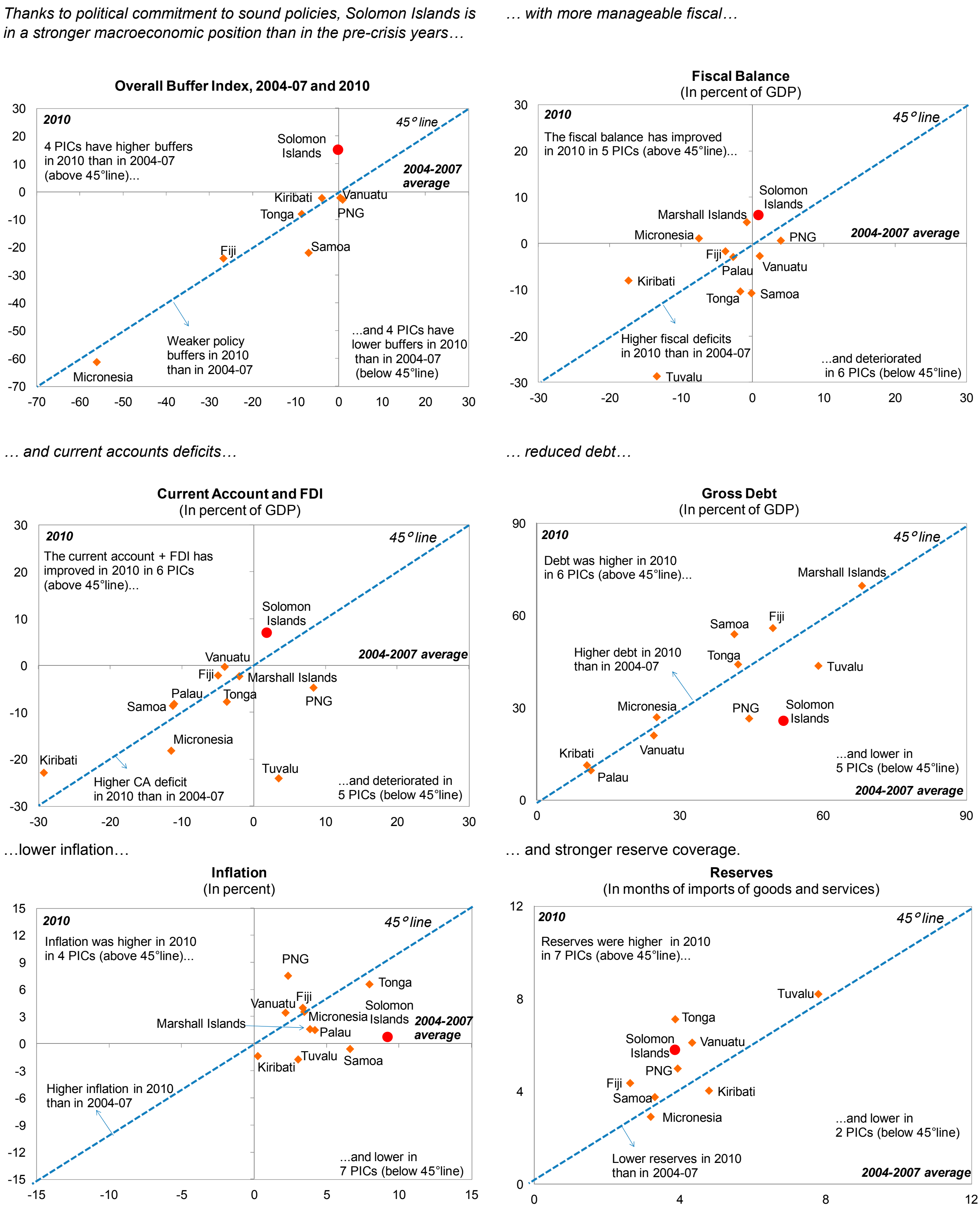
Nominal and Effective Exchange Rates, Jun. 2005–Aug. 2011
(2005 = 100) 1/



1/ Based on U.S. dollar exchange rate.

Sources: Data provided by the Solomon Islands authorities; and IMF staff estimates and projections.

Figure 2. Solomon Islands: From Crisis to Recovery—Rebuilding Policy Buffers 1/

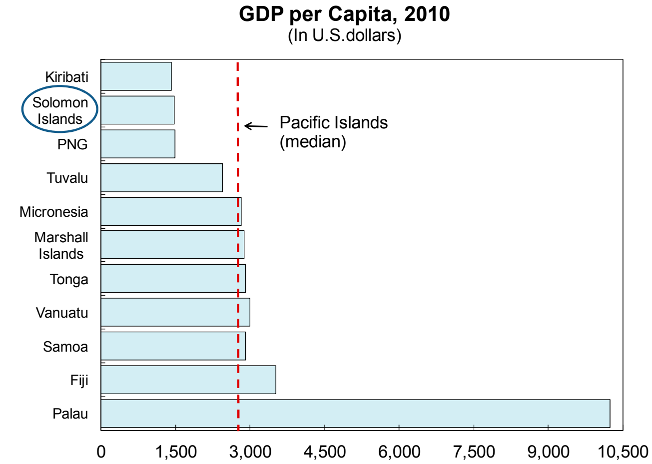


Source: IMF staff calculations.

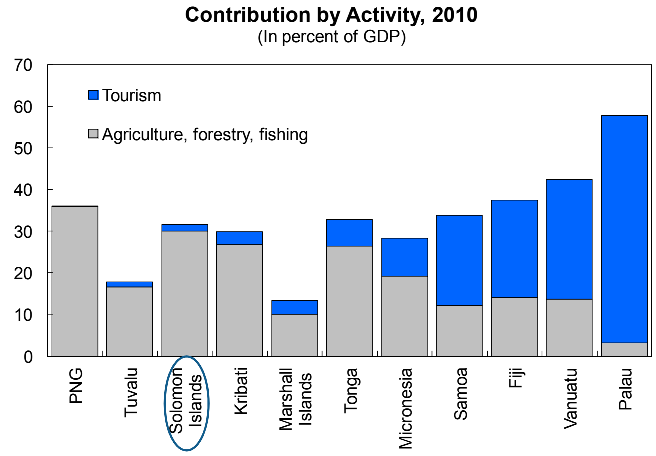
1/ The buffer index comprises: the fiscal balance, the current account balance plus FDI, public debt (all in percent of GDP), inflation and

Figure 3. Solomon Islands: The Cross-Country Context

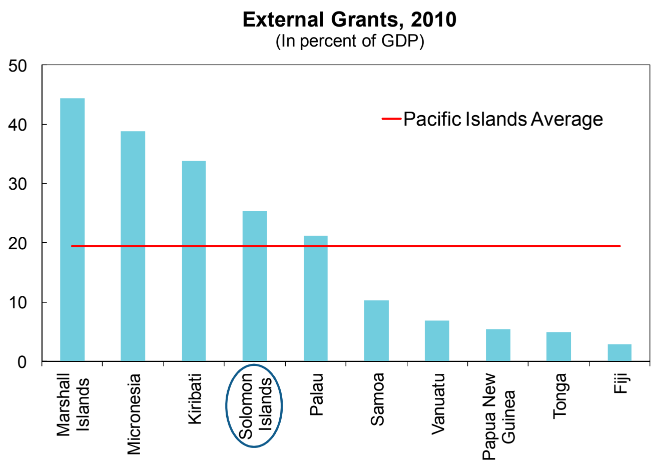
Solomon Islands is one of the poorest countries in the Pacific region...



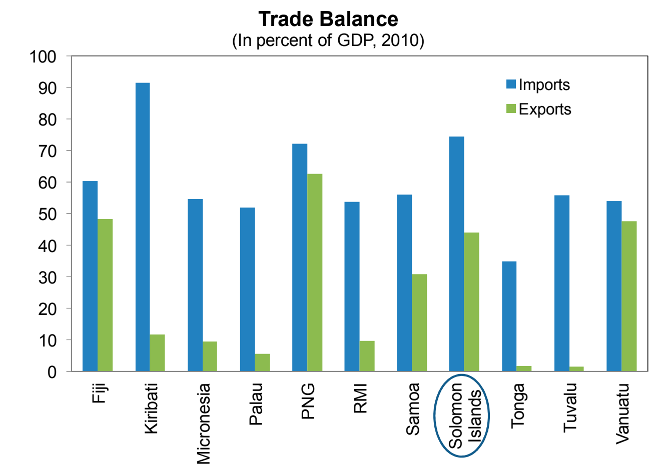
… as subsistence agriculture and forestry are core activities with tourism still relatively small.



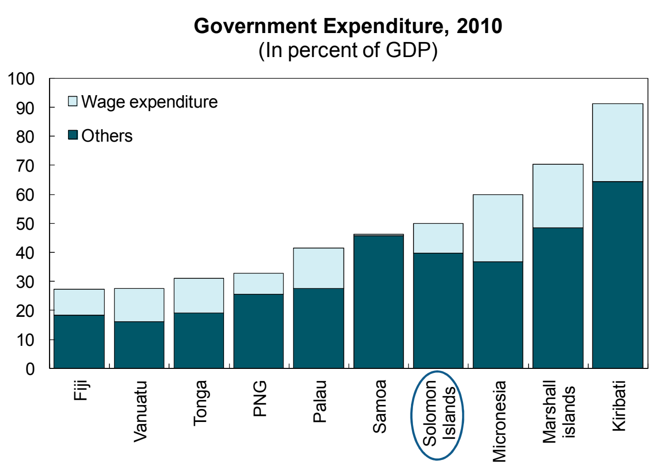
The country relies on foreign aid…



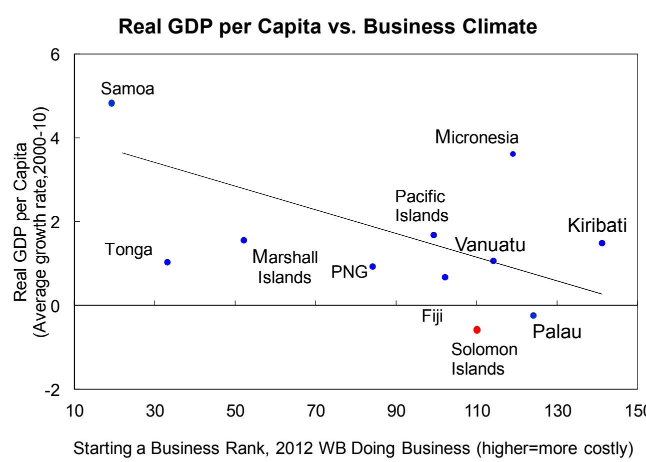
… to finance its trade deficit and large developments needs.



The economy is largely dominated by the public sector due to its narrow production base…



… and constraints to private sector development.



Sources: IMF, APDLISC database, WEO; WB, WDI; country authorities; and IMF staff estimates.

Table 1. Solomon Islands: Selected Economic Indicators, 2008-12

Per capita GDP (2010): US$1,280
Population (2010): 528 thousand (estimate)
Poverty rate (2006): 23 percent

	2008	2009	2010	2011		2012
			Est.	Proj. (CR/11/180)	Rev.Proj.	Proj.
Growth and prices (percentage change) 1/						
Real GDP	7.1	-4.7	7.0	5.6	9.3	6.0
Of which : nontimber nonmining	6.5	-2.6	4.8	4.8	4.8	4.7
CPI (period average)	17.4	7.1	1.0	6.0	6.6	5.3
CPI (end of period)	18.1	1.8	0.8	6.5	7.1	5.2
GDP deflator	11.4	7.3	5.8	2.7	7.6	7.0
Nominal GDP (in SI$ millions)	4,713	4,815	5,449	6,270	6,404	7,265
Per capita GDP (in US$)	1,207	1,159	1,280	1,457	1,554	1,769
Per capita GNI (in US$)	1,018	839	975	1,107	1,210	1,300
Central government operations (percent of GDP)						
Total revenue and grants	46.5	55.2	63.0	57.7	59.5	58.5
Revenue	29.0	30.5	32.2	31.2	33.6	33.8
Grants	17.5	24.7	30.8	26.5	25.9	24.7
Total expenditure	46.7	53.5	56.7	56.0	55.9	57.2
Recurrent expenditure	25.3	28.6	28.4	27.7	27.1	27.7
Development expenditure	19.5	25.6	28.0	28.4	28.9	29.5
Unrecorded expenditure 2/	1.9	-0.7	0.3	0.0	0.0	0.0
Overall balance	-0.2	1.8	6.3	1.7	3.6	1.3
Foreign financing (net)	-1.6	-1.1	-1.2	-0.9	-0.9	0.5
Domestic financing (net)	1.8	-1.6	-5.1	-0.9	-2.8	-1.8
Privatization receipts	0.0	0.9	0.0	0.2	0.2	0.0
Central government debt (percent of GDP, unless otherwise indicated) 3/	35.0	33.2	28.1	24.5	21.3	17.1
Domestic debt	11.2	10.0	8.2	7.0	6.6	3.6
External debt	23.8	23.2	19.9	17.4	14.7	13.5
(In US$ millions, end of period)	140.4	138.7	134.7	137.4	126.9	131.9
Monetary and credit (percentage change, end-year data)						
Credit to private sector	26.5	-4.2	-4.7	5.0	2.0	8.0
Broad money	6.9	24.7	13.5	15.0	21.0	18.0
Reserve money	-2.3	62.5	75.3	13.9	21.6	16.7
Interest rate - deposit (percent per annum)	2.0	2.7	2.6	...	...	...
Interest rate - lending (percent per annum)	17.0	15.4	13.5	...	...	...
Balance of payments (in US$ millions, unless otherwise indicated)						
Current account balance	-124.5	-128.2	-204.4	-171.0	-97.7	-124.3
(Percent of GDP)	-20.5	-21.4	-30.3	-21.7	-11.6	-12.7
(excluding mining-related capital imports, in percent of GDP)	…	…	-11.2	-13.2	0.1	-2.3
Exports of goods and nonfactor services (GNFS)	269.5	234.9	333.0	458.0	524.3	596.8
(Percentage change)	20.6	-12.9	41.8	37.5	57.4	13.8
Log exports	110.3	88.1	124.7	…	187.5	134.5
Imports of GNFS	408.8	344.2	547.8	624.4	628.3	677.8
(Percentage change)	14.0	-15.8	59.2	14.0	14.7	7.9
Foreign direct investment	91.1	116.8	235.6	…	155.7	105.2
Overall balance	-31.0	56.4	119.8	28.8	88.8	25.0
Gross official reserves (in US$ millions, end of period) 4/	89.5	146.0	265.8	304.6	364.6	389.5
(In months of next year's imports of GNFS)	3.1	3.2	5.1	5.5	6.5	6.4
(In months of next year's nonmining-related imports of GNFS)	…	4.2	6.0	7.2	7.6	7.5
Exchange rate (SI$/US$, end of period) 5/	8.00	8.06	8.06	...	7.40	...
Real effective exchange rate (period average, 2005 = 100)	112.7	120.5	112.0	...	...	...
Nominal effective exchange rate (period average, 2005 = 100)	87.9	88.7	83.5	...	...	...

Sources: Data provided by the authorities; and IMF staff estimates and projections.

1/ Incorporates the 2009 revised GDP estimates published by the National Statistics Office in June 2011.
2/ Includes changes in the stock of unpaid payment orders and unpresented checks and the statistical discrepancy.
3/ Includes disbursement under an IMF-supported arrangement
4/ Includes SDR allocations made by the IMF to the Solomon Islands in 2009 and actual and prospective disbursements under the IMF-supported arrangement.
5/ For 2011, as of September.

Table 2. Solomon Islands: Balance of Payments, 2008-16 1/

	2008	2009	2010	2011		2012	2013	2014	2015	2016
			Est.	Proj. (CR/11/180)	Rev. Proj.			Proj.		
	(In millions of U.S. dollars)									
Current account balance	-124.5	-128.2	-204.4	-171.0	-97.7	-124.3	-163.6	-148.0	-140.1	-140.2
Trade balance for goods	-82.4	-74.3	-133.8	-78.3	-5.0	21.8	-13.1	-40.7	-43.9	-48.8
Exports	210.5	164.9	226.5	341.3	409.5	464.4	468.5	472.5	505.6	539.2
Imports	-292.9	-239.2	-360.3	-419.6	-414.5	-442.7	-481.6	-513.3	-549.5	-588.0
Trade balance for services	-56.9	-35.1	-81.0	-88.1	-99.0	-102.7	-126.3	-135.4	-145.7	-156.8
Exports	59.0	69.9	106.5	116.7	114.8	132.3	125.7	133.3	142.2	153.2
Imports	-115.9	-105.0	-187.5	-204.8	-213.8	-235.1	-252.0	-268.7	-287.8	-310.0
Income balance	-95.0	-164.9	-160.7	-189.2	-185.5	-259.8	-252.3	-202.0	-183.7	-171.5
Current transfers balance 2/	109.9	146.1	171.1	184.6	191.7	216.5	228.1	230.2	233.2	236.8
Of which: Official transfers, net	90.5	120.8	167.5	180.7	188.4	212.6	213.3	213.2	213.8	215.1
Capital and financial account balance	104.0	164.7	319.8	199.7	186.5	149.3	153.2	165.7	166.0	169.7
Capital account balance	14.3	26.8	49.8	30.4	31.8	35.2	36.6	37.0	37.1	37.3
Direct investment balance	91.1	116.8	235.6	174.7	155.7	105.2	101.3	106.1	102.5	102.0
Portfolio investment balance	3.3	1.2	-2.6	0.0	0.0 .	0.0	0.0	0.0	0.0	0.0
Other investment balance 3/	-4.8	19.9	37.1	-5.4	-0.9	9.0	15.4	22.7	26.4	30.5
Errors and omissions	-10.5	19.9	4.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-31.0	56.4	119.8	28.8	88.8	25.0	-10.4	17.7	25.9	29.5
Financing	31.0	-56.4	-110.3	-28.8	-88.8	-25.0	10.4	-17.7	-25.9	-29.5
Change in gross reserves (- = increase)	31.0	-56.4	-119.8	-38.8	-98.7	-24.9	10.5	-16.0	-22.5	-25.1
IMF	…	…	9.6	10.0	10.0	-0.1	-0.1	-1.7	-3.4	-4.5
	(In percent of GDP, unless otherwise indicated)									
Current account	-20.5	-21.4	-30.3	-21.7	-11.6	-12.7	-15.6	-13.5	-12.3	-11.7
(excluding mining-related exports and imports of goods and services)	…	…	-14.5	…	-13.1	-22.2	-26.2	-24.0	-22.5	-21.9
(excluding mining-related imports of goods and services)	…	…	-11.2	…	0.1	-2.3	-5.1	-3.4	-2.4	-2.2
(excluding net official transfers)	-35.3	-41.6	-55.1	-44.6	-34.1	-34.4	-35.9	-33.0	-31.0	-29.7
Trade balance for goods	-13.5	-12.4	-19.8	-9.9	-0.6	2.2	-1.2	-3.7	-3.8	-4.1
Exports (in percent of GDP)	34.6	27.6	33.5	43.3	48.8	47.5	44.6	43.2	44.3	45.0
Of which: Logs	18.1	14.7	18.5	12.9	22.3	13.7	9.7	7.6	6.9	6.6
Of which: Fish	3.7	2.8	3.6	4.4	3.3	3.5	3.7	4.3	4.9	5.5
Of which: Minerals	0.4	0.6	0.5	13.5	10.8	19.3	20.6	20.1	19.7	19.4
Imports	48.2	40.0	53.3	53.3	49.4	45.2	45.9	46.9	48.1	49.1
Of which: Food	10.4	10.1	11.6	12.9	11.8	11.5	11.7	12.2	12.7	13.1
Of which: Fuel	13.9	8.7	8.4	11.9	10.3	10.5	10.5	10.7	10.9	11.0
Of which: Machinery and transportation equipment	12.9	12.4	21.2	17.1	16.3	11.5	11.6	11.3	11.2	11.1
Mining imports	…	…	12.1	8.5	8.2	6.3	6.6	6.5	6.3	6.2
Nonmining imports	48.2	40.0	41.2	44.7	41.2	39.0	39.2	40.5	41.8	42.9
Excluding mining capital imports and reinvested earnings		-3.1	5.6	-2.2	16.0	8.4	3.1	2.9	2.4	1.6
Trade balance for services	-9.4	-5.9	-12.0	-11.2	-11.8	-10.5	-12.0	-12.4	-12.7	-13.1
Income balance	-15.6	-27.6	-12.0	-24.0	-22.1	-26.6	-24.0	-18.5	-16.1	-14.3
Current transfers balance	18.1	24.4	25.3	23.4	22.8	22.1	21.7	21.1	20.4	19.8
Of which: Official transfers net	14.9	20.2	24.8	22.9	22.4	21.7	20.3	19.5	18.7	18.0
Capital account balance	3.3	4.5	7.4	3.9	3.8	3.6	3.5	3.4	3.2	3.1
Direct investment balance	21.2	19.5	34.9	22.2	18.5	10.7	9.6	9.7	9.0	8.5
Of which: Inward FDI	22.1	20.0	35.2	22.9	19.2	12.0	11.0	10.9	10.5	10.1
Other investment balance	-1.1	3.3	5.5	-0.7	-0.1	0.9	1.5	2.1	2.3	2.5
Errors and omissions	-2.4	3.3	0.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net international reserves (in US$ million) 3/	89.5	146.0	256.2	285.0	345.0	370.0	359.6	377.4	403.2	432.8
Gross official foreign reserves (in US$ million)3/ 4/	89.5	146.0	265.8	304.6	364.6	389.5	379.0	395.0	417.5	442.6
In months of next year's imports of GNFS	3.1	3.2	5.1	5.5	6.5	6.4	5.8	5.7	5.6	5.5
In months of nonmining-related imports of GNFS	…	4.2	6.0	7.2	7.6	7.5	6.8	6.5	6.4	6.3
Gross external public debt	23.8	23.2	19.9	17.4	14.7	13.5	13.9	15.1	16.4	17.9
Disbursement of consessional borrowing (in US$ millions)	1.3	0.0	0.0	10.0	0.0	12.0	18.4	27.3	31.4	35.9
External public debt service (in percent of exports of GNFS)	5.6	3.6	3.0	2.0	1.9	1.4	1.4	1.7	1.7	1.7
Nominal GDP (in US$ million)	608.2	597.8	675.6	…	839.6	…	…	…	…	…

Sources: Data provided by the Solomon Islands authorities; and IMF staff estimates and projections.

1/ Incorporates the authorities' revision of historical data, including new formula for f.o.b/c.i.f conversion, new estimates of reinvested earnings and donor grants, and reclassification of current and capital transfers.

2/ For 2010-11, includes additional donor support expected under the IMF-supported arrangement.

3/ Includes the SDR allocations made by the IMF in 2009, and private loans from International Finance Corporation in 2010.

4/ Includes actual and prospective disbursements under the IMF-supported arrangement.

Table 3. Solomon Islands: Summary of Fiscal Accounts, 2008-12

	2008	2009	2010	2011			2012
			Est.	Budget	Proj (CR/11/180)	Rev. Proj.	Proj.
			(In millions of Solomon Islands dollars)				
Total revenue and grants	2,193	2,659	3,434	3,635	3,620	3,811	4,248
Total revenue	1,366	1,467	1,757	1,959	1,959	2,150	2,454
Tax revenue	1,199	1,272	1,589	1,760	1,762	1,968	2,235
Income and profits	442	540	638	741	735	727	856
Goods and services	425	423	569	641	639	744	867
International trade and transactions	332	309	382	378	389	498	512
Of which: Tax on logging	209	162	241	199	197	342	279
Other revenue	167	196	168	199	197	182	220
Grants	827	1,192	1,677	1,676	1,661	1,661	1,793
Development grants	717	1,054	1,281	1,469	1,335	1,335	1,439
Recurrent budget grants 1/	109	138	396	207	326	326	355
Expenditure	2,201	2,574	3,091	3,529	3,514	3,583	4,156
Of which: Appropriated 2/	1,484	1,521	1,809	2,060	2,179	2,248	2,628
Recurrent expenditure	1,192	1,376	1,548	1,616	1,735	1,734	2,012
Compensation of employees	453	511	588	588	588	588	680
Interest payments	53	45	23	29	29	28	24
Other recurrent expenditure 1/ 3/	686	820	937	1,000	1,118	1,118	1,308
Development expenditure	921	1,231	1,525	1,914	1,779	1,849	2,144
Of which : Government funded	204	178	243	444	444	514	616
National Transport Fund (NTF)	…	…	…	51	51	51	100
External loan funded	0	0	0	0	0	0	89
Unidentified expenditure 4/	88	-33	18	0	0	0	0
Current balance	284	230	605	550	550	742	797
Overall balance	-8	85	343	106	106	228	92
Total financing	8	-85	-343	-106	-106	-228	-92
Foreign (net)	-75	-53	-65	-58	-58	-58	37
Domestic (net)	84	-77	-279	-58	-58	-180	-129
Banking system	92	-64	-282	-49	-49	-171	-115
Central bank	96	-25	-284	-24	-24	-146	25
Commercial banks	-4	-39	2	-25	-25	-25	-140
Nonbank	-8	-13	2	-9	-9	-9	-14
Others 5/	0	45	1	10	10	10	0
			(In percent of GDP)				
Total revenue and grants	46.5	55.2	63.0	58.0	57.7	59.5	58.5
Total revenue	29.0	30.5	32.2	31.2	31.2	33.6	33.8
Tax revenue	25.4	26.4	29.2	28.1	28.1	30.7	30.8
Income and profits	9.4	11.2	11.7	11.8	11.7	11.3	11.8
Goods and services	9.0	8.8	10.4	10.2	10.2	11.6	11.9
International trade and transactions	7.0	6.4	7.0	6.0	6.2	7.8	7.0
Of which: Tax on logging	4.4	3.4	4.4	3.2	3.1	5.3	3.8
Other revenue	3.5	4.1	3.1	3.2	3.1	2.8	3.0
Grants	17.5	24.7	30.8	26.7	26.5	25.9	24.7
Expenditure	46.7	53.5	56.7	56.3	56.0	55.9	57.2
Recurrent expenditure	25.3	28.6	28.4	25.8	27.7	27.1	27.7
Compensation of employees	9.6	10.6	10.8	9.4	9.4	9.2	9.4
Interest payments	1.1	0.9	0.4	0.5	0.5	0.4	0.3
Other recurrent expenditure 1/ 3/	14.6	17.0	17.2	15.9	17.8	17.5	18.0
Of which : Government funded	12.2	14.2	13.5	12.6	12.6	12.4	13.1
Development expenditure	19.5	25.6	28.0	30.5	28.4	28.9	29.5
Of which: Government funded	4.3	3.7	4.5	7.1	7.1	8.0	8.5
National Transport Fund (NTF)	…	…	…	0.8	8.1	0.8	1.4
External loan funded	0.0	0.0	0.0	0.0	0.0	0.0	1.2
Unidentified expenditure 4/	1.9	-0.7	0.3	0.0	0.0	0.0	0.0
Current balance	6.0	4.8	11.1	8.8	8.8	11.6	11.0
Overall balance	-0.2	1.8	6.3	1.7	1.7	3.6	1.3
(excluding unidentified expenditure)	1.7	1.1	6.6	1.7	1.7	3.6	1.3
Total financing	0.2	-1.8	-6.3	-1.7	-1.7	-3.6	-1.3
Foreign (net)	-1.6	-1.1	-1.2	-0.9	-0.9	-0.9	0.5
Domestic (net)	1.8	-1.6	-5.1	-0.9	-0.9	-2.8	-1.8
Others 5/	0.0	0.9	0.0	0.2	0.2	0.2	0.0
Memorandum items:							
Nominal GDP (in SI$ millions)	4,713	4,815	5,449	6,270	6,270	6,404	7,265
Gross cash balance (in SI$ millions)	137	106	326	351	351	472	447
Target of program cash balance (in SI$ millions) 6/	67	47	263	287	287	287	335
in months of recurrent spending	0.7	0.4	2.0	2.1	2.0	2.0	2.0
Mineral revenue (percent of GDP)	0.0	0.0	0.0	0.0	0.0	0.6	0.9
Nonmineral balance (percent of GDP) 7/	0.9	2.7	3.1	2.1	2.1	3.4	1.9
Noncommodity balance (percent of GDP) 8/	-3.5	-0.7	-1.3	-1.1	-1.0	-1.9	-1.9
Including loan-funded expenditure	-3.5	-0.7	-1.3	-1.1	-1.0	-1.9	-3.2

Sources: Data provided by the Solomon Islands authorities; and IMF staff estimates and projections.

1/ Includes prospective budget support from donors in 2011-12. The 2011 Budget does not include some grants that are projected under the program.

2/ Expenditure appropriated or recorded in the government's recurrent and development estimates.

3/ Includes spending financed by recurrent grants.

4/ Includes changes in the stock of unpaid payment orders and unpresented checks (+ = reduction) and the statistical discrepancy.

5/ Includes privatization and receipts from a telecom company related to the sale of new telecommunication license.

6/ Program cash balance is the sum of government deposits in the cash balance accounts minus unpaid payments orders and unpresented checks.

7/ Nonmineral balance is defined as nonmineral revenue minus government-funded recurrent and development spending excluding interest payments.

8/ Noncommodity balance is defined as nonlogging nonmineral revenue minus government-funded recurrent and development spending excluding interest payments.

Table 4. Solomon Islands: Medium-Term Baseline Scenario, 2009-16

	2009	2010	2011	2012	2013	2014	2015	2016
		Est.			Proj.			
Growth and prices (percentage change) 1/								
Real GDP	-4.7	7.0	9.3	6.0	4.0	3.4	3.7	4.0
Of which : Nontimber and nonmining	-2.6	4.8	4.8	4.7	4.6	4.5	4.4	4.5
CPI (period average)	7.1	1.0	6.6	5.3	4.2	4.2	4.6	4.6
CPI (end of period)	1.8	0.8	7.1	5.2	4.6	4.6	4.8	4.5
GDP deflator	7.3	5.8	7.6	7.0	4.6	3.8	3.8	3.8
Nominal GDP (in SI$ millions)	4,815	5,449	6,404	7,265	7,910	8,486	9,134	9,857
Per capita GDP (in US$)	1,159	1,280	1,554	1,769	1,854	1,887	1,927	1,972
Per capita GNI (in US$)	839	975	1,210	1,300	1,409	1,538	1,617	1,690
Central government operations (percent of GDP)								
Total revenue and grants	55.2	63.0	59.5	58.5	57.6	59.4	58.8	58.1
Revenue	30.5	32.2	33.6	33.8	33.7	36.4	36.8	36.9
Grants	24.7	30.8	25.9	24.7	23.9	23.0	22.0	21.2
Total expenditure	53.5	56.7	55.9	57.2	57.4	57.6	57.1	56.6
Recurrent expenditure	28.6	28.4	27.1	27.7	27.7	27.7	27.7	27.7
Development expenditure	25.6	28.0	28.9	29.5	29.8	29.9	29.4	29.0
Unidentified expenditure 2/	-0.7	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	1.8	6.3	3.6	1.3	0.2	1.8	1.7	1.4
Nonmineral balance 3/	2.7	3.1	3.4	1.9	1.2	0.6	0.6	0.6
Noncommodity 4/	-0.7	-1.3	-1.9	-1.9	-1.5	-1.5	-1.4	-1.2
Central government debt (percent of GDP) 5/	33.2	28.1	21.3	17.1	16.4	16.9	17.8	19.0
Balance of payments (in US$ millions)								
Current account (balance (- deficit)	-128.2	-204.4	-97.7	-124.3	-163.6	-148.0	-140.1	-140.2
(In percent of GDP)	-21.4	-30.3	-11.6	-12.7	-15.6	-13.5	-12.3	-11.7
(excluding mining-related capital imports, in percent of GDP)	…	-11.2	0.1	-2.3	-5.1	-3.4	-2.4	-2.2
Overall balance	56.4	119.8	88.8	25.0	-10.4	17.7	25.9	29.5
Gross official reserves (end of period) 6/	146.0	265.8	364.6	389.5	379.0	395.0	417.5	442.6
(In months of next year's imports of GNFS)	3.2	5.1	6.5	6.4	5.8	5.7	5.6	5.5
(In months of next year's nonmining-related imports of GNFS)	4.2	6.0	7.6	7.5	6.8	6.5	6.4	6.3

Sources: Data provided by the authorities; and IMF staff estimates and projections.

1/ Incorporates the 2009 revised GDP estimates published by the National Statistics Office in June 2011.

2/ Includes changes in the stock of unpaid payment orders and unpresented checks and the statistical discrepancy.

3/ Nonmineral balance is defined as nonmineral revenue minus government-funded recurrent and development spending excluding interest payments.

4/ Noncommodity balance is defined as nonlogging nonmineral revenue minus government-funded recurrent and development spending excluding interest payments.

5/ Includes disbursement under an IMF-supported arrangement.

6/ Includes SDR allocations made by the IMF to the Solomon Islands in 2009 and actual and prospective disbursements under the IMF-supported arrangement.

Table 5. Solomon Islands: Summary Accounts of the Banking System, December 2008 - December 2012 1/

	2008	2009	2010	2011						2012			
	Dec.	Dec.	Dec.	Mar.	Jun.		Sep.	Dec.		Mar.	Jun.	Sep.	Dec.
			Est.	Est.	Prog.	Est.	Prog.	Proj.	Rev. Proj.		Proj.		
					(CR/11/180)		(CR/11/180)	(CR/11/180)					
	(In millions of Solomon Islands dollars, end of period)												
Central Bank of Solomon Islands (CBSI)													
Net foreign assets (NFA)	708	1,051	1,942	2,133	2,130	2,613	2,154	2,170	2,432	2,477	2,523	2,570	2,617
Net international reserves (NIR)	716	1,177	2,066	2,261	2,258	2,743	2,282	2,298	2,558	2,603	2,649	2,696	2,743
Other NFA	-9	-126	-124	-128	-128	-131	-128	-128	-126	-126	-126	-126	-126
Net domestic assets (NDA) 2/	-262	-328	-673	-767	-700	-1,199	-722	-725	-889	-870	-869	-875	-817
Net claims on central government	-52	-77	-361	-373	-331	-639	-353	-385	-507	-488	-486	-493	-485
Claims	138	124	117	118	117	111	117	117	117	117	118	118	115
Deposits	190	201	479	491	449	750	471	503	625	605	605	611	600
Other items (net)	-210	-250	-312	-394	-369	-560	-369	-340	-382	-382	-382	-382	-332
Reserve money	446	724	1,269	1,366	1,430	1,414	1,432	1,445	1,543	1,607	1,655	1,695	1,800
Currency in circulation	273	326	436	449	453	475	456	460	500	510	520	535	510
Bank deposits	166	389	822	908	974	928	972	982	1,040	1,094	1,132	1,157	1,287
Other deposits	7	9	11	10	3	12	3	3	3	3	3	3	3
Other depository corporations													
NFA of commercial banks	137	181	51	36	39	187	41	44	196	206	216	226	246
Assets	143	184	141	195	198	274	200	203	250	260	270	280	300
Liabilities	6	2	89	159	159	87	159	159	54	54	54	54	54
NDA of commercial banks	888	927	760	766	774	870	845	903	778	789	1,069	1,050	924
Net claims on central government	90	51	53	42	43	50	36	29	29	39	34	29	-112
Claims	116	125	121	119	111	118	104	96	96	106	101	96	-44
Deposits	26	74	68	76	68	67	68	68	68	68	68	68	68
Claims on the private sector	1,274	1,219	1,163	1,124	1,157	1,167	1,189	1,221	1,186	1,169	1,225	1,214	1,281
Other items (net)	-476	-343	-456	-401	-425	-347	-380	-346	-436	-419	-190	-193	-245
Reserves and vault cash	188	410	847	938	1,013	963	1,002	1,008	1,068	1,129	1,170	1,192	1,316
Deposits	1,213	1,519	1,658	1,740	1,826	2,019	1,889	1,955	2,042	2,124	2,455	2,468	2,486
Depository corporations survey													
NFA of the banking system	845	1,233	1,994	2,170	2,169	2,799	2,195	2,214	2,628	2,683	2,739	2,796	2,863
Central bank	708	1,051	1,942	2,133	2,130	2,613	2,154	2,170	2,432	2,477	2,523	2,570	2,617
Other depository corporations	137	181	51	36	39	187	41	44	196	206	216	226	246
NDA of the banking system	625	600	87	-1	74	-329	122	178	-111	-81	201	175	107
Net claims on central government	38	-26	-308	-331	-288	-589	-317	-357	-478	-449	-453	-464	-596
Claims on the private sector 3/	1,278	1,224	1,166	1,128	1,160	1,171	1,193	1,225	1,190	1,173	1,230	1,218	1,285
Other items (net)	-690	-598	-772	-798	-798	-911	-753	-690	-822	-806	-576	-579	-582
Broad money (M3)	1,470	1,833	2,080	2,168	2,243	2,470	2,318	2,392	2,517	2,602	2,940	2,971	2,970
M1	898	1,130	1,310	1,494	1,412	1,784	1,459	1,506	1,585	1,638	1,851	1,870	1,870
Currency outside banks	250	305	412	418	414	439	426	434	472	475	481	500	481
Demand deposits	648	824	898	1,075	998	1,344	1,033	1,072	1,113	1,162	1,369	1,370	1,388
Savings and time deposits	572	703	771	675	831	687	859	886	933	964	1,089	1,101	1,101
	(Annual percentage change, unless otherwise indicated)												
Reserve money	-2.3	62.5	75.3	73.7	54.3	52.6	26.3	13.9	21.6	17.7	17.0	16.4	16.7
Credit to the private sector	26.5	-4.2	-4.7	-8.0	-4.9	-4.0	6.7	5.0	2.0	4.0	5.0	6.0	8.0
Broad money	6.9	24.7	13.5	16.7	17.2	29.1	18.1	15.0	21.0	20.0	19.0	18.0	18.0
NFA of the banking system 4/	-9.1	26.4	41.5	47.9	39.3	72.3	30.6	10.6	30.5	23.7	-2.4	-1.1	9.3
NDA of the banking system 4/	16.0	-1.7	-28.0	-31.2	-22.2	-43.2	-12.5	4.4	-9.5	-3.7	21.4	19.1	8.7
Memorandum items:													
Money multiplier	3.3	2.5	1.6	1.6	1.6	1.7	1.6	1.7	1.6	1.6	1.8	1.8	1.6
Loan to deposit ratio (in percent)	105.0	80.3	70.1	64.6	63.3	57.8	62.9	62.4	58.1	55.1	49.9	49.2	51.5
Interest rates (percent per annum)													
Deposit rate 5/	2.0	2.7	2.6	2.4	…	3.8	…	…	…	…	…	…	…
Lending rate 5/	17.0	15.4	13.5	13.5	…	14.3	…	…	…	…	…	…	…
91-Day Treasury Bill Rate	4.0	4.0	2.9	2.9	…	3.0	….	…	….	…	…	…	…
Program targets													
NIR of CBSI (in US$ millions)	90	146	256	280	280	340	283	…	345	351	357	364	370
NDA of CBSI (in SI$ millions)	-262	-328	-673	-767	-700	-1199	-722	…	-767	-870	-869	-875	-817

Sources: Data provided by the Central Bank of the Solomon Islands; and IMF staff estimates and projections.

1/ Based on the program exchange rate of SI$8.06 per US$.

2/ The end-2009 estimates and 2010-11 revised program projections incorporate the changes in the measurement of reserve money following the recommendations of the IMF Safeguards Assessment.

3/ Includes claims of the CBSI on other (nonbank) financial corporations.

4/ Contribution to year-on-year broad money growth, in percentage points.

5/ Weighted average of different maturities.

Table 6. Solomon Islands: Reviews and Disbursement Under the Fund Arrangement

Date	Amount of Disbursement		Condition
	In percent of quota	In SDR	
Reviews and Disbursement Under the Current Standby Credit Facility			
June 2, 2010	30	3,120,000	Approved Fund arrangement
November 17, 2010	30	3,120,000	Completion of the first review and observance of end-June 2010 performance criteria
June 29, 2011	30	3,120,000	Completion of the second review and observance of end-December 2010 performance criteria
November 15, 2011	30	3,120,000	Completion of the third review and observance of end-June 2011 performance criteria
Total	120	12,480,000	
Reviews and Disbursement Under the Successor Precautionary Standby Credit Facility 1/			
November 23, 2011 2/	17	1,733,333	Approved Fund arrangement
May 15, 2012	17	1,733,333	Completion of the first review and observance of end-December 2011 performance criteria
November 15, 2012	17	1,733,334	Completion of the second review and observance of end-June 2012 performance criteria
Total	50	5,200,000	

Source: IMF.

1/ Reflects the schedule if the credits are disbursed, although the baseline framework assumes no disbursement.
2/ The Board discussion on the successor arrangement is scheduled for November 23, 2011, but a draft proposed decision approving the new arrangement will be circulated to the Board for adoption after the current arrangement expires upon the making of the fourth and last disbursement thereunder.

Table 7. Solomon Islands: Indicators of Capacity to Repay the Fund, 2010-21

	2010 Est.	2011	2012	2013	2014	2015	2016 Proj.	2017	2018	2019	2020	2021
Fund obligations based on existing credit (in SDR millions)												
Principal	0.0	0.0	0.0	0.0	1.0	1.7	2.1	2.1	1.7	0.7	0.0	0.0
Charges and interest	0.0	0.0	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Fund obligations based on existing and prospective credit (in SDR millions) 1/												
Principal	0.0	0.0	0.0	0.0	1.0	2.3	3.7	3.9	3.6	2.5	0.6	0.0
Charges and interest	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Total obligations based on existing and prospective credit												
In millions of SDRs	0.0	0.0	0.1	0.1	1.1	2.4	3.8	4.0	3.6	2.6	0.6	0.0
In millions of US$	0.0	0.0	0.1	0.1	1.8	3.7	6.0	6.3	5.7	4.0	0.9	0.0
In percent of gross international reserves	0.0	0.0	0.0	0.0	0.5	0.9	1.4	1.3	1.1	0.7	0.2	0.0
In percent of exports of goods and services	0.0	0.0	0.0	0.0	0.3	0.6	0.9	0.9	0.7	0.5	0.1	0.0
In percent of debt service 2/	0.0	0.0	0.8	0.9	10.0	18.0	28.2	30.3	28.0	20.1	4.6	0.0
In percent of GDP	0.0	0.0	0.0	0.0	0.2	0.3	0.5	0.5	0.4	0.3	0.1	0.0
In percent of quota	0.0	0.0	0.8	0.9	10.9	22.6	36.6	38.3	34.7	24.5	5.6	0.0
Outstanding Fund credit												
In millions of SDRs	6.2	14.2	17.7	17.7	16.6	14.4	10.6	6.7	3.1	0.6	0.0	0.0
In millions of US$	9.6	22.7	28.1	28.1	26.4	22.8	16.8	10.6	4.9	0.9	0.0	0.0
In percent of gross international reserves	3.6	6.2	7.2	7.4	6.7	5.5	3.8	2.2	1.0	0.2	0.0	0.0
In percent of exports of goods and services	2.9	4.3	4.7	4.7	4.4	3.5	2.4	1.4	0.6	0.1	0.0	0.0
In percent of debt service 2/	61.5	133.0	176.6	175.1	147.1	110.2	78.7	51.0	24.2	4.6	0.0	0.0
In percent of GDP	1.4	2.7	2.9	2.7	2.4	2.0	1.4	0.8	0.4	0.1	0.0	0.0
In percent of quota	60.0	136.6	170.0	170.0	160.0	138.2	102.2	64.4	30.0	5.6	0.0	0.0
Net use of Fund credit (in SDR millions)												
Disbursements	6.2	8.0	3.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repayments and repurchases	0.0	0.0	0.1	0.1	1.1	2.4	3.8	4.0	3.6	2.6	0.6	0.0
Memorandum items:												
Exports of goods and services (in US$ millions)	333	524.3	596.8	594.2	605.8	647.8	692.4	733.5	777.7	821.7	807.4	794.7
Gross international reserves (in US$ millions)	266	364.6	389.5	379.0	395.0	417.5	442.6	479.5	518.7	556.4	580.2	582.8
Debt service (in US$ millions) 2/	15.6	17.1	15.9	16.0	17.9	20.7	21.4	20.8	20.4	20.1	19.9	19.8
Quota (in SDR millions)	10.4	10.4	10.4	10.4	10.4	10.4	10.4	10.4	10.4	10.4	10.4	10.4

Source: IMF staff estimates and projections.

1/ Prospective credit includes the 50 percent of quota (SDR 5.2 million) available under the successor precautionary Standby Credit Facility although the baseline framework assumes no disbursement.
2/ Total public debt service, including IMF repayments.

Annex 1. Solomon Islands: Millennium Development Goals

	1990	1995	2000	2005	2009
Goal 1: Eradicate extreme poverty and hunger					
Employment to population ratio, 15+, total (%)	67	67	66	65	65
Employment to population ratio, ages 15-24, total (%)	58	59	55	53	51
GDP per person employed (constant 1990 PPP $)	..	..	..	..	..
Income share held by lowest 20%	..	..	..	..	..
Malnutrition prevalence, weight for age (% of children under 5)	16	..	..	12	12
Poverty gap at $1.25 a day (PPP) (%)	..	..	..	..	..
Poverty headcount ratio at $1.25 a day (PPP) (% of population)	..	..	..	..	..
Vulnerable employment, total (% of total employment)	..	..	..	..	..
Goal 2: Achieve universal primary education					
Literacy rate, youth female (% of females ages 15-24)	..	..	80	..	..
Literacy rate, youth male (% of males ages 15-24)	..	..	90	..	..
Persistence to last grade of primary, total (% of cohort)	..	..	..	..	..
Primary completion rate, total (% of relevant age group)	61	70	..	..	..
Total enrollment, primary (% net)	..	..	..	75	81
Goal 3: Promote gender equality and empower women					
Proportion of seats held by women in national parliaments (%)	0	2	2	0	0
Ratio of female to male primary enrollment (%)	86	88	94	96	97
Ratio of female to male secondary enrollment (%)	64	66	79	84	84
Ratio of female to male tertiary enrollment (%)	..	..	..	..	..
Share of women employed in the nonagricultural sector (% of total nonagricultural employment)	..	..	30.8	..	..
Goal 4: Reduce child mortality					
Immunization, measles (% of children ages 12-23 months)	70	68	87	70	60
Mortality rate, infant (per 1,000 live births)	31	31	30	30	30
Mortality rate, under-5 (per 1,000)	38	38	37	36	36
Goal 5: Improve maternal health					
Adolescent fertility rate (births per 1,000 women ages 15-19)	..	..	57	47	39
Births attended by skilled health staff (% of total)	..	85	85	70	70
Contraceptive prevalence (% of women ages 15-49)	..	11	7	27	27
Maternal mortality ratio (modeled estimate, per 100,000 live births)	130	110	110	110	100
Pregnant women receiving prenatal care (%)	..	..	..	74	74
Unmet need for contraception (% of married women ages 15-49)	..	..	..	11	11
Goal 6: Combat HIV/AIDS, malaria, and other diseases					
Children with fever receiving antimalarial drugs (% of children under age 5 with fever)	..	..	..	19	19
Condom use, population ages 15-24, female (% of females ages 15-24)	..	..	..	..	..
Condom use, population ages 15-24, male (% of males ages 15-24)	..	..	..	..	..
Incidence of tuberculosis (per 100,000 people)	312	240	185	142	115
Prevalence of HIV, female (% ages 15-24)	..	..	..	..	..
Prevalence of HIV, male (% ages 15-24)	..	..	..	..	..
Prevalence of HIV, total (% of population ages 15-49)	..	..	..	..	..
Tuberculosis case detection rate (%, all forms)	39	40	39	59	61
Goal 7: Ensure environmental sustainability					
CO2 emissions (kg per PPP $ of GDP)	0	0	0	0	0
CO2 emissions (metric tons per capita)	1	0	0	0	0
Forest area (% of land area)	83.0	..	81.0	80.1	79.1
Improved sanitation facilities (% of population with access)	..	29	31	29	..
Improved water source (% of population with access)	..	69	70	69	..
Marine protected areas (% of territorial waters)	0	0	0	0	0
Net ODA received per capita (current US$)	146	132	164	419	394
Goal 8: Develop a global partnership for development					
Debt service (PPG and IMF only, % of exports, excluding workers' remittances)	11	1	3	5	3
Internet users (per 100 people)	0.0	0.0	0.5	0.8	1.9
Mobile cellular subscriptions (per 100 people)	0	0	0	1	6
Telephone lines (per 100 people)	1	2	2	2	2
Fertility rate, total (births per woman)	6	5	5	4	4
Other					
GNI per capita, Atlas method (current US$)	790	890	1,000	890	960
GNI, Atlas method (current US$) (billions)	0.3	0.3	0.4	0.4	0.5
Gross capital formation (% of GDP)	20.3	7.6	6.6	13.8	..
Life expectancy at birth, total (years)	57	60	62	65	67
Literacy rate, adult total (% of people ages 15 and above)	..	..	77	..	..
Population, total (million)	…	…	0.4	0.5	0.5
Trade (% of GDP)	94.7	94.8	62.7	88.7	80.5

Source: World Development Indicators
Figures in italics refer to periods other than those specified.

APPENDIX I–LETTER OF INTENT

Ref: RF457/5/5 November 4, 2011

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Ms. Lagarde

Solomon Islands has benefited from the implementation of the government's economic reform program supported by a Standby Credit Facility (SCF) arrangement approved in June 2010. Economic recovery has been stronger than expected, the fiscal and external positions have strengthened, and donors' support has been catalyzed.

Given the observance of all end-June 2011 quantitative targets by large margin and the progress in implementing the structural benchmarks, we request the completion of the third and final review under the SCF arrangement and the release of the corresponding disbursement of SDR3.12 million.

Looking ahead, while growth momentum is expected to remain strong, downside risks to global growth have increased. We remain committed to reforms aimed at strengthening our economic resilience and promoting strong, sustainable, and inclusive growth to help advance our poverty alleviation efforts with a continued engagement with the Fund. To move toward achieving these objectives and to preserve the reform momentum, we are requesting a successor arrangement. Given the strong reserve position and program performance, we would like to request a new precautionary 12-month Standby Credit Facility (SCF) for SDR5.2 million (equivalent of 50 percent quota). We believe that this successor arrangement would help lock in the progress made so far in strengthening macroeconomic performance and economic institutions. It would be a building block in implementing an ambitious medium-term structural reform agenda which could be supported by another Fund facility in the future.

The attached Memorandum of Economic and Financial Policies (MEFP) describes the Government's reform policies during 2011–12, which we believe will strengthen our macroeconomic management framework, preserve the strong external and fiscal positions, maintain a stable monetary condition, and strengthen the financial sector. In order to ensure strong implementation under the precautionary SCF, the program will be monitored through quantitative performance criteria and indicative targets, structural benchmarks, and semi-annual reviews (see MEFP Tables 1 and 2).

We intend to maintain a close policy dialogue with the Fund, and stand ready to take additional measures, as appropriate, to ensure the achievement of the government's macroeconomic objectives under the precautionary SCF. We will consult with the Fund in advance on the adoption of these measures or on any revisions to policies contained in the MEFP, in accordance with the Fund's policy on such consultation. Furthermore, we will provide the Fund with any information it may request on policy implementation, as necessary, to achieve program objectives. We also authorize the publication of this Letter of Intent and the attached MEFP.

Sincerely yours,

/s/	/s/
Hon. Gordon Darcy Lilo, MP	**Denton Rarawa**
Minister of Finance and Treasury	Governor
Ministry of Finance and Treasury	Central Bank of Solomon Islands

Attachments: Memorandum of Economic and Financial Policies and Technical Memorandum of Understanding

APPENDIX I—ATTACHMENT I

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

This memorandum sets forth economic and financial policies and objectives of the Government of Solomon Islands for the period 2011–12 under a requested precautionary Standby Credit Facility (SCF) arrangement with the IMF.

I. RECENT DEVELOPMENTS AND OUTLOOK

1. **Macroeconomic conditions have improved remarkably.** The strong implementation of the IMF program has helped restore economic and financial stability and triggered donor support. Activity rebounded from the global financial crisis by 7 percent in 2010 and is estimated to have grown by nearly 10 percent in 2011. Logging production has been stronger than expected and gold investment supported growth in the transport, telecommunication and construction sectors. Inflation increased to 8¾ percent (year-on-year) in August 2011, partly driven by commodity prices, but there are signs of moderation on a month-on-month basis, with inflation expected to recede to 6½ percent on average in 2011. The balance of payments position has also improved substantially with gross international reserves reaching US$355 million (around 6 months of imports of goods and services) in August 2011, from less than US$100 million in mid-2009.

2. **The near- and medium-term outlook is still favorable, but challenges remain.** An uncertain global environment poses downside risks in the near term, while vulnerability to climate change could take a toll on long-term economic prospects. In the near term, real GDP growth is projected to remain healthy at around 6 percent in 2012 with gold production taking over logging as the main driver of growth. Over the medium term, logging production is expected to decline, but gold production and agriculture should continue to support growth in the range of 4 percent. Headline inflation is likely to remain around 4½ percent in the medium term as commodity prices stabilize. The balance of payments position should also remain strong with gross international reserves above 4 months of imports. Assistance from development partners is also expected to continue to support growth in the medium term. The downside risks are mainly external due to the rapidly weakening global outlook that could hit commodity prices and demand as Solomon Islands remains highly vulnerable to commodity price volatility and external demand shocks. On the upside, the outlook for logging and mining may be stronger than expected should the Asian economies remain resilient to negative spillovers from the current global financial turmoil. Over the medium term, climate change could negatively affect incomes and food security in rural areas through an increase in water salinity, especially in the outer islands.

3. **The reform program under the SCF arrangement is on track**. The program targets for end-June 2011 were met with comfortable margins. Government cash balances reached more than SI$300 million at end-June, covering two months of recurrent spending, and the net international reserves stood at US$340 million. The targets for net credit to government and the central banks' net domestic assets were also met with comfortable margins. We have also implemented most of the benchmarks committed under the program (Tables 1 and 2).

4. **Further reforms are needed to ensure that Solomon Islands reduces its vulnerability to external shocks and remains on a sustainable growth path.** Building on the success of the current program, we are formulating a set of reform policies that can be supported by a successor arrangement with the Fund.

II. Program Policies

To increase resilience to shocks we will need to rebuild our policy buffers and implement growth-oriented structural reforms which would help boost investors' confidence and ensure sustainable and inclusive growth. To this end, our program will continue to focus on strengthening fiscal management framework, improving monetary operations, maintaining a strong foreign exchange position, and containing financial sector risks. The quantitative targets and structural policies underlying our program are summarized in Tables 1 and 2.

5. **Our policies are aimed at preserving stable macroeconomic conditions to help advance our poverty alleviation efforts**. Our macroeconomic objectives include achieving growth at 6 percent in 2012 and 4 percent in the medium term. We will also seek to maintain strong domestic and external balances by preserving adequate fiscal buffers, maintaining low inflation at 4–5 percent, and building a comfortable international reserves position at more than 4 months of imports. The policy framework under our program will also ensure adequate resources for health, education, and infrastructure, which are critical to support our poverty alleviation and growth objectives in the medium-term.

A. Fiscal Policies

6. **We remain committed to preserving a strong fiscal position while providing adequate resources for health, education, and infrastructure (including water sanitation).** The fiscal position has improved over the last year as a result of strong commodity revenues and better fiscal management. The buoyancy of tax collections, over-performance in the cash balance in 2010–11, and additional mining revenue would provide an opportunity to scale-up quality spending in 2012. However, we realize that revenue will continue to remain volatile due to its dependence on commodities. Thus, we will strike a balance between preserving strong fiscal buffers and refocusing on critical infrastructure and social priority expenditure, such as health and education. To achieve this goal, we will ensure that the 2011 supplemental budget and the 2012 budget are consistent with the following policies:

- To retain an adequate fiscal buffer, we will continue to maintain the cash balance at no less than 2 months of recurrent spending.

- To improve the composition of spending and ensure sustainable and inclusive growth, the 2012 budget will shift more resources toward the social sector (health and education) and infrastructure, including water sanitation. Thus, we will maintain spending on education and health at no less than 32 percent of government-funded recurrent budget, in line with our economic reform program and consistent with the Core Economic Working Group's recommendation, and make a larger contribution (SI$100 million in 2012) to the National

Transport Fund.[1] This will help make meaningful progress toward the achievement of the MDGs, which are out of reach under current policies and alleviate poverty. We will continue to restrain growth of non-essential recurrent spending. In particular, large wage/benefits increases and transfers to local constituencies will be resisted.

- To strengthen public financial management and better monitor priority spending, we will revise our budget presentation from input line items to functional/output items by September 2012, in time for the preparation of the 2013 budget (program benchmark). We will also seek assistance from development partners to strengthen procurement and internal audit processes to reduce leakages that affect public service delivery.

- Should commodity revenue surprise on the upside, or under-spending of the development budget materialize due to capacity constraints, we will build up government saving or retire external and/or domestic debt to create fiscal space for critical spending and deal with future shocks. If we decide to retire domestic debt, we will ensure that the injection of liquidity into the private sector does not lead to excessive demand pressure on the economy. We will closely coordinate cash flow projections and plans for debt repayments between Ministry of Finance and Treasury and the Central Bank of Solomon Islands.

- We will continue to boost domestic revenue by strengthening compliance, streamlining exemptions. In July we raised the export price of logs in three equal increases (for July–September 2011, October–December 2011, and January–March 2012) to reach the full market price starting on January 1, 2012, and we will continue to apply the full market price with quarterly adjustment. We will also submit to Parliament the amendments to tax legislations to strengthen exemption rules and clarify the role of exemption committee by end-2011 (program benchmark).

- To enhance public service delivery we will reduce operational and non-technical losses to ensure cost recovery and efficiency gains in the state-owned electricity and water enterprises with the assistance of development partners. In particular, we will resolve cross arrears between the water and the electricity companies and undertake tariff reform for water charges.

7. **Over the medium term, in view of the expected decline in logging revenue and development grants, our fiscal policies will focus on strengthening the management of natural resources and securing sufficient resources for development needs**. The National Development Strategy (NDS) launched in September 2011 will form the basis for a comprehensive poverty reduction and growth strategy over the next few years. The NDS is aimed at alleviating poverty and providing greater benefits and opportunity to improve the lives of all Solomon Islanders in a peaceful and stable society. This would be done by taking better care of the people by fulfilling social needs, improving the livelihood and the economic

[1] We are still working toward reconciling the data on spending on health and education. An indicative floor on this priority spending will be set during the first program review once the tracking mechanism is in place.

benefits, and providing enabling environment to achieve development objectives. Going forward, the strategy will also include costing and prioritization of projects, and will articulate further the linkages between spending, growth and poverty reduction. Measures to boost private sector development and improve access to credit would also ensure a more broad-based growth.

- To strengthen our medium term fiscal position, we will implement a multi-year budget framework by September 2012 in time for the 2013 budget. Casting budget decisions in a multi-year perspective will help design realistic fiscal plans in line with the objectives of the NDS. It will also help build consensus on the appropriate sequencing of development projects.

- To help anchor the fiscal plans over the medium term, we will shift toward targeting the non-commodity fiscal balance as opposed to the cash balance in 2014, as mining becomes a larger source of government revenue. This will insulate the budget from the volatility of commodity revenues, help smooth expenditure over the mining cycle, and ensure a long-term sustainable use of exhaustible resources.

- Implementing a new resource taxation regime will be critical for the country to benefit from its natural resource wealth. In this context, we will seek to obtain Cabinet approval by March 2012 of draft amendments to income tax, custom and excise tax, and goods tax legislations to implement a new mining taxation regime, in line with IMF technical assistance recommendations (program benchmark). Until this new tax regime is in place, we will refrain from approving new mining leases. At the same time, we will enforce the agreements currently in place with mining companies to ensure that the government receives its share of mining revenue.

- Reforms of the mining legislations should move in parallel to provide a predictable investment regime and a transparent regulatory framework to attract foreign investment. In this context, we have also endorsed the principles of the Extractive Industry Transparency Initiative (EITI) and will move toward the EITI participation.

- Adopting fiscal responsibility provisions would help strengthen the medium-term fiscal framework. We will continue to reform the Public Finance and Audit Act (PFAA) by seeking a Cabinet approval by September 2012 of the new PFAA that incorporates fiscal responsibility provisions, management and use of public funds, and management of public debt (program benchmark).

- Resuming concessional borrowing after completing the Honiara Club Agreement (HCA) review in areas where donor grants are less available but have high economic returns such as infrastructure projects would be key. The work on formulating a new debt management strategy, by incorporating the results of the IMF-World Bank Debt Sustainability Analysis, is now ongoing. We plan to finalize the new debt strategy by end-2011 and, together with the signatories of HCA, will complete the HCA review by end-April 2012 (program benchmark), paving the way for concessional borrowing to resume by mid-2012.

- Providing a reliable and a cost-efficient source of energy is critical for private sector development, including the mining sector. To exploit our hydro power potential we will secure financing to develop the Tina River power project with the assistance of the World Bank Group. To provide wider access to renewable energy and reduce reliance on volatile imported diesel, we will promote broader use of solar power.

B. Monetary, Exchange Rate, and Financial Sector Policies

8. **Monetary and exchange rate policies will continue to be geared toward maintaining price and external stability.** Given the comfortable level of foreign reserves, the Central Bank of Solomon Islands (CBSI) let the currency appreciate by 7 percent against the US dollar from March 2011 to August 2011 to mitigate the imported inflation pressure. As a result, inflation is on a downward trend. Yet, monetary conditions have remained accommodative over the past year as a result of the improved balance of payments position, but with no signs of pickup in private credit. In view of the high level of banks' excess reserves, the CBSI has enhanced the use of the central bank Bokolo and treasury bills recently (rising to SI$ 319 million since April 2011) to mop up liquidity. The CBSI will closely monitor credit developments and tighten monetary conditions using both direct and indirect monetary instruments should banks begin to expand credit aggressively. The current exchange rate regime has provided a strong nominal anchor. Exchange rate policy will continue to be managed in a flexible manner to buffer against external shocks.

9. **To strengthen the effectiveness of CBSI in the conduct of monetary policy and supervisory activities, we are amending the CBSI Act.** The process has taken longer than envisaged as we had to seek Cabinet approval of the drafting instructions (obtained in October 2011) for the amendments. Following consultations among stakeholders, we will seek Cabinet approval of the draft Act by end-March 2012 (revised program benchmark).

10. **We will continue our efforts to strengthen the financial sector and improve access to credit.** On-site examinations of all three major banks have now been completed and they have revealed a significant overstatement of capital due to the accounting treatment of Nostro balances. The CBSI has requested the banks to undertake urgent corrective actions and to ensure that all banks are above the minimum capital requirement by end-October 2011. To facilitate large project financing, the prudential guideline on the single borrower limits will be revised by end-2011, taking into consideration the constraints posed by the small size of the banking system and the predominance of three foreign banks. The Financial Institutions Act of 1990 will also be amended to reflect structural changes in the financial system and the latest international best practices. We will request IMF technical assistance for this purpose.

11. **Reforming the National Provident Fund (NPF) to improve its governance and investment performance would be essential to provide retirement income and maintain financial stability**. The drafting instructions to the amendments to the NPF Act (September 2011 benchmark) have taken more time than envisaged due to delays in the provision of external technical assistance and the need for wider consultations among stakeholders to strengthen ownership. In this regard, we plan to seek Cabinet approval of the drafting instructions by end-June 2012 (revised program benchmark). The drafting will be guided by

the approved policy paper on NPF reforms that strengthen governance structure to reduce political influence on investment decision and maximize returns to its members.

III. Other Structural Reforms to Support Private Sector Development

12. **Reforms to support private sector development are critical for inclusive growth.** We will streamline land title registration and transfer of ownership to ease access to credit and improve collateral recovery. To encourage financial access by small enterprises we will explore options to enhance the use of the small business finance scheme administrated by the CBSI and Secured Transactions Act. To achieve these objectives, we will build on the experience of other countries and tap on resources from our development partners.

13. **Solomon Islands is vulnerable to climate change**. An adaptation and migration strategy will need to be developed with the help of development partners to mitigate the adverse impact on the most vulnerable and to fund climate change-proof infrastructure.

IV. Other Issues

14. **Safeguards assessment.** We agree to ensure the completion of the Safeguards Assessment update by the time of first review of the successor precautionary SCF arrangement. The CBSI will provide Fund staff with all necessary information for the update.

15. **Statistics.** Progress has been made in strengthening the quality of national account statistics and fiscal and monetary data for program purposes. We will continue to improve the quality of macroeconomic data by devoting more resources to the national statistics office by hiring more staff.

Table 1. Solomon Islands: Quantitative Performance Criteria (PC) and Indicative Targets (IT) for the Current and Prospective Successor Arrangement

	3/31/2011			6/30/2011			9/30/2011	12/31/2011	3/31/2012	6/30/2012	9/30/2012
	IT (CR/10/359)	IT with adjustors	Est.	PC (CR/11/180)	PC with adjustors	Est.	IT (CR/11/180)	PC	IT	PC	IT
Performance criteria 1/											
Net international reserves (NIR) of the Central Bank of Solomon Islands (CBSI) (floor, end-of-period stock, in millions of U.S. dollars (US$)) 2/	206	197	277	280	284	340	283	345	351	357	364
Net domestic asset (NDA) of the CBSI (ceiling, end-of-period stock, in millions of Solomon Islands dollars (SI$)) 3/	-401	-332	-767	-700	-731	-1199	-722	-767	-870	-869	-875
Net credit to central government (NCG) (ceiling, cumulative change from the beginning of the year, in millions of SI$) 4/	31	100	-23	17	17	-288	-15	-58	27	19	4
New nonconcessional external debt maturing in more than one year, contracted or guaranteed by the public sector (ceiling, end-of-period stock since the beginning of the program, in millions of US$) 5/	0	0	0	0	0	0	0	0	0	0	0
New nonconcessional external debt maturing in one year or less, contracted or guaranteed by the public sector (ceiling, end-of-period stock since the beginning of the program, in millions of US$) 5/	0	0	0	0	0	0	0	0	0	0	0
Accumulation of new external payment arrears by the public sector (ceiling, end-of-period stock since the beginning of the program, in millions of SI$) 5/	0	0	0	0	0	0	0	0	0	0	0
Central government program cash balance (floor, cumulative change from the beginning of the year, in million of SI$) 4/	-33	-105	34	-30	-30	47	-8	…	…	…	…
Central government program cash balance (floor, end-of-period stock, in million of SI$) 4/	…	…	…	…	…	…	…	287	287	292	313
Memorandum items:											
Central government program cash balance (floor, end-of-period stock, in million of SI$) 4/	134	62	297	233	233	309	255	…	…	…	…
Budget support from bilateral and multilateral donors other than IMF (cumulative change from the beginning of the year, in millions of US$), program level.	11	…	2	21	…	25	39	50	14	30	44
Outstanding stock of Solomon Islands government (SIG) treasury bills, excluding restructured government bonds (end-of-period stock, in millions of SI$), program level.	40	…	38	40	…	40	40	40	60	60	60

1/ Evaluated at the program exchange rate.

2/ The adjustors are specified in the Technical Memorandum of Understanding (TMU) and include: the floor on NIR will be adjusted upward (downward) by the amount of budget support from bilateral and multilateral donors (excluding IMF) in excess (short) of the program level.

3/ The adjustors are specified in the TMU and include: the ceilings on NDA will be adjusted downward (upward) by the amount of budget support from bilateral and multilateral donors (excluding the IMF) in excess (short) of the program level. Following the recommendations of the IMF Safeguards Assessment, the program targets starting from end-December 2010 incorporate the recommended changes in the measurement of reserve money. Such changes, however, are not applied in measuring the September 2010 NDA outcome to make it consistent with the September 2010 IT, which was set before the changes were made.

4/ The adjustors are specified in the TMU and include: the floor on central government program cash balance will be adjusted downward and the ceiling on NCG will be adjusted upward by the stock amount of budget support from bilateral and multilateral donors (excluding the IMF) short of the program level; the floor on the program cash balance will be adjusted upward (downward) by the stock of government treasury bills, excluding restructured government bonds, in excess (short) of the program level.

5/ These performance criteria are applicable on a continuous basis.

Table 2. Solomon Islands: Structural Benchmarks

Actions	Macroeconomic criticality	Date	Status
Current Standby Credit Facility Arrangement			
Formulate a resource tax regime, consistent with IMF technical assistance (TA) recommendations.	To broaden the tax base and increase revenue transparency.	June 30, 2011	A policy paper outlining the new resource tax regime has been submitted to Cabinet, and approval was received in September (Met with delay).
Obtain Cabinet approval of a proposal to reform Public Finance and Audit Act and to incorporate fiscal responsibility provisions.	To strengthen budget management and ensure fiscal sustainability.	June 30, 2011	The proposal was submitted to Cabinet in June, and approval was received in July 2011 (Met with delay).
Publish the proposed amendments to the Public Finance and Audit Act including the draft fiscal responsibility provisions for public consultation.	To strengthen budget management and ensure fiscal sustainability.	September 30, 2011	Expected to be published in November 2011 (Expected to be met with delay).
Obtain Cabinet endorsement of the drafting instructions to revise the National Provident Fund (NPF) Act incorporating the reform plan.	To improve the long-term financial viability of the NPF and reduce fiscal risks.	September 30, 2011	In progress, but delayed due to capacity constraints. Technical assistance from donors is being sought and new completion date is set (Delayed, see below).
Publish the opinion rendered by the international audit firm on the Central Bank of Solomon Islands (CBSI) audit results and the IFRS-based financial statements, beginning with the 2010 financial statements.	To improve transparency of the CBSI.	June 30, 2011	The opinion is included in the 2010 CBSI Annual Report published in the CBSI website (Met).
Obtain Cabinet approval of draft amendment to the CBSI Act.	To strengthen the effectiveness of monetary policy.	September 30, 2011	In progress. The drafting instruction to amend the CBSI Act has been approved by the Cabinet in October, but the draft amendment is expected to be approved in March 2012 (Delayed, see below).
Publish finalized national income accounts for 2007-09.	To strengthen macroeconomic indicators.	June 30, 2011	The National Statistics Office (NSO) published the national account statistics in June 2011 (Met).
Successor Arrangement			
Submit to Parliament the amendments to the Customs and Excise and Income Tax Acts to strengthen exemption rules and clarify the role of exemption committee.	To promote fiscal transparency and enhance the efficiency of revenue collections.	December 31, 2011	
Obtain Cabinet approval of a draft amendment to income tax, customs and excise tax, and goods tax legislations related to the new mining tax regime in line with IMF TA recommendations.	To broaden the tax base and increase revenue transparency.	March 31, 2012	
Obtain Cabinet approval of draft amendment to the CBSI Act to strengthen the monetary policy and supervisory framework.	To strengthen the effectiveness of monetary policy.	March 31, 2012	
Complete the Honiara Club Agreement (HCA) review and reach agreements on amendments to the HCA.	To strengthen debt management and maintain public debt sustainability.	April 30, 2012	
Obtain Cabinet approval of the drafting instructions to revise the NPF Act incorporating the reform plan approved by the Cabinet to strengthen its governance structure and investment framework.	To improve the long-term financial viability of the NPF and reduce fiscal risks.	June 30, 2012	
Obtain Cabinet approval of the draft of new Public Finance and Audit Act that covers fiscal responsibility provisions, management and use of public funds, and management of public debt.	To strengthen budget management and ensure fiscal sustainability.	September 30, 2012	
Revise the budget presentation from input line items to functional/output line items.	To strengthen the quality and monitoring of government spending.	September 30, 2012	

APPENDIX I—ATTACHMENT II

SOLOMON ISLANDS: TECHNICAL MEMORANDUM OF UNDERSTANDING

1. The program will be monitored through quantitative performance criteria, indicative targets, structural benchmarks, and reviews. This memorandum sets out the definitions for quantitative performance criteria and indicative targets under which performance under the program will be assessed. Monitoring procedures and reporting requirements are also specified.

I. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATIVE TARGETS

2. Performance criteria for end-December 2011 and end-June 2012 and indicative targets for end-March 2012 have been established with respect to:

- Floors on the level of net international reserves (NIR) of the Central Bank of Solomon Islands (CBSI);
- Ceilings on the level of net domestic assets (NDA) of the CBSI;
- Ceilings on the level of net credit to the central government (NCG); and
- Floors on the central government cash balance.

3. Performance criteria applicable on a continuous basis have been established with respect to:

- Ceilings on the contracting and guaranteeing by the public sector of new medium- and long-term nonconcessional external debt;
- Ceilings on the contracting and guaranteeing by the public sector of new short-term nonconcessional external debt; and
- Ceilings on accumulation of new external payment arrears by the public sector.

II. INSTITUTIONAL DEFINITIONS

4. The central government includes all units of budgetary central government and extra budgetary funds.

5. Depository corporations (DCs) include the CBSI and other depository corporations (ODCs). ODCs include commercial banks, the Credit Corporation of Solomon Islands, and credit unions. Financial corporations include DCs and other financial corporations (OFCs). OFCs are the National Provident Fund (NPF), the Development Bank of Solomon Islands, and the Investment Corporation of Solomon Islands.

III. MONETARY AGGREGATES

6. **Valuation.** Foreign currency-denominated accounts will be valued in Solomon Islands dollar (SI$) at the program exchange rate of SI$7.42 per U.S. dollar, as of end-June 2011. Foreign currency accounts denominated in currencies other than the U.S. dollar and

monetary gold will first be valued in U.S. dollars at actual exchange rates and gold prices used by the CBSI, respectively, before they are converted to Solomon Islands dollars.

A. Reserve Money

7. Reserve money consists of currency issued by the CBSI (excluding CBSI holdings of currency) and all transferable deposits held at the CBSI.

B. Net International Reserves of the CBSI

8. A floor applies to the level of NIR of the CBSI. The floor on NIR will be adjusted upward (downward) by the amount of budget support from bilateral and multilateral donors (excluding IMF) in excess (short) of the programmed level.

9. NIR will be calculated as gross international reserves (GIR) less international reserve liabilities. For program monitoring purposes, the stock of foreign assets and foreign liabilities of the CBSI, as reported in Solomon Islands dollars, shall be valued at program exchange rate in U.S. dollars, as described on paragraph 6.

10. GIR of the CBSI are defined as the sum of:

- Foreign currency assets in convertible currencies held abroad and as vault cash that are under the direct and effective control of the CBSI and readily available for intervention in the foreign exchange market or the direct financing of balance of payments imbalances and are of investment grade or held with an investment-grade institution.
- The reserve position of Solomon Islands in the IMF;
- Holding of SDRs; and
- Monetary gold.

Excluded from the definition of GIR are:

- Foreign currency deposits of ODCs and OFCs held at the CBSI;
- Any foreign currency claims on residents, capital subscriptions in international institutions, and foreign currency assets in nonconvertible currencies, and;
- GIR that are in any way encumbered or pledged, including, but not limited to, reserve assets used as collateral or guarantee for third-party external liabilities.

11. International reserve liabilities of the CBSI are defined as the sum of:

- All outstanding liabilities of Solomon Islands to the IMF, excluding IMF SDR allocations; and
- Foreign currency liabilities in convertible currencies to nonresidents with an original maturity of up to and including one year.

C. Net Domestic Assets of the CBSI

12. A ceiling applies to the level of NDA of the CBSI. The ceiling on NDA will be adjusted downward (upward) by the amount of budget support from bilateral and multilateral donors (excluding IMF) in excess (short) of the programmed level.

13. NDA of the CBSI will be calculated as the difference between reserve money and the sum of NIR of the CBSI and other NFA of the CBSI. Any revisions to the historical stock of reserve money based on changes to the accounting treatment of the profit/loss account of the CBSI will be notified to the Fund immediately and used to adjust monetary aggregates by an equivalent amount, as deemed appropriate. Other NFA of the CBSI includes:

- Foreign assets related to holdings of foreign currency deposits, and securities not included in NIR of the CBSI, and loans, shares, financial derivatives, or accounts receivable with nonresidents; and other foreign assets that are not included in NIR of the CBSI, as defined in Section III. B; and

- Foreign liabilities related to IMF SDR allocations; deposits, securities, loans, financial derivatives, and other accounts payable with nonresidents; and other foreign liabilities that are not included in NIR of the CBSI, as defined in Section III. B.

D. Net Credit to the Central Government

14. A ceiling applies to the NCG measured cumulatively from the beginning of the year. The ceiling on NCG will be adjusted upward by the amount of budget support from bilateral and multilateral donors (excluding IMF) short of the programmed level.

15. NCG is defined as the sum of net claims of: (i) the CBSI, (ii) commercial banks and other ODCs, (iii) OFCs, (iv) insurance companies, (v) and government treasury bills held by the general public.

IV. FISCAL AGGREGATES

A. Cash Balance of the Central Government

16. A floor applies to the program cash balance of the central government. The floor on the program cash balance will be adjusted downward by the amount of budget support from bilateral and multilateral donors (excluding IMF) in short of the programmed level. The floor on the program cash balance will also be adjusted upward (downward) by the stock of government treasury bills, excluding restructured government bonds, in excess (short) of the program level of SI$40 million in 2011 and SI$60 million in 2012.

17. The program cash balance of the central government is defined as the gross cash balance minus the total amount of unpaid payment orders and unpresented checks.

18. The gross cash balance is defined as the sum of government deposits, which are not in any way encumbered or pledged as collateral or used as a guarantee against government incurred liabilities, in the following accounts:

- In CBSI: Solomon Islands Government (SIG) Revenue Account, SIG Funded Development Account, SIG Debt Servicing Account;
- In Australia New Zealand Bank: SIG Creditors Account; Payroll Imprest Account, and Airport Service Fees Account;
- In Bank of South Pacific: Provincial Revenue Holding Account, SIG Inland Revenue Account, Sub Treasury Gizo Account, and Sub Treasury Auki Account; and
- Donor funded budget support accounts that are created by and under control of the government.

V. External Debt

A. Medium- and Long-Term External Debt

19. A ceiling applies to the contracting and guaranteeing by the public sector of new nonconcessional borrowing with nonresidents with original maturities of more than one year. The ceiling applies to debt and commitments contracted or guaranteed for which value has not yet been received. This applies to private debt for which official guarantees have been extended and which, therefore, constitutes a contingent liability of the public sector. The public sector comprises the central government, the CBSI, nonfinancial public enterprises (i.e., enterprises in which the government owns more than 50 percent of the shares), and other official entities.

20. The definition of debt, for the purposes of the program, is set out in Point 9 of the Guidelines on Performance Criteria with Respect to External Debt in Fund Arrangement Executive Board Decision No. 6230-(79/140), as revised on August 31, 2009 (see Annex I).

21. Excluded from the ceiling are (i) the use of Fund resources; (ii) lending from the World Bank and the Asian Development Bank; (iii) debts incurred to restructure, refinance, or prepay existing debts, to the extent that such debt is incurred on more favorable terms than the existing debt and up to the amount of the actually restructured/refinanced/prepaid debt; (iv) concessional debts; (v) any SI$-denominated treasury bill and bond holdings and Bokolo bonds held by nonresidents.

22. For program purposes, the guarantee of a debt arises from any explicit legal obligation of the central government, the CBSI, nonfinancial public enterprises, or other official entities on behalf of the central government or the CBSI to service debt in the event of nonpayment by the main obligor (involving payments in cash or in kind).

23. For program purposes, a debt is concessional if it includes a grant element of at least 35 percent, calculated as follows: the grant element of a debt is the difference between the net present value (NPV) of debt and its nominal value, expressed as a percentage of the nominal value of the debt. The NPV of debt at the time of its contracting is calculated by discounting the future stream of payments of debt service due on this debt. The discount rates used for this purpose are the currency specific commercial interest reference rates (CIRRs), published by the Organization for Economic Cooperation Development (OECD). For debt with a maturity of at least 15 years, the 10-year-average CIRR will be used to calculate the

NPV of debt and, hence, its grant element. For debt with a maturity of less than 15 years, the 6-month average CIRR will be used. To both the 10-year and 6-month averages, the same margins for differing repayment periods as those used by the OECD would continue to be added (0.75 percent for repayment periods of less than 15 years, 1 percent for 15 to 19 years, 1.15 percent for 20 to 29 years, and 1.25 percent for 30 years or more).

B. Short-Term External Debt

24. A ceiling applies to the contracting and guaranteeing by the public sector of new nonconcessional borrowing with nonresidents with original maturities of up to and including one year. The ceiling applies to debt and commitments contracted or guaranteed for which value has not yet been received. This applies to private debt for which official guarantees have been extended and which, therefore, constitute a contingent liability of the public sector.

25. For program purposes, the definition of debt is set out in Point 9 of the Guidelines on Performance Criteria with Respect to External Debt in Fund Arrangement approved by the Executive Board Decision No. 6230-(79/140), as revised on August 31, 2009 (see Annex I).

26. Excluded from the ceiling are (i) debts classified as international reserve liabilities of the CBSI; (ii) debts incurred to restructure, refinance, or prepay existing debts, to the extent that such debt is incurred on more favorable terms than the existing debt and up to the amount of the actually restructured/refinanced/prepaid debt; (iii) SI$-denominated treasury bills and bonds and CBSI and Bokolo bills held by nonresidents; and (iv) normal import financing. A financing arrangement for imports is considered to be "normal" when the credit is self-liquidating.

VI. External Payment Arrears

27. A continuous performance criterion applies to the nonaccumulation of external payments arrears by the public sector, comprising the central government, the CBSI, nonfinancial public enterprises, and other official entities. External payments arrears consist of external debt-service obligations (principal and interest) that have not been paid at the time they are due, as specified in the contractual agreements.

VII. Data Provision

28. The data listed below will be provided for monitoring performance under the program based on data templates agreed with Fund staff. Under each section, reporting responsibilities are indicated in parentheses. Weekly data are requested for submission to Fund staff by the end of the following week. Monthly and quarterly data are requested for submission within six weeks of the end of the observation period. The authorities have committed to using the best available data, so that any subsequent data revisions will not lead to a breach of quantitative performance criteria or benchmarks. All revisions to data will be promptly reported to Fund staff.

A. Monetary Data (CBSI)

- On a weekly basis:
- Daily exchange rates, both buying and selling rates, of Solomon Islands dollar against the U.S. dollar, including the official, interbank, and parallel market exchange rates;
- Stock of NIR and sales and purchases by the CBSI in the foreign exchange markets;
- Stock of reserve money and its components; and
- Treasury bill auction reports.
- On a monthly basis:
- Financial corporations' survey, including the balance sheet of CBSI, the consolidated balance sheet of ODCs, and the consolidated balance sheet of OFCs;
- Liquid asset ratios and/or reserves requirement of the commercial banks;
- Interest rates, including average interbank rate, bank deposit rates, and bank lending rates;
- A detailed breakdown of NCG from the CBSI, commercial banks and other ODCs, and OFCs;
- Foreign exchange cash-flow of the CBSI, including donor disbursements; and
- Balances of each central government account specified in Section IV. A., as recorded or collected by the CBSI.

B. Fiscal Data (Ministry of Finance and Treasury (MoFT))

On a monthly basis:

- Consolidated accounts of the central government, including detailed data on:
- Revenue, including tax and nontax revenues, and recurrent and development grants included in the consolidated budget;
- Recurrent expenditure, including payroll, goods and services, and other recurrent outlays, including those funded by donor support;
- Other recurrent charges of the Ministry of Education and Ministry of Health, separating spending funded by donor support;
- Debt service payments, classified into amortization and interest payments on (i) domestic debt, (i) external debt, (iii) domestic arrears, and (iv) external arrears; and

- Development expenditure funded by (i) central government of Solomon Islands, and (ii) foreign grants and loans included in the consolidated budget.

- Detailed financing components of central government's accounts, classified into foreign and domestic sources.

- Foreign financing includes (i) disbursement and amortization of project and program loans, and (ii) changes in external debt arrears, classified into principal and interest arrears.

- Domestic financing includes (i) borrowing from and repayment to the CBSI, commercial banks and other ODCs, and OFCs; (ii) changes in deposits at the CBSI, commercial banks and other ODCs, and OFCs; and (iii) privatization receipts and changes in domestic debt arrears, classified into principal and interest arrears.

- Stock of domestic debt, including the outstanding balance of government securities, treasury bills, cash advances, and other debt instruments.

- Balances of each central government account specified in Section IV. A., as recorded by the MoFT.

- Stock of unpaid government payment orders and unpresented checks.

C. External Sector Data (CBSI and MoFT)

On a quarterly basis:

- New external debt obligations contracted and/or guaranteed by the government of Solomon Islands, CBSI, and other official entities, including details on the amounts, terms, and conditions of each obligation.

- Stock of outstanding external debt at end-month and disbursement, amortization, and interest payments for short-term external obligations contracted or guaranteed by the government or the CBSI by creditor in original currency and U.S. dollars.

- Stock of external debt at end-month and disbursement, amortization, and interest payments for medium- and long-term external obligations contracted or guaranteed by the government or the CBSI by creditor in original currency and U.S. dollars.

- Stock of arrears on the external debt contracted or guaranteed by the government or the CBSI by creditor in original currency and in U.S. dollars at end-month.

- On a quarterly basis:

- Balance of payment data, including detailed components of current accounts and capital and financial accounts.

D. Real Sector Data (MoFT, National Statistical Office)

On a monthly basis:

- The monthly consumer price index and a detailed breakdown by major categories of goods and services included in the consumer basket.

Annex I. Guidelines on Performance Criteria with Respect to Foreign Debt
Excerpt from Executive Board Decision No. 6230-(79/140), as revised on August 31, 2009

9. (a) For the purpose of this guideline, the term “debt” will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows:

(i) loans, i.e., advances of money to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers’ credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements);

(ii) suppliers’ credits, i.e., contracts where the supplier permits the obligor to defer payments until sometime after the date on which the goods are delivered or services are provided; and

(iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property.

(b) Under the definition of debt set out in point 9 (a) above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.

INTERNATIONAL MONETARY FUND

SOLOMON ISLANDS

Staff Report for the 2011 Article IV Consultation, Third Review Under the Standby Credit Facility, and Request for Arrangement Under the Standby Credit Facility—Informational Annex

Prepared by the Asia and Pacific Department

November 8, 2011

Contents Page

ANNEX I. SOLOMON ISLANDS—FUND RELATIONS

(As of September 30, 2011)

I. Membership Status: Joined September 22, 1978; Article VIII

II. General Resources Account:

	SDR Million	Percent Quota
Quota	10.40	100.00
Fund holdings of currency	9.85	94.73
Reserve position in the Fund	0.55	5.29

III. SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	9.91	100.00
Holdings	9.26	93.43

IV. Outstanding Purchases and Loans:

	SDR Million	Percent Quota
SCF Arrangement	9.36	90.00

V. Latest Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
SCF	6/2/2010	12/1/2011	12.48	9.36
Stand-by	6/22/1983	6/21/1984	2.40	0.96

VI. Projected Payments to Fund:
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2011	2012	2013	2014	2015
Principal				1.04	1.73
Charges/Interest	0.00	0.05	0.05	0.05	0.04
Total	0.00	0.05	0.05	1.09	1.77

VII. Implementation of HIPC Initiative: Not applicable.

VIII. Implementation of MDRI Assistance: Not applicable.

IX. Implementation of PCDR: Not applicable

X. Exchange Rate Arrangements:

The de jure exchange rate arrangement is a conventional peg. The exchange rate of the Solomon Islands dollar is calculated on the basis of a basket of foreign currency but further managed by the Central Bank of the Solomon Islands (CBSI) through interventions on a daily basis to determine its value vis-à-vis the U.S. dollar. At the beginning of June 2008, the Solomon Islands dollar began to depreciate, leaving the peg, before stabilizing around a new level by end-March, 2009. Because there was no discernible pattern during this period, the de facto exchange rate arrangement was classified as other managed. From April 2009 through January 2011, the Solomon Islands dollar remained pegged to the U.S. dollar at SI$8.06 per U.S. dollar. Accordingly, the de facto exchange rate arrangement was reclassified retroactively to a conventional peg from other managed, effective April 1, 2009. Even though the method of exchange rate calculation has not changed, the currency composition and weights of the basket, determined on the basis of the volume and direction of the country's trade, have been updated, effective February 1, 2011. The exchange rate regime of pegging the Solomon Islands dollar to a basket of currency remains unchanged. After implementation of the updated basket in February 2011, the Solomon Islands dollar began to appreciate and move more freely against the U.S. dollar. Due to the increased flexibility, the de facto exchange rate arrangement has been reclassified to other managed from a conventional peg, effective February 1, 2011.

The CBSI determines the exchange rate of the Solomon Islands dollar against the U.S. dollar with a mandatory spread. The CBSI publishes for commercial banks the U.S. dollar/Solomon Islands dollar buying and selling rates and the mandatory spread limits. Under the Central Bank of the Solomon Islands Act, the CBSI may change the exchange rate arrangement only on written instructions from the minister of finance. Solomon Islands maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.

XI. Safeguards Assessment:

Under the Fund's safeguards assessment policy, the Central Bank of Solomon Islands is subject to a safeguards assessment with respect to the proposed Standby Credit Facility. An earlier safeguards assessment, concluded in October 2010, noted that annual financial statements prepared and audited in accordance with international standards have been timely published. However, a disjointed 2009 audit exercise led to a departure from international standards and highlighted capacity limits in the governance and audit areas. Formal reviews of monetary data are warranted and some operational controls require improvement.

XII. Last Article IV Consultation:

The 2009 Article IV Consultation discussions were held in Honiara during July 20–29, 2009. The staff report (IMF Country Report No. 09/309) was considered by the Executive Board and the consultation concluded on October 16, 2009.

XIII. Technical Assistance:

Date	Department	Purpose
January 2005	PFTAC	Financial reporting system
February 2005	PFTAC	Financial supervision of insurance
April 2005	PFTAC	Financial supervision
May, August, and October 2005; and February 2006	MFD	Financial supervision of insurance
May 2005	PFTAC	Tax policy and administration
August 2005	MFD	Reserve management
August 2005, February and April 2006	PFTAC	Statistics
September 2005 and February 2006	PFTAC	AML/CFT
October 2005	LEG	AML/CFT
November 2005 and July 2005	STA	Monetary and Financial Statistics
January 2006	PFTAC and LEG	Tax policy
April and June 2006	MFD	Central Bank Accounting
May, August, and October 2006 and January 2007	PFTAC	Public Financial Management and Accounting
October 2006	MCM	TA program monitoring
October 2006	MCM	Financial sector supervision
October 2006	MCM	Reserve Management
December 2006	PFTAC	Business Revenue Reform
February 2007	PFTAC	Balance of Payments Statistics
February and November 2007 and May 2008	PFTAC	National Income Accounts
March 2007 and March 2008	MCM	Accounting
February 2008-February 2009	STA	Peripatetic Export and Import Price Index Statistics
February-March 2008	PFTAC and FAD	Tax Policy
April 2008, February 2009	PFTAC	Balance of Payments Statistics
June 2008	LEG	Review of Central Bank Act
April 2008-April 2009	MCM	Peripatetic Advisor to CBSI
June 2008, September 2008, June 2009	MCM	Monetary Operations and Liquidity Management
July 2008	STA	Money and Banking Statistics
January 2009, April 2010, April 2011	STA	Monetary and Financial Statistics
April 2009	MCM	Insurance Supervision
June 2009	LEG	Insurance Sector Law
June 2009	MCM	Central Bank Law

April 2010	PFTAC	Balance of Payment Statistics
April 2010, May 2011	PFTAC	National Account Statistics
September 2010	PFTAC	Government Finance Statistics
June 2010, October 2010, March 2011	PFTAC	Financial Supervision
October 2010, March 2011	FAD, PFTAC	Natural Resource Tax Policy
October 2010, June 2011	MCM	Monetary Operation and Liquidity Management
July 2010, October 2010, January 2011	PFTAC	Public Financial Management
April 2011	FAD	Budget Law
April 2011	PFTAC	Macroeconomic advisor visit
April 2011	STA	GDDS Metadata Development
July 2011	PFTAC	Customs Administration
September 2011	LEG	Tax Legislations

XIV. Resident Representative:

The resident representative office for the Pacific Islands was opened in September 2010 in Suva, Fiji. Mr. Yongzheng Yang is the Resident Representative.

ANNEX II: SOLOMON ISLANDS—SUPPORT FROM THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTER[1]

Solomon Islands: PFTAC Country Strategy 2011–13

Background

Solomon Islands has recovered well from a precarious position during the global economic crisis. Growth has accelerated rapidly and international and fiscal reserves increased, mainly on the back of increased logging and mining, but also due to better fiscal management and increased international assistance. The medium-term reform agenda under the Core Economic Working Group emphasizes, amongst other things, strengthening of public financial management in particular with regard to the management of natural resource revenues.

Solomon Islands has been a moderate user of PFTAC TA. Despite the large international presence, mainly through RAMSI which caters for much of the technical assistance needs in the government, PFTAC has made specific technical contributions in particular with regard to the fiscal regime for natural resources. In the PFM area, PFTAC has also contributed to a World Bank-led PER and provided follow up support to a revision of accounting standards. Significant amounts of support have been provided to CBSI in formulating and implementing new prudential regulations for banks and also in developing a more robust inflation forecasting regime.

Strategy 2011–13

PFTAC's TA strategy is guided by the APD regional strategy note and is planned within the results framework for the current PFTAC funding cycle.[2]

The main focus of PFTAC TA will be on strengthening fiscal management, particularly with regard to natural resource management and solidifying the financial sector. In the Government area inputs will either be at the strategic/policy level or dealing with niche

[1] The Pacific Financial Technical Assistance Center in Suva, Fiji, is a regional technical assistance institution operated by the IMF with financial support of the Asian Development Bank, Australia, Japan, Korea, and New Zealand. The Center's aim is to build skills and institutional capacity for effective economic and financial management that can be sustained at the national level. Member countries are: Cook Islands, Federated States of Micronesia, Fiji, Kiribati, Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Timor Leste, Tokelau, Tonga, Tuvalu, and Vanuatu.

[2] See PFTAC program document, available at: www.pftac.org. The specific result in the framework that activities target is identified in italics in the section, for example cash management is referred to as (*1.6*), where 1.6 is the code in the result framework in the program document.

requirements where IMF/PFTAC has a comparative advantage. Support for implementation is expected to continue to come from other donors, in the context of RAMSI or its successor.

In the **Public Financial Management** area, following on from participation in the World Bank-led PER the main focus will be assisting the authorities conduct a follow-up PEFA assessment in early-2012.The assessment will lead to revised PFM reform priorities to be taken forward in the context of the CEWG. The process will guide the need for any PFTAC support to implementation, but priorities are likely to be follow-up on accounting reform and development of systems to appropriately manage natural resource revenues (including fiscal responsibility provisions).

In the **revenue** area, support to the implementation of the fiscal provisions for the mining sector designed with PFTAC TA will be financed by HQ-based trust funds. Solomon Islands has made significant progress in improving revenue administration—it recently was awarded one of two regional awards. The RAMSI TA that assisted in this is expected to continue to take the lead in supporting administration reforms. PFTAC will make resources available to support modernization on income tax legislation and VAT implementation should the authorities choose to pursue this.

In **statistics**, PFTAC has recently assisted the NSO enhance national accounts and balance of payments statistics. The main focus of follow up TA will be to complement inputs by RAMSI-funded advisors, with a particular focus on methodological improvements on the balance of payments. Support may also be available for expanding the range of aggregates available in the National Accounts. A review of the methodology and data sources for the CPI will be undertaken in early 2012.

In **financial sector supervision**, making use of PFTAC support, the CBSI has made great strides in improving its regulatory framework and on and off-site supervision. The skills and processes that have been built can now function effectively with a lower level of technical assistance-probably with one short review visit a year from the PFTAC advisor (at around the same time as an on-site exam). Additional support may be required if CBSI opt to implement the Reserve Bank of New Zealand information technology system to enhance supervision.

In the **macroeconomic** area, work will focus on building macroeconomic modeling and analysis capacity in CBSI with the aim of having better inflation and external forecasts to feed into monetary policy making. Work on developing fiscal forecasts, including for the natural resource sector will continue with the Ministry of Finance, including inputs into their financial programming framework.

ANNEX III: SOLOMON ISLANDS—RELATIONS WITH THE WORLD BANK GROUP

(As of October 2011)

1. The Bank and the Fund teams led by Mr. Vivek Suri (Lead Economist, World Bank Sydney Office) and Ms. Patrizia Tumbarello (IMF Mission Chief for Solomon Islands) maintain a regular dialogue on macroeconomic and structural issues. In recent years, collaborative efforts have focused on the joint Bank-Fund Debt Sustainability Analysis and regular discussions during missions and at headquarters. IMF missions regularly meet Bank staff in the World Bank Honiara office, led by Ms. Edith Bowles (World Bank Country Manager), and at headquarters. Bank staff joined the 2011 IMF Article IV discussions.

2. The teams agree that the key priorities for Solomon Islands include consolidating the recent improvement in the country's macro-fiscal framework in the face of ongoing volatility in external conditions, improving the quality of public spending to ensure the public resources support the provision of basic social services, and ensuring state owned enterprises can sustainably provide public services.

3. The risks to the economy from slippages in domestic policy decisions or a deterioration in external conditions remain considerable. Ongoing efforts to strengthen Solomon Islands' economic management and reinforce protective buffers are to be supported. Some policy areas continue to present short-term challenges, particularly regarding the solvency and urgent maintenance needs of the main public utilities.

4. The Bank and Fund teams agree that the focus has shifted to the medium-term reform agenda. Priority issues include developing a more coordinated and prioritized approach to address the weaknesses in public financial management systems, developing new budget allocation baselines that better reflect actual spending patterns and bringing these closer to the priority of improving delivery of social services, and of strengthening the investment climate and improving mining regulation. The Bank agreed to take the lead in public expenditure management framework and structural reform issues and the Fund will continue to take the lead on macro issues.

5. The Banks and Fund teams agree to continue close collaboration, mainly with regular contact through the Bank's Honiara and Sydney offices, the IMF regional resident representative office in Suva, and at headquarters. The Fund will also continue to collaborate with the government-donor Core Economic Working Group convened regularly in Honiara by the Ministry of Finance and Treasury with World Bank support. Appendix I provides a list of planned activities in the coming year.

Appendix I. Solomon Islands: Bank and Fund Planned Activities, October 2011–September 2012

	Activities	Expected Delivery Date
World Bank	• Line Ministry Public Expenditure Analyses (analytic and TA) • Support for review and revision of mining sector regulatory and institutional framework (TA) • Advisory and analytical support to the Solomon Islands Statistics Office for the 2012 HIES • Supporting Solomon Islands EITI candidature (TA) • Urban land management (TA) • Health sector PER (analytic)	FY 12 FY12 (ongoing) FY 12 (tentative) FY 12 (ongoing) FY 12 FY 12 (tentative)
IMF	• Technical assistance on developing and implementing new resource tax regime and amending relevant tax legislations • Technical assistance on strengthening monetary operations, foreign exchange management, banking supervision, and review of Financial Institution Act. • Technical assistance on public finance management, including assistance with developing a medium-term budget framework and with developing a new public finance and audit act. • Technical assistance on General Data Dissemination System (GDDS), national accounts, price, balance of payment statistics. • Technical assistance on building capacity for inflation forecasting • 2011 Article IV Consultation (including Debt Sustainability Analysis), Third Review of the SCF-supported program and Request for a Precautionary SCF-supported Program. • First Review of the Precautionary SCF-supported program	2010-11 2011-12 2011- 12 2011-12 2011 September-October 2011 April 2012

ANNEX IV: SOLOMON ISLANDS—RELATIONS WITH THE ASIAN DEVELOPMENT BANK

(As of October 2011)

Since joining the Asian Development Bank (AsDB) in 1973, Solomon Islands has received 16 loans amounting to US$79.3 million, six grants amounting to US$51.3 million and 65 technical assistance (TA) projects amounting to US$20.55 million. Including cofinanced amounts, AsDB's ongoing program in Solomon Islands totals $96.1 million. Solomon Islands is eligible for Asian Development Fund (ADF) grants available to countries that are very poor, heavily indebted, or in a post-conflict situation. The AsDB approved ADF grants of US$15.0 million and US$17.0 million in 2009 and 2010, respectively. The 2009–10 ADF allocations for Solomon Islands succeeded in catalyzing substantial grant cofinancing from the governments of Australia and New Zealand, the European Commission, and the Regional Assistance Mission to Solomon Islands (RAMSI).

The AsDB's country assistance strategy seeks to reduce poverty by promoting equitable private-sector-led economic growth through improved transportation infrastructure and services and a stronger business-enabling environment.[1] A new Country Partnership Strategy (2011–15) is being prepared for approval in February 2012. Capacity development and the promotion of good governance are guiding priorities. In light of the global economic turbulences, the AsDB is adjusting its operations to support the government in terms of mitigating the impacts, currently through analytical support and adjustments in the design and delivery of investment projects to increase local content. In line with the improvements in its public debt situation, AsDB assistance is currently provided in a 45:55 ratio mix of grants and concessionary loans, effective 1 January 2011. The government is currently developing the new debt strategy and reviewing the Honiara Club Agreement, aiming to facilitate better access to external borrowing to support much needed infrastructure development.

In transport infrastructure, the AsDB supports the institutional strengthening of the Ministry of Infrastructure Development. Investment projects, all grant funded, include a second Solomon Islands Road Improvement Project (approved in 2009) that is rehabilitating roads and bridges; and a Transport Sector Development Project (approved in 2010). Building on the progress made in earlier transport projects, TSDP has set the stage for a comprehensive transport sector-based approach by implementing and building project management capacities and improving government systems, including procurement and safeguards. The TSDP presents an important step in harmonization and alignment has been the passage, with AsDB assistance, of the National Transport Fund Act in 2009.

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[1] The Interim Country Partnership Strategy 2009–11 can be found at <http://www.adb.org/documents/CPSs/SOL/CPS-SOL-2009-2011.pdf>, and the Country Operations Business Plan 2012-2014 at <http://www.adb.org/Documents/CPSs/SOL/2012-2014/cobp-sol-2012-2014.pdf>.

Following the 2009 global economic crisis, AsDB provided support for an Economic Recovery Support Program (ERSP)[2] in 2010, with the first and second subprogram grants of $5 million each released in April 2010 and September 2011, respectively. The formulation and implementation of the ERSP has been carried out through a joint government-development partner Core Economic Working Group (CEWG) mechanism.[3] The ERSP supported reforms aimed at strengthening fiscal management, restoring macroeconomic and fiscal stability to aid economic recovery, enhancing structural reforms, ensuring that the budget accords priority to vulnerable groups, and public consultation. Structural reforms include long-standing areas of ADB business environment support such as improved SOE oversight, telecommunications deregulation, enactment of the Companies Act and an electronic Companies Registry, a Secured Transactions Act and establishment of the Secured Transactions Registry, submission of the national transport fund regulations.

The AsDB's Pacific Liaison and Coordination Office in Sydney is responsible for country programming, project implementation, and administration, supported by the Pacific Operations Division in Manila.

Solomon Islands: Loans, Approvals, and Disbursements, 2000–10
(In millions of U.S. dollars)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Loan approvals	10.00	--	--	--	--	--	--	--	--	--	--
Loan disbursements	0.00	0.00	0.00	0.00	0.89	2.76	4.09	3.75	0.073	--	--
Cumulative loan amount approved (as of end-of-year)	79.31	79.31	79.31	79.31	79.31	79.31	79.31	79.31	79.31	79.31	79.31
Cumulative net effective loans (as of end-of-year)	54.30	64.05	64.83	65.87	66.31	79.31	79.31	79.31	79.31	79.31	79.31
Cumulative disbursements (as of end-of-year)	54.07	54.07	54.07	54.30	55.16	57.91	62.00	65.75	65.82	65.82	65.82

Contact person: Eugenue Zhukov, Regional Director, Pacific Liaison and Cooperation Office, AsDB Sydney (ezhukov@adb.org).

[2] ADB. 2010. *Report and Recommendation of the President to the Board of Directors on a Proposed Program Cluster and Grant for Subprogram 1, Solomon Islands: Economic Recovery Support Program.* Manila (Grant 197-SOL).
[3] CEWG development partners include ADB, Australia, the European Union, New Zealand, the Regional Assistance Mission to Solomon Islands, and the World Bank.

ANNEX V. SOLOMON ISLANDS—STATISTICAL ISSUES

(As of October 2011)

I. Assessment of Data Adequacy for Surveillance	
General: Data provision has some shortcomings, but is broadly adequate for surveillance.	
National Accounts: Recent technical assistance (TA) from the Pacific Financial Technical Assistance Center has led to improvements in constant and current price GDP estimates. Revised estimates for 2009-2005 incorporating the results of the 2009 Census have been published by the National Statistics Office. While limited data on employment can be obtained from the National Provident Fund, wage data are not compiled.	
Price statistics: A monthly consumer price index (CPI) is produced with a short lag (about a month), but covers only the capital Honiara. The weights of this index were revised in 2007, based on the results of the 2005–06 *Household Income and Expenditure Survey*. The authorities plan to compile a nationwide CPI, and have already compiled a list of goods to be contained in the basket. However, the timing of actual compilation is unclear due to lack of funds. TA has been provided on the development of an import price index but, due to resource constraints, there has been little progress in implementation.	
Government finance statistics: Monthly fiscal data for the central government are published by the Ministry of Finance and Treasury (MOFT). The authorities have started collecting disbursement information on donors' grants, including those nonappropriated in the budget. Monthly public debt data are published, and the quality debt data has improved through better coordination between the MOFT and the Central Bank of Solomon Islands (CBSI).	
Monetary and financial statistics: The CBSI publishes monthly monetary and financial statistics (MFS) in summary form and reports to the IMF's Statistics Department using the standardized report forms (SRFs).	
External Sector Statistics: The CBSI has been compiling quarterly balance of payment statistics (BPS) using its own survey since 2006. Compared to the previous method, which was based on foreign exchange transactions reported through the banking system, the newly compiled BPS has improved both coverage and data accuracy. However, these quarterly data have not yet been reported to the IMF's Statistics Department.	
II. Data Standards and Quality	
Solomon Islands has participated in the General Data Dissemination System (GDDS) starting in 2011.	No data ROSC available.
III. Reporting to STA (Optional)	
No fiscal data are currently reported to STA for publication in the *Government Finance Statistics Yearbook* or in the *International Finance Statistics.*	

Solomon Islands: Table of Common Indicators Required for Surveillance
(As of October 2011)

	Date of latest observation	Date received	Frequency of Data/7	Frequency of Reporting/7	Frequency of Publication/7
Exchange Rates	10/24/11	10/31/11	D	W	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities/1	08/31/11	10/15/11	M	M	M
Reserve/Base Money	08/31/11	10/15/11	M	M	M
Broad Money	08/31/11	10/15/11	M	M	M
Central Bank Balance Sheet	08/31/11	10/15/11	M	M	M
Consolidated Balance Sheet of the Banking System	08/31/11	10/15/11	M	M	M
Interest Rates/2	08/31/11	10/15/11	M	M	M
Consumer Price Index	08/31/11	10/15/11	M	M	M
Revenue, Expenditure, Balance and Composition of Financing/3 – General Government/4	NA	NA	NA	NA	NA
Revenue, Expenditure, Balance and Composition of Financing/3– Central Government	08/31/11	10/15/11	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt/5	08/31/11	10/15/11	M	M	M
External Current Account Balance	06/30/11	09/30/11	Q	Q	Q
Exports and Imports of Goods and Services	08/31/11	10/15/11	M	M	Q
GDP/GNP	12/31/09	06/30/11	A	A	A
Gross External Debt	06/30/11	09/30/11	Q	Q	Q
International Investment Position/6	06/30/11	09/30/11	Q	Q	Q

1/ Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
2/ Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
3/ Foreign, domestic bank, and domestic nonbank financing.
4/ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
5/ Including currency and maturity composition.
6/ Includes external gross financial asset and liability positions vis-à-vis nonresidents.
7/ Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

ANNEX VI. SOLOMON ISLANDS—MAIN WEBSITES OF DATA

Central Bank of Solomon Islands (www.cbsi.com.sb)

Central bank survey
Depository corporation survey
Financial corporation survey
Monetary aggregates
Treasury bills and Bokolo bills
Exchange rates
Interest rates
Balance of payments
Government budget accounts
Public domestic and external debt
Export and imports

Ministry of Finance (www.mof.gov.sb) and National Statistics Office (www.spc.int/prism/country/sb/stats/Index.htm)

Budget documents
Medium-term fiscal strategy
Central government revenue and expenditure
National accounts
Public domestic and external debt
Consumer price statistics
Exports and imports
Population and housing census

INTERNATIONAL MONETARY FUND

SOLOMON ISLANDS

Joint IMF/World Bank Debt Sustainability Analysis 2011[1]

Prepared by the Staff of the International Monetary Fund and the World Bank
Approved by Hoe Ee Khor and Dominique Desruelle (IMF)
and Jeffrey Lewis and Ahmad Ahsan (World Bank)

November 8, 2011

Solomon Islands is at moderate risk of external debt distress according to this World Bank-IMF Low-Income Country (LIC) Debt Sustainability Analysis (DSA). The debt profile is sensitive to shocks to non-debt creating flows, export growth, and financing terms. Containing the risk of debt distress will require continued efforts to rebuild fiscal buffers, establish a multi-year budget framework to provide fiscal discipline, and implement structural reforms that are essential to promote broad-based growth.

I. Background

1. **Solomon Islands is a small commodity exporter heavily reliant on imports, foreign aid and FDI, and vulnerable to external shocks.** The export and production basis are narrow and include mainly logs, more recently gold, and a few agricultural products. As a result, the country is vulnerable to both external demand and commodity price volatility. The country also heavily relies on foreign aid and FDI to finance its structural trade deficit and large development needs.

2. **The economy was hit hard by the global economic crisis, but the 18-month Standby Credit Facility (SCF) Arrangement approved in June 2010 succeeded in stabilizing the economy and catalyzing donor support.** The fiscal position has improved substantially since then as a result of strong economic rebound and improvement in tax compliance and tax arrears collection. The government cash balance increased from almost zero in the first quarter of 2010 to about 2 months of recurrent spending by the second quarter of 2011.

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[1] This DSA was produced in consultation with the Asian Development Bank (AsDB). It is based on the common standard LIC DSA framework. Under the Country Policy and Institutional Assessment (CPIA), Solomon Islands is rated as a weak performer, and the DSA uses the indicative threshold indicators on the external public debt for countries in this category: 30 percent for the present value (PV) of debt-to-GDP ratio; 100 percent for the PV of debt-to-exports ratio; 200 percent for the PV of debt-to-revenue ratio; 15 percent for the debt service-to-exports ratio; and 25 percent for the debt service-to-revenue ratio. The fiscal year of Solomon Islands starts on January 1.

3. **Total public debt has declined from about 60 percent of GDP in 2005 to about 28 percent of GDP as of end-2010 under the framework of the Honiara Club Agreement (HCA).**[2][3] Domestic public debt, including the publicly guaranteed debt of the state-owned enterprises (SOEs) at around 1 percent of GDP, was about one third of total public debt as of end-2010, owed mainly to the banking sector (including the Central Bank of Solomon Islands) and the National Provident Fund. Total external debt has declined from about 50 percent of GDP in 2005 to about 32 percent of GDP as of end-2010, with public and publicly guaranteed (PPG) external debt accounting for about 20 percent of GDP (US$135 million).

4. **Looking forward, the challenge is to diversify the sources of growth away from logging given the projected decline of log production over the medium term.** Nevertheless, the country has a more favorable medium- and long-term outlook than envisaged in the DSA issued in September 2009 (Box 1). This reflects: (i) the success of the SCF that contributed to a healthy fiscal balance and triggered stronger aid inflows from the donor community; (ii) the new debt strategy currently being developed by the authorities in the context of the ongoing review of the HCA which should help regain access to external borrowing to finance much needed infrastructure development; and (iii) the production at the Gold Ridge mine expected to contribute to about 35 percent of export earnings on average in the next decade.

II. External and Public Debt Sustainability Analysis

A. External Debt Sustainability Analysis

5. **The external DSA indicates that Solomon Islands is at moderate risk of debt distress.** Under the baseline scenario (Table 1a), total external debt is projected to decline to around 25 percent in 2011 and further to below 23 percent next year, as foreign aid and FDI are expected to fully finance the trade and services deficit. However, the total external debt is projected to gradually increase starting 2014 reaching around 37 percent of GDP over the longer term. The increase in external debt over the medium term also reflects renewed access to external financing after completion of the review of HCA, compensating for the decline in foreign aid. Similarly, PPG external debt is projected to decline to 15 percent in 2011 and to moderately increase to around 30 percent of GDP over the longer term. Other key indicators of sustainability—the present value of PPG external debt, the ratio of PPG debt service to

[2] At the central government level only.

[3] External borrowing has been restricted since 2005 under the Honiara Club agreement (HCA) which was signed by the government and major creditors. Under this agreement, Solomon Islands cannot borrow from official external lenders until it receives a "green light" rating from the World Bank's International Development Association.

Box 1. Macroeconomic Assumptions under the Baseline Scenario

- **GDP growth and population**. The economy is expected to grow at 9.3 percent in 2011, driven by logging and gold production. In the medium term, growth is projected at 4 percent, as log production declines, consistent with the projection of the Ministry of Finance and Treasury (MOFT). Over the longer term, the growth would decline further to around 3½ percent, reflecting the negative impact of the scheduled closure of the Gold Ridge mine more than offsetting the positive impact of a more diversified export base. Population is projected to grow at around 2½ percent per year.
- **Logging and mining**. After peaking in 2011, log production is expected to decline by 20 percent each year until 2015 and remain stable afterwards. Consistent with the projection of the MOFT, gold production is projected at 55 thousand ounces in 2011, 105 thousand ounces in 2012, and 120 thousand ounces during 2013–19, and to gradually wind down by 2023.
- **Aid flows and FDI**. The amount of aid flows has increased remarkably in recent years, compared to those in the 2009 DSA, reflecting large grant disbursement catalyzed by the SCF-supported program and better recording of grant disbursement since 2009. After peaking in 2010 at 25 percent of GDP, aid flows are expected to remain around 20 percent of GDP over the medium term and decline gradually to their historical average of about 10 percent of GDP by 2031. This assumption reflects the gradual scaling-down of the operation at the Regional Assistance Mission to Solomon Islands (RAMSI). As the Gold Ridge mine is now operational and ready for full-scale production, FDI is projected to decline to 20 percent of GDP in 2011, from 35 percent of GDP in 2010, and further to around 10 percent over the medium term. It would stabilize at around 8 percent over the longer term, slightly lower than its historical average of 9 percent of GDP, reflecting the closure of the Gold Ridge mine more than offsetting the potential investment in new sectors.
- **New loan disbursements** are assumed to average about 2½ percent of GDP over the next 5 years. This amount includes lending on concessional terms from the World Bank and the AsDB, to finance infrastructure and transport projects. Over the longer term, concessional borrowing is projected to average around 3 percent of GDP per year.
- **The primary balance** is expected to average around 1½ percent of GDP over the medium term, driven by strong mining revenue. Over the longer term, however, it is expected to turn into deficit and stabilize at around 1 percent of GDP, because grants and mining revenue are projected to decline while additional external borrowing would partially substitute for previously grant-funded development expenditure. Revenue (exc. grants) is projected to be at around 35 percent of GDP over the medium and long term.
- **The non-interest current account deficit** is projected to be about 11 percent of GDP in 2011, and to worsen to around 15 percent of GDP in the next two years mainly reflecting the decline in log exports more than offsetting the increase in gold exports. It is likely stabilize at about 10 percent of GDP in the medium and long term with the decline in fuel imports—a major input of gold production—together with a more diversified exports base, roughly offsetting the decline in gold exports.

exports and the ratio of PPG debt service to revenue—all remain well below the indicative thresholds (Figure 1). [4]

6. **Sensitivity analysis suggests that the country's debt path is vulnerable to several shocks, in particular, to a shock to the net non-debt creating flows (Table 1b, and Figure 1).** A shock to non-debt creating flows is defined as a lower share of net current transfers and net FDI of GDP in 2012–13 at about one standard deviation less than the historical average.[5] Such a shock would keep the PV of PPG external debt to GDP ratio above the threshold for 19 years before starting to decline to below the threshold in 2031. PV of PPG external debt to exports would also temporarily breach the threshold during the years around the scheduled closure of the Gold Ridge mine. Debt services to revenue/exports ratios would jump around 2022–23 as the grace period of the marginal borrowing is 10 years.

7. **A shock to the nominal export growth and a permanent shock to financing terms would also lead to a breach of thresholds (Table 1b).**[6] Under the shock to the nominal export growth, the PV of PPG external debt to GDP ratio would be above the threshold during 2016–28. A permanent shock to financing terms is defined as a higher interest rate by 2 percentage points during 2011–31 than in the baseline. Such a shock would keep the PV of PPG external debt to GDP ratio above the threshold starting 2023.

B. Public Debt Sustainability Analysis

8. **Public debt analysis paints a similar picture.** In addition to the PPG external debt, public debt includes guaranteed loans for SOEs of about 1 percent of GDP as of end-2010, while it does not include the central government's contingent liabilities of about 1.5 percent of GDP. Under the baseline scenario (Table 2a), the PV of total public debt will further decline to around 15 percent of GDP in the medium term. Over the longer term, it is projected to increase to around 25 percent, driven by external borrowings after the completion of the review of HCA. Public debt sustainability is vulnerable to shocks as well. Under the most extreme stress test scenario—real GDP growth being one standard deviation

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[4] The large residuals in Tables 1a and 2a reflect the assumption that the large mineral revenue in the pipeline will be saved in a special fund to support health, education and infrastructure.

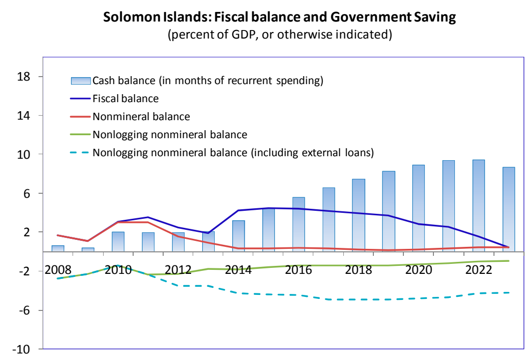
[5] The historical (10-year) averages of foreign aid and FDI are 11.7 and 8.7 percent of GDP, while the standard deviations of these flows are 9.9 and 11.7 percent of GDP. The template does not capture the decline in the imports that the shock may induce.

[6] A shock to nominal export growth is defined as a lower growth rate of export value in US dollar in 2012-2013 at about one standard deviation less than the historical average. The historical (10-year) average and standard deviation of growth of exports is 14.1 percent and 24.2 percent, implying a growth rate of -10 percent in 2012-13 under the stress test. In these two years, current account as a percent of GDP is lower than in the baseline because of lower exports. In 2014-31, current account as a percent of GDP is the same as in the baseline, as imports are adjusted to a permanently lower level.

temporarily lower in the next two years—the PV of debt reaches about 60 percent of GDP by 2021, and more than 90 percent of GDP by 2031 (Table 2b and Figure 2).

C. Fiscal Policy Going Forward: Anchoring The Non-Commodity Balance

9. **Over the medium and long term, it is important to target the non-commodity fiscal balance as opposed to the cash balance.** In the near term, it remains appropriate to target the cash balance as the mining revenue is small. However, over the next decade, mining revenue is about to pick up to an estimated average of around 5 percent of GDP, exposing the cash balance and the overall fiscal balance to the budget to a larger volatility of commodity revenues. Setting a target on the non-commodity balance can insulate the budget from such volatility.



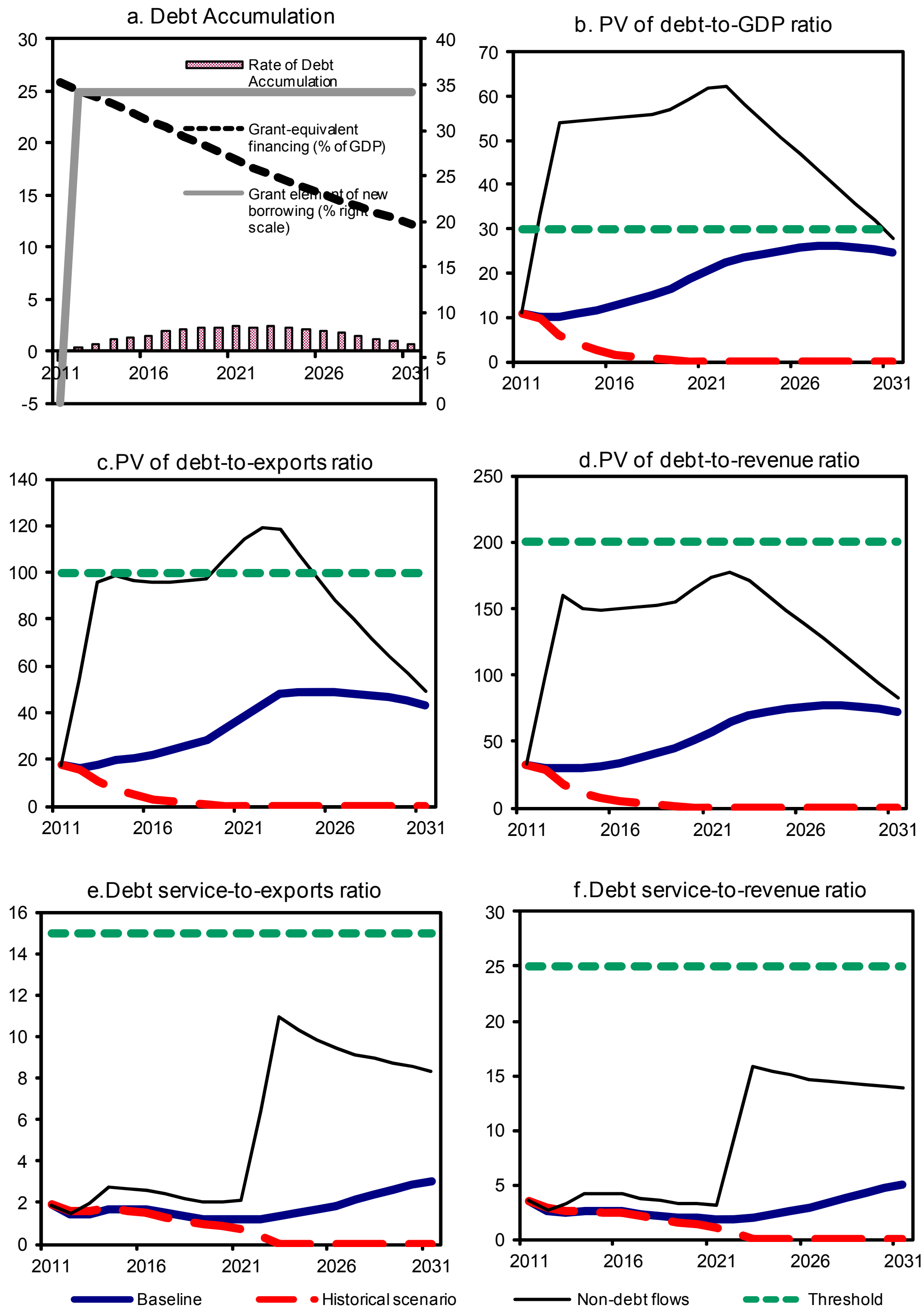
10. **Anchoring a non-commodity balance over the medium term has two advantages over targeting the cash balance.** It would smooth expenditure over the mining cycle, while targeting the overall balance/cash balance could lead to spending levels rising and falling in line with commodity revenue forecasts, regardless of cyclical or efficiency considerations and could spur inflationary pressures. Another advantage is that it may provide room for a fair use of commodity resources across generations.

III. Policy Implications and Conclusions

11. **Solomon Islands is at moderate risk of debt distress.** Maintaining public and external debt at sustainable levels requires actions on multiple fronts. First, continued efforts should be put on rebuilding the fiscal buffers and creating fiscal space, especially in light of the uncertainties surrounding the external environment. Second, the government should step up implementing the structural reforms (such as a new resource tax regime and new mining legislation) that would help maximize the spillovers from the commodity sector to non-commodity sectors, boost investors' confidence and ensure sustainable growth. These reforms would also help strengthen the prospect for exports, reducing the vulnerability to external shocks. Third, establishing a multi-year budget framework would help prioritize the areas that are essential to promote broad-based growth as well as provide fiscal discipline. Finally, structural reforms formulated under the National Development Strategy should be prioritized and implemented as they would help increase potential growth and maintain the debt sustainability over the long term.

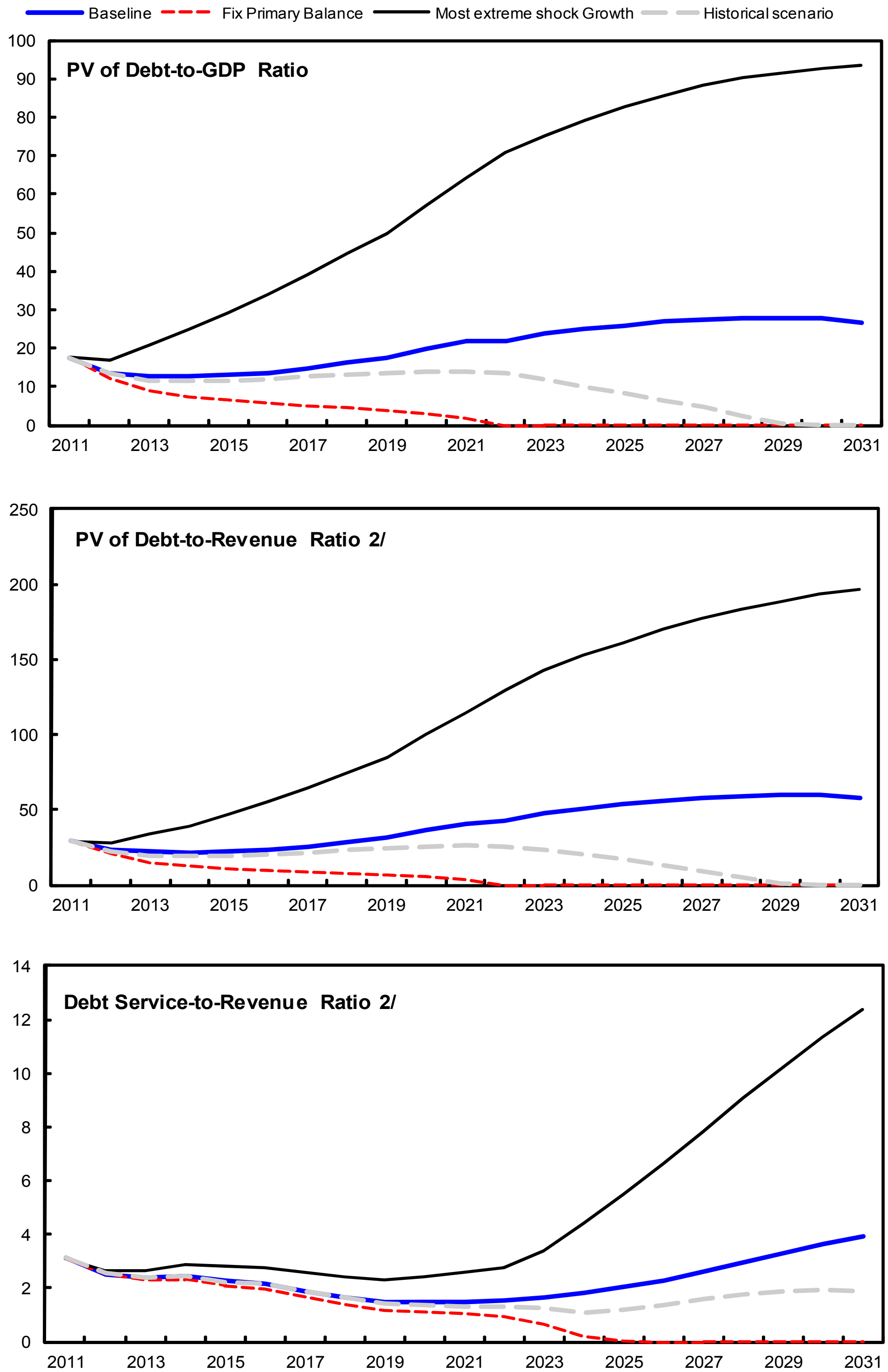
12. **The authorities have broadly agreed with the assessment**. They are fully committed to completing the review of the HCA and formulating a new debt strategy to resume access to external concessional financing. Supported by the precautionary SCF, they will also implement a new resource taxation regime to ensure that the government receives a fair share of mining revenue and they will reform the mining legislation to provide a predictable investment regime to attract foreign investment.

Figure 1. Solomon Islands: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2011-31



Sources: Country authorities; and staff estimates and projections.

Figure 2.Solomon Islands: Indicators of Public Debt Under Alternative Scenarios, 2011-31 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2021.
2/ Revenues are defined inclusive of grants.

Table 1a.: External Debt Sustainability Framework, Baseline Scenario, 2008-31 1/
(In percent of GDP, unless otherwise indicated)

	Actual			Historical 6/ Average	Standard 6/ Deviation	Projections									
	2008	2009	2010			2011	2012	2013	2014	2015	2016	2011-16 Average	2021	2031	2017-31 Average
External debt (nominal) 1/	**32.1**	**32.4**	**32.2**			**24.9**	**22.6**	**22.6**	**23.7**	**24.8**	**26.1**		**36.1**	**37.5**	
o/w public and publicly guaranteed (PPG)	23.8	23.2	19.9			14.7	13.5	13.9	15.1	16.4	17.9		29.0	32.4	
Change in external debt	-8.8	0.3	-0.2			-7.3	-2.4	0.1	1.1	1.1	1.2		2.6	-1.2	
Identified net debt-creating flows	-0.7	2.5	-8.4			-9.3	0.7	5.1	3.1	2.5	2.3		5.0	0.3	
Non-interest current account deficit	**19.3**	**20.7**	**29.6**	**8.3**	**14.0**	**10.9**	**12.1**	**15.0**	**13.0**	**11.7**	**11.1**		**11.1**	**9.3**	11.1
Deficit in balance of goods and services	22.9	18.3	31.8			12.4	8.3	13.3	16.1	16.6	17.2		23.3	23.1	
Exports	44.3	39.3	49.3			62.4	61.0	56.6	55.4	56.7	57.8		54.1	56.8	
Imports	67.2	57.6	81.1			74.8	69.3	69.9	71.5	73.3	75.0		77.4	80.0	
Net current transfers (negative = inflow)	-18.1	-24.4	-25.3	-11.7	9.9	-22.8	-22.1	-21.7	-21.1	-20.4	-19.8		-17.3	-13.6	-16.2
o/w official	-15.1	-20.3	-24.9			-22.5	-21.8	-20.4	-19.6	-18.8	-18.0		-14.7	-9.8	
Other current account flows (negative = net inflow)	14.5	26.8	23.1			21.3	25.9	23.4	17.9	15.5	13.7		5.2	-0.2	
Net FDI (negative = inflow)	**-15.0**	**-19.5**	**-34.9**	**-8.7**	**11.7**	**-18.5**	**-10.7**	**-9.6**	**-9.7**	**-9.0**	**-8.5**		**-6.0**	**-8.1**	-7.6
Endogenous debt dynamics 2/	**-5.1**	**1.3**	**-3.1**			**-1.7**	**-0.7**	**-0.3**	**-0.1**	**-0.2**	**-0.3**		**-0.1**	**-0.9**	
Contribution from nominal interest rate	1.1	0.8	0.7			0.7	0.6	0.6	0.6	0.6	0.6		0.6	0.6	
Contribution from real GDP growth	-2.5	1.5	-2.0			-2.4	-1.3	-0.9	-0.7	-0.8	-0.9		-0.7	-1.5	
Contribution from price and exchange rate changes	-3.7	-1.0	-1.7			…	…	…	…	…	…		…	…	
Residual (3-4) 3/	**-8.1**	**-2.2**	**8.1**			**2.0**	**-3.0**	**-5.0**	**-2.0**	**-1.4**	**-1.0**		**-2.4**	**-1.6**	
o/w exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	…	…	27.1			21.1	19.0	18.9	19.5	20.0	20.7		27.7	29.7	
In percent of exports	…	…	55.0			33.9	31.2	33.3	35.2	35.4	35.8		51.1	52.2	
PV of PPG external debt	**…**	**…**	**14.8**			**10.9**	**9.9**	**10.1**	**10.8**	**11.6**	**12.6**		**20.5**	**24.6**	
In percent of exports	**…**	**…**	**30.1**			**17.5**	**16.3**	**17.9**	**19.5**	**20.5**	**21.7**		**37.9**	**43.3**	
In percent of government revenues	**…**	**…**	**46.0**			**32.5**	**29.4**	**30.0**	**29.7**	**31.6**	**34.0**		**57.4**	**72.5**	
Debt service-to-exports ratio (in percent)	**7.5**	**5.9**	**4.7**			**3.3**	**2.7**	**2.7**	**3.0**	**3.2**	**3.1**		**2.5**	**3.8**	
PPG debt service-to-exports ratio (in percent)	**5.6**	**3.6**	**3.0**			**1.9**	**1.4**	**1.4**	**1.7**	**1.7**	**1.7**		**1.2**	**3.0**	
PPG debt service-to-revenue ratio (in percent)	**8.6**	**4.6**	**4.5**			**3.5**	**2.6**	**2.4**	**2.6**	**2.6**	**2.6**		**1.8**	**5.1**	
Total gross financing need (Billions of U.S. dollars)	0.0	0.0	0.0			0.0	0.0	0.1	0.1	0.1	0.1		0.1	0.1	
Non-interest current account deficit that stabilizes debt ratio	28.1	20.4	29.8			18.2	14.5	14.9	11.8	10.6	9.9		8.5	10.5	
Key macroeconomic assumptions															
Real GDP growth (in percent)	7.1	-4.7	7.0	3.6	6.6	9.3	6.0	4.0	3.4	3.7	4.0	5.1	2.3	4.0	3.6
GDP deflator in US dollar terms (change in percent)	10.0	3.2	5.6	2.6	7.4	13.7	9.9	3.1	0.8	0.8	0.8	4.9	-0.2	2.0	1.4
Effective interest rate (percent) 5/	3.3	2.3	2.3	2.1	0.7	2.9	2.8	2.8	2.7	2.6	2.5	2.7	2.0	1.6	1.9
Growth of exports of G&S (US dollar terms, in percent)	20.6	-12.9	41.8	14.1	24.2	57.4	13.8	-0.4	1.9	6.9	6.9	14.4	-1.6	7.6	5.0
Growth of imports of G&S (US dollar terms, in percent)	14.0	-15.8	59.2	19.6	32.8	14.7	7.9	8.2	6.6	7.1	7.2	8.6	2.8	6.1	5.5
Grant element of new public sector borrowing (in percent)	…	…	…	…	…	0.0	34.2	34.2	34.2	34.2	34.2	28.5	34.2	34.2	34.2
Government revenues (excluding grants, in percent of GDP)	29.0	30.5	32.2			33.6	33.8	33.7	36.4	36.8	36.9		35.8	33.9	34.8
Aid flows (in Billions of US dollars) 7/	0.2	0.3	0.3			0.2	0.2	0.3	0.3	0.3	0.3		0.3	0.3	
o/w Grants	0.1	0.1	0.2			0.2	0.2	0.3	0.3	0.3	0.3		0.3	0.3	
o/w Concessional loans	0.1	0.1	0.1			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Grant-equivalent financing (in percent of GDP) 8/	…	…	…			25.9	25.1	24.5	23.8	23.0	22.2		18.4	12.2	16.5
Grant-equivalent financing (in percent of external financing) 8/	…	…	…			100.0	96.9	95.5	93.5	92.7	91.8		88.9	89.2	89.1
Memorandum items:															
Nominal GDP (Billions of US dollars)	0.6	0.6	0.7			0.8	1.0	1.0	1.1	1.1	1.2		1.5	2.5	
Nominal dollar GDP growth	17.9	-1.7	13.0			24.3	16.6	7.3	4.2	4.5	4.8	10.3	2.1	6.1	5.0
PV of PPG external debt (in Billions of US dollars)			0.1			0.1	0.1	0.1	0.1	0.1	0.1		0.3	0.6	
(PVt-PVt-1)/GDPt-1 (in percent)						-0.9	0.4	0.8	1.1	1.3	1.5	0.7	2.4	0.8	1.9
Gross workers' remittances (Billions of US dollars)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of PPG external debt (in percent of GDP + remittances)	…	…	14.8			10.9	9.9	10.1	10.8	11.6	12.6		20.5	24.6	
PV of PPG external debt (in percent of exports + remittances)	…	…	30.1			17.5	16.3	17.9	19.5	20.5	21.7		37.9	43.3	
Debt service of PPG external debt (in percent of exports + remittance	…	…	3.0			1.9	1.4	1.4	1.7	1.7	1.7		1.2	3.0	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.
2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.
3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.
4/ Assumes that PV of private sector debt is equivalent to its face value.
5/ Current-year interest payments divided by previous period debt stock.
6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.
7/ Defined as grants, concessional loans, and debt relief.
8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table 1b.Solomon Islands: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2011-31
(In percent)

	Projections							
	2011	2012	2013	2014	2015	2016	**2021**	2031
PV of debt-to GDP ratio								
Baseline	11	10	10	11	12	13	**21**	25
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2011-31 1/	11	10	6	4	3	2	**0**	0
A2. New public sector loans on less favorable terms in 2011-31 2	11	10	10	11	13	14	**26**	35
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2012-13	11	11	12	12	13	14	**24**	28
B2. Export value growth at historical average minus one standard deviation in 2012-13 3/	11	19	29	30	30	31	**38**	26
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012-13	11	11	12	13	14	15	**25**	30
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012-13 4/	11	33	54	54	55	55	**62**	28
B5. Combination of B1-B4 using one-half standard deviation shocks	11	36	62	63	64	64	**73**	35
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012 5/	11	14	14	15	16	17	**28**	33
PV of debt-to-exports ratio								
Baseline	17	16	18	20	21	22	**38**	43
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2011-31 1/	17	16	10	7	5	3	**0**	0
A2. New public sector loans on less favorable terms in 2011-31 2	17	16	18	21	23	25	**49**	61
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2012-13	17	16	18	19	20	21	**37**	43
B2. Export value growth at historical average minus one standard deviation in 2012-13 3/	17	38	72	75	75	75	**99**	64
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012-13	17	16	18	19	20	21	**37**	43
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012-13 4/	17	54	95	98	97	96	**114**	49
B5. Combination of B1-B4 using one-half standard deviation shocks	17	56	95	98	96	95	**115**	53
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012 5/	17	16	18	19	20	21	**37**	43
PV of debt-to-revenue ratio								
Baseline	33	29	30	30	32	34	**57**	72
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2011-31 1/	33	29	18	11	7	4	**0**	0
A2. New public sector loans on less favorable terms in 2011-31 2	33	29	30	31	35	39	**73**	102
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2012-13	33	32	35	34	36	39	**66**	83
B2. Export value growth at historical average minus one standard deviation in 2012-13 3/	33	55	87	82	83	84	**107**	76
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012-13	33	34	37	37	39	42	**71**	89
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012-13 4/	33	97	160	150	149	150	**173**	83
B5. Combination of B1-B4 using one-half standard deviation shocks	33	107	185	173	173	174	**203**	103
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012 5/	33	40	41	40	43	46	**78**	98

Table 1b.Solomon Islands: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2011-31 (continued)
(In percent)

	Projections							
	2011	2012	2013	2014	2015	2016	**2021**	2031
Debt service-to-exports ratio								
Baseline	2	1	1	2	2	2	**1**	3
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2011-31 1/	2	2	2	2	2	2	**1**	0
A2. New public sector loans on less favorable terms in 2011-31 2/	2	1	1	2	2	2	**2**	5
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2012-13	2	1	1	2	2	2	**1**	3
B2. Export value growth at historical average minus one standard deviation in 2012-13 3/	2	2	2	3	3	3	**2**	7
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012-13	2	1	1	2	2	2	**1**	3
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012-13 4/	2	1	2	3	3	3	**2**	8
B5. Combination of B1-B4 using one-half standard deviation shocks	2	2	2	3	3	3	**2**	8
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012 5/	2	1	1	2	2	2	**1**	3
Debt service-to-revenue ratio								
Baseline	4	3	2	3	3	3	**2**	5
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2011-31 1/	4	3	3	3	2	2	**1**	0
A2. New public sector loans on less favorable terms in 2011-31 2/	4	3	2	3	3	3	**3**	8
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2012-13	4	3	3	3	3	3	**2**	6
B2. Export value growth at historical average minus one standard deviation in 2012-13 3/	4	3	3	3	3	3	**2**	9
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012-13	4	3	3	3	3	3	**2**	6
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012-13 4/	4	3	3	4	4	4	**3**	14
B5. Combination of B1-B4 using one-half standard deviation shocks	4	3	4	5	5	5	**4**	16
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012 5/	4	4	3	4	4	4	**3**	7
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	33	33	33	33	33	33	**33**	33

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table 2a.Solomon Islands: Public Sector Debt Sustainability Framework, Baseline Scenario, 2008-31
(In percent of GDP, unless otherwise indicated)

	Actual					Estimate	Projections								
	2008	2009	2010	Average 5/	Standard Deviation 5/	2011	2012	2013	2014	2015	2016	2011-16 Average	2021	2031	2017-31 Average
Public sector debt 1/	35.0	33.2	28.1			21.3	17.1	16.4	16.9	17.8	19.0		30.3	34.3	
o/w foreign-currency denominated	23.8	23.2	19.9			14.7	13.5	13.9	15.1	16.4	17.9		29.0	32.4	
Change in public sector debt	-8.2	-1.8	-5.2			-6.8	-4.2	-0.6	0.5	0.9	1.2		2.7	-1.0	
Identified debt-creating flows	-5.6	-3.3	-10.2			-9.3	-3.8	-1.2	-2.5	-2.5	-2.3		0.4	-0.4	
Primary deficit	-0.8	-2.3	-6.7	-2.2	3.4	-4.0	-1.6	-0.4	-2.0	-2.0	-1.7	-1.9	0.6	1.3	1.2
Revenue and grants	46.5	55.2	63.0			59.5	58.5	57.6	59.4	58.8	58.1		53.1	45.4	
of which: grants	17.5	24.7	30.8			25.9	24.7	23.9	23.0	22.0	21.2		17.3	11.5	
Primary (noninterest) expenditure	45.8	52.9	56.3			55.5	56.9	57.1	57.3	56.9	56.4		53.6	46.7	
Automatic debt dynamics	-4.9	0.0	-3.4			-5.1	-2.2	-0.7	-0.5	-0.5	-0.6		-0.2	-1.7	
Contribution from interest rate/growth differential	-3.6	1.3	-2.5			-2.6	-1.5	-0.7	-0.6	-0.7	-0.7		-0.7	-1.6	
of which: contribution from average real interest rate	-0.8	-0.5	-0.3			-0.3	-0.3	0.0	0.0	-0.1	-0.1		-0.1	-0.2	
of which: contribution from real GDP growth	-2.9	1.7	-2.2			-2.4	-1.2	-0.7	-0.5	-0.6	-0.7		-0.6	-1.4	
Contribution from real exchange rate depreciation	-1.2	-1.3	-1.0			-2.5	-0.7	0.0	0.1	0.1	0.1		…	…	
Other identified debt-creating flows	0.0	-0.9	0.0			-0.2	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	-0.9	0.0			-0.2	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	-2.5	1.5	5.0			2.4	-0.4	0.5	3.0	3.4	3.5		2.4	-0.6	
Other Sustainability Indicators															
PV of public sector debt	...	...	23.0			17.5	13.5	12.7	12.7	13.0	13.6		21.8	26.5	
o/w foreign-currency denominated	...	...	14.8			10.9	9.9	10.1	10.8	11.6	12.6		20.5	24.6	
o/w external	...	...	14.8			10.9	9.9	10.1	10.8	11.6	12.6		20.5	24.6	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	3.3	0.3	-4.1			-1.5	0.4	1.7	0.2	0.0	0.2		1.9	3.4	
PV of public sector debt-to-revenue and grants ratio (in percent)	…	…	36.4			29.4	23.2	22.0	21.3	22.1	23.5		41.1	58.4	
PV of public sector debt-to-revenue ratio (in percent)	…	…	71.2			52.1	40.1	37.7	34.8	35.4	36.9		60.9	78.1	
o/w external 3/	…	…	46.0			32.5	29.4	30.0	29.7	31.6	34.0		57.4	72.5	
Debt service-to-revenue and grants ratio (in percent) 4/	7.4	3.8	3.3			3.1	2.5	2.4	2.5	2.3	2.2		1.5	3.9	
Debt service-to-revenue ratio (in percent) 4/	11.9	6.9	6.4			5.5	4.4	4.0	4.0	3.6	3.4		2.2	5.3	
Primary deficit that stabilizes the debt-to-GDP ratio	7.4	-0.5	-1.6			2.8	2.6	0.2	-2.5	-2.9	-2.9		-2.2	2.3	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	7.1	-4.7	7.0	3.6	6.6	9.3	6.0	4.0	3.4	3.7	4.0	5.1	2.3	4.0	3.6
Average nominal interest rate on forex debt (in percent)	2.7	1.3	1.2	1.3	0.8	1.6	1.3	1.3	1.2	1.2	1.3	1.3	1.1	1.0	1.1
Average real interest rate on domestic debt (in percent)	-8.1	-4.9	-3.6	-3.6	2.5	-4.6	-4.2	-1.0	0.3	0.4	0.5	-1.4	5.3	-1.3	1.7
Real exchange rate depreciation (in percent, + indicates depreciat	-4.2	-5.2	-4.5	0.1	7.9	-13.5	...	...	...	...	...	…	…	…	…
Inflation rate (GDP deflator, in percent)	11.4	7.3	5.8	7.2	3.7	7.6	7.0	4.6	3.8	3.8	3.8	5.1	2.8	5.1	4.4
Growth of real primary spending (deflated by GDP deflator, in perc	0.1	0.1	0.1	0.2	0.3	0.1	0.1	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0
Grant element of new external borrowing (in percent)	...	...	...	…	…	0.0	34.2	34.2	34.2	34.2	34.2	28.5	34.2	34.2	...

Sources: Country authorities; and staff estimates and projections.

1/ [Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.]

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 2b.Solomon Islands: Sensitivity Analysis for Key Indicators of Public Debt 2011-31

	Projections							
	2011	2012	2013	2014	2015	2016	2021	2031
PV of Debt-to-GDP Ratio								
Baseline	17	14	13	13	13	14	22	26
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	17	13	12	11	12	12	14	0
A2. Primary balance is unchanged from 2011	17	12	9	7	7	6	2	0
A3. Permanently lower GDP growth 1/	17	14	14	15	17	20	45	105
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2012-13	17	17	21	25	29	34	64	93
B2. Primary balance is at historical average minus one standard deviations in 2012-13	17	15	16	16	16	16	25	28
B3. Combination of B1-B2 using one half standard deviation shocks	17	15	15	17	20	23	43	62
B4. One-time 30 percent real depreciation in 2012	17	18	16	16	16	16	23	29
B5. 10 percent of GDP increase in other debt-creating flows in 2012	17	20	19	19	19	20	28	30
PV of Debt-to-Revenue Ratio 2/								
Baseline	29	23	22	21	22	23	41	58
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	29	23	20	19	20	21	26	0
A2. Primary balance is unchanged from 2011	29	20	15	13	11	10	3	0
A3. Permanently lower GDP growth 1/	29	24	24	25	28	33	81	214
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2012-13	29	28	34	39	47	55	114	197
B2. Primary balance is at historical average minus one standard deviations in 2012-13	29	26	27	26	27	28	46	62
B3. Combination of B1-B2 using one half standard deviation shocks	29	25	25	28	32	38	78	134
B4. One-time 30 percent real depreciation in 2012	29	30	28	27	27	28	44	64
B5. 10 percent of GDP increase in other debt-creating flows in 2012	29	35	33	32	33	34	53	66
Debt Service-to-Revenue Ratio 2/								
Baseline	3	3	2	2	2	2	2	4
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	3	3	2	2	2	2	1	2
A2. Primary balance is unchanged from 2011	3	3	2	2	2	2	1	0
A3. Permanently lower GDP growth 1/	3	3	2	3	2	2	2	10
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2012-13	3	3	3	3	3	3	3	12
B2. Primary balance is at historical average minus one standard deviations in 2012-13	3	3	2	3	2	2	2	4
B3. Combination of B1-B2 using one half standard deviation shocks	3	3	3	3	2	2	2	8
B4. One-time 30 percent real depreciation in 2012	3	3	3	3	3	3	2	6
B5. 10 percent of GDP increase in other debt-creating flows in 2012	3	3	3	3	2	2	2	5

Sources: Country authorities; and staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.
2/ Revenues are defined inclusive of grants.

INTERNATIONAL MONETARY FUND

SOLOMON ISLANDS

Staff Report for the 2011 Article IV Consultation, Third Review Under the Standby Credit Facility, and Request for Arrangement Under the Standby Credit Facility—Supplement

Prepared by the Asia Pacific Department in Consultation with Other Departments

Approved by Hoe Ee Khor and Dominique Desruelle

November 18, 2011

This supplement reports on political developments since the Staff Report (EBS/11/161) was issued on November 9, 2011. The thrust of the staff appraisal remains unchanged.

On November 16, 2011, Mr. Gordon Darcy Lilo, former Minister of Finance under the government led by Mr. Danny Phillip, was elected as the new Prime Minister (PM). His election was supported by the same political coalition—the National Coalition for Reform and Advancement (NCRA)—in power since 2010. Former PM Danny Philip resigned on November 11. The new government has reconfirmed the commitments outlined in the Letter of Intent of November 4, 2011, which was signed by Mr. Lilo and Governor Rarawa, and its attached Memorandum of Economic and Financial Policies.

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IMF Executive Board Concludes 2011 Article IV Consultation with Solomon Islands

On November 23, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the 2011 Article IV Consultation with Solomon Islands.[1]

Background

Solomon Islands' economy has rebounded strongly from the 2008–09 global financial crisis. Growth contracted by nearly 5 percent in 2009 driven by a drop in commodity exports, mainly logging. International reserves were depleted. An 18-month Standby Credit Facility (SCF) Arrangement was approved in June 2010. The program succeeded in restoring macroeconomic and financial stability, catalyzing donor support, and promoting structural reforms. Strong demand for logging from emerging Asia, particularly in China, and favorable terms of trade triggered an unexpected surge in logging production in 2010 and growth rebounded to 7 percent.

A strong commodity-based recovery is underway. Log production surprised on the upside and jumped by 40 percent (year-on-year) in the first eight months of 2011, close to an historical high. This reflected investments of new logging companies, re-entry logging (the harvesting of native stands in areas previously logged and where trees have not re-grown fully), and strong log prices following the earthquake and tsunami in

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Japan in March, which triggered a surge in demand for logs to build temporary housing. The redeveloped Gold Ridge mine which started its operations in April 2011 has also been supporting the economic expansion over the last few months.

Inflation pressures are dissipating. After falling to 1 percent in 2010, inflation increased to 8.7 in August 2011 reflecting base effects and the pass-through of global energy and food prices. However, the latest reading of month-on-month data through August suggest a sustained downward momentum. Both headline and core inflation (excluding food and fuel) are edging down helped by the revaluation of the domestic currency in June and the decline in fuel prices since mid-year, with headline inflation reaching almost a negative territory on a month-on-month basis.

Reserve buffers have been rebuilt. The trade balance shifted from deficit to surplus during April-September 2011, for the first time since 2004 driven by exceptionally strong exports of gold and logging. As a result, the balance of payment position improved, supported by large FDI and aid flows. Gross international reserves increased to US$355 million in June 2011 from less than US$100 million in mid-2009.

However, progress toward reducing poverty has been limited. Despite strong growth, the recovery is uneven and growth remains concentrated in the commodity sector with limited spill-over to the rest of the economy.

Executive Board Assessment

Executive Directors commended the Solomon Islands authorities for the strong performance under their Fund-supported program. Macroeconomic and financial stability have been restored and international reserves have been rebuilt. The government's sound economic management also helped catalyze donor support. While the prospects of the economy are favorable, downside risks have increased with the uncertainty in the global outlook. The vulnerability to commodity price and demand shocks, along with concentration of growth in the commodity sector, pose further challenges.

Directors emphasized that building resilience to shocks, and adopting a more balanced and inclusive growth model, by fostering economic diversification and private sector development, while accelerating progress on poverty reduction remain top priorities. They agreed that the authorities' economic program would help consolidate macroeconomic progress and strengthen institutions and structural policies.

Directors emphasized the importance of preserving the strong fiscal position and strengthening the medium-term fiscal framework. They welcomed the authorities' plan to move to a multi-year budget framework and their commitment to achieving a balance between maintaining strong buffers and increasing spending on critical infrastructure and social priorities. Directors looked forward to the new resource taxation regime to promote fiscal transparency and enhance the efficiency of tax collection; reform of mining legislation to broaden the tax base; and strengthening public financial management. For the medium term, Directors also highlighted the importance of prudent management of mineral resources, anchoring fiscal policy to the noncommodity balance in order to avoid pro-cyclicality, and resuming concessional borrowing to secure development financing.

Directors considered that the monetary and exchange rate policies since the beginning of the year have helped moderate inflation and anchor inflation expectations. They agreed that monetary tightening would be warranted if private sector credit increases rapidly and creates inflationary pressures.

Directors noted that the banking system remains profitable and adequately capitalized. They encouraged the central bank to continue strengthening the supervisory and regulatory framework to mitigate risks facing the financial sector. Directors agreed that reforming the National Provident Fund legislation will also help to preserve financial sector stability.

Directors welcomed the adoption of the National Development Strategy, which should help the authorities achieve their growth and poverty reduction objectives. They called for sustained further efforts to promote private sector-led growth by improving the business environment and access to credit by small businesses, and reforming state-owned enterprises.

Solomon Islands: Selected Economic Indicators, 2008–12

Per capita GDP (2010): US$1,280
Population (2010): 528 thousand
Poverty rate (2006): 23 percent

	2008	2009	2010	2011	2012
Growth and prices (percentage change) 1/					
Real GDP	7.1	-4.7	7.0	9.3	6.0
Of which: nontimber nonmining	6.5	-2.6	4.8	4.8	4.7
CPI (period average)	17.4	7.1	1.0	6.6	5.3
CPI (end of period)	18.1	1.8	0.8	7.1	5.2
GDP deflator	11.4	7.3	5.8	7.6	7.0
Nominal GDP (in SI$ millions)	4,713	4,815	5,449	6,404	7,265
of which: non-mining nominal GDP (in SI$ millions)	4,684	4,779	5,369	5,900	
Per capita GDP (in US$)	1,207	1,159	1,280	1,554	1,769
Per capita GNI (in US$)	1,018	839	975	1,210	1,300
Central government operations (percent of GDP)					
Total revenue and grants	46.5	55.2	63.0	59.5	58.5
Revenue	29.0	30.5	32.2	33.6	33.8
Grants	17.5	24.7	30.8	25.9	24.7
Total expenditure	46.7	53.5	56.7	55.9	57.2
Recurrent expenditure	25.3	28.6	28.4	27.1	27.7
Development expenditure	19.5	25.6	28.0	28.9	29.5
Unrecorded expenditure 2/	1.9	-0.7	0.3	0.0	0.0
Overall balance	-0.2	1.8	6.3	3.6	1.3
Foreign financing (net)	-1.6	-1.1	-1.2	-0.9	0.5
Domestic financing (net)	1.8	-1.6	-5.1	-2.8	-1.8
Privatization receipts	0.0	0.9	0.0	0.2	0.0
Central government debt (percent of GDP, unless otherwise indicated) 3/	35.0	33.2	28.1	21.3	17.1
Domestic debt	11.2	10.0	8.2	6.6	3.6
Of which: principal arrears					
External debt	23.8	23.2	19.9	14.7	13.5
(In US$ millions, end of period)	140.4	138.7	134.7	126.9	131.9
Monetary and credit (percentage change, end-year data)					
Credit to private sector	26.5	-4.2	-4.7	2.0	8.0
Broad money	6.9	24.7	13.5	21.0	18.0
Reserve money	-2.3	62.5	75.3	21.6	16.7
Interest rate - deposit (percent per annum)	2.0	2.7	2.6	...	...
Interest rate - lending (percent per annum)	17.0	15.4	13.5	...	...
Balance of payments (in US$ millions, unless otherwise indicated)					
Current account balance	-124.5	-128.2	-204.4	-97.7	-124.3
(Percent of GDP)	-20.5	-21.4	-30.3	-11.6	-12.7
(excluding mining-related capital imports, in percent of GDP)	…	…	-11.2	0.1	-2.3
Exports of goods and nonfactor services (GNFS)	269.5	234.9	333.0	524.3	596.8
(Percentage change)	20.6	-12.9	41.8	57.4	13.8
Log exports	110.3	88.1	124.7	187.5	134.5
Imports of GNFS	408.8	344.2	547.8	628.3	677.8
(Percentage change)	14.0	-15.8	59.2	14.7	7.9
Foreign direct investment	91.1	116.8	235.6	155.7	105.2
Overall balance	-31.0	56.4	119.8	88.8	25.0
Gross official reserves (in US$ millions, end of period) 4/	89.5	146.0	265.8	364.6	389.5
(In months of next year's imports of GNFS)	3.1	3.2	5.1	6.5	6.4
(In months of next year's nonmining-related imports of GNFS)	…	4.2	6.0	7.6	7.5
Exchange rate (SI$/US$, end of period) 5/	8.00	8.06	8.06	7.40	...
Real effective exchange rate (period average, 2005 = 100)	112.7	120.5	112.0	...	...
Nominal effective exchange rate (period average, 2005 = 100)	87.9	88.7	83.5	...	...

Sources: Data provided by the authorities; and IMF staff estimates and projections.
1/ Incorporates the 2009 revised GDP estimates published by the National Statistics Office in June 2011.
2/ Includes changes in the stock of unpaid payment orders and unpresented checks and the statistical discrepancy.
3/ Includes disbursement under an IMF-supported arrangement
4/ Includes SDR allocations made by the IMF to the Solomon Islands in 2009 and actual and prospective disbursements under
5/ For 2011, as of September.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 11/434
FOR IMMEDIATE RELEASE
November 28, 2011

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes the Final Review Under the Standby Credit Facility Arrangement for Solomon Islands and Approves US$ 4.85 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) has completed the third and final review of Solomon Islands' economic performance under the Standby Credit Facility (SCF) arrangement.

The completion of the review has enabled the disbursement of an amount equivalent to SDR 3.12 million (about US$ 4.85 million), bringing total disbursements under the arrangement to an amount equivalent to SDR 12.48 million (about US$ 19.39 million). The SCF arrangement was approved on June 2, 2010 (see Press Release No. 10/223) for an amount equivalent to SDR 12.48 million (about US$ 19.39 million), or 120 percent of the Solomon Islands' quota.

Following the Executive Board's discussion of the Solomon Islands on November 23, Mr. Naoyuki Shinohara, Deputy Managing Director and Acting Chair, stated:

"Solomon Islands' economy has rebounded strongly from the 2008—09 global financial crisis and the outlook remains favorable. Strong program implementation under the Standby Credit Facility arrangement has succeeded in restoring macroeconomic and financial stability. However, downside risks have increased with the uncertainty in the global outlook. The economy is also vulnerable to commodity price and demand shocks while growth remains concentrated in the commodity sector. Therefore, bolstering resilience to shocks and adopting a more inclusive growth model remain top priorities.

"Preserving a strong fiscal position and strengthening the medium-term fiscal framework would ensure fiscal sustainability. The near-term priority is to strike a balance between maintaining strong fiscal buffers and increasing spending on critical infrastructure and social priorities. Looking ahead, a key challenge is to ensure that the forthcoming mineral wealth spills over to the rest of the economy. To this end, managing resource revenues, anchoring fiscal policy to the noncommodity balance, and resuming concessional borrowing to secure development financing would be critical.

"Monetary and exchange rate policies over the past few months have helped moderate and anchor inflation and are currently appropriate. Monetary tightening would be warranted if private sector credit were to increase rapidly.

"The banking system remains profitable and adequately capitalized. The central bank should continue to strengthen the supervisory and regulatory framework of the financial system. Reforming the National Provident Fund to improve its operation and financial performance will also help preserve financial sector stability."

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 11/448
FOR IMMEDIATE RELEASE
December 7, 2011

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board approves a one-year Standby Credit Facility Arrangement for Solomon Islands

The Executive Board of the International Monetary Fund (IMF) has approved a one-year arrangement under the Standby Credit Facility (SCF) for Solomon Islands, in an amount equivalent to SDR 5.2 million (about US$ 8.08 million). This arrangement is intended to be precautionary, meaning that the authorities do not intend to draw on the Fund's resources unless a need arises.

The SCF-supported program aims at consolidating recent macroeconomic progress, implementing a new resource taxation regime to promote fiscal transparency and enhance the efficiency of tax collection, reforming mining legislation to broaden the tax base, and implementing public financial management reforms to strengthen fiscal institutions. The SCF-supported program is expected to be instrumental in anchoring the authorities' policy agenda going forward.

Statement by Christopher Legg, Executive Director for the Solomon Islands and Leni Hunter, Senior Advisor to the Executive Director November 23, 2011

The current SCF has been the first arrangement between the IMF and the Solomon Islands since the 1980s. It has laid the groundwork for a constructive engagement with the IMF in assisting the Solomon Islands to progress an important reform agenda. The relationship and the program continue to be highly valued by all parties, irrespective of recent political instability which has involved a change of Prime Minister.

The Solomon Islands authorities comfortably met program targets for end-June 2011, and have implemented most of the benchmarks committed to under the program. They appreciate the constructive interactions that they have had with Staff during the current arrangement, and have requested a successor arrangement in the form of a precautionary 12-month SCF for SDR5.2 million.

Although Solomon Islands does not face an immediate balance of payments need, our Authorities' request for a successor precautionary arrangement is motivated by their recognition of vulnerabilities inherent in Solomon Islands' commodity-dependent economy. It is also envisaged that the program will continue to assist with catalyzing donor support.

Of equal importance to the Authorities is a continued engagement with the Fund as they proceed with a multi-year period of structural reform. Proposed benchmarks for 2012 include Cabinet approval for replacement of existing financial legislation to improve the fiscal framework. These cover budget processes, revenue collection, fiscal transparency and debt management. Other benchmarks aim to strengthen the monetary operations and financial supervision, improve the National Provident Fund, and complete the Honiara Club Agreement Review. In the context of emerging opportunities for growth, the Authorities' reform agenda has the potential to create conditions to foster important and needed gains in the living standards of all Solomon Islanders.

The economy is in a markedly better position than it was during the sharp downturn experienced in 2009. Real GDP growth has rebounded and is projected to remain healthy at around 6 percent in 2012, in the context of increased mining and declining logging activity. There are signs that recent inflationary pressures have abated, following a modest upwards revaluation in the exchange rate. However inflation remains at around 6 percent. Favourable commodity prices and accumulated donor funds resulted in a substantial increase in the balance of payments position, with gross international reserves projected to reach around US$420 million by the end of 2012.

Although the external environment continues to pose downside risks, resilience in Asian markets provides some insulation to the Solomon Islands' economy. Over the longer term, the Authorities are conscious of the risk that climate change could negatively affect incomes and poverty in rural areas through an increase in water salinity, especially in the outer islands.

While recent headline GDP performance is strong, the Authorities remain highly conscious of the continued low level of GDP per capita. The need for inclusive growth that alleviates poverty and benefits the wider local population thus remains the key challenge. Unemployment remains high, and appears to be concentrated among youth (labour market statistics are not produced). It remains unclear whether jobs lost from the declining forestry industry will be replaced by more capital-intensive mining. In part this will depend on how quickly mining projects come on-stream, and how much these projects spill over to create demand and jobs in other sectors and industries. Jobs will be created by infrastructure projects such as road works, notwithstanding some recourse to imported labor.

Given the need for inclusive growth, the Authorities attach high priority to the implementation of the structural benchmark on the mining tax regime. They are aware of the dual aims of capturing the benefits from an expendable natural resource for future generations, while maintaining an investment climate that attracts foreign investment and provides employment and income. The Authorities agree with Staff regarding the complexities inherent in mining taxation revenue collection, which requires specialty skills. The process of negotiating mining licenses is also critical, as are processes around negotiations and payments to landowners. Getting the right tax structure and licensing terms, and managing landowner interests, are crucial to the success of the mining industry and its capacity to contribute to the Solomon Islands. The Authorities are appreciative of assistance and advice from the World Bank and IMF on these issues.

In July the Authorities released their National Development Strategy (NDS) covering the period 2011 through to 2020. The development and adoption of the NDS has been heralded a significant milestone by development partners, as it provides direction on development priorities and a framework for costed multi-year sector strategies. The Core Economic Working Group continues to ensure donor efforts are coordinated in line with the Government's priorities.

The Authorities have taken serious note of the recent Public Expenditure Review, which highlighted problems with budget and procurement processes. Given the strong need to alleviate poverty, they wish to ensure that their use of financial resources results in tangible benefits. To achieve this, they need to ensure development spending does not outpace the capacity to follow through on high quality project implementation. The Ministry of Finance and Treasury intends to move to a multi-year budgeting process over the coming year, which will enable the budget to reflect future development project spending. They will also revise the budget presentation from input line items to functional/output line items to strengthen the quality of expenditure outcomes. Further, the Authorities have set aside funds in the National Transport Fund (NTF) as a measure to protect excess cash balances, as well as to ensure quality spending in infrastructure projects.

The Ministry of Finance and Treasury is also considering early debt repayments, which will improve the Government's standing with creditors. In addition, early repayments would create a flow of savings from reduced debt servicing costs that would be spread over future periods. A drawback from early repayments of domestic debt could be an addition to the already substantial stock of liquidity being held in the banking sector. The central bank has been issuing short-term Bokolo bills in order to mop up liquidity. These bills have, to a significant extent, displaced longer-dated Treasury bills.

Some discussions with Staff questioned whether increased liquidity at the banks could lead to excessive lending and inflationary pressures. However, there have been no signs of this occurring to date, with the commercial banks reducing lending from earlier levels (that had been associated with the previously stronger housing market). The Authorities report some businesses having difficulty raising loans. Unsecured lending, and financial service provision in remote areas, are issues that continue to need to be addressed.

As custodian of the bulk of household financial assets, the National Provident Fund plays a key role in the Solomon Islands' economy. Long-awaited legislative reform will give the NPF a greater degree of independence in investment decisions, coupled with enhanced central bank supervision through changes to the Central Bank of Solomon Islands (CBSI) Act. Changes to the CBSI Act will also relax the single-borrower limit which on the margin may have led to constrained lending activity through bank branches.

The Honiara Club Agreement, which involved a zero cap on new borrowing, is due for renegotiation in 2012. The Agreement acted as a significant external constraint on debt accumulation and played a useful role in facilitating the improved fiscal position. However, the Authorities look forward to the opening up of opportunities to take on measured levels of concessionary borrowing which will be directed to projects in areas of high economic returns, e.g. in infrastructure.

Regrettably, poor governance and financial management has led to difficulties in several Solomon Islands' State Owned Enterprises. The postal service, and water and electricity utilities are of concern, creating risks to service provision. The Authorities are already addressing these issues with the help of donors, understanding that such problems pose hurdles to attracting private sector investment. In addition, landowner disputes have delayed plans to improve electricity provision with the Tina River hydro development project.

The continued success of the policy reform agenda will depend in large part on public sector capacity and implementation. The Authorities note the RAMSI mission has had a major impact on the Solomon Islands, contributing many dedicated advisers to the public sector. The withdrawal of RAMSI will need to be carefully timed, with appropriate attention given to maintaining capacity and strengthening local public sector staff.