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Solomon Islands: First Review Under the Standby Credit Facility and Request for Modification of Performance Criteria—Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Solomon Islands.

In the context of the first review under the standby credit facility and request for modification of performance criteria, the following documents have been released and are included in this package:

- The staff report for first review under the standby credit facility and request for modification of performance criteria, prepared by a staff team of the IMF, following discussions that ended on May 15, 2012, 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 June 8, 2012. 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.

- A Press Release summarizing the views of the Executive Board as expressed during its June 25, 2012 discussion of the staff report that completed the request and/or review.

- A statement by the Executive Director for the 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*

*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

First Review Under the Standby Credit Facility and Request for Modification of Performance Criteria

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

Approved by Hoe Ee Khor and Taline Koranchelian

June 8, 2012

Key Issues

Solomon Islands' performance under the SCF-supported program, approved in December 2011, is satisfactory. The current arrangement is intended to be precautionary and, given the current level of reserves, the authorities do not intend to draw on the Fund's resources unless an unexpected need arises. The program aims to consolidate recent macroeconomic progress, reform mining legislation to broaden the tax base, implement a new resource-taxation regime to promote fiscal transparency, and enhance the efficiency of tax collection. Program performance on the quantitative targets is on track. And despite delays, substantial progress has been made toward implementing structural benchmarks. The authorities' commitment to extensive consultations with all stakeholders explains the slower-than-expected pace of structural reforms. Economic growth has been strong, at 11 percent in 2011, and external and fiscal buffers have been rebuilt.

Key policy messages:

- Accelerate structural reforms to ensure more broad-based growth.
- Continue building up fiscal buffers in 2012, given the uncertain external environment.
- Tighten monetary policy if inflation pressures persist.

Team: Discussions took place in Honiara during May 8–15, 2012. The team comprised: Mmes Tumbarello (head), Agustin, Nowak (all APD), Svirydzenka (SPR), and Arbatli (FAD). Mr. Legg (Executive Director) joined the policy discussions. The mission met with Prime Minister Gordon Darcy Lilo, Minister of Finance Rick Houenipwela, Permanent Secretary of Finance Shadrach Fanega, Governor of the Central Bank Denton Rarawa, other senior officials, and development partners.

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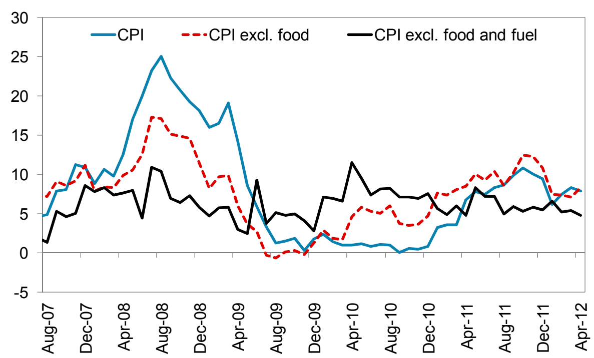
I. Recent Developments and Outlook

1. **A strong commodity-based recovery is underway**. After contracting by 5 percent in 2009, economic activity rebounded by 7.8 percent in 2010 under the program supported by the Fund's Standby Credit Facility (SCF). Growth was nearly 11 percent in 2011, with log and mining production surprising on the upside. This reflected investments of new logging companies; the redeveloped Gold Ridge mine, which began operating in April 2011 (after closing in 2000 owing to civil conflict); and strong gold and log prices. Linkages to China—Solomon Islands' main export partner—have also helped sustain demand for logging. Although growth in 2011 remained concentrated in commodities with limited spillover to the rest of the economy, the preparations for the forthcoming Festival of Pacific Arts are boosting activity in other sectors, mainly construction and retailing. Leading indicators, including the recovery of private-sector credit to 7½ percent growth year-on-year (y/y) in March, suggest that the expansion has remained strong in 2012 to date.

2. **Inflation pressures persist.** After falling to 1 percent in 2010, inflation surged to almost 11 percent in October 2011 (although from a low base), the result of higher global energy and food prices. While recently moderating, headline inflation still stood at 8 percent (y/y) in April reflecting the pass-through of oil prices, the impact on food supplies of recent floods, and strong domestic demand.

Solomon Islands: Inflation, Aug. 2007– Apr. 2012

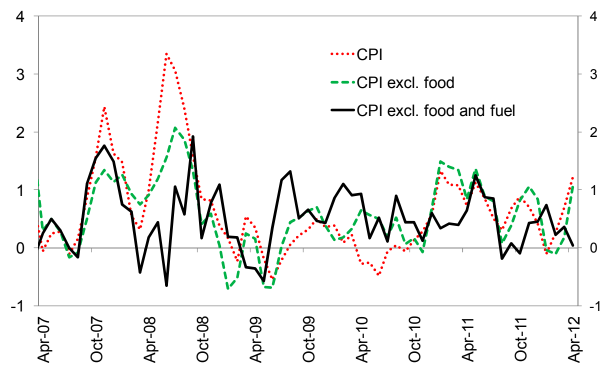
(Year-on-year percent change)



Sources: Country authorities; and IMF staff estimates.

Solomon Islands: CPI Inflation, Apr. 2007– Apr.2012

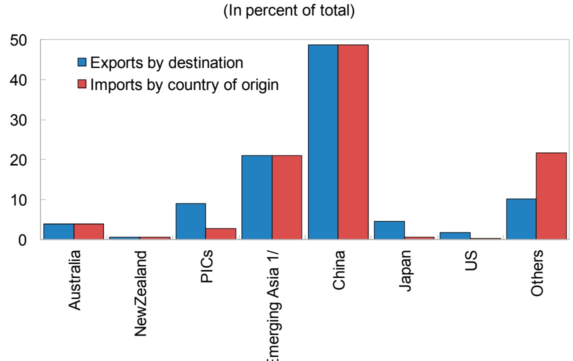
(Three-month-moving average of m/m percent change, sa)



Sources: Country authorities; and IMF staff estimates.

Solomon Islands: Direction of Trade, 2011

(In percent of total)

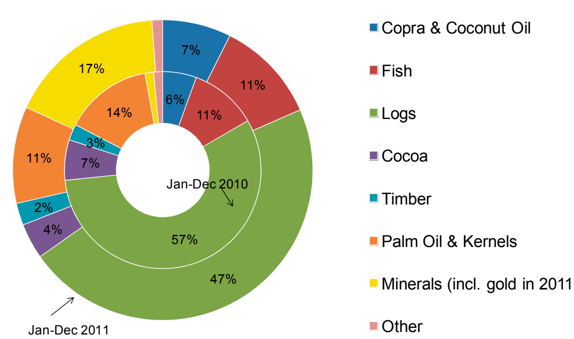


1/ Excludes China.

Sources: Country authorities; and IMF staff estimates.

Solomon Islands: Exports of Goods

(In percent of total exports)



Sources: Country authorities; and IMF staff estimates.

3. **Reserve buffers have been rebuilt and the external position remains strong**. The current account deficit shrank to about 6½ percent of GDP in 2011 from over 30 percent of GDP in 2010 with the trade balance shifting from deficit into surplus in the second half of 2011, led by solid growth in exports of gold and agricultural products. The improved balance of payments was supported by sizable FDI, mainly related to the reopening of the Gold Ridge mine, and aid flows catalyzed by the SCF-supported program. Data for Q1 2012 suggest that the trade surplus reached 2 percent of GDP. As of April 2012, gross international reserves stood at US$450 million (about seven months of imports) compared with US$256 million in 2010 (five months of imports) and less than US$100 million in mid-2009 (Figure 1, and Tables 1 and 2). Because of the strong external position, no disbursement under the current SCF arrangement has been made to date, nor is any expected.

4. **The outlook remains favorable, but with large near-term downside risks**. GDP growth is projected at 7½ percent in 2012, before reverting to 4 percent trend growth in the medium term, with gold production becoming the main driver of expansion. The rehabilitation of the main roads in Honiara for the Pacific Arts Festival and further investment in infrastructure should also underpin growth in 2012 and beyond. The still favorable regional outlook, especially for China and Australia, should continue to have positive spillovers on Solomon Islands. Inflation is likely to ease to about 5 percent in 2012, from 9½ percent in 2011, as commodity prices stabilize and under the assumption that the exchange rate appreciates. The main near-term risks are that financial turmoil in the euro area could escalate and spread globally while heightened geopolitical risks could push crude oil prices higher. And on the domestic front, the fluid political coalition and slippages in implementing structural reforms could be a drag on growth.

5. **Downside scenario.** Staff analysis suggests that in a downside scenario where both external risks materialize, the impact on growth would be substantial.[1] Adverse growth spillovers from Emerging Asia and other main regional trading partners would imply a contraction in FDI and a demand for logging especially from China, and a deterioration of the terms of trade.

Solomon Islands: Baseline and Downside Scenarios

	2012		2013	
	Baseline	Downside 1/	Baseline	Downside 1/
Real GDP growth (in percent)	7.4	3.0	4.0	3.0
Current account balance (in percent of GDP)	-7.8	-18.1	-10.7	-19.0
		6.8	11.7	4.9
Mining exports (in percent of GDP)	18.2	17.4	19.1	18.2
Financing (in millions of U.S. dollars)	-12.8	124.6	-61.9	134.4
Change in gross reserves (- = increase)	-12.7	119.5	-61.8	134.5
IMF 1/	-0.1	5.1	-0.1	-0.1
Gross official reserves (in millions of U.S. dollars)	459.3	292.8	457.7	158.3
in months of next year's imports	7.1	4.5	6.6	2.3
Overall fiscal balance (in percent of GDP)	0.9	-2.4	0.5	-2.1

Source: IMF staff estimates and projections.

1/ The downside scenario reflects the disbursement under the SCF-supported program.

[1] Sheridan, Tumbarello, Wu, 2012, "Global and Regional Spillovers to Pacific Island Countries," IMF Working Paper No. 12/154. This scenario assumes that oil prices would be 50 percent above the baseline in 2012 and 2013, and that the turmoil in the euro area escalates.

II. Program Performance

6. **The one-year SCF arrangement was approved on December 6, 2011, after the previous SCF arrangement had expired, and program performance on quantitative targets is on track**. All continuous performance criteria (PCs) have been met. The PCs for end-December 2011 and indicative targets for end-March 2012 for net credit to the government (NCG), net international reserves (NIR), and net domestic assets (NDA) were met with comfortable margins. The program over-performance reflects stronger-than-projected grants and export receipts, especially from logging. NIR reached US$393 million (seven months of imports). The government cash balance reached SI$522 million as of December 31, covering 3.7 months of recurrent spending and well above the program target of two months.

7. **Substantial progress has been made toward implementing structural benchmarks.** The benchmark on revising the budget presentation to include output lines for expenditure (due at the end of September) has been met ahead of time in February. A new debt management strategy (DMS) was endorsed by the cabinet on May 10. This document supersedes the Honiara Club agreement (HCA)[2] and the review is being completed by presenting the DMS bilaterally to HCA signatories and observers. A ratification meeting is scheduled for early July. The cabinet's approval of draft amendments to the Central Bank of Solomon Islands (CBSI) Act (due at the end of March) is now expected to take place before June 10, owing to the postponement of the consultation process successfully held at the end of April. Capacity constraints, the need for wider consultations among stakeholders, the change in government last November, and the political will to implement more comprehensive reforms explain the slower pace of implementation of the other benchmarks. Rather than introducing ad hoc amendments to the Customs and Excise Tax and Income Tax Acts to strengthen exemption rules (due at end-December 2011), a new more comprehensive customs and excise bill is being drafted with the assistance of the Asian Development Bank (AsDB) and will be presented to the cabinet in October. Compliance with the benchmark on the approval of draft legislation to the new mining tax regime has progressed. The authorities are seeking cabinet's approval by September 2012. This reform has taken longer than expected to allow a wider consultation process with extractive companies, civil society, and landowners.

III. Policy Discussions: Rebuilding Policy Buffers and Ensuring Broad-Based Growth

A. Fiscal Policy

8. **Fiscal policy has strengthened in 2011 and fiscal buffers rebuilt under the SCF-supported program.** The fiscal position improved sharply in 2011, reflecting stronger logging revenues, higher taxes on goods and services, an increase in grants, restraint in recurrent expenditure, and lower-than-planned development spending (Table 3). Revenue performance was driven by a strong pick-up in economic activity, as well as by improved tax

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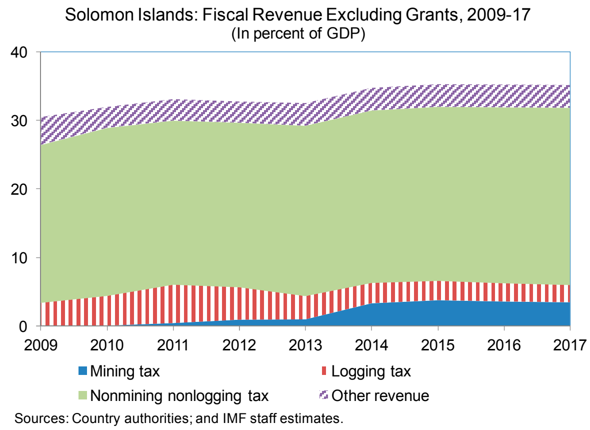
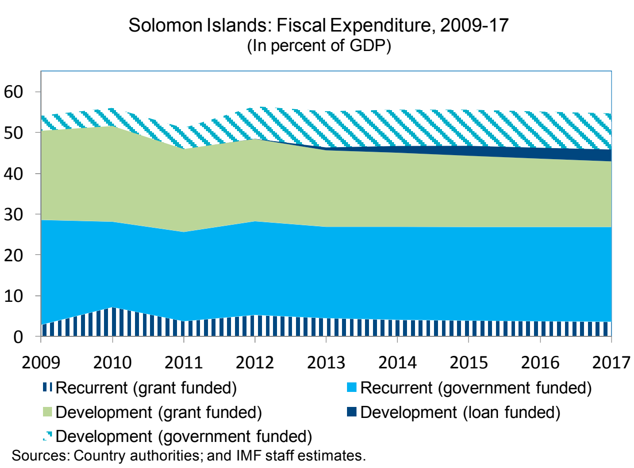
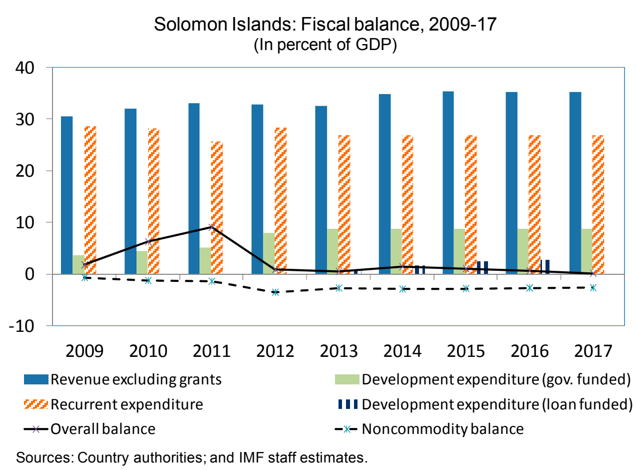
[2] Under the current Honiara Club Agreement, no new government borrowing is allowed. The new debt management strategy is meant to facilitate access to external borrowing on concessional terms. http://www.mof.gov.sb/Libraries/Debt_Management_Strategy/Debt_Management_Strategy_final.sflb.ashx



collection. Part of the recurrent and development grants received at the end of 2011 (the equivalent of about 3 percent of GDP), including transfers to the National Transport Fund, have been earmarked for spending in 2012. Development spending was lower than planned because of delays in project submissions and progress reports for project assessment, as well as constraints in implementation capacity. As a result, the overall fiscal surplus in 2011 hit a record 9 percent of GDP. And the program cash surplus nearly doubled to SI$522 million from SI$263 million in 2010. The cash balance outturn, at about 3.7 months of recurrent spending, far exceeded the two- month target. Central government debt is estimated to have fallen to 20½ of GDP in 2011 from 28 percent in 2010 (Table 4).

9. **The 2012 budget approved in February targets a narrowing in the overall fiscal surplus to about 0.3 percent of GDP in 2012.** This target is consistent with higher spending on infrastructure, health and education, while preserving the cash buffers rebuilt in 2011. The budget projects continued improvements in revenue mobilization led by the ongoing recovery and stronger revenue administration and compliance efforts. Accordingly, total revenues, excluding grants, are expected to reach 35 percent of GDP in 2012, an improvement of 2 percentage points of GDP compared to 2011. Government-funded development spending is projected to surge to 11 percent of GDP from 5 percent of GDP in 2011, partly reflecting a catch up in spending previously envisaged in 2011 and additional spending undertaken through the National Transport Fund. Finally, the budget also envisages an increase in recurrent spending, which is partially due to the one-off expenditure for the 2012 Festival of Pacific Arts. The authorities also plan to retire SI$175 million of domestic debt (equal to 2.2 percent of GDP) later in 2012, subject to revenue and cash-balance developments.





10. **The 2012 program targets are achievable despite revenue shortfalls in the first months of 2012 and new spending pressures.** Staff's revenue projections, consistent with program targets, are based on a more conservative revenue outlook—with revenue lower than the budget by about 2½ percentage points of GDP—and a higher level of current

expenditure, owing to higher than expected expenditures for the Festival of Pacific Arts and higher recurrent spending on education and payroll. Domestically financed development spending is envisioned to increase more gradually relative to the budget to reach 8 percent of GDP.

11. **To save revenue windfall, the authorities have transferred in January 2012 part of the extra revenues to a contingency fund, called the SIG Consolidated Deposits Account, at the central bank.** The transfer of SI$80 million (or 1.1 percent of GDP) in January 2012 brought the balance of the contingency fund to SI$140 million, (equivalent to 1.9 percent of GDP). This account was previously not part of the program cash balance. Going forward, the program is integrating the contingency fund with the program target on cash balances. In particular, starting with the end-June 2012 target, the floor on the program cash balance will be adjusted upward by the difference between the January 2012 level of SI$140 million in the SIG Consolidated Deposits Account and its actual balance, should the actual balance in the SIG Consolidated Deposits Account be lower than SI$140 million (MEFP Table 1). Although the program cash balance target suggests a decline of SI$80 million from SI$522 million at the end of 2011 to SI$442 million at the end of 2012, the cash balance including this account will be maintained at its end-2011 level of SI$582 million, or 3.3 months of recurrent spending.

12. **The mission emphasized that the key challenge is to continue rebuilding policy buffers while pursuing efforts to implement growth-enhancing and poverty-reducing reforms**. Staff also stressed that prudent management of natural resources will be critical for replacing logging over the medium term. The mission conveyed the following key messages:

- *Preserving the cash balance.* Staff argued that maintaining the cash balance at no less than two months of recurrent spending was no longer a meaningful fiscal anchor, given the 2011 outturn, and called for a more prudent fiscal stance. Staff recommended a higher target of 3.3 months of recurrent spending (including the reserves in the contingency fund). Staff urged the authorities to tighten the fiscal stance for the second half of 2012, given the recent fiscal outturn by resisting additional spending pressures and by cutting recurrent non-productive spending. Moreover, if commodity revenues continue to surprise on the upside, or if under-spending of the development budget occurs owing to capacity constraints, the surplus should be saved for future development spending or to expand fiscal space to buffer future shocks.

- *Improving the efficiency and composition of public spending.* To achieve inclusive growth, the authorities should allocate sufficient resources to social sectors (health and education) and infrastructure. The mission commended the authorities for establishing a mechanism to track government-funded spending on health and education. The government has introduced an indicative target for spending on these two sectors at no less than 32 percent of government-funded recurrent spending. However, while a scaling up of development spending, compared to the past, is warranted, the substantial increase in 2012 could narrow the fiscal space to react if downside risks materialize. Staff proposed a slower scaling up of development spending, reflecting capacity constraints and inflation pressures. Given the projected rise in development spending through the National Transport Fund (NTF), which owes to a sizable grant from Australia, staff encouraged the authorities to report to the IMF detailed monthly data on this fund to capture its impact on the overall fiscal stance. Finally, reducing unproductive recurrent spending, including on public-sector allowances, could increase the scope for more critical spending, such as on improving the basic public-wage remuneration and implementing appropriate pay adjustments.

- *Strengthening domestic revenue mobilization.* The mission underscored the need to finalize the amendments to tax legislation and implement the new resource taxation regime in line with the Fund's Fiscal Affairs Department recommendations. The authorities plan to seek cabinet approval of draft amendments to relevant tax legislations by September 2012 (benchmark). They have not approved any new mining leases and remain committed to waiting until the new mining regime is in place. Staff also underlined the need to strengthen revenue administration in the area of mining taxation and held preliminary discussions on possible technical assistance needs on mining taxation and revenue administration. Strengthening exemption rules and clarifying the role of the exemption committee are also important measures to support domestic revenue mobilization. A new comprehensive draft bill on customs and excise tax is being drafted (revised benchmark) and the authorities plan to submit it to the cabinet by the end of October 2012, together with the required amendments to other revenue acts (benchmark). Finally, continuing to apply, as done to date, the full market price for log exports with an automatic quarterly adjustment is also critical for supporting revenue-mobilization efforts.

- *Strengthening public financial management.* Solomon Islands has adopted important reforms in the area of public financial management. These include enhancing the transparency of the budget process through more extensive consultations with stakeholders and improving the presentation of the budget. A program benchmark was met ahead of schedule, through the inclusion of output line items in the 2012 budget presentation. The authorities also adopted a new payroll system that achieved important savings and improved budget accuracy. Considerable progress has been made in reforming the Public Finance Act to incorporate fiscal responsibility provisions (including commitments to developing a medium-term budget strategy, maintaining an appropriate level of cash balance, managing and using public funds, and promoting budget transparency and accountability). Staff urged the authorities to submit to the cabinet the draft Public Finance Act by November 15, 2012 (benchmark). A public workshop on the draft legislation will be held by the end of September (benchmark).

- *Exercising caution in resuming concessional borrowing and strengthening debt management*. The recently-endorsed debt management strategy provides a framework for anchoring borrowing plans going forward. However, to maintain external stability, manage fiscal risks, and ensure that public funds are used for projects with the highest returns, the authorities need to enhance expertise and capacity building in debt management, establish and put in place guidelines and procedures, and strengthen project appraisal and evaluation.[3]

- *Strengthening the fiscal framework, also over the medium term.* Developing a multi-year budget framework would provide more fiscal discipline. Moreover, targeting the non-commodity fiscal balance, as opposed to the cash balance, would help anchor fiscal plans as mining taxes become a large source of government revenue. This rule would help

[3] Among the projects under consideration: the submarine internet cable project (to be financed by borrowing from the AsDB and domestic banks) and the Tina River power project (with possible support from the World Bank).

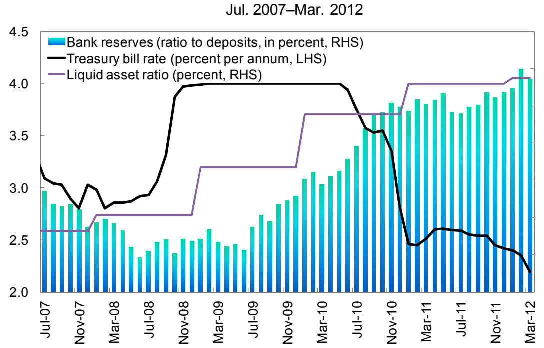
moderate pro-cyclical fiscal policies driven by volatile revenues and would support the economy during downturns (Box 1). It would also ensure a more sustainable use of exhaustible resources.

13. **The authorities remain committed to preserving a strong fiscal position.** To this end, they agreed that in the second part of 2012 fiscal policy will need to be tighter compared to the first few months of 2012 in order to achieve the fiscal targets going forward.

B. Monetary Policy and Exchange Rate Policies

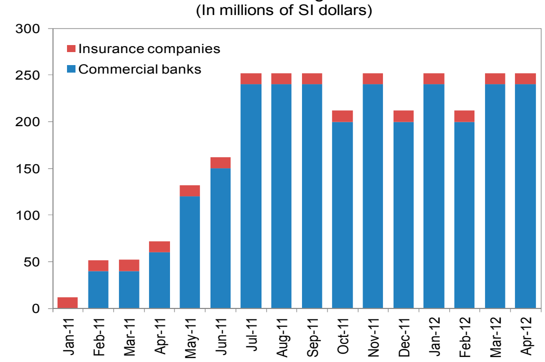
14. **Monetary conditions have remained accommodative over the last few months, but the authorities have begun mopping up excess liquidity**. Even though the Solomon Islands dollar was allowed to appreciate by 8.8 percent against the U.S. dollar in mid-2011—with a rapid and nearly complete pass-through of exchange rate changes to headline inflation—inflationary pressures persist as fuel prices continue rising. In 2010-11, the rapid build-up of foreign exchange reserves led to rapid growth in reserve money. The CBSI started to mop up excess liquidity in early 2011 by issuing its short-term *Bokolo* bills, and its sterilization capacity has increased. As lending interest rates fell from 14½ percent in January 2011 to 10.2 percent in March 2012 (Table 5), private-sector credit picked up for the first time in almost three years, the result of strong activity in the construction and forestry sectors.

Solomon Islands: Bank Reserves and Interest Rate
Jul. 2007–Mar. 2012



Sources: Country authorities; and IMF staff estimates.

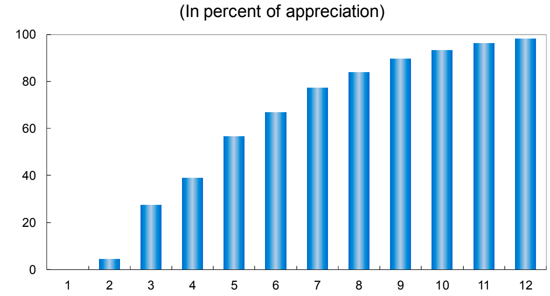
Solomon Islands: Holdings of Bokolo Bills
(In millions of SI dollars)



Source: Central Bank of Solomon Islands.

15. **The central bank should stand ready to tighten monetary policy if inflation risks persist.** The monetary and exchange rate policies over the last few months have helped anchor inflation expectations but monetary tightening (raising the reserve requirement and scaling up its open market operations) will be warranted if price pressures continue. The exchange rate should continue to be managed in a flexible manner in order to provide a buffer against external shocks and to curb imported inflation. Staff's estimates[4] indicate that the exchange rate pass-through is near complete: a 1 percent appreciation of the nominal exchange rate against U.S. dollar lowers the imported component of the CPI by 1 percent within 12 months (chart).

Solomon Islands: Accumulated Response of the Imported Component of CPI to Nominal Exchange Rate Appreciation
(In percent of appreciation)



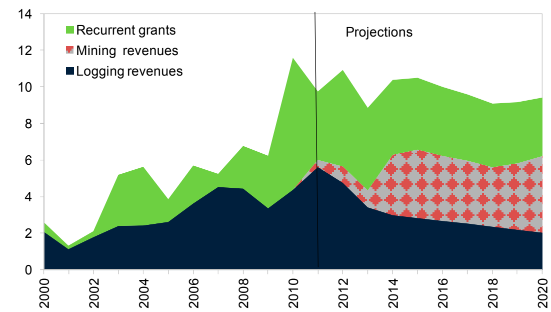
Source: IMF staff estimates. Calculations based on the bilateral rate against the U.S. dollar during January 2000-February 2012.

[4] Peiris, Shanaka J., 2011, *Monetary Transmission Mechanism and Inflation Dynamics in Solomon Islands,* IMF Country Report No. 11/360 (Washington: International Monetary Fund). A nominal appreciation of 4 percent would reduce inflation to about 5 percent in 2012.

Box 1. Assessing the Fiscal Stance in Solomon Islands: The Role of the Structural Fiscal Balance

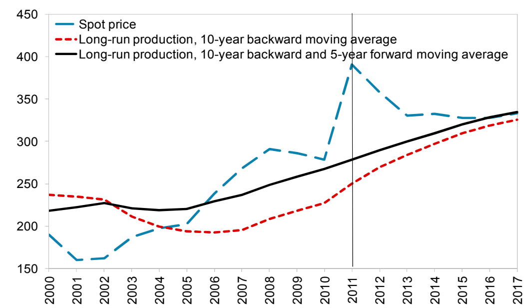
Adjusting for transitory or one-off fluctuations in commodity revenues (from logging and gold) and recurrent grants can significantly affect the measurement of the fiscal stance of Solomon Islands. However, because of data constraints and structural changes in the economy, a meaningful cyclically-adjusted balance based on the output gap is not feasible. Nonetheless, other measures of the fiscal balance can provide a more accurate picture of Solomon Islands' underlying fiscal position. Logging has been an important source of domestic revenue—accounting for 5½ percent of GDP and 17 percent of total non-grant revenues in 2011 (Figure 1). But logging stocks will be exhausted later in the decade, implying that the current revenue levels are well above their long-term trend. In contrast, mining revenues, to date accounting for only 1 percent of GDP, are expected to increase to about 3½ percent of GDP over the medium term.

Figure 1. Solomon Islands: Commodity Revenues and Grants
(In percent of GDP)



Sources: Ministry of Finance of Solomon Islands, and IMF staff estimates.

Figure 2. Solomon Islands: Spot and Long-Run Log Prices
(Price per metric tonne, US$)

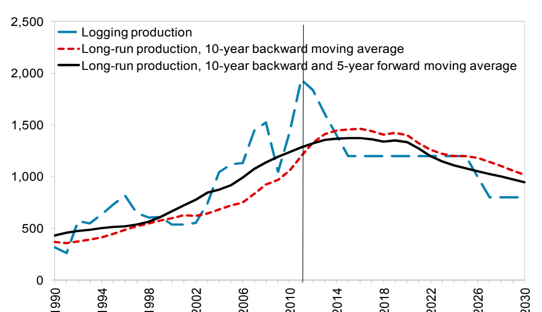


Source: World Economic Outlook.

Correcting logging revenues for transitory or cyclical effects involves estimating long-run price and production levels. Typically, backward- and forward-looking moving averages are used to calculate trend levels (Figures 2-3). Other methods may include various filtering techniques and/or forward prices. This analysis suggests that both the production and price of logs have been well above long-run trends in recent years. As a result the implied improvement in the structural balance in recent years is much lower than that reflected in the headline balance (Figure 4). A similar adjustment could be made for mining revenues going forward.

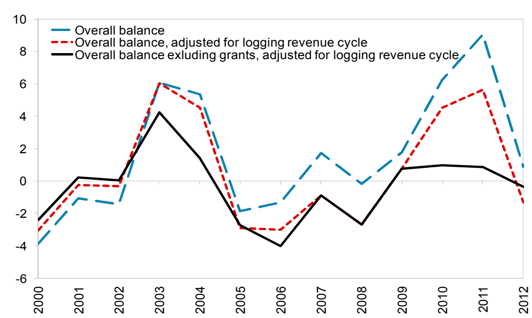
Other definitions of the fiscal balance could also provide a more accurate measurement of the underlying fiscal position in Solomon Islands as opposed to the headline balance. Given the importance of grants as a source of revenue, isolating the fiscal balance from the effects of large one-off grant payments could yield a more accurate assessment of the fiscal position. All these measures suggest that the use of the headline fiscal balance, as opposed to measures of structural balances, would overestimate the improvement in the fiscal position of Solomon Islands over the past two years.

Figure 3. Solomon Islands: Logging Production and Long-Run Trends
(Logging production in cubic meters, 000's)



Source: Solomon Islands National Forest Resources Assessment, 2011 Update, March 2012 by Sinclair, Knight, and Merz.

Figure 4. Solomon Islands: Overall and Structural Fiscal Balances
(In percent of GDP)



Sources: Country authorities; and IMF staff estimates.

This, in turn, lowers the prices of domestic goods and services. The pass-through is relatively immediate with more that 50 percent of the total impact occurring during the first five months. The authorities concurred with staff on the need to tighten monetary policy, should inflation pressures persist.

C. Safeguarding Financial Sector Stability

16. **The financial system is sound and well capitalized but some challenges remain.** Banks' average capital adequacy ratio increased from 24.6 percent at the end of 2011 to 28.5 percent in the first quarter of 2012. At the same time, the ratio of nonperforming loans (NPLs) to total outstanding loans remained flat, at about 6 percent, although it was 2 percentage points below the end-2010 ratio. Banks' profitability remains high, with a return-on-assets ratio (ROA) of 3.1 percent and a return-on-equity ratio (ROE) of 16.2 percent in the first quarter of 2012. Access to credit by the private sector, however, is expensive and constrained by customary land practices. Recent on-site examination of the National Provident Fund (NPF)—Solomon Islands' only pension fund and the largest pool of financial savings—suggests some continuing weakness in its governance and financial performance.

Solomon Islands: Core Financial Soundness Indicators 1/

	2009	2010 2/	2011	2012 Mar
Capital adequacy				
Regulated capital to risk-weighted assets	22.1	22.7	24.6	28.5
Nonperforming loans, net of provisions to capital	9.3	15.0	6.7	5.6
Asset quality				
Nonperforming loans to total gross loans 2/	3.8	7.9	5.9	5.7
Earnings and profitability				
Return on average assets	6.0	4.9	3.2	3.1
Return on average equity	31.6	26.3	16.8	16.2
Net interest income to gross income	52.6	43.9	45.7	48.3
Noninterest expenses to gross income	37.5	41.4	48.2	51.8
Liquidity				
Liquid assets to total assets (liquid asset ratio)	33.4	47.7	56.0	57.4
Liquid assets to short-term liabilities	67.4	72.8	85.9	85.9

Sources: Central Bank of Solomon Islands; and IMF staff estimates.

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

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

17. **Efforts to strengthen the country's supervisory and regulatory framework should continue in line with program commitments.** The authorities expect to obtain cabinet approval of the drafting instruction to revise the NPF Act by end-June 2012 (benchmark). The amendments to the Financial Institutions Act in the pipeline would also help strengthen the regulatory framework by including the NPF. The authorities have requested IMF technical assistance, which will be delivered later this year.

IV. Program Discussions and Monitoring, and Other Issues

18. **Taking into account the program performance at end-2011 and the updated fiscal outlook, the end-June PCs and end-September indicative targets (MEFP, Table 1) have been revised**. Without the proposed modification, macroeconomic policies, especially fiscal policy, would be too loose to be appropriate. As a result, new performance criteria for end-June 2012 and new indicative targets for end-September 2012 have been set.

19. **Political commitment to implementing the SCF-supported program remains strong.** With regard to structural reforms, the authorities' commitment to extensive consultations with all stakeholders explains a slower-than expected pace. Strong commitment is evident in the continued efforts, incremental steps undertaken and the choice of implementing even wider reforms. While extensive consultation is slowing the pace of

implementation, it has also strengthened program ownership by building a wider consensus around these reforms. The authorities expressed great interest in a successor arrangement with the Fund once the current one expires in December 2012. The modalities of the form of engagement will be discussed later in the year.

20. **An updated safeguards assessment is substantially complete.** Financial safeguards at the Central Bank of Solomon Islands (CBSI) have improved in several areas since the 2010 assessment. The CBSI website continues to publish financial statements prepared and audited in accordance with international standards. And several recommendations have been implemented, including the establishment of an Audit Committee, and the filling of Board vacancies. However, weaknesses remain in internal audit and in controls over currency notes, and the draft central bank law will need to be reviewed by staff before finalization.

21. **On the financing side, disbursements from most development partners depend on the continuation and good implementation of the IMF-supported program**. Large donor financing is in the pipeline from Australia and New Zealand (about US$50 million in 2012); the AsDB (US$38 million during 2012–16 to finance infrastructure projects in transport and information and communication technology, in the form of both budget support and concessionary loans); the World Bank (US$2 million in budget support approved in April 2012 and other additional disbursements in the form of grants and loans, including financing of the Tina River hydro project); and the European Union (US$1.7-3.7 million in 2012 in budget support).

22. **Risks to the program stem from delays in implementing structural reforms as well as political instability**. Following the general election in August 2010, Danny Philip was elected Prime Minister. He resigned 15 months later and was replaced by his former finance minister, Gordon Darcy Lilo on November 11, 2011. A further reshuffling of the cabinet occurred in February. Political instability has the potential to severely weaken program ownership. However, the success of the previous and current program strongly suggests that program ownership is very firm and likely to continue. Limited capacity remains a challenge, but Fund technical assistance has been effective in helping the authorities implement the current program.

V. Staff Appraisal

23. **Reserves and fiscal buffers have been rebuilt and a strong commodity-based recovery is underway.** The economy has benefited from the implementation of the government's economic reform program supported by the SCF arrangement owing to strong political commitment to rebuilding fiscal and financial buffers and sound macroeconomic management.

24. **Nonetheless, several challenges remain.** Growth remains concentrated in the commodity sector, mainly logging, with limited spillovers to the rest of the economy. The economy is vulnerable to external shocks, and logging stock—the main engine of growth in recent years—is expected to be exhausted during the current decade. 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.

25. **Enhancing resilience to shocks and making growth more inclusive remain priorities**. This will imply preserving the cash balance accumulated to preserve the fiscal buffers and improving the efficiency and composition of public spending. The authorities should be commended for establishing a mechanism to track government-funded spending on health and education. While a scaling up of spending in health, education, and infrastructure is important to ensure equitable growth, the pace of spending will need to be calibrated taking into account capacity constraints and inflation pressures.

26. **To foster inclusive growth the reform momentum should continue.** The agenda includes reforming mining legislation to broaden the tax base; implementing a new resource-taxation regime to promote fiscal transparency; and enhancing the efficiency of tax collection. Strengthening public financial management is critical for enhancing the transparency of the budget process. The authorities have undertaken significant reforms in this area and their efforts should continue.

27. **Monetary policy needs to be tightened if inflation risks continue.** If growth remains strong and inflation pressures continue to rise, monetary tightening, as well as exchange rate adjustments, will be warranted.

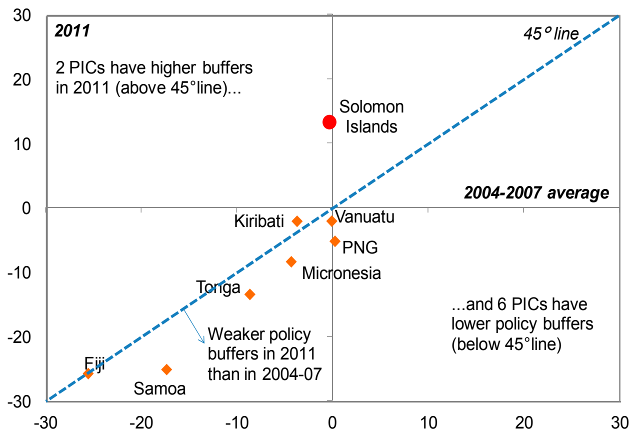
28. **Financial and external stability is not currently at risk, but the supervisory and regulatory framework needs strengthening.** While resuming concessional borrowing is important for tapping the resources to finance large development needs, borrowing should remain prudent to minimize external and fiscal risks.

29. **Based on Solomon Islands' strong program performance, staff recommends the completion of the first review under the SCF-supported program and requests the modification of end-June 2012 performance criteria**.

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

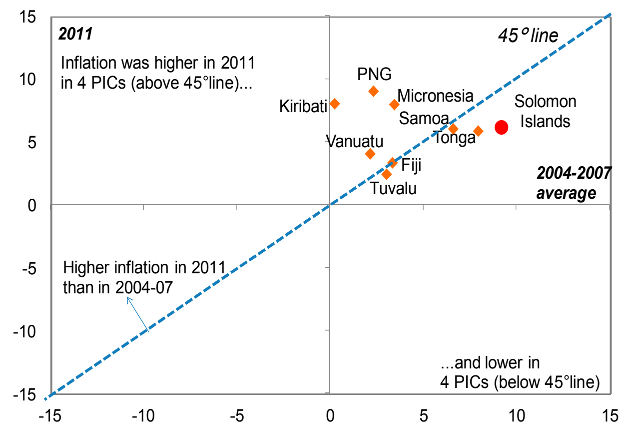
Solomon Islands is one of the only two Pacific Island countries (PICs) that had higher policy buffers in 2011 than during 2004-07…

Overall Buffer Index, 2004-07 and 2011



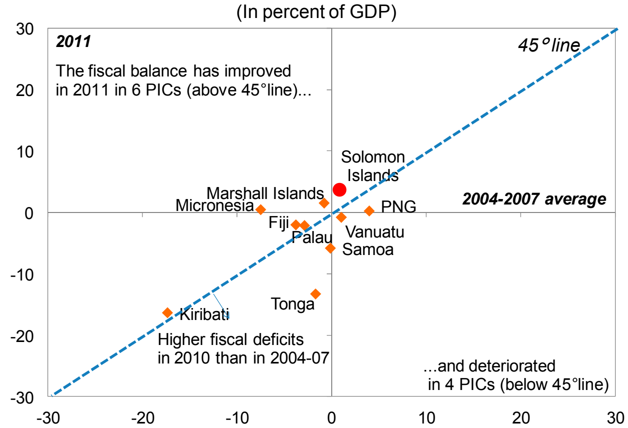
…with lower inflation…

Inflation
(In percent)



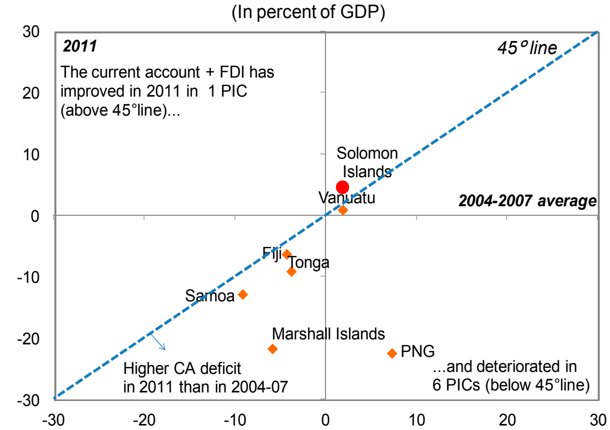
…improved fiscal balance…

Fiscal Balance
(In percent of GDP)



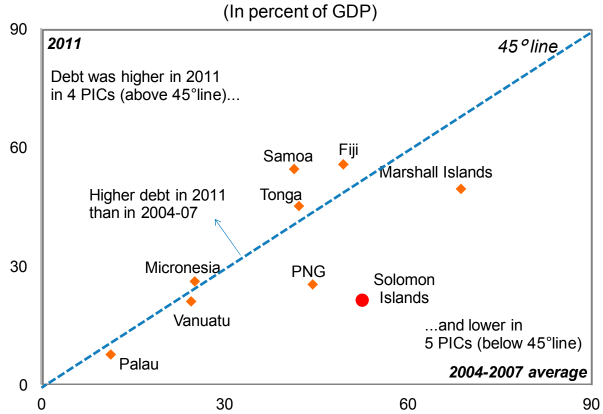
… lower current account deficit...

Current Account and FDI
(In percent of GDP)



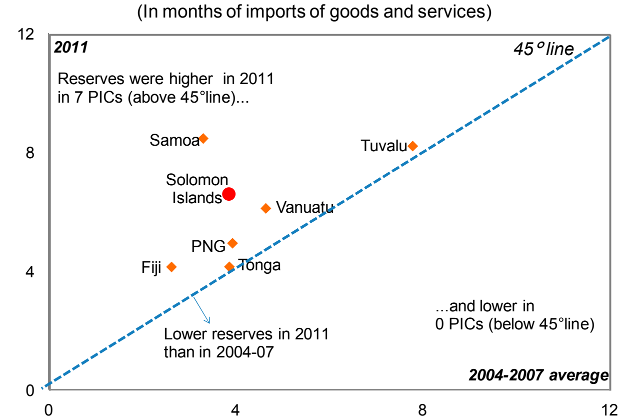
…reduced debt…

Gross Debt
(In percent of GDP)



… and stronger reserve coverage.

Reserves
(In months of imports of goods and services)

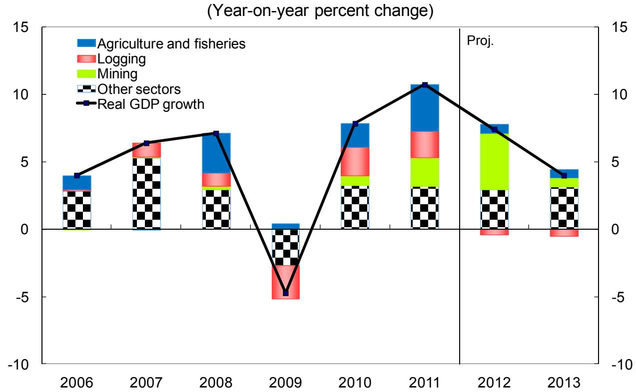


Sources: Country authorities; and IMF staff calculations.

Figure 2. Solomon Islands: Macroeconomic Developments and Outlook

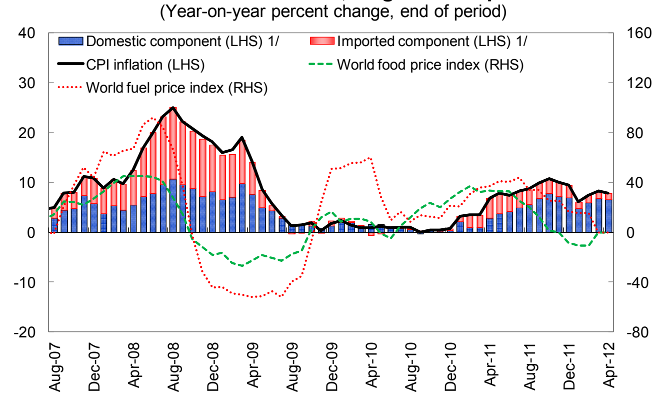
The economic recovery has been driven by booming resource sectors, especially logging and gold mining. Logging is expected to decline over the medium term.

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



Inflation pressures intensified due to the surge in global fuel and food prices.

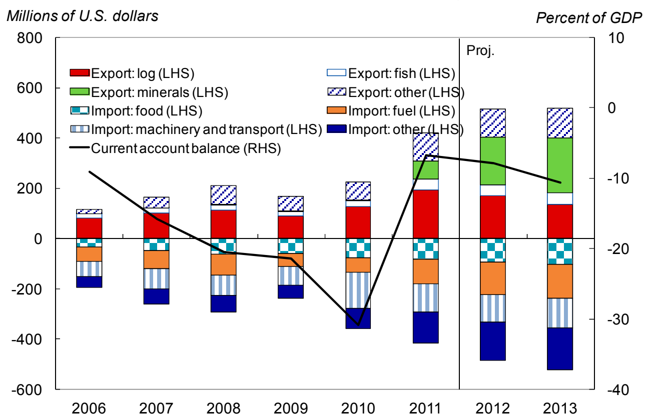
Contribution to Inflation, Aug. 2007– Apr. 2012
(Year-on-year percent change, end of period)



1/ Contribution to CPI inflation (in percentage points).

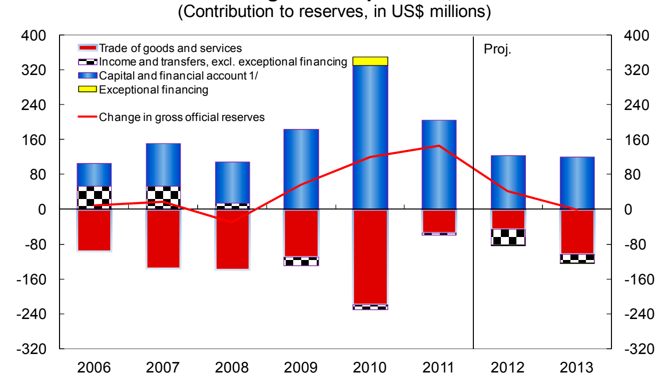
The current account balance improved in 2011, supported by record-high logging and palm oil exports, and recommencement of gold exports.

Current Account Balance and Trade, 2006–13



Reserve buffers have been rebuilt, thanks to donor grants and FDI.

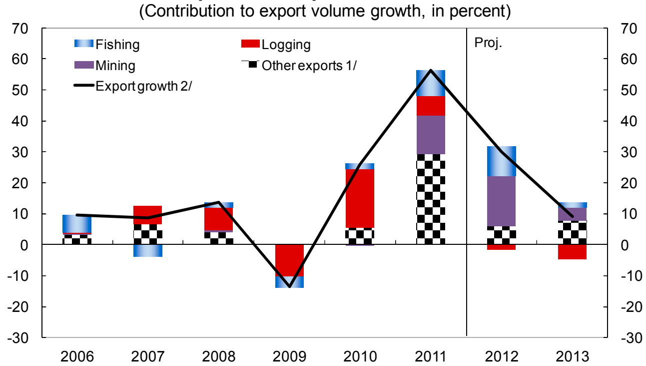
Reserve Change Decomposition, 2006–13
(Contribution to reserves, in US$ millions)



1/ Including errors and omissions.

Export volume has been strong driven by log and mineral exports, although log exports are projected to decline due to overexploitation.

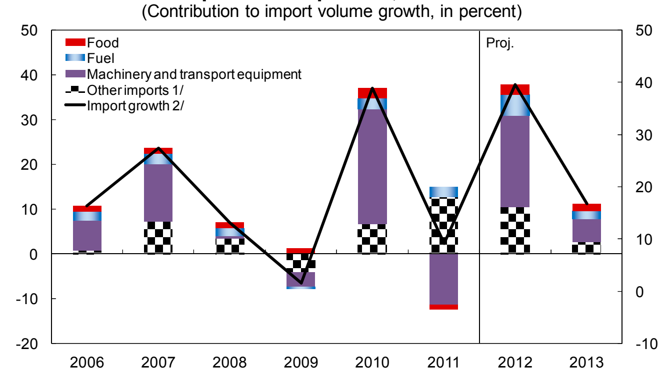
Export Developments, 2006–13
(Contribution to export volume growth, in percent)



1/ Residual.
2/ Year-on-year percent change.

Import volume has declined, reflecting the operational status of the Gold Ridge and lower imports of machinery and transport equipments.

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



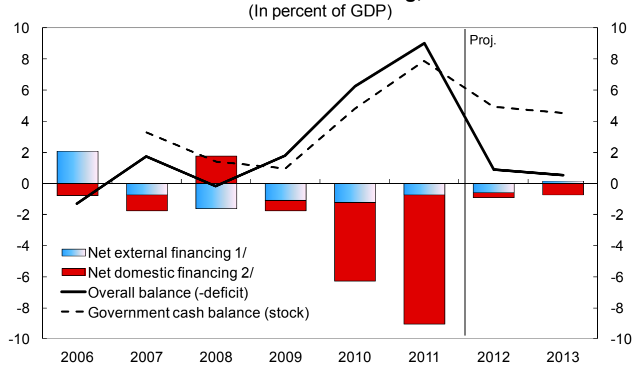
1/ Residual.
2/ Year-on-year percent change.

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

Solomon Islands: Macroeconomic Developments and Outlook (concluded)

The fiscal position continued to improve in 2011, contributing to a large increase in the cash balance.

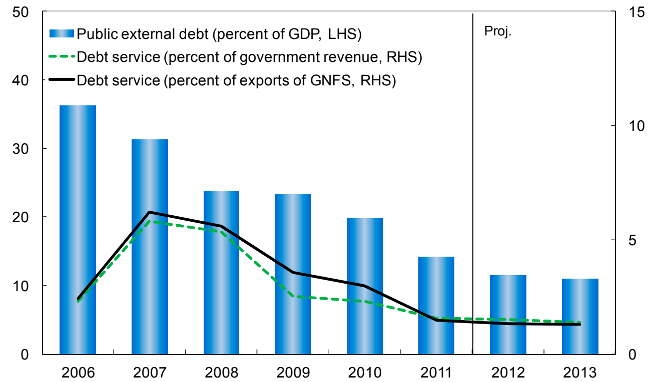
Fiscal Balance and Financing, 2006–13
(In percent of GDP)



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

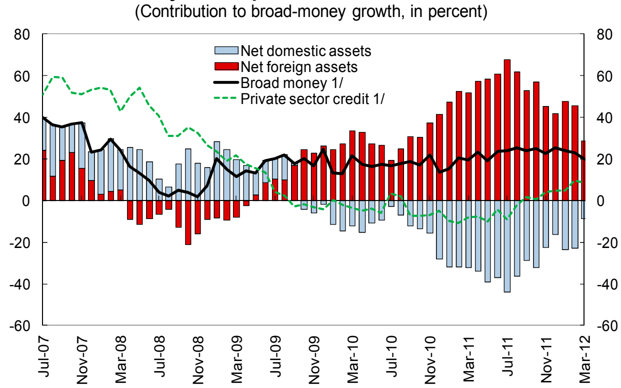
Public external debt continues to decline to sustainable levels.

Public External Debt, 2006–13



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

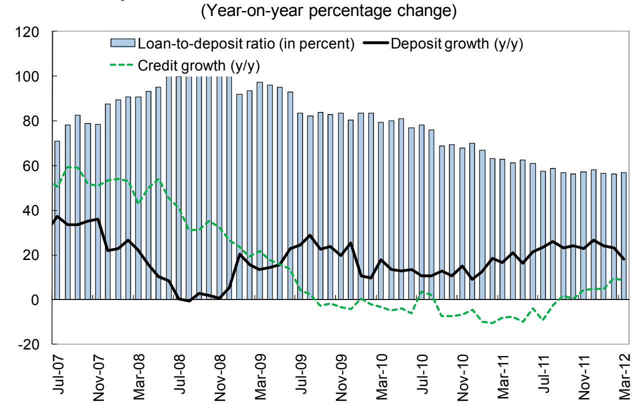
Monetary Developments, Jul. 2007– Mar. 2012
(Contribution to broad-money growth, in percent)



1/ Year-on-year percentage change.

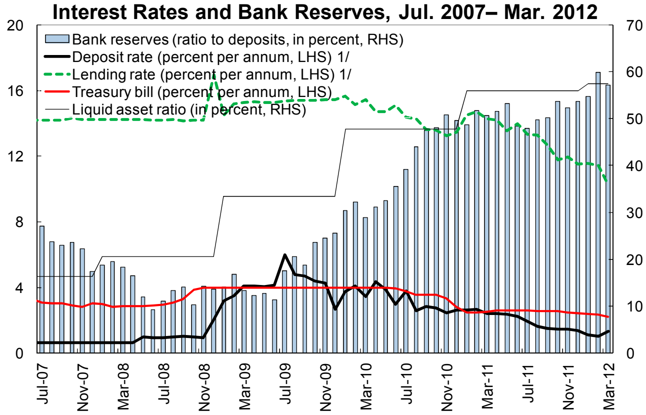
Private sector credit growth finally started to pick up…

Deposit and Credit Growth, Jul. 2007– Mar. 2012
(Year-on-year percentage change)



…reflecting lower lending rates and ample liquidity of the banking sector.

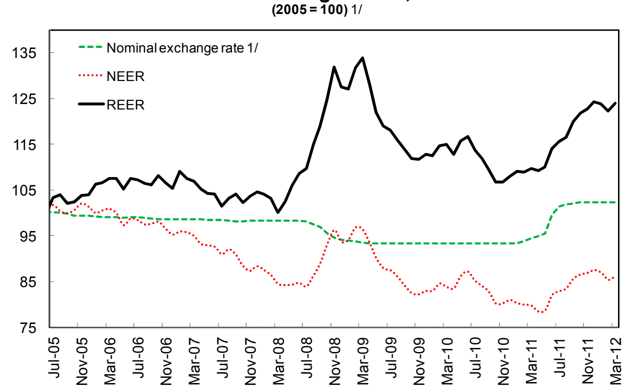
Interest Rates and Bank Reserves, Jul. 2007– Mar. 2012



1/ Weighted average rate of the commercial banks.

The real effective exchange rate has increased due to 8.8-percent currency appreciation in mid-2011.

Nominal and Effective Exchange Rates, Jul. 2005–Mar. 2012
(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.

Table 1. Solomon Islands: Selected Economic Indicators, 2009–13

Per capita GDP (2011): US$1,578 (estimate)
Population (2010): 538 thousand (estimate)
Poverty rate (2006): 23 percent

	2009	2010	2011		2012	2013
			Prog. (CR/11/359)	Est.	Proj.	Proj.
Growth and prices (percentage change) 1/						
Real GDP	-4.7	7.8	9.3	10.7	7.4	4.0
Of which : nontimber nonmining	-2.6	5.4	4.8	7.3	4.2	4.5
CPI (period average)	7.1	0.9	6.6	7.4	4.3	4.5
CPI (end of period)	1.7	0.8	7.1	9.4	4.6	4.5
GDP deflator	7.3	5.9	7.6	9.1	5.0	5.5
Nominal GDP (in SI$ millions)	4,815	5,498	6,404	6,640	7,492	8,216
Of which : nonmining nominal GDP (in SI$ millions)	4,779	5,393	5,900	6,279	6,579	7,171
Per capita GDP (in US$)	1,159	1,267	1,554	1,578	1,843	1,987
Per capita GNI (in US$)	838	945	1,210	1,254	1,368	1,520
Central government operations (percent of GDP)						
Total revenue and grants	55.2	62.6	59.5	60.2	57.0	55.5
Revenue	30.5	32.0	33.6	33.1	32.5	32.3
Grants	24.7	30.6	25.9	27.1	24.5	23.2
Total expenditure	53.5	56.4	55.9	51.2	56.2	55.0
Recurrent expenditure	28.6	28.2	27.1	25.6	28.0	26.6
Development expenditure	25.6	27.9	28.9	25.5	28.2	28.3
Unrecorded expenditure 2/	-0.7	0.3	0.0	0.0	0.0	0.0
Overall balance	1.8	6.2	3.6	9.0	0.9	0.5
Foreign financing (net)	-1.1	-1.2	-0.9	-0.7	-0.6	0.2
Domestic financing (net)	-1.6	-5.1	-2.8	-8.5	-0.3	-0.7
Privatization receipts	0.9	0.0	0.2	0.1	0.0	0.0
Central government debt (percent of GDP, unless otherwise indicated) 3/	33.2	27.8	21.3	20.6	14.5	13.0
Domestic debt	10.0	8.1	6.6	6.4	3.0	2.1
External debt	23.2	19.8	14.7	14.2	11.5	11.0
(In US$ millions, end of period)	138.7	134.7	126.9	128.1	121.9	124.1
Monetary and credit (percentage change, end-year data)						
Credit to private sector	-4.2	-4.7	2.0	4.7	4.8	…
Broad money	24.7	13.5	21.0	25.5	17.0	…
Reserve money	62.5	75.3	21.6	32.8	15.0	…
Interest rate - deposit (percent per annum)	2.7	2.6	...	1.4	...	...
Interest rate - lending (percent per annum)	15.4	13.5	...	11.5	...	...
Balance of payments (in US$ millions, unless otherwise indicated)						
Current account balance	-128.2	-210.1	-97.7	-58.2	-81.2	-122.2
(Percent of GDP)	-21.4	-30.8	-11.6	-6.7	-7.8	-10.7
(excluding mining-related capital imports, in percent of GDP)	…	-12.6	0.1	5.7	1.8	-1.2
Exports of goods and nonfactor services (GNFS)	234.9	330.2	524.3	558.5	679.6	677.6
(Percentage change)	-12.9	40.6	57.4	69.1	21.7	-0.3
Logging exports	88.1	124.7	187.5	191.4	168.8	133.8
Imports of GNFS	344.2	547.8	628.3	612.0	725.9	780.2
(Percentage change)	-15.8	59.2	14.7	11.7	18.6	7.5
Foreign direct investment	116.8	235.6	155.7	141.0	88.7	75.5
(Percent of GDP)	19.5	34.6	18.0	16.2	8.5	6.6
Overall balance	56.4	119.8	88.8	146.4	41.7	-1.6
Gross official reserves (in US$ millions, end of period) 4/	146.0	265.8	364.6	412.3	462.0	460.3
(In months of next year's imports of GNFS)	3.2	5.2	6.5	6.8	7.1	6.6
(In months of next year's nonmining-related imports of GNFS)	4.1	6.3	7.6	7.9	8.2	7.6
Exchange rate (SI$/US$, end of period)	8.1	8.1	...	7.4	...	...
Real effective exchange rate (period average, 2005 = 100)	120.5	112.0	...	115.2	...	...
Nominal effective exchange rate (period average, 2005 = 100)	88.7	83.5	...	82.7	...	...

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.

Table 2. Solomon Islands: Balance of Payments, 2009–17 1/

	2009	2010	2011		2012		2013	2014	2015	2016	2017
			Proj. (CR/11/359)	Est.	Proj. (CR/11/359)	Rev. Proj.			Proj.		
					(In millions of U.S. dollars)						
Current account balance	-128.2	-210.1	-97.7	-58.2	-124.3	-81.2	-122.2	-103.7	-85.4	-89.0	-100.7
Trade balance for goods	-74.3	-136.6	-5.0	0.6	21.8	29.1	-7.1	-30.9	-31.4	-43.6	-61.3
Exports	164.9	223.7	409.5	418.2	464.4	514.1	515.6	527.6	564.3	595.0	622.0
Imports	-239.2	-360.3	-414.5	-417.7	-442.7	-485.0	-522.7	-558.5	-595.7	-638.6	-683.3
Trade balance for services	-35.1	-81.0	-99.0	-54.1	-102.7	-75.5	-95.5	-102.0	-108.5	-115.4	-122.6
Exports	69.9	106.5	114.8	140.3	132.3	165.4	162.0	174.1	188.5	205.0	221.6
Imports	-105.0	-187.5	-213.8	-194.4	-235.1	-240.9	-257.5	-276.2	-297.0	-320.3	-344.2
Income balance	-165.5	-173.3	-185.5	-178.1	-259.8	-267.8	-269.3	-226.2	-207.1	-198.2	-190.3
Current transfers balance 2/	146.7	180.8	191.7	173.4	216.5	232.9	249.7	255.5	261.6	268.1	273.6
Of which : Official transfers, net	120.8	168.5	188.4	164.3	212.6	222.0	226.8	230.3	233.9	237.8	240.5
Capital and financial account balance	164.7	341.4	186.5	245.1	149.3	122.9	120.6	139.3	147.0	150.9	166.3
Capital account balance	26.8	49.8	31.8	71.2	35.2	36.3	38.9	40.1	40.7	41.4	41.9
Direct investment balance	116.8	235.6	155.7	141.0	105.2	88.7	75.5	83.2	79.8	77.9	86.1
Outwards	-3.0	-2.3	-5.8	-3.6	-12.3	-15.9	-19.6	-19.5	-26.9	-32.7	-38.3
Inwards	119.7	237.9	161.5	144.5	117.5	104.6	95.2	102.7	106.7	110.6	124.5
Portfolio investment balance	1.2	-2.6	0.0	1.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment balance 3/	19.9	58.6	-0.9	31.1	9.0	-2.1	6.2	16.0	26.5	31.6	38.4
Errors and omissions	19.9	-11.4	0.0	-40.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	56.4	119.8	88.8	146.4	25.0	41.7	-1.6	35.6	61.6	61.9	65.7
Financing	-56.4	-110.3	-88.8	-136.8	-25.0	-41.7	1.6	-35.6	-61.6	-61.9	-65.7
Change in gross reserves (- = increase)	-56.4	-119.8	-98.7	-146.4	-24.9	-49.7	1.7	-33.9	-58.3	-56.0	-59.5
IMF	…	9.6	10.0	9.6	-0.1	8.0	-0.1	-1.7	-3.3	-5.9	-6.1
					(In percent of GDP, unless otherwise indicated)						
Current account	-21.4	-30.8	-11.6	-6.7	-12.7	-7.8	-10.7	-8.5	-6.6	-6.5	-7.0
(excluding mining-related exports and imports of goods and services)	…	-12.6	-13.1	5.7	-22.2	-16.5	-20.2	-17.7	-15.5	-15.1	-15.4
(excluding mining-related imports of goods and services)	…	-12.6	0.1	5.7	-2.3	1.8	-1.2	0.4	1.9	1.6	0.8
(excluding net official transfers)	-41.6	-55.5	-34.1	-25.6	-34.4	-29.2	-30.5	-27.4	-24.8	-23.9	-23.7
Trade balance for goods	-12.4	-20.0	-0.6	0.1	2.2	2.8	-0.6	-2.5	-2.4	-3.2	-4.3
Exports (in percent of GDP)	27.6	32.8	48.8	48.1	47.5	49.5	45.0	43.3	43.8	43.6	43.3
Of which: Logs	14.7	18.3	22.3	22.0	13.7	16.2	11.7	10.2	9.7	9.1	8.7
Of which: Fish	2.8	3.6	3.3	5.2	3.5	4.3	4.1	4.3	4.7	5.0	5.3
Of which: Minerals	0.6	0.5	10.8	8.0	19.3	18.2	19.1	18.3	17.7	17.2	16.7
Imports	40.0	52.8	49.4	48.1	45.2	46.7	45.6	45.9	46.2	46.8	47.5
Of which: Food	10.1	11.5	11.8	9.8	11.5	9.1	9.1	9.5	9.8	10.0	10.3
Of which: Fuel	8.7	8.3	10.3	11.1	10.5	12.6	11.8	11.6	11.3	11.3	11.4
Of which: Machinery and transportation equipment	12.4	21.0	16.3	13.0	11.5	10.4	10.2	9.8	9.6	9.4	9.2
Mining imports	…	11.4	8.2	6.9	6.3	5.8	5.9	5.7	5.4	5.2	5.0
Nonmining imports	40.0	41.5	41.2	41.1	39.0	40.9	39.7	40.2	40.8	41.6	42.5
Excluding mining capital imports and reinvested earnings	-3.1	4.0	16.0	17.7	8.4	9.7	4.7	5.0	5.5	4.4	2.9
Trade balance for services	-5.9	-11.9	-11.8	-6.2	-10.5	-7.3	-8.3	-8.4	-8.4	-8.5	-8.5
Income balance	-27.7	-11.9	-22.1	-20.5	-26.6	-25.8	-23.5	-18.6	-16.1	-14.5	-13.2
Current transfers balance	24.5	26.5	22.8	20.0	22.1	22.4	21.8	21.0	20.3	19.6	19.0
Of which: Official transfers net	20.2	24.7	22.4	18.9	21.7	21.4	19.8	18.9	18.2	17.4	16.7
Capital account balance	4.5	7.3	3.8	8.2	3.6	3.5	3.4	3.3	3.2	3.0	2.9
Direct investment balance	19.5	34.6	18.5	16.2	10.7	8.5	6.6	6.8	6.2	5.7	6.0
Of which: Inward FDI	20.0	34.9	19.2	16.6	12.0	10.1	8.3	8.4	8.3	8.1	8.7
Other investment balance	3.3	8.6	-0.1	3.6	0.9	-0.2	0.5	1.3	2.1	2.3	2.7
Errors and omissions	3.3	-1.7	0.0	-4.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net international reserves (in US$ million) 3/	146.0	256.2	345.0	393.1	370.0	434.8	433.2	468.8	530.4	592.3	658.0
Gross official foreign reserves (in US$ million)3/ 4/	146.0	265.8	364.6	412.3	389.5	462.0	460.3	494.2	552.4	608.5	668.0
In months of next year's imports of GNFS	3.2	5.2	6.5	6.8	6.4	7.1	6.6	6.6	6.9	7.1	7.4
In months of nonmining-related imports of GNFS	4.1	6.3	7.6	7.9	7.5	8.2	7.6	7.6	7.8	8.0	7.9
Gross external public debt	23.2	19.8	14.7	14.2	13.5	11.5	11.0	11.4	12.6	14.0	15.7
Disbursement of consessional borrowing (in US$ millions)	0.0	0.0	0.0	0.0	12.0	1.1	9.5	21.3	32.2	37.5	43.1
External public debt service (in percent of exports of GNFS)	3.6	3.0	1.9	1.5	1.4	1.3	1.3	1.5	1.5	1.5	1.3
Gross external debt (percent of GDP)	32.4	31.9	24.9	24.1	22.6	20.1	19.0	19.2	20.0	21.1	22.6
Private sector	9.2	12.2	10.2	9.9	9.1	8.6	8.0	7.8	7.5	7.1	6.9
Public sector	23.2	19.8	14.7	14.2	13.5	11.5	11.0	11.4	12.6	14.0	15.7
External debt service (percent of GDP)	2.3	2.3	2.0	1.8	1.6	1.6	1.4	1.5	1.6	1.6	1.4
Principal	1.6	1.6	1.3	1.1	1.0	1.0	0.9	1.0	1.1	1.1	0.9
Interest	0.7	0.7	0.7	0.7	0.6	0.6	0.5	0.5	0.5	0.5	0.5
Nominal GDP (in US$ million)	597.8	681.8	839.6	869.0	…	…	…	…	…	…	…

Sources: Data provided by 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, 2009–13

	2009	2010	2011			2012			2013
			Budget	Proj. (CR/11/359)	Rev. Est.	Budget	Proj. (CR/11/359)	Rev. Proj.	Proj.
Total revenue and grants	2,659	3,442	3,635	3,811	4,000	4,397	4,248	4,272	4,557
Total revenue	1,467	1,757	1,959	2,150	2,199	2,625	2,454	2,434	2,651
Tax revenue	1,272	1,589	1,760	1,968	1,989	2,377	2,235	2,202	2,378
Income and profits	540	638	741	727	669	893	856	780	876
Goods and services	423	569	641	744	752	930	867	841	946
International trade and transactions	309	382	378	498	568	555	512	581	556
Of which: Tax on logging	162	241	199	342	373	…	279	357	281
Other revenue	196	168	199	182	210	248	220	232	273
Grants	1,192	1,685	1,676	1,661	1,801	1,772	1,793	1,838	1,907
Development grants	1,054	1,289	1,469	1,335	1,553	1,444	1,439	1,444	1,537
Recurrent budget grants	138	396	207	326	248	327	355	394	370
Expenditure	2,574	3,099	3,529	3,583	3,400	4,377	4,156	4,207	4,515
Recurrent expenditure	1,376	1,548	1,616	1,734	1,701	2,058	2,012	2,097	2,187
Compensation of employees	511	588	588	588	623	655	680	685	721
Interest payments	45	23	29	28	24	25	24	23	23
Other recurrent expenditure 1/	820	937	1,000	1,118	1,054	1,377	1,308	1,389	1,444
Development expenditure	1,231	1,533	1,914	1,849	1,695	2,320	2,144	2,109	2,328
Government funded	178	243	444	514	342	813	705	602	791
Domestic	178	243	444	514	342	813	616	595	723
External loan	0	0	0	0	0	…	89	8	68
Grant funded	1,054	1,289	1,469	1,335	1,354	1,507	1,439	1,507	1,537
Unidentified expenditure 2/	-33	18	0	0	3	0	0	0	0
Current balance	230	605	550	742	745	895	797	731	834
Overall balance	85	343	106	228	600	20	92	66	43
Total financing	-85	-343	-106	-228	-600	-20	-92	-66	-43
Foreign (net)	-53	-65	-58	-58	-49	-50	37	-44	15
Domestic (net)	-77	-279	-58	-180	-561	31	-129	-22	-58
Banking system	-64	-282	-49	-171	-558	45	-115	-8	-43
Central bank	-25	-284	-24	-146	-477	206	25	153	-5
Commercial banks	-39	2	-25	-25	-81	-161	-140	-161	-39
Nonbank	-13	2	-9	-9	-4	-14	-14	-14	-14
Others	45	1	10	10	10	0	0	0	0
(In percent of GDP)									
Total revenue and grants	55.2	62.6	56.8	59.5	60.2	58.7	58.5	57.0	55.5
Total revenue	30.5	32.0	30.6	33.6	33.1	35.0	33.8	32.5	32.3
Tax revenue	26.4	28.9	27.5	30.7	30.0	31.7	30.8	29.4	28.9
Income and profits	11.2	11.6	11.6	11.3	10.1	11.9	11.8	10.4	10.7
Goods and services	8.8	10.4	10.0	11.6	11.3	12.4	11.9	11.2	11.5
International trade and transactions	6.4	6.9	5.9	7.8	8.6	7.4	7.0	7.8	6.8
Of which: Tax on logging	3.4	4.4	3.1	5.3	5.6	…	3.8	4.8	3.4
Other revenue	4.1	3.1	3.1	2.8	3.2	3.3	3.0	3.1	3.3
Grants	24.7	30.6	26.2	25.9	27.1	23.6	24.7	24.5	23.2
Development grants	21.9	23.4	22.9	20.8	23.4	19.3	19.8	19.3	18.7
Recurrent budget grants	2.9	7.2	3.2	5.1	3.7	4.4	4.9	5.3	4.5
Expenditure	53.5	56.4	55.1	55.9	51.2	58.4	57.2	56.2	55.0
Of which: appropriated	31.6	32.9	32.2	35.1	30.8	38.3	36.2	36.0	36.2
Recurrent expenditure	28.6	28.2	25.2	27.1	25.6	27.5	27.7	28.0	26.6
Compensation of employees	10.6	10.7	9.2	9.2	9.4	8.7	9.4	9.1	8.8
Interest payments	0.9	0.4	0.4	0.4	0.4	0.3	0.3	0.3	0.3
Other recurrent expenditure 1/	17.0	17.0	15.6	17.5	15.9	18.4	18.0	18.5	17.6
Of which: Government funded	14.2	13.4	12.4	12.4	13.9	14.0	13.1	13.3	13.1
Development expenditure	25.6	27.9	29.9	28.9	25.5	31.0	29.5	28.2	28.3
Government funded	3.7	4.4	6.9	8.0	5.1	10.8	9.7	8.0	9.6
Domestic	3.7	4.4	6.9	8.0	5.1	10.8	8.5	7.9	8.8
External loan	0.0	0.0	0.0	0.0	0.0	…	1.2	0.1	0.8
Grant funded	21.9	23.4	22.9	20.8	20.4	20.1	19.8	20.1	18.7
Unidentified expenditure 2/	-0.7	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current balance	4.8	11.0	8.6	11.6	11.2	11.9	11.0	9.8	10.1
Overall balance	1.8	6.2	1.7	3.6	9.0	0.3	1.3	0.9	0.5
(excluding unidentified expenditure)	1.1	6.6	1.7	3.6	9.1	0.3	1.3	0.9	0.5
Total financing	-1.8	-6.2	-1.7	-3.6	-9.0	-0.3	-1.3	-0.9	-0.5
Foreign (net)	-1.1	-1.2	-0.9	-0.9	-0.7	-0.7	0.5	-0.6	0.2
Domestic (net)	-1.6	-5.1	-0.9	-2.8	-8.5	0.4	-1.8	-0.3	-0.7
Others	0.9	0.0	0.2	0.2	0.1	0.0	0.0	0.0	0.0
Memorandum items:									
Nominal GDP (in SI$ millions)	4,815	5,498	6,404	6,404	6,640	7,492	7,265	7,492	8,216
Gross cash balance (in SI$ millions)	106	326	351	472	561	451	447	481	486
Target of program cash balance (in SI$ millions) 3/ 4/	47	263	287	287	522	412	335	442	…
in months of recurrent spending	0.4	2.0	2.1	2.0	3.7	2.4	2.0	2.5	…
Mineral revenue (percent of GDP)	0.0	0.0	0.0	0.6	0.4	…	0.9	0.9	0.9
Non-mineral primary balance (percent of GDP) 5/	2.7	3.1	2.0	3.4	4.2	…	1.9	1.2	0.7
Non-commodity primary balance (percent of GDP) 6/	-0.7	-1.3	-1.1	-1.9	-1.4	…	-1.9	-3.5	-2.7
Non-commodity primary balance, excluding development expenditures (percent of GDP) 7/	3.0	3.2	5.9	6.1	3.8	…	6.5	4.4	6.1

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

1/ Includes spending financed by recurrent grants.

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

3/ Defined as the sum of government deposits in the cash balance accounts minus unpaid payments orders and unpresented checks.

4/ The cash balance of the government in 2012 inclusive of the contingency fund is projected to be SI$ 582 million, or 3.3 months of recurrent spending.

5/ Defined as non-mineral revenue (excludes grants) minus domestically funded recurrent and development spending excluding interest payments.

6/ Defined as non-mineral non-logging revenue (excludes grants) minus domestically funded recurrent and development spending excluding interest payments.

7/ Defined as non-mineral non-logging revenue (excludes grants) minus domestically funded recurrent spending excluding interest payments.

Table 4. Solomon Islands: Medium-Term Baseline Scenario, 2009–17

	2009	2010	2011	2012	2013	2014	2015	2016	2017
			Est.			Proj.			
Growth and prices (percentage change) 1/									
Real GDP	-4.7	7.8	10.7	7.4	4.0	4.2	4.2	4.3	4.0
Of which: nontimber and nonmining	-2.6	5.4	7.3	4.2	4.5	5.3	5.4	4.9	4.5
CPI (period average)	7.1	0.9	7.4	4.3	4.5	4.5	4.4	4.3	4.3
CPI (end of period)	1.7	0.8	9.4	4.6	4.5	4.6	4.2	4.3	4.3
GDP deflator	7.3	5.9	9.1	5.0	5.5	5.1	4.6	4.6	4.4
Nominal GDP (in SI$ millions)	4,815	5,498	6,640	7,492	8,216	8,995	9,804	10,694	11,605
Per capita GDP (in US$)	1,159	1,267	1,578	1,843	1,987	2,064	2,138	2,215	2,283
Per capita GNI (in US$)	838	945	1,254	1,368	1,520	1,681	1,794	1,893	1,981
Central government operations (percent of GDP)									
Total revenue and grants	55.2	62.6	60.2	57.0	55.5	56.7	56.4	55.5	54.6
Revenue	30.5	32.0	33.1	32.5	32.3	34.5	35.0	35.0	34.9
Grants	24.7	30.6	27.1	24.5	23.2	22.2	21.3	20.5	19.7
Total expenditure	53.5	56.4	51.2	56.2	55.0	55.3	55.3	54.9	54.4
Recurrent expenditure	28.6	28.2	25.6	28.0	26.6	26.6	26.6	26.6	26.6
Development expenditure	25.6	27.9	25.5	28.2	28.3	28.7	28.7	28.3	27.9
Unidentified expenditure 2/	-0.7	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	1.8	6.2	9.0	0.9	0.5	1.4	1.0	0.6	0.1
Non-mineral primary balance 3/	2.7	3.1	4.2	1.2	0.7	0.1	0.0	0.0	-0.1
Non-commodity primary balance 4/	-0.7	-1.3	-1.4	-3.5	-2.7	-2.9	-2.8	-2.7	-2.7
Central government debt (percent of GDP) 5/	33.2	27.8	20.6	14.5	13.0	12.7	13.5	14.6	16.3
Balance of payments (in US$ millions)									
Current account (balance (- deficit)	-128.2	-210.1	-58.2	-81.2	-122.2	-103.7	-85.4	-89.0	-100.7
(In percent of GDP)	-21.4	-30.8	-6.7	-7.8	-10.7	-8.5	-6.6	-6.5	-7.0
(excluding mining-related capital imports, in percent of GDP)	…	-12.6	5.7	1.8	-1.2	0.4	1.9	1.6	0.8
Overall balance	56.4	119.8	146.4	41.7	-1.6	35.6	61.6	61.9	65.7
Gross official reserves (end of period) 6/	146.0	265.8	412.3	462.0	460.3	494.2	552.4	608.5	668.0
(In months of next year's imports of GNFS)	3.2	5.2	6.8	7.1	6.6	6.6	6.9	7.1	7.4
(In months of next year's nonmining-related imports of GNFS)	4.1	6.3	7.9	8.2	7.6	7.6	7.8	8.0	7.9

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 2009–December 2012 1/

	2009	2010	2011					2012				
	Dec	Dec	Mar	Jun	Sep	Dec		Mar		Jun	Sep	Dec
						Prog. (CR/11/359)	Act.	Prog. (CR/11/359)	Act.		Proj.	
	(In millions of Solomon Islands dollars, end of period)											
Central Bank of Solomon Islands (CBSI)												
Net foreign assets (NFA)	1,051	1,942	2,133	2,613	2,712	2,432	2,803	2,477	3,092	2,964	3,043	3,129
Net international reserves (NIR)	1,177	2,066	2,261	2,743	2,838	2,558	2,918	2,603	3,208	3,083	3,170	3,260
Other NFA	-126	-124	-128	-131	-126	-126	-115	-126	-116	-119	-126	-131
Net domestic assets (NDA) 2/	-328	-673	-767	-1,199	-1,234	-889	-1,118	-870	-1,331	-1,253	-1,256	-1,191
Net claims on central government	-77	-361	-373	-639	-675	-507	-838	-488	-925	-794	-754	-684
Claims	124	117	118	111	105	117	103	117	101	103	103	103
Deposits	201	479	491	750	781	625	941	605	1,026	898	857	788
Other items (net)	-250	-312	-394	-560	-559	-382	-280	-382	-406	-459	-502	-506
Reserve money	724	1,269	1,366	1,414	1,478	1,543	1,685	1,607	1,761	1,711	1,788	1,938
Currency in circulation	326	436	449	475	470	500	526	510	515	540	535	550
Bank deposits	389	822	908	928	1,002	1,040	1,126	1,094	1,213	1,139	1,221	1,357
Other deposits	9	11	10	12	6	3	33	3	32	32	32	32
Other depository corporations												
NFA of commercial banks	181	51	140	187	170	196	88	206	66	89	122	85
Assets	184	141	195	274	240	250	169	260	168	192	226	189
Liabilities	2	89	55	87	70	54	80	54	102	103	104	104
NDA of commercial banks	927	760	716	768	788	778	838	789	806	991	945	1,032
Net claims on central government	51	53	-7	-51	-57	29	-28	39	-84	-93	-128	-189
Claims	125	121	119	118	108	96	101	106	98	76	21	-60
Deposits	74	68	125	169	165	68	129	68	182	169	149	129
Claims on the private sector	1,219	1,163	1,124	1,167	1,132	1,186	1,216	1,169	1,207	1,225	1,226	1,275
Other items (net)	-343	-456	-402	-347	-288	-436	-351	-419	-317	-142	-153	-55
Reserves and vault cash	410	847	938	963	1,038	1,068	1,171	1,129	1,248	1,179	1,262	1,404
Deposits	1,519	1,658	1,794	1,918	1,996	2,042	2,097	2,124	2,121	2,259	2,329	2,520
Depository corporations survey												
NFA of the banking system	1,233	1,994	2,274	2,799	2,882	2,628	2,891	2,683	3,158	3,053	3,165	3,214
Central bank	1,051	1,942	2,133	2,613	2,712	2,432	2,803	2,477	3,092	2,964	3,043	3,129
Other depository corporations	181	51	140	187	170	196	88	206	66	89	122	85
NDA of the banking system	600	87	-51	-431	-446	-111	-280	-81	-525	-262	-310	-159
Net claims on central government	-26	-308	-380	-691	-732	-478	-866	-449	-1,009	-887	-882	-873
Claims on the private sector 3/	1,224	1,166	1,128	1,171	1,137	1,190	1,221	1,173	1,212	1,230	1,231	1,281
Other items (net)	-598	-772	-800	-911	-851	-822	-636	-806	-728	-605	-659	-566
Broad money (M3)	1,833	2,080	2,222	2,369	2,436	2,517	2,611	2,602	2,633	2,790	2,855	3,055
M1	1,130	1,310	1,547	1,682	1,776	1,585	1,874	1,638	1,908	2,003	2,049	2,193
Currency outside banks	305	412	418	439	434	472	481	475	480	500	494	503
Demand deposits	824	898	1,129	1,243	1,342	1,113	1,393	1,162	1,427	1,503	1,555	1,690
Savings and time deposits	703	771	675	687	659	933	737	964	726	788	806	862
	(Annual percentage change, unless otherwise indicated)											
Reserve money	62.5	75.3	73.7	52.6	30.4	21.6	32.8	17.7	28.9	21.0	20.9	15.0
Credit to the private sector	-4.2	-4.7	-8.0	-4.0	1.7	2.0	4.7	4.0	7.5	5.0	8.3	4.8
Broad money	24.7	13.5	19.6	23.7	24.1	21.0	25.5	20.0	18.5	17.8	17.2	17.0
NFA of the banking system 4/	26.4	41.5	53.5	72.3	65.6	30.5	43.2	23.7	39.8	10.7	11.6	12.3
NDA of the banking system 4/	-1.7	-28.0	-33.9	-48.5	-41.5	-9.5	-17.7	-3.7	-21.3	7.1	5.6	4.7
Memorandum items:												
Money multiplier	2.5	1.6	1.6	1.7	1.6	1.6	1.5	1.6	1.5	1.6	1.6	1.6
Reserve money	62.5	75.3	73.7	52.6	30.4	21.6	32.8	17.7	28.9	21.0	20.9	15.0
Loan to deposit ratio (in percent)	80.3	70.1	62.7	60.8	56.7	58.1	58.0	55.1	56.9	54.2	52.7	50.6
Interest rates (percent per annum)												
Deposit rate 5/	2.7	2.6	2.4	2.2	1.5	…	1.4	…	1.3	…	…	…
Lending rate 5/	15.4	13.5	14.3	14.0	12.7	…	11.5	…	10.2	…	…	…
NCG of financial corporations	75	-204	-276	-594	-635	-384	-765	-357	-909	-793	-792	-787
91-Day Treasury Bill Rate	4.0	2.8	2.5	2.6	2.5	…	2.4	…	2.2	…	…	…
Program targets												
NIR of CBSI (in US$ millions)	146	256	280	340	352	345	393	351	432	421	428	435
NDA of CBSI (in SI$ millions)	-328	-673	-767	-1,199	-1,234	-767	-1,118	-870	-1,331	-1,253	-1,256	-1,191

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$7.42 per US$.

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 Disbursements Under the Standby Credit Facility Arrangement 1/

Date	Amount of Disbursement		Condition
	In percent of quota	In SDR	
December 6, 2011	17	1,733,333	Approved Fund arrangement
June 25, 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.

Table 7. Solomon Islands: Indicators of Capacity to Repay the Fund, 2011–22

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
	Est.						Proj.					
Fund obligations based on existing credit (in SDR millions)												
Principal	0.0	0.0	0.0	1.0	2.1	2.8	2.8	2.4	1.4	0.0	0.0	0.0
Charges and interest	0.0	0.0	0.0	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	1.0	2.1	3.7	3.9	3.6	2.5	0.8	0.0	0.0
Charges and interest	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.0	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	1.1	2.2	3.8	4.0	3.6	2.6	0.8	0.0	0.0
In millions of US$	0.0	0.0	0.1	1.7	3.3	5.9	6.1	5.6	3.9	1.2	0.0	0.0
In percent of gross international reserves	0.0	0.0	0.0	0.4	0.6	1.0	0.9	0.7	0.5	0.1	0.0	0.0
In percent of exports of goods and services	0.0	0.0	0.0	0.2	0.4	0.7	0.7	0.6	0.4	0.1	0.0	0.0
In percent of debt service 2/	0.0	0.0	0.5	9.6	16.1	27.4	29.5	27.3	19.5	5.9	0.0	0.0
In percent of GDP	0.0	0.0	0.0	0.1	0.3	0.4	0.4	0.4	0.2	0.1	0.0	0.0
In percent of quota	0.0	0.0	0.5	10.9	20.8	36.6	38.3	34.7	24.5	7.4	0.0	0.0
Outstanding Fund credit												
In millions of SDRs	12.5	17.7	17.7	16.6	14.6	10.9	7.0	3.4	0.9	0.0	0.0	0.0
In millions of US$	19.3	27.3	27.3	25.7	22.5	16.8	10.8	5.3	1.3	0.0	0.0	0.0
In percent of gross international reserves	4.7	5.9	5.9	5.2	4.1	2.8	1.6	0.7	0.2	0.0	0.0	0.0
In percent of exports of goods and services	3.5	4.0	4.0	3.7	3.0	2.1	1.3	0.6	0.1	0.0	0.0	0.0
In percent of debt service 2/	125.5	167.6	167.3	142.1	108.4	78.6	51.7	25.7	6.6	0.0	0.0	0.0
In percent of GDP	2.2	2.6	2.4	2.1	1.7	1.2	0.7	0.3	0.1	0.0	0.0	0.0
In percent of quota	120.0	170.0	170.0	160.0	140.0	105.0	67.2	32.8	8.4	0.0	0.0	0.0
Net use of Fund credit (in SDR millions)												
Disbursements	6.2	5.2	0.0	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	1.1	2.2	3.8	4.0	3.6	2.6	0.8	0.0	0.0
Memorandum items:												
Exports of goods and services (in US$ millions)	558.5	679.6	677.6	701.8	752.8	800.0	843.6	889.2	938.1	990.9	924.6	921.7
Gross international reserves (in US$ millions)	412.3	462.0	460.3	494.2	552.4	608.5	668.0	747.5	836.7	934.0	1024.1	1100.1
Debt service (in US$ millions) 2/	15.4	16.3	16.3	18.1	20.7	21.4	20.8	20.4	20.2	20.1	20.1	20.2
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 precautionary Standby Credit Facility although the baseline framework assumes no disbursement.
2/ Total public debt service, including IMF repayments.

APPENDIX I–LETTER OF INTENT

Ref: RF457/5/5 June 7, 2012

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

Dear Ms. Lagarde,

Solomon Islands has benefited from its strong engagement with the IMF. The current one-year precautionary Standby Credit Facility (SCF) arrangement, approved on December 6 2011, after the previous SCF expired on December 1, has been instrumental in anchoring the government policy agenda. Economic recovery has been stronger than expected, the fiscal and external positions have improved, and donors' support has been catalyzed.

Given the observance of all end-December 2011 quantitative targets by large margins (Table 1), all continuous performance criteria, and the substantial progress in implementing the structural benchmarks (Table 2), we request the completion of the first review under the SCF arrangement and the modification of the end-June 2012 performance criteria. Because our external position remains healthy and reserve coverage is at a comfortable level, we do not expect to draw on IMF resources under the current arrangement.

We remain committed to reforms aimed at enhancing the resilience of our economy, promoting strong, sustainable, and inclusive growth, and creating jobs across all sectors for our young people. The attached Memorandum of Economic and Financial Policies (MEFP) describes the government's reform policies for the second half of 2012. We believe they will strengthen our macroeconomic management framework, sustain the robust external and fiscal positions, maintain stable monetary conditions, and bolster the financial sector. In order to ensure firm implementation, the program will continue to be monitored through quantitative performance criteria and indicative targets, structural benchmarks, and the final review in November in 2012. Looking forward, to preserve the reform momentum, we would be very interested in continuing a strong engagement with the Fund through a successor arrangement once the current SCF expires.

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 adopting these measures, or on any revisions to the policies laid out 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/

Hon. Rick Houenipwela, MP
Minister of Finance and Treasury
Ministry of Finance and Treasury

/s/

Denton Rarawa
Governor
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

1. **Macroeconomic conditions have improved.** The rigorous implementation of the IMF programs over the last two years, together with strong political will, has helped restore economic and financial stability and triggered donor support. After contracting by 5 percent in 2009, activity rebounded to 6¾ percent in 2010 and to more than 10 percent in 2011. External and fiscal buffers have been rebuilt. Gross international reserves reached almost US$ 450 million (about 10 months of this year's imports of goods and services) as of April 2012, compared with less than US$100 million in early 2009. However, growth remains concentrated in the commodity sector with limited spill-over to the rest of the economy.

2. **The near- and medium-term outlook remains favorable, but we face large risks.** If downside risks do not materialize, in the near term we expect growth to remain healthy at just over 6 percent in 2012, with gold production taking over logging as the main driver of growth. Over the medium term, we expect logging output to decline, but gold production, alongside transport, construction and services should continue to support growth in the 4 percent range. Headline inflation is likely to revert to about 5 percent over the medium term as commodity prices stabilize. The balance of payments position should also remain strong. The main downside risks include the impact on emerging Asia of an escalation of financial turmoil in Europe and a large increase in oil prices triggered by geopolitical risks which could take a large toll on economic growth. The main channels of contagion would be through a deterioration in the terms of trade, contraction in demand for logging from Asia—especially China, our main trading partner—and through financial linkages. However, the resilience of Australian banks should minimize a funding shock risk.

3. **The program under the SCF arrangement is on track**. The program targets for end-December 2011 were met with comfortable margin. We have also implemented two benchmarks committed under the program and have made substantial progress toward achieving the others.

I. PROGRAM POLICIES

4. **Our policies are aimed at enhancing resilience to shocks and implementing growth-oriented structural reforms.** These goals would help boost investor confidence and ensure sustainable and inclusive growth. To this end, our program will continue to focus on strengthening the fiscal management framework, improving monetary operations, maintaining a strong foreign exchange position, and containing financial risks. In order to strengthen ownership and build a strong consensus, we will continue to allow for wider consultations among stakeholders in implementing our ambitious structural reform plan.

A. Fiscal Policies

5. **We remain committed to preserving a strong fiscal position while providing adequate resources for critical social spending to ensure that growth is more inclusive.** The fiscal position strengthened considerably in 2011 as a result of buoyant revenues and better fiscal management. For this reason we request the modification of the end-June 2012 performance criteria. We realize that revenue will continue to remain volatile in the near term, however, owing to its reliance on commodities and that it will decline in the medium term as logging stocks are expected to be exhausted over the next decade. Thus, we will strike a balance between preserving strong fiscal buffers and refocusing on critical infrastructure and priority social spending such as on health and education, to lift long-term potential growth. To achieve these near- and medium-term goals, we will ensure that fiscal policy for the remainder of this year is consistent with the following policies:

- To retain an adequate fiscal buffer, we are strongly committed to preserving the cash balance in line with the 2012 budget. We transferred SI$80 million of savings in January 2012 from the cash balance to a contingency fund (SIG Consolidated Deposits Accounts) that is kept at the CBSI but is not part of the program cash balance. This contingency fund is maintained as an emergency buffer and its balance was SI$140 million in January. Our revised cash balance targets for 2012 reflect this account and are based on the assumption that the balance in the contingency fund would not be lower than SI$140 million. Where required and pending any further marked deterioration in the global economy, we will make necessary fiscal adjustments in order to meet our cash balance target. A prudent fiscal stance is also warranted in light of the recent intensification of inflation pressures. Should commodity revenue surprise on the upside, or under-spending of the development budget materialize due to capacity constraints, we will save this windfall for future development spending or increase fiscal space to buffer future shocks. To help anchor fiscal plans, we will move toward targeting the non-commodity fiscal balance as opposed to the cash balance in the medium term, 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 business cycle, and ensure a long-term sustainable use of exhaustible resources.

- To make meaningful progress toward our goal of achieving inclusive growth and alleviating poverty, we will continue to allocate more resources toward social sectors (health and education) and infrastructure as envisaged in the 2012 budget. We have established mechanisms to track government-funded spending on health and education. Accordingly, we are setting an indicative target for spending on these two sectors at no less than 32 percent of government-funded recurrent spending as part of our economic program with the IMF. This goal is in line with our economic reform agenda and consistent with our undertakings under the Core Economic Working Group. We will also make a larger contribution to the National Transport Fund (NTF) in 2012 to finance transportation infrastructure which will trigger positive growth spillovers and encourage private sector activity. The forthcoming Pacific Arts Festival has provided the opportunity to rebuild roads and invest in infrastructure in line with our national development strategy. To capture the activities of NTF and its impact on the overall fiscal stance, going forward we will report to the IMF monthly data on the accounts of the NTF, including its sources of funding such as transfers from the budget and external grants, expenditures by project, and changes in the NTF accounts at the CBSI and commercial banks.

- To strengthen public financial management and better monitor priority spending, we will continue to make progress toward improving our budget presentation. A considerable step has been achieved in February 2012 when we revised the budget presentation to include output line items, thus attaining a program benchmark (originally set for September 2012) ahead of schedule. We also improved the transparency of the budget process through extensive consultations with non-government organizations and ministries. We will also continue to seek assistance from development partners to strengthen procurement and internal audit processes to reduce leakages that affect public service delivery.
- To avoid waste and rationalize expenditure, we will contain growth of non-essential recurrent spending including by streamlining spending on public sector allowances and benefits.
- To enhance the efficiency of public service delivery and to attract and retain professional and technical personnel in the public service, it is important that the basic supporting mechanisms are improved. This includes resolving existing payroll and establishment problems. It is also key that the appropriate levels of remuneration and pay adjustments are addressed. It is a long process, but the government has made progress and will continue working toward these objectives.
- We will continue to boost domestic revenue by strengthening compliance and streamlining exemptions. A new comprehensive draft bill on customs and excise tax is being drafted (revised benchmark) with the assistance of Asian Development Bank and co-financed by the AusAID. We will submit to Cabinet the new bill by end-October 2012 (redrafted benchmark date) together with the required amendments to other revenue acts (income tax, stamp duties, goods and sales tax acts). This bill already incorporates strengthened exemption rules, which makes the draft amendments on exemptions, originally included as an IMF benchmark, redundant.
- 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 by September 2012 Cabinet approval 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). This reform is taking longer than expected to allow a wider consultation process with different stakeholders such as extractive companies, civil society, and landowners. A consultation meeting with all stakeholders will be held in June. Until this new tax regime is in place, we will refrain from approving new mining leases. At the same time, we will adopt measures to enhance

our revenue administration in the area of mining taxation to ensure that the Government receives its share of mining revenue.

- Strengthening the fiscal framework and public management by continuing to reform the Public Finance Act (PFA) is a high priority for this Government. We are aiming at submitting to Cabinet the draft Act by mid-November (redrafted benchmark date). The new PFA will incorporate provisions on fiscal responsibility, management and use of public funds, and management of public debt. The process involves the production of four discussion papers. Significant progress has been made so far since the review of the Act was announced last October: the release of a discussion paper in February, followed by public consultation; the release of the second and third discussion papers is expected for late May or early June.
- Exercising caution in resuming concessional borrowing would be key in preserving external stability while tapping resources to finance much needed investment projects. These could include the submarine internet cable project and the Tina River Power Project, which will reduce the cost of doing business and encourage private sector investment. The Debt Management Strategy (DMS) endorsed in May by the Cabinet, building on the results of the IMF-World Bank Debt Sustainability Analysis, provides the appropriate framework to anchor borrowing plans going forward. The DMS supersedes the Honiara Club Agreement (HCA) review (program benchmark). The review is being completed by presenting the DMS bilaterally to HCA signatories and observers.

B. Monetary, Exchange Rate, and Financial Sector Policies

6. **Monetary and exchange rate policies will continue to be geared to maintaining price and external stability.** Given the comfortable level of foreign reserves, the Central Bank of Solomon Islands (CBSI) allowed the currency to appreciate by 8.8 percent against the U.S. dollar in the second half of 2011 as a way to mitigate imported inflation. However, inflation pressures have reemerged lately driven by sustained domestic demand and high oil prices. As a result, monetary policy will need to be tightened by raising the reserve requirement and scaling up open-market operations, including through the issuance of *Bokolo* bills. While 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. To reinforce the effectiveness of the CBSI in conducting monetary policy and its supervisory activities, we have drafted a new CBSI Act. The process took longer than expected to allow us to conduct stakeholder consultations, and to incorporate the Attorney General's amendments. We will seek Cabinet approval of the draft act by June 10, 2012 (program benchmark).

7. **We will continue our efforts to strengthen the financial supervisory and regulatory frameworks, and improve access to credit.** To facilitate large project financing, prudential guidelines on the single borrower limits was 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. To this end we have requested IMF technical assistance that will be delivered later this year. 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.

8. **Reforming the National Provident Fund (NPF) to improve its governance and investment framework would be key to provide retirement income and maintain financial stability**. We plan to seek Cabinet approval of the drafting instructions to the amendments to the NPF Act by end-June 2012 (program benchmark), in line with program commitments. This reform will strengthen the NPF's governance structure, reduce political influence on investment decision, and maximize returns to its members. We would like to request IMF technical assistance on strengthening on-site supervision of NPF, insurance companies, and pension funds.

II. Other Issues

9. **Safeguards assessment.** We agreed to ensure the completion of the Safeguards Assessment update by the time of the IMF Board meeting at the end of June. We understand from the IMF Finance Department that the schedule for finalizing this assessment is on track.

10. **Statistics and data monitoring provisions.** Progress has been made in strengthening the quality of national account statistics and fiscal and monetary data, but we will continue to improve the timely reporting of the program relevant data. We will also devote more resources to improving the collection and the quality of national accounts statistics; however, the quality of the national accounts is also dependent on input data from the wider national statistical system across the country. We would like to request IMF technical assistance on statistical sampling techniques, as related to conducting business and employment surveys. We will also continue to encourage our staff, including from the national statistics office, to apply to the IMF economic and financial programming courses, as part of the on-going efforts in capacity building.

Table 1. Solomon Islands: Quantitative Performance Criteria (PC) and Indicative Targets (IT)

	12/31/2011			3/31/2012			6/30/2012		9/30/2012	
	PC (CR/11/359)	PC with adjustors	Act.	IT (CR/11/359)	IT with adjustors	Est.	PC (CR/11/359)	Rev. PC	IT (CR/11/359)	Rev. 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$)) 2/	345	341	396	351	347	424	357	421	364	428
Net domestic asset (NDA) of the CBSI (ceiling, end-of-period stock, in millions of Solomon Islands dollars (SI$)) 3/	-767	-737	-1,118	-870	-836	-1,331	-869	-1,253	-875	-1,256
Net credit to central government (NCG) (ceiling, cumulative change from the beginning of the year, in millions of SI$) 4/	-58	-27	-561	27	61	-143	19	-28	4	-26
New nonconcessional external debt maturing in more than one year, contracted or guaranteed by the public sector (ceiling, end-of-period stock since the beginning of the program, in millions of US$) 5/	0	0	0	0	0	0	0	0	0	0
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$) 5/	0	0	0	0	0	0	0	0	0	0
Accumulation of new external payment arrears by the public sector (ceiling, end-of-period stock since the beginning of the program, in millions of SI$) 5/	0	0	0	0	0	0	0	0	0	0
Central government program cash balance (floor, end-of-period stock, in million of SI$) 4/	287	254	522	287	233	402	292	342	313	392
Indicative Targets (cumulative)										
Government funded recurrent spending on health and education	…	…	…	…	…	…	…	273	…	409
Memorandum items:										
Budget support from bilateral and multilateral donors other than IMF (cumulative change from the beginning of the year, in millions of US$), program level.	50	…	46	14	…	9	30	38	44	47
Outstanding stock of Solomon Islands government (SIG) treasury bills, excluding restructured government bonds (end-of-period stock, in millions of SI$), program level.	40	…	38	60	…	40	60	60	60	60
Balance of SIG Consolidated Deposits Account, millions of SI$.6/	…	…	60	…	…	140	…	140	…	140

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; the floor on the program cash balance will be adjusted upward by the balance in the SIG Consolidated Deposits Account short of the program level (this adjustor applies to end-June PC and end-September IT).

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

6/ The SIG Consolidated Deposits Account functions like a contingency fund for the government and transfers to and from this account can affect the program cash balance. Negative deviations from the projected balance in this account will therefore be used to adjust the program cash balance targets upward. The balance in this account for end-2011 and end-March 2012 are reported for reference since the balance in this account has not been monitored previously as part of the program.

Table 2. Solomon Islands: Structural Benchmarks

Actions	Macroeconomic criticality	Date	Status
Submit to Parliament the amendment 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	Not met, but superseded by a more comprehensive reform. A new comprehensive draft bill on customs and excise tax, including reforming exemption rules, is being drafted with the assistance of the ADB co-financed by Ausaid, as opposed to amending ad hoc the previous draft. Parliament is not likely to reconvene before December. This benchmark has been replaced by a new benchmark (see below).
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	Not met, but in progress. This reform is taking longer than expected to allow a wider consultation process with different stakeholders such as extractive companies, civil society, and landowners. Documentation has been already circulated to stakeholders as part of the public consultation process, including a summary of the amendments and draft legislations (see below, re-set date).
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	Not met, but expected to be met with delay by June 10, 2012. Public consultation was held on April 23. Work on the reform of the CBSI Act is now complete and the authorities expect to submit the final draft to Cabinet for endorsement by June 10.
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	Met. The Debt Management Strategy (DMS), endorsed by Cabinet on May 10, supersedes the Honiara Club Agreement (HCA) review. The review is being completed by presenting the DMS bilaterally to HCA signatories and observers.
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	On track. The TA from Australian Treasury has been secured and is currently assisting to progress the review of the NPF Act. The drafting instruction is expected to get cabinet approval by June 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	Met. The revised presentation has been provided in the 2012 Budget paper approved in February 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	In progress. It has been replaced by a new benchmark and a new intermediate benchmark has been also introduced (see below). The process involves the production of four discussion papers, one of which has been completed. The remaining three will be completed by end-June. Public consultations will be required (in September) before the final draft bill is submitted to Cabinet for approval.
Revised and New Benchmarks			
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.	September 30, 2012	
Discussion papers and draft legislation of the new Public Finance Act to be presented at a public workshop.	To strengthen budget management and ensure fiscal sustainability.	September 30, 2012	
Submit to Cabinet the new Customs and Excise bill, including the clauses related to exemptions and the draft amendments to other revenue acts (income tax, stamp duties, goods and sales tax acts).	To promote fiscal transparency and enhance the efficiency of revenue collections.	October 31, 2012	
Submit to Cabinet the draft of new Public Finance 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.	November 15, 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 the 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 the 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. Starting with the end-June 2012 target, the floor on the program cash balance will be adjusted upward by the difference between the January 2012 level of SI$140 million in the SIG Consolidated Deposits Account and its actual balance, should the actual balance in the SIG Consolidated Deposits Account be lower than SI$140 million.

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 the 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:
    - o Revenue, including tax and nontax revenues, and recurrent and development grants included in the consolidated budget;
    - o Recurrent expenditure, including payroll, goods and services, and other recurrent outlays, including those funded by donor support;
    - o Other recurrent charges of the Ministry of Education and Ministry of Health, separating spending funded by donor support;
    - o 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 the 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 the 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 — EXTERNAL RELATIONS DEPARTMENT

Press Release No.
FOR IMMEDIATE RELEASE
June 25, 2012

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes the First Review Under the Standby Credit Facility with Solomon Islands, and Approves Request for Modification of Performance Criteria

The Executive Board of the International Monetary Fund (IMF) has completed the first review of Solomon Islands' economic performance under a program supported by a Standby Credit Facility (see Press Release No. 11/448), and approved a request for modification of end-June 2012 performance criteria, based on strong program performance.

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

"Firm program implementation under the Standby Credit Facility arrangement has succeeded in restoring macroeconomic and financial stability. Substantial progress has been made toward implementing structural benchmarks, albeit with some delays. However, the economy remains vulnerable to commodity price and demand shocks, and heightened uncertainty in the global outlook poses risks. Bolstering the economy's resilience to shocks and pursuing a more inclusive growth model remain top priorities.

"In order to preserve fiscal sustainability, the near-term priority is to maintain the cash balance accumulated to strengthen the fiscal buffers while improving the efficiency and composition of public spending. Looking ahead, it will be important to ensure that mineral wealth spills over to the rest of the economy. To this end, managing resource revenues and anchoring fiscal policy to the non-commodity balance would strengthen the policy framework.

"The authorities are committed to comprehensive reforms with a view to fostering inclusive growth. The agenda includes mining legislation to broaden the tax base; a new resource taxation regime to promote fiscal transparency; and greater efficiency of tax collection. Strengthening public financial management is also critical for enhancing the transparency of the budget process. Prudent debt management calls for caution in resuming concessional borrowing to minimize external and fiscal risks.

"Monetary and exchange rate policies have helped moderate inflation. The authorities indicate their readiness to tighten monetary policy if inflation risks continue. The exchange rate should continue to act as an external shock absorber.

"The banking system remains profitable and adequately capitalized. Efforts by the central bank should continue to focus on strengthening the supervisory and regulatory framework of the financial system."

Statement by Christopher Legg, Executive Director
June 25, 2012

The Fund's precautionary Standby Credit Facility has provided a crucial policy anchor for my Solomon Island authorities as they have rebuilt policy buffers and continued to progress a significant structural reform agenda, focused on strengthening key policy institutions and governance arrangements while laying the foundation for a more diversified, inclusive development path. The engagement with the Fund has proven especially important as my authorities seek to manage the phased withdrawal of the Regional Assistance Mission for the Solomon Islands (RAMSI).

As is well documented in the Staff Report, growth has continued to recover, driven by the resources sector and trade links to emerging Asia and Australia. The external position has also benefitted from increased aid flows, catalyzed by the SCF supported program. Gross international reserves, which were at risk of declining to worrying low levels in 2009, now provide approximately seven months of import cover.

Improved fiscal performance remains at the core of the program. My authorities acknowledge the importance of preserving and further bolstering fiscal buffers, building on the significant gains – well in excess of program targets – made through 2011.[1] Nevertheless, they consider that the stronger revenue base in prospect for 2012, together with continuing efforts to improve the management and targeting of both recurrent and development expenditures, affords an opportunity to strengthen the focus on long term development objectives. In this context, a strengthened focus on social priorities such as health and education, and on transportation infrastructure, is clearly important both to ensuring that Solomon Islanders begin to see tangible benefits from the recent commodity driven growth and to laying the foundation for future economic diversification. The authorities' national development strategy continues to provide a disciplined organizing framework for such expenditure.

Equally, the significant reduction in the Government's debt burden, and more importantly, Cabinet's approval of a new debt management strategy (to supersede the Honiara Club Agreement which prohibited new government borrowing) provides the basis for a measured and cautious exploration of the possibility of loan financed investments in key infrastructure projects, which cannot be financed by the government alone or from grant development assistance. In this context, my authorities agree with Staff on the importance of building the necessary capacity, and putting in place adequate guidelines and procedures, to ensure adequate project appraisal and evaluation.

More generally, it is clear that structural reforms to strengthen both domestic revenue mobilization and public financial management are key to ensuring that fiscal policy remains supportive of sustainable development objectives over the longer term. Successfully implementing such reforms in the context of a small economy such as the Solomon Islands

[1] My authorities welcome the proposal to integrate into the program's cash balance targets the contingency fund established at the Central Bank to assist in ensuring that windfall revenue gains are saved.

requires a well targeted and prioritized approach, acknowledging the limitations of scarce capacity and the need to manage a complex and inherently fragile political environment. The authorities' MEFP sets out a comprehensive but pragmatic approach, seeking to address both basic supporting mechanisms, such as payroll systems, and more far reaching legislative reforms such as those reflected in the agreed structural benchmarks. The evolution of the latter over time underscores the realities of complex reform processes in small, fragile and geographically dispersed societies. In the case of the proposed reform of the Customs and Excise legislation, it also reflects the authorities' decision to pursue a more comprehensive, less piecemeal approach. In all cases, the change in Government last November strengthened both the authorities' ownership of the agreed reforms and their determination to take sufficient time to do them properly. While the revised timetable remains challenging, my authorities are firmly committed to achieving these benchmarks.

Turning to monetary policy, the monetary authorities remain committed to monitoring developments closely, and will tighten monetary policy as required in response to recent evidence of a re-emergence of both imported and domestically driven inflationary pressures. Excess liquidity in the banking sector remains an issue, and the Central Bank of Solomon Islands will continue to look to reserve requirements and sales of *Bokolo* bonds as its primary policy tools. The amendments to the CBSI Act, shortly to go to Cabinet after extensive community consultations, provide the basis for significantly enhanced supervisory and monetary policy effectiveness. The authorities also recognize the importance of strengthening the National Provident Fund act, as part of broader efforts to enhance the supervisory and regulatory framework, and Cabinet is expected to shortly approve drafting instructions for its revision.

Meanwhile, as Staff has pointed out, external events continue to pose a significant downside risk. The scenario summarized in the Report serves to highlight the fragility of the gains made to date, significant though they are in the Solomon Islands' context. While my authorities do not expect to need to draw upon the current arrangement, they are very conscious that building a robust and resilient economic and institutional base for the Solomon Islands' will require a sustained, long term effort, and they are keen to build further on the constructive relationship they have established with the Fund through this process.