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SOLOMON ISLANDS

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FOURTH REVIEW UNDER THE EXTENDED CREDIT FACILITY ARRANGEMENT AND REQUEST FOR MODIFICATION OF PERFORMANCE CRITERIA—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR SOLOMON ISLANDS

In the context of the Fourth Review Under the Extended Credit Facility Arrangement and Request For Modification of Performance Criteria, the following documents have been released and are included in this package:

- The **Staff Report for** the Fourth Review Under the Extended Credit Facility Arrangement and Request For Modification of Performance Criteria prepared by a staff team of the IMF for the Executive Board's consideration on April 10, 2015, following discussions that ended on January 29, 2015, with the officials of Solomon Islands on economic developments and policies underpinning the IMF arrangement under the Extended Credit Facility. Based on information available at the time of these discussions, the staff report was completed on March 20, 2015
- A **Press Release** including a statement by the Chair of the Executive Board.
- A **Statement by the Executive Director** for Solomon Islands.

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

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

*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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SOLOMON ISLANDS

FOURTH REVIEW UNDER THE EXTENDED CREDIT FACILITY ARRANGEMENT

March 20, 2015

KEY ISSUES

Recent Developments and Outlook. Solomon Islands held its parliamentary elections on November 19, 2014 and elected a new government led by Prime Minister Manasseh Sogavare, representing the Democratic Coalition for Change. The country's Gold Ridge mine, its only gold mine, remains closed and the chances of it re-opening are limited given current gold prices. At the same time, the logging industry is being adversely affected by the depletion of forestry resources. As a result, the near-term outlook has worsened. While lower oil prices constitute a windfall to consumers and producers, diversifying sources of growth and boosting the competitiveness of the economy are key to strengthening medium-term growth prospects. The risks to the outlook are to the downside.

Program Performance. Performance under the Extended Credit Facility (ECF) arrangement has been broadly satisfactory. Performance criteria for end-June 2014 were met by large margins. Indicative targets (ITs) for end September 2014 were also met, except for those on health and education spending, which were both narrowly missed in June and September 2014. Despite delays, the authorities have made progress in implementing the structural reform agenda.

Policy Recommendations

- In the medium term, recalibrate ambitious spending plans in line with implementation capacity, revenue envelope, financing availability, and the need to preserve fiscal buffers for resilience against shocks given the serious setback in mining prospects linked to the closure of the only gold mine.
- Strengthen the quality of public spending and fiscal management by advancing Public Financial Management (PFM) reform, including improving the transparency and accountability in the use of constituency funds.
- Maintain the current monetary stance but stand ready to tighten policy if credit growth and inflationary pressures surge.
- Strengthen financial regulation and supervision, including supervision of the National Provident Fund, and improve private sector access to credit.

Approved By
David Cowen and Masato Miyazaki

Discussions took place in Honiara during January 20–29, 2015. The team comprised Ms. Tumbarello (Head), Ms. Hunter, Messrs. Jamaludin, and Wu (all APD). Mr. Perks (SPR) supported the mission from headquarters. Messrs. Flinner and Zeinullayev (all APD) assisted in the preparation of this report. Ms. Plater (Alternate Executive Director) joined the policy discussions. The team met with Prime Minister Sogavare, Minister of Finance Rini, Central Bank Governor Rarawa, and other senior officials, donors, and the financial sector.

CONTENTS

THE SETTING: CONTEXT AND OUTLOOK

1. **The new government**. Solomon Islands held its parliamentary elections on November 19, 2014. The new Prime Minister, Manasseh Sogavare, representing the Democratic Coalition for Change, announced the new government's reform program in January 2015—an ambitious policy agenda (MEFP paragraph 6) which includes both land and sector reforms, aimed at boosting GDP growth by fighting corruption and enhancing business confidence to attract FDI, supported by large public investment over the medium term. The new government is also developing a Twenty-Year National Development Strategy (2015–35). Diversifying the sources of growth away from logging and mobilizing revenues to finance investment projects will remain key challenges going forward.

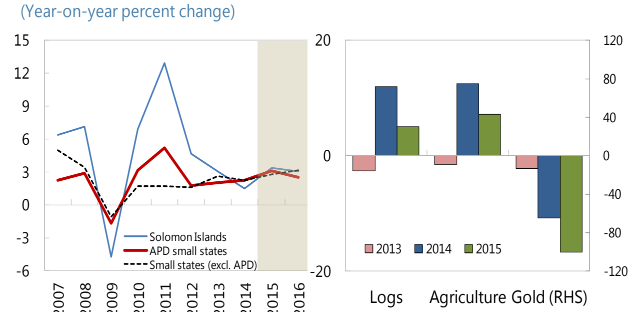
Solomon Islands: Macroeconomic Indicators
(In percent of GDP, unless indicated otherwise)

	2014		2015
	EBS/14/65	Revised	Proj.
Real GDP growth (in percent)	0.1	1.5	3.3
CPI (average, in percent)	7.0	5.1	3.8
Revenue	31.5	33.2	31.5
Grants	17.2	12.9	14.7
Recurrent expenditure	29.3	28.1	28.8
Development expenditure	21.1	16.1	19.5
Overall balance	-1.6	1.9	-2.1
Current account	-14.7	-8.5	-8.4
Current account+FDI 1/	-9.9	-12.9	-3.2
Cash balance (SI$ million)	374	880	776
(In months of recurrent spending)	1.8	4.4	3.5
Net official reserves (In million of US$, end of period) 2/	450	478	524

1/ FDI numbers have been revised down as a result of changes to ensure the correct treatment of net losses under reinvested earnings, in line with the sixth edition of the Balance of Payments and International Investment Position Manual (BPM6).
2/ Evalueted at program exchange rate.
Source: IMF staff estimates and projections.

2. **Recent developments.** The closure of Gold Ridge mine and the flood of April 2014 weakened economic activity. Nonetheless, non-mineral production and exports have surprised on the upside thanks to reentry logging and a rebound in agricultural output and fisheries. As a result, real GDP growth is now estimated at 1.5 percent in 2014 (Tables 1-2). While, the current account is expected to have deteriorated to about -8.5 percent of GDP in 2014 (from -4.5 percent of GDP in 2013), performance has been better than initially anticipated (EBS/14/65) notwithstanding the effects of the mine closure, flood, and slowdown in official transfers in the run-up to the elections. This is due largely to the reduced trade deficit, including delays in import-intensive reconstruction. Net reserves were at US$478 million at end-December 2014 (equal to 8.2 months of imports) against a program target of US$450 million. They declined from US$550 million at end-June 2014 owing to a widening trade deficit, significantly lower-than-expected donor support and some large one-off capital outflows, including some debt repayment. Inflation slowed to about 4.2 percent in December 2014 from 7.5 percent in May because of lower commodity prices and post-flood food-supply recovery.

Solomon Islands: Real GDP Growth and Commodity Production
(Year-on-year percent change)



Sources: Country authorities; and IMF staff calculations.

3. **Baseline scenario.** The economic activity is expected to increase by 3.3 percent in 2015, led by agriculture, tuna processing, and construction, but uncertainty regarding sustainable sources of growth remains. First, prospects for a near-term re-opening of the gold mine are dim with the current price of gold not

facilitating the re-opening of the mine or finding a buyer willing to absorb the high sunk costs. Negotiations with the mining company to transfer ownership to the Solomon Islands' government are underway. Concerns are rising that heavy rain could cause the mine's tailings dam to collapse, incurring environmental damage and fiscal costs—tentatively estimated at up to 2 percent of GDP. Second, despite the strong performance in 2014, growth in the logging sector is expected to be modest this year, particularly given the government's recently announced moratorium on new logging licenses aimed at improving environmental sustainability and tackling illegal activity. And finally, the timing of major infrastructure projects which were earlier expected to support growth in 2014–15 has been shifted to late 2015 and beyond. These projects include the Tina River Hydro and the submarine cable projects.

4. **Risks to the outlook are to the downside**. The aid envelope may decline more than previously envisaged posing additional challenges to Solomon Islands in meeting development objectives. The main risks are tied to weaker growth in a number of emerging markets, as well as potential negative spillovers from emerging Asia in the event of global financial market turbulence which could worsen Solomon Islands' growth prospects. On the upside, consumers' and producers' windfall from sustained low oil prices could raise growth more than anticipated, given the country's dependence on oil imports. Additional upside risks include better prospects for exploiting nickel deposits (starting in late 2015) and a nascent bauxite industry. The new government's development plan includes major projects to spur rural development and boost growth potential. But their impact on medium-term growth will hinge on a critical mass of structural reforms (including land reform). If a downside scenario were to materialize Solomon Islands still has the fiscal space to respond. However, a series of negative shocks, including from natural disasters could quickly erode the policy buffers that the country has re-built since 2010 owing to its strong macroeconomic performance under IMF-supported programs. Solomon Islands remains a fragile state because of its vulnerability to external shocks, its history of civil unrest, and its weak institutional capacity.

Authorities' Views

5. **The authorities considered the risks to the outlook to be balanced and mainly external.** They see the closure of the Gold Ridge mine as the main cause of the deterioration in the near-term economic outlook. According to the new Twenty-Year National Development Strategy, potential growth could reach 5 percent in the medium term, led by the fisheries, telecommunications, and construction sectors—and eventually in the long term by tourism.

PROGRAM PERFORMANCE

6. **Program performance under the ECF arrangement has been broadly satisfactory.**

- **Reserve buffers are at a comfortable level.** All performance criteria (PCs) for June 2014 were met with large margins (MEFP Table 1). In particular, the PC on the cash balance was largely met owing to higher cyclical revenues and lower-than-expected spending, including current spending. All continuous PCs were also met. All indicative targets for September 2014 were met, but the ones on health and education spending for June and September 2014 were narrowly missed owing to stronger procurement requirements by development partners in disbursing ODA.

- **Progress has been made in implementing the structural agenda.** Four structural benchmarks were met: obtaining the Cabinet's approval of drafting instructions for a new Financial Institutions Act; amending the export duty schedule to complete the implementation of the new mining tax regime in line with the IMF's recommendations; and two important Public Financial Management (PFM) reforms—publishing a mid-year budget review and a budget strategy document. These last two benchmarks are expected to increase budget transparency and improve budget planning and execution. But despite the political commitment, reform implementation related to other benchmarks (MEFP Table 2) has slowed with the dissolution of Parliament in September, ahead of the election.

Authorities' Views

7. **The authorities noted that the four recently-met benchmarks have improved the mining tax regime and PFM and have laid the foundation for improved financial system legislation.** They remain committed to achieving the remaining program benchmarks, notwithstanding unanticipated delays and capacity constraints that have led to repeated rescheduling of test dates.

POLICY DISCUSSIONS

A. Preserving Fiscal Space and Improving the Quality of Public Spending

Background

8. **The fiscal position in 2014 was much stronger than targeted in the program (Table 3), but fiscal risks have increased going forward, with mining operations unlikely to resume in 2015 and the expected reduction of donors' support.** According to preliminary data and estimates, in 2014, the fiscal balance posted a surplus of about 2 percent of GDP.

- **Revenues and grants.** Owing to higher-than-expected activity, tax performance in 2014—despite having deteriorated relative to 2013 by 2.8 percentage points of GDP because of the gold mine closure—has been stronger than anticipated (EBS/14/65). Trade taxes were particularly buoyant owing to strong logging exports. Nontax revenues, mainly fishing license fees, also surprised on the upside, as in other small states in the Pacific, owing to the higher minimum fee for fishing per vessel day under the Nauru agreement. As a result, revenues (excluding grants) were higher in 2014—by 1.7 percentage points of GDP—than expected. But grant estimates have been revised down, reflecting far lower disbursements by donors, which may partly reflect earlier political uncertainty.
- **Expenditure.** Mostly because of lower grants, development spending was less than planned, which led to a downward revision of estimates for 2014. With regard to recurrent expenditure,

the payroll bill increased by 13 percent (y/y) in nominal terms, in line with the 2014 budget. While the government's public sector remuneration review, intended to address payroll fiscal risks, is still ongoing due to the administrative slowdown ahead of the elections, the authorities remain committed to it (MEFP paragraph 14). Election-related current spending is estimated at 1 percent of GDP. Other recurrent spending was lower than targeted, notwithstanding the supplementary budget in September 2014 which included higher spending (equivalent to 0.9 percent of GDP) to fund election costs, additional flood-related spending, and a large end-of-term payment to members of Parliament, equal to US$2.7 million (0.2 percent of GDP).

- **Cash and fiscal balances**. In 2014, the fiscal balance posted a surplus of 1.9 percent of GDP. This surplus reflected an under-execution of both current and development spending, especially in the last quarter of 2014. With disbursement of large donor support taking place in December 2014, spending decisions have been postponed to early 2015. As a result, the cash balance at year end was much larger than targeted at SI$880 million, or 4.4 months of recurrent spending.

- **The 2015 fiscal budget and beyond.** The 2015 budget has yet to be unveiled. Preliminary discussions with the authorities point to a fiscal deficit of about 2.1 percent of GDP financed with a drawdown of the cash balance—which would still remain healthy at 3.4 months of recurrent spending at end-2015. The deficit reflects the combined effect of lower expected revenue (including from logging, fuel, and gold) and higher planned spending—the latter from a very low base in 2014—and also political economy pressure to spend during the first year after the elections. Over the next four years, the reform program targets a massive increase in government spending of SI$20 billion (or 230 percent of 2014 GDP), partly financed by drawing down cash reserves. Three quarters of this spending is allocated to infrastructure (mainly roads), health, and education. While the annual borrowing limit for 2015 has not been announced yet, the authorities remain committed to prudent debt management (MEFP paragraph 16).

Staff's Views

9. **Given the large development needs (including infrastructure, health, and education), fiscal space should be used wisely in the 2015 budget in light of Solomon Islands' vulnerabilities and the uncertain outlook.** To this end a balance should be struck between building buffers and spending. Maintaining fiscal buffers is essential to enhance resilience to shocks—including natural disasters. While an increase in spending for capital investment to upgrade infrastructure (including water and sanitation) and enhance health and education outcomes is welcomed, the pace and scale of spending needs to be consistent over the medium term with the country's absorptive capacity, the revenue envelope, availability of financing, and reflect realistic plans for revenue mobilization. Improving the quality of public spending and using the cash balance wisely are paramount given the uncertainty about growth (including mining) prospects. This includes improving accountability in the use of constituency funds by continuing to develop ex-ante spending plans, rules for managing fund accounts and for procuring goods, and reporting on the use of funds, in accordance with the PFM Act. Also in this context, steady implementation of the PFM roadmap is important. With external assistance expected to fall in the medium term, sound

PFM is likely to remain crucial, also to win further donor support. If oil prices fall further, the authorities should save the higher cyclical revenue-from higher GDP-relative to the budget. If external downside risks materialize, the authorities could use some of the fiscal buffers to support the economy. Over the medium term, anchoring fiscal plans to the non-mineral primary balance of about 2 percent of GDP could help manage revenue volatility and promote fiscal sustainability. Realistic spending plans should also be pursued by better sequencing development projects within a medium-term fiscal framework to carefully align resources with spending capacity.

10. **Other fiscal structural reforms should continue to support revenue mobilization.** In addition to PFM reforms, tax reforms are a priority for improving the business environment. Recent TA by the IMF Fiscal Affairs department has identified tax policy and administration measures needed to implement the mining tax regime. Some of the administrative reforms should also benefit overall tax administration. These measures relate to the expensing of prospecting and development expenditures, imposition of penalties for failing to file additional profit tax forms, clarifying the roles of government agencies (and interagency information sharing), and strengthening the taxpayer register. The incidence of overlapping and regressive consumption taxes merits review, given their potential to curtail business opportunities.

Authorities' Views

11. **The authorities stressed the need to increase development spending to boost economic growth prospects, supported by sectoral and structural reforms (MEFP paragraph 6).** They see spending on development as paramount given the country's needs and the size of the fiscal buffers accumulated. Streamlining public sector allowances is also part of the government's agenda to create more fiscal space for development spending (MEFP paragraph 7).

12. **The authorities also emphasized their commitment to improving the quality of spending and pursuing tax reforms with the assistance of the IMF.** They stressed the critical role that the PFM system plays in improving the quality of public spending (MEFP paragraph 13). The authorities are taking steps to continue improving budget planning and execution and increasing budget transparency. Line ministries will be required to develop and monitor an evaluation framework to assess and measure the implementation of development programs. They plan to publish the Final Budget Outcome Report on an annual basis, following the first report in 2014. On constituency funds, they stressed their role in providing public service delivery and government support to rural areas in a highly dispersed geographical landscape. The authorities requested TA (see Letter of Intent) to assist with a comprehensive tax review to ensure a fair, simple, and broad-based tax system, which encourages economic growth by supporting local businesses and attracting foreign investors.

B. Strengthening the Monetary and Exchange Rate Policy Frameworks

Background

13. **Credit to the private sector continued to grow strongly in 2014 at 16.3 percent (Table 4).** Credit growth has been driven mainly by mortgage financing and investment in the

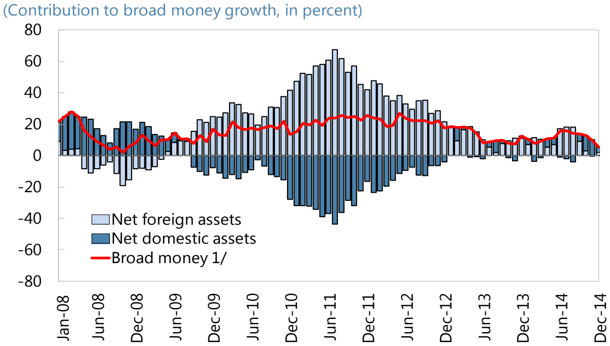
communication sector, each factor contributing 8 percent and 3.5 percent of the total increase, respectively. This increase has not yet put pressure on inflation as the domestic food supply has recovered from the flood and the lower oil prices are curbing domestic prices.

14. **In September 2014, in light of uncertain growth prospects, the CBSI announced a shift toward an accommodative monetary stance over the following six-month period.** In particular, the CBSI capped the stock of its Bokolo bills issuance at SI$710 million. While average lending rates have hovered at around 10 percent for most of 2014, after a steady decline throughout 2013, persistently high excess reserves held by commercial banks and steady credit growth suggest that monetary conditions have remained relatively loose.

15. **The CBSI has fully implemented the invoice-based basket peg regime.** In November, the CBSI also removed the ±1 percent exchange rate band vis-à-vis the U.S. dollar. The recent depreciation of the Solomon Islands dollar against the U.S. dollar (5 percent between October 2014 and March 2015) reflects the closer tracking of the value of the basket, particularly the significant depreciation of the Australian dollar against the U.S. dollar. In line with IMF TA recommendations, the buy and sell margins for U.S. dollar and Australian dollar trades were also increased to promote foreign exchange market efficiency.

Solomon Islands: Monetary Developments

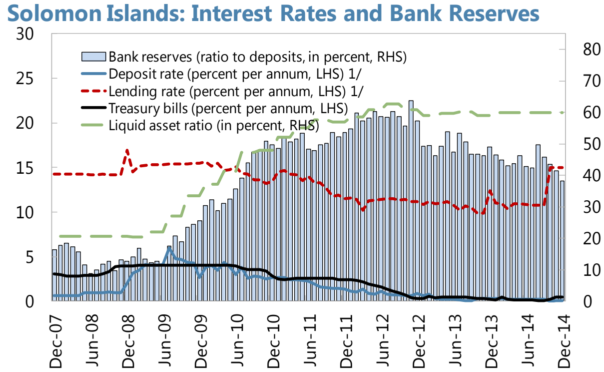
(Contribution to broad money growth, in percent)



1/ Year-on-year percent change.

Source: Central Bank of Solomon Islands.

Solomon Islands: Interest Rates and Bank Reserves

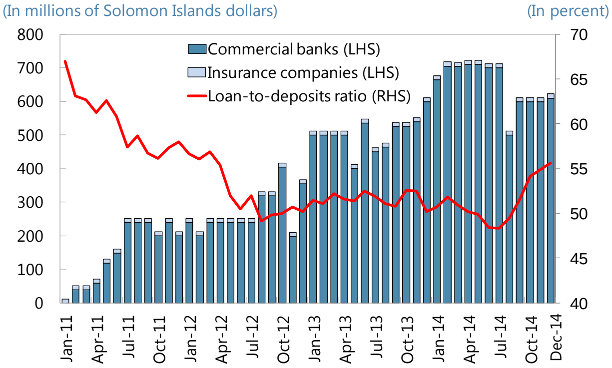


1/ Weighted average rate of commercial banks.

Source: Central Bank of Solomon Islands.

Solomon Islands: Holdings of Bokolo Bills

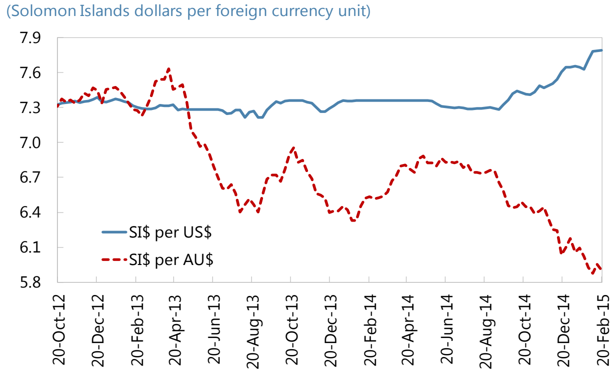
(In millions of Solomon Islands dollars) (In percent)



Source: Central Bank of Solomon Islands.

Solomon Islands: Nominal Exchange Rate

(Solomon Islands dollars per foreign currency unit)



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

Staff's Views

16. **The fall in prices of imported goods has eased the monetary policy trade-off but the authorities should remain vigilant.** While the current stance of monetary policy is broadly appropriate, the authorities should be ready to tighten if credit growth leads to a pickup in demand-driven inflationary pressure or a surge in imports. Staff econometric analysis[1] suggests that credit growth of 16 percent (y/y) could add inflation pressures of up to 1 percent in 2015. If credit growth does lead to a pickup in demand-driven inflationary pressure, the authorities should be ready to use all the instruments at its disposal (reserve requirement and issuing Bokolo bills) to tighten monetary policy. With the monetary transmission mechanism remaining weak, the exchange rate basket peg is the primary nominal anchor. In this context, staff noted the need for the central bank to continue developing its tools for mopping up excess liquidity, including through IMF technical assistance. Staff also strongly welcomed the full implementation of the basket peg of the Solomon Islands dollar, including the removal of the band around the US dollar, which delivers a more stable effective exchange rate and minimizes any further erosion of competitiveness for the moderately overvalued currency.

Authorities' Views

17. **The CBSI has no immediate concerns about inflation**. Despite strong credit growth, inflationary pressures in the near term are weak thanks to lower oil and commodity prices. The CBSI noted that the upcoming IMF TA, led by the Monetary and Capital Market Department will help improve the effectiveness of monetary policy by strengthening the monetary transmission mechanism.

18. **The authorities emphasized that the basket peg regime continues to be an important tool to anchor inflation and maintain competitiveness.** In particular, they noted that the removal of the band around the US dollar should allow bilateral exchange rates to move freely in order to keep the basket peg stable.

C. Preserving Financial Stability

Background

19. **The financial system is generally sound but financial intermediation remains limited.**

- Liquidity and capital adequacy ratios are above minimum regulatory requirements. Asset quality remains adequate, with low NPLs. Profitability, however, declined in 2014, partly reflecting increased competitive pressures generated by the entry of Pan Oceanic Bank Limited (Solomon Islands' fourth bank), founded by a group of Sri Lanka-based investors. The bank was set up to provide banking services to the logging industry after the withdrawal of foreign-owned banks from the logging business. In late January 2015 Westpac, an Australian bank, announced its plans to sell its operations in Solomon Islands, Samoa, Tonga, and Vanuatu to Papua New

[1] Based on a vector autoregression (VAR) model estimated in Bai, Tumbarello, and Wu, "The Drivers of Inflation in the Pacific Island Countries," forthcoming, IMF working paper.

Guinea-based Bank South Pacific (BSP). This is expected to lead to a substantial increase in BSP market share in Solomon Islands' banking sector. Despite brisk credit growth, the magnitude of credit in Solomon Islands relative to the economy is much lower than peers (18 percent of GDP versus 35 percent in the Pacific small states, 40 percent in African small states, and 70 percent in Caribbean small islands, according to the IMF's Financial Access Survey Database). Interest-rate spreads are also among the highest in the region, suggesting much room for improving financial sector efficiency. Solomon Islands continues to be one of the most under-banked small states in the world, when measured by the size of total deposits relative to GDP and the number of bank branches relative to the population. Long-standing structural issues—including the subsistence level of the rural economy, the dispersion of the population in remote villages with little or no road access, high costs of establishing bank branches outside the main cities, and communal land tenure—continue to constrain financial sector development. On the upside, the introduction of mobile banking services—based on the mobile telephone network—by commercial banks over the last 18 months has increased access to banking services among underserved segments of the population. It has also improved financial inclusion, which fosters inclusive growth. The first credit bureau was opened in February 2015—another important step to increase access to credit. Despite delays, the authorities continue to make progress in preparing the revised legislation of the National Provident Fund—Solomon Islands' largest pool of financial savings—which is aimed at improving the governance and investment framework.

Solomon Islands: Core Financial Soundness Indicators, 2012-14 1/

	2012	2013	2014			
			Mar.	Jun.	Sep.	Dec.
Capital adequacy						
Regulated capital to risk-weighted assets	33.1	32.5	30.7	27.1	25.9	31.7
Nonperforming loans, net of provisions to capital	4.3	12.3	6.7	8.7	7.6	8.4
Asset quality						
Nonperforming loans to total gross loans	3.7	7.2	4.9	5.7	4.2	4.6
Earnings and profitability						
Return on average assets	3.2	2.2	1.6	1.5	1.6	2.0
Return on average equity	18.1	14.1	10.4	9.7	10.3	12.6
Net interest income to gross income	46.0	51.8	56.7	54.8	55.3	54.5
Noninterest expenses to gross income	50.6	54.9	53.0	52.6	55.7	53.4
Liquidity						
Liquid assets to total assets (liquid asset ratio)	60.8	59.1	59.9	62.4	59.4	56.5
Core liquid assets to short-term liabilities	60.3	54.7	49.8	60.1	58.0	48.0

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

1/ Commercial banks only, at end-period.

Staff's Views

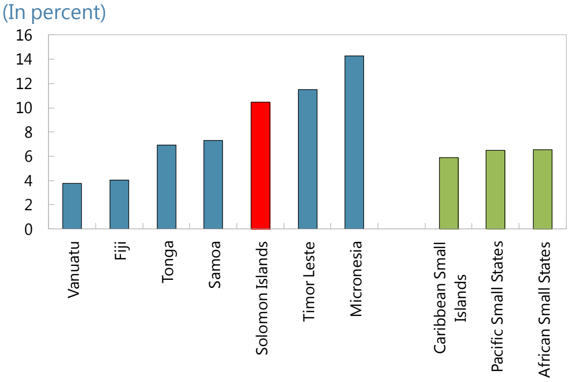
20. **Staff underlined the importance of continued vigilance over the drivers of credit growth, accompanied by ongoing financial sector reform and sustained efforts to improve financial inclusion.** Staff encouraged the authorities to ensure that strict prudential standards are adhered to, particularly given the greater competition for market share in certain subsectors of the credit market—particularly mortgage financing—with the entry of the new bank. Staff welcomed the progress made in strengthening the financial sector's supervisory and regulatory framework and called for continued efforts to fulfill program commitments, specifically relative to a revised National Provident Fund Act (program benchmark, proposed for September 2015). The Credit Union bill (program benchmarks, proposed for September 2015) will also help improve supervision of nonbanking institutions and promote financial inclusion. The introduction of mobile banking is welcome as a way to circumvent physical barriers to financial access. Efforts on financial inclusion are particularly welcome at this

conjunction as lower competition for the provision of financial services in small states can hamper financial inclusion by limiting the supply of credit.[2] Better access to financial services is important for fostering inclusive growth. But adequate regulation and supervision are also needed to ensure financial stability.

Authorities' Views

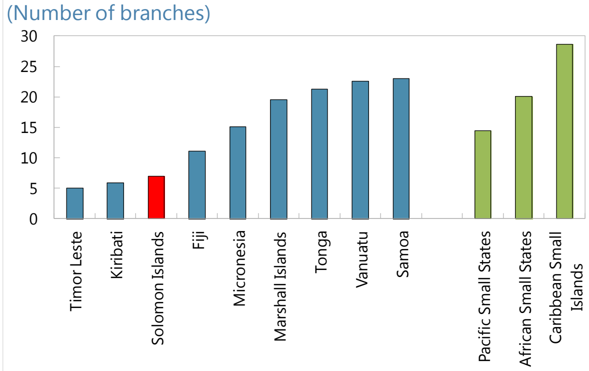
21. **The CBSI agreed that financial sector access is paramount to support inclusive growth and stressed several initiatives being undertaken, including efforts to promote financial inclusion.** Going forward, the CBSI will be strengthening the regulation of mobile banking services and developing new prudential guidelines to ensure adequate consumer protection. The authorities will also collect more data to measure the effectiveness of mobile banking initiatives in promoting financial inclusion. In addition, the CBSI emphasized promoting more financing for small- and medium-sized enterprises as part of its efforts to widen financial access. Developments in the wake of Westpac's planned exit from Solomon Islands will be closely monitored with a view to ensuring that the domestic banking sector remains competitive. The authorities highly value the opening of the credit bureau, which should make access to credit more affordable by reducing the banks and other financial institutions transaction costs and due diligence and by creating credit history for borrowers.

Small States: Spreads Between Lending and Deposit Rates
(In percent)



Source: Country authorities; and IMF staff calculations.

Small States: Commercial Bank Branches per 100,000 Adults
(Number of branches)



Sources: World Bank Group; and IMF staff calculations.

D. Program Discussion and Other Issues

22. **Discussions focused on the fourth review under the ECF arrangement and on setting program conditionality through September 2015 (PCs, indicative targets, and structural benchmarks).** The NIR indicative target and PC for March, June, and September 2015 were raised to US$480 million (7.5 months of imports) to reflect the stabilization and gradual rebound in reserves

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[2] Financial Inclusion in Small States in "Macroeconomic Developments and Selected Issues in Small Developing States," FO/DIS/15/40.

that is expected in 2015. Given broadly satisfactory program performance, staff supports the authorities' proposal to re-phase and modify the structural agenda pursuant to a revised implementation path, owing to the recent elections and the change in government, and to add a new benchmark on the implementation of the Constituency Development Funds Act (program benchmark, July 2015). In addition, given the delay in releasing the complete 2012 Constituency Development Funds (CDFs) audit, the authorities propose modifying the structural benchmark to enable members of Parliament to request the public release of the audit reports for their individual constituencies. This should encourage transparency and best practice and enhance accountability in the use of the constituency funds.

23. **The main risk to the ECF arrangement remains the political uncertainty related to the new government's planned spending in the year after the general elections.** Since the new government's agenda includes highly ambitious spending plans, government pressures to draw down cash reserves beyond program targets have increased. Nonetheless, partnership with the IMF remains strong as indicated in the attached LOI and MEFP.

24. **As in the past, staff will continue to collaborate closely with Solomon Islands' other development partners, including through the Core Economic Working Group.** The IMF-supported program continues to play a catalytic role in disbursements of donor assistance. Combined annual budget support from Australia and New Zealand was substantially lower than projected in 2014 (US$25 million versus US$35 million). This partly reflected a reduction in the run-up to the elections, but also the earlier reallocation of financing to meet immediate post-flood recovery needs and the non-disbursement of performance-linked aid for education. While combined support is currently projected to rebound to US$35 million in 2015, Australia's recent announcement of ODA cuts suggests that additional reductions could be made. The EU may provide budget support for 2015–20 of about $US3.5 million a year, but this may depend on Solomon Islands' progress on PFM reforms. In response to the floods, the Asian Development Bank (ADB) has approved an additional US$13 million for a transportation sector flood-recovery project, alongside US$5 million of planned budget support and US$40 million for other infrastructure projects during 2014–16. And the World Bank Group recently approved US$10 million of additional financing in the form of budget support, project grants, and loans. This sum is expected to be disbursed throughout 2015 and 2016. Staff is continuing to work with the World Bank Group on the debt implications of the potential hydropower project (which has been delayed), which would involve a government guarantee of US$130 million (11 percent of GDP).[3] A full updated DSA, including an assessment of the medium-term debt implication of the proposed hydropower project, will be presented at the fifth review of the ECF arrangement scheduled for June 2015. Solomon Islands has adequate capacity to repay the Fund (Table 7) and the ECF-supported program remains fully financed.

[3] The delay has been partly caused by the lengthy process of acquiring land for the project. The Hydro power plant was initially planned for completion by end-2015. Winning bidders for the projects are now expected to be announced in mid–2015. The project is estimated to require 18 months to complete.

25. **Staff discussed plans to develop a new Poverty Reduction Strategy Paper (PRSP).** The government is planning to release a Medium-Term Development Plan (2015–19) over the next few weeks, building on the national development strategy to achieve more inclusive growth for social cohesion and to ensure a sustainable growth path. This will act as the basis for a PRSP preparation status report, ahead of the next ECF review.

STAFF APPRAISAL

26. **Solomon Islands has made enormous strides in strengthening its macro-financial performance and its institutions over the last few years**. Fiscal and reserve buffers have been rebuilt, and important reforms, notably PFM and financial sector reforms, are being implemented.

27. **The country is now at a critical juncture**. While policy and financial buffers have been rebuilt over the last few years, they can be used up rapidly if the high level of planned spending in the medium-term policy agenda were to materialize. While the country has large development needs, a balance should be struck between building buffers and spending. Going forward, the new government should capitalize on past achievements in macroeconomic management. This will require strengthening its implementation capacity for undertaking capital investment in order to enhance potential growth while maintaining an adequate level of financial buffers to preserve resilience to shocks. Such an approach would be consistent with the weaker economic outlook also driven by less clear sources of growth in the pipeline. To this end, the structural reforms envisaged by the authorities, in particular land reform and tax reforms, are key to support growth in the medium term and enhance productivity across a wide range of sectors.

28. **Fiscal space should be used wisely in 2015, given Solomon Islands' vulnerabilities to shocks and the uncertain growth outlook.** While buffers could be partly used to finance much needed capital projects, the pace of spending should also be consistent with absorptive capacity to avoid waste, and realistic plans for revenue mobilization should be developed. Advancing PFM reforms, including by improving the transparency and accountability of scholarships and constituency funds will be paramount to strengthening the quality of public spending and continuing to attract donor support.

29. **Monetary policy is broadly appropriate, but the authorities should be ready to tighten if high credit growth triggers inflationary pressures.** In this event, the CBSI should use all the instruments at its disposal, including the reserve requirement and Bokolo bill issuance, to mop up excess liquidity.

30. **The authorities are to be commended for fully implementing the basket peg—an appropriate exchange rate regime for Solomon Islands.** The CBSI has removed the exchange rate band around the US dollar since November 2014 to allow the bilateral exchange rates to move freely in order to keep the peg stable. It has also increased the buy-sell margin in foreign exchange trading to allow greater flexibility in exchange rate management.

31. **The financial sector is sound but continued vigilance concerning potential sources of vulnerability is important, along with further efforts to strengthen the supervisory and regulatory frameworks and broaden financial inclusion.** Closer and improved monitoring of the

underlying trends in the main segments of the credit market, including mortgage financing, will be critical. The forthcoming new National Provident Fund Act and the new Financial Institutions Act and Credit Union Act should help promote financial sector stability. In addition, ongoing initiatives to promote mobile banking while ensuring adequate supervision and consumer protection will go a long way toward promoting financial inclusion. Solomon Islands has made remarkable progress in financial inclusion over the last year, compared to other small states in the Pacific, and this is to be encouraged.

32. **Based on Solomon Islands' program performance, staff recommends completion of the fourth review under the ECF-supported program.** The completion of the fourth review will enable the release of the fifth disbursement in the amount of SDR 148,571. Staff also supports the authorities' request for the modification of the structural conditionality (MEFP, Table 2) and for setting the end-June 2015 performance criteria.

Box 1. Solomon Islands: The Impact of Lower Oil Prices 1/

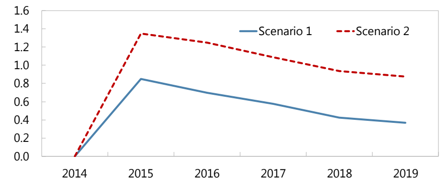
The recent global oil price slump is expected to boost Solomon Islands' economy through four main channels: rising real income will increase consumption; production costs will fall due to lower costs of energy; the external position will improve substantially; and inflation will ease.

Solomon Islands is an oil importer and fuel imports average 10 percent of GDP, or one quarter of total import bill. Staff analysis suggests that lower imports could strengthen the current account balance by 2 percentage points of GDP. Staff estimated that for every 10 percent drop in oil prices, Solomon Islands GDP rises by 0.3 percentage point.[2] This implies an increase in Solomon Islands output by 0.8 percentage point in 2015 relative to the scenario without the oil price drop. Inflation is expected to moderate by 0.3 percentage point given an estimated weight of energy in the CPI basket of around 7 percent.

Reduced energy costs are likely to have a positive effect on consumption and investment although this would be mitigated by incomplete pass-through of international oil prices to domestic retail prices. The cost of energy will decrease as Solomon Islands relies mainly on oil-based fuel for its energy needs and fuel is used for electricity generation. The impact on consumers will depend on the decline in electricity tariffs, which are the highest among all small states.

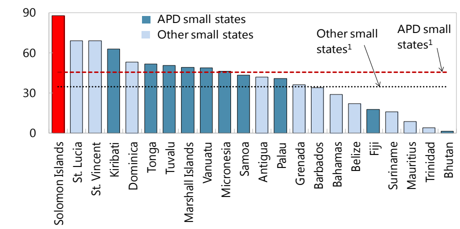
The first round effect of lower oil price on the budget would be negative due to lower collection from import duties and goods tax on fuel (which both amounted to around 2¼ percent of GDP in recent years). Nonetheless, the fiscal balance is expected to improve slightly mainly because of revenue buoyancy from higher economic activity and some expected increase in fuel imports related to investment.

Solomon Islands: GDP Growth Differential Under Lower Oil Price Forecasts [1]
(Percent difference)



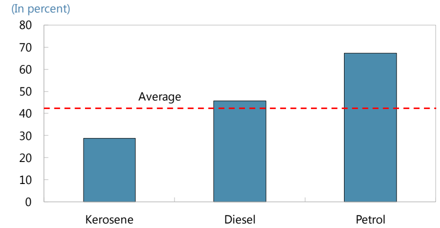
Source: IMF staff estimates.
[1] Illustrates the deviation from growth forecasts that were based on the IMF's oil price forecasts in September 2014. Scenario 1 shows the difference in estimated GDP growth using revised IMF oil price forecasts as of November 2014, while Scenario 2 reflects an additional 15 percent oil price drop.

Small States: Industrial Electricity Tariffs, 2013
(In U.S. cents per KWh)



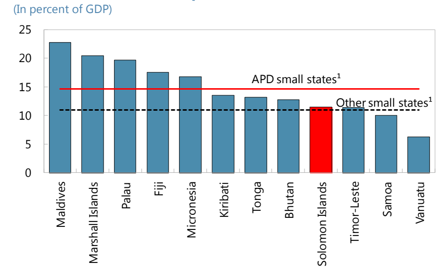
[1] Average.
Sources: Country authorities; International Renewable Energy Agency; and IMF staff estimates.

Solomon Islands: Pass-through of International Fuel Prices to Domestic Retail Prices (June-December 2014) [1]
(In percent)



Sources: CBSI; Bloomberg, L.P.; and IMF staff calculations
[1] Pass-through is calculated as the absolute difference in local fuel prices divided by the absolute difference in international prices, in terms of local currency, multiplied by 100.

APD Small States: Oil Imports, 2012-13
(In percent of GDP)



[1] Average.
Sources: Country authorities; IMF, WEO; and IMF staff estimates.

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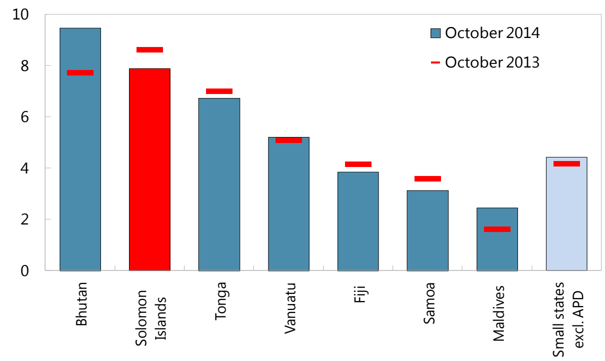
[1] Prepared by Fazurin Jamaludin and Leni Hunter.

[2] A vector autoregression was estimated with Solomon Islands' real GDP, real oil prices, real logging prices, and Australian real GDP. The estimated elasticity between the real oil price and Solomon Islands' GDP is 0.03.

Figure 1. Solomon Islands: Economic Indicators Relative to Other Small States

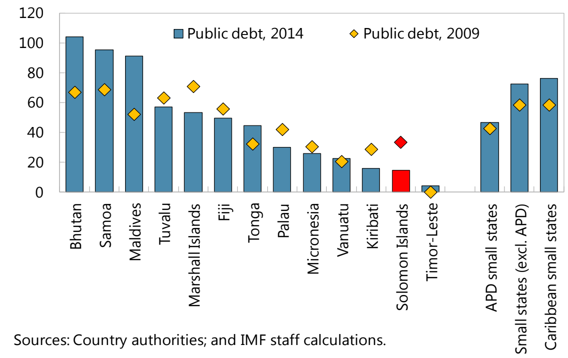
In Solomon Islands, reserves remain at comfortable levels…

APD Small States: Reserves
(In months of next year's imports of goods and services)



…and fiscal space has increased.

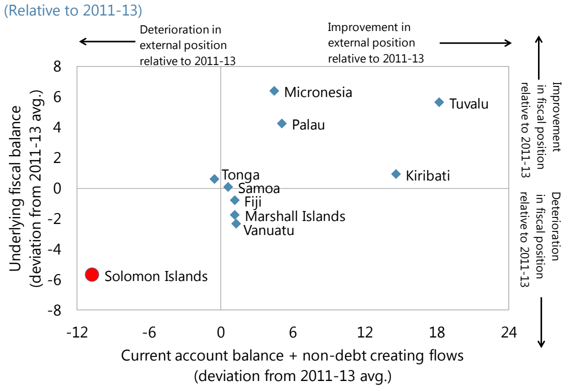
APD Small States: Gross Public Debt, 2014
(In percent of GDP)



Sources: Country authorities; and IMF staff calculations.

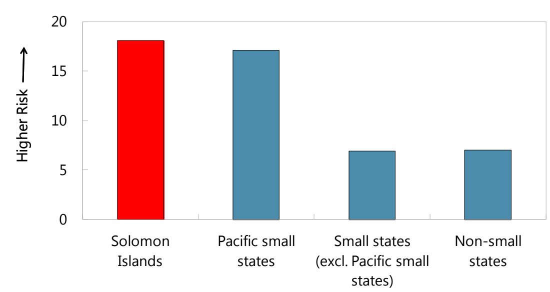
But Solomon Islands needs to continue to rebuild policy buffers…

Change in Fiscal and External Positions, 2014
(Relative to 2011-13)



…given its vulnerability to natural disasters.

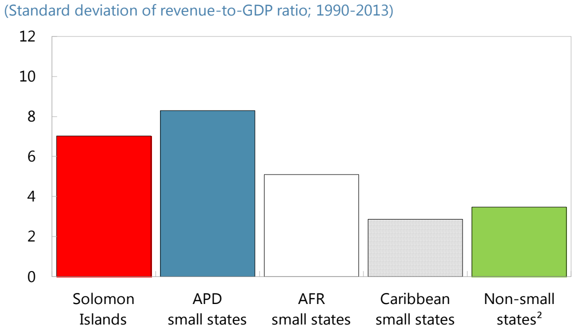
Natural Disaster Risks - World Risk Index, 2013
(In percentage points)



Note: High value indicates high risk. Maximum risk country = 36 percentage points.

Managing revenue volatility is essential…

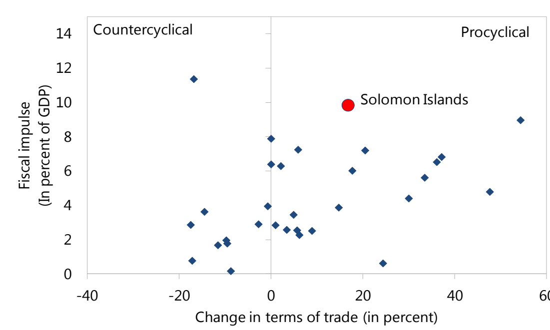
Volatility of Revenue[1]
(Standard deviation of revenue-to-GDP ratio; 1990-2013)



1/ Excludes grants.
2/ Excludes advanced economies.

… to avoid procyclical fiscal policy.

Fiscal Impulse and Terms of Trade, 2005-12

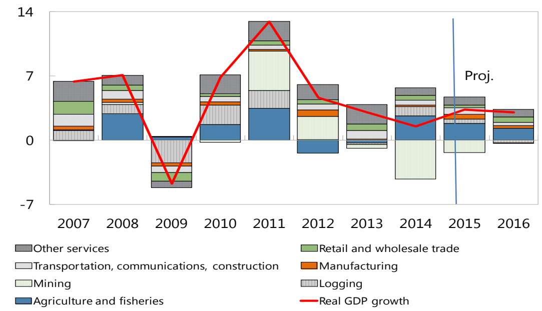


Sources: Country authorities; Alliance Development Works, *World Risk Report 2013;* and IMF staff estimates and projections.

Figure 2. Solomon Islands: Macroeconomic Developments and Outlook

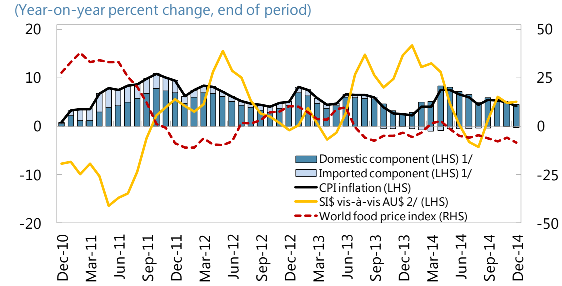
In 2014, despite the drop in mining GDP, logging and agriculture surprised on the upside…

Sources of Growth
(Year-on-year percent change)



…and inflation moderated owing to the pass-through of global commodity prices.

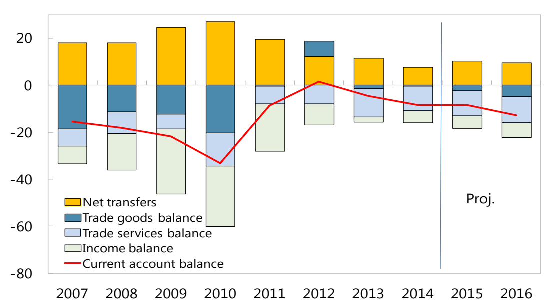
Contribution to CPI Inflation, 2010–14
(Year-on-year percent change, end of period)



1/ Contribution to CPI inflation (in percentage points).
2/ A positive change means an appreciation of the Solomon Islands dollar against the Australian dollar.

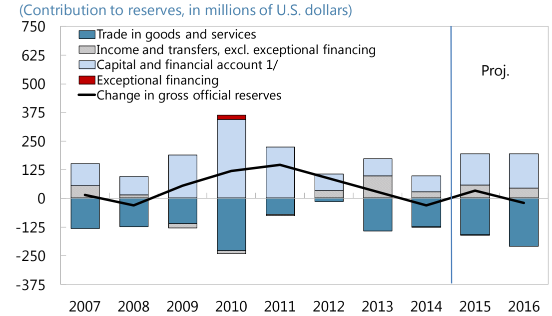
The current account is projected to deteriorate because of lower mineral exports…

Current Account Balance, 2007-16
(In percent of GDP)



…but sufficient financing is expected to be available.

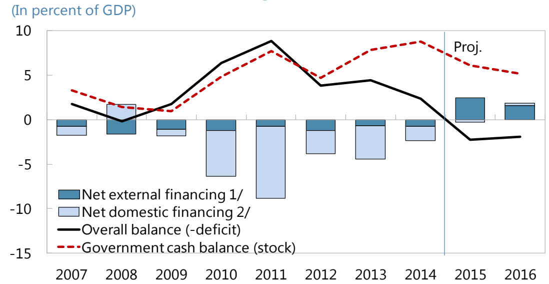
Changes in Reserves: Decomposition, 2007–16
(Contribution to reserves, in millions of U.S. dollars)



1/ Including errors and omissions.

The fiscal balance posted a surplus of 2 percent of GDP in 2014…

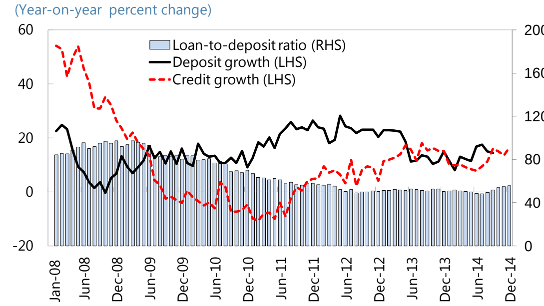
Fiscal Balance and Financing, 2007–16
(In percent of GDP)



1/ In 2007, includes debt forgiveness.
2/ Includes privatization receipts.

…and credit growth has been strong owing to mortgage financing and investment in the communication sector.

Deposit and Credit Growth, Jan. 2008–Dec. 2014
(Year-on-year percent change)



Sources: Country authorities; and IMF staff estimates and projections.

Table 1. Solomon Islands: Selected Economic Indicators, 2012–16

Per capita GDP (2014): US$1,931 (estimate)

Population (2014): 562,000

	2012	2013	2014	2015	2016
			Est.	Proj.	Proj.
Growth and prices (percentage change)					
Real GDP	4.7	3.0	1.5	3.3	3.0
CPI (period average)	5.9	5.4	5.1	3.8	3.4
GDP deflator	6.4	-0.4	8.8	3.8	5.4
Nominal GDP (in SI$ millions)	7,540	7,738	8,542	9,164	9,951
Central government operations (percent of GDP)					
Total revenue and grants	54.4	54.3	46.1	46.2	44.4
Revenue	33.6	35.7	33.2	31.5	31.4
Grants	20.8	18.6	12.9	14.7	13.0
Total expenditure	50.6	49.9	44.2	48.3	46.0
Recurrent expenditure	27.7	29.1	28.1	28.8	27.1
Development expenditure	22.9	20.8	16.1	19.5	18.9
Overall balance	3.8	4.4	1.9	-2.1	-1.6
Foreign financing (net)	-1.2	-0.7	-0.5	2.8	1.9
Domestic financing (net)	-2.6	-3.7	-1.4	-0.7	-0.3
Central government debt (percent of GDP, unless otherwise indicated) 1/	17.6	15.7	13.4	13.6	14.2
Domestic debt	4.9	3.9	3.1	2.8	2.5
External debt	12.7	11.8	10.3	10.8	11.8
Monetary and credit (percentage change, end-year data)					
Credit to private sector	4.1	15.1	16.3	15.3	…
Broad money	17.3	12.4	5.5	24.8	…
Reserve money	22.0	3.0	-10.1	27.0	…
Balance of payments (in US$ millions, unless otherwise indicated)					
Current account balance	15.7	-47.2	-98.2	-101.3	-165.6
(percent of GDP)	1.5	-4.5	-8.5	-8.4	-12.6
Foreign direct investment	77.9	39.7	34.8	62.3	73.9
(percent of GDP)	7.6	3.7	3.0	5.2	5.6
Overall balance	87.3	28.1	-29.7	45.4	-4.9
Gross official reserves (in US$ millions, end of period) 2/	499.6	527.7	496.9	539.8	530.8
(in months of next year's imports of GNFS)	8.4	9.1	8.5	8.5	8.0
Exchange rate (SI$/US$, end of period)	7.3	7.4	7.4	…	…
Real effective exchange rate (end of period, 2005 = 100)	114.3	123.2	125.4	…	…
Memorandum items:					
Program cash balance (in SI$ millions)	355	608	880	776	571

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

1/ Includes disbursements under the IMF-supported programs.

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

Table 2. Solomon Islands: Medium-Term Baseline Scenario, 2012–20

	2012	2013	2014	2015	2016	2017	2018	2019	2020
			Est.	Proj.					
Growth and prices (percentage change)									
Real GDP	4.7	3.0	1.5	3.3	3.0	3.5	3.4	3.5	3.4
CPI (period average)	5.9	5.4	5.1	3.8	3.4	4.1	4.5	4.5	4.5
GDP deflator	6.4	-0.4	8.8	3.8	5.4	3.9	4.2	4.5	5.3
Nominal GDP (in SI$ millions)	7,540	7,738	8,542	9,164	9,951	10,702	11,524	12,457	13,567
Per capita GNI (in US$)	1,697	1,846	1,906	1,942	2,047	2,142	2,233	2,361	2,605
Central government operations (percent of GDP)									
Total revenue and grants	54.4	54.3	46.1	46.2	44.4	44.5	44.1	43.3	42.3
Revenue	33.6	35.7	33.2	31.5	31.4	31.8	31.7	31.3	30.6
Tax revenue	29.9	31.9	29.1	28.3	28.0	28.3	28.3	27.9	27.2
Income and profits	10.4	12.1	10.1	10.1	10.5	11.2	11.8	11.8	11.6
Goods and services	10.9	11.4	10.6	10.3	10.3	10.4	10.4	10.4	10.4
International trade and transactions	8.6	8.5	8.4	7.8	7.2	6.7	6.2	5.7	5.2
Of which: Tax on logging	5.4	5.3	5.7	4.8	4.2	3.6	3.1	2.7	2.3
Other revenue	3.7	3.8	4.1	3.2	3.4	3.4	3.4	3.4	3.4
Grants	20.8	18.6	12.9	14.7	13.0	12.8	12.4	12.0	11.7
Total expenditure	50.6	49.9	44.2	48.3	46.0	44.8	43.7	42.6	41.6
Recurrent expenditure	27.7	29.1	28.1	28.8	27.1	26.2	25.5	24.7	23.9
Development expenditure	22.9	20.8	16.1	19.5	18.9	18.6	18.2	17.9	17.6
Overall balance	3.8	4.4	1.9	-2.1	-1.6	-0.3	0.4	0.7	0.7
Nonmineral primary balance 1/	1.2	3.1	1.6	0.1	1.2	2.1	2.0	2.0	2.2
Noncommodity primary balance 2/	-4.2	-2.2	-4.1	-4.7	-3.1	-1.6	-1.2	-0.7	-0.1
Central government debt (percent of GDP) 3/	17.6	15.7	13.4	13.6	14.2	15.5	16.7	18.0	19.3
Current account balance (- deficit)	15.7	-47.2	-98.2	-101.3	-165.6	-144.5	-148.6	-147.0	-142.5
(In percent of GDP)	1.5	-4.5	-8.5	-8.4	-12.6	-10.3	-9.8	-9.0	-8.0
(Excluding mining-related capital imports, in percent of GDP)	5.6	0.0	-7.8	-8.2	-12.4	-8.3	-7.7	-6.5	-5.8
Overall balance	87.3	28.1	-29.7	45.4	-4.9	9.0	5.8	3.3	-0.5
Gross official reserves (in US$ million; end of period) 4/	499.6	527.7	496.9	539.8	530.8	535.7	541.5	544.8	544.2
(In months of next year's imports of GNFS)	8.4	9.1	8.5	8.5	8.0	7.7	7.3	7.0	6.9
(In months of next year's nonmining-related imports of GNFS)	8.9	9.3	8.5	8.5	8.3	8.0	7.7	7.3	7.2

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

1/ Defined as nonmineral revenue (excludes grants) minus government-funded recurrent and development spending excluding interest payments.

2/ Defined as nonlogging and nonmineral revenue (excludes grants) minus government-funded recurrent and development spending excluding interest payments.

3/ Includes disbursements under the IMF-supported programs.

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

Table 3. Solomon Islands: Summary of Fiscal Accounts, 2012–16

	2012	2013	2014		2015	2016
			Prog. (EBS/14/65)	Est.	Proj.	Proj.
			(In millions of Solomon Islands dollars)			
Total revenue and grants	4,105	4,204	4,161	3,934	4,234	4,422
Total revenue	2,535	2,763	2,691	2,835	2,886	3,127
Tax revenue	2,254	2,469	2,434	2,487	2,591	2,787
Income and profits	785	936	927	863	927	1,047
Goods and services	824	879	909	907	946	1,027
International trade and transactions	645	655	598	717	719	713
Other revenue	281	294	257	348	294	340
Grants	1,570	1,441	1,470	1,099	1,348	1,296
Development grants	1,246	1,145	1,201	940	1,033	1,125
Recurrent budget grants	323	296	269	159	315	171
Expenditure	3,819	3,863	4,301	3772	4,426	4,578
Recurrent expenditure	2,090	2,252	2,499	2400	2,643	2,696
Compensation of employees	695	747	830	847	912	937
Interest payments	18	15	15	11	20	12
Other recurrent expenditure 1/	1,376	1,490	1,654	1,542	1,711	1,747
Development expenditure	1,728	1,608	1,802	1372	1,784	1,883
Government funded	577	560	601	575	751	758
Grant funded	1,151	1,047	1,201	797	1,033	1,125
Unidentified expenditure 2/	0	3	0	0	0	0
Current balance	769	807	461	594	558	602
Overall balance	286	341	-140	162	-193	-156
Total financing	-286	-341	140	-162	193	156
Foreign (net)	-90	-50	100	-43	260	184
Domestic (net)	-196	-290	40	-119	-67	-28
Banking system	-177	-285	212	-98	120	-16
Nonbank	-19	-5	-172	-21	-187	-12
			(In percent of GDP)			
Total revenue and grants	54.4	54.3	48.8	46.1	46.2	44.4
Total revenue	33.6	35.7	31.5	33.2	31.5	31.4
Tax revenue	29.9	31.9	28.5	29.1	28.3	28.0
Income and profits	10.4	12.1	10.9	10.1	10.1	10.5
Goods and services	10.9	11.4	10.7	10.6	10.3	10.3
International trade and transactions	8.6	8.5	7.0	8.4	7.8	7.2
Other revenue	3.7	3.8	3.0	4.1	3.2	3.4
Grants	20.8	18.6	17.2	12.9	14.7	13.0
Development grants	16.5	14.8	14.1	11.0	11.3	11.3
Recurrent budget grants	4.3	3.8	3.2	1.9	3.4	1.7
Expenditure	50.6	49.9	50.4	44.2	48.3	46.0
Recurrent expenditure	27.7	29.1	29.3	28.1	28.8	27.1
Compensation of employees	9.2	9.6	9.7	9.9	10.0	9.4
Interest payments	0.2	0.2	0.2	0.1	0.2	0.1
Other recurrent expenditure 1/	18.3	19.3	19.4	18.0	18.7	17.6
Development expenditure	22.9	20.8	21.1	16.1	19.5	18.9
Government funded	7.7	7.2	7.0	6.7	8.2	7.6
Grant funded	15.3	13.5	14.1	9.3	11.3	11.3
Unidentified expenditure 2/	0.0	0.0	0.0	0.0	0.0	0.0
Current balance	10.2	10.4	5.4	7.0	6.1	6.1
Overall balance	3.8	4.4	-1.6	1.9	-2.1	-1.6
Total financing	-3.8	-4.4	1.6	-1.9	2.1	1.6
Foreign (net)	-1.2	-0.7	1.2	-0.5	2.8	1.9
Domestic (net)	-2.6	-3.7	0.5	-1.4	-0.7	-0.3
Memorandum items:						
Nominal GDP (in SI$ millions)	7,540	7,738	8,530	8,542	9,164	9,951
Target of program cash balance (in SI$ millions) 3/	355	608	374	880	776	571
in months of recurrent spending	2.0	3.2	1.8	4.4	3.5	2.5
Nonmineral primary balance (percent of GDP) 4/	1.2	3.1	-1.6	1.6	0.1	1.2
Noncommodity primary balance (percent of GDP) 5/	-4.2	3.1	-5.9	-4.1	-4.7	-3.1
Noncommodity primary balance, excluding development expenditures (percent of GDP) 6/	3.5	10.3	1.2	2.6	1.8	2.0

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 payment orders and unpresented checks.
4/ Nonmineral revenue (excludes grants) minus government-funded spending excluding interest payments.
5/ Defined as nonmineral nonlogging revenue (excludes grants) minus government-funded spending excluding interest payments.
6/ Defined as nonmineral nonlogging revenue (excludes grants) minus government-funded recurrent spending excluding interest payments.

Table 4. Solomon Islands: Summary Accounts of the Banking System, 2012–15 1/

	2012	2013	2014				2015			
	Dec	Dec.	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec
								Proj.		
	(In millions of Solomon Islands dollars, end of period)									
Central Bank of Solomon Islands (CBSI)										
Net foreign assets (NFA)	3,413	3,625	3,696	3,892	3,820	3,540	3,489	3,566	3,643	3,720
Net international reserves (NIR)	3,525	3,738	3,810	4,006	3,930	3,651	3,600	3,677	3,754	3,831
Other NFA	-113	-113	-114	-114	-111	-111	-111	-111	-111	-111
Net domestic assets (NDA)	-1,358	-1,587	-1,906	-1,945	-1,760	-1,708	-1,487	-1,391	-1,271	-1,254
Net claims on central government	-946	-1,164	-1,229	-1,296	-1,311	-1,280	-1,285	-1,302	-1,282	-1,265
Claims	82	75	73	72	70	69	69	69	69	69
Deposits	1,028	1,239	1,303	1,368	1,381	1,349	1,354	1,371	1,351	1,334
Other items (net)	130	136	147	145	136	136	136	136	136	136
Reserve money	2,055	2,038	1,790	1,947	2,059	1,832	2,002	2,175	2,272	2,326
Currency in circulation	599	603	513	611	593	658	700	725	736	747
Bank deposits	1,446	1,424	1,263	1,326	1,456	1,165	1,282	1,430	1,515	1,559
Other deposits	9	12	14	10	11	9	20	20	20	21
Other depository corporations										
NFA of commercial banks	12	133	155	293	188	287	208	227	220	230
Assets	122	230	233	354	280	365	308	327	320	330
Liabilities	110	98	78	61	92	77	100	100	100	100
NDA of commercial banks	997	1,273	1,457	1,417	1,468	1,515	1,694	1,839	1,838	1,840
Net claims on central government	-97	-164	-143	-129	-126	-146	-149	-154	-161	-177
Claims	65	48	44	47	51	44	42	37	29	14
Deposits	163	212	187	177	177	190	190	190	190	190
Claims on the private sector	1,266	1,457	1,492	1,499	1,638	1,696	1,660	1,719	1,889	1,957
Other items (net)	-172	-20	109	47	-43	-35	-35	-35	-35	-35
Reserves and vault cash	1,513	1,495	1,319	1,389	1,526	1,248	1,365	1,516	1,603	1,647
Deposits	2,522	2,901	2,932	3,099	3,182	3,051	3,266	3,582	3,661	3,717
Depository corporations survey										
NFA of the banking system	3,425	3,758	3,851	4,185	4,008	3,827	3,697	3,792	3,863	3,949
Central bank	3,413	3,625	3,696	3,892	3,820	3,540	3,489	3,566	3,643	3,720
Other depository corporations	12	133	155	293	188	287	208	227	220	230
NDA of the banking system	-361	-314	-448	-527	-293	-193	207	448	567	586
Net claims on central government	-1,043	-1,327	-1,373	-1,425	-1,437	-1,426	-1,433	-1,455	-1,443	-1,441
Claims on the private sector 2/	1,271	1,463	1,499	1,506	1,645	1,703	1,667	1,725	1,896	1,963
Other items (net)	-589	-450	-575	-609	-500	-469	-27	179	115	65
Broad money (M3)	3,064	3,444	3,402	3,657	3,715	3,634	3,903	4,241	4,430	4,536
M1	2,396	2,698	2,554	2,676	2,636	2,653	3,053	3,183	3,464	3,405
Currency outside banks	533	531	457	548	523	575	617	639	649	658
Demand deposits	1,863	2,167	2,097	2,128	2,113	2,078	2,435	2,544	2,815	2,747
Savings and time deposits	668	745	848	981	1,079	981	851	1,057	966	1,131
	(Annual percentage change, unless otherwise indicated)									
Reserve money	22.0	-0.8	1.6	7.6	12.0	-10.1	11.8	11.7	10.3	27.0
Credit to the private sector	4.1	15.1	10.1	7.8	16.0	16.3	11.2	14.5	15.2	15.3
Broad money	17.3	12.4	9.3	15.9	13.8	5.5	14.7	15.9	19.2	24.8
Memorandum items:										
Money multiplier (level)	1.5	1.7	1.9	1.9	1.8	2.0	2.0	2.0	2.0	2.0
Loan-to-deposit ratio (in percent)	50.2	50.2	50.9	48.4	51.5	55.6	50.8	48.0	51.6	52.6
Interest rates (percent per annum)										
Deposit rate 3/	0.9	0.3	0.2	0.2	0.2	0.2	...	...	...	...
Lending rate 3/	11.3	10.7	10.8	10.9	10.8	11.2	...	...	...	...
NCG of financial corporations	-962	-1,252	-1,296	-1,359	-1,378	-1,371	-1,382	-1,407	-1,648	-1,731
91-day treasury bill rate	0.3	0.2	0.3	0.3	0.1	0.4	...	...	...	...
Program targets										
NIR of CBSI (in US$ millions)	479	516	470	551	553	450	480	480	480	...
NDA of CBSI (in SI$ millions)	-1,123	-1,150	-1,268	-1,962	-1,704	-1,582	-1,474	-1,378	-1,357	...

Sources: Data provided by the Central Bank of Solomon Islands; and IMF staff estimates and projections.
1/ Based on the new program exchange rate of SI$7.331 per US$.
2/ Includes claims of the CBSI on other (nonbank) financial corporations.
3/ Weighted average of different maturities, period average.

Table 5. Solomon Islands: Balance of Payments, 2013–19 1/

	2013	2014	2015	2016	2017	2018	2019
		Est.			Proj.		
				(In millions of U.S. dollars)			
Current account balance	-47.2	-98.2	-101.3	-165.6	-144.5	-148.6	-147.0
Trade balance for goods	-16.5	-5.2	-27.9	-62.7	-53.8	-43.2	-41.7
Exports	448.0	451.7	423.2	426.0	472.3	510.3	547.1
Imports	-464.6	-457.0	-451.1	-488.7	-526.1	-553.5	-588.8
Trade balance for services	-128.2	-120.4	-131.2	-149.1	-131.5	-139.3	-147.5
Exports	124.8	114.7	120.9	127.7	134.4	141.3	148.8
Imports	-253.1	-235.1	-252.2	-276.8	-266.0	-280.6	-296.3
Income balance	-22.3	-59.6	-64.9	-80.3	-93.3	-115.7	-125.5
Current transfers balance	119.8	87.0	122.7	126.5	134.2	149.6	167.8
Of which : Official transfers, net	104.9	72.0	106.1	108.4	114.3	127.9	143.4
Capital and financial account balance	91.6	68.5	146.6	160.7	153.4	154.4	150.2
Capital account balance	86.7	66.7	61.1	51.8	54.7	49.1	43.0
Direct investment balance	39.7	34.8	62.3	73.9	64.9	66.0	62.1
Portfolio investment balance	2.2	0.0	0.0	0.0	0.0	0.0	0.0
Other investment balance	-36.9	-33.0	23.2	35.0	33.8	39.3	45.1
Errors and omissions	-16.3	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	28.1	-29.7	45.4	-4.9	9.0	5.8	3.3
Financing	-27.9	29.7	-45.4	4.9	-9.0	-5.8	-3.3
Change in gross reserves (- = increase)	-28.1	30.8	-42.9	9.0	-4.9	-5.8	-3.3
IMF	0.2	-1.1	-2.4	-4.1	-4.1	0.0	0.0
				(In percent of GDP, unless otherwise indicated)			
Current account	-4.5	-8.5	-8.4	-12.6	-10.3	-9.8	-9.0
Trade balance for goods	-1.6	-0.5	-2.3	-4.8	-3.8	-2.9	-2.5
Exports	42.3	39.1	35.1	32.5	33.5	33.7	33.4
Imports	43.8	39.6	37.4	37.3	37.4	36.5	35.9
Mining imports	4.3	0.6	0.0	0.1	1.9	2.0	2.3
Nonmining imports	39.6	39.0	37.4	37.2	35.5	34.5	33.6
Current transfers balance	11.3	7.5	10.2	9.7	9.5	9.9	10.2
Of which: Official transfers net	9.9	6.2	8.8	8.3	8.1	8.4	8.8
Capital account balance	8.2	5.8	5.1	4.0	3.9	3.2	2.6
Direct investment balance	3.7	3.0	5.2	5.6	4.6	4.4	3.8
Of which: Inward FDI 2/	4.0	3.6	5.6	6.2	5.1	4.8	4.2
Other investment balance	-3.5	-2.9	1.9	2.7	2.4	2.6	2.8
Memorandum items							
Net international reserves (in US$ million)	508	478	524	519	528	533	537
In months of next year's GNFS	8.8	8.2	8.2	7.9	7.6	7.2	6.9
Gross official foreign reserves (in US$ million) 3/	528	497	540	531	536	541	545
In months of next year's imports of GNFS	9.1	8.5	8.5	8.0	7.7	7.3	7.0
Gross external public debt	11.8	10.3	10.8	11.8	13.0	14.4	15.7
Disbursement of consessional borrowing (in US$ millions)	0.2	0.4	22.3	34.0	37.9	42.3	47.4
External public debt service (in percent of exports of GNFS)	1.4	1.7	1.8	1.9	1.6	1.3	1.1

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

1/ Incorporates the authorities' revision of historical data, including a 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/ FDI numbers have been revised down as a result of changes to ensure the correct treatment of net losses under reinvested earnings, in line with BPM6 practice.

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

Table 6. Solomon Islands: Reviews and Disbursements Under the Extended Credit Facility

Availability Date1/	Amount of Disbursement		Condition
	In percent of quota	In SDRs	
December 7, 2012	1.4	148,571	Approved Fund arrangement
June 28, 2013	1.4	148,571	Completion of the first review and observance of continous and end-December 2012 performance criteria
January 8, 2014	1.4	148,571	Completion of the second review and observance of continous and end-June 2013 performance criteria
June 20, 2014	1.4	148,571	Completion of the third review and observance of continous and end-December 2013 performance criteria
November 15, 2014	1.4	148,571	Completion of the fourth review and observance of continous and end-June 2014 performance criteria
June 15, 2015	1.4	148,571	Completion of the fifth review and observance of continous and end-December 2014 performance criteria
November 15, 2015	1.4	148,574	Completion of the sixth review and observance of continous and end-June 2015 performance criteria
Total	10.0	1,040,000	

Source: IMF.

1/ For reviews that have already been completed, the date refers to the actual Board date when the review was completed.

Table 7. Solomon Islands: Indicators of Capacity to Repay the Fund, 2014–25

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
	Act.						Proj.					
Fund obligations based on existing credit (in SDR millions)												
Principal	1.0	2.1	2.8	2.8	2.5	1.5	0.1	0.1	0.1	0.1	0.0	0.0
Charges and interest	0.0	0.0	0.0	0.0	0.0	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	1.0	2.1	2.8	2.8	2.5	1.5	0.2	0.2	0.2	0.2	0.1	0.1
Charges and interest	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total obligations based on existing and prospective credit												
In millions of SDRs	1.0	2.1	2.8	2.8	2.5	1.5	0.2	0.2	0.2	0.2	0.1	0.1
In millions of US$	1.5	3.1	4.1	4.1	3.7	2.2	0.2	0.3	0.3	0.2	0.2	0.1
In percent of gross international reserves	0.3	0.6	0.8	0.8	0.7	0.4	0.0	0.1	0.0	0.0	0.0	0.0
In percent of exports of goods and services	0.3	0.6	0.7	0.7	0.6	0.3	0.0	0.0	0.0	0.0	0.0	0.0
In percent of debt service 2/	8.8	15.6	19.4	19.4	17.4	10.3	1.1	1.6	1.6	1.2	1.0	0.5
In percent of GDP	0.1	0.3	0.3	0.3	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0
In percent of quota	10.0	20.0	26.6	26.6	23.7	14.0	1.4	2.1	2.0	1.4	1.0	0.4
Outstanding Fund credit												
In millions of SDRs	12.0	10.4	7.6	4.9	2.4	0.9	0.8	0.6	0.4	0.2	0.1	0.0
In millions of US$	17.6	15.3	11.3	7.2	3.6	1.4	1.2	0.8	0.5	0.3	0.1	0.0
In percent of gross international reserves	3.6	2.8	2.1	1.3	0.7	0.3	0.2	0.1	0.1	0.0	0.0	0.0
In percent of exports of goods and services	3.1	2.8	2.0	1.2	0.5	0.2	0.2	0.1	0.1	0.0	0.0	0.0
In percent of debt service 2/	102.1	78.2	53.5	34.0	17.0	6.5	5.7	4.2	2.7	1.5	0.5	0.0
In percent of GDP	1.5	1.3	0.9	0.5	0.2	0.1	0.1	0.0	0.0	0.0	0.0	0.0
In percent of quota	115.7	100.0	73.3	46.6	23.1	8.9	7.6	5.4	3.5	1.7	0.5	0.0
Net use of Fund credit (in SDR millions)												
Disbursements	0.3	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repayments and repurchases	1.0	2.1	2.8	2.8	2.5	1.5	0.2	0.2	0.2	0.2	0.1	0.1
Memorandum items:												
Nominal GDP (in US$ millions)	1155.2	1205.7	1309.4	1408.2	1516.4	1639.1	1785.1	1944.7	2113.6	2294.7	2491.4	2704.8
Exports of goods and services (in US$ millions)	566.4	544.1	553.7	606.8	651.6	695.9	669.1	695.2	727.4	720.3	696.3	741.3
Gross international reserves (in US$ millions)	496.9	540.3	532.4	538.1	544.7	548.7	548.7	586.6	629.7	689.0	724.5	771.6
Debt service (in US$ millions) 2/	17.3	19.6	21.1	21.2	21.0	21.1	20.5	20.0	19.5	19.1	18.7	18.4
Quota (in SDR millions)	10.4	10.4	10.4	10.4	10.4	10.4	10.4	10.4	10.4	11.4	12.4	13.4

Source: IMF staff estimates and projections.

1/ Prospective credit includes the 7.1 percent of quota (SDR 0.74 million) available under the Extended Credit Facility.

2/ Total public debt service, including IMF repayments.

Appendix 1. Letter of Intent

Ref: RF/457/5/5 March 20, 2015

Madame Christine Lagarde
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Madame Lagarde:

As a small state comprising hundreds of islands located in the South Pacific, Solomon Islands faces several challenges. Smallness and dispersion make public service delivery in the most remote islands extremely difficult. More than eighty percent of our population lives in rural areas without access to electricity. Capacity constraints are also an issue. The severe flood that hit Honiara in April 2014 has also reminded us of how vulnerable our country is to natural disasters. This in conjunction with the closure of the Gold Ridge Mine, which will have a much larger ongoing impact on the economy and Government revenue, displays how critical it is to build resilience to shocks given our narrow production base.

We are convinced that our country also has great potential and that appropriate policies will help overcome some of these challenges and achieve higher economic growth. That is why the Government is placing its policy emphasis on two key development fronts. The first relates to sectoral reform and the second relates to fundamental reform. Central to the sectoral reform agenda is an emphasis on the productive and economic and finance sectors. The second emphasis is to pursue and execute fundamental reform programmes. This is a critical segment of the Government's policies. The collective goal of the fundamental reform programmes is to create confidence in our economy by creating an enabling environment for economic development goals to be achieved, as well as for our people to benefit optimally from the fruits of economic growth. There are two central themes emphasized in these programmes.

The first relates to the pursuit of good governance while the second relates to the evasive goal of opening up our customary lands for economic development and for landowners to fully benefit from the exploit of their tribal lands.

On these endeavors, this government looks forward to continuing the constructive engagement with the IMF under the current three-year Extended Credit Facility (ECF) arrangement to help the country anchor economic policies and ensure macroeconomic stability.

We are very determined to implement our reform agenda, aimed at promoting growth and improve the composition of public spending. The attached Memorandum of Economic and Financial Policies (MEFP) describes the Government's reform policies for 2015. We believe these policies will strengthen our macroeconomic framework and public institutions. To assist with the development of this agenda, the expertise of the IMF is sought to examine the current tax system in place in Solomon Islands and to assist us to develop tax reform proposals that will promote economic growth.

To ensure strong implementation, the program will continue to be monitored through quantitative performance criteria, indicative targets, and structural benchmarks. In terms of recent program performance, all end-June 2014 performance criteria (PCs) have been achieved and by a considerable margin in some instances (MEFP Table 1). We have also made progress in implementing the structural benchmarks (MEFP Table 2). Therefore, we request the completion of the fourth review under the ECF, the modification of the structural conditionality, and propose setting the end-June 2015 performance criteria.

We intend to maintain a close two-way policy dialogue with the IMF, and we stand ready to take additional measures, as appropriate, to ensure the achievement of the Government's objectives under the ECF arrangement. We will consult with the Fund in advance of 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 appropriate information it may request on policy implementation, as necessary, to achieve the program objectives. We also authorize the publication of this Letter of Intent, the related attachments, and the related IMF staff report.

Sincerely yours,

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

Attachments:

- Memorandum of Economic and Financial Policies and Technical
- Memorandum of Understanding

Attachment I. Memorandum of Economic and Financial Policies

Recent Developments, Outlook, and Program Performance

1. **The economy is still recovering from the closure of the Gold Ridge mine.** The only gold mine, Gold Ridge, ceased production and prospects for its near-term reopening are weak. Economic activity in 2014 was not as weak as previously expected as the impact of the April floods in Honiara and Guadalcanal proved relatively short-lived and limited. Agriculture has rebounded and logging, despite secular decline in forestry, has surprised on the upside because of re-entry logging. GDP growth estimates for 2014 are still uncertain—between zero and 1½ percent.

2. **Nonetheless, policy space has been maintained and important reforms achieved.** Gross international reserves stood at around US$500 million at end-November 2014, sufficient to cover 10 months of imports of goods and services. Public financial management (PFM) reforms have continued together with financial sector reforms.

3. **The near- and medium-term outlook is uncertain as new sources of growth are needed given the cessation of operations of the Gold Ridge mine.** With the expected decline in forestry sector in the medium term, growth will need to be supported by increased broader-based activities and productivity across a wide range of sectors, including tuna processing and eventually tourism. But these will require large investment in infrastructure and sanitation. Growth prospects in the near term will be influenced by how quickly future mining projects such as nickel and bauxite come on stream. Investment in the undersea cable and Tina River Hydropower project that are in the pipeline are still under negotiation, but will also help support private sector development in the medium term. Sustained lower oil prices could boost Solomon Islands' economy and lower inflation. However, the expected decline in aid from Australia and other development partners over the medium term may imply lower reserve buffers going forward.

4. **On the ECF program, the June 2014 and September 2014 PCs were met with comfortable margins**. The indicative targets and all continuous PCs were also met, with the exception of the indicative targets on government-funded recurrent spending on health and education, which were narrowly missed.

5. **We have also made progress on the structural reform agenda reflected in the structural benchmarks.** We have met four structural benchmarks since the last review. Draft instructions of a new financial institution Act (end-June 2014 benchmark) were approved by Cabinet. The benchmarks on preparing and publishing the 2014 budget strategy document and the mid-year budget review (end-August 2014 benchmarks)—key from a public finance management perspective to improve budget planning and execution—were also met together with the benchmark related to the new mining tax regime (end-July 2014 benchmark). Progress has been made on other benchmarks related to the review of the Credit Union Act, National Provident Fund (NPF) Act, tertiary education, customs and excise laws, and audits related to the constituency development funds (CDFs). These benchmarks are expected to be completed in or by the second half of this year. These reforms have taken longer than expected, reflecting partly

capacity constraints in the Attorney General's Chambers as well as a slowdown in Cabinet's activity ahead of the general elections in November 2014.

Program Policies

6. **The new government's economic policies are aimed at lifting economic activity by enhancing competitiveness and enabling private sector-led growth.** To meet these objectives, we will need to implement growth-oriented structural reforms to crowd-in the private sector and attract FDI. This will comprise: land and sectoral reforms, including tax reforms. These actions will help restore investor confidence and ensure a lower-cost business environment to diversify sources of growth.

A. Fiscal Policy

7. **We remain committed to preserving a sustainable fiscal position while providing resources for much-needed capital spending.** Despite lower growth and revenues related to the closure of the Gold Ridge mine, and higher spending due to the election, the overall fiscal position was broadly kept intact. Maintaining a prudent fiscal stance in 2015 will remain a top priority given fiscal risks have increased with the uncertainty surrounding mining sector and growth prospects in 2015 onwards. In the 2015 budget, we will therefore target a budgetary position that will not involve any borrowing to fund operating expenditures. This will be done cautiously to ensure a balance between providing for high value development needs while ensuring that sufficient funds are maintained for cash flow purposes. It will occur by containing recurrent spending, especially public sector allowance and benefits as well as the non-capital component of the development budget. The strategy will still allow for spending on capital projects.

8. **Given the large development needs, we will prioritize spending toward key sectors such as health, education, and infrastructure**. To achieve this fiscal strategy, we will produce and publish a medium-term development plan to better prioritize spending. We are committed to maintain spending on education and health at no less than 32 percent of Government-funded recurrent spending to improve human development.

9. **A comprehensive tax reform is needed to simplify the tax system, support business and attract foreign investors.** Thus, we would welcome a full review of the overall tax system with assistance from the IMF. For example, the incidence of overlapping and cascading regressive consumption taxes should be reviewed given their potential to hamper business opportunities. We will also strengthen the tax payer register to improve tax administration and compliance, and further bolster revenue mobilization by amending the Sales Tax Act to eliminate loopholes.

10. **We will continue to improve budget planning and increase budget transparency.** To this end we will publish on a yearly basis the Final Budget Outcome—a report that we firstly released in April 2014 as a benchmark under the ECF arrangement with the IMF. We will also continue publishing the mid-year budget update every July. In addition, beginning with the 2015 budget, both the recurrent and development budget will include tables showing spending on new

or improved physical infrastructure, other direct capital expenditures, capital grants, and other non-capital development.

11. **Given the importance of rural development to the Government's agenda, constituency development funds (CDFs) will form an important part of providing Government support to rural areas.** Like any other form of Government spending, CDFs need to be well managed and provide value for money. While recognising that all constituencies are different, the Government is committed to the adoption of sensible regulations that will help ensure good planning, consultation, effective spending, accountability and transparent reporting in relation to CDFs. CDF expenditure is already subject to all of the requirements of the *Public Financial Management Act, 2013*. CDF's expenditure is also subject to audits from the Office of the Auditor General.

12. **Despite delays we remain committed to publication of the CDF audit conducted by the office of the Auditor General.** An audit of the 2012 constituency funds was delayed by the retirement of the former auditor general, but was completed in December 2013. In order to facilitate publication of audit reports, we request that the structural benchmark for publication of the audit be modified to provide that the Auditor General can release the individual audits of members of Parliament's CDFs at their request, instead of waiting for the all audits to become available in order to publish them.

13. **We are fully aware that a strong PFM system is critical to improve the quality of public spending, particularly as donor assistance is expected to decline over the medium term.** The first PFM Reform Roadmap (2014–17) has been developed to implement the new PFM Act and the Government is fully committed to its implementation. The main priorities are:

- Publishing the budget at the same time as it is tabled in Parliament;
- Introducing a Cabinet requirement for the Ministry of Finance and Treasury and to comment on all Cabinet papers with financial implications before being submitted to Cabinet;
- Putting into effect revised regulations and financial instructions consistent with international standards for disciplined financial management of special funds, targeted balances and expenditure controls consistent with the PFM Act.

14. **We are also undertaking additional reforms which will complement PFM reforms in improving quality of public spending.** We are undertaking a public sector remuneration review to consider options for streamlining and consolidating the existing remuneration benefits. In addition, we are developing a Line Ministry Expenditure Analysis (LMEA). This analysis provides a measure of efficiency of public spending by mapping trends in expenditure in key line ministries with core outputs and service delivery outcomes.

15. **While investing in education is key to sustain long-term growth in Solomon Islands, we will sustain our efforts to strike a better balance between financing tertiary education and investing in primary and secondary education.** Significant progress has been made in bringing the budget for tertiary education scholarships under control in 2014 and we will continue to do so in 2015. A new Cabinet paper on the revamp of the policies for these scholarships—details of which are specified in the TMU—will be prepared. Once the paper is completed, we plan to submit it to Cabinet for approval (currently an end-September 2014

benchmark) and we seek a modification of the test date to end-April 2015. In coordination with development partners, we will also review tertiary education policies (an end-March 2015 benchmark), including the selection criteria, budget allocation, and accountability and transparency of the use of funds. A "think tank" group is scheduled to meet in March before the new structure is implemented.

16. **We have adopted a conservative approach to debt management while tapping resources to finance much-needed investment.** We continue to undertake borrowing in accordance with our established Debt Management Framework, which consists of the Debt Management Strategy as well as the PFM Act and SOE Borrowing Policy. The Annual Borrowing Limit for 2014 was set at SI$250 million, and while the 2015 limit on new borrowing has not yet been finalized, it will be announced in the Budget. The borrowing limit will be set in line with the debt framework and based on the Debt Management Unit's debt sustainability analysis which is consistent with a debt limit equivalent to 25 percent of GDP. Current borrowing proposals include the submarine internet cable project and the Tina River Hydropower Project. Given the high costs of electricity generation in Solomon Islands and current limitations in connectivity, these projects will improve strongly the business environment and foster private sector development.

17. **These policies will help underpin our drive to safeguard the management and use of public funds.** The fiscal policies outlined here are essential in underpinning this Government's fight against corruption, including: the development of a comprehensive National Anti-Corruption Strategy; the enactment of anticorruption legislation; and the establishment of an Independent Commission against Corruption.

B. Monetary, Exchange Rate, and Financial Sector Policies

18. **Monetary and exchange rate policies have been supportive of economic activity since the flood and the uncertain economic prospects also surrounding the mining sector.** With inflation on a downward trend thanks to lower world oil prices, the Central Bank of Solomon Islands (CBSI) shifted monetary policy to an easing bias in September 2014. This has been achieved by fixing a cap on the size of its Bokolo bills issuance. The exchange rate policy, through the implementation of the basket peg regime has also seen a slight depreciation against the U.S. dollar but a significant appreciation against some other key currencies, including the Australian dollar. We have removed the exchange rate band and increased the buy-sell margin in foreign exchange trading to allow greater flexibility in the exchange rate management. We look forward to a follow-up IMF TA in March to help us strengthen the monetary transmission mechanism. Should inflationary pressure arise, the CBSI stands ready to review its monetary policy stance in favor of less accommodative bias to ensure domestic price stability. We will also remain vigilant of strong credit growth on mortgage and consumption loans.

19. **We continue to strengthen financial regulation and supervision to preserve financial stability and to foster the financial sector development as an enabler of economic growth.** With the start of operations of a new bank in July 2014, the total number of banks in Solomon Islands has increased allowing greater financial access. The introduction of mobile banking services since the end of 2013 has further boosted our efforts to make financial system more inclusive. The CBSI has begun consultations with the Asian Development Bank (ADB) on strengthening the regulation of mobile banking services and will be developing new prudential

guidelines to ensure adequate consumer protection. The draft of a new Financial Institutions Bill is currently at the public consultation stage. Revised draft legislation is expected to be sent to Cabinet for approval by September 2015. We continue to work with the ADB on drafting instructions for a revised National Provident Fund (NPF) Act, which will provide a basis for the Attorney General Chambers to draft the NPF legislation update by end-September 2015 and we accordingly seek a modification in the test date for this benchmark. A draft Credit Union Act (an end-December 2014 benchmark) is expected to be submitted to Cabinet by end-September 2015 and we also seek a modification in the test date for this benchmark.

Competiveness and Inclusive Growth

20. **Raising productivity growth and enhance private sector development is high on the Government's reform agenda.** Land reform is one of this Government's top priorities. The forthcoming medium-term development plan will provide the basis for the preparation status report of the Poverty Reduction Strategy, which we will produce for the fifth review of the ECF arrangement. This report will be complemented by a hardship and vulnerability assessment, with the support of the World Bank Group.

C. Program Monitoring

21. **Implementation of the program will continue to be monitored through semiannual reviews based on performance criteria, indicative targets and structural benchmarks.** Indicative target for end-March 2015, performance criteria for end-June 2015, and indicative targets for end- September 2015 are set as per Table 1 and structural benchmarks are set as per Table 2. The program performance will be assessed in the course of the reviews. The fifth review under the ECF arrangement is expected to take place on or after June 15, 2015. The sixth review under the ECF arrangement, assessing end-June 2015 performance criteria, is expected to take place on or after November 15, 2015 on the basis of the performance criteria and structural benchmarks indicated in Tables 1 and 2, and further detailed in the TMU.

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

	6/30/2014				9/30/2014				12/31/2014	3/31/2015	6/30/2015	9/30/2015
	PC (EBS/14/65)	PC with adjusters	Act.	Status	IT (EBS/14/65)	IT with adjusters	Act.	Status	PC (EBS/14/65)	IT	PC	IT
Performance criteria 1/												
Net international reserves (NIR) of the Central Bank of Solomon Islands (CBSI) (floor, end-of-period stock, in millions of U.S. dollars (US$)) 2/	490	490	551	Met	470	465	552	Met	450	480	480	480
Net domestic assets (NDA) of the CBSI (ceiling, end-of-period stock, in millions of Solomon Islands dollars (SI$)) 3/	-1,576	-1579	-1,945	Met	-1,431	-1393	-1,760	Met	-1,194	-1,406	-1,247	-1,185
Net credit to central government (NCG) (ceiling, cumulative change from the beginning of the year, in millions of SI$) 4/	9	9	-107	Met	37	75	-126	Met	40	-10	-35	-20
New nonconcessional external debt maturing in more than one year, contracted or guaranteed by the public sector (ceiling, end-of-period stock since the beginning of the program, in millions of US$) 5/	0	0	0	Met	0	0	0	Met	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$) 5/	0	0	0	Met	0	0	0	Met	0	0	0	0
Accumulation of new external payment arrears by the public sector (ceiling, end-of-period stock since the beginning of the program, in millions of SI$) 5/	0	0	0	Met	0	0	0	Met	0	0	0	0
Central government program cash balance (floor, end-of-period stock, in millions of SI$) 4/	520	520	624	Met	420	382	657	Met	374	560	545	535
Indicative Targets (cumulative)												
Government funded recurrent spending on health and education (cumulative from the beginning of the year, in millions of SI$) 6/	345	…	267	Not met	520	…	479	Not met	710	161	348	542
Memorandum items:												
The threshold of indicative target on health and education (actual 32 percent of government funded recurrent spending)	…		…	…	…		…	…	…	…	…	…
Budget support from bilateral and multilateral donors other than IMF (cumulative change from the beginning of the year, in millions of US$), program level.	29		30	…	37		32	…	48	25	10	11
Outstanding stock of Solomon Islands government (SIG) treasury bills, excluding restructured government bonds (end-of-period stock, in millions of SI$), program level.	40		40	…	40		40	…	40	40	40	40
Balance of SIG Consolidated Deposits Account, millions of SI$ 7/	140		140	…	140		140	…	140	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
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.
4/ The adjustors are specified in the TMU and include: the floor on the 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 the 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
5/ These performance criteria are applicable on a continuous basis.
6/ An indicative target for spending on health and education at no less than 32 percent of government-funded recurrent spending.
7/ 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.

MEFP Table 2. Solomon Islands: Structural Benchmarks

Actions	Macroeconomic criticality	Date	Status
Obtain Cabinet's approval of drafting instructions of a new Financial Institutions Act.	To promote financial sector stability and development.	June 30, 2014	Met.
Amend the Export Duty Schedule (by Ministerial Order) to complete the implementation of the new mining tax regime in line with IMF TA recommendations.	To broaden the tax base and increase revenue transparency.	July 31, 2014	Met.
Produce and publish a mid-year Budget review.	To promote transparency on economic and fiscal developments.	August 31, 2014	Met.
Produce and publish a Budget strategy document.	To facilitate planning and fiscal strategy.	August 31, 2014	Met.
Review the policies on tertiary education and ensure an adequate balance of spending between primary and tertiary education.	To promote the transparency and accountability in the use of public funds.	March 31, 2015	
Revised Test Dates and Proposed New Benchmark			
Obtain Cabinet approval of revamped policies for tertiary scholarships as specified in TMU.	To promote the transparency and accountability in the use of public funds.	April 30, 2015	A Cabinet paper has been drafted and submitted to Cabinet for its deliberation. Reset from 30 September 2014.
Release to public the results of the audits conducted by the office of the Auditor General on spending of constituency funds by the 50 constituencies, and project achievements in 2012. Enable relevant members of Parliament to request the Auditor General's public release of the audit reports for their individual constituencies.	To promote the transparency and accountability in the use of public funds.	June 30, 2015	A draft working copy on each constituency was delivered to each of the relevant Members of Parliament on 5 September 2014 for comments due 10 October 2014. The compiled draft report is now expected to be presented to the Ministry of Rural Development for comment by late January 2015. The authorities aim to get the final report to the Office of the Speaker by late February 2015. Reset from 30 September 2014.
Issue (by Ministerial Order) implementing regulations on the implementation of the Constituency Development Funds Act, in accordance with the PFM Act.	To promote the transparency and accountability in the use of public funds.	July 30, 2015	New program benchmark. This should encourage transparency and best practice and enhance accountability in the use of the constituency funds.
Submit to Parliament the revised NPF Act that strengthens its governance structure and investment framework.	To improve the long-term financial viability of the NPF and reduce financial risks.	September 30, 2015	A set of detailed drafting instructions has been received and the Ministry of Finance and Treasury is preparing a minute to send to the Attorney General's Chambers to review the drafting instructions and being preparing the Bill. The Attorney General's Chambers will prepare and vet the final NPF legislation before it goes to Cabinet and Parliament. Reset from 30 June 2014.
Submit to Parliament 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.	September 30, 2015	ADB is providing technical assistance and the authorities expect to receive the final draft of the Bill from ADB in April. Reset from 30 June 2014.
Submit to Cabinet the draft Credit Unions bIll.	To promote financial sector stability and development.	September 30, 2015	A policy paper on recommendations for reform was endorsed by Cabinet in February 2014. Consultations were completed in July 2014. Discussion of outstanding recommendations, and the consultation report have been finalized. ADB has finalized the Policy Framework for review and circulated for comments from the Review Committee. Reset from December 31, 2014.

Attachment II. 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-June 2015 and indicative targets for end-September 2015 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.
- An indicative target (cumulative) for spending on health and education at no less than 32 percent of government-funded recurrent spending.

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

A. Reserve Money

6. 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

7. 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 the IMF) in excess (short) of the programmed level.

8. NIR will be calculated as gross international reserves (GIR) less international reserve liabilities. For NIR program monitoring purposes, the stock of foreign assets and foreign liabilities of the CBSI will be reported in U.S. dollars and be valued at the program exchange rates, as specified in Table 1.

TMU Table 1. Solomon Islands: Program Exchange Rates

Solomon Islands (Program) Exchange Rates for the ECF Arrangement

(Rates as of September 30, 2013)

Currency	Solomon Islands Dollar per currency unit	U.S. Dollar per currency unit
Australian dollar	6.831	0.932
British pound	11.820	1.612
Euro	9.901	1.350
Japanese yen 1/	13.352	97.890
New Zealand dollar	6.068	0.827
SDR	11.236	1.533
Singapore dollar	5.838	0.796
U.S. dollar	7.331	1.000

1/ Currency unit per Solomon Islands dollar and U.S. dollar.

9. 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.

10. 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 the 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 the 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 the 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. The floor on the program cash balance will be adjusted upward by the difference between SI$140 million (hereafter known as program level) 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 rate used for this purpose is five percent.

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. 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.

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; (iv) concessional debts; and (v) 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 non-accumulation 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 agreement, subject to any applicable grace period.

VII. Tertiary Education

28. Approval will be sought from Cabinet to strengthen the policy of the granting of tertiary scholarships, which will contain at least the following elements:

- *Commitment controls.* The Ministry of Finance will certify the availability of budget allocation before any new award letters can be granted, in order to ensure that the budget ceilings are abided by and no new arrears are incurred. Commitment information will be entered into the Ministry of Finance's Financial Management Information System to record commitments made for each individual scholarship awardee. The Ministry of Education will ensure that the documentation relating to identification and eligibility, expected length of studies, as well as due dates for tuition and stipend payments is provided to the Ministry of Finance in a timely manner.
- *Queuing system.* If there are more candidates for scholarships than resources available in a fiscal year, a queuing policy for eligible applicants based on the timing of their application will be established.
- *Arrears.* All arrears will be cleared and no new arrears allowed.
- *Documentation.* In consultation with the Ministry of Finance, the Ministry of Education will establish the standards for eligibility documentation and documentation retention for each application. The required and retained documentation should include at least the application form, high school transcript, receipt for the payment of the application fee, copy of Ministry award letter, signed declaration letter, transcripts of results in each semester from tertiary institutions and qualifications attained by the scholarship holders.
- *Monitoring and dissemination.* The Ministry of Education will produce regular reports on total number of applicants for scholarships, number granted scholarships, current

number of students classified by gender and educational institutions, and number of terminations or fails in the last 12 months. The Ministry of Education will publish the guidelines for obtaining scholarships and publish their periodic reports.

- *Tuition and Fee Rates*. The Ministry of Education will sign a memoranda of understanding the USP and other tertiary institutions, including to establish the basis of the financial commitment of the Solomon Islands Government.
- *Allowances*. The Ministry of Education, in consultation with the Ministry of Finance, will recommend an allowances policy with specific allowance amounts that vary for students depending on the institutions where they study, the course that they are undertaking, employment status, travel requirements, whether studies are full-time or part-time, the length of the program in which they are enrolled and the number of years they have received the grant.

VIII. Data Provision

29. 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:
- Revenue, including tax and nontax revenues, and recurrent and development grants included in the consolidated budget;
- Recurrent expenditure, including payroll, goods and services, and other recurrent outlays, including those funded by donor support;
- Other recurrent charges of the Ministry of Education and Ministry of Health, separating spending funded by donor support;
- Debt service payments, classified into amortization and interest payments on (i) domestic debt, (i) external debt, (iii) domestic arrears, and (iv) external arrears; and
- Development expenditure funded by (i) central government of Solomon Islands, and (ii) foreign grants and loans included in the consolidated budget.
- Detailed financing components of central government's accounts, classified into foreign and domestic sources.
- Foreign financing includes (i) disbursement and amortization of project and program loans, and (ii) changes in external debt arrears, classified into principal and interest arrears.
- Domestic financing includes (i) borrowing from and repayment to the CBSI, commercial banks and other ODCs, and OFCs; (ii) changes in deposits at the CBSI, commercial banks and other ODCs, and OFCs; and (iii) privatization receipts and changes in domestic debt arrears, classified into principal and interest arrears.
- Stock of domestic debt, including the outstanding balance of government securities, treasury bills, cash advances, and other debt instruments.
- Balances of each central government account specified in Section IV. A., as recorded by the MoFT.
- Stock of unpaid government payment orders and unpresented checks.

C. External Sector Data (CBSI and MoFT)

On a quarterly basis:

- New external debt obligations contracted and/or guaranteed by the government of 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

1. (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.

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Completes the Fourth Review Under the Extended Credit Facility Arrangement with Solomon Islands and Approves US$0.2 Million Disbursement

On April 10, 2015, the Executive Board of the International Monetary Fund (IMF) completed the fourth review of the Solomon Islands' economic performance under the Extended Credit Facility (ECF) arrangement.

Completion of the fourth review enables the Solomon Islands to draw an amount equivalent to SDR 0.149 million (about US$0.2 million) immediately, bringing total disbursements under the arrangement to an amount equivalent to SDR 0.743 million (about US$1.02 million).

The three-year ECF arrangement was approved December 7, 2012, in an amount equivalent to SDR 1.04 million (about US$1.59 million), or 10 percent of the country's quota (see Press Release No. 12/479).

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

"Solomon Islands has made enormous strides in strengthening its macro-financial performance and its institutions over the last few years. Fiscal and reserve buffers have been rebuilt, and important reforms, notably public financial management (PFM) and financial sector reforms, are being implemented. However, sources of growth going forward are unclear as result of setback in mining prospects and the depletion of forest resources. While the country has large development needs, fiscal space should be used wisely in 2015, given Solomon Islands' vulnerabilities to shocks and the uncertain growth outlook.

"The authorities should sustain efforts to advancing Public Financial Management (PFM) reforms, including by improving the transparency and accountability of scholarships and constituency funds and by continuing to strengthen the quality of public spending.

"The current monetary policy stance is appropriate especially as inflationary pressures have remained subdued. The central bank should, however, be ready to tighten if inflationary pressures emerge. The basket peg is an appropriate exchange rate regime for Solomon Islands and the recent removal of the band around the U.S. dollar should help deliver a more stable effective exchange rate and minimize any further erosion of competitiveness.

"Financial soundness indicators are adequate and the authorities' efforts to further strengthen supervision and regulation should continue. The forthcoming, new National Provident Fund Act and Credit Union Act should help enhance financial sector stability. Ongoing initiatives to promote mobile banking while ensuring adequate supervision and consumer protection will go a long way toward promoting financial inclusion."

Statement by Vicki Plater, Alternate Executive Director for Solomon Islands

April 10, 2015

The Solomon Islands authorities remain committed to the continuing engagement of the ECF program, which is helping to promote macroeconomic and financial stability and support the authorities' reform efforts. Solomon Islands faces enormous challenges. A small and remote country, it has a predominantly rural population dispersed over many islands, and has a narrow economic base. Solomon Islands is vulnerable to natural disasters and external shocks. The peaceful election and transition to a new government in late-2014 is an important achievement, indicating greater stability a decade after the end of the period of civil conflict known as the "ethnic tensions" (1998 to 2003). The IMF program is making an important contribution towards strengthening the institutional framework to lift macroeconomic and public financial management, and to address structural impediments to stronger inclusive growth and a more prosperous future. The ECF also plays a confidence-building role with development partners and other stakeholders.

Solomon Islands has continued to make steadfast progress in program implementation. All of the quantitative targets under the 4th Review have been met except for the Indicative Targets on health and education spending, which were narrowly missed due to more robust procurement requirements by donors that slowed expenditure. Four of the structural benchmarks were completed. The 2014 Mid-Year Budget Review and the 2015 Budget Strategy were both produced for the first time, notable steps in implementing the 2013 Public Financial Management Act. In addition, preparation for the implementation of the mining tax regime was completed with amendments to the export duty schedule; and Cabinet approved drafting instructions for a new Financial Institutions Act. Progress has been made on the remaining benchmarks, despite the interruptions to government business and limited sitting of Parliament inevitably associated with a general election, and domestic capacity constraints. Capacity constraints within the Attorney-General's Chambers have delayed timeframes on structural benchmarks involving legislation but they continue to be progressed. The authorities appreciate the flexibility of the IMF to adjust test dates in recognition of these capacity challenges.

The new Government's Priorities

The authorities are confident the country's natural resources and resilient population can be translated into new growth and income opportunities for all Solomon Islanders. The new Government, elected in November 2014, has an ambitious policy agenda to lift medium-term growth. The Government's Policy Programme outlines a long-term strategy to facilitate good governance and encourage broad-based economic development, with a target of at least 5 percent growth per annum. The government will progress reforms on two fronts:

- *Fundamental reforms* will pursue good governance and land reform to create confidence and support an enabling environment for economic development.

Fighting corruption is an important element of the governance agenda and an area that has not previously received much attention. The Government intends to develop a National Anti-Corruption Strategy, enact anticorruption legislation, and establish an Independent Commission against Corruption.

- *Sectoral reforms* are a set of sector-specific initiatives to facilitate entrepreneurship, SME development, further commercial development of natural resources, connectivity through transport and telecommunications, and to efficiently and effectively deliver social services. Improving the quality of expenditure remains a continuing priority for the authorities, complemented by the addition of tax policy reform to the agenda. Solomon Islands has requested IMF assistance to review the current tax system, which includes overlapping and cascading sales taxes, and developing reform proposals that will be more supportive of business.

Economic Outlook

The authorities' current projections are generally in line with Staff's forecasts. At the time the Board considered the 3rd Review of the Solomon Islands ECF, the capital Honiara and surrounding Guadalcanal had just been hit by severe floods. The impact of the 2014 floods proved more limited than initially feared, and economic growth for 2014 is believed to have been stronger than anticipated at the 3rd Review (estimates range between zero and 1.5 percent growth). Nonetheless, the ongoing closure of the Gold Ridge goldmine on Guadalcanal is a substantial drag on the economic and fiscal outlook. Before it closed the mine produced approximately 20 percent of Solomon Islands net exports and was a significant employer and contributor to government revenue (approximately 6 percent of government revenue in 2013). The mine is not expected to reopen in the foreseeable future. Growth in 2015 is expected to be modest and new sources of growth are needed to boost medium-term prospects and strengthen resilience.

Fiscal Policy

The Solomon Islands Government achieved a surplus in 2014 of about 1.9 percent of GDP on preliminary estimates. This outcome was better than expected at the time of the flood as revenues were supported by strong logging exports and fishing license fees, and development expenditure outturns were lower than planned. The cash balance was further buoyed by a disbursement of donor support in December 2014 to fund expenditure in 2015. This lifted the cash balance to 4.4 months of recurrent spending.

The authorities recognize that prudent fiscal management is a necessary part of their economic management strategy. The 2015 Budget was presented late last week. It reflects a balance between sustaining a prudent approach over the medium-term whilst delivering additional expenditure in the short-term in support of the country's priorities and capital needs and to advance the Government's Policy Programme. The Government has budgeted for a fiscal deficit of SI$462m (approx 5 percent of GDP) in 2015 to meet immediate needs, funded by drawing down some of the cash balance. While total expenditure is budgeted to increase by 10 percent in 2015, this is entirely driven by an increase in the development budget to reflect the Government's policy priorities (recurrent expenditure in the budget is flat). The increased development spending is focused on strengthening infrastructure and rural development to ensure the 85 percent of the population in rural areas benefit from improvements to their standard of living. The budget includes notable increases in expenditure on health and basic education, and full-funding for the establishment of the Independent Commission Against Corruption. Capacity constraints will moderate the reality of the pace of fiscal expansion. The Government remains committed to keeping a sustainable and affordable level of debt.

The management and reporting of Constituency Development Funds (CDF) is being improved. The Public Financial Management (PFM) Act 2013 is being applied to CDFs, for example with respect to procurement processes, and parts of the 2013 CDF Act are being applied ahead of the implementing regulations being gazetted. The authorities, under the Prime Minister's leadership, are determined that CDF expenditures are best able to support the development of a vibrant rural economy, and are focused on strengthening the implementation of the PFM Act 2013 and will review the CDF Act 2013 for implementation. In addition, the authorities remain committed to the publication of the results of already-conducted audits on spending of constituency funds and project achievements.

Continuing the efforts to strengthen policies and controls around tertiary scholarships following the 2013 overrun in expenditure, new tertiary scholarships policies have been approved by Cabinet. Cabinet also approved that the 2015 scholarship selection process follows the Ministry of Education and Human Resource Development (MEHRD) processes with the number of scholarships specified to enable value for money, transparency and accountability. Approval was also granted for MEHRD to implement a scholarship tracking database (recently developed scholarship information management system) to record and analyze the base data on current scholarships in the system. Furthermore, the authorities are committed to ensuring a better balance between investing in primary and secondary education, and financing tertiary education. With respect to the Customs and Excise Bill (a structural benchmark) a final draft has now been received.

Strengthening Public Financial Management remains a key priority. The authorities will continue to implement the PFM Act approved in September 2013. Building on the new suite of documents published last year, the 2015 Budget will introduce greater information on capital spending in both the recurrent and development budgets. The Government is firmly committed to implementing the PFM Reform Roadmap 2014-2017, developed with assistance from the Pacific Financial Technical Assistance Centre (PFTAC). In addition, a public sector remuneration review is underway to consider options for streamlining and consolidating the existing remuneration benefits. The authorities continue to take a cautious approach to debt management, using concessional borrowing only for productive priority investments. Solomon Islands' debt is currently around 11 percent of GDP, and the Annual Borrowing Limit set in the 2015 budget (SI$300m) is in line with the Debt Management

Framework (DMF). The DMF ensures that Government borrowing and/or guarantees is used for investing in productive capacity, funding priority core infrastructure and development initiatives and projects that are high priorities in the National Development Strategy.

Monetary Policy and Financial Sector

Monetary and exchange rate policies have supported economic activity during 2014 and remain appropriate. Inflation initially spiked after the April 2014 floods but has since eased, to 4.8 percent in the year to December and 1.6 percent in the year to February 2015. The inflation outlook remains sanguine. The Central Bank of Solomon Islands (CBSI) stands ready to review its monetary policy stance should inflationary pressure arise, and is closely monitoring strong credit growth (from a low base) on mortgage and consumption loans.

The Central Bank of Solomon Islands (CBSI) has now fully implemented the exchange rate's basket-peg regime. This is an important tool to anchor inflation and allow greater flexibility in the exchange rate management, thus helping maintain competitiveness. A subsequent IMF TA Mission has just concluded, providing the opportunity for follow-up on the operation of the basket-peg regime, and helpful input on strengthening the monetary transmission mechanism (such as tools to manage excess liquidity).

Strengthening financial regulation and supervision remains a focus to preserve financial stability and foster financial sector development and financial inclusion. The introduction of a new bank (Pan-Oceanic Bank) into the market in mid-2014 has enhanced financial access and competition. The authorities are mindful to ensure that lending standards are not undermined in this environment. Banks currently have ample liquidity and remain profitable. The introduction of mobile banking since late 2013 is also a meaningful boost to financial inclusion efforts, increasing access to financial services for the underserved rural population. The first credit bureau opened in February 2015. The authorities are working with the Asian Development Bank on strengthening the regulation of mobile banking services and developing prudential guidelines to ensure adequate consumer protection. Progressing the National Provident Fund, Financial Institutions and Credit Union Acts (structural benchmarks) remain priorities in order to further enhance financial sector stability and promote financial inclusion and access to credit. Policy proposals and legislative drafting are at various stages of development with the Financial Institutions the most advanced, with a draft Bill currently out for public consultation.

Conclusion

The authorities are keenly focused on supporting medium-term growth and enabling private sector development in Solomon Islands. The ECF program plays an important role in helping to strengthen the institutional framework and improve the quality of expenditure and tax policy, and in boosting confidence. The Government values continued engagement through the ECF program, which is an important element in the authorities' ambitious reform agenda. To deliver this agenda the Government is seeking a balance between higher development spending to boost economic growth prospects and meet development needs, whilst maintaining prudent fiscal management and sufficient buffers over time.

Finally, the Solomon Islands authorities would like to thank Staff for the quality of their engagement, collaborative approach and readiness to engage with the new Government on its objectives. Technical assistance provided by PFTAC and HQ departments continues to be invaluable to the Solomon Islands authorities' efforts to strengthen macroeconomic management and lift economic performance.