August 2004
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Solomon Islands: 2004 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Solomon Islands

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2004 Article IV consultation with the Solomon Islands, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 6, 2004, with the officials of the Solomon Islands on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 1, 2004. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 16, 2004 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for the Solomon Islands.

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

Selected Issues Paper and Statistical Appendix

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

SOLOMON ISLANDS

Staff Report for the 2004 Article IV Consultation

Prepared by the Staff Representatives for the 2004 Consultation with the Solomon Islands

(In consultation with other departments)

Approved by Steven Dunaway and Michael Hadjimichael

July 1, 2004

- The 2004 Article IV Consultation discussions for the Solomon Islands were held in Honiara during April 27–May 6. The staff team comprised Messrs. Orsmond (head), Dalgic (EP), and Marciniak (all APD). Mr. Francis (OED) participated in several of the concluding meetings.

- The mission met with Prime Minister Kemakeza, Finance Minister Zama, Central Bank of Solomon Islands Governor Houenipwela, other senior officials of the government, and representatives from the parliament, donor community, private sector, civil society, and the local press.

- The Solomon Islands accepted the obligations under Article VIII, Sections 2(a), 3, and 4 in 1979. However, in June 2000, exchange restrictions were introduced that were later intensified. These restrictions, which imposed delays on the availability of foreign exchange for current international payments, were not approved at the conclusion of the last Article IV consultation in January 2003. Since that time, the restrictions have been removed, and the Solomon Islands again maintains an exchange system that is free of restrictions on payments and transfers for current international transactions.

- Data quality, coverage, provision, and timeliness are weak, notably in the real, fiscal, and external sectors. These difficulties impede economic analysis and effective surveillance of policies in the Solomon Islands. The Solomon Islands subscribes to neither the GDDS nor the SDDS.

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EXECUTIVE SUMMARY

Economic Background

- **Solomon Islands' economy deteriorated after the outbreak of conflict in mid-1999.** The level of real GDP subsequently declined by one-quarter, exports halved, and inflation increased to 15 percent. In addition, the budget deficit increased to over 10 percent of GDP, the government defaulted on virtually all domestic and external debt obligations, and international reserves (net of the external arrears) were fully exhausted.

- **Policy performance improved markedly following the arrival of a multinational intervention force in mid-2003 that has restored law and order.** The budget deficit in 2003 was reduced to 1½ percent of GDP reflecting an increase in domestic revenue collections and expenditure restraint, especially for budget payments to ex-militants and the civil service wage bill. Large donor grants have been used to fund development and other expenditures. A budget surplus of 4 percent of GDP is projected for 2004.

- **Economic activity has started to respond to the more favorable law and order and policy environment.** Real GDP is estimated to have grown by 5 percent in 2003 backed by a rising level of exports, and there are signs that private investment is recovering. The level of international reserves has increased sharply, and inflation has fallen back to single-digit levels, reflecting in part stability of the nominal exchange rate.

Key Issues and Staff Recommendations

- **The main challenge is to move beyond the focus on stabilization and implement policies to underpin sustained per capita growth in the rural and urban areas.** Key fiscal, monetary, and structural reforms will be needed to achieve these objectives.

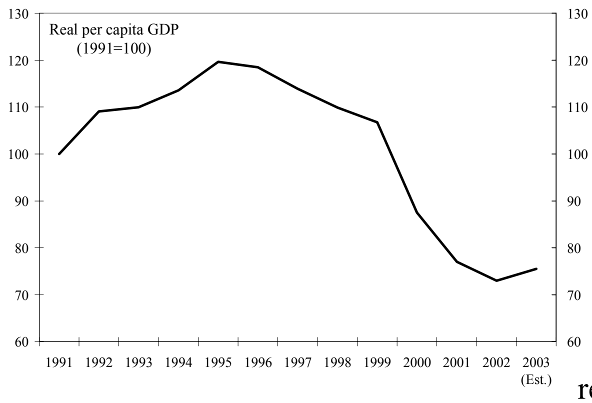
- **The projected 2004 budget surplus is consistent with improving the macroeconomic situation.** To shore up medium-term prospects, tax administration should be further improved and the pressure for tax exemptions resisted. Maintaining control over low priority expenditures is essential to fund a needed sharp increase in social, development, and operations and maintenance outlays. The regularization of government debt and arrears obligations within a sustainable medium-term fiscal framework is also important.

- **Monetary and exchange rate policies should focus on containing inflationary pressures and increasing reserves.** Upward pressure on the exchange rate arising from the large aid flows should continue to be resisted in order to build reserves. At the same time, the central bank should stand ready to sterilize the aid flows and absorb the high level of excess liquidity if needed to keep inflation in check as the economy recovers.

- **Structural reform should include streamlining licensing procedures, aiding rural production, strengthening the enterprise sector, and improving governance.**

I. Recent Developments

1. **Economic performance in the Solomon Islands deteriorated during the last decade.** In the early 1990s, real GDP growth averaged 8 percent a year, driven in large part by an unsustainably high level of logging. However, at the same time, the budget deficit increased as the revenue base was eroded by tax exemptions, and the civil service wage bill grew rapidly. In 1996, the government defaulted on its domestic debt obligations, and the level of per capita income declined. Economic pressures increased further when log prices and export volumes declined in the aftermath of the Asian crisis in 1997–98. In response, and in line with Fund staff advice at the time, the government prepared a wide-ranging reform program focused on fiscal consolidation, but program implementation was not sustained.



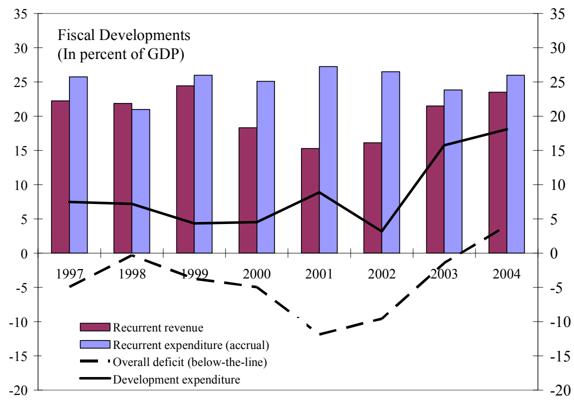
2. **Conditions worsened further after violence between the residents of the Guadalcanal and Malaita islands erupted in mid-1999**. Subsequently, much of the basic infrastructure was destroyed, real GDP declined by one-quarter, and exports halved. The budget deficit increased to over 10 percent of GDP as the government granted numerous import duty exemptions and made large payments, often under duress, to militants that under a peace agreement had been employed onto the police force. These largely squeezed out cash payments for social, development, and debt-service outlays. In the absence of a forceful response by the government to the deteriorating law and order and economic situation, donor support was largely withdrawn. By end-2002 international reserves (net of external debt and import-related arrears) had been virtually exhausted, despite a 30 percent depreciation of the exchange rate and the intensification of exchange restrictions, the rate of inflation had increased to 15 percent, and poverty indicators were deteriorating.

3. **At the conclusion of the last Article IV consultation on January 24, 2003, Directors expressed concern at the poor state of the Solomon Islands economy**. They stressed the urgency of restoring law and order and implementing policy reforms to arrest the deterioration of the economy. Directors called for strong revenue and expenditure measures, highlighting especially control over the wage bill and the large payments to the ex-militants. They advised that the central bank resist efforts to finance the budget deficit, continue frequent downward adjustments to the exchange rate, and closely supervise the financial sector. Directors also urged that the exchange restrictions imposed in mid-2000 be removed as conditions permit.

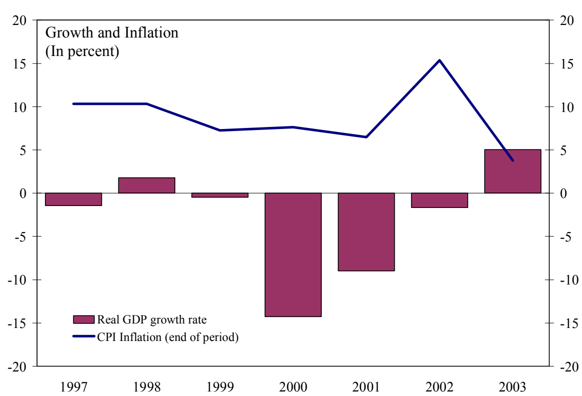
4. **Facing continued economic decline and growing internal unrest in the first half of 2003, a nine-nation, Australian-led intervention force of over 2,000 military and police officers arrived in July, at the request of Prime Minister Kemakeza.** The Regional

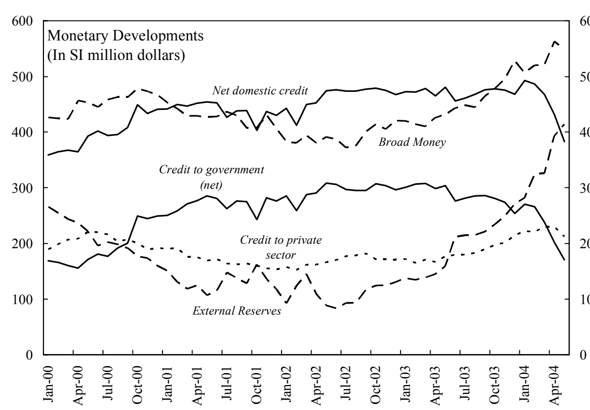
Assistance Mission to the Solomon Islands (RAMSI) quickly restored law and order in Honiara and in the outlying regions. Australia and New Zealand also placed their nationals in key line-positions in the judiciary and major budget departments to aid in the stabilization effort. During a development partners meeting in Honiara held in November 2003, in which Fund staff participated, donors committed sizable grants to help rehabilitate the economy. Australia has also paid the arrears owed to the World Bank and Asian Development Bank.

5. **The government has moved rapidly to stabilize budgetary finances since the arrival of RAMSI.** The budget finished the year with a deficit of just 1½ percent of GDP, compared with 10 percent in 2002. This result was mainly attributable to the marked strengthening of tax collections aided by an amnesty on penalties, the termination of payments to the ex-militants, greater scrutiny over the wage bill, the tightening of expenditure controls, and large general budget grants from the major donors. The government's commitment to prevent new nondebt expenditure arrears from October 2003 has also been strictly enforced.

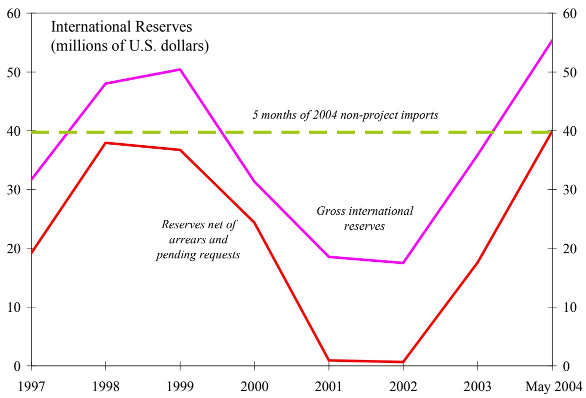


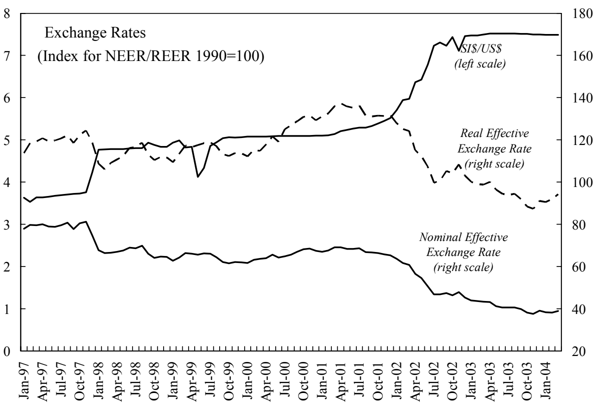
6. **Economic activity has started to respond to the more favorable law and order and policy environment.** Real GDP grew by an estimated 5 percent in 2003, helped by strong fish, copra, and cocoa production. Foreign investors have expressed renewed interest in major natural resource projects, and private sector credit growth has increased as lending interest rates have declined. Overall credit growth, however, has remained low as the large aid flows and the budget surplus since mid-2003 have increased the level of government deposits held at the central bank.





7. **Other economic indicators have also been encouraging.** By May 2004, international reserves had increased to almost $40 million (net of external arrears), reflecting higher export





volumes and world commodity prices, the slow pick up in import demand, large aid flows, and the remonetization of the economy. Inflation has fallen back to single-digit levels, as the supply of food has increased and the nominal effective exchange rate has stabilized. Urban employment is reportedly increasing, although unemployment remains high.

II. Policy Discussions

A. The Medium-Term Framework

8. **The policy dialogue during the mission focused on how to use the window of opportunity provided by the high level of donor assistance to support macroeconomic stability, sustain private-sector-led growth, and improve social indicators.** The authorities have welcomed the military, financial, and technical assistance they have received and, following the restoration of law and order, have taken early action to ensure that this assistance was used in a way that has been consistent with previous Fund advice. The government has completed its National Economic Recovery, Reform, and Development Plan, and established three tasks forces covering the restoration of law and order, economic reform, and infrastructure and government services, which have also completed their reports. Taken together, these documents outline a broad medium-term agenda to lift per capita income, focused on the rehabilitation of the economy (especially in the rural areas) and strengthened governance and financial management (Box 1).

9. **A major uncertainty in crafting a medium-term strategy is estimating the level and time period of donor assistance.** The general purpose budget grants being provided by Australia and New Zealand are scheduled to end in 2004 and 2006 respectively, although some of this assistance may be extended. The European Union has committed development grants amounting to $100 million, but the disbursement period is uncertain. The Asian Development Bank has fielded a mission to restart a $10 million lending program they suspended in 2002, focused on rehabilitating transport infrastructure, and disbursements

might start by end-2004. While they have no lending plans, the World Bank is providing grants to strengthen capacity in key government institutions.

10. **Notwithstanding this uncertainty and the significant impediments to private sector investment and growth (Box 2 and the accompanying *Selected Issues* paper), the authorities and staff agreed that the growth of real GDP during 2004–09 could average 4½–5 percent a year (2 percent per capita) provided appropriate policies are implemented.** In the medium-term scenario and debt-sustainability analysis discussed, inflation would remain in low single digits and the level of international reserves slowly increase, assuming that fiscal and monetary discipline is maintained. Economic growth would initially be driven by donor-financed public investment, and later by rising private investment and exports provided an early start is made to reducing the current regulatory burden and implementing other critical structural reforms. The current account deficit as a share of GDP would gradually decline as exports increase and the level of project-related imports falls back. Assuming the budget deficit averages ½ percent of GDP and the level of new foreign borrowing is contained, which would be appropriate in view of the large fiscal uncertainties and limited absorptive capacity beyond the large grant-financed development spending, the government debt ratio would decline from 100 percent in 2003 to 65 percent of GDP by 2009. External debt would decline to 42 percent of GDP and the servicing burden would remain sustainable, although it was recognized that economic shocks could have a major impact on the projected debt dynamics.[1]

B. Fiscal Policy

11. **To achieve these objectives, the authorities stated that their first priority is to adhere to a fiscal framework for 2004 that can restore confidence in the government's ability to manage its finances.** Following the first of their quarterly reviews of actual budgetary developments, the authorities project a budget surplus (measured on an accrual basis) of 4 percent of GDP, significantly higher than the 2 percent surplus forecast in the 2004 budget that was passed last November. This result is mainly attributable to overperformance on revenue collections in recent months (mainly on sales tax collections), reflecting the recent faster-than-expected pace of economic and export growth, successful efforts to bring businesses back into the tax net, and collection of tax arrears under the amnesty (that was closed at end-2003). The authorities shared staff concerns in regard to the one-off nature of some of these receipts and, more generally, the uncertainty surrounding the future level of revenue collections. In the draft Supplementary Appropriations Bill that was subsequently passed by the parliament, rather than undertaking new expenditure obligations,

[1] The medium-term scenario and debt-sustainability analysis are detailed in the Appendix, and recent trends in social indicators relative to the MDGs are outlined in Annex II.

the government proposed that the higher projected surplus be used to reduce the large stock of expenditure arrears. The staff fully supported this position.

12. **The staff welcomed the advances that have been made in reprioritizing expenditures in 2004.** Progress has been achieved in cleansing the civil service payroll of ghosts, restricting allowances, demobilizing around 800 ex-militants from the police force, and initiating a New Zealand-funded audit of education sector employment. The authorities noted that the savings realized to date had enabled them to raise the nominal wages of the remaining civil servants by 5 percent. In regard to other outlays, they noted that the pace of spending on nonwage social and development expenditures has been slower than envisaged due to low absorptive capacity, but is expected to pick up shortly.

13. **The authorities outlined their approach to strengthen medium-term fiscal finances taking into account the ongoing large rehabilitation expenditures, expected decline in donor flows, and rising operations and maintenance spending associated with the new development projects.** They highlighted in particular the following aspects:

- *To strengthen budget management, the authorities have started to prepare a medium-term fiscal strategy.* The staff suggested this be set within an explicit macroeconomic and fiscal financing framework.

- *The authorities have initiated a multi-year revenue mobilization effort to widen the tax base and strengthen administration.* They indicated that they intend to focus on registration of businesses, training of staff, and increased use of audits, utilizing technical assistance from the Pacific Financial Technical Assistance Center (PFTAC).[2] In this regard, the staff urged that the future tax base not be eroded through income-tax exemptions for existing and new foreign or domestic investments.

- *In addition to the efforts underway to reorganize the civil service, the authorities stressed their intention to further rationalize expenditures over time.* The staff and authorities agreed that the priority should be placed on reallocating spending toward basic health and education, inter-island transport, rural infrastructure and extension services, and operations and maintenance outlays. It will be important that the actual level of development spending is continually monitored and that these outlays remain focused on the medium-term priorities.

14. **Resources will also be required to regularize and reduce external and domestic debt and arrears obligations.** The authorities indicated that they are committed to finalize a rescheduling agreement with their domestic creditors (mainly the commercial banks, the

[2] There is probably little room to raise tax rates in the Solomon Islands because, with the exception of excises, rates are already on the high side relative to other Pacific islands.

National Provident Fund, and the central bank) in the next few months, with the terms of the agreement guided by the authorities' intention to ensure that total external and domestic debt servicing not exceed 15 percent of projected domestic revenue. Thereafter, the authorities intend to discuss with their commercial and some bilateral creditors plans to reduce external debt levels and servicing costs.[3] In regard to the stock of expenditure arrears (the bulk of which are due to utility companies, for wage-deductions due to pension, credit, and trade unions, and to trade creditors), once their legitimacy has been verified, these are expected to be paid down as circumstances permit.

15. **The authorities discussed their plans to establish a federal structure in the Solomon Islands that would include a significant degree of budget decentralization as a means to decrease inter-island tensions.** In response to concerns expressed earlier by the donor community and the staff, the authorities noted that they would proceed only very cautiously. The authorities generally agreed with the staff that the national budget should first be stabilized, and an expenditure monitoring system maintained by the Ministry of Finance of provincial revenue and expenditure be put in place, before implementing this plan, and that provinces should not be allowed to run budget deficits.

C. Monetary, Exchange Rate, and Financial Sector Issues

16. **The discussion of monetary and exchange rate policies focused on the Governor's annual monetary statement, which was delivered on April 8.** The staff agreed with the main objectives for 2004 set out in this statement, namely to maintain inflation in single-digit levels and increase international reserves to at least five months of nonproject imports. The staff pointed out the significant risks to meeting these objectives posed by the high level of excess reserves in the banking system (roughly 20 percent of deposits) and the large government deposits at the central bank representing aid flows for investment projects. The authorities acknowledged these risks, but they did not expect a sharp increase in private sector lending or a sudden drawdown in government deposits. Should either of these events occur, the central bank would move quickly to absorb liquidity in the system. Instruments at their disposal include changes in reserve requirements, direct controls on lending, and open market operations. The authorities noted that their ability to conduct open market operations will be enhanced once the government's debt restructuring plan has been implemented.

[3] Most external debt is owed to the World Bank and Asian Development Bank (57 percent of the total), Taiwan Province of China (16 percent), and two commercial creditors (10 percent). The authorities have been in contact with the external creditors in which they are in arrears, and informed them of their intention to discuss soon an agreed repayment arrangement.

17. **The staff team supported the central bank's policy to resist upward pressure on the exchange rate arising from the large aid flows in order to build reserves.** Partial price and recent trade data available suggest that the current level of the exchange rate is broadly competitive, although recent export volumes have been more determined by domestic supply constraints rather than demand factors.[4] With the restoration of law and order and improvements in inter-island transportation, exports of traditional and new products are expected to continue to increase. Over time, as aid flows diminish and imports rise in line with the economic recovery, the staff recommended that downward pressure on the exchange rate should not be resisted. The authorities generally concurred with this advice, adding that, in the current environment, they are not considering major changes in the present exchange rate regime, such as a move to dollarization. The authorities gradually liberalized the exchange system during 2003, and the staff team welcomed the recent elimination of the remaining restrictions on current transactions.[5]

18. **The authorities noted that they have taken several steps to strengthen the financial sector.** The central bank has been vigilant in ensuring that the commercial banks comply with prudential guidelines, and bank profitability has improved since law and order was restored (Box 3 and the accompanying *Selected Issues* paper). In line with the widening of its supervisory powers in mid-2002, the central bank has also acted to address difficulties in major nonfinancial institutions. Following an on-site inspection in late-2003 and aided by technical assistance from the World Bank, the poor asset quality of the National Provident Fund (NPF) is being gradually addressed. The High Court has approved a central bank request to assume management of the small and insolvent Development Bank of Solomon Islands (DBSI), and the staff team suggested that the operations of the DBSI be wound up.

D. Structural Reforms and Other Issues

19. **There was widespread agreement that structural reform will be critical to lift private sector activity and employment.** Increasing attention is being focused on promoting new investment and employment, especially in potential growth sectors like gold and mining, palm oil production, and tourism, as well as by local manufacturing concerns. The

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[4] The real exchange rate is estimated to be 20 percent below its level before the outbreak of the conflict in 1999 and 10 percent below its level in the mid-1990s. The staff's REER estimates are tentative given the absence since mid-2000 of comprehensive price data.

[5] Effective April 2004, the central bank raised the indicative minimum approval limit on all outward payments from SI$5,000 to SI$25,000, and confirmed to staff that, for transactions above this limit, this approval is necessary only for the purpose of checking the bona fide nature of transactions. They also raised the overnight limit on commercial bank foreign exchange holdings from SI$2 million to SI$3 million.

discussions with the private sector indicated the importance of streamlining licensing procedures, especially by the Foreign Investment Board, and relaxing the limit on foreign labor permits, to further this process. Encouraging small-scale production and inter-island distribution of potential new export crops such as vanilla, teak, and seaweed were widely cited as necessary to increase employment and income generation in the rural areas. The authorities noted that they are preparing a strategy to ensure the sustainable development and management of the forestry and fisheries sectors, and a policy to address land ownership issues. The World Bank and Asian Development Bank are providing technical assistance in several structural reform areas, including through the World Bank's Foreign Investment Advisory Service (FIAS).

20. **The staff team pressed for reform of public enterprises in order to reestablish reliable supply and improve the quality of utility services.** The authorities stated that price increases have already been undertaken in some enterprises, but acknowledged that further efforts will be needed. These could include publishing annual reports, improving the regulatory environment, capital investments, strengthening governance, and rationalizing the workforce. The staff called for the reinvigoration of the enterprise corporatization and privatization program that has stalled in recent years, noting that any proceeds should be used to pay down government debt.

21. **The authorities confirmed their intention to continue to promote an open trade regime.** Starting in 1998, the authorities have reduced tariff rates from five bands that ranged from 5–70 percent to three bands that range from 5–20 percent. The weighted average tariff now stands at 11 percent, and there are no significant nontariff barriers. There are several export taxes, although the export tax on logs is the only large revenue earner. The authorities noted that the log export tax has traditionally served as a substitute for the weaknesses in tax administration over these companies, and the staff urged that this policy be reviewed as the tax administration procedures are strengthened. In the context of the Pacific Island Countries Trade Agreement (PICTA), which was signed in 2003, the Solomon Islands has committed to eliminate tariffs for trade in goods between members by 2016 at the latest.[6] The Solomon Islands does not face any major problems in accessing export markets, and is rated three under the Fund's 10-point trade restrictiveness index.[7]

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[6] In July 2003, the Solomon Islands also ratified the Pacific Agreement on Closer Economic Relations (PACER) that is intended eventually to create a free trade area and regional integration between the Pacific islands and Australia and New Zealand.

[7] The rating could be improved once detailed information on the tariff schedule has been received from the authorities.

22. **The authorities stated that several initiatives are underway to strengthen governance and transparency, and to reduce corruption.** In addition to the improvements in law, justice, and policing, donor assistance is being provided to strengthen key government institutions and watchdog bodies such as the Auditor General and Ombudsman. Budgetary and Cabinet requirements and procedures are also being addressed. The staff team noted that better governance and transparency will assist in ensuring a level playing field within the private sector, and welcomed the intention to establish the Solomon Islands Leadership Integrity Commission, utilizing external technical assistance.

23. **The authorities have prepared a legal framework to address anti-money laundering (AML), although they have not started enforcing AML procedures and a counter-financing of terrorism bill is still in draft form.** In response to staff queries, the authorities explained that their AML legislation comprises three laws that require banks and cash dealers (insurance companies, casinos, and trusts) to report to a Commission any transaction exceeding SI$15,000 that they feel is suspicious.[8] However, this Commission has not yet been established. The authorities have recently completed the questionnaire on AML/CFT that was prepared by MFD, and the staff is following up on this response. The authorities noted that local staff has benefited from training abroad in AML/CFT enforcement, and that they are seeking PFTAC assistance to review and assist implementation of the relevant legislation in this area.

24. **The mission stressed that macroeconomic analysis continues to be hampered by the poor statistical database.** The National Statistical Office (NSO) ceased compiling real and nominal national accounts estimates in 1994 and, until very recently, price data in 2000. The only data available have been partial estimates assembled by the central bank. PFTAC is preparing a plan to rehabilitate the NSO and improve the quality and timeliness of data collection and reporting, and the World Bank is also undertaking a capacity building initiative in this area. The authorities agreed that progress under this plan is a priority.

III. Staff Appraisal

25. **Economic performance in the Solomon Islands has shown a marked turnaround since the last consultation was concluded in early 2003.** The economy has started to respond to the more favorable law and order conditions and improved budgetary finances, with growth accelerating and inflation falling to single digits. Nonetheless, the situation remains fragile, and the main challenge for the government is to move beyond the initial focus on stabilization, and implement policies that will reduce the risks to the medium-term outlook and underpin a sustained improvement in per capita growth.

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[8] The three laws are the Money Laundering and Proceeds of Crime Act (2002), the Mutual Assistance in Criminal Matters Act (2002), and the Financial Institutions Act (1998).

26. **Key fiscal, monetary, and structural reforms will be needed to achieve these objectives.** Budget finances have to be further strengthened so that the programmed increases in social and development outlays (including for critical infrastructure) can be sustained while at the same time the high government debt ratio is set on a firm downward path. Price stability must be maintained in the face of the resumption of economic activity and ongoing large donor flows. In addition, deep structural reform is needed so the private sector can play an increasing role in boosting investment and promoting employment in the urban and rural areas, while generating sufficient foreign exchange earnings to offset the projected increase in imports as the economy recovers.

27. **The revised budget surplus targeted by the authorities for 2004 is consistent with further improving the macroeconomic situation.** In view of the one-time nature of the recent revenue overperformance and the ongoing budget uncertainties, including the level of external grants from major donors after 2004, expenditure allocations should not be ratcheted up in line with these collections. It is appropriate that the Supplementary Appropriations Bill proposed to use the bulk of the projected revenue overperformance in 2004 to pay down wage-related and other arrears.

28. **Expenditure reprioritization is critical to sustain economic growth and improve social indicators.** Accelerating the pace of civil service reform is key to strengthening capacity in the public sector. While progress has been made, continued efforts are needed to rationalize the civil service, with an increase in the skills capacity while reducing costs in nonpriority areas. Maintaining control over salary increases will be vital. If any further general wage increase is contemplated, this should be undertaken only in the context of realized savings in the rest of the wage bill. Priority should be placed on reallocating spending toward basic health and education, rural infrastructure and extension services, and operations and maintenance outlays.

29. **Given the large ongoing expenditure pressures to rehabilitate and restructure the economy, it is critical that the fiscal decisions are consistent with medium-term sustainability.** A comprehensive medium-term fiscal framework should be developed and updated regularly as circumstances evolve. This should include an analysis of actual development project spending and its operations and maintenance components. The authorities' debt restructuring plan and strategy to repay arrears are also appropriate.

30. **Strengthened revenue performance over the medium term will be required to fund new productive expenditures and reduce the high dependency on donor flows.** Revenue efforts should primarily focus on widening the tax base and strengthening tax and customs administration, which would provide an opportunity for a review of the current range of export taxes. To ensure a level playing field and prevent erosion of the future tax base, no new income-tax exemptions for foreign or domestic investments should be granted and consideration could be given to abolishing existing tax and customs exemptions.

31. **Solomon Islands is not ready to implement a decentralization plan in the context of a federal Constitution that would ensure that fiscal stability is maintained.** If it is decided to proceed in this direction, it will be essential that the national budget has been stabilized and that an expenditure monitoring system for provincial revenue and expenditure has been established. Thereafter, safeguards need to be in place to guard against an undue weakening of the national budget as revenue is devolved.

32. **Monetary policy objectives for 2004—containing inflationary pressures and increasing the level of international reserves—are appropriate.** Given the current high levels of excess liquidity and government deposits, continued vigilance will be needed to ensure these objectives are achieved. Upward pressure on the exchange rate should continue to be resisted in order to build reserves. As imports increase and aid flows diminish over time, downward pressure on the exchange rate should not be resisted. The recent elimination of the remaining exchange restrictions will contribute toward ensuring that the exchange rate remains appropriately aligned.

33. **Financial sector reform can assist in sustaining medium-term growth.** The improvement in law and order has helped to strengthen profitability of the banking sector, and continued vigilance by the central bank to enforce its prudential guidelines will be needed. The recent efforts to strengthen the asset quality of the NPF, and to settle the future of the DBSI, are welcome steps. Implementation of AML/CFT laws should be undertaken as a priority.

34. **Structural reform is critical to lift private activity and employment.** Reform of the Foreign Investment Board, foreign labor permits, and licensing procedures is needed to promote new investment, especially in potential growth sectors. Encouraging small-scale production and inter-island distribution of potential export crops will be important, as is the need to ensure the sustainable development and management of the forestry and fisheries sectors. Reform of public enterprises is necessary to strengthen their financial balances and the quality of their services. Future trade liberalization will also assist in promoting private sector development. Strengthening institutions, enhancing governance and transparency, and reducing corruption are clearly critical to support sustained economic growth.

35. **The Solomon Islands' economic statistics framework remains weak.** Improved statistics are essential to the effective execution of the government's reform agenda, and efforts in this area should be given full support by the government and responsible agencies.

36. **It is recommended that the next Article IV consultation with the Solomon Islands be held on the standard 12-month cycle.**

Box 1. Solomon Islands: National Economic Recovery, Reform, and Development Plan

The National Economic Recovery, Reform, and Development Plan (NERDP) was completed at end-2003 and covers the period through 2006. The plan addresses the short-term needs for economic recovery in the Solomon Islands, while laying out the foundations for growth and development over the medium term. The plan was prepared principally by the Ministry of National Reform and Planning, in consultation with a wide range of stakeholders including ministries, parliamentarians, provincial governments, private sector, civil society organizations, and the donor community. Each government ministry was assigned responsibility for a sector, developed key targets for 2006, prepared a work plan to achieve these targets, and is required to monitor and report progress on a regular basis.

Five strategic areas are identified in the plan, with objectives as follows:

- *Normalizing law and order and the security situation:* Enhancing the capabilities of the police force (including demobilizing ex-militants and reintegrating them into the community), the Attorney General's Chambers, the Public Prosecutor, the Public Solicitor, and the judiciary.
- *Strengthening democracy, human rights, and good governance:* Establishing a federal structure, and strengthening the transparency, audit, and accountability of public decision-making and the management of public resources.
- *Restoring fiscal and financial stability and reforming the public sector:* Mobilizing domestic revenue, regularizing formal and informal government obligations, following appropriate monetary and exchange rate policies, assisting rural sector access to credit, reorganizing the public sector, and reform of the state-owned enterprises.
- *Revitalizing the productive sector and rebuilding supporting infrastructure:* Sector-specific policies to revitalize the agriculture, forestry, fisheries, mining, and tourism sectors. Rebuilding supporting infrastructure in relation to land, energy, water, and the environment.
- *Restoring basic social services and fostering social development:* Restoring basic and secondary health and education services, and promoting gender equality and community development.

In mid-2003, the Cabinet also established three taskforces covering the restoration of law and order, economic reform, and infrastructure and government services. Each taskforce was headed by a former Prime Minister and charged with providing recommendations to strengthen progress toward the priorities highlighted in the NERDP. The subsequent final reports of the taskforces collectively stress the importance of rural development, where the majority of Solomon Islanders live. While recognizing a major part of rural development efforts will remain donor-financed in the near future, the reports call for greater participation of the rural sector and provincial authorities in the design and implementation of development projects.

Box 2. Solomon Islands: Impediments to Growth and Poverty Reduction

Real per capita GDP of the Solomon Islands was 7 percent lower in 1999 than at independence in 1978, even before the civil conflict during 1999–2003 reduced real per capita GDP by another one-quarter. Solomon Islands also lags behind most other Pacific Island countries in terms of social indicators. Malaria is rampant, with the highest rate of infection in the world outside of sub-Saharan Africa, and more than a third of the rural population lacks access to safe water. The limited infrastructure, remote geographical location, lack of well-defined property rights, and inadequate education and health services are major obstacles to achieving a higher sustained rate of economic growth.

Agriculture: More than 80 percent of the population live in the rural areas and engage in subsistence or semi-subsistence agriculture. Taking their produce to market is a challenge for smallholders as transport in and between the islands is inadequate. Small producers also lack financial services and technical assistance, and hence other cash crops successfully exploited in the region, such as vanilla, have not been grown. The other component of the agricultural sector, large-scale plantations, has been restrained by the difficulty in acquiring land, most of which is communally owned and lacks titles.

Forestry: Timber extraction is an important source of fiscal revenue and foreign exchange earnings, accounting for two-thirds of the value of merchandise exports. The current level of extraction is estimated to be two to three times above the sustainable level. The main issues are better governance of the sector and encouraging sustainable forestry practices. Foreign operators often exploit uncertainty in the ownership of the land by compensating an individual rather than the collective body of owners.

Fishing: The Solomon Islands has large fish resources. Artisanal fishing is widespread for the primary purposes of subsistence and local sales. Small producers cannot access larger markets due to poor inter-island transportation; most of the fish consumed in Honiara is of the canned and frozen variety. Two major companies export most of their catch, although the cost of transport to the main export markets in Asia is high. Private companies are also disadvantaged by a tax concession enjoyed by the largest firm, which is owned by the government.

Mining: There are rich gold and nickel resources in the Solomon Islands, which are not currently exploited. The Gold Ridge mine was closed at the height of conflict in 2000, and its infrastructure and assets have been severely damaged. The main risk for mining operations is the uncertain legal status of land. Mining companies cannot buy land, and the profit-share arrangements with landowners are often challenged by other claimants to the land.

Tourism: The Solomon Islands has many natural and cultural attractions. Its pristine coral reefs, rich marine life, and large number of World War II wrecks provide for world-class diving and snorkeling opportunities. However, the existing tourism facilities are insufficient, and concentrated in Honiara, eschewing the natural attractions of the outlying areas. While security warnings have been lifted, disease risks and costly air travel discourage tourists.

Manufacturing: Manufacturing is of limited scale in the Solomon Islands, mainly consisting of processing agricultural commodities such as coconut and palm oil and fish processing. There has been little foreign direct investment, and domestic enterprise development has been hindered by the security situation and lack of entrepreneurial experience. The urban areas, particularly Honiara, have grown rapidly, but employment opportunities in the formal sector have remained limited. Even before the outbreak of the conflict in 1999, only one in three men aged 20–24 was estimated to be engaged in paid employment; for women, the ratio was less than one in six.

Box 3. Solomon Islands: Financial Sector Soundness and Supervision

The Solomon Islands' financial system comprises the Central Bank of Solomon Islands (CBSI), three commercial banks (one of which is domestically owned), the National Provident Fund (NPF), the Development Bank of Solomon Islands (DBSI), and a number of small nonbank financial institutions (credit unions, insurance companies, and housing schemes). The commercial banks are reported financially sound despite the difficult economic environment in recent years that was compounded by the government debt defaults. However, the asset quality of the NPF—the largest financial institution—has been severely impaired, and the DBSI has become illiquid and likely insolvent.

Central Bank Soundness: The CBSI's balance sheet has shown a net liability in recent years (SI$28 million in 2003 versus net assets of SI$102 million in 1998) due to full provisioning by the CBSI against its holding of government debt, all of which is in default. The CBSI's financial position is expected to strengthen once the government debt-rescheduling discussions are completed.

Central Bank Supervision: Under the 1998 Financial Institutions Act, the CBSI is the prudential regulator for the commercial banks, and its mandate was extended to cover the NPF and DBSI in August 2002. Supervision of the insurance sector will fall under CBSI purview in mid-2004. Prudential standards are generally in accordance with Basle Core Principle and are enforced by the CBSI through off-site and on-site inspections, with the NPF and DBSI covered for the first time in 2003. However, the majority ownership status of the National Bank of Solomon Islands (NBSI), the largest commercial bank, by three local trust funds remains a pending issue, as the trusts do not meet the guidelines "fit and proper" criterion. The CBSI took legal actions against a pyramid scheme in 2003, reiterating its strong commitment toward safeguarding the financial system.

Commercial Banks Performance: The assets of the commercial banks amount to 32 percent of GDP. Prudential indicators indicate that, both as a group and individually, the commercial banks were broadly sound as of end-2003.

- **Capital Adequacy.** The average risk-weighted capital ratio was 28 percent in 2003, with all three banks well above the 10 percent prudential requirement; the latter may be raised to 15 percent as of mid-2004.
- **Asset Quality.** NPLs gradually increased from SI$6 million (3 percent of total loans) before the tensions erupted in 1999 to reach SI$20 million (11 percent) in 2002, before declining to SI$16 million (8 percent) as performance improved in 2003.
- **Earnings and Profitability.** The return on average assets was 5 percent in 2003 versus 3 percent in 1999. Since 2002, noninterest income has accounted for the bulk of earnings (65 percent of total operating income in 2003 versus 43 percent in 1998), largely as a result of earnings on foreign exchange transactions and from fees and charges.
- **Liquidity.** Liquid asset reserves accounted for 28 percent of total deposit liabilities in 2003 as against 14 percent in 1998, significantly exceeding the 7.5 percent prudential requirement.

National Provident Fund: The NPF is a compulsory saving scheme aimed at earmarking a portion of formal wage income primarily for retirement purposes. Its assets equal two-thirds of banking sector assets. The NPF's assets are comprised of government securities (25 percent), loans (17 percent to government entities and 14 percent to members), shares in public enterprises (18 percent), and the remainder in property and cash deposits. A large portion of its portfolio consists of nonperforming assets, largely reflecting the government debt default, lending to provincial governments (under government guarantee), and for housing loans to NPF members. Operating surpluses have declined in the last four years owing to the impact of the civil conflict, and the heavy withdrawal of contributions by employees made redundant. Government arrears on contributions have also compounded the NPF's liquidity situation. The NPF is in the process of implementing recommendations from the CBSI's recent audit and is reviewing its investment guidelines with World Bank technical assistance.

Development Bank of Solomon Islands: The DBSI is a government-owned development lender. Its assets (net of provisions for bad debt), which account for 7 percent of banking sector assets, are severely impaired reflecting weak governance and a poor credit culture. The DBSI is illiquid (2.6 percent liquidity ratio versus 7.5 percent required for commercial banks). Its provisions for bad debt (38 percent of total loans) are understated, and its deposit liabilities (SI$20 million) and borrowing obligations (SI$28.5 million, of which SI$24 million is due to foreign creditors) are in default. As a result, the DBSI has likely become insolvent. In accordance with the provisions under the 1998 Financial Act, in June 2004 the High Court assigned the CBSI as the provisional manager for DBSI.

Table 1. Solomon Islands: Selected Economic Indicators, 1998–2004

Nominal GDP (2003): US$226 million
Population (2003): 455,000 est.
GDP per capita (2003): US$496
Quota: SDR 10.4 million

	1998	1999	2000	2001	2002	Est. 2003	Proj. 1/ 2004
Growth and prices (percentage change)							
Real GDP	1.8	-0.5	-14.3	-9.0	-1.6	5.1	4.2
Of which: Marketed output	2.5	-1.5	-19.9	-13.9	-3.6	8.0	4.9
CPI (period average)	12.3	8.0	6.9	7.6	9.4	10.1	5.6
CPI (end-of-period)	10.3	7.3	7.6	6.5	15.4	3.8	5.1
Saving and investment (percent of GDP)							
Public saving-investment balance	-0.3	-3.7	-4.9	-11.9	-9.6	-1.4	4.0
Of which: Public investment	7.2	4.3	4.6	8.9	3.2	15.7	18.1
Private saving-investment balance	-1.3	6.9	-5.6	-0.9	2.6	2.9	-4.6
Of which: Private investment	15.2	16.0	17.1	14.1	14.9	17.0	17.2
Central government operations (percent of GDP)							
Total revenue	29.0	27.0	22.1	23.5	18.7	39.8	48.1
Recurrent revenue	21.9	24.4	18.3	15.3	16.1	21.5	23.5
Grants	7.1	2.6	3.7	8.2	2.6	18.3	24.6
Total expenditure 2/	28.2	30.3	29.7	36.1	29.7	39.6	44.1
Recurrent expenditure	21.0	26.0	25.1	27.2	26.5	23.8	26.0
Development expenditure	7.2	4.3	4.6	8.9	3.2	15.7	18.1
Recurrent balance 3/	3.2	-1.3	-6.1	-11.7	-9.9	1.5	4.0
Overall balance 4/	-0.3	-3.7	-4.9	-11.9	-9.6	-1.4	4.0
Foreign financing (net)	4.9	1.9	0.6	5.0	3.8	0.4	-1.1
Domestic financing (net)	-1.4	-0.1	4.2	-1.4	-2.9	-6.6	-0.4
Privatization receipts	0.0	1.8	0.0	0.0	0.0	0.0	0.0
Increase in expenditure arrears	-2.4	-0.4	1.4	3.6	3.5	4.0	-5.0
Increase in principal arrears	-0.8	0.5	-1.2	4.7	5.2	3.6	-8.9
Restructured arrears	0.0	0.0	0.0	0.0	0.0	0.0	11.4
Stock of expenditure arrears (percent of GDP; end-of-period)	3.6	3.1	4.7	8.5	11.5	14.4	8.1
Stock of domestic principal debt arrears (percent of GDP; end-of-period)	0.0	0.0	0.0	3.9	7.1	9.9	0.0
Central government debt (percent of GDP) 5/	62.2	62.5	65.4	82.2	96.2	100.2	92.5
Domestic	24.5	23.1	23.5	33.2	29.5	27.6	26.4
External	37.7	39.3	42.0	49.0	66.7	72.6	66.1
External debt (in millions of U.S. dollars; end-of-period)	122.2	130.5	125.6	134.3	151.6	163.9	159.7
External debt service to exports of GNFS (accrual basis)	2.6	2.7	3.9	8.1	10.1	8.8	6.3
Monetary and credit (percentage change; end-of-period)							
Net foreign assets	47.9	8.9	-39.8	-31.8	30.2	106.4	49.7
Net domestic assets	-23.0	0.7	46.8	-4.4	-4.8	-11.0	-21.6
Credit to government (net)	-20.3	-0.4	43.8	3.4	13.1	-17.1	-6.0
Credit to private sector	25.3	8.3	1.8	-21.8	12.2	26.1	12.0
Broad money	2.3	4.9	0.5	-13.2	4.0	26.0	15.2
Interest rate (3-month Treasury bill rate, average)	6.0	6.0	7.3	8.9	8.3	6.6	...
Balance of payments (millions of U.S. dollars; unless otherwise indicated)							
Exports, f.o.b.	126.3	121.7	65.1	47.1	58.2	74.2	83.0
Imports, c.i.f.	-127.8	-111.3	-98.1	-90.6	-62.3	-85.2	-102.0
Current account	-5.1	10.4	-31.7	-35.1	-15.7	3.2	-1.4
(Percent of GDP)	-1.6	3.1	-10.6	-12.8	-6.9	1.4	-0.6
Capital account	15.1	-1.2	8.5	17.2	6.3	11.0	16.1
Overall balance (accrual)	9.9	9.2	-23.1	-17.9	-9.4	14.3	14.7
Gross official reserves (millions of U.S. dollars; end-of-period)	48.0	50.4	31.3	18.5	17.5	35.9	52.1
(in months of next year's imports of GNFS)	3.6	4.6	3.1	2.8	2.1	3.6	4.5
Exchange rate (SI$/US$, end-of-period)	4.86	5.08	5.10	5.56	7.46	7.49	...
Real effective exchange rate (period average; 1990=100)	112.2	115.1	122.8	133.5	111.1	96.5	...
Nominal effective exchange rate (period average; 1990=100)	66.8	64.1	65.3	67.4	52.4	41.8	...

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

1/ Staff projections.
2/ Expenditures are presented on an accrual basis.
3/ Includes recurrent budget grant support; amortization payments are classified as budget financing.
4/ Overall balance is calculated from below-the-line financing data.
5/ Includes debt amortization arrears.

Table 2. Solomon Islands: Balance of Payments, 1998–2004

(In millions of U.S. dollars)

	1998	1999	2000	2001	2002	2003	Proj. 2004
Current account balance	-5.1	10.4	-31.7	-35.1	-15.7	3.2	-1.4
Current account balance (excluding official transfers)	-16.8	8.9	-19.1	-49.7	-10.3	-10.1	-17.6
Trade balance	-1.5	10.4	-32.9	-43.5	-4.0	-11.0	-19.0
Merchandise exports, f.o.b.	126.3	121.7	65.1	47.1	58.2	74.2	83.0
Of which: Timber	40.8	51.8	44.1	36.1	38.1	49.5	54.1
Of which: Fish	40.3	32.9	8.1	7.1	10.5	12.4	14.0
Merchandise imports, c.i.f. 1/	127.8	111.3	98.1	90.6	62.3	85.2	102.0
Of which: Petroleum	21.5	15.5	18.4	14.4	11.2	11.7	14.5
Services and income (net)	-15.3	-1.5	13.8	-6.3	-6.3	0.9	1.4
Nonfactor services (net)	-8.1	4.3	14.6	-6.4	-0.5	6.0	3.7
Exports	59.1	52.5	48.6	24.7	16.7	21.2	21.8
Imports	67.2	48.2	34.0	31.1	17.1	15.3	18.1
Net factor income from abroad	-7.2	-5.8	-0.8	0.1	-5.8	-5.1	-2.3
Credit	3.0	5.4	7.2	6.2	2.7	3.5	3.9
Of which: Interest	1.7	2.7	2.7	1.1	0.5	0.7	0.9
Debit	10.1	11.2	8.0	6.1	8.5	8.6	6.2
Of which: Interest	1.6	1.6	1.8	2.9	4.3	4.9	2.4
Net current transfers	11.6	1.5	-12.6	14.7	-5.4	13.4	16.1
Private sector	4.6	0.1	-13.3	5.0	-12.3	4.2	6.2
Public sector	7.1	1.4	0.7	9.6	6.8	9.2	9.9
Capital account balance	15.1	-1.2	8.5	17.2	6.3	11.0	16.1
Government sector	22.9	7.3	7.3	18.3	5.8	12.2	17.6
Monetary authorities (net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Medium- and long-term lending	16.0	6.6	1.7	13.9	2.7	-0.5	-4.2
Inflows	19.3	9.7	4.4	16.8	6.0	3.1	0.0
Amortization	3.3	3.1	2.7	2.9	3.3	3.6	4.2
Investment flow (projects)	6.9	0.7	5.5	4.4	3.1	12.7	21.8
Private sector	-7.8	-8.5	1.3	-1.1	0.5	-1.2	-1.5
Investment activities	0.0	2.7	2.4	1.0	1.0	-0.2	-0.2
Medium- and long-term lending	-7.6	-9.6	-0.5	-1.2	0.0	-0.7	-0.8
Inflows	2.8	0.7	0.4	0.0	0.5	0.0	0.0
Amortization	10.4	10.3	0.9	1.2	0.5	0.8	0.8
Other flows	-0.3	-1.6	-0.7	-0.9	-0.5	-0.3	-0.6
Overall balance (accrual)	9.9	9.2	-23.1	-17.9	-9.4	14.3	14.7
Commercial bank holdings (increase)	-2.7	5.1	-3.6	3.5	1.4	2.0	0.0
Errors and omissions	7.9	-2.7	-2.2	-4.5	7.5	2.8	0.0
Exceptional financing	-4.1	0.9	2.7	13.0	2.3	3.4	1.5
Interest arrears	-0.4	-0.3	1.2	2.4	3.5	2.8	0.0
Amortization arrears	-3.7	1.2	1.5	2.3	3.0	1.5	0.0
Pending foreign exchange import requests	0.0	0.0	0.0	8.3	-4.3	-2.4	-0.1
Debt forgiveness	0.0	0.0	0.0	0.0	0.0	1.5	1.5
Overall balance (cash)	16.4	2.4	-19.1	-12.8	-1.0	18.4	16.2
Memorandum items:							
Gross official reserves (millions of U.S. dollars)	48.0	50.4	31.3	18.5	17.5	35.9	52.1
(in months of next year's imports of GNFS)	3.6	4.6	3.1	2.8	2.1	3.6	4.5
(in months of next year's non-project imports of GNFS)	3.9	4.9	3.7	3.3	2.6	4.5	5.5
Net international reserves (excluding external arrears; in millions of U.S. dollars)	37.9	36.7	24.4	0.9	0.6	17.6	33.8
(in months of next year's imports of GNFS)	2.9	3.3	2.4	0.1	0.1	1.8	2.9
Central government external debt (millions of U.S. dollars)	122.2	130.5	125.6	134.3	151.6	163.9	159.7
(in percent of GDP; including debt amortization arrears)	37.7	39.3	42.0	49.0	66.7	72.6	66.1
External arrears (interest plus principal; millions of U.S. dollars)	8.4	10.7	4.6	7.1	11.1	13.8	13.8
Exports of GNFS/GDP	57.2	52.5	38.0	26.2	32.9	42.3	43.4
Imports of GNFS/GDP	60.1	48.1	44.1	44.4	34.9	44.5	49.7
Current account (including transfers)/GDP	-1.6	3.1	-10.6	-12.8	-6.9	1.4	-0.6
External debt-service to exports of GNFS	2.6	2.7	3.9	8.1	10.1	8.8	6.3
External debt-service to ordinary budget revenue	6.9	5.8	8.1	13.9	20.7	17.4	11.7
Exchange rate (SI$/US$, end-of-period)	4.86	5.08	5.10	5.56	7.46	7.49	...

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

1/ Value for 2003 reflects customs clearance data.

Table 3. Solomon Islands: Central Government Operations, 1998–2004

(In percent of GDP)

	1998	1999	2000	2001	2002	Est. 2003	Budget 2004	Revised 2004
Total revenue and grants	29.0	27.0	22.1	23.5	18.7	39.8	49.2	48.1
Total revenue	21.9	24.4	18.3	15.3	16.1	21.5	19.3	23.5
Tax revenue	19.7	22.1	16.9	14.0	15.4	19.6	17.5	21.6
Income and profits	8.3	8.7	6.3	5.1	4.8	5.3	4.9	6.1
Goods and services	3.7	5.1	4.4	4.4	4.6	6.6	5.7	8.1
International trade	7.7	8.3	6.1	4.5	6.1	7.7	6.9	7.4
Other revenue	2.1	2.3	1.5	1.3	0.7	1.8	1.8	1.9
Stamp duty	0.2	0.2	0.1	0.1	0.2	0.2	0.2	0.2
Licenses and fees	0.2	0.2	0.1	0.1	0.2	0.2	0.2	0.2
Miscellaneous revenue	1.7	1.9	1.3	1.0	0.3	1.4	1.4	1.5
Grants	7.1	2.6	3.7	8.2	2.6	18.3	29.9	24.6
Development grants	18.5	17.1	14.4	8.0	2.2	14.4	23.7	18.1
Recurrent budget grants	2.3	0.3	0.7	0.3	0.5	3.9	6.3	6.5
Expenditure 1/	28.2	30.3	29.7	36.1	29.7	39.6	47.3	44.1
Recurrent expenditure	21.0	26.0	25.1	27.2	26.5	23.8	23.7	26.0
Compensation of employees	10.2	11.2	13.3	13.1	11.7	9.7	10.0	10.0
Goods and services	4.7	5.0	4.7	5.0	4.5	5.2	9.1	10.5
Interest	1.7	4.2	3.5	1.3	3.4	2.9	1.7	1.7
Grants to provinces and others	3.8	4.5	2.8	2.3	0.9	2.2	2.1	2.5
Employer social benefits	0.2	0.6	0.3	0.0	0.2	0.2	0.2	0.2
Compensation payments and other	0.4	0.4	0.5	5.4	5.8	3.6	0.6	1.1
Development expenditure	7.2	4.3	4.6	8.9	3.2	15.7	23.7	18.1
Grant financed	6.2	3.6	3.1	8.0	2.2	14.4	23.7	18.1
Concessional loan financed	1.0	0.7	1.5	0.9	1.0	1.4	0.0	0.0
Recurrent balance (above-the-line) 2/	3.2	-1.3	-6.1	-11.7	-9.9	1.5	1.9	4.0
Overall balance (above-the-line)	0.8	-3.3	-7.6	-12.6	-10.9	0.2	1.9	4.0
Discrepancy (negative is net expenditure)	-1.1	-0.4	2.6	0.7	1.4	-1.6	0.0	0.0
Overall balance (below-the-line)	-0.3	-3.7	-4.9	-11.9	-9.6	-1.4	1.9	4.0
Financing	0.3	3.7	4.9	11.9	9.6	1.4	...	...
Foreign (net)	4.9	1.9	0.6	5.0	3.8	0.4	...	...
Disbursements	5.9	2.9	1.5	6.1	5.4	1.4	...	...
Amortization 1/	-1.0	-1.0	-0.9	-1.1	-1.6	-1.6	...	...
Debt forgiveness	0.0	0.0	0.0	0.0	0.0	0.7	...	...
Domestic bank and nonbank (net)	-1.4	-0.1	4.2	-1.4	-2.9	-6.6	...	...
Banking system 1/	-3.0	-0.1	5.2	-3.3	-1.0	-6.6	...	...
Central bank	-3.4	-0.4	4.3	2.9	2.4	-3.9	...	...
Commercial banks	0.4	0.4	1.0	-6.2	-3.5	-2.7	...	...
Nonbank 1/	1.6	0.0	-1.1	1.9	-1.9	0.0	...	...
National Provident Fund	2.1	0.1	-1.4	0.7	-1.2	0.0	...	...
Other	-0.5	-0.1	0.4	1.2	-0.7	0.0	...	...
Privatization receipts	0.0	1.8	0.0	0.0	0.0	0.0	...	...
Increase in expenditure arrears 3/	-2.4	-0.4	1.4	3.6	3.5	4.0	...	...
Increase in principal debt arrears	-0.8	0.5	-1.2	4.7	5.2	3.6	...	...
External	-0.8	0.5	-1.2	0.8	1.9	0.1	...	...
Domestic	0.0	0.0	0.0	3.9	3.4	3.5	...	...

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

1/ Expenditures and debt-servicing are presented on an accrual basis.
2/ Includes recurrent budget grant support; amortization payments are classified as budget financing.
3/ Includes interest arrears.

Table 4. Solomon Islands: Summary Accounts of the Banking System, 1998–2004

	1998	1999	2000	2001	2002	2003	2004
I. Central Bank	(In millions of S.I. dollars; end-of-period)						
Net foreign reserves	225	241	148	91	117	248	384
Net domestic assets	-90	-89	7	57	56	-28	-98
Credit to central government (net)	22	15	80	122	160	94	94
Claims	82	56	55	185	186	186	186
Deposits	-60	-41	25	-63	-27	-93	-93
Other items (net)	-112	-103	-73	-65	-104	-121	-192
Reserve money	135	152	154	149	174	221	286
Currency outside banks	81	100	88	85	92	103	118
II. Monetary survey							
Net foreign assets	227	247	149	102	132	273	409
Net domestic assets	213	215	316	302	287	255	200
Domestic credit	356	372	458	425	471	467	480
Central and local government (net)	178	178	259	270	298	250	237
Private sector	178	194	199	155	173	217	243
Other items (net)	-142	-157	-142	-123	-184	-212	-280
Broad money (M2)	441	462	464	403	419	528	609
Narrow money	221	265	248	246	247	328	378
Quasi money	220	198	216	157	172	201	231
	(Annual percentage change)						
Net foreign assets	47.9	8.9	-39.8	-31.8	30.2	106.4	49.7
Net domestic assets	-23.0	0.7	46.8	-4.4	-4.8	-11.0	-21.6
Net domestic credit	-3.5	4.7	22.9	-7.2	11.0	-0.9	2.8
Of which: Private sector	25.3	8.3	1.8	-21.8	12.2	26.1	12.0
Broad money (M2)	2.3	4.9	0.5	-13.2	4.0	26.0	15.2
Memorandum items:							
Velocity of broad money (marketed output)	2.7	2.6	2.3	2.5	2.5	2.2	2.1
Money multiplier	3.3	3.0	3.0	2.7	2.4	2.4	2.1
Excess liquidity to deposits ratio (end-of-period)	9.6	9.2	8.7	12.8	17.3	19.6	26.6

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

Table 5. Solomon Islands: Indicators of External Vulnerability, 1998–2003

	1998	1999	2000	2001	2002	Est. 2003
Financial indicators						
Government sector debt (in percent of GDP)	62.2	62.5	65.4	82.2	96.2	100.2
Broad money (percent change; 12-month basis)	2.3	4.9	0.5	-13.2	4.0	26.0
Private sector credit (percent change; 12-month basis)	25.3	8.3	1.8	-21.8	12.2	26.1
3 month Treasury bill yield (in percent; nominal)	6.0	6.0	7.3	8.9	8.3	6.6
3 month Treasury bill yield (in percent; real)	-5.6	-1.9	0.4	1.2	-0.9	-3.1
External indicators						
Exports (percent change; 12-month basis in U.S. dollars)	-27.6	-3.6	-46.5	-27.6	23.6	27.4
Imports (percent change; 12-month basis in U.S. dollars)	-40.7	-12.9	-11.9	-7.6	-31.3	36.8
Terms of trade (percent change; 12-month basis)	-7.0	15.8	-11.0	-11.4	30.5	...
Current account balance (in percent of GDP)	-1.6	3.1	-10.6	-12.8	-6.9	1.4
Capital account balance (in percent of GDP)	15.1	-1.2	8.5	17.2	6.3	11.0
Gross official reserves (in millions of U.S. dollars)	48.0	50.4	31.3	18.5	17.5	35.9
Central bank short-term foreign liabilities (in millions of U.S. dollars)	1.7	3.0	2.4	2.2	1.7	2.9
Official reserves (in months of next year's imports of GNFS)	3.6	4.6	3.1	2.8	2.1	3.6
Broad money to reserves	1.9	1.9	2.9	4.3	4.3	2.0
Total external government debt (in percent of GDP)	37.7	39.3	42.0	49.0	66.7	72.6
Total external government debt to exports of GNFS	65.9	74.9	110.5	187.0	202.4	171.7
External interest payments to exports of GNFS (accrual)	0.9	0.9	1.5	4.1	5.7	5.1
External amortization payments to exports of GNFS (accrual)	1.8	1.8	2.4	4.0	4.4	3.8
Exchange rate (SI$/US$; period average)	4.82	4.84	5.09	5.28	6.75	7.51
Exchange rate (SI$/US$; end-of-period)	4.86	5.08	5.10	5.56	7.46	7.49
Real effective exchange rate appreciation (12-month basis)	-6.4	2.6	6.7	8.7	-16.7	-13.2

Sources: Data provided by the Solomon Island authorities; and Fund staff estimates.

SOLOMON ISLANDS: MEDIUM-TERM OUTLOOK AND RISKS

Achieving sustained growth in private sector activity in the urban and rural areas is essential to improve living standards and social indicators in the Solomon Islands, and thereby reduce remaining inter-island tensions. This will require continued fiscal restraint while reprioritizing expenditures, large infrastructure and other development spending to support private investment, a cautious approach to monetary and exchange rate policies, and strong structural reform to address the significant growth impediments that are outlined in the staff report.

Medium-term outlook

The staff has prepared a medium–term outlook based on this scenario (Appendix Table 1). The annual growth rate averages almost 5 percent during 2004–09, driven initially by donor-financed public investment and later by private investment and exports as donor involvement is scaled back. While ambitious, this growth rate is not out of reach provided early action is taken to address the current structural impediments to private sector investment. Work on improving infrastructure has already started, aided by the reactivation of the Asian Development Bank's post-conflict rehabilitation loan, and the authorities have started to consider the regulatory and land ownership issues that have impeded foreign and domestic investment. The export-oriented agricultural and fisheries sectors would benefit from these developments, as would the tourism and minerals sectors that also have significant potential. The export/GDP share is envisaged to gradually increase by 3 percent of GDP, and the share of private investment by 2½ percent of GDP, backed by rising foreign direct investment in the minerals and other sectors. The current account deficit peaks in 2005 in line with the large development outlays and associated imports, and falls back to 2 percent of GDP by 2009 with the improving export performance. The level of international reserves increases in U.S. dollar terms, but declines somewhat as a share in months of (rising) imports. Inflation will remain contained at about 3 percent a year, and the real exchange rate is assumed to remain broadly unchanged at its current level.

Fiscal policy in this scenario would be oriented toward supporting private sector activity and improving social indicators while, at the same time, reducing the level of government debt. A deficit of around ½ percent of GDP a year, combined with robust economic growth, would support a reduction in the government debt ratio from its current level of 100 percent of GDP to 65 percent of GDP by 2009.[1] This will require an increase in

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[1] In line with the authorities' current intentions, the staff's medium-term scenario assumes the securitization of the arrears on pension contributions for government employees due to the NPF (2½ percent of GDP), and the repayment of the other arrears on wage-deductions in 2004–05 (2½ percent of GDP). The balance of the domestic arrears (around 8 percent of

(Continued…)

the revenue share of 1½ percent of GDP between 2004 and 2009, which can be achieved by strengthening tax administration and widening the tax base. In this scenario, domestic and external debt servicing remains around 15 percent of annual domestic revenue, consistent with the authorities' debt-restructuring strategy. Due to the current high external debt share (73 percent of GDP) and significant foreign grant inflows, newly contracted concessional debt is expected to be limited, underpinning a sharp decline in the level of external debt (to 42 percent of GDP by 2009) as net repayments average 1 percent of GDP a year. In these circumstances, the deficit is assumed to be primarily financed from domestic sources, helped by the eventual reopening of the treasury bill market after the restructuring negotiations of existing debt obligations have been concluded.

Grant revenue (classified above-the-line) declines as general budget financing from donors is scaled back starting in 2005 (in line with donor indications), which leads to a large decline in the fiscal surplus in 2005 compared with that projected for 2004. Expenditure pressures for social and infrastructure outlays and new operations and maintenance expenditures will be large. While some savings are assumed from the reprioritization of current outlays, expenditures not backed by development grants nonetheless increase by around 1 percent of GDP over the forecast period.

External debt sustainability in the medium-term baseline

The Solomon Islands' current external debt level is high, although the debt-servicing burden is manageable. The current estimated NPV of external debt relative to GDP (44 percent), exports (102 percent), or government revenue (219 percent) is above indicative thresholds for other low-income countries (Appendix Table 2). However, the current debt service burden as a share of the recently improved level of exports (6 percent) or revenue (12 percent) appears manageable. During the projection period, all sustainability indicators improve steadily due to the net repayments to external creditors, rapid growth of GDP, and the increased levels of revenue and exports in the projection period. Specifically, the ratios of the NPV of external debt to major macroeconomic aggregates fall by roughly one-half of their current levels over the next five years, while debt service indicators would remain broadly stable.

Risks to the medium-term scenario

Several factors pose risks to the outlook described above. The staff has undertaken a series of stress tests to check the country's resilience to external and domestic shocks. The stress tests were conducted using one-standard-deviation shocks that last for two years to the 10-year historical data averages for economic growth, export value growth, the U.S. dollar

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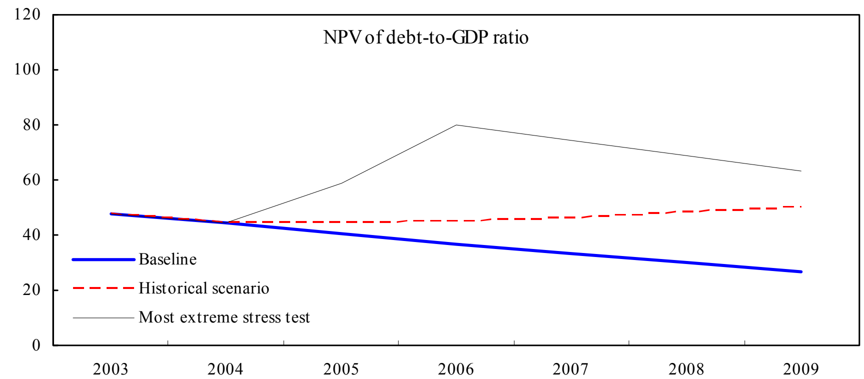
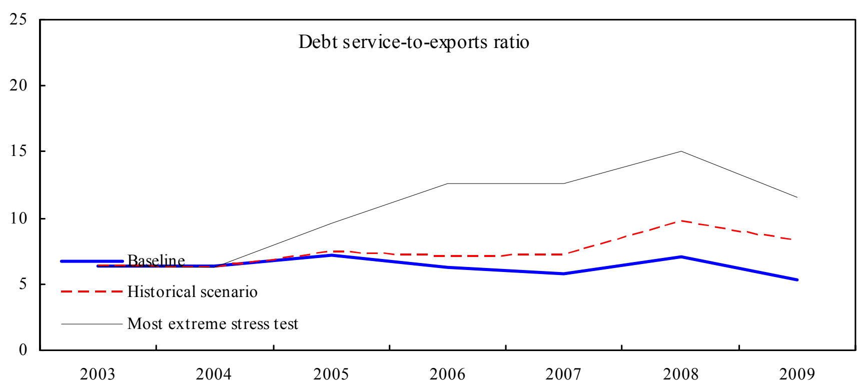
GDP) is assumed to be settled in line with any overperformance on the annual revenue targets.

GDP deflator, and for nondebt creating flows, for a one-half standard deviation shock to all these variables combined, and for a 30 percent nominal exchange rate depreciation.



The stress tests suggest that a temporary shock to the economic growth rate or the exchange rate has a large but manageable impact on the external debt level (Appendix Table 2). As long as the policy environment remains sound, the debt stock returns to its declining path and does not exceed the initial debt level. The most extreme shock arises in the event of the combined shock, where the NPV of the external debt-to-GDP ratio increases to 64 percent by 2009, compared with the projected decline to 27 percent in the baseline estimate. In regard to the servicing burden, the external debt-servicing ratio is most sensitive to a one-standard-deviation shock in the export growth rate, where it would increase from its current level of around 6 percent to reach 15 percent in 2008 before falling back slightly.



These results highlight the potential vulnerabilities faced by the Solomon Islands economy to adverse shocks, especially if the pace of economic and export growth proves less favorable than currently envisaged. Given these uncertainties in future economic developments, following a cautious approach to fiscal and other macroeconomic policies under the control of the government will be essential to provide the flexibility needed to respond to potential adverse developments in economic activity and/or the external environment.

Appendix Table 1. Solomon Islands: Medium-Term Adjustment Scenario, 2002–09

		Est.	Projections					
	2002	2003	2004	2005	2006	2007	2008	2009
Growth and prices (percentage change)								
Real GDP	-1.6	5.1	4.2	4.4	4.7	4.8	5.0	5.1
Of which: Marketed output	-3.6	8.0	4.9	4.8	5.2	5.3	5.6	5.7
CPI (period average)	9.4	10.1	5.6	2.5	3.2	3.0	3.0	3.0
CPI (end-of-period)	15.4	3.8	5.1	3.4	3.0	3.0	3.0	3.0
Saving and investment (percent of GDP)								
Public saving-investment balance	-9.6	-1.4	4.0	-0.4	-0.8	-0.8	-0.7	-0.5
Of which: Public investment	3.2	15.7	18.1	21.4	13.3	8.2	7.6	7.1
Private saving-investment balance	2.6	2.9	-4.6	-9.0	-4.5	-2.0	-1.5	-1.5
Of which: Private investment	14.9	17.0	17.2	18.0	18.7	19.4	19.6	19.5
Central government operations (percent of GDP)								
Total revenue	18.7	39.8	48.1	46.9	38.9	34.0	33.5	33.0
Recurrent revenue	16.1	21.5	23.5	24.7	24.9	25.2	25.2	25.3
Grants	2.6	18.3	24.6	22.2	14.0	8.9	8.3	7.7
Development grants	2.2	14.4	18.1	20.2	12.1	7.1	6.7	6.2
Recurrent budget grants	0.5	3.9	6.5	2.0	1.9	1.7	1.6	1.5
Total expenditure 1/	29.7	39.6	44.1	47.4	39.7	34.8	34.2	33.5
Recurrent expenditure 1/	26.5	23.8	26.0	26.0	26.4	26.6	26.5	26.4
Of which: Recurrent costs of new development projects	...	...	...	0.8	1.9	2.4	2.6	2.8
Development expenditure	3.2	15.7	18.1	21.4	13.3	8.2	7.6	7.1
Recurrent balance	-9.9	1.5	4.0	0.8	0.3	0.3	0.3	0.5
Overall balance 2/	-9.6	-1.4	4.0	-0.4	-0.8	-0.8	-0.7	-0.5
Foreign financing (net)	3.8	0.4	-1.1	-1.1	-0.9	-0.9	-1.7	-1.0
Domestic financing (net)	-2.9	-6.6	-0.4	1.5	1.5	1.4	1.7	1.4
Privatization receipts	0.0	0.0	0.0	0.2	0.4	0.4	0.7	0.1
Increase in expenditure arrears	3.5	4.0	-5.0	-2.4	-0.2	-0.2	0.0	0.0
Increase in principal debt arrears	5.2	3.6	-8.9	-2.1	0.0	0.0	0.0	0.0
Restructured arrears	0.0	0.0	11.4	4.2	0.0	0.0	0.0	0.0
Stock of expenditure arrears (percent of GDP; end-of-period)	11.5	14.4	8.1	5.2	4.7	4.2	3.9	3.6
Stock of domestic principal debt arrears (percent of GDP; end-of-period)	7.1	9.9	0.0	0.0	0.0	0.0	0.0	0.0
Central government debt (percent of GDP) 3/	96.2	100.2	92.5	87.3	81.6	76.0	70.2	65.1
Domestic	29.5	27.6	26.4	26.1	25.2	24.3	23.7	23.0
External	66.7	72.6	66.1	61.2	56.4	51.7	46.4	42.2
External debt (millions of U.S. dollars, end-of-period)	151.6	163.9	159.7	156.9	154.5	151.8	146.5	143.1
External debt service to exports of GNFS (accrual basis)	10.1	8.8	6.3	7.1	6.2	5.8	7.0	5.3
Monetary and credit (percentage change; end-year data)								
Net foreign assets	30.2	106.4	49.7	6.0	2.6	3.4	3.0	3.8
Net domestic assets	-4.8	-11.0	-21.6	18.0	17.6	15.7	15.8	14.2
Of which: Credit to private sector	12.2	26.1	12.0	7.3	7.9	8.1	8.3	8.4
Broad money	4.0	26.0	15.2	9.9	7.9	8.1	8.3	8.4
Interest rate (3-month Treasury bill rate, average)	8.3	6.6	...	...	...	...	...	...
Balance of payments (millions of U.S. dollars; unless otherwise indicated)								
Exports, f.o.b	58.2	74.2	83.0	88.1	95.5	106.3	115.3	124.1
Imports, c.i.f.	-62.3	-85.2	-102.0	-119.6	-118.2	-123.4	-131.7	-140.6
Nonfactor services (net)	-0.5	6.0	3.7	3.1	3.9	4.6	5.2	5.5
Net current transfers	-5.4	13.4	16.1	6.1	6.1	6.1	6.1	6.0
Current account	-15.7	3.2	-1.4	-24.3	-14.6	-8.2	-6.9	-6.5
(Percent of GDP)	-6.9	1.4	-0.6	-9.5	-5.3	-2.8	-2.2	-1.9
Capital account	6.3	11.0	16.1	26.8	15.8	9.8	8.3	8.5
Foreign investment (net)	1.0	-0.2	-0.2	1.8	3.8	5.8	6.8	6.8
Overall balance (accrual)	-9.4	14.3	14.7	2.5	1.1	1.6	1.4	1.9
Gross official reserves (millions of U.S. dollars; end-of-period)	17.5	35.9	52.1	54.5	55.6	57.3	58.7	60.6
(in months of next year's imports of GNFS)	2.1	3.6	4.5	4.7	4.6	4.4	4.2	4.1
(in months of next year's imports of GNFS, net of external arrears)	0.1	1.8	2.9	4.1	4.0	3.9	3.7	3.6
(in months of next year's non-project imports of GNFS)	2.6	4.5	5.5	5.4	5.0	4.8	4.6	4.4

Sources: Fund staff estimates and projections.

1/ Expenditures are presented on an accrual basis.

2/ Overall balance is calculated from below-the-line financing data.

3/ Includes debt amortization arrears.

Appendix Table 2. Solomon Islands: Sensitivity Analyses for Key Indicators of Government External Debt, 2003–09

(In percent)

	Estimates		Projections					
	2003	2004	2005	2006	2007	2008	2009	Average 2004–09
NPV of Debt-to-GDP Ratio								
Baseline	48	44	41	37	33	30	27	35
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2005–09 1/	48	44	44	45	46	48	49	46
A2. New public sector loans on less favorable terms in 2005–09 2/	48	44	41	37	34	31	28	36
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2005–06	48	44	46	47	42	38	34	42
B2. Export value growth at historical average minus one standard deviation in 2005–06 3/	48	44	47	55	51	47	43	48
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2005–06	48	44	46	48	43	39	35	42
B4. Net non-debt creating flows at historical average minus one standard deviation in 2005–06 4/	48	44	48	49	45	41	38	44
B5. Combination of B1–B4 using one-half standard deviation shocks	48	44	59	80	74	69	64	65
B6. One-time 30 percent nominal depreciation relative to the baseline in 2005 5/	48	44	57	52	47	43	38	47
NPV of Debt-to-Exports Ratio								
Baseline	113	102	94	84	74	66	59	80
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2005–09 1/	113	102	102	102	102	105	108	103
A2. New public sector loans on less favorable terms in 2005–09 2/	113	102	94	85	75	68	61	81
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2005–06	113	102	94	84	74	66	59	80
B2. Export value growth at historical average minus one standard deviation in 2005–06 3/	113	102	154	255	229	210	193	190
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2005–06	113	102	94	84	74	66	59	80
B4. Net non-debt creating flows at historical average minus one standard deviation in 2005–06 4/	113	102	110	111	99	90	82	99
B5. Combination of B1–B4 using one-half standard deviation shocks	113	102	143	205	184	169	156	160
B6. One-time 30 percent nominal depreciation relative to the baseline in 2005 5/	113	102	94	84	74	66	59	80
Debt-Service-to-Exports Ratio								
Baseline	9	6	7	6	6	7	5	6
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2005–09 1/	9	6	7	7	7	10	8	8
A2. New public sector loans on less favorable terms in 2005–09 2/	9	6	7	6	6	7	5	6
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2005–06	9	6	7	6	6	7	5	6
B2. Export value growth at historical average minus one standard deviation in 2005–06 3/	9	6	10	13	13	15	12	11
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2005–06	9	6	7	6	6	7	5	6
B4. Net non-debt creating flows at historical average minus one standard deviation in 2005–06 4/	9	6	7	6	6	7	5	6
B5. Combination of B1–B4 using one-half standard deviation shocks	9	6	8	10	10	12	9	9
B6. One-time 30 percent nominal depreciation relative to the baseline in 2005 5/	9	6	7	6	6	7	5	6
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	...	...	48	48	48	48	48	48

Source: Fund staff projections and simulations.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.

2/ Assumes that the interest rate on new borrowing is 2 percentage points higher than in the baseline, while grace and maturity periods are the same as in the baseline.

3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

4/ Includes official and private transfers and FDI.

5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

SOLOMON ISLANDS: FUND RELATIONS

(As of May 31, 2004)

I. Membership Status: Joined 9/22/78; Article VIII

II. General Resources Account:

General Resources Account:	SDR Million	Percent Quota
Quota	10.40	100.00
Fund holdings of currency	9.85	94.73
Reserve position in Fund	0.55	5.29

III. SDR Department:

SDR Department:	SDR Million	Percent Allocation
Net cumulative allocation	0.65	100.00
Holdings	0.00	0.32

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	6/22/83	6/21/84	2.40	0.96
Stand-by	5/29/81	5/28/82	1.60	0.80

VI. Projected Obligations to Fund:

(SDR Million; based on existing use of resources and present holdings of SDRs):

	2004	2005	2006	2007	2008
Principal	0.01	0.01	0.01	0.01	0.01
Charges/Interest	0.01	0.01	0.01	0.01	0.01

VII. Exchange Rate Arrangements:

Since November 2000, the exchange rate for the S.I. dollar has been based on an undisclosed trade-weighted basket of the currencies of the Solomon Islands' major trading partners, with the U.S. dollar as the intervention currency. During 2002, as pressures on external reserves intensified, the Central Bank of Solomon Islands (CBSI) accelerated the rate of currency depreciation, leading to a gradual real depreciation of the S.I. dollar. Since December 2002, the CBSI has kept the exchange rate broadly stable against the U.S. dollar, although there is no public commitment to continue to do so.

VIII. Last Article IV Consultation:

The 2002 Article IV consultation discussions were held in Honiara during November 4–12, 2002. The staff report (January 13, 2003) was considered by the Executive Board and the consultation concluded on January 24, 2003.

IX. Technical Assistance:

Date	Department	Purpose	Duration
Short-term			
January 14, 1998	PFTAC	Statistics	Two weeks
February 3, 1998	PFTAC	Tax administration	One week
May 4, 1998	PFTAC	Tax administration	Four weeks
June 7, 1998	PFTAC	Banking supervision	Two weeks
June 30, 1998	PFTAC	Balance of payments statistics	Two weeks
November 28, 1998	PFTAC	Public financial management	One week
February 9, 1999	PFTAC	Banking supervision	One week
September, 1999	MAE	Treasury bill auctions and monetary operations	Eight weeks
October 3, 2000	MAE	Advisor to CBSI	Two weeks
May, 2001	PFTAC	Banking supervision	One week
October 2002	PFTAC	Banking Supervision	Ten days
January 2003	PFTAC	Statistics	One week
February 2004	PFTAC	Statistics	One week
March 2004	PFTAC	Tax administration	Five days
May 2004	PFTAC	Tax administration	Five days
Long-term			
June 1995–June 1999;	MAE	Advisor to CBSI Governor	Five years extended in October 1999 through October 2000.
January 2001–present	MAE	Peripatetic Advisor to CBSI Governor	Ten six-week missions

X. Resident Representative: None

SOLOMON ISLANDS: POVERTY AND HUMAN DEVELOPMENT INDICATORS

Social indicators of poverty and human development are low in the Solomon Islands. The country ranks below all Pacific island countries, except Papua New Guinea and Vanuatu, in the United Nations Human Development Index, coming in at 123 out of 175 countries. There are few recent poverty statistics, but anecdotal evidence suggests poverty remains high. However, the more extreme forms of poverty, such as malnourishment, have remained limited due to an abundant resource base, assured access to customary land tenure, and resilient social networks. This advantage is under pressure from a population growth rate that, at almost 3 percent a year, is amongst the highest in the world.

Nonetheless, the Solomon Islands has achieved some significant progress in improving living conditions since independence despite falling per capita incomes. Prior to the outbreak of the civil conflict in 1999, sizable health and education expenditures (at 3–5 percent of GDP each) and high per capita aid inflows had helped underpin these improvements. Providing widespread and quality education to the very young population (42 percent under age 14) is a challenge. The primary education enrollment ratio is about 80 percent, although primary education is neither compulsory nor free. School fees reportedly are an important hindrance to achieving universal primary education. The enrollment ratio is only 30 percent in secondary education. In regard to health industries, Malaria is rampant, with the highest rate of infection in the world outside of sub-Saharan Africa, and more than a third of the rural population lacks access to safe water.

The paucity of data makes an assessment of human development trends since the outbreak of the civil conflict in 1999 difficult, but it is likely that the positive trend was halted, if not reversed. Public service delivery was hampered by the conflict, and large inter-island migrations put strains on the existing capacity. Agricultural production for market declined sharply due to the lack of security and transport services.

The aggregate social indicators mask large differences between urban and rural areas. The two main problems in the rural sector are the lack of essential public services such as health and education, and cash income due to difficulties in market access for rural products grown. While the urban areas have better social services and average incomes are higher, the urban poor face difficulties in securing employment and land for residence.

The government has adopted the MDGs in its National Economic Recovery, Reform, and Development Plan, and has committed to monitor progress towards them. Achieving the MDGs by 2015 is still possible, but remains a major challenge. Progress in some areas, such as reducing infant mortality and ensuring environmental sustainability, has so far been inadequate.

Solomon Islands: Millennium Development Goals Progress

	1990	1995	Latest Data 2001–02	Target 2015
Goal 1: Eradicate Extreme Poverty and Hunger				
Prevalence of child malnutrition (percent of children under 5)	21	21	...	11
Goal 2: Achieve Universal Primary Education				
Gross primary enrollment ratio (percent of relevant age group)	...	...	77	100
Goal 3: Promote Gender Equality				
Ratio of girls to boys in primary and secondary education (percent)	77	79	...	100
Proportion of seats held by women in national parliament (percent)	...	2	2	...
Goal 4: Reduce Child Mortality				
Under 5 mortality rate (per 1,000)	36	30	25	12
Infant mortality rate (per 1,000 live births)	29	25	21	10
Goal 5: Improve Maternal Health				
Maternal mortality ratio (per 100,000 live births)	550	...	...	138
Births attended by skilled health staff (percent of total)	...	85	76	...
Goal 6: Combat HIV/AIDS, Malaria and Other Diseases				
Incidence of tuberculosis (per 100,000 people)	...	...	87	...
Incidence of malaria (per 100,000 people)	...	...	16,971	...
Goal 7: Ensure Environmental Sustainability				
Forest area (percent of total land area)	92	...	91	...
Nationally protected areas (percent of total land area)	...	0	0.3	...
CO_2 emissions (metric tons per capita)	0.5	0.4	0.4	...
Access to an improved water source (percent of population)	...	...	71	36
Access to improved sanitation (percent of population)	...	...	34	...
Goal 8: Develop a Global Partnership for Development				
Fixed line and mobile telephones (per 1,000 people)	15	18	21	...
Personal computers (per 1,000 people)	...	25	51	...

Source: World Development Indicators, Human Development Indicators.

Solomon Islands: Relations with the World Bank Group
(As of May 20, 2004)

Following the repayment of debt servicing arrears in September 2003, the Solomon Islands came out of non-accrual status and country relations have been normalized. As a consequence, the suspended Health Sector Development Project (US$4 million equivalent) has been reactivated with a mid-term review scheduled for June 2004.

A joint Asian Development Bank-World Bank assessment mission took place in October 2003, with a follow-up in March 2004. As a result, the World Bank has launched a program comprising small grants and analytical/advisory services for the Solomon Islands Government. Strategic partnership with other donors is a key principle of World Bank support so that activities can be leveraged effectively; the Bank does not envision any new loans in the short term. Details of World Bank activities are given below.

- **Economic reform:** The World Bank is preparing analytical work to support policy advice on macroeconomic management and economic reform priorities, including support to a proposal Economic Reform Unit.
- **Financial sector reform**: At the request of the CBSI, an Institutional Development Fund grant of US$ 254,000 has been approved to support policy advice on financial sector supervision, including for nonbank financial institutions, and relevant macroeconomic analysis.
- **Energy:** An initial review of Solomon Islands Energy Authority was completed in February 2004, and discussions with the government, AsDB, and Australia are ongoing on appropriate next steps in financial/management restructuring. The Bank is also exploring options for rural electrification.
- **Telecommunications**: Assistance with sector policy development and establishment of effective regulatory capacity is being provided, and the Bank is exploring options to enhance rural telecommunications access.
- **Rural income generation**: The Bank is designing a small project activity (grant-financed) to support pilot initiatives in rural areas to help improve the access of small farmers to the cash economy and to generate increased incomes on a sustainable basis.
- **Foreign Investment Promotion:** The government has requested policy advice and technical assistance from the Foreign Investment Advisory Service (FIAS) to prepare a new Investment Promotion Bill. This would resurrect work initiated in 1999. FIAS has agreed in principle and will prepare a proposal for management consideration. FIAS has also agreed to assist in the review of customs and tax incentives in conjunction with technical assistance supported by PFTAC.
- **Education policy:** Discussions are ongoing in the areas of the National Training Plan (scholarships, training needs, tertiary planning), Technical/Vocational Education Plan and strategies, Distance Education Plan and strategy, and developing and monitoring Basic Education indicators. These areas would complement the education sector reforms that the government is implementing with the support of the EU and NZAID.

Solomon Islands: IDA Lending Operations (as of February 29, 2004)

	Disbursed (US$)	Undisbursed (US$)
Health Sector Development Project	1,323,995	2,909,396

Contact person: Natasha Beschorner, Country Program Coordinator, Tel: 202-473-2598

SOLOMON ISLANDS: RELATIONS WITH THE ASIAN DEVELOPMENT BANK
(As of May 20, 2004)

Since joining the AsDB in 1973, the Solomon Islands has received 16 loans for a total amount of US$79.3 million, and 53 TA projects for a total amount of US$10.9 million. The loan and TA projects have been in agriculture and fisheries, transportation, infrastructure rehabilitation, finance, power, water supply and sanitation, ports, reform of state owned enterprises, and institutional development of government ministries and public agencies, particularly the executing agencies of AsDB-financed projects.

During 1994–97, no new operations were initiated because of government arrears on debt servicing obligations. In 1998, with the clearance of overdue loan payments to the AsDB, lending and TA operations resumed. In August 1998, the ADB approved a US$25 million policy-based program loan and a US$1 million TA loan to support the Government's Public Sector Reform Program. The program loan helped finance adjustment costs associated with the reform program, particularly the clearance of government arrears to external and domestic creditors, and separation payments made in 1999 to civil servants. The first tranche of the program loan (US$15 million) was disbursed in November 1998. The second tranche of the loan was not released and was eventually cancelled since, subsequent to the outbreak of ethnic unrest in mid-1999, a new government did not support the program's objectives. In 2000, the AsDB approved a US$10 million post-conflict emergency rehabilitation project loan. However, due to debt servicing arrears, AsDB suspended its operational program in the Solomon Islands in February 2002. Following the settlement of the arrears by Australia on behalf of the Solomon Islands Government in September 2003, AsDB resumed its country operations. The country strategy and program is being formulated for approval in mid-2004.

AsDB operations in the Solomon Islands are guided by the Pacific Strategy for the New Millennium that was approved in 2000. AsDB is currently formulating a new Pacific development strategy for the period 2005–08. Project processing is undertaken by the Pacific Operations Division (PAHQ) in Manila, while project implementation is administered largely by AsDB's South Pacific Regional Mission located in Vanuatu.

Loans, Approvals, and Disbursements, 1997–2002
(In millions of U.S. dollars)

	1997	1998	1999	2000	2001	2002
Loan approvals	0.00	26.00	--	10.00	--	--
Loan disbursements	0.00	15.67	0.32	0.45	0.01	0.00
Cumulative loan amount approved (as of end-of-year)	43.31	69.31	69.31	79.31	79.31	79.31
Cumulative net effective loans (as of end-of-year)	37.61	64.94	64.65	54.30	64.05	64.83
Cumulative disbursement (as of end-of-year)	37.61	53.29	53.61	54.07	54.07	54.07

Contact person: Robert Guild, Desk Officer for the Solomon Islands.

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

(As of May 20, 2004)

The Center's assistance to the Solomon Islands since 1996 has included 19 advisory missions, mostly before 1999. The Solomon Islands sent 19 officials to seminars and workshops, and PFTAC organized 9 attachments (including for the manager of CBSI's Financial Institutions Department to a seminar in Washington).

Public financial management

PFTAC participated in two PEM missions in 1998, one with AusAID, and one with UNDP, to explore the scope for sustainable improvements in financial management. An advisor was a member of the August 2002 IMF mission and reviewed the PEM system. The priority was the rehabilitation of public financial management, including strengthening expenditure and commitment controls, tightening treasury and cash management operations, and improving the budget and accounting system. Indications are that the situation has considerably improved in recent months.

Tax administration and policy

During several missions before February 1999, PFTAC provided input to the administration improvement projects proposed by AusAID and NZAID. Following a review of the Inland Revenue administration, two four-week consultancies for strengthening the audit area were also organized in May and November 1998. In 2003, discussions were held at PFTAC Headquarters on a decentralization strategy that revealed that the tax system is in need of reform. A tax and customs administration mission took place in March and May 2004 with the involvement of a customs expert, partly to determine future PFTAC involvement.

Financial sector regulation and supervision

In late 2002, PFTAC participated in an on-site review of the domestically owned commercial bank. Technical assistance in bank ownership issues, the quality of bank holdings of government bonds, and the supervision of the National Provident Fund has been provided to the CBSI staff in the PFTAC Headquarters. PFTAC also funded the attachment of a CBSI bank examiner to the Reserve Bank of Fiji and the participation of CBSI staff in regional supervision workshops.

Economic and financial statistics

A January 2003 mission revealed that the National Statistics Office (NSO) was barely functional, having suffered severe losses of resources and records in previous years. At that time, PFTAC recommended the temporary transfer of staff responsible for producing the CPI to the CBSI. Following stabilization of the country, the NSO has been partially re-equipped; the CPI is again being produced in the NSO and a business survey for national accounts is planned for mid-2004. A further PFTAC mission in February 2004 devised a recovery plan, including the provision of a long-term adviser, training attachments, and future technical assistance.

Contact person: Luc Leruth, Project Coordinator.

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

SOLOMON ISLANDS: STATISTICAL ISSUES

The Solomon Islands' economic database is poor. The only institution that has provided regular data in the last two years is the Central Bank of the Solomon Islands (CBSI). The staff of the National Statistical Office (NSO) was relocated to the CBSI given the inadequate resources and the lack of security in the Ministry of Finance. NSO is now in the process of recovery, and it is gradually re-taking over data collection and publication responsibilities.

The CBSI publishes data on the real, external, fiscal, and monetary sectors in its *Monthly Review*, *Quarterly Review*, and *Annual Report*. There is a Solomon Islands country page in *IFS,* but delays often occur.

A GDDS mission from PFTAC visited the Solomon Islands in February 2004 to assess the situation and propose an action plan for recovery. The mission concluded that rebuilding the statistical system required extensive TA over at least two years and external funding. The mission recommended the appointment of a chief statistician and an externally funded long-term adviser. The mission also noted the urgency of conducting a business survey and a household income and expenditure survey in order to provide a new base for the national accounts and CPI and enable an assessment of poverty levels. The mission further identified a number of statistical issues which need priority attention, including; liaising with the National Provident Fund to arrange for the receipt of data on employment and other statistics; increasing the response rate on BOP surveys; reducing the dependence on Foreign Exchange Transaction records for BOP purposes; resuming use of Customs data for the estimation of imports; and considering a Population Census as significant population movements in recent years make the 1999 Census results unreliable for planning and analysis purposes.

Real sector
The NSO has not produced national accounts data since 1994. The task was taken over by the CBSI, but its annual estimates build on a limited amount of raw data, primarily commodity exports. Data on production of major export commodities are reported on a monthly basis. Data on employment and wages are not produced. The NSO reclaimed the task of producing the CPI for Honiara from the CBSI in August 2003.

Money and banking statistics
Monetary statistics are compiled by the CBSI on a monthly basis and are provided to the IMF with a two to four week lag.

Public finance
The Ministry of Finance started disseminating monthly press releases on budget realizations in August 2003. The CBSI published data on revenue and expenditure during the conflict, although the reliability of these data is in doubt given the break down of accounting mechanisms and the large expenditure arrears. Data for the provincial government finances are not available.

External sector
Partial quarterly balance of payments data are estimated by the CBSI on the basis of cash foreign exchange transactions reported through the banking system and are available with a three-month lag. In the absence of supplementary surveys (e.g., on foreign direct investment and aid inflows), such data are deficient in both detail and coverage.

Solomon Islands: Core Statistical Indicators
(As of June 28, 2004)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports 1/	Current Account Balance 1/	Public Debt/ Debt Service	Overall Government Balance 2/	GDP 3/
Date of Latest Observation 4/	5/28/04	5/28/04	5/28/04	5/28/04	5/28/04	5/28/04	3/03	7/31/02	12/01	1999	1999	1999
Date Received 4/	6/24/04	6/24/04	6/24/04	6/24/04	6/24/04	6/24/04	5/04	7/31/02	12/01	3/00	3/00	3/00
Frequency of Data 5/	W	W	W	W	W	W	M	Q	Q	A	A	A
Frequency of Reporting 5/	W	M	M	M	M	M	M	Upon request	Upon request	Upon request	Upon request	Upon request
Frequency of Publication	D	M	M	M	M	M	M	A	A	A	A	A
Source of Data	Public media	Central Bank	Central Bank	Central Bank	Central Bank	Central Bank	Statistics Dept.	Central Bank	Central Bank	Ministry of Finance	Ministry of Finance	Central Bank
Mode of Reporting	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	Fax	Fax	Fax	Fax	Fax	Fax
Confidentiality 6/	P	P	P	P	P	P	P	P	P	P	P	P

1/ Detailed balance of payments data derived from foreign exchange transactions through the banking system are available on a quarterly basis with a 3-month lag.
2/ Given the lack of availability of expenditure data, the government balance is estimated based on available data on financing.
3/ The most recent official data are for 1994, but the central bank has produced estimates through 1999.
4/ Includes data received following specific requests by Fund staff.
5/ A = annually; D = daily; M = monthly; Q = quarterly; W = weekly.
6/ P = publicly released information.

INTERNATIONAL MONETARY FUND
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August 12, 2004

International Monetary Fund
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Washington, D. C. 20431 USA

IMF Concludes 2004 Article IV Consultation with the Solomon Islands

On July 16, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Solomon Islands.[1]

Background

The Solomon Islands' economy deteriorated markedly after the outbreak of an inter-island conflict in mid-1999. The level of real GDP subsequently declined by one-quarter, exports halved, and inflation increased to 15 percent. In addition, the budget deficit increased rapidly, the government defaulted on virtually all domestic and external debt obligations, and international reserves (net of the external arrears) were fully exhausted.

The government has moved rapidly to stabilize budgetary finances since the arrival in mid-2003 of the multinational Regional Assistance Mission to the Solomon Islands (RAMSI) that has restored law and order throughout the country. The budget finished the year with a deficit of just 1½ percent of GDP, compared with 10 percent in 2002. This result was mainly attributable to the marked strengthening of tax collections aided by an amnesty on penalties, the termination of payments to the ex-militants, greater scrutiny over the wage bill, and the tightening of expenditure controls. Australia and New Zealand also provided substantial grant support to the budget, in addition to that provided for development spending, which was in part used to pay the overdue debt obligations to the World Bank and the Asian Development Bank.
Taken together, these steps helped finance an increase in social and development outlays.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies.
On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities and this PIN summarizes the views of the Executive Board.

The government's commitment to prevent new nondebt expenditure arrears from October 2003 has been strictly enforced. Improvements in revenue collections and expenditure restraint have continued in 2004, and the authorities project that the 2004 budget will be in surplus.

Economic activity has started to respond to the more favorable law and order and policy environment. Real GDP grew by an estimated 5 percent in 2003, helped by, strong fish, copra, and cocoa production. Foreign investors have renewed their interest in major natural resource projects, and private sector credit growth has increased as lending interest rates have declined. Overall credit growth, however, has remained low as the large aid flows and recurrent budget surplus have increased the level of government deposits held at the central bank. International reserves have increased sharply, reflecting higher export volumes and world commodity prices, the slow pick up in import demand, large aid flows, and the remonetization of the economy. Inflation has fallen back to single-digit levels, as the supply of food has increased and the nominal effective exchange rate has stabilized.

If appropriate macroeconomic and structural policies are implemented, growth of real GDP in the Solomon Islands during 2004–09 could average 4½–5 percent a year (around 2 percent per capita). Inflation would remain in low single digits and the level of international reserves slowly increase, assuming that fiscal and monetary discipline is maintained. The current account deficit as a share in GDP would gradually decline as exports increase and the level of project-related imports falls back. Assuming the budget deficit averages around ½ percent of GDP, the government debt ratio would decline from 100 percent of GDP in 2003 to 65 percent of GDP by 2009.

Executive Board Assessment

Executive Directors welcomed the marked improvement in economic performance in the Solomon Islands that has occurred since the arrival of the RAMSI in mid-2003. Real GDP has increased following four years of decline, inflation has fallen, exports are higher, and reserves have strengthened.

At the same time, Directors observed that the current situation and future economic prospects in the Solomon Islands remain fragile. Much physical infrastructure has been destroyed, social indicators have deteriorated, unemployment remains high, and the government debt stock is large. Against this background, the main challenge will be to implement policies to reduce the risks to the medium-term outlook and underpin a sustained improvement in per capita growth and social indicators. Key policies in this regard will be a strengthening of budget finances—in particular, tight control over expenditures—maintaining price stability, and implementing deep structural reforms to promote private sector employment and exports.

Directors commended the authorities for the prudent fiscal policies they had followed in the second half of 2003 and the rapid turnaround in budget finances. The budget deficit for 2003 was reduced sharply, reflecting higher receipts from better tax administration and firm control over payments to ex-militants and civil service allowances, as well as the resumption of donor grants. Directors endorsed the 2004 budget surplus target, which will enable the government to start to pay down the large stock of expenditure arrears, and they concurred with the plans to regularize the government's debt obligations.

Directors stressed the need for continued fiscal restraint over the medium term to reduce the debt stock and servicing burden, and to ensure that resources are available for urgent social and development requirements. Priority should be placed on reallocating spending toward basic health and education, rural infrastructure and agricultural advisory services, and operations and maintenance outlays. Directors called for further efforts to contain civil service expenditure and boost revenue collections through additional improvements in tax and customs administration. Pressures for new income-tax exemptions for foreign and domestic investment and activity should be resisted. Regarding the possibility of decentralizing a large part of the budget to the provinces under a proposed federal structure for the Solomon Islands, Directors recommended contemplating such a step only after central government finances are on a secure foundation, and an effective system for monitoring provincial government revenues and expenditures is in place.

Directors endorsed the central bank's monetary policy objectives of containing inflationary pressures and increasing the level of international reserves. The current policy of countering upward pressure on the exchange rate should continue, and particular vigilance will be necessary to ensure that inflation remains subdued. Directors welcomed the recent elimination of the remaining restrictions on current international transactions.

Directors observed that the banking system is generally sound. They encouraged the central bank to monitor banks closely to ensure that all prudential guidelines continue to be met as the economic recovery gathers pace. The recent efforts to strengthen the asset quality of the pension fund, and the initial steps taken to settle the future of the development bank, were welcomed. Directors stressed that implementation of laws against money laundering and the financing of terrorism will help safeguard the financial system and should be a priority.

Directors underscored that structural reforms will be critical to lift private sector exports and employment over the medium term. Attention needs to be focused on policies to boost rural production, improve inter-island distribution systems, and promote efficient and ecologically sustainable management of the fisheries and forestry sectors. Regulation and licensing procedures for foreign and domestic investment and activity should be streamlined, and the corporatization and privatization of public enterprises should be considered to help improve their financial balances. Directors stressed that strengthening institutions, enhancing governance and transparency, and reducing corruption will help promote a level playing field for private sector activity.

Directors fully supported the authorities' medium-term development strategy outlined in the National Economic Recovery, Reform, and Development Plan. The success of the Plan will depend crucially on a sustained record of policy implementation to rehabilitate the economy. Continuous monitoring and evaluation of the Plan will be necessary, and in support of that effort, an improvement in the currently weak state of economic data will be essential. Directors called in particular for the rehabilitation of the National Statistical Office in order to improve the quality and timeliness of national accounts, budgetary, and balance of payments statistics.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Solomon Islands: Selected Economic Indicators, 2000–04

	2000	2001	2002	Est. 2003	Proj. 1/ 2004
Growth and prices (percentage change)					
Real GDP	-14.3	-9.0	-1.6	5.1	4.2
CPI (period average)	6.9	7.6	9.4	10.1	5.6
CPI (end-of-period)	7.6	6.5	15.4	3.8	5.1
Central government operations (percent of GDP)					
Total revenue	22.1	23.5	18.7	39.8	48.1
Recurrent revenue	18.3	15.3	16.1	21.5	23.5
Grants	3.7	8.2	2.6	18.3	24.6
Total expenditure 2/	29.7	36.1	29.7	39.6	44.1
Recurrent expenditure	25.1	27.2	26.5	23.8	26.0
Development expenditure	4.6	8.9	3.2	15.7	18.1
Recurrent balance 3/	-6.1	-11.7	-9.9	1.5	4.0
Overall balance 4/	-4.9	-11.9	-9.6	-1.4	4.0
Foreign financing (net)	0.6	5.0	3.8	0.4	-1.1
Domestic financing (net)	4.2	-1.4	-2.9	-6.6	-0.4
Increase in expenditure arrears	1.4	3.6	3.5	4.0	-5.0
Increase in principal arrears	-1.2	4.7	5.2	3.6	-8.9
Restructured arrears	0.0	0.0	0.0	0.0	11.4
Stock of expenditure arrears (percent of GDP; end-of-period)	4.7	8.5	11.5	14.4	8.1
Stock of domestic principal debt arrears (percent of GDP; end-of-period)	0.0	3.9	7.1	9.9	0.0
Central government debt (percent of GDP) 5/	65.4	82.2	96.2	100.2	92.5
Domestic	23.5	33.2	29.5	27.6	26.4
External	42.0	49.0	66.7	72.6	66.1
External debt (in millions of U.S. dollars; end-of-period)	125.6	134.3	151.6	163.9	159.7
External debt service to exports of GNFS (accrual basis)	3.9	8.1	10.1	8.8	6.3
Monetary and credit (percentage change; end-of-period)					
Net foreign assets	-39.8	-31.8	30.2	106.4	49.7
Net domestic assets	46.8	-4.4	-4.8	-11.0	-21.6
Credit to government (net)	43.8	3.4	13.1	-17.1	-6.0
Credit to private sector	1.8	-21.8	12.2	26.1	12.0
Broad money	0.5	-13.2	4.0	26.0	15.2
Balance of payments (millions of U.S. dollars; unless otherwise indicated)					
Exports, f.o.b.	65.1	47.1	58.2	74.2	83.0
Imports, c.i.f.	-98.1	-90.6	-62.3	-85.2	-102.0
Current account	-31.7	-35.1	-15.7	3.2	-1.4
(Percent of GDP)	-10.6	-12.8	-6.9	1.4	-0.6
Capital account	8.5	17.2	6.3	11.0	16.1
Overall balance (accrual)	-23.1	-17.9	-9.4	14.3	14.7
Gross official reserves (millions of U.S. dollars; end-of-period)	31.3	18.5	17.5	35.9	52.1
(In months of next year's imports of GNFS)	3.1	2.8	2.1	3.6	4.5
Exchange rate (SI$/US$, end-of-period)	5.10	5.56	7.46	7.49	...
Real effective exchange rate (period average; 1990=100)	122.8	133.5	111.1	96.5	...
Nominal effective exchange rate (period average; 1990=100)	65.3	67.4	52.4	41.8	...

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

1/ Staff projections.
2/ Expenditures are presented on an accrual basis.
3/ Includes recurrent budget grant support; amortization payments are classified as budget financing.
4/ Overall balance is calculated from below-the-line financing data.
5/ Includes debt amortization arrears.

Statement by Michael Callaghan, Executive Director for Solomon Islands and Geoffrey Francis, Advisor to Executive Director
July 16, 2004

Key Points

- There has been a remarkable turnaround in the Solomon Islands economy over the past twelve months, with the restoration of law and order and greater fiscal discipline.
- The provision of substantial donor assistance has lead to this improvement.
- The authorities recognise that this support has provided a window of opportunity to not only arrest the decline in economic activity, but to put the economy on the path of sustained growth.
- Achieving this outcome will require major structural reforms. At the core of the reform agenda is the maintenance of law and order, fiscal discipline, strengthening institutions, rebuilding infrastructure, and improving the investment environment.
- The authorities appreciate the support they have received from the Fund in addressing the many challenges they face.

A remarkable turnaround

A great deal has changed in the Solomon Islands since last year's Article IV consultations. At last year's consultations, Directors focused on the need to restore law and order and fiscal discipline to arrest the deterioration in the economy. It is pleasing to report this year that substantial progress has been made on all these fronts – law and order has been restored, government expenditure is under control, there is stronger tax compliance and improved collections, and the economy is now growing following years of decline.

As the staff report highlights, the impact of ethnic tensions which erupted in mid-1999 on the economy was devastating. Real GDP fell by over 25 per cent, exports were halved, foreign exchange reserves were depleted, inflation rose, arrears mounted and general confidence plummeted.

Donor support has built upon the resilience of the Solomon Islands people

The Regional Assistance Mission to the Solomon Islands (RAMSI), which was launched in July 2003, was a turning point. However, notwithstanding the massive problems confronting the economy prior to RAMSI, the spirit and perseverance of the Solomon Islands people was not destroyed. Solomon Islands businesses did not wait for government action or donor handouts – they continued with their daily activities, be it fishing, copra cutting, cocoa farming or other pursuits. This resilience in the face of overwhelming hardships provided the base for a remarkable turnaround in economic growth once law and order was restored and confidence boosted. It also attests to the long-term potential of the Solomon Islands.

The Solomon Islands does have considerable potential, although it faces major development challenges. Its 500,000 people live on a scattered archipelago of mountainous islands and coral atolls covering about 28,000 square kilometers. There are about 70 indigenous languages in use and the vast majority of land is communally owned, with usage rights determined by local customs (which can vary greatly among islands).

All components of the economy are now growing

The return to economic growth, estimated at over 5 per cent last year, is significant, with all components of the economy registering improvements. The fisheries sector grew in volume terms, while an improvement in fish prices also made a contribution. Underlying growth in the agriculture sector was a strong recovery in both copra and cocoa production, while growth in the forestry sector stemmed primarily from an expansion in log harvesting. As a direct reflection of the pick-up in confidence, the construction sector grew strongly during the course of the last year – up about 88 per cent.

The restoration of government finances

Importantly, government finances have been stabilised. Expenditure has been brought under control – particularly the public sector wage bill, with the payroll being cleansed of ghost workers and payments to ex-militants terminated – and revenues boosted. A budget deficit of 10 per cent of GDP in 2002 has been reduced to 1½ per cent. The Ministry of Finance is reporting strong revenue collection, reflecting faster economic and export growth, success in bringing businesses back into the tax net, and the collection of tax arrears. Government finances have also benefited from the return of donor support. Despite pressing expenditure needs, the government has used higher-than-projected revenue flows to reduce the stock of expenditure arrears. Net credit to the government has declined. This is a very positive development given the past history of heavy financing by government from the domestic banking system, which has had a crowding-out effect on private sector spending and investment decisions.

Importantly, the government has reached an agreement with domestic bondholders to restructure domestic debt, which is due to be signed on July 15, 2004. The large public debt stock, and the government's problems in servicing this debt, has been a major burden on the economy. In particular, it has dampened the ability of commercial banks to play their role in supporting economic development. Reaching an agreement with major domestic bondholders will allow the financial sector to play its part to boost private sector growth.

Monetary policy and the exchange rate

The Central Bank has maintained its policy of pegging the Solomon Islands dollar to a trade-weighted basket of currencies. Reflecting the increase in exports and donor inflows, the focus of exchange rate policy has shifted from defending the level of reserves to resisting upward pressure on the exchange rate resulting from large aid flows, so as to build reserves. The exchange rate has been broadly stable in 2003 and inflation has been reduced from double-digit to single-digit levels. Exchange restrictions, which were introduced largely as a crisis measure, have been mostly removed. Reserves have risen to around 4.9 months of import cover, although the figure would be significantly lower if allowance is made for the government's accumulated external debt arrears.

The authorities believe that in the current environment, reserve money should continue to be the nominal anchor for monetary policy, using a blend of open market operations and foreign exchange market interventions as the main policy instruments – an arrangement that has served the economy well.

The stronger financial sector

The Central Bank is taking steps to strengthen the financial system. During the past year, the Central Bank has conducted for the first time on-site and off-site examinations of the National Provident Fund and the Development Bank of the Solomon Islands and these institutions have been made subject to supervision and regulation under the Financial Institutions Act 2002. The Central Bank has prepared a report on the financial position of the National Provident Fund and made a number of recommendations to its Board identifying areas that need to be addressed to strengthen its balance sheet, governance and prudential compliance. The Central Bank concluded that the Development Bank of the Solomon Islands had been operating while insolvent and has received a court order to take control of it, which became effective on June 10.

While developments are encouraging, the underlying situation remains fragile

While the past year has been a turning point for the Solomon Islands, and the authorities are very appreciative for the external assistance which the country has received, they are very aware that the underlying situation remains fragile and that it is essential they fully capitalise on the "window of opportunity" presented by RAMSI. They also recognise that the very welcome pick-up in economic activity over the past year follows four consecutive years of substantial decline. It will take some time to restore the economy to pre-crisis levels. In fact, in terms of GDP per capita, the Central Bank estimates that the economy has to maintain a consistent annual growth rate of 10 per cent for the next ten years before the economy achieves the sort of income levels experienced in the four years prior to 1999.

First steps on a long reform path

The authorities are aware that they have just commenced a long reform path needed to address the problems confronting the economy. It is important that the momentum from the restoration of law and order and the turnaround in confidence is maintained.

The authorities have developed a National Economic Recovery Reform and Development Plan which lays the foundations to sustain growth and development over the medium term. The plan aims to comprehensively address past impediments to Solomon Island's development, including revitalising institutions underpinning law and order, strengthening governance, restoring fiscal discipline, maintaining financial stability, reforming the public sector, rebuilding infrastructure, restoring social services and fostering social development. This is a large reform agenda and progress will be difficult, but the benefits will be substantial.

There are a number of key areas which the authorities are addressing. The economy's main sector – logging – has been proceeding at unsustainable levels. In response, the authorities have prepared legislation aimed at strengthening forestry monitoring, regulation and prosecution. The draft legislation has been subject to extensive consultations, including with the timber industry, provincial governments, NGOs, landowners and women's groups.

The need to improve the investment environment is also recognised. Some of the hurdles to lifting investment include: cumbersome investment requirements, the absence of transparent procedures, infrastructure in disrepair, unreliable utilities and transport services, the high cost of doing business and the absence of government support. The importance of addressing these impediments is recognised.

Most importantly, the machinery of government has to be restored, including good governance, accountability and transparency. These are all on the authorities' reform agenda. As part of the reform effort, an Economic Reform Unit, to be staffed by RAMSI and local officials, is being established within the Ministry of Finance to develop and implement a longer-term economic reform agenda.

While the authorities are appreciative of the strong donor support they have received, they are also aware of the risk of "aid dependency". Efforts are being mounted to eradicate this concern.

To conclude, the authorities would like to thank the Fund for their continued support and assistance through some very difficult times. The substantial improvement in the country's economic conditions over the past year has been very encouraging. Nevertheless, the government recognises that for the full potential offered by the current strong donor support to be realised, this will ultimately depend on the actions of the people of the Solomon Islands.

The authorities have consented to publication of the Staff Report and Selected Issues papers.