July 2011
IMF Country Report No. 11/180

Solomon Islands: Solomon Islands - Second Review Under the Standby Credit Facility and Request for Modification of Performance Criteria—Staff Report; Press Release on the Executive Board Discussion;

In the context of the Solomon Islands - Second Review Under the Standby Credit Facility and Request for Modification of Performance Criteria, the following documents have been released and are included in this package:

- The staff report for the Solomon Islands - Second Review Under the Standby Credit Facility and Request for Modification of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on May 13, 2011, with the officials of Solomon Islands on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 14, 2011. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Press Release summarizing the views of the Executive Board as expressed during its June 29, 2011 discussion of the staff report that completed the request and/or review.

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

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

*Also included in Staff Report

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

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INTERNATIONAL MONETARY FUND

SOLOMON ISLANDS

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

Prepared by the Asia Pacific Department in Consultation with Other Departments

Approved by Subir Lall and Dominique Desruelle

June 14, 2011

Standby Credit Facility. An 18-month Standby Credit Facility (SCF) arrangement (120 percent of quota or SDR12.48 million) was approved by the Executive Board on June 2, 2010 (Country Report No. 10/198) followed by the first disbursement of SDR 3.12 million. The first review under the SCF arrangement was completed on November 17, 2010 (Country Report No. 10/359), followed by another disbursement of SDR 3.12 million.

Summary. Program performance has been strong, and macroeconomic developments and the outlook remain favorable. The priority is to consolidate the strong gains made in strengthening fiscal and external positions to enhance the resilience of the economy to shocks. Implementing fiscal policies consistent with the program and moving forward with structural reforms will help ensure fiscal sustainability. In light of the high level of banks' excess reserves, the central bank should closely monitor credit developments and tighten monetary conditions should banks begin to expand credit aggressively. The strong foreign exchange reserves position provides scope for a modest appreciation of the exchange rate to mitigate inflation pressures resulting from rising import prices of fuel and food. Reforming the National Provident Fund and strengthening banking supervision are crucial to preserve financial sector stability.

Discussions. A staff team visited Honiara during May 3–13, 2011, comprising Mr. Khor (head), Mr. Feridhanusetyawan, Mr. Peiris, and Ms. Lin (all APD). Mr. Choi (OED) participated in the policy discussions. The mission met with the Minister of Finance; Minister of Development, Planning, and Aid Coordination; Minister of Public Service; Governor of the Central Bank of Solomon Islands (CBSI); other senior officials, the donor community, and private sector representatives.

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I. Background

1. **Program performance has been strong.** All performance criteria for end-December 2010 were met with comfortable margins, and preliminary outturns at end-March 2011 are in line with achieving the end-June program targets. All program benchmarks for end-December 2010 were implemented, albeit with some delay in obtaining Cabinet approval of amendments to the Customs and Excise and Income Tax Acts to legalize and streamline exemptions (Supplemental Memorandum of Economic and Financial Policies (SMEFP), Tables 1–2).

2. **Macroeconomic performance has been stronger than envisaged at the time of the first review.** Real GDP growth in 2010 is estimated at around 6½ percent, primarily due to strong agricultural production and logging in the second half of the year. Activity was also supported by the robust growth of transport, construction, and communication sectors, spurred by large investments (more than 20 percent of GDP) in gold mining and telecommunications (Figure 1, Table 1).[1] Headline inflation was subdued, averaging 1 percent in 2010 reflecting lower domestic food prices, but increased to almost 6 percent year/year (y/y) in April led by higher import prices of fuel and food. The current account deficit was wider than expected as strong logging and palm oil exports were more than offset by large imports of mining-related construction equipment and services. Nonetheless, the overall balance of payments surplus was larger than projected on account of large foreign investment, donor support, and private capital flows, which resulted in a record level of gross international reserves (US$266 million, around five months of imports of goods and services) (Table 2).

3. **The near-term outlook remains favorable, although headline inflation is projected to increase in line with rising international food and fuel prices**. While log production is projected to decline, macroeconomic activity is expected to grow robustly spurred by gold mining that has come on stream this year. In this context, domestic demand, which has been sluggish thus far, is expected to strengthen. Reflecting the rise in global fuel and food prices, the staff has estimated that headline inflation could reach about 8 percent in 2011, exceeding the authorities' inflation objective of 5 percent. The upside risk to this outlook stems from the logging industry where production has been spurred by high international prices of logs.[2] On the downside, a sharper increase in oil and food prices than is anticipated in the baseline and a stronger expansion in domestic demand would exert pressure on the current account balance and inflation, although the fiscal impact will be small due to the absence of fuel subsidy.

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[1] Gold mining investment in 2010 is estimated at US$125 million (17½ percent of GDP), contributing to about US$110 million of imports of goods and services. Gold exports started in April 2011, and are projected at around 70 thousand ounces in 2011 and 120 thousand ounces annually in the medium term.

[2] The authorities indicated that strong logging production since late 2010 has been partly due to reentry to the existing areas to cut smaller-size trees, which has become profitable due to high price of logs. This suggests that logging production is very sensitive to price movements.

4. **The National Coalition for Reform and Advancement (NCRA) government released its strategic policy actions in January and Parliament passed the 2011 Budget in April.** The government has issued the Policy Translation and Implementation Document that outlines the key strategic actions for each ministry in order for the ministry to achieve the government's overall policy intention as described in the Policy Statement released in October last year. Based on this policy translation document, the government had formulated the 2011 Budget and presented it to Parliament in late March. The government's policy priorities in the budget include reconciliation and social reforms, national security and foreign relations, restoring and developing infrastructure, developing economic base, and reforming the public sector.

II. Policy Discussions

5. **Discussions focused on consolidating the strong gains made in strengthening fiscal and external positions to enhance the resilience of the economy to shocks.** The key policy priorities are to ensure that the 2011 budget and structural fiscal reforms are implemented in line with program commitments, to take precautionary measures to strengthen the monetary and liquidity management in view of the excess liquidity in the banking system, to address inflationary pressure coming from import prices, and to strengthen the financial sector. Program performance criteria on Net International Reserves (NIR), Net Domestic Assets (NDA), Net Credit to Government (NCG) and the government cash balances have been adjusted to lock in the gains from the overperformance in 2010, in order to enhance external and internal financial stability. A few structural benchmarks have been updated and/or added to incorporate new commitments by the government.

A. Fiscal Policy

6. **The fiscal performance in 2010 has been stronger than envisaged under the program** (Table 3)**.** Revenue collections were better than projected due to the stronger-than-expected economic recovery and logging revenue, and improved tax compliance. Recurrent spending was appropriately restrained despite some cost pressures from national elections, additional wage bills, and other spending incorporated in the September 2010 supplementary budget. Meanwhile, some donor support disbursed at end-year remained unspent. As a result, the overall fiscal surplus is estimated at 6 percent of GDP (against a 2½ percent target). The government's cash balance reached SI$263 million (against the adjusted target of SI$165 million) at end-2010, sufficient to cover about two months of recurrent spending compared with less than half month at the beginning of the program. The target on the NCG was also met with a comfortable margin.

7. **The 2011 Budget is broadly in line with program commitments (Box 1)**. Staff welcomed the authorities' commitment to preserving the fiscal overperformance by continuing to build cash reserves in order to maintain the two-month coverage of recurrent spending through end-2011 while channeling resources to the newly established National

Box 1. Solomon Islands: The 2011 Budget

The 2011 Budget is aimed at building up the government's cash balances while channeling resources for infrastructure development. Revenue and expenditure are projected to increase significantly, and a small surplus is targeted to maintain the cash balance at two months of recurrent spending through end-2011. The budget also allocates SI$51 million to the newly established NTF for infrastructure development. The fund will be managed by the NTF Board and any unspent resources would be used for future infrastructure development. Unlike previous budgets, the contingency spending in the budget of about ¾ percent of GDP is fully funded.

The authorities introduced new systems to strengthen the budget process. The budget was formulated following consultations with each ministry, with the recurrent and development budgets included in the consolidated budget using the same format to facilitate budget deliberations in the Cabinet. The Ministry of Finance and Treasury (MOFT) distributed payroll warrants to each ministry to improve management and accountability and will provide support through the centralized payroll system. The government also implemented a new financial management system to monitor each ministry's spending.

Overall tax collections are expected to increase by more than half percent of GDP, owing to revenue efforts in the form of reducing exemptions, and strengthening administration and enforcement actions. Logging revenue is forecast to decline significantly on account of a 30 percent projected fall in logging production. However, tax collection from the new gold production (about ⅔ percent of GDP) is expected to offset this revenue shortfall.

The recurrent budget is kept constant while development budget is raised significantly. Although the wage bill is at the same level as in 2010, it includes a cost of living adjustment and the cost of hiring additional MOFT staff to strengthen revenue collection, whereas last year's wage bill incorporated one-time payments such as retroactive social security contribution. The development budget was increased significantly, partly due to the NTF allocation and the cost of hosting an international Art Festival in 2012.

Solomon Islands: The 2011 Budget and Fiscal Program

	2010		2011	
	Prog. (CR/10/359)	Est.	Prog. (CR/10/359)	Budget
	(In SI$ millions)			
Revenues and grants	2,102	2,258	2,266	2,256
Domestic revenue	1,626	1,758	1,860	1,969
Inland Revenues	1,032	1,120	1,188	1,280
Customs	431	493	498	503
Other ministries (incl. privatization)	163	146	175	186
Recurrent grants	391	396	326	207
Development grants appropriated	85	104	80	80
Expenditure 1/	2,055	1,987	2,211	2,232
Recurrent	1,695	1,637	1,782	1,707
Payrolls	580	588	605	588
Debt servicing	130	112	121	120
Other recurrent	985	937	1,056	1,000
Development	340	333	409	524
SIG funded	255	243	329	444
Of which: National Transport Fund (NTF)	…	…	…	51
Donor funded	85	89	80	80
Unrecorded expenditure	20	18	20	0
Balance (+ = increase in saving)	46	271	55	24
Excluding NTF	…	…	…	75
Memo items:				
Program cash balance (flow)	120	216	75	24
Program cash balance (stock)	167	263	242	287

Source: Solomon Islands Authorities.
1/ Includes contingency provisions of SI$53 million.

Transport Fund (NTF).[3] To capture this, the program targets for the stock of the government's cash balance have been adjusted upward by about SI$50 million for the remainder of the program.[4]

- The overall revenue projection is broadly appropriate, with significant upside potential. Staff pointed out that the projected logging revenue appeared conservative in light of the strong collection in the first quarter and based on discussions with forestry experts. However, the authorities indicated that logging production and revenue are expected to decline in the second half of the year due to scarcer supply and a projected increase in the taxable price of log exports. Staff welcomed the authorities' plan to apply the full formula-based price for log exports with an automatic quarterly adjustment starting in July. There is scope for additional customs revenue in light of the expected recovery in imports and new mining revenue, but continued efforts to strengthen customs enforcement are needed. Implementing the amendments to Customs and Excise and Income Tax Acts to legalize and streamline exemptions will also play a critical role in improving revenue collections.

- The budgeted expenditures reflect the authorities' commitment to limiting the growth of nonessential recurrent spending and ensuring adequate resources for development needs. Moreover, the fact that contingency spending in the budget is fully funded is an indication of greater fiscal discipline. Staff welcomed the plan to contain recurrent spending including the wage bill but encouraged the authorities to protect priority spending, including on health and education, to mitigate the adverse impact of rising fuel and food prices on the poor. In this context, the authorities indicated that they may consider reducing certain taxes on food and fuel items but not introducing new subsidies. The relatively large increase in the government-funded development budget (amounting to about 1 percent of GDP excluding NTF) is ambitious in view of the limited implementation capacity. In this regard, staff encouraged the authorities to prioritize spending on high-impact development projects and save any unspent budgetary resources. Staff welcomed the allocation of resources for infrastructure development through the NTF as a way to ring-fence the investment budget and to improve the implementation rate of investment projects.

- The mission also emphasized the need to ensure that any supplementary budget later in the year would be fully funded by additional revenue or spending cuts elsewhere,

[3] The government-donor NTF was established in June 2010, with assistance from the Asian Development Bank (AsDB), to channel funds from donors and other development partners for infrastructure developments. The Board of Management comprises government officials and donors who contribute to the NTF, and it reports to Parliament through the Ministry of Finance.

[4] The stock of cash balances is projected to decline during the first half of the year reflecting budget seasonality and delayed spending of budget support that was received at end-2010. The target for June 2011 is adjusted down for the expected delay in disbursement of budget support of the AsDB and the European Union from the second to third quarter of 2011.

and that any additional spending would prioritize spending on education, health, and infrastructure, while containing other recurrent spending.

8. **The authorities continued to make progress in implementing fiscal reforms.** The authorities have been making good progress in enforcing actions to collect income tax arrears and ensuring that the enforcement framework is well functioning. Therefore, staff supported the authorities' plan to remove this benchmark for the remainder of the program. The end-December 2010 program benchmarks on incorporating all line ministries into a centralized payroll system, on implementing the new Customs Valuation Act, and on obtaining Cabinet approval of the plan to reform the National Provident Fund (NPF) were all implemented on schedule. The amendment of Customs and Excise and Income Tax Acts to legalize and streamline exemptions took longer than expected, but the authorities submitted the amendment for Cabinet approval at end-May, with approval expected in June. The joint work with the World Bank on the Public Expenditure Review (PER) has identified key challenges in budget formulation, monitoring, and accounting, and provided a ten-year strategy for reforms. The authorities have also made good progress in developing the database to monitor budget execution in each ministry as well as collecting data on health and education, including those funded by recurrent budget support.

9. **Implementing a resource-based tax regime and adopting fiscal responsibility provisions would help ensure long-term fiscal sustainability.** The Fund's technical assistance (TA) missions to develop a resource-based tax regime took place in October 2010 and March 2011. The authorities are now seeking Cabinet approval by end-June 2011 (program benchmark) of a policy paper to formulate a new resource-based tax regime based on the Fund's TA recommendations. Looking ahead, legislative reforms to implement the new regime are expected to be undertaken during 2011–12. This should be complemented by the reform of mining regulations to improve transparency as highlighted by the recent controversy over the issuance of prospecting license for nickel mining. The authorities are also working on the reform of the Public Finance and Audit Act (PFAA), and as part of the reform, incorporate the fiscal responsibility provisions. The reform will be done through a consultative process to build ownership. In this context, the mission welcomed the authorities' plan to obtain Cabinet approval of a proposal to reform the PFAA and incorporate the fiscal responsibility provisions by end-June 2011 (revised program benchmark), and to publish the proposed amendments to the PFAA including the draft fiscal responsibility provisions, by end-September 2011 (new program benchmark). The Fund provided TA on drafting of the fiscal responsibility provisions in April 2011.

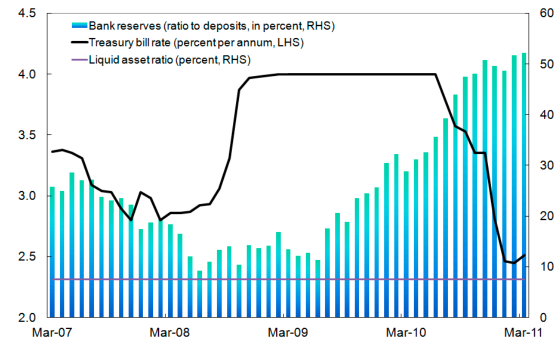
B. Monetary, Exchange Rate, and Financial Sector Policies

10. **Monetary conditions have been highly accommodative but there have been no signs of a pickup in credit** (Table 4)**.** The end-December target for net international reserves was surpassed by a wide margin, with the level estimated at US$256 million (against the adjusted target of US$204 million) at end-2010. With limited sterilization operations, banks' excess reserves have increased rapidly, with the reserves-to-deposit ratio reaching 50 percent

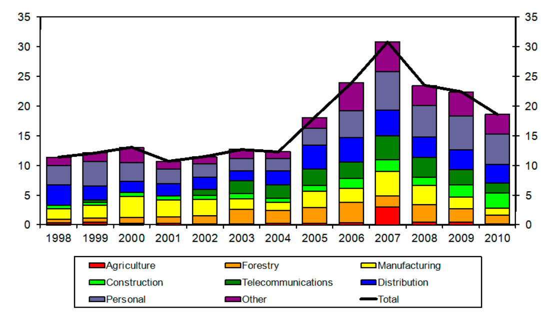
compared with the Liquid Asset Ratio (LAR) of 7½ percent. Reflecting this ample liquidity, the Treasury bill and Bokolo bill rate fell from 4 percent to 1½ percent in May 2011. Given that credit is still retrenching from the pre-2008 credit boom and political uncertainties had delayed the passage of the 2011 budget, banks were generally cautious and credit growth to the private sector was negative through March 2011 despite the easy monetary conditions. The sectoral distribution of banks' loan portfolio indicates a softening of demand for personal loans to finance real estate investments reflecting the expected gradual drawdown in expatriate Official Development Assistance workers as well as repayment of loans in the telecommunications and forestry sector where the investment cycle has matured. The end-December target for net domestic assets of the CBSI was met by a wide margin, owing to a large increase in government deposits at the CBSI.

11. **In view of the excess liquidity in the banking system, the CBSI will need to strengthen its monetary and liquidity management framework and stand ready to tighten monetary conditions should banks begin to expand credit aggressively**. Headline inflation has started to increase rapidly since January due to global fuel and food prices, but core inflation (based on nonfood and nonfuel price index) has remained relatively stable reflecting weak domestic demand. This, along with the continuing retrenchment in domestic credit, suggests that there is no immediate need for a tightening of monetary conditions. However, indications are that credit demand will pick up now that the delayed budget has been passed and spurred by continued strong economic growth. In view of this, staff encouraged the authorities to take precautionary measures to mop up liquidity by conducting larger open market operations and, if necessary, make a calibrated adjustment to the LAR.[5]

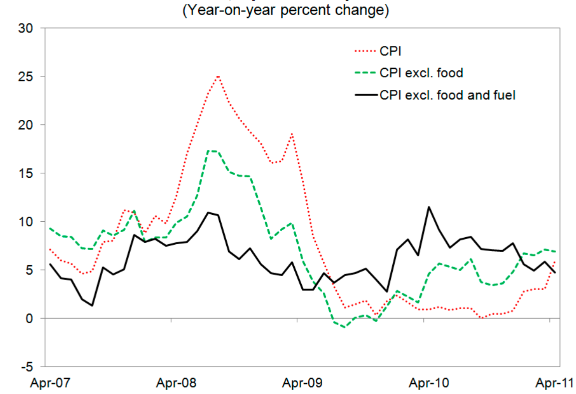
Bank Reserves, and Interest Rate, Mar. 2007–Mar. 2011



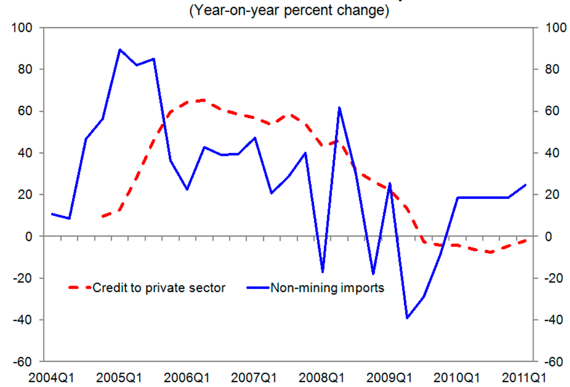
Commercial Bank Credit by Sector
(Percent of GDP)



Inflation, Apr. 2007–Apr. 2011
(Year-on-year percent change)



Credit to Private Sector and Imports
(Year-on-year percent change)



[5] The LAR will be replaced by a statutory cash reserve requirement starting on July 1, 2011 to improve its operational effectiveness.

12. **While the policy of keeping the exchange rate stable has provided the economy with a nominal anchor, the mission welcomed the CBSI's intention to allow greater flexibility in the exchange rate vis-à-vis the U.S. dollar**. In light of the comfortable level of foreign reserves, the CBSI had indicated that it would pursue greater exchange rate flexibility in the context of the trade weighted exchange rate basket regime, to cushion the inflationary impact of rising imported fuel and food prices and has allowed the nominal exchange rate to appreciate by more than 2 percent against the U.S. dollar since February 2011. As noted above, staff analysis suggests that headline inflation could move above the 5 percent inflation objective of the CBSI in 2011 in the absence of policy action. Taking into account the high import content and exchange rate pass-through in the economy, the mission estimated that a modest appreciation of the exchange rate would be quite effective in curbing imported inflationary pressure and bringing headline inflation closer to their inflation objective for the year. Given that the real effective exchange rate has depreciated by about 8 percent since early 2010, adjusting the nominal exchange rate by up to a similar magnitude would not be out of line with medium-term fundamentals and maintaining a comfortable reserve cushion. In light of the overperformance in the balance of payments, the program targets for the NIR have been adjusted upward by US$60 million for the remainder of the program to further reduce vulnerability to external shocks.

13. **Financial institutions remain compliant with prudential ratios although on-site examinations have revealed a weaker picture.** The most recent financial soundness indicators (FSIs) confirm that the banking system remains adequately capitalized and highly profitable. The ratio of nonperforming loans (NPLs) to total loans rose from 6.1 percent at end-June 2010 to 8.3 percent at end-December 2010 reflecting a slightly higher delinquency rate among consumers and small- and medium-size enterprises. While all banks are compliant with prudential ratios, on-site examination of two major banks has revealed weaknesses in financial reporting, resulting in a significant overstatement of capital.[6] It appears that banks are still in a transition phase, adjusting to the new prudential regulations issued in 2010 including gradually drawing down a few large loans which are above the single borrower limit. The NPF reform plan was approved by cabinet as envisaged under the program and the restructuring of a large nonperforming loan was undertaken in 2010. However, major weaknesses remain in the

Solomon Islands: Core Financial Soundness Indicators 1/

	2008	2009	2010			
			Mar.	Jun.	Sep.	Dec.
Capital adequacy:						
Regulated capital to risk-weighted assets	22.6	22.0	21.4	28.4	32.1	33.5
Tier 1 capital to risk-weighted assets	18.3	15.6	24.7	22.8	23.8	24.0
Nonperforming loans, net of provisions to capital	7.4	9.3	16.3	13.1	13.7	15.0
Asset quality:						
Nonperforming loans to total gross loans 2/	2.7	3.8	7.0	6.1	7.6	8.3
Earnings and profitability:						
Return on average assets	6.7	6.0	5.4	5.2	4.8	4.9
Return on average equity	43.0	34.4	33.2	31.1	28.1	28.5
Net interest income to gross income	50.2	52.6	48.3	48.1	47.7	43.9
Noninterest expenses to gross income	34.3	37.5	39.8	40.0	41.9	42.0
Liquidity:						
Liquid assets to total assets (liquid asset ratio)	20.6	33.4	37.7	40.9	47.7	47.7
Liquid assets to short-term liabilities	26.7	54.8	49.9	53.9	66.0	65.0

Source: Central Bank of Solomon Islands.

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

2/ The increase from December 2009 to March 2010 is due to changes in loan classification.

[6] The FSIs are expected to be revised later in the year to reflect the findings of the on-site examinations.

governance and financial performance of NPF as suggested by the on-site examination conducted by the Australian Prudential Regulation Authority.

14. **The supervisory and regulatory framework of the financial system will need to be further strengthened.** Staff welcomed the authorities' intention to amend the central bank law to strengthen the effectiveness of the CBSI in its conduct of monetary policy and supervisory activities (September 2011 program benchmark). The CBSI will continue to conduct on-site examinations of all banks in 2011 as part of a move from a compliance-based regulatory system to a more risk-based supervisory approach. These examinations will need to be followed up by steadfastly enforcing new prudential regulations and taking corrective actions as needed. Reforming the NPF, the largest pool of financial savings in the economy, based on the approved reform plan and on-site examinations, is a priority. The mission discussed progress in drafting the revisions to the NPF Act to incorporate an independent governance structure aimed at minimizing political interference in the operations and investment decisions. In light of the current policy debate on widening the coverage and mandate of the NPF, the authorities indicated that more time is needed to draft such revisions and build ownership among stakeholders. Therefore, the authorities will seek Cabinet approval of the drafting instructions for the revised NPF Act by end-September 2011 (new program benchmark) with the assistance of the World Bank.

C. Other Issues

15. **Financing.** The government is expected to continue to receive additional budget support from donors in 2011. AsDB is expected to disburse the second tranche (US$5 million) of its budget support program in the third quarter of 2011. The European Union (EU) is also expected to disburse around €2¼ million in the second half of the year. These AsDB and EU grants were previously projected to be disbursed in the second quarter, and this delay is reflected in the revised program targets.

16. **Debt management.** The review of the Honiara Club Agreement (HCA) is ongoing and is expected to be completed by end-2011. The authorities have been contacting the signatories of the HCA to formulate the terms of reference and develop the debt management strategy. The authorities have also received confirmation that the arrears to the European Investment Bank have been fully resolved.

17. **Safeguards assessment.** Good progress has been made in implementing the recommendations of the IMF Safeguards Assessment that was completed in October 2010. The CBSI Board has been fully constituted, thereby strengthening its oversight of central bank operation (December 2010 program benchmark). The authorities are preparing to publish the opinion rendered by an international audit firm on the CBSI audit results and the IFRS-based financial statements in order to increase overall transparency (end-June 2011 program benchmark).

18. **Statistical policy.** The authorities have continued to make progress in strengthening macroeconomic statistics. The National Statistics Office (NSO) published the official national

income account estimates for 2007–09 in February (June 2011 program benchmark) and the results of the 2009 Population and Housing Census in May. Work is now ongoing to revise the national account statistics by incorporating the results of the population census. Progress has also been made in strengthening the quality of fiscal and monetary data for program purposes although continued efforts are needed to ensure timely reporting.

19. **Successor arrangement.** The authorities and the donor community expressed their strong interest in a successor arrangement with the Fund to provide a macroeconomic policy framework to support the ambitious economic and financial reforms envisaged over the medium term. In this context, together with the donor community, the authorities are preparing the National Development Strategy, the Economic and Financial Reform Program, as well as implementing the recommendations of the PER. Staff welcomed these initiatives and indicated that the modality of a successor arrangement could be discussed during the third and final review under the SCF arrangement scheduled for late September (Table 5).

III. STAFF ASSESSMENT

20. **Fiscal policy.** The authorities' efforts in delivering strong program performance, preserving the program targets, and implementing the structural reforms are commendable. By adhering to program commitments, the overall fiscal position and cash balances have improved remarkably, and the challenge now is to preserve the strong fiscal position and improve the quality of government spending. In the near term, ensuring that the 2011 Budget and a possible supplemental budget are implemented consistent with the program is important to consolidate the strong gains made in 2010. The authorities should also continue their efforts to strengthen public finance management, including revenue administration, cash and debt management, budget processes, and expenditure prioritization. Medium-term fiscal sustainability would rely on legislative reforms to implement the resource-based tax regime and to incorporate the fiscal responsibility provisions. Given the importance of mining to the future of the economy, the authorities should move quickly to enact a transparent and predictable mining regime to attract foreign investment and ensure that the development of the mining sector benefits the wider population. The review of the HCA should be finalized by end-2011 to send an important signal toward future borrowing capacity and debt sustainability.

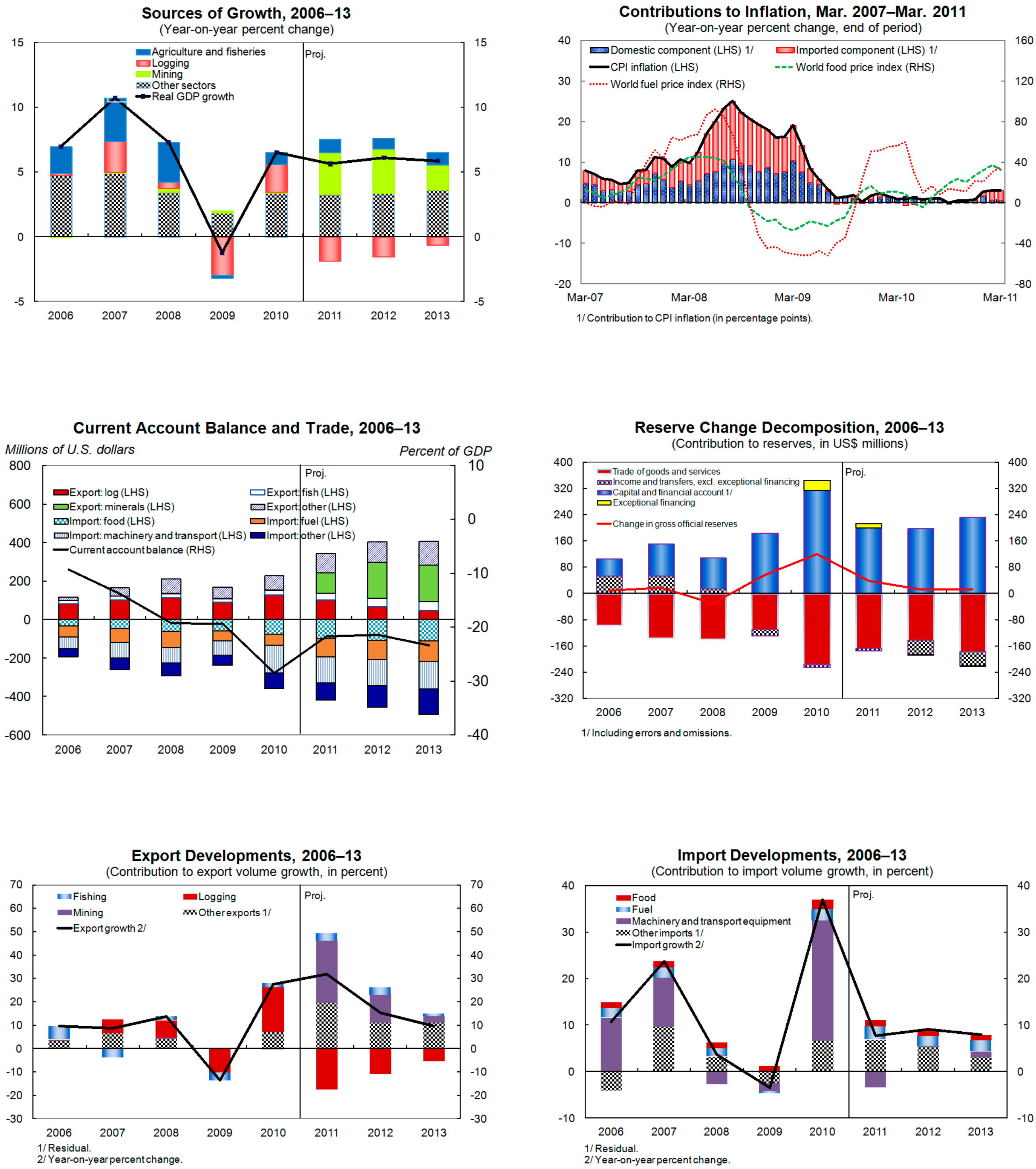
21. **Monetary and exchange rate policies.** Inflation is low but headline inflation has picked up strongly in line with rising imported fuel and food prices. Given the high level of banks' excess liquidity and appetite for secure interest-bearing assets, it would be prudent for the CBSI to start mopping up some of the excess reserves by conducting larger open market operations. The CBSI should also closely monitor credit developments and stand ready to raise the cash reserve requirement if banks begin to expand credit aggressively and demand-led inflationary pressures emerge. In light of the strong external position, staff supports the CBSI's policy to allow a modest appreciation of the exchange rate to help mitigate the impact of rising fuel and food import prices on inflation while maintaining competitiveness and a comfortable level of foreign reserves.

22. **Financial sector policy.** The banking system remains well-capitalized and highly profitable although on-site examinations revealed some weaknesses in financial reporting. The CBSI should continue with on-site examinations of all banks in 2011 and enforce prudential regulations and corrective actions as needed. Reforming the NPF to strengthen its governance structure and minimize political interference remains a top priority in order to safeguard the retirement savings of members and ensure an adequate return. In this context, staff supports the authorities' plan to hold public consultations on the NPF reforms and to seek Cabinet approval of the drafting instructions to amend the NPF Act by end-September with the assistance of the World Bank.

23. **Risks.** In light of the comfortable level of the government cash reserves and the expected windfall revenue from a larger-than-projected logging production, the government will be under pressure to increase spending beyond the budget. In view of this, the authorities will need to ensure that any supplementary budget would be consistent with program commitments, particularly in controlling the growth of nonessential spending and saving the unspent resources to build up cash reserves or to finance future infrastructure development. Maintaining some cash buffer on top of the program target would also be important to mitigate the fiscal risk considering that logging and gold revenues are vulnerable to a decline in prices. Excess liquidity in the banking system could potentially lead to a credit boom and overheating while rising international fuel and food prices continue to pose inflationary risks.

24. **Program overview.** The authorities' achievement in meeting the program's performance criteria and benchmarks is commendable. Based on the performance under the program and the authorities' commitment to implementing the program going forward, staff recommends the completion of the second SCF review and release of the corresponding disbursement.

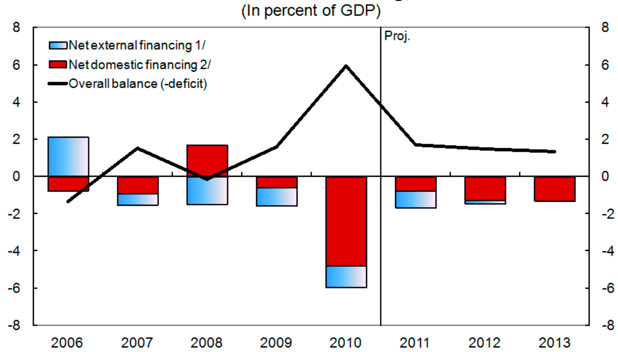
Figure 1. Solomon Islands: Macroeconomic Developments



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

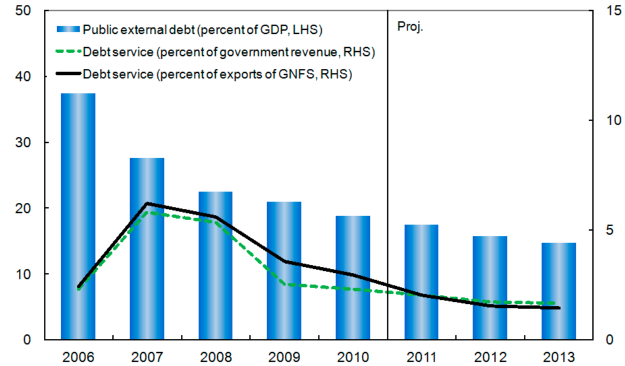
Solomon Islands: Macroeconomic Developments (concluded)

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

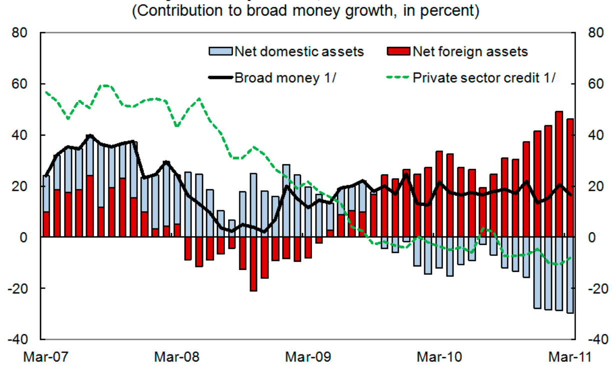


1/ Between 2005–07, includes debt forgiveness.
2/ Includes privatization receipts.

Public External Debt, 2006–13

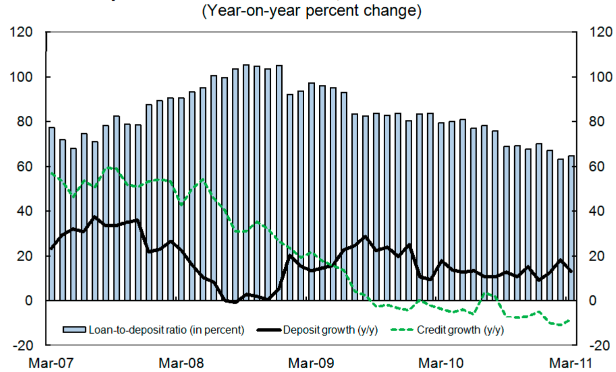


Monetary Developments, Mar. 2007—Mar. 2011
(Contribution to broad money growth, in percent)

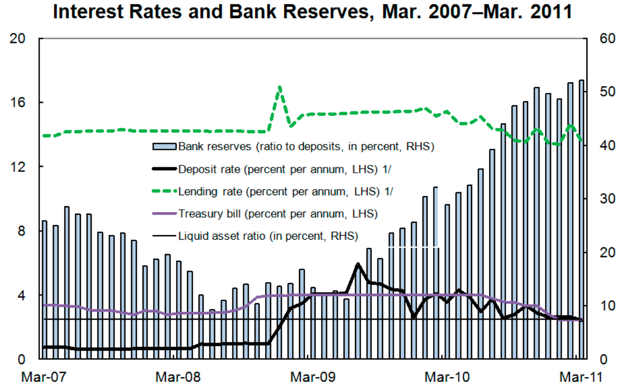


1/ Year-on-year percent change.

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

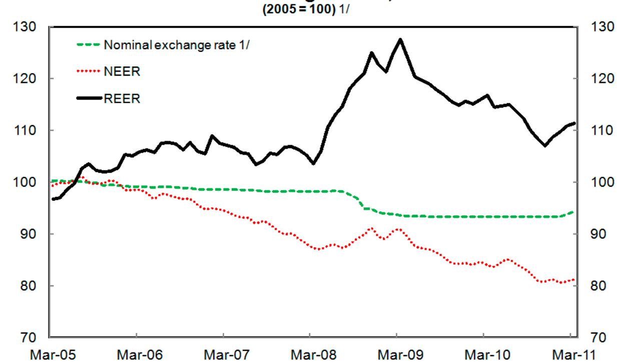


Interest Rates and Bank Reserves, Mar. 2007–Mar. 2011



1/ Weighted average rate of the commercial banks.

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



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

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

Table 1. Solomon Islands: Selected Economic Indicators, 2009-12

Nominal GDP (2009): US$663 million (estimate)
Population (2009): 516 thousand (estimate)

	2009	2010		2011		2012
		Proj.	Est.	Proj.	Rev.Proj.	Proj.
		(CR/10/359)		(CR/10/359)		
Growth and prices (percentage change)						
Real GDP	-1.2	3.9	6.5	7.6	5.6	6.1
Of which : nontimber nonmining	…	…	4.7	…	4.8	4.7
CPI (period average)	7.1	1.5	1.0	4.0	6.0	5.0
CPI (end of period)	1.8	2.9	0.8	4.2	6.5	5.6
GDP deflator	8.0	2.3	1.6	2.8	2.7	3.7
Nominal GDP (in SI$ millions)	5,339	5,679	5,780	6,286	6,270	6,895
Per capita GDP (in US$)	1,285	1,327	1,357	1,437	1,457	1,567
Per capita GNI (in US$)	965	1,084	1,053	1,112	1,107	1,174
Central government operations (percent of GDP)						
Total revenue and grants	49.8	54.0	59.4	53.7	57.7	53.9
Revenue	27.5	28.5	30.4	29.6	31.2	31.7
Grants	22.3	25.5	29.0	24.1	26.5	22.2
Total expenditure	48.2	51.6	53.5	51.3	56.0	52.5
Recurrent expenditure	25.8	28.1	26.8	26.9	27.7	27.6
Development expenditure	23.1	23.1	26.4	24.1	28.4	24.9
Unrecorded expenditure 1/	-0.6	0.4	0.3	0.3	0.0	0.0
Overall balance	1.6	2.4	5.9	2.3	1.7	1.5
Foreign financing (net)	-1.0	-1.2	-1.1	-0.9	-0.9	-0.2
Domestic financing (net)	-1.4	-1.4	-4.8	-1.4	-0.9	-1.3
Privatization receipts	0.8	0.2	0.0	0.0	0.2	0.0
Central government debt (percent of GDP, unless otherwise indicated) 2/	30.5	25.8	27.1	22.7	24.5	21.2
Domestic debt	9.6	6.6	8.3	5.1	7.0	5.5
External debt	20.9	19.2	18.8	17.6	17.4	15.7
(In US$ millions, end of period)	138.7	134.9	134.7	137.0	137.4	135.9
Monetary and credit (percentage change, end-year data)						
Credit to private sector	-4.2	1.0	-4.7	15.0	5.0	10.0
Broad money	24.7	24.9	13.5	15.0	15.0	15.0
Reserve money	62.5	49.2	75.3	14.6	13.9	8.9
Interest rate - deposit (percent per annum)	2.7	…	2.6	...	...	...
Interest rate - lending (percent per annum)	15.4	...	13.5	...	...	...
Balance of payments (in US$ millions, unless otherwise indicated)						
Current account balance	-128.2	-179.1	-204.4	-172.3	-171.0	-185.3
(Percent of GDP)	-19.3	-25.4	-28.5	-22.1	-21.7	-21.4
(excluding mining-related capital imports, in percent of GDP)	…	…	-17.8	…	-13.2	-12.5
Exports of goods and nonfactor services (GNFS)	234.9	255.3	333.0	342.4	458.0	528.9
(Percentage change)	-12.9	9.0	41.8	34.1	37.5	15.5
Imports of GNFS	344.2	461.7	547.8	499.2	624.4	670.3
(Percentage change)	-15.8	35.3	59.2	8.1	14.0	7.3
Overall balance	56.4	54.6	110.2	30.7	28.8	12.8
Gross official reserves (in US$ millions, end of period) 3/	146.0	209.9	265.8	250.0	304.6	317.2
(In months of next year's imports of GNFS)	3.2	5.0	5.1	6.0	5.5	5.3
(In months of next year's nonmining-related imports of GNFS)	4.4	6.3	6.7	7.2	7.2	7.0
Exchange rate (SI$/US$, end of period)	8.06	...	8.06	...	...	...
Real effective exchange rate (period average, 2005 = 100)	120.6	...	111.9	...	...	...
Nominal effective exchange rate (period average, 2005 = 100)	88.7	...	83.5	...	...	...

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

1/ Includes changes in the stock of unpaid payment orders and unpresented checks and the statistical discrepancy.
2/ Includes disbursement under an IMF-supported arrangement
3/ Includes SDR allocations made by the IMF to the Solomon Islands in 2009 and actual and prospective disbursements under the IMF-supported arrangement.

Table 2. Solomon Islands: Balance of Payments, 2009-12 1/

(In millions of U.S. dollars)

	2009	2010		2011		2012	
	Est.	Proj. (CR/10/359)	Prelim.	Proj. (CR/10/359)	Rev. Proj.	Proj. (CR/10/359)	Rev. Proj.
Current account balance	-128.2	-179.1	-204.4	-172.3	-171.0	-155.3	-185.3
Trade balance for goods	-74.3	-163.3	-133.8	-108.7	-78.3	-45.0	-54.0
Exports	164.9	184.1	226.5	266.3	341.3	323.3	402.1
Logs	88.1	101.8	124.7	87.8	101.2	70.9	66.1
Fish	16.6	18.9	24.4	21.9	34.8	25.8	43.8
Minerals	3.7	3.8	3.2	89.5	106.3	153.7	184.9
Other	56.5	59.6	74.2	67.1	99.0	72.9	107.3
Imports	-239.2	-347.4	-360.3	-375.0	-419.6	-368.3	-456.1
Food	-60.4	-70.6	-78.5	-73.0	-101.9	-76.5	-110.7
Fuel	-51.9	-55.0	-56.7	-85.3	-93.7	-102.1	-99.3
Other	-126.9	-221.8	-225.1	-216.7	-224.1	-189.8	-246.1
Of which: Machinery and transport equipment	-74.2	…	-143.4	…	-134.9	…	-134.3
Trade balance for services	-35.1	-43.1	-81.0	-48.0	-88.1	-53.0	-87.4
Exports	69.9	71.2	106.5	76.2	116.7	80.9	126.8
Imports	-105.0	-114.3	-187.5	-124.2	-204.8	-133.9	-214.2
Income balance	-164.9	-128.6	-160.7	-176.7	-189.2	-204.5	-217.2
Current transfers balance 2/	146.1	156.0	171.1	161.1	184.6	147.2	173.2
Of which : Official transfers, net	120.8	155.4	167.5	160.5	180.7	144.9	167.9
Capital and financial account balance	164.7	233.7	319.8	203.0	199.7	186.1	198.1
Capital account balance	26.8	23.8	49.8	26.7	30.4	24.1	27.3
Direct investment balance	116.8	212.6	235.6	184.5	174.7	166.7	173.3
Portfolio investment balance	1.2	0.0	-2.6	0.0	0.0 .	0.0	0.0
Other investment balance 3/	19.9	-2.7	37.1	-8.3	-5.4	-4.7	-2.6
Errors and omissions	19.9	0.0	-5.1	0.0	0.0	0.0	0.0
Overall balance	56.4	54.6	110.2	30.7	28.8	30.8	12.8
Financing	-56.4	-54.6	-110.2	-30.7	-28.8	-30.8	-12.8
Change in gross reserves (- = increase)	-56.4	-63.9	-119.8	-40.0	-38.8	-30.7	-12.7
IMF	…	9.3	9.6	9.3	10.0	-0.1	-0.1
Memorandum items:							
Current account (in percent of GDP)	-19.3	-25.4	-28.5	-22.1	-21.7	-18.3	-21.4
(excluding mining-related imports)	…	-15.2	-17.8	-13.3	-13.2	-12.6	-12.5
(excluding net official transfers)	-37.6	-47.5	-51.9	-42.7	-44.6	-35.4	-40.8
Net international reserves 3/	146.0	200.6	256.2	231.3	285.0	262.1	297.8
Gross official foreign reserves 3/ 4/	146.0	209.9	265.8	250.0	304.6	280.6	317.2
In months of next year's goods and nonfactor services (GNFS)	3.2	5.0	5.1	6.0	5.5	6.7	5.3
In months of nonmining-related imports of GNFS	4.4	6.3	6.7	7.2	7.2	8.3	7.0
Gross external public debt (in percent of GDP)	20.9	19.2	18.8	17.6	17.4	16.3	15.7
External public debt service (in percent of exports of GNFS)	3.6	…	3.0	…	2.0	…	1.5
Nominal GDP	662.8	…	716.7	…	…	…	…

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

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

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

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

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

Table 3. Solomon Islands: Summary of Fiscal Accounts, 2009-11

	2009	2010			2011		
		Budget	Prog. (CR/10/359)	Est.	Prog (CR/10/359)	Budget	Rev.Prog.
	(In millions of Solomon Islands dollars)						
Total revenue and grants	2,659	3,139	3,064	3,434	3,373	3,635	3,620
Total revenue	1,467	1,644	1,616	1,757	1,860	1,959	1,959
Tax revenue	1,272	1,430	1,446	1,589	1,668	1,760	1,762
Income and profits	540	519	576	638	664	741	735
Goods and services	423	569	536	569	601	641	639
International trade and transactions	309	342	334	382	403	378	389
Of which: Tax on logging	162	…	202	241	196	199	197
Other revenue	196	214	170	168	193	199	197
Grants	1,192	1,495	1,448	1,677	1,513	1,676	1,661
Development grants	1,054	1,322	1,058	1,281	1,187	1,469	1,335
Recurrent budget grants 1/	138	173	391	396	326	207	326
Expenditure	2,574	3,153	2,929	3,091	3,226	3,529	3,514
Of which: appropriated 2/	1,521	1,831	1,871	1,809	2,039	2,060	2,179
Recurrent expenditure	1,376	1,536	1,596	1,548	1,690	1,616	1,735
Compensation of employees	511	487	580	588	605	588	588
Interest payments	45	34	31	23	29	29	29
Other recurrent expenditure 3/	820	1,015	985	937	1,056	1,000	1,118
Development expenditure	1,231	1,617	1,313	1,525	1,516	1,914	1,779
Of which: Domestically financed	178	295	255	243	329	444	444
Of which: National Transport Fund (NTF)	…	…	…	…	…	51	51
Unrecorded expenditure 4/	-33	0	20	18	20	0	0
Current balance	230	281	242	605	471	550	550
Overall balance	85	-14	135	343	147	106	106
(excluding NTF)	…	…	…	…	…	157	157
Total financing	-85	14	-135	-343	-147	-106	-106
Foreign (net)	-53	-53	-65	-65	-58	-58	-58
Disbursements	0	0	0	0	0	0	0
Amortization	-53	-53	-65	-65	-58	-58	-58
Debt forgiveness	0	0	0	0	0	0	0
Domestic (net)	-77	47	-80	-279	-89	-58	-58
Banking system	-64	55	-88	-282	-80	-49	-49
Central bank	-25	80	-105	-284	-55	-24	-24
Commercial banks	-39	-25	17	2	-25	-25	-25
Nonbank	-13	-8	8	2	-9	-9	-9
Others 5/	45	20	10	1	0	10	10
	(In percent of GDP)						
Total revenue and grants	49.8	56.2	54.0	59.4	53.7	58.0	57.7
Total revenue	27.5	29.5	28.5	30.4	29.6	31.2	31.2
Tax revenue	23.8	25.6	25.5	27.5	26.5	28.1	28.1
Income and profits	10.1	9.3	10.1	11.0	10.6	11.8	11.7
Goods and services	7.9	10.2	9.4	9.8	9.6	10.2	10.2
International trade and transactions	5.8	6.1	5.9	6.6	6.4	6.0	6.2
Other revenue	3.7	3.8	3.0	2.9	3.1	3.2	3.1
Grants	22.3	26.8	25.5	29.0	24.1	26.7	26.5
Expenditure	48.2	56.5	51.6	53.5	51.3	56.3	56.0
Recurrent expenditure	25.8	27.5	28.1	26.8	26.9	25.8	27.7
Compensation of employees	9.6	8.7	10.2	10.2	9.6	9.4	9.4
Interest payments	0.8	0.6	0.5	0.4	0.5	0.5	0.5
Other recurrent expenditure 3/	15.4	18.2	17.3	16.2	16.8	15.9	17.8
Development expenditure	23.1	29.0	23.1	26.4	24.1	30.5	28.4
Of which: Domestically financed	3.3	5.3	4.5	4.2	5.2	7.1	7.1
Unrecorded expenditure 4/	-0.6	0.0	0.4	0.3	0.3	0.0	0.0
Current balance	4.3	5.0	4.3	10.5	7.5	8.8	8.8
Overall balance	1.6	-0.2	2.4	5.9	2.3	1.7	1.7
(excluding NTF)	…	…	…	…	…	2.5	2.5
Total financing	-1.6	0.2	-2.4	-5.9	-2.3	-1.7	-1.7
Foreign (net)	-1.0	-1.0	-1.2	-1.1	-0.9	-0.9	-0.9
Domestic (net)	-1.4	0.8	-1.4	-4.8	-1.4	-0.9	-0.9
Others 5/	0.8	0.4	0.2	0.0	0.0	0.2	0.2
Memorandum items:							
Nominal GDP (in SI$ millions)	5,339	5,581	5,679	5,780	6,286	6,270	6,270
Gross cash balance (in SI$ millions) 6/	106	…	206	326	261	351	351
Program cash balance (in SI$ millions) 6/	47	…	167	263	242	287	287

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

1/ Reflect propective budget support from donors in 2011-12. The 2011 Budget does not include some grants that are projected under the program.
2/ Expenditure appropriated or recorded in the government's recurrent and development estimates, including supplemental budget appropriations.
3/ Includes spending financed by recurrent budget grants.
4/ Includes changes in the stock of unpaid payment orders and unpresented checks (+ = reduction) and the statistical discrepancy.
5/ Includes privatization and receipts from a telecom company related to the sale of new telecommunication license.
6/ Gross cash balance is the sum of government deposits in the core cash balance accounts. Program cash balance is the gross minus unpaid payments orders and unpresented checks.

Table 4. Solomon Islands: Summary Accounts of the Banking System, December 2009 - December 2011 1/

	2009	2010		2011						
	Dec.	Dec.		Mar.		Jun.		Sep	Dec.	
		Prog.	Est.	Prog.	Prel.Est.	Prog.	Rev. Prog.	Rev. Prog.	Proj.	Rev. Proj.
		(CR/10/359)		(CR/10/359)		(CR/10/359)			(CR/10/359)	
	(In millions of Solomon Islands dollars, end of period)									
Central Bank of Solomon Islands (CBSI)										
Net foreign assets (NFA)	1,051	1,492	1,942	1,535	2,133	1,600	2,130	2,154	1,739	2,170
Net international reserves (NIR)	1,177	1,618	2,066	1,661	2,261	1,726	2,258	2,282	1,865	2,298
Other NFA	-126	-126	-124	-126	-128	-126	-128	-128	-126	-128
Net domestic assets (NDA) 2/	-328	-411	-673	-401	-767	-411	-700	-722	-489	-725
Net claims on central government	-77	-182	-361	-144	-373	-182	-331	-353	-225	-385
Claims	124	119	117	119	118	119	117	117	119	117
Deposits	201	301	479	263	491	301	449	471	344	503
Other items (net)	-250	-229	-312	-257	-394	-229	-369	-369	-264	-340
Reserve money	724	1,080	1,269	1,134	1,366	1,189	1,430	1,432	1,250	1,445
Currency in circulation	326	397	436	410	449	424	453	456	450	460
Bank deposits	389	678	822	721	908	762	974	972	797	982
Other deposits	9	5	11	3	10	3	3	3	3	3
Other depository corporations										
NFA of commercial banks	181	219	51	237	36	241	39	41	232	44
Assets	184	236	141	240	195	243	198	200	250	203
Liabilities	2	17	89	2	159	2	159	159	18	159
NDA of commercial banks	927	989	760	1,003	766	1,031	774	845	1,149	903
Net claims on central government	51	68	53	63	42	58	43	36	43	29
Claims	125	94	121	89	119	84	111	104	69	96
Deposits	74	26	68	26	76	26	68	68	26	68
Claims on the private sector	1,219	1,232	1,163	1,272	1,124	1,320	1,157	1,189	1,416	1,221
Other items (net)	-343	-311	-456	-332	-401	-347	-425	-380	-310	-346
Reserves and vault cash	410	704	847	750	938	806	1,013	1,002	826	1,008
Deposits	1,519	1,912	1,658	1,990	1,740	2,077	1,826	1,889	2,207	1,955
Depository corporations survey										
NFA of the banking system	1,233	1,711	1,994	1,772	2,170	1,840	2,169	2,195	1,971	2,214
Central bank	1,051	1,492	1,942	1,535	2,133	1,600	2,130	2,154	1,739	2,170
Other depository corporations	181	219	51	237	36	241	39	41	232	44
NDA of the banking system	600	578	87	602	-1	620	74	122	660	178
Net claims on central government	-26	-114	-308	-81	-331	-124	-288	-317	-182	-357
Claims on the private sector 3/	1,224	1,236	1,166	1,277	1,128	1,325	1,160	1,193	1,421	1,225
Other items (net)	-598	-544	-772	-594	-798	-581	-798	-753	-579	-690
Broad money (M3)	1,833	2,288	2,080	2,374	2,168	2,460	2,243	2,318	2,632	2,392
M1	1,130	1,410	1,310	1,463	1,494	1,516	1,412	1,459	1,622	1,506
Currency outside banks	305	372	412	381	418	380	414	426	421	434
Demand deposits	824	1,039	898	1,082	1,075	1,136	998	1,033	1,201	1,072
Savings and time deposits	703	878	771	911	675	944	831	859	1,010	886
	(Annual percentage change, unless otherwise indicated)									
Reserve money	62.5	49.2	75.3	44.2	73.7	28.2	54.3	26.3	15.7	13.9
Credit to the private sector	-4.2	1.0	-4.7	4.7	-8.0	8.7	-4.9	6.7	15.0	5.0
Broad money	24.7	24.9	13.5	22.4	16.7	22.5	17.2	18.1	15.0	15.0
NFA of the banking system 4/	26.4	26.1	41.5	18.6	47.9	16.1	39.3	30.6	11.4	10.6
NDA of the banking system 4/	-1.7	-1.2	-28.0	3.8	-31.2	6.4	-22.2	-12.5	3.6	4.4
Memorandum items:										
Money multiplier	2.5	2.1	1.6	2.1	1.6	2.1	1.6	1.6	2.1	1.7
Loan to deposit ratio (in percent)	80.3	64.4	70.1	63.9	64.6	63.6	63.3	62.9	64.2	62.4
Interest rates (percent per annum)										
Deposit rate 5/	2.7	…	2.6	…	2.4	…	…	…	…	…
Lending rate 5/	15.4	…	13.5	…	13.5	…	…	…	…	…
91-Day Treasury Bill Rate	4.0	…	2.9	…	2.9	…	…	…	…	…
Program targets										
NIR of CBSI (in US$ millions)	146	201	256	206	280	214	280	283	…	…
NDA of CBSI (in SI$ millions)	-328	-411	-673	-401	-767	-411	-700	-722	…	…

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

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

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

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

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

5/ Weighted average of different maturities.

Table 5. Solomon Islands: Reviews and Disbursement Under the Standby Credit Facility

Date	Amount of Disbursement		Condition
	In percent of quota	In SDR	
June 2, 2010	30	3,120,000	Approved Fund arrangement
November 17, 2010	30	3,120,000	Completion of the first review and observance of end-June 2010 performance criteria
May 15, 2011	30	3,120,000	Completion of the second review and observance of end-December 2010 performance criteria
November 15, 2011	30	3,120,000	Completion of the third review and observance of end-June 2011 performance criteria
Total	120	12,480,000	

Source: IMF.

APPENDIX I—LETTER OF INTENT

Ref: 457/5/5 May 23, 2011

Mr. John Lipsky
Acting Managing Director
International Monetary Fund
Washington, DC 20431

Dear Mr. Lipsky,

The Solomon Islands has benefited from sound macroeconomic policies of the Government's economic reform program that is supported by a Standby Credit Facility (SCF) arrangement. Economic and fiscal performances were stronger than expected, foreign reserves reached a high level, and inflation has remained moderate.

We will continue to implement the program described in the May 14, 2010 Memorandum of Economic and Financial Policies (MEFP), aimed at promoting strong, sustainable, and equitable growth in a stable macroeconomic environment to help advance our poverty alleviation efforts. We are providing the attached Supplemental MEFP (SMEFP) to request modification of end-June performance criteria to reflect recent developments and reaffirm policy commitments for the rest of the program period.

Given the success of the program to date, the observance of all end-December 2010 quantitative targets, and the progress in implementing the structural benchmarks, we request the completion of the second review and the release of the corresponding disbursement. The program will continue to be monitored through quantitative performance criteria and indicative targets, structural benchmarks, and semi-annual reviews (see SMEFP Tables 1 and 2).

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

Sincerely yours,

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

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

APPENDIX I—ATTACHMENT I

SUPPLEMENTAL MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

I. RECENT DEVELOPMENT AND OUTLOOK

1. **Macroeconomic performance has been stronger than expected and the outlook remains favorable.** Real GDP growth rebounded strongly in 2010 owing to higher-than-expected logging and agricultural productions as well as large mining investment. Inflation remained low in 2010 reflecting domestic supply conditions but is expected to pick up owing to rising global food and fuel prices. The overall balance of payments surplus was larger than anticipated due to large foreign investment, donor support, and other flows, contributing to a record level of gross international reserves. The near-term growth outlook is favorable due to rebound in economic activities including gold mining that has come on stream this year.

2. **The program targets for end-December were met with comfortable margins.** Our fiscal performance in 2010 was stronger than envisaged under the program due to greater revenue collections and expenditure restraint. As a result, we managed to build up our cash balance to around SI$260 million by end-2010, covering two months of recurrent spending. On the monetary side, large foreign exchange inflows from exports, investments, as well as donor support contributed to an increase in net international reserves, reaching US$256 million at end-2010. The targets for net credit to government and the central banks' net domestic assets were also met with comfortable margins (Table 1).

II. PROGRAM POLICIES

A. Fiscal Policies

3. **We have formulated our 2011 Budget to ensure that it reflects our program commitment to strengthening public finance and fiscal sustainability.** We intend to preserve our fiscal over-performance in 2010 by maintaining cash reserves at over two months of recurrent spending through end-2011, while channeling more than SI$50 million to the newly established National Transport Fund (NTF). We have ensured that the budget is fully funded and improved the budget process by aligning the priorities with the government's policy strategy and strengthening the consultation process with each ministry.

- On revenue, we intend to improve tax and customs collections by reducing exemptions, and strengthening administration and enforcement actions. In addition, we expect additional revenue from the commencement of gold exports this year. We remain committed to applying the full amount of the formula-based price for logging exports, with a quarterly automatic price adjustment, starting on July 1, 2011.

- On expenditure, the budget reflects our commitment to limiting the growth of nonessential recurrent spending while ensuring adequate resources for development needs. We intend to restrain the growth of recurrent spending including the wage bill while protecting priority spending and any measures that mitigate the potential adverse impact of rising fuel and food prices on the poor. The development budget reflects our commitment to developing infrastructure, especially in rural areas. We strive to ensure that our development budget will be used to finance high-impact development projects and plan to save any unspent budgetary resources.

- In order to ensure that the budget remains fully funded, and that the budgeted cash balances are preserved, any supplementary budget and additional contingency warrants will be funded by new revenue measures, savings measures, or updated revenue estimates. Any additional spending under a supplementary budget will prioritize education, health, and infrastructure, including through the NTF, while containing other recurrent spending.

4. **We have made good progress in implementing the structural fiscal reforms under the program** (Table 2). We continue to make progress in enforcing actions to collect income tax arrears. Since the enforcement framework is now in place, we request this benchmark be removed for the remaining period of the program. We have implemented the new Customs Valuation Act, incorporated all line ministries into a centralized payroll system, and obtained Cabinet approval of the plan to reform the National Provident Fund (NPF) (December 2010 program benchmarks). The drafting of amendments to the Customs and Excise and Income Tax Acts to legalize and streamline exemptions (December 2010 program benchmark) took longer than expected, but we plan to submit the draft amendment to Cabinet by end-May with approval expected in June.

5. **We are also moving ahead with our fiscal reforms to ensure long-term overall fiscal sustainability.** In this context, we intend to obtain Cabinet approval of a policy paper on formulating the new resource-based tax regime based on Fund Technical Assistance (TA) recommendations by end-June 2011 (program benchmark) and reforming the relevant legislations to implement the new regime during 2011–12. Until this regime is in place, we will refrain from approving mining lease that includes the participation by the government in the sharing of production, revenues, profits, or in the equity capital of the mining company. Prospecting licenses will continue to be granted under the Mines and Mineral Act. We also made progress in drafting fiscal responsibility provisions to be incorporated into the Public Finance and Audit Act (PFAA) that is now being reformed. We seek to ensure that PFAA reform and the formulation of fiscal responsibility provisions are done through a consultative process to build ownership. In view of this, we intend to obtain Cabinet approval by end-June 2011 of a proposal to reform the PFAA, and as part of the reform, incorporate the fiscal responsibility provisions (revised program benchmark). After the first round of consultation with the stakeholders, we intend to publish the proposed amendments to PFAA including the draft fiscal responsibility provisions by end-September 2011 (new program benchmark).

B. Monetary, Exchange Rate, and Financial Sector Policies

6. **Monetary and exchange rate policies are geared toward maintaining price and external stability.** In light of the comfortable level of foreign reserves, the Central Bank of Solomon Islands' (CBSI) has decided on a modest adjustment of the exchange rate to mitigate the inflationary impact of the anticipated rapid increase in imported fuel and food prices.

Monetary growth remains robust and banks' excess reserves continue to accumulate, reflecting large external inflows from large donor support and buoyant exports. Credit growth remains negative despite the pickup in economic activity as banks remain cautious. However, credit growth is expected to pickup in 2011 following the passage of the 2011 Budget and general recovery in the economy. The CBSI will closely monitor credit developments and tighten monetary conditions using both direct and indirect monetary instruments should banks begin to expand credit. In view of the high level of banks' excess reserves, the CBSI will continue to mop up liquidity.

7. **To strengthen the effectiveness of CBSI in the conduct of monetary policy and supervisory activities, we are amending the CBSI Act.** The amendment has been drafted, and we will seek a Cabinet approval of the draft by end-September 2011 (new program benchmark).

8. **We continue our efforts to strengthen the financial sector.** The financial soundness indicators confirm that the banking system remains adequately capitalized and highly profitable, albeit with a modest rise in nonperforming loans. While all banks are above the prudential ratios, on-site examinations of banks revealed weaknesses in accounting and classification, resulting in a significant overstatement of capital and underprovisioning. The CBSI has requested the banks to undertake corrective actions and imposed a fine in the case of one bank, and will continue to enforce new prudential regulations issued in 2010. On reforms to the National Provident Fund (NPF), more time is needed to draft the amendments to the NPF Act (June 2011 program benchmark) with the assistance of the World Bank in line with the policy paper approved by the Cabinet last year. We believe more consultations among stakeholders are needed to strengthen ownership of the NPF reforms. In this regard, we plan to seek Cabinet approval of the drafting instructions to the amendments by end-September 2011 (new program benchmark).

III. Other Issues

9. **External debt and arrears:** As part of the ongoing review of the Honiara Club Agreement (HCA), we are working on our debt management strategy and, together with the signatories of the HCA, formulating the terms-of-reference for the review. We plan to finalize our debt strategy by July, in time for the expected public consultation to formulate our fiscal responsibility provisions to ensure consistency. Moving forward, we plan to have the formal meeting of the HCA review before the end of 2011. We have finally received confirmation that the arrears to the European Investment Bank have been fully resolved.

10. **Safeguards assessment:** We have fully constituted the CBSI Board as recommended by the IMF Safeguards assessment (December 2010 program benchmark). We will be publishing annually, starting with the 2010 accounts, the opinion rendered by the international audit firm on CBSI audit results and the IFRS-based financial statements (June 2011 program benchmark).

11. **Statistical issues:** In February 2011, the National Statistics Office (NSO) published the national income accounts statistics for 2007–09 (June 2011 program benchmark). However, the work is still ongoing to revise these statistics, including by incorporating the results of the population census. The NSO plans to publish the revised statistics by end-June 2011.

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

	9/30/2010			12/31/2010			3/31/2011			6/30/2011		9/30/2011
	IT (CR/10/359)	IT with adjustors	Est.	PC (CR/10/359)	PC with adjustors	Est.	IT (CR/10/359)	IT with adjustors	Prel. Est.	PC (CR/10/359)	Rev. PC	IT
Performance criteria 1/												
Net international reserves (NIR) of the Central Bank of Solomon Islands (CBSI) (floor, eop stock, in millions of U.S. dollars (US$)) 2/	141	146	205	201	204	256	206	197	280	214	280	283
Net domestic asset (NDA) of the CBSI (ceiling, eop stock, in millions of Solomon Islands dollars (SI$)) 3/	-327	-365	-435	-401	-426	-673	-401	-332	-767	-411	-700	-722
Net credit to central government (NCG) (ceiling, cumulative change from the beginning of the year, in millions of SI$) 4/	22	22	30	-80	-80	-279	31	100	-23	-14	17	-15
New nonconcessional external debt maturing in more than one year, contracted or guaranteed by the public sector (ceiling, eop stock since the beginning of the program, in millions of US$) 5/	0	0	0	0	0	0	0	0	0	0	0	0
New nonconcessional external debt maturing in one year or less, contracted or guaranteed by the public sector (ceiling, eop stock since the beginning of the program, in millions of US$) 5/	0	0	0	0	0	0	0	0	0	0	0	0
Accumulation of new external payment arrears by the public sector (ceiling, eop stock since the beginning of the program, in millions of SI$) 5/	0	0	0	0	0	0	0	0	0	0	0	0
Central government program cash balance (floor, cumulative change from the beginning of the year, in million of SI$) 4/	-13	-13	-9	120	118	216	-33	-105	34	10	-30	-8
Memorandum items:												
Central government program cash balance (floor, eop stock, in million of SI$) 4/	34	34	38	167	165	263	134	62	297	177	233	255
Budget support from bilateral and multilateral donors other than IMF (cumulative change from the beginning of the year, in millions of US$), program level.	24	…	29	59	…	62	11	…	2	28	21	39
Outstanding stock of Solomon Islands government (SIG) treasury bills, excluding restructured government bonds (end-period stock, in millions of SI$), program level.	…	…	…	40	…	39	40	…	38	40	40	40

1/ Evaluated at the program exchange rate.

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

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

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

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

Table 2. Solomon Islands: Structural Benchmarks

Actions	Macroeconomic criticality	Date	Status
Ministry of Finance and Treasury			
Apply full enforcement actions to collect income tax arrears.	To strengthen revenue administration and collections.	Continuous	In progress, several prosecutions under way. In view of continued progress made and the well functioning framework for enforcement, this benchmark is removed for the remaining of the program (Met).
Amend the Customs Valuation Act and issue new implementation guidelines by end-2010, bringing the act into full effect.	To strengthen customs administration and revenue collections.	December 31, 2010	The amendment was gazetted in December 2010 (Met).
Receive Cabinet approval of amendments to the Customs and Excise and Income Tax Acts legalizing exemption criteria and guidelines, including full disclosure requirements, and merging existing exemption committees into a unified committee structure.	To promote fiscal transparency and enhance the efficiency of revenue collections.	December 31, 2010	A policy paper outlining the amendments was submitted to the Cabinet in December 2010, and Cabinet approval was received in January 2011. The amendment based on the policy paper is expected to be approved by the Cabinet in June (expected to be met by end-June 2011).
Incorporate all line ministries and employees into the new payroll accounting system.	To strengthen expenditure oversight and control.	December 31, 2010	All line ministries and employees are incorporated in a centralized payroll accounting system, and the reconciliation process is underway (Met).
Obtain Cabinet endorsement of a reform plan to the National Provident Fund (NPF) strengthening governance and oversight.	To improve the long-term financial viability of the NPF and reduce fiscal risks.	December 31, 2010	The proposed reforms were endorsed by the Cabinet in November 2010 (Met).
Formulate a resource tax regime, consistent with IMF technical assistance (TA) recommendations.	To broaden the tax base and increase revenue transparency.	June 30, 2011	A policy paper outlining the new resource tax regime is being drafted with inputs from IMF TA.
Draft fiscal responsibility provisions to be incorporated into either a Fiscal Responsibility Act or an amended Public Finance and Audit Act.	To strengthen budget management and ensure fiscal sustainability.	June 30, 2011	The provisions are being drafted with inputs from IMF TA. This benchmark will be replaced with a revised benchmark (see below).
Submit to Parliament a revised National Provident Fund (NPF) Act incorporating the reform plan endorsed by the Cabinet.	To improve the long-term financial viability of the NPF and reduce fiscal risks.	June 30, 2011	Amendments to NPF Act based on the policy paper is being drafted, however the submission to Parliament is not expected before end-June. This benchmark will be replaced with a new benchmark (see below).
Revised and new benchmark			
Obtain Cabinet approval of a proposal to reform Public Finance and Audit Act and to incorporate fiscal responsibility provisions.	To strengthen budget management and ensure fiscal sustainability.	June 30, 2011	Revised benchmark.
Publish the proposed amendments to the Public Finance and Audit Act including the draft fiscal responsibility provisions for public consultation.	To strengthen budget management and ensure fiscal sustainability.	September 30, 2011	New benchmark.
Obtain Cabinet endorsement of the drafting instructions to revise the National Provident Fund (NPF) Act incorporating the reform plan.	To improve the long-term financial viability of the NPF and reduce fiscal risks.	September 30, 2011	New benchmark.
Central Bank of Solomon Islands (CBSI)			
Issue auction guidelines for CBSI and treasury bills.	To broaden monetary instruments.	December 31, 2010	The guidelines were issued on the CBSI website in December 2010 (Met).
Constitute fully the membership of the CBSI Board of Directors.	To strengthen governance of the CBSI.	December 31, 2010	New members of CBSI Board were appointed and the decision was gazetted in December 2010 (Met).
Publish the opinion rendered by the international audit firm on the CBSI audit results and the IFRS-based financial statements, beginning with the 2010 financial statements.	To improve transparency of the CBSI.	June 30, 2011	In progress.
New benchmark			
Obtain Cabinet approval of draft amendment to the CBSI Act.	To strengthen the effectiveness of monetary policy.	September 30, 2011	New benchmark.
The National Statistics Office			
Publish finalized national income accounts for 2007-09.	To strengthen macroeconomic indicators.	June 30, 2011	The National Statistics Office (NSO) published the national account statistics in February 2011. Work is still ongoing to revise the statistics by incorporating the results of the population census.

APPENDIX I—ATTACHMENT II

SOLOMON ISLANDS: TECHNICAL MEMORANDUM OF UNDERSTANDING

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

I. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATIVE TARGETS

2. Performance criteria for end-December 2010 and end-June 2011 and indicative targets for end-March 2011 have been established with respect to:

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

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

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

II. INSTITUTIONAL DEFINITIONS

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

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

III. MONETARY AGGREGATES

6. **Valuation.** Foreign currency-denominated accounts will be valued in Solomon Islands dollar (SI$) at the program exchange rate of SI$8.06 per U.S. dollar, as of end-2009. Foreign currency accounts denominated in currencies other than the U.S. dollar and

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

A. Reserve Money

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

B. Net International Reserves of the CBSI

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

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

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

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

Excluded from the definition of GIR are:

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

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

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

C. Net Domestic Assets of the CBSI

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

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

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

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

D. Net Credit to the Central Government

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

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

IV. Fiscal Aggregates

A. Cash Balance of the Central Government

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

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

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

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

V. External Debt

A. Medium- and Long-Term External Debt

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

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

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

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

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

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

B. Short-Term External Debt

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

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

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

VI. External Payment Arrears

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

VII. Data Provision

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

A. Monetary Data (CBSI)

On a weekly basis:

- Daily exchange rates, both buying and selling rates, of the Solomon Islands dollar against the U.S. dollar, including the official, interbank, and parallel market exchange rates;
- Stock of NIR and sales and purchases by the CBSI in the foreign exchange markets;
- Stock of reserve money and its components; and
- Treasury bill auction reports.

On a monthly basis:

- Financial corporations' survey, including the balance sheet of CBSI, the consolidated balance sheet of ODCs, and the consolidated balance sheet of OFCs;
- Liquid asset ratios and/or reserves requirement of the commercial banks;
- Interest rates, including average interbank rate, bank deposit rates, and bank lending rates;
- A detailed breakdown of NCG from the CBSI, commercial banks and other ODCs, and OFCs;
- Foreign exchange cash-flow of the CBSI, including donor disbursements; and
- Balances of each central government account specified in Section IV. A., as recorded or collected by the CBSI.

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

On a monthly basis:

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

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

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

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

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

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

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

- Stock of unpaid government payment orders and unpresented checks.

C. External Sector Data (CBSI and MoFT)

On a quarterly basis:

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

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

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

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

On a quarterly basis:

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

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

On a monthly basis:

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

ANNEX I. GUIDELINES ON PERFORMANCE CRITERIA WITH RESPECT TO FOREIGN DEBT

Excerpt from Executive Board Decision No. 6230-(79/140), as revised on August 31, 2009

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

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

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

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

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

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

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International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Second Review Under Standby Arrangement with Solomon Islands, Approves US$4.98 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) yesterday completed the second review of Solomon Islands' economic performance under a program supported by an 18-month arrangement under the Standby Credit Facility (SCF). The completion of the review enables the immediate disbursement of an amount equivalent to SDR 3.12 million (about US$4.98 million), bringing total disbursements under the arrangement to an amount equivalent to SDR 9.36 million (about US$14.95 million). The SCF arrangement was approved on June 2, 2010 (see Press Release No. 10/223) for an amount equivalent to SDR 12.48 million (about US$19.93 million), or 120 percent of the Solomon Islands' quota.

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

“The Solomon Islands authorities are to be commended for their strong program performance under the Standby Credit Facility arrangement. The macroeconomic outlook remains favorable, although inflation is rising due to global food and fuel prices. The authorities are committed to consolidating the improvements in the fiscal and external positions to enhance the resilience of the economy.

“The 2011 Budget reflects the authorities’ commitment to strengthen public finances while promoting infrastructure development. The authorities should remain steadfast in strengthening revenue administration, cash and debt management, budget processes, and expenditure prioritization. It will also be important to implement the new resource-based tax regime and adopt fiscal responsibility provisions. A transparent and predictable mining regime is critical to attracting foreign investment.

“In view of the high level of banks’ excess reserves, it would be prudent for the central bank to mop up liquidity and stand ready to tighten monetary conditions if banks begin to expand credit aggressively. Greater exchange rate flexibility can help mitigate the impact of fuel and food import prices on inflation, and the recent decision to let the currency appreciate modestly is in the right direction.

“The banking system remains well-capitalized and profitable, but the central bank should continue on-site examinations and enforce prudential regulations. Strengthening banking supervision and reforming the National Provident Fund are crucial to ensuring financial sector stability.”