FOR AGENDA

EBS/83/261

CONFIDENTIAL

December 2, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Solomon Islands - Staff Report for the 1983 Article IV Consultation and Review Under the Stand-By Arrangement and Request for Modifications of Performance Criteria

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Solomon Islands, a review under the stand-by arrangement and a request for modifications of performance criteria. A draft decision appears on page 23.

This subject will be brought to the agenda for discussion on a date to be announced. If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Hyong C. Kim, ext. (5)7609.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

SOLOMON ISLANDS

Staff Report for the 1983 Article IV Consultation and Review under the Stand-by Arrangement and Request for Modifications of Performance Criteria

Prepared by the Asian and Exchange and Trade Relations Departments

(In consultation with the Fiscal Affairs, Legal, and Treasurer's Departments)

Approved by Tun Thin and Manuel Guitian

December 1, 1983

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I. Introduction

The 1983 Article IV consultation discussions and review under the stand-by arrangement were held in Honiara during the period October 18-November 1, 1983. The review included reaching understandings with the authorities with respect to the Government's budgetary policy for 1984 as well as the quantitative performance criteria for the period January-June 1984.

The Solomon Islands representatives were led by the Minister of Finance and the Governor of the Central Bank of Solomon Islands and included other officials of the Ministry of Finance, the Central Bank of Solomon Islands, and other government ministries and agencies. The staff team consisted of Messrs. Hyong C. Kim (Head), Shogo Ishii, Roger Nord (EP) (all ASD), Ms. Caroline Atkinson (EP-ETR) and Ms. Lilian Knauseder (ASD).

Solomon Islands has accepted the obligations of Article VIII, Sections 2, 3, and 4.

A stand-by arrangement covering the period June 22, 1983-June 21, 1984 for an amount equivalent to SDR 2.4 million (75 percent of quota) was approved by the Executive Board on June 22, 1983 (EBS/83/81). Under the arrangement, Solomon Islands has made two purchases totaling SDR 0.96 million and as of the end of October 1983, Fund credit extended amounted to 105.0 percent of Solomon Islands' quota.

The third purchase under the stand-by arrangement (SDR 0.48 million) was to have become available after October 31, 1983. However, this purchase has not been made because the ceiling on net credit to the Government has not been observed since July (Table 1). Total domestic credit, on the other hand, has been well below the program ceilings. In the attached letter dated December 1, 1983, the Minister of Finance and the Governor of the Central Bank of Solomon Islands request modifications to the performance criteria for October-December 1983 that raise the subceiling on net credit to the Government and lower the overall ceiling on total domestic credit. The attached letter also describes the program for the period January-June 1984.

On the assumption that Solomon Islands purchases the full amount under the stand-by arrangement, Solomon Islands' use of Fund credit would increase to 150.0 percent of quota (100.0 percent of quota, excluding the purchases under the CFF) (Table 2). However, in the light of the favorable balance of payments outlook for 1983 and the prospect of achieving a small surplus again in 1984, the Solomon Islands authorities have informed the staff that they do not intend to make use of

Table 1. Solomon Islands: Quantitative Performance Criteria and Actual Developments Under the Current Stand-by Arrangement, April-December 1983

	1983			
	April	June	Sept.	Dec. 1/
	(In millions of S.I. dollars; outstanding at end of period)			
Total domestic credit				
Ceiling	35.5	35.5	37.0	...
Actual	34.4	33.2	33.4	34.0
Net credit to Government				
Ceiling	2.5	2.5	2.0	...
Actual	3.1	2.5	3.9	3.0
	(In millions of U.S. dollars)			
External borrowing contracted and/or guaranteed by the Government 2/				
1- to 12-year maturity				
Ceiling	5.0	5.0	5.0	5.0
Actual	--	--	--	--
Of which:				
1 to 5-year maturity				
Ceiling	--	--	--	--
Actual	--	--	--	--

Source: Data provided by the Solomon Islands authorities.

1/ Staff estimates.
2/ The external debt ceiling applies to calendar year 1983.

Table 2. Solomon Islands: Projection of the IMF Position, 1982-84

	1982	1983			1984 1/	
	Dec.	June	Aug.	Oct.	Jan.	April
		(In millions of SDRs)				
Purchases	--	0.48	0.48	--	0.96	0.48
Credit tranches, regular	--	0.48	0.48	--	0.96	0.48
Repurchases	--	--	--	--	--	--
		(In percent of quota)				
Use of Fund credit 2/	75.0	90.0	105.0	105.0	135.0	150.0
(Excluding compensatory financing facility)	(25.0)	(40.0)	(55.0)	(55.0)	(85.0)	(100.0)
Fund holdings of currency 1/	174.4	189.4	204.4	204.4	234.4	249.4
(Excluding compensatory financing facility)	(124.4)	(139.4)	(154.4)	(154.4)	(184.4)	(199.4)

Source: International Monetary Fund.

1/ Includes purchases allowed under the stand-by arrangement. However, the authorities do not intend to make these purchases.
2/ End of period.

additional Fund resources in the remaining period of the stand-by arrangement. Further information on Solomon Islands' relations with the Fund is presented in Appendix I.

II. Background

The Solomon Islands economy is heavily dependent on external developments. It has a narrow export base and is particularly vulnerable to external terms of trade variations. In the three years 1980-82, the terms of trade deteriorated by close to 40 percent. This significantly eroded the profitability of many enterprises and led to the curtailment or postponement of much new private investment. Other private demand, and hence output, was adversely affected by the impact of weaker export prices on incomes from primary production. Government investment also fell in 1982 because of a shortage of skilled manpower for project preparation and execution. The shortage of such personnel became more acute following the dismantling of the Central Planning Office in late 1981. Real GDP declined over the three years 1980-82. The external current account deficit (excluding grants) rose sharply in 1980-81, averaging about 25 percent of GDP. By 1982, however, the weakness of the economy, in particular a sharp decline in imports of investment goods, led to a marked improvement in the external current account position. On capital account, inflows of external grants and concessional loans, which are tied to specific projects, declined after a change in the method of payments by major donors from a system of advance payments to one of reimbursement after expenditures have been made. There has also been a shift from grant aid to concessional loans since 1981. These two developments have led to considerable administrative delays in collecting aid reimbursements.

When the stand-by program was formulated, the authorities believed that if the trend of depressed investment and economic activity continued in 1983, the productive base of the economy would be seriously weakened. Therefore, their strategy for 1983-84 was to promote a recovery in economic activity, particularly through investment in export industries, to strengthen the balance of payments over the medium term. In light of relatively weak external demand conditions, the resumption of investment and associated import requirements were expected to lead to a widening of the current account deficit of the balance of payments in 1983. Hence, the objective of economic policy in 1983 and 1984 allowed for a current account deficit of the balance of payments of 17 percent of GDP in 1983 (compared with 13 percent in 1982) and 15 percent of GDP in 1984, while bringing investment and economic activity back to normal levels. This was to be achieved by limiting the overall budget deficit to 10 percent of GDP in 1983 as in 1982, but with an improvement in current operations and a shift in expenditures toward investment; by maintaining a flexible exchange rate policy; and by increasing interest rates significantly. It was expected that real GDP growth of 3 percent during 1983-84 and a reduction in the rate of inflation from 13 percent on average in 1982 to 10 percent in 1983 and to about 8 percent in 1984, would be consistent with these objectives.

III. Recent Developments and Performance Under the the Stand-by Arrangement

The implementation of the policy measures described in the following sections, together with favorable external developments, has led to the achievement of the 1983 program objectives for the current account of the balance of payments and inflation and to a resumption of real economic growth. The overall budget deficit for 1983 is expected to be on target. The ceilings on external debt have also been observed. While total domestic credit has remained substantially below the program ceilings, net credit to the Government, since July, has exceeded the ceilings established under the stand-by arrangement.

The Government's excess borrowing in 1983 has not jeopardized the achievement of the program targets for the balance of payments and inflation. It was accompanied by much slower than expected growth in private sector credit demand, reflecting generally sluggish economic activity. The authorities are taking immediate measures to reduce their borrowing from the banking system this year and their 1984 fiscal policy will further limit the Government's recourse to the banking system.

1. Production and prices

Preliminary estimates suggest that real GDP, after a small decline in 1982, will increase by about 2 percent in 1983 (Table 3), due largely to an increased fish catch. Total fish exports rose by 50 percent, with the return of warm ocean temperatures and a normal fishing season. Copra production for the year as a whole fell substantially, reflecting a severe cyclone in April. In the second half of the year, however, production recovered sharply in response to a rise in producer prices. 1/ International prices of vegetable oils have surged since the middle of 1983 largely because of a severe drought in the Philippines. Timber production declined slightly in 1983, as land tenure disputes reduced the production of some companies and one company declared bankruptcy and ceased production.

1/ The Copra Board has a monopoly over buying and marketing copra. For its price support program, the Board accumulates reserves when world market prices are high and uses them when world market prices are depressed to provide price support to domestic producers.

Table 3. Solomon Islands: Selected Economic and Financial Indicators, 1981-84

	1981	1982	1983 Program	1983 Revised Estimate	1984 Program
			(Percentage change)		
Output and prices					
GDP at constant prices	1.5	-0.3	3.0	2.0	5.0
Consumer prices (annual average)	16.4	13.0	10.0	8.0	6.0
GDP deflator	16.4	13.0	10.0	8.0	6.0
Money and credit 1/					
Total liquidity	-14.1	22.5	14.5	20.8	13.4
Domestic credit	20.5	14.5	15.5	11.7	10.3
Government	8.2	10.7	2.2	5.2	2.1
Private sector	12.3	3.8	13.3	6.5	8.2
Velocity (GDP/liquidity) 2/	4.1	4.5	4.3	4.1	3.8
			(As percent of GDP)		
Budget					
Domestic revenue	22.6	22.5	21.6	21.6	22.8
Total expenditure	35.3	32.1	31.7	31.7	30.7
Overall deficit (-)	-12.8	-9.6	-10.0	-10.1	-7.9
Grants	5.8	3.3	5.7	3.6	2.8
Foreign borrowing (net)	2.3	3.1	3.1	3.8	3.6
Domestic financing	4.7	3.1	1.2	2.6	1.5
Of which: banking system	(2.2)	(2.2)	(0.3)	(1.2)	(0.5)
Balance of payments					
Current account (excluding grants)	-27.2	-13.4	-16.8	-13.6	-11.5
Current account (including grants)	-16.4	-6.2	-7.4	-6.0	-5.1
Overall balance					
In millions of SDRs	-8.9	4.6	-2.5	1.9	1.2
Public external debt	11.4	21.3	26.3	26.5	27.5
Debt service ratio 3/	1.2	3.6	3.9	2.7	3.5
Gross official reserves in months of imports of goods and services	2.6	4.7	4.5	5.0	4.7
			(Percentage change; in SDR terms where applicable)		
Nominal effective exchange rate 4/	-4.2	-8.4	...	-7.9 5/	...
Real effective exchange rate 4/	2.3	-4.0	...	-5.3 5/	...
Exports, f.o.b.	-0.4	-6.2	2.5	7.4	21.5
Export volume	9.7	-4.9	8.0	5.8	14.5
Imports, f.o.b.	13.0	-16.9	8.6	2.1	16.0
Non-oil imports, f.o.b.	3.6	-19.0	11.2	1.5	17.0
Import volume	-2.2	-18.0	10.2	4.0	9.0
Terms of trade 6/	-21.4	-2.7	-3.5	3.3	--

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

1/ Percentage change in relation to stock of liquidity at beginning of period.

2/ The ratio is calculated on the basis of an annual average liquidity.

3/ Interest plus amortization on public debt as ratio of exports of goods and services and private transfers.

4/ Positive numbers imply appreciation.

5/ August 1983 over December 1982.

6/ Negative numbers imply a deterioration.

The expected strong recovery in investment envisaged under the program did not materialize in 1983. Imports of investment goods are estimated to have risen significantly less than forecast under the program, bank credit to the private sector increased only modestly, and government investment has remained virtually unchanged in nominal terms.

The rate of inflation, as measured by annual average changes in retail prices in Honiara, is expected to decelerate from 13 percent in 1982 to about 8 percent in 1983, 2 percentage points below the program target. A decline in prices of main domestic agricultural products and of some imported food items including rice and sugar contributed to this deceleration. During January-August 1983, retail prices in Honiara were on average 7 percent higher than a year earlier.

2. Public finance

The overall budget deficit (excluding grants) is expected to meet the program target of 10 percent of GDP in 1983 (Table 4). However, this masks a change in the composition of spending and a consequent shift in financing from foreign to domestic sources that has pushed the Government's net borrowing from the domestic banking system above the program ceiling since July. At the end of September 1983, net credit to the Government amounted to SI$3.9 million, compared with the July-September ceiling of SI$2.0 million.

Current expenditures have been higher than the programmed level, leading to a current budget deficit rather than a surplus. Government revenue has been less than expected largely because of a shortfall in revenue from import duties. Capital goods for new investment were partially exempted from duty and a change in the duty rates on fuel resulted in slightly lower receipts. Export duty receipts have risen in 1983, mainly because of the reimposition of export duty on copra in September. Expenditure on goods and services exceeded the level set by the Minister of Finance early in the year when he instructed all government ministries to cut nonstatutory spending by 10 percent. Wage and salary payments also rose by more than envisaged. Established workers are subject to a wage agreement. 1/ However, about half of total government employees, including school teachers, are not covered by the agreement and in 1983 their wages and salaries increased by more than those of established workers. In addition, special benefits and allowances for all public employees increased substantially.

Capital expenditure and net lending is expected to fall considerably short of the budgeted amount in 1983. This has not, however, reduced the Government's need for domestic bank credit. Most capital projects are financed by a combination of external grants and concessional loans. The shortfall in expenditure was therefore accompanied

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1/ This limits wage increases to half the rate of inflation in the preceding year plus 1-3 percentage points. In 1983, basic wages rose by 8 percent for established workers (permanent employees), 9 percent for nonestablished workers and 10 percent for teachers.

Table 4. Solomon Islands: Summary of Central Government Budget, 1981-84

	1981	1982	1983 Original Budget	1983 Prog.	1983 Revised Estimate	1984 Program
	(In millions of Solomon Islands dollars)					
Domestic revenue	31.8	35.7	37.1	38.3	37.8	44.4
Tax revenue	24.2	29.4	31.0	32.2	30.9	36.9
Tax on international trade	(13.4)	(17.2)	(18.2)	(19.4)	(18.1)	(23.1)
Other revenue	7.6	6.3	6.1	6.1	6.9	7.5
Current expenditure	32.2	35.7	37.4	37.7	39.9	42.4
Current balance	-0.4	--	-0.3	0.6	-2.1	2.0
Capital expenditure and net lending	17.6	15.3	28.9	18.4	15.5	17.5
Overall balance	-18.0	-15.3	-29.2	-17.8	-17.6	-15.5
Grants	8.2	5.3	15.2	10.2	6.3	5.5
Foreign borrowing	3.2	5.0	10.6	5.5	6.7	7.0
Domestic financing	6.6	5.0	3.5	2.1	4.6	3.0
(Bank financing)	(3.1)	(3.5)	(1.5)	(0.9)	(2.1)	(1.0)
	(In percent of GDP)					
Revenue	22.6	22.5	20.9	21.6	21.6	23.0
Total expenditure	35.3	32.1	37.4	31.7	31.7	30.7
Overall balance	-12.8	-9.6	-16.5	-10.0	-10.1	-7.9
Domestic financing	4.7	3.1	2.0	1.2	2.6	1.5
Domestic bank financing	2.3	2.2	0.8	0.3	1.2	0.5

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

by a reduction in concessional aid flows. The re-establishment of the Central Planning Office in early 1983 has not yet provided a significant improvement in coordination and monitoring of project implementation.

The Government has taken measures to reduce its borrowing from the banking system during the last quarter of 1983. These include halting advances to provincial governments; refraining from expenditures on new capital projects for which funding has not yet been secured; and reimposing the export duty on copra. In addition, measures have been taken to speed up reimbursement of aid payments from abroad, in particular through the establishment by aid donors of revolving funds at the Central Bank. Some aid donors have agreed to set up such funds. Even with these measures, however, the Government would be unable to bring its net borrowing from the banking system to within the original October-December ceiling by the end of the year. The Government, therefore, requests a modification of that ceiling to SI$3.0 million, as indicated in the attached letter.

3. Money and credit

Monetary and credit developments in 1983 were influenced by the better than expected balance of payments outcome as well as by the weakness in private sector economic activity. Broad money growth decelerated during January-June, when the overall balance of payments was in deficit (Table 5). However, liquidity growth accelerated sharply in the second half of the year as the overall balance of payments moved into a surplus. For the year as a whole, liquidity growth was expected to be faster than envisaged under the program when a balance of payments deficit was forecast. Total domestic credit is expected to be well below the program ceilings in 1983, despite the larger than expected increase in net credit to the Government, as private sector credit demand has been substantially less than was envisaged under the program. The Government therefore requests in the attached letter a lowering of the October-December ceiling for total domestic credit to SI$34.0 million.

In 1983, the monetary authorities of Solomon Islands introduced a number of measures designed to help finance the expected upturn in economic activity within an environment of financial stability. Between February and April, interest rates on Treasury bills, passbook savings deposits, and time deposits of less than SI$25,000 were increased. Annual interest rates now range from 8.5 percent for 90-day deposits to 10.0 percent for deposits of 24 months, while interest rates on deposits in excess of SI$25,000 are in the range of 11.25-11.5 percent. 1/ However, there has as yet been no clear sign indicating the impact of the interest rate adjustments on the growth of domestic financial savings.

1/ Interest income is exempt from income tax.

Table 5. Solomon Islands: Monetary Survey, 1981-84

	1981 1/	1982 1/	1983 March	1983 June	1983 Sept. Prov.	1983 Dec. Staff Proj.	1984 Dec. Staff Proj.
	(In millions of S.I. dollars; outstanding at end of period)						
Net foreign assets	14.2	21.3	19.4	18.2	20.9	25.5	27.0
Of which: Central Bank	(13.6)	(21.3)	(19.3)	(18.6)	(20.5)	(...)	(...)
Domestic credit	24.6	29.3	32.8	33.2	33.4	34.0	39.0
Government	(-2.6)	(0.9)	(2.1)	(2.5)	(3.9)	(3.0)	(4.0)
Private sector 2/	(27.2)	(28.4)	(30.7)	(30.7)	(29.5)	(31.0)	(35.0)
Broad money	32.8	40.2	41.7	40.7	44.2	48.5	55.0
Other items, net	6.0	10.4	10.5	10.7	10.1	11.0	11.0
	(Annual percentage change)						
Domestic credit 3/	20.5	14.5	21.9	14.9	16.0	11.7	10.3
Government	(8.2)	(10.7)	(9.4)	(7.7)	(7.4)	(5.2)	(2.1)
Private sector	(12.3)	(3.8)	(12.5)	(7.2)	(8.6)	(6.5)	(8.2)
Broad money	-14.1	22.5	22.3	14.2	16.6	20.8	13.4

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

1/ Revised to reflect statistical adjustments.
2/ Includes statutory corporations.
3/ In relation to stock of broad money at the end of the same period in the preceding year.

In January 1983, the Central Bank introduced a refinancing facility to encourage commercial banks to lend to priority sectors. The use of the facility has been limited, however. In October, the Government also introduced a small loan guarantee scheme to encourage lending to small borrowers in rural areas. Under the scheme, the Government provides a repayment guarantee of up to 80 percent on loans of SI$25,000 or less.

4. External developments

Balance of payments developments were much more favorable in 1983 than envisaged under the program. The external current account deficit for 1983 is estimated at SDR 19.4 million, equivalent to about 14 percent of GDP. This is considerably below the program target of 17 percent and is at the level which the authorities intended to achieve by 1985. The external terms of trade have improved for the first time in several years (Chart 1) while the program assumed a further deterioration. The improvement occurred in the second half of the year as international prices of copra and palm oil rose sharply. Export volumes have also risen in 1983, largely because of the increased fish catch, although the increase was smaller than projected under the program. Lower than forecast exports of copra and timber more than offset the higher than expected volume of fish exports. However, imports rose by less than projected under the program, in both volume and value terms. Reflecting these developments, the trade balance swung from a deficit of SDR 0.8 million in 1982 to a surplus of SDR 2.0 million in 1983 (Table 6).

Inflows of official grants and loans in 1983 were less than envisaged under the program as capital expenditure fell short of the Government's target. Private capital inflow was slightly more than expected largely because of a short-term capital inflow of almost SDR 1.0 million for the fishing company. The overall balance of payments surplus is estimated at SDR 1.9 million. Gross international reserves are estimated to have reached SDR 41.0 million at the end of 1983, equivalent to about five months of imports of goods and services. The increase reflects both the overall surplus and a drawdown of the last tranche (US$5.0 million) of the Eurodollar loan contracted in 1981. In view of Solomon Islands' vulnerability to external developments, the authorities have aimed at maintaining a relatively high level of international reserves, equivalent to 4-6 months of imports of goods and services.

Disbursed external public debt, including obligations to the Fund, is projected to rise from SDR 29.5 million in 1982 to SDR 32.5 million in 1983. With the exception of the Eurodollar loan, Solomon Islands' external public debt is on highly concessional terms. The debt service ratio is estimated at slightly less than 3 percent in 1983 (5.5 percent including private debt).

Following the 10 percent devaluation in August 1982, the exchange rate of the Solomon Islands dollar was depreciated substantially in both

Table 6. Solomon Islands: Balance of Payments, 1981-86

(In millions of SDRs)

	1981	1982	1983 Program	1983 Revised Estimate	1984 Program	1985 Staff Projections	1986 Staff Projections
Trade balance	-8.2	-0.8	-4.1	2.0	5.7	4.5	5.0
Exports, f.o.b.	56.2	52.7	54.0	56.6	68.9	73.5	80.0
Imports, f.o.b.	-64.4	-53.5	-58.1	-54.6	-63.2	-69.0	-75.0
Of which: Investment	(-30.6)	(-21.2)	(-26.3)	(-22.8)	(-27.1)	(-30.0)	(-33.0)
Services and private transfers (net)	-29.2	-19.0	-21.0	-21.4	-23.6	-26.0	-28.0
Current account balance	-37.4	-19.8	-25.2	-19.4	-17.9	-21.5	-23.0
Official transfers (net)	14.8	10.7	14.1	10.8	9.9	10.5	10.5
Nonmonetary capital (net)	5.8	10.8	8.6	10.4	9.2	11.0	12.5
Official	3.3	4.7	4.6	5.5	5.6	6.0	7.0
Private	2.4	6.1	4.0	4.9	3.6	5.0	5.5
Allocation of SDRs	0.2	--	--	--	--	--	--
Errors and omissions 1/	7.7	2.9	--	0.1	--	--	--
Overall balance	-8.9	4.6	-2.5	1.9	1.2	--	--
Memorandum Items:							
Current account deficit as percent of GDP	-27.2	-13.4	-16.8	-13.6	-11.5	-13.0	-12.5
Solomon Island dollar per SDR	1.025	1.072	1.186	1.227	1.254	1.254	1.254

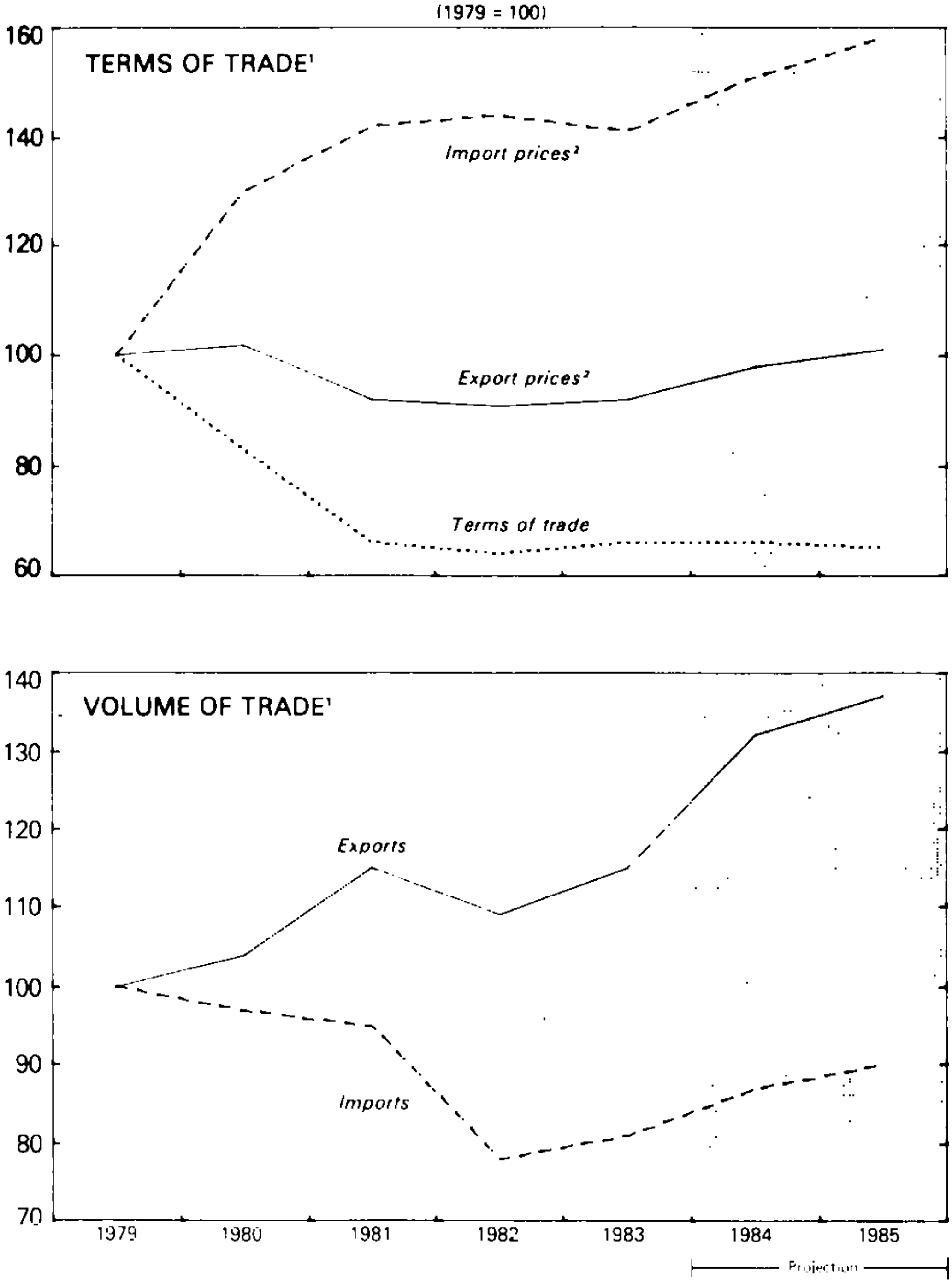
Sources: Data provided by the Solomon Islands authorities; and staff estimates.
1/ Includes valuation adjustment.

CHART 1

SOLOMON ISLANDS

FOREIGN TRADE INDICES, 1979-85

(1979 = 100)



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

[1]Staff estimates.

[2]In terms of SDRs.

nominal and real terms. In the 12 months to August 1983, the nominal effective exchange rate index declined by 14 percent while the real effective exchange rate index fell by 12 percent (Chart 2).

IV. The Economic and Financial Program for 1984 and Medium-Term Prospects

Against the background of an improved balance of payments and a stronger reserves position, the objective of the Government's economic policies in 1984 will be to increase real economic growth and investment while containing the current account deficit of the balance of payments to 12 percent of GDP and achieving a further reduction in inflation. The policy elements of the program will comprise: (a) a reduction in the overall fiscal deficit (excluding grants) from the estimated 10 percent of GDP in 1983 to 8 percent in 1984 and a sharp cut in the Government's recourse to domestic bank financing; (b) maintenance of the flexible exchange rate policy; (c) maintenance of key interest rates at positive levels in real terms; and (d) limits on total domestic credit and net credit to the Government and on the contracting of public and publicly guaranteed nonconcessional external debt. Consistent with these policies will be a growth of real GDP of about 5 percent and a further reduction in the rate of inflation to about 6 percent (Appendix II).

1. Investment and production policies

The authorities will continue their efforts to stimulate private investment in export and import-competing industries in 1984. The authorities intend to simplify fiscal incentives and standardize them within each industry. At present, such incentives include a scheme under which imports of capital goods are exempted from duty, if they constitute essential components of new projects. In October 1983, foreign investment regulations were introduced to speed up investment approval and registration of projects. The recently introduced small loans guarantee scheme is expected to expand bank credit to small investors for rural developments. The authorities are aware of the problem of insufficient reafforestation and are studying ways of inducing private companies to engage in replanting. So far, replanting has taken place only on government-owned land, which represents about 9 percent of total land used for timber production. Companies are offered a reduction in export duty on timber as an incentive for replanting. In 1984, the Forest Fund will be enlarged and used more actively to finance replanting by public sector agencies. The construction of a fish cannery at Noro will begin as soon as the necessary infrastructure is in place.

Output of all major export commodities is projected to expand considerably in 1984. Timber production is expected to rise by 30 percent as a result of a sharp rise in timber licenses granted in 1982-83.

Total fish catch is expected to increase with the addition of two new boats. A coconut oil mill will commence operation in mid-1984. Cocoa production will rise in 1984, due in part to the expected doubling of production by a large plantation. Apart from these traditional crops, the Government will also promote production of nontraditional crops such as cardamom, coffee, and pepper under the small loans guarantee scheme.

2. Fiscal policy

The principal objective of fiscal policy in 1984 will be to contain the overall fiscal deficit to about 8 percent of GDP, a decline of 2 percentage points from the estimated level of 1983. The Government will tighten its fiscal discipline so as to generate a current surplus and will continue efforts to improve the financing and implementation of capital projects. Domestic revenue is projected to increase by 17 percent in 1984 (6 percent in 1983), and total expenditure by 8 percent (9 percent).

The Government will strengthen its revenue efforts in 1984. Effective January 1, 1984, the export duty on timber will be raised to a uniform rate of 15 percent and a new levy on logs will be introduced for the operation of the Forest Fund. Government fees and charges will be increased on January 1, 1984 to levels reflecting actual costs in providing such services. The net revenue impact of the new measures is estimated at 1.4 percent of GDP. Efforts to improve tax administration and collection will be continued. Import duties are expected to increase by less than the growth rate of total imports mainly because of the exemption of duties on imports of capital goods. Income tax receipts are expected to rise by only slightly more than the rate of inflation. This reflects a general decline in profitability in 1983 and business losses occurred in earlier years that can be offset against tax liabilities in 1984.

Improved expenditure control, particularly through the introduction of timely monitoring of fiscal developments that was recommended by a recent FAD technical assistance mission, 1/ will help limit the growth of current expenditures to 6 percent or about the projected rate of price increases. This will enable the Government to achieve a current budget surplus equivalent to about 1 percent of GDP in 1984. Priority will be accorded to expenditures on education, health and natural resources. As devolution from the Central Government continues, transfers to local

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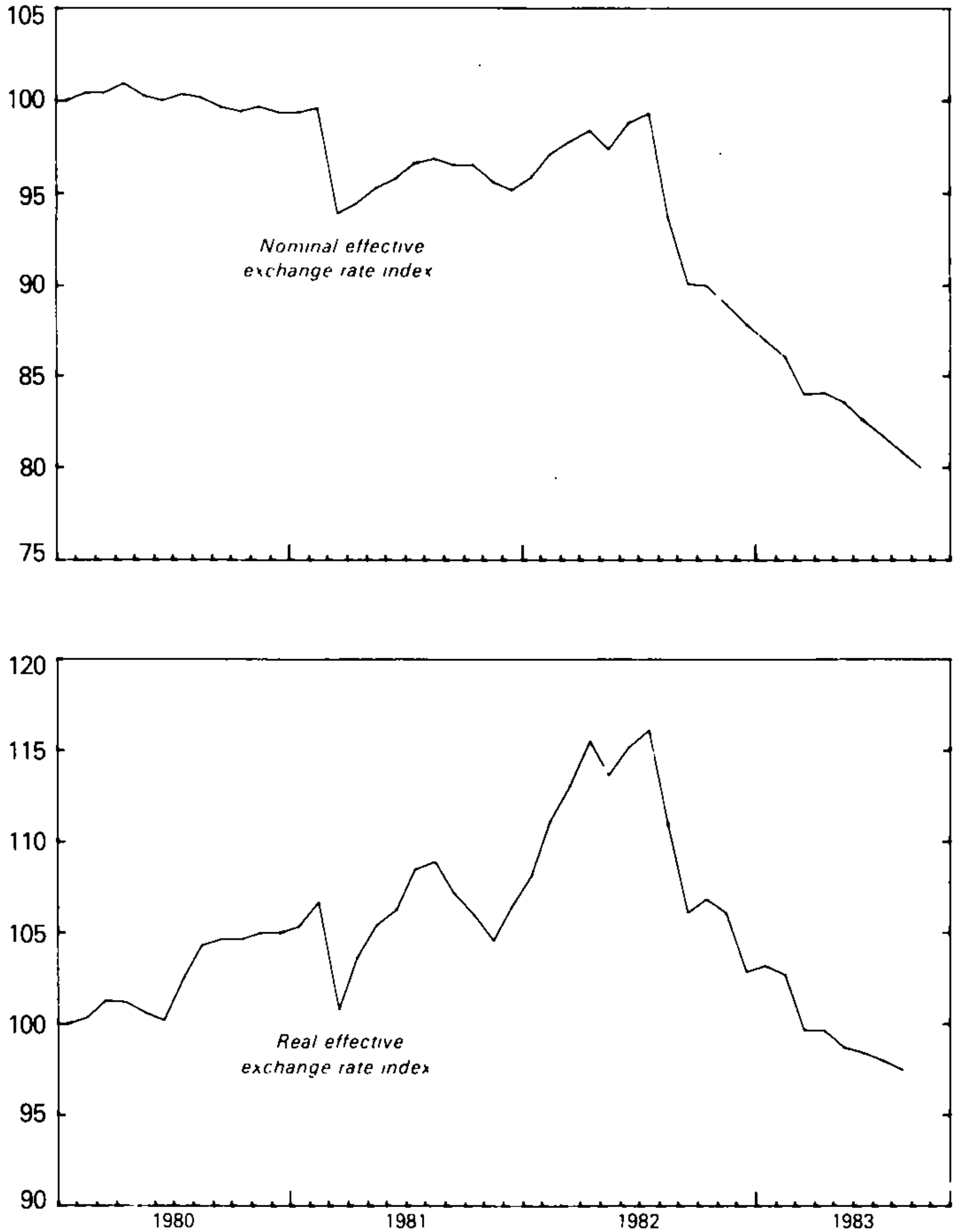
1/ A recent FAD technical assistance mission, following its review of the existing financial management system of the Government, recommended that the Government: (i) develop and apply a macroeconomic framework for estimating important components of the budget and for assessing the budgetary impact on the economy; (ii) develop a fiscal reporting system for monitoring the overall position of government finance; and (iii) further strengthen the administrative capacity to manage external aid.

CHART 2

SOLOMON ISLANDS

EFFECTIVE EXCHANGE RATE INDICES OF THE SOLOMON ISLANDS DOLLAR[1], 1980-SEPT. 1983

(Index: Jan. 1980 = 100)



Source: Staff calculations.
[1] Increase represents an effective appreciation.

governments are expected to increase by about 10 percent. The present policy governing the disbursement of such transfers will be strictly enforced. Local governments are now given 90 days to settle their outstanding bills for purchases of goods and services from the Central Government, and any amount outstanding beyond that period is debited against the remaining monthly payments of annual grants. The Government intends to limit the growth of total public sector wages and salaries, including benefits and allowances, to about the projected rate of inflation. Other current expenditures will either be frozen at their 1983 levels or reduced in nominal terms.

Capital expenditure and net lending together are expected to increase by about 13 percent in 1984. Government capital expenditure will concentrate on infrastructure in support of private investment, the construction of educational and vocational training facilities, and on a malaria eradication program. Net lending is expected to decline from SI$4.8 million in 1983 to about SI$3.5 million in 1984. As in the previous year, the bulk of net lending in 1984 will go to the Development Bank of Solomon Islands, the Government Shareholding Agency, and to the National Fishery Development Corporation. The authorities expect that the restoration of the Central Planning Office early in 1983 and hiring of more expatriates will help to improve the planning and implementation of public projects in 1984. They are aware, however, that administrative problems in planning and financing public investment will continue until a corps of trained indigenous civil servants becomes available.

In 1984, the bulk of the projected budget deficit will be financed by foreign grants and concessional loans. This will enable the Government to contain its recourse to domestic financing to SI$3.0 million, of which not more than SI$1.0 million will be provided by the banking system. As in 1983, the balance will be mainly financed by a loan from the National Provident Fund.

3. Monetary and credit policies

The authorities will continue to restrain credit expansion in support of the balance of payments and inflation objectives. Total domestic credit expansion in 1984 will be limited to about 10 percent of broad money outstanding at the end of 1983. This implies growth in total domestic credit of about 15 percent in 1984. The Government's commitment to limit its credit requirement will allow adequate room for the expansion of credit to the private sector. The program ceilings on total domestic credit and net credit to the Government in the period January-June 1984 take into account some seasonality in government operations. The credit ceilings are consistent with a projected 13 percent annual growth of broad money, compared with an estimated rise of 21 percent in 1983. This monetary policy is in line with the estimated demand for broad money based on the projected nominal GDP growth, lowered inflationary expectations, and on the accumulation of deposits by the Copra Board.

The authorities intend to keep interest rates positive in real terms so as to encourage the mobilization of domestic savings. In setting interest rates, the Central Bank will also take into account interest rate movements in neighboring countries and their implications for capital flows. In addition, the authorities will continue to expand banking services in rural areas and in outlying islands so as to promote domestic saving through the banking system.

4. External prospects and policies

Balance of payments projections for 1984 suggest that the external current account deficit will decline further to about SDR 18.0 million, equivalent to about 12 percent of GDP. The terms of trade, which improved in 1983, are expected to remain unchanged. A sharp rise in the volume of exports is expected, together with higher prices for some major export commodities. The expansion in volume will be particularly pronounced in timber and fish, which together account for more than half of total exports. Price increases are expected for timber, copra and palm oil. Overall, exports are projected to grow by about 22 percent in value and 15 percent in volume. Total imports are projected to increase by 16 percent in value and 9 percent in volume. Increased imports of investment goods and a rebound in rice imports account for much of the projected rise in imports. Reflecting these developments, the trade balance will show a large surplus, which will more than offset a widening of the deficit on the services account, that is largely due to rising costs of freight and insurance.

The projected current account deficit in 1984 will be largely financed by inflows of official transfers and concessional loans. Solomon Islands has traditionally had access to foreign grants and highly concessional loans somewhat in excess of its capacity to identify and implement projects. This is expected to continue in 1984. Private nonmonetary capital inflow is forecast to decline, reflecting repayment by the fishing company of SDR 1.6 million of a short-term loan. The overall balance of payments is expected to be in surplus by about SDR 1.0 million. Gross official reserves at end-1984 are expected to reach about SDR 42.0 million, equivalent to somewhat less than five months of imports of goods and services.

The Government will continue to make use of concessional aid and to limit its borrowing from nonconcessional sources in 1984. During the remaining period of the stand-by arrangement from January to June, the contracting of new public and publicly guaranteed nonconcessional external borrowing with original maturities of between 1 and 12 years will not exceed US$5.0 million. There will be no contracting or guaranteeing of external debt by the Government with original maturities of between 1 and 5 years. The authorities have not contracted any external debt of less than 1-year maturity (apart from normal trade credits) in 1983 and they do not intend to do so in 1984.

The exchange rate of the Solomon Islands dollar, measured against a trade-weighted basket of currencies, depreciated substantially in 1983 in both nominal and real terms. In 1984, the authorities are committed to managing the exchange rate flexibly so as to preserve the profitability of exports and the competitive position of Solomon Islands. Solomon Islands does not maintain restrictions on payments and transfers for current international transactions.

5. Medium-term prospects

Over the medium term, the current account deficit of the balance of payments is expected to remain at about 12-14 percent of GDP, assuming no significant changes in the external terms of trade. Exports are assumed to rise by slightly more than the underlying rate of growth in the economy, as new investment increases export capacity. Imports are assumed to rise in line with economic growth. The deficit on the services account will increase, reflecting rising costs of freight and insurance and higher debt service payments. Real GDP is expected to increase by about 4 percent over the medium term, while inflation is expected to move in line with the rate of increase in import prices. These developments would be consistent with a flexible exchange rate policy that continues to aim at preserving export profitability and competitiveness, and with continued prudent fiscal and monetary policies.

An external current account of up to 14 percent of GDP is considered sustainable by the authorities because of Solomon Islands' access to concessional loans and grants from overseas. Such aid flows are expected to amount to about 10-11 percent of GDP over the medium term. This assumes that aid inflows stabilize at slightly below their present level in relation to GDP, following the sharp decline that took place from 1980 to 1982. The shift from grants to concessional loans that began in the early 1980s is expected to continue. The debt service ratio (on public debt) is projected to rise from about 3 percent in 1983-84 to about 7-8 percent during 1986-87 when the grace period on the Eurodollar loan expires and repurchases in respect of the purchases from the Fund become due (Table 7). The ratio is projected to fall again afterwards, to about 4.5 percent in 1989 and less than 2 percent in 1990.

Private capital flows of about 3-4 percent of GDP are expected over the medium term. Direct private investment is projected at 1-2 percent of GDP, about the same as in the recent past, while private borrowing remains at about 2 percent of GDP. The bulk of private sector

Table 7. Solomon Islands: External Public Debt Service Payments, 1982-1990 1/

(In thousands of U.S. dollars)

	Est. 1982	1983	1984	1985	1986	1987	1988	1989	1990
Amortization	12	13	373	3,055	6,096	6,323	5,531	5,719	1,253
Concessional loans 2/	12	13	163	413	413	547	772	775	1,253
Commercial borrowing 3/	--	--	--	2,222	4,444	4,444	4,444	4,444	--
IMF 4/	--	--	210	420	1,239	1,345	315	--	--
Interest	2,330	2,070	2,700	2,805	2,268	1,715	1,159	649	508
Concessional loans 2/	272	300	370	615	602	590	560	527	504
Commercial borrowings 3/	2,000	1,600	2,100	1,983	1,517	1,062	590	118	--
IMF 4/	58	170	230	207	149	63	9	4	4
Total	2,342	2,083	3,073	5,860	8,364	8,038	6,690	6,368	1,761
As percent of exports of goods and services	3.3	2.7	3.5	6.2	8.2	7.1	5.4	4.6	1.1
Total (excluding Fund obligations)	2,284	1,913	2,633	5,233	6,976	6,630	6,366	6,364	1,757
As percent of exports of goods and services	3.2	2.5	3.0	5.6	6.8	5.9	5.1	4.6	1.1

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

1/ Based on outstanding debt at end-September 1983, and projected debt 1984-1990.
2/ Based on projected borrowing.
3/ LIBOR is assumed to be 10 percent in 1983 and 9.5 percent in 1984-1990. The present Eurodollar loan is assumed to be the only commercial borrowing over the period.
4/ Assumes no further purchases under the stand-by arrangement.

borrowing in the past has consisted of suppliers' credits and loans from, or arranged by, parent companies. Much of it is at concessional rates, with 15 percent of the SDR 14 million outstanding at end-1982 bearing no interest at all. A shift towards higher interest borrowing is expected in the future as the economy develops. It is assumed that less than half of the new borrowing will be at below market interest rates, compared with about 60 percent in the past. Even with the shift, the burden of private sector debt service is expected to remain modest over the medium term, at less than 5 percent.

V. Performance Criteria and Proposed Modifications

The quantitative performance criteria for the remaining period of the current stand-by arrangement will include quarterly ceilings on total domestic credit of the banking system and net credit to the *Government and ceilings on the contracting and/or guaranteeing by the* Government of external debt in the 1- to 12-year maturity range and the 1- and 5-year maturity range, respectively (Table 8). In addition, the arrangement contains the usual performance criteria throughout the period relating to restrictions on payments and transfers for current international transactions, multiple currency practices, bilateral payments agreements with Fund members and import restrictions for balance of payments reasons.

The ceilings on net credit to the Government have been exceeded since July but total domestic credit has remained well below the program ceilings. The Government has taken measures to reduce its borrowing from the banking system. Moreover, performance in respect of the balance of payments and inflation in 1983 has been better than envisaged under the program. Accordingly, the authorities request modifications of the ceilings on total domestic credit and net credit to the Government for the fourth quarter of 1983. The proposed modifications would lower the overall ceiling on total domestic credit and raise the subceiling on net credit to the Government.

Table 8. Solomon Islands: Quantitative Performance Criteria, October 1983-June 1984

	1983 Oct. 1-Dec. 31 Prog.	1983 Oct. 1-Dec. 31 Proposed	1984 Jan. 1-Mar. 31	1984 Apr. 1-June 30
	(In millions of Solomon Islands dollars)			
Total domestic credit from the banking system	38.3	34.0	35.0	36.5
Of which:				
Net credit to Government	1.8	3.0	2.5	3.0
	(In millions of U.S. dollars)			
New external borrowing contracted and/or guaranteed by the Government				
1 to 12-year maturity	5.0	5.0 1/	5.0	5.0 2/
Of which:				
1 to 5-year maturity	-- 1/	-- 1/	--	-- 2/

1/ Cumulative from January 1, 1983.
2/ Cumulative from January 1, 1984.

VI. Staff Appraisal and Proposed Decision

In 1983, Solomon Islands' economic and financial performance has been broadly satisfactory. The authorities have taken a number of important steps in line with the economic and financial program in support of which the stand-by arrangement was approved. The exchange rate was depreciated substantially in both nominal and real terms. Key interest rates were raised early in the year and have remained positive in real terms. While the overall fiscal deficit for 1983 is likely to be observed, there was an overrun in current expenditures and continued problems in the management of external aid inflows. As a result, Government recourse to bank credit has exceeded the program ceilings, a trend that it is important to reverse.

To this end, for 1984, fiscal discipline has been strengthened. The policies outlined in the attached letter, together with the expected improvement in the external environment, will lead to a further reduction in the current account deficit of the balance of payments in relation to GDP. Cautious wage and financial policies will help reduce the rate of inflation further from its 1983 level. A significant increase in the volume of exports and higher investment expenditure will contribute to faster growth in real GDP.

To support the external adjustment, budgetary policy in 1984 appropriately aims at reducing the overall budget deficit through raising revenues and restraining current expenditures. In particular, the wage formula should be applied to wages and allowances as the basis for determining the rate of increase in public sector wages. Revenues from export and import duties will rise as a result of higher international trade and the Government's proposed increases in export duty rates. This will contribute to achieving a current surplus to supplement the inflow of external resources, so that the authorities can continue their efforts to speed up the implementation of capital projects on a sustained basis.

The stance of monetary policy in 1984 is in line with the adjustment strategy of the authorities. The Government's excess borrowing from the banking system in 1983 did not appear to have crowded out private sector credit demands, as these remained weaker than expected. In 1984, however, the Government's access to bank credit should be limited to the level envisaged under the new program in order to achieve the balance of payments and price objectives while providing sufficient credit to the private sector. The Government's interest rate policy should foster the mobilization of domestic resources and improve their allocation.

The further reduction in the current account deficit of the balance of payments projected for 1984 is a welcome objective to which flexible management of the exchange rate and continued adherence to a liberal trade and exchange system will contribute. A current account deficit equivalent to about 12-14 percent of GDP is considered sustainable, given the projected availability of sustained external grants and concessional loans to the Government. These aid flows are equivalent to at least 10-11 percent of GDP and they are expected to be supplemented by direct private investment projected at 1-2 percent of GDP. However, the availability of concessional resource transfers does not diminish the need to make effective economic use of such resources.

The staff believes that the proposed modifications of credit ceilings will not jeopardize the inflation and balance of payments objectives of the original program. In addition, the 1984 program includes measures that will reduce the overall fiscal deficit and limit the Government's recourse to the banking system. The staff, therefore, recommends that the Executive Board approve the modifications of the credit ceilings as of the date of the Executive Board decision, in line with the proposal in the letter to the Managing Director dated December 1, 1983 from the Minister of Finance and the Governor of the Central Bank of Solomon Islands. The staff also recommends approval of the performance criteria proposed for January-June 1984.

In view of the scheduled general elections in February 1985, it is recommended that the next Article IV consultations with Solomon Islands be held in March-April 1985.

The following draft decision is proposed for adoption by the Executive Board:

1. Solomon Islands has consulted with the Fund in accordance with paragraph 3 (b) of the stand-by arrangement (EBS/83/81, 4/22/83) and paragraph 19 of the letter from the Minister of Finance and the Governor of the Central Bank of Solomon Islands dated April 21, 1983 attached thereto.

2. The letter from the Minister of Finance and the Governor of the Central Bank of Solomon Islands dated December 1, 1983 shall be annexed to the stand-by arrangement for Solomon Islands, and the letter from the Minister of Finance and the Governor of the Central Bank of Solomon Islands dated April 21, 1983 shall be read as supplemented and modified by the letter of December 1, 1983.

3. Accordingly, the limits on total domestic credit of the banking system and net credit to the Government for the period October-December 1983 shall be those referred to in paragraph 3 of the letter of December 1, 1983 in place of those referred to in paragraph 14 of the letter of April 21, 1983 and specified in the table attached to it.

Fund Relations with Solomon Islands
(as of October 31, 1983)

Date of membership:	September 22, 1978.
Quota:	Present: SDR 3.2 million. Proposed: SDR 5.0 million.
Article VIII status:	The Solomon Islands Government accepted the obligations of Article VIII, Sections 2, 3, and 4.
Trust Fund:	Not eligible.
Use of Fund resources:	A one-year stand-by arrangement was approved on May 29, 1981 (EBS/81/101) in the amount of SDR 1.6 million (50 percent of quota), of which SDR 0.8 million was purchased. On June 22, 1983, the Executive Board approved a one-year stand-by arrangement (EBS/83/81) in the amount of SDR 2.4 million (75 percent of quota); purchases in total of SDR 0.96 million were made on June 27 and Aug. 1, 1983. Under the compensatory financing facility, Solomon Islands purchased the equivalent of SDR 1.6 million (50 percent of quota) in October 1982 in respect of an export shortfall for the period ended June 1982.
Fund holdings of Solomon Islands dollars:	SDR 6.54 million or 204.4 percent of quota, of which: SDR 1.76 million (55 percent) under credit tranches; SDR 1.6 million (50 percent of quota) under the CFF.
SDR holdings:	SDR 2.13 million, or 324.7 percent of net cumulative allocation of SDR 654,400.
Exchange rate system:	Since August 1982, the Solomon Islands dollar has been pegged to a trade-weighted basket of currencies: the U.S. dollar, the Australian dollar, the Japanese yen, and the pound sterling. The Central Bank is authorized to make discretionary adjustments to the exchange rate of the Solomon Islands dollar with respect to the basket, which do not exceed 2 percent in any four-week period. The Solomon Islands dollar rate is calculated daily according to movements in the cross exchange rates of the components of the currency basket.
Technical assistance:	The Central Banking and Fiscal Affairs Departments and the Bureau of Statistics have provided technical assistance in the areas of monetary management, financial management system of the Government, provincial taxation, and in balance of payments and general statistics. The Fund is currently providing three experts under the CBD Technical Assistance Program serving as Operations Manager, Research Manager and Foreign Exchange Operations Advisor of the Central Bank of Solomon Islands. In addition, the CBD is expected to provide shortly an advisor on bank supervision.
Last Article IV consultation:	Article IV consultation discussions were last held during July 19-30, 1982. The Staff Report (SM/82/199, 10/4/82) was discussed by the Executive Board on October 25, 1982.

Solomon Islands: Summary of the Financial Program 1/

		(In percent)
Assumptions: (1984)	Terms of trade	No Change
	(Export prices)	(6.0)
	(Import prices)	(6.0)
	Real GDP growth	5.0
Targets: (1984)	Inflation	6.0
	Balance of payments	
	Current account deficit	SDR 17.9 million (11.5 percent of GDP)
	Overall surplus	SDR 1.2 million

Principal elements of the program

1. Budget

To reduce the overall deficit from 10 percent of GDP in 1983 to 8 percent in 1984, and to reduce domestic bank borrowing from SI$2.1 million in 1983 to SI$1 million.

2. *Money and credit*

To limit total credit expansion to 10.3 percent and net credit to the Government to 2.1 percent of projected stock of liquidity at end-1983 and monetary expansion to 13.4 percent, with appropriate quarterly ceilings as performance criteria. To maintain key interest rates positive in real terms. The income velocity of money is projected to decline slightly in 1984.

3. Exchange rate

Flexible exchange rate policy aimed at maintaining export competitiveness.

4. Investment

To encourage private investment through exchange rate policy and fiscal incentives.

5. External borrowing

To limit public and publicly guaranteed external borrowing with maturities of 1 to 12 years to US$5 million and no borrowing in the 1- and 5-year maturity range.

1/ *The financial program applies to the period January-June 1984.* Major policy assumptions and targets are, however, based on the calendar year 1984.

World Bank Group Operations in Solomon Islands (As of October 31, 1983)

Summary

	Project Status	Date of Approval	Beneficiary	Purpose	Amount US$ mn.	Terms
1.	Approved	March 1981	Development Bank of Solomon Islands (DBSI)	Relending	1.5	IDA
2.	Approved	Feb. 1982	Government of Solomon Islands	Primary education	5.0	IDA
3.	Proposed	Dec. 1983	Government of Solomon Islands	Rural services	3.5	IDA

Project Description

1. The project will assist the DBSI in providing finance for investments in all sectors of the economy for the period 1981-83. The AsDB is the lead cofinancier for this operation. Its US$2.0 million credit became effective on May 21, 1981 and disbursements from the credit have commenced. DBSI operations are proceeding approximately as planned and disbursement requests for the IDA credit have also been received.

2. The project supports government development plans in the education sector. It assists the Government in helping provinces and communities increase access to primary schools by creating new, and upgrading established facilities, providing training to raise the quality of teachers, assisting in the development of more relevant curricula, and improving management.

3. The proposed project, which is co-financed by the AsDB, concentrates on development in the rural areas. It will assist the Government in establishing an agricultural infrastructure which would support the needs of the rural community. Its main objectives are to create an opportunity to develop land and to provide agricultural support services to small farmers.

Solomon Islands: Basic Data

Area:	27,556 square kilometers
Population (1983):	249,000
Population growth (annual average 1979-82)	3.5 percent
GDP per capita (1983):	SDR 574

	1981	1982	1983 Estimate	1984 Projection
Output and prices				
(Annual rate of change in percent)				
Real GDP	1.6	-0.2	2.0	5.0
Consumer prices (annual average)	16.4	13.0	8.0	6.0
Money and credit				
(Annual rate of change in percent) 1/				
Broad money	-14.1	22.5	20.8	13.4
Total domestic credit	20.5	14.5	11.7	10.3
Credit to private sector	12.3	3.8	6.5	8.2
Public finance				
(Annual rate of change in percent)				
Domestic revenue	34.2	12.3	5.9	17.5
Current expenditure	33.6	10.9	11.8	6.3
Capital expenditure and net lending	6.0	-13.1	1.3	12.9
Total expenditure	22.4	2.4	8.6	8.1
Foreign trade				
(Annual rate of change in percent)				
Export volume	9.7	-4.9	5.8	14.5
Export unit value	-9.2	-1.4	1.4	6.0
Import volume	-2.2	-18.0	4.0	9.0
Import unit value	15.5	1.3	-1.8	6.0
Terms of trade	-21.4	-2.7	3.3	--
Balance of Payments				
(SDR million)				
Exports (f.o.b.)	56.2	52.7	56.6	68.9
Imports (f.o.b.)	-64.4	-53.5	-54.6	-63.2
Trade balance	-8.2	-0.8	2.0	5.7
Current account balance	-37.4	-19.8	-19.4	-17.9
Overall balance	-8.9	4.6	1.9	1.2
Gross international reserves				
(End of period)				
In millions of SDRs	18.5	33.7	41.2	42.4
In months of imports of goods and services	2.6	4.7	5.0	4.7
Selected financial ratios				
(In percent)				
Current account/GDP	-27.2	-13.4	-13.6	-11.5
Government budget deficit/GDP	-12.8	-9.6	-10.1	-7.9
External debt/GDP 2/	11.4	21.3	26.5	27.5
External debt service ratio 3/	1.2	3.6	2.7	3.5
Oil imports/total imports	23.0	25.0	25.5	24.7

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

1/ In relation to stock of broad money at beginning of period.

2/ External public sector debt.

3/ Interest plus amortiztion on public debt as ratio of exports of goods and services.

Honiara, Solomon Islands

December 1, 1983

Dear Mr. de Larosiere:

1. In our letter of April 21, 1983, we requested a stand-by arrangement for a period of one year through June 21, 1984 in an amount of SDR 2.4 million. This request was approved by the Executive Board of the Fund in June 1983. It was agreed at that time that the authorities would review the developments under the program supported by the stand-by arrangement and would reach with the Fund before December 31, 1983, understandings regarding the Government's budgetary policy as well as quantitative performance criteria for the remaining period of the stand-by arrangement.

2. Performance under the program has exceeded expectations in respect of the balance of payments and domestic price inflation. A combination of external events and the policy measures we have undertaken in fiscal, monetary, and exchange rate management, has improved the external position more rapidly than we earlier forecast. We would, however, like the stand-by arrangement to remain in place until it expires in mid-1984. Subject to the modifications we request in this letter, we intend to continue to carry out our express commitments under this stand-by arrangement.

3. Performance under the domestic credit ceilings has been below our expectations. Total domestic credit has not come close to the agreed ceiling, reflecting a rather quiet period in direct investment and a wait-and-see attitude by existing enterprises in view of the recession in world trade. Net credit to the Government, on the other hand, has persistently pressed against the agreed ceiling and at the end of September stood at SI$3.9 million, against the agreed ceiling of SI$2.0 million. The level of the Government's use of short-term bank financing has proved particularly resistant to the strenuous efforts by the Government to reduce it. It has arisen from the need to bridge the twin gaps between current revenues and expenditures and between aid receipts and development project outlays. We are now expecting a swing into current surplus in the last two months of the year, and a catching-up of aid receipts against expenditures, which we expect to reduce the Government's use of bank credit to no more than SI$3.0 million by the end of the year. We therefore request a modification to the relevant performance criterion for the last quarter of 1983 from SI$1.8 million to SI$3.0 million. The corresponding ceiling on total domestic credit should be brought down from SI$38.4 million to SI$34.0 million in recognition of slower than expected private borrowing, and the effects on broad money of the recent improvement in the external trade balance.

4. In 1983, we took important steps in line with the economic and financial program in support of which the stand-by arrangement was approved. Following the 10 percent devaluation in August 1982, the exchange rate has been depreciated steadily against the U.S. dollar, in order to achieve a real depreciation against a trade-weighted basket of currencies. This has improved the profitability of Solomon Islands' exports and the prospects for private investment. Key interest rates were raised in March-April 1983, and have remained positive in real terms. In order to improve the management of monetary policy, the Central Bank introduced a liquidity ratio requirement of 15 percent for commercial banks in place of the 5 percent reserve requirement. It also opened a new lending facility to support long-term lending of banks to priority sectors. In the fiscal area, the Government has taken steps to speed up its implementation of capital projects and improve the management of external aid inflows. Early in 1983, the Government resumed central monitoring and coordination of its development budget with the re-establishment of the Central Planning Office. More recently, the Government has asked a number of aid donors to set up revolving funds in Solomon Islands in order to speed up aid reimbursement. Some donors have already agreed to do this and the Government expects more to do so during 1984.

5. In spite of these administrative improvements, the fiscal elements of the program have not been wholly achieved. Current expenditures exceeded the original budget, despite efforts by the Government to reduce them administratively. This was due in part to lack of effectiveness in some of the control measures used, and in part to in-pipeline momentum of much of the Government's expenditures on personnel and maintenance of economic infrastructure. Despite the reimposition of export duty on copra in September, government revenue was less than forecast because of a shortfall in import duties. These developments mainly accounted for the Government's greater than programmed recourse to domestic bank financing.

6. Returning to the external position, increased volumes of fish exports have helped to raise export earnings substantially above levels originally estimated, despite prices for fish and timber remaining relatively low. Improved prices for vegetable oils, and stability in the international prices of fuel and manufactures, have brought an improvement in the terms of trade for the first time in four years. Together with a lower level of imports than expected, this has narrowed the current account deficit of the balance of payments to an estimated SI$23.6 million, equivalent to 14 percent of GDP, which is the level we had aimed to achieve by 1985. The overall balance of payments position is estimated to be in surplus. Preliminary indications are that real GDP has increased in 1983 by 2 percent, slightly less than we had envisaged, while inflation decelerated from an annual average of 13 percent in 1982 to about 8 percent in 1983, a somewhat greater fall than we had foreseen.

7. Our main policy objective under the current program was to bring the current account deficit of the balance of payments down to a level at which it could be financed on a sustainable basis, while increased efforts would go into attaining a rate of real economic growth of 5 percent or more. In the light of the recession that had occurred in world trade, this objective required very substantial adjustment, along with some assistance from the more favorable external economic climate we foresaw. We have now attained what we regard as a sustainable level of current account deficit, provided that our access to grants and concessionary loans is continued and that the use of our increased financial resources is effectively channelled into productive purposes. Our economic policy objectives for 1984 are to achieve a real rate of growth of at least 5 percent, while reducing the current account deficit of the balance of payments to about 12 percent of GDP. Our policies on prices and wages will aim to ensure as far as possible, by use of wages guidelines, price controls, and monetary policy, that domestic price changes reflect only the impact of changes in import prices of goods and services. Our present estimates indicate that this will mean an inflation rate in 1984 below that which we are currently measuring.

8. The Government will continue its efforts to stimulate private investment in export industries in order to strengthen the balance of payments. It will continue to assist the private sector through its fiscal, monetary, and exchange rate policies. In 1983, foreign investment regulations were introduced to speed up investment approval procedures and registration of projects. We have recently introduced a small loans guarantee scheme which will assist banks to provide credit to small investors in rural areas, and the scope for further institutional improvements is being studied. The Government is aware of the problem of insufficient reafforestation, which will pose a serious economic and environmental threat to the economy over the medium term. We are studying ways of inducing private logging companies to engage in replanting; and in 1984, the Forest Fund will be enlarged and used more actively to finance replanting by public sector agencies.

9. Against a background of an improved balance of payments and a stronger reserves position, the main source of expansion in the economy will be the revitalized agricultural sector, and increased direct private investment in fisheries, manufacturing, agricultural processing and domestic transport. This will be financed by a blend of external and domestic bank resources. Expansion of credit to the private sector will be directed primarily to new investment and increased productive capacity. The Government's own financing needs will be kept under firm control. The 1984 overall budgetary deficit should be about 8 percent of GDP. The bulk of this will be financed by foreign grants and concessionary loans. Total current revenue of SI$44 million and expenditures of SI$42 million will provide a surplus on current account. This will enable us to contain the Government's

recourse to domestic financing to SI$3.0 million, of which not more than SI$1 million will be provided by the banking system. Measures to ensure the improved control necessary to achieve this will include implementation of the administrative changes recommended by the recent Fund technical assistance mission.

10. Total government revenue is expected to grow by 15 percent to SI$44 million. The projected revenue growth reflects the expected growth in international trade and the estimated impact of the revenue measures we intend to take in 1984. These include an increase in export duty on logs to a uniform rate of 15 percent, a special levy on timber exports for the Forest Fund and a number of adjustments in fees and charges for government services. Copra export duty was reintroduced in September 1983. The additional government revenue from these new measures is estimated at over SI$3.0 million, or about 2 percent of estimated GDP.

11. The government budget provides for current expenditure of SI$42 million. This incorporates an increase in wages and salaries of 6 percent. Lower rates of nominal increase are allowed to low priority areas of the budget. Increases of 10 percent in nominal terms will be allowed to priority sectors including education and training, health and the development of provincial government. In the development budget, government expenditure will concentrate on infrastructure in support of economic development, and on investment in education and training.

12. The main objective of monetary policy during 1984 will be to finance the investment and operating costs of the economy as it picks up speed to a growth rate of 5 percent or more, while guarding against any tendency to widen the balance of payments deficit to more than 14 percent of GDP in the medium term, or to add domestic price pressures to the expected rise in import costs. To achieve this, the growth of total domestic credit of the banking system will be limited to 15 percent during 1984. This increase of SI$5.0 million in total domestic credit comprises SI$1.0 million increase in net lending to the Government and SI$4.0 million to the private sector. Together with the projected increase in net foreign assets of the banking system of SI$1.5 million, it is consistent with an estimated growth of 13 percent in broad money during the year. To achieve the above objective, we will limit total domestic credit of the banking system and net credit to the Government in the first half of 1984 as indicated in the attached table. The credit program takes into account the seasonal pattern we expect in economic activity.

13. To promote the mobilization of savings through the financial system, the Central Bank will continue to maintain key interest rates positive in real terms. In implementing this policy, the Bank will also take into account interest rate movements in neighboring countries and their implications for capital flows. In addition to interest rate policy, we shall endeavor to develop the financial system and improve banking services to facilitate the mobilization of domestic savings.

14. We have implemented a flexible exchange rate policy in 1983. We remain committed to managing the exchange rate in 1984 so as to preserve the competitive position of Solomon Islands and the profitability of exports.

15. The Government will continue a cautious policy in the management of external debt in 1984. In line with this policy, during the period from January 1, 1984 to June 30, 1984, the contracting of new public and publicly guaranteed external nonconcessional borrowing with an original maturity of more than 1 year and up to and including 12 years will not exceed US$5 million. The Government will not contract any new public or publicly guaranteed external borrowing with original maturities of one to five years.

Yours sincerely,

/s/

A.V. Hughes
Governor
Central Bank of Solomon Islands

/s/

Bartholomew Ulufa'alu
Minister of Finance

Attachment

Mr. J. de Larosiere
Managing Director
International Monetary Fund
Washington, D.C., 20431
U.S.A.

ATTACHMENT

Solomon Islands: Limits on Net Credit to Government and
Total Domestic Credit of the Banking System
January-June 1984

(In millions of Solomon Islands dollars)

	Net credit to Government	Total domestic credit
During January 1-March 31, 1984	2.5	35.0
During April 1-June 30, 1984	3.0	36.5