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CONTAINS CONFIDENTIAL
INFORMATION

October 4, 1982

To: Members of the Executive Board

From: The Acting Secretary

Subject: Solomon Islands - Staff Report for the 1982 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1982 Article IV consultation with the Solomon Islands.

It is proposed that this subject, together with the Solomon Islands' request for a purchase under the compensatory financing facility (EBS/82/177, 10/4/82), be brought to the agenda for discussion on Monday, October 25, 1982.

Att: (1)

Other Distribution:
Department Heads

CONTAINS CONFIDENTIAL INFORMATION

INTERNATIONAL MONETARY FUND

SOLOMON ISLANDS

Staff Report for the 1982 Article IV .ation

Prepared by the Staff Representatives for the
1982 Consultation with Solomon Islands

Approved by P.R. Narvekar and Donald K. Palmer

October 4, 1982

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I. Introduction

The 1982 Article IV consultation discussions with Solomon Islands were held in Honiara during July 19-30, 1982. The Solomon Islands delegation was headed by Mr. A. V. Hughes, Chairman of Solomon Islands Monetary Authority, and included officials from the Ministry of Finance, the Solomon Islands Monetary Authority, the Central Planning Office, and Ministries of Natural Resources, Agriculture and Land, and Trade, Industry and Labor. The staff representatives also met with the Minister of Finance, Mr. B. Ulufa'alu. The staff team consisted of Messrs. H.C. Kim, J. Healy, Z. Khan (all ASD), Ms. W. Tseng (ETR), and Mrs. G. Martin (ASD, Secretary). Mr. A.R.G. Prowse, Executive Director for Solomon Islands, attended some of the meetings as observer.

Solomon Islands has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange and trade system free of restrictions on payments and transfers for current international transactions.

II. Background

Solomon Islands is a small, open economy. An archipelago of widely scattered mountainous islands in the southern Pacific Ocean, the country has a population of about 230,000 and a land area of about 29,000 square kilometers. Agriculture, fishing, and forestry are the principal economic activities, with some 40 per cent of total output being derived from subsistence agriculture. The monetized sector of the economy mainly produces copra, timber, fish, and palm oil, largely for export. Exports and imports are equivalent to about 45 per cent and 50 per cent of GDP, respectively. Formerly a British protectorate, the country attained full independence in July 1978.

During the 1970s, the economy achieved rapid growth, averaging about 8 per cent annually, while broadening and deepening its productive base. The main impetus to growth came from a sustained expansion of exports, increased import substitution in food production, and high levels of private and public investment financed by capital inflows and foreign aid. The diversification of the export base, which throughout most of the 1960s had relied almost exclusively on copra, was the major economic development during the decade. Timber emerged as an important export toward the end of the 1960s, followed by the development of the fishing industry during the early 1970s and of the palm oil industry in the second half of the decade. The attainment of near self-sufficiency in food production was another important achievement. This economic progress was accompanied by reasonable domestic price stability and overall balance of payments surpluses through 1979.

After an exceptionally good year in 1979, in which the terms of trade improved by 25 per cent and the volume of exports rose by 27 per cent, the economy suffered a setback in 1980. Real GDP declined by 5 per cent, inflation accelerated to 16 per cent, and the balance of payments position swung into a substantial deficit. These adverse developments were due to a sharp deterioration in the terms of trade, compounded by declining export volumes in some major commodities--copra and fish. Although investment continued to increase, real consumption expenditure fell as a consequence of the fall in agricultural income and a reduction in real wages in the government sector. The acceleration in inflation largely reflected movements in import prices. The current account recorded a deficit of about SDR 9 million (8.5 per cent of GDP) in 1980, due to the weakened export performance and the lagged outflow of remittances of profits and dividends generated during 1979. The overall balance of payments registered a deficit of SDR 5 million; this was largely financed by a decline in gross official reserves which, at end-1980, amounted to SDR 23.2 million, equivalent to about four months of imports.

III. Performance Under Stand-By Arrangement

The economic program for 1981 was formulated to mitigate the effects of the sharp deterioration in the terms of trade on the balance of payments, while sustaining investment for steady growth over the medium term. The program was supported by a one-year stand-by arrangement from May 1981 in an amount equivalent to SDR 1.6 million (50 per cent of quota). Policy measures were designed to expand exports, restrain less essential imports, and mobilize domestic resources; these measures included a 6 per cent devaluation of the Solomon Islands dollar in March 1981, a continuation of wage restraint for government employees, and a substantial increase in import duties. The program was broadly successful in achieving its targets for the current account and for inflation (Table 1 and Chart 1). Real growth resumed in 1981, following a sharp decline in 1980, although the growth was considerably below the medium-term objective. Only half of the total amount available under the stand-by arrangement was purchased, because the subceiling on net credit to the Government was exceeded during most of the period due to an unexpected delay in foreign financing of an investment project. The authorities did not request an adjustment of the ceiling. All other performance criteria were observed (Table 2).

1. The balance of payments

The current account deficit of the balance of payments increased from SDR 9.3 million (8.5 per cent of GDP) in 1980 to SDR 17.2 million (12.4 per cent) in 1981, broadly in line with the expectations underlying the program. The increase was due to a 19 per cent deterioration in the terms of trade and a rise in the volume of oil imports related to expanded fishing and logging activities. The increase in the deficit, however, was only about half of what would have been expected from the deterioration in the terms of trade, implying substantial external adjustment. The adjustment was achieved mainly by a 10 per cent expansion in the volume of exports. The current account target was achieved despite a

Table 1. Solomon Islands: Selected Economic Indicators, 1979-82

	1979 Actual	1980 Actual	1981 Program 1/	1981 Actual	1982 Estimate
		(In millions of SDRs)			
Balance of payments					
Current account	8.0	-9.3	-15.7	-17.2	-16.9
(As per cent of GDP)	(7.9)	(-8.5)	(-12.4)	(-12.4)	(-12.1)
Overall balance	5.7	-5.2	-2.3	-10.3	-7.2
External borrowing (1-12 year approvals)	--	--	40.0	17.4	--
		(As per cent of GDP)			
Budget - Revenue and grants	28.6	31.4	29.2	28.2	28.1
- Expenditures	31.0	34.2	35.9	35.0	35.4
- Overall deficit (-)	-2.4	-2.8	-6.7	-6.8	-7.3
Public external debt	2.7	5.3	12.4	9.8	20.0
Debt service ratio 2/	--	--	1.7	1.0	3.5
		(Percentage change)			
GDP growth at constant prices	18.1	-5.5	5.0- 6.0 3/	0.6	-4.0
Consumer prices	9.7	15.9	12.0-14.0	14.6	14.0
Total liquidity	50.2	-8.7	2[illegible].5	-16.4	0.6 4/
Domestic credit 5/	25.5	14.5	26.8	21.2	9.8 4/
Government 5/	-2.5	-7.5	6.6	8.8	5.8 4/
Statutory corporations 5/	10.2	5.8	2.4	1.5	-0.6 4/
Private sector 5/	17.8	16.2	17.8	10.9	4.6 4/
Real effective exchange rate index 6/	7.0	2.6	...	3.8	...
Terms of trade 7/	25.1	-21.2	-23.0	-19.1	-6.2
Export volume	26.6	4.4	13.0	9.7	0.2
Import volume	43.8	-2.4	1.0	0.7	-6.8

1/ The stand-by arrangement extended over the 12-month period ending May 1982, although all targets and policies were based on figures for calendar year 1981. The GDP series has been revised upward recently; the program targets were calculated using the former series.

2/ Interest plus amortization on public debt as ratio of exports of goods and services.

3/ This is the medium-term growth objective.

4/ June 1981-June 1982.

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

6/ Positive numbers imply appreciation.

7/ Negative numbers imply a deterioration.

Table 2. Solomon Islands: Performance 1/ Under Stand-By Arrangement
May 1981-May 1982

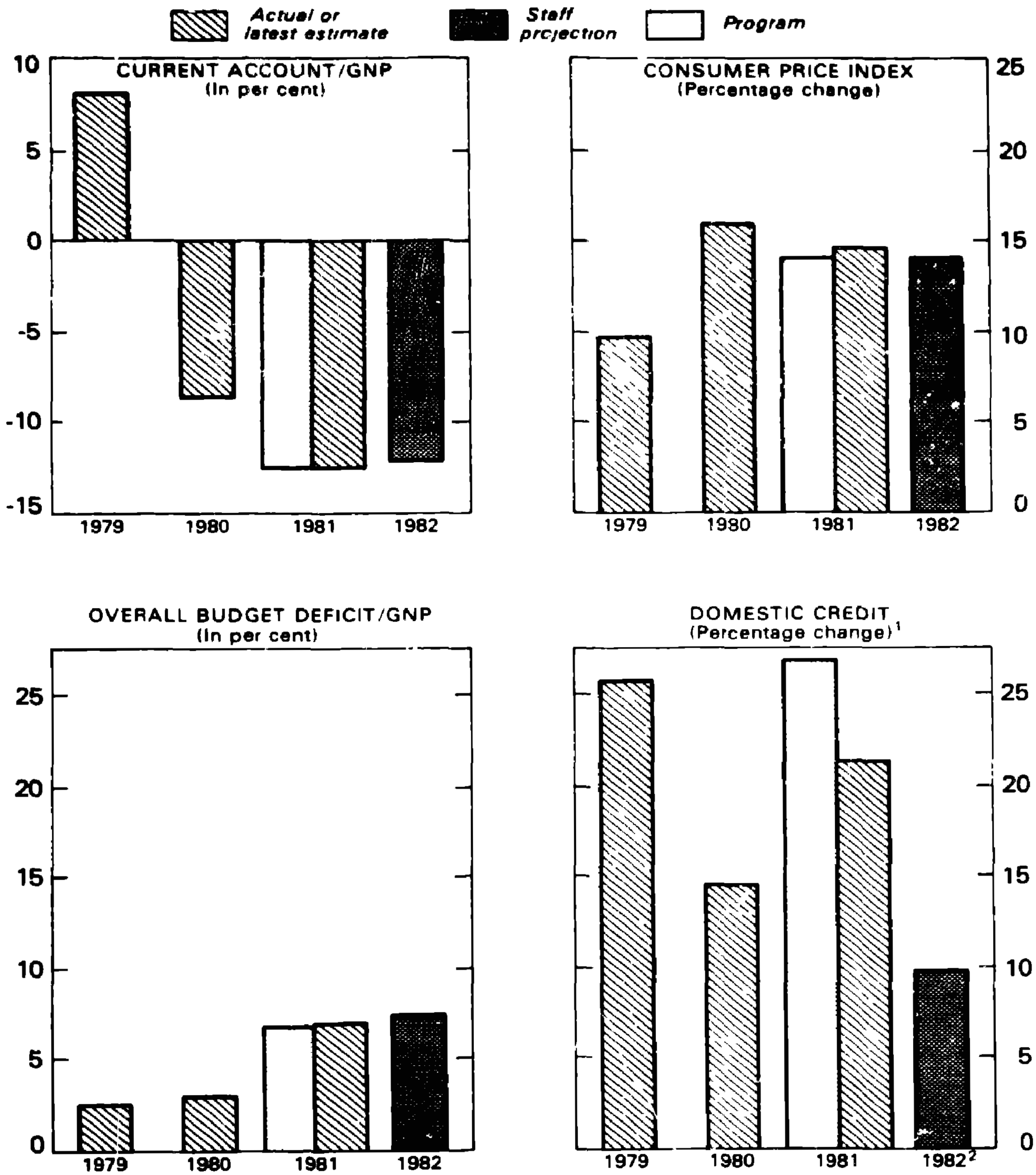
	1981								1982				
	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	April	May
	(In millions of Solomon Islands dollars; end of period)												
Total domestic credit													
Actual	22.4	25.1	24.7	23.6	25.0	24.2	23.8	24.9	25.2	24.0	25.6	25.8	27.6
Ceiling	(25.8)	(25.8)	(25.8)	(25.8)	(25.8)	(27.0)	(27.0)	(27.0)	(30.8)	(30.8)	(30.8)	(30.8)	(30.8)
Net credit to government													
Actual	-1.1	-1.0	-0.7	-1.8	-0.5	-1.2	-3.07	-2.3	-2.4	-1.7	-0.8	-0.4	-0.02
Ceiling	(-2.1)	(-2.1)	(-2.1)	(-2.1)	(-3.1)	(-3.1)	(-3.1)	(-3.1)	(-2.3)	(-2.3)	(-2.3)	(-2.3)	(-2.3)
	(In millions of SDRs)												
External debt contracted													
1-5 years													
Actual	--	--	--	--	--	--	--	--	--	--	--	--	--
Ceiling	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(--)
1-12 years													
Actual	--	--	17.4	17.4	17.4	17.4	17.4	17.4	17.4	17.4	17.4	17.4	17.4
Ceiling	(40.0)	(40.0)	(40.0)	(40.0)	(40.0)	(40.0)	(40.0)	(40.0)	(40.0)	(40.0)	(40.0)	(40.0)	(40.0)

1/ Relating to quantitative performance criteria.

CHART 1

SOLOMON ISLANDS

SELECTED POLICY INDICATORS-TARGETS AND OUTTURN, 1979-82



Sources Data provided by Solomon Islands authorities and staff estimates

1 As per cent of stock of liquidity at begining of period

2 For period June 1981 June 1982

shortfall in official transfers and a higher level of oil imports, because the terms of trade deterioration was somewhat less than expected and there was a substantial decline in imports of investment goods.

Total net inflow of nonmonetary capital was considerably less than envisaged. Delays in project implementation resulted in a shortfall in foreign financing. Direct foreign investment was also depressed due to the uncertain export prospects. Consequently, the overall balance of payments deficit of SDR 10.3 million was much larger than anticipated (SDR 2.3 million). The overall deficit was financed, in approximately equal proportions, by a decline in gross reserves and drawings on a Eurocurrency loan. Gross international reserves at end-1981 amounted to SDR 18.5 million, equivalent to 3.5 months of imports.

The contracting of external debt totaled SDR 17.4 million (i.e., the Eurocurrency loan of US$20 million) during the program period, which was within the program's ceiling of SDR 40 million on nonconcessional external borrowing. Mainly as a result of this loan, external public debt as a proportion of GDP rose from 5 per cent in 1980 to about 20 per cent in 1982. On the basis of contracted external debt outstanding at end-1981, the debt service ratio is projected to rise to about 5 per cent during 1985-87, when the grace period on the Eurocurrency loan expires.1/ The program ceiling also provided for the contracting of SDR 20 million in connection with the Lungga hydroelectric project; however, as explained below, this borrowing was not undertaken due to the postponement of the project.

2. Inflation and growth

Consumer prices, on an end-year basis, increased by 14.6 per cent in 1981, compared with the target of 12 to 14 per cent. Inflation in 1981 was mainly attributable to a 21 per cent increase in the domestic price of imports stemming from increases in supplier prices, the devaluation of the Solomon Islands dollar, higher shipping costs, and a sizable increase in import duties levied at the beginning of the year; imported goods have a weight of about 50 per cent in the consumer price index. Other factors contributing to inflation were a sharp rise in domestic food prices and wage settlements averaging about 15 per cent.

Real GDP increased by about 1 per cent in 1981, well below the 5 to 6 per cent growth targeted over the medium term. Weak external demand conditions and the deterioration in the terms of trade adversely affected profits and private investment. Although data on investment are not available in the national accounts, indicators suggest that investment in 1981 was well below the levels in recent years; imports of investment goods in real terms declined sharply, bank credit to primary and manufacturing sectors fell by over 50 per cent, and private direct investment from abroad virtually ceased on account of uncertain export prospects.

1/ As a ratio to GDP, interest payments on public debt are estimated at about 1 per cent during 1985-87.

Consumption expenditure was also depressed as a consequence of a fall in agricultural incomes and the stagnant level of real wages; food imports declined by about 9 per cent in volume, and there was a marked deceleration in the imports of other consumer goods.

3. Domestic financial policies

The budgetary outcome was broadly on track, except for a shift from project-related external financing to greater recourse to domestic borrowing. The overall deficit of the government budget in 1981 was about 7 per cent of GDP (SI$9.6 million), which was the program target. Despite the weak economy, domestic revenues rose by about 34 per cent during 1981, largely on the basis of a substantial increase in import duties, significant increases in fees and charges for government services, and more efficient income tax collection. This revenue performance was substantially better than had been anticipated in the program. However, recurrent expenditures were also larger than anticipated and entirely absorbed domestic revenue, leaving no current surplus to help finance the development effort. Although the wage bill for public sector employees was in line with program projections, other recurrent expenditures exceeded original estimates; in particular, current expenditures relating to the operation of the marine and shipping fleet, educational services, and the provision of administrative capabilities for the provinces increased considerably. Capital expenditures and net lending rose by only 6 per cent in 1981, substantially less than had been anticipated, reflecting delays in project implementation. Accordingly, the related foreign grants that finance a large portion of capital expenditures were also less than envisaged.

In anticipation of external financing, the Government made infrastructure investments on urban housing sites and related services for the project staff in advance of the construction of the Lungga hydroelectic plant. However, the project was postponed when unexpected complications bearing on its technical and economic feasibility emerged. As a result, external financing was delayed for the infrastructure investments that had already been made. While trying to arrange for alternative external financing, the Government financed these expenditures through recourse to the banking system and in so doing, exceeded the subceiling on net credit to the Government during most of the program period.

Monetary developments during 1981 were substantially different from what had been foreseen in the economic program. The program had assumed that the sharp fall in business deposits with the banking system during January-February 1981 would be reversed during the remainder of the year as business conditions improved. Given a projected balance of payments deficit, the expansion of domestic credit had been programmed to allow for this recovery in total liquidity. In the final outcome, the economy was weaker than had been envisioned, and enterprises continued to deplete deposits with the banking system to make foreign payments rather than incurring additional debt, either foreign or domestic. At end-1981, the level of deposits had fallen significantly below the February level, resulting in a 16 per cent decline in broad money. This development was partially reflected in a substantial increase in the income velocity of money. The expansion of domestic credit was equivalent to only 21 per cent of the stock of broad money, compared to the program target of 26 per cent, with the demand for private sector credit accounting for only about half of the expansion in domestic credit.

As deposit withdrawals were larger than the reduction in demand for private credit, liquidity conditions of banks tightened significantly, particularly in the latter part of the year. Commercial banks raised interest rates on short-term deposits by 0.25 to 0.75 per cent, and lending rates, by 1 to 2 per cent. At year end, the average deposit rate stood at about 9 per cent. When adjusted for the tax-exempt character of interest income, the yield on deposits was equivalent to about 14 per cent.1/ Commercial lending rates ranged between 11 to 15 per cent. To prevent a further liquidity contraction from disrupting normal economic activity, the Solomon Islands Monetary Authority (SIMA) introduced a lending facility to commercial banks to provide supplemental funds for investment projects and normal business requirements. SIMA also issued credit guidelines to encourage banks to lend to priority sectors.

4. Investment and energy policies

An important objective of the economic program was the expansion of exports through sustained investment. Despite the economic difficulties in 1981, most major industries continued to implement investment projects begun in earlier years. In the fishing industry, a new ship was added to the fleet, and two additional ships are currently being built. Two new timber projects have been licensed and are expected to raise log exports by about 25 per cent in 1983, while investment in palm oil and cocoa production has concentrated on increasing the area under cultivation.2/ Investments in replanting coconut to increase copra production have been made mainly by smallholders. Larger copra investments have not taken place due to uncertain prospects for world prices in the near term. Although domestic producer prices have been kept relatively stable through price supports, the continuing weakness of international copra prices has depleted the Copra Board reserves to a level at which it may not be possible to maintain support prices at the existing level for domestic producers.

Imported oil provides the major source of energy in Solomon Islands and accounted for about a quarter of total imports in 1981. To reduce the dependency on imported oil, the Government proposed a hydropower plant near Honiara on the Lungga River with the capacity to meet the expected electricity demand of the region through 1990. The Government

1/ Most time deposits with the banking system are held by the National Provident Fund and by a relatively small number of companies which are in the 35 per cent income tax bracket.

2/ Most of these projects are joint ventures in which the Government is a sizable minority shareholder.

is reassessing the project because the final estimated cost was unacceptably high. If the Government decides to shelve this project, a wood-burning power plant will be developed instead. The feasibility of producing biowaste energy and solar energy economically is also being studied. To encourage energy conservation, the Government's policy has been to raise domestic energy prices in line with the import prices of oil;1/ the rates of taxation on imported petroleum products were more than doubled in 1981, to a range of about 10 to 20 per cent. Retail prices for gasoline and electricity were increased by 19 and 25 per cent, respectively, during the year.

IV. Economic Prospects and Policies

1. 1982 developments and outlook

The economic situation confronting Solomon Islands in 1982 remains difficult. External demand continues to be weak, and a further deterioration of 6 per cent in the terms of trade is projected. Reflecting the external environment, private consumption and investment remain depressed. Preliminary estimates suggest that real GDP will decline by 4 per cent during the year. The rate of inflation is expected to be about 14 per cent, largely reflecting another substantial increase in import duties at the beginning of the year and the 10 per cent devaluation of the Solomon Islands dollar in August 1982.

The balance of payments projections for 1982 indicate a slight reduction in the current account deficit to SDR 16.9 million (12 per cent of GDP). Total export receipts are projected to decline by 5 per cent, mainly due to sharp reductions in the price and volume of fish exports stemming from excess supply conditions in the North American market (Table 3). With the exception of timber, prices for all major export commodities are projected to decline. At the same time, import payments are projected to fall by 6 per cent mostly because of a 5 per cent decline in the import volume associated with the depressed economy (Chart 2). Net payments for services are forecast to decline substantially, reflecting reduced remittances of profits and dividends and lower payments for use of the fishing fleet due to a shortened season. Inflows of official transfers are projected to fall, partly as a result of a reduction in grants from the United Kingdom. Assuming a slight increase in foreign loan disbursements, the overall deficit is projected to decline to SDR 7.2 million in 1982. The deficit will be financed by a drawdown of international reserves.

The sluggish economy in the first half of 1982 was mirrored in monetary and credit developments. Domestic credit to the private sector rose only marginally, while the Government's recourse to bank credit increased considerably due to revenue shortfalls (Table 4). Business deposits also appear to have increased slightly during the first half

1/ Petroleum products are imported and distributed by a private company, and the Government does not provide any subsidy in the consumption and distribution of petroleum products.

Table 3. Solomon Islands: Balance of Payments, 1979-82

(In millions of SDRs)

	1979	1980	1981 Program	1981 Estimate	1982 Est.
Trade balance	7.8	-0.6	-10.1	-8.2	-7.2
Exports, f.o.b.	53.0	56.3	55.0	56.1	52.8
Imports, f.o.b.	-45.2	-56.9	-65.1	-64.3	-60.0
(Oil)	(-5.8)	(-9.1)	(-12.6)	(-14.8)	(-16.4)
Services (net)	-15.2	-24.0	-24.2	-24.0	-18.9
(profits and dividends)	(-3.6)	(-11.5)	(-8.7)	(-3.0)	(-1.0)
Transfers (net)	15.4	15.3	18.6	15.0	9.2
Official	13.6	14.7	18.0	14.8	8.7
Private	1.8	0.6	0.6	0.2	0.5
Current account balance	8.0	-9.3	-15.7	-17.2	-16.9
Nonmonetary capital	4.9	2.4	14.1	6.5	9.7
Private	3.1	-0.7	4.6	3.4	3.9
Government	1.8	3.1	9.5	3.1	5.8
Allocation of SDRs	0.2	0.2	0.2	0.2	--
Errors and omissions 1/	-7.4	1.5	-0.9	0.2	--
Overall balance	5.7	-5.2	-2.3	-10.3	-7.2
Monetary movements	-5.7	5.2	2.3	10.3	7.2
Monetary authorities (net) 2/	-5.6	4.7	2.3	9.5	7.2
Assets	-6.0	4.9	-4.5	4.7	-1.5
Liabilities	0.4	-0.2	6.8	4.8	8.7
Of which: Use of Fund credit	--	--	1.2	0.8	...
Commercial banks	-0.1	0.5	--	0.8	--
Memorandum item:					
Gross international reserves					
Amount outstanding (SDR mn.)	28.1	23.2	27.7	18.5	20.0
In months of imports	5.9	4.3	4.0	3.7	3.7

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

1/ Includes valuation adjustment.

2/ Includes Central Government.

Table 4. Solomon Islands: Monetary Survey, December 1979–June 1982

	1979 Dec.	1980 Dec.	1981 March	1981 June	1981 Sept.	1981 Dec.	1982 March	1982 June
	(In millions of Solomon Islands dollars)							
Net foreign assets	30.7	22.5	18.2	14.1	14.1	12.0	14.0	13.1
Domestic credit to:	10.9	16.9	18.8	25.1	25.0	24.9	25.6	28.5
Government (net)	-2.5	-5.6	-3.9	-1.0	-0.5	-2.3	-0.8	1.0
Statutory corporations	2.8	5.2	5.4	5.5	5.5	5.8	5.0	5.3
Private sector	10.6	17.3	17.3	20.6	20.0	21.4	21.4	22.2
Broad money	41.3	37.7	33.8	34.8	33.7	31.5	33.3	35.0
Narrow money	11.1	15.1	14.2	14.5	13.7	14.2	14.3	14.2
Quasi-money	30.2	22.6	19.6	20.3	20.0	17.3	19.0	20.8
Other items (net)	0.3	1.7	3.2	4.4	5.4	5.4	6.3	6.6
	(Annual percentage changes)1/							
Domestic credit to:	25.5	14.5	3.4	19.5	27.6	21.2	20.1	9.8
Government (net)	-2.5	-7.5	-9.5	-1.5	13.8	8.8	9.2	5.8
Private sector	17.8	16.2	8.2	16.2	12.0	10.9	12.1	4.6
Broad money	50.2	-8.7	-11.1	-10.5	-12.2	-16.4	-1.5	0.6

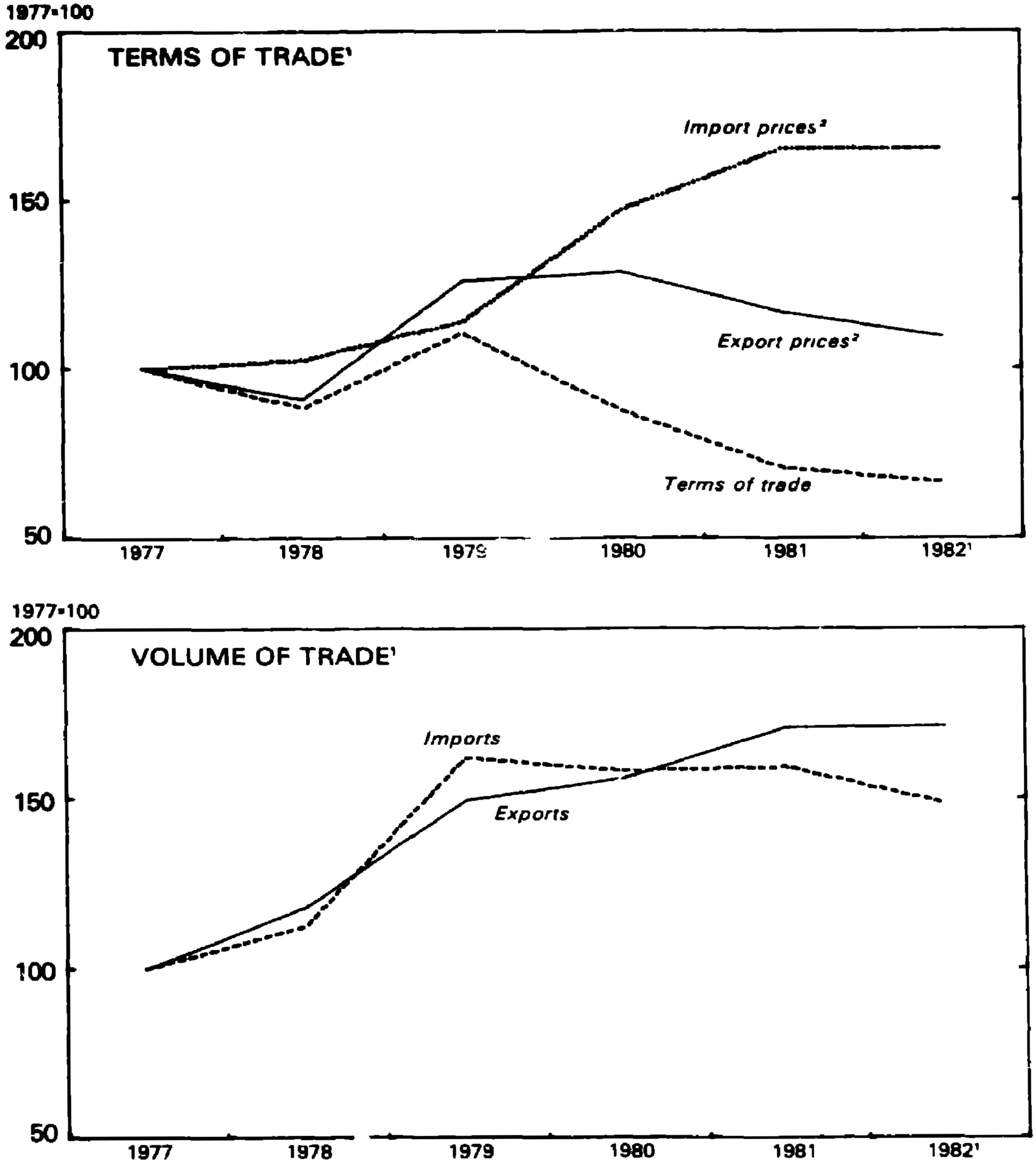
Source: SIMA Annual Report, 1981.

1/ In relation to stock of broad money outstanding in the same period of preceding year.

CHART 2

SOLOMON ISLANDS

FOREIGN TRADE INDICES, 1977-82



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

[1] Staff estimates

[2] In terms of SDRs

from the low levels of December 1981. Broad money rose by 10 per cent during the period, mainly reflecting an increase in deposits of the National Provident Fund.

Based on fiscal developments during the first half of 1982, the overall budget deficit is expected to be SI$11.1 million (7.3 per cent of GDP), compared to a deficit of SI$8.3 million (5.5 per cent) in the original budget (Table 5). The larger-than-expected deficit is mainly the result of a sizable shortfall in import duties and a modest overrun in recurrent expenditures. In the 1982 budget, measures were announced to raise revenues from import duties by 44 per cent, whereby such duties would account for almost half of total tax revenue. The measures included the imposition of duties ranging between 5 to 10 per cent on all previously duty-free items, a sharp increase in duties on petroleum products, and increases of 5 to 15 per cent on almost all other items. During the first half of the year, however, import duty revenues were substantially lower than expected due to a decline in import volumes; an 18 per cent increase in revenue from import duties is now expected in 1982. Export duties have also been revised downward as a result of weak external demand. Recurrent expenditures are projected to be 11 per cent higher than in 1981, partly due to a 10 to 12 per cent increase in wage and salary payments for government employees; no provision for an increase in employee compensation had been made in the original budget. A 19 per cent increase in capital expenditures is now estimated for 1982, which represents a sharp downward revision relative to the original estimate. Delays in the planning and execution of development projects account for the revision. The estimate for foreign grants, which finance a large portion of development expenditures, has also been adjusted accordingly. The authorities intend to finance the increase in the estimated budget deficit, relative to the original budget estimate, largely through domestic bank borrowing.

2. Longer-term prospects and policy issues

Given the decline in real GDP in recent years, a principal goal for 1983 should be the resumption of export-led growth. Solomon Islands has considerable potential for further growth through the development of its natural resources. Although the copra industry is relatively mature, expansion in exports could be generated by further investments in timber, palm oil, and fishing. Cocoa is expected to emerge as an important export during the second half of the decade and experimental production of coffee has also yielded promising results. Moreover, export production could be spurred by the development of capabilities for processing primary output, such as the new fishing cannery planned for 1985. Against this background, the staff discussed with the authorities macroeconomic targets and policies for 1983, focusing on those which would provide appropriate incentives for sustained investment in export industries, while mobilizing domestic savings to a level consistent with a sustainable balance of payments position.

Table 5. Solomon Islands: Summary of Central Government Budget, 1979-82

(In millions of Solomon Islands dollars)

	1979	1980	1981 Program	1981 Prelim.	1982 (Estimate) Budget	1982 (Estimate) Revised 1/
Revenues and grants	32.2	37.4	39.0	40.0	51.3	42.9
Domestic revenue	19.5	23.7	26.8	31.8	37.3	34.1
Tax revenue	15.7	18.5	20.5	24.2	29.7	26.5
Income tax	(5.0)	(7.3)	(8.5)	(9.6)	(10.3)	(10.5)
Export duties	(5.5)	(4.4)	(4.5)	(4.1)	(4.8)	(3.8)
Import duties	(4.4)	(5.6)	(7.1)	(9.3)	(13.4)	(11.0)
Other tax revenue	(0.8)	(1.2)	(0.5)	(1.2)	(1.2)	(1.2)
Other revenues and fees	3.8	5.2	6.3	7.6	7.6	7.6
Grants	12.7	13.7	12.2	8.2	14.0	8.8
Expenditure and net lending	34.9	40.7	48.0	49.6	59.6	54.0
Recurrent	19.9	24.1	27.9	32.0	33.9	35.4
Capital	12.0	11.4	15.6	10.8	19.9	12.8
Net lending	3.0	5.2	4.6	6.8	5.8	5.8
Overall deficit	-2.7	-3.3	-9.0	-9.6	-8.3	-11.1
Total financing	2.7	-3.3	9.0	9.6	8.3	11.1
Domestic	0.7	-0.1	3.0	6.4	0.8	3.1
Of which: Banking system	(-0.7)	(-3.1)	(2.5)	(3.3)	(--)	(...)
Foreign borrowing (net)	2.0	3.4	6.0	3.2	7.5	8.0

Sources: Data provided by the Solomon Islands authorities, SIMA Annual Report, 1981, Ministry of Finance; and staff estimates.

1/ Staff estimate.

Recovery in external demand would offer considerable scope for an expansion in export volume. Given suitable policies, a reduction in the current account deficit from 12 per cent of GDP in 1982 to about 9 per cent in 1983 would be an appropriate target. A deficit of this magnitude can be financed by the expected net inflow of capital, the current level of reserves, and commercial borrowing which would be consistent with maintaining debt service at about 6 per cent of exports of goods and services over the medium term. Consistent with this adjustment, a recovery of real GDP growth to a range of 4 to 5 per cent appears feasible, as improved external conditions revive domestic investment, production, and income. A substantial reduction in inflation to less than 10 per cent should also be an important policy objective.

a. Exchange rate policy

During the discussions, the authorities and the staff shared the view that export profitability had been impaired by the fall in international commodity prices and by the appreciation of the Solomon Islands dollar. Due to the sharp appreciation of the U.S. dollar against other major currencies during 1981-82 and the relatively higher rate of inflation in Solomon Islands, the trade-weighted real effective exchange rate index had risen by March 1982 to a level about 9 per cent higher than the level of February 1981 (Chart 3).1/ A comparison of export profitability by commodity in Solomon Islands with that in its main competitor countries, based on exchange rate movements and domestic costs, suggests that this appreciation had eroded relative export profitability. According to indicators constructed by the staff, export profitability in Solomon Islands had deteriorated by 1 per cent in copra and 6 per cent in fish in relation to its competitors during the period March 1981 through December 1981, the latest date for which data are available.2/ On average, a 4 per cent deterioration in export profitability was indicated. Discussions with industry representatives confirmed that a number of important export companies faced tight financial situations.

The authorities devalued the Solomon Islands dollar by 10 per cent on August 13, 1982. In addition, the authorities switched the currency peg to a trade-weighted basket and allowed for a 2 per cent discretionary band in either direction around the peg. In the staff's view, the latest exchange rate adjustment should contribute to enhancing profitability in the export and import-competing sectors. The adoption of a trade-weighted currency basket is also expected to improve exchange rate management by focusing on conditions prevailing in trading partner countries that affect export and import demand. It continues to be necessary to monitor exchange rate and price developments in competitor countries to provide an indication of relative export competitiveness.

1/ During 1981-82, the Solomon Islands dollar was pegged to a settlement-weighted currency basket dominated by the U.S. dollar, although the United States is a relatively minor trading partner.

2/ For details on the export-competitor weighted effective exchange rate index, see the forthcoming Recent Economic Developments, Annex I.

b. Wage policy

The Government is the largest employer in Solomon Islands, and wage adjustments for its employees usually establish a guideline for the rest of the economy. The Government recently entered into a three-year agreement with the Union of Government Employees whereby wages would be adjusted upward each year by 3 per cent plus one half of the increase in the consumer price index during the preceding 12 months. While recognizing the possible merits of such an arrangement in dampening inflationary pressures, the staff observed that it could also lead to an increase in the real wages that exporters would pay their labor during a profit squeeze stemming from recessionary trends in external markets. The staff suggested that provision be made in wage settlements to take account of profit conditions and labor productivity.

c. Fiscal policy

Despite the difficult economic situation during 1980-82, the revenue performance has been remarkably buoyant. Tax revenues as a per cent of GDP rose steadily from a level below 14 per cent in 1979 to an estimate exceeding 17 per cent in 1982. This increase is entirely due to revenues generated by higher personal income tax receipts and import duties. As a result of a substantial increase in tariff rates, import duties are expected to provide over 40 per cent of total tax revenue in 1982, compared with 28 per cent in 1979. The staff observed that the average rate of import duties to imports, however, now stands at about 18 per cent, almost double the average rate in 1979, and that the potential for further increases in import duties may be more limited. In the future, the scope for greater reliance on domestic-based taxes should be reviewed in order to provide a more stable and balanced source of revenue.

Budgetary expenditures and net lending as a per cent of GDP increased from about 31 per cent in 1979 to about 35 per cent in 1982. To a large extent, this rapid growth in expenditures is due to the transfer of functions from colonial to national authorities and the enlargement of the government administration following independence in mid-1978. Recurrent expenditures as a per cent of GDP have risen by about a third since 1979 to 23 per cent in 1982, with substantial increases in grants to local governments and in expenditures on health care and education. The authorities indicated that the 1983 budget would reflect their aim to slow expenditure growth as a means of reducing the fiscal and external deficits.

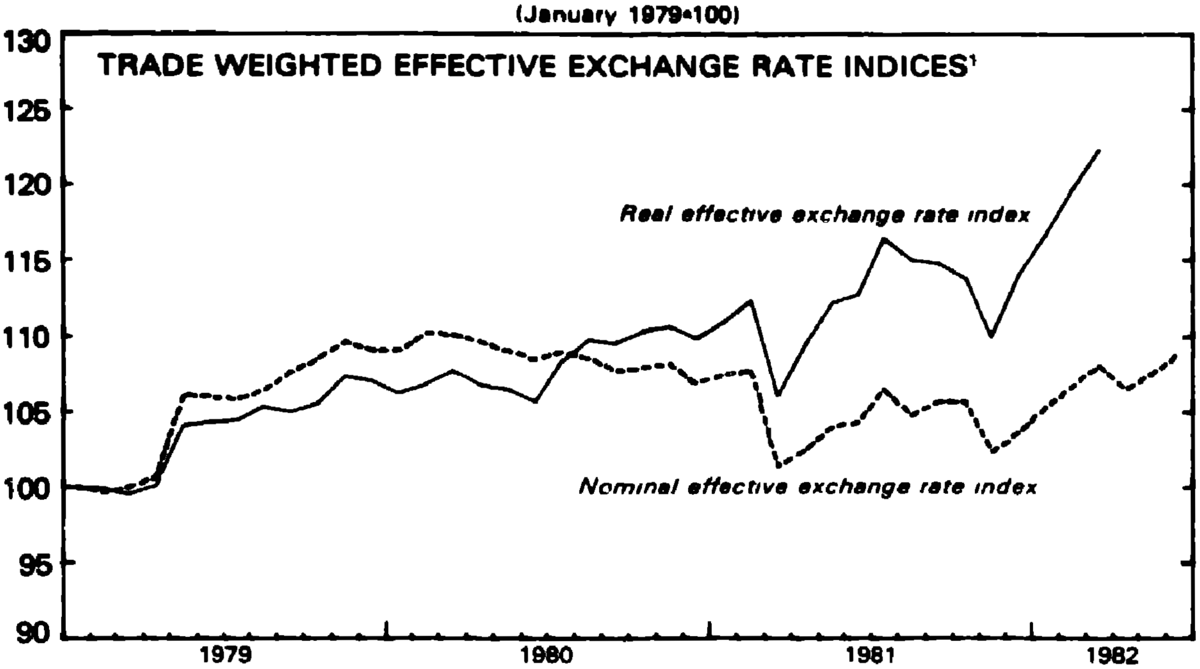
Since independence, capital expenditures have been largely financed by foreign grants and concessionary loans from governments and multilateral institutions. These expenditures have virtually stagnated since 1979, mainly as a result of shortages in skilled manpower for project formulation and implementation. In 1983 and beyond, however, the availability of external financing could emerge as a constraint, as grants from the United Kingdom, which accounted for about three quarters of total foreign grants in 1981, are to be phased down significantly in real terms. The authorities are seeking alternative sources of external funding.

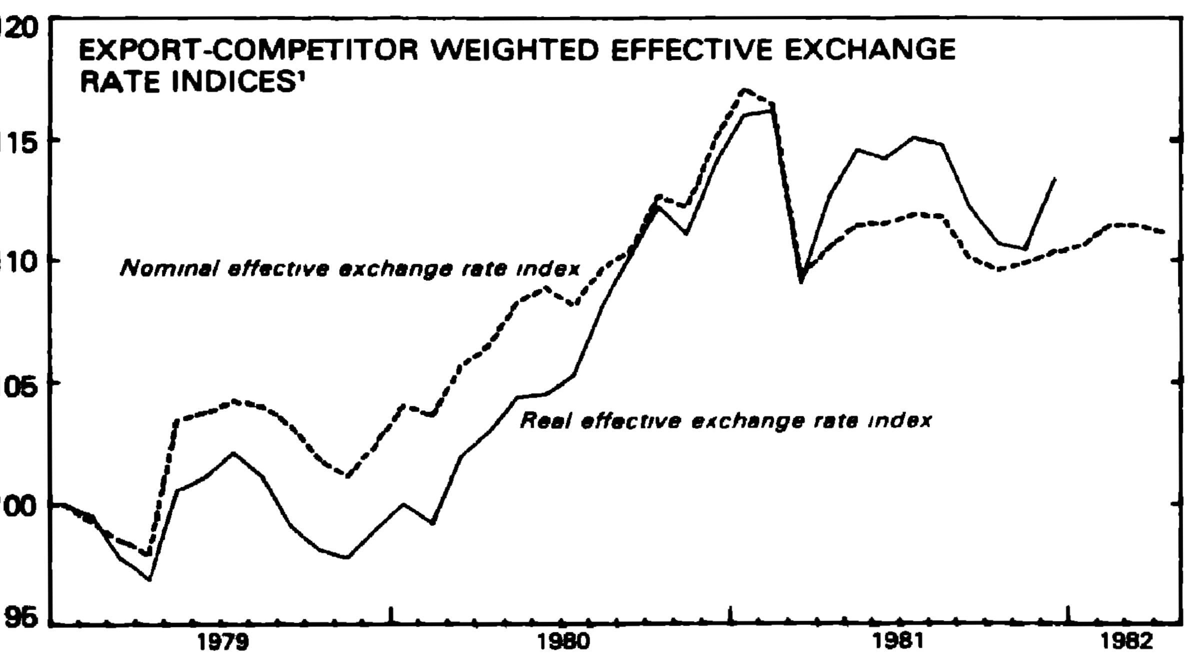
CHART 3

SOLOMON ISLANDS

EFFECTIVE EXCHANGE RATE OF THE SOLOMON ISLANDS DOLLAR, 1979-82

(January 1979=100)





Source: Staff calculations

[1] Increase represents an effective appreciation

d. Monetary and credit policy

From its establishment in 1976 through 1980, SIMA refrained from using the usual credit control powers of the central bank, preferring to allow domestic credit expansion to the private sector to be determined by commercial bank lending decisions. In early 1981, however, SIMA took the first step to strengthen its control over credit expansion by introducing reserve requirements on commercial banks. During the second half of the year, SIMA established a lending facility, which operates like a discount window, whereby commercial banks can borrow funds on a short-term basis in order to supplement their own resources. Treasury bills were issued for the first time in October 1981 with the expectation that the continued development of the Treasury bill market would eventually provide a basis for open market operations. SIMA also intends to influence credit conditions by adjusting the interest rate paid on commercial bank excess reserves on deposit. Each of these measures is expected to improve the efficacy of monetary policy.

The authorities indicated their intention to continue policies to promote the mobilization of financial savings and the development of the financial system. While the authorities recognized that higher rates might mobilize additional financial savings, they emphasized that interest rates were market-determined and that policy efforts to raise deposit rates 1/ at the present time could also cause lending rates to rise. They were concerned that in a period of economic weakness, this would further depress private investment activity. As part of their effort to extend the banking system into rural areas, the authorities established in March 1981 the National Bank of Solomon Islands (NBSI), a joint venture with a foreign commercial bank and the Government. In conjunction with the Development Bank of Solomon Islands, NBSI has expanded the number of agency branches in the outlying islands and has improved these facilities. In addition, banking opportunities are being offered to the outer provinces through a system of mobile banks operated on ships that visit the islands on a regular basis.

V. Staff Appraisal

With an export structure highly dependent upon a relatively small number of commodities, Solomon Islands has experienced a deterioration in the terms of trade of more than 25 per cent during 1981-82. Nevertheless, the economy has achieved a significant degree of external adjustment; the deterioration in the current account of the balance of payments has been limited to less than one half of what would have resulted from the decline in the terms of trade during the period. Weak external demand conditions and the terms of trade development, however, had a severe effect on profits and private investment. Real GDP rose only marginally in 1981 and is projected to decline significantly in 1982.

1/ The average yields on such deposits are currently positive in real terms and roughly in line with rates available in external markets on a tax-adjusted basis.

For 1983, a modest improvement in the terms of trade is envisaged, and real GDP is expected to grow by 4 to 5 per cent on the stimulus provided by an increase in export volume.

In the face of unfavorable external economic developments, the Government's economic and financial policies during 1981-82 were designed to expand exports, restrain less essential imports, and to increase domestic resource mobilization. The policy measures included a devaluation of the Solomon Islands dollar in March 1981 and in August 1982, substantial increases in import duties and improvements in tax collection, and a continuation of investment projects in export industries. At the same time, monetary policy was conducted in a flexible and pragmatic manner. As a whole, these policies helped contain the deterioration in the external accounts. However, the budget deficits and the Government's net use of bank credit were greater than expected in both years. There have been problems in the planning and execution of development projects and also in containing recurrent expenditures to budgeted levels. Although the revenue performance has been buoyant, this has been based partly on a markedly increased dependence on import duties. The scope for greater reliance on domestic-based taxes should be reviewed in order to provide a more stable and balanced source of revenue.

The policy strategy for 1983 should aim at stimulating export-led growth by influencing the domestic cost/price structure. The devaluation in August 1982 and the increased flexibility in exchange rate policy should help enhance export profitability. However, it is important that this exchange rate adjustment be supported by appropriate monetary and fiscal policies and by measures to contain wages.

Budgetary policy is of crucial importance. The staff believes that failure to reduce the budget deficit significantly in 1983 would hinder the adjustment effort and may crowd out private investment or intensify pressures on the balance of payments and prices, particularly since foreign aid prospects are somewhat less optimistic. The tax performance is likely to benefit from further improvements in revenue collection and from the resumption of economic growth. However, the staff believes that additional budgetary adjustment would be needed and that it should come largely from restraint in current expenditures.

In that connection, monetary policy must be conducted in a manner that covers the credit needs of the productive sector, without adversely affecting the balance of payments or generating inflation. The staff welcomes the recent measures to improve the scope for monetary management. At the same time, the staff believes that efforts should be continued to strengthen the mobilization of domestic savings and encourage the development of the financial system; the extension of banking facilities in rural areas and active use of interest rate policy could contribute to the realization of these objectives.

The Government's policy linking wage increases to the inflation rate in the preceding year is intended to provide a guideline for wage settlements in the rest of the economy and to dampen inflationary pressures. While cognizant of the advantages of this arrangement, the staff believes that wage settlements in the private sector must also take into account changes in productivity and the profitability of the enterprises.

The staff believes that policy adjustments along the above lines should strengthen the export sector and improve the balance of payments over the medium term. However, considering the uncertainties in the world economic situation, the staff believes that the authorities should maintain flexibility in domestic policies to permit further adjustments should the need arise.

Fund Relations with Solomon Islands

Date of membership:	September 22, 1978.
Quota:	SDR 3.2 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:	Under the one-year stand-by arrangement (May 29, 1981-May 28, 1982) for SDR 1.60 million, SDR 0.8 million were purchased leaving an undrawn balance of SDR 0.8 million on expiry of the arrangement.
Fund holdings of Solomon Islands dollars (as of August 31, 1982):	SDR 3.98 million or 124.40 per cent of quota.
SDR holdings (as of August 31, 1982):	SDR 1.25 million, or 192.23 per cent 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 of four of its major trading partners: the U.S. dollar, the Australian dollar, the Japanese yen, and the pound sterling. Concomitantly, the Monetary Authority was authorized to make discretionary adjustments to the exchange rate of the Solomon Islands dollar with respect to the currency basket, which do not exceed, on balance, 2 per cent in any four-week period. The representative rate of the Solomon Islands dollar, established with the Fund, is the rate for the U.S. dollar obtained on the basis of the mid-point between buying and selling rates for the Solomon Islands dollar against the Australian dollar and the representative rate for the Australian dollar.
Technical assistance:	The Central Banking and Fiscal Affairs Departments and the Bureau of Statistics have provided technical assistance in the areas of monetary management, 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 General, Operational, and Research Managers of the Solomon Islands Monetary Authority. In addition, the CBD will provide assistance in drafting legislation governing the transformation of the Monetary Authority into a central bank.
Last Article IV consultation:	October 29, 1980 (SM/80/244); staff discussions were held during September 1-14, 1980.

World Bank Group Operations in Solomon Islands

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

Project Description

1. The project will assist the DBSI in providing finance for investments in all sectors of the economy for the period 1981-82. The AsDB is the lead cofinancier for this operation. Their US$2.0 million credit became effective on May 21, 1981 and disbursements from their credit have commenced. DBSI operations are proceeding approximately as planned and disbursement requests for the IDA credit are expected to commence soon.

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

Solomon Islands

Basic Data

Area: 28,896 square kilometers

Population (1981): 233,000

GDP per capita (1981): SDR 506

	1979	1980	1981	1982 Staff Proj.
Output and prices (annual rates of change in per cent):				
Real GDP	18.1	-5.5	0.6	-4.0
Consumer prices	9.9	15.9	14.6	14.0
Money and credit (annual rates of change in per cent): 1/				
Broad money	50.2	-8.7	-16.4	0.6 2/
Total domestic credit	25.5	14.5	21.2	9.8 2/
Credit to private sector	17.8	16.2	10.9	4.6 2/
Public finance (annual rates of change in per cent):				
Domestic revenue	41.5	21.5	34.1	9.7
Current expenditure	20.3	21.1	32.8	10.6
Capital expenditure and net lending	32.7	10.7	6.0	5.7
Total expenditure	27.4	16.6	21.9	9.8
Foreign trade (annual rates ot change in per cent):				
Export volume	26.6	4.4	9.7	0.2
Export unit value	40.0	1.8	-9.2	-6.1
Import volume	43.8	-2.4	0.7	-6.8
Import unit value	11.1	29.0	12.2	0.1
Terms of trade	25.1	-21.2	-19.1	-6.2
Balance of payments (SDR million):				
Exports (f.o.b.)	53.0	56.3	56.1	52.8
Of which: Copra	14.4	9.7	7.9	7.6
Timber	13.1	13.8	14.3	18.9
Palm oil	5.9	6.2	6.9	6.6
Fish (fresh and frozen)	13.0	18.3	18.5	10.4
Imports (f.o.b.)	45.2	56.9	64.3	60.0
Trade balance	7.8	-0.6	-8.2	-7.2
Current account balance	8.0	-9.3	-17.2	-16.9
Overall balance	5.7	-5.2	-10.3	-7.2

Solomon Islands (concluded)

Basic Data

	1979	1980	1981	1982 Staff Proj.
Gross international reserves (end of period):				
In millions of SDRs	28.1	23.2	18.5	20.0
In weeks of imports	32.6	20.0	15.1	17.4
Selected financial ratios (in per cent):				
Current account surplus or deficit/GDP	7.9	-8.5	-12.4	-12.1
Government budget deficit/GDP	2.4	2.8	6.8	7.3
External debt/GDP 3/	2.7	5.3	9.8	20.0
External debt service ratio 4/	--	--	1.0	3.5
Oil imports/total imports	12.8	16.0	23.0	27.3

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

1/ In relation to stock of broad money at beginning of period.
2/ From June 1982-June 1981.
3/ External public sector debt.
4/ Interest plus amortization on public debt as ratio of exports of goods and services.