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SM/82/199
Correction 1

CONTAINS CONFIDENTIAL
INFORMATION

October 22, 1982

To: Members of the Executive Board
From: The Acting Secretary
Subject: Solomon Islands - Staff Report for the 1982 Article IV
Consultation

The following corrections have been made in SM/82/199 (10/4/82):

Page 8, line 8: for "10 to 30 per cent" read "10 to 20 per cent"

Page 16, line 2: for "by 6 per cent" read "by 4 to 5 per cent"

Corrected pages are attached.

Att: (2)

Other Distribution:
Department Heads

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.

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.