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SM/82/203
Correction 1

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INFORMATION

October 22, 1982

To: Members of the Executive Board

From: The Acting Secretary

Subject: Solomon Islands - Recent Economic Developments

The following corrections have been made in SM/82/203 (10/12/82):

Page 2, para. 2, line 2: for "a 21 per cent" read "a 19 per cent"

Page 5, line 2: for "38,000 metric tons" read "34,000 metric tons"

Page 27, column 1982, line 28: for "21.6" read "20.0"

line 29: for "4.0" read "3.7"

Page 30, 2nd full para., penultimate line: for "to SDR 21.6 million"
read "to SDR 20.0 million"

Corrected pages are attached.

Att: (4)

Other Distribution:
Department Heads

I. Introduction and Summary

During the 1970s, Solomon Islands recorded an annual average growth rate of about 8 per cent; however, in 1980, GDP at constant factor cost declined by 5.5 per cent. A sharp deterioration in the terms of trade compounded by a fall in copra and fish output adversely affected the profit position of businesses, and this, coupled with uncertain export prospects, curtailed the growth of new private investment. The pattern of economic development remained broadly the same in 1981; although output of most major commodities revived due to favorable production conditions, real operating surpluses of businesses and households continued to decline on account of further deterioration in the terms of trade. Real GDP grew by less than 1 per cent during the year. Available indicators suggest that investment in 1981 was well below the levels of recent years. In 1982, external demand continues to be weak and the terms of trade is expected to deteriorate further. Preliminary estimates suggest that real GDP will decline by 4 per cent.

The rate of inflation slowed to 14.6 per cent in 1981 from 15.9 per cent in 1980, due mainly to a lower rate of increase in external prices. In the first half of 1982, consumer prices increased at an annual rate of slightly less than 14 per cent, reflecting in part a sharp increase in import duties at the beginning of the year. Wage settlements averaged 10 to 12 per cent during 1980-82. Formal employment rose by 7 per cent in 1981.

Fiscal developments in 1981 were characterized by a rapid growth of domestic revenues and recurrent expenditures and by declines in capital outlays and foreign grants. Domestic revenues rose by 34 per cent, reflecting large increases in revenues from import duties and income taxes. Current expenditures increased by 33 per cent due partly to an increase in expenses relating to the administration of local governments. Delays in project formulation and execution contributed to a fall in capital outlays and also to a reduction in foreign grants. Reflecting these developments, the overall budget deficit expanded from 2.8 per cent of GDP in 1980 to 6.8 per cent, with the increase in the deficit mostly financed through greater recourse to domestic borrowing.

In 1982, the overall budget deficit is expected to expand further to 7.3 per cent of GDP, mainly as a result of stagnation in the growth of total revenues and grants. The revenue strategy in the original budget was to increase domestic revenues by 17 per cent over 1981, largely on the basis of a 44 per cent rise in revenues from import duties. During the first half of the year, the increase in import duty revenues was below expectations because of a decline in import volume, and total domestic revenues are now expected to increase by 7 per cent for the year. Current expenditures are expected to increase by 11 per cent, while continued delays in project formulation and execution are expected to constrain the growth of capital outlays and net lending to about 6 per cent.

Monetary and credit developments during 1981-82 reflected the erosion in export profitability and the uncertain business climate. Broad money fell by 16 per cent as depressed export earnings and the sluggish economy led enterprises to liquidate a large portion of their time deposits with the banking system to make foreign payments. In addition to depleting deposits, some enterprises also turned to the banking system to borrow funds for working capital. Partly as a result of this, total domestic credit rose by 21 per cent of the stock of broad money, with over half of the credit expansion in the private sector. During the first half of 1982, the rise in total domestic credit was equivalent to about 11 per cent of the stock of broad money at end-1981, with almost all of the credit expansion financing revenue shortfalls in the government budget. Broad money rose by 10 per cent during the first half, mainly reflecting a further increase in time deposits held by the National Provident Fund (NPF).

The balance of payments position remained weak in 1981, due mainly to a 19 per cent deterioration in the terms of trade. The volume of exports rose by about 10 per cent while that of imports virtually stagnated. As a result, the current account deficit widened from SDR 9.3 million (8.5 per cent of GDP) in 1980 to SDR 17.2 million (12.4 per cent). Although the capital inflow rose substantially due to an increase in private borrowing, the overall deficit nearly doubled to SDR 10.3 million, which was financed by a drawdown of international reserves and a Eurocurrency loan. The pattern of balance of payments developments has remained broadly the same in 1982; the terms of trade are projected to deteriorate further by 6 per cent. The volume of exports is expected to stagnate while that of imports is to decline considerably due to the sluggishness of the economy. As the value of imports is projected to decline more than that of exports, the trade deficit is expected to be smaller. With the reduced trade deficit, a modest reduction in the current account deficit to SDR 16.9 million (12.1 per cent of GDP) is projected for 1982. Net capital inflows are estimated to increase slightly, reflecting the inflow of loans for development projects. The overall deficit is expected to decline to SDR 7.2 million.

As most of external public debt is on highly concessional terms, debt service payments have been negligible in recent years. In 1981, the Government contracted its first syndicated loan of US$20 million in the Eurodollar market. The debt service ratio was 1 per cent in 1981 and is projected to rise to about 5 per cent during 1985-87 when the grace period on the Eurodollar loan expires. At the end of June 1982, gross international reserves amounted to SDR 29.0 million, equivalent to about five months of estimated imports. Such reserves are projected to decline by the end of the year to SDR 20.0 million, equivalent to less than four months of imports.

During the period from March 1981 to the early part of August 1982, the Solomon Islands dollar was pegged to a settlement-weighted currency basket dominated by the U.S. dollar. The trade-weighted real effective exchange rate index had, however, risen by March 1982 to a level about 9 per cent higher than the level of February 1981, when the Solomon Islands work stoppage on one of the major plantations, production revived in 1981 and reached an all time high of 34,000 metric tons, despite a continuing decline in export and domestic buying prices (Table 2). The perverse movements between production and price of copra reflected the results of substantial replanting of coconut trees by smallholders three to five years ago and attempts by producers to maintain income levels in the face of declining prices (Chart 1). In 1981, the share of smallholders in total production of copra continued to increase and reached 70.4 per cent as a consequence of improvements in collection of copra from the outer islands. In 1982, copra production is expected to increase by 2.7 per cent. Considerable potential exists in increasing production through improved collection of copra and in exploiting the number of possible by-products of coconut.

The Copra Board has a monopoly over buying and marketing copra. To increase collection of copra from the outer islands, the Board has established three collection points where copra is graded and packed for export. Since February 1980, the Board buys copra from all producers at a price composed of a uniform basic price and a variable freight equalization component. To determine the latter, the country is divided into four different zones, and freight compensation is paid to producers in each zone on the basis of the average cost of transportation and distance from the nearest collection point. Collection of copra from the outer islands has been further enhanced by improved inter-island shipping facilities.

In setting its domestic buying price, the Copra Board aims at providing producers with a relatively more stable price than the one existing in the international market. For its price support program, the Board accumulates reserves during times of price buoyancy in the world market and uses them when world market prices are depressed to provide price support to domestic producers.1/ During 1981-82, with the sharp

1/ The domestic buying price is determined on the basis of the London c.i.f. export price adjusted for freight and other cost. For example, in June 1982, the domestic buying price was higher than the net receipt of the Copra Board:

	(In U.S. dollars per metric ton)
London c.i.f. export price	315
Freight	70
Fixed cost of Copra Board	20
Shrinkage 5 per cent, brokerage 1/2 per cent of fob value	13
Net receipts of Copra Board	212
Domestic buying price	249
Of which: average freight equalization payment	35
Basic buying price	214
Implicit price support	37

Table 2. Solomon Islands: Copra Production and Prices, 1977-82

	Marketed Production ('000 metric tons)				Prices (SI$ per metric ton)	
	Small-holder	Plantation	Total	Smallholder Share (per cent)	Copra Board 1/ Buying Price Incl. Freight Payment	Export Unit Value 2/
1977	18.1	11.1	29.2	62.0	191	297
1978	17.6	9.9	27.5	64.1	233	301
1979	23.1	10.5	33.6	68.9	332	494
1980	20.5	8.7	29.2	70.1	318	383
1981	23.7	10.0	33.7	70.4	275	255
1982 (Proj)	24.6	10.0	34.6	71.1	275	248

Sources: Statistics Office, Statistical Bulletin, No. 5/82; and data provided by Solomon Islands authorities.

1/ Average price for first grade copra, including the average freight equalisation payment.
2/ Export unit value reflects the F.O.B. Honiara export price.

Table 9. Solomon Islands: Balance of Payments, 1979-82

(In millions of SDRs)

	1979	1980	1981 Estimate	1982 Projections
Trade balance	7.8	-0.6	-8.2	-7.2
Exports, f.o.b.	53.0	56.3	56.1	52.8
Imports, f.o.b.	-45.2	-56.9	-64.3	-60.0
Oil	(-5.8)	(-9.1)	(-14.8)	(-16.4)
Nonoil	(-39.4)	(-47.8)	(-49.5)	(-43.6)
Services (net)	-15.2	-24.0	-24.0	-18.9
Receipts	4.5	9.0	12.2	13.0
Payments	-19.6	-33.0	-36.2	-31.9
Of which: profits and dividends	(-3.6)	(-11.5)	(-3.0)	(-1.0)
Transfers (net)	15.4	15.3	15.0	9.2
Official	13.6	14.7	14.8	8.7
Private	1.8	0.6	0.2	0.5
Current account balance	8.0	-9.3	-17.2	-16.9
Nonmonetary capital	4.9	2.4	6.5	9.7
Private	3.1	-0.7	3.4	3.9
Government	1.8	3.1	3.1	5.8
Allocation of SDRs	0.2	0.2	0.2	--
Errors and omissions 1/	-7.4	1.5	0.2	--
Overall balance	5.7	-5.2	-10.3	-7.2
Monetary movements	-5.7	5.2	10.3	7.2
Monetary authorities (net) 2/	-5.6	4.7	9.5	7.2
Assets	-6.0	4.9	4.7	-3.1
Liabilities	0.4	-0.2	4.8	10.3
Of which: Use of Fund credit	--	--	0.8	...
Commercial banks	-0.1	0.5	0.8	--
Memorandum items:				
Conversion rates - SI$ per SDR				
Average	1.12	1.08	1.03	1.09
End of period	1.13	1.02	1.03	...
Gross international reserves				
Amount outstanding (SDR mn.)	28.1	23.2	18.5	20.0
In months of import	5.9	4.3	3.7	3.7
Current account balance (as per cent of GDP)	(7.9)	(-8.5)	(-12.4)	(-12.1)

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

1/ Includes valuation adjustment.

2/ Includes Central Government.

Balance of payments developments in 1982 have been characterized by continuing deterioration in prices for most major exports and a sharp fall in imports stemming from the sluggishness of the economy. Projections for the year indicate a smaller deficit on the trade balance, as the value of imports is projected to decline more than that of exports. With the reduced trade deficit, a modest reduction in the current account deficit to SDR 16.9 million (12.1 per cent of GDP) is projected, despite a decrease in inflows of official transfers. Net capital inflows are projected to increase slightly, reflecting mainly the inflow of loans for development projects. The overall deficit is projected to decline to SDR 7.2 million.

2. Merchandise trade

In 1981, export earnings stagnated as the fall in export prices completely offset the 10 per cent increase in volume. Lower prices affected most principal export commodities--timber, fish, and copra--which comprised 73 per cent of total exports. The sharpest price declines occurred in copra and timber, the export unit values of which were (in SDR terms) lower than in 1980 by 19 per cent and 15 per cent, respectively (Appendix Table XXI). Timber exports rose by 22 per cent in volume to over 300,000 cubic meters for the first time, providing the main volume uplift in the export sector. The volume of fish exports rose by 10 per cent, reflecting partly the addition of a new boat to the fishing fleet. However, the world market for fish became increasingly unfavorable during 1981 due to the virtual closure of the North American market to imports of tuna. The volume of copra exports remained constant during 1979-81, aided partly by price support provided by the Copra Board to domestic producers. The Government suspended the export duty on copra in 1981. The volume of palm oil exports was also unchanged as existing projects matured and production stabilized. Among other export commodities, the volume of cocoa exports continued to expand in 1981 while rice exports fell as production leveled off and largely met the domestic market need; rising costs related to pest control and a sharp fall in world prices of rice were the major factors contributing to this development.

The export structure of Solomon Islands continued to be dominated by four major commodities--fish, timber, copra, and palm oil--which accounted for 90 per cent of total exports in 1981 (Chart 4). During 1979-81, mainly reflecting the nearly halving of copra prices in the world market, the relative importance of copra in total exports declined, while that of timber increased almost equiproportionately. In recent years, cocoa has increasingly become an important foreign exchange earner.

In 1981, import payments rose by 13 per cent, reflecting mainly the substantial rise in petroleum imports associated with expanded logging and fishing operations (Appendix Tables XXII and XXIII). In contrast, most major categories of nonpetroleum imports declined in volume terms. In particular, there was a marked slowing down in imports of consumer goods due to reduced real incomes and the availability of locally-grown rice at competitive prices. Food imports declined by about 9 per cent in volume. Imports of machinery and transport equipment also declined considerably, reflecting the slowdown in investment activity.

The composition of imports has changed somewhat in recent years. With increasing self-sufficiency in food, food imports declined from 16 per cent to 11 per cent of total imports between 1977-81. During the same period, petroleum imports rose from 14 per cent to 23 per cent of total imports. Manufactured goods, including machinery and transport equipment, continued to comprise the bulk of imports, accounting for 60 per cent of the total in 1981.

In 1982, total export earnings are projected to decline by 5 per cent, reflecting a continued decline in most export prices and stagnant volume. During the first half of the year, prices plummeted for fresh and frozen fish due to excess inventories in the North American market, and for palm oil, as Malaysia (the world's major exporter) increased its export volume substantially. Copra prices also remained weak. Only timber prices appeared to be recovering from the low levels of 1981. Unlike in the previous year, the volume of exports is not expected to increase in 1982, reflecting mainly the substantial decline in fish exports and the continued stagnation in copra exports. However, growth in the volume of palm oil exports is projected to remain strong, as a result of increased yields from a new pollination technique. Timber exports are also forecast to increase slightly toward the medium-term target of 400,000 m^3.

Import payments are projected to decline by 6 per cent in 1982 due to a projected fall in import volume stemming from continued sluggishness in economic activity and reduced real incomes. In the first quarter of 1982, import payments were 17 per cent below the level of the corresponding period in 1981. However, imports are projected to increase somewhat during the remainder of the year, reflecting replenishment of depleted stocks and lumpiness in import payments occurring toward the end of the year. Import prices are projected to increase only by 1 per cent as oil prices are forecast to stabilize and non-oil prices from industrial partner countries are projected to decline.

Solomon Islands' major export markets in 1981 were Japan (37 per cent), the United States, including American Samoa and Trust Territories (24 per cent), the United Kingdom (12 per cent), and the Netherlands (12 per cent) (Appendix Table XXIV). In recent years, the share of total exports to Japan and the United States has increased, while that to the neighboring Pacific island countries and to countries of the European Economic Community declined. Australia continued to be the major source of imports, accounting for about 28 per cent of the total (Appendix Table XXV). Singapore has become an increasingly important supplier of imports. The shares of imports from Singapore, Japan, New Zealand, and the United Kingdom were 22 per cent, 15 per cent, 9 per cent, and 8 per cent, respectively.

3. Services, transfers, capital movements, and reserves

The deficit in the services account remained unchanged in 1981 as the rising costs of freight and insurance and chartering of fishing boats were offset by a decline in outward remittances of dividends and interest, due to reduced profitability in the agriculture and timber enterprises. Transfers also remained unchanged from the 1980 level. Net inflows of nonmonetary capital rose, due to increased private borrowing mainly by the timber industry. However, direct private investment virtually ceased in 1981, reflecting uncertainty over the medium-term outlook for exports.

In 1981, the overall payments deficit of SDR 10.5 million was financed, in roughly equal proportions, by a decline in reserves and a drawdown of SDR 4.3 million (US$5 million) from an Eurodollar loan of US$20 million. Gross official reserves, including the net foreign position of commercial banks and small overseas working balances of the Government, declined by SDR 4.7 million to SDR 18.5 million, the equivalent of 3.7 months of imports (Appendix Table XXVI).

In 1982, net service payments are forecast to decline, owing mainly to reduced remittances of profits and dividends as the financial performance of the exporting sector weakens and payments for use of the fishing fleet decline due to a shortened fishing season. Inflows of official transfers are also projected to decline, reflecting partly the termination of grants from the United Kingdom and partly the decline in the number of projects for which grant financing is available. Net capital inflows are projected to increase slightly, mainly as a result of disbursements for development projects. The projected overall deficit of SDR 7.2 million is expected to be financed by a further drawdown of the Eurodollar loan. Gross official reserves are expected to decline from SDR 29.0 million at the end of June 1982 to SDR 20.0 million at the end of the year, equivalent to four months of estimated exports.

4. External debt

a. Public debt

Due to the availability of grant financing, Solomon Islands' external public debt has been small (Appendix Table XXVII). In 1981, the Government contracted its first syndicated loan of US$20 million in the Eurodollar market. The terms of the loan are eight years, including a four-year grace period on capital repayments, with interest rates of 7/8 per cent above LIBOR for the first two years, 1 per cent for the next two years, and 1.5 per cent thereafter. Repayments are to be made in nine equal instalments beginning in mid-1985. The first drawdown of US$5 million was made in August 1981, and the second of US$10 million, in February 1982. The remaining balance of US$5 million is expected to be drawn before May 1983. Since 1978, the Government has utilized loans from the OPEC Special Fund for balance of payments financing. The most recent of these loans, amounting to US$1 million, was contracted in October 1981, with terms of eight years, including a grace period of three years and interest of 0.5 per cent per year. At end-1981, a balance of US$0.5 million remained to be drawn. Apart from the Asian Development Bank, a recent source of long-term concessional loans was the European Development Fund which, in November 1980, provided a loan equivalent to EUA 780,000 at an interest rate of 0.5 per cent per year for 30 years including a 10-year grace period. In 1981,