

EBS/82/177

CONFIDENTIAL

October 4, 1982

To: Members of the Executive Board

From: The Acting Secretary

Subject: Solomon Islands - Use of Fund Resources - Compensatory
Financing Facility

Attached for consideration by the Executive Directors is a paper on a request expected to be received from the Solomon Islands for a purchase equivalent to SDR 1.6 million under the compensatory financing facility. A draft decision appears on page 9.

It is proposed that this subject, together with the staff report for the 1982 Article IV consultation with the Solomon Islands (EBS/82/199, 10/4/82), be brought to the agenda for discussion on Monday, October 25, 1982.

Att: (1)

INTERNATIONAL MONETARY FUND

SOLOMON ISLANDS

Use of Fund Resources--Compensatory Financing Facility

Prepared by the Research and the Asian Departments

(In consultation with the Exchange and Trade Relations,
Legal, and Treasurer's Departments)

Approved by Wm. C. Hood and P.R. Narvekar

October 4, 1982

The Managing Director has been informed that the Solomon Islands authorities will shortly request a purchase of SDR 1.6 million, equivalent to 50 per cent of quota, under the compensatory financing decision. The request is being made with respect to a shortfall in merchandise exports calculated for the 12 months ended June 1982. If approved, the proposed purchase would raise the Fund's holdings of the member's currency from 124.4 per cent to 174.4 per cent of quota.

This paper, which is being circulated in advance of the formal request from Solomon Islands, is presented in four sections and an annex. The sections deal with: (1) balance of payments position, (2) estimation of the export shortfall, (3) causes of the shortfall and export prospects, and (4) staff appraisal and proposed decision. The member's relations with the Fund are summarized in the Annex.

1. Balance of payments position

The external payments position of Solomon Islands continued to deteriorate during 1981-82. ^{1/} The current account deficit widened from SDR 9.3 million in 1980 to SDR 17.2 million in 1981 as the trade deficit rose sharply on account of a 19 per cent deterioration in the terms of trade (Table 1). Total export earnings remained almost the same despite an increase in export volume, while import payments rose by 13 per cent, reflecting mostly an increase in import prices. Net inflows of nonmonetary capital rose substantially due to an increase in private

^{1/} Developments in balance of payments for 1981 and prospects for 1982 are reviewed in detail in the Staff Report (SM/82/199) and Recent Economic Developments (forthcoming).

Table 1. Solomon Islands: Balance of Payments, 1979-82

| | 1979 | 1980 | 1981 Estimate | 1982 Proj. |
|---|-------|-------|------------------|---------------|
| - - - (In millions of SDRs) - - - | | | | |
| A. Current account | 8.0 | -9.3 | -17.2 | -16.9 |
| 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 |
| Services (net) | -15.2 | -24.0 | -24.0 | -18.9 |
| Transfers (net) | 15.4 | 15.3 | 15.0 | 9.2 |
| B. Capital account | 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 |
| C. Errors and omissions <u>1/</u> | -7.4 | 1.5 | 0.2 | -- |
| D. Allocations of SDRs | 0.2 | 0.2 | 0.2 | -- |
| E. Overall balance (A through D) | 5.7 | -5.2 | -10.3 | -7.2 |
| F. Monetary movements | -5.7 | 5.2 | 10.3 | 7.2 |
| Monetary authorities (net) <u>2/</u> | -5.6 | 4.7 | 9.5 | 7.2 |
| Assets | -6.0 | 4.9 | 4.7 | -1.5 |
| Liabilities | 0.4 | -0.2 | 4.8 | 8.7 |
| Commercial banks | -0.1 | 0.5 | 0.8 | -- |
| <u>Memorandum items:</u> | | | | |
| Current account balance (as per cent of GDP) | 7.9 | -8.5 | -12.4 | -12.1 |
| Gross international reserves (SDR millions) | 28.1 | 23.2 | 18.5 | 20.0 |
| In months of imports | 5.9 | 4.3 | 3.7 | 3.7 |

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

1/ Includes valuation adjustment.

2/ Includes Central Government.

borrowing. However, the improvements in the capital account only partially offset the deterioration in the current account, and the overall balance recorded a deficit of SDR 10.3 million.

In 1982, total export receipts are estimated to fall by 5 per cent largely due to further declines in export prices and steep declines in the volume of fish exports. Import payments are expected to decline by 7 per cent, owing entirely to a projected fall in import volume associated with the weak economy and sharp upward adjustments of import duties at the beginning of the year. The terms of trade are forecast to deteriorate further by 6 per cent, following a fall of 40 per cent during 1980-81. Inflows of official transfers are expected to decline in 1982, reflecting partly a reduction in grants from the United Kingdom. As a result of these developments, the deficit in the current account is expected to reach SDR 17 million (12 per cent of GDP) or at about the same level as in the previous year. Despite an increase in nonmonetary capital inflows expected for the year, the overall balance of payments deficit for 1982 is estimated at SDR 7.2 million. The deficit will be financed by a draw-down of international reserves.

In view of the variability of its export earnings and of the lumpiness of its import payments, the Solomon Islands authorities have traditionally maintained a level of reserves equivalent to about three to four months of imports. At the end of June 1982, gross official international reserves amounted to SDR 29.0 million, equivalent to about five months of estimated imports, reflecting a drawdown earlier in the year of US\$10 million in respect of a Eurocurrency loan. However, such reserves are expected to fall to SDR 20 million, equivalent to less than four months of imports, by the end of 1982 to finance the projected overall deficit for the year. In early 1982, the Solomon Islands received ECU 400,000 under STABEX as part of compensation payments for a shortfall in copra exports incurred in 1981.

2. Estimation of the export shortfall

Following two years of substantial growth (36 per cent in 1978/79 and 49 per cent in 1979/80), Solomon Islands' export earnings grew by 3 per cent in 1980/81 and fell by 1 per cent in the shortfall year (1981/82). The stagnation in earnings is expected to continue through the first post-shortfall year as external demand for most of Solomon Islands' major exports is forecast to remain weak. A recovery based on anticipated increases in both commodity prices and volumes is projected for the second post-shortfall year. On the basis of these export movements, the shortfall in merchandise exports for the year ended June 1982 is estimated at SDR 1.6 million, which is the amount of the proposed purchase (Table 2).

Table 2. Solomon Islands: Estimation of the Export Shortfall

(In million of SDRs)

| | Years Ending June | | | | |
|-------------------|-------------------|------|------|----------------------|------|
| | 1980 | 1981 | 1982 | Projected Exports 1/ | |
| | | | | 1983 | 1984 |
| Exports | 54.8 | 56.7 | 56.2 | 57.0 | 65.0 |
| Shortfall | | | 1.6 | | |
| Proposed purchase | | | 1.6 | | |

1/ Based on judgmental forecast of earnings given in Table 3.

3. Causes of the shortfall and earnings prospects

Copra, Solomon Islands' traditional export, contributed all of the shortfall in total export earnings. The shortfall in copra exports is entirely attributed to lower prices as the volume of shipments in the shortfall year was slightly above the average level in the two pre-shortfall years; only a slight recovery in copra shipments is projected for the two post-shortfall years. Small excesses are estimated for nearly all the other exports.

Reflecting the general decline in commodity prices over the past two years, the aggregate export unit values of the five major exports (timber, fresh and canned fish, palm oil and copra) in the shortfall year ended June 1982 remained at the depressed level of the preceding year. Average export unit values are expected to remain weak through the first post-shortfall year and to recover slightly in the second.

a. Timber

Earnings from timber (mostly sawn logs) have emerged as the largest single export, accounting for nearly 31 per cent of total exports in the shortfall year. The opening up of new forest concessions by major timber companies resulted in both the production of a higher quality timber and larger export shipments; the volume of exports in 1981/82 rose to a record 331,000 cubic meters. This, together with an improvement in prices due to a shift of export composition to higher quality timber, led to a 40 per cent rise in timber exports in the shortfall year. Based on expected further expansion of output by new forest concessions and gradual recovery in timber prices resulting from strengthening of world demand, export earnings

Table 3. Solomon Islands: Export Earnings and Shortfalls by Major Commodities 1/

| | Years Ending June | | | | | | | Shortfall | |
|-----------------------------------|-------------------|-------|-------|--------|--------|--------|--------|-----------|----------------------|
| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | Geometric Arithmetic |
| Total exports | 26.9 | 27.1 | 36.9 | 54.8 | 56.7 | 56.2 | 57.0 | 65.0 | 1.6 1.7 |
| Timber | 8.6 | 6.1 | 7.8 | 16.1 | 12.3 | 17.2 | 19.0 | 22.0 | 0.1 |
| Fish | 8.1 | 6.4 | 8.0 | 14.4 | 25.8 | 18.1 | 16.0 | 18.0 | 0.4 |
| Fresh fish | (6.7) | (5.0) | (6.3) | (12.5) | (22.9) | (15.4) | (13.0) | (14.5) | (-0.1) |
| Canned fish | (1.4) | (1.4) | (1.7) | (1.9) | (2.9) | (2.7) | (3.0) | (3.5) | (-) |
| Palm oil | 2.8 | 3.2 | 5.6 | 5.5 | 6.2 | 7.1 | 7.5 | 8.5 | -0.2 |
| Copra | 5.5 | 8.9 | 11.3 | 14.1 | 7.2 | 7.8 | 8.5 | 9.5 | 1.3 |
| Other exports | 1.9 | 2.5 | 4.2 | 4.7 | 5.2 | 6.0 | 6.0 | 7.0 | -0.3 |
| -- (In millions of SDRs) -- | | | | | | | | | |
| -- (Annual percentage changes) -- | | | | | | | | | |
| Total exports | 1 | 36 | 49 | 3 | -1 | 1 | 1 | 14 | |
| Timber | -29 | 28 | 106 | -24 | 40 | 10 | 10 | 16 | |
| Fish | -21 | 25 | 80 | 79 | -30 | -12 | -12 | 13 | |
| Fresh fish | (-25) | (26) | (98) | (83) | (-33) | (-16) | (-16) | (12) | |
| Canned fish | (-) | (21) | (12) | (53) | (-7) | (11) | (11) | (17) | |
| Palm oil | 14 | 75 | -2 | 13 | 15 | 6 | 6 | 13 | |
| Copra | 62 | 27 | 25 | -49 | 8 | 9 | 9 | 12 | |
| Other exports | 32 | 68 | 12 | 11 | 15 | 15 | 15 | 17 | |

1/ Data provided by the Solomon Islands authorities and Fund staff estimates.

Table 4. Solomon Islands: Value, Volume and Unit Value by Major Commodities

(1982=100)

| Value Share in Total Exports in 1982 (In Per Cent) | Years Ending June | | | | | | | Shortfall in Per Cent of Level in Shortfall Year | | |
|---|-------------------|------|------|-------|-------|-------|-------|---|-------|-----------------|
| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | | 1984 | |
| | | | | | | | | | | |
| Value | 89.3 | 50 | 49 | 65 | 100 | 103 | 100 | 102 | 116 | 4.0 |
| Timber | 30.6 | 50 | 35 | 45 | 94 | 72 | 100 | 110 | 128 | -1.0 (excess) |
| Fish | 32.2 | 45 | 35 | 44 | 80 | 143 | 100 | 88 | 99 | -0.1 (excess) |
| Fresh fish | (27.4) | (44) | (32) | (41) | (81) | (149) | (100) | (84) | (94) | (-1.0)(excess) |
| Canned fish | (4.8) | (52) | (52) | (63) | (70) | (107) | (100) | (111) | (130) | (1.6) |
| Palm oil | 12.6 | 39 | 45 | 79 | 77 | 87 | 100 | 106 | 120 | -3.2 (excess) |
| Copra | 13.9 | 71 | 114 | 145 | 181 | 92 | 100 | 109 | 122 | 17.2 |
| Volume | | 70 | 64 | 80 | 93 | 104 | 100 | 104 | 111 | 2.2 |
| Timber | | 80 | 72 | 73 | 80 | 80 | 100 | 104 | 116 | -5.0 (excess) |
| Fish | | 73 | 50 | 88 | 109 | 140 | 100 | 106 | 110 | 12.2 |
| Fresh fish | | (69) | (44) | (84) | (112) | (144) | (100) | (105) | (108) | (12.8) |
| Canned fish | | (91) | (83) | (106) | (92) | (115) | (100) | (111) | (124) | (7.8) |
| Palm oil | | 39 | 43 | 67 | 67 | 87 | 100 | 104 | 108 | -8.1 (excess) |
| Copra | | 71 | 101 | 90 | 107 | 88 | 100 | 101 | 103 | -0.4 (excess) |
| Unit value | | 71 | 76 | 82 | 107 | 99 | 100 | 97 | 104 | 1.3 |
| Timber | | 62 | 50 | 63 | 116 | 89 | 100 | 106 | 110 | 3.8 |
| Fish | | 62 | 71 | 50 | 73 | 102 | 100 | 84 | 90 | -10.9 (excess) |
| Fresh fish | | (63) | (73) | (49) | (72) | (103) | (100) | (80) | (88) | (-12.2)(excess) |
| Canned fish | | (57) | (62) | (59) | (76) | (93) | (100) | (100) | (105) | (-5.8)(excess) |
| Palm oil | | 102 | 104 | 118 | 115 | 100 | 100 | 102 | 111 | 5.4 |
| Copra | | 99 | 113 | 161 | 168 | 105 | 100 | 108 | 118 | 17.6 |

in the two post-shortfall years are projected to average SDR 20.4 million, implying an annual growth of 12 per cent from the shortfall year. A small excess of SDR 0.2 million is estimated for timber exports in 1981/82.

b. Fish

Fish exports (fresh, frozen and canned) are subject to wide fluctuations from year to year, depending on the size of the catch and marketing conditions. Earnings in the shortfall year fell by 30 per cent, largely on account of a steep drop in the volume of shipments reflecting saturation of the North American market due to excess supply, which is expected to continue through the first post-shortfall year. Earnings from fish and fish products are projected to decline further in the first post-shortfall year, but to recover in 1983/84 to SDR 18 million, about the same level as in the shortfall year. No shortfall is estimated for fish exports in 1981/82.

c. Palm oil

Palm oil exports rose by 15 per cent in the shortfall year and accounted for 13 per cent of total exports in 1981/82. The volume of exports, which has expanded considerably in recent years as a result of increased yields from a new pollination technique, is expected to continue to increase in the next two years but at a slower rate of about 4 per cent per annum. Average export prices in 1981/82 remained depressed, as the leading world exporter (Malaysia) increased its export volume substantially, but they are expected to recover gradually in the post-shortfall period as world demand increases gradually. Earnings from palm oil in the two post-shortfall years are projected to average SDR 8 million, compared with SDR 7.1 million in the shortfall year. An excess of SDR 0.2 million is calculated for 1981/82.

d. Copra

After reaching a peak of SDR 14.1 million in 1979/80, the value of copra exports dropped by 49 per cent to SDR 7.2 million in the 12-month period ended June 1981; the steep decline was largely due to the fall in copra prices on the world market. In the following year, the value of copra exports recovered by 8 per cent to SDR 7.8 million, reflecting a 14 per cent increase in export volume which more than offset the further decline in unit values.

Because of the significant decline in world prices, there have been no large-scale investments in the copra production in the Solomon Islands in recent years. Over two thirds of the country's output is produced by smallholders. The volume of exports in the first post-shortfall year is expected to remain virtually unchanged from 1981/82 and to recover only slightly in 1983/84. A moderate recovery of copra prices is projected on the basis of an improved balance between supply and demand. On the basis of these assumptions, earnings in 1982/83-1983/84 are expected to average

SDR 9 million compared with the SDR 7.8 million realized in the shortfall year. An export shortfall of SDR 1.3 million is estimated for copra exports, all of which is attributed to lower prices.

e. Other exports

This group of exports, consisting mainly of cocoa, rice, tobacco, palm kernels and other miscellaneous products, rose by 15 per cent in the shortfall year to SDR 6 million. In the two post-shortfall years, rice exports are expected to drop sharply as the producing company, which experienced serious financial problems in 1981-82 owing to rising costs and a sharp fall in world prices, is being restructured to meet mainly domestic needs. Cocoa exports, however, are expected to continue their recent growth. Earnings from the group are estimated at SDR 6 million in the first post-shortfall year and at SDR 7 million in the second. A small excess of SDR 0.3 million is calculated for the group as a whole.

4. Staff appraisal and proposed decision

The Solomon Islands authorities are expected to request a purchase equivalent to SDR 1.6 million, or 50 per cent of quota, under the compensatory financing facility in respect of an export shortfall of the same amount estimated for the year ended June 1982. The Solomon Islands currently has no outstanding purchases under the compensatory financing facility.

In 1982, the current account deficit is forecast to remain at the high level of SDR 17 million recorded in 1981, due primarily to a 6 per cent deterioration in the terms of trade. Capital inflows, which are expected to rise from SDR 6.5 million in 1981 to SDR 9.7 million, will cover only part of the projected 1982 current account deficit and, consequently, the overall balance of payments is estimated to record a deficit of SDR 7 million in 1982. Gross official reserves, reflecting a US\$10 million Eurocurrency loan obtained earlier this year, amounted to SDR 29 million at the end of June 1982, but reserves are expected to fall to SDR 20 million (or about 3.7 months of imports) by the end of 1982. The staff believes that Solomon Islands balance of payments need justifies the proposed purchase under the compensatory financing facility.

After expanding by 49 per cent in the 12-month period ended June 1980, total export earnings grew by only 3 per cent in 1980/81 and fell by 1 per cent in the shortfall year. Exports are projected to remain stagnant in the first post-shortfall year because a small recovery in the volume of exports is expected to be partly offset by a further decline in export unit values. A recovery of 14 per cent in earnings is projected for the second post-shortfall year as a result of both higher volumes and prices. The shortfall in total exports is attributed to copra, Solomon Islands' traditional crop; the shortfall in copra exports was entirely due to lower prices. Following a 37 per cent fall in 1980/81, copra export unit values fell a further 5 per cent in the shortfall year owing to the persistent

weak external demand. Small excesses are estimated for all other major exports. The staff therefore believes that the shortfall in total exports is largely attributable to circumstances beyond the member's control, and that, in view of the projected recovery, it is temporary in character. The request for a compensatory purchase is expected to include a statement that Solomon Islands will cooperate with the Fund in efforts to find, where required, appropriate solutions for its balance of payments difficulties.

The staff considers that the request by Solomon Islands under the compensatory financing decision will meet all the requirements set forth in that decision. Accordingly, the following draft decision is proposed for adoption by the Executive Board, after a duly authenticated request has been received:

1. The Fund has received a request by the Government of Solomon Islands for a purchase of the equivalent of SDR 1.6 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979).

2. The Fund approves the purchase in accordance with the request.

Fund Relations with Solomon Islands
(As of August 31, 1982)

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: SDR 3.98 million or 124.40 per cent of quota.

SDR holdings: SDR 1.25 million, or 192.23 per cent of net cumulative allocation of SDR 654,000.

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.

Exchange practices subject to Article VIII: None.

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.