

**FOR  
AGENDA**

SM/08/300

September 10, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Solomon Islands—Staff Report for the 2008 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2008 Article IV consultation with the Solomon Islands, which is tentatively scheduled for discussion on **Monday, October 20, 2008**. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of the Solomon Islands indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Ms. Thacker (ext. 37464), Ms. Fernandez (ext. 35902), and Mr. Vitek (ext. 37393) in APD.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Thursday, September 18, 2008; and to the Asian Development Bank and the European Commission, following its consideration by the Executive Board.

This document, together with a supplement providing an informational annex, will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities. The supplement, which is not being distributed in hard copy, will also be available in the Institutional Repository; a link can be found in the daily list (<http://www-int.imf.org/depts/sec/services/eb/dailydocumentsfull.htm>) for the issuance date shown above.

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INTERNATIONAL MONETARY FUND

SOLOMON ISLANDS

**Staff Report for the 2008 Article IV Consultation**

Prepared by the Staff Representatives for the 2008 Consultation  
with Solomon Islands

Approved by Kalpana Kochhar and Martin Fetherston

September 10, 2008

**Discussions:** Held in Honiara, Solomon Islands, July 16–25, 2008. The mission met with the Minister of Finance, Governor of the Central Bank, other ministries and government agencies, public enterprises, the business community, and donors.

**Team:** Ms. Thacker (Head), Ms. Fernandez, and Mr. Vitek (all APD). Mr. Moveni (OED) joined some of the meetings.

**Past Fund Advice:** Executive Directors' comments at the conclusion of the last Article IV consultation on July 16, 2007, can be found at <http://www.imf.org/external/np/sec/pn/2007/pn07110.htm>.

**The effectiveness of past surveillance remains mixed** (see Annex I, Supplement 2).

**Exchange Arrangement:** The Solomon Islands accepted the obligations of Article VIII, Sections 2(a), 3, and 4 in 1979 and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions. The exchange rate regime is a de facto peg to the U.S. dollar.

**Outreach:** The mission met with donors.

**Publication:** The mission encouraged the authorities to publish the Article IV documents as they have done in previous years.

**Statistics:** Despite some improvements, the coverage and quality of data remain poor, partly reflecting capacity constraints, and hamper effective surveillance.

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## EXECUTIVE SUMMARY

### Background and Challenges

**Economic performance remains strong, but inflation has increased.** Real GDP grew by 10.3 percent last year. For 2008, real GDP growth is projected at 7¼ percent, reflecting a continued rise in unsustainable logging activity, and strong growth in nonlogging sectors. Inflation has picked up recently due to increases in international food and fuel prices and loose domestic policies. The fiscal deficit is expected to widen significantly, reflecting the approval of a large supplementary budget in August. The current account deficit is also expected to widen due to higher food and fuel imports, and mining-related FDI. Reserves are expected to remain at 3 months of projected imports.

**Over the medium term, logging and aid inflows are expected to fall sharply, negatively impacting growth, and the balance of payments and fiscal positions.** Exports from the gold mine, scheduled to start operation in 2010, will offset the decline in reserves, but the budget will be strained, requiring significant efforts to boost revenues and cut expenditures.

### Key Policy Issues and Recommendations

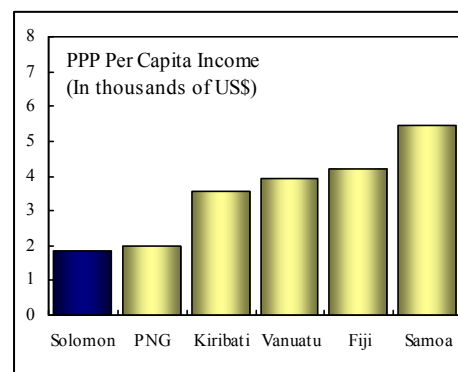
**Against this background, the mission focused on three key policy issues:**

- **Tightening monetary and fiscal policies to contain inflation.** The authorities have responded to higher inflation by tightening credit conditions and removing taxes on rice. However, monetary and fiscal policies need to be tightened further to prevent inflation from becoming entrenched. The mission recommended raising the liquid asset requirement (LAR) and restraining fiscal spending. The authorities agreed with the need for additional monetary tightening, but argued that political and economic constraints prevent a reduction in fiscal spending.
- **Safeguarding fiscal and external sustainability over the medium term as logging activity declines.** On the fiscal front, urgent measures are needed to strengthen the medium-term fiscal framework, pursue reform measures to boost revenues, and accelerate the restructuring of loss-making state-owned enterprises. On the external front, export diversification is critical to replace declining logging export receipts. Impediments to the operation of the gold mine need to be urgently addressed, including the resolution of land ownership issues. The mission also encouraged the authorities to permit greater exchange rate flexibility to safeguard reserves.
- **Stimulating nonlogging sector growth.** Progress on structural reforms remains slow. The authorities' medium-term strategy focuses on fostering competition, improving the provision of basic services, upgrading infrastructure, and addressing land ownership issues.

## I. INTRODUCTION

1. **The political situation in the Solomon Islands (SI) has been generally stable since 2003, but remains fragile.** The Regional Assistance Mission to the Solomon Islands (RAMSI) has helped to maintain peace and order since 2003, focusing on strengthening the country's institutional capacity and preventing future conflict. However, a recent study argues that long-term peace-building requires a clearer understanding of the causes and dynamics of conflict.<sup>1</sup> The government has taken serious steps in this direction through examining the root causes of the ethnic tensions and is preparing a Political Integrity Bill to enhance political stability.

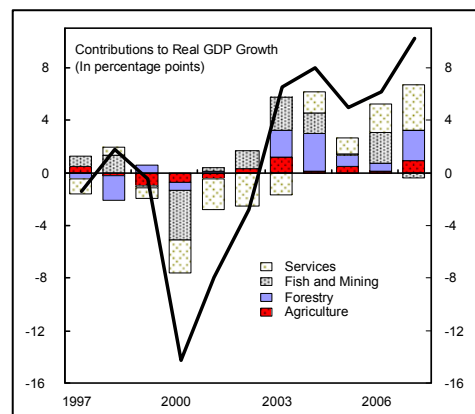
2. **Despite rapid growth during the last five years, the SI ranked the poorest among the Pacific Island countries in 2007.** Real GDP growth averaged 7 percent during the last five years, driven by unsustainable logging sector activity and aid inflows. However, progress towards achieving the Millennium Development Goals remains slow and per capita income remains below its pre-conflict level (Annex VI, Supplement 2).



## II. RECENT DEVELOPMENTS AND THE NEAR-TERM OUTLOOK

3. **Real GDP growth increased to 10.3 percent last year,** driven by the logging and services sectors (Table 1). Preliminary figures for the first half of 2008 suggest continued strong growth in these sectors, while other sectors, most notably palm oil production and fisheries, have also picked up. Real GDP is projected to increase by over 7 percent in 2008.

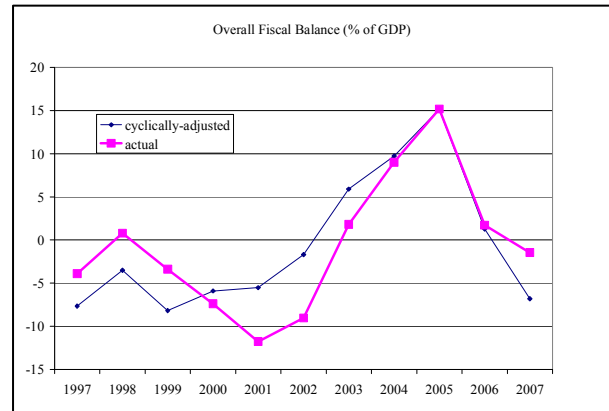
4. **The rapid increase in international commodity prices has fueled inflationary pressures.** Headline inflation increased to over 16 percent (3-month moving average) at end-June 2008 from 10 percent at end-2007, and core inflation is up 14 percent during this period (Box 1). At the same time, rapid private sector credit growth since 2004, an expansionary fiscal stance since last year and the gradual depreciation of the SI dollar in nominal effective terms have also been important contributory factors. As food and fuel prices stabilize and recent monetary measures to tighten excess liquidity gain traction (see below), headline inflation is projected to decline somewhat and end the year at about 15 percent (year-on-year).



<sup>1</sup> Hameiri, Shahr (2007), "The Trouble with RAMSI: Reexamining the Roots of Conflict in the Solomon Islands."

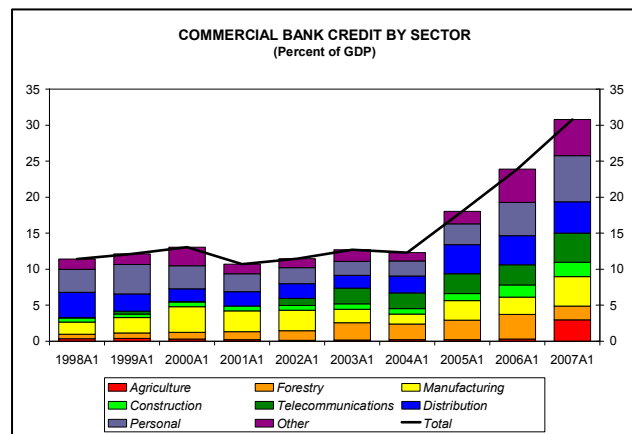
### 5. **Fiscal policy continues to be expansionary.**

Despite significant revenue overperformance last year, the fiscal balance swung to a deficit of 1.5 percent of GDP from a surplus of 1.7 percent of GDP in 2006 (Table 2). Most of the increased spending was on recurrent items—wages, and goods and services. On a cyclically-adjusted basis, the fiscal deficit in 2007 was even more expansionary. Preliminary data for the first half of 2008 suggest that spending continues to exceed revenues. In addition, the government has approved a supplementary budget, estimated at an unprecedented 5½ percent of GDP, with 2½ percent to meet payroll increases granted in May. However, the bulk of the financing for new spending has yet to be identified.



### 6. **Excess liquidity at commercial banks has declined.**

Private sector credit increased at an annual rate of about 60 percent during the last three years, albeit from a low base, with personal loans rising the fastest (Table 3). In order to reduce excess liquidity and commercial bank lending, the CBSI has allowed the National Provident Fund (NPF) to invest abroad up to 30 percent of its investment portfolio (about US\$20 million) and introduced standing deposit facilities in July. As a result, bank lending has slowed recently.



**7. Reserves remain adequate, but the deterioration in the terms of trade is expected to widen the current account deficit.** A pickup in logging exports (both volume and price effects) and aid inflows, together with higher FDI, more than offset the increase in the food and fuel import bill last year (Table 4). As a result, official international reserves increased by US\$16 million to US\$120 million (about 4 months of projected imports). However, reserves have declined more recently due to debt repayments, NPF investments abroad, and higher imports. The current account deficit is projected to widen to 7 percent of GDP in 2008, financed largely by aid inflows and mining-related FDI. Reserves are expected to remain at about 3 months of projected imports during the remainder of the year.

**8. The SI dollar depreciated by 9 percent in nominal effective terms during the year to end-May 2008,** reflecting its de facto peg to the U.S. dollar (Box 2). However, it remained fairly stable in real effective terms, and external price competitiveness does not

appear to be a significant concern for now.<sup>2</sup> That said, if inflation increases further, and wage adjustments raise the cost of production, this could weaken competitiveness and reduce exports, especially those of nonlogging sectors like fisheries, palm oil, and tourism. Combined export receipts from these industries amounted to 9½ percent of GDP in 2007.

9. **The banking system remains well-capitalized and profitable.** Nonperforming loans (NPLS) remain low at 3 percent (Table 5). Personal loans, the fastest growing sector, are generally collateralized by individuals' savings in the NPF and default on these loans is extremely small.

10. **There has been some progress on structural reforms.** The State-Owned Enterprise (SOE) Act, aimed at improving the efficiency of the SOE sector, and the Secured Transactions Act, allowing movable property to be used as collateral, were passed by parliament. The Civil Aviation and the Telecommunications Bills allowing and enhancing competition in these sectors are expected to be approved later this year. However, little progress has been made in addressing land ownership issues and easing infrastructure bottlenecks.

11. **Risks to the outlook are mainly on the downside.** Inflationary pressures from an excessively expansionary fiscal stance, potential demand for further wage increases, and further negative terms of trade shocks could trigger macroeconomic instability in the short run and derail the progress made recently.

### III. MEDIUM-TERM MACROECONOMIC OUTLOOK AND RISKS

12. **The medium-term outlook hinges critically on the success of developing nonlogging sources of growth, to offset the expected sharp decline in logging activity** (Table 6). The logging sector currently accounts for 20 percent of government tax revenues and 65 percent of exports. But logging activity is expected to decline rapidly beyond 2009 and to become negligible by 2013, reflecting the unsustainably high rates of logging. Therefore, growth in other sectors, including mining (gold and nickel), palm oil production, tourism, and the services sectors, needs to be stimulated. In particular, gold mining operations, now scheduled to start in 2010, are critical to sustaining exports and foreign reserves once logging declines.

13. **Risks are skewed mainly to the downside.** The principal risk to external sustainability is a further delay in the start of gold mining operations which could reduce foreign exchange inflows to finance imports, resulting in a rapid depletion of reserves. Also,

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<sup>2</sup> This exchange rate assessment is based on a qualitative analysis of recent and projected future balance of payments dynamics, supplemented by implementation of the equilibrium real exchange rate approach. Implementation of the macroeconomic balance and external sustainability approaches is precluded by data availability constraints.



a lack of progress on structural reforms, in particular to address infrastructure bottlenecks, could slow growth significantly and lead to a decline in average income per capita. Nevertheless, future donor aid inflows in excess of current commitments could mitigate some of these downside risks to external sustainability. The following three scenarios illustrate alternative medium-term outcomes, contingent on policy actions taken by the authorities in the coming period:

- **Baseline scenario:** Gold mining operations are assumed to start in 2010, as currently scheduled, but the pace of structural reforms remains moderate. While gold exports will help to offset the decline in logging export receipts, the contribution to domestic growth is expected to be limited, given the capital-intensive nature of the project and the largely unskilled local labor it will employ. As a result, the economy is expected to muddle along with an average real growth rate in the range of 3–4 percent per year, allowing for a modest increase in average per capita income over time.<sup>3</sup>
- **Reform scenario:** An acceleration of structural reforms could lift the economy onto a steeper growth trajectory. In particular, improvements in infrastructure and a decline in the cost of doing business could unlock the vast growth potential in the agriculture, fisheries (including canning), and tourism sectors, and expedite production in the mining sector. This would enhance fiscal and external sustainability.
- **Worst-case scenario:** Given the history of the Solomon Islands and the fragile nature of the coalition government, political and economic instability could resurface. If this were to occur, gold mining operations could be further delayed and other sectors—fishing, agriculture, and tourism—could lose their current growth momentum. With the rapid depletion of forests and therefore logging, this could push the economy into a protracted period of low growth with large deficits and rapidly declining reserves, necessitating difficult economic adjustments.

#### IV. POLICY DISCUSSIONS

14. **Against this background, the mission focused on the following key issues:**

- **Adjusting monetary and fiscal policies to contain the second-round effects on inflation from recent surges in international food and fuel prices.** The authorities shared the mission’s concern, but argued that recent wage increases, and the consequent rise in budget spending, was necessary to mitigate some of the impact on the poor.

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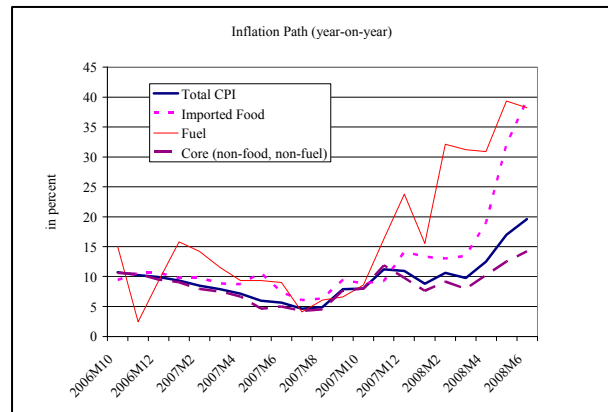
<sup>3</sup> Average population growth is projected at 2.8 percent.

- **Safeguarding fiscal and external sustainability over the medium term as logging activity declines.** The authorities agreed that timely commencement of gold mining operations was key to alleviating the pressures on the balance of payments from declining logging exports. They also recognized the need to rationalize the budget and cut spending to ensure fiscal sustainability given the current budget envelope. That said, they were hopeful that they could mobilize additional aid inflows.
- **Stimulating nonlogging sector growth through infrastructure development and the resolution of land ownership issues.** The authorities' medium-term development strategy focuses on these issues, and they are taking steps to allow more competition and encourage private sector growth.<sup>4</sup>

### A. Macroeconomic Policies to Contain Inflation

#### Background

15. **The increase in inflationary pressures, unless contained, could unravel the recent gains in macroeconomic stability.** While most countries faced with rising international commodity prices have been tightening policies to contain inflation, expansionary monetary and fiscal policies (as discussed above) have exacerbated the second-round effects and led to additional pressure on prices.



#### Discussions

16. **The mission advised the authorities that domestic demand management policies need to be tightened to contain inflation:**

- **The mission discouraged the authorities from adjusting the exchange rate to counter rising inflationary pressures and instead encouraged greater exchange rate flexibility.** The real effective exchange rate is broadly in line with medium-term fundamentals. With reserves falling recently due, in part, to the rising import bill, adjusting the exchange rate to counter inflation could put further pressure on reserves and jeopardize the competitiveness of nonlogging sectors like mining, fisheries, and

<sup>4</sup> The authorities presented this to donors in June. However, reception has been lukewarm with donors suggesting that the projects need to be costed and integrated within the framework of ongoing projects. Authorities are revising the document in line with these suggestions.

tourism. Instead of temporarily reducing inflation by revaluing the currency, allowing for greater downward exchange rate flexibility, underpinned by appropriately tight monetary and fiscal policies, would help to safeguard reserves while containing inflation.

- **On the monetary front, the authorities recognized that further tightening is needed.** The authorities pointed out that recent measures (discussed above) have been effective in slowing credit growth. They concurred with staff to continue to use the standing deposit facilities, and agreed to raise the LAR if additional tightening was needed.
- **On the fiscal front, the authorities argued that they were constrained both by economic and political realities.** The authorities stressed that their initial response to inflationary pressures was to eliminate the goods tax and the import duty on rice to partially offset imported food price increases, while allowing the economy to adjust to higher fuel prices.<sup>5</sup> However, with the continued rise in commodity prices, calls for wage increases, including most vocally by the opposition, had to be accommodated.<sup>6</sup> That said, they argued that there will likely be some underspending in the development budget given capacity constraints.

## **B. Addressing Medium-term Fiscal and External Sustainability**

### **Background**

17. **Debt levels have fallen, but remain significant.** At end-2007, only the NPV of external debt to GDP (38 percent) breached its Board-endorsed threshold (see Supplement 1). All debt indicators are projected to decline and remain below their thresholds in the medium term under the baseline scenario. However, historical scenarios and several stress tests cause a number of indicators to significantly exceed their thresholds. In particular, public sector debt and external debt levels are highly sensitive to temporary declines in real GDP growth and export growth, respectively. Moreover, the medium-term outlook hinges critically on the start of gold mining operations in 2010, without which the balance of payments and foreign reserves would come under severe pressure. Based on these considerations, Solomon Islands is classified as in moderate risk of debt distress, and the

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<sup>5</sup> Fuel prices are determined by private importers and retailers; however, electricity and transportation prices can be increased only after consultation with the government.

<sup>6</sup> The opposition submitted a no-confidence vote (which was defeated), citing government's lack of response to the plight of the poor due to higher food and fuel prices.

government should continue its nonborrowing policy, depending solely on grants until debt sustainability risks are mitigated.<sup>7</sup>

**18. Fiscal and external sustainability could be at serious risk if gold mining is delayed.** Log exports have been very buoyant in the last five years (both due to the unsustainable rate of logging and due to higher log prices) and have nearly doubled as a share of GDP. However, instead of saving the windfall, budget spending has been increasing in line with additional revenues. With the contribution from the logging sector expected to decline sharply, gold export revenues will be instrumental in alleviating downward pressure on foreign reserves. On the other hand, fiscal sustainability will depend on cutting expenditures, unless donors provide budget support, as gold mining will contribute only marginally to improve the fiscal situation given the generous tax concessions granted to the gold mining company. The government's medium-term fiscal strategy recognizes this and envisages significant spending cuts, although it does not identify the areas where these cuts would occur.

## Discussions

**19.** The authorities broadly agreed with the mission's recommendation on areas that could generate expenditure savings.

- **Strengthen the government's medium-term fiscal framework and restructure the budget:** In particular,
  - Undertake civil service reforms to reduce the wage bill, including by eliminating vacant positions, and avoiding ad hoc increases in wages;
  - Enhance monitoring and accountability of public enterprises to raise efficiency, and restructure those that continue to incur losses (the latter will also reduce the contingent liabilities of the government); and
  - Enhance the transparency and accountability of spending by both the central government and line ministries to ensure that monies are not misspent.
- **Expedite fiscal structural reforms to boost revenues:** There is considerable scope for strengthening tax administration, including by reducing exemptions and enforcing tax collection, especially in the logging sector. In particular:
  - **Further raise the determined price of logs and introduce an automatic adjustment mechanism.**<sup>8</sup> Following strong lobbying by the logging sector,

<sup>7</sup> Thus far, the authorities have honored their commitment not to incur new borrowing. In 2008, a small amount was disbursed in relation to an existing ADB loan.

<sup>8</sup> The authorities use the determined price to calculate the tax obligation of log exporters. Adjustments to it are currently done on an ad hoc basis.

the government deferred its plan to raise the determined price from June to October. Implementing this in October as planned would send a strong signal of the authorities' commitment to reforms, and would boost tax revenues (Box 3). Furthermore, saving some of this windfall to meet budgetary needs over the medium term when logging revenues decline could ease the pressure to cut spending.

- **Improve monitoring of the logging sector to increase tax compliance.** Anecdotal evidence suggests that only 30–40 percent of log shipments are inspected, resulting in foregone tax revenues of nearly 4 percent of GDP in 2007. The mission urged the authorities to enhance monitoring by employing qualified personnel. This would not only help generate revenues that could finance much-needed social and development spending (for example, for financing free primary education or for funding more vocational training), but would also encourage sustainable logging activity.
- **Accelerate SOE reforms:** Following the completion of the current audit program, SOEs should be subject to regular disclosure of annual financial statements to improve financial management and restructuring. Also, divestment of enterprises that are in commercially viable sectors, for example Soltai Fishing Company and Solomon Airlines, is likely to strengthen the government's balance sheet, and should be undertaken.

20. **Enhance export diversification to preserve external sustainability.** External sustainability hinges on the success of offsetting the imminent decline in logging export receipts with growth in other export-oriented sectors, especially mining. The mission therefore urged the government to address bottlenecks that have repeatedly caused delays in starting gold mining operations (discussed below), while emphasizing that additional tax concessions should be avoided. Over the long term, nickel mining also has tremendous potential to generate foreign exchange receipts and boost reserves. Should ongoing exploration work establish that nickel mining is commercially viable, the mission advised the government to negotiate an equitable profit sharing agreement with assistance from qualified consultants.

### C. Stimulating Nonlogging Sector Growth

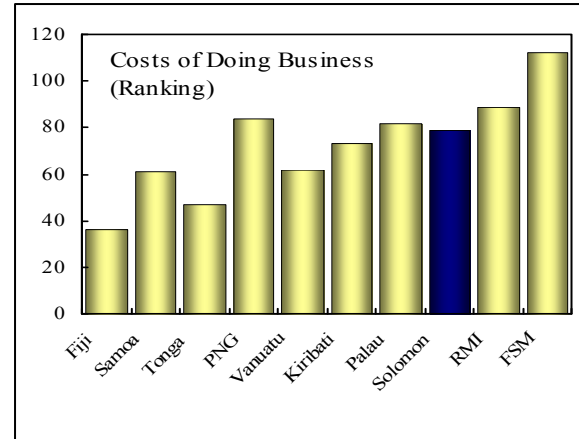
#### Background

21. **Progress in removing constraints to broad-based growth has been slow.** Major impediments include ambiguity in land ownership, poor infrastructure, a shortage of skilled labor, and unreliable and costly electricity, water, and telecommunication services. In addition, poor governance remains widespread and the cost of doing business is relatively high by regional standards. SOEs continue to make losses and require frequent cash injections from the government. On the positive side, some progress has been made in

improving road infrastructure with the help of the Asian Development Bank (AsDB), and in enhancing competition in the airline industry.

## Discussions

22. **The authorities agreed with staff and pointed to recent measures that are being taken to improve the basic institutional and infrastructure framework to stimulate nonlogging sector growth.** In particular:



- **Land ownership issues:** The draft Tribal Land Bill is currently being discussed by the Ministry of Lands and the Attorney-General's office, and is expected to be tabled in the November parliamentary sitting. If passed, this law would help expedite the resolution of land ownership issues, easing access to land for commercial purposes.
- **Increased competition in telecommunications:** The government's agreement with Telekom, which now holds a monopoly in providing telecommunication services, is expected to be reviewed later this year to allow competition in the sector.
- **Improved business environment for the private sector:** The Companies Act and Insolvency Act defining the framework in which private enterprises operate will be tabled in the November parliamentary sitting.
- **State-owned enterprises:** External managers are being hired with the assistance of the World Bank to improve the financial viability and service delivery of the Solomon Islands Electricity Authority (the state-owned electricity company).
- **Infrastructure improvements:** The authorities emphasized their continued commitment to work with the AsDB to improve road and water transport and port facilities.
- **Alternative sources of energy:** The authorities are also exploring this area, including hydro, solar and biomass plants, with the help of the World Bank and other donors, especially as this will help to reduce their dependence on diesel imports for electricity generation.

## V. OTHER ISSUES

23. **Various financial soundness indicators reveal that commercial banks remain well capitalized and profitable.** All three commercial banks are subsidiaries of foreign banks and are supervised both by the CBSI and the supervisory authorities of their parent

banks. Most lending is collateralized and risk-weighted capital asset ratios, at about 20 percent as of March 2008, remain above the prudential norm. Moreover, nonperforming loans remain low as a share of total loans at below 3 percent.<sup>9</sup> However, given the rapid credit growth in recent years, and the expected moderation in growth over the medium term, NPLs could rise. The CBSI agreed to continue its close monitoring of the banking sector.

24. **The statistical database remains poor and hampers surveillance.** Despite some improvements, the coverage and quality of the real, public, and external sectors remain deficient. Public sector statistics are inconsistent with the GFS methodology, and do not track provincial government or SOE activities. The recurrent and development budgets have yet to be integrated. External sector data suffer from serious misclassification problems. The latest Household Income and Expenditure Survey (HIES), completed in September 2006, has been used to revise the national accounts and construct GDP by expenditure component, with assistance from PFTAC. However, these have yet to be officially published.

## VI. STAFF APPRAISAL

25. **Political stability remains fragile.** While the overall political situation has remained stable since 2003, repeated jockeying by politicians and random jumps across party lines has resulted in numerous changes in government, confounding consistent policy making. Efforts to consolidate the party system, including through the Political Integrity Bill aimed at preventing frequent party defections, are welcome, and should help create a more stable political environment.

26. **Recent growth performance has been very strong, but its sustainability is in question.** Real GDP growth reached a 15-year high last year, driven by unsustainable logging sector activity and strong service sector growth stimulated by donor aid inflows.<sup>10</sup> More recently, some nonlogging sectors like palm oil production, fisheries, and tourism have also picked up. However, average per capita income remains below its pre-conflict level.

27. **Monetary and fiscal tightening are urgently needed to contain inflation.** While the rise in international commodity prices has been the major cause of higher inflation, expansionary domestic monetary and fiscal policies have exacerbated import price pressures as reflected in the pickup in core inflation. In this context, recent efforts by the CBSI to rein in excess liquidity through its standing deposit facilities are welcome. In order to anchor inflation expectations, the CBSI should tighten the monetary stance further, including through an increase in the LAR. To avoid placing an undue burden on monetary policy, fiscal policy also needs to play a supportive role by minimizing spending of the supplementary budget, where possible.

<sup>9</sup> Loans are classified as NPLs if they are overdue for more than 90 days.

<sup>10</sup> Aid flows are expected to decline over the medium term in line with current donor commitments.

28. **Maintaining fiscal sustainability will require a concerted effort to boost tax revenues and cut expenditure growth.** Efforts to bolster tax revenues will need to be intensified, including by strengthening tax administration, raising the determined price of logs to reflect international market prices, and cutting ad hoc tax exemptions. In addition, reforms to rationalize civil service employment and restrain the future growth of the wage bill, enhance the monitoring of SOEs, and restructuring/privatizing loss-making ones will yield substantial savings. Improving expenditure control procedures to ensure that spending remains within budgeted levels and increasing transparency of all government accounts will also help cut expenditures.

29. **Structural reforms to generate nonlogging sector growth are critical to sustain the growth momentum and preserve medium-term fiscal and external sustainability.** Given the imminent decline in logging sector activity, efforts to develop alternative sources of growth should be intensified. In this context, the government's efforts to allow competition in the airlines and telecommunications industries are welcome. However, reforms to address land ownership issues, improve infrastructure, and eliminate rent-seeking activities to lower the high cost of doing business need to be implemented swiftly.

30. **The real effective exchange rate appears to be broadly in line with medium-term fundamentals.** However, a decline in competitiveness if inflation and wage growth are not contained, and pressure on reserves if the decline in logging exports is not offset by exports from other sectors, could necessitate exchange rate adjustment. Greater exchange rate flexibility could help avoid sudden disruptive economic adjustments.

31. **The banking system remains profitable and NPLs are low, but the CBSI should continue to monitor the situation closely.** While commercial banks' focus on collateralized lending combined with rapid economic growth in recent years has helped to keep NPLs low, banks remain vulnerable to a slowdown in logging sector activity. The CBSI should continue to monitor banks closely to ensure that asset quality remains sound.

32. **The quality, timeliness, and availability of most data remains poor and hampers effective surveillance.** Data on monetary statistics are adequate. However, data on national accounts and balance of payments, despite significant technical assistance, continue to be inadequate. Data on the provincial governments and SOEs is almost nonexistent. The authorities should give priority to improving data collection and quality, including by committing adequate resources.

33. **It is recommended that the next Article IV consultation take place on the standard 12-month cycle.**

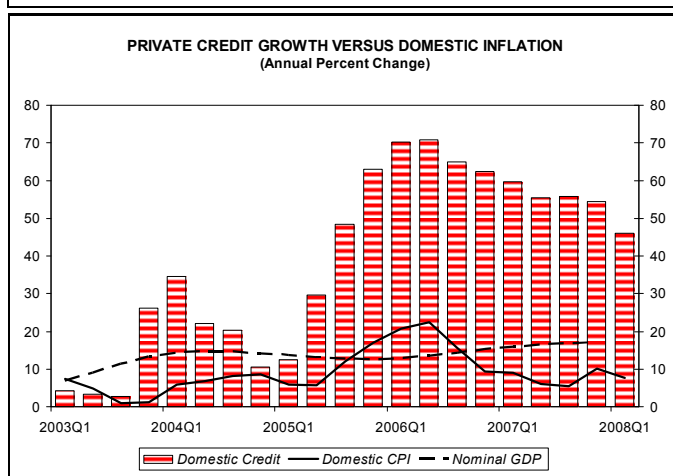
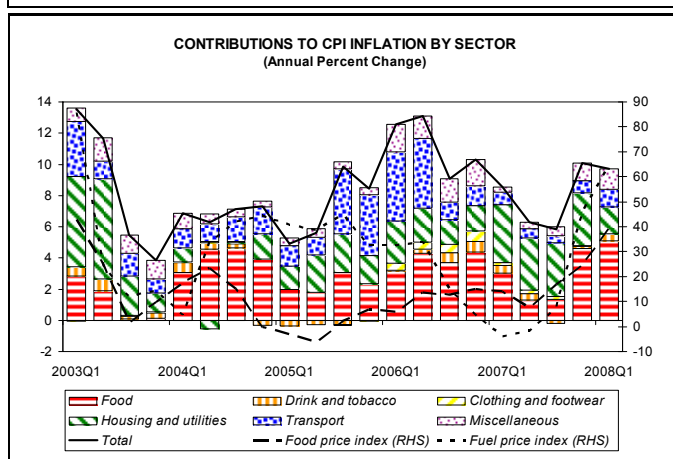
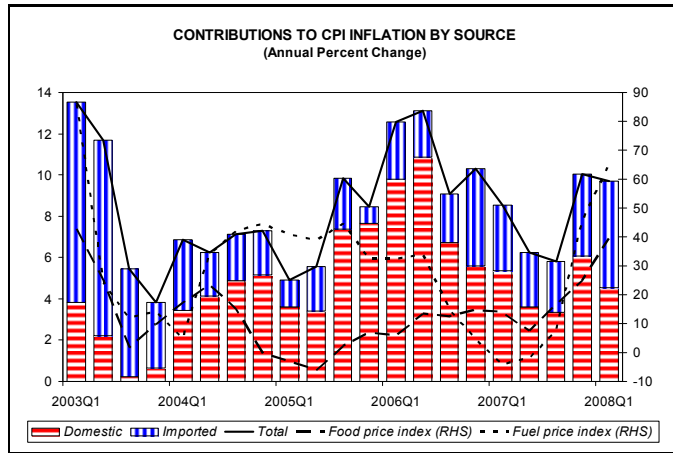


### Box 1. Recent Inflation Developments in the Solomon Islands

**Inflation in the Solomon Islands has increased recently.** Following a decline from a peak of 13.1 percent in 2006Q2 to a trough of 5.8 percent in 2007Q3, annual consumption price inflation rose to 9.7 percent in 2008Q1. This surge was primarily attributable to an increase in import price inflation, which rose from 6.2 percent in 2007Q3 to 13.0 percent in 2008Q1. This recent experience parallels those of other Pacific Island countries.

**Increases in international food and fuel prices accounted for the majority of the recent surge in inflation, exacerbated by depreciation of the currency in nominal effective terms.** Given a weight of 43 percent in the consumption basket, an increase in food price inflation from 3.1 percent in 2007Q3 to 11.9 percent in 2008Q1 contributed to an increase in consumption price inflation of 3.7 percent over this period.

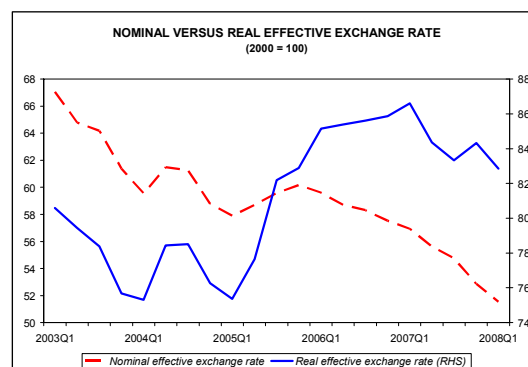
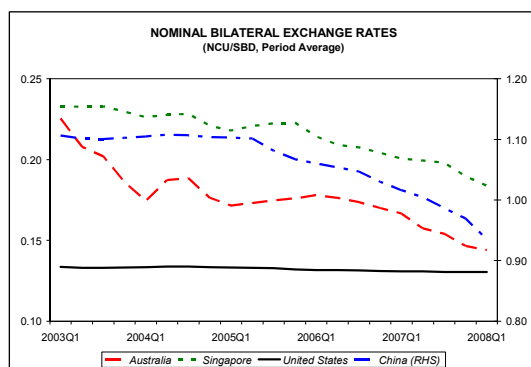
**Loose monetary and fiscal conditions have supported high domestic inflation.** Domestic credit to the private sector has grown at rates of about 60 percent during the last three years, about four times the growth rate of nominal GDP. Further tightening of the monetary policy stance is needed to ensure that inflation is contained.



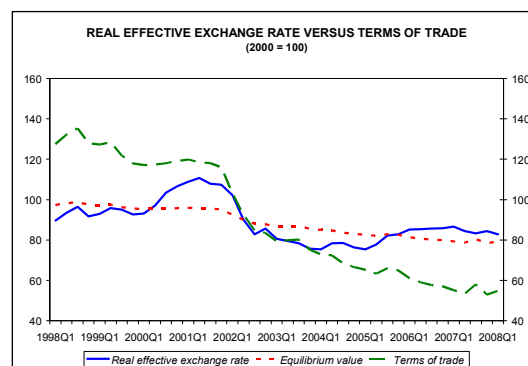
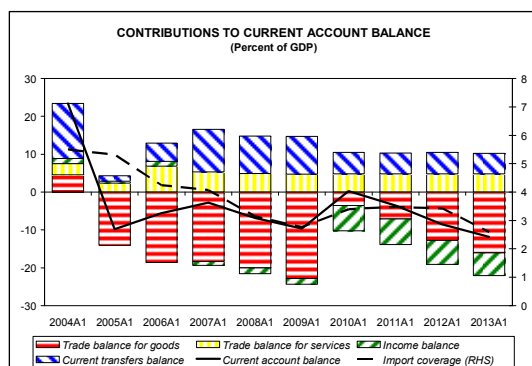
## Box 2. An Exchange Rate Assessment for the Solomon Islands

The Solomon Islands' dollar has experienced trend nominal depreciations with respect to the currencies of major trading partners. Since 2003, the Solomon Islands' dollar depreciated by 36 percent relative to the Australian dollar, by 21 percent relative to the Singapore dollar, and by 16 percent relative to the Chinese yuan. These developments reflect its de facto peg to the US dollar over this period.

The value of the Solomon Islands' dollar has remained broadly constant in real effective terms. During recent years, trend nominal effective depreciation has offset erosion of external price competitiveness caused by higher inflation in the Solomon Islands than among its major trading partners.



A qualitative exchange rate assessment suggests that the value of the real effective exchange rate is broadly in line with medium term fundamentals. A macroeconomic projection conditional on a constant real effective exchange rate suggests sustainable balance of payments dynamics over the medium term. However, the risks surrounding this baseline projection are tilted towards the downside. If gold mining does not begin in 2010, or if further large increases in international food and fuel prices occur, then depreciation of the currency in real effective terms may be needed to safeguard reserves following the imminent decline in logging.



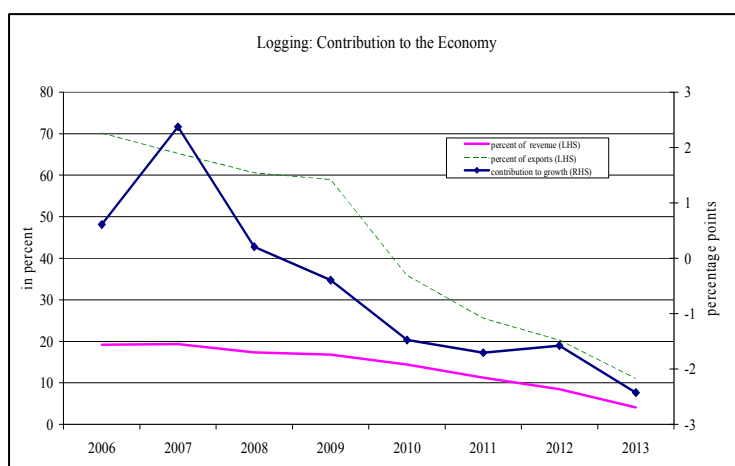
A quantitative exchange rate assessment also suggests that external price competitiveness is not a significant concern. Accounting only for trend deterioration in the terms of trade with the equilibrium real exchange rate approach suggests that the value of the real effective exchange rate is currently broadly in line with its estimated medium run equilibrium value.<sup>1</sup> However, if further large negative terms of trade shocks occur, then depreciation of the currency in real effective terms may be needed to preserve external sustainability.

<sup>1</sup> The equilibrium real exchange rate approach yields an overvaluation estimate of 4 percent for 2008Q1. Data availability constraints preclude implementing the macroeconomic balance and external sustainability approaches.

### Box 3. Developments in the Logging Industry

**Since 2003, reliance on logging has steadily increased.** In 2007, logging increased by about 25 percent and accounted for a quarter of real GDP growth, 65 percent of exports, and almost 20 percent of tax revenue. The sharp increase in logging activity was in part the result of the issuance of new licenses, re-entry into former logged areas, the approval of tree-felling operations to allow palm oil and reforestation projects to occur,

favorable international prices, and continued strong demand from major log importers such as China. The recent acceleration of logging activity has hastened the depletion of the natural forests to the extent that by 2013, experts predict there will be no natural commercially viable logs left.



**To help slow down logging activity, the government has recently passed some measures.**

These include: (i) the cancellation of licenses of logging companies who fail to submit acceptable public environment reports; (ii) the issuance of a directive to the Foreign Investment Board not to approve any new application for logging operations; and (iii) adjusting the reference prices of logs from an average of US\$71 to US\$78 per cubic meter effective May 1, 2008. However, the government has backtracked on announced plans to further increase reference prices to US\$85 by June 1, 2008 and reintroduce an automatic price adjustment mechanism to bring reference prices in line with movements in market prices.

**Despite the recent adjustment, reference prices of logs remain well below international market prices, resulting in foregone government revenues.** Despite the May 1 increase, reference prices remain about

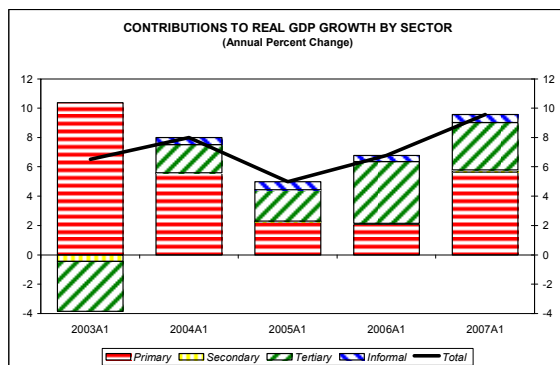
Estimates of Foregone Revenue from Log Exports to China: Q1 2008

|                    | USD/m3         | Source / assumptions                                    |
|--------------------|----------------|---|
| Landed (CIF) price | \$ 176.4       | Chinese Customs data (MIS ITTO)                         |
| - freight          | \$ 64.4        | Solomon Islands ITTO 3 month rolling average            |
| - insurance        | \$ 3.5         | 2% of CIF price -estimated                              |
| - agent fee        | \$ 10.5        | 6% of CIF price - estimated                             |
| <b>sub-total</b>   | <b>\$ 98.0</b> |   |
| Declared FOB       | \$ 63.9        | PNG via SGS report / SIG Customs Division data          |
| <b>DIFFERENCE</b>  | <b>\$ 34.1</b> | unaccounted difference between declared & landed        |
|                    | 270            | Log exports to China in thousand cubic meters (Q1 2008) |
|                    | \$ 9.2         | Foregone revenue, US million dollars                    |
|                    | \$ 2.4         | (in percent of GDP)                                     |

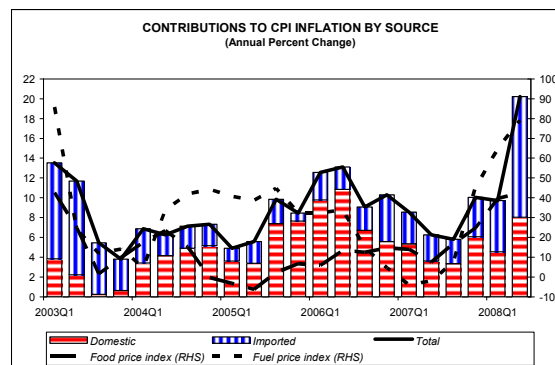
72 percent below average international prices. The delayed adjustment in reference prices of logs to reflect market values has resulted in lost tax revenues, estimated at about 3.0 percent of GDP in 2006 and 3¾ percent of GDP in 2007. Rough estimates show that foregone revenues would be as high as 10 percent of GDP in 2008.

Figure 1. Solomon Islands: Graphical Summary of Recent Macroeconomic Developments

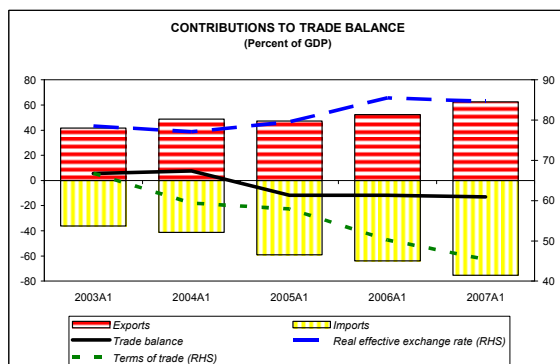
Real GDP growth reached 10.3 percent in 2007, driven by strong growth in the primary sector.



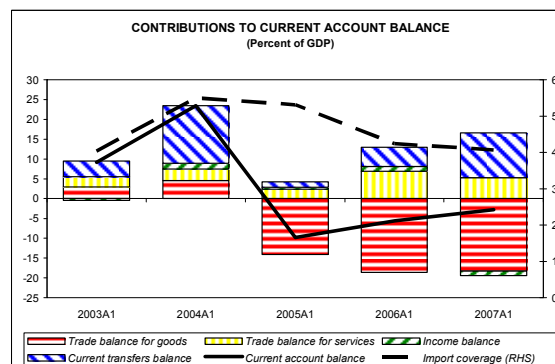
Inflation rose sharply in 2008, primarily due to international food and fuel prices.



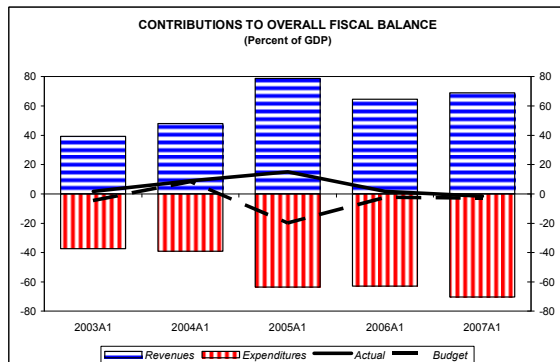
The trade deficit widened to 19 percent of GDP in 2007, reflecting a deterioration in the terms of trade.



The current account deficit narrowed to 3 percent of GDP in 2007, while reserve coverage remained stable at 4 months of projected imports.



The overall fiscal balance swung to a deficit of 1.5 percent of GDP in 2007 from a surplus of 1.7 percent of GDP in 2006, outperforming the budget.



Private sector credit growth of about 55 percent in 2007 supported high domestic inflation.

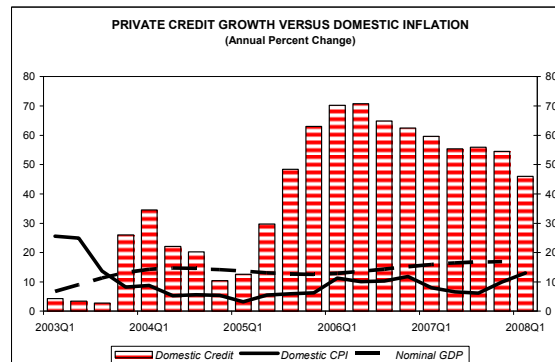


Figure 2. Solomon Islands: Projections of Key Macroeconomic Variables under Baseline and Alternative Scenarios

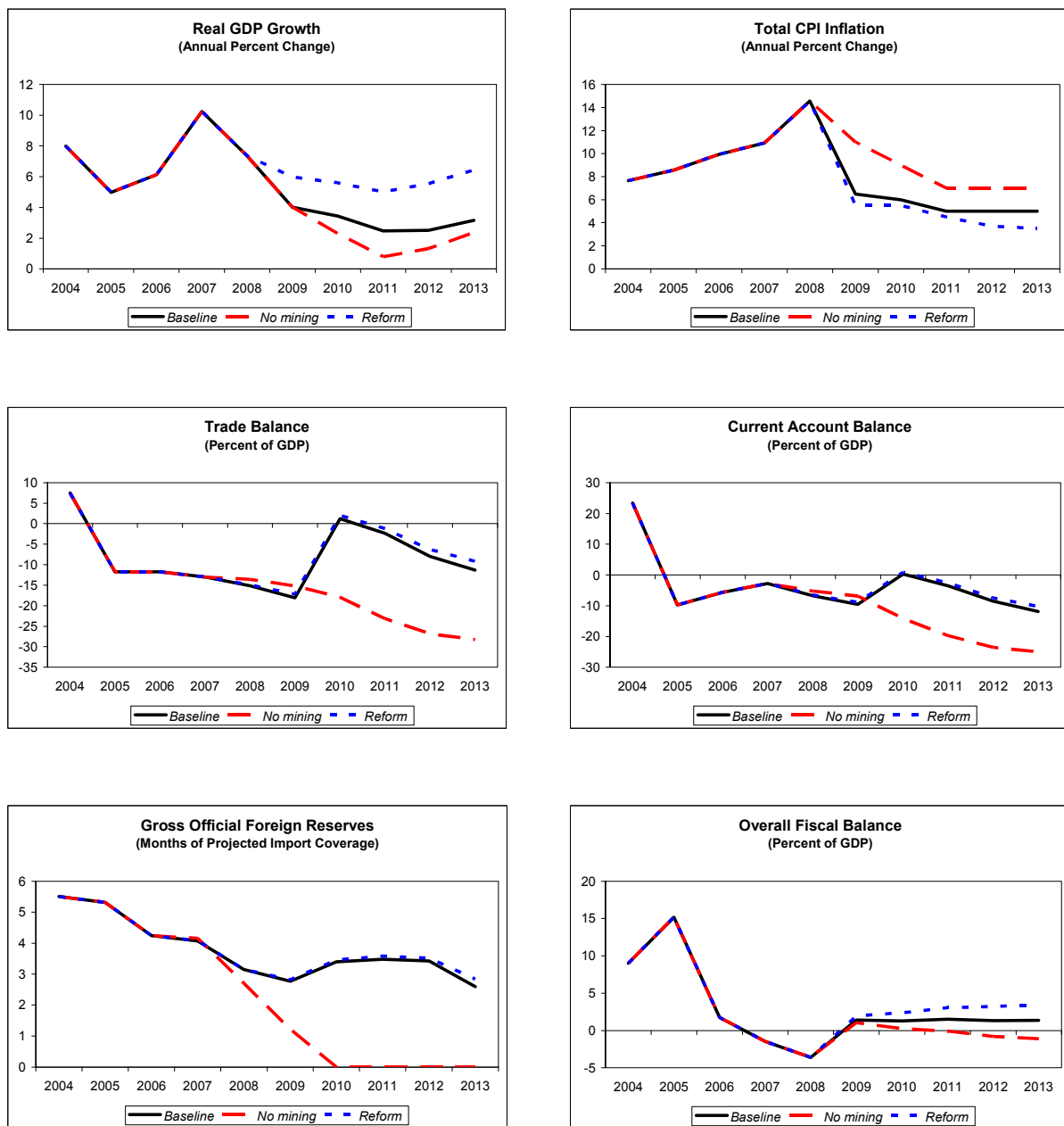


Table 1. Solomon Islands: Selected Economic Indicators, 2003-09

Nominal GDP (2007): US\$388 million  
 Population (2007): 508,420  
 GDP per capita (2007): US\$764  
 Quota: SDR 10.4 million

|   | 2003  | 2004  | 2005  | 2006  | 2007<br>Est. | 2008<br>Proj. | 2009  |
|---|-------|-------|-------|-------|--------------|---------------|-------|
| Growth and prices (percentage change)                           |       |       |       |       |              |               |       |
| Real GDP  | 6.5   | 8.0   | 5.0   | 6.1   | 10.3         | 7.3           | 4.0   |
| CPI (period average)  | 10.0  | 6.9   | 7.4   | 11.2  | 7.7          | 15.1          | 8.8   |
| CPI (end of period)   | 3.7   | 7.6   | 8.6   | 9.9   | 10.9         | 14.6          | 6.5   |
| Per capita GDP (in US\$)  | 503   | 560   | 609   | 676   | 764          | 905           | 966   |
| Central government operations (percent of GDP)                  |       |       |       |       |              |               |       |
| Total revenue   | 39.2  | 48.1  | 66.2  | 64.7  | 69.0         | 61.6          | 60.7  |
| Recurrent revenue   | 21.2  | 26.3  | 29.7  | 32.3  | 36.8         | 33.0          | 32.4  |
| Grants  | 18.0  | 21.8  | 36.6  | 32.5  | 32.2         | 28.6          | 28.3  |
| Total expenditure 1/  | 37.4  | 39.1  | 63.6  | 63.0  | 70.4         | 65.2          | 59.3  |
| Recurrent expenditure   | 21.9  | 21.6  | 26.7  | 30.7  | 33.0         | 35.3          | 30.1  |
| Development expenditure   | 15.5  | 17.4  | 36.9  | 32.3  | 37.5         | 29.8          | 29.2  |
| Overall balance 2/  | 1.8   | 9.0   | 2.6   | 1.7   | -1.5         | -3.6          | 1.4   |
| Foreign financing (net)   | 0.8   | 0.0   | 4.7   | 2.1   | 3.2          | -1.0          | -1.7  |
| Domestic financing (net)  | -9.3  | -6.7  | -2.3  | -1.8  | -1.1         | 4.2           | 0.1   |
| Other   | 9.9   | -2.3  | -3.0  | -0.3  | -0.5         | 0.3           | 0.1   |
| Discrepancy (neg. are net expenditures)                         | -3.3  | 0.0   | -2.0  | 1.8   | 0.1          | 0.0           | 0.0   |
| Central government debt (percent of GDP) 3/                     | 120.4 | 88.6  | 72.6  | 63.5  | 52.3         | 41.9          | 36.1  |
| Domestic  | 51.5  | 30.1  | 24.0  | 18.1  | 14.4         | 11.6          | 10.0  |
| External  | 68.9  | 58.4  | 48.6  | 45.4  | 37.9         | 30.3          | 26.1  |
| External debt (in US\$ millions, end of period)                 | 157.7 | 153.1 | 142.6 | 151.7 | 147.3        | 143.1         | 135.5 |
| External debt service to exports of GNFS (accrual basis)        | 5.0   | 3.5   | 5.3   | 2.5   | 5.2          | 2.9           | 4.2   |
| Monetary and credit (percentage change, end-year data)          |       |       |       |       |              |               |       |
| M3  | 25.4  | 19.5  | 38.9  | 26.4  | 24.0         | 16.1          | 14.6  |
| Base Money  | 26.5  | 75.7  | 20.0  | 8.1   | -2.0         | -5.0          | 11.6  |
| Interest rate (3-month t/bill rate, average)                    | 5.8   | 6.0   | 4.5   | 3.4   | 3.2          | ...           | ...   |
| Balance of payments (US\$ millions, unless otherwise indicated) |       |       |       |       |              |               |       |
| Current account   | 20.9  | 61.5  | -28.7 | -18.8 | -10.8        | -32.2         | -49.9 |
| (Percent of GDP)  | 9.1   | 23.5  | -9.8  | -5.6  | -2.8         | -6.8          | -9.6  |
| Overall balance (accrual)                                       | 18.8  | 43.4  | 16.0  | 9.4   | 17.0         | -19.3         | -8.8  |
| Gross official reserves (US\$ millions, end of period)          | 36.3  | 79.5  | 94.6  | 103.5 | 119.8        | 100.5         | 91.7  |
| (in months of projected imports of GNFS)                        | 4.0   | 5.5   | 5.3   | 4.2   | 4.1          | 3.1           | 2.8   |
| Exchange rate (SI\$/US\$, end of period)                        | 7.49  | 7.51  | 7.58  | 7.62  | 7.66         | ...           | ...   |
| Real effective exchange rate (period average, 2000=100)         | 78.5  | 77.1  | 79.5  | 85.5  | 84.7         | ...           | ...   |
| Nominal effective exchange rate (period average, 2000=100)      | 64.4  | 60.3  | 59.1  | 58.5  | 55.0         | ...           | ...   |

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

1/ Expenditures are presented on an accrual basis.

2/ Calculated from above-the-line data.

3/ Includes arrears.

Table 2. Solomon Islands: Central Government Operations, 2003–09  
(In percent of GDP)

|   | 2003 | 2004  | 2005 | 2006 | 2007<br>Revised<br>Budget | 2007<br>Est. | 2008<br>Proj. | 2009 |
|---|------|-------|------|------|---------------------------|--------------|---------------|------|
| Total revenue and grants                | 39.2 | 48.1  | 66.2 | 64.7 | 66.1                      | 69.0         | 61.6          | 60.7 |
| Total revenue                           | 21.2 | 26.3  | 29.7 | 32.3 | 29.8                      | 36.8         | 33.0          | 32.4 |
| Tax revenue                             | 19.4 | 23.6  | 25.2 | 26.7 | 25.8                      | 31.1         | 29.3          | 28.7 |
| Other revenue                           | 1.8  | 2.7   | 4.5  | 5.5  | 4.1                       | 5.7          | 3.7           | 3.7  |
| Grants 1/                               | 18.0 | 21.8  | 36.6 | 32.5 | 36.3                      | 32.2         | 28.6          | 28.3 |
| Expenditure 2/                          | 37.4 | 39.1  | 63.6 | 63.0 | 68.9                      | 70.4         | 65.2          | 59.3 |
| Recurrent expenditure 3/                | 21.9 | 21.6  | 26.7 | 30.7 | 28.1                      | 33.0         | 35.3          | 30.1 |
| Of which:                               |      |       |      |      |                           |              |               |      |
| Compensation of employees               | 9.3  | 8.8   | 10.6 | 9.8  | 11.0                      | 11.9         | 10.9          | 10.4 |
| Goods and services                      | 5.8  | 7.8   | 11.1 | 16.4 | 13.7                      | 16.7         | 16.0          | 16.8 |
| Development expenditure                 | 15.5 | 17.4  | 36.9 | 32.3 | 40.8                      | 37.5         | 29.8          | 29.2 |
| Overall balance (above the line)        | 1.8  | 9.0   | 2.6  | 1.7  | -2.8                      | -1.5         | -3.6          | 1.4  |
| Discrepancy (neg. are net expenditures) | -3.3 | 0.0   | -2.0 | 1.8  | 0.0                       | 0.1          | 0.0           | 0.0  |
| Financing                               | 1.4  | -9.0  | -0.6 | 0.1  | 2.8                       | 1.6          | 3.6           | -1.4 |
| Foreign (net)                           | 0.8  | 0.0   | 4.7  | 2.1  | ...                       | 3.2          | -1.0          | -1.7 |
| Domestic bank and nonbank (net)         | -9.3 | -6.7  | -2.3 | -1.8 | ...                       | -1.1         | 4.2           | 0.1  |
| Banking system (accrual)                | -9.1 | -8.7  | -1.9 | -1.9 | ...                       | -0.7         | 4.4           | 0.3  |
| Nonbank (accrual)                       | -0.2 | 2.0   | -0.4 | 0.1  | ...                       | -0.5         | -0.2          | -0.1 |
| Privatization receipts                  | 0.0  | 0.0   | 0.0  | 0.3  | ...                       | 0.0          | 0.6           | 0.0  |
| Increase in expenditure arrears 4/      | 4.1  | -5.2  | -3.4 | -0.6 | ...                       | -0.5         | -0.2          | 0.1  |
| Principal debt arrears                  | 5.8  | -10.0 | 0.4  | 0.0  | ...                       | 0.0          | 0.0           | 0.0  |
| Restructured Bonds                      | 0.0  | 12.8  | 0.0  | 0.0  | ...                       | 0.0          | 0.0           | 0.0  |

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

1/ Based on donors' commitments through 2010.

2/ On an accrual basis.

3/ Includes the supplementary budget for 2008.

4/ Includes interest arrears.

**Table 3. Solomon Islands: Summary Accounts of the Banking System, 2003-08**  
(In millions of S.I. dollars, end of period)

|                                    | 2003  | 2004  | 2005  | 2006   | 2007<br>Est. | 2008<br>Proj. |
|------------------------------------|-------|-------|-------|--------|--------------|---------------|
| <b>Central Bank</b>                |       |       |       |        |              |               |
| Assets                             | 486.1 | 806.0 | 942.2 | 1004.0 | 1143.1       | 1057.5        |
| Foreign                            | 271.1 | 596.8 | 716.9 | 790.5  | 918.0        | 788.2         |
| Government                         | 185.5 | 185.6 | 196.9 | 161.7  | 149.7        | 172.5         |
| Other                              | 29.5  | 23.7  | 28.4  | 51.8   | 75.4         | 96.8          |
| Liabilities                        | 486.1 | 806.0 | 942.2 | 1004.0 | 1143.1       | 1057.5        |
| Foreign                            | 21.5  | 22.5  | 17.2  | 17.4   | 44.5         | 69.5          |
| Currency in circulation            | 111.2 | 137.7 | 168.0 | 203.4  | 262.9        | 327.0         |
| Deposits                           | 202.8 | 451.9 | 575.2 | 534.8  | 475.9        | 323.4         |
| Other                              | 150.5 | 193.9 | 181.7 | 248.4  | 359.7        | 337.5         |
| Capital                            | -28.4 | 16.3  | 158.6 | 158.6  | 209.1        | 261.5         |
| <b>Commercial Banks</b>            |       |       |       |        |              |               |
| Assets                             | 612.2 | 775.6 | 990.6 | 1273.1 | 1505.3       | 1906.9        |
| Capital                            | 99.6  | 121.1 | 159.2 | 180.2  | 188.3        | 247.3         |
| Reserves                           | 115.3 | 260.4 | 309.5 | 313.0  | 243.2        | 153.7         |
| Required                           | 32.0  | 40.9  | 54.9  | 72.9   | 86.6         | 103.7         |
| Excess                             | 83.4  | 219.5 | 254.6 | 240.0  | 156.6        | 50.0          |
| <b>Monetary Survey</b>             |       |       |       |        |              |               |
| Net foreign assets                 | 266.1 | 579.9 | 712.5 | 770.0  | 852.0        | 669.9         |
| Central bank                       | 249.6 | 574.2 | 699.7 | 773.1  | 873.5        | 718.6         |
| Commercial banks                   | 16.5  | 5.7   | 12.8  | -3.1   | -21.5        | -48.7         |
| Domestic credit                    | 466.5 | 316.5 | 425.6 | 621.0  | 946.0        | 1374.9        |
| Private sector                     | 217.3 | 238.6 | 389.1 | 632.3  | 976.9        | 1342.8        |
| Public sector                      | 249.2 | 77.9  | 36.4  | -11.2  | -30.9        | 32.1          |
| M1                                 | 327.9 | 371.8 | 537.9 | 703.4  | 909.7        | 1097.4        |
| Currency in circulation            | 102.7 | 123.2 | 153.0 | 177.6  | 232.0        | 280.7         |
| Demand deposits                    | 225.2 | 248.6 | 384.9 | 525.8  | 677.7        | 816.7         |
| M2                                 | 395.4 | 447.8 | 626.0 | 802.4  | 1032.2       | 1241.1        |
| Savings deposits                   | 67.5  | 76.0  | 88.1  | 98.9   | 122.4        | 143.7         |
| M3                                 | 520.2 | 621.7 | 863.7 | 1091.6 | 1353.0       | 1570.7        |
| Time deposits                      | 124.8 | 173.9 | 237.8 | 289.2  | 320.9        | 329.6         |
| Other items net                    | 212.4 | 274.7 | 274.3 | 299.5  | 445.0        | 474.1         |
| <b>Memorandum Items</b>            |       |       |       |        |              |               |
| Base money                         | 226.5 | 398.1 | 477.5 | 516.4  | 506.1        | 480.8         |
| Interest rates (percent per annum) |       |       |       |        |              |               |
| Deposit rate                       | 0.92  | 0.96  | 0.98  | 1.00   | 0.71         | 0.50          |
| Lending rate                       | 14.70 | 14.29 | 14.12 | 13.92  | 14.12        | 14.23         |

Sources: Data provided by the Central Bank of the Solomon Islands, and Fund Staff projections.



**Table 4. Solomon Islands: Balance of Payments, 2006-13**  
(In millions of U.S. dollars)

|  | 2006   | 2007   | 2008   | 2009   | 2010   | 2011   | 2012   | 2013   |
|--|--------|--------|--------|--------|--------|--------|--------|--------|
|  |        | Est.   |        |        | Proj.  |        |        |        |
| Current account balance                | -18.8  | -10.8  | -32.2  | -49.9  | 1.7    | -21.1  | -54.8  | -80.6  |
| In percent of GDP                      | -5.6   | -2.8   | -6.8   | -9.6   | 0.3    | -3.5   | -8.6   | -11.9  |
| Trade balance for goods                | -62.1  | -71.1  | -94.8  | -118.3 | -19.6  | -42.6  | -81.5  | -109.4 |
| Exports                                | 121.4  | 168.9  | 200.7  | 204.1  | 313.2  | 300.8  | 280.2  | 273.5  |
| <i>Of which:</i> Logs                  | 84.6   | 109.6  | 126.5  | 125.1  | 108.1  | 69.5   | 38.5   | 24.5   |
| <i>Of which:</i> Fish                  | 19.2   | 19.8   | 23.6   | 24.4   | 25.8   | 29.0   | 32.2   | 33.9   |
| <i>Of which:</i> Minerals              | 0.8    | 0.9    | 0.9    | 0.9    | 122.7  | 142.7  | 146.8  | 148.8  |
| Imports                                | -183.5 | -240.0 | -295.5 | -322.4 | -332.8 | -343.4 | -361.7 | -383.0 |
| <i>Of which:</i> Food                  | -21.6  | -30.2  | -38.0  | -39.1  | -39.8  | -40.0  | -40.3  | -40.6  |
| <i>Of which:</i> Fuel                  | -54.4  | -56.8  | -91.0  | -99.6  | -106.8 | -108.7 | -110.3 | -113.2 |
| Trade balance for services             | 23.0   | 20.5   | 23.2   | 24.7   | 26.5   | 28.6   | 30.5   | 32.4   |
| Income balance                         | 4.3    | -4.2   | -7.2   | -7.9   | -37.3  | -40.3  | -40.5  | -40.8  |
| Current transfers balance              | 16.1   | 44.0   | 46.7   | 51.6   | 32.0   | 33.2   | 36.6   | 37.2   |
| Capital account balance                | 29.4   | 36.0   | 43.8   | 43.4   | 38.4   | 33.6   | 31.4   | 32.2   |
| Financial account balance              | -16.0  | -20.9  | -30.9  | -2.2   | -15.4  | -3.3   | 28.3   | 54.2   |
| Direct investment balance              | 11.5   | 33.8   | 35.8   | 59.7   | 31.9   | 28.9   | 52.2   | 76.9   |
| Other investment balance               | -27.4  | -54.7  | -66.6  | -61.9  | -47.2  | -32.3  | -23.9  | -22.6  |
| Errors and omissions                   | 14.7   | 12.7   | 0.0    | 0.0    | 0.0    | 0.0    | 0.0    | 0.0    |
| Overall balance                        | 9.4    | 17.0   | -19.3  | -8.8   | 24.7   | 9.1    | 4.9    | 5.9    |
| Memorandum Items                       |        |        |        |        |        |        |        |        |
| Gross official foreign reserves        | 103.5  | 119.8  | 100.5  | 91.7   | 116.4  | 125.5  | 130.5  | 136.4  |
| In months of current import coverage   | 5.8    | 4.9    | 3.4    | 2.9    | 3.5    | 3.7    | 3.6    | 3.6    |
| In months of projected import coverage | 4.2    | 4.1    | 3.1    | 2.8    | 3.4    | 3.5    | 3.4    | 2.6    |
| Gross external debt (percent of GDP)   | 52.8   | 44.1   | 36.5   | 32.3   | 29.4   | 26.4   | 24.1   | 22.1   |
| Private sector                         | 7.4    | 6.2    | 6.2    | 6.2    | 6.2    | 6.2    | 6.2    | 6.2    |
| Public sector                          | 45.4   | 37.9   | 30.3   | 26.1   | 23.2   | 20.2   | 17.9   | 15.9   |
| External debt service (percent of GDP) | 1.3    | 3.2    | 1.7    | 2.4    | 2.1    | 2.2    | 1.9    | 1.8    |
| Principal                              | 1.0    | 2.4    | 1.1    | 1.6    | 1.3    | 1.5    | 1.2    | 1.1    |
| Interest                               | 0.4    | 0.8    | 0.7    | 0.7    | 0.8    | 0.8    | 0.7    | 0.7    |
| Nominal GDP                            | 334.1  | 388.3  | 472.8  | 518.8  | 555.9  | 598.3  | 639.0  | 679.8  |

Sources: Data provided by the authorities, and Fund Staff projections.

Table 5. Solomon Islands: Indicators of External Vulnerability, 2003-09

|   | 2003  | 2004  | 2005  | 2006  | 2007  | 2008  | 2009 |
|---|-------|-------|-------|-------|-------|-------|------|
|   |       |       |       |       | Est.  | Proj. |      |
| <b>Financial indicators</b>   |       |       |       |       |       |       |      |
| Government sector debt (in percent of GDP)                              | 120.4 | 88.6  | 72.6  | 63.5  | 52.3  | 41.9  | 36.1 |
| Broad money (percent change, 12-month basis)                            | 25.4  | 19.5  | 38.9  | 26.4  | 24.0  | 16.1  | 14.6 |
| Private sector credit (percent change, 12 month basis)                  | 25.4  | 9.8   | 63.1  | 62.5  | 54.5  | 37.5  | 19.8 |
| 3 month T-bill yield (in percent, nominal)                              | 5.8   | 6.0   | 4.5   | 3.4   | 3.2   | ...   | ...  |
| 3 month T-bill yield (in percent, real)                                 | 2.1   | -1.6  | -4.0  | -6.6  | -7.7  | ...   | ...  |
| <b>External indicators</b>  |       |       |       |       |       |       |      |
| Merch. Exports (percent change, 12-month basis in US\$)                 | 28.5  | 30.7  | 5.7   | 18.2  | 39.2  | 18.8  | 1.7  |
| <i>Of which</i> : Non-timber exports                                    | 23.1  | 39.4  | 0.9   | 5.4   | 61.1  | 25.1  | 6.5  |
| Merch. Imports (percent change, 12-month basis in US\$)                 | 4.5   | 26.1  | 68.9  | 27.5  | 30.8  | 23.1  | 9.1  |
| Terms of trade (percent change, 12 month basis)                         | -16.6 | -11.1 | -2.4  | -13.3 | -9.6  | -13.7 | -2.2 |
| Current account balance (in percent of GDP)                             | 9.1   | 23.5  | -9.8  | -5.6  | -2.8  | -6.8  | -9.6 |
| Capital account balance (in percent of GDP)                             | 5.5   | 0.6   | 9.4   | 8.8   | 9.3   | 9.3   | 8.4  |
| Gross official reserves (in US\$ millions)                              | 36.3  | 79.5  | 94.6  | 103.5 | 119.8 | 100.5 | 91.7 |
| Central Bank short-term foreign liabilities (in US\$ millions)          | 2.9   | 3.0   | 2.3   | 2.3   | 5.8   | 8.9   | 10.6 |
| Central Bank foreign currency exposure (in US\$)                        | 33.4  | 76.5  | 92.4  | 101.2 | 114.0 | 91.7  | 81.1 |
| Foreign currency exposure of the financial sector (in US\$ millions) 1/ | 2.2   | 0.8   | 1.7   | -0.4  | -2.8  | -6.2  | -7.5 |
| Official reserves (in months of next year's imports of GNFS)            | 4.0   | 5.5   | 5.3   | 4.2   | 4.1   | 3.1   | 2.8  |
| Gross international reserves to broad money                             | 52.3  | 96.0  | 83.0  | 72.2  | 67.9  | 50.2  | 41.5 |
| Total external public sector debt (in percent of GDP) 2/                | 68.9  | 58.4  | 48.6  | 45.4  | 37.9  | 30.3  | 26.1 |
| Total external debt to exports of GNFS 3/                               | 192.9 | 140.4 | 120.7 | 101.1 | 70.8  | 61.3  | 57.8 |
| External interest payments to exports of GNFS 3/                        | 2.7   | 2.1   | 4.0   | 0.7   | 1.3   | 1.1   | 1.3  |
| External amortization payments to exports of GNFS 3/                    | 2.3   | 1.4   | 1.3   | 1.8   | 3.8   | 1.8   | 2.9  |
| Exchange rate (SI\$/US\$, period average)                               | 7.51  | 7.48  | 7.53  | 7.61  | 7.65  | 7.71  | 8.01 |
| Exchange rate (SI\$/US\$, end of period)                                | 7.49  | 7.51  | 7.58  | 7.62  | 7.66  | ...   | ...  |
| REER appreciation (+) (period average)                                  | -12.9 | -1.8  | 3.1   | 7.5   | -1.0  | ...   | ...  |

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

1/ Net foreign assets of commercial banks.

2/ Includes arrears.

3/ Includes both public and private sector external debt.

Table 6. Solomon Islands: Medium-Term Baseline Scenario, 2005-13

|  | 2005  | 2006  | 2007  | 2008  | 2009  | 2010  | 2011  | 2012  | 2013  |
|--|-------|-------|-------|-------|-------|-------|-------|-------|-------|
|  |       |       | Est.  |       |       |       |       |       |       |
|  |       |       |       |       |       |       |       |       |       |
|  |       |       |       |       |       |       |       |       |       |
| Growth and prices (percentage change)                  |       |       |       |       |       |       |       |       |       |
| Real GDP   | 5.0   | 6.1   | 10.3  | 7.3   | 4.0   | 3.4   | 2.5   | 2.5   | 3.2   |
| Of which: Nontimber                                    | 4.5   | 6.1   | 8.7   | 6.5   | 5.1   | 5.7   | 6.3   | 5.3   | 4.3   |
| CPI (period average)                                   | 7.4   | 11.2  | 7.7   | 15.1  | 8.8   | 6.2   | 5.5   | 5.0   | 5.0   |
| CPI (end of period)                                    | 8.6   | 9.9   | 10.9  | 14.6  | 6.5   | 6.0   | 5.0   | 5.0   | 5.0   |
| Nominal GDP (millions of SI\$)                         | 2,207 | 2,542 | 2,971 | 3,647 | 4,154 | 4,613 | 5,106 | 5,586 | 6,085 |
| Nominal GDP (millions of US\$)                         | 293   | 334   | 388   | 473   | 519   | 556   | 598   | 639   | 680   |
| Per capita GDP (in US\$)                               | 609   | 676   | 764   | 905   | 966   | 1,006 | 1,054 | 1,095 | 1,133 |
| Per capita GDP in 2008 prices (in US\$)                | 802   | 819   | 879   | 918   | 928   | 934   | 931   | 928   | 932   |
| Central government operations (percent of GDP)         |       |       |       |       |       |       |       |       |       |
| Total revenue and grants                               | 66.2  | 64.7  | 69.0  | 61.6  | 60.7  | 45.9  | 44.0  | 43.4  | 42.4  |
| Recurrent revenue                                      | 29.7  | 32.3  | 36.8  | 33.0  | 32.4  | 31.9  | 31.0  | 30.4  | 30.4  |
| Grants 1/  | 36.6  | 32.5  | 32.2  | 28.6  | 28.3  | 14.0  | 13.0  | 13.0  | 12.0  |
| Total expenditure 2/                                   | 63.6  | 63.0  | 70.4  | 65.2  | 59.3  | 44.6  | 42.5  | 42.1  | 41.0  |
| Recurrent expenditure                                  | 26.7  | 30.7  | 33.0  | 35.3  | 30.1  | 29.5  | 28.1  | 27.6  | 27.3  |
| Development expenditure 1/                             | 36.9  | 32.3  | 37.5  | 29.8  | 29.2  | 15.1  | 14.3  | 14.5  | 13.7  |
| Overall balance 3/                                     | 2.6   | 1.7   | -1.5  | -3.6  | 1.4   | 1.3   | 1.5   | 1.3   | 1.4   |
| Central government debt (percent of GDP) 4/            | 72.6  | 63.5  | 52.3  | 41.9  | 36.1  | 31.7  | 27.6  | 24.1  | 21.6  |
| Monetary and credit (percentage change, end-year data) |       |       |       |       |       |       |       |       |       |
| Broad money  | 38.9  | 26.4  | 24.0  | 16.1  | 14.6  | 11.9  | 11.0  | 9.8   | 9.2   |
| Interest rate (3-month t/bill rate, average)           | 4.5   | 3.4   | 3.2   | ...   | ...   | ...   | ...   | ...   | ...   |
| Balance of payments                                    |       |       |       |       |       |       |       |       |       |
| Current account  | -28.7 | -18.8 | -10.8 | -32.2 | -49.9 | 1.7   | -21.1 | -54.8 | -80.6 |
| (Percent of GDP)                                       | -9.8  | -5.6  | -2.8  | -6.8  | -9.6  | 0.3   | -3.5  | -8.6  | -11.9 |
| Overall balance (accrual)                              | 16.0  | 9.4   | 17.0  | -19.3 | -8.8  | 24.7  | 9.1   | 4.9   | 5.9   |
| Gross official reserves (US\$ millions, end of period) | 94.6  | 103.5 | 119.8 | 100.5 | 91.7  | 116.4 | 125.5 | 130.5 | 136.4 |
| (in months of next year's imports of GNFS)             | 5.3   | 4.2   | 4.1   | 3.1   | 2.8   | 3.4   | 3.5   | 3.4   | 2.6   |

Sources: Data provided by the authorities; and Fund Staff estimates.

1/ Based on donor commitments through 2010. Development grants and grant-financed development spending are currently administered by donors, and hence are not under the direct control of the government. They exclude police and military spending, but include TA.

2/ Expenditures are presented on an accrual basis.

3/ Calculated from above-the-line data.

4/ Includes interest arrears.



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## **APPENDIX I. IMF Executive Board Concludes 2008 Article IV Consultation with the Solomon Islands**

On October 20, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Solomon Islands.<sup>1</sup>

### **Background**

Economic performance has been robust since peace and order was restored in 2003 largely on account of unsustainable logging and aid flows. Real GDP growth averaged 7 percent in the past five years and macroeconomic stability has been maintained. Despite this stellar growth performance—unprecedented since the country's independence in 1978—the Solomon Islands remains the poorest in the region. The anticipated sharp decline in logging and aid flows poses serious risks to medium-term fiscal and external sustainability. Moreover, there have been frequent changes in government which has slowed the pace of critical structural reforms to enhance nonlogging sources of growth.

In 2007, growth accelerated to 10.3 percent, driven mainly by logging and other emerging sectors (palm oil and services), but is expected to decline to 7 percent in 2008 as logging activity starts to fall. Inflation rose to about 16 percent (3-month moving average) in June from 10 percent in end-2007, but will likely moderate towards the end of the year as commodity prices stabilize and recent monetary tightening measures take hold. Reserve levels remained comfortable at end-2007, but the current account is

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<sup>1</sup> Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

projected to widen in 2008 due to the deterioration in the terms of trade. Nevertheless, reserves are likely to remain adequate given continued strong donor inflows, logging export receipts, and FDI inflows from the mining sector.

After several years of surpluses, the fiscal balance swung to a small deficit in 2007. Strong revenue performance was overtaken by spending excesses on wages and goods and services. In 2008, the budget will likely remain expansionary, with a supplementary budget of nearly 6 percent of GDP passed by parliament recently. This calls for further monetary tightening to help prevent inflation from becoming entrenched.

Medium-term challenges from declining logging activity and aid flows are daunting and require accelerating critical reforms. Measures to strengthen the government's fiscal position remains slow, although some progress has been made. In particular, a medium-term fiscal framework has been drafted and the determined price of logs (which is used for the calculation of logging taxes) has been raised in May 2008. The expected decline in logging revenue calls for serious efforts to broaden the revenue base, rationalize fiscal spending, and strengthen the finances of state-owned enterprises to place the fiscal sector on a more sustainable footing. The debt situation has improved recently, but remains highly sensitive to a decline in export and GDP growth. Meanwhile, external sustainability relies solely on the coming on stream of gold production in 2010, after several delays in commencement owing *inter alia* to land ownership issues.

Limited progress has been made to stimulate sustained nonlogging sources of growth. The country remains beset with poor infrastructure, land ownership issues, a shortage of skilled labor, and unreliable and costly basic services. In addition, weak governance remains a serious concern. Nevertheless, some progress has been made in improving infrastructure with the help of ADB and enhancing competition in the airline industry. Other measures are also in the pipeline, including a draft Tribal Land Bill, strengthening the management of the state-owned electricity company, further improvements in infrastructure, and enhancing competition in the telecommunications sector.

## Executive Board Assessment

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**Public Information Notices (PINs)** form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Table 1. Solomon Islands: Selected Economic Indicators, 2003-09

Nominal GDP (2007): US\$388 million  
 Population (2007): 508,420  
 GDP per capita (2007): US\$764  
 Quota: SDR 10.4 million

|   | 2003  | 2004  | 2005  | 2006  | 2007<br>Est. | 2008<br>Proj. | 2009  |
|---|-------|-------|-------|-------|--------------|---------------|-------|
| Growth and prices (percentage change)                           |       |       |       |       |              |               |       |
| Real GDP  | 6.5   | 8.0   | 5.0   | 6.1   | 10.3         | 7.3           | 4.0   |
| CPI (period average)  | 10.0  | 6.9   | 7.4   | 11.2  | 7.7          | 15.1          | 8.8   |
| CPI (end of period)   | 3.7   | 7.6   | 8.6   | 9.9   | 10.9         | 14.6          | 6.5   |
| Per capita GDP (in US\$)  | 503   | 560   | 609   | 676   | 764          | 905           | 966   |
| Central government operations (percent of GDP)                  |       |       |       |       |              |               |       |
| Total revenue   | 39.2  | 48.1  | 66.2  | 64.7  | 69.0         | 61.6          | 60.7  |
| Recurrent revenue   | 21.2  | 26.3  | 29.7  | 32.3  | 36.8         | 33.0          | 32.4  |
| Grants  | 18.0  | 21.8  | 36.6  | 32.5  | 32.2         | 28.6          | 28.3  |
| Total expenditure 1/  | 37.4  | 39.1  | 63.6  | 63.0  | 70.4         | 65.2          | 59.3  |
| Recurrent expenditure   | 21.9  | 21.6  | 26.7  | 30.7  | 33.0         | 35.3          | 30.1  |
| Development expenditure   | 15.5  | 17.4  | 36.9  | 32.3  | 37.5         | 29.8          | 29.2  |
| Overall balance 2/  | 1.8   | 9.0   | 2.6   | 1.7   | -1.5         | -3.6          | 1.4   |
| Foreign financing (net)   | 0.8   | 0.0   | 4.7   | 2.1   | 3.2          | -1.0          | -1.7  |
| Domestic financing (net)  | -9.3  | -6.7  | -2.3  | -1.8  | -1.1         | 4.2           | 0.1   |
| Other   | 9.9   | -2.3  | -3.0  | -0.3  | -0.5         | 0.3           | 0.1   |
| Discrepancy (neg. are net expenditures)                         | -3.3  | 0.0   | -2.0  | 1.8   | 0.1          | 0.0           | 0.0   |
| Central government debt (percent of GDP) 3/                     | 120.4 | 88.6  | 72.6  | 63.5  | 52.3         | 41.9          | 36.1  |
| Domestic  | 51.5  | 30.1  | 24.0  | 18.1  | 14.4         | 11.6          | 10.0  |
| External  | 68.9  | 58.4  | 48.6  | 45.4  | 37.9         | 30.3          | 26.1  |
| External debt (in US\$ millions, end of period)                 | 157.7 | 153.1 | 142.6 | 151.7 | 147.3        | 143.1         | 135.5 |
| External debt service to exports of GNFS (accrual basis)        | 5.0   | 3.5   | 5.3   | 2.5   | 5.2          | 2.9           | 4.2   |
| Monetary and credit (percentage change, end-year data)          |       |       |       |       |              |               |       |
| M3  | 25.4  | 19.5  | 38.9  | 26.4  | 24.0         | 16.1          | 14.6  |
| Base Money  | 26.5  | 75.7  | 20.0  | 8.1   | -2.0         | -5.0          | 11.6  |
| Interest rate (3-month t/bill rate, average)                    | 5.8   | 6.0   | 4.5   | 3.4   | 3.2          | ...           | ...   |
| Balance of payments (US\$ millions, unless otherwise indicated) |       |       |       |       |              |               |       |
| Current account   | 20.9  | 61.5  | -28.7 | -18.8 | -10.8        | -32.2         | -49.9 |
| (Percent of GDP)  | 9.1   | 23.5  | -9.8  | -5.6  | -2.8         | -6.8          | -9.6  |
| Overall balance (accrual)                                       | 18.8  | 43.4  | 16.0  | 9.4   | 17.0         | -19.3         | -8.8  |
| Gross official reserves (US\$ millions, end of period)          | 36.3  | 79.5  | 94.6  | 103.5 | 119.8        | 100.5         | 91.7  |
| (in months of projected imports of GNFS)                        | 4.0   | 5.5   | 5.3   | 4.2   | 4.1          | 3.1           | 2.8   |
| Exchange rate (SI\$/US\$, end of period)                        | 7.49  | 7.51  | 7.58  | 7.62  | 7.66         | ...           | ...   |
| Real effective exchange rate (period average, 2000=100)         | 78.5  | 77.1  | 79.5  | 85.5  | 84.7         | ...           | ...   |
| Nominal effective exchange rate (period average, 2000=100)      | 64.4  | 60.3  | 59.1  | 58.5  | 55.0         | ...           | ...   |

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

1/ Expenditures are presented on an accrual basis.

2/ Calculated from above-the-line data.

3/ Includes arrears.