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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.[1]

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 non-logging 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

[1] 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 foreign direct investment (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 non-logging 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 Asian Development Bank 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

Executive Directors welcomed the Solomon Islands' continued strong economic growth, driven mainly by logging activity, but also by a pickup in non-logging activity. However, Directors noted that inflation has risen as a result of fuel and food price shocks, rapid private sector credit growth, and an expansionary fiscal stance. Debt indicators are declining but remain high, and the current account is projected to deteriorate in the near term because of the terms of trade shock. Over the medium term, the economic outlook hinges critically on developing non-logging sources of growth and exports to offset the expected decline in logging activity.

Directors therefore highlighted the urgency of tightening fiscal and monetary policies and forcefully implementing structural reforms to maintain macroeconomic stability, safeguard fiscal and external sustainability, and accelerate growth in the non-logging sectors. In particular, they stressed the importance of ensuring that gold mining operations start as expected in 2010, to alleviate possible pressure on the balance of payments arising from declining log exports. Directors welcomed the authorities' commitment not to undertake new external borrowing.

Directors commended the government's adoption of a medium-term fiscal strategy to achieve a balanced budget, by both boosting tax revenue and reducing non-priority expenditure. Efforts to improve tax administration and widen the tax base would be crucial. Raising the reference price of logs to reflect international market prices and narrowing ad hoc tax exemptions could make essential contributions. Directors stressed the need to rationalize civil service employment, contain the government wage bill, and enhance the efficiency of state-owned enterprises. Better expenditure-control procedures would keep spending within budgeted levels and foster enhanced budgetary transparency and accountability.

Directors observed that, while the recent decline in commodity prices would ease inflationary pressures, further tightening of monetary policy would prevent inflation from becoming entrenched. They supported efforts by the central bank to rein in excess liquidity. Directors recommended that the central bank seek to develop financial markets further and make greater use of interest rate mechanisms of monetary control. To avoid placing undue burden on monetary policy, fiscal policy needs to play a supportive role, especially in the near term.

Directors agreed that the real effective exchange rate appears to be broadly in line with medium-term economic fundamentals. They also considered that the current exchange rate peg to a basket of currencies has served the country well. Nonetheless, greater exchange rate flexibility could help encourage export diversification, easing the impact of the expected decline in log exports.

Directors noted that the turbulence in global financial markets has not had a noticeable impact on the financial sector in the Solomon Islands. Banks are profitable, liquid, and well-capitalized, and non-performing loans are low. Nevertheless, banks remain vulnerable to slower growth especially in the logging sector. Directors therefore advised the central bank to continue to monitor banking developments closely to ensure that asset quality remains sound.

Directors commended the various structural reforms being implemented to enhance the business climate and stimulate the growth of non-logging sectors. They attached high priority to efforts to improve the infrastructure, allow competition in the airline and telecommunications industries, address land ownership issues, and lower the cost of doing business. Directors strongly encouraged the authorities to move quickly on these reforms.

Directors welcomed the authorities' continuing efforts to improve the quality and timeliness of macroeconomic data. They stressed the need to allocate sufficient resources, ensure adequate staff training, and benefit from continued Fund technical assistance.

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Solomon Islands: Selected Economic Indicators, 2003-09							
Nominal GDP (2007): US$388 million							
Population (2007): 508,420							
GDP per capita (2007): US$764							
Quota: SDR 10.4 million							
	2003	2004	2005	2006	2007	2008	2009
					Est.	Proj.	
Growth and prices (percentage change)							
Real GDP	6.5	8.0	5.0	6.1	10.3	7.3	4.0
CPI (period average)	10.0	6.9	7.4	11.2	7.7	15.1	8.8
CPI (end of period)	3.7	7.6	8.6	9.9	10.9	14.6	6.5
Per capita GDP (in US$)	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 and projections.

1/ Expenditures are presented on an accrual basis.
2/ Calculated from above-the-line data.
3/ Includes arrears.