

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

**FOR
AGENDA**

MASTER FILES

ROOM C-130

01

SM/87/193

CONTAINS CONFIDENTIAL
INFORMATION

August 5, 1987

To: Members of the Executive Board

From: The Secretary

Subject: Solomon Islands - Staff Report for the 1987 Article IV
Consultation

Attached for consideration by the Executive Directors is the staff report for the 1987 Article IV consultation with Solomon Islands, which will be brought to the agenda for discussion on a date to be announced.

Mr. Baumgartner (ext. 7307) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

SOLOMON ISLANDS

Staff Report for the 1987 Article IV Consultation

Prepared by the Staff Representatives for the
1987 Article IV Consultation with Solomon Islands

(In consultation with the Legal and Treasurer's Departments)

Approved by P.R. Narvekar and H.B. Junz

August 4, 1987

	<u>Contents</u>	<u>Page</u>
I.	Background and Recent Developments	1
	1. Recent developments	1
	2. Cyclone Namu	4
II.	Report on the Discussions	4
	1. Economic outlook	4
	2. Policy discussions	6
	a. Fiscal policy	6
	b. Monetary policy	9
	c. External policies	11
	d. Development planning and structural issues	12
III.	Staff Appraisal	13
	Text Tables	
	1. Balance of Payments Developments and Prospects, 1984-91	2
	2. Central Government Operations, 1984-87	8
	3. Monetary Survey, 1984-87	10
	Chart	
	1. Effective Exchange Rates, Export Prices, and Profitability Indicator, 1982-87	12a

	<u>Contents</u>	<u>Page</u>
Annexes		
I.	Basic Data	16
II.	Social and Demographic Indicators	17
III.	Fund Relations	18
IV.	World Bank Group Operations in Solomon Islands	21
V.	Statistical Issues	23

I. Background and Recent Developments 1/2/

The Solomon Islands economy consists of a modern export-oriented sector--comprising tree crop plantations and commercial fishing and logging--and a large subsistence agricultural sector. Solomon Islands' main exports are tuna fish, timber, copra, palm oil, and cocoa. With the exception of smallholder production of copra and cocoa, export production is concentrated in a few large enterprises, most of which are joint ventures. The rapid development of the fishing and forestry sectors has resulted in strong growth of output during the period 1981-86; staff estimates indicate average annual growth of about 8 percent with large year-to-year fluctuations. However, a steep downward trend in export prices--the terms of trade declined by a total of 40 percent between 1981 and 1986--implied that real GDP, adjusted for changes in the terms of trade, grew by only 2 percent (annual average) during this period.

1. Recent developments

Recent developments were dominated by a steep decline in world market prices of Solomon Islands' exports, in particular of vegetable oils, and the effects of cyclone Namu (see Section 2 below). Following a short-lived boom in 1984, export unit values (in terms of SDRs) fell by a total of about 40 percent in 1985-86. The external current account deficit rose from 6 percent of GDP in 1984 to 24 percent in 1985 and the overall balance swung into deficit (SDR 17 million), with foreign reserves declining from the equivalent of 5 months of imports in 1984 to 3 1/2 months in 1985 (Table 1). Export value continued to decline (by 19 percent) in 1986, despite a substantial increase in the volume of fish and timber exports. However, the effect of lower exports was partly offset by a decline in imports, owing to falling incomes (notably from copra production), a tightening of monetary policy, lower oil prices, and a 23 percent depreciation of the Solomon Islands dollar in

1/ The 1987 Article IV consultation discussions were held in Honiara from May 12 to May 23, 1987. The Solomon Islands authorities were represented by the Ministers of Finance and Economic Planning; the Governor of the Central Bank; and senior officials of the Ministries of Finance, Economic Planning, Agriculture and Land, Natural Resources, Public Services, and Trade, Commerce and Industry. The mission also met with representatives of the private business and financial sectors. The staff team consisted of Messrs. Baumgartner (head), Ishihara, Fritz-Krockow (all ASD) and Fries (ETR), and Miss Greasley (secretary, SEC).

2/ Solomon Islands has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on payments and transfers for current international transactions.

Table 1. Solomon Islands: Balance of Payments Developments and Prospects, 1984-91

	1984	1985	1986	1987	1988	1989	1990	1991
	(In millions of SDRs)							
Exports, f.o.b.	89.4	69.1	56.2	55.3	71.0	87.0	94.0	101.0
Imports, f.o.b.	-64.1	-68.3	-57.0	-62.4	-81.0	-74.0	-80.0	-86.0
Services and private transfers (net)	-34.2	-31.1	-33.5	-32.9	-42.0	-47.0	-50.0	-56.0
Current account	-8.9	-30.3	-34.3	-40.0	-52.0	-34.0	-36.0	-41.0
Grants	14.2	11.6	23.7	25.0	24.0	19.0	15.0	15.0
Concessional loans (net)	4.2	6.0	8.8	7.9	7.0	7.0	7.0	7.0
Commercial borrowing (net)	1.9	2.1	4.4	3.3	13.0	3.0	3.0	3.0
Direct investment	1.8	0.9	1.8	1.6	2.0	2.5	2.5	2.5
Short-term capital	...	-0.9	1.1	--	--	--	--	--
Errors and omissions	-6.7	-6.9	-2.7	--	--	--	--	--
Overall balance	6.5	-16.5	1.6	-2.2	-6.0	-2.5	-8.5	-13.5
Reserves (increase -)	-2.2	13.1	8.4	--	-4.0	-1.5	-2.0	-2.5
IMF	-0.2	-0.4	0.1	-1.2	-0.3	-0.2	-0.6	-0.5
Purchases	(- -)	(- -)	(-1.3)	(- -)	(- -)	(- -)	(- -)	(- -)
Repurchases	(-0.2)	(-0.4)	(-1.2)	(-1.2)	(-0.3)	(-0.2)	(-0.6)	(-0.5)
Eurocurrency loan	-9.8	4.9	-8.5	--	--	--	--	--
Other (net)	5.7	-1.1	-1.6	--	--	--	--	--
Financing gap	--	--	--	3.0	10.3	4.2	11.1	16.5
	(Percent change)							
Memorandum item:								
Export volume	13.1	-10.3	18.2	-7.2	26.0	20.0	3.5	2.5
Import volume	10.3	5.6	-10.9	5.0	27.0	-10.0	5.0	5.0
Export unit values (SDRs)	36.2	-13.9	-31.1	6.0	1.5	2.5	5.0	4.0
Import unit values (SDRs)	1.1	0.9	-6.3	4.5	2.0	2.0	3.0	3.0
Terms of trade	34.7	-14.6	-26.5	1.2	-0.5	0.5	2.0	1.0
GDP	1.0	1.0	20.0	-5.0	8.0	16.0	2.0	2.0
Terms of trade adjusted GDP	25.0	-10.0	-4.0	-4.0	3.0	15.0	4.0	3.0
	(Percent)							
Current account/GDP	-6.0	-23.5	-33.9	-45.4	-56.3	-30.1	-30.1	-32.5
Debt service ratio <u>1/</u> <u>2/</u>	7.1 <u>3/</u>	8.5	7.9 <u>3/</u>	8.5	10.7	12.9	13.7	15.1
Debt/GDP	40.4	54.6	69.2	98.5	129.4	118.7	129.1	143.2
Reserves in months of imports of goods and services	4.8	3.4	2.5	2.5	2.3	2.5	2.5	2.5

Sources: Data provided by the Solomon Islands authorities and staff projections.

1/ Total debt service in percent of exports of goods and services.

2/ Assumes that financing gap is closed through borrowing at commercial terms.

3/ Excludes early repayment of Eurocurrency loan.

nominal effective terms. While the current account deficit widened to 34 percent of GDP in 1986, an unexpectedly large increase in foreign aid resulted in an overall balance of payments surplus of SDR 2 million. An early disbursement of STABEX grants from the European Community (EC) of SDR 8 million, equivalent to 14 percent of export value, for shortfalls in vegetable oil exports accounted for most of the rise in foreign aid inflows. However, reserves declined by SDR 9 million to the equivalent of 2 1/2 months of imports, as Solomon Islands prepaid most of a Euro-currency loan drawn down in 1981-83 and 1985 to boost gross reserves.

Output stagnated in 1985 but is estimated to have grown by close to 20 percent in 1986, mainly reflecting the large increases in the volume of fish and timber exports. However, because of the sharp decline in export prices, terms of trade adjusted GDP is estimated to have fallen by about 10 percent in 1985 and by a further 4 percent in 1986. Despite a substantial increase in fixed capital formation by the public sector, domestic demand was subdued in 1985-86, owing to weak private consumption and investment. The increase in public investment was a major factor behind the widening of the central government budget deficit from 6 percent of GDP in 1984 to 12 percent in 1985 and 20 percent in 1986. A decline in receipts from export duties and substantial growth of current expenditure also contributed to the increase in the fiscal deficit. The resulting rise in the Government's domestic borrowing requirement was partly responsible for the rapid growth of domestic credit in 1985 (59 percent) and during most of 1986. However, the inflow of STABEX grants toward the end of 1986 led to a temporary contraction in net credit to the Government. Total money supply showed virtually no growth in 1985, but rose by 12 percent in 1986, considerably more rapidly than nominal GDP of the monetized sector (which grew by 3 percent). Consumer price inflation rose from 10 percent in 1985 to 14 percent in 1986. The information on wage developments is sketchy, but partial data on monthly earnings in the formal sector indicate that real wages remained broadly unchanged in 1985-86, while operating surpluses of companies and copra-producing households declined substantially.

In the first half of 1987, gross international reserves declined by about SDR 3 million. Exports, as well as imports, were down by about 15 percent in the first quarter from a year earlier, with the decline in exports arising from lower shipments of copra and palm oil. Total domestic credit grew rapidly in the first six months of 1987, fueled by the large financing needs of the central government. Preliminary data indicate that money supply growth (year-on-year) accelerated from 8 percent in the first quarter of 1987 to 19 percent in the second quarter. Abstracting from special factors, consumer price inflation was in the range of 10-15 percent in the first half of 1987.

2. Cyclone Namu

In May 1986, Solomon Islands was hit by a severe cyclone, which resulted in heavy loss of life and substantial damage to the economy. The total damage to private houses, public buildings, agricultural production facilities and infrastructure is estimated at SDR 10 million (equivalent to about 10 percent of GDP). The heaviest damage was sustained by the oil palm plantation. The output of palm oil in 1987-88 is expected to decline to one half of its pre-cyclone level and a full recovery of production is not expected before 1990. Other tree crops, such as coconuts and cocoa, suffered less damage. Foreign governments and international organizations provided large assistance for rescue and relief operations. Aid worth several million SDRs was provided in the form of food and medical supplies, equipment, air and ship transport, and personnel for health care and reconstruction; in addition, foreign cash grants of some SDR 1 million were provided. The impact of the cyclone on the budget was to raise the deficit by SI\$4-5 million, equivalent to 2 percent of GDP. Imports for government-financed relief and reconstruction operations amounted to about SDR 2 million in 1986 and reconstruction will require sizable imports in 1987-88. The cumulative balance of payments effect of the cyclone, taking account of both the decline in exports and the additional import requirements, is estimated at SDR 11 million in 1986-88 (excluding the relief provided in the immediate aftermath of the cyclone). To help Solomon Islands meet the immediate foreign exchange needs arising from the disaster, the Fund provided emergency assistance of SDR 1.25 million (25 percent of quota) in September 1986. Foreign aid donors have pledged substantial assistance for reconstruction and have also restructured aid programs to accommodate rehabilitation projects.

II. Report on the Discussions

In concluding the 1986 Article IV consultation, Executive Directors noted that the balance of payments outlook had worsened and expressed concern about the increase in the fiscal deficit, the rapid growth of credit, and the deterioration in export profitability. They advocated the adoption of comprehensive adjustment measures. Executive Directors also noted the need to address several structural problems that appeared to increasingly constrain development.

1. Economic outlook

There was broad agreement between the authorities and the staff that the prospects for 1987 are for a decline in real GDP (of about 5 percent), continued rapid inflation (of up to 15 percent), and some weakening of the balance of payments position. Domestic demand is expected to grow significantly in 1987 on account of a substantial increase in development expenditure, a recovery of private investment and the boost to private consumption provided by an increase in the

producer price of copra in early 1987. The strengthening of domestic demand is expected to result in an increase in import volume of some 5 percent. The closure of the largest timber company because of land access problems and cyclone damage to the oil palm plantation are projected to reduce the export volume by about 7 percent. With broadly unchanged terms of trade, the current account deficit would widen from SDR 34 million (34 percent of GDP) in 1986 to SDR 40 million (45 percent of GDP) in 1987. The inflow of foreign aid--including STABEX grants equivalent to SDR 10 million--is expected to be broadly unchanged from the 1986 level. Nevertheless, a small external financing gap of some SDR 3 million is likely to emerge in 1987.

The medium-term outlook for the balance of payments depends heavily on the prospects for export prices, the expansion of export capacity and the inflow of foreign aid. Furthermore, the level of export profitability and the stance of demand management policies would have an important bearing on the external balance. For the purpose of the medium-term projections, it was assumed that present policies and the present level of export profitability would remain unchanged.

Staff projections suggest that, on average, world prices of Solomon Islands' main exports are likely to rise broadly in line with world inflation in the period 1988-91. The authorities noted that current plans for increasing export capacity are concentrated in the fishing industry. In the next two years, the fish catch is expected to increase to 75,000 tons from 40,000 tons in 1986, owing to the acquisition/leasing of additional fishing vessels in late 1987-early 1988. Furthermore, a new cannery with 5-6 times the capacity of the current one is expected to start operations in 1989 and run at full capacity by 1991. This would substantially increase the domestic value added of fish exports. The production of copra and cocoa is projected to increase gradually in the next 4-5 years as a result of current plantings. The issuance of new logging licenses and increased production by existing companies are expected to bring timber output and exports back to their 1986 levels within the next two years. However, land access problems and the need to preserve the resource base will probably not allow significant further growth of production. Export volume is projected to rise by about 25 percent in 1988 and 20 percent in 1989, reflecting a virtual doubling of fish exports and a rebound in exports of timber and, to a lesser extent, palm oil. Thereafter, the growth of export volume is forecast to slow to about 3 percent per annum.

The large investments in fisheries and, more generally, the achievement of the objective of average real GDP growth of about 5 percent will require a sustained large increase in imports. Import volume is projected to rise by over 25 percent in 1988, mainly reflecting the peak of investment activity in the fishing sector as well as the implementation of some infrastructure projects. Import volume would return to more normal levels in 1989 and grow by about 5 percent per annum in 1990-91. Present projections of copra and palm oil exports

suggest that the inflow of STABEX grants would remain large in 1988, but would decline substantially in 1989 and cease in 1990.

This medium-term scenario indicates a widening financing gap and, in view of the present very low level of reserves, raises questions about the medium-term sustainability of the balance of payments position. Staff calculations indicate that a closing of the financing gap in 1988-91 entirely through commercial borrowing would result in an increase in the debt service ratio from 9 percent in 1987 to 15 percent in 1991, with further increases in subsequent years.

2. Policy discussions

The policy discussions focused on the Government's primary objective of achieving continued rapid growth while ensuring a viable external position. The discussions covered a broad range of demand management and supply-oriented policies. While the authorities agreed with the need for policy adaptations, they stated that major action, particularly in the area of fiscal policy where the need for adjustment is greatest, could not be taken before the submission of the 1988 budget to Parliament in late 1987. They expected, however, to be in a position to take adjustment measures thereafter and expressed interest in discussing possible use of Fund resources, including an arrangement under the structural adjustment facility, at that time. In view of this, the mission discussed with the authorities the thrust of a program that could be supported by use of Fund credit under the structural adjustment facility. In broad terms, such a program would contain measures to correct the fiscal imbalance; tailor the development program to the country's absorptive capacity; curb the growth of wages; prevent excessive credit growth while bringing about a better distribution of credit between the public and private sectors; ensure adequate export profitability as the foundation for further growth of the export sector; and address the structural problems impeding economic development.

a. Fiscal policy

The substantial increase in the Central Government budget deficit in 1985-86 and the prospects for continued large deficits have made fiscal adjustment the central policy issue. The authorities noted that the increase in the budget deficit had arisen from various sources. Weaknesses in the tax system and in tax administration had been important contributing factors, and the decline in export prices had led to a sharp drop in revenue from export duties and slower growth of income tax receipts. At the same time, the rapid growth of the population--estimated at 3.5 percent per annum--had resulted in rising demand for government services, such as education and health care. The devolution of power to provincial governments had increased expenditure, and efforts to scale back the size of public administration and impose restraint on wage increases had not met with much success. The increase in public investment had given rise to the need for larger recurrent

expenditure, which initially had not been taken into account, and inefficiencies in planning had boosted the size of the development budget. Furthermore, relief operations and reconstruction following cyclone Namu had required additional expenditure in 1986.

The 1987 budget provided for no growth of revenue but an increase in total expenditure of about 24 percent (while current expenditure was estimated to remain unchanged, development expenditure was projected to rise by 60 percent) (Table 2). The deficit was expected to amount to some 28 percent of GDP, with about 85 percent of the deficit being financed through foreign grants and loans. Tax revenue was expected to decline somewhat, mainly owing to a reduction in the duty on fish exports from 3 percent to 1 percent and lower timber exports following the closure of the largest logging company. Import duty collections were projected to rise slightly despite a halving of duty rates on imports of fuel and other goods by the fishing industry. The objective of zero growth in current expenditure was to be achieved through cuts in subsidies to public enterprises (offset, however, by larger lending), a reduction in transfers to provinces, and the absence of increases in civil service salaries and employment. The substantial increase in development expenditure reflected the start-up of some large projects in the fisheries sector, increased lending to some public enterprises, reconstruction following the cyclone, and improvements in project implementation.

Developments in the first 3-4 months of 1987 indicate that total revenue is likely to be somewhat higher, because of more buoyant activity, larger exports and imports, and improvements in tax collection. However, a large part of the revenue increase will be offset by refunds of SI\$3 million of export and import duties paid by the fishing industry in 1986 and of export duty paid in 1984 (the refund of the 1984 export duty was agreed upon in 1985 but was not actually carried out). With this action, the impact on the 1987 budget of all tax relief measures provided to the fishing industry is about SI\$6 million, or 10 percent of total revenue. Nontax revenue is likely to be lower than budgeted because of the postponement of increases in various fees and charges. Current expenditure is expected to be 10 percent higher than projected earlier because of a recently granted 8 percent salary increase for civil servants and larger subsidies and transfers to provinces. Delays in project implementation are likely to result in some shortfall in capital expenditure. The deficit is now expected to reach SI\$67 million, or 29 percent of GDP. The inflow of foreign grants and loans is estimated to be SI\$64 million--with STABEX grants amounting to some SI\$25 million--leaving only a small domestic financing requirement. However, until the time of disbursement of the STABEX grants in the second half of 1987, bank borrowing by the Government will be large.

The authorities are very much aware of the deterioration in the fiscal position and of the fact that the inflow of STABEX grants has helped to disguise this. The staff emphasized that once the STABEX grants decline or cease altogether the domestic financing need would become massive, unless decisive action was taken in the meantime. However, measures have been limited, so far, to efforts to strengthen tax administration, accelerate the reimbursement of development expenditures from donors, and exercise better control over current expenditure, partly with the help of technical assistance from abroad.

To reduce the deficit in coming years, the Government is now considering a reform of the tax system, with the help of technical assistance from the Fund, and a comprehensive review of all expenditures. The tax reform would be designed both to increase the efficiency of the tax system and broaden the tax base. Consideration will be given to simplifying the income tax system and reducing some rates to offset bracket creep; increasing effective taxation of corporations; including business activities in rural areas into the tax net; and introducing a consumption tax. A review of import tariffs is also envisaged. The authorities hope to introduce the first elements of the tax reform with the 1988 budget. While the tax reform is expected to result in a substantial increase in revenue, the authorities expressed the view--and the staff agreed--that fiscal adjustment also required a reversal of the trend of rapid growth of expenditure. To achieve this, the authorities intend to restrain the growth of civil service salaries; review the entire administrative system; give priority to projects with low recurrent cost implications; and transfer some public sector activities to the private sector. However, concrete measures are yet to be formulated.

b. Monetary policy

The authorities stated that the principal concern of monetary policy in 1986 had been to reduce the pressure on the balance of payments. To slow the growth of bank credit, the Central Bank in early 1986 introduced a more restrictive system of lending to banks. In the event, banks' use of central bank funds, which had risen rapidly in 1985 and early 1986, declined slowly during the remainder of 1986 and bank credit to the private sector ceased to grow (Table 3). By contrast, government borrowing from the Central Bank rose rapidly in the first nine months of 1986, but the inflow of STABEX grants resulted in a sharp contraction in net bank credit to the Government in the last quarter. Following this, the Government again had large recourse to central bank credit in the first quarter of 1987.

In early 1987, the Central Bank extended a concessional loan of SI\$6 million to the Government Shareholding Agency (GSA) to enable the GSA to increase equity participation in the Solomon-Taiyo Ltd. (STL) fishing company and allow STL to repay its bank loans. To absorb the resulting increase in bank liquidity, banks' access to central bank

Table 3. Solomon Islands: Monetary Survey, 1984-87

	1984	1985	1986				1987 Mar.
			Mar.	June	Sept.	Dec.	
<u>(In millions of SI\$)</u>							
Net foreign assets	41.7	27.6	19.0	20.8	23.4	41.2	38.9
Domestic credit	<u>39.5</u>	<u>62.6</u>	<u>71.3</u>	<u>73.9</u>	<u>76.3</u>	<u>62.3</u>	<u>70.3</u>
Government (net)	3.2	12.6	18.3	20.8	22.8	8.5	16.0
Nonfinancial public enterprises	5.3	1.6	1.1	0.6	0.1	0.4	--
Private sector	29.9	47.3	50.8	50.7	51.8	51.6	46.5
Other financial institutions	1.1	1.1	1.2	1.7	1.7	1.8	7.8
Other items, net	-16.7	-25.5	-21.4	-25.0	-26.3	-30.8	-34.4
Broad money	<u>64.5</u>	<u>64.7</u>	<u>69.0</u>	<u>69.7</u>	<u>73.4</u>	<u>72.7</u>	<u>74.8</u>
Narrow money	28.6	27.2	28.7	27.3	30.8	31.0	28.1
Quasi-money	35.9	37.5	40.3	42.4	42.6	41.7	46.7
<u>(Annual percent change)</u>							
Domestic credit	16.2	58.6	59.4	40.3	46.2	-0.4	-1.5
Of which:							
Private sector	45.8	58.3	45.8	33.8	25.7	9.2	-8.4
Broad money	<u>34.6</u>	<u>0.4</u>	<u>10.3</u>	<u>5.7</u>	<u>22.6</u>	<u>12.3</u>	<u>8.3</u>
Narrow money	52.3	-4.8	15.7	6.1	30.4	14.2	-2.2
Quasi-money	23.1	4.5	6.7	5.5	17.6	10.9	15.9

Source: Data provided by the Central Bank of Solomon Islands.

funds was reduced from 15 percent to 5 percent of total deposit liabilities, and bank borrowing from the Central Bank fell close to zero. However, as banks remained rather liquid, the Central Bank in late May announced that the liquid assets ratio would be raised from 25 percent to 27.5 percent with effect from July 1, 1987 (with a further increase to 30 percent possible) and that the Central Bank would discontinue its lending facility to commercial banks, but would stand ready to provide funds on a case-by-case basis.

The authorities expressed the view that developments in liquidity in 1986 and early 1987 had been broadly satisfactory, but that the need to restrain credit growth while accommodating the Government's large borrowing needs had resulted in an undesirable crowding out of private sector credit. They emphasized that the balance of payments would remain the principal concern of monetary policy in 1987. They also noted that the Central Bank would again be called upon to provide large amounts of financing to the Government (at least until the time of disbursement of the STABEX grants). In view of these constraints, it was unavoidable that credit to the private sector would remain tight. To alleviate the burden on the private sector, the Central Bank hopes to bring about a reduction in interest rates by 2-3 percentage points, without accelerating credit growth. The Central Bank considers this possible, because it is believed that the bargaining power of some large depositors had resulted in an upward bias in interest rates. Although interest rates have risen by 3-5 percentage points in the last two years, negative real interest rates have emerged on most deposits. The staff cautioned against strong efforts to reduce interest rates and stressed the need for continued monetary restraint, both to contain pressure on the balance of payments and reduce inflation.

c. External policies

The gradual depreciation of the Solomon Islands dollar, which was sustained through early 1987, was sufficient to bring about some recovery in export profitability in 1987 (Chart 1). At present exchange rates and world prices, exports, with the exception of copra and palm oil which account for only 10 percent of total export receipts, are expected to be profitable. In view of this, the authorities have recently reduced the pace of depreciation of the Solomon Islands dollar. They emphasized that attention should now be placed on the reduction of costs, the scope for which was large in some of the export industries. The authorities were also concerned about a possible large impact on prices and wages of a further substantial exchange rate adjustment. However, flexible management of the exchange rate would be maintained to prevent a deterioration of current profit levels.

The fishing industry, which had incurred large losses in recent years, is expected to return to profitability in 1987, because of some strengthening of prices, substantial tax relief, and the conversion of debt with high interest rates into equity. Efforts at further cost

reduction, notably with respect to the use of foreign crews, will continue, but progress may be slow because of the envisaged rapid expansion of the fleet. The copra sector was hit particularly hard by world price developments, and the domestic producer price had to be reduced substantially in 1986 because of unsustainable losses incurred by the Commodity Export Marketing Authority (CEMA). However, the producer price was increased by more than 40 percent in early 1987 to revitalize smallholder production and allow the plantations to cover their costs, which are high by international standards (largely because of high total labor costs). At the rate of price support provided in early 1987, the CEMA's reserves would have been exhausted in about one year. In view of this, consideration was given to providing some portion of the STABEX grants to the CEMA for price support. However, before making the funds available, the Government intended to review the producer price. Subsequent world price developments and an upward revision of the staff's projection of the world price of copra suggest that, at the current producer price, CEMA's loss in 1987 would be small.

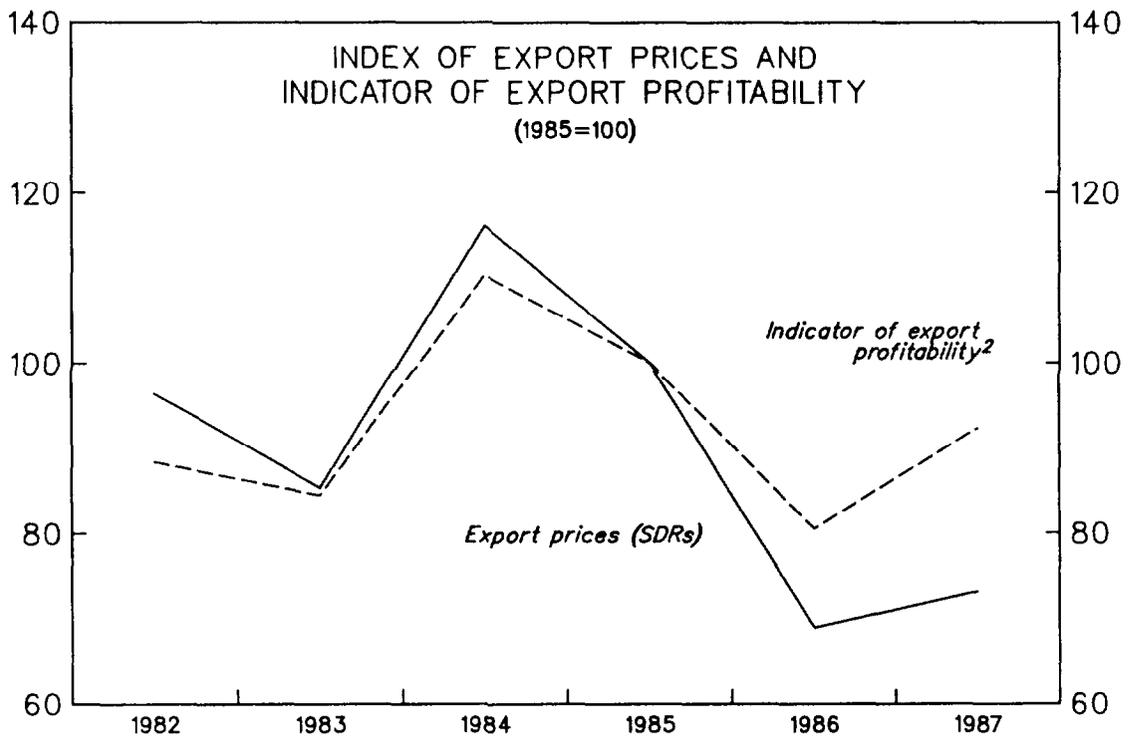
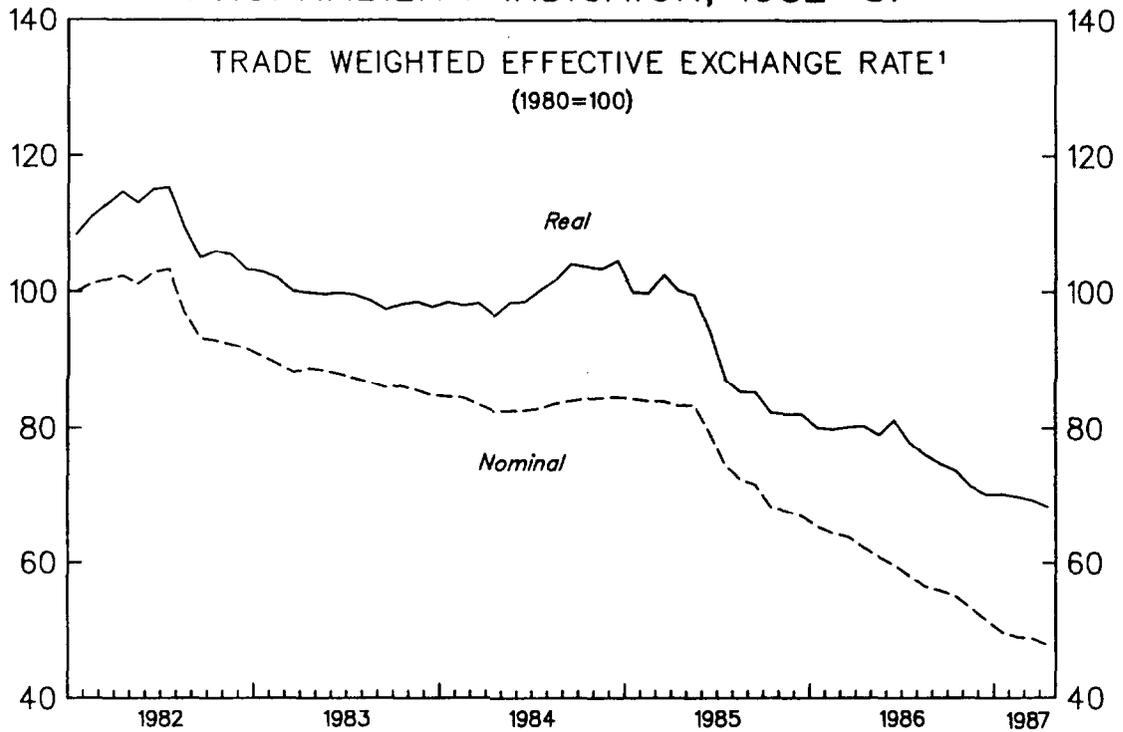
The staff observed that, with the exception of timber, export profitability was not robust and profit margins could be wiped out by small price declines. The viability and continued growth of the export sector depended crucially on the continuation of an exchange rate policy geared to ensuring adequate profitability. At the same time, there was a need to contain the rise in wage costs and establish a more rational price support policy for copra.

Solomon Islands has pursued a prudent external debt policy and the authorities stated that borrowing at commercial terms would remain limited to a few projects that can generate substantial foreign exchange earnings. If a residual financing need of the order of magnitude currently projected for 1987 were to arise, use would be made of the Eurocurrency facility, which was established for purposes of reserve management.

d. Development planning and structural issues

Development planning has suffered from shortages of trained personnel and organizational deficiencies. To help resolve these problems, the authorities are now making greater use of foreign technical assistance and have established an Action Program for public sector investment for the period 1987-89. The projects included in this program focus on natural resource development, in particular, agriculture and fisheries, and on infrastructure and education. They were chosen on the basis of newly introduced project selection criteria, which are designed to eliminate low-priority projects. Negotiations for the foreign financing of these projects were already well advanced. The staff observed that the Action Program was very ambitious and was not imbedded in a fully developed macroeconomic framework. Furthermore, it was important to take full account of the recurrent cost implications of the projects. In this context, the authorities expressed the hope that

CHART 1
SOLOMON ISLANDS
EFFECTIVE EXCHANGE RATES, EXPORT PRICES AND
PROFITABILITY INDICATOR, 1982-87



Source: Staff calculations.

1 Decline indicates depreciation.

2 Ratio of export prices (in Solomon Islands dollar) to Honiara retail price Index; increase indicates improvement in profitability.



donors would be willing to provide some support for recurrent expenditure during the start-up phase of projects. To speed up project implementation, a number of measures were taken in 1986-87, including the creation of a project monitoring unit and wider use of outside contractors.

The prospects for continued rapid growth of output are clouded by the presence of a number of structural problems. Among these, the customary land tenure system has been the most important and, equally, the most intractable issue. Its main adverse effect is the uncertainty it implies with respect to land tenure because of rival claims. Since the traditional system is deeply ingrained in society, it is only amenable to slow change. To alleviate land tenure problems, the Government intends to introduce by mid-1988 legal provisions that would permit the demarcation and recording of land boundaries. This would reduce conflicting claims on land. In the timber sector, the authorities have been concerned about the slow pace of reforestation. To an important extent, this is related to the land tenure issue. The Government now has several projects under consideration, which would establish large government-owned plantation forests and ensure continuation of the present level of exports. However, little progress has been made in encouraging reforestation on land under customary ownership. Land tenure problems and the complexity of the provisions of the Foreign Investment Act have impeded foreign investment. To accelerate the approval process, the Government plans to introduce a one-step approval by the Ministry of Trade, Commerce and Industry. It is also intended to ease the restrictions on nonresident employment. Further, the Government recognizes that poor transportation and marketing services have hampered the growth of agriculture and several projects are under consideration to ease these constraints.

III. Staff Appraisal

The year 1986 was a difficult one for the Solomon Islands economy because of a steep decline in export prices and the damage caused by cyclone Namu. Although output grew remarkably rapidly in 1986, real GDP adjusted for the terms of trade fell for the second year in a row. The authorities responded to the increased pressure on the balance of payments and the worsening of the external outlook by depreciating the Solomon Islands dollar and tightening monetary policy. Reflecting this and the--unexpectedly--large inflow of foreign grants, the balance of payments outcome was substantially better than expected. However, the large inflow of foreign grants masked widening underlying large deficits in the balance of payments and the central government budget. Since the amount of exceptional external financing is likely to recede in the next few years, the underlying imbalances, which are not sustainable over the medium term, need to be addressed. The inflow of large foreign grants has provided time for taking the necessary adjustment measures; this breathing space must be used effectively.

Fiscal policy has been the weakest link in the adjustment effort. There is no easy solution to the fiscal problems. While considerable scope exists for increasing revenue, considerations of economic efficiency and the acceptable size of government in the economy impose limits on raising the tax/GDP ratio. Tax reform should aim at both widening the tax base and increasing the efficiency of the tax system. However, tax reform alone will not be sufficient to resolve the fiscal problems. Very hard decisions will have to be made regarding expenditure, and the necessary review of expenditures will have to include the present administrative system and the costs it engenders. The scope for relinquishing to the private sector some of the services currently provided by the public sector at substantial budgetary costs also needs to be explored.

Closely linked with the fiscal issue is that of economic planning and development expenditure. There is a need for large development expenditures to realize the considerable growth potential of the economy and to meet the demands of the rapidly growing population. At the same time, the development budget has to be efficient and must be tailored to the country's absorptive capacity. The efforts under way to establish better investment priorities and to ensure more efficient project implementation are appropriate and must, indeed, be strengthened. Furthermore, greater consideration has to be given to the implications for future recurrent expenditure of a larger development budget.

Monetary policy has had to steer a difficult course between providing large amounts of credit to the Government and restraining overall credit growth for balance of payments reasons. In this situation, credit to the private sector was the inevitable victim. However, monetary restraint will have to continue for reasons of both internal and external balance. In view of this and the present negative real deposit rates, the staff cautions against strong efforts to reduce interest rates lest this be accompanied by an acceleration of monetary growth. In this context, the recent acceleration of money supply growth is a matter for concern.

The flexible exchange rate policy pursued since 1985 has played an important role in limiting the erosion of profitability in the export sector and containing the growth of imports. There is a need to maintain the flexible management of the exchange rate and to ensure that adequate incentives are being provided for the expansion of the export sector over the medium term. In some important sectors of export industry, notably fishing, export profitability is far from robust and was only achieved at the expense of a large revenue loss to the budget. The profit situation in the fishing industry remains a matter for concern, particularly in view of the plans for rapid expansion of the fishing fleet. Every effort must be made to ensure that the large investments in the fishing sector are profitable and do not require budgetary support.

The large increase in the producer price of copra in early 1987 was not, at the time, justified by world price developments. Although the outlook for copra prices and, hence, for the financial position of the CEMA has since improved, there is a need to firmly adopt a support price policy that does not threaten to become a burden on the budget. The high production costs of plantations in the copra sector--in comparison with those in other countries--and rising costs elsewhere in the economy are in part related to the growing efforts of organized labor to ensure large wage increases. This development is a matter for concern because inflexibility of real wages would have adverse implications for employment and would also deprive the instruments of economic adjustment of much of their power.

The relatively rapid growth of output in the 1980s--though subject to substantial year-to-year fluctuations and overshadowed by a marked decline in the terms of trade--was mainly based on making use of the rich marine and forestry resources. While fishing and fish processing will, for some time, uphold growth, sustaining rapid GDP growth in the medium term will depend importantly on a broadening of the development effort. This, in turn, requires that the authorities address a number of important structural issues. Most prominent among these are the land tenure problems, the weaknesses in investment planning and project implementation, the poor transportation and marketing services, the slow pace of reforestation, and the impediments to foreign investment.

The fiscal and external imbalances and the structural problems establish a clear agenda for economic policy, comprising measures in the areas of both financial and structural policies, which are to be sustained over an extended period. The staff hopes that the authorities will soon be in a position to discuss a comprehensive program that could be supported by the use of Fund resources under the structural adjustment facility.

It is recommended that the next Article IV consultation with Solomon Islands be held on the standard 12-month cycle.

Solomon Islands: Basic Data

	1984	1985 Prel. Actuals	1986 Prel. Actuals	1987 Proj.
Output and prices (annual rate of change in percent)				
Real GDP	1.0	1.0	20.0	-5.0
Real GDP terms of trade adjusted	25.0	-10.0	-4.0	-4.0
Consumer prices (annual average)	11.1	9.5	13.6	15.0
Money and credit (annual rate of change in percent)				
Broad money	34.6	0.4	12.3	10.0
Total domestic credit	17.0	58.6	-0.4 <u>1/</u>	28.4 <u>2/</u>
Credit to private sector	26.1	37.7	7.6	34.4
Credit to Central Government <u>3/</u>	-3.8	14.6	-6.3 <u>1/</u>	-1.1 <u>2/</u>
Public finance (annual rate of change in percent)				
Total revenue	38.7	9.4	9.4	2.3
Total expenditure	9.5	27.5	30.8	27.9
Current expenditure	17.6	25.0	15.5	9.5
Capital expenditure and net lending	-11.7	36.7	81.1	66.6
Deficit (SI\$ mn.)	-11.2	-22.9	-41.1	-67.2
Foreign grants <u>4/</u>	4.7	2.1	25.4	38.9
Foreign borrowing	4.6	6.8	18.3	25.1
Domestic borrowing	1.9	14.0	-2.6	3.2
Bank borrowing	-1.8	(9.4)	(-4.1)	(-0.8)
Foreign trade (annual rate of change in percent)				
Export volume	13.1	-10.3	18.2	-7.2
Export unit value (SDRs)	36.2	-13.9	-31.1	6.0
Import volume	10.3	5.6	-10.9	9.0
Import unit value (SDRs)	1.1	0.9	-6.3	4.7
Terms of trade	34.7	-14.6	-26.5	1.2
Balance of payments (SDR million)				
Exports (f.o.b.)	89.4	69.1	56.2	55.3
Imports (f.o.b.)	-64.1	-68.3	-57.0	-65.4
Trade balance	25.3	0.8	-0.8	-10.1
Current account balance <u>5/</u>	-8.9	-30.3	-34.3	-43.0
STABEX grants	—	—	8.0	10.0
Overall balance	6.5	-16.5	1.6	-5.3
Gross international reserves (end of period)				
In millions of SDRs	45.0	32.6	24.2	24.2
In months of imports of goods and services	4.8	3.4	2.5	2.5
Exchange rates <u>6/</u>				
Solomon Islands dollar/SDR	1.317	1.771	2.430	2.576 <u>7/</u>
Nominal effective exchange rate <u>8/</u>	84.4	67.6	53.1	47.7 <u>7/</u>
Real effective exchange rate <u>8/</u>	104.0	86.8	77.8	71.2 <u>7/</u>
Selected financial ratios (in percent)				
Current account/GDP <u>5/</u>	-6.0	-23.5	-33.9	-48.8
Government budget deficit/GDP	-5.8	-11.9	-20.4	-29.0
External debt/GDP <u>9/ 10/</u>	40.4	54.6	69.2	98.5
External debt service ratio <u>10/ 11/</u>	7.1 <u>12/</u>	8.5	7.9 <u>12/</u>	8.5
Official grants and concessional loans/GDP	12.4	13.6	32.1	37.3
Official grants and concessional loans/ imports of goods and services	16.2	15.2	29.4	28.8

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

1/ Developments in credit to the Central Government and total domestic credit in 1986 were heavily influenced by the inflow of STABEX grants of SI\$16 million towards the end of the year; excluding this, total domestic credit grew by 39.6 percent and credit to the Central Government by 18.4 percent.

2/ Based on the assumption of STABEX grants of SI\$25.0 million.

3/ Annual rate of change in percent in relation to stock of broad money at beginning of period.

4/ Includes STABEX grants of SI\$16 million and SI\$25 million in 1986 and 1987, respectively.

5/ With official grants below the line.

6/ End of period.

7/ End-April 1987.

8/ 1980 = 100.0

9/ Total external debt.

10/ Including IMF.

11/ Total interest plus amortization as a proportion of exports of goods and services.

12/ Excludes prepayment of the Eurocurrency loan.

SOLOMON ISLANDS

Social and Demographic Indicators

Area:	27,556 sq. km.
Population:	286,000 (1986)
Rate of growth	3.5 percent per annum (1980-86)
Density (1986):	10.4 per sq. km.
GDP per capita (1986)	SDR 345
Population characteristics (1981):	
Life expectancy	54
Infant mortality	46
Crude birth rate (per/000)	45
Crude death rate (per/000)	12
Health (1979)	
Population per physician	7,130
Population per hospital bed	230
Distribution of land (1980):	
Customary land	86.7 percent
Alienated land	13.3 percent
Held by:	
Government	(8.9 per cent)
Private	(4.4 percent)
Access to piped water (1979-81):	
Percent of population	
Total	31 percent
Urban	95 percent
Rural	24 percent
Access to electricity:	
Percent of population--urban	80 percent
Education:	
Adult literacy rate	15 percent
Primary school enrollment	73 percent

Sources: World Bank Report No. 4989-SOL, Solomon Islands, Country Economic Memorandum, August 1984; and data provided by the Solomon Islands authorities.

Solomon Islands - Fund Relations
(As of June 30, 1987)

(Amounts in millions of SDRs,
unless otherwise indicated)

I. Membership Status

- (a) Date of membership: September 22, 1978
(b) Status: Article VIII

(A) Financial Relations

II. General Department

- (a) Quota: SDR 5.0 million
- | | <u>Amount</u> | <u>Percent of quota</u> |
|--|---------------|-------------------------|
| (b) Total Fund holdings of SI dollars: | 6.68 | 133.6 |
| (c) Fund credit: | 2.19 | 43.8 |
| Of which: Credit tranches | 1.79 | 35.8 |
| CFF | 0.40 | 8.0 |
| (d) Reserve tranche position: | 0.51 | |
| (e) Lending to the Fund: | None | |

III. Current Stand-by and Special Facilities

- (a) Current stand-by or extended arrangement: None
- (b) Previous stand-by arrangements during the last 10 years
- | | |
|-----------------------|-----------------------------|
| I. (i) Duration: | June 22, 1983-June 21, 1984 |
| (ii) Amount: | SDR 2.4 million |
| (iii) Utilization: | SDR 0.96 million |
| (iv) Undrawn balance: | SDR 1.44 million |
| II. (i) Duration: | May 29, 1981-May 28, 1982 |
| (ii) Amount: | SDR 1.6 million |
| (iii) Utilization: | SDR 0.8 million |
| (iv) Undrawn balance: | SDR 0.8 million |
- (c) Special facilities
- Compensatory financing: SDR 1.6 million in respect of an export shortfall for the period ended June, 1982; approved by the Board on

Amount Percent of allocation

October 25, 1982 and purchased on October 28, 1982.

Emergency assistance:

SDR 1.25 million for assisting Solomon Islands in meeting the country's immediate foreign exchange needs resulting from natural disasters; approved by the Board on September 19, 1986 and purchased on September 24, 1986.

IV. SDR Department

(a) Net cumulative allocation:	0.65	100.0 percent
(b) Holdings:	0.58	88.6 percent
(c) Current Designation Plan:	--	--

V. Administered Accounts

(a) Trust Fund loans:	None
(b) SFF Subsidy Account:	None

VI. Financial Obligations due to the Fund

	<u>Overdue Financial Obligations</u>	<u>Principal and Interest Due</u>			
		<u>1987 1/</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>
Principal	--	0.64	0.30	0.16	0.63
Repurchases	--	0.64	0.30	0.16	0.63
Trust Fund repayments	--	--	--	--	--
Charges and interest including SDR and TR	--	0.07	0.09	0.08	0.06
Total	--	0.71	0.39	0.24	0.69

(B) Nonfinancial Relations

VII. Exchange Rate Arrangement

The exchange rate is determined daily on the basis of a currency basket; market rate of US\$1 = SI\$2.0117 at end May 1987.

1/ Second half of 1987.

VIII. Last Article IV Consultation

Staff discussions were held during April 30-May 9 and July 9-11, 1986. The Staff Report (EBS/86/177) for the 1986 Article IV consultation was discussed by the Executive Board on September 19, 1986. The 1986 Article IV consultation was conducted after a 12-month interval.

IX. Technical Assistance

The Central Banking and Fiscal Affairs Departments and the Bureau of Statistics have provided technical assistance in the areas of monetary management, financial management system of the Government, provincial taxation, and in balance of payments and general statistics. In March 1987, a technical assistance mission from the Fiscal Affairs Department reviewed the tax system. In April 1987, the Bureau of Statistics sent a mission to review all areas of statistics of interest to the Fund. The Fund is currently providing two experts under the CBD Technical Assistance Program serving as Operations Manager and Research Manager to the Central Bank of Solomon Islands. The Research Manager has been appointed to the position of Advisor to the Governor of the Central Bank of Solomon Islands effective June 1985. The Fund has also provided a budget advisor under the FAD Technical Assistance Program since late 1985.

X. Resident Representative None

WORLD BANK GROUP OPERATIONS IN SOLOMON ISLANDS
(As of June 30, 1987)

1. The Bank group strategy for the Solomon Islands focuses on the education sector and activities which support agricultural development. IDA has undertaken five projects in the Solomon Islands since 1981. The first project, for the Development Bank of the Solomon Islands (DBSI), (IDA contribution - US\$1.5 million), cofinanced with the ADB, assisted DBSI in providing finance for investments in agriculture and other sectors of the economy. A second project in primary education, undertaken directly by the Bank, (IDA contribution - US\$5 million) improved access to primary schools in the provinces by creating new, and upgrading established facilities, providing training to raise the quality of teachers, assisting in the development of more relevant curricula, and improving management. A project for the provision of rural services, (IDA contribution - US\$3.5 million) was the third IDA operation in the Solomon Islands. Also cofinanced with the ADB, it assisted the Government in establishing agricultural infrastructure which would support the needs of the rural community. The main objectives were to create an opportunity to develop land and to provide agricultural support services to small farmers. A fourth IDA credit for US\$2.0 million was approved in 1985 for upgrading and maintenance of the main road on Guadalcanal. This credit was cofinanced with the ADB and the OPEC development fund.

2. A fifth IDA credit for US\$5.0 million was approved by the Bank's Board of Directors on April 29, 1986. While the Bank is taking the lead in this project, the Australian Development Assistance Bureau is a major cofinancier. This operation is designed to expand the secondary education system and improve educational quality and management in Solomon Islands.

3. The Bank completed a Country Economic Memorandum on the Solomon Islands in August 1984. In a recent report ("Solomon Islands: Review of Agricultural Programs", No. 6358a-SOL, December 23, 1986), IDA reviewed the agricultural investment program, with an emphasis on rural smallholders. The report also examined recent trends in population, health and nutrition in relation to the rural smallholder population.

The report recommended that the rural services project be continuously reviewed to make project components more cost effective. It also identified a need for careful review of the recurrent cost implications of the livestock development project and reconsideration of project components that appear unworkable. To enhance financial viability of the Livestock Development Authority, the report suggested privatization of some of its activities. Regarding the development strategy, the report suggested, inter alia, that the Government accelerate its program of land registration to identify ownership,

undertake cadastral surveys, and demarcate and register customary lands in agricultural opportunity areas, followed by all customary lands. Logging concessions should only be granted on land for which an acceptable land use plan has been prepared for the post logging period. A nucleus estate with smallholder schemes should be encouraged to increase cash crop production by smallholders. The report also suggested that donors may wish to increase their assistance for reforestation through training and technical assistance programs. Furthermore, the Development Bank of Solomon Islands should be reformed with a view to improve accounting and financial management; the subsidized interest rates should be raised to market levels. In the area of population and health, the report indicated a need for the strengthening of family planning efforts through an information, education, and communication program. The Government also needed to ensure that the recurrent cost of the investment program is affordable.

Solomon Islands--Statistical Issues

The main sources of statistics are the Central Bank and the office of the Government Statistician in the Ministry of Finance. Substantial progress has been made in recent years to establish an adequate statistical base. Nevertheless, considerable problems remain, notably in the areas of the national accounts, production, prices, wages and public finance. In some of these areas, it has been necessary to include staff estimates in the data presented.

1. Outstanding statistical issues

A technical assistance mission from the Bureau of Statistics, visited Honiara during April 30-May 18, 1987 to review all areas of statistics of interest to the Fund.

a. National accounts, production, and prices

Statistics on national income in the monetized sector are available, and the compilation of national accounts by expenditure category has begun on an experimental basis; however, national accounts by industrial origin are not compiled. The data on GNP in the nonmonetized sector were recently revised, but they remain rough estimates. Statistics on production of major agricultural commodities are available, but there is no information on manufacturing activity.

A Bureau of Statistics technical assistance mission in January 1985 recommended that the scope of the national accounts data be expanded to encompass estimates of GDP by industrial origin and by expenditure categories. Subsistence agriculture was estimated to account for about 30 percent of GDP, but the underlying production estimates were extremely weak, having been based on data for calorie intake in other developing countries and population growth for the Solomon Islands. The latest technical assistance mission determined that the results of the Rural Income and Expenditure Survey of 1982 have now been used to revise the national accounts estimates, as suggested by the earlier mission. Further improvements are expected to follow from Asian Development Bank technical assistance in these areas in the near future. Present plans call for an annual sample survey of investment, beginning with the manufacturing sector.

The weights for the consumer price index were recently revised, but the index pertains only to Honiara. The January 1985 statistical mission recommended that consumer price indices should be compiled for at least two other major population centres, and that a weighted average should be constructed to represent the whole country, but these recommendations have not been given high priority. Similarly, the mission's recommendation that the Statistician's Office begin the

collection of wholesale prices in respect of the major export and import commodities has not been implemented because of the difficulty of collecting price data at the producer level. Only partial information is available on wages in the private sector.

b. Monetary accounts

The most recent technical assistance mission was able to reconcile the data provided to previous consultation missions with those published in IFS, and as a result, the currentness of the monetary data for the Solomon Islands in IFS is expected to improve markedly in the near future. In addition, the coverage of financial data in IFS will be expanded to include a Banking Survey.

An interest rate section will be introduced on the country page for the Solomon Islands in the July 1987 issue of IFS.

c. Government finance

Government finance statistics on the consolidated public sector are not compiled, as data are available only for the Central Government. The statistics presented are derived from budget documents.

There are two major problem areas in Central Government finance statistics: the present system of reporting results in some improper classification of current expenditure as capital expenditure and vice versa; and the monetary survey statistics on government bank borrowing differ from those recorded in government accounts.

The unavailability of data on the operations of provincial governments is of particular concern since the trend toward devolution is increasing. This has resulted in a larger transfer of financial resources from the Central Government to the provincial governments.

Government finance data published in IFS are based on the Government Finance Statistics Yearbook (GFSY). The 1986 GFSY contains data for the central government for 1975 through 1978 and for 1983. Recently, substantial progress has been made in the compilation of central government finance data, and it is expected that a significant improvement in the currentness of the data, in addition to the availability of back data, will be achieved in the 1987 GFSY.

d. Balance of payments

The most recent data in the Bureau of Statistics' files refer to 1985. These data were derived from Solomon Islands - Recent Economic Developments (SM/86/204) of August 20, 1986. Although the authorities do not send balance of payments data directly to the Bureau of Statistics, this situation is expected to improve in the future with a change in the correspondent agency.

