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EBS/86/177

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August 6, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Solomon Islands - Staff Report for the 1986 Article IV Consultation and Use of Fund Resources - Emergency Assistance

Attached for consideration by the Executive Directors is the staff report for the 1986 Article IV consultation with Soloman Islands, and its request for a purchase equivalent to SDR 1.25 million for emergency assistance. A draft decision appears on page 19.

It is proposed to bring this subject to the agenda for discussion on Friday, September 19, 1986.

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

Att: (1)

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INTERNATIONAL MONETARY FUND

SOLOMON ISLANDS

Staff Report for the 1986 Article IV Consultation and Use of Fund Resources--Emergency Assistance

Prepared by the Staff Representatives for the 1986 Article IV Consultation with Solomon Islands

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

Approved by P.R. Narvekar and Eduard Brau

August 5, 1986

Contents

Contents

Page

I. Introduction

A staff team comprising Messrs. Baumgartner (Head), Choudhry, Mendis (all ASD), and Floros (ETR), and Ms. Carvalho (Secretary, STA) visited Honiara during April 30-May 9, 1986 to hold the 1986 Article IV consultation discussions with Solomon Islands. Discussions were held with the Governor of the Central Bank, senior officials of the Ministries of Finance and Economic Planning and other government agencies, and representatives of the private business sector. The mission also met with the Minister of Economic Planning, and the head of the mission was received by the Prime Minister. Following a severe cyclone that struck Solomon Islands in mid-May, a staff team consisting of Messrs. Baumgartner and Choudhry visited Honiara during July 9-11 for further discussions for the Article IV consultation and to discuss use of emergency assistance. The mission met with the Minister of Finance, the Governor of the Central Bank and with senior officials of the Ministry of Planning, who are coordinating the relief and rehabilitation efforts.

In a letter dated July 30, 1986, addressed to the Managing Director (Attachment I), the Minister of Finance and the Governor of the Central Bank of Solomon Islands informed the Managing Director of the heavy damage caused by the cyclone and made a request to purchase an amount equivalent to SDR 1.25 million (25.0 percent of quota) from the ordinary resources under the Fund's policy on assisting members in meeting their immediate foreign exchange needs resulting from natural disasters. The letter outlines the general policies as well as the initial measures introduced to correct the internal and external imbalances exacerbated by the cyclone. It also states that the authorities will continue to collaborate with the Fund in finding appropriate solutions for Solomon Islands' balance of payments problems; in this context, the authorities envisage the formulation of an adjustment program that could be supported by a stand-by arrangement. The Government also intends, in due course, to formulate a program that could be supported by use of Fund resources under the structural adjustment facility.

As of July 31, 1986, Fund holdings of Solomon Islands dollars subject to repurchases amounted to SDR 1.96 million, or 39.2 percent of quota. If the requested purchase is approved, Fund holdings of Solomon Islands dollars subject to repurchase would rise to SDR 3.21 million, or 64.2 percent of quota.

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.

II. Recent Developments

Solomon Islands is a small open economy that is heavily dependent on exports of fish, timber, copra, palm oil, and cocoa; the average export/GDP ratio was about 55 percent in 1981-85. Agriculture, forestry, and fishing are the main activities, with manufacturing contributing only a small amount to GDP. A monetized sector comprising coconut, oil palm and cocoa plantations, commercial fishing and logging, and services accounts for about 80 percent of GDP. Smallholder production of copra provides the main link between this sector and the rural subsistence sector. There has been a significant downward trend in Solomon Islands' external terms of trade in the first half of the 1980s, masked by large year-to-year fluctuations. Following a period of relative stability in the second half of the 1970s, the terms of trade declined at an average annual rate of 5 percent between 1980 and 1985. Average GDP growth in the period 1981-85 is estimated to have been 3.5 percent, about the same as the high population growth rate. Foreign aid flows from both bilateral and multilateral sources have amounted to about 13 percent of GDP in recent years.

1. Developments before the cyclone

Developments in 1984-85 were marked by large swings in the external terms of trade. A steep rise in the world prices of copra and palm oil, due to production shortfalls in other countries, resulted in an improvement in the terms of trade of about 30 percent in 1984 (Charts 1 and 2). The value of exports in SDR terms rose by more than 50 percent, and the current account deficit (with official grants recorded in the capital account) declined from 17 percent of GDP in 1983 to 6 percent of GDP in 1984 (Table 1). Real GDP is estimated to have increased by about 19 percent, with real incomes in the monetized sector rising by as much as 25 percent.

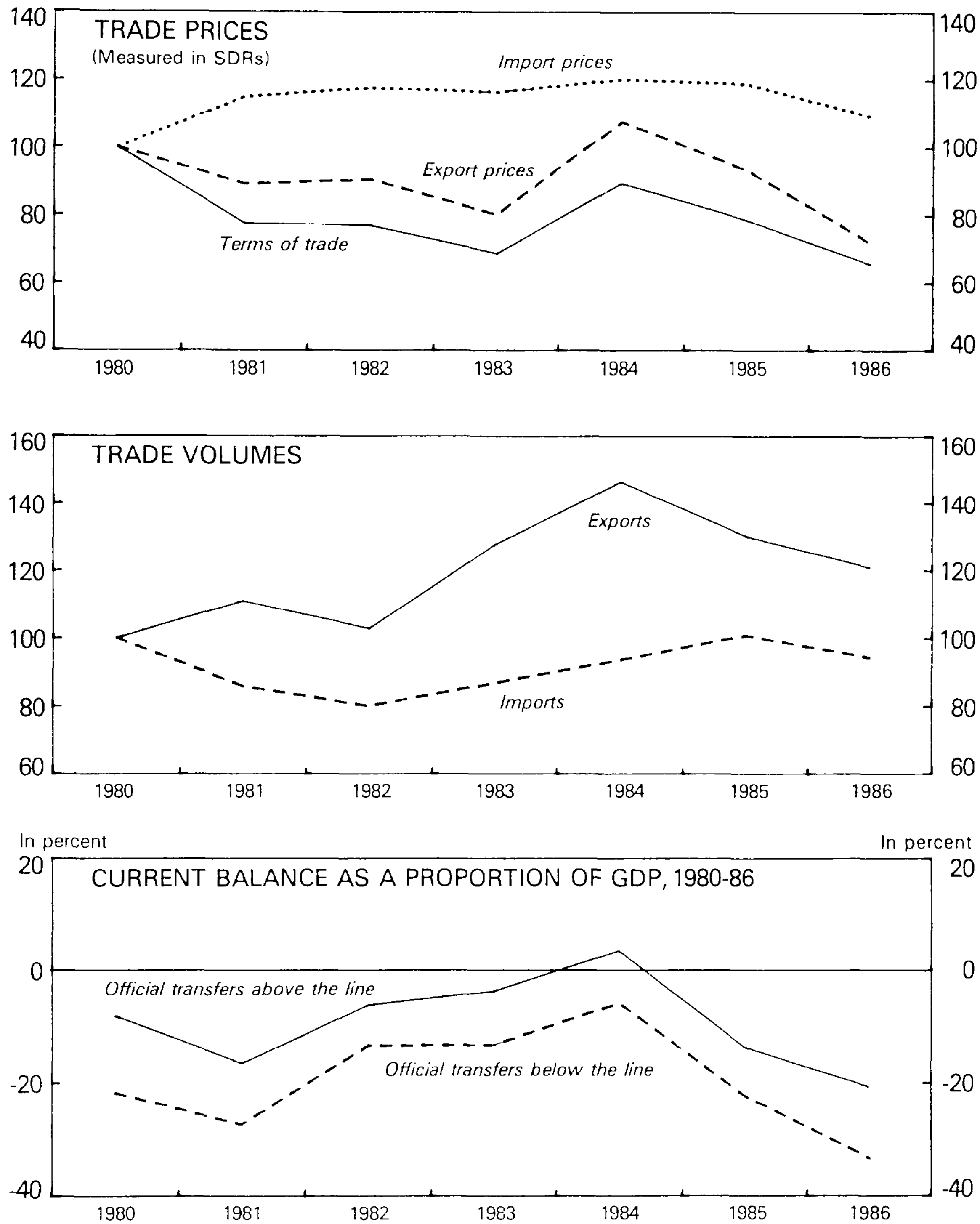
As the world supply of vegetable oils recovered in 1985, prices fell steeply in 1985 resulting in a 12 percent deterioration in Solomon Islands' terms of trade and a widening of the current account deficit to 22 percent of GDP. The SDR value of exports declined by 20 percent, reflecting not only lower prices but also a decline in volume. At the same time, imports continued to rise as domestic demand remained strong; import volume is estimated to have increased by about 8 percent in 1985, the same rate of increase as in 1984. With inflows of official grants declining, the overall balance of payments turned into deficit (SDR 16 million) and gross international reserves declined by SDR 13 million from the equivalent of five months of imports of goods and services at the end of 1984 to the equivalent of three months at the end of 1985. To alleviate the drain on reserves, Solomon Islands drew down US$5 million of a US$30 million Eurocurrency loan contracted in 1984.

CHART 1

SOLOMON ISLANDS

TRADE AND PAYMENTS INDICATORS, 1980-86

(1980 = 100)



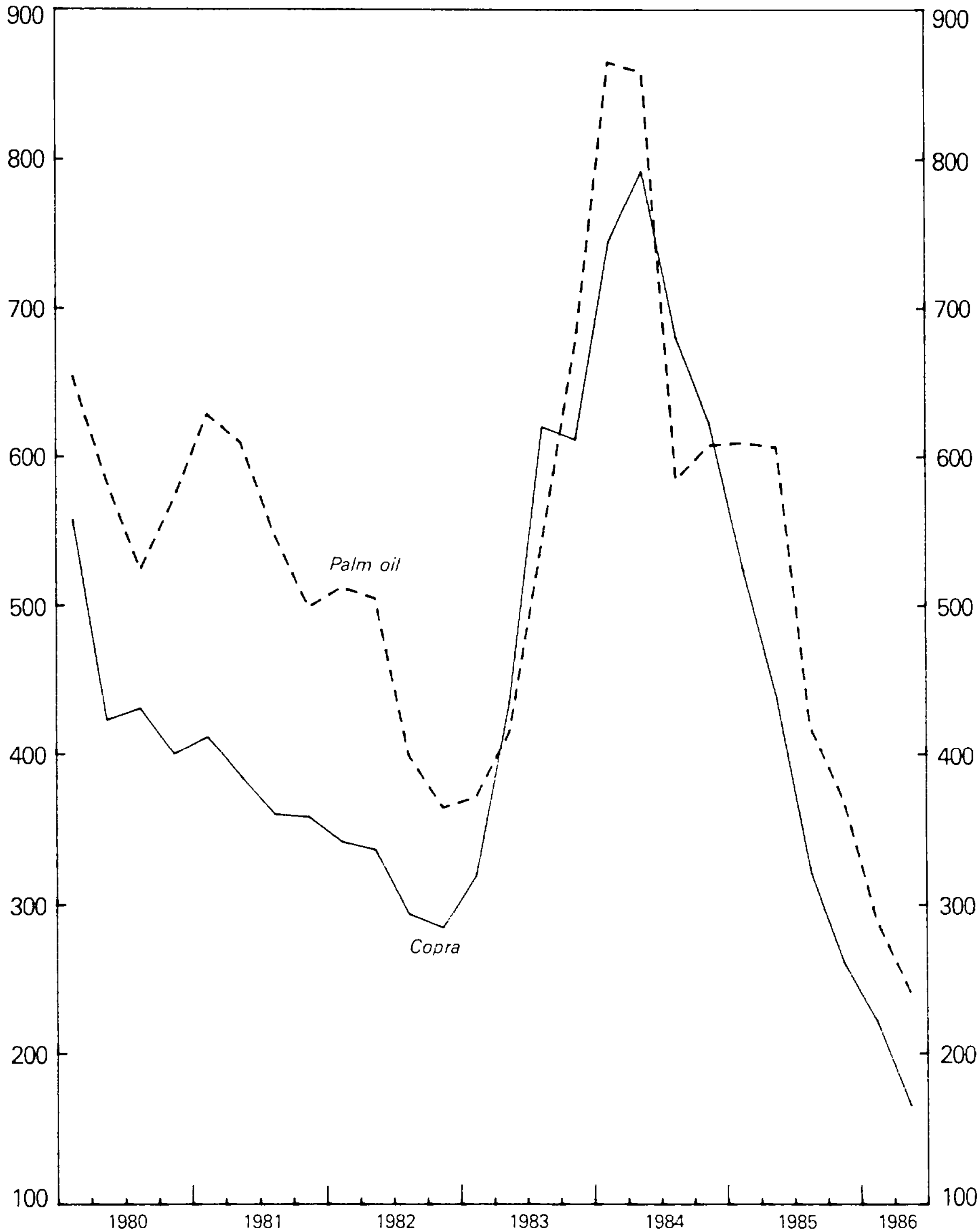
Source: Data provided by the Solomon Islands authorities, and staff estimates.

CHART 2

SOLOMON ISLAND

WORLD PRICES OF COPRA AND PALM OIL, 1980-86

(U.S. dollar per metric ton)



Source: International Financial Statistics, IMF.

Table 1. Solomon Islands: Balance of Payments, 1983-86

(In millions of SDRs)

	1983	1984	1985	1986 1/
Balance of trade	0.5	25.2	0.7	-9.5
Exports, f.o.b.	58.0	89.4	69.1	49.3
Imports, f.o.b.	-57.5	-64.1	-68.3	-58.8
Oil	(14.5)	(15.0)	(13.8)	(7.7)
Other	(43.0)	(49.1)	(54.5)	(51.1)
Services (net)	-23.4	-32.5	-29.7	-25.7
Receipts	15.6	17.2	17.4	17.4
Payments	-39.0	-49.7	-47.1	-43.1
Private transfers (net)	-2.4	-1.7	-1.3	-1.4
Current account balance	-25.3	-9.0	-30.3	-36.5
Net long-term capital	19.8	22.2	19.4	20.2
Official transfers (net)	13.9	14.2	11.6	13.8
Nonmonetary capital (net)	5.9	8.0	7.7	6.4
Official (net)	2.5	4.2	4.7	4.1
Disbursements	(2.7)	(4.4)	(5.9)	(4.7)
Amortization	(-0.2)	(-0.2)	(-1.2)	(-0.6)
Private (net)	3.0	1.9	2.1	1.4
Disbursements	(4.3)	(3.8)	(4.0)	(5.0)
Amortization	(-1.3)	(-1.9)	(-1.9)	(-3.6)
Direct investment	0.4	1.9	0.9	0.9
Errors and omissions	8.2	-4.6	-5.2	--
Overall balance	2.7	8.6	-16.1	-16.4
Change in net foreign assets	-2.7	-8.6	16.1	16.4
Commercial banks (net)	-2.5	-0.9	0.5	--
Monetary authorities (net)	-0.2	-7.7	15.6	16.3
Assets, increase (-)	-9.8	-2.2	12.5	16.5
Liabilities	9.6	-5.5	3.1	0.1
Of which: IMF	(1.0)	(-0.2)	(-0.4)	(0.1)
Eurocurrency loan	(5.5)	(-8.9)	(3.5)	(--)
Other 2/	(3.1)	(3.7)	(--)	(--)
Memorandum items:				
Gross reserves 3/				
(In millions of SDRs)	42.9	45.1	32.6	16.3
(In months of imports of goods and services)	5	5	3	2
Current account balance (as percent of GDP)	-17.3	-5.9	-22.3	-33.3

Sources: Data supplied by the Central Bank of Solomon Islands; and staff estimates.

1/ Excludes aid for reconstruction and rehabilitation as firm estimates are not yet available.
2/ Residual.
3/ Excluding commercial banks.

The balance of payments pressure emanating from the decline in export prices was exacerbated by strong domestic demand. This reflected the lagged effects on income of the export price boom as well as rapid growth of bank credit to the private sector, generous price support provided to copra producers by the Commodity Export Marketing Agency (CEMA), and a substantial widening of the fiscal deficit. Despite restraining measures, bank credit to the private sector rose by 60 percent in 1985. Total money supply, however, remained unchanged, as the rapid credit expansion was associated with a large decline in net foreign assets. The CEMA's pricing policy for copra added significantly to demand pressures. When the world price of copra rose to record levels in 1984, a large part of the increase was passed on to producers; producer prices remained high in 1985 and the CEMA made substantial use of reserves for price support. The Central Government budget deficit increased from 7 percent of GNP in 1984 to 11 percent in 1985 because of lower export duties, substantial increases in transfers and growing weaknesses in tax administration and expenditure control. However, capital expenditure remained virtually unchanged owing to problems with respect to project planning and implementation. Government borrowing from the banking system rose from nil in 1984 to SI$8.6 million (4 percent of GDP) in 1985. Inflation remained broadly unchanged, at about 10 percent, in 1985 as demand spilled over quickly into imports. Real GDP is estimated to have declined by 7 percent in 1985 as a result of a substantial decline in net exports. Investment stagnated, while public and private consumption continued to increase.

Developments in the first half of 1986 indicated continued strong pressure on the balance of payments--gross international reserves declined by SDR 6 million during this period--caused primarily by the further decline in world prices of vegetable oils. By May 1986, the world price of copra had fallen to US$155 per ton, compared with a peak of US$836 in June 1984 and an average of US$456 per ton in 1980-85; developments in the world price of palm oil were similar. The Central Government budget continued to be in large deficit, requiring bank borrowing of SI$8 million in the period January-June 1986. Growth of domestic credit continued at a rapid pace in the first quarter of 1986, but slowed sharply in the second quarter. The stock of broad money rose at an annual rate of about 20 percent during the first half. In the first five months of 1986 retail prices in Honiara were about 9 percent higher than a year earlier, partly due to increases in import duties.

2. Effects of the cyclone

Solomon Islands was hit by a severe cyclone on May 18-20, 1986 which resulted in the loss of 140 lives and caused extensive damage to homes, gardens, cash crops and the supporting environment of about a third of the population of 290,000. The effects of the cyclone were heaviest in southern Malaita--the country's most populous island--and the eastern part of Guadalcanal, the center of commerce and large-scale agricultural activities. The natural forests in these areas were partly destroyed by strong winds and mudslides. Coconut trees also suffered heavy damage, with up to one quarter of the trees having been blown down. Parts of the principal oil palm plantation, the entire rice crop in the ground, part of the rice stocks, and many vegetable gardens were destroyed by flooding and silting. The majority of cocoa plantings is in cyclone-affected areas and the number of trees lost as well as the yield reduction on remaining trees are large. There was extensive damage to schools and other public buildings, and most of the traditional houses in southern Malaita and eastern Guadalcanal were damaged or destroyed. Roads, bridges and other infrastructure also sustained severe damage.

Immediate relief measures, carried out with substantial help from several donor countries and multinational organizations focused on supplying the most affected areas with food, medicines and temporary shelters. A preliminary assessment of the cyclone effects indicates that the total damage to infrastructure, public buildings, and agricultural production facilities is of the order of SDR 12 million, equivalent to more than 10 percent of 1985 GNP. The amount of imports required for repair and reconstruction, which is expected to take 1 1/2-2 years, is about SDR 8 million. Furthermore, imports for immediate disaster relief (food, etc.) financed from own resources amounted to about SDR 1.5 million. Because of the damage to coconut and oil palms and cocoa trees, the volume of exports of copra, palm oil and cocoa in 1986-88 is likely to be up to 25 percent below earlier estimates, while longer-term effects are likely to persist. However, as world prices of vegetable oils are currently very low and are not expected to rise substantially in the near future, the annual loss of export earnings in 1986-88 is estimated to be no more than about SDR 2 million, equivalent to 4 percent of projected 1986 export earnings.

In all, the impact on the balance of payments in the period June-December 1986, is expected to reach SDR 5 million (excluding any additional aid that may be provided), or four times the amount of emergency assistance requested from the Fund. Against this, total gross reserves amounted to SDR 26 million in June 1986, but, as indicated above, the drain on reserves stemming from a weak underlying payments position has been large. The foreign exchange requirement arising from the disaster is expected to increase in 1987, as the reconstruction effort gets fully under way. Besides requesting emergency assistance from the Fund to help meet the immediate needs, the Government has asked bilateral and multilateral donors to provide financial support in addition to the aid given in the immediate aftermath of the cyclone. In view of the limited absorptive capacity, reconstruction and rehabilitation will inevitably entail postponement of other important projects and thus a slower development of the productive capacity of the economy in the next few years.

III. The Economic Outlook

The effects of the cyclone have exacerbated an already difficult external outlook. Export prices (in SDR terms) are expected to decline by 23 percent in 1986, resulting in a 17 percent deterioration in the terms of trade despite the drop in petroleum prices (Table 2). With export volume falling by 7 percent, partly as a result of the cyclone, exports are likely to decline to SDR 49 million in 1986 from SDR 69 million in 1985. Pre-cyclone estimates indicated a marked decline in import volume reflecting the terms-of-trade-induced reduction in real GDP. Taking account of the additional imports for relief and reconstruction, it is now estimated that import volumes will decline by about 7 percent in 1986. Based on these projections of exports and imports and a slightly lower deficit on services account--largely reflecting lower profit remittances--the current account deficit would widen to SDR 37 million (33 percent of GDP) in 1986 from SDR 30 million (22 percent of GDP) in 1985. Inflows of foreign aid are expected to be somewhat higher in 1986 than in preceding years. This balance of payments outlook implies a decline in reserves from SDR 33 million at the end of 1985 to SDR 16 million (equivalent to two months of imports of goods and services) at the end of 1986. Real GDP is projected to decline by about 10 percent in 1986. The annual average increase in the Honiara retail price index is expected to be around 11 percent, with prices rising more rapidly in the second half of the year due to shortages of fruits and vegetables.

The outlook for the balance of payments beyond 1986 is critically dependent on the prospects for export prices, notably vegetable oil prices. Unusually ample supplies of vegetable oils have resulted in record low prices, which are expected to remain low in 1987. Staff projections, however, suggest a significant increase in prices in the medium term to levels close to those prevailing in the early 1980s. As a result, Solomon Islands' terms of trade are expected to remain unchanged in 1987 and to improve by a total of about 15 percent in the period 1988-90. Current plans provide for a substantial expansion in the export capacity in the fishing sector through the acquisition of two large fishing boats, which are expected to increase the fish catch by 30 percent, and the construction of a new cannery. The cannery, when fully in operation in the late 1980s, will result in a substantially higher domestic value-added of fish exports. There are currently no plans for expansion of the coconut and oil palm plantations, but maintaining the current production volume will require substantial investments. The ongoing large-scale planting of cocoa trees is expected to bring about a three-fold increase in export volume by 1990. In the timber sector, land access problems and issues related to resource management are likely to result in a significant decline in export volume in the short run and also cloud the medium-term outlook for timber exports. Exploration of mineral resources (e.g., gold) has begun, but no production forecast are yet available. In all, export

Table 2. Solomon Islands: Medium-Term Balance of Payments Scenario, 1984-90

	1984	1985	1986 1/	1987 1/	1988 1/	1989	1990
				Scenario based on present policies			
				(In millions of SDRs)			
Exports, f.o.b.	89.4	69.1	49.3	52.0	65.0	76.0	87.0
Imports, f.o.b.	-64.1	-68.3	-58.8	-71.0 2/	-67.0	-71.0	-76.0
Services and private transfers (net)	-34.2	-31.0	-27.1	-29.0	-35.0	-37.0	-40.0
Current account	-9.0	-30.3	-36.5	-49.0 2/	-34.0	-32.0	-29.0
Grants and concesssional loans (net)	18.4	16.3	17.9	30.0 2/	28.0	25.0	25.0
Commercial borrowing (net)	1.9	2.1	1.4	16.0 2/	4.0	3.0	3.0
Direct investment	1.9	0.9	0.9	2.0	3.0	4.0	5.0
Errors and omissions	-4.6	-5.2	--	--	--	--	--
Overall balance	8.6	-16.1	-16.4	-1.0	-2.0	--	4.0
Reserves (increase -)	-2.2	12.5	16.3	-7.7	-7.7	-2.6	-2.6
IMF	-0.2	-0.4	0.1	-1.3	-0.3	-0.4	-0.4
Purchases	(--)	(--)	(1.3)	(--)	(--)	(--)	(--)
Repurchases	(0.2)	(0.4)	(1.2)	(1.3)	(0.3)	(0.4)	(0.4)
Eurocurrency loan	-8.9	3.5	--	--	-3.0	-3.0	-3.0
Other (net)	2.6	0.5	--	--	--	--	--
Financing gap	--	--	--	10.0	13.0	6.0	3.0
				(Percent change)			
Memorandum items:							
Export volume	14.6	-11.0	-7.1	3.0	19.0 3/	10.0	4.0
Import volume	8.0	7.7	-6.5	18.0 2/	-8.0	3.0	4.0
Export unit prices (SDRs)	34.4	-13.1	-23.1	2.0	6.0	6.0	11.0
Import unit prices (SDRs)	3.3	-1.1	-8.0	2.0	3.0	3.0	3.0
Terms of trade	30.2	-12.2	-16.5	--	3.0	3.0	8.0
GDP growth	19.4	-6.5	-10.0	3.0	5.0	5.0	5.0
				(In percent)			
Current account/GDP	-5.9	-22.3	-33.3	-39.6	-25.6	-17.0	-13.2
Debt service ratio 4/5/	7.0	8.6	13.8	15.0	20.0	21.0	22.0
Debt/GDP 5/	37.6	57.0	67.7	87.0	89.0	84.1	75.0
Reserves in months of imports of goods and services	5.0	3.0	2.0	3.0	3.0	3.0	3.0
Ratio of outstanding Fund credit to:							
GDP	2.1	2.0	2.6	1.3	0.9	0.1	--
Fund quota	63.2	55.2	57.2	31.2	25.2	17.2	9.2
Ratio of Fund repurchases and charges to:							
Exports of goods and services	0.6	0.7	1.8	2.0	0.5	0.5	0.4
Level of reserves	1.3	1.8	8.0	6.2	1.2	1.1	1.1

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

1/ Excludes aid for reconstruction and rehabilitation as firm estimates are not yet available.
2/ The sharp increase over 1986 reflects imports for reconstruction, and the planned large investments in the fishing sector (the acquisition of two vessels and a new fish cannery) and in infrastructure, which are to be financed by grants, concessional loans, and some commercial borrowing. Implementation of these projects will carry over into 1988.
3/ Reflects larger fish exports due to the acquisition of two additional fishing boats in 1987 and recovery from the effects of the cyclone.
4/ Total debt service in percent of export of goods and services.
5 Assumes closing of the financing gap through borrowing at commercial terms.

volume is expected to grow only modestly in 1987 but to rise by a total of about 30 percent in 1988-90, mainly reflecting the recovery from the cyclone and larger exports of fish and cocoa.

The large investments in the fishing sector, some important infrastructure projects, and imports for repair and reconstruction are expected to result in a large increase in imports in 1987. While this would be followed by some decline in 1988, as these large projects and reconstruction are completed, achievement of the official target of 5 percent GDP growth would require a resumption of import growth thereafter. About two thirds of the additional project-related imports in 1987-88 are expected to be financed with foreign grants or concessional loans, with the remainder of the financing being provided at commercial terms. The utilization of foreign aid has been well below its potential and the authorities expect that, with administrative improvements on both sides, a larger inflow of aid can be achieved.

The medium-term balance of payments scenario based on present policies indicates sizable financing gaps of about SDR 10-13 million per annum in 1987-88. About one third to one half of these financing gaps reflects the effects of the cyclone. While the need for additional financing would decline in 1989-90--in line with the projected recovery in export prices--this in itself would not be sufficient to re-establish a sustainable balance of payments position. Staff estimates indicate that a closing of the financing gap in 1987-90 entirely through commercial borrowing would result in an increase in the debt service ratio from 9 percent in 1985 to 22 percent in 1990, with further increases in subsequent years. This medium-term outlook underscores the need for adjustment and larger financing at concessionary terms.

IV. Policy Discussions

In view of the recent widening of internal and external imbalances and the prospect of sizable external financing gaps, the discussions focused on a strengthening of the balance of payments position through appropriate demand management and supply-oriented policies.

1. External policies

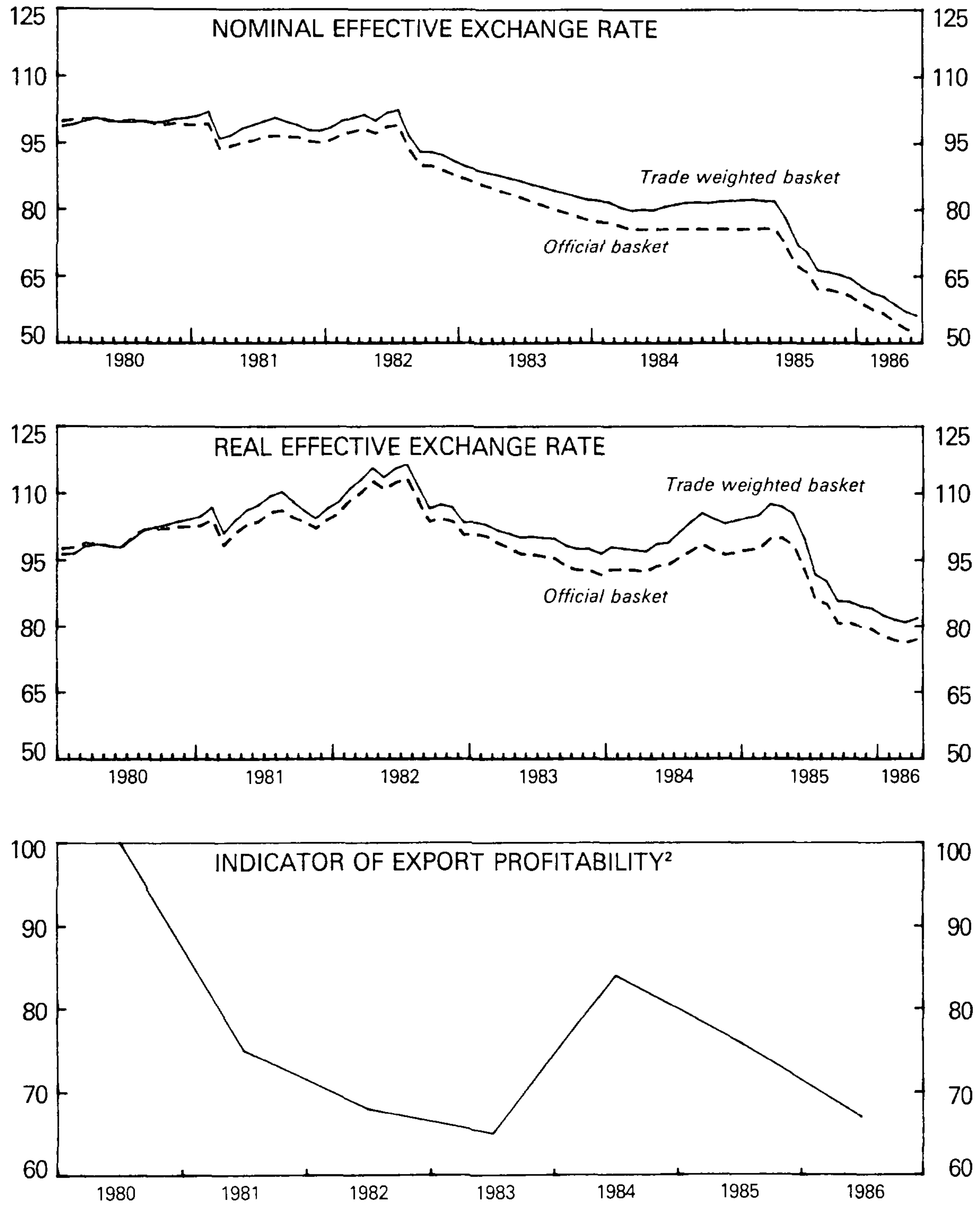
Following the downturn in export prices in early 1985, greater exchange rate flexibility was introduced, and the Solomon Islands dollar was depreciated by about 30 percent in nominal effective terms (19 percent against the U.S. dollar) in the 12 months to June 1986 (Chart 3). Nevertheless, average export profitability declined by a total of 20 percent in 1985-86. Profits of exports of palm oil and copra fell to record lows in 1986, and the fishing industry, which incurred losses in 1982-85, was not expected to return to profitability in 1986. In all, more than one half of total export production was faced with very low profits or was expected to make losses in 1986.

CHART 3

SOLOMON ISLANDS

EFFECTIVE EXCHANGE RATES AND PROFITABILITY INDICATORS, 1980-86[1]

(1980 = 100)



Source: Staff calculations.

1 Increase indicates an effective appreciation or higher profitability.

2 Ratio of export unit values to Honiara retail price index.

The CEMA has tried to protect copra producers from the sharp decline in world prices by maintaining high producer prices, but the continued weakening of the world price and the resulting large loss of reserves eventually forced substantial reductions in the producer price (Chart 4). By mid-1986, the average producer price had been lowered to SI$250 per ton, compared with a peak of SI$530 in the second quarter of 1985. At the current price of SI$250 per ton the large coconut plantations cannot fully cover their costs, but they were expected to maintain maximum production in the short run because of the cushion of reserves they have probably built. By contrast, smallholder production has been price responsive, subject to the overall supply constraint in the short run, and was expected to decline by some 25 percent as a result of the reduction in the producer price to SI$250 per ton. Since the CEMA continues to incur a large and unsustainable loss at the current producer price--reserves would be depleted by mid-1987--a further reduction in the price is being considered.

The authorities stated that the substantial increases in the producer price of copra in 1984-85 had been in excess of what was needed to ensure maximum production, as there is an upper limit to supply in the short run. Having distributed a large part of the windfall gains in 1984-85, the CEMA was not now in a position to provide adequate support in the face of a record low world price. Against the background of this experience, the CEMA has adopted a new pricing policy, replacing the discretionary policy by a formula based on a seven-year moving average of the f.o.b. export price. If the world price is above or below this benchmark, half of the difference is passed on to producers. More recently, a price support limit of SI$100 dollar per ton was established. It is planned to institute price stabilization schemes also for palm oil and cocoa. The staff stressed the importance of providing stable and attractive producer prices for copra while ensuring the financial viability of the stabilization fund. Recent policy had fallen short of these objectives.

In the fishing industry losses were expected to continue in 1986 because of a further weakening of fish prices and higher debt service, even though a number of measures were taken to improve the industry's financial position. These included a reduction in the export tax from 7 percent to 3.5 percent, measures to reduce the costs of imported materials through a shift to lower cost suppliers, and a gradual replacement of high-wage foreign crews by local fishermen.

The staff expressed the view that the profit situation in the export sector had become alarming. Not only was this likely to result in lower export production in the short run, but it also jeopardized the needed expansion of the export sector. Falling prices for copra, palm oil and fish had been the primary cause of the deterioration in export profitability, but, with these commodities constituting a large share of the country's resources, the financial viability of the fish and vegetable oil industries had to be ensured despite the adverse external circumstances. The staff urged the authorities' to make more active use of the exchange rate to ensure an immediate and substantial improvement in export profitability and also help close the financing gap through a reduction in imports.

The authorities agreed that there was a need to strengthen profitability. They said that the primary objective of exchange rate policy was to ensure adequate and stable profitability of export production. The exchange rate is seen as a major instrument in achieving adjustment and encouraging investment in the economy. However, in making exchange rate adjustments the effect on inflation had to be taken into account, and the authorities were concerned that large discrete adjustments would trigger matching increases in domestic costs. In the present situation, the policy of flexible management of the exchange rate would be continued with a view both to strengthening export profitability and compressing the demand for imports.

Solomon Islands has, on the whole, pursued a prudent external debt policy, largely relying on concessional loans and grants for its external financing needs. Total external debt (both public and private) was equivalent to 57 percent of GDP in 1985, with official debt at commercial terms amounting to about a fourth of the total; the amount of short-term debt is small and is limited to debt of the fishing industry to its foreign parent company. The debt service ratio stood at 9 percent of exports of goods and services in 1985. The largest commercial loan is a US$30 million Eurocurrency credit line, of which one half was drawn down in 1984-85. The authorities stated that they remain committed to a cautious external debt policy and would limit commercial borrowing to loans for prudent reserve management and projects that can generate foreign exchange earnings more than sufficient to service the debt. The staff warned that primary reliance on commercial financing to close the prospective financing gaps would lead to an unsustainable balance of payments position.

2. Fiscal policy

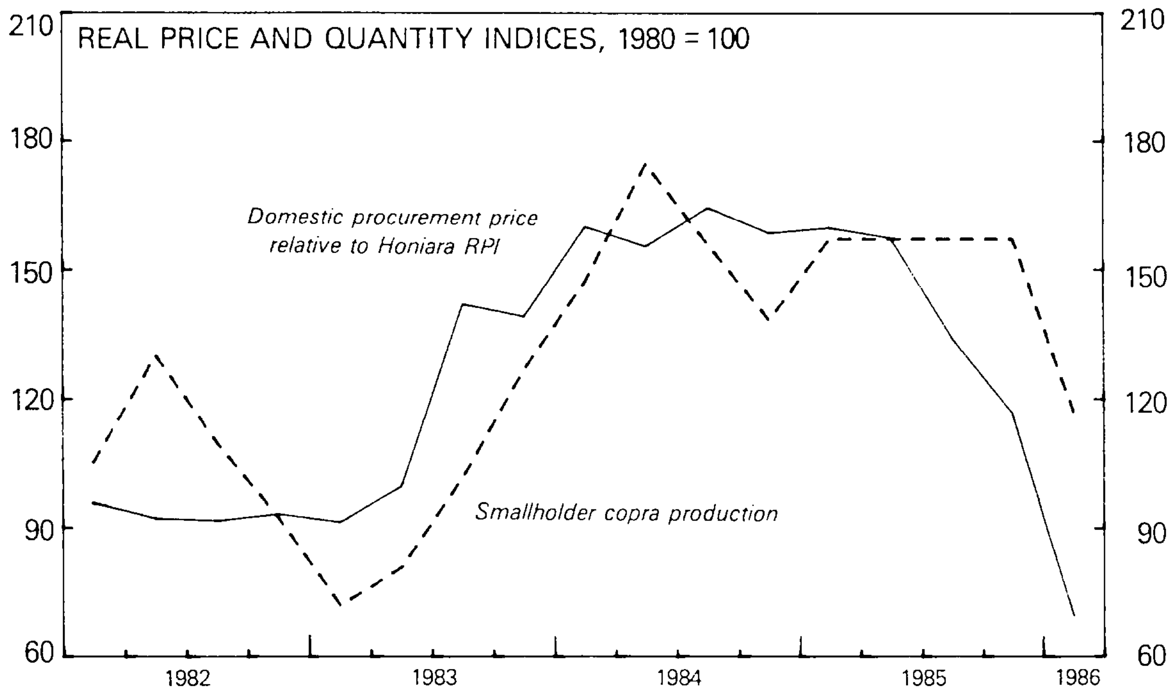
Fiscal policy has suffered from weaknesses in budget planning, the accounting system, tax administration and expenditure control. These weaknesses, which intensified in 1985-86, largely reflect shortages of trained staff. There have also been delays in receiving foreign aid owing to late claims and complex reimbursement procedures; this has resulted in larger domestic expenditure and borrowing. In addition, the steep decline in export prices and the associated difficulties of some of the export industries had a substantial adverse impact on revenues in 1985-86.

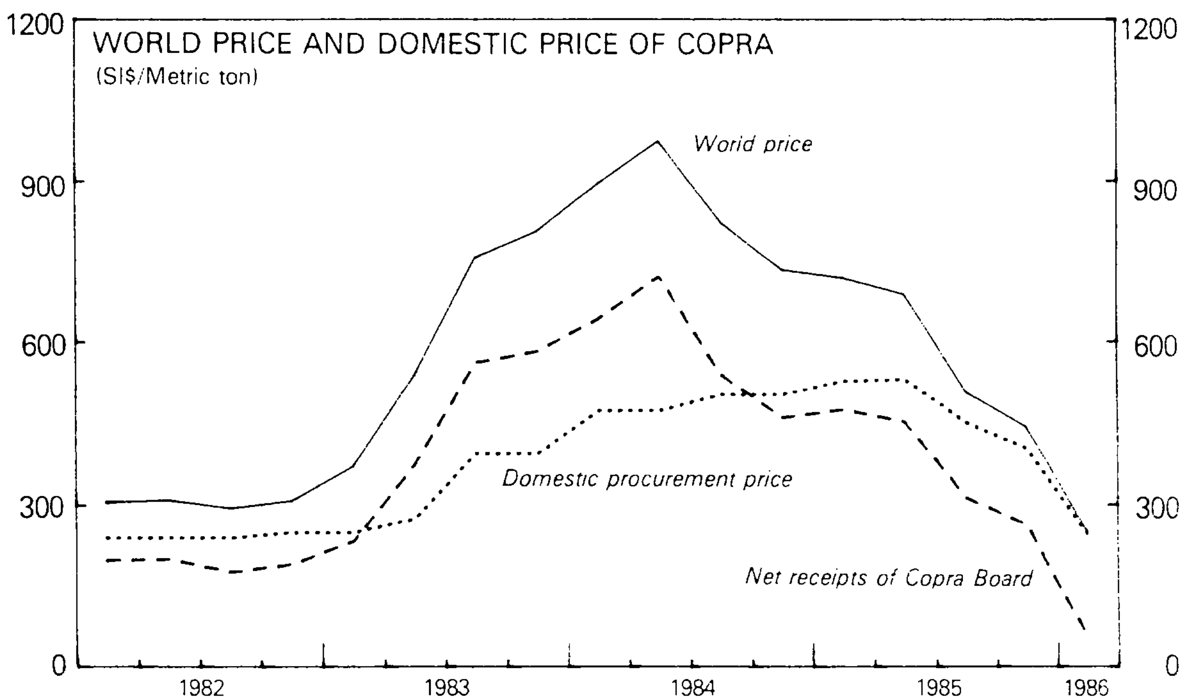
The 1986 budget provided for a 10 percent increase in total revenues and a 9 percent decline in current expenditure (Table 3). The total deficit was expected to amount to 12 percent of GDP because of high capital expenditures; this estimate included, following traditional

CHART 4

SOLOMON ISLANDS

COPRA PRICES AND OUPUT, 1982-86





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

Table 3. Solomon Islands: Central Government Budget, 1983-86

(In millions of Solomon Islands dollars)

	1983	1984	1985 Prel. Actual	1986 Budget	1986 Rev. Est.
Total revenue	34.2	48.9	51.6	56.5	52.2
Tax revenue	28.9	43.9	46.5	52.0	48.0
Income tax	10.6	14.3	16.7	20.0	17.0
Taxes on international trade	17.1	28.5	28.0	30.4	29.4
Import duties	(12.5)	(17.3)	(20.3)	(21.5)	(25.0)
Export duties	(4.6)	(11.2)	(7.7)	(8.9)	(4.4)
Other	1.2	1.1	1.8	1.6	1.6
Other revenue	5.3	5.0	5.1	4.5	4.2
Total expenditure	53.6	63.5	74.9	81.2	78.4
Current expenditure	38.5	48.4	57.4	52.1	61.1
Wages 1/	(18.0)	(13.8)	(16.9)	(17.5)	(18.0)
Other goods and services	(8.2)	(12.2)	(13.6)	(11.3)	(15.4)
Subsidies and current transfers	(12.3)	(22.4)	(26.9)	(23.3)	(27.7)
Capital expenditure and net lending	15.1	15.1	17.5	29.1	17.3
Current balance	-4.3	0.5	-5.8	4.4	-8.9
Overall deficit	-19.4	-14.6	-23.3	-24.7	-26.2
Financing	17.8	12.8	22.2	24.7	26.2
Foreign grants and borrowing (net)	13.7	7.7	8.7	20.7	11.0
Domestic financing (net)	4.1	5.1	13.5	4.0	15.2
Banking system	(1.6)	(0.2)	(8.6)	(...)	(11.2)
Nonbank	(2.5)	(4.9)	(4.9)	(...)	(4.0)
Change in arrears	...	...	1.0	...	...
			(In percent of GDP)		
Memorandum items:					
Total revenue	22.8	24.5	25.3	27.4	25.3
Current expenditure	25.6	24.3	28.1	25.3	29.6
Capital expenditure and net lending	10.0	7.6	8.6	14.1	8.4
Overall balance	-12.9	-7.3	-11.4	-12.0	-12.7

Sources: Data provided by the Solomon Islands authorities.

1/ Wages of departmental enterprises are excluded from 1984 onward, and salaries of central government civil servants seconded to the provinces are included in current transfers (to provinces) in 1984-86.

budgetary practice, a number of projects the implementation of which was regarded as highly unlikely. More than 80 percent of the deficit was to be financed through foreign grants and concessional loans (reflecting the unrealistically high budgeted capital expenditures). The growth in revenues was to be derived from the normal buoyancy of taxes, a small increase in import duties in September 1985 and an increase in the tax on higher company incomes, which was not, however, implemented in the event. A sharp tightening of expenditure control was expected to ensure lower current expenditure.

The likely fiscal outcome in 1986 was discussed in the light of developments in the first half of the year and the estimated impact of the cyclone. The authorities now expect that total revenues will be 8 percent below the budget estimate because of substantially lower receipts from income tax and export duties. This revenue shortfall would only be partly offset by increases in import duties introduced in March-April (the major element of this was an increase in the duty on petroleum, which absorbed half of the decline in the world price). Total current expenditure is projected to exceed the budget estimate by 17 percent, mainly because of earlier underestimation of interest payments and transfers to provinces as well as the provision of emergency relief. The estimate of capital expenditure was scaled back to a level not exceeding that in 1985. The authorities indicated, that unless additional concessionary financing can be secured, reconstruction will require some diversion of funds from other projects. The overall deficit is now estimated to rise to SI$26 million (13 percent of GDP) from SI$23 million (11 percent of GDP) in 1985. Foreign financing is estimated to amount to SI$11 million, significantly larger than in 1985; total domestic financing is projected at SI$15 million and bank borrowing is expected to amount to SI$11 million.

The staff noted that this fiscal outcome for 1986 implied a substantially lower deficit in the second half of the year than in the first half, because total domestic borrowing in the period January-June 1986 had already amounted to some SI$10 million. The authorities were confident that the deficit could be lowered in the second half, because of additional steps taken to restrain expenditure, a further increase in the petroleum tax in July, increased efforts to collect outstanding amounts of foreign aid, and the generally lower borrowing requirement in the second half reflecting the normal seasonal pattern of receipts and expenditures. The Government also indicated that the general level of import duties was under review. In this context, the authorities emphasized that, in the short run, the scope for raising revenues is largely confined to import duties (the average rate of import duty is less than 25 percent). Preparation of the 1987 budget is underway and the Government is planning to take a number of important measures to reduce the fiscal deficit in 1987. These measures include a freeze on public service wages and employment, a substantial reduction in subsidies, and increases in taxes, charges and fees. The Government also intends to make further improvements in tax administration and expenditure control procedures and to review the tax and tariff systems. To make further progress in these areas, the Government has requested the provision of technical assistance from abroad.

3. Monetary policy

In the past, monetary policy was guided primarily by the concern to prevent monetary conditions from restraining growth. Following the deterioration in the external position in 1985, increased attention was given to containing demand and a number of measures were introduced to curb the growth of domestic credit. These measures comprised an increase in the liquid asset ratio from 15 to 25 percent; increases in the rate of interest on central bank funds provided to banks by a total of 4 percentage points to a maximum of 16 percent; and the transfer to a blocked central bank account of half of the proceeds of a SI$7.2 million Government bond issue placed with the National Provident Fund. However, these measures were not successful in reducing the growth of credit to the private sector for a number of reasons. First, banks substantially increased their borrowing of central bank funds despite the increase in costs, as the demand for credit remained strong; second, because of growing borrowing needs of the Government, the blocked funds were released later on in the year; and, third, the CEMA withdrew its reserves from the Central Bank, which had been frozen in 1984 in order to reduce bank liquidity. In the event, credit to the private sector rose by 60 percent and total domestic credit grew by 65 percent in 1985, substantially faster than in 1984 (Table 4). Interest rates, which are largely market determined, rose by 3-5 percentage points in the course of 1985, with real interest rates on both large and small longer-term deposits becoming positive and the average lending rate climbing to 16 percent, well above the rate of inflation.

In commenting on developments in 1985, the monetary authorities noted that the large borrowing requirements of the Government and the reflow of CEMA reserves to the banking system had undermined the other measures to stem the growth of credit. Furthermore, the liquidity needs of the fishing industry and some large timber companies, which had to be met, had accounted for a substantial part of the credit expansion. However, to ensure more effective control over banks' access to central bank funds, the Central Bank replaced the sliding scale of interest charges by a new system in early 1986. Under this system, banks can borrow the equivalent of up to 15 percent of their deposit liabilities at an interest rate of 14 percent; above this, a penalty rate of 20 percent applies. In the event, bank borrowing from the Central Bank declined by almost one half in the second quarter of 1986, and credit to the private sector ceased to increase during this period.

The authorities agreed with the staff that monetary policy will have to make an important contribution to both external adjustment and the additional saving effort required for reconstruction. The Central Bank intends to limit the growth of total domestic credit to about

Table 4. Solomon Islands: Monetary Survey, 1983-86 1/

(In millions of Solomons Islands dollars)

	1983 Dec.	1984 Dec.	1985 Dec.	1986 March	1986 June
Net foreign assets	30.0	42.3	28.4	19.6	21.8
Domestic credit	28.6	36.5	61.0	69.1	71.5
	(-3.7)	(27.6)	(67.1)	(68.1)	(40.0)
Central Government (net)	3.2	3.4	12.0	17.8	19.9
Provincial Government (net)	-0.3	-0.9	-0.1	-1.0	-0.9
Statutory corporations	5.1	4.4	1.8	1.5	1.7
Private sector	20.6	29.6	47.3	50.8	50.7
	(-8.4)	(43.7)	(59.8)	(46.0)	(31.4)
Broad money	48.0	64.3	64.5	68.2	70.9
	(19.4)	(34.0)	(0.3)	(8.6)	(7.4)
Narrow money	19.5	29.4	26.9	27.5	28.4
	(16.8)	(50.8)	(-8.5)	(10.0)	(10.6)
Other items (net)	-10.6	-14.4	-24.8	-20.4	-22.4
Memorandum item:					
Velocity of broad money 2/	2.4	2.5	2.5	2.4	2.3

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

1/ Figures in parentheses are growth rates in percent over the corresponding period of the preceding year.
2/ In relation to GDP of the monetized sector.

10 percent in the second half of 1986, compared with 17 percent in the first half. The Central Bank believes that, in view of the most recent developments, this objective can be achieved without further strong measures, but it has instructed banks to curb their lending for purposes other than reconstruction, and it stands ready to take additional measures should the need for further restraint arise. There were further moderate increases in interest rates in mid-1986.

With respect to development of the financial system, a fourth commercial bank and a foreign finance company opened offices in Honiara, and rural banking facilities were improved in 1985. Steps will also be taken to strengthen the Development Bank so that it can better assist in the reconstruction effort.

4. Development planning and structural policies

The absence of an appropriate medium-term framework for investment planning has been a major obstacle to development. After a hiatus of several years in planning, a National Development Plan for the period 1985-89 was approved in August 1985. The plan is largely indicative, establishing a broad investment strategy to replace the ad hoc approach to investment planning followed in recent years. The plan provides for annual average investment equivalent to about 15 percent of GDP. More than one third of the total resources is to be devoted to the improvement of economic infrastructure, about one fourth is planned to be allocated to the development of natural resources and about 10 percent each would be spent on education and welfare. The Government is currently in the process of identifying core projects for priority implementation. These projects are to be selected on the basis of their contribution to productive capacity, employment generation, foreign exchange earnings and elimination of constraints on development; regional aspects, too, are to be taken into account. About one half of total resources are to be provided by foreign donors in the form of grants and concessional loans. The inflow of private foreign capital, both direct investment and commercial borrowing, would account for about one fourth of resources, with the rest being raised domestically. Average real GDP growth is projected at 5 percent per annum, and the annual rate of inflation is not to exceed 10 percent. Annual development programs will be formulated and incorporated in the annual budgets on the basis of the overall plan. A mid-term review of the plan is scheduled for 1987.

The Plan recognizes that public investment has suffered from weaknesses in project planning and implementation. These problems have been due to shortages of trained manpower and organizational deficiencies. To increase the number of qualified personnel, the Government has requested several bilateral and multilateral donors to provide technical assistance and it is also stepping up its own efforts to train local manpower. To improve project implementation, an interdepartmental task force was formed, which was given the necessary power to speed up ongoing work and improve efficiency. In addition, the aid management unit in the Ministry of Economic Planning was strengthened to ensure larger and more efficient utilization of foreign assistance.

One of the principal structural issues relates to the complex system of customary land tenure. This system has impeded increases in productivity in agriculture in some of the more populated areas and development of the forestry sector, largely because of uncertainty as to land tenure. To reduce the problems arising from traditional land tenure, which is a highly sensitive issue, the Government has a bill under consideration, which provides for the registration of land boundaries. It is also proposed that each area will have a recognized spokesman to deal with the Government and outside interests. These modifications should facilitate agricultural development and lead to more efficient and secure land use. In another area of structural policy, the Government is preparing a revision of the Foreign Investment Act with a view to simplifying procedures and providing better investment incentives.

V. Staff Appraisal

Solomon Islands is faced with a very difficult situation. The sharp decline in world prices of vegetable oils has led to the emergence of strong pressure on the balance of payments and this pressure has been exacerbated by the effects of the recent severe cyclone. A substantial widening of the fiscal deficit and the, until very recently, rapid growth of credit have also contributed to the worsening of the external payments position. International reserves are likely to decline sharply in 1986 and the balance of payments outlook is for sizable financing gaps in coming years. On current projections, no immediate recovery of vegetable oil prices from their present low levels is expected, but prices may strengthen during 1988-90. The current and prospective external imbalances clearly require the adoption of strong and comprehensive adjustment measures. However, the present situation also calls for larger external financing at concessionary terms, in particular, to help with reconstruction following the cyclone. In this regard, it is hoped that donors will respond favorably to Solomon Islands' larger financing needs resulting from the natural disaster that has struck the country at a particularly adverse time.

The extent of the adjustment required now would be less, if less expansionary policies had been pursued during the period of high vegetable oil prices in 1984 and early 1985, thus permitting the accumulation of a more adequate cushion of reserves. Foremost on the agenda for adjustment must be an immediate and substantial improvement in profitability in the export sector, which has deteriorated alarmingly. In the absence of timely action, export production is likely to decline further and development and expansion of the export sector would be impaired. It is true that the poor profitability of exports is mainly due to external factors, and domestic policy cannot completely protect export production from external shocks. However, economic policy needs to ensure the continued viability and growth of the export sector despite the presence of adverse external circumstances. Record low export profitability, a large decline in reserves in 1986 to a very low level, and prospective large external financing gaps provide strong indication of the need for substantial and immediate exchange rate action. Support price policy for copra must be directed more firmly at ensuring stable and attractive prices as well as financial viability of the stabilization fund. There is also need to help the fishing industry through appropriate structural measures. The present cautious external debt policy should, of course, be continued.

The deterioration in the fiscal situation is another major concern. Low export prices have been a contributing factor, but rising current expenditure and weaknesses in the tax system, tax administration and expenditure control have played a major role. Increases in import duties alone cannot and should not close the gap between revenues and expenditures. The staff welcomes the authorities' intention to consider for the 1987 budget a freeze of public service wages and employment, a sharp reduction of subsidies, and increases in taxes, fees and charges. Strong action in these areas will be required to achieve a substantial reduction in the fiscal deficit. At the same time, the authorities should intensify their efforts at improving tax administration and expenditure control, and also review the tax and tariff systems as soon as possible.

The measures introduced by the Central Bank in 1985 to curb the growth of domestic credit were less effective than expected, partly because of the Government's large borrowing needs, and domestic credit continued to expand very rapidly. There is need to reassert more effective monetary control, and the steps taken in early 1986 to restrain credit growth appear to have had initial success. In the present situation, the emphasis must remain on exercising tight control over credit developments both to reduce the external imbalance and contain inflationary pressures. In this context, the staff welcomes the Central Bank's intention of limiting credit growth to 10 percent in the second half of 1986.

The damage caused by the cyclone in May 1986 is large. Repair and reconstruction will take at least 1 1/2-2 years and the impact on the balance of payments arising from larger imports and lower exports is substantial. The authorities have requested financial assistance from the Fund to help meet the immediate foreign exchange needs. In their letter outlining the broad policies to be pursued in the period ahead the authorities indicate that they envisage the formulation of an adjustment program that can be supported by a stand-by arrangement from the Fund. In view of the large internal and external imbalances, the staff urges the authorities to adopt such a program as soon as possible. The staff also welcomes the authorities' intention to develop, in due course, a program that can be supported by use of Fund resources under the structural adjustment facility. It is important that policies be developed to address the structural problems that impede more rapid growth and the attainment of a stronger external position.

The staff believes that Solomon Islands' use of Fund resources in the amount requested is in accordance with the Fund's practice regarding the provision of assistance in cases of natural disaster.

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

V. Proposed Decision

The following decision is proposed for adoption by the Executive Board.

1. The Government of Solomon Islands has requested a purchase equivalent to SDR 1.25 million.

2. The Fund notes the intentions of the Government of Solomon Islands as stated in its letter dated July 30, 1986, and approves the purchase in accordance with the request.

Solomon Islands: Basic Data

Area:	27,556 square kilometers
Population (1985 est.):	290,000
Population growth:	3.5 percent
GDP per capita (1985):	SDR 470

	1983	1984	1985	1986 Staff 1/ Proj.
Output and prices (annual rate of change in percent)				
Real GDP	5	19	-7	-10
Consumer prices (annual average)	6.7	11.1	9.5	11.0
Money and credit 2/				
Broad money	19.4	34.0	0.3	2.5
Total domestic credit	-2.7	16.5	38.1	32.7
Credit to private sector	-4.7	18.8	27.5	15.2 3/
Credit to Government	4.2	0.4	13.4	17.4
Public finance (annual rate of change in percent)				
Total revenue	3.6	43.0	5.5	1.1
Total expenditure	5.3	18.5	18.0	4.7
Current expenditure	11.3	25.7	18.6	6.4
Capital expenditure and net lending	-7.4	--	15.8	-1.0
Deficit (SI$ mn.)	-19.4	-14.6	-23.3	-26.2
Foreign assistance	13.7	7.7	8.7	11.0
Domestic borrowing	4.1	5.1	13.5	15.2
(Bank borrowing)	(1.6)	(0.2)	(8.6)	(11.2)
Domestic arrears	...	...	1.0	...
Foreign trade (annual rate of change in percent)				
Export volume	24.3	14.6	-11.0	-7.1
Export unit value (SDRs)	-11.5	34.4	-13.1	-23.1
Import volume	8.4	8.0	7.7	-6.5
Import unit value (SDRs)	-1.0	3.3	-1.1	-8.0
Terms of trade	-10.6	30.2	-12.2	-16.5
Balance of payments (SDR million)				
Exports (f.o.b.)	58.0	89.4	69.1	49.4
Imports (f.o.b.)	-57.5	-64.1	-68.3	-58.8
Trade balance	0.5	25.2	0.7	-9.4
Current account balance 4/	-25.4	-9.0	-30.3	-36.7
Overall balance	2.7	8.6	-16.1	-16.4
Gross international reserves (end of period)				
In millions of SDRs	42.9	45.1	32.6	16.3
In months of imports of goods and services	5	5	3	2
Exchange rates				
Solomon Islands dollar/SDR 5/	1.279	1.317	1.771	2.017 6/
Nominal effective exchange rate 5/	82.4	81.9	64.5	56.8 6/
Real effective exchange rate 5/	96.4	103.9	86.5	80.4 7/
Selected financial ratios (in percent)				
Current account/GDP 4/	-17.3	-5.9	-22.3	-33.3
Government budget deficit/GDP	-12.9	-7.3	-11.4	-12.7
External debt/GDP 8/ 9/	41.4	37.6	57.0	67.7
External debt service ratio 9/ 10/	4.0	7.0 11/	8.6	13.8
Official grants and concessional loans/GDP	11.2	12.1	12.0	16.3
Official grants and concessional loans/imports of goods and services	17.0	16.2	14.1	17.6

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

1/ Based on current policies.
2/ Annual rate of change in percent in relation to stock of broad money at beginning of period.
3/ Includes statutory corporations.
4/ With official grants below the line.
5/ End of period.
6/ June 1986.
7/ April 1986.
8/ Total external debt.
9/ Including IMF.
10/ Total interest plus amortization as a proportion of exports of goods and services.
11/ Excludes early repayment of the 1981 Euro-dollar loan.

Solomon Islands - Fund Relations
(As of June 30, 1986)

(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

		Amount	Percent of quota
(b)	Total Fund holdings of SI dollars:	6.65	133.0
(c)	Fund credit:	2.16	43.2
	Of which: Credit tranches	0.96	19.2
	CFF	1.20	24.0
(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 October 25, 1982 and purchased on October 28, 1982.

IV. SDR Department

	Amount	Percent of allocation
(a) Net cumulative allocation:	0.65	100.0
(b) Holdings:	0.18	27.9
(c) Current Designation Plan:	--	--

V. Administered Accounts

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

VI. Overdue Obligations to the Fund

None

(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$1.7164 on June 27, 1986.

VIII. Last Article IV Consultation

Staff discussions were held between May 22-31, 1985. The Staff Report (EBS/85/215) for the 1985 Article IV consultation was discussed by the Executive Board on August 28, 1985. The 1985 Article IV consultation was conducted after a 19-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 early 1985, the Bureau of Statistics sent two missions to provide technical assistance in general economic data and government finance statistics. 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 is also providing 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, 1986)

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. A mission visited Honiara in April 1986 to assist the Government in reviewing their agricultural investment program, particularly in the rural smallholder area. The mission looked at the sustainability of the current program and desirable policies and directions of investments in the future, as well as the health and welfare of the small farmer. The report is scheduled to be completed in the fall of 1986.

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. 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 started on an experimental basis; national accounts by industrial origin are not compiled. The data on GDP in the nonmonetized sector were recently revised but remain rough estimates. Statistics on production of major agricultural commodities are available but there is no information on manufacturing activity. The price index used pertains to Honiara only and the weights were recently revised. Only partial information is available on wages in the private sector.

A technical assistance mission visited Honiara in January 1985 and reviewed the methodologies underlying the compilation of the statistics on the national accounts, production, prices, and external trade. A report containing recommendations in these areas was submitted to the authorities in May 1985.

Regarding the national accounts, the mission recommended that the scope of 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 for other developing countries and population growth for the Solomon Islands. Although some surveys on household income and expenditure were conducted during 1981 and 1982, the results were not processed due to the lack of technical expertise. The compilation of national accounts by expenditure category and the revision of the estimate of GDP of the nonmonetized sector reflect the recommendations of the mission.

The mission suggested that price indices be compiled for at least two other major population centers and that a weighted average be constructed to represent the whole country.

The mission also suggested that the authorities begin the collection of price data in respect of the major export and import commodities at the wholesale level, although the computation of a wholesale price index has to be deferred to a later stage due to shortages of staff.

b. Monetary accounts

The monetary statistics as presented in the IFS differ from those shown in staff reports and recent economic developments papers, which follow the presentation by the Central Bank of Solomon Islands (CBSI) in its Annual Reports. The principal difference between these two presentations are with respect to the CBSI's foreign liabilities and the CBSI's claims on the Government (net). This difference is mainly due to the treatment of a US$20 million Euro-dollar loan in 1981 and a US$30 million Eurocurrency credit line made available in 1984. 1/ In both cases, the official borrower is the Government but the counterpart funds of disbursements are deposited in a blocked account with the Central Bank. In reporting to the Bureau of Statistics, the CBSI shows the movements in the counterpart funds indistinguishably from other government deposits, while in its Annual Reports, these are shown as changes in its foreign liabilities. For purposes of IFS presentation, it would be desirable to identify the counterpart funds and to classify them as such rather than as foreign liabilities of the CBSI or as the latter's deposit liabilities to the Government. In addition, IFS nets out the Fund-related accounts, as the Treasury IMF accounts are classified under CBSI's claims on the Government, and treats certain nonmonetary assets and liabilities differently.

c. Government finance

Statistics on the consolidated public sector are not compiled, as government finance statistics are available only for the Central Government.

The Government finance data 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

1/ This explains also differences in the overall balance of payments.

increasing. This has resulted in a larger transfer of financial resources from the Central Government to the provincial governments who are also increasingly borrowing from the banking system.

The 1985 Government Finance Statistics Yearbook contains institutional derivation and the main statistical tables for the Central Government for the period 1975 through 1978 and 1983. Data published in IFS are based on the GFS Yearbook. The data for 1983 were compiled during a technical assistance mission undertaken in February 1985. A mission report containing detailed compilation procedures and recommendations for further improvements was submitted to the authorities on June 4, 1985. Comments on the report, or new data based on its recommendations have not been received to date.

d. External sector

Balance of payments and trade statistics are available on a regular and timely basis. The latest data published in Balance of Payments Statistics relate to 1984. The general statistics mission in January 1985 reviewed the methodology underlying the construction of the export and import unit value indices and suggested revised procedures for improving the import unit value index.

2. Coverage, currentness, and reporting of data in IFS

A country page for Solomon Islands was introduced with the July 1985 issue of IFS. The table below shows the currentness and coverage of data published for Solomon Islands in the July 1986 issue. These data are based on reports sent to the Fund's Bureau of Statistics by the Central Bank of Solomon Islands, which during the past year have been provided on an irregular basis.

Status of IFS Data

		Latest Data in July 1986 IFS
Real Sector	- National Accounts	1980 (Total GDP 1983)
	- Prices: consumer prices	December 1985
	- Production: copra	September 1985
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	1983
	- Financing	1983
	- Debt	1983

Monetary Accounts	- Monetary Authorities	December 1985
	- Deposit Money Banks	December 1985
	- Other Financial Institutions	November 1985
External Sector	- Merchandise Trade:	
	Values	December quarter 1985
	Unit values (exports)	December quarter 1985
	- Balance of Payments	1984
	- International Reserves	May 1986
	- Exchange Rates	May 1986

July 30, 1986

Dear Mr. de Larosiere:

1. As you are aware, Solomon Islands was struck by a severe cyclone on May 18-20, 1986, which affected three of the country's six main islands. Your prompt message of sympathy was much appreciated here. The cyclone resulted in the loss of 140 lives, and the homes, gardens, cash crops and supporting environment of about one third of the total population of 290,000 were destroyed or badly damaged. The set back to the economy is extensive and reconstruction and rehabilitation will take several years. The heaviest damage occurred on Malaita, the most populous island, and the eastern part of Guadalcanal, one of the country's centers of agriculture and commerce. Large parts of the natural forests on Malaita and Guadalcanal were destroyed by winds and mudslides, leading to a risk of further erosion and flooding from normal heavy rains. There has also been widespread damage to the three main treecrops, copra, palm oil, and cocoa, which have contributed about one third to exports in recent years. In Malaita, one of the principal areas of smallholder production of copra, about 25 percent of the coconut trees were blown down, implying substantial production loss for 5-10 years. Furthermore, several of the larger cocoa plantations suffered wind damage, and a part of the oil palm plantation on Guadalcanal was destroyed by flooding. Flooding and silting destroyed the rice crop and some rice stocks and inflicted heavy damage on food gardens, wiping out parts of the local supply and making cultivation impossible until the thick layer of the mud is removed. Private housing and many public buildings, including schools, hospitals, and police stations, were damaged or destroyed in a large part of the country. Because of the widespread destruction of the forest stock of traditional building materials, reconstruction will require the importation of building materials. There has also been heavy damage to bridges and equipment, requiring imports of materials and skilled manpower for reconstruction and replacement.

2. The Government, with substantial help from several donor countries and multinational organizations, provided immediate relief, supplying the most affected areas with food, medicines, and temporary shelters. The Government has now made a preliminary assessment of the damage. It is estimated that the costs for replacement will be on the order of SI$22 million (about 10 percent of 1985 GDP). Of this amount, the foreign exchange requirement is estimated to be about SI$15 million, most of which will arise in the next 18 months or so. If these costs for repair and replacement had to be met from the country's own resources it would be a severe blow to economic prospects. Low

vegetable oil prices had already resulted in a sharp deterioration in the external position prior to the cyclone, and lower export production and higher imports as a result of the cyclone will exacerbate the pressure on the balance of payments. Solomon Islands' gross international reserves amounted to SDR 26 million at the end of June 1986, equivalent to about three months of imports of goods and services. To avoid a sharp decline in reserves or a large increase in commercial indebtedness, Solomon Islands has appealed to donor countries and international organizations for financial and material assistance. In this context, the Government requests a purchase equivalent to SDR 1.25 million (25 percent of quota) under the Fund's policy of emergency assistance related to natural disasters.

3. The Government will continue to collaborate with the Fund in finding appropriate solutions to Solomon Islands' balance of payments problems. As described below, a number of measures have been taken in the areas of fiscal, monetary, and exchange rate policy, and others are under consideration. The Government fully recognizes the seriousness of the underlying balance of payments situation and envisages the formulation, when the extent of the required adjustment can be more precisely defined, of an adjustment program that can be supported by a stand-by arrangement from the Fund.

4. The cyclone has required the diversion of substantial government resources from budgeted purposes to immediate disaster relief, and a considerable amount of expenditure for reconstruction and rehabilitation will be necessary in 1986-88. At the same time, total revenue will be reduced by the effect of the cyclone on income-earning activity and, in the absence of corrective measures, the deficit would widen significantly. Some of the additional expenditure has been financed through foreign aid, and the Government hopes that additional aid on a substantial scale will be provided. The Government is well aware that measures are required to contain budget deficits and hold the domestic borrowing requirement to acceptable levels. Immediately, the Government has taken further steps to restrain expenditures. An increase in the tax on petroleum to absorb the savings from the decline in the petroleum price since April has also been announced. The Government is further reviewing the general level of import duties to increase revenues. In preparing the 1987 budget, the Government is planning a freeze on public service pay scales and numbers employed, a sharp reduction in subsidies to departmental enterprises, and increases in taxation, and fees and charges such as to produce a balance in the current budget. Meanwhile the Government will continue with its efforts to tighten tax administration and expenditure control and will review the tax and tariff systems as soon as possible.

5. Tight monetary policy will be maintained overall in order to contain inflation and the pressure on the balance of payments in the aftermath of the cyclone as well as encouraging the additional saving

effort required for reconstruction. The Central Bank will aim to limit total domestic credit expansion to about 10 percent in the second half of 1986. This is consistent with maintaining a minimum level of external reserves and preventing the emergence of inflationary pressures. Within this framework, the Central Bank has issued guidance to the commercial banks to concentrate their lending on productive sectors and the provision of loans for reconstruction while curbing all other lending, in particular for imports of consumer goods. To encourage savings, interest rates on deposits were recently raised, maintaining the positive real interest rates. Steps will also be taken to strengthen the Development Bank so that it is in a better position to help in the reconstruction and rehabilitation effort.

6. Against the background of the worsening of the balance of payments outlook, the record low profitability of copra and palm oil exports, and the low reserves of the copra price stabilization fund, the Solomon Islands dollar was depreciated by a total of about 30 percent in nominal effective terms in the last year. The authorities will continue with the policy of flexible management of the exchange rate. Implementing this policy, the authorities will keep in mind the need to ensure adequate export profitability and compress the demand for imports. The Government will continue with its prudent external debt policy and external public debt at nonconcessional terms will not be incurred other than for purposes of prudent reserves management or for expenditures that are expected to generate foreign exchange income adequate to service the debt. The Government will not impose any restriction on payments and transfers for current international transactions, introduce any multiple currency practice, or impose new or intensify existing import restrictions for balance of payments purposes, and will not enter into bilateral payments agreements that are inconsistent with Aticle VIII.

7. The Government recognizes that structural problems have impeded the attainment of more rapid growth and a stronger external position. The recently completed Five-Year Development Plan forms the basis on which the Government intends to develop policies to overcome these structural impediments, notably, those that have impeded larger public and private foreign investment, and to deal with the resource management and land tenure issues that make it difficult to harness the natural resources of the country to economic development in a sustained and equitable manner. The Government intends, in due course, to formulate a program that can be supported by use of Fund resources under the structural adjustment facility.

8. While purchases from the Fund above the first credit tranche remain outstanding, the Government will consult with the Fund periodically, in accordance with the policies on such consultations, to examine the progress being made in implementing policies designed to solve the balance of payments problems, with a view to adopting any

additional measures that may be necessary to facilitate the required adjustment.

Yours sincerely,

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