

**FOR
INFORMATION**

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To: Members of the Executive Board
From: The Secretary
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Solomon Islands—Assessment Letter for the Asian Development Bank

April 20, 2020

Recent Developments, Outlook and Risks

1. The COVID-19 pandemic is having a severe impact on the Solomon Islands economy. Prior to the pandemic, growth had slowed to 1.2 percent (y/y) in 2019 due to a substantial slowdown in logging activity combined with a pause in economic activity around the elections period. In the April 2020 *World Economic Outlook* (based on information available at the end of March), growth is projected to turn negative in 2020, reflecting a decline in logging, agricultural, mining and fisheries exports, contraction in tourism, as well as some negative impact of domestic containment measures that include a ban on international flights and entry of non-citizens and strict mandatory quarantine for all returning passengers. The government has announced (on April 8) an extension of the state of emergency until end July, with additional containment efforts including scaling down public services to essential services only and temporarily closing schools and some services. The government is actively encouraging its citizens to return to their home islands, disrupting business activity and consumer spending. Growth is expected to recover in 2021 as logging activities resume. While the decline in oil prices will alleviate pressure on the external accounts, the current account deficit nevertheless is projected to increase significantly as commodity exports and tourism fall.

2. Risks are skewed to the downside. External risks include a sharper-than-expected and more prolonged global slowdown that would further hamper demand for Solomon Islands exports. Recent expansion of containment efforts could have a stronger-than-expected impact on domestic activity. Solomon Islands has been ramping up infrastructure development in anticipation of Pacific Games 2023. Extended travel restrictions and supply chain disruptions could delay the projects. Volatility in commodity prices – both on imports (rice and oil) and exports (logs, tuna and agricultural products) adds to the risk profile. Domestic risks, including lax fiscal policy, impending decline in logging, and vulnerability to severe natural disasters, are exacerbated by the uncertainty surrounding the pandemic. Finally, given the country's geographic dispersion and isolation, managing a pandemic can be particularly challenging for the Solomon Islands. A local outbreak would lead to a significant increase in human costs, strain the weak health infrastructure and adversely affect unemployment and growth.

Policy Response and Settings

3. To mitigate the impact of the pandemic, the government is working on a fiscal stimulus package. The key elements in the first phase are expected to include a utility relief component from Solomon Power and the Ports Authority; loan and interest relief from banks and financial institutions; provision of financial assistance to members of the National Provident Fund; and tax relief for specific sectors. The government is committed to re-prioritizing and enforcing budgetary discipline in the line ministries to alleviate budget pressures resulting from the pandemic. The government has scaled down non-essential public services and its employees have all been ordered to take emergency leave. The government is also planning for

a financial injection into the productive and resource sectors, possibly through the Development Bank of Solomon Islands, and direct equity investments into state-owned enterprises and public-private companies.

4. The weak fiscal position increases vulnerability of the Solomon Islands to the pandemic. The fiscal deficit is projected to increase significantly in 2020, even without accounting for the expected fiscal stimulus package, and is expected to remain elevated over the medium term with a gradual decline in logging revenues. Substantial new measures and external budget support will be needed to build fiscal buffers (towards a broad cash balance of at least two months of total spending) and for debt to remain within the government's target of 35 percent of GDP. Public debt is currently low but is expected to rise over the medium term, with the negative impact of the pandemic leading to a further build-up of debt vulnerabilities. The 2019 Article IV Debt Sustainability Analysis concludes that Solomon Islands is at moderate risk of debt distress. All debt indicators remain below the relevant indicative thresholds under the baseline scenario, but breach thresholds under the extreme stress scenario. In this context, a comprehensive approach to medium-term fiscal policy that safeguards debt sustainability is needed. Improving budget planning in line ministries, strengthening commitment controls and procurement planning, and prioritizing spending in line with the National Development Strategy would help safeguard fiscal sustainability.

5. The Central Bank of the Solomon Islands (CBSI) has confirmed its commitment to continue the expansionary monetary policy for the next six months. This easing cycle started in September 2019 to support a low inflation environment with weak growth outlook and slowing credit growth. The monetary policy stance is appropriate for current conditions, although the transmission channels are weak. Excess liquidity in the banking system is structural, in part reflecting lags between donor inflows and spending. Addressing constraints on National Provident Fund investment abroad, stemming CBSI valuation losses, and tackling weak investor protection and uncertain property rights would reduce excess liquidity, enable collateralized lending, and improve monetary policy effectiveness. Financial sector reforms should continue, including to strengthen supervision and increasing capacity to respond effectively to risks to the financial system.

6. The basket exchange rate peg remains an appropriate nominal anchor for Solomon Islands. Credibility of the basket exchange rate regime is preserved by maintaining an adequate level of gross official reserves. As a result of the widening current account deficit and without additional external financing, reserves are expected to fall below the top of the reserve adequacy range (estimated as four to seven months of prospective imports) this year, which may lead to a short-term balance of payment need, and to decline further in 2021 and over the medium-term. Maintaining a safety buffer of reserves, close to the top of the adequacy range, is warranted given the exchange rate regime and lack of market access, potential shocks (including natural disasters) and exceptional uncertainty in the current circumstances.

7. Comprehensive structural reforms would help narrow the current account gap over the medium term and foster diversification in new growth sectors. Improving sanitation, transport, communication and energy services would facilitate diversification. Enforcement of contracts,

procedures for trading across borders, insolvency resolution and access to finance are areas for improvement. Digitalization and registration could potentially improve record keeping, revenue collection, open access to credit and help tackle property rights issues. SOEs have performed well in recent years, with high profits from monopoly positions— stronger regulation or other initiatives could help promote greater affordability.

IMF Relations

8. Solomon Islands successfully completed an IMF-supported program, the Extended Credit Facility arrangement, in March 2016. Solomon Islands is on a standard 12-month Article IV consultation cycle. The 2019 Article IV consultation was concluded by the IMF's Executive Board on February 5, 2020. As part of the Fund's response to help address the impact of the COVID-19 pandemic, Solomon Islands will receive debt service relief through the Catastrophe Containment and Relief Trust (CCRT) and is considering additional support through the Rapid Credit Facility/Rapid Financing Instrument.

Solomon Islands: Selected Economic Indicators, 2015–2021							
Per capita GDP (2017): US\$2,144							
Population (2017): 613,712							
Quota (current): SDR 20.8 million							
	2015	2016	2017	2018	2019	2020	2021
					Est.	Projections	
Output							
Real GDP growth (%)	2.5	3.2	3.7	3.9	1.2	-2.1	3.8
Real GDP per capita (%)	0.3	1.0	1.5	1.6	-0.9	-4.2	1.5
Prices							
Consumer prices, average (% change)	-0.6	0.5	0.5	2.7	2.2	2.4	3.0
Consumer prices, end-of-period (% change)	3.5	-2.2	2.1	3.9	2.2	1.7	4.1
General government finances							
Fiscal balance (% of GDP)	0.0	-3.9	-4.5	0.7	-2.7	-7.3	-7.8
Balance of payments							
Current account (% of GDP)	-3.0	-4.0	-4.9	-4.5	-6.4	-15.0	-14.7
Sources: Data provided by the Solomon Islands authorities; and IMF staff estimates and projections							