August 23, 2021
Approval: 8/30/21

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 20/14-1

10:00 a.m., February 5, 2020

1. Solomon Islands—2019 Article IV Consultation

Documents: SM/20/26 and Correction 1; and Supplement 1; and Supplement 2; and Supplement 2, Correction 1

Staff: Stuart, APD; Sun, SPR

Length: 32 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
	A. Abdullahi (AE), Temporary
	T. Nguema-Affane (AF), Temporary
	C. Moreno (AG), Temporary
N. Ray (AP)	
	Z.Mohammed (BR), Temporary
	K. Lok (CC), Temporary
	E. Cartagena Guardado (CE), Temporary
L. Levonian (CO)	
	S. Benk (EC)
	P. Rozan (FF)
	K. Merk (GR)
	N.Thiruvenkadam (IN), Temporary
	M. Psalidopoulos (IT)
	K. Chikada (JA)
	M. El Qorchi (MD)
	F. Al-Kohlany (MI), Temporary
	V. Rashkovan (NE)
	J. Sigurgeirsson (NO)
	A. Biriukv (RU), Temporary
	R. Alkhareif (SA)
	A. Srisongkram (ST), Temporary
	P. Trabinski (SZ)
	J. Freeman (UK), Temporary
	R. Farber (US), Temporary

H. Al-Atrash, Acting Secretary
S. Kalra, Summing Up Officer
R. Smith Yee, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
Asia and Pacific Department: V. Balasundharam, N. Kaendera, J. Ostry, T. Schneider, A. Stuart, J. Turunen, H. Xu. Legal Department: N. Stetsenko. Strategy, Policy, and Review Department: Y. Sun. World Bank Group: R. Utz. Alternate Executive Director: N. Heo (AP), C. White (AP). Senior Advisors to Executive Directors: P. Braeuer (GR), L. Johnson (AP), J. Shin (AP), L. Smith (CO). Advisors to Executive Directors: T. Iona (AP), A. Korinthios

(IT), K. Kuretani (JA), A. Park (AP), N. Shenai (US), L.Siliva (AP), I. Skrivere (NO), J. Yoo (AP), A. Zaborovskiy (EC), Z. Zedginidze (NE), S. Alavi (MD), J. Barroso (BR), Y. Pierre (BR).

1. SOLOMON ISLANDS—2019 ARTICLE IV CONSULTATION

Mr. Ray and Ms. Johnson submitted the following statement:

The Solomon Islands is a low-income country of around 650,000 people, speaking over 120 languages, across some 900 islands in the South Pacific. The Solomon Islands has a total land area of about 28,400 square kilometers spread over 1.34 million square kilometers of ocean – an area larger than France, Germany and Poland combined. Its dispersed population, large infrastructure needs, narrow economic base, and exposure to natural disasters and commodity price volatilities pose many development challenges. The authorities are aware of the macroeconomic risks the country faces and appreciate the analysis, advice and technical assistance provided by the Fund.

Economic Outlook

The authorities note that preliminary data suggest that economic growth has slowed further than staff's expected 2.7 percent in 2019 owing to weak performances from commodities combined with subdued domestic demand. The forestry sector declined as a result of weak demand for logs from China. Uncertainties emanating from the national elections in April and the newly elected government's decision to switch ties from the Taiwan Province of China to China eroded business confidence and weakened domestic demand. Over the medium term, staff estimate growth to average around 2.7 percent with growth expected to be supported by infrastructure spending and mining activity that is expected to commence in late 2020. Inflation remains within the target range of 2 to 4 percent. Foreign reserves are equivalent to 8.1 months of imports.

The authorities agreed with the overall economic assessment. They are aware that the economy may be transitioning away from the logging sector with consequential effects on export earnings, employment, government revenue and overall demand. Diversification is a challenge for the authorities and more granular advice from staff on how to adjust would be welcome. An inter-agency committee has been established to develop a logging sustainability policy to be implemented in 2020. The mining sector has been identified as one of the main potential growth drivers over the medium term and the authorities collaborated with one of the development partners to improve the legislative framework. The expected reopening of the Gold Ridge Mine and major infrastructure projects will support growth in the next few years. These projects – including the undersea cable and the Tina River Hydro

Project – will also help to improve business conditions and improve productivity in the long term.

Fiscal Policy

Budget pressures resurfaced in 2019. Revenue underperformance, of around 5 percent in the first six months, reflected broad-based declines across major revenue categories most notably log export duties, import duties and corporate income tax.

Stabilizing public finances remains a priority for the government, but the general election in early 2019 interrupted progress on fiscal consolidation. The authorities are maintaining their efforts to strengthen tax compliance, to progress tax reform – including indirect tax reform, and to tighten expenditure controls and procurement processes at the Ministry of Finance and Treasury.

The authorities are committed to the current debt management framework which has been in place since 2012. Given the country's large infrastructure needs, the authorities are working closely with development partners, including China, to address these needs. On the preparation for the 2023 Pacific Games, the authorities are negotiating grant financing from bilateral development partners for the investments required, but are prepared to borrow if necessary, within the bounds of the debt management framework.

Monetary and Financial Sector Policies

The Central Bank of Solomon Islands will continue an accommodative monetary policy stance in view of the low inflation environment, the weak growth outlook and slowing credit growth. The authorities consider that the basket exchange rate peg remains an appropriate nominal anchor for Solomon Islands.

There remains structural excess liquidity in the banking system, reflecting limited demand for credit. The authorities acknowledge the staff advice around the options to reduce structural excess liquidity over time, including facilitating further offshore investment by the National Provident Fund. But with contained credit growth and low inflation, the authorities prefer a more gradual approach to avoid putting any unnecessary pressure on domestic banks.

The banking sector remains well-capitalized and profitable, in a shallow and under-developed market. Interest rates on lending remain exceptionally high, as do ATM fees, and the authorities are working with the banks (both foreign and local) to understand the drivers. A correspondent banking relationship has been established between the one local bank and its overseas counterpart for a period of three years from January 2019, which has reduced financial stability risks.

Given the temporary nature of the correspondent banking arrangement, the Central Bank is urging the local bank to ensure bank processes comply with the overseas bank requirements and for the local bank to provide regular updates to the supervision department. Additionally, the authorities are continuing to encourage the local bank to establish alternative correspondent banking relationships in non-USD currencies.

The authorities are continuing to implement a number of measures to foster financial inclusion. The next financial inclusion strategy plan from 2020 will shift focus to green finance to build climate change resilience and the authorities remain committed to mainstreaming financial literacy in the school curriculum.

Natural Disaster Resilience

Solomon Islands faces many natural disasters, including tropical cyclones, drought, earthquake, tsunami and flood. Disasters could occur with higher frequency and severity owing to climate change and global warming. In any year, there is a one in seven chance that the Solomon Islands will face a severe natural disaster.

The National Development Strategy released in January 2015 envisages higher investment in climate and natural disaster proof infrastructure. But the weak fiscal position hampers the ability for the authorities to prepare for a major natural disaster.

As a country that is highly vulnerable to climate change and exposed to shocks from high frequency of natural disasters, the authorities are pleased that the Debt Sustainability Analysis continues to take account of these factors. They acknowledge the importance of rebuilding fiscal buffers to respond to natural disasters and to undertake infrastructure investments to increase resilience.

Technical Assistance

The authorities highly value the capacity development and technical assistance provided by the Fund. In this regard, they very much welcome the addition of Annex 1 to the staff report, which highlights priority areas for technical assistance.

The authorities welcome continuing technical assistance on public financial management, cash flow management, and assistance to develop a medium-term revenue strategy, which should boost revenue collections from both tax and non-tax categories.

Given the weak monetary policy transmission channels, the authorities have also sought additional technical assistance for the development of a monetary policy framework while expressing an interest in follow-up technical assistance on reserve and exchange rate management and/or transfer pricing in the mining sector.

While the authorities highly value the assistance provided by the Fund, they encourage further efforts to coordinate technical assistance across development partners given capacity constraints. They are interested in knowing whether Annex 1 could be expanded to capture assistance provided by other partners such as the World Bank or OECD. The authorities consider that technical assistance at the operational level would also be very valuable as it would greatly enhance knowledge transfer and enhance the authorities' capacity to implement recommendations.

The authorities thank the Fund for their advice and ongoing technical assistance and look forward to further constructive engagement in the future.

Mr. Farber, Ms. Pollard and Mr. Shenai submitted the following statement:

We thank staff for their well-written staff report and Mr. Ray and Ms. Johnson for their helpful buff.

Macroeconomic performance since the conclusion of the ECF in 2016 has been mixed. Further reforms are needed to enhance resilience, preserve financial access, safeguard the peg, and catalyze non-logging growth. Striking the right balance between state-directed economic diversification while managing fiscal and financial risks will be key.

Given Solomon Islands' moderate risk of debt distress, the authorities should proceed cautiously on infrastructure investment to focus on high quality projects and refrain from non-concessional borrowing. The development of a medium-term revenue strategy while finalizing the PFM and Constituency Development Funds (CDF) Acts can create fiscal space for priority investment and social spending. Additional controls, particularly for CDF and line ministries, should help safeguard fiscal sustainability and reduce opportunities for corruption.

We urge the authorities to manage risks associated with the new Development Bank (DBSI) and to consider additional reforms to address gaps in financial access. Promoting banking sector competition can reduce high lending-deposit spreads, while deepening mobile money penetration can reduce transactions costs. We welcome the authorities' steps to strengthen the AML/CFT regime in line with the Mutual Evaluation recommendations. Additional staffing in the Financial Intelligence Unit should help boost financial transparency as well as AML prevention and enforcement.

Staff's External Sector Assessment finds that the real effective exchange rate is overvalued in both the CA and REER approaches. We hope the CBSI's review of the exchange rate basket will help address this real overvaluation by identifying basket weights in line with underlying fundamentals. IMF TA on reserve and exchange rate management could be beneficial. Greater disclosure of the composition of the basket would enhance transparency and confidence in the peg as well.

We strongly agree that improving the business climate while strengthening the anti-corruption framework can promote structural transformation and address governance weakness. We thought Annex VII was well-written and highlighted several plausible channels of diversification. We were surprised, however, to see staff seem to suggest import-substitution policies in the agriculture sector would be advisable in pages 14 and 44 in the staff report. We believe leveraging gains in connectivity and fostering specialization in niche markets, rather than import-substitution, would be a better approach to enhancing agriculture productivity. Additional staff comment would be welcome.

Mr. Buisse, Mr. Ronicle, Mr. Rozan, Ms. Freeman and Mr. Sode submitted the following joint statement:

We thank staff for their assessment of the Solomon Islands, and thank Mr. Ray and Ms. Johnson for their informative buff statement. As highlighted in the buff statement, the Solomon Islands are at an important juncture – with key challenges similar to those of many small island states, particularly the need to diversify the economy, boost investment in connective infrastructure, manage natural resource sustainably and adapt to the significant threats posed by Climate Change. How the authorities meet these challenges in the near term will be key to future sustainable growth. While we agree with the broad thrust of Staff's recommendations, we wish to focus comment on these key challenges.

Diversifying the Economy and Managing Natural Resource Sustainably

We welcome the Authorities' desire for sustainable logging, despite the challenges a reduction in output from this sector poses to the economy. The protection of nature on the islands will play a key role in resilience to climate change, in the protection of biodiversity, and for long-term growth and food security, and we hope that long-term natural resource management will feature heavily in economic planning. We agree that agriculture, fishing and tourism could be useful expansion sectors, and, if done sustainably, could build resilience and diversification into the Islands' long-term economic growth outlook. Staff mention that hedging should be possible for the logging sector. The World Bank has recently extended commodity hedging products for IDA countries. Has this been considered as a route for a logging hedge?

While over the medium-term mining remains a growth sector, it is essential to design the right policies and institutions to develop these resources. In its 2018 Country Partnership Framework with the Solomon Islands, the World Bank highlighted that "large scale mining is likely to exacerbate ethnic disputes and conflict in Solomon Islands if: (i) the wealth generated from mineral resources accrues mainly to foreign mining companies, limited numbers of powerful male landowners, and a central state that does not prioritize the use of these resources to enhance the delivery of public services; and (ii) the social and environmental costs of mining accrue mainly to the people in the surrounding area and the wider province". Hence, we welcome the provision of technical assistance by the Fund on the fiscal aspects of bauxite pricing. Could staff elaborate on the institutional readiness of Solomon Islands to sustainably develop its mining sector? Could staff share lessons on sustainable mining from other regional peers (for example, Nauru whose Article IV was recently undertaken)? We would also value comment on further technical assistance, as requested by the authorities, to support the Authorities' in the appropriate pricing of their natural resources. Lastly, we agree with staff's recommendations to support investment through building a more accommodating business environment.

Connective Infrastructure and the Financial Sector

The new undersea cable has the potential to bring significant development and economic benefits to the people of the Islands. As Staff state, putting in place the right mechanisms to support digital skills, the right regulatory environment, and encouraging private sector investment will be key to realizing the benefits and reducing the risks of digital. We hope that the support provided by New Zealand and the World Bank can be put in place ahead of the cable's completion.

We also see significant benefits of connectivity for financial inclusion and hope that the new 2020 financial inclusion strategy can ensure that no one is left behind, including those in more rural areas, women and girls, and those less able, as the country develops. We welcome the inclusion of green finance and climate resilience in the next financial inclusion strategy and hope that regional peers and development partners can share lessons in this space.

We hope that clearing the backlog of financial services legislation and fixing weaknesses in the AML/CFT framework will be a priority for the new government. The gaps found by the Asia Pacific Group 2019 Mutual Evaluation in the effective implementation of the AML/CFT framework should be addressed swiftly.

Climate Change

Climate change is a macrocritical risk for the country. We support staff's focus on the need to build a fiscal buffer to deal with future natural disasters. As the Debt Sustainability Analysis demonstrates, natural disasters can have a large impact on growth and debt dynamics. This highlights the very real challenges already facing the Islands. Given this, we would have liked more Staff analysis on how the Authorities' could invest in adaptation and therefore reduce the impacts of a disaster. We think the Solomon Islands would benefit from a Climate Change Policy Assessment and Disaster Risk

Management Strategy. Could staff comment on whether these have been considered?

Fiscal

While the 2023 Pacific Games will be an opportunity to showcase the Islands' as a host for tourism and to boost national infrastructure, it is crucial that investments related to this event remain contained and aim at delivering legacy benefits. Given debt trajectories and the need for future concessional loans and grant financing, we encourage the authorities to ensure all external financing is transparent and based on sound public finance practices. We agree with staff that the authorities should seek highly concessional or grant financing.

Lastly, there remains a need to invest in the Islands' Human Capital to meet economic growth and the sustainable development goals. Could staff comment on areas of focus, structural reforms needed and priorities for investment?

Mr. Sun and Ms. Lok submitted the following statement:

We thank staff for the informative set of reports and Mr. Ray and Ms. Johnson for the useful buff statement. Factors including a high exposure to natural disasters, dispersed population, and narrow economic base together pose significant development challenges for Solomon Islands. A comprehensive set of policies is needed to strengthen efficiency and governance to build buffers and foster sustainable and inclusive growth. We broadly agree with staff's appraisal and would confine our comments to the following.

To maintain resilience against shocks and support infrastructure and development spending, it is necessary to build on existing efforts and further improve fiscal management and planning. On the revenue side, we welcome the progress so far in recovering tax arrears and enhancing tax compliance. We encourage the authorities to maintain the current momentum and look forward to positive results in the implementation of tax reforms. On the expenditure side, efficient and effective management is key, and we take positive note from the buff statement that there are efforts to tighten controls and procurement processes at the Ministry of Finance and Treasury. Enhanced investment management and prioritization would be essential given the large spending needs expected for the 2023 Pacific

Games and infrastructure development more broadly. Given the above, we welcome the fact that public financial management, revenue administration, and tax policy are priority topics for Fund technical assistance to Solomon Islands.

Economic diversification through exploring new sources of growth is important for long-term sustainable and inclusive growth in Solomon Islands. We appreciate staff's detailed discussion on medium- and long-term growth opportunities in Annex VII of the staff report. To ensure that any new source of growth can fully meet its potential and result in broad-based benefits to the population, it is necessary to strengthen governance and reduce risks of leakages. We welcome the authorities' efforts and look forward to the finalization of the Mining Act and its effective enforcement. Meanwhile, we are also encouraged by the passage of the anti-corruption bill and the implementation efforts underway. Going forward, we encourage staff to continue to closely engage with the authorities and provide insights and technical assistance where needed to support economic diversification and development.

The monetary policy stance and basket exchange rate peg remain appropriate. We take comfort from the fact that a correspondent banking relationship has been established and in turn reduced immediate financial stability risks. To maintain this relationship, it is important to continue to strengthen governance and risk management in the banking system and fill remaining gaps in the AML/CFT framework. In staff's view, how can the Fund provide further assistance to the authorities in this area? Meanwhile, we concur with staff that measures are needed to ensure that the new Development Bank does not add to the country's fiscal risks.

With these remarks, we wish the authorities every success in their policy endeavors.

Ms. Mannathoko and Mr. Abdullahi submitted the following statement:

We thank staff for the helpful report and Mr. Ray and Ms. Johnson for their informative buff statement. As a small island state, Solomon Islands is susceptible to frequent climate shocks and this, coupled with a dispersed geographical location and exposure to commodity price volatility, places it under ongoing fiscal strain. The country now faces a deteriorating fiscal position and significant governance and structural challenges reflecting in part, over-dependence on a depleting natural resource. Despite the tangible progress in rebuilding institutions during an IMF supported program, fiscal, governance, and structural challenges have since remerged, pointing to underlying institutional weaknesses and the need for concerted efforts to address them. We note that after the recovery in growth to 3.9 percent in 2018, expansion slowed to 2.7 percent in 2019, and is projected to remain under 3 percent in the short to medium term as the current account deficit continues to widen and fiscal pressure builds up. We agree with staff therefore, that the outlook remains challenging, and broadly support the staff appraisal and their thoughtful recommendations. We offer the following comments for emphasis.

Prioritization of fiscal reform: In view of the significant downside risks to the outlook, we encourage the authorities to prioritize reversing the deterioration of fiscal balances. Progress on fiscal reforms and the stronger fiscal outcomes recorded in 2018, appear to have been interrupted by the election cycle. Concrete actions are needed to strengthen revenue mobilization and improve spending efficiency amidst emerging fiscal pressures. While we welcome the tangible steps that authorities are taking in this direction, we note that more needs to be done and support staff's recommendation that the authorities develop a comprehensive approach to medium-term fiscal policy, take steps to advance public finance management, and improve public investment management. We also agree with the sensible suggestion to set the tax reference price for logs in line with world market prices, to help curtail international profit shifting. Could staff comment on the extent to which these actions will enhance revenue collection and on how much revenue loss they currently represent.

Exchange rate policy: We concur with staff and the authorities that the current exchange rate peg to a basket is appropriate, especially given the likely resumption of mineral exports in the medium term. However, we also encourage the authorities to consider setting up an internal procedure or mechanism that will trigger internal discussions to realign the basket and peg with fundamentals, in response to large exogenous shocks, in order to avoid currency overvaluation. We welcome the authorities' planned review of currency weights in the currency basket, and of the management of exchange rate operations, and encourage them to use the review to also formulate an adjustment procedure or rule.

Financial sector reforms: We encourage the authorities to prioritize clearing the current backlog of financial legislation and strengthening the AML/CFT regime and its supervision. The establishment of correspondent banking relationships (CBR) by the single domestic bank is a positive development. However, the risk of reduced CBR services could still re-emerge, therefore a strong AML/CFT framework and relevant financial sector reforms remain important. We also urge the authorities to address shortcomings in the effective implementation of the AML/CFT framework in timely manner.

Structural reform and diversification: Diversification away from over-dependence on logging is a priority. While agriculture, fisheries and tourism have some potential to play a larger role in contributing to growth, the mining sector holds the greatest promise, but only if it is managed properly. In this regard, we welcome the authorities' commitment to create the necessary legislative and policy environment with strong enforcement to avoid the type of governance problems that affected the logging sector. We encourage them to be steadfast in designing and implementing strong mineral legislation and associated governance reforms. Could staff comment on the economic potential of this sector, particularly the size of gold and bauxite deposits that are commercially- exploitable?

We note that the undersea internet cable has significant potential to reinvigorate private sector growth and financial inclusion through improved connectivity and encourage the authorities to work on the requisite regulatory framework and human and capital investments needed to bring this about.

Governance reforms: Progress in strengthening governance and the anti-corruption framework is critical. To this end, we welcome the passage of the Anti-Corruption Act, however, we wish to highlight that the appointment of truly independent and credible commissioners for the commission falling under the Act will be critical in determining the effectiveness of this reform. Moving forward, establishing of an asset disclosure and monitoring system, and rejoining the Extractive Industries and Transparency Initiative will also be important.

With these comments we wish the authorities success as they pursue these reforms.

Mr. Mozhin and Mr. Biriukov submitted the following statement:

We thank staff for the set of insightful papers on Solomon Islands and Mr. Ray and Ms. Johnson for their informative buff statement. We generally agree with the thrust of the staff appraisal and would like to highlight several points.

We encourage the authorities to restore best fiscal practices that existed prior to the end of the IMF program in 2016. Fiscal position has deteriorated since then and the risks to the outlook are mostly on the downside. Cash balances remain low and could be completely depleted in the near term if no adjustment measures were taken. We see merit in fiscal buffers restoration to a level of around 2 months of total spending. This would provide ground for proper day-to-day cash management and create fiscal space to respond to small shocks.

The authorities need to take a conservative approach to the Pacific Games (PG) preparations even despite Solomon Islands' moderate risk of debt distress. Major international sporting events are not only expensive but also don't usually stay on budget. We recall that most of the facilities created for the 2004 Athens Olympics contributed to Greece's debt crisis and remain empty. In this respect, we support staff's proposal to contain PG investments and priorities spending in line with the National Development Plan.

Slowdown in logging activity brings the need to generate new sources of growth. Forestry has been a dominant sector in the economy, making up 60 percent of total exports. However, heavy dependence on logging is a vulnerability, given that the pace of harvesting is well above what is considered sustainable in the longer term. We commend the authorities for implementation of a sustainability policy with the aim of protecting the environment and ensuring sustainable economic growth. This would slow down the rapid depletion of the country's forests and reduce logging output. The mining sector, which is small but has considerable potential, could seize the initiative and become a new growth driver.

To reap the benefits from the mining sector, the authorities need to address regulatory difficulties and challenging operating environment, which remain the major obstacles for the sector. A high priority should be given to finalizing the Mining Act to create a conducive environment for mining. Gaps in agency coordination, tax administration and audit procedures also need to be tackled.

With these remarks, we wish the authorities success in facing challenges ahead.

Mr. Villar and Mr. Cartagena Guardado submitted the following statement:

We thank staff for a candid and well-informed Article IV report, and Mr. Ray and Ms. Johnson for their informative buff statement. We mostly agree with the thrust of the staff appraisal and want to emphasize a few points.

We commend the measures that authorities are taking to strengthen prudential regulation and the AML/CMT framework. It is instrumental to update Solomon Islands' financial legislation to tackle backlogs and boost a deeper financial sector. Stronger regulation will also be a good baseline to widen corresponding banking relations and to assure adequate payment systems both with foreign economies and domestic markets. Steps by authorities to promote new bills are important for the stability of the financial sector. We welcome capitalization of the banking system, however, we note with concern the rise of NPLs and the need to continue strengthening provisions for them. The financial inclusion strategy is a good step to promote financial deepening especially in the current environment of low ratio of credit-to-GDP, loan demand and high interest rates that constrain growth.

Strengthening the country's fiscal resilience is instrumental. We concur with staff that a short-term challenge is to strengthen the low cash balance, but policies to ensure revenue mobilization and control expenditures are also important, especially in the current context of revenue underperformance. The evaluation of new taxes and the modernization of the tax administration are positive steps by the authorities; the challenge remains executing policies in the short term considering the decline of logging revenues. We concur with staff on the importance of setting the authorities' medium-term fiscal strategy, which will create more certainty for policy making.

Building resilience to natural disasters and climate change is a challenge. We welcome the National Development Strategy that includes objectives such as creating a resilient and environmentally-sustainable development model for the country. As reported in Annex III, Solomon Islands is highly vulnerable to natural disasters and climate change; therefore, policy responses that develop fiscal buffers and space are important to fight these vulnerabilities and making the country more resilient.

Strengthening and enforcing governance standards remain a challenge. We welcome the steps taken in the framework of the authorities' anti-corruption agenda, including the anti-corruption bill. We concur with staff that strengthening transparency and regulatory oversight in the mining sector is instrumental for growth and revenue generation.

Capacity Development. We agree with staff on the need to assign high priority and resources to improve the macroeconomic statistics. The authorities' engagement with the Fund on technical assistance will help the country's capacity development goals.

Mr. Benk, Mr. Trabinski, Mr. Imashov and Mr. Zaborovskiy submitted the following joint statement:

We thank staff for the report, and Mr. Ray and Ms. Johnson for their informative buff statement. While Solomon Islands' past economic performance has been encouraging, the country faces significant challenges in multiple areas. In particular, the high dependency on the logging industry, and the rapid deforestation raise environmental and economic sustainability concerns. In this context, we broadly agree with staff's recommended policy approach and offer a few comments for emphasis.

Strengthening the fiscal framework will be crucial for sustaining economic growth, safeguarding fiscal sustainability, and ensuring resilience to exogenous shocks. Within the context of projected lower revenues in 2020, a medium-term fiscal policy strategy would support the authorities' economic objectives. Moreover, the public financial management capacities should be improved to strengthen budget credibility and public sector service delivery. We support staff's recommendations, including on building a cash balance, clearing domestic arrears, and prioritizing spending. Broadening the tax base and increasing revenue transparency would be welcome steps in this regard. We call on the authorities to advance in improving the reporting and audit standards to strengthen the use of public funds in service delivery. Staff comments on how the Disaster Contingent Savings Facility is operating would be welcome.

The monetary policy stance seems appropriate, but the growth outlook is uncertain and credit growth is moderate. Excess liquidity in the banking system remains high, in part reflecting lags between donor inflows and spending. We support staff's call to improve monetary policy effectiveness, notably by addressing constraints on the National Provident Fund investment abroad and the stemming CBSI valuation losses. We also encourage the authorities to continue to strengthen the AML/CFT framework, including through enforcing compliance. Meanwhile, with access to financial services still relatively low, we welcome the authorities' efforts to increase financial literacy and inclusion.

Effective governance is a pre-condition for the delivery of basic services and fostering investor confidence. Weak linkages between government agencies and provinces highlight the importance of building cross-governmental connections. The misalignment between budget and policy priorities have an impact on service delivery and public expectations. In this regard, enhancing the capacity and professionalism of public officials, as well as tackling corruption and governance issues, are of paramount importance. We encourage the authorities to address existing social needs, specifically in the education and healthcare sectors, as well as to tackle gender equality issues within the context of the 2016-2035 National Development Strategy. Moreover, we support the enhancement of the structural reforms for building institutional capacity and strengthening the governance framework to promote greater private sector participation in economic activity. Could staff elaborate more on the Fund's capacity building strategy for Solomon Islands?

Further diversification of the economy would support sustainable growth. While the country's geographic location and dispersion add an additional layer of complexity, reducing the significant infrastructure gap would have a positive effect on productivity and competitiveness. The forthcoming upgrades of transport infrastructure could support the further development of economic activity, especially in the tourism and agriculture sectors, and should promote a more efficient use of available resources. Improved internet access will support business activity and result in higher economic growth over the medium term. We take positive note that the next financial inclusion strategy plan from 2020 will focus on green finance to build climate change resilience. Could staff comment on the possibility of conducting a Climate Change Policy Assessment?

Mr. Merk and Mr. Braeuer submitted the following statement:

We thank staff for the well written report and Mr. Ray and Ms. Johnson for their helpful buff statement. The Solomon Islands are facing key challenges. Fiscal pressures are emerging with debt projected to grow substantially. Growth has slowed in 2019 and, with the logging industry in decline, generating new sources of growth is becoming an urgent challenge.

We see the need for stronger fiscal management and join staff's call to implement measures to keep fiscal buffers above a minimum level. On the spending side better quality of spending and better prioritization is needed. Spending on the Pacific Games should be grant-financed and contained and should deliver legacy benefits. On the revenue side we encourage the authorities to sustain the current momentum regarding the recovery of tax arrears and the strengthening of the revenue administration. A comprehensive medium-term fiscal policy would be beneficial and would enable the authorities to gradually begin building a buffer for natural disasters.

With logging unsustainable and in decline, diversification of the economy is needed to develop new sources of growth. We appreciated Annex VII of the report highlighting possibilities and challenges of possible diversification channels. Structural reforms to improve the business environment and progress in strengthening governance would help foster private sector development.

Mr. Sigurgeirsson and Ms. Skrivere submitted the following statement:

We thank staff for the report and Mr. Ray and Ms. Johnson for their helpful buff statement. We broadly share staff's appraisal and offer the following remarks on economic diversification and governance, fiscal policy, financial sector reforms, and technical assistance for emphasis.

Economic diversification needs to go hand-in-hand with measures to strengthen governance. Solomon Islands has been heavily dependent on the logging industry, with extraction well-above sustainable rates for many years. We thank staff for the very informative Annex VII, which clearly illustrates the need for economic diversification to support growth over the medium term and offers a helpful guide for new growth sectors. While the reopening of the Gold Ridge mine and the development of nickel and bauxite mining projects could offset the decline in logging activity, we strongly emphasize the need to develop and enforce a strong regulatory framework for the mining industries. If unaddressed, the governance concerns could undermine the positive effect these new sectors could have on growth.

More forceful efforts are needed to improve the fiscal position and make the Solomon Islands economy more resilient to potential shocks. We note with concern staff's projections of the erosion of the cash balance. In this regard, we encourage the authorities to strengthen revenue administration and improve the quality and efficiency of public spending. We also note with some concern the significant increases in planned infrastructure spending in relation to the Pacific Games and urge the authorities to ensure high levels of transparency and sound procurement and public financial management practices for the planned investments. More generally, we continue to see merit in staff's suggestion to introduce an operational fiscal target on the overall deficit to help guide policy action and the annual budget discussions, since the debt limit is currently not binding.

The resilience of the financial sector should be further improved. The progress on the re-establishment of correspondent banking relationships (CBRs) is encouraging. Nevertheless, the authorities should continue addressing governance concerns in the banking system to ensure that CBR pressures do not reappear. Additionally, we stress the need to address the gaps in the AML/CFT framework identified in the 2019 Mutual Evaluation. In this regard, we welcome the recently taken steps to strengthen the capacity of the FIU.

As a small low-income economy facing a range of development challenges, Solomon Islands should be helped by well-sequenced and coordinated technical assistance (TA). We welcome the information provided in Annex VI on TA priorities for FY20. We would be interested to hear from staff if there are efforts to create a standardized template for how TA activities are reflected in Article IV reports to ensure comparability and consistency across countries? We also take note of the authorities' comments in the buff statement on the possibility to also include information on TA provided by other institutions.

Mr. Chikada and Mr. Kuretani submitted the following statement:

We thank staff for the informative reports and Mr. Ray and Ms. Johnson for their insightful buff statement. The Solomon Islands faces various challenges and vulnerabilities, including its high dependence on logging activity, precarious fiscal position, large infrastructure gap and climate change. We view the Fund's advice and technical assistance crucial to help this small island state with dispersed population to tackle the challenges and address vulnerabilities. As we basically concur with the thrust of the staff's appraisal, we will limit our comments to the following points:

Growth Opportunities

Diversification should be the main pillar of overall growth strategy as well as hedge against vulnerabilities. We positively note that the authorities are aiming to transform their main industry from logging to other industries and find staff's analysis on the medium- and long-term growth opportunities (Annex VII) helpful to grasp the country's potential. At the same time, we would like to underscore the importance of diversifying export counterparts and sources of foreign investments.

Fiscal Policy

Building fiscal buffers by implementing fiscal reforms and careful consideration for large infrastructure projects are needed. We concur with staff that a fiscal buffer above minimum level is necessary to handle day-to-day cash management and to respond to small shocks. In this context, we encourage the authorities to take a comprehensive approach to medium term fiscal policy by making policy goals, identifying a spending envelope, and setting a medium-term revenue strategy (MTRS). We welcome the authorities' plan to introduce a VAT law and encourage them to implement more tax reform to generate revenue more efficiently, fairly and equitably. We welcome the TA priorities in Annex VI in staff report and found that public financial management (PFM) is the first priority. We encourage staff to work on this issue with the authorities and address PFM weakness. While the authorities are seeking grant financing from variety of bilateral development partners for the Pacific Games (PG), we take note with concern that there is a risk that PG spending is not fully covered by grants. We advise the authorities to be careful about PG related investment so as not to exacerbate fiscal position Related this, could staff provide more information on large infrastructure lending by development partners, including China, as mentioned in the buff statement.

Financial Sector Policy

Financial sector reforms are needed to continue to strengthen financial stability. We welcome the establishment of a correspondent banking relationship (CBR) for a domestic bank and reduced financial stability risks. However, the outdated financial sector legislation could undermine the financial supervision and financial system, and we encourage the authorities to further strengthen financial oversight by utilizing the Fund's TA in financial analysis and stress testing. We also welcome that the authorities' next financial inclusion strategy plan will focus on green finance to build climate change resilience. Could staff elaborate how the country intends to use green finance to increase resilience to climate change and how it is related to financial inclusion.

Mr. Tan and Mr. Srisongkram submitted the following statement:

We thank staff for the report, and Mr. Ray and Ms. Johnson for the buff statement. Economic growth in Solomon Islands slowed due to weakened logging demand, and the post-election transitions. The growth outlook is subject to substantial downside risks from both external and domestic sources, including fiscal slippages and climate change. The key priorities are therefore to strengthen the fiscal position in order to create sufficient buffers, to press ahead with reforms to promote new drivers of growth, and to create conditions conducive to sustainable growth. We agree with the broad thrust of the staff appraisal and offer the following comments.

Maintaining fiscal prudence and building fiscal buffers remain key priorities. We are somewhat concerned by staff's assessment that the fiscal position could deteriorate substantially in the absence of meaningful adjustments to rein in budget pressures. This risks further limiting available policy room to respond to the myriad of downside risks facing Solomon Islands and to build resilience against climate change. Given that revenue underperformance stems from slowing logging exports and domestic demand, near-term adjustments may need to rely on expenditure control. We agree with staff that expenditure control should be achieved through better planning and greater focus on improving the quality of spending so as to avoid growth impact associated with deep expenditure cuts. The FY2020 budget's focus on collecting arrears, capping tax exemptions and re-allocating/prioritizing expenditure is therefore welcome, and we underscore the need to calibrate and sequence these measures carefully to ensure growth-friendly fiscal consolidation. The authorities' commitment to the established debt management framework is well noted. To reinforce said commitment, we would emphasize the importance of securing grant financing for 2023 Pacific Games (PG) related spending. We also encourage the authorities to continue working with the Fund to develop a medium-term fiscal framework to anchor fiscal policies and foster fiscal sustainability over the longer horizon.

We welcome the authorities' careful approach to monetary and exchange rate policies. The CBSI's accommodative monetary policy stance is appropriate given growth uncertainties, subdued inflation and weak credit growth. Their preference for a more gradual approach to reducing excess liquidity is also in line with the broader policy stance. On the basket exchange rate peg, we agree with CBSI on the importance of sustaining competitiveness in a challenging global environment and thus view that the transition towards greater exchange rate volatility against the USD should take place gradually, especially given that logging is currently an important sector for the economy and is likely to remain so at least in the near future. Could staff elaborate on their statement that "the logging sector should be able to hedge foreign exchange risk"? How prepared is Solomon Islands if the CBSI were to allow greater volatility vis-à-vis the USD in terms of availability of hedging instruments and businesses' ability to manage exchange rate risk?

Diversifying the drivers of growth is essential to promote more sustainable growth. The authorities' ongoing efforts to develop a logging sustainability policy, to better capitalize on the country's mining resources and to improve connectivity are welcomed steps in the right direction. Good governance and strong regulatory oversight in the management of natural resources as well as a conducive business climate are important factors for realizing this goal. This is a daunting task given Solomon Islands' unique challenges arising from its remoteness, geographical dispersion, lack of local services provision and strained capacity as highlighted in the staff report. In this regard, we encourage staff to work closely with the authorities to provide more granular guidance, drawing on lessons from the logging sector as well as from cross-country experiences, and coordinating TA with other development partners to overcome capacity constraints as needed.

The authorities should remain steadfast in their efforts to strengthen and develop the financial sector. An effective AML/CFT framework and securing correspondent banking relationships (CBRs) are pivotal to safeguarding financial stability in small states. In this regard, we are encouraged by the CBSI's actions to address the Asia Pacific Group's (APG's) recommendations and to support the systemically important domestic bank in retaining established CBR and exploring alternative CBRs. What is staff's assessment on the likely impact on CBR in view of the gaps identified by the APG's mutual evaluation?

We wish the authorities success in their future endeavors.

Mr. Bhalla and Mr. Natarajan submitted the following statement:

We thank the staff for the detailed report and Mr. Ray and Ms. Johnson for the informative buff statement. After achieving a healthy growth in recent past, Solomon Islands is expected to face challenges arising due to structure of its economy and uncertainty arising in the export sector. While we broadly agree with the staff assessment of challenges of the economy, we also recognize the potential upsides which can augment future growth.

After clocking an average of 3.6 percent in 2016-18, growth rate is expected to decrease to 2.7 percent in 2019 and a modest average of 2.7 percent during 2019-24. Gradual decline in logging sector would affect growth but would be largely compensated by growth in mining and infrastructure. The downside risks comprise of fiscal weakness, decline in logging and global trade tensions.

On the fiscal front, we agree with the staff suggestion to strengthen cash balance management. The medium-term fiscal policy should aim at revenue generation and expenditure control measures in line with the priorities set in National Development Plan. Fiscal deficit is projected at -2.7 percent for 2019 and is expected to deteriorate further in the medium-term. We encourage the authorities to focus on recovery of tax arrears, strengthen tax administration and right pricing of logs and minerals to protect revenue.

Inflation has subsided to 1.7 in 2019 from 4.4 percent in 2018, and current account deficit has reached 4.5 percent of GDP in 2018 due to higher infrastructure imports. Considering the staff suggestion on exploring options for currency pegging, we welcome the authorities' proposal to review the exchange rate basket - its composition, weight and management of exchange rate operations. Financial sector is characterized by moderate level of NPLs. However, interest rate on personal loans at a high of 17 percent requires a better understanding of banks' pricing structure and processes. Could the staff comment on the possible reasons for this phenomenon and its impact on demand for credit and investment?

At a macro level, the economic base requires to be widened to develop sectors with high potential like agriculture, fisheries and tourism and diversification of products and markets for exports. This underscores the need for better business environment in the area of property rights, contract law, internet connectivity across islands, and transport & communication besides strengthening AML/CFT framework.

Mr. Chodos and Ms. Moreno submitted the following statement:

We thank staff for a well written report and Mr. Ray and Ms. Johnson for the informative buff statement. Solomon Islands' economy is showing signs of slowdown against a backdrop of weaker Chinese demand for logs. Logging is the main industry, but after overexploitation it is in need for better management and sustainable policy. The authorities face the urgent challenge of finding new sources of growth, which can be mining and fishery, to name the most prominent. In addition, structural reforms should be implemented, including those to strengthen governance, to curtail corruption and improve transparency. Fiscal debt remains low, but budget pressures have reemerged. The financial sector remains well-capitalized and profitable, though efforts to develop a deeper and more sophisticated industry could be boosted. Given the high vulnerability to natural disasters, the authorities need to promote investment in infrastructure to increase resilience against climate-related risks.

Fiscal policy should address the emerging budget pressures. We agree with staff that in the short term, the goal should be to take measures to sustain the cash balance at or above the equivalent of two months of total spending. Spending should be prioritized in line with the National Development Strategy (NDS), containing pressures on payrolls, and focusing on quality spending on health and education. We encourage the authorities to restore the fiscal consolidation process which was interrupted by the 2019 elections. Maintaining fiscal buffers above minimum levels and designing a framework with an operational fiscal target and a medium-term revenue strategy are desirable policies. We commend the authorities for eliminating domestic arrears, and suggest they continue the path of improving debt management to avoid it increasing in the near term. Negotiating grant financing from bilateral development partners should be attempted first, and if necessary, issue debt to finance the significant investment required by the Pacific Games 2023, appears as a sensible strategy to limit fiscal risk and debt accumulation. Lastly, fiscal consolidation and structural reforms would help narrow the current account gap that is widening, revealing a weaker external sector position than medium-term fundamentals suggest.

We agree with staff and concur with the authorities, that the stance of the monetary policy can continue being accommodative. Inflation is subdued and credit growth slowed, alongside a weakening activity. Regarding the currency, maintain the basket peg seems appropriate as it has served the economy well so long it is a useful nominal anchor.

The structural liquidity in the financial sector remains high and calls for policy action. Can staff comment on the tools that the Central Bank has to deal with this excess liquidity? We agree with staff that pursuing regional efforts to retain correspondent relationships and welcome that the Central Banks is urging the local bank to ensure bank processes comply with the overseas bank requirements and for the local bank to provide regular updates to the supervision department, as highlighted by Mr. Ray and Ms. Johnson. Overall, priority should be given to the moving forward with the legislative framework agenda including fostering financial inclusion.

Given the potential of the mining industry as a new driver of growth, we encourage the authorities to enhance efforts towards establishing a mining fiscal regime. Improving the business environment, as well as the connectivity, and investing in human capital are also strategies that can support medium-term growth. To support the medium-term fiscal consolidation strategy, and with advice of the Fund, efforts to progress on a tax reform should be maintained, as well as on strengthening tax compliance.

We welcome the technical assistance priority Annex and look forward to a close relationship between the authorities and the Fund. As stated by Mr. Ray and Ms. Johnson, a more granular advice on how to diversify the economy would be helpful. Assistance to improve macroeconomic statistics would allow for better understanding of the economy´s behavior on lead to better surveillance on the side of the Fund, and better targeted policies on the side of the authorities.

With these comments we wish the Solomon Islands authorities and its people the best in their future endeavors.

Mr. Psalidopoulos, Mr. Rashkovan, Ms. Korinthios and Mr. Zedginidze submitted the following joint statement:

We thank staff for the informative set of reports and Mr. Ray and Ms. Johnson for the helpful buff statement. We welcome the authorities' constructive engagement with staff as well as the considerable progress made since the tensions in the early 2000s - although economic, financial and governance challenges still remain. We broadly agree with staff's assessment and offer the following comments for emphasis.

Improvements in expenditure planning and public financial management are key to improve fiscal outturn. Indeed, the recent developments in public finances show weaknesses. In particular, we note that revenue shortfall in the first half of 2019 was significant, in part due to lower than expected economic growth. Also, declining overall balance in the staff's baseline forecast calls for gradual fiscal adjustment. We note that some progress has been made to improve tax collection, however the authorities should step up their efforts to strengthen revenue mobilization.

Regarding DSA, we note that data coverage is limited to central government, guarantees and the central bank. Could staff comment on why certain elements were not included in the DSA, such as state and local government?

Generating new sources of growth is paramount. We strongly believe that structural reforms should aim to increase diversification of the economy that has been dependent on logging activity for so many years. There are several undergoing infrastructure projects and we take note of staff's cautioning to be careful about possible fiscal risks. On the other hand, we see that staff appears confident about the new opportunities that could be opened up by the new undersea internet cable. We would appreciate further comments on this.

Tackling governance and corruption vulnerabilities are key for improving the business environment. In this regard, we share staff' policy recommendation to strengthen the enforcement of governance standards, improve transparency and advance the anticorruption agenda. We positively note the passing of the new anti-corruption bill and the establishment of the secretariat in the Prime Minister's office. Also, we commend the authorities' interest in continued Fund technical assistance to support the effective implementation of the anti-corruption bill and we agree with them on the importance of coordinated technical assistance across development partners. Among other measures suggested by staff, the enforcement of the law targeting high-level corruption should be a high priority on the agenda of the authorities.

We see that in the banking system structural excess liquidity remains. While we take note of staff's advice around the options to reduce structural excess liquidity over time, including facilitating further offshore investment by the National Provident Fund, and see merit in the authorities' view of a more gradual approach to avoid putting any unnecessary pressure on domestic banks. Moreover, a high interest rate spread on lending most likely indicates lower efficiency in the banking sector, but we believe that a better understanding of banks' pricing models should help to gain further insight on this matter and design corrective measures.

Finally, we welcome staff's emphasis on climate related risks in the report. The Solomon Islands is particularly vulnerable for climate change related risks, like many other island states. We agree that climate change can have profound downside effect and should be considered macro-critical. Therefore, we also welcome the authorities' plan to integrate green finance and climate resilience objectives into the financial development strategy.

With these remarks, we wish the authorities success in their future endeavors.

Ms. Levonian, Ms. McKiernan and Ms. Smith submitted the following statement:

We thank staff for their thorough and comprehensive report and Mr. Ray and Ms. Johnson for the insightful buff. We note that economic conditions in the Solomon Islands have softened in recent years; however, the authorities seem sensitive to the country's vulnerabilities and are taking steps to address them. Against this background, we are generally in agreement with staff's assessment and recommendations and will focus our comments on issues surrounding economic growth, fiscal policy, financial sector development, and climate change resilience.

Developing strong institutional frameworks is critical for supporting diversification of the sources of economic growth. The viability of the logging industry – the cornerstone of the economy – continues to diminish amid both supply-side and demand-side challenges, which makes developing new sources of growth a pressing priority. Moreover, with escalating health concerns, demand from China may wane more than previously estimated. Accordingly, we agree with the suite of suggestions for diversification, including promoting agriculture, tourism, and the mining sector. We would add that sound legislation and policies that support human capital development (across all demographics) and investment (both domestic and foreign) are crucial to sustaining these industries.

In this context, reforms to improve governance, including the enactment of anti-corruption legislation and complementary institutional changes, should improve transparency and efficiency, which, in turn, would support diversification. We expect that the transition from heavy reliance on logging to other viable industries will be difficult, and the authorities may benefit from further staff analysis and technical assistance.

We agree with staff's recommendation that adequate resources are directed to the compilation and dissemination of economic data. From that perspective, would staff have data on labor force participation and income, by gender?

Fiscal responsibility and debt sustainability remain paramount for achieving long-term goals. The overall deficit-to-GDP ratio has been on a gradual rise and is expected to climb further in the coming years. Against this backdrop, we concur with the measures put forward by staff to broaden the tax base and strengthen revenue administration. We also applaud the authorities' progress in this regard thus far.

As it relates to spending, we endorse staff's call for a focus on productive spending. Moreover, given the ambitious capital investments plans in the pipeline, the authorities may seek to shift some of recurrent spending toward capital expenditure. To this end, a strengthening in public finance and debt management is imperative for accomplishing developmental goals without compromising fiscal sustainability.

Sustained progress on financial sector reform is crucial for boosting investment and mitigating risks to financial stability. Staff's report highlights several financial sector deficiencies, namely rising non-performing loans, very high interest rates, and deficiencies in the AML/CFT framework. We acknowledge the authorities' efforts toward addressing these challenges and encourage them to continue making progress. Notably, the substantial increase in Financial Intelligence Unit personnel and the launch of digital banking to give persons in rural areas access to financial services are steps in the right direction. Further continued investigation of the underlying factors contributing to high interest rates is also necessary as lower borrowing costs may aid in absorbing excess liquidity.

Building resilience to natural disasters is necessary but needs to be balanced against competing fiscal demands. We appreciate staff's emphasis on the Solomon Islands' high susceptibility to natural disasters, as well as their work in including natural disaster shocks in their debt sustainability analysis. However, given the high probability of these shocks and their potential to severely damage fiscal and growth prospects, what progress, if any, has been made in resilience planning and infrastructure development?

Mr. Sylla, Mr. Nguema-Affane and Mr. Ondo Bile submitted the following statement:

We thank staff for the comprehensive set of reports, and Mr. Ray and Ms. Johnson for their informative buff statement.

Decisive policies and reforms are needed to maintain macroeconomic stability in the Solomon Islands. We note that weaker logging activity, higher imports for donor-financed investment projects, and lower domestic demand due to the organization of elections have led to growth moderation and the deterioration of fiscal and current account balances in 2019. Downside risks to the outlook are significant and include fiscal policy slippages, rising protectionism, a less favorable global economic environment, loss of correspondent banking relationships, and vulnerability to more frequent and severe natural disasters. These point to the need for steadfast implementation of sound policies and bold reforms to support economic transition away from the logging sector to new sources of growth while preserving macroeconomic stability and enhancing resilience to shocks. We broadly share staff's policy recommendations in this regard and wish to make the following comments for emphasis.

A comprehensive fiscal policy should be undertaken to rebuild fiscal buffers and contain fiscal risks notably those stemming from the organization of the 2023 Pacific Games. In light of re-emerging fiscal pressures from lower revenue and increasing spending, we agree that a comprehensive approach to fiscal policy is needed to put public finances on a sound footing. In this vein, the measures in the 2020 budget to strengthen revenue mobilization and enhance spending efficiency should be steadfastly implemented. The ongoing fiscal reforms, including the planned introduction of VAT, should as well be accelerated. Moreover, we consider appropriate the staff's recommendations to prepare a Medium-Term Revenue Strategy and further strengthen public financial and investment management. Given the country's exposure to natural disasters, building buffers is crucial to increase resilience. At the same time, support from the international community is needed to help the country adopt viable climate-change adaptation and mitigation strategies. In this connection, we urge the authorities to develop a natural disaster contingency plan. Moreover, greater transparency and accountability of Constituency Development Funds (CDFs) should be pursued to ensure quality and effective development spending.

While monetary and exchange rate policies have been prudent, efforts to enhance the monetary policy framework should be sustained. We agree that the current monetary policy stance is appropriate and encourage the authorities to pursue reforms to reduce excess liquidity and improve monetary policy effectiveness. Regarding impediments to greater monetary policy effectiveness, could staff elaborate more on the constraints on National Provident Fund (NPF) investment abroad? On exchange rate policy, we welcome the upcoming revision of the exchange rate basket to, among others, determine the appropriateness of the basket's composition and currency weights. The Central Bank's readiness to follow up on previous TA advice on reserves and FX management to guide actions going forward is also commendable.

The financial sector supervision and oversight framework needs further strengthening to preserve stability. The re-establishment of a correspondent bank relationship (CBR) with the systematically-important domestic bank is welcome. However, continued efforts are warranted to address the gaps in governance and risk management in the banking system. In addition, improving the effectiveness of the AML/CFT framework is critical to secure and maintain CBRs. We welcome the ongoing implementation of the Asian Pacific Group Mutual Evaluation's recommendations to this end and to safeguard financial stability. Moreover, we encourage a swift adoption of key legislations to modernize the financial sector. We commend the progress made in fostering financial inclusion, notably through the NPF and the new Development Bank (DBSI). The development of a new financial inclusion strategy focused on green finance to build resilience to climate change, highlighted in Mr. Ray and Ms. Johnson's buff statement, goes in the right direction. We also support the authorities' intention to address the relatively high lending interest rates that constrain private sector development and look forward to positive developments on this issue in the next staff report.

Structural reforms should focus on improving the business climate to support private sector development, notably in areas of large growth potential. Considering the expected decline of logging exports--the main source of revenue and employment over the past ten years--reform efforts should target sectors with high growth and employment potential, such as mining, fisheries, agriculture and tourism, and leverage the improved internet connectivity. We look forward to the strengthening and implementation of the anti-corruption framework as well as other legislations and reforms that would address corruption vulnerabilities, improve governance, and increase transparency in the management of the growing mining sector. In this regard, we echo the authorities' call for enhanced TA from the Fund and other development partners.

With these remarks, we wish the authorities of Solomon Islands success in their endeavors.

Mr. El Qorchi and Mr. Alavi submitted the following statement:

We thank staff for an insightful report and Mr. Ray and Ms. Johnson for their informative buff statement. We are in broad agreement with the staff appraisal and wish to underline the following points for emphasis.

Solomon Islands has made commendable progress towards rebuilding institutions, strengthening governance, and preserving overall macroeconomic stability. In recent years, growth performance has been strong, inflation remained contained, and international reserves coverage has been adequate. Nonetheless, growth appears to have decelerated in 2019 reflecting weaker export and election-related temporary interruptions in economic activity. Growth prospects, over the medium term, are subject to risks from weak policy setting, a widening current account deficit, and deteriorating fiscal position. Continued depletion of an already over-exploited forestry resources and the country's elevated vulnerability to severe natural disasters pose substantial challenges to long-term growth sustainability. Against this backdrop, we urge the authorities to press ahead with a set of well-coordinated policies and reform efforts to properly mitigate and manage growing fiscal risks, create policy space, and build resilience against shocks. Diversifying the economy and generating new sources of growth are also needed to create jobs, support intergenerational distribution of natural resources, and ensure long-term sustainability.

Improving the fiscal position is key to creating room for policy maneuver in the context of emerging fiscal strains—particularly due to the 2023 Pacific Games— and lower revenues leading to an erosion of fiscal buffers. In this regard, we support the envisaged measures in FY 2020 budget to strengthen revenue administration and improve spending efficiency. Adoption of a medium-term fiscal strategy supported by carefully implemented tax reforms—including the introduction of VAT—and strengthening financial management are needed to achieve fiscal sustainability. Additionally, addressing transparency deficit in the spending of Constituency Development Funds will improve budget outcomes and enhance the quality of spending.

We welcome the authorities' accommodative monetary policy in an environment of slowing economic activity and subdued inflationary pressures. We also agree that the basket exchange rate peg has proved to be an appropriate nominal anchor in the context of weak interest rate transmission channel. We welcome the ongoing review of the basket's composition and recommend its adoption as a regular annual exercise. We also encourage managing the exchange rate in line with the basket weights to lessen the erosion of competitiveness.

Financial sector reforms should focus on mitigating risks to financial stability and preventing potential fiscal cost. In this regard, we welcome the re-establishment of correspondent banking relationship for a domestic bank. Further improving governance and strengthening risk management in the banking sector would foster financial sector stability—while strengthening the effectiveness of the AML/CFT framework in line with recommendations of the recent APG Mutual Evaluation—will enhance the sector's integrity and credibility. We also support the ongoing efforts to foster financial inclusion and look forward to the recalibration of the authorities' financial inclusion strategy with emphasis on green finance and climate resilience.

Salmon Island's current economic model of heavy reliance on primary commodities—and the logging industry in particular—is unsustainable. Therefore, we welcome the authorities' recognition of the need to diversify and transform the economy away from logging activities to generate new sources of growth. Tourism, mining, fisheries, and agriculture have the potential to underpin the authorities' diversification agenda. The new undersea internet cable project should also contribute to better connectivity and low-cost service delivery. Investing in human capital, reducing infrastructure gaps, and creating a business-friendly environment would facilitate the authorities' development goals.

We wish the authorities continued success.

The Acting Chair (Mr. Furusawa) made the following statement:

Good morning, everyone. We begin with today's agenda item on Solomon Islands - 2019 Article IV Consultation. Bank staff is attending this meeting. Seventeen gray statements have been issued by 20 Directors.

Solomon Islands experienced favorable economic performance in recent years. However, growth has slowed, the fiscal position is deteriorating, and governance challenges remain. In addition, Solomon Islands remains highly vulnerable to natural disasters. In your gray statements, you highlight that sound policies and structural reforms are needed to maintain stability, diversify the economy, and promote sustainable growth.

I think today's discussion could usefully focus on the key issues reflected in your gray statements, the need for new sources of growth, which are environmentally sustainable, and the need for capacity development to address the challenges and risks.

With that, I would like to open the floor for a discussion. Mr. Ray, would you like to start? Would the staff make brief remarks on the key issues?

The staff representative from the Asia and Pacific Department (Ms. Stuart), in response to questions and comments from Executive Directors, made the following statement:[1]

I would like to thank Directors for their thoughtful statements. I have a couple of remarks based on the gray statements. I have one new update, and then I will speak briefly to the issue of capacity development.

First, recent indicators suggest that growth may have been somewhat weaker at the end of 2019 than we had expected at the time of the mission. Exports came in lower than expected in November and December, and the

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

central bank's production indicator pointed to a continued slowdown in logging, palm oil, and fishing exports. These were partly offset by an increase in copper exports.

Second, a number of Directors asked about capacity development for Solomon Islands and the strategy. As a small economy facing many different capacity development needs, the Article XIV team always focuses heavily on thinking through the areas in which the Fund can usefully provide support and how best to do that. We liaise closely with our colleagues at Pacific Financial Technical Assistance Centre (PFTAC), who are the main providers of Fund capacity development to Solomon Islands.

As you see in Annex VI, the Fund is engaged in capacity development in a number of key areas that are also major issues for surveillance; for example, such as strengthening public financial management, improving revenue administration, looking at the overall setting for a Medium-Term Revenue Strategy, and improving governance and risk management in the banking system. In each of these areas, we discussed with the authorities what they see as their needs; and in some areas, we tailor the assistance more narrowly and more narrowly targeted if we see that progress has slowed in some areas, taking the example of public financial management reform, for example.

We discuss in each area with the relevant expert at PFTAC to see how best to make progress. On occasion, PFTAC experts also join part of the Article IV mission, especially if the capacity development area is particularly high on the surveillance agenda as well.

As Solomon Islands is one of the highest users of PFTAC capacity development, we do have quite close coordination between PFTAC, the Asian Development Bank (AsDB) and World Bank, with regular collaboration individually and regionally. There are also various official forums, such as the PFTAC Steering Committee, the Friends of Budget Support meeting of development partners, and the authorities' meetings with the core economic group which help in terms of coordination.

Nonetheless, for small developing economies, the sequencing and coordination of capacity development with multiple donors and development partners is always an ongoing challenge. We try to make sure that our support is not duplicative of other donors and that our advice is also presented in a sequenced way.

The effective integration of both capacity development and surveillance is a top priority for the Asia and Pacific Department (APD), and it is something that we continue to work continuously on.

In this year's report, we did choose to experiment by adding Annex VI, which a number of Directors commented on. We had seen something similar in other staff reports and thought it would be a useful way to summarize capacity development efforts, and we can continue to experiment in the future.

Those are the points that I wanted to make to the Board.

The Acting Chair (Mr. Furusawa) made the following statement:

Thank you very much for the update and the useful information on capacity development efforts.

Do Directors who have not issued a gray statement want to take the floor?

Mr. Alkhareif made the following statement:

Solomon Islands is a culturally and geographically diverse country, but it faces many challenges when it comes to economic diversification. In this context, we welcome the authorities' efforts to enhance economic diversification.

We note from Mr. Ray's buff statement that the authorities are keen to receive granular policy advice on economic diversification policies and reforms. We encourage the IMF to enhance its cooperation with the World Bank and other international organizations that have capacity and technical expertise in these areas.

Indeed, economic diversification does not mean import substitution. I very much support the points raised by Mr. Farber and his colleagues in their gray statement, that instead of focusing on import substitution, the country should focus on leveraging its comparative advantage and building productivity for their human capital base.

We encourage the authorities' efforts to enhance governance and improve the business environment, which is key for greater economic diversification.

On the fiscal front, we encourage the authorities to create fiscal space for priority investment and social spending. We note the revenue underperformance, and we encourage the authorities to develop a robust Medium-Term Revenue Strategy. We also encourage the authorities to strengthen the public financial management and the debt management capacity. And here, I welcome the remarks raised by the mission chief about capacity development in this area.

On monetary and financial sector policies, we agree that the basket exchange rate peg serves the country well. The banking sector is very liquid, profitable, and well capitalized. We welcome the re-establishment of the correspondent banking relationship for the domestic bank. Here, we encourage the authorities to continue their efforts to enhance the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) framework, in line with the mutual evaluation recommendations.

Finally, we commend the authorities for their efforts under the national development strategy to enhance investment and climate-proof infrastructure. We also support their efforts to build fiscal buffers to create more room for future natural disaster resilience. Indeed, the focus should be on climate adaptation, rather than climate mitigation, and we encourage further efforts in this area.

With these remarks, we wish the authorities success in their future endeavors.

Mr. Trabinski made the following statement:

Many thanks to staff for the excellent report and Mr. Ray for his buff statement.

We broadly share the thrust of the staff appraisal enclosed in the report. We have just one short question.

We share the staff's view regarding the need to improve conditions for the private sector to unleash the organic growth of this part of the economy. However, one of the many impediments pointed out by staff in the report concerns the communal landownership. It seems that granting ownership of land would be a good step forward to improve private sector performance also, but not only by lowering the bank interest rates offered on loans. Could staff provide us more information about the authorities' approach to this particular issue? Specifically, are there any plans to change the status quo? If not, what are the obstacles to this?

Ms. Levonian made the following statement:

I would like to thank staff for the comprehensive work and Mr. Ray and Ms. Johnson for the very helpful buff statement. We covered our main thoughts in our gray statement, so I will be very short.

First, Solomon Islands' vulnerability to climate change and natural disaster is undeniable. Moreover, like many other states, although the authorities are willing to take steps toward building resilience, their resources are constrained. For this reason, we must continue to find effective and achievable measures to build resilience to natural disasters, including concessional financing.

Second, diversifying the growth model by shifting its reliance on and resources from one industry to another can be very difficult. In the case of Solomon Islands, it will require a fair amount of new capital technology, knowledge, and expertise. Therefore, the authorities will benefit from realistic, manageable tools and advice that are tailored to their country-specific circumstances.

Third, I encourage the authorities to more aggressively pursue financial sector development and stability, given its importance for long-term growth and development.

Lastly, as staff offer assistance to the authorities in compiling and publishing macroeconomic statistics, I encourage them to include labor force and income statistics by gender.

Ms. Moreno made the following statement:

I thank staff for the report and Mr. Ray and Ms. Johnson for the informative buff statement. We agree with the staff recommendations and also with the issues raised in the report, and also with the issues raised this morning by the Chair in his opening remarks, so I am not going to repeat those issues.

I only have one question, could staff comment on the tools that the central bank has to deal with excess liquidity in the financial sector, which appears to be structural.

Mr. Rashkovan made the following statement:

I thank staff for the interesting reports and Mr. Ray for the helpful buff statement. We issued a joint gray statement, so I have just a few comments.

First, we associate ourselves with Ms. Levonian's comments on the climate issues on Solomon Islands.

Second, we know that the Asia Pacific Group Mutual Evaluation Committee finds gaps in the implementation of the AML/CFT framework, and we positively note the authorities' willingness to increase the oversight over the AML/CFT risks and to strengthen the framework, based on the evaluation's recommendations, but we ask staff to follow this.

In addition, in the evaluation report, we find that some of the caveats of the central bank's current oversight are limited coverage of the assessment of high-risk customers and a lack of internal controls for financial institutions. We believe that the newly established correspondent bank should harness benefits on the AML/CFT front as well. Having centralized correspondent banking should make it easier to effectively implement the AML/CFT framework. We highlight the macro-criticality of these issues and encourage staff to follow up during the next Article IV mission.

Third, given the limited operational framework and integration to the Australian market, we agree with staff that the exchange rate peg, as a nominal anchor, is appropriate. We note that inflation seems well contained. At the same time, it is a little bit strange that the report does not have anything about the central bank per se. So how do you see it? It would be interesting to see the comments of staff from the central bank. How do you see it? Is it strong enough? What are the weaknesses and the strengths of it?

Finally, in line with the recently published strategy for fintech applications in the Pacific island countries, we see some potential of fintech to improve financial inclusion in the Solomon Islands. Again, with this in mind, and in the framework of the Bali Fintech Agenda, this report does not have anything on fintech, so your comments are welcome.

Mr. Farber made the following statement:

We issued a gray statement. We have one brief point to make this morning, as many of the points have already been covered by Mr. Alkhareif.

Solomon Islands' unique geography presents opportunities and challenges for infrastructure investment. This chair welcomes the authorities' commitment to the current debt management framework, but at the same time, we urge the authorities to manage the debt sustainability risks associated with both Pacific Games in 2023 and other investments carefully, including by avoiding collateralization, sticking to grants and concessional loans, disclosing the full terms of any bilateral debt, and promoting debt transparency and ensuring high domestic content. With that, we welcome staff's continued engagement on debt management and also thank them for the responses to the technical questions. We wish the authorities well.

The Acting Chair (Mr. Furusawa) - Are there any other comments or questions from Directors? If not, let's hear from staff. Could the staff comment on the issues raised by Directors and answer the questions, please.

The staff representative from the Asia and Pacific Department (Ms. Stuart), in response to further questions and comments from Executive Directors, made the following additional statement:

On the question about customary landownership, it is a big challenge. It is deeply rooted in the culture, and the bulk of Solomon Islands' land is customarily owned so it is difficult for developers to develop because they need to negotiate with a lot of people in order to gain access to the land. It is a challenge often for infrastructure development; for example, for the Gold Ridge mine and also for negotiations for the internet cable landing site. Solving it would definitely help because then you could develop things like mortgage markets.

What are the authorities doing about it? They have worked with the World Bank on this issue. They are looking at ways in which they can bring in all stakeholders in the community of the customarily owned land so that this can also improve gender access to the wealth provided by the land.

It is a very long haul. It is a tricky issue, and it requires a lot of negotiations. It is something that we think will take a long time to fix, but it is an issue that the authorities are aware of and are trying to manage.

On the issue of excess liquidity, financial sector development would help here. In the recent past, the central bank's balance sheet position, which was negative, was holding back the development of the Bokolo bill market; but looking forward, excess liquidity could be handled better, if that market were able to grow.

Also, the National Provident Fund is an important depositor in the banking system. Part of the contribution to the excess deposits is from the National Provident Fund, so actions that enable it to invest partly abroad, as well, would also help.

On the central bank's capacity, the central bank has, I would say, good capacity in terms of economists. I still think the basket exchange rate peg is the right exchange rate regime for the central bank. We had good discussions on economic issues with the central bank and, for example, can talk them through the external sector assessment and the Debt Sustainability Analysis, so there is a good cadre of young staff there who work well.

We are currently discussing with the Monetary and Capital Markets Department on how to make follow-up technical assistance targeted on the issue of reserves management. Also, they are thinking about this review of the exchange rate basket composition.

On fintech and financial inclusion, the authorities are actually very active in terms of thinking about promoting financial inclusion and have been promoting mobile money in the remote islands. That has taken off quite well, and they are up to stage two of that financial inclusion process. It is something that we have covered in the report last year and the previous year to that, so we focused on it a little less in this year's report.

The Acting Chair (Mr. Furusawa) - Thank you very much for your very insightful and constructive comments. To conclude the discussion, I call on Mr. Ray.

Mr. Ray made the following concluding statement:

Let me start by thanking colleagues both for your comments this morning but also for your thoughtful contributions in your gray statements. We will communicate them to our Solomon Islands authorities.

Solomon Islands is one of the larger Pacific island countries, and it has one of the stronger natural endowments as well. Parts of it are particularly beautiful; other parts, perhaps not so. It has some very good mineral assets, and it had some very good forestry assets. It has fish, et cetera. But it shares many of the challenges of the other countries in the region. Its remoteness and geography pose unique challenges. It has a widespread population, a limited economic base, and is increasingly vulnerable to natural disasters--one of the more vulnerable countries to natural disasters in the world, just because of geography--and also to climate change. The Pacific Ocean is rising faster in the Solomon Islands than in most other parts, for some scientific reason I will not pretend to understand; but it does mean that they have actually lost some islands in recent years.

Just as an example, we had a Solomon Islands colleague in our office until very recently. He is from the central bank, and his family is a 30-hour boat trip from Honiara. When I say “boat,” it is what we would call a tinny in Australia. It is a small, aluminum dingy with an outboard motor and, hopefully, if he is lucky, a tarpaulin over the top to keep the sun off. Thirty hours, it gives us a sense of how spread out these islands are.

His home island is being eroded by the sea and has saltwater coming up through the soil. There has been serious thought of moving the whole population off the island, and that would mean that they would have no land.

My authorities are fully aware of the challenges they face, and they welcome the mission team’s advice, but they are in a difficult environment. The government remains committed to making some positive changes in terms of stabilizing public finances, particularly through tax reform, completing key infrastructure projects, like the hydro dam and the undersea cable, and implementing measures to tackle corruption.

I might also mention that they are aware of the fiscal risks of hosting the Pacific Games, which comes around to each country in the Pacific. That is an issue that I think other islands have had to wrestle with, but it is a very important set of games in the Pacific.

Staff were right to focus on the economic and governance challenges facing my authorities, but diversification for small states is difficult. I agree with those who have commented about leveraging comparative advantage.

As colleagues have raised, landownership in the Solomon Islands is all customary. It is also often contested, so that even the transition to mining could lead to increased tensions and will require careful policy management by the authorities, part of which is to get their fair share. Coming from a mining country, I know that that can be difficult for the best of us, for those of us with a lot more resources than the Solomon Islands. It is something that Fund staff should keep a very close eye on.

There are significant opportunities for diversification to mining, but it does come with risks. A lot of it has to do with making sure that there are well-functioning institutions capable of handling both the foreign investors and socioeconomic change. It is here where I think the Fund can assist by providing more a granular analysis on the challenges for particular sectors and by outlining practical implementation pathways.

As Ms. Levonian stressed, the reform agenda should be tailored to take into account capacity and also the particular characteristics of the country. It should also leverage support from regional and international development partners. While the Fund is playing a critical role in providing capacity in the Solomon Islands—and my authorities are grateful for that—it could also assist in coordinating some of the assistance from other development agencies, perhaps through PFTAC.

I would like to welcome the addition of both Annex I and Annex VI in the report.

Just as a personal comment, I think Ms. Stuart hinted at it, that most of the capacity sits in the central bank, which brings with it its own challenges.

Let me conclude by thanking the entire mission team, led by Alison Stuart, for both the excellent and constructive work that they put into the whole process. I thought that the answers to your technical questions showed how much they know. It never ceases to amaze me how much a small team knows about some of these countries.

I would also like to take the opportunity, a little bit more broadly, to thank Alison for her leadership of the Small States Division in APD. I wish her well in her new role.

The Acting Chair (Mr. Furusawa) - Thank you very much, Mr. Ray. We wish the authorities success.

The Solomon Islands is an Article VIII member, and no decision is proposed. The 2019 Article IV consultation with the Solomon Islands is hereby concluded.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the recent growth performance, the improvement in the fiscal position in 2018, low inflation and a comfortable international reserves cover. However, they noted that growth is slowing, fiscal pressures have begun to re-emerge and risks to the outlook are mostly on the downside. Directors urged the authorities to maintain fiscal discipline, strengthen governance and improve the business environment to sustain growth.

Directors emphasized that policy measures are needed to secure fiscal sustainability and build resilience, including to natural disasters through investment and contingency planning. They encouraged rebuilding the government cash balance, for which it would be essential to strengthen expenditure control and prioritize spending in line with the National Development Strategy. Sustaining efforts to boost revenues, increasing tax compliance, improving efficiency of the tax system and strengthening revenue administration would also bolster the fiscal position.

Directors urged the authorities to press ahead with expenditure reforms which would improve budget outcomes and the quality of spending through strengthening procurement planning, enforcing commitment controls, and greater transparency of the Constituency Development Funds. Directors stressed prudent management of development partner-financed infrastructure investments. Spending for the Pacific Games 2023 should be contained, financing should be transparent, follow procurement and public financial management best practices, and should be on grant or highly concessional terms in line with debt sustainability and implementation capacity. Directors welcomed the progress in anti-corruption efforts and encouraged stronger enforcement.

Directors considered that the basket exchange rate peg regime remains appropriate for Solomon Islands. They welcomed the review on the composition of the basket. Fiscal consolidation and structural reforms would help bring the external sector position closer to that suggested by medium-term fundamentals.

Directors emphasized the need to generate new sources of growth and viewed improved internet connectivity as an opportunity to foster private-sector development and public sector service provision. Harnessing benefits from connectivity would require improvements in the regulatory framework, and complementary investments in infrastructure and human capital. Progress in strengthening governance should continue where improvements in the legislative framework, regulation and oversight would be necessary to create a conducive environment for mining and avoid governance problems.

Directors encouraged the authorities to sustain progress on financial sector reforms. The strengthening of the AML/CFT framework would help alleviate risks to correspondent banking relationships.

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

APPROVAL: August 30, 2021

CEDA OGADA
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Fiscal Policy

1. ***We also agree with the sensible suggestion to set the tax reference price for logs in line with world market prices, to help curtail international profit shifting. Could staff comment on the extent to which these actions will enhance revenue collection and on how much revenue loss they currently represent?***

- To reduce the scope for transfer pricing, the government has simplified the scheme for determining the export price for logs by reducing the number of categories and making it less complex. However, staff is of the view that the reference price for logs remains well below international market prices, resulting in foregone government revenues. Between 2016 and 2018 reference prices were adjusted by 10-15 percent, a small increase compared to the substantial gap with world market prices. The delayed adjustment in reference prices resulted in lost tax revenues estimated at about 2.7 percent of GDP in 2016. Rough estimates (Box I in the Solomon Islands 2018 Article IV Staff Report), showed that foregone revenues were as high as 5 percent of GDP for 2017.

2. ***We call on the authorities to advance in improving the reporting and audit standards to strengthen the use of public funds in service delivery. Staff comments on how the Disaster Contingent Savings Facility is operating would be welcome.***

- The Asian Development Bank (ADB) approved a Disaster Contingent Savings Facility for Solomon Islands ($3 million policy-based loan and a $3 million grant) as part of the ADB's regional disaster resilience program. The goal is to strengthen a) policy governance and institutional arrangements for disaster management; b) improve disaster risk management investment risk planning; and c) expand disaster risk financing.
- A longer-term Natural Disaster Fund has not yet been established. The budget framework allows the authorities to issue contingent warrants, including for natural emergencies and disasters and beginning with the 2018 Budget the authorities have set aside 0.6 percent of total spending excluding grants as a contingency. Staff recommends building a somewhat larger buffer of up to 2.5 percent of GDP gradually over the long term, once the immediate task of rebuilding the cash balance has been completed.

3. ***We advise the authorities to be careful about Pacific Games related investment so as not to exacerbate fiscal position Related this, could staff provide more information on large infrastructure lending by development partners, including China, as mentioned in the buff statement.***

- The infrastructure projects mentioned in the buff statement likely relate to Pacific Games 2023. China is providing aid for the construction of a main stadium for the Games. We do not yet have additional details on large infrastructure lending from China. Lending from other development partners for the Games is not yet fully identified.

4. ***Regarding DSA, we note that data coverage is limited to central government, guarantees and the central bank. Could staff comment on why certain elements were not included in the DSA, such as state and local government?***

- Little data is available for the state and local governments.

Monetary and Exchange Rate Policies

5. ***We agree that the current monetary policy stance is appropriate and encourage the authorities to pursue reforms to reduce excess liquidity and improve monetary policy effectiveness. Regarding impediments to greater monetary policy effectiveness, could staff elaborate more on the constraints on National Provident Fund (NPF) investment abroad?***

- The National Provident Fund currently holds only 8 percent of its assets overseas. The NPF itself wants to increase this and is being encouraged to do so by the central bank. One constraint is that investments are scrutinized by the Ministry of Finance and need approval. Another constraint is the need to put in place appropriate staffing and a governance framework for more active investment management.

6. ***Could staff elaborate on their statement that "the logging sector should be able to hedge foreign exchange risk"? How prepared is Solomon Islands if the CBSI were to allow greater volatility vis-à-vis the USD in terms of availability of hedging instruments and businesses' ability to manage exchange rate risk?***

- The logging sector is dominated by foreign-owned multinational companies who can comfortably hedge foreign exchange risk. The same applies for the mining sector.

Financial Sector

7. ***We take comfort from the fact that a correspondent banking relationship has been established and in turn reduced immediate financial stability risks. To maintain this relationship, it is important to continue to strengthen governance and risk management in the banking system and fill remaining gaps in the AML/CFT framework. In staff's view, how can the Fund provide further assistance to the authorities in this area?***

- The authorities are beginning to take steps to address the AML/CFT deficiencies identified in the Mutual Evaluation Report. When the authorities identify training and capacity development needs there are a range of possible suppliers of capacity development for AML/CFT, these include the APG, World Bank, bilateral development partners and the IMF. Once the authorities identify specific priorities, staff could help advise, based on current workloads and expertise, which CD provider it would be best to approach on different topics.
- Under current IMF staff plans, the authorities will be invited to join the regional training provided by LEG at STI on AML/CFT issues in June 2020. PFTAC is also following up with the authorities on the areas identified in the Supervision Framework Enhancement Program, including a mission on risk rating and supervisory action which is planned for March 2020. There are also plans to continue assistance to implement regulatory reform in FY21, specifically targeted at improving governance and risk management in the banking system.

8. ***Could staff elaborate how the country intends to use green finance to increase resilience to climate change and how it is related to financial inclusion?***

- Solomon Islands is a member of the Alliance for Financial Inclusion (AFI) and has endorsed Sharm El Sheikh Accord on Financial Inclusion, Climate Change and Green Finance. Members have pledged to incorporate financial inclusion policies and regulatory approaches which positively affect climate change, green finance and sustainable development into their national financial inclusion strategy framework.
- Financial inclusion can help build the resilience of individuals to climate change by promoting access to insurance, savings, and credit, which can help those who are vulnerable to the effects of climate change to manage through disaster events. Insurance services spread out risks and reduce losses caused by extreme weather events. Use of weather index-based insurance can help insulate farmers from losses due to weather shocks. Research shows that subsidized insurance can also potentially encourage larger investment than would otherwise be the case (but governments' need to be mindful of the fiscal costs). Similarly, savings help consumption smoothing in the event of natural disasters and boost agricultural investment. Access

to credit can also boost climate-resilient technology investment, particularly in the agricultural sector.

9. ***We are encouraged by the CBSI's actions to address the Asia Pacific Group's (APG's) recommendations and to support the systemically important domestic bank in retaining established CBR and exploring alternative CBRs. What is staff's assessment on the likely impact on CBR in view of the gaps identified by the APG's mutual evaluation?***

- The current CBR contract with the domestic bank is for three years from end 2018 and this has lessened immediate financial stability risks. Staff would also note that it is encouraging that the authorities are already taking some actions to address the gaps found in the APG mutual evaluation (see paragraph 31 of the Report). However, as noted in the Report and as emphasized in the 2018 Article IV Report (paragraph 39 and Appendix V), the difficulties experienced in maintaining a CBR also demonstrate the broader need to address the reputational, environmental and governance concerns related to the logging sector.

10. ***Financial sector is characterized by moderate level of NPLs. However, interest rate on personal loans at a high of 17 percent requires a better understanding of banks' pricing structure and processes. Could the staff comment on the possible reasons for this phenomenon and its impact on demand for credit and investment?***

- Chapter 17 of the Book on Growth and Resilience in the Small States of the Pacific looked specifically at high interest rate spreads in the Solomon Islands. This work concluded that several factors drive high spreads in Solomon Islands, including high overhead costs, small scale, lack of investor protection and property rights, and high bank concentration. Inadequate infrastructure, communal ownership of land—are problems also shared by many other Pacific small states, but Solomon Islands appears to be trailing many of its peers in these areas. For instance, Solomon Islands underperforms all small states on most measures on infrastructure quality, with the exception of Comoros. The high transaction costs of doing business in Solomon Islands are also reflected by the fact that electricity tariffs and the cost of Internet in Solomon Islands are the highest among Pacific island small states.
- High interest rates are expected to have a negative impact on demand for credit and investment. However, weak institutions, poor infrastructure, and a difficult business environment are also key factors holding back the private sector and so it is not evident that higher interest rates are the primary cause. Commercial banks often cite a lack of quality projects as holding back their activity.

11. ***The structural liquidity in the financial sector remains high and calls for policy action. Can staff comment on the tools that the Central Bank has to deal with this excess liquidity?***

- The number of instruments at the disposal of the central bank to manage excess liquidity is limited. The central bank has mostly relied on its own debt instruments, the Bokolo bills, as a tool to manage liquidity. Issuance of the bills has been limited, in part muted by the central bank's valuation losses, despite an increased appetite from the commercial banks. Efforts to promote interbank lending are being explored and further market development would aid monetary policy implementation. The authorities have also been looking at establishing liquidity arrangements where banks can invest some of their excess liquidity offshore and allowing the NPF to further invest offshore using their deposits in the banking system.

Structural Reforms

12. ***We were surprised, however, to see staff seem to suggest import-substitution policies in the agriculture sector would be advisable in pages 14 and 44 in the staff report. We believe leveraging gains in connectivity and fostering specialization in niche markets, rather than import-substitution, would be a better approach to enhancing agriculture productivity. Additional staff comment would be welcome.***

- There is scope to increase agriculture production for both import substitution and to foster specialization in niche markets such as copra and seaweed. While connectivity will help farmers to gain access to useful information on new agricultural practices, production and management technologies, and access to niche markets, Solomon Islands also needs to expand food production for domestic consumption. Imported rice, a staple in the diet has increased substantially, weighing on the import bill. The government has responded with a National Rice Development Program to increase domestic production, but this is unlikely to fully substitute for rice imports.

13. ***Staff mention that hedging should be possible for the logging sector. The World Bank has recently extended commodity hedging products for IDA countries. Has this been considered as a route for a logging hedge?***

- In the Staff Report we refer to hedging by the foreign private sector companies operating in the logging sector.
- The World Bank has only recently introduced commodity hedges linked to loans by linking repayment obligations on IDA loans to commodity prices. Whether commodity hedges are available on future loans would be an issue for the Solomon Islands authorities to explore with the World Bank.

14. ***Could staff elaborate on the institutional readiness of Solomon Islands to sustainably develop its mining sector? Could staff share lessons on sustainable mining from other regional peers (for example, Nauru whose Article IV was recently undertaken)? We would also value comment on further technical assistance, as requested by the authorities, to support the Authorities' in the appropriate pricing of their natural resources.***

- The mining sector has a significant role to play in Solomon Islands' economy, especially in providing budget revenues essential to fund development needs. While the policy framework and institutions to guide and monitor mining activities in Solomon Islands are in place, more work is needed to strengthen the country's readiness to govern and monitor the mining sector. These include strengthening the mining legislation, enforcing the legislation and regulations, and raising the capacity in the Ministry of Mining for contract negotiation.
- Solomon Islands has drawn lessons from its forestry sector on the economic and environmental impact of unsustainable policies. The government is working with development partners to put in place good practices in mining. Fund TA is also based on global good practices.
- Pricing mineral exports appropriately (ensuring they are not underpriced) is essential to combat international profit shifting and the avoidance of local taxes. Recent IMF technical assistance in this area highlighted serious vulnerabilities that are harming revenue receipts and proposed further capacity development for the government to address them. Further technical assistance on these issues is available, funded by the Managing Natural Resource Wealth Topical Fund. A project proposal has been submitted to the government for their review. The Fund stands ready to provide further assistance if requested.

15. ***We encourage them to be steadfast in designing and implementing strong mineral legislation and associated governance reforms. Could staff comment on the economic potential of this sector, particularly the size of gold and bauxite deposits that are commercially- exploitable?***

- Both the World Bank and IMF agree that mining is likely to replace logging as a key driver for growth. While other activities can contribute to a more diversified economy—including agriculture, fishing, and tourism—they are unlikely to be large enough on their own to fully make up for the decline in logging. However, the mining sector will need to be managed well to reap the opportunities and mitigate risks, including environmental risks. This is why staff place emphasis in the Report on strengthening the governance of mining sector, implementing effective environmental regulation and stakeholder benefit-sharing arrangements. In terms of scale, projections suggest the sector could account for around 8-10 percent of GDP in the medium term. The World Bank (2010 report) estimated that gold mining production had potential for annual exports of around US$100mn. Staff project gold production to start in 2023 and reach a peak of little over US $80 million in 2027. Bauxite deposits are smaller, but Solomon Islands has a highly marketable grade of bauxite, and the sector could expand with active exploration underway. Nickel production is also expected to grow.

16. ***We support the enhancement of the structural reforms for building institutional capacity and strengthening the governance framework to promote greater private sector participation in economic activity. Could staff elaborate more on the Fund's capacity building strategy for Solomon Islands?***

- Staff will answer this question in their oral remarks.

17. ***There remains a need to invest in the Islands' Human Capital to meet economic growth and the sustainable development goals. Could staff comment on areas of focus, structural reforms needed and priorities for investment?***

- Development partners are working with Solomon Islands to improve quality and access to education and health for all citizens. Priorities for the education sector are guided by the National Education Action Plan focusing on:
- foundation skills in basic education—improving learning outcomes, especially early literacy and numeracy for all students. Investment in primary and secondary schooling would require a reprioritization of spending from tertiary scholarships to primary and secondary. We have emphasized this with the Ministry of Education during our Article IV consultations.
- skills for economic growth—increasing the number of people with technical and vocational skills in areas of demand
- tertiary support—enabling students to undertake tertiary studies, enhancing cross-cultural understanding through people-to-people links and building the capacity of people to contribute to economic and social development.
- In the health sector, priorities are in maternal and child health, preventative measures on non-communicable diseases, investing in the health system to deliver essential medicines and better health services to communities and supporting rural water and sanitation facilities.

18. ***We would have liked more Staff analysis on how the Authorities' could invest in adaptation and therefore reduce the impacts of a disaster. We think the Solomon Islands would benefit from a Climate Change Policy Assessment and Disaster Risk Management Strategy. Could staff comment on whether these have been considered?***

- We agree that Solomon Islands could benefit from a CCPA (see question number 19).

- The authorities do have structures in place to help manage disasters and to invest in recovery and adaptation. The Ministry of Environment, Climate Change, Disaster Management & Meteorology has a dedicated National Disaster Council that is in the process of developing provincial level disaster management plans that align with the National Disaster Management Plans (2018).
- Regarding staff's analysis, the 2018 Article IV Staff Report included additional detail on (i) public investment management and (ii) financial inclusion in support of climate change adaptation. The recommendations from both these pieces of work remain relevant, although they are covered in less detail in this year's Report.
- For public investment management, the 2018 Staff Report noted that prioritizing public spending towards developing disaster-resilient infrastructure can yield long-term dividends. It also noted weaknesses in the planning, allocation, and implementation of public investment. It concluded that better prioritization of investment projects was needed, that project appraisal could be strengthened, including by conducting feasibility studies, and that project selection could be enhanced by using strict criteria for selection to reduce the scope for political interference. These changes, among others, would help boost the gains from infrastructure investment. Tapping external concessional financing from development partners would also be optimal since domestic borrowing can crowd out the private sector.
- For financial inclusion see question 8.

19. ***We take positive note that the next financial inclusion strategy plan from 2020 will focus on green finance to build climate change resilience. Could staff comment on the possibility of conducting a Climate Change Policy Assessment?***

- Staff agrees a CCPA could be useful for the Solomon Islands and we recommend the authorities consider requesting one. The CCPA program is currently being reviewed following the last of the 6 pilots (currently underway in Tonga). Assuming CCPAs are continued, a Solomon Islands request would then be considered, together with any other requests received for CCPAs.

20. ***We appreciate staff's emphasis on the Solomon Islands' high susceptibility to natural disasters, as well as their work in including natural disaster shocks in their debt sustainability analysis. However, given the high probability of these shocks and their potential to severely damage fiscal and growth prospects, what progress, if any, has been made in resilience planning and infrastructure development?***

- The Ministry of Environment, Climate Change and Disaster Management focuses on resilience planning and infrastructure strengthening guided by National Adaptation Programme of Action (NAPA). However, the ministry is not adequately financed to manage large scale projects; the Ministry received around 1.2 percent of the appropriated budget in 2020. The government has also tapped into funding from the WB, ADB and other multilateral funds such a GCF for building climate change resilience.

21. ***There are several undergoing infrastructure projects and we take note of staff's cautioning to be careful about possible fiscal risks. On the other hand, we see that staff appears confident about the new opportunities that could be opened up by the new undersea internet cable. We would appreciate further comments on this.***

- The new undersea internet cable would provide faster and more reliable internet services to local businesses and households. This would directly foster private sector development and help with financial inclusion. However, to optimize the gains, investment in complementary infrastructure such as affordable electricity, development in human capital, combined with a lowering of the cost of the internet would be required.

22. ***We agree with staff's recommendation that adequate resources are directed to the compilation and dissemination of economic data. From that perspective, would staff have data on labor force participation and income, by gender?***

- There is limited data on labor force participation and no data that differentiates by income or gender. The Central Bank captures trends in employment through participation in the National Provident Fund and newspaper adverts.
- Based on Solomon Islands National Provident Fund contributors the 'Active and slow active' contributors grew by 3.7 percent to 60,904 contributors in September 2019 from 58,739 contributors at end of December 2018. This only captures labor force participation in the formal sector. Meanwhile, for the demand for labor indicators, job vacancy advertisements in the newspaper dropped. September 2019 is at 454 adverts compared to 801 adverts in the same period in 2018.

Fund Issues

23. ***We welcome the information provided in Annex VI on TA priorities for FY20. We would be interested to hear from staff if there are efforts to create a standardized template for how TA activities are reflected in Article IV reports to ensure comparability and consistency across countries?***

- Staff is in the process of learning from and mainstreaming emerging good practices on integrating capacity development (CD) with surveillance and lending, including on reflecting CD issues in country reports. Following this, staff will develop guidelines in the summer, that will feed into the post-CSR surveillance guidance.