International Monetary Fund

Solomon Islands and the IMF

Solomon Islands: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

Press Release:
IMF Executive Board Approves a Three-Year Arrangement Under the Extended Credit Facility (ECF) for Solomon Islands and US$0.228 Million Disbursement
December 10, 2012

November 13, 2012

The following item is a Letter of Intent of the government of Solomon Islands, which describes the policies that Solomon Islands intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Solomon Islands, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

Country's Policy Intentions Documents

E-Mail Notification
Subscribe or Modify your subscription

LETTER OF INTENT

November 13, 2012

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Ms. Lagarde,

Solomon Islands has greatly benefited from the partnership with the IMF in the implementation of the Government's economic reform program supported by a precautionary Standby Credit Facility (SCF) arrangement approved in December 2011. Economic activity, although moderating, has remained strong; short-term macroeconomic imbalances have been addressed; and donor's support has been catalyzed. Given the observance of all end-June 2012 quantitative targets by a large margin and the progress in implementing structural benchmarks, we request the completion of the second and final review under the SCF arrangement. Given the arrangement was intended to be precautionary, we are not requesting the release of the outstanding disbursement of SDR5.2 million.

Looking ahead, growth momentum has eased and downside risks to global growth have increased. Solomon Islands continues to remain vulnerable to shocks associated with its undiversified production and export base, strong dependency on aid, and frequent natural disasters. Despite our situation, we remain committed to reforms aimed at strengthening our economic resilience and promoting strong, sustainable, and inclusive growth beyond the commodity sector to help reduce poverty. To move toward achieving these goals and preserve the reform momentum, we are requesting a successor arrangement in the form of a low-access three-year Extended Credit Facility (ECF) in the amount equivalent to 10 percent of our quota (SDR 1.04 million or about US$1.6 million). Should external downside risks materialize prompting large balance of payment needs, we would request a corresponding augmentation of access under the ECF arrangement.

We believe that this successor arrangement will help us secure the progress achieved with respect to macroeconomic stability under the two consecutive SCF arrangements (since June 2010) and will complement ongoing Government's reforms under the Core Economic Working Group policy dialogue. Our recent experience demonstrates how a virtuous cycle of strong commitment to reforms, rebuilding of policy buffers, and strengthening the macro framework can quickly boost business confidence and spur growth. The new ECF arrangement will also be instrumental in helping the Government implement its ambitious medium-term structural reform agenda and tackle persistent institutional weaknesses. The requested ECF arrangement will also help strengthen our fiscal framework, preserve external stability and debt sustainability, maintain stable monetary conditions, and strengthen our financial sector. The Memorandum of Economic and Financial Policies (MEFP), which describes the Government's reform policies during 2013–15, is attached. We also request the release of the first disbursement equivalent to SDR 0.149 million upon the Executive Board's approval of this arrangement. The program will be monitored through quantitative performance criteria and indicative targets, structural benchmarks, and semi-annual reviews

(MEFP Tables 1 and 2). The first review under the ECF arrangement is expected to take place on or after June 15, 2013, and the second review is expected to take place on or after November 15, 2013.

Solomon Islands believes that the policies set forth in the attached Memorandum of Economic and Financial Policies (MEFP) are adequate to achieve the objectives of its program, but it will take any further measures that may become appropriate for this purpose. Solomon Islands will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultation. Furthermore, we will provide the Fund with any information it may request on policy implementation, as necessary, to achieve program objectives. We also authorize the publication of this Letter of Intent and the attached MEFP.

Sincerely yours,

/s/	/s/
Hon. Rick Houenipwela, MP	**Denton Rarawa**
Minister of Finance and Treasury	Governor
Ministry of Finance and Treasury	Central Bank of Solomon Islands

Attachments: MEFP and Technical Memorandum of Understanding

ATTACHMENT I

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

I. RECENT DEVELOPMENTS AND OUTLOOK

1. **Macroeconomic conditions have improved.** The implementation of IMF-supported programs over the last two and half years, together with strong political commitment, has helped preserve macroeconomic and financial stability as well as trigger donor support. After contracting by 5 percent in 2009, economic activity rebounded to 6¾ percent in 2010 and exceeded 10 percent in 2011. External and fiscal buffers have been rebuilt, with gross international reserves increasing to US$ 496 million (about ten months of this year's imports of goods and services) as of September 2012, relative to US$412 million at end-2011. Reserves levelled off in September, however, compared to August.

2. **Growth is slowing to around 5 percent in 2012 including in the commodity sector—and private sector activity remains subdued**. Growth is being driven by mining and service sectors. Logging has surprised on the upside so far in 2012, but contribution to growth has been much smaller than in previous years. Inflation has eased to 4.7 percent (year-on-year) in August, despite the rise in international food prices as the global food price spike did not affect rice—the main food component in the CPI basket.

3. Growth will moderate further in 2013 and beyond, with mainly external downside risks. Logging production is expected to decline in 2013 and beyond, but gold production together with services are expected to continue to support growth of almost 4 percent in the medium term. Headline inflation is likely to be in the 4-6 percent range over the medium term as commodity prices stabilize. But our economy will remain heavily dependent on aid that is essential to finance the structural trade deficit. Moreover, risks of a serious global slowdown have heightened considerably. If the downside risks to the global outlook materialize, Solomon Islands will be affected mainly through weaker growth in emerging Asia. The main channels of contagion would be a worsening the terms of trade, contraction in demand for logging from Asia—especially China, our main trading partner—and lower foreign direct investment. However, given the uncertainty surrounding logging production, GDP growth could be higher over the medium term, should logging activity be larger than expected.

4. **The program under the Standby Credit Facility (SCF) arrangement is broadly on track**. The program performance criteria for end-June 2012 were met with comfortable margins. Government cash balances reached SI$391 million at end-June, covering two months of recurrent spending, and net international reserves stood at US$454 million. The targets for net credit to the Government and the central bank's net domestic assets were also met with comfortable margins. However, we missed the indicative target for September on the cash balance by SI$35 million, owing to shortfalls in revenues relative to the 2012 Budget and higher recurrent spending related to hosting the recent Festival of Pacific Arts, and increased spending on tertiary education. Moreover, development spending has been higher than in previous years. This reflects much larger allocations in the 2012 Budget (4 percent of GDP compared to 2 percent in 2010 and 2011) to be spent through the Rural Constituency Development Livelihoods Fund (RCDL). We have also implemented most of the benchmarks committed under the program (Tables 1 and 2). Despite a strong commitment, we continue to face capacity constraints which have slowed the pace of

implementation of some structural benchmarks. Moreover, building a consensus in favor of reforms requires a wider consultation process among shareholders and civil society to ensure that these reforms are benefitting the entire population. That said, substantial progress has been made in achieving the structural reforms agreed under the current IMF-backed program.

5. **Looking ahead, further reforms are needed to ensure that Solomon Islands reduces its vulnerability to external shocks and remains on a sustainable growth path.** Building on the success of the current program, we are formulating a set of policies that can be supported by a successor medium-term arrangement with the Fund.

II. Program Policies

6. **Our policies aim at enhancing resilience to shocks and implementing growth-enhancing structural reforms that will benefit all Solomon Islanders.** By doing so we aim to boost investor confidence and ensure sustainable and inclusive growth. Our program will focus on strengthening the fiscal framework, improving monetary operations, maintaining a strong foreign exchange position and ensuring debt sustainability, and containing financial risks. We will also focus on reforms aimed at tackling our institutional and structural weaknesses, such as public financial management and tax reform. Furthermore, we will continue to support private sector development by promoting financial inclusion that enhances access to financial services by the private sector, especially in the rural areas.

A. Fiscal Policies

7. **We remain committed to preserving a strong fiscal position while providing adequate resources for critical social spending.** The fiscal position strengthened considerably in 2011, and continued to be relatively robust during the first half of 2012, as a result of buoyant revenues and sound fiscal management. However, the shortfall in revenues relative to the 2012 Budget estimates owed partly to the doubling of the threshold for personal income tax as well as higher-than-budgeted expenditure that resulted in a deterioration of the fiscal position during the third quarter of 2012. We realize that logging revenue will continue to remain volatile in the near term, and that it will decline over the medium term as logging stocks are exhausted over this decade. While we expect that increased revenue from mining will offset some of the losses from logging over the medium and long term, this is likely to slow. The implementation of the mining tax regime will help ensure better return for Solomon Islanders on the extraction of our natural resources. Thus, we will use much more conservative revenue projections and will contain expenditure to rebuild policy buffers. At the same time, we will refocus on ensuring a higher quality of public spending to lift long-term growth potential. To achieve these near- and medium-term goals, we will ensure that fiscal policy for the remainder of 2012—as well as in the 2013 budget and over the medium term—is consistent with the following:

- We are firmly committed to continuing to use the cash balance as our fiscal anchor and to preserve its level according to the quantitative targets and performance criteria reported on Table 1. Going forward this will imply a tighter fiscal policy relative to 2012 and strengthening our fiscal position in the 2013 Budget. We believe that a prudent fiscal stance is further warranted given the deterioration in the global outlook. Should commodity revenue surprise on the upside, or under-spending of the development budget materialize owing to capacity constraints, we will save this windfall for future development spending or increase fiscal space to buffer future shocks.

- We will contain public expenditure and enhance the quality of public spending. Given the expected decline in logging revenue over the medium term, we will keep public spending at a more sustainable level in line with the expected slower growth in revenue receipts. However, the basic public sector wage has declined in real terms over the last ten years. Thus, we are planning an increase in basic public sector wages in 2013. The size of the increase will be prudent and determined in the ongoing 2013 Budget process. At the same time we will aim at consolidating the number and magnitude of public-sector allowances and benefits into the remuneration base and control the use of other allowances, such as overtime. In so doing we will also increase the transparency of remuneration levels, which provides a more definitive base for making future projections of public service payroll Going forward, a comprehensive reform of the payroll system is necessary to be able to attract and retain high-qualified staff in key areas in the public service sector and improve the composition of the overall payroll. Should revenue surprise on the upside, resources should be spent on high-priority areas as education, health, and infrastructure, which in turn will help us make progress toward our goal of achieving inclusive growth and alleviating poverty. We will continue to make large contributions to the National Transport Fund to finance transportation infrastructure that would trigger positive growth spillovers to all sectors and encourage private sector development. We will maintain spending on education and health at no less than 32 percent of the Government-funded recurrent spending, in line with our economic reform program and consistent with the Core Economic Working Group's recommendations; we will also continue to track government-funded spending on education and health. We will also strike a balance between financing tertiary education abroad and investing in primary education, given the low enrolment rate in basic education by regional standard.

- We will contain the use of constituency funds. The use of constituency funds is meant to increase the effectiveness of public service delivery in the rural areas. We are in the process of enhancing the accountability on how these funds are spent. Internal audits are underway and we look forward to the upcoming assessment by the Office of the Auditor General (OAG) to provide advice to the Government on how to standardize procedures to evaluate and prioritize ex ante our development projects. Thus, to enhance transparency in the use of public funds, we are introducing an accountability system in which the OAG reports back to the Cabinet and Parliament on actual spending and project achievements.

- To strengthen public financial management and better monitor priority spending, we will continue to make progress toward improving our budget presentation. We took an important step in the 2012 Budget by revising our budget presentation to include output line items, thus attaining a program benchmark (end-September 2012 benchmark) ahead of schedule. We also improved the transparency of the budget process through deeper consultations with non-governmental organizations and ministries as well as with provincial governments for the first time. In 2012, a new chart of accounts has been put in place to better capture Government expenditure according to natural account codes

This will improve the transparency and accountability in the allocation of spending in the 2013 Budget. We will also continue to seek assistance from development partners to advance current work being done to strengthen procurement, financial management information systems and internal audit processes in order to reduce leakages affecting public service delivery.

- To strengthen our medium-term fiscal position, we are currently implementing a multi-year budget framework. We have developed a framework that includes f**orward estimates** of revenues and current expenditure that will be included in the 2013 recurrent Budget (end-December 2012 benchmark). We will complete this process next year by including forward estimates for the 2014 Development Budget. Casting budget decisions in a multi-year perspective will help us design realistic fiscal plans in line with the objectives laid down in the National Development Strategy (NDS). The multi-year budget framework will also help build consensus on the appropriate sequencing of development projects.

- We are strongly committed to strengthening the fiscal framework and public management by continuing to reform the Public Finance Act (PFA). The new PFA will incorporate provisions on fiscal responsibility, management and use of public funds, and management of public debt. We have drafted four discussion papers (and posted them on the Ministry of Finance and Treasury web site) which we presented in a public workshop in August at the presence of the Government, development partners, private-sector representatives, and civil society (end-September 2012 benchmark). Despite substantial resource constraints, we are aiming to submit to Cabinet the draft legislation on the PFA by mid-November (mid-November 2012 benchmark). We will also submit to parliament the draft of the PFA by end-October 2013 (end-October 2013 benchmark). Consequently, we will be revising the Financial Instructions and accompanying finance manuals and guidelines during the course of 2013. These are subsidiary instruments to the new PFA, which will not come into effect until January 1, 2014. Training will be an integral component in embedding these reforms.

- We will continue to boost domestic revenue by strengthening compliance and streamlining exemptions. In order to achieve this, a new comprehensive bill on customs and excise taxes (end-October 2012 benchmark) is being drafted with the assistance of the Asian Development Bank and co-financed by the AusAID. However, given recent resource constraints in finalizing the draft legislation, the elements on exemptions may need to be considered by Cabinet ahead of the rest of the legislation. This will also include changes to the exemption processes relating to income taxes, stamp duties, and goods and sales tax acts which are in other legislation. We are planning on obtaining Cabinet approval to release the draft bill implementing the new Customs and Excise Act for public consultation, including the clauses related to exemptions and the draft amendments to other revenue acts (income tax, stamp duties, goods and sales tax acts) by end-December 2012 (end-December 2012 benchmark) and to Parliament by November 2013 (end-November 2013 benchmark). Looking forward, we are currently considering further tax reforms aimed at strengthening and broadening the narrow tax base.

- Implementing a new resource taxation regime will be critical for Solomon Islands to benefit from its natural resource wealth. We are aiming at seeking Cabinet approval of draft amendments to income tax legislation, custom and excise taxes, and goods tax legislations to implement a new mining taxation regime, in line with IMF technical assistance recommendations, originally set by end-September 2012 (end-September 2012 benchmark), by mid-December 2012 (end-December 2012 benchmark) and to submit it to Parliament by November 2013 (end-November 2013 benchmarks). The reform on mining legislation has taken longer than expected to allow for a wider consultation process with different stakeholders—including extractive companies, civil society, and landowners—and also because of further and unexpected resource constraints at the drafting stage. A consultation meeting with all stakeholders was held in July. Until this new tax regime is in place, we will refrain from approving new mining leases. At the same time, we will adopt measures to enhance revenue administration in the area of mining taxation to ensure that the government receives its share of mining revenue. Finally, we will continue to apply, as we have done since January 2012, the full market price for log exports with an automatic quarterly adjustment, to support revenue-mobilization efforts.

- We will exercise caution in resuming concessional borrowing to preserve domestic and external stability while tapping resources to finance much needed investment projects. These projects include the Submarine Cable System Project and the Tina River Power Project, which will reduce the cost of doing business and encourage private sector investment. The internet submarine connection is expected to be fully operational by the middle of 2014. This project will reduce communication costs significantly, enhance efficiency and create new information and communication industries. It will also ease the business registration process. The Tina River Project will reduce significantly the cost of energy. The Debt Management Strategy (DMS), endorsed in May by the Cabinet, builds on the results of the IMF-World Bank Debt Sustainability Analysis, provides the appropriate framework to anchor borrowing plans going forward. The DMS has been incorporated in the Honiara Club Agreement (HCA) review (end-April 2012 benchmark). We are setting a yearly borrowing limit in the 2013 Budget which will include domestic, external and SOE borrowing and guarantees, to preserve debt sustainability. This limit will be revised on a yearly basis depending on the debt outlook and our investment needs, but we will continue to maintain a conservative approach. The next steps include: developing instructions for SOE borrowing (end-March 2013 benchmark) and including it in the DMS; identifying the outstanding debt of SOEs; developing an on-lending policy framework; and designing a framework to estimate the cost of guarantees.

B. Monetary, Exchange Rate, and Financial Sector Policies

8. **Monetary and exchange rate policies will continue to be geared to maintaining price and external stability**. We have contained inflationary pressures by issuing short-term *Bokolo bills*. The monetary transmission mechanism has also improved over the last couple of years, but remains weak. Given the clouds surrounding the global outlook, we will continue to closely monitor credit, liquidity and real sector developments in conducting monetary policy for the rest of the year and will scale up the issuance of *Bokolo bills*, if needed. Given our vulnerability to external shocks, we also recently modified our exchange rate regime. While the previous regime (a de facto peg to the U.S. dollar), in place since 2002, has provided a strong nominal anchor, in October we moved toward a basket peg

using as weights the currency denominations of the largest shares of our external payments. This was in line with recent IMF technical assistance recommendations on promoting greater exchange rate flexibility and foreign exchange market development. We believe this arrangement will provide more flexibility, with a view to maintaining external stability and absorbing external shocks. To reinforce the effectiveness of the CBSI in conducting monetary policy and its supervisory activities, we have drafted a new CBSI Act. The Cabinet approved the draft in July (end-March 2012 benchmark) and we plan to be ready to submit the final Act to Parliament by December 2012 (end-December 2012 benchmark).

9. We will continue our efforts to strengthen the financial supervisory and regulatory frameworks, and improve access to credit. Reforming the National Provident Fund (NPF) to improve its governance and investment framework are critical for providing retirement income and maintaining financial stability. The drafting instructions for the NPF Act endorsed by Cabinet in July (end-June 2012 benchmark) will strengthen the NPF's governance structure and investment framework, reduce political influence on investment decisions, and maximize returns to its members. We are planning to be ready to submit the revised NPF Act to Parliament by October 2013 (end-October 2013 benchmark). We would like to request IMF technical assistance in strengthening on-site supervision of the NPF and insurance companies as well as in formulating prudential regulations and reports for the NPF. The planned amendments to the Financial Institution Act should also help strengthen the financial sector's regulatory framework. An IMF TA mission will arrive shortly to assist us in reviewing the Financial Institution Act to reflect international best practices. We will also request the IMF to follow up with TA on banking supervision to capitalize on the recent assistance received from PFTAC as well as on continued capacity building efforts in financial markets supervision. To address the continuing weakness in access financial services, especially in the rural areas, we will advance our current work on financial inclusion, including by providing financial literacy training and financial education in schools. We will also prepare to present our work developed by the financial inclusion taskforce in a public workshop by March 2013 (end-March 2013 benchmark).

C. Other Structural Reforms to Support the Private Sector and Other Issues

10. **It is the intention of our government to continuously improve the business climate by enacting appropriate business friendly policies and laws.** We believe that reforms to support private sector development are critical for inclusive growth. The conditionality under the successor arrangement will continue to be aligned with the development strategy (economic and financial reform matrix) developed under the Core Economic Working Group (CEWG)—a government-donor partnership. We are planning to submit to the IMF a revised National Development Strategy at the time of the second review of the prospective ECF, together with the sector strategies developed by the Ministry of Planning and Aid Coordination (MDPAC) and key development partners that will serve as the Poverty Reduction Strategy Paper.

11. **Safeguards assessment.** We agree to ensure the completion of the Safeguards Assessment update by the time of the first review under the successor ECF arrangement. The CBSI will provide Fund staff with all the necessary information for the update.

12. **Statistics**. Progress has been made in strengthening the quality of national accounts and related economic statistics and fiscal and monetary data for program purposes, but there

have been some delays in the timely release of national accounts and fiscal data. Delays in the provision of national accounts data have been, in part, attributable to the implementation of the Household Income and Expenditure Survey (HIES) 2012/13. The HIES will provide relevant data for policy and decision-making, in particular, in updating the weights of the current CPI, providing estimates for GDP, poverty and MDG indicators. However, we have recently filled two key positions within the Ministry of Finance and this should help us provide timely data to monitor our program with the IMF. We will continue to improve the quality of macroeconomic data by devoting more resources to the National Statistics Office through the hiring of additional permanent staff if resources become available. The CBSI would like to request a follow-up TA to support the ongoing Monetary and Financial Statistics Project.

Appendix I. Table 1 —Solomon Islands: Quantitative Performance Criteria (PC) and Indicative Targets (IT)

	12/31/2011		3/31/2012		6/30/2012			9/30/2012			12/31/2012	3/31/2013	6/30/2013	9/30/2013
	PC with adjustors	Act.	IT with adjustors	Act.	PC (CR/12/156)	PC with adjustors	Act.	IT (CR/12/156)	IT with adjustors	Act.	PC	IT	PC	IT
Performance criteria 1/														
Net international reserves (NIR) of the Central Bank of Solomon Islands (CBSI) (floor, end-of-period stock, in millions of U.S. dollars (US$)) 2/	341	390	346	423	421	424	454	428	428	473	470	475	480	485
Net domestic asset (NDA) of the CBSI (ceiling, end-of-period stock, in millions of Solomon Islands dollars (SI$)) 3/	-737	-1,118	-835	-1,290	-1,253	-1272	-1,309	-1,256	-1258	-1,425	-1,173	-1,122	-1,120	-1,102
Net credit to central government (NCG) (ceiling, cumulative change from the beginning of the year, in millions of SI$) 4/	-27	-561	62	-149	-28	-28	-266	-26	-26	-250	95	6	-33	-60
New nonconcessional external debt maturing in more than one year, contracted or guaranteed by the public sector (ceiling, end-of-period stock since the beginning of the program, in millions of US$) 5/	0	0	0	0	0	0	0	0	0	0	0	0	0	0
New nonconcessional external debt maturing in one year or less, contracted or guaranteed by the public sector (ceiling, end-of-period stock since the beginning of the program, in millions of US$) 5/	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Accumulation of new external payment arrears by the public sector (ceiling, end-of-period stock since the beginning of the program, in millions of SI$) 5/	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Central government program cash balance (floor, end-of-period stock, in million of SI$) 4/	254	522	232	402	342	321	391	392	372	337	425	440	420	383
Indicative Targets (cumulative)														
Government funded recurrent spending on health and education 6/	…	…	…	…	273	…	294	409	…	418	611	147	294	441
Memorandum items:														
32 percent of actual government funded recurrent spending	…	…	…	…	…	…	240	…	…	372	…	…	…	…
Budget support from bilateral and multilateral donors other than IMF (cumulative change from the beginning of the year, in millions of US$), program level.	…	46	…	9	38	…	40.6	47	…	47	61	11	26	44
Outstanding stock of Solomon Islands government (SIG) treasury bills, excluding restructured government bonds (end-of-period stock, in millions of SI$), program level.	…	38	…	40	60	…	39	60	…	40	40	40	40	40
Balance of SIG Consolidated Deposits Account, millions of SI$ 7/	…	60	…	140	140	…	140	140	…	140	140	140	140	140

1/ Evaluated at the program exchange rate.

2/ The adjustors are specified in the Technical Memorandum of Understanding (TMU) and include: the floor on NIR will be adjusted upward (downward) by the amount of budget support from bilateral and multilateral donors (excluding IMF) in excess (short) of the program level.

3/ The adjustors are specified in the TMU and include: the ceilings on NDA will be adjusted downward (upward) by the amount of budget support from bilateral and multilateral donors (excluding the IMF) in excess (short) of the program level. Following the recommendations of the IMF Safeguards Assessment, the program targets starting from end-December 2010 incorporate the recommended changes in the measurement of reserve money. Such changes, however, are not applied in measuring the September 2010 NDA outcome to make it consistent with the September 2010 IT, which was set before the changes were made.

4/ The adjustors are specified in the TMU and include: the floor on central government program cash balance will be adjusted downward and the ceiling on NCG will be adjusted upward by the stock amount of budget support from bilateral and multilateral donors (excluding the IMF) short of the program level; the floor on the program cash balance will be adjusted upward (downward) by the stock of government treasury bills, excluding restructured government bonds, in excess (short) of the program level; the floor on the program cash balance will be adjusted upward by the balance in the SIG Consolidated Deposits Account short of the program level (this adjustor applies to end-June PC and end-September IT).

5/ These performance criteria are applicable on a continuous basis.

6/ An indicative target for spending on health and education at no less than 32 percent of government-funded recurrent spending.

7/ The SIG Consolidated Deposits Account functions like a contingency fund for the government and transfers to and from this account can affect the program cash balance. Negative deviations from the projected balance in this account will therefore be used to adjust the program cash balance targets upward. The balance in this account for end-2011 and end-March 2012 are reported for reference since the balance in this account has not been monitored previously as part of the program.

Appendix I. Table 2—Solomon Islands: Structural Benchmarks

Actions	Macroeconomic criticality	Date	Status
Current Standby Credit Facility Arrangement			
Obtain Cabinet's approval of draft amendment to the CBSI Act to strengthen the monetary policy and supervisory framework.	To strengthen the effectiveness of monetary policy.	March 31, 2012	Met in July. The CBSI draft bill 2012 was submitted to Cabinet on June 11 and was approved to be taken to Parliament at the next sitting
Complete the Honiara Club Agreement (HCA) review and reach agreements on amendments to the HCA.	To strengthen debt management and maintain public debt sustainability.	April 30, 2012	Met. The Debt Management Strategy (DMS), endorsed by Cabinet on May 10, supersedes the Honiara Club Agreement (HCA) review. The review is being completed by presenting the DMS bilaterally to HCA signatories and observers.
Obtain Cabinet's approval of the drafting instructions to revise the NPF Act incorporating the reform plan approved by the Cabinet to strengthen its governance structure and investment framework.	To improve the long-term financial viability of the NPF and reduce fiscal risks.	June 30, 2012	Met in July. The Drafting instructions for the NPF Act Review was submitted to Cabinet and was endorsed. The next step is to do consultation with key stakeholders which is expected to start no later than September 2012.
Revise the budget presentation from input line items to functional/output line items.	To strengthen the quality and monitoring of government spending.	September 30, 2012	Met. The revised presentation has been provided in the 2012 Budget approved in February 2012.
Discussion papers and draft legislation of the new Public Finance Act to be presented at a public workshop.	To strengthen budget management and ensure fiscal sustainability.	September 30, 2012	Met in August. The MoFT completed publishing all four PFA Act Review discussion papers on their website. On August 22, the discussion papers were presented at a public workshop.
Obtain Cabinet's approval of a draft amendment to income tax, customs and excise tax, and goods tax legislations related to the new mining tax regime in line with IMF TA recommendations.	To broaden the tax base and increase revenue transparency.	September 30, 2012	Not met, but in progress. This reform is taking longer than expected to allow a wider consultation process with different stakeholders and because of resource constraints at the legal drafting stage. The authorities plan to seek Cabinet approval of draft amendments to relevant tax legislation by end December 2012 (see below).
Submit to Cabinet the new Customs and Excise bill, including the clauses related to exemptions and the draft amendments to other revenue acts (income tax, stamp duties, goods and sales tax acts).	To promote fiscal transparency and enhance the efficiency of revenue collections.	October 31, 2012	Not met, but in progress. Given pressing resource constraints in the legal drafting, the authorities are now aiming to send to Cabinet the draft on the exemption bill by late November and submit to the cabinet the rest of legislation by December 2012 (see below).
Submit to Cabinet the draft of new Public Finance Act that covers fiscal responsibility provisions, management and use of public funds, and management of public debt.	To strengthen budget management and ensure fiscal sustainability.	November 15, 2012	On track. The authorities aim to submit to cabinet the draft legislation by mid-November.
Successor Arrangement			
Obtain Cabinet's approval of a draft amendment to income tax, customs and excise tax, and goods tax legislations related to the new mining tax regime in line with IMF TA recommendations.	To broaden the tax base and increase revenue transparency.	December 31, 2012	
Obtain Cabinet's approval to release the draft bill implementing the new Custom and Excise Act for public consultation including the clauses related to the exemptions and the draft amendments to the other revenue acts (income tax, stamp duties, goods and sales tax acts).	To promote fiscal transparency and enhance the efficiency of revenue collections.	December 31, 2012	
Submit to Parliament the final CBSI Act to strengthen the monetary policy and supervisory framework.	To strengthen the effectiveness of monetary policy.	December 31, 2012	
Submit to Parliament the multi-year budget framework on revenues and recurrent spending	To strengthen the quality and monitoring of government spending.	December 31, 2012	
Submit to Cabinet the instructions for SOE borrowing.	To strengthen debt management and maintain public debt sustainability.	March 31, 2013	
Workshop organized by the National Financial Inclusion taskforce taking stock of progress to date to better access financial services in rural areas.	Increase access to financial services ensure inclusive growth	March 31, 2013	
Submit to Parliament the revised NPF Act that strengthens its governance structure and investment framework.	To improve the long-term financial viability of the NPF and reduce fiscal risks.	October 31, 2013	
Submit to Parliament the draft of new Public Finance Act covers fiscal responsibility provisions, management and use of public funds, and management of public debt.	To promote fiscal transparency and enhance the efficiency of revenue collections.	October 31, 2013	
Submit to Parliament the new Customs and Excise bill, including the clauses related to exemptions and the draft amendments to other revenue acts (income tax, stamp duties, goods and sales tax acts).	To promote fiscal transparency and enhance the efficiency of revenue collections.	November 30, 2013	
Submit to Parliament draft amendment to income tax, customs and excise tax, and goods tax legislations related to the new mining tax regime in line with IMF TA recommendations.	To broaden the tax base and increase revenue transparency.	November 30, 2013	

ATTACHMENT II

SOLOMON ISLANDS: TECHNICAL MEMORANDUM OF UNDERSTANDING

1. The program will be monitored through quantitative performance criteria, indicative targets, structural benchmarks, and reviews. This memorandum sets out the definitions for quantitative performance criteria and indicative targets under which performance under the program will be assessed. Monitoring procedures and reporting requirements are also specified.

I. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATIVE TARGETS

2. Performance criteria for end-December 2012 and end-June 2013 and indicative targets for end-March 2013 have been established with respect to:

- Floors on the level of net international reserves (NIR) of the Central Bank of Solomon Islands (CBSI);
- Ceilings on the level of net domestic assets (NDA) of the CBSI;
- Ceilings on the level of net credit to the central government (NCG); and
- Floors on the central government cash balance.
- An indicative target (cumulative) for spending on health and education at no less than 32 percent of government-funded recurrent spending.

3. Performance criteria applicable on a continuous basis have been established with respect to:

- Ceilings on the contracting and guaranteeing by the public sector of new medium- and long-term nonconcessional external debt;
- Ceilings on the contracting and guaranteeing by the public sector of new short-term nonconcessional external debt; and
- Ceilings on accumulation of new external payment arrears by the public sector.

II. INSTITUTIONAL DEFINITIONS

4. The central government includes all units of budgetary central government and extra budgetary funds.

5. Depository corporations (DCs) include the CBSI and other depository corporations (ODCs). ODCs include commercial banks, the Credit Corporation of Solomon Islands, and credit unions. Financial corporations include DCs and other financial corporations (OFCs).

OFCs are the National Provident Fund (NPF), the Development Bank of Solomon Islands, and the Investment Corporation of Solomon Islands.

III. Monetary Aggregates

6. **Valuation.** Foreign currency-denominated accounts will be valued in Solomon Islands dollar (SI$) at the program exchange rate of SI$7.36 per U.S. dollar, as of end-June 2012. Foreign currency accounts denominated in currencies other than the U.S. dollar and monetary gold will first be valued in U.S. dollars at actual exchange rates and gold prices used by the CBSI, respectively, before they are converted to Solomon Islands dollars.

A. Reserve Money

7. Reserve money consists of currency issued by the CBSI (excluding CBSI holdings of currency) and all transferable deposits held at the CBSI.

B. Net International Reserves of the CBSI

8. A floor applies to the level of NIR of the CBSI. The floor on NIR will be adjusted upward (downward) by the amount of budget support from bilateral and multilateral donors (excluding the IMF) in excess (short) of the programmed level.

9. NIR will be calculated as gross international reserves (GIR) less international reserve liabilities. For program monitoring purposes, the stock of foreign assets and foreign liabilities of the CBSI, as reported in Solomon Islands dollars, shall be valued at program exchange rate in U.S. dollars, as described on paragraph 6.

10. GIR of the CBSI are defined as the sum of:

- Foreign currency assets in convertible currencies held abroad and as vault cash that are under the direct and effective control of the CBSI and readily available for intervention in the foreign exchange market or the direct financing of balance of payments imbalances and are of investment grade or held with an investment-grade institution.
- The reserve position of the Solomon Islands in the IMF;
- Holding of SDRs; and
- Monetary gold.

Excluded from the definition of GIR are:

- Foreign currency deposits of ODCs and OFCs held at the CBSI;

- Any foreign currency claims on residents, capital subscriptions in international institutions, and foreign currency assets in nonconvertible currencies, and;

- GIR that are in any way encumbered or pledged, including, but not limited to, reserve assets used as collateral or guarantee for third-party external liabilities.

11. International reserve liabilities of the CBSI are defined as the sum of:

- All outstanding liabilities of the Solomon Islands to the IMF, excluding IMF SDR allocations; and

- Foreign currency liabilities in convertible currencies to nonresidents with an original maturity of up to and including one year.

C. Net Domestic Assets of the CBSI

12. A ceiling applies to the level of NDA of the CBSI. The ceiling on NDA will be adjusted downward (upward) by the amount of budget support from bilateral and multilateral donors (excluding the IMF) in excess (short) of the programmed level.

13. NDA of the CBSI will be calculated as the difference between reserve money and the sum of NIR of the CBSI and other NFA of the CBSI. Any revisions to the historical stock of reserve money based on changes to the accounting treatment of the profit/loss account of the CBSI will be notified to the Fund immediately and used to adjust monetary aggregates by an equivalent amount, as deemed appropriate. Other NFA of the CBSI includes:

- Foreign assets related to holdings of foreign currency deposits, and securities not included in NIR of the CBSI, and loans, shares, financial derivatives, or accounts receivable with nonresidents; and other foreign assets that are not included in NIR of the CBSI, as defined in Section III. B; and

- Foreign liabilities related to IMF SDR allocations; deposits, securities, loans, financial derivatives, and other accounts payable with nonresidents; and other foreign liabilities that are not included in NIR of the CBSI, as defined in Section III. B.

D. Net Credit to the Central Government

14. A ceiling applies to the NCG measured cumulatively from the beginning of the year. The ceiling on NCG will be adjusted upward by the amount of budget support from bilateral and multilateral donors (excluding the IMF) short of the programmed level.

15. NCG is defined as the sum of net claims of: (i) the CBSI, (ii) commercial banks and other ODCs, (iii) OFCs, (iv) insurance companies, (v) and government treasury bills held by the general public.

IV. Fiscal Aggregates

D. Cash Balance of the Central Government

16. A floor applies to the program cash balance of the central government. The floor on the program cash balance will be adjusted downward by the amount of budget support from bilateral and multilateral donors (excluding the IMF) in short of the programmed level. The floor on the program cash balance will also be adjusted upward (downward) by the stock of government treasury bills, excluding restructured government bonds, in excess (short) of the program level of SI$40 million. The floor on the program cash balance will be adjusted upward by the difference between SI$140 million (hereafter known as program level) in the SIG Consolidated Deposits Account and its actual balance, should the actual balance in the SIG Consolidated Deposits Account be lower than SI$140 million.

17. The program cash balance of the central government is defined as the gross cash balance minus the total amount of unpaid payment orders and unpresented checks.

18. The gross cash balance is defined as the sum of government deposits, which are not in any way encumbered or pledged as collateral or used as a guarantee against government incurred liabilities, in the following accounts:

- In CBSI: Solomon Islands Government (SIG) Revenue Account, SIG Funded Development Account, SIG Debt Servicing Account;
- In Australia New Zealand Bank: SIG Creditors Account; Payroll Imprest Account, and Airport Service Fees Account;
- In Bank of South Pacific: Provincial Revenue Holding Account, SIG Inland Revenue Account, Sub Treasury Gizo Account, and Sub Treasury Auki Account; and
- Donor funded budget support accounts that are created by and under control of the government.

V. External Debt

A. Medium- and Long-Term External Debt

19. A ceiling applies to the contracting and guaranteeing by the public sector of new nonconcessional borrowing with nonresidents with original maturities of more than one year. The ceiling applies to debt and commitments contracted or guaranteed for which value has not yet been received. This applies to private debt for which official guarantees have been extended and which, therefore, constitutes a contingent liability of the public sector. The public sector comprises the central government, the CBSI, nonfinancial public enterprises

(i.e., enterprises in which the government owns more than 50 percent of the shares), and other official entities.

20. The definition of debt, for the purposes of the program, is set out in Point 9 of the Guidelines on Performance Criteria with Respect to External Debt in Fund Arrangement Executive Board Decision No. 6230-(79/140), as revised on August 31, 2009 (see Annex I).

21. Excluded from the ceiling are (i) the use of Fund resources; (ii) lending from the World Bank and the Asian Development Bank; (iii) debts incurred to restructure, refinance, or prepay existing debts, to the extent that such debt is incurred on more favorable terms than the existing debt and up to the amount of the actually restructured/refinanced/prepaid debt; (iv) concessional debts; (v) any SI$-denominated treasury bill and bond holdings and Bokolo bonds held by nonresidents.

22. For program purposes, the guarantee of a debt arises from any explicit legal obligation of the central government, the CBSI, nonfinancial public enterprises, or other official entities on behalf of the central government or the CBSI to service debt in the event of nonpayment by the main obligor (involving payments in cash or in kind).

23. For program purposes, a debt is concessional if it includes a grant element of at least 35 percent, calculated as follows: the grant element of a debt is the difference between the net present value (NPV) of debt and its nominal value, expressed as a percentage of the nominal value of the debt. The NPV of debt at the time of its contracting is calculated by discounting the future stream of payments of debt service due on this debt. The discount rates used for this purpose are the currency specific commercial interest reference rates (CIRRs), published by the Organization for Economic Cooperation Development (OECD). For debt with a maturity of at least 15 years, the 10-year-average CIRR will be used to calculate the NPV of debt and, hence, its grant element. For debt with a maturity of less than 15 years, the 6-month average CIRR will be used. To both the 10-year and 6-month averages, the same margins for differing repayment periods as those used by the OECD would continue to be added (0.75 percent for repayment periods of less than 15 years, 1 percent for 15 to 19 years, 1.15 percent for 20 to 29 years, and 1.25 percent for 30 years or more).

B. Short-Term External Debt

24. A ceiling applies to the contracting and guaranteeing by the public sector of new nonconcessional borrowing with nonresidents with original maturities of up to and including one year. The ceiling applies to debt and commitments contracted or guaranteed for which value has not yet been received. This applies to private debt for which official guarantees have been extended and which, therefore, constitute a contingent liability of the public sector. The public sector comprises the central government, the CBSI, nonfinancial public enterprises (i.e., enterprises in which the government owns more than 50 percent of the shares), and other official entities.

25. For program purposes, the definition of debt is set out in Point 9 of the Guidelines on Performance Criteria with Respect to External Debt in Fund Arrangement approved by the Executive Board Decision No. 6230-(79/140), as revised on August 31, 2009 (see Annex I).

26. Excluded from the ceiling are (i) debts classified as international reserve liabilities of the CBSI; (ii) debts incurred to restructure, refinance, or prepay existing debts, to the extent that such debt is incurred on more favorable terms than the existing debt and up to the amount of the actually restructured/refinanced/prepaid debt; (iii) SI$-denominated treasury bills and bonds and CBSI and Bokolo bills held by nonresidents; (iv) concessional debts; and (v) normal import financing. A financing arrangement for imports is considered to be "normal" when the credit is self-liquidating.

VI. External Payment Arrears

27. A continuous performance criterion applies to the non-accumulation of external payments arrears by the public sector, comprising the central government, the CBSI, nonfinancial public enterprises, and other official entities. External payments arrears consist of external debt-service obligations (principal and interest) that have not been paid at the time they are due, as specified in the contractual agreement, subject to any applicable grace period.

VII. Data Provision

28. The data listed below will be provided for monitoring performance under the program based on data templates agreed with Fund staff. Under each section, reporting responsibilities are indicated in parentheses. Weekly data are requested for submission to Fund staff by the end of the following week. Monthly and quarterly data are requested for submission within six weeks of the end of the observation period. The authorities have committed to using the best available data, so that any subsequent data revisions will not lead to a breach of quantitative performance criteria or benchmarks. All revisions to data will be promptly reported to Fund staff.

A. Monetary Data (CBSI)

On a weekly basis:

- Daily exchange rates, both buying and selling rates, of the Solomon Islands dollar against the U.S. dollar, including the official, interbank, and parallel market exchange rates;
- Stock of NIR and sales and purchases by the CBSI in the foreign exchange markets;
- Stock of reserve money and its components; and
- Treasury bill auction reports.

On a monthly basis:

- Financial corporations' survey, including the balance sheet of CBSI, the consolidated balance sheet of ODCs, and the consolidated balance sheet of OFCs;
- Liquid asset ratios and/or reserves requirement of the commercial banks;
- Interest rates, including average interbank rate, bank deposit rates, and bank lending rates;
- A detailed breakdown of NCG from the CBSI, commercial banks and other ODCs, and OFCs;
- Foreign exchange cash-flow of the CBSI, including donor disbursements; and
- Balances of each central government account specified in Section IV. A., as recorded or collected by the CBSI.

B. Fiscal Data (Ministry of Finance and Treasury (MoFT)

On a monthly basis:

- Consolidated accounts of the central government, including detailed data on:
    - Revenue, including tax and nontax revenues, and recurrent and development grants included in the consolidated budget;
    - Recurrent expenditure, including payroll, goods and services, and other recurrent outlays, including those funded by donor support;
    - Other recurrent charges of the Ministry of Education and Ministry of Health, separating spending funded by donor support;

  - Debt service payments, classified into amortization and interest payments on (i) domestic debt, (i) external debt, (iii) domestic arrears, and (iv) external arrears; and

  - Development expenditure funded by (i) central government of the Solomon Islands, and (ii) foreign grants and loans included in the consolidated budget.

- Detailed financing components of central government's accounts, classified into foreign and domestic sources.

  - Foreign financing includes (i) disbursement and amortization of project and program loans, and (ii) changes in external debt arrears, classified into principal and interest arrears.

  - Domestic financing includes (i) borrowing from and repayment to the CBSI, commercial banks and other ODCs, and OFCs; (ii) changes in deposits at the CBSI, commercial banks and other ODCs, and OFCs; and (iii) privatization receipts and changes in domestic debt arrears, classified into principal and interest arrears.

- Stock of domestic debt, including the outstanding balance of government securities, treasury bills, cash advances, and other debt instruments.

- Balances of each central government account specified in Section IV. A., as recorded by the MoFT.

- Stock of unpaid government payment orders and unpresented checks.

C. External Sector Data (CBSI and MoFT)

On a quarterly basis:

- New external debt obligations contracted and/or guaranteed by the government of the Solomon Islands, CBSI, and other official entities, including details on the amounts, terms, and conditions of each obligation.

- Stock of outstanding external debt at end-month and disbursement, amortization, and interest payments for short-term external obligations contracted or guaranteed by the government or the CBSI by creditor in original currency and U.S. dollars.

- Stock of external debt at end-month and disbursement, amortization, and interest payments for medium- and long-term external obligations contracted or guaranteed by the government or the CBSI by creditor in original currency and U.S. dollars.

- Stock of arrears on the external debt contracted or guaranteed by the government or the CBSI by creditor in original currency and in U.S. dollars at end-month.

On a quarterly basis:

- Balance of payment data, including detailed components of current accounts and capital and financial accounts.

D. Real Sector Data (MoFT, National Statistical Office)

On a monthly basis:

- The monthly consumer price index and a detailed breakdown by major categories of goods and services included in the consumer basket.

ANNEX I. GUIDELINES ON PERFORMANCE CRITERIA WITH RESPECT TO FOREIGN DEBT

Excerpt from Executive Board Decision No. 6230-(79/140), as revised on August 31, 2009

9. (a) For the purpose of this guideline, the term "debt" will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows:

(i) loans, i.e., advances of money to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements);

(ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until sometime after the date on which the goods are delivered or services are provided; and

(iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property.

(b) Under the definition of debt set out in point 9 (a) above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.