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SOLOMON ISLANDS

June 2014

THIRD REVIEW UNDER THE EXTENDED CREDIT FACILITY ARRANGEMENT AND REQUEST FOR MODIFICATION OF PERFORMANCE CRITERIA—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR SOLOMON ISLANDS

In the context of Solomon Islands third Extended Credit Facility review, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on June 20, 2014, following discussions that ended on May 15, 2014, with the officials of Solomon Islands on economic developments and policies underpinning the IMF arrangement under the Extended Credit Facility. Based on information available at the time of these discussions, the staff report was completed on June 5, 2014
- A **Press Release** including a statement by the Chair of the Executive Board.
- A **Statement by the Executive Director** for Solomon Islands.

The following documents have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Solomon Islands*
Memorandum of Economic and Financial Policies by the authorities of Solomon Islands*
Technical Memorandum of Understanding*

*Also included in Staff Report

The publication policy for staff reports and other documents allows for the deletion of market-sensitive information.

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SOLOMON ISLANDS

June 5, 2014

THIRD REVIEW UNDER THE EXTENDED CREDIT FACILITY ARRANGEMENT AND REQUEST FOR MODIFICATION OF PERFORMANCE CRITERIA

KEY ISSUES

Recent Developments. After four years of consecutive growth, the unprecedented floods that hit Honiara in early April 2014 have undermined economic activity. The flash floods caused loss of life and widespread damage to key infrastructure, water and sanitation systems, housing, and agricultural output. The only gold mine was closed and is still not operating.

Outlook and Risks. As a result, economic growth prospects have worsened. Economic growth in 2014 is projected at near zero, despite reconstruction efforts, on account of the closure of the mine and other flood-related income losses. In 2015, activity is expected to increase by 3½ percent led by large foreign-financed infrastructure projects. With the continued decline in logging output, growth will need to be supported by increased productivity across a wide range of sectors, including agriculture, tuna processing, and tourism. Boosting the competitiveness of the economy is key to strengthening the medium-term growth outlook. Risks to the outlook are on the downside with the upcoming parliamentary legislative elections adding an element of uncertainty to the outlook.

Program Performance. Program performance under the ECF arrangement has been broadly satisfactory. Reserve buffers have been rebuilt and are at a comfortable level, well above the average of other small states. All performance criteria (PCs) for end-December, the indicative targets (ITs) for March, and the continuous PCs were met with considerable margins, except for the IT on government-funded recurrent spending on health and education, which was narrowly missed. Despite delays, progress has been made in implementing an ambitious structural reform agenda. As in the past, reforms have taken longer than expected owing mainly to resource constraints and the need to consult more broadly with stakeholders.

Policy Recommendations.

- Support economic activity through fiscal policy in the short term using fiscal buffers rebuilt in recent years, but strictly re-prioritize toward capital spending.
- Improve the quality of public spending by advancing PFM reform including by enhancing the transparency and accountability of scholarship and constituency funds.
- Maintain the current monetary policy stance but stand ready to tighten monetary policy if credit growth surges together with inflationary pressures.
- Follow the currency basket more closely.

Approved By

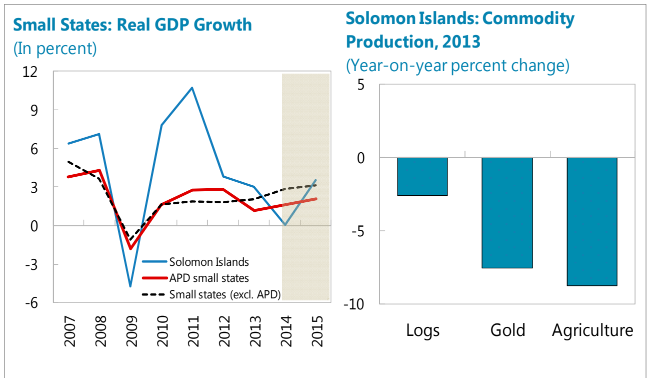
Luis Breuer and
Masato Miyazaki

The mission team led by Ms. Tumbarello visited Honiara during May 6–15, 2014. The team comprised Messrs. Jamaludin, Wu (all APD), and Perks (SPR). Ms. Plater, Alternate Executive Director, joined the discussions. The mission overlapped with a World Bank mission assessing the costs of the recent flood. The IMF team met with Prime Minister Lilo, Minister of Finance Houenipwela, Central Bank Governor Rarawa, Permanent Secretary of Finance Fanega, other senior officials, development partners, and financial sector representatives.

CONTENTS

THE SETTING, OUTLOOK, AND RISKS

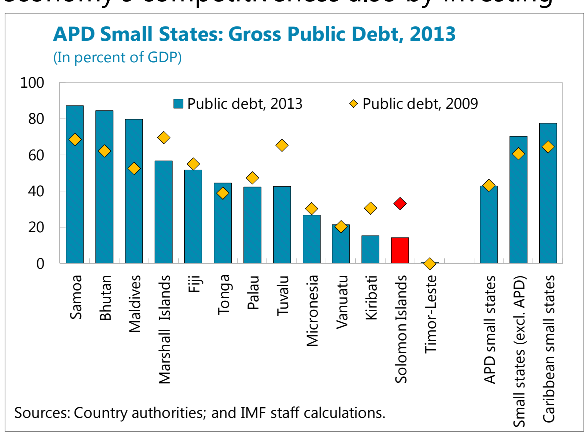
1. ***Context.* After three years of strong commodity-led growth (averaging 8 percent per year), in 2013 economic performance slowed to 3 percent in Solomon Islands** (Table 1). This deceleration was due to a decline in agricultural output owing to unfavorable weather, lower gold production caused by the restructuring of the Gold Ridge mine in the wake of lower world gold prices, and the ongoing depletion of logging stocks.



Sources: Country authorities; and IMF staff calculations.

2. ***Floods.* The unprecedented floods which hit the island of Guadalcanal, in particular, Honiara, Solomon Islands' capital, in early April 2014 have undermined economic activity**. The flash floods caused loss of life and widespread damage to key infrastructure, water and sanitation systems, housing, and agricultural output. One fifth of Honiara's population was displaced to shelters. Rural areas around the capital were also heavily affected. The only gold mine was closed and is still not operating. The rapid disaster-impact-assessment prepared by the World Bank points to combined government and private income losses equal to 4.7 percent of GDP. Despite the devastation, Solomon Islands does not qualify for payout under the terms of the World Bank´s pilot Pacific Disaster Risk Financing and Insurance Program because disbursements are linked to specific physical parameters (e.g. the wind speed triggering a cyclone) that were not triggered during the recent flood.

3. ***Outlook.* Reflecting these negative developments, economic growth prospects have worsened** (Figure 1). Economic growth in 2014 is projected at near zero, despite reconstruction efforts, owing to the current closure of the mine and other flood-related income losses. In 2015, activity is expected to increase by 3½ percent led by large foreign-financed infrastructure projects. Growth prospects will also depend on how quickly gold production re-starts and on whether future mining projects, such as nickel, come on stream. With the continued decline in logging output, growth will need to be supported by increased productivity across a wide range of sectors, including agriculture, tuna processing, and tourism. Boosting the economy's competitiveness also by investing in human and physical capital is key to strengthening medium-term growth. The decline in aid in the pipeline from Australia and other development partners, poses an additional medium-term challenge, though potential investment projects—including the Tina River Hydro Power project,[1] a second tuna processing plant, and higher gains from large investments in mobile telecommunication—suggest some upside risk to the growth outlook. The current account deficit is forecast to nearly double to about 15 percent in 2014 and 2015 from 8 percent in 2013,



Sources: Country authorities; and IMF staff calculations.

[1] The Fund and the World Bank are working with the authorities to assess the debt implication of the potential hydro power project. An updated DSA will be attached to the staff report during next ECF review.

reflecting the underlying long-run decline in logging exports and an increase in capital imports. Over the medium term the current account deficit will narrow with the recovery of exports and the winding down of import-intensive investment (Table 2).

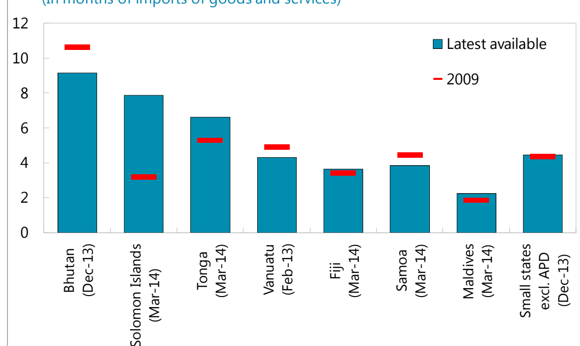
4. ***Risks*. The risks to the outlook are on the downside.** On the domestic front, the upcoming parliamentary election, set for the fall of 2014, introduces yet more uncertainty to the outlook. Moreover, the external environment could worsen leading to lower external demand and more unfavorable terms of trade. A series of negative shocks, including additional natural disasters, could quickly erode the policy buffers (including low public debt) that Solomon Islands has built since 2010 under the IMF-supported programs as a result of strong macroeconomic stability. Solomon Islands remains a fragile state because of its strong dependence on aid, vulnerability to shocks, including frequent natural disasters, and weak institutional capacity.

PROGRAM PERFORMANCE

5. **Program performance under the ECF arrangement has been broadly satisfactory.**

- **Reserve buffers have been rebuilt and are at a comfortable level**, well above the average of other small states. All performance criteria (PCs) for end-December, the indicative targets (ITs) for March, and the continuous PCs were met with considerable margins, except for the IT on government-funded recurrent spending on health and education, which was narrowly missed.

APD Small States: Reserves
(In months of imports of goods and services)



Sources: Country authorities; and IMF staff calculations.

- **Despite delays, meaningful progress has been made in implementing an ambitious structural agenda**—including in the areas of debt management policy, fiscal planning and Public Financial Management (PFM). Three benchmarks were met ahead of time: the on-lending and guarantee policies to strengthen the debt management framework (February 2014 benchmark), the 2013 budget report (April 2014 benchmark), and the benchmark on the submission to Cabinet of the draft regulation for the constituency development fund (December 2013 benchmark). On the last benchmark, however, more consultation, at the provincial level— which is underway—is needed to advance for cabinet's approval.

- **Progress has been made with all other benchmarks**, although these were not met. Major strides were made on benchmarks related to the new mining tax regime with parliament's approval of amendments to the Income Tax Act and the Mines and Minerals Act in April—which implement all but one of the Fund's TA recommendations on mining tax reforms (March 2014 benchmark). To complete the mining tax reform agenda, a ministerial order on streamlining export duty on gold is planned for July of this year. As for new policies for tertiary scholarship (January 2014 benchmark), the cabinet has prepared new regulation but further progress has been delayed by the need to reconcile a new, unexpected policy prepared by the Ministry of Public Service on allocating in-service scholarships for public servants. In the meantime, the authorities have made progress in strengthening the management of tertiary education scholarships, including by setting up a new team to monitor existing scholarships and improve spending control in 2014. Early indications suggest that these measures have made the process more efficient and that spending will remain below the budget ceiling this year. The authorities are also preparing a report to parliament on the audit of constituency development funds projects in 2012 before releasing the results of the audit to the public (March 2014 benchmark). As in the past, reforms have taken longer than expected, despite strong political commitment, owing mainly to resource constraints, including the bottleneck in the Attorney General's Chambers, and the need to consult more broadly with stakeholders and increase ownership by building consensus. The authorities have requested a re-phasing of existing benchmarks in the attached MEFP to better calibrate the timing with capacity constraints.

POLICY DISCUSSIONS

A. Fiscal Policy: Supporting the Economy While Preserving Fiscal Stability

Background

6. **In 2013 the fiscal balance posted a surplus of 4.3 percent of GDP**—well above the program target of 0.3 percent of GDP (EBS/13/168) and the supplementary budget approved in September which implied a deficit of 3.7 percent of GDP (Table 3). This outturn was driven by an underexecution in development spending funded by donors. The fiscal surplus was slightly higher (by 0.4 percentage point) in 2013 relative to 2012 mainly because of the decline in development spending funded by donors. The 2013 supplementary budget approved in September 2013 envisaged higher recurrent spending relative to the original budget envelope but this did not materialize in line with staff advice (EBS/13/168). Recurrent spending outturn was lower by 7 percentage points of GDP, relative to the September supplementary budget. The cash balance outturn, at 3.2 months of recurrent spending, exceeded the two-month target. Building fiscal buffers has been part of the authorities' strategy to deal with natural disasters by buying self-insurance.

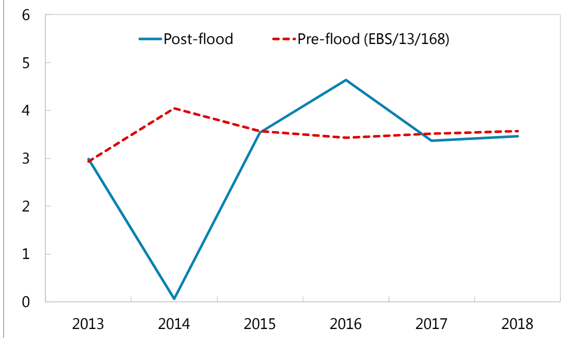
7. **The 2014 budget approved in December targeted a smaller overall fiscal surplus, equal to 1.2 percent of GDP.** The narrowing of the surplus mainly reflects a large increase in current spending equivalent to 4 percentage points of GDP relative to 2013. This is partly explained by a 3½ percent increase in public servant salaries starting in June 2014 as well as 320 new public administration hires starting mid-year and an increase in public-sector allowances and benefits. In addition, the impact of one-off election-related spending in 2014, amounting to 0.7 percent of GDP is expected to be reversed in 2015. On the upside, the budget also envisages 1½ percentage points of GDP reduction in constituency funds managed by members of parliament (to 2 percent in 2014 from 3½ percent in 2013). The budget also incorporates a small decline in tertiary scholarship spending, in line with previous staff recommendations for improving the quality, transparency, and accountability of public resources. Implementation of development spending is expected to accelerate as reforms continue—including through the creation of Budget Implementation Committees in line ministries to monitor and facilitate the implementation of the budget and associated projects. On the revenue side, several measures in the pipeline are expected to strengthen revenue performance relative to 2013. These include: streamlining exemption rules, enhancing IT system in tax collection, and strengthening revenue collection capacity through training and recruitment of new staff.

8. **Fiscal risks have increased and fiscal prospects have deteriorated relative to the last review because of the flood and the current closure of the gold mine.** For 2014, staff projects a fiscal deficit of 1.6 percent of GDP owing to the combined effect of revenue losses by 1.7 percent of GDP (or SI$150 million) and additional government-funded spending to support the recovery equivalent to 1.2 percent of GDP (or SI$100 million) (Box 1). The deficit will be financed with cash reserves. Program targets have been set consistently.[2] A supplementary budget in July is expected to appropriate additional external funds and increase flood-related spending.

[2] The cash balance will decline from SI$620 million at end-March 2014 to SI$374 million at end-2014.

Box 1. The Macroeconomic Impact of the Flood

Solomon Islands: Flood Impact on Real GDP Growth
(In percentage change)



Sources: Country authorities; and IMF staff estimates and projections.

- **GDP growth** is expected to drop by 4 percentage points in 2014 relative to the pre-flood forecast, largely owing to income losses in the mining, agriculture, and transport sectors.

- **Inflation** will rise to 7.0 percent in 2014 because of temporary spikes in food prices, before reverting to trend (4½ percent) in the medium term.

- **Total costs of the flood related to the public sector** amount to 4 percent of GDP in FY2014. The government will meet part of these costs (about 3 percent of GDP) through a draw-down of the cash balance. The rest is expected to be largely met by direct donor support or humanitarian aid. Foreign-financed infrastructure projects already pre-committed before the flood (e.g., Japan International Corporation Agency) are also expected to contribute to rehabilitation.

- **Revenue losses.** Tax revenues are expected to drop by SI$150 million relative to the 2014 budget as a result of the drop in GDP and the disruption of mineral production.

Solomon Islands: Macroeconomic Impact of the Flood
(In percent of GDP, unless indicated otherwise)

	2014 Pre-flood (EBS/13/168)	2014 Post-flood	2015
Real GDP growth (In percent)	4.0	0.1	3.5
CPI (Average, in percent)	5.9	7.0	5.5
Revenue	33.2	31.5	31.9
Grants	18.0	17.2	16.6
Overall balance	0.3	-1.6	-0.8
Current account	-13.5	-14.7	-15.5
Current account+FDI	-3.8	-9.9	-6.3
Cash balance (SI$ million)	407	374	444
Cash balance (In months of recurrent spending)	1.9	1.8	2.0
Net official reserves (US$ million, end of period)	509	466	440

- **Government-funded spending.** The physical damage to infrastructure and to the health and education sectors is estimated by the World Bank at 1.2 percent of GDP. We assume that SI$60 million (0.7 percent of GDP) will be allocated to recurrent spending, and SI$40 million (0.5 percent of GDP) in development spending.

- **The fiscal balance** could reach a deficit of 1.6 percent of GDP. The deficit will be financed partly by domestic savings. The program cash balance would drop to 1.8 months of current spending.

- **The flood-related budget support** received as of early May amounted to SI$15 million (or 0.2 percent of GDP), while SI$45 million (or 0.4 percent of GDP) was in in-kind and humanitarian aid which have been channeled via NGOs.

- **The current account deficit** could widen to 14.7 percent of GDP from a pre-flood level of 13.0 percent. The large loss of commodity exports (mainly gold and agriculture) is partly offset by the reduction in mining-related imports, especially fuel, while some import-intensive reconstruction and investment are only expected to occur in 2015.

- **FDI** is expected to drop to 6 percent of GDP from 9.8 percent of GDP in the pre-flood scenario, but to recover to 9 percent of GDP in 2015, driven by large projects in the pipeline.

- **Reserves.** Net international reserves are expected to drop to US$466 million at end-2014 from US$526 million at end-March 2014—US$40 million lower than the pre-flood projection.

Staff's Views

9. **In the near term, fiscal policy should support economic activity, but re-prioritization toward capital spending is needed to upgrade infrastructure, water and sanitation systems, and schools.** Part of the fiscal space rebuilt in recent years should be used for reconstruction and much-needed capital projects—and to absorb cyclical revenue losses. Staff analysis (Box 2) suggests that Solomon Islands is among those countries that stands to gain the most from increasing the share of their budget devoted to fund capital spending. Moreover, the forthcoming 2014 supplementary budget should strictly contain recurrent spending relative to the 2014 budget, especially public sector allowances and benefits. In this context, the mission welcomed the forthcoming public sector remuneration review which is expected to revise remuneration arrangements and address the payroll fiscal risk. Extra spending on the election and any increase in constituency funds should also be resisted. Improving the transparency and strengthening the regulation of these funds, and also containing their size, are vital for increasing the rate of return on public spending and improving its quality (Figure 2)—especially given the expected drawdown in cash reserves and for catalyzing donors' support. Using the cash balance wisely is also essential given the current uncertainty surrounding the economic and fiscal outlook for 2015. Over the medium term, anchoring fiscal plans to the non-mineral primary balance of about 2 percent of GDP should help promote fiscal sustainability.

10. **Dealing with natural disasters in the future will entail a multi-pillar strategy.** Current recovery and reconstruction efforts provide an opportunity to accelerate growth-enhancing structural reforms and climate adaptation and mitigation strategies, including upgrading of infrastructure. More broadly, building resilience to future natural disasters will require maintaining adequate fiscal and external buffers. However, for large disasters, the International Financial Institutions and bilateral donors are likely to remain important sources of finance. Continued participation in the external sovereign insurance mechanism could provide some additional coverage.

11. **Fiscal reforms are advancing.** The forthcoming PFM roadmap and the recent strengthening of debt management are paramount in building sound fiscal institutions—one of the key objective of the current ECF arrangement. The PFM roadmap which is due by end December 2014 in line with the PFM Act will provide a strong and coherent platform to anchor the implementation of PFM reforms, included in the recently enacted PFM Act. As part of the implementation of the PFM Act, the authorities are drafting a budget strategy and a mid-year budget review that staff strongly supports (August 2014 program benchmarks). These documents will foster budget discipline and budget planning in line with the PFM Act. The inclusion of on-lending operations and government debt guarantee in anchoring borrowing decisions would provide a more accurate picture of Solomon Islands' debt position. This will help inform government decisions and avoid eroding fiscal space too quickly, as borrowing pressures will increase with the much-needed capital investments. The pending review of policies on tertiary education is critical for signaling the government's commitment to promote transparency and accountability in the use of public funds. Also urgent is mobilizing additional revenues with the tax reforms in the pipeline—including the new customs and excise bill and raising non-tax revenue with additional technical assistance provided by PFTAC.

Box 2. Quantifying the Opportunity Cost of Building Fiscal Buffers[1]

Pacific Island Countries: Opportunity Cost of Building Fiscal Buffers

Country	Social Return of Capital 1/	Average Interest Rate (Cost of government spending)	Social Return of Capital Net of Interest Rate Payments
	(a)	(b)	(c)=(a)–(b)
Fiji	13.1	7.2	5.9
Kiribati	14.8	3.2	11.6
Marshall Islands	10.0	1.4	8.6
Micronesia	13.0	2.7	10.2
Palau	6.2	3.0	3.2
Papua New Guinea	12.8	4.1	8.7
Samoa	13.9	3.7	10.2
Solomon Islands	**13.9**	**1.5**	**12.4**
Tonga	10.3	2.2	8.1
Vanuatu	11.0	3.6	7.4
PICs	12.2	3.1	9.1
Memorandum:			
Low-income countries	14.2	...	...

1/ Capital share in income was assumed at 0.3 and the depreciation rate was assumed at 0.07.

Source: IMF staff estimates.

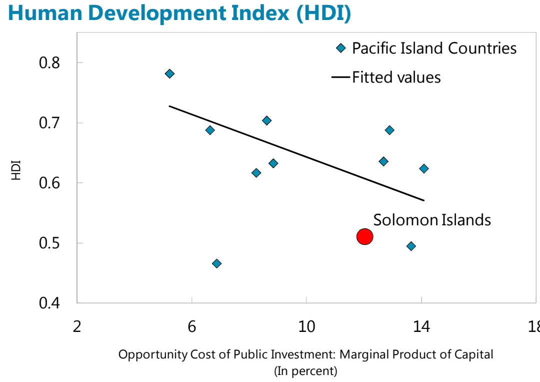
Policymakers in small developing states face a key fiscal policy choice, between building fiscal buffers to enhance resilience to shocks—including natural disasters— and funding development spending. When a government increases the fiscal space by raising public savings instead of financing spending for development needs, it forgoes the rate of return of the associated public investment. The opportunity cost of building fiscal buffers is a metric that can be used to assess the optimal mix between building fiscal space and capital spending.

Staff estimated the social return of public investment under the assumption that it equals the marginal productivity of capital.[2] Following Caselli and Feyrer (2007), a Cobb-Douglas production function was calibrated for a group of Pacific Island economies using data on output and investment from the Penn World Table and WEO data over the period 1970–2010.[3]

The results suggest that Solomon Islands faces the highest rate of return from capital spending in the region. Thus, Solomon Islands would benefit from investing in capital spending. This is consistent with the country's large infrastructure needs (Box 1, EBS/13/168). Also the social return to capital in the PICs is in line with the return in low-income countries.

The chart sheds some light on the country-specific room for fiscal maneuver. A plot of the estimated cost of building buffers against the Human Development Index (HDI)—a proxy for measuring infrastructure needs—suggest that Solomon Islands is among those countries that stands to gain the most from increasing the share of their budget devoted to fund capital spending.

Opportunity Cost of Building Fiscal Buffers and Human Development Index (HDI)



Source: IMF staff estimates.

[1] Prepared by Ezequiel Cabezon.

[2] Based on Baldacci, Cabezon, and Tumbarello, "Strengthening Fiscal Frameworks to Support Macro Stability and Growth in the Pacific Islands" (forthcoming, IMF Working Paper).

[3] Caselli and Feyrer, 2007, "The Marginal Product of Capital," The Quarterly Journal of Economics, MIT Press, Vol. 122(2), pages 535-568.

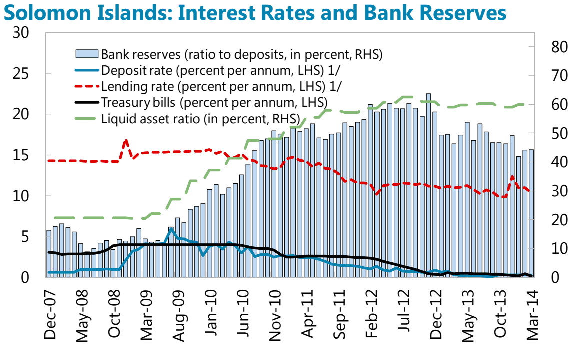
B. Strengthening Monetary and Exchange Rate Policies

Background

12. **After years of sluggishness, credit growth to the private sector picked up again** (Table 4). Bank credit to the private sector expanded by 15 percent (y/y) last year, and by 10 percent during the first quarter of 2014, with the fastest growth being observed in credit to households and, to a lesser degree, to the telecommunications and construction sectors. At the same time, inflation slowed to less than 3 percent (y/y) in December from 6 percent in mid-2013 owing to lower global food prices and the 3½ appreciation of the Solomon Islands dollar against the Australian dollar.

Inflation ticked up to 5 percent (y/y) in April 2014, owing to domestic food supply disruption and the 5½ percent depreciation of the Solomon Islands dollar vis-à-vis the Australian dollar. The central bank also increased its sterilization through open market operations and nearly doubled the placement of its short-term Bokolo bills since 2013 until February 2014, when the amount of outstanding Bokolo bills began to stabilize. Monetary conditions have nonetheless remained accommodative, as reflected in persistently high excess reserves held by commercial banks. Technical assistance from the IMF Monetary and Capital Markets Department (MCM) scheduled for July 2014 will focus on ways to further improve the effectiveness of the monetary transmission mechanism.

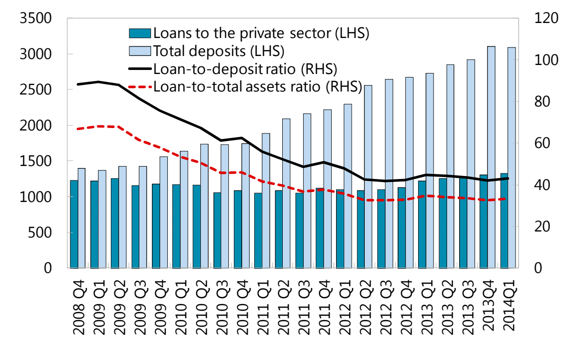
Solomon Islands: Interest Rates and Bank Reserves



Source: Central Bank of Solomon Islands.
1/ Weighted average rate of commercial banks.

Solomon Islands: Bank Loans and Deposits

(In thousands of Solomon Islands dollars)

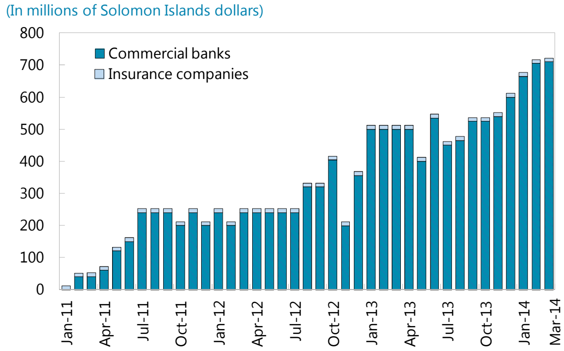


Sources: Central Bank of Solomon Islands; and IMF staff estimates.

13. **The Central Bank of Solomon Islands (CBSI) has recently reviewed the implementation of the basket peg regime.** The central bank moved to an invoice-based basket peg from a U.S. dollar peg in 2012, with the intention to set the bilateral SI$/USD exchange rate in order to keep the value of the basket constant. However, to avoid excessive fluctuations against the USD, the CBSI has not allowed the bilateral rate to deviate by more than one percent in either direction from a pre-set "base" rate. The CBSI has recently reviewed its operational implementation of the basket peg, and now plans further refinements to ensure that the peg is followed more closely, including by gradually widening the band, and moving the base rate so that it is more in line with the basket peg.

Solomon Islands: Holdings of Bokolo Bills

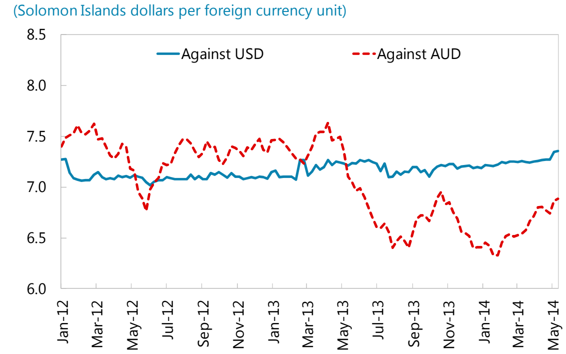
(In millions of Solomon Islands dollars)



Source: Central Bank of Solomon Islands.

Solomon Islands: Nominal Exchange Rate

(Solomon Islands dollars per foreign currency unit)



Sources: Central Bank of Solomon Islands; Bloomberg; and IMF staff estimates.

Staff's Views

14. **Monetary policy is broadly appropriate, but the authorities should be ready to tighten if credit growth becomes excessive and triggers a deterioration in credit quality and a pickup in demand-driven inflationary pressure.** The central bank should use all the instruments at its disposal, including reserve requirement, and issuing Bokolo bills. In addition, staff welcomed the authorities' plan of gradually widening the operational band of the exchange rate and moving the base rate so that it is consistent with the basket peg over time. This would also avoid eroding competitiveness as the currency appears moderately overvalued.

C. Preserving Financial Stability

Background

15. **The financial system is generally sound but financial depth is limited.** Banks' capital adequacy, liquidity, and profitability have been broadly adequate and stable since the end of 2012. Non-performing loans (NPLs) as a share of total loans had increased to 7.2 percent in December, owing to a temporary delay in rental payments by the government on housing rented from homeowners, which in turn, led to a temporary increase in loan delinquency among homeowner borrowers. However, NPLs declined to 4.9 percent as of March 2014 upon the resumption of payments. While credit to the private sector as a percent of GDP rose in 2013 and throughout the first quarter of 2014, it remains much lower than that in regional and non regional peers (20 percent of GDP versus 40 percent in the Asia and Pacific small states and 70 percent in other small states). Major structural issues, including insufficient investor protection, communal land tenure, and weak land registration, continue to constrain financial sector development. In April 2014, the CBSI issued a full banking license to Pan Oceanic Bank Limited, Solomon Islands' first locally incorporated bank, bringing to four the number of commercial banks in Solomon Islands. The bank was set up by Global Management Consultants (GMC), a Sri Lanka-based consulting consortium, with the support of DFCC Bank, a Sri Lankan bank. Financial sector reforms are advancing. Consultations with stakeholders on a new National Provident Fund (NPF) Act have been completed, and the law is about to be drafted with the goal of submitting it to parliament by June 2014.[3]

Solomon Islands: Core Financial Soundness Indicators 1/

	2011	2012	2013				2014
			Mar	Jun	Sep	Dec	Mar
Capital adequacy							
Regulated capital to risk-weighted assets	30.9	33.1	33.0	32.2	33.3	32.5	30.7
Nonperforming loans, net of provisions to capital	6.7	4.3	4.7	4.6	5.5	12.3	6.7
Asset quality							
Nonperforming loans to total gross loans	5.9	3.7	4.0	3.8	4.0	7.2	4.9
Earnings and profitability							
Return on average assets	3.2	3.2	2.6	2.5	2.4	2.2	1.6
Return on average equity	16.8	18.1	15.4	15.1	14.4	14.1	10.4
Net interest income to gross income	45.7	46.0	51.7	50.6	52.0	51.8	56.7
Noninterest expenses to gross income	48.2	50.6	52.4	53.4	53.6	54.9	53.0
Liquidity							
Liquid assets to total assets (liquid asset ratio)	57.1	60.8	59.0	59.7	60.2	59.1	59.9
Core liquid assets to short-term liabilities	69.4	60.3	48.8	54.4	56.8	54.7	49.8

Sources: Central Bank of Solomon Islands; and IMF staff estimates.
1/ Commercial banks only, at end-period.

Staff's Views

16. **A sound and deeper financial sector is paramount to sustain growth.** Efforts to strengthen the financial sector's supervisory and regulatory framework should continue in line with program commitments. Maintaining the momentum in efforts to strengthen the regulatory

[3] The NPF is Solomon Islands' only pension fund and the largest pool of financial savings.

framework through the enactment of a new Financial Institutions Act remains vital, as well as revising the NPF Act to bolster its governance structure and investment strategy. Making progress on a new Credit Union Act (program benchmarks December 2014, and March 2015) will also be important to improve supervision and financial inclusion. Rental payment delays were caused by weak execution of expenditures by line ministries, though the implementation of the forthcoming PFM reform roadmap is expected to improve PFM capacity across all areas of government and help ensure more timely payments.

D. Program Discussion and Other Issues

17. **Discussions focused on the third review under the ECF arrangement and on setting program conditionality (PCs and indicative targets through December 2014 and structural benchmark through March 2015).** Taking into account the program performance at end-March 2014 and the updated fiscal outlook, staff supports the authorities' proposal of modification of the end-June PCs targets (MEFP, Table 1). Without the proposed modification, the quarterly fiscal spending profile would be unrealistic, implying a much slower decumulation of the cash balance in the second half of 2014 than expected given the authorities' expenditure plans. As a result, performance criteria for end-June 2014 have been revised and indicative targets for end-September 2014 and PCs for end-December are proposed to be set. The structural agenda has been re-phased in Tables 2.A and 2.B of the MEFP and two new benchmarks on PFM reform have been added. Despite the structural agenda being very ambitious, the authorities wanted to keep the structural agenda on a tight schedule to leverage the reform momentum and continue signaling their strong commitment to reforms.

18. **The main risk to the ECF arrangement remains the political uncertainty related to the upcoming elections that could slow the pace of reforms**. But the success of the current and previous programs, despite capacity constraints, is a good indication that program ownership in Solomon Islands is strong and largely nonpartisan.

19. **The satisfactory implementation of the IMF-supported program remains key to ensuring continued disbursements from development partners.** Despite some decline in the long term, donor financing is expected to remain sizable over the next few years (Tables 5, 6, and 7). In 2014, Australia and New Zealand are expected to provide up to US$35 million in combined budget support, with the World Bank also providing US$2 million. The Asian Development Bank does not plan to disburse budget support in 2014 but plans to provide US$5 million in 2015 under the Economic and Financial Reform Program, alongside US$40 million to continue financing transportation and information-and-communication-technology infrastructure projects. The Japan International Cooperation Agency (JICA) is also expected to provide a total of around US$40 million in grants between 2014 and 2016 to improve port facilities and upgrade Kukum Highway. The authorities have been taking a cautious approach in asking external assistance in the form of loans to avoid a build-up of external debt. Solomon Islands have also received bilateral external assistance relating to the flood, thus far amounting to roughly US$8 million (or 0.6 percent of GDP)–with half expected to be reallocated from existing aid programs and the other half additional financing. The World Bank is also considering scaling up flood-related assistance through a combination of budget support and project financing.

20. **Staff also discussed with the authorities the new Poverty Reduction Strategy Paper or preparation status report, which is required to be completed by June 2015.** This will be based

on the National Development Strategy and may also be informed by any additional development plans produced in the wake of the recent flood.

STAFF APPRAISAL

21. **The recent floods have taken a toll on economic activity and aggravated the challenges that Solomon Islands faces as a small and fragile state.** The recent natural disaster, compounded by the current closure of the country's only gold mine, has worsened near-term growth prospects. Despite reconstruction efforts, growth outlook will depend on how quickly gold production re-starts and on whether future mining projects come on stream. Moreover, growth will need to be supported by increased productivity across a wide range of sectors. The expected decline in ODA over the medium term poses an additional challenge. Boosting the competitiveness of the economy is key to strengthening growth prospects.

22. **In the near term, fiscal policy should support economic activity, but the right spending mix is paramount to avoid wasting cash reserves and preserve fiscal discipline.** Part of the fiscal buffer rebuilt in recent years should be used for reconstruction and much-needed capital projects—and to absorb cyclical revenue losses. The forthcoming 2014 supplementary budget should give priority to public spending on infrastructure, while strictly containing spending on the election and avoiding an increase in constituency funds. Improving the transparency and strengthening the regulation of these funds, and also containing their size, are vital for increasing the rate of return on, or value of, public spending and improving its quality—especially given the expected drawdown in cash reserves. Using the cash balance wisely is also essential in light of the current uncertainty surrounding the economic and fiscal outlook for 2015. The authorities should also continue to control spending on tertiary education.

23. **The authorities should sustain their efforts in building sound fiscal institutions.** To this effect, forthcoming public financial management (PFM) roadmap together with the upcoming budget strategy and mid-year budget review, and the recent strengthening of debt management are key in fostering budget discipline and budget planning in line with the PFM act. But further efforts are needed to complete the unfinished structural agenda. The pending broader review of policies on tertiary education, in addition to containing the size of spending, is critical for signaling the government's commitment to promote transparency and accountability in the use of public resources.

24. **Monetary policy stance is appropriate.** Recent inflationary pressures have been mainly supply driven and they are expected to be short-lived. Moreover, as fiscal stimulus is intended to take the form mainly of capital projects—and spending will be gradual—it is expected to be less inflationary. However, the central bank should stand ready to tighten monetary conditions should credit growth become excessive and trigger a deterioration of credit quality and demand-driven inflationary pressures.

25. **The basket peg is an appropriate exchange rate regime for Solomon Islands, but the currency basket should be followed more closely by adjusting the bilateral rate**. This should be done by gradually widening the operational band and moving the base rate so that it is more in line with the basket peg.

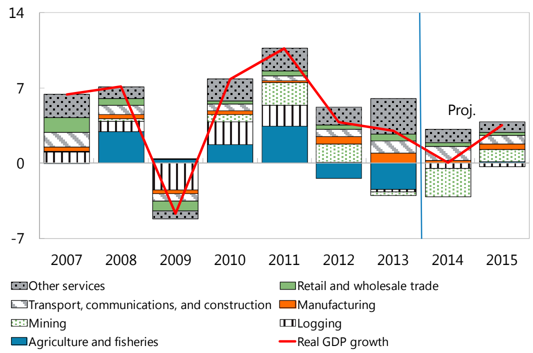
26. **The financial sector is sound but supervisory and regulatory frameworks need strengthening.** The forthcoming new National Provident Fund Act and the new Financial Institutions Act and Credit Union Act should help promote financial-sector stability and inclusion.

27. **Based on Solomon Islands' program performance, staff recommends completion of the third review under the ECF-supported program.** In light of the program's quantitative performance at end March 2014, staff supports the authorities' request for modification of end-June 2014 performance criteria and setting of end-December 2014 performance criteria. Given the strong program ownership, staff supports the authorities' request for modification and resetting of several structural benchmarks (MEFP, Tables 2.A and 2.B) and a proposal for establishment of two new PFM-related benchmarks.

Figure 1. Macroeconomic Developments and Outlook

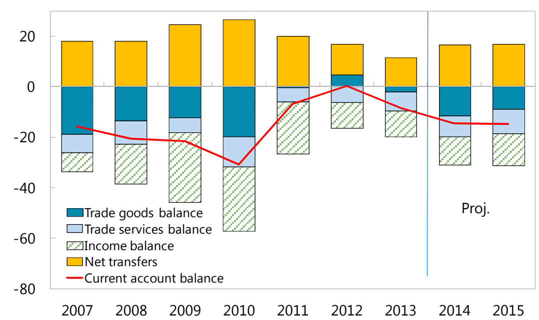
The importance of the commodity sector has declined. Growth will be zero in 2014.

Sources of Growth, 2007–15
(Year-on-year percent change)



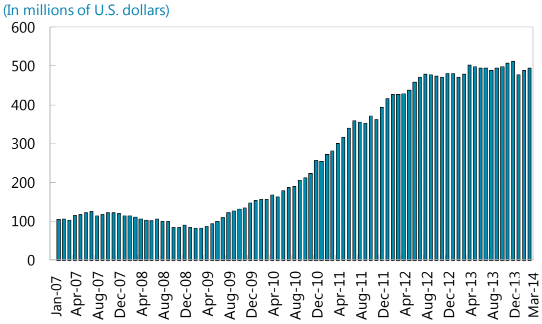
The current account deficit is expected to widen given the severe drop in exports and an increase in imports related to post-flood reconstruction…

Current Account Balance
(In percent of GDP)



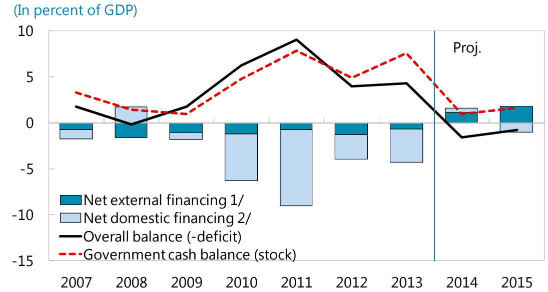
…though reserves, which have been rebuilt over recent years, are expected to provide some buffer.

Solomon Islands: Net International Reserves, Jan. 2007–Mar. 2014
(In millions of U.S. dollars)



Expected revenue losses will lead to a weaker fiscal position…

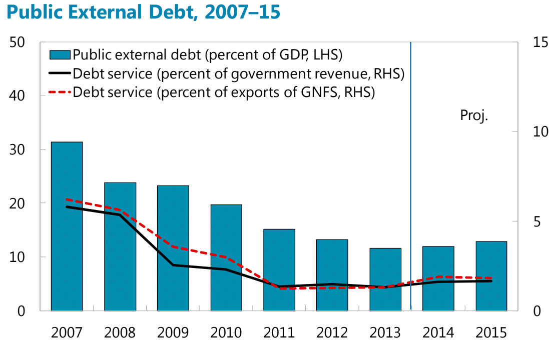
Fiscal Balance and Financing, 2007–15
(In percent of GDP)



1/ In 2007, includes debt forgiveness.
2/ Includes privatization receipts.

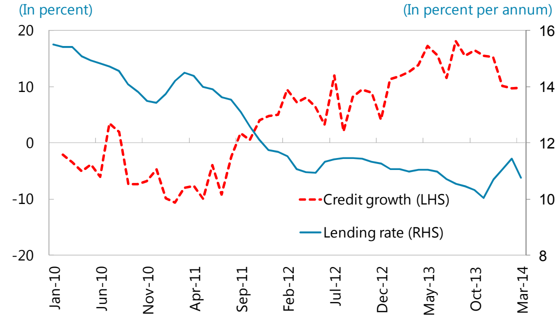
…though fiscal space has been rebuilt.

Public External Debt, 2007–15



Credit growth has been on a broadly upward trend as lending rates decline amid greater competition.

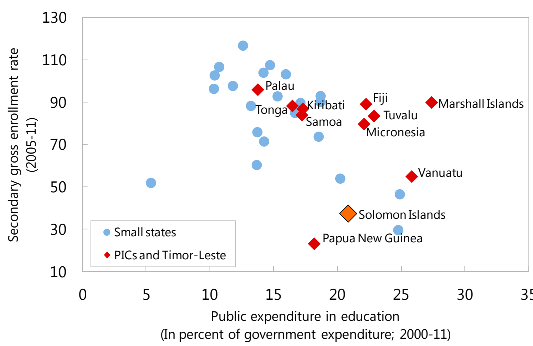
Credit Growth and Lending Rate, Jan. 2010–Mar. 2014
(In percent) (In percent per annum)



Sources: Country authorities; and IMF staff estimates and projections.

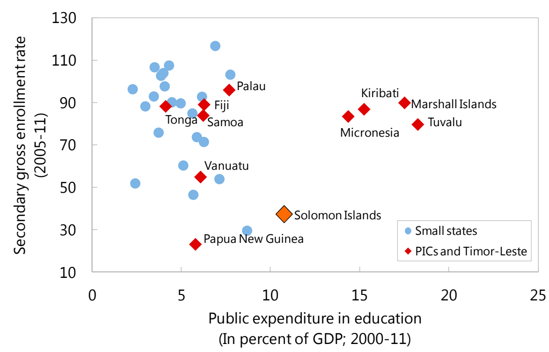
Figure 2. Small States: Social Spending and Selected Human Development Indicators

Public Expenditure in Education and Secondary Enrollment



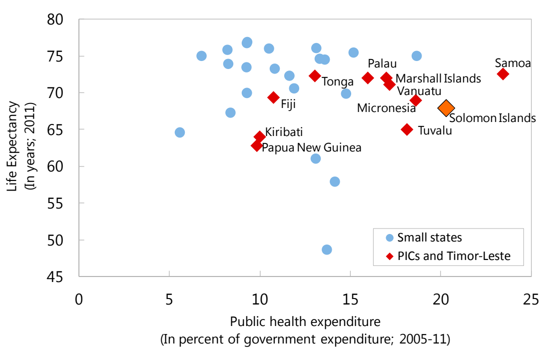
Sources: World Bank, WDI; Country authorities; IMF, WEO; and IMF staff estimates.

Public Expenditure in Education and Secondary Enrollment



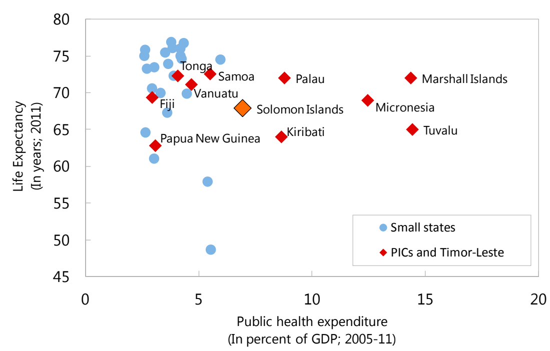
Sources: World Bank, WDI; Country authorities; IMF, WEO; and IMF staff estimates.

Life Expectancy and Public Health Expenditure



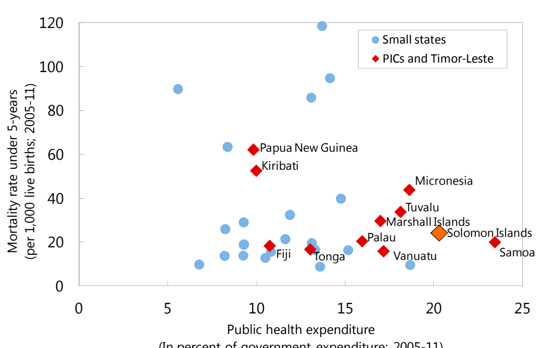
Source: World Bank, WDI.

Life Expectancy and Public Health Expenditure



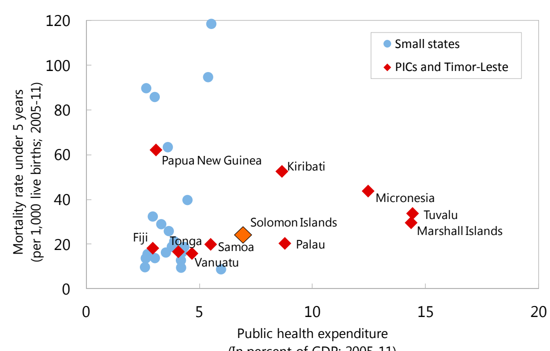
Source: World Bank, WDI.

Mortality Under 5-years and Public Health Expenditure



Source: World Bank, WDI.

Mortality Under 5-years and Public Health Expenditure



Source: World Bank, WDI.

Sources: Country authorities; and IMF staff estimates and projections.

Table 1. Solomon Islands: Selected Economic Indicators, 2012–15

Per capita GDP (2013): US$1,931 (estimate)
Population (2013): 562,000
Poverty rate (2006): 23 percent

	2012	2013		2014		2015
		Prog. (EBS/13/168)	Est.	Prog. (EBS/13/168)	Proj.	Proj.
Growth and prices (percentage change)						
Real GDP	3.8	2.9	3.0	4.0	0.1	3.5
CPI (period average)	5.9	6.1	5.4	5.9	7.0	5.5
GDP deflator	5.7	5.8	6.0	5.6	7.3	5.1
Nominal GDP (in SI$ millions)	7,281	8,006	7,946	8,800	8,530	9,281
Per capita GDP (in US$)	1,801	1,950	1,936	2,096	2,016	2,147
Central government operations (percent of GDP)						
Total revenue and grants	55.8	53.5	52.5	49.6	48.8	48.5
Revenue	34.8	32.9	34.8	32.1	31.5	31.9
Grants	21.0	20.5	17.8	17.4	17.2	16.6
Total expenditure	51.9	53.2	48.3	49.3	50.4	49.4
Recurrent expenditure	28.7	30.4	28.3	28.5	29.3	28.1
Development expenditure	23.1	22.7	19.9	20.8	21.1	21.2
Unrecorded expenditure 1/	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	3.9	0.3	4.3	0.3	-1.6	-0.8
Foreign financing (net)	-1.2	-0.6	-0.6	1.1	1.2	1.8
Domestic financing (net)	-2.7	0.3	-3.7	-1.4	0.5	-1.0
Central government debt (percent of GDP, unless otherwise indicated) 2/	17.7	14.6	14.8	14.1	14.6	15.0
Domestic debt	4.5	3.2	3.3	2.5	2.6	2.2
External debt	13.2	11.4	11.6	11.5	12.0	12.9
Monetary and credit (percentage change, end-year data)						
Credit to private sector	4.1	16.0	15.1	16.0	12.9	9.8
Broad money	17.3	14.5	12.4	7.4	16.0	...
Reserve money	22.0	2.8	-0.8	6.7	3.3	...
Interest rate - deposit (percent per annum, period average) 3/	0.9	...	0.3	...	0.2	...
Interest rate - lending (percent per annum, period average) 3/	11.3	...	10.7	...	10.4	...
Balance of payments (in US$ millions, unless otherwise indicated)						
Current account balance	2.2	-46.2	-91.5	-156.8	-171.0	-195.8
(percent of GDP)	0.2	-4.2	-8.4	-13.0	-14.7	-15.5
Exports of goods and nonfactor services (GNFS)	635.2	598.0	573.9	614.0	492.0	554.4
(percentage change)	14.1	-5.8	-9.6	2.7	-14.3	12.7
Imports of GNFS	650.8	708.2	678.6	799.3	721.0	788.1
(percentage change)	6.7	8.8	4.3	12.9	6.2	9.3
Foreign direct investment	65.7	49.0	103.6	112.4	70.1	116.7
(percent of GDP)	6.6	4.5	9.5	9.3	6.0	9.3
Overall balance	87.3	20.0	28.1	8.9	-42.2	-25.7
Gross official reserves (in US$ millions, end of period) 4/	499.6	520.0	527.7	527.8	484.3	455.7
(in months of next year's imports of GNFS)	8.8	7.8	8.8	7.6	7.4	6.5
Exchange rate (SI$/US$, end of period) 5/	7.3	...	7.4	...	7.4	...
Real effective exchange rate (end of period, 2005 = 100) 6/	127.6	...	141.0	...	125.4	...
Nominal effective exchange rate (end of period, 2005 = 100) 6/	86.7	...	92.7	...	110.3	...

Sources: Data provided by the authorities; and IMF staff estimates and projections.

1/ Includes changes in the stock of unpaid payment orders and unpresented checks and the statistical discrepancy.

2/ Includes disbursements under the IMF-supported programs.

3/ For 2014, it reflects the January-March average.

4/ Includes SDR allocations made by the IMF to Solomon Islands in 2009 and actual and prospective disbursements under the IMF-supported programs.

5/ For 2014, it reflects the latest observation (May).

6/ For 2014, it reflects the latest observation (March).

Table 2. Solomon Islands: Medium-Term Baseline Scenario, 2012–19

	2012	2013	2014	2015	2016	2017	2018	2019
		Est.			Proj.			
Growth and prices (percentage change)								
Real GDP	3.8	3.0	0.1	3.5	4.0	3.5	3.6	3.5
Of which : nontimber and nonmining	2.3	4.1	3.6	3.0	3.0	3.2	3.5	4.0
CPI (period average)	5.9	5.4	7.0	5.5	5.0	4.5	4.5	4.5
GDP deflator	5.7	6.0	7.3	5.1	5.7	4.7	4.5	4.5
Nominal GDP (in SI$ millions)	7,281	7,946	8,530	9,281	10,209	11,060	11,976	12,952
Per capita GDP (in US$)	1,801	1,936	2,016	2,147	2,311	2,449	2,595	2,746
Per capita GNI (in US$)	1,615	1,738	1,790	1,872	1,962	2,087	2,239	2,446
Central government operations (percent of GDP)								
Total revenue and grants	55.8	52.5	48.8	48.5	47.6	46.9	46.3	45.6
Revenue	34.8	34.8	31.5	31.9	31.6	31.6	31.5	31.5
Tax revenue	31.0	31.1	28.5	28.8	28.5	28.5	28.5	28.4
Income and profits	10.8	11.8	10.9	11.3	11.4	11.7	12.1	12.3
Goods and services	11.3	11.1	10.7	10.9	11.0	11.0	11.0	11.0
International trade and transactions	8.9	8.2	7.0	6.6	6.2	5.8	5.3	5.1
Of which: Tax on logging	5.6	5.1	4.3	3.9	3.4	3.1	2.7	2.5
Other revenue	3.9	3.7	3.0	3.1	3.1	3.1	3.1	3.1
Grants	21.0	17.8	17.2	16.6	16.0	15.3	14.7	14.1
Total expenditure	51.9	48.3	50.4	49.4	48.0	47.2	45.9	45.0
Recurrent expenditure	28.7	28.3	29.3	28.1	27.2	27.0	26.3	25.9
Development expenditure	23.1	19.9	21.1	21.2	20.8	20.1	19.6	19.1
Unidentified expenditure 1/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	3.9	4.3	-1.6	-0.8	-0.4	-0.3	0.3	0.6
Nonmineral primary balance 2/	1.2	2.5	-1.6	1.6	2.0	2.2	2.3	2.1
Noncommodity primary balance 3/	-4.3	-2.6	-5.9	-2.3	-1.4	-0.9	-0.5	-0.4
Central government debt (percent of GDP) 4/	17.7	14.8	14.6	15.0	15.5	16.5	17.6	18.9
Balance of payments (in US$ millions)								
Current account balance (- deficit)	2.2	-91.5	-171.0	-195.8	-202.9	-179.2	-176.4	-173.7
(In percent of GDP)	0.2	-8.4	-14.7	-15.5	-14.6	-11.9	-10.8	-9.9
(Excluding mining-related capital imports, in percent of GDP)	4.5	-4.2	-13.3	-13.5	-11.6	-9.0	-8.1	-6.9
Overall balance	87.3	28.1	-42.2	-25.7	-21.2	15.6	23.8	18.6
Gross official reserves (in US$ million; end of period) 5/	499.6	527.7	484.3	455.7	430.2	441.3	465.2	483.7
(In months of next year's imports of GNFS)	8.8	8.8	7.4	6.5	6.0	6.0	5.9	5.9
(In months of next year's nonmining-related imports of GNFS)	9.5	9.0	7.6	6.8	6.4	6.2	6.2	6.2

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

1/ Includes changes in the stock of unpaid payment orders and unpresented checks and the statistical discrepancy.

2/ Defined as nonmineral revenue (excludes grants) minus government-funded recurrent and development spending excluding interest payments.

3/ Defined as nonlogging and nonmineral revenue (excludes grants) minus government-funded recurrent and development spending excluding interest payments.

4/ Includes disbursements under the IMF-supported programs.

5/ Includes SDR allocations made by the IMF to Solomon Islands in 2009 and actual and prospective disbursements under the IMF-supported programs.

Table 3. Solomon Islands: Summary of Fiscal Accounts, 2012–15

	2012	2013			2014			2015
	Act.	Supplement Budget	Prog. (EBS/13/168)	Est.	Budget	Prog. (EBS/13/168)	Proj.	Proj.
	(In millions of Solomon Islands dollars)							
Total revenue and grants	4,062	4,543	4,280	4,174	4624	4,361	4,161	4,505
Total revenue	2,535	2,648	2,636	2,763	2839	2,829	2,691	2,962
Tax revenue	2,254	2,396	2,410	2,469	2584	2,580	2,434	2,675
Income and profits	785	879	868	936	962	944	927	1,047
Goods and services	824	884	903	879	960	1,000	909	1,015
International trade and transactions	645	633	640	655	662	636	598	612
Other revenue	281	252	226	294	255	248	257	287
Grants	1,526	1,896	1,643	1,411	1786	1532.4	1,470	1,543
Development grants	1,203	1,235	1,235	1,116	1201	1,267	1,201	1,262
Recurrent budget grants	323	661	408	296	585	265	269	281
Expenditure	3,775	4,838	4,258	3,834	4520	4,335	4,301	4,582
Recurrent expenditure	2,090	2,789	2,438	2,252	2758	2,507	2,499	2,610
Compensation of employees	695	762	735	747	864	830	830	876
Interest payments	18	15	15	15	15	15	15	16
Other recurrent expenditure 1/ 2/	1,376	2,012	1,688	1,490	1879	1,662	1,654	1,718
Development expenditure	1,685	2,049	1,820	1,578	1762	1,828	1,802	1,972
Government funded	577	719	490	560	561	561	601	709
Grant funded	1,108	1,330	1,330	1,018	1201	1,267	1,201	1,262
Unidentified expenditure 3/	0	0	0	3	0	0	0	0
Current balance	769	520	607	807	666	587	461	633
Overall balance	286	-294	22	341	104	26	-140	-77
Total financing	-286	294	-22	-341	-104	-26	140	77
Foreign (net)	-90	-45	-45	-50	100	99	100	169
Domestic (net)	-196	339	23	-290	-205	-125	40	-93
Others	0	0	0	0	0	0	0	0
	(In percent of GDP)							
Total revenue and grants	55.8	57.2	53.5	52.1	54.2	49.6	48.8	48.5
Total revenue	34.8	33.3	32.9	34.5	33.3	32.1	31.5	31.9
Tax revenue	31.0	30.2	30.1	30.8	30.3	29.3	28.5	28.8
Income and profits	10.8	11.1	10.8	11.7	11.3	10.7	10.9	11.3
Goods and services	11.3	11.1	11.3	11.0	11.3	11.4	10.7	10.9
International trade and transactions	8.9	8.0	8.0	8.2	7.8	7.2	7.0	6.6
Other revenue	3.9	3.2	2.8	3.7	3.0	2.8	3.0	3.1
Grants	21.0	23.9	20.5	17.6	20.9	17.4	17.2	16.6
Development grants	16.5	15.5	15.4	13.9	14.1	14.4	14.1	13.6
Recurrent budget grants	4.4	8.3	5.1	3.7	6.9	3.0	3.2	3.0
Expenditure	51.9	60.9	53.2	47.9	53.0	49.3	50.4	49.4
Recurrent expenditure	28.7	35.1	30.4	28.1	32.3	28.5	29.3	28.1
Compensation of employees	9.5	9.6	9.2	9.3	10.1	9.4	9.7	9.4
Interest payments	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Other recurrent expenditure 1/ 2/	18.9	25.3	21.1	18.6	22.0	18.9	19.4	18.5
Development expenditure	23.1	25.8	22.7	19.7	20.7	20.8	21.1	21.2
Government funded	7.9	9.0	6.1	7.0	6.6	6.4	7.0	7.6
Grant funded	15.2	16.7	16.6	12.7	14.1	14.4	14.1	13.6
Unidentified expenditure 3/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current balance	10.6	6.5	7.6	10.1	7.8	6.7	5.4	6.8
Overall balance	3.9	-3.7	0.3	4.3	1.2	0.3	-1.6	-0.8
Total financing	-3.9	…	-0.3	-4.3	-1.2	-0.3	1.6	0.8
Foreign (net)	-1.2	…	-0.6	-0.6	1.2	1.1	1.2	1.8
Domestic (net)	-2.7	…	0.3	-3.6	-2.4	-1.4	0.5	-1.0
Others	0.0	…	0.0	-0.8	0.0	0.0	0.0	0.0
Memorandum items:								
Nominal GDP (in SI$ millions)	7,281	7,946	8,006	8,006	8,530	8,800	8,530	9,281
Target of program cash balance (in SI$ millions) 4/	355	…	411	603	…	…	374	444
in months of recurrent spending	2.0	…	2.0	3.2	…	…	1.8	2.0
Nonmineral primary balance (percent of GDP) 5/	1.2	…	1.3	2.5	…	…	-1.6	1.6
Noncommodity primary balance (percent of GDP) 6/	-4.3	…	-3.8	2.5	…	…	-5.9	-2.3
Noncommodity primary balance, excluding development expenditures (percent of GDP) 7/	3.6	…	2.3	9.5	…	…	1.2	2.9

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

1/ Includes spending financed by recurrent grants.

2/ Since 2014, some account items have moved from "Other recurrent expenditure" to "Compensation of employees" under the revised Chart of Accounts.

3/ Includes changes in the stock of unpaid payment orders and unpresented checks (+ = reduction) and the statistical discrepancy.

4/ Defined as the sum of government deposits in the cash balance accounts minus unpaid payment orders and unpresented checks.

5/ Defined as nonmineral revenue (excludes grants) minus government-funded recurrent and development spending excluding interest payments.

6/ Defined as nonmineral nonlogging revenue (excludes grants) minus government-funded recurrent and development spending excluding interest payments.

7/ Defined as nonmineral nonlogging revenue (excludes grants) minus government-funded recurrent spending excluding interest payments.

Table 4. Solomon Islands: Summary Accounts of the Banking System, 2011–14 1/

	2011	2012	2013				2014			
	Dec	Dec	Mar	Jun	Sep	Dec.	Mar	Jun	Sep	Dec
									Proj.	
			(In millions of Solomon Islands dollars, end of period)							
Central Bank of Solomon Islands (CBSI)										
Net foreign assets (NFA)	2,779	3,421	3,418	3,521	3,518	3,612	3,682	3,444	3,365	3,285
Net international reserves (NIR)	2,893	3,534	3,529	3,633	3,631	3,724	3,796	3,563	3,483	3,404
Other NFA	-114	-113	-111	-111	-113	-112	-114	-119	-119	-119
Net domestic assets (NDA)	-1,094	-1,366	-1,656	-1,718	-1,679	-1,574	-1,892	-1,563	-1,418	-1,208
Net claims on central government	-838	-946	-1,080	-1,267	-1,195	-1,164	-1,229	-1,140	-985	-935
Claims	103	82	80	79	78	75	73	75	75	75
Deposits	941	1,028	1,161	1,346	1,273	1,239	1,303	1,215	1,060	1,010
Other items (net)	-256	-420	-575	-451	-484	-410	-663	-423	-433	-272
Reserve money	1,685	2,055	1,763	1,804	1,839	2,038	1,790	1,882	1,947	2,078
Currency in circulation	526	599	553	540	529	603	513	539	566	594
Bank deposits	1,126	1,446	1,203	1,259	1,299	1,424	1,263	1,329	1,367	1,470
Other deposits	33	9	7	5	11	12	14	14	14	14
Other depository corporations										
NFA of commercial banks	87	12	124	158	194	132	154	159	159	159
Assets	167	122	221	246	291	230	232	249	249	249
Liabilities	80	110	98	89	97	97	78	90	90	90
NDA of commercial banks	838	997	977	1,189	1,231	1,274	1,454	1,532	1,591	1,708
Net claims on central government	-28	-97	-77	-155	-121	-164	-143	-172	-176	-180
Claims	101	65	60	52	53	48	44	40	36	32
Deposits	129	163	137	207	175	212	187	212	212	212
Claims on the private sector	1,216	1,266	1,356	1,392	1,411	1,457	1,487	1,504	1,541	1,645
Other items (net)	-350	-172	-302	-48	-59	-19	111	200	225	242
Reserves and vault cash	1,171	1,513	1,495	1,305	1,354	1,495	1,319	1,388	1,429	1,429
Deposits	2,097	2,522	2,596	2,652	2,779	2,901	2,928	3,079	3,179	3,296
Depository corporations survey										
NFA of the banking system	2,867	3,433	3,542	3,679	3,713	3,744	3,836	3,603	3,524	3,444
Central bank	2,779	3,421	3,418	3,521	3,518	3,612	3,682	3,444	3,365	3,285
Other depository corporations	87	12	124	158	194	132	154	159	159	159
NDA of the banking system	-256	-369	-679	-529	-448	-300	-437	-31	173	500
Net claims on central government	-866	-1,043	-1,157	-1,422	-1,317	-1,327	-1,373	-1,311	-1,161	-1,115
Claims on the private sector 2/	1,221	1,271	1,361	1,398	1,417	1,463	1,494	1,510	1,548	1,652
Other items (net)	-611	-598	-883	-505	-549	-436	-559	-230	-214	-37
Broad money (M3)	2,611	3,064	2,863	3,151	3,264	3,444	3,399	3,573	3,697	3,945
M1	1,874	2,396	2,202	2,408	2,540	2,699	2,554	2,685	2,778	2,964
Currency outside banks	481	533	261	493	474	531	457	480	504	635
Demand deposits	1,393	1,863	1,942	1,914	2,066	2,168	2,097	2,205	2,274	2,329
Savings and time deposits	737	668	661	743	724	745	845	888	919	980
			(Annual percentage change, unless otherwise indicated)							
Reserve money	32.8	22.0	0.0	-8.8	-8.5	-0.8	1.6	4.3	5.9	2.0
Credit to the private sector	4.7	4.1	12.6	15.6	15.2	15.1	9.8	8.1	9.2	12.9
Broad money	25.5	17.3	8.8	7.8	9.6	12.4	18.7	13.2	13.2	14.6
NFA of the banking system 3/	42.0	21.7	17.2	11.0	7.4	10.1	10.3	-2.4	-5.8	-8.7
NDA of the banking system 3/	-16.5	-4.4	-8.4	-3.2	2.3	2.2	8.4	15.8	19.0	23.3
Memorandum items:										
Money multiplier (level)	1.5	1.5	1.6	1.7	1.8	1.7	1.9	1.9	1.9	1.9
Loan-to-deposit ratio (in percent)	58.0	50.2	52.2	52.5	50.8	50.2	50.8	48.8	48.5	49.9
Interest rates (percent per annum)										
Deposit rate 4/	2.0	0.9	0.6	0.2	0.1	0.3	0.2	…	…	…
Lending rate 4/	13.3	11.3	11.0	11.0	10.5	10.7	10.8	…	…	…
NCG of financial corporations	-765	-962	-1,076	-1,337	-1,239	-1,252	-1,296	-1,243	-1,214	-1,212
91-day treasury bill rate	2.4	0.3	0.4	0.5	0.4	0.2	0.3	…	…	…
Program targets										
NIR of CBSI (in US$ millions)	393	479	477	494	495	516	470	475	480	485
NDA of CBSI (in SI$ millions)	-737	-1,123	-1,094	-1,358	-1,219	-1,150	-1,268	-1,159	-1,100	-1,100

Sources: Data provided by the Central Bank of Solomon Islands; and IMF staff estimates and projections.

1/ Based on the new program exchange rate of SI$7.331 per US$.

2/ Includes claims of the CBSI on other (nonbank) financial corporations.

3/ Contribution to year-on-year broad money growth, in percentage points.

4/ Weighted average of different maturities, period average.

Table 5. Solomon Islands: Balance of Payments, 2012–19 1/

	2012	2013		2014	2015	2016	2017	2018	2019
		(EBS/13/168)	Est.			Proj.			
	(In millions of U.S. dollars)								
Current account balance	2.2	-46.2	-91.5	-171.0	-195.8	-202.9	-179.2	-176.4	-173.7
Trade balance for goods	46.7	-43.0	-23.0	-134.3	-112.9	-84.6	-76.8	-77.1	-112.2
Exports	492.8	446.8	439.8	351.7	405.0	479.9	508.4	529.1	532.0
Imports	-446.1	-489.8	-462.9	-486.0	-517.9	-564.5	-585.2	-606.3	-644.1
Trade balance for services	-62.3	-67.1	-81.7	-94.8	-120.9	-119.8	-100.1	-105.7	-110.3
Exports	142.4	151.2	134.1	140.2	149.4	158.5	167.9	178.0	189.7
Imports	-204.7	-218.4	-215.8	-235.0	-270.3	-278.3	-268.0	-283.7	-299.9
Income balance	-102.4	-135.9	-111.4	-130.4	-161.1	-209.3	-222.5	-223.5	-192.0
Current transfers balance	120.3	199.9	124.6	188.4	199.1	210.8	220.2	229.9	240.7
Of which : Official transfers, net	104.9	171.5	107.8	165.3	182.1	192.4	200.1	208.0	216.1
Capital and financial account balance	108.2	66.2	144.4	128.7	170.1	181.7	194.7	200.2	192.3
Capital account balance	96.6	50.7	82.7	32.6	25.7	27.2	28.3	29.4	30.5
Direct investment balance	65.7	49.0	103.6	70.1	116.7	122.8	129.4	128.2	113.4
Portfolio investment balance	-5.5	0.0	1.5	0.0	0.0	0.0	0.0	0.0	0.0
Other investment balance	-48.6	-33.6	-43.3	26.0	27.7	31.8	37.0	42.6	48.4
Errors and omissions	-23.2	0.0	-24.8	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	87.3	20.0	28.1	-42.2	-25.7	-21.2	15.6	23.8	18.6
Financing	-87.1	-20.0	-27.7	42.2	25.7	21.2	-15.6	-23.8	-18.6
Change in gross reserves (- = increase)	-87.3	-20.5	-28.1	43.4	28.5	25.6	-11.2	-23.8	-18.6
IMF	0.2	0.5	0.5	-1.1	-2.8	-4.4	-4.4	0.0	0.0
	(In percent of GDP, unless otherwise indicated)								
Current account	0.2	-4.2	-8.4	-14.7	-15.5	-14.6	-11.9	-10.8	-9.9
Trade balance for goods	4.7	-3.9	-2.1	-11.6	-8.9	-6.1	-5.1	-4.7	-6.4
Exports (in percent of GDP)	49.8	40.7	40.4	30.3	32.1	34.6	33.8	32.5	30.2
Imports	45.1	44.7	42.5	41.9	41.1	40.7	38.9	37.2	36.6
Mining imports	4.1	3.7	4.0	1.2	1.8	2.9	2.7	2.6	2.8
Nonmining imports	41.0	41.0	38.5	40.7	39.2	37.8	36.2	34.7	33.8
Of which: Official transfers net	10.6	15.6	9.9	14.3	14.4	13.9	13.3	12.8	12.3
Capital account balance	9.8	4.6	7.6	2.8	2.0	2.0	1.9	1.8	1.7
Direct investment balance	6.6	4.5	9.5	6.0	9.3	8.9	8.6	7.9	6.4
Of which: Inward FDI	6.9	4.9	9.7	6.6	9.6	9.1	8.7	8.0	6.6
Other investment balance	-4.9	-3.1	-4.0	2.2	2.2	2.3	2.5	2.6	2.8
Errors and omissions	-2.3	0.0	-2.3	0.0	0.0	0.0	0.0	0.0	0.0
Net international reserves (in US$ million)	480.1	500.2	508.0	465.7	440.0	418.8	434.4	458.2	476.8
In months of next year's GNFS	8.5	7.5	8.5	7.1	6.3	5.9	5.9	5.8	5.9
Gross official foreign reserves (in US$ million) 2/	499.6	520.0	527.7	484.3	455.7	430.2	441.3	465.2	483.7
In months of next year's imports of GNFS	8.8	7.8	8.8	7.4	6.5	6.0	6.0	5.9	5.9
Gross external public debt	13.2	11.4	11.6	12.0	12.9	13.6	14.8	16.0	17.3
Disbursement of consessional borrowing (in US$ millions)	0.2	0.5	0.5	22.0	32.0	36.0	40.5	45.4	50.8
External public debt service (in percent of exports of GNFS)	1.3	1.3	1.3	1.9	1.8	1.7	1.5	1.4	1.3

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

1/ Incorporates the authorities' revision of historical data, including a new formula for f.o.b/c.i.f conversion, new estimates of reinvested earnings and donor grants, and reclassification of current and capital transfers.

2/ Includes actual and prospective disbursements under the IMF-supported programs.

Table 6. Solomon Islands: Reviews and Disbursements Under the Extended Credit Facility

Date	Amount of Disbursement		Condition
	In percent of quota	In SDRs	
December 7, 2012	1.4	148,571	Approved Fund arrangement
June 28, 2013	1.4	148,571	Completion of the first review and observance of continuous and end-December 2012 performance criteria
January 8, 2014	1.4	148,571	Completion of the second review and observance of continuous and end-June 2013 performance criteria
June 15, 2014	1.4	148,571	Completion of the third review and observance of continuous and end-December 2013 performance criteria
November 15, 2014	1.4	148,571	Completion of the fourth review and observance of continuous and end-June 2014 performance criteria
June 15, 2015	1.4	148,571	Completion of the fifth review and observance of continuous and end-December 2014 performance criteria
November 15, 2015	1.4	148,574	Completion of the sixth review and observance of continuous and end-June 2015 performance criteria
Total	10.0	1,040,000	

Source: IMF.

Table 7. Solomon Islands: Indicators of Capacity to Repay the Fund, 2013–25

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
	Est.	Projections											
Fund obligations based on existing credit (in SDR millions)													
Principal	0.0	1.0	2.1	2.8	2.8	2.5	1.5	0.1	0.1	0.1	0.1	0.0	0.0
Charges and interest	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Fund obligations based on existing and prospective credit (in SDR millions) 1/													
Principal	0.0	1.0	2.1	2.8	2.8	2.5	1.5	0.2	0.2	0.2	0.2	0.1	0.0
Charges and interest	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total obligations based on existing and prospective credit													
In millions of SDRs	0.0	1.0	2.1	2.8	2.8	2.5	1.5	0.2	0.2	0.2	0.2	0.1	0.0
In millions of US$	0.0	1.6	3.3	4.4	4.4	3.9	2.3	0.2	0.3	0.3	0.3	0.0	0.0
In percent of gross international reserves	0.0	0.3	0.7	1.0	1.0	0.8	0.5	0.1	0.1	0.1	0.0	0.0	0.0
In percent of exports of goods and services	0.0	0.3	0.6	0.7	0.6	0.5	0.3	0.0	0.0	0.0	0.0	0.0	0.0
In percent of debt service 2/	0.0	9.8	15.8	19.5	19.4	17.0	9.9	1.1	1.4	1.4	1.1	0.0	0.0
In percent of GDP	0.0	0.1	0.3	0.3	0.3	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0
In percent of quota	0.0	10.0	20.6	27.0	26.9	23.8	14.3	1.5	2.0	2.0	1.6	1.0	0.3
Outstanding Fund credit													
In millions of SDRs	12.9	12.2	10.4	7.6	4.9	2.4	0.9	0.7	0.5	0.3	0.2	0.0	0.0
In millions of US$	19.7	18.7	16.0	11.8	7.6	3.7	1.4	1.2	0.8	0.5	0.2	0.0	0.0
In percent of gross international reserves	3.7	3.9	3.5	2.8	1.7	0.8	0.3	0.2	0.2	0.1	0.0	0.0	0.0
In percent of exports of goods and services	3.4	3.8	2.9	1.9	1.1	0.5	0.2	0.2	0.1	0.1	0.0	0.0	0.0
In percent of debt service 2/	131.6	114.8	76.8	53.0	33.6	16.4	6.1	4.9	3.5	2.2	0.9	0.0	0.0
In percent of GDP	1.8	1.6	1.3	0.9	0.5	0.2	0.1	0.1	0.0	0.0	0.0	0.0	0.0
In percent of quota	124.3	117.1	100.0	73.4	46.6	23.1	8.8	7.1	5.1	3.2	1.3	0.0	0.0
Net use of Fund credit (in SDR millions)													
Disbursements	0.3	0.3	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.0	2.0
Repayments and repurchases	0.0	1.0	2.1	2.8	2.8	2.5	1.5	0.2	0.2	0.2	0.2	0.1	0.1
Memorandum items:													
Exports of goods and services (in US$ millions)	573.9	492.0	554.4	638.4	676.3	707.1	721.6	725.7	704.3	703.3	697.0	735.3	777.5
Gross international reserves (in US$ millions)	527.7	484.3	455.7	430.2	441.3	465.2	483.7	489.7	518.0	558.5	629.2	715.7	822.2
Debt service (in US$ millions) 2/	14.9	16.3	20.9	22.4	22.5	22.8	23.4	23.4	23.5	23.7	25.0	26.9	29.2
Quota (in SDR millions)	10.4	10.4	10.4	10.4	10.4	10.4	10.4	10.4	10.4	10.4	11.4	12.4	13.4

Source: IMF staff estimates and projections.

1/ Prospective credit includes the 7.1 percent of quota (SDR 0.74 million) available under the Extended Credit Facility.

2/ Total public debt service, including IMF repayments.

Appendix. Letter of Intent

Ref: RF457/5/5 June 4, 2014

Madame Christine Lagarde
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Madame Lagarde:

Solomon Islands has benefited greatly from the strong engagement with the IMF, including from its role as trusted macroeconomic advisor. The current three-year Extended Credit Facility (ECF) arrangement, approved on December 7, 2012, has been instrumental in anchoring Government policies and catalyzing donor support. Looking back, we have implemented an ambitious package of legislative reforms. Political stability and strong ownership have been essential in establishing macroeconomic stability and fostering economic growth.

However, as you know, a severe flood hit Honiara at the beginning of April, undermining the economic outlook. This recent tragedy has reminded us of how vulnerable our country is to natural disasters and how critical it is to build resilience to shocks, something we have done over the last few years by rebuilding policy buffers. We will need to use part of our policy buffers wisely to absorb some of the revenue losses and support reconstruction efforts following the flood. Re-prioritization of public spending will also be necessary. Looking ahead, we will need to implement critical reforms to improve the business environment, attract FDI, and lift growth potential.

We are very determined to continue our reform agenda, aimed at enhancing the resilience and competitiveness of our economy, and promoting strong, sustainable, and inclusive growth. The attached Memorandum of Economic and Financial Policies (MEFP) describes the Government's reform policies for the second half of 2014. We believe these policies will strengthen our macroeconomic and fiscal framework and strengthen public institutions.

To ensure strong implementation, the program will continue to be monitored through quantitative performance criteria, indicative targets, and structural benchmarks. In terms of recent program performance, all end-December 2013 quantitative targets and continuous PCs have been achieved and by a considerable margin in some instances (MEFP Table 1). We have also made progress in implementing the structural benchmarks (MEFP Tables 2.A and 2.B). Therefore, we request the completion of the third review under the ECF and the modification of end-June 2014 performance criteria, and propose setting new end-December 2014 performance criteria along with modification of the structural conditionality (MEFP Tables 1, 2.A, and 2.B).

We intend to maintain a close policy dialogue with the Fund, and we stand ready to take additional measures, as appropriate, to ensure the achievement of the Government's objectives under the ECF arrangement. We will consult with the Fund in advance of adopting these measures, or on any revisions to the policies laid out in the MEFP, in accordance with the Fund's policy on such consultation. Furthermore, we will provide the Fund with any appropriate information it may request on policy implementation, as necessary, to achieve the program objectives. We also authorize the publication of this Letter of Intent, the related attachments, and the related IMF staff report.

Sincerely yours,

/s/

Hon. Rick Houenipwela, MP
Minister of Finance and Treasury
Ministry of Finance and Treasury

/s/

Denton Rarawa
Governor
Central Bank of Solomon Islands

Attachments:

I. Memorandum of Economic and Financial Policies
II. Technical Memorandum of Understanding

Attachment I. Memorandum of Economic and Financial Policies

Recent Developments, Outlook, and Program Performance

1. **The recent flood in early April 2014 has taken its toll on the economy**. The heavy rain that hit the Guadalcanal Island, especially Honiara, disrupted agricultural output, severely damaged key economic infrastructure, and resulted in the loss of lives. With one fifth of Honiara's population displaced to shelters and disruption in other rural areas, the Government declared a state of emergency. The only gold mine, Gold Ridge, ceased production and looks unlikely to recommence in the near term and prices of agricultural produce have spiked. The Government now needs to focus on reconstruction to rehabilitate major infrastructure, including public utilities and schools.

2. **Even prior to the floods, growth had decelerated to 3 percent in 2013, compared with an average 6½ percent during 2010–12.** Activity had slowed as a result of a drop in commodity production: agricultural output owing to unfavorable weather; weaker gold production and lower world gold prices; and commercial forest due to the ongoing depletion of stocks.

3. **However, strong political leadership has helped rebuild policy space and deliver important legislative reforms.** Taking stock of what we have achieved, gross international reserves stood at around US$538 million at end-March (about 9.4 months of 2014 imports of goods and services), fiscal buffers have been rebuilt to absorb shocks, and the face value of public and publically guaranteed debt has been reduced to 13 percent of GDP at end-2013. An ambitious package of legislative reforms has also been passed by Parliament, including Public Financial Management (PFM) and Central Bank of Solomon Islands (CBSI) Acts.

4. **Recent events have deteriorated the near- and medium-term outlook, although activity will be supported by rehabilitation efforts and other investment projects in the pipeline.** The closure of the only gold mine will imply a substantial decline in GDP growth in 2014. Growth prospects will be influenced by how quickly gold production re-starts and on whether future mining projects such as nickel come on stream. With the expected continued decline in logging output, growth will need to be supported by increased activity and productivity across a wide range of sectors, including agriculture and tuna processing. Investment in telecommunications (mobile network and undersea cable) and energy-related infrastructure (Tina River Hydropower project) that are in the pipeline should also help support private sector development and increase FDI. After spiking in April 2014, inflation is likely to revert to about 4½ percent over the medium term. The balance of payments position should also remain solid. However, the expected decline in aid from Australia and other development partners, including the eventual wind-down of RAMSI, together with uncertain prospects in the mining sector, imply lower reserve buffers in the medium term.

5. **On the ECF program, the December 2013 and March 2014 program targets and PCs were met with comfortable margins**. The indicative targets, and all continuous PCs were also met, with the exception of the indicative target on government-funded recurrent spending on health and education, which was narrowly missed.

6. **We have also made progress on the structural reform agenda reflected in the structural benchmarks.** We have met three structural benchmarks since the last review. Draft regulations on Constituency Development Funds (CDF)—key from a public finance management perspective—were submitted to Cabinet in December (end-December 2013 benchmark) and On-lending and Guarantees Policies were endorsed by Cabinet in December 2013 (end-February 2014 benchmark) and incorporated into the Debt Management Framework. Finally, the 2013 Final Budget Outcome Document was published in April 2014 (end-April 2014 benchmark). Despite some progress, benchmarks relating to the audit of CDFs (end-March 2014 benchmark), the submission to the Cabinet of draft Credit Unions Act (end-March 2014 benchmark), Cabinet approval of revamped policies for tertiary scholarships (end-January 2014 benchmark), and the review of tertiary education policies (end-March 2014 benchmark) have not yet been met. Substantial progress has been made on benchmarks related to the new mining tax regime (end-January and end-March 2014 benchmarks) and these benchmarks are expected to be completed in the second half of this year. As in the past, these reforms have taken longer than expected, partly because of capacity constraints in the Attorney General's Chambers and the need for broad consultation with stakeholders. Looking ahead, these constraints will persist, along with a break in Parliamentary activity relating to the forthcoming general election (expected to take place in the last quarter of 2014). However, we remain committed to implementing the remaining reforms as soon as practically possible.

Program Policies

7. **Our policies are aimed at enhancing resilience to shocks and increasing competitiveness.** To meet these objectives, we will need to implement growth-oriented structural reforms to foster private sector development and attract FDI. These actions will help restore investor confidence and ensure more diverse and sustainable sources of growth.

A. Fiscal Policy

8. **We remain committed to preserving a sustainable fiscal position while providing urgent resources for reconstruction and much-needed social spending.** The fiscal balance remained strong in 2013. Relative to the 2013 budget and supplementary budget, the strong outturn reflected buoyant revenues due to improved tax compliance and increased fishing license fees, as well as under-execution of public spending (including slower implementation of large development projects). However, our fiscal outlook has deteriorated considerably as a result of recent events. The flood and developments in the mining industry will lead to a decline in revenues and output. We will therefore need to strike the right balance between re-prioritizing planned spending and using part of the fiscal buffers that we have built under the IMF-supported program to finance reconstruction and priority social spending. While the government will take strong ownership of the reconstruction efforts, donor assistance will continue to be key. To achieve this fiscal strategy, we will produce and publish a budget strategy document (newly proposed end-August 2014 benchmark) and a mid-year budget review (newly proposed end-August 2014 benchmark). We will also ensure that fiscal policy for the remainder of 2014—as well as in the 2015 budget—is consistent with the policies laid out below.

9. **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 in Table 1.** The much tighter revenue envelope calls for difficult decisions on how to spend public funds as well as drawing on fiscal buffers accumulated in previous years. The forthcoming 2014 supplementary budget will need to contain the added spending pressures associated with conducting the election. Maintaining a prudent fiscal stance in 2014 is critical given the deterioration in the fiscal outlook and uncertainty surrounding mining sector prospects in 2015.

10. **Mobilizing additional revenues is critical in the current environment.** We will continue to boost domestic revenue by strengthening tax compliance and streamlining exemptions. Given the expected reductions in revenue, reforms to strengthen the underlying fiscal position beyond that associated with cyclical recovery will be required. We are drafting a new customs and excise bill, which is currently being finalized before legislative vetting by the Attorney General, prior to submission to Parliament (end-June 2014 benchmark). We have made major strides on the mining tax regime, with Parliament's approval of amendments to the Income Tax Act and the Mines and Minerals Act in April, which implement all but one of the 2011 IMF technical assistance recommendations (former end-January and end-March 2014 benchmarks). To complete our shift to the new mining tax regime, we plan to issue a Ministerial Order to streamline the rates of export duty on gold by end-July 2014 and request that the test date be reset to end-July 2014. Reforms of the mining legislation have moved in parallel to provide a predictable investment regime and a transparent regulatory framework to attract foreign investment. In this context, we also endorse the principles of the Extractive Industries Transparency Initiative. The commencement of the PFTAC Technical Assistance mission to improve capacity to collect non-tax revenues is also timely. We will further bolster revenue mobilization by amending the Sales Tax Act to eliminate loopholes.

11. **In the forthcoming 2014 Supplementary Budget, we will review and reprioritize public spending, improving the spending mix by increasing much-needed capital projects.** We will allocate more resources for roads and bridge rehabilitation, as well as for water and sanitation and reconstruction of schools. We will utilize the budget committee that includes the Ministry of Finance and the Ministry of Planning to review spending priorities. We will maintain spending on education and health at no less than 32 percent of Government-funded recurrent spending, consistent with the Core Economic Working Group's recommendation.

12. **We are strongly committed to improve the transparency, strengthen the regulations, and contain the size of Constituency Development Funds.** It is important that these resources be managed in a way that ensures value for money and consistency with the National Development Strategy and Provincial Development Strategies. We will introduce a centralized process to evaluate and prioritize development projects and to enhance transparency. We will also introduce an accountability system under which members of Parliament report back to the Cabinet and Parliament on actual spending and project achievements. We have created a committee chaired by the Minister of Finance to prepare the implementing regulations, in line with the 2013 Public Financial Management Act. The regulations have been submitted to Cabinet (end-December 2013 benchmark) but are still being reviewed.

13. **Under the new regulations, the use of these funds will be subject to a stronger reporting regime.** This will entail providing the public in a constituency with timely information on

the total funds available in the constituency, more opportunities for timely constituency input on plans for fund use, specific projects that constituent members can apply for, eligibility requirements, application deadlines, and procedures for selecting awardees, and publicly announcing awardees. Importantly, further progress needs to be made to improve financial accountability and transparency, including: development of plans for fund use through a consultative process involving a cross section of a constituency including women, church representatives, tribal/community leaders, and youth; ensuring that Constituency Accounts are Government Bank Accounts; and that accounts are managed consistently with the 2013 PFM Act. The audit of the 2012 constituency funds, which was delayed by the retirement of the former auditor general, was completed in December 2013. Before publishing the results (former end-March 2014 benchmark), we plan to submit the report to Parliament at its next sitting in late July. We request that the structural benchmark for publication be reset to end-September 2014.

14. **We are strongly committed to continuing to strengthen PFM.** We are fully aware that a strong PFM system is critical to the achievement of the objectives embedded in the National Development Strategy. In recognizing the pivotal role that PFM plays in sustaining economic growth, we undertook a Public Expenditure and Financial Accountability (PEFA) assessment in 2012 and passed the PFM Act in September 2013. The PFM Act and the PEFA assessment have given us a strong platform to introduce further reforms, including the first PFM Reform Roadmap (2014-17). The Roadmap has identified four priority areas: full implementation of the 2013 PFM Act; further development of delivery systems; compliance with controls on budget, expenditure, and debt; and stronger revenue collection. The Roadmap goals will be accompanied by a program to strengthen ownership and awareness of PFM across all levels of government and among the general public.

15. **We will sustain our efforts to strike a better balance between financing tertiary education and investing in primary education.** Significant progress has been made in bringing the budget for tertiary education scholarships under control in 2014. A Cabinet paper on the revamp of the policies for these scholarships—details of which are specified in the TMU—has been prepared and we are currently revising it to take into account a new policy prepared by the Ministry of Public Service on the allocation of in-service scholarships for public servants. Once the paper is completed, we plan to submit it to Cabinet for approval (former end-January 2014 benchmark) and we request that the test date be reset to end-September 2014. In coordination with development partners, we will also review tertiary education policies (former end-March 2014 benchmark), including the selection criteria, budget allocation, and accountability and transparency of the use of funds. Work on this initiative is progressing and we therefore request that the test date be reset to end-March 2015. We are committed to making any further changes necessary to improve the balance between primary and tertiary education.

16. **We will continue to exercise caution in resuming concessional borrowing to preserve domestic and external stability while tapping resources to finance much-needed investment.** Since the last review, the Debt Management Framework has been further strengthened with Cabinet endorsement of new On-lending and Guarantee Policies, a key structural benchmark (end-February benchmark). In addition to these new Policies, the Framework also consists of the PFM Act, Debt Management Strategy and SOE Borrowing Policy. Each year, we will continue to set an annual borrowing limit depending on the debt outlook and our investment needs. Importantly, the borrowing limit covers all borrowing, external and domestic SOE borrowing, and Government

guarantees. The limit for 2014 has been set at SI$250 million, in line with the Framework and based on the Debt Management Unit's debt sustainability analysis. Under the Debt Management Framework, all new Government borrowing proposals must be evaluated by an advisory committee. Current proposals in the pipeline include the submarine internet cable project, which will significantly improve communications, and the Tina River Hydropower Project, which will improve the reliability, and reduce the cost of energy. These projects will increase productivity, improve the business environment, and help attract further private investment.

B. Monetary, Exchange Rate, and Financial Sector Policies

17. **While maintaining price and external stability will continue to be a priority, monetary and exchange rate policies will also need to be more supportive of economic growth.** In the pre-flood environment of declining inflation and lower global food and fuel prices, the Central Bank of Solomon Islands (CBSI) shifted to a neutral monetary policy stance. But with inflationary pressures arising from post-flood domestic food supply disruptions that are expected to be temporary, the CBSI stands ready to review its monetary policy stance in favor of supporting economic activity. In this context, we look forward to further IMF technical assistance on improving the monetary transmission mechanism in 2014. The exchange rate policy can also play a role, according to our current analysis. The CBSI has also recently reviewed the operational implementation of the basket-peg regime and will make adjustments to the formula to ensure that the peg is followed more closely. The CBSI will also widen the current band of ± 1 percent around the base parity of the bilateral SI/US$ exchange rate to maximize the gains from the basket peg.

18. **We will enhance our efforts to strengthen financial regulation and supervision and improve access to credit.** The Central Bank of Solomon Islands issued a banking license to a new bank in April 2014. Once the new bank commences operations, the total number of operating banks will increase to four. The Cabinet endorsed recommendations for a draft National Provident Fund Act in December 2013, and we are working with the view of submitting a bill to Parliament (end-June 2014 benchmark). Following endorsement of the *Policy Framework for Amending the Credit Union Act*, a draft is expected to be submitted to Cabinet (former end-March 2014 benchmark) in the second half of this year and we request that the test date for this benchmark be reset to end-December 2014. Given this delay, we similarly seek a modification of the test date for the submission of a draft Credit Union Act to Parliament (end-June 2014 benchmark) to end-March 2015. We are also in the process of obtaining Cabinet approval of a policy paper with proposals on the drafting of a new Financial Institutions Act (end-June 2014 benchmark), in line with the January 2013 IMF TA recommendations.

Competitiveness and Inclusive Growth

19. **Raising productivity growth and developing new exports remain high on the Government's reform agenda.** The exchange rate is just one of the variables affecting competitiveness. By the end of 2014, we will complete a hardship and vulnerability assessment, with the support of the World Bank, which will provide the foundations for a new comprehensive Poverty Reduction Strategy Paper (PRSP) by the first quarter of 2015. We will use the PRSP to focus our reform efforts on fostering more inclusive growth and shared prosperity.

Program Monitoring

20. **Implementation of the program will continue to be monitored through semiannual reviews based on performance criteria, indicative targets and structural benchmarks**. Performance criteria for end-June 2014 and end-December 2014, and indicative targets for end-September 2014 are set as per Table 1 and structural benchmarks are set as per Tables 2.A and 2.B. The program performance will be assessed in the course of the reviews. The fourth and fifth reviews are expected to take place on or after November 15, 2014 and June 15, 2015, respectively, on the basis of the performance criteria and structural benchmarks indicated in Tables 1, 2.A, and 2.B, and further detailed in the TMU.

MEFP Table 1–Solomon Islands: Quantitative Performance Criteria (PC) and Indicative Targets (IT)

	9/30/2013				12/31/2013				3/31/2014				6/30/2014		9/30/2014	12/31/2014
	IT (EBS/13/168	IT with adjustors	Act.	Status	PC (EBS/13/168)	PC with adjusters	Act.	Status	IT (EBS/13/168)	IT with adjusters	Act.	Status	PC (EBS/13/168)	PC	IT	PC
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$)) 2/	485	480	495	Met	490	473	516	Met	470	469	526	Met	470	490	470	450
Net domestic assets (NDA) of the CBSI (ceiling, end-of-period stock, in millions of Solomon Islands dollars (SI$)) 3/	-1,202	-1163	-1,693	Met	-1,150	-1029	-1,588	Met	-1,268	-1264	-1,906	Met	-1,159	-1,576	-1,431	-1,194
Net credit to central government (NCG) (ceiling, cumulative change from the beginning of the year, in millions of SI$) 4/	-6	33	-267	Met	35	157	-290	Met	-24	-20	-46	Met	-50	9	37	40
New nonconcessional external debt maturing in more than one year, contracted or guaranteed by the public sector (ceiling, end-of-period stock since the beginning of the program, in millions of US$) 5/	0	0	0	Met	0	0	0	Met	0	0	0	Met	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$) 5/	0	0	0	Met	0	0	0	Met	0	0	0	Met	0	0	0	0
Accumulation of new external payment arrears by the public sector (ceiling, end-of-period stock since the beginning of the program, in millions of SI$) 5/	0	0	0	Met	0	0	0	Met	0	0	0	Met	0	0	0	0
Central government program cash balance (floor, end-of-period stock, in millions of SI$) 4/	390	352	539	Met	411	290	603	Met	429	425	620	Met	440	520	420	374
Indicative Targets (cumulative)																
Government funded recurrent spending on health and education (cumulative from the beginning of the year, in millions of SI$) 6/	449	...	486	Met	599	...	668	Met	179	...	163	Not met	359	345	520	710
Memorandum items:																
The threshold of indicative target on health and education (actual 32 percent of government funded recurrent spending)	...	...	...	...	...	...	...	...	...		...	...	...	...	...	...
Budget support from bilateral and multilateral donors other than IMF (cumulative change from the beginning of the year, in millions of US$), program level.	48	...	43	...	67	...	51	...	11		11	...	26	29	37	48
Outstanding stock of Solomon Islands government (SIG) treasury bills, excluding restructured government bonds (end-of-period stock, in millions of SI$), program level.	40	...	40	...	40	...	40	...	40		40	...	40	40	40	40
Balance of SIG Consolidated Deposits Account, millions of SI$ 7/	140	...	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.
4/ The adjustors are specified in the TMU and include: the floor on the 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 the 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.
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.

MEFP Table 2.A–Solomon Islands: Structural Benchmarks

Actions	Macroeconomic criticality	Date	Status
Submit to Cabinet the implementing regulations for the Constituency Development Funds Act that provide guidelines for the selection and prioritization of projects, and spell out the mechanisms to promote transparency and reporting, control, audit, and evaluate constituency funds spending in line with the new Public Finance Act.	To promote the transparency and accountability in the use of constituency funds.	December 31, 2013	Met in December 2013.
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.	January 31, 2014	Not met. The Cabinet approved draft legislative amendments to the Income Tax Act and the Mines and Minerals Act in February 2014. The authorities indicate that upon a closer look at the legislative framework, these legislative amendments (along with a related Ministerial Order) implement the IMF TA recommendations on the mining tax regime, and that amendments to the customs and excise and goods tax legislations are not necessary. To complete the implementation of Fund TA recommendations, a ministerial order reducing the rates of export duty on gold will be issued in July 2014.
Obtain Cabinet's approval of revamped policies for tertiary scholarships as specified in TMU.	To promote the transparency and accountability in the use of public funds.	January 31, 2014	Not met. The Cabinet paper has been prepared but needs to be reconciled with the practices of the Ministry of Public Service, which also administers some policies related to tertiary scholarships. The authorities propose a re-phasing of this benchmark (see below).
Submit to Cabinet the onlending and guarantees instructions under the framework of the Debt Management Strategy.	To promote public debt management.	February 28, 2014	Met in December 2013.
Submit to Cabinet the draft Credit Unions Act.	To promote financial sector development.	March 30, 2014	Not met. A policy paper on recommendations for reform has been endorsed by the Cabinet in February and consultations are underway. The authorities propose a re-phasing of this benchmark (see below).
Release to public the results of the audits conducted by the office of the Auditor General on spending of constituency funds by the 50 constituencies, and project achievements in 2012.	To promote the transparency and accountability in the use of public funds.	March 30, 2014	Not met. The audit for all constituencies was completed in December 2013, but the unexpected retirement of the Auditor General in mid-November, among others, resulted in some delay. The authorities are planning to submit the report on the findings to Parliament at its next sitting in July 2014 before publishing the results of the audit. The authorities propose a re-phasing of this benchmark (see below).
Review the policies on tertiary education and ensure an adequate balance of spending between primary and tertiary education	To promote the transparency and accountability in the use of public funds.	March 30, 2014	Not met. Changes to the policy have yet to be endorsed by the Cabinet. The authorities propose a re-phasing of this benchmark (see below).
Submit to Parliament draft amendment to income tax, customs and excise tax, and goods tax legislation related to the new mining tax regime in line with IMF TA recommendations.	To broaden the tax base and increase revenue transparency.	March 30, 2014	Not met. The Parliament passed amendments to the Income Tax Act and the Mines and Minerals Act in April 2014. The authorities indicate that upon a closer look at the legislative framework, these legislative amendments (along with a related Ministerial Order) implement the IMF TA recommendations on the mining tax regime, and that amendments to the customs and excise and goods tax legislations are not necessary. To reflect this, the authorities propose a re-phasing and rewording of this benchmark (see below). A Ministerial Order reducing the rates of export duty on gold will be issued by July 2014 to complete the implementation of Fund TA recommendations on the new mining tax regime.

MEFP Table 2.B–Solomon Islands: Structural Benchmarks

Actions	Macroeconomic criticality	Date	Status
Produce a Final Budget Outcome Report.	To increase fiscal openness, transparency and planning.	April 30, 2014	Met in April 2014.
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.	June 30, 2014	
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 financial risks.	June 30, 2014	
Obtain Cabinet's approval of drafting instructions of a new Financial Institutions Act.	To promote financial sector stability and development.	June 30, 2014	
Revised and Proposed New Benchmarks			
Amend the Export Duty Schedule (by Ministerial Order) to complete the implementation of the new mining tax regime in line with IMF TA recommendations.	To broaden the tax base and increase revenue transparency.	July 31, 2014	Modified and reset from March 30, 2014.
Produce and publish a mid-year Budget review.	To promote transparency on economic and fiscal developments.	August 31, 2014	New benchmark.
Produce and publish a Budget strategy document.	To facilitate planning and fiscal strategy.	August 31, 2014	New benchmark.
Obtain Cabinet approval of revamped policies for tertiary scholarships as specified in TMU.	To promote the transparency and accountability in the use of public funds.	September 30, 2014	Reset from January 31, 2014.
Release to public the results of the audits conducted by the office of the Auditor General on spending of constituency funds by the 50 constituencies, and project achievements in 2012.	To promote the transparency and accountability in the use of public funds.	September 30, 2014	Reset from March 30, 2014.
Submit to Cabinet the draft Credit Unions Act.	To promote financial sector stability and development.	December 31, 2014	Reset from March 30, 2014.
Review the policies on tertiary education and ensure an adequate balance of spending between primary and tertiary education.	To promote the transparency and accountability in the use of public funds.	March 31, 2015	Reset from March 30, 2014.
Submit to Parliament the draft Credit Unions Act.	To promote financial sector stability and development.	March 31, 2015	Reset from June 30, 2014.

Attachment II. 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-June and end-December 2014 and indicative targets for end-September 2014 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

A. Reserve Money

6. 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

7. 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.

8. NIR will be calculated as gross international reserves (GIR) less international reserve liabilities. For NIR program monitoring purposes, the stock of foreign assets and foreign liabilities of the CBSI will be reported in U.S. dollars and be valued at the program exchange rates, as specified in Table 1.

TMU Table 1. Solomon Islands: Program Exchange Rates

Solomon Islands (Program) Exchange Rates for the ECF Arrangement

(Rates as of September 30, 2013)

Currency	Solomon Islands Dollar per currency unit	U.S. Dollar per currency unit
Australian dollar	6.831	0.932
British pound	11.820	1.612
Euro	9.901	1.350
Japanese yen 1/	13.352	97.890
New Zealand dollar	6.068	0.827
SDR	11.236	1.533
Singapore dollar	5.838	0.796
U.S. dollar	7.331	1.000

1/ Currency unit per Solomon Islands dollar and U.S. dollar.

9. 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.

10. 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

A. 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 rate used for this purpose is five percent.

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. Tertiary Education

28. Approval will be sought from Cabinet to strengthen the policy of the granting of tertiary scholarships, which will contain at least the following elements:

- *Commitment controls.* The Ministry of Finance will certify the availability of budget allocation before any new award letters can be granted, in order to ensure that the budget ceilings are abided by and no new arrears are incurred. Commitment information will be entered into the Ministry of Finance's Financial Management Information System to record commitments made for each individual scholarship awardee. The Ministry of Education will ensure that the documentation relating to identification and eligibility, expected length of studies, as well as due dates for tuition and stipend payments is provided to the Ministry of Finance in a timely manner.
- *Queuing system.* If there are more candidates for scholarships than resources available in a fiscal year, a queuing policy for eligible applicants based on the timing of their application will be established.
- *Arrears.* All arrears will be cleared and no new arrears allowed.
- *Documentation.* In consultation with the Ministry of Finance, the Ministry of Education will establish the standards for eligibility documentation and documentation retention for each application. The required and retained documentation should include at least the application form, high school transcript, receipt for the payment of the application fee, copy of Ministry award letter, signed declaration letter, transcripts of results in each semester from tertiary institutions and qualifications attained by the scholarship holders.
- *Monitoring and dissemination.* The Ministry of Education will produce regular reports on total number of applicants for scholarships, number granted scholarships, current number of students classified by gender and educational institutions, and number of terminations or fails in the last 12 months. The Ministry of Education will publish the guidelines for obtaining scholarships and publish their periodic reports.
- *Tuition and Fee Rates.* The Ministry of Education will sign a memoranda of understanding the USP and other tertiary institutions, including to establish the basis of the financial commitment of the Solomon Islands Government.

- *Allowances*. The Ministry of Education, in consultation with the Ministry of Finance, will recommend an allowances policy with specific allowance amounts that vary for students depending on the institutions where they study, the course that they are undertaking, employment status, travel requirements, whether studies are full-time or part-time, the length of the program in which they are enrolled and the number of years they have received the grant.

VIII. Data Provision

29. 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 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

1. (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.

Press Release No. 14/298
FOR IMMEDIATE RELEASE
June 23, 2014

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes the Third Review Under the Extended Credit Facility Arrangement for Solomon Islands and Approves US$0.23 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) on June 20 completed the third review of the Solomon Islands' economic performance under the Extended Credit Facility (ECF) arrangement.

An IMF team visited Honiara, the capital, in May to conduct the third review of the ECF-supported economic program and to assess the impact on the economic outlook of the severe floods that hit in April 2014. The unprecedented floods have undermined economic activity, causing loss of life and widespread damage to key infrastructure, water and sanitation systems, housing, and agricultural output. One fifth of Honiara's population was displaced to shelters. Rural areas around the capital were also heavily affected.

Completion of the third review enables the Solomon Islands to draw an amount equivalent to SDR 0.149 million (about US$0.23 million) immediately, bringing total disbursements under the arrangement to an amount equivalent to SDR 0.594 million (about US$0.92 million).

The three-year ECF arrangement was approved December 7, 2012, in an amount equivalent to SDR 1.04 million (about US$1.59 million), or 10 percent of the country's quota (see Press Release No. 12/479).

Following the Executive Board's discussion on the Solomon Islands, Mr. Min Zhu, Deputy Managing Director and Acting Chair, stated:

"The severe floods that hit parts of the country in April 2014, coupled with the closure of the country's gold mine, have adversely affected the growth outlook and aggravated the challenges that Solomon Islands faces as a small and fragile state.

"While fiscal policy should support economic activity in the near term, reviewing spending priorities is paramount to preserve fiscal discipline, particularly in view of the uncertain economic and fiscal outlook. Part of the fiscal buffer should be used for reconstruction and capital projects and to absorb cyclical revenue losses while expenditure on this year's elections should be strictly contained.

"The authorities should sustain their efforts in building sound fiscal institutions. To this end, the forthcoming public financial management roadmap, budget strategy, and mid-year budget review, together with the recent strengthening of debt management, are key in fostering budget discipline and improve budget planning. The pending broader review of policies on tertiary education, in addition to containing the size of spending, is critical for signaling the government's commitment to promote transparency and accountability in the use of public resources.

"Current inflationary pressures are expected to be short-lived. However, the central bank should stand ready to act should credit growth trigger a deterioration of credit quality and demand-driven inflation. While the basket peg is an appropriate exchange rate regime for Solomon Islands, its implementation could be improved through a gradual widening of the operational band and a better alignment of the base rate with the basket peg.

"The financial sector appears sound, and the authorities' efforts to strengthen supervision and regulation—including the forthcoming National Provident Fund Act, Financial Institutions Act, and the Credit Union Act—will help promote financial sector stability and financial inclusion."

Statement by Jong-won Yoon, Executive Director for Solomon Islands and Vicki Plater, Advisor to Executive Director

June 20, 2014

The Solomon Islands authorities highly value the engagement with the IMF and remain firmly committed to the three-year ECF program, which is helping to promote continued macroeconomic and financial stability and build momentum for reform. The program is making an important contribution towards strengthening the institutional framework to lift macroeconomic and public financial management in a durable way, and to address structural impediments to stronger growth and higher living standards. The ECF (and predecessor SCF arrangements) have helped strengthen donor support and the ongoing success of the program will help to build confidence with development partners.

The key challenges faced by Solomon Islands (and other small Pacific Island states) are clear – small size, remoteness, and a dispersed population; a narrow economic base; and vulnerability to natural disasters and external shocks. This has unfortunately again been in evidence in recent months. Severe flash-flooding on 3 April centered on the capital of Honiara and the surrounding Guadalcanal Province resulted in 21 deaths, significant damage to infrastructure, disruption to production and commerce, and left thousands of people homeless (at its peak over 10,000 people were housed in shelters, approximately 20 percent of the Honiara population). As Honiara is the administrative, economic and transport hub of Solomon Islands, the damage and disruption also have consequential impacts on other provinces.

The severe flooding also prompted the immediate closure of the Gold Ridge goldmine on Guadalcanal, which was already operating at a loss. It is clear that the goldmine will not be reopening in the near future. Given the significance of the mine to exports (approximately 20 percent of Solomon Islands net exports), employment, and government revenue (approximately 6 percent of government revenue in 2013), this is a significant blow to the economic outlook and will have implications for government finances for the remainder of 2014 and into 2015. The authorities and the company are now in constant dialogue to ensure the mining operation site is stabilized and operations are resumed in the near future.

Solomon Islanders are nonetheless resilient and the authorities are determined to manage fiscal and monetary policy wisely in the aftermath of these events. The authorities intend to make prudent use of some of the fiscal buffers that they have studiously built up over several years with the support of the Fund program; manage expenditure pressures, including those related to the upcoming general election; and reprioritize spending to ensure necessary disaster recovery and reconstruction efforts are met.

Progress under the ECF has been generally steady. All of the quantitative performance criteria for December 2013 and March 2014 program targets have been met including good levels of cash reserves and international reserves. Several of the structural benchmarks have also been achieved, specifically the early approval of the On-lending and Guarantees policies under the Debt Management Framework (achieved December 2013); submission to Cabinet of the implementing regulations for the Constituency Development Funds Act (December 2013); and publication of a Final Budget Outcome Report for 2013, a new document that enhances fiscal openness, transparency and planning (April 2014). Other benchmarks continue to be progressed albeit not fully met. Noteworthy progress has been made with respect to management of tertiary scholarships; and enacting a new mining tax regime. The ECF program has a heavy emphasis on legislative reforms consistent with its focus on strengthening the institutional framework. However, capacity constraints in the Attorney-General's office and the limited sitting of Parliament this year due to the general election (expected October/early-November) hamper progress.

Given the significant external shocks that have recently hit Solomon Islands, the authorities request flexibility within the ECF program in terms of modifying the June 2014 performance criteria and setting future quantitative targets. The authorities are not currently seeking any enhanced access to Fund resources.

Economic Outlook

In 2013 GDP is estimated to have increased by 3.0 percent. Following recent events, no growth in GDP is expected in 2014 (compared with 4.0 percent anticipated in the 2013 Article IV Report). This largely reflects the closure of the gold mine as well as flood-related disruption to key infrastructure, the agricultural sector and lower business confidence. The impact of these recent events will only be partly offset by reconstruction efforts and donor support. A modest rebound in growth is projected in 2015, although the extent of the rebound will depend on when the gold mine reopens.

Inflation is expected to rise to 7.0 percent in 2014 due to temporary spikes in food prices as a result of the flooding, but then return back towards 5 percent in 2015.

The external balance is expected to deteriorate. Exports will decline this year due to the gold mine closure and the hit to agricultural production (for example, the Guadalcanal Plains Palm Oil (GPPOL) plantation, an important exporter, is expected to take 3-6 months to resume full production). Imports will rise due to import-intensive reconstruction investment but this will be offset to a degree by reduced demand for fuel and chemical imports that were inputs to gold production. The current account deficit is likely to deteriorate. The authorities project the current account deficit to be in the order of 13-14 percent of GDP in 2013 and 2014, marginally smaller than Staff's projection of around 15 percent (the difference largely reflecting different assumptions on imports and anticipated donor flows). Staff's forecasts are generally in line with the authorities' current projections.

Fiscal Policy

The Solomon Islands Government achieved a surplus in 2013, due to slower expenditure on both the development budget and recurrent spending, and higher non-tax revenue from fisheries license fees. This outcome was better than expected given earlier concerns, including an unanticipated blowout in tertiary scholarship expenditure. The 2013 surplus built on previous performance to strengthen fiscal buffers.

Given recent developments the fiscal balance is expected to deteriorate to a deficit of 1.6 percent of GDP in 2014. This will see the cash balance drop from 3.2 months of current spending in 2013 to 1.8 months of current spending in 2014 under the Fund's projections. A fiscal deficit is also expected in 2015 – around 0.8 percent of GDP assuming gold mining resumes in mid 2015.

The authorities recognize that maintaining a prudent fiscal stance in 2014 is even more critical, given the uncertainty surrounding 2015 growth prospects. A supplementary budget will be introduced at the next sitting of Parliament (July/August) to regularize expenditure incurred in relation to the initial flood response and reprioritize spending to accommodate flood-related reconstruction. It will also authorize some limited increase in the cost of administering the upcoming general elections.

The government remains committed to ensuring improved management of Constituency Development Funds (CDF). Draft regulations to implement the CDF Act were submitted to Cabinet in December; to instill greater transparency and accountability on the use of CDFs, and ultimately support high quality expenditure. The draft regulation has since been consulted on in all constituencies and now awaits agreement from the bipartisan committee responsible to forward to Cabinet for final approval. The 2014 Budget reduced spending for CDF by one-third in light of the upcoming election. Audits of 2012 spending of constituency funds have now been completed by the Auditor-General. A report on the findings is due to be submitted to Parliament in July and the results then published.

Significant progress has been made in addressing the previous overrun in tertiary scholarships. The government has cut the appropriation for tertiary scholarships; reduced the number of scholarships; canceled scholarships where people were not performing; and tightened expenditure controls. Led by the Prime Minister, these politically difficult measures have substantially addressed the immediate weaknesses. Further policy development is underway that will help secure the gains made and address the balance of education spending, enabling the relevant structural benchmarks to be met.

The enactment of the new mining tax regime is nearly complete; Parliament approved relevant amendments to the Income Tax Act and Mines and Minerals Act in April, with the final element, a Ministerial Order to streamline export duty rates on gold, expected to be issued in July. Additional measures to mobilize revenue are also in train, including a new Customs and Excise Bill (legislation currently being finalized) and measures to strengthen tax compliance and streamline exemptions. Amendments to the Sales Tax Act are also planned to eliminate loopholes.

More generally, strengthening Public Financial Management remains a key priority. The authorities remain focused on implementing the PFM Act approved in September 2013, which was a critical reform. Amongst other things, this includes publication of a suite of new reports. The 2013 Final Budget Outcome report was published in April, an ECF benchmark. The authorities have requested the inclusion of ECF benchmarks related to two additional documents that SIG must publish for the first time this year under the PFM Act: the Budget Strategy for 2015; and a mid-year 2014 Budget Review. Progress on both is underway and including these as program benchmarks will help maintain momentum. To further improve public financial management, the authorities have drafted a PFM Reform Roadmap 2014-2017 with assistance from the Pacific Financial Technical Assistance Centre (PFTAC). The Roadmap recognizes that improved public financial management requires leadership, coordination and capability across the Solomon Islands Government; not simply the Ministry of Finance and Treasury.

The authorities continue to take a cautious approach in resuming concessional borrowing. Although government debt as a share of GDP is low and assessed to be at moderate risk of debt distress, the authorities are mindful that in a small and vulnerable economy, it is very easy for debt sustainability to be tested. The completion of the new On-lending and Guarantee Policies, endorsed by Cabinet in December 2013, further adds to the robustness of the Debt Management Framework. Any Government borrowing and/or guarantees must be for investing in productive capacity, funding priority core infrastructure and development initiatives and projects that are high priorities in the National Development Strategy.

Monetary Policy and Financial Sector

The Central Bank of Solomon Islands (CBSI) moved to a neutral monetary policy stance in March (pre-floods) from its previous moderately contractionary stance. CBSI envisages maintaining this position but is alert to the possibility of shifting monetary policy to focus more on stimulating growth if such circumstances proved necessary.

The CBSI is actively working to improve policy management. It has just completed a review of how exchange rate policy is operationalized, with a view to greater flexibility and more effective implementation of the exchange rate basket. Upcoming IMF technical assistance will focus on improving the effectiveness of the monetary transmission mechanism.

The asset quality of the banking system improved in the first quarter of 2014 and banking sector profitability remains fairly strong. The introduction of a new bank into the market, although it will likely focus on the forestry sector initially, appears to be prompting greater competition between the existing banks.

Progressing the National Provident Fund, Financial Institutions and Credit Union Acts (ECF benchmarks) remain priorities in order to further enhance financial sector stability and promote financial inclusion and access to credit. Policy proposals and legislative drafting are at various stages of development.

Structural Reforms

Diversification of the economy remains critical. A number of initiatives are currently being explored by private sector actors including another tuna cannery and a nickel project. The Government held a workshop earlier in the year on sources of growth involving private sector. The authorities would welcome further engagement with the IMF on issues of competitiveness at the time of the next ECF review to help foster productivity and inclusive growth.

Conclusion

The authorities continue to place a high priority on the reforms embedded within the ECF program to help build a resilient society and ensure ongoing responsible fiscal management as a platform for the country's future economic development. In the current environment the Government will need to use some the fiscal buffers accumulated in the past wisely to absorb some of the revenue losses and support urgent reconstruction efforts. The authorities nonetheless remain committed to preserving a sustainable fiscal position and reprioritizing spending to provide urgent resources for reconstruction and much-needed social spending.

Finally, the Solomon Islands authorities would particularly like to note the quality of IMF Staff's engagement. Staff's flexibility to delay the review mission at short notice due to the flood was appreciated, and the eventual timing of the visit proved very helpful as the authorities were estimating the impact of the flood and closure of the gold mine on the economic and fiscal outlook. Furthermore, even with the 3 week delay, Staff was still able to deliver to the original Board schedule without diminishing the quality of the product. This has been very helpful and a credit to the mission chief Ms Tumbarello and her team. Technical assistance provided by PFTAC and HQ departments continues to be invaluable to the Solomon Island authorities' efforts to strengthen macroeconomic management and lift economic performance.