



# SOLOMON ISLANDS

March 2016

## 2016 ARTICLE IV CONSULTATION AND FIFTH AND SIXTH REVIEWS UNDER THE EXTENDED CREDIT FACILITY ARRANGEMENT—PRESS RELEASES; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR SOLOMON ISLANDS

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2016 Article IV consultation, and the Fifth and Sixth Reviews Under the Extended Credit Facility Arrangement with Solomon Islands, the following documents have been released and are included in this package:

- **Press Releases** summarizing the views of the Executive Board as expressed during its March 21, 2016 consideration of the staff report that concluded the Article IV consultation with and the Fifth and Sixth Reviews Under the Extended Credit Facility Arrangement with Solomon Islands.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on March 21, 2016, following discussions that ended on | January 28, 2016, with the officials of Solomon Islands on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on March 8, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- A **Statement by the Executive Director** for Solomon Islands.

The documents listed below 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 IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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INTERNATIONAL MONETARY FUND



Press Release No. 16/124  
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March 21, 2016

International Monetary Fund  
Washington, D.C. 20431 USA

**IMF Executive Board Completes the Fifth and Sixth Reviews Under an ECF Arrangement with Solomon Islands, Approves SDR 0.297 Million (US\$ 0.42 million) Disbursement**

On March 21, 2016, the Executive Board of the International Monetary Fund (IMF) completed the fifth and sixth reviews of the Solomon Islands' economic performance under the Extended Credit Facility (ECF) arrangement.

Completion of the fifth and sixth reviews enables the Solomon Islands to draw an amount equivalent to SDR 0.297 million (about US\$ 0.42 million) immediately, bringing total disbursements under the arrangement to an amount equivalent to SDR 1.04 million (about US\$ 1.46 million).

The three-year ECF arrangement was first approved December 7, 2012, in an amount equivalent to SDR 1.04 million (about US\$ 1.46 million), or 10 percent of the country's quota (see [Press Release No. 12/479](#)). In December 2015, the Executive Board extended the ECF to March 31, 2016 to allow the authorities enough flexibility to make further progress in implementing their structural reform agenda under the program (see [Press Release No. 15/575](#)).

During the same meeting, the Board also concluded the 2016 Article IV consultation. A separate press release will be issued shortly.

Following the Executive Board's discussion, Mr. Mitsuhiro Furusawa, Deputy Managing Director and Acting Chair, stated:

“Solomon Islands has made enormous strides in enhancing macroeconomic stability in recent years, with satisfactory implementation of the authorities' economic program supported by the IMF's Extended Credit Facility (ECF) arrangement. Important reforms have been implemented including in public financial management (PFM), tax administration, debt management, exchange rate regime, and the financial sector.

“Solomon Islands continues to face long-term development challenges and opportunities. The Medium-Term Development Plan articulates a comprehensive growth and development strategy and implementation plan that are aligned with the Sustainable Development Goals. A multi-pillar strategy at the national, regional, and multilateral levels is crucial to enhance resilience to natural disasters.

“With uncertainty regarding future sources of growth and a challenging external outlook, fiscal space should be preserved. In implementing the 2016 budget and in formulating future budgets, the authorities should keep cash reserves at a minimum of two months of total spending. The authorities should sustain efforts to advancing PFM reforms, including by improving the transparency and accountability of scholarships and constituency funds and by continuing to strengthen the quality of public spending.

“Monetary policy is appropriate. But given the high credit growth, the authorities should remain vigilant. The basket peg regime is working well and the level of the exchange rate should be assessed periodically to ensure that it remains supportive of competitiveness and growth.

“The financial system is sound and the authorities’ efforts to further strengthen supervision and regulation should continue. The new National Provident Fund Act, a new Credit Unions Act and a new Financial Institutions Act should help enhance financial sector stability. The recently adopted National Financial Inclusion Strategy for 2016–20 will help expand financial access, especially in rural areas.”



INTERNATIONAL MONETARY FUND



Press Release No. 16/132  
FOR IMMEDIATE RELEASE  
March 23, 2016

International Monetary Fund  
Washington, D.C. 20431 USA

### **IMF Executive Board Concludes 2016 Article IV Consultation with Solomon Islands**

On March 21, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the 2016 Article IV Consultation with Solomon Islands.<sup>1</sup>

The Solomon Islands economy is estimated to have grown by 3.25 percent in 2015 led by logging activity, tuna processing, construction, and retail services. The impact of Cyclone Raquel and El Niño has caused a reduction in agricultural production. After experiencing deflation earlier in the year, inflation remained contained at 2.9 percent (year-on-year) in 2015, driven by higher food prices due to the depreciation of the Solomon Island dollar vis-à-vis the US dollar and the effects of El Niño-related drought on the domestic food supply.

Near-term prospects are favorable but risks to the outlook are tilted to the downside. In 2016, growth is expected to remain solid at 3 percent, driven by investment in construction, communications, and manufacturing. Weaker growth in emerging Asia—especially China—could worsen Solomon Islands' growth prospects, including through lower-than-expected demand for log exports. The El Niño phenomenon will likely continue to weigh on agriculture and fisheries in the early part of 2016.

In 2015, fiscal policy was much less expansionary relative to the budget. The fiscal deficit is estimated at 0.3 percent of GDP, much smaller than 5.7 percent budgeted. The fiscal deficit was financed by a small drawdown in the cash balance. Although the decline in cash balance in 2015 was much larger than implied by the deficit, the drawdown also reflected the repayment of SI\$100 million of domestic debt in mid-December 2015. Public debt at 10.4 percent of GDP is one of the lowest in the region and across small states.

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<sup>1</sup> Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

The monetary policy stance has been very accommodative in an effort to support growth and this has been reflected in strong credit growth. The financial system is sound, and progress on financial inclusion has been remarkable, although further financial deepening represents important growth and development opportunities. The domestic financial sector has undergone significant consolidation in 2015, and overall, banks are adequately capitalized, liquid, and profitable.

Net international reserves remained flat at US\$506 million at end-December 2015 relative to end-2014 (US\$496 million), equivalent to 9.8 months of imports, the highest coverage in the Pacific islands. The current account deficit will widen slightly to 4.5 percent of GDP in 2016, but the external position should remain strong with net international reserves projected at 9.6 months of imports. In the medium term, the current account deficit is expected to widen somewhat to support imports related to big infrastructure projects.

### **Executive Board Assessment<sup>2</sup>**

Executive Directors welcomed Solomon Islands' satisfactory performance under the program and commended the authorities for their considerable achievements in enhancing macroeconomic stability owing to a prudent fiscal policy and the implementation of structural reforms, including notable progress in building core institutions.

Directors noted that, while the economic outlook is favorable, it is subject to downside risks from the country's vulnerabilities to external shocks, including natural disasters. They emphasized the importance of preserving fiscal buffers, enhancing resilience to natural disasters, and stepping up the structural reform agenda to foster inclusive and diversified growth. In this regard, Directors welcomed the new Medium-Term Development Plan (2016–20), which contains a comprehensive growth and development strategy that is aligned with the Sustainable Development Goals. They looked forward to the authorities' continued close engagement with the Fund and development partners to support its implementation.

Directors supported the design of a multi-pillar strategy at the national, regional, and multilateral levels to enhance resilience to natural disasters. They welcomed the plan to create a contingency fund for natural disasters.

Directors stressed the importance of preserving fiscal space and adequate buffers. They encouraged the authorities to keep cash reserves at a minimum of two months of total spending and to prioritize infrastructure and social spending. They also welcomed the authorities' intention to set quarterly targets on cash reserves in their budgeting process. Directors encouraged the authorities to sustain their efforts to build sound fiscal institutions in order to finance infrastructure spending while preserving debt sustainability. These include public

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<sup>2</sup> At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

financial management reforms by enhancing the transparency and accountability of tertiary scholarship and constituency funds; improvements in budget planning and presentation; and the mobilization of additional revenues by strengthening tax compliance and streamlining exemptions.

Directors considered the current monetary policy stance to be appropriate. They encouraged the central bank to stand ready to tighten policy should inflationary pressures emerge, and consider appropriate measures to absorb excess liquidity to improve monetary transmission. Directors welcomed the full implementation of the basket peg. They encouraged the authorities to reassess periodically the level of the exchange rate to ensure that it remains supportive of competitiveness, and to consider including the renminbi in the basket.

Directors noted that the financial sector is generally sound, and called for continued efforts to strengthen the supervisory, regulatory, and legal frameworks. They welcomed the forthcoming new National Provident Fund and Credit Union Acts to help safeguard financial stability. Directors encouraged the authorities to build on the progress achieved to improve financial inclusion and access, and welcomed the recently adopted National Financial Inclusion Strategy for 2016–20.

Directors supported the authorities' agenda aimed at achieving inclusive growth and diversifying the sources of growth. This will involve reforms to improve the business and investment climate, infrastructure development, as well as investments in health, education, and human resource development.

## Solomon Islands: Selected Economic Indicators, 2012–17

Per capita GDP (2014); US\$1,931 (estimate)  
Population (2014): 562,000

Quota: SDR 10.4 million  
Main products and exports: logs  
Main export markets: emerging  
Asia

Poverty rate (2006): 23 percent

	2012	2013	2014	2015 Est.	2016 Proj.	2017 Proj.
<b>Growth and prices (percentage change)</b>						
Real GDP	4.7	3.0	2.0	3.3	3.0	3.3
CPI (period average)	5.9	5.4	5.2	-0.4	1.3	2.9
GDP deflator	6.4	4.4	3.2	1.6	4.3	1.8
Nominal GDP (in SI\$ millions)	7,540	8,109	8,530	8,948	9,617	10,110
<b>Central government operations (percent of GDP)</b>						
Total revenue and grants	54.4	51.8	48.0	46.1	43.8	43.3
Revenue	33.6	34.1	33.2	34.7	31.6	31.6
Grants	20.8	17.8	14.8	11.5	12.2	11.7
Total expenditure	50.6	47.6	46.3	46.4	45.1	43.9
Recurrent expenditure	27.7	27.8	28.1	28.6	25.5	25.6
Development expenditure	22.9	19.8	17.8	17.8	19.6	18.3
Overall balance	3.8	4.2	1.7	-0.3	-1.4	-0.6
Foreign financing (net)	-1.2	-0.6	-0.5	-0.2	-0.2	1.4
Domestic financing (net)	-2.6	-3.6	-1.2	0.4	1.6	-0.9
<b>Central government debt (percent of GDP, unless otherwise indicated) 1/</b>						
Domestic debt	17.6	15.5	13.3	10.4	8.9	10.1
External debt	4.9	4.3	2.9	0.6	0.5	0.6
	12.7	11.3	10.4	9.8	8.4	9.4
<b>Monetary and credit (percentage change, end-year data)</b>						
Credit to private sector	4.1	15.1	16.4	16.7	3.2	...
Broad money	17.3	12.4	5.6	15.0	11.8	...
Reserve money	22.0	3.0	-10.1	23.4	12.3	...
<b>Balance of payments (in US\$ millions, unless otherwise indicated)</b>						
Current account balance	18.2	-38.5	-50.1	-30.0	-53.8	-98.0
(percent of GDP)	1.8	-3.5	-4.3	-2.6	-4.5	-7.8
Foreign direct investment	21.3	50.4	20.3	23.0	37.7	43.7
(percent of GDP)	2.1	4.5	1.8	2.0	3.1	3.5
Overall balance	87.3	28.1	-12.7	18.1	28.0	39.9
<b>Gross official reserves (in US\$ millions, end of period) 2/</b>						
(in months of next year's imports of GNFS)	500	528	514	520	544	580
	8.4	9.3	10.2	10.1	9.8	10.3
<b>Net official reserves (in US\$ millions, end of period)</b>						
(in months of next year's imports of GNFS)	480	508	496	506	534	574
	8.1	8.9	9.8	9.8	9.6	10.2
<b>Exchange rate (SI\$/US\$, end of period) 3/</b>						
	7.3	7.4	7.4	8.1	...	...
<b>Real effective exchange rate (end of period, 2005 = 100) 3/</b>						
	114.5	123.6	127.7	130.1	...	...
<b>Memorandum items:</b>						
Cash balance (in SI\$ millions)	355	608	880	694	544	630
in months of recurrent spending	2.0	3.2	4.4	3.3	2.7	2.9

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

1/ Includes disbursements under the IMF-supported programs.

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

3/ The 2015 numbers refer to November.



# SOLOMON ISLANDS

## STAFF REPORT FOR 2016 ARTICLE IV CONSULTATION AND THE FIFTH AND SIXTH REVIEWS UNDER THE EXTENDED CREDIT FACILITY ARRANGEMENT

March 8, 2016

### KEY ISSUES

**Context:** Solomon Islands is a small island state, a low-income country that is severely affected by external shocks, including commodity price declines, natural disasters, and climate change.

**Program:** Solomon Islands has achieved considerable gains in terms of macroeconomic stability under the Extended Credit Facility program. Policy buffers are among the highest in the Pacific small states and other small states. Despite the low access, the program has been effective in catalyzing donor support. Quantitative program performance has been excellent and progress in the structural reform agenda has helped greatly in achieving macroeconomic stability.

**Article IV Consultation:** The consultation introduced a policy framework to address natural disasters and climate change. It focused on policies that could support the Sustainable Development Goals (SDGs) identified by the authorities in the new National Development Strategy (NDS) for 2016–35.

**Outlook and risks:** Economic growth in 2015 is estimated at 3¼ percent. Near-term prospects remain favorable but new sources of growth are needed over the medium term. Risks are tilted to the downside, notably weaker growth in emerging Asia.

#### Key policy recommendations:

- Enhance resilience to natural disasters by developing and implementing a multi-pillar strategy at the national, regional, and multilateral levels.
- Preserve cash reserves as a buffer against shocks at no less than two months of total spending.
- Improve the quality of public spending by advancing PFM reforms.
- Mobilize additional revenue by strengthening tax compliance and streamlining exemptions to finance infrastructure spending and preserve debt sustainability.
- Maintain the current monetary stance, but stand ready to tighten if inflationary pressures emerge and continue implementing the currency basket peg exchange rate regime.
- Strengthen financial regulation and supervision—including supervision of the National Provident Fund—and continue championing financial inclusion.

Approved By  
**Hoe Ee Khor and  
 Masato Miyazaki**

Discussions took place in Honiara during January 19-28, 2016. The staff comprised Ms. Tumbarello (head), Messrs. Jamaludin and Wu, (all APD), Craig (SPR), and Hackett (PFTAC advisor on PFM). Mr Khor attended the final meetings. Ms. Plater (OED) joined the policy discussions. The team met with Prime Minister Sogavare, Central Bank Governor Rarawa, Permanent Secretary of Finance Kuma, Permanent Secretary of Planning Fanega, and other senior officials, donors, and private sector representatives. Tlek Zeinullayev and Antoinette Kanyabutembo provided excellent research and editorial assistance for this report.

## CONTENTS

<b>THE SETTING AND OUTLOOK</b>	<b>4</b>
<b>ECF ARRANGEMENT: RECENT PERFORMANCE</b>	<b>6</b>
<b>POLICIES TO SUPPORT THE SDGS—INVESTING IN RESILIENCE AND FOSTERING FINANCIAL INCLUSION</b>	<b>9</b>
A. Policy Framework to Enhance Resilience to Natural Disasters and Climate Change	11
B. Preserving Fiscal Space and Investing in Resilient Infrastructure by Improving the Quality of Public Spending	14
C. Enhancing Monetary and Exchange Rate Policy Tools for Macroeconomic Stability and Growth	18
D. Toward Greater Financial Development, Stability, and Inclusion	20
E. Engagement with Donors and Other Issues	24
<b>STAFF APPRAISAL</b>	<b>25</b>
<b>BOXES</b>	
1. Synergies Between the Structural Agenda under the ECF Arrangement and Macro-Financial Stability	8
2. Growth Spillovers from China	27
3. External Balance Assessment and Competitiveness	28
<b>FIGURES</b>	
1. The Cross-Country Context	29
2. Financial Access and Inclusion	30
3. Macroeconomic Developments and Outlook	31
<b>TABLES</b>	
1. Selected Economic Indicators, 2012–17	33
2. Medium-Term Baseline Scenario, 2012–20	34
3. Summary of Fiscal Accounts, 2013–17	35
4. Summary Accounts of the Banking System, 2013–16	36

5. Balance of Payments, 2013–20	37
6. Reviews and Disbursements Under the Extended Credit Facility	38
7. Indicators of Capacity to Repay the Fund, 2014–25	39

**APPENDICES**

I. Risk Assessment Matrix	40
II. Authorities' Response to Fund Policy Advice	41
III. Letter of Intent	42
Attachment: Memorandum of Economic and Financial Policies	44

## THE SETTING AND OUTLOOK

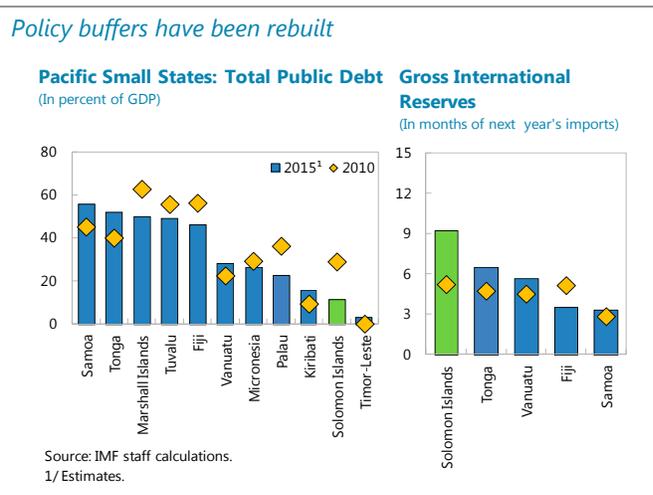
**1. Solomon Islands is a small island state and a low-income country that faces severe development challenges as well as great opportunities.** Some challenges are common to other small Pacific island nations in fragile situations: vulnerability to external shocks, including terms of trade, natural disasters and climate change; poor infrastructure; high dependency on aid; a history of social unrest; and weak capacity. The population is geographically dispersed—with 80 percent living in rural areas. The economy has traditionally been supported by logging activity as well as agriculture. But with the forestry sector expected to decline over the medium and long term, new sources of growth and a more diversified economy are needed to keep living standards from falling. Tourism has enormous potential as well as its combined synergies with agriculture. Moving up the value chain in the fishery sector also has great potential. All this will require better infrastructure, improved public financial management (PFM), and a better business climate to attract much-needed FDI to finance development needs. External financing and technical assistance from development partners will continue to be important in meeting these challenges and tapping these opportunities.

### *The ECF-supported program has helped enhance resilience and strengthen institutions*

**2. Solomon Islands has achieved remarkable gains in macroeconomic and financial stability with the help of structural reforms since the ECF arrangement started in December 2012 (see Box 1).** Policy buffers have been rebuilt and are

currently among the highest in the Pacific and among other small states. Leveraging on the achievements of two previous back-to-back IMF programs supported by Standby Credit Facility arrangements since 2010, the ECF arrangement has been instrumental in strengthening macroeconomic management capacity and institutions. Important reforms have been implemented: Public Financial Management (PFM) reforms (with a new Public Financial Management Act and the introduction of a multi-year budget framework;

a new debt management framework to strengthen debt management capacity and sustainability); and financial sector reforms such as the new Central Bank of Solomon Islands Act to enhance Central Bank's independence (MEFP, Table 1). These reforms have helped strengthen macroeconomic management. Despite the low access, the ECF-supported program has been instrumental in catalyzing donors support. The pace of reforms has slowed over the last year but progress has continued. Under the ruling coalition led by Prime Minister Sogavare, the policy focus has shifted to rural development and more recently, to anti-corruption. Given delays associated with the completion of the structural agenda for the fifth review and sixth reviews, the authorities have requested an extension of the ECF-supported program through end-March 2016 and that the fifth and sixth reviews be combined.



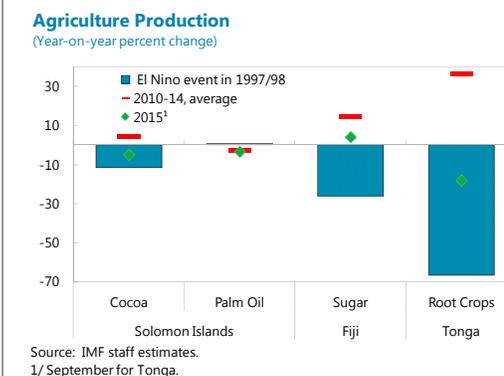
### *Growth remains solid despite natural disasters...*

**3. The economy is estimated to have grown by 3¼ percent in 2015, led by logging activity, tuna processing, construction, and retail services.** The country continues to be subject to natural disasters and climate and weather-related events: the impact of Cyclone Raquel and El Niño caused a reduction in agricultural output. Inflation has remained contained at 2.9 percent (year-on-year) in December, shifting from deflation early in the year. Inflationary pressures were driven by higher food prices owing to the depreciation of the Solomon Island dollar vis-à-vis the U.S. dollar and the effects of El Niño-related drought on the domestic food supply. After a strong recovery in the first half of 2015, donor support and FDI both weakened in the second half. Net international reserves remained flat at US\$506 million at end-December 2015 relative to 2014 (US\$496 million) equivalent to 9.8 months of imports (Table 1).

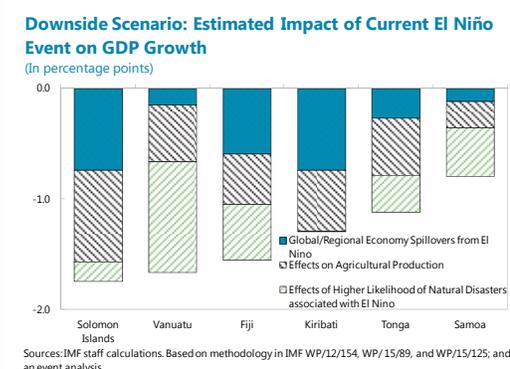
**4. Near-term prospects remain favorable.** In 2016, growth is expected to stay solid, at 3 percent. Activity will be driven by investment in construction, communications, and manufacturing—owing to a new brewery and tobacco factory, and higher yields from increased tuna processing capacity. Because of the current economic slowdown in China, lower demand for logging exports is expected in the near term. The ongoing El Niño event—forecast to continue at least until the first half of 2016—will reduce fish catch as well as agricultural production. Inflation is expected to stabilize around 1.5–3 percent in the near term. Continued low fuel prices are also likely to support consumption and lower production costs. The current account deficit will widen slightly to 4.5 percent of GDP in 2016, but the external position should remain strong, with net international reserves projected at 9.6 months of imports.

**5. New sources of growth are needed in the medium term.** With the continued fall in logging production, 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 by investing in infrastructure is also key to strengthening medium-term growth. The planned decline in aid from Regional Assistance Mission to Solomon Islands (RAMSI) which will be totally wound down by 2017, could pose additional medium-term challenges. Given the weaker prospects for mining activity and more frequent natural disasters, staff has lowered the countries’ potential growth from 4 to 3 percent. The current account deficit is expected to widen somewhat to support imports related to large infrastructure projects.

### *El Niño has already affected crop production...*



### *...and could further impact GDP growth in 2016*



*...but headwinds are strong*

**6. Risks to the outlook are tilted to the downside.** Weaker growth in emerging Asia—especially China—could worsen Solomon Islands’ growth prospects,<sup>1</sup> including through lower-than-expected demand for log exports. The outlook for nickel mining continues to be clouded by protracted litigation; and the nascent bauxite sector is not expected to contribute to near-term growth despite the recent resolution of licensing disputes. El Niño will likely weigh on agriculture and fisheries. Long-standing plans for large infrastructure projects—the Tina River Hydropower Plant and submarine cable projects<sup>2</sup>—could have stronger-than-expected positive spillovers, although their implementation could be delayed again.

**Authorities’ Views**

**7. The authorities’ economic outlook is broadly consistent with that of the staff.** They also see risks tilted to the downside and mainly external. Weakening growth in emerging Asia is a source of concern.

Significant Risks, Skewed Somewhat to the Downside		Likelihood	Impact
Upside	1. Persistently low oil prices boost domestic demand	Medium	Medium
	2. Reopening of Gold Ridge mine	Low	Medium
	3. Positive larger-than-expected spillovers from large infrastructure projects	Low	High
Downside	1. Sharper-than-expected global growth slowdown	Medium	Medium
	2. Tighter or more volatile global financial conditions	Medium	Low
	3. Sharp growth slowdown and financial risks in China – medium term – short term	Medium Low	High High
	4. El Niño undermines near-term growth	High	Medium

**ECF ARRANGEMENT: RECENT PERFORMANCE**

**8. Program performance has been broadly satisfactory.** All end-December 2014 PCs, end-March 2015 ITs, end-June 2015 PCs, and end-September 2015 ITs have been met by considerable margins. The exception is the Indicative Target (IT) on government-funded recurrent spending on health and education, which was narrowly missed at each test date due to a tighter procurement process by development partners. The forthcoming regulations under the Public Financial Management Act should help enhance government’s

**Summary of Program Performance Indicators**

Foreign Exchange Reserves Indicators*	End-2010	End-2012 (ECF start)	End-2015
Net International Reserves, end-of-year (US\$ million)	256	479	554
NIR in months of imports	5.1	8.1	9.8
<b>Fiscal Indicators</b>			
Cash balance (SI\$ million)	263	355	694
SIG Deposit Account	n.a.	140	140
Public debt (percent of GDP)	28.9	17.6	10.4
of which/ External debt (percent of GDP)	20.1	12.7	9.8

Note: Key quantitative performance criteria from MEFP, Table 2.

\*Reserves reported at program exchange rates.

<sup>1</sup> VECM analysis suggests that a one percentage point negative shock to China’s GDP growth causes Solomon Islands’ GDP to decline by 0.3 percentage point, causing a cumulative response of 1.8 percentage points over 10 quarters (Box 2).

<sup>2</sup> The Tina River Hydropower Plant project, earlier expected to have large positive spillovers in 2016, has been postponed to early 2017 and the timeline for the implementation of the submarine cable project is unclear.

procurement process. Net international reserves remain at comfortable levels. The cash balance for December 2015, although outside the monitoring of the program, stood at SI\$694 million (3.2 months of recurrent spending). The government has also maintained cash reserves of the consolidated accounts at SI\$140 million (0.7 month of recurrent spending) (Table 1 and MEFP Table 2).

**9. Structural reforms have continued in the context of the ECF arrangement and the program's objectives have been achieved.** As indicated in the MEFP, the authorities remain firmly committed to completing the reforms even after the ECF-supported program expires. The pace of the legislative process is proceeding steady, as the authorities' commitment to tabling several bills at the next sitting of Parliament, even though continued capacity constraints in the Attorney General's Chambers and the complexity of these legislations have slowed down the process.

- Implementation of benchmarks related to the new customs and excise bill (end-September 2015 benchmarks) is proceeding and the bill was approved by the cabinet in February, together with the Policy Paper on the Credit Union legislation (end September 2015 benchmark) which will be integrated into a draft bill (end September 2015 benchmark) already prepared with the TA support by the Asian Development Bank and will be vetted by the Attorney General once approved by cabinet. The recent approval by the cabinet signals the strong momentum for these bills to proceed to the next stage of the enactment process. Similarly, a policy paper for cabinet submission is being prepared for the National Provident Fund (NPF) bill.
- On education policies, progress in implementing the two benchmarks has been made. The rebalancing of spending away from tertiary education has been met in 2015.<sup>3</sup> Policies on the award and continuation of tertiary scholarships have been tightened to achieve better targeting and contain costs. The government has identified problems with the quality and quantity of the teaching cadre that will require greater investment in tertiary teacher preparation programs to meet projected supply needs at the elementary/secondary level.
- Regarding the benchmark on implementing regulations of the Constituency Development Funds (CDF) Act, the authorities, in consultation with PFTAC, have proposed an alternative commitment to increase transparency and accountability in the use constituency funds: namely the implementation of procurement regulations under the Public Financial Management Act, which apply to all government procurements. Thereby the regulations of the CDF Act have been superseded by the enactment of the Public Financial Management Act. Steps have been already taken to improve the accountability and transparency of these funds through more disciplined procurement processes and the application of the PFM Financial Instructions. In staff's assessment, this alternative commitment addresses issues of accountability and transparency, which was the intent of the original benchmark, and is an adequate substitute.
- The benchmark on the publication of the results of the audit reports on the use of spending of CDFs is close to being met. The audit reports have been completed by the Auditor General and will be submitted to Parliament at the next sitting before they are released to the public.

<sup>3</sup> The share of government-funded spending on tertiary education decreased from 33.3 percent in 2014 to 30.5 percent in 2015.

### **Box 1. Solomon Islands—Synergies Between the Structural Agenda under the ECF Arrangement and Macro-Financial Stability**

**The structural reforms under the ECF arrangement have helped enhance macroeconomic and financial stability.** Even where reforms are still in progress, the preparatory groundwork is continuing to support their implementation in due course.

- The new Central Bank of Solomon Islands (CBSI) Act, by providing more independence to the Central Bank has helped maintain a sound fiscal position (December 2012 benchmark) and has strengthened the effectiveness of monetary policy.
- The benchmarks related to debt management strategy, including SOE borrowing policy, on-lending policy and guarantee policy have contributed to increase fiscal space.
- PFM reforms (the New Public Financial Management Act, budget strategy document, mid-year budget review and final budget outcome report, and multi-year fiscal framework) have helped strengthening fiscal institutions.

**Reforms that are still in progress are also important for financial and macro stability:**

- In anticipation of the new financial institutions Act—developing financial instruction was a June 2014 benchmark—the CBSI has already laid the groundwork and issued or endorsed several Prudential Guidelines in these areas. For example, in 2015 CBSI issued two Prudential Guidelines to banks on more disclosure on bank fees and charges levied on customers and a complaints management framework and procedures for banks for dealing with complaints from customers. The issue of consumer protection is also very important in the CBSI leading role on financial inclusion, which has been also covered by a benchmark under the ECF-supported program (March 2013 benchmark).
- In February 2016, in anticipation of the new FIA, the CBSI Board endorsed a Fitness and Propriety Regulation for applicants who apply for a license to establish a financial institution in Solomon Islands as part of the licensing and governance requirements. This regulation will be submitted to the Minister of Finance for further endorsement and gazetting.
- In anticipation of the new Credit Union Act, the CBSI Board has endorsed a new Prudential Guideline on Credit Union Investments as part of good corporate governance. This guideline came into force on 1 March 2016.

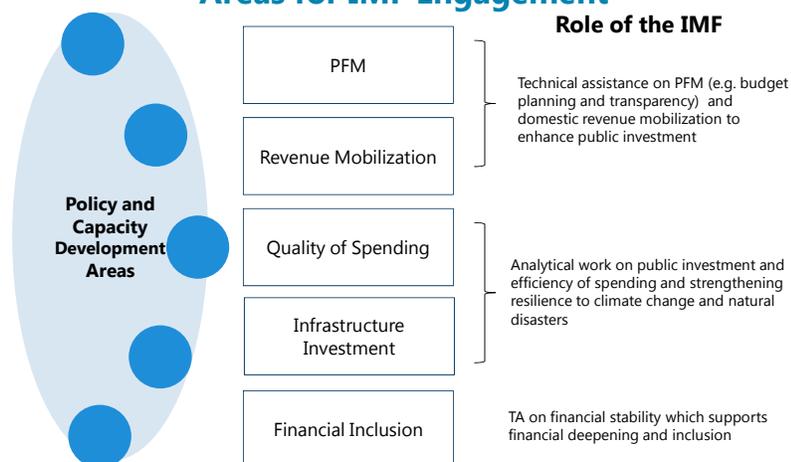
The CBSI Board also endorsed a new Prudential Guideline on Investments for the National Provident Fund (NPF) that will come into force after further consultations with NPF.

## **Beyond the ECF-supported Program**

**10. When the arrangement expires, staff plans to continue the close engagement built over the last few years.** This will include the provision of policy advice on a 12-month Article IV consultation cycle on macroeconomic policies and structural reforms that are macro critical in close coordination with other development partners. In line with Fund's new commitments under the Financing for Development agenda to increase its focus on fragile states, we aim to step up IMF TA and trainings over the medium term. Given the focus of the government on rural development the Fund could support these objectives by offering policy advice and TA in key areas of Fund's work (macroeconomic

stabilization, strengthening fiscal framework, resilience to natural disasters, revenue mobilization, and financial inclusion). This would be done in close cooperation with development partners whose primary focus is in rural development such as the World Bank Group and the EU.

### Rural Development in Solomon Islands: Possible Areas for IMF Engagement



Source: IMF staff compilation.

## POLICIES TO SUPPORT THE SDGs—INVESTING IN RESILIENCE AND FOSTERING FINANCIAL INCLUSION

**11. Achieving the Sustainable Development Goals (SDGs) is at the top of the government’s development agenda.** In the forthcoming National Development Strategy (NDS) covering 2016–35, the authorities have identified five specific development objectives and aligned them to corresponding Sustainable Development Goals (SDGs).

**12. To achieve the SDGs and align them in a coherent policy framework, the authorities have developed a five-year rolling plan—the medium-term development-plan (MTDP) 2016-20.** Approved by Parliament in December, the MTDP is designed to translate the government’s long-term development objectives into operational priorities and specific programs and projects, and also align them with annual budget plans for line ministries. The MTDP has been submitted to the Board by the authorities as the economic development document (EDD) and meets the Fund’s requirements under the new policy for poverty reduction strategies. The plan lays out specific reforms in the main economic sectors and proposes important advances in land policies, governance, and anti-corruption. It identifies priority spending areas and strategies to enhance spending effectiveness, including by further strengthening public finance management to reach better resource allocation decisions. It sets out policies to manage the impact of climate change and natural disasters that can jeopardize development outcomes, including through greater emphasis on disaster risk preparedness and mitigation.

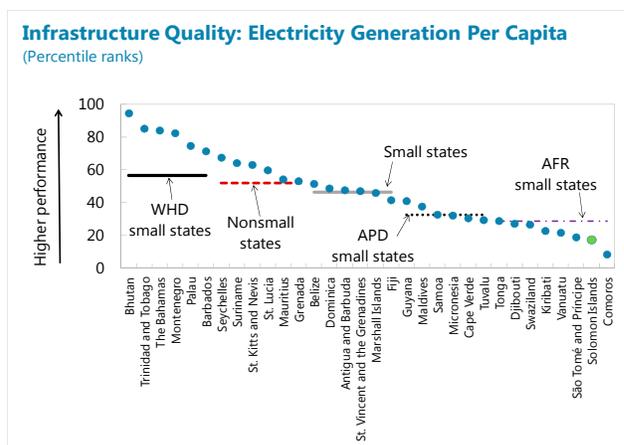
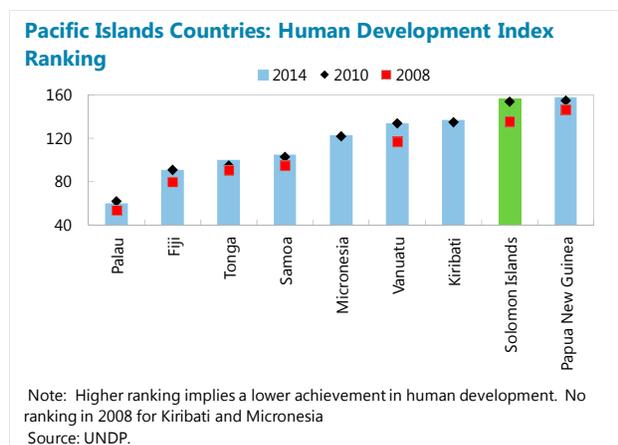
Solomon Islands: SDGs Identified in the 2016–35 National Development Strategy (NDS)		
Key development objectives identified by the NDS	Corresponding SDGs <sup>1/</sup>	Role of the IMF
Sustained and inclusive economic growth	<div style="display: flex; justify-content: space-around;"> <div style="background-color: #ff7f0e; padding: 5px; text-align: center;">5 Gender Equality</div> <div style="background-color: #ff7f0e; padding: 5px; text-align: center;">9 Resilient Infrastructure &amp; Innovation</div> </div> <div style="display: flex; justify-content: space-around; margin-top: 5px;"> <div style="background-color: #d62728; padding: 5px; text-align: center;">8 Inclusive Economic Growth &amp; Decent Work</div> <div style="background-color: #d62728; padding: 5px; text-align: center;">10 Reduced Inequality</div> </div>	<ul style="list-style-type: none"> <li>✓ Analytical work on public investment</li> <li>✓ TA on domestic revenue mobilization</li> <li>✓ TA on financial stability to support financial deepening and inclusion</li> <li>✓ Policy advice on strengthening macroeconomic management framework</li> </ul>
Poverty alleviation	<div style="display: flex; justify-content: space-around;"> <div style="background-color: #d62728; padding: 5px; text-align: center;">1 No Poverty</div> <div style="background-color: #1f77b4; padding: 5px; text-align: center;">6 Clean Water &amp; Sanitation</div> </div> <div style="background-color: #8c564b; padding: 5px; text-align: center; margin-top: 5px;">2 Zero Hunger</div>	<ul style="list-style-type: none"> <li>✓ Surveillance and policy advice on macro-economic policies</li> </ul>
Access to quality social services	<div style="background-color: #2ca02c; padding: 5px; text-align: center; margin-bottom: 5px;">3 Good Health and Well Being</div> <div style="background-color: #d62728; padding: 5px; text-align: center;">4 Quality Education</div>	<ul style="list-style-type: none"> <li>✓ Coordination with the World Bank Group and development partners</li> </ul>
Resilient and environmental sustainable development	<div style="display: flex; justify-content: space-around;"> <div style="background-color: #ffc107; padding: 5px; text-align: center;">7 Affordable and Clean Energy</div> <div style="background-color: #ffc107; padding: 5px; text-align: center;">12 Responsible Consumption</div> </div> <div style="display: flex; justify-content: space-around; margin-top: 5px;"> <div style="background-color: #ffc107; padding: 5px; text-align: center;">11 Sustainable Cities &amp; Communities</div> <div style="background-color: #2ca02c; padding: 5px; text-align: center;">13 Climate Action</div> </div> <div style="display: flex; justify-content: space-around; margin-top: 5px;"> <div style="background-color: #1f77b4; padding: 5px; text-align: center;">14 Sustainable Use of Oceans</div> <div style="background-color: #2ca02c; padding: 5px; text-align: center;">15 Protect Forests &amp; Ecosystem</div> </div>	<ul style="list-style-type: none"> <li>✓ Provide analytical and policy framework on how to incorporate the cost of natural disasters and climate change</li> <li>✓ Capacity development</li> </ul>
Stable and effective governance and public order	<div style="background-color: #1f77b4; padding: 5px; text-align: center; margin-right: 10px;">16 Peace, Justice, and Strong Institution</div> <div style="background-color: #1f77b4; padding: 5px; text-align: center;">17 Partnerships for the Goals</div>	<ul style="list-style-type: none"> <li>✓ TA on PFM with a particular focus on improved medium-term revenue and expenditure forecasting; stronger integration of planning and budgeting within a medium-term framework.</li> <li>✓ LEG high-level comments on the anti-corruption bill and AML/CFT regimes.</li> </ul>

<sup>1/</sup> Staff compilation.

**13. In building stronger institutions and achieving the related SDG, an anti-corruption bill is being prepared, with drafting to be completed in the first quarter of 2016.** This bill is one of the government's top priorities and aims to put the bill before parliament by mid-2016 (MEFP, paragraph 8). The Anticorruption Bill is being accompanied by the Whistle Blower Bill and a revamped Ombudsman Bill. Measures to strengthen the anti-corruption framework will help enhance transparency in the use of public resources, could improve business climate, and boost investor confidence.

**14. A review of the former NDS covering 2011-20 prepared by the Ministry of Planning in February 2015 found that only 28 percent of the indicators reflected any progress towards meeting the 2020 targets.** Real GDP growth per capita fell short of expectation after the end of the commodity super cycle. Progress has been achieved in water and electricity supply, and communication,

but not in transportation. Solomon Islands did not make any progress in the human development index (HDI) in recent years. The labor participation rates by youth and gender have not improved. And despite progress in electrification, electricity consumption per capita is one of the lowest among all small states.



**The MTDP has a strong emphasis on poverty reduction and allocates resources totaling SI\$183 million (2 percent of GDP) to this end.** The plan includes investments in water supply and sanitation, a constituency renewable rural electrification program, and a national food security enhancement program. Overall, SI\$730 million (or 8 percent of GDP) has been earmarked for health, education, and human resource development under the MTDP.

**15. Enhancing policymaking in four key areas would help Solomon Islands attain its development goals.** It will also help lock in the progress to date in strengthening macroeconomic performance and institutions under the IMF-supported programs. In line with the NDS objective and corresponding SDGs, the Article IV Consultation thus focused on the following policies:

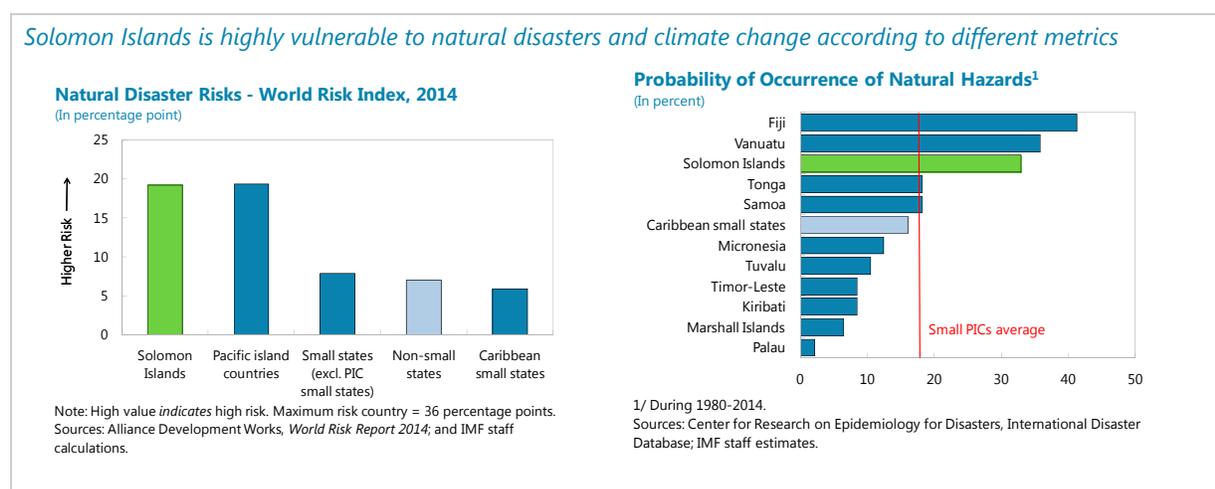
- *Enhancing resilience to natural disasters and climate change;*
- *Preserving fiscal space while investing in resilient infrastructure;*
- *Enhancing monetary and exchange rate policy tools for stability and growth; and*
- *Promoting financial deepening and inclusion to foster inclusive growth*

## A. Policy Framework to Enhance Resilience to Natural Disasters and Climate Change

**16. Climate change and natural disasters are macrocritical in Solomon Islands.** The combination of its location (along the ring of fire of the Pacific Rim) and its small size heightens its vulnerability to earthquakes, cyclones, tsunamis, and floods. The damage and losses related to flash floods in 2014 were estimated at 9 percent of GDP.

**17. IMF staff analysis suggests that natural disasters in the Pacific have a negative impact on both short-term and potential growth.**<sup>4</sup> A natural disaster with damages and losses equivalent to 1 percent of GDP causes a drop in GDP averaging 0.3 percentage point in the year of the disaster. Given the large impact of the natural disasters, potential growth in Solomon Islands is estimated to be lower by 0.3 percentage point per year.

**18. In the context of the Medium-Term Development Plan, the authorities have designed several programs on both climate change mitigation and adaptation.** The Ministry of Agriculture contributes to both these goals by shielding farmers from the impact of natural disasters and climate change; enhancing soil conservation and management; improving land fertility or using crops that are climate-change-proof; and enforcing the regulatory framework. The government is currently setting up a contingency fund for natural disasters.



## Staff's Views

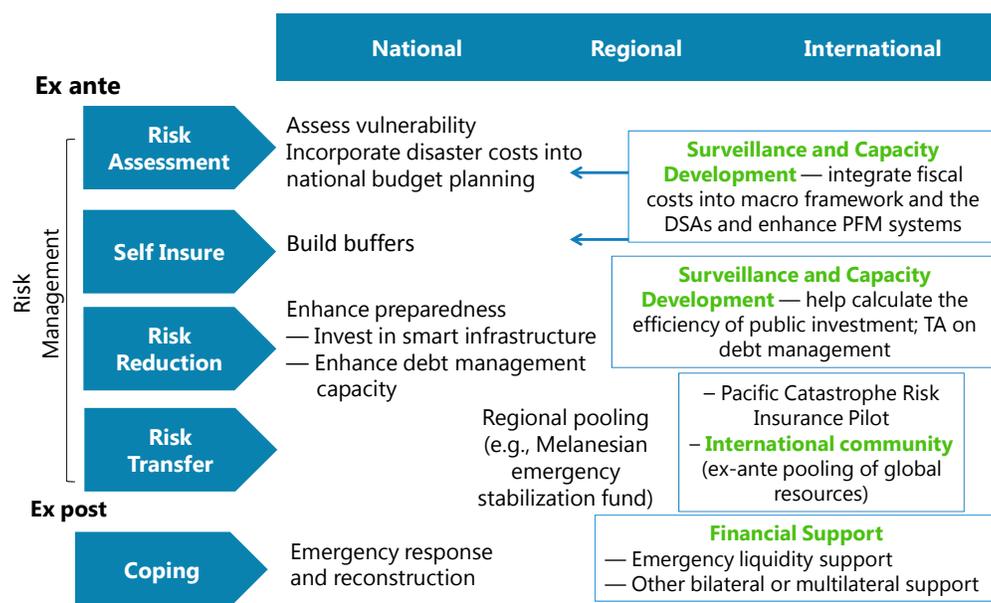
**19. Enhancing resilience to natural disasters and climate change entails a multi-pillar strategy at the national, regional, and multilateral levels.** It also requires enhancing Solomon Islands' risk-management capacity. The key pillars of disaster risk management, before the event, include:

- *undertaking a risk assessment*; at the national level, building ex-ante resilience entails identifying risks and explicitly integrating them into the fiscal frameworks and budget planning. This should be achieved by incorporating the projected fiscal costs of climate change and natural disasters into annual budgets within a medium-term framework;
- *providing self-insurance* by building policy and financial buffers to enhance resilience to shocks. Although the current level of macroeconomic buffers is adequate, in recent budgets 0.1-0.25 percent of GDP were put aside for natural disasters purposes only. In addition to accumulating reserves and maintaining fiscal space (keeping debt low), buffers could be accumulated also in the National Transport Fund, a donor-financed infrastructure fund fully integrated in the budget;

<sup>4</sup> See "[Enhancing Macroeconomic Resilience to Natural Disasters and Climate Change in the Small States of the Pacific](#)," IMF WP/15/125, for the proposed multipillar policy framework discussed with the authorities.

- *reducing risks* by enhancing preparedness, including by investing in “smart” infrastructure that can better cope with climate change and natural hazards and by enhancing debt-management capacity;
- *transferring risk*, either through catastrophic sovereign insurance or other newly created sub-regional schemes (i.e., “Emergency and Stabilization Fund for Melanesian Countries”).

### Multi-Pillar Framework: Strengthening Ex-Ante and Ex-Post Resilience



Source: Cabezon, Hunter, Tumbarello, Washimi, Wu (2015), Enhancing Macroeconomic Resilience to Natural Disasters and Climate Change in the Small States of the Pacific, IMF Working Paper 15/125. **Green shows where the IMF plays a role.**

**20. Ex-post disaster risk management includes strategies to manage the impact of a disaster and facilitate a rapid recovery.** At the national level, the main actions include emergency response and reconstruction efforts. A sound reconstruction program should consist of measures to reduce such risks through resettlement away from the coastline, where feasible, and infrastructure investment. Reconstruction can serve to accelerate broader growth-enhancing structural reforms. Donor financing will remain important in enhancing the ability to cope as these countries are too small, and the costs too high, to be fully internalized by building buffers.

#### Authorities’ Views

**21. The authorities agreed with the multi-pillar approach proposed by staff.** The government is currently setting up a contingency fund for natural disasters. It seeks to reduce risks by enhancing preparedness, including by investing in resilient infrastructure and by enhancing debt-management capacity.

**22. Regional solutions to transfer risks are also being considered.** Solomon Islands decided to withdraw from the third and final pilot of the Pacific Catastrophe Risk Insurance for the Pacific islands, a joint initiative led by the World Bank Group with financial support from Japan, because it did not qualify for payout during the 2014 floods as disbursements are linked to specific physical parameters (e.g. the wind speed triggering a cyclone) that were not triggered despite the massive floods. The authorities are

considering whether to participate in the newly proposed Melanesian Emergency and Stabilization Fund (around US\$500 million), covering not only natural disasters as well as also other macroeconomic shocks with balance-of-payment impact, and is meant to provide immediate liquidity ahead of support from the international financial institutions.

## B. Preserving Fiscal Space and Investing in Resilient Infrastructure by Improving the Quality of Public Spending

**23. In 2015, actual fiscal policy was much less expansionary relative to the original budget.** The fiscal deficit is estimated at just 0.3 percent of GDP relative to the 5.7 percent budgeted. The smaller deficit was due to two factors: first, more buoyant revenues (equivalent to 2.8 percent of GDP) owing to higher fishing license fees and international taxes as the forestry sector surprised on the upside (with this increase more than compensated by the drop in goods and services taxes as a result of lower value of fuel imports); and second, lower government-funded development spending of 2 percent of GDP and donor-funded development spending of 0.6 percent of GDP relative to the original budget. Despite a higher payroll (1 percent of GDP), the other recurrent spending funded by the government (which includes allowances, and payment to state-owned-enterprises for community services, and scholarships) fell by almost the same amount, also the result of limiting tertiary scholarships. The increase in payroll reflects a cost of living adjustment of 4 percent to all public servants, teachers and police from July 1, 2015 as well as the use of overtime and allowance by line ministries.

**24. The fiscal deficit was financed by a small drawdown in the cash balance (SI\$21 million) and SI\$2 million in external loans.** The decline in cash balance between 2015 and 2014 was much larger than implied by the deficit, because it also reflected the repayment by the government of SI\$100 million of domestic debt in mid-December,

	2014		2015	
	Budget	Outturn	Budget	Est. Outturn
Total revenue and grants	52.9	48.0	45.4	46.1
Total revenue	33.3	33.2	31.9	34.7
Tax revenue	30.3	29.2	28.4	29.3
Income and profits	11.3	10.1	10.2	11.1
Goods and services	11.3	10.6	10.4	9.5
International trade and transactions	7.8	8.4	7.8	8.7
Other revenue	3.0	4.1	3.4	5.4
Grants	19.6	14.8	13.6	11.5
Recurrent budget grants	6.9	2.0	4.7	2.6
Development grants	12.7	12.7	8.9	8.9
Expenditure	51.6	46.3	50.9	46.4
Recurrent expenditure	32.3	28.1	30.5	28.6
Compensation of employees	10.0	9.9	10.1	11.2
Interest payments	0.2	0.1	0.4	0.4
Other recurrent expenditure	22.1	18.1	19.9	16.9
Government funded	15.4	15.0	15.3	14.5
Grants funded	6.7	3.1	4.7	2.4
Development Expenditure	19.3	17.8	20.5	17.8
Government funded	6.6	5.6	11.6	9.4
Grants funded	12.7	12.2	8.9	8.3
Discrepancy 2/	...	0.4	...	0.1
Overall balance	1.2	1.7	-5.5	-0.3
<i>Memorandum items:</i>				
Constituency development funds (CDFs)	2.2	2.4	4.9	4.8
Capital spending 1/	5.5	5.2	9.3	7.8
of which CDFs	0.9	0.9	2.1	2.8

Sources: Country authorities and staff estimates.  
1/ Includes both recurrent and development spending.  
2/ Includes unrepresented checks and statistical discrepancy.

Change in the cash balance in 2015 (relative to 2014)	186
<i>of which</i>	
Total amortization payments	147
<i>of which</i>	
One-off domestic debt repayment	100
Other scheduled amortization payments	48
Change in cash balance in 2015 (relative to 2014) net of debt repayments	39
<i>of which</i>	
Clearance of unrepresented checks	-25
Increase in non-cash balance	43
Financing of the deficit using cash balance	21
<i>Memorandum items:</i>	
Cash balance at end 2014	880
Cash balance at end 2015	694

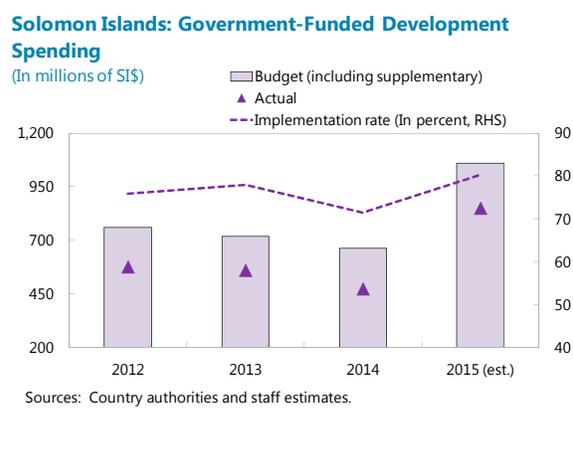
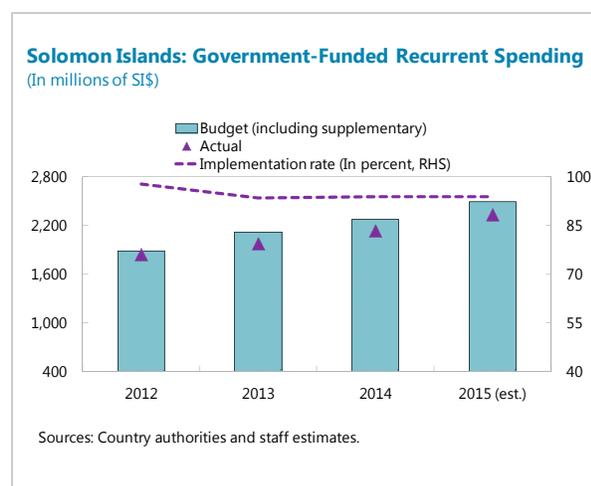
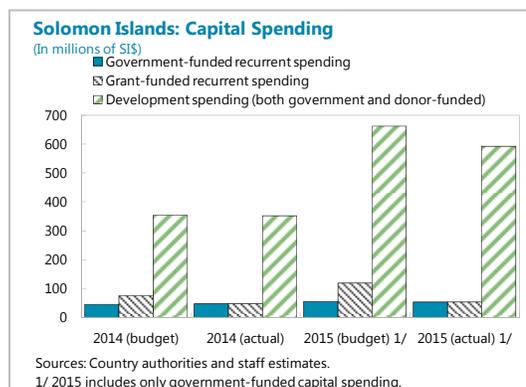
1/ The small fiscal deficit in 2015 has been financed by using SI\$21 million of cash balance and SI\$2 million of external loans.  
Sources: Country authorities and staff estimates.

mainly to the central bank, commercial banks, and NPF, and additional scheduled amortization (totaling SI\$147 million or 1.6 percent of GDP).

**25. The small deficit in 2015 relative to 2014 was driven by higher non-tax revenue** (1.3 percent of GDP). On the expenditure side, after a slow start due to delays in passing the budget until April, the pace of both recurrent spending and development spending picked up in the second half of the year. Implementation of government-funded development spending—a substantial part of which is constituency development funds (CDFs)—was far higher (4 percent of GDP) than in 2014 in line with the larger share of this spending in the 2015 budget.

**26. In terms of spending composition, the 2015 budget and outturn include a higher share of capital spending.** In 2014 capital spending amounted to 5.2 percent of GDP, while in 2015, it reached 7.8 percent, of which 35 percent was in constituency funds.

**27. Fiscal risks have increased going forward.** The 2016 budget approved in December envisages a deficit of 5.7 percent of GDP, about the same as the 2015 budget. As in the past, if fully implemented, the budget implies a sharp decline in cash reserve (to SI\$197 million). However, revenue projections are very conservative, with a drop of 3.3 percentage points of GDP (excluding grants) relative to the 2015 outturn, and upside surprises may occur, especially in non-tax revenues. Based on more realistic revenue projections as well as assuming an 85 percent implementation rate of government-funded recurrent spending and a 90 percent implementation rate of government-funded development spending (in line with recent experience), the actual deficit will likely be closer to 1.5 percent of GDP, with the cash balance at SI\$544 million at the end of 2016.



## Staff's Views

**28. Given large development needs (including infrastructure, health, and education), fiscal space should be used for infrastructure investment and to build resilience over the medium term, given the country's vulnerabilities and the uncertain outlook.** A balance should be struck between

building buffers and spending. Maintaining fiscal buffers is essential to enhancing resilience to shocks—including to natural disasters. While the increase in spending for capital investment to upgrade infrastructure and improve health and education outcomes is welcomed, the pace and scale of spending needs to be made consistent over the medium term with the country's absorptive capacity, the revenue envelope, and the availability of financing. It should also reflect realistic plans for revenue mobilization. The rate of drawdown in the cash balance implied by the 2016 budget should be contained as well as the pace of spending. Improving the quality of public spending and using the cash balance wisely are paramount in view of the uncertain growth prospects and vulnerability to natural disasters and other external shocks.

**29. Given the increase in fiscal risks with regard to the implementation of the 2016 budget, staff's specific recommendations included:**

- *urging the authorities to preserve cash reserves as a buffer against natural disasters and other shocks and to keep total reserves (including the consolidated cash balance) at no less than two months of total spending to anchor fiscal plans in the near term.* This will imply keeping the total cash balance at a minimum of SI\$595 million at end 2016. Going forward, greater attention must be paid to cash management particularly to cash flow forecasting. More accurate cash flow forecasting would also improve the analytical value of the mid-year budget review which currently evaluates inflows and spending relative to a standard assumption of equal monthly proportions, despite historical data that shows seasonality for some receipts and spending;
- *re-iterating the importance of using the budget as a tool to anchor fiscal planning and emphasizing the need for fiscal consolidation beginning 2017.* Staff stressed that unrealistic budget projections are counterproductive—and jeopardize the external financing so critical for supporting the country's economic development plans;
- *stressing the importance and urgency of improving budget presentation and reporting on budget execution by continuing PFM reforms.* The latter will be key to assess the quality of public spending. For example, while the 2015 budget appropriately allocated more spending to capital projects, given the large infrastructure needs; however, the budget outturn does not report to the public the implementation of capital spending. A clearer identification of capital spending, which is now reported under both recurrent and development spending, will also better highlight government priorities;
- *urging continued efforts to improve the quality of public spending including strengthening the accountability of constituency funds.* While this expenditure item meant to provide public service delivery to a broad spectrum of the population, it is important to ensure that the rate of return on this spending is higher than the opportunity costs of building buffers by enhancing its quality and accountability. The mission provided suggestions for a simple supplement to the development budget that would describe for each constituency fund the planning processes, development achievements, and future plans for CDF use. Providing this information in publicly available documents is important as these funds are viewed by the government as one of the major tools to support rural development;
- *welcoming the authorities' intention to scale up infrastructure investment to support higher and inclusive growth, given the large infrastructure gap.* The National Transport Fund is an important vehicle for investing in infrastructure, with the authorities' plans on the driving seat.

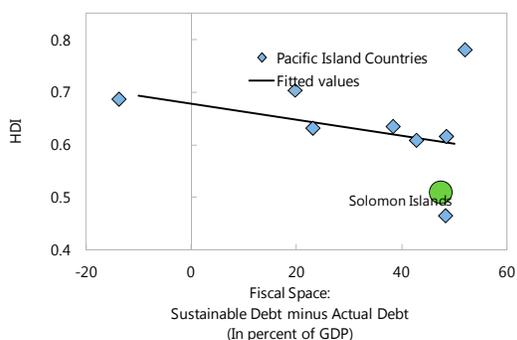
- *stressing the need to strengthen revenue mobilization* (including non-tax revenue), including by leveraging technical assistance where possible. This will be key to financing infrastructure spending and preserving debt sustainability. Exemption will also need to be streamlined as the revenue base will narrow with the depletion of the forests for logging.
- *advising the authorities to anchor fiscal plans* over the medium-long term to a non-commodity primary deficit target of 2.5 percent of GDP. This will help manage revenue volatility including from natural disasters and promote fiscal sustainability. Realistic spending plans should also be pursued by sequencing development projects within a medium-term fiscal framework to carefully align resources with spending capacity; and
- *highlighting the importance of incorporating risks associated with natural disasters and climate change into the macro framework and DSA* to enhance risk assessment ex ante, in line with the government's priorities.

**30. The mission strongly welcomed the authorities' intention to establish quarterly internal fiscal targets when the ECF-supported program expires.** These targets will help preserve fiscal buffers and better calibrate spending plans (see paragraph 33 below and paragraph 11 of the MEFP).

**31. Fiscal space has been rebuilt and Solomon Islands has one of the lowest debt levels among peers and non-peers—at 10.4 percent of GDP.** Yet, the DSA suggests that Solomon Islands continues to face a moderate risk of debt distress, consistent with the 2013 assessment in light of its vulnerability to external shocks and need to scale up infrastructure spending to finance development. Although there is no breach of debt sustainability thresholds under the baseline, under some alternative scenarios, thresholds are breached, notably the thresholds for the present value of government debt relative to exports and GDP. The authorities should be cautious in resuming concessional financing. Total public debt rises above the threshold in the extreme permanent low growth scenario. The analysis highlights Solomon Islands' ongoing vulnerability to external risks and heavy reliance on imports and aid. Staff included in the baseline 0.2 percent of GDP as recurrent spending and 0.3 percent as development spending as mitigation costs to natural disasters and tailored an extreme-weather-event scenario. On the upside, the country's debt management framework and capacity are strong, thanks to a series of PFM reforms as indicated in the MEFP (paragraph 13).

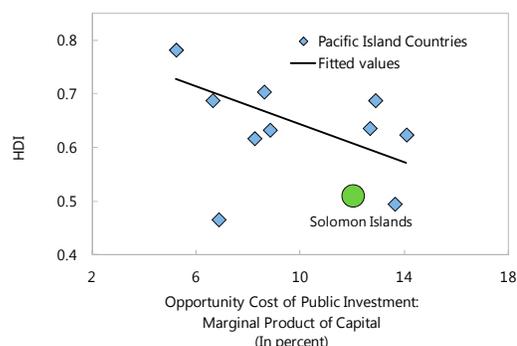
*The large fiscal spaces should be used to invest in infrastructure and human development*

**Fiscal Space and Human Development Index (HDI)**



Source: IMF staff estimates. Fiscal space calculated as the difference between the actual debt and its estimated sustained debt derived from a fiscal reaction function of primary balance to public debt (using a model similar to Ostry and others (2010) and tailored it to PICs. The sustainable debt is the amount of debt where the primary fiscal balance stabilizes the debt-to-GDP ratio.

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



Source: IMF staff estimates. The opportunity costs of building buffers has been estimated using a Cobb-Douglas function.

## Authorities' Views

**32. The authorities remain committed to maintaining fiscal discipline and a strong cash reserve after the IMF-supported program expires** (MEFP paragraph 11). They intend to target the broad definition of cash balance (cash balance plus the reserves in the government consolidated deposit account equivalent to SI140 million) at no less than two months total spending. In addition as the ECF arrangement expires, the authorities are planning to put in place internal quarterly fiscal targets, similar to the one set in the past with the IMF, to lock in gains in terms of fiscal management achieved over the last few years.

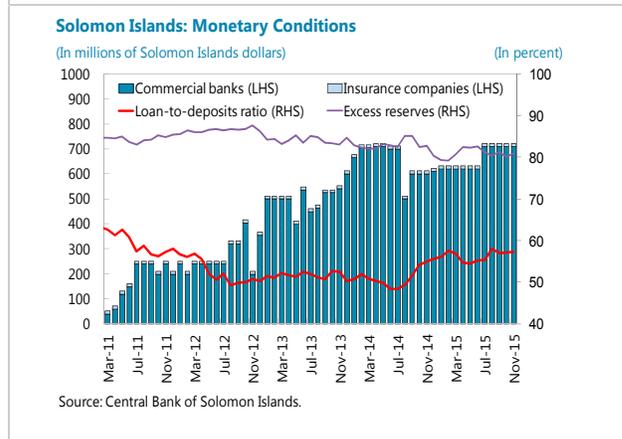
**33. The authorities are strongly committed to further strengthening PFM measures.** Actions include: the implementation of the PFM Roadmap, including finalizing the draft Procurement Rules and Regulations as well as other implementing instructions for the 2013 PFM Act. The authorities are considering requesting assistance from PFTAC to improve cash flow forecasting and management.

**34. The authorities concur with the importance of strengthening the fiscal framework.** They are open minded on the use over the medium term of the non-commodity balance as a fiscal anchor to help manage volatility of revenues and ensure a smooth path of infrastructure spending to support rural development. They asked the mission team to continue to work together with their staff over the next few months to further discuss the choice of a fiscal anchor also in the context of building resilience to natural disasters.

## C. Enhancing Monetary and Exchange Rate Policy Tools for Macroeconomic Stability and Growth

**35. Monetary policy has been very accommodative in an effort to support growth**—as shown by a number of indicators—high levels of bank liquidity and the very low interest rates on Bokolo bills. Credit growth reached 19 percent in November (y/y) driven by loans to households, including consumption and mortgages; and lending for investment in manufacturing and communication; and logging sector. Nonetheless, relative to GDP, credit remains at about 20 percent, much lower than in other Pacific islands and small states. Credit growth has partly fed into higher imports. Staff's econometric analysis suggests a strong positive and statistically significant relationship between domestic credit and imports, after controlling for food and fuel prices.

*Monetary policy remains accommodative given high excess reserves*



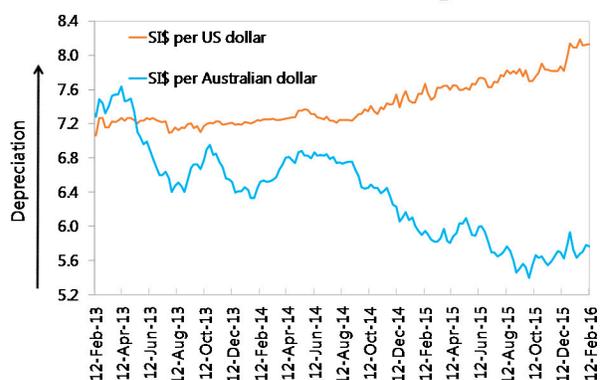
**36. The monetary transmission mechanism remains weak amid high excess liquidity.** The CBSI currently uses its own debt instruments—Bokolo bills—as a tool to manage banking sector liquidity but issuance has been sufficient to absorb only a portion of the excess liquidity in the system. Bokolo bill auctions were conducted on a fortnightly basis and the amount floated was kept at SI\$355 million per auction throughout the year. While there was evidently an appetite for increased Bokolo bills from the commercial banks, particularly following the

takeover of Westpac by Bank South Pacific (BSP), it was decided that any excess liquidity that the banks held should be directed to private sector lending. Efforts to promote interbank lending and the establishment of a repo facility were also explored. As for Treasury bills, which are also administered by the CBSI on behalf of the government, the cap on the outstanding stock remained at SI\$40 million throughout 2015.

**37. The basket peg regime has worked more effectively since the removal of the operational 1 percent band around the exchange rate against the US dollar in September 2014, and the widening of the bid offer spread.** The basket peg has allowed the SI dollar to weaken against the US dollar by 10 percent since then along with other currencies in the region. The Solomon Islands dollar appreciated by 12 percent against the Australian dollar over the same period, reflecting the strengthening of the US dollar against most currencies. In real effective terms, the exchange rate has been stable since the removal of the band (Box 3). Communication to the public on exchange rate policy has been strengthened by publishing the basket rate on the CBSI website. This has helped promote stability of the trade weighted index, despite some volatility.

*Since September 2014, the SI dollar has depreciated vis-à-vis the US\$ and appreciated vis-à-vis the Australian \$*

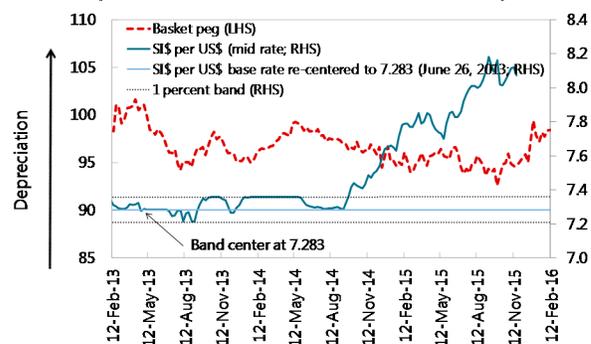
**Solomon Islands: Bilateral Nominal Exchange Rates**



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

*The basket peg regime has worked well since the removal of the operational band but some volatility remains*

**Solomon Islands: Nominal Exchange Rate and Basket Peg**  
(Index 26-Sept-2013=100) (Solomon Island dollar per U.S. dollar)



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

## Staff Views

**38. Excess liquidity has not fed into higher inflation, but credit growth has picked up strongly over the past two years and the authorities should begin mopping up excess liquidity.** Staff's econometric analysis suggests that credit growth of 10 percent could increase inflation by 0.6 percentage point within a year. The CBSI could use the CRR (cash reserve requirement) ratio to manage bank liquidity, and treat the level of excess liquidity more explicitly as a quantitative target. While increasing the CRR alone will not be sufficient to mop up excess liquidity completely, in combination with reforming the NPF (see paragraph 51), it could help the CBSI gain traction in liquidity management.

**39. While the basket regime is working well, it can be made more flexible through a periodic review and adjustment of the appropriateness of level of the peg to ensure it remains supportive of competitiveness and economic growth.** An assessment of external balance suggests that the

exchange rate may already be somewhat overvalued (Box 3). While more closely tracking the exchange rate basket has slowed down the erosion of competitiveness from the appreciation of the US dollar, it has not addressed the overvaluation of the exchange rate that was carried over from the previous regime (i.e., when the currency was closely pegged to the dollar). It will also not prevent future real appreciation, caused by underlying inflation differentials. To avoid this and correct for the overvaluation, the CBSI should periodically review the level of the exchange rate and adjust its level if necessary. With China being the most important export market, the authorities should consider including the renminbi in the basket.

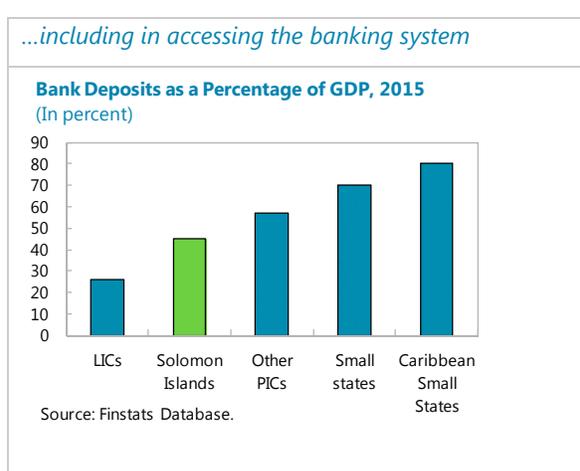
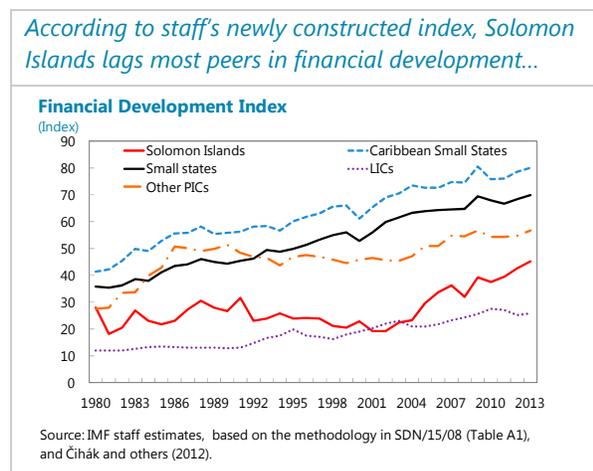
### Authorities' Views

**40. On monetary policy,** with regard to using the CRR ratio as a tool to manage liquidity, the CBSI expressed concern that not all banks are in a position to shoulder the additional burden of a higher CRR. Technical assistance on how to conduct liquidity swaps is being provided by the Reserve Bank of Australia.

**41. On exchange rate policy, the CSBI noted that the effective implementation of the basket peg has allowed some flexibility to absorb external shocks, thus reducing the burden on monetary policy.** The authorities noted that the rise in inflation was driven by the depreciation of the Solomon Islands dollar. They did not rule out devaluation in the future and indicated that they would monitor competitiveness indicators to identify situations where the strength of the exchange rate might be acting as a drag on growth. They also plan to keep the composition of the basket under review and consider later this year whether to include the renminbi in the basket.

## D. Toward Greater Financial Development, Stability, and Inclusion

**42. Despite progress, the domestic financial sector remains underdeveloped, and the reach of financial service providers has been limited.** According to a comprehensive index of financial development constructed by staff—applying a methodology pioneered by Čihák and others (2012)—that combines indicators of financial depth, access, and efficiency for financial institutions and markets, Solomon Islands has lagged small states peers in financial development (but not other low-income-countries).



The limited size of commercial bank deposits relative to GDP also places Solomon Islands among the most underbanked countries of small states. Other measures of financial inclusion also point to limited access to financial services (Figure 2).

**43. The financial sector has a simple structure but is beset with inefficiencies.** These reflect the small domestic market, inadequate infrastructure, the difficulty of securing collateral due to communal land ownership, and generally high transaction costs. Interest rate spreads have long been the highest among small states in the Pacific. The financial sector consists of two major foreign commercial banks, one domestic bank, a non-bank financial institution, and a saving and retirement fund—NPF, a systemically important financial institution with a large share of its assets held as deposits in the banking system.<sup>5</sup> The impact of de-risking on costs of sending remittances has started to emerge with a few small money transfer operators having ceased operations. However, the impact of these closures is not as large as in other Pacific Islands.

**44. The CBSI has been proactive in promoting financial inclusion.** In 2014, together with commercial banks, the CBSI introduced mobile banking services to deepen financial access in geographically dispersed and remote areas, making Solomon Islands a leader in mobile banking services among Pacific small states, with mobile banking well positioned to leapfrog conventional banking in providing financial services. The government's national financial inclusion target for 2015 of opening 70,000 new bank accounts was met ahead of time, as was the subsequently revised target of 160,000. In February 2016, the National Financial Taskforce, chaired by the Governor of the CBSI, endorsed Solomon Islands' National Financial Inclusion Strategy (NFIS) for 2016–20. The strategy will introduce new financial inclusion targets for the upcoming years and promote higher usage of financial services.

**45. While credit has grown by double digits since 2013 (Table 4), the financial sector indicators remain sound.** The

thinness of the domestic financial sector has resulted in occasional volatility in indicators of bank asset quality. The non-performing loans (NPL) ratio, however, moderated to 4.1 percent at the end of 2015, below its 5½ percent long-term average, after temporarily spiking in the second quarter. The domestic financial sector has undergone significant consolidation. In October 2015,

Solomon Islands: Core Financial Soundness Indicators, 2012-15<sup>1</sup>

	2012	2013	2014	2015			
				Mar	Jun	Sep	Dec
<b>Capital adequacy</b>							
Regulated capital to risk-weighted assets	33.1	32.5	31.6	31.5	32.8	30.9	31.3
Nonperforming loans, net of provisions to capital	4.3	12.3	8.5	8.8	14.2	9.4	7.7
<b>Asset quality</b>							
Nonperforming loans to total gross loans	3.7	7.2	4.7	4.7	7.0	4.8	4.1
<b>Earnings and profitability</b>							
Return on average assets	3.2	2.2	2.1	2.7	2.4	2.2	2.2
Return on average equity	19.1	14.4	13.4	17.1	14.6	13.4	14.2
Net interest income to gross income	46.0	51.8	56.7	52.1	54.6	55.2	54.7
Noninterest expenses to gross income	50.6	54.9	51.6	47.4	51.5	51.8	51.9
<b>Liquidity</b>							
Liquid assets to total assets (liquid asset ratio)	58.4	56.7	53.8	53.7	53.5	52.4	48.4
Core liquid assets to short-term liabilities	60.3	54.7	48.2	54.0	50.9	51.2	46.2

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

1/ Commercial banks only, at end-period.

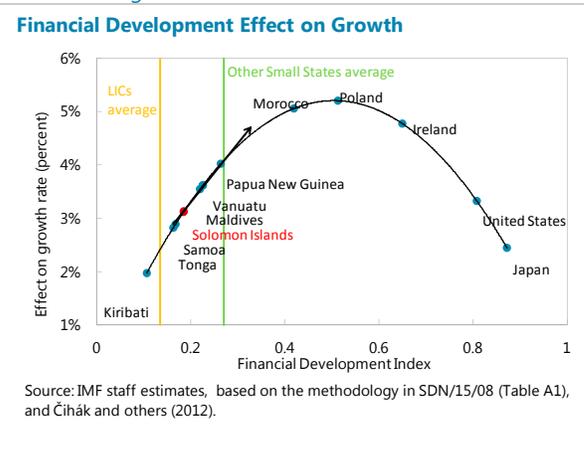
<sup>5</sup>The NPF mandate allows a 70:30 split between domestic and foreign investments. Less than 10 percent of its portfolio is invested abroad, and more than 20 percent of its investments are in the form of domestic cash and fixed-term deposits. Staff estimates NPF domestic cash and deposits to account for around one-fifth of total outstanding deposits held by commercial banks in 2015.

the CBSI approved the plans of the Australian bank, Westpac, to sell its Solomon Islands operations to the PNG Bank South Pacific (BSP). As a result, the total number of banks is reduced from four to three. The increase in BSP’s market share has significantly increased market concentration in the banking sector as measured by the Herfindahl-Hirschman Index (HHI), from an average of 30 percent to 40 percent, with 100 percent being a monopoly.<sup>6</sup>

**Staff’s Views**

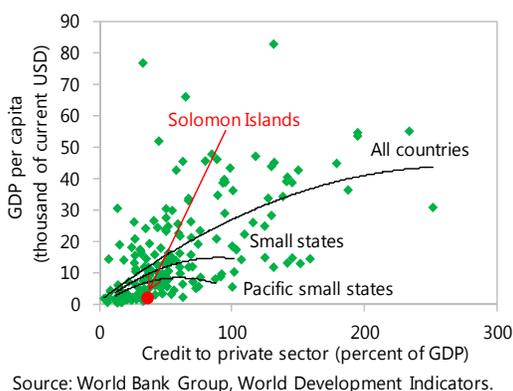
**46. Efforts to increase financial development and inclusion to promote growth are important and will need to be balanced against the need to maintain financial stability.** Staff estimates show that the potential positive effect on growth of further financial development is substantial, even when compared to other small states. However, while an increase in access to financial services can support growth, promote inclusion, and reduce inequality, a rapid rise in access to credit unaccompanied by adequate strengthening in financial supervision can undermine financial stability.

*Further financial development could generate large cumulative growth returns.*

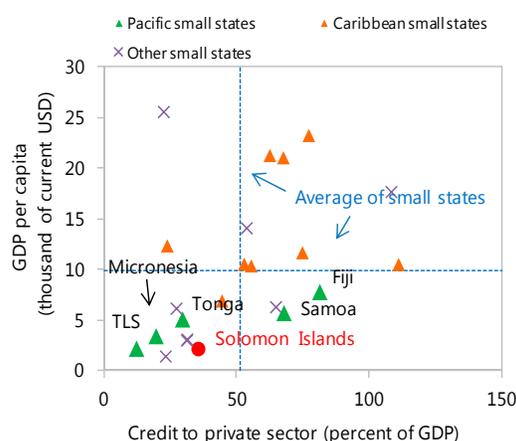


*Solomon Islands, like many other Pacific Islands...*

**Financial Depth and Economic Development**



*...would gain from further financial deepening.*



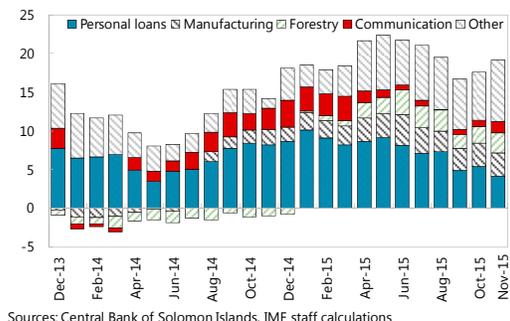
**47. While mortgage financing and consumption loans have been the main drivers of credit growth, risks to banks appear to be contained.** Most loans to households are secured either by housing, movable assets or retirement savings at the NPF. While personal loans have continued to be the single biggest driver of loan growth throughout 2015, at the aggregate level, their importance has

<sup>6</sup> HHI is defined as the sum of squared market shares of individual banks. It ranges from 1/n, where n is the total number of banks, to one (or 100 percent) and tends to zero as the market approaches perfect competition. In the case of Solomon Islands, market shares are calculated in three ways: using deposits, loans, and assets.

steadily declined as more new credit is being channeled to other productive economic sectors, helping curb the growth of banks' exposure to households. Mortgage financing has been partly driven by migration to Honiara from the outer provinces. However, borrowers' pledge of their retirement savings at the NPF is a source of concern.

*While personal loans continue to be the main driver of credit growth, its importance has declined...*

**Solomon Islands: Contributions to Credit Growth by Sector**  
(In percentage points)



*...and the bulk of personal loans has pivoted away from consumption credit towards mortgage financing.*

**Solomon Islands: Contribution to Personal Loans Growth**  
(In percentage points)

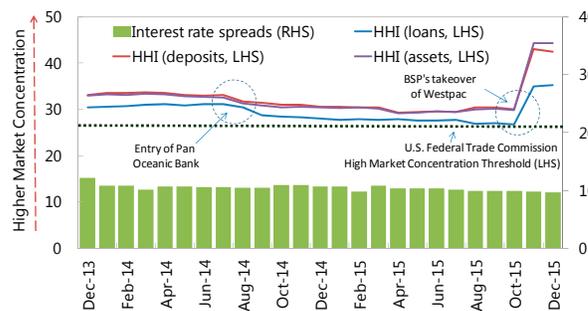


**48. The impact of the recent banking sector consolidation on interest rate spreads is expected to be relatively small amid widespread structural impediments.**

Even before the banking consolidation, interest rate spreads have remained relatively sticky. According to staff estimates, the recent increase in market concentration will raise spreads by 70-90 basis points.<sup>7</sup> To reduce the cost of financing for borrowers—and support the broader financial inclusion agenda—concerted efforts are needed to address longstanding structural issues including high transaction costs due to the infrastructure gap and limited availability of collateral due to communal land ownership. The proposed land reform under the MTDP is a key step in this context.

*The impact of banking sector consolidation will be relatively small as spread is driven by structural impediments*

**Solomon Islands: Banking Sector Concentration Indicator**  
(Herfindahl-Hirschman Index (HHI); percent)



**49. The financial sector reform agenda continues to be critical for inclusive growth.** Efforts should continue towards introducing a new Credit Unions Act and a new Financial Institutions Act to promote financial sector stability and development. The new National Provident Fund bill should be introduced promptly to improve the NPF governance and investment framework, and safeguard retirement savings. These reforms could also help reduce the excess liquidity in the financial system as

<sup>7</sup> Based on Jamaludin, Klyuev, and Serechetapongse in IMF WP/15/96.

the NPF could channel funds currently kept in low-yield domestic deposits into assets with higher rates of return. Equally important is the proposal to reduce the portion of retirement savings that could be used as collateral against personal loans, which will help safeguard retirement savings. The NPF should also regularly conduct actuarial assessments to gauge and ensure the sustainability of the pension system. See Box 1 for further financial sector reforms.

**50. The CBSI has established good practices in financial transparency and accountability with the financial statements prepared and audited in accordance with international standards published on the CBSI website.** A new law for the CBSI, enacted in 2012, provides adequate financial and legal autonomy. Improvements are needed in oversight by the Audit Committee with the addition of a financial expert. Strengthening staff capacity in the internal audit function is needed for the development of a risk-based audit function.

#### Authorities' Views

**51. The authorities agree on the importance of balancing financial inclusion against financial stability.** They reiterated that financial inclusion is at the top of the government development agenda. They pointed out that credit access remains low, with only 3.8 percent of adults currently with formal or informal credit accounts, and that the NFIS only targets a modest 10 percent of adults having access to credit by 2020. Any negative impact of the recent banking sector consolidation will be limited as the high spread in interest rate is caused by structural factors. Moreover, product substitutability among banks will ensure that interest rates remain competitive.

**52. The authorities agree on the need for a new National Provident Fund Act that will help improve the long-term financial viability and reduce the financial risks of the NPF.** The Ministry of Finance is currently preparing a policy paper to seek Cabinet approval of drafting instructions for a new NPF bill (paragraph 19, MEFP). The authorities have also endorsed the recommendations of the last IMF safeguard assessment (paragraph 20 of the MEFP).

## E. Engagement with Donors and Other Issues

**53. Financial and technical assistance from development partners will continue to be key to support development.** The annual aid envelope from Australia, the single largest aid donor, is A\$35 million. Despite RAMSI winding down in 2017, the bilateral envelope will continue to be substantial. Annual bilateral ODA from New Zealand amounts about to NZ\$28 million. Assistance has been focusing on health, economic development and education. The World Bank Group anticipate approving a US\$2.5 million energy access project in April and expect to disburse approximately US\$10 million across its portfolio (energy, rural development, environment and fisheries) across 2016. The European Union approved a national grant allocation of EUR 40 million for the period to 2020 focusing on Water, Sanitation and Hygiene (WASH) and Rural Development. In addition, it currently provides sector budget support in Rural WASH of about EUR 2.5 million per year, for the next four years. This depends on four general eligibility criteria, among which progress in PFM, and sectoral performance indicators. The Asian Development Bank (ADB) is expected to provide in 2016 US\$5 million of budget support as grants, and US\$21 million as loans to finance infrastructure projects under the sustainable Transport Infrastructure Improvement Program in the second quarter of 2016. The Japan International Cooperation Agency (JICA) together with the Japanese Ministry of Foreign Affairs supports a variety of

multi-year development projects, including the upgrading of the port and road network in the capital, and waste management, energy infrastructure, education and public health projects across the country. While some of this support is channeled through the IFIs, JICA's direct support has a large grant component with the budgeted amount totaling around US\$40 million so far for 2015-17. Solomon Islands has adequate capacity to repay the Fund and the ECF arrangement remains fully financed.

**54. The authorities also plan to leverage improvements in the area of national statistics to boost their capacity to assess and forecast macroeconomic developments.** The recent Household Income and Expenditure Survey (HIES) published last October, will pave the way for updating the composition of the consumer basket and the development of a national CPI—in 2017—as the current CPI only reflects Honiara prices only. The HIES data is currently being used to analyze poverty and the results will be released by end of the first quarter 2016. In 2018, the National Statistical Office also plans to use the HIES findings to rebase GDP statistics to better reflect the current structure of the economy. Over the long term, the National Statistics Development Strategy (2015–35)—planned for Cabinet endorsement in early 2016—identifies priorities and actions to be implemented in an effort to create a robust, sustainable, and well-coordinated national statistical system.

## STAFF APPRAISAL

**55. The program objectives to enhance macroeconomic stability and fiscal and monetary institutions have been achieved.** Solomon Islands has made considerable gains in terms of macroeconomic stability over the last few years thanks to the structural benchmarks under the ECF arrangement. Strong fiscal and external reserve buffers have been rebuilt thanks to a strengthening of the macroeconomic framework, which helped catalyzed donor support. Important reforms have been implemented: notably, PFM reforms (a new Public Financial Management Act, related draft implementing instructions and draft procurement instructions, and a new debt management framework—and related SOE borrowing and guarantee policies—to strengthen debt management capacity and sustainability); and among others the new Central Bank Act to enhance the effectiveness of monetary policy. Thanks to these structural measures policy space has been rebuilt and public debt at 10.5 percent is one of the lowest among small states. The authorities remain fully committed to continuing the process of strengthening institutions that have been guided by the structural benchmarks under the ECF arrangement.

**56. Solomon Islands faces long-term development challenges as well as opportunities.** Tapping opportunities requires a comprehensive strategy involving both the public and the private sector. In the new National Development Strategy (NDS), the authorities have identified five specific development objectives and aligned them to corresponding Sustainable Development Goals (SDGs). The authorities' Medium-Term Development Plan (MTDP) for 2016-20 sets out plans to achieve the objectives of the NDS, including details of specific policies and projects and public expenditure prioritization.

**57. Investing in resilience to enhance preparedness to natural disasters entails a multi-pillar strategy at the national, regional, and multilateral levels.** It requires enhancing the country's risk-management capacity. Staff encourages the authorities to incorporate the costs of natural disasters into the multi-year fiscal framework and support the plan to create a contingency fund for natural disasters.

**58. With the uncertainty regarding future sources of economic growth and a challenging external outlook, fiscal space should be preserved in implementing the 2016 budget and in outer years.** As the program with the IMF expires, progress achieved in ensuring macroeconomic stability will need to be locked in by maintaining a healthy fiscal position and fiscal buffers given the country's vulnerability to external shocks, including from terms of trade, climate change, and natural disasters.

**59. We urge the authorities to keep cash reserves at a minimum of two months of total spending and to strictly prioritize spending.** As in 2015, the 2016 budget document presents an expansionary budget deficit of 5.7 percent of GDP. In the staff assessment, the budget deficits should be not higher than 1.5 percent of GDP and the cash balance not lower than 2 month of total spending in order to be consistent with the commitments of the authorities in the MEFP.

**60. Measures to improve the quality of public spending are essential for enhancing resilience and support rural development.** To this end, PFM reforms that strengthen the accountability of public resources, including the constituency funds, should be accelerated.

**61. The authorities should sustain their efforts to implement reforms to build sound fiscal institutions.** These include improving the quality of public spending by implementing public finance management reforms, including by enhancing the transparency and accountability of tertiary scholarship and constituency funds; and mobilizing additional revenues by strengthening tax compliance and streamlining exemptions in order to finance infrastructure spending while preserving debt sustainability.

**62. Monetary policy is appropriate but the authorities should remain vigilant.** Excess liquidity in the banking system has not fed into higher inflation, but given high credit growth, the authorities should start mopping up excess liquidity.

**63. The currency basket regime is now working well.** The basket peg is an appropriate exchange rate regime for Solomon Islands but the level of the exchange rate should be assessed periodically and if necessary, adjusted, to ensure that it remains supportive of competitiveness and economic growth. The inclusion of the renminbi should be considered given China is the first export market for Solomon Islands.

**64. The financial system is sound, and efforts to strengthen supervisory and regulatory frameworks should continue.** A new NPF Act will be important for strengthening the NPF's governance framework and investment regime as to safeguard the retirement savings of the population. Other financial sector reforms include the introduction of a new Credit Unions Act and a new Financial Institutions Act. Efforts to promote financial inclusion are commendable especially in deepening financial access in rural areas and should continue. Solomon Islands has become a leader in mobile banking services among the Pacific islands.

**65. Based on the Solomon Islands' program performance, staff recommends the completion of the fifth and sixth reviews under the ECF-supported program.** The completion of the fifth and sixth reviews will enable the release of the sixth and seventh disbursements in the amount of SDR 297,145.

**66. With the ECF arrangement expiring, it is proposed that the next Article IV consultation take place on a 12-month cycle.**

### Box 2. Solomon Islands—Growth Spillovers from China

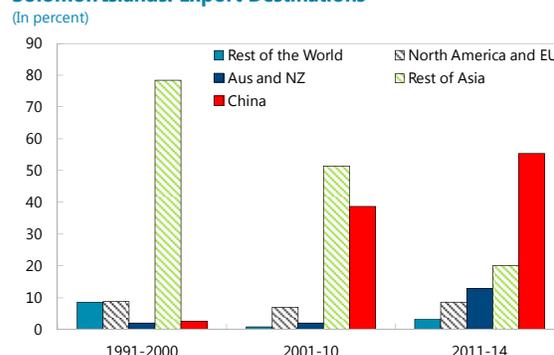
**The Solomon Islands and Chinese economies has become increasingly integrated over the last three decades, with China now the Solomon Islands’ largest trading partner.**

Export shares between these two countries increased thirtyfold during 1998-2014. A similar pattern is evident between emerging Asia (especially China) and other Pacific islands. PICs’ exports to emerging Asia have increased sevenfold since the early 1990s, while their imports from emerging Asia have grown more than fourteen times.

**After controlling for natural disasters,** a regression analysis between real GDP growth rates of Solomon Island and China for two different sub-periods suggests a strong and increasing co-movement between business cycles of these two countries over the last three decades.

*China has become the first export market for Solomon Islands*

#### Solomon Islands: Export Destinations



Sources: IMF, Directions of Trade Statistics.

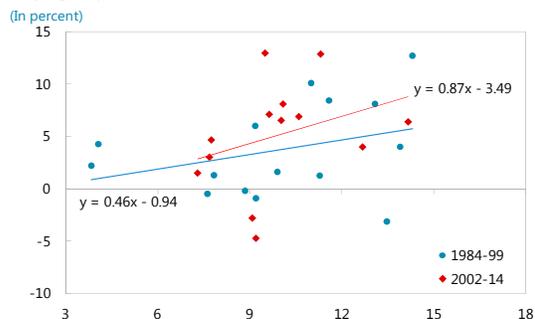
**A vector error correction model (VECM)** that quantifies both the long- and short- run impacts suggests that growth spillovers from China to Solomon Islands are significant and persistent up to three quarters. In the long run, the Johansen test suggests that there is cointegrated relationship between GDP in these two countries. In the short run, spillover from China’s growth to Solomon Islands is also significant.

#### Downside scenario

The model shows that if China’s growth rate is 1.5 percentage points lower (y/y) than the current WEO baseline during 2016Q1-2020Q4, the negative impact on Solomon Islands will be 0.4 percentage point per year over the same period (based on Eri Ikeda, Patrizia Tumbarello, and Yiqun Wu, forthcoming IMF working paper: “Growth Spillovers from China to the Pacific Islands”).

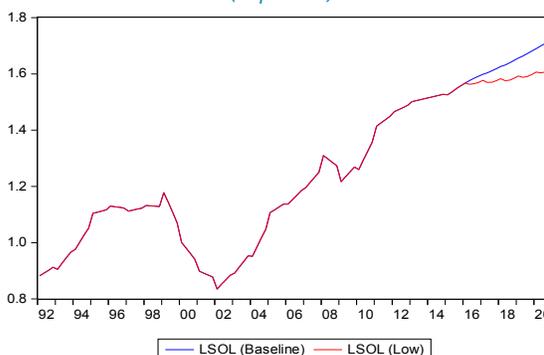
*Business cycle co-movement between Solomon Islands and China has increased through time*

#### Solomon Islands: Correlation of Real Growth Growth with China



*A slowdown of China will affect Solomon Islands’ growth*

#### Impact of China’s slowdown on Solomon Islands’ GDP Growth



### Box 3. Solomon Islands— External Balance Assessment and Competitiveness

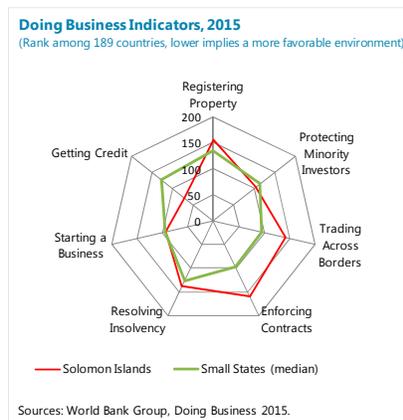
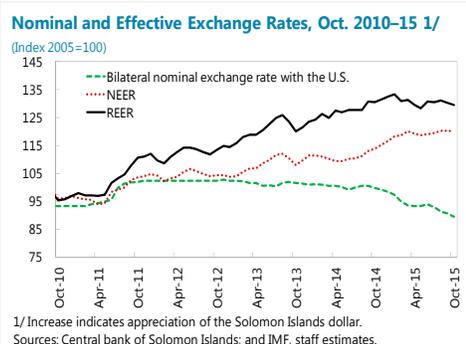
**External balance benefits from a high level of FX reserves and foreign aid, but a loss of competitiveness over the medium term that could slow growth.**<sup>1</sup> Solomon Islands’

terms-of-trade should deteriorate with the global commodity price cycle as the 50 percent fall in global timber prices is passed through into local prices and timber output declines. Competitiveness was lost when the currency was effectively pegged to the US dollar, which led to a REER appreciation exceeding 30 percent between mid-2011 and end-2014. The shift to a basket peg with a broader set of currencies stabilized the REER but did not reverse the appreciation. Also weighing on competitiveness is the relatively high cost of doing business. This partly reflects its small size and remote location; but, even relative to the median of small states, the cost of engaging in international trade, of enforcing contracts, and registering property are too high, the latter making access to finance more difficult.

**Model-based estimates of external balance highlight the need to pay attention to competitiveness.** Two of three IMF models—the REER and external sustainability approaches—imply that the real exchange rate (RER) moderately stronger than the level consistent with external balance (Table). This is not so for the Current Account (CA) approach as the CA norm—the deficit consistent with external balance when policies are set at their desired level—is larger than the actual CA deficit. However, this reflects several temporary factors, and the model suggests competitiveness is a concern when adjustments are made for them. First, the deficit was reduced by delays in infrastructure investments, in 2015, and will widen when they are undertaken. Second, FX reserves (at 10-months of imports) are above the IMF’s reserve adequacy metrics (of 3½ months), thus, reserve accumulation does not need to be a goal of policy, raising the norm. Third, high aid dependence, which allow the country to run a much bigger CA deficit, and when this effect is excluded from the CA approach model the RER gap is positive. These contributions of high foreign aid and FX reserves could diminish in the future and should not divert attention from the need to strengthen competitiveness now.

**Competitiveness needs be strengthened using, structural, fiscal and exchange rate policies to ensure external balance in the medium term.** The economy needs to adjust to term of trade shocks, particularly declines in the prices and production of timber, by developing alternative export industries. This needs to be led by supply side policies that address impediments to doing business, particularly by reducing the high administrative cost of international trade and by improving accesses to finance. Better infrastructure investment is also essential, particularly in communication and energy and to build resilience against natural disasters to help businesses and rural areas recover rapidly. This requires strengthening fiscal policy frameworks (i.e. PFM). The option of a one-off adjustment in the level of the basket peg should remain under consideration if competitiveness needs to improve and to respond to international monetary developments impacting Solomon Islands. Such developments include volatility in the US dollar as the Federal reserve exits quantitative easing, and in the renminbi, as China targets a broader currency basket and eases capital controls.

<sup>1/</sup> Prepared by Sean Craig (SPR).



#### External Balance Assessment (In percent of GDP)

	Current account actual	Current account norm <sup>1</sup>	Real exchange rate gap
CA approach	-2.5	-6	-12
With adjustment for aid dependence <sup>2</sup>	"	"	15
REER approach	n.a.	n.a.	17
External stability approach	n.a.	n.a.	7

Notes: Estimates from three IMF panel regression models estimated with data for IMF members (available on IMF.org).  
<sup>1/</sup> Actual FX reserves are well above the IMF reserve adequacy metric (of 3½ months), so the policy parameter for desired reserve accumulation is set to zero, raising the norm.  
<sup>2/</sup> The high dependence on foreign aid sharply increases the deficit consistent with external balance; and, when this effect is set to zero in the model a positive RER gap results instead. This is the case when the aid/GDP ratio is only cut in half.

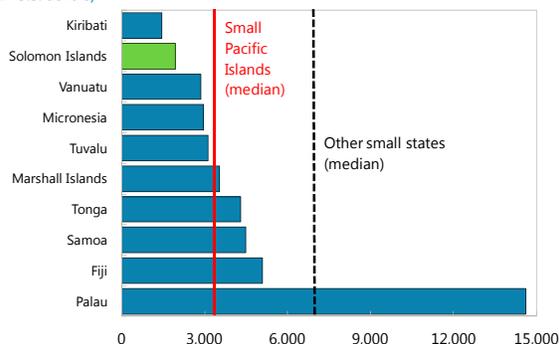
**Figure 1. Solomon Islands: The Cross-Country Context**

Solomon Islands is one of the poorest small states and faces several challenges...

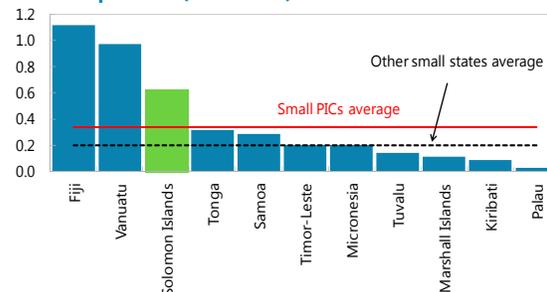
...including vulnerability to natural disasters...

**GDP per Capita, 2015**

(In U.S. dollars)



**Pacific Island Countries: Average Number of Natural Disasters per Year (1980-2014)**

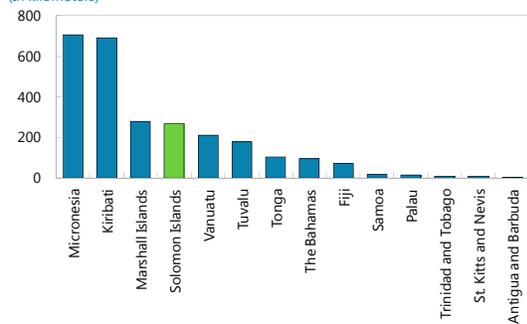


Sources: Center for Research on Epidemiology of Disasters, International Disaster Database; and IMF staff estimates.

... geographical dispersion ...

**Geographical Dispersion: Average Sea Distance Between Two Inhabitants of the Same Country**

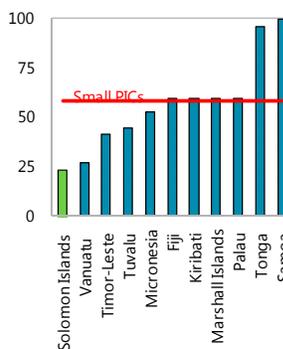
(In kilometers)



... and high infrastructure gaps.

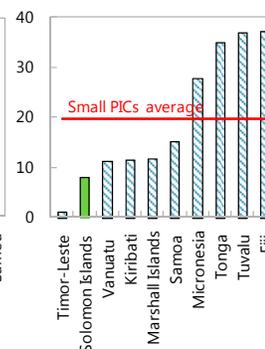
**Access to Electricity**

(In percent of population)



**Internet Users**

(Per 100 people)

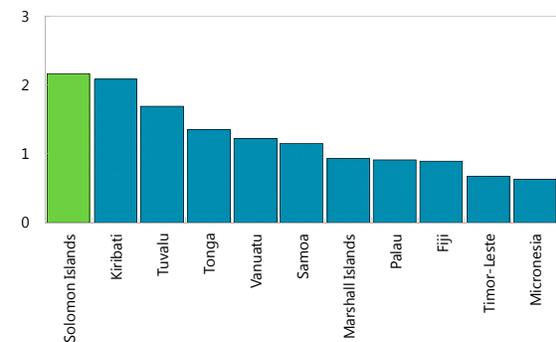


Source: World Bank Group, WDI.

Managing revenue volatility is essential...

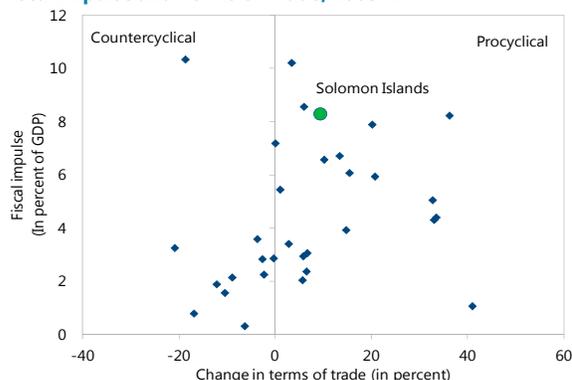
**Volatility of Tax Revenue**

(Standard deviation of detrended tax revenue-to-GDP ratio; 1990-2014)



... to avoid procyclical fiscal policy.

**Fiscal Impulse and Terms of Trade, 2005-14**

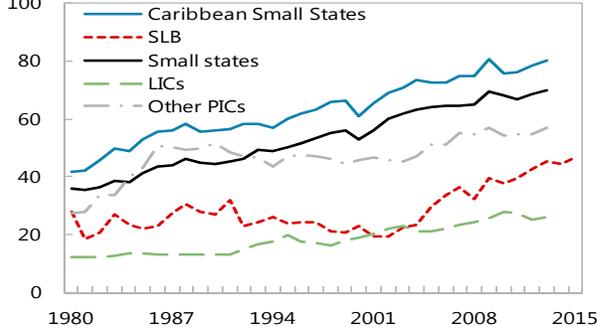


Sources: Country authorities; and IMF staff estimates.

**Figure 2. Solomon Islands: Financial Access and Inclusion**

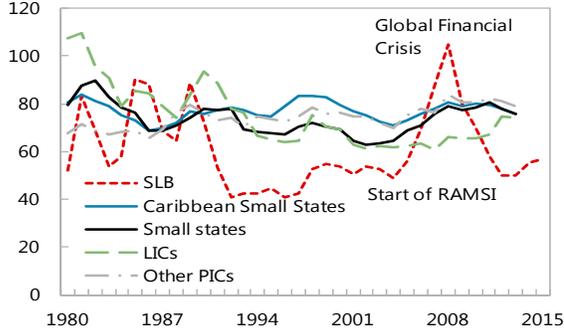
The level of financial deepening, as measured by the relative size of deposits, has continuously increased...

**Domestic Bank Deposits to GDP**  
(In percent)



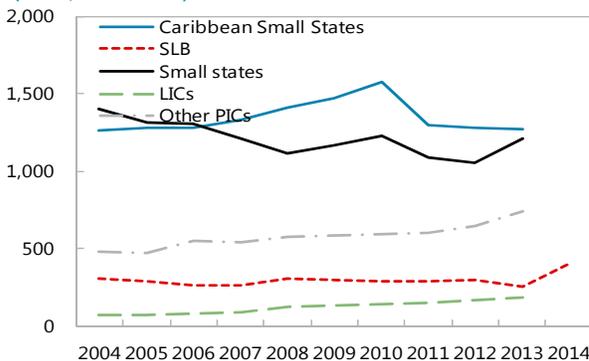
...although bank lending activity has yet to recover from the effects of the global financial crisis.

**Private Credit to Deposits**  
(In percent)



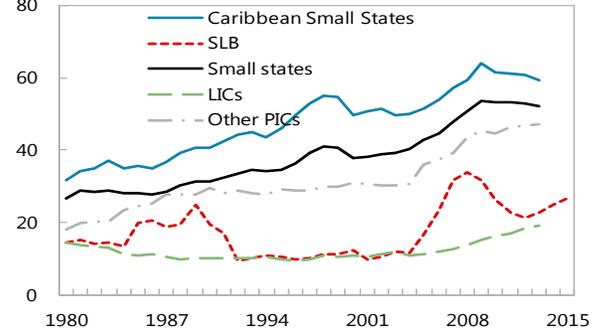
... resulting in relatively low access to the banking system...

**Accounts, Commercial Banks**  
(Per 1,000 Adults)



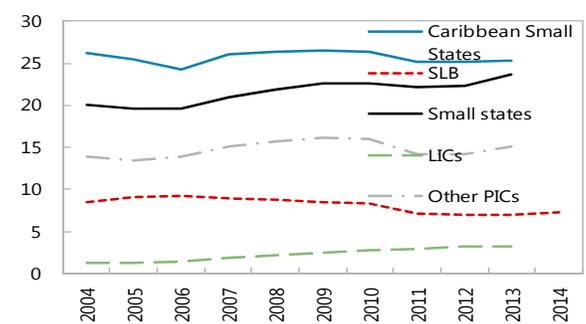
...and credit to the private sector has been on an upward trend from a low base...

**Private Credit to GDP**  
(In percent)



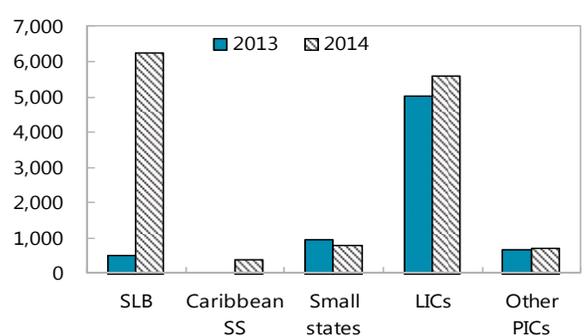
Geographical dispersion presents a major impediment for commercial banks' ability to reach customers...

**Number of Branches, Commercial Banks**  
(Per 100,000 Adults)



...although growth in mobile banking could leapfrog conventional banking in providing financial access.

**Number of Mobile Money Transactions**  
(Per 1,000 Adults)



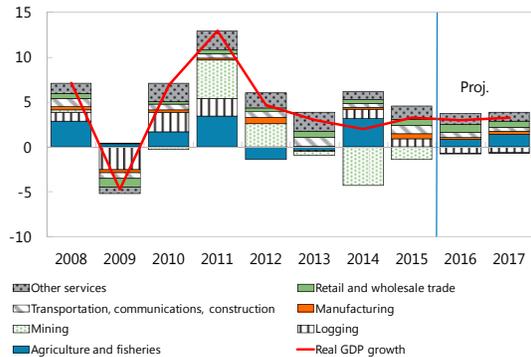
Source: Finstats Database; IMF staff estimates.

**Figure 3. Solomon Islands: Macroeconomic Developments and Outlook**

Growth in 2015 has been driven by stronger-than-expected logging activity and construction.

**Sources of Growth**

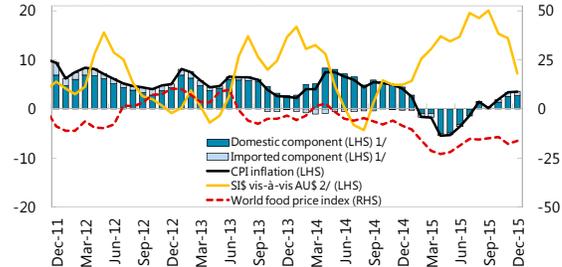
(Year-on-year percent change)



Inflation at 3 percent reflects currency depreciation and supply side factors on agriculture caused by El Niño.

**Contribution to CPI Inflation**

(Year-on-year percent change, end of period)

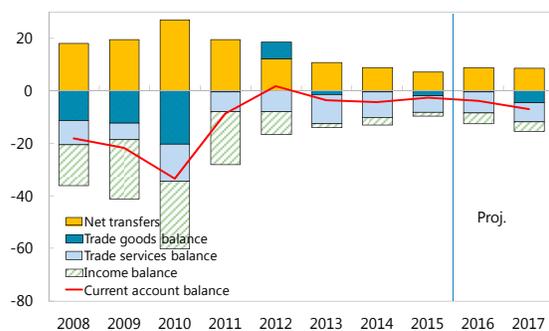


1/ Contribution to CPI inflation (in percentage points).  
2/ A positive change means an appreciation of the Solomon Islands dollar against the Australian dollar.

The current account is projected to deteriorate...

**Current Account Balance**

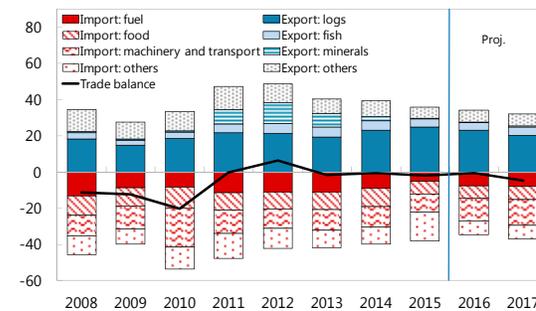
(In percent of GDP)



...because of lower mineral and log exports.

**Merchandise Trade**

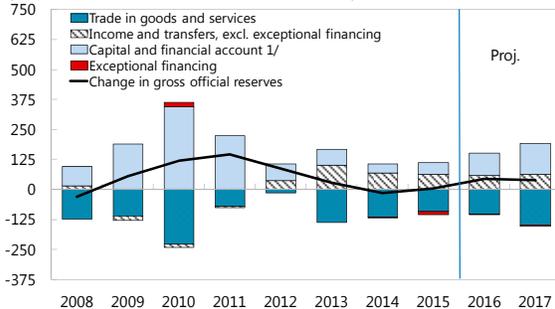
(In percent of GDP)



But sufficient financing is expected to be available...

**Changes in Reserves: Decomposition**

(Contribution to reserves, in millions of U.S. dollars)

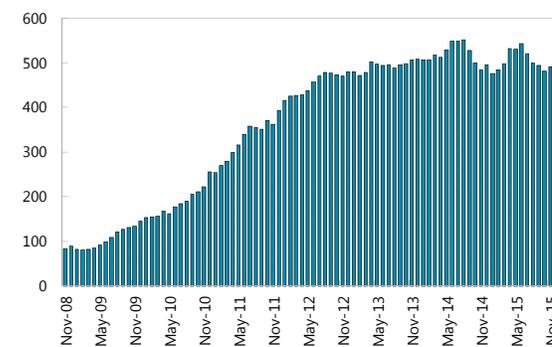


1/ Including errors and omissions.

... as reserves have been rebuilt.

**Net International Reserves**

(In millions of U.S. dollars)



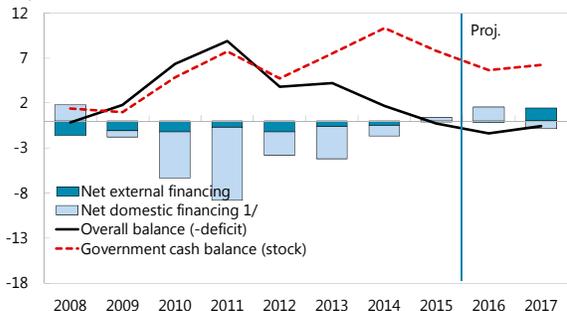
**Figure 3. Solomon Islands: Macroeconomic Developments and Outlook (concluded)**

The fiscal deficit is expected to narrow to 1.4 percent of GDP in 2016 from 2.5 percent in 2015.

Fiscal space remains large.

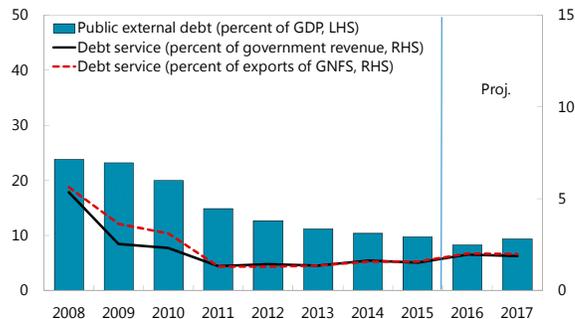
**Fiscal Balance and Financing**

(In percent of GDP)



1/ Includes privatization receipts.

**Public External Debt**

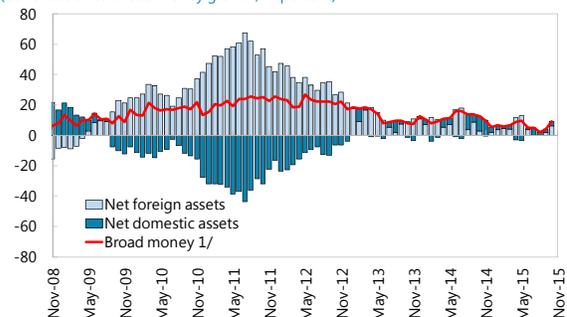


Money supply growth has slowed somewhat...

...while credit continued to grow briskly, driven by manufacturing, logging, and household sectors.

**Monetary Developments**

(Contribution to broad money growth, in percent)

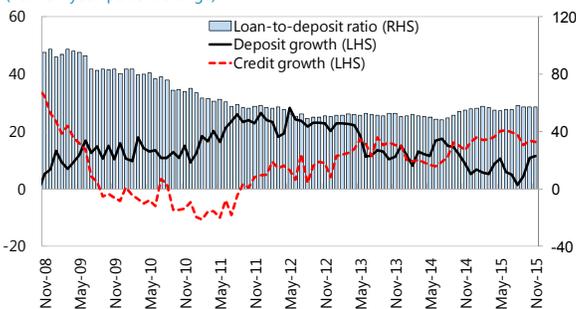


1/ Year-on-year percent change.

Source: Central Bank of Solomon Islands.

**Deposit and Credit Growth**

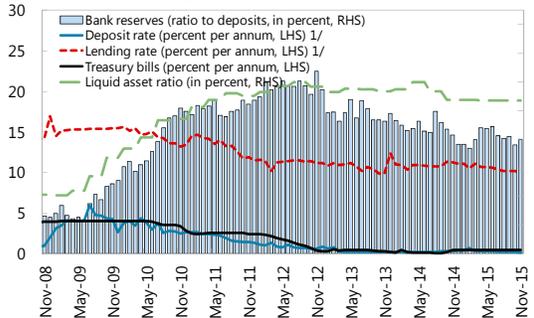
(Year-on-year percent change)



Bank reserves have declined, but remain substantial.

Noninterest income related to foreign exchange activities continues to support banks' profitability.

**Interest Rates and Bank Reserves**

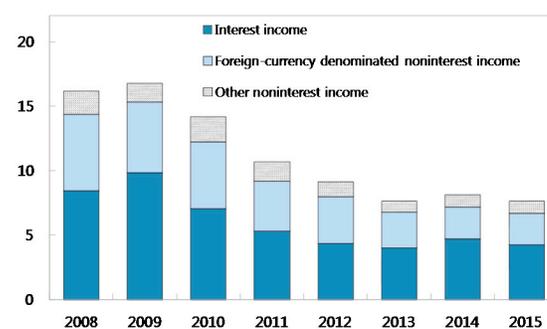


1/ Weighted average rate of commercial banks.

Source: Central Bank of Solomon Islands.

**Interest and Noninterest Income**

(In percent of total assets)



Source: Central Bank of Solomon Islands; IMF staff estimates.

**Table 1. Solomon Islands: Selected Economic Indicators, 2012–17**

	2012	2013	2014	2015	2016	2017
				Est.	Proj.	
Per capita GDP (2014): US\$1,931 (estimate)	Quota: SDR 10.4 million					
Population (2014): 562,000	Main products and exports: logs					
Poverty rate (2006): 23 percent	Main export markets: emerging Asia					
Growth and prices (percentage change)						
Real GDP	4.7	3.0	2.0	3.3	3.0	3.3
CPI (period average)	5.9	5.4	5.2	-0.4	1.3	2.9
GDP deflator	6.4	4.4	3.2	1.6	4.3	1.8
Nominal GDP (in SI\$ millions)	7,540	8,109	8,530	8,948	9,617	10,110
Central government operations (percent of GDP)						
Total revenue and grants	54.4	51.8	48.0	46.1	43.8	43.3
Revenue	33.6	34.1	33.2	34.7	31.6	31.6
Grants	20.8	17.8	14.8	11.5	12.2	11.7
Total expenditure	50.6	47.6	46.3	46.4	45.1	43.9
Recurrent expenditure	27.7	27.8	28.1	28.7	25.5	25.6
Development expenditure	22.9	19.8	17.8	17.8	19.6	18.3
Overall balance	3.8	4.2	1.7	-0.3	-1.4	-0.6
Foreign financing (net)	-1.2	-0.6	-0.5	-0.2	-0.2	1.4
Domestic financing (net)	-2.6	-3.6	-1.2	0.4	1.6	-0.9
Central government debt (percent of GDP, unless otherwise indicated) 1/	17.6	15.5	13.3	10.4	8.9	10.1
Domestic debt	4.9	4.3	2.9	0.6	0.5	0.6
External debt	12.7	11.3	10.4	9.8	8.4	9.4
Monetary and credit (percentage change, end-year data)						
Credit to private sector	4.1	15.1	16.4	16.7	3.2	...
Broad money	17.3	12.4	5.6	15.0	11.8	...
Reserve money	22.0	3.0	-10.1	23.4	12.3	...
Balance of payments (in US\$ millions, unless otherwise indicated)						
Current account balance	18.2	-38.5	-50.1	-30.0	-53.8	-98.0
(percent of GDP)	1.8	-3.5	-4.3	-2.6	-4.5	-7.8
Foreign direct investment	21.3	50.4	20.3	23.0	37.7	43.7
(percent of GDP)	2.1	4.5	1.8	2.0	3.1	3.5
Overall balance	87.3	28.1	-12.7	18.1	28.0	39.9
Gross official reserves (in US\$ millions, end of period) 2/	500	528	514	520	544	580
(in months of next year's imports of GNFS)	8.4	9.3	10.2	10.1	9.8	10.3
Net official reserves (in US\$ millions, end of period)	480	508	496	506	534	574
(in months of next year's imports of GNFS)	8.1	8.9	9.8	9.8	9.6	10.2
Exchange rate (SI\$/US\$, end of period) 3/	7.3	7.4	7.4	8.1	...	...
Real effective exchange rate (end of period, 2005 = 100) 3/	114.5	123.6	127.7	130.1	...	...
Memorandum items:						
Cash balance (in SI\$ millions)	355	608	880	694	544	630
in months of recurrent spending	2.0	3.2	4.4	3.2	2.7	2.9
SIG Deposit Account (MEFP Table 2; monitored under the ECF in addition to the cash balance, in SI\$ millions)	140	140	140	140	140	140
in months of recurrent spending	0.8	0.7	0.7	0.7	0.7	0.6
Boarder cash balance (=Cash balance+ SIG Deposit Account; in SI\$ millions)	495	748	1,020	834	684	770
in months of total spending 4/	2.1	3.1	4.2	2.9	2.3	2.6
in months of recurrent spending	2.8	4.0	5.1	3.9	3.3	3.6

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

1/ Includes disbursements under the IMF-supported programs.

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

3/ The 2015 numbers refer to November.

Table 2. Solomon Islands: Medium-Term Baseline Scenario, 2012–20 1/

	2012	2013	2014	2015	2016	2017	2018	2019	2020
				Est.			Proj.		
<b>Growth and prices (percentage change)</b>									
Real GDP	4.7	3.0	2.0	3.3	3.0	3.3	3.0	3.0	3.0
CPI (period average)	5.9	5.4	5.2	-0.4	1.3	2.9	2.9	3.0	3.0
GDP deflator	6.4	4.4	3.2	1.6	4.3	1.8	1.8	2.5	3.0
Nominal GDP (in SI\$ millions)	7,540	8,109	8,530	8,948	9,617	10,110	10,603	11,194	11,872
Per capita GNI (in US\$)	1,703	1,944	1,944	1,921	1,922	1,982	2,040	2,104	2,183
<b>Central government operations (percent of GDP)</b>									
Total revenue and grants	54.4	51.8	48.0	46.1	43.8	43.3	43.0	42.5	42.1
Revenue	33.6	34.1	33.2	34.7	31.6	31.6	31.8	31.7	31.6
Grants	20.8	17.8	14.8	11.5	12.2	11.7	11.2	10.8	10.4
Total expenditure	50.6	47.6	46.3	46.4	45.1	43.9	41.4	41.1	40.7
Recurrent expenditure	27.7	27.8	28.1	28.6	25.5	25.6	25.0	24.9	24.6
Development expenditure	22.9	19.8	17.8	17.8	19.6	18.3	16.4	16.2	16.1
Overall balance	3.8	4.2	1.7	-0.3	-1.4	-0.6	1.6	1.5	1.4
<b>Central government debt (percent of GDP) 1/</b>									
Current account balance (- deficit)	18.2	-38.5	-50.1	-30.0	-53.8	-98.0	-93.6	-87.4	-89.9
(In percent of GDP)	1.8	-3.5	-4.3	-2.6	-4.5	-7.8	-7.1	-6.2	-6.1
(Excluding mining-related capital imports, in percent of GDP)	5.9	0.8	-3.1	5.3	-4.1	-7.4	-6.8	-6.0	-5.9
Overall balance	87.3	28.1	-12.7	18.1	28.0	39.9	45.2	58.9	68.1
<b>Gross official reserves (in US\$ million; end of period) 2/</b>									
(In months of next year's imports of GNFS)	8.4	9.3	10.2	10.1	9.8	10.3	10.7	11.2	11.9
(In months of next year's nonmining-related imports of GNFS)	9.0	9.5	12.0	10.2	9.9	10.3	10.8	11.2	12.0
<b>Memorandum item</b>									
Noncommodity primary balance 3/	-4.2	-2.1	-3.3	-9.4	-6.7	-5.4	-2.9	-2.7	-2.5

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

1/ Includes disbursements under the IMF-supported programs.

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

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

Table 3 Solomon Islands: Summary of Fiscal Accounts, 2013–17

	2013	2014	2015			2016		2017
	Act.	Act.	Budget	Suppl.	Est.	Budget	Proj.	Proj.
	Budget							
	(In millions of Solomon Islands dollars)							
Total revenue and grants	4,204	4,093	4,063	4,104	4,128	4,313	4,208	4,374
Total revenue	2,763	2,835	2,850	2,856	3,103	3,024	3,038	3,193
Tax revenue	2,469	2,487	2,544	2,544	2,621	2,710	2,685	2,835
Income and profits	936	863	916	916	991	994	1,021	1,123
Goods and services	879	907	934	934	855	967	921	955
International trade and transactions	655	717	694	694	776	750	744	756
Other revenue	294	348	306	312	482	314	353	359
Grants	1,441	1,259	1,213	1,249	1,025	1,290	1,170	1,181
Development grants	1,145	1,086	795	795	795	885	885	890
Recurrent budget grants	296	172	418	454	230	405	285	291
Expenditure	3,863	3,948	4,558	4,814	4,151	4,862	4,338	4,434
Recurrent expenditure	2,252	2,400	2,727	2,959	2,557	2,869	2,456	2,587
Compensation of employees	747	847	903	997	1,005	1,001	1,001	1,022
Interest payments	15	11	40	40	40	8	8	9
Other recurrent expenditure 1/	1,490	1,542	1,785	1,921	1,512	1,860	1,447	1,556
Development expenditure	1,608	1,516	1,831	1,855	1,588	1,993	1,882	1,847
Government funded	560	474	1,036	1,061	842	1,108	997	957
Grant funded	1,047	1,042	795	795	747	885	885	890
Discrepancy 2/	3	32	0	0	6	0	0	0
Current balance	807	607	541	591	777	559	867	897
Overall balance	341	145	-496	-709	-23	-549	-130	-60
Total financing	-341	-145	496	709	23	549	130	60
Foreign (net)	-50	-43	-16	-66	-14	-20	-20	146
Domestic (net)	-290	-102	511	776	37	569	150	-86
	(In percent of GDP)							
Total revenue and grants	51.8	48.0	45.4	45.9	46.1	44.8	43.8	43.3
Total revenue	34.1	33.2	31.9	31.9	34.7	31.4	31.6	31.6
Tax revenue	30.4	29.2	28.4	28.4	29.3	28.2	27.9	28.0
Income and profits	11.5	10.1	10.2	10.2	11.1	10.3	10.6	11.1
Goods and services	10.8	10.6	10.4	10.4	9.5	10.0	9.6	9.5
International trade and transactions	8.1	8.4	7.8	7.8	8.7	7.8	7.7	7.5
Other revenue	3.6	4.1	3.4	3.5	5.4	3.3	3.7	3.5
Grants	17.8	14.8	13.6	14.0	11.5	13.4	12.2	11.7
Development grants	14.1	12.7	8.9	8.9	8.9	9.2	9.2	8.8
Recurrent budget grants	3.6	2.0	4.7	5.1	2.6	4.2	3.0	2.9
Expenditure	47.6	46.3	50.9	53.8	46.4	50.6	45.1	43.9
Recurrent expenditure	27.8	28.1	30.5	33.1	28.6	29.8	25.5	25.6
Compensation of employees	9.2	9.9	10.1	11.1	11.2	10.4	10.4	10.1
Interest payments	0.2	0.1	0.4	0.4	0.4	0.1	0.1	0.1
Other recurrent expenditure 1/	18.4	18.1	19.9	21.5	16.9	19.3	15.0	15.4
Development expenditure	19.8	17.8	20.5	20.7	17.8	20.7	19.6	18.3
Government funded	6.9	5.6	11.6	11.9	9.4	11.5	10.4	9.5
Grant funded	12.9	12.2	8.9	8.9	8.3	9.2	9.2	8.8
Discrepancy 2/	0.0	0.4	0.0	0.0	0.1	0.0	0.0	0.0
Current balance	9.9	7.1	6.0	6.6	8.7	5.8	9.0	8.9
Overall balance	4.2	1.7	-5.5	-7.9	-0.3	-5.7	-1.4	-0.6
Total financing	-4.2	-1.7	5.5	7.9	0.3	5.7	1.4	0.6
Foreign (net)	-0.6	-0.5	-0.2	-0.7	-0.2	-0.2	-0.2	1.4
Domestic (net)	-3.6	-1.2	5.7	8.7	0.4	5.9	1.6	-0.9
Memorandum items:								
Cash balance (in SI\$ millions) 3/	608	880	410	123	694	197	544	630
in months of recurrent spending	3.2	4.4	1.8	0.5	3.3	0.8	2.7	2.9
SIG Deposit Account (MEFP Table 2; monitored under the ECF in addition to the cash balance, in SI\$ millions)	140	140	140	140	140	140	140	140
in months of recurrent spending	0.7	0.7	0.6	0.6	0.7	0.6	0.7	0.6
Boarder cash balance (=Cash balance+ SIG Deposit Account; in SI\$)	748	1,020	550	263	834	337	684	770
in months of total spending 4/	3.1	4.2	1.7	0.8	2.9	1.0	2.3	2.6
in months of recurrent spending	4.0	5.1	2.4	1.1	3.9	1.4	3.3	3.6
Noncommodity primary balance (percent of GDP) 5/	-2.1	-3.3	...	...	-9.6	...	-6.7	-5.4

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

1/ Includes spending financed by recurrent grants.

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

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

4/ Total spending is defined as total recurrent spending and government-funded development spending in line with the consolidated budget presentation.

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

**Table 4. Solomon Islands: Summary Accounts of the Banking System, 2013–16 1/**

	2013	2014	2015				2016			
	Dec.	Dec.	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec
	Projection									
(In millions of Solomon Islands dollars, end of period)										
Central Bank of Solomon Islands (CBSI)										
Net foreign assets (NFA)	3,625	3,540	3,786	4,152	3,925	3,960	3,712	3,739	3,767	4,079
Net international reserves (NIR)	3,738	3,651	3,896	4,263	4,041	4,077	3,829	3,856	3,884	4,196
Other NFA	-113	-111	-110	-111	-116	-117	-117	-117	-117	-117
Net domestic assets (NDA)	-1,587	-1,708	-1,916	-2,051	-1,933	-1,699	-1,532	-1,464	-1,423	-1,350
Net claims on central government	-1,164	-1,280	-1,480	-1,585	-1,346	-1,108	-1,007	-969	-857	-819
Claims	75	69	68	57	55	5	69	69	69	69
Deposits	1,239	1,349	1,548	1,641	1,402	1,113	1,076	1,038	926	888
Other items (net)	136	136	129	135	131	121	122	129	130	138
Reserve money	2,038	1,832	1,870	2,101	1,992	2,261	2,179	2,275	2,343	2,539
Currency in circulation	603	658	631	637	629	739	776	815	856	899
Bank deposits	1,424	1,165	1,229	1,457	1,356	1,511	1,392	1,449	1,476	1,629
Other deposits	12	9	9	7	7	11	11	11	11	12
Other depository corporations										
NFA of commercial banks	133	287	207	166	152	169	173	177	182	186
Assets	230	365	302	299	236	281	285	289	294	298
Liabilities	98	77	95	133	84	112	112	112	112	112
NDA of commercial banks	1,273	1,516	1,557	1,570	1,725	1,750	1,657	1,734	1,576	1,757
Net claims on central government	-164	-146	-179	-234	-221	-243	-241	-235	-227	-217
Claims	48	44	42	42	37	15	17	22	30	40
Deposits	212	190	221	276	258	257	258	257	257	257
Claims on the private sector	1,457	1,697	1,750	1,807	1,888	1,981	1,883	1,902	1,951	2,045
Other items (net)	-20	-35	-14	-3	57	12	15	66	-148	-71
Reserves and vault cash	1,495	1,248	1,318	1,542	1,441	1,596	1,484	1,545	1,578	1,735
Deposits	2,901	3,051	3,083	3,277	3,318	3,515	3,314	3,456	3,335	3,678
Depository corporations survey										
NFA of the banking system	3,758	3,827	3,993	4,318	4,078	4,129	3,885	3,917	3,949	4,265
Central bank	3,625	3,540	3,786	4,152	3,925	3,960	3,712	3,739	3,767	4,079
Other depository corporations	133	287	207	166	152	169	173	177	182	186
NDA of the banking system	-314	-192	-359	-481	-208	51	125	269	152	407
Net claims on central government	-1,327	-1,426	-1,659	-1,819	-1,568	-1,351	-1,248	-1,204	-1,084	-1,036
Claims on the private sector 2/	1,463	1,703	1,756	1,813	1,895	1,988	1,890	1,909	1,958	2,052
Other items (net)	-450	-469	-455	-475	-536	-586	-517	-435	-722	-608
Broad money (M3)	3,444	3,635	3,634	3,837	3,869	4,180	4,010	4,186	4,101	4,672
M1	2,698	2,653	2,773	2,957	2,954	3,271	3,062	3,196	3,131	3,568
Currency outside banks	531	575	542	552	545	655	684	719	754	792
Demand deposits	2,167	2,078	2,230	2,405	2,409	2,617	2,377	2,478	2,377	2,775
Savings and time deposits	745	982	861	879	915	908	948	990	970	1,105
(Annual percentage change, unless otherwise indicated)										
Reserve money	-0.8	-10.1	4.5	7.9	-3.3	23.4	16.5	8.3	17.6	12.3
Credit to the private sector	15.1	16.4	17.1	20.3	15.2	16.7	7.7	5.3	3.3	3.2
Broad money	12.4	5.6	6.8	4.9	4.1	15.0	10.3	9.1	6.0	11.8
Memorandum items:										
Money multiplier (level)	1.7	2.0	1.9	1.8	1.9	1.8	1.8	1.8	1.8	1.8
Loan-to-deposit ratio (in percent)	50.2	55.6	56.8	55.1	56.9	56.4	56.8	55.0	58.5	55.6
Interest rates (percent per annum)										
Deposit rate 3/	0.2	0.2	0.5	0.3	0.3	0.2	...	...	...	...
Lending rate 3/	10.7	11.3	10.9	10.7	10.2	10.3	...	...	...	...
NCG of financial corporations	-1,252	-1,354	-1,588	-1,752	-1,500	-1,317	-1,217	-1,176	-1,063	-1,018
91-day treasury bill rate	0.2	0.3	0.5	0.5	0.5	0.5	...	...	...	...
Program targets										
NIR of CBSI (in US\$ millions)	508	496	498	543	495	...	...	...	...	...
NDA of CBSI (in SI\$ millions)	-1,150	-1,582	-1,782	-1,904	-1,794	...	...	...	...	...

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

1/ Based on actual and projected exchange rates.

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

3/ Weighted average of different maturities, period average.

Table 5. Solomon Islands: Balance of Payments, 2013–20 1/

	2013	2014	2015	2016	2017	2018	2019	2020
		Est.			Proj.			
	(In millions of U.S. dollars)							
Current account balance	-38.5	-50.1	-30.0	-53.8	-98.0	-93.6	-87.4	-89.9
Trade balance for goods	-16.8	-4.9	-21.6	-4.9	-59.1	-53.3	-40.7	-41.9
Exports	447.8	455.2	413.8	411.2	406.8	412.9	438.2	462.0
Imports	-464.6	-460.1	-435.4	-416.1	-466.0	-466.2	-478.9	-503.9
Trade balance for services	-122.2	-111.8	-71.9	-97.8	-90.7	-95.7	-101.3	-104.0
Exports	125.7	111.8	97.4	103.1	109.1	114.1	119.5	125.5
Imports	-247.9	-223.6	-169.3	-200.8	-199.8	-209.8	-220.8	-229.5
Income balance	-18.1	-35.7	-18.7	-47.9	-47.6	-46.0	-50.8	-54.2
Current transfers balance	118.6	102.3	82.1	96.8	99.4	101.4	105.4	110.2
<i>Of which</i> : Official transfers, net	103.7	86.6	67.5	77.7	78.6	78.7	80.2	82.5
Capital and financial account balance	96.2	62.3	44.3	81.8	138.0	138.8	146.3	158.0
Capital account balance	86.7	70.6	47.7	55.3	55.6	56.3	57.4	59.0
Direct investment balance	50.4	20.3	23.0	37.7	43.7	45.5	46.5	48.9
Portfolio investment balance	0.1	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Other investment balance	-41.0	-29.0	-26.4	-11.2	38.6	36.9	42.5	50.1
Errors and omissions	-29.6	-24.9	3.8	0.0	0.0	0.0	0.0	0.0
Overall balance	28.1	-12.7	18.1	28.0	39.9	45.2	58.9	68.1
Financing	-27.9	11.6	48.7	-28.0	-39.9	-45.2	-58.9	-68.1
Change in gross reserves (- = increase)	-28.1	12.7	49.9	-24.8	-36.0	-45.2	-58.9	-68.1
IMF	0.2	-1.1	-1.2	-3.2	-4.0	0.0	0.0	0.0
	(In percent of GDP, unless otherwise indicated)							
Current account	-3.5	-4.3	-2.6	-4.5	-7.8	-7.1	-6.2	-6.1
Trade balance for goods	-1.5	-0.4	-1.9	-0.4	-4.7	-4.0	-2.9	-2.8
Exports	40.3	39.5	36.1	34.2	32.2	31.2	31.3	31.1
Imports	41.8	39.9	37.9	34.6	36.9	35.2	34.2	34.0
Trade balance for services	-11.0	-9.7	-6.3	-8.1	-7.2	-7.2	-7.2	-7.0
Exports	11.3	9.7	8.5	8.6	8.6	8.6	8.5	8.5
Imports	22.3	19.4	14.8	16.7	15.8	15.8	15.8	15.5
Income balance	-1.6	-3.1	-1.6	-4.0	-3.8	-3.5	-3.6	-3.7
Current transfers balance	10.7	8.9	7.2	8.1	7.9	7.6	7.5	7.4
<i>Of which</i> : Official transfers net	9.3	7.5	5.9	6.5	6.2	5.9	5.7	5.6
Capital account balance	7.8	6.1	4.2	4.6	4.4	4.2	4.1	4.0
Direct investment balance	4.5	1.8	2.0	3.1	3.5	3.4	3.3	3.3
<i>Of which</i> : Inward FDI 2/	4.8	1.8	2.0	3.1	3.4	3.4	3.3	3.3
Other investment balance	-3.7	-2.5	-2.3	-0.9	3.1	2.8	3.0	3.4
Memorandum items								
Net international reserves (in US\$ million)	508	496	506	534	574	619	678	746
In months of next year's GNFS	8.9	9.8	9.8	9.6	10.2	10.6	11.1	11.8
Gross official foreign reserves (in US\$ million) 3/	528	514	520	544	580	626	684	752
In months of next year's imports of GNFS	9.3	10.2	10.1	9.8	10.3	10.7	11.2	11.9
Gross external public debt	11.3	10.4	9.8	8.4	9.4	10.7	12.2	14.0
Disbursement of concessional borrowing (in US\$ millions)	0.2	0.4	0.5	0.2	27.4	31.4	36.0	41.8
External public debt service (in percent of exports of GNFS)	1.4	1.6	1.6	1.9	2.0	1.9	1.6	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/ FDI numbers have been revised down as a result of changes to ensure the correct treatment of net losses under reinvested earnings, in line with BPM6

3/ Includes actual and prospective disbursements under the IMF-supported arrangement.

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

Availability Date <sup>1/</sup>	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 based on observance of continuous and end-December 2012 performance criteria
January 8, 2014	1.4	148,571	Completion of the second review based on observance of continuous and end-June 2013 performance criteria
June 20, 2014	1.4	148,571	Completion of the third review based on observance of continuous and end-December 2013 performance criteria
April 10, 2015	1.4	148,571	Completion of the fourth review based on observance of continuous and end-June 2014 performance criteria
June 15, 2015 <sup>2/</sup>	1.4	148,571	Completion of the fifth review based on observance of continuous and end-December 2014 performance criteria
November 15, 2015	1.4	148,574	Completion of the sixth review based on observance of continuous and end-June 2015 performance criteria
Total	10.0	1,040,000	

Source: IMF.

1/ For reviews that have already been completed, the date refers to the actual Board date when the review was completed.

2/ The fifth review was combined with the sixth review.

**Table 7. Solomon Islands: Indicators of Capacity to Repay the Fund, 2014–25**

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
	Act.					Proj.						
Fund obligations based on existing credit (in SDR millions)												
Principal	1.0	1.0	2.4	2.8	2.5	1.5	0.1	0.2	0.2	0.1	0.1	0.0
Charges and interest	0.0	0.0	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	1.0	1.0	2.4	2.8	2.5	1.5	0.1	0.2	0.2	0.2	0.1	0.1
Charges and interest	0.0	0.0	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	1.0	1.0	2.4	2.8	2.5	1.5	0.1	0.2	0.2	0.2	0.1	0.1
In millions of US\$	1.5	1.5	3.4	3.9	3.5	2.1	0.2	0.3	0.3	0.2	0.2	0.1
In percent of gross international reserves	0.3	0.3	0.6	0.7	0.6	0.3	0.0	0.0	0.0	0.0	0.0	0.0
In percent of exports of goods and services	0.3	0.3	0.7	0.8	0.7	0.4	0.0	0.0	0.0	0.0	0.0	0.0
In percent of debt service 2/	9.1	8.0	20.7	22.6	18.7	10.7	1.0	1.3	1.4	1.1	0.8	0.4
In percent of GDP	0.1	0.1	0.3	0.3	0.3	0.1	0.0	0.0	0.0	0.0	0.0	0.0
In percent of quota	10.0	10.0	23.4	26.7	23.8	14.1	1.3	1.8	2.0	1.4	1.0	0.5
Outstanding Fund credit												
In millions of SDRs	12.0	10.4	7.6	4.9	2.4	0.9	0.8	0.6	0.4	0.2	0.1	0.0
In millions of US\$	17.5	14.6	10.8	6.9	3.4	1.3	1.1	0.8	0.5	0.3	0.1	0.0
In percent of gross international reserves	3.4	2.8	2.0	1.2	0.5	0.2	0.2	0.1	0.1	0.0	0.0	0.0
In percent of exports of goods and services	3.1	2.8	2.1	1.3	0.6	0.2	0.2	0.1	0.1	0.0	0.0	0.0
In percent of debt service 2/	105.8	79.7	65.0	39.4	18.2	6.8	5.9	4.0	2.5	1.4	0.5	0.0
In percent of GDP	1.5	1.3	0.9	0.5	0.3	0.1	0.1	0.1	0.0	0.0	0.0	0.0
In percent of quota	115.7	100.0	73.4	46.6	23.1	8.9	7.7	5.6	3.6	1.8	0.6	0.0
Net use of Fund credit (in SDR millions)												
Disbursements	0.3	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repayments and repurchases	1.0	1.0	2.4	2.8	2.5	1.5	0.1	0.2	0.2	0.2	0.1	0.1
Memorandum items:												
Exports of goods and services (in US\$ millions)	567.1	511.1	514.3	515.9	527.0	557.7	587.5	630.2	631.0	687.7	767.3	778.2
Gross international reserves (in US\$ millions)	514.3	519.6	544.4	580.3	625.5	684.4	752.5	842.6	894.8	964.7	1049.8	1122.5
Debt service (in US\$ millions) 2/	16.6	18.3	16.6	17.5	18.7	19.5	19.2	20.5	21.1	21.4	21.9	22.3
Quota (in SDR millions)	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 I. Solomon Islands—Risk Assessment Matrix<sup>1</sup>

Shock	Likelihood	Impact	Policy Response
<b>Tighter or more volatile global financial conditions:</b> <ul style="list-style-type: none"> <li>Sharp asset price decline and decompression of credit spreads</li> <li>Surge in the US dollar</li> </ul>	<p>(i) <b>Medium</b></p> <p>(ii) <b>High</b></p>	<p><b>Medium</b></p> <p>Continued strengthening of the US dollar may pose challenges to effective management of the basket peg, which may exacerbate real exchange rate appreciation and lead to eroding competitiveness. Failure to manage non-US dollar reserves adequately may also lead to significant valuation losses.</p>	<p>Continue effective implementation of the basket currency peg in line with IMF TA. Strengthen reserve management, including through Fund TA. Over time, seek to realign the exchange rate with underlying fundamentals and address infrastructure bottlenecks to improve productivity and boost competitiveness.</p>
<b>Sharper-than-expected global growth slowdown:</b> <ul style="list-style-type: none"> <li>Significant slowdown in other large EMs/frontier economies</li> <li>Structurally weak growth in key advanced and emerging economies</li> </ul>	<p>(i) <b>Medium</b></p> <p>(ii) <b>High/Medium</b></p>	<p><b>Medium</b></p> <p>While the direct impact is limited, Solomon Islands is prone to indirect effects through regional economies, including Australia.</p>	<p>Use policy buffers, including countercyclical fiscal policy and international reserves, to cushion the impact. Over time, diversify sources of growth.</p>
<b>Sharp growth slowdown in China:</b> <ul style="list-style-type: none"> <li>Insufficient progress with reforms leads to a continued buildup of vulnerabilities</li> <li>Sharp slowdown in 2015-16</li> </ul>	<p>(i) <b>Medium</b></p> <p>(ii) <b>Low</b></p>	<p><b>High</b></p> <p>Given the increased trade linkages with China, Solomon Islands would be affected by a severe economic slowdown. Indirect effects via other regional economies e.g. Australia, would also have an impact.</p>	<p>Use policy buffers, including countercyclical fiscal policy and international reserves, to cushion the impact. Over time, diversify sources of growth.</p>
<b>Persistently lower energy prices</b>	<p><b>High</b></p>	<p><b>Medium</b></p> <p>Persistently lower oil prices have kept inflationary pressures in check and deflationary pressures have been limited.</p>	<p>Take advantage of favorable conditions to ease the fiscal adjustment and buy time for structural reforms to yield results.</p>
<b>Adverse effects of El Niño on agriculture</b>	<p><b>High</b></p>	<p><b>Medium</b></p> <p>The onset of an El Niño event will likely weigh on agricultural production in early 2016.</p>	<p>Financial support may be warranted for the most vulnerable.</p>
<b>Reopening of Gold Ridge mine</b>	<p><b>Low</b></p>	<p><b>Medium</b></p>	<p>Strengthen fiscal buffers and use the resulting fiscal space to investing in resilient infrastructure</p>
<b>Positive spillovers from large infrastructure projects</b>	<p><b>Low</b></p>	<p><b>High</b></p> <p>Long-standing plans for large infrastructure projects could have positive spillovers into the economy from 2016 onwards</p>	<p>Take advantage of favorable conditions to ease the fiscal adjustment and buy time for structural reforms to yield results.</p>

## Appendix II. Solomon Islands: Authorities' Response to Fund Policy Advice

Fund Recommendation	Policy Actions
<p><b>Fiscal Policy</b> Increase fiscal openness, transparency and planning.</p> <p>Broaden the tax base and increase revenue transparency.</p>	<p>In August 2014, the government produced and published a Budget strategy document. The authorities produced in 2014 a Final Budget Outcome Report (an ECF structural benchmark), and produced and published a mid-year Budget review (an ECF structural benchmark).</p> <p>Amend the Export Duty Schedule (by Ministerial Order) to complete the implementation of the new mining tax regime in line with IMF TA recommendations.</p>
<p>Promote transparency and accountability of public funds.</p>	<p>The Auditor-General conducted an audit of the spending and project achievements of the constituency development funds for 2012, and is expected to submit the audit reports to Parliament during the next sitting of Parliament. On tertiary education policy, a tertiary education structure has been proposed and will pave the way to review the tertiary education policy. A think tank has met and firmed up the tertiary education structure.</p>
<p>Promote public debt management.</p>	<p>The authorities submitted to Cabinet the on lending and guarantees instructions under the framework of the Debt Management Strategy.</p>
<p><b>Monetary and Financial Sector Policy</b> Strengthen supervisory and regulatory framework for the financial system.</p>	<p>The CBSI Act was passed by Parliament in November 2012 to strengthen the monetary policy and supervisory framework. The Cabinet has also approved the drafting instructions for a new Financial Institutions Act and started the process to draft a Credit Unions bill to promote financial sector stability and development as part of the benchmarks under the ECF.</p>
<p>Improve operations and financial performance of the National Provident Fund (NPF).</p> <p>Strengthen the monetary transmission mechanism.</p>	<p>Cabinet approved in July 2012 draft instructions to revise the NPF Act to strengthen its governance structure and investment framework.</p> <p>In March 2015, in line with IMF TA recommendations, the CBSI announced its plans to implement a series of measures—including a potential change in the cash reserve requirement ratio and introducing a forex swap facility—to increase the effectiveness of the monetary transmission mechanism.</p>
<p><b>Exchange rate policy</b> Follow the basket peg more closely, including by widening the operational <math>\pm 1</math> percent exchange rate band removed the vis-à-vis the U.S. dollar and re-centering it periodically.</p>	<p>The invoice-based basket peg regime has been fully implemented and the operational band was removed in November 2014. As a result, the Solomon Islands dollar has more closely tracked the value of the basket. The authorities are considering periodic re-centering, in line with recent TA recommendations.</p>
<p><b>Structural policy</b> Focus on key areas of infrastructure development and diversifying the sources of growth. Particular emphasis should be put on access to power, telecommunications, and transportation</p> <p>Introduce a well-articulated development plan in the context of a comprehensive Poverty Reduction Strategy.</p>	<p>Progress has been slow, hampered by a number of factors, including the closure of the gold mine, ongoing nickel mining licensing disputes. However, Tina River Hydropower Project is expected to get underway in 2017.</p> <p>A rolling 5-year Medium-Term Development Plan has been introduced to support the National Development Strategy, Revised versions of both these documents were approved by Parliament in Jan 2015.</p>

## Appendix III. Letter of Intent

Ref: RF457/5/5

March 8, 2016

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

Dear Madame Lagarde:

As a small island state, Solomon Islands faces considerable development challenges arising from its smallness, remoteness, and dispersion. It also remains vulnerable to external shocks and natural disasters. At the same time, we are convinced that our country has great potential and that appropriate policies and stronger institutional capacity will help overcome some of our development challenges and achieve higher economic growth.

Solomon Islands has greatly benefited from the partnership with the IMF in implementing our government's economic reform program, supported by a three-year Extended Credit Facility (ECF) arrangement approved in December 2012. Fiscal and external buffers have been rebuilt and important reforms—relating to public financial management (PFM) and the financial sector—are being implemented.

In terms of recent program performance, all end-December 2014 performance criteria (PCs), end-March 2015 indicative targets (ITs), end-June 2015 PCs and end-September 2015 ITs have been achieved by a considerable margin, with the exception of the ITs on government-funded recurrent spending on health and education, which were narrowly missed. We have also made progress in implementing the structural benchmarks. Therefore, we request the completion of the fifth and sixth (final) reviews, and the sixth and seventh disbursements, under the ECF arrangement, each in the amount of SDR 0.149 million (US\$ 0.2 million).

The attached Memorandum of Economic and Financial Policies (MEFP) describes our government's reform policies. We believe these policies have, and will continue to, strengthen our macroeconomic framework and public institutions. The reform agenda aims to promote growth and improve the composition of public spending.

We intend to maintain our constructive engagement with the IMF, 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.

As in the past, we authorize the publication of this Letter of Intent, with attachments, and the related IMF staff report.

Sincerely yours,

/s/

**Hon. Danny Philip, MP**

Acting Minister of Finance and Treasury

/s/

**Denton Rarawa**

Governor

Central Bank of Solomon Islands

Attachment: - Memorandum of Economic and Financial Policies

## Attachment. Memorandum of Economic and Financial Policies

**1. Solomon Islands has made considerable progress toward achieving macroeconomic stability and implementing structural reforms since the approval of the current three-year Extended Credit Facility (ECF) arrangement on December 7, 2012.** In the process, we have also benefited from several IMF technical assistance missions, with the intensive involvement of PFTAC in a wide range of areas: statistics, fiscal policy, public financial management (PFM), exchange rate management, monetary operations, and the financial sector. The ECF program has been instrumental in anchoring government policies, strengthening institutional capacity, and catalyzing donor support. Fiscal and external buffers have been rebuilt also thanks to the structural benchmarks implemented under the ECF-supported program. Net international reserves rose to 9.8 months of imports in December 2015 from 7.8 months at the start of the ECF program, and external public debt has dropped to 9.8 percent of GDP from 12.7 percent over the same period. We are implementing important reforms—notably in PFM and the financial sector. We are mindful that these and other structural reform efforts need to be accelerated to make Solomon Islands more resilient to shocks and improve the well being of its population.

### RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

**2. After slowing in 2014, owing to the floods, real growth has picked up again.** It is expected to have reached 3.25 percent in 2015, reflecting strength in the forestry sector and the windfall to consumers and producers from lower oil prices. However, the impact of Cyclone Raquel, which hit parts of the country in July 2015, damaged food production of subsistence farmers in some remote areas. In addition, the ongoing El Niño event—linked to incidents of drought in the country—appears to be weakening agricultural output and it is contributing to raise food prices toward the end of the year. Nonetheless, the external position has strengthened and net international reserves rose to US\$506 million at the end of December, thanks to strong log exports and donor support.

**3. Growth in 2016 is expected to remain at 3.2 percent, but risks are tilted toward the downside.** The likelihood of reopening the Gold Ridge mine remains small. El Niño could continue to weigh on agricultural output and fishery sector in 2016. At the same time, downside risks to the regional outlook have increased, particularly for emerging markets, which are major trade partners for Solomon Islands. And the logging industry is expected to decline over the medium term. These all point to the need for new sources of growth, including from manufacturing and tourism. Investment in infrastructure will be essential to support rural development as well as private sector development and raise productivity across a wider range of sectors.

### PROGRAM PERFORMANCE

**4. Quantitative targets have been met under the ECF program.** All end-December 2014 performance criteria (PCs), end-March 2015 indicative targets (ITs), end-June 2015 PCs, and end-September 2015 ITs were all met by a considerable margin, except for the ITs on the government-funded recurrent spending on health and education, which were narrowly missed (Table 2). Cash balance increased from SI\$880 at end December 2014 to SI\$1,055 million in June 2015 (well above the program target of SI\$545 million) as government-funded development spending was held back

by the delay in approval of the 2015 budget. By end September 2015 it decreased to SI\$893 million owing to a pick-up in government-funded development spending, but is still significantly above the end-September IT of SI \$535 million, declining further to SI\$694 million at end December 2015, after the prepayment of \$99.5million in domestic debt as well as SI\$48 million of scheduled amortization. The ITs on government-funded recurrent spending on health and education were narrowly missed, owing to stronger procurement requirements by development partners in disbursing ODA.

**5. Despite delays, the country has also made progress with structural reform (Table 1) and with legislative reforms in the context of the program’s structural benchmarks.** We have obtained Cabinet’s approval in February of the policy paper regarding the forthcoming Credit Unions bill—(September 2015 benchmark) which we now expect to be sent to the Attorney General by March 2016. We are currently preparing a submission to Cabinet seeking approval, expected by end-March 2016 for the Attorney General’s Chambers to proceed with the drafting of the new National Provident Fund bill based on the previously approved drafting instructions. We plan to table this bill before Parliament by September 2016. We have obtained Cabinet’s approval in February 2016 for the Attorney General’s Chambers to vet the new Customs and Excise bill before it is tabled in Parliament by September 2016 (also an end-September 2015 benchmark). But given continued capacity constraints in the Attorney General’s Chambers and the complexity of these legislations, we expect a slower pace of progress at the next stage of the legislative process.

**6. We are strongly committed to further strengthening PFM measures in the pipeline.** We are fully aware that strong PFM is critical to improving the quality of public spending and are fully committed to the PFM Roadmap (2014-17) and the priorities identified. Regarding the issuance (by Ministerial Order) of the implementing regulations on the implementation of the Constituency Development Funds Act, in accordance with the PFM Act, the Government’s approach has changed. It will now progress the fiscal and public financial management commitments through implementing the PFM Roadmap, including finalizing the draft Procurement Rules and Regulations. The new procurement regulations are scheduled to come into effect on July 1, 2016 or earlier. Regarding the release to public of the results of the audits conducted by the office of the Auditor General on the spending of the Constituency Development Funds in 2012, it is expected that the Auditor General will submit the audit reports to Parliament during the Parliament sitting of July 2016 (end-June 2015 structural benchmark).

**7. We have sustained our efforts to strike a better balance between financing tertiary education and primary education.** We are finalizing the review of our policies on tertiary education to ensure an adequate balance of spending between primary and tertiary education and also to obtain Cabinet approval of revamped policies for tertiary scholarships. A tertiary education structure has been proposed and will pave the way to review the tertiary education policy (March 2015 structural benchmark). A think tank has met and firmed up the tertiary education structure. Regarding revamping policies for tertiary education, while progress has been made, the process has been longer than expected. The government is preparing a new Education bill which should be ready in the first half of 2016 and will carefully revisit this matter once the bill is ready.

**8. In addition to progress on structural reform anchored by the structural benchmarks, we are taking major steps to tackle corruption.** Solomon Islands acceded to the UN Convention

against Corruption (UNCAC) in 2012. This government has put fighting corruption at the top of the political agenda. We recognize the economic costs of corruption and are taking steps to strengthen the anti-corruption framework, including by adopting a national anti-corruption strategy and establishing an independent anti-corruption commission. An anti-corruption bill is expected to be completed by the first quarter of 2016. The Anticorruption Bill is being accompanied by the Whistle Blower Bill and a revamped Ombudsman Bill. The object of the Anti-Corruption Bill is to give legislative effect to the United Nations Convention Against Corruption by:

- prohibiting corruption in the public and private sectors;
- providing for the investigation and punishment of corruption offences;
- establishing the Solomon Islands Independent Commission Against Corruption; and other legal and institutional mechanisms;
- making related provisions; and
- to effectively combat corruption in Solomon Islands in all its aspects in both the public and private sectors.

**9. To achieve these objects the bill will:**

- give legislative effect in Solomon Islands to certain provisions of the Convention (UNCAC) that are binding on the Government;
- establish the Solomon Islands Independent Commission Against Corruption (SIICAC) with preventive, investigative and prosecution powers;
- reaffirm the continuing role of the Government in the fight against corruption with the publication/implementation of a national Anti-Corruption Strategy; and,
- provide other legal and institutional mechanisms which strengthen the regulatory framework and the capacity to detect, investigate and prosecute corruption effectively.

## PROGRAM POLICIES

### Fiscal Policy

**10. Our fiscal position has strengthened under the ECF program, although more recently spending has accelerated to support rural development.** Despite having projected a large deficit in the 2015 budget under full implementation, the budget deficit turned out to be smaller owing to spending capacity constraints and the delay in passing the 2015 budget.

**11. As the IMF-supported program expires, we are committed to maintaining a strong cash reserve and preserve fiscal discipline.** We remain committed to preserving a sustainable fiscal position while providing resources to support economic growth and much-needed social spending. In 2016, we will achieve a sustainable fiscal balance. We will put in place quarterly fiscal targets to limit fiscal risks by ensuring that the cash balance does not fall below two months of total expenditure in 2016 onwards as defined in the consolidated budget (government-funded development spending plus total recurrent spending). This will be achieved by keeping expenditure flows closely in line with domestic revenue collection. We will continue to assess whether this anchor is adequate enough to manage fiscal risks to the budget, including those related to climate change and other shocks both in the short and medium-term.

**12. We are undertaking additional measures to complement PFM reforms already in the pipeline under the ECF program to enhance budget presentation and improving the quality of public spending.** We will review the spending mix in the 2016 budget in the mid-year budget review and realigning public spending with our development priorities, including through the implementation of much-needed capital projects. As part of the implementation of the PFM Act, we will continue to prepare and publish a mid-year budget review and adjust spending plans in the short and medium term to make them consistent with revenues. Going forward, we remain committed to strengthening budget presentation to ensure broader understanding of the cost effectiveness of spending. This will imply a better integration of budgeting and planning. This will require in the 2017 budget a presentation that clearly identifies within the recurrent and development expenditure, the capital spending component. The 2015 and 2016 budget outturns will also report on the implementation of capital spending which has increased under the current government. In the medium term we also plan to move towards linking budget to outputs and expenditures in one budget document.

**13. We will seek to mobilize revenues by strengthening tax compliance and streamlining exemptions.** We will submit to Parliament the new Customs and Excise bill (an end-September 2015 structural benchmark), which includes the clauses related to exemptions and the draft amendments to other revenue acts (i.e., income tax, stamp duties, and goods and sales tax). This process will be facilitated by the prompt Cabinet approval to send the bill to the Attorney General's Chambers for vetting as noted above.

**14. We will exercise caution in resuming concessional borrowing to preserve domestic and external stability.** All proposed new Government borrowings will be assessed against the Government's Debt Management Framework (DMF), which comprises of a Debt Management Strategy, SOE Borrowing Policy, On-lending Policy and Guarantee Policy—all benchmarks achieved under the ECF-supported program. Legal aspects of the DMF are incorporated in the PFM Act. An Annual Borrowing Limit of SI\$300 million has been set for 2016. This level of borrowing is consistent with the debt sustainability threshold imposed under the DMF (i.e. face value of debt to GDP of 25 percent).

### Policies to Enhance Resilience to Natural Disasters

**15. Enhancing resilience to natural disasters and climate change remains a high priority for this government.** Going forward we will more clearly identify in the budget document total resources budgeted for natural disasters adaptation and mitigation and integrate them in the DSA. We will accumulate a specific contingency for natural disasters either in the natural transport fund or another government contingency fund. We will reduce risks by enhancing preparedness, including by investing in resilient infrastructure and by enhancing debt-management capacity; We are also discussing regional solution (Melanesian fund) that could provide limited although immediate liquidity within one week after the disaster. We will also explore catastrophic insurance schemes.

**16. One of the major issues after disaster strikes is the collection of data from outer remotest islands due to limited infrastructure connectivity.** However, our effort in improving our

housing income and expenditure surveys has relieved this issue in order for immediate emergency disbursements. We recognized though the need for effective emergency response by means of training and awareness to occur between the National Disaster Council and the Ministry of Finance for immediate payment process.

### Monetary, Exchange Rate, and Financial Sector Policies

**17. Monetary and exchange rate policies have been supportive of economic activity.** We have maintained an accommodative monetary policy stance in light of contained inflationary pressures amid low global commodity prices. We will pursue measures to reduce excess liquidity in the financial sector, deepen the foreign exchange market, develop the domestic interbank market, and ultimately, create an environment in which monetary policy becomes an effective tool for macroeconomic management.

**18. We continue to see the basket peg exchange rate regime as important for anchoring inflation and maintaining competitiveness.** The removal of the operational 1 percent band around the base rate in September 2014 has allowed more flexibility of bilateral exchange rates and ensured that the currency basket remains more stable. Since then, the Solomon Islands dollar has depreciated against the US\$ by around 10 percent, reflecting the strong appreciation of the US dollar against the Australian dollar and other currencies. Separately, we have also increased the buy-sell margin in foreign exchange trading to allow greater flexibility in exchange rate management to allow the full benefits of the basket to be realized. Going forward improvements in the implementation of the basket regime are warranted. We have started to announce the bilateral rate every day to help keep the peg constant. We will also review periodically the appropriateness of the level of the peg.

**19. We have sustained our efforts to strengthen financial regulation and supervision to preserve financial stability and foster financial sector development to promote growth.** The CBSI has been proactive in promoting financial inclusion. In the last two years, together with commercial banks it introduced mobile banking services to deepen financial access in geographically dispersed and remote areas, making Solomon Islands a leader in mobile banking services among Pacific small states, with mobile banking well positioned to leapfrog conventional banking in providing financial services. We are seeking Cabinet approval to allow the Attorney General's Chambers to proceed with the drafting of the revised National Provident Fund (NPF) Act that strengthens the NPF's governance structure and investment framework, as well as the draft Credit Unions Act, which will help promote financial sector stability and development. To demonstrate our commitment to financial reform, we have included both items in the government's legislative agenda for 2016.

**20. We will continue to make progress in implementing the recommendations of the latest IMF safeguard assessment.** In particular the CBSI will continue to recruit and train Internal Audit Unit staff to strengthen its internal audit function and have an independent quality assurance review of the Unit within five years.

## Promote Inclusive Growth and Other Issues

**21. Sustaining rural development remains high on the reform agenda.** Our new Medium-term Development Plan for 2016-20, approved by Parliament in December 2015, sets out how we intend to achieve the objectives set out in the National Development Strategy (NDS) for (2016-2035), including the detailed of specific policies and projects. The NDS identifies selected sustainable development goals (SDGs): these include: sustained and inclusive economic growth, poverty alleviation; access to quality social services, resilient and environmental sustainable development, stable and effective governance and public order. We have submitted this Medium-Term Development Plan to the IMF Executive Board, which alongside the NDS provides the basis for an Economic Development Document.

MEFP Table 1. Solomon Islands: Structural Benchmarks

Actions	Macroeconomic criticality	Date	Status
Submit to Parliament the final CBSI Act to strengthen the monetary policy and supervisory work.	To strengthen the effectiveness of monetary policy.	December 31, 2012	Met.
Obtain Cabinet's approval to release the draft bill implementing the new Custom and Excise Act for public consultation including the clauses related to the exemptions and draft amendments to the other revenue acts (income and sales tax Acts).	To promote fiscal transparency and enhance the efficiency of revenue collections.	December 31, 2012	Met in February 2013.
Submit to Parliament the multi-year budget framework on revenues and recurrent spending	To strengthen the quality and monitoring of government spending.	December 31, 2012	Met.
Submit to Parliament the draft of the new Public Finance Act that covers fiscal responsibility provisions, management and use of public funds, and management of public debt.	To promote fiscal transparency and enhance the efficiency of revenue collections.	October 31, 2013	Met in July 2013.
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.
Workshop organized by the National Financial Inclusion taskforce taking stock of progress to date to better access financial services in rural areas.	Increase access to financial services ensure inclusive growth.	March 31, 2013	Met in February 2013.
Submit to Cabinet the instructions for SOE borrowing.	To strengthen debt management and maintain public debt sustainability.	June 30, 2013	Met.
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.
Produce a Final Budget Outcome Report.	To increase fiscal openness, transparency and planning.	April 30, 2014	Met.
Obtain Cabinet's approval of drafting instructions of a new Financial Institutions Act.	To promote financial sector stability and development.	June 30, 2014	Met.
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	Met.
Produce and publish a mid-year Budget review.	To promote transparency on economic and fiscal developments.	August 31, 2014	Met.
Produce and publish a Budget strategy document.	To facilitate planning and fiscal strategy.	August 31, 2014	Met.
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	Not met. A tertiary education structure has been proposed as a step towards reviewing the tertiary education policy. The 2015 fiscal outturn shows a re-balancing of spending away from tertiary education in line with the objective of the benchmark (paragraph 9 of the Staff Report).
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.	April 30, 2015	Not met. The new scholarship policy and procedures manual is completed. It will be submitted to cabinet as soon as the new Education Bill is tabled before Parliament in the first half of 2016. Criteria for scholarship award and continuation have been tightened.
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. Enable relevant members of Parliament to request the Auditor General's public release of the audit reports for their individual constituencies.	To promote the transparency and accountability in the use of public funds.	June 30, 2015	Not met. The audit reports have been completed. It is expected that the Auditor General will submit the completed audit reports to Parliament during the next sitting of Parliament before they are released to the public.

MEFP Table 1. Solomon Islands: Structural Benchmarks (continued)

Actions	Macroeconomic criticality	Date	Status
Issue (by Ministerial Order) implementing regulations on the implementation of the Constituency Development Funds Act, in accordance with the PFM Act.	To promote the transparency and accountability in the use of public funds.	July 30, 2015	Not met. The authorities have proposed an alternative commitment namely implementation of procurement regulations under the Public Finance Act. They have indicated that the transparency and accountability objectives of the benchmark can be met by the application of the Public Finance Act that was enacted in January 2014 instead of adopting the implementing regulations of the CDF Act which have been superseded by the implementation of the Public Finance Act. Steps have already been taken to improve accountability and transparency in these funds through more disciplined procurement processes required by the draft Procurement Rules and Regulations which are now at an advanced stage and will come into effect before July 2016 and the application of other regulations that implement the Public Finance Act. According to staff's assessment, this alternative commitment addresses issues of accountability and transparency, which was the intent of the original benchmark, and is an adequate substitute.
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.	September 30, 2015	Not met. The Ministry of Finance is currently drafting a policy paper to seek Cabinet approval, expected by end-March 2016, for the Attorney General's Chambers to draft the new NPF bill. The new bill is expected to be tabled before Parliament in the third
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.	September 30, 2015	Not met. The draft bill was approved by Cabinet in February 2016. After the bill is sent to the Attorney-General for vetting, it is expected to be tabled before Parliament in the third quarter of 2016 given the size of the bill.
Submit to Cabinet the draft Credit Unions bill.	To promote financial sector stability and development.	September 30, 2015	Not met. The draft Credit Union bill has been prepared with the support of TA from ADB and is ready. In February 2016, Cabinet has approved a policy paper on the draft bill. After the bill is vetted by the Attorney-General, it is expected to be resubmitted to Cabinet for approval in the second quarter of 2016.

MEFP Table 2. Solomon Islands: Quantitative Performance Criteria (PC) and Indicative Targets (IT)

	12/31/2014				3/31/2015				6/30/2015				9/30/2015			
	PC (EBS/14/65 with adjusters)	PC	Act.	Status	IT (EBS/15/23)	IT with adjusters	Act.	Status	PC (EBS/15/23)	PC with adjusters	Act.	Status	IT (EBS/15/23)	IT with adjusters	Act.	Status
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/	450	440	516	Met	480	467	552	Met	480	482	596	Met	480	471	565	Met
Net domestic assets (NDA) of the CBSI (ceiling, end-of-period stock, in millions of Solomon Islands dollars (SIS)) 3/	-1,194	-1,122	-1,582	Met	-1,406	-1,310	-1,782	Met	-1,247	-1,265	-1,904	Met	-1,185	-1,122	-1,794	Met
Net credit to central government (NCG) (ceiling, cumulative change from the beginning of the year, in millions of SIS) 4/	40	111	-102	Met	-10	86	-234	Met	-35	-35	-398	Met	-20	-20	-146	Met
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	Met
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	Met
Accumulation of new external payment arrears by the public sector (ceiling, end-of-period stock since the beginning of the program, in millions of SIS) 5/	0	0	0	Met	0	0	0	Met	0	0	0	Met	0	0	0	Met
Central government program cash balance (floor, end-of-period stock, in millions of SIS) 4/	374	303	880	Met	560	464	1,049	Met	545	545	1,055	Met	535	535	893	Met
Indicative Targets (cumulative)																
Government funded recurrent spending on health and education (cumulative from the beginning of the year, in millions of SIS) 6/	710	...	676	Not met	161	...	144	Not met	348	...	326	Not met	542	...	515	Not met
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	...	38	...	24	...	11	...	35	...	37	...	46	...	37	...
Outstanding stock of Solomon Islands government (SIG) treasury bills, excluding restructured government bonds (end-of-period stock, in millions of SIS), program level.	40	...	40	...	40	...	40	...	40	...	40	...	40	...	40	...
Balance of SIG Consolidated Deposits Account, millions of SIS 7/	140	...	140	...	140	...	140	...	140	...	140	...	140	...	140	...

1/ Evaluated at the program exchange rate.

2/ The adjusters 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

3/ The adjusters 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 adjusters 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

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.



# SOLOMON ISLANDS

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION AND FIFTH AND SIXTH REVIEWS UNDER THE EXTENDED CREDIT FACILITY ARRANGEMENT—INFORMATIONAL ANNEX

March 8, 2016

Prepared By

Asia and Pacific Department  
(In consultation with other departments)

## CONTENTS

FUND RELATIONS	2
SUPPORT FROM THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE	6
RELATIONS WITH THE WORLD BANK GROUP	8
RELATIONS WITH THE ASIAN DEVELOPMENT BANK	10
STATISTICAL ISSUES	12
MAIN WEBSITES OF DATA	14

## FUND RELATIONS

(As of January 31, 2016)

**Membership Status:** Joined September 22, 1978; Article VIII

### General Resources Account:

	SDR Million	Percent of Quota
Quota	10.40	100.00
Fund holdings of currency	9.85	94.73
Reserve position in the Fund	0.55	5.29

### SDR Department:

	SDR Million	Percent of Allocation
Net cumulative allocation	9.91	100.00
Holdings	8.23	83.07

### Outstanding Purchases and Loans: SDR Million                      Percent Quota

	SDR Million	Percent of Quota
ECF Arrangements	0.74	7.14
SCF Arrangements	10.40	100.00

### Latest Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
ECF	12/7/2012	3/31/2016	1.04	0.74
SCF	12/6/2011	12/5/2012	5.20	0.00
SCF	6/2/2010	12/1/2011	12.48	12.48

### Projected Payments to Fund<sup>1</sup>:

(SDR Million; based on existing use of resources and present holdings of SDRs):

	.....Forthcoming				
	2016	2017	2018	2019	2020
<b>Principal</b>	<b>2.77</b>	<b>2.77</b>	<b>2.46</b>	<b>1.46</b>	<b>0.13</b>
<b>Charges/Interest</b>	<b>0.00</b>	<b>0.01</b>	<b>0.01</b>	<b>0.01</b>	<b>0.00</b>
<b>Total</b>	<b>2.77</b>	<b>2.79</b>	<b>2.46</b>	<b>1.47</b>	<b>0.14</b>

<sup>1</sup> When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

**Implementation of HIPC Initiative:** Not applicable.

**Implementation of MDRI Assistance:** Not applicable.

**Implementation of PCDR:** Not applicable

**Exchange Rate Arrangements:**

The exchange rate arrangement is a conventional peg. The Solomon Islands dollar is pegged to an invoice-based basket of currencies consisting of the U.S. dollar (with the weight of 58 percent), the Australian dollar (32 percent), the New Zealand dollar (5 percent), the Japanese yen (3 percent), and the British pound (2 percent). The Central Bank of Solomon Islands sets the exchange rate vis-à-vis the U.S. dollar in such a way as to maintain the value of the basket constant in Solomon Islands dollars given the movements of currencies in the basket relative to each other. Since the second half of 2014, exchange rate policy management has aimed to keep the value of the basket stable and to avoid real exchange rate misalignment stemming from inflation differentials with trading partners. Solomon Islands maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions. Commercial banks can exchange the Solomon Islands dollar against other currencies and are free to set the bid-ask spread for all currencies except the U.S. dollar and Australian dollar on which there is a spread limit of  $\pm 20$  and  $\pm 25$  basis points, respectively. In addition, the central bank maintains a standing facility through which it will buy and sell foreign exchange with commercial banks and the government at spot offer and sell rates.

**Last Article IV Consultation:**

The 2013 Article IV Consultation discussions were held in Honiara during October 21–November 1, 2013. The staff report (IMF Country Report No. 14/12) was considered by the Executive Board and the consultation concluded on January 8, 2014.

**Technical Assistance:**

Date	Department	Purpose
January 2005	PFTAC	Financial reporting system
February 2005	PFTAC	Financial supervision of insurance
April 2005	PFTAC	Financial supervision
May, August, and October 2005; and February 2006	MFD	Financial supervision of insurance
May 2005	PFTAC	Tax policy and administration
August 2005	MFD	Reserve management
August 2005, February and April 2006	PFTAC	Statistics
September 2005 and February 2006	PFTAC	AML/CFT
October 2005	LEG	AML/CFT
November 2005 and July 2005	STA	Monetary and Financial Statistics
January 2006	PFTAC and LEG	Tax policy
April and June 2006	MFD	Central Bank Accounting
May, August, and October 2006 and January 2007	PFTAC	Public Financial Management and Accounting
October 2006	MCM	TA program monitoring
October 2006	MCM	Financial sector supervision
October 2006	MCM	Reserve Management
December 2006	PFTAC	Business Revenue Reform
February 2007	PFTAC	Balance of Payments Statistics

Date	Department	Purpose
February and November 2007 and May 2008	PFTAC	National Income Accounts
March 2007 and March 2008	MCM	Accounting
February 2008-February 2009	STA	Peripatetic Export and Import Price Index Statistics
February-March 2008	PFTAC and FAD	Tax Policy
April 2008, February 2009	PFTAC	Balance of Payments Statistics
June 2008	LEG	Review of Central Bank Act
April 2008-April 2009	MCM	Peripatetic Advisor to CBSI
June 2008, September 2008, June 2009	MCM	Monetary Operations and Liquidity Management
July 2008	STA	Money and Banking Statistics
January 2009, April 2010, April 2011	STA	Monetary and Financial Statistics
April 2009	MCM	Insurance Supervision
June 2009	LEG	Insurance Sector Law
June 2009	MCM	Central Bank Law
April 2010	PFTAC	Balance of Payment Statistics
April 2010, May 2011	PFTAC	National Account Statistics
September 2010	PFTAC	Government Finance Statistics
June 2010, October 2010, March 2011	PFTAC	Financial Supervision
October 2010, March 2011	FAD, PFTAC	Natural Resource Tax Policy
October 2010, June 2011	MCM	Monetary Operation and Liquidity Management
July 2010, October 2010, January 2011	PFTAC	Public Financial Management
April 2011	FAD	Budget Law
April 2011	PFTAC	Macroeconomic Advisor Visit
April 2011	STA	GDDS Metadata Development
July 2011	PFTAC	Customs Administration
September 2011	LEG	Tax Legislations
November 2011	MCM	Exchange Rate Flexibility and Foreign Exchange Market Development
February 2012	STA	Consumer Price Index
June 2012	FAD	Public Finance and Audit Act
September 2012	STA	Monetary and Financial Statistics
January 2013	LEG	Financial Institutions Act
March 2013, September 2013	STA	External Sector Statistics
May 2012, May 2013	MCM	National Provident Fund
February 2013, August 2013	PFTAC	National accounts
November 2013	PFTAC	PFM law and the Constituency Development Fund Law
December 2013	PFTAC	PFM Roadmap Development Guidance – Phase I
March 2014	STA	Balance of payments statistics
March 2014	PFTAC	Non Tax Review and National Accounts
July and October 2014	PFTAC	Develop Macro Framework
August 2014	PFTAC	National Accounts
September 2014	MCM	Enhancing the effectiveness of monetary policy and exchange rate regime

Date	Department	Purpose
September 2014	PFTAC	PFM Roadmap Implementation
October 2014	FAD	Implementing the new mining tax regime
October 2014	PFTAC	Non Tax Review introductory mission
November 2014	STA	External sector statistics
March 2015	MCM	Improving the monetary transmission mechanism
April 2015	STA	Monetary and financial statistics
May 2015	PFTAC	Support 5 <sup>th</sup> ECF Review
June 2015	PFTAC	Training on FP Framework to assess debt sustainability
August 2015	MCM	Evaluation of TA needs on banking supervision
August 2015	PFTAC	Financial Supervision
May 2015	STA	Government finance statistics
August, September 2015	STA	Government finance statistics
October 2015	STA	Balance of payments statistics
January 2016	PFTAC	Support the 2016 Article IV Consultation and 5 <sup>th</sup> and 6 <sup>th</sup> ECF Reviews
February 2016	PFTAC	Credit Union Program
February 2016	PFTAC	National Accounts

**Resident Representative:** The resident representative office in the Pacific Islands was opened in September 2010 in Suva, Fiji. Mr. Tubagus Feridhanusetyawan is the current Resident Representative.

# SUPPORT FROM THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE<sup>1</sup>

## Solomon Islands: PFTAC Country Strategy 2013–17

### Background

The Solomon Islands has recovered well from a precarious position during the global economic crisis. Growth has accelerated rapidly and international and fiscal reserves increased, on the back of increased logging and mining, but also due to better fiscal management and increased international assistance. The medium-term reform agenda under the Core Economic Working Group emphasizes, amongst other things, strengthening of public financial.

**Solomon Islands has been a moderate user of PFTAC TA.** Despite the large international presence, mainly through RAMSI which caters for much of the technical assistance needs in the government, PFTAC has made specific technical contributions in particular with regard to the fiscal regime for natural resources. In the PFM area, PFTAC has reviewed and provided suggestions on a draft PFM law and associated implementing instructions, participated in a PEFA assessment, assisted in advocating at both political and technical level the PFM Reform Roadmap, and introductory training on international public sector accounting standards (IPSAS). Significant amounts of support have been provided to CBSI in formulating and implementing new prudential regulations for banks and also in developing a more robust inflation forecasting regime.

### Strategy 2013-2017

PFTAC's TA strategy is guided by the APD regional strategy note and is planned within the Results-Based Management (RBM) framework for the current PFTAC funding cycle.<sup>2</sup> The main focus of PFTAC TA will be on strengthening fiscal management and solidifying the financial sector. In the Government area inputs will either be at the strategic/policy level or dealing with niche requirements where IMF/PFTAC has a comparative advantage. Support for implementation is expected to continue to come from other donors, in the context of RAMSI or its successor.

In the **Public Financial Management** area, following on the results from the 2012 PEFA, the main focus is expected to be assisting the authorities in implementing the PFM Roadmap. Priorities are likely to be on cash management reform, and finalizing implementing instructions for a PFM law approved in 2013. The authorities have also requested assistance with improving non-tax revenue management.

<sup>1</sup> The Pacific Financial Technical Assistance Centre in Suva, Fiji, is a regional technical assistance institution operated by the IMF with financial support of the Asian Development Bank, Australia, Japan, Korea, and New Zealand. The Center's aim is to build skills and institutional capacity for effective economic and financial management that can be sustained at the national level. Member countries are: Cook Islands, Federated States of Micronesia, Fiji, Kiribati, Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Timor-Leste, Tokelau, Tonga, Tuvalu, and Vanuatu.

<sup>2</sup> See PFTAC program document, available at: [www.pftac.org](http://www.pftac.org). The specific result in the framework that activities target is identified in italics in the section, for example cash management is referred to as *(1.6)*, where 1.6 is the code in the result framework in the program document.

In the **revenue** area, the Solomon Islands continue to receive significant assistance from New Zealand Inland Revenue Department (NZIRD). This technical assistance, facilitated by the New Zealand Ministry of Foreign Affairs (MFAT), is expected to continue over the next few years. Recent activities include: (a) the Solomon Islands Inland Revenue Division (SIIRD) undertaking a comprehensive constraints analysis which provides recommendations to further elevate organizational performance; and (b) a business process mapping exercise geared towards streamlining internal processes. SIIRD staff regularly attend PFTAC facilitated training initiatives under the umbrella of the Pacific Island Tax Administration Association.

In **financial sector supervision**, making use of PFTAC support provided the CBSI with improved oversight of the financial institution sector. As a result of extensive assistance over the past years, supervisors now have the skills and processes in place to effectively carry out on-site examinations of banking institutions which will, over the next year, result in a more targeted technical assistance from PFTAC's on-site examination advisors. Additionally support was provided, in late 2013, to the CBSI for their successful implementation of the Reserve Bank of New Zealand's Financial Sector Information System which resulted in enhanced supervision capabilities. Technical advisory assistance was recently provided by PFTAC, with the support of the IMF Legal Department, with the revision of the Credit Union Act. Additional technical assistance will be delivered to the CBSL in 2016 for building credit union financial reporting standards including strengthening the credit union oversight at the CBSL.

In **statistics**, PFTAC has provided more frequent assistance to the NSO in recent years. This has been successful in improving local capacity to compile GDP estimates, exemplified in January 2016 by the NSO's unaided publication of annual GDP estimates, by production and expenditure, for 2014. The coverage and timeliness of data obtained from the business survey and administrative sources, including GFS and overseas aid, have also been improved. The main tasks for future TA will be to assist in rebasing GDP from 2004 to 2012, make further improvements to sources and methodologies and enhance the analytical capabilities of local compilation staff. PFTAC will also liaise with an advisor from the Australian Bureau of Statistics who is assisting the NSO in rebasing and improving the CPI, as had been recommended by an IMF HQ mission in 2012.

In the **macroeconomic** area, PFTAC is continuing to support the development and use of a financial programming framework involving staffs from both the Ministry of Finance and CBSI. Going forward, the task is to progress debt sustainability analysis, which is an important tool for evaluating and assessing the long-run impact of government policies. Support is also being provided to assist in the construction of quarterly GDP and an output gap measure to gauge inflationary pressures in the economy.

## RELATIONS WITH THE WORLD BANK GROUP

(As of January 2016)

The Bank and the Fund teams led by Mr. Robert Utz (Lead Economist and Program Leader, World Bank Sydney Office) and Mrs. Patrizia Tumbarello (IMF Mission Chief for Solomon Islands) maintain a regular dialogue on macroeconomic and structural issues, as do their respective technical teams. In recent years, collaborative efforts have focused on the joint Bank-Fund Debt Sustainability Analysis and regular discussions during missions and at headquarters. Visiting IMF missions regularly meet Bank staff in their Honiara office, led by Ms. Anne Tully (World Bank Country Representative), and at headquarters.

The teams agree that the key priorities for Solomon Islands include consolidating the recent improvement in the country's macro-fiscal framework in the face of ongoing volatility in external conditions and heightened levels of planned government spending, improving the quality of public spending to ensure public resources support the access to basic social services, improving the investment climate to support business development, and ensuring state-owned enterprises can sustainably provide public services.

The risks to the economy, from slippages in domestic policy decisions or a deterioration in external conditions remain considerable. Ongoing efforts to strengthen Solomon Islands' economic management and reinforce protective buffers are to be supported, as are efforts to improve the quality of spending.

The Bank and Fund teams agree that the focus has shifted from post-conflict recovery to the medium-term reform and growth agenda. Priority issues include developing a more coordinated and prioritized approach to weaknesses in public financial management systems and ensuring that the reforms achieved to date are sustained and become regular practice, identifying policy reform priorities for fostering inclusive growth and reducing hardship, ensuring budget allocations are better aligned with needs to achieve the priority of improving delivery of social services, and of strengthening the climate for investments, particularly in the mining sector. Between the Bank and the Fund, the Bank takes the lead in public expenditure management framework and structural reform issues, and the Fund will continue to take the lead on macro issues.

The Banks and Fund teams agree to continue close collaboration, mainly with regular contact through the Bank's Honiara and Sydney offices, the IMF regional resident representative office in Suva, and at headquarters. The Fund will also continue to collaborate with the government-donor Core Economic Working Group convened regularly in Honiara by the Ministry of Finance and Treasury with World Bank support. Appendix I provides a list of planned activities in the coming year.

## Appendix I. Solomon Islands: Bank and Fund Planned Activities (January–December, 2016)

	<b>Activities</b>	<b>Expected Delivery Date</b>
<b>World Bank</b>	<ul style="list-style-type: none"> <li>• Line Ministry Public Expenditure Analyses (subject to government request) (analytic and TA)</li> <li>• Programmatic support for mining sector governance (TA)</li> <li>• Advisory and analytical support to the Solomon Islands Statistics Office for the 2013 HIES</li> <li>• Supporting Solomon Islands EITI implementation (TA)</li> <li>• Health sector public financial management support (Analytic and TA)</li> <li>• Solomon Islands Public Sector Governance Analytics (TA)</li> <li>• National Education Action Plan Costing (TA)</li> <li>• Core Economic Working Group policy dialogue, supporting a new series of Development Policy Operations</li> <li>• Pacific Tuna Advisory project IFC TA</li> <li>• Pacific Credit Bureau Phase 2 IFC TA</li> <li>• Pacific Investment Climate Rapid Response IFC TA</li> <li>• BSP/ANZ Solomon Rural Banking IFC TA</li> </ul>	<p>FY 16 (ongoing)</p> <p>FY 16 (ongoing)</p> <p>FY 16 (concluded)</p> <p>FY 16 (ongoing)</p> <p>FY 16 (ongoing)</p> <p>FY 16 (ongoing)</p> <p>FY16 (ongoing)</p> <p>FY 16 (ongoing)</p> <p>FY16 (ongoing)</p> <p>FY 16 (ongoing)</p> <p>FY 16 (ongoing)</p> <p>FY 16 (ongoing)</p> <p>FY 16 (ongoing)</p>
<b>IMF</b>	<ul style="list-style-type: none"> <li>• 2016 Article IV Consultation, Fifth and Sixth Reviews of the ECF-supported program</li> <li>• Technical assistance on new banking legislation on credit union supervision, including support in legal expertise in handling the public comments on the draft act, and finalizing the draft.</li> <li>• Technical assistance on legal issues pertaining to insolvency and creditor rights</li> </ul>	<p>January 2016</p> <p>2016–17</p> <p>2016–17</p>

## RELATIONS WITH THE ASIAN DEVELOPMENT BANK

(As of January 2016)

Since joining the Asian Development Bank (AsDB) in 1973, Solomon Islands has received 19 loans amounting to US\$102.42 million, 11 Asian Development Fund grants amounting to US\$81.41 million, and 73 technical assistance projects amounting to US\$25.82 million.

The AsDB's Country Partnership Strategy (2012–16) was endorsed in March 2012. The strategy seeks to reduce poverty in line with the government's national development strategy, 2011–20, by promoting equitable private sector-led economic growth through assistance in four core areas: transport; information and communication technology; public sector management; and energy. Private sector development, capacity development, and the promotion of good governance are thematic priorities.<sup>1</sup> In 2016, the AsDB is beginning the preparation of a new Country Partnership Strategy which will cover AsDB's engagement for the 2017–21 period.

In line with improvements in its public debt situation, Solomon Islands' borrowing status was changed by the AsDB from grant-only to a 50:50 mix of grants and concessionary loans, as of 1 January 2011.

**Transport.** Building on AsDB's existing Transport Sector Development Project, AsDB will continue to support a sector-wide approach to management and development of a multimodal transport system. A proposed Sustainable Transport Infrastructure Improvement Program will promote transport sector development and provide funding to the national transport fund for investment and capacity development activities according to the National Transport Plan, 2011–30.

**Information and communication technology.** The Broadband for Development Project, which will be financed by both sovereign and nonsovereign investments, will deliver good-quality, high-speed internet services at affordable prices to Solomon Islanders in both urban and rural areas. The original project was approved in 2012, with additional financing proposed for 2016, once final decisions around project design are made by the government.

**Public sector management.** In coordination with development partners and operating through the Core Economic Working Group, AsDB will continue supporting the government-led public sector management reforms with policy-based programs. The main goal of AsDB's assistance in public sector management is to improve the enabling environment for private-sector led, inclusive growth and development. A fourth policy-based program grant has been programmed by AsDB for 2016. This follows AsDB's program grants approved in 2010, 2011, and 2013. AsDB will continue to provide technical assistance to support public sector management reforms, including commercial legal reform, state-owned enterprise reform, improving access to finance, and support for the preparation of a new national development strategy.

<sup>1</sup> The Country Partnership Strategy 2012–16 can be found at <<http://www.adb.org/documents/solomon-islands-country-partnership-strategy-2012-2016>>, and the Country Operations Business Plan 2016–18 at <<http://www.adb.org/documents/solomon-islands-country-operations-business-plan-2016-2018>>.

**Energy.** AsDB support will complement the efforts of other partners in energy sector reform through sustainable off-grid power services. A project to build a small hydropower plant and increase access to modern energy services was approved in 2014. A solar power development project is planned for 2016, and a further energy project in 2018.

In 2008, AsDB established a development coordination office in Honiara, to strengthen partnerships with the government, and to facilitate coordination with other stakeholders. In 2016, the office will be upgraded to an AsDB Extended Mission, which will further strengthen AsDB's presence on the ground.

The AsDB's Pacific Liaison and Coordination Office in Sydney is responsible for country programming and project implementation in Solomon Islands, supported by the Pacific Operations Division in Manila.

## STATISTICAL ISSUES

<b>I. Assessment of Data Adequacy for Surveillance</b>	
<b>General:</b> Data provision has some shortcomings, but is broadly adequate for surveillance.	
<b>National Accounts:</b> Recent technical assistance (TA) from the Pacific Financial Technical Assistance Center has led to improvements in national accounts at constant and current prices. GDP estimates through 2014 on the production side and the expenditure side were released in January 2016, and PFTAC will now provide TA to assist with rebasing the constant price accounts to 2012.	
<b>Price statistics:</b> A monthly consumer price index (CPI) is produced with a short lag (about a month), but only covers the capital Honiara. The authorities are currently expanding the coverage in order to compile a nationwide CPI, with assistance from the Australian Bureau of Statistics. The index weights are also to be revised using the results of the 2012/13 Household Income and Expenditure Survey. A core inflation index was released in December 2013.	
<b>Government finance statistics:</b> Monthly fiscal data for the central government are published by the Ministry of Finance and Treasury (MOFT). The authorities have started collecting disbursement information on donors' grants, including those nonappropriated in the budget. Monthly public debt data are published, and the quality debt data has improved through better coordination between the MOFT and the Central Bank of Solomon Islands (CBSI). The MOFT does not report revenue, expenditure, balance and composition of financing for the general government because it currently does not have the capacity to compile such statistics.	
<b>Monetary and financial statistics:</b> The CBSI publishes monthly monetary and financial statistics (MFS) in summary form and reports data for the central bank, other depository corporations and other financial corporations to the IMF's Statistics Department using the standardized report forms (SRFs). An integrated monetary database meeting the monetary data needs of the CBSI, APD and STA is in operation. Financial soundness indicators are reported quarterly.	
<b>External Sector Statistics:</b> The CBSI has been compiling quarterly balance of payment statistics (BPS) using its own survey since 2006. Compared to the previous method, which was based on foreign exchange transactions reported through the banking system, the newly compiled BPS has improved both coverage and data accuracy. However, these quarterly data have not yet been reported to the IMF's Statistics Department. Solomon Islands has been one of the beneficiaries of the Japan Administered Account (JSA) Project on the improvement of external sector statistics. A TA mission under this project was conducted in 2013, with more missions planned. The CBSI does not report the international investment position (IIP) because it currently does not have the capacity to compile such statistics.	
<b>II. Data Standards and Quality</b>	
Solomon Islands has participated in the General Data Dissemination System (GDDS) starting in 2011.	No data ROSC available.
<b>III. Reporting to STA (Optional)</b>	
No data are currently reported to STA for publication in the <i>Government Finance Statistics</i> .	

### Table of Common Indicators Required for Surveillance

(As of February 2016)

	Date of latest observation	Date received	Frequency of Data/7	Frequency of Reporting/7	Frequency of Publication/7
Exchange Rates	Jan-16	Feb-16	D	W	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities/1	Dec-15	Feb-16	M	M	M
Reserve/Base Money	Dec-15	Feb-16	M	M	M
Broad Money	Dec-13	Feb-16	M	M	M
Central Bank Balance Sheet	Dec-15	Feb-16	M	M	M
Consolidated Balance Sheet of the Banking System	Dec-15	Feb-16	M	M	M
Interest Rates/2	Dec-15	Feb-16	M	M	M
Consumer Price Index	Dec-15	Feb-16	M	M	M
Revenue, Expenditure, Balance and Composition of Financing/3 – General Government/4	NA	NA	NA	NA	NA
Revenue, Expenditure, Balance and Composition of Financing/3– Central Government	Dec-15	Jan-16	M	M	Q
Stocks of Central Government and Central Government-Guaranteed Debt/5	Dec-15	Jan-16	M	M	M
External Current Account Balance	Dec-15	Jan-16	Q	Q	Q
Exports and Imports of Goods and Services	Dec-15	Jan-16	Q	Q	Q
GDP/GNP (GDP production)	2014 (Production 2014)	2015 (Production 2014)	A	A	A
Gross External Debt	Dec-15	Jan-16	Q	Q	Q
International Investment Position/6	NA	NA	NA	NA	NA

1/ Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

2/ Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

3/ Foreign, domestic bank, and domestic nonbank financing.

4/ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

5/ Including currency and maturity composition.

6/ Includes external gross financial asset and liability positions vis-à-vis nonresidents.

7/ Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); and not available (NA).

## MAIN WEBSITES OF DATA

### **Central Bank of Solomon Islands ([www.cbsi.com.sb](http://www.cbsi.com.sb))**

Central bank survey  
Depository corporation survey  
Financial corporation survey  
Monetary aggregates  
Treasury bills and Bokolo bills  
Exchange rates  
Interest rates  
Balance of payments  
Government budget accounts  
Public domestic and external debt  
Export and imports

### **National Statistics Office ([www.spc.int/prism/country/sb/stats/Index.htm](http://www.spc.int/prism/country/sb/stats/Index.htm)) and Ministry of Finance ([www.mof.gov.sb](http://www.mof.gov.sb))**

Budget documents  
Medium-term fiscal strategy  
Central government revenue and expenditure  
Central government cash balance  
National accounts  
Consumer price statistics  
Exports and imports



# SOLOMON ISLANDS

March 8, 2016

## STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION AND FIFTH AND SIXTH REVIEWS UNDER THE EXTENDED CREDIT FACILITY ARRANGEMENT—DEBT SUSTAINABILITY ANALYSIS<sup>1</sup>

Approved By  
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Prepared jointly by the International Monetary Fund and  
the World Bank Group

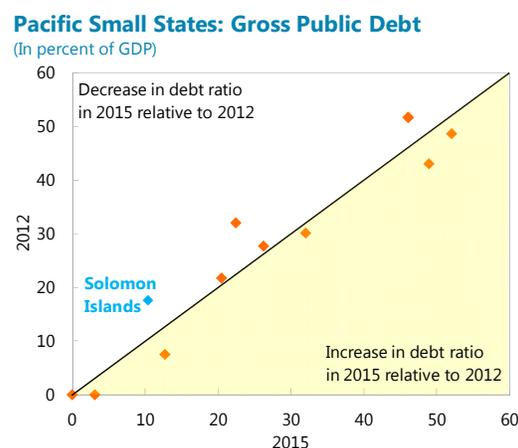
*Debt sustainability analysis indicates that Solomon Islands faces moderate risk of external debt distress, consistent with the last assessment in 2013. Under the baseline scenario, all external and public debt indicators remain below the relevant sustainability thresholds. However, the alternative scenarios suggest that this baseline is subject to significant risks, particularly a shock to financing terms and one where growth is permanently lower. The DSA has been extended to incorporate risks from natural disasters and climate change, drawing on cost estimates from recent events in the region. Under an alternative scenario of a single extreme weather event, debt remains sustainable. However, such events occur on average every 10 years and multiple events could pose a risk to debt sustainability over the 20-year DSA horizon. This risk can be mitigated by infrastructure investment and a buildup of cash reserves.*

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<sup>1</sup> The DSA was prepared by R. Sean Craig and Yiqun Wu with contributions from Chandana Kularatne.

## RECENT DEBT DEVELOPMENTS

**1. Fiscal buffers have been rebuilt in the Solomon Islands in recent years.** Public debt fell sharply to 17 percent of GDP at end-2012 from about 60 percent in 2005 under the Honiara Club Framework, which prohibited new borrowing. Since 2012, the country's debt position has registered one of the strongest gains in the region (Figure on gross debt in Pacific Small States). This reflects a new debt management strategy, adopted by the government in May 2012, that allowed external borrowing to resume and provided an anchor to ensure that debt remained at prudent levels by setting an annual government external borrowing limit of SI\$300 million (3 percent of GDP). Government external borrowing remained well below this limit and external debt has continued to fall to about 10 percent of GDP by end-2015. This partly reflected delays in a number of planned investment projects, including the undersea cable project and the electricity network upgrade. In December 2015, the government also repaid the entire stock of domestic debt, worth SI\$99.5 million (US\$12.2 million) using cash reserves, reducing total public debt to 10.4 percent of GDP at the end of 2015. Looking forward, possible fiscal anchors for the Solomon Islands are targets for cash reserves and the non-commodity primary budget balance, which is used in the DSA and discussed in the staff report. Debt sustainability benefits come from improvements in public financial management (PFM), which should continue to enhance revenue mobilization and the quality of spending.<sup>2</sup>



## DSA ASSUMPTIONS

**2. The macroeconomic assumptions in the DSA reflect developments through end-2015.** They underpin the projection that starts in 2016 and runs for 20 years. These include a reduction in donor support, a gradual decline in forestry output, and a prolonged closure of the Gold Ridge Mine, all of which contribute to deterioration in the trade and current account balances in the medium term. The discount rate used to calculate the net present value (NPV) of external debt remains at 5 percent. The key assumptions are:

- **Growth.** Long-term growth is maintained at between 3 and 3½ percent under cautious assumptions and is somewhat lower than growth set out in the authorities' development plans. Positive growth spillovers are assumed to result from planned increases in development investment, reflected in capital spending, which helps counteract the expected long-term fall in forestry and minerals sector.

<sup>2</sup> There is considerable scope to strengthen tax administration given that, for example, only 187 people account for 70 percent of income tax revenues. This effort is being supported by the donors and the IFIs, particularly by the IMF's Technical Assistance Center in the Pacific, PFTAC, which has emphasized efforts to strengthen PFM.

- **Non-interest current account deficit.** The deficit is expected to increase to close to 7.5 percent of GDP by 2017 from around 2 percent in 2015, reflecting a number of import-intensive projects in the pipeline—the Tina River Hydropower Project (TRHP), the undersea cable and Soltuna—as well as lower exports from the delay in reopening the Gold Ridge Mine until 2020. Also contributing to an improvement in the balance after 2020 is an assumed fall in fuel imports of 25 percent as TRHP comes on line that year.
- **External borrowing.** External borrowing in 2015 helped finance the electricity network upgrade, and should occur in 2016 and 2017, partly to finance the undersea fiber optic cable. Concessional borrowing is projected to average about 2½ percent of GDP annually over the next five years and 3.2 percent of GDP over the longer term. The effective interest rate on external borrowing is around 1.5 percent in line with rates on concessional lending from the multilateral development banks and donors.
- **Fiscal anchor and outlook.** The non-commodity primary fiscal balance is used as the fiscal anchor, which is set at a 2.5 percent deficit over the medium and long term. This results in a rising primary fiscal surplus that peaks at 2.6 percent of GDP in 2025 and then declines, turning into a small deficit by the end of that decade as commodity revenues decline with grants, logging and mining revenues projected to fall a share of GDP. This contributes to a buildup in cash reserves (reflected in the DSA residual) that is then run down. Grant-funded development expenditure is projected to decline and only be partially substituted for by external borrowing. Revenues (excluding grants) are forecast to fall to about 30 percent of GDP over the medium and long term with the decline in commodity-related revenues.<sup>3</sup>
- **Aid flows and FDI.** Aid flows are expected to average about 13.5 percent of GDP over the medium term—down from the 19 percent of GDP assumed in 2013. In the long term, aid declines to about 10 percent of GDP even though the level continue to rise in nominal and real terms. Historic and projected FDI numbers have been revised down substantially since 2013, largely due to improvements in data.<sup>4</sup> Net FDI is now projected to be around 3½ percent of GDP over the medium to long term. The part of the current account deficit not financed by aid and FDI flows is assumed to be financed by external borrowing.
- **Logging and mining.** Logging output is expected to decline by about 4 percent per year on average until 2025 and then to stabilize at this lower level. Gold Ridge Mine is expected to remain closed until 2020, owing to persistently low gold prices and the high cost of resuming operations after the flood damage. After reopening, production is assumed to peak at 62,000 ounces per annum in 2023 and then to run down gradually. It is assumed to run for 10 years with a cumulative output of 465,000, significantly lower than assumed in 2013 before the flood which, together with lower gold prices, probably reduced capacity.

<sup>3</sup> This represents a substantial improvement from the decline in revenues to 27 percent of GDP assumed in the 2013 DSA and reflects the benefit of PFM reforms that are underway.

<sup>4</sup> Following recent TA, historic FDI data has been aligned with BPM 6 standards, to re-categorize net losses as negative reinvested earnings; TA also identified weaknesses in survey methodologies that led to a significant overestimation of FDI flows.

### Box 1. Solomon Islands: Incorporating Climate Change and Extreme Weather Shocks into the DSA

The Pacific Island states are particularly exposed to climate change and vulnerable to extreme weather events, which climatologists warn may be worsened by climate change. To provide effective policy advice, these major long term costs and risks need to be quantified and incorporated into an analytic framework—which the DSA provides—to assess how they will impact countries’ fiscal position and external debt sustainability.

This assessment draws on research that estimates both the recurrent cost of climate change and of the frequency and cost of natural disasters.<sup>1</sup> The recurrent cost of mitigating the effects of climate change is estimate at around 0.5 percent of GDP per year and is reflected in the DSA baseline. This cost is assumed to be covered from government resources (i.e. not by additional borrowing) and to be divided between the recurrent budget (0.2 percent of GDP) and development budget that finances ongoing capital expenditures for climate change adaptation (0.3 percent of GDP). The extreme natural disaster shock is incorporated in the DSA as a new adverse scenario that results in losses and damage of around 15 percent of GDP and reflected in a fall in real GDP growth of roughly 7.5 percentage points in the year of the disaster, a deterioration of fiscal balance of about 7.5 percent of GDP in the year after the disaster, and about 15 percent of GDP of additional external public debt.

The DSA, by design, includes only one extreme weather natural disasters as a scenario over its 20 year horizon. However, more than one extreme weather event is possible over this period, in which case extreme weather could have a significantly larger cumulative effect on debt sustainability than the DSA results show (Figure 2). In preparation for such events, countries need to have the capacity to mobilize large resources quickly at infrequent intervals, which they can do by building up a substantial cash buffer over time that they can draw down. Also, infrastructure investment to build resilience to reduce the cost of extreme weather events becomes more important in light of this higher frequency. The Article IV Staff Report discusses the design of a medium term fiscal framework and anchor to support these efforts and contain the risks to debt sustainability from climate change and extreme weather.

<sup>1</sup> Estimates are reported in Cabezon, Hunter, Tumbarello, Washimi, and Wu (WP/15/125). This working paper draws on the Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI) report (2013) prepared by the World Bank, other IFIs, and regional donors.

- **Tina River Hydropower Project.** This project involves a government guarantee of around US\$150 million (12 percent of GDP) to cover a power purchase agreement (PPA) between the project developers and Solomon Islands Electricity Authority (SIEA). Since PPAs are not typical financial instruments, the guarantee is not recorded on the government balance sheet or in the DSA baseline. However, a customized scenario captures the full materialization of this contingent liability in which SIEA is unable to make the PPA payment and government steps in to pay the full PPA amount, estimated to be US\$20 million per year (a “worst-case” scenario). This is reflected in higher public expenditure, resulting in a larger fiscal deficit over the 30-year contract period and higher public debt.

## EXTERNAL AND PUBLIC DEBT SUSTAINABILITY ANALYSIS

**3. External Debt Sustainability Analysis.** Under the baseline scenario, all external Public and Publicly Guaranteed (PPG) debt indicators remain below the policy relevant thresholds. Total external debt is projected to gradually increase from 13 percent in 2015 to 36 percent of GDP over the long term while PPG external debt is projected to rise to around 34 percent of GDP. This rise is driven largely by the financing of infrastructure investment, of which an increasing share is financed by concessional debt rather than grants. This represents an improvement from the last DSA, reflecting a lower-than-expected resumption in external concessional borrowing since 2013.<sup>5</sup> All indicators of sustainability (i.e. total and PPG debt as a ratio of GDP or revenues or in present value (PV) terms, and external debt servicing) remain well below the indicative thresholds. The PV of PPG debt in terms of export ratios remains below the indicative threshold of 100 percent, but rises from around 16 to 67 percent owing to the declining trend in commodity exports. Sensitivity analysis highlights two risks to external debt sustainability, also identified in the 2013 DSA. These correspond to a shock to financing terms – a rise in interest rates on new borrowing of 2 percentage points – that leads to a breach in the threshold for ratios of PV of PPG external debt to GDP (of 30 percent), and a negative export shock (Table 2).

**4. Public Debt Sustainability Analysis.** Public debt remains below the threshold for debt sustainability under the baseline scenario (Figure 2). However, sensitivity analysis also reveals that public debt sustainability remains vulnerable to shocks, particularly to the extreme shock of permanently lower growth and the fix-primary deficit scenarios (which “fixes” this deficit at its recent, expansionary, level relative to the baseline, which has some consolidation). In both scenarios, the PV of debt to GDP ratio breaches the 38 percent of GDP benchmark threshold by the end of the next decade. In the extreme shock scenario, the PV of debt to revenue ratio rises to 169 percent of GDP by 2036. Scenario analysis suggests that if the TRHP PPA contingent liability materializes, the impact on public debt would be manageable (Figure 2), with relatively small effects on the PV of debt to GDP, revenue and debt service to revenue indicators. This contributes to a rise in the PV of debt to GDP rises from 7 to 30 percent, about 7 percentage points above the baseline, but it stays below the 38 percent benchmark. Similarly, the natural disaster shock discussed above results in a sharp, near term rise in the PV of debt to GDP that diminishes as growth rebounds and remains below the benchmark (Figure 2).

<sup>5</sup> This reflects the fact that part of the current account deficit has been financed through the aid in kind for capital projects from donors, which are expected to be scaled back, and contributes to a shift from negative to positive residuals at the start of the projection in Table 1 (i.e. these inflows are reflected in capital account but are not captured in net debt-creating flows in the Table, which only correct for FDI inflows; and, thus, are reflected directly in the residual.)

## CONCLUSIONS

5. **The current DSA suggests that the Solomon Islands continue to face a moderate risk of debt distress, consistent with the 2013 DSA.**<sup>6</sup> Although there is no breach of thresholds under the baseline, external debt does rise above the debt to GDP and exports thresholds in the long run under some scenarios. Overall, the analysis demonstrates the vulnerability of public debt sustainability to external financing, fiscal and growth shocks; and, conversely, the contribution of donor funding and FDI to debt sustainability. This highlights the need for to maintain a prudent fiscal policy. Borrowing that leads to a buildup in debt should therefore remain cautious, targeting projects that broaden the export base and strengthen potential growth (e.g. infrastructure investment) and increase resilience of debt sustainability to shocks.

6. **The DSA has been extended to incorporate the effects of extreme weather events and climate change in both the baseline and alternative scenarios.** The baseline now includes the recurrent fiscal costs of climate change, estimated at 0.5 percent of GDP per year, which includes infrastructure investment to protect against adverse weather. The natural disaster shock scenario assumes losses of 15 percent of GDP; involving a sharp, temporary fall in GDP, and large, one-off reconstruction outlays. The DSA finds that external and public debt remains sustainable under this scenario. However, in interpreting this finding, it is important to recognize that the DSA includes only one instance of each shock over its 20 year horizon, and that multiple extreme weather events are possible over this period in light of their 10 year average frequency (Box 1). Policy, therefore, needs to prepare for the possibility of multiple extreme weather events that could have a significantly larger cumulative effect on debt sustainability than the DSA results show.

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<sup>6</sup> Solomon Islands is classified as having weak policies and institutions based on its three-year average CPIA score of 2.94. While this is a slight improvement on the 2013 average score of 2.89, which informed the previous DSA, it remains below the 3.25 threshold required for classification as medium policy performer.

**Table 1. Solomon Islands: External Debt Sustainability Framework, Baseline Scenario, 2013-2036 1/**  
(In percent of GDP, Unless Otherwise Indicated)

	Actual			Historical Average	Standard Deviation	Projections									
	2013	2014	2015			2016	2017	2018	2019	2020	2021	2016-2021 Average	2026	2036	2022-2036 Average
<b>External debt (nominal) 1/</b>	<b>19.6</b>	<b>19.5</b>	<b>12.9</b>			<b>12.1</b>	<b>15.5</b>	<b>18.7</b>	<b>21.2</b>	<b>23.9</b>	<b>25.8</b>			<b>32.3</b>	<b>36.4</b>
<i>of which: public and publicly guaranteed (PPG)</i>	11.3	10.4	9.8			8.4	9.4	10.7	12.2	14.0	16.3			25.6	34.0
Change in external debt	-1.8	-0.1	-6.6			-0.8	3.4	3.1	2.6	2.6	1.9			1.2	-0.2
Identified net debt-creating flows	-2.7	1.9	0.7			1.0	3.9	3.2	2.4	2.2	-1.0			0.1	10.8
<b>Non-interest current account deficit</b>	<b>2.9</b>	<b>3.8</b>	<b>2.1</b>	10.8	10.6	<b>4.2</b>	<b>7.5</b>	<b>6.7</b>	<b>5.7</b>	<b>5.5</b>	<b>2.7</b>	5.4		<b>3.9</b>	<b>14.7</b>
Deficit in balance of goods and services	12.5	10.1	8.2			8.5	11.9	11.2	10.1	9.8	8.3			10.1	15.7
Exports	51.6	49.2	44.6			42.8	40.8	39.8	39.9	39.6	41.0			40.2	32.5
Imports	64.2	59.3	52.7			51.3	52.7	51.0	50.0	49.4	49.4			50.3	48.2
Net current transfers (negative = inflow)	-10.7	-8.9	-7.2	-15.6	6.0	-8.1	-7.9	-7.6	-7.5	-7.4	-7.6	-7.7		-9.0	-3.1
<i>of which: official</i>	-10.0	-8.6	-7.0			-7.6	-7.3	-7.0	-6.7	-6.4	-6.5			-7.2	-0.9
Other current account flows (negative = net inflow)	1.1	2.6	1.1			3.8	3.5	3.1	3.1	3.1	2.0			2.8	2.1
<b>Net FDI (negative = inflow)</b>	<b>-4.5</b>	<b>-1.8</b>	<b>-2.0</b>	-9.0	7.1	<b>-3.1</b>	<b>-3.5</b>	<b>-3.4</b>	<b>-3.3</b>	<b>-3.3</b>	<b>-3.7</b>	-3.4		<b>-3.5</b>	<b>-3.3</b>
<b>Endogenous debt dynamics 2/</b>	<b>-1.1</b>	<b>-0.2</b>	<b>0.7</b>			<b>-0.1</b>	<b>-0.1</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>-0.1</b>			<b>-0.3</b>	<b>-0.7</b>
Contribution from nominal interest rate	0.5	0.5	0.6			0.2	0.3	0.4	0.5	0.6	0.7			0.7	0.6
Contribution from real GDP growth	-0.6	-0.4	-0.6			-0.4	-0.4	-0.4	-0.5	-0.6	-0.7			-1.0	-1.3
Contribution from price and exchange rate changes	-1.0	-0.4	0.7			...	...	...	...	...	...			...	...
<b>Residual (3-4) 3/</b>	<b>0.9</b>	<b>-1.9</b>	<b>-7.3</b>			<b>-1.7</b>	<b>-0.5</b>	<b>0.0</b>	<b>0.2</b>	<b>0.5</b>	<b>3.0</b>			<b>1.1</b>	<b>-11.0</b>
<i>of which: exceptional financing</i>	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0			0.0	0.0
PV of external debt 4/	...	...	10.2			9.9	12.7	15.1	16.9	18.8	19.7			22.7	24.3
In percent of exports	...	...	22.9			23.1	31.0	38.0	42.4	47.4	48.0			56.6	74.7
<b>PV of PPG external debt</b>	<b>...</b>	<b>...</b>	<b>7.1</b>			<b>6.2</b>	<b>6.6</b>	<b>7.1</b>	<b>7.9</b>	<b>8.8</b>	<b>10.2</b>			<b>16.0</b>	<b>21.8</b>
In percent of exports	...	...	16.0			14.4	16.1	18.0	19.8	22.4	24.9			39.8	67.2
In percent of government revenues	...	...	20.6			19.5	20.8	22.5	24.8	28.0	32.1			47.8	70.1
Debt service-to-exports ratio (in percent)	2.7	2.9	3.6			3.2	3.4	3.6	3.5	3.3	3.3			3.0	4.7
PPG debt service-to-exports ratio (in percent)	1.4	1.6	1.6			1.9	2.0	1.9	1.6	1.3	1.3			1.6	3.5
PPG debt service-to-revenue ratio (in percent)	2.1	2.3	2.0			2.6	2.6	2.3	2.1	1.7	1.7			1.9	3.6
Total gross financing need (Millions of U.S. dollars)	-2.5	40.4	19.0			29.9	68.5	61.5	53.3	51.5	5.7			33.8	480.0
Non-interest current account deficit that stabilizes debt ratio	4.8	3.9	8.7			5.0	4.1	3.5	3.2	2.8	0.8			2.8	15.0
<b>Key macroeconomic assumptions</b>															
Real GDP growth (in percent)	3.0	2.0	3.3	4.5	4.5	3.0	3.3	3.0	3.0	3.0	3.2	3.1	3.4	3.8	3.5
GDP deflator in US dollar terms (change in percent)	5.1	1.9	-3.7	5.7	5.6	1.7	1.8	1.8	2.5	3.0	0.3	1.8	2.0	3.4	2.5
Effective interest rate (percent) 5/	2.7	2.7	2.9	2.5	0.4	1.9	2.3	2.7	2.9	2.9	2.9	2.6	2.3	1.7	2.1
Growth of exports of G&S (US dollar terms, in percent)	-7.3	-1.1	-9.9	16.4	25.9	0.6	0.3	2.1	5.8	5.3	7.3	3.6	4.5	4.8	4.4
Growth of imports of G&S (US dollar terms, in percent)	12.1	-4.0	-11.6	15.6	25.2	2.0	7.9	1.5	3.5	4.8	3.4	3.9	6.1	6.4	5.8
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	30.9	44.3	44.3	44.3	44.3	44.3	42.0	44.3	44.3	44.3
Government revenues (excluding grants, in percent of GDP)	34.1	33.2	34.7	...	...	31.6	31.6	31.8	31.7	31.6	31.9	...	...	33.5	31.1
Aid flows (in Millions of US dollars) 7/	197.3	170.2	131.4	...	...	146.2	175.0	180.0	186.9	196.4	201.6	...	...	236.5	296.0
<i>of which: Grants</i>	197.3	170.2	131.4	...	...	146.2	147.6	148.6	150.9	154.5	152.4	...	...	172.0	178.1
<i>of which: Concessional loans</i>	0.0	0.0	0.0	...	...	0.0	27.4	31.4	36.0	41.8	49.1	...	...	64.5	118.0
Grant-equivalent financing (in percent of GDP) 8/	...	...	...	...	...	12.2	12.6	12.3	11.9	11.7	11.3	12.0	9.9	6.2	8.8
Grant-equivalent financing (in percent of external financing) 8/	...	...	...	...	...	99.9	91.3	90.3	89.3	88.1	86.4	90.9	84.8	77.8	82.8
<b>Memorandum items:</b>															
Nominal GDP (Millions of US dollars)	1110.5	1153.6	1147.2			1202.1	1263.8	1325.4	1399.3	1484.0	1535.6			2016.3	3686.6
Nominal dollar GDP growth	8.3	3.9	-0.6			4.8	5.1	4.9	5.6	6.1	3.5	5.0	5.5	7.4	6.0
PV of PPG external debt (in Millions of US dollars)	...	...	79.8			74.2	82.9	94.7	110.3	131.3	157.1	...	...	322.4	804.9
(PVT-PVt-1)/GDPt-1 (in percent)	...	...	...			-0.5	0.7	0.9	1.2	1.5	1.7	0.9	2.0	1.8	1.9
Gross workers' remittances (Millions of US dollars)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0			0.0	0.0
PV of PPG external debt (in percent of GDP + remittances)	...	...	7.1			6.2	6.6	7.1	7.9	8.8	10.2			16.0	21.8
PV of PPG external debt (in percent of exports + remittances)	...	...	16.0			14.4	16.1	18.0	19.8	22.4	24.9			39.8	67.2
Debt service of PPG external debt (in percent of exports + remittances)	...	...	1.6			1.9	2.0	1.9	1.6	1.3	1.3			1.6	3.5

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as  $[r - g - \rho(1+g)] / (1+g+\rho+g)$  times previous period debt ratio, with  $r$  = nominal interest rate;  $g$  = real GDP growth rate, and  $\rho$  = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Assumes that PV of private sector debt is equivalent to its face value.

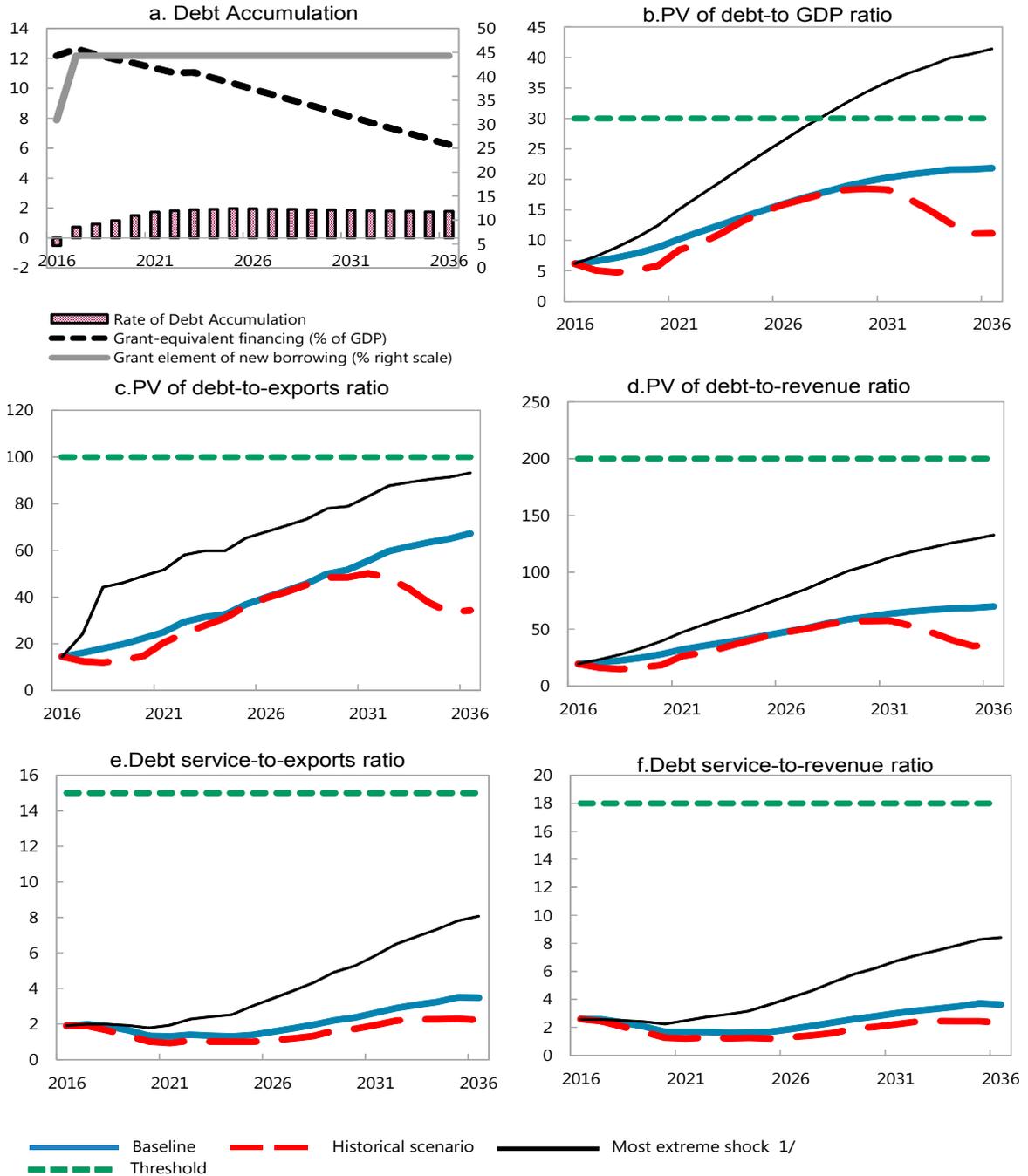
5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

**Figure 1. Solomon Islands: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2016-2036 1/**



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2026. In figure b, it corresponds to a Terms shock; in c, to a Exports shock; in d, to a Terms shock; in e, to a Terms shock and in figure f, to a Terms shock

**Table 2. Solomon Islands: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2016–2036**  
(In percent)

	Projections							2036
	2016	2017	2018	2019	2020	2021	2026	
<b>PV of debt-to GDP ratio</b>								
<b>Baseline</b>	6	7	7	8	9	10	<b>16</b>	22
<b>A. Alternative Scenarios</b>								
A1. Key variables at their historical averages in 2016-2036 1/	6	5	5	5	6	8	16	5
A2. New public sector loans on less favorable terms in 2016-2036 2	6	7	9	11	12	15	<b>26</b>	41
<b>B. Bound Tests</b>								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	6	7	8	8	9	11	<b>17</b>	23
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	6	9	14	15	16	17	<b>22</b>	24
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	6	7	7	8	9	11	<b>17</b>	23
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	6	6	7	8	9	10	<b>16</b>	22
B5. Combination of B1-B4 using one-half standard deviation shocks	6	2	0	0	0	1	<b>8</b>	18
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	6	9	10	11	13	15	<b>23</b>	31
<b>PV of debt-to-exports ratio</b>								
<b>Baseline</b>	14	16	18	20	22	25	<b>40</b>	67
<b>A. Alternative Scenarios</b>								
A1. Key variables at their historical averages in 2016-2036 1/	14	12	12	13	15	21	39	15
A2. New public sector loans on less favorable terms in 2016-2036 2	14	18	22	26	32	37	<b>66</b>	127
<b>B. Bound Tests</b>								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	14	16	18	20	22	25	<b>40</b>	67
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	14	24	44	46	49	52	<b>68</b>	93
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	14	16	18	20	22	25	<b>40</b>	67
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	14	16	17	19	22	24	<b>39</b>	67
B5. Combination of B1-B4 using one-half standard deviation shocks	14	5	0	0	0	2	<b>19</b>	55
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	14	16	18	20	22	25	<b>40</b>	67
<b>PV of debt-to-revenue ratio</b>								
<b>Baseline</b>	20	21	22	25	28	32	<b>48</b>	70
<b>A. Alternative Scenarios</b>								
A1. Key variables at their historical averages in 2016-2036 1/	20	16	15	16	19	26	47	16
A2. New public sector loans on less favorable terms in 2016-2036 2	20	23	28	33	39	47	<b>79</b>	133
<b>B. Bound Tests</b>								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	20	21	24	26	30	34	<b>51</b>	75
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	20	28	44	46	49	53	<b>65</b>	78
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	20	21	23	26	29	33	<b>49</b>	72
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	20	21	22	24	27	31	<b>47</b>	70
B5. Combination of B1-B4 using one-half standard deviation shocks	20	6	0	0	0	3	<b>24</b>	59
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	20	29	32	35	40	46	<b>68</b>	99

### Title 3. Solomon Islands: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2016-2036 (continued)

#### Debt service-to-exports ratio

<b>Baseline</b>	2	2	2	2	1	1	2	3
<b>A. Alternative Scenarios</b>								
A1. Key variables at their historical averages in 2016-2036 1/	2	2	2	1	1	1	1	2
A2. New public sector loans on less favorable terms in 2016-2036 2	2	2	2	2	2	2	3	8
<b>B. Bound Tests</b>								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	2	2	2	2	1	1	2	3
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	2	2	3	3	2	2	3	5
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	2	2	2	2	1	1	2	3
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	2	2	2	2	1	1	2	3
B5. Combination of B1-B4 using one-half standard deviation shocks	2	2	2	1	1	1	0	2
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	2	2	2	2	1	1	2	3

#### Debt service-to-revenue ratio

<b>Baseline</b>	3	3	2	2	2	2	2	4
<b>A. Alternative Scenarios</b>								
A1. Key variables at their historical averages in 2016-2036 1/	3	2	2	2	1	1	1	2
A2. New public sector loans on less favorable terms in 2016-2036 2	3	3	2	2	2	2	4	8
<b>B. Bound Tests</b>								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	3	3	2	2	2	2	2	4
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	3	3	3	3	2	2	3	4
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	3	3	2	2	2	2	2	4
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	3	3	2	2	2	2	2	4
B5. Combination of B1-B4 using one-half standard deviation shocks	3	3	2	1	1	1	0	2
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	3	4	3	3	2	2	3	5

#### Memorandum item:

Grant element assumed on residual financing (i.e., financing required above baseline) 6/	43	43	43	43	43	43	43	43
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Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.

2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline, while grace and maturity periods are the same as in the baseline.

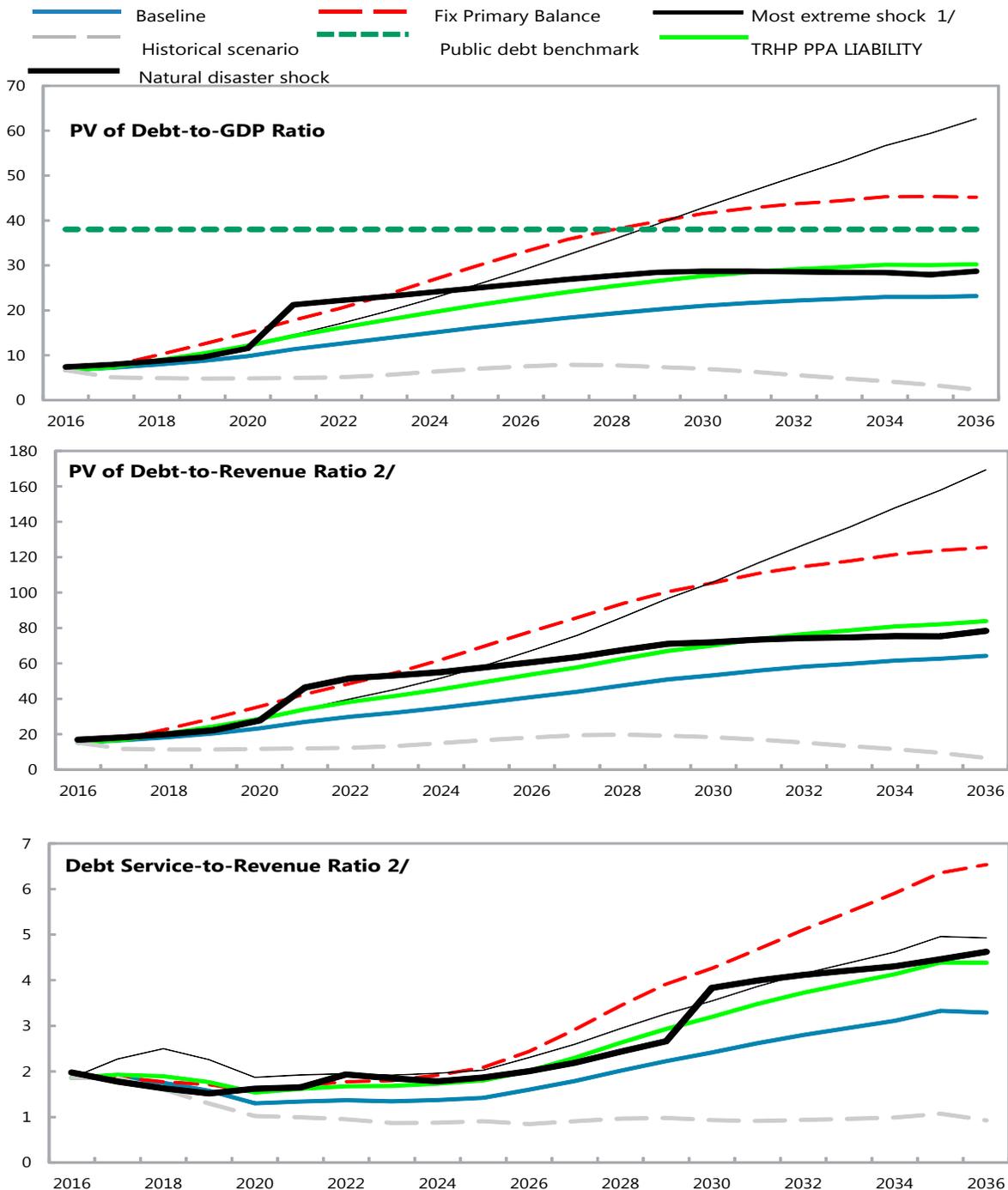
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly an offsetting adjustment in import levels).

4/ Includes official and private transfers and FDI.

5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

**Figure 2. Solomon Islands: Indicators of Public Debt Under Alternative Scenarios, 2016-2036 1/**



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2026.

2/ Revenues are defined inclusive of grants.

**Table 4. Solomon Islands: Public Sector Debt Sustainability Framework, Baseline Scenario, 2013–2036**  
(In percent of GDP, Unless Otherwise Indicated)

	Actual			Average <sup>5/</sup>	Standard Deviation <sup>5/</sup>	Estimate					Projections			
	2013	2014	2015			2016	2017	2018	2019	2020	2021	2016-21 Average	2026	2036
<b>Public sector debt 1/</b>	15.5	13.3	10.4			8.9	10.1	11.5	13.1	14.9	17.4		26.8	35.3
<i>of which: foreign-currency denominated</i>	11.3	10.4	9.8			8.4	9.4	10.7	12.2	14.0	16.3		25.6	34.0
Change in public sector debt	-2.1	-2.3	-2.9			-1.5	1.2	1.4	1.6	1.9	2.5		1.7	0.2
Identified debt-creating flows	-5.4	-2.1	0.2			0.6	0.2	-2.1	-2.1	-2.1	-1.3		-3.5	-1.8
Primary deficit	-4.4	-1.9	0.1	-3.1	3.1	1.3	0.5	-1.7	-1.6	-1.5	-1.0	-0.7	-2.5	0.1
Revenue and grants	51.8	48.0	46.1			43.8	43.3	43.0	42.5	42.1	41.8		42.0	36.0
<i>of which: grants</i>	17.8	14.8	11.5			12.2	11.7	11.2	10.8	10.4	9.9		8.5	4.8
Primary (noninterest) expenditure	47.5	46.1	46.3			45.0	43.8	41.3	40.9	40.5	40.8		39.5	36.0
Automatic debt dynamics	-1.0	-0.3	0.0			-0.6	-0.3	-0.4	-0.5	-0.6	-0.3		-0.9	-1.9
Contribution from interest rate/growth differential	-0.7	-0.4	-0.5			-0.4	-0.3	-0.3	-0.4	-0.4	-0.5		-0.9	-1.3
<i>of which: contribution from average real interest rate</i>	-0.2	-0.1	-0.1			-0.1	0.0	0.0	0.0	0.0	0.0		0.0	0.0
<i>of which: contribution from real GDP growth</i>	-0.5	-0.3	-0.4			-0.3	-0.3	-0.3	-0.3	-0.4	-0.5		-0.8	-1.3
Contribution from real exchange rate depreciation	-0.3	0.2	0.5			-0.3	0.0	0.0	-0.1	-0.2	0.2		...	...
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0
Residual, including asset changes	3.3	-0.1	-3.1			-2.1	1.0	3.5	3.6	4.0	3.8		5.1	2.0
<b>Other Sustainability Indicators</b>														
<b>PV of public sector debt</b>	...	...	7.7			6.7	7.2	7.9	8.7	9.8	11.3		17.2	23.1
<i>of which: foreign-currency denominated</i>	...	...	7.1			6.2	6.6	7.1	7.9	8.8	10.2		16.0	21.8
<i>of which: external</i>	...	...	7.1			6.2	6.6	7.1	7.9	8.8	10.2		16.0	21.8
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...
Gross financing need 2/	-2.7	-0.2	2.8			2.5	1.7	-0.6	-0.6	-0.6	-0.1		-1.6	1.4
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	16.7			15.2	16.6	18.4	20.6	23.3	27.0		41.0	64.3
PV of public sector debt-to-revenue ratio (in percent)	...	...	22.2			21.1	22.8	24.8	27.5	31.0	35.5		51.5	74.3
<i>of which: external 3/</i>	...	...	20.6			19.5	20.8	22.5	24.8	28.0	32.1		47.8	70.1
Debt service-to-revenue and grants ratio (in percent) 4/	2.3	2.5	4.8			1.9	1.9	1.8	1.6	1.3	1.3		1.6	3.3
Debt service-to-revenue ratio (in percent) 4/	3.5	3.5	6.4			2.6	2.6	2.4	2.1	1.7	1.8		2.0	3.8
Primary deficit that stabilizes the debt-to-GDP ratio	-2.3	0.4	3.0			2.7	-0.7	-3.1	-3.2	-3.4	-3.5		-4.2	-0.1
<b>Key macroeconomic and fiscal assumptions</b>														
Real GDP growth (in percent)	3.0	2.0	3.3	4.5	4.5	3.0	3.3	3.0	3.0	3.0	3.2	3.1	3.4	3.8
Average nominal interest rate on forex debt (in percent)	1.1	1.1	0.9	1.3	0.6	0.9	1.1	1.2	1.3	1.4	1.4	1.2	1.4	1.5
Average real interest rate on domestic debt (in percent)	-3.0	-2.0	-0.4	-4.0	2.7	...	...	-0.6	-0.5	-0.5	2.6	0.3	0.3	-0.5
Real exchange rate depreciation (in percent, + indicates depreciation)	-2.8	1.6	5.4	-3.3	5.8	-2.7	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	4.4	3.2	1.6	6.0	3.2	4.3	1.8	1.8	2.5	3.0	0.3	2.3	3.5	4.9
Growth of real primary spending (deflated by GDP deflator, in percent)	-3.0	-0.9	3.6	0.0	1.6	0.2	0.4	-2.9	2.1	2.0	3.9	1.0	2.6	4.3
Grant element of new external borrowing (in percent)	...	...	...	...	...	30.9	44.3	44.3	44.3	44.3	44.3	42.0	44.3	44.3

Sources: Country authorities; and staff estimates and projections.

1/ Coverage of public sector debt is general government and gross debt.

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

**Table 5. Solomon Islands: Sensitivity Analysis for Key Indicators of Public Debt 2016–2036**

	Projections							
	2016	2017	2018	2019	2020	2021	2026	2036
<b>PV of Debt-to-GDP Ratio</b>								
<b>Baseline</b>	7	7	8	9	10	11	17	23
<b>A. Alternative scenarios</b>								
A1. Real GDP growth and primary balance are at historical averages	7	5	5	5	5	5	7	2
A2. Primary balance is unchanged from 2016	7	8	10	12	15	18	33	45
A3. Permanently lower GDP growth 1/	7	7	9	10	12	14	29	63
A.4 Tina PPA - Contingent Liability	7	7	9	10	12	14	23	30
<b>B. Bound tests</b>								
B1. Real GDP growth is at historical average minus one standard deviations in 2017-2018	7	8	10	12	14	17	29	42
B2. Primary balance is at historical average minus one standard deviations in 2017-2018	7	7	9	9	10	12	18	24
B3. Combination of B1-B2 using one half standard deviation shocks	7	6	7	8	10	11	19	27
B4. One-time 30 percent real depreciation in 2017	7	9	10	10	10	11	16	21
B5. 10 percent of GDP increase in other debt-creating flows in 2017	7	13	13	14	15	17	22	26
<b>PV of Debt-to-Revenue Ratio 2/</b>								
<b>Baseline</b>	15	17	18	21	23	27	41	64
<b>A. Alternative scenarios</b>								
A1. Real GDP growth and primary balance are at historical averages	15	12	11	11	12	12	18	7
A2. Primary balance is unchanged from 2016	15	18	23	29	36	43	78	126
A3. Permanently lower GDP growth 1/	15	17	20	23	28	34	67	169
A.4 Tina PPA - Contingent Liability	15	17	20	24	29	34	54	84
<b>B. Bound tests</b>								
B1. Real GDP growth is at historical average minus one standard deviations in 2017-2018	15	18	23	28	33	40	67	116
B2. Primary balance is at historical average minus one standard deviations in 2017-2018	15	16	20	22	25	29	42	65
B3. Combination of B1-B2 using one half standard deviation shocks	15	14	16	19	23	27	45	76
B4. One-time 30 percent real depreciation in 2017	15	22	22	23	25	27	38	59
B5. 10 percent of GDP increase in other debt-creating flows in 2017	15	30	31	33	36	40	53	73
<b>Debt Service-to-Revenue Ratio 2/</b>								
<b>Baseline</b>	2	2	2	2	1	1	2	3
<b>A. Alternative scenarios</b>								
A1. Real GDP growth and primary balance are at historical averages	2	2	2	1	1	1	1	1
A2. Primary balance is unchanged from 2016	2	2	2	2	2	2	2	7
A3. Permanently lower GDP growth 1/	2	2	2	2	1	2	2	7
A.4 Tina PPA - Contingent Liability	2	2	2	2	2	2	2	4
<b>B. Bound tests</b>								
B1. Real GDP growth is at historical average minus one standard deviations in 2017-2018	2	2	2	2	2	2	2	6
B2. Primary balance is at historical average minus one standard deviations in 2017-2018	2	2	2	2	1	1	2	3
B3. Combination of B1-B2 using one half standard deviation shocks	2	2	2	1	1	1	2	4
B4. One-time 30 percent real depreciation in 2017	2	2	3	2	2	2	2	5
B5. 10 percent of GDP increase in other debt-creating flows in 2017	2	2	2	2	2	2	2	4

Sources: Country authorities; and staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.

2/ Revenues are defined inclusive of grants.

**Table 6. Solomon Islands: Baseline Macroeconomic Assumptions**  
(In percent of GDP, Unless Otherwise Stated)

	2015	2016	2017	2018	2019	2020	2013 DSA*
Real GDP growth	3.3	3.0	3.3	3.0	3.0	3.0	3.5
GDP deflator in US dollar terms (change in percent)	-3.7	1.7	1.8	1.8	2.5	3.0	5.5
Non-interest current account deficit	2.1	4.2	7.5	6.7	5.7	5.5	9.8
Exports (Goods and Services)	44.6	42.8	40.8	39.8	39.9	39.6	48.7
Imports (Goods and Services)	52.7	51.3	52.7	51.0	50.0	49.4	61.7
Government revenues (excluding grants)	34.7	31.6	31.6	31.8	31.7	31.6	32.0
Primary (noninterest) expenditure	46.3	45.0	43.8	41.3	40.9	40.5	49.0
Net FDI (negative = inflow )	-2.0	-3.1	-3.5	-3.4	-3.3	-3.3	-7.5
Aid Flows	11.5	12.2	13.8	13.6	13.4	13.2	19.5
Grants	11.5	12.2	11.7	11.2	10.8	10.4	17.3
Concessional Loans	0.0	0.0	2.2	2.4	2.6	2.8	2.2

\* Projected medium-term values in the 2013 DSA

Source: IMF staff projections

**Statement by Ms. Vicki Plater, Alternate Executive Director for Solomon Islands  
March 21, 2016**

**The ECF program has helped Solomon Islands achieve macroeconomic and financial stability and supported the authorities' efforts to strengthen core institutions. The Solomon Islands authorities are determined to consolidate these gains, maintaining the important buffers built and continuing the reform agenda.** This will ensure continuing improvements in the quality of resource allocation and government spending, and ultimately help achieve stronger, sustainable, more diversified and inclusive growth. This is vital to ensure improved economic opportunities and outcomes for all Solomon Islanders, particularly the 80 percent of the population that live in remote rural areas. To this end the authorities appreciated the constructive engagement and tailored advice of Staff in the ECF Review and Article IV mission. The Article IV Reports focus on building resilience to shocks (particularly natural disasters) and financial inclusion is also timely as these are important priorities, integrally linked to rural development. My authorities look forward to continuing close engagement with the Fund into the future.

**The achievements made under the ECF program have been significant, delivering clear benefits to macroeconomic stability.** Fiscal and external buffers have increased: net international reserves rose to 9.8 months of imports in December 2015; external public debt has dropped to 9.8 percent of GDP; and the government's cash reserves for December 2015 were 3.2 months of recurrent spending (SI\$694m). Steady growth has been achieved and inflation well contained. The government budget was near-balance in 2015 (-0.3 percent of GDP). Even in periods of stress the economy has proved resilient: during the deadly floods that hit Honiara and Guadalcanal in 2014; the out-of-season Cyclone Raquel in 2015; the ongoing El Niño event, and the sudden closure of the Gold Ridge mining operation in early 2014.

**These gains have been underpinned by notable progress in building institutions under the ECF arrangement, a key objective of the program.** In particular, the Public Financial Management (PFM) Act and the Central Bank of Solomon Islands (CBSI) Act, subsequent regulatory and implementation steps, and the comprehensive Debt Management Framework (comprising the Debt Management Strategy, SOE borrowing policy, On-lending policy, and Guarantee policy) have helped the authorities strengthen macroeconomic stability and resilience. They provide an important anchor, and the stronger institutional architecture also limits the potential for hard-fought gains to be eroded in the future. Alongside the program, improvements in exchange rate management and monetary operations, supported by useful and targeted TA, have also enhanced macroeconomic management and stability.

**Institutional strengthening is inevitably a long-term path in states that are small, low-income, and/or in fragile situations; the Solomon Islands is all three. My authorities are committed to continuing steadfastly along this path.** As a small, dispersed, and remote country vulnerable to external shocks and frequent natural

disasters, continuing to build resilience is vital. Furthermore, lifting growth is a key challenge. Long-term economic growth averages around 3.5 percent, barely above the rate of population increase. The drift of the population from rural to urban areas and the growing number of unemployed youths also could undermine the recent improvements in social cohesion and security. The authorities are determined to progress critical reform efforts in order to sustain medium to long term macroeconomic stability and growth. This includes giving priority to completing the legislative process to strengthen the financial environment; continuing improvements to public financial management including implementing the new Procurement Rules and Regulations; and Anti Corruption measures, led by the Prime Minister. These are elaborated below.

**Performance has been sound in achieving the program's objectives.** All quantitative criteria under the program have been met by a considerable margin; this strong performance continued in December 2015 (outside the monitoring of the program). The only exception was the Indicative Targets on government-funded recurrent spending on health and education, which were narrowly missed owing to stronger procurement requirements by development partners in disbursing ODA in these sectors. Solid progress is continuing to be made across the government's reform agenda to further build on the key institutional measures already established. Legislative bottlenecks - resulting from continuing capacity constraints in the Attorney General's Office, and exacerbated by the limited number of parliamentary sittings that generally take place during a year (given the challenges of a small very-dispersed country) – and the complexity of some legislation have seen timeframes extended even while progress continues. The combination of the 5<sup>th</sup> and 6<sup>th</sup> reviews, in conjunction with the short extension of the program approved by the Board in December 2015, has been helpful to accommodate progress on reforms and a platform for continued engagement with the Fund.

### *Economic outlook*

**Economic growth is solid although the authorities agree that risks are to the downside.** The economy is estimated to have grown by 3¼ percent in 2015. Growth is expected to remain around 3 percent in 2016 driven by construction, communication and manufacturing activity as the contribution from logging is expected to soften. The Solomon Islands authorities are nonetheless cautious about the outlook as key trading partners, in particular China, are slowing. While Solomon Islands has yet to see the implications of slowing growth in Asia, it poses a risk to commodity prices and demand. The full extent of the impact of the current El Niño event remains uncertain, in addition to the ever-present risk from natural disasters.

**Achieving sustained and inclusive growth is a key objective of the Solomon Islands authorities,** as set out in their Economic Development Document (the Medium Term Development Plan 2016 to 2020, circulated separately to the Executive Board in line with the IMF's new policy on Poverty Reduction Strategy (PRS) documentation). Agribusiness and fisheries offer considerable potential for future growth, as does tourism and mining in the medium-term. Investment in infrastructure will be essential to support rural development as well as private sector development, and to raise productivity across a wider range of sectors. In addition, other complementary measures are needed to

improve the business environment including land reform, which is part of the government's agenda of "fundamental reforms".

### *Fiscal performance and policies*

**Solomon Islands recorded a fiscal deficit of 0.3 percent of GDP in 2015, maintaining solid cash buffers whilst also repaying all its domestic debt early.** The budget outturn was markedly better than the budgeted deficit of 5.5 percent of GDP, reflecting a slower pace of spending early in the year and careful expenditure management, and better than expected revenues. The outturn also incorporated the early repayment of SI\$100m (approx 1.1 percent of GDP) of domestic debt, further building buffers. This good performance was retained even as the government was able to lift the implementation rate of development spending relative to previous years (whereas in previous years the cash balance has been bolstered by the inability of the government to implement its spending plans).

**The Solomon Islands authorities are committed to preserving fiscal discipline and maintaining a strong cash reserve following the completion of the ECF arrangement.** Solomon Islands' vulnerability to natural disasters underlines the importance of maintaining meaningful buffers, as does the more challenging external environment currently prevailing. While the 2016 Budget projects a similar deficit to that projected in 2015, the Solomon Islands authorities are committed to carefully manage the budget in order to preserve the gains made under the ECF. In particular, my authorities appreciated the opportunity to discuss with Staff what tools could be useful to help them manage their fiscal affairs following the expiry of the ECF. The authorities will target the cash balance to not fall below two months of total expenditure. To give effect to this, the authorities will put in place quarterly fiscal targets, and look to align expenditure flows with revenue collection. Additional TA is being sought by the authorities from the Fund to strengthen the management of consolidated funds, including cash balances. In addition the authorities will review overall progress in spending as well as the spending mix at the Mid-Year Update to ensure it is in line with the Solomon Islands' development priorities and fiscal objectives. The authorities will take a cautious approach to resuming concessional borrowing and have set an Annual Borrowing Limit of SI\$300 million for 2016, consistent with the debt sustainability threshold under their Debt Management Framework (of a face value of debt to GDP of 25 percent).

**Mobilising domestic revenue in an efficient way remains important** for the authorities to deliver their development objectives. The new Customs and Excise Bill – a long (400 pages) and complex piece of legislation including amendments to other revenue Acts - will help to protect government revenue and promote accountability and transparency in decision making. It has been approved by Cabinet for vetting by the Attorney General's Chambers, and is expected to be presented to Parliament later in the year.

**Solomon Islands will continue to strengthen budget management and presentation, and would value continued discussions on appropriate medium-term fiscal anchors.** My authorities see merit in enhancing the presentation of the budget and are open to ideas on how this could be progressed. My authorities also look forward to continued

discussions with staff on their recommendation to use a non-commodity primary balance target as a medium- to long-term fiscal anchor. It will be important to understand the merits and implications of different options, noting that an anchor must be economically meaningful as well as easily understood to be most useful from a political management perspective.

**The authorities are strongly committed to continue to strengthen public financial management practices, with further measures in train.** The new Procurement Rules and Regulations are well-advanced and will come into effect by 1 July 2016, entrenching discipline to procurement processes. This will help enhance the improvements being made in the quality of resource allocation decisions as a result of the PFM Act. In addition Cabinet has recently approved the development of a Capital Structure policy for SOEs over the medium term with the objective of improving the performance, governance and oversight of SOEs by promoting efficient investment decisions.

**Considerable resource has been put into strengthening the systems for planning, procurement and reporting of Constituency Development Funds.** The Ministry of Rural Development is significantly scaling up its staffing; each constituency office is now well-resourced (including an accountant) and the Ministry is strengthening its central capacity to analyze constituency development plans and ensure consistency in reporting. A new project database system will further enhance this. A significant amount of information is now being produced as every constituency has an annual development plan and they report progress quarterly. The PFM Act has provided more governance to the implementation of CDFs, which are now abiding by procurement processes and will be covered by the new Procurement Rules and Regulations. My authorities welcome the suggestions Staff have made as to how the information produced could be presented in an accessible way – such as in the development budget by constituency – to further increase awareness of what is being delivered through the CDFs (e.g. Staff’s analysis that the amount of spending on capital projects under the CDFs is projected to increase in 2016). The completed audit reports on CDFs are expected to be submitted to Parliament at the sitting in the middle of the year, upon which they will be publicly available.

**Control of tertiary education spending is being enhanced.** The Solomon Islands authorities are keen to ensure that the capacity of Solomon Islands at tertiary level increases over time, but recognize it is important to consider what is the most effective way to do this and also ensure that Solomon Islands has the vocational and trade skills that it needs. A clear process is being used to determine the allocation of new scholarships and to ensure the continued performance of scholars abroad. Nonetheless there are continuing demand pressures as more students meet the academic achievement threshold than scholarships available. Work is well underway on a new Education Bill (expected before Parliament later this year) and reviewing tertiary education policies. The results are expected to enhance clarity and responsibility for tertiary spending, separate from primary and secondary education spending.

**The Government is pursuing a strong anti-corruption agenda as an utmost priority.** An Anti-Corruption Bill is expected shortly that will give effect to the UN Convention Against Corruption, prohibiting corruption in the public and private sectors and

establishing mechanisms for the investigation, prosecution and punishment of corruption offences. It will establish the Solomon Islands Independent Commission Against Corruption (SIICAC). Complementary legislation will also be introduced in the form of a Whistle Blower Bill and a revised and enhanced Ombudsman Bill.

**Staff's analysis on resilience to natural disasters is very timely as this is a high priority.** The Solomon Islands authorities are placing an increased emphasis on disaster risk preparedness and mitigation as immediate priorities, as set out in their EDD. They are exploring different mechanisms to build buffers within a multi-pillar approach. Domestically they are setting up a contingency fund for natural disasters, and looking to strengthen the work of the National Transport Fund. They are also considering regional mechanisms, including a proposed Melanesian Fund that would provide short-term liquidity support. They will examine a future phase of the Pacific Catastrophic Risk Insurance scheme, although earlier pilots failed to meet expectations and Solomon Islands withdrew when it did not receive any payout following the 2014 floods. Enhancing debt management capacity is also critically important when subject to frequent natural disasters, and my authorities will look over time to better integrate this into the DSA.

#### *Monetary, exchange rate and financial policy*

**Monetary policy remains accommodative but the authorities are watchful for any signs of inflationary pressures.** In the first half of 2015 Solomon Islands experienced deflation, which warranted supportive monetary policy and expansionary fiscal policy. There was a return to low inflation in the second half of 2015. The authorities have maintained current monetary policy settings but are alert to any building of inflationary pressures. The authorities are conscious that monetary policy effectiveness is hampered by excess liquidity and appreciate Staff's views on tools that might help better manage this. The authorities do not view the cash reserve requirement ratio as a viable tool at the current juncture, and are receiving technical assistance from the Reserve Bank of Australia on how to conduct liquidity swaps.

**The basket exchange rate regime is operating well.** Innovations to remove the operational 1 percent band and to increase the buy-sell margin in foreign exchange trading have enhanced exchange rate management. Bilateral exchange rates have shown greater flexibility while the currency basket remains more stable. Bilateral exchange rates are now published daily. The authorities are considering whether to include the renminbi in the currency basket. My authorities are open to a periodic review of the appropriate level of the peg but are conscious that without fundamentally addressing some of the supply side constraints in the economy (such as the business climate and land reform), the competitiveness benefits from devaluation may be shortlived. The authorities are interested in continuing discussions on how to achieve a sustainable lift in competitiveness.

The Central Bank of Solomon Islands (CBSI) is continuing work to implement the final recommendations from the helpful Safeguards assessment.

**Further upgrades to the legislative framework to ensure a stable and efficient financial sector are well advanced.** My authorities are committed to bringing these to completion as a priority, as they are key planks in their efforts to strengthen financial stability and inclusion. In particular:

- The Credit Unions Act will help promote financial sector stability and development. In February Cabinet endorsed the detailed policy paper and instructed the Attorney General's Chambers to draft the legislation. A model Credit Union Bill has been prepared, which should substantially reduce the time needed to finalize the Bill.
- The revised National Provident Fund (NPF) Act will strengthen the NPF's governance structure and investment framework. Cabinet approval is being sought for the Attorney General's Chambers to proceed with drafting.
- The Financial Institutions Act will modernize and strengthen supervision of the financial sector. The CBSI has developed new financial instructions, issued new Prudential Guidelines, and endorsed a Fitness and Propriety Regulation, in anticipation of the new Act.

**My authorities welcome Staff's innovative and timely analysis on financial inclusion, key to the government's rural development objectives and to empowering women.** The CBSI has been proactive in promoting financial inclusion and the Governor chairs the National Financial Inclusion Taskforce (NFIT) including government, financial institutions, communication providers, and donors. NFIT recently endorsed the next medium-term National Financial Inclusion Strategy (NFIS2), which sets out clear goals and a coordinated approach to broaden and deepen financial inclusion in Solomon Islands. Solomon Islands is a leader in mobile banking services among Pacific small states, and one of the Taskforce's four working groups is focused on digital finance. The authorities are mindful that it is important to balance financial inclusion with financial stability.

**In conclusion,** the ECF program has helped strengthen the institutional environment to achieve and safeguard continued macroeconomic stability. Solomon Islands is committed to continuing to advance their reform agenda, including completing remaining legislative processes and continuing to strengthen public financial management. My authorities view these as integral to their objective to build a robust and diversified economy that delivers benefits for all, particularly those in the rural areas. Even when capacity constraints and political management may slow the pace of progress, the direction of effort and commitment is clear and the authorities are continuing to move forward.

The IMF remains an important partner for Solomon Islands. My authorities would like to thank Staff for their untiring commitment and support through the ECF. They look forward to continued close engagement with the Fund following the expiry of the program, including through technical assistance aligned with key priorities. The move to a 12 month Article IV cycle is welcome and will help foster this.