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Solomon Islands: 2005 Article IV Consultation—Staff Report; and Public Information Notice on the Executive Board Discussion

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 2005 Article IV consultation with the Solomon Islands, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on July 12, 2005, with the officials of the Solomon Islands on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on September 13, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) updating information on recent developments and summarizing the views of the Executive Board as expressed during its September 28, 2005 discussion of the staff report that concluded the Article IV consultation.

The document listed below will be separately released.

Selected Issues and Statistical Appendix paper

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

SOLOMON ISLANDS

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for
the 2005 Consultation with the Solomon Islands

Approved by Steven Dunaway and Michael Hadjimichael

September 13, 2005

- The 2005 Article IV Consultation discussions were held in Honiara during June 30–July 12. The team comprised Ms. Papi (head), Messrs. Ginting and Porter (all APD). Mr. Francis (OED) attended the policy meetings.
- The team met with Deputy Prime Minister Rini, Finance Minister Boyers, Governor Houenipwela of the Central Bank of the Solomon Islands (CBSI), other senior government officials, donors, and private sector representatives.
- The Solomon Islands accepted the obligations of Article VIII, Sections 2(a), 3, and 4 in 1979. Exchange restrictions reintroduced starting in 2000 were removed in 2003. The Solomon Islands now maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.
- While improving, data quality, coverage, and timeliness remain weak, hampering surveillance.
- As last year, the authorities indicated their intention to publish the Article IV documents.

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EXECUTIVE SUMMARY

Economic Developments and Challenges

The improvement in the Solomon Islands' economic performance registered after the arrival of the Australian-led intervention force in mid-2003 has continued.

- **The economy has begun to recover.** Strong commodity exports and substantial donor support drove growth and strengthened the external position significantly in 2004. Inflation moderated from its conflict peak. Likewise, the budget recorded a large surplus. Although moderating, growth is supported by two major projects restarting in 2005. The projected deterioration in the external current account reflects investment-related imports, but reserve coverage should remain comfortable. The budget is projected to record a small deficit due to one-off factors and higher spending as capacity and wages rise.

- **Despite a positive near-term outlook, the country faces enormous challenges.** With logging set to decline from its unsustainable level, much depends on new private activities coming on stream to replace lost incomes, exports, and government revenue. The Solomon Islands is the poorest country in the Pacific, with per capita GDP two thirds of its preconflict level. The key challenge is to sustain per capita income growth and broaden its base, while safeguarding macroeconomic stability.

Key Policy Issues

The discussions focused on the macroeconomic policies needed to support the reform process over the medium term. Now is a good opportunity to tackle long-standing issues, provided the forthcoming elections do not derail reforms.

- **A strong fiscal position should be maintained over the medium term.** With expenditure pressures set to rise and revenues projected to fall, staff suggested a 1½ percentage points of GDP adjustment in the 2006 budget. This year's deficit should also be kept below budget.

- **The central bank's policy to resist upward pressure on the exchange rate is appropriate.** The CBSI has de facto pegged the currency to the U.S. dollar since 2003. Downward pressure on the exchange rate should not be resisted. With the conduct of monetary policy likely to become more challenging, the CBSI should continue to stand ready to take appropriate measures, were credit growth to become inflationary.

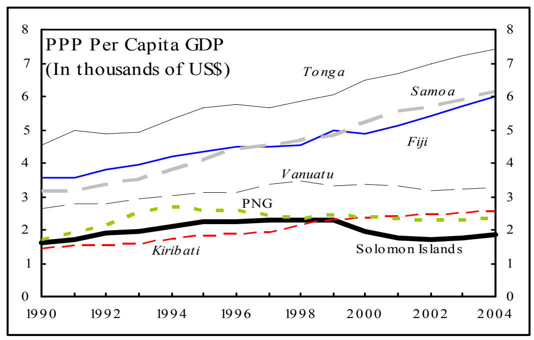
- **After regularizing its domestic debt, the government is seeking debt relief from its external creditors.** The staff's debt sustainability analysis suggests that debt is high and its dynamics fragile.

- **Structural reforms should be accelerated to promote private sector development.** The new foreign investment regime should be introduced, state enterprise reform deepened, and governance reform vigorously pursued.

I. Background

1. **The recovery that began in mid-2003 has continued, but structural reforms have lagged.** With the restoration of law and order and extensive donor assistance after the Australian-led intervention-force (Regional Assistance Mission to the Solomon Islands, RAMSI) arrived in mid-2003, macroeconomic stability has been maintained and some improvements in service delivery achieved. The government has begun addressing some of the reform priorities identified in the 2003–06 *National Economic Recovery, Reform, and Development Plan* (NERRDP)—law and order, good governance, financial stability and public sector reform, revitalizing the productive sector, rebuilding infrastructure, restoring basic services, and fostering social development—but progress has been mixed.

2. **Enormous challenges remain.** Per capita GDP is still only two thirds of the preconflict level as the civil conflict of 1999–2000 destroyed infrastructure and disrupted economic activity. Given rapid population growth, it would take about 27 years of 4½ percent annual growth to reach preconflict per capita GDP. The Solomon Islands has the lowest real per capita GDP of all Pacific island countries (PICs), and the gap with the best performing PICs has almost doubled in the past 20 years. Although data deficiencies hamper the assessment, several social indicators appear to fall well short of the Millennium Development Goals (MDGs), with high incidence of malaria and almost a third of the population lacking access to safe water (Annex VI).



3. **While the conflict set the Solomon Islands back, its economic problems have deeper roots.** In particular, obstacles to private sector development—such as limited infrastructure, ill-defined property rights, and labyrinthine regulations—have made the economy overly-reliant on timber. Weak governance and public sector management have also fostered macroeconomic imbalances.

4. **The country is at a cross-roads—logging will decline, and unless growth picks up elsewhere, living standards will fall.** At the current, unsustainable rate, the authorities estimate that logging will exhaust forests by 2015, making it critical to develop a sustainable forestry management plan, and create an environment conducive to growth in other sectors—mainly agricultural commodities, mining, tourism, and small manufacturing.

5. **Previous Article IV consultations have underscored the need to maintain macroeconomic stability while tackling structural reforms.**[1] Although macroeconomic

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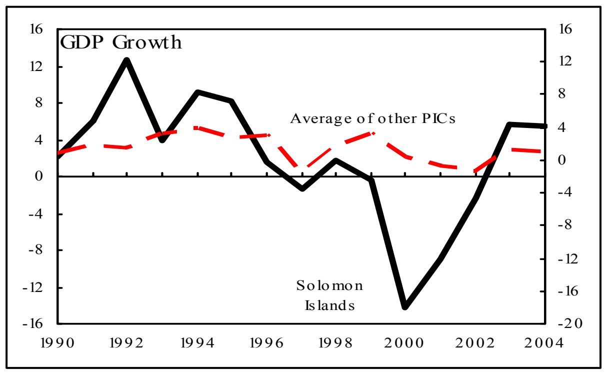
[1] Directors' comments at the conclusion of the 2004 Article IV consultation can be found at http://www.imf.org/external/np/sec/pn/2004/pn0489.htm.

stability has been maintained, progress on structural reforms has been slow. In the fiscal area, tax administration has improved, and the government has started work on a medium-term fiscal framework. Nevertheless, recommendations to avoid new income tax exemptions and generalized wage increases unless in the context of realized savings in the rest of the wage bill have not been followed. In the structural area, work has started on a wide range of reforms, but progress, especially on the legislative front, has been slow, as attaining reform buy-in has required extensive consultations.

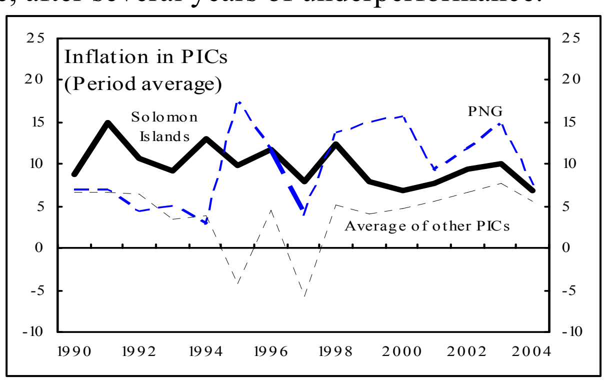
6. **The political situation is fluid.** The parliamentary elections, scheduled for early 2006, might make it difficult to accelerate the reform agenda. Further, with volatile political allegiances and typically a high turnover of parliamentarians in any election, the result is unpredictable.

II. Recent Economic Developments and Near-Term Outlook

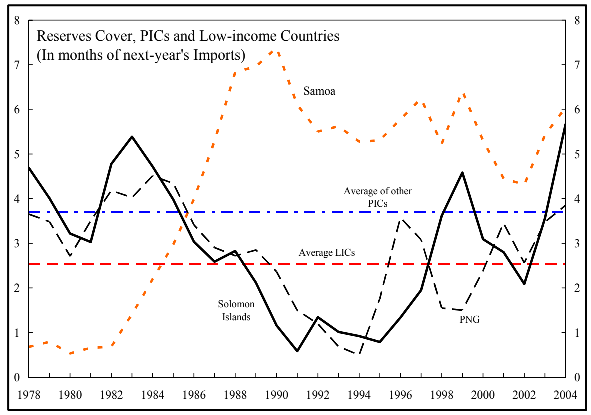
7. **The recovery should continue this year, keeping the Solomon Islands' real growth rate above the regional average.** Boosted by logging, real GDP growth was 5½ percent in 2004 for the second year running (Table 1 and Figure 1). Two major projects, the reopening of a palm oil plantation and the rehabilitation of a gold mine, started earlier this year. Real growth is projected to moderate somewhat to 4½ percent in 2005 because of no net contribution from logging (despite it remaining at about four times the sustainable rate), but new activities should raise nonlogging growth to 5 percent from 3¼ percent in 2004. The Solomon Islands' growth in the past three years has been about 2½ percentage points above the PICs' average, after several years of underperformance.



8. **After rising to 7.8 percent by end-2004, inflation is projected to be broadly unchanged in 2005, remaining above the regional average.** Inflation rose in 2004 due to increased nontradable demand by expatriates and rising fuel prices. This year, inflation is projected to remain at about the 2004 level, due to the continued pass-through of persistently high oil prices and the pickup in economic activity.



9. **Following a large improvement in 2004, the external position is projected to be less favorable in 2005.** Export volume growth exceeded 35 percent in 2004, with both timber and other primary commodity exports booming. This, coupled with low imports and an almost doubling of current transfers, resulted in a 12½ percent of GDP current account surplus. Net international reserves (NIR) rose to US$76 million (5½ months of imports)—high by historical and comparators' standards—boosted also by sizable inflows of official development assistance (Table 2 and Figure 2). The deterioration expected in 2005, with the current account shifting to a deficit of 11 percent of GDP, is mainly due to the high import content of investment projects, a rising oil import bill, and recovery from a low import base. With development grants and FDI (linked almost entirely to the two major projects underway) expected to be strong, NIR should decline only marginally to about US$75 million, 4.5 months of projected 2006 imports.



10. **After an unusually large surplus in 2004, the fiscal position is projected to post a small deficit.**[2] The central government surplus was 8¼ percent of GDP in 2004 due to higher grants, improved tax collection, eliminating militia payments, tighter expenditure controls, and limited spending capacity (Table 3 and Figure 3). Strong growth and clearing of most domestic arrears cut the public debt-to-GDP ratio to 92 percent from 122 percent in 2003. Despite further tax revenue gains, a small deficit (½ percent of GDP) is projected in 2005, as spending capacity and the wage bill rise, and external direct budget support falls. The public debt-to-GDP ratio should fall again modestly, but the realization of contingent liabilities equivalent to 6½ percent of GDP is projected to lead to a slightly higher NPV of external debt to GDP and to exports, both above thresholds.

11. **Reserve money growth was primarily reflected in a large buildup of banks' excess reserves in 2004, but credit growth has recently picked up.** Soaring net foreign assets at the central bank led to a 74 percent rise in reserve money in 2004, despite a buildup of government deposits (Table 4 and Figure 4). Banks' caution limited real private credit growth to 2.5 percent and resulted in banks accumulating excess reserves amounting to 39 percent of deposits. Reflecting the pickup in economic activity, real private credit growth rose to 21 percent year-on-year in May and banks' excess reserves dropped to 32 percent of deposits.

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[2] Due to data availability, the analysis of the fiscal position is limited to the central government.

III. Policy Discussions

12. **With broad agreement on the challenges facing the Solomon Islands, discussions focused on the macroeconomic policies needed to support the reform process over the medium term.** The critical challenges are to sustain growth, broaden its base, and address poverty, while safeguarding fiscal sustainability and sound monetary and financial sector policies. It was recognized that structural reforms play a key role in achieving these goals. While highlighting the risks of inaction, staff stressed that the current situation offers an opportunity to tackle long-standing issues, provided budget discipline is maintained and large donor assistance continues as expected.

A. Medium-Term Outlook

13. **Two key uncertainties shroud the medium-term outlook:**

- **The contribution of logging and activities that could replace it.** The contribution of logging to growth over the next few years depends on whether sustainable forestry management will be introduced and, if so, when. The contribution of other sectors to growth, mainly agricultural commodities and mining, will depend on investor confidence and an improved business environment, as well as technical factors affecting individual sectors, such as mining exploration.

- **The amount and timing of donor flows.** The largest single donor, Australia, recently committed funding for AusAID and RAMSI through 2009, with indications that assistance will continue beyond that date. The European Union has pledged a substantial amount, although disbursements have been slow. New Zealand's budget support is scheduled to end in 2006, but continued assistance has been signaled. While these flows are expected to continue to be sizable over the next several years, they will likely moderate and, their pace and size remain unpredictable.

14. **The staff's baseline medium-term macroeconomic scenario illustrates the potential rewards of the authorities' planned reforms.** Under the assumptions that macroeconomic stability is maintained, a critical mass of structural reforms is implemented (see below), and RAMSI and donors stay engaged, staff projects that annual growth could plausibly average about 4½ (1½ per capita) percent in 2006–10, driven mainly by private investment and exports (Annex I, and Tables 5 and 6). Inflation is projected to decline gradually. The external current account deficit would peak in 2006, due to imported capital goods, and narrow gradually over the projection horizon as export capacity is developed. Reserves would fall modestly as aid moderates, but reserve coverage would stabilize at four months of imports. Nevertheless, all projections are subject to considerable uncertainty.

15. **Risks to the baseline scenario are skewed to the downside, even though a faultless implementation of reforms might engender a stronger supply response.**

Downside risks stem from lackluster policy implementation, political instability, lower donor flows and international commodity prices, and disruptions in the development of major projects. Staff views setbacks in policy implementation as the main risk at least in the near term, partly because of the upcoming elections. Further, this phase of economic reform is more difficult than the initial stabilization, as it requires confronting vested interests and improving governance. A slow reform process, simulated in the staff's alternative scenario, would undermine macroeconomic stability and could limit donor support (Table 7). Lack of economic opportunities could also rekindle ethnic tensions. Given high external vulnerability, the external position would deteriorate if new export activities do not commence, also because private remittances are not sizable (Table 8). In such a scenario, debt service arrears would likely accumulate and imports contract. The fiscal accounts would also come under strain and force a large reduction in public services and spending. On the other hand, a stronger reform drive with flawless implementation could push growth to an annual average of about 6 percent in 2006–10.

16. **The authorities broadly agreed with the staff's analysis, and underscored the complexity of their task.** They welcomed the focus on the medium term and expressed their intention to advance reforms to stimulate growth, while pointing out that slow implementation of some infrastructure projects also reflected donors' slow disbursements. The authorities shared the view that growth needs to be private-sector led, with the public sector establishing the enabling environment. Further, they explained that the government's current poverty reduction strategy centers around promoting growth, and noted that the subsistence economy plays an important role in alleviating extreme poverty and providing a buffer against shocks. Nevertheless, highlighting the difficulties, the authorities described their starting point as comprising a degraded public sector, weak institutions, and obsolete or non-existing infrastructure.

B. Fiscal Policy

17. **The 2005 budget envisages a shift to a 1½ percent of GDP deficit from an 8¼ percent of GDP surplus in 2004.** About half of the deterioration in the budget balance is due to exceptional, one-off factors, primarily Australia ending direct budget support (3.3 percent of GDP) and revenue from a tax amnesty and payment of back taxes (1 percent of GDP) in 2004, and a civil servants bonus paid in June 2005 (0.8 percent of GDP). Also, the budget allocates additional resources for key priorities and higher spending is partly due to the government's taking over some programs previously run by donors. While acknowledging the importance of the special factors affecting the budget in 2004–05, staff cautioned against an overly expansionary fiscal stance and its implications for the budget over the medium term, arguing that the budgeted expenditure increase could be too large to be spent well at current capacity levels and that a stronger budget balance would avoid frequent changes of direction in fiscal policy.

18. **Staff advised saving any revenue over-performance and any under-spending on investment projects and in other areas that may occur this year, while holding current expenditure tightly to the budget.** Tax revenue is likely to over-perform as tax

administration improvements yield results, and logging and import duties are on track to exceed budget estimates. The pace of domestically-financed capital spending, some government programs, and the process of filling vacancies are again likely to fall prey to capacity constraints. Some current spending overruns, especially in administrative and representation costs, are expected, but should not fully offset other factors. Provided the government resists emerging spending pressures in nonpriority areas, the budget outturn could be roughly 1 percent of GDP better than budgeted.[3] The authorities noted that expenditure pressures were intensifying, but were fairly confident to keep within budget even if the contingency warrants are spent. Under existing legislation, the cabinet has the power to spend a certain amount beyond parliamentary appropriations, the so-called contingency warrants, which in 2005 amount to 1 percent of GDP for recurrent outlays and an equal amount for development spending. In the staff's projection, only the recurrent contingency warrant is assumed to be utilized.

19. **Medium-term fiscal risks loom.**[4] Besides spending pressures arising from wage demands and administrative costs, social, infrastructure, and operations and maintenance needs are likely to strain the budget going forward. An anticipated decline in aid flows over time is one source of these pressures, as services currently offered by donors, as well as infrastructure construction projects will be taken on by the government. Maintenance costs for new infrastructure will also become an increasingly important source of these pressures. On the revenue side, direct foreign budgetary support is likely to decline further, and tax receipts from logging and imports (due to tariff reductions as part of the Pacific Island Countries Trade Agreement) are expected to fall. Moreover, the government still has a substantial stock of arrears, and debt servicing costs are projected to rise.

20. **To meet the medium-term challenge that the Solomon Islands faces, the authorities agreed that the 2006 budget should seek to consolidate the fiscal position.** Given limited sources of financing and the need to reduce public debt to safer levels, an adjustment of about 1½ percentage points of GDP would be appropriate and is feasible. It could be obtained by ensuring this year's 16 percent bonus to civil servants is not incorporated in base salaries (equivalent to about ¾ percent of GDP), further tax administration gains, containing nonproductive outlays, and, if necessary, by adjusting excises, fees, and the determined prices for logs (which has not been done in years).

21. **The authorities said that decisions regarding the composition of public expenditure require careful medium-term planning.** Currently, donors are providing several basic government services. Spending for police and law and justice is high in the

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[3] In contrast to budget support grants, development grants, for which very limited data exist and are estimated by staff, are currently administered directly by donors, and hence cannot directly generate a surplus for the government budget.

[4] These risks are discussed in the Selected Issues paper.

present post-conflict situation and should decline over time. Also, these services will cost less once provided by local personnel. Nevertheless, as donors scale down their activities, the government will need to decide which services to provide, as well as the level of infrastructure spending.

22. **The authorities have started work toward a medium-term fiscal framework and welcomed the staff's proposal of a combined-source budget.** A medium-term fiscal framework would help determine the resource envelope and avoid large swings in the level of public services. Incorporating donor flows into a combined-source budget would be an important tool to help the government decide on the level of services, by providing a quantification of the overall level of services currently offered, at present unavailable due to scant information on donor activities. It should also improve the fit between the government's priorities and donors' projects and facilitate donor coordination.

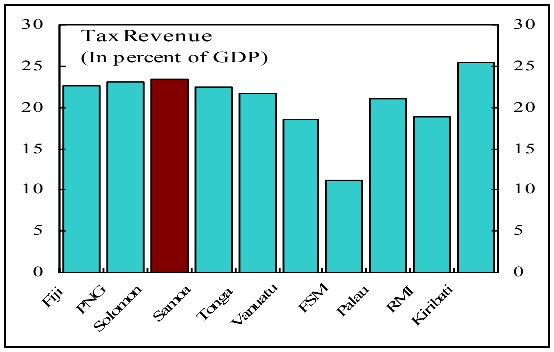
23. **The government needs to make spending more productive.** The Solomon Islands' 2005 wage bill is the highest among the large PICs, and PICs generally have wage bills well above the low-income country average. Staff encouraged the authorities to accelerate preparations for a comprehensive civil service reform, which should be integrated within the medium-term budget framework. To deal with the tension between containing the wage bill and filling critical vacancies, room for needed qualified professionals could be created by rationalizing civil service employment and decompressing the wage scale. In the social sectors, obtaining better outcomes for already sizable levels of spending and reallocating resources toward primary education and health care has priority.

Social Spending and Wage Bill in Selected Pacific Island Countries
(In percent of GDP)

	Education Spending	Health Spending	Wage Bill
Solomon Islands 1/	**8.5**	**4.0**	**10.6**
Fiji	5.6	2.7	10.4
PNG	2.3	3.9	9.2
Samoa	4.8	4.7	7.9
Other PICs average	6.4	5.2	17.7
East Asia and Pacific	3.2	1.9	...
Low-income countries	3.2	1.5	5.7

Sources: World Bank, 2005 World Development Indicators, IMF Staff Reports
1/ Budget figures for 2005

24. **Over the medium-term, widening the tax base is imperative.** While the tax revenue-to-GDP ratio is broadly in line with other PICs, tax rates, with the exception of excises, are among the highest in the region. Staff urged the authorities not to grant new tax exemptions, reduce the scope of existing ones, and continue implementing the Pacific Financial Technical Assistance Center's (PFTAC) recommended tax and customs administrative reforms. The authorities responded that no future tax holidays are envisaged, but noted that the backlog of logging duty exemptions would continue to erode revenue for some time.



Tax Rates in Selected Pacific Island Countries			
	Personal Income Tax 1/	Corporate Income Tax	Sales Tax or VAT
Solomon Island	40	30 2/	15 3/
Fiji	32	30	12.5
Kiribati	35	25	0
PNG	47	30	10
Samoa	29	29	12.5
Vanuatu	...	...	12.5
Tonga	10	30	15

Sources: Fund staff reports.
1/ Highest income bracket.
2/ Corporate tax rate for non-residents is 35 percent.
3/ Sales tax rate for rice is 5 percent and other consumption goods is 10 percent.

25. **The tax reform being considered by the authorities envisages a VAT-type tax as the linchpin of the indirect taxation system.** The authorities noted that the proposed tax reform would have several advantages, notably eliminating distortionary effects, especially cascading under the present goods and sales taxes, removing most of the existing exemptions, and providing an alternative revenue source to replace the loss from import and logging duties anticipated over the medium term. Later, the tax reform would also simplify direct income taxes and lower rates.

26. **Staff advised caution on fiscal decentralization.** As plans to implement a federal system are being actively discussed, they continued to advise that fiscal decentralization was not prudent until public finances and administrative capacity strengthen and would likely entail weaker fiscal discipline. The authorities noted that the aim of decentralization would be to improve service delivery in the provinces and that any move toward decentralization would take a long time to implement. If this proposal were to go ahead, safeguards to prevent local governments from borrowing should be put in place.

C. Debt

27. **The authorities described their debt situation as "unsustainable," and were keen to regularize it.** They pointed to the narrow revenue base, the large arrears, and the high opportunity cost of servicing debt given the country's development spending needs. Hence, they viewed the need to regularize the external debt situation as a critical ingredient to support reforms. The government is proceeding with its Honiara Club proposal to restructure external debt and clear external arrears. The authorities explained that they were seeking debt relief from their external creditors and viewed the multilateral framework to be provided by the Honiara Club under the auspices of a broker as more propitious than bilateral negotiations. They expected that these negotiations would start after the conclusion of this consultation. On the domestic side, having restructured domestic bonds in 2004, the government is gradually paying expenditure arrears owed mainly to suppliers

Solomon Islands: External Debt as at end-2004
(In millions of US$)

	Outstanding Balance	Share of Total
Total (including arrears)	159.9	100.0
Arrears 1/	15.8	9.9
Total (excluding arrears)	144.1	90.1
Multilateral	100.1	62.6
Of which:		
Asian Development Bank	49.5	30.9
World Bank (IDA)	46.4	29.0
Bilateral	37.0	23.1
Commercial	7.1	4.4

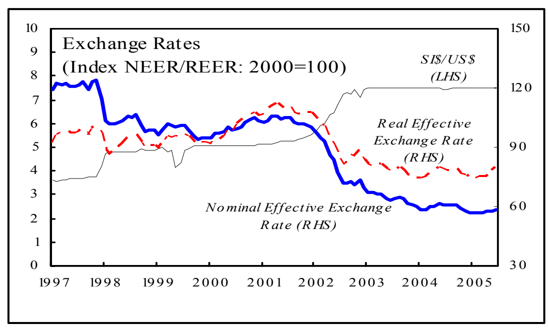
Sources: Solomon Islands' Authorities and Fund staff estimates.
1/ Arrears are principally to bilateral and commercial creditors.

(amounting to about 8 percent of GDP) and formulating plans on how to handle the largest claims.

28. **Staff encouraged the government to normalize relations with its creditors and discussed the debt sustainability analysis (DSA).** Staff also underscored the importance of honoring future debt service obligations. The staff's DSA suggests that debt is high, with some indicators currently above thresholds, and its dynamics fragile (see Annex I). Although debt indicators improve over time in the baseline scenario, some scenarios and shocks, even some temporary ones, could cause debt ratios to deteriorate significantly. These findings, combined with the country's poor credit history, and the high likelihood of further contingent liabilities being realized, suggest that the Solomon Islands is at high risk of debt distress.

D. Exchange Rate and Monetary Management

29. **Staff continued to support the CBSI's policy to resist upward pressure on the exchange rate in the face of strong foreign inflows.** After depreciating by 34 percent in 2002, primarily reflecting the civil unrest, the CBSI has de facto pegged the Solomon Islands dollar to the U.S. dollar since early 2003, and has indicated that this exchange rate regime would be maintained in the near term. Staff supported this policy as reserve accumulation in these circumstances is appropriate because large aid flows are expected to be volatile, and taking this opportunity to build reserves helps buffer the economy against the influence of these flows and potential external shocks. An appreciation of the exchange rate would reduce external competitiveness, and although export performance is heavily influenced by supply factors, it would undesirably disadvantage exporters additionally through prices.



30. **As aid flows diminish and imports grow in line with the economy, staff suggested that downward pressure on the exchange rate should not be resisted.** Given the country's exposure to external shocks and the priority of maintaining an adequate level of reserves, the CBSI agreed with this advice, and indicated that the exchange rate regime would be reviewed when necessary. They explained that, at a minimum, reserves should cover 3½ months of imports and agreed that the real exchange rate level—almost 20 percent lower than pre-conflict levels—appears broadly adequate at present, as indicated by the positive performance of nontimber exports.

31. **The exchange rate has so far provided an effective nominal anchor, but going forward the conduct of monetary policy is likely to become more challenging.** Inflation has remained below 8 percent in the past two years, but continued strong foreign inflows and a substantial drawdown of government deposits or banks' excess reserves as credit rises could jeopardize the CBSI's single digit indicative target, given the limited instruments at its disposal. The Governor explained that, if credit growth were to become inflationary, the

CBSI stands ready to take appropriate measures, including moral suasion and administrative measures, if necessary. Improving the functioning of the T-bill market could also be pursued to develop indirect instruments for liquidity management in the future, but its contribution in the short run would be limited due to the perceived risk of government debt.[5]

E. Financial Sector Issues

32. **The commercial banking system continues to perform well, while the development bank should be liquidated.** All commercial banks—comprising two foreign banks with a combined market share of 57 percent and a local private bank—are well capitalized and the aggregate capital to risk-weighted assets ratio is over 25 percent. Asset quality has improved with a decline in nonperforming loans to 1.9 percent of total from 5.5 percent at end–2003. Despite the recent fall, profitability remains robust (return on equity averages about 20 percent) and liquidity is high.[6] The CBSI, as the court-appointed manager, has made progress in repaying depositors of the troubled Development Bank of the Solomon Islands (DBSI) and shrinking its balance sheet. Staff advised to liquidate the DBSI and confront the challenge of financing the institution's liquidation, currently estimated to cost ¾ percent of GDP.

33. **The profitability of the National Provident Fund (NPF) remains a concern.** Despite improved liquidity, poor asset quality (nonperforming assets are estimated at 13 percent of total) and low yields affect the NPF's ability to generate a return sufficient to cover operating costs and the 2.5 percent annual return to contributors mandated by law. The authorities noted that greater transparency in the NPF's operations had already been introduced and efforts were being made to improve governance and redefine the objectives of the institution to protect members' contributions, including by preparing a new NPF bill. Staff recognized the benefits of allowing the NPF to invest abroad, especially given limited domestic investment opportunities, but advised that conservative investment guidelines be adopted to prevent asset mismanagement.

34. **Staff welcomed the progress on anti-money laundering and combating the financing of terrorism (AML/CFT).** After the amended AML Act came into force in May, the CBSI issued the Customer Due Diligence guidelines to banks to introduce reporting requirements for AML/CFT. With the Fund's and donors' assistance, a financial intelligence unit is in the process of being established.

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[5] The development of the T-bill market is discussed in the Selected Issues paper.

[6] While deposit-lending spreads remain high due to the high risk environment, banks typically offer lower lending rates to clients with good creditworthiness and hence high spreads are not deemed an obstacle to private sector development. Although spreads obviously contribute, the major source of banks' profitability are foreign exchange transactions.

F. Structural Reforms and Other Issues

35. **The newly established Economic Reform Unit is leading several reform efforts to meet the NERRDP objectives, but much remains to be done to implement them.** The authorities and staff shared the view that reforms to promote a better business environment, reforming state-owned enterprises (SOEs), enhancing infrastructure, and improving governance are key priorities, with building civil service capacity a prerequisite for all of them. Staff highlighted the signaling effect of individual reforms reaching the implementation stage and the importance of sustaining the reform momentum to support business confidence.

36. **A new foreign investment bill is spearheading the efforts to improve the business environment.** The proposed bill would reform the investment regime—rendering the registration process simpler, more transparent, and nondiscretionary—but awaits parliamentary passage. Staff also encouraged the authorities to proceed with a review of investment incentives and administrative barriers to businesses (especially, business licensing procedures and foreign labor permits), which the Foreign Investment Advisory Service of the International Finance Corporation is facilitating.

37. **SOE restructuring has advanced somewhat.** Staff commended the authorities' efforts to restructure Solomon Airlines, expected to be ready for privatization in late 2005, and suggested that it might serve as a model for reforming other SOEs. With the assistance of the World Bank, a draft restructuring plan for the Solomon Islands Electricity Authority has been prepared, although some key decisions have yet to be made. It is expected that the restructuring of the Water Authority would start next. A review of the regulatory environment for utilities is also being considered and the audited accounts of public enterprises are being prepared. SOE restructuring would improve service delivery and support the revival of economic activity, as well as reduce fiscal risks, as some of these companies are making losses mainly financed via inter-institution arrears.

38. **With external assistance, infrastructure is slowly starting to be rebuilt.** Financed by donors, road construction and other infrastructure projects have recently commenced. The Asian Development Bank (AsDB) is assisting the government in strengthening the ministry of infrastructure and develop a national transport plan. Inter-island shipping, a key ingredient to rural development, is also being addressed and additional wharves are being built.

39. **The authorities recognize the importance of better governance and, with RAMSI's assistance, are making progress in several areas.** Last July, parliament approved legislation to introduce a single ballot box, which is expected to reduce the scope for vote-buying. Programs to strengthen many institutions, including parliament, the justice system and watchdogs, and increase the participation of civil society in oversight are under way. Some economic institutions, for example the Ministry of Finance and the NPF, have become more transparent by publishing regular press briefings and their accounts.

40. **The authorities are improving the statistical database, which is barely adequate for surveillance and continues to hamper it (Annex VII).** Data deficiencies are significant in the real, fiscal, and external sectors. With the exception of crude GDP estimates, national accounts have not been produced since 1994. Very limited data are available on donor activities and the accounts of public institutions outside the central government do not exist. Partial balance of payments data are estimated using foreign exchange transactions, and are suspected to misstate trade. These shortcomings make assessing the fiscal stance and the external position challenging. The National Statistical Office (NSO) is beginning a household income and expenditure survey this October, plans to prepare complete national accounts in 2006, and is preparing preliminary trade estimates based on customs data. Staff and the authorities agreed on the need to collect data on aid flows and produce accounts for public institutions outside the central government.

IV. Staff Appraisal

41. **The notable improvement in the Solomon Islands' economic performance, which started after RAMSI's arrival, has continued.** Against the backdrop of improved security, macroeconomic stability has been maintained and economic activity has rebounded. The authorities have achieved better service delivery and started to work on structural reform. Aid flows have risen, and donors have pledged assistance for some time to come.

42. **Nevertheless, major challenges remain.** The key issue is to sustain per capita growth over the medium term, while logging will decline from its present unsustainable rate. This requires embracing structural reform and setting macroeconomic policies within a longer-term horizon. Structural reforms are needed to promote private sector development. Fiscal reforms have to ensure adequate provision of government services and infrastructure without jeopardizing fiscal sustainability. Price stability is necessary for a stable macroeconomic environment. Now is a good opportunity to tackle long-standing issues, but risks are skewed to the downside.

43. **Given limited financing sources and the need to reduce public debt, the government must consolidate its budget.** A start toward this could be made by ensuring that this year's budget outturn comes in better than budgeted. This could be achieved by saving any revenue overperformance and any underspending, while holding current outlays tightly to the budget. There is also an opportunity in the 2006 budget to consolidate the fiscal position by ensuring one-off bonuses paid to civil servants in 2005 do not enter base salaries, pursuing further tax administration gains, and containing nonproductive expenditure. Although debt indicators improve under the baseline scenario, fragile debt dynamics and the country's credit history suggest that the Solomon Islands is at high risk of debt distress. The authorities should normalize relations with creditors as soon as possible.

44. **Over the medium term, the efficiency of government spending will have to be substantially raised and revenue should be kept broadly constant in relation to GDP.** Spending decisions and a civil service reform should be set within a medium-term budget framework and a combined-source budget incorporating aid flows. The government should

start re-orienting expenditure away from the wage bill and toward infrastructure, maintenance, and primary education and health care. No new tax exemptions should be granted and the scope of existing ones curtailed. The proposed tax reform would go a long way in improving revenue generation. Fiscal decentralization, at least until public finances and capacity strengthen, would be imprudent and would likely weaken fiscal discipline.

45. **The policy of stabilizing the exchange rate in the face of strong foreign inflows is appropriate.** The CBSI has de-facto pegged the Solomon Islands dollar since early 2003 and rebuilt reserves, as large aid flows are expected to be temporary and volatile. However, downward pressure on the exchange rate should not be resisted given the country's exposure to external shocks and the priority assigned to maintaining an adequate reserve level. External competitiveness appears adequate at present.

46. **The exchange rate regime has so far served the country well as a nominal anchor, but going forward, the conduct of monetary policy could become more challenging.** As the CBSI has recognized, continued strong foreign inflows combined with a drawdown of government deposits and an acceleration in private credit growth might jeopardize its indicative single digit inflation target. The CBSI should continue to stand ready to rein in credit growth, including, if necessary, via administrative measures, given limited instruments at its disposal.

47. **The commercial banking system continues to perform satisfactorily, though the NPF's weak profitability is a concern and the DBSI should be liquidated.** Commercial banks are well capitalized and asset quality has improved. The NPF, however, continues to suffer from low profitability, despite improved liquidity. Letting the institution invest abroad could be beneficial, but strict investment guidelines should be adopted first. The new NPF bill should be passed. Pressures to revive the DBSI should be resisted and the bank liquidated.

48. **Structural reforms play a crucial role in creating an enabling business environment for private sector development and achieving higher per capita income.** Passage of the foreign investment bill would send a signal to investors and donors about the authorities' commitment to reform. Deepening and extending SOE reform, in particular of the utilities, is needed to improve service delivery and reduce fiscal risks. Infrastructure is slowly being rebuilt, which is key to boost new economic activities. Better governance and institution strengthening are afoot in a number of areas and their continuation is critical in maintaining confidence and ensuring equal opportunities for all in society.

49. **The statistical database is barely adequate for surveillance and continues to hamper it.** Data shortcomings in the real, fiscal, and external sectors, hinder the assessment of the fiscal stance and external position. Nonetheless, remedial efforts are under way in a number of areas.

50. **It is proposed that the next Article IV consultation be conducted on the 12-month cycle.**

Table 1. Solomon Islands: Selected Economic Indicators, 2000–05

Nominal GDP (2004): US$258 million
Population (2004): 469,400
GDP per capita (2004): US$550
Quota: SDR 10.4 million

	2000	2001	2002	2003	2004 Est.	2005 Proj.
Growth and prices (percentage change)						
Real GDP	-14.3	-9.0	-2.4	5.6	5.5	4.4
Of which : Marketed output	-19.9	-13.9	-4.8	8.9	7.8	5.0
CPI (period average)	6.9	7.6	9.4	10.1	6.9	6.6
CPI (end of period)	7.6	6.5	15.4	3.8	7.8	8.0
Nominal GDP (millions of SI$)	1,523	1,447	1,527	1,710	1,932	2,151
Nominal GDP (millions of US$)	299	274	226	228	258	285
Per capita GDP (in US$)	714	637	510	499	550	591
Central government operations (percent of GDP)						
Total revenue	22.1	23.5	18.8	37.6	48.9	48.5
Recurrent revenue	18.3	15.3	16.2	19.5	26.8	26.6
Grants	3.7	8.2	2.6	18.1	22.1	21.8
Total expenditure 1/	29.9	36.2	29.8	39.5	40.6	49.0
Recurrent expenditure	25.3	27.3	26.6	23.9	22.9	27.9
Development expenditure	4.6	8.9	3.2	15.6	17.7	21.1
Recurrent balance 2/	-6.3	-11.8	-10.0	-0.5	8.4	1.0
Overall balance 3/	-7.8	-12.7	-11.0	-1.9	8.3	-0.5
Foreign financing (net)	0.6	5.0	3.8	0.4	-1.6	-0.6
Domestic financing (net)	4.2	-1.4	-3.0	-9.0	-6.7	1.3
Other	0.4	8.5	9.0	10.0	-2.4	-0.2
Stock of expenditure arrears (in percent of GDP, end of period) 4/	4.9	8.9	12.1	14.9	8.0	7.8
Domestic principal arrears (percent of GDP)	0.0	3.9	7.1	12.1	0.0	0.0
Central government debt (percent of GDP) 5/	69.7	94.1	114.1	122.0	92.3	88.0
Domestic	27.8	45.1	47.1	51.5	30.4	26.7
External	42.0	49.0	67.0	70.6	62.0	61.4
External debt (in US$ millions, end of period)	125.6	134.3	151.6	160.8	159.9	175.1
External debt service to exports of GNFS (accrual basis)	3.9	8.1	10.3	9.0	5.9	7.8
Monetary and credit (percentage change, end-year data)						
Net foreign assets	-39.8	-31.8	30.2	106.4	111.0	0.8
Net domestic assets	46.8	-4.4	-4.8	-11.0	-60.4	85.1
Net domestic credit	23.0	-7.2	11.0	-0.7	-36.1	43.3
Credit to private sector	1.8	-21.8	12.2	26.1	10.6	40.0
Broad money	0.5	-13.2	4.0	26.0	28.1	13.4
Interest rate (3-month t/bill rate, average) 6/	7.3	8.9	8.3	5.8	6.0	3.5
Balance of payments (US$ millions, unless otherwise indicated)						
Exports, f.o.b	65.1	47.1	57.8	74.2	96.7	100.2
Imports, c.i.f.	-98.1	-90.6	-62.3	-85.2	-98.7	-140.3
Current account	-31.7	-35.1	-16.3	3.1	32.3	-30.8
(Percent of GDP)	-10.6	-12.8	-7.2	1.3	12.5	-10.8
Capital account	8.5	17.2	6.3	11.1	8.1	27.5
Overall balance (accrual)	-23.1	-17.9	-10.0	14.2	40.4	-3.2
Gross official reserves (US$ millions, end of period)	31.3	18.5	17.5	36.0	79.0	78.5
(in months of next year's imports of GNFS)	3.1	2.8	2.1	3.6	5.7	4.7
Exchange rate (SI$/US$, end of period) 6/	5.10	5.56	7.46	7.49	7.51	7.52
Real effective exchange rate (period average, 2000=100) 7/	100.0	109.2	90.8	78.5	77.4	78.3
Nominal effective exchange rate (period average, 2000=100) 7/	100.0	103.2	80.1	64.0	59.6	57.8

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

1/ Expenditures are presented on an accrual basis.
2/ Includes recurrent budget grant support.
3/ Calculated from above-the-line data.
4/ Includes interest arrears.
5/ Includes arrears.
6/ 2005 column reflects data for end-July 2005.
7/ 2005 column reflects data for end-May 2005.

Table 2. Solomon Islands: Balance of Payments, 2000-05

(In millions of U.S. dollars)

	2000	2001	2002	2003	2004 Est.	2005 Proj.
Current account balance	-31.7	-35.1	-16.3	3.1	32.3	-30.8
Current account balance (excl. net public sector transfers)	-32.4	-44.7	-22.9	-6.1	21.3	-35.5
Trade balance	-32.9	-43.5	-4.5	-11.0	-2.0	-40.1
Merchandise exports, f.o.b.	65.1	47.1	57.8	74.2	96.7	100.2
Of which: Timber	44.1	36.1	37.7	49.5	62.6	62.7
Fish	8.1	7.1	10.5	12.4	17.6	16.6
Merchandise imports, c.i.f.	98.1	90.6	62.3	85.2	98.7	140.3
Of which: Petroleum	18.4	14.4	11.2	11.7	23.3	37.6
Services and income (net)	13.8	-6.3	-6.3	0.7	9.0	-2.1
Nonfactor services (net)	14.6	-6.4	-0.4	6.0	7.7	2.4
Net factor income from abroad	-0.8	0.1	-5.9	-5.3	1.4	-4.5
Net current transfers	-12.6	14.7	-5.5	13.4	25.2	11.4
Private sector	-13.3	5.0	-12.1	4.2	14.2	6.7
Receipts	16.5	24.0	15.9	18.4	37.1	14.4
Payments	29.7	19.0	28.1	14.2	22.9	7.6
Public sector	0.7	9.6	6.6	9.2	11.1	4.7
Receipts	2.2	10.0	7.3	14.3	13.0	6.6
Payments	1.5	0.4	0.7	5.2	1.9	1.9
Capital account balance	8.5	17.2	6.3	11.1	8.1	27.5
Government sector	7.3	18.3	5.8	12.2	8.5	20.9
Medium and long-term lending	1.7	13.9	2.7	-0.5	-4.0	-1.7
Inflows	4.4	16.8	6.0	3.1	0.3	3.4
Amortization	2.7	2.9	3.3	3.6	4.3	5.1
Investment flow (projects)	5.5	4.4	3.1	12.7	12.5	22.6
Private sector	1.3	-1.1	0.5	-1.1	-0.4	6.6
Investment activities (including FDI)	2.4	1.0	1.0	-0.1	0.3	7.3
Medium and long-term lending	-0.5	-1.2	0.0	-0.7	-0.5	-0.3
Inflows	0.4	0.0	0.5	0.0	0.0	5.0
Amortization	0.9	1.2	0.5	0.8	0.5	5.3
Other outflows	-0.7	-0.9	-0.5	-0.3	-0.3	-0.4
Overall balance (accrual)	-23.1	-17.9	-10.0	14.2	40.4	-3.2
Commercial bank holdings (increase)	-3.6	3.5	1.4	2.0	2.2	0.0
Errors, omissions, and valuation	-2.2	-4.5	7.2	3.3	1.1	0.0
Exceptional financing	2.7	13.0	3.1	3.0	3.7	2.8
Interest arrears	1.2	2.4	4.1	3.0	2.3	2.0
Amortization arrears	1.5	2.3	3.3	1.5	1.4	1.0
Pending import requests	0.0	8.3	-4.3	-2.4	-1.5	-0.1
Debt forgiveness	0.0	0.0	0.0	1.0	1.5	0.0
Restructured arrears	0	0	0	0.0	0.0	0.0
Overall balance (cash)	-19.1	-12.8	-1.0	18.5	43.0	-0.4
Memorandum items:						
Gross official reserves	31.3	18.5	17.5	36.0	79.0	78.5
(In months of next year's imports of GNFS)	3.1	2.8	2.1	3.6	5.7	4.7
NIR	29.0	16.3	15.8	33.1	76.0	75.5
(in months of next year's imports of GNFS)	2.9	2.5	1.9	3.3	5.5	4.5
(in months of next year's non-project imports)	3.7	3.2	2.5	4.1	6.4	5.3
NIR (excluding pending import requests and external arrears)	24.4	0.9	0.6	17.7	60.0	42.7
(in months of next year's imports of GNFS)	2.4	0.1	0.1	1.7	4.3	2.6
External debt (including arrears)	125.6	134.3	151.6	160.8	160.2	175.4
(in percent of GDP)	42.0	49.0	67.0	70.6	62.1	61.5
External arrears (interest plus principal)	4.6	7.1	11.1	13.8	15.8	32.8
Exports GNFS/GDP	38.0	26.2	32.9	41.9	49.2	45.4
Imports GNFS/GDP	44.1	44.4	35.1	44.1	47.0	58.6
Exports GNFS--Value Growth	-36.1	-36.8	3.7	28.1	33.2	1.9
Exports GNFS--Volume Growth	-33.6	-25.1	-1.7	52.4	35.6	-0.2
Timber Exports--Value Growth	-14.9	-18.2	4.4	31.4	26.4	0.3
Non-Timber Exports--Value Growth	-71.5	-47.5	82.5	22.8	38.3	9.4
Imports GNFS--Value Growth	-17.2	-7.9	-34.7	26.5	20.9	37.8
Imports GNFS--Volume Growth	-19.4	-2.9	-34.7	15.2	8.5	25.6
Current account (including transfers)/GDP	-10.6	-12.8	-7.2	1.3	12.5	-10.8
Current account (excluding transfers)/GDP	-10.8	-16.3	-10.1	-2.7	8.2	-12.4
Exchange rate (SI$/US$, average)	5.09	5.28	6.75	7.51	7.48	...
Terms of trade (index: 1990=100)	117.8	118.1	91.0	80.0	70.7	66.0

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

Table 3. Solomon Islands: Central Government Operations, 2000–05

(In percent of GDP)

	2000	2001	2002	2003	2004 Est.	2005 Budget	2005 Proj.
Total revenue and grants	22.1	23.5	18.8	37.6	48.9	45.1	48.5
Total revenue	18.3	15.3	16.2	19.5	26.8	25.6	26.6
Tax revenue	16.9	14.0	15.5	17.7	24.0	22.3	23.4
Income and profits	6.3	5.1	4.8	3.9	7.7	6.5	7.2
Goods and services	4.4	4.4	4.6	6.5	8.5	8.4	8.5
International trade and transactions	6.1	4.5	6.1	7.3	7.8	7.4	7.8
Tax on logging	...	...	...	3.2	3.3	2.7	3.0
Other revenue	1.5	1.3	0.7	1.8	2.8	3.4	3.2
Stamp duty	0.1	0.1	0.2	0.2	0.2	0.2	0.2
Licenses and fees	0.1	0.1	0.2	0.1	0.3	0.2	0.3
Miscellaneous revenue	1.3	1.0	0.3	1.5	2.3	3.0	2.7
Grants	3.7	8.2	2.6	18.1	22.1	19.5	21.8
Development grants 1/	14.4	8.0	2.2	14.3	17.6	17.6	19.5
Recurrent budget grants	0.7	0.3	0.5	3.8	4.5	1.9	2.3
Expenditure 2/	29.9	36.2	29.8	39.5	40.6	46.5	49.0
Recurrent expenditure	25.3	27.3	26.6	23.9	22.9	27.0	27.9
Compensation of employees	13.1	13.0	11.6	9.4	8.9	10.5	10.1
Goods and services	5.0	5.3	4.7	5.8	7.9	10.9	11.6
Interest	3.6	1.3	3.3	2.8	1.8	1.8	2.3
Grants to provinces	2.7	2.3	0.9	2.0	2.6	2.5	2.6
Employer social benefits	0.3	0.0	0.2	0.2	0.2	0.1	0.1
Other	0.6	5.4	5.8	3.8	1.4	1.0	1.1
Development expenditure	4.6	8.9	3.2	15.6	17.7	19.5	21.1
Grant financed 1/	3.1	8.0	2.2	14.3	17.6	17.6	19.5
Concessional loan financed	1.5	0.9	1.0	1.4	0.1	1.2	1.2
Domestically financed	0.0	0.0	0.0	0.0	0.0	0.7	0.3
Recurrent balance (above the line) 3/	-6.3	-11.8	-10.0	-0.5	8.4	0.4	1.0
Domestic balance (above the line) 4/	-8.4	-12.9	-11.4	-5.7	3.8	-3.3	-2.8
Overall balance (above-the-line)	-7.8	-12.7	-11.0	-1.9	8.3	-1.5	-0.5
Discrepancy (negative are net expenditures)	2.6	0.6	1.2	0.5	2.3	0.0	0.0
Overall balance (below-the-line)	-5.1	-12.1	-9.8	-1.4	10.6	-1.5	-0.5
Financing	5.1	12.1	9.8	1.4	-10.6	1.5	0.5
Foreign (net)	0.6	5.0	3.8	0.4	-1.6	...	-0.6
Disbursements	1.5	6.1	5.4	1.4	0.1	...	1.2
Amortization (accrual)	0.9	1.1	1.6	1.6	1.7	...	1.8
Debt forgiveness	0.0	0.0	0.0	0.7	0.0	...	0.0
Domestic bank and nonbank (net)	4.2	-1.4	-3.0	-9.0	-6.7	...	1.3
Banking system (accrual)	5.2	-3.3	-1.1	-8.8	-8.7	...	1.6
Central bank	4.3	2.9	2.4	-3.9	-5.9	...	2.1
Commercial banks	1.0	-6.2	-3.5	-5.0	-2.8	...	-0.5
Nonbank (accrual)	-1.1	1.9	-1.9	-0.2	2.0	...	-0.3
National Provident Fund	-1.4	0.7	-1.2	0.0	1.7	...	-0.3
Other	0.4	1.2	-0.7	-0.2	0.3	...	0.0
Privatization receipts	0.0	0.0	0.0	0.0	0.0	...	0.4
Increase in expenditure arrears 5/	1.6	3.8	3.7	4.1	-5.2	...	-0.9
Principal debt arrears	-1.2	4.7	5.3	5.8	-10.1	...	0.3
External	-1.2	0.8	1.9	0.1	0.5	...	0.3
Domestic	0.0	3.9	3.4	5.7	-10.7	...	0.0
Restructured Bonds	0.0	0.0	0.0	0.0	13.0	...	0.0
Memorandum items:							
Underlying balance (above the line) 6/	-4.8	-11.6	-8.1	-2.9	4.7	-0.9	0.3

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

1/ Estimated by staff as currently only limited data exist. Development grants and grant-financed development spending are currently administered by donors, and hence are not under the direct control of the government.
2/ On an accrual basis.
3/ Includes domestic revenue, recurrent expenditure, and recurrent budget grant support.
4/ Defined as domestic revenue net of recurrent expenditure and non-grant financed development spending.
5/ Includes interest arrears.
6/ Defined as domestic primary balance excluding one-off items.

Table 4. Solomon Islands: Summary Accounts of the Banking System, 2000–05

	2000	2001	2002	2003	2004 Est.	2005 Proj.
I. Central Bank	(In millions of S.I. dollars, end of period)					
Net foreign reserves	147.7	91.0	117.5	248.3	570.3	574.7
Net domestic assets	6.6	56.8	49.8	-26.6	-186.6	-178.6
Credit to the government (net)	80.0	122.3	159.5	94.6	-20.7	23.7
Claims	54.5	185.2	186.3	186.4	185.4	185.4
Deposits	25.5	-62.9	-26.8	-91.8	-206.1	-161.7
Other items (net)	-73.4	-65.4	-109.6	-121.2	-165.9	-202.3
Reserve money	154.4	149.4	174.0	220.7	383.6	396.1
Currency outside DMBs	88.3	84.7	91.5	102.7	123.2	139.7
II. Monetary survey						
Net foreign assets	148.9	101.6	132.2	273.0	575.9	580.4
Net domestic assets	315.6	301.6	287.1	255.4	101.1	187.1
Domestic credit	457.6	424.7	471.4	467.9	299.2	428.6
Government (net)	258.8	270.0	298.3	250.6	81.7	115.5
Claims	239.0	335.2	336.9	351.3	331.3	320.7
Deposits	19.8	-65.2	-38.6	-100.8	-249.6	-205.2
Credit to rest of NFPS	3.6	1.9	1.8	1.4	-21.3	-21.3
Private sector	195.2	152.7	171.3	216.0	238.9	334.4
Other items (net)	-142.0	-123.0	-184.3	-212.5	-198.1	-241.5
Broad Money (M2)	464.5	403.2	419.3	528.4	677.0	767.4
Narrow money	248.3	246.4	247.1	327.9	427.2	484.2
Quasi money	216.2	156.8	172.2	200.5	249.8	283.2
	(Annual percentage change, end of period)					
Reserve money	1.3	-3.3	16.5	26.9	73.8	3.3
Net foreign assets	-39.8	-31.8	30.2	106.4	111.0	0.8
Net domestic assets	46.8	-4.4	-4.8	-11.0	-60.4	85.1
Net domestic credit	23.0	-7.2	11.0	-0.7	-36.1	43.3
Of which : Private sector	1.8	-21.8	-20.7	26.1	10.6	40.0
Broad money (M2)	0.5	-13.2	4.0	26.0	28.1	13.4
Memorandum items:						
Velocity of broad money (marketed output)	2.3	2.5	2.4	2.2	2.0	1.9
Money multiplier	3.0	2.7	2.4	2.4	1.8	1.9
Excess liquidity to deposits ratio	10.1	12.8	17.7	20.2	39.5	33.3
Net international reserves (in millions of US$)	29.0	16.3	15.8	33.1	76.0	75.5
Private sector credit growth in real terms	-5.4	-26.5	-2.8	21.5	2.6	29.6
Government credit (net) growth in real terms	35.0	-2.0	-4.2	-19.1	-69.8	30.9

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

Table 5. Solomon Islands: Medium-Term Baseline Scenario, 2003–10

	2003	2004	2005	2006	2007	2008	2009	2010
		Est.	Projections					
Growth and prices (percentage change)								
Real GDP	5.6	5.5	4.4	4.8	4.4	4.4	4.4	4.4
Of which : Marketed output	8.9	7.8	5.0	5.5	4.9	4.9	4.9	4.9
CPI (period average)	10.1	6.9	6.6	7.7	7.7	7.1	6.3	5.5
CPI (end of period)	3.8	7.8	8.0	8.0	7.5	6.8	6.0	5.0
Nominal GDP (millions of SI$)	1,710	1,932	2,151	2,394	2,676	2,988	3,303	3,626
Nominal GDP (millions of US$)	228	258	285	307	327	350	371	394
Per capita GDP (in US$)	499	550	591	618	642	668	689	711
Per capita GDP in 2005 prices (in SI$)	4,275	4,387	4,457	4,544	4,613	4,686	4,758	4,831
Central government operations (percent of GDP)								
Total revenue	37.6	48.9	48.5	42.8	40.9	40.6	39.7	37.8
Recurrent revenue	19.5	26.8	26.6	27.0	27.0	27.1	27.0	27.0
Grants	18.1	22.1	21.8	15.8	14.0	13.5	12.7	10.8
Total expenditure 1/	39.5	40.6	49.0	41.6	39.8	39.4	38.6	36.6
Recurrent expenditure	23.9	22.9	27.9	26.5	26.4	26.1	25.9	25.7
Development expenditure	15.6	17.7	21.1	15.2	13.4	13.3	12.6	10.9
Recurrent balance 2/	-0.5	8.4	1.0	2.7	2.6	2.9	2.9	3.0
Overall balance 3/	-1.9	8.3	-0.5	1.2	1.2	1.2	1.2	1.2
Foreign financing (net)	0.4	-1.6	-0.6	-0.5	-1.0	-1.9	-1.7	-1.7
Domestic financing (net)	-9.0	-6.7	1.3	-0.5	-0.2	0.6	0.5	0.4
Privatization receipts	0.0	0.0	0.4	0.0	0.0	0.0	0.0	0.0
Increase in expenditure arrears 4/	4.1	-5.2	-0.9	-0.1	0.0	0.1	0.1	0.1
Increase in principal arrears	5.8	-10.1	0.3	0.0	0.0	0.0	0.0	0.0
Restructured bonds	0.0	13.0	0.0	0.0	0.0	0.0	0.0	0.0
Stock of expenditure arrears (in percent of GDP, end of period) 4/	14.9	8.0	7.8	7.0	6.4	5.9	5.6	5.3
Domestic principal arrears (percent of GDP)	12.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Monetary and credit (percentage change, end-year data)								
Net foreign assets	106.4	111.0	0.8	12.1	-4.3	-5.4	5.3	2.8
Net domestic assets	-11.0	-60.4	85.1	24.9	59.6	40.2	21.4	19.1
Net domestic credit	-0.7	-36.1	43.3	20.6	26.3	25.6	19.3	16.9
Credit to private sector	26.1	10.6	40.0	28.5	28.6	23.9	19.9	17.4
Broad money	26.0	28.1	13.4	15.2	12.6	11.7	12.9	11.1
Interest rate (3-month t/bill rate, average) 6/	5.8	6.0	3.5	...	...	...	...	...
Balance of payments (US$ millions, unless otherwise indicated)								
Exports, f.o.b	74.2	96.7	100.2	116.0	120.8	128.3	136.4	143.3
Imports, c.i.f.	-85.2	-98.7	-140.3	-170.0	-163.0	-166.3	-168.3	-174.7
Current account	3.1	32.3	-30.8	-41.8	-29.8	-24.9	-17.6	-15.9
(Percent of GDP)	1.3	12.5	-10.8	-13.6	-9.1	-7.1	-4.7	-4.0
Capital account	11.1	8.1	27.5	45.6	21.5	16.3	16.4	14.1
Overall balance (accrual)	14.2	40.4	-3.2	3.8	-8.3	-8.6	-1.2	-1.8
Gross official reserves (US$ millions, end of period)	36.0	79.0	78.5	83.7	77.0	70.1	70.7	70.8
(in months of next year's imports of GNFS)	3.6	5.7	4.7	5.2	4.6	4.2	4.0	4.0
Exchange rate (SI$/US$, end of period) 6/	7.49	7.51	7.52	...	...	...	...	...
Real effective exchange rate (period average, 2000=100) 7/	78.5	77.4	78.3	78.3	78.3	78.3	78.3	78.3
Nominal effective exchange rate (period average, 2000=100) 7/	64.0	59.6	57.8	...	...	...	...	...

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

1/ Expenditures are presented on an accrual basis.
2/ Includes recurrent budget grant support.
3/ Calculated from above-the-line data.
4/ Includes interest arrears.
5/ Includes arrears.
6/ 2005 column reflects data for end-July 2005.
7/ 2005 column reflects data for end-February 2005.

Table 6. Solomon Islands: Medium-Term Baseline Scenario—Balance of Payments, 2003–10

(In millions of U.S. dollars)

		Est.	Projections					
	2003	2004	2005	2006	2007	2008	2009	2010
Current account balance	3.1	32.3	-30.8	-41.8	-29.8	-24.9	-17.6	-15.9
Current account balance (excl. net pub. sec. transfers)	-6.1	21.3	-35.5	-46.5	-34.5	-29.5	-22.3	-20.6
Trade balance	-11.0	-2.0	-40.1	-53.9	-42.2	-38.0	-31.9	-31.4
Merchandise exports, f.o.b.	74.2	96.7	100.2	116.0	120.8	128.3	136.4	143.3
Of which: Timber	49.5	62.6	62.7	52.6	45.9	42.7	37.7	33.0
Fish	12.4	17.6	16.6	17.3	17.6	18.2	18.8	19.9
Minerals (incl. gold)	0.1	0.4	0.5	10.0	13.6	17.3	21.3	25.4
Palm Oil	0.0	0.0	0.0	8.0	10.0	12.2	14.6	16.9
Copra	1.0	3.4	3.5	5.8	7.0	8.5	9.8	11.1
Cocoa	7.1	5.4	6.2	9.4	12.1	14.1	16.7	18.2
Other	4.2	7.4	10.7	12.9	14.5	15.4	17.6	18.8
Merchandise imports, c.i.f.	85.2	98.7	140.3	170.0	163.0	166.3	168.3	174.7
Of which: Petroleum	11.7	23.3	37.6	44.7	45.0	45.1	46.1	47.1
Services and income (net)	0.7	9.0	-2.1	0.1	0.1	0.4	1.1	1.7
Nonfactor services (net)	6.0	7.7	2.4	1.4	3.0	3.1	3.6	3.9
Net factor income from abroad	-5.3	1.4	-4.5	-1.3	-2.9	-2.7	-2.5	-2.2
Net current transfers	13.4	25.2	11.4	11.9	12.3	12.8	13.3	13.8
Private sector	4.2	14.2	6.7	7.3	7.6	8.1	8.6	9.1
Receipts	18.4	37.1	14.4	15.5	16.2	17.2	18.3	19.4
Payments	14.2	22.9	7.6	8.2	8.6	9.2	9.7	10.3
Public sector	9.2	11.1	4.7	4.7	4.7	4.7	4.7	4.7
Receipts	14.3	13.0	6.6	6.6	6.6	6.6	6.6	6.6
Payments	5.2	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Capital account balance	11.1	8.1	27.5	45.6	21.5	16.3	16.4	14.1
Government sector	12.2	8.5	20.9	24.7	21.3	19.0	18.9	15.7
Medium and long-term lending	-0.5	-4.0	-1.7	-1.5	-3.2	-6.5	-6.4	-6.6
Inflows	3.1	0.3	3.4	3.4	2.0	0.0	0.0	0.0
Amortization	3.6	4.3	5.1	4.9	5.2	6.5	6.4	6.6
Investment flow (projects)	12.7	12.5	22.6	26.1	24.4	25.4	25.3	22.3
Private sector	-1.1	-0.4	6.6	21.0	0.3	-2.7	-2.5	-1.7
Investment activities (incl. FDI)	-0.1	0.3	7.3	15.3	7.1	4.1	4.3	4.5
Medium and long-term lending	-0.7	-0.5	-0.3	5.9	-6.5	-6.5	-6.4	-6.4
Inflows	0.0	0.0	5.0	12.5	0.0	0.0	0.0	0.0
Amortization	0.8	0.5	5.3	6.6	6.5	6.5	6.4	6.4
Other outflows	-0.3	-0.3	-0.4	-0.3	-0.3	-0.3	-0.4	0.2
Overall balance (accrual)	14.2	40.4	-3.2	3.8	-8.3	-8.6	-1.2	-1.8
Commercial bank holdings (increase)	2.0	2.2	0.0	0.0	0.0	0.0	0.0	0.0
Errors, omissions, and valuation	3.3	1.1	0.0	0.0	0.0	0.0	0.0	0.0
Exceptional financing	3.0	3.7	2.8	1.4	1.6	1.7	1.8	1.9
Interest arrears	3.0	2.3	2.0	1.4	1.6	1.7	1.8	1.9
Amortization arrears	1.5	1.4	1.0	0.0	0.0	0.0	0.0	0.0
Pending import requests	-2.4	-1.5	-0.1	0.0	0.0	0.0	0.0	0.0
Debt forgiveness	1.0	1.5	0.0	0	0	0	0	0
Overall balance (cash)	18.5	43.0	-0.4	5.2	-6.7	-6.9	0.6	0.1
Memorandum items:								
Gross official reserves	36.0	79.0	78.5	83.7	77.0	70.1	70.7	70.8
(In months of next year's imports of GNFS)	3.6	5.7	4.7	5.2	4.6	4.2	4.0	4.0
NIR	33.1	76.0	75.5	80.7	74.0	67.1	67.7	67.8
(in months of next year's imports of GNFS)	3.3	5.5	4.5	5.0	4.5	4.0	3.9	3.8
(in months of next year's non-project imports)	4.1	6.4	5.3	5.8	5.1	4.6	4.4	4.3
NIR (excl. pending import requests and external arrears)	17.7	60.0	42.7	46.5	38.2	29.7	28.5	26.6
(in months of next year's imports of GNFS)	1.7	4.3	2.6	2.9	2.3	1.8	1.6	1.5
External debt (including arrears)	160.8	160.2	175.4	175.3	173.7	168.9	164.2	159.5
(in percent of GDP)	70.6	62.1	61.5	56.9	52.7	48.0	44.0	40.3
External arrears (interest plus principal)	13.8	15.8	32.8	34.2	35.8	37.5	39.2	41.2
Exports GNFS/GDP	41.9	49.2	45.4	48.0	47.1	46.7	46.8	46.4
Imports GNFS/GDP	44.1	47.0	58.6	65.0	59.0	56.7	54.4	53.3
Exports GNFS--Value Growth	28.1	33.2	1.9	14.1	4.9	6.0	6.2	5.2
Exports GNFS--Volume Growth	52.4	35.6	-0.2	18.6	5.5	4.2	6.9	5.4
Timber Exports--Value Growth	31.4	26.4	0.3	-16.1	-12.9	-7.0	-11.8	-12.2
Non-Timber Exports--Value Growth	22.8	38.3	9.4	69.4	18.1	14.4	15.3	11.6
Imports GNFS--Value Growth	26.5	20.9	37.8	19.7	-3.0	2.6	1.7	4.1
Imports GNFS--Volume Growth	15.2	8.5	25.6	19.0	-1.7	3.9	2.2	3.6
Current account (including transfers)/GDP	1.3	12.5	-10.8	-13.6	-9.1	-7.1	-4.7	-4.0
Current account (excluding transfers)/GDP	-2.7	8.2	-12.4	-15.1	-10.5	-8.4	-6.0	-5.2

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

Table 7. Solomon Islands: Medium-Term Alternative Scenario, 2003–10

		Est.	Projections					
	2003	2004	2005	2006	2007	2008	2009	2010
Growth and prices (percentage change)								
Real GDP	5.6	5.5	4.4	1.6	1.4	1.4	1.4	1.3
CPI (end of period)	3.8	7.8	8.0	8.0	8.5	9.0	9.5	10.0
Per capita GDP in 2005 prices (in SI$)	4,275	4,387	4,458	4,404	4,344	4,286	4,229	4,168
Central government operations (percent of GDP)								
Total revenue	37.6	48.9	48.5	28.0	25.4	24.2	22.8	21.8
Recurrent revenue	19.5	26.8	26.6	24.1	22.7	21.9	20.7	20.0
Grants	18.1	22.1	21.8	3.9	2.7	2.3	2.0	1.8
Total expenditure 1/	39.5	40.6	49.0	32.3	29.6	26.3	24.8	23.7
Recurrent expenditure	23.9	22.9	27.9	28.9	26.9	24.0	22.7	21.9
Development expenditure	15.6	17.7	21.1	3.4	2.7	2.3	2.0	1.8
Overall balance 2/	-1.9	8.3	-0.5	-4.3	-4.2	-2.1	-2.0	-1.9
Central government debt (percent of GDP) 3/	122.0	92.3	88.0	85.7	82.4	82.6	83.8	85.3
Broad money (percentage change, end-year data)	26.0	28.1	13.4	-4.5	-17.8	-11.1	3.5	5.6
Balance of payments								
Exports (GNFS; percentage change)	28.1	33.2	-1.5	-7.5	-5.4	-4.0	-3.1	-3.1
Imports (GNFS; percentage change)	26.5	20.9	37.8	-4.8	-7.5	-7.8	-11.9	-5.8
Current account (including net transfers; percent of GDP)	1.3	12.5	-12.3	-12.8	-11.3	-8.6	-4.9	-3.7
Current account (excluding net transfers; percent of GDP)	-2.7	8.2	-13.9	-13.3	-11.3	-8.6	-4.9	-3.7
Gross official reserves (US$ millions, end of period)	36.0	79.0	78.5	48.8	17.5	5.0	4.7	5.1
(in months of next year's imports of GNFS)	3.6	5.7	5.6	4.0	1.5	0.5	0.5	0.5

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

1/ Expenditures are presented on an accrual basis.
2/ Calculated from above-the-line data.
3/ Includes arrears.

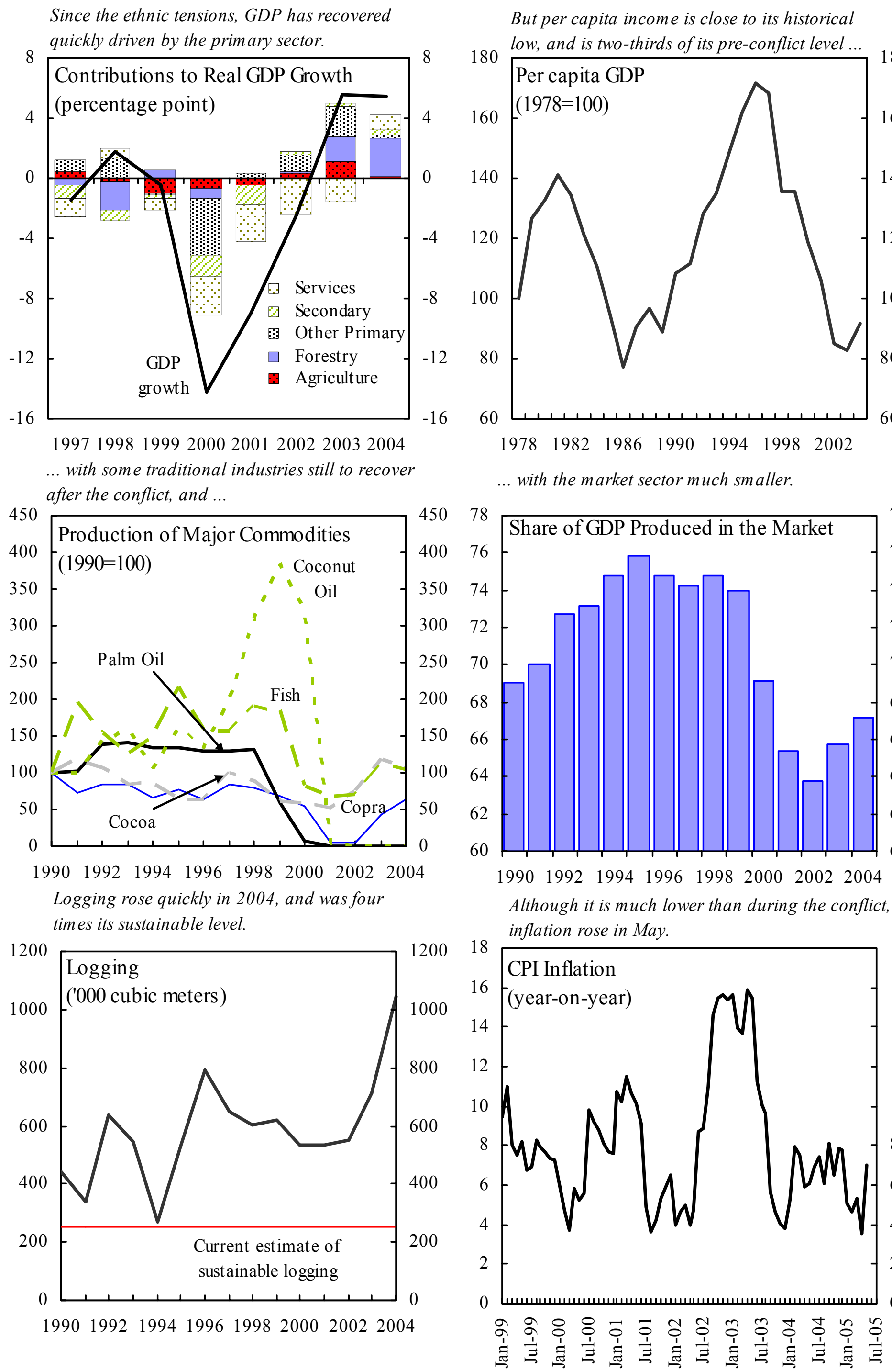
Table 8. Solomon Islands: Indicators of External Vulnerability, 2000–05

	2000	2001	2002	2003	2004 Est.	2005 Proj.
Financial indicators						
Government sector debt (in percent of GDP)	69.7	94.1	114.1	122.0	92.3	88.0
Broad money (percent change, 12-month basis)	0.5	-13.2	4.0	26.0	28.1	13.4
Private sector credit (percent change, 12 month basis)	1.8	-21.8	12.2	26.1	10.6	40.0
3 month T-bill yield (in percent, nominal) 1/	7.3	8.9	8.3	5.8	6.0	3.5
3 month T-bill yield (in percent, real) 1/	0.4	1.2	-0.9	-3.8	-0.9	-2.9
External indicators						
Merch. Exports (percent change, 12-month basis in US$)	-48.1	-27.6	22.6	28.4	30.4	3.5
Merch. Imports (percent change, 12-month basis in US$)	-11.9	-7.6	-31.3	36.9	15.8	42.1
Terms of trade (percent change, 12 month basis)	-5.0	0.3	-22.9	-12.1	-11.6	-6.7
Current account balance (in percent of GDP)	-10.6	-12.8	-7.2	1.3	12.5	-10.8
Capital account balance (in percent of GDP)	2.9	6.3	2.8	4.9	3.1	9.6
Gross official reserves (in US$ millions)	31.3	18.5	17.5	36.0	79.0	78.5
Central bank short-term foreign liabilities (in US$ millions)	2.4	2.2	1.7	2.9	3.0	3.0
Central bank foreign currency exposure (in US$)	29.0	16.3	15.8	33.1	76.0	75.5
Short term foreign assets of the financial sector (in US$)	...	...	...	...	...	...
Short term foreign liabilities of the financial sector (in US$)	...	...	...	...	...	...
Foreign currency exposure of the financial sector (in US$ millions) 2/	0.2	1.9	2.0	3.3	0.8	0.7
Official reserves (in months of next year's imports of GNFS)	3.1	2.8	2.1	3.6	5.7	4.7
Gross international reserves to broad money	0.3	0.3	0.3	0.5	0.9	0.8
Total external public sector debt (in percent of GDP) 3/	42.0	49.0	67.0	70.6	62.0	61.4
Total external debt to exports of GNFS	110.5	187.0	203.5	168.5	125.8	135.2
External interest payments to exports of GNFS	3.7	3.1	4.1	2.6	2.0	2.3
External amortization payments to exports of GNFS	5.6	1.5	0.8	3.5	2.3	3.2
Exchange rate (SI$/US$, period average)	5.09	5.28	6.75	7.51	7.48	…
Exchange rate (SI$/US$, end of period) 1/	5.10	5.56	7.46	7.49	7.51	7.52
REER appreciation (+) (period average)	6.0	9.2	-16.8	-13.6	-1.4	1.2

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

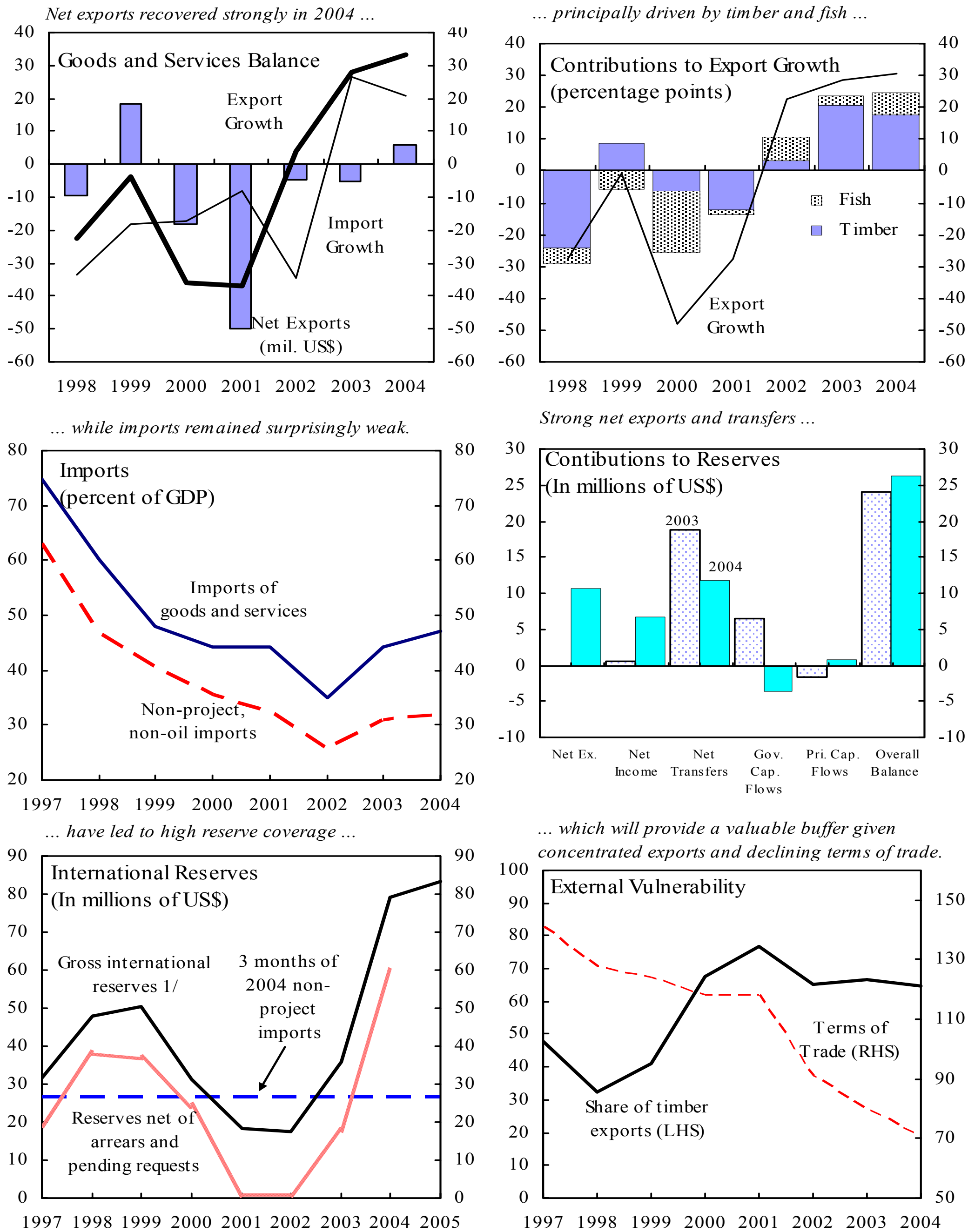
1/ 2005 column reflects data for end-July 2005.
2/ Net foreign assets of commercial banks.
3/ Includes arrears.

Figure 1. Solomon Islands: Selected Economic Indicators, 1978-2005



Sources: Data provided by the authorities, WEO and IFS databases; and Fund staff estimates.

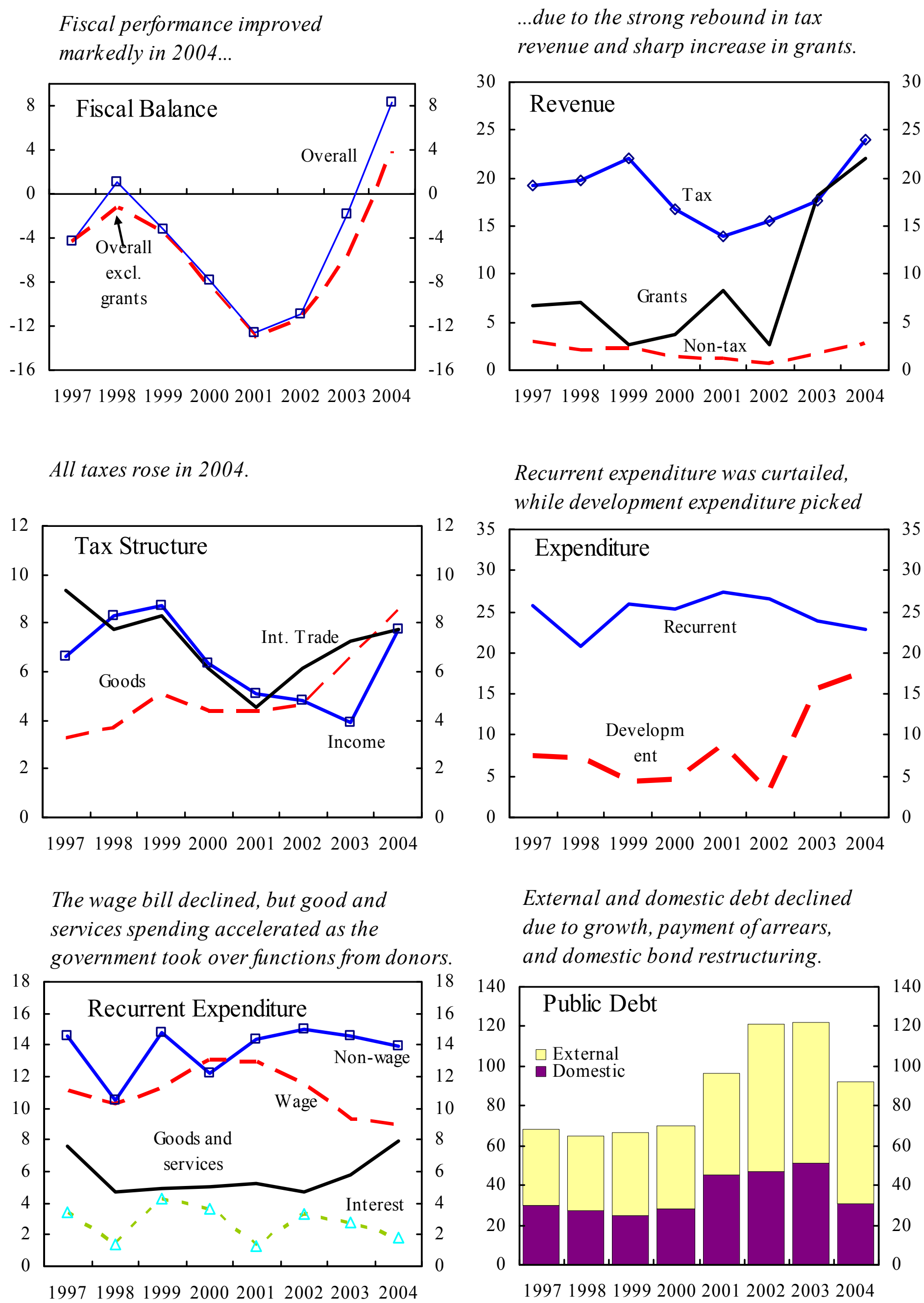
Figure 2. Solomon Islands: External Sector Developments, 1997-2005



Sources: Data provided by the authorities, WEO and IFS databases; and Fund staff estimates.

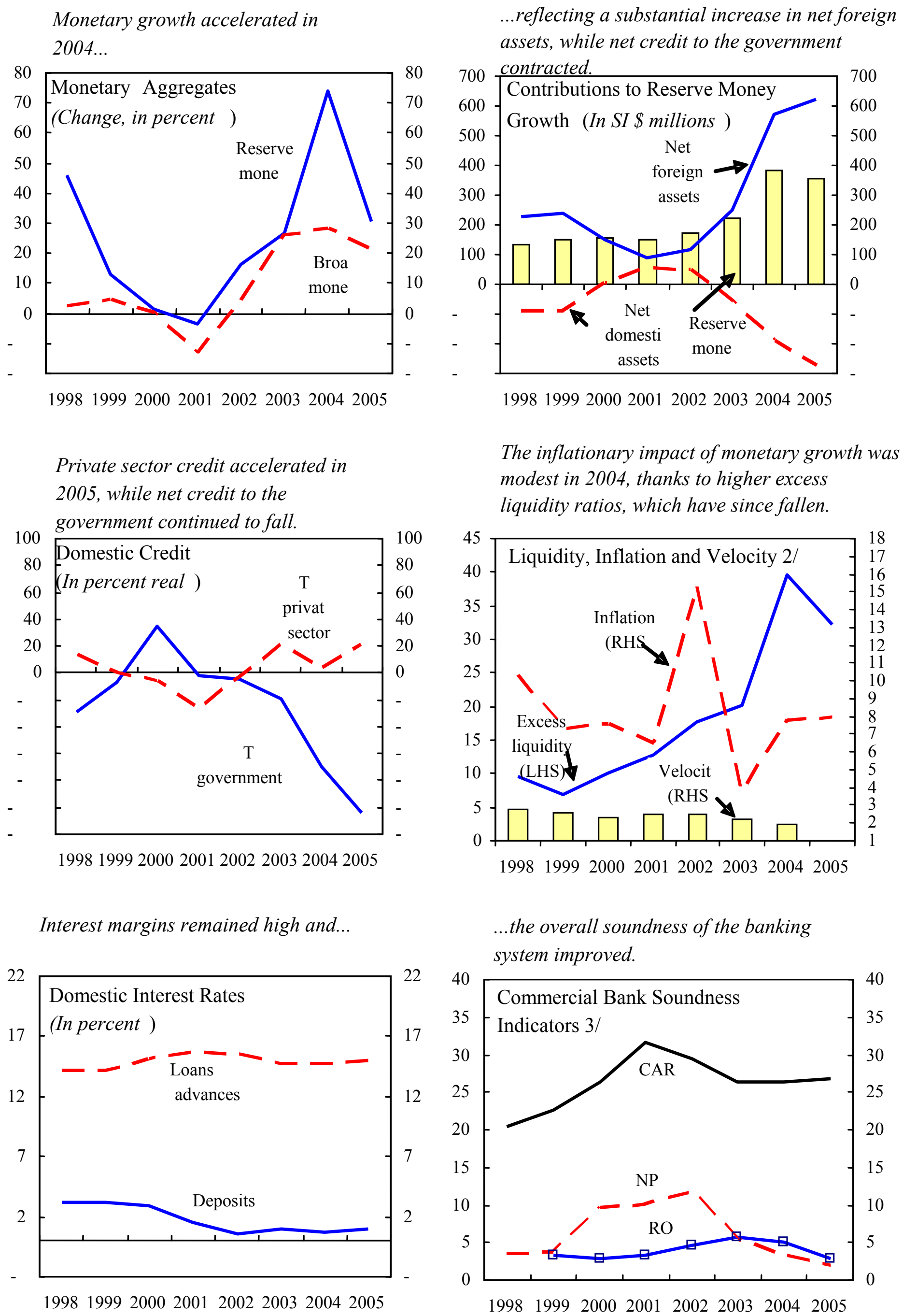
1/ 2005 estimate refers to end-July.

Figure 3. Solomon Islands: Fiscal Developments, 1997-2004 1/
(In percent of GDP)



Sources: Data provided by the authorities and Fund staff estimates.
1/ 2004 data are staff estimates.

Figure 4. Solomon Islands: Monetary Sector Developments, 1998-2005 1/



Sources: Data provided by the authorities and Fund staff estimates.
1/ 2005 data refer to May.
2/ Excess liquidity is in percent of deposits.
3/ 2005 financial indicators refer to the first quarter.

SOLOMON ISLANDS: MEDIUM-TERM SCENARIO AND DEBT SUSTAINABILITY ANALYSIS[1]

If the government implements its reform agenda, the Solomon Islands could enjoy higher living standards over the medium term, although its debt situation remains fragile. If necessary reforms are not implemented, however, living standards and debt indicators could deteriorate further.

Medium-term scenario

The staff's baseline medium-term framework is underpinned by policy adjustment. It assumes that RAMSI and donors remain engaged, and although declining, aid flows continue to be substantial (9 percent of GDP in 2010 from 20 percent in 2005), and logging activity is halved. It also assumes that a critical mass of structural reforms is implemented so that new private activities take up the slack left by logging. Finally, it assumes that financial stability is maintained, underpinned by fiscal adjustment. In line with government policy, no new borrowing takes place.[2] However, downside risks to this scenario, particularly related to policy implementation, are high.

Under these assumptions, real GDP growth is projected to average 4½ percent in 2006–10, driven largely by investment and exports (Tables 5 and 6). Per capita income would rise by a cumulative 10 percent and inflation decline gradually to 5 percent as supply constraints ease. In spite of declining logging, exports grow strongly over the medium term, especially in 2006, as new export activities—primarily palm oil and mining—come on stream and expand. The current account deficit peaks (at around 13½ percent of GDP) in 2006 due to imported capital goods, and narrows over the projection horizon to around 4 percent of GDP. Reserves fall modestly as official development assistance (ODA) moderates and external debt repayments jump in 2008, but reserve coverage stabilizes at around 4 months of imports. The overall fiscal position is projected to improve resulting in modest budget surpluses over the medium term, with expenditure adjustment of 1½ percent of GDP and further revenue measures keeping the revenue-to-GDP ratio broadly constant, while import and logging duties fall by 2½ percent of GDP between 2005 and 2010.[3]

If reforms stall causing donors and investors to leave, macroeconomic stability would likely falter (Table 7). Under such an alternative scenario, growth is projected to slow to about 1½ percent, leaving real per capita income 6.5 percent lower by 2010 and almost 14 percent below the baseline. Inflation could gradually rise to 10 percent as supply

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[1] Prepared jointly with World Bank staff.

[2] Staff assumes no gross external borrowing throughout the projection horizon. Net domestic borrowing remains negative throughout the projection period.

[3] Staff assumes that the government gradually eliminates outstanding informal expenditure arrears by 2010, and realized contingent liabilities (of around 1.5 percent of GDP) to the NPF by 2015.

constraints reemerge. Production and exports weaken, and lower ODA and no FDI result in considerable import compression. With weaker growth limiting revenue, no revenue measures to compensate falling logging and import duties, and an inability to borrow, the government is forced to reduce recurrent spending by one fifth, with service provision falling further in line with lower ODA. Unpaid debt service adds to arrears, with government debt largely unchanged in 2010 from its level at end-2006.

Debt sustainability in the baseline scenario[4]

The external debt sustainability analysis under the baseline scenario paints a mixed picture (Annex I Table 1).[5] At end-2004, the NPV of external debt to GDP (at 45 percent) exceeded the Board-endorsed indicative threshold, while the ratios of the NPV of debt to exports and revenue were below their respective thresholds. However, with the recent realization of an external contingent liability worth 5 percent of GDP, the ratios of the NPV of debt to both GDP and exports are projected to exceed their respective thresholds at end-2005.[6]

In the baseline adjustment scenario, all debt indicators improve over time. The NPV of debt to exports is projected to fall below its threshold in 2006, but the NPV of debt to GDP still exceeds its threshold in 2010. Debt service to both exports and revenue (at 5.5 and 9.3 percent, respectively, in 2005) always remain below thresholds.

The high level of domestic debt and informal expenditure arrears pose significant risks to fiscal sustainability (Annex I Table 2). At end-2004, domestic debt was 30 percent of GDP (including expenditure arrears), bringing total public debt (including arrears) to 92 percent of GDP. Reflecting the realization of both the external contingent liability as well as domestic contingent liabilities worth 1.5 percent of GDP, public debt to GDP is projected to fall only slightly in 2005.[7] While all debt indicators decline under the baseline, the NPV of public debt remains above 100 percent of government domestic revenue and around 30 percent of GDP even in 2015.

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[4] Data on private external, state enterprise, and provincial government debt are not available. Therefore, the analysis is limited to central government debt data.

[5] This analysis assumes that the government remains current on all obligations from mid-2005, and that all debt in arrears is treated as a current short-term obligation with NPV equal to its face value. Existing external arrears are assumed to continue growing with accrued interest.

[6] The realized contingent liability relates to a government-guaranteed loan which the creditor called in during 2005. The loan was originally made to the government fishing company, Soltai, but was later transferred to the Investment Corporation of the Solomon Islands which has been unable to service it.

[7] The domestic contingent liabilities realized this year relate to loans made by the NPF to provincial governments and guaranteed by the central government.

Risks to the debt dynamics

Historical scenarios and even some *temporary* stress tests highlight the fragility of the Solomon Islands' debt position (Annex I Tables 3 and 4).

- *External Debt*: A return of key variables to their historical averages would see the ratio of the NPV of debt to exports and GDP rise during the projection period. Even a temporary fall in export growth would see the NPV of debt to exports jump and exceed the threshold almost throughout the period to 2025 and result in an external debt service ratio above its threshold for two years before 2010. A temporary fall in GDP growth would keep the NPV of debt to GDP above its threshold past 2010 and the NPV of debt to exports above its threshold to 2008. The concentration of exports, and their historical volatility, suggest these are very relevant stress tests for assessing vulnerability.[8]

- *Public Debt*: Lower GDP growth, even temporarily, and a return of growth and the primary balance to their historical averages result in the ratios of the NPV of public debt to GDP and revenue rising.

These results are indicative only, as major uncertainties surround critical variables. In particular, macroeconomic variables (especially GDP) are subject to large measurement errors. Data on aid flows are extremely limited, and staff estimates, based on discussions with donors, are subject to great uncertainty as future ODA plans are sketchy.

Contingent liabilities—currently estimated at 10 percent of GDP—are another key source of uncertainty. If all were realized as external debt, the NPV of debt would exceed 30 percent of GDP even in 2015. Additional contingent liabilities are likely to be uncovered as audits of state enterprise and provincial government accounts are underway for the first time in many years. Since state enterprises and provincial governments have few resources, a large share of any contingent liabilities related to them is likely to be realized.

The Solomon Islands is at high risk of debt distress. Some external debt indicators are currently above thresholds and domestic debt, arrears, and contingent liabilities are also high. Although debt indicators fall over the medium term under the staff's adjustment scenario, historical scenarios and several stress tests, even some temporary ones, lead to a deterioration in the debt burden. These tests seem especially relevant given the Solomon Islands' volatile economic history, and the nascent stage of the current reforms and recovery process. These findings, together with the country's poor credit history, suggest that the Solomon Islands is at high risk of debt distress.

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[8] The coefficient of variation of export growth was almost -6 over the last ten years, with roughly the same volatility in absolute terms over the period since 1978.

Annex I. Table 1. Solomon Islands: External Debt Sustainability Framework, Baseline Scenario, 2002–25 1/
(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average 5/	Standard Deviation 5/	Estimate	Projections								Board Endorsed Threshold 6/
	2002	2003	2004			2005	2006	2007	2008	2009	2010	2005-10 Average	2015	2025	
External debt (nominal) 1/	**67.0**	**70.6**	**62.0**			**61.4**	**57.1**	**53.0**	**48.1**	**44.2**	**40.4**		**26.0**	**13.4**	
o/w public and publicly guaranteed (PPG)	67.0	70.6	62.0			61.4	57.1	53.0	48.1	44.2	40.4		26.0	13.4	
Change in external debt	18.0	3.6	-8.6			-0.6	-4.2	-4.1	-4.9	-4.0	-3.7		-2.3	-0.7	
Identified net debt-creating flows	16.6	-6.1	-25.5			-1.4	-2.1	-2.3	-3.0	-4.7	-4.2		-2.2	-2.2	
Non-interest current account deficit	**5.8**	**-2.4**	**-13.5**	**1.3**	**7.0**	**9.8**	**13.0**	**8.5**	**6.5**	**4.2**	**3.6**		**2.5**	**-0.2**	
Deficit in balance of goods and services	2.2	2.2	-2.2			13.2	17.1	12.0	10.0	7.6	7.0		5.6	2.6	
Exports	32.9	41.9	49.2			45.4	48.2	47.4	46.9	47.0	46.6		42.1	38.9	
Imports	35.1	44.1	47.0			58.6	65.4	59.4	56.9	54.6	53.6		47.6	41.5	
Net current transfers (negative = inflow)	2.4	-5.9	-9.8	-2.9	4.7	-4.0	-3.9	-3.7	-3.6	-3.6	-3.5		-3.2	-2.8	
Other current account flows (negative = net inflow)	1.3	1.2	-1.5			0.5	-0.3	0.3	0.2	0.2	0.1		0.1	0.0	
Net FDI and other non-debt-creating flows (negative = inflow)	**-1.6**	**-5.4**	**-4.9**	**-1.9**	**1.9**	**-10.3**	**-13.4**	**-9.5**	**-8.4**	**-7.9**	**-6.9**		**-4.3**	**-2.0**	
Endogenous debt dynamics 2/	**12.3**	**1.7**	**-7.0**			**-0.8**	**-1.6**	**-1.2**	**-1.2**	**-1.0**	**-0.9**		**-0.4**	**0.1**	
Contribution from nominal interest rate	1.9	2.2	1.3			1.7	1.2	1.1	1.0	1.0	0.9		0.7	0.6	
Contribution from real GDP growth	1.4	-3.7	-3.4			-2.5	-2.7	-2.3	-2.2	-2.0	-1.8		-1.1	-0.5	
Contribution from price and exchange rate changes	9.0	3.3	-4.9			…	…	…	…	…	…		…	…	
Residual (3-4) 3/	**1.5**	**9.7**	**16.8**			**0.8**	**-2.2**	**-1.9**	**-1.9**	**0.7**	**0.5**		**-0.1**	**1.5**	
o/w exceptional financing	-1.4	-1.3	-1.4			-1.0	-0.5	-0.5	-0.5	-0.5	-0.5		-0.5	-0.5	
NPV of external debt	...	...	45.0			46.5	43.5	40.8	37.6	34.9	32.4		22.3	12.6	
In percent of exports	...	...	91.3			102.3	90.3	86.1	80.1	74.4	69.6		52.9	32.4	
NPV of PPG external debt	**...**	**...**	**45.0**			**46.5**	**43.5**	**40.8**	**37.6**	**34.9**	**32.4**		**22.3**	**12.6**	**30**
In percent of exports	**...**	**...**	**91.3**			**102.3**	**90.3**	**86.1**	**80.1**	**74.4**	**69.6**		**52.9**	32.4	**100**
In percent of revenue (excluding grants)	**...**	**...**	**168.1**			**174.5**	**161.3**	**151.3**	**138.7**	**129.3**	**120.0**		**82.4**	...	**200**
Debt service-to-exports ratio (in percent)	4.9	6.2	4.4			5.5	4.8	4.6	5.1	4.7	4.5		3.3	1.4	
PPG debt service-to-exports ratio (in percent)	4.9	6.2	**4.4**			**5.5**	**4.8**	**4.6**	**5.1**	**4.7**	**4.5**		**3.3**	1.4	**15**
PPG debt service-to-revenue ratio (in percent)	10.0	13.2	**8.1**			**9.3**	**8.6**	**8.2**	**8.9**	**8.2**	**7.8**		**5.1**	2.1	**25**
Total gross financing need (billions of U.S. dollars)	0.0	0.0	0.0			0.005	0.006	0.004	0.002	-0.005	-0.005		-0.002	-0.015	
Non-interest current account deficit that stabilizes debt ratio	-12.2	-6.0	-4.9			10.3	17.2	12.6	11.4	8.2	7.3		4.8	0.5	
Key macroeconomic assumptions															
Real GDP growth (in percent)	-2.4	5.6	5.5	-0.5	10.8	4.4	4.8	4.4	4.4	4.4	4.4	4.5	4.0	3.8	
GDP deflator in US dollar terms (change in percent)	-15.5	-4.6	7.4	-1.0	9.1	5.8	2.5	2.3	2.5	1.5	1.6	2.7	1.9	1.4	
Effective interest rate (percent) 4/	3.2	3.3	2.0	2.1	1.1	3.1	2.0	2.1	2.1	2.1	2.2	2.3	2.6	4.2	
Growth of exports of G&NFS (US dollar terms, in percent)	3.7	28.1	33.2	-4.9	42.8	1.9	14.1	4.9	6.0	6.2	5.2	6.4	4.2	4.7	
Growth of imports of G&NFS (US dollar terms, in percent)	-34.7	26.5	20.9	-9.1	39.3	37.8	19.7	-3.0	2.6	1.7	4.1	10.5	4.7	4.1	
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	50.1	50.1	47.9	...	...	...	49.3	...	...	
Memorandum item:															
Nominal GDP (billions of U.S. dollars)	0.226	0.228	0.258			0.285	0.306	0.327	0.350	0.371	0.394		0.526	0.882	

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

1/ Refers to central government debt only due to data availability.
2/ Derived as $[r - g - \rho(1+g)]/(1+g+\rho+g\rho)$ times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = 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/ Current-year interest payments derived by previous period debt stock.
5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.
6/ These thresholds apply to countries with weak policies and institutions and are discussed in *Operational Framework for Debt Sustainability Analysis in Low-Income Countries--Further Considerations* .

Annex I. Table 2. Solomon Islands: Public Sector Debt Sustainability Framework, Baseline Scenario, 2002–25

(In percent of GDP, unless otherwise indicated)

	Actual				Estimate	Projections							
	2003	2004	Historical Average 6/	Standard Deviation 6/	2005	2006	2007	2008	2009	2010	2005-10 Average	2015	2025
Public sector debt 1/	121.9	92.5			88.6	81.2	73.5	65.6	59.2	52.9		32.5	15.4
Of which: Foreign-currency denominated	70.4	62.1			61.9	58.4	54.0	49.1	45.1	40.9		26.3	13.6
Change in public sector debt	0.8	-29.4			-3.9	-7.4	-7.8	-7.9	-6.4	-6.2		-3.5	-0.9
Identified debt-creating flows	-11.4	-22.2			-7.0	-7.3	-7.4	-6.7	-5.4	-5.4		-3.5	-0.2
Primary deficit	-0.9	-10.1	1.0	5.8	-1.8	-2.9	-2.8	-2.6	-2.5	-2.4	-2.5	-2.1	-0.6
Revenue and grants	37.6	48.9			48.5	42.8	40.9	40.6	39.7	37.8		34.4	31.3
Of which: Grants	18.1	22.1			21.8	15.8	14.0	13.5	12.7	10.8		7.3	4.4
Primary (noninterest) expenditure	36.7	38.7			46.6	39.9	38.2	38.0	37.2	35.4		32.3	30.7
Automatic debt dynamics	-9.8	-12.0			-6.3	-4.4	-4.7	-4.1	-3.0	-2.9		-1.3	0.3
Contribution from interest rate/growth differential	-7.4	-9.4			-4.8	-5.0	-4.3	-3.8	-3.2	-2.8		-1.3	0.2
Of which: Contribution from average real interest rate	-1.0	-3.0			-0.9	-0.9	-0.9	-0.7	-0.5	-0.3		0.0	0.8
Of which: Contribution from real GDP growth	-6.4	-6.4			-3.9	-4.1	-3.4	-3.1	-2.8	-2.5		-1.4	-0.6
Contribution from real exchange rate depreciation	-2.4	-2.6			-1.5	0.5	-0.3	-0.3	0.2	-0.2		...	...
Other identified debt-creating flows	-0.7	0.0			1.1	0.0	0.0	0.0	0.0	-0.1		-0.1	0.0
Privatization receipts (negative)	0.0	0.0			-0.4	0.0	0.0	0.0	0.0	0.0		0.0	0.0
Recognition of implicit or contingent liabilities 2/	0.0	0.0			1.5	0.0	0.0	0.0	0.0	-0.1		-0.1	0.0
Debt relief (HIPC and other)	-0.7	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
Residual, including asset changes	12.2	-7.3			3.1	-0.1	-0.3	-1.2	-1.0	-0.9		0.0	-0.6
NPV of public sector debt	102.3	75.3			73.1	66.4	60.2	54.1	49.1	44.4		28.5	14.4
Of which: Foreign-currency denominated	50.9	45.0			46.5	43.5	40.8	37.6	34.9	32.4		22.3	12.6
Of which: External	50.9	45.0			46.5	43.5	40.8	37.6	34.9	32.4		22.3	12.6
NPV of contingent liabilities (not included in public sector debt) 2/	...	...			10.0	9.0	8.1	7.2	6.5	6.0		3.9	1.8
Gross financing need 3/	1.9	-1.7			4.1	1.0	0.7	0.6	0.4	0.3		0.2	0.3
NPV of public sector debt-to-revenue ratio (in percent) 4/	523.6	281.5			274.6	245.7	223.3	199.7	181.6	164.4		105.5	53.6
Of which: External	260.4	168.1			174.5	161.3	151.3	138.7	129.3	120.0		82.4	46.9
Debt service-to-revenue ratio (in percent) 4/ 5/	14.5	25.0			17.0	10.6	9.5	8.5	7.8	7.3		4.8	2.3
Primary deficit that stabilizes the debt-to-GDP ratio	-1.7	19.3			2.1	4.5	5.0	5.3	3.9	3.8		1.4	0.3
Key macroeconomic and fiscal assumptions													
Real GDP growth (in percent)	5.6	5.5	-0.5	6.9	4.4	4.8	4.4	4.4	4.4	4.4	4.5	4.0	3.8
Average nominal interest rate on forex debt (in percent)	3.3	2.0	3.1	1.0	3.1	2.1	2.1	2.1	2.2	2.2	2.3	2.6	0.0
Average real interest rate on domestic currency debt (in percent)	-4.3	-5.4	-3.6	2.8	-4.1	-3.7	-4.5	-4.3	-3.3	-2.6	-3.7	-1.8	29.3
Real exchange rate depreciation (in percent, + indicates depreciation)	-3.4	-4.0	3.9	12.2	-2.5	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	6.1	7.1	7.1	2.7	6.6	6.2	7.1	6.9	5.9	5.2	6.3	4.7	4.1
Growth of real primary spending (deflated by GDP deflator, in percent)	46.4	11.3	3.9	24.3	25.8	-10.3	-0.2	3.9	2.3	-0.8	3.5	3.0	3.3
Grant element of new external borrowing (in percent)	...	...	...	...	50.1	50.1	47.9	...	...	...	49.3	...	...

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

1/ Gross central government debt, including informal arrears. Foreign currency denominated debt converted using end-of-period exchange rate.
2/ Current estimate of contingent liabilities recognition. Remaining contingent liabilities are estimated at 10 percent of GDP.
3/ 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.
4/ Revenues excluding grants.
5/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.
6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Annex I. Table 3. Solomon Islands: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2005–25
(In percent)

	Estimate	Projections						
	2005	2006	2007	2008	2009	2010	2015	2025
	(NPV of debt-to-GDP ratio)							
Baseline	46	44	41	38	35	32	22	13
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2006-25 1/	46	47	48	49	50	52	60	81
A2. New public sector loans on less favorable terms in 2006-25 2/	46	44	41	...	...	...	...	...
A3. Realization of half of contingent liabilities as external debt in 2006 3/	46	48	46	42	40	37	26	16
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2006-07 4/	46	49	51	47	43	40	26	14
B2. Export value growth at historical average minus one standard deviation in 2006-07 5/	46	54	66	61	58	55	42	18
B3. US dollar GDP deflator at historical average minus one standard deviation in 2006–07	46	49	52	48	44	41	26	14
B4. Net non-debt creating flows at historical average minus one standard deviation in 2006–07 6/	46	53	58	54	51	48	35	15
B5. Combination of B1-B4 using one-half standard deviation shocks	46	62	86	81	76	72	54	24
B6. One-time 30 percent nominal depreciation relative to the baseline in 2006 7/	46	61	57	52	48	44	28	13
	(NPV of debt-to-exports ratio)							
Baseline	102	90	86	80	74	70	53	32
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2006–25 1/	102	98	101	104	107	112	144	208
A2. New public sector loans on less favorable terms in 2006–25 2/	102	91	87	...	...	...	...	...
A3. Realization of half of contingent liabilities as external debt in 2006 3/	102	100	96	90	84	79	63	42
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2006–07 4/	102	102	109	100	92	86	61	36
B2. Export value growth at historical average minus one standard deviation in 2006–07 5/	102	191	375	354	335	319	269	129
B3. US dollar GDP deflator at historical average minus one standard deviation in 2006–07	102	102	111	102	94	87	62	36
B4. Net nondebt creating flows at historical average minus one standard deviation in 2006–07 6/	102	110	122	115	108	102	84	40
B5. Combination of B1-B4 using one-half standard deviation shocks	102	153	239	226	213	202	168	80
B6. One-time 30 percent nominal depreciation relative to the baseline in 2006 7/	102	127	120	111	102	95	67	33
	(Debt-service ratio)							
Baseline	5.5	4.8	4.6	5.1	4.7	4.5	3.3	1.4
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2006–25 1/	5.7	5.4	5.6	6.7	6.6	6.9	7.8	10.8
A2. New public sector loans on less favorable terms in 2006–25 2/	5.7	4.9	4.8	5.3	...	...	...	...
A3. Realization of half of contingent liabilities as external debt in 2006 3/	5.7	5.4	5.2	5.6	5.1	4.9	3.7	1.7
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2006–07 4/	5.7	5.6	6.1	6.6	6.0	5.8	4.2	1.5
B2. Export value growth at historical average minus one standard deviation in 2006–07 5/	5.7	8.4	13.9	16.6	15.3	14.6	11.0	10.5
B3. US dollar GDP deflator at historical average minus one standard deviation in 2006–07	5.7	4.9	4.8	5.2	4.7	4.5	3.3	1.4
B4. Net nondebt creating flows at historical average minus one standard deviation in 2006–07 6/	5.7	4.9	5.1	5.8	5.4	5.1	3.8	3.0
B5. Combination of B1-B4 using one-half standard deviation shocks	5.7	6.9	9.4	11.0	10.1	9.7	7.3	6.4
B6. One-time 30 percent nominal depreciation relative to the baseline in 2006 7/	5.7	4.9	4.8	5.2	4.7	4.5	3.3	1.4
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 8/	49	49	49	49	49	49	49	49

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

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and nondebt 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/ Assumes an interest rate equal to U.S. 6 month Libor + 2 percent.
3/ Liabilities realized and add to arrears from the beginning of 2006, attracting an interest rate equal to 2004 six month libor.
4/ Ratios calculated using baseline export-to-GDP, since GDP and exports are driven by the same primary commodities.
5/ 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 assuming an offsetting adjustment in import levels).
6/ Includes official and private transfers and FDI.
7/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
8/ 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.

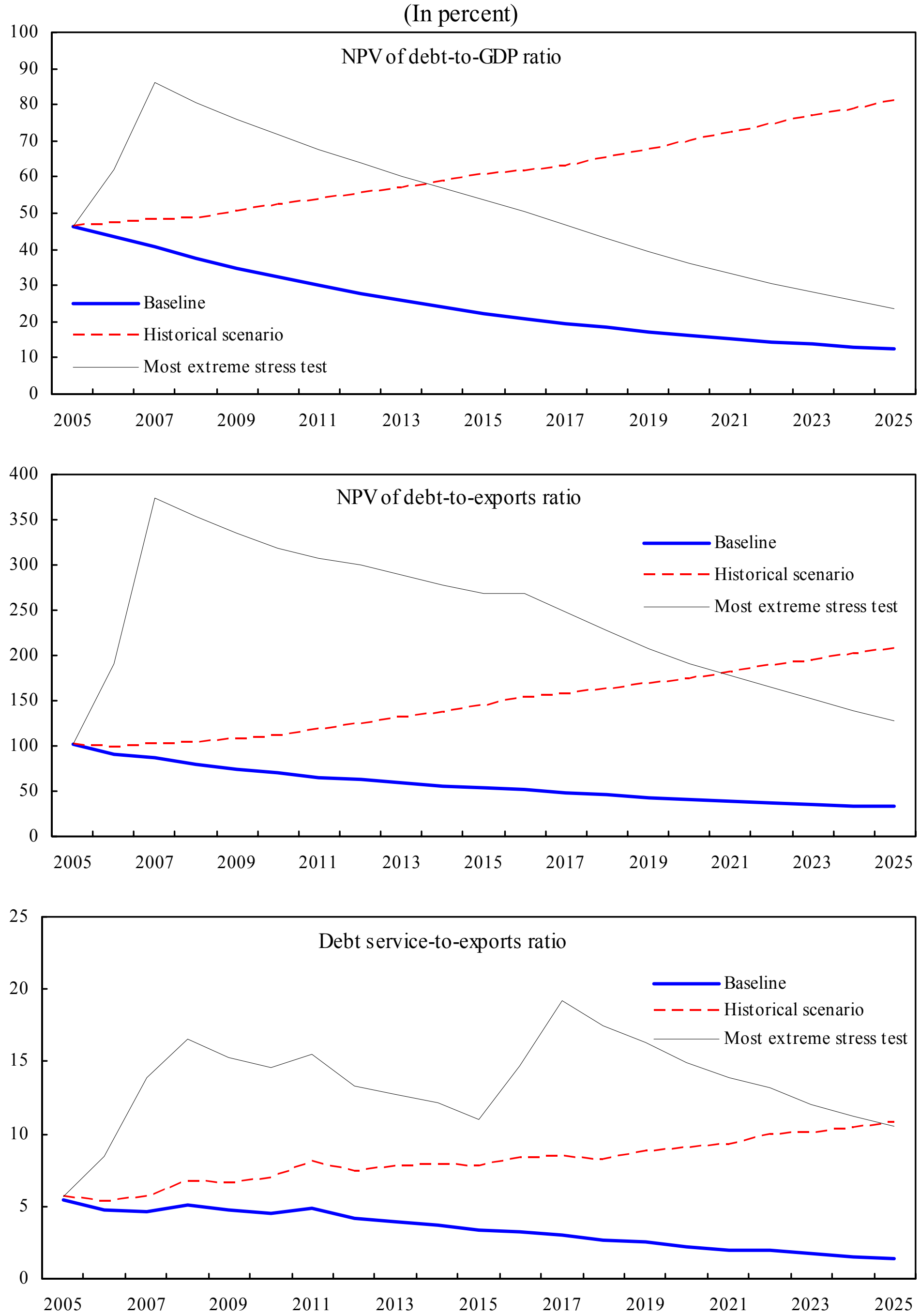
Annex I. Table 4. Solomon Islands: Sensitivity Analysis for Key Indicators of Public Debt, 2005–25

	Estimate	Projections						
	2005	2006	2007	2008	2009	2010	2015	2025
	(NPV of Debt-to-GDP Ratio)							
Baseline	73	66	60	54	49	44	29	14
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	73	74	74	74	75	76	88	116
A2. Primary balance is unchanged from historical average	73	70	67	64	62	60	57	54
A3. Permanently lower GDP growth 1/	73	68	63	59	56	53	54	102
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviation in 2006-2007	73	78	87	86	86	86	97	132
B2. Primary balance is at historical average minus one standard deviation in 2006-2007	73	75	78	71	66	61	44	24
B3. Combination of B1-B2 using one half standard deviation shocks	73	79	85	75	67	60	36	6
B4. One-time 30 percent real depreciation in 2006	73	87	81	74	69	64	46	21
B5. 10 percent of GDP increase in other debt-creating flows in 2006	73	76	69	63	58	53	36	17
	(NPV of Debt-to-Revenue Ratio) 2/							
Baseline	275	246	223	200	182	164	106	54
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	275	272	274	273	277	281	326	431
A2. Primary balance is unchanged from historical average	275	259	249	236	229	222	212	202
A3. Permanently lower GDP growth 1/	275	251	234	217	207	198	201	378
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviation in 2006-2007	275	290	323	317	318	319	358	493
B2. Primary balance is at historical average minus one standard deviation in 2006-2007	275	279	288	262	243	225	162	88
B3. Combination of B1-B2 using one half standard deviation shocks	275	292	314	278	249	223	134	24
B4. One-time 30 percent real depreciation in 2006	275	324	299	273	254	235	168	79
B5. 10 percent of GDP increase in other debt-creating flows in 2006	275	280	256	232	213	195	135	63
	(Debt Service-to-Revenue Ratio) 2/							
Baseline	17.0	10.6	9.5	8.5	7.8	7.3	4.8	2.3
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	17.0	11.2	11.3	11.4	11.6	12.0	13.9	34.1
A2. Primary balance is unchanged from historical average	17.0	10.6	10.2	9.9	9.6	9.5	9.0	15.5
A3. Permanently lower GDP growth 1/	17.0	10.8	9.8	9.2	8.7	8.5	8.4	21.2
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviation in 2006-2007	17.0	12.0	12.8	12.9	13.1	13.3	14.8	34.4
B2. Primary balance is at historical average minus one standard deviation in 2006-2007	17.0	10.6	11.4	11.9	10.6	9.9	7.2	8.0
B3. Combination of B1-B2 using one half standard deviation shocks	17.0	11.6	12.7	12.7	11.1	10.0	6.1	2.6
B4. One-time 30 percent real depreciation in 2006	17.0	11.6	11.4	10.4	9.7	9.1	6.5	3.5
B5. 10 percent of GDP increase in other debt-creating flows in 2006	17.0	10.6	11.4	10.1	9.2	8.6	6.0	5.2

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

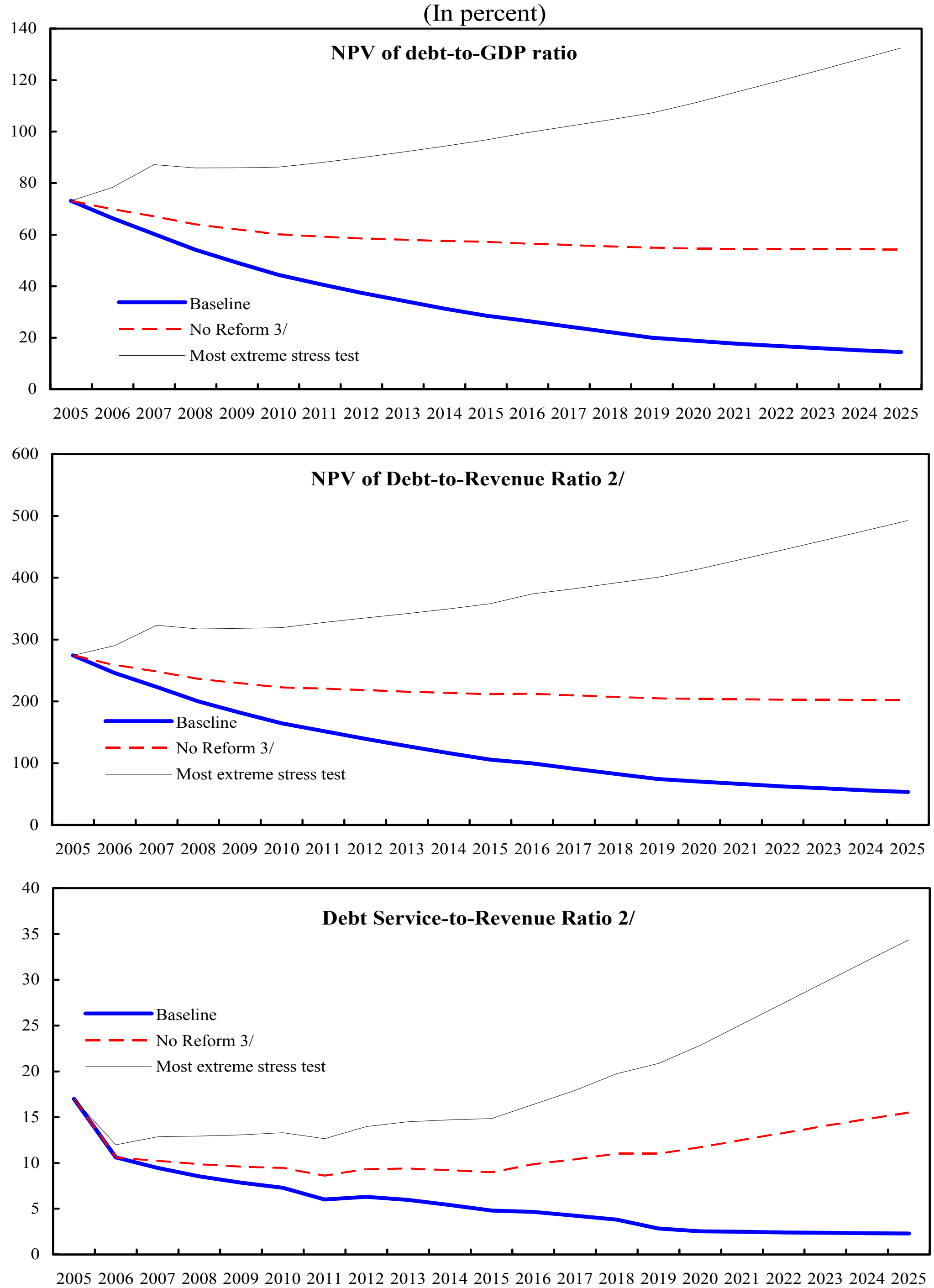
1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of 20 (i.e., the length of the projection period).
2/ Revenues are defined excluding grants.

Annex I Figure 1. Solomon Islands: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2005-2025
(In percent)



Source: Staff projections and simulations.

Annex I Figure 2. Solomon Islands: Indicators of Public Debt
Under Alternative Scenarios, 2005–25
(In percent)



Source: Staff projections and simulations.
1/ Most extreme stress test is test that yields highest ratio in 2015.
2/ Revenue including grants.
3/ Primary balance remains at historical average.

SOLOMON ISLANDS: FUND RELATIONS

(As of June 30, 2005)

I. Membership Status: Joined September 22, 1978; Article VIII

II. General Resources Account:	**SDR Million**	**Percent Quota**
Quota	10.40	100.00
Fund holdings of currency	9.85	94.73
Reserve position in the Fund	0.55	5.29

III. SDR Department:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	0.65	100.00
Holdings	0.00	0.16

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements: None

VI. Projected Payments to Fund:

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

	Forthcoming				
	2005	2006	2007	2008	2009
Charges/Interest	0.01	0.02	0.02	0.02	0.02
Total	0.01	0.02	0.02	0.02	0.02

VII. Implementation of HIPC Initiative: Not applicable.

VIII. Exchange Rate Arrangements:

Since November 2000, the exchange rate for the Solomon Islands (SI) dollar has been based on an undisclosed trade-weighted basket of the currencies of the Solomon Islands' major trading partners, with the US dollar as the intervention currency. During 2002, as pressures on external reserves intensified, the Central Bank of Solomon Islands (CBSI) accelerated the rate of currency depreciation, leading to a gradual real depreciation of the SI dollar. Since December 2002, the CBSI has kept the exchange rate broadly stable against the US dollar, although there is no public commitment to continue to do so. Exchange restrictions reintroduced starting in 2000 were removed in 2003. The Solomon Islands now maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.

IX. Last Article IV Consultation:

The 2004 Article IV consultation discussions were held in Honiara during April 27–May 6, 2004. The staff report (IMF Country Report No. 04/258) was considered by the Executive Board and the consultation concluded on July 16, 2004.

X. Technical Assistance:

Date	Department	Purpose	Duration
Short-term			
January 14, 1998	PFTAC	Statistics	2 weeks
February 3, 1998	PFTAC	Tax administration	1 week
May 4, 1998	PFTAC	Tax administration	4 weeks
June 7, 1998	PFTAC	Banking supervision	2 weeks
June 30, 1998	PFTAC	Balance of payments statistics	2 weeks
November 28, 1998	PFTAC	Public financial management	1 week
February 9, 1999	PFTAC	Banking supervision	1 week
September, 1999	MAE	Treasury bill auctions and monetary operations	8 weeks
October 3, 2000	MAE	Advisor to CBSI	2 weeks
May, 2001	PFTAC	Banking supervision	1 week
October 2002	PFTAC	Banking Supervision	10 days
January 2003	PFTAC	Statistics	1 week
February 2004	PFTAC	Statistics	2 weeks
May 2004	PFTAC	Tax and customs administration	2 weeks
September 2004	MFD	AML/CFT	1 week
January 2005	PFTAC	Financial reporting system	2 weeks
February 2005	PFTAC	Financial supervision of insurance	2 weeks
April 2005	PFTAC	Financial supervision	2 weeks
May 2005	MFD	Financial supervision of insurance	2 weeks
May 2005	PFTAC	Tax policy and administration	2 weeks
August 2005	MFD	Reserve management	2 weeks
Long-term			
June 1995–June 1999;	MAE	Advisor to CBSI Governor	5 years extended in Oct. 1999 through 2000.
January 2001–present	MFD	Peripatetic Advisor to CBSI Governor	10 six-week missions

XI. Resident Representative: None

SOLOMON ISLANDS: SUPPORT FROM THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTER[1]
(As of July 2005)

Tax administration and policy
A mission in May 2004 designed plans and a time-table for modernizing and enhancing the efficiency of the Customs and Tax Divisions. The authorities agreed to the strategy and have decided to proceed with implementation. The authorities have laid the groundwork for further modernization by: appointing two project managers (Tax & Customs) who will be funded by AusAID; requesting NZAID to fund the implementation of required computer software in the Customs Division; implementing a computer system to help manage the operations of the Inland Revenue Division (IRD) that will be funded by AusAID, and implementing a new organizational structure for IRD, which includes a Large Taxpayer Unit. Meanwhile, a new income tax bill to provide a final PAYE withholding system has been drafted with the assistance of LEG.

A further mission in May 2005 reviewed the current tax system. The mission outlined a detailed strategy for the implementation of tax reform over the next few years and assessed the required technical assistance to support this strategy. It is anticipated that PFTAC and the Fund's LEG will assist with the implementation process and a request for legal drafting for the new tax policy reform package is expected shortly.

Financial sector regulation and supervision
The Central Bank of Solomon Islands (CBSI) has been assigned considerable new responsibilities, including the supervision of insurance companies and the establishment of a Financial Intelligence Unit (FIU). In September 2004, an advisor visited the CBSI to advise on the implementation of an anti-money laundering regime. A peripatetic consultant visited in January 2005 to assist with streamlining the financial reporting system; and experts visited in February and May 2005 to review the supervision and regulation of the insurance industry. In April 2005, a PFTAC expert worked with an MFD expert to provide assistance on the supervision of an insurance company; provide advice on oversight of the Solomon Islands National Provident Fund; develop supervisory guidelines on AML/CFT activities in financial institutions and prepare a project document for establishment of a FIU. CBSI staff also attended a seminar on monetary policy in shallow markets arranged by PFTAC/MFD in March 2005.

Economic and financial statistics
During 2003, the National Statistics Office (NSO) restarted activity, with the production of the Honiara CPI. A PFTAC mission in February 2004 devised a recovery plan, and AusAID and NZAID have committed to provide funding for a long-term advisor, new computers, and a head count of the population. The CBSI currently compiles balance of payments and national accounts data and CBSI staff attended a regional training course on balance of payments statistics arranged by PFTAC in April 2005.

Contact person: Susan Adams, Project Coordinator, sadams@imf.org.

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[1] The Pacific Financial Technical Assistance Centre (PFTAC) in Suva, Fiji, is a regional technical assistance institution operated by the IMF with financial support of the Asian Development Bank, Australia, Japan, 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, Tokelau, Tonga, Tuvalu, and Vanuatu.

SOLOMON ISLANDS: RELATIONS WITH THE WORLD BANK GROUP

(As of July 2005)

Since becoming a Bank member in June 1978, the Solomon Islands has received eight IDA credits totaling US$50 million in the infrastructure, education, health, finance, and agriculture sectors. Following the repayment of all outstanding arrears in September 2003, the Solomon Islands came out of non-accrual status, and country relations have normalized. The Solomon Islands is eligible for an IDA 14 allocation of SDR 5.7 million (indicative only) over FY2006-08. In FY06, this will be on a grant-financed basis with future years subject to annual assessment.

The Bank's assistance program in the Solomon Islands is guided by the Government's own development priorities articulated in the *National Economic Reform, Recovery, and Development Plan* (2003-06), and the Bank's broader *Pacific Regional Strategy*, which has a focus on two main pillars: public expenditure management and private sector development. The Bank's focus for the Solomon Islands is in the following areas:

- **Health Sector.** The IDA-funded (US$4.0 million) Health Sector Development Project approved in mid-2000 is helping address some of the challenges in the sector through the strengthening of the reproductive health and malaria programs, the testing of new approaches, and through improved planning, management and monitoring.
- **Education Sector.** The government has launched a new education strategy and is developing a sector-wide approach to education planning and financing with support from NZAid and the EU. The Bank is providing selected policy inputs into this process, drawing on the lessons of such approaches elsewhere (including in the Pacific).
- **Energy Supply.** The Bank is supporting government's efforts to improve the efficiency of the energy sector by providing technical assistance for the financial restructuring of the Solomon Islands Electricity Authority (SIEA), regulatory reform and capacity building, as well as to explore options to improve rural access and service delivery in remote areas. It is expected that this work will expand to include the water utility (Solomon Islands Water Authority).
- **Telecommunications Sector.** The Bank is providing technical assistance to the Government to examine ways to improve the competitiveness of the sector to reduce telecommunication costs and improve the service quality and coverage.
- **Rural Growth.** The Bank is looking to partner with key donors active in the sector to develop an overall sector strategy and pilot project, to diversify and increase rural income-generating opportunities as the basis for stronger and more inclusive growth.
- **Financial Sector Recovery and Development.** The Central Bank Capacity Building Project with an Institutional Development Fund (IDF) grant of US$ 254,000 has been approved to support capacity building at the Central Bank. The Bank has also provided technical assistance and policy advice to the National Provident Fund to strengthen investment portfolio management.
- **Foreign and Domestic Investment**. The Foreign Investment Advisory Service (FIAS) has provided assistance to the government for the preparation of new foreign investment legislation and is assisting with a review of investment incentives and administrative barriers to business.

Solomon Islands: IDA Lending Operations (as of July 20, 2005)

	Disbursed (USD million)	Undisbursed (USD million)
Health Sector Development Project	2.85	1.42

Contact person: Mahesh Sharma, Country Program Coordinator, msharma@worldbank.org

SOLOMON ISLANDS: RELATIONS WITH THE ASIAN DEVELOPMENT BANK
(As of July 2005)

Since joining the Asian Development Bank (AsDB) in 1973, the Solomon Islands has received 16 loans for a total amount of US$79.3 million, and 57 TA projects for a total amount of US$13.2 million. The loan and TA projects have been in agriculture and fisheries, transportation, infrastructure rehabilitation, finance, power, water supply and sanitation, ports, reform of state-owned enterprises, and institutional development of government ministries and public agencies, particularly the executing agencies of AsDB-financed projects.

During 1994–97, no new operations were initiated because of government arrears on debt servicing obligations. In 1998, with the clearance of overdue loan payments to the AsDB, lending and TA operations resumed. In August 1998, the ADB approved a US$25 million policy-based program loan and a US$1 million TA loan to support the Government's Public Sector Reform Program. The first tranche of the program loan (US$15 million) was disbursed in November 1998. The second tranche of the loan was not released and was eventually cancelled since, subsequent to the outbreak of ethnic unrest in mid-1999, a new government did not support the program's objectives. In 2000, the AsDB approved a US$10 million post-conflict emergency rehabilitation project loan. However, due to debt servicing arrears, the AsDB suspended its operational program in the Solomon Islands in February 2002. The AsDB resumed its country operations after the settlement of the arrears in September 2003. In 2003, one new TA grant was approved for institutional strengthening of the Ministry of Infrastructure Development; in 2004, two TA grants were approved in support of inter-island transportation and state-owned enterprise reforms and private sector participation; one TA grant for interisland transport reform has been approved in 2005, and another one for business environment reforms is proposed for approval in late 2005. However, in agreement with the Government, the AsDB will provide no new loans to the country until public finances have stabilized.

The AsDB's operations in the Solomon Islands are guided by the Pacific Strategy 2005-2009. In support of the Government's *National Economic Recovery, Reform, and Development Plan*, the AsDB will assist the Government in: (i) improving inter-island transportation; (ii) reforming state-owned enterprises; and (iii) providing an enabling environment for the private sector. The AsDB's Pacific Liaison and Coordination Office (PLCO), established in early 2005 in Sydney, is responsible for country programming, project implementation and administration, supported by the Pacific Operations Division (PAHQ) in Manila.

Loans, Approvals, and Disbursements, 1999–2004

(In millions of U.S. dollars)

	1999	2000	2001	2002	2003	2004
Loan approvals	--	10.00	--	--	--	--
Loan disbursements	0.32	0.45	0.01	0.00	0.23	0.86
Cumulative loan amount approved (as of end-of-year)	69.31	79.31	79.31	79.31	79.31	79.3
Cumulative net effective loans (as of end-of-year)	64.65	54.30	64.05	64.83	65.87	66.3
Cumulative disbursements (as of end-of-year)	53.61	54.07	54.07	54.07	54.30	55.1

Contact person: Winfried Wicklein, Desk Officer for the Solomon Islands, wwicklein@adb.org

SOLOMON ISLANDS: POVERTY AND HUMAN DEVELOPMENT INDICATORS

Social indicators of poverty and human development are low in the Solomon Islands. The country ranks below all Pacific island countries, except Papua New Guinea and Vanuatu, in the United Nations Human Development Index, coming in at 124 out of 175 countries. There are few recent poverty statistics, but anecdotal evidence suggests poverty remains high. However, the more extreme forms of poverty, such as malnourishment, have remained limited due to an abundant resource base, assured access to customary land tenure, and resilient social networks. This advantage is under pressure from a population growth rate that, at about 3 percent a year, is amongst the highest in the world.

Nonetheless, the Solomon Islands has achieved some progress in improving living conditions since independence despite falling per capita incomes. Prior to the outbreak of the civil conflict in 1999, sizable health and education expenditures (at 3–5 percent of GDP each) and high per capita aid inflows had helped underpin these improvements. Providing widespread and quality education to the very young population (43 percent under age 15) is a challenge. The primary education enrollment ratio is about 97 percent, although primary education is not compulsory. The enrollment ratio is only 30 percent in secondary education. Concerning health, malaria is rampant, with the highest rate of infection in the world outside of sub-Saharan Africa, and more than a third of the rural population lacks access to safe water.

The paucity of data makes an assessment of human development trends since 1999 difficult. It is likely that the positive trend was halted, if not reversed during the years of the civil conflict. Public service delivery was hampered, and large inter-island migrations put strains on the existing capacity. While the conflict led to a sharp decline in agricultural production for market (due to the lack of security and transport services), it has recovered since mid-2003, and anecdotal evidence suggest that the delivery of pro-poor services is improving.

The aggregate social indicators mask large differences between urban and rural areas. The two main problems in the rural sector are the lack of essential public services such as health and education, and cash income due to difficulties in market access for rural products. While the urban areas have better social services and average incomes are higher, the urban poor face difficulties in securing employment and land for residence.

The government has adopted the Millennium Development Goals (MDGs) in its *National Economic Recovery, Reform, and Development Plan*, and has committed to monitor progress toward them. Achieving the MDGs by 2015 is still possible, but remains a major challenge. Progress in some areas, such as reducing malaria incidence, maternal mortality and ensuring environmental sustainability, has so far been inadequate.

Solomon Islands: Millennium Development Goals Progress

	1990	2000	Data 2002–03	Target 2015
Goal 1: Eradicate Extreme Poverty and Hunger				
Prevalence of child malnutrition (percent of children under 5)	21	21	...	11
Goal 2: Achieve Universal Primary Education				
Net enrollment ratio in primary education	39	74	79	100
Goal 3: Promote Gender Equality				
Ratio of girls to boys in primary education (percent)	81	86	...	100
Ratio of girls to boys in secondary education (percent)	58	70	..	100
Proportion of seats held by women in national parliament (percent)	...	2	0	...
Goal 4: Reduce Child Mortality				
Under 5 mortality rate (per 1000)	36	30	22	12
Infant mortality rate (per 1000 live births)	76	68	19	25
Goal 5: Improve Maternal Health				
Maternal mortality ratio (per 100,000 live births)	...	130	...	...
Births attended by skilled health staff (percent of total)	...	...	87	...
Goal 6: Combat HIV/AIDS, Malaria and Other Diseases				
Incidence of tuberculosis (per 100,000 people)	392	81	60	...
Incidence of malaria (per 100,000 people)	45,000	15,172	19,600	less than 8000
Goal 7: Ensure Environmental Sustainability				
Forest area (percent of total land area)	92	90.6	87	...
Nationally protected areas (percent of total land area)	...	0	1.3	...
CO2 emissions (metric tons per capita)	0.5	0.4	...	...
Access to an improved water source (percent of population)	...	71	70	100
Access to improved sanitation (percent of population)	...	30	...	...
Goal 8: Develop a Global Partnership for Development				
Fixed line and mobile telephones (per 1,000 people)	16	...	19	...
Personal computers (per 1,000 people)	...	25	44	...

Sources: World Bank,World Development Indicators and World Bank Human Development Indicators,
United Nations, Millenium Development Indicator Database.

Solomon Islands: Social Indicators

	Latest Single Year			Same Region/Income Group	
	1975–80	1985–90	1997–2003	East Asia & Pacific	Low-Income
POPULATION					
Total population, mid-year (millions)	0.2	0.3	0.5	1,855	2,312
Growth rate (Percent annual average for period)	3.4	3.2	2.8	1.0	1.9
Urban population (percent of population)	10.5	14.6	21.4	39.1	30.4
Total fertility rate (births per woman)	7.1	5.9	5.3	2.1	3.7
INCOME					
GNI per capita (US$)	480	730	560	1,070	440
Consumer price index (1995=100)	19	58	203	...	...
Food price index (1995=100)	...	...	...	...	...
SOCIAL INDICATORS					
Public expenditure					
Health (% of GDP)	...	...	4.5	1.9	1.5
Education (% of GDP)	...	...	3.4	3.2	3.2
Social security and welfare (% of GDP)	...	...	...	...	...
Net primary school enrollment rate					
(Percent of age group)					
Total	...	83	...	93	77
Male	...	89	...	93	82
Female	...	77	...	94	72
Access to an improved water source					
(Percent of population)					
Total	...	...	70	78	75
Urban	...	...	94	92	89
Rural	...	...	65	69	70
Immunization rate 1/					
(Percent under 12 months)					
Measles	...	70	78	82	65
DPT	46	77	71	86	67
Child malnutrition (percent under 5 years)	...	21	21	15	44
Life expectancy at birth					
(Years)					
Total	58	64	70	70	58
Male	57	64	68	68	57
Female	59	65	71	71	59
Mortality					
Infant (per 1,000 live births)	43	29	19	32	80
Under 5 (per 1,000 live births)	56	36	22	41	123
Adult (15-59)					
Male (per 1,000 population)	...	...	221	179	319
Female (per 1,000 population)	...	...	154	122	268
Maternal (modeled, per 100,000 live births)	...	...	130	116	689
Births attended by skilled health staff (percent)	...	...	85	87	38

Source: World Bank, 2005 World Development Indicators CD-ROM.

1/ Immunization refers to children aged 12-23 months who received vaccinations before one year of age.

SOLOMON ISLANDS: STATISTICAL ISSUES

The Solomon Islands' economic and financial database is poor. Data shortcomings significantly limit the staff's analysis, particularly for the real, fiscal, and external sectors. Only the Central Bank of the Solomon Islands (CBSI) regularly provides monetary statistics that are adequate for surveillance purposes. Overall, the data are barely adequate for surveillance. Although the rebuilding of the National Statistical Office (NSO) has commenced, the CBSI continues to publish highly summarized monetary and price data in its *Monthly Economic Bulletin* and data on all sectors in its *Quarterly Review* and *Annual Report*. There is a Solomon Islands page in the *IFS,* but significant updating delays occur.

Real sector statistics

The NSO has not produced national accounts data since 1994. The task of preparing GDP estimates was taken over by the CBSI, but its annual estimates build on a limited amount of source data (primarily commodity exports and employment estimates) and no breakdown of GDP by expenditure categories is provided. Data on production of major export commodities are reported on a monthly basis. Limited data on employment can be obtained from the National Provident Fund, while wage data are not produced. The NSO reclaimed the task of producing the CPI (which currently applies only to Honiara) from the CBSI in August 2003, but the weights are outdated.

Monetary and financial statistics

Monetary statistics are compiled by the CBSI on a monthly basis and summary data are published in the *Monthly Economic Bulletin,* while more detailed data are published in the *Quarterly Review* and *Annual Report*. The monetary and financial statistics provided to the Fund are considered adequate for surveillance purposes. Prior to the civil conflict, monetary statistics were reported to the Fund's Statistics Department with a four-week lag. Over the past several years, however, direct reporting to STA by the CBSI was suspended (monetary statistics obtained from APD continued to be published in the *IFS*). Recently, the CBSI has resumed direct reporting to STA, but it fails to utilize the standardized report forms (SRFs) for reporting monetary statistics to the IMF, introduced in October 2004.

Government finance statistics

The Ministry of Finance (MOF) started disseminating monthly press releases on budget realizations in August 2003. However, expenditure and financing data provided by the MOF are not consistent with GFS methodology, and the reliability of historical data is doubtful given the breakdown of accounting mechanisms and large expenditure arrears accrued during the crisis. Separate data for the provincial government finances are not available and financial data for state enterprises have not been compiled for several years. With the exception of direct budget support, the authorities do not collect information on disbursements of grants or grant-financed development spending. The installation of the Commonwealth Secretariat Debt Recording and Management System (CS-DRMS) database in the CBSI and MOF in March has improved the quality of official debt data. The MOF has not reported annual GFS data for publication in the *Government Finance Statistics Yearbook* (*GFSY*).

External sector statistics

Partial quarterly balance of payments data are estimated by the CBSI on the basis of cash foreign exchange transactions reported through the banking system and are available with a three-month lag. In the absence of supplementary surveys (e.g., on foreign direct investment and aid inflows), such data are deficient in both detail and coverage.

Remedial Measures

The NSO is being rehabilitated, and is gradually resuming data collection and publication responsibilities. A PFTAC GDDS mission in February 2004 concluded that rebuilding the statistical system will require extensive TA over at least two years and external funding. Following its recommendations, a new government statistician was appointed in 2004 and a long-term adviser—funded by AusAid and NZAid—took up his post in April 2005.

The NSO is currently conducting a business survey and has commenced preparation for a household income and expenditure survey (HIES), expected to take place over a six month period beginning in October 2005. The HIES results will then be used to construct new bases for the national accounts and the CPI weights. Work on producing 2005 national accounts estimates is expected to commence in April-May 2006. The NSO has started work on a construction price index, and following the HIES, plans to prepare national headline and underlying CPIs. A population census is planned for late 2009, with preparations expected to commence in 2007.

The PFTAC GDDS mission identified a number of other statistical issues that still require attention, including increasing the response rate to balance of payments surveys in order to reduce reliance on foreign exchange transaction records, and resuming use of customs data for the estimation of imports and exports. The PC Trade software, scheduled to be installed at the Customs Division in 2006, will make it easier for the NSO to make use of customs data to prepare trade estimates. Nonetheless, the NSO should soon be in a position to produce export and import value estimates based on customs data, with volume estimates to follow. The NSO continues to be hampered by weak technological skills amongst its staff and low survey response rates, which it is seeking to address through tougher penalties under the Statistics Act. The NSO has prepared a prototype of government finance statistics tables based on recurrent revenue and expenditure data provided by the Ministry of Finance. However, this work in progress is still very preliminary, and is hampered by the dearth of aid and development spending information. Audits of state enterprise accounts are currently underway and, once completed, should provide a better picture of public sector finances. PFTAC is planning to provide technical assistance to the NSO in the area of government finance statistics compilation.

SOLOMON ISLANDS: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of August 23, 2005)

	Date of latest observation	Date received[8]	Frequency of Data[9]	Frequency of Reporting[9]	Frequency of publication[9]
Exchange Rates	July 2005	July 2005	D	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	July 2005	July 2005	W	M	M
Reserve/Base Money	July 2005	August 2005	M	M	M
Broad Money	July 2005	August 2005	M	M	M
Central Bank Balance Sheet	July 2005	August 2005	M	M	M
Consolidated Balance Sheet of the Banking System	July 2005	August 2005	M	M	M
Interest Rates[2]	July 2005	August 2005	W	M	M
Consumer Price Index	May 2005	July 2005	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]					
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	December 2004	April 2005	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[5]	December 2004	March 2005	A	A	A
External Current Account Balance[6]	December 2004	May 2005	Q	Q	Q
Exports and Imports of Goods and Services[6]	March 2005	July 2005	Q	Q	Q
GDP/GNP[7]	December 2004	May 2005	A	A	A
Gross External Debt	December 2004	March 2005	A	A	Upon Request

[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 non-bank 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] Detailed balance of payments data derived from foreign exchange transactions through the banking system are available on a quarterly basis with a 3-month lag.
[7] The most recent official data are for 1994, but the central bank has produced real production estimates through 2004.
[8] Including data received following specific requests by Fund staff.
[9] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); and Not Available (NA).

INTERNATIONAL MONETARY FUND
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EXTERNAL RELATIONS DEPARTMENT

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IMF Executive Board Concludes 2005 Article IV Consultation with the Solomon Islands

On September 28, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Solomon Islands.[1]

Background

The recovery, which began after the arrival of Regional Assistance Mission to the Solomon Islands (RAMSI) in mid-2003, has continued. With the restoration of law and order and extensive donor assistance, in the last two years the economy registered positive per capita growth, lower inflation, improved public finances, and a stronger external position. International reserves have been rebuilt to comfortable levels.

After several years of underperformance, the Solomon Islands' growth in the past three years has been about 2½ percentage points above the Pacific Island Countries' average. Boosted by logging, real GDP growth was 5½ percent in 2004 for the second year running. In 2005, although nonlogging growth should accelerate due to the pickup in investment and significant fiscal stimulus, absent a net contribution from logging, growth is projected to moderate to 4½ percent. Inflation rose to 7.8 percent in 2004 due to increased nontradable demand by expatriates and rising fuel prices, and is projected to be broadly unchanged this year, due to the continued pass-through of persistently high oil prices and the pickup in economic activity.

The central government recorded a large surplus of 8¼ percent of GDP in 2004 due to

[1] 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. 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.

higher budget support grants, improved tax collection, eliminating militia payments, tighter expenditure controls, and limited spending capacity. Despite further revenue gains, a small deficit (½ percent of GDP) is projected in 2005, as capacity and the wage bill rise and budget support falls. About half of the deterioration between 2004 and 2005 is due to exceptional factors, primarily Australia's withdrawal of budget support, one-off revenue from a tax amnesty and payment of back taxes in 2004, and one-off civil servants bonus this year.

The external position improved markedly in 2004. The current account recorded a surplus of 12½ percent of GDP, owing to a strong recovery of both timber and other primary commodity exports, low imports, and an almost doubling of current transfers. Net international reserves (NIR) rose to US$76 million, equivalent to 5½ months of 2005 projected imports. In 2005, the current account is projected to post a large deficit, mainly due to the high import content of investment projects, but also to a rising oil import bill and recovery from a low import base. Despite the wide current account deficit projected for 2005, with development grants expected to be strong and FDI to rise considerably, NIR are projected to decline only marginally.

Soaring net foreign assets at the central bank led to a 74 percent rise in reserve money in 2004. However, a large buildup of banks' excess reserves prevented strong money growth from translating into high inflation. Banks' caution limited real private credit growth to 2.5 percent and resulted in banks accumulating excess reserves equivalent to 39 percent of deposits. Real private credit growth rose to 21 percent year-on-year in May 2005, as banks' excess reserves dropped to 32 percent of deposits.

Although macroeconomic stability has been maintained, progress on structural reforms has been mixed. In the fiscal area, tax administration has improved, and the government has started work on a medium-term fiscal framework. In the structural area, work has started on a wide range of reforms, but progress, especially on the legislative front, has been slow, mainly because attaining reform buy-in has required extensive consultations.

Executive Board Assessment

Executive Directors welcomed the continued recovery of the Solomon Islands' economy and the maintenance of macroeconomic stability. Inflation is expected to remain in single digits; strong commodity exports and substantial aid flows have strengthened the external position; and reserve coverage is comfortable. Directors commended the authorities for these improvements, but noted that the country still faces difficult challenges that will require sustained policy efforts in the coming years. Logging is expected to decline from its current unsustainable level over the medium term and unless growth in other sectors picks up, living standards will likely fall. Against this background, Directors urged the authorities to set macroeconomic policies with a longer-term horizon, embrace fiscal reform to make room for social and infrastructure-related spending without jeopardizing fiscal sustainability, and step up the pace of structural reform to promote private sector development.

Directors commended the authorities for the marked improvement in the fiscal position in 2004 and welcomed the increased focus of spending on priority sectors in the 2005 Budget. At the same time, spending plans should take into account the country's still limited absorptive capacity, and the authorities were advised to save any revenue overperformance and underspending to keep this year's deficit below budget. Going forward, Directors stressed the need for continued fiscal consolidation, given limited financing sources and the need to reduce the high level of public debt. In this connection, they emphasized the importance of implementing a medium-term fiscal framework, and urged the authorities to adopt a combined-source budget that would include all aid flows.

Directors agreed that further rationalization and tighter controls over expenditure, in particular the wage bill, are needed in order to help reorient spending toward primary education and health, infrastructure, and maintenance. Progress over the medium term will require a broad based reform of the civil service. Directors welcomed the authorities' proposed tax reform to bolster domestic revenue in the face of declining import and logging duties and encouraged continued efforts to strengthen tax administration. They also urged the authorities to reduce the scope of tax exemptions. Directors considered that fiscal decentralization should be preceded by a strengthening of the public finances and of administrative capacity and should not be allowed to weaken fiscal discipline. Given that the Solomon Islands debt situation will remain fragile even if sound policies are implemented, Directors welcomed the authorities' plans to normalize relations with creditors, and, in this context, emphasized the importance of tackling arrears.

Directors considered that the policy of stabilizing the exchange rate in the face of strong foreign inflows, which has been in place since early 2003, remains appropriate at the current juncture. Looking ahead, they agreed that it will be important to avoid intervention in the face of possible downward pressures on the exchange rate, and a few Directors also suggested keeping under review the possibility of allowing some appreciation if warranted. Directors noted that continued strong foreign inflows, a drawdown of government deposits, and the acceleration in private credit growth could pose challenges for the conduct of monetary policy. They called on the central bank to continue to develop further its instruments of monetary policy, and to stand ready to rein in credit growth in the face of inflationary pressures.

Directors noted that the banking system of the Solomon Islands is generally sound, although the pick up in credit growth will require strong risk management practices by banks. Directors expressed concern about the continued poor profitability of the National Provident Fund (NPF) and the associated fiscal risks. In this context, they welcomed the authorities' efforts to introduce greater transparency in the NPF's operations and their initiative to improve its governance, including through the planned legislation. Directors also recommended that the troubled Development Bank of the Solomon Islands be liquidated. They welcomed the amended anti-money laundering (AML) Act and the steps being taken to combat money laundering and the financing of terrorism.

Directors underscored that a strengthened commitment to wide-ranging structural reforms will be key to creating an enabling business environment for private sector development, and mitigate the impact of declining logging activity on growth over the medium term. In this context, the passage of the foreign investment bill and significant efforts to streamline regulation and licensing procedures will send a positive signal to investors and donors. It will also be important to deepen state-owned enterprise reform and strengthen the regulatory environment for utilities in order to improve service delivery and reduce fiscal risks. Directors also highlighted the critical importance of better governance and stronger institutions, including an efficient civil service, to enhance confidence, promote a level playing field for private sector activity, and ensure the effective management of aid flows.

Directors noted that several shortcomings of the statistical database continue to hamper surveillance. While welcoming the remedial efforts that are currently under way, they urged the authorities to step up efforts to improve the reliability, coverage, and timeliness of data, which will enable the authorities to strengthen economic analysis and policymaking.

Solomon Islands: Selected Economic Indicators, 2000–05

	2000	2001	2002	2003	2004 Est.	2005 Proj.
Growth and prices (percentage change)						
Real GDP	-14.3	-9.0	-2.4	5.6	5.5	4.4
CPI (period average)	6.9	7.6	9.4	10.1	6.9	6.6
CPI (end of period)	7.6	6.5	15.4	3.8	7.8	8.0
Nominal GDP (millions of US$)	299	274	226	228	258	285
Central government operations (percent of GDP)						
Total revenue	22.1	23.5	18.8	37.6	48.9	48.5
Recurrent revenue	18.3	15.3	16.2	19.5	26.8	26.6
Grants	3.7	8.2	2.6	18.1	22.1	21.8
Total expenditure 1/	29.9	36.2	29.8	39.5	40.6	49.0
Recurrent expenditure	25.3	27.3	26.6	23.9	22.9	27.9
Development expenditure	4.6	8.9	3.2	15.6	17.7	21.1
Recurrent balance 2/	-6.3	-11.8	-10.0	-0.5	8.4	1.0
Overall balance 3/	-7.8	-12.7	-11.0	-1.9	8.3	-0.5
Foreign financing (net)	0.6	5.0	3.8	0.4	-1.6	-0.6
Domestic financing (net)	4.2	-1.4	-3.0	-9.0	-6.7	1.3
Other	0.4	8.5	9.0	10.0	-2.4	-0.2
Stock of expenditure arrears (in percent of GDP, end of period) 4/	4.9	8.9	12.1	14.9	8.0	7.8
Domestic principal arrears (percent of GDP)	0.0	3.9	7.1	12.1	0.0	0.0
Central government debt (percent of GDP) 5/	69.7	94.1	114.1	122.0	92.3	88.0
Domestic	27.8	45.1	47.1	51.5	30.4	26.7
External	42.0	49.0	67.0	70.6	62.0	61.4
External debt (in US$ millions, end of period)	125.6	134.3	151.6	160.8	159.9	175.1
External debt service to exports of GNFS (accrual basis)	3.9	8.1	10.3	9.0	5.9	7.8
Monetary and credit (percentage change, end-year data)						
Net foreign assets	-39.8	-31.8	30.2	106.4	111.0	0.8
Net domestic assets	46.8	-4.4	-4.8	-11.0	-60.4	85.1
Net domestic credit	23.0	-7.2	11.0	-0.7	-36.1	43.3
Credit to private sector	1.8	-21.8	12.2	26.1	10.6	40.0
Broad money	0.5	-13.2	4.0	26.0	28.1	13.4
Balance of payments (US$ millions, unless otherwise indicated)						
Exports, f.o.b	65.1	47.1	57.8	74.2	96.7	100.2
Imports, c.i.f.	-98.1	-90.6	-62.3	-85.2	-98.7	-140.3
Current account	-31.7	-35.1	-16.3	3.1	32.3	-30.8
(Percent of GDP)	-10.6	-12.8	-7.2	1.3	12.5	-10.8
Capital account	8.5	17.2	6.3	11.1	8.1	27.5
Overall balance (accrual)	-23.1	-17.9	-10.0	14.2	40.4	-3.2
Gross official reserves (US$ millions, end of period)	31.3	18.5	17.5	36.0	79.0	78.5
(In months of next year's imports of GNFS)	3.1	2.8	2.1	3.6	5.7	4.7
Exchange rate (SI$/US$, end of period) 6/	5.10	5.56	7.46	7.49	7.51	7.52

Solomon Islands: Selected Economic Indicators, 2000–05

	2000	2001	2002	2003	2004 Est.	2005 Proj.
Real effective exchange rate (period average, 2000=100) 7/	100.0	109.2	90.8	78.5	77.4	78.3
Nominal effective exchange rate (period average, 2000=100) 7/	100.0	103.2	80.1	64.0	59.6	57.8

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

1/ Expenditures are presented on an accrual basis.
2/ Includes recurrent budget grant support.
3/ Calculated from above-the-line data.
4/ Includes interest arrears.
5/ Includes arrears.
6/ 2005 column reflects data for end-July 2005.
7/ 2005 column reflects data for end-May 2005.