Solomon Islands balance of payments, 1984–89[1]

Carlene Y. Francis and Denton Rarawa

Policy issues

The balance of payments is generally considered to be in equilibrium when there are no wide or persistent fluctuations in the level of external reserves. An increase in external reserves over time reflects the relative strength of the economy, while a sustained decline indicates some underlying weaknesses in the economy. In order to ensure that a protracted downturn in external reserves does not compromise the economy's growth and development objectives, the authorities must adopt appropriate short-term or long-term policy measures to arrest the decline.

One of the primary functions of the Central Bank, as outlined in the Central Bank Act, is 'to promote monetary stability and foster financial conditions conducive to the orderly and balanced economic development of Solomon Islands'. The Central Bank, therefore, monitors developments in the balance of payments closely, and it is required to advise the government promptly on any adverse developments and to recommend the most appropriate policy response.

In assessing the balance of payments performance, there are several balances that must be considered. For policy purposes, however, the Central Bank usually focuses on the current account. The current account position reflects the underlying strength or weakness of the economy and its capacity to mobilize and utilize its resources efficiently and effectively. A current account deficit implies that domestic demand is running ahead of output, and must be financed by increased liabilities incurred in the capital account. If the growth of these liabilities or use of reserves cannot be sustained, then the current account deficit itself is not sustainable, and must be reduced to avoid running out of foreign currency resources. This may be done by increasing output of traded goods or reducing demand. The Central Bank, through its application of monetary policies, plays a key role in restraining domestic demand and in stimulating increased output.

In an open developing economy like Solomon Islands, a current account deficit is not a bad thing. Indeed, it is quite normal for developing countries to run deficits in their current accounts as they pursue policies designed to promote growth and development. Such policies would necessarily involve a high level of imports of capital goods, and expansion of domestic demand for all kinds of consumer goods, many of which are not made locally. The key consideration, therefore, is not the deficit per se but rather its sustainability. Between 1987 and 1989, the Solomon Islands current account deficit as a ratio to monetary GDP rose from 21.5 per cent to 37.3 per cent, far in excess of the 10–15 per cent that is considered to be sustainable. This, therefore, underscores the need for urgent and effective action to bring the deficit under control.

If the trends in net external reserves are considered, particularly over the period 1986–88, it may be concluded that the country was performing quite well. This would not be correct, however, as the underlying balance of payments position since 1984 has been quite weak. The inflow of STABEX (European Community Stabilization of Exports Scheme) funds, particularly between 1986 and 1988 has helped to disguise the growing pressure on the external reserves. For policy reasons, therefore, it is more useful to look at the current account position when assessing the balance of payments performance in an economy like Solomon Islands.

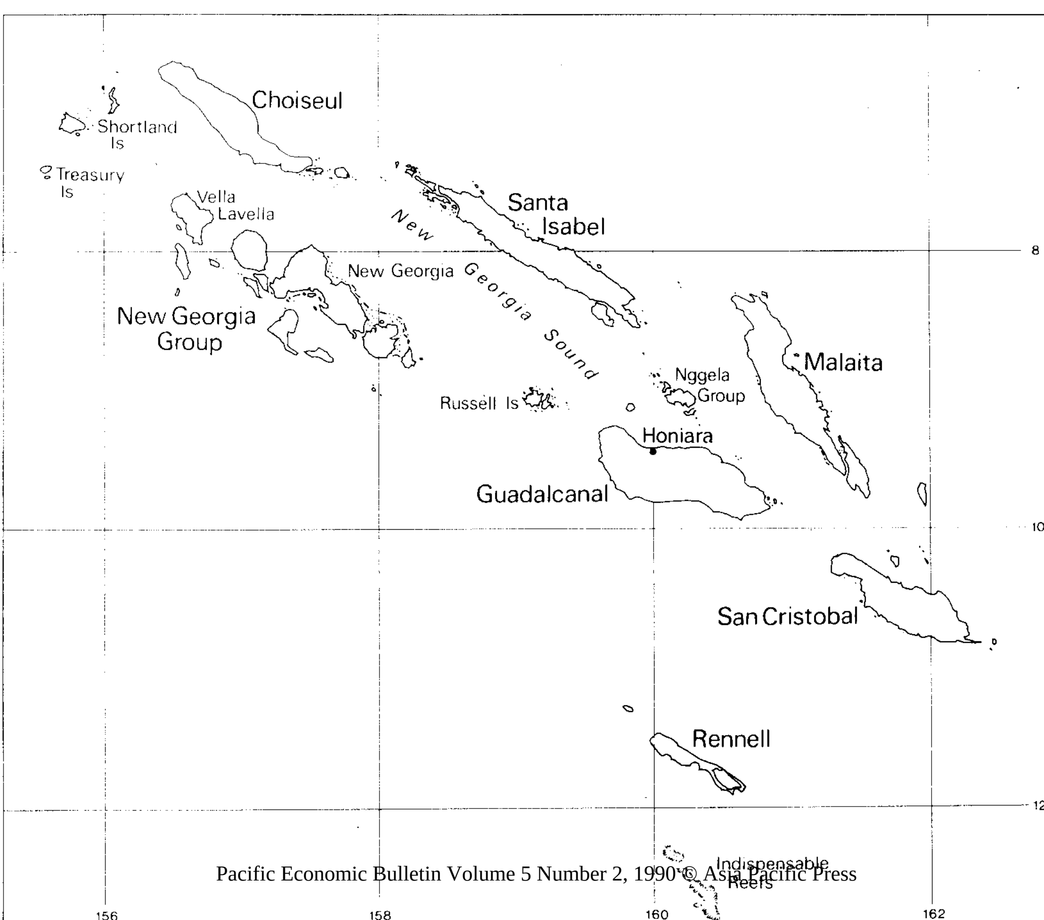
1 This is a condensed version of an article in the Central Bank of Solomon Islands *Quarterly Review* June 1990, Vol. 2, No.2.

The policy measures that the Central Bank may use in an effort to reduce the current account deficit include credit controls and exchange rate adjustments. The credit control tool that is most widely used to restrain demand is interest rate ceilings. When the cost of credit increases and availability falls, as a result of the 'crowding out' effect, it becomes more expensive for companies to expand and hold inventories and the demand for private sector credit should generally fall. This reduced demand for credit should be reflected in fewer imports, hence easing the pressure on external reserves. In reality, however, import demand has remained high, fuelled in part by heavy government expenditures. This, in the face of sluggish export receipts, will exert considerable pressure on external reserves.

With regard to exchange rate adjustments, the Central Bank is charged with the responsibility of carrying out exchange rate policies set by the Minister of Finance, in consultation with the Bank. The broad objectives of exchange rate policy are to maintain the competitiveness of both Solomon Island exports and production for the domestic market, as well as to protect the country's external reserves, while seeking as much domestic price stability as the growth objective will allow.

From a longer-term perspective, a country can improve the balance of payments through appropriate action to constrain demand and increase output. All countries have found that fiscal policy must work in tandem with monetary and exchange rate policies if domestic demand is to be effectively reduced. On the supply side, governments have found that they must provide the necessary incentives to promote and expand production, and provide the right environment for increased investment and output by the private sector. In developing countries, every effort has to be made to remove structural impediments to growth, such as those relating to land, transportation, telecommunications and the training of local personnel.

Solomon Islands



Developments

Since the boom years of 1983–84, when commodity prices moved sharply in favour of the Solomon Islands, the Solomon Islands balance of payments has come under increasing pressure. The value of international transactions has risen dramatically, even if allowance is made for inflation. Total foreign payments have risen from slightly over SI$200 million in 1984 to something less than SI$500 million in 1989. In total, the accounts have been in balance, but the growth in current receipts, other than official aid, from SI$139 million in 1984 to SI$262 million in 1989 has been slower than the growth in payments. The rise in official foreign aid from SI$18 million to SI$85 million and increased foreign borrowings has prevented foreign reserves from falling. Yet their constancy (SI$48.9 million at the end of 1983 and SI$49.8 million at the end of 1989) means that the reserve cover as conventionally measured (number of months of current payments that could be purchased with current reserves) has fallen from five and a half months at the beginning of 1984 to two months at the end of 1989 (Chart 1).

1984–86

Following a surplus of SI$9 million in 1984, the current account swung into a deficit of SI$34 million in 1985 before posting a small surplus in 1986 (Table 1). The current account deficit as a ratio of monetary GDP soared to 21 per cent in 1985, well above the 10–15 per cent that experience suggests is a sustainable level (Chart 2). The deterioration in the current account in 1985 reflected the sharp turnaround in the trade balance from a surplus of SI$16 million in 1984 to a deficit of SI$21 million in 1985. Following a rise of 65 per cent in 1984, exports fell by 10 per cent to SI$105 million. This resulted mainly from a general fall in commodity prices that was particularly sharp in the case of vegetable oils, compounded by a decline in the volume of fish, logs and palm oil. Reflecting the drop in export earnings, exports as a ratio of monetary GDP fell to 63 per cent in 1985 from a year earlier ratio of 74 per cent (Chart 3).

Table 1 **Solomon Islands balance of payments, 1984–89** (SI$ million)

	1984	1985	1986	1987	1988	1989
Current account	**8.6**	**-34.1**	**0.1**	**-14.7**	**-37.7**	**-69.3**
Goods and services	*-6.8*	*-47.6*	*-67.8*	*-78.3*	*-120.7*	*-157.6*
Merchandise trade (net)	15.8	-21.1	-30.3	-43.2	-81.2	-84.5
Exports, fob	(118.6)	(105.1)	(111.2)	(126.6)	(170.6)	(171.3)
Imports, cif	(102.8)	(126.2)	(141.5)	(169.8)	(251.8)	(255.8)
Services (net)	-22.6	-26.5	-37.5	-35.1	-49.5	-73.1
Travel	(-1.2)	(-1.8)	(-4.9)	(-2.4)	(-7.2)	(-5.1)
Investment income	(-7.1)	(-3.5)	(-5.3)	(-3.0)	(-3.4)	(-1.7)
Other services	(-14.3)	(-21.2)	(-27.3)	(-29.7)	(-38.6)	(-66.3)
Transfers (net)	*15.4*	*13.5*	*67.9*	*63.6*	*93.0*	*88.3*
Official	18.6	17.5	67.3	63.9	96.0	85.5
Private	-3.2	-4.0	0.6	0.3	-3.0	2.8
Capital account	**12.0**	**12.8**	**14.3**	**29.2**	**83.2**	**44.0**
Private (net)	*6.4*	*3.1*	*2.8*	*13.1*	*31.6*	*46.3*
Long-term	2.5	3.2	9.0	-4.7	24.5	33.3
Direct investment	2.5	1.3	3.6	20.2	3.6	13.6
Other	1.4	-1.4	-9.4	-2.4	3.5	-0.6
SI government (net)	*5.6*	*9.0*	*11.0*	*16.1*	*51.6*	*-2.3*
Net errors and omissions	-19.6	8.4	5.5	-9.4	-32.9	0.6
Changes in external reserves (net) (- = increase)	**-1.0**	**12.9**	**-19.9**	**-5.1**	**-12.5**	**24.7**

Source: Central Bank of Solomon Islands.

Chart 1 **Solomon Islands foreign reserves in terms of months of imports of goods and non-factor services**

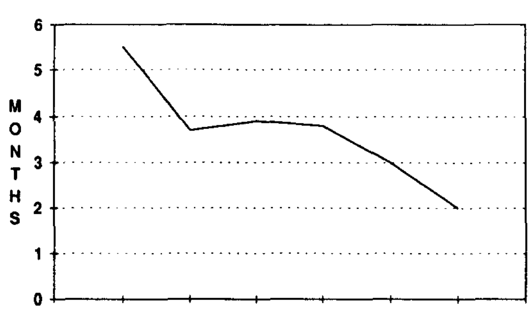


Chart 2 **Solomon Islands current account as a percentage of monetary GDP**

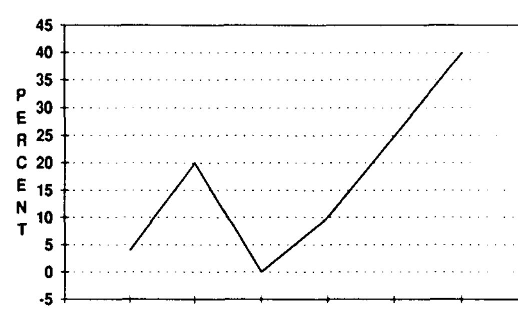
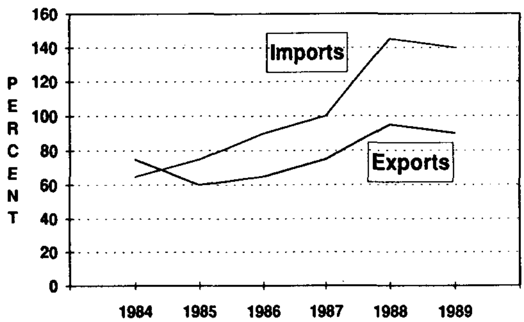


Chart 3 **Solomon Islands merchandise trade as a percentage of monetary GDP**



Buoyed by rising incomes from the boom years and an expansion in domestic credit, arising in part from a growing fiscal deficit, imports increased by 23 per cent to SI$126 million in 1985. This growth in imports caused the import/GDP ratio to rise to 75 per cent from 65 per cent in 1984 and led to a drop in the import cover (imports in months of goods) and non-factor services from over five months in 1984 to two months in 1989.

The adverse impact of Cyclone Namu on the volume of copra and palm oil, coupled with a decline in commodity prices, resulted in the growth of exports slowing to 6 per cent in 1986 (SI$110 million). Exports as a ratio to GDP fell to 70 per cent from the level a year earlier of 74 per cent. Import growth also moderated to 12 per cent from 23 per cent a year earlier. This slowdown in import growth was reflected in a rise in the import cover to almost four months.

The impact of the widening of the trade deficit and the services deficit on the current account was totally offset by a massive inflow of official transfers in 1986, resulting in a small surplus of SI$0.1 million in the current account. The influx of foreign funds related to the Cyclone Namu emergency relief effort and subsequent rehabilitation programs together with SI$17 million in STABEX funds from the European Community to compensate for the shortfall in export receipts during the previous four years accounted in large part for the SI$55 million increase in net transfers in 1986, of which SI$50 million was official.

On the capital account, net private capital inflows over the first half of the review period totalled SI$13 million, of which SI$15 million represented net borrowings and SI$1.5 million net outflows from other investments (including direct investment). A large part of private sector borrowing in Solomon Islands occurs between resident enterprises and their head offices or related companies abroad. Net official capital inflows, from external borrowings, totalled SI$26 million for the period. During this period also, the government contracted a second Eurodollar loan facility of US$30 million from a syndicate of foreign banks to be used for balance of payments support. The bulk of government's borrowings are from international financial institutions and are on concessional terms.

The turnaround in net external reserves in 1986 to an increase of SI$20 million from a year earlier deficit of SI$13 million resulted largely from the receipt of STABEX funds, as there were no fundamental shifts in the underlying balance of payments position. The importance of STABEX receipts to Solomon Islands balance of payments performance became very evident in the second half of the review period when the drawdown of these funds reduced the need for external reserves to cushion the impact of adverse balance of payments effects.

1987–89

In the post Cyclone Namu period 1987–89, there was a widening of the current account deficit from SI$15 million in 1987 to SI$38 million and SI$69 million in 1988 and 1989 respectively. As a ratio to GDP, the account deficit moved from a sustainable 9 per cent in 1987 to 22 per cent in 1988 and 37 per cent in 1989. This deterioration in the current account position reflects the continued widening of the trade deficit. Exports grew at an annual average rate of 16 per cent and imports at 23 per cent. The merchandise trade gap peaked in 1988 when imports jumped to 144 per cent of GDP with exports at 97 per cent.

Export volume fell in 1987 in the aftermath of Cyclone Namu and a sharp drop in the fish catch. However, the strengthening of commodity prices (with the exception of copra), though still markedly lower than in 1984, produced an export growth of 14 per cent in 1987. The strong 35 per cent growth experienced in 1988 reflected a 30 per cent rise in the fish catch, an increase in palm oil volume to pre Cyclone Namu levels, and rising commodity prices (with the exception of fish prices which dropped from US$964 per tonne to US$800). Generally lower commodity prices and a drop of 19 per cent in the fish catch reduced the 1989 export growth to a minimal amount.

The robust growth of imports over the period reflects the growth in private consumption, fuelled in part by a widening fiscal deficit partly financed by foreign borrowing. The start-up of several new projects, such as the Noro cannery, and the expansion of existing enterprises in the agricultural and manufacturing sectors led to a rise in imports. This was supported by a rise in both domestic bank credit to the private sector and foreign direct investment. The sharp increase in imports in 1988 results in part from the lumpiness associated with the receipt of two purse-seine vessels valued at some SI$41.6 million.

Reflecting the growth in imports, the import cover dropped to two months in 1989 from a little over three months in 1987.

Persistently rising net outflows in the services account, from SI$35 million in 1987 to SI$73 million in 1989 produced an accumulated deficit of SI$158 million. This resulted primarily from a marked increase in the net outflow of 'other' services from SI$30 million in 1987 to SI$66 million in 1989, reflecting mainly higher outflows relative to overseas expenses of companies in Solomon Islands.

Massive inflows of official aid led to a surplus in the transfers account of SI$245. In 1986 and 1988, Solomon Islands received SI$63 million in STABEX funds. In 1987 and 1988, the total STABEX inflow was SI$45 million, representing the largest single inflow of cash aid in both years. Without STABEX, the deficit in the current account would have been much larger, with external reserves declining accordingly, unless offsetting measures had been taken to stem the flow. The absence of any STABEX receipts in 1989 largely accounts for the SI$37 million worsening of foreign reserve movements.

Some notable developments occurred in the capital account over the period 1987–89. From a cumulative surplus of SI$39 million in the first half of the review period, the surplus on the capital account surged to SI$156 million in the second half. Net private capital inflow moved from a surplus of SI$13 million in 1987 to SI$46 million in 1989. The main development in 1987 was the rise in direct investment to SI$20 million from a cumulative total of SI$7 million over the 1984–86 period. The main factors contributing to this were a SI$7 million debt to equity conversion by a major export company (offset by an equal repayment of foreign debt), a SI$5 million investment in an existing flour mill, and new equity investments in existing enterprises in the fisheries and large-scale agricultural sectors.

In 1988, net private long-term capital moved to a surplus of SI$25 million from a deficit of SI$5 million in 1987. This turnaround resulted from the implementation of several large investment projects in the fisheries, agriculture and forestry sectors. The growth for 1989 reflected the continuation of work in the fisheries sector and increased investment in the forestry sector, with the establishment of two new logging companies. The SI$10 million increase in direct investment in 1989 was related to the sale of the Mendana Hotel to a foreign company and increased equity investments relative to the two new logging companies and Solomon Telecom.

The most noteworthy development in official long-term capital flows was in 1988 when net inflows rose to SI$52 million from SI$16 million. This was accounted for by repayments for work-in-progress on the purse-seine vessels that were delivered in 1988.

Conclusion

The large and growing deficit in the current account of the balance of payments, particularly over the last three years has become a cause for great concern. It seems clear from other countries' experience, that the appropriate policy response in dealing with the country's balance of payments problems must be a coordinated one between fiscal, incomes, monetary and exchange rate policies. Anything less than this will fall short of achieving the desired objective of promoting the 'orderly and balanced economic development of Solomon Islands'.