Economic survey

Facing up to the challenges of development in Solomon Islands

Satish Chand

Since its arrival in Solomon Islands in July 2003, the Australian Government-led Regional Assistance Mission to Solomon Islands (RAMSI) has made a number of significant achievements, including restoring peace in the nation and discipline to the budgetary process. Budget deficits have been contained, foreign reserves have recovered to healthy levels, inflation is down to single digits, and interest rates on domestic credit are trending down. These are no mean achievements, but the economy is as yet to show significant signs of a rebound. Even with the large fiscal stimulus provided by donor funds, per capita income over the past two years has only grown at an annual rate of 1.7 per cent. At this rate, it will take some 19 years to recover the ground lost during the crisis. It is indeed time for the Solomon Islands government to face up to the challenge of raising the rate of growth of output if the current generation is to see discernable improvements in their wellbeing.

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July 2005 marks the second anniversary of the commencement of the Regional Assistance Mission to Solomon Islands (RAMSI). This anniversary brings with it the opportunity to reflect on the achievements to date and the challenges that lie ahead. This paper provides an objective account of the road travelled since the first peacekeepers landed on Red Beach; particularly with respect to progress in creating sustainable income-earning opportunities for the half-million Solomon Islanders who welcomed the mission when it reached the shores of this country once labelled 'the friendly isles'.[1] Peace has returned to Honiara, normalcy is returning slowly to the countryside. The runaway public debt—due to persistent government deficits that reached 11 per cent of GDP and pushed debt to 113 per cent of GDP in 2002—has been reined in, credit extended by local businesses to government is being cleared for the first time since 1996, foreign exchange restrictions imposed in June 2000 have been relaxed, foreign reserves that had fallen to less than one month of import cover in late 2002 had bounced back by May 2005 to 8 months of import cover, and basic services are slowly recovering the ground lost during the four-year conflict. These achievements were made with the help of some 2,000 military and police personnel, another 20 technical assistance personnel placed within the Ministry of Finance, and an injection of significant sums of donor funds.

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Donors have been extremely generous to Solomon Islands, but such generosity in the absence of good economic management can impede growth. Aid provided for 2003 amounted to US$60 million, equivalent to 24 per cent of national income.[2] More recent data is not available, but anecdotal evidence suggests that aid inflows have increased rapidly since then. The 2005 Budget shows that donors funded approximately 55 per cent of the recurrent budget and nearly the entire development budget. Australian support in the first year of RAMSI amounted to some A$200 million; this is to continue with a four-year total commitment given in the 2005–06 Australian Commonwealth budget of A$841 million.[3] The European Union has committed development grants totalling US$100 million and the Asian Development Bank has lifted its suspension on a US$10 million lending program approved in 2002 (International Monetary Fund 2004). Such large injections of donor funds will (and should) taper off over the coming decade when Solomon Islands will be expected to generate its own funds for sustaining the machinery of the state. Large injections of aid can create significant problems for economic management; namely, the loss of competitiveness of the domestic tradable sector, that is, the ‘Dutch disease’ phenomenon, and lead to inflationary pressures given the fixed exchange rate regime. The improvement in the budgetary position of the state has already created wage pressures, with public servants and members of parliament given a one-off pay rise late in 2004. These wage pressures are likely to ripple throughout the economy, given that the public sector is the largest employer and sets the employment conditions for the rest of the economy.

While local capacity to generate revenues from internal sources to fund the current level of commitments is clearly lacking, rapid and sustained economic growth has to take place over the forthcoming decade if Solomon Islands is to be in a position to fund its recurrent budget from internal sources. The conditions for such growth have to be put in place now; thus Solomon Islanders, and their leaders in particular, must face up to the challenges of putting the economy on a higher growth trajectory. In short, Solomon Islands has to face up to the challenges of development now.

A slow economic recovery

The Solomon Islands’ economy is on a slow road to recovery. Aggregate GDP fell by 25 per cent in the three years of conflict, but the return of peace has brought a growth dividend of 3.8 per cent in 2003, 5.8 per cent in 2004, and the expectation of another 5 per cent in 2005. This rebound is welcome, but there is still a long way to go to recover lost ground during the four-year crisis. Aggregate GDP to the end of 2004 had bounced back to 86 per cent of the level in 1998 while per capita GDP had edged back to 73 per cent of the level then; the large discrepancy between the two is explained by population growth of approximately 2.8 per cent per annum.[4] It will take another decade to reach the level of per capita income in 1998 if aggregate GDP continues to grow at around 6 per cent annually. Aggregate GDP would need to grow in excess of 10 per cent per annum if Solomon Islanders are to see noticeable increases in their income over the coming decade. This in itself is daunting, but other challenges include the political hurdles in the approach to the upcoming elections in 2006, the court challenge to the legality of RAMSI, and the risk of an HIV/AIDS epidemic.

Solomon Islands is not a resource-poor country (Table 1). The data on Solomon Islands is of poor quality, thus the figures reported must be interpreted with caution. Population density is low compared to both

Table 1 **Some basic indicators of development, 2001**

	Solomon Islands[a]	Papua New Guinea	Fiji	Indonesia
Population (‘000)	431	5,253	817	208,980
Per capita GDP (PPP, US$)	1,910	2,570	4,850	2,940
Per capita GDP (1995 US$)	587	897	2763	1,034
Population density (per square kilometre)	15	12	45	115
Investment rate (per cent of GDP)	..	19	13	17
Liquid liabilities (M3 / GDP, per cent)	30	32	38	57
Aid (per cent of GNI)	22.2	7.2	1.5	1.1
Aid per capita (US$)	136.60	38.67	31.78	7.18

Source: Data for Solomon Islands is from Central Bank of Solomon Islands 2005. *Monthly Economic Bulletin*, Volume 2, Number 6, Central Bank of Solomon Islands, Honiara. Data for other countries is for 2001 and sourced from World Bank, 2003. *World Economic Indicators*, World Bank, Washington, DC.

Fiji and Indonesia, per capita GDP is 65 per cent that of Papua New Guinea, while aid receipts on a per capita basis as of 2001 were 3.5 times that of Papua New Guinea and considerably higher than Fiji and Indonesia. Solomon Islands has a total land area that is one and a half times that of Fiji, and thus has a population density that is much lower than Fiji and marginally greater than Papua New Guinea but significantly less than that of Indonesia. There is considerable potential for expansion of primary production given the large subsistence sector, the mostly under-utilised coastal and marine resources, and the yet to be explored mineral deposits. The nation is known to have rich gold deposits on Guadalcanal and Western Province, and nickel deposits on Isabel Island, with ongoing prospecting for copper, oil, and diamonds (International Monetary Fund 2004).

Social indicators of development

The social indicators of development for Solomon Islands compare unfavourably to those for Fiji and Vanuatu and are only marginally better than those for Papua New Guinea. The rapid population growth, measured at the last census in 1999 at 2.8 per cent per annum, is forecast to slow down over the next decade to approximately 2.3 per cent. Some 42 per cent of the population are less than 15 years of age, thus the growth momentum is likely to continue for a generation at least. The rate of spread of HIV / AIDS could adversely affect the rate of growth of the population, however. Gender disparities in Solomon Islands are the highest in the region, with only 30 girls for every 100 boys enrolled in tertiary education; the corresponding figures for Fiji, Papua New Guinea, and Vanuatu are 100, 55, and 50, respectively (Secretariat of the Pacific Community 2004). These figures suggest that eliminating gender disparities will take considerable concerted and sustained effort. Solomon Islands ranks poorly relative to two of its three Melanesian neighbours on all the social indicators of development and has a rate of incidence of malaria that is the worst in the Pacific (Table 2). Solomon Islands, moreover, has all of the risk factors associated with the spread of HIV / AIDS. The incidence of HIV / AIDS, therefore, could be much higher, given the high rates in neighbouring Papua New Guinea that has a very similar risk profile.

Demand for public goods such as primary education, basic healthcare, and access to transport infrastructure is likely to grow in the short to medium term. Solomon Islands historically has had high rates of population growth; the fertility rate at 5.3 is one of the highest in the world.[5] The demand for primary education and basic healthcare will grow as more people access these services with the improving law and order situation. The relatively low primary school enrolment rates and the high incidence of malaria suggest that the demands on budgetary resources for basic health services will grow. The poor state of transport infrastructure and internationally uncompetitive utilities will also demand significant public investment. The resources for such investment are lacking, however.

Macroeconomic conditions

The level and the rate of growth of per capita GDP over the period from independence is shown in Figure 1. The level of income is expressed in constant US dollars at 1995 prices. Per capita income peaked in 1996 at US$850, and was on the way down when the crisis began in mid 1999. By the end of 1998, per capita income had fallen by 6 per

Table 2 **Social indicators of development**

	Solomon Islands	Papua New Guinea	Fiji	Vanuatu
Life expectancy	61[a]	57	69	68
Illiteracy rate (adult)	..	35	7	..
Primary school enrolment rate (data for 2000)	56	77.4	94.7	78.2
Under 5 mortality rate (per '000 live births)[b]	73	88	22	33
Under-weight children (per cent of <5yr olds, data for 2000)[b]	21.0	24.9	15.0[c]	12.1
Fertility rate	5.3	4.4	2.7	4.4
Forecast population growth rate (2004–15)[b]	2.3	2.2	0.7	2.7
Incidence of malaria (per 100,000 population, data for 2002)[b]	16,170	1,430	-	6,930
Death rate from TB (per 100,000 population, data for 2002)[b]	14.8	56.0	0.4	16.3
Number of known HIV / AIDS cases (date)	2 (2 / 2004)	7,320 (8 / 2002)	142 (12 / 2003)	2 (12 / 2003)

[a] Data from the Solomon Islands National Statistics Office, 2005. *Social Statistics*, Government of Solomon Islands, Honiara.
[b] Data from Secretariat of the Pacific Community, 2004. *Pacific Islands Regional Millennium Development Goals Report 2004*, November, Secretariat of the Pacific Community, Noumea.
[c] Data for 1990.
Source: Data for life expectancy and fertility rate (that is, the number of live births per '000 women) are for 2001 and extracted from World Bank 2003. *World Economic Indicators*, World Bank, Washington, DC.

cent from the peak with the remainder of the fall taking place during the period of the crisis; that is from 1999 to 2002. At the end of 2002, per capita income had fallen by one third from its peak in 1996. The collapse in production during the crisis is not peculiar to Solomon Islands; experiences from neighbouring Fiji and several African nations show similar and possibly larger collapses during periods of conflict. The data do not show the levels of income to the end of June 2003; and even more importantly the trauma and pains of those directly affected by the violence. The eviction of many from their homes and places of employment, the retraction of formal activity into subsistence production, the loss of freedom of movement by the innocent majority trapped in their homes during the fighting, and the loss of access to basic services such as primary education and basic healthcare by many Solomon Islanders are not captured by the data, but the effects of these may very well have overwhelmed the loss of GDP (Figure 1). While the fighting was mostly confined to Guadalcanal, the whole nation suffered from loss of public services as the apparatus of the central government based in Honiara was paralysed by the crisis.

Since its arrival in July 2003, RAMSI has been successful in restoring and then maintaining peace and stability. GDP in this period has grown at approximately 4.5 per cent annually; with a population growth rate of approximately 2.8 per cent, per capita GDP has risen at an average of 1.7 per cent per year. At this rate, it will take some 19 years to reach the level of per capita income at the end of 1998; and by then Solomon Islands would have only recovered the ground lost

Figure 1 **Solomon Islands: per capita GDP, levels and growth rates since independence, 1978–2004**

Source: Data to 2001 is from World Bank 2003. Data from 2001 onwards is based on growth rates reported by International Monetary Fund, 2004. *Staff Report for the 2004 Article IV Consultation*, International Monetary Fund, Washington, DC; and Asian Development Bank, 2005. Country programming mission to the Solomon Islands 2005, Mission Report, Asian Development Bank, Manila (unpublished).

during the four-year crisis. The one clear lesson from the crisis in Solomon Islands is that conflicts play havoc with an economy, and have long-lasting and adverse consequences for the welfare of the resident population. The other, and possibly less clear, lesson from this experience is that a stagnant economy, particularly in a climate of rapid population growth, is a recipe for conflicts (see Chand 2002). Both of these observations underscore the importance of maintaining peace, possibly with an efficient law and order machinery and from growth of the domestic economy that provides jobs to those seeking employment. Per capita income would need to grow by an average of 7 per cent over the next decade if Solomon Islands is to double its current (that is, 2005) level of per capita income and even then it would have just surpassed the current level of per capita income in Papua New Guinea. Given the projected annual population growth rate of 2.3 per cent, aggregate GDP would need to grow by 9.3 per cent. These achievements, modest as they may appear, will not come about without decisive action on the part of Solomon Islanders.

Fiscal position—budget deficit and debt levels of the state

Expenditure growth has been contained through improved governance. The civil service payroll has been cleansed of 'ghost' workers; and, some 800 ex-militants hired as police officers during the crisis have been demobilised. The Office of the Auditor General has been tasked to carry out audits of government departments with an additional SBD$2.3 million in the 2005 Budget. The audits, to have the desired effect of improving governance, would have to be released to the public in a timely fashion. The ministries of Education and Human Resource Development and Health received the largest share, 28 and 13 per cent, respectively, of the total outlay of SBD$655 million in the 2005 recurrent budget. Primary education, basic health, and law and order ranked high in terms of the allocation of public resources. The government has allocated SBD$9.4 million in the 2005 Budget to fund an 8 per cent one-off payment to public servants. Another SBD$2.4 million has been allocated to fund terminal grants of SBD$40,000 each for the 50 members of parliament when the current parliament is dissolved on 5 December 2005, with the balance of the SBD$400,000 being used to fund increases in salaries and allowances for members of parliament.

Revenues have increased since the return of peace as compliance with the existing laws has improved. Further growth in tax collections would have to be sourced from increased GDP since tax effort at 26 per cent of GDP may already have peaked. Donors continue to provide budgetary support, but this is due to be phased out in the near term. Support to the recurrent budget from Australia lapsed at the end of 2004 while that from New Zealand to the education budget could lapse at the end of 2005. Foreign aid, however, continues to provide substantial support to recurrent activities. The 2005 recurrent budget, for example, had donor support of SBD$40 million to education, SBD$50 million to health, SBD $90 million to administration of justice, and some SBD$550 million to police. The Australian Government paid the arrears and serviced commitments to the Asian Development Bank and the World Bank to mid 2004, assistance valued at SBD$11.4 million; in addition, Australia provided recurrent-budget support of some SBD$60 million in 2004 (Zama 2004). The pressure to raise funds domestically to fund the recurrent budget will increase considerably as the recurrent budget is weaned off donor support.

A medium-term fiscal financing framework is being developed to factor in the anticipated declines in donor funding and ongoing commitments to new development projects, with a view to keeping debt levels in check. The prevailing debt situation, and a moratorium on further public-sector borrowing, will put additional pressure on domestic revenues, particularly if budget balance is to be maintained. Domestically sourced revenues accounted for only 45 per cent of the SBD$1.4 billion recurrent expenditure in the 2005 Budget. Some of the SBD$770 million provided by donors to the recurrent budget is spent outside Solomon Islands, including on overseas training, equipment and supplies. While the donors continue to fund nearly the entire development budget, there is a risk that donor support will be withdrawn from the recurrent budget exactly when the absorptive capacity for greater assistance is established.[6] The improving law and order situation, for example, allows expansion of basic services to rural communities but this can only be done with donor support given the prevailing fiscal position. The medium-term framework covers the recurrent budget only—the failure to account for the implications of the development budget on the future recurrent budget could be problematic. A clear set of development priorities together with a corresponding set of monitoring and evaluations framework could see better use of the available resources to the public sector.

The government of Solomon Islands has made good progress in managing its debt obligations, but much remains to be done before a sustainable position is reached. Public debt as of May 2005, inclusive of arrears to trade creditors and contingent liabilities, amounted to SBD$2.2 billion, equivalent to nearly 100 per cent of GDP.[7] Some 54 per cent of this debt is external with most of it being held by international financial institutions and mostly on concessional terms. The 2005 Budget allocation for debt servicing of SBD$112 million represents some 20 per cent of domestic revenue while the cost of servicing all of the debt at SBD$130 million would amount to approximately a quarter of domestic revenues. The International Monetary Fund (2004:7) estimates that by 2009 debt levels will have fallen to 65 per cent of GDP while the share of external debt will decline to a sustainable level of 42 per cent.

Local financial institutions, namely the National Provident Fund and the three commercial banks, as well as trade creditors, hold the domestic debt. These financial institutions have agreed to a restructuring in the form of a heavily discounted amortising bond that gives them the certainty of repayments over the long term. The restructured bond has a lower interest rate (from as much as 9 per cent to an average of 2.25 per cent), a longer term of up to 14 years with a grace period of 7 years applying to half of the principal, and some 60 per cent of the interest arrears, valued at approximately SBD$11.9 million, being written off (Zama 2004). The government, on its part, has agreed to meet monthly repayments on the restructured amortising bond: an arrangement that will ease cash-flow management whilst maintaining fiscal credibility. Domestic creditors have taken a large hit in this restructuring, but the arrangement is better than having the government continue to default on its obligations (the government first defaulted on its domestic debt in 1996). The National Provident Fund, the largest creditor to the state, made provisions for bad debts of SBD$52.9 million in 2004.[8] This leaves the balance sheet of the fund in a precarious position with assets totalling some SBD$13.9 million; a sum considered to be well short of the future obligations in terms of member entitlements.[9]

While considerable progress has been made in clearing arrears, the government is still in default on some of its debts with the prevailing debt position remaining unsustainable.[10] A debt management strategy was put in place in 2004 and is being used to progressively pay down and restructure debt. Trade creditors, for example, after having their claims verified have been paid in full or up to a minimum of SBD$6,000 per claim. Up to December 2004, the government had paid half of the balance owing to public sector employees. These debt payments have provided a stimulus to domestic economic activity, particularly in Honiara.

Monetary conditions

The recovery of exports in 2004 and a steady increase in imports has led to an improvement in the balance of trade. The balance of trade for the first eight months of 2004, the most recent period for which data is available, had a surplus of SBD$124 million. The trade surplus, together with large injections of foreign aid, has led to a rapid build up of foreign reserves. As of May 2005, foreign reserves with the Central Bank of Solomon Islands were at a record high of SBD$646.8 million, sufficient for eight months of import cover (Central Bank of Solomon Islands 2005). The Central Bank was nearly out of reserves in 2002, but now faces the opposite challenge of managing this build up so as to prevent a real exchange rate appreciation. The Central Bank of Solomon Islands may have to mop up any excess liquidity and sterilise the large aid flows over the short to medium term; such action will adversely affect its balance sheet.

Annual inflation (measured by changes in the three-month average Honiara retail price index) peaked at 15 per cent in early 2003 but has since fallen and as of May 2005 was at 5.3 per cent; inflation is expected to be around 6 per cent for 2005. The return to law and order has improved food supplies into the Honiara market, thus driving down food prices. The higher oil prices and costs of housing have offset some of the impact of lower food prices, however. The interest rate, as measured by the Central Bank's 'indicative weighted average interest rate', as of May 2005 was 14.5 per cent, while the corresponding rate on deposits was 0.98 per cent. The high interest rates on borrowings, the negative real (that is, inflation adjusted) interest rates on deposits, and a significant build up of liquidity within the banking system indicate serious problems with financial intermediation. The high interest rate margins, in particular, indicate that lending-risk remains high and potentially a short supply of 'bankable' projects. This is evidenced by the fact that banks have held short-term (that is 28-day) Treasury Bills with yields of around 2.7 per cent rather than reduce the lending rate to private enterprise.

Two of the three major domestic financial institutions are in serious strife. The Development Bank of Solomon Islands is reported to be insolvent and the Central Bank of Solomon Islands is in the process of managing its closure (International Monetary Fund 2004). The National Provident Fund is also in financial difficulty, with members threatening industrial action on account of the poor management of their funds. National Provident Fund management have an obligation to the contributors in maximising the return on their equity but to date the fund has been a source of cheap credit to the government and for high-risk, politically motivated projects. Policymakers, and Central Bank of Solomon Islands (given its responsibility for prudential supervision), could draw on the experiences of Vanuatu, which managed its way out of a very similar predicament in 1997 (see Asian Development Bank 2002).

Sectoral prospects

Agriculture accounts for nearly 20 per cent of GDP but is home to some 80 per cent of the total population. During the 1990s, agricultural exports, principally of copra, cocoa and palm oil, averaged around 20 per cent of total exports but this share had fallen to less than 7 per cent in 2002. The return of peace in 2003 saw a recovery in agricultural exports; by the end of 2004, fish accounted for some 18 per cent of total exports while cocoa and copra accounted for 6 and 4 per cent, respectively. Forest products accounted for some 65 per cent of total exports in 2004. Logging exports have remained high throughout the period of conflict due to the activity being confined to the Western Province, a region that experienced relatively little fighting. The prevailing rate of logging, at some 700,000 square metres per annum, is estimated to be three times the sustainable rate and, if continued, will see the commercially valuable forests being depleted by 2010–15 (International Monetary Fund 2004). Plantation forestry commenced only in 1986, but the industry is in a nascent stage, and thus unlikely to take the pressure off logging of native forests over the short to medium term. Major export commodities such as palm oil and minerals are likely to take considerable time to recover given the damage done to plant and equipment and continuing negotiations with landowners. In the absence of growth in the other export sectors, logging is likely to continue, for the short term at least, as the major source of internally generated foreign exchange and government revenues.[11]

Manufacturing is a small sector, accounting for less than 10 per cent of GDP. The major manufacturing activities revolve around processing of primary produce, including fish canning, processing of oil palm and copra, and small-scale timber milling and tobacco processing: the last solely for the domestic market.[12] A small and fragmented domestic market, lack of a competitive transportation infrastructure, expensive and unreliable utilities, and extensive regulation including laws relating to foreign direct investment have impeded growth of this sector. While little can be done in terms of policy in relation to the first (that is, the small and fragmented market), policies can be used to minimise the costs of the remaining three.

The influx of a large expatriate population has witnessed considerable growth in construction, restaurant trade, hotel and rental accommodation, but most of this has been confined to Honiara. Tourism has potential, but this will take time to be realised. The rich culture, Second World War relics, and pristine marine environment, including a UNESCO World Heritage-listed coral reef, suggest that Solomon Islands has considerable potential for growth of tourism. The prevalence of malaria, problems with transportation (including the relatively high costs of airfares compared to alternative destinations such as Fiji and Vanuatu), lack of tourist infrastructure, and the shadow of the recent conflict suggest that it will be a while before tourism becomes a major source of income.

It is clear that the major challenge for policymakers is to raise the rate of growth of the economy; how this may be done is unclear. A start could be made by relieving the more obvious constraints to enterprise so as to give the local private sector an opportunity to increase investment. The tasks involve improving access to transportation infrastructure and island shipping in particular so as to integrate the local markets and allow exports. High value tuna caught in Solomon Islands waters, for example, is unable to reach the lucrative Asian markets due to the lack of a competitive transportation network. The poor state of inter-island shipping and road infrastructure is hampering trade within the country. Donors and the Asian Development Bank, in particular, are working towards addressing some of these problems. The Japanese government is assisting with the upgrading of the Honiara International Airport, with electricity generation and water supply for Honiara,[13] and with rehabilitation of the domestic tuna fisheries sector. The Solomon Islands Government has appealed for further donor assistance with the upgrading of the main roads and bridges to encourage economic activity on the two main islands. Small dispersed island communities have relied on canoes with outboard motors as their means of contact with the major centres; this remains the principal mode of transport, but the high costs and unreliable services have made much of agricultural trade unprofitable for these communities.[14]

Poor access to competitively priced credit has been identified as another impediment to enterprise. The small and fragmented market, together with an extended period of poor law and order, has seen banking services contract to the major urban centres and the capital in particular. The improving law and order situation and experimentation with rural banking by a major commercial bank may see some recovery of the lost ground. Further research on the constraints to extension of credit to enterprises will have to be undertaken with a view to improving access. The costs of extending credit, including the costs of enforcing debt contracts, will have to be scrutinised if access to credit is to be improved. Small producers working their customary-owned land, and often with high costs of transport to markets, face strong diseconomies of scale.[15] These producers, therefore, need to be all the more productive relative to their counterparts in larger markets to be competitive in export markets. Solomon Islands thus needs to specialise in high-value products and draw on the best technical expertise available to remain competitive in its export markets.

The major foreign direct investments into Solomon Islands are in the resource sector; namely, logging, fishing, and gold mining. Banking and plantation agriculture have also attracted some foreign direct investment. These sectors have returns that are sufficiently large to cover the costs of enterprise whilst offering the investors an internationally competitive return on their investment. Foreign investments are known to supply capital, technical know-how, and links into export markets, thus providing a boost to growth. The lack of foreign direct investment in labour-intensive sectors such as manufacturing and services (tourism, for example) suggests that the costs of such investment may be prohibitive. The reform of the tariff system, removal of discretion with respect to customs duties, relaxation of rules with respect to the issuing of work permits, will all encourage foreign direct investment.

Long-term investment such as in tourism and plantation agriculture will necessitate long term and secure access to land, however. Facilitating such access will be a challenge, given that some 87 per cent of land is held under communal title. Tensions between landowners and settlers have also hampered the possibility of drawing workers from labour-abundant regions such as the Malaita province. Freer goods trade, both within the nation that comprises several hundred small communities and internationally, has the potential to substitute for migration in order to raise income. Naturally, scale issues imply that there is a limit to the extent to which goods trade can be used as a substitute for labour mobility. Negotiations with landowners in respect of foreign investments in the gold mine and oil palm ventures were continuing at the time of writing. Given the political sensitivities, Solomon Islanders will have to take the lead in resolving problems with long term and secure access to land and with issues of internal migration. It is nevertheless clear that improving access to land and labour is central to any growth strategy. Aqorau in advocating decentralisation with empowerment of resource owners, notes that

> [l]eaders should really work from the grassroots, strengthen communal and landowner participation in development, augment the economic base of the grassroots through their participation in development, and ensure strong economically viable communities that provide for their own social and economic welfare (Aqorau 2005:n.p.).

Economic reforms

An Economic Reform Unit was created within the Ministry of Finance and Treasury and charged with the responsibility of coordinating reforms across the sectors and the various stakeholders. The Economic Reform Unit is heavily engaged in attracting foreign direct investment into Solomon Islands, having played a role in the reopening of the oil palm plantation on Guadalcanal and the lone gold mine. New Britain Palm Oil Limited, the new foreign investor in Guadalcanal Plains Palm Oil Limited, have demonstrated their capacity in dealing effectively with communally owned land in Papua New Guinea. The new company has earmarked SBD$200 million to be invested in the project over the next five years. It is yet to be seen if New Britain Palm Oil will be able to replicate its successes in Papua New Guinea, but their willingness to invest in Solomon Islands provides a strong signal to other potential investors of the improving investor climate. Australian Solomons Gold is in the process of securing finance before commencing reconstruction work on the dilapidated mine site. It is anticipated that Gold Ridge Mining will begin producing gold at its refurbished mine from late 2006; this would be a significant boon to the economy as the mine was contributing some 30 per cent of the GDP prior to the eruption of fighting.

Public sector participation in commerce is being rationalised. In this context, privatisation strategies for Solomon Airlines, the government-owned international carrier, and the government-owned printery and slipway are in progress. Donor support in the form of technical assistance is being sought for reforms in a number of sectors. The World Bank is engaged in the review of Solomon Islands Electricity Authority. The Asian Development Bank is carrying out studies of shipping and aviation sectors; and is assisting the government formulate its strategy for state-owned enterprise reform. Rather than dealing with privatisation of state-owned enterprises on a case-by-case basis, as has been the practice to date, there is a compelling case for the design of a generic corporatisation and privatisation strategy for the nation as a whole.

While the return of large foreign investors to Solomon Islands is a healthy sign, the two that have taken the plunge so far have done so reportedly after being given substantial tax concessions. The concessions provided have been justified on the grounds that they will generate broader interest amongst investors. This may indeed be the case, but the task at hand is to create an investor-friendly environment that is neutral between investors. Special deals for individual investors and room for discretion run the risk of abuse, as demonstrated during the crisis with respect to the issue of import licenses and duty concessions. It will take some effort to create a neutral regime given the precedence created by these ‘special deals’.

The challenge for the reformers is to create an environment that is conducive to investment, both foreign and domestic. Much of this work to date has revolved around improving governance by increasing transparency of decision-making and thus reducing corruption. Logging and fisheries pose particular challenges given the large rents and the challenge of ensuring sustainable management of these resources. Reef fish around the heavily populated areas, for example, are already being harvested well beyond regenerative capacity. Work has commenced on new foreign investment legislation and a new tax system, both of which are aimed at reducing the regulatory barriers to investment. The government signed the Pacific Islands Air Services Agreement on 12 May 2005; it is hoped that this 'open skies' policy will reduce the market power of the incumbents and thus lower the costs of air transport. The government has also signed the Pacific Islands Civil Aviation Safety and Security Treaty in the hope of improving air safety. Enabling legislation for the above were being drafted at the time of writing. Trade liberalisation is continuing with tariff rates reduced from five bands, ranging from 5 to 70 per cent in 1998, to three bands ranging from 5 to 20 per cent in 2004.

While some progress has been made in the aviation sector, little has been done to improve inter-island shipping. The latter is important given the fragmented domestic market and the critical role of inter-island shipping in raising private sector output. One option for the central government in reducing regulatory barriers to investments in transportation and communications infrastructure would be to take carriage of policies for the two sectors. This will reduce anomalies between provinces and provide greater security of market access for investors.

While regulatory reforms are targeted at reducing red tape, obtaining secure, long-term access to land remains a difficult issue. Landowner concerns continue with respect to both the gold mine and the oil palm operations. Compounding the above issues are problems with migrant labour. It is clear that labour for any major operations on Guadalcanal would have to be imported from the other provinces, from Malaita in particular. The large differences in endowments of workers and other natural resource endowments means that any major investment at any locality would entail at least some movement of workers. The risk of reigniting the landowner–settler conflicts from which the nation is emerging, with substantial donor support, has to be managed from the outset. Some of the pressures for inter-provincial migration may be relieved through provision of public infrastructure more broadly within the country. Auki, on Malaita, for example, has the potential to develop labour-intensive manufacturing provided inter-island shipping becomes competitive. Solomon Islanders must realise that basic economics drives investment and thus some mobility of people is not only inevitable but healthy for economic growth, as it allows industries to locate where they have the best chance of success. The tuna-canning factory, for example, has to be located close to a port and to where most of the fish are caught. The fish could be taken to the place where the workers live (that is, the jobs could be moved to the people), but the costs of doing so may be prohibitive. Poor infrastructure in the country, together with the highly varied levels of access to services, are responsible in large part for the uneven regional development and the large internal migration.

Improving governance is a perennial challenge in most of the Pacific islands and Solomon Islands is not an exception. The abuse of discretionary authority for personal gain by senior members of the executive was widespread during the crisis.[16] Corruption within the senior echelons of the public service remains of serious concern. A Corruption Targeting Task Force has been created within the Royal Solomon Islands Police and is investigating both past and ongoing allegations of abuse of positions of authority for personal gain.

When will the need for RAMSI expire?

While no-one is certain how long RAMSI will be seen as necessary, the withdrawal of troops from the six-year peacekeeping mission to East Timor on 24 June 2005 provides some guidance.[17] The peacekeeping component of RAMSI is already being wound down. The military was sent in to provide security; thus with security restored their withdrawal is overdue. The police were sent to restore law and order; a significant winding down on this front may also be overdue given the achievements made to date. The civilian component tasked to rebuild the machinery of state is as yet a long way from achieving its mandate, thus a lot more effort may have to be devoted to this objective. The region as a whole, and Australia in particular, has an obligation to make a credible commitment to a military and police response to any deterioration in security and/or law and order. As long as there is a credible commitment of prompt deployment of armed security personnel to Solomon Islands, the chances of any deterioration should be minimal.

Over its first six years of deployment, RAMSI will cost Australian taxpayers alone in excess of A$1.3 billion dollars.[18] On a per capita basis, Solomon Islands is one of the largest recipients of Australian aid. It is therefore useful to consider the length of time that RAMSI should be in place. Let us consider an optimistic scenario: one that is likely to eventuate if all of the reforms being planned for are successfully implemented and the nation escapes any major natural disasters. Four assumptions have to be made in working out the minimal length of time before RAMSI could be dismantled. First, the need for RAMSI will disappear once the domestic economy is able to fund the recurrent budget fully. Second, tax revenue is assumed to be 26 per cent of GDP. Third, the prevailing level of services (law and order, for example) provided by the public sector is the minimum necessary to maintain peace and stability.[19] Fourth, the rate of growth of productivity in the delivery of public goods equals the rate of population growth.

At a tax take of 26 per cent of GDP, aggregate GDP would need to grow by a factor of 2.4 before support from donors to the recurrent budget can be discontinued. How long could this take? It would take approximately a decade of sustained (real) growth of aggregate GDP of around 9 per cent per annum to reach such a level of output. Such a rapid and sustained rate of growth is unprecedented, possibly with the exception of China in the recent past. None of the Pacific island states has managed to achieve even half of that rate of growth (that is 4.5 per cent annual growth of GDP) over a decade. It will, therefore, take a lot of effort (and good fortune) to reach a growth target sufficient to see the need for RAMSI expire within a decade. The above scenario assumes that the development budget will continue to be funded by donors. Even the optimists would have to concede that RAMSI will have to remain in place in some form for a decade at least. The premature departure of RAMSI could, at a minimum, mean a much lower level of access to public services and, at worst, a return to the dark days of 1999 to 2003.

Conclusions

Peace and stability has been maintained since the arrival in July 2003 of the Regional Assistance Mission to Solomon Islands. The islanders, in welcoming the troops and police to their capital, did so in anticipation of a quick return to normalcy and they were not let down on this count. The slow bounce back in income growth since the restoration of peace is disappointing, but should not have been unexpected. Implementing the institutions and policies on which robust, long-term economic growth is based is never easy. Per capita income has recovered slowly and in the two years since the arrival of RAMSI has nudged back to 78 per cent of the level just prior to the crisis. The challenge of accelerating growth of output is critical if the current generation of Solomon Islanders are to see the end of RAMSI. Aggregate GDP will have to more than double if the recurrent outlays are to be funded from internally generated revenue. This will take at least a decade and only if rapid growth is sustained over the full term of recovery. Such growth will materialise only if the impediments to investment are lowered considerably. Solomon Islands, therefore, has to face up to the challenges of development.

The four-year conflict weighed down formal sector activity, particularly in the capital, and pushed much market activity into the subsistence sector. Slow recovery suggests that the bulk of the impediments to growth remain. Problems such as high costs of transportation and utilities, the potential for tensions between landowners and settlers, and difficulties in acquiring land on a secure and long-term basis remain. These concerns need to be addressed if the economy is to grow sufficiently quickly to alleviate the need for the continuing presence of RAMSI. Since the formation of RAMSI, donors have been generous with Solomon Islands, but better value could be extracted from this generosity if the total value of inputs and the deliverables are made more transparent.

The highly uneven rates of growth across the archipelago are likely to sustain pressures for migration from the poorer to the more prosperous regions, with the ensuing challenges of managing such a transition. More widespread development across the provinces, together with an expansion of inter-island shipping, is likely to reduce pressure for internal migration. The growth of a Gizo-Auki-Honiara trading triangle, for example, could act as a substitute for labour mobility between the three major urban centres. Solomon Islanders themselves must take responsibility for instituting the necessary reforms for growth of income. RAMSI, however, has a role to play in building capacity, including the training of the locals who will in the very near future take control of the process of designing and implementing reforms. It is only the local people who have the necessary information and the self-interest in inducing change in relation to politically sensitive issues such as facilitating long-term and secure access to land. The latter is critical to resolving some of the problems between settlers and landowners, the source of the conflict.

The achievements since the arrival of RAMSI have been significant. Law and order and fiscal prudence (critical to macro-economic stability) have been achieved through a combination of good management and donor support. Donor support will not last for long and is already being withdrawn from the recurrent budget. The onus of growing the economy to a level where it is able to fund the recurrent outlays of the state is on Solomon Islanders now. Given the unsustainable debt position of the state, donors may have a (limited) role in supporting major capital works but the initiatives for such investments will also have to come from within Solomon Islands. Questions remain as to whether there is the political will to initiate such reforms and whether the capacity exists to implement the policies that are needed for private investment and growth of production. The term of the current government expires at the end of this year, with national elections being planned for early 2006. The lead-up to national elections will be an interesting period since it will reveal the visions of the aspiring political leadership.

Growth is critical for improvement in the social indicators of development. Unless growth of output accelerates soon, a generation of Solomon Islanders will miss out on the opportunity to see an improvement in their wellbeing. This will be extremely unfortunate given the large generosity of donors since the inception of RAMSI. International experience shows that aid has only a marginal role in raising the rate of growth of income, thus the onus is on Solomon Islanders to make the best of available support while it is there. Large injections of aid can provide the resources to institute the more difficult reforms, but it could just as well provide funds that allow leaders to procrastinate about the very reforms that are critical to growth of production. Which of these two prevail is a matter for Solomon Islanders to decide.

Notes

1 The author forecast many of the challenges in resuscitating the Solomon Islands economy when RAMSI first arrived; many of the issues raised then remain relevant (see Chand 2003).

2 Data sourced from the *International Development Statistics* Online database, accessed on 11 July 2005. It was not possible to get an accurate estimate of the level of donor support provided and the breakdown in terms of how much was spent in the country, on salaries, and goods and services under RAMSI.

3 The exchange rate as of 15 June 2005 was one Australian dollar to SBD$5.76 and one United States dollar to SBD$7.72.

4 The population growth rate has been falling; it was 3.5 per cent in the 1970s.

5 The fertility rate is defined as 'the number of children that would be born to a woman if she were to live to the end of her childbearing years and bear children in accordance with prevailing age-specific fertility rates' (World Bank 2003).

6 Some SBD$15 million has been transferred from the 2005 recurrent budget to the development budget for maintenance of 'critical infrastructure'.

7 The Central Bank of Solomon Islands (2005) reports a lower total debt figure; that of SBD$1,782.5 million. The figures reported here are sourced from the Ministry of Finance and Treasury. The breakdown of the total debt of SBD$2,192.2 million, according to the Ministry, comprised of external debt of SBD$1,183.6 million (including interest arrears), domestic debt of SBD$525.7 million, and estimates of other debt obligations, such as trade creditor arrears, contingent liabilities, guarantees and provincial debts of SBD$482.88 million.

8 The National Provident Fund in 2003 accounted for two thirds of total banking sector assets. Some 25 per cent of the assets of the Fund comprised government securities; another 17 per cent comprised loans to government entities, and a further 18 per cent was equity in public enterprises. Member contributions to 2002 amounted to SBD$317 million (Chand 2003).

9 The figures reported here are from the *2004 Annual Report* of the National Provident Fund, as reported by *Pacific Beat* of 18 March 2005.

10 External debt that is being serviced is only to the international financial institutions, thus leaving out the other external creditors.

11 Logging exports accounted for two-thirds of total merchandise exports in 2003 (International Monetary Fund 2004).

12 Some of the milled timber is exported.

13 This work is being undertaken in partnership with the World Bank.

14 The recent decision by the Minister of Finance and Treasury to eliminate import duties on shipping vessels, outboard motors (of up to 40 horsepower), parts, and marine safety equipment is with a view to lowering shipping costs.

15 The difference between customary ownership and communal ownership is that the former comprises individual rights but this is

established and enforced by the clan as a whole.

[16] Abuses included the granting of tax exemptions and citizenship certificates, as well as large compensation payments to cronies.

[17] The first of the nearly 13,000 Australian troops that served in East Timor arrived there in September 1999.

[18] Costs of the military component of RAMSI are unavailable. Australian aid over the term of RAMSI amounts to in excess of A$400 per year for every man, woman and child in Solomon Islands.

[19] Solomon Islanders have to decide on the level of services that they will be able to fund independently. This is important given the current donor-determined level of service provision.

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Table A1 **GDP, and per capita GDP, 1978–2004** (constant 1995 US$, million)

Year	GDP (US$ million)	GDP per capita	GDP per capita growth (annual, per cent)
1978	106.7	498.5	5.23
1979	133.3	601.7	20.7
1980	125.2	546.8	–9.1
1981	142.1	599.4	9.6
1982	146.3	595.8	–0.6
1983	166.6	655.3	10.0
1984	168.6	641.1	–2.2
1985	170.1	625.2	–2.5
1986	203.7	724.7	15.9
1987	208.7	718.6	–0.8
1988	216.2	721.2	0.4
1989	233.8	755.7	4.8
1990	237.9	745.9	–1.3
1991	246.5	749.9	0.5
1992	269.5	796.7	6.2
1993	274.9	790.1	–0.8
1994	289.2	809.0	2.4
1995	309.5	843.2	4.2
1996	320.3	850.1	0.8
1997	312.8	808.4	–4.9
1998	316.4	796.4	–1.5
1999	312.2	765.3	–3.9
2000	277.9	663.1	–13.4
2001	252.8	587.0	–11.5
2002	248.8	561.1	–4.4
2003	258.3	566.8	1.0
2004	273.2	583.8	3.0

Source: Data to 2001 is from World Bank 2003. Data from 2001 onwards is based on growth rates reported by International Monetary Fund, 2004. *Staff Report for the 2004 Article IV Consultation*, International Monetary Fund, Washington, DC; and Asian Development Bank, 2005. Country programming mission to the Solomon Islands 2005, Mission Report, Asian Development Bank, Manila (unpublished).