Resuscitating the Solomon Islands economy

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The Solomon Islands' economy was already showing signs of recovery when the first peacekeepers from the regional assistance mission arrived in Honiara in late July of 2003. Cocoa, copra, and log exports were recovering in response to a recovery in international demand for these commodities, not least due to a rebound in economic growth in Asia. The fiscal position of the state, however, and the law and order situation was fragile until the arrival of the peacekeepers. The early phase of the intervention has had considerable success in restoring peace and in disarming the militants. Restored peace and tranquillity, however, will only last if the economy grows sufficiently rapidly to fulfil the aspirations of the people. This paper considers the longer-term challenge of resuscitating growth so as to place the economy on a higher growth trajectory, as this will be the criterion on which the success of the mission will ultimately be judged.

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The Solomon Islands, once a British protectorate, and also known as the 'Happy Isles', has been anything but happy since the eruption of violence in 1999. The economy has been stagnant since 1990. Most formal sector activities, including gold mining and the only large oil palm plantation, take place around the capital, Honiara, located on the island of Guadalcanal. Consequently, Guadalcanal has attracted a large inflow of settlers from other parts of the country. The security challenge faced in Solomon Islands is a symptom of a lack of development in a climate of rapid population growth. A permanent solution, therefore, will involve accelerating development.

Some 87 per cent of land in Solomon Islands is under communal title with 4 per cent under individual title and the remainder owned by the state. Thus most of the settlements are on land without secure claims. Weak delivery of public security has made the settlers rely on the family and clan to provide security to property and person. This has fanned a process of settler communities built around clan and regional cleavages;

Honiara is similar to Port Moresby and Port Vila in this regard. The traditional landowners of Guadalcanal, realising the loss of their claims on the settled land, began agitating against the settlers. The Guadalcanal Revolutionary Army (GRA), later the Istabu Freedom Movement (IFM), was formed in late 1998; it was instrumental in the initial violence against the settlers, most of whom had family ties to the island of Malaita. Around mid 1999 and at the height of the violence, some 20,000 Malaitans were forced off Guadalcanal. The police, alleged to be taking sides in the conflict, were unable to contain the violence. An envoy sent by the Commonwealth Secretariat was also unable to negotiate peace and bring the violence to a close. The Malaita Eagle Force (MEF) appeared around 2000 as a counter force to the GRA. The escalation in fighting between the GRA and MEF brought with it the worsening of the security and law and order situation in Honiara. In the meantime, the returnees to Malaita increased tensions on the island as the influx of people created shortages in access to cultivable land and basic services.

Australia and New Zealand made a second attempt to broker peace which led to the signing of the Townsville Peace Accord in October 2000. The Accord had some initial success in disarming the militants, but the leader of IFM refused to sign it, and the fighting intensified—yet another failure to restore peace. In late 2002 and also after the 2003 Budget had been passed, some police, who were former militants, extorted public funds that were earmarked for reducing a backlog of debt. The two failed attempts at brokering peace accompanied by a severe deterioration in law and order called for a much tougher stance if peace was to be restored. On 24 July 2003, the first contingent of 2,225 peacekeepers, led by Australia and comprising military and police personnel from Australia, Fiji, New Zealand, Tonga and Samoa, arrived in Honiara.

The Regional Assistance Mission is tasked with providing security, restoring law and order, and rebuilding the machinery of state where it is broken. Within a month of their arrival, the peacekeepers restored law and order and achieved considerable success in disarming militants. This achievement, however, is only the beginning. The success of intervention will ultimately be judged by a return to peace and tranquillity without the continuing need for the peacekeepers. Sustained economic growth sufficient to provide employment opportunities and income to enough Solomon Islanders is critical to such an outcome. The task of accelerating development has hardly begun but it will ultimately determine the success of this mission. The battle will involve attracting long-term private investments for growth and creation of income-earning opportunities for the majority of the people. Such an outcome requires a significant reduction in sovereign risk—a return to law and order is the first step in this long journey. Much more will need to be done to secure property rights to future returns from long-term investments.

The Australian taxpayer will be footing a bill of approximately A$300 million, nearly the same as annual aid to Papua New Guinea in aggregate terms, but some ten times larger on a per capita basis. The amount of aid raises two related questions: first, is this recapitalisation of a 'failing state' sufficient to lift it from its current level to a sustainable state; and second, can Australia afford such an outlay over the medium term, particularly if similar calls are made from other fronts in the near future.

The foregoing raises questions about how success in the Solomon Islands will ultimately be judged. The operation has three key components—the military component to provide security, the police component to install law and order, and a civilian component to rebuild the machinery of state.

Even if these goals are achieved within the next twelve months, what guarantee is there that the country will not fall back to a crisis situation once the peacekeepers have left? Such a reversal following significant investments will amount to a failure of the intervention; in order to succeed, the intervention has to lift Solomon Islands to a point where backsliding is unlikely.

Progress of the Regional Assistance Mission

The mission is to evolve through a series of stages with some overlap expected between the intervening stages. The initial deployment of the military component was to establish and then maintain security, a feat that was nearly complete by September 2003. The police component—given the task of re-establishing the rule of law—was initiated soon after the military deployment. Rule of law had deteriorated considerably on Guadalcanal, to a lesser degree in Malaita, and minimally in the rest of the country. The impact of the breakdown of law and order in Honiara was felt throughout the nation due to the centralised nature of the bureaucracy, and Honiara's role in international commerce. It is envisaged that commerce, particularly within the tree-crop sector (dormant during the crisis) will pick up as stability is restored in Honiara and inter-island shipping services resume. A boost in exports and foreign reserves will contribute to a recovery in public finances (mostly via import tariffs). Much of the revenue collected will be directed towards improving access to basic services. The humanitarian organisations are also expected to return and begin the task of emergency assistance, including assisting people displaced by conflict. The return of workers to their former employment is necessary to restore production to levels prior to the crisis.

While law and order is being restored and non-governmental organisations are returning to their roles in the rebuilding process, the administrative structures of the state will be revived and strengthened. This is progressing rapidly at the centre but much remains to be done beyond Honiara. For much of the period of conflict, administrative arms of government away from Honiara were starved of resources, with cuts in operating costs and non-payment of salaries and wages. An injection of fresh resources into the national budget should see a rapid revival in the restoration of these services as the capacity is present, but dormant. Some of the buildings and systems of government have deteriorated and will require restoration.

The next step involves restoring fiscal credibility—beginning with the stabilisation of the budget. While revenues for the first six months of 2003 have been growing, expenditure has outpaced income growth such that the budget deficit to June 2003 had blown out to approximately 8 per cent of GDP, after having reached 11 per cent in 2002. A large part of the blow-out can be attributed to 'extra-budgetary' outlays, constituting payments made under duress to militants by the Ministry of Finance. Seventeen experts were posted to the Ministry of Finance in September 2003 with the primary responsibility of restoring integrity to financial and economic management. Their task will include carrying out a stocktake of the state of public finances, including arrears, development of a credible strategy to retire arrears over time, eradication of unbudgeted extravagances, and building up the revenue base for the public sector.

The task of stabilising the budget, particularly if the Australian Treasury provides budgetary support over the immediate term, could be relatively easy. Building this to a sustainable position such that basic services are funded from internally generated revenue will be a lot more difficult. This would be particularly problematic if moral hazard in extending the assistance is to be minimised.

The task of rebuilding state institutions requires investment in enhancing domestic capacity right from the start; this process will be critical for a smooth transfer of responsibility for policymaking as external support is withdrawn. It may be wise to start this process immediately. Posting experts with line responsibilities and direct accountability to Canberra runs the risk of displacing, and in the process demoralising, local staff who will ultimately take over the reins of running the state. Considered thought must be given now to ensure that the newly injected expertise into Honiara complements rather than displaces local capacity. Furthermore, the transition process for handing over responsibility for policymaking should begin at the start with identification and training of staff with key positions filled in a systemic and systematic fashion. The resource implications of such a process has to be built into the program with clear milestones identified from the start. Creating realistic expectations on the part of the Australian taxpayer regarding their commitment to the mission is part of this process. Similarly, the expectations of Solomon Islanders must also be managed, to minimise gaps between reality and perceptions.

The next phase of the mission will entail growing the capital base by expanding physical infrastructure and improving access to basic services such as primary education and basic healthcare. It is envisaged that international donors who have the funds and necessary expertise will become heavily involved at this stage. The onus will be on the planners to ensure that new public investments provide the best possible return. For fiscal sustainability, returns on loan-funded projects must be sufficient to cover repayments.[1] Australia has paid off Solomon Island debt service areas to international financial institutions (IFIs), namely the Asian Development Bank and the World Bank, in the hope of engaging them in the development stage. The IFIs have expressed their willingness to re-engage in the development of Solomon Islands. The onus of due diligence in respect of public investments funded by the IFIs must rest with those providing the funds, and the Australian taxpayer should be spared the responsibility of underwriting these loans. The perception that the Australian Treasury will bail out the Solomon Islands could be counterproductive.

The final stage will be to establish an environment that will attract sufficiently large business and foreign capital to generate income-earning opportunities for the majority of the people. The regulatory changes necessary for lowering barriers to foreign investment will be relatively straightforward, but reforms to property rights to land to enable long-term investments in land and buildings could be problematic. The last has been a sticking point in all of Melanesia: proposals for land reform have resulted in political rallies, riots and loss of seats in national parliament in Papua New Guinea and Fiji. Proposals for reforming the existing systems to provide long-term and secure access to land (rather than changing the ownership of land) will have to be treated cautiously given political sensitivities. It will, however, be equally difficult to attract long-term investment while maintaining competitive rates of return on investments without such reform. For example, the high interest rates on borrowing and the prevalence of 'high grading' in mining and logging are the direct result of insecure access to land and land-based resources.

The intervention will be a costly failure if it is not able to reach this final stage. Only then will the need for an external force to ensure peace and stability expire. Such a position requires the emergence of an economy able to provide income-earning opportunities for the bulk of the population and resources sufficient to fund and maintain institutions of civil society. The current state of the economy is well short of meeting this requirement—thus the challenge for the interveners is to recapitalise the economy to the point where backsliding is least likely.

The current state of the economy

By developing economy standards, Solomon Islands is not a desperately poor country. Even after the fall in per capita GDP of 30 per cent since the beginning of the conflict to US$590 in 2002, most of the social indicators of development are better than neighbouring Papua New Guinea and much in accord with the rest of Melanesia. For example, average life expectancy of 69 years (Table 1) is comparable to Fiji (69) and Vanuatu (68) while the population density of 13 people per square kilometre is amongst the lowest in the region.[2] While the level of income and other indicators of development do not suggest mass poverty, the stagnant economy with a population growing at 2.8 per cent annually provide ample reasons for concern. The population growth momentum is likely to remain for a generation as some 42 per cent of the population is below 15 years of age. Furthermore, the distribution of income is highly skewed, for example, average household income in Honiara is four times that of rural households while the top one per cent of the households in Honiara share approximately 90 per cent of the total income (Solomon Islands 2003). According to the 1999 census, 61 per cent of the 14 to 29 year age group were in search of paid work. Many of these youth move to urban centres, Honiara in particular, in search of employment.

The economy was stagnant well before the beginning of the conflict. The lack of employment opportunities in a climate of rapid population growth contributed to the conflict while the conflict itself dragged an already stagnant economy down further compounding the initial problems (Chand 2002). The conflict exacerbated a worsening unemployment problem; according to a Central Bank of Solomon Islands (CBSI 2003) survey, some 8,000 people had lost formal sector jobs through redundancies or were sent on unpaid leave following the crisis.

The economy was showing signs of recovery for the six months to June 2003. Exports of round logs, cocoa, copra, and fish were growing, with foreign reserves reaching US$30 million, equivalent to two months of import cover (Hou 2003). These gains have been made as a result of improvements in law and order and some rebound in international prices for exports (Hou 2003). The fiscal position, however, remains tight. The budget deficit to June 2003 amounted to

Table 1 **Solomon Islands basic statistics, compared to Papua New Guinea, 2001**

	Solomon Islands	Papua New Guinea
Population ('000s, estimate)	430.8	5,300.0
Gross national income (GNI) per capita (US$, estimate)	590.0	580.0
Fertility rate	5.3	4.4
Life expectancy (years)	68.9	57.2

Note: The fertility rate is defined as the number of births per woman.
Source: World Bank, 2003. *World Tables*, World Bank, Washington, DC. Country profile sourced from http://devdata.worldbank.org.

SI$43.3 million, equivalent to 8 per cent of GDP (Hou 2003). Public-debt levels of the state at approximately SI$1.6 billion is well above the level of GDP. Debt arrears to June 2003 had risen to SI$197.5 million, constituting a major drag on the growth of private enterprise and the financial sector. The major constraints to a quicker rebound, particularly in the aftermath of the restoration of law and order, are the poor state of infrastructure, the high cost of credit and the insecurity of property rights, including access to land.

Over the period of the conflict the government has built up arrears to the private sector. These unpaid debts are putting a severe strain on the cash flows of the private sector whilst driving up interest rates in an already contracting economy. The government first defaulted on its external debt repayments of SI$9 million in 1995; by the end of 2002 external debt arrears had soared to SI$83 million with debt service exceeding 20 per cent of non-grant revenues (Solomon Islands 2003). As access to foreign financing was lost, the National Bank of Solomon Islands (NBSI), the National Provident Fund (NPF) and the CBSI were increasingly called upon to finance the deficits; government debt with the CBSI at the end of 2002 totalled SI$178.6 million, well above the legal ceiling of 40 per cent of revenues averaged over the preceding three years. Total government debt as at the end of 2002 is estimated to be SI$1,635 million, of which SI$1,087.3 million (equal to 66 per cent) is external (Solomon Islands 2003).

It is highly unlikely that the economy will be able to service its debt for the foreseeable future. This will continue to put pressure on interest rates, given the high sovereign risk. The exchange rate risk has been high as well: the SI dollar was devalued by 25 per cent in 2002 but then revalued by the same amount a few days later. In the meantime, deposit rates fell with the average interest rate on deposits falling from 3.8 per cent in 1998 to 0.6 per cent by the end of 2002. For much of the period of the conflict real interest rates (net of inflation) on deposits were negative. The weighted average interest rate on loans, in contrast, increased in the same period from 14.1 per cent in 1998 to 16 per cent in 2002. Interest rate spread rose from 10.9 percentage points in 1998 to 16 percentage points in 2002, while conditions for issue of credit to the private sector were made even more stringent. The high cost of credit reflects the exchange rate and sovereign risk premiums. While on the one hand, clearing such debt by the interveners could provide a much-needed boost to private commerce, it will also create problems of moral hazard and could also be seen as rewarding corruption to the

Table 2 **Broad trends in some of the aggregates**

	Start of crisis	End of crisis	Change (per cent of GDP)
GDP (US$ million)	372.0 (1998)	283.0 (2002)	–89.0 (31 per cent)
Stock of external debt (US$ million)[a]	210.0 (1998)	284.0 (2002)	74.0
Inflation	13.0 (1997)	8.5 (2001)	Stable?
Net foreign assets (US$ million)	49.374	18.859	–30.514

[a] The debt data is from IMF sources converted at the official exchange rate.
Source: The World Bank country profile data accessed via http://devdata.worldbank.org

extent that such debt was built up under dubious circumstances. Similarly, the use of the Australian dollar instead of the domestic currency will eliminate the exchange rate premium so long as fiscal sustainability is maintained.

Sectoral growth prospects

The large injection of foreign personnel into Honiara will see a surge in output as demand for housing, utilities, and food products increases. Imports will surge as construction materials, fuel and other inputs from abroad are brought in to meet most of this rise in demand. Most will, however, be confined to the urban sector and Honiara in particular. The tree crop sector, copra and cocoa in particular, have been dormant and will rise as costs of production fall and prices received by the producer at the village level rise. Regular shipping services for transporting copra have been a major hurdle; a void left by the closure of the marketing board and one that the private sector has been slow to fill. This has been less of a problem for cocoa as it is less bulky and has a longer storage life. The closure of the Solomon Islands Plantation Limited (SIPL) resulted in the loss of 2,000 jobs, the decimation of the oil palm sector, and a sharp fall in cocoa production. Since the majority of the workers in SIPL were originally from Malaita, the reopening of the plantation is unlikely in the short term, given the problems with return migration. Owners of the land on which SIPL is located have made fresh demands and the resolution of these will also take time. It is estimated that some US$20 million is required just to repair damaged property and to bring SIPL into operation.

Solomon Islands is located on the 'rim of fire', thus has mineral prospects with known deposits of nickel, silver and gold. Commencement of mining in the near future, however, is unlikely. Gold Ridge, the only mine in operation prior to the conflict, is unlikely to re-open in the short term given continuing negotiations with landowners on secure and long-term access to the resource. In the meantime much of the capital equipment at the mine site has been stolen, damaged or fallen into disrepair. Some US$100 million is required to bring the mine to its former operational stage. Investors in the mine will need long-term secure access to the ores with profits sufficient to justify the large investment required to restarting mining.

Solomon Islands' largest manufacturer, Solomon Taiyo Limited (STL) tuna cannery, has been operating at 40 per cent capacity as catch levels have fallen with the deteriorating security situation. In August 2001, a year after the withdrawal of Maruha Corporation of Japan as the joint partner in STL, the Government incorporated a new company—Soltai Fishing and Processing Limited (SFPL)—to take over operations of STL. There is significant potential for expansion of the industry as the government-issued total allowable catch of 120,000 tonnes per annum is yet to be taken up. Such expansion, however, requires foreign investment.

Log exports are continuing but at an unsustainably high level: at the current rate of harvest, log exports for 2003 will reach a record 800,000 cubic metres. The continuation of harvesting at current rates will see the resource depleted in less than a decade (Solomon Islands 2003). There is evidence of 'high grading' of the resource, that is, the best natural forests and previously undisturbed areas are being harvested with minimal concern for conservation and the extent of soil degradation. In terms of sectoral prospects, there is potential for growth in construction and utilities in the immediate term but the sustainable sources of growth can only come from the primary sectors. Secure property rights to returns from such investments and a more competitive interest rate are prerequisites for the above.

Reforms necessary to increase private sector participation

The economy will be revived in the immediate term with increased resources and demand—thanks to the intervention force. This growth spurt, however, will last only while demand remains. Given its resource endowments, the small domestic market and the failure of state-owned enterprises, growth will have to be sourced from the private sector. Such growth can only be sustained in an internationally competitive climate where production is concentrated in sectors in which the country has a comparative advantage.

The roles of policy in creating such an environment is relatively clear. These revolve around providing an environment conducive for private commerce. Foremost among these is the removal of regulatory impediments to trade in goods and services as well as to foreign direct investment. The existing regime relating to import licenses, cumbersome processes relating to obtaining investment approvals, and restrictions on the issue of work permits to foreign investors must be minimised and simplified. The second area requiring urgent attention is the prohibitively high rates of interest on borrowings. Such high rates make only those investments with commensurate rates of return commercially viable; inevitably this is in sectors with significant rents such as in the resource sector.

Policy instability, originating from large discretionary powers vested in the bureaucracy or political leadership, is a serious disincentive to long-term investment. This must be addressed to secure private, long-term investment in land, buildings and physical infrastructure. Import licences and tax exemptions have been issued in the past with little transparency or predictability. Insecurity of access to land following the closure of SIPL and Gold Ridge mine have encouraged short-term investment only in projects providing the highest returns. While such insecurities prevail, 'high grading' will continue. Success of imbedding principles of good governance will be critical to reviving long-term investment by the private sector. Policymakers will have to address the insecurity of access to land as an immediate priority. This has often been placed in the 'too hard' basket in Solomon Islands and the rest of Melanesia, and will require leadership, significant determination and public education of the various stakeholders. However, Papua New Guinea provides a good example, where discussion of the individualisation of title to customary land (through long-term leasehold) has moved from being a 'no-go' topic only a few years ago to where it is an everyday topic in the newspapers.

Supply of secure property rights and a legal system that enables contracting with confidence will reduce the cost of credit, and provide a much-needed boost to domestic investment. Considerations must also be given to the introduction of an effective secured transactions framework such as crop liens and mortgages on movable assets to lower the cost of credit.

The domestic financial sector is heavily burdened with debt to government. At the end of 2002, the stock of government bonds held by the National Bank of Solomon Islands (NBSI) amounted to SI$91 million while the corresponding figure for the National Provident Fund (NPF) was SI$56 million. This is in contrast to holdings of government bonds by the ANZ and Westpac Banks of SI$34 million and SI$25 million, respectively (Solomon Islands 2002:97). The holders of government debt are forced to roll it over at an administratively-set interest rate of 3 per cent, considerably lower than in the original contract and consequently being challenged in court by NBSI. The domestic financial sector will be under severe strain if the value of government debt is marked down to realistic levels. As an example, member contributions to the NPF at the end of 2002 amounted to SI$317 million while the book value of assets, without any adjustment for the quality of the assets, was SI$ 366 million. It is highly unlikely that NPF will be able to meet its future cash-flow obligations in respect of member entitlements without budgetary support. Commercial banks are already factoring this problem into their dealings with clients as deposits with the NPF can no longer be used as collateral to secure personal loans. The risks of a collapse of the financial sector are ominous as similar problems in Vanuatu in 1997 led to riots on the street of Port Vila, leading to the launch of a comprehensive reform program.

The genuineness of some of the public debt is questionable; thus, clearing out of such debt by donors will entail problems of moral hazard. Determining the status of this debt will take time; moreover, given resource constraints, clearing of all public debt may not be feasible in the immediate term. One strategy worth detailed consideration is to quarantine all debt accumulated prior to the arrival of the technical team in the Ministry of Finance to be carefully examined. Such a strategy should be made public with a guarantee that any future claims for goods and services provided to the State under appropriate authorisation from the Ministry of Finance will be honoured. This will lower the sovereign-risk premium while placing pressure on businesses with claims on the state to prove the legitimacy of their claims. Fiscal credibility could be enhanced in the process.

Finally, reforms inevitably create losers and winners, even when the economy grows as a result. The losers, therefore, have an incentive to resist reforms. The threat of resistance to reforms cannot be underestimated. The experience of the last three Fijian coups suggests that when the underlying motive is greed, communities can be manipulated along ethnic lines into resisting reforms on the basis of manufactured grievances.

Conclusion

The Regional Assistance Mission to Solomon Islands has regained security within a short time and is well on the way to restoring law and order in this highly fragmented island nation. This is the first step in a long journey to achieving lasting peace and long-term economic development. The success of the intervention will be judged by its ability to raise economic growth to a level sufficient to generate income-earning opportunities for the majority of the people. In such an environment, the majority of the workforce is engaged in value-adding activity and thus has neither the time nor the incentive to engage in socially disruptive behaviour. A well-trained and well-resourced law enforcement agency with community support should be able to contain any frictions, thus minimising the chance of a repetition of the chaos seen in the recent past. The restoration of law and order is important but it is only a means to achieving development sufficient to reach a point where backsliding is unlikely.

A number of necessary conditions will have to be met for the economy to grow sufficiently rapidly to be able to satisfy the aspirations of the majority of the people. A return to fiscal prudence, orderly clearing of arrears built up by the public sector, and reduction of debt to sustainable levels is a necessary initial undertaking. Public sector reforms involving the downsizing of the workforce in Honiara,[3] a shift in expenditure away from recurrent outlays and into service delivery and development, and devolution of responsibility with commensurate resources to local authorities must be pursued from the start. Public capital development including strengthening of the law enforcement agencies and the delivery of basic services and public infrastructure must be built to levels sufficient to lower the costs of private commerce. Anything less would amount to undercapitalising a failing state and leaving it vulnerable to rolling back into the stage from it was initially rescued.

The developmental challenge is one of transforming an economy dependent on a narrow, urban-based public sector to a private sector-led and more diversified economy that draws on the productive potential of the entire nation. The role for government in such an economy falls into three broad categories: first, as a provider of basic services such as basic healthcare and primary education; second, as a provider of regulatory control over public goods, including regulatory supervision of the financial sector and natural monopolies; and third, investment in and maintenance of public infrastructure.

The intervention force together with the development partners have a significant role to play in recapitalising Solomon Islands to a position where the virtuous circle of growth in income-earning opportunities for the general population support institutions of civil society, whilst drawing people away from socially disruptive and often predatory behaviour. It is only when such a process has begun can the peacekeepers leave the country with an assurance of lasting peace and prosperity.

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Notes

1 The social rate of return from a public investment must exceed the opportunity cost of capital for the net worth of the state to improve from such outlays; implementing such a test is not easy, thus the more restrictive and simpler requirement of commercial viability.

2 Data on both Solomon Islands and Papua New Guinea are of poor quality, thus care has to be taken in interpreting the figures quoted here.

3 The public sector accounted for 24 per cent of formal sector employment in 1998 and possibly a lot more subsequently as the private sector contracted whilst new police constables were hired during the period of the conflict.

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