Economic survey

The Solomon Islands economy: recent developments and the impact of ethnic tensions

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This survey provides background to the economy of Solomon Islands and examines factors relating to the country's economic development. It points to fundamental hurdles to economic progress, and stresses that while ethnic conflict was an important reason for the current economic decline, many of the difficulties of the past 10 years can be attributed to more fundamental causes.

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The economic base of Solomon Islands is very narrow, with only a handful of export commodities—logs, fish, copra and coconut oil, palm oil and minerals—and the economy is extremely susceptible to external shocks. There is little manufacturing and the services industry is small and, while there is untapped potential, tourism remains negligible.

This vulnerability became obvious with the impact of the East Asian financial crisis in 1997. Fast follow-on effects from internal ethnic rivalry underscored the weakness. Within weeks of the outbreak of ethnic conflict in mid 1999, and the events of early June 2000, Solomon Islands was in deep crisis: production slumped by about 80 per cent; an already unsustainable government debt burden worsened; the government's acute cash-flow difficulties worsened; foreign reserves drastically declined; the fiscal deficit skyrocketed; and the investment climate became unwelcoming.

Expectations were high from the peace negotiations, which began in late 2000. These negotiations have been fruitful in that ethnic conflict ceased after the signing of the Townsville Peace Agreement in October 2000, and since then, the peace process has been, by and large, on track. More than anything, there is an eagerness within the general populace to be getting on with their lives and to put the past behind. That is indeed what the government needed to move forward, and it could have used the opportunity provided by the Agreement to take decisive action to put the country on the path to recovery. However, the then executive government was in no shape to tackle this task and, if anything, there was more infighting and political rhetoric than

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action and the situation deteriorated further. Over the last two years, the government has presided over a period of economic mismanagement and confused policy.

There has been good progress on the issue of security in Solomon Islands. However, with investor and public confidence at rock bottom, it is fair to say that recovery in these areas will take some time. While some economic activity has already resurfaced, many of the industries that are important to Solomon Islands have remained closed since 2000. At the same time, there appears to be some resurgence in the fishing and forestry sectors. If similar improvements can be reported in agriculture and mining, Solomon Islands should be set on the path of economic recovery.

Much will depend on the government of Sir Allan Kemakeza creating a sound policy environment, a stable political climate and the return of investor confidence. Moreover, it has to be recognised that for economic recovery to be achievable, Solomon Islands relies on its development partners' continued support.

Recent economic history

There are four main reasons for the Solomon Islands' economic woes.

First, a barrage of external adversities, beginning from the mid 1990s—for example, falling world commodity prices and the East Asian financial crises—had devastating effects on Solomon Islands' macroeconomic stability.

Second, there was an absence of a sound policy environment and macroeconomic framework that would be conducive to, and enhance, long-term economic growth and development prospects. In particular, fiscal policy for most of the past 10 years had no sense of direction. The political environment in Solomon Islands is consequently perceived as unstable and its investment climate rated as unfriendly. Meanwhile, public sector investment and economic development programs have been piecemeal and lacking in cohesion.

Third, structural factors have impeded economic development—the land tenure system, remoteness from markets, cumbersome investment procedures, an unskilled labour market and the small size of the economy—rendering it vulnerable to external shocks. Notwithstanding the importance of these factors, if they had been addressed consistently and systematically, private sector growth and sustainable economic development would have been enhanced.

Fourth, self-inflicted injuries to the economy have recurred. These are perhaps the main reasons for the prevailing economic circumstances and the internal ethnic conflict of the past two and a half years is a case in point. There is no question that the recent ethnic rivalries have resulted in a drastic decline in general security and a paralysed production sector. Public confidence in law and order enforcement is low, and investor confidence will take a long time to restore. But a more glaring reason for the undermining of the economy's well-being has been chronically lax fiscal policy. Over the past 10 years, government policy has had no sense of direction or coherence and was not a useful guide to the rest of the economy at a time when the political economy was mostly in a confused and dire state.

Any suggestion that ethnic rivalry is wholly responsible for the Solomon Islands' economic decline is debatable. It can more reasonably be argued that the recent rivalries are a manifestation of a failure to address fundamental economic problems. In recent times, tensions have become a convenient excuse not to take appropriate—and difficult—action to address the underlying problems of the economy. The country needs an enabling macroeconomic environment, however the record shows a decade of inappropriate macroeconomic policies, persistent financial mismanagement, political instability, a hostile investment climate, and a lack of political will to undertake the necessary reforms.

Actions in other policy areas have largely been muted by developments on the fiscal side. Monetary policy, for example, has been reactionary and defensive, mainly to cushion the after effects of an expansionary fiscal policy. The increasing government domestic debt situation—especially government advances from the Central Bank of Solomon Islands[1]—has dominated monetary policy decisions and actions. Given government's increasing appetite for credit, the private sector has been stifled, and actions to guard against a crowding-out effect have only helped mitigate against worse monetary developments. Conduct of monetary policy in the recent past has been subdued largely by the persistent financial stress experienced by the government.

On the external front, the balance of payments has had a succession of surpluses in recent years, emanating mainly from the capital account (Table 1). The effect on external reserves has also been positive, but this could not be sustained given the narrow export base. Exports have more than halved since June 2000, indicating that the Solomon Islands balance of payments has an inherently weak trade account. It follows also that the external reserves have been subjected to enormous pressures to the extent that monetary policy has resorted to merely slowing down the declining trend in the level of the reserves.

During the first half of the 1990s, Solomon Islands enjoyed growth rates averaging up to 5 per cent, a period of relative economic boom (see Table 1). Meanwhile, the government was experiencing great financial difficulties. Herein lies the paradox of Solomon Islands: a gloomy political economy while the rest of the economy was booming. Fiscal policy lies at the centre of this paradox. For four years up to and including 1997, the government built up its debt and creditors' arrears at a rapid rate. Since 1996, the

Table 1 **Solomon Islands: economic indicators, 1993–2001**

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Money supply (SI$'000)	249.2	309.4	340.1	393.5	418.3	438.5	458.3	460.0	399.0
Balance of payments									
Current account (SI$'000)	–23.73	4.33	46.63	39.0	–54.3	53.4	120.8	–223.6	–172.3
External financing of the budget (per cent of total expenditure)	34.0	39.0	30.0	35.0	30.0	56.0	44.0	34.0	62.0
Total expenditure: (percentage of GDP)	49.0	53.0	40.0	39.0	33.0	37.0	41	44.0	89.0
Inflation (per cent)	9.2	13.3	9.6	11.8	8.1	12.4	8.0	6.2	12.0
Real GDP (per cent)	2.4	5.3	10.1	3.5	–0.8	1.3	–0.5	–14.1	–20.0
Population ('000)	343	353	364	375	386	398	409	420	432
GDP per capita (US$)	760	840	1,010	1,100	1,120	900	840	660	490

Source: Central Bank of Solomon Islands, 2001. *Quarterly Report*, December, Honiara; Solomon Islands, 2001. *Report on the 1999 Population and Housing Census: basic tables and census description*, Government of Solomon Islands, Honiara; International Monetary Fund, 1996. *Solomon Islands—recent economic developments*, IMF Staff Country Report 96/74, Washington, DC.

economy had been subjected to enormous constraints, in particular irresponsible public sector policies and reckless management by the government.

The fragility of the Solomon Islands' economic base is a related factor. Fiscal problems have persistently crowded out growth prospects, and by the mid 1990s, Solomon Islands was riding on the back of a single commodity—logs. With the East Asian financial crisis in 1997, boom turned to bust.

Ethnic conflict, which culminated in the outbreak of severe violence, has caused deep and far-reaching effects on the country's economic and social situation. On Guadalcanal, there was extensive damage to transport infrastructure, schools, water supply and sanitation systems, government buildings and health facilities. The damage inflicted on the economy and social infrastructure is estimated to be over US$250 million, or about 20 per cent of Solomon Islands' GDP. Violence disrupted and slowed economic activity and placed severe strains on the delivery of government services throughout the country. In 2000 the economy declined by over 14 per cent. Positive economic growth will be difficult to achieve in the coming years, and it will take time and dedication to reverse current trends.

Developments 1997–2001

The current economic environment—a subdued investment climate, weakened private sector, high inflation rates, persistent government cash flow problems, large budget deficits, increasing government debt, a weak balance of payments position, and the absence of a political will for reforms—have all been characteristics of economic management in Solomon Islands for the last decade.

Many opportunities to address these underlying problems were lost after the mid 1990s. Among other things, global economic conditions, particularly in Asia, were favourable, as the economies important to Solomon Islands rebounded from the 1997 crisis. Domestically, the new administration, which assumed power in late 1997, quickly instituted necessary reforms. In 1998, the government's Public Sector Reform Program was put into motion, providing an important impetus for economic reforms and recovery. By the end of 1999, these reforms had already impacted positively on most of the important indicators: inflation had declined to 8 per cent, the balance of payments swung to an overall surplus and the external reserves rose to the equivalent of more than three months of import cover, the highest in years. Government finances were brought under control, debt arrears were settled, debt servicing was normalised, and the payroll remained in check. Furthermore, government accounts were produced in a timely manner, for the first time in years. Also for the first time in 10 years, the overall fiscal balance registered a surplus of more than 1 per cent of GDP. Actions to ensure a strong and effective revenue stream also delivered positive outcomes, and developments to strengthen private sector growth showed encouraging signs.

The economic and structural reforms of 1997–99 produced the best opportunity to reverse the underlying impediments to economic growth. However, these reforms lasted only half of the life of Parliament when the administration was forced out of office in June 2000. Positive developments were reversed, and any possibilities for curtailing the economic trends and fundamentals were effectively derailed.

Production

Well before the outbreak of ethnic conflict, world prices were very low for most of the commodities Solomon Islands exports, especially for fish and logs. Production costs of these commodities were difficult to contain. Fishing, for example, had stopped, as overheads made it prohibitive to continue operating. The outbreak of ethnic conflict dealt the hardest blow to production: the resultant deterioration in law and order forced the remaining operators and traders to scale down or close operations altogether. In terms of the real sector, the long-term concern is not only the amount of damage inflicted on economic infrastructure—increasing as the sector remains inoperative—but also the loss of investor confidence in the enforcement of law and order. This situation has kept many important economic agents from re-opening. The damage is overwhelming, and it will take years to rehabilitate.

Production figures for 2001 indicate that the sector was still operating below half of its capacity. The objective, given the circumstances, should be to encourage existing operators to reopen before even looking at attracting new investors into the country.

Palm oil

Solomon Islands Plantation Limited (SIPL), the country's only palm oil producer, closed in June 1999 (Table 2). Although its reserve tankers lasted for the rest of that year, as of 2000 oil palm products (palm oil and palm kernel) were lost from Solomon Islands' production statistics. With the closure of the company, about 2,000 jobs were lost. As well, a clinic and a school—funded by the company for surrounding communities—were completely destroyed through militia activities. At the same time, the local economy on northwest Guadalcanal ceased. It had thrived on income from royalties, land rents, community service grants, and vegetable and meat markets. Many other service providers who had depended on the company have now ceased operating. The reopening of SIPL is very doubtful. It has already been closed for over three years, its plant has sustained extensive damage through militia activities, and there are ongoing security problems. Capital outlays for rehabilitation would be prohibitive, and the Commonwealth Development Corporation, the major shareholder, has since pulled out.

Copra and coconut oil

A combination of factors has adversely affected production in this sector, including declining world prices, financial problems in the Commodities Export Marketing Authority (CEMA) and its subsidiary, the Russell Islands Plantation Estates Limited (RIPEL), and the effects of the ethnic tensions. Copra production continues, at a significantly lower level, while coconut oil only started production again at the end of 2001. Owing to ethnic tensions, most producers on north Guadalcanal have stopped making copra. RIPEL, the only coconut oil producer, has also been affected, laying off most, if not all, of its Guadalcanal workforce. By the end of 2001, operations in the Russell Islands had virtually stopped, with the company facing a forced sale as a consequence. Several hundred jobs are at stake.

Fish

The fish catch in 2001 dropped by more than 15 per cent on the previous year. The reason was primarily poor prices, which forced National Fisheries Development Company (NFD)[2] to close operations in 2000, and Solomon Taiyo Ltd (STL)[3] to close down in 2001. Nevertheless, production picked up rather strongly again from the second half of 2001 following improved tuna prices at the beginning of the year, as well as the resumption of the Soltai Fishing and Processing Company. The fishing industry might have been the least affected by the ethnic tensions considering the locations of their operations outside Guadalcanal. However, the spillover effects from the security situation caused STL to lay off almost 1,000 workers and NFD about 200 workers. With the two major companies now back in operation, fishing activities have resumed and, despite the current low prices, the industry is expected to revive.

Timber and logs

Production in 2001 was at the same level as in the previous year. Like fishing, logging should have been less affected by the tensions. However, since 2001 production has declined following disruptions to some of the large logging operators, notably Earth Movers Ltd, Pacific Timbers Ltd (operations on Guadalcanal) and Eagon Resources Ltd (Choiseul Province). Currently, there is no forestry activity on Guadalcanal. Companies have relocated to other parts of the country, and these disruptions have resulted in the loss of a few hundred jobs. The closure of these companies has also entailed loss of royalties, resource rents, social amenities such as schools and clinics, and sources of income to the respective local communities. With the recent reopening of Eagon Resources Ltd in Choiseul Province, and renewed activities in the Western Province, log production is expected to increase in 2002.

Minerals

The Gold Ridge mine (the only mining company in the country) began operation in 1998 and, within a year, production was above initial projections.[4] Following further drilling, it was discovered that the volume and value of gold deposits in the concession area was better than originally tested. Equipment had been installed to double its extraction capacity and extend its production when ethnic unrest flared. Apart from the obvious loss of gold exports, about 300 local people lost their jobs as a result of the closure. Other services discontinued included a health clinic, a primary school, numerous income-generating projects and other professional services, all of which had relied on the mine. Prospects for reopening the mine remain uncertain. Meanwhile, there have been some positive developments with the San Jorge nickel mine project, and operations may begin soon.

External sector

In the past several years the Solomon Islands' economy has been heavily influenced by the performance of the external sector. Total production is now at less than half of its normal capacity. Consequently, foreign exchange earnings have dropped significantly. For the past two years the temporary tightening of exchange controls has assisted with the maintenance of external reserves,

Table 2 **Production, by major commodity, 1993–2001**

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Copra (metric tons)	29,057	22,500	26,148	21,989	28,679	26,971	23,242	19,004	1,701
Coconut oil (metric tons)	4,286	2,827	4,372	3,520	5,399	8,339	10,345	8,553	117
Palm oil (metric tons)	30,986	29,737	29,562	28,680	28,863	29,077	12,877	-	-
Palm kernel (metric tons)	7,043	7,183	6,861	6,834	7,005	6,821	3,182	-	-
Cocoa (metric tons)	3,297	3,337	2,482	2,464	3,907	3,454	2,395	2,316	2,034
Fish (metric tons)	32,486	39,005	56,133	41,199	40,654	49,390	47,961	21,163	17,699
Timber/logs ('000 cubic metres)	547	267	850	792	650	604	622	536	534
Gold ('000 ounces)	-	-	-	-	-	45	110	50	-
Silver ('000 ounces)	-	-	-	-	-	47	67	21	-

Source: Central Bank of Solomon Islands, 2001. *Quarterly Report*, December, Honiara.

Table 3 **Solomon Islands: balance of payments, 1996–2001** (SI$ million)

	1996	1997	1998	1999	2000	2001
Current account	39.0	–54.3	53.4	120.8	–223.6	–172.3
Merchandise trade	155.6	32.8	67.0	192.6	–117.3	–182.7
Services	–214.8	–207.0	–96.4	–232.8	–118.9	–48.3
Income	–24.5	-30.8	–35.7	–81.9	–21.4	0.6
Current transfers	122.7	150.7	118.5	242.2	33.9	58.2
Capital and financial account	–56.5	74.1	81.7	–93.8	131.8	108.2
Capital account	–19.1	–3.8	34.0	44.3	67.5	23.0
Financial account	–37.4	77.9	47.7	–138.1	64.3	85.5
Net errors and omissions	80.7	14.2	–52.1	–3.2	–5.2	6.9
Overall position	63.1	33.9	83.0	23.0	–97.2	–57.2
Financing	–63.1	–33.9	–83.0	–23.0	97.2	57.2
Reserves						
Foreign exchange	63.1	33.9	83.0	23.0	97.2	57.2
Other claims	-	-	-	-	-	-

Note: All figures are provisional.
Source: Central Bank of Solomon Islands, 2001. *Annual Report*, Central Bank of Solomon Islands, Honiara.

but this would have been extremely difficult without significant donor financial assistance.[5] From 1996, Solomon Islands enjoyed consecutive balance of payments surpluses, but in 2000 the position swung to a staggering SI$97 million deficit, the highest recorded in recent economic history (Table 3).

Balance of payments

Current account. The dramatic fall of the current account over the last two years was largely driven by the trade account, due to an accelerated fall in exports as against a lesser decline in imports (see Table 3). Imports have fallen by 25 per cent while exports slumped by over 40 per cent. It is worth noting that the situation improved in 2001—both imports and exports declined by about 16 per cent. The current account balance in 2001 improved on 2000, but this time, on account of services. Performance during the first half of 2002 indicates that this improvement may continue as a result of continuous contraction in imports and anticipated improvements in export receipts. The movements in services and income accounts continue to show a declining trend, albeit with some significant improvements compared to the previous year. As regards transfers, the flow of official transfers—mainly from Taiwan (ROC), as well as private transfers—is expected to continue in 2002. However, these would have been outstripped by the steady outflow of gifts, subsistence, and school fees in recent months. The much-heralded 1999 STABEX transfers are now not expected in 2002. Despite positive indications on the trade account and transfers, overall, the current account remains fragile.

Capital account. Except for transactions in 1998 in respect of the mine expansion, there has been very little activity in this account in the past three years. However, there were some large transactions in official capital when the first loan disbursement from the Asian Development Bank (ADB) and World Bank Group were received in 1998 and 1999 respectively. Before June 2000, capital repayments, dividends and transfer payments of profits were small but steady. The first and second tranches of the EXIM Bank loan,[6] totaling SI$87 million, were received in 2001, and the third tranche was received in February 2002. These should impact favourably on the official capital account. Except for the hopes placed in the nickel mine, very little else is expected in terms of private capital inflows in the near future.

External reserves

From June 2001, external reserves fell at an alarming rate (SI$5 million per week until the first quarter of 2002) due to a combination of factors: low exports, acceleration in imports and capital transfers due to panic, and a general level of uncertainty, especially among the expatriate and business community. By the end of June 2001, reserves were at SI$114 million compared with about SI$151.3 million at the end of December 2000. For most of 2001, external reserves stabilised at around SI$120 million, equivalent to two months of imports cover. Given that exports have declined, donor financial assistance has been the most critical source of foreign exchange since the ethnic tensions erupted. There has been a noticeable decline in import demand since 2001, as major companies have yet to reopen. In the meantime, however, strict exchange controls have provided a means of slowing import demand. The receipt of the second and third tranches of the EXIM Bank loan have helped boost reserves, albeit temporarily. By June 2002 external reserves were at less than one month of import cover. All hopes are now pinned on the receipt of the fourth tranche of the EXIM Bank loan from Taiwan (ROC) and the 1999 STABEX transfers from the European Union. For the medium term, foreign exchange earnings can be expected from the revived fishing industry, increased log production, and renewed activities in copra and cocoa. In the meantime, however, more, and more stringent, administrative controls—which began in 2000—are still the main defensive tool. Soon however, even these tools will prove inadequate.

Exchange rate

Traditionally, exchange rate policy has been geared towards maintaining a competitive export sector. However, with the depletion of the export sector, this policy could not be retained without causing further destabilisation in other areas. In the circumstances, drastic action on the exchange rate is unlikely to produce the desired effect, and may worsen the situation. Since the major currency devaluation in 1997, the exchange rate has been fixed to the US dollar to maintain a stable exchange rate. However, recent movements in major currencies—in particular the Australian dollar—may have meant that the stabilisation policy was being maintained at the expense of the exports. In March 2002, the exchange rate was adjusted downwards by 25 per cent as a defensive measure to protect external reserves. However, that action resulted in the removal of the then Minister of Finance, Hon. Michael Maina, and four days later, the adjustment was reversed due to political pressure. This was another demonstration of the lack of cohesion in policy formulation and the absence of the political will to address the underlying causes of economic problems in Solomon Islands.

Government finances

The current government cash flow problems are a direct result of serious financial mismanagement by successive governments over the last 10 years. This has been compounded by the negative effects of ethnic tensions; however, the irresponsible financial management witnessed in the last three years has worsened an already fragile situation. Management of public finances has been dominated by daily and weekly cash flow problems in the Treasury Division. The ongoing task of matching expenditures with revenues means that Ministry officials do not have time for policy matters.

Revenues

With the downturn in the economy, the government's revenue base has been reduced by more than 50 per cent. Traditionally, revenue collections have been above budget in the two main revenue departments: Inland Revenue and Customs and Excise. However, in the last two years, collections by these departments have drastically declined to about half their 1999 levels. Indications are that this decline will continue because of the downturn in the economy. As well, a generous method of granting remissions has resulted in significant amounts of forgone revenues; the latest estimates by the Customs Department reveal that, for customs duty alone, almost SI$50 million was forfeited in 2001. Taking into account the value of goods tax forfeited, total government revenues forgone during 2001 may have been over SI$60 million.[7] Over the past year several initiatives were taken by officials to address the dire financial situation. Sadly, these attempts did not work due to a lack of cooperation and the apparent disregard of the desperate situation at the political level. In 2001, two task forces were appointed to address fiscal problems.[8] As expected, nothing worthwhile emerged. The practice continued in 2002, until the discretionary granting of remissions was withdrawn and some remissions previously granted were cancelled following continued public pressure. Owing to further ongoing pressure for the granting of remissions, a committee was recently appointed to advise the Minister of Finance on applications for remission.[9] Whilst it is too early to ascertain the transparency and efficiency of this mechanism, one thing is certain: revenues will not be enhanced.

Expenditure

The problem with public expenditure is that it has been impossible to contain costs. Over the past two and a half years, claims on the

Table 4 **Solomon Islands: government cash flow and budget performance, 1997–2001** (SI$ million)

	1997	1998	1999	2000[E]	2001[B]
Revenue	468.0	613.3	562.6	388.1	214.4
Inland revenue	153.6	197.3	217.0	159.1	124.2
Customs	135.6	116.0	143.9	99.7	72.2
Other ministries	30.0	28.9	98.6	18.6	18.0
Grants	148.8	271.0	103.1	110.7	-
Expenditure	534.8	420.4	493.3	625.1	301.9
Payroll	155.1	156.4	149.7	150.5	184.3
Other charges	165.4	147.6	175.1	229.1	91.5
Debt servicing	44.1	36.4	44.4	49.2	23.1
Capital expenditure	170.2	80.0	124.1	196.3	3.0
Overall balance	–66.7	192.8	69.3	–237.0	–87.5

[E] Estimates
[B] Budget
Source: Central Bank of Solomon Islands, 2001. *Annual Report*, Central Bank of Solomon Islands, Honiara.

government have taken on a new dimension, as the central bill-paying system has been hijacked by the payment of compensation claims. Payroll expenditure, which would have been normally under SI$155 million per annum, has increased due to an explosion in police recruitment since October 2000. Treasury officials find some expenditure items—particularly the police payroll and certain compensation claims by former militant groups and associates—almost impossible to resist without compromising their personal security.[10] The issue of bogus claims has had, and continues to have, very serious implications on the government cash flow.[11] But equally serious is that these claims have been paid at the expense of normal government services.[12] This cash flow problem has now extended to salary payments for all government workers, whose pay in most cases has been in arrears for two pay periods.

Debt stock and arrears

Total government stock of debt at the end of June 2002 stood at SI$1,359 million: this comprised 'overseas debts' of SI$883 million, 'domestic debt' at SI$476 million and 'other creditors' at about SI$90 million. The overseas debt stock was stable for most of 2000, however, since 2001 it has been rising steadily on account of the disbursement of the first three tranches of the EXIM Bank loan, which totalled SI$130 million at the end of June 2002. Domestically, gross government debt rose by over SI$124 million in 2001; most, if not all, of that increase came from the Central Bank. However, to the end of June 2001, government debt stock has remained stable. The more serious issue is the arrears situation. Demands on government revenue have increased and, consequently, government has continued to build debt arrears. At the end of May 2001, both Overseas and Domestic Debt arrears were SI$55 million and SI$57 million respectively.[13] In addition, there is an unknown (but likely significant) amount due to trade creditors and grants in respect of government services and house rentals. The government has thus not only defaulted on its loans, but continues to accumulate arrears on its normal services, including payment of salaries of its workers.

Monetary sector

Movements in the monetary aggregates reflect a subdued economic environment, which began in 1999. Except for credit, all monetary aggregates have been declining since then. Net foreign assets fell by 60 per cent to the end of 2001.

Money supply

Domestic money supply declined by 13 per cent from 1999 to the end of 2001. This downward decline was seen in both components of money supply. Apart from government borrowings, this was a major reason for the substantial decline of 60 per cent in net foreign assets over the same period.

Liquidity

Excess liquidity in the banking system grew quite rapidly following the events of June 2000. Since then, bank excess liquidity has remained at SI$55 million per month. As a matter of tradition, banks invest their liquidity in Treasury Bills, and this was noticeable in 1998 and 1999 following the mass withdrawal of banks from the Treasury Bills market. As a result, stocks drastically fell and bank liquidity rose. Considering the liquid nature of Treasury Bills, liquidity in the system has remained stable between 1999 and 2001. However, the stocks represent members of the public and the change in the definition of liquid asset ratio does not compel banks to hold these securities. Banks therefore were building up their call account balances with the Central Bank.

Domestic credit

Bank credit growth for the past two years has declined significantly. Domestic credit is always influenced by government borrowings from the Central Bank—the 'crowding-out' effect, as demonstrated during the four years up to, and including, 1999. That period saw a steady growth in private sector credit while net government credit from the Central Bank was maintained at zero growth rate. The substantial decline of 20 per cent in 1998 resulted in positive private sector lending of 25 per cent for that year. However, this trend was reversed in 2000 when credit to government rose by 45 per cent. Consequently, by 2001 private sector credit had decreased by 22 per cent.

On a positive note, this trend has slowed in 2002, mainly due to domestic financial institutions—including the Central Bank—having closed their doors to any further government borrowing. However, given the prevailing investment climate there has been little positive movement in private sector borrowing. On the other hand, along with hopes of an improvement in the security situation, there are indications of renewed commercial activity in the real sector. It is expected that commercial bank lending should be more active in the second half of 2002.

Interest rates

Movements in weighted average interest rates have been mixed. For commercial banks, lending interest rates have gone up from 14 per cent in 2000 to about 15.5 per cent in 2001. However, during the same period, deposit rates have declined from 3.12 per cent to 0.54 per cent. Consequently, interest margins have increased to 15 per cent. Call account rates have remained at 3 per cent for the past five years.[14] Attempts to influence interest rates through the Treasury Bills auctions market have not succeeded, mainly due to the non-participation of commercial banks. For the past two years, commercial banks have cut down on interest rates in order to cut costs, and given the high liquidity situation and low demand for credit, have had very little appetite for deposits. The Central Bank is reviewing interest rates, particularly its call rate and those other rates associated with government accounts. The Treasury Bills rate has also been revised downwards and will be constantly reviewed in line with commercial banks' deposit rates.

Table 5 **Solomon Islands: monetary survey, 1995–2001** (SI$ '000)

	1995	1996	1997	1998	1999	2000	2001
Money supply	340.0	393.5	418.3	438.5	458.3	460.0	399.0
Narrow money	169.6	198.2	211.3	220.6	264.8	248.3	246.3
Broad money	170.4	195.2	206.9	217.9	193.6	211.7	152.7
Domestic credit	350.1	356.9	368.9	355.8	372.6	457.0	424.4
Net credit to government	226.9	226.0	226.9	178.0	178.3	258.2	269.8
Credit to private sector	123.2	130.9	142.0	177.8	194.3	198.8	154.6
Net foreign assets	42.2	106.4	150.9	225.1	243.4	144.2	97.2
Liquidity	22.0	39.9	21.6	8.5	52.3	60.9	64.6
Total holdings of Treasury Bills	189.2	205.4	225.7	229.7	86.6	60.8	50.0

Source: Central Bank of Solomon Islands, 2001. *Quarterly Report*, December, Honiara.

Inflation

The Solomon Islands Statistical Office produces most of the economic information for the country, including inflation data. It has, however, been unable to produce up-to-date data for a number of years. The latest inflation data showed 6 per cent for May 2000—a significant drop considering that inflation in previous years has struggled to get below 10 per cent. No doubt, this was the result of a tight fiscal policy adopted by the, then, new administration since its assumption of the government in late 1997. The fact that the Statistical Office is not able to produce current information is a serious matter, and one that must be addressed urgently. The production of timely data on inflation, trade, national incomes and other relevant areas is crucial for planning and policy formulation. Despite an abiding interest, past attempts by certain donor partners to invigorate the Statistical Office have failed. This failure is due primarily to government placing little importance on the role of the Statistical Office, and because of serious management capability gaps within the office itself.

Financial sector

Solomon Islands' financial system is made up of three commercial banks, a development bank, a superannuation fund, a handful of insurance-brokering companies, and the credit union movement. Of the three commercial banks, two are Australian owned, and one is owned domestically.[15]

Commercial banks

Commercial banks in Solomon Islands are profitable. However, the results for 2001 indicate that levels of profit have fallen considerably, reflecting a reduction in their core source of income, namely, lending. As of 2001, the issue of greatest concern to banks, as for the National Provident Fund, is their investment in government securities (Restructure Bonds) which have now become non-performing assets. Of the total amount of outstanding bonds of SI$207 million at the end of June 2002, the commercial banks hold about SI$150 million. This represents over 30 per cent of the total assets of the banking system. Adding to that the holdings of the National Provident Fund, the financial system holds almost 90 per cent of the total outstanding stock of government securities. This situation represents real and serious risks to the stability of the financial system, the condition of the government securities market, and the state of government revenues.

The banks' worst fears materialised in April 2001 when the first tranche (SI$54 million) of the Restructure Bonds were defaulted by the government. Although interest is being serviced, in April 2002 the second tranche of SI$54 million was also defaulted. In an effort to register their claim on government revenues, the banks sought and received a High Court ruling in their favour. Subsequent attempts to agree on a scheme of repayment and interest servicing were unsuccessful until the government took the ultimate step of prescribing terms.[16] It is highly likely that provisioning will be allowed in order to gain a realistic picture of the banks' balance sheets. It should be noted that banks, especially the locally owned banks, are likely to confront severe risks (including solvency) once these assets are provided. Every effort will be made to ensure minimum disturbance to the financial system.

Development Bank of Solomon Islands

The Development Bank of Solomon Islands' (DBSI) financial problems have been well documented. Since the 1980s, the DBSI has been plagued by ill-conceived, and at times aimless, government policy—politically oriented lending schemes, and a loan portfolio heavily tilted towards sectors producing marginal returns. Management problems also existed. Under the former government's financial sector reform program, DBSI came under a review.[17] Among many recommendations, the review strongly urged that the bank should be brought under the supervisory purview of the Central Bank. This is provided for in the Financial Institutions Act (1998) and now awaits a ministerial order for implementation.

A large portion of DBSI's loan portfolio is located in Honiara and Guadalcanal, and most of the bank's loans are to projects in these two locations. As a result of ethnic tensions however, most, if not all, of these projects were destroyed. Now that these loans may never resume, DBSI has lost its entire portfolio to non-performing assets. Given that it has not recovered from its cash-flow problems, these new losses have exacerbated an already desperate situation. DBSI has not had any cash injections from its usual source—the European Investment Bank—for a number of years due to non-servicing of existing debts to that organisation. Recent attempts to raise cash locally have resulted in a serious imbalance between the bank's liabilities and its loan portfolio. These deposits have matured, but the DBSI has defaulted because it could not find cash for repayments.[18] The DBSI is thus surviving at the mercy of its creditors.

The DBSI has played a vital role in the economic development of Solomon Islands, and should be given the opportunity to contribute further. Unlike the commercial banks, its infrastructure network remains throughout most of the country.[19] This network, if utilised effectively, can enhance financial services and financial intermediation in Solomon Islands, particularly in rural areas. The DBSI is best placed to take on the role of delivering financial services throughout the country. The government has the unenviable task of deciding on how to reinvigorate the DBSI.

National Provident Fund

Like DBSI, the National Provident Fund (NPF) is currently cash-strapped, although its problems are more recent. These problems are attributable to management decisions, and to ill-conceived directions by successive governments on the role and function of the Fund. It was a management decision that the Fund invest most of its cash resources into real estate—including a property in Brisbane—all of which have made little or no return. There was also the creation of the infamous insurance firm (Solomon Mutual Insurance) that was a drain on the Fund's cash reserves until recently. Previous governments made at least three amendments to the National Provident Fund Act, which have led to the Fund's cash-flow problems through rapidly reduced member contributions.[20] The new management has recommended amendments to the legislation with the aim of correcting obvious anomalies, but this has been objected to by certain Cabinet Ministers in the present government.

The economy has not been producing enough jobs to increase membership, hence those reaching retirement age and becoming eligible to withdraw their contributions are increasing faster than new entrants. This is exacerbated by mass redundancies since 1998, resulting in lesser contributions—averaging SI$2 million per month, as opposed to previous payments of SI$5 million each month. The National Provident Fund has been surviving on the cash reserves of past years; with recent management forecasts indicating that these reserves will run dry in 2002. The Fund would be insolvent already if not for delaying tactics in deciding on members' applications for withdrawal of contributions.

The prevailing financial crisis only adds salt to these wounds. For a number of years government has not paid public officers' contributions. Up to 1998, the government owed more than SI$15 million in members' contributions, which it was repaying until

2000. Treasury has been unable to quantify the current level of outstanding contributions, but given the inability to pay public servants these outstanding contributions are no doubt extremely high (estimated to be SI$20 million at the end of first quarter 2002). In addition, the Fund holds more than SI$97 million of the defaulted Restructure Bonds, and another SI$12 million at DBSI. These holdings represent approximately 30 per cent of the Fund's total assets portfolio, causing cash flow problems, and carries serious implications for the Fund's earning capacity on its assets.

The Financial Institutions Act also stipulates that NPF be supervised by the Central Bank. Like DBSI, the National Provident Fund management appears willing, but will have to wait until a Ministerial order is signed.

Other non-bank financial institutions

The credit union movement provides a bridge between the formal banking sector and members and, crucially, fills the gaps left by the degradation of the formal banking system. Large credit unions are experiencing problems, largely due to mismanagement by their own members. Ethnic tensions have affected many credit unions adversely. For example, mass redundancies have impacted negatively on the cash flows of employee-based credit unions. The umbrella body, SICUL, is wholly ineffective, and unable to look after the movement. The Central Bank is keenly looking to address this situation, and necessary amendments to the Credit Union Act will be made soon. The Financial Institutions Act stipulates that (major) credit unions operate under Central Bank supervision.

The insurance sector is regulated and supervised by the Office of the Controller of Insurance. The effectiveness of the office is blunted by the government's indecision regarding the regulatory functions to be vested in the Controller. This is partly due to the office and the sector being marginalised amidst other government priorities. Plans to have the office integrated with central bank functions were recently advanced by the government, but have been put on hold. The Central Bank itself has been unwilling to assume responsibilities outside of its mandate and management capacity. This resistance is aggravated by the government's apparent feeling that the Central Bank belongs in the 'too hard basket'. For the moment, the office is physically located in the Central Bank and staffed by one officer.

Conclusions and policy issues

The Solomon Islands' economy has bottomed out under the weight of the economic and financial troubles of the past decade. While some blame can rightly be leveled at external causes, much of the country's problems are self-inflicted. Particularly, the government's policy acts and omissions have made the task of escaping present circumstances more difficult. Fiscal policy needs urgent attention and economic fundamentals are in need of correction.

Undoubtedly, ethnic conflict has both highlighted and exacerbated the problems of the economy. The socioeconomic infrastructure has been badly damaged and repair and restoration of the physical infrastructure will be costly and take time. Restoration of confidence in investment, government, and law and order, will be crucial to the rebuilding process. The Kemakeza government will need to do more than practise pseudo-economic management and repeat the rhetoric of the past. Prime Minister Kemakeza will have to demonstrate his capability to govern, to develop a respectable restoration plan and to ensure that his government executes it faithfully. Prevailing circumstances give the government little choice but to pursue a comprehensive reform agenda aggressively, if it is to revive the economy.

Economic survey

The scope and detail of economic restoration is a matter for the government, but the following areas must be the central concerns of any such agenda.

Fiscal policy

The objective must be to arrest the current decline in government cash flows, restore confidence in public finance management, address the current high expenditures level by targeting a cap on payroll, and put a stop to the flow of compensation claims against the government. On the revenue side, decisive measures will have to be taken to enhance revenue collection. The government needs to reestablish confidence in the securities market with a clear and definite plan on the resumption of debt servicing that will address the debt arrears to both local and overseas creditors. The budget process must be restored, starting with a respectable budget for the remainder of 2002, and the adoption of a multi-year budgeting approach. Clear policy guidelines on government borrowing, and effective debt management must also be established.

Law and order

Rebuilding and reconstruction of the economy requires an environment that is ready to accept radical changes, where investors will be free to look for, and take up, available opportunities, and where government officials will conduct administration unconcerned about intimidation. Confidence will only return if the police force combats crime unreservedly and with neutrality. For this to happen, the government has to deal decisively with all elements that compromise the effectiveness and neutrality of the police force and law-enforcement agencies.

External balances

External reserves have declined dramatically. Administrative controls are no longer able to address or sustain the situation, hence more aggressive policy action is required. The export sector must return to production, and the closed sectors—including mines, palm oil, and copra—must reopen as soon as possible. In the meantime, the country will need a significant level of external assistance. Thus, early agreement with the International Monetary Fund, the Asian Development Bank and the World Bank on a financial and economic reform program is crucial, so that assistance can be secured for reconstruction of essential socio-economic infrastructures. Also, bilateral assistance should be quickly obtained to finance badly needed economic growth and social programs. An important hurdle in this regard is the general lack of confidence and trust in the Kemakeza government.

Investment

In order to revive investor confidence it is essential to secure the return of law and order. The police force has to be reliable, and be seen to deal impartially with crime and criminals. The immediate objective should be to retain existing investors. Every effort and encouragement must be devoted to ensuring that those who have closed their operations re-open. Assurances as to the long-term prospects of the country must be given. The principal long-term goal will be to provide an enabling environment for investment. For this to happen, measures must go beyond simply maintaining law and order. They must work to establish confidence in the long-term security situation, stability of government, transparent rules and regulations, and so on. There are many other impediments to investment in Solomon Islands that need to be addressed in a timely and practical way.

Financial system

The status of the government Restructure Bonds poses serious risks to the banks and the National Provident Fund, and threatens both the solvency and stability of the financial system. The system's health is of paramount importance, as its downfall will have far-reaching and devastating effects on the economy and population—worse still than the ethnic conflict. The ongoing crisis in government finances, and the consequential debt arrears to the financial system, must be addressed urgently and in a logical manner. In this regard, the confidence of financial institutions in the government has been negligible. As well, solvency risks in public enterprises are a cause for concern to the financial system. Distortions in financial resource allocation must be avoided. The capabilities of the financial system need to be harnessed for the benefit of the economy.

Good governance

Political groups that have dominated successive governments in the last ten years have driven the Solomon Islands to the point where misappropriation of public funds, corruption, nepotism, and ignorance of standard procedures are now common at all levels of government. This has resulted in serious inefficiencies in government services and public enterprises, and a total collapse of public service machinery. There are serious failures of transparency and accountability. The objective is to restore and encourage transparency, accountability, and responsibility in government, and to ensure that the political arm returns to governing in its proper sense.

The concern is that 'bad governance' is endemic in all public sector enterprises. Solomon Islands is a small country and what happens in the public sector has a direct effect on all other sectors and the people in general. Public entities (SIEA, SIWA, CEMA), that are going bankrupt will need to be revived quickly, as they provide services essential to both industry and the livelihood of the population. Their solvency has implications for the financial system.

Development partner support

Solomon Islanders must acknowledge that since 2000, the country has been surviving on donor assistance. Furthermore, it should be recognised that in the present circumstances, Solomon Islands will need to obtain significant additonal external resources. This will entail maintaining the confidence, trust, goodwill and continued support of donor partners. If the country is serious about change, the conditions required by donor partners should not be ignored—they are necessary conditions regardless of who imposes them. Open dialogue must be established in order to create a better understanding and fuller appreciation of the country's circumstances. Furthermore, the partnership concept should be extended locally—at different levels of government, the private sector, churches, non-government organisations and local communities—to ensure that assistance is well coordinated and is not diverted before reaching the intended beneficiaries.

Macroeconomic framework

To attain a sound budgetary process, a tightened monetary policy stance and an acceptable debt management profile will entail aggressive pursuit of a reform agenda. The agenda should cover all socioeconomic sectors. Policy measures must be formulated to arrest the deteriorating revenues and external reserves positions. The government and the donor community must, of necessity, be committed to the program.

Notes

1 Solomon Islands is the only country in the region where the government is borrowing heavily from its central bank. It is no coincidence therefore that the government should be experiencing chronic debt difficulties, high inflation, endemic cash flow problems and a precarious level of foreign

reserves, even when the region is experiencing an economic boom.

2 The National Fisheries Development Company is owned by US interests and is mainly undertaking purse-seine fishing. The owners are also running large onshore operations in American Samoa.

3 Solomon Taiyo Ltd was a joint venture between Maruha, a Japanese company, and the Solomon Islands government. Under a joint venture agreement that dates back to the early 1970s, this company had not made any profit until its closure in 2001. Instead, it has been running up inter-company debts for the past 30 years—a source of much contention in the government. Maruha pulled out last year leaving the government no other option but to 'pick up the pieces'. The government registered the new company, Soltai Fishing and Processing Ltd, and has had to give the company a substantial subsidy (in the form of import duty exemptions) for at least the next five years.

4 Original projections were 100,000 ounces of poured gold per annum. Fresh drillings put these projections at close to 150,000 ounces per annum.

5 Except for Taiwan (ROC), most assistance from multilaterals (European Union) and bilaterals in the last two years has been directly to assist in the provision of education and health services. Taiwan (ROC) financial assistance for budgetary support has been at least SI$80 million so far in 2002. Apart from that, the first three tranches (SI$145 million) of the EXIM Bank loan from Taiwan (ROC) has been received. The last tranche, of US$5 million, is expected later this year.

6 In 2000, the Solomon Islands government negotiated a semi-commercial loan of US$25 million with the EXIM Bank of Taiwan. The entire loan proceeds have been used for payment of claims on lost and damaged property during the ethnic tensions.

7 Customs Department calculations showed that the value of duty remissions granted in the period January to August 2001 was SI$49.5 million. Based on these figures, the estimated value of goods tax forfeited for the remainder of 2001 is SI$15.3 million. Discretionary granting of remissions continued until early 2002. Although no figures are available yet, it is estimated that the total value of forgone revenues in respect of these remissions will be very high.

8 The Revenue Enhancement Task Force was headed by Tommy Chan and the Expenditure Control Task Force was chaired by Snyder Rini. These two men were Ministers (for Forestry and Finance respectively) in the 2000–1 government, a period that saw the most reckless fiscal management.

9 This Committee, which is chaired by the Controller of Customs, consists of officials from several departments. The committee has taken over the administrative function of the Controller under the Customs Act.

10 Payroll increases have come in three ways: first, through the recruitment of Special Constables numbering about 1,800; second, about 500 public officers who previously took voluntary leave without pay have rejoined the service with no budget provision; and thirdly, various *ex gratia* payments and allowances being paid to police officers and other public officers since 2000.

11 During a press conference in April 2001, Prime Minister Sogavare revealed that payments totaling SI$40 million in respect of compensation and various other claims were bogus. This practice continues.

12 As at June 2002, it is estimated that unpaid grants to provinces, health and education, outstanding rentals, and other trade creditors, were in excess of SI$90 million.

13 This includes the SI$54 million of Restructured Bonds, which matured in April 2001. Another SI$54 million matured in April 2002, but this amount has yet to be included, as the matter is currently under discussion with creditors following the High Court decision in April. This figure excludes interest arrears owing to the Central Bank, which for the moment are being considered as not in arrears until the end of the fiscal year.

14 Banks are paid 3 per cent interest on their cash holdings, equivalent to 7.5 per cent of their total liability in compulsory liquid asset requirement holdings.

15 The National Bank of Solomon Islands (NBSI) was previously a partnership between the National Provident Fund and the Bank

of Hawaii. In 2001, the Bank of Hawaii pulled out, and gifted their 51 per cent shares to be divided between three trusts. This is a matter of contention between the Central Bank (as regulators) and the Bank of Hawaii. The issue for the Central Bank now is how the shareholding may be executed to ensure the NBSI is transferred to 'fit and proper' owners.

16 The government will repay and service the debt on the following terms: a three year moratorium on principal and a 3 per cent interest rate to begin 1 August 2002. Where individual contractual arrangements with creditors put the interest rate above 3 per cent, the excess will accrue monthly. Repayment will span 20 years.

17 The Maxwell and Stamp Review 1998.

18 The bank introduced the Mani Grow Scheme to raise funds for lending. However, the scheme has a short maturity compared to the respective loans. These deposits total more than SI$10 million, one of which belongs to the National Provident Fund and was due early in 2001.

19 There are seven branch offices of the DBSI in the provincial centres.

20 First, the reduction from 50 to 40 years of age for automatic withdrawal of members' entire savings, allowing more people to withdraw than are joining as members. Second, where members have been made redundant and been without continuous employment for three months, they are eligible to withdraw savings. Third, the one-third pledge of contributions to provide security for member's commercial bank loans: where a member defaults on the loan, a third of the member's contributions will be called on by the commercial bank.

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