Solomon Islands

Economic growth in Solomon Islands in recent years has been driven by rapid expansion of exports, especially forestry products. Government revenues have been augmented substantially by forestry taxation; however, public expenditure has increased even more rapidly. High fiscal deficits have placed considerable pressure on the financial system. In 1995, accommodation from the banking system became difficult for the Government to secure and it had to resort to special measures, such as deferring payments to private creditors to secure temporary finance. Inflation in 1995, though lower than in 1994, remained high, but the balance-of-payments deficit on current account (excluding transfers) fell sharply as exports surged.

Prospects for 1996 are not encouraging. Improvement in the fiscal balance is problematic, with doubts about the outcome of the changes in revenue structure provided for in the 1996 budget. The balance of payments is still precarious and management of very limited external reserves is likely to present some difficulties. The reduction of the fiscal deficit and return to a position of macroeconomic balance is still a matter of high priority in providing the foundations for long-term sustainable growth.

Recent Trends and Prospects

Economic growth in 1995 was stronger than in 1994, especially in the second half of the year. GDP growth is estimated at 4 percent compared with only 1.1 percent in 1994; however, it is still well below the rate of 8 percent achieved on average during 1992 and 1993. As in previous years, primary production for export was the main stimulus. Log production was substantially higher than in 1994; there was a large rise in fisheries output because of good weather and improved production and processing facilities. Copra and cocoa output was also higher than in 1994.

Government revenue increased by over 10 percent in 1995, with revenue from log export taxes amounting to 23 percent of the total. Total expenditure rose by an estimated 10.4 percent to yield an overall budget deficit of about 6 percent of GDP compared with a deficit of 7.7 percent in 1994. However, in achieving this apparent improvement, development expenditures were kept well below budget and, in real terms, were some 9 percent lower than in 1994.

The Government encountered considerable difficulty in financing the 1995 deficit. Borrowing from the Central Bank reached the legal limit in August 1995 and the commercial banks were unwilling to lend further to the Government as doubts about the security of Treasury bills increased. The Government in effect financed a part of the deficit by delaying payments to private sector suppliers of goods and services, by failing to make budgeted transfers of timber levies to local authorities, and by deferring some project expenditures.

Money supply (M2) growth in 1995 declined to 15 percent from over 20 percent in 1994. Lower rates of domestic credit expansion, especially to the Government, and the leakage into imports were contributing factors in the decline. Inflation at 9 percent was lower in 1995 than it was in the previous year at nearly 13 percent.

The external accounts showed some improvement in 1995. Export earnings rose by 28.7 percent compared with only 5.8 percent in 1994. Timber exports, which comprise more than half of total exports (Figure 2.30), increased by 21 percent as the rate of logging rose sharply. Fish exports showed the largest gain, rising by 85 percent compared with a rise of only 3 percent in 1994. Cocoa and copra exports also increased but together they comprised only about 7percent of the total. The expansion of exports, however, was virtually matched by higher imports which rose by nearly 26 percent after having fallen by over 1 percent in 1994. Consumer goods formed a substantial part of the total. The increase in the trade surplus was, therefore, modest, improving to 5.1 percent of GDP in 1995, from 3.5 percent in the previous year. With a decline in the deficit on net services and transfers, the current account recorded a surplus of 2.4 percent of GDP compared with a deficit of 0.9 percent in 1994. The capital account, however, was in significant deficit

as a result of private debt repayment by logging and fishing companies. Even after allowing for official and other transfers amounting to 3.5 percent of GDP, the overall balance of payments for 1995 was expected to show a small deficit, leaving the external reserves at the low level of about one month's imports. This is a matter of some concern as it leaves little margin for coping with trade and exchange rate fluctuations or capital movements.

Driven as it is by the export sector, economic growth in 1996 is likely to be below that of 1995, perhaps no more than 3 percent at best. Constraints on capacity will mean that any increase in output of the fishing industry will be well below that of 1995, and the same is likely to apply to forestry output. The budget for 1996 provides for a fall in the overall deficit to about 4 percent of GDP. Recurrent expenditure is budgeted to rise by about 6 percent and revenue by over 10 percent. However, the revenue structure incorporates some major changes. Revenues from business and personal taxes, timber, and other export taxes are to decline significantly; this will be compensated by a foreign exchange tax and a bank debit tax which together are projected to constitute nearly a quarter of total revenue. Given problems of administration, compliance, and ease of evasion, revenue shortfall must be expected and a budget deficit in excess of what is programmed, with attendant problems of its financing, could well occur. The outlook for the external sector also is not promising. The high rate of export growth is unlikely to be repeated; however, import growth, though lower than in 1995, could be substantial as a result of the lagged effect of increased incomes in 1995. The foreign exchange tax, however, could restrict the extent of that increase.

Policy and Development Issues

The immediate requirement if macroeconomic stability is to be restored in the near term is the substantial reduction of the fiscal deficit, with emphasis on the containment of recurrent expenditure. The adoption of a more prudent fiscal stance would also put the country in a more resilient position and better able to deal with the effects on government revenue and the balance of payments over the longer term of a necessary reduction in the rate of forest exploitation.