Solomon Islands

Growth moderated but remained strong in 2012, driven by ramped up mining activity. Further moderation in growth is expected over the next 2 years as forestry resources dwindle. To offset the decline of logging, the country needs to further develop other industries and revenue sources, as well as control the growth of government expenditure.

Economic performance

Growth slowed to 5.5% in 2012, from 10.6% in the previous year (Figure 3.34.1). The deceleration mainly reflected a much smaller increase in forestry sector output than in recent years. Logging provides 16% of output but, having reached record levels, grew by only 0.5% in 2012, compared with annual increases of around 36% in the previous 2 years (Figure 3.34.2). Agricultural output fell in 2012 with the production of cocoa falling by 33% and copra by 19% because of sluggish demand overseas. Palm oil and fisheries recorded small increases in production.

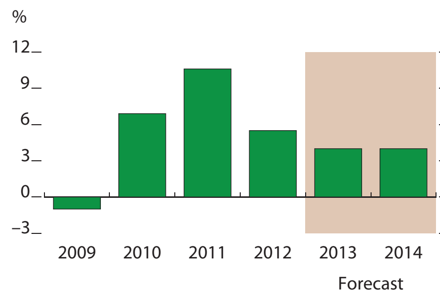
Industry (mostly mining, manufacturing, and construction) and services (mostly trade, transport, and communications) drove growth in 2012. Gold production from the Gold Ridge mine ramped up, and exports were 2.4 times higher in 2012 than in 2011. Solomon Islands' hosting of the Festival of Pacific Arts and higher foreign direct investment helped fuel growth outside of mining.

After a current account deficit in 2011 equivalent to 8% of GDP, the deficit for 2012 is estimated at 6% of GDP, as higher grants from development partners offset declines in export revenues (Figure 3.34.3). The country has seen a significant rise in its foreign reserves, bolstered by large inflows of grants and foreign direct investment. Higher fishing license revenues were also a significant source of foreign currency inflows in 2012. Foreign exchange reserves equaled 10.4 months of imports in December 2012, up from 8.9 months in December 2011.

Inflation declined from 7.4% in 2011 to 5.9% in 2012 because of slower economic growth, the revaluation of the domestic currency, and the Central Bank of Solomon Islands mopping up liquidity (Figure 3.34.4). In October 2012, the central bank replaced the Solomon Islands dollar peg to the US dollar with a peg to a basket of currencies. This was to enable the Solomon Islands dollar to respond more flexibly to market fluctuations.

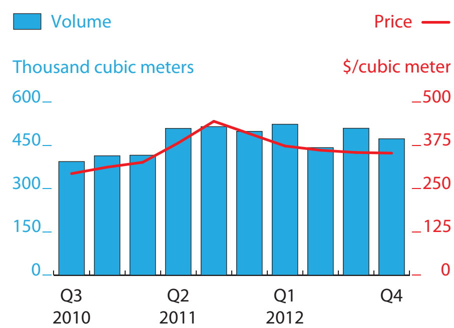
The government incurred a fiscal deficit equivalent to 1.9% of GDP in 2012, reversing a surplus equivalent to 5.1% of GDP in 2011. It financed the deficit by running down fiscal reserves that had been built up as a buffer

3.34.1 GDP growth



Sources: Central Bank of Solomon Islands; ADB estimates.
Click here for figure data

3.34.2 Log exports



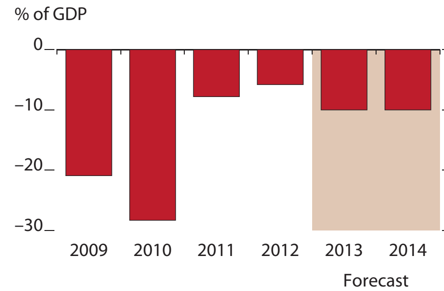
Sources: Central Bank of Solomon Islands; World Bank. Commodity Price Data (Pink Sheet). http://econ.worldbank.org (accessed 15 March 2013).
Click here for figure data

This chapter was written by Milovan Lucich of the Pacific Liaison and Coordination Office, ADB, Sydney.

against volatile revenue flows. The deficit reflected both lower revenues and increased spending. Revenue in 2012 increased by 17% over 2011 in line with strong nominal GDP growth, but this was less than the government budgeted, as lost revenues from doubling the income at which personal taxes are levied were higher than expected. Rises in spending were related to hosting the Festival of Pacific Arts—whose cost equaled 2.5% of GDP—and increasing constituency funds paid to members of Parliament, which have doubled in recent years to 4% of GDP.

Public debt continued to fall from the equivalent of 19% of GDP in 2011 to 15% in 2012 (Figure 3.34.5). The country resumed concessional borrowing in 2012 to finance the sovereign component of the Broadband for Development Project, which will connect the country to an undersea fiber optic cable.

3.34.3 Current account balance



Sources: Central Bank of Solomon Islands; ADB estimates.
Click here for figure data

Economic prospects

Growth is expected to slow further, to 4%, in 2013. Although agricultural production and gold output are projected to increase, log production is seen to decline. A scaling up of gold mining is expected as the Gold Ridge mine reaches full production capacity of 95,000 ounces per year, up from 79,400 ounces in 2012.

The Regional Assistance Mission to Solomon Islands will start to wind down in 2013 and thereafter focus largely on building the capacity of the Royal Solomon Islands Police Force. The mission's military component will be withdrawn from mid-2013 as the country transitions from post-conflict and crisis recovery to sustainable development based on the National Development Strategy, 2011–2020. The mission has also been a major development partner, but the effect of withdrawal on the economy will be minimized by transferring its development activities to the programs of other development partners, in particular Australia and New Zealand.

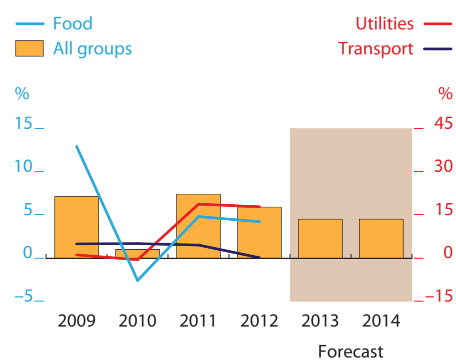
In 2014, growth is projected to remain at 4% with continued investment in mining and its spillover effects on the economy. Additional investment in telecommunications is expected to harness opportunities created by the broadband project.

Typical price lags in Solomon Islands mean international food price rises from mid-2012 are expected to affect inflation in early 2013 but dissipate by midyear. Over the full year 2013, average inflation is expected to ease to 4.5% as economic growth slows. Similar inflation is expected in 2014, in line with the modest growth forecast for that year.

The 2013 budget marks a return to fiscal consolidation with a balanced budget planned. Expenditure growth has been limited to 7% despite a planned increase in public wages. This compares with an average 22% annual increase in expenditure from 2004 to 2011. Revenue growth is estimated at 8% in 2013, creating a small budget surplus of $100,000—effectively a balanced budget.

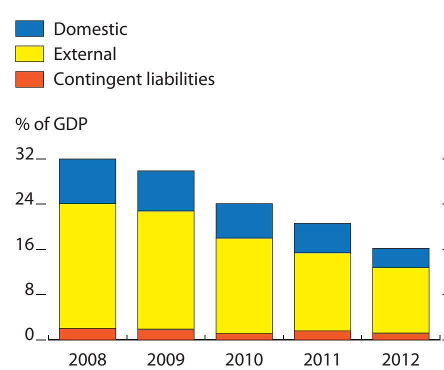
The central bank is expected to continue to soak up excess liquidity through the sale of short-term bills. The exchange rate will continue to be managed against a basket of currencies, and the central bank may allow further appreciation if inflation accelerates.

3.34.4 Inflation



Sources: Central Bank of Solomon Islands; ADB estimates.
Click here for figure data

3.34.5 Public debt



Source: Central Bank of Solomon Islands.
Click here for figure data

The current account deficit is expected to widen slightly to 10% of GDP in 2013, as the logging decline severely depresses export growth, and import growth—driven by construction and mining—remains firm. The deficit will be funded through continued inflows from development partners and foreign direct investment. Import cover is expected to remain comfortable at 7–8 months in 2013 and 2014.

3.34.1 Selected economic indicators (%)

	2013	2014
GDP growth	4.0	4.0
Inflation	4.5	4.5
Current account balance (share of GDP)	–10.0	–10.0

Source: ADB estimates.

Policy challenge—encouraging fiscal sustainability

Logging provides 15% of government revenue, 60% of exports, and 32% of foreign exchange earnings. It is the largest source of formal employment after the government, providing 5,000 jobs. Forests have been extensively exploited, with logging rates reaching several times the sustainable rate in recent years. One study warns that natural forest resources may be exhausted before 2020. A decline in logging would adversely affect the government's finances and require it to identify new sources of revenue, such as a new taxation regime for the mining sector, to support government expenditures.

In addition to developing alternative sources of revenue, the government will need to contain public expenditure growth and improve the quality of public spending. Despite a return to fiscal consolidation in the 2013 budget, the economy continues to face large fiscal risks. Major risks in the budget include the potential for overestimating domestic revenue, a greater-than-expected decline in logging, and expenditure pressures that may arise if the government needs to accommodate a fractious coalition. The large wage and salary bill will remain an ongoing fiscal strain, particularly with the planned increase in public wages, and could displace funding for investment and essential public services if the revenue outcome is lower than expected.

An issue that warrants particular attention is that of constituency development funds. Funds are given directly to members of Parliament for projects in their electoral areas. Amounts have increased substantially in recent years, growing to equal about 4% of GDP, and the use of these funds remains a part of government spending without accountability. The projects financed by these funds are not even enumerated in budgets or medium-term development plans. Capping and monitoring the use of constituency funds would be warranted. A welcome first step to improve the transparency and accountability of these funds is the drafting of a constituency development fund bill. The draft bill provides for establishing constituency development offices to help administer the funds in line with constituency development plans and brings the funds under the Public Finance and Audit Act, making them subject to audit and a complaints mechanism. Strengthening this bill to reduce the discretion available to parliamentarians, together with its passage and implementation, would significantly improve governance and public financial management in Solomon Islands.