Solomon Islands

Economic growth moderated in 2013 as forestry, agriculture, and mining declined. A slight pickup in growth is forecast for 2014, but rapid population growth will rule out much improvement in GDP per capita. Slower growth in recent years has placed pressure on the government budget and reinforced the need to control government expenditure and improve its quality to meet the needs of an expanding population.

Economic performance

Growth slowed to 2.9% in 2013 from 4.8% in the previous year (Figure 3.34.1). This weak outcome, which reflected mainly declines in earnings from gold and agriculture, only slightly outpaced population growth at 2.5%. The value of gold production fell by 15% in 2013, mainly because gold prices were lower and the gold processing plant underwent major refurbishment. Agricultural production fell in 2013, with most agricultural commodities recording output declines because of poor weather in the first half of the year and lower prices.

Logging fell by 3.0% because of weather and prices but still recorded the country’s third-largest annual harvest (Figure 3.34.2). This rate of extraction, and its heavy reliance on logging previously harvested forests, appears unsustainable, such that production is expected to continue to contract as forest stocks decline.

Growth in 2013 was driven by expansion in construction, manufacturing, and services. In particular, investment in the Gold Ridge mine and expanded production at the Noro tuna-processing factory boosted growth.

Consumer price index inflation averaged 6.0%, up slightly from 5.9% in 2012 (Figure 3.34.3). Inflation was high in the first half of 2013, largely because unusually heavy rains in the second quarter drove up food prices, but it moderated in the second half. Falling prices for imported goods helped subdue the inflation average for the whole year. The appreciation of the Solomon Islands dollar against the Australian dollar in particular helped tame inflation because Australia is the main source of imports.

After a small current account deficit in 2012, the deficit widened to 2.0% of GDP in 2013 as export earnings from gold, logging, and agricultural commodities fell and imports expanded to support major investment projects. Despite the deteriorating current account deficit, foreign reserves remained high, bolstered by large inflows of grants and foreign direct investment. As of December 2013, foreign exchange reserves provided 7.8 months of import cover, down from 8.5 months in December 2012.
In 2013, the Central Bank of Solomon Islands undertook short-term measures to alleviate inflationary pressure, including mopping up liquidity by issuing short-term bills. Although the central bank formally moved to peg the Solomon Islands dollar to a basket of currencies in October 2012, it has continued in practice to intervene in currency markets to limit fluctuations in the US dollar–Solomon Islands dollar exchange rate. The appreciation of the US dollar in 2013 therefore meant that the Solomon Islands dollar appreciated strongly against the Australian dollar over the year. Following a major Australian bank’s withdrawal of trade financing for logging exports in response to environmental concerns about logging practices, the Government of the Solomon Islands offered additional banking licenses. So far, however, only one provisional license has been granted—to a domestically incorporated bank with ties to Sri Lanka—and this bank has yet to start operations.

The government budgeted a small fiscal surplus in 2013, but revenue growth disappointed. Domestic revenues actually fell, inducing the government to reduce capital expenditures. The buildup of large spending arrears necessitated the approval of a supplementary budget in September 2013. For the year, the overall deficit equaled 0.7% of GDP.

The government continued to make progress in controlling external debt, which fell from the equivalent of 13.0% of GDP at the end of 2012 to 11.4% a year later. The government’s debt-management strategy provides for an annual limit on new borrowing based on an annual analysis of debt sustainability undertaken as part of the budget process. A debt-management advisory committee composed of senior government officials with expertise in debt management, planning, and economic and monetary policy was established to provide advice to the finance minister on proposed new borrowing by the public sector.

**Economic prospects**

Growth is expected to pick up slightly, to 3.0%, in 2014. Agricultural production and gold output are projected to increase and offset declining log production as forest resources dwindle. Gold mining is expected to scale up as the Gold Ridge mine moves towards full production capacity of 95,000 ounces per year, well above the production of 57,400 ounces in 2013. The recovery in agriculture output in the second half of 2013 is predicted to continue in 2014.

In 2015, growth is projected to hold steady at 3.0%, driven by fiscal stimulus from investment projects and their spillover effects on the economy. Modest increases in gold production are also expected as planned improvements in production processes are implemented. Logging is expected to continue to decline in the medium term at an average annual rate of 8.0%.

Inflation is expected to moderate slightly in 2014, falling to an average annual rate of 5.5% as the inflationary impact of poor weather in mid-2013 dissipates. Reflecting the country’s modest growth expectations and continued declines in import prices, inflation is expected to moderate further, to 5.0%, in 2015.

A balanced budget is planned for 2014, but its achievement appears uncertain. The target assumes a 7.2% increase in recurrent revenue, but
this will depend upon stronger economic growth and improvements in revenue administration and compliance (Figure 3.34.4). In 2014, some increase in expenditure is expected to cover the 2014 election, including one-time grants worth more than $50,000 to politicians upon their leaving office. The government has decided to reduce constituency and discretionary funding for members of Parliament by one-third in 2014 to offset expected election costs, but this is one area where expenditures could exceed estimates. Tertiary education is another, as expenditure has exceeded the budget in recent years.

The central bank is expected to continue to soak up excess liquidity by selling short-term bills as credit growth recovers from the lows of recent years. Over time, the effects of the central bank’s use of a currency basket rather than a peg to the US dollar should become more pronounced, and the Solomon Islands dollar can be expected to track more closely the movements of the currencies of its major trading partners, particularly Australia.

The current account deficit is expected to deteriorate further in 2014, widening to the equivalent of 6.0% of GDP in 2014 and 10.0% in 2015 (Figure 3.34.5). Rising deficits will stem primarily from expected declines in logging exports, while import growth is seen to continue, driven by imports of construction and mining equipment. The deficit will be funded through continued assistance inflows from development partners and foreign direct investment. Import cover is expected to remain comfortable at 6–7 months through 2014 and 2015.

Policy challenge—improving the quality of government spending

The strong growth outcomes experienced by Solomon Islands since 2003, in the years following ethnic tensions, have translated into only mixed outcomes in terms of improved social indicators. This suggests that the government needs to free up fiscal space for essential development expenditures to facilitate more inclusive growth. To accomplish this with slower growth and weaker revenues will require significant adjustments to government spending priorities and improvement in the quality of public expenditure.

Spending on tertiary scholarships is a concern that warrants particular attention. The 2014 budget describes the government’s decision to provide free university education last year as the most significant risk to fiscal sustainability in Solomon Islands. Funding for tertiary education grew fivefold from 2009 to 2013. Scholarships are supposed to be allocated through a nomination review committee, but it appears that committee review has often been sidelined by ministerial intervention. A result is more scholarships being granted than initially budgeted. There appears to be inadequate linkage between the skills demanded by the labor market and the areas of study enjoying scholarship support. Finally, the large increases in tertiary funding seem to have crowded out much-needed expenditure on basic education, which tends to be more inclusive because the cost of access is low.
Another concern in regard to the government’s ability to spend to promote inclusive growth is the rapid expansion of the public payroll in recent years. Expenditure on public sector employees has been growing at an average annual rate of 10% over the past 6 years. While base salaries have not increased substantially, growth in rental subsidies, allowances, and overtime payments has fueled higher expenditures, as have “grade creep” and proliferation in the number of public workers. Controlling payroll expenditure and ensuring sufficient funding for other budget items are essential to the sustainable delivery of other government services.

Constituency funds, which are funds allocated directly to parliamentarians to spend on projects in their districts, are another area where expenditure overruns have been common.

Government action is under way to address these problems and ensure that public expenditure promotes inclusive growth. The government has agreed to limit the number of scholarships awarded for Solomon Islands National University after 2013, and an education sector review scheduled to take place this year will assess the balance of funding between primary and tertiary education. This year will also see a review of public sector remuneration. Regulations for operationalizing the Constituency Development Funds Act, 2013 are being introduced, and a 2012 audit of constituency fund spending is being finalized. These measures are being incorporated into the performance benchmarks for an extended credit facility arrangement with the International Monetary Fund and for budget support programs. They warrant close monitoring in the run-up to the election scheduled for late 2014.