

Solomon Islands Economic Briefing

A sharp upturn, but familiar challenges loom



WBSI 2011-01

1. Overview

2010 brought a recovery for the Solomon Islands economy from the crises of 2009. Exports reached new highs and government finances are now in far better health than has been the case for many years, with a small budget surplus and cash reserves at healthy levels. Consumers have enjoyed stable prices overall.

But the sustainability of this recovery is fragile. Most of the uptick has been due to a surge in logging activity, with log exports reaching high levels in late 2010. The expected decline in logging will be only partially offset by the operation of the Gold Ridge mine. Positioning the economy for long-term growth will require strong management of mining revenues as well as efforts to maximize Solomon Islands return from natural resource industries in general. At the same time, translating these revenues into improved delivery of social investments will entail improvements in quality of spending, building on reform progress since 2009.

2. The recovery – sharp, but with fragilities

Solomon Islands' economy recovered from the shocks of 2009

Solomon Islands' GDP growth recovered in 2010 from the 2009 global economic crisis. (Figure 1) The economy is estimated to have expanded by about 7¼ percent in 2010, far stronger than earlier anticipated, following -1¼ percent contraction in 2009. Central Bank of the Solomon Islands' (CBSI) data shows that overall production in 2010 returned to the level it had been in 2008. Even with the recovery in 2010, incomes have barely kept pace with population growth. This averages almost 2¼ percent a year, according to early releases from the 2009 census, meaning that per capita economic production across the whole nation is barely higher today than it was 3 years ago.

...largely driven by logging, which raises sustainability concerns

Logging activity drove much of the economy's resurgence, especially late in 2010. Excluding logging, growth would have been around 3½ percent in 2010. Log production and exports reached record levels. Over 50,000 logs were exported in December 2010, almost twice the monthly average of the rest of the year. (Figure 2) Anecdotal reports attribute this strength to new species being logged, areas logged a decade or more ago being re-entered to take trees now large enough to log, and to areas previously uneconomic to log now made viable by the increase in timber prices. Higher prices added to the increase in activity: average export prices increased by over one-quarter in the year to January 2011, to SBD 742 per m³ and the value of log exports in the fourth quarter of 2010 was 140 percent higher than a year earlier.

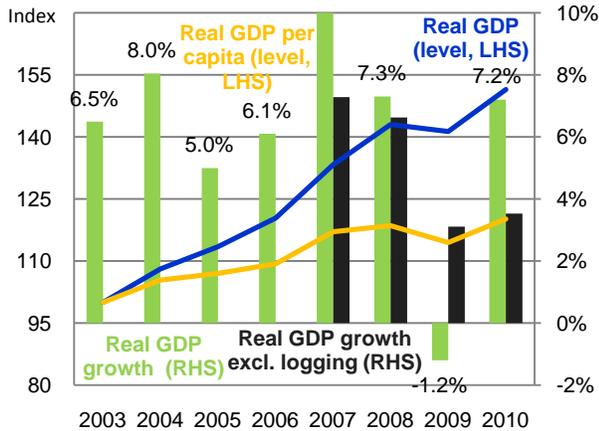
The recovery across Solomon Islands' trading partners also supported the local economy

By the third quarter of 2010 exports exceeded their pre-crisis peaks, and the recovery accelerated in the fourth quarter with the record log exports. As the economies of Solomon Islands' export destinations recovered, Solomons' exports also improved. Various sector-specific factors contributed as well – agricultural production recovered after 2009's flooding, better boats and the restarting of production at Soltai supported fishing activity, and improved inter-island shipping services helped cocoa farmers to more efficiently transport crops to processors and exporters. International prices for Solomon Islands' cash crops were high (with the exception of cocoa). (Figure 3)

The recovery in global conditions has made it easier for large foreign investors to access funds – in 2008 and 2009 the general uncertainty over the global economic outlook and the heightened risk aversion of investors made it very difficult for large corporations to borrow or raise funds,

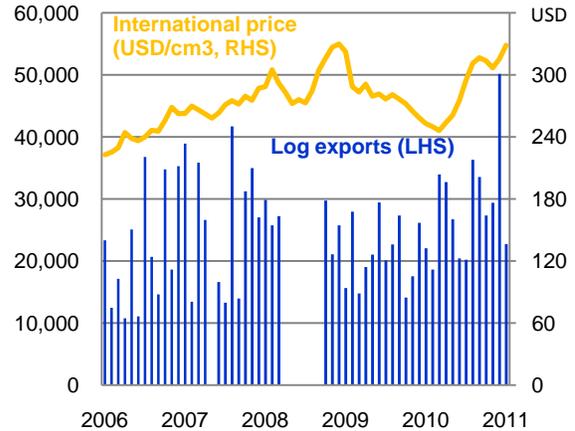
especially if they were looking to invest those funds in small, fragile states. As global conditions have improved, these companies now have greater access to funding. The implication is that if Solomon Islands improves its investment climate, the chances of attracting foreign investment is higher now than it was in 2008 or 2009. In the recent past, the Solomon Islands has indeed provided investors new opportunities, through issuing additional mobile phone licenses and in mining. These investments are already boosting output from these sectors.

Figure 1: GDP growth picked up sharply (annual percentage change)



Sources: CBSI and IMF

Figure 2: ...as logging hit new, unsustainable records (thousands of logs exported)



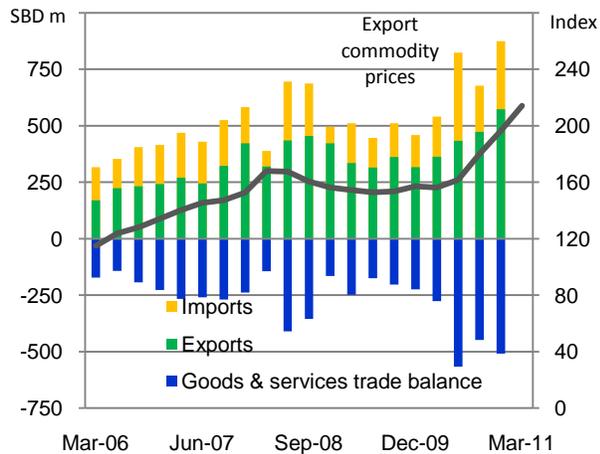
Sources: Customs and World Bank commodity prices

Global commodity price increases have not yet impacted domestic prices

Prices in Honiara did not change much or fell through mid-2010. Reported statistics from late 2010 do not show an impact from higher global food prices. (Figure 4) Overall consumer prices grew by only 0.3 percent in the year to November 2010 (the most recently available data), and local prices were particularly weak, falling over 10 percent on average.

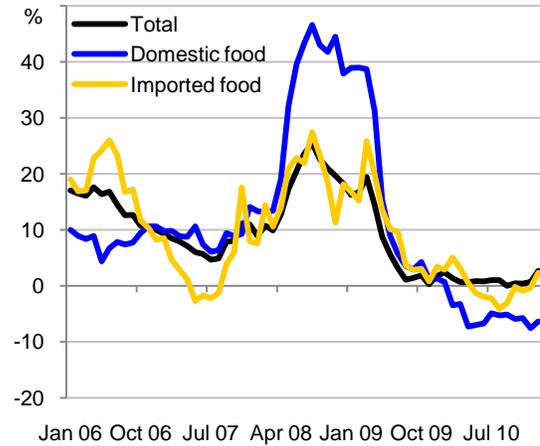
Food prices recorded a small increase in the third quarter of 2010, but were still lower than a year earlier. Movements in global food prices affect Pacific nations' retail prices with a 2 to 6 month lag, the time it takes for the goods to pass through wholesale and shipping chains. And many of the global food prices that rose in mid-2010 are not relevant for most households in the Solomons, particularly outside the capital. (See Box 1) Far more important are movements in domestic fuel prices, and these are rising with the increase in global crude oil prices. By January 2011, the late 2010 increase in global oil prices was beginning to appear in Honiara prices, prompting, for example, a 30 percent increase in taxi fares.

Figure 3: Global prices of Solomon Islands' exports have recovered, lifting export (and import) values (SBD levels and composite export price index)



Note: Experimental export price index is the average global of Solomon Islands' commodity exports, weighted by export shares. Sources: CBSI. World Bank commodity prices, and World Bank staff calculations.

Figure 4: ... but not yet consumer prices (year-on-year percentage change)



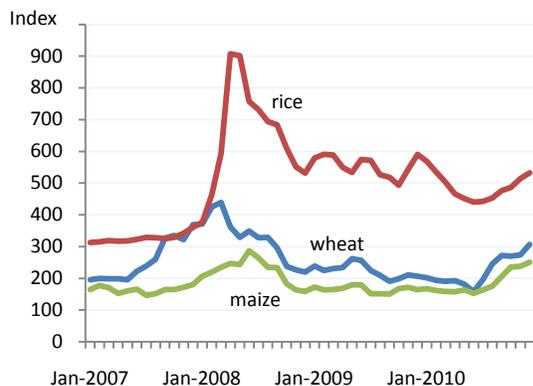
Sources: NSO, CBSI and World Bank staff

Box 1: Global food prices are rising, but their impact on the Solomons has been limited...so far

Food prices throughout developing East Asia & Pacific (EAP) have risen significantly since the middle of 2010, contributing to the increase in headline inflation in some countries. (Figure 5) And the pace of increases in food prices also quickened in most countries around the turn of 2011. Increases this time have been slower and smaller than in 2008 – but prices are starting from a higher level, meaning that they are now hitting record highs again and the situation bears close watch. For example, the 25 percent increase in international grain prices during 2010 has not matched the 96 percent increase between the start of 2007 and the mid-2008 peak, while prices for rice - the key regional staple and the main food imported to the Solomon Islands – fell 12 percent over 2010 to be 40 percent below its 2008 peak. Over the past year, food inflation (the 12-month increase in food prices) rose by 10 percentage points or more in Mongolia, Indonesia, Vietnam, and China. With the exception of Cambodia and the Philippines, 12-month food inflation is now higher in all EAP countries than it was in early 2010. Further increases in rice and other food prices could have severe impacts on the poor in several EAP countries. Already Asian governments have responded, with governments announcing plans to establish rice reserves in each member country and to attempt to stabilize rice prices.

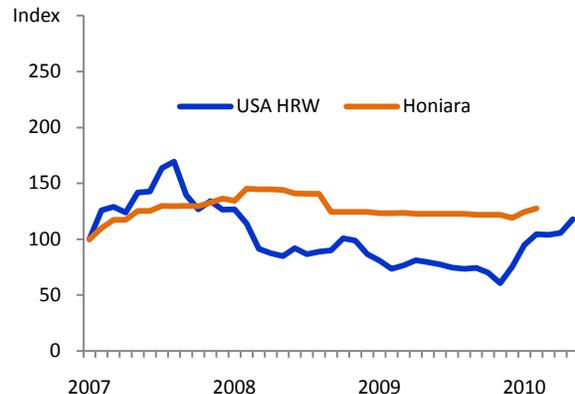
Fortunately, little of these movements in global food prices has impacted the Solomon Islands to date. In November (the most recent data available), food prices as measured in the Consumer Price Index were 5.5 percent below their March levels. Indeed this is consistent with experience during the food price increase of 2008, when there was little connection between local and global wheat prices, while rice prices stepped up by only a fraction of the increase in global spot prices.

Figure 5: Some global food prices rose sharply in 2010 (international price, in USD per tonne)



Sources: World Bank staff

Figure 6: But the pass-through into local retail prices varies by commodity – with very little pass-through for wheat (wheat price indices, Honiara retail price lagged 2 months)

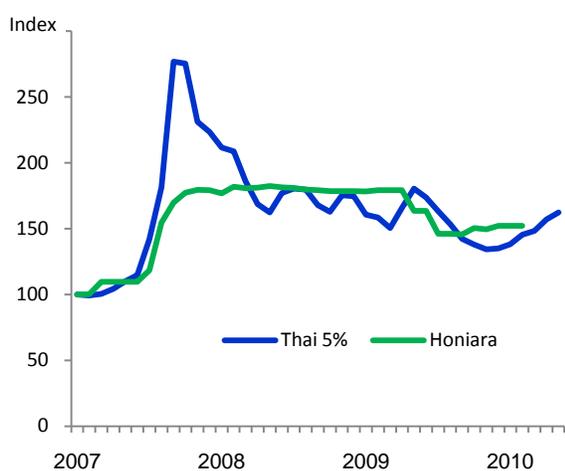


Sources: NSO, CBSI and World Bank staff

Many households insulate themselves from global food price movements by growing their own food. Across the Solomon Islands almost half of all food consumed is self-grown, and this share increases to two-thirds among poorer households. Even in relatively densely populated Honiara, the poorest group of households grew 6.5 percent of the food they consumed themselves in 2006 and anecdotes suggest this share increased during the 2007-08 food price crisis. (2006 Household Income and Expenditure Survey)

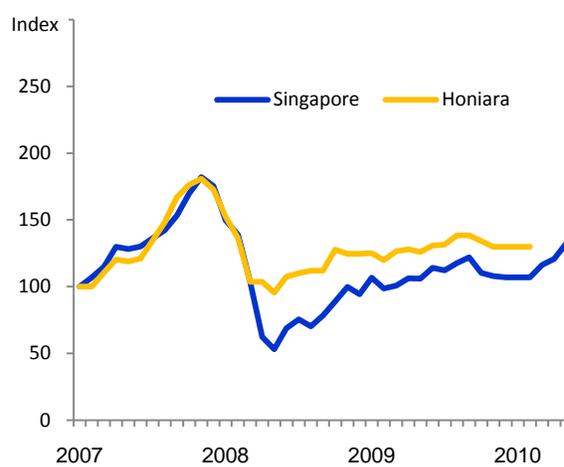
When these food prices do rise, poorer urban households are the most affected. Rice accounts for almost one-quarter of total spending among the poorest third of provincial urban households, falling to 14.4 percent among poorer rural households (household welfare is indicated by total spending, with the 30 percent of households spending the least per capita treated as 'poor' here, although estimates of the food and materials poverty rate differs). In contrast flour and flour-based items make up only 1.5 percent of poorer households' budgets in rural areas. Households instead rely on traditional carbohydrates, such as cassava particularly in rural areas (33.7 percent of poorer rural households' total spending is on tubers, falling to 8 percent in Honiara). Further, urban households are often less protected by traditional social safety nets, and that little protection becomes even more strained during periods of food price stress. Poorer urban households are among the poorest in the country, and poor households in the Solomon Islands are most likely to be found in urban areas, especially Honiara.

Figure 7: ... a loose relationship with international prices for rice, which was affected by the zero-rating of import tariff in 2008 and increasing wholesale competition... (rice price index, Honiara retail price lagged 2 months)



Sources: NSO, CBSI and World Bank staff

Figure 8: ... but the connection is tight for fuel, suggesting further rises in local fuel price are imminent (petrol price indices; Honiara retail price lagged 2 months)



Sources: NSO, CBSI and World Bank staff

Recent rises in fuel prices may have a far larger impact on household welfare. The dispersed and remote distribution of the population and very limited local production means increases in fuel prices affect all goods, and the one-third increase in global oil prices has only partially appeared in local prices, given the lags in processing shipping and distribution.

Sources: NSO, UNDP and World Bank staff

The health of the government's cash position has improved

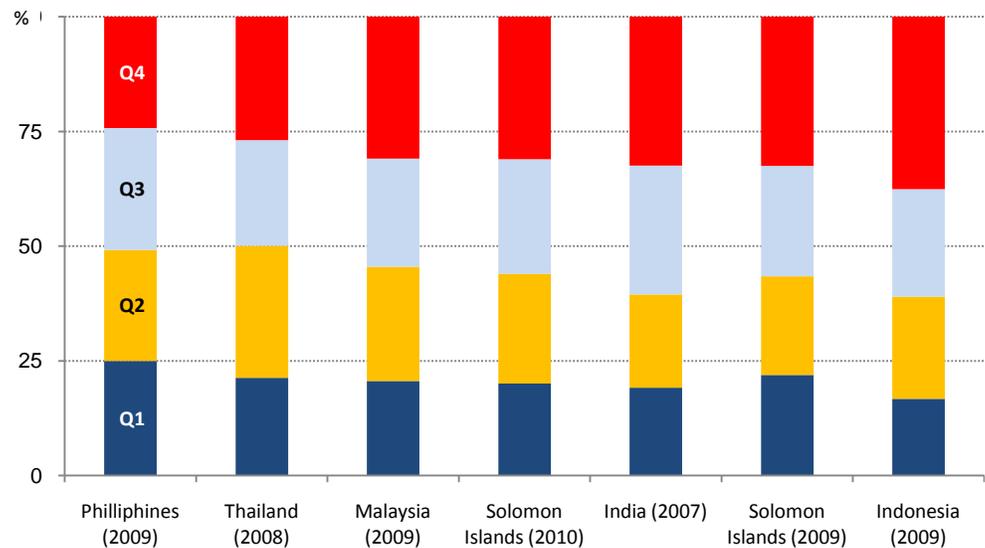
Government finances ended 2010 in surplus – with the government spending slightly less than it received through taxes and grants over the year. The budget finished 2010 with a surplus of SBD 193 million, in contrast to the deficit of SBD 250 million anticipated earlier in the year. The differences are due to both stronger revenues (7 percent more than projected, due to higher tax receipts, and, again, logging was a key contributor) and spending 16 percent below budget, with the development budget particularly under-spent. Solomon Islands spending is fairly evenly spread over the year, in contrast to many other countries. (Figure 9) The government reports having settled all valid accounts and arrears in 2010, an improvement on previous years. The government has recently started to post spending and revenue outturns, along with other information, on the Ministry of Finance's website, a welcome development.

The Solomon Islands government now has a much stronger cash reserves position. The 2010 surplus and the receipt of SBD 157 m of budget support from the European Union has reinforced cash reserves and represents a significant improvement from just two years ago,

when cash balances had fallen to dangerously low levels. Solid cash reserves mean that the government is less exposed to unexpected shocks, such as sudden changes in global prices or natural disasters. The 18-month IMF Standby Credit Facility, established in May 2010, has provided a framework within which the government’s cash management position and related issues can be addressed.

Government debt continued to decline, resulting in an improvement of the country’s risk rating to ‘yellow light’ status from ‘red light’ status under the Honiara Club Agreement. Government debt fell to SBD 1,347 million (29.3 percent of GDP) in November 2010.

Figure 9: Solomon Islands government spending is distributed more consistently through the year than in many larger economies
(share of total budget disbursed each quarter)



Sources: MoFT, CBSI, and World Bank East Asia network

Monetary policy eased a little, while the central bank has stabilized the excess liquidity in the banking system

Monetary conditions eased slightly on balance, as the interest rates banks charge on loans fell and the SBD weakened overall. The SBD remained near 8.1 per US dollar to the start of March 2011, implying some modest appreciations against major trading partner currencies compared with 6 months previously. The average interest rate on commercial loans declined from over 15 percent in June to 13.6 percent by December 2010 and net interest margins fell as time deposit rates recorded a small increase over this period. Yet private credit growth remained very weak – the stock of commercial loans has declined since mid-2009.

After rising through much of 2010, excess liquidity in the banking system appears to have stabilized. Excess liquidity are the funds held by commercial banks, often in various facilities at the central bank, that could be used for lending. While held at the central bank these funds have little impact on price pressures, but if they were to shift quickly into new loans, this could create excess demand and price pressures in the domestic economy. Total liquidity in the banking system was SBD 822.4 million in January 2011, while excess liquidity was SBD 690.1 million; both are a little below the levels of late 2010.

The stabilization in liquidity reflects both policy interventions and stabilizing foreign exchange reserves. The central bank resumed auctioning short-term paper, the 28 day ‘Bokolo Bill’, with a SBD 20 million auction at the start of February and another in mid March. CBSI hopes that these issues will help to lay the path for establishing a policy interest rate, and to compliment

the 56 day and longer Treasury bills which the government largely uses for cash management purposes. Leading into this sale, bids on Treasury paper far exceeded the offer and yields continued to fall, to a weighted average of 2.57 percent by the end of January.

Meanwhile foreign exchange reserves reached record levels at the turn of 2011, near SBD 2130 (or USD 260 million) or around 9 months of imports. This is far stronger than the less-than 3 months' cover in early 2009. Stabilizing the level of reserves also reduces the liquidity pressures in the domestic banking system, as little of the reserves accumulated in 2010 were 'sterilized' by issuing central bank paper.

3. The outlook – confronting the familiar challenges, of unsustainable logging, rising global prices, and of improving the government's delivery of social investments to all Solomon Islanders

The recent momentum is likely to continue through 2011

The outlook is for stronger growth in the economy in 2011, expanding by as much as 7 percent. Key to this will be the scaling up of production and exports from the Gold Ridge mine, following the first pour earlier in March. Logging activity was surprisingly strong in late 2010, raising questions about both the sustainability and quality of the overall economy's recent growth given the risk that this performance may be reversed in the near future. Given its highly unsustainable pace, the consensus expectation remains for a sharp decline in logging by mid-decade. On the upside, private sector investment and activity may be further boosted with the release of a third mobile phone operators' license in the second quarter of 2011. The license would include an option to install 3G technology, which allows the use of smart phones and mobile internet, which may enable mobile-based services like internet banking.

But ongoing reforms need to be strengthened to give more Solomon Islanders access to its benefits

Important reforms in public financial management, state owned enterprises, and telecommunications are supporting improvements in service delivery, and growth. Into the medium term, supporting more sustainable growth, and ensuring that government is able to share the benefits of that growth with all citizens of the Solomon Islands, will require a considerable strengthening of reform efforts.

This Solomon Islands Economic Briefing was prepared at the World Bank office in the Solomon Islands, drawing on material produced across the World Bank Group. It reports on and synthesizes the past six months' key developments in the national economy, assesses the outlook, and some implications for future policy. It is intended to prompt further discussion of economic issues in the Solomon Islands among a wide audience, including policy makers, business leaders, and the community of analysts and professionals engaged in Solomon Islands' evolving economy.

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