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Statement by Mr. Prowse on Solomon Islands
Article IV Consultation and Purchase under the
Compensatory Financing Facility
Executive Board Meeting 82/136
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The Solomon Islands authorities regard the staff report as a balanced and fair view of recent developments and prospects in the Islands. In particular, the staff capture very well and concisely the post-independence economic history of the Solomon Islands. As they note, Solomon Islands is a small, open island economy with a population of about 230,000 persons with some 40 per cent of total output being derived from subsistence agriculture, and an export structure highly dependent on a relatively small number of commodities which, in the last couple of years, have suffered a grievous fall in price and demand. Nevertheless, relatively speaking the Solomons have considerable potential for export growth in agriculture, forestry and fishing, and perhaps for import substitution in the energy field.

Through the 1970s the Solomon Islands made remarkable progress both in terms of output growth and diversification, achieving an average annual rate of economic growth of about 8 per cent during 1973-79 together with tolerable price stability and a strong external position. As the staff document, however, economic performance suffered a very serious setback in 1980 and 1981, largely reflecting a drastic deterioration in the terms of trade and stagnant international markets for its products.

The response to these developments, which have been largely beyond the direct influence of the Solomon Islands authorities, has been a combination of adjustment and, to some extent, a recourse to commercial borrowing. Moreover, and quite notably, the authorities are aware that continuing adverse external circumstances will inevitably mean continuing strong adjustment policies.

The substantial adjustment measures which have been adopted through 1980 and 1981 broadly have been aimed at expanding exports, restraining inessential imports, and increasing domestic resource mobilization. More particularly, there has been notable flexibility in exchange rate policy, and there have been significant devaluations of the Solomon Islands dollar in March 1981 (6 per cent against the basket) and in August 1982 (10 per cent against the basket), with the real effective exchange rate index, given all the methodological and statistical problems this involves, standing at about the same level in August 1982 as it did in August 1981 and August 1980. There have been significant increases in import duties, with the dual objective of increasing revenue and contributing to external adjustment, and credit guidelines have been adopted directing credit to priority areas (notably the export sector). Moreover, I support the staff assessment that monetary policy has been conducted in a flexible and pragmatic manner. The staff note recent measures which have been adopted which can be expected to improve the efficacy of monetary policy, and the authorities

are committed to the development of the financial infrastructure and the mobilization of domestic savings. To the extent that this can be meaningful in a relatively embryonic monetary and financial structure, rates are market-determined, and average yields on deposits are currently positive in real terms and roughly in line with rates available in external markets on a tax-adjusted basis, though there is a debate in the Solomons, as elsewhere, about the responsiveness of domestic sources to adjustments in interest rates.

It might be recorded at this point also that the Government has confirmed that the Solomon Islands Monetary Authority will become the central bank of the Solomon Islands before the end of the current financial year and in consequence will undertake new and expanded functions with a correspondingly developed structure and management. Indicative of these new functions is the discretion which the Government has now bestowed on SIMA to adjust the rate for the Solomon Islands dollar against the basket of currencies within a 4 per cent band. This is encouraging evidence of the authorities' commitment to flexibility in this important area of policy.

In a small developing island economy it is inevitable, as the staff note, that budget policy will be of crucial importance. The Solomon Islands authorities are certainly well aware of that and, indeed, deserve credit in several respects in this matter. This is the more so when one accepts the particular nature of a budget in such an economy. Thus, as the staff note, to a large extent the increase in expenditures over the period since 1979 is due to the transfer of functions from the colonial authorities to the national authorities and the essential enlargement of government administration following this change. Moreover, it is in my submission quite remarkable that despite the non-cash sector being estimated to produce some 40 per cent of total output, the Solomon Islands authorities are able to finance virtually all of their recurrent expenditure from recurrent revenue. In other words, the recurrent budget is virtually balanced, and there are few if any small economies who could claim such an achievement in such a short period following independence.

Given the very limited room for manoeuvre which the authorities have in their central government budget it is all the more important that we keep in mind this achievement in regard to the recurrent budget. The large total deficit, of course, to a considerable extent reflects the fact that Solomon Islands is a developing country still very much in the process of building up its infrastructure and its social capital. Moreover, a very large part of this deficit is funded from off-shore grants for development purposes. It is a very real issue how far in a small developing country, at any rate, a deficit which reflects grant-financed development expenditure should be seen as a critical factor. In any case the various elements of the deficit do have different qualitative and quantitative effects on the economy, and it is very important that these disaggregated aspects be kept in mind.

The fiscal position is also assisted by the authorities' policy to raise domestic energy prices in line with the import price of oil, and there is no subsidy in the consumption and distribution of petroleum products.

The staff suggest that future budgetary adjustment would need to come largely from restraint in current expenditures. This view is not really contested, particularly given the constraints on increasing taxation as revealed in the report "Provincial Taxation in the Solomon Islands", prepared by the Fund staff in August 1981. In this regard it is notable that in 1981 central government final expenditure declined by the order of 10-11 per cent in real terms, including a reduction of 2 per cent in real terms in the expenditure on goods and services. As to wages, like the governments of many more sophisticated economies, the Solomon Islands authorities would hope that wage and salary increases could be linked to measurable improvements in productivity, but while this is difficult enough to achieve in highly sophisticated economies, in the Solomons it is a much more difficult task where the lack of adequate statistics including in relation to productivity, but also more generally, is a severe problem in analysis and policy assessment. Indeed, agreement to restrict wage increases annually to half the increase in the Consumer Price Index in the previous year (plus 3 per cent) is an achievement that might be regarded as worthwhile in many countries.

All in all, the Solomon Islands is fortunate in its potential resources and in the quality of its administration, and in that context a continuing dialogue with the Fund could be expected to be fruitful in terms of the development of economic policy.

Finally, the proposed CFF purchase appears to be a straightforward, technically satisfactory proposal and certainly one where the cooperation test is fully satisfied. I commend it to Executive Directors for their support.