

Solomon Islands and Vanuatu: an economic survey

Rod Duncan

Governance strengthening programs such as the RAMSI in Solomon Islands and CRP in Vanuatu have achieved major overhauls of public service institutions, but the responses in terms of economic growth and human welfare indicators have been poor. Growth prospects post-RAMSI in Solomon Islands and post-CRP in Vanuatu are hindered because they are still high-cost economic environments for foreign investors.

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The Governance for Growth (GfG) program in Vanuatu is the next stage in AusAID's post-governance reforms. The focus in GfG is on removing constraints to growth in rural areas, and this is more likely than previous programs to yield returns in growth in rural and urban areas. The GfG program produced a great result by reforming the telecommunications sector and bringing Digicel into Vanuatu. GfG is now looking at electricity and transport in the country—some of the highest-cost services in the world.

Solomon Islands will not see an improvement in growth until it moves into a post-RAMSI stage and reduces the costs of doing business, as Vanuatu is hopefully doing. Expect the next few Solomon Islands' economic surveys to look like the post-CRP surveys in Vanuatu: 'We've had the RAMSI reforms, so where is the growth?'

The economies of Solomon Islands and Vanuatu have rebounded well from the crises in the early 2000s. Growth rates in gross domestic product (GDP) have been high enough that real GDP per capita has gone past the pre-crisis levels in each country (Figure 1). This is a considerable achievement, given the disorder that occurred.

Are these two countries likely to see these rates of growth of real GDP per capita continue? The view expressed in AusAID's (2006) Pacific 2020:2 report was that '[e]conomic growth will not be sufficient to solve all problems facing these countries, but it is necessary. No country has succeeded in reducing poverty without it.'

To overcome the economic, social and political challenges facing Solomon Islands and Vanuatu, the countries must create a future with sustained real GDP growth per capita.

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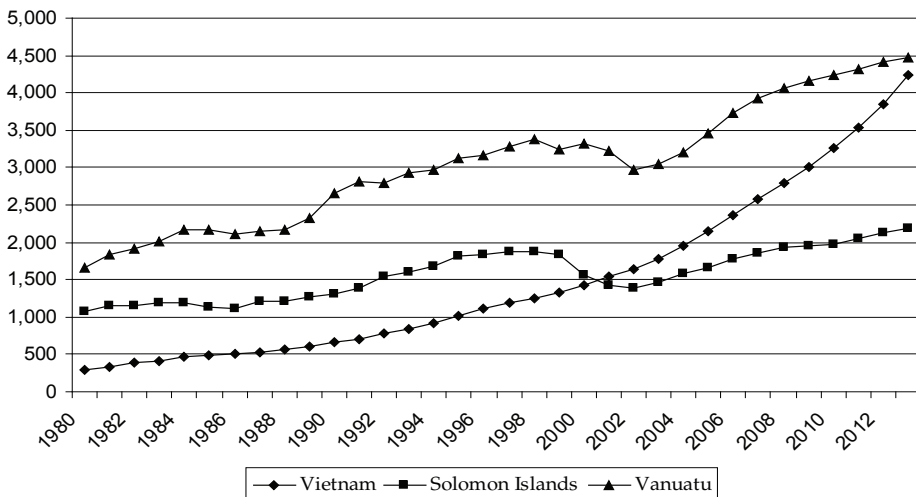
The International Monetary Fund (IMF 2008) predicts growth rates in both countries to slow in the near to medium term. The IMF predicts that annual real growth rates in Solomon Islands will fall from 4.2 per cent in 2008 to 2.8 per cent in 2009 and to 1.7 per cent in 2013. Likewise, the IMF predicts that annual real growth rates in Vanuatu will fall from 4 per cent in 2008 to 3.5 per cent in 2009 and to 2.5 per cent in 2013. Given that population growth projections for both countries (World Bank 2008c; IMF 2008) are about 2.5 per cent, real GDP growth per capita is predicted by the IMF to start falling in Solomon Islands and to stagnate in Vanuatu by 2013.

It is of interest to compare the predictions for Solomon Islands and Vanuatu with the prediction for Vietnam. For the Pacific island countries, the high current real growth rates are expected to fall back to, remain at or fall below population growth rates, while the IMF’s predictions for real rates of growth

for Vietnam are 7.3 per cent in 2008, 7.3 per cent in 2009 and 8 per cent in 2013. Vietnam is predicted to take off like the East Asian ‘tiger’ economies did in the past. Why does the IMF predict such different futures for Solomon Islands and Vanuatu? Why does the prediction for Vietnamese growth seem as inevitable as the prediction for Pacific stagnation?

It is the aim of this survey to draw out some of the differences in the countries that are likely to create this divergence of future paths. Unfortunately, given the circumstances in Solomon Islands and Vanuatu, the IMF forecasts look to be realistic guesses. The high real per capita growth rates required by *Pacific 2020* (AusAID 2006) are unlikely without continued structural reforms, and such reforms will be politically and economically costly.

Figure 1 Forecasted per capita real GDP on a purchasing power parity basis



Source: International Monetary Fund (IMF), 2008. *World Economic Outlook*, International Monetary Fund, Washington, DC.

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Macroeconomic stability

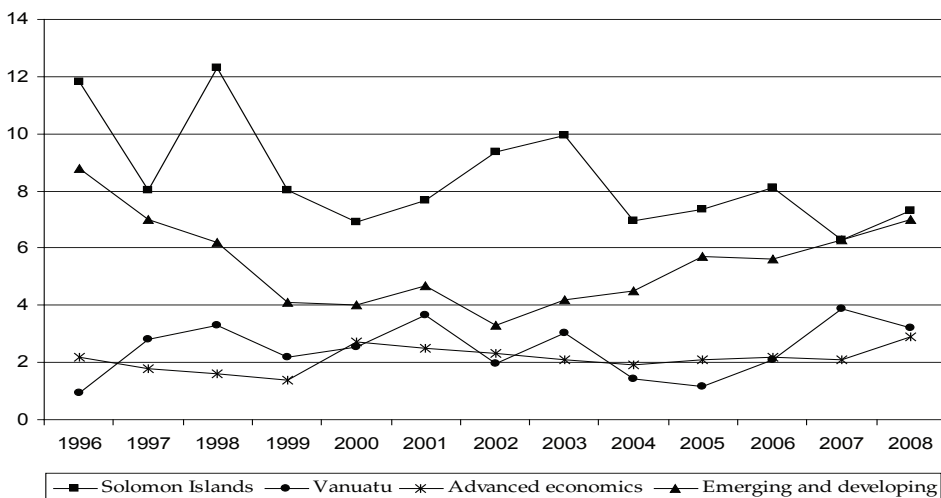
Overall, the fiscal and monetary policies of Solomon Islands and Vanuatu have been sensibly managed and their administrations and public services deserve credit for the continued restraint exercised. Some signs, however, are appearing that point to underlying imbalances in the two economies.

The central banks of both countries have managed to keep inflation under control (Figure 2). In recent years, Solomon Islands' inflation rate has been brought down to the median level for emerging and developing economies, while the inflation rate in Vanuatu has been brought down to the median level for advanced economies. Inflation rates have turned upwards in 2008 due to the pressure of higher oil and food prices, but both countries have succeeded in keeping inflation rates within levels experienced in other countries.

There is a need, however, to keep an eye on inflation in the short term as the recent increases in global food and fuel prices have not been fully absorbed. Fortunately, there has been no suggestion of using the government budget to subsidise fuel or food prices, which would be unwise even if there were sufficient revenue. In Solomon Islands, inflation in the last quarter of 2007 and the first quarter of 2008 remained high, at 10 per cent and 9.7 per cent, respectively (CBSI 2008a). In July 2008, the Central Bank of Solomon Islands (CBSI 2008c) released a warning that the May 2008 inflation rate had risen to 13.1 per cent in annual terms. In Vanuatu, the June 2008 quarterly figures (RBV 2008) showed a consumer price index (CPI) increase of 1.5 per cent. In annual terms, this would be equivalent to the highest rate of inflation since the 1980s.

Government budget deficits have been low, with both countries recording budget surpluses in the years up to 2007. Both,

Figure 2 Comparative inflation rates, 1996–2008



Source: International Monetary Fund (IMF), 2008. *World Economic Outlook*, International Monetary Fund, Washington, DC.

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however, had small budget deficits in 2007. External debt levels have been lowered in both countries, but government expenditure has risen very quickly in the past few years as spending has been ramped up with rising government revenue and a perceived need to rebuild after the crises. There is, however, a need to urge caution about the rising levels of expenditure.

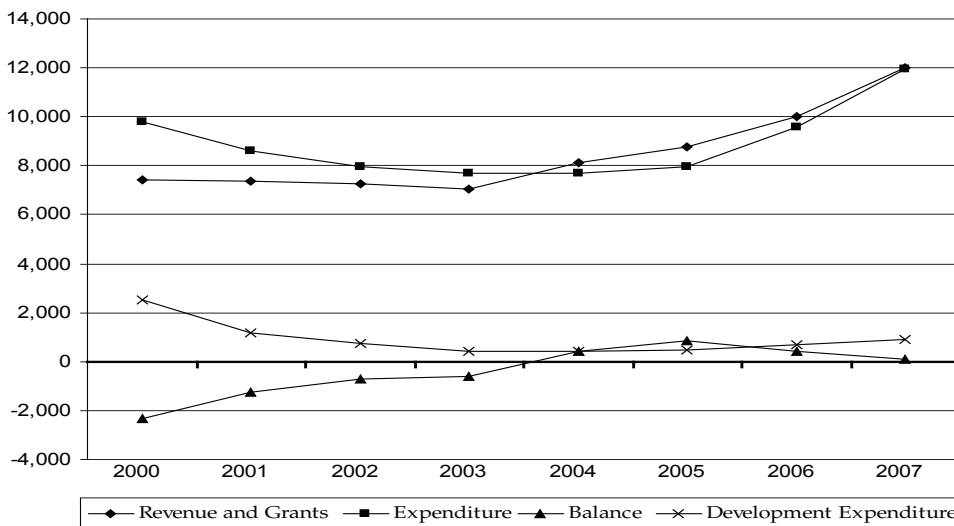
From 2003 to 2006, government expenditure rose by 66 per cent in Solomon Islands in Solomon Islands-dollar terms, or from 21 per cent to 32 per cent of GDP (CBSI various years; ADB 2008). From 2004 to 2007, Vanuatu government expenditure rose by 50 per cent in vatu terms, or from 21 per cent to 29 per cent of GDP (RBV 2007). The recent rapid rate of expenditure increase has outstripped that of revenue, so both countries have moved from a surplus into a deficit budget position (Figure 3, for

Vanuatu). A concern is that if economic growth slows, expenditure growth will likewise have to be scaled back.

The budget position of the Solomon Islands government is particularly vulnerable to changes in the revenue stream from logging. As discussed below, the revenue stream from logging is most likely a short-term windfall, as logging is occurring at above-replacement rates. Even a short-term problem in logging revenue has a major impact on government revenue.

According to the CBSI (2008c), the export duty from logs fell by SI\$16.6 million in June 2008 during a dispute with logging companies over the export price. This fall represented approximately 15 per cent of the entire monthly revenue for the government. Only a strong increase in company taxes prevented the logging dispute leading to a decline in total revenue. A more permanent

Figure 3 Fiscal policy in Vanuatu



Source: Reserve Bank of Vanuatu, 2007. *Quarterly Economic Review*, December, Reserve Bank of Vanuatu, Port Vila.

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change in the logging revenue stream would put the Solomon Islands government under severe pressure.

A lingering concern about the Vanuatu budget is the low level of development expenditure. Development expenditure fell from 2.5 billion vatu in 2000 to 0.41 billion vatu in 2004. Development expenditure has recovered a little in recent budgets to a figure of 0.9 billion vatu in 2007 (Figure 4).

Recent economic surveys of Vanuatu (Sugden and Tevi 2004; Henckel 2006) pointed to this potential problem, and the Asian Development Bank's Outlook (ADB 2008:258) entry for Vanuatu mentioned that the rise in civil service salaries had 'limited ministries' ability to buy goods and services for public service delivery'. It is uncertain how much of this slashing of development expenditure is real and how much might be

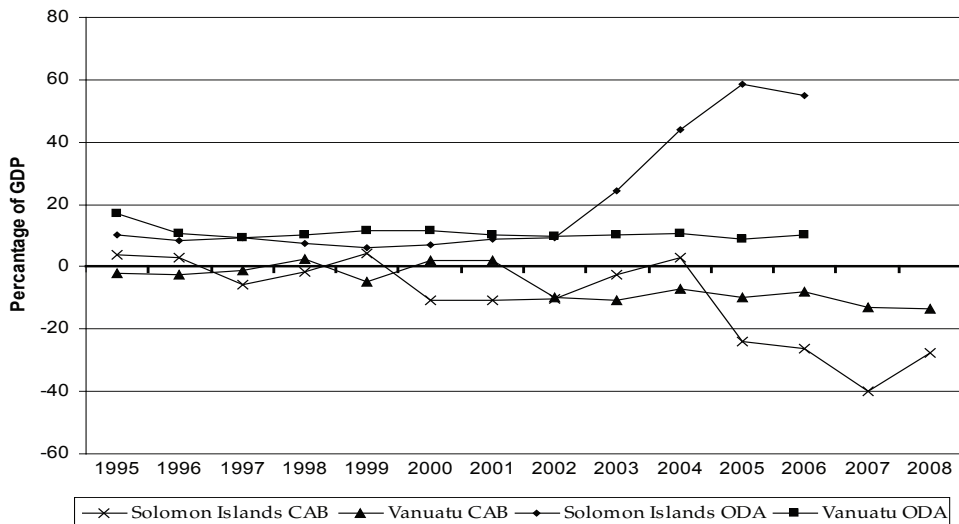
a result of a change in bookkeeping.

The current account balances for both countries have taken a sharp downturn in recent years. The IMF's *World Economic Outlook* (2008) forecasts a -27.4 per cent current account deficit in 2008 for Solomon Islands, viewed as a percentage of GDP, after a -40 per cent current account balance in 2007. The current account deficit in Vanuatu is predicted to be -13.7 per cent of GDP for 2008.

No doubt, some of this borrowing is warranted for the economic rebuilding after the crisis years, however, the size of these deficits is extraordinary. Little of this increase in borrowing can be linked to an increase in private foreign investment in the two countries.

The deepening current account deficits could be a result of the high levels

Figure 4 Current account balances and aid flows



CAB = current account balance

ODA = official development assistance

Source: International Monetary Fund (IMF), 2008. *World Economic Outlook*, International Monetary Fund, Washington, DC; Organisation for Economic Cooperation and Development (OECD), 2008. *Development Assistance Committee Database*. Available from <http://webnet.oecd.org/wbos/index.aspx>

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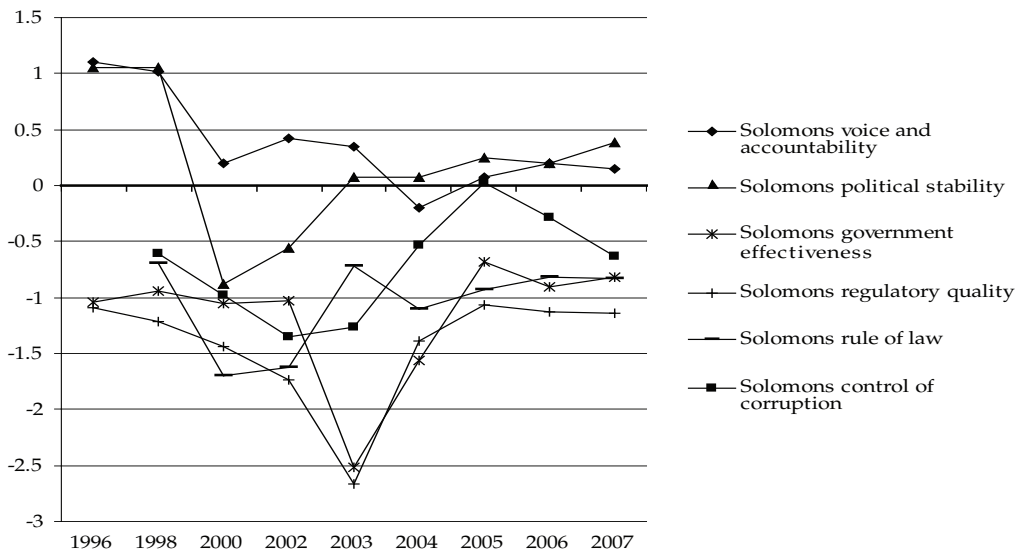
of current and planned development assistance that the two countries are receiving. Official development assistance in Solomon Islands grew from US\$21 million in 2000 to US\$179 million in 2006 (OECD Development Assistance Committee Database: <http://webnet.oecd.org/wbos/index.aspx>). AusAID (<http://www.ausaid.gov.au/country/>) estimates that total official development assistance to Solomon Islands will be more than US\$200 million (A\$236 million) in 2008–09. For Vanuatu, official development assistance rose from US\$28 million in 2000 to US\$41 million in 2006, and is predicted by AusAID to rise to more than US\$45 million (A\$52 million) in 2008–09.

These aid flows represent a considerable amount of money for small Pacific island

nations. The 2008–09 estimates for official development assistance would constitute more than 50 per cent of GDP for Solomon Islands. For Vanuatu, the 2008–09 assistance levels represent 10 per cent of GDP. In per capita terms, aid to Solomon Islands is predicted to be more than A\$380 per capita and for Vanuatu it is predicted to be A\$220 per capita. In comparison, Vietnam, which has lower real GDP per capita than Vanuatu, receives about A\$20 per capita in aid.

There has to be concern about the distorting effects of these large flows of foreign dollars on the allocation of resources in Solomon Islands and Vanuatu. The large flows probably increase real exchange rates and lower the real returns to exporters, such as farmers. In some

Figure 5 Governance in Solomon Islands



Source: Source: International Monetary Fund (IMF), 2008. *World Economic Outlook*, International Monetary Fund, Washington, DC; Organisation for Economic Cooperation and Development (OECD), 2008. *Development Assistance Committee Database*. Available from <http://webnet.oecd.org/wbos/index.aspx>

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sense, the two economies are fortunate that so much of this aid will be immediately cycled back to the donor countries as salaries and purchases of imports. The distortion of resource allocation is not as large as if the foreign aid were purchasing domestic resources.

Governance and politics

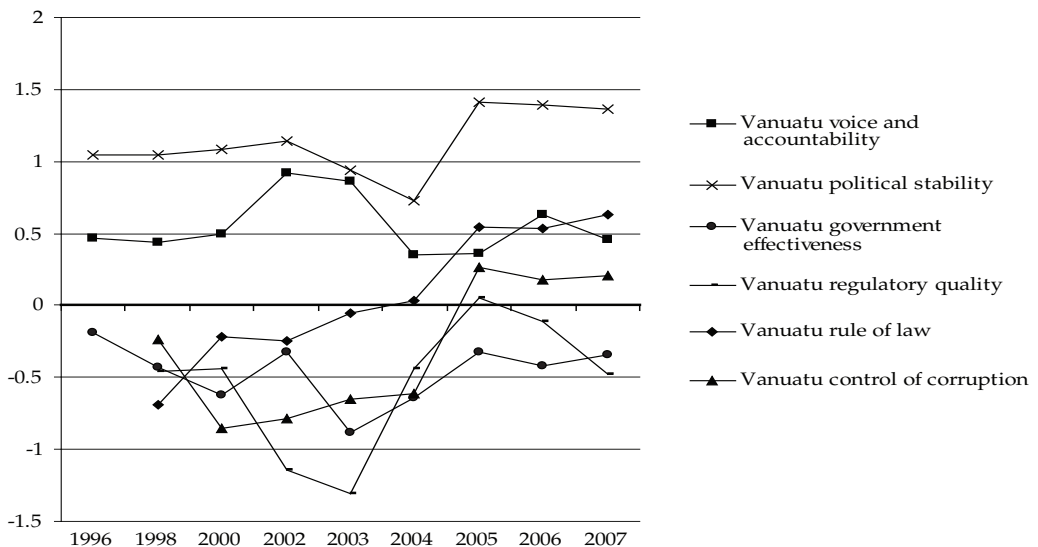
Most of the governance indicators for Solomon Islands and Vanuatu have taken a disappointing turn in recent years. The World Bank’s *Governance Matters* database (Kaufmann et al. 2008) shows various measures of governance (Figures 5 and 6).

It was one of the aims of the CRP in Vanuatu, begun in 1997, and the RAMSI program in Solomon Islands, begun in

2003, to improve governance and capability within the public service. The World Bank’s governance indicators suggest that these programs have had little long-term success in improving the public service.

If the CRP and RAMSI were effective, we would expect to see improvements in the measures of public service and governance, such as ‘government effectiveness’, ‘regulatory quality’, ‘rule of law’ and ‘control of corruption’. It appears that public service capability was brought back to pre-crisis levels by 2005—perhaps in part due to the CRP and RAMSI—but we do not see much further improvement from 2005 to 2007. The sole exceptions appear to be the rule of law and control of corruption measures in Vanuatu, which do appear to have improved compared with pre-crisis levels. Progress in most other measures,

Figure 6 Governance in Vanuatu



Source: Kaufmann, D., Kraay, A. and Mastruzzi, M., 2008. *Governance matters VII: aggregate and individual governance indicators 1996–2007*, Policy Research Working Paper 4654, World Bank, Washington, DC.

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however, appears to have halted, and, in some cases—such as control of corruption in Solomon Islands and regulatory quality in Vanuatu—has gone backwards.

We might also expect that public sector reform, such as both countries underwent as part of the CRP and RAMSI, would have resulted in a streamlining of procedures and regulations. It was hoped that such streamlining would encourage foreign investment and trade. The evidence of such reforms would then be apparent in surveys such as the World Bank's *Doing Business*.

If we look at the *Doing Business* indicators, however—available from 2005 in Vanuatu and 2006 in Solomon Islands—there is no evidence that the CRP or RAMSI have improved the regulatory environment for business. The regulatory environment in both countries could even have declined in absolute terms in the past few years; certainly, we can say that other countries have been reforming and Solomon Islands and Vanuatu have fallen behind other countries in relative terms. On the overall index, the 'ease of doing business', Solomon Islands fell from fifty-third of 155 countries in 2006 to seventy-ninth of 178 countries in 2008 (a higher rank indicates a more difficult business environment). On the overall index, Vanuatu fell from forty-ninth in 2006 to sixty-second in 2008. This decline is not due simply to the two countries standing still while other countries reform (although this is true to some extent); on some measures, Solomon Islands and Vanuatu have done worse recently.

Doing Business reports on the number of procedures and the expected length of time in days to accomplish typical business tasks. The World Bank found that the number of procedures to start a business in Solomon Islands rose from five in 2006 to seven in 2008, while the number of days required rose from 35 to 57. Likewise, the World Bank found that the number of procedures to register

property in Solomon Islands rose from six in 2006 to 10 in 2008, while the number of days required rose from 86 to 297.

For Vanuatu, the numbers are more mixed for changes between 2006 and 2008. The number of days required for 'dealing with licences' fell from 82 in 2006 to 51 in 2008, but the 'time for export' and 'time for import', representing delays in days for international trade, rose from seven and nine, respectively, in 2006 to 26 and 30, respectively, in 2008.

The comparison country of Vietnam—ninety-ninth of 178 in 2008—was ranked worse than Solomon Islands and Vanuatu. Judging by the different growth predictions from the IMF for Vietnam and the Pacific island countries, a better *Doing Business* rank is not a sure determinant of success. While these numbers might or might not be good predictors of economic success, they suggest that regulatory reform has stalled in Solomon Islands and Vanuatu—just as governance reform has stalled.

If governance and regulatory reforms have stalled, a concern is that the long-term political and economic problems that led to the crisis in Solomon Islands will lead to another internal conflict in the future. The militias have been disarmed and RAMSI has been very successful as a peace-keeping force (Glenn 2007). There is, however, a high degree of income inequality between urban and rural areas (SISO 2007). The island of Malaita, home to 140,000 of the total Solomon Islands population of 533,000 (SISO 2007), is not receiving the levels of development assistance or new projects that are going to Guadalcanal. The development and operation of the Gold Ridge gold-mine on Guadalcanal is likely to reopen these issues in the future.

The current boom in tourism and timber

Two sectors have been of particular importance in the recovery of both countries: timber in Solomon Islands and tourism in Vanuatu—and partly also in Solomon Islands. These sectors, however, face their own limits to growth, which will probably vindicate the predictions of the IMF.

The tourism sectors in both countries have experienced a strong recovery after a dip during the crises. Some of this increase might be the result of relative good fortune, due to rising perceptions of risk in other Asia Pacific vacation destinations such as Bali and Fiji. Some of the increase in tourist numbers is due to reforms such as opening up international air traffic into Solomon Islands and Vanuatu.

Solomon Islands and Vanuatu are signatories of the 2003 Pacific Islands Air Service Agreement under the Pacific Islands Forum. The loosening of controls on flights into both countries has resulted in some new services being introduced by Pacific carriers. Air Pacific started a service to Solomon Islands, while Pacific Blue, Air New Zealand and Solomon Airlines are running services to Vanuatu.

From 2003 to 2008, tourist arrivals rose by 50 per cent in Solomon Islands and 60 per cent in Vanuatu. Total visitor arrivals in Solomon Islands rose from 7,372 in 2003 to 15,169 in 2007 (CBSI 2008b). Arrivals in Vanuatu by air rose from 50,400 in 2003 to 81,345 in 2007 (RBV 2008) and, up to June 2008, the number of arrivals by air to Vanuatu was higher than for the same period in 2007. Despite a dip in 2004, cruise ship arrivals in Vanuatu saw a similar increase—from 50,430 in 2003 to about 85,000 arrivals a year in 2006 and 2007. Up to the middle of 2008, cruise ship arrivals in Vanuatu held steady at the numbers for 2006 and 2007.

While these tourist numbers are good news for both countries, tourism remains a niche sector. Overseas name recognition for Solomon Islands and Vanuatu as Pacific vacation destinations is limited. Fiji is already aggressively marketing low-cost resort vacations and it is bound to recover politically at some point. It remains to be seen whether the tourist numbers in Solomon Islands and Vanuatu will fall back again if Fiji can regain the momentum in tourism that it had before the 2006 coup.

As has been commented on by Gay (2004), the high costs of services and transportation within both countries will keep their resorts small and prevent rapid expansion. As high-cost tourism operators, resorts in Solomon Islands and Vanuatu will be able to attract only the niche tourists, such as divers and eco-tourists. Operations that cater to such tourists will not be able to provide the large numbers of formal-sector jobs that the countries need to produce continued rapid growth.

In Solomon Islands, the timber industry has been a large factor in the country's recent economic success. Timbers exports made up 73 per cent of total exports in 2006 and 67 per cent in 2007, and 24 per cent of GDP in 2006 and 27 per cent in 2007 (ADB 2008). If the value of timber exports is subtracted from GDP, non-timber GDP grew more slowly than the inflation rate in 2006 and 2007; so the value of real GDP outside timber exports has not grown. It could be said therefore that the current economic boom in Solomon Islands is simply a timber boom.

This timber boom cannot be sustained. The current rate of logging is far above the natural replacement rate, as non-governmental organisations have been warning for some time now. The CBSI (2007:17) warned in its 2007 Annual Report that 'the current rate of log extraction is completely unsustainable. According to a study by the Forestry Department, the

industry is expected to slow down after 2012; however the decline is now expected to start as soon as 2010 given the huge increase in extraction in the past couple of years.'

The ADB (2008b) warns of a decline in logging rates after 2009 and a depletion of forests by 2013. Despite these clear warnings from the central bank and the ADB, logging rates increased in the first half of 2008 above the rates for 2007. Timber exports climbed from about 500,000 cubic metres in 2000–02 to about 1.1 million cubic metres in 2004–06, and then rose sharply in 2007 to more than 1.4 million cubic metres. In May 2008, before the recent price dispute, monthly timber exports were 171,475 cubic metres (CBSI 2008d:4), equivalent to a rate of more than 2 million cubic metres annually.

It seems likely that the end of Solomon Islands' timber boom is fast approaching—whether in 2010 or some short time later. The recent sharp fall in timber export revenue due to the price dispute and the impact this fall had on the government's revenue base should be a warning of what is to come. When Solomon Islands' timber industry collapses, the government will have to find a way to make up for the loss of 15–20 per cent of total tax revenue.

A sensible course for Solomon Islands to steer would be to curtail logging rates sharply and to induce loggers to move towards sustainable and plantation logging, as set out rather optimistically in the AusAID *Pacific 2020* report (2006). This would require an enormous expansion of the plantation-timber area. Of the harvested timber volume in 2007, 93 per cent was from natural forests, while only 7 per cent was from plantations (CBSI 2007). Solomon Islands is a very long way from having a sustainable timber industry.

What are the real constraints to economic growth?

If tourism and timber are not going to deliver the rapid growth needed to turn Solomon Islands and Vanuatu into a Vietnam, what will? In the 2006 *Pacific Economic Bulletin* survey for Vanuatu, Timo Henckel (2006:2) hoped that policymakers would pursue bold reforms so that 'Vanuatu does not wake up every morning on "Groundhog Day" when nothing has changed and yesterday's problems are still today's problems'.

Reforms need to focus on the key factors that are making the predicted future for Solomon Islands and Vanuatu different from the predicted future for Vietnam. Vietnam is ranked worse than Solomon Islands and Vanuatu on the *Doing Business* standings, yet Vietnam is predicted to grow strongly in the near and long term, whereas Solomon Islands and Vanuatu are predicted to stagnate. Governance does not therefore appear to be the 'binding constraint' to growth, in the sense of the term developed by Hausmann et al. (2005). So what are the binding constraints?

The analysis of Hausmann et al. would suggest that the binding constraints in the Pacific are the ones that have been identified in many studies, such as the ADB's (2005) private-sector assessment of Solomon Islands or AusAID's *Pacific 2020* (2006) assessment for the entire Pacific. Apart from poor governance and weak property rights, these constraints are low-quality and expensive infrastructure and low-quality and high-cost labour.

So, have the bold reforms been taken that will avoid Henckel's 'Groundhog Day' vision? In most cases, these reforms have not taken place; but there is one bright counter-example: mobile telecommunications.

Telecommunications

Reform in the mobile telecommunications sector is one of the best stories to come out of the Pacific in the past decade. The performance of the telecommunications sector in Samoa, Papua New Guinea and, lately Vanuatu is a story that should give a measure of hope for the rest of the Pacific. Hopefully, these examples will spur mobile telecommunications reform in Solomon Islands.

In the AusAID *Pacific 2020* (2006:3) report, a desperate note seemed to enter the discussion: ‘the Pacific island region seems to be missing the mobile telecommunications revolution that is sweeping much of the developing world, bringing large benefits to producers and customers alike’.

In Samoa, the opening up of the mobile phone market in 2005 saw the number of subscribers rise from 1.5 per 100 people in 2002 to 46 per 100 in 2007 (ITU 2007). There is evidence that the cost of mobile phone calls also fell after the opening up of the market (AusAID 2008).

The Irish mobile phone company Digicel was granted operating rights in Papua New Guinea on 20 July 2007. The growth in the mobile phone sector since the introduction of Digicel into the PNG market has been so strong that the Treasury’s 2008 mid-year report (Papua New Guinea Treasury 2008:3) only a year later explains an upward revision of economic growth as being due to several factors, the first of which is the expansion of mobile phone services.

The same explosive growth in mobile phone services occurred in Papua New Guinea after the introduction of competition. In 2002, there were only 0.3 mobile subscribers per 100 people in Papua New Guinea. This number increased to 4.7 subscribers per 100 people in 2007 (ITU 2007), and the Treasury estimated that this had increased to 17 subscribers per 100

people by mid 2008 (Papua New Guinea Treasury 2008). At the same time, Treasury estimated that the price of mobile phone calls fell by 50 per cent from mid 2007—when Digicel entered the market—to 2008.

Digicel launched in Vanuatu on 25 June 2008. While numbers are difficult to gather on the success of the Digicel venture, anecdotal evidence suggests that Digicel penetration into the Vanuatu market has been as large as in Papua New Guinea. Mobile phone subscriptions were already rising before deregulation, from 2.4 subscribers per 100 people in 2002 to 11.5 per 100 people in 2007 (ITU 2007). Digicel claims to have invested US\$35 million in its mobile network there (Cellular News 2008). The potential exists in Vanuatu for a mobile phone penetration level similar to that in Samoa.

There have been several attempts to calculate the economic and social welfare benefits of increasing mobile phone penetration. These efforts are further ahead in Africa, such as Souter et al. (2005), a UK Department for International Development project. A very interesting project is being conducted by the Pacific Institute of Public Policy (PIPP 2008) to study how mobile phones are being used in rural areas in Vanuatu.

Solomon Islands currently has mobile phone subscription rates below the pre-deregulation levels of Papua New Guinea and Vanuatu. While the number of subscribers has risen from 0.2 per 100 people in 2002 to 2.2 per 100 people in 2007, this level is significantly below that of its neighbours. The same potential for change in the mobile phone market exists in Solomon Islands.

One lesson suggests itself in a comparison of deregulation in Papua New Guinea and Vanuatu. In Papua New Guinea, the incumbent, Telikom, was not compelled to allow the new entrants access across telecommunications networks. In

Vanuatu, cross-network access was part of the deregulation. In Papua New Guinea, many users carried two mobiles: a Telikom mobile to make phone calls to landlines and connections in the urban areas and a Digicel mobile to phone their *wantoks* in the villages. In Vanuatu, users generally have only one mobile phone. Obviously, cross-network access should be part of any telecommunications deregulation.

Water and electricity infrastructure

Solomon Islands and Vanuatu have some of the highest charges for electricity (AusAID 2007) and the lowest rates of extension to rural areas (Cox et al. 2007). In both countries, water and sewerage services exist only for those in the major urban areas. The water authority in Solomon Islands has a very poor governance record, while the French utility UNELCO in Vanuatu appears to have been essentially unmonitored by the Vanuatu government. A report by Castalia Strategic Advisors (2004) on infrastructure regulation in Vanuatu reported complaints that the government units responsible for supervising UNELCO lacked the accounting and legal expertise to supervise the concession contract.

In Vanuatu, the AusAID program GfG, which was involved in the mobile telecommunications deregulation, is currently assisting the government to create an independent utility regulator. One of the first tasks of the regulator will be to look at electricity and water charges to see if the high prices are warranted. The GfG program is also looking for opportunities to open up the electricity and water markets in Vanuatu. Its options are, however, restricted by the very long-term monopoly licences granted to Union Electric du Vanuatu Limited (UNELCO).

Shipping into and out of Solomon Islands and Vanuatu

The World Bank's *Doing Business* (2008b) rates the Vanuatu wharves as one of the most expensive places in the world to undertake exporting and importing. The cost to import a container at Port Vila is US\$2,225—3.5 times as expensive as in Papua New Guinea and six times as expensive as the cheapest country in the world, Singapore. Similarly, exporting a container out of Port Vila costs US\$1,815—3.1 times as expensive as Papua New Guinea and 4.4 times as expensive as Singapore.

In the individual country report for Vanuatu (World Bank 2008b), the World Bank reports the breakdown of the 'cost to import' and the 'cost to export'. Ports and terminal handling charges constituted 17 of the 26 days of the delay to export and US\$1,150 of the US\$1,815 cost to export. Ports and handling charges constituted 17 of the 30 days' delay to import and US\$1,150 of the \$2,225 cost to import.

In comparison, ports and terminal handling charges account for three days' delay and US\$174 of the cost of exporting in Papua New Guinea. In Vietnam, ports and terminal handling charges account for three days' delay and US\$369 of the cost of exporting.

Is the story as bad as the World Bank presents? While there had been criticisms of the *Doing Business* methodology, the high charges at the Port Vila and Santo wharves were also noted in the ADB's shipping study (2007). Based on Vanuatu Ministry of Finance and Economic Management data from 2003, the ADB estimated that stevedoring charges at Port Vila and Santo were seven times more expensive than at Port Moresby.

High costs of importing and exporting are a tax on the rest of the Vanuatu economy. While the political situation in Port Vila makes it difficult to change the management

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or practices at the wharf there, the rest of Vanuatu should be reminded of the price it pays for the poor management at the docks.

One would assume that in countries made up of hundreds of small islands, inter-island shipping would be a principal concern of the central government. A country without internal communications and transportation is not truly a country at all, but a collection of separated communities. Sadly, however, a 'collection of separated communities' is a reasonably accurate description of Solomon Islands and Vanuatu. Internal transportation between the islands is currently difficult and costly for residents outside the capital cities. Without adequate transportation, other reform initiatives would appear to be a waste of resources: why spend money on agricultural outreach programs to areas where farmers have no opportunity to get their produce to markets?

There have been some initiatives to improve the inter-island transport situation, such as the ADB's (2007) Solomon Islands inter-island shipping report. This initiative followed on the heels of EU studies in Solomon Islands in 1999 and 2007. The ADB also developed several ideas for wharf construction and improvements in its outer islands infrastructure project in Vanuatu in 1999. Despite the many studies, nothing concrete appears to have been done.

There appears to be little domestic political interest in doing anything about the state of inter-island shipping in either country, and this is most likely the principal problem. The GfG program in Vanuatu is, however, looking at inter-island infrastructure, which could be a positive sign for the future.

Banking

In the banking sector, the development banks and national provident funds in both countries have followed similar

paths, familiar to those with experience in the Pacific. The development bank in Vanuatu was closed, but a worrying recent development was the possibility of it reopening. The current suggestion is to re-establish the development bank under the Department of Finance and Economic Management. It would be a far better idea not to pursue a development bank at all; but, if it is politically impossible to avoid, the development bank should be placed under the supervision of the Reserve Bank of Vanuatu.

On a positive note, a branch of the French bank BRED was opened in Port Vila. While this will have little impact on the provision of banking services outside urban areas, it is hoped that its entry will bring a greater level of competition to urban banking services. Twenty per cent or less of the population in both countries, however, lives in the urban areas serviced by banks. The majority of the populations have little or no access to banking services. This makes even simple processes such as cash transfers very expensive, which will become increasingly obvious if Australia and New Zealand move ahead with programs to import temporary labour from the Pacific and the remittance flows increase.

What is needed is a 'Digicel' of the banking world to find an innovative way to move banking services out into rural and remote communities. As with mobile phones, the expansion of these services to rural communities would be a tangible benefit in the daily lives of all of the population. One possibility is for banking services to piggy-back on the expansion of mobile phone coverage, as is already happening in Africa and Asia ('On the frontier of finance', 15 November 2007, *Economist*). We do not know yet what form such banking services would take, but it is essential that banking regulations be relatively open to innovative answers coming from new companies. Just

as Telikom is fighting a fierce battle to scale back telecommunications reform in Papua New Guinea, existing banks will lobby hard to keep the banking services market closed.

Education

Solomon Islands and Vanuatu have made impressive strides in enrolling children in primary schools. Although the quality of the schooling might be questioned (and the reliability of Pacific education data are always in question), more than 90 per cent of children are enrolled in primary school. The breakdown in schooling seems to be occurring at the secondary level: only 32 per cent of males and 27 per cent of females are enrolled in secondary schooling in Solomon Islands. For Vanuatu, the enrollment rate is slightly higher at 44 per cent of males and 38 per cent of females. In Vietnam, meanwhile, 77 per cent of males and 75 per cent of females are enrolled in secondary education.

Why, then, do parents not continue the education of their children in an environment such as the Pacific, where the lack of educated labour is a common explanation for the high costs of business? Why are secondary school enrolments one-half to one-third of primary school enrolments?

The low enrolment figures in Solomon Islands and Vanuatu must be due to a perceived lack of return on that education, compared with Vietnam. The small scale of the formal sectors in Solomon Islands and Vanuatu and the lack of opportunity for the use of higher qualifications outside the formal sector probably explain the lack of supply of skilled labour. The most likely explanation would be that the parents of children in Solomon Islands, Vanuatu and Vietnam share the predictions of the IMF about the future of each country.

Aid and development: is there another model?

Recent aid efforts in Solomon Islands and Vanuatu have tended to be either project related, such as the US Millennium Challenge Corporation program in Vanuatu, or governance programs such as current versions of RAMSI in Solomon Islands and the CRP in Vanuatu. There have been problems with both.

The Millennium Challenge Corporation (MCC) has allocated US\$66 million to spend on infrastructure projects in Vanuatu between 2006 and 2011. The projects funded are road improvements in the islands of Efate and Santo. These islands are a seemingly odd choice for a program that aims to reduce poverty. The two most remote provinces of Torba and Tafea are also the provinces that contain the highest rates of poverty (Vanuatu National Statistics Office 2008). These are also the most isolated provinces due to the lack of reliable inter-island shipping. Instead of developing projects to improve infrastructure in the poorest provinces, the MCC is funding road projects on the two islands that contain the two urban areas, with the lowest levels of poverty and the highest levels of existing infrastructure in Vanuatu.

Funding programs on the richer islands while allowing development to languish in the poorer islands only worsens the inter-island disparities that currently exist in both countries. These disparities—and the resulting migration and rivalry—are the root cause of the ethnic problems that flared in Solomon Islands. The MCC program does not seem to have a full understanding of the conditions into which it is delivering aid to Vanuatu.

The governance-building efforts such as CRP and RAMSI have a very different application but have probably worsened

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the same problem in Solomon Islands and Vanuatu. The governance programs have succeeded in restoring governance to the levels that existed in the mid 1990s, but they have not greatly improved governance beyond that. A cynical interpretation might be that the levels of governance in the mid 1990s were those that the economic élite wished for, so certain domestic interest groups do not want higher levels of governance.

The governance reforms have not succeeded in creating broad-based, long-term rates of real GDP growth in Solomon Islands or Vanuatu, such as those predicted for Vietnam. This is because governance problems are not the binding constraint in either country. Governance reforms might be worthwhile even if they do not lead to real growth, in the sense that a population might prefer a better functioning government; however, a well-run finance ministry or a competent central bank does not make up for expensive or non-existent transport and other services from the point of view of a subsistence farmer considering whether to produce excess agricultural output or a foreign investor considering whether to build a new tourist resort.

While governance programs have not produced a long-term return in terms of improved governance or higher economic growth, they have poured aid resources into Honiara and Port Vila. Pouring resources into the richer islands of Guadalcanal and Efate is only worsening the inter-island disparities in income and opportunity, while doing nothing to address the development of the outlying and poorer islands.

The GfG program in Vanuatu is a new type of development program and one that might be a better model than some of the previous ones. AusAID has funded GfG with a projected budget of A\$50 million. The purpose of the GfG program is to identify and correct obstacles to growth in

rural communities. So far, the GfG program has had one major success with the mobile telecommunications reform and has also assisted the effort to open up air travel into Vanuatu. The GfG program is now looking to reform the electricity and water markets, inter-island transportation and the always-political commodity marketing board. There are other areas that GfG should look into, such as the high charges at the Port Vila wharf.

Governance reforms and project aid can lead to some improvements in the conditions in countries, but they can often also lead to misallocation of resources. Deregulation efforts have already scored several big successes. If one were to consider the 'value per \$1 of aid', the deregulation efforts of the GfG in air transport and mobile communications would easily be the best value for money for the people of Vanuatu, while the continued support for reform in the public service would appear to have almost no return at all.

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