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**Trade Policy Review Body**

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## **TRADE POLICY REVIEW**

**Report by**

**SOLOMON ISLANDS**

Pursuant to the Agreement Establishing the Trade Policy Review Mechanism (Annex 3 of the Marrakesh Agreement Establishing the World Trade Organization), the policy statement by Solomon Islands is attached.

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Note: This report is subject to restricted circulation and press embargo until the end of the first session of the meeting of the Trade Policy Review Body on Solomon Islands.



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## **1. ECONOMIC ENVIRONMENT**

### **1.1 ECONOMIC OVERVIEW**

1. Economic performance since the last TPR in 1998 has been volatile, with real growth ranging from negative 14 per cent to positive 10 per cent. Although economic performance has recently improved, Solomon Islands still remains reliant on a narrow commodity base and is vulnerable to world conditions. Internal ‘tensions’ in 2000 lasting until 2003 destabilised governance and severely disrupted economic performance, reducing growth and destroying investors’ confidence. Although growth has since been robust, reaching 10 per cent in real terms in 2007, GDP per capita has only recently reached the pre-tensions level. Growth remains heavily dependent on the logging industry which is expected to decline sharply in the next two years due to the limited remaining sources of supply.

2. In 2008, GDP growth in real terms was 5 per cent, slightly down on the average 7 per cent of the last 5 years. Given the predicted depletion of logging resources and the depressed global economic climate, real economic growth is likely to fall further in the immediate future.

### **1.2 FISCAL POLICY**

3. Fiscal performance has varied throughout the last ten years with severe problems caused by the tensions, particularly the rapid build-up of public debt. Post-tensions government revenues have improved as a result of economic growth, tax reform, donor assistance and increased tax compliance. At the same time, government expenditure has also increased rapidly. Finances were stabilised in 2006, since when there have been successive fully-funded budgets. However, the near future presents serious challenges for the Government’s fiscal position as the anticipated decline in the logging industry will damage government revenues and this may be exacerbated by the deterioration in the global economic climate. It is expected that government revenue will fall in the future, potentially requiring a retrenchment on the part of the Government.

### **1.3 MONETARY POLICY**

4. The Solomon Islands Dollar has consistently tracked a basket of currencies dominated by the US Dollar in the last ten years. Excess liquidity rose considerably between 1999 and 2006, although it has now fallen significantly as a result of Central Bank actions. Domestic credit rebounded strongly post-tensions, overtaking pre-tension levels. This has been driven largely by increases in private sector credit.

5. Reserves have gradually decreased in recent years. This is a result of revaluation effects and the high costs of fuel and food. During 2008, reserves fell below the benchmark of three months’ worth of goods and non-factor services.

### **1.4 NATIONAL DEBT**

6. Both official public debt and public sector arrears increased greatly from 2000, and by 2002, 100 per cent of government loans were in default. However, the signing of the Honiara debt agreement in 2005 signalled a government commitment to no new borrowing and sustainable debt management. By 2008, nearly all debt had been regularised and the ratio of public debt to GDP – although still high, at 43 per cent – has decreased significantly in the last few years.

## **1.5 INFLATION**

7. The inflation rate over the last ten years has been volatile, although more recently it had been relatively stable until the last two years. After a moderate rate of 4 per cent in 2004, inflation rose sharply to 23 per cent in 2008, heavily influenced by rising global commodity prices, particularly in oil and rice.

## **1.6 TRADE AND FOREIGN DIRECT INVESTMENT**

8. The trade balance was adversely hit during the tensions, partly as a result of the destruction of the mining industry, which is yet to be restart production. Other industries such as palm oil have now resumed production. The overall trade balance has declined substantially in the last five years recording a SBD 750m deficit in 2008. This has largely been the result of high fuel (on which Solomon Islands is heavily dependent for its energy needs) and food prices. The trade balance is expected to worsen as logging exports decrease. Data is limited, but indications suggest that FDI, whilst remaining low, has showed a gradual rise since the end of the tensions. A new Foreign Investment Act, which came into force in 2005, has facilitated investment from overseas and tightened regulation.

## **1.7 SECTORAL PERFORMANCE**

9. Logging dominates Solomon Islands' economy. Following a decline after the Asian crisis and disruption caused by the internal tensions, logging has rebounded strongly during the last five years. It currently accounts for 20 per cent of the economy, contributes 12 per cent of government revenue, two thirds of export receipts and approximately 7,000 full-time jobs out of a total formal sector of only 44,350 nationwide (over 15 per cent). However, logging is predicted to decline rapidly over the next two years, necessitating a significant structural adjustment. Unemployment is already rising due to demographic trends and rural-urban migration, but the additional effect of the logging decline is likely to extend beyond those directly employed in the industry once indirect effects are taken into consideration.

10. Production in other commodities has improved significantly in the aftermath of the tensions despite remaining small relative to the logging industry: recent years have seen increases in production of copra, palm oil and fish.

## **1.8 ECONOMIC CHALLENGES**

11. There are a number of significant challenges facing Solomon Islands' economy. Logging is expected to decline rapidly from 2009 leading to major revenue, balance of payments and unemployment problems. Solomon Islands lags behind other pacific countries in terms of metrics such as ease of doing business and investment climate, due in particular to high utility costs, poor communication services and underdeveloped financial services, all of which are particularly severe beyond the main urban centres. A lack of capacity in governance, ongoing security concerns and acute vulnerability to world commodity prices have further undermined economic performance.

12. The current reform programme is aimed at addressing many of these problems. Obstacles to long-run growth in non-logging sectors are being indentified and removed. Sectors that have been identified as having a strong potential for growth include mining (the country's only established gold mine shall reopen shortly), tourism, agriculture and fisheries. Government expenditure is increasingly aimed at improving the long-run productive capacity of the economy, whilst avoiding inflationary expenditure by focusing on infrastructure, health and education.

13. A number of business reforms were enacted in 2008, with a view to increasing the ease of doing business and attracting further foreign investment. Underperforming state-owned enterprises are being reformed and a monitoring unit has been established. The tax regime is currently being changed to create a broader tax base and ensure a fairer return from resources. Further new customs and tax measures will bolster revenues through increased compliance.

## **1.9 CONSTITUTIONAL REFORM**

14. The Government's constitutional reform programme aims to address the dislocation between the formal political system (derived from the Westminster system) and prevailing systems of power and authority, both traditional and emerging. Parliamentary democracy in Solomon Islands has suffered superficially from the lack of a history of strong political parties and adversarial opposition, but more fundamentally from the disconnect between the values associated with representative democracy (placing emphasis on the individual, the rule of law in a cohesive, homogeneous society) which contrast starkly with prevailing Solomon Islands values of representative democracy (involving participatory, consensual decision-making, and a stronger conception of collective rights, pluralism and restorative justice).

15. The programme seeks to redress this balance by creating a federalised system of governance, which will devolve greater planning and decision-making to the provincial and community levels. This may require the development of a system of fiscal federalism to address the disproportionately centralised control of government expenditure.

## **2. TRADE AND TRADE-RELATED POLICIES**

### **2.1 REGIONAL TRADE AGREEMENTS**

16. Solomon Islands is actively participating in and negotiating a variety of regional trade agreements, discussed below. There are two main reasons that the Government expends greater administrative effort in the pursuit of regional agreements than in multilateral negotiations.

#### **2.1.1 Regional-First Liberalisation**

17. Multilateral negotiations have already extended highly preferential market access to Solomon Islands as a least developed country, through many developed Members' GSP schemes. Indeed, Solomon Islands' current level of tariff preferences is probably as high as it ever has been or ever will be. Nevertheless, the economy has failed to capitalise on this opportunity, for a wide variety of reasons: inability to meet technical standards, SPS requirements, the difficulty of overcoming the prohibitive costs and delays associated with distance, and a sheer inability to supply a quantity of product which foreign customers consider viable. One means of addressing this multiplicity of constraints that Solomon Islands is pursuing alongside other Pacific economies is to concentrate on and promote the regional market, in which technical standards are more realistically attainable, distances may be shorter and customer size is smaller. It also provides an opportunity to experience and understand the challenges and consequences of ambitious liberalisation in a forum that is more forgiving of the administrative constraints of those undertaking the technical work before approaching similar tasks in a multilateral forum.

## **2.1.2 Offensive Interests and Labour Mobility**

18. The second major reason to pursue regional agreements is the opportunity to discuss subjects of enormous offensive interest to countries like Solomon Islands which are ignored in multilateral forums, such as rules governing the use of traditional knowledge. By far the most important of these to Solomon Islands is the temporary movement of natural persons. In the Solomon Islands context, such ‘temporary movement’ refers to unskilled and semi-skilled workers (such as caregivers and tradesmen), overseas for a sufficient period to make the placement economically viable (which may be as little as six months within the Pacific region, rising to two years or more for distant markets with much higher transport costs).

19. Solomon Islands has been participating in the Recognised Seasonal Employer scheme under which unskilled labourers can work in New Zealand for up to seven months each year, and Government has an active work programme to improve the scheme’s facilitation and regulation. Although the numbers of workers are small by international standards (238 up to June 2008, although indications are strong that Solomon Islands’ participation programme will expand rapidly in 2009), the gains even from a single participant can directly lift multiple dependents out of poverty in rural areas virtually untouched by the formal economy, for whom alternative economic opportunities are slow to materialise. The Government is seeking the funding to establish a regional pilot for a further scheme to train caregivers in the Pacific and place them in fixed-term employment abroad. Solomon Islands has an overwhelming comparative advantage in the provision of inexpensive, low-skill labour relative to many neighbouring and distant economies, so it is perfectly natural that it should seek to incorporate this comparative advantage in the negotiation of trade agreements, just as it accommodates the comparative advantage of more advanced economies in the negotiation of subjects such as trade in goods and services. It provides a means for Solomon Islands to overcome some of its most intractable constraints of distance from and cost of transport to major markets, whilst providing additional benefits such as the spill-over effects of technology transfer, the broad up-skilling that very low-skill workers immersed in a foreign economy experience, and the socially beneficial opportunity to use accumulated earnings to invest directly in the chronically credit-constrained rural economy.

## **2.2 MFN TARIFF POLICY**

20. A comprehensive review and rationalisation of Solomon Islands’ current MFN tariff policy is planned as an early component of the Integrated Framework project. The following summarises the rationale for the current structure.

### **2.2.1 Import Duty**

21. A broad reform of the MFN import duties was implemented in 2007, harmonising tax rates, reducing statutory exemptions and reducing average tariffs, with most goods now taxed at 10 per cent, very much below Solomon Islands’ WTO bound rates. Whilst the Government sees a liberal tariff policy as a desirable driver of growth, it recognises the enormous fiscal challenges ahead: the narrow tax base due to the limited extent of the formal sector, the rapid decline of logging, the volatility of foreign aid flows and the vulnerability of fiscal revenue to commodity price shocks. Future policy-making challenges are likely to require great flexibility to defend the fragile fiscal position.

### **2.2.2 Export Taxation**

22. Even if the dominant role of logging is disregarded, the domestic economy is highly dependent on the export of a small number of unprocessed commodities. The small manufacturing base is constrained not only by high local costs of doing business, but by high international transport



costs which impact the cost both of shipping final products and of raw materials, considering the limited scope for sourcing inputs from the tiny and undiversified local economy.

23. Whilst the Government recognises the limited scope for using an activist trade policy to promote industrial activity under such circumstances, it recognises that Solomon Islands lags other comparator economies in the extent to which it processes its agricultural and fisheries exports. Such processing typically reduces the ultimate proportional cost of transportation to a final market by increasing the ratio of value to volume, providing a means to mitigate the country's inherent geographical challenges. Considering the financial and administrative limitations on Government, at current levels of economic development, export taxes are considered to be an important component of a broader effort to establish processing operations that can generate greater economic returns, particularly in rural areas, which suffer the most acute burden of poverty.

### **2.3 INTEGRATED FRAMEWORK**

24. The Integrated Framework represents the first attempt to perform a comprehensive baseline analysis and needs assessment of trade policy and trade-related technical assistance in Solomon Islands. As such, the Diagnostic Trade Integration Study (DTIS) is an important milestone in the slow process of developing a coherent national approach to the interlinked activities of policy consultation and formation, the development of domestic legislation, demand-driven trade-related technical assistance, the prioritisation of offensive and defensive interests in international agreements, and the mainstreaming of trade issues into broader government planning processes.

25. The main mission was completed in 2008, and final publication of the DTIS is expected in early 2009. With the support of a national capacity building programme under the Enhanced Integrated Framework, the first new projects under the work programme recommended by the DTIS will begin this year.

### **2.4 INTELLECTUAL PROPERTY**

26. As a least developed country far from the technological frontier which has minimal capacity to conduct original research and development activities, Solomon Islands' interests in intellectual property rights are to ensure support for its broader policy priorities of poverty reduction and rural development. At the multilateral level, these are best served by taking full advantage of all exceptions and flexibilities which improve ordinary people's access to cheap medicines and educational materials, and maximising the private sector's ability to transfer and adapt technology from abroad. At the regional level, this involves active support for programmes to recognise and protect traditional knowledge, to restore the balance of intellectual property law in favour of indigenous intellectual assets for the benefit of rural communities.

### **2.5 AVIATION AND TELECOMMUNICATIONS**

27. Reducing costs in service sectors such as telecommunications and aviation are important policy priorities of Government. The Government recognises the importance of liberalisation within the context of a broad policy which also addresses the concomitant need for adequate public investment in infrastructure, appropriate government regulation, and the social necessity of extending the provision of these services beyond the limits of commercial viability. Solomon Islands' geography is amongst the most adverse even in the Pacific, with a low population density widely dispersed over extreme distances, making the provision of transport links and even cellular telecommunication services extremely expensive. Given the negligible purchasing power of most of these communities, profitable service provision is not possible, and yet without such links to the

national economy, prospects for economic development are non-existent. The management and sequencing of such a complex work programme present very real challenges in policy formation that go far beyond the opening of previously closed sectors to new entrants. Nevertheless, the Government recognises the importance that low-cost access to these services has for the growth of tourism, the provision of financial services beyond Honiara, and of small-scale rural enterprise more generally.

28. Two further international carriers were welcomed to the principal international air route between Honiara and Brisbane during 2008. The Government is currently negotiating a premature end to the monopoly license granted to the single incumbent telecom provider, with a view to creating a competitive environment, which is expected to reduce prices significantly.

### **3. TRADE RELATIONSHIPS**

#### **3.1 GENERALISED SYSTEM OF PREFERENCES**

29. As a least developed country, Solomon Islands benefits from tariff preferences under many developed countries' Generalised System of Preferences schemes, including the European Union, Australia and New Zealand.

#### **3.2 ECONOMIC PARTNERSHIP AGREEMENT**

30. As part of the Pacific ACP group of countries, Solomon Islands has been participating in the negotiation of an Economic Partnership Agreement (EPA) with the European Commission since 2002, in anticipation of the expiry of the waiver permitting Cotonou trading preferences to continue until the end of 2007. Unfortunately, no agreement could be reached prior to the waiver expiry, and so trade between Solomon Islands and the EU has been governed by the part of the latter's GSP scheme offered to LDCs, called 'Everything but Arms', since the beginning of 2008. Negotiation of a comprehensive EPA is ongoing.

#### **3.3 MELANESIAN SPEARHEAD GROUP**

31. The Melanesian Spearhead Group (MSG) links Solomon Islands with its closest political, social and cultural neighbours in Melanesia: Papua New Guinea, Vanuatu, Fiji and a non-state group in New Caledonia. Given these ties, it was natural that the MSG would be the first regional platform on which a reciprocal trade agreement could be built. First signed in 1993, the agreement has gradually expanded coverage over the last 25 years and a newly revised text was ratified last year to coincide with the launching of a new Secretariat. Consultations concerning possible cooperation in various services areas have been ongoing for the past few years.

#### **3.4 PACIFIC ISLAND COUNTRIES TRADE AGREEMENT**

32. The Pacific Island Countries Trade Agreement (PICTA) entered into force in 2003, as a trade in goods agreement between the fourteen island members of the Pacific Islands Forum, although Solomon Islands did not begin trading under PICTA until late 2007. The agreement plans for the elimination of almost all tariffs between parties by 2021. An accelerated programme of negotiations on the inclusion of both trade in services and labour mobility began in early 2008 and is scheduled to complete this year. The very small size of the entire Pacific labour market makes progress on labour mobility particularly urgent, for the development and retention of more specialist skills and to smooth the over- and under-supply of skilled and unskilled labour across small economies in the same way that intranational labour migration would in a more typically sized economy.

### **3.5 PACIFIC AGREEMENT ON CLOSER ECONOMIC RELATIONS**

33. Solomon Islands signed the Pacific Agreement on Closer Economic Relations (PACER), a framework agreement for economic cooperation between fourteen Pacific island countries, Australia, and New Zealand, in 2001. The agreement foresees countries beginning negotiation of a free-trade agreement not later than 2011. Parties have begun to consult on the subject at an informal level. The inclusion of provisions on labour mobility is an important reason that Solomon Islands is motivated to consider a free-trade agreement with Australia and New Zealand as soon as the constraints of adequate domestic democratic consultation and administrative capacity allow.

## **4. MULTILATERAL TRADE RELATIONS**

34. Solomon Islands is represented at the WTO through the Geneva office of the Pacific Islands Forum Secretariat (PIFS), and by our Ambassador to the European Union, based in Brussels.

### **4.1 SMALL, VULNERABLE ECONOMIES WORK PROGRAMME**

35. Solomon Islands, through the PIFS Geneva office, has been actively involved in the work programme on SVEs, alongside 21 other countries mostly from the Pacific, Caribbean and Central America. The programme seeks to implement the mandate of the November 2001 Declaration of the Fourth Ministerial Conference in Doha, which states

We agree to a work programme, under the auspices of the General Council, to examine issues relating to the trade of small economies. The objective of this work is to frame responses to the trade-related issues identified for the fuller integration of small, vulnerable economies into the multilateral trading system[.]<sup>1</sup>

36. The work programme has designed forms of special and differential treatment appropriate for countries that are typically isolated, dispersed, distant from major markets, with small, fragmented, imperfect domestic markets, undiversified exports to few markets, open economies, low competitiveness, inadequate infrastructure, poor productivity and high transport costs.

### **4.2 AID FOR TRADE**

37. Solomon Islands recognises that it still has a great deal of reform and investment left to do in order to enable its economy to meet its full potential. The array of specific, prioritised project proposals generated through the recent Diagnostic Trade Integration Study process under the Integrated Framework programme have illustrated just how much remains to be done, and how dependent Solomon Islands will be on the support of donor partners if these fundamental needs are to be adequately addressed. The Integrated Framework, and especially the programme of capacity expansion supported by the Enhanced IF budget, has already substantially increased the country's capacity to absorb and effectively use aid for trade investments.

38. However, Solomon Islands has traditionally relied on a narrow concentration of sources for its aid for trade, most notably the European Union under the European Development Funds (EDF). Whilst the Government is extremely grateful to the EU for its generous, long-term support, it recognises the benefits of attracting a broader variety of donor partners into providing support in this area, particularly given the as-yet uncertain future of the EDF beyond the expiry of the Cotonou Agreement in 2020.

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<sup>1</sup> WT/MIN(01)/DEC/1, 20<sup>th</sup> November 2001, paragraph 35.

### **4.3 NAMA AND PREFERENCE EROSION**

39. As a least developed country Member, Solomon Islands is already benefiting from generously improved market access into many developed and developing economies as a result of the Doha Development Round. As a result, then, the conclusion of Doha is likely on balance to impact Solomon Islands negatively by eliminating or greatly reducing significant tariff preferences. Of particular concern to the national economy will be the loss of a valuable fisheries preference into the EU market. Whilst Solomon Islands believes in the long-run benefits of progressive mutual tariff reduction, it nevertheless recognises that the costs of adjustment will be significant, and of particular concern in the context of a small, vulnerable, least developed economy with very limited flexibility to support and facilitate significant shifts in employment. In this context, the aid for trade already received both through the Integrated Framework programme and from bilateral donors is both timely and necessary, but Solomon Islands recognises that it has a long way to go before it is able to offer its private sector the internationally competitive infrastructure, services and transport links it needs to survive without historical tariff preferences.

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