CENTRAL BANK of SOLOMON ISLANDS

Article: 01/2017 **Sunday 23rd April, 2017**

Debt- Growth Nexus- Case for Solomon Islands

By Natasha Eddie, Communications, CBSI

External borrowing or debt is a common practice in developing and least developed countries around the world for various reasons. If local borrowing is limited, these countries depend on sourcing external funds to subsidise their deficit budgets or cushion revenue shortfalls and to fund major infrastructure or development projects.

External debts are often sourced from foreign commercial banks, multilateral institutions like the International Monetary Fund, World Bank and Asian Development Bank, and bilaterally from other Governments.

Debt plays a crucial role in boosting economic growth, notwithstanding the associated negative impact it can cause when it is unsustainable.

Despite the vast literature on the link between external debt and economic growth, there is minimal coverage done in the Pacific island countries especially in the Solomon Islands. Solomon Islands first borrowed externally before it gained Independence in 1978 and this dependency still prevails to the present.

From the year 1978 to 2000 the Government borrowed externally mostly for infrastructures, until 2000-2005 when the borrowing was then focused on commercial related undertakings.
In the period of 2006 -2010 the country took in only one external creditor, the IMF, under a standby credit facility for Balance of Payment purposes until 2016. *(Debt-Growth Nexus, CBSI working paper, Economics and Research Department, 2016)*

A team of economics and research analysts from the Central Bank of Solomon Islands were motivated to find out what would be the likely impact of such borrowing on the economy. The team carried out a research beginning mid last year. And just recently presented their research paper titled **'Debt-Growth- Nexus' The case for Solomon Islands.**

The presentation was made on the 13th of April at the CBSI training room.

The objective of the paper was to explore whether there is a relationship between external debt and economic growth;
To investigate whether public external borrowing contributed towards the economic growth of Solomon Islands in both and short and long run; and lastly to estimate the sustainable level of debt.

Because of these objectives, three variables were used in the research, they were Debt, Real GDP, and the Exchange rate.

Moreover, the team used two simple models to see the net impact of external debt on real growth of the country. Along with that, rigorous tests were used to ensure that the models met the appropriate economic standards. This included the Unit Root, Cointegration, Granger Causality, and Stability Tests.

The findings show that there is a positive relationship between external debts and the RGDP or economic growth for Solomon Islands.

However, it is only significant in the long run and not on the short run. In the long run 1 percent in debt stock will lead to 0.3 percent change in RGDP. The exchange rate is not significant in the long run.

The speed of adjustment from the short run model shows that it will take 3.3 years for real GDP to adjust back to its long run equilibrium.

This simply means, if there is a big borrowing it will take three and a half years for the economy to adjust back to its normal state.

The sustainable debt to GDP ratio is found to be between 30- 40 percent of NGDP and currently Solomon Islands is only at 8 percent which is regarded as a comfortable level.

Based on the results shown, the research team explained that Solomon Islands government can still borrow externally but they must have a limit.

“The Government has a larger space to play around with its debt, but there has to be a benchmark.”

“If the Government start borrowing, it is more likely to continue, therefore it is important to establish or put a benchmark on sustainable debt.”
The research team recommends; the Government should only borrow for capital development.

“The Government should only borrow to invest in productive sectors that could boost the economy in the long run. Examples of two productive services is the Tina hydro and the undersea cable. If we only want to borrow for consumption, then it would not be appropriate. Also a good idea is to borrow within capacity which can be serviced because the ability to pay external debts depends on how much we earn.”

The team concluded in their research that debt contributed positively and significantly to economic growth in the long run but insignificant in the short run. Moreover, in fiscal policy, debt level is an important indicator to growth nonetheless it should be closely monitored.

End//