Dollarising the Solomon Islands economy

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As part of a package of economic policies to get the Solomon Islands’ economy back on its feet, it has been proposed that the country adopt the Australian dollar in place of its present currency, the Solomon Islands dollar. Two years ago I suggested that the PNG economy would perform more effectively if that country used the Australian dollar instead of the PNG kina. I extended this suggestion to say that all the South Pacific island countries not presently using Australian or New Zealand currency should follow suit.

Given its present distressed economic state, the currency issue is of second-order importance. Still, there is the danger that the central bank—the best-performing institution in the country—could be forced to print money at an excessive rate by the cash-strapped government, adding to the country’s woes by causing runaway inflation.

The main reason for my recommendation that Papua New Guinea shift to the Australian dollar was that the central bank had lost its independence under successive administrations. The changeover to the Australian currency would mean that the government would no longer have an independent monetary policy, and this would remove one area of policy indiscipline from the government’s hands. In Solomon Islands, the central bank has fought tooth and nail against various administrations over the past decade or so to maintain its independence and prevent the government from profligate deficit financing. However, despite the bank’s efforts, inflation has averaged 10 per cent annually over the 1995–2001 period, and the Solomon Islands dollar has been under devaluation pressure during that time.

As with Papua New Guinea, adoption of the Australian dollar would have several beneficial effects. Dollarisation of the economy would greatly reduce currency risks facing investors, so long as the Australian monetary authorities maintain their good performance. The inflation and interest rate risks would also be substantially reduced as inflation would be tied to Australian inflation with the exception of movements in the prices of non-tradables. Similarly, interest rates would be largely determined in Australia.

Hence, the investment environment could be substantially improved over the longer term, so long as the issues leading to the ongoing ethnic tensions can be resolved. However, fiscal indiscipline could still lead to capital flight and interest rates would rise.
But the government could not print money to fund deficits. It would have to issue bonds for this purpose, which would provide some discipline over its fiscal performance.

The move to the Australian dollar would save the costs of running a central bank—a luxury in a small, poor country. As the present central bank staff are among the best trained people in the country, closing the bank and moving them to other core government jobs involving financial management would be doubly beneficial. The government would forego the revenue earned from printing money (seigniorage). However, the loss of seigniorage and the costs of the changeover of the currency would likely be more than outweighed by the gains from the lower interest rates on domestic borrowings. Indeed, the Australian government may be prepared to share some of the seigniorage from issuing Australian dollars with the Solomon Islands government.

Two issues are critical in the adoption of a common currency: first, the countries sharing the currency should share much the same external shocks; second, nominal wages should be flexible, especially downwards, in order for the economy to adjust to shocks that the common currency does not adjust to—otherwise, all the adjustment has to be through unemployment. Unlike Argentina, where neither of these conditions were satisfied, Solomon Islands is basically a primary commodity exporting country like Australia, and does not have restrictive wage legislation. In Argentina’s case, the United States has a very different traded goods profile and therefore the two countries do not share common external shocks to any great extent, and Argentina has very strong unions, which made it very difficult to reduce nominal wages and thus reduce real wages in the face of uncontrolled government expenditure, particularly by the states.

Given that the technical considerations necessary for a common currency to be effective are satisfied, Solomon Islands could benefit hugely from the effects the use of the Australian dollar would have on investment. Reduction of currency, interest rate and inflation risks would improve the investment climate greatly. Perhaps even more important could be the impact on country risk of the elimination of the ever-present risk of government over-riding the central bank’s management of monetary policy.