1995 Speech

Governor's Speech - on the occasion of the Launching of the CBSI 1995 Annual Report

Good morning and a warm welcome to you.

I feel very privileged indeed that you have spared time from your work schedules to come here this morning for the launching of the Central Bank's 1995 Annual Report. It provides me with the opportunity to fulfil the Central Bank's duty to present its best assessment of economic conditions in the Solomon Islands, and to account for our actions over the last year. Besides, in our calender of events, the production of the Annual Report forms a significant part of the Bank's activities. In that connection, we in the Bank are encouraged by your attendance at this morning's gathering.

Introduction

There are 7 main messages contained in the 1995 CBSI Annual Report that I wish to convey to you this morning:

<u>First</u>, in 1995 the SI economy had a strong growth estimated at around 7%. The stimulus for this growth was provided by a strong rise in export volumes and prices, a high level of activity in the building and construction sector, and a high level of public expenditure.

<u>Second</u>, inflation moderated somewhat during the first three quarters but accelerated in the last quarter of 1995. The average inflation rate of 10 percent during that year remained well above that of our trading partners. Bringing the inflation rate down remains one of the major policy challenges in 1996.

<u>Third</u>, the foreign reserves position remained weak and broadly unchanged over the previous year. The strong growth in exports resulted in surpluses in the trade and current accounts but this was offset by a deficit on the capital account where, unlike in previous years, there were a net outflows of capital. The overall position of the balance of payments therefore remained weak.

<u>Fourth</u>, credit and monetary growth rates declined to more moderate levels in 1995. This has helped promote price and balance of payments stability.

Fifth, and on the negative side, serious concerns remained during the year about excessive government expenditure, the size of the fiscal deficit and its financing difficulties. This is perhaps one of the most pressing policy challenges facing the nation and I shall return to this topic in some detail.

Sixth, concerns are again raised on forestry-related issues including the sustainability of harvesting, environmental impacts, the effective monitoring of logging activities and questions relating to the economic benefits to Solomon Islands. The report examines these forestry sector issues in some detail.

Finally, the CBSI had a successful year of operations, including profits of $5.39 million of which $4.48 million will be paid to the Consolidated Fund. Details of the CBSI operations are given in Chapter 8 of the Annual Report. The main operations of the Central Bank include the issue and redemption of currency notes and coins, as banker to banks, government and statutory bodies, the management of the government securities market, foreign reserves management, exchange control administration, the administration of banking legislation, supervision of commercial banks and credit unions, management of the Small Business Finance Scheme, and as a liaison institution between the Solomon Islands and international financial institutions.

I now propose to make a more detailed presentation of each of the points made so far.

Output

First I would like to turn to the performance of the real sector of the economy, and in particular that of output and inflation. This year I can provide this assessment on a bright note. The summary for real sector in 1995 *is "output growth up, inflation rate down*". This performance demonstrates that the economy of the Solomon Islands is capable of generating positive results. The following Chart shows output growth over the last decade.

Chart on Output Growth

The taller bars in the later years indicate the stronger growth rates in the 1990s relative to most of the 1980s

Many of you in the business sector will have seen good profits and growth in turnover. CBSI's provisional estimates are that the output of the economy grew by 7% in 1995. As you can see from the Chart, the 1990s has so far been a decade of strong output growth. Growth in the 1990s has so far averaged nearly 6% each year, compared with 3% in the second half of the 1980s. By this measure the Solomon Islands' economy has been booming in the 1990s.

Output growth in 1995 was led by the fishing, logging and construction industries (refer to page 14 in the Annual Report for the GDP table). Each of these industries produced more output than ever before. The fishing industry enjoyed a very good catch in 1995. It was 40% up on the previous year. The logging industry produced around 850,000 cubic metres in 1995, 15% higher than the previous record harvest in 1994. This production was boosted by increased profitability arising from tax remissions and exemptions awarded to the industry. However, this level of log production has raised the issues of sustainability, environmental impact and questions on the net benefits to Solomon Islands. These are important issues to the nation.

While high growth was a good news in 1995, there is a concern that this growth rate may not be maintained in the future. The industries, especially natural resource based industries that generated growth in 1995, may contract in the future, and may not have the same capacity to expand again. As a matter of fact, in the fishing industry for example, production has already fallen so far in 1996. In the forestry sector, current rates of log production may use up all commercial forest resources sooner than we expect. Construction activity depends upon bank financing and other resources generated in primary industries which are volatile.

In this context, it is important that current policy takes advantage of the present period of high growth to save some of this income for investment and infrastructure development now. So the important question is, What is happening to the income currently being generated? I shall return to this later.

Employment data in this year's Report, sourced from the National Provident Fund, shows that there has been little employment growth since the start of the decade. Given the high growth rate in the labour force this is an issue of great concern. An economy whose growth is more dependent on the exploitation of natural resources rather than investment in new productive capacities, is not likely to sustain the demands of its rapidly increasing labour force in terms of employment. The economy needs investment. But a stable environment conducive for investment has to be created first. For example, it should ensure labour costs are competitive with other countries. Also, related policies such as taxation, needed infrastructure developments as well as effective administrative and regulatory systems must be part of this environment. Only then would we be able to generate more investment and create new jobs.

Inflation

The rate of inflation (as measured by the Honiara retail price index) fell to 10% by the end of 1995. This was down from 13% in 1994. You will see from the Chart (on page 24 of the Annual Report) that index fell sharply from its recent peak of 15% in September 1994 to the trough of 8% in July 1995.

Chart: Annual % Change in Honiara Retail Price Index.

The red line indicates the all items' index, which is the average of the local items' index (green line) and the imported items' index (blue line). The green line is the higher one, indicating that local items have been the main cause of inflation since mid 1992.

The inflation rate fell in 1995 mainly because of improved supplies and tightness in financial conditions. Furthermore, the relative weakness of the Australian dollar meant only modest growth in the price of consumer items imported from Australia, our main source of imported consumer goods.

However, you will also see from the chart that inflation started to pick up in the later part of 1995. By March 1996, it was back up to 14%. Recent price rises in domestic items have included large increases in rents and water charges. Clearly there is still some way to go before we achieve the stability in prices which will prevent incomes and savings being eaten away by inflation.

External Sector

During the year, there were positive developments in the external sector. Export performance was particularly strong. Total exports increased by 23% to $573 million, led by the exceptional fish catch which increased fish exports by 37%.

Export values have increased well over three times between 1990 and 1995. Even after allowing for the effects of inflation this is 150% increase in export values over the same period. This rapid increase can be seen in the following Chart which is reproduced from page 27 of the Annual Report.

Chart: Export Values of Principal Commodity Groups

The total area under the chart illustrates the rapid increase in exports since the export boom started in 1991. The chart became much more blue in the 1990s, as logs became more important. In 1995, logs accounted for around half the value of exports. This is down a little from last year, owing to the increase in fish exports (the green shaded area).

Imports also grew sharply in 1995, by 18% although this growth was less than the growth in exports. As a result the trade account registered a surplus of $21 million, the first surplus in 10 years. Similarly, the trade surplus led to the first surplus in 10 years on the current account of the balance of payments.

In contrast the capital account registered Solomon Islands' second recorded deficit, the first being in 1994. The main reason for the deterioration in the capital account in 1994 and 1995 was the sharp decline in direct foreign investment. Between 1989 and 1993 net direct foreign investment in the Solomon Island economy averaged $40 million a year. In 1994 and 1995 this average was down to just $3 million. One cause for this is the increase in the repatriation of profits which in previous years had been reinvested by foreign companies operating in the Solomon Islands.

The fall in investment from overseas is a major policy concern. I consider it a worrying development for a small developing country like the Solomon Islands to be a net payer to the outside world in terms of its capital account. It should be the other way round: let's face it, we need foreign investment. While domestic savings is growing, it remains insufficient to generate the investment and growth in employment that the economy needs. Unfortunately, we are not attracting enough investment in this country. As a matter of fact, due to the current climate of uncertainty, several of the larger established companies have adopted a "wait and see" approach before committing new funds. This has got to be reversed. But to achieve that, requires stability in and coherence between fiscal, monetary, exchange rate and incomes policies. Furthermore, rules governing taxation, labour relations and investment incentives have to be effective and applied consistently and fairly to all investors.

The end result of the current account surplus and capital account deficit was that for much of the year, the external reserves remained below one month's import cover.

This can be seen from the following Chart.

Chart showing External reserves in months of import cover of goods and services.

The Chart shows reserves in terms of how many months of imports of goods and services they could buy.

The Chart shows that in spite of the export boom, little progress has been made in improving the external reserves position. This could be explained by the growth in incomes as well as an expansionary fiscal policy which have fuelled demand and imports. This, along with lower inward private sector investment, has prevented the external reserves from increasing in the 1990s.

Monetary Survey and Monetary Policy

Monetary developments in 1995 were dominated by developments in government finances. In spite of strong output growth, monetary growth slowed, from 24% in 1994 to 10% in 1995. The monetary slow down was led by a sharply lower growth in domestic credit to government from the banking system which fell from 26% in 1994 to 6% in 1995.

It is worth noting that in 1995, all the growth in government credit from the banking system came from the Central Bank. Excluding interest arrears, commercial banks actually reduced their stock of government debt during 1995. The general slowdown in money and credit growth is evident from the following chart (taken from page 33 of the Report)

Chart: Money and Net domestic Credit.

The Chart shows monetary and credit growth going downhill in 1995. The sharpest fall is in growth in credit to government as shown by the red line. This pulled down growth in not only total domestic credit but also growth in broad money (the blue line). Private sector credit grew strongly until late 1995, when it too began to subside.

In 1995 lower growth in credit from the banking system to government contributed to lower monetary growth. However, unlike in previous years the government finance much of its deficit in 1995 by running up arrears to all its creditors such as private suppliers, NPF and other state enterprises. This limited monetary growth because money tied up in government debt did not end up in creditors' banks account. In turn this dampened domestic demand, inflation and import growth.

The long term objectives of monetary policy remain as they have been for many years. They are to contribute to monetary and price stability, growth in foreign exchange reserves and to foster financial conditions conducive to the development of the Solomon Islands economy. Progress in achieving these objectives however, has been frustrated by inconsistencies in the use of different policy instruments. There are opportunities for progress in 1996 if the authorities use monetary and fiscal policies consistently: fiscal stabilisation would provide an opportunity to continue to build confidence in the government securities market and to put the prospects for economic development on track. It is to fiscal policy I would like to turn to next.

Fiscal Issues

Fiscal developments in 1995 have influenced the economy more strongly than ever. Many of you will be aware of the government's financial difficulties that became acute in 1995. I shall discuss these difficulties and the Central Bank's reaction later. First however, I would like to put an historical perspective on the current situation.

The problems in servicing public debt in 1995 are not merely the product of actions in that year or any other single year. In fact these problems are the culmination of six years of high government borrowing. The ensuing build-up of public debt is illustrated in the following chart which shows government borrowing by holder of the debt.

Chart on Government Domestic Debt By Holder

The Chart illustrates the growth in government debt to the domestic financial system in the 1990s. Total borrowing from commercial banks, CBSI and the public increased rapidly between 1990 and 1994. Before 1995, the banks had been the main providers of additional finance. The major difference in 1995 was that *commercial banks reduced the stock of debt owed by government (excluding arrears).*

The fiscal deficit in 1995 was large, but this would not have led to difficulties had government been running smaller or manageable deficits in the past.

The historical perspective on the current problems can be made even more sharp in the contrasting experiences of the government and the private sector. The 1990s have seen a rapid growth in income for both the government and private sector. However, while the private sector has saved some of its incomes and become wealthier, government has sharply increased its operating expenditures and built up debt. The following chart shows how these revenues have affected the wealth of the two sectors.

Chart: Net financial wealth in the public and private sectors, 1990 to 1995

The bars above (green) zero show the rapid growth in private sector net financial assets in the 1990s. The bars below (red) zero appear almost like a mirror image. They represent growth in net government debt since 1990.

Financial wealth of the private sector increased by $220 million between 1990 and 1995. Over the same period net government debt to the financial system increased by over $240 million. Borrowings of this magnitude would have been justified had they been used for investment purposes to build roads, schools, hospitals and so on. But instead, most of the borrowings were used up for consumption.

There are many examples of governments around the world managing revenues badly and squandering revenues from commodity booms. In these countries, rapid expenditure growth, and a build-up of government debt is often followed by fiscal crisis and in turn, often have to be solved by taking painful drastic cuts in expenditure.

In the case of Solomon Islands, a high fiscal deficit has co-existed with a revenue boom in recent years. It would be far easier for the government to address the problem now in the current conditions than it would be if action is delayed until revenues start to fall.

There are benefits in keeping a firm lid on expenditure when there is cyclical growth in revenues. It may be difficult to reduce expenditures when revenues are high, but it is even more so when revenues fall as a commodity boom subsides. It is against this background that I see great potential benefits from the decisive actions the government has started to take in the last two weeks to reduce the fiscal deficit.

The financial difficulties experienced by government in 1995 came partly as a result of widespread duty remissions and exemptions. While Inland revenues grew by 35%, (led by higher company tax receipts), Customs collections actually fell. Exemptions grew fastest in the logging sector. The declared rate of log taxation is between 35% and 38%. However, due to exemptions, only around two thirds of the potential revenue was collected in the second half of 1995. The value of timber export tax exemptions were over $24 million in 1995. This compares to an average of $7 million in the two years to mid-1994. In 1995 revenues foregone because of timber export tax exemptions were equivalent to 8% of the total government revenues.

The current tax system has served the government well. For example, in spite of the growing value of exemptions, the current system has generated a 51% increase in recurrent revenues between 1993 and 1995. I believe that the financial difficulties can be averted within the framework of the present tax regime without the need to restructure it. Potentials for even better results can be achieved by strengthening tax administration and collection, and by withdrawing duty exemptions. I am pleased to note that the Acting Minister of Finance has very recently announced measures to deal with these weaknesses in revenue administration arising from tax exemptions.

Excessive public expenditure lies at the root of many of the problems facing the Solomon Islands economy. Hence more progress could be made in controlling expenditure. At present it is difficult for government to know exactly how much is being spent, either in aggregate or relative to amounts provided to each Ministry in the Budget. It is believed that a lot of expenditure is incurred on unbudgetted items. Expenditure control is therefore an important area for government to focus on if the fiscal situation is to be improved. In this connection, the initiatives launched by the Acting Minister of Finance at the end of April 1996 is a welcome start. I encourage the Prime Minister to keep his resolve in the difficult task ahead. And I would urge all of us, particularly his Cabinet and Parliamentary colleagues, as well as all Public Accounting officers to recognise that firm and decisive action must be taken now to resolve the fiscal problem. There is neither a short cut non an easy way out. Besides, the longer we postpone action, the more serious the problem becomes and the more difficult the solution will be.

Some of you may not be aware of the problems experienced in financing the fiscal deficit in 1995 and the first half of 1996. I would therefore like to explain the background to the problems that have caused great concern to those in government, the banking sector and the rest of us.

Early in 1995 it became clear that the $79 million budgeted deficit was beyond the financing capabilities of the financial system. At that time, commercial banks had little liquidity with which to buy government securities, and were discouraged by the size of the fiscal deficit. As I showed you earlier, commercial banks have actually reduced their stock of government debt in 1995.

Until early August 1995, government was still able to borrow from the Central Bank, but soon after, this changed. On August 4 borrowing from CBSI reached the legal ceiling that is defined by the Central Bank Act.

In the latter half of 1995, government started to build up arrears on interest payments on government securities as well as on overseas loan repayments. By the end of the year the total value of domestic and foreign arrears, including interest on securities and other arrears, reached over $50 million.

The Central Bank has been making efforts with the Ministry of Finance and the financial community in finding solutions to the arrears problem. However, only more recently under the leadership of the Prime Minister, in his capacity as Acting Minister of Finance, have solutions been forthcoming. In April this year, he took decisive action to clear interest arrears on government securities. And the dialogue between the financial institutions and the government opened up. This must continue, to ensure interest repayments are not only kept current, but also to reach an understanding on all other existing domestic debts and to settle outstanding arrears to foreign creditors. The Central Bank shall be working closely with the government and other major creditors on this in the coming weeks.

The outlook for 1996 and beyond depends upon key policy decisions taken now, particularly in the area of government finance. The 1996 Budget provided for a deficit of $50 million. In addition around $50 million of arrears inherited from 1995 need to be cleared. As discussed already, a strategy aimed at controlling expenditures and removing tax distortions should allow government to balance its budget in 1996, repay arrears and re-open the door to borrowing from the financial system.

I have devoted much of this morning's talk to fiscal policy. This is because the economy has so much to gain if government succeeds in putting its financial affairs in order, and so much to lose if it does not. The recent initiatives by the Prime Minister, if implemented fully, could set the basis for optimistism about the future. I believe in so doing, the government has given itself a platform on which to build for a future in which it can prosper in harmony with the private sector. However, there is much work still to do especially in ensuring that these measures are carried through.

Finally, I would like to take this opportunity to clear certain misconceptions in the community about the Central Bank's lending role vis-a-vis a government. It is true there are enormous pressures brought upon the Central Bank from time to time to finance government deficit. I welcome this opportunity to explain the purpose of Central Bank lending to government. That purpose is not to make up for any weaknesses in government finance that may arise as a result of excessive expenditures or weaknesses in revenue administration. This is made quite explicitly in the CBSI Act.

Lending by the Central Bank is justified only as a temporary measure in times of unexpected shortfalls in government revenues. It is in the context of the Central Bank's objective of maintaining stable demand in the economy that it is authorised to provide "temporary advances" to Government. These temporary advances are to be repaid within 6 months of the end of the financial year in which they were granted.

It should be explained that the reason why the law is so mindful about Central Bank lending to government is because it is dangerous to the economy: it fuels excess demand in the economy, it is inflationary, it causes deterioration of foreign exchange reserves, and it undermines the value of the currency.

The Central Bank's lending to government is governed by Section 30 of the CBSI Act 1976 which provides a set of stringent conditions under which Central Bank may lend to government. (I refer you to pages 8 and 9 of the Annual Report where these conditions are set out in detail). In early August, it became clear to the Board of Directors that the stringent conditions were not being met. In order to comply with the law, the Central Bank Board had no option but to stop further lending to government.

I hope this will make clear that CBSI was neither the cause of government financial problems, nor can it be the solution. However, I believe the Central Bank can play an important role in finding solutions.

Summary of Developments

In summary I would like to bring together the threads of economic developments in 1995 by returning to my opening statement that 1995 was a year of economic contrasts, and I would like to draw some conclusions from these contrasts.

In 1995 there was strong growth in exports, but the external reserves did not grow. There was strong output growth, but savings declined. There was strong growth in government revenues, but government was faced with a financial crisis. Most of all, the 1990s has seen rapid growth in the incomes of both the private sector and government: the private sector has accumulated wealth as a result, but government has plunged deeper into debt.

The key to the contrasts is fiscal policy. The external reserves could improve if lower government spending reduced the excess demand that has fuelled import growth. Monetary and savings growth can grow more strongly once government begins to clear arrears to the private sector. The contrast between growth in private sector wealth and public sector debt is the result of continuous fiscal deficits to finance government consumption.

I cannot emphasise more than I have already done, that the big imbalances between government revenues and expenditures must be addressed. Fiscal adjustments will help to build a stronger long term financial position for both the public and private sectors. These adjustments will mean lower debt and therefore lower taxes in the future. They will reduce excessive demand growth. That means lower inflation, growth in our external reserves and a more stable exchange rate than would otherwise be possible. An improved government financial position will foster an environment in which the private sector can prosper alongside government. This is the brighter scenario which continued progress on fiscal retrenchment can put within reach.

The 1990s has been a decade of economic opportunity. It remains so. The Solomon Islands has the resources to generate increased economic benefits to its people if structural weaknesses in the economy are addressed. It will not be easy to implement the changes needed to harness the strengths of the economy.

It may take a little time and much commitment before the full rewards from these efforts are secured. Economic progress will require effort, greater consultation and cooperation between the relevant government agencies, statutory corporations, the private sector and non government organisations. In that connection too, I hope that we can all offer encouragement and support to the government in its brave efforts to restore health to its financial position.

Closing Remarks

In concluding, I would like to acknowledge the assistance of and thank those who have helped to produce the 1995 Annual Report. Firstly, to the CBSI Board and my own staff. This is the collaborative work of the Board, management and staff of the Bank, but particularly those in our Economics Department. Secondly, I thank those of you who have cooperated with us in our consultations early this year, and in supplying information which helped us to build the detailed picture on which the economic report is based. In that regard, we appreciate the kind assistance of various government departments, statutory corporations, private sector companies, diplomatic offices, NGOs and individuals. The views expressed in the Report are of course entirely the responsibility of the Bank. Thirdly, I must mention here that we have had valuable cooperation from three sources: the office of the Auditor General, Robert Emery Accountants (our external Auditors) and Solomon Islands Printers, which, as in the past, have had to bear with our last minute completion of details to ensure copies of the report are available this morning.

Ladies and gentlemen, I have already taken up too much of your morning but may I now commend the 1995 CBSI Annual Report for your reading, and thank you very much for listening.