

1996 Speech

GOVERNORS STATEMENT AT THE LAUNCHING OF THE CBSI 1996 ANNUAL REPORT

I. Introduction

Honourable Ministers and Members of representatives of the diplomatic corps, permanent secretaries and senior government officials, heads of statutory authorities, bank managers, Directors of the Central Bank, officials of non-government organisations, representatives of the private sector, representatives of the media, ladies and gentlemen!

It is my pleasure and honour to welcome you tonight to the official launching of the Central Bank's 1996 Annual Report. The launching of the Central Bank Annual Report is a special occasion for the Bank and I thank you for making the time available from your busy schedules to attend this evening. This occasion provides an opportunity for me to fulfil a responsibility of the Central Bank in presenting an assessment of economic conditions and prospects for Solomon Islands and to account for the Bank's actions in 1996.

At the outset, I would like to thank all the government departments, statutory authorities, the banks, private sector companies, NGOs, and individuals who have provided data and information used to complete this report. I would also like to acknowledge the useful comments provided by the Board of CBSI and other individuals on earlier drafts of this report.

I will present my talk in two parts. In the first part, I will briefly survey the major developments and policy issues in the Solomon Islands economy in 1996. The main messages coming from this part of my presentation will be the following:

- There was a slow down in the rate of economic growth in 1996.
- The impetus for economic growth in 1996 (as has been in the last few years) came mainly from the harvesting of natural resources rather than from investment and productivity growth.
- Inflation has declined in 1996 but remains higher than those of our main trading partners and neighbours.
- The balance of payments outcome on one hand has been good with strong exports and weak imports. But on the negative side, there was a build up of external debt service arrears by the government.
- Public finances have continued to be weak with major shortcomings in the administration of both revenues and expenditure.
- The government securities market has remained inoperative.
- The banking system was liquid but growth in credit was depressed in 1996.
- Logging activities have continued unabated at a high rate, raising questions of sustainability and environmental damage and,

- There is increased optimism about the start of Solomon Islands first gold mine in 1997.

In the second part of my presentation, I will look at the major challenges facing Solomon Islands. In this section the messages to note are, the need for micro and macro economic reforms, adoption of appropriate policies to maximise value from natural resources, the need for good governance and, the importance of partnership in development.

I will end my talk with the conclusion that in order to move forward with sustainable economic and social development in the future there is an urgent need to address these challenges seriously.

II. Developments in 1996

I will now turn to survey the main highlights of the Solomon Islands economy during 1996.

Real Sector:

Growth in 1996 in the real sector slowed down to a provisionally estimated rate of 3-4% compared with 7% in 1995.

As foreshadowed on this occasion 12 months ago, this slowdown was attributed to a downturn in primary production especially in the fisheries and agriculture sectors and depressed growth in domestic credit. Construction activities appear to have also slowed down and foreign investment flows have been insignificant. Several multimillion dollar projects have been approved through the FIB machinery but these have yet to materialise. Creation of new employment opportunities has therefore been slow especially in the formal sector. The slowdown in the production of some export commodities however, was offset by favourable prices for these commodities on the world market.

The annual inflation rate although high in the first half of 1996, has declined in the latter part of the year to around 9% and down further to 7% in the first quarter of 1997.

The decline in the inflation rate reflects lower domestic demand and price stability in countries where most of Solomon Islands imports come from. However, inflation in Solomon Islands is still very high in comparison with our major trading partners and regional neighbours. This is an area which has to be addressed coherently, as keeping inflation low is a necessary requisite to maintaining competitiveness of Solomon Islands production.

That will require adequate coordination between monetary, fiscal and wages policies. An effective coordination of these policies is essential in order to achieve stable prices as well as stable nominal and real exchange rates. I shall be returning to this issue later on in my talk.

External Sector

The external sector was the main source of growth in the economy during 1996. The overall surplus on the balance of payments was \$64 million (the highest surplus ever recorded in Solomon Islands since Independence) compared with a \$3 million deficit in the previous year. This massive turnaround was driven by the trade account which saw exports increased by 10% to \$656 million while imports grew marginally by 2% to \$540 million.

This positive outcome allowed the external reserves to rise to \$117 million at year end which resulted in the build-up of liquidity in the banking system. The level of external reserves at year end represents about two months of import cover compared with less than one month cover at the end of 1995.

Another contributing factor to the higher level of external reserves, though negative, was the build-up of government external debt service arrears. The reserves have been kept artificially high because of a \$24 million arrears on official external debt. If government had serviced all its external debt commitments in 1996, the reserves would have fallen by \$24 million.

The total external debt of Solomon Islands grew by 12% to \$583 million, almost the same level as the country's gross domestic product. Of this the government held 60% and the private sector the remaining 40%. Solomon Islands' official external debt is mostly on concessional terms and therefore it should not pose an undue burden on debt repayments. It is most unfortunate however, that the government had failed to honour its debt obligations to these foreign creditors. As in the past, I would urge the government to adopt a coherent debt strategy and settle its obligations to foreign creditors as a priority.

In 1996 the Solomon Islands dollar depreciated marginally against the basket of currencies to which it is tied. Against the individual currencies, the SI dollar appreciated 10% against the Japanese Yen and depreciated by 4-11% against the other major currencies.

An important objective in managing the exchange rate policy is to ensure that Solomon Islands has enough external reserves to meet its balance of payments obligations. The pursuit of this policy, which entailed some nominal depreciation of the SI dollar against the exchange rate basket, has been largely successful in meeting its primary objective.

While on the subject of Exchange rate policy, I would like to clarify the Bank's position regarding recent suggestions to include gold bars as part of the external reserves with the aim to appreciate the Solomon Islands dollar. I thought I should make the explanation by reminding us of a few things. First, it is important to remember that the exchange rate is simply the price of foreign currency in local currency and this price is determined by supply and demand for foreign exchange in the economy. Secondly, nowadays very few countries hold gold as part of their official reserves and those that do are gradually selling off these assets. This is one of the reasons for the downward trend in gold prices. Thirdly, the world monetary system has moved away from the gold standard a long time ago and never return to it again, hence it has not been an important consideration in managing exchange rate policy.

For these and other reasons, the Bank believes that the current system where the exchange rate is based on a trade-weighted basket of currencies has been successful in ensuring stability as well as the competitiveness of the export sector and at this stage, there is no reason to change it. Besides, even if the government decided to include gold as part of the reserves, someone has to produce the money to buy it in the first place. Under current circumstances, I am not sure if this is a worthwhile proposition at all.

Monetary Sector

Monetary conditions fluctuated during 1996 and were dominated by developments in government finances and the balance of payments. Broad money rose by 16% during the year reflecting the strong growth in deposits generated by the trade surplus mentioned earlier. Domestic credit however was more subdued as the government securities market remained inactive and the banks maintained a cautious approach to further lending. This had a dampening effect on domestic demand which contributed towards the slower rates of inflation witnessed in the second half of 1996 and early 1997.

The slow-down in domestic credit caused a liquidity build-up during the year. Free liquidity therefore, grew to a peak of \$84 million in October, prompting the Central Bank to introduce the Bokolo Bills to mop up the excess liquidity. Consequently, free liquidity declined to \$40 million at year end.

The interest rate margin between average deposit and lending rates widened during the year as banks reduced deposit rates but maintained lending rates in the face of increasing pressures on their profitability arising from the government's inability to service its debts on a regular and timely basis. It will be noted that interest rates in Solomon Islands are deregulated and the banks are free to set their own rates. The Central Bank is however concerned about the high interest rate margins and is anxious to see them reduced. Measures are being considered to address this concern during 1997.

Government Finance

Fiscal operations of government are a critical aspect of macroeconomic management in the Solomon Islands, given the large size and importance of government as a player in the economy. Its policies and activities therefore can have a dramatic and immediate impact on other sectors of the economy.

The government's financial problems worsened in 1996 and these had impacted on output, balance of payments and monetary conditions. The loss of confidence in the government securities market for example, led to the slow down in domestic credit and dampened demand which led to slower growth in import payments during the year. It also led to the accumulation of debt service arrears which increased to \$50 million at the end of March 1997.

Government revenues were on target with the Budget estimates. As a matter of fact, these were 7% higher than the previous year. Revenues could have been even higher had it not been for the widespread tax exemptions and remissions

given to the private sector. For the logging industry alone, this was about \$50 million,

which is almost equivalent to the estimated fiscal deficit for the year. If tax exemptions and remissions on other exports and imports are taken into account, the total revenues foregone by the government in 1996 would be substantially higher.

An added complication to this problem is the absence of adequate data on public finance. For 1996, it is not possible to estimate government expenditures due to non-availability of adequate data. It would however, be correct to assume expenditures have been higher than the previous year hence the deficit could be around \$60 million.

The absence of timely data on government expenditure is indeed a serious setback in managing and for effective monitoring of fiscal operations. It is therefore imperative to strengthen the collection and collation of government finance statistics (GFS).

Problems in fiscal management have also contributed to many other problems in public sector. For example, these have led to the failure to address the physical and social infrastructure needs of Solomon Islands and to service and maintain existing public infrastructure. Better prioritisation of expenditure and its more effective administration are urgently required. The much-talked-about expenditure control measures must now be put in place to ensure government finances are strengthened and improved in 1997.

It is ironic that government was experiencing serious cash flow and arrears problems at a time when the export sector (especially log exports) was booming and government revenues were strong. This points to what I believe is the main cause of the current fiscal problems - an unbridled government expenditure policy.

It is not news that uncontrolled government expenditure is the root of all the financial problems faced by the government. We have seen that revenues have been on target and the current tax-to-GDP ratio of 24% represents a very outstanding performance compared to other developing countries. It would seem to me that the key challenge to the government in this respect would be to use its revenues efficiently and to control expenditures effectively.

Gold Ridge

In the context of the need for sound and effective management of public finances, I would like to record the Bank's preliminary perspective on Gold Ridge, particularly in relation to the excitement about the benefits it would bring to Solomon Islands. I say our impressions are preliminary because a proper analysis to ascertain the impact of the project on the domestic economy has yet to be done. In that regard, it is gratifying to note that a study to address a lot of these issues has been commissioned by the Ministry of Finance.

Recently there appeared to be an impression in certain quarters that when the new gold mine is operational it will solve our fiscal and balance of payments problems. The gold mine may indeed create significant economic activity and bring potential benefits in terms of employment and government revenues. Export receipts will definitely be increased as the export base is broadened. In terms of investment, once Gold Ridge is up and running, it will boost further investment in the minerals sector. These are some of the potential benefits Gold Ridge will bring to this economy. However, in the context of the current fiscal situation, and more particularly in terms of total government financing needs, receipts from this project will be insignificant. Furthermore, revenues in the form of income tax payable by the mining company are not expected for another five or six years. What this means is that while the Gold Ridge project and other mining activities will indeed produce potential long term benefits, it is not a basis for adopting a relaxed attitude to fiscal adjustment. Fiscal adjustment is an urgent task for the government and it must be started without any further delay. The further this process is postponed into the future, the greater will be the magnitude of future adjustment required and the more painful it will become.

CBSI Operations

I would like now to say a word about CBSI's operations.

The Bank reported another profitable year in 1996, with an operating profit of \$4.5 million being registered for the year.

I realise that a lot of the functions performed by the Bank are not readily seen by the public because much of its activities do not have a "physical presence", for example in regulating the banking system, conduct of monetary policy and so on. However, there are several areas where the community comes into direct contact with the Bank's activities. One such example, is that of issuing the Solomon Islands currency. In 1996, the Bank issued a new series of notes with additional security features and using more durable paper. At the end of the year the total currency issued was \$63 million. This is made up of \$59 million in notes and \$4 million in coins.

Another important function performed by the Bank, which is relevant to some of us here tonight, is the administration and implementation of the Small Business Finance Scheme (SBFS). In 1996, the Bank was involved in 34 loan proposals with guarantees worth \$1.4 million. Since the scheme started some five years ago over 300 loans worth \$11 million have been processed by the Bank.

The Central Bank also plays an important role in supporting the Credit Union movement. During the year, this involved registration of new credit unions, financial assistance to Solomon Islands Credit Union League (SICUL) and giving of advice and support for credit unions experiencing management and other difficulties.

The other task being performed by the Bank which I would like to highlight, is the role of the Bank as a source of economic information. You will no doubt agree that without relevant information, important decisions cannot be made properly. The Bank has been able to provide this service to the community and policy makers, by

making economic information available through its regular reports, like the one we are launching tonight. And for the information of those who are not aware of it yet, apart from the Annual Report, we publish a Monthly Bulletin and a Quarterly Review. We, in the Bank believe that the timely provision of these reports is an important contribution considering that very few other institutions produce and analyse economic data in Solomon Islands.

These are but a few of the activities performed by the Bank in 1996. Discussions on and descriptions of the rest, including the administration of the Banking Act and Exchange Control Regulations, are included in the annual report.

III Challenges and Future Directions

After having spoken about economic developments and the Bank's operations during 1996, I would like to devote this final part of my talk on what I consider to be the challenges and opportunities facing Solomon Islands.

Solomon Islands has been independent for almost two decades. During that time, progress has been made in some areas but, on the whole, the opportunities for social and economic advancement of the country have been either under-utilised or largely foregone. Consequently, the rate of economic growth in the Solomon Islands has been very low; and as noted earlier, what economic growth did occur, especially in the last five years, it was on the basis of unsustainable harvest of natural resources rather than on the basis of productive investments.

The poor economic performance of the past is reflected in the equally poor economic and social indicators for Solomon Islands. According to a recent report by the Asian Development Bank, Solomon Islands GNP per capita basis of US\$560 is one of the lowest in the region. In addition, the social indicators for Solomon Islands in terms of life expectancy, doctors and teachers per 1,000 population, infant mortality, access to safe drinking water, adult literacy and average years of schooling are among the worst in the region. At the same time too, rapid urbanisation and weaknesses in public policy in the Solomon Islands have been associated with rising crime rates, breakdown of the family unit and values, increases in sexually transmitted diseases, alcohol abuse, teenage pregnancies and other social problems.

In these circumstances, it is only appropriate to take stock of the situation and pose the question to policy makers, administrators, and indeed, the whole nation, as to why is it that our performance has been so bad after 19 years of independence; after almost \$3 billion of government expenditure, and after rapid harvest of our abundant and valuable natural resources? We need to do a thorough soul search as to why things have not gone well for the Solomon Islands and why we lag so far behind other countries in the region which have achieved vast improvements in their standards of living, with less natural resources.

I do not for one moment pretend to have the answers to these important questions since economic and social development is a complex multi-faceted process. Besides, there are many factors at play in the development process and it is quite difficult to separate them and attach specific importance to any single one of them.

Notwithstanding that, I would like to suggest some of the issues that must be addressed if investment and growth is to be accelerated and maintained. These issues can be classified into 5 categories namely: macro-economic management, sectoral policies, problems associated with natural resource exploitation and management, the need for good governance and the importance of partnership in development.

Macro-economic Management

As the Central Bank has said over the years, the major problem in macro-economic management has been excessive government expenditure, continuous unsustainable deficits and debt accumulation. This problem has developed and has grown in magnitude over the years and it has now reached a situation where the government's till is literally empty.

The solution to this problem is obviously to reduce expenditures to affordable levels. This, in the current circumstances, means trimming the government machinery to a size which can be financed from ordinary revenues. Operating expenditures need to be controlled and, as a general rule, borrowing should be confined to financing of the capital program only.

Another weakness of public expenditure has been the excessive focus on general administration and low priority given to maintenance and capital expenditure. Too much financial resources is already spent on civil service emoluments and general administration. In this regard, the recent public service pay awards as well as increased terminal grants to members of parliament cannot be explained by normal economic rationale, let alone any logic in view of the current financial circumstances of the government.

In addition, the quality of many of the public sector capital projects needs to be improved. This explains why the high investment - to - GDP ratio of around 30-35% has had little impact on economic growth. As I said earlier, the main impetus for economic growth in recent years has come from the rapid harvesting of natural resources and not from growth in investment and productivity. Hence, there is now an urgent need to improve the quality and effectiveness of government expenditure and to those which will give high economic and social rates of return to the citizens of this country.

To achieve that, there is no better place to start than with the fiscal budget. In order to restore confidence in this important document, an overhaul and proper rationalisation of the budget process must be done. A very important principle is to plan on spending only what is earned. If Government has to borrow, it should only do so from non-inflationary sources, that is, from outside the Central Bank. It will not be realistic for government to contemplate further borrowing given its inability to service debt and hence the low level of confidence in the securities market.

Having said all that, I believe that improvements in the government's financial position can be achieved. This would however, require strong political will and support as well as a firm support within the technical government apparatus. In order to set the stage for government finances to return to normalcy, I strongly suggest that decisive steps be now taken on the following line:

- (1) Apply and maintain tight control on expenditures. To do this, a system of expenditure monitoring and control mechanism will need to be introduced.
- (2) Make it illegal for any one in government to commit funds for any purposes outside of the approved Budget.
- (3) Give priority to making those payments where government has legally binding commitments and cut back on other expenditures of a discretionary nature.
- (4) Eliminate all tax and duty exemptions. I believe the elimination of these concessions would bring immediate benefits to the government.
- (5) Establish clear guidelines and criteria for the future granting of tax and duty concessions. I would recommend that the awarding of tax exemptions and concessions should be vested in an interdepartmental committee of senior officials without the Minister. The Minister should be allowed to focus on policy issues rather than deal with administrative matters.
- (6) Revenue administration should be strengthened to improve collections and compliance by tax payers. If this needs technical assistance in the concerned departments, as I believe it will, then appropriate steps should now be put in place to get such assistance as improvements from that will be far reaching.
- (7) The revival of the securities market will be crucial if the government is to borrow new funds from non-inflationary sources to finance any deficit it may have. A combination of a realistic budget, its effective implementation and monitoring, and above all, establishing a track record of timely servicing of government securities will be essential to restoring confidence in the securities market.

Monetary policy will play a very crucial role in such a course of action as outlined above and this is where Central Bank should be involved. In its conduct of monetary policy the Bank has two key objectives namely, low inflation and balance of payments stability. It must be emphasised however that the achievement of these objectives will require close consultation and coordination with other policies, particularly fiscal, wages and exchange rate policies. For example, low inflation can only be achieved if a tight monetary policy is accompanied by a tight fiscal policy, a wages policy which is linked to productivity growth and affordability, and a stable exchange rate. Efforts must be enhanced therefore to developing a suitable framework for policy coordination with a view to harmonising the key objectives and directions in the main arms of macro-economic policy. This process calls for the generation of suitable statistics and analysis and, above all, a desire among the various relevant parties to cooperate in the national interest. As in the past, the CBSI stands ready to play its part in any effort to achieve these aims.

Sectoral Reform Policies

Apart from the need for more comprehensive and coordinated macro economic policies, we need to formulate sectoral policies and plans. These should address in more detail what needs to be done to strengthen individual sectors of the economy. For example, action should be focused on developing a policy frame work and infrastructure requirements of the agricultural, fisheries, forestry, mining, manufacturing, tourism, transport, communications, health, education, energy and housing sectors. I think in order that these issues be properly addressed they need to be comprehensively studied and analysed first.

It seems to me that this would be an area which technical and financial assistance will be required. I am sure appropriate assistance can be easily arranged with the multilateral institutions such as the World Bank and Asian Development Bank and perhaps even through bilateral assistance. However, such assistance should be expected only if action on our part demonstrates decisiveness, determination and a commitment to reforms. Once again, the commitment of the political government to undertake comprehensive reforms will be essential.

Benefits from Natural Resource

Solomon Islands is really fortunate to be well endowed with natural resources such as forests, fish and minerals. But the need to properly manage these resources is becoming more and more urgent. Not only that it is important to be mindful of sustainability and environmental problems but that any gains from the sale of these resources be invested wisely in the development of other assets, particularly, the human resources and the physical infrastructure. The extractive nature of these industries, and the non renewability of the resource as in the case of mining, makes the need to properly utilise the windfall revenue from exploiting these resources, all the more important.

To reiterate the point, let me mention four concerns which in the last few years have become quite evident from the way natural resources have been managed in the Solomon Islands.

First, SI has not been receiving full value from its harvest of natural resources both in terms of tax revenues and foreign exchange earnings. The main reasons for this appear to be the excessive use of export tax concessions and remissions and transfer pricing in the export of Solomon Islands natural resources.

Second, there is the concern about the use of government revenues from the proceeds of natural resources. Most of these revenues have been used for general operating expenditure and very little or none at all has gone towards the building up of the capital base of the economy. This to me is a very inefficient application of revenues, especially those derived from a depleting resource.

Third, there is the concern about the sustainability of harvesting the resources, especially in the forestry and fisheries sectors. The current rate of logging, for example, is I believe unsustainable. In this context, the recent adoption of a Code of Practice in the forestry sector is a welcomed development, but to achieve its objectives it requires full compliance by all parties involved in the logging industry. The concern about sustainability raises further questions regarding the sharp adjustments to government expenditure and living standards which might be

necessitated after these resources are depleted. This also raises other issue of whether it is fair and equitable for the present generation to harvest and consume all the proceeds from the harvest of natural resources and leave nothing for the future generations.

Finally, there is the concern about the environmental impact of natural resources exploitation. The impact this will have on soil erosion, marine life, the flora and fauna and the subsistence livelihood of rural people should not be underestimated.

All these issues will have to be addressed urgently to ensure that Solomon Islanders derive maximum value from the exploitation of their resources.

Good Governance

Good governance is an essential ingredient for economic and social advancement for any nation. The concept of good governance embodies notions of efficiency, transparency, and equity in public policies and administration. I am not here to make judgements on whether or not to what extent the efficiency, transparency and equity criteria are currently being met in public administration in Solomon Islands. Instead, I would like to point out a few areas of concern which should be addressed.

First, in the conduct of public affairs, I believe that ethical standards must be set at the highest level. If our leaders are not honest and inefficient in carrying out their responsibilities, this will have a bad demonstration effect on public servants and the rest of the community. This could lead to the eventual loss of faith and trust in government.

Second, in the recent past, there are numerous reports of corruption in high places. Sadly, bribery and corruption has become a way of life in some quarters, most prominently in the allocation of land, business licences, tax concessions and so on. I would urge that harsh penalties must be introduced for bribery and corruption and must apply equally to those who offer and those who receive bribes. Accordingly, the capabilities of the Solomon Islands Police and judiciary must be strengthened to investigate and prosecute those involved.

Third, there have been many allegations that the quality of our public administration is poor. The civil service appears to be heavily politicised especially in the area of making appointments. This should be based on merit alone and appropriate training programs should be introduced to build up the necessary skills for the job.

Fourth, the legal and regulatory framework should be improved and strengthened. Many of our laws were introduced during the colonial era are now out-of-date and should be revised.

I might add that the responsibility of ensuring good governance is expected of us all. To that end, I believe the civil society, churches and non-government organisations should realize their role in promoting good governance. Accordingly the community should be encouraged to legally and appropriately ensure that good governance is upheld.

Partnership

This leads me now to conclude my talk, and I think be-fitting, to end with a challenge to all of us: that the enormous challenges facing the Solomon Islands economy can not be solved by the Government alone. It calls for effective and meaningful partnership: partnership between the different levels of government, the private sector, non-government organisations, churches and our local communities. It also calls for a partnership with overseas friends.

As we review our performance, we must recognise our strengths as well as our weaknesses. Let us not forget that SI has many friends who are willing to lend a helping hand so we must not shy away from seeking help from friends around the world in overcoming our weaknesses and problems.

At the same time let us be mindful of those who come as friends but in fact have selfish motives and agendas. In this connection, I would like to caution all of us to always be on guard against the “get-rich-quick” operators, schemers and con-men who make their living out of telling lies. You need no reminding but lest we forget, the truth is that there is no short-cut to becoming successful in business or in life except through hard and honest work. Remember also that con-men are not only after your money; Theirs is a trade which may cause irreparable damage to your own, as well as your business reputation and integrity. You should have no time for them.

Before I resume my seat, it would be most unfair of me not to acknowledge the hard and professional work of our printers, our External Auditors, the Auditor General's office, as well as my own staff, in particular, those in the Economics Department, in making sure we have the 1996 Annual Report completed and available for tonight's occasion. I would also like to also register our thanks to the management of Honiara Hotel for looking after us this evening.

Ladies and gentlemen, I think I have already overran your patience, but may I now commend the 1996 CBSI Annual Report to your reading. May God bless you and thank you for listening.