1997

GOVERNOR'S STATEMENT AT THE LAUNCHING OF THE CBSI 1997 ANNUAL REPORT

I. Introduction

Honorable prime Minister, Speaker of Parliament, Minister of Finance, Ministers', Members of Parliament, Honorable Chief Justice, Attorney General, 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 organizations, representatives of the private sector, representatives of the media, ladies and gentlemen.

It is my pleasure and honor to welcome you tonight to the official launching of the Central Bank's 1997 Annual Report. It is gratifying to note that for the first time in my association with the Central Bank, both the Prime Minister and Finance Minister are attending this function. This signifies a change in governance where there is now more openness and consultations in the decision-making process.

The launching of the Central Bank annual Report is a special occasion for the Bank. This occasion provides an opportunity for me to fulfill an important 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 1997.

At the outset, I would like to thank all the government departments, statutory authorities, the banks, private sector companies, NGOs, and individuals who have produced date 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 four parts. In the first part, I will summarize the main messages coming out of the 1997 Annual Report; in the second part, I will briefly survey the major developments and policy issues in the Solomon Islands economy in 1997; in the third part I shall highlight the major aspects of the Bank's operations in 1997 and in the fourth part I shall be saying a few words on the prospects and challenges in 1998 and beyond.

There are five messages coming from the 1997 Annual Report and these are summarized as follows:-

<u>First</u> our poor economic performance in the past has been due primarily to weak policies and institutions including inappropriate fiscal policy, weak public

administration, poor quality of our infrastructure and weak legal and regulatory framework, and inadequate incentives for the private sector.

As an aside, and on a more positive note, it is heartening that after the well-known failures of past governments, we now have a Government in place that has adopted the right approach in dealing with the many social and economic problems of the nation. Indeed some important initial steps have been taken and no doubt much more will be done in time. It is therefore important that we all support these endeavors by the Government as it establishes the foundations for a more prosperous and happier future for us and our children.

The second message is that the economic performance in 1997 was mixed. Some positive developments during the year were overtaken by the impact of the Asian crisis in late 1997. This gave rise to both budgetary as well as balance of payment problems.

The third message I wish to convey is the importance of economic policy coordination. That this means is that all policy arms of Government must move in the same direction and should not be at cross-purposes and contradict each other. I believe that we have achieved a lot in this area in recent months through policy discussions and dialogue among ourselves, with multilateral financial institutions and other development partners. However, there is still room to improve and to fine-tune policy coordination and we should put more effort into this.

The fourth message relates to the foundations for long-term growth of the SI economy. The need for establishing a conducive environment for private sector investment cannot be over emphasized. This requires implementation of sound macro-economic policies, a transparent legal and regulatory framework simple institutional requirements and good physical infrastructure to complement private sector investment. Efficient transport system, good health services, a reliable and efficient electricity supply, and a supply of education and trained manpower are essential requirements for private sector development. Many of these shortcomings will need to be addressed over the long term in the context of our Development Plan.

The fifth message is that the future of Solomon Islands depends very much on how prudently we manage our economic policies, how we frame and implement our public investment program, how fast we reform our laws, regulations and sector policies, how well we mange our natural resources, and how well we encourage and stimulate the private sector to take a leading role in the development of this nation. The Government has already started with actions in many of these areas and I encourage and support the Government in its endeavors to meet all these challenges in the years ahead.

II. Developments in 1997

I will now survey the main highlights of the SI Economy during 1997. These developments are covered in more detail in the report.

Gross Domestic Product

In 1997, real GDP growth is believed to have slowed, for a second year in a row, from 3.5% in 1996 and 7% in 1995. The evidence of economic slowdown comes from the overall primary production index for the major commodities which showed a decline of 8% in 1997 following a decline of 5% in the previous year. The slowdown came as a result of lower production in the forestry and fisheries sectors together with developments in international prices for Solomon Islands' principal export commodities.

Inflation

The rate of inflation, as measured by the Honiara Retail Price Index, averaged 8.5% at the end of 1997 as against 9.2% in 1996. though relatively low in comparison to previous years, this is till high compared to that of Solomon Islands' main trading partners.

The decline in the inflation rate in 1997 actually began towards the fourth quarter of 1996. In large part, this resulted from subdued domestic demand stemming from the government's inability to access further credit and the relatively tight monetary policy stance adopted since the fourth quarter of 1996.

Action by the government to devalue the Solomon Islands dollar at the end of the year added new pressure on the import component of the CPI. Consequent to the devaluation, the import component of the CPI. Consequent to the devaluation, the import component of the index overtook the local items as the main contributor in the rise of the Honiara Retail Price Index. Over time, a rise in the import component will translate into a rise in the local component of the index.

The conduct of macro-economic policies should aim to minimize inflationary pressures, especially in view of the need to maintain export competitiveness. This is also vital to the attainment of the reform objectives. And the key to minimizing further pressures will be through efective coordination of the exchange rate policy with other policies of government, including fiscal, incomes and monetary policies. In our circumstances, these policies must be supported by the private sector which should make every endeavor to exercise price restraint. This would also compliment efforts to stabilize wages.

Government Finances

Government finances have been a major cause of macro-economic instability for some years. This issue is discussed in detail in the Report.

Government finances during 1997 remained problematic with weak revenue administration, over-expenditure and mounting debt arrears. As you are well aware, this problem has continued over a number of years.

In the absence of data on expenditure it is estimated that the government had a budget deficit of $110 million as measured by the change in the total stock of debt between 1996 and 1997.

Revenues collected in 1997 were lower than in the previous year and the budge estimates for 1997. It is estimated that revenue collections would have been higher by $96 million or 30% if there had been no duty exemptions and remissions. I wish to point out that had the duty exemptions and remissions not been given, the fiscal deficit in 1997 would have been only $14 million rather $110 million. It is pleasing to note that this problem is now being addressed by the new government.

Total expenditure on a cash basis was $306 million in 1997, well below 1996 expenditures and the 1997 budget estimates. However, the worsening of the government arrears position by $110 million during 1997 suggests that total expenditures was significantly higher than the cash expenditure.

The new Government has made significant progress in rescheduling and reorganizing most of its domestic debt. This is most welcome especially by the financial institutions whose earnings and cash flow positions were seriously affected by the arrears. I believe the new government is serious in its endeavors to address the debt service arrears and to re-open the securities market. However, the task remains far from complete, especially in addressing external debt arrears.

Fiscal management must be improved drastically if there is to be success in improving the Government financial position. The Auditor General's concerns in his reports for 1993-95 precisely highlight these needs. It points to the urgent need to improve SIG accounting and audit standards. The Auditor General's inability and refusal to express an opinion on the accuracy or otherwise of the SIG accounts because of inadequate financial records is a serious indictment of government's financial management. This must be rectified quickly. Other serious concerns brought out in the Auditor General's reports include the breach of the relevant instructions and regulations, the wide discrepancies between SIG accounting records and bank statements, large value of dishonored cheques and unretired imprests to public officers, large unrecorded liabilities, and large contingent liabilities in the form of SIG guarantees. All these concerns must be addressed as a matter of priority.

In addition, expenditure monitoring and control procedures are currently non-existent. These procedures must be introduced quickly to ensure that each Ministry within government complies with the budget allocations made to it. Accurate, reliable and timely accounts would be an essential requirement for government tot monitor and control its expenditures.

External Sector

The balance of payments outcome for 1997 showed an overall surplus of $34 million, lower than the $62 million surplus in 1996. The surplus raised the level of reserves to $150 million or just under two months of import cover, slightly higher than at the end of 1996. The surplus came largely from the capital account flows. The trade account was in deficit because of the downturn in log exports in the second half of the year along with a sharp rise in imports.

The external account performance in 1997 was influenced by the government external arrears position; the Asian economic crisis, and the devaluation of the SI dollar. At the end of 1997, the amount of government external arrears totaled $75 million, of which more than $52 million arose from non-servicing of debt since 1995, and $23 million represented outstanding contributions to regional and other international organizations. If these arrears were cleared, the underlying level of reserves would be reduced by one-half. This provides an import cover of only a month. In other words, we are overstating the true position of the external reserves to the extent of $75 million. Sadly, the events that led to the current arrears situation could have been avoided, as I explained in my earlier comments on government finances.

The impact of the Asian economic crisis on Solomon Islands key export commodity probably brought home the message of the need for sustainability, more than any other event during the year. Just as the government arrears had artificially keep the reserves level high, so has the flow from log exports, long known to come from unsustainable harvesting rates. Further, up to mid 1997, the economy had been made to depend on logs for more than 50% of its export receipts while government counted on it for more than 50% of its revenues from international trade taxes. The fundamental cause for concern is that the economy has become vulnerable to external shocks because of over dependence on the logging industry. This is a structural weakness of the economy which needs to be addressed by government if Solomon Islands is to cushion against future adverse developments in one or two major export commodities, as is now happening.

The devaluation implemented in mid-December was a necessary step in the light of the external reserves being seriously threatened by, among other developments, the slowdown in log export receipts. Prior to this action, the reserves were falling precipitously and had it not been for the flows of official transfers in the preceding months, the reserves would have been significantly lower in terms of import cover. The devaluation allowed the reserves to be sustained at around two months cover by the year-end.

As emphasized in the Report, for the devaluation to have a positive impact on the balance of payments, and to minimize the pressures on price levels that inevitably follow, this action must be supported by other appropriate policy measures. Restrictive monetary, fiscal and incomes policies will need to be firmly in place to improve the balance of payments weaknesses.

Monetary Developments

Monetary developments were influenced by the balance of payments, as domestic credit remained subdued as a result of problems in government finances. The irony is that the sluggish growth in credit took place at a time when there was surplus liquidity in the system as well as relatively low interest rates.

Broad Money (M3) growth during the year slowed to 6% as against 16% in the previous year. The slowdown came particularly in the second half of the year as the external sector felt the impact of the slowdown in log receipts.

Total domestic credit rose by only 3% for 1997, up slightly from a growth of 2% in 1996. Credit to government remained depressed because of the continuing problems in the government securities market. Credit to the private sector rose by 7%, slightly up on the 6% in the previous year.

Surplus liquidity remained relatively high throughout the year. This in part, caused interest rates to decline. However, deposit rates fell faster than lending rates and resulted in the widening of interest rate margins.

Price and external stability remained important objectives of monetary policy throughout the year. The inflation rate remained relatively low and stable by historical standards. External reserves increased but came under pressure towards the end of the year. Under these circumstances, a relatively tight monetary policy stance was maintained since the last quarter of 1996. The required liquid asset ratio (LAR) could not be deployed for monetary policy purposes partly because the ratio was already at its legal maximum of 40%, and partly because the securities market was inoperative. Given this situation, the mop-up instrument (Bokolo Bills) remained in place throughout the year.

III. CBSI Operations

I would now like to turn to CBSI's operation in 1997.

The Bank had another year of profitable operations in 1997. Total operating profits were $3.3 million compared with $4.5 million in 1996. The reduction in profits arose from several factors including a reduction in domestic interest income from lending, interest costs associated with the conduct of monetary policy through the issue of Bokolo Bills and higher administration expenses.

One of the important functions of the Central Banks is to provide economic data, analysis and advice on matters affecting the SI economy. The Economics Department of the Bank is engaged in the compilation and analysis of economic data and dissemination of the same to the Management, Board of Directors, Government and, through the Bank's regular publications, to the general public. The Central Bank publications are one of the few sources of regular economic information in the country and it is highly valued by those interested in the SI economy.

The Central Bank also has the statutory obligation to advise Government, through the Minister of Finance, on economic and financial matters. The Bank has tried to achieve this through meetings with the Minister and Permanent Secretary of finance, written communications, participation in the Government's Policy and Structural Reform Taskforce and Committee, participation an inter-departmental meetings, and more recently, briefing to the Caucus and Cabinet as required.

The Central Bank on numerous occasions warned governments in the past about the existing and emerging economic and financial problems. Had these warnings been taken seriously, I believe that we would not have been in the current economic situation. It is very gratifying that a change in approach has now taken place and the new SIAC government has recognized the importance of the Central Bank's advisory role.

In the area of Government debt management, considerable efforts were placed by CBSI on regularizing the SIG debt and debt service arrears. The Central Bank facilitated the process by developing various scenarios for discussion, assisting the Government in negotiations with the creditors, and opening the Revenue and Debt Service Accounts for the SIG to allow it to better manage its finances. This has so far enabled the Bank to service the securities market regularly since January 1998.

The issue, redemption and destruction of currency notes formed a significant part of the Bank operations. Currency issued by the Central Bank in 1997 amounted to $73 million or 11% more than in 1996.

The Bank continued to administer the Banking Act 1976. A new Financial Institutions Bill was drafted in 1997 and this was enacted in April 1998. The basic, purpose of the new legislation is to update the registration and supervision provisions governing financial institutions.

The Bank also administered the Exchange Control Regulations, which are applied liberally for current account transactions and restrictions applied only to capital account transactions. There was some tightening of exchange control policies toward the end of 1997 but this was eased again in early 1998.

Other major activities included management of foreign reserves, exchange rate policy, supervision of commercial banks and support to the SI Credit Union League. These are explained in some detail in Chapter 8 in the Annual Report.

Considerable emphasis was placed on staff training in 1997. This follows our recognition that ultimately it is the quality of our staff which will determine the quality of the Central Bank. The Bank will continue to emphasize staff training and development.

IV. Challenges and Future Directions

Now I will briefly say a few words about the challenges facing Solomon Islands.

1998 will essentially be a year of adjustment and consolidation. Some important steps have been taken towards economic stability but this is not enough. We must continually monitor and assess the domestic and external economic environment and adjust our policies as required by the changing circumstances.

In the area of macro-economic management, the most serious problem in the past has been excessive government expenditure, weak revenue administration including the widespread use of tax exemptions and remission, unsustainable fiscal deficit and debt accumulation. These problems will need to be tackled with utmost urgency. The <u>first</u> most important challenge for the government therefore is to address these fiscal imbalances.

The SIAC Government has the declared policy, and may I add, the political will to correct the fiscal imbalances of the past. Important positive actions have been taken including those announced in the text of the 1998 Budget. Nonetheless, I see considerable risks that the Government objective of achieving a balanced budget might come under serious threat for reasons of revenue weaknesses and expenditure overruns. My biggest fear is that the highly optimistic revenue forecast in the 1998 Budget may not be realized under the depressed economic conditions expected for much of this year. At the same time, pressures for new expenditures can not be ruled out. These weaknesses are already reflected in the Government's cash flow for the first four months of this year. I would therefore be most important for the Government to closely monitor developments in its cash flow and take remedial measures immediately so as to address the underlying causes of the problem.

The <u>second</u> most important challenge for the Government is to improve public finance management by improving its accounting standards and by establishing proper internal audit procedures. These points have been highlighted in the recent Auditor General's reports for 1993-95 and I do not wish to repeat them here. What I would like to emphasize, however, is that monitoring and control of public expenditures is likely to be very difficult unless competent accounting capabilities are established in each Government ministry. It is most gratifying to note that the Government is already taking measures to address this concern. I would still urge the Government to accelerate these necessary processes.

The <u>third</u> most important challenge for the Government is to keep its commitments to its creditors and service the SIG debt on time. This process has begun in February 1998 and it is most important that the debt service obligations are continually met on time to restore confidence in Government finances and to establish some kind of "track record" so that the securities markets can be re-opened. Furthermore, the credibility of SIG with external creditors remains weak and efforts must now be made to reorganize debt arrears to foreign creditors. This is very important in order for the Solomon Islands to access foreign private sources of capital once again.

The fourth challenge facing the Solomon Islands in 1998 is bringing inflation down. For some years now, our inflation rate has remained higher than that of our trading partners. This has not been helpful in maintaining the competitiveness of our export sector and has been the major determining factor in the depreciation of the SI dollar. We must try and change this; inflation must be brought down. This objective can only be achieved if we pursue tight fiscal, monetary and incomes policies and address some of the structural causes of inflation.

Moderation of wage growth can play an important role in containing inflation. Government needs to play a much more proactive role in the national wage determination than has been the case hitherto. While I warmly welcome Government's recent announcement to freeze public service salaries, further concrete steps are required to ensure this actually happens. It would also be helpful if the government were to give directives to statutory bodies and guidelines to the private sector on this matter. The guidance of government will be important to statutory bodies and the private sector employers in order to take decisions that are supportive of Government policy.

Yet another area of concern in 1998 will be the balance of payments developments and the level of foreign exchange reserves which remains at a relatively low level. The outcome in the balance of payments and reserves position will depend essentially on how we conduct our macro-economic policies (which are within our control), and developments in the external markets for SI exports (which are outside our control). Should the external environment deteriorate further in 1998, we should be prepared to take additional corrective measures; otherwise our foreign exchange reserves will be quickly depleted.

This brings me to the Government's role in economic development. This has already been adequately spelt out by the Government on several occasions both inside and outside of Parliament and I will not bore you further on it. In 1998, Government has a capital program of $200 million and a large part of the operating budget is to be used for human resource development through spending on health and education. As I stated last year, the efficiency and effectiveness of Government expenditure should be improved drastically to ensure that we get more for each dollar of public expenditure. Historically, the average investment-to-GDP ratio in Solomon Islands has been around 30-35%. This ratio is high by world standards but it has had little impact in promoting sustained economic growth. Hence, one of the challenges facing us is to improve the quality and effectiveness of Government expenditure and to give priority to projects and programs which will give high social and economic rates of return.

On this occasion last year, I emphasized the importance of good governance as an essential ingredient for economic and social advancement of Solomon Islands. On that occasion, I also called for effective and meaningful partnership between different levels of Government, the private sector, non-government organizations churches, our local communities and our overseas development partners. I am happy to note that the new government has already embraced the concept of partnership and has embarked on a path that addresses these concerns.

To conclude, we in the Solomon Islands have just embarked upon a long and difficult journey of reform and development. The results will only come with time. But it is important that we continue on the path that has been adopted and not turn back because of some obstacles along the road. We need strong political will, we need cooperation and partnership in the community, and we need assistance from our development partners to achieve better lives for all our citizens. I am sure that positive results will come from these efforts in not too distant a future.

Ladies and Gentlemen – may I conclude by commending the 1997 CBSI Annual Report to you.

May God bless you and thank you for listening.