1999 Speech

GOVERNOR RICK HOU'S STATEMENT
ON THE LAUNCHING OF CBSI 1999 ANNUAL REPORT
12 MAY 2000 (IRON BOTTOM SOUND HOTEL)

1. Introduction

Honourable Ministers, Members of Parliament, members of the diplomatic corps, Permanent Secretaries, senior government officials, heads of statutory authorities, bank managers, Directors of the Central Bank, representatives of NGOs, representatives of the private sector, representatives of the media, ladies and gentlemen, It is my pleasure and honour this morning to welcome you all to the official launching of the Central Bank's 1999 Annual Report. The launching of the Annual Report is a special occasion for the Bank. I thank you for making the time available to attend. It is the opportunity for me to fulfil the Bank's responsibility to present an assessment of the Solomon Islands economic conditions and to account for the Bank's operations in 1999. In this morning's presentation I would also highlight some major policy issues, challenges and prospects for Solomon Islands for this year.

At the outset, I would like to thank all who contributed in one way or another to the successful completion of the Report. Many of you who are familiar with the process have actually seen this as a useful exercise when we come to see you for the annual consultations every February. The information and comments provided by individuals and especially members of the CBSI Board, on earlier drafts of the Report are acknowledged with thanks.

Let me first recap very briefly where we were economically at the end of 1998.

At the end of 1998, economic growth faltered and the rate of inflation remained high at more than 13%. The reasons for the sluggish growth in 1998 were the collapse of the log market in late 1997 and the inability of domestic forces to capitalise on improved international economic conditions. The impact of the devaluation at the end of 1997 was the major factor for the persistently high prices in 1998 and a good part of 1999. On the positive side however, Solomon Islands' international reserves rose to more than three months of import cover. Fiscal discipline began to pay off with good progress achieved in terms of clearing government debt arrears, making its debt servicing current. Besides that, the government securities market that collapsed in 1995 was on its way to being revived. Furthermore, the pick-up in log exports and the coming on stream of gold exports during the year had a positive impact on the country's international reserves. Underpinning these developments - on both the external sector and fiscal performance - was the contribution from development partners. The official inflows and other forms of assistance from development partners not only enabled government to clear off some of the long-standing arrears, but also began to put public finances on the right footing.

By the end of 1998, therefore, the Solomon Islands economy fortunately had made considerable headway in shaking off the persistent economic hardship of the past years. I should mention here that this did not come by luck - albeit we need more of it - but by design, stemming from the consistent implementation of harmonised fiscal and monetary policies that were supported by favourable forces in the international economy. Some of you may recall that in the past, I have strongly emphasised that one of the major weaknesses in our system has been the lack of co-ordination between all policy arms of government. I am pleased that there has been considerable improvement in this area recently. Besides, there has been improved credibility in policies, strengthened public administration, and reinforcement of public institutions and wider acceptance of reforms. Continued policy harmonisation will surely consolidate the platform from which we can launch future sustainable growth.

2. Objectives and Policy Settings for 1999

The objectives for 1999 were to consolidate and build on the achievements in 1998 with further objectives of lowering inflation, improving the international reserve cover, normalising government debt and achieving more positive and sustainable economic growth. The framework in which these objectives were to be pursued entailed tight **fiscal and monetary policies**, a **stable exchange rate** and **a wage freeze**. This is but one aspect of the government reform program. Other elements of the program focussed on restructuring the public service, privatising and reform of state-owned enterprises, and enhancing private sector growth.

Let me now turn to the economic assessment of 1999 performance.

3. 1999 Macro-economic Outturn

(i) Economic activity and growth

The unrest cast a shadow over the improved policy environment and deprived the nation of the potential benefits from the upturn in the international economy. It took a great toll on the level of economic activity in 1999: which would have been far better but for the constraints imposed on the limited resources of government, the players in the economy and individuals by the unrest.

In view of the intensity of the unrest, the destruction of business properties and intimidation of workers, many businesses and some institutions on Guadalcanal were forced to scale down operations or close down altogether. Many small-scale commercial enterprises on north Guadalcanal have been abandoned due to the destruction. The monetary values of lost properties and other commercial losses may never be known but these may run into hundreds of millions of dollars. You will appreciate that given this sort of atmosphere, investment – both from local and foreign sources – has to decline, not that Solomon Islands has been at the competitive edge in terms of investment attraction. The opportunities for expanding domestic economic activity under a substantially improved domestic policy environment and the upturn in the international economy were not harnessed to their full in the past year. Consequent to this, and because of the scaling down and closure of business operations, the result in 1999 was an overall contraction of Solomon Islands' gross domestic product by around half a percent. The closure in June of SIPL was the major cause of the decline. This, along with the reduction in output in the fisheries sector, driven by the weakness in the international market for fish, more than offset the notable expansions in the mining and forestry sectors. GDP per capita declined more sharply in line with population growth. Preliminary data from the recent census indicate that Solomon Islands annual population growth rate may have fall between 3.0% to 3.2%. This is still by far the highest in the Pacific region and remains among the highest in the world.

(ii) Inflation

Against the contraction in economic activity, inflation (using the 3-month moving average) abated to 7.8% from 13.3% in 1998. Import prices moderated substantially reflecting the waning impact of the 1997 devaluation. Weak domestic demand during the year was a consequence of the relative tightness in fiscal and monetary policies. However, persistent price pressure came from the domestic side, particularly from the food category, reflecting the tension-related shortage in the food supply in Honiara. Any imported price pressure came towards the end of the year as the world oil price increase emerged at the pump.

Whilst admitting our inflation statistics are not without flaw, the sustained price moderation over the year has been very encouraging, especially in relation to investment decisions. Lower inflation should lead to a rise in real returns for holders of financial assets. In particular, the persistent high inflation rates up until last year has meant that deposit rates have always been negative, let alone in real terms. This is a major disincentive to savings, which in turn has implications on investment. Lower inflation should also ease pressure on interest rates and enable nominal borrowing costs to fall.

Preliminary inflation figures for March and April 2000 indicate continuation of overall price moderation, to 5.5% and 5.6% respectively. It is important that we sustain the present trend through continued appropriate co-ordination of policies.

(iii) The Budget and Financial Accounts

As can be appreciated, due to the adverse economic circumstances confronting the country, there was immense pressure on the Budget both on the revenue and expenditure sides. On expenditure, more than $50 million incurred related to security expenses. These pressures were eased by the receipt of privatisation proceeds and the important contributions and assistance of development partners (EU, Australia, Japan, NZ, UK, Taiwan) and international institutions (World Bank, Asian Development Bank). The assistance from development partners was not only timely in terms of the reform efforts, but also crucially important as it provided the underpinning to the government's ability to cope with the adverse budgetary circumstances. Indeed, as it turned out, that has lifted the pressure on SIG's cash flow situation so tremendously that like in the previous year, the budget did not recourse to domestic financing in 1999.

The outturn of the 1999 budget saw a fully financed fiscal deficit of less than 2.5% of GDP. The budget estimates for the year show that there was an overall deficit of $41.2 million in 1999 as against a deficit of $27.3 million in 1998. This resulted from expenditure reaching $712.1 million compared to revenues totalling $670.9 million. Total expenditure was made up of $366.3 million recurrent (of which $52.1 million was related to the unrest on Guadalcanal) and $345.8 million capital. Nonetheless, the total recurrent revenues from domestic sources exceeded total recurrent expenditure by $32.5 million. The government contributed $20.5 million towards financing capital expenditure. Financing of the remaining capital expenditure of $325.3 million was from external sources.

Fiscal management has improved dramatically over the recent past, resulting in relatively more timely data on both revenue and expenditure. The improved management was also reflected in the achievement of other objectives of the reform program.

(a) Government accounts

It is encouraging to note that already there are important steps that have been taken to address this somewhat forgotten long-term problem. In fact, the backlog government financial accounts have been compiled in preparation for audit. Under the Department of Finance current work schedule, preparation of the 1997 accounts *are* to be completed by May, the 1998 accounts by September and the 1999 accounts by December. This is a very big leap from the past legacy and practice of being unaccountable towards putting government accounts in order. Thanks to the Australian government who is providing assistance for auditing of the 1996, 1997 and 1998 accounts in 2000.

(b) Government Debt & Debt Servicing

The government is now current with virtually all its external and domestic debt servicing.

By the end of the year the government had cleared all debt arrears except for those related to two external loans. External debt arrears stood at $54.4 million at year-end and these were entirely towards the EFIC and Marubeni loans. These arrears were made up of $32.9 million in principal and $21.5 million interest. Early this year however, the EFIC loan and its arrears have been successfully rescheduled to terms that include a five-year grace period, principal repayment over a twenty-year period, with a 3% interest rate. Negotiations are continuing for the rescheduling of the Marubeni loan.

The government has rescheduled almost all its debts to affordable levels. The process began in January 1998 with the commitment to repaying of debt arrears to December 1997. This was advanced further in April 1999 with the re-structuring of domestic debt that involved converting more than $200million of "frozen" Treasury Bills into longer term Restructuring Bonds with two to five year maturities. Early this year we started "de-frosting" the remaining SBD22 million of frozen treasury bills. This process is due to be completed by June this year. The amount remaining now is less than $8 million.

(c) Government Securities Market

The successful clearance of arrears and debt restructuring led to the re-opening of the government securities market in May 1999. As you all know, the market had been inoperative since August 1995. The *re-launch* of the market through an auction process was aimed at restoring confidence in the government securities market, establishing market related interest rates, giving the Central Bank the means to influence liquidity, and providing the public with safe investment opportunities at positive real interest rates.-

On the first anniversary of the Treasury Bill auction I am encouraged to note the progress in attaining these objectives. Confidence is returning; the auction does provide market related rates; Bokolo bills are phased out as monetary policy instruments; moreover there is a growing interest from the public in the returns that Treasury Bills give when compared with bank deposit rates. With the decline in inflation most Treasury Bills now offer a positive real rate of return.

(vi) Monetary Policy

For many years, unaligned fiscal policy had undermined monetary policy goals. Since 1998 CBSI had firmer control of monetary policy as government began to bite the fiscal bullet. With the Treasury Bills auction from May 1999 the Central Bank had the means to influence monetary conditions. At the same time the Central Bank reduced the Liquid Asset Requirement (LAR) from 40% to 7.5% and redefined eligible assets to exclude Treasury Bills, thus transforming banks from being captive holders to willing holders. Henceforth interest would only be paid on banks' balances that satisfied the LAR. In tune with tight monetary conditions, the penalty rate for rediscount of Auction Bills was raised to 3% from 0.125% previously applied for the rediscount of Bokolo Bills and Treasury Bills.

Liquidity within the system varied, as did the level of participation by banks and the public in the Treasury Bill auction. By the end of the year, auction participants held $34 million bills. By the first week of May 2000, participants held $73 million of which $36 million were with commercial banks and $37 million with other holders.

The 91-day bills yielded 7.39% in mid December 1999. The 91-day yield in the second week of May 2000 was 7.20%.

A comparison of the 91-day Bills with commercial banks' time deposits with similar maturity reveals that interest rates for three to six month time deposits at year-end were between 2.75% and 4% per annum. By the end of March the range was 2.75%-3.50%. Note the difference! Compare the rates with the inflation rate! It is clear that the 91-day bill offers a higher yield that is now positive in real terms.

Commercial banks' interest rates at the end of the year saw lending rates averaging 14.12% while deposit rates averaged 3.2%. Consequently there is a wide margin between interest paid deposits and the interest rate charged on loans. The Central Bank is taking a closer look at the reasons why the margins are so high relative to our Pacific Island neighbours and other countries. Once the results are available we shall decide upon an approach to try and remedy the situation.

(a) Growth in Money

In line with the policy of restrained monetary growth, broad money supply increased only 4.3% over the year, largely on account of the positive developments in the external accounts.

(b) Domestic Credit

In keeping with the policy stance net credit to government in 1999 hardly increased only a mere half a percent. Overall, domestic credit rose moderately by 4.8%, accounted for solely by the expansion in credit to the private sector. While the tightness in monetary policy contributed to the relative flatness in lending, there was also a lack of incentive to borrow by prospective borrowers and, conversely, hesitance on the part of lenders to lend under the unfavourable circumstances that persisted for the most part of the year.

Gross credit to the private sector on an annual basis grew by 9.2% ($16.4 million). Only in the last quarter of the year did credit to the private sector pick up strongly (7.9% or $14.1 million) with a rise in the demand for trade finance.

(c) External Sector & Foreign Reserves

The external sector posted an overall surplus of $23 million that follows from a surplus of $83 million in 1998. (The surplus resulted in a $17 million rise in the net foreign assets of the banking system). As in 1998, the official inflows were a significant contributor to the surpluses. The current account registered a surplus of $194 million in 1999, largely on account of the trade surplus. Exports rose 6% during the year, accounted for largely by the increase in receipts for logs, coconut oil and gold. There would have been a better performance had it not been for the drastic decline in palm products export proceeds. Fish exports also declined as a result of very poor market conditions. Imports declined 14% over the year.

The overall surplus in the balance of payments for the year brought the level of international reserves to $255 million or more than three months of import cover a position similar to that in 1998.

The level of international reserves in early May 2000 stood at more than $230 million, around three months of import cover. Performance of the our exports and imports over the first four months of 2000 indicates that while exports have been on the rise relative to the same months last year, imports are also increasing but at a faster rate. This resulted in the international reserves declining over the first three months of the year. The decline, however, is being moderated by the differences in periodical flows, including official inflows. The external reserves are not likely to decline by any significant level with high expectations for exports to recover further, as well as the second tranches from ADB and World Bank and Stabex transfers materialise. Reserves in terms of import cover most likely should remain around three months.

The management of the exchange rate, in the absence of excessive pressure on the level of our international reserves, which is not now anticipated, will continue to focus on stabilisation against the US dollar. In accordance with this policy stance, overall the SBD was stable during the year viz. a viz. the four main currencies of the basket, except the Yen. While this is tailored to minimise inflationary pressures, the impact of the movements in the cross rates between international currencies on inflation cannot be controlled.

4. Financial Sector

Under the Financial Institutions Act 1998, the mandate for the Central Bank to regulate banking business, for licensing, and supervising financial institutions was further strengthened. An amendment to the Act in 1999 through the Financial Institutions 1999 Amendment Act extended further the definition of banking business to include pyramid selling. This made it illegal for people to advertise, promote or operate pyramid schemes in the Solomon Islands without a license to do so under the provisions of the Financial Institutions Act. The inclusion of the definition of pyramid schemes in the Financial Institutions Act is intended to control situations such as in 1998 when a lot of pyramid schemes promoters caused many small savers to lose their savings due to unfulfilled promises of financial returns.

As part of the government financial sector reform, the Development Bank of Solomon Islands and the National Provident Fund will be brought under the direct supervision of the Central Bank. Recent independent studies of these institutions have made recommendations to this effect. Government is now considering these recommendations. Internally within the Central Bank and as part of the financial sector reform process, the Financial Institutions Department (FID) was strengthened to enable it to meet the wider responsibilities of supervising both banking and non-banking financial institutions.

The Financial Institutions Act also allows the Central Bank to directly supervise larger Credit Unions subject to ministerial order. Under the current credit union legislation, the CBSI Governor is already the Registrar of Credit Unions. The Government wishes to shift control and supervision of the insurance industry to the Central Bank. Despite the strengthening of the FID the Central Bank recognises that its resources are not yet fully adequate to handle all these very challenging responsibilities.

5. Challenges and Prospects

The macro-economic picture for 1999 has been positive in several respects as macro-economic policies continue in harmony under the government's reform agenda. These achievements were despite the toll from the social disturbances on Guadalcanal. The keys to the achievements in 1999 were therefore a consequence of the policy consistency of government, the will on the part of government to have these implemented, and the support rendered by development partners towards these policies and the reform program. The objectives for 2000 once again are to consolidate and build on the achievements so far made. To achieve that, it is critical that policy consistency and strong political will in the implementation are maintained.

Looking ahead, economic growth in 2000 will be influenced by the pace of recovery from the losses of the past year. Given the continued closure of SIPL and the putting off of many investment plans because of the current security situation, growth will be modest, if not marginally decline. This is despite the projected growth in the mining and forestry sectors.

Continued tension–related food shortage and the potential rise in wages in the private sector pose the major threats to the fight against inflation in 2000. However, the current inflation rates do not appear to be particularly under pressure with rates (provisional) in January at 7.5%, February 6.8%, March 5.5% and April at 5.6%. With that achievement, the inflation target for 2000 at between 6% and 7% appears attainable. The ultimate goal however, is to bring inflation in line with the level of inflation in trading partner countries.

Import cover from international reserves is to remain at about three months. As in the past two years, the major influence will stem from official inflows although exports should hold up while excessive growth in imports would be dampened through tight fiscal and monetary measures.

The outlook for the fiscal sector is for a fiscal deficit equivalent to 2.5% of GDP with financing largely from highly concessional external sources. The government started the year with a balanced budget objective. However, as will be appreciated, there will be mounting pressures from the security problems. Just as the law and order costs – all related to the unrest – turned out to be one of the biggest expenditure items in 1999, so will there be further pressure in 2000.

On this occasion last year, I recall pointing out the view of the Bank and the community at large, especially here in Honiara, that the greatest threat to achieving the objectives in 1999 would be the social unrest on Guadalcanal. That, sadly, turned out to be the case. The severity and magnitude of the cost it has already brought on the country is unprecedented. In 1999 alone government paid more than $52 million in costs related to the unrest.

This unrest was the single most important national issue in 1999. It is the major issue of challenge for this year and it demands an urgent resolution. You are all aware of the human sufferings and the losses that are being inflicted. More than 30,000 people were displaced, hundreds of children's education disrupted, many hundreds of people - mainly women and children - denied medical attention, innocent people being intimidated and harassed. Many families have had to be separated. It has caused a very serious dent along ethnic lines (especially between Malaita and Guadalcanal) and thereby undermining the social fabric of our nation. Already heads are rolling as if human lives no longer have any value. Law and order is a foregone memory - at least for the time being because it appeared that even the police has succumbed to the criminals. The country is to be rated among those, which have been ravaged by civil war, ethnic cleansing and the like. It is the recipe for a real disaster: one, which we may live to regret because it is self-inflicted. Let us not forget that our actions today will determine the cause of life in the future for our children. Don't rob innocent children of their future. Surely they won't forgive us. It is sad to learn that such human degradation, social and economic havoc can be caused by a handful of people. One wonders if the perpetrators will even benefit out of this. History has taught us that the common people, in whose name such causes were fought, turned out to be the biggest losers. It is indeed a very sad chapter in the history of our nation but surely it cannot be part of our nation building.

Restoration of peace is Solomon Islands' priority right now. However modest or favourable the outlook for Solomon Islands economy may be, again, as in the past year, it will depend on the security situation and how quickly the issues involved are resolved. If the situation persists and escalates, investor confidence in the economy will weaken further with adverse consequences on economic growth. How much further can the economy, the government or our development partners sustain the financial costs of these disturbances? How much more human suffering and killing can we sustain before reconciliation is even discussed? The toll on the country is already unbearable. It is important that efforts to resolve these disturbances are done swiftly, but with uttermost care, sincerity and honesty.

The progress after the meeting of all parties in Buala remains fragile. We therefore look forward to a more positive outcome from the current Auki talks. The government and the silent majority must work together and pressure the bickering elements to resolve community differences on Guadalcanal once and for all. Opposing views must be reconciled and differences set aside and aim at making peace. I believe that even the warring parties will eventually realise that they owe it to their families. And I still believe that inspite of the heavy toll the unrest has already taken that when they take a serious and careful look at the consequences, wisdom and understanding will prevail. Peace must be given the best try otherwise we are bound to lead the country into chaos.

In terms of the economic conditions, the opportunities are here and the prospects should be fully exploited to our advantage. I will now end by summarising them as follows:

On the policy front, I re-iterate that there has been considerable progress in terms of policy co-ordination and implementation at the macro-economic level. It is a challenge to sustain this momentum. The long-standing issue of excessive government expenditure, unsustainable deficits, and debt accumulation are now coming under control. The root causes to these problems have been largely dealt with under the government's reform program. For example, the issues of an oversize public service, granting of remissions, linking wage awards to inflation rather than productivity, and poor governance have been appropriately addressed and should continue to be part of an improved decision making process. The government's non-recourse to domestic borrowing and greater reliance from non-inflationary sources is encouraged. It should be that any borrowing be confined to finance capital projects. Efforts to overhaul and rationalise the budget process must also continue. On the revenue side, there have been considerable efforts to improve revenue administration and compliance by taxpayers.

At the sectoral level, there have been important steps taken in the study of and formulation of appropriate sectoral policies necessary to strengthen those sectors through developing policy frameworks and requirements. Part of these formed the privatisation process. In 1999, the fisheries, forestry, and financial sectors benefited from the studies. Progress in this area has been facilitated by use of technical assistance and financial assistance from development partners, an appropriate avenue to rely on.

An effective and meaningful partnership with development partners that has evolved in the recent past should be further harnessed to its full. I believe there has been, and is a lot of goodwill on the part of our development partners: that we must maintain. Solomon Islands cannot face all the challenges on its own. Our resources are meagre and we must learn to make up for the gap through appropriate use of resources of development partners. But the reliance on external assistance must reduce as Solomon Islands develops. This is also a challenge that I believe could be achieved in the longer term. The progress so far on the policy front is heading us towards this right direction. Let us take the opportunity and run with it.

Ladies and gentlemen, may I now commend the 1999 Annual Report for your reading. I thank you all for coming and may God bless us all.