CENTRAL BANK OF SOLOMON ISLANDS

2002 ANNUAL REPORT

Statement by R N Hou, Governor, Central Bank of Solomon Islands,
on the occasion of the Launching of the CBSI 2002 Annual Report

(Under the auspices of the Chamber of Commerce)

Honiara Hotel

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Theme: The Productive Sector (and Donors) came to the Rescue

Introduction

I would like to thank the Chamber of Commerce and Industries on whose initiative and planning, today's event has become a reality. I am also very grateful for the invitation extended to me to give the talk.

My talk is devoted to you all in the productive sector: the many private enterprises, groups and individuals, who have persevered over the years, particularly in the last three years, under tremendous suppression: suppression, which have resulted from government policies and actions [including inactions]; from rogue elements both inside and outside Solomon Islands; and from a generally unfriendly investment climate. Against such hostile environment and unrelenting hardships, you continued to survive, and demonstrated great tenacity and resilience.

The same can be said of our traditional development partners, especially those who are locally represented in the country. Despite our inability to show a change of attitude, you have continued to support us anyway.

Apart from the goodwill of every ordinary hard working Solomon Islander, I am convinced that the most important explanation for the economy keeping its head above water is the resilience of the productive sector. This time, with the help of our donor friends, you have shown yet again that the productive sector is indeed the anchor to the well being of our economy, and that we in this country can attest to the slogan "the private sector is the engine for growth".

It is very difficult to say with confidence, if Solomon Islands has improved per se. Given almost a decade of declining economic growth versus a persistent fast growing population, it is fairly safe to reason that Solomon Islanders' standards of well being may have actually fallen significantly.

On the economic front, I shall demonstrate that in terms of the 2002 outcomes, there are signs of recovery. But perhaps I should add two qualifications to this. First, not much of this improvement can be attributed to government policy or actions. If anything policy actions, including inactions in recent times, have demonstrated a lukewarm approach to what is already an unfriendly investment environment. Such negative signals do very little to encourage the [private] enterprising community, and the productive sector of this country. Secondly, it is important to note that this apparent recovery is very fragile: it may even be temporary. As I will show later on, policy actions that are necessary to induce investor confidence, and the fundamental issues that have impeded economic development in this country, remain unresolved.

Background
Compared to other developing countries in the region, Solomon Islands is relatively well endowed with the resources to generate increased benefits. The fact, however, is that after twenty-five years of political independence, the country remains relatively poor with more than half the population struggling to meet their basic needs. Despite being one of the highest per capita donor recipient developing nation in the region, Solomon Islands per capita income has fallen during the period. Successive governments have lacked the political will and commitment to tackle the structural problems and underlying weaknesses in the economy. Developments since 2000 have only made the situation far worse.

More emphasis should be placed on policies and strategies that enhance the export sector and wholeheartedly embrace fiscal responsibility. To do this Government must restore both investor confidence and be seen to tackle the law and order issue firmly, as private sector investment depends on confidence in the rule of law. Of course there are many structural issues and polices that impede investment, but these can be addressed later. In addition, all facets of Government policy must operate in concert to attain a realistic balanced budget, tight monetary policy, a more stable exchange rate, and wage restraint.

Some progress has been made in law and order. We have seen the appointment of a new Police Commissioner, the decommissioning of 800 special constables with UN support, and despite being sporadic, there have been welcomed police actions. In particular, police swift actions in recent days to arrest suspected criminals have demonstrated that the police are able to enforce the law. Sadly, this progress is marred by incidences such as the brutal murder of Sir Fred Soaki in February 2003, the non capture of his murderer, recent developments in the Weather Coast, another brutal murder of an expatriate missionary on Malaita this week and continued harassment of treasury staff by certain elements of the disciplinary forces. These would suggest that the strategies used so far have not worked in resolving the law and order problem.

A Faint Gleam of Light
On the economic front however, there are signs of improvement. Last year, real domestic product (GDP) fell by only 2.4%, compared to declines of 14.2% and 9.1% in 2000 and 2001 respectively. GDP improved as a result of favourable developments in the global economy, and the resilience of the productive sector. The rise in commodity prices and positive developments in the export sector led to a balance of payments surplus of $57.4 million in 2002, reversing the $57.2 deficit in the previous year.

The trade account improved significantly and registered a surplus of $68.8 million. Consequently, the current account deficit narrowed to $41.0 million from $172.3 million in 2001, an increase of more than 300%. Despite the bounce back of exports in 2002, only logs and cocoa registered volumes anywhere near the 1998 and 1999 levels. Fish catch during 2002 was merely 35% of the 1998 volume but if the 2003 first quarter results of 8000 metric tons are maintained throughout the year, total catch for this year can reach up to 60% of the 1998 level. Log exports are unsustainable in the medium term and cocoa is a success story that owes current high prices to the problems in the Ivory Coast. Improvements in copra have yet to produce any real impact on the statistics.

Foreign Reserves: is it real?
In 2002 the gross external reserves rose 26.1% to around $130 million, equivalent to more than two months worth of imports of goods and non-factor services. In US$ terms however, the position is somewhat different with US$18.7million at end 2001 compared to US$17.5 million at the end of 2002. The rise would therefore be attributed to the depreciation of the SBD$. The position at the end of April 2003 indicates that the external reserves are ahead in both currencies at SBD$145 million or US$19.3 million. These positive developments are a direct result of the resurgence in exports, firmer administrative controls by the Central Bank, policy actions by the Bank in terms of the exchange rate, as well as increased donor financing. However, when accounting for the value of pending foreign exchange applications of around $30 million, together with accumulated overseas debt arrears of about $83 million, the gross external reserves at the year-end would have been nearly zero.

The exchange rate at the end of 2001 was SBD$5.56 to US$1 and had depreciated to SBD$7.46 by the end of 2002. The latter is around the rate that was briefly achieved in March 2002 with the devaluation that was quickly reversed amid political disarray. Regrettably, 2002 saw the departure of two Ministers of Finance, one involuntary in April and the other voluntary in December.

Fiscal Affairs in the Dark (A Government Fiscally Challenged)
The IMF has made a number of visits to Honiara in 2002 and in November had agreed with the Government that the 2003 draft budget was realistic and that proposed measures, if implemented, would lead to more fiscal coherence. However, events since then - for instance in December when large payments made from the debt service account, the resignation of the then Minister of Finance and his PS, diversion of donor funds, and on-going financing of unbudgeted expenditures – have caused second thoughts at the IMF and among the donor community. Indeed fiscal discipline has yet to be achieved. The fiscal juggling act continues with little reference to the budget. Arrears mount and creditors go unsatisfied. Any increased revenues are quickly swallowed up in unbudgeted expense. The planned rightsizing of the public service that could have been largely funded from outside, was abandoned in late 2002 and has not been seen on the agenda since.

Fiscal operations for 2002 therefore resulted in an overall deficit of $309.1 million. This came from the rise in provisional total expenditures to $674.1million against provisional total revenues, including grants, of $365.0 million. The rise in expenditures, which surpassed the budget estimates, was driven by the surge in unbudgeted expenditures and was financed by the massive accumulation of arrears amounting to $241.7 million. In other words, the Government did not pay its debts. The deficit is therefore around 17% of estimated nominal GDP.

Government Debt: in the "too hard basket"

With the precipitous 50% fall in government revenues and the growth in overall debt to over 100% of estimated nominal GDP, Government's debt burden, that was thought sustainable in 2000, has become intolerable by 2003. Even with fiscal discipline the debt numbers are staggering. The Government failed to meet the 2001, 2002 and 2003 maturities of its 1999 issue of Restructuring Bonds. This non-performing debt stock represents a major component of financial sector assets and is already taking a toll on the ability of the sector to function normally. Unless drastic measures are taken, the Government is on track to repeat its failure in 2004. Since July 2002, Government is paying 3% per annum on these bonds, a rate that is lower than both the coupon of fixed rate bonds and the floating rate bonds if penalties are included. Bondholders sought relief from the courts for the first unpaid tranche, which was obtained but no payment of the order has been made. Government has missed maturities on both Treasury Bonds and Development Bonds that are also financial sector assets. The 15% of revenues that government promised to set aside for debt servicing has been inconsistently applied, and in any case, it is insufficient to service domestic debt let alone foreign debt. Already reaching $254 million in April this year, debt arrears alone would consume total budgeted ordinary revenue collections for 2003. Satisfying our many creditors is unimaginable, if amounts owing to domestic trade creditors are included in the debt mountain, as payments for other purposes are frequently made from debt service balances. Solomon Islands urgently need a formal debt compromise that would place all the debt on a long-term payout at a low interest rate with a significant principal moratorium. Most of Government's foreign debt is already on such concessional terms.

The numbers captured by the debt recording management system (DRMS) at the Central Bank show that government total debt stock at the end of 2002 reached $1.7 billion. The rise last year was due to draw down of two last tranches of the EXIM bank loan and the effect from movements in the exchange rate. The DRMS showed that debt arrears have reached $195 million at the end of 2002 and have risen to $254 million at the end of April 2003. Of this amount, $90 million is in respect of formal foreign debt and $164 million for domestic debt. Estimates of other domestic arrears go as high as $160 million but could be much higher if debts of statutory bodies were included. Government debt has already exceeded estimated nominal GDP to an uncomfortable level. Clearly this is a problem that cannot be ignored.

National Economic Recovery & Development Plan: one more try!

Planners are once again working on a plan to reconstruct the economy. This time the planners have UNDP support. The donors are to meet the Government in late June to discuss the plan. Already the Cabinet has already endorsed the Multi Donor Economic Governance Report of February this year. This would imply that the government has endorsed measures stipulated in the report. It is now time to carry out the actions. This and past Governments have had similar plans that they failed to implement. The country desperately needs a plan, which has the confidence and support of the international community, local ownership and one which can be implemented immediately. Time is running out. Donors are increasingly impatient. The private sector is looking for drastic policy change. The people are suffering from a lack of political will and indecisiveness. The Government must seize any opportunity for reform that the plan demands and that the donors expect.

Revised inflation at the end of 2002 was 15.4%. Figures for 2000 and 2001 are unreliable as data collections were incomplete. This rate of inflation is unsustainably high.

Financial Sector – in distress

The banking system remained liquid throughout the year. In January 2002, the level of liquidity was $57.0 million, but by June, it had declined to $41.0 million. However, this rose steadily thereafter and reached $81 million by year-end reflecting the rise in net foreign assets during the period. Similarly, excess liquidity rose significantly by 37.6% to $56.1 million compared to a growth of 25.0% in 2001. Liquidity has reached almost $100 million by mid May 2003.

In the current fragile security environment, banks remain reluctant to lend. There is still an absence of bankable loans due to an uncertain investor climate. Private sector credit that had reached $225 million by May 2000 (equal to US$45 million) was down to $173 million (about US$23 million) by the end of 2002 and has not grown until early May 2003.

Commercial bank lending to Government reached more than $150 million last year. All of this is in the non-performing Restructuring Bonds. Other financial sector holders of Government paper are NPF and insurance companies, which hold over $90 million, excluding $28 million in the auction Treasury Bills market which is supported by the Central Bank. The Central Bank has fully provided for its total holdings of government debt, although it still holds the amount of $175 million in Government Advances. The Government has not paid interest on these advances for the last few years.

The Development Bank (DBSI) - now under Central Bank supervision - is illiquid and has been unable to repay its depositors for some time. The Bank has trimmed its operations but is burdened with bad debt and has also not been able to lend for some years. The Government is unable to provide further liquidity and is seeking outside assistance.

Like the DBSI, the SI National Provident Fund has come under Central Bank supervision, but is becoming a source of concern from a number of angles, not least supervisory. The Fund holds the only sizeable form of financial asset in the country, and does so on behalf of the members on trust. That being the case, the Fund Board, as trustees, has the onerous duty to ensure members' forced savings are secure and are earning a reasonable return. The immediate concerns relate to its liquidity needs, but the more fundamental concern relates to the quality of its balance sheet, and particularly its investment portfolio. This is yet to be properly assessed. The Bank hopes to address this soon.

Unlike DBSI and NPF, the commercial banks have declared profits in 2002. However, all of this was derived from non-core business sources such as foreign exchange operations, the weakness of the Solomon dollar and the rise in interest margins as deposit rates fell to new lows. Given the existing precarious condition of DBSI and NPF, the financial sector will most certainly be handicapped by government debt. A comprehensive debt compromise, which would necessarily have to include the debt held by the financial sector, must be agreed as a matter of urgency.

During the year, two pyramid scheme-type operations surfaced in Solomon Islands. One, the Family Charity Fund SI (FCF SI), was registered as a charitable organization and promised its subscribers substantial sums of money for a small membership fee. The Central Bank, after conducting an investigation into the affairs of the scheme, reported the matter to the Director of Public Prosecution early during the year for investigation and appropriate action against the owners of the scheme. To protect the public, the Central Bank issued many public warnings against investing in the scheme, but many people refused to pay attention to the warnings. As a result, they found themselves not only losing their subscription fees but also nursing their losses for the false hope of becoming millionaires. Following intimidation and threats against the Central Bank and ANZ in early May 2003 by organizers of the FCFSI, the commercial banks and CBSI closed in protest and for the security of staff and premises. Police have arrested and charged the promoters of the Fund with "obtaining money under false pretences" and "threatening behaviour". But the case is pending a court hearing.

Another fraudulent money scheme, the Royal Assembly of Nations and Kingdoms [RAONK], with a connected group based in neighbouring Papua New Guinea was able to persuade the Solomon Islands government that they could give a grant of billions of dollars to the government to repay its debts. Having ascertained the background to the activities of the group and individuals concerned, the Central Bank advised the Government to refrain from being involved. The Government eventually disassociated itself from the group following mounting public pressure after the failure to deliver promised billions of dollars to government. It is understood however, that elements of RAONK are still in Honiara.

Unfortunately many Solomon Islanders, including the Government, have a very soft heart for these financial schemes. This is a reflection of a society which has lost its sense of judgement, and whose leaders shy away from making important decisions. Instead they choose short cuts for deep-seated problems. This is fantasy in a real world, and cause instability in the banking system – which is very damaging in a small open economy like ours, as well as a potential cause for further social disorder. It is important therefore that a concerted and decisive effort is mounted on protecting the public, and the Government, from promoters of fraudulent money schemes. Such actions should include a nation-wide campaign against, and public education on these money schemes. Action should also include strengthening relevant legislations and law enforcement agencies to deal with these money schemes.

Action – still to come!

There is little reason to rejoice. Access to donor funds to fund economic recovery depends on the Government getting its fiscal act together. Private sector activities, the engine for growth, need a change in public policy direction and a conducive investment climate. This we know has proved difficult in the past.

The current law and order situation has been quoted as the main obstacle to any reforms and major drawback to private sector investment plans. Difficult as it may be, the government has no option but to tackle it head on. Police action in recent days to arrest criminals is a positive sign to indicate the situation can be dealt with. However, public confidence in the police and government is yet to be restored.

The fiscal situation is drifting into deeper water. The Government must put its feet down and clamp down on spending money toward unbudgeted items. The immediate action now is to return to Parliament to obtain approval for a supplementary budget. Then it must stick to the budget.

Meanwhile the Government must address the medium and long-term situation. This it can be done by developing the National Economic Recovery and Development Plan. It is very essential however, that such a plan should have international donor support, local ownership, be sustainable and one which is easy to implement. The Government must then make every effort to comply with this plan.

I conclude by remarking that this is my last annual report launch. My second term of office proved most eventful and comes to an end in August this year. I hope that my successor will live through less interesting times!

Thank you.

28 May 2003