



*CENTRAL BANK OF SOLOMON ISLANDS*

## **2003 ANNUAL REPORT**

**Statement by Governor Rick N. Houenipwela, on the Occasion of the Launching of  
the 2003 Annual Report of the Central Bank of Solomon Islands, on 10 May 2004  
at the King Solomon Hotel**

King Solomon Hotel

May 10 2004

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### **Introduction**

Honourable Ministers, Members of Parliament, Representatives of Diplomatic Corps, Permanent Secretaries, Heads of statutory authorities, bank managers, CBSI Directors, Representatives from the Chamber of Commerce, church representatives, heads of private enterprises, NGO leaders, representatives from the media, ladies and gentlemen.

I have the pleasure firstly, to welcome you to this launching, and secondly the honour to address you this morning. This is an important event in the CBSI calendar. It provides the opportunity for us at the Bank to comment on the performance of the economy in 2003, and also to fulfil our responsibility to account for the Bank's activities during that year.

### **Background**

On this occasion a year ago [when launching the 2002 Annual Report] I mentioned that while there were signs of recovery, I cautioned at that time numerous fundamental problems existed. Today I am happy to say that good progress has been made on many of these fronts. For example, with the help of RAMSI, Law and Order has been effectively tackled. Fiscal discipline has been re-established: Government finances are under firm control – MOF has reported stronger tax compliance and improved collections. Treasury has effectively terminated compensation payments, and are applying tighter expenditure controls. Government is expected to reach a compromise soon with major domestic bondholders. This would move the debt burden closer to being resolved. The National Recovery, Reconstruction and Development Plan (NERRDP) has been endorsed and the donor community is back in force – with large levels of external grants. This is a reflection of the increased confidence in the country.

While launching the 2002 Annual Report, I also mentioned that the recovery of the economy was due to the resilience and perseverance of the productive sector. I am happy to note that this positive trend has not only persisted, but that once again it is the real sector that has boosted a real turning point in the economic recovery.

### **The Economy has turned around**

Year 2003 opened with policy settings, which tried to achieve the objectives to build the reserves, stabilise government finances, harness a stable economic platform for private sector investment and reduce inflation to below 10%. That the actual situation on the ground was an uncertain, investor-hostile environment, it would render these objectives merely dreams. However, it is gratifying to note that with the perseverance and commitment of our productive sector and other players, economic activities have resumed since 2002. This gave much needed impetus and the basis for a real turnaround in activities, which were interrupted by the ethnic tension. This should not be overlooked.

In the annual report we estimated that growth of 3.8% took place in 2003. However, since going to print, new data had been received which suggest that the economy had grown by about 5.8% in real

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terms. This is a remarkable achievement, which was observed by the recent IMF Article IV Mission to have been unprecedented and seen nowhere else in the world. They have attributed this to the resilience of the productive sector, a return of sound fiscal management and an enduring economic reforms agenda.

That the economic turnaround began in 2002 is an important reminder, not to be overlooked. The recovery has started well before RAMSI was ever conceived - when the international community already wrote off this country. The reminder is that it happened as a result of the commitment and perseverance of all ordinary Solomon Islanders. It happened due to Solomon Islands firms and private enterprises and the rural producers, who did not wait for government leadership, direction or handouts. Our producers [fishermen, copra cutters, cocoa farmers, etc.] and other small economic players went back to their daily activity; they did not take “a wait and see” approach; they did not wait for donor handouts and they did not wait for government policy direction. That would have been a long wait. They simply got on with their lives. They kept the faith in the country during the last four difficult years, and have shown their dedication. They are indeed the backbone of this country. They kept on producing for export and carried on business despite the hardships. These Solomon Islanders pointed the way – let’s follow their lead. Moaning and waiting for donors, or expecting action from the government, is no substitute for action. This is “Great Effort at the Grassroots” and deserves encouragement. We salute these unsung heroes of the recovery miracle.

### **Reasons for the growth**

The economic recovery occurred as a result of a combination of four interconnected factors. These are listed below:

***Law and order restored:*** There is no doubt that these positive developments would not have happened without the restoration of law and order. Of course relative improvement was seen since 2002, but immediately after RAMSI arrived, law and order came under firm control. This has spurred the progress in economic activity in the last quarter of 2003, as confidence in the investment environment also returned. This was most noticeable in Honiara [where all the troubles have been] and in government finances, which until then was in a mess.

***Positive external conditions:*** The increased global growth experienced for most of the year has had a positive impact on the economy, especially on the external sector. In particular, the economies in Asia – which are important export markets for Solomon Islands - have continued persistent growth. It is also very important for the global market that the US economy has been improving and continues to do so. Consequently there has been a general positive outlook for world economic output. The offshoot is that we saw relatively firm prices for some export commodities. The challenge is to broaden the economic base to be sustainable in times of low commodity prices.

***Persistent donors support:*** Some of the traditional donors have continued with projects and funding during the last four years. And of course the overwhelming donor support, which has rallied around RAMSI since its arrival, has spurred this progress further, particularly the external sector. We sincerely thank the donors for their recognition of our needs. Successful and timely monitoring of donor flows and the progress of the development budget is important to a complete and transparent understanding of the fiscal situation.

***Private sector resilience:*** Once again the economy has benefited from the perseverance of the productive sector. These are the Solomon Islands firms, private informal groups and the many

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hundreds of individuals, who just chose to get on with their daily lives. They decided not to get carried away by political rhetoric. They do not care about what our leaders and ex militants do to the Treasury, and they do not rely on what the government does or does not do. They are about just getting on with their daily business and doing it better. Once again the players have proven the slogan that “the private sector is the engine for growth”.

### **Where was this happening?**

I shall now turn to take a very brief survey of the main highlights – by sector – of the economy during 2003.

### **External Sector**

The balance of payments was maintained in positive territory throughout most of the year, until the dramatic improvements in the last quarter, which by year-end registered an overall surplus of \$140.6 million, the highest since independence. This significant improvement was due to some major positive developments in the current account, which swung from negative balance in 2002 to a \$204.0 million surplus in 2003. This is explained by substantial donor inflows, which had the transfers account surplus soar to the unprecedented level of \$400 million.

**External Reserves:** The level of external reserves was relatively flat in the first quarter of 2003. However, following further improvements in law and order, export production was boosted in all four main commodities. The combination of stronger export receipts and significant donor inflows in the second half of the year, saw the reserves rocketing to \$271.1 million by the end of December, despite the rise in import payments during the period. At this level the external reserves represented about 4.9 months of import cover. However, if government’s accumulated external debt arrears and \$12.5 million worth of pending foreign exchange applications at the end of the year were paid, this level would be significantly lower.

**Exchange Rates:** The Central Bank maintained the policy of pegging the Solomon Islands dollar to a trade-weighted basket of currencies important to Solomon Islands. Reflecting the increase in exports and donor inflows, the focus of exchange rate policy shifted from defending the reserves level to minimizing inflationary pressures and inducing general business confidence. Accordingly, during the year, the exchange rate had been stabilised against the US dollar.

### **Real Sector**

As already discussed, the economy made a remarkable recovery last year, with all major GDP components registering growth. As a result of the improved law and order environment, and external demand conditions, the export sector reversed the decline in previous years. Last year, the main impetus to this dramatic turnaround came from the agricultural, forestry and fishery sectors. Underlying the growth in the agricultural sector was the impressive performance in both copra and cocoa production, while growth in the forestry sector stemmed primarily from the expansion in the log production during the year, which averaged about three times the sustainable harvesting rate. The fishery sector also grew in volume and improvements in average fish prices also contributed. As a direct reflection of the level of confidence, the construction sector also grew strongly (88.2%) in residential, commercial and other dwellings during the year.

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## **Inflation**

The average annual rate of inflation (as measured by the 12 months moving average of the Honiara Retail Price Index) was 10.1% in 2003, higher than 9.4% in 2002 and 7.6% in 2001. The marginal increase was due mainly to a 19.8% rise in the imported component of the Honiara Retail Price Index (HRPI) compared to 11.9% in 2002. This contrasts the fall in inflation in most of Solomon Islands major trading partners and relative stability in the exchange rate during the year. The increase mainly reflects the general high cost in doing business in the country, which often causes traders to increase prices even if the goods cost them less.

On a monthly basis, however, inflation had continued to decline from 15.5% in January to 4.1% in December. While the CPI has increased in the first few months of 2004, it is still keeping within the single digits target.

## **Monetary Sector**

The conduct of monetary policy throughout the year has been to ensure the rise in liquidity does not lead to consumption that would undermine the foreign reserves and, in providing an environment conducive for economic growth by capping undue inflationary pressures. Given the fragile macroeconomic conditions, the attainment of these objectives was crucially important for two fundamental reasons. First and foremost is to forestall severe foreign exchange shortages and to avoid inflicting far-reaching socio-economic costs of such shortages on the economy. Secondly, to promote investor-confidence, so as to attract and retain both old and new investors. Given that Solomon Islands is rated among the least attractive in the region, if not in the world, as an investment destination, this is a very difficult goal to achieve.

In the current environment, where all conventional monetary policy instruments are blunt, reserve money continues to be the nominal anchor for the conduct of monetary policy. To that end, the combined blend between Open Market Operations [OMO] and Foreign Exchange Market [FEM] interventions were used as main policy instruments for monetary management. We believe that this has served the economy well, and hence management of monetary policy will continue to rely on these instruments, until the circumstances change.

In 2003, the broad money supply [M3] grew by 25.4% to \$520.2 million, compared with a 4.0% growth in 2002. This increase, which began in mid-2003, had been driven fundamentally by an increase in net foreign assets. That commercial bank lending remained subdued, this trend has resulted in the growing level of excess bank liquidity. As confidence returns, it is expected that this excess liquidity would be reduced during 2004.

**Domestic Credit:** Total domestic credit [TDC] from the banking system fell by a marginal 0.8% to \$466.5 million, partly reversing the growth of 10.8% in 2002. The fall in TDC was attributed to a drop in net credit to government by 16.1% to \$249.2 million. Credit to the private sector, however, rose by 25.4% to \$249.2 million during the year.

The decline in net credit to government reflected the increasing level in government deposits with the banking system. This came as a result of revenue enhancing measures instituted by the government, inflows of donor assistance, and strong expenditure control measures taken in the second-half of 2003. The latter is perhaps the single most important development in government finances in the post-

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conflict period. This is a welcome and timely development indeed considering the government's efforts and eagerness to reach a debt compromise with its domestic creditors quickly in 2004.

The decline in net credit to government is a positive development given the past history of heavy financing by government from the domestic banking system, which has had a crowding-out effect on private sector spending and investment decisions. In that regard, the sooner a debt settlement is reached, the sooner the domestic money market can be utilised to spur economic activity and private sector growth. This is what can be expected when the fiscal is seen to be under sound management over a period of time.

## **Government Finances**

The thrust of the 2003 Budget was to consolidate the peace process, restore essential government services, particularly in the education and health sectors, and invigorate private sector activities. The budget was framed on the platform of good governance, increased accountability and transparency. Like in the previous few years, it was a 'balanced budget' with total expected revenues (excluding grants) matching total recurrent expenditures at \$259 million.

However, as the implementation of the budget progressed, it became obvious that government would not achieve its budgeted objectives due to a number of reasons: extortion of funds by criminal elements and a mere lack of political will to effectively manage its finances. This led to the significant rise in unbudgeted expenditures, which had severely affected the delivery of basic services, particularly in both the education and health sectors. This trend continued during the first seven months of the year.

However, following the arrival of RAMSI in late July, the situation drastically changed as the law and order situation was addressed and stringent budgetary controls were instituted at the Department of Finance. As more revenue enhancement actions were taken, significant improvements became noticeable in both revenue and expenditures performance. By year-end, the government's overall deficit was cut to \$103.9 million from more than \$300 million the previous year.

**Government Debt:** At the end of 2003, total government debt rose from \$1.56 billion to \$1.60 billion. The external debt, which accounted for 65.9% of the total stock, increased by 2% (\$21.3 million) to \$1,108.6 million mainly as a result of exchange rate movements while the domestic debt rose by \$55.4 million to \$494.3 million as a result of upward movements in the Auction Treasury Bills market. About half of this debt was accounted for by SIG Advances from the Central Bank. The increase in interest arrears on these outstanding debts also contributed to the increase in the stock of domestic debt.

The overhang from this large stock of debt is a problem for the economy. Almost everybody has been or still being affected by this problem. In particular, in the financial sector, it has dampened the ability of the commercial banks to play their due role. In the case of other financial institutions, namely DBSI and NPF, the implications are more serious. It is therefore critical to the financial system, and the economy generally, that a debt compromise is reached soon. In that connection, all hope is pinned on the current negotiations, which resumed early this year, between the government and the major bondholders.

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## **Financial System**

During the year, CBSI conducted for the first time on-site and off-site examinations on the National provident Fund (NPF) and the Development Bank of Solomon Islands (DBSI) since these two financial institutions were brought for supervision and regulation under the Financial Institutions Act in 2002. In line with the findings of the reports actions relevant to the two institutions are being taken. For NPF the Central Bank has made a report and issued various recommendations to its Board and Management on areas needing addressing. As regards, the DBSI the Central Bank has concluded that the bank has been operating while it is insolvent, and has therefore sought a court order for the takeover of the management of DBSI, as stipulated under the Financial Institutions Act 1998. As noted earlier, a critical issue to all the financial institutions is the SIG Debt overhang.

The commercial banks however, have shown another exceptionally good year in terms of the profitability, despite having been relatively quiet in their core lending business. Apart from the debt situation, the banking system is generally sound, and has remained above all minimum prudential requirements. Resolving the government debt issue quickly is in the best interest of all parties concerned.

The successful prosecution of the promoters of the Family Charity Fund late in 2003 and early this year, resulting in their serving various prison terms, should send a clear message to fraudsters that the Courts would not tolerate their scheming. However, much needs to be done to eradicate an obvious increase in cargo cult mentality in the Solomon Islands and a seeming readiness to be easily duped.

In line with government plans, the administrative arrangements to facilitate the transfer of the Office of the Controller of Insurance to the Central Bank began late in the year. It is envisaged that this activity will be completed by the middle of 2004. Given that this is an extra responsibility to the Bank, the Bank Management will ensure budgetary provisions are included in the Bank's budget mid year review in 2004.

### **Underlying situation remains fragile**

Indeed we can rejoice that that some of the fundamental problems are now being addressed: two major set back to the economy – law and order, and government finances - are now under firm control and good management. Consequently confidence is also returning. So we can rejoice that indications are showing the economy is obviously on the recovery path.

However, lest we forget, we are definitely not out of the woods yet. Remember, the positive growth in 2003 is after 4 years of consecutive negative growth rates. Any positive growth in the next several years would only take us to the pre-crisis levels. In terms of GDP per capita, it is estimated that the economy has to maintain a consistent average annual growth rate of 10% for the next ten years before we can achieve the sort of income levels experienced in the four years prior to 1999.

Dramatic as it may appear, this positive development indicates that we have just taken the first step in the right direction. The economy is now responding to decisive steps that have been taken on just two [law and order, and fiscal policy] of a number of important and fundamental problems that beset the Solomon Islands. In other words, we have only just embarked on the long reform agenda. As noted above and many times before, the recovery path will be long and the hurdles will be difficult to overcome.

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Ladies and gentlemen, taking the reform agenda to its conclusion would no doubt produce long-term benefits for this country. But reform will not come without making sacrifices and enduring the pain now. This is entirely the task of the government to determine. However, I would like to suggest that as part of this process, the following areas should be considered:

**External position:** The balance of payments position is still very precarious. The extra ordinary rise in the external reserves has been partly due to an extra ordinary level of donor inflows. The export sector is not only very narrow but remains vulnerable to many exogenous factors. The economy's main stay – logging – is unsustainably high. The export base must be broadened. We cannot rely on donor financing forever.

**Investment environment:** Like it or not, Solomon Islands is rated one of the riskiest investment destinations in the world. The political and social climate is unstable and unpredictable. There are too many investment hurdles: investment procedures are cumbersome and tedious; procedures are not transparent; land use is a nagging problem; infrastructure is in disrepair and utility services unreliable; land, sea and air transportation is unreliable at best; the cost of doing business is comparatively high; and any government institution having anything to do with investment is near to dysfunctional. Given that we compete with hundreds of other countries for international capital, we have a lot to do before we can be talking about attracting new investors.

**Government Debt:** This remains a very critical part of the reform agenda. The debt overhang paralyses many small businesses, including the financial system. Its early resolution will provide that needed relief. Combined with outstanding arrears, the current debt level is unsustainable. A clear policy on debt must be designed to guide future loans procurement and other financial obligations. But it is critical that the current negotiations reach a debt compromise, which is sustainable and affordable.

**Infrastructure Development:** Aside from the need to attend to the dire condition of existing roads, bridges, wharves, airfields and shipping services, the current level of physical infrastructure would not take this country forward in its economic development aspirations. Notwithstanding the importance of the social sector, it is equally important that the country's physical infrastructure is attended to so that the capability of the economy to meet the demands of the population in the future is enhanced. Without even a basic land and sea transportation system, the hardships encountered, particularly by the rural population, are very real and have led to local entrepreneurship being severely undermined. Instead, the availability of adequate and working infrastructure would provide an enabling environment to the population to look after themselves.

**Restore Government role:** The government machinery needs to be restored so as to ensure government efficiently and effectively resumes its proper role – of governing. This would encapsulate the principles of democracy – good governance, accountability and transparency. But also equally important - and most urgently - the public service must be returned to effective and efficient function in order to provide an efficient regulatory framework for the private sector and service to the population. This entails robust recruitment procedures and uncompromising employment rules, which ensure high quality standards are maintained. Such processes should also ensure corruption and nepotism are eradicated and an efficient legal framework upholding the rule of law. It is gratifying to note that work is already progressing in a number of the government departments to address these concerns.

**Population growth:** When the population is growing at a consistent rate of nearly 3% per annum, against four years of economic recession, we need at least ten years of consistent growth just to catch

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up: it will be 2008 before we return to where we were in 1998 in nominal terms. Individually we shall still be poorer in 2008 than we were in 1998 and poorer than we were in the eighties. The economy would not grow strong enough to sustain the demands from a fast growing young population. This time bomb is just waiting to explode. Drastic measures have to be taken now to address this.

**Donor dependency:** I have said before that Solomon Islands is among the highest recipients of donor assistance. With the recent overwhelming support in recent months from the international community, this is already a very mild description of that position. The concern for policy makers is two fold: one, with all these millions of dollars having pumped into Solomon Islands, especially over the last ten years, what have we to show? Secondly, and perhaps more importantly, is the risk that Solomon Islands may, if not already, be drawn into the aid dependency syndrome. Sadly this is reflected by the widespread cargo cult mentality, which has been revealed through the various money schemes and other treasure hunting schemes that have engulfed this country in recent years. Efforts must not be spared to eradicate this as it only results in an unproductive population.

**Subsistence sector:** The role of the subsistence sector is very critical in Solomon Islands. This has been proved again in the past four years. Many thousands of Solomon Islanders have been saved again and again from absolute poverty because of the existence of a subsistence [informal] sector, which has taken the role of a social security scheme: it is the social safety net, when the formal sector fails. We cannot do without it. It must therefore be maintained.

### Looking ahead?

I would like to reiterate a few more practical areas as pointers to the way ahead as I conclude my remarks. First, we should build on the private sector and producers' resilience. Time and time again, Solomon Islands have ridden on the back of this sector. However, over the years, private sector development has been neglected. Producers need an enabling environment – not to be overdosed with donations and government handouts. They need the physical infrastructure repaired, improved and upgraded. They need an environment conducive to investment.

Let the government get on with the business of governing, not the governing of business. For example, help small and rural enterprise by restoring the extension services: agriculture, fisheries and business advisory services. Help Solomon Islanders to help themselves. Do not suffocate and stifle enterprise with political rhetoric.

Secondly, improve on the present confidence level in law and order. Improve the capacity in the police force and other law enforcement agencies. Build confidence in their long-term capacity, and ensure sustainability of this capacity.

Fourth, it is critically important that the current extensive donor support is applied appropriately, for asset building and investment mobilisation. If we can learn from the past then we must stop funding politically motivated projects that are wasteful and useless for long-term development. Promote development with the private sector and rural producers in mind – stop building up Honiara further. Whilst donors rightly focus on the social sectors, it is worth noting that such assistance is not helping create wealth and jobs.

Fifthly, the positive developments in 2003 offer the best opportunity to rebuild and reform the Solomon Islands economy and to establish a solid basis to sustain the recovery process. With the normalization of the security situation, restoration of public confidence in and effectiveness of law

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enforcement agencies, expected growth in the global economy and increase in donor support into efforts to re-grow the economy, it is crucial that this window of opportunity is kept open. We must use the opportunity offered by RAMSI to change the political, economic and social landscape beyond recognition and make a better life for our children and our children's children.

Sixth, there is the need to harness democratic principles in Solomon Islands. This will hinge on a political mindset and environment where the principles of good governance, responsibility and accountability are not only upheld, but also actually practised. We must have an environment where fiscal responsibility and accountability is exercised from the centre out to the provinces. When we note what has been happening in the last few years to the Honiara City Council, and with similar doubts about some of the provincial executive governments, we have to ask how a new system of government would result in improved responsibility and accountability? In that connection too, a very vital consideration for the proposed federal government system is the cost, which to date remains unknown.

Ladies and gentlemen, the above list could go on. However, I am confident that when we begin to address these issues, I see several years of economic progress ahead of us. I can say this with confidence because the economic turnaround in 2003 is proof. It came as a result of a few but important decisive steps, which have already been taken in some of the fundamental areas. For that I salute the hundreds of ordinary folks around this country, and the many private investors in the various sectors of the economy, for pulling us up by our bootstraps. We also owe many thanks to the donor community for re-engaging on development issues. Lastly, but not the least, our sincere thanks to the Regional Assistance Mission to Solomon Islands for enabling government to be conducted transparently without threats and demands from sections of the community, and returning Solomon Islands once more to a normal peaceful country.

In conclusion, I now wish to acknowledge the contributions by many of you to the production of this report. First, I would like to thank PriceWaterhouseCoopers, our external auditors, who made sure the annual accounts were completed in time. I am grateful to donor resident offices, government departments, private companies and some individuals, who provided us with much of the data we used in the various analyses in the report. I extend thanks to the CBSI Board members for their guidance, SI Printers for making the report available this morning, and King Solomon Hotel for the use of these fine facilities. Lastly my personal thanks to my staff, especially those in the Economics Department under Mr Ishmael Wore, and the Accounting Staff, under Mr Edward Ronia, who worked tirelessly on the various sections of the report over the last several weeks to ensure the 2003 Annual Report is ready for this morning.

A last word in closing: should you wonder why I am still at the Central Bank, (after I said that last year would be my last launch). With the arrival of RAMSI I was asked and encouraged by many people both here and overseas to stay on for a further term. I consulted my family, friends and colleagues and took their advice to remain to participate in the rebuilding of the Solomon Islands economy.

Ladies and gentlemen, I now commend the Central Banks 2003 Annual Report for your reading.

May God bless you all, and I thank you for your attention.

Honiara, May 10 2004

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