Central Bank of Solomon Islands

2004 ANNUAL REPORT LAUNCHING

Statement by Deputy Governor Denton Rarawa on the Occasion of the Launching of the 2004 Annual Report of the Central Bank on 10 May 2005 at the King Solomon Hotel

SALUTATIONS

Hon. Speaker of the National Parliament and Acting Governor General,
Hon. Minister(s) of the Crown;
Hon. Members of Parliament,
Members of the Diplomatic Corps;
Permanent Secretaries and other Senior Government Officials;
Heads of statutory authorities;
CBSI Directors;
Commercial bank managers;
Representatives of Non-Government Organizations, Churches, Women's groups, Youth and the Media;
Representatives of the Private Sector; Chamber of Commerce
Ladies And Gentlemen,

Let me welcome you all and thank you for accepting our invitation and taking time out from your busy schedules to be with us this morning. The Governor is on his way back from the ADB meeting in Istanbul and sends his greetings.

The launching of the annual report is a special occasion on the CBSI Calender. It provides an opportunity for us at the Bank to comment on the performance of the economy in the previous year, and also an opportunity for us to inform the public about the Bank's own actions and activities in that year.

My presentation this morning will be in three parts: the first part will review economic developments last year, the second part discuses key fundamental issues and problems facing the country that need to be reformed to reinforce the progress witnessed to date and enable the country to prosper in the medium term. The third part of this presentation will briefly look at the highlights in the operations of the Central Bank last year.

BACKGROUND

Exactly a year has passed since the Governor launched the 2003 Annual Report. And I am pleased to report that the economic recovery that started in late 2002 and enhanced by the presence of RAMSI in 2003 has continued in 2004.

We estimate that real GDP has grown at a rate of 5.5% in 2004 very close to the rate for 2003. The key drivers of this growth are the rise in private sector activities, favourable external conditions, return of confidence in law and order and donor support.

One consequence of the improved economic climate is that the Central Bank returned to profit in 2004 and its balance sheet regained a net asset position after being in negative territory for some years. The balance sheet will further improve in 2005 once ongoing discussions with the Ministry of Finance to sort the debt situation with the Central Bank are concluded in the next few months.

However, before the euphoria sets in, we must remember that the level of economic activity in 2004 is still below pre tension levels. It will take many years to restore GDP to those levels. And while our population continues to grow at 2.8% per annum it will take even longer to grow per capita GDP to the levels enjoyed by our Pacific Island neighbours.

So a lot of work still needs to be done, a lot of areas and issues still need to be addressed. Economic reforms are needed in many areas of the economy to consolidate the progress to date so that we can build a better future for our people. I will touch on a few of these issues later this morning.

II. ECONOMIC DEVELOPMENTS IN 2004

Let me make a brief survey of economic developments in 2004.

The Solomon Islands economy, as noted earlier, registered its second consecutive year of growth in 2004 when it recorded 5.5% growth in real GDP. This growth came primarily from increased private sector activity, particularly significant growth in exports and continued donor support.

Once again it is the real sector that has maintained the growth, although a disturbing feature is the current unsustainable logging boom.

GDP

The real growth of 5.5% in 2004 was slightly below 2003 but well above our forecast of 4% for the year. The growth in GDP was driven largely by increased production in our export commodities, particularly logs and copra.

Production

There was mixed performance in the production of our main commodities in 2004. While logs and copra increased, fish and cocoa slightly decreased. Apart from logs and cocoa, we are still catching up on lost production since 2000.

In terms of **log production**, about 1,043,150 cubic meters were produced in 2004, the highest to date. This level is clearly not sustainable and has serious implications for the stock of natural forest and over dependence of the economy on a single commodity. Plantation logs are and will remain insufficient to match the harvesting of natural forests. At the same time, taxes on logs are being given away and/or evaded and export prices for Solomon Islands' logs seem out of step with world prices.

The new Forest Bill expected to be enacted by Parliament in 2004 regrettably remains on hold.

Fish catch could have been much higher but for vessel and equipment deficiencies at Soltai. The generosity of the Japanese government to help Soltai increase its fishing fleet is gratefully acknowledged. But in the long term government should seek greater private sector involvement in this important industry.

Copra production returned to levels experienced in pre tension times but a dark shadow lies over the industry with the current stand-off between workers and management at RIPEL on Yandina that is almost one year old. **Cocoa** production was slightly lower in 2004 and was also affected by the strike action by workers at Yandina.

Commodity prices were generally favourable in 2004 and producers rallied to the opportunity this afforded.

There is potential to increase our production levels further especially for fish, copra and cocoa. And copra and cocoa production directly benefits the rural people.

Inflation

Inflation in Solomon Islands moderated in 2004 despite the significant rise in international oil prices. Inflation averaged at 6.9% in 2004 compared with 10.1% in 2003. The slowdown in inflation in 2004 reflects the fall in the imported component of the consumer price index, as a result of the stability of the SBD/USD exchange rate.

Inflation is expected to be lower in 2005. At the end of March 2005 inflation was around 5%.

Balance of Payments

The balance of payments recorded an overall surplus of $321 million in 2004. This outcome reflects improvements in the current account of the BOP on the back of strong growth in export receipts, which rose by 30% in 2004. Imports payments on the other hand marginally rose by 3% in 2004 and this is expected to rise in 2005.

Donor inflows also featured prominently in the balance of payments outcome for 2004.

Exports are driven largely by log exports. Log exports represent nearly 70% of total exports. This heavy dependence on a single commodity is a major structural weakness of the economy. The economic base need to be widened to reduce this dependency.

External Reserves

The external reserves reported a significant rise in both USD and SBD terms. At the end of the year, the reserves stood at $596 million. This represents about seven (7) months of import cover. However, if government's accumulated external debt arrears totalling $119 million at the end of the year were paid, the external reserves level would be significantly lower.

The improvement in the external reserves reflects the strong growth in exports than imports and donor inflows.

The high level of reserves allowed the Central Bank to relax exchange controls last year and further relaxation will be announced soon.

Government Finances

Fiscal discipline was re-established and Government finances have improved significantly and now in better shape than in the past. The government recorded an overall surplus of $102 million in 2004, reversing the series of deficits in the previous years. The positive outcome was due to stringent expenditure controls at the Department of Finance and revenue enhancement measures taken during the year. For the first time, SIG was able to build up deposits in the banking system.

The Government reached debt compromise with major domestic creditors and repaid some of its trade creditors in 2004. The donor community continued to give valuable budget support and significant levels of external grants. This is a reflection of the increased confidence in the country. Donor budget support, however, has ceased although donor support will be needed for a long time to come.

As the government deals with its external debts, sustaining debt repayments and convincing external creditors to support the government is very critical. However, this is being undermined by the granting of over generous investment incentives and tax concessions to both old and new investors. It would be very difficult, if not impossible, to ask creditors to forgive our external debts when we are giving away large amounts of money in tax incentives and exemptions.

Monetary Sector

In 2004, the broad money supply [M3] grew by 19% to $622 million, compared with a growth of 25% in 2003. The rise was driven fundamentally by the rise in net foreign assets. That commercial bank lending remained subdued, this trend has resulted in the growing level of excess liquidity during the year. It is expected that this excess liquidity would be reduced in 2005 as private sector lending increase.

Total domestic credit [TDC] from the banking system on the other hand, fell by 32% to $317 million in 2004. The fall in TDC was mainly attributed to a significant fall in net lending to government by 69% to $78 million. This more than offset the 10% rise in credit to the private sector during the year.

The fall in net credit to government reflected the rise in government deposits in the banking system during the year. This came as a result of the fiscal surplus recorded in 2004. This is a significant change from the past where heavy financing by government from the domestic banking system has had a crowding-out effect on private sector borrowing.

So in summary, the economic outturn in 2004 was positive suggesting that the economic recovery is continuing. But the economy remains fragile and fundamental problems remain. There is a need for economic reforms to continue and rigorously pursued so that the growth witnessed so far can be sustained.

II. KEY POLICY ISSUES

Let me discuss some fundamental issues and problems facing the country that need to be reformed to reinforce the progress to date and enable the country to prosper in the medium term.

1. Unsustainable logging and remissions on log exports

Last year log production was the highest, yet export duty on logs only rose by $6 million. This means that a substantial portion of the total log output in 2004 never attracted export duty because they have been exempted. The question is, who is benefiting from these tax exemptions and remissions? Most are obtained in the name of community reafforestation projects but it is unlikely that this money is reaching the communities. So we have a “triple problem” situation where our forest resources are being cut at an unsustainable level, the government loses out on export duty because of duty exemptions but the rural communities who are supposed to be the beneficiaries of the tax exemptions never receive the proceeds of the remissions. The value of export duty exemptions on logs were about $30 million in 2004.

2. Investment environment needs reform

The current investment regime in Solomon Islands is an impediment to business development in the country and needs to be reformed. The high cost and risk of conducting business in the country and poor and inadequate infrastructure is a tax on the economy. An enabling environment for private sector-led economic growth needs to be promoted in the country.

In this context, the recent announcement by Government that it will introduce a new foreign investment legislation in the coming Parliament sitting is welcomed news and a step in the right direction.

However, to be effective the new Act needs to be complemented by reforms in related areas such as efficiency in other government departments that deal with foreign investors, security of land use and tenure; taxation, skilled labour, exchange controls and access to credit. These areas have to be addressed before we can witness substantial inflows of foreign investment.

3. Debt mountain is unsustainable

The current level of Government debt at over $2 billion (of which $1.7 billion is formal debt) is very high and unsustainable. This debt is a tax on future generations of this country.

While investors may genuinely need some assistance from government, government cannot afford to give away tax revenues when its debts remain high.

4. Donor dependency need to be reduced

Solomon Islands has been receiving donor funding since independence. And in recent years, this has increased dramatically. Yet the country remains one of the poorest in the region. Current estimates put us last in terms of per capita income [US$500] behind our regional neighbours.

At the moment, donor support is an important component of our recovery process. For example, about half of the growth in foreign reserves is accounted for by donor support.

5. Govt. Machinery need to be strengthened

Weaknesses in governance, public sector management needs strengthening. We need to seriously consider the economic viability of the proposed federal system: Solomon Islands need an efficient political and administrative system, not one that would be more expensive than we can afford.

III. CBSI IN 2004

Now let me briefly say a few words about the activities of the Central Bank in 2004. Highlights of CBSI activities during the year are described in Chapter 8 of the report. Last year was a challenging but good year for the Bank.

As already noted earlier, the Central Bank witnessed a turnaround in its finances and recorded an $8 million profit last year compared to a $4 million loss in 2003. A combination of increased incomes and reduction in costs accounted for the positive outcome. And the Bank’s balance sheet also turned around and recorded a net asset position last year.

At the same time however, additional functions and responsibilities were placed on the Bank during the year. For example, the Governor was appointed as Acting Controller of Insurance in 2004. This widened the Bank’s supervisory overview to include the insurance sector. As part of implementing the Anti-money laundering legislation, a Financial Intelligence Unit was added to the Central Bank towards the end of the year.

The Bank took control of the management of DBSI with a mandate to pay off depositors and I am pleased to report that since the CBSI take over of DBSI in June 2004, we have made steady progress and reduced depositors liabilities from $19 million in June 2004 to $14 million at the end of March 2005.

On currency developments, the note upgrading exercise that began in 2002 was completed last year. Due to the problem of counterfeiting, and the special needs of ATM's, the $50 note was further upgraded in 2004. A hologram is added as a new security feature and Cornerstone technology added to strengthen the corners of the note. The new $50 note should be in circulation by mid 2005. Work began on a $100 note, which is now at the design stage. If everything goes to plan, the new $100 note should be released into circulation in the second half of 2006.

As noted earlier, the Bank was able to relax most of the Exchange Control measures introduced in June 2000. Further relaxation will be announced in the next few days or week.

CONCLUSION

In concluding, ladies and gentlemen, we have seen that developments in 2004 have been positive and the recent reopening of the palm oil plantation and ongoing negotiations and efforts to restart the Gold Ridge mine are welcomed. The Government has announced forthcoming changes to the Foreign Investment Act that should encourage investors. These are positive changes in the right direction.

The Central Bank has and will continue to focus on the need for improving financial services, especially in rural areas and expects further work in this area in 2005.

But a number of concerns and challenges remain. Sustaining medium term debt repayment is an important issue for the Government. The new federal system if implemented, would bring additional costs. The Government should re-examine its policy on investment incentives such as over generous tax holidays that ultimately benefit the foreign investor's home government.

The cost of doing business in Solomon Islands is very high compared to other Pacific Island economies. It is very expensive and time consuming to set up and register companies in the country: a process that is also open to corruption. Solomon Islands need to streamline and simplify the administrative requirements for businesses so that transactions costs in the country can be reduced.

The economy is heavily dependent on donor funding for the development budget. Nearly 70% of our export performance is due to logging and the rate of harvest is now several times the sustainable level. Inadequate infrastructure and poor transport links are inhibiting growth and development. These are issues that need to be addressed as a matter of priority if the economy is to sustain the growth levels seen in the last two years.

Finally, let me thank those involved in putting this report together

Many private organizations, government departments and agencies, statutory bodies, donors and RAMSI provided the data used in this report. Thank you for your continuous support. The analysis and interpretations in the report, of course, are entirely the responsibility of the Bank.

I would also like to thank our external auditors, PriceWaterhouseCoopers and the Auditor General for certifying the 2004 Financial Accounts, our printers SolStar Printing Ltd for getting the report out on time and to King Solomon hotel for the use of their venue this morning and for the coffee and snacks.

Lastly, to the CBSI Board and Management, thank you for the guidance and useful comments on earlier drafts of the report. And to my staff from the Economics department who did most of the work on the report, and our Accounting staff for the financial part of the report.

Ladies and Gentlemen, with these few words, let me commend the 2004 CBSI Annual Report for your leisure time reading and thank you very much for your attention.

Honiara, May 10th 2005