



CENTRAL BANK OF SOLOMON ISLANDS

2005 ANNUAL REPORT

**Statement by Governor Rick Hou on the Occasion of the Launching of the 2005
Annual Report of the Central Bank of Solomon Islands**

Mendana Kitano Hotel

May 15 2006

Statement by Governor Rick Hou on the Occasion of the Launching of the 2005 Annual Report of the Central Bank at Mendana Kitano Hotel on 15 May 2006

1. SALUTATIONS

Honourable Ministers and Members of Parliament,
Representatives of the Diplomatic Corps,
Permanent Secretaries and other senior government officials,
Heads of Statutory Authorities and State Owned Enterprises,
CBSI Directors,
Commercial banks managers,
Representatives from the Private Sector and Chamber of Commerce,
Representatives of the Churches, Non Government Organizations,
Representatives of Women and Youth groups
Representatives from the media,
Ladies and Gentlemen

First, let me welcome you to this launching event and thank you for accepting our invitation to be with us this morning¹. Secondly, it is indeed a great honour and privilege for me to address you this morning. The launching of the Bank's annual report is an important event in the Bank's calendar of events because it provides an opportunity for us to comment [before an audience like this] on the performance of the economy last year, and to inform the public about the Bank's activities and thus account for our actions during last year.

My presentation this morning will be in four parts: first, I will do a quick overview of economic developments last year; second, I will discuss some key challenges facing the country; third, I will briefly touch on the outlook for this year and the near future; and finally, describe some of the highlights in the operations of the Central Bank last year.

2. ECONOMIC PERFORMANCE IN 2005

Last year, when the Deputy Governor launched the 2004 Annual Report, he noted the continuation of the recovery process in 2004. This morning, I am pleased to report that this growth trend continued throughout 2005.

The recent riots in Honiara, is a set back to the recovery process but based on preliminary assessments by the Bank, I am confident that any negative effects on the Solomon Islands economy would not be as severe as initially feared. Although losses to businesses, properties and employment are serious to individual business owners and employees affected, the short to medium term impact from the riots on the main macroeconomic indicators would be insignificant.

¹ The launching had been originally planned for a week ago. However, the recent riots in Honiara have put those plans back by a week until today.

Ladies and gentlemen, let me do a quick survey of developments in the economy last year. In general, most of all the main macroeconomic indicators show positive trends during the year, although areas of concern remain.

2.1 Gross Domestic Product [GDP]

The Central Bank estimates that real GDP grew by 5% in 2005 coming on the back of growth in agriculture, forestry, construction, and strong development partner support. This is the third year of consecutive growth, which has allowed real GDP per capita to increase by 2% to US\$651. But this is still below pre-tension levels and much lower than levels enjoyed by our Pacific Island neighbours. So we have a lot of catching up to do and given our circumstances, this may take many years.

2.2 Production

The overall production index rose 4.7% in 2005 as a result of increased output of logs, cocoa and copra while fish declined during the year.

At 1.1 million cubic metres, **Log** production is at record levels, the second year in a row that log production exceeded one million cubic meters. This is obviously unsustainable. We cannot continue cutting our forests at this rate forever. In fact, at this rate we will run out of forest resources in a matter of years. And in that connection, the heavy dependence on logs is a major weakness in the economy.

Fish catch at 23,853 tons was 12% lower than the previous year because of weak production by the two main fishing companies operating in Solomon Islands. Aging catching vessels and poor fishing conditions contributed to the low fish catch. The provision of two new pole and line boats by the Japanese Government would help Soltai increase fish catch and the strategic alliance with Tri-marine to increase loin production would benefit this important industry.

Copra production rose to 26,279 tons, which is similar to pre-tension levels. But the ongoing industrial problems affecting RIPEL – the biggest plantation in the country – seriously impede the potentials in this industry. I hope the new Government can address the impasse between RIPEL management and the workers as a matter of urgency.

Cocoa production was higher than in 2004 as new areas of production come on stream. Along with copra, cocoa has a lot of potential to improve rural livelihoods. The ongoing industrial impasse between management and workers of RIPEL at Yandina and on north Guadalcanal is not helpful to this important commodity.

Meanwhile, commodity prices were generally favourable during 2005 as a result of strong global demand, which Solomon Islands farmers have benefited from.

However, the production capacity for fish, copra and cocoa has not been reached, which means that the potential for production to reach new levels exists. Given that copra and cocoa are two

commodities in smallholder hands, and spread through out the country, any improvements to them will directly benefit the rural people. More effort and greater emphasis should be given to the promotion of both these commodities.

2.3 Inflation

The average annual rate of inflation (as measured by the 12 months moving average of the Honiara Retail Price Index) rose to 7.2% in 2005, up from 6.9% in 2004. The rise in inflation last year was due to the pass-through effect from high oil prices, the RAMSI effect and strong domestic demand. However, the stable SBD/USD exchange rate and low inflation in most of Solomon Islands major trading partners, helped moderate upward pressures on domestic prices.

Upward pressures on inflation continue in 2006. At the end of March 2006 inflation was around 8.5%. Although still within the target for this year, this upward trend is a concern, as any further increases would seriously jeopardise the recovery process.

2.4 Balance of Payments

The overall balance of payments registered a surplus of \$120 million in 2005. Despite this surplus position, the trade account swung back into deficit last year, the first time in two years. The deterioration in the trade balance is attributed to the dramatic rise in imports, particularly oil and capital imports during the year. Oil imports now account for 30% of Solomon Islands total imports and with oil prices likely to remain high for some time, it is imperative that alternative sources of energy are investigated. In this connection, the use of renewable energy sources like solar, hydro and bio-fuel need to be pursued with renewed vigour to mitigate pressures from high price of oil.

2.5 Foreign Reserves

As a result of the surplus in the balance of payments, the level of foreign reserves rose 21% to \$717 million at year-end. This is equivalent to about five months cover of imports and non-factor services or six months of imports only. However, if the government's accumulated external debt arrears totalling \$76 million at the end of the year were factored in, the reserves would be lower by that amount.

2.6 Exchange Rates

The Central Bank maintained the policy of stabilizing the Solomon Islands dollar against the US dollar in 2005. This policy stance is geared towards minimizing inflationary pressures and inducing general business confidence rather than defending the reserves level. Accordingly, on average, the Solomon Islands dollar depreciated by 0.6% against the US dollar, 4% against the Australian dollar and 7% against the New Zealand dollar during the year. Movements against the Pound sterling and Euro were insignificant.

2.7 Government Finance

The fiscal outturn for 2005 reflected the performance of the economy during the year. Total recurrent revenues rose 22% to \$625 million as a result of robust activity in both the private and public sectors. Total expenditures on the other hand, rose by 29% to \$637 million due primarily to increases of 25% and 35% in Payroll and Other Charges respectively.

The stock of formal government debt fell by 4% to \$1.6 billion at the end of 2005 reflecting the decline in both external and domestic debts. External debt declined by \$69 million to \$1.1 billion as a result of the full settlement of the Marubeni loan. Domestic debt also fell by 2% to \$598 million due to principal repayment of restructured and amortised bonds. Other guaranteed debts, especially those due to NPF, would be addressed in 2006.

The government met its foreign creditors under the auspices of the Honiara Club round table meeting and secured commitment from creditors to a two-year moratorium on interest payments subject to government progress on the reforms agenda.

The donor community has remained committed to the development of the country and provided valuable budget support, technical assistance and other forms of grants during the year.

2.8 Monetary Developments

The monetary sector reported broad based growth in 2005. Money supply grew by 39% to \$864 million, driven largely by increases in net foreign assets [NFA] and credit to the private sector. Total domestic credit rose by 34% to \$426 million, which was attributed to a 63% rise in credit to the private sector. This was partially offset by a 53% fall in net credit to government. The fall in net credit to government was due primarily to a build up in government deposits in the banking system as well as some principal repayments during the year.

At the same time, liquidity in the banking system rose by 19% to \$309 million while deposit and lending rates moved slightly towards convergence as a result of the narrowing of the interest rate margin to 13.45% in 2005, down from 13.74% in the previous year.

The conduct of monetary policy in 2005 was aimed at ensuring that the rise in liquidity did not lead to excessive consumption that would have undermined the external reserves and fuel inflation. To achieve these objectives, a combination of Open Market Operations [OMO] and Foreign Exchange Market [FEM] interventions were used as the main policy instruments for monetary management. The build up of deposits in the Central Bank by government also helped sterilised, at least for the time being, about \$80 million.

2.9 Financial Institutions

2.91 Commercial Banks

The commercial banks in Solomon Islands remain safe, sound and profitable. All the financial soundness indicators such as asset quality, capital adequacy, earnings, profitability and liquidity in 2005 all point to a strong banking system in the country.

The banks recorded a 28% growth to \$990 million in their combined balance sheet during the year, largely due to solid growth in loans and advances and call deposits with the Central Bank.

Commercial bank lending to the private sector grew by 63% to \$389 million in 2005. The bulk of this lending went into the wholesale/retail distribution sector and personal sector. This trend appears to continue: where already, in the first four months of 2006 lending to the private sector grew by 11%.

2.92 Development Bank of Solomon Islands (DBSI)

In terms of the High Court order, the Central Bank's administration of DBSI under the Court Appointed Manager (CAM), the priority is to repay DBSI's deposit liabilities from its assets. In this regard, I am pleased to report that we have made steady progress and reduced depositor's liabilities from \$19 million in June 2004, when we took over, to \$4 million at the end of 2005. The turn out last year was so good that we were able to return a small operating profit of \$1 million to DBSI. At the end of April 2006, total deposit liabilities have declined further to \$2.8 million. Despite this success, DBSI's capital base or net worth remains negative.

It is expected that the CBSI management of DBSI would end by December this year. I am confident that we will be able to repay all DBSI's depositors and creditors or at least put aside enough money to pay them during this period.

Meanwhile, the bank's future is also under serious consideration. DBSI had been inactive for several years, but its role and the need for development type financing, especially in rural areas, has not diminished. As highlighted by the report of the conference on rural financial services early last year, the need for credit in rural areas is in fact higher than ever. This report is now with the Economic Reform Unit (ERU) of the Department of Finance to take action where appropriate on the recommendations. Already we have had useful discussions with the ERU on ways and means of progressing these recommendations forward.

2.93 Solomon Islands National Provident Fund (SINPF)

The National Provident Fund made some progress in 2005 in terms of reforms and embarking on a recapitalization plan to improve its investment base. The Fund is not short of liquidity but suffers from limited investment opportunities in the country. Almost all its investment portfolio is in country with a third of it in low yielding liquid assets. Given the limited opportunities and low returns to members, the Fund is developing investment strategies to improve returns and reduce risks.

A component of this strategy is to look abroad for better investment opportunities. Several meetings have been held between the Central Bank and the Fund on this issue and I am

confident this matter will be resolved in a manner which would be for the long term benefit of members and the country.

2.94 Insurance

The insurance industry in Solomon Islands is small but the prospects for growth in the market are good especially in terms of premium volumes. In fact in 2005, total premiums increased by 43% to \$22 million while the total assets of the industry grew by 31% to \$45 million. Much work is still needed to improve confidence in and to ensure the integrity of the insurance industry. However, events such as the recent riots and burning of business premises in Honiara have not helped in these efforts.

The integration of the functions of the Office of the Controller of Insurance (COI) into the Central Bank was completed in 2005 with the formal transfer to the Bank of the officer manning the insurance office. The Bank has started reviewing the principle insurance legislation to strengthen areas of weaknesses in the law and ensure it conforms to international best practices in the industry.

One of the major tasks for the Office of COI during the year is dealing with Solomon Mutual Insurance (SMI), especially the non-renewal of its operating license. Under the High Court order for serious compliance breaches of the Insurance Act, the company is now managed by a provisional liquidator.

2.95 Credit Unions

The number of active registered credit unions at the end of 2005 was 14, down from 27 in 2004. However, only half of these submitted financial returns to the Registrar's office that showed total assets of \$28 million, members' contributions of \$22 million and loans of \$18 million.

The Solomon Islands Credit Union League [SICUL], the umbrella body of the credit union movement in the country - is more or less defunct. Audit investigations into the activities of SICUL revealed serious weaknesses in financial management and administration. The Registrar's office and the SICUL board are collaborating to revive and strengthen the SICUL.

A five-phase study carried out by the Pacific Economic Development Facility (PEDF) of the World Bank was temporarily halted after phase two of the project. It is expected that the study would resume after the terms of reference for the study are modified to focus on SICUL.

Summary

To summarise, I have noted that the economic outturn in 2005 was generally positive, suggesting that the economic recovery in the previous two years has continued last year. However, it cannot be overemphasised that the underlying situation in Solomon Islands remains fragile and that the gains to date from the recovery process can be easily reversed if action to address this for the long term does not start now.

3. KEY POLICY & DEVELOPMENT ISSUES

Let me now turn to look at some of the fundamental issues and impediments in the Solomon Islands economy.

Compared to other small developing countries in the region and elsewhere, Solomon Islands is relatively well endowed with natural and human resources that can be harnessed to enhance the economic well being of its people. I am convinced that this can only be achieved through economic growth. Unfortunately, the country remains poor with a large section of its population struggling to meet their basic needs. This is because the impediments to economic growth have been largely left un-addressed. The Bank, and many others, has mentioned these before, so I am sure we are all aware of these issues, and I bet we even have ideas of how to address them. I need to stress however, that after twenty-eight years of independence, the fundamental problems are still with us, largely un-addressed. Some of these impediments include:

3.1 Narrow Economic Base

The narrow production and export base of the country is no news to us. We know that we have the potential to increase the productive base. But we have not been successful doing so. One thing is certain, if we want to achieve higher growth levels, increase job opportunities for our people, raise our GDP per capita income and improve our standard of living, especially of our rural people, we must expand the economic base.

We should not forget the sobering reminder that we have the fastest growing population in the region, where about 50% are below the age of 25 years. This means the economy must grow twice as fast than the population growth to provide jobs for our people and create wealth to raise the living standards of the population.

One way of expanding the economy is to provide the enabling environment for private sector-led growth and investment. In this connection, the enactment of the new investment legislation, and the proposed changes to the current tax regime are important steps in the right direction. Besides, we now have reports, which recommend ways to improve and enhance investment and how to address impediments to doing business in the country.

Concerted action is what we need. Further reforms should be taken to enhance efficiency in the machinery dealing with investment and business: for example, enhance security of land use and tenure, streamline taxation laws, increase local skills levels, enhance access to credit and so on.

To this end, it is gratifying to note that the new government has already sounded out its desire to work on reforms that would ensure resource owners to be active participants in the economic development process. Needless, to say, reforms need political will and commitment. We in the Bank stand ready to work with the government on these.

3.2 Debt Burden is Unsustainable

The economy is shouldering a huge debt and arrears burden with high debt servicing costs and debt to GDP ratios. The current level of government debt at over \$2 billion (of which \$1.6 billion is formal debt) is very high and unsustainable. Not only is the high debt a tax on future generations of this country, but also the high debt service cost means that a large portion of our tax revenues is devoted to paying debts and less for services delivery, that is less to developing the country.

Of the formal debt, \$1.1 billion represents external debt. Seen from another perspective, this means that each Solomon Islander - every man, woman and child - owes at least \$2,000 to international creditors and financial institutions.

We need to reduce our debt burden to sustainable levels. The previous government made some significant headway in addressing the government's debts and I would urge that this process must continue. We need to build on the successes made last year.

3.3 Donor Dependency

Solomon Islands has received a lot of aid money since independence. And in recent years, this has increased dramatically. In fact it is reported that of all the regional countries, we are among the highest aid per capita recipient. Yet the country is categorised as one of the poorest in the region. Recent estimates put Solomon Islands per capita income at around US\$651 well behind most of our regional neighbours.

At the moment, donor support is critical to our recovery process. Nearly half of the growth in our foreign reserves is accounted for by donor support. But this dependency on donors, although appreciated, is not good for our country.

Heavy dependence on donors undermines our growth potentials because in most cases, it encourages a lazy population. Instead of working hard, we seek donor assistance as a quick fix to our problems. But once the donor funds dry up, our efforts quickly falter.

3.4 Weak Governance

Governance is an area, which may not be too obvious to us, but it is in my view one of the main reasons for the health of an economy. Good governance principles are very weak both in the public and private sector. To have a strong and vibrant investment and business environment, we need to have a strong and vibrant government machinery, strong and efficient institutions that can support private sector growth and development. A weak governance environment actually discourages good investment and therefore stops private sector initiatives and effort.

Efforts in addressing these weaknesses have been identified for example, ensuring the legal framework especially those laws that cover economic sectors are overhauled and the relevant

government departments to be strengthened and up skilled. However, as before taking those appropriate actions has remained outstanding.

3.5 Reforms Agenda

The government has already embarked on a number of very essential reforms. In the financial sector for example, a comprehensive reforms program is already underway, which we believe will help create the conditions conducive for the economy to grow. It is very crucial therefore that these continue, otherwise it will be very difficult to grow the economy and attract the kind of investors we need.

3.6 Political Stability

Investor confidence was being gradually restored until the recent riots in Honiara. No doubt the riots and destruction of China Town has caused further damage to our reputation as an investment destination. But more importantly, the recent political swings were a stern reminder of the fragile political situation in this country. In the current environment, instability and uncertainty like in the past few weeks would seriously undermine long term efforts to restore investor confidence. Political uncertainty is a cost and disincentive to investment because it turns good investors away. The priority focus of our effort therefore, is to start sending out the right policy signals to investors. I believe this is a priority for the new government, but this task does not belong to the government, or anyone for that matter: it belongs to all of us. And we need each other because it will need extra hard work to mend the damage done to our reputation as a sovereign country that is able to manage itself.

3.7 Social Cohesion

This is a more “subtle” and not-too-obvious problem. But it is obvious the country is coming under enormous strain holding together. It would appear that we, Solomon Islanders, know of more ways than one to disintegrate Solomon Islands. I see this as more serious than the problems identified in the economy because this has implications for the country’s unity and long-term economic and social advancement as a united people. Our social institutions [both formal and traditional] and government machinery are unable to sustain the effects from these weaknesses and fragilities, which are manifested through social upheavals like the riots in Honiara last month.

Our leaders, be they in government, business, churches, non-government organisation, various communities, youth and women groups, and including banks, need to recognize these weaknesses and work together to address them. I suggest that we can all start by being more accountable, transparent and responsible in our respective leadership roles and service in our respective organisations. Start making that change where you are. When we all do that in our places of work, schools, communities, and so on, our collective efforts can make a change in this country.

These issues have to be addressed as a matter of priority in order to achieve the much-needed growth in the economy. I would urge all stakeholders, especially the government and all its agencies, as well as our development partners, to cooperate in implementing the necessary reforms as a matter of urgency. Failure to do so will only delay or even undermine the recovery process already underway.

4. ECONOMIC PROSPECTS

Let me say a few words about the economic prospects for 2006 and in the medium term.

The country is at the crossroads of its economic development. Before the riots in Honiara, the Solomon Islands economy was expected to grow at around 4-5% in real terms. With the country's reputation as a safe investment destination seriously damaged and investor confidence eroded, the challenge now is to quickly repair the damage done and restore confidence to sustain growth in the medium term.

To achieve this, the government needs to be sending out the right policy signals and assuring the market that it is committed to reforms especially in the areas of enhancing conditions for growth in investment and businesses.

The growth prospects for the global economy and in particular the Asian economies remain positive. Forecasts indicate solid growth especially in the US, Japan and China. But there are downside risks to world growth emanating from continued high oil prices and emerging inflation in the major economies.

Against this international backdrop, the economic outlook for Solomon Islands in 2006 and beyond remains positive. If global growth remains strong and inflationary pressures contained, it would create a window of opportunity for the Solomon Islands economy to grow, create new jobs and raise the living standards of its citizens.

We have the potential to do this. There is scope for key sectors like agriculture, mining, construction, fishing, tourism, distribution and utilities to generate further growth. But we need the right policies and environment to ensure these sectors are developed. The re-opening of the Gold Ridge mine, palm oil plantation and Pacific Timbers milling operation on Guadalcanal will all contribute to increase in economic activities and growth in 2006 and beyond.

Sustaining this growth rate, however, depends largely on maintaining the reform agenda that the previous government has started. It is also crucial that decisive action is taken to address existing impediments that constrain the economy's growth potentials. Special attention needs to be given to addressing weaknesses and inadequacies of infrastructure, financial services, government services, the investment climate and the need to spread economic activities throughout the country. Not to mention, the political will and commitment to follow through with corrective policies and actions is absolutely critical.

Despite the positive outlook, there are several risks to growth in 2006. These relate to potential adverse developments in the world economy, particularly the rise in oil prices and inflation. As a small island nation, Solomon Islands is affected by developments in the global economy. We depend on the rest of the world for much of our income and for many of our key business and consumer goods.

Forestry is expected to decline as the major source of export income, government revenues and royalties to resource owners. Without additional investment this may leave a huge gap in the economy. We must be prepared for the time when our trees are gone.

5. CENTRAL BANK OPERATIONS IN 2005

Ladies and Gentlemen, I would like to say a few words about the activities of the Central Bank in 2005. The highlights of the Bank's activities during the year are described in Chapter 8 of the report and the CBSI Calendar of events.

Last year had been a challenging, but positive one for the Bank. Challenging because, we have been asked to take on new responsibilities and functions, some of which, we don't have the necessary expertise nor resources to help us perform those functions. At the same time, the year had been positive and rewarding for the Bank, especially the financial outcome for the year.

Last year, the Central Bank recorded a net profit of \$202 million compared to \$8 million in the previous year. Much of this profit (\$175 million) came from a huge windfall arising from the reversal of the 100% provisioning on CBSI advances to SIG in 2001 following the regularisation of these advances last year. After discounting this one-off windfall, the Bank would have still reported a net profit triple that of 2004. This enabled the Central Bank to allocate \$18 million for transfer to the Government Consolidated Fund.

The Bank's balance sheet also grew by 49% to \$940 million last year, reflecting increases of \$120 million and \$190 million in foreign and domestic assets respectively.

At the same time however, additional functions and responsibilities were placed on the Bank during the year. As part of implementing the anti-money laundering legislation, the Financial Intelligence Unit was established in the Central Bank and an analyst recruited to oversee the work of the unit.

On currency developments, work on the \$100 and \$2 notes, is progressing with proofs for final approval expected next month before actual production begin in July. This is a delay of a few months on the original arrangements with the printers. If everything goes to plan, the new \$100 note should be released into circulation around September this year.

6. CONCLUSION

In concluding, ladies and gentlemen, as I have stated earlier, developments in the economy in 2005 have been generally positive despite adverse impact from high fuel prices. And the riots in

Honiara last month, although was a set back to the long term confidence in the economy, is unlikely to have major adverse impact on the economy in the short term as originally feared.

Nevertheless, a number of challenges remain. It is important that the Government addresses these head-on with renewed vigour. Consolidating and sustaining the gains in the economy to date is critical. And to ensure this happens the government must address the impediments that constrain our efforts.

The economy is heavily dependent on donor funding for the development budget. Two thirds of our exports 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.

Finally, let me thank those involved in putting this report together. I acknowledge the contributions by many of you to the production of this report.

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 our responsibility.

I would also like to thank our external auditors, PriceWaterhouseCoopers and the Auditor General for completing and certifying the Bank's Financial Accounts for 2005; our printers The Southern Star Printers Ltd for getting the report out on time and to the Kitano Mendana Hotel for the use of this venue this morning and for the coffee and snacks.

Lastly, but not the least, I would like to thank the Central Bank Board for the guidance and useful comments on earlier drafts of the report. Also members of my management team, my staff from the Economics Department who did most of the work on the report, our Accounting staff for the financial part of the report, and the staff of Corporate Services Department for organising this event.

Ladies and Gentlemen, I now have the privilege to now commend the 2005 CBSI Annual Report for your leisure time reading.

I thank you very much for your attention. May God bless you all.

Honiara, May 15th 2006