Statement by Governor Rick Hou on the Occasion of the Launching of the 2007 Annual Report of the Central Bank of Solomon Islands (CBSI)

Solomon Kitano Mendana Hotel
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Salutations

Honourable Ministers, Members of Parliament, Representatives of the Diplomatic Corps, Permanent Secretaries and senior government officials, heads of statutory authorities, bank managers, Directors of the Central Bank, officials of non-government organisations, representatives of the private sector, representatives of the media, ladies and gentlemen!

It is a pleasure and an honour to warmly welcome you all this morning to the official launching of the Central Bank's 2007 Annual Report. The launching of the Central Bank Annual Report is a special event in the Bank's calendar so we at CBSI would like to thank you for making the time available from your busy schedules to accept our invitation.

This occasion provides an opportunity for me to fulfill a responsibility of the Central Bank in presenting an assessment of economic conditions and prospects for Solomon Islands and to account for the Bank's operations in 2007.

Introduction

I will give my presentation in four parts: in the first part, I will give a brief overview of the Solomon Islands economic developments since independence, and pointing to major issues and challenges during that period. In the second part, I will provide a survey of developments in the economy during 2007. Thirdly I will sketch our outlook for this year and indicate prospects for the immediate future with possible areas to address. Fourthly and finally, I will present a brief on the operations of the Central Bank during the year.

Part I: Solomon Islands: 30 years on

Since independence thirty years ago, Solomon Islands has experienced some progress in certain areas, but on the whole, the economy has suffered from serious set backs in the fundamentals. In terms of its economic and social indicators, Solomon Islands is rated very low in the region. Some of the reasons for this below-average performance are exogenous factors, such as natural disasters of the seventies and 1980's, persistent low commodity prices for Solomon Islands exports in the eighties and 1990's, the Asian financial crisis in late 1990's, and rising oil prices. However, it should be noted that much of this out come is also due to self-inflicted injuries or things, which the country could have avoided by prompt action. For example, two fundamental problems of the past two decades are firstly, the excessive exploitation of the natural forest including the squandering of the windfall from this resource. Secondly, the continuing expenditure driven fiscal imbalance, resulting in a debt burden which has skyrocketed to an unsustainable level in 1995. The absence of a coherent policy environment has contributed to the sluggish growth in the economic base and in private sector development ever since. Lack of foresightedness has resulted in the geographical imbalance in economic development, which is one of the main causes, if not the major reason, for the social unrest in 2000 – another self-inflicted injury.

For three decades as an independent nation, economic management in Solomon Islands has been plagued by these same factors. During the first ten years, economic growth was driven mainly by the agriculture and fishing sectors. It was a period of maturing but an ever-changing political landscape. Fiscal and monetary policies could not find common ground, rendering the policy environment to be fragile.

The next ten years to 1997 was a period with economic growth averaging 5% backed by an export boom dominated by the forestry sector. However, there were consistent pressures on the foreign reserves while on the fiscal front an expansionary policy was pursued resulting in wider budget deficits and a staggering debt burden. These fiscal problems have persistently cast a cloud over the economy, until in 1995 when the financial system was under extreme strain resulting in the collapse of the security market that year. To make matters worse, two years later the Asian financial crisis took with it Solomon Islands main exports markets, especially for logs, which demonstrated the Bank's warnings about the country's over-dependency on this dominant export commodity. Despite a resilient private sector, evidence suggested that the impact from the crisis was a serious setback to the economy that caused a dampening effect, especially on the production sector as local companies tried to adjust. Meanwhile, inflation was averaging more than 10% with a persistent population growth of 3% implying that Solomon Islanders' per capita income levels were declining in real terms.

It was a period when public sector institutions and principles of good governance were systematically undermined while the economic and social infrastructure was left to deteriorate. This was exacerbated by an unpredictable political situation which resulted in a subdued investment climate for most of that period. Given the situation, both the exchange rate and monetary policies have had to resort to defensive role during the period.

The subsequent 5 years to 2003 saw the worst economic recession in Solomon Islands. GDP fell by more than 10% and inflation continued in double digits while the external reserves were only enough to cover a matter of weeks worth of imports. It was a period mostly without any law and order as Honiara was effectively ruled by militant groups that preyed on the Treasury for their livelihood and pressured the government for a "peace road map" which was signed with an open cheque. Consequently fiscal policy was mostly in disarray while the private sector – the engine for growth – was subdued.

The last five years opened with a very depressing and uncertain economic outlook. Nevertheless, it is worth noting that since 2004, this period is witnessing a record level of economic high growth, and relatively low [until recently] inflation rates. Furthermore, on the external front the balance of payments returned to surplus and the external reserves increased to record levels. Fiscal management, meanwhile, finally returned under sound management as revenues increased and expenditures came under control. More importantly there were significant improvements in investor confidence as law and order gained public confidence. As a result, investment activities, both by foreign and domestic sources, demonstrate robustness and the domestic economy is showing good prospects for the future.

However, the positive developments in the past few years and buoyant outlook of the economy would not have been possible without the intervention - and continued presence – of RAMSI in the country. Even before the ethnic social tensions, the fragile economic situation was of a subdued investment climate, a small and weak private sector, persistent government cash flow problems, large budget deficits, increasing government debt, high inflation, and a weak balance of payments position. This is the macro-economic setting that has plagued Solomon Islands economic management since independence.

Policy Issues and Challenges

The underlying situation therefore remains fragile. After 30 years of economic history many fundamental issues remain as challenges for economic managers today. To start addressing some of these challenges could just be the catalyst needed to spur the economy. The following list is by no means exhaustive.

Political Landscape

The political environment is an important determinant for many aspects of daily lives of ordinary people. Of particular importance to Solomon Islands is the level of investment in the country: it reflects how much confidence the investment community has in the political government. Sadly, Solomon Islands political history has been anything but helpful to the investment community and private sector development. In fact, Solomon Islands is rated very high risk because of the fragile political situation here. There is no guarantee of consistency of government policy with its actions, and political groupings are only a convenience to individual MPs.

Social Cohesion

Given the wide ethnic spread and traditional groupings throughout the country, consistent work is required to cement the country as one united nation. Harnessing such a diverse population has been a challenge for successive governments as this ethnic diversity has been the root cause of social disharmony for some considerable time already. This remains a great risk to investment in this country.

Fiscal Management

Fiscal policy had been largely problematic during this period. With very little integrity in the budget process, there was always uncertainty about policy matters such as tax, incomes, investment and so on. In these circumstances it was the resilience of the private sector that kept the domestic economy going. Sound public finance management can encourage increased economic activities. Maintaining fiscal coherence was indeed a tough call on governments in the 25 years after independence.

Private Sector Development

The private sector is the engine for growth bringing real and sustainable growth. The issue for the Solomon Islands is how much inducement and encouragement has been accorded to this very important sector. Past history shows a continuous disregard for the private sector.

SIG Debt

Debt is a burden to future generations and a charge on revenue sources. Debt sustainability in Solomon Islands has fragilities when compared to export proceeds, given that export performance will be dramatically reduced when logging (currently accounting for over 60% of export proceeds) suffers a precipitous decline in three to four years. The mounting debt burden reached crisis proportions in the mid 1990s when holders of government debt instruments regarded these as extremely high risk. Consequently, they shut all doors on the government for future borrowing. This has exerted extreme pressures on government with serious consequences for general services and on the rest of the economy.

Narrow Economic Base

The economic base was limited to a few export commodities which were vulnerable to external factors such as price volatility, weather conditions and so on. That would render a fragile economic base. However, it provided economic benefit to the country during the past thirty years and allowed for other areas of economic potential, for example tourism, construction, mining, professional services, retail and so on, to be developed which widened the economic base of the country.

High Population Growth

During the past three decades, there was an apparent lack of appreciation of the enormous disparities in population densities and natural resources endowment between provinces. There was no policy in relation to the fast growing population and the consequential demands on government versus economic output during the period. Given that the economy has not been growing in concert with the population, and given that a large portion [40%] of the population is young, the pressures that come with it are a real time bomb. Land disputes have increased as communal land and its resources are exploited with the growing population. Policy could be redesigned to harness this vast human resource into productive use and enabling them take a more active role in economic development. Rural dwellers can help deal with the inflated price of rice by returning to traditional root crops that are more nutritious and healthy forms of food.

Donor Support Vs Donor Dependency

The level of donor support to Solomon Islands has not only increased but also diversified in the last thirty years. It was very unlikely that this country would manage without the assistance of the international development partners. To the extent that such assistance was used for the greater and longer term benefit of the country, is encouraging. However, an off-shoot of donor support appeared to have prevailed in recent years. As a result of the increasing ease to mobilize funding assistance through an already unsustainable level of funding through unproductive channels such as the RCDF, Solomon Islands and its citizens are fast-becoming donor dependent. This is exacerbated by increasing government handouts, especially through national MPs and their provincial counterparts. Easy money options in this country are creating the disease I call *Donor Dependency Syndrome* (DDS) where the country, its institutions and citizens become "paralyzed" to normal hard work and shying away from being agents of real economic activity. Instead they spend time, energy and resources fantasizing in waves of pyramid schemes and other easy money schemes.

Weak Public Institutions

All public institutions provide the apparatus for economic development and conduit for service delivery. Over time, the public institutional framework has been weak and riddled with mismanagement. This has become an important source of concern for the country. From the perspective of private sector development, the public service had been the biggest drawback, if not, the obstacle. Turning this monster around has proven a difficult challenge.

Double digit Inflation

High inflation remains a threat to incomes and undermines real economic growth. It undermines a country's potential and discourages needed foreign investment. This is the case for Solomon Islands as demonstrated in the last two and half decades of economic development.

Systemic Fragilities in the Financial System

The financial system remained strong for most of the post-independence period. However, in 1995 commercial banks were exposed to government debt instruments and consequently over 40% of banks' balance sheets became impaired assets. Later on in 2002 the abrupt departure of Bank of Hawaii resulted in the dramatic change in NBSI ownership which became a regulatory head ache. To a lesser extent, the situation at DBSI was a blot on the financial system that led to the Central Bank having to take over its management following a High Court order.

Part II: Developments in 2007

2007 opened after four years of high growth that outstripped population growth with a very positive economic outlook. Investor confidence and the high level of business activity experienced in recent years increased further both from foreign direct investment and domestic businesses activities. The Solomon Islands economy therefore remained buoyant during the year, resulting in an estimated growth rate of 10.3% the highest in two decades, albeit with a spurt in logging providing a large part of this growth.

All sectors of the economy showed much improved performance during the year. However, the real sector has again led the charge, as all the major commodities registered growth. Except for fish, which recorded a 28% fall, all other sectors showed positive contributions in terms of the GDP. The agriculture sector, which accounted for 18.5% of GDP, rose by 21% mainly from palm oil products, copra and cocoa, although cocoa didn't reach the 2005 levels. In terms of production, copra rose by 31.2%, cocoa by 12.7% whilst palm oil and kernel registered a threefold and fourfold rise in outputs respectively. 'Other services' (including government spending on health, education etc) expanded further by 6.7%. Log production remained the single major driver which reached a new record in 2007.

In terms of the fiscal, developments both in revenues and expenditures showed positive outcomes to end with an overall surplus of $10.6 million for the year. This was the result of a 28.2% improvement in revenues largely due to improved economic conditions and stronger tax compliance. Total expenditures for the year expanded by 30.8%, most of which were in recurrent expenses.

On the external front, with strong global growth and the positive trend in the previous five years, 2007 ended with an overall BoP surplus of $127.6 million compared to $73.5 million in 2006. This outcome was attributed to strong performances in all the three main accounts namely, the current, capital and financial accounts.

In value terms, the export sector remained strong in 2007 with logs and timber registering a rise of 33.3% to $857.7 million in line with high production level for the year. Exports in palm oil products, cocoa, copra and 'other' exports also increased. Current transfers account also registered a 9.9% rise in surplus. The outcome was a significant rise in the official foreign reserves to $918.0 million, which represented 3.9 months cover of imports of goods and non-factor services.

Monetary growth recorded in previous years was repeated in 2007 reflecting robust domestic economic activities. Money supply rose by 24% compared to 26% in 2006. Both private sector credit and net foreign assets were the main drivers of this growth, with accelerated growth of 54.5% to $976.9 million for the former and 10.6% rise to $852.5 million for the latter. Net credit to government changed from a negative $11.2 million to a negative $30.9 million during the year, reflecting SIG claims on the banking system had increased significantly during the year. Excess liquidity in the banking system remained high despite a 35% fall during the year, which was due mainly to offshore investments by the Solomon Islands National Provident Fund.

Domestic inflation remained high with the Honiara Retail Price Index (HRPI) registering 10.0% in 2007, based on a re-weighted basket of the index. An increasing international oil price, a rising rice price with domestic demand-driven inflation and depreciation of the domestic currency will put upward pressures on domestic prices in the months ahead.

The robust economic outturn in 2007 came as a result of a number of factors. Improvement in law and order was a definite positive factor. It brought greater investor confidence, an active business environment and in turn more economic activity.

Part III: Outlook for 2008 and Prospects Beyond

I am persuaded that the current donor support was also a major reason for this positive outcome. In this connection it is worth noting again that the continued presence of the Regional Assistance Mission to Solomon Islands (RAMSI) and its activities have assisted the fostering of general confidence in the country and a positive outlook for the economy. Actions taken so far by the government were helpful to forge a positive business environment during the year. For example, the government's strong support for major investment projects such as the Gold Ridge Mine, the Guadalcanal Plains Palm Oil Limited and other upcoming investment projects give an important signal to the investment community of the level of commitment by the government in promoting private sector development in this country. At the same time, it is important that investors – both foreign and local - are regarded as being on a level playing field.

Turning now to the future, based on the growth trend in recent years, and economic developments in the first four months of this year, we should expect another positive outcome for 2008. While no growth is anticipated in the forestry sector, I am confident that given the prevailing commodities boom, agricultural activities, particularly in palm oil products, will increase significantly.

In its 2008 Monetary Policy Stance, the Central Bank foreshadowed monetary developments would slow down but not subdued. The Bank will remain vigilant to developments in the main economic indicators outlined in the 2008 Monetary Policy Stance. And we will take appropriate action should the movements in any of these key economic indicators be inconsistent with our policy objectives.

I am confident that the domestic banking system is capable of providing the catalyst for further private sector expansion and another positive year. Private sector credit expansion is therefore expected to continue on the back of a strong growth in domestic demand. On the downside, strong domestic demand, as well as persistent high international food and oil prices will pose a threat to domestic inflation.

The balance of payments outlook is also positive. I believe that there is great potential for exports receipts to rise as production from all commodities is expected to increase. I am of course acutely aware of the risks associated with the strong surge – which began in

2006 - in imports. At the same time, I am hopeful that external donor assistance will continue at their current levels. As already discussed 2007 provided a strong basis to be optimistic about 2008. Despite the circumstances in the global financial system, growth in Asia and the rest of Australasia is expected to be the source for our exports boom. The gross external reserves are therefore should remain strong in 2008.

Having said that, I am reminded that this optimistic outlook will not happen by itself. The government has an important role to play here. Government can provide the enabling environment to business enterprises especially in the rural sector where the majority of the population resides.

In this regard, Government's intention to stimulate rural development is praiseworthy. Our farmers deserve more support from extension services than has been given in the past. The subsistence agriculture that binds the rural communities can expand to provide food to replace the increasingly expensive rice imports. Traditional root crops are more nutritious and offer a more healthy diet than Australian polished rice. Coconut and cocoa plantations are growing old and the yields are falling so they need replanting.

It is encouraging to note that the Government's intentions to encourage rural financial services are already picking up following the establishment of a number of financial schemes in conjunction with commercial banks. More activities in this area should be expected in the coming months with the help of World Bank and other development partners.

I would suggest that State Owned Enterprises (SOEs) should be at a minimum commercialized and made to become more efficient and profitable. Opportunities for privatisation should not be overlooked. To address the multitude of problems that beset many of the SOEs, new board appointments with real business background should replace directors who attend board meetings only to collect allowances.

Further more, I suggest that hand in hand with development partners and investors, the Government can help create public/private partnerships that add value to the growth process. Important economic infrastructure, transportation links and competition in telecommunication would stimulate growth in rural financial services and tourism that is hampered by lacks in many areas. In that regard, the recent statements by the Prime Minister on telecommunications are encouraging

It is gratifying to note that the Government has recognised the need for improved international relations at a regional and wider level. Improving investor confidence can start by improving international relations. To that, it is heartening to know that Solomon Islands is once again enjoying a cordial relationship and mutual respect with its regional neighbours. This should further enhance the current positive business climate and boost investor confidence in the country.

The private sector would benefit from the passage of the Secured Transactions Bill and from proposed improvements to the companies register. The Foreign Investment Act that simplifies foreign investment procedures has seen increased investor registration although more needs to be done to actually convert proposals into real projects. I would urge that steps be taken to improve on this.

And finally the Government should not overlook the human capital that abounds in our city, towns and villages. In this connection, we should commend the excellent work that has been going on in addressing this issue by the rural training centres, where school dropouts [and others] are given training in skills that will not only give them a place in society, but also to support small and medium enterprises, as envisaged under the government's Rural Development Strategy.

Part IV: CBSI Operations – 2007

Let me now turn to the operations of the Bank in 2007. The CBSI staff compliment increased over the last four years as the Bank was given more responsibilities to oversee. The six main departmental functions operated normally during the year. Supervision and regulatory functions were active during the year especially with on-going responsibilities over DBSI and the establishment of the Financial Intelligence Unit in CBSI. It was also a busy year for the Bank's properties division and personnel section with new recruitments, an exercise which we have found a little frustrating because of the lack of appropriately qualified and experienced people in the job market. Currency operations ordered new currency notes during the year which the Bank took possession of in early 2008.

There were a number of changes on the Board as directors served their full terms during the year and replacements were appointed. However, three vacancies left by Directors F Kairi, B Saunders and Y. Sato remain to be filled while we await confirmation of three appointments to replace them.

Despite heavy budgetary commitments for the year, the Bank applied stringent internal control measures which not only enhanced the integrity of the Banks accounts but also ensured a net profit at the end of the year.

The 2007 accounts are the second set of accounts to be presented in compliance with International Financial Reporting Standards (IFRS). The Bank received technical assistance from the IMF for the review of the financial statements when they were produced.

The year turned a net profit of $29.5 million under the CBSI Act: this is compared with $21.8 million in 2006. As required under the CBSI Act the funds have been allocated to the Bank's reserves as well as to the SIG Consolidated Fund. Total Assets have increased by 9.5% to $1,141.6 million at the end of 2007.

The term of appointment of PriceWaterhouseCoopers (PWC) our external auditors, was extended by the Auditor General for a year to carry out the 2007 audit. As is the practice a new appointment will be made after a public tender of the assignment. The internal audit function is currently out-sourced. With the plan to have an in-house internal audit unit, the Bank has recruited a qualified accountant that continues to understudy PWC as Internal Auditors.

In keeping with out statutory obligations, this section of the report has been submitted to the Hon Minister last April.

Acknowledgments

In conclusion, I would like to acknowledge the contributions of certain people in the production of the 2007 Annual Report: firstly, the Auditor General and especially the Management and staff of PWC, who made sure the accounts, are completed in time. And especially this year when we have to present the Bank's accounts in compliance with International Financial Reporting Standards and the International Accounting

Standards. Secondly, our printers, EN Digital Printing Technology Ltd, for ensuring the report is printed before this morning. Thirdly, my thanks, on behalf of the Bank, to the management and staff of Solomon Kitano Mendana Hotel for availing these excellent facilities for our use this morning. Fourth, I would like to express our thanks to those of you – in the financial institutions, government departments, statutory bodies, private sector companies and elsewhere - who have kindly supplied the information we used for the report. Of course the analysis and commentary are our responsibility. Fifthly, I would like to acknowledge the guidance and advice rendered by my fellow directors in the final version of the report. And lastly, my thanks to my staff, in particular, the Manager and staff of the Economics Department, and the Manager and staff of our IT and Accounting Department. These men and women have tirelessly and relentlessly worked on the various sections of the report over the last several weeks, to make sure we have the 2007 Annual Report completed and available for this morning's occasion.

Closing remarks

Finally, some of you might recall that five years ago during a similar occasion as this when I launched the CBSI 2002 Annual Report at the Honiara Hotel, I announced that it would be the final Annual Report I would deliver as my term of office was about to end. Fate determined otherwise and I have served for another five years. Today I can say with certainty that the 2007 Annual Report shall be my last one.

Ladies and gentlemen, I think I have already overrun your patience, but may I now commend the 2007 CBSI Annual Report to your reading.

May God bless you and thank you for listening.