Overview of the Banks Functions and Operations

A central bank cannot achieve its multiple objectives without the support of other government policy measures or what is commonly called Fiscal Policy. Economic activity, which is a measure of the total expenditures of households, businesses and government for consumption and investment, is influenced by both monetary and fiscal policies and must work in tandem. A policy action taken by a central bank or government to achieve a particular objective may conflict with another stated objective, hence underscoring the need for consultation on and synchronization of policy objectives, targets and instruments.

For example, Government deficit spending designed to stimulate employment may lead to increased household expenditure and higher prices for goods. Further, government's borrowing to finance a deficit may cause interest rates to rise. If this were to happen, some local investment projects may be delayed or permanently shelved. Alternatively, if a central bank increased the supply of money to bring about a decline in interest rates in order to promote local investment, this may have adverse balance of payments consequences arising from an increase in capital imports and/or a flight of short-term capital to earn higher interest rates overseas.

Monetary policy aims, by and large, to control the money stock. The factors which influence the money stock are:

- Issue of notes and coins by a central bank;
- Variations in government's cash holdings and deposits with a central bank and/or commercial banks;
- Changes in loans and advances to government and/or in holdings of treasury bills and other government securities by a central bank and/or commercial banks;
- Changes in the foreign exchange reserves of a country;
- Variations in the statutory cash reserve requirement and the liquid assets ratio;
- Changes in a central bank's discount rate, also referred to as the Bank rate; and
- Adjustments in commercial banks' desired level of excess reserves.

In order to achieve its objectives which include, among other things, the development of a sound credit and banking system, a central bank must be equipped with special powers and policy instruments to effectively influence the factors which affect the money stock:

- The Central Bank as Currency Authority
- The Central Bank as Banker and Advisor to the Government
- The Central Bank as Banker to the Commercial Banks
- The Central Bank as Manager of the External Reserves

The Central Bank as Currency Authority

The Central Bank has sole authority for the issue of notes and coins in Solomon Islands. The unit of currency is a dollar which is divided into one hundred cents.

The value of the SBD$ is determined from a currency basket comprised of the currencies of the five main trading partners, ie. USD$, AUD$, NZD$, Pound Sterling and the Japanese Yen. The weight assigned to each currency reflects its importance in trade with Solomon Islands. These weights are reviewed annually by the Bank. No change can be made to the weights without the prior approval of the Minister of Finance.

The Bank calculates the value of the SBD$ each day against the intervention currency which is currently the US dollar. The Bank has been empowered to make discretionary changes to the calculated rate, within certain specified limits, so as to make it consistent with current policy objectives. The Bank is also required to provide weekly records to the Minister of Finance on the actual rates and movements during the week.

SI dollar notes of various denominations issued by the Bank are legal tender in Solomon Islands at their face value for the payment of any amount.

The Bank from time to time arranges for the printing of notes and minting of coins for its stock and for issue to the public. Old notes returning to the Bank from circulation are re-issued if they are in good condition. The Bank also redeems notes of one denomination into another; notes into coins or coins into notes. The denomination of notes in circulation are $100, $50, $20, $10, $5, and $2; and coins, in denomination of $2, $1, 50 cents, 20 cents and 10 cents. At end-December 1994, notes in active circulation totaled $51.4 million and coins $3.4 million.

The Central Bank has issued commemorative $100 gold coins; and silver coins in denominations of $10 and $5. These coins are legal tender but they do not circulate. The Bank has also commemorated major events such as the Pacific War, the Battle for Guadalcanal, Pacific Navigators, and other events through the issuance of commemorative coins which are of interest to coin collectors.

The Central Bank as Banker and Advisor to the Government

All central banks act as banker and adviser to their respective governments. In keeping with this general practice, section 27 (1) of Central Bank of Solomon Islands Act 1976, amended in 1985, provides that CBSI shall act as banker and adviser to the government. This section also stipulates that the Bank shall act as adviser to the Minister of Finance on monetary and banking matters.

Before describing these functions in detail, it would be useful to explain why it is necessary to give the Central Bank these particular responsibilities. The main reason is that the execution of these duties will help the Bank in its main task of formulating and implementing policies to maintain monetary stability.

A change in monetary stock, as previously mentioned, occurs when there is variation in one or a combination the following:

- Government' cash holdings and deposits with the Central Bank and or commercial banks;
- Loans and advances to government; and
- Holdings of treasury bills and development bonds by the Central Bank and/or commercial banks.

For example, if government's tax and other receipts exceed its expenditure (ie. Budget surplus), government's cash holding and deposits at the Central Bank and/or commercial banks will rise. Consequently, the stock of high-powered money with the public will fall.

On the other hand, if the government's tax and its receipts are less than its expenditures (ie. budget deficit) and if the government finances this budgetary deficit through short-term loans and advances from the banking system, or if it borrows against treasury bills or other securities from the Central Bank, the stick of high-powered money will rise. If the deficit is financed by borrowing from the Central Bank, this new injection of funds into the system will add to inflationary pressures in the economy, hence threatening monetary stability. The Central Bank is obliged, therefore, to advise the government to exercise restraint in its borrowings from the Bank because of the inflationary impact of such borrowings.

There are other legal restraints in place to prevent excessive government borrowing. In order to ensure that excessive borrowing by government does not result in excessive monetary expansion and resulting instability. The Central Bank Act provides that the total amount of all outstanding advances extended by the Bank to the government or to any statutory corporation and the holdings by the Bank of notes, treasury bills, securities and other evidence of indebtedness of, or guaranteed by, the government or any statutory corporation (exclusive of some statutory credit as outlined in the Act) should not exceed 30% of the government's average annual ordinary revenue calculated over the last three financial years. If this limit is reached the Bank must notify the Minister of Finance immediately and permit no further increases. The Minister is empowered to direct the Bank to permit further temporary increases up to a ceiling of 40% of the average annual ordinary revenue for a period not exceeding six months.

The Central Bank meets the government's need for long-term finance by arranging for the issue of Development Bonds and making a market for these bonds. The Bank's close contact and technical knowledge of the financial marketing enables it to play a key role in advising the government on the amount of funds that can be raised, the interest rate to be applied to the different maturities, and other related terms and conditions. This is designed to ensure that the operations relating to the issue of such bonds have the desired effect on the money and capital markets and allows the government to raise long-term funds on the best possible terms.

The Central Bank is also empowered to maintain accounts for statutory corporations.

Regarding the Bank's advisory functions, informal meetings are held between the Minister of Finance, the Permanent Secretary of the Ministry, the Governor and Deputy Governor, usually on a fortnightly basis, to discuss current issues and problems. The Bank also keeps in close contact with the Budget Unit and other relevant sections of the Ministry of Finance to ensure, among other things, that the government's domestic debt is financed without any disruptions to the financial system.

The Central Bank as Banker to Commercial Banks

Section 30 of the Central Bank Act provides that the Central Bank acts as banker to any commercial bank in Solomon Islands, of which there are currently three. The Bank also acts as banker for other local financial institutions, such as, the Australian Guarantee Corporation (AGC). It further empowers the Bank to open and maintain accounts in overseas banks or other depositories and appoint such correspondents or agents as may be necessary for the effective operation and management of the Bank.

In order to explain how the Central Bank's operations arising from its relationship with commercial banks affect the money stock and how the various powers and instruments that the Bank uses to bring about the desired effect on the money stock, we must first describe the main functions of CBSI in relation to the commercial banks. Under Section 30 of the Central Bank Act, the Bank is empowered to:

- Open accounts for and accept deposits payable on demand from commercial banks or other financial institutions;
- Buy, hold, sell and discount treasury bills;
- Buy, hold and sell securities issued or guaranteed by the government and maturing within ten years;
- Make deposits with commercial banks for a fixed period not exceeding one year unless with expressed approval of the Minister; and
- Grant loans and advances to commercial banks for a fixed period of one year on the security of all or any of the following:
    - Gold coin or bullion;
    - Treasury bills issued by the government;
    - Securities issued or guaranteed by the government.

There is also a provision in the Central Bank Act which aims to promote economic development by allowing the Bank, with the approval of the Minister of Finance, to buy, hold and sell shares in any corporation set up with the approval of the government for the purpose of facilitating the financing of development (provided that the total value of any such holding of such shares shall not exceed an amount equivalent to 20% of the paid-up capital and reserves of the Central Bank).

Commercial banks are financial intermediaries which accept deposits from the public and lend a large proportion of these deposits to eligible borrowers – individuals, companies, statutory corporations and the government. That portion of the deposit that is not lent, or otherwise invested, is kept as reserves to meet cash demands of depositors.

The other relationship which affects the total money supply is the ratio in which the public holds currency and deposits. Central banks have no control over this ratio. However, it is possible to make an assessment of the movements in this ratio by applying statistical estimation methods. The extent to which a central bank is successful in correctly assessing the ratio in which the public holds currency to deposits and in setting the appropriate level of the reserves ratio will determine its success in effectively controlling or influencing the stock of high-powered money and hence, the total money supply.

As indicated earlier in this chapter, all commercial banks and other local financial institutions (presently only AGC) hold balances with CBSI. However, these are not to meet a statutory reserves requirement. They are “call balances” on which CBSI currently pays interest of 6%. Such balances facilitate inter bank cheque clearings.

The Central Bank, with the approval of the Minister, also has the power to vary the ratio of liquid assets to deposit liabilities. This ratio is called the liquid asset ratio and is the most common tool used by CBSI. However in practice, it is more of a reactive rather than an active tool of monetary policy, as its main use is to provide the avenue for the financing of the government’s deficit through the issue of Treasury Bills to commercial banks. The required liquid assets ratio presently includes notes and coins, balances with CBSI, and treasury bills. The Central Bank Act provides that any bank which fails to maintain this prescribed level of liquid assets will be charged a levy of 1/10 of 1% per day of the amount of the deficiency until such time as the deficiency is corrected.

The Central Bank formulates its monetary and credit policies in consultation with the government and in accordance with the overall national development goals. The main objective of monetary policy in a small open economy like Solomon Islands is to protect the country’s international reserves. From the foregoing, it can be seen that CBSI has at its disposal all the conventional tools of monetary and credit control – discount rates, open market operations, variable reserves and liquid assets ratios and selective credit control. However, the main instrument used by the Bank has been the liquid assets ratio, supplemented by interest rates i.e. by varying interest rates on funds held with CBSI and/or by placing limits on interest rates payable/charged on bank deposits and loans/overdrafts. Changes in the call rate of interest (i.e. on banks’ call balances with CBSI) affect commercial banks’ earnings and indirectly their deposit and lending rates.

In addition, the Central Bank, like most central banks in developing countries, may use moral suasion to restrain credit growth. This is perhaps the most popular tool of credit control, particularly in small economies where central banks are in close and personal contact with commercial banks and other key players in the market. If CBSI wants commercial banks to exercise greater restraint on credit expansion or if it wishes to see more credit directed to the priority sectors, such as, agriculture and/or small-scale industries, it may advise banks through the issuing of a letter to mange their credit inline with these policy objectives. In order to encourage banks to lend more to the priority sectors and to reduce the cost of credit and the exchange risk to approved borrowers in these sectors, CBSI has introduced a Small Business Finance Scheme. A leaflet prepared by the Banking Supervision Department on this scheme is available for further details.

In keeping with the need to consult with banks and other financial institutions, the Governor/Deputy Governor and the Manager of the Banking Supervision and Extension Department hold periodic meetings with bankers, individually or collectively, to air, among other things, the Bank’s views on matters relating to monetary policy.

The Central Bank as Manager of the External Reserves

The country's external reserves are managed by CBSI. The Bank is empowered to maintain deposits in approved foreign financial institutions and draw on these deposits for setting foreign exchange transactions on the country's account or its own account.

The external reserves which the Central Bank is required to maintain should comprise of all or any of the following:

- Gold;
- Foreign notes and coins;
- Balances payable on demand held with financial institutions abroad;
- Bills of exchange and promissory notes denominated in foreign currency;
- Treasury bills issued by foreign governments, a determined from time to time by the Board;
- Marketable securities issued or guaranteed by foreign governments or international financial institutions, as determined from time to time by the Board;
- Any internationally-recognized reserve asset. (Though it has not been spelt out what an internationally-recognized reserve asset is, an example of one such asset is the International Monetary Fund's "Special Drawing Rights").

The above specification of the types of assets which together or individually form the reserve of external assets give an indication of the principles to be followed for the management of the country's foreign exchange reserves. Firstly, as far as possible the assets must be held in liquid form and should be readily available for settling the country's international transactions. Secondly, foreign exchange in excess of the amounts required for settling the country's international transactions shall be invested in interest-bearing securities which are marketable and which are likely to appreciate in value and can be liquidated without much capital loss.

In conducting foreign exchange operations and in acquiring foreign securities, the Central Bank follows sound investment principles. In that regard there is an Investment Committee in the Bank which meets, as required, to decide on new investments and deposits in regard to the Bank's liquidity needs, international exchange rate and interest rate developments, and economic trends in the major currency markets to which SI trade is directly related.