Foreign Reserves, What are they?

Welcome back to another educational feature from the Central Bank of Solomon Islands (CBSI). This week we take a look at a new topic on "Foreign Reserves" or sometimes referred to as "Gross Foreign Reserves." In this feature we will explain what Foreign Reserve is, why it is important and how it helps the economy of the country.

By, CBSI Media

What is Foreign Reserves? A burning question that a lot of us might have in mind and would want to know more about. In simple terms, foreign reserves refer to 'the amount of foreign currency that a country holds as its reserves'. The word "Foreign" implies that it is held in foreign currencies. The word "Reserve" is used because it is held and kept aside for future use for the country. Sometimes we hear financial experts or politicians use the term "International Reserves" which, basically means the same thing. Foreign reserves are classified as "Official Foreign Reserve Asset". They are held in various internationally recognized foreign currencies including the US dollar (USD), British pounds (GBP), Euro (EUR), Japanese yen (JPY), Australian dollar (AUD), NZ dollar (NZD), Singapore dollar (SGD), Chinese yuan (CNY), SDR and Gold.

Why is it important to hold on to Foreign Reserves? Solomon Islands is a small island 'Open Economy', meaning that we can openly trade with any country in the world. To do that, our country needs to hold certain amount of foreign currencies as official foreign reserves for this purpose. We cannot trade internationally with our own Solomon Islands dollar because it is not recognized as a global reserve currency; therefore, we need to use global reserve currencies to facilitate trade with the world.

Holding of foreign reserves meets four essential purpose for the country. Firstly, it ensures that Solomon Islands residents can easily facilitate international transactions with the rest of the world. Secondly, it is vital for the government of Solomon Islands in its settlement of its external obligations including external debt servicing and procurement of goods and services. Thirdly, foreign reserves provide a degree of confidence to the financial system, that Solomon Islands is capable of meeting all current and future international obligations. Fourthly, foreign reserves support and maintain confidence in the monetary policy framework, which the Central Bank implements from time to time to diagnose the economy towards mitigate external shocks and maintaining price stability.

As such, the level of foreign reserves of the country is one of the key macroeconomic indicators of the economy. It indicates the strength of the economy in terms of foreign external assets, which is an important consideration in terms of balance of payments.

In what ways does Foreign Reserves assist us? Foreign Reserves have both direct and indirect impact to us and the economy as a whole. It is from Foreign Reserves that the country is able to buy imported goods and items from other countries, like food, clothes, fuel, vehicles, medicines, machines and construction equipments and so forth. We cannot buy these items with our

Solomon Dollar; we need US Dollar or other recognized reserve currencies in order to buy them. Directly, it helps us facilitate trade with the rest of the world and indirectly, we are able to enjoy imported items as listed above; for our use and satisfaction. On the same note, our government and private sector may receive offshore debts and utilize foreign reserves for settlement. Having an adequate level of foreign reserves certainly gives confidence to the market and the country's ability to meet its international obligations. It proves that the country is financially strong and stable. However, very excessive foreign reserves may not be good for the economy as well as it may trigger excess liquidity in the system, driving high price levels (Inflation). On the other hand, Very low foreign reserves may also be bad for the country as it may signal negative growth in the economy and a risk to international trade. That is why it is fundamental that CBSI manages foreign reserves on a daily basis to ensure stability in the financial system.

Who Owns and Manages our Foreign Reserves? The Foreign reserves of Solomon Islands belong to the Government and people of Solomon Islands. The CBSI is mandated by law and is vested with the sole responsibility to hold and manage the country's official foreign reserves on behalf of the Government and the people. In doing so, the CBSI is able to influence the macroeconomic environment to bring about price stability. The management of foreign reserves is guided by three fundamental principles of SAFETY – protecting foreign reserves from adverse external risks, LIQUIDITY – ensuring sufficient liquidity at all times to cover all external obligations and YIELD – income is realized from reserves holdings. The CBSI achieves these objectives by engaging in buying and selling of foreign currencies with commercial banks. It is also important to remember that the CBSI is mandated to manage and report on official foreign reserves only, in this instance, foreign currencies held by CBSI.

Why CBSI is responsible for the Foreign Reserves and not the Government? There are two fundamental macroeconomic policies in any country. These are Fiscal Policy and Monetary Policy. The fiscal policy is concerned with government revenue and public spending so government bureaucracies administer it. As the monetary policy is concerned with influencing the money supply to achieve the ultimate objective of price stability, the CBSI as the mandated institution for the regulation and issuing of money is also vested with responsibility of managing foreign reserves. The CBSI Act 2012 and the Exchange Control Act 1976 mandate this responsibility.

What instruments make up foreign reserves? Foreign Reserves are held in various forms or instruments which are prescribed in the CBSI Act 2012. The CBSI is allowed to hold foreign reserves in the form of Bank notes and coins, spot foreign exchange transactions, credit balances and automated overnight reverse repurchases, term deposits and certificate of deposits, bills and bonds. The CBSI also holds foreign reserves in the form of physical gold. As a binding agreement with all IMF member countries, the CBSI also maintains Reserves in the form of special drawing rights (SDR) with the IMF.

Is it possible for the country run out of Foreign Reserves? Certain economic and social risks may cause a country to deplete its level of foreign reserves. In times of economic recessions or social

unrests, diminished investor confidence and uncertainty may often result in capital flight. A situation whereby businesses and individuals will seek to transfer capital and savings to safe havens, which increases demand for foreign currency and forces the Central bank to a sellout. Solomon Islands experienced this phenomenon first hand during the Ethnic Crisis in 2000. The economy was in crisis, many foreign investors closed their businesses and left the country, our export sector was crippled and government revenue diminished with donors also closing their doors. The economy was in a state of shock; with minimal foreign currency inflows, which could not sustain the reserves basket for trade. The CBSI then set in crisis control measures and utilizing exchange control tools to ration available foreign reserves in order to sustain import demands. One of the controls then, was to restrict all offshore payments, except for fuel, medicine and selected food items.

It is important to note that CBSI plays an important role in the economy and maintaining its autonomy is critical in managing foreign reserves and administering important measures in times of crisis.

(***Part 2 of this article will focus on some technical details of foreign reserves and will be featured next week Sunday.)***

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Note: *The views and opinions expressed in this article are those of the authors and do not necessarily reflect the position of the Central Bank of Solomon Islands*