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 you might have in mind and would want to know more about. In simple terms, foreign reserves refers to 'the amount of foreign currency a country hold as its reserves'. The word "Foreign" is used because it is held in foreign currency denomination, example the US Dollar. The word "Reserve" is used because it is held and kept aside for future use for the country. Sometimes we hear financial experts use the term "International Reserves," and this is basically the same thing. Foreign reserves can also be classified as our foreign asset.

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 foreign reserves to trade. We cannot trade internationally with our own Solomon Islands dollar, therefore we need foreign currencies like the US dollar, or Euro etc. to facilitate trading with the world.

Four key reasons why foreign reserves is important for the country:

1. To ensure that we (Solomon Islands residents) can easily facilitate International trade transactions with the rest of the world
2. To ensure and support the Government of Solomon Islands in meeting or repaying its external debt obligations and other foreign exchange needs
3. Provide level of confidence to the financial system that Solomon Islands is capable to meet its current and future international obligations
4. Support and maintain confidence in the policies of monetary and exchange rate management, to maintain price stability and limit external vulnerabilities

In addition, foreign reserves are one of the key macroeconomic and financial indicators of the economy. They depict the country's foreign exchange wealth of the economy. Sources of our foreign reserves can also determine the status and level of our country's economic performances, especially our trade balances or 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, like food, clothes, fuel, vehicles, medicines, machines and construction equipment's etc. We cannot buy these items with our Solomon Dollar; we need US

Dollar 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 other hand our government and private sector will be able to pay their offshore debt with our level of foreign reserves. Having an adequate level of foreign reserves gives confidence to the market and the country's ability to meet its international obligations, and prove that the country is financially strong and stable. However, a 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). Very low foreign reserves may also be bad for the country as it may signal negative growth in the economy and risk of international trading in the economy. That is why CBSI is monitoring this on a daily basis to ensure it is stable.

Who Owns and Manages our Foreign Reserves? Foreign reserves of Solomon Islands belongs to the Government and people of Solomon Islands. CBSI is mandated and responsible to hold and manage the country's foreign reserves on behalf of the Government, as according to the CBSI Act of 2012. CBSI must administer and manage this foreign reserves to help achieve the overall goal and objective of Central Bank, which is price stability, but at the same time ensure that our foreign reserves are SAFE, provides LIQUIDITY and YIELD income for the country. Central Bank also keeps foreign reserves to support commercial banks facilitate international payments. Central Banks buys and sell foreign reserves to and from the commercial banks and the donors.

Our foreign reserves is in US Dollar, Australian Dollar, EURO, GBP, SDR and Gold. The foreign reserves are all foreign currencies (Financial Assets) held by CBSI. The country's foreign reserves reported by CBSI are total foreign reserves held by CBSI only.

Why CBSI is responsible for the Foreign Reserves and not the Government? The administration and overall management of the Monetary Policy operations is with CBSI. The government only manages and drives the Fiscal Policy (Tax). Foreign Reserves comes under the monetary policy management which is the core function of CBSI. This is clearly stated in the CBSI Act 2012. There are a number of associated legislations that also help CBSI to govern and manage our Foreign Reserves. The Exchange Control Act (Foreign Exchange Regulation) is one fundamental legislature that drives and helps control our foreign reserves.

Where do the reserves come from? The CBSI Act 2012 allows CBSI to hold reserves in the following financial asset portfolios:

1. Gold
2. Bank note and coins, denominated in freely convertible foreign currencies
3. Credit balances and interbank deposits denominated in freely convertible foreign currencies
4. Readily-marketable securities denominated in freely convertible foreign currencies **5.** Claims from International financial institutions resulting from repurchase agreements etc.
6. Special Drawing Rights (SDR) held in CBSI accounts in IMF.

On what type of cases can the country run out of Foreign Reserves? The country's level of foreign reserves is subjected to many risks as well. A country can run out of foreign reserves if it is in a depression, in crisis, and if the economy export base is weak. Solomon Islands experienced a low level of reserves during the Ethnic Crisis in 2000. The foreign reserves were so low that there was only two weeks of import cover, meaning that the country had inadequate foreign reserves level, fitting only two weeks of imports. The economy was in crisis, many foreign investment companies closed their businesses and left the country, most of the country's exporting industries also closed down their doors and the export industry simply stopped. Most investors repatriated their money back overseas and there were basically no foreign reserves inflows. At this time CBSI took measures to tighten its exchange control policy in order to ensure our reserves did not vanish. One of the controls then, was to stop all payments offshore, except only for fuel, medicine and selected food imports. This is because our foreign reserves was so low and it was about to be wiped out. Those were very difficult times but today, our foreign reserves level is now adequate and is sitting on a high end, comfortable at 10.3+ month of import cover, which is the average over the last 5-10 years.

(***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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