CENTRAL BANK of SOLOMON ISLANDS
P.O. BOX 634, Honiara, Solomon Islands

Press Release: 01/2021 **Monday 18th January 2021**

Role of CBSI in the Secondary Market for Government Bonds

This article aims to clarify CBSI's role in the secondary market for government bonds.

Role of CBSI

In September 2020, the Central Bank of Solomon Islands (CBSI) announced an accommodative (expansionary) monetary policy stance. The two most common tools available to CBSI are the open market operations (OMO) and the cash reserve ratio (CRR). A non-traditional monetary policy instrument which has become useful and utilized by most central banks during the 2009 global financial crisis and the current economic fallout caused by the Coronavirus-2019 (COVID19) pandemic is known as quantitative easing i.e. purchasing of government bonds and other financial instruments (assets) by the central bank in the open (secondary) market.

In line with its accommodative monetary policy stance, and apart from the normal open market operations, CBSI reduced its CRR from 7.5% to 5%, and also announced that it will commence purchasing government bonds in the secondary market to mitigate the impacts of the coronavirus pandemic on the Solomon Islands economy. On 21st December 2020, CBSI purchased its first SIG Covid19 Bond valued at $60 million from the Solomon Islands National Provident Fund. CBSI has also informed other bond holders about the existence of this secondary market option.

Why is CBSI involved?

The CBSI Act 2012 section 36(1) prohibits CBSI from directly lending to the government with the exception of intraday credits and temporary advances. However, section 36(4) provides for the Bank to purchase government securities in the secondary market. Such legal provisions are common or standard for other modern and independent central banks around the world.

Other important considerations

There are of course other important issues to be considered when a decision is made to purchase government bonds in the secondary market.

First is the state of the macroeconomy. The use of QE and other unconventional monetary policy tools are vital to provide an effective response to significant economic shocks. During such periods, central banks provide the anchor and support to government to help cushion against the slowdown in economic activity. Thus, QE should not be used too liberally or during times of economic boom; it is in effect a backup tool for the economy. Moreover, it is frequently utilized in countries where interest rates are near zero, thus limiting the effectiveness of standard monetary tools such as policy rates.

Second consideration is the state of the government's debt. Once the central bank purchases the bonds in the secondary market, and new debt is sold in the primary market, total public debt would now undoubtably rise. In the case of the Solomon Islands, the country's debt level currently stands at around 11% of GDP as at end December 2020; a remarkably low level in the region. The comfortable debt threshold for the Solomon Islands means there is ample space for government to take on additional debt, to respond to shocks or implement other major capital initiatives.

For the primary bond holders of government bonds such as the statutory agencies and state-owned enterprises, the announced coupon rate of 5% per annum is comparatively a higher rate of return compared to the weighted average interest rate on deposits of around 0.45% in commercial banks as at September 2020. The prospect for a relatively better return would be an important consideration, in addition to supporting government's fiscal policy response.

Finally, the use of government bonds to respond to economic shocks is an important fiscal policy tool. Its use must always be appropriate and specifically targeted for key initiatives and major capital projects such for COVID19, the upcoming Tina Hydro project, amongst others. This is because at the end of the day, government's credibility to take on the debt, spend and repay it are significant considerations for macroeconomic development and stability.

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