

Reflections on central banking in Solomon Islands

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The Central Bank of Solomon Islands is an orthodox monetary institution cast in the same mould as central banks in most Commonwealth developing countries. There is nothing unusual about its statute or its ancestry. It was a monetary authority created when Solomon Islands introduced its own currency in 1976/77, a year before independence. At the time there was a great deal of excitement at the introduction of the Solomon Islands dollar, but many people now think that having its own currency has been a mixed blessing for the small economy. Though the ability to move the exchange rate has lessened the damaging impact of expansionary fiscal policy on the economy over the last 10 years or so, successive governments have proved unable to resist the temptation to monetise the fiscal deficit through central bank financing. This has accelerated inflation, widened the current account deficit of the balance of payments, and depleted the external reserves.

The Central Bank Act outlines the objectives of the Central Bank, which are the standard ones, including issuing currency, exchanging money, advising the government on banking and financial matters, promoting monetary stability, supervising and regulating banking business and promoting a financial structure and conditions conducive to orderly economic development.

The functions of the Bank are also quite standard as to its operations and the ways in which the Governor, Deputy Governor and the directors are appointed and can be removed. These procedures were the subject of some debate 10 years ago and again more recently. In the mid-1980s there were attempts to remove the Governor because the Governor of the day (that is, the author) was critical of some aspects of fiscal policy and its impact on economic performance. The durability of the Governor's appointment was then thought to have merit and it seems that a number of people have recently thought so again. Removal of the Governor of the Central Bank of Solomon Islands is possible, but has to be done in the manner described by the Act. In effect, the government has to explain to the people, represented by a tribunal headed by a judge, why it wants to remove the Governor and demonstrate that he or she has committed serious misconduct. The directors of the Central Bank, once appointed, can only be removed before expiry of their term for serious misbehaviour or insanity.

While the Central Bank's ability to think and act with some degree of autonomy is crucial to effective monetary policy, the Minister's statutory powers are also important. The Minister has powers under the Central Bank Act to issue policy

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directives to the Central Bank, after consultation with the Governor. As far as I know this has never been done. But it could be. The Minister would then be clearly accountable for the consequences.

Most of the functions of the Central Bank are in effect shared with the government. Where the Central Bank has powers to act it must usually act in consultation with the Minister. In other areas where the Minister will decide policy he or she must first consult the Bank, and the Central Bank then manages that policy; that is the case with the exchange rate, and some aspects of monetary policy. In practice, the expertise needed for the exercise of responsibility will often be located in the Central Bank and so the consultation process will tend to be led by the Central Bank. But there still has to be regular and thorough consultation on exchange rate policy and monetary policy.

Sometimes other parts of the government may be uncomfortable with exchange rate policy or policies on credit or interest rates. So there has often been a kind of alliance between the Ministry of Finance and the Central Bank, counterbalancing a more politically driven view of the exchange rate or money and credit coming from other parts of the government.

It was probably useful for the evolution of the Central Bank to have one Governor for the first 10 years or so of its development, giving a sense of continuity in senior and middle management. Most of the personnel in the Central Bank don't come from a government background. They are from private banks, or from a commercial business background, or have come straight into the Central Bank from university. So there is not a strong Treasury or civil service influence within the Central Bank. It has been possible for the management of the bank to develop an organisational culture that was reasonably robust and independent.

The small size of the community helps to mitigate institutional friction. There are people in the Central Bank who were at school and university with their opposite numbers in the Prime Minister's office, Ministry of Commerce and of course the Treasury. That is immensely helpful. When the news headlines would make you think these institutions were at war with each other, very often the people operating the machine are still on good terms.

Those functions of the Central Bank around which tensions have arisen with the government are usually to do with inherently conflicting objectives. For example, the Central Bank is not only a banker to the government but it is an adviser to the government. It may have to advise the government not to use its banking services. The advisory role has caused a number of problems with the government. Robust and objective advice is not always welcome when you are caught up in political tussles and sometimes it has been misconstrued as hostile advice. This is the 'shoot the messenger' reaction to unwelcome news.

But the effectiveness of both fiscal and monetary policy requires a firm basis of coherence and mutual understanding. The Central Bank is the manager of monetary policy and the manager of the exchange rate. The policies within which that management role is being exercised have to be determined by a process of genuine consultation between the Bank and the government.

One of the Central Bank's roles is the market maker in government securities. There has been an enormous increase in the issue of government securities as a way of raising money for government in Solomon Islands in recent years and more of them have been held by the Central Bank than it wishes to hold. It is this role of the Central Bank—the issuer and repurchaser and the payer out of maturities of government securities—that has recently been in the headlines. The Central Bank is also the

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supervisor of the financial system. So the supervisor of the financial institutions is on the one hand exhorting them to buy government securities, thus tying up lendable funds in financing the budget deficit, and on the other hand looking at their balance sheets to see whether they are playing a proper role in the development of a dynamic and well-financed economy. There are conflicts here that cannot be resolved simply by letting interest rates find their own level.

Questions of autonomy of the Central Bank are partly a matter of law, but are just as much an interaction of the key personalities of the Prime Minister and the Minister of Finance, the permanent secretaries of the key ministries, the management of the Central Bank, the Board of Directors, senior managers and departmental managers of the Central Bank. The way these personalities interact, whether they trust and get along with each other, is all a part of the way in which the Central Bank can exercise a reasonable degree of autonomy. This is not to suggest that the Central Bank exists in some way independently. It doesn't. It is a creature of parliament and answerable for its actions. By the same token, though, it can exercise quite a lot of semi-autonomous influence if it is sensible and can be seen to be a straightforward technocratic institution and not involved in politics.

The economic and financial environment is part of this. If times are difficult, if there is a public sense that perhaps the government did not see the wood for the trees, or that fiscal policy is somehow out of kilter, this will tend to give the Central Bank a need and an opportunity to exercise more influence, provided it is always conscious of its underlying dependence on parliament and public support. This cultivation of public awareness has been a key part of the Central Bank's strategy over the years. An important role of the Central Bank is the

publication of periodic reports. A lot of emphasis has been put on these reports to get them as accurate as possible, keep them up-to-date and keep them flowing, even though this has, on occasion, been an irritant to the government.

The government came into 1995 with a very expansionary budget, including big increases in log export revenues and domestic borrowing, and the Central Bank saying to the government 'we don't think you are going to be able to finance this budget'. In the event, it has not been possible for the government to borrow as much money as it intended. Hence the inflation and balance of payments impact will not be as bad as it would have been had the government been able to borrow all that it wanted. That exemplifies one of the paradoxes of this game—warning the government that crises are at hand.

The Central Bank doesn't only warn against impending disaster; it tries to do something about it. To the extent that it succeeds, the crisis is diminished and the Bank is accused of crying wolf. The Central Bank had been pushed to its legal limits in its financing of the government in 1994. The Central Bank took the view that this had gone on long enough—they were not getting replies to their correspondence with the Ministry and they were not getting access to the key people in the government to explain the seriousness of the financing problem, so it decided to draw the line. As the Central Bank cashed maturing treasury bills for members of the public, this was debited to the government's account at the Central Bank so the Central Bank's advances to the government increased. They went up well above the legal limit, so the Central Bank suspended dealing in government securities and predictably this brought the roof in. Members of the public were upset that they couldn't cash their treasury bills, so complained to the government. The

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government said that the Central Bank was trying to bring down the government. What the Central Bank was trying to do was get its message across that this was not a legitimate way of financing the government's deficit. It certainly brought the matter to public attention. The government's response seems to have been to revive earlier proposals to amend the Central Bank Act to facilitate the removal of the Governor, the Deputy Governor and the directors, and, with more immediate effect, to raise the legal limit on the credit the Central Bank can extend to the government.

There is a section of the Central Bank Act limiting Central Bank funding of government to 30 per cent of the average of the last three years' government ordinary revenues. There is also a disaster clause which allows this limit to increase to 40 per cent for 6 months. In 1995 it had been above 40 per cent for some time. The proposed change to the Central Bank Act raises that ceiling to 40 and 50 per cent. But such a ceiling tends to operate not as a deterrent, but an incentive to go up to that level. If that amendment is made to the Act there is little doubt that the debt will rise to the new ceiling very quickly and will tend to overshoot again. So it may not be the best way of solving the problem anyway, even from the government's point of view.

When the government made its intentions known, there was strong and focused public criticism from a remarkably wide range of points of view, including the trade union congress. Apparently in response to this, changes to the Central Bank Act were not proceeded with at the recent meeting of parliament. It is probably still the government's intention to amend the Act but perhaps the details of the amendment are being reviewed to make them less obviously an attack on the Bank's limited autonomy.

That autonomy, circumscribed though it is, is widely perceived as contributing to

the soundness (relatively speaking) of the Solomon Islands financial system. But management of the system requires a substantial degree of internal trust, manifested in good communications. Communications between the Central Bank and the government financial managers are extremely important. The Central Bank has had difficulties in communicating at the top, much more so than at the middle level. Economies can limp along with imperfect relationships and inappropriate policies for a long time, but performance, output and incomes suffer unnecessarily. If the government legislates to change the relationship with the Central Bank so as to weaken the independence of the Bank's management, this can be interpreted as a potential weakening of financial stability, with damaging economic consequences.

Solomon Islands' experience only underlines the truism that macroeconomic management can't be done by only the fiscal authorities or only the monetary authorities or indeed the public sector investment managers, it has to be done by all of them together. A breathing space would be useful now, to enable cool heads and common sense to reassert themselves. Perhaps the central bankers in Honiara can take some slight comfort from something that Robert Gardiner, a Ghanaian who was for many years head of the Economic Commission for Africa, is reported to have said

You can rely on democratically elected governments to do the right thing...but only after exhausting all other possibilities.

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