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Foreign Exchange Policy and Income Distribution: Lessons from Liberia
THE MAGIC TRIANGLE

BUSINESS ENVIRONMENT

MACRO STABILITY

LIVING STANDARDS
After several years of high growth and moderate inflation, the post-war Liberian economy experienced several external shocks over the past five years that have led to a downturn in growth and a jump in inflation and currency depreciation.

Since its inception as an independent state in 1847, Liberia has kept a very divided social and economic structure.

This divided social structure has shaped a growth pattern, where concessions agreements in mining and agricultural plantations make up the bulk of GDP and exports.

Hence, exports and fiscal revenue are exposed to highly volatile commodity prices.

Moreover, the very nature of the production composition is such that poverty and jobs do not positively respond to any growth in GDP.
Beginning in 2014, the Ebola crisis and a decline in the prices of their primary commodity exports (iron and rubber) caused economic growth to collapse.

Most recently, the presidential election, declining inflows of foreign aid, and the withdrawal of the United Nations Mission in Liberia (UNMIL) troops are posing further challenges to the Liberian authorities.

The fragility of the Liberian economy is exacerbated by the high level of dollarization with both the US dollar and Liberian dollar being legal tender.

Loss of confidence in domestic policies can lead to rapid currency substitution from Liberian to US dollars and thus contribute to exchange rate instability and inflation.
In recent years, economic growth has been slow, the exchange rate has depreciated rapidly, and inflation has accelerated. Real GDP declined 1.6% in 2016 and grew tepidly at 2.5% in 2017, the exchange rate depreciated year-on-year by 22.5% in 2017.

**Figure 1**: GDP Growth in Liberia Plummets

*Source: World Development Indicators*
Recent Macroeconomic Trends and Policies in Liberia

Inflation

Figure 4: Inflation in WAMZ Countries

- Inflation had been stable around 10% for the past several years before soaring to over 20% in 2018.
- The price level in Liberia is highly sensitive to exchange rate movements.
- Thus, the external shocks leading to a depreciation of the currency also led to rising import costs affecting the price level more broadly.
- The growth of the monetary base over the course of the past year has only escalated the inflationary pressures.
- While the inflation rate for most WAMZ countries decreased recently, Liberia’s inflation has surged, reaching the highest rate in the group in 2018.
Prices for both domestic and imported food have risen at the same rate as the price level overall.
Recent Macroeconomic Trends and Policies in Liberia

WAMZ Countries Nominal Exchange Depreciation, 2016-2018
(year over year percentage changes)

- The Liberian dollar has depreciated between 2013 and 2018 with a sharp acceleration in the last two years.
- In 2016, almost all WAMZ countries were experiencing substantial currency depreciation.
- Liberia’s depreciation of about 10 percent was in the middle of the group.
- Since late 2017, however, Liberia’s currency depreciation has surged while others have leveled off or declined, so that the Liberian dollar has been by far the greatest in WAMZ.
- This is in line with its higher inflation rate.

Note: We omit Nigeria due to their fixed exchange rate for part of the period.
Source: International Financial Statistics
Recent Macroeconomic Trends and Policies in Liberia

Government Budget

• High pressures on the fiscal balance: need to invest in infrastructure and social programs, the large public sector wage bill, limited sources of tax revenue, and declining aid inflows.
• Public sector wages constituted 51.5% of total government budget and almost 10% of GDP.
• The PAPD four pillars: Power to the People, Economic Growth, Peace and Security, and Governance.
• Budget constraint is an important risk factor for the Pro-Poor Agenda for Prosperity and Development PAPD: 2018 -2023
Recent Macroeconomic Trends and Policies in Liberia

• Foreign aid accounted for over half of total revenue in both 2016 and 2017, whereas tax revenue accounted for just over a third of total government revenue.

• The decline in foreign aid has been detrimental to fiscal balance.

• The reasons why aid flows decline: the winding down of Ebola-related grants, and donor fatigue.

• The declining grant receipts will require that the GoL rely more heavily on tax revenue for government financing.
Recent Macroeconomic Trends and Policies in Liberia

Debt Sustainability

- In 2008, the GoL had over $4.7 billion in debt, representing over 600 percent of GDP.
- By 2010, much of this multilateral debt had been forgiven through the Heavily Indebted Poor Countries Initiative.
- Shortly after completing the program, the GoL began borrowing heavily to invest in infrastructure and engage in debt-financed economic development.
- GoL has so far kept their debt accumulation to a manageable level.
- Maintaining debt sustainability will depend on the GoL’s ability to replace declining aid flows with tax revenue and reduce current expenditure while maintaining a high level of capital investment.

Table 4: Debt Sustainability Analysis

<table>
<thead>
<tr>
<th>Solvency</th>
<th>2017</th>
<th>Thresholds for Debt Distress</th>
</tr>
</thead>
<tbody>
<tr>
<td>PV of External Debt as a Percent of GDP</td>
<td>15.4</td>
<td>30</td>
</tr>
<tr>
<td>PV of External Debt as a Percent of Exports</td>
<td>66.2</td>
<td>140</td>
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<tr>
<td>PV of Total Public Debt as a Percent of GDP</td>
<td>17.6</td>
<td>35</td>
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<tr>
<th>Liquidity</th>
<th>2017</th>
<th>Thresholds for Debt Distress</th>
</tr>
</thead>
<tbody>
<tr>
<td>External Debt service as a Percent of Exports</td>
<td>1.4</td>
<td>10</td>
</tr>
<tr>
<td>External Debt Service as a Percent of Revenue</td>
<td>14</td>
<td></td>
</tr>
</tbody>
</table>

Sources: IMF Article IV Consultation Debt Sustainability Analysis (2018)
Recent Macroeconomic Trends and Policies in Liberia

Monetary Policy

CBL

- Monetization of fiscal deficit is a big challenge in controlling inflation and exchange rate depreciation.
- The use of the official exchange rate as a policy anchor for inflation instead of an inflation target is problematic.
- The main policy instruments are: intervention in FX market, issuance of TB, adjusting the reserve requirement.
- Main constraint: undercapitazation and low level of foreign exchange reserves
Recent Macroeconomic Trends and Policies in Liberia

Figure 15: Broad Money - Liberian Dollars (M2)

Between June of 2017 and June of 2018, the local currency in circulation, money supply, monetary base all grew rapidly.

Source: Central Bank of Liberia
Poverty and Jobs

Poverty Incidence in Liberia
Structural Factors Behind Macroeconomic Imbalances

- A High Dependence on Few Commodities and Foreign Aid
- High Corruption Incidence
- A Weak Business Environment

Liberia Exports Composition (2010, 2016)

Structural Factors Behind Macroeconomic Imbalances

Business Climate

Bribery Incidence

Bribery Depth

Source: WB Ease of Doing Business.
Lessons for LIC in Africa

- Short-term: slow the pace of depreciation
  - Forex interventions
  - Adopt credible policy stance
- Medium-term: address monetary policy instruments and authority
  - Reduce political influences on the CBL
  - Adopt a monetary policy regime consistent with the capacity and the realities of the Liberian economy and financial system
- Long Term
  - Address the fundamentals of private sector led growth anchored to value-added exports
  - Reforms in the business climate to reduce transaction costs
  - Invest in key infrastructure in targeted areas with growth potential
Lessons for LIC in Africa

- Reforms in the business climate
- Reforms of key economic institutions/Monetary/Fiscal
- Strategic promotion of a set of value-added exports/SEZ
- Emphasize concessional financing to avoid debt overhang
- Reform of public expenditures to reduce deficit financing
- Reforms in labor policies to stimulate private sector investments
- Anchor macroeconomic policies to traditional institutions to engender investor confidence.