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**Foreign Exchange Policy and Income  
Distribution: Lessons from Liberia**



**Politique de change et développement durable  
dans les pays à faible revenu**

**14 FÉVRIER 2019 | 9h00 > 18h00**



**Foreign exchange policy  
and sustainable development  
in low-income countries**  
**FEBRUARY 14, 2019 | 9h00 > 18h00**

**Banque de France - Espace Conférences - Paris**

# THE MAGIC TRIANGLE



# BACKGROUND

- 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.

# BACKGROUND

- 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.

# BACKGROUND

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

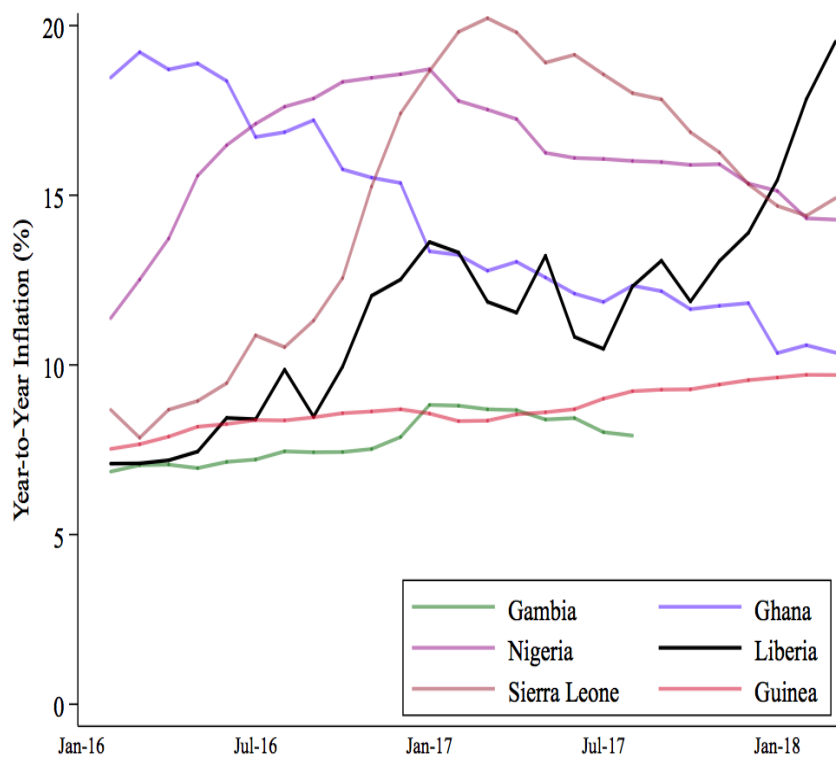
**Figure 1: GDP Growth in Liberia Plummetts**



# Recent Macroeconomic Trends and Policies in Liberia

## Inflation

**Figure 4: Inflation in WAMZ Countries**

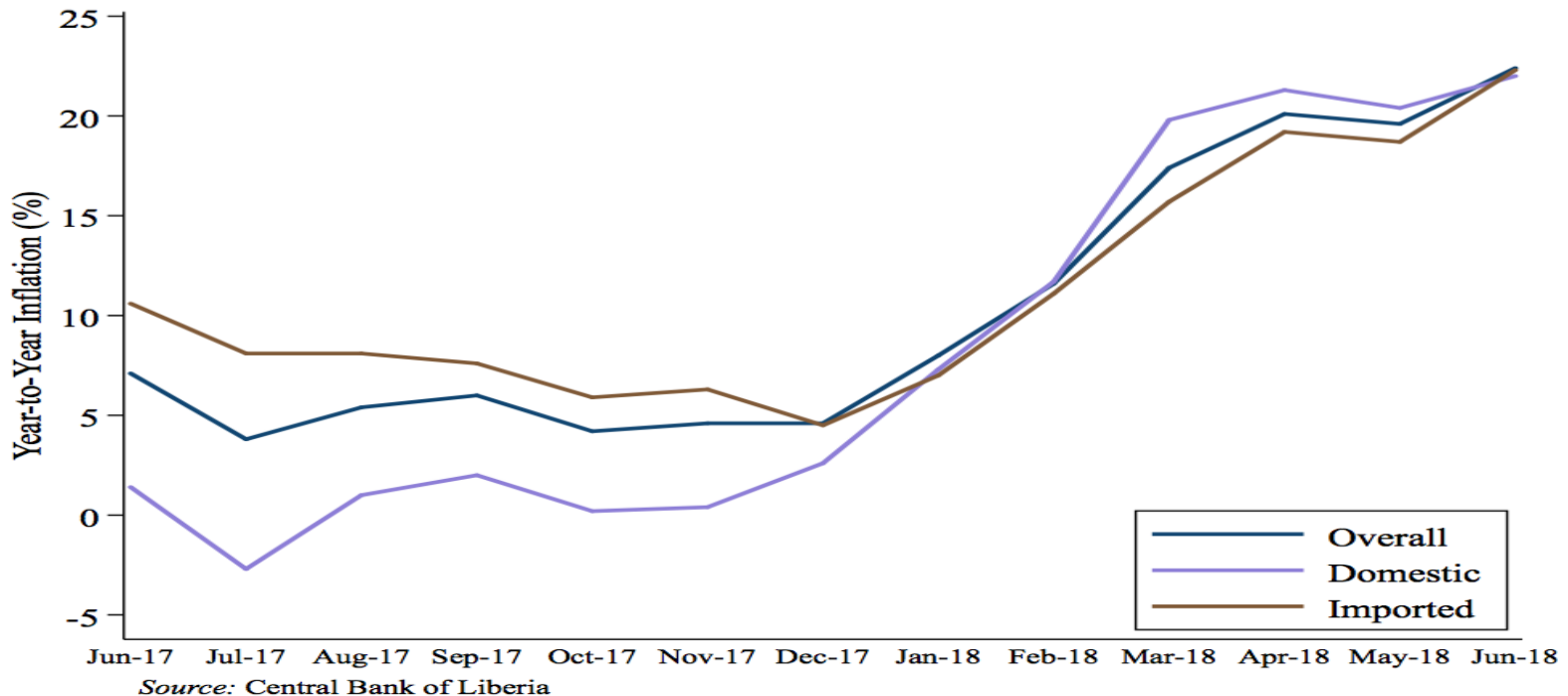


Source: International Financial Statistics

- 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.

# Recent Macroeconomic Trends and Policies in Liberia

## Food Price Inflation

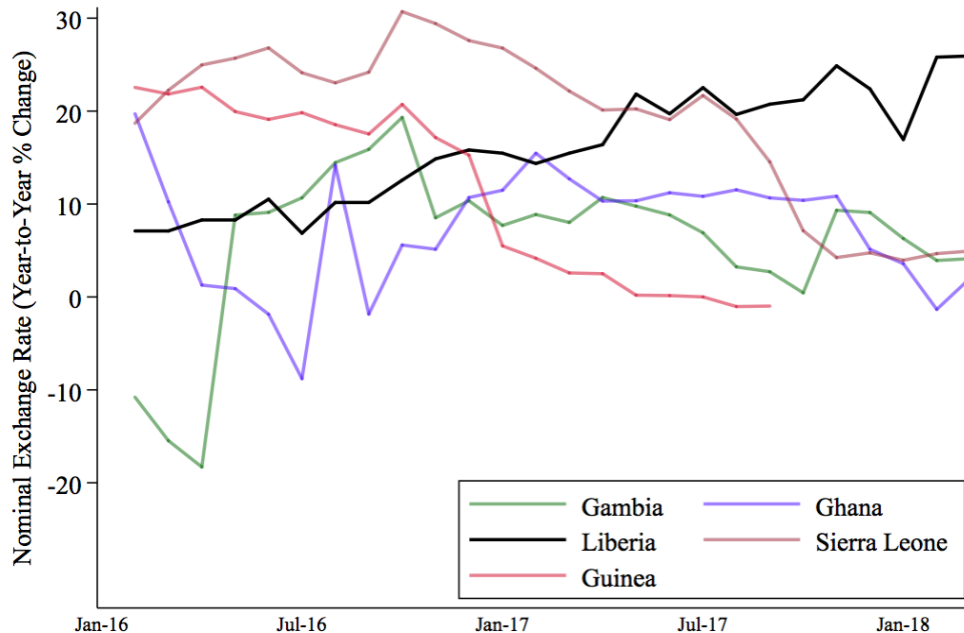


Prices for both domestic and imported food have risen at the same rate as the price level overall.

# Recent Macroeconomic Trends and Policies in Liberia

## WAMZ Countries Nominal Exchange Depreciation, 2016-2018

(year over year percentage changes)



Note: We omit Nigeria due to their fixed exchange rate for part of the period.

Source: International Financial Statistics

## Exchange Rate

- 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



# 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.

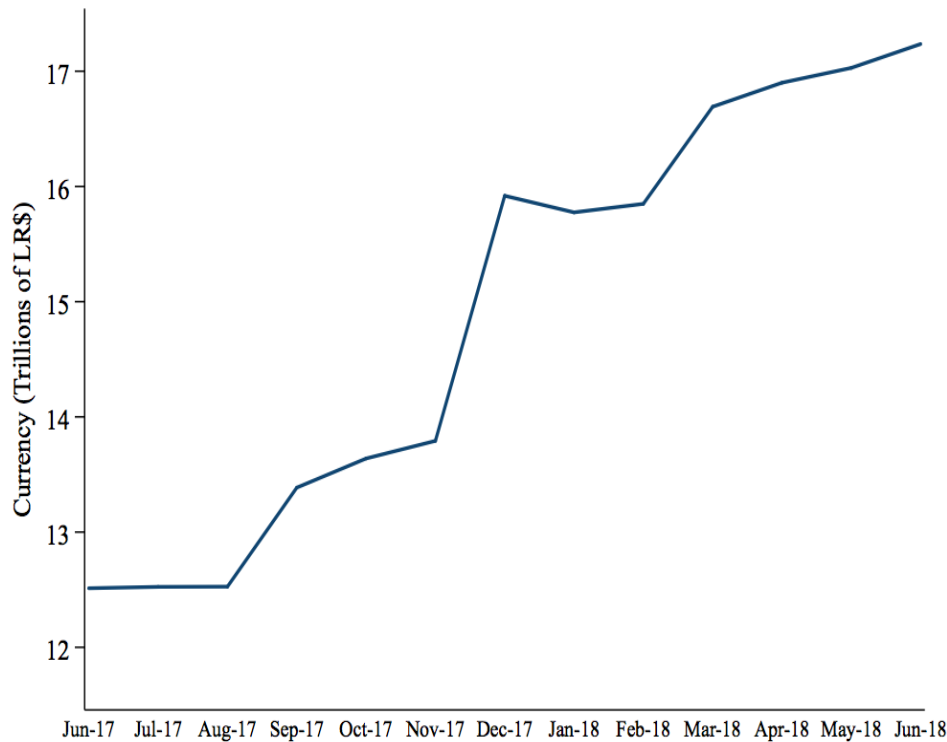
**Table 4: Debt Sustainability Analysis**

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

Sources: IMF Article IV Consultation Debt Sustainability Analysis (2018)

# Recent Macroeconomic Trends and Policies in Liberia

**Figure 13:** Liberian Dollars in Circulation



Source: Central Bank of Liberia

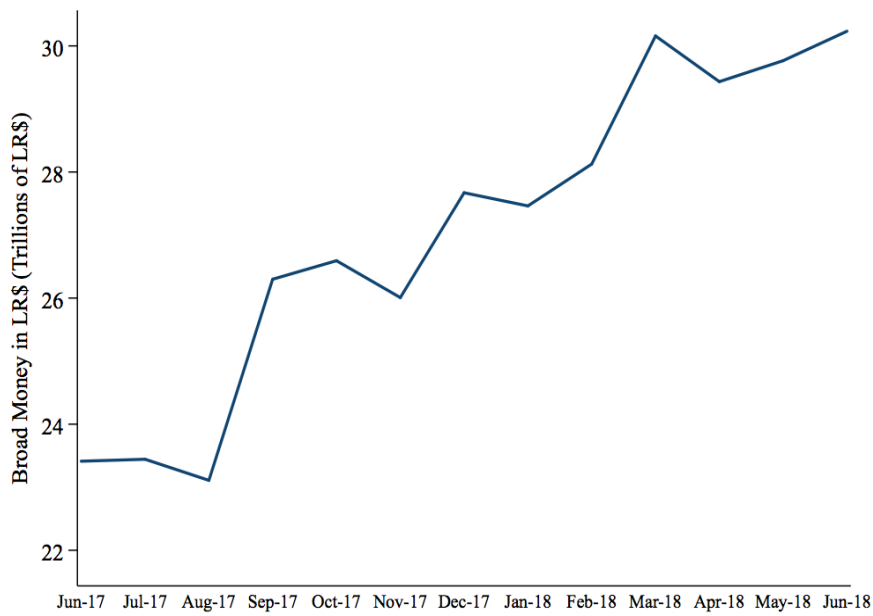
## Monetary Policy

### 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: undercapitalization 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



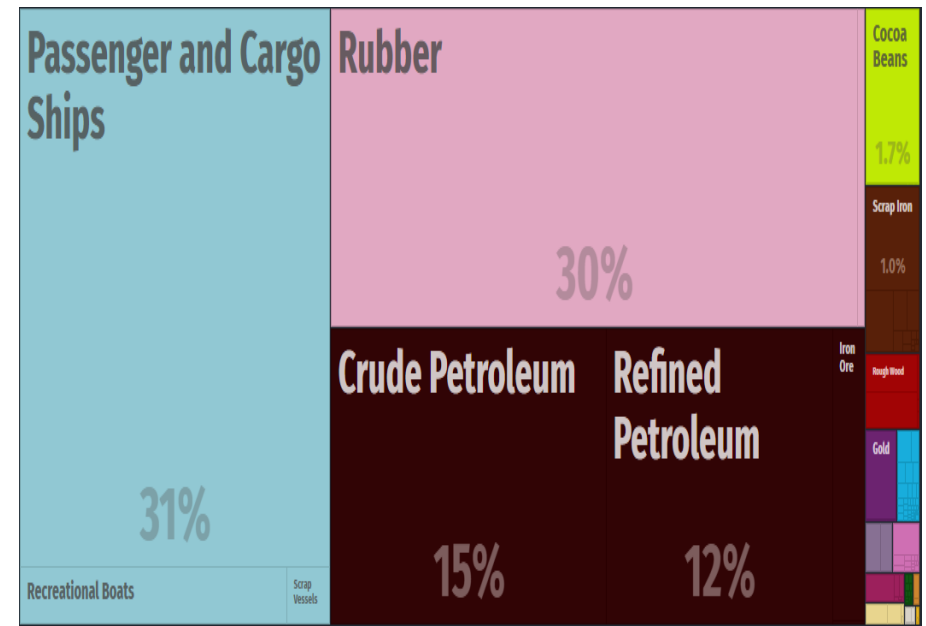
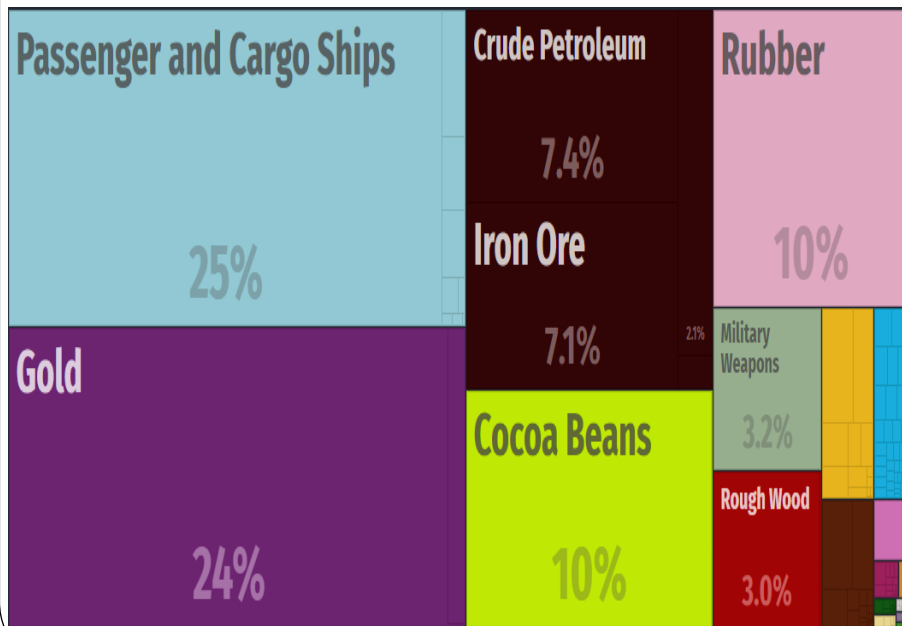
# Structural Factors Behind Macroeconomic Imbalances

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

Liberia Exports Composition (2010, 2016)

2016

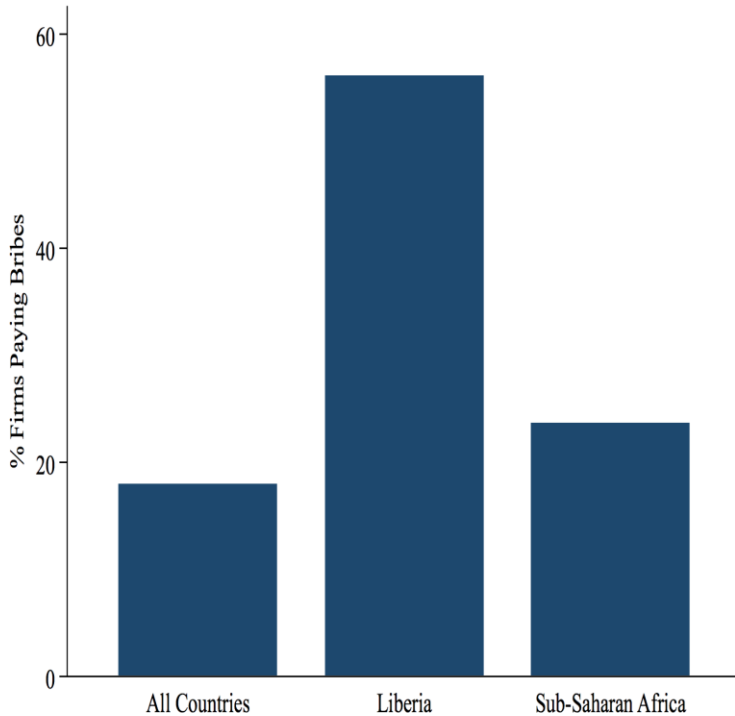
2010



# Structural Factors Behind Macroeconomic Imbalances

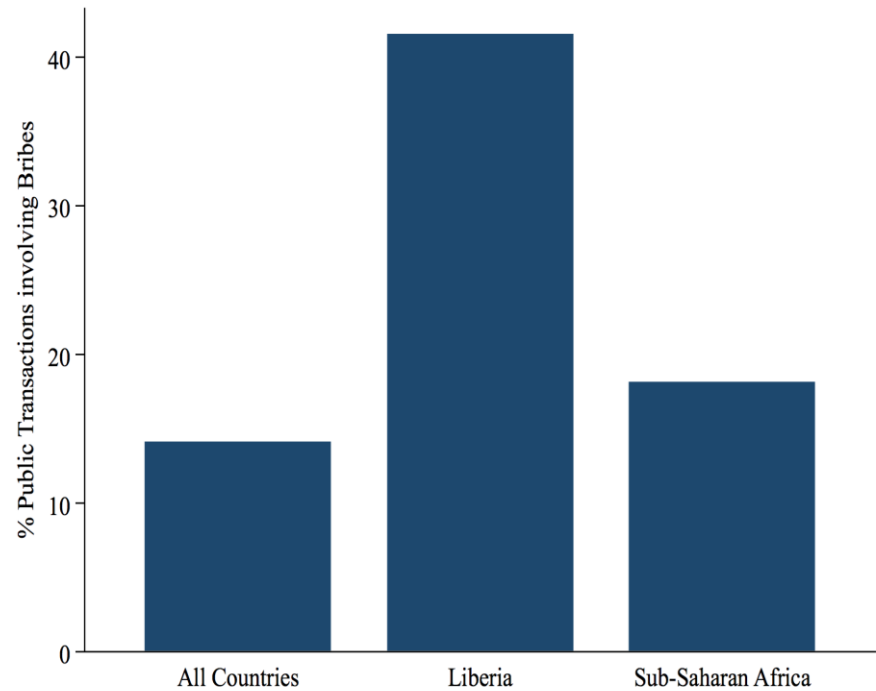
## *Business Climate*

### Bribery Incidence



Source: WB Ease of Doing Business.

### 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.