IMPROVING MONETARY POLICY EFFECTIVENESS IN SIERRA LEONE

Recent high inflation has posed a significant challenge to Sierra Leone’s economic stability and sustainability, including the burden it places on the most vulnerable. Despite past improvement in the conduct of monetary policy, this paper shows that fiscal dominance and shallow financial markets continue to weigh on the effectiveness of monetary policy. Nurturing an enabling macro-financial environment by curtailing fiscal financing needs and fostering market development will be instrumental to strengthening monetary policy. In this regard, the Government’s commitment to fiscal adjustment is an important complement to their goal of reducing inflation to single digits. Addressing the structural challenges of monetary policy will also require sequenced institutional and operational reforms.

A. Introduction

1. Inflation in Sierra Leone was historically volatile and has remained persistently high in recent years (Figure 1). Through the decade of economic recovery following the end of the civil war, inflation gradually came down and stabilized at single digits, only to ratchet up quickly to double digits when the country was hit by Ebola and global commodity prices collapsed in 2014-15. Since then, inflation has remained elevated.

2. The effectiveness of monetary policy in taming inflation has been hampered by the tension between maintaining price stability and meeting fiscal financing needs. The surge in inflation in recent years coincides with a period of increasing credit to the government by the domestic banking system. Meanwhile, frequent supply shocks, such as disruptions in the mining sector and natural disasters, pose significant challenges to the conduct of monetary policy.

3. Attaining and maintaining single-digit inflation is one of the key objectives of the Government’s National Development Plan. High inflation undermines economic activities, increases government borrowing costs, eats away households’ income, discourages investment, and disproportionally harms the poor. Improving monetary policy effectiveness to create a more predictable and stable low-inflation environment is therefore particularly important.

Figure 1. Sierra Leone: Development of Inflation and Growth

Source: IMF staff calculations.

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4. Against this backdrop, this paper aims to analyze impediments to and scope for improving monetary policy effectiveness in Sierra Leone. The rest of the paper is organized as follows. Section B describes the institutional context for the conduct of monetary policy. Section C discusses current macroeconomic environment. Section D analyzes the effects of monetary policy. Section E provides an overview of priority policy areas for improving the effectiveness of monetary policy.

B. Institutional Context

5. Monetary policy is formulated by the Monetary Policy Committee (MPC) whose effectiveness has increased over time. The MPC includes Governor, Deputy Governor, a representative of the Ministry of Finance, and three other members recommended by the Minister of Finance and the Governor. The MPC meets every quarter, mainly reacting to recent economic developments. There has been good progress regarding quality and timeliness of materials for monetary policy decision-making. The Bank of Sierra Leone (BSL) has started forecasting near-term inflation since December 2018. The BSL’s web-based data warehouse went live in March 2019, providing a database of macro-economic time series as far back as 2001 for the four sectors (real, external, fiscal, and monetary and financial) of the economy.

6. While price stability is the primary objective of monetary policy in the BSL Act, there are constraint on it being the effective operating objective in practice.

- Tensions among de jure objectives. The BSL’s mandate encompasses other important goals, including macroeconomic and financial stability, as well as financial market development. While these goals are complementary to that of price stability, tensions involving short-run trade-offs between price stability and other goals can arise, posing challenges to the conduct of monetary policy. For example, subdued growth and high inflation impose competing pressures on monetary policy.

- Tensions among de facto objectives. Among others, the BSL faces the following de facto competing objectives in formulating its policies: achieving price stability, meeting fiscal financing needs, achieving foreign exchange reserves targets, mitigating exchange rate volatility, and enhancing credit to the private sector. Pursuing multiple objectives—particularly when they are conflicting—complicates policy design and is often the source of policy slippages.

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2As of early March 2020, the second deputy under the new Bank of Sierra Leone (BSL) Act is yet to be appointed.

3Section 7.A of the new BSL Act states: “(1) the objective of the Bank shall be to achieve and maintain price stability. (2) Without prejudice to subsection (1) the Bank shall contribute to fostering and maintaining a stable financial system. (3) Without prejudice to the attainment of the previous two objectives, the Bank shall support the general economic policy of the Government. The previous BSL Act also defined price stability as the primary objective of monetary policy.”
7. **In practice, monetary policy is currently implemented in the context of reserve money targeting.** The BSL’s reliance on quantity as the policy target reflects two key constraints. First, lack of developed financial markets hinders the BSL’s ability to anchor monetary policy through prices. While the BSL sets monetary policy rate (MPR), it mainly serves a signaling purpose. The BSL does not have the operational support of liquidity management to align market rates with its policy rate. Second, lack of reliable information on real interest rates makes it difficult to assess the status of macroeconomic situation. Divergence of interest rates among different government securities, for example, shows a distorted picture of the liquidity condition and clouds the assessment of the state of the macroeconomy (Figure 2).

8. **The current monetary policy framework is more backward-looking in formulating, implementing, and communicating monetary policy.** Policy analysis focuses on recent economic developments rather than underlying or forward-looking pressures that drive inflation. Furthermore, policy horizon is short, typically focusing on the end-year inflation forecast without a comprehensive assessment of the economic outlook, future risks, the consistency of the policy path with the inflation objective, and contingency plans in the event of large shocks. The MPC is still in the course of improving its communication strategy, including to explain its decisions, past outcomes and actions necessary to align expected inflation outcomes with the policy objectives.

C. **Macroeconomic Environment**

9. **Sierra Leone’s financial system remains shallow and inefficient, dominated by commercial banks in terms of assets, and financial markets are in their infancy.** Total banking assets account for only about 18 percent of GDP in 2018. The spread between lending and deposit rates amounts to 15 percent, signaling high inefficiency of financial intermediation. Inter-bank market activity is very limited. Instead, banks deal with their liquidity situation individually with the BSL. The secondary market of government securities is virtually non-existent, and money market activities are limited. The small size of financial sector relative to GDP particularly limits the BSL’s ability to influence aggregate demand.

10. **Fiscal dominance characterizes the macro-financial landscape.** Compared to its peers, Sierra Leone’s banking sector had much higher credit to the government (including state-owned enterprises) and significantly lower credit to the private sector in percent of GDP (Figure 3).

- The credit function of banks is limited to the public sector. On the asset side, commercial banks heavily invest in T-bills and credit to the private sector is of secondary importance. Around 65 percent of commercial banks’ credit is channeled to the central government while only about
35 percent of credit funds the private sector (Figure 4). Moreover, credit to the private sector is typically extended to contractors who work on government-related projects, making the implicit share of credit to the public sector even larger.

- Fiscal financing needs dominate the central bank’s balance sheet. Nearly 99 percent of central bank’s credit goes to the central government, compared to about 1 percent of credit to commercial banks. Credit to the government in percent of GDP has doubled from 2012 to 2018 while credit to the private sector hovers around 5 percent (Figure 4).

![Figure 3. Sierra Leone: Banking Sector Credit Allocation in Comparison with Peers](image)


![Figure 4. Sierra Leone: Fiscal Dominance](image)

Source: IMF staff compilation based on the data from the BSL.

11. **The BSL and Ministry of Finance compete on the short end of the yield curve.** The inability of the government to borrow long-term has resulted in distorted T-bill rates. T-bill maturity is concentrated at 1-year (over 90 percent of all T-bills), with a high yield of above 20 percent. Such high return on government securities discourages commercial banks from expanding credit to the private sector and incentivizes the government to borrow from the BSL at a lower rate. In addition, the limited market depth to absorb government financing needs puts the government at risk of
running arrears to contractors, which drives up non-performing loans makes banks shy away further from credit to the private sector. This creates a vicious cycle of central bank financing, limited financial market depth, and runaway inflation.

12. **Vulnerability to external shocks adds to the challenging macroeconomic environment.** Sierra Leone relies heavily on imported goods and services (30 percent of GDP), which suggests that exchange rate passthrough is potentially high. While reserve coverage is broadly adequate as of end-December 2019 (preliminarily at 3.5 months of imports), real exchange rate overvaluation (assessed to be in the order of 20-30 percent) implies that depreciation pressures could quickly place pressure on reserve adequacy. Shocks to the external sector will likely have a significant impact on inflation, further complicating the inflation management.

D. **Effectiveness of Monetary Policy**

13. **Shallow financial markets prevent the MPR from affecting household and business activities effectively.** The small share of domestic credit to the private sector implies that there is a limited role of interest rates in affecting private demand. More importantly, there is a disconnect between the MPR and interest rates relevant for consumption and investment decisions. Notably, the MPR has been raised multiple times since 2015 to contain rising inflation, but there has been almost no change of deposit and lending rates (Figure 5, left panel). As a result, the influence of monetary policy rate on aggregate demand of the private sector is insignificant. By contrast, there is much stronger co-movement of monetary policy rate and treasury yields (Figure 5, right panel). Such dichotomy suggests that the MPR affects aggregate demand mainly through the public sector by influencing the government’s borrowing cost.

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**Figure 5. Sierra Leone: Transmission Channels through Monetary Policy Rate**

Sources: Bank of Sierra Leone and IMF staff calculations.

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4Technically, a 100-basis point increase in the MPR is associated with 54-75 basis points increase in Treasure bills in the same month, whereas it is associated with only 7-8 basis points increase in deposit and lending rates with a one-month lag.
14. The association between money aggregates growth and inflation is less than clear. The past decade can be divided into two periods by the twin shocks of Ebola and the global commodity price slump in 2014–15. The period before the twin shocks was characterized by more fiscal discipline and single digit inflation, but the period after witnessed the fiscal pressure from the twin shocks, subsequent loss of fiscal discipline around 2016-17, and rising inflation. Inflation has ratcheted up rapidly since 2015, despite similar growth rates of money aggregates throughout the decade (Figure 6).

15. Inflation is strongly correlated with fiscal financing needs. One notable development after 2015 is the change in the composition of money aggregates. There was a sharp rise of the central bank’s net credit to government—a component of base money—that coincided with the surge in inflation (Figure 7). The correlation between inflation and net credit to government as a share of base money is 0.90 between January 2011 and March 2019. The substantial increase in government borrowing and associated surge in inflation underscore the disproportionate influence of the public sector on the economy. Past lack of fiscal discipline has undermined monetary policy effectiveness and worsened inflation.
16. **Taken together, monetary policy transmission—either through quantities or price—is weak and is overwhelmingly influenced by fiscal behavior.** Under fiscal dominance, the central bank is often required to finance the fiscal needs directly or indirectly through lending to the government. Monetization of fiscal deficits results in large increases in money supply, pushing up aggregate demand and inflation. Furthermore, higher interest rates resulting from tighter monetary policy can increase the government’s debt service burden, and the fiscal authority might put pressure on the central bank to undertake policies that are less tightening than optimal. Controlling money growth to contain inflation, in the face of pressure to finance the deficit and build international reserves, squeezes the credit to the private sector. With credit to the private sector hovering at around 5 percent of GDP, the current policy environment does not augur well for strengthening in the near-term channels through which price-based monetary policy can impact aggregate demand.

17. **Reserve money targeting, while appropriate in the near term, has limitations.** In the face of severe fiscal dominance, reserve money targeting helps anchor inflation by setting quantitative limits on reserve money growth. Reserve money targeting also plays a monitor role in Fund-supported programs. Nevertheless, reserve money targeting raises some challenges. As evident in Figure 6, there is a weak correlation between money aggregates growth and inflation in the short run. While the quantity theory of money states a proportional relationship between money supply and price level, that relationship mostly likely exists in the long run. In addition, liquidity shocks can lead to volatile short-term interest rates, increasing liquidity risks and hampering monetary transmission.

**E. Priority Policy Areas for Improvement**

18. **Nurturing an enabling macro-financial environment is equally important as putting in place technical building blocks to enhance the effectiveness of monetary policy.** As noted above, structural challenges severely constrain the conduct of monetary policy. Many liquidity management instruments are already in place. However, they fail to gain control over liquidity conditions and inflation in the presence of fiscal dominance. Shallow financial markets further limit the scope of monetary operations as market depth is insufficient to absorb excess liquidity created by fiscal imbalances. Adequately addressing these issues is necessary to transition to the next stage of market development and enable more effective liquidity management.

19. **Curtailing fiscal dominance is the first, and crucial, step toward fostering market development and strengthening monetary policy.** The likelihood of deepening financial market crucially hinges on a sound financial relationship between the BSL and the government. Reducing central bank financing to the government will break the vicious cycle where the loss of control over liquidity conditions puts pressure on inflation that in turn increases the borrowing cost from commercial banks and reinforces the need of the government to borrow from the central bank. High return on government securities also discourages commercial banks from providing credit function to the private sector, stalling market development. Ultimately, the Government’s
commitment to put the fiscal deficit on a sustainable path, in line with the Fund-supported program, is fundamental to curtailing fiscal dominance.

20. **Parallel reforms to build institutional and operational capacity will be key to moving toward market-based monetary policy.** Establishing operational independence of the central bank, strengthening the role of commercial banks in financial intermediation, fostering interbank market development, and diversifying markets need to be sequenced. In each step, incentives among different participants should be well aligned. The Fund has produced ample analytical work on, and technical assistance to, countries at various stages of market development and monetary policy reform implementation (e.g. IMF 2005, IMF 2015a, IMF 2015b, Berg and Portillo. 2018), which serve as good references for sequencing reforms.

21. **This should involve well-sequenced actions to put in place sound technical building blocks.** More concretely, there are a few important areas where progress can be made.

- **Establishing sound institutional and governance setting for the central bank.** The new BSL Act provides the legal framework to reinforce the independence of the BSL, and effective implementation will be crucial. Nevertheless, building and maintaining political commitment is critical to ensure *de facto* independence over the long term. Short of *de facto* independence in the near term, a joint determination of medium-term inflation objective by both the government and BSL will help to insulate the inflation objective from political pressures and strengthen the credibility of this policy goal. However, the BSL should have the sole responsibility of achieving the inflation objective and be ready to handle inherently difficult tradeoffs when other policy goals conflict with price stability. In addition, monetary policy can stabilize the financial environment but cannot force banks to lend.

- **Transiting to a hybrid operational framework.** The objective is to enhance the central bank’s control of short-term interest rates, while relying on reserve money as the primary operating target, which makes it a hybrid of monetary targeting and interest rate targeting. Such an operating framework is expected to reduce interest rate volatility. Effective operations that aim at stabilizing excess reserves and keeping the reserve balances on the target path should be the first objective in reducing short-term rate volatility. The interest rate corridor that the BSL introduced in 2016 helped limit rate volatility. By capping the volatility of market interest rates, the interest rate corridor has strengthened policy signaling and transmission between the policy rate and the interbank rates.

- **Strengthening monetary policy implementation framework.** It is important for the BSL to gradually set up a comprehensive implementation framework for injecting (draining) liquidity when there is overall shortage (excess) of liquidity in the banking system. The primary goal of foreign exchange operation is to smooth the excess exchange rate volatility or to achieve the foreign exchange reserve targets.

- **Enhancing analytical capacity.** The BSL has made good progress in strengthening its analytical capacity and sustaining these efforts is critical to support a forward-looking approach. To this
end, the BSL should continue to strengthen its capacity to interpret data in a timely manner and produce model-based medium-term forecasts, in line with key recommendations in the recent technical assistance (IMF 2019). Meanwhile, Statistics Sierra Leone should continue to strengthen the quality of inflation data and closely collaborate with the BSL to facilitate accurate interpretation of data and assessment of the inflation outlook.

- **Establishing a forward-looking and effective communication strategy.** The BSL should develop a transparent forward-looking monetary policy strategy that reflects timely and comprehensive assessments of the monetary transmission mechanism, in particular as monetary policy affects key economic variables (output, inflation, exchange rate) with a lag. Effective monetary policy transmission requires the BSL to make the financial environment more predictable by enhancing its communication strategy, particularly with respect to discussing and explaining adjustment to forecast and targets.
References


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