

**WEST AFRICAN MONETARY AGENCY  
(WAMA)**



**ECOWAS MONETARY COOPERATION PROGRAMME**

***MACROECONOMIC CONVERGENCE REPORT  
2007 SIERRA LEONE***

***FREETOWN, JUNE 2008***

In 2007, the Government of Sierra Leone continued to emphasize high economic growth and macroeconomic stability through prudent fiscal and monetary policies while developing the relevant infrastructure for poverty alleviation and other social services in the rural community.

The provisional data indicates that the economy remained robust with a real GDP growth rate of 7.0 percent, driven by activities in the agricultural, mining and construction sectors. However, inflation accelerated moderately, originating from supply shortfalls and civil unrest in neighboring Guinea. The external sector remained resilient in spite of the unfavourable crude oil shock, as reflected by the continued stability of the domestic currency against the major international currencies. With the exception of the government Treasury bills and lending rates, interest rates generally remained unchanged.

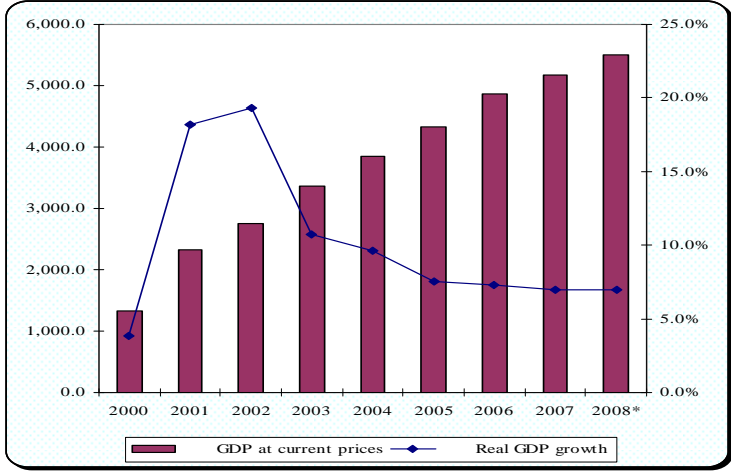
**1 Sector Analyses**

**1.1 Real Sector**

During the year under review, the government emphasized higher productivity in the agricultural, mining and services sectors by encouraging foreign direct investment. In the agriculture sector for instance, the government continued to provide inputs such as improved seed varieties and agricultural extension services.

The provisional data show that real GDP grew by 7.0 percent in 2007, albeit, the growth rate was marginally below that (7.3%) recorded in 2006 and the revised target of 7.1 percent programmed for the year under review. This performance was supported by continued expansion in the agricultural, mining, manufacturing, construction and services sectors.

**Graph 3.49** :Trends in Nominal GDP and Real Growth Rate



The data further indicates that the primary sector grew by 6.6 percent, recording strong growths in rice, cassava and potatoes production. Output in the secondary sector also rose by 6.5 percent whilst that of the mining sector enhanced significantly by about 10.0 percent following entry by two new mining companies in the rutile and bauxite industries. The services sector also recorded a growth rate of 5.0 percent, with trade, insurance, finance and real estate showing modest signs of recovery.

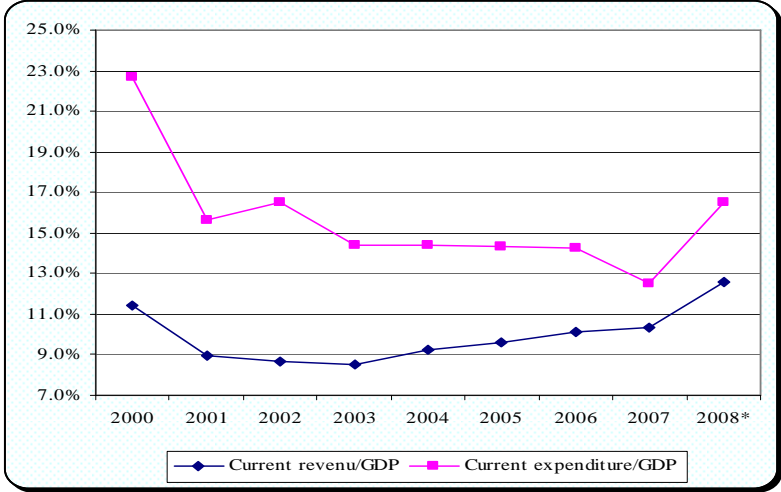
Inadequate power supply and the rising oil prices impacted adversely on economic activity. To help address the power problem within the short-term, the government recruited a service provider to augment supply of electricity in Freetown. Work is also progressing steadily on a hydroelectric project which is nearing completion for distribution to other parts of the country. The government has also

concluded arrangements with consultants to augment supply under a number of donor funded projects including BADEA, Saudi fund and JICA.

**1.2 Public Finances**

The 2007 fiscal policy aimed at enhancing revenue mobilization, improving expenditure controls and achieving a sustainable level of domestic debt. Taking cue from recent delays in donor inflows and weak revenue performance, the government had, in 2006, adopted a cash budgetary system based on expenditure prioritization.

**Graph 3.50 : Trends in Current Revenues and Expenditure**



The available data shows that fiscal policy improved moderately in 2007. Government fiscal operations resulted in a budget deficit (on commitment basis, excluding grants) of 5.6 percent of GDP compared to 8.5 percent in the preceding year. The primary balance declined from a deficit of 6.1 percent to 3.4 percent in 2007. The relative improvement in fiscal policy was attributed to a contraction in total expenditure, albeit, revenue performed below expectation. The budget deficit was financed from both domestic and external sources, particularly by the Bank of Sierra Leone and drawings on external lending.

Total domestic revenue represented 10.4 percent of GDP, after a 7.9 percent increase in 2007 compared to 19.5 percent in the preceding year. Tax revenue, which represented 84.8 percent of total domestic revenue, also enhanced marginally from 8.5 percent of GDP to 8.9 percent. Non-tax revenue increased marginally by 0.1 percent compared to 24.3 percent in 2006. The relative slowdown in revenue mobilization may be attributed to the weak tax base, inefficient revenue mobilization and sub-optimal operational capacity of the productive units due to the persistent energy crisis.

Total grants received in 2007 constituted 4.8 percent of GDP compared with 7.0 percent in the preceding year. This reduction was attributed to donor concerns about the outcome of the elections and the country’s inability to meet certain required benchmarks.

Effective expenditure controls contributed to a 9.6 percent reduction in total expenditure (including net lending), which constituted about 16.1 percent of GDP. Recurrent expenditure declined by 6.9 percent and it represented 78.6 percent of total expenditure. This decrease was due to reduction in other unspecified expenditure, interest payments due to debt relief under the HIPC initiative and savings made on the wage bill following elimination of ghost names on the public sector payroll.

Lack of adequate financing for development projects forced the government to curtail its capital expenditure by 19.0 percent of the level of investments incurred in 2006. About 76.2 percent of total investment of the year was financed from external sources.

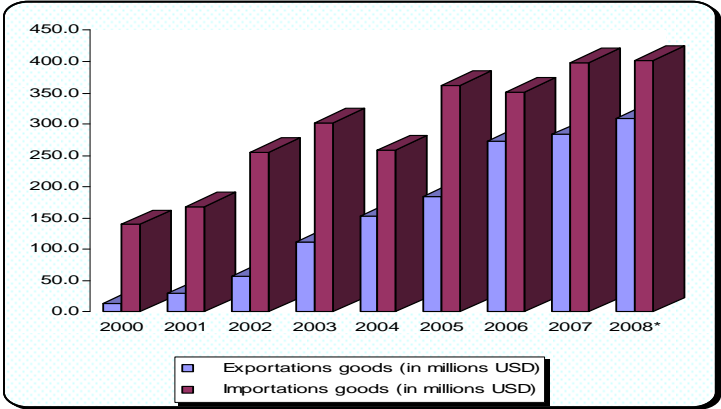
In contrast to one of the policy objectives, the stock of domestic debt enhanced by 9.8 percent to Le 632,974.0 million, representing 12.3 percent of GDP. This increase was mainly attributed to government borrowing through the issuance of 91 day treasury bills by the central bank. About 60.0 percent of the government’s domestic debt was held by the banking system.

**1.3 External Sector**

The 2006 external policy of the Government of Sierra Leone focused on enhancing foreign exchange reserves. In line with this objective, the government encouraged investment in the export sector.

The provisional data shows that the external sector continued to strengthen in 2007 following the resumption of economic activities in the agricultural and mining sectors. The overall deficit on balance of payments narrowed from 3.8 percent of GDP in 2006 to 1.8 percent. However, the deficit balance on the current account relative to GDP widened from 6.9 percent to 9.6 percent, due to adverse developments on the merchandise trade account. Output of the country’s traditional export commodities (gold, bauxite and rutile) and favourable terms of trade contributed to a moderate (3.6%) increase in exports. On the other hand, merchandise imports rose by 13.3 percent compared to the 2.9 percent reduction recorded in 2006, owing to a significant increase in non-oil imports. Oil imports, which represented about 30.0 percent of the total imports bill, were maintained at US\$ 121.5 million, owing to efficiency measures instituted to control fuel consumption, especially, for power generation.

**Graph 3.51** : Trends in Imports and Exports



The provisional data further shows that constraints in the capital account eased in 2007, driven mainly by inward capital transfers. However, the level of foreign direct investments continued to dwindle from US\$ 74.4 million to US\$ 61.8 million and US\$ 31.4 million in 2005, 2006 and 2007 respectively. The net effect of transactions in the balance of payments led to a moderate increase in gross external reserves from US\$ 184.2 million (4.9 months of imports cover) at end-2006 to US\$ 215.6 million (5.1 months of imports cover) by end-2007.

The domestic currency, the leone, remained relatively stable due to an improvement in the balance of payments. The currency depreciated marginally by 0.1 percent against the US dollar, 4.7 percent

against the pound sterling and 10.3 percent against the euro.<sup>1</sup> The relatively higher depreciation against the pound sterling and euro was attributed to the appreciation of these currencies on the international financial market. The Bank of Sierra Leone also contributed to the stability of the domestic currency through its weekly intervention on the inter-bank foreign exchange market.

The country’s external debt position declined significantly from US\$ 1,610.9 million at end-2006 to US\$ 316.9 million by end-2007, owing to massive debt relief received from the country’s development partners under the multilateral debt relief initiative (MDRI) following the country’s attainment of the HIPC completion point in 2006. With this development, the country’s debt position which had hitherto been unsustainable, improved significantly.

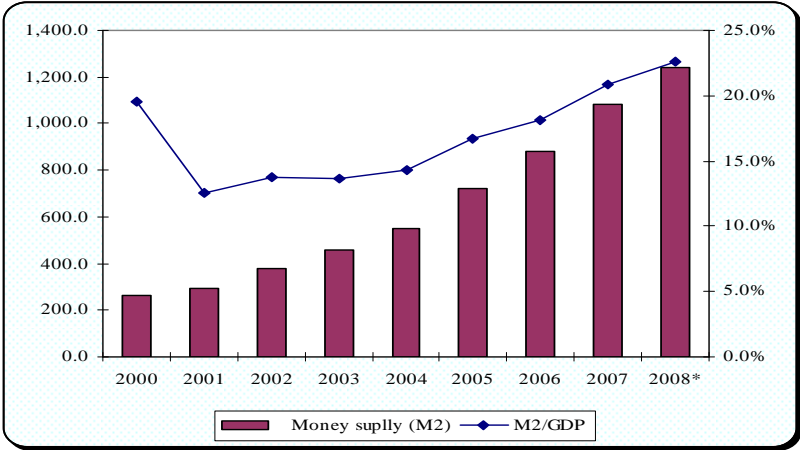
SIERRA LEONE: EXTERNAL DEBT SUSTAINABILITY DATA

	2002	2003	2004	2005	2006	2007
External debt position (millions of US\$)	1,536.0	1,662.2	1,710.2	1,689.6	1,610.9	316.9
External debt /GDP (%)	121.8	115.9	119.9	112.9	98.1	18.3
External debt/exports of goods and non-factor services (%)	1439.6	938.6	793.6	643.6	510.3	105.2
External debt service/GDP (%)	3.7	3.2	3.1	1.7	1.1	0.5
External debt service/export of goods and non-factor services (%)	43.5	25.8	20.8	9.9	5.5	3.1

1.4 Monetary Sector

To support the government’s fiscal policy, the Bank of Sierra Leone focused on sustaining the single digit inflation achieved in 2006 by strengthening liquidity management. In this regard, reserve money and broad money supply were programmed to expand by 4.4 percent and 5.0 percent respectively in 2007.

Graph 3.52 :Trends in Money Supply



<sup>1</sup> The leone depreciated by 1.4 %, 13.2 % and 11.1 % against the US dollar, the pound sterling and euro respectively in 2006.

Contrary to the planned objectives, monetary policy was rather expansionary as the monetary aggregates exceeded the targets programmed for the year. Reserve money increased by 26.2 compared to 10.7 percent in 2006. Growth in broad money supply ( $M_{2+}$ ) also exceeded the programmed target by 17.7 percentage points. This expansion reflected in all components of money supply, especially in quasi money (savings and time deposits) and foreign currency deposits.

#### **SIERRA LEONE: GROWTH IN MAJOR MONETARY AGGREGATES (%)**

	2001	2002	2003	2004	2005	2006	2007
Reserve Money	29.4	24.9	22.4	12.6	24.3	10.7	26.2
Broad Money Supply ( $M_{2+}$ )	33.7	29.6	21.9	20.1	31.3	21.5	22.7
Narrow Money ( $M_1$ )	35.4	30.6	18.4	17.6	23.1	15.4	12.5
Currency In Circulation	30.7	27.4	27.3	8.6	13.0	19.1	12.5
Demand Deposits	43.4	35.7	5.1	33.8	38.0	10.9	12.4
Quasi Money	17.3	33.7	27.7	118.3	44.9	30.1	35.6
Foreign Currency Deposit	51.4	20.1	29.8	30.4	54.9	32.5	42.5

The expansion in broad money supply was fuelled mainly by net foreign assets (NFA) which grew by 34.1 percent following the astronomical growth of 665.1 percent recorded in 2006. Net Domestic Assets (NDA) also rose by 7.4 percent compared to 31.5 percent in 2006. The increase in NDA was dominated by enhancements in credits extended by the banking system to the private sector and public institutions.

Inflation accelerated moderately during the year from 7.3 percent to 13.8 percent. A combination of factors accounted for this increase, among which were the lagged effects of the central bank's financing of fiscal operations, domestic credit expansion by the deposit money banks, supply constraints occasioned by the political crisis in Guinea and the 2007 presidential and parliamentary elections held during the third quarter of the year.

The movements in nominal interest rates indicated a growing preference for short-term financial instruments and an increasing cost of capital. The discount rate on 91 days government Treasury bill increased from 14.2 percent in 2006 to 21.2 percent. On the other hand, the 12 month deposits rate dipped from 12.8 percent to 12.0 percent. The average savings rate remained unchanged at 7.8 percent whilst the lending rate rose by 100.0 basis points to 28.0 percent. The increasing Treasury bills and lending rates were attributed to government borrowing from the private sector and an increasing demand for loanable funds.

## **2 Performance under Macroeconomic Convergence**

The analysis shows that Sierra Leone's performance with regard to the convergence criteria improved marginally in 2007 as the country met only two targets, that is, the primary criterion on central bank budget deficit financing and the secondary criterion on real exchange rate stability.

### **2.1 Primary Criteria**

The achievement on some of the primary benchmarks progressed whilst others deteriorated. The cash budgeting and other prudent fiscal policy measures adopted in recent years has so far been useful in

controlling expenditure. Consequently the budget deficit ratio relative to GDP reduced from 8.5 percent to 5.6 percent, although, missing the required target by 1.6 percentage points.

### SIERRA LEONE: STATUS OF CONVERGENCE

	target	2001	2002	2003	2004	2005	2006	2007	2008
<b>Primary Criteria:</b>									
i) Budget Deficit/GDP	≤4%	11.4	11.8	9.2	8.6	9.5	8.5	5.6	7.9
ii) Inflation Rate	≤5	3.4	-3.1	11.3	14.6	13.1	7.3	13.8	13.5
iii) Budget Deficit Financing	≤10%	31.7	0.0	25.1	0.0	0.0	13.3	0.8	1.3
iv) Gross External Reserves	≥6m	3.3	0.6	1.7	3.8	4.8	4.9	5.1	4.6
<b>Secondary Criteria:</b>									
i) Domestic Arrears	=0.0	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
ii) Tax Revenue/GDP	≥20%	8.6	8.4	8.3	8.3	8.1	8.5	8.9	8.4
iii) Salary Mass/Tax Revenue	≤35%	56.1	62.0	57.6	56.0	65.5	61.6	60.9	60.9
iv) P. Invest/Tax Receipts	≥20%	7.3	8.9	11.1	8.2	7.9	10.6	9.1	8.9
v) Real Interest Rate	≥0	0.1	7.1	-7.3	-8.6	-7.2	-1.8	-8.3	-6.3
vi) Real Exchange Rate**	±%	10.8	-12.4	-17.8	-10.7	2.0	3.7	-0.9	0.5
<b>Total No. Of Criteria Met</b>		2	3	0	1	2	1	2	2

Sources: BSL, IMF

\*projected end-2008 data

Inflation (year-on-year) accelerated moderately from 7.3 percent to 13.8 percent by end-December 2007. In addition to the impact of the rising fuel prices, this development was attributed to monetary phenomena and supply constraints at the domestic front. In particular, the inflationary pressures were driven by the shortage of essential commodities during the political disturbances in neighbouring Guinea during the first half of the year.

The financial constraints encountered in 2006 eased during the year under review. Consequently, Sierra Leone met the central bank budget deficit financing target at 0.8 percent in 2007, having exceeded the required target in the preceding year. This performance is quite encouraging, given the inadequate domestic revenue and shortfalls in external grants owing to uncertainties surrounding the 2007 parliamentary and presidential elections.

Favourable developments in the balance of payments during the second half of the year led to a moderate increase in the country's external reserves in spite of an increasing imports bill. Thus, the gross external reserves increased further from 4.9 months of imports cover to 5.1 months. Sierra Leone needs to strengthen the relevant policies to sustain its external sector performance in order to meet the required target of 6.0 months of imports.

## 2.2 Secondary Criteria

Performance on the secondary criteria was not encouraging as the achievement on most of the prescribed benchmarks in this category was below expectation. It should be stated at this juncture that the criterion on domestic arrears could not be assessed due to data unavailability.

Tax revenue remained relatively low, hovering below 9.0 percent of GDP in spite of efforts aimed at enhancing revenue mobilization. This outcome reflects a weak and inefficient capacity of the revenue mobilization agencies.

Sierra Leone has since 2005 recorded marginal improvements in the wage burden. However, the salary mass/tax revenue ratio remained high, at 25.9 percentage points above the maximum requirement of 35.0 percent in 2007. In addition to the low tax revenue and a bloated civil service accounted for this high wage burden. The government has initiated measures to address this problem by reducing the

incidence of ghost workers on public sector payroll, including the payment of salaries and allowances through the banking system.

The level of public investments financed from domestic sources also stood at 9.1 percent compared to the minimum requirement for 20.0 percent of tax revenue. Investments being an expense item subject to the discretion of the authorities, the limiting factor relates to the low revenue and high demand for recurrent expenditure. The authorities may need to enhance revenue mobilization in order to improve performance in this area.

The increasing inflation contributed to the prevalence of negative real interest rates.<sup>2</sup> The downward movement in negative real interest rates from 1.8 percent to 8.3 percent implies a growing disincentive for long-term investment. In addition to this development, whilst the average savings rate remained at 7.8 percent, the average lending rate increased, thus further worsening the large interest rate spread. Further liberalization of the financial market and the introduction of more financial assets may help determine equilibrium interest rates that may respond to movements in inflation and other market conditions.

Using a fluctuation band of  $\pm 5.0$  percent, the real exchange rate was stable. The nominal exchange rate has been relatively stable in recent years. In spite of the fact that the country has been experiencing moderate inflationary pressures in recent years, the relative stability of the nominal exchange rate against the major international currencies, especially, the US dollar contributed to this feat.

### **3 Prospects for 2008**

Economic activity would be expected to remain buoyant in 2008 given the continued investments the agricultural and mining sectors and efforts being made to address the energy crisis. A growth rate of 6.3 percent has been estimated for the year. *Ceteris paribus*, projections show that the inflationary pressures experienced in 2007 would continue to persist, to be influenced partly by the lagged effects of the money creating activities of the banking system and a rebound of consumer demand as the new government rolls out its development agenda in all sectors of the economy. Available data obtained revealed that the average consumer price level rose by 3.2 percent during the first quarter of 2008, indicating an annualized inflation rate of 13.5 percent.

The 91 days treasury bills and average lending rates would also be expected to trend upwards, following a higher demand for investment and the increasing government borrowing from both the banking system and private sector. The increasing merchandise exports and debt relief would dampen the demand for foreign exchange, and thus, help maintain the relative stability of the domestic currency.

The projections further show that performance under macroeconomic convergence would remain difficult in 2008. The country may be able to meet the same two targets (central bank budget deficit financing and real exchange rate stability) realized in the preceding year. The higher demand for expenditure in education, health, services and infrastructure would place an upward pressure on the budget deficit, given the existing constraints in revenue mobilization. The authorities would continue to grapple with inflation, wage burden, public investment financed from domestic sources and negative real interest rates. The rising imports bill on both oil and non-oil commodities would also dampen level of external reserves.

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<sup>2</sup> Real interest rate is the difference between the minimum savings rate and inflation.

#### **4 Conclusion and Policy Recommendations**

The level of economic activity has resurged in recent years following massive investments in the agricultural and mining sectors with the support of the country's development partners. However, prevailing constraints in the real sector and weak infrastructure contributes to low revenue mobilization.

This revenue mobilization problem, in addition to a high demand for government spending on wages and infrastructure development leads to high budget deficits which have been accommodated in recent years by the central bank. Inadequate donor inflows and delays in disbursements create severe financial problems for government.

Despite the efforts aimed at controlling excess liquidity, the monetization of fiscal operations, credit creating activities of the commercial banks and structural constraints contributed to inflationary pressures. Interest rate also trended upwards owing to an increasing demand for capital.

The current account has been under pressure in recent years, mainly, on account of strong growth in imports and the higher cost of fuel. However, higher foreign exchange inflows contributed to the relative stability of the domestic currency.

In the light of the prevailing constraints, the government would need to address the institutional constraints, the fiscal problem which adversely affect monetary policy effectiveness, diversify and enhance the productivity of the real sector. In this respect the following recommendations may be relevant:

1. introduce value added tax (VAT) as an effective tax mechanism on goods and services so as to means enhance tax revenue;
2. strengthen the capacity of revenue collection agencies by automating revenue collection, reviewing and extending the range of taxable activities and creating a database on all tax payers;
3. reduce government expenditure to match available resources;
4. continue to rehabilitate productive infrastructure and intensify human capacity building to support production of goods and services;
5. develop the private sector by encouraging private direct investment in the real sector and establishment of cottage industries;
6. take appropriate steps to reduce the public sector wage bill by instituting auditing mechanisms to weed out ghost names, automating and streamlining public services for higher productivity;
7. liberalize the financial market, introduce additional financial assets and create necessary conditions for a flexible interest rate regime;
8. increase the level of foreign reserves through export promotion and diversification;
9. develop the fishing and mineral sectors where the country enjoys relative comparative advantage.