Monetary Policy Framework of the Central Bank of Liberia as Approved by the Board of Governors of the Bank (Resolution No. BR/R-02/2005) during its 2nd Regular Meeting held on June 22, 2005

I. Introduction

It is self-evident that monetary policy plays an important role in the performance of an economy of any nation. However, the effectiveness of the policy in achieving the intended goal largely depends on the institutional factors that constrain or facilitate the implementation process of the policy. Having emerged from a devastating civil war which lasted for about 14 years and exacerbated the fragility of the financial sector and the macroeconomy, a formulation of a monetary policy framework for Liberia must be designed to address those issues that tend to undermine efforts at engendering improvement in the banking system in particular, and the national economy in general. This must be done in consideration of the general effect of the civil war on the economy. For example, the current small size of the banking system with only three banks (there were about 14 banks prior to the civil war), poor state of the financial structures, considerable weakened macroeconomy, lack of an effective interface between fiscal and monetary operations in general terms, etc.

The Liberian civil war which started in late 1989 brought massive destruction upon the country. Although there is now relative improvement in the general security, social and economic condition of the country under the administration of the Liberian National Transitional Government (LNTG) formed under the Accra Peace Accord in 2003 with the assistance of the international community, the economy continues to be plagued by a multiplicity of social and economic problems.

The real sector of the economy has generally remained in a state of dormancy since the 1990s with production level of the sector far below prewar level. Production of cash crops (e.g. coffee and cocoa) generally ceased throughout the country due to the war and a UN sanction on export of logs and diamond which is still in force.

Developments in the external sector have generally been unfavorable for Liberia for years now. The Country has not been able to export and earn any significant foreign currency from the rest of the world. The trade deficits have continued to widen. They were recorded as US$2.1 million for 2002 and US$60.8 million for 2003. The magnitude of the external debt is unsustainable. As at December 2002, the aggregate external debt stock of the country was reported at US$2.7 billion (about 663.2 percent of its estimated 2002 real GDP of US$404.37 million). For 2003, the external debt stock stood at US$2.9 billion and as at June ending 2004, it was estimated at US$3.4 billion. At present, the country lacks the ability to pay external creditors and its creditworthiness has eroded internationally.

In the social sector, basic social services (e.g. pipe-borne water, electricity, medical, education, transportation, housing, etc.) are inadequate. A large proportion of the population does not have adequate spendable money and the level of destitution widens by the day as more and more Liberian refugees return home as a result of the relative peaceful environment in the country largely created by the deployment of the UN peace keeping troops. At present, the transitional government is making effort to make salaries of civil servants current while at the same time making some payments against salary arrears due civil servants by the former regime.

The financial sector of the economy has become very small with only three deposit-taking institutions. This is largely attributable to the 14-year civil war. Presently, the overall activities of the banking system are grossly inadequate given the needs of the economy. Understandably, the banks, since the 1990s, have been engaged in selective lending by economic sectors, with their aggregate loan portfolio not having any significant impact on the macroeconomy. Seemingly, they have been exercising strategic precautionary measures in the face of the general political and economic situation in the country.

The above introduction indicates the specific circumstances, limitations and impediments that continue to undermine efforts aimed at the social and economic development of the country. This paper therefore, proposes a monetary policy framework to serve as a basis for the formulation and implementation of monetary policy in Liberia.

II. Monetary Policy Objective

Generally, monetary policy of central banks in a simplified analysis amounts to the determination of the “optimal” quantity of money or (in a dynamic sense) the optimal rate of growth of the money stock. But there is more to monetary policy than the determination of the optimal stock or growth rate of money because optimal money stock is not easy to define.

The principal monetary policy objective of the Central Bank of Liberia (CBL) is to maintain exchange rate stability in the Liberian economy, and by extension, price stability. Maintaining exchange rate stability is considered the principal policy objective because at the moment, it is the only available variable that the CBL can target in order to affect monetary conditions in a meaningful way. However, the difficulty in maintaining the exchange rate stable has generally been due to a shortage of foreign reserves which has undermined the CBL’s ability to periodically intervene in the market when it becomes necessary to do so.

The cost of living in Monrovia and its environs and probably in the rest of the country, is generally reflected in the behavior of the exchange rate of the Liberian dollar relative to the United States dollar which is also a legal tender in Liberia. Prices of all goods and services are tied to the US dollar through the exchange rate. The US dollar has practically become a currency of choice in most transactions.

Most consumable goods are imported and domestic prices of goods and services in Liberian dollars often fluctuate largely as a result of the behavior of the exchange rate. For example, if a bag of rice, the nation’s staple food, is sold for US$21 when the exchange rate is L$50 to US$1, the market price in Liberian dollars would be L$1,050 per bag. However, if the Liberian dollar depreciates and the rate goes to L$57 to US$1, the US dollar price for a bag of rice remains at US$21.00 while the price in Liberian dollars becomes L$1,197. The story is the same with most essential commodities in the Liberian market including petroleum products, cement, spare parts and pharmaceuticals.

Achieving the Bank’s long-term monetary policy objective will generally depend on devising and pursuing policies designed to:

a. Preserve the purchasing power of the national currency – ensuring that the level of money supply is generally consistent with developments in the macroeconomy and intervening in the foreign exchange rate market for the purpose of stabilizing the rate when conditions necessitate.

b. Promote internal and external equilibrium in the national economy by initiating monetary policies (complemented by appropriate fiscal policies) that will ensure price stability.

c. Encourage the mobilization of domestic and foreign savings and their efficient allocation for productive economic activities through the implementation of a prudent market-driven interest rate policy.

d. Facilitate the emergence of financial and capital markets that are capable of responding to the needs of the economy through appropriate policy measures. These measures would ensure the gradual introduction of trading instruments (CBL or GOL securities) on a short-term basis.

e. Foster monetary, credit and financial conditions conducive to orderly, balanced and sustained economic growth and development.

However, for the immediate future, the Bank must undertake to formulate policies that are implementable under the prevailing macroeconomic condition for the realization of its primary objective of exchange rate stability. Such policy areas would include, but not limited to, the establishment of a system of liquidity monitoring, a forward-looking reserve requirement system, creation of a credit facility for commercial banks, etc.

III. Transmission Mechanism

The Liberian financial system is very small with only four banks including the Central Bank of Liberia. Two of the three commercial banks are said to be having some problem of solvency. Consequently, several of the traditional channels for transmitting monetary policy impulses are basically non-existent.

Given the prevailing condition in the country, the most important channel of transmission of monetary policy impulses is the exchange rate. Direct interventions in the foreign exchange market by the CBL in the past few years led to some stability in the exchange rate and prices of a number of essential commodities (e.g. rice, gasoline, cement, etc.). However, the effect of the interventions could not be sustained due to lack of adequate foreign exchange reserves.

The reserve requirement ratio (RRR) has not proven to be effective as a transmission mechanism in the Liberian situation. The major reason for its ineffectiveness is that over 80 percent of currency in circulation is held outside of the banking system which cannot be affected through adjustments in the reserve requirement ratio. This problem was clearly seen when the CBL adjusted the ratio from 22 to 50 percent on Liberian dollar deposits and reduced it to 18 percent for US dollar deposits with commercial banks in an attempt to strengthen the value of the domestic currency in 2002. The reserve requirement is a very important transmission mechanism. It is the readily available policy tool to the Bank for reducing excess liquidity or making the banks liquid as the case may be.

Movements in money supply as one of the channels can be seen as a transmitting effect of monetary policy. Increase in money supply not consistent with developments in the macroeconomy leads to price increases. Inflation reduces the purchasing power of the consuming public and makes businesses unprofitable due to consumers' inability to buy. On the other hand, when money supply is optimal (generally in line with developments in the economy), the opposite of what is stated above holds true.

Mobilization of savings and the extension of credit by banks can be affected by movements in banks' deposit and lending interest rates and such, movements represent important transmission channel for monetary policy. In competitive markets, banks compete for deposits and offer interest rates on lending which are determined in consideration of their cost of funds. Generally, interest rates have not played any significant role as an effective channel of transmission of monetary policy impulses in Liberia primarily because of the size and low level of competition in the banking system.

Deposit interest rates had been practically between 5 and 6 percent for years without any economic justification. In fact, they have taken a downward trend in recent time. This has been one of the side effects of the smallness of the Liberian banking system in which the few banks seemed to have developed oligopolistic behaviors, charging high interest rates on lending thereby dampening the level of financial intermediation.

IV. Dollarization

Liberia has a cash-based economy with two legal tender – the Liberian national currency (Liberian dollar) and the United States dollar. However, the level of dollarization in Liberia is very high and has increased in recent years. This can generally be ascribed to the desire of residents who had tried to diversify and protect their assets from the risks of a perceived depreciation of the Liberian dollar and an eventual economic instability as a result of the 14-year civil war. The motives for the increased dollarization of the economy, particularly during and after the war years, are two-fold: currency substitution and asset substitution. For currency substitution, the US dollar is demanded in order to be used essentially as a means of payment and unit of account by residents who perceived high inflation which makes the use of the domestic currency costly. For asset substitution, there are those who have tried over the years to take precautionary measures against macroeconomic risks such as price instability and the prolonged near-dormancy of the productive sector of the economy.

The main challenge is the actual measurement of the degree of dollarization. No data on the exact amount of US dollars circulating in the economy is available, thus the dollarization indices converted to Liberian dollars as indicated in Table 1 below may understate the true degree of dollarization.

Table 1: Money Supply and Broad Money
Liberian & United States Dollars
(2nd Quarter, 2003; 1st & 2nd Quarters, 2004)
(In Millions L$)

	2003	2004	
	2nd Quarter	1st Quarter	2nd Quarter
Broad Money (M2)	**2,738.5**	**3,774.3**	**4,218.7**
M1	**2,144.3**	**3,167.2**	**3,469.6**
Currency in Circulation (outside banks) (MA) L$	1,067.2	1,317.3	1,394.7
Demand Deposits (CoB)	1,077.2	1,849.9	2,074.8
United States Dollars component of demand deposits denominated to Liberian Dollars	921.2	1,676.0	1,913.9
Liberian Dollars	155.9	174.0	160.9
Time and Savings (CoB)	594.1	607.1	749.2
United States Dollars component of Time and Savings deposits denominated to Liberian Dollars	432.1	418.0	518.1
Liberian Dollars	162.0	189.1	231.1
United States Dollars component of Broad Money (M2) denominated to Liberian Dollars	1,353.3	2,094.0	2,432.0
Percentage share of US dollars to Liberian dollars (M2).	49.4%	55.5%	57.6%
Exchange Rate (End-of-Period)	62.50	54.50	57.50

Source: Central Bank of Liberia, Monrovia, Liberia

The ratio of US dollar deposits (converted to Liberian dollars) to total deposits (inclusive of US dollar deposits) held in the commercial banks as at the end of June, 2004, was recorded at 86.1 percent, and 57.6 percent as a percentage share of broad money (M2). This shows that in terms of dollar value, US dollars represented more than 50.0 percent of money supply at end of June.

The massive bank failure during and after the 14-year war created confidence crisis in the banking system and uncertainty about the future of the financial sector which continues to make people hold substantial amount of both Liberian and US dollars outside of the banks. The lack of modern payments system and limited use of checks promote the use of cash dollars in the economy. With the effects of the civil war still being felt and the prevailing fragile macroeconomic and security environment, Liberians generally continue to prefer US dollars as a store of value and, it is also conceivable, that large amounts of US dollars circulate in the economy as a result of smuggling and illegal activities, which typically trade in US dollars. All of these have helped to accelerate the dollarization of the economy.

Money Supply

For a 12-month period (June 2003 – June 2004, Table 1), broad money (M2) (including US dollar deposits) rose by 54.0 percent, largely as a result of a 79.7 percent rise in the US dollar component denominated in Liberian dollars. The Liberian dollar component of broad money increased by 23.3 percent during the same period.

The high level of dollarization of the economy along with the Liberian dollar has the propensity to render monetary policy implementation ineffective, thus making the achievement of policy goals difficult. One major reason for this is that the Central Bank does not have control over the volume of US dollars circulating in the system and because it is a foreign currency which accounts for a substantial component of total liquidity, the Bank cannot act as lender of last resort whenever it becomes necessary as a result of a systemic crisis.

Monetary Policy Options

The question that is now being asked in many quarters is whether Liberia should adopt a full dollarization. Supporters of dollarization maintain that it would ensure fiscal discipline and dampen policy and exchange rate risks. It brings about a higher level of confidence among international lenders and investors thereby lowering interest rates, fiscal expenditures (as a result of lower interest payments), encouraging more foreign direct investment and consequently boosting investment, exports and GDP. They further maintain that dollarization establishes a firm basis for a sound financial sector and avoids a balance of payment crisis.

However, these benefits don't come without a price. Full dollarization wipes away control of monetary and exchange rate policy from the dollarizing country and the ability of the central bank to print banknotes ceases to exist and this, in turn, limits the bank's lender-of-last resort function. The country loses seigniorage, abandons its national currency which is a symbol of sovereignty and nationhood.

Given the above-mentioned advantages and disadvantages of full dollarization and the prevailing social, economic and political situation in Liberia, it will be prudent to maintain the present currency arrangement for now. Full dollarization will be very costly for the Liberian economy. For example, the initial cost of replacing the existing stock of Liberian dollars is estimated at US$36 million (an equivalence of 8 percent of GDP). In addition, Liberia would have to give up real goods and services to accommodate future increases in money demand. The Liberian economy basically depends on a few commodity exports, which makes it highly vulnerable to external shocks. If Liberia were to adopt full dollarization, the lack of lender-of-last resort would limit credit expansion and increase lending rates by commercial banks, which would reduce the contribution of financial intermediation to Liberia's recovery.

V. Monetary Operations

The scope of monetary operations has been generally limited in Liberia. The operational objectives of the Bank have remained to be: creating and maintaining a low level and stable inflationary environment; encouraging a sustainable flow of capital; and ensuring that real interest rates reflect the opportunity cost of capital. This would contribute to a favorable and enabling environment for a sustainable economic growth and development.

Almost all central banks consider price stability as one of the main, if not the sole, objective of monetary policy because it brings about external stability or equilibrium position of the balance of payments. Hence, the exchange rate is sometime used as a major intermediate target for monetary policy. In some countries, its importance tends to grow as the financial system becomes more liberal and open. In fact, this is why it is very important in the Liberian context since it is the only available variable to the CBL for affecting monetary conditions in a meaningful way at the moment.

Alternative Monetary Operations

With a clearer view of the dual currency arrangement, the limited monetary operations and the overall operational objectives of the Central Bank of Liberia, it is useful to briefly review the realm of alternative monetary policy regimes. Typically, central banks adopt either a reserves operating framework or an interest rate operating framework in the approach to monetary control. In a reserves operating framework, a central bank works through the multiplier link between reserves and money supply. Under this arrangement, reserve requirement (on commercial banks' liabilities) play an important role. Central banks may also seek to control the money stock by influencing short-term interest rate by adopting an interest rate operating framework. In this case, the central bank focuses on interest rate as its principal intermediate target. Most central banks following this procedure tend to target short-term (interbank) interest rates. Both the reserves and interest rate framework can not be targeted at the same time.

Interest rate is one of the most important price signals in an economy and is perhaps the most pervasive in terms of impact. It is important among monetary policy tools that are used to direct and induce economic development. Due to its impact on resource allocation, interest rate policy has been used to influence the inter and intra sectoral allocation of finances. Hence, where short-term interest rate is used as an important operating target for monetary policy, the instruments employed by the central bank are its own interest rates (Discount Rate/Bank Rate, repo rate, money market intervention rate, etc.) and the access that commercial banks are granted to central bank financing.

Many central banks consider stable exchange rate as an intermediate target of monetary policy. In this case, central banks set a fluctuation band of certain percentage points around a central rate as the "tolerance" band. When the market rate breaches the band, the central bank intervenes in the foreign exchange market by buying or selling foreign exchange. The intervention is intended to ensure that the currency does not move far away out of alignment with the central rate. This means that to be able to maintain the exchange rate at the desired level, the central bank needs sufficient foreign exchange reserves. The Bank's immediate program is geared towards this direction.

VI. Monetary Instruments

The introduction of a wide range of monetary instruments by central banks engenders competition, efficiency, transparency and broadens financial intermediation in the banking system. It promotes liquidity management of commercial banks and gradually leads to the development of functional money and financial markets which could serve as catalysts for economic growth and development. In the case of Liberia, the use of such instruments has been extremely limited due to the underdevelopment of a conventional money market and the virtual non-existence of a financial market.

Bonds or securities issued by governments have generally been the main instruments for the development of money market and interbank trading. Trading in these instruments liquifies the financial system in particular and the national economy in general. The use of these instruments increases financial intermediation among market participants.

A standing central bank credit facility is another instrument used to enhance the financial capacity of commercial banks and to promote financial intermediation and efficiency. The key advantages of such standing credit facility are transparency and predictability of accessing central banks' resources to cover short-term needs. It gives banks an assurance that, when confronted with problems of shortfall in the clearing and a lack of alternatives for raising immediate funds in the interbank market, they can settle the clearing with the central bank's funds at a reasonable interest rate which has a clear relationship with short term market interest rates.

VII. Market Development

Market architecture is an important element in the evolution to market oriented instruments of monetary operation. Prior to the emergence of interbank and money markets, the availability of an official (central bank) financing facility can be particularly helpful at the primary stages of market development. Other economic fundamentals need to be in place for the development of money and financial markets and the process usually takes time. In the case of Liberia, the role of the Central Bank and the fiscal authorities will be critical in this endeavor.

VIII. Conclusion and Recommendations

Capacity building in the monetary policy area is a long-term task and both the basic condition and the low level of financial activity in Liberia suggest a slow and gradual process. Efforts by the Central Bank to affect monetary conditions continue to be constrained by the fragile financial situation.

The banking system remains generally undercapitalized and an effective resolution strategy is a precondition for a functional monetary policy and market development. In view of the foregoing, the following policy measures are recommended for consideration by the Central Bank for the building of a truly functional financial sector:

A. Short-Term

- Establish a liquidity monitoring system: The Central Bank should develop a framework for liquidity monitoring and eventually forecasting the changes in banking system liquidity using the CBL's balance sheet initially.

- Revise the present reserve requirement system: A reserve requirement system that is forward-looking with a shorter maintenance period be established.

- Introduce a standing credit facility at the CBL: The CBL should establish a credit facility exclusively in Liberian dollars for commercial banks for various purposes including the enhancement of their liquidity positions and settlement of shortfalls at the clearing.

- Continue foreign exchange auctions: The Bank should continue the implementation of the foreign exchange auction program started in 2004.

- Prepare forex purchase auctions. At some point, the CBL should initiate a program of selling Liberian dollars through auctions to improve its foreign reserve capacity.

- Prepare framework for short-term securities: As it may take some time to clarify the alternatives, the Bank should begin to prepare the necessary framework for the issuance of short-term securities, including the legal, settlement, trading rules, and transfer ownership.

Based on the results from the implementation of the above-listed short-term measures, the CBL must consider putting in place additional measures in the medium- and long-term as presented below:

B. Medium-Term

- Issuance of short term securities
  - CBL Papers or Government
  - Book-entry system (at CBL)
  - Code of conduct
- Liquidity forecasting
- Prepare for repos
  - Master repurchase agreement
  - Introduction of repos/reversed repos (with banks only)
- Establish interbank forex market
- Refine the reserve requirement system (narrow the time lag between maintenance and base periods)

C. Long-Term

- Ensure functioning interbank and money markets
  - Regular open market operations
  - Market-determined interest rates
- Develop longer term securities market
  - Bond auctions
  - Secondary trading

The Paper is generally intended to serve as a monetary policy-formulation guide and the above-recommended actions will need to be implemented gradually with the assistance of the international community and the Bretton Woods Institutions, particularly the IMF.