Presentation at the Hearing of the Finance Committee of Parliament
Tuesday, 19th January 2021
at Parliament Building, Tower Hill, Freetown

By Professor Kelfala M. Kallon
Governor, Bank of Sierra Leone

Honourable Chairman, Honourable Members of the Finance Committee of Parliament, Ladies and Gentlemen, it is my distinct honour and privilege to meet with you this morning to update and/or discuss recent events in the economy—especially the December 2020 cash shortage in the banking system. However, before addressing this issue, it is necessary that I update this Committee on how the Bank has performed its statutory responsibilities during my 27-month tenure.

Upon becoming Governor on 2nd October 2018, I inherited an economy in which low economic growth and high unemployment coexisted with high inflation, a situation that is referred to as stagflation by economists. Interest rates were high, and the Leone was depreciating against other currencies at an alarming rate. The latter fueled the dollarization of the economy, as economic agents sought to hedge against the Leone's international loss of value by quoting prices and receiving payments in US dollars (USD).

Specifically, the end-of-month inflation rate for September 2018 was 17.8 percent. The 91-Day, 182-Day, and 364-Day Treasury Bill rates stood at 8.2 percent, 6.0 percent, and 23.3 percent respectively. Meanwhile, the economy sputtered at a growth rate of 3.5 percent in 2018, falling slightly from 3.8 percent in 2017.

According to the Bank of Sierra Leone's governing law, the Bank of Sierra Leone Act 2019, the Bank's key responsibilities are as follows:

1. The maintenance of macroeconomic stability;
2. The maintenance of financial system stability; and
3. The management of the nation's currency.

In the rest of this presentation, I will provide evidence for you to determine how well or poorly the Bank met these statutory obligations.

I. The Maintenance of Macroeconomic Stability

Macroeconomic stability simply means price stability (meaning, a low and stable rate of inflation) and high real economic growth. "Price", in the macroeconomic context, encompasses three aggregate price measures:

a. The prices of goods and services, most frequently measured by the Consumer Price Index (CPI);
b. The international price of the currency (the exchange rate); and
c. The domestic price of money (the interest rate).

An influential theory of exchange rate determination, the Purchasing Power Parity Theorem, holds that the rate of appreciation or depreciation of a domestic country's currency against a foreign currency is equal to the difference between the inflation rate in the two countries. For instance, if

Sierra Leone's inflation rate exceeds the United States' by, say, 10 percent, the Leone would depreciate against the United States dollar (USD) by 10 percent, and vice versa.

Inflation impacts the interest rates by lowering the quantity of goods and services a given quantity of money can buy. This will cause the public to increase its real money holdings in order to purchase its preferred quantity of goods and services, which then causes the price of money (the interest rate) to rise. Conversely, disinflation raises the quantity of goods the existing money stock can buy. This causes the public's demand for money to fall, thereby causing interest rates to similarly fall. Therefore, lowering the inflation rate is a necessary precondition for lowering both the interest rate and the rate of depreciation of the domestic currency. In other words, causation runs from the inflation rate to the other two variables.

Based on the above, we can conclude that a low and stable rate of inflation plays a critical role in fostering macroeconomic stability. Therefore, the monetary policy framework of the Bank of Sierra Leone under my leadership has been singularly focused on achieving (and maintaining) a single-digit inflation rate, while being careful to not exacerbate the unemployment problem.

Because inflation is by and large a product of fiscal indiscipline, the Bank put robust measures in place to force the Ministry of Finance to live within its means or pay a high price for failing to do so. For instance, all cheques it submitted to the Bank were to be fully covered. Otherwise, they would be returned for "insufficient funds" and, more importantly, assessed a fine of one million Leones per cheque. This simple administrative rule caused the Ministry to synchronize its spending with its income on a daily basis. Other measures were also imposed to raise the cost of BSL loans to Government, so as to engender fiscal discipline. The Bank also used open-market operations (the selling of government bonds to the public through the banking system) to mop up excess liquidity in the system. Finally, and very importantly, the Ministry's fiscal consolidation drive caused a narrowing of the fiscal gap, which helped to support the Bank's anti-inflationary policies.

Moreover, when the supply constraints caused by the Corona Virus Disease of 2019 (COVID-19) Pandemic threatened price stability in the country, the Bank implemented a low-interest Special Credit Facility (SCF) for the procurement and distribution of essential commodities. By preventing a general shortage of those commodities in the country, the SCF tempered the inflationary uptick that was observed in the Second Quarter of 2020 and restored the country to its pre-COVID-19 disinflationary path.

The end-result of the Bank's extremely contractionary monetary policy has been a drop in the inflation rate to 10.4 percent by end-December 2020 (from the 17.8 percent I inherited in October 2018). Our forecast suggests a continuing downward trending of the inflation rate in 2021, which would make Sierra Leone fulfill the single-digit-inflation primary criterion of the ECOWAS Single Currency Roadmap.

As expected, disinflation has resulted in a drop in the interest rate. For example, the yield on a 364-day Treasury Bill dropped from its end-September value of 23.3 percent to 10.1 percent in end-November 2020. Moreover, assisted by the administrative directives the Bank imposed in August 2019, disinflation caused the Leone-USD exchange rate to stabilize around 10,000 Leones per USD since January 2020. Impressively, the Leone has also generally appreciated against other currencies within the sub-region, as well as those of Africa's legendary star performers. Also, the economy has, by and large, been de-dollarized. Furthermore, the Bank's external reserves are at a healthy five-and-half months of imports.

Meanwhile, real GDP growth, which had sputtered at 3.5 percent in 2018, jumped to 5.3 percent in 2019. Pre-COVID, it was projected to grow by 5.9 percent in 2020. However, this optimistic outlook quickly changed to gloom as a result of the COVID-19 Pandemic. The negative impact of the supply-constraining restrictions imposed by Government (such as inter-district Lockdowns) as well as global supply-chain disruptions caused a contraction of the real economy by 2.7 percent in 2020. Assuming that we have seen the worst of the Pandemic, the economy is expected to rebound with a 3.1 percent growth in 2021. This optimistic forecast is, however, conditional on the severity of the impact of the Second Wave of the Pandemic on both domestic and international economic activity.

II. Financial System Stability

The financial system continues to be resilient and stable, as evidenced by improvements in key financial soundness indicators and minimum systemic risks, even though non-performing loans continue to be relatively high. Moreover, public confidence in the banking system remains high, as evidenced by the fact that the recent cash shortage in the commercial banks did not create runs on the banking system.

III. The Currency Crisis of December 2020

On 29th March 2018, the Bank placed an order for 100 million banknotes of various denominations, which were delivered on 12th March 2019 and 16th July 2019, respectively. Given the historical note-issuance data at the time, the stock of new notes in the vaults of the Bank on 12th March 2019 was sufficient to serve the cash needs of the country through December 2020 in normal times**.** The second consignment was therefore intended to be a buffer for any unexpected demand shocks during the year.

A. The Advent of COVID-19

Following the global outbreak of COVID-19, Government put modalities in place to mitigate its adverse effects on the people of this country. This created an immediate increase in government expenditure on healthcare, social protection, and measures to control the spread of the virus within the country. Sierra Leone being a cash-dependent economy, this increased government spending expectedly caused an increase in the demand for cash. Consequently, although the stock of currency notes in its vaults were sufficient to fill the normal cash needs of the economy through December 2020, the Bank placed an emergency order on 29th April 2020 for 85 million notes of various denominations to increase its buffer stock. Because it takes 6 to 9 months for an order to be delivered, this order should have been delivered no earlier than October 2020.

However, like the Bank of Sierra Leone, most central banks placed orders for banknotes so as to mitigate the impact of COVID-19 on the cash-liquidity of their banking systems. Because Messrs De La Rue (DLR) is the main supplier of currency notes for most countries, including Sierra Leone, the huge increase in orders by central banks, coupled with the supply-chain disruptions created by long periods of COVID-19 Lockdowns in Europe and elsewhere, caused a very long queue of DLR customers desiring banknotes. The anticipated consequences of any delay in the delivery of the order caused me to make a special plea to the Managing Director of DLR (whom I met during an official visit to the company soon after assuming the Governorship) to prioritize the Bank's order and, thereby, avert a possible cash crisis. As a result of this intervention, 60 million of the 85 million notes ordered in April 2019 were delivered by chartered flights in three tranches on

September 25th, November 12th, and December 11th, 2020. The remaining 25 million notes on this order were received on 18th January 2021.

B. Second Order of 85 Million Notes

Historically, at least 60 percent of all notes issued by the Bank are redeposited by commercial banks into the BSL's vaults. These redeposits, minus mutilated notes, are then reissued to the public through the commercial banks. In June 2020, however, the Bank noticed a huge drop in commercial bank cash redeposits, which caused it to issue more new notes, thereby reducing its stock of issuable notes to its barest minimum. To accommodate this shock, the Bank placed an emergency order for another 85 million notes on 10th July 2020.

This situation was further heightened by IMF and World Bank disbursements of 1.162 trillion Leones, which created an unprecedented demand for cash by Government to finance its COVID-related activities. Also adding fuel to the fire was Government's decision to pay the benefits of former government officials and contractors, much of which were withdrawn as cash. The net result was a shortage of currency in the banking system, even though there was already enough currency in the country to finance the economy for over two years.

With further pleas to DLR on behalf of the Bank, by the High Commissioner of the United Kingdom to Sierra Leone, H. E. Simon Mustard, DLR has moved the delivery date for our second order to mid-February 2021. And, as a further precautionary measure, the Bank placed another order for 125 million notes on 23rd December 2020, which are expected to be delivered in the Third Quarter of 2021. Therefore, barring any unforeseen COVID-induced disruptions in DLR's supply chain, the short-term measures the Bank has implemented will ensure that, regardless of any hoarding of banknotes that may occur, which cannot go on forever since the hoarders have limited vault capacities, there will be no cash shortage in the banking system of Sierra Leone in the foreseeable future.

C. **Expected Impact of Increased Currency Notes on Inflation**

It has been variously opined, by mostly uninformed pundits, that this increased acquisition of currency notes by the Bank will lead to inflation. What these pundits do not understand is that cash becomes only inflationary when it is in circulation, not when it is lodged in bank vaults. In short, claiming that cash-in-vault, no matter its volume, will cause inflation is as silly as claiming that water in the pipes in our homes will cause flooding. We know that water in the pipes in our homes cause flooding only when it is released at a greater rate than their drainage capacity. Similarly, cash becomes inflationary only when it is issued to the public at a higher rate than the rate of growth of the economy. Continuing with the water metaphor, the Bank's current acquisition of banknotes is to merely ensure that it has enough water in its pipes to adequately fight any future currency shortages. More importantly, when the cash being currently hoarded in private vaults is released into the economy, the Bank will simply sterilize the excess currency to keep a non-inflationary aggregate money supply in the economy. In any case, Sierra Leoneans should be comforted by the fact that a Governor who has reduced inflation from 17.8 percent at end-September 2018 to 10.4 percent at end-December 2020 knows a thing or two about what causes inflation and how to fight it.

D. **The Way Forward**

Obviously, printing new notes is not a viable long-term solution to the country's cash problems.

Weaning Sierra Leoneans off their cash dependency through the promotion of electronic payment systems is the only long-lasting solution. The implementation of the National Switch, which will speed up the digitization of our payment system and thereby reduce the demand for cash, is the first major hurdle that this country has been unable to jump over. Twice in the past, attempts to procure the National Switch for Sierra Leone were terminated because of corruption. The Bank is pleased to announce that under its current leadership, and with the support of the World Bank, the procurement contract for the National Switch, with an expected Go-Live date of Quarter 3 of 2021, will be signed by the Governor next week. To increase the use of electronic payments once the National Switch goes live, the Bank is in talks with our development partners about helping it to provide Point-of-Sales machines to businesses in order to promote the use of credit and debit cards as means of payment. We are also in consultation with the Ministry of Finance to pilot the payment of salaries of government employees through electronic wallets, which should also minimize the demand for, and use of, cash in the economy. Finally, we are in consultation with DSTI about introducing central bank digital currency in the near future. When these initiatives are completed, Sierra Leone will be better able to manage unexpected shocks to the demand for cash, as is the case in The Gambia, Ghana, Nigeria, and the Francophone countries—all of which have functioning National Switch Payment Systems.

Finally, it is worth pointing out that this is not the first time that Sierra Leone's banking system has faced a currency shortage. In fact, a more serious and longer-lasting currency shortage occurred as recently as the last quarter of 2011, which lasted way into the first quarter of 2012. It is also worth noting that the COVID-induced cash shortage is not unique to Sierra Leone. It has afflicted a host of countries, both in and outside the subregion, but not to the degree experienced by Sierra Leone, Liberia, and Guinea. This is because these three countries are extremely cash dependent due to their poor use of electronic payment systems. In the case of Guinea, intelligence reports tell us that huge stocks of Leones are being used there as a parallel currency. This has reduced the severity of their cash problem relative to ours and Liberia's.

Therefore, it behooves Sierra Leone to join the ranks of countries that have embraced a largely non-cash payment system if we are to permanently banish these periodic disruptions in the availability of cash in the banking system. Parliament also needs to consider granting the Bank of Sierra Leone powers to restrict the hoarding of Leones in the country and its export outside the country.

Concluding Remarks

During my 27-month tenure as Governor of the Bank of Sierra Leone, much has been achieved in terms of the Bank's core mandate of maintaining macroeconomic stability. Specifically:

1. Inflation has been reduced from 17.8 percent at the beginning of my tenure to 10.4 percent at end-December 2020;

2. The 364-day Treasury Bill rate has dropped from its end-September value of 23.3 percent to 10.1 percent at end-December 2020;

3. The exchange rate, which was depreciating at an alarming rate at the start of my tenure, stabilized around 10,000 Leones per USD.

4. The economy has been largely de-dollarized;

5. The National Switch project, which was prematurely terminated twice because of corruption in the procurement process, is expected to go live in the Third Quarter of 2021.

Also, the Bank acted proactively to prevent a cash shortage in the banking system due to COVID-19-inspired spending, even though it was not successful in the end due the factors beyond its control. This made the problem less severe than what obtained in 2011-2012.

In conclusion, I dare say that the success of the Bank's policies at achieving and maintaining macroeconomic stability during my tenure, which have been anchored by what has been derisively labeled as "textbook economics", is unrivalled by any monetary policy successes within a comparable period in the history of the Bank of Sierra Leone.

Finally, I want to assure the people of this country that the economy of Sierra Leone (including its financial system) is resilient and making progress, even in the midst of the current COVID-induced global economic crisis.

I thank you for your kind attention.