

The Credit Markets of Africa series

Alwyn B. Taylor

**MONEY AND BANKING
IN SIERRA LEONE**



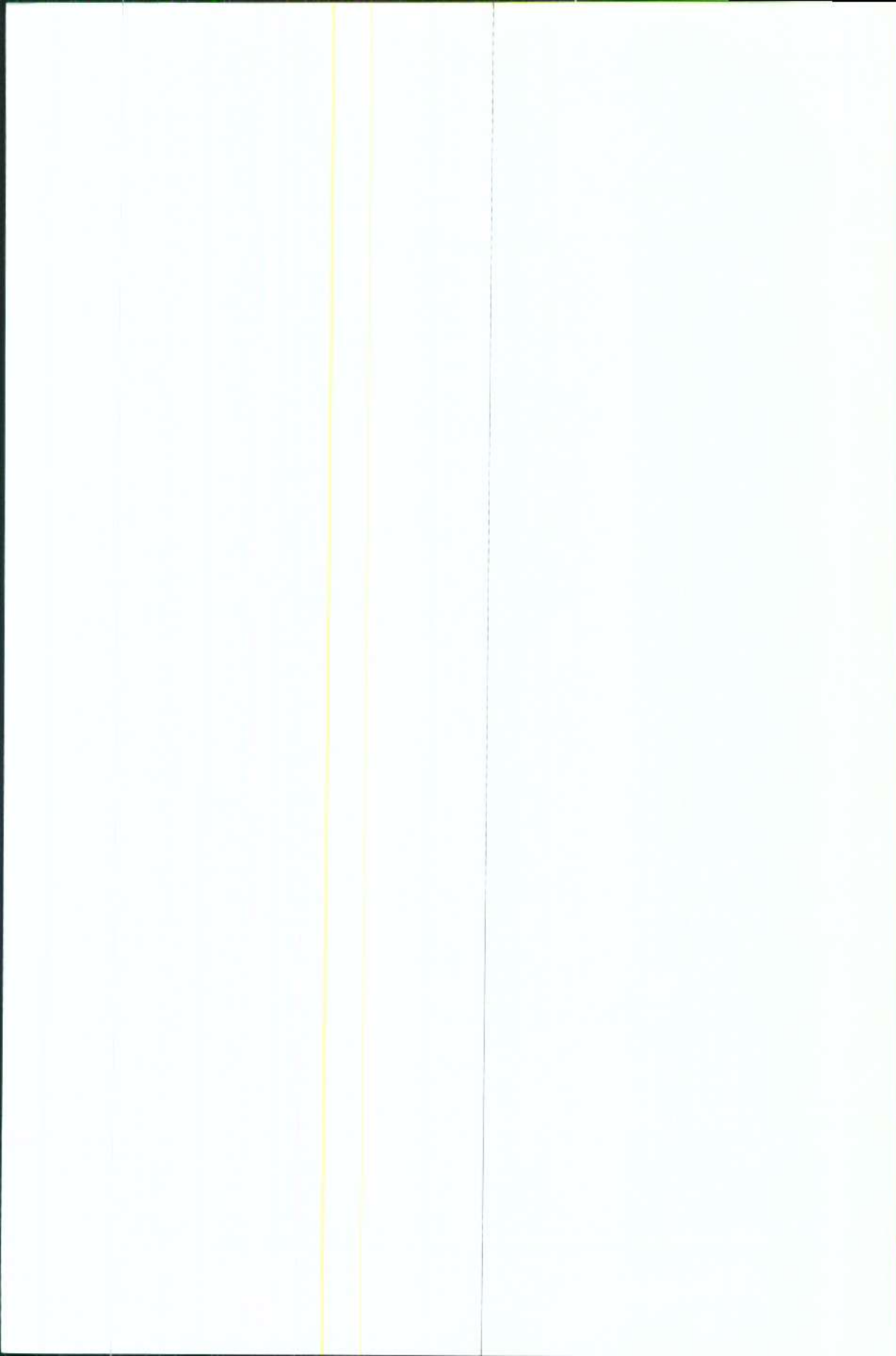
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**MONEY AND BANKING
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ALWYN B. TAYLOR

FOREWORD

The study deals with the nature and operations of financial institutions in Sierra Leone during the period 1960-1976.

Sierra Leone's development strategy has relied heavily on external sources for its financing. As evidence of this excessive reliance on external sources of finance, the Ten-Year Development Plan 1961/62 - 1971/72 expected up to 75 per cent of the total cost of the development programme to be met from external sources. The plan had to be abandoned largely because the anticipated external financial resources were not available. In the case of the 1974/75 - 1978/79 Development Plan, one-third of the total expenditure of Le 623.1 million was expected from external sources. Here also the inflows have been far below expectations.

But even if the volume of external capital that was available to the country was considered adequate in previous years, such finance is no longer adequate for present development needs. On the other hand, these external flows are not now available in their previous scale. For example, official flows in the form of aid and grants have declined substantially and most of these flows now take the form of loans, the repayment obligations of which are already causing serious problems for the budget as they are now 20 per cent of total revenue. In the case of foreign private investments, these have taken place mainly in the mining sector, while the investments outside the mining sector have been on the decline. Whereas medium and long term funds from these external sources have not shown any rapid growth, outflows in the form of remittances from

previous investments, debt servicing commitments, external expenditure by the government and private remittances, have increased sharply with the result that net inflows have been relatively small. In these circumstances, the country cannot depend too much on external sources for the financing of its development programme. To achieve the objective of rapid economic development, increasing reliance should be placed on domestic sources.

However, because of rapid increases in the recurrent budget and sluggish growth in revenue, the recurrent budget has generated only small surpluses for the financing of the development expenditure. At the same time, transfers from public sector enterprises have not been significant as a number of public corporations have incurred losses in recent years. Hence, increasing emphasis on domestic sources for development capital presupposes reliance on voluntary domestic financial resources.¹ This in practice involves institutionalisation of domestic savings.

Equally important as the mobilization of additional resources by financial institutions is the efficient allocation of available ones.² The experiences of a number of underdeveloped countries

¹ Financial institutions can mobilize voluntary savings by offering their own financial assets in exchange for primary securities. They are able to do this because firstly, the financial assets they offer have a wide range of maturity as well as convenience and in consequence are easily acceptable. An added attraction of financial assets is that they are well known and are easily divisible. Further, financial institutions pay interest to savers for their savings, the interest paid depending on the type of financial assets preferred by the saver. By the payment of interest and the provision of an attractive and convenient form of savings holding, these institutions may increase the rate and volume of savings. But the extent to which these institutions can mobilize domestic savings depends on how accessible they are to the public.

² In the absence of financial institutions, all economic units have to rely on their own resources and those they can borrow from their friends and close relatives. As pointed out by Gurley and Shaw, in this type of situation each economic unit will have to maintain a balanced budget, that is, each will invest its own savings with no outlets for excess savings. Usually, however, those who are willing and

have shown that the volume of investment does not necessarily guarantee development. Rather, development requires that financial resources flow into areas and sectors considered of strategic importance for the development of the economy. In effect, therefore, the process of institutionalization and productive investment of domestic savings calls for an organized financial institutional structure that is consistent with the socio-political and economic framework of the country.³

Our primary concern is thus to assess the extent to which the monetary and financial system has contributed to the availability and use of development finance. We have therefore attempted to answer three basic questions. These are: (a) The extent to which the financial structure has been successful in mobilizing domestic financial resources and the extent to which the system makes possible the continuous mobilization of domestic financial resources; (b) The extent to which domestic savings mobilized by financial institutions have been used for productive investment; and (c) The extent to which the financial system as a whole meets the needs

ready to take risks and undertake investments do not have the necessary finance, while those who have the funds are either too frightened to undertake risks or not patient enough to wait for long periods before they reap the rewards of their efforts, or do not possess the ability to be entrepreneurs. In these circumstances, if each economic unit has to invest its own savings there is likely to be less savings and inefficient investment because of differences in ability, values and attitude towards risks and uncertainty. Putting at the disposal of entrepreneurs funds available to them, financial institutions make possible the financing of a larger volume of investment.

John G. Gurley and Edward S. Shaw, "Financial Institutions and the Saving-Investment Process", *The Journal of Finance*, May 1956, pp. 260-263; Gurley and Shaw, *Money in a Theory of Finance*, New York, The Brookings Institution, 1960, Chaps. II and III.

³ Solis argues that the banking system is an instrument which can be used by the monetary authority to modify the allocation of loanable funds and resources to the various sectors and thus influence the demand for factors of production, goods and services. L. Solis, "The Financial System in the Economic Development of Mexico", *Weltwirtschaftliches Archiv*, No. 1, September 1968, pp. 36-48.

of government's development strategy especially in ensuring that resources from institutional sources flow into areas and sectors considered of importance for economic development.

Also, our analysis of the role of the monetary and financial system in the context of economic development includes a discussion on monetary management because of the link between money, income and the balance of payments brought about by the open and underdeveloped nature of the economy.

METHOD OF ANALYSIS

To answer the first two of our basic questions, we have analysed the sources and uses of funds of each financial institution. This analysis also enables us to comment on the extent to which the pattern of resource utilisation by the financial institutions has been different from that which obtained under the colonial monetary system. It also enables us to give some indication on the size of the gaps in the credit structure.

To answer the third question, that is, the extent to which the flow of financial resources has been consistent with the development strategy, first requires the identification of the development objectives and once this has been done the flow of financial resources is examined in the light of these objectives.

In his 1968/69 Budget Speech the Minister of Finance specified the direction of economic development as follows:

"Our most abundant resources are land and manpower and it is my feeling voiced earlier and shared by my colleagues that we must look to the growth of agricultural production as our main hope for economic development".⁴

⁴ *Budget Speech for the 1968/69 Financial Year*, Freetown, Government Printer, 1968, p. 3.

From this and other pronouncements by the government, the development strategy is aimed at achieving the following objectives: Self-sufficiency in the production of foodstuffs, especially staple foods; increase in the volume and value of agricultural exports and diversification of output; promotion of agricultural produce processing, and lastly the development of local industries based on agricultural production.

These were also the objectives of the previous government as can be seen from the following quotations from that government's development plan: "Until the developments of secondary industries have made rapid advances agriculture like other extractive occupations must continue to play a significant role in making the economy viable both externally and internally . . .".⁵ "The springboard for industrialization will be sought in the processing of agricultural and other primary products . . .".⁶ "In the encouragement of foreign investment preference will be given to those industries which are based on the use and fabrication of local materials or the use of domestic substitutes for imported materials . . .".⁷

This emphasis on agricultural development can be justified on several grounds. The agricultural sector is the largest single contributor to GDP accounting for an average of 33 per cent during the 1960's. Productivity of agriculture is, however, low and this is borne out by the fact that 75 per cent of the economically active population is engaged directly or indirectly in agriculture. One consequence of low productivity has been large importation of foodstuffs due to shortfalls in local production. A second consequence is that income per worker in this sector is very low.

⁵ David Carney, *Ten-Year Plan for Economic and Social Development, 1961/62 - 1971/72*, Freetown, Government Printer, 1963, p. 24.

⁶ *Ibid.*, p. 24.

⁷ *Ibid.*, p. 59.

Whereas the per capita income for the country as a whole averaged Le 150 for the period 1963/64 to 1975/76, the average for the agricultural sector for the same period was Le 110.

With increased agricultural productivity it should be possible to achieve self sufficiency in foodstuffs that can be produced in the country. To take one example, a 10 per cent increase in rice production would result in a saving of Le 3 million on rice importation. Numerous studies have indicated that Sierra Leone can increase rice production, and the Chinese demonstration team has shown that three crops are possible within one year. With West Africa being a large importer of rice there are export prospects for this commodity too.

In a country like Sierra Leone industrialization must be aimed at the domestic market only, as severe competition in the world market makes the outlet for industrial products abroad difficult. However, the size of the domestic market is quite small in view of the very low incomes. Hence, a programme of industrialization for the local market can succeed only with increased agricultural productivity which ensures that the mass of the people have a steadily rising purchasing power.

Migration to the towns, a problem in most underdeveloped countries, is the direct result of the absence of profitable employment prospects in the rural areas. A study by Levi found that "migrants predominantly come from the rural areas where there is high population pressure on the land and no alternative labour intensive method of production to land".⁸ He concluded his study as follows: "Would it be going too far to suggest that government should concentrate on injecting resources into areas so as to raise labour productivity and carry out an extensive programme to teach people

⁸ J. R. S. Levi, "Labour Migration and Unemployment", *Economic Review of the Bank of Sierra Leone*, Nos. 4 and 5, June 1970, p. 10.

how to ensure fertility . . . ?"⁹ If his finding is accepted policy measures aimed at improving the productivity of the farmer should reduce migration to the towns.

Capital is usually very scarce in underdeveloped countries and Sierra Leone is no exception. The development of the agricultural sector economizes in the use of capital since it has been shown that rapid and significant returns in agriculture are possible with relatively small amounts of capital. This is important, because the bulk of the labour force in this sector is unskilled but is at the same time ready and willing to adopt new methods given the necessary incentive.

To summarize, the government's development strategy, which places the emphasis on agricultural development, is justified as increased agricultural productivity leading to less expenditure on food imports will conserve foreign exchange; secondly, because the size of the market limits severely the extent of industrialization for the home market; thirdly, because it is a labour surplus country; and finally, because there is plenty of fertile land available.

To achieve a break-through in agriculture however, modern methods of production must ultimately reach the mass of small pro-

⁹ *Ibid.*, p. 5. He found close association between labour productivity and migration as can be seen from the following: "In Chart I registered urban unemployment in Sierra Leone is plotted against time, the least squares trend line drawn and the deviation from trend obtained as shown. These deviations from trend are plotted on a graph against rice production (as a measure of rural real incomes), in Chart II, for the six years shown against each point, these being the only years for which data are available. The graph demonstrates a surprisingly strong relationship $r = -0.972$ which is significantly different from zero at the 1 % level and almost at the 0.1 % level; the 95 % confidence interval is 0.731 to -0.997 . This suggests that unless urban real wages remain fairly constant, which I am sure they did not, migration and consequent unemployment are not very sensitive to them. That unemployment on the other hand is very sensitive to the current level of earnings may be shown by looking at the bumper 1961 harvest; this was apparently only about 10% higher than average and yet registered unemployment fell by 30%". He then went on to show the relationship between rice production and migration.

ducers, in addition to the development of plantations. These developments require an adequate flow of resources especially for the essential inputs and for credit facilities. The financial structure will be making a contribution to the development of the country, if there exist within the system institutions ready to provide the special assistance agriculture and small-scale businessmen need.

An objective of financial development is to encourage savers to hold their savings in liabilities of financial institutions and to ensure the efficient utilization of these savings. Consequently, a fundamental requirement is "the establishment of a unified, efficient inexpensive medium to exchange 'money' capable of elastic changes under the control of 'wise' monetary authorities".¹⁰ In underdeveloped countries such as Sierra Leone there is a high correlation between money (currency in circulation plus demand deposits), income and the balance of payments. The relationship is the direct consequence of the openness of the economy.

Because of this close relationship between money, income and the balance of payments and since an efficient monetary system is essential for the mobilization and utilization of savings, it is necessary that income determination, monetary development and the balance-of-payments developments be analysed in an integrated model. After a careful examination of various models we consider the Polak Model to be the most appropriate for the Sierra Leone economy.¹¹ Its significance for the study is that it enables us to show the effects of credit creation on the balance of payments and hence the extent to which development can be financed by borrowings from the banking system.

¹⁰ Hugh T. Patrick, "Financial Development and Economic Growth in Underdeveloped Countries", *Economic Development and Cultural Change*, No. 2, January 1966, p. 185.

¹¹ An outline of the Polak Model and its application to the Sierra Leone economy is given in Chapter VI.

One of the main conclusions of the Polak Model is that an increase in domestic credit will cause a gradual decline in the foreign exchange reserves of the country to the full extent of the additional credit. Since additional credit results in a depletion of foreign exchange reserves, monetary management becomes important to ensure that utilization of credit increases the productive capacity of the economy so as to justify the loss of external reserves; and also, because of the consequences of reserve loss for short period stability, monetary management becomes important to bring about some co-ordination between the desire for long term development and the need for short period stability.

In summary, the study postulates that the development of the monetary and financial system will result in more domestic financial resources being available for the development of the Sierra Leone economy. In our examination of this proposition, two main themes emerge. The first is the need to increase the flow of financial resources to activities and sectors consistent with the country's development objectives. The second is that the scope for traditional monetary policy is very limited and that emphasis must be placed on the level and flow of external reserves.

CHAPTER SUMMARY

We begin with an analysis of the colonial monetary system, of which the monetary and financial system of Sierra Leone was a part until 1963, in order to emphasize the features which ensured its success during that period, and to point out the inadequacies of that system once independence was achieved. This discussion enables us to suggest required reforms in the light of the emphasis on rapid economic development, which became the objective of economic policy after independence.

Since the monetary and financial system can best be understood within the economy of which it is a part, we discuss the structural features of the Sierra Leone economy in Chapter II.

The detailed examination of the monetary and financial system of Sierra Leone begins in Chapter III with a discussion of the Bank of Sierra Leone. The discussion in this chapter is concentrated on the sources and uses of resources available to the Bank, the Bank's contribution to economic development, and limitations on its effectiveness. In our discussion of the Bank's contribution to economic development we examine the enabling provisions of the Bank's Act as well as look at what the Bank has done in practice.

Chapter IV examines sources and uses of funds available to commercial banks. Regression analysis is employed to explain trends in total deposits during the 1960's as well as in each category. On the allocation of funds, we examine the composition of loans and their utilization by sectors. We also discuss the contribution of the commercial banks to economic development.

The Post Office Savings Bank and other financial institutions are discussed together under non-bank financial institutions in Chapter V. Here also, the concern is with the sources and uses of funds. Also included in this chapter are institutions which have recently been established. The sources and uses of funds available to the unorganized sector are also discussed in this chapter. The discussion in this section is centred around the volume of borrowing and lending, the rate of interest payable and sources of savings.

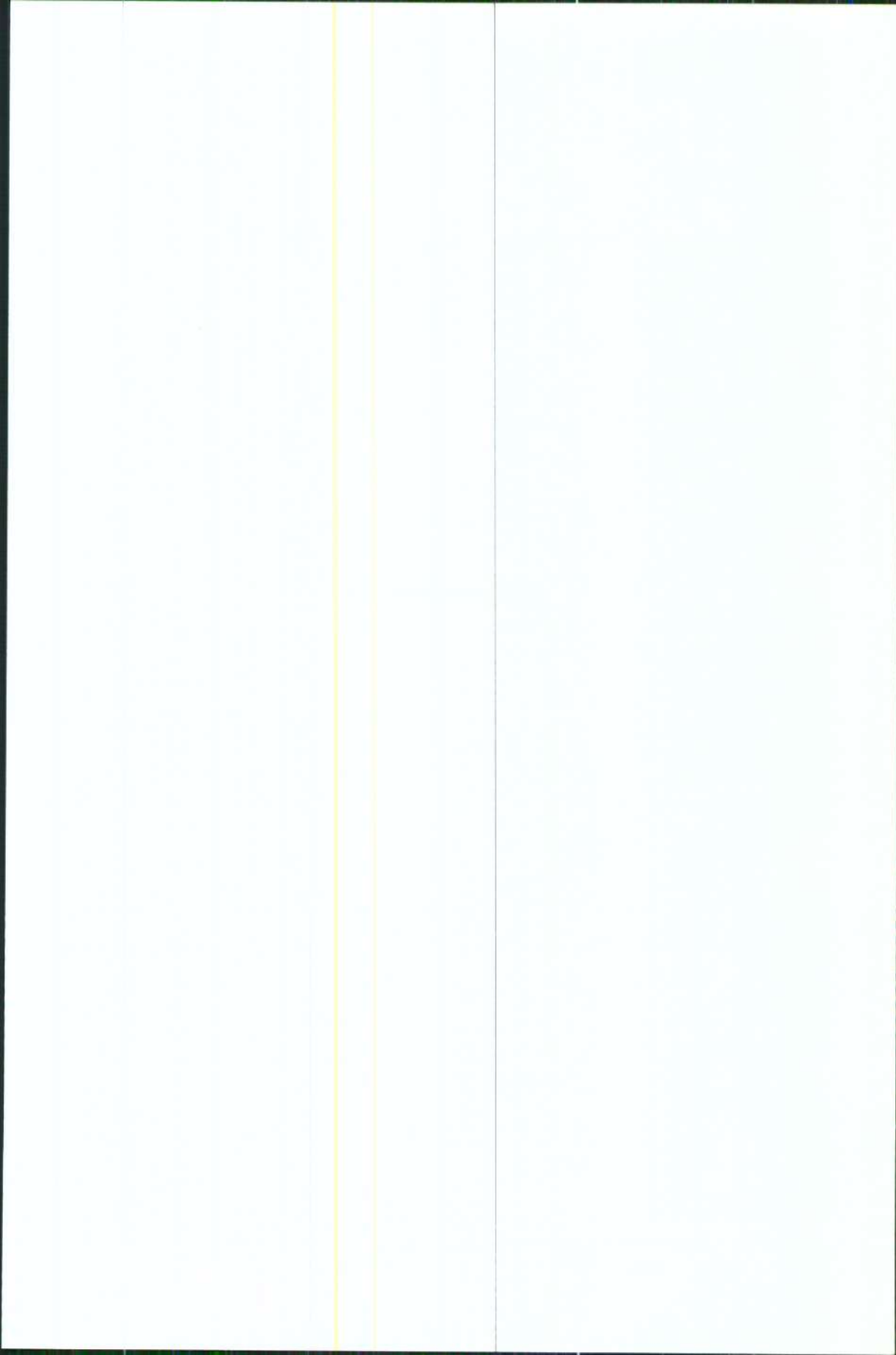
Attempts are also made in Chapter VI to quantify the extent of unsatisfied demand for credit in the agricultural and small-scale industries sectors. The emphasis on these sectors lies in their importance for the development of the economy. Based on the results of a pilot survey undertaken in 1968, we derive some order of magnitude of the demand for agricultural credit. In the case of the industrial sector we do not attempt to refute the argument (confirmed by a number of studies) that effective demand for credit by small-

scale industries in underdeveloped countries is low. Instead, we suggest explanations for the low effective demand for capital amongst small-scale industries in Sierra Leone and argue that this demand would be higher if credit facilities were supported by ancillary services.

The introductory section of this chapter brings together the sources and uses of aggregate funds as well as examining the behaviour of the Sierra Leone money supply. With the aid of the Polak Model we show the significance of monetary management for the Sierra Leone economy. We also suggest the direction of monetary management in the light of the observed behaviour of the money supply.

In the conclusion we suggest proposals for reform which we believe would increase the efficiency of the monetary and financial system and enable the system to mobilize domestic resources for economic development and ensure their utilization for productive investment.

Our findings support the contention that, given appropriate policies, more domestic financial resources can be mobilized. Their productive utilization, however, requires fundamental changes in the operational policies of existing institutions as well as the establishment of more specialized agencies.



Chapter I.

THE MONETARY AND FINANCIAL SYSTEM PRIOR TO THE ESTABLISHMENT OF THE CENTRAL BANK

Prior to 1964 when the central bank was established, the monetary and financial system of Sierra Leone was a part of the colonial monetary system. This chapter highlights the distinguishing features of that system which made it adequate for the needs of the colonial era as well as points out its inadequacies once political independence, with the emphasis on accelerated economic development, was achieved.

1. THE MAIN FEATURES OF THE COLONIAL MONETARY SYSTEM

The colonial monetary system was characterized by: (a) A currency board which was the issuing authority; (b) commercial banks and other financial institutions which were all branches of British institutions; (c) the absence of deficit financing; (d) special grants from the United Kingdom Treasury; and (e) reliance on the London money and capital markets both by the government and the financial institutions.¹

We shall now examine each of these in turn beginning with the currency board arrangement.

¹ For a discussion of the colonial monetary system, see Ida Greaves, *Colonial Monetary Conditions*, London, H.M.S.O., 1953.

*The West African Currency Board (WACB)*²

The West African Currency Board was established in November 1912, by an Executive Order of the British Secretary of State for the Colonies following the recommendations of the Emmot Committee appointed in 1911, "to enquire into matters affecting the currency of the British West African Colonies and Protectorates". It was intended to serve three main purposes. First, the initiation of a West African issue of currency; second, the assurance of convertibility of local currency into sterling at a known rate of exchange; and third, the provision of revenue to the governments through sharing in the profits of issue. The West African Currency Board which served Sierra Leone, Ghana, The Gambia and Nigeria operated from London and was appointed by the Secretary of State for the Colonies. The currency situation which led to the establishment of the WACB was quite precarious. To illustrate, Sierra Leone had the following currencies in circulation: First was the commodity currency, mainly iron bars and tobacco; second was the currency issued by the Sierra Leone Company, the macuta, which was the provincial currency coined by Portugal for Angola. The third category was the British silver introduced after the transfer of political responsibility from the Sierra Leone Company to the Colonial Office. In the fourth category were the doubloon and the dollar of Spain and Mexico, the 20 franc piece, the gold coins of the United States (the Eagle), the 5 franc piece of Belgium, Italy and Sweden.

² For a more detailed discussion on the West African Currency Board, see W. T. Newlyn and D. C. Rowan, *Money and Banking in British Colonial Africa*, Oxford, Clarendon Press, 1954, Chap. II; C. V. Brown, *The Nigerian Banking System*, London, George Allen & Unwin, 1966, pp. 51-53; J. B. Loynes, *The West African Currency Board*, London, Grosvenor Press, 1962; R. A. Sowelem, *Towards Financial Independence in a Developing Country*, London, George Allen & Unwin, 1967, pp. 24-29, 212-235.

Between November 1912 and July 1963 the responsibility for the issuing of currency in Sierra Leone rested with the West African Currency Board. The responsibility of the WACB was defined as follows: "To provide for and to control the supply of currency to the British West African Colonies and Protectorates, to ensure that the currency is maintained in satisfactory conditions, and generally to watch over the interest of the Dependencies in question so far as currency is concerned".³ In practice, these general obligations of the WACB meant, in the words of Greaves, "It is the function of a Currency Authority to satisfy the demand for local currency not to regulate it; controlling the supply of currency in a colony is entirely a technical matter of providing for local requirements while guarding against losses from theft and forgery; it means deciding what types and denominations of currency are to circulate and issuing them on demand, not exercising discretionary authority over the total amount that is available".⁴

Under the provisions of the WACB local currency could only come into circulation with the surrender of an equivalent amount in sterling. At the same time, the WACB was obliged to redeem local currency against sterling. The regulations under which the WACB operated ensured that the value of the WACB currency was always stable with respect to sterling.

A departure from the 100 per cent sterling backing was made in 1957 and 1958 when the WACB acquired Le 4 million of Sierra Leone government securities. The introduction of this fiduciary element did not change the basis on which the WACB operated as the one-for-one marginal relationship between WACB currency and sterling was not affected.

³ Newlyn and Rowan, *op. cit.* p. 46.

⁴ Greaves, *op. cit.* p. 12.

Commercial banks and other financial institutions

Apart from being branches of large British commercial banks, the commercial banks in Sierra Leone, like the currency in circulation, were integrated within the banking system of the United Kingdom through interlocking directorships and through the use of the London money and capital markets. Sierra Leone, like other colonies, did not have a money market or outlets for discounting facilities and the temporary employment of surplus funds. Another feature of these banks was that they were supra-national, that is, they operated in several areas throughout the world with the result that their operations in Sierra Leone represented only a tiny fraction of their total worldwide business. One implication of this was that funds moved freely from one area to another. As the commercial banks were part of the British banking system they operated "on essentially the same principles as branches located inside the same frontiers as their head offices".⁵

The results of these characteristics were firstly, that credit policies were determined in London and control over the branches was exercised from London. Secondly, because they looked at their banking operations as a whole, they did not hold foreign reserves specifically against their operations in any one country, Sierra Leone in this case. This being the case, their credit policies had no direct relationship to the amount of reserves which they lost or gained on account of a particular country but were determined by their liquidity position in general. Thirdly, because of the integration of the banking system of the colonies with the London money and capital markets and because of the absence of local investment outlets for their surplus funds, the assets of the commercial banks consisted mainly of investments in London. Apart from the commercial banks, other financial institutions also invested most of their resources in

⁵ *Ibid.*, p. 27.

the London money and capital markets. The Post Office Savings Bank, for instance, was required by law to invest its resources in securities of the British and Commonwealth governments and other colonial governments but not in securities issued by the Sierra Leone government. Pensions, provident and superannuation funds were all invested in London. The same was true of investments of insurance companies.

The absence of deficit financing

Three important features of colonial government finance were first, the absence of deficit financing; second, the dependence on the London money and capital markets; and third, the receipt of special grants from the British Treasury.

Because London was both the monetary headquarters of the country and also the country's capital market, Sierra Leone as well as other colonial governments held balances in London in addition to the loans and grants they obtained.

When colonial governments made use of the borrowing facilities of the London capital market, they enjoyed a privileged position which was made possible by various acts of the British Parliament, the most important being the Colonial Loans Act of 1899 and the Colonial Stock Act of 1900.

Between 1900 and 1938, Sierra Leone floated a total of six stocks on the London market at rates varying between 3 and 4.5 per cent and in each case these stocks were guaranteed by the British government. The total value of these stocks was Le 4 million and maturity ranged between twenty and twenty-five years. The London capital market was used again between 1943 and 1958 to raise Le 12 million. The average redemption was twenty years but this time the rate of interest ranged between $5\frac{1}{2}$ and $5\frac{1}{8}$ per cent. In addition, there were two United Kingdom exchequer loans

amounting to Le 3 million and interest at $5\frac{5}{8}$ and $6\frac{1}{2}$ per cent respectively.

In addition to such borrowings the government received periodic grants from the United Kingdom Treasury.⁶ These grants were quite substantial and started about 1800 with a grant of Le 14,000. During most of the period 1839 to 1864 grants-in-aid exceeded 80 per cent of the total expenditure of the country.⁷ Between 1865 and 1895, however, grants averaged 45 per cent. There was a sharp rise thereafter and in 1900 these grants were 97 per cent of total expenditure. Grants during the period 1945 to 1961/62 were as follows (thousand Le):

1945/46 to 1958/59	1959/60	1960/61	1961/62
9,062	1,890	2,398	5,474

Source: Ministry of Overseas Development, *Aid to Developing Countries*, London, H.M.S.O., 1963, Cmd 2147, Appendix A, pp. 42-43.

Although as a percentage of total expenditure these grants have declined in importance to less than 10 per cent of total expenditure, by 1961/62 they were still quite large in absolute terms.

Observations on the colonial monetary system

This monetary and financial arrangement was quite consistent with the economic situation of the country. Sierra Leone, like all other colonies, was closely related to the United Kingdom. Virtually

⁶ N. A. Cox-George, *Finance and Development in West Africa: The Sierra Leone Experience*, London, Dennis Dobson, 1961, pp. 156-158. Also United Africa Company, *Statistical and Economic Review*, No. 20, September 1957, p. 18.

For colonial development and welfare grants up to 1957, see United Africa Company, *Ibid.*, p. 18.

⁷ Cox-George, *op. cit.*, pp. 156-158.

all her exports went to the United Kingdom and likewise most of her imports originated from Britain, and she depended on Britain for the supply of a number of services including shipping and insurance as well as the principal source of investment capital. Because trade was the link between the colonies and the United Kingdom, commercial banks in all colonies, including Sierra Leone, concentrated their credit on the financing of the export/import trade between Britain and the colonies and invested in the London money market surplus funds which could not be profitably invested at home. In fact, the banks were established primarily for the financing of the export/import trade.

Again, like other colonies, Sierra Leone was not regarded as a separate or foreign country but rather "more properly as the place where Britain considered it convenient to produce primary and mineral products".⁸ In effect "these colonies were extensions of the United Kingdom".⁹ Consequently, the trade between the United Kingdom and Sierra Leone (and for that matter all other colonies) was not external trade in the sense of trade between two foreign countries, but "resembles the traffic between town and country and is amenable to the principles of home trade".¹⁰ This was supported by the fact that the colonies never had a trade policy of their own and were always included in the balance of payments of the United Kingdom. Policies introduced to correct an adverse balance of payments of the United Kingdom had to be implemented by the colonies. But on the other hand, grants-in-aid both covered any current account deficits and were a substantial source of development capital.

⁸ J. S. Mill, *Principles of Political Economy*, quoted by Greaves, *op. cit.*, p. 2.

⁹ *Ibid.*

¹⁰ *Ibid.*, pp. 2-3.

2. THE STRUCTURE OF THE ECONOMY AND THE WORKINGS OF THE COLONIAL MONETARY SYSTEM

Not only were the colonial monetary arrangements consistent with the objectives of colonial policy, they also met the requirements of an open and financially dependent economy.

The conclusion which will be drawn from our discussion of the structural features of the Sierra Leone economy in Chapter II are the following: The economy is dependent on foreign trade; the foreign trade sector is the generator of incomes. The consequence of dependence on the foreign trade sector as the main source of income is that this sector also determines the level of employment, output, demand and prices. In addition, the country is dependent on a narrow range of primary products, namely, diamonds, palm kernels, cocoa and coffee. While diamond exports account for about 60 per cent of total exports receipts, receipts from palm kernels account for about 50 per cent of agricultural exports and about 10 per cent of total exports. Another consequence of the dependence on foreign trade is that it not only determines the level of individuals' incomes but also dictates the level of government revenue. Also the amount of deposits the commercial banks are able to mobilize depends on income which, in this case, means export incomes, and since economic activities are centred around the export/import trade, the volume of commercial banks' loans and advances is influenced by the demand for credit from that sector.

Secondly, our discussion reveals that most of the increases in the investments financed from domestic sources occurred after 1968 so that during the pre-independence period, investments were largely financed from external sources. All the mining companies were entirely owned by large foreign international companies. In the case of agricultural produce, these were in the hands of peasant farmers. But the marketing of crops was undertaken by the trading com-

panies, mainly foreign owned, and they provided the credit that was required for financing the trade.

Thirdly, as the banking system during the colonial period was relatively underdeveloped and investment largely originated from external sources, those who saved in the economy either invested those savings themselves or found others who needed finance and they did so without the assistance of financial institutions. There was no separation of the saving from the investment activity. In such a situation intentions about savings and investment were related with the result that the divergence between ex-ante-savings and investment was reduced.

Fourthly, in addition to this economic dependence, the country was also financially dependent. The commercial banks as well as other financial institutions were, as we saw earlier, all branches of foreign institutions and the absence of a local money and capital market meant that those with surplus funds sought investment outlets outside the economy and depended on external sources for short term accommodation.

Given these structural features let us now examine how changes in the money supply could come about in order to illustrate the workings of the monetary arrangement. An autonomous rise in exports resulting in a balance-of-trade surplus leads to increased domestic incomes. Those who have acquired the additional incomes would either spend it on local goods and services or deposit it with a commercial bank. To spend the export proceeds on goods and services the recipients would surrender their foreign earnings to the West African Currency Board in exchange for local currency. So that if the increased incomes were spent, the currency component of the money supply would increase. If on the other hand the additional incomes were deposited with the commercial banks, their deposit liabilities would increase but at the same time their external assets would also rise. The money supply would rise if, as a result of their higher liquidity, commercial banks decided to expand their

loans and advances. This however was not automatic since the volume of loans that the banks could extend depended on demand, on the availability of securities that were acceptable to the commercial banks, and on the existence of customers that satisfied the banks' conception of creditworthiness.

As the commercial banks were primarily established to finance the export/import trade, the demand for credit came from the foreign trade sector. Assuming then that there were borrowers who satisfied the banks' condition for a loan, the money supply increased further as a result of an expansion in the volume of lending by the commercial banks. But it should be noted that the additional deposits could be retained by the commercial banks in the form of increased external assets.

In the case of capital inflows to finance investment, foreign assets were surrendered to the WACB to meet the local cost of the investment. As in the previous case, some of the incomes made possible by the investment increased the deposits at commercial banks with the possibility of a further rise in the money supply.

In the case of an excess of imports over exports or capital outflows, currency in circulation contracted. But because commercial banks could determine what was or was not a creditworthy risk, and because their loans in any one country were not affected by the level of reserves in respect of that country, they could influence the money supply independently of this adverse balance of payments. Suppose in this situation commercial banks decided to increase their lending in Sierra Leone because, in their view, acceptable investment opportunities existed. In such a case, the volume of lending would have increased and not have contracted with the adverse balance of payments. Of course, in the absence of exogenous disturbances, balance would be restored by a contraction of the money supply caused by the leakage into imports and the public's demand for cash. That this type of commercial bank re-

sponse was possible can be seen from the following quotation from Newlyn and Rowan:

"In 1951 . . . the statistics show a huge increase in bank lending combined with a singularly large contraction in sterling assets. The magnitude of this inverse movement of the two variables is quite extraordinary and requires explanation. For the banks to increase their local earning assets by 60 per cent over a year in which their sterling balances fell 40 per cent is a remarkable indication of the importance and the volatility of bank lending in determining the local monetary situation".¹¹

Newlyn and Rowan then go on to suggest that the fact the banks "could behave in this way and thus give great elasticity to bank credit, is due to the supra-territorial nature of the banking structure. The banking system of Southern Rhodesia is not self-contained, and Southern Rhodesia forms but a small part of the banking territory of the banks operating there".¹²

In contrast, however, the normal behaviour of commercial banks in West Africa, especially up to the 1950's, was passive. Referring to the sources of changes in the money supply in Nigeria between 1943 and 1951, Newlyn and Rowan observe as follows: "... makes it abundantly plain that the influence of bank credit creation was small and accounted for less than 8 per cent of the change in the total money supply over the period".¹³ The passive response was the normal reaction of commercial banks in Sierra Leone, because they did not have cause to increase their lending since trading firms met all their own credit requirements for financing the export/import trade. Commercial banks were thus merely

¹¹ Newlyn and Rowan, *op. cit.*, pp. 171-172.

¹² *Ibid.*, p. 173.

¹³ *Ibid.*, p. 163.

"a custodian of cash and not a local provider of short term capital".¹⁴ Given this passive response, commercial banks' lending declined with an adverse balance of payments.

We can now summarize the factors which could affect the money supply during the colonial period as (a) changes in the external assets of the WACB and the commercial banks; (b) changes in the level of savings and time deposits; and (c) changes in the volume of lending by the commercial banks. Each of these sources of change originated from the external determinants of income.

But in practice, the financing of exports, imports or investment required the expansion of the currency circulation in advance of the sale overseas of the produce. This is because export crops had to be purchased from peasant farmers, who because of their small incomes could not afford to wait until the produce were exported. The money required to increase the supply of local currency was provided by the trading firms. In the case of imports, the foreign firms also provided their own finance or obtained the required credit from their own banks abroad. The decision to invest was taken by foreign firms and it depended on the world demand for the products. As long as the demand for produce existed they were always able to obtain the required investment capital from international sources. Once the decision to invest had been taken, the foreign firms made available the sterling assets which were necessary to meet the local cost of the investment.

For each of these activities, exports, imports and investment, the trading firms made available the necessary sterling assets without which the local currency could not increase. The volume of resources which these firms had to make available depended on import

¹⁴ H. A. Shannon, "The Modern Colonial Sterling Exchange Standard", *International Monetary Fund Staff Papers*, Vol. 2, April 1952, p. 323.

and export prices which were determined in the world markets. Hence the amount of resources they could provide depended on world market conditions. Here we need to emphasize the part played by trading firms in the workings of the system as they ensured its flexibility. Hence, the colonial monetary system worked well because the trading firms and the commercial banks were ready to provide the sterling assets which were necessary for the increase of the money circulation in advance of the sale of exports produce in world markets.

Now, the level of domestic incomes was externally determined, that is, changes in exports, domestic investment and government expenditure were due to factors outside the control of the economy. Similarly, employment, output and prices were also determined externally. At the same time, these external determinants of incomes were also the factors that explained changes in the money supply. In any economy, changes in the value of external transactions will affect domestic incomes and the money supply. But the major difference between an open underdeveloped economy and an economy in which external transactions are relatively unimportant as a determinant of income is that, in the latter case, it is possible to neutralize the effects of external transactions and in consequence these external transactions need not affect the money supply. In the former case on the contrary, that is, in an open underdeveloped economy, external transactions are the primary determinants of incomes and the money supply.

The colonial monetary arrangements, by eliminating discretionary control, in essence enabled the monetary system to respond automatically to the external determinants of income, thereby avoiding fluctuations in the value of the domestic currency. But suppose that the monetary arrangements did not reflect the external deter-

minants of income. Let us consider the effects of an autonomous increase in bank lending and investment which are not matched by export earnings or capital inflows. Given the propensity to import, a large fraction of the net additions to income will flow out of the economy. Since the head office is not likely to maintain an overdrawn position indefinitely, the consequent loss of foreign assets by the banks may lead to a contraction in lending. In the case of autonomous investment, a large part of expending flows out as a direct expenditure on equipments; this in addition to what is lost as a result of the high marginal propensity to import. In this case also, the result is a loss of foreign assets. Unless foreign assets are already very large, autonomous bank lending and investment may lead to a balance-of-payments problem.

To the extent that the convertibility of local currency to foreign currencies was essential for foreign trade and capital inflows on which the country relied for its income, the colonial monetary system was consistent with the structural features of the economy and the limited objectives of colonial economic policy.

3. THE SIGNIFICANCE OF POLITICAL INDEPENDENCE

Colonial economic policy was however quite inadequate after political independence was attained in 1961. In pursuit of achieving a rate of economic development, the strategy entailed diversification of the economy with less emphasis on foreign trade than had previously been the case under the colonial arrangement. In effect, therefore, a structural transformation to ensure continuous development of the economy was what political independence envisaged.

Against this background of desire for fundamental changes in the economic structure, a monetary and financial system which

is outward-oriented is largely inappropriate. Nor can the monetary and financial system be uninterested in the country's desire for economic development. For while it is possible to discuss particular industries isolated from the economy in which they are situated, the monetary and financial system must be seen within the economy of which it is a part.

With the emphasis on rapid economic development after independence, the monetary and financial system has to be an instrument of economic development. This is essential because the commitment to rapid development requires a substantial amount of capital, which can come from internal sources or originate from abroad. But there are several reasons why the emphasis must be on mobilizing domestic resources. There is first of all a large demand for investment funds throughout the world from other underdeveloped countries as well as the more developed ones. It should be noted moreover that investment funds do not necessarily flow to areas of high priority for development, but rather to those countries in which the returns, in the form of profits, are greatest. Hence, investment funds are flowing increasingly to relatively rich countries such as Australia and South Africa. Given the large demand for investment funds, the possibilities are that capital for investment may not be available to small countries, such as Sierra Leone, on favourable terms.¹⁵ Then, there is also the fact that capital inflows in the form

¹⁵ Already in 1951 Sir Cecil Trevor had observed that: "In present conditions, the demand on the London market is particularly heavy and it is in the interest of all concerned that other means of raising capital should be explored as far as possible before reporting to London. To this end, it is particularly desirable that colonial governments should be encouraged to raise as much as possible of their loan requirements locally". Sir Cecil Trevor, *Report on Banking in the Gold Coast and on the Question of Setting Up a National Bank*, Accra, Government Printer, 1951, para. 176.

of grants and aids have shown a marked decline since 1963/64.¹⁶

These inflows now take the form of loans, the repayment obligations of which account for about 20 per cent of total revenue. For these reasons the country will have to look increasingly to domestic sources for its development capital. And it should be the responsibility of the monetary and financial institutions, in this changed situation caused by political independence, to mobilize domestic resources for development. At the same time, the lending policies and loan utilization pattern must reflect the changed direction of economic policy.

There are other reasons why the simple colonial device is no longer suitable today. We have emphasized the fact that the colonial monetary arrangements worked well because the trading firms and the commercial banks were willing and able to surrender the sterling backing that was necessary for any increase in the currency circulation. It was relatively easy for trading firms and commer-

¹⁶ The decline in grants from the United Kingdom can be seen from the following figures:

BRITISH AID TO SIERRA LEONE (thousand Le)

1962/63		1963/64		1964/65	
Grants	Loans	Grants	Loans	Grants	Loans
2,152	2,286	1,000	4,120	—	1,660
1965/66		1966/67		1967/68	
Grants	Loans	Grants	Loans	Grants	Loans
—	1,840	214	2,838	—	766

Source: Ministry of Overseas Development, *British Aid: Statistics of Official Economic Aid to Developing Countries*, London, H.M.S.O., June 1967, Table 19.

As regards foreign private investment, inflows are not on their previous scale but at the same time remittances from earlier investment continue. Other outflows include remittances by foreign personnel who have come to assist in the development process either as technicians, businessmen or advisers; investment abroad; and up to 1964 paid passages for holidays abroad for senior civil servants.

cial banks to do this because the financing of the export/import trade resulted in their earning foreign exchange. One of the consequences of independence is that trading firms have been excluded by law from the marketing of agricultural produce. In addition, we argue in Chapter III that trading firms no longer bring in their own finance but rely on commercial banks. Retaining the colonial monetary arrangements in these circumstances would result in marketing difficulties.

Quite apart from the problem of short run elasticity there is the problem of long term expansion in the money supply. As the economy grows, incomes and the volume of transactions also lead to a rising demand for money. Unless this increased demand for money is met, there will be a deflationary drag in the economy.

We have noted that the currency board arrangements together with trading firms and commercial banks ensure that there will be sufficient elasticity but only in so far as the foreign trade sector is concerned. The problem, however, arises when the expansion is in the domestic sector as, for example, an increase in the production for local consumption. The local entrepreneur does not have access to commercial banks' funds either because he does not meet the banks' lending conditions or because he does not have the conventional securities that are acceptable to the banks. Commercial firms are equally uninterested as the activity is not connected with export/import trade nor will it lead to their earning foreign exchange. The result is that the expansion cannot be financed. Given the desire for rapid economic development it is essential to diffuse credit to all sectors of the economy if the desired development is to be achieved.

A scarcity can arise in another way. We begin with an equilibrium situation in the government budget. We next assume that there is a shortfall of revenue over expenditure. This difficulty can be dealt with by deficit financing. But it should be recalled that the colonial monetary arrangement did not permit such financing. As-

suming also that the government does not have large cash balances which can be run down, then only the commercial banks can provide the necessary accommodating finance.¹⁷

In the absence of the necessary accommodating finance, economic activities would have to be reduced as the government attempts to balance revenue and expenditure. Such a reduction in economic activity may however influence the commercial banks to reduce their volume of loans and advances with further contraction in the level of economic activity. Even if commercial banks are willing to provide the necessary accommodating finance, the point which must be borne in mind is that development in these circumstances will depend on the goodwill of foreign institutions whose policies are dictated from their head offices overseas.

Next, in 1957 when Ghana decided to withdraw from the colonial monetary arrangements, the then Ghanaian Minister of Finance described the system as the "financial hallmark of colonialism". The withdrawal of Nigeria too coincided with the attainment of independence. Hence, on political grounds, Sierra Leone could not have retained the system for very long. It should be noted that Ghana and Nigeria accounted for 70 per cent of the WACB currency in circulation in West Africa. Their withdrawal meant a consider-

¹⁷ There is no reason for optimism that the commercial banks will be ready to provide finance for activities other than those connected with the export/import trade. Newlyn and Rowan observed as follows: "Expatriate banking in Nigeria began in 1894. Fifty-five years later, in 1949, bank advances were, on average, some 5 per cent of the money supply. This is hardly a record which encourages a belief in the secular elasticity of expatriate deposit banking". Newlyn and Rowan, *op. cit.*, p. 196. We show in Chapter IV that there was a considerable expansion in loans and advances in Sierra Leone during the 1960's, so that it can be argued that these banks are no longer "conservative" in their lending policies. This is not the case, however, for we point out in that chapter that the reason for the expansion was due to the change in the method of financing the export/import trade. The banks' loans and advances have gone mainly to the large expatriate firms with only a small fraction of the total available to Sierra Leonean enterprises. In relation to Sierra Leonean enterprises, therefore, the above quoted statement is still relevant.

able reduction in the activities of the Board. Thus, the WACB's continued existence was doubtful after 1961 when Sierra Leone became an independent state.

Finally, several authors have argued that by ensuring automatic adjustments the colonial monetary arrangements avoided balance-of-payments problems.¹⁸ However, economic development in Sierra Leone involves importation on a large scale of capital equipment and technical services which are required for development and which are not available locally. Also, improvements in the standard of living and the demonstration effect imply increased importation of a wide range of consumer goods. There are therefore not likely to be any balance-of-payments difficulties as long as economic activities are kept very low. But when action is taken to improve the productive capacity of the economy, balance-of-payments difficulties tend to emerge.

4. DIRECTION OF MONETARY AND FINANCIAL REFORM

As we have concluded that the colonial monetary system, with its limited objectives, could not have survived very long after Sierra Leone achieved her political independence, it is necessary to give some indication of the desired direction of monetary and financial reform.

¹⁸ Hazelwood argues as follows: "The special feature introduced by the colonial monetary system is that a colony cannot have a balance of payments problem as that term is now commonly understood This is ensured in two ways. First, by prohibiting deficit finance, the colonial monetary arrangements prevent the maintenance of local incomes and expenditure on imports when external earnings have fallen. Secondly, the '100 per cent reserve system' looks after dissaving (including the withdrawal of liquid capital by expatriate enterprises) when internal incomes fall . . . The '100 per cent reserve currency' prevents balance of payments difficulties because there is always sterling available to meet expenditure from hoards". A. Hazelwood, "The Economics of Colonial Monetary Arrangements", *Social and Economic Studies*, Vol. 3, No. 4, December 1954, p. 298.

Since the main criticisms of the currency arrangements were the automatic link which the system was supposed to create between the money supply and the balance of payments, those who have advocated reform of the system have hoped that one of the consequences of the reform would be to create an institution that would be capable of taking discretionary action with the objective of stabilizing domestic money incomes, output and employment.¹⁹ Given a foreign trade sector representing about 30 per cent of GNP, output and incomes were to a large extent dependent on external factors. At the same time, a large part of investment expenditure was accounted for by the government sector whose decisions were not necessarily influenced by purely economic considerations. But even in the case of private investment, domestic interest rates were not particularly important in influencing investment decisions as most of these were financed by capital inflows. Further, the high import leakages substantially reduced the margin of discretion which the authorities had in setting the level of internal demand. So that it was the structural features of the economy and not the currency board regulations that limited the scope for completely independent action by the monetary authorities.

But the fundamental problem facing the country is the vicious circle of under-employment, low incomes and low savings. The basic requirement in this underdeveloped setting is the develop-

Greaves remarks: "... if a colony is unable to meet its external obligations it is because of lack of money — of income in internal currency — not because of the lack of foreign exchange". Greaves, *op. cit.*, p. 88.

¹⁹ Thus the Ceylonese Monetary Law charged the central bank of that country with the following: "... by regulating the supply, availability cost and character of credit so as to secure as far as possible, the following objectives: (a) the stabilization of domestic monetary values, (b) the preservation of the par value of the Ceylon rupee, (c) the promotion and maintenance of a high level of production, employment, and real income in Ceylon, and (d) the encouragement and promotion of the full development of productive resources of Ceylon". R. S. Sayers (ed.), *Banking in the British Commonwealth*, Oxford, University Press, 1952, p. 418.

ment of the money and financial system to make possible the mobilization and efficient utilization of domestic financial resources in order to increase the relative importance of domestically financed investment. Such a development, by reducing the relative importance of external pressure, also increases the ability of the monetary authority to influence domestic incomes and employment. Hence, monetary and financial reform must give prominence to the developmental aspects of policy.

However, when the development of the monetary and financial institutions is placed within the context of rapid economic development in the country, the exchange rate of the currency becomes an inescapable issue. This is because with a fixed exchange rate a conflict develops between the objective of accelerating internal investment and maintaining an external balance. In theory, this balance-of-payments "trap" arises as follows. We begin with a situation in which exports and imports are equal and with a given level of income. It is now decided to increase investment substantially. Such an investment programme presupposes increases in imports as most of the capital goods required for development are not available locally. Also, the rise in the level of investment raises the initial level of income, some of which may be spent on imported consumer goods. And even if we assume that the investment may lead to an expansion in exports, this is possible only after a time-lag. Hence, the outcome is a deficit in the balance of trade with the extent of the gap depending on the proportion of direct expenditure, on imports, on the propensity to import, and on the supply elasticity of the export sector. If we rule out large-scale capital inflows then there is an inevitable conflict between rapid development and equilibrium in the balance of payments.

There are two possible approaches in dealing with this balance-of-payments constraint. The first approach involves the adoption of a flexible exchange-rate policy. Such a policy allows automatic adjustments in relative prices. In the second approach in which

a fixed exchange rate is maintained, the external balance is restored by the adoption of certain deflationary policies, while the imbalance has to be financed by means of the country's international reserves.

The main advantage of a fixed exchange rate policy is that it ensures stability. A fixed exchange rate also implies that certain specific guidelines are to be followed by the monetary authority, with the responsibility of the system's management vested in the monetary authority rather than with the politicians.

The floating alternative, it has been argued, eliminates the likely conflict between rapid development and external balances as it ensures the preservation of external equilibrium. With the absence of external disequilibrium, the authorities are in a position to pursue autonomous domestic policies which are consistent with development objectives. However, the success of such a policy presupposes that "all other things remain equal". In practice there may be a number of constraints. These obstacles include the price elasticities of imports and exports, existing international agreements on the marketing of produce, existing trading links and the relative size of the country. It should be noted that currencies of small countries such as Sierra Leone derive their usefulness from their convertibility at a fixed rate of exchange to a major currency, sterling in this case. Consequently, assuming it is decided to adopt a flexible exchange rate policy, the question which arises is, should the Leone be free to fluctuate against all currencies or ought it to be pegged to a major currency such as sterling or other currency groupings while floating with respect to other currencies?²⁰ Indeed,

²⁰ On this issue Mundell's suggestions concerning optimum currency areas become interesting. His proposal is to establish currency areas comprising several countries, as between such different areas exchange rates could be freely variable; within each area, exchange rates should be fixed and payment adjustments would be assured because of his assumption of closer economic integration and co-operation. Robert A. Mundell, *International Economics*, New York, The Macmillan Company Ltd., 1968, Chap. 12. See also R. I. McKinnon, "Optimum Currency Areas", *American Economic Review*, Vol. 53, pp. 717-724.

the increased foreign exchange costs of servicing external borrowings with a depreciated currency will be an additional burden on development expenditure. Also, one of the advantages of floating is that the consequent depreciation of currency value stimulates the export of commodities which were previously uncompetitive. But most of Sierra Leone's exports are mineral and primary produce and the country, during the period of our study, did not experience difficulties in selling its products at prevailing prices. In addition, the manufacturing sector is small. Hence, the stimulus to export which results from floating the currency is of little practical significance.

At the same time, the higher import prices need not lead to any substantial import substitution because of the absence of entrepreneurs, the nature of the commodities being exported, and the small size of the Sierra Leone market (see Chapter II). As exports need not show any significant expansion while imports cost more, the value of the currency is likely to depreciate further to restore an external balance. This continuous depreciation of the currency value and the resulting impact on domestic prices may force the government to intervene in the foreign exchange market. Hence, the existence of constraints calls for a relatively stable exchange rate policy.

The year 1971, however, marked the end of the system of fixed exchange rates established under the International Monetary Fund. Since then, virtually all currencies, and the pound sterling in particular, have been allowed to float.

It is quite unlikely that the pound sterling will reassume its former role. This is because the British economy has undergone a fundamental transformation since 1914 when it dominated the world scene. Furthermore, her economy has performed badly in recent years. Although a number of indicators now show that there should be a considerable improvement in the performance of the

British economy in future years, given its unpredictable nature, one cannot be too certain about the outcome and especially the duration of an improvement in economic performance.

Since we have argued that a relatively stable exchange rate for the Leone is likely to be more advantageous, the other options opened to the country can now be re-examined.

5. CONCLUSIONS

In this chapter we have argued that the colonial monetary system was quite adequate for the limited economic objective of that period. With the attainment of political independence, the basic problem is how to increase substantially the relative importance of domestic investment as well as ensure their efficient utilization.

It goes without saying that an efficient monetary and financial system by itself cannot ensure development. Nevertheless such a system is an indispensable instrument of economic development. As Hazelwood puts it:

"... inadequate or inappropriate monetary arrangements may make it difficult for a country to take full advantage of its economic potentialities. Endowing it with 'advance' monetary institutions will not transform a 'backward' country into an 'advance' one, but changes in its monetary system may oil the wheels of economic progress".²¹

The next four chapters, which discuss the present monetary and financial system, have as their primary objective to establish the extent to which this system has contributed to the availability of domestic financial resources for development.

²¹ Hazelwood, *op. cit.*, p. 291.