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Why Did Fiscal Stimulus Work in Sierra Leone during the Crisis?

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In 2008 the global financial crisis swept the developed world. Despite hopes to the contrary, the impact quickly spread to developing countries, through the adverse effects of financial markets, export demand, capital flows and remittances. With a few exceptions the international financial institutions advised governments of low income countries against expansionary fiscal measures to counter the impact of the global crisis (Weeks, Forthcoming 2011).

Generally, both the World Bank and IMF are sceptical about the usefulness of active fiscal policy. While they might concede that such policy could be effective in developed countries, they generally regard it as irrelevant for low income countries.

It is certainly true that monetary policy is largely irrelevant for most low income countries, especially in Africa, where almost 20 governments are bound by common currency agreements or restrictive exchange-rate arrangements (see Weeks 2010). However, countercyclical fiscal policy can indeed be effective in low income countries if properly designed (see Weeks 2009a, 2009b).

During 2008-2010, such a policy was implemented in several countries. Perhaps one of the least likely candidates for implementing an effective fiscal intervention was Sierra Leone, one of the poorest countries in the world, recently emerged from civil war, heavily aid dependent, and constrained by limited administrative capacity. But implement a fiscal stimulus the government did, and with notable success.

In early 2009 Government experts projected that the decline in Sierra Leone's export revenue would be 15-20% for the calendar year. Rather than maintain the policy *status quo* and simply hope for the best, the Ministry of Finance and Economic Development (MFED), with support from the local office of the United Nations Development Programme, designed a macro response that was put into effect by the third quarter of 2009.

Sierra Leone's Policy Package

The policy package was designed to be countercyclical and short run in nature since it was specified to last only 18 months (extending into the first quarter of 2011). The package consisted of three elements: 1) a fiscal stimulus, 2) a real depreciation of the country's currency, the *Leone*, and 3) an accommodating monetary policy.

By coincidence the Caucus of African Governors of the IMF, World Bank and African Development Bank met in Freetown when the Sierra Leone countercyclical policy was initiated. On the first day of the meeting, the Caucus unanimously endorsed, in its "Freetown Declaration", countercyclical intervention as the appropriate response in Africa to the global recession (see Weeks 2009a).

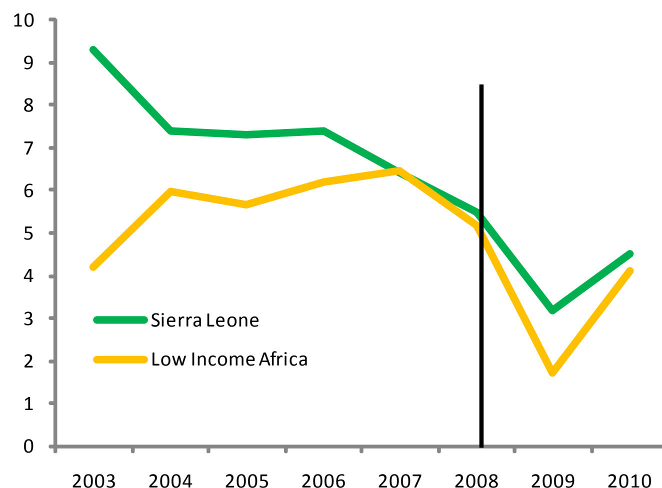
Essential to the design of the Sierra Leone package was the stipulation that the stimulus would be kept consistent with a trade balance and inflation rate that would not destabilise the economy. The Government's ensuing depreciation of the exchange rate was designed to prevent a widening of the trade deficit, by stimulating exports and reducing imports. However, this depreciation could have breached the inflation constraint by raising the price of imports (by the so-called "pass-through" effect).

Thus, it was necessary to carefully balance the exchange rate adjustment and the fiscal expansion in order to both achieve the desired stimulus and maintain macro stability. Technical modelling suggested that this balance could be attained with a fiscal expansion of just less than two percentage points of GDP and a nominal depreciation of slightly less than 20%. In theory this combination would produce a real adjustment of 15%. The central bank's conversion of external assistance into domestic currency provided for *de facto* monetary accommodation of the fiscal and exchange rate measures.

The Success of the Stimulus

The most recent statistics suggest that MFED was strikingly successful in counteracting the adverse effects of the global recession through such a set of macroeconomic interventions.

GDP Growth Rates, Sierra Leone and Low Income Africa, 2003-2010



Source: MFED data, World Development Indicators and IMF

The Figure shows that Sierra Leone's growth displayed a characteristic post-war spurt in 2001-2002 and then converged towards the average for all low income African countries during 2003-2008. However, by the second half of 2009, when MFED initiated its stimulus, Sierra Leone was growing at over 3%, more than 1.5 percentage points higher than the

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average for all African low income countries, and the country continued to perform better than average in 2010.

The Table supports the view that Sierra Leone's superior growth performance resulted, in significant measure, from the Government's policies. On the basis of the annual data, public expenditure increased from 21% of GDP in 2008 to 22% in 2009, and then to over 23% in 2010 (though the last is a preliminary figure). The stimulus effect is shown in the increase in the fiscal deficit, excluding external grants, in both 2009 and 2010.

Fiscal and Trade Deficits (% of GDP), Sierra Leone 2008-2010

Year	Public Expenditure	Domestic Revenue	Fiscal Deficit	Exports	Imports	Trade Balance
2008	21.0	11.3	9.7	12.7	27.8	-15.0
2009	22.0	11.6	10.4	12.1	27.3	-15.2
2010	23.3	12.4	10.9	15.5	27.5	-12.0

Sources: Data for 2008-2009 from MFED (2010) and 2011 Budget Speech of the Minister of Finance. The fiscal deficit does not include external grants.

At the same time, there was a real depreciation of about 15% in the *Leone* with respect to the US dollar from the third quarter of 2009 through the first quarter of 2010, along with a slightly lower depreciation vis-à-vis the Euro (Weeks Forthcoming 2011). This depreciation was associated with a fall in the trade deficit from 2009 to 2010, an outcome that proved better than anticipated.

Despite the success of Sierra Leone's fiscal stimulus, it is important to highlight the continued fragility of its growth over the medium term. The war-created idle capacity that allowed rapid economic expansion during the early 2000s is exhausted. The economy remains heavily dependent on external grants (which are politically unreliable) to cover its trade deficit. Poor transport, power and communications infrastructure leaves private investment severely depressed.

General Lessons

Nonetheless, there are some important lessons that could be drawn from the Sierra Leone experience, modest though it is. In the 1960s and 1970s governments of developing countries implemented countercyclical policies with little success. Their failures resulted, to a great extent, from a lack of attention to exchange rate competitiveness.

As a result, their fiscal expansions quickly generated unsustainable trade deficits. The drain on their holdings of foreign exchange reserves frequently forced them into a fiscal reversal or inflation-generating exchange controls. This 'go-stop' pattern of macro interventions repeated itself throughout Latin America, for example.

In contrast, the Government of Sierra Leone implemented what might be called a New Macro Intervention (NMI): fiscal expansion based on a competitive exchange rate. Part of the novelty of this policy package is its return to a pragmatic application of active macroeconomic interventions.

The success of the NMI will depend, of course, on the specific institutional and economic characteristics of each country. For example, in countries with exchange-rate inelastic exports (e.g., petroleum), currency adjustment would affect only imports in the short run. For countries in common currency arrangements, the NMI could not be implemented due to the impossibility of adjusting the exchange rate.

However, for most developing countries the New Macro Intervention remains a feasible option. Hopefully, the Sierra Leone example will help motivate other governments in Africa to return to a development strategy that includes a countercyclical macroeconomic policy and abandons the counter-productive fiscal stance of rigidly maintaining balanced budgets geared to low inflation targets.

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For more background material, see the John Weeks website: http://jweeks.org

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