EBS/85/77

CONFIDENTIAL

March 28, 1985

To: Members of the Executive Board

From: The Acting Secretary

Subject: Sierra Leone - Exchange Arrangements and Real Effective Exchange Rate - Information Notice

The attached paper on a recent change in the exchange arrangements of Sierra Leone and an information notice on the real effective exchange rate of the Sierra Leonean leone is circulated for the information of Executive Directors.

If Executive Directors have technical or factual questions relating to this paper, they should contact Mr. Quirk, ext. 8520.

Att: (1)

INTERNATIONAL MONETARY FUND

Sierra Leone--Exchange Arrangements and Real Effective Exchange Rate Information Notice

Prepared by the African Department and the Exchange and Trade Relations Department

(In consultation with the Legal Department)

Approved by A.D. Ouattara and Eduard Brau

March 27, 1985

In the attached communication dated February 21, 1985, the Governor of the Central bank of Sierra Leone has notified the Fund of a change in Sierra Leone's exchange arrangements. With effect on that date, the leone was devalued and its exchange rate peg was changed to the SDR from the U.S. dollar.

I. Background

Sierra Leone's exchange arrangements have been modified on a number of occasions in recent years. The leone was pegged to the SDR at the rate of SDR 1 = Le 1.37 until December 17, 1982 when a dual exchange rate regime was introduced. 1/ On July 1, 1983 the exchange system was unified when the leone was devalued by 50 percent in foreign currency terms and pegged to the U.S. dollar at the rate of US$1 = Le 2.50. 2/ In early 1984 a dual exchange system was introduced by the authorities: this system consisted of importers negotiating directly for foreign exchange proceeds of gold and diamond exports, and an official market for all other transactions in which the exchange rate remained fixed at US$1 = Le 2.50. All imports and exports continued to be valued for customs purposes at the official exchange rate. This system continued to operate until September 1984.

1/ The following were sources and uses of foreign exchange in the official market: 1. sources: official loans (aid), official grants, Fund purchases, Sierra Leone Produce Marketing Board (50 percent retained), DIMINCO (33 percent retained), iron ore (33 percent retained), and bauxite (33 percent retained); 2. uses: imports associated with official loans and grants, Fund repurchases and charges, principal and interest payments, pipeline reductions, crude oil, flour and wheat, and prescribed textbooks and educational materials.

2/ Sierra Leone's unification of the dual rate system was described in EBS/83/149 (7/20/83) and SM/84/222 (10/10/84).

Since September 1984, limited allocations of foreign exchange for private sector payments (amounting to some US$10 million) had been made under an arrangement whereby a newly formed company, the Precious Minerals Marketing Company (PMMC), accepted applications for foreign exchange at buying and selling rates differing from the official rate. The effective supply price for foreign exchange to the company was close to the parallel market rate which, in January 1985, was about Le 9 per U.S. dollar, whereas the company sold foreign exchange at exchange rates of Le 5.0 to Le 6.0 = US$1--with the PMMC recompensed by the Government for the differences between the buying and selling rates. Other channels for the use of the foreign exchange proceeds of the Sierra Leonean economy were the required surrender of foreign exchange to the Central Bank for official uses (including payments for imports of oil and debt servicing), a very small amount of surrender to commercial banks, retention allowances for own use by certain exporters, and an extensive parallel market. The exchange rate in the parallel market has been depreciating; in October 1984 the prevailing rate was Le 6 = US$1, while in January 1985 it was in the range Le 8 to Le 10 = US$1.

The arrangements in effect for the allocation of foreign exchange through the PMMC gave rise to buying and selling rates that differed from the official exchange rate, and thereby a multiple currency practice subject to Fund approval. In addition, Sierra Leone's exchange system involved restrictions on payments and transfers for current international transactions resulting from the system of foreign exchange budgeting, limits on payments for invisibles, and external payments arrears, and a multiple currency practice arising from the nonpayment of interest on deposits of the leone counterpart of commercial arrears--all subject to Fund approval, which was not granted at the conclusion of the 1984 Article IV Consultation with Sierra Leone in November, 1984.

II. Real Effective Exchange Rate--Information Notice

The recent evolution of Sierra Leone's real effective exchange rate, as measured by the standard index developed in connection with the information notice system, is set out in the attached table and chart. Based on this index, as of January 1985 the Sierra Leonean leone had appreciated in real effective terms by more than 10 percent since the last occasion on which the Executive Board had had an opportunity to discuss Sierra Leone's exchange rate policy--the Article IV consultation in November 1984. The appreciation was estimated to have amounted to 14.1 percent. Over the same period, inflation has been running at an annual rate of 55 percent, while the peg to the U.S. dollar has also resulted in an effective appreciation.

III. Modification to Exchange Arrangements

On February 21, 1985 the official exchange rate for the leone was devalued to Le 6 = US$1 from Le 2.5 = US$1, representing a 58.3 percent depreciation with respect to the U.S. dollar, the intervention currency. From that date, the leone has been pegged to the SDR, with the Bank of Sierra Leone issuing daily equivalent exchange rates for the leone in terms of all major currencies. According to available information, the exchange rate in the parallel market has depreciated further since this action.

Other actions taken in February included an official statement that all existing regulations for provision of documentation of foreign exchange earnings (CD2 forms) and for surrender of foreign exchange must be strictly complied with. With respect to the latter, it was announced that the foreign exchange retention allowances described above are to be reviewed by a Ministerial Committee created for this purpose. The authorities have also announced that the import licensing system will be liberalized. In the meantime, all payments for imports were required to be effected through letters of credit established with local banks. The staff understands that the foreign exchange allocation committee operating through the PMMC has been disbanded, but that no replacement allocation mechanism has yet been announced.

IV. Staff Appraisal

Sierra Leone's exchange system has been experiencing serious dislocation evidenced by large external payments arrears, including arrears to the Fund, and a low level of foreign exchange availability in the official market for ongoing payments. The scarcity of foreign exchange is, in the staff's view, in large measure a direct consequence of an inability to enforce surrender obligations and the continuing wide spreads between official and parallel exchange rates that, even after the recent devaluation, are providing a strong incentive for evasion of the official exchange system, and a corresponding shrinkage of the taxable and dutiable base. In the absence of sufficient official reserves to maintain such a pegged exchange rate without incurrence of further arrears, the staff believes that a flexibly determined exchange rate established by a unified exchange market within the domestic banking system, as accepted by the authorities in principle, would be beneficial. It is essential that such a flexible exchange arrangement be supported by appropriate demand management policies. With the exception of fuel prices, the staff has observed that the public already buys most basic imports at the equivalent of the parallel exchange rate. Adoption of more flexible exchange rate arrangements would therefore represent an end to the implicit subsidization of importers and taxation of productive and exporting industries; it would also lead to reduced pressure for capital flight. As noted in SM/84/222, in view of Sierra Leone's difficult medium-term economic outlook, and the need for urgent comprehensive policy actions, the staff believes that the establishment of an appropriate exchange rate system is a pressing priority. Formal liberalization of the foreign exchange allocation and import licensing arrangements that have been largely ineffective owing to the issuance of unnumbered licenses, illegal imports and exports, and the low level of exchange availability, would also contribute to greater confidence and to the repatriation of foreign exchange proceeds. The staff does not propose that the Executive Board take any action at this time.

FROM: BANK OF SIERRA LEONE 21/2/85

TO: THE MANAGING DIRECTOR IMF WASHINGTON DC

REPEAT THE DIRECTOR AFRICAN DEPARTMENT

COPY IMF REPRESENTATIVE

WITH EFFECT FROM CLOSE OF BUSINESS TODAY 21ST FEBRUARY 1985 THE SIERRA LEONE AUTHORITIES HAVE ANNOUNCED AN EXCHANGE RATE ADJUSTMENT.

THE FULL TEXT OF THE GOVERNMENT RELEASE IS AS FOLLOWS:

FOR SOME TIME NOW, THE ECONOMY HAS SUFFERED FROM LACK OF FOREIGN EXCHANGE DUE PRINCIPALLY TO NON-COMPLIANCE WITH SURRENDER OBLIGATIONS COMBINED WITH EXISTING RETENTION FACILITIES. THE SITUATION HAS NOW BEEN MADE EVEN MORE DIFFICULT BY HAVING AN EXCHANGE RATE WHICH IS NO LONGER RESPONSIVE TO THE NEEDS OF THE ECONOMY.

2. MORE RECENTLY, THE GOVERNMENT INITIATED DISCUSSIONS WITH THE IMF WITH A VIEW TO REACHING UNDERSTANDING ON A NEW STAND-BY ARRANGEMENT. THESE DISCUSSIONS HAVE NOT YET BEEN CONCLUDED IN PART BECAUSE THE GOVERNMENT IS NOT IN A POSITION AT THIS STAGE TO ACCEPT ALL THE IMF'S CONDITIONS INCLUDING AN IMMEDIATE INCREASE IN BOTH THE PRICES OF PETROLEUM PRODUCTS AND RICE.

3. IN THE MEANTIME, AND WITHOUT PREJUDICE TO THE FINAL OUTCOME OF THESE DISCUSSIONS, THE GOVERNMENT HAS DECIDED AS AN ESSENTIAL FIRST STEP TO HAVE A MORE REALISTIC EXCHANGE RATE FOR THE LEONE AND THEREAFTER TO MAINTAIN A FLEXIBLE EXCHANGE RATE POLICY.

4. ACCORDINGLY, THE GOVERNMENT HAS DECIDED TO EFFECT AN EXCHANGE RATE ADJUSTMENT THE CONSEQUENCE OF WHICH IS THAT AS OF TODAY, THE EXCHANGE RATE FOR THE LEONE IN TERMS OF THE U.S. DOLLAR IS LE 6 TO US$1.

5. FURTHERMORE, AND ALSO WITH EFFECT FROM TODAY, FEBRUARY 21ST THE LEONE IS NOW DE-LINKED FROM THE U.S. DOLLAR AND PEGGED TO THE SPECIAL DRAWING RIGHT (SDR) OF THE INTERNATIONAL MONETARY FUND. THE BANK OF SIERRA LEONE WILL ISSUE ON A DAILY BASIS, THE EQUIVALENT OF THE LEONE FOR ALL MAJOR CURRENCIES.

6. THE GOVERNMENT IS ALSO AWARE THAT EXCHANGE RATE ACTION ON ITS OWN AND WITHOUT APPROPRIATE SUPPORTIVE MEASURES CAN, AT BEST, ACHIEVE ONLY LIMITED RESULTS. CONSEQUENTLY, THE GOVERNMENT WILL NOW PUT IN PLACE THE FOLLOWING:

FIRST, ALL FOREIGN EXCHANGE EARNERS, WITHOUT EXCEPTION, MUST COMPLY STRICTLY WITH SURRENDER REQUIREMENTS.

SECOND, ALL RETENTION FACILITIES ARE TO BE REVIEWED WITH IMMEDIATE EFFECT. TO THIS END, A MINISTERIAL COMMITTEE HAS BEEN APPOINTED TO REVIEW RETENTION FACILITIES AND ENSURE COMPLIANCE WITH SURRENDER REQUIREMENTS.

THIRD, THE IMPORT LICENSING SYSTEM WILL BE LIBERALIZED, ALTHOUGH ALL IMPORTS MUST BE EXECUTED THROUGH LETTERS OF CREDIT ESTABLISHED WITH LOCAL BANKS.

7. FINALLY, IN ORDER TO MINIMIZE THE RELATIVE COST BURDEN OF THE ADJUSTMENT PROGRAM, THE GOVERNMENT HAS DECIDED TO INSTITUTE A NEW INCOMES POLICY AIMED AT ADJUSTING SALARIES AND WAGES.

REGARDS

J.S.A. FUNNA

GOVERNOR, BANK OF SIERRA LEONE

Received in Cable Room: February 21, 1985

Table. Sierra Leone: Real Effective Exchange Rate and Related Series

(Indexes: 1980 = 100)

	Real Effective Exchange Rate 1/ 2/	Nominal Effective Exchange Rate 1/	Relative Consumer Prices (Local Currencies)	Exchange Rate in terms of U.S. dollars 1/	Consumer Price Index (Seasonally Adjusted)	Consumer Price Index (Not Seasonally Adjusted)
Quarterly						
1979						
I	101.8	103.8	98.1	99.0	82.4	80.4
II	104.6	102.9	101.7	97.9	87.8	89.2
III	103.8	100.9	102.8	100.2	92.7	94.4
IV	107.1	102.5	104.5	100.1	97.1	96.0
1980						
I	103.8	101.4	102.4	100.2	98.7	96.1
II	98.5	100.4	98.1	99.5	96.8	98.6
III	98.0	99.3	98.7	101.4	100.1	102.1
IV	99.7	98.9	100.9	98.9	104.6	103.1
1981						
I	104.8	100.1	104.6	95.6	111.1	108.2
II	114.8	103.7	110.7	90.8	121.9	124.5
III	122.7	107.9	113.7	87.1	127.7	130.4
IV	122.7	106.2	115.5	89.2	132.5	130.0
1982						
I	128.5	107.2	119.8	87.3	139.3	135.8
II	140.6	109.1	128.8	85.9	153.2	157.0
III	154.6	110.4	140.0	83.4	169.3	173.0
IV	171.9	112.5	152.8	82.6	184.7	180.5
1983						
I	206.4	115.8	178.2	83.8	222.4	217.1
II	227.6	116.0	196.2	82.8	245.1	251.7
III	134.0	61.1	219.3	42.0	273.5	279.3
IV	169.4	62.2	272.3	42.0	358.0	348.6
1984						
I	190.3	63.2	301.3	42.0	393.2	384.8
II	214.0	64.2	333.3	42.0	444.0	456.3
III	244.0	68.6	355.7	42.0	476.6	486.2
IV	272.4	71.8	379.1	42.0	513.8	499.7
Monthly						
1984						
Nov. 3/	266.6	70.6	377.6	42.0	513.8	...
Dec.	285.0	73.1	389.9	42.0	533.0	...
1985						
Jan.	304.2	75.6	402.5	42.0	552.8 4/	...
Percentage change						
Nov. 1984–Jan. 1985	14.1	7.0	6.6	--	7.6	...

Source: Information No ice System.

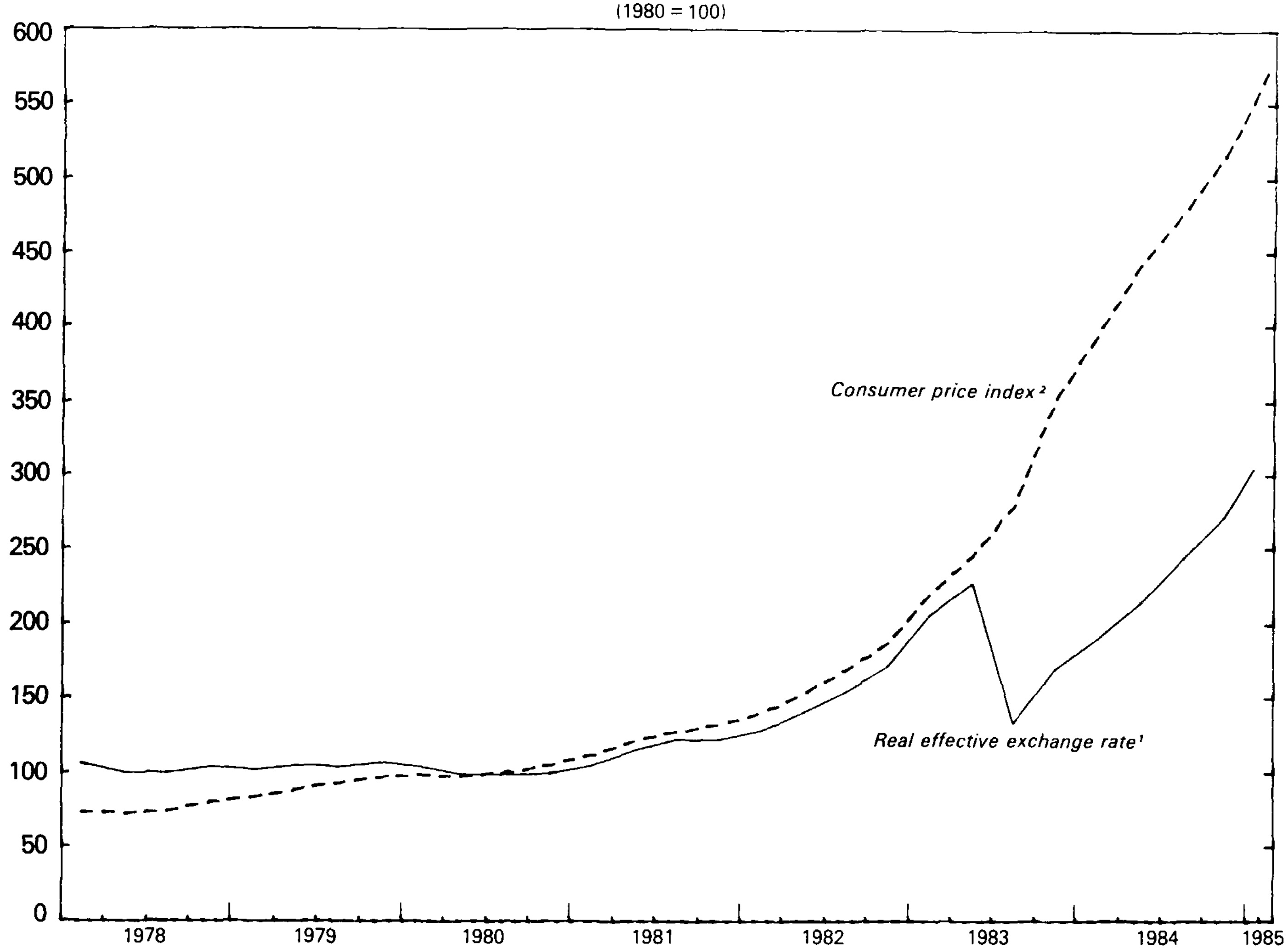
1/ Increase means appreciation.
2/ Using seasonally adjusted consumer price indexes.
3/ Date of latest consideration by Executive Board.
4/ Monthly data derived by interpolation of seasonally adjusted quarterly series; the first quarter data are staff estimates.

CHART

SIERRA LEONE

INFORMATION NOTICE SYSTEM INDEX OF REAL EFFECTIVE EXCHANGE RATE

(1980 = 100)



[1] Trade-weighted index of nominal exchange rates deflated by seasonally adjusted relative consumer prices; increases mean appreciation.

[2] Seasonally adjusted. The figure for the first quarter of 1985 is a staff estimate

ATTACHMENT III