SOMALIA

FRAMEWORK FOR PLANNING OF LONG-TERM RECONSTRUCTION AND RECOVERY

Guidelines for Macroeconomic Reconstruction

prepared by the

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Macroeconomic Reconstruction--
Some Policy and Institutional Guidelines

Introduction

No information from official sources on economic and financial developments in Somalia has been available to the IMF since late 1990, but it is clear that macroeconomic policy systems have collapsed. In view of this situation, the scope of this paper is limited to qualitative recommendations for the re-establishment of the key macroeconomic systems in Somalia--namely the fiscal, monetary, and exchange rate systems. The re-establishment of these systems is a pre-requisite for a new government's capacity to formulate and implement macroeconomic policies. The reconstruction of these macroeconomic systems will need to be substantially advanced along with the collection of basic macroeconomic data before a quantified macroeconomic framework can be eventually developed.

Other important elements for macroeconomic reconstruction are a functioning government, including a minimum level of physical infrastructure and an effective civil service--initially perhaps entailing some reliance on expatriates. Considerable technical assistance and external financial resources will be needed to put these initial conditions in place and ensure the effective functioning of the macroeconomic system. In view of these constraints, this paper seeks to deal only with a few central areas of macroeconomic policy and institutions that are critical even in the early phase of a new government.

Section I summarizes macroeconomic policies and developments prior to the collapse of the Government in early 1991, and then reviews developments over

1991-93 on the basis of the very limited information available. Section II provides recommendations for the early stages of the reconstruction for a reformed fiscal system, and Section III presents policy and institutional guidelines for reformed monetary and exchange systems. These macroeconomic elements assume a resolution to the present unsettled political and security conditions. The proposals should be considered a starting point given present conditions and are intended only to put in place the basic initial elements of fiscal, monetary, and exchange systems. Deepening and extension of the proposals could take place following specific technical assistance efforts, including from the IMF. It is expected that, once missions can again visit Somalia, a detailed evaluation will be made of the IMF's possible contribution to technical assistance for the reconstruction of the fiscal, financial, and exchange systems.

I. Background

1. Developments prior to 1991

A brief review of economic developments in the years prior to the fall of the last national Government in early 1991 will help highlight the kinds of macroeconomic problems that would need attention in the future.

Somalia's economic and financial positions were weak over these years. Over 1986-90, real economic growth declined steadily and moved into negative ranges. Inflation also rose strongly as the fiscal position weakened, credit policy particularly toward the nongovernment sector became undisciplined, and the free market exchange rate depreciated sharply. The economic contraction and rising inflation also reflected the drought of 1989-90. The external position was structurally weak, reflecting a heavy dependence on external grants and a large accumulation of external arrears.

The Government's budget position during 1986-90 was characterized by a steady structural weakening. While the ratio of revenues to GDP was about unchanged, there was a steady rise in the expenditure ratio. The budget deficit, including grants and on a commitments basis, averaged more than 25 percent of GDP. For the most part, the financing of these deficits entailed considerable reliance on foreign borrowing. Government expenditures were marked by a growing compression of real outlays for administrative purposes as well as economic and social services--with adverse effects on the quality of government services--and by the diversion toward defense and security. The budget's deterioration also reflected the poor economic and financial performance of the public enterprise sector; many enterprises relied on budget subsidies and/or withheld payments to the Government. Budget management moreover suffered from a lack of systematic accounting for a large share of capital expenditures executed under the public investment program, including projects financed by donors.

Before mid-1990 Somalia's formal banking system comprised essentially the Central Bank of Somalia (CBS) and one commercial bank, the Commercial and Savings Bank of Somalia (CSBS). The operations of the commercial bank were characterized by lack of financial discipline, mismanagement, and fraud. Substantial unauthorized credits were disbursed by CSBS branches in the late 1980s--mostly in the form of bank-endorsed circulating checks--that were not backed by equivalent deposits, and a large part of the bank's credit portfolio was non-performing. While the authorities had intended to reform the CSBS, no action was taken. The period witnessed a steady loss of confidence in the formal banking system, resulting in large-scale hoarding of cash and consequent shortages of currency notes. By 1990 the CSBS was insolvent and reliant on the Central Bank for cash advances to finance lending operations and meet the liquidity needs of depositors and circular-check holders. Under these circumstances, the banking activities of the CSBS were suspended except for loan recoveries, and a new government-owned bank, the Somali Commercial Bank, was established. However, by mid-1990 formal financial intermediation was virtually nonexistent, with most business operations relying on self-financing and/or on the informal financial market.

A lax credit policy toward the nongovernment sector led to an average annual growth of broad money of about 100 percent over 1986-90, and in this environment, inflation rose from 35 percent to over 200 percent in 1990. Interest rate policy was characterized by ceilings on both lending and deposit rates, and with strong inflation, real interest rates were highly negative. The negative real commercial bank deposit rate rose from about 10 percent in 1986 to 170 percent in 1990.

Over 1986-90, Somalia's external current account deficits (after grants) averaged about US$115 million (more than 10 percent of GDP). In large part, this reflected declining exports and rising external interest obligations. The overall deficits were financed largely through the accumulation of arrears; the end-1990 arrears stock was estimated at US$575 million--more than nine times exports. External debt at end-1990 was US$1.9 billion (360 percent of GDP).

In 1988 the Somali authorities adopted an exchange rate policy intended to increase external competitiveness by gradually correcting the overvaluation of malnutrition, and disease. With better security, there have been indications of a revival of agricultural production and commercial activity. Some limited food-for-work reconstruction programs have been initiated. In parts of the country, some schools have reopened. With the continued absence of a formal banking system, trade financing and foreign exchange transactions are being carried out in the commercial sector. The Somali shilling has appreciated sharply since end-1992, apparently reflecting local currency shortages and the foreign currency demand for shillings arising from foreign entities operating in Somalia.

II. Reconstruction of the macroeconomic system

The reconstruction of Somalia's macroeconomic systems should initially be directed at putting in place the basic elements of macroeconomic management in a market-oriented framework, and at rebuilding confidence by avoiding monetization of the deficit, establishing realistic exchange arrangements, and ensuring positive real interest rates. The principles that should govern the design of institutional structures should be simplicity, transparency, and efficiency. The pace of economic recovery, moreover, will depend critically on early attention to structural problems confronting the productive sectors. These will need to be addressed in order to revive activity in the agricultural and livestock sectors, promote small-scale enterprises, and attract foreign investment either as joint ventures or wholly foreign-owned enterprises.

1. Fiscal system

The guidelines proposed below are designed to put in place a basic fiscal system which avoids the major problems experienced previously in Somalia. Most of the proposals are intended for implementation during the first year of the official exchange rate and ultimately achieving unification with the free market exchange rate. This objective was hindered, however, by the high rate of inflation, and the official rate became substantially overvalued.

2. Developments over 1991-93

The Government's fall in January 1991 was followed by civil war and a serious deterioration in economic conditions. Agricultural output was adversely effected by the civil war as there were large displacements of the rural population in search of secure conditions. The civil war compounded the effects of the 1989-90 drought, and both contributed to the widespread food shortages and starvation which characterized 1991-92. The livestock sector, the source of most exports, was also severely affected by the drought, shortages of veterinary supplies and services which resulted in widespread disease, and banditry. Finally, there was massive domestic and external migration, comprising a significant part of the population. In the process, many educated and technically qualified nationals left the country. The government administration collapsed, resulting in the nearly complete break down of the systems for the delivery of public sector services. Much of Somalia's infrastructure and stock of housing and government buildings suffered substantial damage during the civil war, and there was widespread plundering of durable goods as well as materials and supplies owned by the central, regional, and local governments and by individual Somalis.

The security and economic situations have improved in most areas of the country since the deployment of United Nations multilateral forces in December 1992. This allowed multilateral, bilateral, and NGO food relief supplies to reach most areas during 1993, which brought down death rates due to starvation, reconstruction. As noted earlier, given the present institutional and information gaps, these guidelines are fairly broad in nature.

The Somali environment requires a fiscal system that will seek the following objectives:

(i) A consolidated budget that incorporates all government revenues and outlays as well as all financing from domestic and foreign sources. In principle, no government fiscal transactions should occur off-budget. In the initial phase of reconstruction, however, specific programs to address particular reconstruction, development, or social needs, such as in the education and health areas, may need to be implemented directly by donors off-budget as this approach may be more acceptable to donors. Foreign-funded emergency relief programs would also merit being outside the regular budget in order to underscore their temporary nature. As more normal conditions are established, however, clear guidelines will need to be put into effect for consolidating into the budget all externally-generated resources or financing apart from direct humanitarian assistance.

(ii) A budgetary process that is transparent and easy to administer.

(iii) A tax system that has low administrative costs and the potential for an expanding tax base and tax buoyancy.

(iv) Current expenditure allocations that make appropriate provisions for the government wage bill, the costs of economic and social services, as well as operation and maintenance expenses. In particular, the size of the civil service should be kept small in order that it can be adequately paid from budget resources.

(v) Domestic bank financing will not entail financing from the monetary agency (see below), and must be voluntary for domestic commercial banks.

a. <u>Revenue</u>

In the current situation, it is not practical to seek to levy new taxes, and this task should be left until later. During 1988-89, tax revenue accounted for about 85 percent of total revenue, with taxes on international trade accounting for over 35 percent of total revenue, and administrative and statistical taxes-- essentially fees and charges--for about 15 percent. The criterion of low cost and easy administration suggest that first efforts at generating budget revenues be directed at reinstituting these taxes. Duty levels should be reasonable in order to encourage the private sector's use of operating ports and airports and to avoid incentives for smuggling. Fees and charges for public services and utilities should be re-established, and set at levels that cover production costs. The public enterprises, moreover, should be required to make profit transfers to the budget.

Excise and sales taxes are not likely to be practical initially, given administrative difficulties and because the match, cigarette, textile, and soft drink factories from which most of these taxes were formerly collected are currently inoperative. Nevertheless, technical work should be initiated for re-imposing simple excise and sales tax systems as soon as feasible. Until an effective administration is established which is able to identify the base for income and property taxes and collect these taxes, the tax system should not broadly apply these levies. However, initially it may be possible to implement withholding taxes on salaries of civil servants and the income of public enterprises and larger private firms.

It is also important to ensure that the structural problems that existed in the pre-war period do not re-emerge to undermine new efforts at revenue mobilization. This will include:

(i) an adequate number of tax collection centers outside Mogadishu;

(ii) an updating of tax laws;

(iii) the establishment of an efficient tax and expenditure audit system; and

(iv) appropriate penalties for tax evasion.

b. Expenditure

Since a new government's revenue collections will initially be limited, expenditures must be tightly restrained to contain the budget deficit. In principle, current expenditures should be fully covered by domestic revenues. (In contrast, during 1989-90 revenue covered only about one-third of current expenditure.) To facilitate this goal, the costs of the civil service must be kept to the minimum necessary to provide basic public services. The civil service should be limited to a set of core ministries with only essential staff which are adequately compensated. The pre-war situation of an excessively large but underpaid civil service should be avoided. Additionally, an appropriate level of resources will need to be committed to operation and maintenance expenditures to ensure adequate servicing of public sector infrastructure. In the pre-war period, there were high levels of security-related outlays (20 percent) and foreign representation (10 percent) expenses. Fiscal policy will need to be firmly administered in order to avoid a re-emergence of this situation. An appropriate balance must also be struck for public sector outlays among the different regions of the country and vis-a-vis

Mogadishu, in order to avoid the type of centralization of expenditure that induced northern Somalia to declare independence. Therefore, the budget framework should make specific provisions for regional allocations which could take into account variables such as population size and state of development.

Foreign grants and other external resources may prove insufficient to meet the costs of reconstruction, re-establishment of social services, and other development needs, and the pace of these activities could move more quickly if budget revenues were available.

c. Financing

Government fiscal operations should not entail borrowing from the monetary agency (see below) as such a policy stance will enforce the discipline needed for sound fiscal operations. Moreover, under the proposed monetary system, there should be no requirement that domestic commercial banks provide financing to the budget. Eventually, borrowing from the domestic nonbank sector could be envisaged.

Given Somalia's large external debt and arrears, the new government should seek substantial debt relief and foreign assistance on a grant basis, and foreign borrowing to finance the budget and balance of payments should be avoided except on highly concessional terms. Financing will need to be mobilized to regularize Somalia's relations with international financial institutions.

III. Monetary and exchange systems

This section provides some preliminary suggestions for basic monetary and exchange systems to be established by a new government. These take into consideration the macroeconomic problems experienced prior to 1991 and the need for financial and exchange rate stability required for an environment conducive to a reactivation of the private sector and economic growth. The suggested initial arrangements could be enhanced as conditions permit.

1. Monetary system

Given past experience, the reconstruction of the financial system should aim at putting in place simple monetary arrangements that restrict the government's role in the money creation process while facilitating private sector activity. For these purposes, the financial system could comprise a monetary agency (currency board) and a number of privately owned commercial banks. 1/

a. The monetary agency

The monetary agency would have only the following limited functions 2/:

- issue and redeem domestic currency
- offer commercial banks and other authorized exchange dealers convertibility of the domestic currency on demand at a fixed exchange rate.
- act as banker to the Government.
- maintain financial relations with multilateral organizations on behalf of the Government.
- regulate and supervise commercial banking operations.

To ensure fiscal discipline, the agency would not finance budget deficits and would not hold government debt. Moreover, to prevent excesses in the provision of credit to the nongovernment sector, the agency would not discount

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1/ The financial system could eventually also include private insurance companies and other nonbank financial institutions as conditions permit.

2/ These could be supplemented over time as the agency gained experience and demonstrated its capacity to handle more complex responsibilities.

public or private sector commercial paper and would not operate a discount window for commercial banks. Under the envisaged currency and exchange system (see below), the financial resources of the agency would be essentially limited to the foreign reserve backing for the domestic currency, and it would not be in a position to provide sizable liquidity to commercial banks. 1/ Commercial banks therefore would need to maintain appropriate foreign correspondent banking arrangements to meet their liquidity requirements. To facilitate bank intermediation rather than the use of cash in domestic transaction, the local banks should organize a clearing function among themselves. A principal implication of the above monetary arrangements is that the monetary agency will possess no domestic assets or liabilities apart from some limited miscellaneous holdings and valuation accounts, and therefore if the agency is correctly managed, the scope for financial instability would be virtually eliminated.

The weak performance of the former Central Bank of Somalia (CBS) stemmed from the low quality of its administration, overstaffing, and a complex organizational structure. In particular, the quality of management and thus operations suffered from the absence of a board of directors with policy formulation and oversight responsibilities. The new agency should therefore be managed by a governor responsible to a board of directors. The qualifications for senior management and director positions should include an appropriate educational background, previous banking experience, and sound character in order that the staffing and management of the agency are consistent with an

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1/ In the event the agency's foreign exchange cover for the local currency exceeded 100 percent, it could employ some of its excess resources to provide lender-of-last-resort facilities to commercial banks.

efficient discharge of its obligations under its charter. The objectives of a simple organizational structure and efficient operations would be assisted by limiting the number of departments of the agency initially to four: a treasury department, an accounting and audit unit, a banking supervision unit, and a statistics unit.

b. Commercial banking

Somalia's former banking system was publicly owned, and government interference resulted in the gross mismanagement of the CSBS, difficulties in establishing an alternate public sector bank, and impediments to the licensing of new private banks. These problems suggest that new government-owned commercial banks should be avoided.

Given the monetary agency proposal, a consistent commercial banking arrangement would entail local or foreign banks that are privately owned and not subject to government or agency control apart from prudential oversight. These banks would require a sound capital base and access to foreign correspondent bank resources. As a prerequisite, a banking law would need to be put in place quickly.

Available information indicates that, even in the current unsettled situation, the Somali commercial sector is actively engaged in financial and money-changing operations. Therefore it is likely that, given an appropriate political and economic environment, private Somalis will seek to set up private commercial banks, either wholly owned by nationals or as joint ventures with foreign investors. Nevertheless, given the limited resources of Somalis, a new government may initially need to campaign actively for and facilitate the setting up of branches of foreign banks. The advantages offered by foreign participation would be lender-of-last-resort access and international confidence in the banking system.

As the monetary agency can not provide sizable emergency liquidity to commercial banks, they should be required individually to hold adequate reserves abroad or locally, or be able to draw on external lines of credit to meet their lending and deposit liquidity needs. These arrangements could subsequently be modified to encompass borrowing from a domestic interbank market, if the latter were to be developed. Finally, to ensure a sound banking system, the monetary agency will need to possess a capacity for effective oversight, utilizing basic prudential regulations and supervisory practices including on-site and off-site monitoring.

2. Currency and the exchange system

It is proposed that the financial system operate with a new local currency issued by the monetary agency which has full foreign currency reserve backing at the margin and is convertible at a fixed rate into a specified foreign currency. Ideally, 100 percent reserve coverage would be desirable. But it is feasible to operate with initial coverage below 100 percent without running a significant risk of speculative attack, and to require 100 percent coverage of any subsequently issued currency. Foreign financial resources would need to be indentified for the intial reserve backing. The reserve position of the agency, however, would benefit over time from seigniorage. A cautious approach to establishing the exchange rate for the new shilling will be required to avoid overvaluation while meeting the demand for money balances. The process of demonetizing the present Somali shilling would need to be initiated immediately after the new monetary and exchange arrangements are put in place.

The exchange and payments systems should be fully open to all current account and capital transactions.

These arrangements are intended to promote simple administration and transparency of the exchange system, confidence in the new currency, external openness, and monetary and price stability. In the latter regard, the full convertibility of the currency and the fully open nature of the economy would ensure that the domestic rate of inflation would not diverge significantly from inflation in the currency peg country. Since interest rates would also need to be fully free to move in tandem with rates in the currency peg country in order to avoid destabilizing capital flows, the monetary agency would not be able to pursue an independent monetary policy.