SIERRA LEONE ECONOMIC UPDATE

FINANCIAL INCLUSION FOR ECONOMIC GROWTH AND DEVELOPMENT

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Sierra Leone Economic Update

Financial Inclusion for Economic Growth and Development

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Abbreviations and Acronyms

AML: Anti-Money Laundering

ATM: Automated Teller Machine

BLS: Bank of Sierra Leone

CAD: Current Account Deficit

CB: Community Bank

CET: ECOWAS Common External Tariff

DSA: Debt Sustainability Analysis

ECOWAS: Economic Community of West African States

EDSA: Electricity Distribution and Supply Authority

EMDE: Emerging Markets and Developing Economies

FDI: Foreign Direct Investment

FSA: Financial Services Association

GDP: Gross National Product

GST: Goods and Services Tax

ICT: Information and Communications Technology

IFIs: International Financial Institutions

IMF: International Monetary Fund

MDAs: Ministries Departments and Agencies

MPR: Monetary Policy Rate

MTO: Medium Taxpayer Office

MTRS: Medium-term Revenue Strategy

M3: Broad Monetary Aggregate

NASSIT: National Social Security Insurance Trust

NBO: Net Operating Balance

NDA: Net Domestic Assets

NFA: Net Foreign Assets

NPLs: Nonperforming Loans

LTO: Large Taxpayers Office

POS: Point of Sale

PPG: Public and Publicly Guaranteed

PPP: Purchasing Power Parity

PV: Present Value

RFI: Rural Financial Institution

RM: Reserve Money

ROA: Return on Assets

ROE: Return on Equity

SSA: Sub-Saharan Africa

SSL: Statistics Sierra Leone

TSA: Treasury Single Account

TFP: Total Factor Productivity

US: United States

USD: US dollar

YoY: Year-on-Year

Foreword

The Sierra Leone Economic Update (SLEU) is an annual publication that reports on and analyzes recent economic developments, reviews regional and global contexts and analyzes the implications for the country, and presents the medium-term outlook and prospects for the economy. The 2019 Update features a selected topic relevant to promoting inclusive growth and poverty reduction, namely Financial Inclusion for Economic Growth and Development. The target audience for the SLEU includes policy makers, business leaders, development partners and analysts interested in Sierra Leone's economy.

Sierra Leone's macroeconomic situation remains challenging despite the bold and courageous policy measures taken by the new Government, which assumed office just over a year ago. Macroeconomic imbalances remain in both the fiscal and external accounts. Growth is still low (3.7 percent); inflation and exchange rate depreciation are high (16.8 and 7.3 percent, respectively); the fiscal and current deficits are high (6.6 and 13.8 percent, respectively) and increasing debt has resulted in the country being downgraded from moderate to high risk of debt distress. Unlocking the bottlenecks to robust and sustained real economic growth through economic diversification and addressing pre-existing macroeconomic weaknesses will be crucial for building a resilient economy that promotes inclusive growth and reduces poverty. The medium-term outlook is promising, with economic growth expected to reach 5.2 percent by 2021, anchored primarily by supply side factors, including favorable agricultural output, uptick in mining activities and strong performance of the services sector.

The special topic of the 2019 Update focuses on deepening the financial sector for inclusive economic growth and development. Usage of the financial system is low in Sierra Leone with only about 5 percent of adults using formal savings products and about 54 percent saving money within the past year. Access to finance for enterprises is a significant barrier to growth of the private sector with 40 percent of firms indicating lack of credit as their biggest constraint. Only 11 percent of Sierra Leoneans have mobile money accounts compared to 20.8 percent in Liberia, 38.9 in Ghana and 72.9 percent in Kenya. The government plays a significant role in the financial sector and could spur financial sector development by creating the financial infrastructure to provide financial services to underserved populations. Bolstering the role of Digital Financial Services in Sierra Leone is critical to ensuring affordable and accessible financial services through, for instance, mobile phones.

We are pleased to present a rich menu of policy options in this second edition of the SLEU. It is my hope that this 2019 Update will inform and stimulate policy debate and help set an agenda for prioritizing financial sector development in Sierra Leone.

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Executive summary

Sierra Leone's macroeconomic performance continued to improve but at a slower pace. Economic growth in 2018 was estimated at 3.7 percent. This was marginally lower than the 3.8 percent growth in 2017, with an output gap of around 3 percent. The slower growth in 2018 was in the context of a global slowdown reflecting slower growth in major advanced countries, a more-than-expected slowdown in Emerging Markets and Developing Economies (EMDE) and a steady regional expansion—ECOWAS was among the fastest-growing country groups in 2018. In Sierra Leone growth was spurred by a recovery in domestic investment and an improvement in net exports on the demand side, and faster expansion of agriculture on the supply side. However, private consumption, the largest demand-side driver in 2017, was a drag on growth in 2018. At the current pace, Sierra Leone's growth is neither fast enough nor broad-based enough to absorb the fast-growing working-age population, as necessary to increase per capita income and reduce poverty. Furthermore, growth is still very volatile, reflecting the economy's dependence on primary commodities. There have long been large fluctuations in agricultural and mineral production in the country. Macroeconomic imbalances are also of great concern despite recent improvements in the balance sheet of the central government.

The fiscal balances are improving, thanks to increased mobilization of domestic revenue. In 2018, the overall fiscal deficit was estimated at 6.6 percent of GDP, compared with 8.6 percent in 2017. The improved fiscal position was because revenues-to-GDP ratio increased by 17.2 percent while the expenditures-to-GDP ratio remained essentially the same as in 2017. For 2018, interest payments were estimated at 10.1 percent of total revenues, 7.9 percent of total spending, and 1.9 percent of GDP. The 2018 primary fiscal deficit was 4.7 percent of GDP, down from 6.5 percent in 2017, while the cyclically-adjusted primary deficit was estimated at 4.3 percent of potential GDP.

Public debt is threatening external sustainability, as Sierra Leone's debt indicators deteriorated. The ratio of government debt-to-GDP rose from 64.6 percent in 2017 to 66.3 percent. External debt accounted for the largest increase, growing by 24.8 percent—nearly twice the rate of domestic debt. In 2018, debt service reached 13.7 percent of revenues and 7.3 percent of exports. Sierra Leone is now one of the most indebted countries in Africa; in 2018 the debt-to-GDP ratio for Sub-Saharan Africa (SSA) averaged only 48.7 percent. Cross-country data suggest that to bring its debt-to-GDP ratio to the SSA average, Sierra Leone would need to narrow its primary fiscal deficit by 3 percentage points of GDP.

The fiscal stance is still expansionary but at a slower pace. The gap between the cyclically-adjusted primary fiscal deficit and its natural level has been widening since 2015, though at a slower pace. The fiscal stance was a deficit of 3.5 percent of GDP in 2017 but narrowed to 2.0 percent of GDP in 2018. The fiscal impulse—the rate of change to the fiscal stance—has been improving since 2016, which suggests that fiscal policy has become less expansionary. But given the magnitude of its debt burden, Sierra Leone needs to do more to bring down its debt ratios.

The external sector's performance remained weak with the widening of the current account deficit and depreciation of the exchange rate. The current account deficit (CAD) widened from 10.9 percent of GDP in 2017 to 14.0 percent, due mainly to debt service payments and payments for services, especially for transportation (air and sea), communication and insurance. A significant boost in agricultural and fisheries exports and a slight reduction in imports of food and manufactures resulted in a small trade surplus in 2018. The CAD was adequately financed by inflows into the capital and financial accounts, mainly from foreign direct investment (FDI) and portfolio flows. The Leone depreciated against the U.S. dollar at both the official and parallel market windows as demand increased for foreign currency to settle foreign payment obligations, especially for fuel imports. However, gross coverage of external reserves remained adequate at more than 3 months of imports.

Inflationary pressure persisted throughout 2018. Inflation was mainly driven by the depreciation of the exchange rate, food supply problems early in 2018, and the adverse impact of the liberalization of fuel prices in July 2018. Both food and nonfood inflation were above 16 percent, although the average inflation rate declined slightly from 18.2 percent in 2017 to 16.8 percent in 2018. The Bank of Sierra Leone (BSL) raised the monetary policy rate (MPR) by two percentage points in a bid to reduce inflation; and the rise in the MPR pushed up money market rates. Nevertheless, monetary aggregates expanded despite the increase in the MPR, underscoring the weakness in monetary policy transmission. Although bank lending increased gradually as business confidence improved, credit and foreign exchange liquidity risks remain a concern: nonperforming loans (NPLs) were above 10 percent and some banks still had difficulties in clearing U.S. transactions.

Economic growth is expected to accelerate over the medium term, spurred by structural reforms. By 2021 economic growth is expected to accelerate from 3.7 percent in 2018 to 5.2 percent, **reflecting** structural reforms to diversify the economy. Favorable agricultural output, an uptick in mining activities, and solid performance in services will be the main growth drivers. Aggregate demand is also expected to increase as private consumption recovers from its slump in 2018 and a resurgence of confidence in the economy continues to attract investment. With robust revenue mobilization and tighter expenditure control, the fiscal deficit, including grants, is expected to narrow further, from 6.6 percent of GDP in 2018 to 4.3 percent in 2019, before rising slightly to 5.2 percent by 2021. The BSL is expected to maintain tight monetary policy, complemented by fiscal consolidation, over the medium term that should bring inflation down. By 2021 the CAD is expected to narrow from 14.0 percent of GDP to 10.5 percent based on anticipated increases in mineral and agricultural exports. Over the medium term, increased export earnings would help to stabilize the exchange rate and keep reserves coverage above 3 months of imports.

Yet there are significant downside risks to the medium-term economic outlook. Among these are a deterioration in Sierra Leone's terms of trade; lower than anticipated FDI inflows; depreciation of the exchange rates and higher prices; fiscal slippages caused by adverse debt dynamics and large arrears; and problems in the financial sector. A terms-of-trade deterioration, particularly if international crude oil prices rise relative to prices for iron ore and other metals, could negatively impact growth, revenues, and foreign exchange earnings. Lower FDI inflows could reduce CAD financing, requiring a drawdown of reserves, which could add to pressures on the exchange rate. Underperformance of revenue in the face of spending pressures could result in fiscal slippages. Similarly, the spike in the country's debt in recent years has resulted in a downgrade from 'moderate' to 'high' risk of debt distress for both external and overall public debt. And large payment arrears across numerous sectors could jeopardize budget execution and result in further fiscal slippages. Finally, current financial sector problems, including high lending rates, sluggish growth in private sector credit, questionable asset quality, and liquidity constraints in some banks, could undermine financial sector stability and growth.

To address existing macroeconomic weaknesses and enhance economic growth, the authorities should maintain the fiscal consolidation path, improve debt policy and management and intensify efforts to clear the large stock of arrears. Given the surge in public debt and the current high risk of debt distress, the government's fiscal and debt management priorities should be to reduce the deficit and arrears, discourage non-concessional borrowing, and reprofile its debt to enhance debt sustainability. Maintaining a tight monetary policy stance is critical to price stability. New BSL policies should be directed to deepening financial markets and strengthening supervision and regulation of banks. The authorities should speed up the passage of amendments to the Banking and BSL Acts to intensify oversight of financial institutions and enhance BSL independence.

Unlocking the bottlenecks to robust and sustained economic growth through economic diversification also requires structural reforms. Whether Sierra Leone can promote sustained inclusive growth and reduce poverty depends on whether it can modify the structure of the economy to generate more and better-paid manufacturing and service jobs. That could be accomplished by facilitating creation by the private sector of formal manufacturing and services activities and increasing the productivity of the informal sector. Improving agriculture by enhancing the productivity of staple crops—rice and cassava – increasing production of coffee and cocoa and expanding access to markets offers a direct path to sustained growth and poverty reduction. It is also vital to broaden access to infrastructure (energy, transport, and ICT) and the factors of production (labor and capital) that are critical for improving productivity and reducing production cost. Current policies to enhance human capital through free quality education and health programs should be sustained by making delivery of public services more efficient.

While usage levels of the financial system are low in Sierra Leone, there appears to be an unmet demand for financial sector products. Based on survey data, less than one of adults indicated that they did not have a need for financial sector products. While usage of formal lending products is about 4 percent, 49 percent of adults borrowed money during the past year. Survey results show similar patterns in terms of savings, with about 5 percent of adults using formal savings products but 54 percent saving money within the past year.

Access to finance for enterprises is a significant barrier to growth of the private sector. Enterprise survey data indicates that about 40 percent of firms indicated that access to finance is their largest barrier to growth (with no other factor being chosen by more than 15 percent of firms). This is particularly true for small and medium sized firms. The majority of bank lending is focused on working capital, and only a small percentage of firms are able to borrow from financial institutions for investment.

The government plays a significant role in the financial sector and can help to greatly improve financial sector development. The government has influence on about 40 percent of financial sector assets through its ownership of two state-owned banks and the role that it plays in the National Social Security Insurance Trust ("NASSIT"). However, in the case of all of these institutions, the government is taking actions that lead to inefficient utilization of these assets. Reforms highlighted in this paper related to these institutions could contribute significantly to financial sector development.

The government plays a role in supporting enterprise sector development through filling market gaps and providing financial services to underserved populations utilizing other mechanisms. These include Development Finance Institutions, credit guarantee schemes, and other support programs for the enterprises sector. Government's also often support the development of the enterprise sector through other mechanisms. These include technical assistance to support enterprises gaining access to finance and other grant programs to support the development of the enterprise sector. These are often done by different Ministries in a country and also involve support from multiple IFIs and donors. It is important that these resources are targeted towards those segments of the enterprise sector that are likely to increase productivity and lead to job growth and that the different programs are coordinated and complementary. Considering the different stakeholders involved, ranging from different government Ministries, IFIs, and donors, that are involved with programs that support the enterprise sector, it is recommended that a centralized coordination body is created that would be responsible monitoring and evaluating the results of the different programs to ensure that the limited funds that are available achieve the greatest impact.

The government can also facilitate financial sector development through the supervisory and regulatory functions that it performs in the financial sector, and through the financial infrastructure that it provides to help improve the efficiency of the financial system. While there have been significant improvements in the supervisory and regulatory framework at the BSL, there is a need to transition to risk-based supervision. Improvement's in the BSL's governance framework are also necessary. In regard to financial infrastructure, improvements are needed to continue developing the payments system and credit infrastructure. The BSL has already prioritized reforms in these areas, and efforts are currently underway both of these areas.

Digital Financial Services (DFS) are critical to the country's economic development. Bolstering the role of DFS in Sierra Leone is critical to ensuring consumers have affordable and accessible financial services provided through low-cost and personal means such as mobile phones, which meet their diverse financial needs. Additionally, DFS is critical to helping improve the efficiency of payments, whether they be for business, agriculture, personal or from government, as they stand to help make payments quicker than clearing a check, more reliable since payments can clear instantly or overnight, and more convenient than carrying around large numbers of Leones.

Yet, while DFS plays an important role in the financial inclusion landscape in Sierra Leone, it lags behind its peers. At present, only 11 percent of Sierra Leoneans have mobile money accounts, behind Cote d'Ivoire (34.1), Ghana (38.9), Guinea (13.8), Liberia (20.8), and Kenya (72.9).[1] In Sierra Leone to date, DFS is largely limited to mobile money transfers, digital credit, and electronic payment systems, such as ACH or RTGS systems. In this context, cash is still the preferred method of payment with very few Sierra Leoneans having received digital payments. While these systems have helped advance access to, the accessibility of, and the efficiency of financial services, they have limited usage by consumers and/or only represent the tip of the iceberg of DFS' potential. DFS stands to help more Sierra Leoneans by increasing their usage by consumers in every day transactions from credit, savings, bill payment, P2P, and government payments, more broadly. Additionally, DFS is much more complex than electronic payment systems and mobile money systems that are present in the country at the moment. The budding fintech

[1] Findex, 2017.

space in Sierra Leone and the pending implementation of the national retail payment switch, highlight the array of services that will help increase access, affordability, and efficiency of financial services. Yet, there are an array of challenges which require attention if DFS is to truly reach its potential in Sierra Leone and serve key demographics like women and farmers.

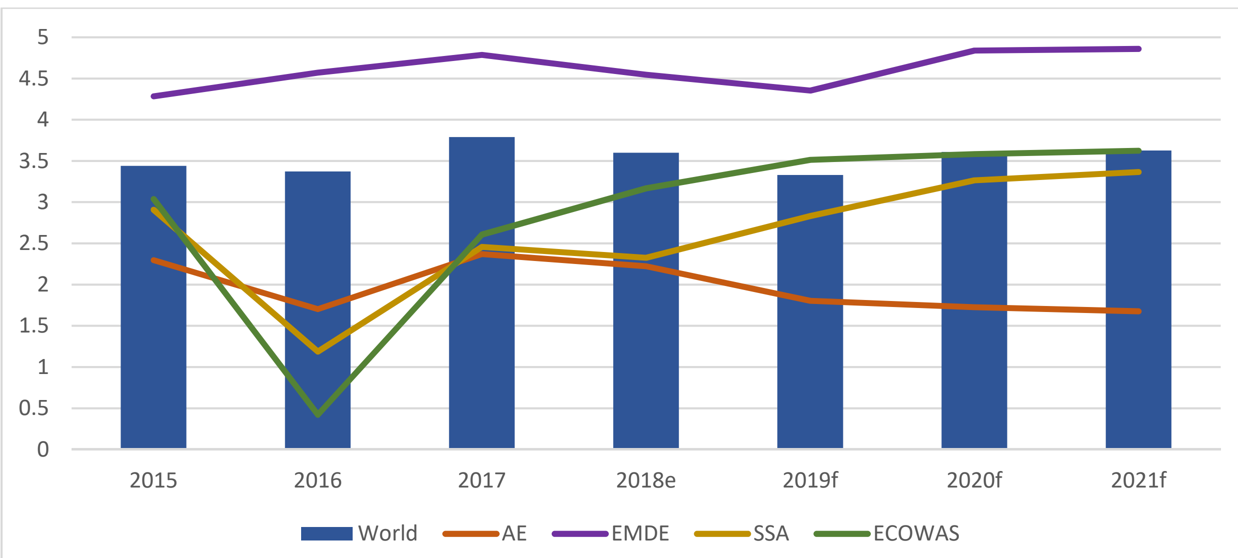
Therefore, it is critical that the Government, development partners, and the private sector, work to address such challenges through investments to bolster the foundational enablers of DFS and enhance access and usage of DFS. Regarding foundational enablers of DFS, there is a need to: 1) enhance the DFS regulatory and licensing regime. There is also a need to support infrastructural development through: 2) increased investments in underlying core infrastructure for a digital economy, 3) financial institutions' investment in payment systems infrastructure, and 4) investments in complementary infrastructure. To enhance access and usage, there is a need to support: 5) financial literacy to facilitate increased uptake, 6) expansion of the agent network to increase access points, 7) DFS products and services tailored to diverse needs and contexts, such as remote areas and agriculture, and 8) the digitization of government payments to enhance delivery and facilitate financial inclusion. Such investments are critical to ensuring a comprehensive approach to addressing the DFS ecosystem challenges. Furthermore, it is important that such efforts ensure groups such as rural residents and women are equal participants in DFS development. It is also important to emphasize that a participatory approach to the development of the ecosystem is necessary, as no one stakeholder has the resources, expertise, or incentives to help DFS reach its potential in Sierra Leone.

Part 1: Recent Developments, Prospects, and Policies

1.1. Global and Regional Growth Prospects

The global economic expansion is ebbing. Global growth slowed to 3.6 percent in 2018, down from 4 percent in 2017 (Figure 1). Among major deterrents to growth were US–China trade tensions, China rebalancing from investment-oriented to consumption-oriented growth, the slump in the German auto industry, continued monetary normalization in advanced countries, and macroeconomic vulnerabilities in Argentina and Turkey. Growth in the advanced economies slowed to 2.2 percent. With the highest growth rate of the advanced economies (2.9 percent), the United States economy is still supported by the 2017 Tax Cuts and Jobs Act and the continuing accommodative stance of Federal Reserve's monetary policy. In the Euro Area, real GDP growth slowed more than expected, to 1.8 percent as consumer and business confidence were eroded in Germany and France, reflecting slower investment growth and weaker external demand from Asia. At 0.8 percent, growth in Japan also moderated, mainly due to natural disasters. Despite slowing more than expected, emerging market and developing economies (EMDE) grew faster than advanced economies, reaching 4.5 percent, more than twice as fast as advanced economies. India, which grew 7.1 percent, and China at 6.6 percent, were the fastest-growing of the EMDE.

Figure 1: Global and Regional Growth, 2015–2021f



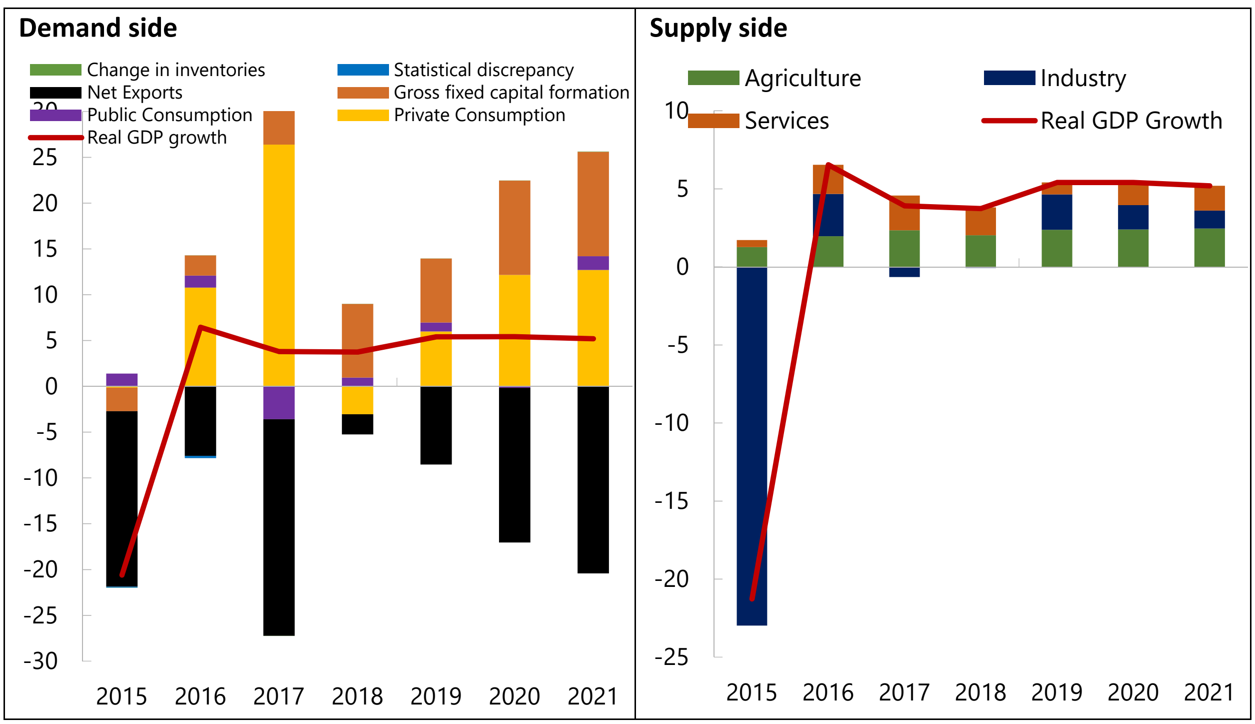
Sources: MFMod and WEO databases. AE: Advanced Economies, EMDE: Emerging Markets and Developing Economies, SSA: Sub-Saharan Africa, ECOWAS: Economic Community of West African States. e=estimates, f=forecast.

In 2018, Sub-Saharan Africa (SSA) grew at an average rate of 2.3 percent, a slight slowdown from 2017, mainly the result of a slump in net exports (oil exports in particular), the continued volatility of commodity prices and civil conflicts in some countries. This regional performance hides some sub-regional heterogeneity. With a growth rate estimated at 3.2 percent in 2018 (up from 2.6 percent in 2017), ECOWAS was among the fastest-growing subregions of SSA. Its economic growth benefited from higher domestic demand, especially infrastructure investment and private consumption. On the supply side, the main drivers were pro-growth policy reforms (Côte d'Ivoire), increased agricultural production (Benin, Togo, and Sierra Leone), and further expansion of manufactures and services (Ghana). Faster growth in ECOWAS is likely to be good for Sierra Leone's economic prospects through trade and, to a lesser extent, financial services links. Cote d'Ivoire and Ghana are Sierra Leone's third and fourth largest markets for goods and services after Netherlands and China.[2] Furthermore, most of Sierra Leone's remittances inflows (43.1 percent) came from Guinea in 2017.[3]

1.2. Recent Developments: Growth

Sierra Leone's economy continued its expansion in 2018 but output is still below potential. Sierra Leone's economy continues its post-Ebola expansion, though at a slower pace. Aggregate growth in 2018 was estimated at 3.7 percent, down marginally from 3.8 percent in 2017 (Figure 2), but slightly higher than the SSA average of 2.3 percent.

Figure 2: Economic Growth in Sierra Leone, 2015–2021f



Sources: MFMod database.

[2] The data on Sierra Leone's top trade partners came from the World Integrated Trade Solution (https://wits.worldbank.org/countrystats.aspx?lang=en).

[3] The data on Sierra Leone's bilateral inflows of remittances came from the World Bank's Migration and Remittances Database (http://www.worldbank.org/en/topic/migrationremittancesdiasporaissues/brief/migration-remittances-data).

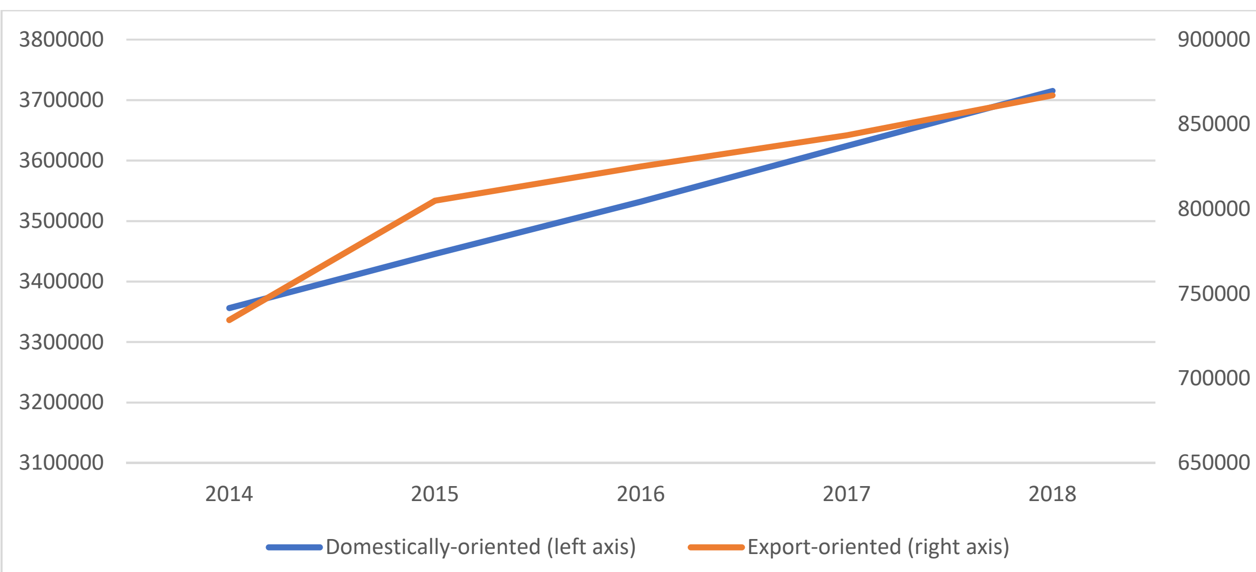
But there is still room for strong growth as aggregate output is still below potential by 2.6 percentage points.

1.3. Sources of growth

Growth in 2018 was driven by domestic investment and increased exports. On the demand side, the two most important components of output were private consumption and gross fixed capital formation. But given its 5.9 percent plunge from 2017 to 2018, private consumption was a severe drag on aggregate growth, subtracting 3 percentage points. Depressed private consumption was the result of a combination of domestic (post-election adjustments and limited access to private credit) and external factors (depreciation-related inflationary pressures). Sierra Leone's 2018 aggregate growth reflected higher capital accumulation and an improvement in net exports.; the contribution of gross fixed capital formation was 8 percent, offsetting the drop in private consumption. Resumption of pre-election public infrastructure projects has been central to boosting investment. If sustained, investment growth could increase Sierra Leone's potential output and enhance the prospects for medium-term growth. The contribution of net exports to aggregate growth went up by more than 20 percentage points in 2018, reflecting an unprecedented 16 percent increase in agricultural exports.

On the supply side, growth was the result of agricultural expansion. In part because industrial production (mining in particular) was disrupted, Sierra Leone's growth was driven by agriculture and services. With a contribution of 2 percent in 2018, the agricultural sector was the main driver of growth.

Figure 3: Production of Primary Agricultural Commodities, 2014–2018 (Mt)

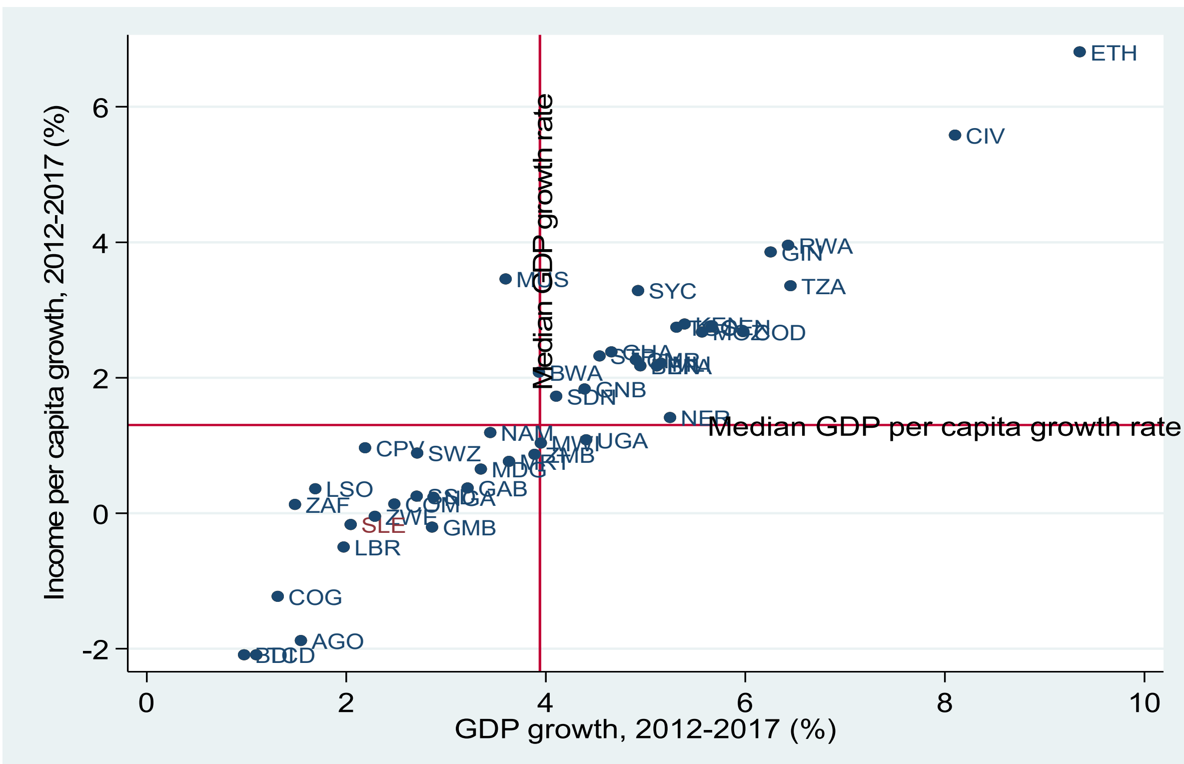


Sources: Sierra Leone Ministry of Agriculture data.

The authorities have been encouraging increased agricultural productivity as a means of diversifying the economy beyond mining.[4] The recent structural reforms such as the Seed Certification Agency Act, the National Fertilizer Act, the Fisheries Act are likely to help increase productivity in this sector. Agricultural production was driven by continued expansion in the production of key domestically-oriented agricultural commodities such as Rice, Cassava, and Maize. Some export-oriented commodities such as Oil Palm also contributed to increased agricultural output, but to a lesser extent (Figure 3). The contribution of mining to aggregate growth was negative because of the recent closure of the main mining company—Shandong Iron and Steel Company. Iron ore production is expected to resume in 2019.

Total Factor Productivity (TFP) has been on the decline, with an average decline of 2.8 percent since 2015. TFP declined by 2.8 percent in 2018. Relatedly, the labor share of output has also been declining. This substantial decline in TFP calls for structural reforms to improve the allocation of resources across sectors to raise the productive capacity of the economy.

Figure 4: GDP and income per capita growth in SSA, 2012–2017



Source: MFMod and WDI databases. GDP numbers are adjusted for PPP to allow for consistent cross-country comparisons. 2012-17 is the latest quinquennial period for which data on PPP-consistent GDP are available. The growth rate of income per capita between 2012 and 2017 is calculated as the log-difference of PPP-consistent income per capita between 2012 and 2017, divided by the number of years (5) and multiplied by 100.

[4] The four pathways recommended by the 2018 Sierra Leone Systematic Country Diagnostic are: (a) strengthening agricultural productivity; (b) diversifying the economy and creating poverty-alleviating jobs; (c) strengthening the management of mineral resources; and (d) increasing human capital to access new opportunities.

Despite Sierra Leone's recent steady growth, several structural challenges prevent the country from achieving inclusive growth and shared prosperity. By international standards, Sierra Leone's income per capita is still very low. With the population growing at more than 2 percent per year, the Country's economy is not growing fast enough to substantially increase income per capita. In 2018, real GDP per capita grew by 1.5 percent, down from 1.6 percent the previous year, and the number of people living on less than the international line of $1.90 a day, though on a declining trend since 2016, is still relatively high (Table 1). The 2018 poverty rate, estimated at 47.1 percent, is among the highest in the world. Cross-country data show that among African countries, not only is Sierra Leone's rate of economic growth was below the median rate but also the annual average growth rate of income per capita was among the lowest the last quinquennial (Figure 4). From 2012 to 2017, the median rate of growth of income per capita in SSA was 1.3 percent. In contrast, Sierra Leone's income per capita declined by -0.16 percent over the same period. This decline in per capita income is not specific to Sierra Leone. Other countries such as Liberia and Congo experienced similar declines in their income per capita.

Table 1: Sierra Leone- Selected Economic Indicators (2015 -2021)

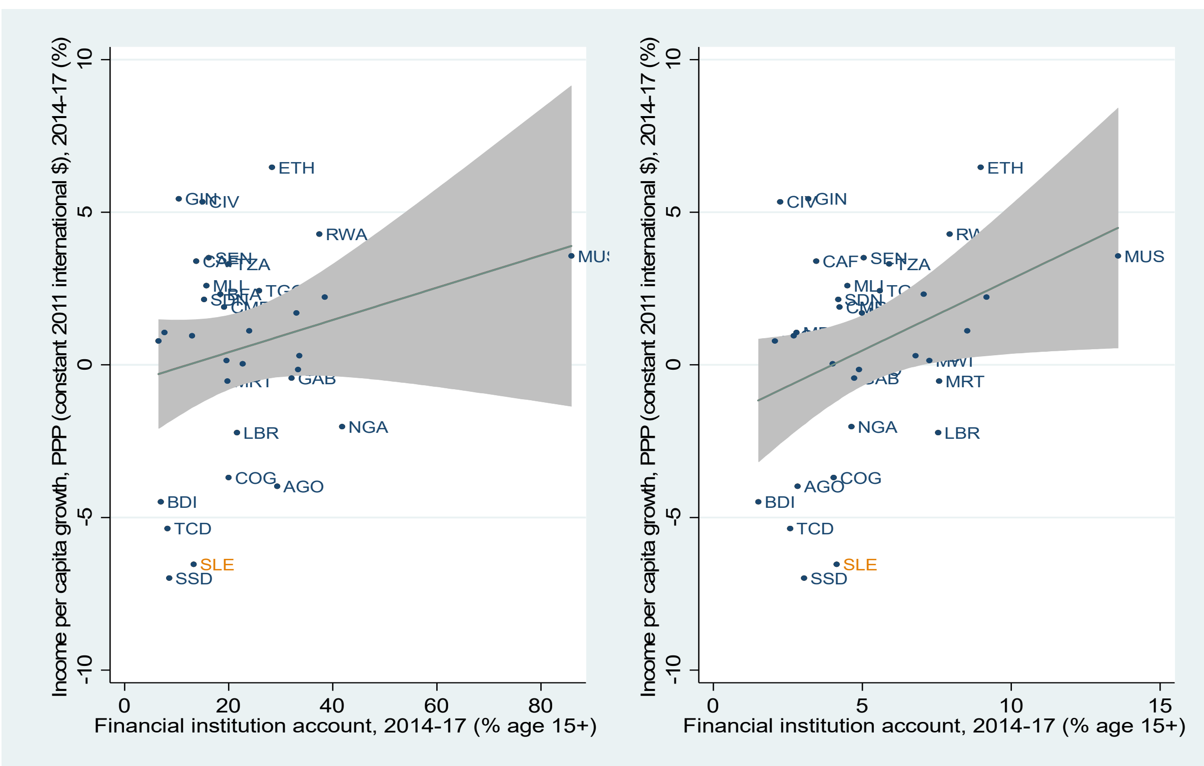
	2015	2016	2017	2018e	2019f	2020f	2021f
Real GDP growth, at constant market prices (%) (a)	-20.59	6.44	3.79	3.74	5.40	5.41	5.19
Private Consumption (contribution)	-0.15	10.76	26.37	-3.04	5.97	12.14	12.69
Government Consumption (contribution)	1.38	1.31	-3.59	0.94	0.97	-0.16	1.49
Gross Fixed Capital Investment (contribution)	-2.57	2.20	4.30	8.02	6.97	10.28	11.39
Net Exports (contribution)	-19.15	-7.59	-23.64	-2.20	-8.54	-16.88	-20.42
Real GDP growth, at constant factor prices (%)	-21.26	6.53	3.90	3.73	5.40	5.40	5.19
Agriculture (contribution)	1.26	1.96	2.33	2.02	2.37	2.39	2.45
Industry (contribution)	-22.98	2.69	-0.65	-0.07	2.26	1.55	1.14
Services (contribution)	0.45	1.87	2.22	1.79	0.76	1.46	1.59
Output gap (% of potential GDP)	-11.62	-6.71	-4.23	-2.53	-0.77	0.06	-0.47
Real GDP per capita (USD)	437.16	455.34	462.57	469.75	484.90	500.72	516.20
Real GDP per capita growth (%)	-22.33	4.15	1.58	1.55	3.22	3.26	3.09
Net operating balance (% of GDP)	-4.58	-7.97	-8.63	-6.60	-4.32	-5.16	-5.15
Primary operating balance (% of GDP)	-3.76	-7.10	-6.50	-4.71	-3.30	-0.28	-2.74
Cyclically-Adjusted Primary Balance (% of potential GDP) (b)	-1.99	-5.90	-5.78	-4.28	-3.18	-0.29	-2.67
Fiscal stance (% of potential GDP)	0.32	-3.57	-3.46	-1.96	-0.86	2.02	-0.34
Fiscal impulse (% of potential GDP)	2.41	-3.90	0.11	1.50	1.09	2.89	-2.37
Government Debt (% of GDP)	45.62	56.59	64.59	66.28	60.86	57.08	53.12
International poverty rate ($1.9 in 2011 PPP) (%)	…	47.8	47.4	47.1	46.3	45.5	44.8
Lower middle-income poverty rate ($3.2 in 2011 PPP) (%)	…	78.3	78.1	77.8	77.2	76.6	76.1
Upper middle-income poverty rate ($5.5 in 2011 PPP) (%)	…	91.3	90.9	90.6	89.9	89.2	88.6

Sources: World Bank Staff calculations using MFMod and MPO databases. Notes: (a) The contributions of change in inventories and statistical discrepancy were not reported because they are quantitatively negligible. (b) The output elasticity of revenue used to adjust primary balance was calculated as the coefficient of a simple log-log regression of income on output based on historical data (2010-2018). e = estimate, f = forecast.

Financial inclusion is good for income per capita growth. As illustrated in Figure 5, SSA countries that have better access to financial services such as saving accounts and borrowing also tend to have faster growth of income per capita. For instance, Mauritius has the highest rate of population with access to saving accounts and credits from financial institutions and also has one of the fastest growth rates of income per capita in the sample. On the other hand, South Sudan has one the lowest rates of financial inclusion and, at the same time, the slowest income per capita growth of the sample. In Sierra Leone, the average rate of 15+ population who borrowed from a financial institution is 5 percent and the corresponding rate of 15+ population who has an account with a financial institution is 14.7 percent. These rates were respectively 9 and 28.3 percent in Ethiopia. Setting aside causality issues, the negatively sloped regression lines between financial inclusion and poverty in Figure 5 suggests that Sierra Leone's income per capita would have grown by 6 percent between 2014 and 2017, rather than the actual decline, if it had the same level of financial inclusion as Ethiopia. The importance of financial inclusion for economic development will be further elaborated in Part 2 of this report.

Sierra Leone's rate of economic growth is neither high enough nor broad-based enough to absorb the faster growing working-age population. In Sierra Leone, as elsewhere in SSA, the working-age population is growing faster than total population, which heightens the pressure to create new and better-quality jobs. In 2018, its working-age population grew at 2.8 percent and is expected to grow faster over the medium term. Sierra Leone's economic growth is one of the most unstable in the world. Between 2010 and 2018, the standard deviation of real GDP growth was 12.0 percent, compared with only 1.6 percent for SSA. Finally, Sierra Leone's economy has not experienced a level of structural transformation, whereby labor has shifted from low-productivity sectors to high-productivity sectors. Growth is still driven by traditional sectors such as agriculture and mining, where employment is precarious, seasonal, and low-paying—a major reason why TFP has been declining.

Figure 5: Financial inclusion and income per capita growth in SSA, 2014-17

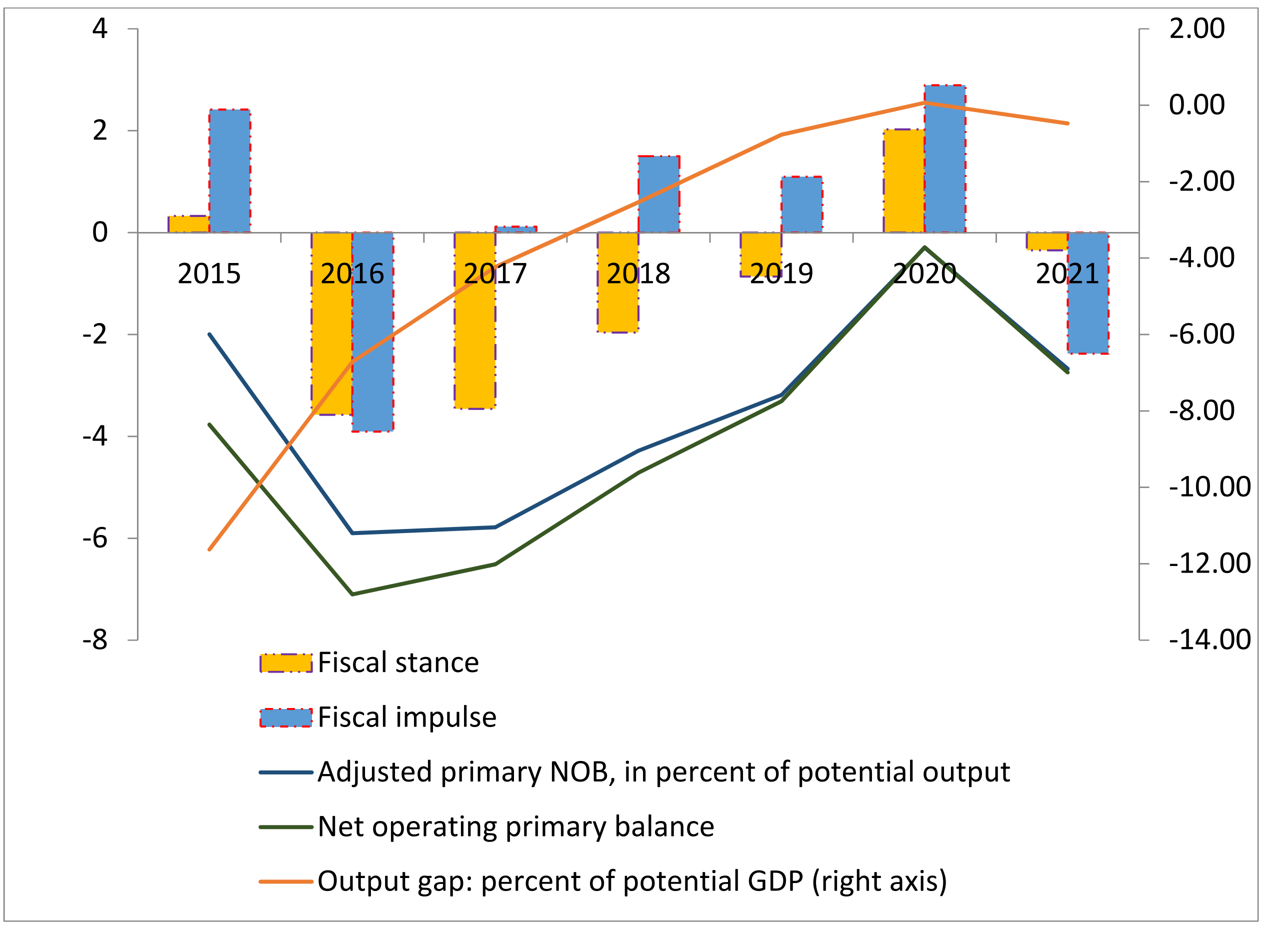


Source: WDI and Global Financial Inclusion databases. Income per capita numbers are adjusted for PPP to allow for consistent cross-country comparisons. 2014-17 is the latest triennial period for which data on PPP-consistent GDP are available. The growth rate of income per capita between 2014 and 2017 is calculated as the log-difference of PPP-consistent income per capita between 2014 and 2017, divided by the number of years (3) and multiplied by 100.

1.4. Fiscal policy

Higher domestic revenues and better expenditure controls are improving fiscal balances. In 2018, the fiscal deficit was estimated at 6.6 percent—an improvement from 8.6 percent in 2017 (Figure 6). This fiscal performance was the result of an increase in revenues, and better expenditure controls, as expenses stayed at approximately the same level for 2017. The ratio of revenues to GDP increased from 14.9 percent in 2017 to 17.2 percent in 2018. Tax revenues, and direct taxes, in particular, were important contributors to the improved revenue performance. The increased revenue performance reflects the recent adoption of measures to improve domestic revenue mobilization. These measures include, among others, the establishment of a Treasury Single Account (TSA) and the reduction of tax exemptions. Total expenditures increased only marginally from 23.5 percent to 23.8 percent of GDP over the same period. This relatively stable ratio of expenditures to GDP also reflects recent measures to better control spending despite pressures from increased interest payments—which represented 10.1 percent of total revenue, 7.9 percent of total spending, and 1.9 percent of GDP in 2018. Interest payments were primarily on domestic debt, which accounted for 55.9 percent of total interest payments. Excluding interest payments, which reflect previous policies, the primary deficit as a ratio of GDP was 4.7 percent in 2018, less than the 6.5 percent in 2017.

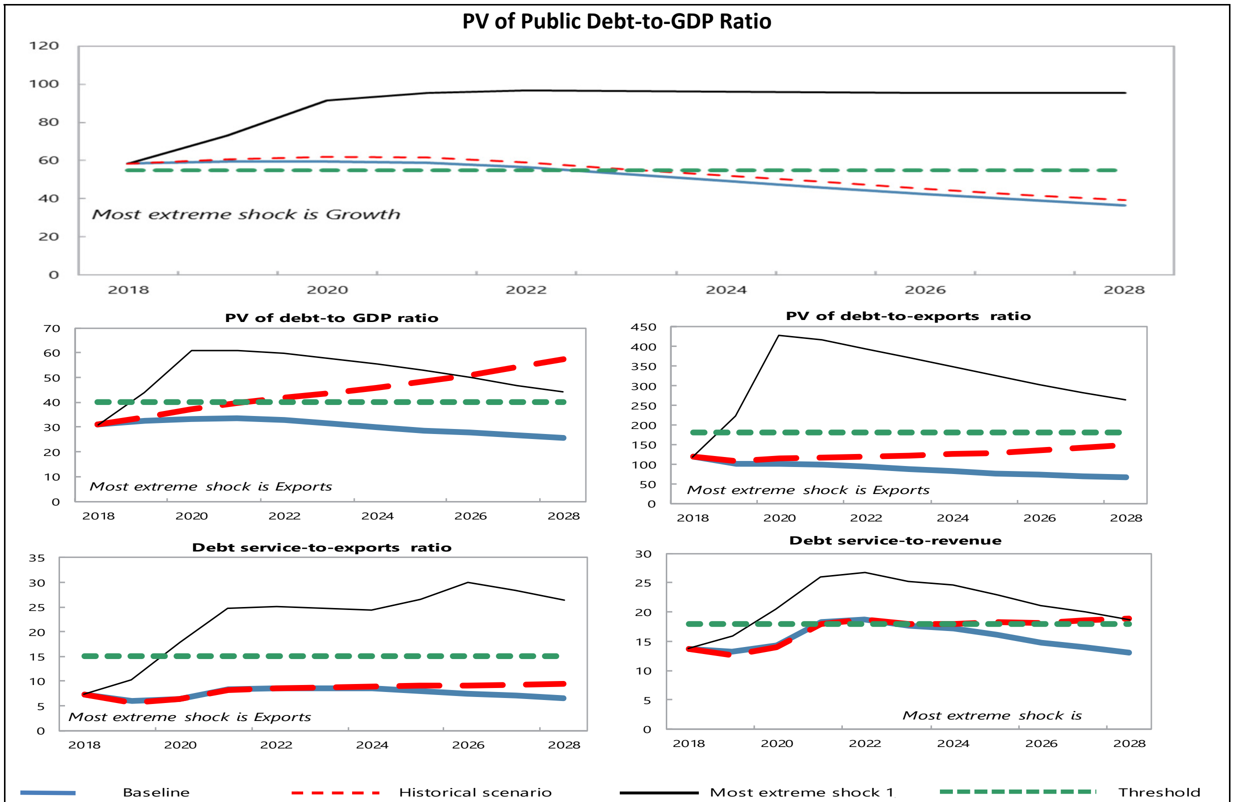
Figure 6: Fiscal Balances, Stance, and Impulse



Source: MFMod database.

Even though the fiscal deficit has been declining since 2016, it is still relatively high by international standards. Sierra Leone's 2018 fiscal balance was almost twice that of Sub-Saharan Africa as a whole and was the highest of the ECOWAS region.[5] It is also much higher than the fiscal deficit of African metal and mineral resource rich countries, which was 3.2 percent of GDP in 2018. Sierra Leone will need to sustain its fiscal consolidation efforts to prevent a rapid increase in its debt and continue to assure macroeconomic stability.

Figure 7: Indicators of Public Debt and Publicly Guaranteed External Debt under Alternative Scenarios, 2018-2028



Sources: Country authorities; and staff estimates and projections (2018).

1/ The most extreme stress test is the test that yields the highest ratio in or before 2028. Stress tests with one-off breaches are also presented (if any), while these one-off breaches are deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most extreme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

2/ The magnitude of shocks used for the commodity price shock stress test are based on the commodity prices outlook prepared by the IMF research department.

As a result of the large fiscal imbalances, public debt has increased and threatens external sustainability. The ratio of government debt to GDP increased from 64.6 percent of GDP in 2017 to 66.3 percent in 2018, largely due to an increase in external debt. Although the external share of public debt was almost 50 percent, external debt grew by 24.9 percent—almost twice the rate of domestic debt. Solvency indicators

[5] ECOWAS stands for Economic Community of West African States, which was created in 1975 and as of now includes the following 15 members: Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Mauritania, Niger, Nigeria, Senegal, Sierra Leone, and Togo.

also point to an increased risk of debt distress, as the growth rates of government revenues and export revenues do not keep up with the rate of increase of debt service. In 2018, debt service reached 13.7 percent of government revenues and 7.3 percent of exports earning. Furthermore, given the external share of GDP of around 50 percent and the continued depreciation of the exchange rate, Sierra Leone is facing currency-mismatch risks.

The most recent Debt Sustainability Assessment puts the country at a "high risk" of debt distress for both external public debt and overall public debt (World Bank, International Monetary Fund, 2018). The risk of external debt distress has changed to "high" in the current DSA from a "moderate" risk in the June 2017 DSA due to a deterioration of the debt service to revenue ratio and a tightening of the debt service thresholds (Figure 7). Under the baseline scenario, all but one indicator for public and publicly guaranteed (PPG) external debt remain below their respective thresholds. The debt service-to-revenue ratio breaches the threshold for two years (2022-23), because of the amortization schedule of currently contracted loans. The external debt outlook remains sensitive to both export and growth shocks. A large export shock leads to significant increases in the PV of debt-to-GDP, debt to exports, and debt service to exports, while a large growth shock leads to a significant increase in the PV of debt services to revenue. The PV of public debt in the baseline scenario is projected to be above the benchmark throughout the projection period. Public debt sustainability would be vulnerable to fiscal and extreme shocks to both growth and exports shocks. Reducing Sierra Leone's risk of debt distress requires sustained fiscal consolidation, sound public financial management, and prioritization of infrastructure projects.

1.5. External developments

External sector performance remained feeble reflecting weak exports and sluggish donor inflows. The current account deficit widened to 13.8 percent of GDP from 10.9 percent in the previous year, due mainly to the increase in the trade deficit as well as debt service payments and payments for services especially for transportation (air and sea), communication and insurance. The trade deficit increased slightly by 0.1 percentage points of GDP to 14.6 percent of GDP in 2018, due largely to the sharp reduction in exports that was not totally offset by the large drop in imports.

Total merchandise exports declined sharply by 2.0 percentage points of GDP to 15.5 percent of GDP (US$602.8 million) in 2018, due mainly to the reduction of mineral exports. Total mineral exports declined by 17.1 percent in 2018 due to the collapse of iron ore exports, as the main ore mining company ceased operations early in 2018. This led to sharp reduction in the share of mineral exports in total exports. Agricultural exports received a boost as the country started exporting palm oil in addition to improvement in the traditional exports, particularly of cocoa and coffee (see Table 2).

Total merchandise imports fell to 30.7 percent of GDP in 2018 from 34.5 percent of GDP in the previous year, due to the decline in major imports (food items, manufactured goods, fuel and lubricants and machinery and transportation equipment. Food imports declined by 9.2 percent, largely because of the reduction in the importation of beverages and flour reflecting strong domestic food harvest (see Table 2).

Figure 8: Trade and Current Account

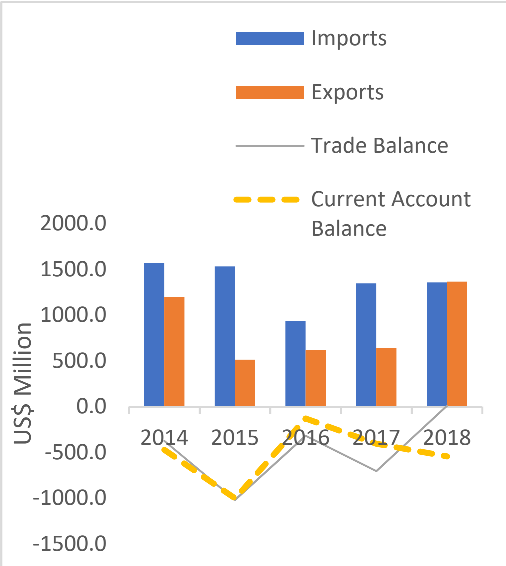
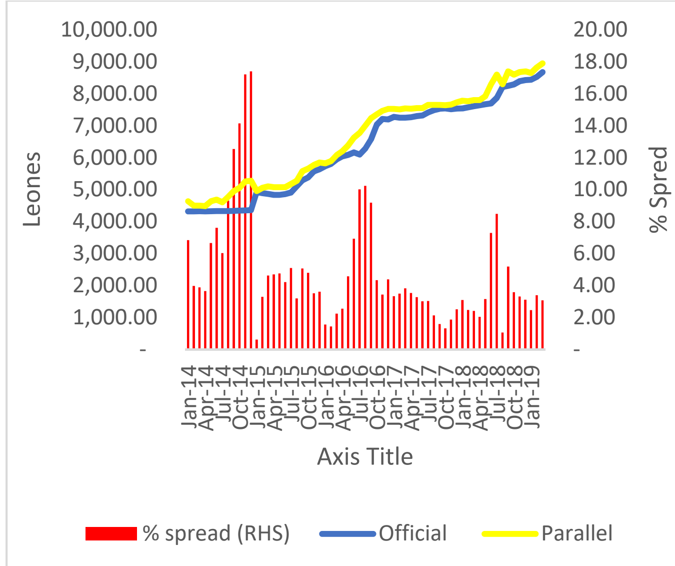


Figure 9: Leone/US$, Jan-14 – Dec-18



Sources: BSL, SSL and WB Staff Estimates

Table 2: Sierra Leone's Trade and Current Account (US$, Million)

	2014	2015	2016	2017	2018
Total Merchandise Exports	**1,194.2**	**511.7**	**614.6**	**652.1**	**602.8**
% of GDP	26.0	12.1	16.7	17.5	15.5
Mineral	1,094.0	376.2	457.6	433.1	359.0
O/w Iron ore	*742.1*	*77.4*	*129.9*	*131.9*	*13.1*
Agriculture (coffee, cocoa, palm oil)	28.4	20.5	21.5	25.1	126.4
Fisheries	1.2	4.2	5.0	9.5	10.5
Reexports	8.4	4.2	4.8	2.0	58.0
Other	62.2	105.7	125.7	184.2	68.9
Total Merchandise Imports	**1,568.2**	**1,530.3**	**934.2**	**1,284.2**	**1,197.7**
% of GDP	34.2	36.0	25.4	34.5	30.7
Food and Beverages (including rice)	370.3	571.5	286.5	486.5	441.5
O/w Rice		*141.5*	*97.0*	*153.1*	*191.4*
Manufacture goods	147.7	159.1	138.1	182.7	151.3
Crude, Fuel and Lubricants	527.8	334.8	191.5	211.3	204.8
Machinery and Transport Equipment	331.4	319.3	196.6	298.8	255.5
Others	191.1	145.6	121.5	104.9	144.6
Trade Balance	**-374.0**	**-1,018.6**	**-319.6**	**-632.1**	**-594.9**
% of GDP	-8.2	-23.9	-8.6	-14.5	-14.6
Current Account Balance	**-472.7**	**-1,003.1**	**-130.7**	**-407.0**	**-545.1**
% of GDP	-10.3	-23.6	-3.6	-10.9	-13.8

Sources: BSL, SSL and WB Staff Estimates

Importation of machinery and transportation equipment declined by 14.5 percent, largely reflecting closure of the main iron ore mine while imports of manufactured goods declined by 17.2 percent, as domestic demand weakened on account of the depreciation of the Leone. Importation of mineral fuel and lubricants also fell largely reflecting the liberalization of domestic fuel prices and the gradual increase in international crude oil prices.

The capital and financial account of the balance of payments continued to record a surplus following favorable capital inflows which largely financed the current account deficit. Inflows to the capital and financial account improved to 13.0 percent of GDP from 8.6 percent in the previous year, driven mainly by foreign direct investments and portfolio flows. Foreign direct investments, especially in agriculture and mining, more than doubled in 2018, reflecting renewed confidence in the economy following the change of Government early in the year. Gross external reserves coverage remained adequate but declined slightly to US$481 million (3.3 months of imports) from US$503 million (3.5 months of imports) in 2017.

The exchange rate continued to depreciate in 2018. The Leone depreciated against the U.S. dollar by 7.3 percent on average at the official window and 12.5 percent year-on-year (YoY)) on the parallel market, driven by increased demand for foreign currency to settle foreign payment obligations especially for fuel imports. The premium between official and parallel market rates also increased sharply in 2018, by 3.8 percent on average compared 2.7 percent in the previous year, due mainly to speculative activities (see Figure 9). The BSL intervened occasionally through foreign exchange auctions to slow the depreciation and prevent market pressures from destabilizing the thin market. Both the nominal and real effective exchange rate depreciated in 2018.

1.6. Inflation, Monetary policy and financial sector

Inflationary pressure persisted throughout 2018. The depreciation of the exchange rate, food supply constraints early in 2018 and the adverse impact of the liberalization of fuel prices in July 2018 were the main drivers of inflation. Average inflation (year-on-year) nonetheless moderated slightly to 16.8 percent in 2018 from 18.2 percent in the previous year, following the tightening of monetary and fiscal policy by the Authorities. Both food and non-food inflation remained high (above 16 percent) although their rates declined slightly, from 19.5 and 18.2 percent in 2017 to 18.3 and 16.4 percent, respectively in 2018. High food prices have been the main driver of inflation in recent years (see Figure 10) due mainly to supply side bottlenecks, reflecting low yields of locally produced food crops especially rice (the country's staple food), and poor transportation networks. Inflation increased slightly to 17.2 percent in the first quarter of 2019 driven mainly by the increase in non-food inflation to 17.9 percent but counterbalanced by the moderation in food inflation to 15.3 percent.

The BSL kept monetary policy tight in 2018 and early 2019 in a bid to reduce the high inflation rate. The monetary policy rate (MPR) was increased by 50 basis points to 15.0 percent in May 2018 and further by 150 basis points in July 2018. The MPR was kept unchanged at 16.5 percent from July 2018 through March 2019 as the BSL weighed the impact of the Government's fiscal consolidation efforts. Key money market rates (interbank rate, treasury bill rates and lending rates) increased, reflecting the increase in the MPR and the high cost of borrowing (see Figure 12). In addition, the interest rate on BSL's standing lending facility increased (to 20.5 percent in 2018 from 19.0 percent in 2017) as some banks resorted to the collateralized discount window following tight liquidity condition in the money market. However, the 12-

month saving rate remained unchanged at 5.8 percent during the year, widening the spread between lending and savings rate.

Figure 10: Consumer Prices, Annual Changes

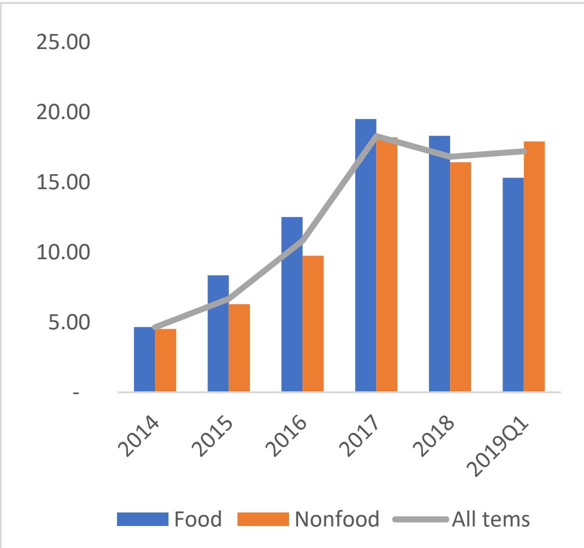
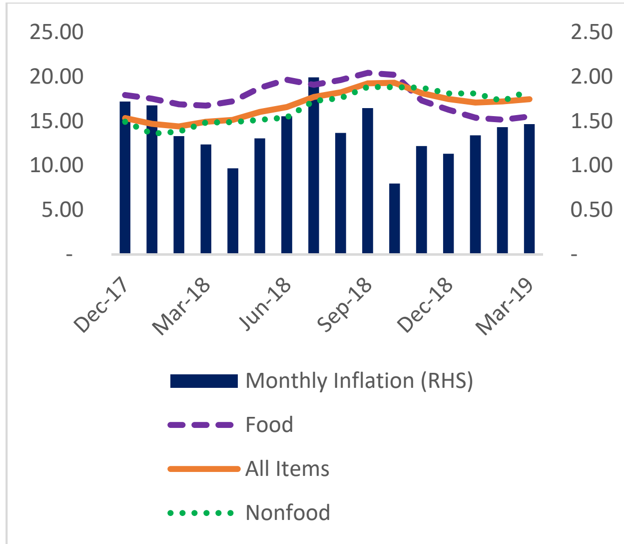


Figure 11: Monthly Inflationary Trends



Sources: BSL, SSL and WB Staff Estimates

Figure 12: Interest rate trends

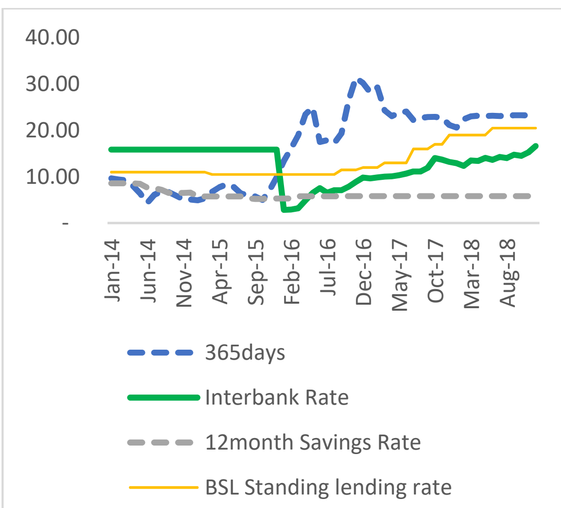
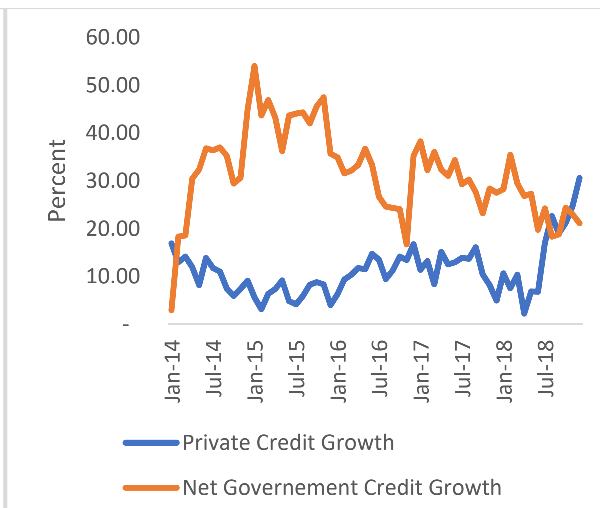


Figure 13: Private and Government Credit, Annual Changes



Sources: BSL and WB Staff Estimates

Although the BSL increased the MPR to signal its tight policy stance, the growth rate of the broad monetary aggregate (M3) more than doubled, underscoring the weakness in monetary policy transmission. The BSL's inability to curtail the rapid growth of M3 (to 14.3 percent from 6.9 percent in 2017) could be largely explained by the growth in net domestic assets (NDA) (to 26.7 percent from 18.8 percent in 2017) precipitated by increased government borrowing from the banking system. Net foreign assets (NFA) declined by 10.5 percent in 2018, same as in 2017, due largely to the continued increase in foreign liabilities arising from increased payment obligations. The growth rate of reserve money (RM), BSL's primary operating target, moderated to 6.5 percent in 2018, from 9.0 percent in the previous year, due mainly to the continued slowdown in the growth rate of quasi-money caused by a drawdown of foreign currency deposits following exchange rate depreciation. Both M3 and RM continued to expand in the first quarter of 2019, growing by 13.1 and 6.0 percent, respectively.

Bank lending has increased as business confidence has gradually improved. Private sector credit growth, which had been below the growth rate of credit to the Government since 2014, increased significantly in 2018, to 30.6 percent from just 4.9 percent in the previous year, driven mainly by loans to the commercial and construction sectors (see Figure 13). Private sector credit growth reached 40 percent (YoY) in 2019Q1. The construction and commerce sectors continued to receive the largest share of credit in 2018, at 21.7 percent and 30.0 percent, respectively. Other sectors such as manufacturing, agriculture, mining and transportation and communication received less than 10 percent of total credit each. The low growth of private sector credit (which averaged 8.7 percent per annum between 2014 and 2017) in the previous years is not unrelated to sluggish performance of the economy in recent years. High levels of government borrowing from the banking system as well as substantial business risks, and limited investment options for banks have been responsible for slow growth of private sector credit (see Part 2 for a more detailed discussion). In addition, the interest rate on government securities exceeds rates on other money market instruments (see Figure 12) and thereby crowds out private investment. The growth rate of net credit to Government averaged 35.8 percent per annum over the 2014 – 2017 period, driven largely by increased government borrowing from the banking system to finance fiscal the deficits. However, the pace of growth of net government credit slowed to 21.1 percent in 2018 from 27.5 percent in the previous year, as the Government embarked on a fiscal consolidation path, which helped to reduce its borrowing needs.

Table 3: Key Financial Soundness Indicators

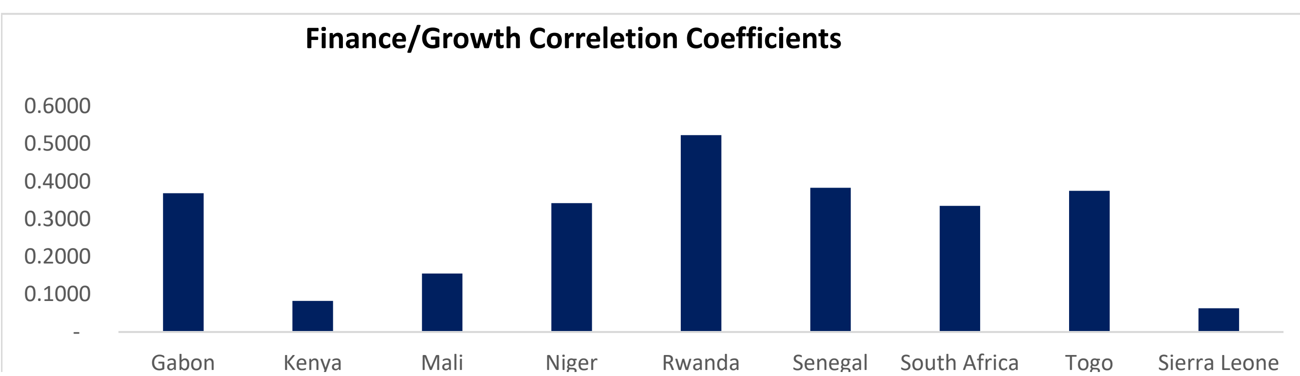
	2015	2016	2017	2018
Indicator (%)				
Capital Adequacy Ratio	34.0	30.7	34.1	38.4
Non-Performing Loans to Gross Loans	31.7	22.7	14.6	12.7
Return on Assets	3.2	3.2	5.3	6.1
Return on Equity	18.3	22.3	25.6	27.3
Overall Liquidity Ratio	69.0	71.8	66.9	67.9
Aggregate Net Open Position in FX to Capital	(6.8)	(2.0)	(14.4)	(12.8)
Memo:				
Total Assets (Le' Billion)	5,287.6	6,333.2	7,433.0	8,549.1
Total Deposits (Le' Billion)	4,287.0	5,076.2	5,275.0	6,110.5
Capital base (Le' Billion)	651.6	734.7	938.4	1,193.1
Gross Loans and Advances (Le' Billion	1,341.9	1,502.4	1,534.5	1,813.3

Sources: BSL and WB Staff Estimates

The financial sector remains relatively stable as demonstrated by the improvement in key financial soundness indicators (see Table 3). Total assets of the banking system increased by 15.1 percent to 27.0 percent of GDP in 2018, on account of increases in deposits and shareholders' funds. Both total deposit and shareholders' funds increased during 2018, reflecting new products to attract deposits and retained earnings to shore-up capital. Demand deposits accounted for the highest percentage of total deposits, followed by savings deposits and time deposits. Although the average capital adequacy ratio of the banking industry remained far above the 15 percent minimum, it does not adequately capture the risks faced by some banks and the situation vary widely across the industry. Profitability improved as both return on assets (ROA) and return on equity (ROE) increased to 6.1 and 27.3 percent, respectively. All but one bank recorded unaudited pre-tax profits. The ratio of nonperforming loans to gross loans (NPLs) declined to 12.7 percent as the BSL continued to implement measures to strengthen risk management in banks. Although overall liquidity improved slightly to 67.9 percent, some banks faced challenges in meeting their foreign exchange liquidity needs due to the continued depreciation of the Leone during the year. As a result, the net foreign currency open position to capital remained negative, although it narrowed slightly to -12.8 percent in 2018. Credit and foreign exchange liquidity risks are major risks facing the banking sector as non-performing loans remain above 10 percent while some banks continued to face difficulties to clear US transactions. Weaknesses in the macroeconomic environment including high

Box 1: Finance and Economic Growth Nexus

The link between financial development and economic growth has been well established in the economic literature (Schumpeter 1912; Mckinon 1973; and Shaw 1973). The financial sector provides the conduit for channeling savings into productive investments through intermediation of funds between borrowers and lenders. Businesses and enterprises with sufficient access to bank credit have greater potential to grow by investing borrowed funds to expand production, which increases economic growth. Several studies have examined the impact of financial market development on economic growth and found evidence of a positive effect of finance or financial intermediation on economic growth (King and Levin 1993; Guiso et al., 2004; Demirguc-Kunt and Levin 2008). While several measures of financial development have been proposed, credit to the private sector has been favored as the most widely used alternative measure of financial intermediation. The advantage of credit to the private sector is that it accurately measures the role of financial intermediaries in channeling savings to the private sector by excluding the public sector. Although this indicator excludes stock and bond markets, it is more relevant for many developing countries where capital market development is still at the embryonic stage. We computed the correlation coefficient between private sector credit growth and economic growth in selected sub-Saharan African countries over the period 1990 to 2017. The results show a positive correlation between private sector credit and economic growth for all countries–albeit a weak one for Sierra Leone (less than 0.1). Sierra Leone records the lowest private sector credit as a share of GDP (4.0 percent on average) which largely underscores the weak relationship between finance and economic growth. Although correlation does not imply causation, the noticeable relationship indicates that improving financial market development could have positive implications for economic growth.



inflation, persistent exchange rate depreciation and substantial government borrowing to finance fiscal deficits represent significant challenges to banks and the wider financial sector.

1.7. Economic Outlook

Despite sluggish economic performance over the last two years (2017 and 2018), Sierra Leone's medium-term growth prospects are promising. Economic growth is expected to accelerate from 3.7 percent in 2018 to 5.4 percent in 2019 and stabilize at around 5 percent by 2021. The outlook assumes structural reforms to diversify the economy. Supply side factors including favorable agricultural output, uptick in mining activities (driven by increased price for iron ore) and strong performance of the services sector, are expected to be the main growth drivers. However, aggregate demand is also expected to improve as private consumption recovers from its decline in 2018, while investments remain relatively strong as confidence in the economy improves. Consistent with the higher growth, lower inflation and increased social spending (on safety nets and education through the free education program recently launched), poverty is projected to fall to 46 percent in 2019 and 45 percent by 2021. Real GDP per capita is expected to reach US$516 by 2021 from US$469 in 2018.

On the supply side, agriculture will be a key driver of growth in the medium-term, growing at 4.7 percent on average. Increased foreign direct investments in crop production (including pipeline investments by Dole) and fisheries are expected to drive the performance of the agriculture sector. In addition, recent reforms to liberalize the inputs market by promoting private sector participation in the fertilizer and seeds markets are expected to increase output. The performance of the service sector is also expected to improve over the medium-term (4.4 percent by 2021). Tourism, trade (wholesale and retail) and transportation and communication will be the key drivers as the economy continues to recover and aggregate demand improves. Business regulatory reforms to improve competitiveness and the ease of doing business, enhanced connectivity and broadband access as well as the anticipated improvement in the delivery of government services, could further promote growth in the services sector. The implementation of the Government's flagship quality education program is also expected to support the expansion of government services and stimulate economic activity

Industrial activity is expected to recover over the medium-term, with growth of about 15 percent on average. The expected resumption of iron ore mining at the Marampa Mines (by Gerald Metals) in 2019 as well as the anticipated opening of new mines for diamond, rutile and gold will drive growth in industry and provide upside potentials for higher overall GDP growth over the medium term. Construction is also expected improve with the rebound in public investment and the resumption of domestically funded infrastructure projects.

On the demand side, private consumption and investments are expected to drive growth as government consumption slows due to fiscal consolidation efforts. The resumption of publicly funded road projects and the free quality education and health programs is expected to support public investment in the medium term while private investment will be driven by foreign direct investment inflows in mining and agriculture, including pipeline investments by Gerald Metals, Sierra Rutile and Dole. Private consumption will be largely supported by the expected boost in agricultural output as well as lower inflation over the medium-term.

The BSL is expected to maintain a tight monetary policy stance, which complemented by fiscal consolidation is expected to reduce inflation over the medium term. Inflation initially increased to 17.2 percent in 2019Q1 but is expected to fall gradually to 11.1 percent by 2021, under a strengthened monetary policy framework and a tighter fiscal stance as well as increased domestic food supply on account of the favorable outlook for agriculture. The BSL is expected to maintain flexible market-determined exchange rates and limit its intervention in the foreign exchange markets to curb speculative activity and stabilize the exchange rate.

The overall fiscal deficit is projected to decline as fiscal consolidation efforts are sustained. The fiscal deficit including grants is expected to narrow from 6.6 percent of GDP in 2018 to 4.3 percent of GDP in 2019 but increase slightly to 5.2 percent of GDP by 2021, underpinned by increased revenue and strict expenditure control. As revenue mobilization gains momentum to create more fiscal space, the Government plans to scale up its spending on infrastructure and social protection, which explains the slightly higher deficits in 2021. The fiscal consolidation path assumes the continuation of the policy actions introduced in 2018 as well as introduction of some additional measures over the medium term. On the revenue side, domestic revenue is expected to increase from 14.9 percent of GDP to 17.7 percent by 2021 driven largely by the implementation of robust measures for improving revenue administration including elimination of excessive duty and tax waivers and implementation of the treasury single account (TSA) (see Box 2). Most of the projected revenue increase (of 1.2 percent of GDP) between 2019 and 2021 is expected to come from sustaining the revenue actions introduced in 2018, but the Government is also expected to make further progress on the implementation of its medium-term revenue strategy (MTRS) – including introduction of electronic cash registers for goods and services tax, and robust collection of corporate and personal income taxes and tax arrears.

On the expenditure side, total spending is projected to decline over the medium-term. Total expenditure would initially fall from 23.8 percent of GDP in 2018 to 21.8 percent in 2019 as fiscal consolidation efforts gain momentum with the reduction in the wage bill and lower spending on goods and services. Also, one-off pre-election spending pressures in 2018 are expected to ease in 2019 while expenditure control measures introduced in 2018 will continue over the medium term. In addition, expenditure control over MDAs will be reinforced through better wage control via payroll automation and biometric registration of all civil servants; improvements in public procurement through the publication of price norms and limiting the use of the sole-sourcing method of procurement; and a strict prioritization of capital expenditures to allow spending on essential infrastructure and social programs, including investment in the Government's flagship Free Quality Education, within the limited available resources. However, total expenditure will increase slightly to 22.9 of GDP in 2021 with the increased spending on infrastructure, social protection and poverty reduction initiatives.

The risk of debt distress rating is expected to improve to 'moderate' from 'high' risk over the medium-term. Sustained fiscal consolidation, especially improvements in revenue mobilization, sound public financial management, prudent domestic and external borrowing policies, and prioritization of infrastructure projects—to which the authorities have committed under the new program with IMF is expected to reduce the risk of debt distress over the medium-term.

The external sector performance is expected to improve over the medium-term, despite the slowdown in the global economy. The current account deficit is expected to narrow from 14.0 percent of GDP in 2018 to 10.5 percent of GDP in 2021, supported by anticipated increases in mineral and agricultural exports. Total export is projected to grow by 24.8 percent on average over the medium-term with the anticipated resumption of iron ore production given the expected increase international prices for metals and ore as China's inventories fall. Agricultural exports (palm oil exports, coffee and cocoa exports) are expected to continue to grow, supported by the anticipated stability in global prices of agricultural products and foreign direct investment flows to the agriculture sector. Imports are expected to grow by an average 24 percent over the medium-term, as aggregate demand picks up. The current account deficit is expected to be financed by inflows to the financial account, especially FDI in agriculture and mining (Dole, Gerald Metals and Sierra Rutile), which in turn will help stabilize the exchange rate and maintain reserve coverage of above 3 months of imports over the medium-term.

Box 2: Revenue Mobilization Measures

Tax Policy Measures

a. Adoption of the ECOWAS Common External Tariff (CET), which is likely to raise the current low levels of tariff;
b. Development and implementation of a policy on tax and duty waivers;
c. Development and enforcement of transfer pricing provisions;
d. Collection of stamp duty as non-tax revenue;
e. Upward revision of fees/rates levied by Ministries Departments and Agencies.

Tax Administration Measures

a. Upfront payment of import duty, excise duty and road user charges by Oil Marketing Companies on petroleum products;
b. Strengthening the compliance of rental income tax and enhancing rental database by using third party data including Statistics Sierra Leone, Electricity Distribution and Supply Authority (EDSA) and Local Government;
c. Strengthening the collection of personal income tax from professionals including lawyers, doctors, accountants and engineers;
d. Strengthening field audits of large taxpayers and conducting special audit on the sector where technical knowledge is ensured for proper assessment of tax liabilities;
e. Auditing Goods and Services Tax (GST) registered businesses of both Large Taxpayer Office (LTO) and Medium Taxpayer Office (MTO) cases that claim huge GST credits.
f. Use of third-party data such as original commercial invoices information and custom intelligence to challenge under-declared import values;
g. Conducting review, standardize processing and clearance of transit goods;
h. Promoting voluntary compliance, and implementing SMEs taxpayer preparer scheme, and compliance risk management approach;
i. Construction of revenue post at new border posts to combat cross-border smuggling;
j. Implementation of National Revenue Authority's anti-corruption strategy such as protection of whistle blowers and training of procurement staff;
k. Preparation of 'Strategy for Enforcement' of existing tax legislation;
l. Establishment of tax court to prosecute tax defaulters.

Tax Information System

a. Automation of tax collection process through adopting an Integrated Tax Administration System (ITAS) for domestic tax, the web-based automate system for customs data (ASYCUDA World), and the electronic cash registers for GST;
b. Implementation of an automated payment gateway and reconciliation system to reconcile revenue in terms of tax assessed, collections, transfers and arrears;
c. Integration of the payment and reconciliation system with all banking and GOSL systems.

1.8. Risks

The medium-term economic outlook faces both opportunities and downside risks, but downside side risks are more pronounced. A key opportunity pertains to resumption in iron ore production and larger than expected production of rutile, diamonds and gold following the expected increase in global metal prices especially iron ore prices. As a result, medium term growth could be larger than anticipated. On the other hand, the main downside risks to the medium-term outlook include: a deterioration in Sierra Leone's terms of trade; lower than anticipated FDI inflows and the effects on the exchange rate and prices; fiscal slippages including adverse debt dynamics; and financial sector weaknesses. First, a deterioration in the terms-of-trade, particularly through increases in international crude oil prices (relative to metal prices including iron ore) due to weaker-than-expected iron ore demand from China combined with tighter supply conditions due to sanctions on Iran, could negatively impact growth, revenues, and foreign exchange earnings over the medium-term.

Second, lower than anticipated FDI inflows could reduce financing of the current account deficit and result in a drawdown of reserves, thereby adding further pressure on the exchange rate. The continued depreciation of the exchange could pose further challenges to the authorities' disinflation efforts. Furthermore, the increase in retail fuel prices following the subsidy removal and exchange rate depreciation will be headwinds for inflation, keeping it above single digit over the medium-term.

Third, lower than expected revenue mobilization and reemergence of spending pressures could lead to fiscal slippages. The baseline assumption is that the Government will adhere to its medium-term fiscal consolidation targets. Failure to do so and the consequent widening fiscal deficits could worsen macroeconomic imbalances and hinder economic stability. In addition, the resulting expansion of government borrowing could crowd out the private sector's access to credit with adverse consequences for private sector investment and growth. Similarly, the sharp rise in public debt in recent years has led to a change in the risk of debt distress rating from 'moderate' to 'high' for both external and overall public debt.

Large payment arrears across several sectors pose a challenge to budget implementation and could result in further fiscal slippages. Although the stock of payment arrears is estimated to have reached SLL 1.1 trillion (3.5 percent of GDP) in 2018, it is likely to be higher still as invoices remained unprocessed while arrears have also accumulated in pension contributions.

Finally, financial sector weaknesses pose risks to growth. High lending rates, slow private sector credit growth and weak asset quality and low levels of liquidity in some banks could negatively impact financial sector stability and economic growth over the medium-term. The high cost of funds, which is underpinned by a risky lending environment including macroeconomic imbalances, remains the main challenge to private investment and bank growth.

1.9. Policy Reform Priorities

Given the above risks to the growth outlook, addressing the bottlenecks to sustained growth through economic diversification and addressing existing macroeconomic weaknesses would be crucial for building a resilient economy, capable of reducing poverty and boosting shared prosperity. Sierra Leone can sustain robust real economic growth and reduce poverty by:

i) **Maintaining macroeconomic stability**; The authorities should sustain fiscal consolidation policies to strengthen macroeconomic stability and economic growth. The Government should ensure that fiscal targets are met consistently. The continuation of vigorous revenue mobilization efforts and structural reforms to improve tax efficiency should be complemented with stringent expenditure rationalization policies such as efficient wage control through payroll automation and biometric registration of all civil servants; improvements in public procurement by limiting the use of the sole-sourcing method of procurement and implementing e-procurement; and a strict prioritization of capital expenditures to allow spending on essential infrastructure and social programs. Given the recent spike in public debt, the authorities should improve debt management by implementing a debt management strategy that inter alia, discourage non-concessional borrowing. Also, the capacity of the debt management unit should be strengthened to improve debt recording and reporting. The authorities should also implement measures to discourage further accumulation of arrears, including strengthening the capacity of its cash manage committee and the Fiscal Risk and SOE Oversight Unit, strict implementation of price norms in procurement and improving commitment controls. The BSL should continue to tighten monetary policy to reduce inflation to single digits and ensure that exchange rate will continue to be market determined to allow the economy to adjust to external shocks and maintain export competitiveness. The central bank's interventions in the foreign exchange market should be limited to smoothening excessive volatility but avoid encouraging speculative activities. The development of money markets including the interbank foreign exchange markets should be prioritized to allow for efficient price discovery and the efficacy of monetary policy. The authorities should also ensure full implementation of structural reforms for strengthening banking supervision and regulation, including ongoing efforts to restructure the two state-owned banks. BSL should conduct independent Asset Quality Reviews for all banks to ensure proper loan classification and provisioning practices and develop time-bound supervisory action plans.

ii) **Improving productivity in agriculture**: The Government should ensure full implementation of structural reforms to enhance the productivity of staple crops (rice and cassava) and increase the production of cash crops (coffee and cocoa). Promoting private sector participation in agricultural inputs market especially for fertilizer, seeds and agrochemicals and targeted investments in rural infrastructure such as feeder roads and storage facilities would be vital for boosting productivity of agriculture and diversifying the economy. Given growing climate risk and the potential decline in rainfall intensity, the authorities should adopt policies for strengthening the agriculture sector's resilience including climate-resistant seeds and inputs. The authorities should also implement strategies to improve access to finance for commercially oriented smallholder and subsistence farmers. Enhancing financial literacy, increasing investment in the financial infrastructure and incentivizing financial operators to expand agent networks and access points would be critical to providing finance for smallholder farmers. Improving access to land is critical for promoting farm employment and enabling the rural poor to earn viable livelihoods.

iii) **Striving for value addition and increased productivity in manufacturing firms/services to diversify the economy beyond reliance on the primary sectors:** With Sierra Leonean firms being generally less productive than, for example, firms in Benin and Cote d'Ivoire, it crucial for the authorities to implement policies to improve firm-level productivity. The Government should make targeted interventions to encourage private investment in selected value chains, such as food processing for rice and fish. Facilitating access to credit and training programs for a targeted number of formal and informal entrepreneurs could have substantial productivity spillover effects. The Government should undertake targeted investment in Information Communication Technology (ICT) and energy to promote firms' use of technology and reduce cost of production. The Simplifying and reducing the fixed costs of business registration are crucial for encouraging new entrants and promoting post-entry survival of young firms.

iv) **Increasing investment in physical capital is vital for developing the infrastructure and unlocking the bottlenecks to sustained growth:** Improving the quality of electricity supply, by reducing the frequency and duration of power outages could free up capacity in the manufacturing (including food processing) and services sectors (formal and informal) and expand digital financial services and mobile penetration. Investment in ICT to expand the fiberoptic network could further enhance the footprint of digital financial services and mobile phone penetration.

v) **Investing in human capital and skills:** The Government should sustain current policies to increase human capital through the free quality education and health programs and promote the efficiency of public service delivery. In the medium term, an increase in human capital resources at the national level will improve the business climate, boosting the output of private sector activities and the attractiveness of Sierra Leone for future investment. Improved health also reduces days lost to illness, increasing the supply of labor for agriculture or informal non-farm enterprises. Furthermore, quality education has been shown to improve the uptake of modern farming practices and allow, for example, fishermen and fish traders to move up the value chain.

Part 2: Financial Inclusion and Development

Sound financial systems underpin economic growth and development. Robust financial systems generate jobs and improve productivity. It gives people the confidence to invest and save money and allows for the efficient flow of funds towards their most productive uses. Access to finance also improves a country's overall welfare because it enables people to thrive and better manage their needs, expand their opportunities and improve their living standards. When people are financially included, it's easier to manage consumption, payments and savings, access better housing, healthcare and education, and start small businesses.

Figure 14: Private Sector Credit/GDP (%), low-income SSA countries

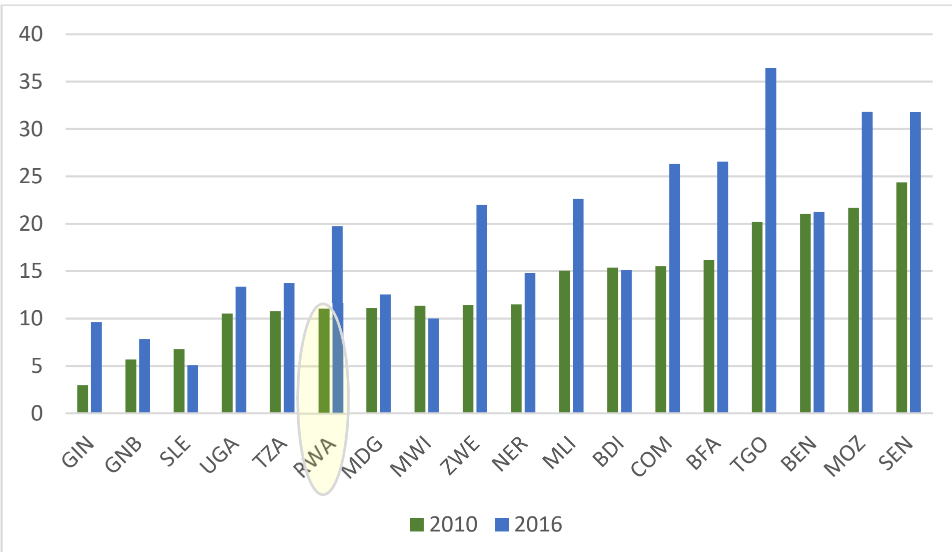
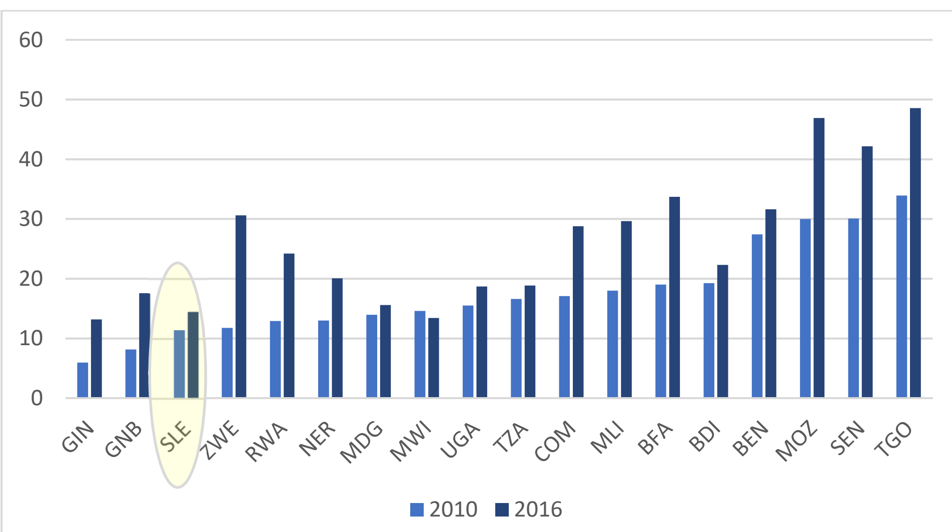


Figure 15: Bank Assets/GDP (%), low-income SSA countries



Sierra Leone is falling behind peer countries in increasing the depth of the financial sector. Financial depth can be measured based on the size of the financial markets relative to the overall size of the economy. The traditional measure of financial depth is credit to the private sector from deposit money banks compared to GDP. Private Sector Credit/GDP was 5.3 percent in 2018 and has declined by 31 percent since 2010. As shown in Figure 14, this is one of the lowest amongst all low-income SSA countries and one of the few that has seen a decline in recent years. While private sector credit is declining, overall financial sector assets have increased in recent years (Figure 15) and has mainly been driven by an increase in deposits (which are the sole source of funding for the banking system). In spite of this increase in funding, private sector credit has remained low as bank credit/bank deposits has declined and is one of the lowest amongst all low-income SSA countries (Figure 16).

Figure 16: Bank Credit/Bank Deposits (%), low-income SSA countries

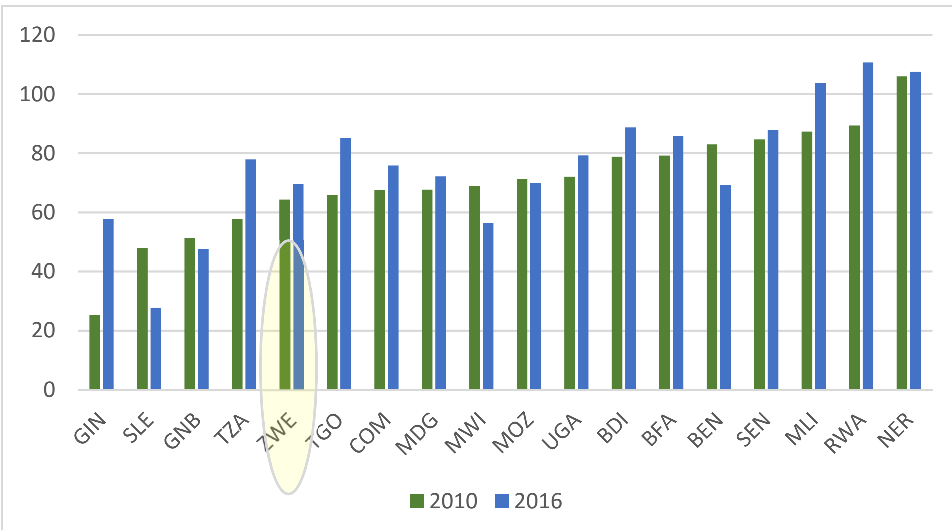
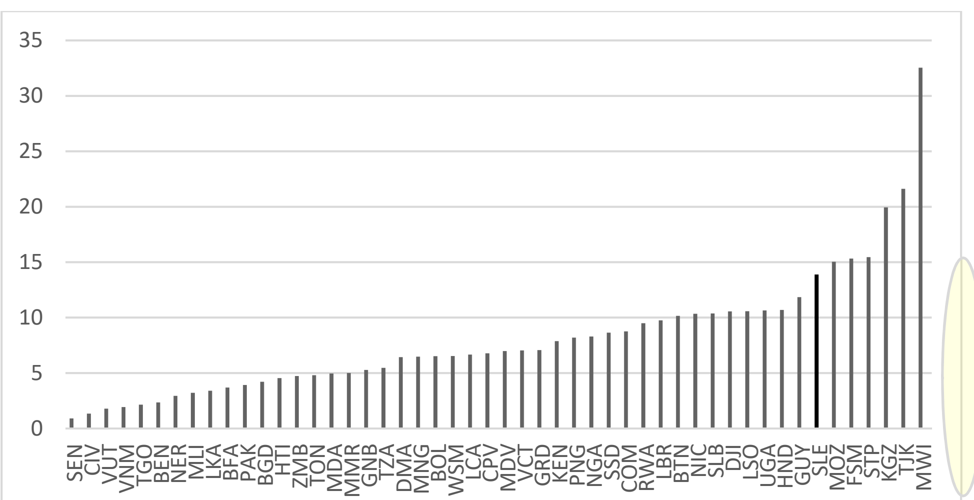


Figure 17: Bank lending/deposit spread (2017, IDA countries)



Sierra Leone has one of the most inefficient and costly financial systems relative to peer countries. An efficient financial system should perform its intermediating functions in the least costly way possible. If intermediation is costly, the higher costs usually gets passed on to customers. One measure of efficiency is the bank lending/deposit spread. This spread is 13.85 percent in Sierra Leone and is one of the highest amongst all IDA countries (Figure 17).

Sierra Leone has made extremely limited progress in increasing financial inclusion relative to peer countries, and a major driver of this is the limited penetration of digital finance. In the past three years, financial inclusion indicators such as the penetration of account growth have grown much more rapidly in peer countries, with Sierra Leone having experienced the lowest growth amongst all low-income SSA countries. The same is true for the penetration of digital finance, which is also has experienced the lowest growth amongst all low-income SSA countries.

Sierra Leone is falling behind in developing and deepening its financial system and increasing access to finance for household and SMEs. Why this is happening is a complex question. This paper aims to identify key policy reforms that can contribute to deepening of the financial system, but it does not attempt to provide a comprehensive reform roadmap for financial sector development. Rather it focuses on two areas that can contribute to this needed deepening of the financial sector. These areas are: 1) improving the role of the state in the financial sector; 2) increasing the penetration of digital Finance. Prior to sections focusing on these two areas, an overview of the financial sector in Sierra Leone is presented.

2.1. Financial Sector Overview in Sierra Leone

A. Access to Finance for Households

Financial inclusion is low and is growing at a significantly slower rate compared to its peers. In 2017, only 19.8 percent of the adult population had an account at a formal financial institution or with a mobile money provider. This increased from 15.6 percent in 2014 but remains significantly lower than other similar countries. While the increase has been relatively modest, many peer countries have seen significant growth rates in financial inclusion over the past few years (Figure 18).

There is a significant unmet demand for financial service products. Table 1 presents survey data from FINDEX about the main reasons for not having an account. The primary reasons for people not having an account is because they are too expensive (28.5 percent) and because they lack the necessary documentation (28.9 percent). While cost and documentation are the main barriers, less than one percent indicate that they do not have a need for financial services. Thus, it appears that there is significant demand for financial products if barriers such as pricing, documentation, and other barriers identified in Table 1 are overcome.

There is a significant amount of borrowing outside of the financial system. This is likely to be at higher rates than those available from banks. Borrowing from financial institutions in Sierra Leone is also much lower than in peer countries (Figure 19). Only 4.3 percent of survey respondents indicated that they have borrowed from a financial institution. However, 49 percent of survey respondents indicated that they had borrowed any money in the last year, 29 percent indicated that they had borrowed from family or friends, and 18 percent from savings clubs (Table 2)

A significant percentage of people save in Sierra Leone, but only a small percentage utilize financial institutions for their savings. The percentage of adults utilizing financial institutions for savings is also much lower in Sierra Leone compared to peer countries (Figure 20). However, 54 percent saved money in the last year, with 34 percent using a savings club or someone outside the family (Table 3). There also appears to be a significant unmet demand for savings product offerings based on the low percentage of savers who are utilizing the financial system.

Figure 18: Account Penetration in Sierra Leone and other low-income SSA countries

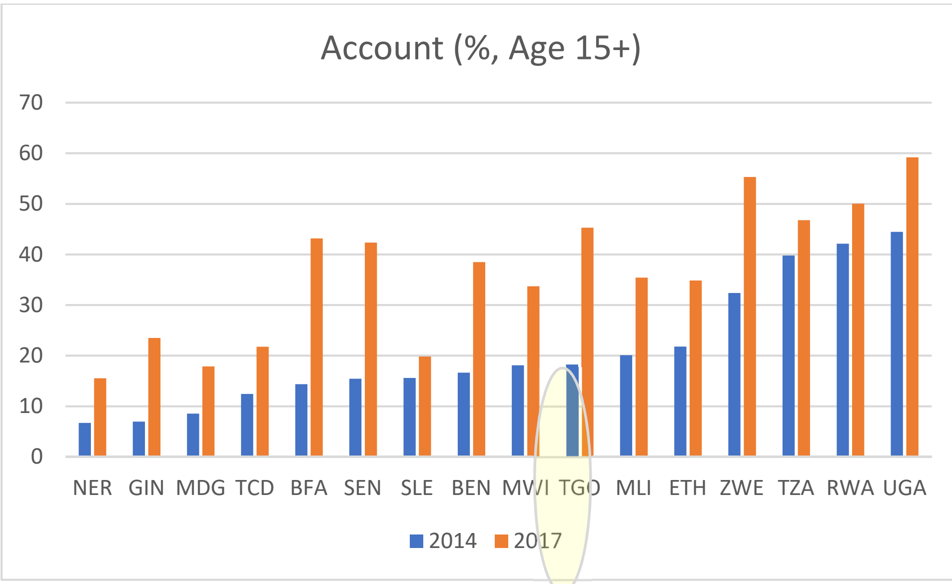


Figure 19: Credit Penetration in Sierra Leone and other low-income SSA countries

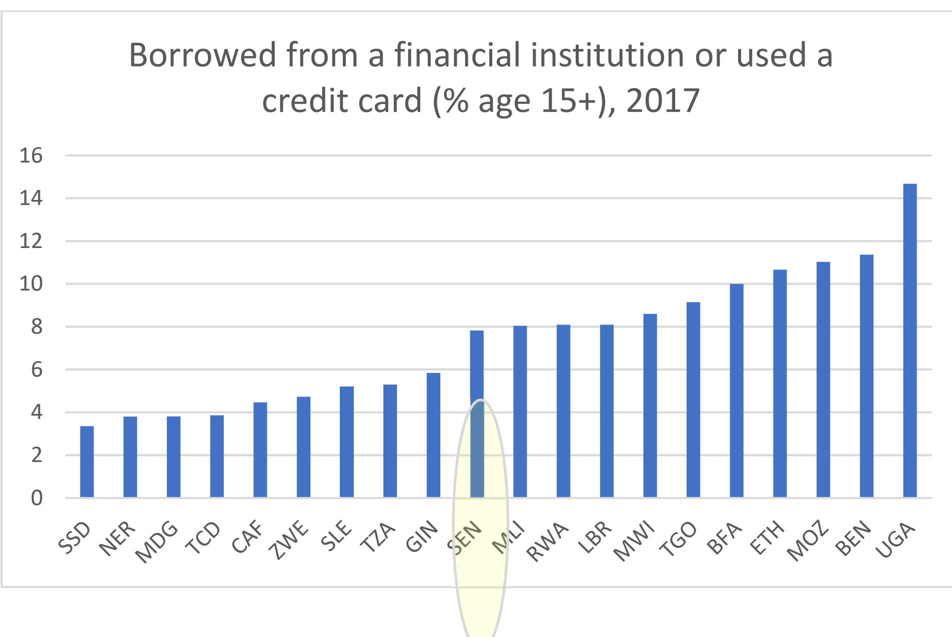


Figure 20: Savings Penetration in Sierra Leone and other low-income SSA countries

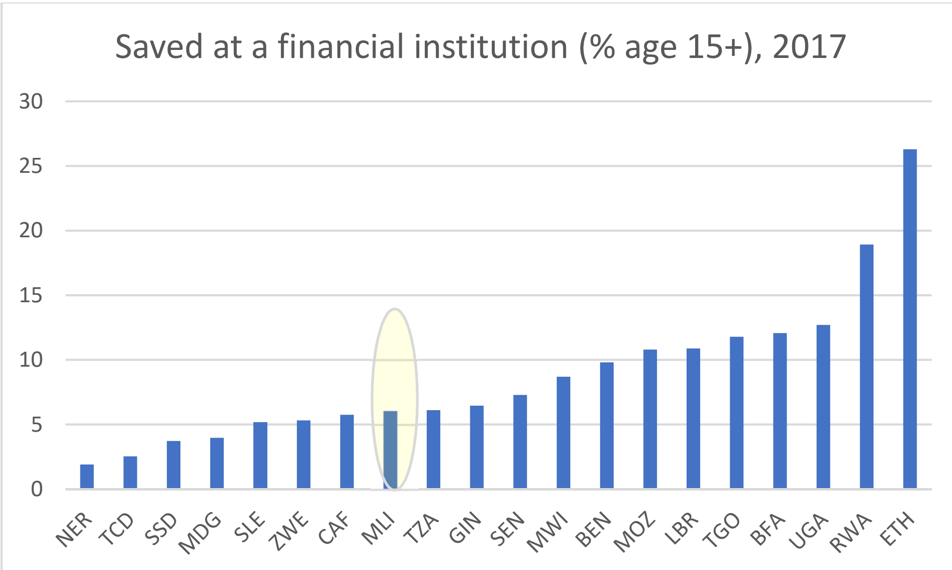
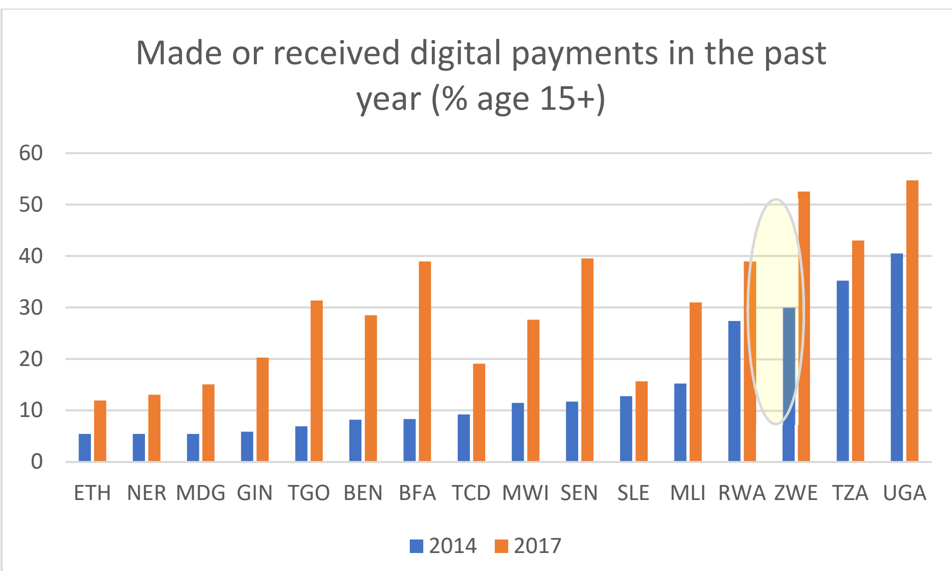


Figure 21: Penetration of Digital Payments in Sierra Leone and other low-income SSA countries



The adoption of DFS has been much lower than in peer countries. The G-20 High-level Principles for DFS defines it as "financial products and services, including payments, transfers, savings, credit, insurance, securities, financial planning and account statements. They are delivered via digital/electronic technology such as e-money (initiated either online or on a mobile phone), payment cards and regular bank accounts."[6] DFS has been a major driver of increased financial inclusion in many countries. However, the penetration of digital financial services in Sierra Leone has been relatively minimal relative to peer countries (Figure 21). 12.7 percent of the adult population made or received digital payments in 2014. While it has increased to 15.6 percent in 2017, the majority of peer countries have seen significant increases during that seem time period. The usage of mobile phones to check account balances is also extremely low relative to peer countries (Figure 22). While Sierra Leone lags in the adoption of digital finance products relative to peer countries, there is a significant percentage of households with access to a mobile phone. While mobile phone penetration is lower than in peer countries (Figure 23), 45 percent of the adult population has access to mobile phones and this does not fully explain why DFS penetration is growing so slowly in Sierra Leone.

Figure 22: Usage of mobile phone or internet to check account balances, Sierra Leone and other low-income SSA countries

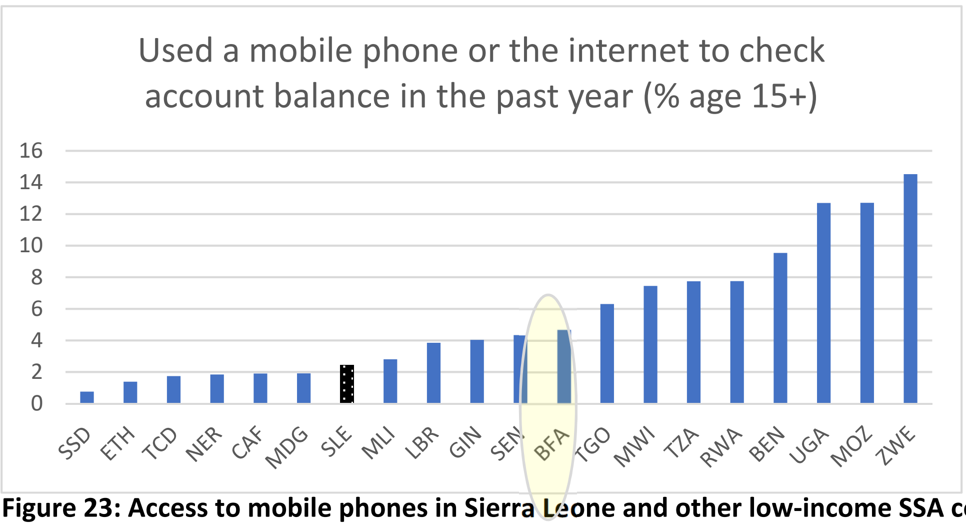
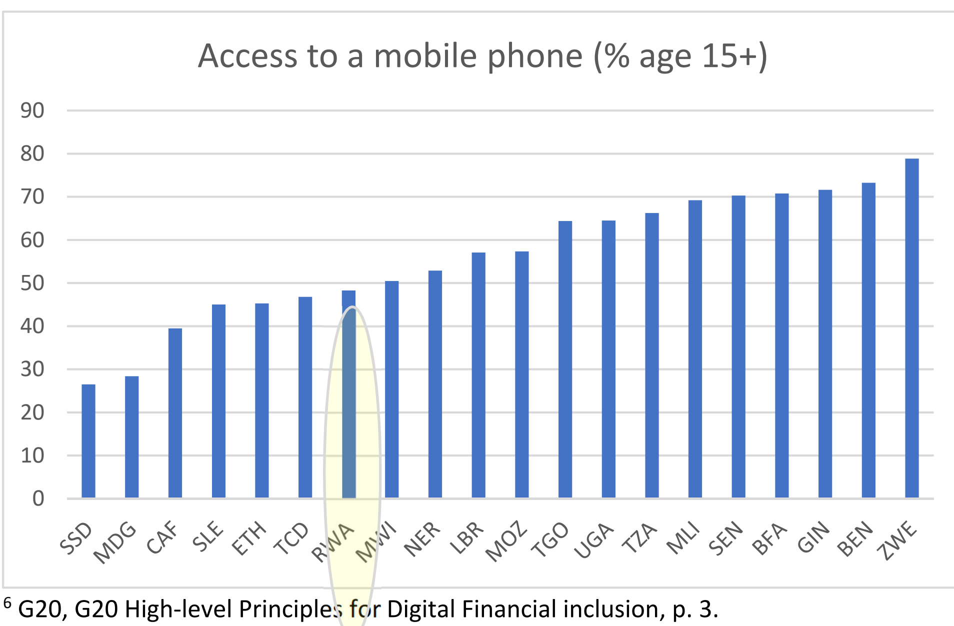


Figure 23: Access to mobile phones in Sierra Leone and other low-income SSA countries

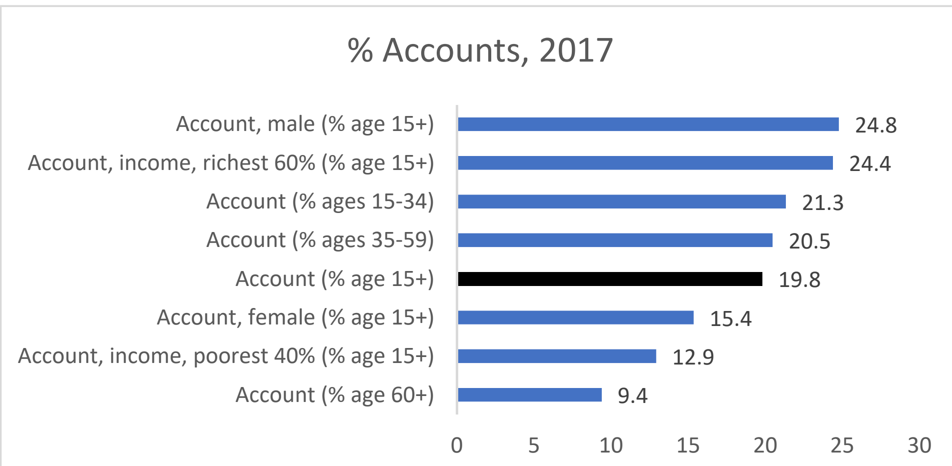


[6] G20, G20 High-level Principles for Digital Financial inclusion, p. 3. https://www.gpfi.org/sites/default/files/documents/G20%20High%20Level%20Principles%20for%20Digital%20Financial%20Inclusion%20-%20Full%20version-.pdf

Financial inclusion varies, with women and the poor facing even greater barriers. While the percent of adults with accounts in Sierra Leone was 19.8 percent in 2017, the percentage for women was only 15.4 percent. The poorest 40 percent and those over 60 years old also had significantly lower account usage than the average.

Women are financially excluded due to an array of issues and have different financial lives than men, the latter of which requires tailored products and services. In Sierra Leone, women are more financially excluded than men due to a number of reasons including: social and cultural barriers, literacy, legal and regulatory barriers, and lack of relevant products, among others. In this context, women's financial lives and challenges differ to men's, due to, among others, their: longer life expectancies resulting in a higher likelihood of spending part of their retirement as widows, higher likelihood of career interruption due to child rearing responsibilities, and primary responsibility as caregivers at home. These responsibilities mean that women demand different financial products and services than men. Thus, making the quest for financial inclusion of women distinct from that of men.

Figure 24: Penetration of Accounts in Sierra Leone



B. Access to Finance for Enterprises

Access to finance is the largest business environment constraint for enterprises in Sierra Leone. Based on the 2017 enterprise survey in Sierra Leone, access to finance was listed as the most significant business environment constraint by almost 40 percent of firms interviewed. None of the other top 10 constraints were chosen by more than 12 percent of firms interviewed.

Small firms face particular barriers in accessing finance. Access to finance was listed by 44 percent of small firms as the most significant constraint. However, it was not amongst the top three for medium or large enterprises (Figure 26). Small firms also have significant lower usage of checking/savings accounts and borrowing than medium and large firms (Figure 27).

The lack of financial sector depth and inefficiency leads to enterprises utilizing other sources of credit for investment. The majority of investments by enterprises are made utilizing their own funds and financed internally. This is particularly high for smaller firms (Figure 28).

Table 1: Account Usage and Reasons for Not Having an Account, FINDEX

	Account (% age 15+)	Financial institution account (% age 15+)	No account because financial institutions are too far away (% without a financial institution account, age 15+)	No account because financial services are too expensive (% without a financial institution account, age 15+)	No account because of lack of necessary documentation (% without a financial institution account, age 15+)	No account because of lack of trust in financial institutions (% without a financial institution account, age 15+)	No account because of religious reasons (% without a financial institution account, age 15+)	No account because of insufficient funds (% without a financial institution account, age 15+)	No account because someone in the family has an account (% without a financial institution account, age 15+)	No account because of no need for financial services ONLY (% without a financial institution account, age 15+)
2017	19.8	13.0	18.2	28.5	28.9	10.1	4.1	77.6	4.3	0.6

Table 2: Borrowing Behavior, FINDEX

	Borrowed any money in the past year (% age 15+)	Borrowed from a financial institution (% age 15+)	Borrowed from a savings club (% age 15+)	Borrowed from family or friends (% age 15+)	Borrowed to start, operate, or expand a farm or business (% age 15+)	Credit card ownership (% age 15+)	Debit card ownership (% age 15+)
2017	49.0	4.3	18.0	29.1	10.8	1.5	1.7

Table 3: Savings Behavior, FINDEX

	Saved any money in the past year (% age 15+)	Saved at a financial institution (% age 15+)	Saved to start, operate, or expand a farm or business (% age 15+)	Saved using a savings club or a person outside the family (% age 15+)	Main mode of withdrawal: ATM (% with a financial institution account, age 15+)	Main mode of withdrawal: bank teller (% with a financial institution account, age 15+)
2017	54.2	5.2	17.0	33.6	10.5	83.0

Figure 25: Top 10 Business Environment Constraints

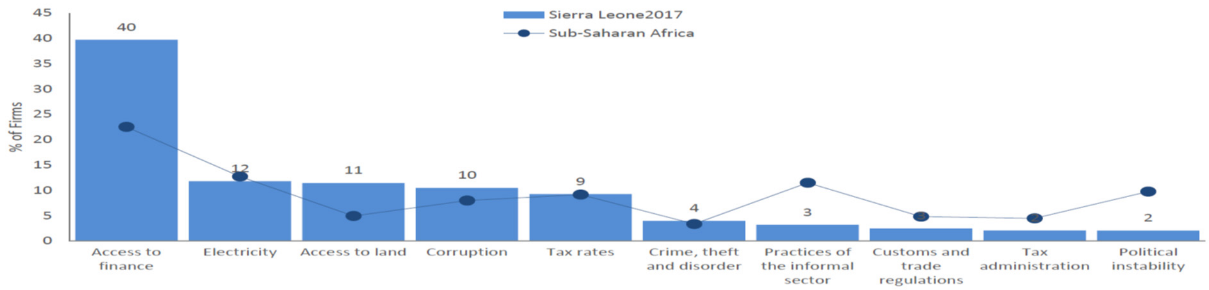


Figure 26: Top 3 Business Environment Constraints by Firm Size

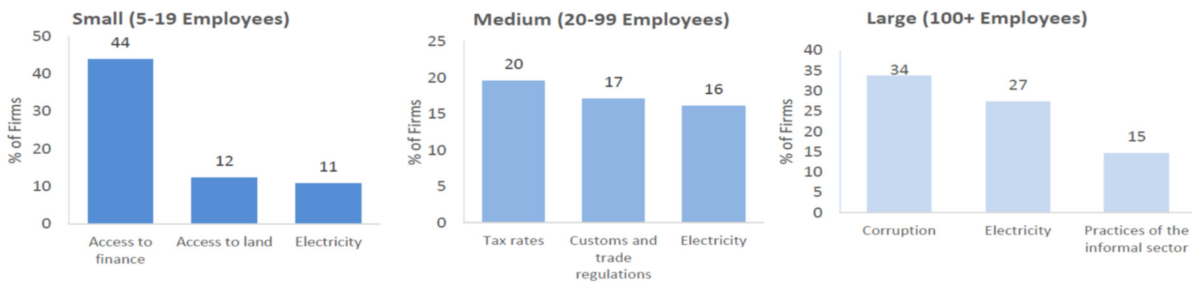


Figure 27: Use of Financial Services by Firm Size

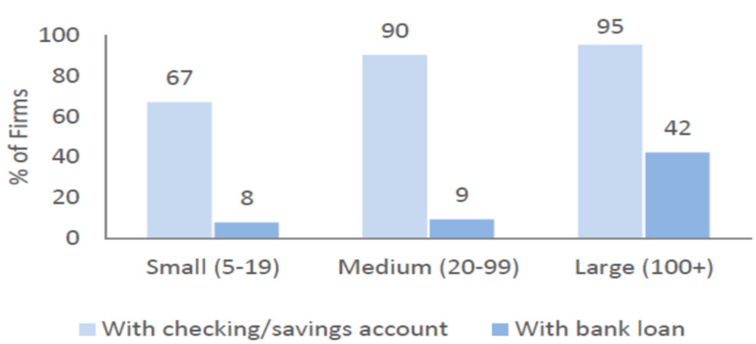
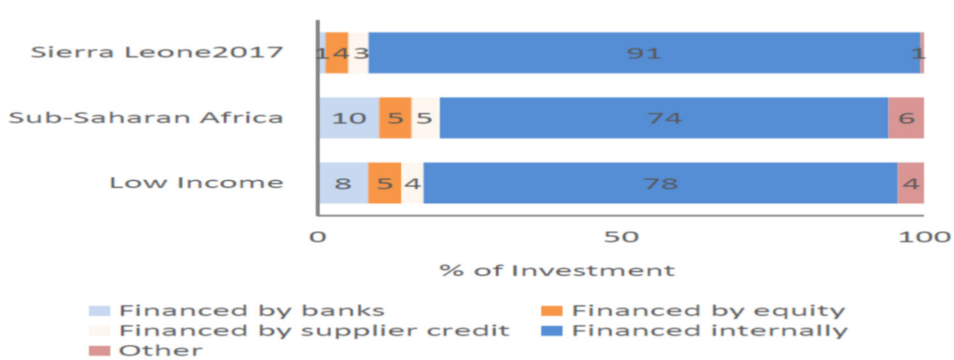


Figure 28: Sources of Financing for Purchases of Fixed Assets



C. Financial Service Providers

The financial sector is dominated by the commercial banking sector (see Table 1). There are 14 commercial banks operating in Sierra Leone (10 are foreign owned, 2 are domestic, and 2 are state-owned). These account for 80 percent of the total assets in the financial system. The only other sizable institution, the National Social Security Insurance Trust ("NASSIT") accounts for 17 percent of total assets. There are also 18 credit-only microfinance institutions (MFIs), 5 deposit taking MFIs, and 17 community banks, 59 financial services associations (FSAs), an Apex Bank, 2 mobile financial services providers, 11 insurance companies, a stock exchange, and 62 exchange bureaus.

Table 1: Components of the financial system by total assets (in Le trillion)

	2012	2013	2014	2015	2016	2017
Commercial banks	3,618	4,329	4,817	5,287	6,333	7,432
Community banks	24	30	41	41	41	61
NASSIT	660	810	994	1,180	1,414	1,551
Credit microfinance				26	85	67
Discount houses	23	21	12	21	21	18
Deposit-taking microfinance	50	43	51	59	59	161
Leasing company			2	-	-	-
FSA	-	-	-	30	38	47
Apex Bank	-	-	8	32	39	39
Total	**4,377**	**5,233**	**5,926**	**6,677**	**8,030**	**9,377**

Source: BSL

Box 3. Evolution of the banking industry in Sierra Leone[7]

Prior to Sierra Leone gaining independence in 1961 and subsequent establishment of the Bank of Sierra Leone (BSL) in 1964, the West African Currency Board (WACB) was responsible for the issue of currency in Sierra Leone. The WACB was established in 1912 and was also responsible for currencies in The Gambia, Ghana and Nigeria. Following independence, the country established its own currency. In 1963, the BSL Act was passed into law and the BSL started operations on 4th August 1964 which marked the issue of the Leone as a legal tender.

In late 1980s the financial system was comprised of the banking sector with four (4) commercial and eight (8) rural banks. The four commercial banks were Standard Charted Bank (SL) Limited, Barclays Bank (SL) Limited, Sierra Leone Commercial Bank (SLCB), and International Bank for Trade and Industry (IBTI). Standard Chartered Bank (SL) Ltd and Barclays Bank (SL) Ltd had Standard Chartered Bank PLC and Barclays Bank PLC as major shareholders, SLCB was wholly state-owned and IBTI was privately owned. There were also other financial institutions such as the National Development Bank which had a commercial banking window, the National Cooperative Development Bank, the Post Office Savings Bank, the Sierra Leone Housing Corporation, the Finance and Trust Corporation, the Alliance Housing Corporation and insurance companies.

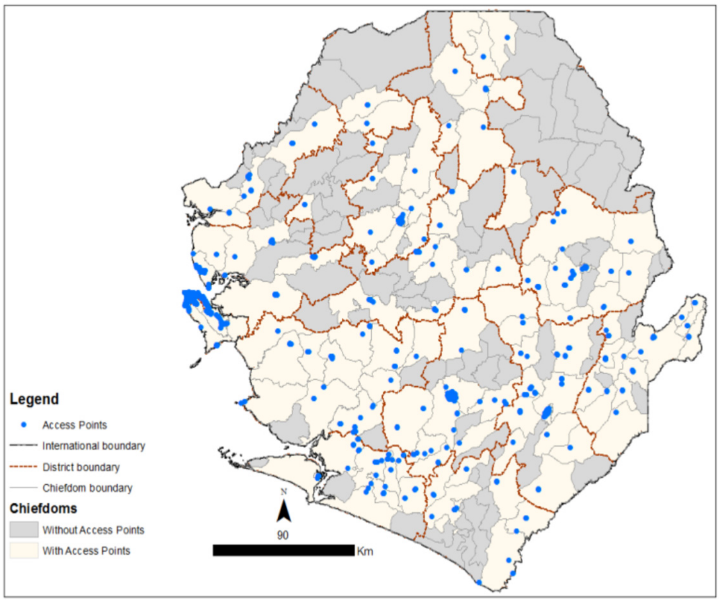
In the early 1990s, the Bank of Credit and Commerce International (BCCI) and Meridian Bank also received licenses to operate in Sierra Leone, bringing the number of commercial banks to 6. Following the intensification of the rebel war (1991-1999), some of the branches of commercial banks were closed as well as all rural banks. The First Merchant Bank (FMB) Sierra Leone Limited commenced operations in 1999 and 17 Foreign Exchange Bureaux were licensed to undertake spot transactions in foreign currencies at different dates. In 2000, the Barclays Bank PLC, the major shareholder of the Barclays Bank (SL) Limited, sold its shares to the Government of Sierra Leone. The bank was renamed, Rokel Commercial Bank (SL) Limited.

At the end of 2017 the total number of commercial bank branches was 14. Other financial institutions were also established: The First Discount House (SL) Limited, the Home Finance Company (SL) Limited and 5 foreign exchange bureaux. Three more banks and six branches were established in 2001.

[7] Bank of Sierra Leone, 2017 Financial Stability Report

Access to financial services is limited by the number and types of access points, which are concentrated in urban areas. The 2017 BSL geospatial mapping survey highlights that there are 1,811 active financial service access points. Overall mobile money comprises 75 percent of access points, while MFIs and banks comprise only seven and six percent, respectively. In terms of geographic dispersion, 41 percent of access points are in Western Urban and Bo alone, while 41.5 percent of chiefdoms in the country do not have any financial service access points, including mobile money. Community Banks (CB), Financial Service Associations (FSA), deposit taking microfinance institutions (MFIs), credit only MFIs, and mobile money providers, have a greater presence in rural areas than banks, which are primarily located in urban areas.

Figure 29: Access Points in Sierra Leone



Access Points	No.	Percent
Mobile Money Agents	1,356	75%
Microfinance Institutions (MFIs)	125	7%
Commercial Banks	110	6%
Foreign Exchange Bureaus (FEB)	103	6%
Financial Services Associations (FSA)	57	3%
ATMs	43	2%
Community Banks	17	1%
TOTAL	1,811	

Source: Geospatial Data Analysis and Mapping for Financial Inclusion Report, BSL, 2017.

Banks in Sierra Leone have a low propensity to lend to the private sector. Net loans to net assets have remained low and remains less than 20 percent (Figure 30). Banks also remain relatively liquid, with net loans/net deposits at over 27 percent (Figure 31). On the other hand, banks are holding increasing levels of T-bills (Figure 32) as the 1-year T-bill rate has increased from slightly less than 10 percent in 2015 to over 20 percent (Table 2)

Figure 30: Net Loans/Net Assets

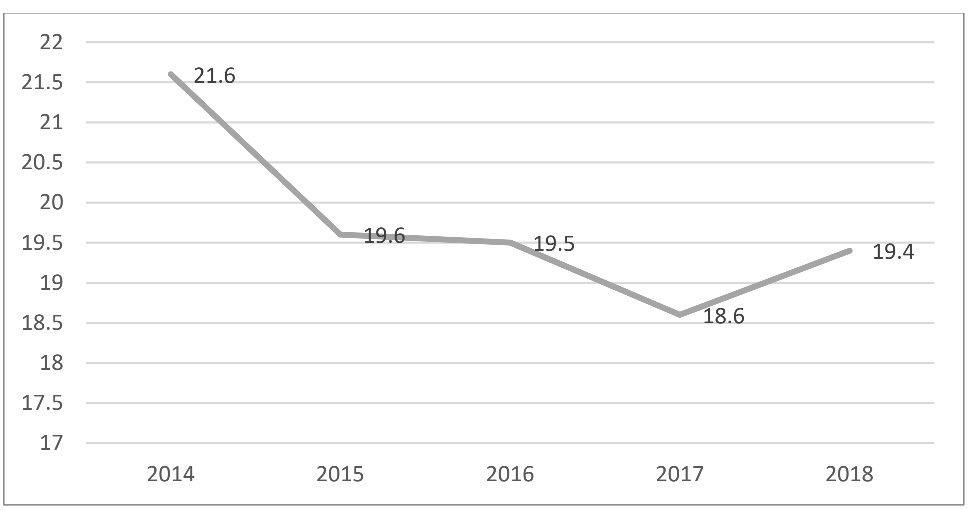


Figure 31: Net Loans/Net Deposits

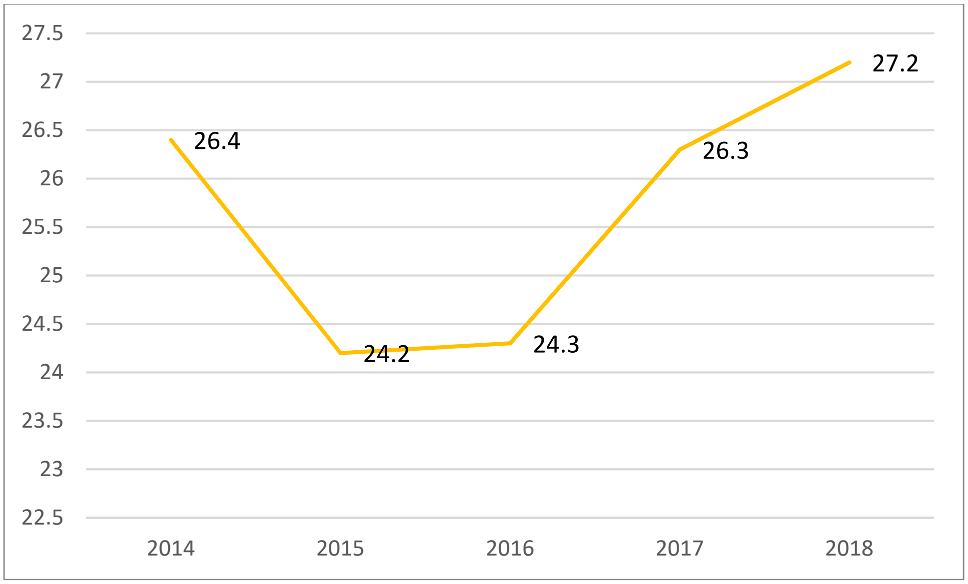


Figure 32: T-bills/total assets

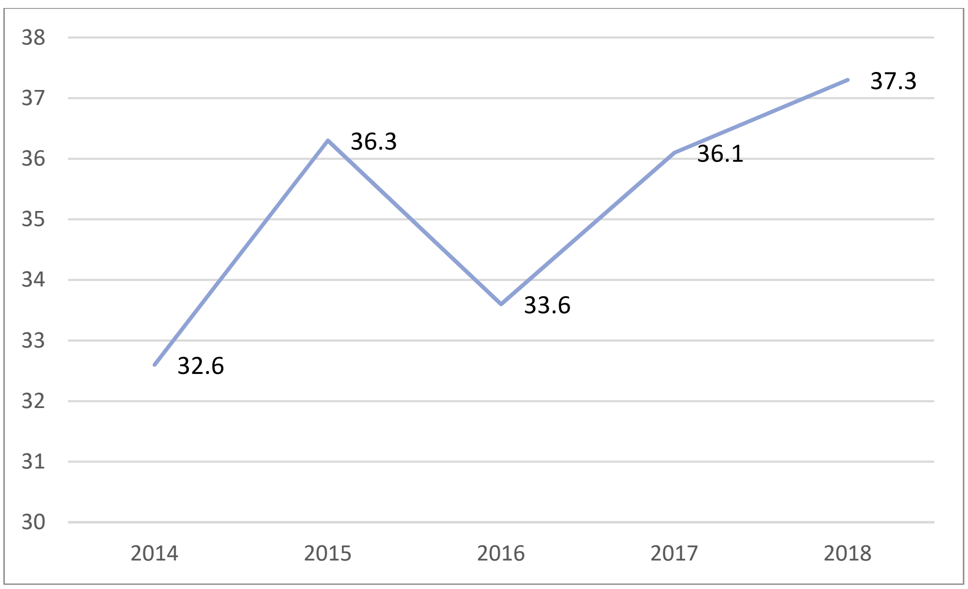
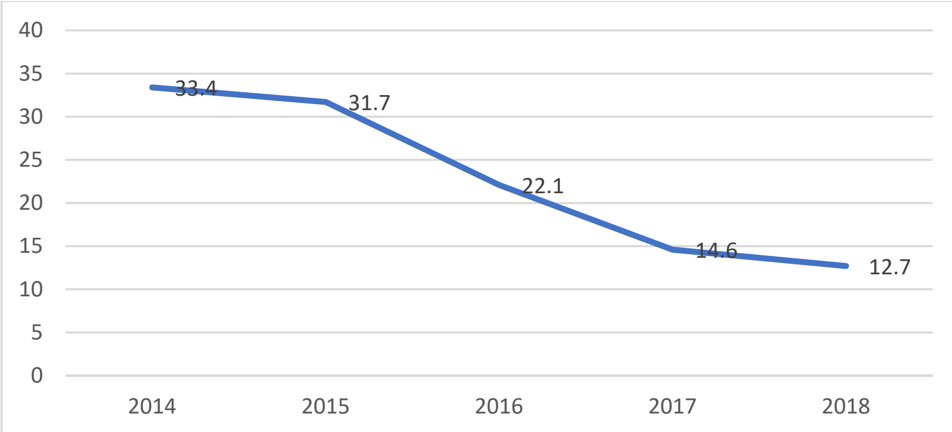


Table 2: Average Yields

INTEREST RATES (Yearly Averages)	2012	2013	2014	2015	2016	2017	2018
Monetary policy rate (MPR)	20,0	10,0	10,0	9,5	11,0	14,5	16,5
Commercial banks savings (effective)	6,4	4,7	3,2	2,5	2,4	2,4	2,4
Commercial banks 3 months (effective)	9,8	5,6	4,2	3,0	2,9	2,9	2,9
Commercial banks 12 months (effective)	11,9	8,6	6,6	5,3	5,8	5,8	5,8
Treasury bills 3 months (effective yield), average	19,0	3,4	2,4	1,1	9,4	8,2	7,8
Treasury bills 6 months (effective yield), average	25,5	7,5	2,8	3,1	16,2	9,7	8,1
Treasury bills 1 year (effective yield), average	25,8	9,5	5,1	9,9	30,2	21,2	23,2
T-bond I - year (effective yield), average	20,0	6,0	5,0	5,0	5,0	5,0	5,0
T-bond 2 - year (effective yield), average				13,5	14,4	14,4	14,4
Commercial bank lending (overdraft rate)	**21-29**	**19.7-25.3**	**19.23 - 25.14**	**18.12 - 24.80**	**17.92 - 24.77**	**17.92 - 24.78**	**17.92 - 24.78**

Source: BSL

Figure 33: Non-performing loans (%)



Although NPLs have declined in recent years, concerns about asset quality remain. NPL levels exceeded 30 percent and have declined in recent years. However, they remain higher than the prudential limit of 10 percent. The significant increase in NPLs took place in 2013 and 2014, and at the same time as the overall slowdown in economic activities due to a decline in iron ore prices and the Ebola virus

Overall, the banking system is well capitalized and resilient to shocks, with capital adequacy at almost 40 percent (Figure 34). This is well above the 15 percent minimum requirement. However, there is significant variation amongst banks. Figure 35 segments the commercial banks operating in Sierra Leone based on their CAR, percent T-bills, and asset size. Three broad segments emerge:

A) These are mostly Private banks that invest only about 20 percent of their assets in T Bills, hold more loans than T Bills, and are generally larger and older institutions.

B) These tend to be more recently-established private banks. Most of their assets are held in correspondent accounts or T Bills (40 to 60 percent of their assets) and therefore have large regulatory capital excesses.

C) These are the two state owned banks and are also heavily invested in T Bills, but with far less regulatory capital to maneuver.

Figure 34: Capital Adequacy (%)

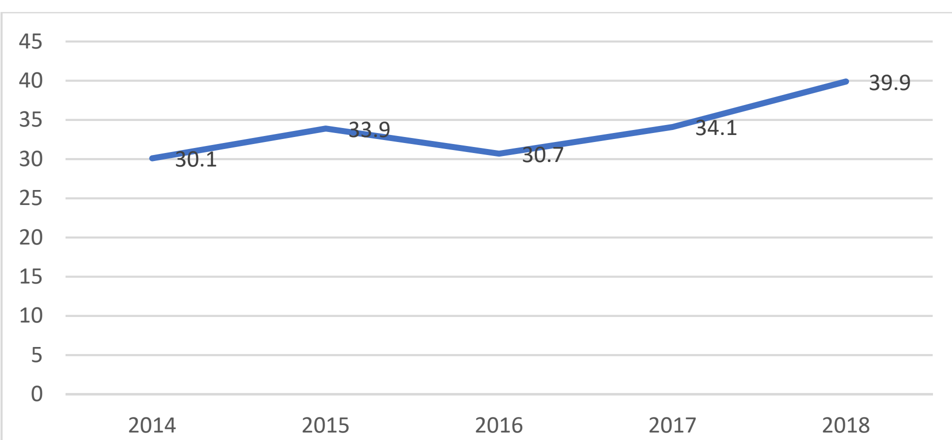
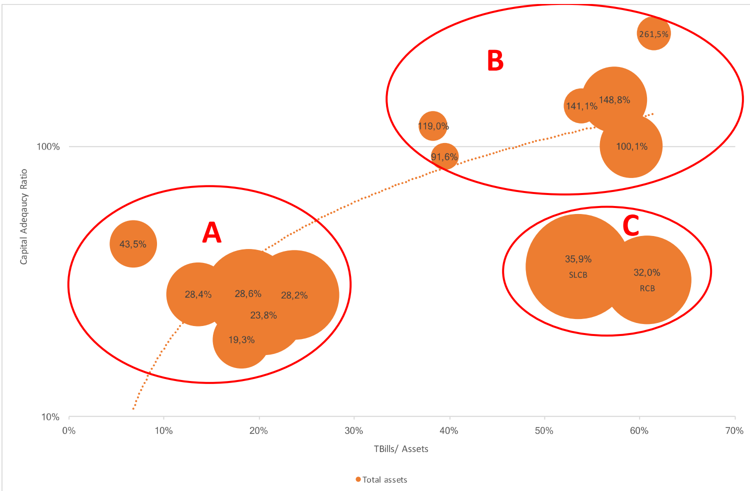


Figure 35: Commercial banks operating in Sierra Leone segmented by T-bills to total assets, CAR, and asset size



2.2. Role of the Government in the Financial Sector

Governments can play a number of different roles in financial sector development. This includes: (i) as the owner of commercial financial institutions; (ii) through direct intervention in supporting access to finance for the enterprise sector; (iii) as the regulator and supervisor of financial institutions; (iv) by putting in place the necessary financial infrastructure; and (iv) facilitating the creation of public pension funds. This section provides reform priorities in each of these five areas.

A. Role of the Government as the Owner of Commercial Banks

There are two state owned banks operating in Sierra Leone, Sierra Leone Commercial Bank (SLCB) and Rokel Commercial Bank (Rokel). SLCB is 100 percent state owned, while Rokel used to be Barclays Bank's subsidiary in Sierra Leone and was acquired by the government in 2000.

SLCB and Rokel have both had financial difficulties in recent years. Both banks have recently suffered significant losses primarily due to high levels of non-performing loans and poor credit decision making. Both of the banks have returned to profitability, but this has mostly been driven by utilizing their substantial funding to invest in government T-bill that are yielding over 20 percent. A major driver of the poor performance of the two institutions in recent years has involved political interference in the operations of the banks.

The ownership structure of commercial banks, and whether it is private or state-owned, does not matter in most cases. There are examples of extremely well run and managed privately owned and state-owned commercial banks throughout the world. What is important is that they are operated on a commercial basis and with sound governance practices.

While ownership of commercial banks does not matter, state owned banks have been shown to have several negative impacts when poorly run. Like all government owned commercial enterprises, state owned banks can be negatively impacted through political interference. State-owned banks that negatively impact financial sector development tend to do so in two ways:

(i) increasing credit to the public sector and decreasing credit to the private sector

(ii) related party activities with SOEs and other government related entities

(i) Increasing credit to the public sector and decreasing credit to the private sector (crowding out)

The state-owned banks operating in Sierra Leone have a significantly higher share of T-bills to total assets than the other banks operating in Sierra Leone. The two state owned banks both have over 50 percent of their assets held in T-bills, which has grown significantly during the past few years. The two banks now have, by far, the largest T-bill portfolio amongst the banks operating in Sierra Leone.

Figure 36: T-bills/Total Assets

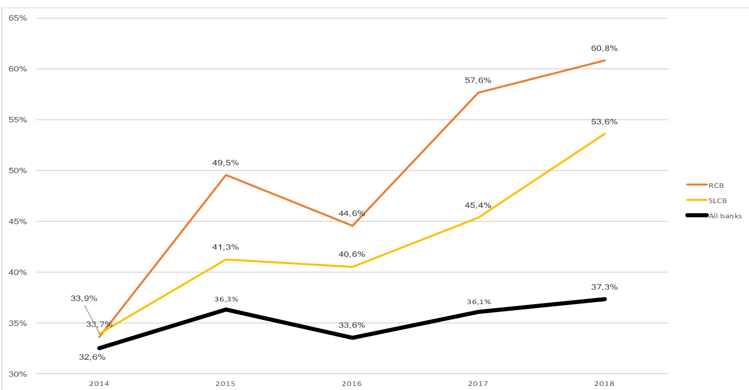
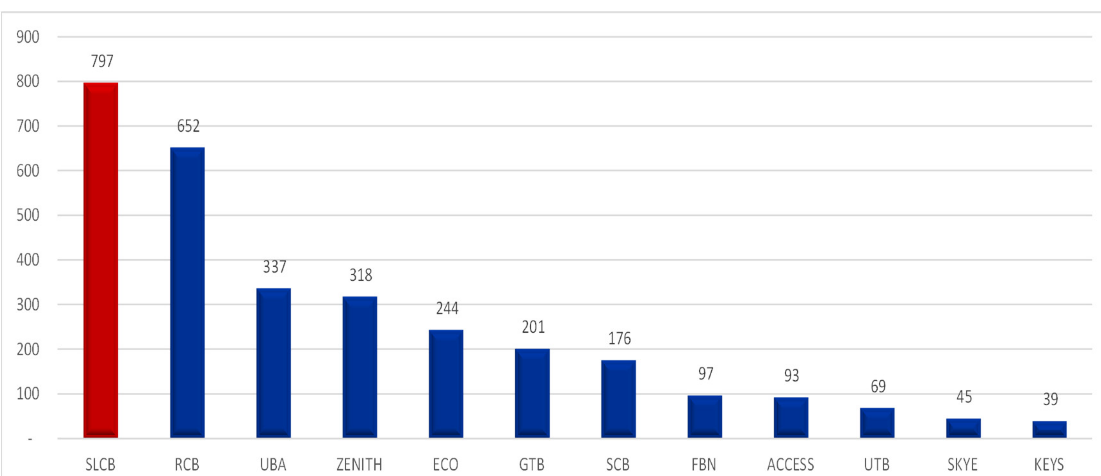


Figure 37: T-bills held by commercial banks operating in Sierra Leone, end-2018



Both of the institutions are also providing less credit to the private sector than the other banks operating in Sierra Leone. Both SLCB and Rokel's have a much lower percentage of private sector lending than other banks operating in Sierra Leone. This is confirmed by both Figure 38 and 39, which examine lending as a percent of asset and deposits.

Figure 38: Net Loans/Net Assets for state-owned banks and all banks in Sierra Leone

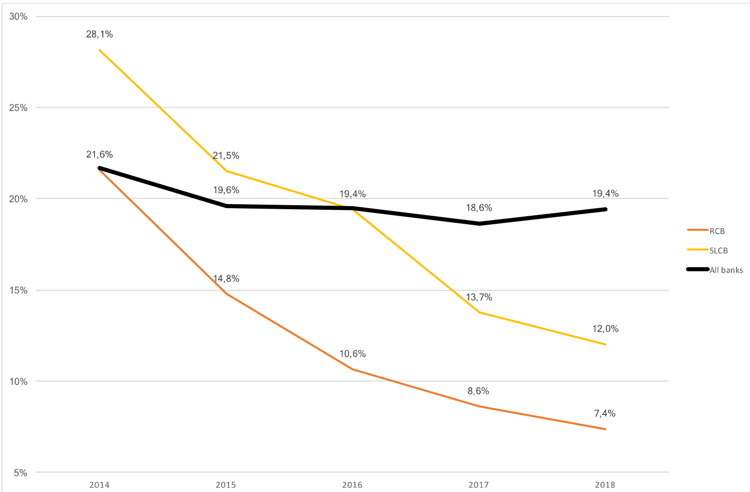
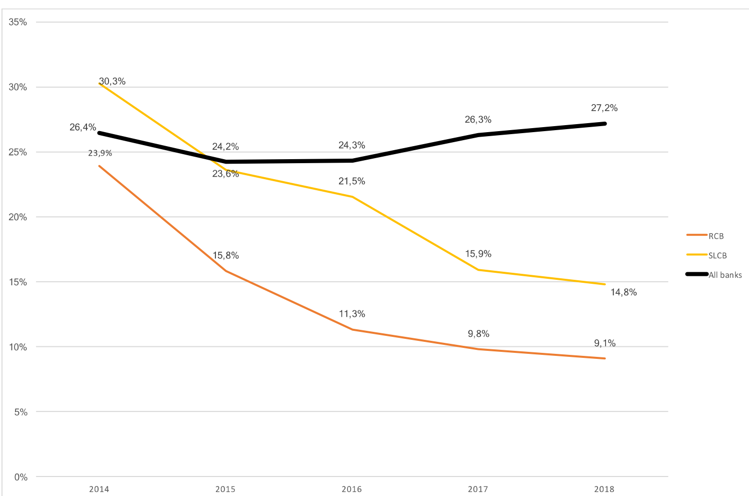


Figure 39: Net Loans/Net Deposits for state-owned banks and all banks in Sierra Leone



The behavior of both of the state-owned banks is contributing to the "crowding out" of private sector lending. Outside of the two-state owned banks, the other banks operating in Sierra Leone have maintained a relatively stable asset portfolio in terms of lending and T-bills. On the other hand, the two state-owned banks have decreased their commercial lending activities significantly, while at the same time increasing their holdings of T-bills. The government, through its ownership of the state-owned banks, has contributed to the decline in the access to finance for enterprises and households by increasing their T-bill holdings and decreasing their lending activities.

(ii) Related party activities with SOEs and other government related entities.

Commercial relationships with SOEs and other government related entities with state-owned banks have been problematic in many countries. This is due to the ability to provide "soft budget support" via state owned banks to a government entity that normally would not be able to access finance if the government was not also the lender. Countries with significant State- Owned Enterprises (SOEs) have had a particularly poor history with state-owned banks, as the banks are often used as a captive source of lending for poor performing SOEs or other government related entities. Deposits from government related entities have also been problematic in some countries, as they are sometimes not placed on market terms and thus potentially could be utilized to provide financing for poor performing SOEs.

State Owned Banks have performed particularly poorly in countries facing fiscal difficulties. In many cases where state owned banks were utilized to provide "soft budget support" to loss making or poorly performing public entities, this masking of what are essentially fiscal transfers has led to significant problems due to the ability to delay dealing with these problematic entities in a transparent manner. State owned banks have also been utilized to mask other fiscal issues, such as providing preferential loans to government contractors as a way to mask arrears.

State owned banks are also often utilized to achieve social objectives rather than focusing only on commercial objectives. This can include providing loss-making services to certain customer segments or maintaining loss-making branches in underserved areas of a country. If the government does ask a state-owned commercial bank to undertake loss-making activities, it is very important that this subsidy is transparent and that it does not undermine the profit seeking motivation of a commercial bank.

Developing a reform strategy for the state-owned banks

The government should first determine whether it wants to retain or divest one of both institutions. As indicated earlier, both public and private ownership of commercial banks has been successful in other countries. If the government chooses to remain involved as the owner of commercial banks, a decision also needs to be made about the appropriate institutional structure (e.g., does it make sense to have two banks?).

If a decision is made to retain ownership of commercial banks, the government should put in place mechanisms to eliminate related party activities. This includes limits on activities with state owned entities such as SOEs, local governments, etc. This will limit the potential for providing "soft budget support" to problematic state entities in a non-transparent manner.

The government needs to develop a robust corporate governance framework for both state-owned banks and state-owned enterprises. Corporate governance improvements are critical to mitigating against political interference[8]. Past efforts at reform have made clear that poor state-owned bank performance, where it occurs, is caused less by exogenous or sector-specific problems than by fundamental problems in their governance—that is, in the underlying rules, processes, and institutions that govern the relationship between state-owned bank managers and their government owners. Driven by the divergence of political interests between ownership (by the government on behalf of the citizens of the country) and control (by the directors and managers that run the company), these governance

[8] Excerpted from World Bank Toolkit on Corporate Governance from SOEs.

problems can include complicated and at times contradictory mandates, the absence of clearly identifiable owners, politicized boards and management, lack of autonomy in day-to-day operational decision making, weak financial reporting and disclosure practices, and insufficient performance monitoring and accountability systems. Where these shortcomings are more common, state-owned banks may also be a source of corruption.

Many countries have taken concrete and significant steps to address these challenges, improve their operations, and achieve the benefits of good corporate governance. Evidence shows that a good corporate governance system in a country is associated with a number of benefits for all companies, whether private or state owned. These benefits include better access to external finance by firms, which in turn can lead to larger investments, higher growth, and greater employment creation; lower costs of capital and higher firm valuation, which make investments more attractive and lead to growth and greater employment; improved operational performance through better allocation of resources and more efficient management, which create wealth more generally; reduced risk of corporate crises and scandals, particularly important given the potentially large economic and social costs of financial crises; and better relationships with stakeholders, which help improve social and labor relationships, help address such issues as environmental protection, and can help further reduce poverty and income inequality. Taken together, these benefits can boost the efficiency of state-owned banks and, in turn, that of the economy as a whole and make transactions among companies more competitive and transparent; result in more efficient allocation of resources by reducing the fiscal burden and fiscal risk of state-owned banks; lead to greater public and private investment in critical sectors such as infrastructure that contribute to competitiveness and growth; and reduce vulnerabilities in the financial system and promote financial sector development more broadly.

There are several elements to improve state-owned bank governance that should be put in place, including:

- Establishing a sound legal and regulatory framework for corporate governance
- Creating proper ownership arrangements for effective state oversight and enhanced accountability by developing a sound performance-monitoring system
- Promoting financial and fiscal discipline by reducing preferential access to direct and indirect public financing and monitoring and managing the fiscal burden and potential fiscal risk
- Professionalizing boards by developing a structured and transparent process for board nominations, and defining the respective roles of the state, as owner, of boards, and of management.
- Enhancing transparency and disclosure by improving reporting and disclosure and strengthening the control environment.

Considering the current performance issues related to SOEs in the country and the historical linkages between poor performing SOEs and the commercial state-owned banks, it is important that the corporate governance improvements apply not only to the state-owned banks but also to all state-owned enterprises. This is needed to limit the potential for "soft budget" support for SOEs and other government related entities in the future if the government chooses to retain ownership in the commercial banking sector.

The government needs to determine an appropriate strategy for whatever commercial banks it decides to retain banks. It also needs to ensure that the bank has the appropriate capabilities and control environment to execute on the chosen strategy. Considering the underdeveloped nature of the financial sector in Sierra Leone and the fact that SLCB and Rokel are amongst the largest banks in the country, they have the potential to drive financial sector innovation and development if they are well managed.

B. Role of the Government in Direct Interventions to Improve Access to Finance

Government's also support filling market gaps and providing financial services to underserved populations utilizing other mechanisms. These include Development Finance Institutions, credit guarantee schemes, and other support programs for the enterprises sector.

Development Finance Institutions fulfill long-term development roles by filling market gaps in long-term credit and agriculture finance and by promoting access to finance for SMEs (see Box 4). However, the track record of DFIs globally is mixed, with a considerable number with high levels of NPLs, poor risk management, and significant political interference. In the current environment where there are concerns about the governance of other state-owned financial institutions, it is not recommended that the government create a new Development Financial Institution.

Box 4: Apex Bank Sierra Leone

The Apex Bank Sierra Leone was established in 2014 jointly by the Ministry of Agriculture, Forestry and Food Security (MAFFS) and International Fund for Agricultural Development (IFAD). Apex is licensed by the to provide financial and non-financial services to its network of RFIs (Rural Finance Institutions). These RFIs currently include CBs and FSAs. The vision of Apex Bank is to "improve the quality of life of the economically disadvantaged rural Sierra Leoneans mostly from the rural communities through the provision of inclusive and sustainable financial services (such as savings, credit, remittances, insurance and payment services) through the community banking system (the CBs & FSAs).

However, three key issues have affected the achievement of the development objectives[9]:

a. Lack of capitalization of the network: the Apex Bank has been unable to mobilize external funds as planned. This strongly affects its capacity to increase outreach and reach sustainability. Operational Self Sufficiency (OSS) of the Apex Bank remains very low and there is a need for a clear business strategy should be defined to reach viability, without which the sustainability of the services provided by the network (FSAs and CBs) will be compromised.

b. Limited results in terms of agricultural financing, in particular for small scale farmers, due to a lack of an adequate agricultural finance strategy and the limited success in mobilizing fund.

c. Limited autonomy of the Apex Bank in terms of strategic decisions, which has led in particular to the signing of agreements with unconducive conditions for the Apex Bank sustainability.

Government's also often provide credit guarantee schemes to impact the limited availability of credit to SMEs or other underserved segments of the economy. Credit guarantee schemes typically serve as risk transfer and risk diversification mechanisms. By replacing part or all the risk of the borrower with that of the issuer of the guarantee (depending on the coverage ratio), they tend to lower the lender's risk. They can also diversify risk by guaranteeing loans across different sectors or geographic areas. Credit guarantee schemes are designed to enable lenders to learn about the creditworthiness of constrained borrowers without incurring the initial risks involved and to allow these borrowers to establish a repayment reputation and in time graduate to nonguaranteed loans. Public guarantee schemes are often supported by IFIs, such as the World Bank Group, and other donors, and have become one of the most popular mechanisms of intervention to expand the use of financial services for credit-constrained firms, such as SMEs. of spreading and diversifying risk. The government may wish to consider working with IFIs

[9] https://www.ifad.org/en/web/operations/project/id/1710/country/sierra_leone

and donors to create new credit guarantee schemes to support access to finance for targeted segments of the enterprise sector.

Government's also often support the development of the enterprise sector through other mechanisms. These include technical assistance to support enterprises gaining access to finance and other grant programs to support the development of the enterprise sector. These are often done by different Ministries in a country and also involve support from multiple IFIs and donors. It is important that these resources are targeted towards those segments of the enterprise sector that are likely to increase productivity and lead to job growth and that the different programs are coordinated and complementary. **Considering the different stakeholders involved, ranging from different government Ministries, IFIs, and donors, that are involved with programs that support the enterprise sector, it is recommended that a centralized coordination body is developed.** This entity would also be responsible for monitoring and evaluating the results of the different programs to ensure that the limited funds that are available achieve the greatest impact.

C. Role of the Government as the Regulator and Supervisor of Financial Institutions

The government plays a key role in developing the financial sector through promoting resilience and stability. One of the key functions that need to be established is an effective supervision and regulatory regime for financial institutions to address the following market failures: (a) anticompetitive behavior, (b) market misconduct, (c) information asymmetries, and (d) systemic instability. These market failures can negatively impact financial sector development, economic growth, and shared prosperity.

The Bank of Sierra Leone (BSL) is the primary regulator and supervisor of financial institutions in Sierra Leone[10]. The BSL has been gradually improving its supervisory and regulatory framework, with amendments to the Banking Law and BSL Act having been submitted to Parliament in October 2018. The BSL is also transitioning to risk-based supervision to ensure that its resources are focused on those institutions where there is greatest risk. The BSL is also increasing its efforts at increasing cooperation with banking supervisor in other countries. To help strengthen the BSL's focus on Financial Stability, the BSL has established a new Financial Stability Department. This department has the responsibility to identify, assess and communicate financial vulnerabilities and risks in the banking system.

For a banking supervisor to be effective, it must have operational independence, transparent processes and sound governance. Improvements in the BSL's governance framework are necessary. This includes efforts underway to reconstitute the BSL Board and Audit Committee, and other improvements that are included in the amendments to the BSL act. and submit to parliament amendments.

Although improvements in the legal and regulatory framework have been made, there is a need to evaluate the implementation of these changes via a Financial Sector Assessment (FSAP)[11]. The Financial Sector Assessment Program (FSAP) is a joint program of the World Bank and IMF. The FSAP provides a comprehensive framework through which assessors and authorities in participating countries can identify financial system vulnerabilities and develop appropriate policy responses. The program also helps bring financial sector analysis closer to the center of economic policy discussions within a country. Participating

[10] The list of main laws that govern the financial system of Sierra Leone are the: Bank of Sierra Leone Act 2011; Banking Act 2011; Borrowers and Lenders Act 2014; Credit Reference Act 2011; Other Financial Services Act 2007 (Stock Exchange); Other Financial Services Act 2001 (all other financial institutions); Payments System Act 2009; Anti-money Laundering and Combating of Financing of Terrorism Act 2012; Companies Act 2009; and Bankruptcy Act 2009.

[11] http://www.worldbank.org/en/programs/financial-sector-assessment-program

in the program helps inform domestic policy-makers of the need for sequenced actions in areas requiring urgent attention and offers countries a comprehensive framework in which to take on financial sector reforms. It also provides countries with an opportunity to measure their compliance with financial sector standards and codes and, therefore, to benchmark their regulatory and supervisory systems against internationally-accepted practices.

Sierra Leone is one of the few countries that has not had an FSAP, and priority should be given to request an FSAP. About 155 countries have participated in the FSAP Program, and more than 300 FSAPs have been conducted since the inception of the program in 1999. That has helped client counties identify vulnerabilities in their financial systems and develop appropriate policy responses.[12] However, there are a limited number of FSAPs that can be conducted every year, especially since it is now mandatory for 29 countries that are considered to be systemically important to conduct one every five years.

D. Role of the Government in Financial Infrastructure

Government's play a key role in establishing critical financial infrastructure that: i) promote the availability and exchange of reliable credit information; and ii) mitigate counterparty risks and promote usage of the financial system through the establishment of a well-functioning payments system. A well-developed financial infrastructure makes credit markets more efficient by reducing information asymmetries and legal uncertainties that may hamper the supply of new credit. This improves the *depth* of credit market transactions and broadens access to finance.

Transparent credit information is a prerequisite for sound risk management and financial stability[13]. Credit reporting institutions, such as credit bureaus, support financial stability and credit market efficiency and stability in two important ways. First, banks and nonbank financial institutions (NBFIs) draw on credit reporting systems to screen borrowers and monitor the risk profile of existing loan portfolios. Second, regulators rely on credit information to understand the interconnected credit risks faced by systemically important borrowers and financial institutions and to conduct essential oversight functions. Such efforts reduce default risk and improve the efficiency of financial intermediation. In a competitive credit market, these efforts ultimately benefit consumers through lower interest rates.

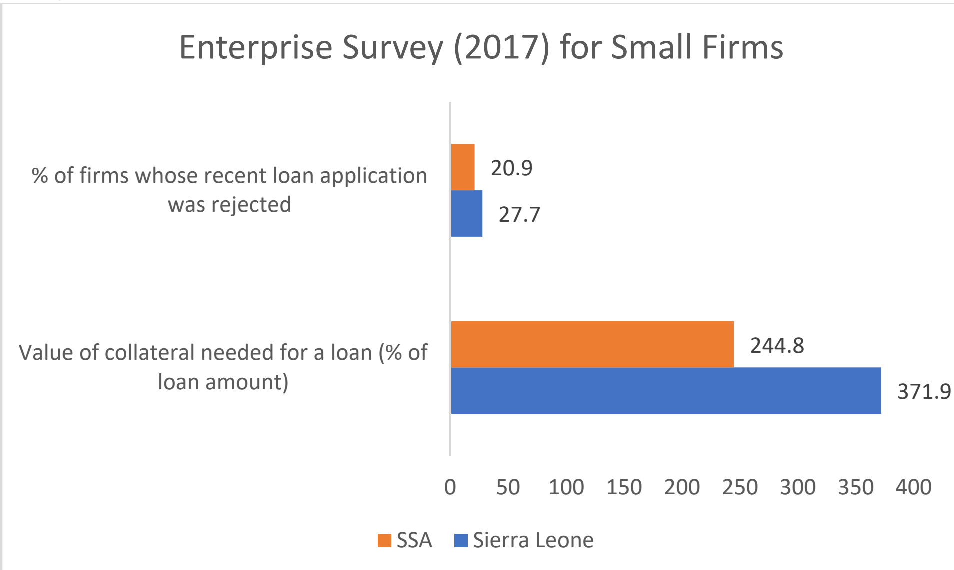
Effective credit reporting systems can mitigate a number of market failures that are common in financial markets around the world, and most severely apparent in less developed economies. The availability of high-quality credit information, for example, reduces problems of adverse selection and asymmetric information between borrowers and lenders. This reduces default risk and improves the allocation of new credit. Information sharing can also promote a responsible "credit culture" by discouraging excessive debt and rewarding responsible borrowing and repayment.

Perhaps most important, credit reporting allows borrowers to build a credit history and to use this "reputational collateral" to access formal credit outside established lending relationships. This is especially beneficial for small enterprises and new borrowers with limited access to physical collateral.

[12] https://www.worldbank.org/en/topic/financialstability
[13] http://www.worldbank.org/en/publication/gfdr/gfdr-2016/background/credit-bureau

In recent years, the BSL has made progress in establishing a credit reference bureau (see Box 5). However, collateral requirements remain extremely high and a large percentage of enterprises in Sierra Leone continue to have their applications rejected (see Figure 40).

Figure 40: Enterprises in Sierra Leone continue to face high collateral requirements and a high chance of rejection



Box 5. BSL Credit Reference Bureau[14]

The BSL's Credit Reference Bureau was set up by an Act of Parliament in 2011. The CRB is organized as a unit within the BSL and it gathers and maintains database for the formation of credit histories including publicly available information and processes the credit related data to prepare a credit reference report.

The CRB provides credit reports to financial institutions and it receives on average one hundred (100) requests per day. The credit reference bureau since inception has produced forty-four thousand, three hundred and two (44,302) credit reports, of which thirty thousand, two hundred and six (30,206) were requests for credit reports by individuals applying for loans. The Credit Reference Bureau has started receiving data from Community Banks and Microfinance institutions and will start to issue credit reports to them soonest.

Secure, affordable, and accessible payment systems and services promote development, support financial stability, and help expand financial inclusion[15]**.**

Payment and settlement systems are the mechanisms established to facilitate the clearing and settlement of monetary and other financial transactions. Safe and efficient payment and settlement systems:

- Promote economic and financial-sector development by supporting equitable cost-sharing, the efficient distribution of financial resources, and consumers' confidence in the use of money.
- Support financial stability by mitigating settlement risk related to financial transactions and facilitating the smooth flow of liquidity.
- Enable access to transaction accounts as a means to safely store value, and make and receive payments, thus helping to fulfill the World Bank Group's vision of Universal Financial Access (UFA) by 2020.

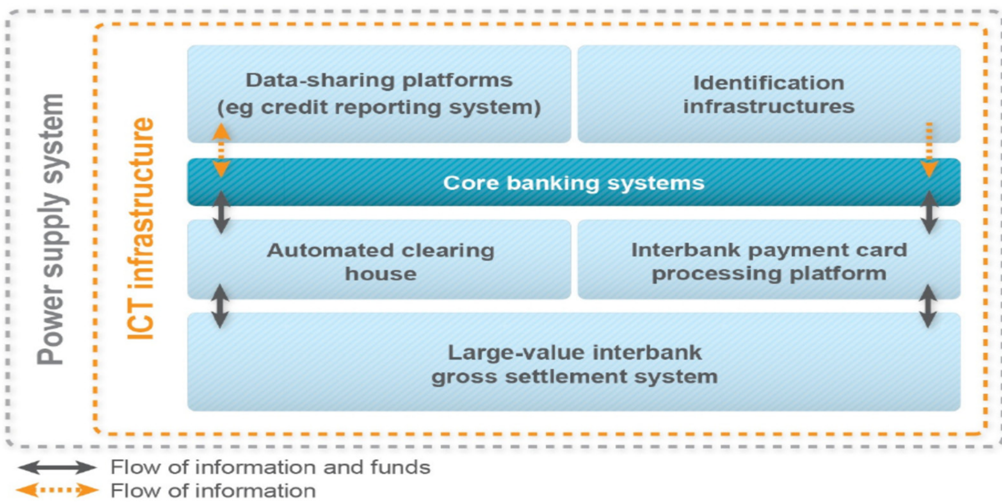
[14] Bank of Sierra Leone, 2017 Financial Stability Report

[15] https://www.worldbank.org/en/topic/paymentsystemsremittances

- Underpin critical reforms in fragile and conflict-affected states and help deliver cash transfers in the aftermath of natural disasters to facilitate relief efforts.
- Support the digitization of Government payments as part of cross-cutting work in areas like Social Protection, eGovernment and Public Financial Management reforms. The work spans across the revenue collection and expenditure side, including large scale programs like tax collection, public sector salary payments, public procurement and Government to Person (G2P) payments.

Key infrastructures include an interbank system for retail electronic funds transfers (i.e. an automated clearing house (ACH)), a payment card processing platform or platforms (i.e. a payments switch) and a large-value interbank settlement system (i.e. a real-time gross settlement system (RTGS)); a robust communications infrastructure; and an effective and efficient identification infrastructure[16]. Absence of any of these infrastructure components hinders the national payment system in exploiting the potential benefits of modern payment instruments, and therefore adversely affects financial inclusion. The interactions between these infrastructure components are shown in Figure 41.

Figure 41: Overview of Payments Infrastructure[17]



Large-value interbank settlement systems have been a focus of central banks for more than three decades and, as a result, they are nearly universally implemented nowadays. While these systems are only rarely associated with financial inclusion efforts, they are a critical foundation as they enable the safe and efficient settlement of many other interbank payments infrastructures. Moreover, there are a number of countries in which the RTGS system is also used for retail payments.

Interbank systems for retail payments – often referred to as ACHs – and interbank payment card processing platforms (card switches) play a more direct role in financial inclusion as these infrastructures are designed for the daily processing (including clearing and often netting) of a large number of payments of typically low value. ACHs have generally focused on two distinct retail payment products: direct credit transfers and direct debit transfers. The existence of a national ACH effectively increases the network size of access points (e.g. ATMs or branches) for individual customers, since it acts as a hub for processing interbank transactions and consequently exhibits positive network externalities.

[16] Excerpted from World Bank Report Payments Aspects of Financial Inclusion, April 2016
[17] World Bank Report Payments Aspects of Financial Inclusion, April 2016

Any branch of a bank or other PSP member of an ACH can be used to initiate a funds transfer to a customer of another ACH member. This supports countrywide reachability, even if a bank does not have access points deployed in specific regions. An interbank payment card processing platform is a mechanism that connects various payment card issuers, typically banks. It allows the exchange of payment card transactions of a bank's cardholders with another bank's merchant, ATM or another card acceptance device – provided that both banks are participating in the platform. Payment card processing platforms also play an important role in increasing the effective size of the access channel network by interconnecting the ATMs and Point of Sale (POS) terminals of different issuing banks. By doing so, they increase the positive network externalities to the benefit of customers. For example, in certain cases, PSPs with a regional or local focus can offer their customers nationwide and even international coverage via card payment platforms.

Sierra Leone introduced an RTGS system in 2013, which currently includes participation by all 14 commercial banks operating in Sierra Leone. The system is responsible for processing large value transactions of above SL 50 million or approximately USD 6 million. According to payment system statistics published by the BSL, 124,788 transactions at a total value of USD 3.2 billion moved through the RTGS in 2015.

The ACH became operational in 2013. The system is an interbank system for retail payments (of less than SL 50 million). All commercial banks in the country participate in the ACH system. However, to date, usage of the system has been very low. A very small proportion of GDP flows through the ACH (0.2 percent), and the lack of volume is likely the result of the very low levels of bank account penetration in the country. Direct credit transactions totaled 126,481 in 2015, with a total value of US$7.6 million. While the ACH can facilitate direct credit; direct debit payments are yet to go live in Sierra Leone. Activating direct debit payments through the ACH has been delayed for a number of years, with a continued lack of momentum on defining agreements, mandate forms and other procedural and regulatory factors.

While Sierra Leone has put in place an RTGS and ACH system, it is critical that a retail payment switch is put in place to facilitate interoperability and innovation. This is a critical missing element of the payments system. The BSL is currently supporting the development of a retail payment switch. This is being financed through a USD 12 million IDA credit, which was approved in January 2019. With the exception of a few banks, which are connected to each other through bilateral agreements and the various institutions connected by ACH, financial service providers, including banks, MFIs, and mobile network operators (MNO) are not connected to each other. Concretely this means most consumers cannot transfer money between a bank account and their mobile wallet or send money from an MFI savings account to a family member whose only form of financial access is a mobile phone. For example, for the market vendor who would like to transfer funds from their mobile money account to their bank account, they can only do so if the two institutions have integrated with each other to facilitate such a transaction. This is especially important in areas that are not serviced by banks. For a teacher who is paid his/her salary at an FSA, the only point of access to these funds is the FSA alone which itself means many teachers have to walk long distances or pay for transport to collect their salaries, while other potentially more convenient locations, such as a mobile money agents or ATMs, are not currently possible. The BSL sees the switch as a solution to this problem by creating a common platform through which all service providers can have access to the payments system. This would allow for interoperability and ultimately contribute to financial inclusion and deepening. Additionally, the switch will help facilitate innovation. For example, the fintech sector is in a holding pattern waiting to adopt services similar to PayPal and informal savings among others but require the national switch to facilitate these transactions.

E. Role of the Government in facilitating Public Pensions

The National Social Security Insurance Trust ("NASSIT") accounts for 17 percent of total financial sector assets. It was established in 2001 as a Statutory Public Trust set up to administer Sierra Leone's National Pension Scheme. NASSIT's main task is to collect contributions and pay pensions to formal sector workers who are covered mandatorily and the self-employed and informal sector workers who can voluntarily choose to join its pension scheme.

There are negative rates of return on investment. Because NASSIT charged such high rates and initially had few pensions to pay, it generated an enormous quantity of reserves. Without a robust financial market, these reserves were invested in politically and socially motivated projects, less focused on generating good returns for the people whose money was being invested. As a result, NASSJT has generated negative real rates of return throughout its history, based on its 2014 Actuarial Valuation. Put in layman's terms, the reserves have not been managed in a way that they will help pay pensions in the future, but instead have been partially lost. The total portfolio now stands at Le347.72 billion and according to the BSL the portfolio includes:

- On-going Real Estate projects (31.5 per cent)
- Corporate Debentures (19.8 per cent)
- Equity investment (14.4 per cent)
- Fixed Deposit (11.3 per cent)
- Government securities (12.0 per cent)
- Call Deposit (8.2 per cent)
- Land Property (2.8 per cent)

There is a need to undertake a detailed review of the asset portfolio of NASSIT. Considering the substantial financial sector assets that are held by NASSIT and the relatively poor historical performance, a detailed review of the portfolio and investment policies should be conducted. If done properly, these financial sector assets could be channeled to more productive investments and lead to the further development of the financial sector in Sierra Leone.

Summary of main recommendations on the role of the government in the financial sector

The government plays a number of roles in the financial sector in Sierra Leone: (i) as the owner of commercial financial institutions; (ii) through direct intervention in supporting access to finance for the enterprise sector; (iii) as the regulator and supervisor of financial institutions; (iv) by putting in place the necessary financial infrastructure; and (iv) facilitating the creation of public pension funds.

Key reform priorities in each area are as follows:

(i) *as the owner of commercial financial institutions* – develop a strategy for the state-owned banks that introduces corporate governance reforms to allow the state-owned banks to operate on a fully commercial basis

(ii) *through direct intervention in supporting access to finance for the enterprise sector* – develop a centralized coordination body that would be responsible for monitoring and evaluating the results of the different programs to ensure that the limited funds that are available achieve the greatest impact.

(iii) *as the regulator and supervisor of financial institutions* – continue efforts to improve governance and transparency of the central bank and enhance banking supervision.

(iv) *putting in place the necessary financial infrastructure* – prioritize development of a retail payments switch to enhance interoperability

(v) *facilitating the creation of public pension funds* – conduct a detailed review of the asset portfolio of NASSIT and the investment policy

2.3. Digital Financial Services

As seen in more developed African markets, mobile money's impact on financial access has demonstrated the potential of DFS to transform and increase access to financial services. Moreover, DFS has helped spur product development and the digital and branchless ways one receives financial services. In terms of supporting inclusion, improved product development and remote access, among others, have helped make financial services in reach for more impoverished segments of society. For example, mobile money accounted for 7 of the 17 percentage points increase in access to financial services in Ghana between 2010 and 2015, and jointly with non-bank financial institutions (NBFIs), mobile money accounted for another 8 of the 17 percent points. Therefore, to help address low levels of financial inclusion and the geospatial dimensions of access as evidenced in limited access points in Sierra Leone, it is critical to bolster the DFS sector to ensure it plays the role it has the potential to.

A. Digital Financial Services Landscape in Sierra Leone

DFS in Sierra Leone are very much at an early stage. At present, when one refers to DFS in Sierra Leone, they are largely talking about the previously discussed electronic bank payments via the ACH and RTGS, mobile money cash-in/cash-out within the same network, and nascent digital credit, the lack of diversity of which inherently results in low DFS uptake and usage. Spurred by the gains of mobile money, there is a small, but growing fintech sector in Sierra Leone.

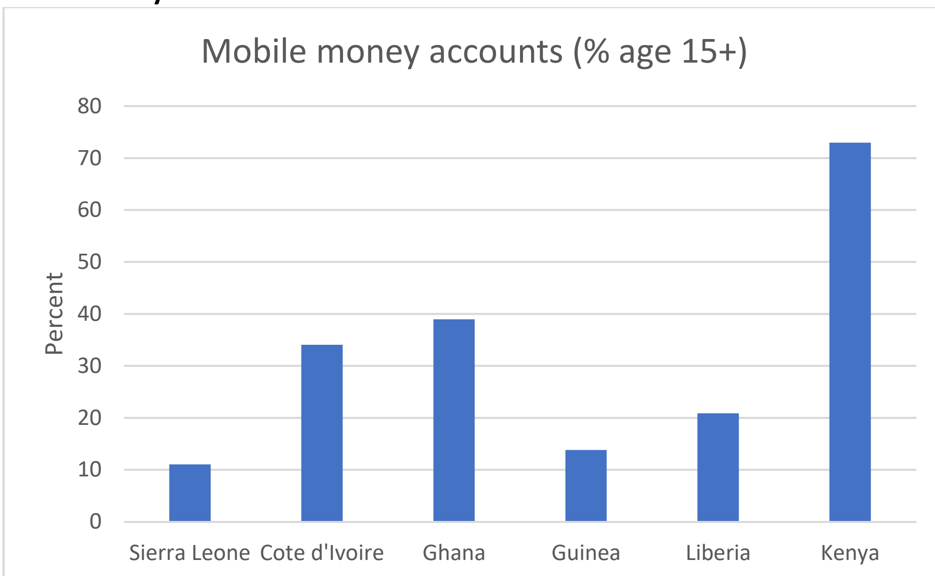
DFS plays a critical role in access to financial services in Sierra Leone. Mobile money accounts currently provide access to financial services for 11 percent of adults in Sierra Leone and mobile money agents currently account for 75 percent of access points in the country. Additionally, while access to financial services (account a financial institution and/or with a mobile money provider) stands at 19.8 percent of the population, 13 percent only have an account at a financial institution, while 11 percent have mobile money accounts, meaning that 6.8 of the 19.8 percent, or 34.3 percent of those that are financially included, only have access to financial services due to mobile money.

The adoption of digital financial services in Sierra Leone is much lower than in peer countries. Mobile money is the main form of DFS available in Sierra Leone and across Africa, yet mobile money account ownership in Sierra Leone is critically low and exemplifies how far behind Sierra Leone is relative to its peers and the DFS giant Kenya (Figure 42). At present, only 11 percent of Sierra Leoneans have mobile money accounts (40), which is below Cote d'Ivoire (34.1), Ghana (38.9), Guinea (13.8), Liberia (20.8), and Kenya (72.9).[18] Cash is still the preferred method of payment with only 1.5 percent of adults having received payments from self-employment through a mobile phone, compared to 8.1 percent in Kenya, 5 percent in Ghana, and 1 percent in Liberia. Similarly, only 2.1 of adults have received payment for agricultural products by mobile phones, compared to 9.4 percent in Ghana, 12.7 in Kenya, while other peers are equally low. Critical to increased mobile money account usage, is increasing mobile phone

[18] Findex 2017.

access, which currently stands at only 45 percent, and the ability to use it in rural areas (thus improving coverage) and for financial transactions (e.g., financial services possible through USSD-enabled feature phones).

Figure 42: Mobile Money Accounts



Source: Findex

Box 6: The case of Kenya and M-PESA
Mobile money in Kenya has been a key driver of financial inclusion, helping to facilitate access to financial services for 24 million people.[19] With M-PESA, owned by Safaricom, as the market leader, mobile money has helped to drive not just financial inclusion, but digital savings, credit, access to bank accounts, and even innovation in the financial sector. M-Shwari, through a partnership with Safaricom and Commercial Bank of Africa, is a digital bank account, which allows customers to save and receive loans through their M-PESA wallet. This partnership has helped banks come downstream, while the credit aspect enables those financially excluded from brick and mortar institutions to generate credit scores. In fact, while mobile money accounts overtook bank accounts in 2009, bank accounts have again taken the lead as they have adapted their models to both compete and collaborate.[20] Similarly, Government has also adapted, allowing the purchase of M-AKIBA, a mobile traded retail bond, available via M-PESA or Airtel Money.[21]

In Sierra Leone, the fintech sector is comprised of a number of companies using or aiming to use open access and/or white labelled software to develop financial products and services that better meet the financial needs of a larger segment of Sierra Leoneans than traditional financial services. The recent first round of the FinTech challenge provided much needed support to the nascent sector, encouraging innovation in a number of critical areas of financial sector development. The first round of the Sierra Leone FinTech Challenge (2017) was an initiative by BSL, in partnership with FSD Africa funded by the U.K. government and UNCDF MM4P, with support from USAID and the Last Mile Trust Fund. The challenge focused on supporting financial inclusion through innovation in the fintech space to test and evaluate regulatory aspects of the winners' technologies and business models. Four businesses were ultimately selected to enter the newly established regulatory sandbox at BSL, to test and evaluate regulatory aspects

[19] CGAP. September 2017. https://www.cgap.org/research/publication/banking-m-pesa-age
[20] CGAP. September 2017. https://www.cgap.org/research/publication/banking-m-pesa-age
[21] M-AKIBA. http://www.m-akiba.go.ke/

of their respective technologies and business models. These businesses were: 1) mypay, which offers a third-party processing solution that allows for P2P, P2B, B2P, and B2B solutions; 2) IDT Labs' miKashBoks (Icommitt) which helps farmers develop savings plans and save over a period of time per their production goals and then purchase inputs; 3) InvestEd which provides a mobile platform to train entrepreneurs, including financial literacy, who then qualify for credit, and 4) Noory is an API that helps to facilitate interoperability.[22]

Box 7: The Bali Fintech Agenda

BSL's support for the regulatory sandbox, adoption of DFS more generally, and the efforts to procure a national switch are in support of the Bali Fintech Agenda; however, as the Economic Update lays out, there is room for improvement in areas of regulation and licensing and the need for various investments to foster development in the DFS and fintech spaces to better be in line with this agenda.

1. Embrace the promise of fintech.
2. Enable new technologies to enhance financial service provision.
3. Reinforce competition and commitment to open, free, and contestable markets.
4. Foster fintech to promote financial inclusion and develop financial markets.
5. Monitor developments closely to deepen understanding of evolving financial systems.
6. Adapt regulatory framework and supervisory practices for orderly development and stability of the financial system.
7. Safeguard the integrity of financial systems.
8. Modernize legal frameworks to provide an enabling legal landscape.
9. Ensure the stability of domestic monetary and financial systems.
10. Develop robust financial and data infrastructure to sustain fintech benefits.
11. Encourage international cooperation and information-sharing.
12. Enhance collective surveillance of the international monetary and financial system.

Beyond the role DFS already play in access to financial inclusion, they stand to play an even more transformative role in people's financial lives. With less than 20 percent of the adult population financially included, innovations in the DFS space from solutions that facilitate increased access to mobile money accounts to new products and services facilitated by the fintech sector, stand to increase demand and thus financial inclusion. Yet there are a series of barriers, and thus opportunities, to DFS development.

B. Barriers to DFS Development

While DFS stands to help promote financial inclusion in Sierra Leone, there are an array of barriers to its development. Critical foundational enablers around the regulatory and licensing regime and investments in infrastructure require improvement. More specifically: 1) the regulatory and licensing regime around DFS is an impediment; 2) general infrastructure deficits raise operating costs, 3) the core underlying infrastructure for a digital economy is rudimentary; 4) DFS infrastructure, such as electronic payment systems, is minimal; and 5) complementary DFS infrastructure, such as a unique ID, is lacking. Additionally, 6) consumer trust and financial literacy in the financial sector and for DFS, key drivers of access and usage, are low.

[22] UNCDF, https://www.uncdf.org/article/3635/four-fintechs-approved-to-enter-the-sierra-leone-sandbox-programme

Foundational Barriers to DFS Development

The regulatory and licensing regime is an impediment

The legal and regulatory environment contains some of the critical elements to foster DFS growth, but it is outdated, not cohesive, and lacks key pieces of regulation, all of which serve to diminish the potential for DFS to play a larger role in access to financial services. Sierra Leone has three of the four of what CGAP notes are the basic regulatory enablers for DFS. The four enablers are: 1) allowing non-bank actors to provide electronic money, 2) allowing DFS providers to use third party agents (such as shops), 3) having a proportionate Anti-Money Laundering (AML) framework, allowing simplified customer due diligence for low risk accounts and transactions, and 4) a consumer protection framework tailored to the range of DFS products and services facilitating safety and confidence in the sector. While Sierra Leone does not have a tiered KYC framework for opening accounts, mobile money accounts are straightforward to open. Furthermore, Sierra Leone does not have consumer protection regulations, the absence of which, among others, may result in consumers not having adequate disclosure on DFS products like digital credit, which can be very expensive in the local market. Under BSL's Financial Sector Development Project (2011-2017) with the World Bank, there was a review of the legal and regulatory framework surrounding payment systems along with proposed amendments to the Payment Systems Act (2009), but these amendments were never adopted. In this context, an array of gaps, such as the absence of regulations on Agent Banking (forthcoming in collaboration with US Treasury, but which have been in development for a prolonged period of time), USSD, and remittances, have also been identified. Additionally, the regulatory sandbox represents progress in allowing innovation in financial services. With a multitude of regulations in the DFS space developed over time and with support from different players, it is critical to examine their coherence to ensure the regulations are in line with one another. Under the recently approved Financial Inclusion project with the World Bank, BSL will revisit the review and conduct an updated one with a view to updating the requisite legal and regulatory framework.

The licensing regime in SL for DFS also requires bolstering to allow the sector to flourish. While many DFS-related regulations are in place, it is critical that the BSL also enhances its licensing regime to allow institutions to provide the permissible products and services as deemed in the regulations. In this respect, one fintech noted that it took three years to be licensed and only four entities have been allowed to enter the regulatory framework thus far on a competition basis. Moving forward, BSL will need to liberalize the licensing of such entities to allow them to commence operations in Sierra Leone, otherwise, there is no incentive to conduct DFS activities in Sierra Leone. Additionally, it will be important for BSL to distinguish between their supervisory and payment oversight functions to ensure that the former does not impede upon the latter.

General infrastructural deficits raise the cost of doing business in Sierra Leone

General infrastructural deficits significantly raise the operating costs of DFS in Sierra Leone. Mobile money remains unprofitable due to high operational costs. At the beginning of 2016 there were 1.3 million registered users, with only approximately 10 percent of them being active. Growth of mobile money has been driven by the combined network of 1,356 locations throughout the country, which accounts for 75 percent of the total financial access points. While DFS sector is growing, MMO's experience high operational costs from establishing agents themselves where there is limited infrastructure to build upon (e.g., using a bank or super market as an agent) and there is limited supporting infrastructure (e.g., road networks, electricity, etc.), all of which increase expenses related to maintaining this network of agents (e.g., providing liquidity and supervising agents). In this context, the mobile money sector is yet to become profitable, which impedes on its ability to grow further and provide additional services.

Box 7: Impact of the Absence of a Regulatory Framework on Remittances
In the absence of a formal regulatory framework on remittances, anti-competitive practices, such as exclusive arrangements between the principle money transfer provider and agent pay out networks, persist. It is reported that exclusive arrangements prohibit pay out partners of international money transfer operators (mainly banks) from partnering with other international money transfer operators operating in the market or wanting to enter the market. Through restricting access to pay out networks across the country, incumbent providers can in effect close the market off to new entrants, maintaining their market share, and potentially charge relatively high prices for using their service. The cost of sending USD 200 to Sierra Leone, from one of the main sending markets, the UK, is above the global average price for sending this amount, which may in part be due to the exclusive arrangements prevalent in the market, that block new entrants.[23]
Additionally, there is a lack of regulatory clarity on the termination of inbound remittances onto mobile money wallets (mobile wallet), missing an opportunity to leverage this large inflow of funds to improve financial inclusion throughout the country. To date, it is not clear on whether mobile money operators (MMOs) are allowed to participate in the international remittances market. As such, none of them have partnered with money transfer operators to facilitate the termination of transactions onto a mobile wallet. By allowing mobile money providers to participate in the market, BSL would significantly increase the pay-out options for international remittances customers in Sierra Leone, given the number of mobile money agents throughout the country. For non-mobile money customers, who receive international remittances, allowing the termination into a mobile wallet, that can then be cashed out at an agent location, could encourage this market segment to open new accounts given the increased convenience gained from a broader network of payout locations. For countries such as Kenya and Ghana, where the termination of international remittances transactions onto a mobile wallet is permitted, growth in this use case has been significant.
Agent banking regulations allowing for the cashing out of international remittances transactions at agent locations will mean that the remittances market will also benefit from the increased number access points available throughout the country. The pending agent banking regulations should allow agent networks to cash out international remittances, which will increase convenience to remittance beneficiaries throughout the country.

The core underlying infrastructure for a digital economy is rudimentary

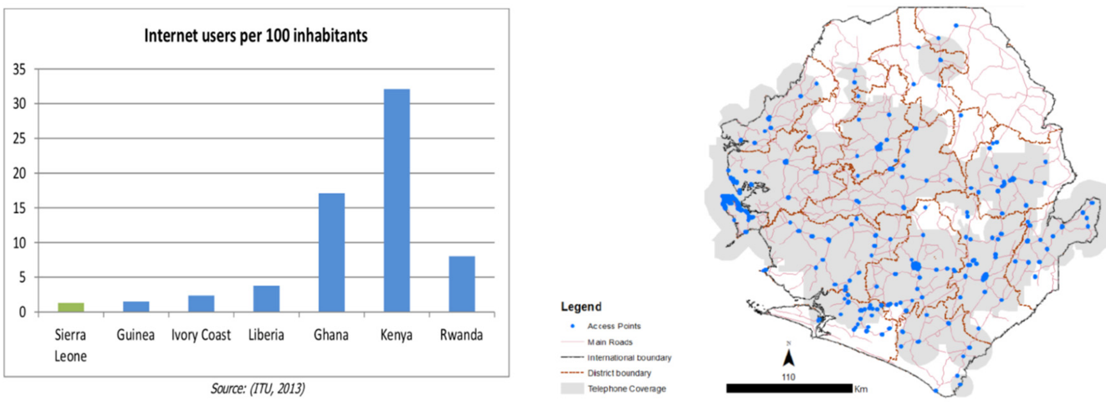
In 2013 Sierra Leone connected to the Africa Coast to Europe Cable, providing a communications link between the countries in West Africa and Europe via an undersea cable. The connection provides access to high speed internet for the country, with a number of west African states now operationalizing the link. In the case of Sierra Leone, work is still required to build out the infrastructure throughout the country to take full advantage of the connection. USD 72 million is being spent on developing the country's internal capacity to deliver broadband services across the country. The World Bank has provided financial and technical support to the government of Sierra Leone to support their efforts in joining the consortium, covering the costs required for Sierra Leone's connection to the cable, as well as improving within the government's own virtual private network, as well as supporting network connections throughout the country. Yet key connections, such as that of BSL, is not planned and it relies on radio signal to connect to financial institutions, which is slower and susceptible to disruptions.

When looking at other countries in the Mano River region, Sierra Leone lags behind on both internet usage and mobile phone subscriptions. Mobile phone penetration is high with an estimated 84.9 out of every 100 adults having a mobile phone subscription, however the delivery of financial services through mobile phones is yet to take off. According to the International telecommunications union, mobile phone subscriptions are close to becoming ubiquitous in Sierra Leone, with 84.9 of 100 adults having one, yet

[23] The price of sending USD 200 from the UK to Sierra Leone currently stands at 8.79 percent of the send amount. The current global average price is 6.99 percent, 1.8 percentage points lower than the Sierra Leonean average.

the penetration of mobile accounts still remains very low at 11 percent of the adult population. The utility of mobile phones and mobile money is also adversely impacted by a limited coverage and often weak GSM network. Poor telecommunication infrastructure diminishes the potential of DFS to play a role in helping increase access to financial services. For example, MFIs are constrained in their ability to provide DFS given the poor GSM network. In fact, according to Apex Bank, 54 of the country's 59 rural FSAs are within reach of telecommunication towers, but the quality of their connectivity varies. In the absence of additional and improved MNO towers, v-satellite connections would be necessary.

Figure 43: Internet Users and GSM Network Coverage



Source: ITU, 2013; and Geospatial Data Analysis and Mapping for Financial Inclusion Report, BSL, 2017.

DFS infrastructure, such as electronic payment systems, is minimal

Banks and MNOs are in the initial stages of DFS adoption and await the national switch to increase DFS' place in Sierra Leone. Banks are connected to the ACH and RTGS systems and offer mobile platforms and ATMs, with some bilateral agreements with MNOs, yet these systems still have minimal usage. MMOs also offer DFS and their numerous mobile money agents show their capacity and willingness to engage in DFS, but profitability remains a challenge, and MMO DFS remains effectively mobile money cash in/cash out services and nascent digital credit. In this context, banks, MNOs and MFIs eagerly await the implementation of the national switch to help facilitate the interoperability of digital payments but await guidance from BSL as to what type of investments in infrastructure this requires, particularly given some have started to make investments in switching platforms given the unsuccessful attempts to bring a national switch to Sierra Leone in the past.

MFIs in Sierra Leone also lack the requisite infrastructure, including payment systems, to facilitate electronic payments. At present, MFIs are isolated institutions in which consumers cannot process transactions between different institutions. For example, a member of a CB cannot currently access their funds at another CB, or at a MFI, FSA, or commercial bank. Consequently, MFI members (almost 190,000) remain dependent on cash transactions in part since they cannot process transactions between other financial institutions. To facilitate MFI linkages to the country's payment system's infrastructure, including the ACH and national retail payment switch, it is essential that they have the requisite telecommunications connectivity and core banking applications (CBAs).

Complementary DFS infrastructure is lacking

At present, Sierra Leone lacks much of the complementary DFS infrastructure to enable the DFS sector to thrive. For example, of the approximately 200 MFI branches (deposit taking MFIs, Deposit-taking MFIs, CBs, and FSAs) many lack the necessary CBAs. Without CBAs, or ones of poor quality, MFIs cannot receive or process ACH payments, nor can they be connected and benefit from the investment in the national retail payment switch.[24] Another key complementary infrastructure that is lacking is a unique ID. While the recent issuance of voter ID cards has improved the situation, the vast of majority of holders have only received temporary cards. Only five percent of people in Sierra Leone are registered in a national identity registry.

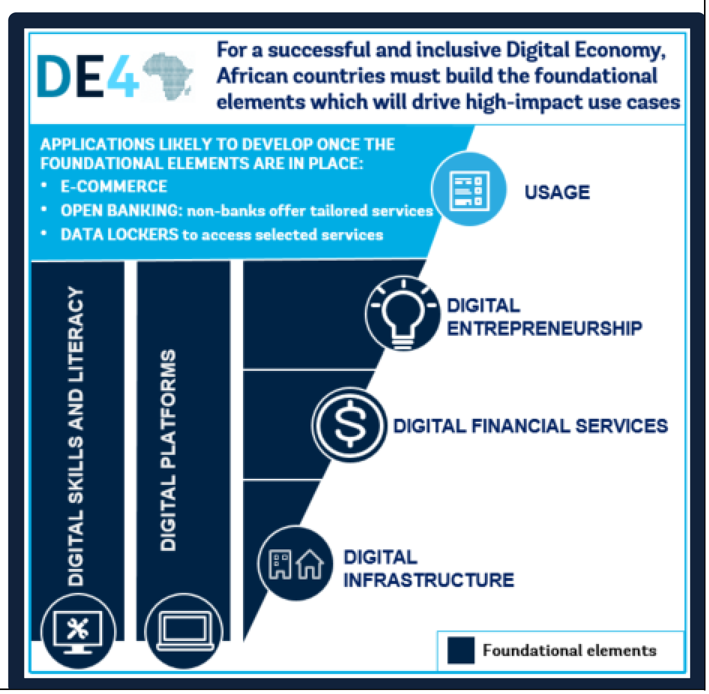
Box 8: The Digital Economy for Africa (DE4A) Moonshot

The World Bank Group has launched the Digital Economy for Africa (DE4A) initiative to partner with the African Union, governments, and the private sector, to secure the benefits of digital technologies. DE4A takes an innovative approach to integrate the range of WBG expertise and instruments, in order to build the digital ecosystem needed to drive technology adoption and innovation.

The DE4A initiative envisions a new set of cross-boundary support mechanisms for building digital economies in a coordinated manner. To ultimately spur the development of high-impact applications for health, education, e-commerce, agriculture, and social service delivery, among others, DE4A's targeted interventions will assist countries with strengthening the foundational elements of a digital economy. These foundational elements include: (i) digital infrastructure; (ii) digital financial services; (iii) digital entrepreneurship; (iv) digital platforms; and (v) digital skills. Digital ID is recognized as a critical enabler of the Digital Economy and is a focus within the digital platforms foundational element.

The WBG will be conducting a DE4A diagnostic in Sierra Leone. Considering the limited growth in digital finance relative to peer countries, the DE4A diagnostic will help to develop a broader digital economy strategy. The diagnostic will aim to:

- *Set goals and/or priorities for building a Digital Economy,* informed by a Digital Economy index.
- *Define a country strategy and action plans:* Country engagements will be informed by a DE4A diagnostic, which will assess the five DE foundational pillars.
- *Preparing tailored programs:* DE4A will bring to bear a wide range of WBG instruments, including advisory services and analytics (ASAs), development policy operations (DPOs), investment project financing (IPFs), risk-sharing facilities, and IFC investment.



There are five operational ID databases in Sierra Leone – covering births and deaths (3 million registrations); passports (350,000 records); a national ID system (300,000 individuals); a pension system

[24] To help ensure that FSAs play a significant role in the expansion of electronic payment systems, it will be important to finalize the process of allowing them to take deposits.

(1 million unique entries) and a voter's system (2.7 million unique entries). With each system capturing different data points, they have been developed in silos, making it almost impossible to consolidate or create an interoperable system that could build a digital identity of an individual based on the data already collected. The lack of a robust unique ID system has implications for an array of factors from fraud and ensuring social payments reach their intended beneficiaries, but also for financial inclusion. In this context, a unique ID is critical to financial service providers as it helps ensure financial institutions meet Know Your Customer (KYC) requirements for Anti-money Laundering and Countering the Financing of Terrorism (AML/CFT), while helping decrease fraud and building credit histories, among many others. In this respect, UNDP, UNCDF, and Kiva's recently announced efforts to establish a digital ID that uses distributed ledger technology, along with a modern credit bureau, is a welcome intervention.

Financial Literacy and Trust in the Financial Sector and DFS: Key Drivers of Access and Usage

Low financial literacy and trust in the financial sector, including DFS, negatively impact demand

A critical factor in the uptake of financial services is financial literacy, particularly with new technologies in DFS and fintech. With fewer years of schooling, lower literacy, and less experience with formal financial services in rural areas, bolstering the capacity of consumers to responsibly demand formal financial services is critical. In this respect, new technologies, often times with less information and no customer service personnel to explain the product, presents additional challenges and helps the perception that cash remains the best and safest way to transact. Additionally, consumer trust in the financial sector is low, which perpetuates the usage of cash and the reliance on informal financial services. In fact, 10.1 percent of adults who do not have an account at a financial institution noted that they do not have one because of a lack of trust in financial institutions.

C. Overcoming the Barriers to DFS' Development

To ensure DFS further promotes financial inclusion and its reach into rural Sierra Leone, there is a need to bolster the foundational enablers of DFS and enhance access and usage of DFS. With respect to the foundational enablers of DFS, there is a need to: 1) enhance the DFS regulatory and licensing regime. There is also a need to support infrastructural development through: 2) increased investments in underlying core infrastructure for a digital economy, 3) financial institutions' investment in payment systems infrastructure, and 4) investments in complementary infrastructure. To enhance access and usage, there is a need to support: 5) financial literacy to facilitate increased uptake, 6) expansion of the agent network to increase access points, 7) DFS products and services tailored to diverse needs and contexts, such as remote areas and agriculture, and 8) the digitization of government payments to enhance financial service delivery and facilitate financial inclusion.

Foundational Barriers to DFS Development

Bolster the DFS regulatory and licensing regime

Given the fragmented and outdated regulatory framework and weak licensing regime surrounding DFS, there is a need to help bolster these areas to create a more conducive environment for the sector's takeoff. On regulations, a comprehensive review is necessary to ensure their coherence and also address gaps from remittances to agent banking to USSD, among others. There is also a need to develop regulations on consumer protection and a tiered account opening system. Additionally, building capacity around these regulations and others, DFS more broadly, and around payment system's oversight at the

BSL, stand to help bolster the licensing regime to improve the efficiency in which institutions are licensed to foster growth and innovation in the sector. Additionally, there are ancillary efforts needed to support DFS, such as amendments to allow FSAs to become deposit taking to allow them to issue mobile wallets and issuing a national standard on Basic Transaction Accounts (BTAs), which includes mobile wallets.

Increase investments in underlying core infrastructure for a digital economy

In the context of weak underlying core infrastructure, it is important that the country continues to allocate and attract resources for these critical investments. In particular, it will be important for institutions to link up to the fiber optic cable. With respect to DFS, the BSL does not have a fiber optic connection and continues to remain connected to financial institutions by a radio signal. To enhance the efficiency and effectiveness of investments in the national switch, it will be critical for BSL to link up to the fiber optic cable and establish such connections to the headquarters of financial institutions in Freetown, where the bulk of financial transactions of the country take place. Additionally, it will be critical for MNO's to expand their GSM network to improve its geographic distribution and the quality thereof. As costs are a primary driver of cell tower networks, dialogue on shared investments and development partner support needs to progress. Additionally, rural financial institutions RFIs need to be able to link up to the country's payment systems infrastructure through investments in telecommunications, such as modems and v-satellite connections, depending on their proximity to cell towers.

Facilitate financial institutions' investment in payment systems' infrastructure

Outside of banks, MFIs are not connected to the country's core payment systems infrastructure. Most MFIs do not have connections to the ACH and RTGS, and Apex Bank, which provides these payment services for CBs and FSAs, is currently using a guest window to provide payments to CBs as they lost their system in a fire in 2018. At a cost of approximately USD 275,000, facilitating linkages to the ACH and check processing may be prohibitive for MFIs. In this context, it would be important for all MFIs to consider utilizing shared systems, such as one under Apex or elsewhere. Furthermore, Apex, in its current role building capacity of FSAs and CBs, could play a critical in helping these MFIs (and other MFI types like credit only and depositing taking MFIs depending on their mandate down the road) in adopting DFS and driving usage in rural areas and with lower income population segments and MSMEs. At the same time, it will be important to help promote ACH payments into individual accounts, as opposed to bulk RTGS payments as is common with banks and MFIs, to not only help improve the efficiency of ACH payments and financial inclusion, but to allow them to be processed through the national switch. Additionally, it will be important for ACH debits to begin in Sierra Leone, which can help provide another source of volume and thus viability for the switch.

Investment in the national retail payment switch is critical to facilitating the digitization of payments given its ability to connect financial institutions. Moreover, to transact across institutions, e.g., from one bank to another, or from a Bank to an MNO, there need needs to be switching platforms in place. At present in Sierra Leone, a number of institutions have bilateral arrangements connecting them; however, to connect all of the institutions, either institutions would have to have an array of such bilateral agreements (as is the case in Tanzania), or the country can have a national switch. The abundance of bilateral agreements can be inefficient and expensive from a business operations side of things. In this context, small start-up fintechs are unable to bear the cost of such extensive bilateral agreements. For example, mypay, has developed a third-party processing solution, similar in nature to PayPal, that allows for P2P, P2B, B2P, and B2B solutions. For example, mobile money solutions are currently just cash in/cash out which does not allow for payment across MNOs. With a national switch, solutions such as mypay and other financial institutions will be able to utilize the switch by paying a small transaction fee. Thus, such fintech groups are waiting for the switch to be implemented.

Additionally, key infrastructure such as ATMs and POS, are few and far between while more innovative solutions are non-existent. Investments in ATMs will be critical to helping support access to resources and liquidity management for an array of actors, but also for helping to bridge the gap between users of cash and the country's payment systems. For example, ATMs can allow those without an ATM card or account, to access cash using information from mobile devices; this could be particularly helpful for those receiving domestic or international remittances. Additionally, it also helps individuals to begin using and get their feet through the front door of financial institutions. Additionally, investments in POS terminals to facilitate digital transactions for merchants will be important for helping facilitate the digitization of payments at high value locations, such as gas stations or in trade. In a limited context, POS terminals could also help with government revenue collection, such as for taxes on goods. Additionally, such terminals will be needed for super agents to leverage the national switch and transact across financial institutions. mypay has developed an NFC card and a sticker that can be placed on USSD phones to allow for consumers or businesses to simply tap their phones to pay or be paid. In this respect, innovations that allow for such transactions using low cost-technology will be critical, including non-smart phones, bracelets, scanners, etc.

Increase investments in complementary infrastructure

In addition to core and payment systems' infrastructural deficits, there are an array of complementary investments that are needed in the country. First, MFIs lack CBAs or ones which allow them to connect to the ACH and other payment system's infrastructure. The upfront costs of these systems may serve as a barrier to entry for MFIs into the DFS space, making support for CBAs essential. It will be important to bolster MFI/Fintech partnerships to allow MFIs entry into the fintech/DFS space, while also allowing fintech's the opportunity to expand into rural areas by leveraging existing clientele bases. The successful implementation of the digital ID is also critical to increasing access to financial services by improving the identification of individuals, which also allows for enhanced capacity to link consumers to their credit history and help enhance the data available for this analysis, such as mobile money transactions or social transfers via mobile means.

Access and Usage of DFS

Enhance financial literacy to support increased uptake

A critical factor in the uptake of financial services is financial literacy, particularly with new technologies in the DFS and fintech spaces. In contexts such as Sierra Leone, fewer years of schooling, particularly in rural areas, low literacy, and less experience with formal financial services (due to limited access), bolstering the capacity of consumers to responsibly demand formal financial services is critical. In this respect, new technologies, often times with less information and no customer service personnel to explain the product, presents additional challenges to uptake and helps perpetuate the perception that cash remains the safest way to transact and low trust in the financial sector, including for DFS. In this context, BSL has developed a financial literacy framework to coordinate efforts to improve financial literacy levels amongst the general population. The framework covers 2018-2020, in line with the broader National Strategy for Financial Inclusion (2017-2020). The strategy targets schools, the informal sector, women, and rural communities. The objective is to improve the population's general understanding of finance and the tools needed to improve their financial lives.

While the financial literacy framework being developed covers a broad range of issues relating to financial services, there is no specific focus on DFS. Given the limited focus on DFS in the current financial literacy framework, the Sierra Leone Financial Inclusion Project with the World Bank will finance the development of modules aimed at improving the understanding of DFS, interoperability, and agent banking, to increase demand for DFS.

It is also critical to better understand the appropriate delivery channels for DFS financial literacy modules, including specific modules for women. For example, BSL is exploring the use of channels such as radio, text, and voice messaging to deliver critical information on DFS, while also examining the potential of using tools, such as gaming, and community level demonstrations and plays. In this respect, Salone Microfinance Trust and Invested, winners of the first fintech challenge, through the regulatory sandbox window created an Android based financial literacy video application and upon completion, people are eligible for loans. It will also be important to leverage existing channels that have access to groups in need of financial services, such as promoting financial literacy in tandem with agricultural extension services as advocated by UNCDF.[25] In all of these modules and delivery channels, it will also be important to ensure that they include teachable moments to improve understanding and trust. This work also needs to focus on women's usage of DFS, as their mobile account ownership, the primary entry point of individuals into the DFS landscape and a proxy for their general DFS usage, is lower than men's, 8.7 percent compared to 13.6 percent, respectively.

Expansion of the agent network to increase access points

To catalyze the development of access points, there is a need to establish a framework that will help incentivize the private sector to establish agent networks in areas where the business case for doing so is weak - an access point innovation competition would be an effective way of supporting financial institutions to grow networks in currently underserved regions. Establishing an innovation competition that will support the development of access points in currently underserved areas of the country is critical to helping provide the private sector with resources to cover the risks associated with and costs of increasing outreach into rural areas. An access point innovation competition could build on the findings of the geospatial mapping, working to establish 'investment zones' based on the degree of difficulty observed for establishing an access point and the commercial viability of the locations, given the levels of economic activity in the region or chiefdom. Operating a matched funding model, private sector institutions could apply for funds to develop networks in underserved regions of the country. Deploying technology-based solutions would be an important element of the proposed activities. In keeping with the interoperability to be facilitated by the national retail payment switch, the competition would expect all proposals to develop interoperable non-exclusive networks. Outside of such a fund, it is important to revisit the issue of joint infrastructural investments, such as mobile network towers.

Support DFS products and services tailored to diverse needs and contexts, such as remote areas and agriculture

[25] UNCDF.

It is important to introduce innovative products and services into the agricultural space which are tailored to the financial lives of farming households. Products, such as IDT Labs' planned mobile money wallet savings application "miKashBoks" helps farmers develop savings plans and save over a period of time per their production goals. Then when farmers reach their goal, they can utilize a coupon to buy inputs from an authorized agent (initially planned with mobile money agents). This application will also help farmers ensure the quality of their inputs (as agents are certified) and it will also eventually allow them to save their revenues and get in contact with buyers and transact all through the mobile application. Additional IDT labs also aims to leverage information generated through the application to create credit scores to facilitate access to loans with BRAC and A Call to Action (non-deposit taking MFIs), which can be received and repaid through the application.

In savings, products and services will need to be accessible and affordable. On accessibility, facilitating interoperability between mobile wallets and MFIs stands to help improve rural resident's access to financial services. While MFIs do have a significant footprint in rural areas, many Sierra Leoneans still travel long distances to reach these institutions. To alleviate this costly and risky burden, it will be important to help ensure there are push and pull capabilities between mobile wallets and MFIs through the switch and also allow digital wallets for MFIs (which take deposits), to ensure this functionality. Among others, this arrangement will allow MFIs customers to deposit and withdrawal from their MFI account via mobile means and receive digital payments, such as for rural government employees. In tandem, it will be important to link mobile wallet efforts to those on IDs to help ensure their linkages, e.g., the ability to capture credit history from mobile money transactions into consumers' financial histories. However, the challenge is to enable these institutions and other MFIs, to utilize mobile phones to push and pull from such accounts vis-à-vis interoperable electronic transfers. Products, such as miKashBoks, by leveraging and eventually creating new agents, facilitate accessibility, but they will need to remain affordable in a context of high costs for fintech companies to offer such products, particularly due to the high costs from using MMO's systems, which fintechs are dependent on.

Similarly, digital credit with repayment streams, which reflect farmers financial flows, will be critical to more wide-spread uptake. At present, loans are short-term in nature and cater to shopkeepers, market persons, and those in need of quick money. Furthermore, the consumer protection dimensions of this need to be better understood, as interest rates are presently extremely high in Sierra Leone, and the impact of delinquency on credit scores, the extent of disclosure, among others, all of which also impact uptake, are not fully understood.

Digitizing agricultural payments are a logical avenue to support the digitization of financial transactions in rural areas and stands to significantly help farming families. Beyond consumption, payments for the purchase of agricultural inputs, labor, and the sale of agriculture, represent a significant share of commercial transactions in rural areas. By digitizing payments, farmers can build/add to transaction histories to increase their eligibility for access to credit, avoid problems of payment from suppliers or buyers, reduce their personal risk from carrying cash, and in the event that they do not currently have an account with a financial institution or a MMO, this can serve as an entry way into the formal financial system as farmers would need an account with a MMO or brick and mortar institution to receive digital payments. Yet, value chains are largely informal, so the potential to tap into pre-existing formal payment channels is limited at present.

Linking the digitization of payments to the digitization of information stands to ensure these investments are utilized to their full capability. One key intervention in this space is to link agricultural price and information systems (i.e., logistics systems) to digital payments. The availability of a digital channel to access prices, buyers and sellers, leverage harvests as collateral through warehouse receipts, and to also make and receive payments, would help ensure the development of a cohesive digital market for producers. Another potential area of development in this space is agricultural insurance which utilizes digitized information to inform payouts to farmers in the event of crop destruction.

Digitize government payments to enhance financial service delivery and facilitate financial inclusion

A key opportunity to support the expansion of access to financial services and facilitate volume on the country's national payment systems, while also supporting government initiatives, is through large volume and reoccurring transactions like digitizing government payments. This approach facilitates financial inclusion by obliging beneficiaries to have accounts, while also making the investments in financial infrastructure more viable through increased transactions.

One key opportunity for leverage large volume and reoccurring payments is with social payments for the extreme poor and vulnerable. At present, the World Bank is supporting a program, "Ep Fet Po," with the National Commission for Social Action (NaCSA), which helps facilitate the quarterly payment of Le. 250,000 (approximately USD 30) to 27,553 vulnerable households, located primarily in rural areas, in nine districts. At present, the program delivers cash to collection points, which are no more than four kilometers from the households, and any designated family member can collect the cash. As the contract for the service provider, Splash, has expired, NaCSA is exploring a new provider.

Ep Fet Po also stands to benefit from enhanced delivery mechanisms, which facilitate scaling up this critical effort, while also promoting these households' connection to the formal financial sector. On delivery, there is a critical need to digitize these payments to beneficiaries (along with from MoF to NaCSA) to help increase the ease of receiving the payment, while reducing the risk and costs associated with the physical delivery of cash. Digitizing payments will allow beneficiaries to receive their payments without traveling four kilometers or longer to collect their payments.

Such deliveries can be made to mobile wallets (or to an existing bank account if they have one), which can be cashed out at a mobile agent of one's choosing (facilitated with the introduction of the national switch), financial institutions with the requisite financial infrastructure, and banking agents (with introduction of the regulations under development). In facilitating the latter, Ep Fet Po, beneficiaries will help get their foot through the door of financial institutions, which will help them slowly build the credit scores (from social transfers and mobile money purchases), capacity to utilize formal financial services, and thus help incentivize institutions to increasingly develop products and services, which cater to more impoverished segments of society. Digitizing payments will also help reduce risks from corruption by increasing the accuracy of beneficiary identification and from theft from the movement of cash on behalf of the beneficiary and the service provider. As multiple beneficiaries per household can collect the payment, the alternative collector could also obtain digital account access, further helping increase access to financial services.

Digitizing social protection programs can be an effective tool to include women in the formal financial sector. Given women make up 95 percent of Ep Fet Po, digitizing payments and linking beneficiaries to formal financial products, for example mobile money payments, could be an effective way to facilitate women's access into the formal financial sector.

The national switch will help rural government employees and civil servants access their salaries. Teachers working in schools located in rural areas in Sierra Leone face significant challenges accessing their salaries. Currently, approximately 8,900 teachers are paid via Apex Bank through CBs and FSAs. While these rural financial institutions have a significant presence in rural areas with almost 80 CBs and FSAs combined, many teachers must still travel a significant distance to access their salaries at these locations. Consequently, teachers may go to collect their salary during the week, which impacts the quality of children's education and presents a security risk as they need to travel to and from the institution with their salary in cash. With the implementation of a national switch vis-à-vis its interoperability functionality, teachers will have the ability to access their salaries deposited in CB accounts via mobile wallets, which will reduce absenteeism. Other teachers receive their salary in cash at FSAs, yet these institutions are not allowed to take deposits. With the implementation of a switch and the ability of FSAs to take deposits under forthcoming regulatory amendments, teachers who currently receive their salaries at FSAs, will be able to have their salaries deposited directly in their mobile wallets.

With SLCB's and RCB's share of the financial sector's assets and of civil servant and government employees' salaries, these institutions stand to play a critical role in the digitization of payments. With their volume of accounts and transactions, the two state-owned banks will need to ultimately play a critical role in the digitization of payments, particularly government payments to civil servants and employees. Digital payments stand to improve the inefficiencies of manual payments and the inconveniences of needing to visit a financial institution to do deposits and withdrawals. Thus, it is critical that these institutions occupy a key role in the country's efforts to digitize payments and that they have the requisite investments to better utilize pre-existing electronic payment system's infrastructure and the forthcoming switch. At the same time, it is important that these institutions address their underlying challenges in key areas like corporate governance and others, and that they also develop robust DFS plans, so that DFS helps bolster these institutions and does not exacerbate their challenges.

Conclusion

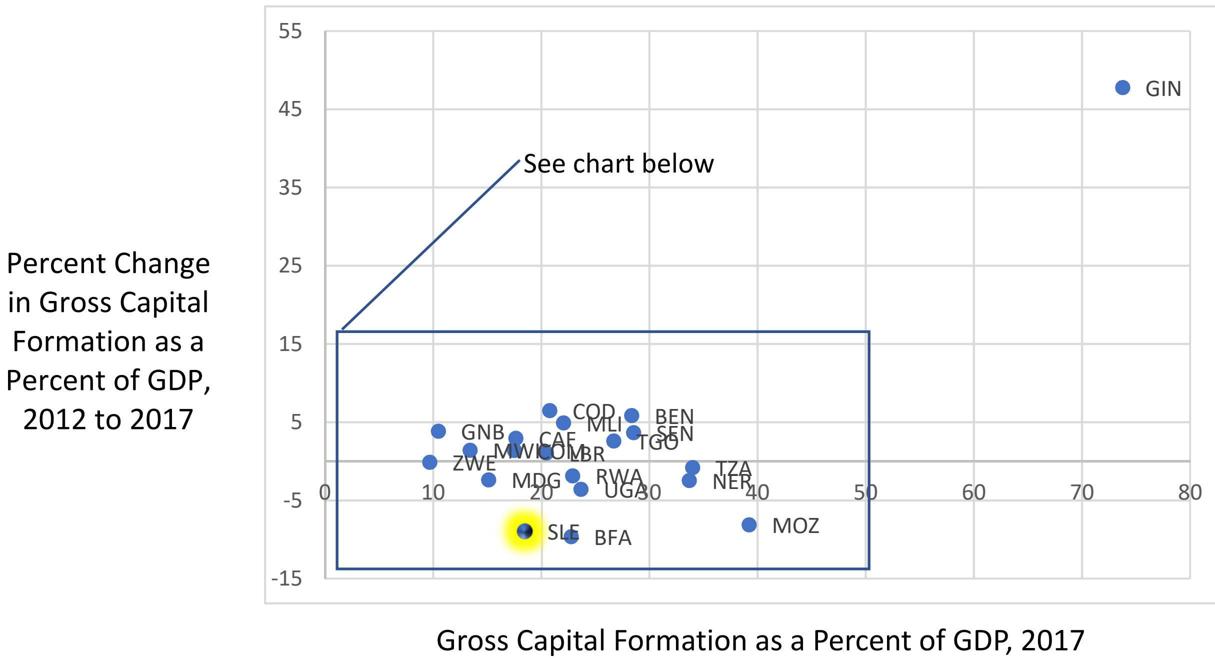
Sierra Leone's macroeconomic performance continued to improve but at a slower pace. For 2018, economic growth is estimated 3.7 percent in 2018, marginally lower than the 3.8 percent in 2017. This growth rate is still nearly 3 percentage points below potential. These developments occurred in the context of a global slowdown reflecting slower growth in major advanced countries and a steady regional expansion—ECOWAS was among the fastest-growing country groups in 2018.

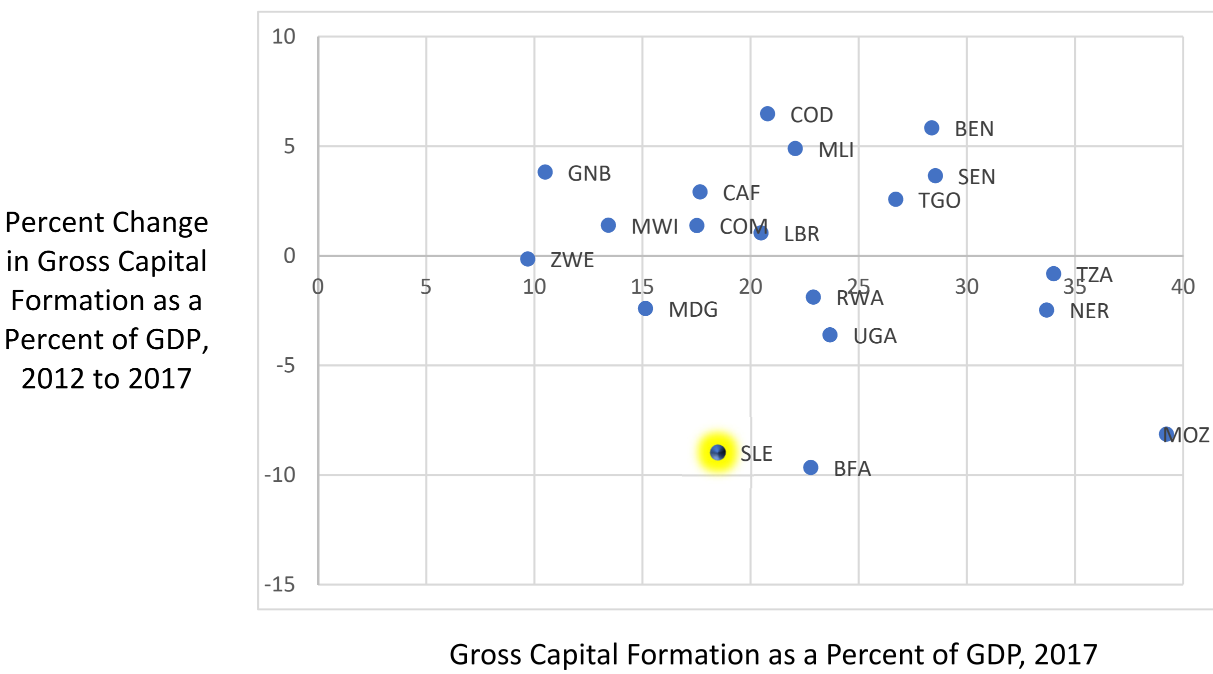
Growth in 2018 was spurred by a domestic investment boom and a more favorable foreign environment, on the demand side, and a faster expansion of the agricultural sector, on the production side. At this pace, Sierra Leone's economic growth is neither high enough nor broad-based enough to absorb the faster growing working-age population to increase per capita income and reduce poverty. The fiscal balances are improving, thanks an increased mobilization of domestic revenue. But the burden of the public debt is still threatening external sustainability, as Sierra Leone's debt indicators deteriorated with respect to both solvency and liquidity. The fiscal stance still expansionary but at a slower pace.

External sector performance remained weak while inflationary pressure persisted throughout 2018. Economic growth is expected to reach 5.2 percent by 2021, anchored primarily by supply side factors including favorable agricultural output, uptick in mining activities and strong performance of the services sector.

The medium-term economic outlook nonetheless faces significant downside risks such as unfavorable exchange rate and prices; fiscal slippages including adverse debt dynamics and huge arrears; and financial sector weaknesses among others. Unlocking the bottlenecks to robust and sustained real economic growth through economic diversification and addressing preexisting macroeconomic weaknesses would be crucial for building a resilient economy that promotes inclusive growth and reduces poverty.

Figure 44: Gross Capital Formation as a Percent of GDP for Sierra Leone and other low-income SSA countries, 2017 (x axis) compared to change from 2012 to 2017 (y axis)





Sierra Leone is falling behind in developing and deepening its financial system and increasing access to finance for household and SMEs. Why this is happening is a complex question. This paper identified several key reform priorities related to: 1) improving the role of the state in the financial sector; and 2) increasing the penetration of digital finance.

There is an urgent need to develop a comprehensive strategy for deepening the financial sector in Sierra Leone. This deepening is required for poverty reduction, job creation, investment and growth. Investment, as measured by Gross Capital Formation, in Sierra Leone is extremely low relative to peer countries in the region and is growing at a much lower pace compared to these peer countries (Figure 44). The deepening of the financial sector is one of the many areas that can increase this investment going forward, which can support poverty reduction, job creation, and growth.

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