SUPPORTING ECONOMIC TRANSFORMATION

PRIVATE SECTOR DEVELOPMENT IN LIBERIA

Financing for economic transformation in a fragile context

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ACRONYMS

AFDB	African Development Bank
CBL	Central Bank of Liberia
CDC	CDC Group
DFI	Development Finance Institution
EIB	European Investment Bank
FCAS	Fragile and conflicted-affected states
FDI	Foreign direct investment
GDP	Gross domestic product
GoL	Government of Liberia
IFC	International Finance Corporation
IMF	International Monetary Fund
NIC	National Investment Commission of Liberia
NFBI	Non-bank financial institutions
PIU	Project Implementing Unit
REER	Real effective exchange rate
SEZ	Special economic zone
SMEs	Small and medium-sized enterprises
SSA	Sub-Saharan Africa
UK	United Kingdom
UN	United Nations
UNECA	United Nations Economic Commission for Africa
US	United States

EXECUTIVE SUMMARY

Economic transformation is needed if low-income countries are to transition to middle-income countries with the prosperity and stability that this confers. It is formally defined as consisting of two processes - the shifting of labour and other **resources from lower- to higher-productivity sectors** and **increases in productivity** within sectors. It can be more informally understood for low-income countries as shifting resources from low-productivity agriculture and informal sectors to high-productivity formal sectors in combination with the diversification of production, growth in export competitiveness and the expansion of formal-sector employment (McMillan et al., 2017).

The most important **constraints to economic transformation in fragile and low-income countries** are poor infrastructure, limited financing, ineffective institutions and social and economic environments inimical to business. Together, they often create an **economic structure concentrated in low productivity agriculture and informal employment.** These, in turn, reinforce 'poverty traps' and impede creation of political and economic resilience. If initiating change for the better in such countries is difficult, then maintaining momentum is even more challenging.

Indeed, the extent of these challenges explains why there is only a limited number of low-income countries that have successfully transformed out of poverty and economic fragility (IMF, 2015).

Liberia is a typical fragile, low-income state. It has a high concentration of GDP and employment in subsistence agriculture and informal occupations. It relies heavily on the extractive sector for fiscal revenues and exports. Economic growth is constrained by ineffective infrastructure, few sources of private finance and a cultural environment that hampers business. These factors result in some of the highest poverty levels in the world. In 2016, per capita GDP was only $367 (approximately 60% of the average for low-income countries) and around 64% of the population was living on less than one dollar a day.

Creating structural change in such an environment is difficult and faces significant challenges especially when tackled at a nationwide level. However, the literature on economic transformation[1] [2] shows that it is neither economically necessary nor politically realistic to address all impediments to economic transformation at once.

Instead, a **focused and coordinated approach on a single sector** commanding a measure of comparative advantage when combined with **essential pre-conditions** can initiate take off of economic growth. These preconditions are established private property rights, adequate infrastructure and export cost competitiveness.[3]

This implies that Liberian policy should focus on developing a 'single sector'. The Government's economic strategy has already identified **agricultural as the preferred sector**. This is because of Liberia's rich endowments in agriculture, the potential for increasing productivity through local processing and indigenous value-chains and its potential to create a range of employment opportunities.

Specific policy recommendations that could drive success in developing the agricultural sector are:

- Creating a strong **public-private coordination** mechanisms to overcome coordination failures in private sector development;

[1] See McMillan et al, 2017, for a detailed review of the literature including the evidence-base relating to a 'single sector' approach and a fuller set of references including the literature from Rodrik and Lin.

[2] Detailing specific case studies is beyond the scope of this paper but is available on the SET website including in McMillan et al, 2017 and in detailed studies on specific countries. However, the country case studies provided there illustrate that there are different pathways to economic transformation which rely on varied policy combinations and ways of addressing political-economic obstacles. They include Rwanda in agricultural processing, Ethiopia and Bangladesh in manufacturing including of textiles and clothing and Mauritius where there was a successful transition from plantation agriculture to manufacturing and then to high-value services.

[3] The literature also challenges that 'good governance' is a prerequisite for economic transformation. (McMillan et al., 2017)

- Continuing a focus on **establishing improved infrastructure** but with a greater emphasis on supporting private sector development in agriculture including developing new value-chains and enhancing existing ones;
- **Mobilising private finance** for investment in the agriculture sector including the use of blended finance; and
- **Increasing the DFI-led 'impact accelerator funds'** to create demonstration effects and 'learning by doing' opportunities that can act as a catalyst for broader social and economic transformation.

Finally, it should be noted, that such focus single sector approach should be seen as a starting point for economic transformation in low-income countries. In the medium-term, it would be hoped that much greater deepening and diversification of multiple sectors across the economy would be achieved and, indeed, would be seen as necessary for achieving middle income status where economies are not only larger but more complex and diversified, providing the means to achieve broadly-shared prosperity and economic and political stability are the goals of economic transformation.

1. INTRODUCTION

Increasingly, the development community has become focused on how to stabilise fragile and conflict-affected states (FCAS), not only to enhance economic development, but also to safeguard international security and stability.

It has been found that multiple factors interact to re-establish stability and resilience after conflict. Re-establishment of political stability and accountability and economic stabilisation are important. However, relatively few FCAS have managed to move away from conflict follow a long-term path leading to becoming stability and prosperity (IMF, 2015).

This paper examines Liberia as one instance of a FCAS that, it is hoped, is making this transition. It concentrates on one particular aspect of economic renewal - the revival of private sector growth.

Liberia is of particular interest because, although it remains fragile,[4] it has made significant progress including establishing a stable democratic government. Further, it has set out an economic strategy that is well-grounded in the country's comparative advantages and has attracted significant donor support.

Nevertheless, Liberia remains one of the poorest countries the world and the barriers to moving beyond being a stable, but poor, country towards economic prosperity remain significant. Section 2 shows that the structure of its economy remains heavily concentrated in agriculture and extractives while inadequately developed infrastructure and lack of finance are significant constraints on economic transformation.

Section 3 discusses how to tackle these issues. It suggests that for a fragile state, like Liberia, a possible path is to focus on a single sector. For Liberia, this is most likely to be the agricultural sector and to include development of local processing and value-chains (World Bank, 2012; AFDB, 2013; Republic of Liberia, 2015) in close coordination with donors and private investors.

Elsewhere[5] such an approach has allowed limited capacity to be narrowly focussed thus facilitating greater success. Equally importantly, such approaches have also provided important demonstration effects that can be a catalyst for 'kick-starting' broader transformation change.

Section 3 also makes specific policy suggestions that could help facilitate this approach. They include the need for:

- Creating a strong **public-private coordination** mechanism to overcome coordination failures in private sector development;
- Continued focus on **establishing improved infrastructure** but with a greater focus on supporting private sector development in agriculture including value-chains;
- The **mobilisation of private finance** for investment in the agriculture sector including the use of blended finance; and
- **Increases in DFI-led 'impact accelerator funds'** to create demonstration effects and 'learning by doing' opportunities that can be a catalyst for broader transformation.

Section 4 concludes by commenting that starting and maintaining economic transformation in FCAS including Liberia is a difficult process but that careful coordination and shared financing amongst the Government, donors and private investors may offer a pathway for this to happen as well as that such an approach is a starting point for broader transformation.

[4] Under the IMF definitions (IMF, 2017) and the World Bank's 'Harmonised List of Fragile Situations, FY2017'. http://www.worldbank.org/en/topic/fragilityconflictviolence/brief/harmonized-list-of-fragile-situations.

[5] See footnote 2 for case study examples and further references.

2. THE ECONOMIC AND FINANCIAL LANDSCAPE

2.1 Introduction

Liberia is a relatively small state on the west coast of Africa with a population of 4.5 million. Its history and current environment illustrates both the potential and the fragility of countries with a history of conflict, vulnerability to economic shocks, high levels of poverty and chronic economic underdevelopment.

The Republic of Liberia was established in 1847 and its Constitution and Declaration of Independence was inspired by that of the United States of America. Between 1980 and 2003, it suffered from political instability and a devastating civil war originating in long-standing economic and political inequality between ethnic groups (Ciment, 2013).

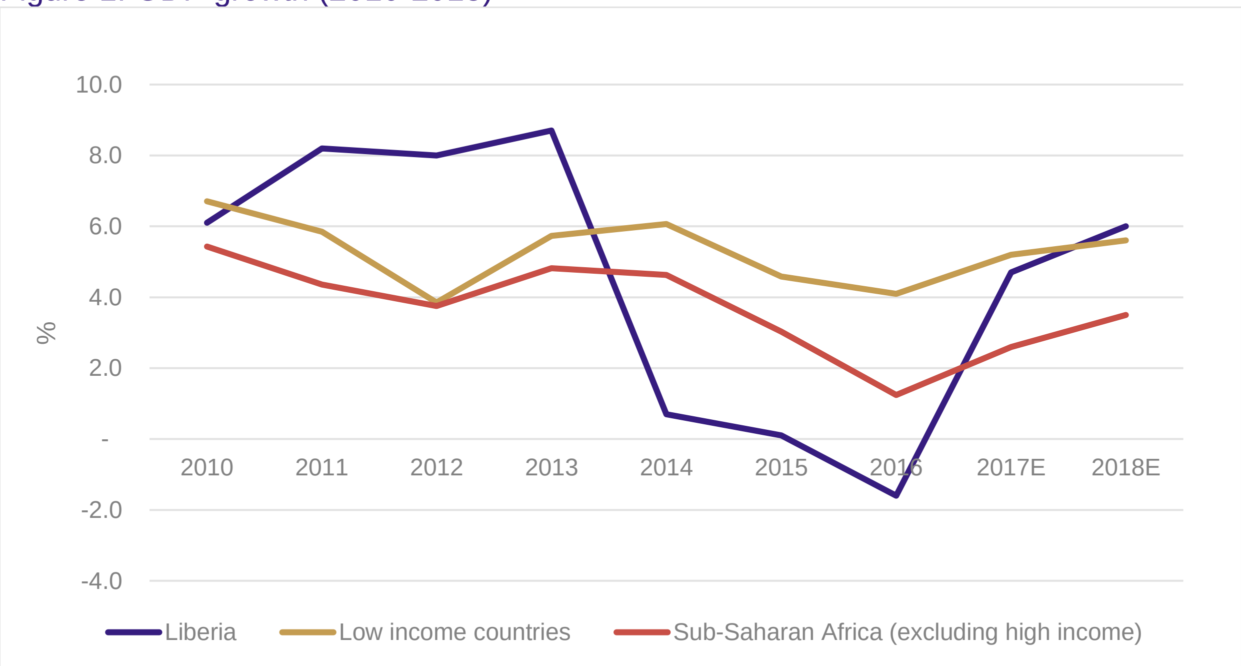
Following the election of Ellen Johnson Sirleaf in 2006 and with assistance from the UN Security Council, political and economic stability was reestablished. Economic growth was rapid, averaging 7% annually. However, the Ebola crisis and the collapse of global commodity prices caused GDP growth to fall to negligible levels between 2014 and 2016 with accompanying reductions of 15% of public spending in real terms and increased inflationary pressures due to the depreciation of the Liberian Dollar and the increased oil prices on the domestic market. (Central Bank of Liberia, 2017) The United Nations Mission in Liberia was also extended until March 2018 in order to support recovery from these shocks (IMF, 2016).

By 2017, these negative factors had ameliorated and GDP growth is currently projected to be 4.7%. In addition, at the time of writing, the October 2017 elections were progressing peacefully towards formation of a new government and fiscal management remains ‘strong’, according to the IMF (IMF, 2016).

The real effective exchange rate (REER) for the Liberian dollar appreciated by approximately 41% between 2002 and 2015. This included appreciations against its major export trading partners of China, Poland, Greece, the US and Germany.

Savings are strongly and consistently negative, according to the World Bank Development Indicators, because of illicit flows and repatriation of profits by foreign companies (Figure 1).

Figure 1: GDP growth (2010-2018)



Source: World Bank Development Indicators database for 2010 to 2016. IMF 2017 for 2017 and 2018 estimates.

Despite some hopeful signs, the Liberian economy suffers from underlying structural problems. These include dependence on agriculture and mining (with the consequent vulnerability to fluctuating global demand and prices for commodities) and a lack of basic infrastructure and institutional capacity. The result is that Liberia suffers from high levels of poverty and aid dependency.

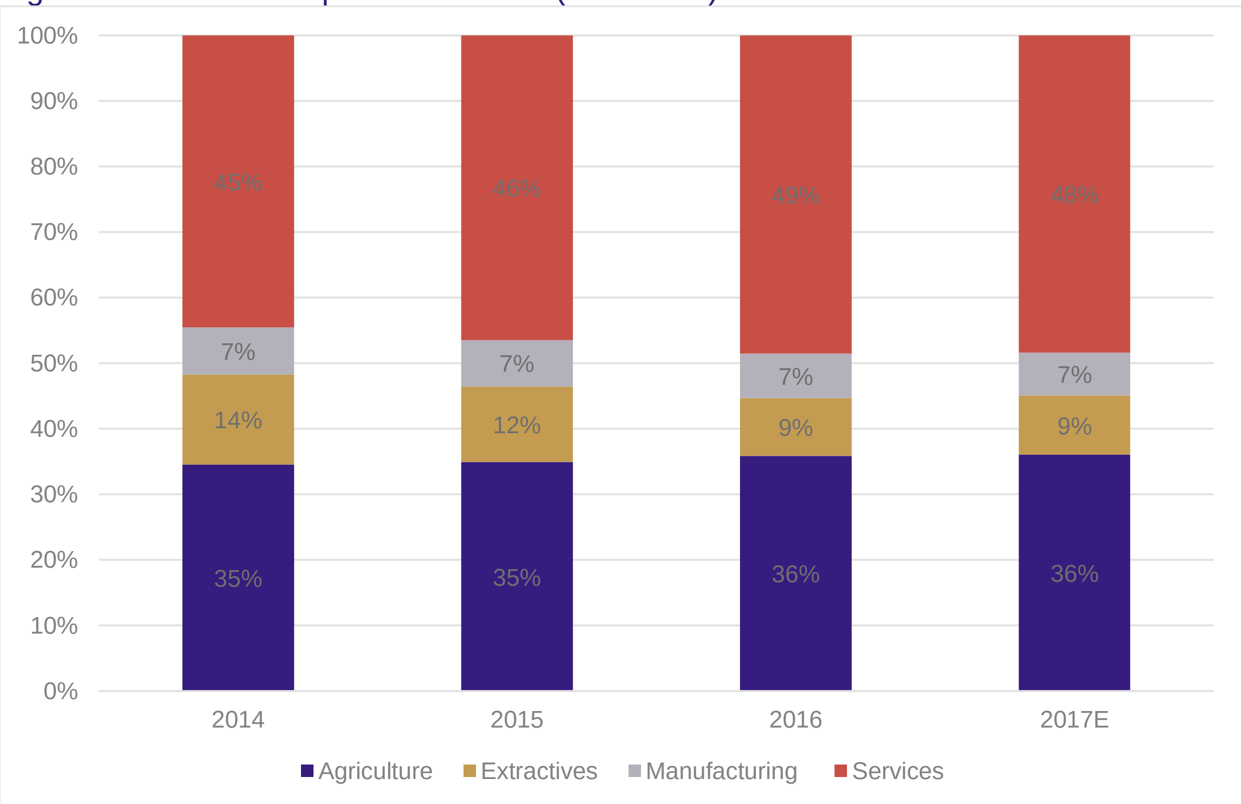
One of the most critical constraints is a lack of finance, especially for private sector development, which depends on accessing capital to make the investments that underlie increases in productivity, which is critical for economic growth.

2.2 The structure of the Liberian economy

In common with many low-income countries, Liberia's economy is heavily concentrated in the agricultural and extractive sectors. This is of importance because both sectors suffer from significant drawbacks in relation to their ability to be engines of economic transformation because neither are associated with increased productivity nor employment creation.

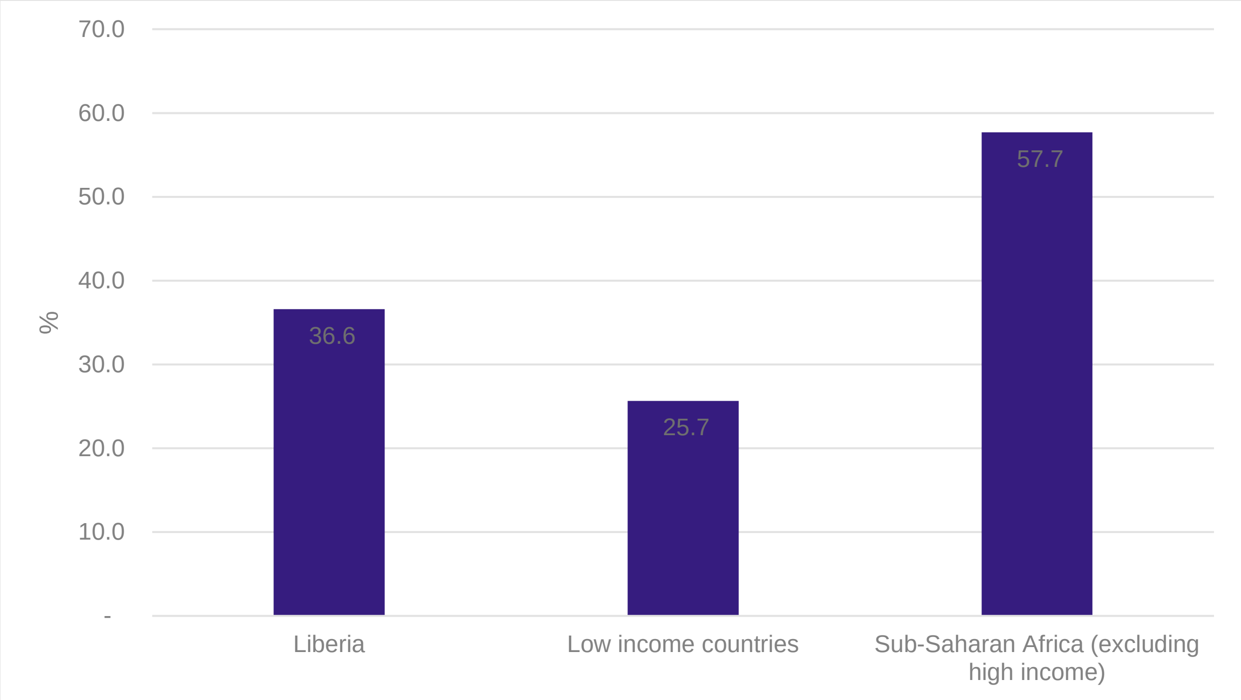
As illustrated in figures 2 and 3 below, agriculture in Liberia makes up approximately 36% of GDP including production of rice, cassava, rubber, cocoa and palm oil (Figure 2). Whilst high, this proportion of agriculture to GDP is lower than the average of 57.7% for sub Saharan African region (Figure 3).

Figure 2: Sectoral composition of GDP (% of GDP)



Source: Central Bank of Liberia, 2016.

Figure 3: Agriculture as a percentage of GDP (2016)



Source: World Bank Development Indicators database.

There has been recent diversification in agricultural exports. For example, between 2003 and 2010, rubber made up around 85% of Liberia's exports but, after 2010, there was a significantly higher share for other products including cocoa and palm oil. (Central Bank of Liberia, 2016)

Agriculture remains predominantly subsistence or low productivity shareholder farming with high levels of informal employment. Nevertheless, there are a number of large-scale commercial firms especially in palm oil and rubber. For example, agricultural sector includes Firestone and Equatorial Palm. These companies function in dedicated sites and have overcome the infrastructure constraints inherent in the Liberian economy by establishing dedicated infrastructure for electricity generation and transport. They also provide formal employment, although wages are relatively low.[6]

Currently, these firms undertake relatively limited processing in Liberia and export unprocessed or semi-processed products for processing abroad. This is due to the high cost of processing in Liberia including, in particular, the high cost of electricity. Increasing the levels of processing in these sectors would be a significant gain for the Liberian economy because it has both the potential to increase formal employment and to increase productivity which could result in rising wages. [7] How this could be achieved as discussed further in section 3.

GDP and exports are also concentrated in the extractive sector which composes approximately 10% of GDP and 17% of exports (Central Bank of Liberia, 2016).[8] As for agricultural production, there is a mix of high and low productivity production in the extractives sector. High productivity, capital intensive production is typically undertaken by international mining companies under concessions agreed with the Government. Some of the major investors in the sector include Acelor Mittal and Aureus Mining. Low-productivity production includes artisanal miners of diamonds and gold using little capital. Although artisanal mining can provide employment for poor households, it also can result in valuable commodities being exported

[6] They also provide facilities for their workers including housing, education and health facilities.

[7] Source: Interview material.

[8] The mining sector also exposes the Liberian economy to global commodity price cycles as was illustrated in the post-2012 period when the Liberian economy was negatively affected by the global commodity price downturn.

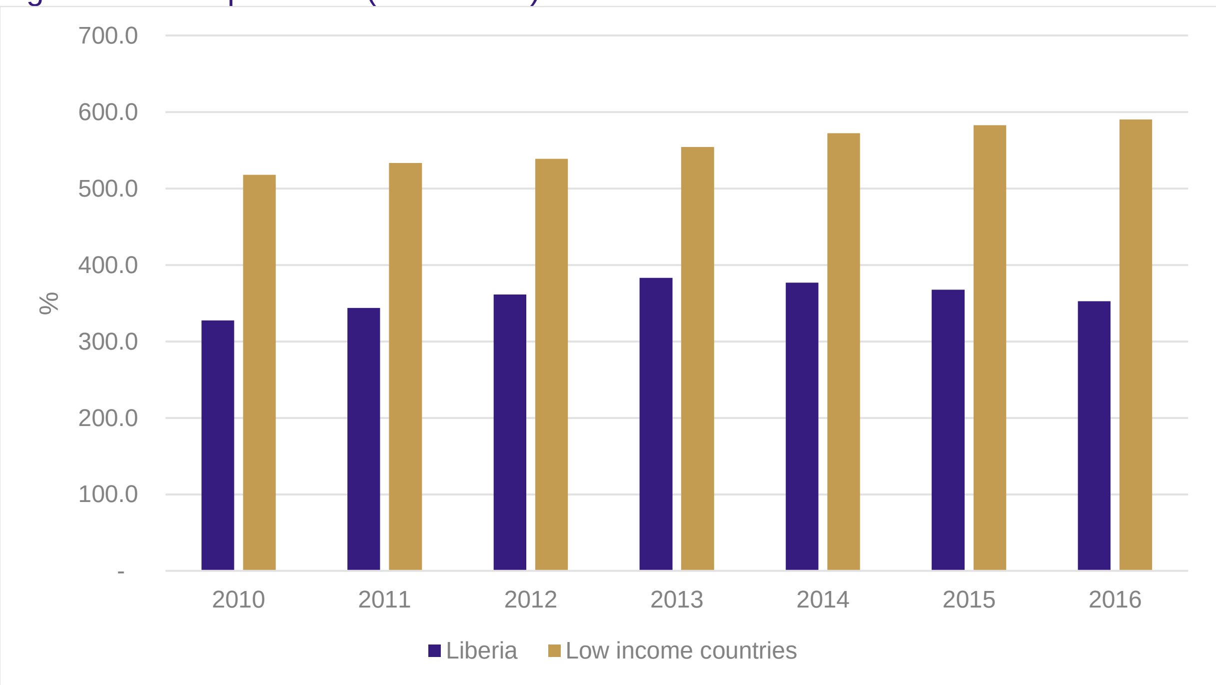
through informal channels or inefficient markets. This means that exports go unreported, taxes are not collected and prices achieved are lower than would otherwise have been.

Liberia has significant potential for increasing production in the extractive sector because of its rich natural resources. Formal mining concessions offer both benefits and drawbacks for economic transformation. Expansion could provide fiscal revenues through taxation and make direct contributions to infrastructure development including paved roads and railways as part of concession agreements. They can provide formal employment that is typically high-skilled employment and so attract higher wages and benefits but can also be dominated by expatriate staff. They do not provide a significant volume of low-skill jobs, with the sector only employing around 20,000 people in 2017. They also have not, to date, provided significant spillover effects because supplies are largely imported and they undertake limited processing in Liberia (Said, 2017).

Finally, the services sector commands an average share of GDP of around 47%. However, it provides predominantly low-skill, low-wage untradeable services including informal activities [9] and services related to aid donors and the United Nation's mission. These latter are in decline with the UN mission, in particular, being withdrawn in 2018. The impact of this reduction in aid or security-related flows from international donors was seen in the GDP figures in 2016 and 2017. In addition to these formal services there are also relatively informal, low productivity services such as petty trade and commerce. Although these currently provide significant employment, they also are linked to low wages (Central Bank of Liberia, 2016; Prizzon, 2017, forthcoming).

This structure of the economy has led to a high concentration of employment in low productivity and informal occupations. Poverty levels in Liberia remain high with 2016 per capita GDP of $367, 60% of the average for low-income countries, and 64% of the population living on less than one dollar a day. These low per capita income levels have negative implications for public welfare including high levels of child and maternal mortality, malnutrition and preventable disease including diarrhea, malaria and HIV (Figure 4).[10]

Figure 4: Per capita GDP (2010-2016)



Source: World Bank Development Indicators database.

[9] The largest contributors were Trade & Hotels (32.0%) and Government Services and construction (both 15%) plus Electricity & Water (+6.1%) and Transport & Communications (+6.0%). Source: CBL, 2016.

[10] Source: UNICEF

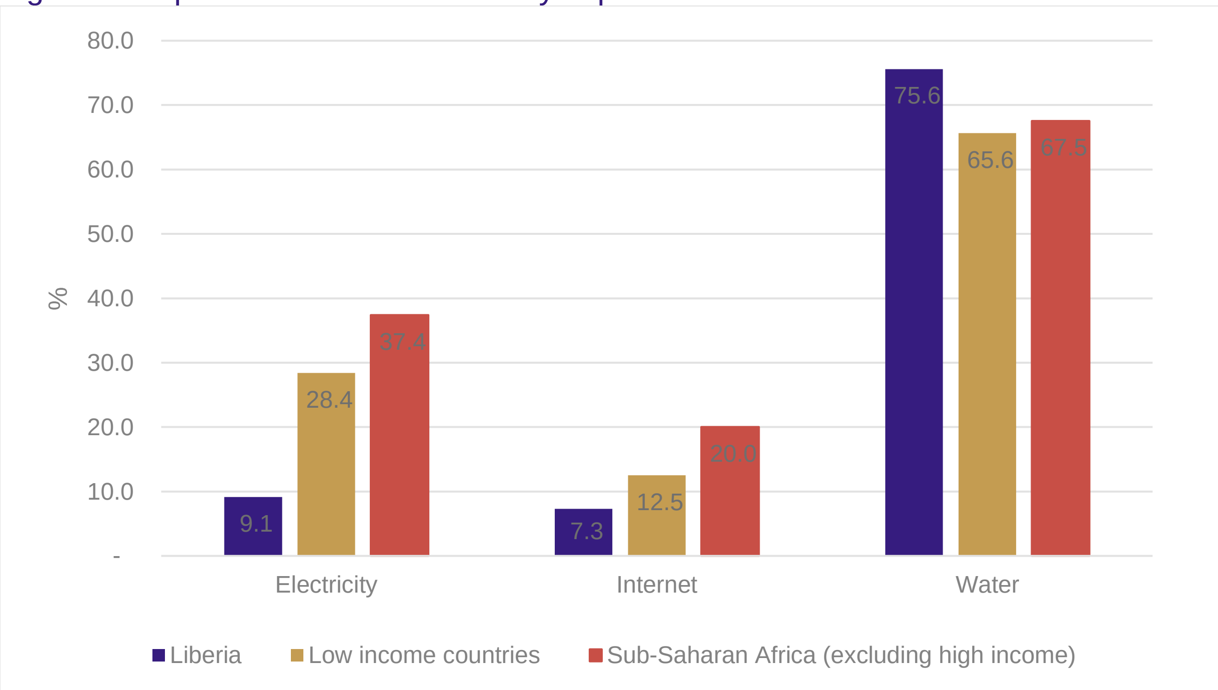
These issues, as well as the history of fragility and conflict in Liberia, have led to Liberia receiving significant flows of aid. Liberia was also granted more than $4 billion worth of debt relief under the Heavily Indebted Poor Countries Initiative. This debt relief led to a significant reduction in the level of sovereign debt from over 655% of GDP in 2009 to less than 20% of GDP in 2012. (IMF, 2015)

As a result, Liberia was the second most aid-dependent country in the world with donor financing and spending making up 37% of GDP in 2014 (including aid to support Liberia during the Ebola crisis) and donors remain active in Liberia. For example, as at 2017, the World Bank have 30 active projects with a net commitment of just under $400 million (Prizzon, 2017, forthcoming).[11]

In order to accumulate the resources to tackle these economic and social problems, Liberia needs to 'kick start' economic transformation. However, Liberia is also hamstrung in its ability to do this. The most critical of these is inadequate infrastructure. Electricity is expensive by African standards, is only partially reticulated and its supply is unreliable. Roads, seaport and airport facilities remain primitive and inefficient. Access to infrastructure varies widely around the country. (World Bank, 2012; AFDB, 2013; Government of Liberia, 2015)

The population with access to electricity is approximately one third of the average for low-income countries and one quarter of that the sub-Saharan Africa. The level of the population with access to the internet it approximately two thirds of that low-income countries and 40% of that for sub-Saharan Africa. Access to clean water is, however, above the average for both low-income countries and sub-Saharan Africa (Figure 5).

Figure 5: Population with access to key aspects of infrastructure



Source: World Bank Development Indicators database. Most recent year available used. For electricity – 2014; internet – 2016; water – 2015.

Addressing the infrastructure deficits would significantly enhance the prospects for medium-term economic growth in Liberia. Progress has been made in a number of areas. For example, financed by a consortium of donors[12] and the Government of Liberia, the Mount Coffey hydroelectric plant became operational in 2017 and has increased the levels of access to electricity for households from 2% to 9% (which remains

[11] Source: World Bank website.

[12] The Government of Norway, Government of Germany (KfW Development Bank), European Investment Bank and the U.S. Government (Millennium Challenge Corporation).

very low in comparative terms). There has also been progress in building paved, all-weather roads into the interior of Liberia, which is particularly important because they improve market access for key agricultural areas. Nevertheless, progress in infrastructure remains constrained by lack of institutional capacity to plan, prioritise and manage infrastructure projects. For example, the Mount Coffey hydroelectric plant took more than 10 years to execute (Said, 2017).

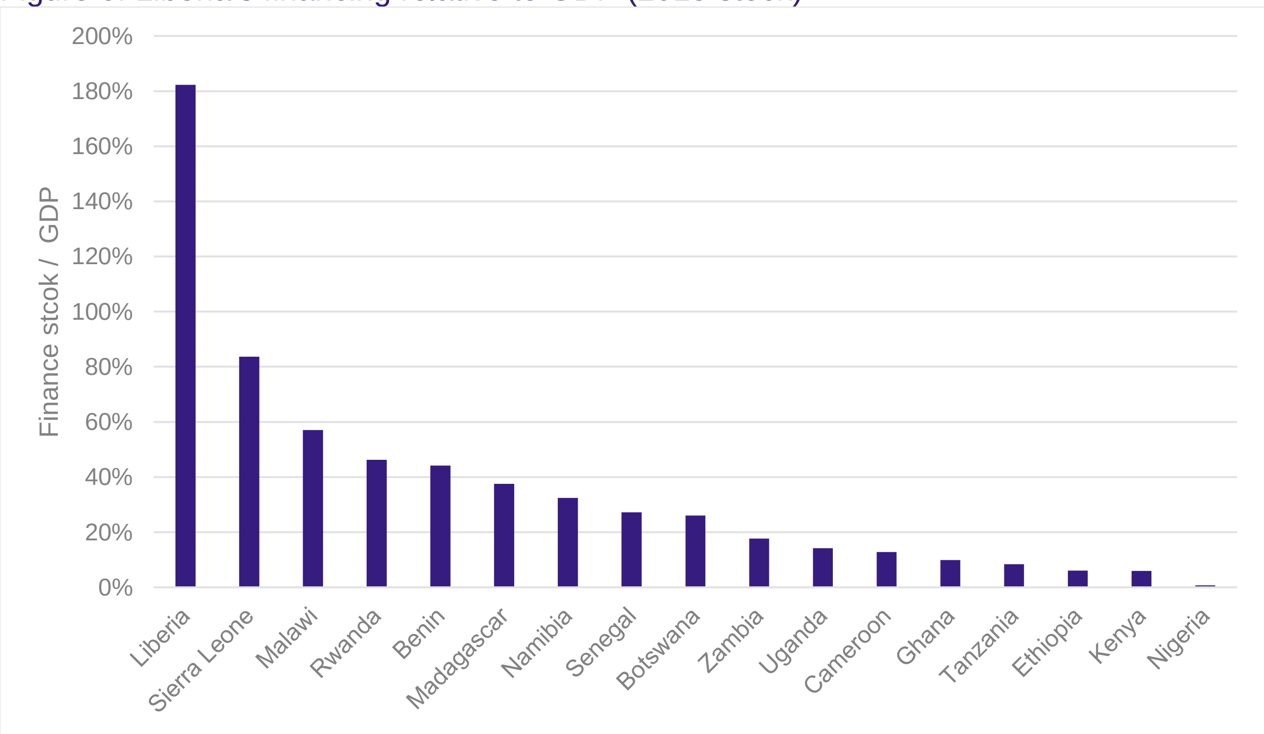
Liberia's business environment also remains a constraint on growth with it ranking 174th out of 190 countries on the World Bank's 2017 'Ease of Doing Business' index. The most significant constraints include the availability of electricity, weak contract enforcement and the difficulty in cross-border trade. The first and third of these highly ranked issues relate to poor infrastructure. However, other aspects of its ranking were more positive including the ease of starting a business, access to credit and taxation of enterprises and Liberia has improved its rankings somewhat in recent years.[13] However, tackling these matters is itself heavily constrained by ineffective public and private institutions (Said, 2017).

2.3 The financial landscape

Addressing structural impediments to economic growth will require significant financing for both public and private investment. This section reviews the current financing landscape and the level of financial development in Liberia.

Liberia has relatively high levels of financing relative to its GDP. As shown in Figure 6 below, Liberia's relative financing stock is amongst the highest in Africa at 180% of GDP (Figure 6). These high ratios reflect the high levels of FDI in Liberia, which compose 88% of its 2015 financing stock, and which reflect investments by international companies in the mining and agricultural sectors, as discussed above (Figures 7 and 8).

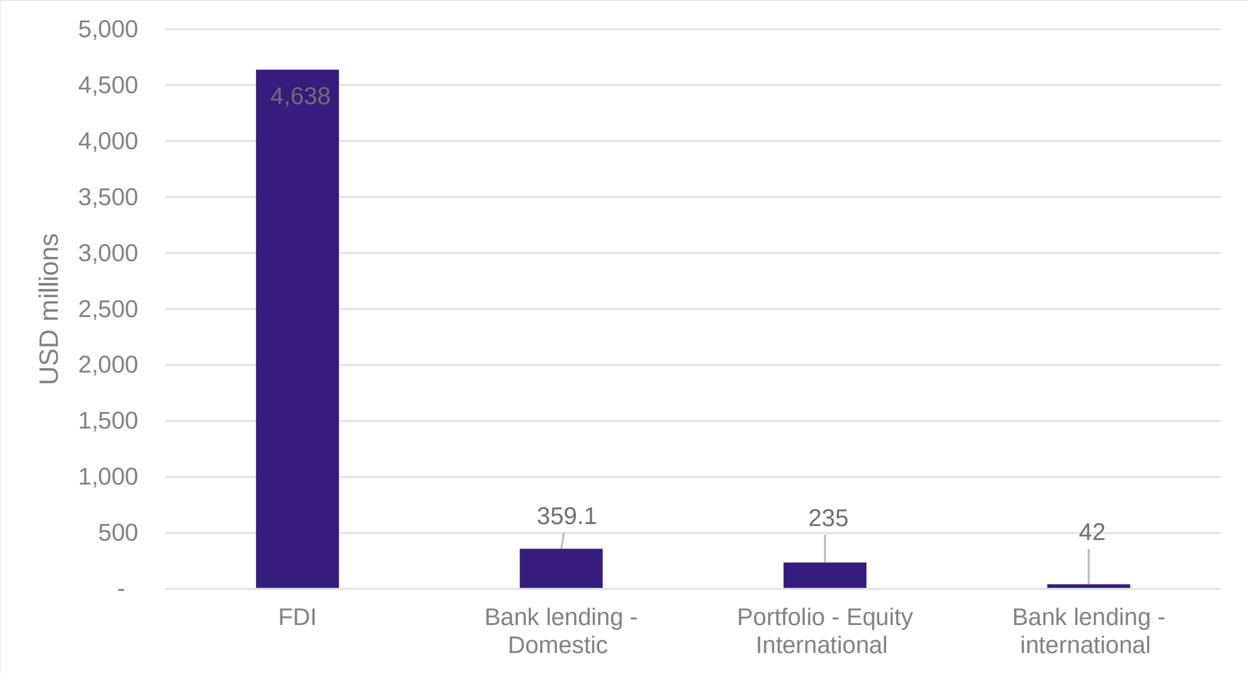
Figure 6: Liberia's financing relative to GDP (2015 stock)



Source: Tyson (2017, forthcoming).
Notes: 'Financing' is defined as FDI, domestic and international bank lending and capital markets (equity and debt).

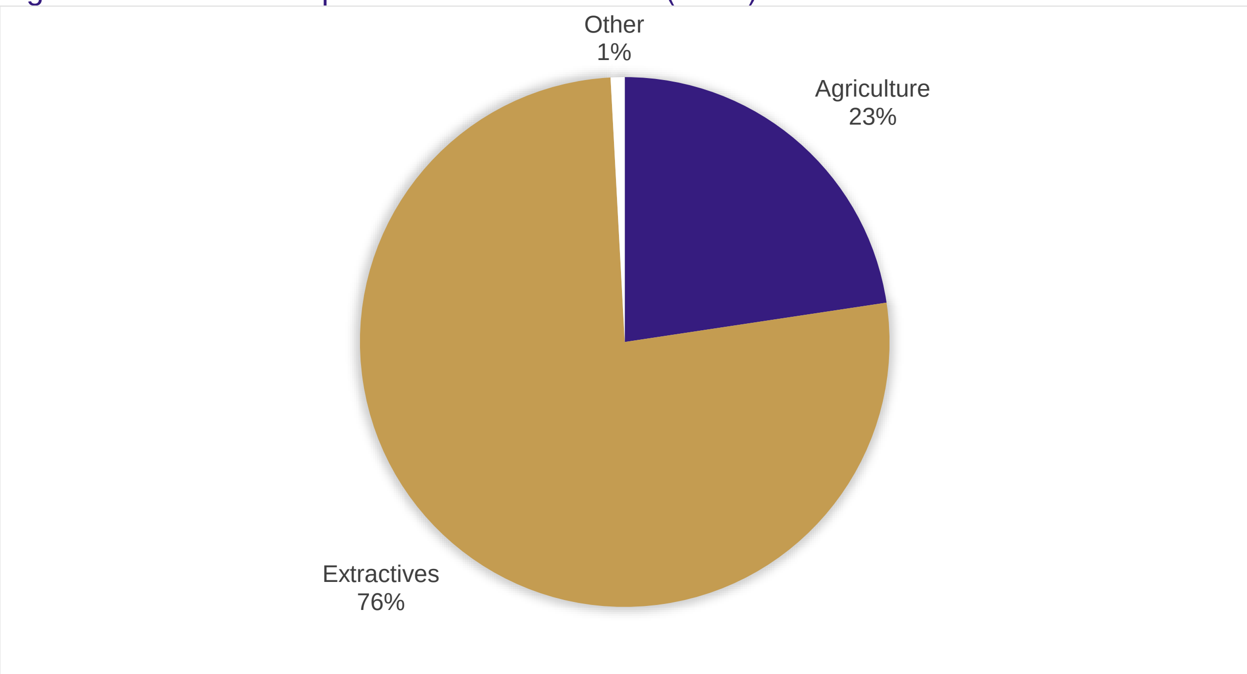
13 Source: World Bank 'doing business' website.

Figure 7: Liberia's financing by source (2015 stock)



Source: Tyson (2017, forthcoming).

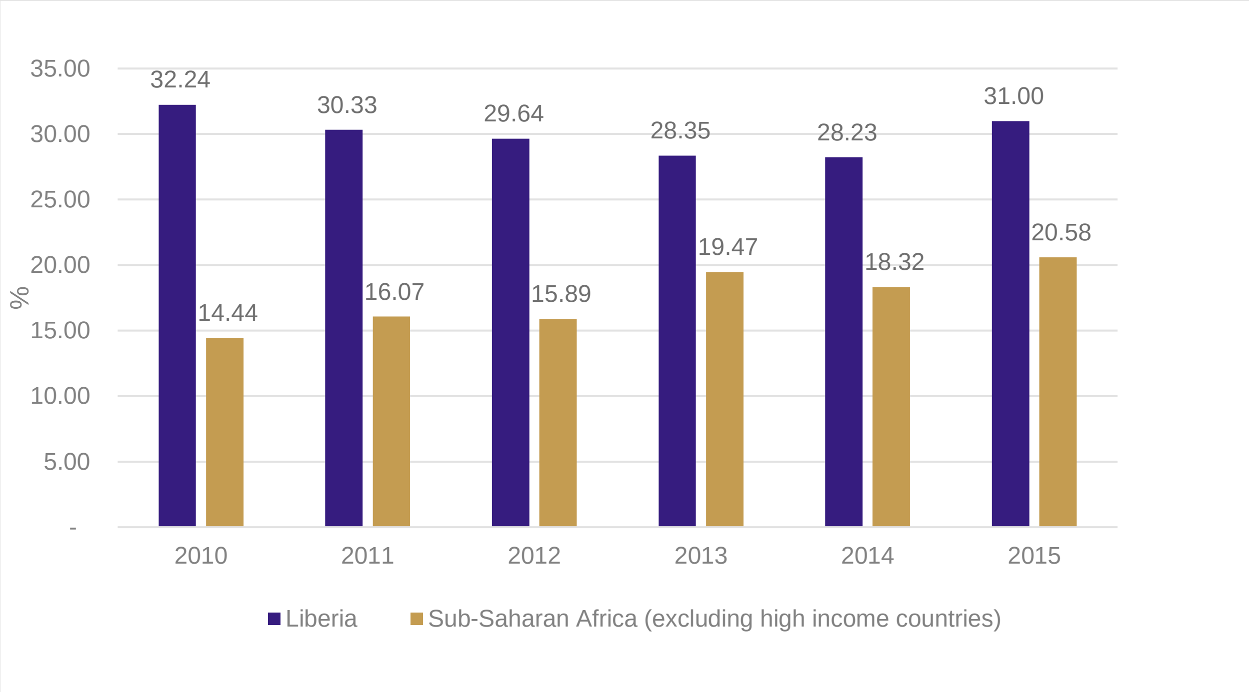
Figure 8: Sectoral composition of Liberia's FDI (2015)



Source: Tyson (2017, forthcoming).

After FDI, domestic bank lending is the most important source of financing. Liberia has nine commercial banks. They are well-capitalised with high levels of liquidity. However, their business is concentrated in a limited number of established firms and in the capital, Monrovia (Central Bank of Liberia, 2016; 2017). Domestic private credit from these banks averaged only 10% of total financing, although the ratio of domestic bank lending to the private sector relative to GDP is above the average for sub-Saharan African countries (Figure 9), and lending is relatively short-term.

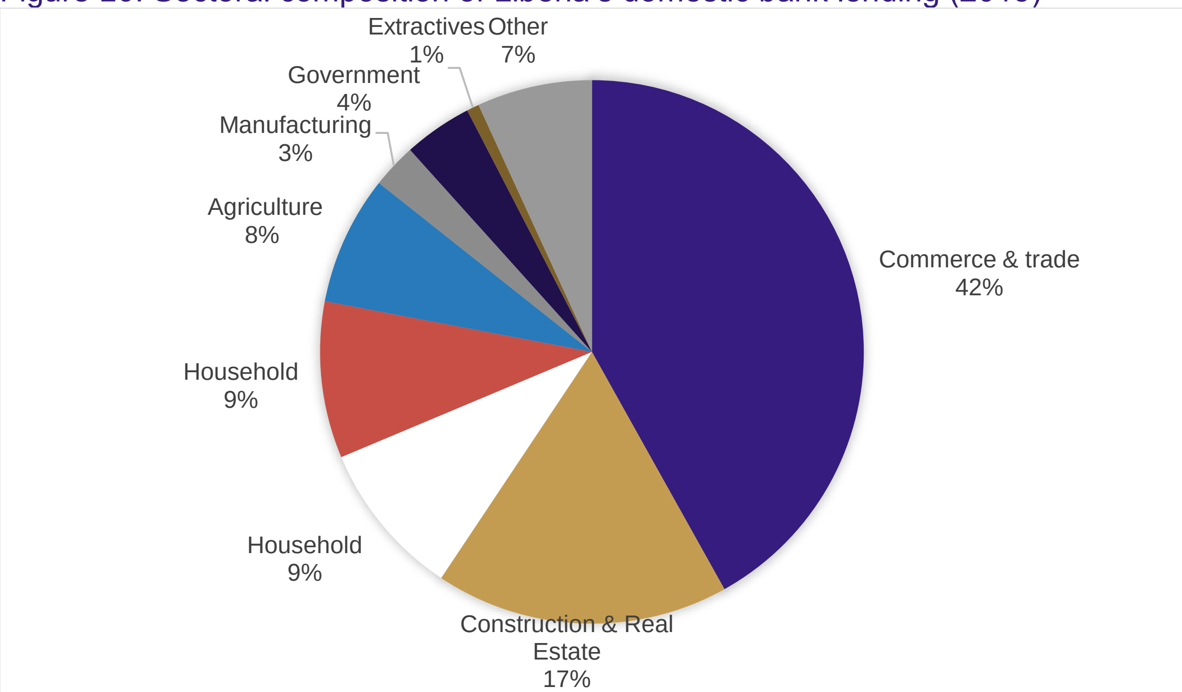
Figure 9: Liberia's domestic credit to private sector by banks (% of GDP)



Source: World Bank Development Indicators database.

Domestic bank lending is concentrated in sectors which offer only a limited contribution to economic transformation. As illustrated in figure 10, the 2015 stock of lending is concentrated in short-term commerce and trade, which received 42% of bank lending, and construction and real estate, which received 17% of bank lending. Although such lending for credit and commerce can be important in supporting ongoing business activities, it does little to provide the investment required for economic transformation. By contrast, there is relatively limited bank lending to sectors with the potential to increase productivity and create mass employment. These include the agricultural sector, which receives only 8% of 2015 bank lending, and manufacturing which received only 3% of 2015 bank lending (Figure 10).

Figure 10: Sectoral composition of Liberia's domestic bank lending (2015)



Source: Central Bank of Liberia, 2016.

These issues are reflected in domestic firms reporting access to finance a major constraint to growth. According to Liberia's Ministry of Commerce and Industry (2014) 35% of small firms, 27% of medium-sized firms and 30% of large firms see access to finance is a major constraint on their business. This partially reflects the high levels of credit risk inherent in the SME sector as well as the Liberian economy more broadly which disincentives bank lending appetite.

Non-bank financial institutions (NFBI) play an important role in Liberia's domestic financial system. They are the main source of finance in rural areas. NBFIs include approximately 30 micro-financing institutions and community financial institutions, 400 credit unions and 2,300 village saving and loan associations. These institutions are focused on credit and informal savings with limited deposit-taking (Central Bank of Liberia, 2016).

Mobile banking has grown significantly in recent years. By 2016, more than a million people in Liberia, 22% of the population, used mobile banking services. This has been achieved through growth in the businesses of regional banks in partnership with mobile phone companies, and has facilitated new economic opportunities such as the use of mobile banking for financing services for small-scale farmers as part of the Government agricultural programme, the Liberian Agricultural Transformation Agenda (Central Bank of Liberia, 2016; 2017).

Liberia also has a dual-currency system using both the US dollar and the Liberian dollar as legal tender. This has resulted in a high level of dollarisation in its formal banking system and a 70% level of dollarization for broad money measures. (Central Bank of Liberia, 2017). Such dollarisation can be positive because it prevents the evolution of hyperinflation and can be a factor in stemming capital flight from countries. However, such dollarisation can be difficult to reverse (Box 1).

In addition, it can undermine monetary policy independence and has contributed to a lack of export competitiveness because the US dollar has appreciated against a broad group of currencies over approximately the last five years. Illustrating this, the real effective exchange rate (REER) for the Liberian dollar appreciated by approximately 41% between 2002 and 2015 (Papadavid and Tyson, 2017). It would be desirable for the Liberian dollar to become the predominant currency in Liberia, replacing the US dollar, to allow for the competitive revaluation of exports. However, this is difficult to enact because of the public distrust in the Liberian dollar. (Central Bank of Liberia, 2017) Policy to de-dollarise the economy including comparative country experiences is discussed further in Box 1.

In relation to capital markets, financing for Liberia is limited. Domestic capital markets are thin, with only limited short-term issuance of treasury bills. There is no domestic equity market. Further development of domestic capital markets, including corporate and Liberian dollar denominated bonds and equities, is a strategic goal of the Central Bank. (Central Bank of Liberia, 2017)

However, recently there have been some international equity issuances. These have all been issued through the London Stock Exchange on its Alternative Investment Market which is designed to support relatively small equity issuances of higher risk stocks. Between 2010 and 2014, these raised more than $250 million for investment in Liberia, although funds went predominantly to the extractive sector (Table 1).

Table 1: London stock exchange issues for Liberian companies (2010 – 2015)

Year	Company	Sector	IPO value (USD millions)
2014	Canadian Overseas Petroleum Ltd	Extractives	26.1
2011	Aureus Mining Inc.	Extractives	158.4
2011	Hummingbird Resources plc	Extractives	50.6
2010	Equatorial Palm Oil plc	Agriculture	16.1

Source: Tyson (2017, forthcoming).

Liberia has also received financing from development finance institutions (DFIs) to support private sector development. For example, the International Finance Corporation (IFC) has made a variety of investments in the private sector accompanied by technical assistance. These include $8.5 million in agriculture financing in the rubber and cocoa sectors, $25 million in a rubber renovation programme and $18.5 million seed investment in a private equity fund for small and medium enterprises. The U.K.'s DFI, CDC group, have also made some small investments in Liberian education and financial services. However, while welcome, these DFI investments remain small relative to financing needs (Prizzon, 2017, forthcoming).

There are also a number of programmes focused on the SME sector. For example, the Central Bank of Liberia launched the Small-Medium Enterprises Credit Stimulus Initiative which provides concessional financing to SMEs and the Ministry of Finance and Development Planning has funded $2.1 million of loans to the SME sector via the Liberia Bank of Development and Investment (IMF, 2016). Similarly, USAID provides loan guarantees through EcoBank and International Bank and the African Development Bank is provided technical assistance to Access Bank for MSME support (Prizzon, 2017, forthcoming).

However, overall, the number of private sector development projects is lower than in neighbouring fragile states. For example, the IFC and CDC have fewer funded projects than in neighbouring Sierra Leone, there is no blended finance projects except for one managed by USAID targeting bank lending to SMEs and no innovation challenge funds in Liberia (Prizzon, 2017, forthcoming).

Box 1: Policy options for de-dollarization

Dollarization - defined as the holding by residents of assets and liabilities denominated in a foreign currency - is relatively common amongst developing countries, often as a response to hyperinflation and exchange rate depreciation.

Such dollarisation is difficult to reverse and dependent upon the re-establishment of broad economic stability. Indeed, in a sample of 85 countries which were dollarized, only 4 successfully de-dollarised in the period from 1980 to 2001. Similarly, in a more recent study by the IMF of 42 dollarized economies who sought to reverse dollarisation, only 11 succeeded.

Further, dollarisation is persistent – that is, it has a high level of hysteresis – and progress towards de-dollarisation can also rapidly reverse. For example, bouts of risk aversion in global capital markets and higher external interest rates have driven reversals in de-dollarization since 2008.

Attempts have been made to force de-dollarisation. However, this has frequently led to a worsening of financial and macroeconomic conditions including capital flight, damage to the reputation of governments and are, in any case, typically short-lived.

More effective measures for de-dollarisation have been prudential measures which make transacting in US dollars less commercially attractive than in the preferred currency for banking institutions. Such measures have the key advantages of both reducing the risks associated with forced measures but also being effective within a relatively short timeframe, with significant responses within 1 to 3 months of their introduction even when macroeconomic instability remains high. It should be noted, however, that prudential measures need to be carefully designed and monitored to ensure that they do not cause disintermediation, allow for regulatory arbitrage or increase capital flight.

Source: Tyson, 2016 (unpublished).

2.4 Conclusion

The structure of Liberia’s economy and its financial sector significantly limit the country’s scope for economic transformation. The formal economy is heavily dominated by the extractive sector which attracts the bulk of its financial resources.

The remainder of Liberia's economy remains significantly underdeveloped. In it informal activities in agriculture and services are important and are characterised by minimal levels of higher productivity production, low levels of agricultural processing and a very small manufacturing sector.

Development of sectors important for economic transformation remains constrained by poor infrastructure and limited access to finance. Tackling these issues requires a fundamental redirection of the Liberian economy and significant mobilisation of additional financing.

Box 2: Financial access and domestic savings mobilisation in Liberia

One potential source of financing for development is domestic savings. However, currently in Liberia, savings are strongly and consistently negative, according to the World Bank Development Indicators, because of illicit flows and repatriation of profits by foreign companies.

More fundamentally, domestic savings are strongly correlated to per capita income, which in Liberia are amongst the lowest in the world.

Greater levels of financial access could improve savings mobilisation. In Liberia, financial access is better than comparative countries although still lower than the overall average for sub-Saharan Africa.

The Central Bank of Liberia has also been active in supporting the development of mobile money services, a key enabler of financial access. This has included establishing legislative frameworks and supporting mobile money services by telecoms and banking companies.

This has resulted in a significant increase in financial access in Liberia. However, services continue to face barriers to further growth including adjusting services to the dual currency system, establishing financial infrastructure such as customer identification and credit bureaus and an absence of deposit-taking NBFIs.

Further progress in improving financial access including though mobile services are likely to result in further increases in domestic savings. However, it is unlikely to be a significant source of investment finance for development in the near-term because of the constraints discussed above.

Sources: European Report on Development, 2014; Tyson, 2015; Interview material.

3. POLICY FOR ECONOMIC TRANSFORMATION

3.1 Introduction

The economic transformation of an economy involves, at its most fundamental, increases in productivity and the creation of formal employment on a mass scale. For the majority of low-income countries this means development of agricultural processing and manufacturing, involving relatively low-skilled, but formal, employment, and gradual increases in productivity and growth of exports over the long run (McMillan et al., 2017).

As discussed in Section 2, the Liberian economy currently is highly concentrated in extractives with low levels of agricultural processing and manufacturing. Economic transformation is dependent upon the development of these sectors accompanied by the mobilisation of the finance needed for this to happen.

The Government of Liberia has recognised these issues and set out in the 2015 Economic Stabilisation and Recovery Plan a programme for economic development. Key initiatives included tackling the infrastructure constraints discussed earlier, developing agricultural value-chains in rubber, oil palm, cocoa, fish and cassava and establishing a special economic zone (SEZ) in Monrovia (Government of Liberia, 2015).

This strategy appears well-grounded in Liberia’s competitive advantages and in the goals of economic transformation. However, executing the strategy is challenging. This section addresses how it might be approached, drawing on the economic literature relating to transformational experiences of comparative countries.

3.2 'Lessons' from the economic literature

Many of the constraints to structural change in low-income countries, such as Liberia, are well known. The most important of these are poor infrastructure, a lack of financing, weak institutions and poor business environments.

Initiating significant change in such countries is difficult and maintaining transformation momentum even more challenging. Indeed, these challenges explain why there is a very limited number of low-income countries that have successfully transformed themselves to middle-income countries, especially in sub-Saharan Africa, and why very few formerly fragile and conflict-affected states are among them (IFC, unpublished).

However, the literature on economic transformation provides useful guidance on successful strategies for execution that is of relevance to Liberia. Importantly it shows that, for countries with multiple barriers to transformation, it is neither necessary nor realistic to address all constraints on economic transformation at once. Instead, an approach focussed on a single sector of comparative advantage combined with a mechanism to coordinate political leadership is the main catalyst for change. In addition, it indicates that a variety of political institutional arrangements can support such change (McMillan et al., 2017).

The 'sector' can vary according to the country and its comparative advantages and might include a particular economic sector – such as agriculture in Liberia including rubber, oil palm, cocoa, fisheries, cassava and rice) - or a particular region or 'zone' including special economic zones (McMillan et al., 2017).

The literature also shows that there are essential preconditions for growth take-off. The most important of these are established private property rights, adequate infrastructure and export cost competitiveness. In Liberia, of these three pre-requisites, the weakest is infrastructure. Additionally, export cost competitiveness is weak because of the dollarisation restraining export competeviness (as discussed in Box 1).

It is important to note that this list of 'must have' preconditions does *not* include a need for pre-existing 'best practice' governance. A significant body of research supports the view that institutional strength is not needed for economic transformation to start or to be maintained. For example, in Asia there have been spectacular development successes in regimes that score low on conventional rankings for governance quality. In addition, cross-country analysis shows, at best, an ambivalent relationship between democracy, accountability, anti-corruption and citizen empowerment devices and economic growth. Indeed, most political regimes since the 19th century that have presided over major economic breakthroughs for their country have not been reformed in advance of economic transformation (McMillan et al., 2017).

However, it should be noted, that these findings are based primarily on the experiences of Asian and Latin American countries and which have incorporated country-specific institutional arrangements that have supported success. There are relatively few examples in Africa. Nevertheless, some have emerged demonstrating that transformational change is possible even under 'weak governance'. These include manufacturing in Ethiopia and Rwanda and agricultural processing in Ghana and Uganda (McMillan et al., 2017).

This challenges the view prevalent among development analysts that 'good governance' is a prerequisite for economic transformation. To date, this view has led to technical assistance to support institutional development being a key feature of donor-supported programmes. This is true of Liberia. Instead, these findings imply that Liberia, in face of limited capacity and resources, should not focus on developing institutional capacity or broad economic development but on a more targeted approach by developing a 'single sector' and its infrastructure.[14]

[14] Given the difficulty of tackling poor export competiveness resulting from dollarization. See Box 1 for discussion of this issue.

The literature also provides guidance about factors that can enable success in such a focused strategy. These include it being led by a public agent that is politically empowered to coordinate the strategy among public and private sector organisations and to closely involve (i.e. embed) key entrepreneurs and financiers. Government bodies, such as the National Investment Commission of Liberia, have already begun building such 'embedded' relationships. However, this requires further development especially among international investors. This strategy promises to provide rapid and influential demonstration effects which can be a catalyst to broader support and consensus so accelerating and broadening development initiatives.

Finally, the literature also shows that successful economic transformation has often emerged from a period of economic experimentation to find what works and what does not in a specific country using an adaptive trial-and-error approach with 'small bets' and rapid adjustments until a workable solution is found. In this context, a key role for policy is the facilitation of 'learning' – about new technologies, new ways of doing business and new ways of managing the economy (McMillan et al., 2017).

3.3 Policy suggestions

The 'lessons' from the literature indicate that the most successful approach to Liberian economic transformation is likely to be a focused approach on a selected key sector. Based on the analysis in the 2015 Economic Plan, this is likely to be agriculture and could include a focused selection from possible products with commercial potential such as rubber, oil palm, cocoa, fisheries, cassava and rice. It should be accompanied by mechanisms to coordinate between government, donors, private entrepreneurs and investors.

Below, the paper highlights in more detail what this broad conclusion might mean for policy specifics for both the Government of Liberia and supportive donor institutions.

3.3.1 Strong public-private co-ordination mechanisms for agricultural development

Liberia's ambition is to develop value-chain processing in agriculture.[15] Successful development of value chains promises benefits of increased productivity, value-added production and employment creation.

However, today, value-chains in Liberia are largely absent. This is difficult for individual firms to develop them because success requires a coordinated and simultaneous development of all stages of the value-chain together with the required supportive infrastructure (Tyson, 2017). Nevertheless, some firms have overcome these difficulties independently by developing value-chains in totality including dedicated infrastructure. For example, individual investors have engaged in construction of warehouses, storage and processing facilities, investment in farm inputs, dedicated power production and the development of farmer organisations.

In Liberia, such investors have included Firestone in rubber and Equatorial Palm Oil in palm oil. In neighbouring Sierra Leone, these models have been implemented in commercial cocoa farming. However, these business models are cost-intensive and time-consuming which limits the investors willing to adopt them. In any case, they often lead to limited value-added processing in the host country.

Investors could be helped to overcome these barriers through a formal coordination mechanisms led by the Government with a strong mandate in the development of the agricultural sector. The goal of the coordination should be to manage the simultaneous public and private investments required for the sector's development, provide leadership and coordination and partner with investors to overcome 'roadblocks' as the sector develops. In addition, such an organisation could lead to a dedicated drive to expand exports including trade negotiations for key export markets.

[15] And potentially in mining where similar policy considerations might apply.

As noted in Section 3.2, comparative country experiences have shown that a variety of institutional structures can provide this coordination function and that they should be tailored to the specific country context as long as they have high-level and independent mandates.

Consideration as to how this could be executed in practice in Liberia should be the subject of further discussion. However, successful and analogous examples have already been executed in Liberia. They include infrastructure development being successfully coordinating by the Ministry of Public Works' Project Implementing Unit (PIU), a ministerial-led unit with a mandate for infrastructure development. (Prizzon, 2017, forthcoming), and the revised organisational structure of the Central Bank of Liberia to provide leadership and oversight of economic planning and financial development (Central Bank of Liberia, 2017). Similar organizations with high-level mandates could be established or extended to lead development of the agricultural sector and coordinate the related financial and infrastructure developments to support it.

A further possible option for implementing this in Liberia is to work closely with existing large-scale firms in agriculture to encourage an increase their processing within Liberia. Engaging such 'anchor investors' has proved a successful path to developing increased processing in other developing countries because it leverages investors industry expertise in combination with support from the government and provision of finance. Such approaches have been particularly successful for FDI in low-income countries and would be suitable for replication in Liberia especially in the palm oil, rubber and cocoa sectors.[16]

3.3.2 Synchronised and targeted infrastructure development

To date, infrastructure development in Liberia has received significant financing and capacity building support from donors including the World Bank, the African Development Bank and the Chinese Government. Projects are also being coordinated by the Liberian Government through the Ministry of Public Works' PIU which has managed over 105 projects worth $1.4bn since 2006. (Prizzon, 2017, forthcoming) The literature indicates that this focus is well-grounded because infrastructure is a prerequisite for growth take-off.

However, given the extended time periods and large-scale financing that is involved in national projects, infrastructure that is specific to the single sector could be further prioritised. For example, electricity could be supplied differentially to relevant enterprises and transport infrastructure prioritised where it provides access to markets including export markets. It could also include development of trade corridors from agricultural areas to processing points (such as in urban SEZs) and export facilities including sea and air ports.

Such strategies have already been part of the infrastructure planning for Liberia including building paved road linking the agricultural production areas in the interior of Liberia to regional export markets across land borders and to the main port at Monrovia. For example, the World Bank and partners have provided more than $400 million in financing to build all-weather paved roads along 'growth corridors' including connecting inland towns such as Ganta in Nimba County, international borders and Monrovia.[17]

In addition, there are plans to build electricity transmission lines between Monrovia and Tubmanburg and from Monrovia to Firestone and for the development of a hydro-electric plant on the St Paul river. This promises to provide an increased supply of cheaper electricity including all-season generation capacity. It has received funding for a detailed feasibility study from the EIB, and work is also progressing on the West African Power Pool electricity interconnection project from Cote d'Ivoire from 2019. These changes are expected to increase the installed capacity more than six-fold by 2020 (Republic of Liberia, 2015; African Development Bank, 2017[18]) However, these projects could be more closely coordinated with investments in the private sector, including those from DFIs.

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[16] Source: Interviews with DFIs.

[17] Source: World Bank. http://www.worldbank.org/en/news/feature/2017/02/13/improved-road-network-in-liberia-boosts-trade-and-commerce

[18] https://www.afdb.org/en/blogs/measuring-the-pulse-of-economic-transformation-in-west-africa/post/addressing-infrastructure-constraints-to-inclusive-growth-in-liberia-17200/

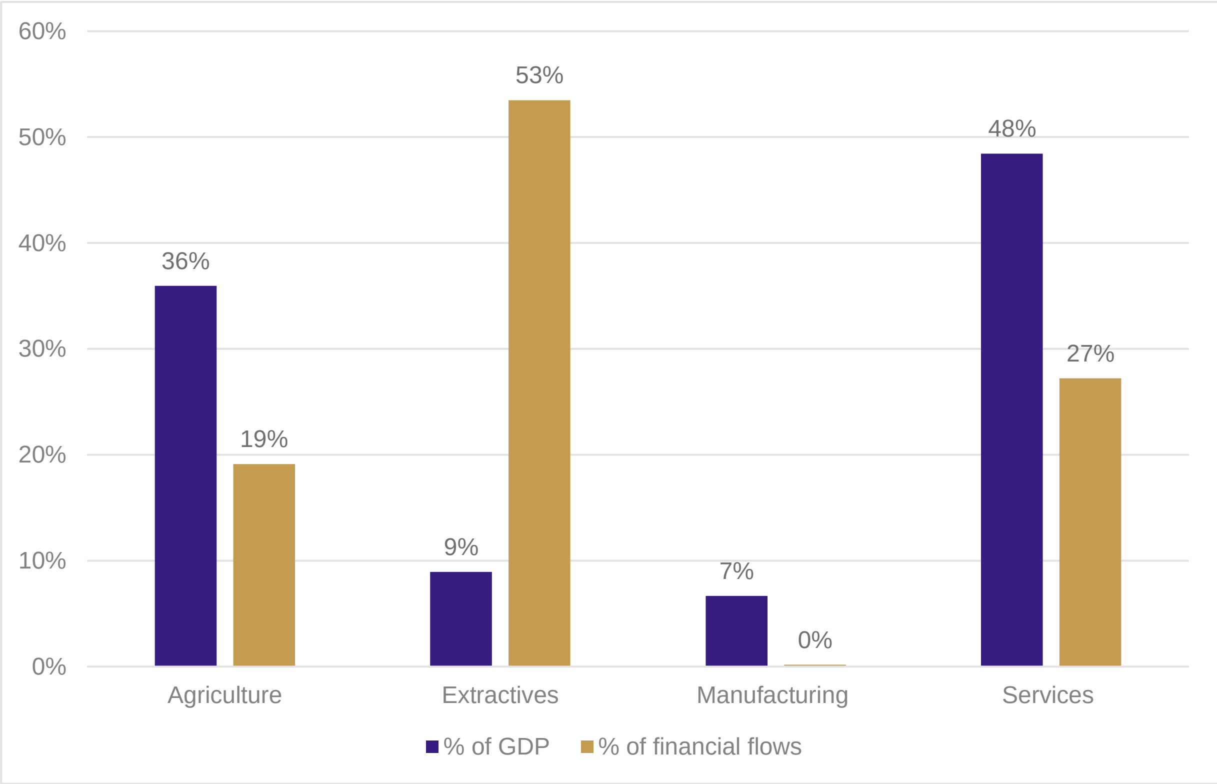
3.3.3 Mobilise private finance for agricultural and infrastructure development

Private finance in Liberia is a critical constraint to growth because of its lack of involvement in infrastructure and investment in agriculture.

In infrastructure financing, donors have already provided significant financing. However, much more is needed if the limitations on growth imposed by inadequate infrastructure are to be lifted. Such scale of financing is likely to be led by multi-lateral donors including the World Bank and the African Development Bank and other bi-lateral donors. Nevertheless, co-finance with private investors is possible which could involve existing specialist funds such as the Africa 50 Fund at the African Development Bank and DFIs including the IFC and CDC. For such development agencies, power and roads should continue to be a focus because of the significant development impact that they can deliver.

Levels of financing agriculture are also low. This is illustrated in in figure 9 below which shows the relative share of GDP and of private finance by sector. As can be seen, agriculture has a relatively low level of financing, especially relative to the extractive sector. These limitations on finance needed for capital investments in processing and in higher productivity agricultural production are severe.

Figure 11: Liberia's GDP and financing stock by sector (2016)



Source: Tyson (2017, forthcoming) (data sourced from CBL, the World Bank database and *The Financial Times*).

Government and donor funding for private sector investment is limited. Limitations include the absolute amount of financing and a paucity of specialist financing such as DFI projects, blended financing and innovation challenge funds. Because of this, more finance needs to be mobilised including that specific to agriculture including financing to support agricultural value chain development.

Table 2 below illustrates the range of policy options for international donors to agriculture. They include wholesale financing to the sector via intermediary banks, risk-sharing for venture capital projects and vanilla loans for larger companies. In addition, private sector development can be supported through technical advice.

Table 2: Policy instruments for manufacturing and agricultural processing

Instrument	Typical structures	Example market segment
Debt and equity financing	Debt and equity, including in local currency and for relatively long periods	Larger companies and value-chains
'Ring-fenced' funds via financial intermediaries	Intermediaries are typically local banks or microfinance institutions serving small and microbusinesses	SMEs and small farmers
Venture capital funds	Equity, quasi-equity and debt for new investments, including via fund-of-funds and risk-sharing with investors	Innovative businesses and greenfield sites
Raising and managing third-party funds	Including loan syndication and funds to provide diversification benefits to investors through risk-pooling	Funds in manufacturing; not used extensively to date
Advisory services and technical advice	Support for domestic financial institutions, private investors and firms; can be difficult to leverage because it is cost-intensive	Building a pipeline of 'bankable firms'

Source: Tyson (2017).

Consideration should be given as to which of these approaches are suitable for Liberia especially in light of the perception amongst private investors of the high risk of investing in Liberia. This warrants a focus on risk mitigation by donors. For example, policy instruments could include co-investments with private investors through equity, mezzanine debt and risk pooling.

Engaging with 'anchor investors' could also bring significant advantages in value-chain development. Discussions with such investors with a view to providing them with co-financing arrangements that would facilitate additional investment in processing should be an important part of mobilising finance for the agricultural sector in Liberia. This is especially true of those who have already made investments in Liberia but with low levels of agricultural processing and those who have not made investments in Liberia to date but who have expertise in agriculture in other low-income countries.

In addition, in the immediate term, there is a strong role for 'impact accelerator funds' because of their ability to initiate transformational change through strong demonstration effects and a forum for 'learning by doing'.

It is also of note that the agricultural sector provides development impact effects that are compatible with the goals of socially responsible investors and DFIs. This is because of its potential to create employment and hence alleviate poverty while upholding environmental and social standards. Hence, the expansion of these activities should be of particular interest to investors holding dual mandate for financial returns and development impacts. They should be focused on as potential investment partners.

Finally, there are concerns that these forms of blended financing can lead to subsidies and rent seeking. These issues relate to the difficulty of assessing financial additionality, creating unwarranted 'subsidies' for private investors. (For example, Carter and Tyson, 2017) However, this unlikely in the instance of Liberia. Currently, where there is very limited private finance outside of FDI in the extractive sector. the Liberian agricultural sector enjoys negligible private financing flows so blended finance is unlikely to replace financial flows that would have happened anyway. Hence, the risk of unwarranted subsidies from blended finance is limited.

Box 3: Special Economic Zones in Liberia

In order to be successful, special economic zones need to provide clustering effects. Elsewhere these have included providing firms with dedicated access to electricity, public funding of transport links and special concessions to investors such as tax breaks and publicly-funded staff training.

For example, in Ethiopia, SEZs have been run by a dedicated public organisation that closely coordinates practical and institutional operations with the goal of providing a ”one-stop shop” for investors. SEZs include delivery of reliable energy through a dedicated substation. The SEZs have attracted a number of investors and are expected to generate 60,000 jobs. However, they continue to face challenges including power failures and sourcing supplies, cost of transport and labour-management issues. (Hoque, 2017)

Similarly, in Rwanda, the government established a Special Economic Zones Authority of Rwanda to develop SEZs. As for Ethiopian, SEZs provided dedicated infrastructure and trade facilitation for producers. This included reliable power, water, storage and warehousing and technology infrastructure as well as improved transport connections by road and rail. Investors are also offered tax incentives. The SEZs have attracted investors from China and the United Kingdom in textile production. However, development has been slowed by Rwanda's landlocked status with related high cost of transport and a shortage of appropriately skilled labour. (Papadavid and Tyson, 2017)

The Liberian Government's 2015 economic strategy includes development of special economic zones including in Monrovia and Buchanan. These choices appear sound as they offer proximity to ports and supplies of labour from the urban population. However, the zones are currently underdeveloped. For example, there is limited electrical power and weak transport between the special economic zone, input supplies and export facilities.

Consideration should be given to how the existing SEZs can be developed to provide stronger clustering effects including integrating them into the broad strategy for development of agricultural processing and value chains.

3.4 Conclusion

This section has discussed how Liberia might execute its economic strategy. The reality is that there is no easy or formulaic pathway to starting and sustaining economic transformation. Further, Liberia faces significant barriers to such a pathway including ineffective infrastructure and very limited private finance.

However, economic literature suggests that a possible option is using close partnership between public and private actors to coordinate simultaneous public and private investments and financing of private sector investments. This is most likely to be achieved by the Government of Liberia leading mechanisms for this coordination. This could include the creation of a dedicated politically empowered agent or extended mandates for existing public agents such as the PIU or the Central Bank.

Equally important is that donors align their activities to support development in the agricultural sector including coordinated infrastructure development (which is already partially an execution by donors such as the World Bank) and mobilising private finance.

In relation to the latter, further progress is needed. In the immediate term in Liberia, there is a strong role for ‘impact accelerator funds’ to lead demonstration projects and for existing ‘anchor firms’ to be engaged to extend their existing activities in the agriculture sector into greater levels of processing in Liberia.

Whilst economic transformation is a complex and difficult process, in the short-term it would be possible for this strategy to start the process. Given the depth of poverty and economic underdevelopment in Liberia today, execution of such a strategy should be given consideration.

4. CONCLUSION

Economic growth plays a key role in stabilising fragile and conflict affected states. However, relatively few countries have made the transition from a FCAS to a stable state and even fewer still to a prosperous one.

Further, creating conditions for economic stability and growth requires not only economic growth, but also structural change the fundamental processes of which are increases in productivity and formal employment.

The barriers to this are high. Liberia illustrates the difficulties. Its economic structure is typical of FCAS and low-income countries with a high concentration of GDP and employment in subsistence agriculture and informal occupations and a reliance on the extractive sector for fiscal revenues and exports. It is vulnerable to major changes in the real effective exchange rate. It commands low levels of saving. Economic growth is constrained by ineffective infrastructure, low levels of private finance and social and economic environments which hamper businesses. The economy is vulnerable to shocks such as the Ebola crisis and global commodity price falls. Poverty levels are high. The Government suffers from weak institutional capacity and low fiscal revenues.

However, Liberia also illustrates the possibilities of positive change in fragile and conflict affected states. The end to its civil war in 2003 brought strong economic growth and political stability. In October 2017, it held democratic elections that were broadly seen to be fair and peaceful at the time of writing. Donors assistance has achieved improvements in infrastructure, such as increases in electrical power and paved roads, and in capacity at public institutions.

However, the economic literature suggests that a more focused approach is needed if structural economic transformation is to be initiated and maintained. As discussed in this paper, Liberia, with its limited capacity and resources, may be better to focus on development of a single sector – most likely to be agriculture including processing and value-chains – by building stronger coordination mechanisms to deliver the required infrastructure and to coordinate the public and private sector investments.

Donors have already delivered significant support in Liberia. However, they could help in this strategy by re-orientating and increasing support for private sector development in agriculture. As well as by participating in coordinated programmes with the Government and delivering industry-specific infrastructure. This requires increased and innovative financing.

Such financing should include, in the immediate term, increased accelerator impact funds and blended finance. It should also include working with large-scale firms with the industry expertise to build value chains including those already active in Liberia and those active in the sector in other low-income countries.

The challenges to executing the strategy are many. However, Liberia has an aspiration to become a middle-income country by 2030 - a goal which promises to bring a permanent end to the grinding poverty that the majority of its citizens suffer as well as stability and prosperity. Such a goal is worthy of sustained efforts and risk-taking by the Government of Liberia and its people in partnership with the donors who support them.

Finally, it should be noted that such focus single sector approach should be seen as a starting point for economic transformation in low-income countries. In the medium term, it would be hoped that much greater deepening and diversification of multiple sectors across the economy would be achieved and, indeed, would be seen as necessary for achieving middle income status where economies are not only larger but more complex and diversified, providing the means to achieve broadly-shared prosperity and economic and political stability are the goals of economic transformation.

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