Governance, Budget Deficits And Financial Crisis: An Analysis Of Government's Role In The Liberian Banking Crisis

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ABSTRACT

The adverse macroeconomic consequences of financial crises have heightened research interests in their causes. However, little is known about the role of political influence as a cause of financial crises in small developing countries. This research explores the role of governance as one of the causes of failures in nine of Liberia's twelve commercial banks during the financial crises during the period 1986 to 1999. In particular, this paper explores how the government used appointments primarily based on kinship to influence the banking sector and render the National Bank of Liberia ineffective in implementing its regulatory powers. The research found that regulatory standards, weakened by nepotism, led to corruption and mismanagement in the banking sector. In addition, through the government's political influence over the National Bank of Liberia, it was able to finance unsustainable fiscal deficits by borrowing from commercial banks and the National Bank of Liberia, culminating in severe financial crises.

Keywords: Governance; Financial Crisis; Liberia Banking Crisis; Budget Deficit

1. INTRODUCTION

Following the global financial crisis that caused the worldwide recession in 2007, research interests in understanding its causes and consequences have increased. In addition, the role of government in mitigating the macroeconomic impacts of financial crises and in providing appropriate policy responses to prevent future crises have gained increased attention (Reinhart & Rogoff, 2008). By 1997, Liberia experienced a wave of bank failures, including two-thirds of its commercial banks. Those failures caused significant losses of bank reserves, personal savings, and business deposits. In light of these experiences, a number of questions remain unanswered about the causes of the failures. This paper explored the role of governance among the causes of the bank failures in Liberia. Particularly, it explores how the government used the National Bank of Liberia to weaken regulatory standards, bank management, and monetary policy in order to finance fiscal deficits, hence causing the financial crisis. The paper used data obtained from the IMF, the Central Bank of Liberia, and interviews with Liberian policymakers to explore the link between political leadership, budget deficits, and Liberian bank failures between 1986 and 1999.

The following section reviews the extant literature on banking and financial crises, followed by sections providing a summary of the political system and governance in Liberia leading up to the financial crises of the late 20th Century, an analysis of the causes of the Liberian financial crises, and some closing thoughts.

2. LITERATURE REVIEW

Among the studies on crises in the banking industry around the world, Reinhart and Rogoff (2008) studied sixty six countries covering 1800 to 2007 and found that banking crises have occurred in countries of varying profiles: they differ by level of development, political system, and geographic location. The study also found that banking crises have usually been associated with a high incidence of sovereign defaults on external debts. It suggested that in order to prevent banking crises, sovereign external debt should be kept at a reasonable level.

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Demirguc-Kunt and Detrigiache (1998) studied the determinants of banking crises in a cross-section of developing and developed countries. The authors found evidence that low growth and high inflation can lead to banking crises and the study also found that high real interest rates are associated with systemic banking problems. In addition, Demirguc-Kunt and Detrigiache (1997) found that countries with weak institutions (as measured by law and order) are more likely to experience banking crises. Since policymakers play important roles in influencing the inflation and interest rates as well as the quality of institutions, it is plausible that the effectiveness of governance may help explain the occurrence of financial crises.

Another paper (Kaminsky & Reinhart, 1999) examined the behavior of a number of macroeconomic variables before and after financial crises in twenty countries. They reached the conclusion that high interest rates and low growth rate were the best signal of impending financial crises. In addition, they found that a loss of foreign reserves was a factor in signaling financial crises.

Previous studies have largely focused on macroeconomic variables in explaining banking crises across countries. However, little is known about the determinants of banking crises within a small developing country such as Liberia. Furthermore, there is limited knowledge on how political culture and the quality of governance contribute to financial crises. This study is one of the first attempts to close these gaps by focusing on the role of governance as a cause of the crises in the Liberian banking sector between 1986 and 1999.

3. BACKGROUND AND FOUNDATION OF THE LIBERIAN BANKING CRISIS

Liberia is a small West African country with a population of 4.1 million (World Bank, 2012) and was the first Sub-Saharan African country to obtain independence from the American Colonization Society on July 26, 1847. Its legal and political systems are based on a constitutional democracy with three legally separate branches of government - executive, judiciary, and legislative. The country is headed by the president who is head of the executive branch. The President, assisted by the Minister of Finance, develops the government's fiscal policies and annual budgets which are reviewed and approved by the legislature before becoming law. Subsequent to 1976, government spending was generally balanced with revenues and grants receipts. Its budget balances, as a percentage of GDP, were low and reflected surpluses for several years until 1976. In addition, the country's external debts were relatively low, averaging less than twenty percent of GDP for most of the years before 1976.

However, after 1975, Liberia's spending in excess of revenues and grants increased significantly. As reflected in Table I, the budget balance declined from a surplus of 0.17% of GDP to a deficit of 21.75% in 1989. Meanwhile, the country's external debts increased from 16.59% of GDP to 246.45% in 1989. The increase in external debt during the fourteen-year period represents an average annual growth rate of 98.98%. Meanwhile, while its external debts and deficits increased between 1975 and 1989, its GDP declined by an average annual rate of 1.68%.

Table I. Significant Macroeconomic Indicators and Dates in Liberian History

Variable	1975	1980 Military Coup	1985 Default	1989 Civil War Begins	1997 End of Civil War	2012
Gross Domestic Product (GDP)	1077.06	1196.08	1087.52	372.36	240.73	1155.24
GDP growth rate	-3.50	-4.10	-0.80	-27.00	106.00	8.31
Inflation rate	13.50	14.70	-1.20	25.25	9.97	6.90
Government						
Revenue (millions of $)	136.60	238.90	217.50	274.10	25.60	443.00
Spending (millions of $)	134.80	372.60	371.90	355.10	28.20	461.00
Deficit/Surplus % of GDP	0.17	-11.18	-14.18	-21.75	-1.08	-18.00
External Debt-GDP ratio	16.59	57.33	114.96	246.45	994.90	24.28

Source: CBL, IMF, UNCTAD, and author's computations.

The government was unable to reverse the downward trend in macroeconomic variables because of poor governance, corruption, mismanagement, and wide-spread tax evasion. Consequently, declining tax revenue and sustained increases in government expenditure led to a raising budget deficit. Additionally, in order to prepare for

the conference of the Organization of African Unity (OAU), held in Monrovia, Liberia, in 1978, the government further increased expenditures in order to build facilities and fund operational costs of hosting the conference. Meanwhile, the economy was hit by the impact of the global recession due to the 1973 – 1974 oil price shocks. These forces combined to increase government deficit spending which was financed by increased government external and internal debts.

In 1980, a violent military coup against the government of the True Whig party (TWP), headed by President William R. Tolbert, ended the rule of the political party that had ruthlessly ruled the country from 1878 to 1980. During its rule, the officials of the party who ran the government disenfranchised most of the native population, enslaved some of them, and outlawed the formation and operation of viable opposition political parties.

Following the 1980 coup, Master Sargent Samuel K. Doe - the coup leader- and 16 other junior military officers ruled Liberia by military decrees until the 1986. The new military regime suspended the constitution but promised fundamental changes in the political culture in order to reduce corruption and promote inclusiveness and multiparty democracy. Notwithstanding, the new regime conducted extra-judicial trials of several top former government officials who were promptly declared guilty and executed. Their positions were filled by allies, friends and supporters of the members of the new military regime.

The new regime gained instant popularity among many Liberians, especially among the indigenous Africans. Although the government obtained power illegally, it sought and gained international recognition and support from many nations, including the United States and its allies. Meanwhile, the government reestablished diplomatic relations with Israel which had ended due to the Arab-Israeli conflict and Israel's controversial relationship with Egypt.

In light of the Cold War and the Reagan administration's desire to keep the new military regime from seeking alliance with the Soviet Bloc countries, it gave increased military and other aids to the government of Liberia. Consequently, Liberia's new military leader received the honor of a White House visit in 1982.

Despite the extensive goodwill from the local population and the international community toward the new government, most of its leaders were poorly educated and sought retribution for the oppression and abuses suffered for more than a century under the TWP government. In addition, as their political predecessors had done, they sought to use their public offices to enrich their kinsmen and themselves. Accordingly, they appointed their relatives and close friends to fill most key public policy positions including the cabinet, deputy cabinet, and heads of state-owned enterprises.

Meanwhile, the financial sector was one of the key areas impacted by the military coup. At the time of the coup, there were seven banks in Liberia, including the National Banks of Liberia (NBL) which functioned as the nation's central bank. The NBL was created by a legislative act in 1974 which provided the NBL with the following powers:

1. Regulate the supply of money
2. Promote monetary stability
3. Promote credit and exchange rate policy and a sound financial structure which would be conductive to a balanced growth in the Liberian economy

In addition to these powers, the legislative act also authorized the NBL to issue coins which, in addition to U.S. dollars, could be used as legal tender for the discharge of debts in Liberia. The NBL was also authorized to regulate financial institutions and foreign exchange deals and to serve as licensing authority for all financial institutions, including the branches of foreign banks. The legislation also specified that the NBL shall guard against the tendencies of shareholders of commercial banks to use depositors' funds to engage in activities to enrich themselves at the expense of depositors.

Despite this powerful legislation, the NBL did not vigorously enforce the provisions of the legislation and allowed cronyism and nepotism to persist as a primary determinant of employment and promotion. In addition, it

allowed kinship to be used to determine access to commercial bank loans and to obtain a more favorable (Liberian $ to U.S. $) exchange rate, despite a much lower market rate. In addition, the new regime applied little or no emphasis on expertise in appointments to a number of highly technical positions and hence discouraged investment in training and human capital development. One consequence was a decline in workers' morale and productivity but, more importantly, weak governance caused a capacity deficit in the management and leadership at NBL and other publicly-owned financial institutions.

4. ANALYSIS OF THE LIBERIAN BANKING SYSTEM

As it was under the constitutional government, the NBL's powers were defined by the 1974 legislation and its amendment of 1979 banking functions were limited to serving as a fiscal agent of the government and issuing small denomination coins to facilitate the divisibility of larger denomination currencies. At the time of the coup in 1980, the economy was dollarized with the US dollar serving as the main currency. All of the coins issued by the National Bank of Liberia had a 100% par value to the U.S. dollar (for example, a Liberian quarter had the same value as a U.S. one).

One primary action of the government following the coup was its emphasis on replacing the leaders of the banking sector. Accordingly, the head of the military junta appointed one of his loyalists as governor of NBL. Before his appointment, the new governor served as one of the lower management support staffs at the NBL and had a part-time enrollment in undergraduate studies at the University of Liberia but, most importantly, he had kinship with the head of the military government. Other appointments with an emphasis on kinship followed the governor's appointment. With the new appointments, the National Bank also began reducing regulatory standards and chartering requirements in order to allow other kinsmen and loyalists of the military regime to enter the banking industry. In the next few years, the government, through the NBL, issued charters to another seven commercial banks.

Meanwhile, in order to gain additional popularity, the government doubled the salaries of civil servants and members of the military and state security services. At the same time, there was an increase in capital flight as a number of residents and businesses fled the country. The result was a fall in government revenue; notwithstanding, government spending continued to increase. The resulting increase in budget deficits was financed by issuing debts and minting new coins, each valued at five dollars. The issuance of the five-dollar coins effectively started the use of dual currency in Liberia - the US dollar and the Liberian dollar at a fixed one-to-one official exchange rate.

At the end of 1985, the budget deficit reached $154 million, which was equivalent to 15.6% of GDP, and the external debt reached 120% of GDP. The country could no longer continue servicing its external debt and the government defaulted, prompting the IMF and other international creditors to suspend credit to Liberia.

4.1 Domestic Financial Institution to Government's Rescue

Having lost its credibility with multilateral financial institutions, the government increased its borrowings from domestic financial institutions in order to substitute for lack of international loans. With a national bank (NBL) leadership largely determined by kinship and controlled by the Head of State, the government borrowed from the commercial banks and from NBL. In addition, it borrowed from the reserves of commercial banks held at the NBL. In order to provide additional liquidity, the NBL minted additional Liberian five dollar coins. Consequently, the market exchange rate of the Liberian dollar depreciated from 1 to 0.4 US dollar by the end of 1987. Meanwhile, because of government influence over the NBL, it maintained the official fixed exchange rate of one Liberian dollar to one US dollar for top government officials and their relatives while the market rate was much lower. This caused a significant loss of NBL's foreign reserves.

Following the beginning of the Liberian civil war in 1989, the economy shrank by 59% in 1990, government revenues declined, and its borrowings from domestic institution increased further. By the beginning of 1991, the NBL had difficulties sustaining its lending to the government from its own assets and began lending commercial bank's reserves to the government. As a result, the NBL could no longer provide a favorable response to commercial banks' demands for withdrawals of their reserves.

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Meanwhile, kinship-based appointments and leadership in the financial sector continued through the civil crises and facilitated government borrowings from the NBL and the commercial banks. In addition, NBL abdicated some of its regulatory responsibilities and failed to effectively enforce other rules that prohibited insider lending in the commercial banking sector. Consequently, in addition to increased lending to government, insider lending also increased. The result was illiquidity in a large number of commercial banks. They, too, could no longer support the withdrawal requests of their depositors and were nearly bankrupt.

By the end of 1997, nine of the twelve (75%) commercial banks had failed. Table 2 provides a summary of ownership of the commercial banks and their status at the end of the 1997.

Table 2: Ownership (Percent) and Status of Liberian Banks as of December 1997

Bank	Liberian	Foreign	Year Established	Status
Agricultural and Cooperative Development Bank (LBDI)	100	0	1978	F
Ducor Trade and Commercial Bank (DUTCH Bank)	100	0	1994	F
Eurobank	100	0	1990	F
First Commercial and International Bank (FICB)	80	20	1990	F
First United American Bank (FUAB)	0	100	1988	F
International Trust Company (ITC)	15	85	1960	A
Liberian United Bank (LUBI)	70	30	1992	F
Liberian Bank for Development and Investment (LBDI)	20	80	1965	A
Liberia Trading and Development Bank (TRADEVCo)	0	100	1954	A
Meridien BIAOBank Liberia Limited (MBLL)	0	100	1985	F
Monrovia Banking Corporation (ROVIABANK)	100	0	1989	F
National Housing and Savings Bank (NHSB)	100	0	1972	F

Key: F = failed; A= active. Source: Banking Commission Report

Table 2 shows that 75% (nine of the twelve banks) of the commercial banks failed during the crises. Of the nine failed banks, seven were Liberian-owned and their leaders and management were heavily influenced by the political authorities due to the practice of kinship-hiring, patronage, and mismanagement at the NBL which extended through the banking sector. The three banks that survived the crises were mainly foreign-owned, whose leaderships and management were primarily appointed through the home country headquarters using more rigorous standards. Consequently, they were more successful in resisting the pressures to lend to the Liberian government and were less susceptible to political interference. Notwithstanding, TRADEVCo - one of the three banks that survived the crises - was liquidated in 2004.

4.2 Current Status of the Liberian Financial Sector

In 1998, President Charles Taylor appointed a commission that was charged with reviewing the sector in order to propose ideas for ending the banking crises and strengthening the sector. As a result of the banking commission's recommendations, the NBL Act was repealed by the legislative act of 1999 which created the Central Bank of Liberia (CBL). The 1999 CBL Act gives it the functions and powers of the NBL plus additional powers to have functional independence in conducting monetary policy. Furthermore, it gives the CBL discretion in deciding lending and exchange rate policies, but it specifically prohibits lending from commercial banks' reserves at the CBL. In addition, the act prohibits the CBL from lending to the government and its agencies except in exceptional cases when government needs to fulfill short-term liquidity needs.

Under the new legislation, in 2006 President Ellen Sirleaf appointed a new Executive Governor and members of the Board of Directors of the CBL. The new governor has a Ph.D. previously served in an upper executive management position at the IMF. Since their appointments, the CBL has worked on strengthening regulations and standards for entry into the banking sector. There are currently nine active banks in the sector, including two of three banks that survived the crises. The other seven are mainly foreign owned banks.

5. CONCLUSION

This paper draws from the author's experience when serving as Liberia's Deputy Minister of Finance and uses data from the Central Bank of Liberia, the IMF, and interviews with Liberian bankers to explore the role of governance in Liberian financial crises in the past. The paper analyzed how the use of kinship-based appointments to significant leadership and management positions at the NBL (now Central Bank of Liberia) brought about the failure of most of the commercial banks. Unlike previous studies that emphasized macroeconomic variables and others that emphasized financial ratios of financial institutions (Trussel & Johnson, 2012), the research shows that the weaknesses of the National Bank of Liberia, caused by political interference exercised through kinship-based appointments, was a primary cause of Liberia's 1986-1999 financial crisis.

AUTHOR INFORMATION

George Gonpu holds a B.Sc. (Summa Cum Laude) in Economics from the University of Liberia, MA in Economics from Northwestern University, and Ph.D. in Economics from the University of Illinois. He taught econometrics, finance, macroeconomics, and money and banking at several U.S. universities, including Cleveland State, Grand Valley State, Hunter College, Rutgers, and at the University of Liberia. In addition, he served in the Government of Liberia as Deputy Minister of Finance and in industry at AT&T Corporation as a consultant. His research interests are in applied international macroeconomics, economics of development, and fiscal, monetary, and public policy. E-mail: ggonppu@ramapo.edu

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