

Somalia: The long road to currency reform

By Mohamed Dalmar

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In January 2010, the then Transitional National Government ordered the printing of Somali shilling banknotes worth 5 trillion from Sudan at the cost of US\$ 17 million. However, the delivery of this money was halted after meeting a strong opposition from the International community, Puntland and concerned Somali citizen on the grounds believed that the Government has not done the preparatory work needed to introduce a new currency and that, absent any effective monetary policy, the currency will only add to the monetary chaos already afflicting the country. A new Somali Federal Government came to power in September 2012. It also had to refrain from importing the banknotes from Sudan although under pressure to print money. As of to date the banknotes lie idle in the safes of the Sudanese printing company and their delivery has been postponed to an unknown future.



This paper discusses the challenges that the government faces in introducing a new currency, the preparatory work it has to undertake before putting such currency in circulation and the mechanism through which it can create a strong and credible national currency.

Historical context

In the 1980s, before the collapse of the Somali state, Somalia has had a very distressing monetary experience marked by financial chaos, currency collapse, runaway inflation and bank failure. By 1989, the whole banking system either collapsed or was on the verge of collapsing owing to too much government involvement, mismanagement and corruption. The Central bank lost control of money supply and became mainly a tool for financing the government's huge budget deficit; the Commercial and Savings Bank was declared bankrupt; and the Somali Development Bank was incapacitated because of lack of resources.

That the situation got out of control is demonstrated by the following facts:

- Just in one year, 1989, the last year for which we have data, money supply increased by a staggering amount of So.Sh. 96 billion;
- The Commercial and Savings Bank made unsecured and fraudulent loans to the tune of 60 billion;
- Inflation rate skyrocketed by 110% and the shilling depreciated by 278%¹

¹ International Financial Statistics Year Book. IMF, Washington 1991.

All this money was created while per capita GNP declined in real terms by 29% between 1978 and 1989². Such was the legacy of the government before it collapsed: a worthless currency and a banking system in tatters.

While the official banking system was failing and losing public confidence, an informal parallel (black) market banking system was emerging and growing in strength. To fill the gap left by the official banking system, a multitude of small parallel banks started providing banking services, including cashing cheques at heavy discount, converting currency, safe keeping of money and providing small scale lending facilities. Most of these small informal banks were located in Bakaraha market, the *Wall Street* of Somalia.

Following the collapse of the Somali state and the outbreak of the civil war in 1991, the Central Bank and what was left of the other state-owned banks vanished. Their cash and valuables were looted, their buildings were vandalized and their records were destroyed. However, the disappearance of the formal government banks did not mean the end of the financial services in Somalia. The foreign exchange market operated by money-changers grew bigger and more vibrant as it benefited from the absence of government controls and the sizeable inflow of remittances from the Somali diaspora. These remittances are channeled through the money transfer companies, the *Hawala* which built, over the years, a very elaborate network of offices and agents capable of transferring funds not only to Somalia but also to any part of the world instantly. In addition, the Hawala evolved into providing some basic banking services such as accepting non-interest-bearing deposits and the issuance of vouchers.

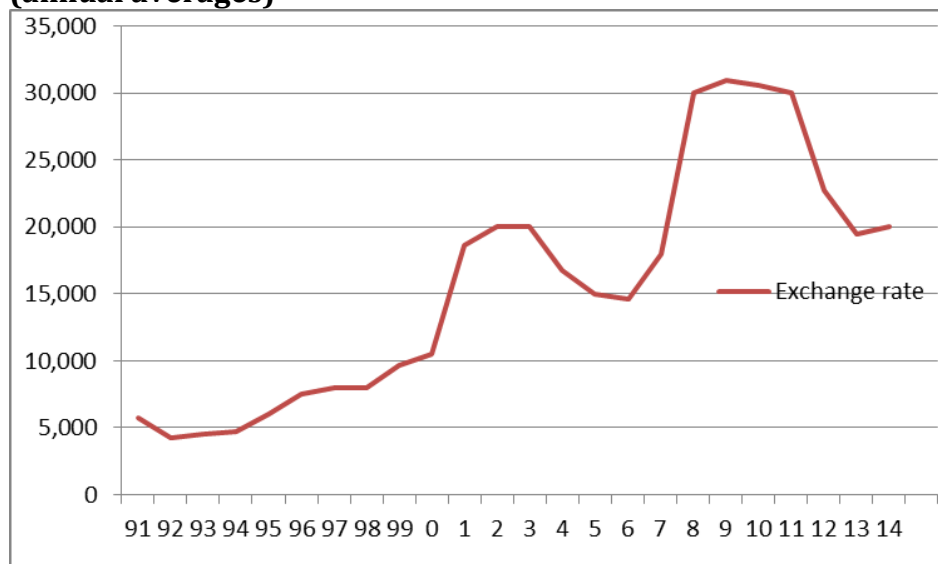


A striking development since 1992 has been the printing of fake currency by warlords, business people, faction leaders and regional administrations to fund their political or perhaps illegal purposes. The importation of fake currency caused runaway inflation that affected ordinary people's lives by eroding the value of their meagre incomes. The situation became worse when in 2007 some unscrupulous business people and regional administrators imported printing machines and produced notes of low quality further eroding the value of the Somali shilling and its usefulness as a currency. In the last three years, however, the Somali shilling showed remarkable strength simply because no new fake currency was issued. Currently, the exchange rate is stable at around So.Sh. 20,000 per US dollar. To my knowledge, no accurate statistics are

² From Bad Policy to Chaos in Somalia: How an Economy Fell Apart. Jamil Abdalla Mubarak - 1996 - Page 4

available as to how much fake money was created. I would not exaggerate if I estimate that close to a trillion worth of Somali shilling banknotes have been put in circulation since 1992.

Evolution of Exchange Rates - So.Sh. per US dollar in Bakaraha Market, 1991 -2014³ (annual averages)



Recent development

Some progress has been made in recent years toward the establishment of a formal banking system. The Central Bank of Somalia (CBS) re-opened in 2006 in Mogadishu. A Central Bank Act was passed in 2011 and a Financial Institutions Act was passed in 2012. As stated in its Act, the Central Bank is given the mandate “to achieve and to maintain price stability..... and foster

List of commercial banks in Somalia

1. Al Barakaat Bank
2. Amal Bank
3. First Somali Bank
4. International Bank of Somalia
5. National Bank of Somalia
6. Salaam Salaam Bank
7. Salaam Somali Bank
8. Somali Commercial Bank
9. Universal Bank of Somalia

Source:

http://en.wikipedia.org/wiki/List_of_banks_in_Somalia

and maintain a stable and competitive market-based financial system”. A mandate the bank is not in a position to pursue at the present time due to its limited technical and human resources. Two other central banks exist in Somaliland and Puntland and both function mainly as treasurers for their respective governments. Also, the Somali Development Bank was re-established in 2012 and later renamed as Somali Development and Reconstruction Bank.

³ FSANU market updates – various issues

Development is also happening in commercial banking area. The major Hawala companies are expanding into commercial banking having opened bank branches in Mogadishu, Hargeysa and Bossaso; and more Somali entrepreneurs are entering into retail banking business. Automatic Teller Machines (ATM) have been introduced in Hargeysa and Mogadishu and at least one commercial bank reported to have obtained the SWIFT code that enables them to connect with international correspondent banks and easily carry out international money transfers. The Central bank has one already. Furthermore, banks from the neighboring countries namely, Kenya and Yemen have expressed interest in opening branches in Somalia. But despite these developments, “the Somali financial sector remains underdeveloped, informal and unsupervised, with limited access to credit and savings, and no protection for consumers and financial institutions.”⁴ Several factors constrain the development of a successful Somali commercial banking system, namely:

- The absence of legal systems to enforce contracts and property rights,
- Lack of a fully functioning Central Bank,
- Inadequate accounting systems and
- High level of insecurity in the country.

A major concern is that the Hawalas quickly obtain bank licenses, start banking businesses and “maneuver faster than the authorities can build regulatory capacity”.⁵

A bright spot in Somalia’s financial markets is however, the spectacular growth of mobile money which filled the gap left by traditional commercial banks by offering more extensive, efficient and convenient financial services. Mobile-money is provided by the major telecommunication companies: Hormud in Southern Somalia, Somtel in Somaliland and Golis in Puntland. Mobile money has brought financial inclusion to hundreds of thousands of unbanked Somalis and revolutionized the way financial transactions are carried out in Somalia. Instead of cash, everybody is now using mobile money even pastoralists and street hawkers have mobile money accounts. The success of mobile money services in Somalia is attested by a survey conducted by Gates Foundation, World Bank and Gallup which found that “Somalia was one of the most active mobile money markets: 26% of the population reported using mobiles to pay bills, which is the highest rate in



⁴ Istanbul conference on Somalia 21 – 23 May 2010. Draft discussion paper for Round Table “Banking, remittances, and the role of the central bank in promoting financial and private sector development in Somalia”

⁵ Scek, Aues. Resoring Credibility – A Monetary Reform Agenda – Somalia’s Monetary and Financial Policy Challenges

the world, and 32% to send and receive money”.⁶ One consequence of using mobile money is the quasi-total dollarization of the economy. We remember that the Somali shilling was used as a medium of exchange only for small scale transactions and the US dollar for large ones. Now everything is paid in U.S. dollars through mobile money: groceries, bus fare, shoeshine services, a cup of tea, a bottle of camel milk, etc. It also stabilized the exchange rate by reducing the demand for Somali shillings in line with its reduced supply.

Creating the right environment

Understandably, the introduction of a new currency is high on the list of government priorities and it should be. But before speeding ahead, the government must create the right environment and commit to addressing the following issues which are critical for the establishment of sound and effective financial institutions:

Corruption: The first issue to address is *corruption* which reached alarming proportions and undermines all efforts of state-building. The evidence is overwhelming. Transparency International ranked Somalia as the most corrupt country on earth. [The U.N. Monitoring Group](#) on Somalia and Eritrea accused Somalia's President and his former foreign minister of conspiring to steal the Central Bank's frozen foreign assets, although the President and the Minister denied strongly the accusation. Yusur Abrar quit her job as governor of the Central Bank of Somalia after only seven weeks because she refused to be part to the alleged scheme defrauding Somalia's frozen assets. In an earlier report the Monitoring Group accused the Somali government of using the Somali Central Bank as a personal "slush fund", with an average 80% of withdrawals made for private purposes.⁷ Similarly, Abdirazak Fartaag, the former head of Public Finance Unit, accused previous Somali governments of using the Central Bank as a personal ATM machine and warned about \$238 million aid money received by successive Somali governments during the period 2000-2011 but not accounted for.⁸

In 2012, the World Bank revealed that “in 2009 and 2010, about \$130 million in funds delivered to the transitional government seem to have disappeared into thin air.”⁹ Sadly, no investigation was launched to probe these weighty accusations.

Security: Some significant progress has been made on the security side in recent years as African Union Mission in Somalia (AMISOM) peacekeepers and Somali forces have pushed Al-Shabaab out of most urban centres in the country. However, Al-Shabab fighters are far from being defeated. They are still strong in the rural areas and have the capacity to carry out terrorist

⁶ Mobile money in Africa. Press 1 for modernity. One business where the poorest continent is miles ahead . The Economist, Apr 28th 2012

⁷ UN Report of the Monitoring Group on Somalia and Eritrea: Somalia, 2014

⁸ <http://pambazuka/en/category/features/83908>. 2012-07-26, issue595

⁹ Jacey Fortin. International Aid Disappeared, Diverted or Squandered in Somalia. International Business Times. June 1, 2012

attacks in Mogadishu at their discretion. A big security challenge is the inability of the federal government to provide effective administration to the areas liberated from Al-Shabab leaving armed groups, clan militias and criminals to fill the vacuum and endanger the security of the population. After fifteen years of successive Somali Federal Governments, “Somalia’s national security forces continue to be weak, clan-based, and without salaries for weeks, despite foreign funding. Yet another stream of money lost in Somalia’s notorious corruption”.¹⁰

Fiscal Discipline: Monetary policy cannot work if not supported by a responsible fiscal policy promoting economic stability and growth. One of the most urgent tasks of the government is to mobilize domestic resources and reduce its overreliance on foreign aid. Equally urgent is to control government expenditure, administer public funds in an efficient, accountable and transparent way and, above all, show that the revenue collected through taxation is used for the public benefit. The government should realize that the practice of printing money to generate quick revenue is no longer an option. Excessive money creation to fund government deficits is what caused economic ruin in the first place.

Peace-Building and Reconciliation: A range of activities should be done in this regard, chief among them is reconciliation. As stipulated in the Constitution, the Truth and Reconciliation Commission should be immediately established and put to work to promote reconciliation, healing and peace-building among the Somali communities through a frank and honest dialogue. As one analyst notes: “If a way could be found for [Somali] people to confront the past, and accept responsibility for the violence, corruption and other problems, perhaps Somalia and Somalis could find a way of living together that is productive rather than destructive.”¹¹

Other issues relate to completing the federal structure, approval and ratification of the Constitution, negotiation with Somaliland, establishment of the Constitutional Court and Boundaries and Federation Commission.

Strengthening the Central Bank of Somalia

It’s very important to build a strong Central Bank which serves as a solid foundation for the nascent Somali banking system. As the apex institution of country's financial and monetary system, the Central Bank is crucial not only to the functioning of the financial sector but also to the functioning of the entire economy. It secures monetary and financial stability, ensures an efficient payments system, keeps the banking system safe and sound and ultimately facilitates economic growth and better quality of life for the people. The importance of the Central Bank of Somalia (CBS) is recognized by the Constitution which included a specific provision under Article 23 stating that “The Federal Central Bank of the Federal Republic of Somalia shall be responsible for formulating and implementing financial policies and monetary policies and all

¹⁰ <http://www.brookings.edu/blogs/up-front/posts/2013/06/26-obama-africa-somalia-security-felbabbrown>

¹¹ Somalia: Failed state or fantasy land ? By Mary Harper. BBC News. 2 August 2012

the banks shall abide by the regulations set by the Federal Central Bank” Also, Part II, section 5 of the CBS Act sets out the Bank’s functions as follows:¹²

- a) Formulate, implement and be responsible for monetary policy and implement the foreign exchange policy;
- b) hold and manage the foreign exchange reserves of Somalia;
- c) license, regulate and supervise all banks and financial institutions so as to foster the liquidity, solvency and proper functioning of a stable financial system;
- d) formulate and implement such policies as to best promote the establishment, regulation and supervision of efficient and effective payment, clearing and settlement systems;
- e) where appropriate, administer payment, clearing and settlement systems;
- f) act as banker and adviser to, and as fiscal agent for the Government and public entities;
- g) act as sole issuer of legal tender Somali currency notes and coins; and
- h) Shall compile, analyze, and publish the monetary, financial balance of payments statistics and other statistics covering various sectors of the national economy

To fulfill its enormous responsibilities the CBS needs a massive infusion of resources, both human and material including the adoption of modern information technology systems and better management practices.

To understand how the CBS could be resuscitated, it may be worthwhile revisiting its history.

When Northern Somalia took its independence from Britain, June 26, 1960, there was no banking system or meaningful financial institutions in the north other than a treasury office that Colonial Britain

had established before they left. However, unlike its brethren in the north, the Italian Somaliland in the south, before its independence in July 1, 1960, under the trusteeship of the UN had a mandate to prepare for independence, that resulted in the establishment of government institutions including financial institutions.



¹² The Central Bank of Somalia Act Law no. 130 of 22 April 2012

The CBS was established on 1st July 1960. It was then known as *Somali National Bank* or *Banca Nazionale Somala*. It inherited the branch of Bank d'Italia in Mogadishu, converted in 1959 to Cassa per la Circolazione Monetaria della Somalia, and took over all of its assets, liabilities, notes and coins in circulation, foreign exchange reserves, its premises and procedures as well as its Italian staff. Only the janitors were Somalis. With the Somali government's blessing, Banca d'Italia became the mentor or the lead institution guiding and supporting the new Somali National Bank. Under its direction, a process of Somalization was immediately started through the recruitment of young Somali professionals by open and competitive written examinations and oral interviews. The successful candidates were offered salaries & benefit packages much higher than those offered to their counterparts in the civil services as well as an intensive on-the-job training and continuous career development. And to maintain regional balance, the hiring was done both in Mogadishu and Hargeysa by a ratio of 2:1 although Mogadishu residents represented Somalis from all over Somali inhabited regions.

In its first six years of operation, under the direction of its Italian manager Mr. Francesco Palamenghi Crispi the bank recruited 160 employees and opened branches in all regional capitals of the country. In addition, the CBS received, over the years, a lot of support and technical assistance from the IMF, the World Bank and from other national and international banks. By 1969, only the general manager, Mr. Giuseppe Morasca was an Italian officer seconded by Banca d'Italia. He was replaced with a Somali manager Mr. Omer Ahmed Omer by the new military government immediately after they took control of the country in October 1969. Later in the 1970s and 1980s, the military government discontinued the recruitment by competitive examinations. Instead, all secondary school leavers were assigned to different agencies including the CBS.

My point is, given the enormous level of destruction suffered by the CBS, the best way to reconstruct it is to link or twin with a stronger central bank. Such bank will lead the CBS during its initial phase of development. It will provide mostly human resources in terms of middle and senior level managers who will lead the most important departments of CBS and will supervise the recruitment and the training of Somali professionals. I can think of the Central bank of Turkey taking on this role. Turkey has been eager to help rebuild Somalia. I can also think of other central banks such as Bank of Canada or Bank of England or the Central Bank of Norway (Norges Bank) filling such a role if properly approached. The Norwegian government is helping the Somali government to pay the salaries of its employees. It is more effective to entrust the task of rebuilding the CBS to one strong central bank rather than engaging with a multitude of donors, consultants, and NGOs with different agendas and modus operandi.

Effectiveness of CBS's monetary policy

The primary objective of the CBS is "to achieve and to maintain domestic price stability" as stated in its Act (article 4). Article 5 of the same Act empowers the CBS "to formulate, implement and be responsible for monetary policy and implement the foreign exchange policy". In other words, the goal of the monetary policy of CBS is to attain price stability which means a lower rate of

inflation. This is in line with new trends in most central banks' laws singling out the pursuit of price stability as the overriding goal of monetary policy. The premise is that price stability is essential in that it provides a stable and predictable environment where people can plan their economic activities with confidence and thus encourages long-term investment, job creation and economic development.

The question is how the CBS will achieve price stability or lower rate of inflation? Before answering this question let us understand what causes inflation. There is a broad consensus among economists that inflation is mainly caused by excessive creation of money without a corresponding increase in real output; a situation often referred as "too much money chasing too few goods". If inflation is caused by excessive creation of money it can also be reduced by creating less money. Here the CBS comes into the picture. As the monetary authority of the country, the Bank has been given the responsibility to regulate the money supply by using the instruments of monetary policy at its disposal.

Suppose that the CBS is fighting inflation. Theoretically, the Bank can use a number of monetary policy instruments to contain the inflationary pressure. For example, it can raise the interest rate to increase the cost of credit, curb the demand for goods and services and ease the inflationary pressure; or it can sell treasury bills in open market operations to withdraws excess liquidity from the economy and curb the demand for goods and services, or it can raise the proportion of reserves that the commercial banks are required by law to hold with the central bank to limit the amount of money available for lending, or it can sale foreign exchange to money-changers to withdraws liquidity of local currency from the system and reduce inflation. However, all these instruments are not applicable to Somalia except the foreign exchange option. They are not applicable because there is no such thing as money market or interbank market or bond market in Somalia where treasury bills are traded and interest rate is determined; and the whole banking system is yet to develop, let alone manipulating commercial banks' reserves. What to do then?

Fix the exchange rate

As mentioned above, the only monetary policy option available to the CBS is foreign exchange intervention, mainly selling or buying US dollars. But, even this instrument is not effective for the following reasons: the foreign exchange market in Somalia is thin and very sensitive to small interventions; the bulk of money supply in Somalia is made up of US dollars and is beyond the control of the CBS; and more importantly, inflation does not fall when the Somali shilling appreciates. Theoretically, an appreciating currency would lower the prices of imported goods. However, this did not happen. The appreciation of the Somali shilling against the U.S. dollar in the last three years did not produce a commensurate decrease in essential imported commodity prices. In March 2012, when the shilling appreciated by 30% in four months, a frustrated Mogadishu resident said: "We are worried about the exchange value of the dollar and its decline, even though the prices of goods have not come down as a result"¹³. On the contrary, when the

¹³ Inflation, high prices hard on daily lives of Somalis by Mahamud Mohamed. Sabahi March 27, 2012

Somali shilling depreciates merchants adjust the prices of imported commodities upward immediately.

What is the solution then? Fix the exchange rate by pegging the value of the Somali shilling to the US dollar at a specified rate, e.g. 20,000 Somali shillings per 1 US dollar. A fixed exchange rate system is more appropriate for a country like Somalia with the following characteristics:

- a small open economy with imports accounting for a large proportion of GDP
- a rudimentary and informal financial system
- lack of institutions and expertise to conduct an independent monetary policy
- history of currency crisis and lack of confidence in the local currency
- dollarization of the economy,
- a thin and inefficient foreign exchange market dominated by few money-changers.
- an economy in transition
- Lack of reliable information about economic indicators

A fixed and stable exchange rate is beneficial for the Somali economy. It eliminates the uncertainty and costs arising from exchange rate fluctuations and speculations. It allows people to plan their business decisions with confidence and, as a result, encourages long-term investment and economic growth. It keeps inflation under control as the value and stability of the Somali shilling is directly linked to the value and stability of the U.S. dollar. In effect, the CBS is borrowing the credibility of the monetary policy of the Federal Reserve Bank of United States of America.

Having stabilized the exchange rate, the CBS does not have to worry about formulating and implementing monetary and exchange rate policies. It will be free to concentrate its efforts on the more pressing issue which is building its capacity to fulfil its mandate as the monetary authority of the country.

A truly fixed exchange rate

I strongly recommend that the exchange rate be fixed by means of a currency board arrangement in order to re-establish credibility in the Somali shilling. After decades of monetary chaos, runaway inflation and currency collapse, the only way to restore the trust and the credibility of the Somali shilling is through the currency board arrangement.

Under this system, the Somali shilling shall be fully convertible and fully backed by foreign reserves. Convertibility is guaranteed as the CBS will stand ready to convert Somali shillings into US dollars on demand at the specified exchange rate without any restrictions. To do so, the CBS must have adequate foreign reserves and in fact it has. As reported by the Monitoring Group a sum of US\$ 9 million of recovered Somali foreign assets is deposited to a CBS account at Ziraat Bankasi (Agricultural Bank of Turkey) where it currently remains. These assets and

others not yet recovered will serve, if protected, as extra reserves. Regular reserves are built gradually as the CBS converts dollars into shillings. By law, the Bank will be banned to issue Somali shillings without first acquiring the equivalent in US dollars¹⁴. The CBS earns profit from interests on foreign reserves.

I believe that the Government faces a stark choice: either a sound, credible and fully guaranteed currency is provided or else the US dollar is used as legal tender in Somalia. Because of past painful monetary experiences, people will not accept a currency printed at will without any constraint or standard. Such a currency will be rejected by the business community and by the regional governments. Moreover, it will exacerbate the mistrust between the Federal government and the regional governments thus undermining the national unity. I, therefore, urge the government to commit itself to seriously and honestly implement the currency board system because it brings the same benefits of dollarization (stability and confidence), and in addition it generates seigniorage (profit) to CBS and offers a way to retain the national currency. As I see it, it is no longer a matter of what type of currency we should print in terms of design, colour, denominations, etc. etc. It is a matter of whether we shall have a national currency or not. We can emulate the example of Djibouti. The Banque Centrale de Djibouti has followed a Currency Board regime for over 30 years with a stable Djibouti Franc that is fully backed by foreign exchange reserves. If Djibouti did it we can do it.

Introducing a new currency

Printing currency is easy and straightforward provided that the necessary groundwork is laid down and appropriate institution building has taken place beforehand. In the case of Somalia, groundwork includes an improved security situation, a stronger central bank, better financial management, political stability and above-all commitment to adopt a fixed exchange rate through a currency board system. If these conditions are met or at least the government is making effort to meeting them, then printing money becomes a matter of logistics and action planning: deciding on the number of banknotes to print, selecting the banknote printer through an open and competitive process, creating designs for the banknotes, determining the denominations, security features, distribution channels, etc. Just an example: The CBS could consider making three coins with a face value of 1,000, 5,000 and 10,000 Somali shillings and four banknotes with face value of 20,000, 50,000, 100,000 and 200,000 Somali shillings.

As regards the fake 1000 Somali shilling note now circulating, my opinion is not replace it but to let it circulate alongside with the new banknotes until it wears out overtime as Ali Mahdi's "N" currency did. In the meantime, I would advise the Government to use mobile money to pay its

¹⁴ I have previously recommended the currency board system. See Abdurahman, Mohamed Dalmar. Monetary and exchange rate policies: 1960-2001: the experience of Somalia. Author House 2005

employees and to collect taxes to further restrict the use of 1,000 So.Sh. note and drive it out of circulation. As for the Somaliland shilling, discussions about its fate could be part of the negotiations between the Federal Government and the government of Somaliland.

Conclusion

Right now, there is no currency crisis in Somalia. The U.S. dollar is the principal currency used as a medium of exchange, unit of account (measure of value) and store of value; mobile money facilitates the payment system within the country and remittance companies (Hawalas) connect the country to the outside world. Therefore, there is no rush to print new currency which, most probably, will not be accepted by the market. Instead, the government's priorities should be restoring security and political stability, fighting corruption, promoting national reconciliation expanding its authority to all parts of the country and reaching out to all regional administrations.

I am recommending the adoption of the currency board system because I believe it is the only way to restore the credibility of the Somali shilling given the history of monetary chaos. The currency board system “offers the prospect of a stable exchange rate, which can promote both trade and investment. Its strict discipline also brings benefits that ordinary exchange-rate pegs lack. Profligate governments, for instance, cannot use the central bank's printing presses to fund large deficits.”¹⁵

If money is printed at will without any constraint and accountability, it generates extreme inflation and robs the people of their livelihood. It does not matter who prints the notes, a government (national, regional, and local), a faction, a warlord, a businessman or a businesswoman.

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¹⁵ The ABC of a currency board: Currency boards can help countries parry attacks on their currencies. But is Hong Kong running its board the right way? The Economist. Oct 30th 1997