The Impact of Exchange Rate Adjustment on the Economy of South Sudan

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I. Background

South Sudan's economy is currently under a severe stress[2], which has its origin in three powerful shocks: a) violent conflict that erupted on December 15, 2013; b) subsequent drastic decline in the daily oil production in Upper Nile State with oil fields in the Unity State completely shutdown; and c) the drop in oil prices in the international market for crude oil by about 63% in September 2015 compared to that of June 2014. The three shocks have contributed in widening the revenue-expenditure gap of the government annual budget, such as FY2015/2016. That is, the first shock meant drastic increase in the security sector expenditure due to the prevailing violent conflict. While the other two shocks (fall in both volume and price of oil) meant a sharp decline in the government revenues, since more than 90% of its revenues comes from oil.

The fiscal implication of the above stated shocks is quite telling. My estimates of the fiscal deficit resulting from reduced oil output (less than 167,000 b/d[3]) and lower price ($40/barrel of Dar blend for FY2015/2016) are worrying, to say the least. The situation becomes, however, alarming if we critically look at the price of crude oil in relation to a fixed figure of $24.1/bbl. as a mandatory transfer (i.e. payment) to Khartoum for transport tariff, processing fees, transit fees, and transitional financial arrangement (TFA[4]) of which $15/bbl. is for TFA. It becomes more alarming if you add other mandatory payments, such as 5% to oil producing States (2.0% for a sate and communities taking 3%); repayments of advanced oil sales to Chinese and Malaysian oil companies. That is, net (i.e. what the government will get per a barrel) benchmark price for FY2015/2016 budget would be about $3.1/bbl. (meaning $40 – $24.1 - $2.5 (for producing States and communities) - $10.3 (repayment of advanced

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[2] In fact, the economy is in intensive care, so our doctors must work hard to rescue the patient from passing away, God forbid. But, the signing of the IGAD+CPA, now known as Agreement on the Resolution of Conflict in South Sudan (ARCISS) is comforting, though peace would be expensive and in any case the spending would be for development and not destructive activities in South Sudan.

[3] Government gets about 50% of this figure and the rest is taken by the oil operating companies as cost oil and some part of profit oil.

[4] This is a misnomer for it should have been called transitional financial assistance to Sudan by South Sudan. It should have also been based on a percentage of the oil price and level of daily oil production so as to minimize the risks associated with fluctuations in both oil outputs and prices.

oil sales). The Ministry of Petroleum and Mining (MPM) of the Government of Republic of South Sudan (GRSS) has estimated the GRSS' net share of profit oil to be 24 million barrels in FY2015/2016[5]. This figure will change with the achievement of peace in the oil producing States of Unity and Upper Nile. I expect production to resume in Unity State as soon as there is sustainable peace.

Moreover, the huge fiscal deficit has been monetized. That is the deficit is being financed through borrowing from the Central Bank of South Sudan (CBoSS). The fiscal deficit has been compounded by inappropriate exchange rate regime in which the South Sudanese Pound (SSP) is pegged to the United States of America dollar ($) at a fixed rate of SSP2.96/$1.0. This exchange rate regime has been in place since independence on July 9, 2011. The CBoSS could then defend such a rate for it had over $2.0 billion in reserves. However, the reserve started to dwindle with the voluntary shutdown of oil production in January 2012 by GRSS over transit fees dispute with Khartoum. The CBoSS cannot defend that rate now, evidenced by prevailing rate in the parallel market for foreign exchange, which seems to have stabilized around SSP16.5/$1.0 during the last 8 weeks as of 12 October 2015.

Given the unique situation of South Sudan economy in which GRSS is the main earner of foreign exchange through oil revenues, the huge fiscal deficit can literally be eliminated overnight. That is, if the GRSS sells its petrodollar to the CBoSS at a rate, say of SSP16.0/$1.0, determined by the parallel market forces of demand and supply instead of the fixed rate, it would have adequate revenues in terms of SSP. This would also reduce (if not eliminate) the amount of SSP being printed by CBoSS to finance the deficit. Hence, this Review calls for the adjustment of the exchange rate so as to eliminate the huge fiscal deficit that would in turn reduce the amount of SSP being printed on the one hand, and revitalize the economy on the other.

The rest of this Ebony Policy Review is divided into three parts. Part two gives a brief overview of the exchange rate regimes. Part three looks at the likely costs and benefits of the exchange rate adjustment policy on the economy of South Sudan. And part four concludes this Review.

II. Understanding the Exchange Rate Regimes in South Sudan

There are several exchange rate regimes, but I would briefly state only three types of exchange rate regime.

The first is the free **float exchange rate regime** in which the rate is determined freely by the market forces of demand and supply without intervention from the central bank (or monetary authority). Such a system is suitable for developed economies, such as United States of America (USA), United Kingdom (UK), and Japan, which have robust financial markets and strong central banks.

The second is the **managed float exchange rate regime**, where the rate of the national currency is allowed to fluctuate (between a minimum and high rates) around a determined value against a foreign currency (US dollar in most cases). The central bank would normally intervene if the rate of national currency falls below the minimum value or rises above the maximum value within which it is allowed to move

[5] Net profit oil for the GRSS is after Oil Operating companies deduct the cost oil (i.e. consisting of current and capital cost of production) and their share of profit oil. But, this figure is before payment to Khartoum and oil producing states and communities.

freely through the market forces of demand and supply in the inter-bank market for foreign exchange, usually referred to as auction system. It is interesting to note that the three East African countries – Kenya, Tanzania, and Uganda –have the managed float regime. This was, according to my recollections, the system the Central Bank of South Sudan (CBoSS) wanted to adopt. But there was a change of leadership of CBoSS one month after the independence of South Sudan on July 9, 2011, which in turn led to a new policy direction.

The third is the **fixed exchange rate regime** in which the price of the national currency is pegged to an international currency, such as the US dollar or to a basket of currencies[6]. South Sudan has this system and the CBoSS is envisaged to defend it through appropriate interventions within the framework of its monetary policy. This system was adopted after independence on the argument that the new country had at the time: a) limited link/not fully integrated into the international markets; b) less diversified production base; c) a single export product, which is crude oil; d) undeveloped financial market; and e) lacking monetary discipline and credibility.

However, my review of the literature indicates that such a system is inherently crisis-prone[7]. This is now established to have been true in the light of the current economic situation in South Sudan. Moreover, it requires that the monetary authority (CBoSS) must have high levels of international reserves.

III. The Costs and Benefits of Exchange Rate Adjustment on the Economy of South Sudan

There are essentially four (4) operating rates in the economy of South Sudan. The first is the official rate in which GRSS (i.e. Ministry of Finance and Economic Planning) sells United States dollar to the CBoSS at SSP2.96/$1.0. The second is also an official rate in which CBoSS sells to the banking sector - commercial banks and foreign exchange bureaus (or forex) at a rate of SSP3.02/$1.0. The third is also an official rate, and it is where the banking sector sells to its customers (general public and business sector) one United States of America dollar for SSP3.1623. And the fourth rate is determined by market forces of demand and supply in the parallel (popularly known as black) market, which implies it is not an official rate. The average weekly rate in the parallel market is SSP16.0/$1.0. Hence, my reference to the exchange rate adjustment (or realignment) is to have a single rate (meaning unifying the four rates) in the economy.

One of the options before the CBoSS authorities is to adopt a **managed float exchange rate regime**. The CBoSS can get a six-month average rate of the parallel market for foreign exchange and use it as a starting rate for the new exchange rate regime. The market has already factored in a rate of SSP16.0/$1.0 (at the time of

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[6] I would think that GRSS should have pegged, at independence, SSP to a basket of East African shillings (Kenya, Tanzania, and Uganda shillings) instead of the U.S. dollar. This is still possible to do.

[7] Andrew K. Rose (2011). Exchange Rate Regimes in the Modern Era: Fixed, Floating, and Flaky. Journal of Economic Literature, Vol. 49 (3), pp. 652 – 72; FahrettinYagci (2001).Choice of Exchange Rate Regimes for Developing Countries. Africa Region Working Paper Series No. 16, The World Bank; Edward Stansfield & Alan Sutherland (1995). Exchange Rate Realignments and Realignment Expectations.

writing this Review) in determining prices of various goods and services being transacted in our economy. Alternatively, the monetary authorities can adopt the prevailing parallel market rate on the D-Day, which would be SSP16.0/$1.0 if the decision to realign is in October 2015. Our monetary authorities do not need to have a huge amount of international reserves under the managed float exchange rate system That is, they are not required to defend it, since the rate is determined through auction system in which the monetary authorities would make available certain amount of dollars in the inter-bank market for foreign exchange on weekly basis[8].

I know that the CBoSS has credible information of the monthly demand for foreign exchange and would therefore be able to effectively manage the new system. I would, however, call for an urgent reform of the CBoSS if we were to have a successful managed float exchange rate regime. But, what are the likely costs and benefits of such a policy? I would try to answer this question in the remaining part of this section of the Review.

3.1 What are the potential positive effects of the exchange rate adjustment policy on the economy of South Sudan?

I would like to point out at the beginning of this section of the Review that United States of America dollar ($) is a very important commodity to the economy of South Sudan. Moreover, it is fortunate that the GRSS is the major owner of this commodity, which it earns through the exportation of its crude oil. I would, however, argue that the GRSS has not been behaving like a rationale economic agent! Why? It sells the dollar to the CBoSS at a lower price instead of seeking a higher price prevailing in the "real market" for foreign exchange. A classical example in the context of South Sudan, which I have been using at several occasions to explain this economic irrationality is how our cattle traders behave. They look for markets in which they can get the highest price. I just wonder how a government, with potential effective capacity and institutions to formulate and implement sound policies for the development of this country, has failed to utilize these endowments. But, let me state the potential positive effects.

There are seven (7) likely positive effects of the exchange rate adjustment policy. They are briefly discussed below.

1. Stable Macroeconomic Environment: A realignment of the exchange rate regime would, literally, eliminate overnight the current huge fiscal deficit. How? The government has been running in the FY2014/2015 budget a monthly fiscal deficit of SSP650 million. The government has been financing this fiscal deficit through borrowing from CBoSS by what is technically known as deficit financing (i.e. printing paper money). The FY2015/2016 budget shows an overall fiscal deficit of SSP7.0 billion or roughly the same monthly deficit financing from CBoSS. According to the Minister of Finance the government has been getting $100.0 million/month ($60.0 million from oil revenues and $40.0 million from non-oil)[9]. This fiscal deficit arises due to the fact that the government sells its $60.0 million/month of oil revenues at a rate of SSP2.96/$1.0, which gives her SSP300.0 million/month (i.e. SSP177.6

[8] I would recommend that the GRSS to have both commodity and financial cushion/buffer in place, to enable the authorities to combat those who will try to hoard basic goods as it happened in November 2013 when CBoSS attempted to realign the exchange rate.

[9]

from oil and SSP122.4 from non-oil revenues) against a monthly expenditure of SSP950 million.

In the light of the preceding paragraph, the GRSS has a shortfall (i.e. fiscal deficit) of SSP650 million/month. And if GRSS were to sell to the CBoSS its petrodollar at, say, SSP16.0/$1.0, it would get SSP960.0 million. Moreover, if you add SSP122.4 million of non-oil revenues, you get SSP1.082 billion, which would translate, other things being equal, to a budget surplus of SSP132.4 million/month! But, given the accumulated areas to Sudan and some of the GRSS expenditures (such as military, debt service, travel, and transfer to embassies) are paid directly in dollars, the figure of $60.0 million/month from oil revenues might be unrealistic. In this regard, it would be appropriate to talk of fiscal deficit reduction than elimination and surplus. I would, nevertheless, argue that GRSS is likely to receive $100 million/month during the transition period as a combination of oil revenues, external loans, and budget support by development partners, especially if the implementation of ARCISS is on course. Hence, I would predict a budget surplus within the first six months of the establishment of TGoNU if a managed float exchange rate regime were adopted.

A major benefit, of the exchange rate adjustment, to the economy is the restoration of macroeconomic stability. It is, however, important to note here that macroeconomic stability would not be restored in a sustainable manner without a supportive fiscal policy. This is because expansionary fiscal policy will challenge the ability of the CBoSS to maintain a degree of stability in the exchange rate market. When floating the exchange rate, expansionary fiscal policy would make the SSP to depreciate and in turn fueling inflation, which would be a sure sign that the macroeconomic environment is not stable

For instance, with the GRSS running a surplus, the private sector would now be able to access credit. That is, the banking sector has not been lending to the business sector due to uncertainty associated with war and unstable macroeconomic environment. Commercial banks would now be able to meet the demand of both households and firms for credit. This particular potential positive impact of the realignment policy on the economy is difficult to comprehend without explaining how an economy operates. In this regard, it would be appropriate to highlight some key concepts. A central concept, in my view, on how an economy operates is **transaction**, which describes the process of buying and selling of goods, services, and assets (e.g. financial and other assets) in a given market. For instance, a buyer gets, say, bread by paying cash or credit (i.e. through credit card or cheque) to the seller of bread. If the transaction is performed through credit, then this implies two additional concepts of **asset** and **liability** to the seller and buyer of bread respectively.

2. Revitalization of the Agricultural Sector: With expensive imports, the import-substituting domestic sector of the economy would be able to provide goods and services at much lower prices. That is, agriculture products, such as poultry; fish; cassava; sorghum; maize; banana; and so forth would be sourced domestically, which means raising effective demand on the one hand, and creating employment for rural youth on the other. Agriculture is the source of livelihoods for more than 80% of the total population of South Sudan, which lives in the rural areas[10]. A public policy that improves the livelihood of such a high percentage of the population would undoubtedly be a good one. There are two important documents of the Sudan

10 Source: NBS (2010), Key Economic Indicators.

People's Liberation Movement (SPLM) in which agriculture is conceptualized as the engine of growth[11]. This engine was to be fueled, according to Dr. John Garang de Mabior, through our crude oil. We, however, decided to fuel the engine of economic growth of the East African economies, instead of our own economy. Hence, the realignment policy would provide an important opportunity to revitalize this critical sector of our economy.

3. Diversification of Exports: The realignment of exchange rate policy would accelerate the diversification process of South Sudanese economy, especially the export sector. Instead of depending on a single commodity, such as crude oil for exports, the economy would be able to export, within a year, products, for example timber/teak, gum Arabic, gold, fish, livestock, coffee[12], and honey.

4. Investing in the Mining Sector: South Sudan has, besides oil, other precious minerals, such as gold, copper, talc, and lead, among others. The new policy would attract foreign direct investment (FDI) into this sector, especially with respect to gold mining. The reason why exchange rate adjustment would fuel FDI is that investors will have more clarity on the exchange rate market and can plan ahead. Predictability is one of the underlying factors of business confidence, and therefore a key element in the world of private sector investment. Right now with the gap between the official and parallel market rates it is very difficult for foreign investors to predict at what exchange rate they would repatriate their profits. Moreover, and as stated under section dealing with diversification of exports, gold can be exported in large quantities as soon as there is an enabling environment for doing business in South Sudan. The Agreement on the Resolution of Conflict in South Sudan (ARCISS) provides such an enabling environment, which is complemented by the restoration of macroeconomic stability underpinned by fiscal discipline and flexible exchange rate regime.

5. Emerging Manufacturing Sector: There are only two categories of small-scale manufacturing in South Sudan. These are water factories and White Bull Breweries. They are currently on the verge of closing due to lack of foreign exchange. The exchange rate adjustment would enable these factories to continue to operate, while attracting new ones into areas, such as juice processing, and other agro-industries. It is vitally important here for GRSS to refrain from administered prices. The main reason these factories are closing is not the scarcity of dollars per se (though that is a very important reason), but the fact that they have been banned from increasing their retail prices. If prices were freely set a bottle of water today could have been around SSP 5-10. People who could not afford would have resorted to perhaps boiling water to kill the germs rather than buy expensive water. The market would have reacted one way or the other. But blocking prices make producing water a losing proposition. No investor in her/his right mind would produce consistently at a loss. Same thing for fuel: if it were not for Nilepet there would have been no fuel here whatsoever. At the current parallel market exchange rate, selling a liter of fuel at

[11] Peace Through Development and SPLM Strategic Framework for War-to-Peace Transition.

[12] A recent report by the London-based Guardian Newspaper stated that South Sudan is exporting this coffee in small quantities from Yei area of Central Equatoria State. The brand is called Suluja ti South Sudan and is being exported to France by Nespresso, which sees South Sudan as the "cradle of coffee."

SSP6 when on street corners it goes for close to SSP100 is not a business proposition. But, I would recommend that subsidy on fuel be maintained for six (6) months after the adoption of the exchange rate adjustment policy.

6. Investing in the Service Sector: Many families that are not able to maintain their children in East African schools would have to relocate them back to South Sudanese public and private schools. The same apply to the health sector. Moreover, ecology-based tourism (e.g. wildlife) is likely to benefit from the adjustment policy. Tourists would find it attractive to visit our national parks, provided that there is security.

7. Improvement in Governance: A final important positive effect of exchange rate adjustment is the likely improvement in governance and use of public resources. The current dollar allocation system at the CBoSS is the most egregious form of embezzlement of public funds. This is because those who have access to such a system enrich themselves at the expense of the majority. In addition, the Letter of Credit (LC) system is another connected avenue for embezzling public funds[13]. By adjusting the exchange rate the monetary authorities would eliminate the gap between the parallel market and official exchange rates that has been the reason rent-seeking has flourished. Hence, the CBoSS will have to establish, with technical backstopping from the IMF, an inter-bank market for foreign exchange through which allocation should be reformed. Moreover, the NLA has already recommended that the current LC system be abandoned and to turn it over to the commercial banks.

3.2 What are the likely negative implications of the exchange rate adjustment policy on the economy of South Sudan?

There would be a sharp rise in prices of the basic commodities, as the market will try to outsmart the monetary authorities in the execution of the new exchange rate regime. This is a plausible scenario, which is informed by the rational expectations argument and/or the time consistency of economic policy and the driving forces behind business cycles hypothesis by Kydland and Prescott[14]. One of the quickest actions the market would take is hoarding of goods, so as to create “artificial” scarcity. It would be recalled how the market reacted in November 2013 when CBoSS attempted to realign the official exchange rate with that of the parallel market. Such a hoarding would in turn fuel high inflation in the economy with negative consequences on the standard of living of the population in general, and those on fixed income in particular. This is particularly true in an economy that is import-dependent, such as that of South Sudan. But, it must be stated here again that the market in South Sudan has already factored into its prices the prevailing parallel market exchange rate.

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[13] I am reliably informed that about $1.0 billion is the total value of the LC saga that is being investigated by the NLA! The market would still be full of imported goods if such an amount were actually used for the sole purpose stated in the LCs.

[14] The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 2004 was awarded jointly to Finn E. Kydland and Edward C. Prescott "for their contributions to dynamic macroeconomics: the time consistency of economic policy and the driving forces behind business cycles."

Nevertheless, some analysts who refuse to monitor the market on regular basis, would say:

a) The import sector of the economy would be hurt in that the prices of imported goods and services will go up. For example, the cost of imported inputs for industries, such as water factories and White Bull breweries will go up in terms of SSP. The consequences of expensive inputs would lead, other things being equal, to reduction in the effective demand for their products, which would in turn make these firms to lay off workers.
b) In addition, those who have families outside South Sudan, especially in East Africa would experience sharp fall in the value of their SSP. By way of illustration a monthly take home income of a backbencher member of the National Legislative Assembly (NLA) is SSP 9,470, which is equivalent to $3,000 at the current official exchange rate. The same figure of SSP 9,470 would only be equivalent to $591.88 if you follow my bold proposal of adopting a rate of SSP16.0/$1.0. And if I were supporting my family in Nairobi or Kampala with $1,000/month or SSP 3,300, then one would clearly see the magnitude of the negative effect of such a policy on those South Sudanese with a fixed income, including members of the NLA.

A serious analyst would dismiss the above two likely general negative implications of the exchange rate adjustment policy. This is on the argument that the market has already factored into its prices the prevailing rates in the parallel market for foreign exchange. For instance, the example of the salary of a backbencher member of NLA is today $591 based on the purchasing power as determined by the prevailing parallel market exchange rate, even though the rate has not been officially adjusted. Moreover, industries such as water factories and White Bull breweries would be able to have access to foreign exchange through inter-bank market for foreign exchange. This easy access to hard currency means that they would stay in operational and continue creating jobs.

IV. Concluding Remarks

Policymakers in South Sudan face a daunting task of managing an economy that would seem to be in an intensive care. The economy has been hit by two man-made disasters. The first is a thunderbolt in the form of a violent conflict that erupted on the night of December 15, 2013. While the second is a consequence of the first – complete shutdown of operations in the oil fields in Unity State and reduction of oil production in Upper Nile State. These two man-made malady have been complicated by an external flu – a drastic fall of the oil prices in the international market. The overall impact of these three shocks is the huge fiscal deficit, which has placed the economy into intensive care. Two prescriptions have been recommended – ARCISS and exchange rate adjustment. The first (i.e. ARCISS) is being administered, while the second is awaiting the decision of family members (that is, policymakers). I urge them to take that decision now before it is too late!