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Exchange Rate Reform in South Sudan

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Why is the exchange rate important?

- Exchange rate is a price – perhaps the most important price in the economy
- Affects trade, capital flows, fiscal position, balance of payments, competitiveness and growth
- Exchange rate must adjust to changing economic circumstances
- If set at the "wrong level" a wide range of problems can result

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Overvaluation: the price of eggs

	Ugandan eggs $	Ugandan eggs - SSP	SSP eggs
SSP3=USD1	$1	SSP3	SSP5
SSP10=USD1	$1	SSP10	SSP5

- Suppose eggs cost $1 to produce in Uganda and SSP5 to produce in South Sudan
- If the exchange rate is SSP3=USD1, the Ugandan eggs are cheaper than the SS eggs, and will have an advantage in the market.
- If the exchange rate is SSP10=USD1, the SS eggs are cheaper than the Ugandan eggs, thereby encouraging local production

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Current Exchange Rate regime

- Fixed official rate at SSP2.96=USD1
- Parallel market rate, currently at SSP16.40=USD1
- Increasing divergence between official and parallel market rates
- Extreme shortage of foreign currency
  - No USD in the banks
  - Little USD in BSS
  - Now affecting operations of firms in the private sector who cannot buy inputs
- Very low foreign exchange reserves
  - All used up defending the official rate
- Rising inflation – now approaching 80%
- Overvalued exchange rate
- No development of alternative export activities – not viable due to exchange rate overvaluation, amongst other reasons
- Most profitable activity is "round tripping", based on privileged access to forex at official rates – rent seeking, unproductive behaviour

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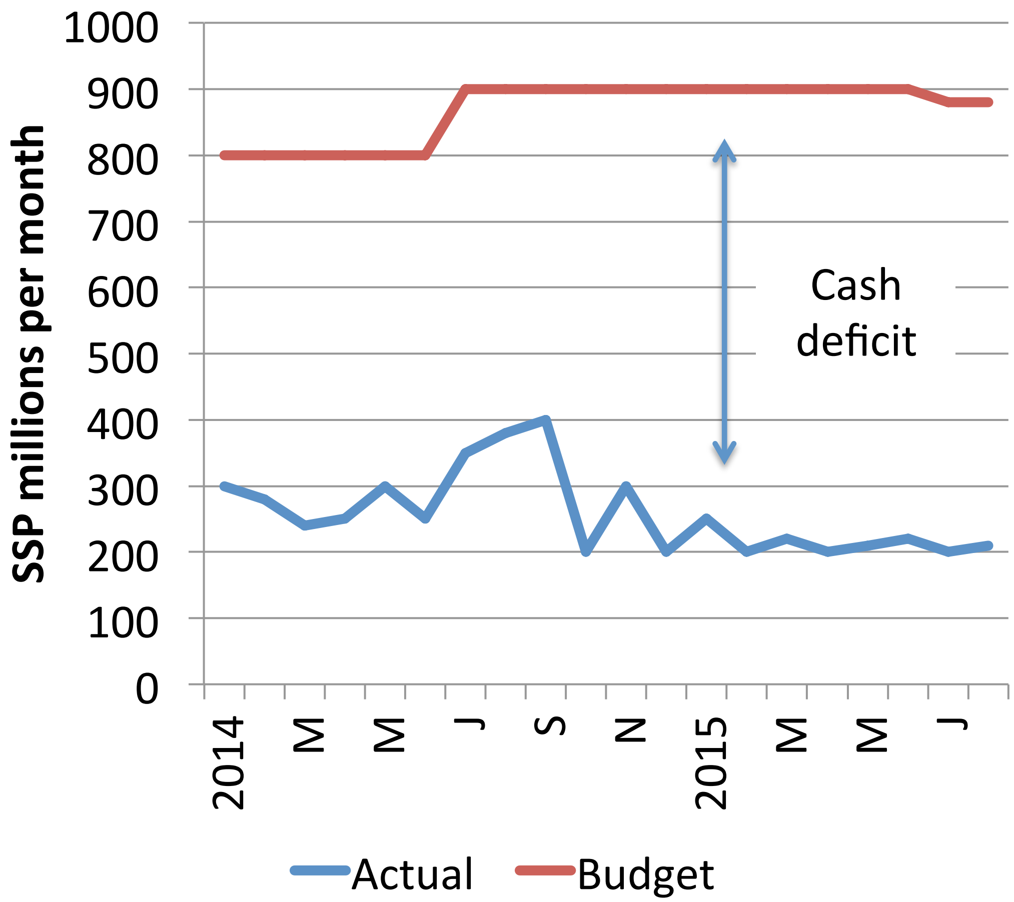
Government Budget



Source: Bank of South Sudan

- Actual revenues falling far below budget
- Due to low oil prices and production constraints
- Large budget deficit
- Revenues financing only 25%-30% of spending
- Deficit financed by borrowing from BSS

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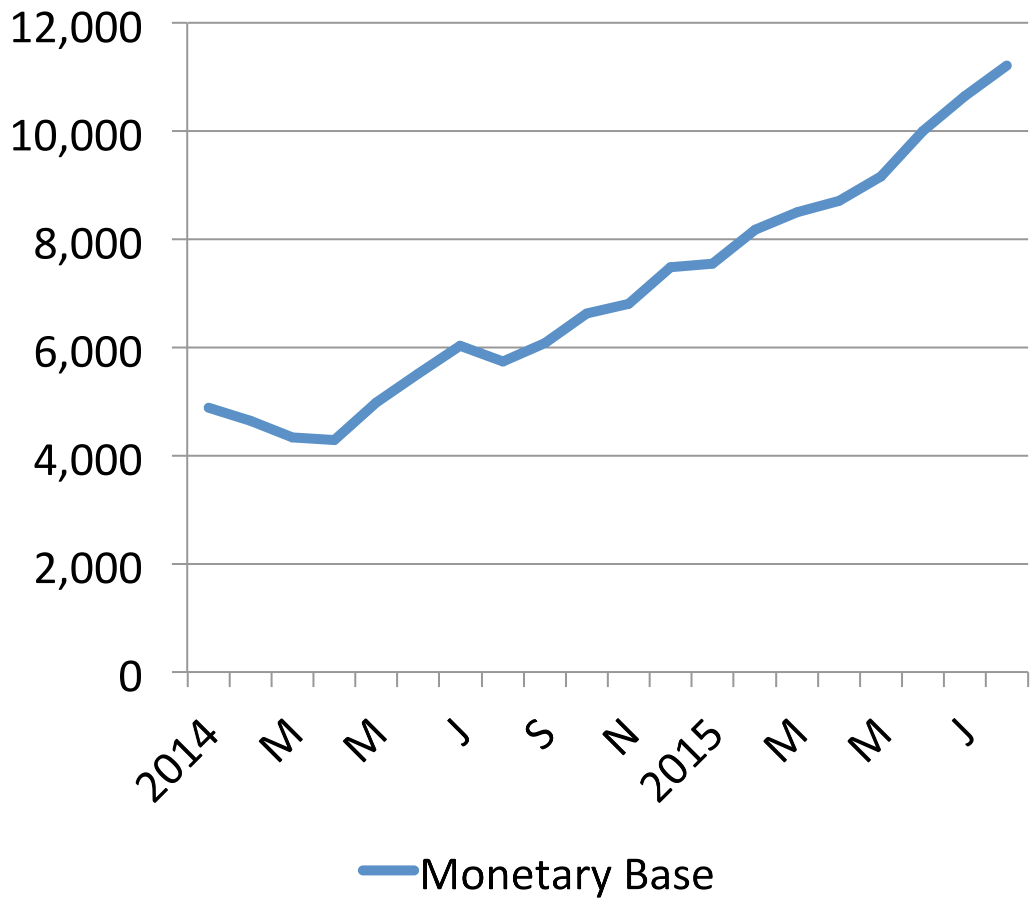
Leading to dramatic expansion of the money supply



Source: Bank of South Sudan

- Monetary financing of budget deficit causing money supply growth
- Now increasing at an annualised rate of almost 100%
- Growth of SSP liquidity

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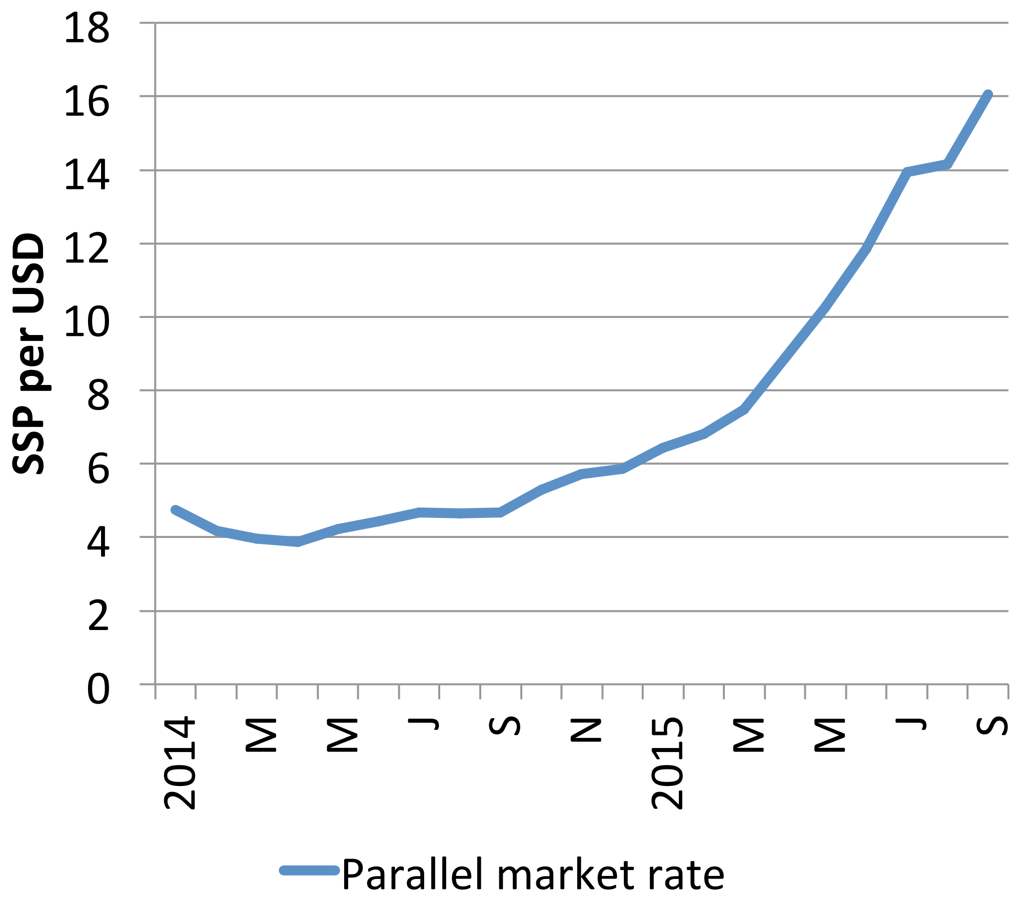
In turn driving exchange rate depreciation



Source: Bank of South Sudan

- Increasing SSP liquidity chasing diminished supply of USD
- Parallel market rate has fallen from 5.92 on Jan 2nd 2015 to 16.35 on Oct 7th, depreciation of 64%

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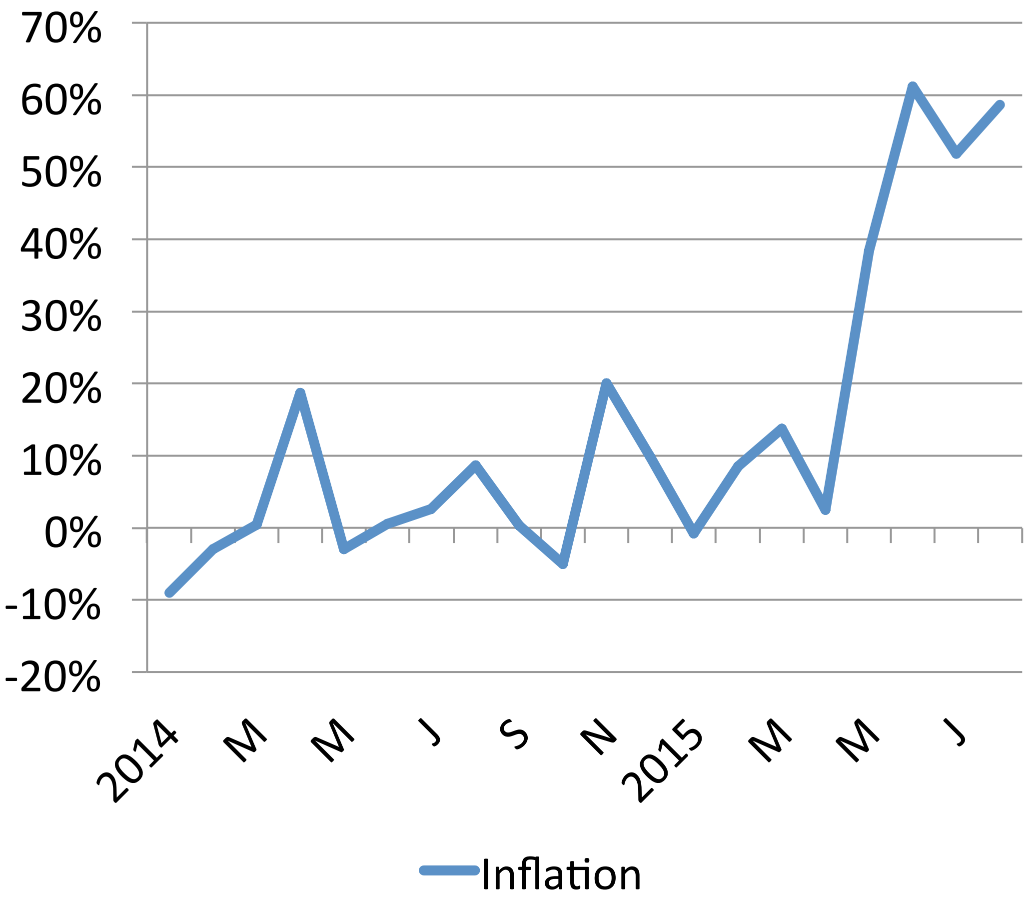
Leading inevitably to higher inflation



- Annual inflation has jumped from an average of well below 10% in 2014 to 60% in mid-2015

Source: Bank of South Sudan

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And exhaustion of fx reserves

Source: Bank of South Sudan

- Reserves have fallen from USD2 billion at end 2011 to only USD61 million
- Less than one week of import cover

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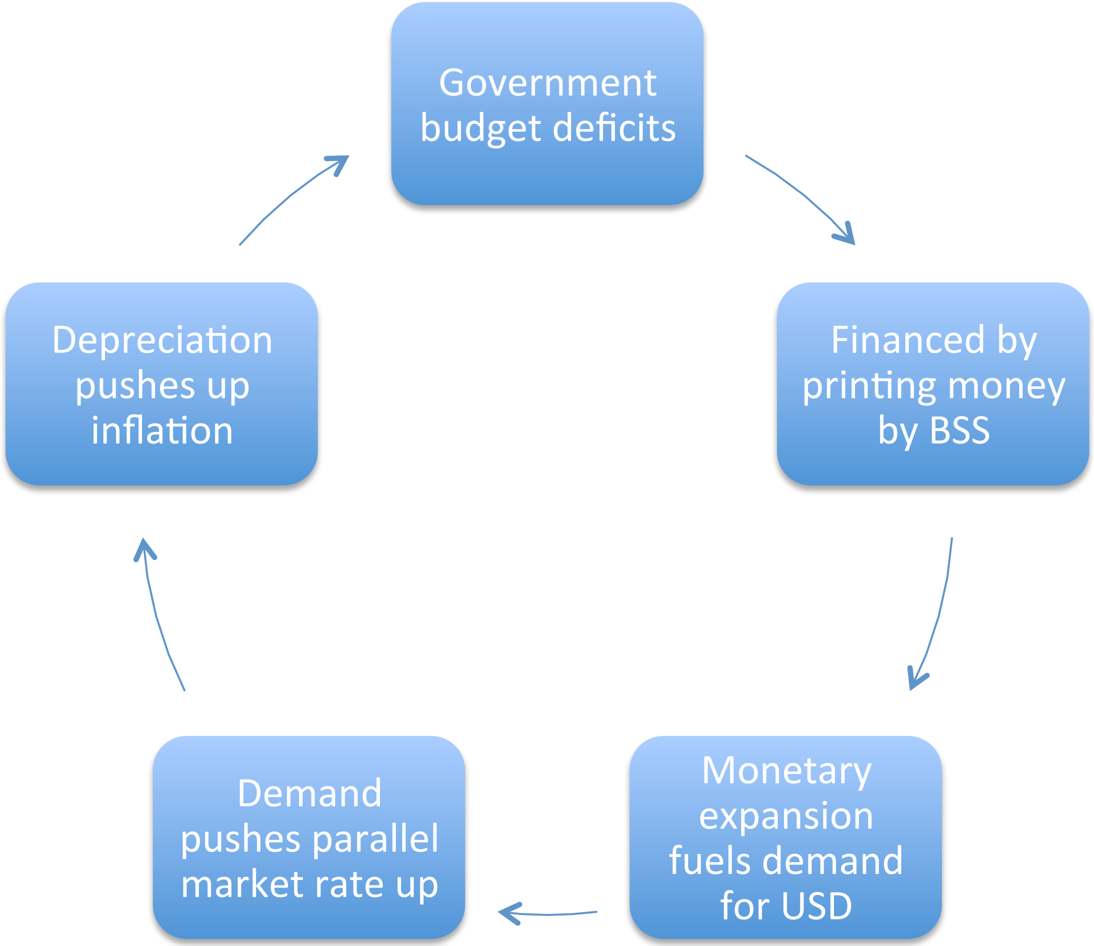
All the above are connected in a vicious circle



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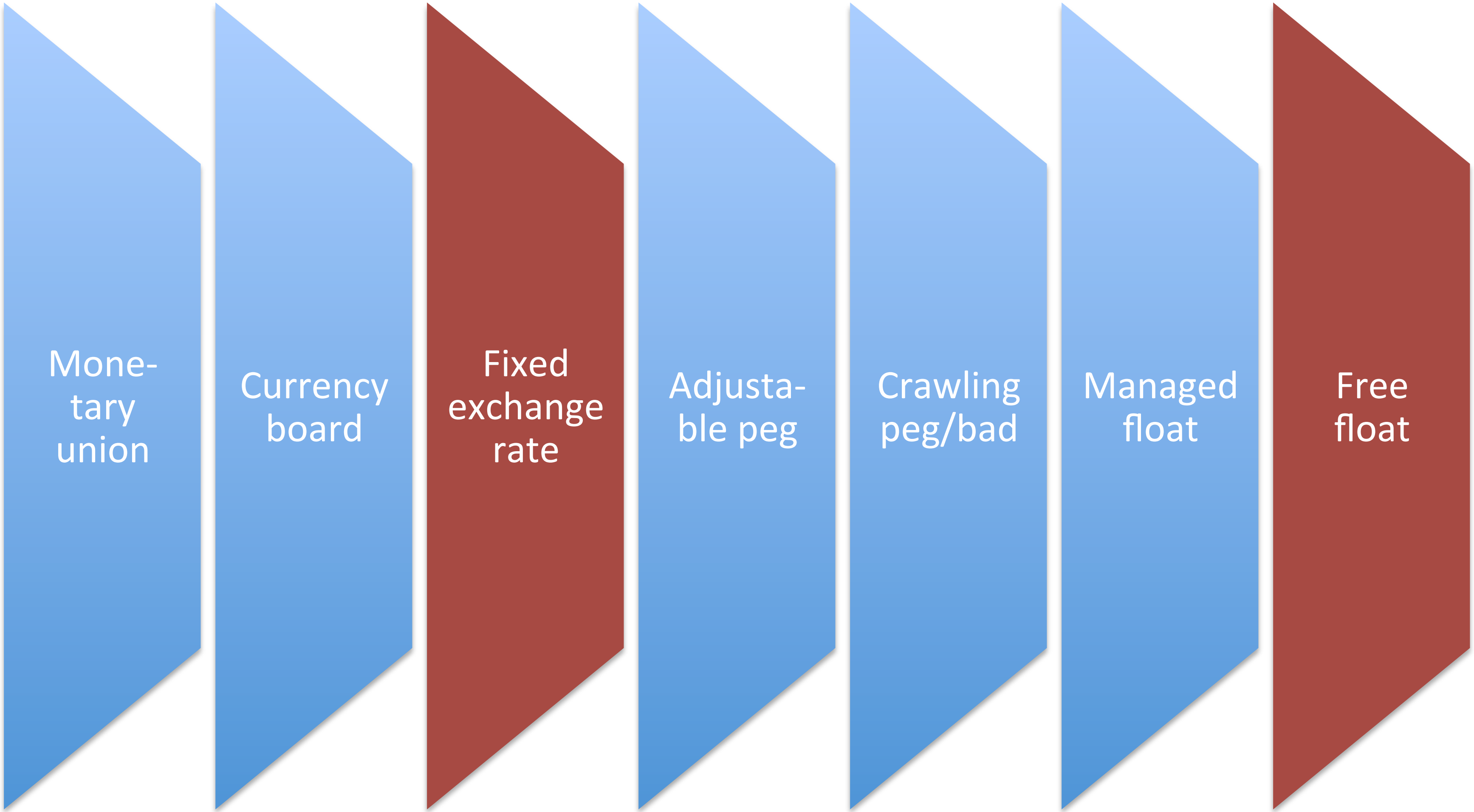
Where does the current road take us?

- To Zimbabwe?
  - Excessive government spending
  - Contracting fiscal revenue
  - Monetisation of deficit by RBZ
  - Spiralling inflation – reaching a monthly rate of 79.6 billion percent in late 2008
  - Abandonment of Zimbabwe dollar
  - Bankruptcy of RBZ
  - Full dollarisation, with adoption of USD as official national currency
- An extreme case, but a lesson for what happens if nothing is done

Types of exchange rate regime



What needs to be achieved in reforms?

- Three requirements:
  - Devalue or depreciate the exchange rate to match the parallel rate
  - Ensure that post-devaluation, the same situation does not arise again – i.e. the exchange rate must adjust in future to changing economic circumstances, not be held at an artificial level
  - Re-establish economic credibility and confidence

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Barriers to Reform

- Current exchange rate regime is unsustainable
- Everybody agrees that something has to be done
- Reform programme drawn up
- But nothing (?) has been done
- What are the barriers to reform?
  - Vested interests?
  - Lack of agreement on exact nature of reform?
  - Inability to satisfy pre-requisites for reform?
  - Fear of the unknown?

Potential alternatives

- Devalue, and keep a fixed rate regime
- Introduce a free float
- Introduce a managed float
- Intermediate regime, such as a devaluation followed by a crawling peg

None of these are easy solutions and all have advantages and disadvantages, but some are better than others

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Assessment of Alternatives

	Devaluation + fixed peg	Free float	Managed float	Devaluation + crawling peg
Pre-requisites	• Reserves • Data	• Auction system • Monetary policy	• Auction system • Reserves • Monetary policy • Data	• Reserves • Data
Advantages	• Eliminates XR differential – if large enough	• Adjusts to shocks • Eliminates parallel market • Credibility	• Partial adjustment to shocks	• Eliminates XR differential – if large enough • Crawl inhibits re-emergence
Disadvantages	• Size of optimum devaluation unknown • Does not stop differential re-emerging • Does not adjust to shocks • No reserves	• Exchange rate could be volatile	• Target rate unknown • Distinguishing permanent and temporary shocks • Support overvalued XR	• How large should devaluation and crawl be? • Does not adjust to shocks • No reserves

All options require fiscal restraint to have any chance of success

Free Float

- Could be done In a "big bang" approach, involving:
  - Ending preferential supplies of FX at official rate
  - Divide FX oil inflows between GoSS and BSS
  - All non-government FX to be sourced in the market
  - Establish 2-way auction
    - Sale of FX by BSS to banks via regular auction
    - If banks have surplus, can offer back to BSS
  - Allow banks to buy and sell FX in the market at any rate
  - Interbank FX market

Managed Float?

- A lot of attention focused on move to managed float, once reserves have been built up;
- USD300-600m target quoted – based on what?
- Where from?
  - Current BSS reserves ($61m)
  - IMF SDRs ($150m)
  - BoP surpluses
    - Restrict imports
    - Higher exports
  - Borrowing (from where?)
  - Development partners (other priorities)
- Seems unlikely that significant reserves can be accumulated to reach this target
- What would USD300-600m achieve? (only 1-2 months import cover)
  - Would stabilise a floating rate for a short period of time only
- Focus on building reserves could delay reforms unnecessarily

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Timing?

- Near future could be favourable:
- Peace agreement – political credibility
- Exchange rate reform would complement – economic credibility
- Additional FX inflows – DPs, increased oil production
- Would help to support a floating rate
- Political buy-in essential

Risks

- Unstable, depreciating floating rate:
  - Underlying problem is budget deficits; if this is not fixed, the new floating rate could be unstable, and depreciate further
  - People rush to use their SSPs to buy USD
- Inflation:
  - Prices are already set in the parallel market, so floating the official rate would not make much difference, as inflation is already high
- Delay
  - Postponing reforms in order to build up reserves will make problems worse, and in any case it is unlikely that funds will be forthcoming to build up reserves

Big Bang or Incremental Reform?

- Big bang would be traumatic – even if a positive shock eventually
- A more gradual approach might work better:
  - Allow banks to trade FX freely, at any rate
  - Move parallel market into the banks, help to build an interbank market
  - Reduce non-govt FX allocations at the official rate
  - BSS to sell FX to banks at auction – would help government income
  - Official rate becomes less important for non-govt transactions

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Risks

- Risks of doing nothing are greater than the risks of doing something
- Risks of delay are greater than the risks of reform

THANK YOU

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