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Macro-economic policy reform options for Sudan



- In brief:**
- Sudan is in an unsustainable economic position with high and rising inflation, fiscal and balance of payments deficits and negative GDP growth. The situation needs urgent intervention to stabilise the economy and reverse the deterioration.
 - One of the major causes of this instability is high and increasing subsidies, notably for fuel, which are unaffordable and are being financed by money printing, which is fuelling inflation and exchange rate depreciation. This is compounded by low collections of domestic tax revenues and an overvalued official exchange rate.
 - Intervention to address the problem requires that fuel subsidies are reduced, that fiscal deficits are not monetised, domestic tax revenues are increased, and the exchange rate is liberalised and unified. In terms of speed of implementation, a balance is needed between a gradual approach to manage any adverse impacts on the population, and the urgency of stabilising the economy. Increased social welfare transfers can be used judiciously to offset the impact on the most vulnerable groups.
 - The government is dependent upon external support to help manage the transition. It is also essential that a well-conceived and widespread information and communications campaign is undertaken so that the Sudanese population is aware of the rationale for the reforms, understand that the status quo is not sustainable, and are assured that, in due course, there will be benefits from lower inflation and economic growth.

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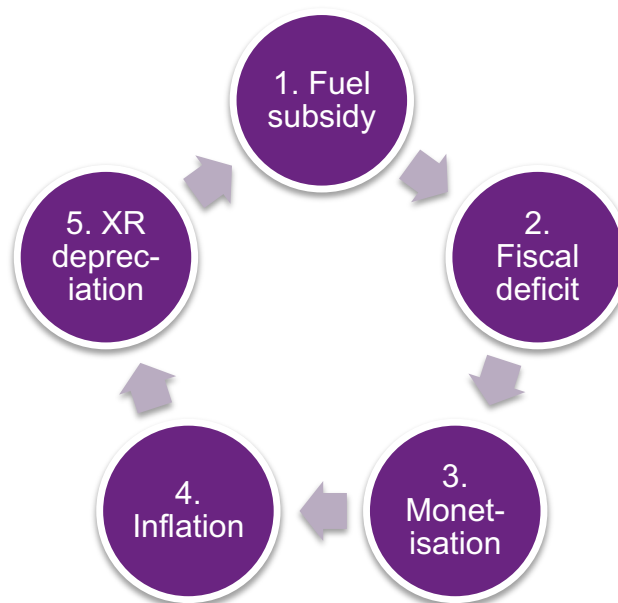
Introduction

Sudan's macro-economic position is dire, with rising inflation, fiscal and balance of payments deficits, a depreciating parallel market exchange rate, and a contracting economy (negative real GDP growth). The macro-economic situation has deteriorated sharply over the past two years, and by some measures – notably inflation and the parallel market exchange rate – the pace of deterioration has increased in recent months. The increasing pace of decline indicates that the macro-economic situation is unsustainable. In economic terms, “the house is on fire” and requires urgent intervention. Such intervention is needed to, first, stabilise the economy, and second, to start reforms that will build the basis for sustainable long-term economic growth and prosperity. This note provides options for intervention that will primarily address the need for immediate macro-economic stabilisation as well as longer-term prosperity.

The current situation

The most obvious manifestation of the current economic crisis is rising inflation and the depreciating parallel market exchange rate. However, these phenomena are only a part of a vicious circle of economic policy and outcomes driving a downward economic spiral and are symptoms rather than the cause of the crisis.

Figure 1: The macro-economic ‘vicious cycle’



The underlying cause of the economic crisis is an unsustainable level of subsidies, notably for fuel (petrol, diesel, kerosene, LPG). The subsidies are paid for by government, even though it does not have the tax or other revenues to do so. In the past, the payment of the subsidy was done indirectly, via the Central Bank of Sudan (CBOS), with the cost partially hidden, but under the new government the cost is now directly in the budget. The net effect of financing the cost of subsidies indirectly or directly is the same, as it leads to money creation by the CBOS under both channels. However, including the cost of the subsidies in the budget provides greater transparency and accountability.

When combined with the relatively low level of government revenues in Sudan, the cost of fuel subsidies leads to a budget (fiscal) deficit, which is, in turn, financed by money creation, or “printing money”, by the CBOS. This leads to rapid growth of the money supply, which in turn causes inflation.

The combination of high inflation and a balance of payments deficit (driven in part by the cost of fuel imports) leads to depreciation of the (parallel) market exchange rate. The depreciation then increases the cost of the fuel subsidy, which is equal to the difference between the cost of imported fuel (which rises in SDG terms as the exchange rate depreciates) and the (fixed) regulated price. Hence the vicious circle and unsustainable policy combination.

The situation is worsened by weak domestic revenue mobilisation (thereby increasing the budget deficit) and lack of access to external debt financing (which means that the fiscal deficit is financed by monetary expansion). However, this is not the root of the problem; the size of the fuel subsidy is so large that this would not be sustainable even if revenues were higher and those other constraints were less binding. A related outcome is that the high level of spending on fuel subsidies “crowds out” other forms of government spending, notably on social safety nets/transfers, social spending (health and education) and investment (capital) spending.

Sustainability issues

Table 1: Deteriorating macro-economic indicators

		2017	2018	2019
Fuel subsidies	% of GDP	2.2%	8.3%	10.6%
	% of govt. spending	16%	50%	57%
	% of govt. revenues	30%	94%	135%
Inflation	%, end of period	25%	73%	60%
Real GDP growth		0.7	-2.3	-2.5
(Broad) money supply growth		67%	112%	67%

Source: IMF

The current situation is not sustainable. Between 2017 and 2019, the cost of fuel subsidies is estimated to have increased from 16% to 57% of fiscal spending and 2.2% to 10.6% of GDP. Inflation has increased from 25% in 2017 to an estimated 60% in 2019 and is set to rise further if fiscal deficits are not reduced and monetary growth contained. In 2019, the cost of fuel subsidies exceeded total government revenues.

Without change, the prospect is that the vicious cycle will continue, with fuel subsidies remaining at around 12% of GDP, fiscal deficits around 18% of GDP, inflation persisting in the range of 80%-100%, and rapid depreciation of the parallel market exchange rate towards SDG2,000 per USD by 2025.

What interventions or policy actions can break this vicious cycle? There is no doubt that the current level of fuel subsidies is unsustainable and needs to be reduced, preferably to zero. It is neither sustainable in macroeconomic and fiscal terms, nor does it particularly benefit vulnerable or needy groups of the population. The critical question is how quickly the subsidies can be reduced, and what complementary policy actions are desirable and possible?

Box 1: Fuel prices and subsidies

The retail price of fuel (petrol, diesel, kerosene, LPG) in Sudan has been fixed in SDG terms for a number of years, dating back to the time prior to the independence of South Sudan when Sudan was a significant oil producer. Since the independence of South Sudan in 2011, Sudan has been a net oil importer, and hence the majority of oil products consumed in the country have to be purchased on international markets at world prices.

The actual cost of fuel therefore depends on international fuel prices and the exchange rate. There are

currently various different exchange rates, but with a general shortage of foreign exchange at preferential exchange rates, ultimately currency has to be sourced in the parallel market where the rate is currently around SDG100 per USD. Current retail prices only cover approximately 10% of the cost of fuel, hence the retail subsidy rate is around 90% and fuel is effectively being given away.

The subsidy introduces various distortions. Subsidies increase demand, and subsidising the cost of one of Sudan's major imports increases the import bill and the current account deficit. The fuel subsidy also provides a huge incentive for the resale of subsidised fuel on the domestic black market, and smuggling to neighbouring countries, where substantial profits can be made.

As with any free or heavily subsidised commodity, the market experiences excess demand. The elevated demand for the commodity cannot be met by suppliers – due to limitations on the amount of losses or subsidies that can be financed – hence supply has to be physically rationed. In the case of fuel, this is manifested as fuel shortages in filling stations, and the resulting queues.

Fuel prices in Sudan are among the lowest in the world. In February 2020, the average price for gasoline around the world was USD1.08 per litre and diesel USD1.00/l.¹ The import cost of refined fuel products is around USD0.55 per litre (excluding inland transport costs and wholesale/retail margins). Apart from Sudan, the only countries that charge less than USD0.55/l are all net oil exporters – in which case the cost of the subsidy is an opportunity cost,² i.e. export income / fiscal revenues foregone, rather than a direct fiscal cost.

The fuel subsidy cost in Sudan is considerable. In 2019, the estimated cost was SDG215 billion, or 57% of total government spending, and is responsible for almost the entire budget deficit, estimated at SDG220 billion. The cost of the fuel subsidy is estimated at 10.6% of GDP in 2019. A subsidy of this magnitude would be unsustainable under any circumstances, but is particularly problematic when domestic revenues are so low (total revenues and grants were estimated at 7.8% of GDP in 2019).

Exchange rate policy

Sudan's current exchange rate policy comprises a number of different exchange rates, including the fuel rate (SDG 6.75 per USD), customs rate (SDG15/USD), and the official rate (SDG47.5/USD in early 2020). Although foreign exchange is in principle made available for designated imports at the fuel and official rates, in practice it is not generally available at those rates through official channels. There is also an unofficial (but acknowledged) parallel market rate, which generally reflects supply and demand in the foreign exchange market and accounts for around 80% of the total value of foreign exchange transactions. The parallel market rate has depreciated from SDG50/USD in late 2018 to 100 in early 2020, driven by large balance of payments deficits. For most economic agents (outside of government or well-connected circles), foreign exchange can only be accessed through the parallel market.

There are close linkages between the fiscal deficit, monetary expansion, inflation, the balance of payments, and the exchange rate. Essentially, the high level of fuel subsidies is driving instability across all of the other metrics, and the exchange rate adjusts to ensure that the current account balance (deficit) can be financed (via investment inflows).

Maintaining multiple exchange rates adds further economic distortions. There is an incentive for economic agents who can obtain foreign exchange at the official rate to re-sell the currency in the parallel market, and make a substantial profit, and then repeat the process. Such "round-tripping" acts as a severe drain on foreign exchange intended to be made available at the official rate. Removing

¹ <http://www.globalpetrolprices.com/>

² Assuming that the retail price is not less than the domestic cost of production and distribution.

this distortion requires unifying the foreign exchange market (removing the privileged fuel and official rates) and allowing the exchange rate to be broadly market-determined.

The customs exchange rate is used purely for valuation purposes, rather than actual transactions, and is used for calculating the SDG value of imported commodities subject to import tariffs and VAT. The customs rate is more akin to a tax rate, rather than a conventional exchange rate.

In due course, the customs rate should be unified with the market rate, although at a measured pace. Rapid unification of the customs exchange rate could boost revenues significantly but would add to inflation and pressures on living standards. In order to minimise the adverse impact, increasing the customs exchange rate should be accompanied by reducing (and simplifying) tariff rates. This requires some time to implement, and it would not be necessary to unify the customs rate at the same time as unifying the official and market rates.

Box 2: Relevant lessons from international experience

Although each country's situation is unique, there are nonetheless lessons that can be learned from countries that have faced similar macro-economic challenges to that of Sudan. These lessons can be grouped into three specific challenges: bringing down high inflation, exchange rate liberalisation, and reducing fuel subsidies, and are summarised below.

Many countries have brought inflation down quickly from very high rates, with most such stabilisation programmes including broad-based reform agendas. A critical component is fiscal and monetary tightening, with large and rapid reductions in budget deficits supporting a sharp slowdown in monetary expansion and hence inflation. Reforms can be helpfully underpinned by price and exchange rate regime liberalisation, as well as broader institutional reforms (e.g. to the central bank, rule of law, and state-owned enterprises). All of these help to provide credibility and boost the confidence of domestic and external investors.

Exchange rate liberalisation and unification of dual (or multiple) exchange rate regimes is often a major component of stabilisation packages. Although this may involve an effective devaluation of the exchange rate, and hence an increase in import prices and inflation, this is less so if the parallel market exchange rate is already used for the majority of imports (as is the case in Sudan). Furthermore, it removes a key economic distortion and allows resources to be allocated more efficiently. These efficiency gains (combined with lower inflation) support a recovery in economic growth. Another key conclusion is that if exchange rate reforms are not accompanied by other macro-economic reforms – especially dealing with the drivers of high inflation, such as the fiscal deficits and monetary expansion mentioned above – they will not be successful, and exchange rate weakness will continue (e.g., as in South Sudan).

A key issue with regard to exchange rate liberalisation and unification is whether it should be done in one step (“big bang”) or more gradually. However, there is no clear conclusion on this, as it entails a trade-off: a big bang brings efficiency gains forward quickly and provides credibility, but entails a one-time (and potentially quite large) shock to existing producers and consumers. A more gradual approach spreads the pain, but delays efficiency gains and may have questionable credibility.

On reforming (reducing) fuel subsidies, the lessons from other countries are clearer, from both successful and unsuccessful episodes. A common starting point is that large fuel subsidies are fiscally unsustainable and do not generally benefit the poor, but that their removal is more of a political process than an economic one and can easily fail if mishandled. Perhaps the three key lessons are that (i) a strong communications campaign is critical prior to the removal / reduction of subsidies; (ii) a gradual process rather than an overnight change is more likely to be palatable to the population; and (iii) there must be mitigating measures to offset negative impacts, especially on the most vulnerable groups of the population.

The communications campaign should emphasise why subsidies are harmful to the economy and the damage that they cause and explain that their removal presents an opportunity to deliver more effective support for the population, especially for the poor. More generally, the campaign should ensure transparency regarding the reform process, and aim to build trust for the government's actions. There may even be a need for an independent body to handle fuel pricing to shift lobbying pressure away from the government. Mitigation measures can take various forms, but some kind of cash-based compensation for the poorest groups is required. This may not be as relevant for the better off groups (who will lose more from the reduction of subsidies); for them, the benefits will be longer-term, from development of productive sectors, lower inflation, higher growth and increased employment.

Reform paths

A sustainable path to reform has three key components: (i) policy, (ii) communication; and (iii) implementation. It requires carefully balancing a range of different (possibly conflicting) objectives.

- Reducing the fiscal deficit quickly enough to achieve macroeconomic stability, which in turn depends on:
 - Reducing/eliminating fuel subsidies;
 - Mobilising domestic revenues (taxes etc.);
 - External financial support (donor funds, access to capital markets).
- Compensatory measures to offset the impact of subsidy reduction on vulnerable groups.

It also needs complementary policy measures:

- Exchange rate reform to provide appropriate prices and incentives for balance of payments sustainability, improved exports and long-term growth;
- Tight monetary policy to contain the impact of subsidy removal on inflation.

The cost of the fuel subsidy is estimated at USD3.5 billion in 2019 (about \$85 per capita, averaged across the whole population of Sudan). The original 2020 Budget proposed reducing fuel subsidies to zero during 2020, with faster reduction in petrol subsidies than diesel subsidies. This proposal was withdrawn after encountering significant opposition from civil society, and a revised schedule for the reduction of fuel subsidies now has to be drawn up. The optimal pace of subsidy reduction depends on:

- The target fiscal deficit path;
- The speed at which domestic revenue mobilisation can be improved;
- The extent to which external (donor) support can be mobilised;
- The cost of compensatory social safety net measures.

There are a range of combinations of subsidy removal and social safety net spending that would achieve a target of reducing the fiscal deficit to a sustainable level (defined as a deficit of 1% of GDP or less) within 3 years (by 2023), depending on speed at which domestic tax revenues can be increased and the availability of external funding for budget support. One such indicative fiscal stabilisation programme, based on the following assumptions, is shown below:

- **Revenues**
 - Doubling of domestic tax revenues (from 6% to 12% of GDP)
 - Doubling of oil revenues and external grants (from 1.8% to 4% of GDP)

- **Fuel Subsidies**

- Elimination of fuel subsidies over two years from mid-2020, in three equal annual instalments (or more gradually on a quarterly or monthly basis, by approximately USc6.8/quarter or USc2.25/month). This would lead to the following indicative fuel price (in US cents per litre – priced in SDGs at the parallel market exchange rate):

Table 2: Fuel price changes as subsidy is removed

	2019	2020	2021	2022	2023
Fuel price (avg., USc/l)	6	24	42	60	60
% change		300%	75%	43%	0%

- It is important to emphasise that fuel pricing will have to be calculated in USD and converted to SDG at the prevailing market exchange rate if the subsidy is to be contained at the budgeted level. A USD-based pricing formula (based on prevailing crude oil prices with margins for refining and transport costs and distribution/retail margins), with the subsidy explicitly applied to the price that results from the formula calculation, would achieve this³.

- **Other expenditures**

- Increase in social spending, from 0.7% of GDP in 2019 to 3.1% of GDP from 2021 onwards (approximately USD1 billion in 2021);
- Increase in spending on public sector wages from 2.9% of GDP in 2019 to 3.5% of GDP in 2021; (assuming no growth in public sector employment, this would represent an increase of 28% in USD terms);
- Increase in other spending, including transfers and capital spending, from USD1.1 billion in 2019 to USD3.4 billion in 2023 (3.3% to 9% of GDP).

The outcome would be to reduce the fiscal deficit from an estimated 11% of GDP in 2019 to 6.0% in 2021 and 0.8% in 2023. The reduction in the deficit (by 10.1% of GDP) is largely achieved by reducing fuel subsidies (9.4% of GDP). The increase in revenues (7.7% of GDP) is mostly devoted to increased public sector wages (0.6% of GDP), social spending (2.4% of GDP) and other spending, transfers and capital spending (4.2% of GDP).

As this fiscal programme still has budget deficits, there is a funding gap that needs to be filled. This amounts to USD5.9 billion over the four years from 2020 to 2023 and needs to be filled either by (i) increasing domestic revenues at a faster pace than projected above; (ii) a higher level of external support (grants). Towards the end of this period, there may be scope for external borrowing, but this is dependent upon successful debt restructuring (through the HIPC programme).

Table 3: Indicative fiscal programme (% of GDP)

% GDP	2019	2020	2021	2022	2023
Total revenues	7.8	11.3	14.0	14.5	16.0
Domestic (tax) revenues	6.0	7.5	9.0	10.5	12.0
Oil revenue & grants	1.8	3.8	5.0	4.0	4.0
Total spending	18.7	18.9	20.0	16.8	16.8
Wages	2.9	3.2	3.5	3.5	3.5

³ Such a formula-based approach is used for calculating regulated fuel prices in South Africa and Botswana (although it is taxes that are applied to the base price, not subsidies).

Fuel subsidies	10.6	8.8	5.3	1.8	0.0
Other subsidies	1.2	1.4	1.5	1.4	1.2
Social spending	0.7	2.0	3.1	3.1	3.1
Other spending, transfers & investment	3.3	3.5	6.6	7.0	9.0
Fiscal Balance	10.9	7.6	6.0	2.3	0.8
Funding gap (\$ bn)	3,663.4	2,643.0	2,140.2	832.9	302.9

Source: author

As removing fuel subsidies are central to achieving fiscal sustainability, a key issue is how quickly they can be reduced. This is not a technical issue – from a fiscal and economic sustainability perspective, they should be eliminated immediately; rather, it is a political economy issue, in the sense of what rate of subsidy elimination could be tolerated without triggering civil unrest that might threaten the stability of the government. There is some understanding that the current economic situation is unsustainable and that changes are necessary and, furthermore, that some of those changes will be painful. However, it is not just the removal of fuel subsidies that may trigger civil unrest: continued high inflation and regular fuel shortages – i.e. the results of not undertaking fiscal reform – could also do so. What is most likely to be sustainable (from a political economy perspective) is a package comprising of:

- removal of fuel price subsidies at a more gradual pace (e.g. in 3 tranches over 2 years as suggested above), rather than all at once;
- improved availability of fuel; and
- clamping down on the black-market resale and smuggling of fuel.

Improving the availability of fuel would be helped by multiple distribution channels. Large corporate users of fuel, who buy wholesale, already pay a much higher price than the standard retail price. The recent emergence of a two-track fuel retail system, with some fuel stations selling fuel at the market price rather than the subsidised price, should also help availability.

The main risk with the proposal for a gradual reduction in fuel subsidies is that it may be too slow to achieve macro-economic stabilisation. If external resources are not available to plug the fiscal and balance of payments gap, the danger is that monetisation of the deficit will continue, driving the exchange rate down further, and either increasing the subsidy again or leading to a faster fuel price increase in SDG terms.

To reduce this risk, subsidies could be reduced more quickly, for instance by removing subsidies on petrol (gasoline), kerosene and LPG quickly (within 3 months, by Q2 2020) and removing diesel subsidies more slowly, over a 12 month period. This would achieve quicker fiscal stabilisation, with a sustainable budget in 2021, a much reduced external financing requirement, and less risk of continued exchange rate instability and depreciation. However, the impact of fuel price increases would be felt more quickly.

Table 4: Summary alternative fiscal programme – faster subsidy removal (% GDP)

% GDP	2019	2020	2021	2022	2023
Total revenues	7.8	11.3	14.0	14.5	16.0
Total spending	18.7	18.5	15.1	15.0	16.8
Fuel subsidies	10.6	8.4	0.4	0.0	0.0
Fiscal Balance	10.9	7.2	1.1	0.5	0.8
Funding gap (\$ bn)	3,663.4	2,447.8	394.6	183.7	302.9

The importance of an effective information and communications strategy cannot be overemphasised. This should cover an explanation of the current situation, the consequences of not reforming, and informing the population about the need for some tough decisions (including fuel subsidy reduction) in the short-term in order to lay the ground for sustainable, longer-term growth.

Raising domestic tax revenues

Sudan has one of the lowest rates of domestic tax collection in the world, at an estimated 7.4% of GDP in 2019 (excluding grants). The average across all low- and middle-income countries was 21% in 2014⁴. Such a low rate of revenue collection is not sustainable, especially given Sudan's needs for investment in infrastructure and improvements in social spending (health and education).

As such, the government needs to develop a strategy that tackles the essential elements of domestic revenue mobilisation: tax administration, compliance and policy. On the policy side, the government has several options that can raise revenue in the short term, specifically reducing or eliminating corporate tax exemptions, and bringing more companies into the tax net (especially security sector companies). Another tool would be to increase the customs exchange rate, which would effectively raise the import tariff rate, albeit with the disadvantage of increasing inflation further. Given the apparent complexity and lack of transparency regarding existing exemptions, a simple approach may be to remove all exemptions that have been granted by earlier ministerial discretion and retain only those that have been legally mandated under the Investment Law (e.g. time-limited tax holidays). Improved tax administration also has the potential to generate revenue gains in the short to medium term. But to realise those gains, the government must invest in the capacity of the tax authority to collect taxes that are currently in place.

The new peace agreement in South Sudan should enable that country to increase oil production, which would, in turn, assist Sudan with increased revenues from transit and other oil-related fees.

Impact of reducing fuel subsidies on inflation

Reducing fuel subsidies and raising fuel prices at the proposed rate would obviously have an impact on inflation. With fuel prices accounting for 2.5% of the CPI basket, the direct impact on the overall price level of even a large increase in fuel prices will be limited; the proposed increase of 300% in mid-2020 would only raise the overall CPI by 7.5%. There will be second-round effects, e.g. on transport and distribution costs, although this will be mitigated to some extent by the fact that many transporters are already buying fuel at black market costs. Containing the second-round effects will require the following:

- Securing external budget support to meet the fiscal financing gap and support the balance of payments (and hence minimise the depreciation of the parallel market exchange rate); this requires USD 5.9 billion in external support from 2020-23.
- Not monetising the fiscal deficit (so, if external budget support falls short and/or domestic revenue mobilisation is ineffective, spending will have to be reduced by the same amount);
- Close management of banking system liquidity, with reserve money targeting, use of available liquidity absorption instruments, and increasing bank reserve requirements if necessary.

⁴ World Bank, World Development Indicators

Social impact mitigation

Proposals have been put forward for a temporary Quasi-Universal Basic Income covering 80% of the population to mitigate the impact of fuel subsidy removal and other reforms. At a rate of \$5 per person per month, such a QUBI scheme would cost USD 2 billion a year, or around 6% of GDP. However, it is not clear that this would be affordable, even if external donor support is available, as it would still leave a large budget deficit to be financed in 2020-21. Second, the proposed withdrawal of the scheme after two years could be politically difficult and runs the risk of locking in an unsustainably high level of spending, and higher fiscal deficits.

Projections here include around half that amount, enough to finance a similar level of support for the most needy 40% of the population. Payment through electronic channels (such as mobile money) should be explored. The government should also conduct an expenditure review of the existing social safety net to improve its effectiveness.

Another group that would be adversely impacted by the increased fuel prices would be the urban middle class, many of who are government employees and whose real incomes are badly affected by inflation. They would benefit by the rapid reduction in inflation that this programme targets. The programme also entails an increase in public sector salaries, by 28% in USD terms, over 2020-21 to partially offset the impact.

Exchange rate unification/liberalisation

The current exchange rate regime includes several different rates that introduce further distortions into the economy and mostly do not reflect the demand and supply of foreign exchange. To the extent that foreign exchange transactions take place at the official rate, this represents a subsidy for imports and a tax on exports, neither of which are appropriate for economic growth and balance of payments sustainability. In particular, the gap between the official and parallel market rates needs to be closed over time. In addition, the parallel market needs to be formalised (incentivised to operate through formal institutions). Steps towards achieving this including:

- (i) Permitting bureaux de change to operate, on a restricted basis (e.g. with a cap on the size of transactions they can handle), but at a market-determined exchange rate; if legalised, it is likely that such bureaux de change would start operating quickly;
- (ii) Allowing banks to set their own exchange rate, based on the market;
- (iii) Closing the gap between the official and parallel rates, by raising the official rate gradually towards the parallel market rate (e.g., to close the gap over a 12 month period);
- (iv) After this period, calibrate the official rate to the market rate – as determined by average rates in the bureaux and interbank markets – on a daily basis;
- (v) The CBOS should move towards a system of foreign exchange auctions with the banks as a means of supplying foreign exchange to the market.

Liberalisation also includes removing any requirements for exporters (especially gold exporters) to sell foreign exchange to the CBOS at the official rate. Such a requirement imposes a tax on exports (and hence discourages exports and encourages smuggling and false export declarations), and ultimately reduces the availability of foreign exchange.

It is not necessary to accumulate significant foreign exchange reserves prior to exchange rate liberalisation. Given the current chronic current account deficit, it will be almost impossible for the CBOS to accumulate any reserves without large capital inflows from foreign sources. Even if reserves were available from such sources, and the intention was to use them to smooth the transition to a

unified rate and reduce exchange rate volatility, it is not evident that this is a rational use of scarce reserves. The parallel market rate is the best current estimate of the equilibrium (market clearing) exchange rate and it is likely that, in practice, any reserves would be used to support an overvalued exchange rate (hence subsidising imports) rather than simply smoothing volatility or avoiding exchange rate overshooting (where it depreciates beyond the equilibrium level). Focusing on the need to accumulate foreign exchange reserves prior to exchange rate unification and liberalisation is likely to delay the necessary adjustment of the single most important price in the economy to a realistic level.

The success of exchange rate unification and liberalisation also depends on fiscal reform: if a large, monetised fiscal deficit persists, then the exchange rate will continue to depreciate rapidly.