Policy Brief

SDN-20260 | October 2021

International Growth Centre

Sarah Logan

Exchange rate reform in Sudan

In brief:

- Since 2018, Sudan had been in severe economic distress, with a growing divergence between the official and parallel exchange rates and high and rising inflation, fueled by Sudan's significant fiscal deficit, which reached 11% of GDP in 2019. With limited access to financial markets and concessional financing, Sudan was bridging the fiscal deficit by monetisation.
- A transitional government was appointed in September 2019 to undertake necessary political and economic reforms ahead of elections planned for 2023. To date, the transitional government has implemented several technically and politically difficult macroeconomic reforms, notably fuel subsidy removal and exchange rate reform.
- Fuel subsidy removal was effected in late 2020, resulting in an annual saving of approx. USD 3.5 billion, which public funds can be allocated toward more effective or pro-poor purposes.
- Exchange rate reform was undertaken in February 2021, with the adoption of a managed float regime that saw unification of the official and parallel exchange rates. The customs exchange rate is being reformed separately.
- Six months after exchange rate reform, the exchange rate has remained stable and inflation, while still high, has begun to decline in what is hoped is an early sign of macroeconomic improvement.
- Alongside Sudan's removal from the State Sponsor of Terrorism List (SSTL) in December 2020 and considerable progress towards debt relief in 2021, these reforms are likely to go a long way towards opening up Sudan for business.

This brief was produced by the State Fragility initiative

Introduction

In April 2019, former Sudanese president Omar al-Bashir was removed from office amid widespread protests, triggered in large part by Sudan's deepening economic crisis and deteriorating standards of living. After several very tumultuous months, a transitional government was established in September 2019, comprising the Sovereignty Council (with military and civilian representatives) and a civilian Council of Ministers headed by Prime Minister Abdulla Hamdok. The transitional government was given 39 months to undertake the extensive political and economic reforms needed to prepare Sudan for democratic elections.[1]

From the start, the transitional government faced a number of significant challenges, notably an extensive reform agenda that included some technically and politically difficult macroeconomic reforms that, while necessary, would potentially cause economic hardship to Sudan's poorest citizens in the short term before reforms yield benefits in the medium to long term.

Sudan's economy had been deteriorating since 2011, when South Sudan seceded with around 75% of the country's oil reserves. Sudan's GDP per capita had declined by 64% since 2015, from USD 1,656 in 2015 to USD 595 in 2020.[2] Alongside this, Sudan was experiencing **high levels of inflation**, which exceeded 60% since 2018 and reached 260% in November 2020, and a **rapidly depreciating exchange rate**: the parallel exchange rate (250 SDGs to the USD) was almost five times the official exchange rate (55 SDGs to the USD) by November 2020. The customs exchange rate was pegged at 15 SDGs to the USD, far below even the official exchange rate.

Sudan's **large balance of payments deficit**, with imports significantly exceeding exports, further aggravated these dynamics. The balance of payments deficit reached around USD 5.2 billion in 2019. The unfavourable official exchange rate resulted in most foreign exchange transfers into Sudan, including remittances, going through informal channels – this worsened ongoing foreign exchange shortages, which caused sporadic shortages of essential commodities such as fuel, wheat, and medicines.

Sudan also had an **incredibly high external debt** of approximately USD 64 billion, comprised in large part of interest on arrears. The IMF estimated that 39% of Sudan's public and publicly guaranteed external debt was owed to non-Paris Club creditors, 38% to Paris Club creditors, 11% to international finance institutions, and 12% to commercial creditors.[3] This level of indebtedness limited Sudan's access to capital markets and concessional financing.

Considerable **debt relief** progress was made around the Paris Conference in May 2021, with bilateral debt forgiveness and the US, UK, Ireland, Sweden, and others contributing to clearing Sudan's arrears to international finance institutions, including the African Development Bank, International Monetary Fund, and the World Bank.

Debt relief and Sudan's removal from the State Sponsor of Terrorism List (SSTL) in December 2020 have helped ease constraints to capital markets and concessional financing. Continued progress toward meeting requirements of the IMF's Staff Monitored Programme (SMP) is necessary for Sudan to qualify for further debt relief under the highly indebted poor countries (HIPC) initiative.

Requests for IGC analysis

During 2020, the IGC responded to two requests from the Sudanese government for input on macroeconomic issues: in February 2020, we provided policy advice on how government could curb inflation and exchange rate depreciation, and in November and December 2020, we co-hosted roundtable discussions to explore exchange rate reform options.

[1] The 39-month transitional period was reset in October 2020 when the Juba Peace Agreement was signed between the transitional government and the Sudan Revolutionary Front.
[2] World Bank, World Development Indicators.
[3] IMF, 2021a.

Critical reforms were identified in the following areas:

1. Closing the fiscal deficit
2. Unifying and liberalising the exchange rate.

These issues and identified policy recommendations are explored below.

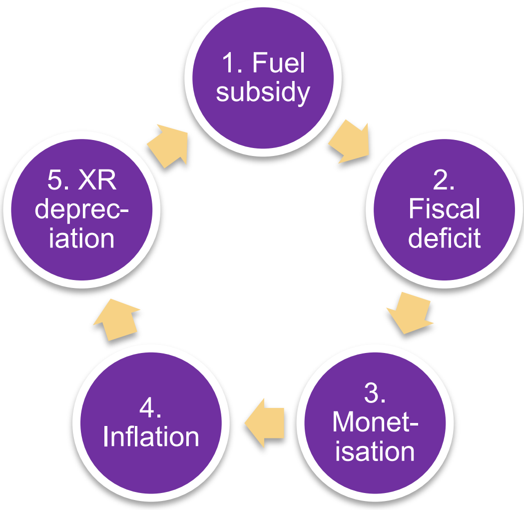
1. Closing the fiscal deficit

Sudan had a **persistent and growing fiscal deficit** with government spending far exceeding revenues collected. In 2019, the fiscal deficit was around 11% of GDP.[4] As Sudan had little access to capital markets or concessional financing given its extremely high external debt, government was bridging this gap by **printing money**, which in practice was driving high inflation and depreciation of the SDG. Closing the fiscal deficit would depend on reforms on both the expenditure side and revenue side.

1.1. Reducing government spending

Initial IGC analysis focused primarily on the expenditure reforms needed to close the fiscal deficit. Sudan's fiscal deficit was driven in large part by **costly subsidies on basic commodities**, with **fuel subsidies** being one of the biggest contributors to the deficit, comprising a staggering 57% of government spending (and 135% of government revenues) in 2019.[5] Explicit subsidies existed on fuel, electricity, wheat, and medicines, and government was bearing the cost of large implicit subsidies through grossly overvalued official and customs exchange rates.

Figure 1 The vicious macroeconomic cycle of fuel subsidies[6]



The vicious cycle created by subsidies is shown in Figure 1 above, using fuel subsidies as an example. The retail price for fuel had been fixed in SDGs since before 2011, when Sudan still controlled the oil reserves taken by South Sudan in 2011. By 2019, consumers were only paying 10% of the international price, with government covering the rest of the cost of every litre of fuel purchased – this amounted to a staggering bill of **USD 3.5 billion annually** by 2019. Government did not have the revenues to cover this bill, leading to a growing fiscal deficit that they attempted to close through monetisation (i.e., by printing money). As monetisation of the deficit drove inflation and exchange rate depreciation, it made it ever more expensive for government to cover the next subsidy bill: the share of the international price paid by consumers became smaller, and

[4] IMF, 2020.
[5] Jefferis, 2020.
[6] Ibid.

that paid by the government ever larger, with each cycle.

Apart from being incredibly costly and financially unsustainable, subsidies are very **inefficient** generally fail to achieve the welfare benefits purportedly justifying them. Subsidies benefit those who consume a lot of the subsidised commodity – for fuel, this is invariably wealthier segments of society who own motor vehicles and household generators. Indeed, evidence from emerging economies has shown that, in absolute terms, the top income quintile captures six times more in petroleum and diesel subsidies than the poorest quintile.[7] Importantly, fuel subsidies also **crowd out public funding** that could be better spent on alternative activities that could boost private sector development and job creation or better target benefits to those most in need, such as social safety nets or provision of health and education services.[8]

Subsidising fuel also creates massive **arbitrage opportunities** and much of Sudan's subsidised fuel was being smuggled out of the country or re-sold domestically on the black market at higher prices. It became extremely difficult for ordinary Sudanese citizens to buy subsidised fuel, with long queues forming at petrol stations and most people resorting to purchasing fuel on the black market at higher prices.

Fuel subsidy removal is always politically challenging, even when, as in Sudan's case, ordinary Sudanese citizens benefitted very little from fuel subsidies, sustaining the policy was crippling the country economically, and there were far more effective and pro-poor uses for Sudan's limited public funding.

Despite the political difficulties, fuel subsidy removal was announced in October 2020. The private sector was required to import fuel at commercial prices and to work with government to ensure prices reflected international prices and exchange rate movements, in order to prevent further foreign currency depreciations resulting in a return of fuel subsidies. Domestically-produced fuel would be reserved for strategic industries and sold at a discounted rate, a decision considered to be ill advised as it would retain price distortions. Some inefficiencies between private sector and government coordination also led to a creeping re-emergence of fuel subsidies, requiring further action to address in mid-2021.

1.2. Improving domestic revenue mobilisation

Sudan's tax-to-GDP ratio is among the lowest in the world, estimated at about **5.4% of GDP** in 2020, falling far short of the revenues needed to sustain government expenditure and therefore also contributing to Sudan's fiscal deficit. Sudan's widespread poverty and informality argues against reform through raising tax rates. Rather, revenue reform in Sudan will require efforts such as eliminating tax exemptions granted to military-owned and politically-connected firms, broadening the tax base, improving the efficiency of tax administration, and curbing gold smuggling.

These type of revenue reforms will take relatively longer to design and effectively implement than reforms to reduce government spending. Quick progress on revenue reforms is also hampered in part by a lack of comprehensive information and reliable data on Sudan's existing tax policy and administration framework, which is opaque and complex and results in a system lacking in transparency and subject to negotiation, with considerable scope for corruption, tax avoidance, and tax evasion. Future IGC analysis will focus on reforms to improve domestic revenue mobilisation in Sudan.

Critically, reducing Sudan's fiscal deficit would mean a smaller budgetary gap, thereby easing the extent of monetisation. Slowing the printing of money would be vital to curbing inflation and exchange rate depreciation.

[7] del Granado, A. et al., 2010.
[8] Asare, J. et al., 2020.

2. Unifying and liberalising the exchange rate

Sudan had been using a **fixed exchange rate regime**, where the official exchange rate was set at 55 SDGs to the USD. Over the 2018-2020 period, the country experienced a growing divergence between the official exchange rate and a parallel exchange rate, which reached 250 SDGs to the USD in November 2020. It was estimated that 90% of transactions were taking place at the parallel rate.

The customs exchange rate was also extremely overvalued, set at 15 SDGs to the USD. This made imported goods relatively cheap for consumers as the customs rate was used to calculate the value of goods and, therefore, duty due on imports. As a result, government was under-collecting on customs revenue, which contributed to Sudan's budget deficit – and, in turn, to high inflation and exchange rate depreciation dynamics. **Inflation hit 260% in November 2020**, rapidly eroding Sudanese citizens' purchasing power and outstripping any benefit they may have received from subsidised commodities or cheaper imports.

In the face of this growing multiple exchange rate issue, there was general consensus that **unifying the exchange rate** was urgent and necessary. Exchange rate unification was also a requirement of the IMF's Staff Monitored Programme that Sudan needed to satisfy in order to qualify for debt relief under HIPC.

However, there was less consensus on ***how*** unification could be undertaken in Sudan's volatile macroeconomic situation and in the absence of a cushion of foreign currency reserves. Exploring this formed the basis of a series of roundtable discussions between several macroeconomic experts – Chris Adam (Oxford), Shanta Devarajan (Georgetown), Andres Velasco (LSE), and Kupukile Mlambo (Reserve Bank of Zimbabwe)) – and representatives from the Central Bank of Sudan (CBOS), Ministry of Finance and Economic Planning, and the Prime Minister's Office in November and December 2020.

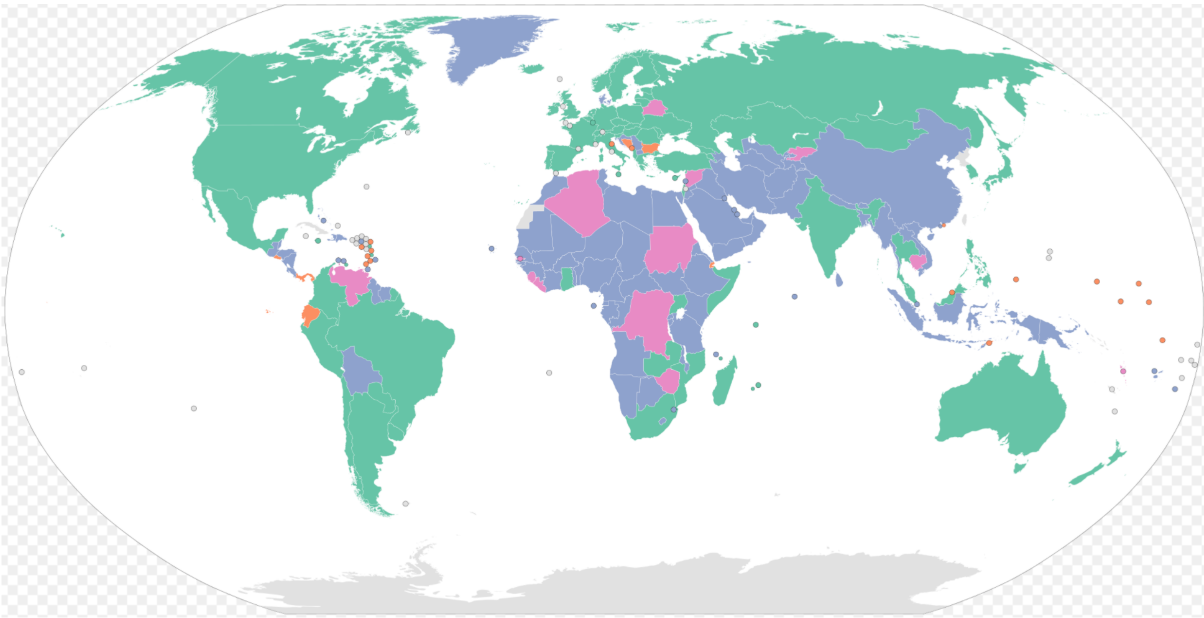
Box 1 Types of exchange rate regime

Fixed exchange rate – also known as a pegged exchange rate – a nominal exchange rate is firmly set against a foreign currency/basket of foreign currencies/other measure of value (such as gold) by the central bank, which maintains the fixed rate by buying and selling its currency on the open market to maintain the market equilibrium at the fixed exchange rate value; alternatively, the central bank may make it illegal to trade currency at any other rate. Few large economies use this regime anymore.

Managed float – also known as a dirty float or crawling peg – the exchange rate regime is neither entirely free floating nor fixed. The currency value is kept in a range against another currency/basket of foreign currencies by the central bank regularly buying and selling currencies. Critically, the central bank needs a cushion of foreign currency reserves to maintain this system. Around 43% of countries are thought to use this system, as shown in Figure 2 below.

Free float – also known as a pure, clean, or flexible float – this is a flexible exchange rate system solely determined by market forces of demand and supply of foreign and domestic currencies. An exchange rate is allowed to fluctuate depending on foreign exchange market events and there is (theoretically at least) no central bank intervention. Most of the world's currencies, including all the most widely traded ones, use this system.

Figure 2 Exchange rate regimes globally in 2013, as classified by the IMF[9]



De facto exchange rate arrangements as classified by the International Monetary Fund. Floating (*floating* and *free floating*) Soft pegs (*conventional peg*, *stabilized arrangement*, *crawling peg*, *crawl-like arrangement*, *pegged exchange rate within horizontal bands*) Hard pegs (*no separate legal tender*, *w:currency board*) Residual (*other managed arrangement*)

The discussions between macroeconomic experts and the Sudanese government centred around the following key issues:

2.1. The preeminent need to close the fiscal deficit

The **fiscal deficit and its monetisation** was the root cause of Sudan's macroeconomic instability, yet it was receiving comparably less focus than the symptoms of the problem, namely inflation and exchange rate depreciation. Greater focus on how the fiscal deficit could be closed was urged, as progress on that was essential for greater stabilisation.

It was emphasised that **sequencing matters** – exchange rate unification is only possible in the context of fiscal consolidation/closing the fiscal deficit and some progress on fiscal consolidation is needed *before* exchange rate reform can be undertaken (since reducing monetisation of the deficit is essential to this effort). Without closing the deficit or reducing the rate of monetisation, exchange rate reform would likely fail because:

- A fixed exchange rate will quickly become unsustainable as the market will just develop a new parallel rate.
- A floating exchange rate will lead to a rapidly deteriorating exchange rate and, potentially, hyperinflation.

How quickly exchange rate reform could be enacted would depend on how quickly progress towards fiscal consolidation could be made. It was noted that most countries that successfully moved to a free float only floated quite far down the road after having already achieved two things:

[9] Wikipedia.

- They brought down the fiscal deficit to a situation that didn't require massive monetising (e.g., the deficit became 1 percentage point of GDP rather than 10 percentage points of GDP).
- They strengthened their banking system and ensured that it was well capitalised (weak banks end up needing bailouts, which requires monetisation).

2.2. Sudan's lack of foreign currency reserves was a critical problem

Sudan did not have foreign currency reserves to support a managed float regime. In this context, government was being pushed to adopt a free float immediately, which was extremely risky and, without any prior fiscal consolidation, threatened to push Sudan into hyperinflation. It was recognised that, while a floating exchange rate with a relatively open capital account may be the destination, reaching that point could not be rushed, it could only be done gradually. Before reaching the point where a free float would be feasible, Sudan needed some sort of **managed exchange rate regime** for a time, while progress towards closing the fiscal deficit was made.

This phased approach has been used successfully by other countries transitioning to free float regimes. Many Latin American countries used a crawling peg (managed float) during their transition to a free float; Chile used a system of bands. It was clear from the experience of Latin America that those countries that tried to move to a floating regime too quickly, without adequately reducing their fiscal deficits first, did not have good outcomes.

Despite evidence that a quick move to a free float was highly unlikely to work in Sudan, with its high fiscal deficit, little progress toward fiscal consolidation, and weak domestic banking system, the World Bank and the IMF appeared to have been pushing the Sudanese government to take this route – since, on the face of it, Sudan's lack of foreign currency reserves closed off the option of a managed float regime.

During the discussions, it was suggested by the macroeconomic experts in attendance that the Sudanese government approach the World Bank and/or IMF for a transitional loan or exchange rate stabilisation fund to use as a cushion to support a managed float, as this route would be less risky for Sudan.

All cautioned that liberalising the exchange rate would likely entail a period of volatility and increased prices while the market value of the currency was determined. However, Sudan's relatively established parallel rate would likely help shorten the period of adjustment.

2.3. Customs rate reform needed to be managed separately

It was recognised that the customs rate needed to be reformed separately to unification of the official and parallel exchange rates, and that it should be reformed in a way that was **good for fiscal accounts**, i.e., it should be revenue ***collecting*** rather than merely revenue neutral. Sudan's customs rate, at 15 SDGs to the USD, was extremely overvalued and was costing the government dearly in implicit subsidies. It was also making Sudanese exports uncompetitive on international markets.

However, government was wary of raising the customs rate (and lifting the implicit subsidies) too quickly because of the negative impact that this would have on Sudanese citizens as some locally-produced goods (that used imported intermediate inputs) and all imported goods would become more expensive in SDG terms. To mitigate this impact, it was recognised that the **customs rate could be gradually increased while simultaneously lowering customs tariffs**. The customs rate reform would take several months to effect, during which period inflation would remain high as increased import duties were passed on to consumers via higher prices.

While government was keen to undertake this adjustment in a revenue neutral way, Sudan's dire fiscal situation meant that foregoing the possibility of increased revenue would be a significant lost opportunity to close the fiscal deficit and enable greater macroeconomic stability. Government representatives were urged to raise the customs rate as much as was politically feasible, to start closing the fiscal deficit.

Ensuring reform of the customs rate was revenue collecting would lead to two things:

- Imports would be more expensive, so people would be encouraged to import less, which would be useful since Sudan had no foreign currency reserves to fund imports.
- Government could clearly demonstrate that they were doing something about the fiscal deficit and that progress towards greater macroeconomic stabilisation was being achieved.

A **revenue target approach** could be used: as the customs rate was raised, customs tariffs could be lowered to enable a set target to be reached, which could either be revenue neutral or revenue collecting. For this approach to work, it's important that everyone knows what is going on, and clear communication needed to be supported by predictable follow through in action.

It was emphasised that government should not try to shore up foreign currency reserves by restricting imports – this approach almost never works as people will always find ways to circumvent import restrictions. A more effective and less distortive approach would be to reduce the demand for imports (and foreign currency) by raising the cost of imports (by raising the customs rate and/or customs tariffs).

2.4. Allocating scarce foreign currency to importers

On the Sudanese government's request, a specific discussion on mechanisms to **predictably and fairly allocate scarce foreign currency among importers** was held with the Reserve Bank of Zimbabwe (RBZ), who have refined the use of a **Dutch auction system**. In brief, the Zimbabwe system involves:

- Weekly bids made by importers and adjudicated by a committee comprising of government and industry representatives. Foreign currency is allocated from the highest bid downwards until availability runs out. Those who bid high are more likely to secure foreign currency, but they pay more for it.
- The weighted average of the week's bids is then calculated and published. Over time, the weekly weighted average has stabilised in a relatively tight band.
- Foreign currency can only be used to import capital goods, essential raw materials for producers, to cover loan repayments, or to pay dividends. Foreign currency would not be allocated to firms that already had the value of requested foreign currency in their bank accounts (firms' bank accounts are checked weekly), and customs and import documentation are checked and firms are monitored for three months after receiving foreign currency to ensure that it was used for the stated purpose.

This auction process requires **significant monitoring capacity**; the system will not work if it cannot be properly monitored. RBZ cautioned that the capacity to monitor and manage the process must be factored in before this route is adopted.

3. Implementation of exchange rate reform

From February 2021 onwards, several significant economic reforms were put into motion by the Sudanese government:

- Adoption of a managed float regime – In February 2021, the Sudanese government undertook its planned exchange rate reform, adopting a **managed float regime** and unifying the official and parallel exchange rates at 375 SDGs to the USD. As Sudan lacked the foreign currency reserves needed to support a managed float, they appear to have acted on the recommendation of the macroeconomic experts and approached the IMF and World Bank for an **exchange rate stabilisation fund**, which appears to have been received and has enabled CBOS to manage the unification process in a less volatile way.

The unified exchange rate has **remained stable** since liberalisation within the +/- 5 percent band around CBOS's indicative rate, at between 430 and 447 SDGs to the USD in recent months. This stability is likely due in large part to the parallel exchange rate having been so well established prior to unification. Eventually, **reserve money** will be used as the exchange rate anchor, but a stronger fiscal position is needed for CBOS to have sufficient monetary policy instruments at their disposal.

- Closing the fiscal deficit – Exchange rate liberalisation will only hold if the fiscal deficit is further closed. The Sudanese government aims to close the fiscal deficit by 3% of GDP in 2021, bringing the fiscal deficit down to **2.9% of GDP**.[10] Key to achieving this will be:
    - Continued **elimination of subsidies** on fuel as well as electricity and other commodities, including wheat.
    - **Customs rate reform**, which appears to be being done using a revenue target approach that raises the customs rate gradually while simultaneously lowering customs tariffs. It is unclear yet to what extent this reform will be revenue collecting.
    - **Increased domestic revenue mobilisation** through a number of comprehensive revenue reforms.
- Closing the balance of payments deficit – Exchange rate liberalisation made Sudanese **exports more competitive**, resulting in exports increasing by 54% in Q1 2021; conversely, it made imports relatively more expensive, resulting in a 17% decline in imports during the same time period.[11] This has contributed to **closing the trade deficit**, and balance of payments deficit more broadly.

  Progress is similarly being made on **increasing the supply of foreign currency**. For example, exchange rate unification resulted in a five-fold increase in remittances entering Sudan through formal channels.[12] Sudan's removal from the State Sponsor of Terrorism List in December 2020, exchange rate liberalisation, and the significant progress made towards debt relief in 2021 notably increase Sudan's attractiveness as a destination for foreign direct investment. Further work on strengthening Sudan's domestic banking system and business environment will be necessary to further increase foreign investor confidence.
- Inflation – Although exchange rate unification had little inflationary impact, inflation has nonetheless remained high and has continued to rise in 2021, from 304% in January to 423% in July. This has been due to higher fuel prices (as a result of fuel subsidy removal), adjustment of administered prices, and food and fuel shortages that have arisen due to higher input and transportation costs, trade disruptions due to Covid-19 restrictions, and flooding incidents in Sudan. Inflation appears to have **slowed in more recent months**, coming down to 387% in August.[13]

  High inflation is having an extremely detrimental impact on Sudanese citizens, who already suffer from very low purchasing power, further increasing food insecurity and economic hardships. This has brought into even sharper focus the dire need to **increase social and infrastructure spending**, notably establishing a robust social safety net to protect Sudan's most vulnerable citizens. Progress on implementation of the Sudan Family Support Programme (SFSP) is welcome in this regard.

[10] IMF, 2021b.
[11] Ibid.
[12] Ibid.
[13] Reuters, 2021.

- Debt relief – In June 2021, the IMF determined that Sudan had **reached the HIPC decision point**, recognising that it had taken the necessary steps to begin receiving debt relief under HIPC.[14] It is estimated that Sudan would reach HIPC completion point in 2024 and, should cooperation from all creditors be achieved, Sudan's debt would be reduced to USD 6 billion.[15]

Although continued effective implementation of these reforms, as well as of further reforms, is undoubtedly needed, it is hoped that the recent decrease in inflation is an early sign of **economic stabilisation** after several tumultuous years. These reforms have been difficult on both Sudanese citizens and the civilian transitional government, and it is high time that they are able to reap the rewards of having walked this difficult economic reform tightrope.

References

Asare, J. et al. (2020). 'Low oil prices during COVID-19 and the case for removing fuel subsidies,' International Growth Centre.

del Granado, A. et al. (2010). 'The unequal benefits of fuel subsidies: A review of evidence for developing countries,' International Monetary Fund.

IMF (2020). 'IMF executive board concludes 2019 Article IV consultation with Sudan,' https://www.imf.org/en/News/Articles/2020/03/10/pr2083-sudan-imf-executive-board-concludes-2019-article-iv-consultation.

IMF (2021a). 'Sudan: Enhanced Heavily-Indebted Poor Countries Initiative – Preliminary Document,' https://www.elibrary.imf.org/view/journals/002/2021/066/article-A002-en.xml.

IMF (2021b). 'Sudan: Second review under the Staff-Monitored Program and request for extension – Staff report; and statement by the Executive Director for Sudan,' IMF Country Report No. 21/143.

IMF (2021c). 'Sudan to receive debt relief under the HIPC initiative,' https://www.imf.org/en/News/Articles/2021/06/29/pr21199-sudan-to-receive-debt-relief-under-the-hipc-initiative.

Jefferis, K. (2020). 'Macroeconomic reform options for Sudan,' International Growth Centre.

Reuters (2021). ' Sudan inflation slows to 387.56% in August,' https://www.reuters.com/world/africa/sudan-inflation-slows-38756-august-2021-09-14/#:~:text=In%20recent%20weeks%2C%20the%20currency,the%20highest%20rate%20of%20977.01%25.

Wikipedia, 'Floating exchange rate,' https://en.wikipedia.org/wiki/Floating_exchange_rate.

World Bank, World Development Indicators, GDP per capita, https://data.worldbank.org/indicator/NY.GDP.PCAP.CD?locations=SD.

[14] IMF, 2021c.
[15] Ibid.