

Exchange Rate Reform in South Sudan

Dr. Keith Jefferis



1. Introduction

The exchange rate has become an increasingly important economic issue in South Sudan in recent years, but particularly so during the current year. For many people, the South Sudanese Pound (SSP) has been increasingly weak and volatile, manifested in a sharply depreciating parallel exchange rate. This has been accompanied by an increasingly severe shortage of dollars, even in the parallel market.

Exchange rate developments result from a combination of underlying economic developments and the choices that are made regarding the formulation and implementation of exchange rate policy. The choices that are made by policymakers are important, and have a significant impact on both the path of the exchange rate and macroeconomic balance more generally.

This paper considers the role of the exchange rate in the economy and its importance as a macroeconomic instrument, and outlines the policy choices that are available to governments in general, and the government of South Sudan in particular. We discuss the drivers of exchange rate developments in South Sudan, before reviewing the available options and making some suggestions as to how to deal with the current problems relating to the exchange rate.

2. Why is the exchange rate important?

What is the exchange rate? The exchange rate is simply a price – of foreign currency in terms of domestic currency, or of one country's money in terms of another's. But it is not

just any price. From a macroeconomic perspective, it is one of the most important prices in the economy – perhaps the most important for an open economy involved in trade and investment flows with the rest of the world. It influences the flow of goods, services, and capital in a country, and exerts strong pressure on the balance of payments, inflation and other macroeconomic variables. It affects almost all aspects of economic relations between the domestic economy and the rest of the world.

The exchange rate is a key determinant of the incentives facing domestic economic agents – by influencing the relative prices of different types of goods and services, both domestic and international, the exchange rate helps to determine what type of economic activities are profitable, and therefore influencing where financial resources are invested and how economic agents spend their time. It therefore provides the basis for a particular type of development trajectory, and the nature of economic activities that evolve in the economy.

Besides influencing the rate and pattern of economic growth, the exchange rate has fiscal implications, particularly in an economy where the government derives much of its income from foreign currency sources. The exchange rate also affects the price of imports, and therefore inflation. The type of exchange rate regime adopted has monetary policy implications, and therefore has a large influence on how the central bank operates, as well as the nature of its balance sheet and its financial strength.

Therefore, the choice and implementation of an exchange rate regime is a critical policy choice. It is a fundamental aspect of economic management to safeguard competitiveness, macroeconomic stability, and growth. If the exchange rate is set at the “wrong” level – out of line with economic fundamentals - the implications for the economy are far-reaching. The most common mistake that countries make with regard to the exchange rate is to allow it to become “overvalued”; i.e. the domestic currency has a higher valuation, in terms of foreign currency, than is justified with regard to economic fundamentals. An overvalued currency makes imports too cheap, makes exporting unattractive, provides poor incentives for investors, and ultimately undermines confidence in the economic policy environment.

Of course the macroeconomic environment is not fixed. Economic conditions in the global economy and facing individual countries are constantly changing. Many of these developments are beyond the control of individual governments and policymakers. The changing oil price would be one such example. One of the key challenges facing policymakers is how to react to such changes – how to adjust the economic policy levers. The exchange rate plays a key role in such macroeconomic adjustment to changing economic circumstances, responding to shocks. If it adjusts properly, it helps to maintain external balance – one of the two key macroeconomic balances in the economy.

3. What determines the exchange rate?

The level of a country's exchange rate at any point in time depends on two key factors:

- (i) Supply and demand for foreign and domestic currency in the foreign exchange market
- (ii) The way in which the monetary authorities (usually the central bank and/or the ministry of finance) intervene in the market to manage the exchange rate (i.e., the exchange rate regime in place).

Supply and demand for foreign currency reflects the balance of payments (BoP), which has several components:

- the balance of trade, in terms of export receipts and import expenditures;
- other elements of the current account of the BoP, including transfers to and from non-residents
- the capital account, including inflows from foreign investors, and outflows by domestic residents (their choices as to whether to keep their assets in terms of domestic or foreign currency)

If foreign currency outflows exceed inflows – i.e. there is a balance of payments deficit - the demand for foreign currency will exceed supply; the price of foreign currency (in terms of domestic currency) will tend to rise, and – all other things being equal - the exchange rate will depreciate. The opposite will happen if there is a balance of payments surplus. These changes in the value of the currency enable the exchange rate to play its important role in balancing the balance of payments.

The actual value of the exchange rate is also determined by policy – the type of exchange rate regime in place in a country.

When the exchange rate regime allows the actual exchange rate to adjust to the balance of payments, the exchange rate will be in equilibrium (i.e. stable in relation to prevailing economic circumstances – although the equilibrium value can change as economic circumstances change).

Exchange rates do not always adjust to the balance of supply and demand. Some countries choose to use their foreign exchange reserves to manage their exchange rate. If there is excess demand for foreign exchange, the central bank may supply foreign currency to the market from the reserves, to prevent the exchange rate from weakening. Conversely, if there is excess supply of foreign exchange, the central bank may accumulate foreign

exchange reserves rather than allow the domestic currency to strengthen. Clearly there are limits to how far a weak exchange rate can be supported by the reserves (which cannot fall below zero), while there is no corresponding limit to how far a strong currency can be prevented from appreciating by reserve accumulation (although there are monetary policy implications).

The ability of countries to manage their exchange rates is, in part, limited by the size of the foreign exchange reserves. But it is also constrained by the impact of the exchange rate on the economy. When the level of a managed exchange rate is different to the level that would be consistent with balance of payments equilibrium, the exchange rate will be undervalued or overvalued, which will have various other economic effects.

Most importantly, an overvalued exchange rate will cause imports to be under-priced (i.e. dollars are cheap to buy in terms of domestic currency) and exports to be unprofitable (dollar receipts from exports will not buy much in terms of domestic currency). This will in turn:

- discourage investment in export production (because exports are not as profitable as they should be);
- discourage investment in production to compete with imports (because imports are cheap and difficult to compete with);
- encourage investment in non-tradeables (goods and services that are related to the domestic economy, not foreign trade);
- discourage export-based economic diversification; and
- push the balance of payments into deficit, leading to outflows of foreign currency reserves.

Box 1: Impact of an overvalued exchange rate.

Suppose it costs \$1 to produce 12 eggs in Uganda, and SSP5 in South Sudan. If the exchange rate is SSP3=USD1, the South Sudan eggs cost \$1.65, making the Ugandan eggs cheaper. Hence egg producers in South Sudan will struggle to compete with Ugandan eggs, and most likely eggs will be imported from Uganda rather than produced domestically. But if the exchange rate is SSP10=USD1, the South Sudan eggs only cost \$0.5 to produce, making them cheaper than the Ugandan eggs. This encourages production in South Sudan, as local producers are competitive against imports.

4. Recent exchange rate development in South Sudan

Official exchange rate policy currently involves:

- choice of exchange rate regime: a fixed peg to the USD;
- choice of level of the peg: SSP2.95 = 1USD – unchanged since independence¹.

The choice of the value pegged rate has been somewhat arbitrary – it reflects the pre-independence rate, not necessarily the economic circumstances of the newly-independent Republic of South Sudan.

As it turns out, economic circumstances have changed significantly since Independence, mostly in an adverse direction:

- soon after independence, there was an oil production/export shutdown, due to disagreement with Sudan;
- more recently - since the resumption of oil exports – there have been two adverse shocks:
 - civil war from December 2013, leading to higher defence spending, disruptions to oil production, and higher risk perceptions for investors;
 - the collapse in oil prices, from over \$100 per barrel in 2013 to \$50 or less in 2015;
- the situation has been compounded by the consequences of the agreement with Sudan over payments for use of pipelines and compensation, which are fixed in US dollar terms and not related to the oil price; as a result the reduction in South Sudan's export receipts has been even greater, proportionately, than the fall in the oil price.

The consequence has been a dramatic reduction in South Sudan's oil export revenues, and hence in overall export receipts. This has pushed the BoP into deficit – i.e. the demand for foreign currency exceeds supply.

A floating exchange rate would have responded to these developments by depreciating, thereby increasing the local currency equivalent of export revenues and increasing the domestic price of imports, helping to bring the BoP back towards equilibrium.

¹ For official transactions. The commercial bank rate is fixed at 3.15

However, because the exchange rate was officially pegged, this did not happen. Instead a disequilibrium resulted. In the official market, the exchange rate did not adjust, and yet there was insufficient foreign exchange available to satisfy demand at this price. The supply of foreign exchange in the official market was rationed, thereby balancing demand and supply through rationing (i.e. unsatisfied demand).

This unsatisfied demand led to the emergence of a parallel market, and hence a de facto segmentation of the foreign exchange market into the official and parallel markets. In the parallel market, supply and demand were brought into balance by market forces that pushed the parallel exchange rate (in SSP per USD) increasingly far from the official rate.

However, the story does not end here. For some time, the divergence between the official and parallel market rates was kept in check, especially once oil exports resumed, and to some extent the Bank of South Sudan (BoSS) used its foreign exchange reserves to meet unfulfilled demand for foreign exchange.

However this became unsustainable once exports dropped further, due to the developments noted above, and the foreign reserves were largely depleted. An increasing proportion of the (diminishing) earnings of foreign exchange were used to service the government demand and official market (allocations to individuals and companies for specified purposes). There was reduced supply to the commercial banks and the parallel market – pushing the price of dollars in the parallel market ever higher, thereby widening the divergence between official and parallel market rates.

This in turn led to further problems. The divergence between official and parallel market rates created huge incentives for “round tripping” buying dollars at the official rate and selling at the parallel rate – earning profits not related to any economic activity – unproductive activity that economists call “rent seeking”. This was particularly manifested in official allocations by the BoSS, with sizeable direct allocations for individuals and even larger allocations to companies through the third-party administered letter-of-credit (LC) scheme. Because of the lack of transparency regarding such allocations, and lack of clarity over how priority demands are determined, much of the foreign currency allocated in this way is believed to have been used for profit making through round-tripping rather than for officially prioritised imports².

² *The Auditor General has recently submitted an audit opinion to Parliament in which he estimates that the value of this ‘round tripping’ was over \$900m through the LC scheme*

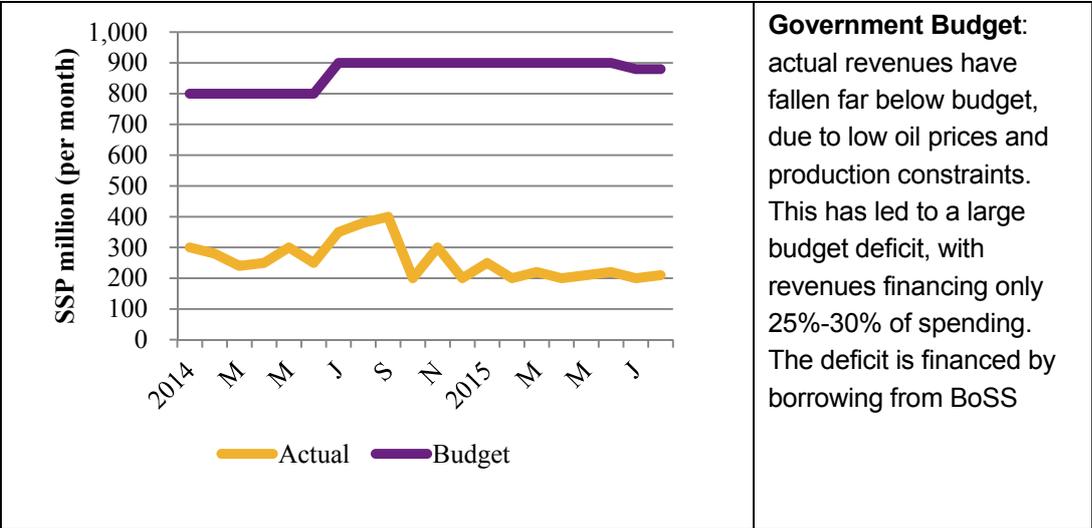
Importers found it increasingly difficult to secure foreign exchange to buy imports, and this has in turn affected producers who need imported inputs – in some cases reducing output and employment.

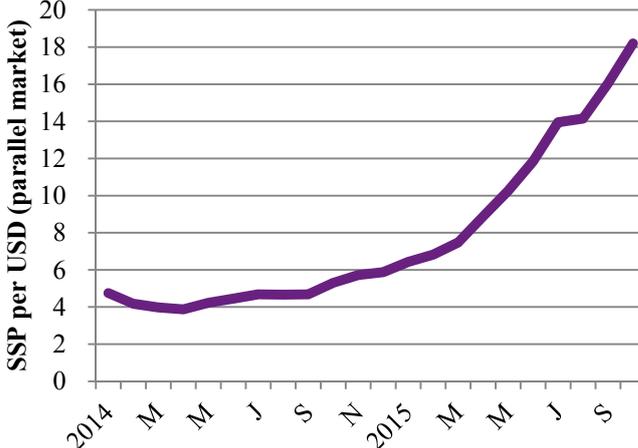
It has also created fiscal problems. Government revenues fell, due to lower oil income, compounded by the fact that GoSS only received SSP at the official rate to finance its domestic spending.

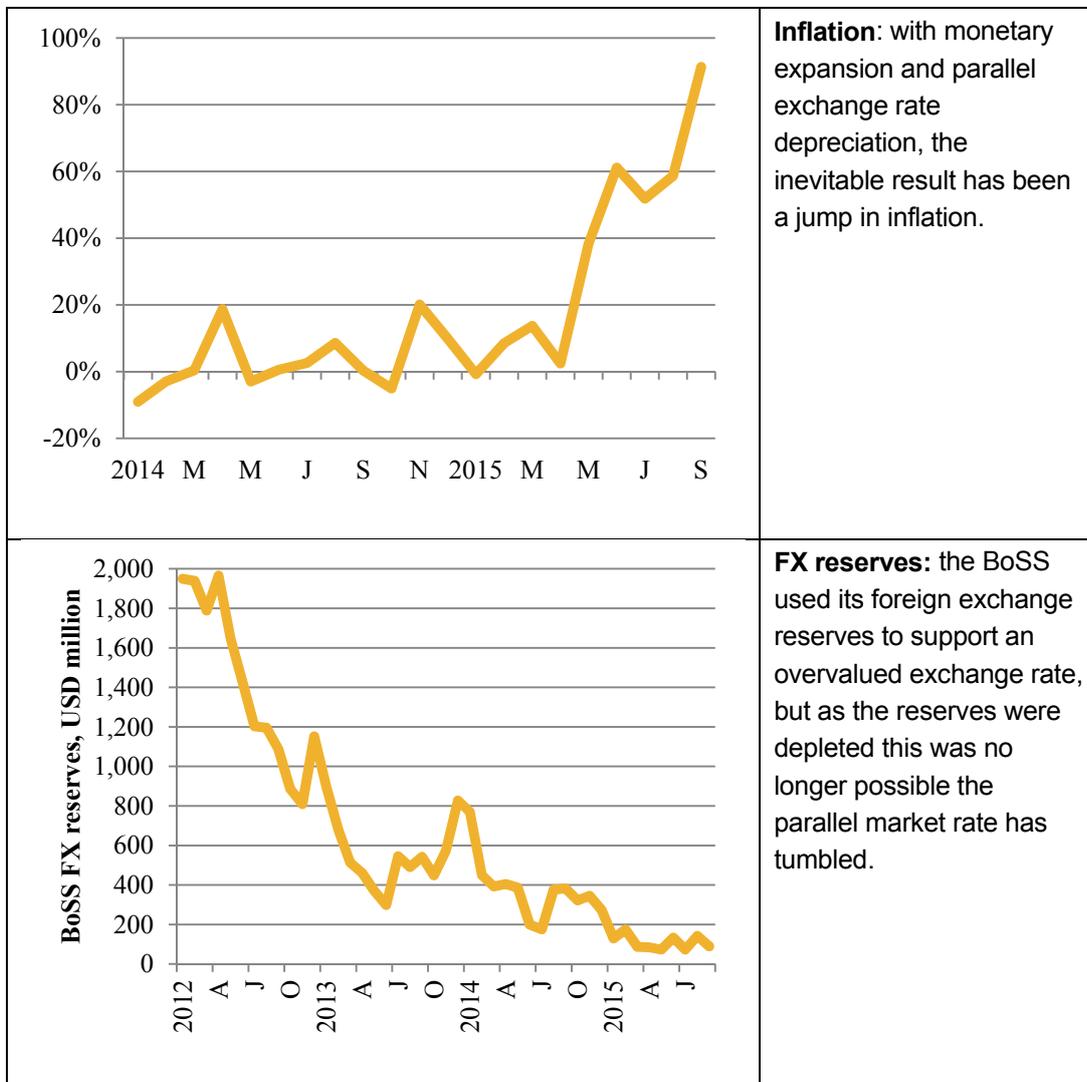
The resulting budget deficit has been financed by borrowing from the BoSS, essentially involving the BoSS creating or printing money to finance the budget. The additional SSP thus created in part flow back into the parallel market, creating demand for dollars that pushes the parallel market rate even higher.

This monetary expansion has in turn led to inflation, much of it through the mechanism of more expensive imports that have to be paid for with dollars purchased in the parallel market, at a higher price which flows through to the prices of imported goods and services.

Figure 1: Fiscal, monetary and exchange rate developments



	<p>Money supply: with “money printing” by the BoSS to finance the deficit, the monetary base has grown at an ever-increasing rate. Hence the supply of SSP in circulation has jumped.</p>
	<p>Parallel market exchange rate: increasing SSP liquidity chasing the diminished supply of USD has pushed the parallel market rate from 5.92 on Jan 2nd 2015 to 18.2 on Oct 29th, a depreciation of 68%.</p>



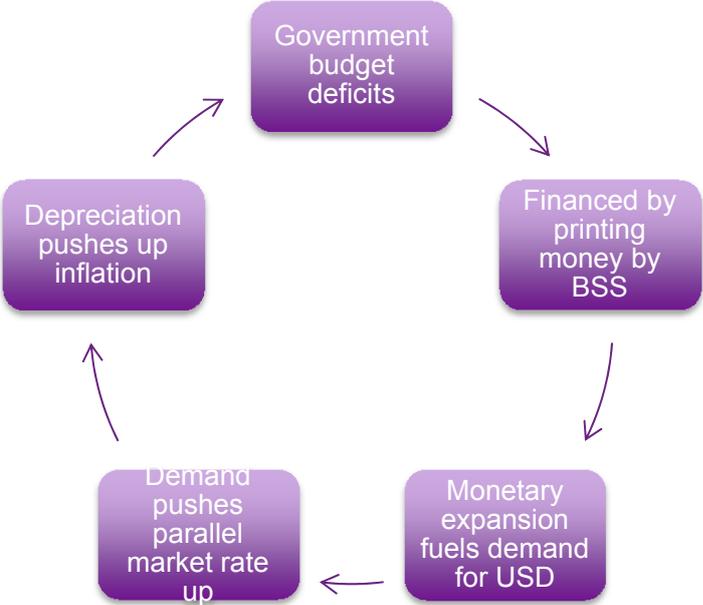
Sources: BoSS Statistical Bulletin; Ministry of Finance and Economic Planning

Hence we have the beginnings of a vicious circle, comprising insufficient foreign inflows, reduced government revenues, more government borrowing, more money creation, a higher parallel market rate, higher inflation, and reduced living standards.

The situation is compounded by a belief that the exchange rate will continue to weaken, and therefore that economic agents who have foreign exchange should hang on to their dollars for as long as possible, thereby reducing the supply of dollars to the market. Many entities are also wary of the risks of exchanging cash dollars in the parallel market, or are prohibited by internal rules from doing so, and therefore find ways of using dollars held

outside of the country to finance local transactions. Hence foreign currency transactions by South Sudan residents are increasingly forced offshore, as a result of the current exchange rate policy.

Figure 2: Fiscal – Monetary – Exchange Rate links



The current situation is also characterised by a lack of transparency, which increases uncertainty, and risk, even further. There is no readily available information about how much foreign exchange is received from official and private sources, or on how much is made available by the government, the BoSS, the banks, foreign exchange bureaus etc., to whom and at what rate. This creates an incentive for hidden, under-the-counter transactions, and makes it difficult to hold accountable those who receive foreign exchange at preferential rates – whether government, the BoSS, the banks or others.

The shortage of foreign exchange has also caused major problems for the banking system, making it difficult to function normally. The banks hold some of their foreign currency assets on deposit with the BoSS. However, these deposits are not readily accessible, which led to the temporary suspension of local US dollar interbank transactions and withdrawals. The extremely low level of the BoSS's foreign exchange reserves means that the central bank also has restricted access to the external facilities that normally facilitate interbank transactions, causing further problems for the banking system. As a result, even those who have access to foreign exchange are reluctant to keep those funds in local banks,

preferring to hold them outside of the country, thereby worsening the shortage even further.

5. Lessons from other countries

This situation is clearly unsustainable. But it is not the first time that a country has found itself in this situation. The experience is always a difficult one. The most extreme recent example is perhaps Zimbabwe, where similar macroeconomic imbalances fuelled by monetary expansion led to hyper-inflation, the eventual collapse of the currency, and the wholesale “dollarisation” of the economy with the adoption of the US dollar as the official currency and the abandonment of the domestic currency.

The Zimbabwe experience is worth looking at in some detail. Throughout the 2000s, the Zimbabwe government ran increasingly large budget deficits that were funded by a mixture of borrowing from capital markets and – when this became impossible – money creation by the central bank, the Reserve Bank of Zimbabwe (RBZ). High levels of spending were partly driven by political reasons – the government was concerned about losing elections – and were accommodated by a central bank that was subject to political control, and was not independent. A mixture of inappropriate economic policies, including exchange rate overvaluation, caused the economy to contract, and with it, government revenues, which exacerbated the fiscal deficit. This combination eventually led to a hyperinflationary spiral, with inflation reaching a monthly rate estimated at 79.6 billion percent in late 2008.

Despite strict controls on the use of foreign currencies, the population progressively abandoned the domestic currency, the Zimbabwe dollar. Other currencies were increasingly used for unit of account and store of value purposes. These included the US dollar, and those of neighbouring countries, notably the South African Rand and Botswana Pula. In February 2009 the government accepted the inevitable, lifted all currency controls, and announced a multi-currency system, whereby the US dollar, SA rand, Botswana Pula and the Euro were all given legal tender status, along with the Zimbabwe dollar. For various reasons, the US dollar became the dominant currency and the de facto sole legal tender. Inflation dropped dramatically, to single figures, once RBZ could no longer create money. The Zimbabwe dollar disappeared and was subsequently officially demonetised³. In the process, people who held financial assets denominated in Zimbabwe dollars – such as pensioners and holders of bank accounts or government debt – were impoverished. Amongst the losers were the RBZ, which had lent the government large sums of money

³ *The Zimbabwe dollar has not completely vanished; high value notes from the hyperinflationary era – for instance ZWD 100 trillion – are now sold as tourist souvenirs.*

that were never repaid, causing the bankruptcy of the central bank. Due to this, and the end of the domestic currency, the RBZ ceased to exist as a monetary authority.

But such an economic crisis does not have to end like this, and there are fortunately other examples from which to learn. Tanzania, Uganda and Zambia have all been through periods of overvalued official exchange rates, huge parallel market premiums, balance of payments deficits, fiscal deficits and economic contraction. They all eventually had to undertake massive reforms, both to the foreign exchange market and the economy more generally, and are all now in much better shape, albeit not without economic challenges. All three countries moved from a fixed exchange rate system with a parallel market to a floating rate system, more or less overnight – the so-called “big bang” approach. This involves freeing up the exchange rate, allowing the currency’s value to be market determined, removing exchange controls, along with other economic reforms, of which getting the fiscal deficit under control is the most important.

Zambia’s case is particularly relevant to South Sudan, as it is a commodity exporter – almost all of its foreign exchange earnings come from copper, which has a volatile price, rather like oil. Zambia had experienced years of economic decline in the 1970s and 1980s, due in part to trying to maintain a fixed exchange rate as copper prices and earnings declined, leading to an overvalued exchange rate, a shortage of foreign currency, a parallel market, large budget deficits, rising inflation, and a failure to diversify away from dependence upon copper.

In the 1980s, the government recognised that reform of the exchange rate regime was necessary, and it moved to a more flexible system. However, it failed to implement other complementary reforms, and in particular did not deal with fiscal deficits. Exchange rate reform therefore failed. By the early 1990s, following a change of government, a broad-based set of reforms was implemented, including structural reforms, floating the exchange rate, removing exchange controls, and implementing a cash budget to eliminate the fiscal deficit. The initial months were difficult, with rising interest rates and a sharply depreciating exchange rate, but after six months or so the situation stabilised. Zambia has maintained a floating exchange rate for the past 20 years, which has provided a valuable channel of adjustment as copper prices have risen and fallen. But it has only worked because exchange rate reform has been accompanied by other structural and fiscal reforms.

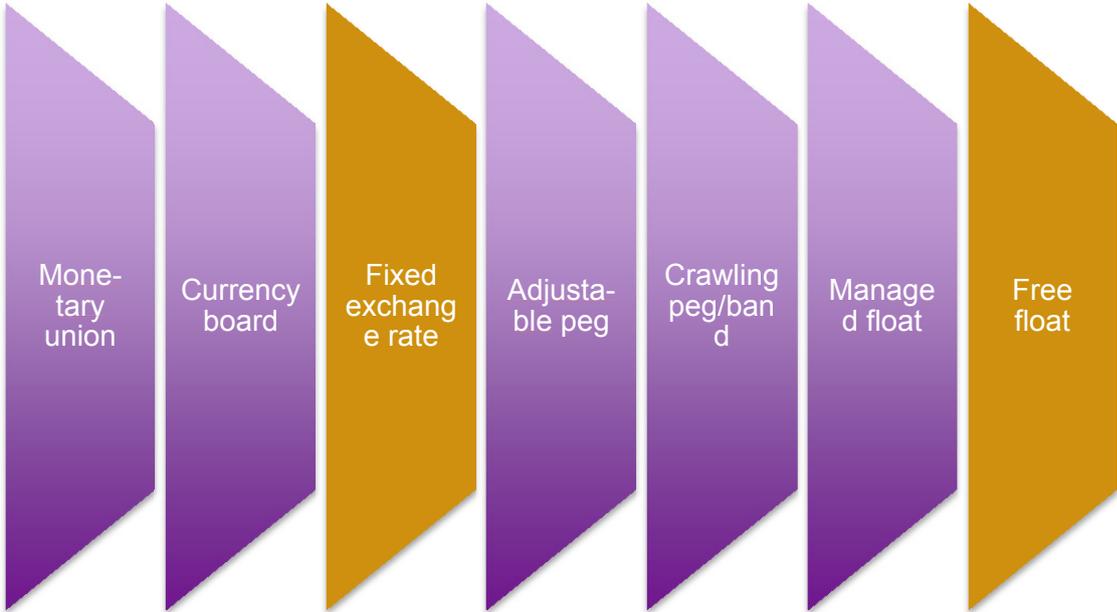
6. Exchange rate policy options

Given that the current situation in South Sudan is unsustainable, what are the available policy options? We start by looking at potential alternative exchange rate regimes. The

fundamental choice is between an exchange rate that is fixed or pegged to another currency, and an exchange rate that floats, with its value mainly determined by market forces.

There are a variety of more detailed options available. These are usually characterised on a spectrum ranging from monetary union (no independent currency) at one extreme to a free float at the other extreme. There are various intermediate points such as hard pegs (e.g. currency boards and fixed exchange rates), adjustable pegs, crawling pegs and managed floats. And if a currency is pegged, there is the question of which currency to peg to.

Figure 3: Exchange rate policy options



There are examples of different countries implementing all of these different exchange rate policies, and of individual countries implementing different policies at different times. There is no one right answer to the choice of appropriate exchange rate policy – it depends on country circumstances at a particular point in time.

For a particular policy to work, there are many pre-requisites. One of the key ones is credibility – if the adopted policy is not seen as credible by economic agents and the public in general, it will not be sustainable. This in turn depends on the chosen policy being appropriate for the specific conditions. This is perhaps a more relevant pre-requisite for a fixed or managed exchange rate, which will only be sustainable if there is a belief that the

authorities – the central bank – can defend the peg by having sufficient foreign exchange reserves, or that export earnings are sufficiently high to meet demand for foreign exchange for imports etc.

A second pre-requisite is that other economic policies are complementary. For instance, large budget deficits will tend to undermine the credibility of a fixed peg, and will also lead to expectations that a floating exchange rate will be weak and likely to depreciate. In other words, a large budget deficit will make any exchange rate unstable, regardless of the exchange rate regime.

These problems can be seen even when a country does not have its own currency – the recent Greek example being one, where the lack of supportive policies to make the Greek economy competitive and to keep the budget deficit under control undermined confidence in the country's ability to remain within the EMU – which it did only by agreeing to undertake dramatic economic reforms to the budget and the determinants of competitiveness.

Different exchange rate policies have different advantages and disadvantages. Without going into all the technical details, amongst the main advantages of a sustainable peg – a fixed exchange rate – is that it provides an anchor for inflation. Fixed exchange rate economies tend to have lower inflation than floating rate economies, although the difference is not great. Fixed exchange rates can also be appropriate for mineral economies, in that they can provide a buffer against the volatility of commodity markets and help to guard against Dutch Disease, but this can only work in the long run if the fixed rate is undervalued relative to balance of payments flows. However, fixed rates can also be very dangerous, in that they can easily be pegged at overvalued levels, which we have seen in South Sudan.

This is associated with perhaps the biggest disadvantage of fixed exchange rates, which is that they do not provide a means of adjustment to changing economic circumstances. A fixed peg can be maintained even when circumstances have changed and would normally demand a devaluation. It is extremely difficult to determine what is the appropriate exchange rate for a fixed peg, which tends to change over time. A fixed peg is also vulnerable to speculative attack, especially when it is out of line with fundamentals and the central bank has limited reserves.

This is part of South Sudan's problem. The fixed peg may have been appropriate at Independence, when oil production and export earnings were high, but economic circumstances have since changed – the oil shutdown, the civil war and falling oil prices, and the exchange rate should have been adjusted in response.

A floating rate has the huge advantage that it provides automatic adjustment to shocks and changing circumstances – the rate will simply be determined in the market as circumstances dictate. This helps the macro economy to adjust as necessary. On the downside, a floating rate can be volatile. It also requires institutional reforms. For instance, if most of a country's foreign exchange is earned by the government – as is often the case in a mineral economy, there has to be a mechanism for the central bank (on behalf of the government) to supply foreign exchange to the market, and to determine the rate in the market. This is typically done through some kind of auction system, with foreign exchange supplied to the banks and other dealers on a competitive price basis. But the central bank still has to decide how much foreign exchange to supply to the market on a daily basis.

Furthermore, whereas a country with a fixed exchange rate already has a monetary policy - which comprises simply of maintaining the fixed rate – a floating rate country requires an alternative monetary policy, such as targeting monetary aggregates or inflation targeting.

The international experience in recent decades has been a shift towards the extremes of the exchange rate spectrum – towards hard pegs and monetary unions at one end and free floats at the other – what has sometimes been termed the “hollowing of the middle”. This is due to the extreme difficulties in maintaining adjustable pegs and managed floats in a world of greater capital mobility. Where fixed exchange rates have been maintained, they generally involve either rigid pegs such as currency boards, or countries with very high foreign exchange reserves, amounting to several multiples of the money supply.

7. What needs to be done and what are the barriers to exchange rate reform in South Sudan?

Exchange rate reform in South Sudan should have the following objectives:

- devaluing the exchange rate to a level that is consistent with the market – i.e. unifying the official and parallel markets, thereby reducing or eliminating the parallel market premium (and hence the incentive for rent-seeking and the distortions it introduces);
- having a mechanism or exchange rate regime that prevents the build-up of disequilibrium in future – i.e. allows future adjustment to changing economic circumstances;
- restoring economic credibility and confidence.

There is widespread agreement that the current situation is unsustainable, and that something needs to be done about the exchange rate. A tentative reform programme has

been drawn up, but nothing has been done. This raises the question of what are the barriers to reform. Several can be identified:

1. **Vested interests – rent seeking.** People who have access to foreign currency at the official rate, and who can sell it at the parallel rate, are making a lot of money, at the expense of the government and the general population. This is one clear group who have an interest in preventing or delaying reform.
2. **Lack of agreement on what needs to be done.** It may be that there is general agreement that something needs to happen, but there are different views on what that should be - for instance, some may prefer a devaluation of the current official rate, others a move to a floating exchange rate.
3. **Inability to fulfil the pre-requisites for reform.** It may be that there is agreement on what needs to be done, but the pre-requisites for reform cannot be met – for instance, rebuilding the official foreign exchange reserves before undertaking reform; or that general principles can be agreed (rebuild the reserves), but the details are not (how much reserves, how to accumulate).
4. **Reluctance to venture into the unknown.** Reforming the exchange rate regime would be a major change in the economic environment, and would provide the economy with a major shock – a positive shock, but a shock nonetheless. There is uncertainty about what would happen. However, this should not be a barrier to change - the status quo is not tenable, and leads down a very distressing path, possibly to hyper-inflation and the loss of the domestic currency – the Zimbabwe solution. The risks of not undertaking reform are much greater than the risks of undertaking reform.

Various options are available for reforming the exchange rate, including:

- devalue the official rate, but keep a fixed exchange rate;
- move to freely floating exchange rate;
- move to a managed float (i.e. with interventions to keep the rate at a desired level or to reduce volatility);
- adopt an intermediate solution, such as a devaluation plus a crawling peg.

None of these options are easy, and all have advantages and disadvantages. But in order to achieve the objectives mentioned, some kind of floating exchange rate arrangement will be necessary.

Even after a devaluation, a pegged exchange rate is likely to soon become overvalued, re-creating the current problems. An adjustable peg would be better, but there is not enough data or information to determine what would be an equilibrium rate of adjustment, so again the exchange rate is likely to become overvalued.

A floating rate has three key advantages. First, it enables automatic adjustment to changing economic circumstances. Second, it will automatically eliminate the parallel market. Third, it will demonstrate a seriousness about economic reform that will help to re-establish credibility.

Moving to a floating exchange rate would involve a number of reforms, including:

- Allow banks to buy and sell foreign exchange at any price (in contrast to the current system where they are required to transact only at the official rate – and hence hardly transact at all)
- Ensure that all official (government) receipts of foreign exchange are sold to the BoSS;
- Ensure that all non-government purchases of foreign exchange go through the market (banks and FX bureaus);
- Ensure that BoSS only supplies foreign exchange to government and banks, and not to foreign exchange bureaus, individuals and firms;
- Establish an auction system, mainly for BoSS to sell FX to the banks at a market-determined price, but also to allow the banks to sell surplus FX to the BSS;
- Determine a benchmark exchange rate on a daily basis, based on transactions through the auction system and in the interbank market;
- Remove the official exchange rate, and use the BoSS benchmark rate for both purchases of foreign exchange from GoSS, and sales to GoSS;
- Establish an interbank FX market.

Floating the exchange rate undoubtedly has risks, notably if money creation continues to finance government spending. In this case, further depreciation and eventual inflation would follow. It is therefore important to emphasise that fiscal restraint is necessary for any stable exchange rate regime.

There has been discussion of having a managed float as the XR regime, rather than a free float. To some extent the distinction is arbitrary, because most countries that have a floating exchange rate have some kind of intervention in the market to manage the rate. In principle, managing the exchange rate may involve attempting to target a particular level of the exchange rate, or simply trying to reduce the volatility that can arise with a floating rate.

But this also has problems:

- The danger of attempting to defend an overvalued rate, and depleting the few remaining reserves;
- Difficulties in distinguishing between temporary shocks (which can be compensated for) and permanent shocks, which should be allowed to affect the rate.

There has been a proposal to move to a managed float once sufficient reserves have been accumulated to support the new rate – estimated at US\$300-600m. However, it is not clear what the target figure of US\$300-600m is based on, or where the necessary foreign exchange would come from. In principle a country can accumulate reserves from balance of payments surpluses, or by borrowing, or by sourcing funds from development partners (DPs). With current levels of exports, there is no prospect of South Sudan accumulating reserves from BoP surpluses. It will also be very difficult to borrow commercially. While DPs may be willing to assist South Sudan, providing funds to rebuild foreign exchange reserves, when there is no guarantee on what they would be used for, and when the DPs have other priorities, is extremely unlikely. Some reserves could be obtained from South Sudan's quota of SDRs at the IMF, but this would raise less than US\$150 million. Given that the targeted level of reserves is unlikely to be achieved in the near future, focusing on the prior accumulation of reserves will postpone necessary reforms. Furthermore, if US\$300-600m could be accumulated, what effect would this have? This is equivalent to only 1-2 months of import cover. It is only likely to provide temporary relief or stabilisation of a floating exchange rate, before the reserves are again depleted.

While accumulating reserves would be helpful in supporting a move to a floating rate, it should not be over-emphasised. Some gestures could be made, e.g. cutting back on unnecessary official foreign travel, but it is more important to focus on the other pre-requisites, such as getting a functional foreign exchange market established, and reducing allocations of foreign exchange at the official rate to non-government entities. Most importantly, fiscal reform is necessary to restore macroeconomic balance.

Table 1: Summary of exchange rate regime options

	Devaluation + fixed peg	Free float	Managed float	Devaluation + crawling peg
Pre-requisites	<ul style="list-style-type: none"> Reserves Data 	<ul style="list-style-type: none"> Auction system Monetary policy 	<ul style="list-style-type: none"> Auction system Reserves Monetary policy Data 	<ul style="list-style-type: none"> Reserves Data
Advantages	<ul style="list-style-type: none"> Eliminates XR differential – if large enough 	<ul style="list-style-type: none"> Adjusts to shocks Eliminates parallel market Credibility 	<ul style="list-style-type: none"> Partial adjustment to shocks 	<ul style="list-style-type: none"> Eliminates XR differential – if large enough Crawl inhibits re-emergence
Disadvantages	<ul style="list-style-type: none"> Size of optimal devaluation unknown Does not stop differential reemerging Does not adjust to shocks No reserves 	<ul style="list-style-type: none"> Exchange rate could be volatile 	<ul style="list-style-type: none"> Target rate unknown Distinguishing between temporary and permanent shocks Support overvalued XR 	<ul style="list-style-type: none"> How large should the devaluation and crawl be? Does not adjust to shocks No reserves

8. Concluding comments

Moving to a freely floating would be a major economic development. While it would eliminate many of the current problems, it would still require major adjustments by all participants. However, the timing for such a change in the near future could be good. The Peace agreement to end the civil war, currently being implemented, will help to build political credibility. Economic reform would complement this by helping to bring economic credibility. Furthermore, the peace agreement could lead to additional foreign exchange inflows, from Development Partners, and from the re-opening of oil wells that have been closed due to the war – although at current oil prices this may not make much difference. This would help to protect any floating rate on the downside, and reduce the risks of significant further depreciation.

Any reform requires full political buy-in, before the event, in order to ensure public understanding after the event. The political question also has important elements of timing in terms of the projected move to a new transitional unity government. Realistically, this is likely to be one of the first economic challenges facing the new administration.

There is concern that floating the exchange rate would lead to higher inflation, given that imports make up such a high proportion of consumption goods. There may be some impact, but it is evident that most prices are already set with reference to the parallel market rate – which is one reason why inflation has already risen to high levels. The most important impact is likely to be on the price of fuel, which is based on the import price converted at the official exchange rate, even though the availability of foreign exchange to import fuel at this rate is very limited. People are increasingly forced to buy fuel on the black market, where it is priced at the parallel market rate – which becomes the de facto fuel price. Any exchange rate reform will have to be accompanied by a removal of fuel subsidies, if the underlying problem of excessive fiscal spending is to be brought under control.

Banks will also have to adjust to the new situation, and some may experience losses if their foreign currency assets and liabilities are not matched. Similarly, the BoSS may require recapitalisation, given that its foreign currency liabilities almost certainly exceed its foreign currency assets, and revaluing at the market rate could reveal significant losses.

The need for exchange rate reform is acute – doing nothing is not really an option. Reform will come at some point – if it is not done voluntarily, it will be forced by events, as in Zimbabwe, where the collapse of the currency brought about both exchange rate and fiscal reform. However, it is better to do so while there are some options and choices.

None of the options available to South Sudan are easy – it really is a question of choosing the least bad. Having reviewed all of the options, none of those involving a continuation of a fixed rate or a move towards a more flexible but still managed rate are likely to work. The real issue is whether to move to a floating exchange rate in a “big bang” approach, or more gradually. While a “big bang” would eventually yield positive results, it would be a bumpy ride, and hence a gradual approach should be considered, as follows:

- Start by facilitating the formalisation of the parallel market – moving it from the street to the banks. This involves allowing the banks to trade freely in foreign exchange without trying to directly influence the rate at which they do so. The prescribed bank exchange rate of SSP3.15 to the USD would therefore be withdrawn. This would make foreign exchange more readily available, albeit at a

price, and help to support the development of foreign exchange trading between the banks (interbank market).

- At the same time, allocations to non-government demand at the official rate should be ended and replaced by allowing the BoSS to sell some foreign exchange to the banks on auction (rather than at the official rate). This would also help the government, which would receive extra income from selling any spare foreign exchange at the much higher parallel market rate rather than the official rate.
- Publish information on all foreign currency receipts and sales by the government and the BoSS, to build transparency.
- The official rate might continue to exist for some time, but it would progressively become less important for transactions other than for government. As a part of a more comprehensive economic program addressing the structural fiscal deficit, government foreign exchange going to official entities would be progressively transferred to the auction market.
- Finally, government needs to develop a credible plan for achieving a sustainable fiscal position and sharply reducing the budget deficit. While this is politically difficult given the demands on the budget, the alternative is ever-increasing inflation and eventual collapse of the currency, regardless of the exchange rate regime in place.

The objective of the gradual reform programme should be to move towards a fully liberalised, floating exchange rate within a reasonably short timeframe – say 12-24 months.