Republic of South Sudan

Ministry of Finance and Economic Planning

QUARTERLY MACROECONOMIC UPDATE

Macroeconomic Planning Department

Q.2 FY 2015/2016

April 2016

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List of Abbreviations and Acronyms Used in Quarterly Reports

Institutions:

BoSS	Bank of South Sudan (Central Bank)
CoM	Council of Ministers
EU	European Union
GoRSS	Government of the Republic of South Sudan
IMF	International Monetary Fund
MoFEP	Ministry of Finance and Economic Planning
MoJ	Ministry of Justice
MPD	Macroeconomic Planning Department
MPMI	Ministry of Petroleum, Mining and Industry
NBS	South Sudan National Bureau of Statistics
NLA	National Legislative Assembly
RSS	Republic of South Sudan
SPLA	Sudan Peoples' Liberation Army
SPLM	Sudan Peoples' Liberation Movement

Legislation:

PFMA	Public Financial Management and Accountability Act
PRMA	Petroleum Revenue Management Act
PSA	Petroleum Sharing Agreement
SSDI	South Sudan Development Initiative
SSDP	South Sudan Development Plan

Misc. Units and Terms:

bbl / kbbl / mbbl	Barrels of Oil / Thousands of… / Millions of…
CPI	Consumer Price Index
FY	Fiscal/Financial Year
GDP	Gross Domestic Product
GNI	Gross National Income
PIT	Personal Income Tax
Q.*X*	Quarter No.*X*
SSP / SSP m./ bn	South Sudanese Pounds / Millions of… / Billions of…
USD / USD m./bn	United States Dollars / Millions of… / Billions of…
VAT	Value Added Tax (Sales Tax)

The quarterly macroeconomic report presents updated assessments of macroeconomic trends. It presents analysis and opinions held by the Macroeconomic Planning Department (MPD) and should not be seen to represent wider views of MoFEP. It serves as background information to Quarterly Budget Execution Report presented by the Minister of Finance and Economic Planning as part of the implementation the Public Financial Management and Accountability Act (PFMAA).

This report builds on information provided by National Bureau of Statistics (NBS) and the Bank of South Sudan (BSS) as well as other departments in MoFEP supplied portions of the data.

I. FORWARD

The first half of 2015-2016 has seen a continuation and escalation of the economic crisis in South Sudan. In addition to the conflict, which has disrupted domestic production and increased the government deficit, the global price of oil fell substantially – due to increased global supply and a worsening global economic outlook. The September 2012 Cooperation Agreement with Sudan requires South Sudan to pay Sudan Transitional Financial Assistance (TFA) and associated fees for every barrel of oil produced, totalling USD 24.1 per barrel. With the price of South Sudan's oil at times below USD 25, honouring this agreement would result in the complete collapse of oil revenues and even an accumulation of debt.

The Government of the Republic of South Sudan (GRSS) showed its commitment to implementing difficult reforms to try and address the economic crisis by implementing exchange rate reform on December 16 2015. The previous peg of USD / SSP 2.96 was abandoned, and the SSP floated. It was hoped that this would substantially increase the SSP value of oil revenues, and so reduce the government's deficit and so help to address the economic crisis. As intended, non-oil revenues have increased as a result of the reform because sales and customs taxes now based on more accurate valuations of goods. However, gross oil revenues have since collapsed, and the value of USD expenditures has also increased.

It has become clear that in order to fully address the economic crisis, and maximise the benefits of the exchange rate reform, substantial fiscal reforms are needed. In particular, reducing USD expenditure would allow GRSS to sell more USD to the market, generating more SSP revenue to fund salaries, and also providing the market with USD for crucial imports (e.g. food, medical supplies, and education supplies). GRSS showed commitment to this by significantly reducing subsidies on fuel prices, raising the price of petrol per litre from SSP 6 to SSP 22. But further reforms are necessary. One option would be to increase supervisions and control over those institutions participating in USD auctions to see to it that USD bought from BSS is put back into circulation and sold to the private sector, rather than being transferred outside the country.

Reducing expenditure becomes particularly difficult as the GRSS is committed to implementing the internationally agreed August 2015 Peace Agreement. This has numerous spending requirements, from cantonment for the organised forces to reintegrating the returning opposition into government.

This quarterly report analyses the first half of 2015 – 2016. The picture it paints is not a happy one. South Sudan relies on imports to survive. With the huge plunge in USD revenue, there has been and will continue to be a huge plunge in imports and so consumption. Given many people's consumption was already at subsistence levels, this has resulted in a marked incidence of poverty and hunger. Without significantly increased external support, South Sudan is facing a humanitarian crisis.

But with peace, government reform, and increased external support, there is hope that South Sudan can recover and we can mitigate some of the suffering. Once the Transitional Government of National Unity (TGoNU) is formed, addressing the macroeconomic crisis should be a priority. The Ministry of Finance and Economic Planning stands ready to provide policy suggestions that will help to reduce spending and increase revenues. In turn, prudent government reforms will help to create trust in the GRSS that will be important for mobilizing increased external support. With reform, peace, and donor support, together we can start improving the lives of the South Sudanese people, who need and deserve better.

With hope for a peaceful and prosperous future,

Philip Boldit
Director General, Macroeconomic Planning

II. KEY DATA AND SUMMARY TABLE

Table 1: Key Macroeconomic Indicators

	Q2 15-16	Q1 15-16	Q4 14-15	Q3 14-15	Q2 14-15	Q1 14-15
Inflation (ttyeop[1)])	110%	91%	61%	14%	10%	0%
Inflation (annualised)	91%	116%	332%	10%	31%	9%
Parallel exchange rate (USD)[1]	20.55	16.05	11.85	7.48	5.88	4.83
BSS Credit to Central Govt.[1,2,*]	15,766	13,252	12,044	10,088	8,124	6,004
Money Supply[1,2,*]	19,085	12,472	10,003	8,510	7,492	6,082

Notes: TTY through the year, 1 End of Period, 2 SSP millions, *from BSS accounts

Table 2: Key Fiscal Indicators

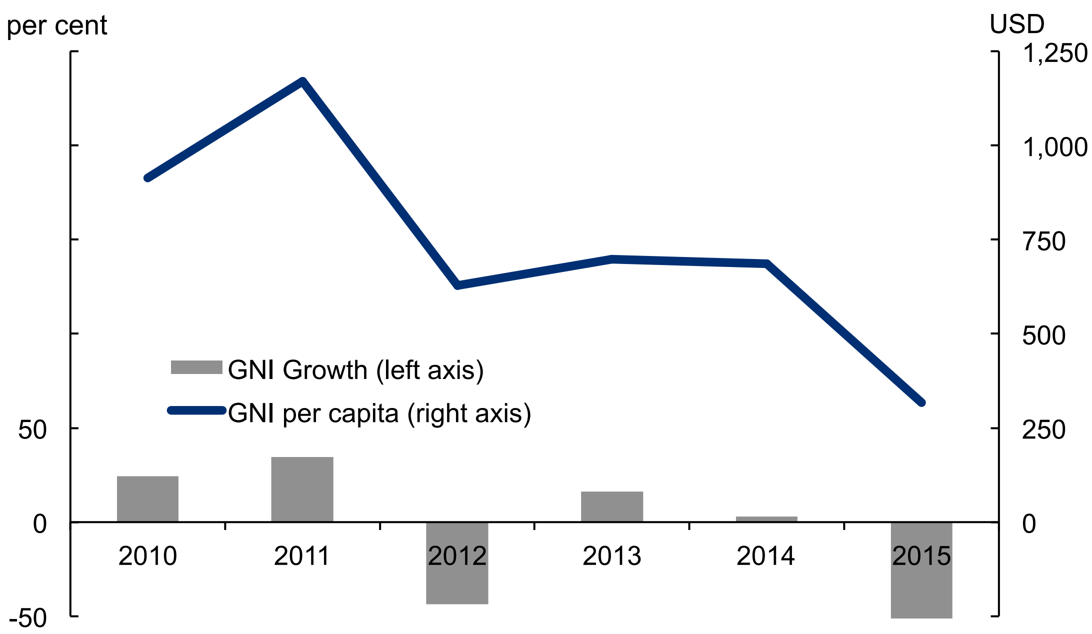
	Annual Budget	Q1 Actual	Q2 Actual	YTD Actual (Half Year)	YTD as % of Annual Budget
Net oil revenue	1,515	143	814	957	63%
Non-oil revenue	5,328	323	368	691	13%
Total Revenue	**6,843**	**466**	**1,183**	**1,649**	**24%**
Grants	128	27	43	70	55%
Total Resources	**6,971**	**493**	**1,226**	**1,719**	**25%**
Salaries	5,463	1,403	1,471	2,875	53%
Operating	1,672	705	1,018	1,722	103%
Capital	266	329	399	727	273%
Transfers	2,795	620	686	1,305	47%
Other	8	7	-	7	92%
Unclassified	-	-	59	59	No Budget
Arrears, Contingency and Interest	100	-	-	-	0%
Total Government Spending	**10,304**	**3,064**	**3,632**	**6,696**	**65%**
Externally Funded Spending	338	28	68	96	28%
Total Spending	**10,642**	**3,092**	**3,700**	**6,792**	**64%**
Surplus / (Shortfall)	**-3,671**	**-2,599**	**-2,474**	**-5,073**	**138%**

III. EXECUTIVE SUMMARY

The second quarter of 2015-2016 saw a new phase in what has become one of the biggest income shocks that any country has every experienced…

The latest oil price slump adds to a series of shocks to hit South Sudan's economy in the space of just three years. First, in 2012 oil production was shut down in response to Sudan confiscating South Sudanese oil at Port Sudan. This resulted in an estimated GNI fall of over 20 per cent. Then, at the end of 2013, a civil war broke out, disrupting oil and agricultural production. Finally, through 2014 and 2015 the price for Dar Blend fell from over \$100 per barrel to below \$20 per barrel, with a particularly sharp slump at the end of Q2. This collapse in oil prices was particularly painful for the Government of Republic of South Sudan (GRSS) due the 2012 Cooperation Agreement with Sudan that requires roughly \$25 per barrel to be transferred to Sudan. If adhered to, the GRSS would now receive negative revenue for each barrel of oil produced. In the last year South Sudan's Gross National Income has fallen almost 50 per cent.[1]

Chart III.1:Income Shocks



[1] Based on National Bureau of Statistics Data and Macroeconomic Planning Department estimates.

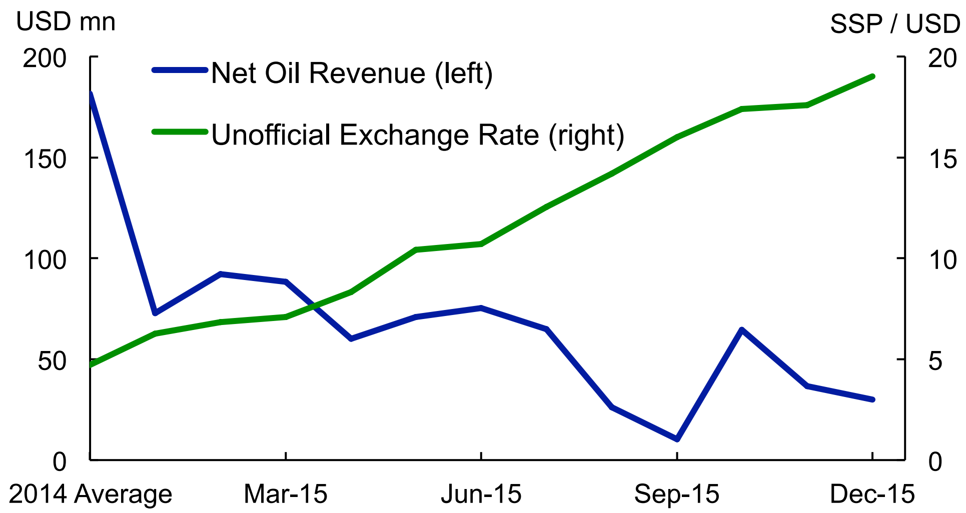
…transitioning to this new equilibrium would be extremely challenging for any country.

The cumulative effect of these shocks is staggering: GNI per capita has fallen from a peak of $1,170 in 2011 to $314 by December 2015. This is sufficient to take South Sudan from a Lower Middle Income Country to one of the poorest countries in the world. Whilst there has been substantial effort by international partners to continue humanitarian efforts, external support has not increased commensurately with the fall in national income, for a variety of reasons.

Adjusting to the new income levels has resulted in extremely high inflation and depreciation.

Combined with compulsory transfer payments to Sudan, the fall in oil price resulted in the near total collapse of government oil revenues. In addition, as GRSS tried to maintain service delivery to the people, and increase security spending due to the ongoing conflict, spending levels increased despite the fall in government revenue. The resulting deficit was primarily funded by borrowing from the Bank of South Sudan (BSS), as well as accumulating arrears.

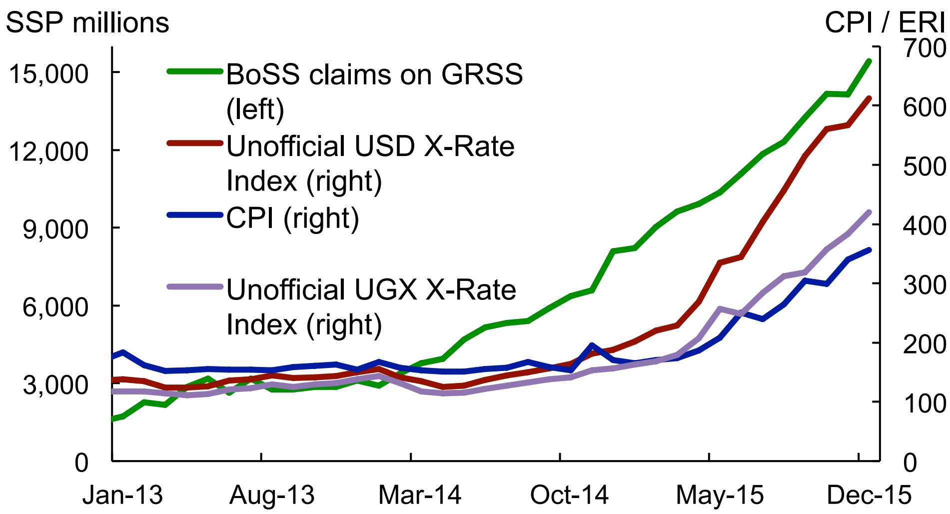
Chart III.2 Oil Revenues and Exchange Rate



As the supply of USD *fell* due to falling oil revenues, the supply of SSP *increased*, due to BSS lending to GRSS. This put substantial pressure on the exchange rate, which was fixed at 2.96 SSP / USD in 2011. At the start of the Fiscal Year, July 2015, the unofficial exchange rate was 10.7 SSP / USD. But by the middle of December, it was 22.8 – an increase of 113%.

Similarly, by the end of Q2 15-16, year-on-year CPI inflation was 110%. This was a substantial increase from the end of 2014-2015, just six months previously, when through the year inflation was 61%.

Chart III.3: Q2 15-16 Inflation and Depreciation



The rapidly deteriorating economic situation necessitated exchange rate reform…

The scarcity of USD meant that very few organisations or people had access to the official exchange rate, which was creating significant distortions and inequity in the economy. In addition, since few people had access to the official rate, it had ceased to provide much in the way of macroeconomic stability and certainty. Finally, the official peg was significantly depressing the SSP value of GRSS revenues and understating the cost of USD expenditure in the official budget. Because of the above reasons, GRSS and BSS decided to implement exchange rate reform on 16 December, moving from a fixed exchange rate to a floating exchange rate.

…but the timing of exchange rate reform was unfortunate.

The exchange rate reform coincided with a severe drop in the price of oil, with Brent falling from above $45 to below $30, substantially reducing supply of USD to South Sudan and so depreciating the currency. In addition, the reform of the exchange rate was accompanied with the reduction of subsidies for fuel, as well as taxes on imported goods increasing due to the change in the exchange rate used to value the good in SSP terms. This led to a marked increase in inflation at the end of Q2 and beginning of Q3. At the same time, government salary arrears built up in November were paid in December financed with loans from BSS, increasing the money supply. Finally, December and January often see an increased demand for foreign currency as residents try to get USD or UGX to visit family abroad for Christmas or pay foreign school fees. These circumstances combined to cause a sharp depreciation in the currency through then end of Q2 and into the beginning of Q3. In addition, it is possible the exchange rate harmonisation ended some people's hopes that the currency would eventually head back toward the official exchange rate, and so "wait and see" became "buy USD as soon as possible". This change in expectations could be connected to reports of an increase in foreign investors deciding to sell their businesses, and move money out of the country, which would also increase demand for USD and cause depreciation. But, again, the root cause of most of these factors was the loss of USD income, not the exchange rate reform itself.

The second half of 2015-2016 will be a challenging one…

The oil price is set to remain low for most of 2016. At the same time, the non-oil sector may continue to contract. This is because:

1) The effects of the conflict that started in December 2013 continue to be felt;
2) Falling private and public sector consumption due to spillover from the contracting oil sector will negatively impact the non-oil sector.

Adjusting to this new income level will be painful, and will require many prudent fiscal reforms to reduce real government spending. With the amount of currency available for imports a small fraction of what it once was, GRSS will need to prioritise those imports that are key to providing core functions and services, such as medical and education supplies, and spending on non-necessary imports must fall. But, at the same time as public finances come under extreme pressure to the extent that it becomes difficult to perform basic and crucial government functions, expenditure requirements will substantially increase due to the implementation of the Peace Agreement.

…but with prudent reforms, increased external support, and a better global economic outlook, things could improve.

In order to address the macroeconomic crisis, and alleviate the suffering of the people of South Sudan, GRSS and its partners must try to achieve the following:

1. **Government revenues need to be increased.**

The floating of the exchange rate demonstrated GRSS' commitment to implementing the reforms needed to try to address the macroeconomic crisis. This has already doubled GRSS' month on month non-oil revenue collection.[2] GRSS is currently in negotiations to adjust the TFA agreement in line with the prevailing oil price of $40 which was unforeseen by all observers at the time of the agreement when oil prices were above USD 100pb and forecast to steadily rise by the IEA and IMF. If TFA payments were to be radically reduced, then net oil revenues would increase – especially in SSP terms given the exchange rate reform. In addition, an improvement in the global economic outlook, and particularly the price for crude oil, would also increase South Sudan's ability to address this macroeconomic crisis.

2. **Real government expenditure needs to be drastically reduced.**

Due to the collapse in oil revenues, the government has far less *real* revenues than it used to. National income has fallen significantly with the fall in oil price and production, and nothing can replace this lost revenue in the short term. Despite the fall in revenues, expenditure has remained high. Since government expenditure in *USD* terms faces a binding constraint (net oil revenues), *real* expenditure ***must*** fall. Given this, it is crucial that each dollar and pound spent represents the best possible value for money for the people of South Sudan. Spending must be focussed on key priorities, if the government hopes to maintain service delivery.[3] Without reductions in real spending, inflation and depreciation will continue and probably accelerate. If the SSP is to be protected and once again become a stable currency, it is vital these important reforms are taken.

[2] See Table X, Chapter IX on Fiscal Sector.

[3] GRSS has prioritized service delivery. His Excellency President Salva Kiir introduced a budget for service delivery in 2013/14, which was then extended by the Honourable Finance Minister David Deng in 2014/15. Budget execution in this area has been exemplary. But the real value of this budget has fallen drastically due to inflation and depreciation. Only by taking the necessary reforms to reduce non-essential expenditure, and therefore inflation, will the value of such key budget items be protected.

3. **International support needs to be increased.**

South Sudan's economy and people rely on imports to survive. However, the amount of foreign currency available to import crucial goods such as food has fallen drastically with net oil revenues. This has created a humanitarian crisis. A joint UN-GRSS report estimating that 2.8 million South Sudanese currently face starvation. GRSS and its international partners need to work together to ensure the support the people of South Sudan get mitigates the worst effects of the crisis. The reforms mentioned above should help to restore trust in GRSS and will be a first step to working with partners to increase the support South Sudan receives to manage this unprecedented crisis. Increasing support now will save lives and reduce the need for greater crisis support later on. Increased external support will not only help those most in need, addressing the humanitarian crisis, but the increased supply of foreign currency will help to address the macroeconomic crisis and stabilise depreciation and inflation. This in turn will improve GRSS' capacity to ensure the continuation of key service delivery.

Only with all three elements of reform will it be possible to stabilise the economy and mitigate the humanitarian catastrophe we are facing.

IV. GROSS DOMESTIC PRODUCT

In December 2015, the National Bureau of Statistics (NBS) released the national accounts for calendar year 2014. National aggregates for Gross Domestic Product are given below. Gross National Income is perhaps a more relevant metric for national welfare, as it strips out income that is transferred abroad, and that the South Sudanese people do not, in general, benefit from. Most notably this includes transfer payments to Sudan that are made on oil production.

Table IV.1: National Accounts

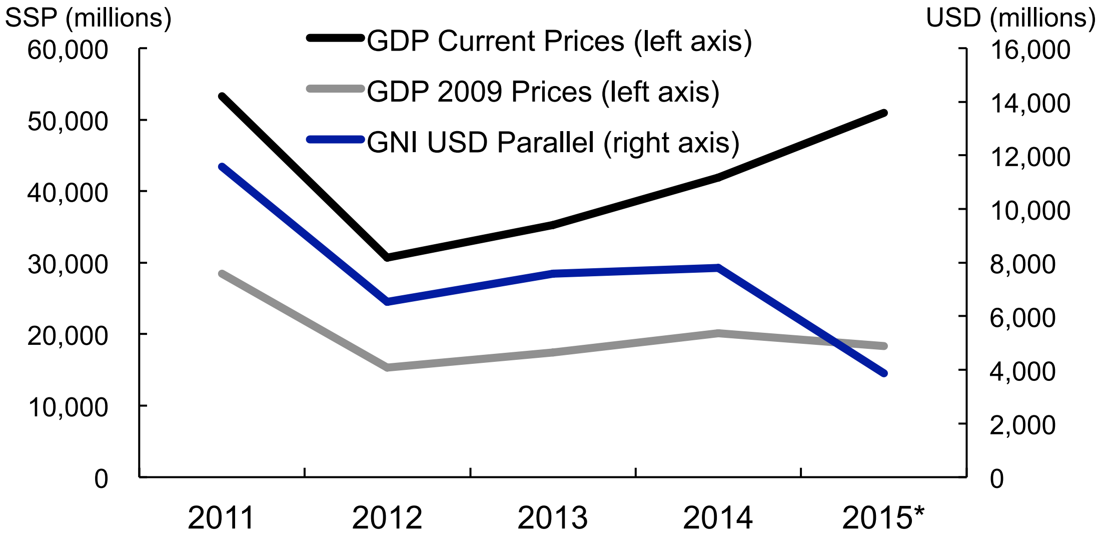
SSP Current Prices	**2011**	**2012**	**2013**	**2014**	**2015***
GDP (millions)	53,284	30,659	35,288	41,911	50,941
GDP Per Capita*	5,384	2,952	3,243	3,681	4,260
GNI	34,282	29,304	32,226	36,464	47,466
GNI per capita	3,464	2,821	2,961	3,203	3,969
SSP 2009 Prices					
Real GDP (millions)	28,421	15,324	17,397	20,161	18,357
Real GDP Per Capita	2,872	1,475	1,599	1,771	1,535
Real GDP Growth	-5	-46	14	16	-9
USD (Parallel Rate)					
GNI*	11,582	6,526	7,588	7,808	3,873
GNI Growth*	35	-44	16	3	-50
GNI Per Capita*	1,170	628	697	686	324

Source: NBS Notes: *2015 figures and GNI MOFEP estimates

The figures show that, following the reversal of the large positive shock in 2011 and 2012, there was a strong increase in nominal GDP. But this was largely driven by inflation and population growth, with real GDP increasing only marginally from 2012 to end 2015. When converted into USD at the market exchange rate, South Sudan's GNI is half the 2012 level. This large reduction in South Sudan's income has been caused by the fall in oil production, oil prices, and the destruction caused by the civil conflict.

Chart V.I shows this divergence between the nominal SSP value of GDP, the real SSP value of GDP, and the USD value of GNI. The USD value of South Sudan's income has fallen by more than the constant price as the rate of USD / SSP depreciation has been stronger than the rate of inflation.

Chart IV.1



The relative composition of the South Sudanese economy has been very volatile, as shown by Table X. This is due to the volatility of both oil production and price.

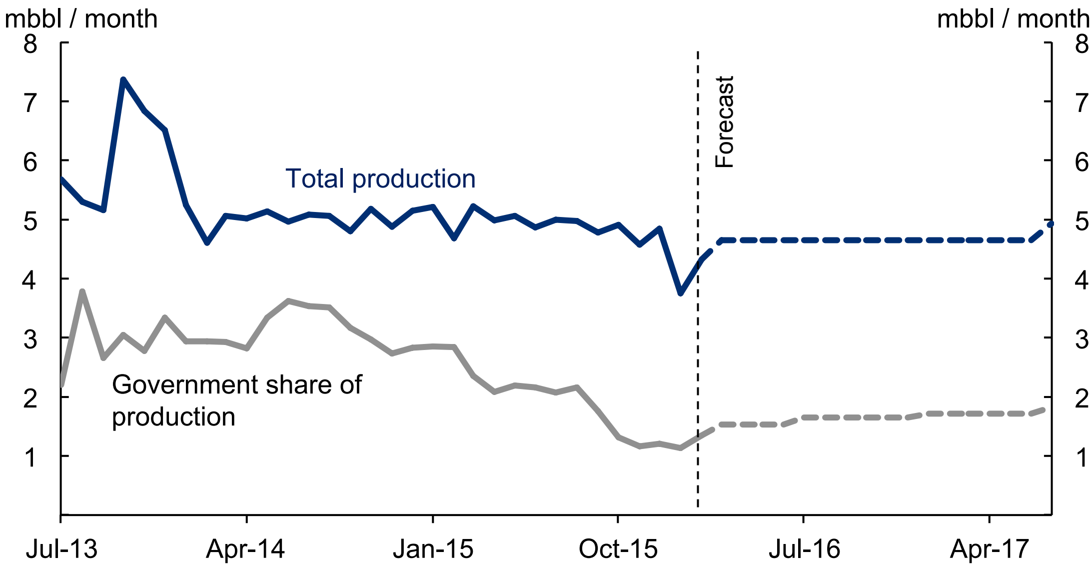
Table IV.2: Composition of South Sudan GDP

Industry	2011	2012	2013	2014
Million SSP				
Extraction of crude petroleum	32,658	2,328	5,262	9,363
Government activities	4,191	4,659	5,434	6,130
Percentage contribution				
Extraction of crude petroleum	61.3	7.6	14.9	22.3
Government activities	7.9	15.2	15.4	14.6

V. OIL SECTOR

The first half of 2015-2016 saw total oil production remain relatively stable. July 2015 saw the highest monthly production of Q1 and Q2, at 5 million barrels, compared to last year's high of 5.2 million in both January and March 2015. November 2015 saw the lowest production of 4.6 million barrels. This picked up in December, before dropping markedly to 3.7 million barrels in January.

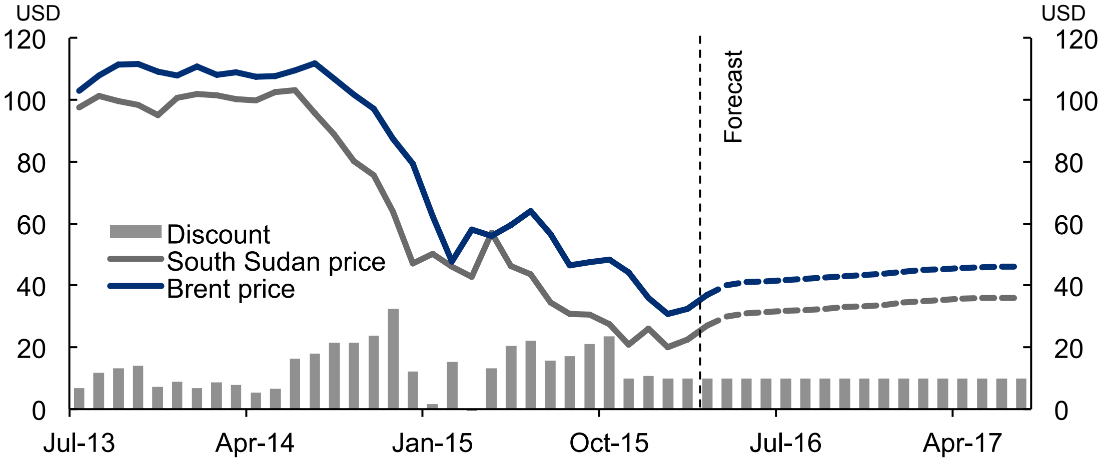
Chart V.1: Oil Production



There have been significant changes in the government share of contracted quantities through the last eighteen months. At the end of Q2 15-16 the government share of production reduced to 1.2 million per month, from 3.5 million at the start of the last fiscal year. This was due to falling oil prices increasing the share of production the oil companies need to cover their costs, as specified in the oil profit sharing agreement in the Petroleum Revenue Management Act. In addition, deliveries of in-kind payments to Sudan through the Kosti power plant and Khartoum refinery have further reduced the Government contract quantities.

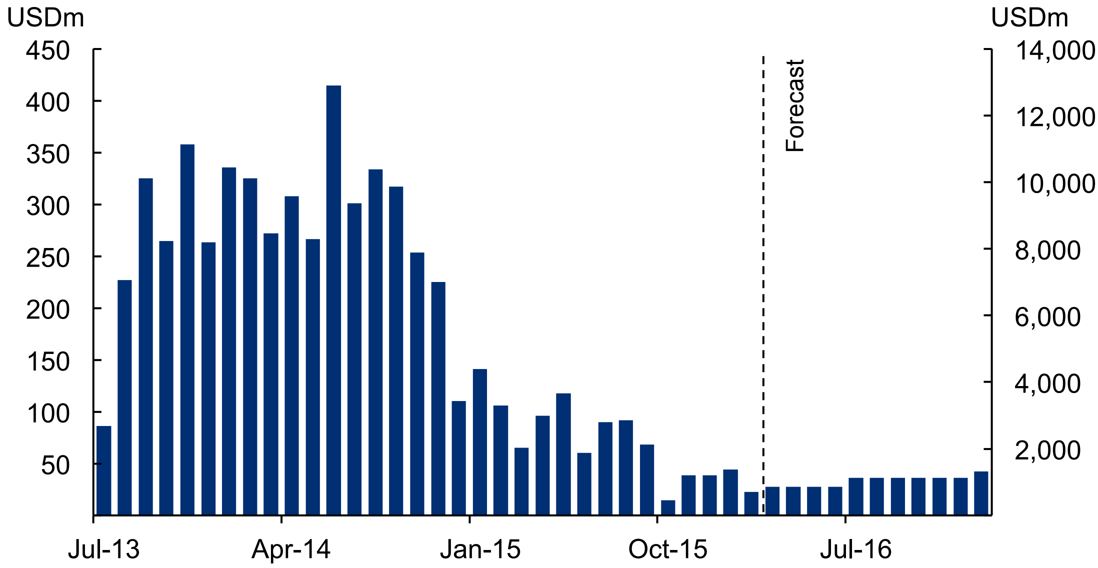
Following the crash in oil prices at the start of the 14-15 fiscal year, where the price of Dar Blend fell from over 100 USD in June 2014 to 37 USD in January 2015, the oil price recovered and was stable for most of calendar year 2015 at around USD 50 pb. However, at the end of Q2 2015-2016 the oil price for Dar fell again from USD 51 pb in November to USD 20 pb.

Chart V.2: Oil Price



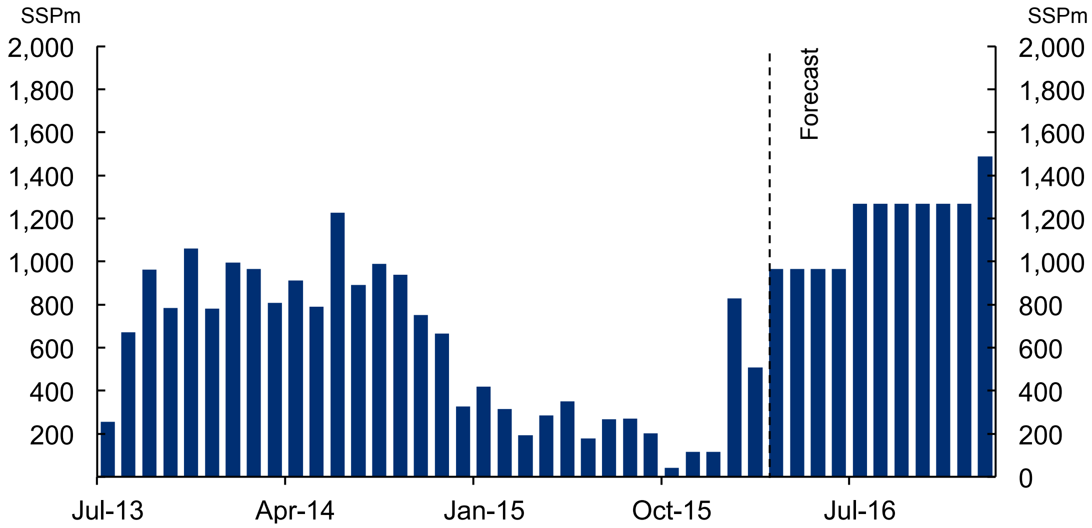
The latest crash in the oil price was caused by increases in global supply and expected supply due to US fracking, the Iran Nuclear deal, and OPEC announcing no reduction in production – as well as a reduced global economic outlook. The South Sudan price oil price has moved together with the international oil price (the reference price, Brent blend). MPD think that most significant deviations from the average discount for Dar Blend of USD 10 is a result of accounting issues (e.g. a discrepancy of when the oil was sold from when it was delivered. Looking at historic data, it appears the USD 10 discount is fairly robust to changes in the price of Brent blend, and has been relatively consistent across time.

Chart V.3: Gross USD Revenue (less in-kind)



The first quarter of 2015-2016 saw net oil revenues roughly consistent with the previous quarter, around USD 80 million per month. This fell in the second quarter due to the collapse in oil price. If the 2012 Cooperation Agreement with Sudan were to be honoured, which requires GRSS to pay Sudan USD 15 per barrel in TFA and USD 9.1 in fees, then by the end of Q2 GRSS would receive **negative** revenue per barrel. This contributed to the default in payments to Sudan, and the accumulation of arrears. Sudan agreed to take a maximum of 700,000 barrels per month as in-kind payments, for use at their Kosti power plant and Khartoum refinery.

Chart V.4 Gross SSP Revenue (less in-kind)

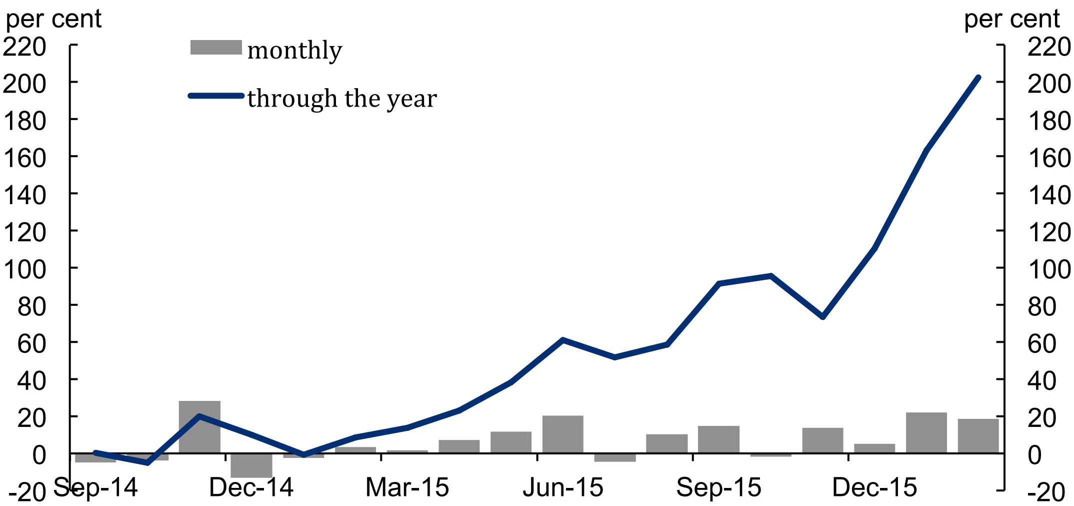


Following the floating of the exchange rate, gross SSP revenues picked up strongly in January. This was essentially an accounting change, as Chart X.3 shows. That said, however, the strong pick up in SSP revenues could help to reduce the government deficit, should GRSS find a way to drastically reduce all USD expenditure.

VI. INFLATION

Throughout the first half of 2015-2016, prices have increased quickly. Through-the-year inflation at the end of Q2 was 110 per cent, rising in January 2016 to 163 per cent (i.e. prices rose 163 per cent from January 2015 to January 2016). And through-the-year inflation for February 2016 was 203 per cent. This is by far the highest it has been in the history of South Sudan and also currently among the highest in the world. Monthly inflation in January was 24 per cent, and 18 per cent in February. If annualized, January's rate would give annual inflation of 1214 per cent, and February's 645 per cent, which shows the speed at which inflation is increasing. January had particularly high inflation due to the removal of fuel subsidies and increase in the rate at which the value of goods is converted from USD to SSP when levying taxes. But this high monthly inflation from January continued into February, which is a worrying sign. Without policy changes, the annual inflation rate for 2015-2016 will be several hundred per cent.

Chart VI:1 Monthly and Through the Year CPI Inflation



Source: National Bureau of Statistics

The average monthly inflation in Q1 and Q2 2015-2016 was 6.3 per cent, which is significantly higher than the average monthly inflation of the previous fiscal year, which was 4.6 per cent. Since Q2, inflation has since spiked higher.

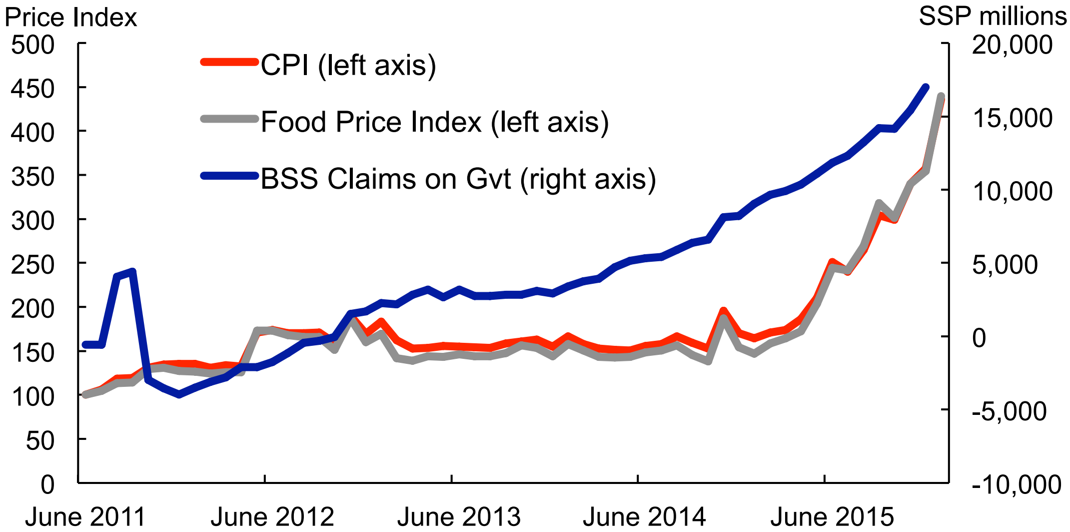
Table VI.1: Q1 and Q2 2015-2016 Inflation

	Jul-15	Aug-15	Sep-15	Oct-15	Nov-15	Dec-15
CPI	239.9	264.8	304.1	299.1	340.1	356.8
TTY Inflation	52%	59%	91%	96%	74%	110%
Monthly Inflation	-4.4%	10.4%	14.9%	-1.7%	13.7%	4.9%

Why is inflation so high?

In all countries, the main determinant of inflation in the long run is the money supply – the total amount of domestic currency. In South Sudan, the money supply has been increasing strongly for more than a year, with the monetary base increasing 80 per cent through the first two quarters of 2015-2016. The increase in the money supply has been driven primarily by increased GRSS borrowing from BSS. This is illustrated by the fact that in the first half of 15-16 to November, BSS credit to the government has increased by SSP 3.3bn whilst the monetary base has increased by SSP 3bn.[4]

Chart VI.2: Price Index and BSS lending to GRSS since Independence

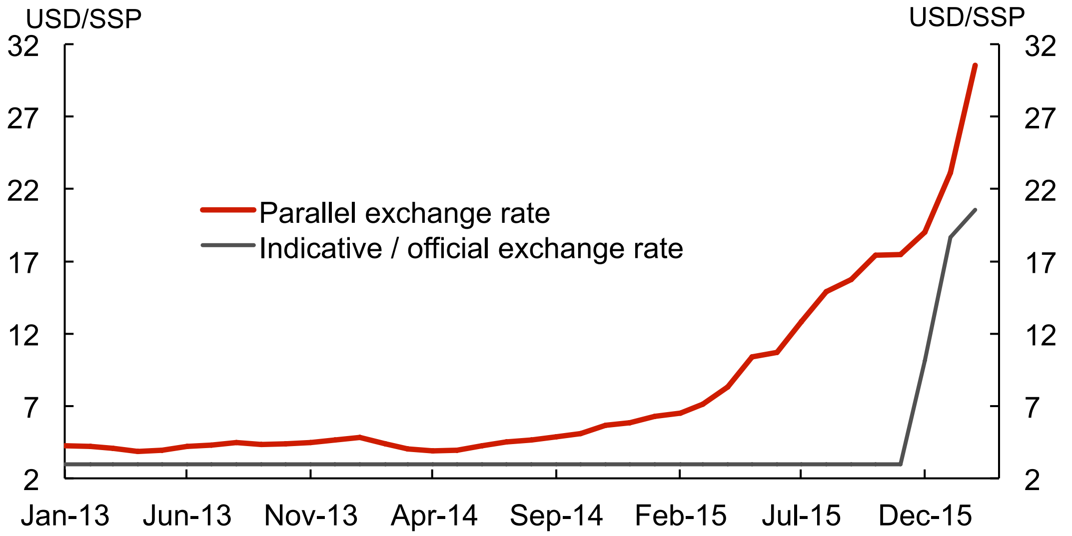


[4] Monetary financing (also known as printing money) is always inflationary. This can be shown from economic theory using the accounting identity the "equation of exchange" ($MV = PQ$). This states that the *money supply* multiplied by the *velocity of money* is equal to the *price level* multiplied by *real expenditures*. And so, increasing the supply of money must increase the *price level multiplied by real expenditures*. In South Sudan the real expenditure / real GDP has gone down, and so increasing the money supply with constant velocity of money will necessarily cause inflation. There is reason to believe the velocity of money (i.e. how quickly people spend their cash) will increase in a highly inflationary environment, as the attractiveness of saving reduces. And so, with falling real GDP, increasing money supply, and increasing velocity of money, extremely high levels of inflation is to be expected.

VII. EXCHANGE RATE

The parallel exchange rate depreciated strongly against the USD in the first quarter of 2015-2016, despite the official peg of USD / SSP 2.96 being maintained. At the start of Q1 it was USD / SSP 11.95 and by the beginning of Q2 it had reached USD / SSP 16.05, a depreciation of 34 per cent in just 3 months. This continued into Q2 – with the unofficial exchange rate hitting USD / SSP 18.75 by 15 December.

Chart VII.1: USD / SSP Exchange Rate up to Q3 2015-2016



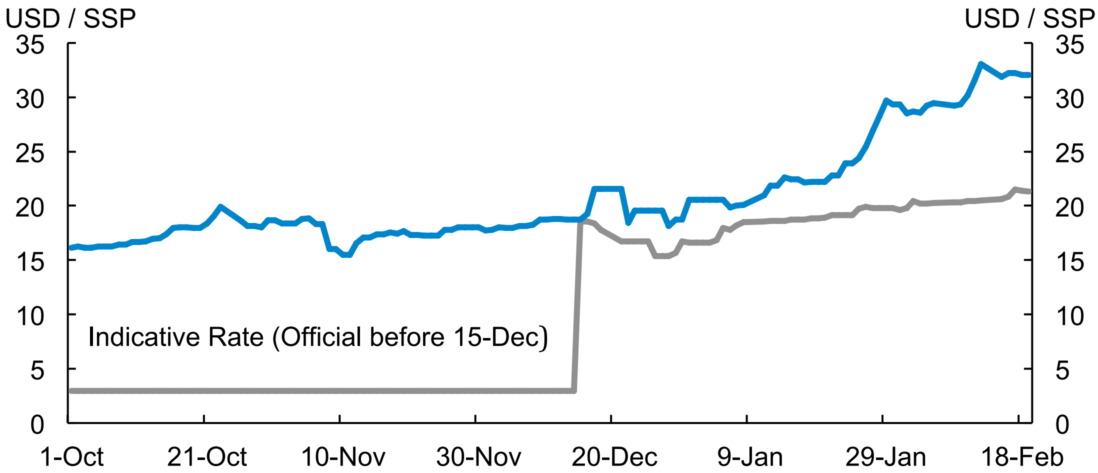
The depreciation was caused by the collapse in oil revenues greatly reducing the supply of USD to the economy. At the same time, the monetization of an increasing government deficit increased the supply of SSP to the economy. The result was strong depreciation. The peg of USD / SSP 2.96 had become meaningless, as extremely limited number of organisations and people used the official exchange rate. In addition, the peg was creating large distortions and inequities in the economy. It also created opportunities for those with access to the official exchange rate to profit from it at the expense of those without access.

The GRSS, in cooperation with the BSS and with the assistance of the IMF, decided to reform the exchange rate regime and float the SSP, with South Sudan's SDR reserves being auctioned to try and reduce the rate of depreciation. It was hoped that the float would greatly increase the SSP value of oil revenues, whilst also increasing customs revenues. But whilst the SSP value of revenues increased, so too did the SSP value of expenditure by an equal amount (and in some cases more).[5] Only by reducing USD expenditure will the exchange rate reform help GRSS to substantially reduce the deficit.

[5] When USD expenditure is greater than USD revenue, the difference is accumulated as government arrears.

The fact that adequate fiscal reforms did not accompany monetary reform meant that SSP continued to be created whilst USD revenues continued to fall due to the latest oil price slump. These factors, possibly combined with increased demand for USD for various reasons, led to accelerated rate of depreciation going into Q3.

Chart VII.2: Exchange Rate Reform going into Q3[6]



How to stabilise the currency?

MPD are optimistic that should the following happen, the exchange rate may stabilize:

- Reduction in government expenditure will reduce the deficit, reducing the need to print money and so reduce the supply of SSP thereby strengthening it.
- If oil prices at the global market improve, oil sales will increase the supply of USD to South Sudan, strengthening the currency. Reducing payments to Sudan will have the same effect.

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[6] **What is the difference between the Parallel and Indicative Rates?** The BSS surveys the rates offered on the black market each morning. This is the 'parallel rate'. The rate at which banks trade USD with one another should be the 'indicative rate'. After the exchange rate was floated, a substantial gap opened up between the parallel rate and the indicative rate. On the first day of the float they were the same, but by 12 Feb the indicative rate was 20.5 whereas the parallel rate was 33. The reasons for this substantial gap were not entirely clear. Theory would suggest that competition and trade between banks for USD would close the gap – if they can sell USD at the parallel rate then banks should be willing to compete to buy them to sell at a profit until the interbank rate is close to the parallel rate. But this was not happening. One possibility is that it simply took time for the interbank market to develop – as banks were not experienced in trading currency due to operating under a fixed rate regime for several years. After an education effort by the BSS to encourage banks to trade USD freely amongst themselves, and to bid for USD at the rate they would be willing to pay, the gap was substantially closed, from over 50 per cent to below 10 per cent. Worryingly, however, the gap between the parallel rate and the indicative rate has since reopened, with the parallel rate being 25% higher than the indicative rate. It is not yet clear why this has happened.

- Similarly, increasing oil production by resuming oil production in Unity State will also increase USD supply to the market, and so strengthen the SSP.
- An IMF Programme could mobilise significant external resources and, in coordination with reduced GRSS expenditure, strengthen the SSP.

Box 1: Has the exchange rate reform caused depreciation?

The short answer is **no.** South Sudan was experiencing extremely high depreciation and inflation **before** the exchange rate reform. It is true that the rate of depreciation has been particularly high since the reform but this is mainly because the oil price collapse **reduced the supply of USD in South Sudan**. The price of the SSP is determined by the demand and supply of SSP relative to foreign currency:

- The lack of exports and falling price of oil has **reduced demand for SSP.**
- Increasing BSS credit to GRSS (printing money) **increases the supply of SSP.**

These are the primary factors causing rapid deprecation in South Sudan. There have also been suggestions that other factors have had a role:

- The worsening economy and business environment have led foreign-owned business to liquidate and increased demand for USD;
- Since December, school fees in neighbouring countries have increased demand for USD;
- Expectations of future depreciation have increased as a result of the reform.

For a peg to be sustained, a country must have the foreign finances to support it at the pegged level. That means a stable Balance of Trade and a lot of reserves – but South Sudan has neither. In addition, the peg must be changed when economic fundamentals change - many oil-exporters have devalued their currency since the recent oil price crash.

In summary, the exchange rate reform has not been the root cause of recent depreciation. It has increased both oil and non-oil SSP revenue and will in time help GRSS to reduce the government deficit, and so **strengthen the SSP**. South Sudan’s economy is no longer suited to a fixed exchange rate, which distorts the economy and public financial management.

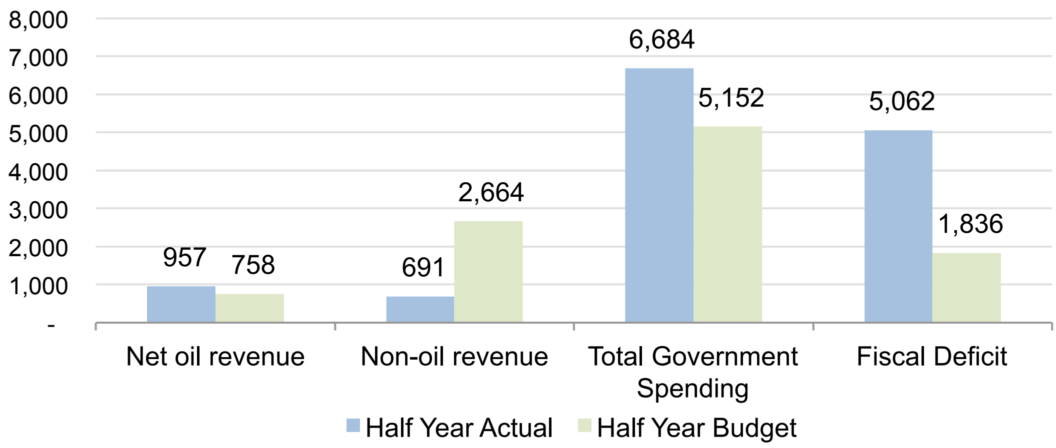
VIII. FISCAL

Fiscal Sector and the economy

Unfortunately the fiscal situation continued to deteriorate in the first half of 2015-2016, with real revenues falling substantially on previous years. The fall in revenues has led to increased stock of GRSS borrowing from the BSS, which is one of the two core reasons why inflation and depreciation have reached such high levels (the other being a fall in supply of USD to the economy). In turn, the high levels of inflation have eroded the government's spending power and so reduced the efficacy with which line ministries can provide critical services. If service delivery is to be maintained going forward, a rebalancing of the government's expenditure is required, in addition to external support.

Budget Execution for Q2 2015-2016[7]

Chart VIII.1: Half-Year Revenue & Expenditure

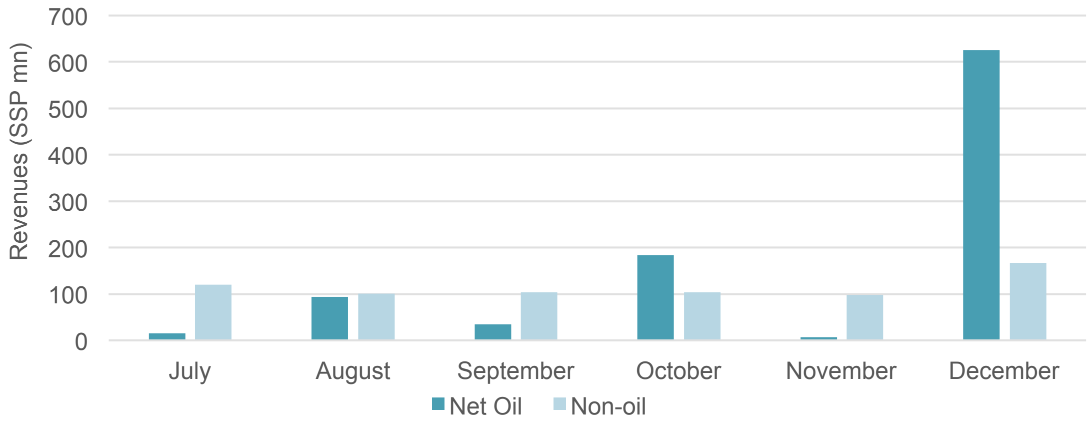


Total Government revenue was SSP 1,183 million in the second quarter, resulting in total half year revenues of SSP 1,649 million, which was just 24 per cent of the annual budget estimate. This shortfall was primarily due to under performance of non-oil revenues compared to budget in both quarters, which totalled SSP 691 million, just 13 per cent of the annual budgeted amount. Net oil revenues were significantly higher in the second quarter (SSP 814 million) than in the first (SSP 143 million), despite similar gross revenue levels, due to underpayment of TFA and transit fees to Sudan.

All else equal, net oil and non-oil revenues can be expected to increase in Q3 and Q4, as a result of the exchange rate alignment. However, oil revenues may be negatively affected if the global oil price continues to decline, and by the continuing uncertainty surrounding payments to Sudan.

[7] The Budget Department of MOFEP produce a more detailed quarterly budget execution report that is available on the Ministry's website.

Chart VIII.2: Half-Year Revenue & Expenditure



Total spending in the first half of 2015/16 was SSP 6,684 million, such that 66 per cent of the annual budget was spent in the first half of the year. This overspend is primarily the result of a number of agencies exhausting much of, and in some cases exceeding, their annual operating (and to lesser extent their annual capital) budgets over the half year. Operating expenditure contributed SSP 786mn to overspending in the first half of the year, and capital spending contributed a further SSP 270mn. In addition, the inequity in the release of operating budgets is leading to the overfunding of some government operations at the expense of others compared to budgeted levels.

Both salaries and transfers were executed relatively close to budgeted levels over the period. It should be noted, however, that overspending elsewhere meant the majority of both November salary and transfer payments could not be executed on time, and had to be delayed until December.

Overspending by the Ministry of Finance and Economic Planning, and the Office of the President was particularly large, with both spending their annual operating budget in the first quarter and overspending on salaries in both quarters.

The budget deficit for the first half of 2015/16 was SSP 5,062 million – which exceeded the annual budgeted deficit (SSP 3,671 million). A large proportion of the deficit has not been financed and therefore a sizeable level of operating and capital expenditures in the first half remains uncleared, as unpaid liabilities.

Non-oil Revenue

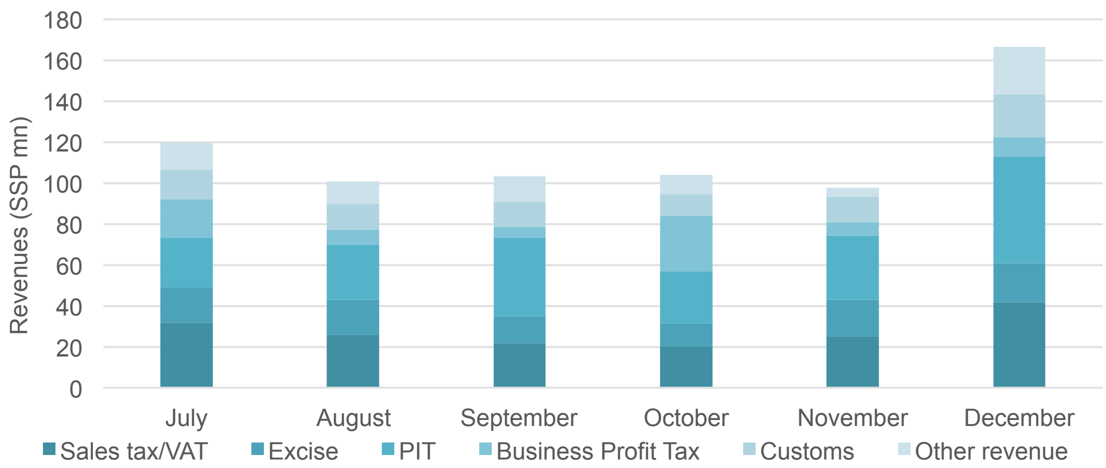
The outturn for non-oil-revenue in the first half of 2015/2016 was SSP 691 million, only 13 per cent of the annual budgeted figure of SSP5.3bn. In both quarters of 2015/16 non-oil revenue collections were higher than in the same quarter in 2014/15. As such, the reason for the shortfall in non-oil revenues in the first half of the fiscal year is due to the overly optimistic non-oil revenue budget projection which estimated that non-oil revenues would more than triple from 2014/15 levels.

Non-oil revenues are likely to increase in the second half of the year for two reasons:

- High inflation is likely to push up the nominal value of revenue collected from sales tax and business profits tax.
- The exchange rate harmonization will increase taxes collected by customs as goods will now be valued at the higher exchange rate.

The initial effects of this can be seen in December revenues, for example revenue from customs was SSP 77 million, compared to the average level of SSP 45 million over the previously 5 months. However, in the context of very high inflation it should be noted that non-oil revenues have fallen in real terms in 2015/16. As inflation now exceeds 100 per cent, non-oil revenues needed to double over the year, in order to maintain their real value.

Chart VIII.3: Half-Year Revenue & Expenditure



Box 2: The Harmonization of Fiscal and Monetary Policy

Fiscal Policy uses **government spending and taxes** to target Aggregate Demand in the economy, and therefore influence inflation and GDP. Monetary Policy attempts to influence inflation and GDP through **controlling the money supply**. In most countries the money supply is controlled either through using the central bank's interest rate, or by maintaining a fixed exchange rate. However, **financing government expenditure with loans from the central bank increases the money supply, meaning independent, targeted monetary is not possible.** Therefore, South Sudan cannot have reliable and effective monetary policy until there is a reduced government deficit, which will enable less borrowing from the Bank of South Sudan. Until then, BSS will have little control of money supply, interest rates, or the exchange rate, and so will not be able to materially impact inflation.

In addition, for monetary and fiscal policy to be effective, it is important that policies are coordinated between the Ministry of Finance and the Central Bank. The appropriate monetary policy depends on prevailing and future fiscal policy, and vice versa. Therefore, MOFEP and BSS have been working to improve coordination, cooperation, and collaboration between the two organisations. These efforts have led to a Memorandum of Understanding being signed between the two organisation in March 2016. It is hoped that improving cooperation will lead to improved policy implementation, and so improved economic outcomes.

IX. DEBT[8]

With the Government's resource envelope tightening more quickly than expenditure can respond, the sources of deficit financing has become particularly important. The 2015/16 Budget accounted for new GRSS borrowing of SSP 3.67 billion. In the first two quarters of 2015-2016 GRSS borrowed SSP 4.3 billion from domestic sources. In addition, USD 50 million was obtained as an advance on oil sales in November, of which USD 15.4 million was repaid in December 2015. This gives total of SSP 4.24bn new borrowing in the first two quarters of FY 15-16, using the December 31 indicative exchange rate to convert USD liabilities. This does not include arrears accumulated externally or domestically.

Domestic Debt

Domestic borrowing from the Bank of South Sudan (BSS) increased by 51 per cent from SSP 10.2 billion as at end of Q4 2014-15 to SSP 15.5 billion by end of Q2 2015-16. This was largely due to increased drawing on the Government's Standing Overdraft facility with the BSS to fund salaries and overheads within the period. Government's increased leverage on domestic financing in the last two years has been due to the over 80 per cent fall in oil revenue and the low level of non-oil receipts.

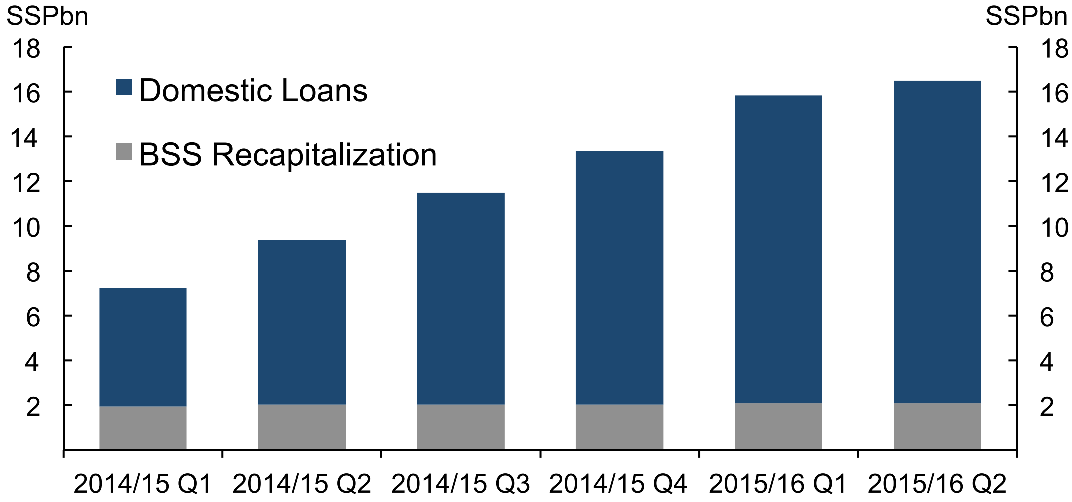
Table IX.1: Outstanding Government Borrowing from Bank of South Sudan at 31.12.2015

Source	Amount (SSP)
Government Direct Borrowing from BSS,	13,036,341,773
Interest Accrued from Direct Borrowing	375,636,831
Sub-total: Direct Borrowing BSS	**13,411,978,604**
Capital Restoration of the BSS	1917373479
Interest on Capital Restoration	172,563,613
Total Borrowing from BSS	**15,501,915,696**
Borrowing from Commercial Banks (T-Bills)	1,799,876,198
Interest accrued on T-Bills	66,713,725
Total Gov't Borrowing from Banking Sector,	17,368,505,619

GRSS sold a Treasury Bill for SSP 500m in December, increasing the stock of commercial bank liabilities to SSP 1.9bn by the end of the second quarter.

8 *Produced by Debt Management Unit*

Chart IX.1: Government Domestic Borrowing as at 31.12.2015



External Loans

The total outstanding external loans as at Q2 2015-16 is USD 134 million. This includes USD 100 million for China EXIM Bank meant for the reconstruction of Juba International Airport. As at end of the review period, all the external loans (which are mostly World Bank/IDA loans) were in their grace period, hence no principal repayments had commenced on them. Apart from the China EXIM loan all the IDA loans are largely concessional.

Table IX.2: GRSS External Loans as at 31.12.15

Number	Project Name	Original Principal	Undisbursed Amount	Disbursed Amount	First Repayment	Last Repayment
IDA52130	SS-Local Governance & Service Delivery	50,000,000	33,028,700	16,971,300	04/15/2023	10/15/2052
IDA52840	Safety Net and Skills Development	21,000,000	18,125,901	2,874,099	12/01/2023	06/01/2053
IDA53630	South Sudan-EA Regional Transp.	80,000,000	70,607,844	9,392,156	06/01/2024	12/01/2053
IDA54010	SS-Health Rapid Results Project	10,000,000	6,246,386	3,753,614	04/15/2024	10/15/2053
IDA55370	Statistical Capacity Building Project	9,000,000	7,532,977	1,467,023	01/15/2021	07/15/2052
NA	Completion of Juba International Airport	150,000,000	50,000,000	100,000,000	10/30/2018	10/30/2038
	Total	**320,000,000**	**185,541,807**	**134,458,193**		

Oil Advances

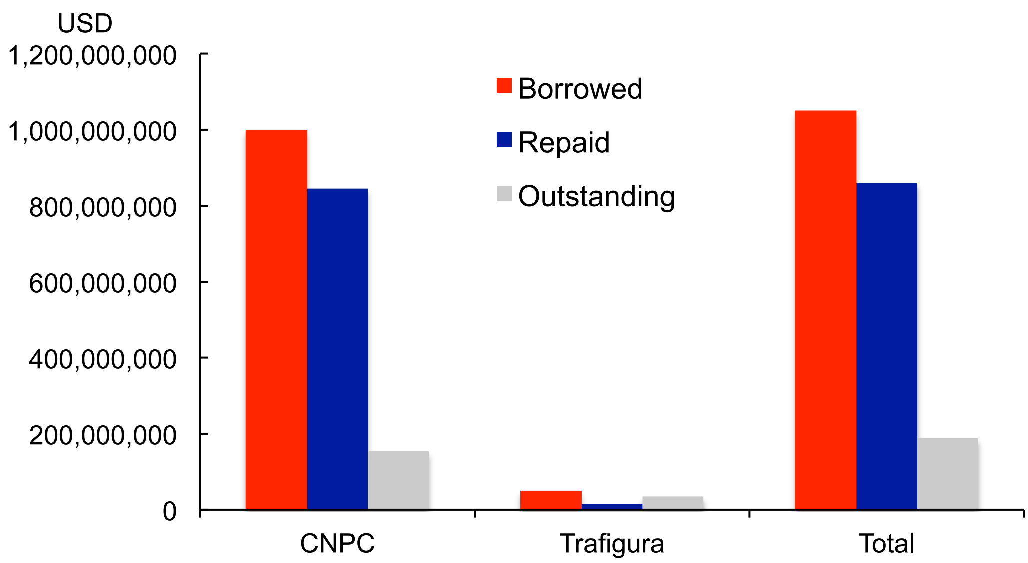
Oil advances are one of the financing windows of the Government where short-term funds are raised in exchange for oil. The counterparties in the transaction are the international oil companies operating joint-venture producing arrangement with the Government. Under the arrangement funds are advanced to the government in a forward oil-swap deal where the government repays in 45 days at a negotiated interest rate of 3 per cent. The lead arranger in the Oil Advance deal is the Ministry of Petroleum and Mining, while the MOFEP is the primary obligor. As at end of December 31, 2015, the outstanding obligation on the advances is USD189 million.

Table IX.3 Committed Oil Advances as at December 31st 2015 (USD)

Company	Total Amount Borrowed	Total Amount Repaid	Outstanding Balance
CNPC	1,000,000,000	845,713,840	154,286,160
Trafigura	50,000,000	15,400,000	34,600,000
Total	**1,050,000,000**	**861,113,840**	**188,886,160**

Two companies namely CNPC and Trafigura raised a total of USD1.05 billion for the Government and had an outstanding payment of USD189 million after the Government repaid USD861 million as at the review period.

Chart IX.3: Oil Advances as at 31.12.15 (USD)



With the further decline in Government revenue caused by the fall in global oil prices and the transit fees paid to Sudan for oil export, it is envisaged that Government would continue to raise oil advances from the oil companies and this may increase the level of government borrowing in 2016.

Other Liabilities

As at end of Q2 15-16, there are pipeline items and other liabilities within the country's debt portfolio. These are a varied collection of pipeline and other liabilities, ranging from loans yet to be drawn, to Central Bank liabilities, to arrears on Transitional Financial Assistance to Sudan. The table below shows a list of the items as at 31 Dec 2015.

Table IX.4: Pipeline Loans and Other Liabilities

Loan Title	Creditor	Loan Amount	Amount Disbursed	Amount Outstanding
Kuwait Hospital Loan	Kuwait Fund for Development	11,900,000	Undrawn	NIL
QNB Line of Credit*	Qatar National Bank	650,000,000	650,000,000	-
WB Energy Loan	World Bank	15,000,000	Undrawn	NIL
WB IDCB Loan	World Bank	20,000,000	Undrawn	NIL
Arrears of TFA	Republic of Sudan	N/A	N/A	1,830,282,685

Notes: The QNB line of credit is a liability of BSS. TFA are payments associated with the Transitional Financial Arrangement with Sudan – efforts are being made to renegotiate this agreement in respect of much reduced oil prices.

X. AID COORDINATION UNIT[9]

Concessional External financing (aid) comprises development and humanitarian support in the form of loans and grants, for the most part, from official agencies. The majority is currently implemented without the involvement of the government and is not appropriated in the budget, even though it may be captured in sector plans and referred to in the budget speech. Since the December 2013 crisis, many development partners have moved much of their funding previously allocated for development support to humanitarian support.

Aid which uses government systems is appropriated in the budget and the disbursements reported. Table 1 shows the individual projects in the 2015/16 budget and their quarterly disbursements. Aid which is implemented through government financial systems it is referred to as 'On-Budget'. The component of the 'Local Governance and Service Delivery Project' (WB) which funds the Payam Development grants, and 'Aid Information Management Systems' (UNDP) are currently the only projects which meet this description. Several other World Bank and African Development Bank projects involve government systems in their disbursement process and these are called 'On-Account' projects.

In Q2 a total of SSP 60.59 million was disbursed, of which SSP 24.5 million were in the form of loans and SSP 36.1 million were disbursed as grants, based on an exchange rate of 2.96 SSP to 1 USD.

Table X.1: Disbursements in 2015/16 (SSP millions)

Project Name (Development Partner)	Fund code	Loan/ Grant	GRSS Agency	2015/16 Exp. (SSP)	Q1 (SSP)	Q2 (SSP)	YTD (%)
AIMS (UNDP)	61201	Grant	Accountability	0	-	-	N/A
Emergency Food Crisis Response (World Bank)	61301	Grant	Natural Resources	2.94	2.98	2.63	190%
Private Sector Development (World Bank)	61302	Grant	Economic functions	2.35	-	6.80	288%
Health Rapid Results (World Bank)	61303	Grant	Health	20.56	15.50	0.82	79%
Rural Roads (World Bank)	61304	Grant	Infrastructure	26.73	0.50	8.25	33%
Local Governance and Service Delivery (World Bank)	61305	Grant	Accountability	17.63	-	13.45	76%
Strengthening the Capacity of South Sudan Audit Chamber (World Bank)	61306	Grant	Accountability	0.31	-	0.14	45%

9 *Produced by Aid Coordination Unit*

State and Peacebuilding Fund (World Bank)	61307	Grant	Economic functions	2.94	1.26	0.71	66%
Procurement Capacity Development (World Bank)	61308	Grant	Accountability	0.92	-	0.25	27%
Institutional Development and Capacity Building (PPA) (World Bank)	61309	Grant	Public Administration	2.94	-	1.93	65%
Institutional Support to PFM and Aid Coordination (AfDB)	61501	Grant	Accountability	8.61	1.84	0.82	31%
Juba Power Distribution (AfDB)	61502	Grant	Economic functions	26.93	0.97	0.29	5%
TA for the Transport Sector (AfDB)	61503	Grant	Infrastructure	14.73	-	-	0%
Local Governance and Service Delivery (World Bank)	71101	Loan	Accountability	27.18	1.03	13.68	54%
Health Rapid Results (World Bank)	71102	Loan	Health	0	-	9.86	N/A
East Africa Regional Transport Project (World Bank)	71103	Loan	Infrastructure	66.74	-	-	0%
Safety Net and Skills Development (World Bank)	71104	Loan	Natural Resources	10.28	-	0.36	3%
Statistical Capacity Building (World Bank)	71106	Loan	Accountability	3.53	0.59	0.59	33%
Airport (China EXIM)	71201	Loan	Infrastructure	102.82	TBC	TBC	0%
Total				338.14	24.67	60.59	25%

In addition, two new loan financed projects which were not appropriated in the budget have been initiated. The World Bank project 'Energy Sector Technical Assistance' disbursed USD 223,684, and the Kuwait Fund project 'Constructing and Equipping of Kuwait Women and Children Hospital' for which disbursements are not currently available.

XI. POVERTY REDUCTION[10]

Poverty is affecting an increasing number of South Sudanese. According to GRSS estimates, 2 million people are starving. The Macroeconomic Planning Directorate estimates that there has been an almost 70 per cent income shock since 2011, including 50 per cent in 2015. This means a poverty crisis is in the making, because incomes were already close to subsistence levels for many households before the income shock. The income shock is affecting households in a number of ways, including through inflation, and under and unemployment. Meanwhile, the continuing consequences of the conflict continue to hurt households across the nation (including destruction of crops, herds and property along with displacement of people).

The Poverty Reduction Unit and NBS are tabulating the Welfare Monitoring Survey 2012 in preparation for analysis, with input from Statistics Norway. In time, this will lead to a better understanding of poverty in South Sudan.

[10] *Produced by Poverty Reduction Unit*

XII. ECONOMIC OUTLOOK

The economy has been subject to extreme shocks since independence:

- In 2012 the shutdown of caused a loss of most of government revenue – leading to a depletion of government savings, reserves, and the creation of substantial debt.
- In December 2013 the civil war led to disruptions of oil and non-oil production, reducing government revenues, whilst exerting substantial upwards pressures on government spending, particularly in the security sector.
- Finally, the latest oil price slump has led to a period of zero or even negative net oil revenues so far in 2016.

These shocks have contributed to a large reduction in national income. As a consequence, South Sudan is facing its gravest threat to the economy since independence. High inflation and rapid depreciation and a strong depression in the domestic economy are undermining economic stability.

Lack of foreign currency earnings reduces the dollar value of the exchange rate and translates into increased prices and falling purchasing power. Real income in the non-oil sector outside the rural subsistence economy may fall to a tenth of the 2014 level in 2016. Without significant increases in external support, South Sudan will not be able to finance necessary food imports and the food security situation will deteriorate to crisis levels.

Attempting to remedy the situation by increasing nominal government spending has led to accumulation of debt, arrears, and increased money supply. Increased money in circulation only increases demand for foreign currency, and thereby increases both inflation and depreciation – it does not fix the problem.

Lack of funds for financing imports is causing a deep depression

A part of total imports to South Sudan is directly financed from abroad. Oil companies directly finance investments and import of goods and services needed to operate the oil sector. Donor governments and NGOs finance imports of consumption goods distributed as relief assistance. If we subtract these import items, we arrive at imports that are financed by the non-oil sector.

Over the period 2008 to 2014, net oil revenues financed around 85 per cent of the imports (amounting on average to USD 300 mill.) to the non-oil sector after having subtracted donor financed imports. The remaining

15 per cent have been financed mainly by non-oil exports, transfers and net borrowing.

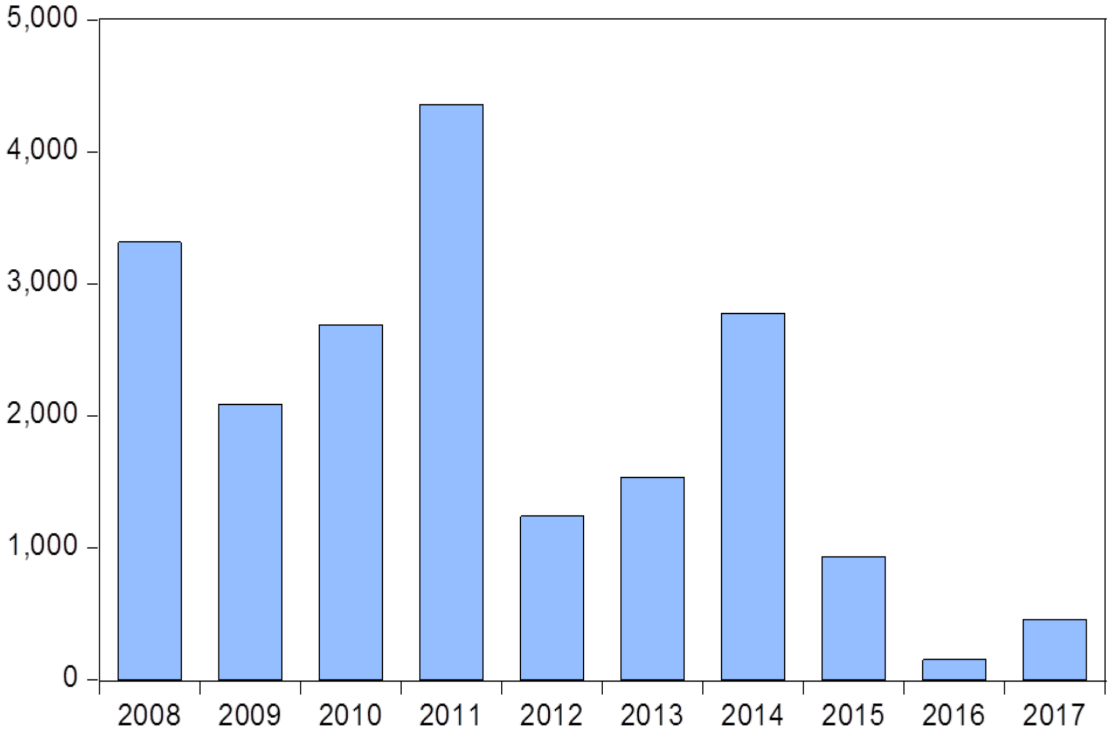
If we assume the same financing of imports in 2016 and 2017, the total USD for imports, excluding what is financed by donors, will decline to USD 250 mill in the FY 2016/17. This entails a reduction of 90 per cent of imports in the market economy relative to the calendar year 2014.

Lower imports translate into reduced consumption, mainly in urban areas among wage earners participating in the market economy. Those relying on assistance from donors and those making livelihood from subsistence agriculture will be less affected. Domestic production will decline as there will be no funds to finance imported inputs.

If the availability of foreign currency does not improve markedly, the reduction of imports could trigger a markedly deterioration of the already difficult food situation in South Sudan.

Chart XII.1: The budget for financing imports*

Net oil reveneus plus USD 300 mill.



The estimate of USD 300 million is based on average of the difference between net oil revenues and non-oil, non-donor financed imports, valued at off. Exchange ate and black market exchange rate.

Compensations for inflation will fuel inflation and may undermine stability

Given the permanent negative oil shock due to lower oil prices, a large exchange rate adjustment and an associated upward shift in the domestic price level has been inevitable. The challenge is to avoid that the price shock creating sustained and increasing inflation through 2016 and beyond, undermining monetary stability.

A drastically reduced budget for financing imports mean that households have to reduce their consumption of imported food, diesel, vehicles, clothes, and all other goods by the same portion. Likewise, government agencies have to reduce their activities to a small fraction of earlier levels.

For the country as a whole, it is impossible to escape this adjustment. Increasing the money supply will only create inflation and will no impact whatsoever on the amount of goods and services available.

Thus compensations for price increases to sectors will have no effect on the total supply. Compensations can, however impact the distribution of goods and services. Those who are able to secure large compensations for price increases may increase their share of resources on the expense of those who are less successful. The risk of embarking on compensation schemes is that it will trigger accelerating inflation as groups compete for larger share of the small available resources. Thus, if we are to avoid hyperinflation and destruction of our currency, we have to limit compensations.

Radical policy responses are needed to avert a massive hunger catastrophe and save lives…

South Sudan is facing an unprecedented income shock. Some reforms could help ease this transition. Ways to reduce expenditure could include:

- reducing the number and size of foreign trips and embassies;
- stop paying for civil servants' USD medical bills;
- screening the payroll to remove 'ghost workers', or employees who don't exist, other than to earn an extra income for corrupt officials;
- strict spending controls for all ministries;
- removing the fuel subsidy;
- ceasing expenditure on non-essential capital goods (no more vehicles)

Measures to increase revenues include

- modernising the Financial Act and updating the Tariff Schedule;
- ensuring revenue raising agencies are appropriately funded;

- creating new taxes to target luxury goods and the wealthy;
- remove exemptions.

The economic adjustments facing South Sudan are immense. This calls for deep fiscal reforms. But this will not be enough. External support or concessional financing to reduce BSS borrowing and bring inflation under control will be needed.

Without reduced government expenditure, inflation and depreciation will continue, probably at an accelerating rate, and dollarization could become a distinct possibility.