CLOSE HOLD

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Briefing by Marcelo Giugale, World Bank Director of Economic Policy and Poverty Reduction Programmes for Africa
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Note-to-File

1. Marcelo Giugale, World Bank Director of Economic Policy and Poverty Reduction Programmes for Africa, presented an analysis of the likely economic and social impact of the oil shutdown to a group of key donors that included the US, UK, EU, Norway and IMF. DSRSG/RC/HC/ UNDP RR Lise Grande also attended.

2. The same presentation had been given the previous day (29 February 2012) to H.E. President Salva Kiir Mayardit and several Ministers including the Ministers of Finance and Economic Planning, Commerce and Presidential Affairs. There is a strong possibility that the presentation will be given to the Council of Ministers at a future date and also to the negotiating team representing South Sudan in the Addis talks.

3. Mr. Giugale's presentation outlined: a) the likely economic and social impact of the oil shutdown; b) the policy decisions which the Government will face and c) the support that the World Bank may be able to provide.

4. The analysis draws on available data and refers to comparable shocks in other countries including Mexico in 1994, Indonesia in 1997, Russia in 1998 and Argentina in 2001. Given the highly sensitive nature of the analysis and the implications of this for the negotiations, the World Bank has asked that the content be treated as "close hold."

Economic Impact

5. In his opening statement, Mr. Giugale said that the World Bank has never seen a situation as dramatic as the one faced by South Sudan. In his view, neither the President nor the senior Ministers present in the meeting were aware of the economic implications of the shut-down. He candidly said that the decision was shocking and that the officials present had not internalized nor understood the consequences of the decision. These include:

   Collapse of Gross Domestic Product (GDP): Because oil receipts, combined with government spending (98 percent of which is derived from oil sales), account for 82% of GDP, the shut-down of production will lead to a dramatic contraction of the economy. Mr. Giugale stressed that this is an unprecedented situation insofar as countries in crisis usually face a collapse in *growth*, rather than of *GDP*.

   Massive depreciation of the South Sudanese Pound (SSP): This will be driven by several factors including the sharp fall in the amount of dollars entering the economy through oil receipts. Once people realize that the value of the pound is slipping, there will be a run for dollars and families with dollars will almost certainly shift them outside the country—by walking them out if necessary. This, in turn, will put the pound under catastrophic pressure. The "explosion in the demand for dollars will lead to an immediate implosion in the pound." Mr. Giugale pointed out that because most South Sudanese are not fully "financially literate" the run on the pound has not yet happened. Once it starts, the currency will almost certainly collapse.

Exponential rise in inflation: Because virtually all basic and luxury commodities are imported, inflation will rise at almost exactly the same rate as the pound depreciates.

Depletion of reserves: If the government is able to stick to the austerity measures it has recently adopted, World Bank estimates that reserves will be depleted by July. The World Bank expects that the government will cut back spending by, at most, a quarter against current levels. At this rate of spending, the government's fiscal reserves are expected to last until July 2012 at which point state collapse becomes a real possibility. Even if some of the more draconian measures which are being discussed are adopted, reserves will hold only through October.

Monthly Expenditure (million SSP)	**Reduction in Monthly Expenditure** *(percentage)*	**Depletion of Reserves**
880	0	June 2012
750	15	July 2012
650	26	August 2012
500	43	October 2012
350	60	February 2013
200	77	December 2013

Social Impact

6. In addition to the economic consequences, the shutdown will lead to a rapid reversal in key development gains that have been achieved since the signing of the CPA. These include:

    Increased Poverty: The proportion of the population living in poverty is likely to rise from 51% in 2012 to 83% in 2013 (as compared with 90% in 2004); in gross numbers 3.6 million additional people are likely to fall below the poverty line

    Higher Child Mortality: The under-5 child mortality rate is likely to double from 10% of live births in 2012 to 20% of live births in 2013 (as compared with 25% in 2004)

    Lower School Attendance: Enrollment rates are likely to drop from 50% in 2012 to 20% in 2013 (as compared with 20% in 2004)

7. One of the most dramatic consequences will be deepening food insecurity linked directly to spiraling inflation. Drawing on WFP data, the World Bank dismissed the idea that the large segment of the population which does not participate in the cash economy will be insulated from the impact of the shutdown. This is an argument which the government has made

since the decision to shut-down production. Mr. Giugale pointed out that local production (including WFP food assistance) only accounts for 54% of consumption—the rest comes directly from food imports. Even the poorest households interact with the cash economy during the three-five month hunger gap through some form of trade, usually livestock. The terms of trade for livestock (goats and cattle) will depreciate sharply against imported staple food commodities, pushing millions of households out of the market and deepening food insecurity. This is likely to occur at the height of the planting and harvest season, with profound implications for the next two-three productive cycles.

Policy Options

8. Mr. Giugale pointed that government plans to expand non-oil revenues to cover part of the fiscal gap are not only unrealistic, they may be damaging to the economy in the short term and, even if the government manages to triple non-oil revenues as they project, their impact will be negligible. In his presentation to the President, Mr. Giugale discussed a number of policy options emphasizing:

   - the urgency of implementing severe austerity measures and immediately prioritizing expenditure;
   - the overriding importance of rapidly establishing social safety net programmess that provide direct transfers to the most vulnerable in cash or kind;
   - the difficulty of establishing alternative modalities for oil export;
   - the importance of screening external financing offers;
   - the impossibility of maintaining a fixed exchange rate.

Government Response

9. In their discussion with Mr. Giugale, the government reiterated its position that South Sudanese people have suffered for years and will be prepared to suffer again. They evidenced little understanding of the impact of the oil shutdown and insisted that they will find a way forward. The President was pre-occupied by food insecurity and the collapse of the pound. He noted the risk that unscrupulous financiers pose to the new state and was concerned that donors would "lose faith" in the government because of the decision.

10. Mr. Giugale said that the findings of the World Bank's analysis might help to strengthen reformers within the government and that civil service reforms that have been otherwise politically unviable could receive support. He cautioned, however, that this should not be assumed since the collapse of the economy is more likely to result in social and political fragmentation, unrest and instability. Although there may be increased incentives to expand agricultural production, he explained that the lack of infrastructure and need for imported inputs will almost certainly undermine growth in the sector.

Update on Government Austerity Measures

11. At a meeting of Undersecretaries and Donor Heads of Mission on 28 February, the Minister of Finance and Economic Planning formally presented the government's austerity measures to partners.

12. The Minister noted that a four-month Austerity Budget has been approved by Cabinet and will be implemented until the end of the 2011-2012 fiscal year. The budget foresees a 50% cut in operational costs and capital expenditure and a 10% cut in state block transfers. Salaries will continue to be paid in full and the total monthly spending for the remainder of the fiscal year will be SSP 650 million per month—a total cut of only 26 percent. Cuts will be made across all sectors, but will not be evenly split. Defense, education, and agriculture will be less affected. The Minister noted the importance, besides basic services, of maintaining security during this period.

13. The Minister explained that an Austerity Committee, chaired by the Minister of Finance, will continuously review measures for their effectiveness and relevance and will make adjustments where necessary to reflect changes in revenues.

14. The Minister noted that financing over the austerity period is expected to come from three sources: (i) increased non oil revenue generation; (ii) government reserves; (iii) external financing. The government is taking measures to revive oil revenues, including through construction of refineries and an alternative pipeline. He said that the first refinery is expected to be operational in 18 months.

The international community does not understand nor support the way the government is behaving. The Presidency needs to a) recruit specialists that can help to set a clear realistic strategy to get through the crisis; b) recruit public relations experts to communicate and explain the decision to shut-down production and the strategy the government will be following to deal with the consequences; c) recruit high level special advisors to manage relations with donor capitals and build international support during the crisis; and d) insist on a single message that puts the best light on the decision from all key officials. The Presidency also needs to address a) low motivation among public officials and b) the problem of vague loyalty. Both of these very sensitive problems are impacting on the functioning of the new government and are seen by the international community as indications of a government that has no focus, no strategy and no ability to communicate its goals.

- The reasons behind the decision to shut-down oil are not being explained clearly nor persuasively. This is leading to a deepening divide between the new government and its partners, upon which the RSS depends for political and economic support.

- The officials briefing the international community are sending mixed and damaging messages. For example, key officials have said that the aim of the shutdown is to bring down Khartoum—others have said that the decision was taken because the government is losing money anyway. Neither of these reasons is clear nor acceptable to the international community.

The Government is not being realistic in managing the implications of the shut-down. Experts from the UN and World Bank should be invited to come in and help advise the government on dealing with austerity and fragility. This would show that the government is serious and is seeking the best international solution to the problems it is facing.

- Simply saying that "the government can get through the crisis" is seen by the international community as unrealistic.

- Apart from vague guidance from the Ministry of Finance, there are no concrete directions or priorities for planning agencies. As it stands, it does not appear that any agency (spending unit) is seriously planning for the impending crisis. Agencies are not re-prioritizing or restructuring their budgets. There has simply been a flat, uniform cut of approximately 26%.
- The lack of serious attention to the implications for the population is deeply worrying and sends the message that the Government doesn't care about its people and is prepared to make them suffer for an unclear goal.

- This approach has the further problem of reinforcing the perception that the government is not behaving in a way which deserves the support of the international community. Donors have been asked to help cover the gap by supporting basic services. They are increasingly unwilling to do this or support any other aspect of the government's aid strategy.