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How USAID Has Initiated and Encouraged
Economic Policy Reform in the Sudan

by

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I. Introduction

This paper describes the areas in which the Mission has been involved in policy dialogue and reform. The nature and purpose of the dialogue/reform process are also discussed. In the second part of the paper, an attempt is made to generalize our experience and the lessons learned as a result of discussions of policy issues and reform measures with senior government officials.

II. The Process of Policy Dialogue and Reform

A. The PL 480 Program

Our role in economic policy reform in the Sudan has evolved from our PL 480 program. Annually over the past three years the USG has provided Sudan with US$ 50 million in PL 480 wheat. In 1982, it was generally believed that bread consumption was increasing at the rate of about 10-15 percent per annum, although the consumption of bread was largely an urban phenomenon. The food grain of the Sudan has been white sorghum in the form of a spongy, flat bread known as "kisra".

Imported wheat at the time was clearly beginning to replace sorghum as the basic food grain at least in the growing urban areas. It appeared to me that a consumption pattern was beginning to emerge that would in the short run increase the dependence on wheat imports, which Sudan could ill-afford. In 1982 Sudan was facing a trade-gap of LS 600 million[1/], a growing external debt of $5 billion and a budget deficit of LS 350 million. It was believed that Sudan had a comparative advantage in the production of sorghum, but a comparative disadvantage in the production of wheat. The share of domestic wheat in total

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1/ US $1.00 = LS 1.30 at the official rate of exchange. At the time the commercial bank rate was $1.00 = LS 1.80. On October 21, 1984 the Bank of Sudan adjusted the commercial bank to LS 2.10.

wheat consumption was declining due to the growth in consumption.

We were aware that PL 480 programs in many LDCs have been criticized as creating production disincentives, permitting governments to pursue subsidized food policies which favored urban consumers over rural producers, and increased the claim on scarce foreign exchange balances for food imports to satisfy new consumption patterns developing in urban areas. Given the circumstances surrounding a potential policy issue, I decided to investigate the economic context in which the USG was providing such massive aid through the PL 480 program. Since the Sudan had an overvalued exchange rate and the nominal bread price appeared to be "artificially cheap", it struck me that bread pricing was a critical issue which should be an analytical priority of the Mission Agricultural Economist.[1/]

I then set out to assemble more detailed data on imports, domestic production, and wheat utilization. I also obtained data on the wheat/bread cost-price structure. It soon became clear that bread consumption was being significantly subsidized, maybe as much as 25-30 percent.

The situation was outlined to the Agricultural Development Officer, the Deputy Director and the Mission Director. A case was made to pursue a policy dialogue with the appropriate government policy makers to adjust bread prices with the aim to eliminate the budget subsidy. The Mission Director supported the idea and gave the direction to proceed with the analysis.

Discussions were held with officials of the Ministry of Commerce, Cooperation and Supply (MCCS), the government body responsible for importing

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1/ I was the Mission Agricultural Economist from December 1981 to October 1983.

wheat and establishing the administered prices within the wheat/bread marketing system. The actual detailed cost-price structure was established. The point of subsidy was identified and the magnitude calculated. The explicit budget subsidy was calculated to be approximately $30 million at the prevailing official exchange rate.

The facts were presented to the Mission Director who then requested that I present my analysis and a justification for pursuing the elimination of the budget subsidy at the next meeting of the U.S. Mission Economic Council.[1/] This was done. However, the appropriateness of including the measure as a PL 480 self-help measure was questioned on political grounds. The issue was, could the government withstand a bread price increase of the necessary magnitude? Time was required to consider the potential political impact and whether the USG wanted to be responsible for the resulting bread price increase. In the end the Ambassador decided that USAID should not pursue the proposed price change.

It was back to the drawing boards. I decided that I had made a strategic error ... positive economics could not be sold to the Ambassador. It was clear an alternative approach was required: a political economy framework. Fortunately, Professor Carl Gotsch, a well-known economist on the Faculty of Food Research Institute at Stanford University, was being engaged at the time by the Mission as an economic consultant to review agricultural policy in the Sudan. Professor Gotsch reviewed my analysis and identified how it could be reconstructed into a political-economic framework. While the basic economic analysis was not altered the presentation was recast to give more weight to the salient political trade-offs. Gotsch presented the case to the Ambassador at the

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1/ A combined USAID/Embassy forum for economists to discuss issues with the Ambassador. With the arrival of the new Ambassador the Council has become the "AID/ECON Meeting" where the Ambassador discusses current issues with the USAID Director.

next U.S. Mission Economic Council meeting. At the end of the meeting the directive of the Ambassador was to proceed.

After five negotiating sessions which centered on the cost and benefits of budget subsidies, problems associated with excess demand, domestic production disincentives, opportunity costs of the subsidy, shifts in consumption patterns toward imports, impacts on the claims for foreign exchange, the bread price and the consumer price index, and potential consumer reactions, the government decided to remove the $30 million bread subsidy. The price adjustment was made during July 1983, without political repercussion, by reducing the size of the loaf from 320 to 230 grams.

Having encouraged the government to remove the budget subsidy on bread, the next logical step was to tackle the implicit foreign exchange rate subsidy. This was a relatively straight forward calculation resulting from a divergence between the overvalued official exchange rate ($1.00 = LS 1.30) and the commercial bank rate ($1.00 = LS 1.80). The calculations revealed, however, that a hidden tax was built into the wheat/bread cost-price structure due to an 18% inflated C.I.F. price for wheat. Our analysis took account of the overvalued exchange rate, recent changes in transport, milling costs and baking margins and the impact on the price of the end-product with and without alternative rates of tax (12 and 18%) built into the C.I.F. price of wheat. Our analysis also accounted for alternative weights (loaf-sizes) and nominal prices. The analysis, therefore, was able to identify the trade-offs between (1) nominal prices, (2) size of loaf, (3) alternative shadow exchange rates, and (4) the level of tax built into the C.I.F. price of wheat. At the end of the negotiations the Minister of Commerce decided to hold the nominal price fixed, reducing the size of the loaf (from 230 to 170 grams) and the C.I.F. tax built into the pricing structure.

This agreement to eliminate the implicit foreign exchange rate subsidy was a self-help measure under our FY 84 Title III ($30 million) Program, signed during December 1983. The price increase took place during July 1984.

While undertaking the initial analysis to quantify the implicit foreign exchange rate subsidy it became evident that imported wheat would turn out to be priced higher than domestically produced wheat. On the surface this appeared to be a desirable policy result. However, it was known that domestic wheat producers enjoyed factor subsidies and that the commodity price appeared to be less than the opportunity cost of importing wheat. Consequently, I requested one of our economists on our Agricultural Planning and Statistics Project to undertake an analysis of wheat pricing and cost of production to determine what the import parity price of wheat would be at the prevailing commercial bank foreign exchange rate. In short, the study revealed the need to improve the financial incentives of wheat producers and increase the price of domestically produced wheat.

Import parity pricing for domestically produced wheat was thus included in the negotiations. The aim was to achieve comparable prices for domestically produced wheat and imported wheat based upon import parity at the free market exchange rate. The government agreed to adjust the domestic wheat price on the basis of the study for the 1983/84 crop production season.

While we believed we were making progress on wheat pricing by eliminating both explicit budget and implicit FX subsidies, we came to the view that due to the price elasticity of demand for bread (inelastic) we were not likely to achieve much progress on dampening the demand for imported wheat. The aggregate demand for wheat flour and consequently wheat bread still appeared to be increasing at an annual growth rate of not less than 10 percent.

During the period 1975-79 the Food Research Center of the University of Khartoum had undertaken a pilot project on the technical feasibility of milling composite sorghum/wheat flour for bread making. The pilot project perfected sorghum milling and composite flour blending and the new baking technology. In addition, the project demonstrated that substituting sorghum for wheat at a rate of 10-15% did not create technical problems in baking or detectable consumer reaction. The food technologists at the center had demonstrated that a 25% rate of substitution was technically feasible.

We decided in consultation with the Food Research Center to include the adoption of sorghum/wheat composite flour for commercial bread making as a self-help measure. The Sudanese decided that we should conduct an economic feasibility study of composite flour. The results were to be available in time for negotiations for the next PL 480 agreement.

Through our Agricultural Planning and Statistics Project we obtained a sorghum flour milling engineer, the food technologist who had previously been the project manager of the University of Khartoum composite flour pilot project and Professor Carl Gotsch of the Stanford Food Research Institute. The economic feasibility study was conducted by the three consultants in collaboration with Sudanese millers, Food Research Center scientists and Ministry of Commerce officials. The main conclusions of the study were that at prevailing relative prices of sorghum and wheat, that with composite flour (1) the price of bread, would not be lowered significantly, (2) the potential savings for Sudan would be $10-15 million dollars per annum in foreign exchange for wheat imports during the early stage of the adoption of composite flour, (3) millers could obtain a good return on their investment in modern sorghum mills and blending equipment and (4) given the limited export market for Sudanese sorghum,

would offer sorghum producers a potentially large domestic market for their crop.

The study was discussed with Ministry officials and included on the agenda for the next PL 480 negotiations. At the next session on self-help measures it was agreed to conduct a commercial trial of composite flour among private sector bakers over a 6 month period during CY 1984. The University of Khartoum Food Research Center agreed to mill the sorghum flour, blend the wheat and sorghum flours and distribute the resulting composite flour to the bakers participating in the commercial trial. The Center also agreed to provide technical and managerial supervision of the trial. USAID agreed to provide local currency support for the trial including the cost of procuring and blending the composite flour. The trial is just now getting underway.

During late May 1984, we formulated the self-help measures for our FY 84 Title I ($20 million) agreement. The focus of our self-help measures was to go beyond the wheat production-consumption sector for the first time.

Some earlier work done by myself and others indicated that import parity was not a principle being followed in agricultural pricing policy in the Sudan.

Some preliminary calculations revealed that farmer-level prices were within the range of 32-60 percent of the border price. The analysis further revealed that an existing implicit foreign exchange rate tax was being applied to agricultural exporters. Agricultural exporters were being paid in Sudanese pounds on the basis of an overvalued foreign exchange rate conversion formula. They are being paid LS 142 per $100 F.O.B. value for their exports as opposed to LS 180 if the conversion into local currency had been based upon the free market, commercial bank rate. This amounted to a tax of 21% on the exporter, which was being passed on to the producers of agricultural exports in the form of lower prices.

Given Sudan's need to increase agricultural exports and foreign exchange earnings and financial incentives for exporters and producers, we decided to propose self-help measures that would tackle the economic distortions resulting from the overvalued exchange rate applied to agricultural exports.

During the first negotiating session with officials of the Ministry of Commerce, Cooperation and Supply we confronted surprise that we desired to expand our PL 480 policy dialogue beyond the wheat sector. We explained that PL 480 Title III legislation was not commodity specific, but more general and encouraged broader analysis of sectoral issues which could result in self-help measures broadly defined to encourage "rural development". We were also told that farmers in the traditional sector did not require higher prices, and if they were to receive them, they would produce less (the "backward bending supply curve" revisited)!

After some discussion the Ministry informed us that the GOS could not negotiate import parity pricing with USAID, since our discussion involved exchange rates. The government's position was that this type of discussion could only be held with the IMF.

We did not accept this position on the grounds that import parity pricing had in fact been the basis for the earlier self-help measure which eliminated the implicit FX rate subsidy on imported wheat and, in part, the basis for increasing the price of domestically produced wheat. We took the position that economic analysis and policy formulation cannot be undertaken without consideration of the exchange rate, particularly when Sudan has a multiple exchange rate regime, with a significantly overvalued official and commercial bank rate.

We revised our approach to propose price increases (we were focusing on oilseeds and gum arabic produced in the rainfed sector) by determining the percentage that auction market prices would increase to achieve import parity at the free market exchange rate. This approach was to "avoid" the exchange issue. However, for our next session with the government the Ministry engaged the assistance of the Deputy Governor of the Bank of Sudan, the State Minister of Finance and the Under-Secretary of Economy to make the case that import parity pricing, which out of necessity involved exchange rate issues, could not be discussed with a bilateral donor. Again we heard arguments in favor of not increasing producer prices given the view that financial incentives were adequate; or, if paid higher prices, farmers might produce less. However, in the end agreement was reached that focusing upon percentage increases of auction market floor prices could be the basis for further dialogue. Working in collaboration with the Ministry, up-dated estimates of production costs, returns to farmers, marketing costs and export prices were prepared. Analysis was undertaken to determine what farm level prices would have to be if farmers were paid a price which would reflect export parity at the higher commercial bank rate. In the end the Ministry agreed upon a 25% increase in the auction market floor price for oilseeds (groundnuts and sesame) and gum arabic.

The final self-help measure agreed to during the FY 84 Title III negotiations was the involvement of the private sector millers in inland transport. Up until now inland transport has been handled by public sector entities, often with great delays in handling and distribution and at higher costs than prevailing within the private sector trucking industry. Also, it was agreed that the private sector millers would be allowed to participate directly in the international procurement of wheat. The aim of this reform was to capture potential efficiencies that could be realized by the private sector and to give the millers the opportunity to control their raw material supply and supply-price. Our discussions with private sector millers indicated that they had a strong interest and financial ability to undertake these tasks. They also indicated their intention to form a millers' federation with its own equity which would operate under Company Law. The millers believed that they could achieve economies of scale and would have the financial incentives to lower cost of procurement, inland transport and consequently raw material (wheat) supply. Turning over these functions to the private sector will pave the way for getting the government out of the direct wheat import business, thereby releasing government officials to pursue other legitimate functions of a Ministry of Commerce.

B. Petroleum Import Facility

1. Background

Without doubt, petroleum is the single most critical imported commodity influencing Sudan's productive capacity today. Petroleum constitutes 25 percent of the import bill. The problem the country faces with respect to procuring petroleum is the result of trade deficits and uneconomic credit arrangements that have made the management of scarce foreign exchange difficult and long term planning impossible.

The government attempts to control petroleum consumption through geographic allocations and rationing while holding retail prices below international prices. Shortages occur due to excess demand at prevailing prices and the black market thrives. This results in production losses, reduced exports and a further constriction of the supply of foreign exchange.

In 1982 and 1983 Sudan paid $60 million over world prices for its petroleum imports. Because Sudan could not meet obligations under a $9 billion debt, it lost access to normal international commercial credit. Therefore, the government was compelled to deal with petroleum dealers who were prepared to take unusual risks for unusual profits. High administrative fees and exorbitant interest rates were charged. To obtain its petroleum, the Government of Sudan has taken to pledging cotton futures, which were often heavily discounted.

The debacle has been administered by a public sector corporation which imports, prices and allocates fuel administratively. The four petroleum companies operating in the Sudan -- Shell, Mobil, Total and Agip -- are only permitted to distribute. Misallocation is chronic. Illicit sales at the wholesale level are habitual. A black market rages along, with prices at two to three times the administered level. Outlying regions are plagued by constant shortages. Public sector entities are favored in allocation. Difficulties with allocation result in economic inefficiencies that could push total losses to $100 million annually.

2. Objectives

The idea of a Petroleum Facility first was discussed with the government when President Nimeiri visited the U.S. in November 1983. At the time it was decided to try to find a new system to overcome Sudan's fuel shortages and high cost procurement practices. At the Consultative Group meeting in December 1983, discussions were held to determine how Sudan could overcome its problems with importation, allocation and internal distribution. USAID was asked to work out the establishment of the Facility with the Government of Sudan and to coordinate donor support. The purpose of the Facility is to help assure a sufficient and reliable supply of petroleum purchased at world prices and to establish an efficient system of financing, procuring, importing, allocating and distributing petroleum products for the Sudanese economy.

3. Nature of the Reforms

The Petroleum Facility calls for all fuel to be purchased under competitive bidding from prequalified bidders. This procedure is expected to save the Sudan $60 million per year in petroleum imports, or will permit approximately a 17 percent increase in supply. Planning will be done under the auspices of a committee of representatives of the General Petroleum Corporation, the Bank of Sudan and the four private petroleum companies. The private companies will import and have a voice in making regional and institutional allocations. No special allocations will be allowed individuals at the wholesale level as has been the case. An added reform was to move the pricing of diesel off the overvalued official exchange rate (LS 1.30/$1.00) and price diesel at the higher free market rate to reflect international prices. The savings in dollars was to be used to increase the importation of diesel, considered to be the fuel of the economy.

Financing will be through a special fund to which donors and the Bank of Sudan would contribute. Sources of funding for the first year were anticipated to be as follows:

	(million)
Saudi Arabia	$ 60
United States	40
Other Donors	15
Sudan	205
Private Petroleum Companies (Commercial Credit)	40
	$360 1/

With this level of financing, the supply of petroleum products can be increased by as much as 17 percent.[2/] Or, if the savings were used for only diesel, the supply of diesel could be increased by about 30 percent.

The funds from the petroleum companies are expected to be in the form of forward financing of 90 days. Because this financing will roll forward as supplies are received, for the first year it will constitute a net resource. In order to induce this financing, the U.S. contribution will be held approximately 9 months as a guarantee. Should Sudan prove unable on any occasion to pay for petroleum, the guarantee could be used to meet any obligation incurred under forward financing. During the final quarter of the year the U.S. funds could be used to purchase petroleum. The Petroleum Facility is the first occasion upon which AID funds have been used in the Sudan to leverage a financial arrangement with the private sector.

1/ The USG support is intended to be for 3 years. The facility is also intended to be a device to improve the allocation of foreign exchange of the Bank of Sudan, with the ultimate objective to get petroleum purchases out of the Bank of Sudan and petroleum off the official exchange rate.

2/ Since Sudan's petroleum import bill was about $360 million, and unit import prices would be internationally competitive, the savings would permit the Sudan to procure more fuel.

The petroleum initiative will require that significant changes be made in the internal allocation and distribution system. Initially, gasoil (diesel fuel) will be removed from the allocation system and the present mechanisms and procedures for such allocation eliminated. Marketing companies will then assume responsibility for competitively determining and satisfying customer demands. The facility will import sufficient quantities to meet this demand.

This reform will insure that economic priorities are satisfied first, as gasoil is consumed almost exclusively in the productive transport, agricultural and industrial sectors. In addition, the reform will greatly reduce the size of the allocation program (as gasoil accounts for over 50% of consumption) thereby assuring greater efficiency in internal distribution and eliminating a major source of black market activities. In order to assure a reasonable level of consumption, GPC will be called upon to adjust prices upward, to the world market level.

4. Implementation

AID has obligated $40 million from our FY 84 C.I.P. program as our first annual contribution. The Dutch Government has already contributed about $5 million and the Saudi Arabian Government ahs indicated a willingness to contribute $60 million pending an operable IMF Standby Arrangement with the GOS. However, what is holding up the implementation of the facility is, an acute foreign exchange shortage, and the fact that the GOS cannot make its initial GOS contribution. The GOS was to contribute $55 million. Now it is not expected that the government will be able to do so before December or January 1985. However, the structural, legal and operational aspects of the facility are in place pending the first financial contribution of the government. And the four oil companies operating in the Sudan are awaiting the establishment of the facility.

The policy reform regarding the removal of the subsidized diesel price is currently part of our on-going policy dialogue with tentative targets established for the price adjustment.

C. AID's Macroeconomic Policy Reform

1. Introduction

Five factors pulled USAID into a direct involvement with macroeconomic policy issues, and eventually reform. These were (1) a deteriorating economy and an increasingly overvalued exchange rate with the consequent distortions giving the wrong signals to the economy, (2) conceptual and analytical issues which forced us to deal with the exchange rate issue, (3) magnitude of our economic assistance to the Sudan (presently $200 million) which required us to consider whether or not our assistance program could have the desired impact given present government policies, (4) the fact that the IMF was unable, on its own, to achieve the planned economic reform under its 1984 standby and (5) the increasing resident capability of the mission in terms of economic expertise.

In addition, in our FY 86 CDSS we clearly stated that the Mission was initiating, in July 1984, a macroeconomic policy dialogue with the government. As stated in the CDSS a movement toward the free market foreign exchange rate would favor the private sector and eliminate the exchange rate advantage the public utilities were enjoying. The private sector only had limited access to the commercial bank rate LS 1.80/$ and was forced to obtain most of its foreign exchange at the black market rate, LS 2.30/$. On the other hand, government entities were obraining their foreign exchange at the official rate, LS 1.30/$1.

2. Background

From a macro perspective the performance of the Sudanese economy has continued to deteriorate over the past several years despite a few hopeful reforms undertaken in the past two years. But the external debt has continued to increase and is now estimated to be $9 billion. Inflation is running at 25-30 percent. Merchandise imports are twice the value of exports, and the overall balance of payments gap continues to require major rescheduling of the external debt. Massive foreign aid flows are necessary to keep the economy afloat. The Central Bank is unable to finance petroleum imports without costly credit arrangements, nor is it able to keep up with arrears to the IMF and other major donors and regional monetary funds. The private sector has become confused by the state of emergency and with policy changes that have taken place over the past year as a result of Islamic Sharia Law and the changes in the Civil Transactions Act and banking regulations. The reinforcement of outdated administered prices has created severe shortages of many commodities. Remittances from Sudanese working abroad have greatly declined, undoubtedly due to the political climate and the uncertainty prevailing in the business community. Earlier in the year capital flight took place, perhaps as much as $30-40 million per month. The Sudanese pound continued to be increasingly overvalued.

Identification and analysis of implicit foreign exchange rate subsidies on imported wheat and petroleum, and the fact that the overvalued exchange rate was built into the pricing of domestically produced commodities, forced us to deal with the major macro-price directing the economy (i.e., the exchange rate). Sudan could never achieve realistic import parity pricing, improve the structure of economic incentives and direct resources to their most efficient use without adjusting its overvalued exchange rate.

USAID Sudan has a $120 million C.I.P., a $50 million PL 480 Program and $25 million Development Assistance Account. It was questionable to continue assistance to an economy that was not guided by positive pricing policies, was becoming increasingly in debt and showed no positive sign of economic recovery. Thus, the Mission was forced to consider the economic policy environment to which the USG was providing such large levels of assistance. It soon became clear that the Mission could not leave macroeconomic issues entirely to the IMF/GOS relationship. We had a responsibility to our government and the U.S. taxpayer to determine how AID could assist the government in macro policy reform.

During July/August 1984, the GOS had not implemented reforms as required by the 1984 IMF Standby Arrangement.

In July the GOS was unable to pay $42 million in arrears it owed the Fund. Consequently, the Standby Arrangement became inoperable and drawings stopped. Consultations between the IMF and the GOS could not continue under Article IV.

We recognized the USG's commitment to the IMF as the principal mechanism by which international financial order is maintained between the industrial countries and the third world. The importance of the IMF in assisting the Sudan to restructure its economy, reforms its monetary and fiscal policies, and improve its balance of payments and foreign exchange earning capacity is recognized within the donor community. The question we asked ourselves was: How could the GOS/IMF relationship be reconstructed

We undertook a rough analysis of the cash flow situation facing the Bank of Sudan, including foreign debts coming due over the next six months. It was clear that the Central Bank would be unable to pay its arrears to the IMF before January 1984.[1/2/] Under the circumstances the GOS was not likely to undertake the needed reforms or have an operable Standby until some time during the first quarter of 1985.

1/The arrears to the Fund would increase from $42 million in July 1984 to $82 million by January 1985.

2/During July, the GOS was faced with a major decision. Whether to pay the arrears to the Fund or put its first contribution ($30 million) into the USAID sponsored petroleum facility. It made the difficult choice in favor of the facility, but was soon unable to make the payment because of its inability to monetize cotton export contracts. Thus, as it turned out, it would not have been able to pay the Fund arrears in any case.

Over the past year USAID was obligating and disbursing large sums of economic assistance. In addition, it was taking the lead role to help the government establish a $360 million petroleum import facility. It was estimated the facility would save the Sudan $40-60 million dollars annually. While USAID was achieving important marginal economic reforms through our PL 480 program, the IMF was clearly not making progress with required macro reforms in the areas of the exchange rate adjustments, credit expansion, restraint on government expenditures, private sector incentives and export promotion. USAID was thus forced to consider the costs and benefits of a possible 6-8-month delay in the necessary reforms.

3. The Beginning of Our Involvement

When it became clear that the IMF Standby was about to collapse the USAID Director took the position that it was necessary to initiate a macroeconomic policy dialogue with the GOS. Discussions were held on exchange rate issues with the Governor of the Bank of Sudan. We attempted to discuss budget and credit issues with the Minister of Finance. Initially both the Governor and the Minister took the position that macroeconomic issues, particularly exchange rate and budgetary issues[1/] could not be discussed with a bilateral donor. The GOS took the position that macro conditionality could not be a covenant in our C.I.P. agreement. However, the government eventually agreed to foreign exchange rate adjustments in principle. We tied our remaining FY 84 C.I.P. ($62 million) to macro policy reform, and our assistance to the petroleum facility to gasoil pricing, with disbursements tied to specific agreements on reform.

1/ It was in fact an inappropriate time to discuss budget issues with the Minister of Finance because the new budget was in preparation. In addition, the Ministry was also preparing its new budget in line with recently imposed Islamic (Sharia) Law which was to abandon "conventional" mechanisms of generating government revenue and instituting new sharia taxes.

In discussions with the government it was made clear that USAID was serious about macro reform and conditionality. The Governor of the Central Bank knew he had to act on the economy's overvalued exchange rate regime and we attempted to identify the adjustments which could be justified both economically and politically. Our discussions centered on the nature of the distortions and their impacts on the economy.

It soon became apparent that the Governor was considering a sequential process to exchange rate reform, one which would achieve alignment of the official and commercial bank rates within 10 months but with significant adjustments up front.

As a result of our discussions with the Governor we focused on adjustments of the official and commercial bank rates and the 75/25 foreign exchange conversion formula used to value in local currency agricultural export earnings. These were principal items in the IMF Agenda when the standby was suspended. We proposed:

(1) the immediate adjustment in the Commercial Bank Rate,

(2) alignment of the official and the free market rates not later than May 1985, and

(3) the immediate movement on the 75/25 FX conversion formula with the objective to abolish it by May 1985. The aim was to stimulate export promotion and eliminate both commodity and factor price distortions within the agricultural sector.[1/]

1/It may be useful to briefly describe these two issues as they illustrate the policy issues we have been dealing with in the Sudan and the role of in-house economic analysis in the policy dialogue process.

An in-house analysis of the 75/25 FX conversion formula was undertaken to form the basis for our further detailed discussions. We also undertook a comprehensive study of gasoil pricing with the aim to eliminate the subsidy and reduce the excess demand which were creating both fuel shortages and major claims on Sudan's meagre foreign exchange earnings.

4. The Foreign Exchange Rate Conversion Study 1/

At the time the study was undertaken Sudan was pursuing a policy of implicitly subsidizing inputs for the public agricultural schemes and taxing exporters of all agricultural commodities by way of an effective exchange rate (US$ 1.00 = LS 1.425) 2/ significantly below the commercial bank rate. Thus, Sudan had not passed on to exporters and producers costs and benefits of the last devaluation. The result was the dampening of incentives, particularly in light of domestic inflation, and permitting factor-price distortions to continue, thereby not encouraging export promotion or efficient utilization of imported inputs.

It was our view that these distortions were aggravating the Sudan's economic recovery program. The trade gap was widening, external debt increasing, and the government was running a large persistent budget deficit. Inadequate foreign exchange was available to pay for essential imports and costly credit arrangements were being pursued to finance a large petroleum import bill.

1/"An Evaluation of Sudan's 75/25 Foreign Exchange Rate Conversion Formula", by F.E. Winch (P. 29 plus tables).

2/The conversion formula works as follows: seventy-five percent of the foreign exchange was converted at the official rate (LS 1.30/$) and twenty-five percent at the commercial bank rate (LS 1.80/$).

On the other hand, a major source of foreign exchange is agricultural exports. Agricultural production has not increased appreciably in the last decade except for sorghum in the mechanized rainfed sector. Over the past two years production in the rainfed sector has declined due to the drought. Foreign exchange earnings from agricultural exports have not kept pace with import requirements or Sudan's foreign debt obligations.

Given the lack of response by producers to government policies, it was clear that agricultural pricing policies required investigation.

The purpose of this study was to evaluate the appropriateness of the effective exchange rate (US$ 1.00 = LS 1.425) used to value agricultural exports and to determine whether or not this exchange rate achieves sufficient producer incentives and the necessary export competitiveness for Sudan's major crops. The point of departure was an IMF paper, "Sudan: Competitiveness of Agricultural Crops" (August 1984).

A case is made that contrary to the conclusion of the Fund, the returns to management are not adequate and are based upon an inappropriate criterion. Alternative methods of calculating returns to farmers were evaluated. The analysis showed that net returns to the production of agricultural crops and export competitiveness are both highly sensitive to the returns imputed to the farmers' managerial skill in both the irrigated and the rainfed sectors.

A series of sensitivity analyses illustrating the effects of alternative exchange rates on production incentives and export competitiveness were undertaken. The objective was to identify the impacts of pricing policies which reduce or eliminate the overvalued exchange rate used to price export commodities and imported inputs. Repricing on the basis of a more reasonable exchange rate could eliminate the heavy implicit foreign exchange tax burden on agricultural exporters and the implicit foreign exchange subsidies currently provided to producers using imported inputs (largely the public sector irrigated schemes).

When the IMF's original imputed return to farmers (which is based upon farmer's off-farm opportunity costs as a skilled worker in urban areas) was used in the calculations, a foreign exchange rate of not less than US$ 1.00 = LS 2.00 (i.e., 100 percent at this rate) is required for all but one crop to achieve the desired competitiveness coefficient. 1/

Our sensitivity analysis revealed that at an exchange rate of US$ 1.00 = LS 2.00 or higher, strong financial incentives, significant profits and the necessary export competitiveness could be achieved for Sudan's principal export crops. If the government were to abandon the foreign exchange rate conversion formula and price commodities and imported inputs at international prices as reflected by a more appropriate exchange rate, present implicit foreign exchange rate subsidies on imported inputs and the implicit taxes on commodity export prices could be eliminated, and at the same time provide attractive incentives to farmers. Pricing policies based upon international prices and a real exchange rate could produce

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1/The term "competitiveness" as used in IMF analytical framework, is used in a restricted sense. It does not relate directly to Sudan's capacity to compete in world markets. However, the competitiveness coefficients do reveal whether or not it would be profitable to produce a commodity for export, given world prices, imported input requirements and prices, domestic resource costs, an implied production function and an exchange rate to link domestic and international values. It is thus a domestic index of export competitiveness among Sudan's crops. If the coefficient of competitiveness is less than the exchange rate, the commodity is profitable for export oriented production.

a desirable policy result; a policy whereby producers, exporters and the government treasury could all benefit. In the intermediate run the added gains should translate into greater output and export earnings.

The original IMF analysis was extended in the USAID study to consider net foreign exchange returns to imported inputs. The analysis shows that irrigated cotton earns by far the least amount of foreign exchange per unit of foreign exchange invested in imported inputs of all the crops included in the study.

The analysis further shows that reducing the area devoted to the historic crop, cotton, and increasing the area in groundnuts on the large Gezira scheme would result in greater foreign exchange earnings (LS 6 million) and a substantial savings (LS 93 million) in imported input requirements.

The additional area that could be put into mechanized sorghum production was calculated, given the savings in traded and non-traded inputs that would result from reducing cotton and increasing groundnut production in the Gezira scheme. The analysis illustrates that such an expansion of mechanized sorghum production would require a relatively small amount of the savings realized from the above shift and would generate an international value added of about LS 25 million.

The following are the major conclusions of the study:

(1) The effective exchange rate used to value in Sudanese pounds agricultural exports (US$ 1.00 = LS 1.425) is inadequate to achieve attractive financial incentives to either exporters or producers.

(2) The exchange rate required to achieve export competitiveness is highly sensitive to the returns to farmers (the imputed return to producers' management function).

(3) If attractive financial incentives are to be provided to exporters and producers in the irrigated and rainfed sectors, the effective exchange rate used to value output and traded inputs should be not less than US$ 1.00 = LS 2.00.

(4) Removing existing input and commodity price distortions via the exchange rate will not only generate attractive returns to producers, but also give significant scope for explicit tax revenues.

(5) By reducing its dependence on irrigated cotton as the major source of foreign exchange and increasing the area devoted to groundnuts in the irrigated sector, Sudan would earn more foreign exchange and greatly reduce the requirement for imported inputs.

(6) If a small proportion of the savings realized from reducing the area devoted to cotton and increasing the area under groundnuts in the Gezira scheme were invested in mechanized rainfed sorghum production, substantial returns would be realized.

(7) The overall conclusion is that Sudan's agricultural pricing policy needs to be revised immediately to reflect the real cost of inputs to the economy and the real value of the commodities produced. This would encourage farmers to increase production, thereby permitting the Sudan to significantly increase foreign exchange earnings.

5. The Study on Re-Pricing Gasoil 1/

One of the issues raised during the negotiations leading to the establishment of the petroleum facility was the covenant proposed by USAID for the GOS to eliminate the subsidy on diesel. The GOS did not want to eliminate the subsidy because of concern about the impact such a reform would have on cost of agricultural production, particularly in the irrigated sector.

USAID agreed to undertake a study to address the issue. Economists in the Agricultural Planning and Statistics Project carried out a study of

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1/Re-pricing of gasoil (diesel) and its effects on agriculture, by W. Bateson and S. Sidhu p. 42). "Gasoil" is diesel.

diesel pricing in order to quantify the impact of price increases on the cost of production on a crop-by-crop basis. The study focused on determining fuel's factor share in agriculture production in both the public and private sectors.

The analysis quantifies the diesel supply problem. It shows that the real value of revenue from diesel sales is only adequate to replace 60 percent of the quantity sold, given the nominal gasoil price and the price of foreign exchange. It also estimates net losses due to inadequate supply at over LS 100 million for the agricultural sector in 1983.

A sensitivity analysis estimates what the wholesale and retail price increases of diesel would have to be if import parity pricing were to be adopted at alternative shadow rates of exchange. An analysis of the black market price for diesel showed that prevailing prices in this market are based upon an implicit FX rate of LS 4.95/$. (against a commercial bank rate at the time of LS 1.80/$ and a free market rate of about LS 2.30/ $1.00). The study shows that the impact of diesel price increases will be fully felt by the public sector where the effective diesel price is the subsidized administered price. It explains why the impact will be less in the private sector since the import parity price will be less than the prevailing black market price. With diesel priced at import parity at LS 2.20/$), the percentage increase in farm prices necessary to cover diesel price increases at import parity was calculated. However, the increases in production costs that would result from pricing gasoil at import parity were found to be much less than had been expected - a maximum of 9 percent in the irrigated sector and less than 5 percent in the rainfed sector.

The main conclusions of the study are the following:

(1) The petroleum facility could save Sudan about $60 million in petroleum imports which if devoted to additional supplies of diesel could increase the supply by up to 30 percent.

(2) Since diesel sales revenue is not sufficient to replace the quantity sold it is necessary to price diesel at its real replacement cost or import parity price.

(3) The real import parity price should be based upon the shadow foreign exchange rate of LS 2.20/$. This would translate into a 90 PT (54 percent) per gallon diesel price increase.

(4) Increases in the cost of agricultural production resulting from pricing diesel at import parity will be manageable. For most crops the necessary price increases will be less than 5 percent. For cotton produced on the pump schemes, the necessary producer price increase will be less than 10 percent. For the private sector without access to sufficient gasoil at the official rate, the cost of production will actually decline.

(5) Without supply security there can be no effective price stability for diesel users, since the present pricing structure does not return adequate revenues to replace diesel consumed.

(6) To achieve adequate supplies of diesel, security of price and supply, and increased agricultural production and foreign exchange earnings, it is necessary that the government assure:

- adequate allocation of foreign exchange to the petroleum facility,

- adopt import parity pricing of gasoil at the free market foreign exchange rate, and

- a tax on diesel if supply and demand for gasoil do not come into equilibrium.

6. The Role and Usefulness of these Studies

During our discussions with senior government officials we were able to identify the issues they wanted to evaluate. These included magnitude of changes, impacts of proposed changes, how incentive structures would be altered, and relative costs and benefits, including the incidence of costs and benefits. It was clear that policy makers required quantitative analysis and identification of the trade-offs, including the cost of inaction versus the benefit of reform. These studies provided this type of information and gave analytical as well as conceptual substance to our policy dialogue.

When these studies were presented to the GOS they were seized upon by the policy makers. The Governor of the Central Bank carefully went over the study on the exchange rate conversion formula and spent two hours discussing the findings with us. It suggested drastic changes away from current policy and reached what many government officials considered radical conclusions. After studying the analysis, the Governor initiated policy reforms that were clearly tied to the main conclusions of the study.

On the diesel study, it was the Finance Minister of State who spent several hours with us going over the study. The analysis showed how the economy would benefit from raising diesel prices, a conclusion officials have been loath to accept. The government has not yet moved on diesel prices but the State Minister made it clear that he knows they will have to do so. (It is clear the Minister will also use this study as his basis for the anticipated reform on diesel pricing.)

The importance of our studies and the credibility they achieved for us was clearly demonstrated on October 19, 1984. The Governor of the Bank of Sudan called us to his office to outline both the exchange rate and credit policy reforms he was going to announce on October 21, 1984.

In our discussions with the Governor of the Bank of Sudan and the State Minister of Finance we pointed out the important policy linkages between our two recent studies. Namely, if the government were to abandon the 75/25 FX conversion formula for the pricing of agricultural commodities (moving from LS 1.42/$ to LS 2.10/$) such a movement would not only cover the increase in production costs that would result from pricing diesel at import parity, but would also result in price increases sufficient to eliminate the foreign exchange rate subsidies for all other imported inputs involved in agricultural production. In addition, financial returns to producers would be substantially improved, not to mention the increased returns to be realized by agricultural exporters.

7. Reform

On October 21st, the Governor of the BOS adjusted the commercial bank rate from 1.80 to 2.10 (16.7% increase). In addition, for purposes of pricing exports the 75/25 FX Rate Conversion Formula was abolished for all crops except cotton and gum arabic. The effective exchange rate was thereby increased from US$ 1.00 = LS 1.42 to 2.10 (47.9% increase). For cotton and gum arabic the 75/25 formula was maintained thereby increasing the effective rate for these crops from 1.42 to only 1.51 (since 25 percent would now be converted at the new commercial bank rate).

As a result of these price reforms the GOS has provided, with the exception of cotton and gum, substantial incentives for increased production and foreign exchange earnings.

However, for cotton the minor increase in the price is not an increase in real terms given domestic inflation. In fact, the structure of incentives within the irrigated schemes will shift radically away from cotton since farmers will earn substantially more by producing groundnuts. There will also be incentives to divert imported inputs intended for cotton to other crops or the black market and to divert labor away from cotton to groundnuts. Consequently, cotton yields could be expected to decline unless cotton is also moved off the formula.

We have pointed out these facts to both the Governor and the State Minister. We have also explained that the government now has an ideal opportunity to price imported inputs within the irrigated schemes on the basis of import parity at the new 2.1/$ rate. We have urged the State Minister of Finance to adopt the 2.1 rate for cotton, for both inputs and product, thereby removing the remaining economic distortions, realigning the inter-crop structure of incentives and paving the way for the required gasoil price increase. The Governor indicated he would take cotton off the 75/25 rate when the Ministry of Finance decides to price imported inputs at import parity. The State Minister agrees there should be only one exchange for inputs and outputs alike and one rate for all crops. The next action is thus with the Ministry of Finance. Both the Ministry of Finance and the Bank of Sudan agree that there should be a unified rate somewhat above 2.10.

We have encouraged the GOS to move on cotton and gasoil pricing. We encouraged the GOS to eliminate the 1.30 official exchange rate completely with the aim to have only one exchange directing the economy, not later than May 1985. The government has thus initiated exchange rate reforms which can only improve the situation and the FX liquidity position of the banking system. More is required (e.g. a floating rate), but we are encouraged by the government's moves and strategy.

Now a great deal remains to be done on the budget and here we strongly believe the IMF should take an active role to assist the Minister of Finance to achieve a viable budget based upon realistic revenue collections and restraint on government expenditures, particularly in the area of extra-budgetary expenditures (credit to government entities).

Thus, a viable policy reform package is still not in place, but we are cautiously optimistic that some of the remaining economic reforms will be achieved in the coming weeks and months. But, what is already clear is that the government has set real forces in motion that can only improve the general state of the Sudanese economy.

III. Generalizing our Experience

A. Policy Dialogue/Reform Process

As this paper shows USAID has been rather active in policy dialogue which has resulted in meaningful reform. The process has often been iterative, involving discussions, study, further discussions, analysis, dialogue with policy makers and additional analysis followed by negotiation of self-help measures, covenants or conditions precendent depending on the agreement used to foster the economic reforms.

Economic studies have played a very important role and have served as the basis of much of our substantive dialogue. To date we have relied upon our own staff (mission and contract advis rs) to carry out these studies. As explained earlier, the quantitative and descriptive analyses contained in the studies have been thoroughly studied by senior government policy makers with whom we have held our policy discussions. If any one factor has been responsible for effective policy dialogue and the resulting reforms, it has been our economic analyses which have been prepared for and studied by senior government policy makers.

Our policy dialogue and the ultimate negotiations have followed a pattern. We have normally involved only two (and in the case of the latest PL 480 self-help measures, three) senior USAID officials in our policy discussions on any one set of reforms. As a result the issues remain clear and the dialogue moves forward from one session to the next. Familiarity with the views and the thinking of those particpating is achieved. Mutual respect and credibility are achieved. Less back-tracking on issues results, old ground does not have to be revisited. Others on both sides are brought into the discussions as required but the ultimate responsibilities and commitments remain with the principal participants in the dialogue process.

The process involves conceptual and analytical issues, study results and evaluation of where change (proposed reform) will lead. In addition to economic considerations, practical and political considerations are addressed. In the end agreement on the issues and reforms under discussion, if not always mutually arrived at, is usually within the expectations of those involved in the policy dialogue.

B. Major Obstacles to Reform

The major obstacles to reform are the perceived non-acceptance of the magnitude or value of the estimated benefits, and uncertainties associated with reform. How can we be sure the reform will work? Will the benefits actually accrue? Will they positively affect as many people as we estimate? Will the desired impact on the economy actually be achieved? Or will the reform just simply result in higher prices and cost of living without reducing demand? How can we be sure higher prices will encourage more efficient use of resources, thereby improving productivity and increasing supply responses and general welfare? How can we be certain the farmer will produce more if we raise his product prices? Some have suggested he will produce less!

There are also the risks associated with reform. Reforms are not costless--someone will be worse off. What will be the political reaction? Will the students and workers take to the streets? Will our peers and colleagues within and outside the government understand and support the need for reform?

Several of the reforms we have proposed have required the approval of ministers outside the ministry in which our negotiations have taken place. Most of the reforms we have encouraged have required the approval of the President of the Republic. This was the case for the initial bread price increase, the establishment of the Petroleum Import Facility and the exchange rate adjustments which have very recently taken place. Undertaking reforms that require top level approval involve political and professional risks, particularly if they don't work.

C. U.S. Foreign Policy Interests

U.S. foreign policy interests have never been an explicit subject in our economic policy dialogue. Our dialogue has rather centered upon what is in the best economic interest of the Sudan; how can we encourage policy makers to remove existing economic distortions, improve the structure of incentives, and direct resources toward areas of investment where the Sudan can achieve high economic payoffs and ultimately economic recovery. We have operated on the assumption that our approach was within U.S. foreign policy interests, as one important tenet of U.S. foreign policy is to encourage the development of the third world, in part so they can become viable trading partners with the U.S. and the rest of the world.

D. Size and Composition of the USAID Program

USAID is the largest donor to the Sudan; our annual disbursements are now greater than the IBRD, although the World Bank has a large portfolio of multi-year obligations. Our PL 480 Program provides the Sudan with enough wheat to satisfy 5-6 months of consumption per year (domestic wheat satisfies about 1½ months). Our annual C.I.P. is now the largest single donor financed commodity assistance agreement the Sudan receives.

The size of our program and the degree of the Sudan's economic dependence on the USG are important factors which contribute to our posture and success with policy dialogue. However, we have not, in my view, taken advantage of our size, or abused our posture. We have never engaged in policy reform to achieve a record of reform, nor have we chosen simple or easily achievable reforms.

The dialogue we have pursued has been challenging and at times exceptionally rewarding professionally. The nature of the policy dialogue and negotiations we pursue requires a great deal of preparation and constant rethinking of the issues, positions and strategy. Policy dialogue requires a strong disciplinary conceptual framework and a fluid, but well thought out set of "arguments", explanations, views and tentative positions. Dogmas or rigidities do not achieve viable positions. Listening to and understanding opposing views or counter positions is absolutely required. Appreciating "where one is coming from" is essential. Together "both sides" attempt to achieve a direction and ultimate position on reform within a political economy framework which is acceptable to the donor and the host government.

E. Role of the IMF and IBRD in our Policy Dialogue/Reform Process

The policy dialogue and reform we have achieved through our PL 480 Program has been undertaken independently of other donors including the IMF and the World Bank. The idea of a Petroleum Import Facility was originally conceived by USAID project advisors in the National Energy Administration of the Ministry of Energy. The concept was further developed collaboratively with the advisors and the Mission, and was ultimately proposed to AID/Washington and then to the President of the Republic while he was in Washington in November 1983. The IMF was initially skeptical of the plan. However, it ultimately supported of the facility as a means to help close Sudan's Balance of Payments gap. The USG presented the plan at the 1984 Consultative Group Meeting to seek widespread donor support for the facility. The IMF and the IBRD supported the Facility at the CG as did the GOS. Several donors voiced tentative financial support pending capital approval. In the end for the first year only the Dutch Government contributed to financing along with the GOS and the USG. German aid gave offset commodity support of $1 million. The Saudi Arabian Government also committed financial support pending an operable IMF/GOS Standby Arrangement.

Regarding policy dialogue on macroeconomic issues, USAID has only had limited contact with the IMF. We have attempted an open exchange of views with the Fund, but the stumbling block has been the inability of the IMF to share with us the contents of their Standby Arrangement, or in any meaningful way thoughts on a possible new reform package. However, we have discussed with the Fund our policy issues and plans to engage in macroeconomic policy dialogue with the GOS.

F. The Nature of Donor Coordination

In the area of economic policy dialogue (as is the case in other technical areas) USAID Sudan has frequent informal discussions with the other principal donors. We also meet formally on a quarterly basis through the Consultative Group sponsored Joint Monitoring Committee, chaired by the Minister of Finance or, more often, by one of his Under-Secretaries.

The aim of these discussions has been to assess the economic and political environment in which we work, to keep up to date on what other donors are doing and thinking and to share our ideas and plans with them. We have kept the other donors abreast of our concerns, and policy discussions with senior officials of the government. We find that maintaining a close professional relationship and open dialogue with the other principal donors is mutually beneficial and reinforcing.

G. The Role of Economic Analysis

It would be highly presumptuous to participate in policy dialogue without the underpinning of economic analysis. While economic theory and comparative experiences drawn from other developing countries facing similar economic circumstances can be highly useful, they are not enough. Theory per se or others' experiences do not help us to deal directly with the major issues that confront our host country policy makers. That is, how change will impact on their problems, their people, their sectors, the economy, or the uncertainties to be assessed when deciding upon reforms to adopt.

To deal with these issues requires economic analysis. The depth or breadth of our analysis depends on the issues being investigated, the data available, the resources one can apply to generate the necessary data and the techniques employed to carry out the analysis. However, the "data problem" is often overstated (albeit real) by analysts working in developing countries. There are many sources of useful secondary data at our disposal -- IMF and IBRD reports and memoranda, our own project sponsored studies, and studies produced by other donors. Also, various ministries, government departments and agencies have assembled data and prepared studies and reports which we can use.

During policy discussions, policy makers require numbers, other economic facts, identification and analysis of trade-offs and the projected impact of proposed reforms. This can only be achieved via good economic analysis.

The analytical techniques used and the presentation of the analysis are also important as it must be readable and self explanatory. We have also learned that it is important to discuss the conceptual issues to be addressed in the analysis with the policy makers in advance and during the analytical stage, to insure that the relevant issues and considerations are being tackled in the analysis. If you know the issues and trade-offs of concern to the policy maker, there is a greater probability that your analysis will be studied, seriously considered and ultimately used in deciding upon the reforms (nature and magnitude) the government will ultimately adopt.

Our policy dialogue and the ultimate reforms achieved under our PL 480 Program, in the establishment of the Petroleum Import Facility, and the macroeconomic policies pursued under our FY 84 C.I.P. program were all supported by economic analyses done either in-house or by our project advisors. The form and content of these analyses were, in part, influenced by the government policy makers participating in the dialogue process. If we had not discussed our intended studies with the policy makers, we probably would not have analyzed some of their key issues.

H. Our Policy Reform Agenda

Our experience with policy dialogue was initiated through our PL 480 Program and initially addressed budget subsidies and wheat pricing issues. Having tackled the major economic distortions facing the wheat consumption/production sector, our analysis and policy dialogue broadened to include setting the stage for partially substituting domestically produced sorghum for imported wheat via composite wheat/sorghum flour in breadmaking. We then followed what we believed to be a logical step to introduce the principle of import parity pricing for imported and domestically produced wheat with the aim to eliminate the implicit foreign exchange rate subsidies involved in wheat pricing. This in turn lead us to consider import parity pricing for other domestically produced crops.

At this stage we were forced to seriously consider the impact of an overvalued exchange rate on the structure of incentives facing the agricultural sector as well as the supply and demand of diesel. We evaluated the impact of the foreign exchange rate conversion formula which was implicitly taxing agricultural exporters and consequently producer incomes. The study on the conversion formula has been described earlier in the paper.

Two project economists from our Agricultural Planning and Statistics Project undertook a comprehensive study of the impact of subsidized diesel on the economy and the impact removal of the subsidy would have on the costs of agricultural production. The results of these two studies have been described earlier.

Thus, a policy reform agenda was not based upon a detailed forward plan. It evolved from dealing with economic distortions influencing wheat consumption and later wheat production. Our approach was micro and sequential but then evolved toward the analysis of more comprehensive macroeconomic distortions and policy issues.

USAID/Sudan was pulled toward consideration of the macro price directing the economy despite the usual lead role of the IMF on exchange rate issues. In part the USAID role developed as a result of our policy dialogue surrounding import parity pricing and the petroleum initiative and in part from an inoperable IMF Standby.

Attention to macro issues began nearly a year ago, after USAID had successfully negotiated through the PL 480 Program the elimination of a 30 percent foreign exchange rate subsidy on imported wheat by bringing it to import parity at the Commercial Bank Rate. We then realized the sectoral approach would not take full effect and could even cause new distortions if not accompanied by reform on the increasingly overvalued Sudanese Pound. We were convinced that a major economic distortion that was adversely affecting agriculture and the overall economy was the 75/25 foreign exchange rate conversion formula. This formula resulted in a 21 percent tax on agricultural exporters and consequently a tax on agricultural producers.

The FX Conversion formula was addressed for three reasons: because of USAID's large balance of payments support program, major emphasis on agriculture in our program portfolio, and the fact that the IMF had determined that the resulting effective exchange rate was inadequate to maintain incentives for exporters and producers. Our analysis clearly pointed to the need to improve the structure of financial incentives and the distortions created by the overvalued exchange rate.

The economic policy issues that USAID raised in order to help steer the Sudanese economy toward economic recovery are issues which others have often not been able to discuss successfully with the government. Why has USAID been reasonably successful in the area of policy reform? It is due in part to the size of our assistance program, and the size of our resident economic staff. In the macro area, reform came about in part because discussions between the government and the IMF had broken down because the GOS was in arrears to the Fund. Also, USAID has demonstrated responsiveness to the government's concerns and economic issues; our response time is typically much shorter than that of any other donor. This gives USAID a great deal of credibility.

The GOS in turn is responsive to the economic issues USAID raises and is anxious to discuss specifics on proposed policy reform. At first the government viewed exchange rate issues as a matter for discussion solely with the IMF. However, the value of exchange rate discussions with USAID was soon realized since other policy issues could not be examined meaningfully without reference to the exchange rate. Once we got over this hurdle real progress was achieved in our policy discussions which deal with pricing issues, exchange rate subsidies, the role of macro prices on incentives, supply responses, balance of payments, foreign exchange earnings and the drive toward a short-term revitilization of the economy.

Policy dialogue with the underpinning of solid economic analysis, coupled with continued balance of payments support to help the Sudan through its current foreign exchange crisis, will permit USAID to make continued progress in the area of policy reform.

FEWinch
October 29, 1984