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Does the observed value of Somali shilling deviate from its predicted value?

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Abstract

Somali economy has been functioning informally for the last two decades and the foreign exchange market has been functioning under mutual trust and customary laws. The study examines whether the observed value of Somali shilling (SOS) deviates from its predicted one. The study used two-stage modeling technique where ARMA and co-integration are used as an input selection techniques and ANN is used in the forecasting stage. The study found that overvaluation is more likely than undervaluation in Somalia. This implies speculators with the interest of making short term profits may dominate the market, which will have miserable economic consequences.

JEL codes: C67; E47; E52; F31; E26

Keywords: Actual value; Two-stage modeling; Somali economy; Regulation

1. Introduction

Currency stability is considered crucial for emerging market economies to improve the economic and financial infrastructure of their countries. Currency stability is important at a time where currency crisis become common for the global economy. The recent euro's crisis recalls the importance of the agenda for international monetary reform (Eichengreen, 2012). Exchange

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rates always get primary attention in the international monetary system reform agenda (McKinnon, 2012). In China, the policy of exchange rate stability has been serving as a nominal anchor for its domestic price level (McKinnon, 2012). Further, it balanced exchange relationships with its smaller neighbors (McKinnon, 2012). As today's exchange rates are more flexible and the controls on international movement of financial capital are relaxed, carry trade problems has become more acute (McKinnon, 2012). Even, at the beginning, IMF recommended such behest as a necessary step toward economic liberalization, nevertheless, it has reversed its recommendation (McKinnon, 2012). Currently, IMF seems to be more tolerant of controls of liquid international capital flows after long history of opposing it (McKinnon, 2012).

Due to the recurrent global financial crisis and currency crashes, there is potential risk of dollar losing its value in the foreign exchange markets. This might lead the dollar to lose the position of a global currency. According to Mussa (2012), there is a great fear that the value of dollar in foreign exchange markets will crash due to continuous U.S. current account deficit. If this persists, a day will come when foreigners will not consider dollar based assets to their already large net accumulations of U.S. based assets (Mussa, 2012).

In the context of Somalia, the US dollar plays enormous role in facilitating the economic activities of the country but it is the time to move from such heavily dollarized economy to a local currency-based one because the dollar could crash at any time, which will have a negative excessively impact on the economy of the country. In 1960, while the civil government was new and its experiences were limited, it achieved a stable foreign exchange market, which stimulated Somali exports. The stability of Somali currency did not only encourage the creation of a competitive international trade but also secured for the local people to maintain their purchasing power. From a civil administration, Somalia shifted into a military regime in 1969 following Mr. Siad Barre's bloodless military coup (Leeson, 2007). Mr. Barre created an economy that was significantly growing particularly in the areas of livestock and agriculture. During this time, Somalia's foreign exchange market was very stable as the value of the shilling against US dollar remained unchanged for almost a decade.

In 1980s, Somali shilling (SOS) started losing its value against the dollar subsequent to the devastated political and economic crisis of that decade. So, Somalia's economy, that was once growing, started declining due to number of reasons including poor policy making. Consequently, the foreign currency market started collapsing and the shilling was excessively overvalued, which facilitated the emergence of a flourishing parallel market (Abdurahman, 2005). Due to the instability of the currency market, Somalia's trade with Arabian Peninsula and Europe declined and the people in the domestic market lost their purchasing power since the inflation rate was out of control. Although the government introduced trade restrictions and financial punishments to limit the operations of the parallel currency market, the government could not stop the parallel market as traders were willing to take the risk (Abdurahman, 2005).

Somalia's central government collapsed in 1991, which created a county-wide political and economic vacuum. Since the collapse of the government, people have been using unregulated foreign exchange market (FX). Nevertheless, Somalia's foreign exchange market is criticized of not having basic foundations of an FX market. Subsequent to the fall down of the Somali central bank, the country's FX market has been operating without any formal regulation (Luther & White, 2011). Accordingly, Somali shilling (SOS) has appreciated and depreciated for the past twenty years freely on the basis of the supply and demand forces.

The purpose of this paper is to examine whether the actual value of SOS/USD deviated from its predicted values during this period. Money Supply (MS), Exports (X), Imports (M), and Consumer Price (CP) are used as the determinants of the SOS. The study compares the % changes between

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