EBS/95/61

CONFIDENTIAL

March 31, 1995

To: Members of the Executive Board

From: The Secretary

Subject: Sudan - Performance Under Staff Monitored Program - Status Report to the Executive Board

Attached for the information of Executive Directors is a status report on Sudan's performance under the staff monitored program. This paper will be taken up at the informal meeting on country matters scheduled for Wednesday, April 12, 1995.

Mr. Ghesquiere (ext. 34535) or Mr. Martelino (ext. 38748) is available to answer technical or factual questions relating to this paper prior to the informal discussion.

Att: (1)

Other Distribution
Department Heads

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

SUDAN

Performance Under Staff-Monitored Program--Status Report to the Executive Board

Prepared by the Middle Eastern and Policy Development and Review Departments

(In consultation with the Treasurer's and Legal Departments)

Approved by Paul Chabrier and Thomas Leddy

March 31, 1995

On January 13, 1995, the Executive Board concluded the 1994 Article IV consultation with Sudan and further considered the complaint with respect to Sudan's compulsory withdrawal from the Fund (EBS/94/245 and EBS/94/250). Executive Directors welcomed the authorities' intention to implement a program of economic adjustment and reform for the year ending June 1995 that the staff had agreed to monitor informally. Directors urged Sudan to fully adhere to the program and strengthen it further. They requested to be kept closely informed on policy implementation and payments to the Fund. The Board approved the resumption of Fund technical assistance to Sudan in support of the program.

A staff team 1/ visited Khartoum during March 7-17, 1995 to review developments under the authorities' program, initiate Fund technical assistance in tax reform and macroeconomic statistics, and begin discussions with the authorities on their plans for the period after June 1995 with regard to restoring cooperation with the Fund.

1. Developments under the program

Earlier expectations of record agricultural production based on abundant rainfall have been confirmed, including by an FAO mission. As a result, the staff's projection of economic growth of 7.5 percent in 1994/95 may need to be revised upward. The authorities expect the rate of growth to exceed 10 percent.

1/ Consisting of Messrs. Ghesquiere (Head), Martelino, Iradian and Ms. Banerji (all MED), Mr. Gruenwald (PDR), and Mr. Kanesa-Thasan (consultant). Technical assistance missions from STA (Mr. Raymond) and FAD (Mr. Abdel-Rahman) overlapped with the MED mission.

With the intent of fully realizing this year's agricultural export potential, the Bank of Sudan relaxed seasonal credit for harvesting in December 1994. Banks were granted temporary relief on a case-by-case basis of up to 5 percent from the statutory reserve requirement (30 percent of domestic currency denominated demand deposits). As a result, the increase in bank credit to the private sector and public enterprises between June and December 1994 exceeded the limit under the program (LSd 27 billion) by LSd 6 billion (equivalent to 2 percent of beginning period money stock). The net domestic assets of the banking system (at constant exchange rates) exceeded the program limit by a similar margin.

For the period July-December 1994 the balance of payments was weaker than projected, due mostly to lower exports, with the result that the end-December target for the net foreign reserves of the Bank of Sudan was missed by US$21 million. Preliminary and possibly incomplete data indicate that exports were about 14 percent (US$35 million) below program projections, with particularly weak results for gum arabic. The authorities explained that exporters had built sizable inventories in the expectation of a more depreciated rate under the newly adopted flexible exchange rate regime.

After trading in a range of LSd 460 to LSd 490 per U.S. dollar during most of 1994, the exchange rate in the parallel market depreciated to LSd 550 by end-February 1995 and to LSd 580 per U.S. dollar by mid-March 1995. In addition to the acceleration of credit expansion in late 1994, the authorities attributed the recent nominal depreciation in the parallel market to an upsurge in demand for foreign exchange related to the pilgrimage season from February onward. The delay in exports and the elimination in December 1994 of the last two items from the negative import list (passenger cars and sugar) may also have contributed. Moreover, a nominal exchange rate adjustment would have occurred at some point as catch-up with ongoing inflation.

Tracking the movement in the parallel market rate, the exchange rate in the interbank market depreciated in real effective terms by about 8 percent during November 1994-February 1995. The surrender requirements of export proceeds to the Bank of Sudan were lowered in December 1994 and January 1995, consistent with the authorities' commitments in the program, and the spread between the two exchange rates narrowed to 17 percent by mid-February as expected. However, the interbank market rate responded only partially to the subsequent depreciation of the parallel market rate and the spread widened to 23 percent (according to Bank of Sudan information) in early March. A possible explanation is that the system may still be too rigid to allow commercial banks to profitably quote exchange rates that substantially differ from the Bank of Sudan exchange rate. The spread has since narrowed again to about 19 percent. 1/

1/ Banks continue to be penalized for quoting more depreciated rates than the market average and strong bank/customer relations may dissuade exporters from switching to the smaller, more aggressive banks in response to more favorable exchange rate quotes.

The increase in net credit to the Government from the banking system during July-December 1994 was within the agreed limit (LSd 20 billion) and the authorities reported no build-up of domestic arrears. However, revenue shortfalls were substantial, in particular nontax revenue such as various fees and charges, and receipts from sugar operations. The revenue shortfalls prompted cuts in development expenditure, transfers to regions, and payments for foreign debt service which delays a restoration of cooperation with other multilateral creditors, in particular the African Development Bank and the Arab Monetary Fund.

The fiscal measures specified for March 1, 1995 in the authorities' letter of September 1, 1994 to the Managing Director (EBS/94/182) were implemented on March 15, 1995: the price of gasoline was raised from LSd 1,050 to LSd 1,110 per gallon of 4.545 liters; the exchange rate for customs duty valuation was raised from LSd 390 to LSd 440 per U.S. dollar; and the subsidy on furnace oil for electricity generation was reduced by one third. 1/ The lifting of the import ban on passenger cars at end-1994 has not given rise to significant imports as the authorities raised the tariff rate from 125 percent to 200 percent in January, casting doubt on the attainability of the LSd 6 billion in fiscal revenue during January-June 1995 programmed from this source. Parliamentary approval of legislation authorizing the issuing of government bonds foreseen for December 1994 was obtained on March 15, 1995. The program envisages LSd 2 billion of bonds to be issued in 1994/95.

Notwithstanding the additional credit expansion, the growth of liquidity (M2) decelerated sharply from 90 percent during the 12-month period ended June 1994 to 50 percent during January-December 1994. Money growth decelerated more than foreseen under the program as bank customers withdrew dollar denominated deposits to meet liquidity needs. The 12-month rate of inflation fell to 105 percent by December 1994 compared with 120 percent in December 1993. The rise in consumer prices further slowed to 90 percent in February 1995 over the preceding 12 months, in line with program projections.

No new external public or publicly guaranteed loans were contracted at nonconcessional terms during the first half of the fiscal year. During this period, foreign debt service payments (all interest and charges) amounted to US$17 million, of which 88 percent was to the Fund. Foreign grants and loan disbursements amounted to US$82 million, compared with US$111 million expected in the program. Shortfalls with respect to disbursements received result in large part from delays in clearing arrears to the African Development Bank.

1/ The formulae specified in the Annex to the letter required an increase in the price of gasoline to LSd 1,128 per gallon and in the customs duty exchange rate to LSd 434 per U.S. dollar starting March 1, 1995. The price adjustment for gasoline effected in December 1994 exceeded the level specified in the letter of intent.

2. Report on policy discussions

The authorities acknowledged the deviations from the benchmarks for end-December 1994. They said they had not been fully aware of the magnitude of the overextension of bank credit and agreed to reinstitute some of the close monitoring mechanisms that had ceased to be operative following the move away from bank-specific credit ceilings. They also agreed to shorten the time lag for reporting monthly information to the Fund.

In the authorities' view some of the deviations from the program would be self-correcting during January-June 1995. Agricultural credit extended at harvest time was soon to be repaid, exports would not be withheld much longer, and the peak in seasonal demand for foreign exchange had passed. Fiscal revenue collection would accelerate as agencies would pass on to the Treasury receipts they had already collected.

Evidence for January 1995 partly supported this view. Private sector credit expansion was limited to about LSd 1 billion compared with LSd 10 billion programmed for January-March 1995. Export proceeds and fiscal revenue were significantly higher in January than in previous months. Nevertheless, the staff expressed concern at the deviations from the program, particularly in view of the importance of establishing credibility of policies, and urged the adoption of corrective measures.

The authorities agreed to tighten credit to the private sector and public enterprises. Commercial banks were instructed, effective March 21, 1995 to: (i) increase vault cash to the equivalent of 15 percent of demand deposits from 10 percent currently; (ii) request an increase in the share of the customer's own financing in "Musharaka" lending operations from 55 percent to 75 percent for local trade and from 20 percent to 30 percent for priority sectors; 1/ (iii) require principal prepayment of 50 percent instead of 35 percent in "Murabaha" operations; and (iv) call overdue bank loans. These measures are expected to reduce bank credit to the private sector and public enterprises by LSd 8.4 billion and bring it back within the credit limit of LSd 42 billion for 1994/95 (13 percent of beginning period money stock) as programmed. The measures will also result in an increase in the cost of bank borrowing, which is currently in a range of 35-70 percent. The stepped-up cost of borrowing and prospects for a further decline in the rate of inflation can be expected to begin to result in positive real lending rates.

Following the Executive Board's decision to allow a resumption of Fund technical assistance to Sudan, the mission--with the assistance of FAD staff--held extensive discussions on tax reform. Technical work already undertaken by a tax advisory committee which the authorities had instituted at their own initiative proved helpful. The authorities agreed to implement the following measures before end-March 1995 with a view to containing the

---

1/ For a description of modalities of commercial bank lending in Sudan see (SM/94/311, 12/30/1994), pp. 63-66.

inflation-induced erosion of the tax base: (i) the profit tax will be payable in full at the time the declaration is submitted; (ii) the appeals process will be shortened and the tax on nondisputed elements will be payable prior to the acceptance of the appeal; (iii) sanctions against delinquent taxpayers will be tightened; (iv) profits realized through trade or business activities of charitable, educational, or cultural associations will be subject to tax; and (v) the tariff on passenger cars will be restored to 125 percent. The authorities have informed the staff that measures (i) through (iii) were taken effective March 19, 1995, and measures (iv) and (v) were taken effective March 29, 1995.

The Finance Minister confirmed that the fiscal policy stance that will be adopted in the budget for July 1995-June 1996 will be consistent with no government borrowing from the banking system. The following structural measures developed in cooperation with FAD staff, will be included in the budget law that will be submitted to Parliament in June 1995: (i) all corporate profits will be subject to a single rate (40 percent); (ii) personal income tax schedules, which differ according to the source of income, will be replaced by a global income tax; (iii) the business profit tax will be subject to a minimum 1 percent turnover tax that will apply to all corporations; (iv) tax exemptions will not be renewed and approval of new exemptions will be subject to stringent requirements.

In the area of indirect taxes, the Finance Minister intends to request Fund technical assistance for preparing a study on the introduction of a broad-based general sales tax; the tax would have a threshold based on turnover, would be applicable also to imports, and would avoid cascading effects. A study on import tariff reform will seek to simplify the various import taxes into a single tariff schedule while narrowing the range of duty rates. It is the intention to introduce these reforms no later than July 1996.

The authorities reaffirmed their commitment to move toward a unified flexible foreign exchange regime in the form of an interbank market, but restated their concern about the possibility of excessive rate volatility. They expected that the tightening of credit policies effective March 21 would help narrow the spread between the exchange rate in the parallel market and the interbank market rate to about 13 percent by end-March and would spur export receipts. The surrender requirement to the central bank was reduced from 65 percent of exports to 50 percent effective March 21, 1995 (compared with a reduction to 60 percent foreseen in the letter of intent). Regulations for the licensing of nonbank foreign exchange dealers would be issued by end-March 1995. The staff urged the authorities to liberalize the exchange rate regime further by removing key impediments to the development of a genuine interbank market. The authorities responded that they would consider further moves only after the experience has been reviewed with nonbank dealers, who will become operative during April-June 1995.

3. Payments to the Fund

The authorities reaffirmed their intention to adhere to the payments schedule submitted earlier to the Executive Board. In 1995, Sudan has made payments to the Fund of SDR 2.875 million on January 20, SDR 3.05 million on February 27, and SDR 3.5 million on March 28. Outstanding arrears at end-March 1995 amounted to SDR 1,189 million, the same level as at end-December 1994, and are expected to be reduced by SDR 4 million between end-March 1995 and end-June 1995.

4. Other issues

The authorities inquired about prospects and timing for moving toward a Rights Accumulation Program, should this approach remain available beyond April 1995. The staff responded that a solid record on performance in regard to economic policies and payments to the Fund was a first prerequisite. Also, a strong three-year structural reform and adjustment program with appropriate external financing assurances would need to be in place. The authorities recognized the importance of embarking on a concrete strategy for normalizing financial relations with international donors and creditors and indicated that efforts to this end would be accelerated.

It was agreed that a staff team would visit Khartoum in the first week of May for a further review of developments under the program and discussions on the 1995/96 program.

5. Staff assessment

Information available to the staff indicates that the agreed fiscal policy stance under the program is being adhered to and that recourse by the Government to bank financing remains within program limits. However, significant revenue shortfalls have prompted cuts in expenditure with adverse repercussions for Sudan's longer term development and relations with multilateral creditors.

The authorities eased credit to the private sector in late 1994 in an effort to help secure the abundant exports in prospect. At the same time, exporters built up inventories or delayed foreign currency repatriation in the expectation of a more depreciated exchange rate. Credit limits under the program were exceeded for end-December 1994 and the reserves of the central bank fell short of target. In the staff's view, strict adherence to the credit stance outlined in the program would have contributed to expectations of a more rapid fall in inflation, a further narrowing of the gap between the official and the parallel market rate (at a less depreciated rate for the latter), and higher export receipts.

The difficulties experienced in attaining the export target notwithstanding highly favorable conditions for agricultural output call into question the appropriateness of the current exchange rate system. Although the authorities have implemented the various reductions in export surrender requirements consistent with the letter of intent, these modifications to the system have not been sufficient to narrow the differential between the exchange rates in the interbank and the parallel markets durably. Exports continue to be subject to a large and variable implicit foreign exchange tax under the current dual exchange rate regime.

The staff welcomes the corrective policy measures recently adopted. The tightening of credit announced on March 21, 1995 and the apparent slowdown in credit expansion already underway should help achieve a return to the original credit path envisaged for the remainder of 1994/95. Combined with strict avoidance of net recourse by the Government to bank borrowing during January-June 1995 or domestic arrears, the program's inflation objective for June 1995 (55-60 percent) remains within reach.

The fiscal revenue measures which the Minister of Finance is committed to make an integral part of the 1995/96 budget, along with the preparation of a broad-based sales tax, offer prospects for fundamental reform. The resolute pursuit of this fiscal reform program will be essential for improvement in economic and financial performance.

Given the renewed widening of the spread between the official and parallel market rates, it is essential that the authorities move as quickly as possible to further liberalize the regime through facilitating the operation of nonbank foreign exchange dealers. In the event the margin between the two markets fails to narrow durably, the staff recommends that key restrictions of the current system that impede the development of a genuine interbank market--the fixed buy/sell spread of the commercial banks and the surrender requirement at the central bank reference rate--be removed already during the current fiscal year.