The adverse impact of the secession and of the lack of agreement on oil transit fees are heavily affecting vital economy activities, causing serious economic imbalances and increasing hardship for the population, in particular for the poor. The policy measures taken by the authorities have not been much successful yet in tackling the deteriorating economic situation, and the substantial loss of oil revenues is now being translated into serious external and internal deficits, inflation, and economic hardship.

- **Current account.** After a substantial surplus of US$ 2.7 billion during Jan-June 2011 prior to the secession, the current account balance drastically turned into a large deficit of US$ 1.2 billion during July-September 2011, and further aggravated into a US$ 1.5 billion deficit during October-December 2011, due to the loss of oil exports. The recent steady increase of gold exports may reflect the authorities’ effort to boost gold production as one of the alternative sources of exports.

- **Foreign exchange.** The loss of the main source of foreign exchange (oil revenue) and increasing uncertainty over the economic prospects have been putting significant depreciation pressure on the local currency, and foreign exchange reserves have been dwindling. The Sudanese pound has depreciated by around 50 percent in the parallel market since the secession further widening the gap with the official exchange rate.

- **Inflation.** Inflation continued to accelerate for the first four consecutive months in 2012 and reached 28.6 percent in April, mainly due to continuing high food price inflation and partly due to the rising import cost of basic goods as a result of weakening local currency value. The high inflation trend adds to economic duress for the poor and vulnerable.

- **The budget.** The current 2012 budget relies on rather optimistic assumptions on key variables, such as revenues and foreign financing. The fiscal targets for the 2012 fiscal year (fiscal deficit in the order of 3.4 percent of GDP) are likely to be difficult to achieve. Fiscal retrenchment is likely to affect the funding for important development projects and social services.
The shut down of oil production by South Sudan’s government and rising military tensions across the border aggravate Sudan’s economic woes and uncertainties. Following the collapse of the negotiations over the post-CPA arrangements for oil transit, South Sudan’s government announced the shutdown of its oil production on January 20, 2012. The situation has afterwards further escalated both politically and militarily, and is seriously affecting economic activities in both countries, which are heavily relying on oil revenues. While the dialogue between the two sides resumed shortly after the oil production shutdown, the prospects of the long-protracted negotiation are highly uncertain considering the wide disagreement over oil between two sides: Sudan reportedly demanded US$ 36 per barrel for a mix of fees over the use of pipeline, the port and other services while South Sudan’s offer remained under one dollar per barrel along with around US$ 5 third-party fees. Furthermore, rising military tensions surrounding border states, in particular the recent conflict surrounding the oil-rich town of Heglig, South Kordofan State, is adding to the uncertainty over the prospect of oil production and economic stability of the two neighboring countries.

The government has set up an emergency plan and just finalized preparations of an Interim Poverty Reduction Strategy Paper (I-PRSP) in an effort to mitigate the effects of the transition. A three-Year Salvation Economic Program (2011-2013) has been formulated by the government to reverse the trade deficit by actively promoting imports substitution and exports. The plan aims at promoting self-sufficiency by 2013 on a number of agricultural products such as wheat, sugar, and cooking oil, as well as increasing exports of cotton, processed meat, gum Arabic, and gold. The authorities have also finalized preparation of an Interim PRSP, which is one of the technical pre-conditions for debt-relief. The Interim PRSP has been approved by the Council of Ministers on March 22, 2012, to clear the document for subsequent presentation to the Parliament.

II. The 2012 budget reflects the fiscal shock of the secession, but outstanding questions on the realism of key assumptions is likely to call for significant revision of the budget

The 2012 budget was approved by the National Assembly on December 19, 2011. The budget is the second one reflecting the impact of the secession and represents the first year of the new five-year plan (2012-2016). Key objectives of the budget include sustaining economic growth, restoring external balance, containing price stability, and supporting the vulnerable and the poor. While laying out some elements of the needed fiscal adjustment, some key underlying assumptions of the budget remain over-optimistic; any revision of the budget will depend upon the outcome of the on-going post-CPA negotiations. The key features of the 2012 budget include the following:

Revenue Side

- Counter-intuitively, the 2012 budget projects total revenue to increase by 5 percent (SDG 1 billion) compared with the 2011 actual budget performance despite the oil revenue loss. The significant oil revenue drop (SDG 2.7 billion) and tax revenue shortfall (SDG 1 billion) is
projected to be largely off-set by the increase of oil-related fees (SDG 3.6 billion) paid by South Sudan and other non-oil revenues (SDG 1.1 billion) including grants. Oil revenue is projected to be reduced to around 55 percent of the pre-secession level (2010) with its share among the total revenue dropping from 41.6 percent to 20 percent.

- **While the projected reduction of oil revenue loss is significant, the current oil revenue projection (SDG 4.7 billion) may still be too optimistic given the past trends.** The current budget expects oil sales revenue to be SDG 4.7 billion and to come exclusively from the expected production of the Sudanese (North only) oil wells. This may be optimistic given the past oil sales revenue trends: The oil revenue share entitled to the Government of Sudan during the pre-secession period (which included the revenues from the production of the Northern oil wells and its 50 percent share of oil revenues generated from the Southern oil wells) was around SDG 5.3 billion in 2009 and SDG 3 billion in 2010, respectively. The current oil revenue projection of the budget is not far from the pre-secession level given that the previous 50 percent share from the Southern oil fields do not exist any longer.

- **Assumption on oil-related fees remains highly uncertain.** The 2012 budget assumes SDG 6.6 billion (28 percent of total revenue) under “other revenues” items, most of which is planned to come from various fees over oil transition from South Sudan. The current projection of oil-related fees seems to reflect the stance of the Government of Sudan in the on-going oil revenue negotiation and would have to be adjusted according to the actual negotiation outcome. Given the significance of the oil-related fees (again, 28 percent of total revenue), the adjustment may significantly undermine the credibility of the current fiscal plan. For example, should the oil-related fees turn out to be half the budget projection as a result of on-going negotiation, it would increase the fiscal deficit for 2012 by SDG 3.3 billion, raising the deficit to GDP ratio from targeted 3.4 percent to 4.9 percent, under the current projection of the nominal GDP for 2012 in the budget.

**Expenditure Side**

- **Along with the revenue prospects, total expenditures are also planned to increase by around 7 percent compared with the 2011 actual figure.** This increase largely comes from debt service increase by 64 percent (SDG 1.2 billion), increases in national development spending (by 82 percent) and development transfer to state governments (by 64 percent). While prioritizing public investment expenditure and pro-poor spending areas is needed for the long-term economic development, it remains doubtful whether the proposed increase in key development and pro-poor areas could be actually
implemented, given the highly uncertain revenue prospect and the past patterns of mid-year spending adjustment, which were heavily concentrated on development spending in times of revenue shortfalls. During the 2008-2010 periods, for instance, under-execution of development spending accounted for significant portion of mid-year expenditure adjustment (measured by under-executed amount of budget) in response to revenue shortfalls. Figure 3 shows that under-execution of development spending accounted for 78 percent and 90 percent of total expenditure adjustments in 2009 and 2010 respectively.¹

- **Subsidies on petroleum products remain in effect in 2012 (SDG 2.2 billion), fixing crude oil prices for local refineries at US$ 49 per barrel.** But the budget intends to immediately eliminate subsidies for sugar and bread. There is a serious debate within the government, National Assembly and experts on how to remove petroleum product subsidies. The budget also plans for a targeted social protection system; measures include new support to 250,000 poor families.

The 2012 budget projects the fiscal deficit to be 3.4 percent of GDP. But this may be difficult to achieve given the uncertain revenue prospects and its significant reliance on external financing and central bank. The budget projects that around 60 percent of the fiscal deficit will be financed by external financing and 40 percent by domestic financing. Clear and transparent financing policy is important to improve domestic price stability and manage the debt and fiscal sustainability.

- **Projected domestic financing heavily relies on the support from the Central Bank.** Direct borrowing from the Central Bank is projected to finance about 51 percent (SDG 1.5 billion) of total domestic financing and the rest of it is to be financed by the issuance

¹ World Bank Sudan Policy Note, Rapid Assessment on the Public Investment Portfolio in the Fiscal Adjustment Context (forthcoming)
of various government securities including Government Investments Certificates (Shahama), Government Investments Sukuk (Sarh). Given the weak revenue prospect and fragile domestic market sentiment due to rising political and economic uncertainties, the fiscal reliance on Central Bank financing is likely to increase in 2012, raising concern on further jeopardizing price stability and raising anticipated inflation over the short- and medium-term.

- **Total external financing to be signed in 2012 was projected to be US$ 2.3 billion including US$ 1.9 billion of foreign loans.** Main lenders include China, Islamic Development Bank and various regional development funds including Kuwaiti Economic Development Fund, Arab Economic Development Fund. External financing plan heavily prioritizes development spending, allocating 60 percent (SDG 2.6 billion) of projected total foreign loans and grants (SDG 4.4 billion) to national development projects. As a result, more than 50 percent of national development spending (SDG 5.1 billion) is projected to be financed by external sources. The excessive reliance on volatile and pro-cyclical foreign sources of development spending has been one of underlying causes for the erratic management of development spending in the past.

- **Past budget execution data shows that foreign financing plan of the budget was typically overstated in the past and the foreign funding plans have been significantly under-executed compared to the domestic financing portion.** In particular, the budget execution rate of foreign development funding sharply dropped in 2008 amidst the global credit crunch and still remained around only 20 percent in 2010. Furthermore, the prospect of external financing is likely to be less favorable to Sudan in the absence of a significant portion of oil which previously functioned as major collateral. Well-established planning of foreign financing would be an important task for macro-economic management through monetary and fiscal policies, especially under the increasing fiscal adjustment demands and external financing needs. Excessive reliance on foreign non-concessional financing needs particular attention, given its impact on liabilities and the prospect of further external financing through international donor communities.
Inflation continued to accelerate in the first four consecutive months in 2012, with annual inflation rate hitting alarming 28.6 percent in April 2012. The April inflation rate was a significant jump by 6 percentage points from March. The current soaring inflation trend came from increasing food price and continued devaluation of local currency in the parallel market. Driven by several basic food items (meat, cereals, vegetables, cooking oil, and fruit), the cost of food rose by additional 7.2 percent in April compared with March 2012. Meat costs price rose 7.4 percent, while bread price went up by 4.6 percent and vegetables price by 8.3 percent. On the state level, North Darfur, South Darfur, and Sinnar states continue as states with highest inflation rates in April, with rates of 48.3 percent, 35.3 percent, and 33.9 percent respectively.

Inflation will likely remain double-digit over the next months, reflecting the high food price trend and weakening local currency in the parallel market. The poor are those most negatively affected by high inflation, due to their high food share in consumption, and limited means to preserve the erosion of the value of their savings. Inflation has more than doubled since March 2009 despite the government’s consecutive policy measures to contain the soaring food price. Earlier measures undertaken by the government still remain active, including cuts in import tariffs for wheat, flour, sugar and capital goods, and releasing grain stocks of domestic reserves, tax cuts on selected food products, and eased regulation on imports of milk and chicken. With the limited success of these policy measures to maintain price stability, the high inflation trend is adding to the already tight socioeconomic challenges of the poor and vulnerable, given high unemployment, foreign exchange shortage and U.S. economic sanctions.
Monetary growth turned into expansionary stance since December in 2011. Broad Money (M2) grew by 4.4 percent in December and 5 percent in January month-on-month respectively – making 9.5 percent money growth during the two consecutive months. Including October and November, broad money increased by alarming 15 percent for only four months. The recent fast increase in liquidity needs attention, considering the recent high inflation trend and the possibility of significant fiscal financing gap being monetized through the Central Bank in large scale.

- The composition of the broad money growth strongly indicates that the recent rapid money growth could be driven by domestic credit expansion, mainly through government channel. While currently available monetary composition data is still limited to the third quarter of 2011 at the time of writing this note, currently available monetary survey data confirms this possibility. After positive growth trend during the most period since 2010, the broad money supply contracted by 2.3 percent during the third quarter of 2011, largely due to the negative money supply by 4.2 percent in September.

- The money supply contraction could be explained by shrunken economic activities following the secession and also partly due to confusion in the midst of the sudden introduction of new currency. However, despite the contraction of overall money supply, net claims on public sector grew at 16.6 percent while the money supplies through foreign channel (i.e., Net Foreign Asset) and net private sector credit shrunk by 34.1 percent and 5.6 percent respectively. Given the large current account deficit trend and weakening private sector businesses since the secession, it indicates that the government sector could be leading the strong growth of money supply largely through central bank financing since late 2011.
The oil revenue shock is rapidly translated into heavy deficits in the external accounts. The most recent balance of payment data reveals that the current account and trade balances turned into huge deficit following the loss of oil exports in the second half of 2011. The trade balance showed a deficit of US$ 2.5 billion between July and December (US$ 1.1 billion for the third quarter and US$ 1.4 billion for the fourth quarter), a sharp turn from a surplus of US$ 3.7 billion between January and June. Consequently, the current account surplus of US$ 2.7 billion between January-June sharply deteriorated to a deficit of US$ 2.7 billion for the period between July and December.

- Exports plummeted by 74.5 percent during the latter half of 2011 compared to the previous six months due to sharp drop in oil exports, leading to huge trade deficit. As the ownership of the Southern oil fields had been transferred to South Sudan in July, 2011, Sudan’s petroleum export dramatically dropped by 90 percent to US$ 678 million during the third and fourth quarter, from US$ 6.6 billion during the first and second quarter in 2011. In particular, there were no exports of crude oil (which previously accounted for around 98 percent of petroleum goods export) since August, showing the magnitude of the impact of the secession on Sudan’s trade sector. As a result, the export share of petroleum goods dropped to 10 percent from around 88 percent in the first half of 2011.

- Gold exports continued to increase and became the dominant source of foreign exchange earnings. Exports of gold in the second half of 2011 reached SDG 0.9 billion, noticeable increase by 71 percent from SDG 0.5 billion in the first half of the year. As a result, the export share of gold among total export jumped to over 60 percent – now in the absence of crude oil export – from meager 7-10 percent during the pre-secession period.
• Imports increased for two consecutive quarters amidst the huge losses in exports. Imports during the July-December period in 2011 reached SDG 3.7 billion, up by 24 percent (US$ 0.9 billion) from the previous half of the year. The import growth was driven by increases in imports of food items (37 percent), chemical goods (51 percent), and raw materials including petroleum products (53 percent). There is high uncertainty over how long the increasing trend of imports can continue under the worsening foreign exchange situation.

The capital and financial account shows that the foreign direct investment continues to be relatively robust despite the political and economic transition. Net FDI during the third quarter of 2011 increased by 87 percent to SDG 0.8 billion from SDG 0.4 billion during the previous quarter. Net portfolio investment continued to be minimal and recorded net outflow since the third quarter of 2010, showing SDG 5.6 million net outflow during the third quarter of 2011.

The heavy impact on the external balance was largely anticipated and is expected to persist in 2012. Against this prospect, the government has repeatedly expressed its plan to boost the oil production in oil wells located in (formerly) Northern Sudan including Block 6, in an attempt to export a portion of the increased oil production; but details or the feasibility of the plans are yet unknown. Furthermore, given that oil produced in Northern oil wells, directed to domestic consumption at subsidized prices, leaves a significant unmet demand to be filled by imports of petroleum products, it also remains uncertain how much of the oil production boost could actually be allocated to exports.

The magnitude of the impact on export of the secession underscores the urgent need to promote broad-based economic growth. As non-oil products previously accounted for only 22 percent of total export, it will be a significant long-term challenge to find and promote alternative source of export. There is no short-term solution to this difficult situation. The government has been trying to increase gold exports — another commodity — by controlling the smuggling of gold. The recent steady increases of gold export may reflect the authorities’ effort to boost gold production as one of the alternative source of export. However, relying on gold as another commodity to provide foreign exchange will not be a permanent solution to the current economic crisis, particularly given the fact that the excessive reliance on oil was the fundamental cause of the current difficult situation. Also, while gold is the most significant non-oil item for export, relying on gold would not lead to sufficient export compensation given its
insignificant amount compared to the oil export losses. Strategic improvement of non-oil sectors and promotion of broad-based growth will need to be persistently pursued from the long-term perspective to achieve sustainable and diversified economic growth.

V. Large external imbalances and highly uncertain economic prospects are putting heavy pressures on the foreign exchange situation.

Depreciation pressures on the local currency continue to mount, as a result of the considerable drop in foreign exchange inflows following the secession. A significant premium continues in the parallel markets; widening the gap between the official and black-market rates amidst the Central Bank’s policy to ease tight foreign exchange situation through regulations and import controls. The official exchange rate has been kept at SDG 2.67 per US dollar since April 2011, while the parallel market exchange rate has been hovering in the range of SDG 5-5.5 per US dollar since March 2012. Prospects of further foreign exchange shortage are even greater now, following the shutting down of oil production by South Sudan and prolonged delay in the negotiation on post-CPA arrangement. In particular, the recent escalation of military conflict surrounding the Heglig area further pushed the market exchange rate close to SDG 6 per US dollar in April, which could be a temporary overshooting but still indicates fragile market sentiment over the local currency value.

The government’s effort to keep the official exchange rate at fixed level amidst the huge external imbalance is inevitably leading to extreme shortage of foreign exchange. While the current level of international reserve remains unknown, the balance of payment statistics shows that reserve assets continuously declined during the second and third quarter in 2011. Given the ongoing political and economic developments, it is not likely that the current foreign exchange situation significantly improves in the near term.

The tightening foreign exchange situation forced the government to implement a series of drastic measures to defend its foreign exchange reserves. Adding to a series of regulatory responses imposed in 2011 by the Central Bank of Sudan, in January 2012, the ceiling on the foreign hard currency that travelers can bring to Ethiopia, Egypt, South Sudan and Eritrea was tightened from previous US$ 1,000 to US$ 500. In February 2012, the Central Bank also announced that all foreign travelers should pay their hotel accommodation by foreign hard currencies. However, in the absence of reliable source for foreign exchange supply, tightening
regulations on foreign currency outflow imposed by the government would be likely to have only limited effect to ease extreme imbalance in the foreign exchange market.

**VI. Technical discussions on debt relief for Sudan under zero option**

Technical discussions of debt issues are ongoing in the context of the Sudan External Debt Technical Working Group (TWG), co-chaired by the World Bank and the IMF. The latest meeting in April 2012 included an update of debt relief scenarios to show the likely impact of HIPC on Sudan. The original results of the simulation were earlier shared with the authorities in Khartoum in November 2011. The debt relief simulations included an assessment of the impact of the following initiatives: Paris Club Naples Terms (also known as “traditional debt relief”); the Heavily Indebted Poor Countries Initiative (HIPC); the Multilateral Debt Relief Initiative (MDRI), and Paris Club “beyond HIPC” bilateral debt relief. It is estimated that through the simulated full application of all channels of debt relief the total debt stock – proxied for end-2012 to stand at about US$38 billion in nominal terms – could potentially decline by around 83 percent. The meeting also provided an update to creditors on the progress made by the Government of Sudan in the preparation of the Interim Poverty Reduction Strategy.