Sudan Economic Report

October
2007

BETWEEN CRITICAL POLITICAL CHALLENGES AND WIDE STRUCTURAL REFORM REQUIREMENTS

- The Sudanese economy witnessed another year of remarkable performance in 2006, in spite of all political odds. Continuously increasing foreign direct investments (FDIs), inflows of capital, and strong aggregate investment and consumption demand at large contributed to boosting economic growth. Indeed, real GDP growth was estimated at an outstanding 9.3% in 2006, as per the Central Bank of Sudan, one of its highest levels ever attained. Such favorable conditions were yet accompanied by inflationary pressures, especially in the latter part of the year, which called for Central Bank measures to daunt such an unwelcome yet inevitable phenomenon.

- Sudan's agriculture sector that accounted for 40% of GDP in 2006, and remains the major employer in the country, performed well last year despite major obstacles. The agriculture sector registered a historical high growth rate of 8.3% in 2006, up from 7.2% in 2005. In particular, it is the farming component that has driven growth with its output increasing by 15.9% in 2006.

- Sudan's industrial sector enjoyed a strong momentum in 2006 and contributed to the overall economic boom the country is witnessing. Industry (oil and non-oil) grew by 9.0% in real terms in 2006 and accounted for a constant 28.3% share of GDP. Non-oil manufacturing, on one hand, that makes up some 7% of GDP, increased in real terms by 7% year-on-year. The buoyant oil sector, on the other hand, accounting for 15.2% of GDP and growing by 10% in 2006, made available the hard currency to finance basic imports for domestic manufacturing.

- Economic buoyancy, driven by the oil boom and increased openness, kept trade activity in Sudan on the rise. The total value of imports and exports increased by 18.5% in 2006. Exports grew by 17% to US$ 5.65 billion in 2006, on account of the rallying oil exports earnings, while imports progressed by a slightly higher 19% to US$ 7.1 billion last year. Subsequently, a sizeable trade deficit of US$ 1.45 billion was recorded in 2006 for the second consecutive year, breaking from a trend of more modest deficits or very small surpluses since the turn of the decade.

- Sudan's fiscal performance in 2006 was weaker than planned, although the country has been doing generally well in adhering to an IMF-set reform agenda, aiming at restoring fiscal discipline and ensuring stability. The overall public finance deficit widened to about 4.2% of GDP in 2006, a record high, exceeding by 2% the target projected in the 2006 IMF program and increasing by 1.6% from its 2005 rate. At the level of indebtedness, available figures indicate that the end-2006 stock of external public debt is estimated at over US$ 28.2 billion, up by 4.4% since 2005. From a high of 160% at the start of the decade, external debt to GDP declined to 81% in 2006.

- The banking sector in Sudan continued to benefit from the favorable economic conditions and the undergoing reforms commenced by the authorities in recent years, and witnessed an extended surge in all major sector aggregates. Banking activity, measured by total assets, hiked by an outstanding 51.2% to reach SD 2,314.4 billion at year-end 2006, its highest growth in recent years. Such a progression was mainly driven by growing customer deposits and total loans to the private sector. The former rose by a yearly 25.9% to SD 1,230.9 billion. The latter registered an even more remarkable growth over the previous year (+55.8%), standing at a record high of SD 1,058.3 billion at year-end 2006.

- The severe market price corrections that impacted most of the region's bourses in 2006 had limited consequences on the Sudanese stock market. In fact, while the Arab Monetary Fund (AMF) composite index of MENA stock markets dropped sharply by 42.5% year-on-year in 2006, the AMF Khartoum Stock Exchange index declined by a moderate 4.4%, moving from 205.26 at year-end 2005 to 196.30 at year-end 2006. This suggests that the buoyant economic activity in the country over the past year and the resulting high liquidity could not fully contain the effect of the stock market bubble burst.

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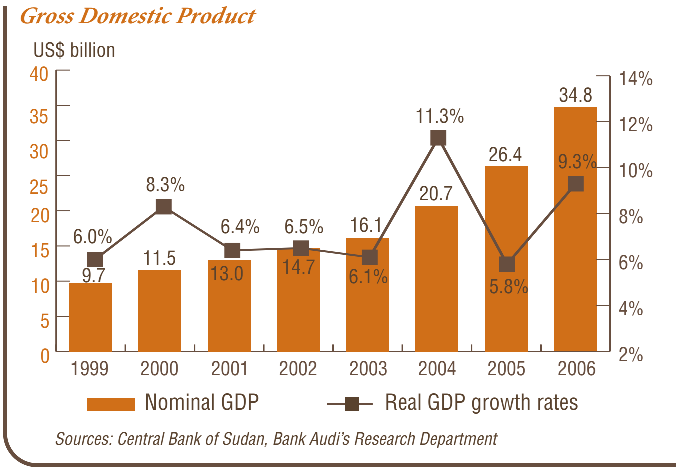


1. ECONOMIC CONDITIONS

1.1. REAL SECTOR

1.1.1. Agriculture

Sudan's agriculture sector that accounted for 40% of GDP in 2006, and remains the major employer in the country, performed well last year despite major obstacles. The agriculture sector registered a historical high growth rate of 8.3% in 2006, up from 7.2% in 2005. In particular, it is the farming component that has driven growth with its output increasing by 15.9% in 2006. The major crops farmed in Sudan are Arabic gum, cotton, wheat, sesame and groundnuts. These generated US$ 300 million of exports, or three quarters of total non-oil exports. The output of Sudan's main crops increased in 2006, except for cotton and Arabic gum. Likewise, land productivity improved notably.

In details, wheat production increased over the same period by 14.3% to yield 416 thousand tons last year, as a result of a 2.4% growth in land productivity as well as larger farmed lands. Corn produced grew by a notable 65% over the period to reach 4.3 million tons in 2006, mainly because of an expansion in farmed areas by 34% in 2006, along with a 3% growth in productivity. Millet output also grew by 141% after having registered low yields in 2005 and totaled 675 thousand of tons. Millet harvest improved as the land productivity jumped 68% higher and land farmed increased by 14% in 2006. Sesame also peaked again with 400 thousand tons produced in 2006, up by 44% from the previous year, with farmed area larger by 17% and productivity higher by 21% in 2006. Groundnuts followed suit, with a good 555 thousand tons in 2006, up by 6.7% since 2005 despite a drop in farmed land by 46% relative to the previous year, yet the growth was mainly coming from a 40% increase in productivity of the farmed land.

In contrast, Arabic gum production slipped by 61% to reach 11.9 thousands metric tons in 2006. On one hand, this crop suffered from cold and rainy weather that reduces trees' exudation and substantially cuts yields. On the other hand, prices of its exports, managed by Sudan's government-controlled Gum Arabic Co., also dropped because of a large buffer stock the company possessed, especially with the previous year's substantial harvest. The company faced the lowest prices in more than a decade and Arabic gum exports revenues dropped by 53.3% year-on-year to generate US$ 50.2 million in 2006. Cotton production also fell by 12.7% during the same period to 394 thousand bales last year, due to the decrease in cultivated areas by 21% despite the increase in productivity from 3.6 quintal per feddan to 3.9 quintal per feddan in 2006.

As to livestock production, it did well with meat products reporting a positive growth over the year. Indeed, beef meat output progressed by 1.8% to 1.73 million metric tons, that of fish increased by a notable 7.7% to 70 thousand metric tons last year, and poultry meat production rose by 4.2% to 25 thousands metric tons in 2006. In contrast, milk production declined in 2006 by 3.1% to 7.3 million tons and eggs production stood still at 9.15 million tons.

Thus, overall, agricultural production in 2006 was rather favorable though this has not been a direct result of modernization or technological transformation, but was mostly due to suitable environmental conditions.

1.1.2. Industry

Sudan's industrial sector enjoyed a strong momentum in 2006 and contributed to the overall economic boom the country is witnessing. Industry (oil and non-oil) grew by 9% in real terms in 2006 and accounted for a constant 28.3% share of GDP. Non-oil manufacturing, on one hand, that makes up some 7% of GDP, increased in real terms by 7% year-on-year. The buoyant oil sector, on the other hand, accounting for 15.2% of GDP and growing by 10% in 2006, made available the hard currency to finance basic imports for industrialization.

Oil production continued to rise with new reserves being discovered. According to the Oil and Gas Journal, Sudan contained proven oil reserves of five billion barrels as of January 2007, up from an estimated 563 million barrels of proven oil reserves in 2006. The civil wars had limited oil exploration to the Central and South-Central regions of the country. Crude oil production averaged 414,000 barrels per day (b/d) in 2006, up from 363,000 b/d in 2005, according to the US Energy Information Administration. Domestic consumption in 2006 was almost 23% of production, with the rest being exported.

Sudan earned US$ 5 billion from petroleum exports, unscathed by the western sanctions. Indeed, China has been its almost single customer and partner, extensively investing in the petroleum sector. China National Petroleum Corp. (CNPC) owns more than 40% of the Greater Nile Petroleum Operating Company (GNPOC), Sudan's largest oil producer that was in charge of all production prior to 2005. In 2006, four new fields began production while many more were still under exploration, operated by Chinese companies as well as other Arab and Asian companies' consortiums. Sudan plans to be producing one million b/d of crude oil by the end of 2008, according to the Minister of State for Mines and Energy.

Sudan refines crude oil and has a total refining capacity of 121,700 barrels per day (b/d), with the two largest refineries being El Gily and Khartoum. In July 2006, CNPC announced the completion of the Khartoum refinery expansion project, which doubled the refinery's capacity from 50,000 b/d to 100,000 b/d. The second largest refinery at Port Sudan is being replaced by a new one, constructed by Petronas, the Malaysian state oil company since 2005 for a capacity of 150,000 b/d, as a substitute for the existing 40-year-old facility, which has a capacity of just 20,000 b/d. The new facility is expected to cost around US$ 1 billion and to be commissioned in early 2009. In addition to these larger refineries, Sudan is also building a 15,000 b/d plant at El Obeid, a small facility at Abu Gabra with a capacity of about 2,000 b/d and a 5,000 b/d topping plant.

As such, oil has been playing a big role in Sudan's economic expansion. However, this does not explain all the country's recent gains, as Sudan is also witnessing a growth in private consumption and foreign investment in its non-oil sectors, owing to growing confidence, macroeconomic stability and government reforms.

After the low growth of the nineties, non-oil manufacturing started to climb by the beginning of the decade. In 2006, Sudan's manufacturing sector grew in real terms by 7% and accounted for 7% of GDP. The most successful industries are in food processing, notably sugar refining. The government is also encouraging the textile industry, despite major obstacles.

Sudan's sugar industry has been operating, since the beginning of this decade, at levels beyond planned capacity. Output reached 0.73 million tons in 2006, which is 111% of planned full capacity output, after peaking at 0.76 million tons in 2004. Expansionary plans of the industry are under way, ranging from increasing plantations to building refineries for export. Sudan's sugar production benefits from a number of comparative advantages making it one of the country's promising industries. With most of the sugar cane grown in large plantations, producers can achieve maximum factory capacity utilization, operate efficient irrigation systems, and make optimal use of sugar by-products. The industry is also characterized by low-cost production and government protection. It also enjoys preferential access to international markets, under free trade areas like COMESA. After 2009, it will also have the possibility of duty and quota free access to European markets under the "Everything but Arms" (EBA) European Commission initiative.

Textile and yarn production is another targeted industry in Sudan, benefiting from homegrown cotton. However, the industry suffers from many internal and external problems keeping growth in output limited and production at less than 10% of potential capacity last year. While textile production in 2006 increased to 28 million yards from 25 million yards in 2005, yarn production declined from 9 thousand tons in 2005 to 6 thousand tons in 2006.

Overall, when comparing the last few years to the previous decade, it is clear that Sudan's manufacturing sector is progressing, though slowly. The domestic private sector has been contributing to the industrial base expansion and foreign investment has been pouring in, despite the US-led sanctions. Of course the oil boom made this improvement possible, but it is worth stressing that authorities' efforts have also played a key role in pushing for the appropriate reforms. Still, much more needs to be done in order to raise competitiveness to international levels, as the modernization process has only just started.

1.1.3. Construction

The construction sector has been thriving in Sudan lately. Although it accounted for only 4% of GDP in 2006, it continued to drive economic activity, growing by a healthy 10% (in real terms) last year. The sector is benefiting from the revamping of the urban infrastructure estimated to cost some US$ 7 billion.

The Merowe Dam is one of the major infrastructure projects estimated to cost some US$ 2 billion, with China heavily investing in it. Another example is the US$ 500 million airport expected to open in 2011. In addition, a number of new projects targeting businesses and foreign investors are coming into the country. These consist of multibillion dollar investments in impressive retail outlets, office blocks, top-class hotels and a huge residential hinterland.

In parallel, Sudan still imports around 90% of its domestic cement needs, with its cement factories capacities and technology quite weak. In 2006, official figures reported a 40% decline in cement production to 202.2 thousand metric tons, since factories were shut down for renovation. The current capacity of cement plants in Sudan is only about 500,000 tons, whereas the overall demand is projected to rise up to 4 million tons over the next few years. The promising outlook of the sector and the weak capacities available attracted Arab investors to join the Sudanese private sector and set a new cement company (Berber Cement) in 2005 to build a new factory with a production capacity of 1.5 million tons/year and to become operational in 2008.

Overall, with the current oil-led economic boom and investment flows into the country, Sudan's construction sector outlook remains positive. As the largest country in Africa has been overridden with civil war, the requirements for reconstruction and development are huge while the oil boom is triggering the necessary liquidity to finance mega projects, which should translate into accrued contribution to economic growth at large.

1.1.4. Transport & Telecommunication

The non-financial services performance in Sudan varied among different sectors, with transportation hampered by an underdeveloped infrastructure system, while telecommunication activities provided promising signals.

With only 15% of the country's road system asphalted linking the major cities of Sudan, the role of land transportation is not taking its adequate share of the prevailing economic boom. However, just like other sectors, many new roads are being built, financed by soft loans from bilateral and multilateral Arab donors. Some 4,674 km of asphalt layers were completed by 2006. Land transport, in lorries, trucks, minibuses and buses, took 19.2 million passengers in 2006, up by 26% year-on-year and moved 8.0 millions of cargo tons, versus 9.2 million tons the previous year.

The 4,725 km rail network is not any better, in need for significant overhaul. Indeed, China signed a US$ 1.2 billion contract with Sudan's government to upgrade 762 km with another project to refurbish the northern part consisting of 830 km, yet the bulk remains in very poor condition, especially parts relating the conflict-ridden regions, such as Darfur, to the rest of the country. With these improvements started, rail

Selected Real Sector Indicators

	2002	2003	2004	2005	2006	Var 03/02	Var 04/03	Var 05/04	Var 06/05
Agriculture: production of major crops									
Arabic gum (in thousands of metric tons)	16.5	15.9	16.7	30.4	11.9	-3.6%	5.0%	82.0%	-60.9%
Cotton (in thousands of bales)	378	449	346	451	394	18.8%	-22.9%	30.3%	-12.7%
Corn (in thousands of metric tons)	4,394	2,825	4,690	2,619	4,327	-35.7%	66.0%	-44.2%	65.2%
Millet (in thousands of metric tons)	578	581	769	280	675	0.5%	32.4%	-63.6%	141.1%
Wheat (in thousands of metric tons)	247	330	398	364	416	33.6%	20.6%	-8.5%	14.3%
Sesame (in thousands of metric tons)	274	122	399	277	400	-55.5%	227.0%	-30.6%	44.4%
Groundnuts (in thousands of metric tons)	990	550	790	520	555	-44.4%	43.6%	-34.2%	6.7%
Industry: oil and non-oil production									
Crude oil production (in thousands of barrels)	85,930	95,771	77,014	103,323	132,738	11.5%	-19.6%	34.2%	28.5%
Refined oil production (in thousands of metric tons)	2,684	2,789	3,161	3,175	3,912	3.9%	13.3%	0.4%	23.2%
Sugar production (in thousands of tons)	697	728	755	712	728	4.4%	3.7%	-5.7%	2.3%
Cement production (in thousands of metric tons)	205	272	307	331	202	32.7%	12.9%	7.8%	-38.9%
Electricity and water									
Electricity production (gigawatts-hour)	3,094	3,354	3,749	4,125	4,521	8.4%	11.8%	10.0%	9.6%
Electricity consumption (gigawatts-hour)	1,758	2,320	2,495	2,987	3,457	32.0%	7.5%	19.7%	15.7%
Water production (cubic meters per day)	1,480	2,218	2,381	2,620	2,742	49.9%	7.3%	10.0%	4.7%
Trade and services									
Air transport (national carrier: in thousands of passengers)	493.5	495.6	562.8	441.5	544.3	0.4%	13.6%	-21.6%	23.3%
Maritime transport (cargo: in thousands of tons)	198.8	192.9	138.2	156.9	181.7	-3.0%	-28.4%	13.5%	15.8%
Railways transport (cargo: in thousands of tons)	1,277.6	1,266.0	1,265.4	1,137.1	1,318.0	-0.9%	0.0%	-10.1%	15.9%
Roads achieved (asphalt layer completed in km)	3,800.0	4,120.0	4,237.4	4,427.4	4,673.5	8.4%	2.8%	4.5%	5.6%
Fixed line subscribers (Sudatel, in thousands)	700	937	1,029	1,067	300	33.8%	9.8%	3.7%	-71.9%
Mobile phone subscribers (Mobitel, in thousands)	266	554	1,049	1,596	2,464	108.7%	89.2%	52.2%	54.4%

Sources: Central Bank of Sudan, Bank Audi's Research Department

cargo transport saw a growth in activity in 2006. The tons of merchandise transported using this system increased by 16% year-on-year to 1.3 million tons. Railways were also used by passengers. This mode of transport was becoming less and less used, over the years, with the passenger load declining by 25% on a yearly average, over the 2001-2005 period, yet in 2006 passengers transport by train increased by 10%.

As to air transport, in line with the reported boom and the increased investors' interest in the economy, Sudan's national carrier reported a rise in passengers and cargo services. Passengers' traffic increased by 23.3% year-on-year to 544 thousand passengers, while cargo transport grew by a notable 90% to 15.2 thousand tons. With such growth, mainly driven by business visitors rather than tourism, foreign carriers are increasingly serving Sudan. These developments encouraged the government to build a new international airport to replace the present one. Initial contracts were awarded in 2006 and construction of the new airport is expected to be completed around 2011.

Maritime transport did also quite well in 2006, reflecting the dynamic trade activity. Cargo shipped on the Sudanese line increased by 15.8% year-on-year to total 182 thousand tons in 2006. River transport through the Nile is another transport medium increasingly used, though less frequently than most other transport modes, for moving both passengers and cargo from North to South. River cargo transport increased by 8.2% in 2006 to reach 79.4 thousand tons in 2006, while passengers transport grew by 31.6% over the same period to take 25 thousand passengers in 2006.

Telecommunication is another important sector with significant potential and major spillovers on economic and social development. This sector is being liberalized and privatized, attracting domestic and foreign investors to an untapped market with relatively low penetration rates. Sudatel that used to be a 100% government entity, was listed on the Khartoum Stock Exchange, and then raised its capital by selling to Arab partners to finance a plan for capacity expansion and upgrades. By the end of 2005, Sudatel also broke its monopoly of the fixed line segment for the first time when Canar, a joint Sudanese-Arab private venture, was launched to become the second fixed-line operator in the country. Accordingly, Sudatel lost a significant number of its clients to competition, as reflected by a 71.9% drop in subscribers from 1.067 million in 2005 to as low as 0.3 million in 2006, despite the expansion in the network from 1.75 million lines to 2.023 million lines in 2006. The entrance of a second player energized the market, especially as it offered a number of advanced internet services. By 2006, Sudan had 3.5 million subscribers and 16 internet hosts.

Likewise, Sudan's mobile segment of the sector is gaining ground with new cellular operators launched in the last couple of years, creating a more competitive environment and benefiting consumers. By 2006, the market hosted three cellular service providers: Mobitel, MTN Sudan which used to offer the Areeba service, and Sudatel's new cellular CDMA network. MTN ended the monopoly of Mobitel in July 2005 when it launched its services. Later the same year, Sudatel finalized its CDMA cellular network, branded as "Sudani", and started its operations in late 2005. The year 2006 actually witnessed a complete privatization of the mobile phone operator Mobitel, when its Kuwaiti shareholder (MSI) that used to have 61% of ownership acquired the other 39%.

It is estimated that by end-2006 the mobile market would have more than doubled to exceed 4.7 million subscribers, following a similar growth in market size in 2005. The penetration rate at year-end 2006 was around 10%, as reported by Business Monitor International (BMI). This is still low compared to the 20% average penetration rate across Africa following a boom in usage over the past three to four years. Thus, Sudan represents one of Africa's most lucrative telecommunications markets, receiving important foreign investment to benefit from enormous potential. According to BMI, the mobile subscriber base is expected to increase by more than 140%, taking penetration to almost 25% in 2007.

1.2. EXTERNAL SECTOR

Economic buoyancy, driven by the oil boom and increased openness, kept trade activity in Sudan on the rise. The total value of imports and exports increased by 18.5% in 2006. Exports grew by 17% to US$ 5.65 billion in 2006, on account of the rallying oil exports earnings, while imports progressed by a slightly higher 19% to US$ 7.1 billion last year. Subsequently, a sizeable trade deficit of US$ 1.45 billion was recorded in 2006 for the second consecutive year, breaking from a trend of more modest deficits or very small surpluses since the turn of the decade. The trade deficit was 30% larger in 2006 than in 2005.

The widening of the deficit is mainly the result of the liberalization process and tariff cuts taking place over the past years, not to mention the increased flexibility in the exchange rate system that translated into a 13% appreciation in the dinar's value against the dollar in 2006, raising concerns about the competitiveness of non-oil exports. National economic development requirements are also fuelling imports. Machinery, equipments and manufactured goods account for more than half of the purchases from abroad.

In contrast, exports earnings' growth is slowing down, since its main component, oil revenues, is increasing at a slower rate than in previous years. In fact, both the oil exports' annual increase and the total exports growth in 2006 were the lowest in four years. The downward trend is expected to persist, since oil revenue growth is limited by a lower oil quality coming from new blocks, keeping the quotes for Sudanese oil that are obtained on international markets low. Furthermore, competitiveness of Sudan's other exports is still lagging due to supply bottlenecks and the impact of civil wars affecting mainly agrarian production that makes up the majority of non-oil exports and, just like most other primary exports, is subject to price volatility in commodity markets.

In details, oil exports continue to account for the bulk of Sudan's exports, accounting for 90% of total exports in 2006 and for 15% of GDP. Oil exports grew by 20% in 2006, compared to an average annual rate of 132% during the 2001-2005 period. Non-oil exports, in contrast, lost ground and declined by 10.6% over the year, since such commodities are subject to international price variations. Sesame, livestock, cotton, and Arabic gum are the main non-oil exports accounting, respectively, for 29%, 21%, 15%, and 9% of total non-oil exports and for no more than a cumulative 7.5% of total exports.

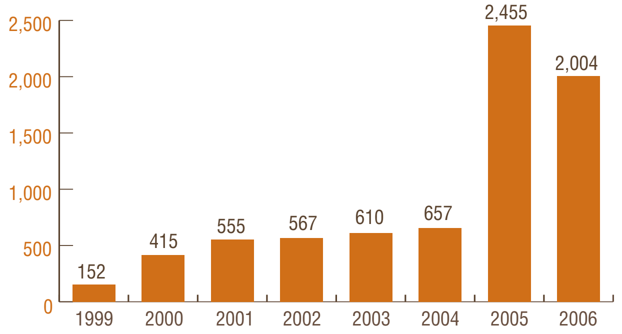
In contrast, imports that have increased by 19% in 2006, are composed mainly of manufactured goods, machinery and equipment, means of transport, and chemicals. Although such industrial imports are expected to be of benefit for the development and industrialization of a resource-rich country like Sudan, they are increasingly weighing on the country's short-term economic performance and trade balance.

Sudan's main trading partner is China, capturing an enormous share of exports and imports. In 2006, it accounted for 75.0% of total exports, up from 71% the previous year, followed by Japan with 9.2%, and the United Arab Emirates with 4.0%. China is also the main import source with 20.8% of total imports, followed by the European Union with 13.4%, Saudi Arabia with 8.0%, and the United Arab Emirates with 5.5%.

In addition to a structural trade deficit, Sudan has been incurring a historically growing current account deficit, due to the negative invisibles' account. In 2006, the current account deficit reached US$ 4.3 billion (12.5% of GDP), up by a huge 57% since 2005. Most invisibles' receipts are aid and remittances, yet these remain minimal compared to much higher payments made for transport and travel as the country is being flooded with foreign businessmen, not to mention the repatriations of profits of foreign companies.

On the positive side, Sudan is witnessing a steady increase in its capital account, that jumped by 85% in 2006 to reach close to US$ 4.5 billion and almost offset the current account deficit. The official figures estimate net

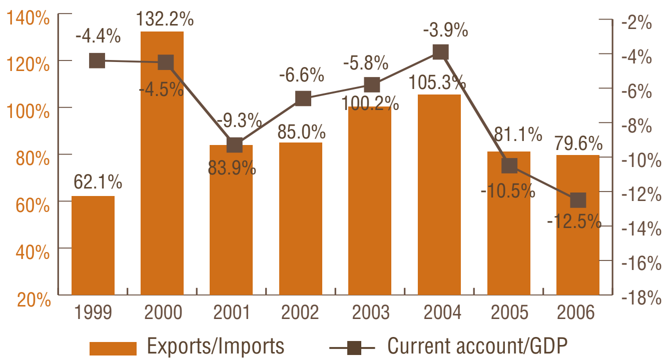
Arab Investments in Sudan (in US$ million)



Sources: Inter-Arab Investment Guarantee Corporation, Bank Audi's Research Department foreign direct investment (FDI), in 2006, at US$ 3.5 billion, rising by 53% year-on-year. With increased liberalization, net FDI has not been limited to the oil industrial but targeted many other sectors, such as construction, industry, transport and banking.

In conclusion, although the capital account has been climbing, fuelled by the strong inflow of FDI, Sudan ended up with a small balance of payments deficit in 2006, as a result of the notable widening in its merchandise trade deficit. The balance of payments reached US$ -209 million, compared to four previous years of surpluses, though quite small. Such a modest deficit might recur in the near-term as FDI in Sudan - the main engine of the capital account's growth - remains short of a rapidly growing trade deficit driven by lower oil revenues and import purchases for the country's development.

Foreign Sector Indicators



Sources: Central Bank of Sudan, Bank Audi's Research Department

1.3. PUBLIC SECTOR

Sudan's fiscal performance in 2006 was weaker than planned, although the country has been doing generally well in adhering to an IMF-set reform agenda, aiming at restoring fiscal discipline and ensuring stability. The worsening of fiscal conditions was not only the result of oil-related developments, but other factors came into play as well this year, with the country still undergoing the challenging tasks of reintegration and reconstruction.

The overall public finance deficit widened to about 4.2% of GDP in 2006, a record high, exceeding by 2% the target projected in the 2006 IMF program and increasing by 1.6% from its 2005 rate. The higher fiscal deficit was financed by depletion of resources in the oil savings account, issuance of government bonds and promissory notes, central bank credit, and accumulation of debt in arrears.

In details, actual public revenues in 2006 amounted to SD 1,507.5 billion, 12% lower than budgeted, but 23.7% higher than the figure achieved in 2005. Tax revenues that account for 39% of total revenues, increased from their achieved level in 2005 by 17.5% and totaled SD 588.1 billion, yet remained 13% lower than budgeted. The shortfall in this category was largely due to the wide use of tax exemptions. Under tax revenues, direct taxes retain a minimal share of 16% and only 6% of total fiscal revenues and, in 2006, they did not increase, standing at SD 95.1 billion.

Indirect taxes, in contrast, were the main growth driver of total tax revenues, rising by 21.5% year-on-year to reach SD 493 billion, and accounting for almost a third of all revenues. The VAT receipts more than doubled, but were 25% short of their budgeted figure. They totaled SD 177.1 billion and some 30% of total tax revenues. Likewise, increased import activity raised revenues from duties, as reflected by an 11.2% increase in excise duties that make up 18% of tax revenues and stood at SD 106 billion in 2006.

As to oil revenues, which make the bulk of non-tax revenues and around half of total fiscal revenues, they also were lower than projected, mainly because of the Dar blend crude priced in international markets at below budgeted levels, although total production was higher than in 2005. Non-tax revenues, thus, amounted to SD 919 billion in 2006, up by 28.1% from the previous year, but some 10% lower than what was budgeted.

In parallel, total public spending amounted to SD 1,825 billion, a good 13% lower than what was estimated in the budget, but also 32% higher than the previous year's figures. Generally speaking, expenditures remained in line with the IMF commitments, while their year-on-year actual growth can be explained by priority reconstruction needs and increases in transfers to states in an effort to support greater decentralization and to meet commitments of the peace agreements, in the absence of sufficient donor funding.

Only capital spending deviated significantly from the 2006 budget, driven by the national development needs. These expenditures that account for around 20% of total government spending, were almost 20 times more than budgeted, reaching SD 354 billion, yet only 4% higher than in 2005.

The excess investment spending was partially compensated for by the government's restraint at the level of current spending, as reflected in a lower than budgeted federal government expenditures. Specifically, salaries and benefits with other centralized operational items and social subsidies totaled SD 816.3 billion (45% of total expenditures), and were 10% lower than budgeted, though 31.4% higher than the figure achieved in 2005.

Sudan added a new category of spending in 2006 for the government of the South's transfers. The South received SD 295.6 billion, the equivalent of 16% of public expenditures. The central government has similar

Selected Public Finance Indicators

SD billion	2002	2003	2004	2005	2006	Var 03/02	Var 04/03	Var 05/04	Var 06/05
Revenues	472.2	703.6	1,023.9	1,218.4	1,507.5	49.0%	45.5%	19.0%	23.7%
o.w. Tax revenues	213.7	266.8	420.3	500.7	588.1	24.8%	57.5%	19.1%	17.5%
o.w. Non-tax revenues	258.5	436.8	603.6	717.7	919.4	69.0%	38.2%	18.9%	28.1%
Expenditures	517.8	736.2	1,103.9	1,384.7	1,825.3	42.2%	49.9%	25.4%	31.8%
o.w. Current expenditures	377.0	563.3	793.6	1,043.5	1,471.3	49.4%	40.9%	31.5%	41.0%
o.w. Development and investment expenditures	140.8	172.9	310.3	341.2	354.0	22.8%	79.5%	10.0%	3.8%
Fiscal balance	-45.6	-32.6	-80.0	-166.3	-317.8	-	-	-	-
Foreign debt (in US$ billion)	23.6	25.7	26.8	27.0	28.2	8.9%	4.2%	0.8%	4.4%
Revenues/GDP	12.2%	16.7%	19.2%	18.9%	20.0%	4.6%	2.4%	-0.2%	1.0%
Expenditures/GDP	13.4%	17.5%	20.7%	21.5%	24.2%	4.2%	3.1%	0.9%	2.7%
Fiscal balance/GDP	-1.2%	-0.8%	-1.5%	-2.6%	-4.2%	0.4%	-0.7%	-1.1%	-1.6%
Foreign debt/GDP	160.4%	159.6%	129.3%	102.3%	81.1%	-0.8%	-30.3%	-27.0%	-21.1%

Sources: Central Bank of Sudan, Bank Audi's Research Department

transfers to northern states that take up a good 20% of total spending and amounted to SD 359.4 billion, almost unchanged from the 2005 level, but 25% lower than budgeted.

It is also important to add that public expenditures' growth has been driven, in recent years, by the increase in debt servicing, as Sudan struggles with its large stock of debt and arrears. Although detailed figures are not available, it is well established that the country has been making significant efforts recently to meet its debt servicing obligation.

Based on the available official data, the end-2006 stock of external public debt is estimated at over US$ 28.2 billion, up by 4.4% since 2005, and by about 35% since 2001. Sudan has been grappling with a large stock of debt in arrears but the country has been receiving concessional lending from Arab and Asian countries. The increase of the debt stock over the past years by more than a third largely reflects a US$ 6.3 billion buildup in arrears to official bilateral (Paris Club and non-Paris Club) creditors, and new drawings of some US$ 520 million from Arab multilateral and bilateral creditors as well as from China and India.

However, Sudan, acknowledging its debt overhang problems, has been working on finding solutions in this respect. Aided by the strong economic expansion and growing GDP, external debt went down from a high of 160% of GDP at the start of this decade, to 80% in 2006. The government has been cooperating with the international financial institutions and multilateral agencies on managing its arrears and to meet a debt relief process, despite the fact that this task seems to be difficult not only technically but for political reasons as well.

The challenging fiscal imbalances are looming over 2007 and are expected to continue into the next couple of years, as fiscal policy will need to focus on the difficult task of funding development needs, and hence fuelling expenditures, along with keeping a public finance stance consistent with macroeconomic stability. In short, such trends could put at risk the goals set out in the country's reform program. Unless the international community responds to the recent favorable fiscal management track record, bypass the political constraints, and effect some form of debt relief to allow the country to reap the fruits of the recent economic booms and channel them towards a sustainable development process, Sudan will remain in a debt trap, unable to fully service debt, implement the various peace agreements, and address critical poverty and reconstruction requirements.

1.4. FINANCIAL SECTOR

1.4.1. Monetary Situation

The buoyant economic performance of 2006, marked by a substantial increase in oil production and a vibrant construction and trade and services activity, has had positive spillovers on the monetary sector. The favorable conditions that continued to reign over the country triggered more capital inflows pouring in, an ensuing enhanced liquidity in the Sudanese economy, a surge in bank loans to the economy, and more generally an increase in broad money supply, yet these favorable developments were accompanied by inflationary pressures, especially in the latter part of the year. This called for Central Bank measures to daunt such an unwelcome yet inevitable phenomenon.

Broad money growth reached a solid 27% in 2006, mainly supported by a 336% annual average increase in claims on the public sector, which boosted net domestic assets by 78%. Money supply yet somewhat slowed down towards the end of the year, following a sharper increase over the first half, due in large part to a deceleration in the growth of private sector loans during the second half of the year. The year-to-June growth of loans to the private sector reached 52.3%, against a much lower 2.3% in the July-to-December period.

A few other factors also dampened the surge in broad money supply. Among those, we mention the rise in the negative net foreign assets, which moved from SD -58 billion in 2005 to SD -184 billion in 2006, and the corrective actions adopted by the Central Bank, especially during the last quarter of 2006, principally foreign exchange sales to mop up domestic liquidity associated with fiscal expansion and the injections into the state-owned Omdurman Bank, in addition to the emergence of government arrears which left an impact on the banks' balance sheets.

Another effect of rising oil export earnings and strong FDI inflows over the past year was the appreciation of the Sudanese dinar by 13% and 21% in nominal and real effective terms respectively, noting that the national currency started to appreciate since late 2004 due to improved market fundamentals coupled with a move towards a market-driven exchange rate.

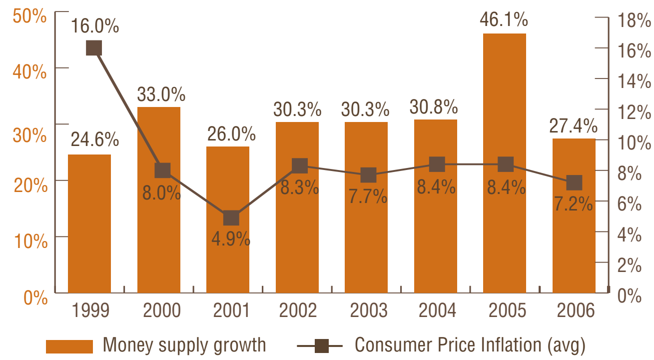
The robust economic growth in 2006 and the expansion of broad money however were accompanied by an increase in pressures on prices. Indeed, the inflation rate almost tripled from 5.6% in 2005 to 15.8% in 2006. A substantial part of the reported figure is attributed to the government's decision to reduce subsidies on domestic fuel products and sugar since mid-2006, which led the inflation rate in the second half of the year to be much more important than that of the first half. In fact, the annual average inflation stood at a single-digit rate of 7.2% over the year as a whole, mainly favored by the relative stability in prices in the year-to-June period, and even lower than the 8.4% figure reported in 2005.

Within such a context, the Central Bank adopted the said corrective actions to absorb domestic liquidity through the sale of foreign currency, and ultimately curb down inflation. In addition, it shifted from a managed float exchange rate regime to a peg over the past year in the aim of stabilizing the value of the national currency, which required its heavy intervention on the foreign exchange market. These developments however resulted in a decline in net international reserves by 26.7% year-on-year to reach a low level of US$ 1.4 billion at year-end 2006, thus covering only 1.7 months of imports. Under such conditions, the monetary authorities decided to allow greater exchange rate flexibility and progressively rebuild reserves. In addition, the Central Bank looked towards acquiring government securities from the banking system in order to increase its armada of indirect monetary policy instruments, since the trading of such securities could be used to meet liquidity management objectives, instead of relying on sales of foreign exchange.

In parallel, the Central Bank announced in 2006 its plan to introduce the new Sudanese pound as the national currency, under which each new pound is equivalent to 100 Sudanese dinars. The operation has been allocated finance from the World Bank-administered multilateral trust fund earmarked for the support of the North-South peace process. The introduction of the new currency, originally planned for December 2006, was delayed to early 2007, as the Central Bank wanted to allow further appreciation of the Sudanese dinar, partly in order to alleviate inflationary pressures. The government plans to complete the transition in 2007, and is aiming for an exchange rate of SP2:US$1, mostly in order to protect the competitiveness of non-oil exports.

Looking forward, the Sudanese monetary authorities face several challenges, namely curbing down incumbent inflationary pressures, bolstering net international reserves, and maintaining a quasi-stable exchange rate. The authorities' 2007 monetary policy targets to monitor price stability, to channel the sales of foreign exchange towards serving government and market needs, and to remove the floor on cash margin for sight letters of credit and import. The IMF, in its latest report on the country, recommended that the conduct of monetary policy relies increasingly on open market operations with an emphasis on indirect monetary policy instruments, in order for the Central Bank of Sudan to efficiently impose a sound and stable monetary environment.

Money Supply and Inflation



Sources: Central Bank of Sudan, International Monetary Fund, Bank Audi's Research Department

1.4.2. Banking Activity

The banking sector in Sudan continued to benefit from the buoyant economic conditions and several undergoing reforms commenced by the authorities in recent years, and witnessed an extended surge in all major sector aggregates. Banking activity, measured by total assets, hiked by an outstanding 51.2% to reach SD 2,314.4 billion at year-end 2006, its highest growth in recent years.

Such a progression was mainly driven by growing customer deposits and total loans to the private sector. Customer deposits rose by a yearly 25.9% to SD 1,230.9 billion at year-end 2006, and accounted for 53.2% of total assets. The share of foreign currency deposits has continued to decline, from 27.2% in 2005 to 19.4% in 2006. Total loans registered an even more remarkable growth over the previous year (+55.8%), standing at a record high of SD 1,058.3 billion at year-end 2006, and pinpointing the increasing role of banks in the financial intermediation process, and their catering to the funding needs of economic agents. The sector also expanded via equity increases, as total capital accounts more than doubled to reach SD 389.1 billion last year. This was mainly owed to the important reforms raising the banks' provisions and encouraging merger and acquisition operations.

In spite of such robust performances, the Sudanese banking sector's dimension in the economy remains weak in both absolute and relative terms. The ratio of assets to GDP stood at 28.4% in 2006, against much higher averages of 93.3% for the MENA region and of 81.8% for emerging markets. Similarly, deposits to GDP reached 15.1%, lower than the MENA region average of 58.9% and the emerging markets estimated average of 61.7%. The ratio of loans to the private sector to GDP attained 13.0%, against a considerably higher MENA region average of 41.9%, and a much higher estimated emerging markets average of 53.1%. As such, the sector has room to expand further, supported by a favorable monetary and regulatory environment, and by the oil boom and other external flows.

Moreover, the 29 banks operating in Sudan as at year-end 2006, of which 26 are commercial banks and three are specialized banks, are scattered over 522 branches, leading to a residents per branch ratio of 69,383, clearly one of the highest figures among regional peers, and way higher than similar emerging and advanced markets benchmarks, thus stressing further on the necessity -and opportunity- to expand further the banks' retail network coverage, and more efficiently serve a potentially larger and continuously growing customer base.

Financial soundness indicators have unfortunately deteriorated in 2006, mirroring rapid loan growth, fiscal expansion, the accumulation of government arrears, and the intervention of the State-owned Omdurman Bank, according to the latest IMF report. This was mainly reflected in the worsening of the banks' loan portfolio quality, as the non-performing loans (NPLs) to total loans ratio has surged, from 7.1% in 2005 to as much as 19.4% in 2006. The IMF believes that the single most important factor behind this is tied to Omdurman Bank, as prolonged mismanagement, regulatory forbearance, and accumulation of illiquid government debt triggered weaknesses for the bank and justified the intervention of official authorities and liquidity injections from the sector's regulator in the last quarter of 2006 and the first month of this year. Other banks appear to have registered deterioration in asset quality as well, according to the Fund. Loan provisions to NPLs have subsequently declined, from 26.5% in 2005 to 14.0% in 2006.

Profitability indicators have also dropped but remained comparatively satisfactory, with the pre-tax return on assets at 3.6% in 2006, versus a higher 5.0% in 2005, and the pre-tax return on equity at 35.4%, versus 56.0% in the previous year. On a more positive note, liquidity improved, as the liquid assets to total assets ratio moved upwards, from 16.9% in 2005 to 25.0% in 2006, and as capitalization levels appear to be satisfactory, with the BIS ratio at 19.7% in 2006. However, the IMF asserts that the existing low provisioning levels of banks might actually render them undercapitalized.

Within such a context, Sudanese authorities have lately reassured that they are determined to go forward with their plans to restructure and bolster the banking system. Authorities appear to be working on the implementation of a strategy for resolving recent problems with Omdurman Bank, and would prepare a plan for the resolution/restructuring of the bank by June of next year. Likewise, authorities are planning the rehabilitation of the Saudi Sudanese Bank. The Central Bank of Sudan intends to actively enforce prudential standards and ensure that banks comply with existing regulations, as per a recent Letter of Intent addressed to the International Monetary Fund. Commercial banks will be asked to submit specific action plans to achieve full compliance with existing regulations on capitalization and provisioning, especially as concerns over the asset quality status of banks are exacerbated by the still high pace of banking loans growth.

In parallel, the favorable economic performance of the country in recent years, coupled with the Central Bank's new strategy for screening mergers and acquisitions and opening the sector to foreign banks, has enticed regional and international entities to set up banks in Sudan, especially those of the Gulf Cooperation Council (GCC) countries, looking to make the most of the money pouring in, in spite of all political uncertainties.

More specifically, the setting up of a new southern Central Bank, the Bank of Southern Sudan in mid-2006, under the overall supervision of the Central Bank of Sudan, has facilitated the gradual establishment of a non-Islamic banking system in the South of the country, with several banks from neighboring countries such as Kenya having already set up representative offices in Juba, the South's capital, as per the Economist Intelligence Unit, while an Islamic banking system continues to operate in the North of Sudan. Such a dual banking system would present both opportunities and challenges for improved financial intermediation and management.

The coexistence of Islamic and conventional financial entities is likely to increase competition and open the door for banks to mobilize greater resources by attracting greater savings -and borrowings- that would have otherwise stayed out of an interest-based financial system, ultimately enhancing the quality of financial products and services available to customers, and further contributing to growing banking activity and subsequently to bolstered economic performance at large.

1.4.3. Equity Market

The severe market price corrections that impacted most of the region's bourses in 2006 had limited consequences on the Sudanese stock market. In fact, while the Arab Monetary Fund (AMF) composite index of MENA stock markets dropped sharply by 42.5% year-on-year in 2006, the AMF Khartoum Stock Exchange index declined by a moderate 4.4%, moving from 205.26 at year-end 2005 to 196.30 at year-end 2006. This suggests

Banking Activity

SD million	2002	2003	2004	2005	2006	Var 03/02	Var 04/03	Var 05/04	Var 06/05
Total assets	611,239	789,597	1,043,506	1,530,310	2,314,428	29.2%	32.2%	46.7%	51.2%
% change in assets	34.2%	29.2%	32.2%	46.7%	51.2%	-5.1%	3.0%	14.5%	4.6%
Total deposits	363,074	472,952	646,649	977,595	1,230,865	30.3%	36.7%	51.2%	25.9%
% change in deposits	32.4%	30.3%	36.7%	51.2%	25.9%	-2.2%	6.5%	14.5%	-25.3%
Total capital accounts	73,692	110,308	143,711	183,862	389,089	49.7%	30.3%	27.9%	111.6%
% change in capital accounts	54.7%	49.7%	30.3%	27.9%	111.6%	-5.0%	-19.4%	-2.3%	83.7%

Sources: Central Bank of Sudan, Bank Audi's Research Department

that the buoyant economic activity in the country over the past year and the resulting high liquidity could not fully contain the effect of the stock market bubble burst.

On a more positive note, and in spite of the aforementioned decline in prices, the total market capitalization managed to rise by an important 25%, from SD 747.3 billion at year-end 2005 to SD 931.0 billion at year-end 2006, mainly due to the listing of three new companies, with the total number of listed companies reaching 52 at end-2006. In addition, the total trading value increased by a massive 72% over the past year, from SD 120.4 billion in 2005 to SD 206.6 billion in 2006, supported by a substantial surge in the number of traded shares from 1,731 million shares in 2005 to 7,583 million shares in 2006, this time fully mirroring the favorable economic conditions.

With the trading value growing at a higher rate than the market capitalization, the turnover ratio, measured by the total trading value to market capitalization, rose from 16.1% in 2005 to 22.2% in 2006, thus reflecting a relatively more liquid market in 2006.

On the other hand, the Sudanese stock market size, notwithstanding the rise in trading activity and market liquidity, is still considered small both in absolute and relative terms. In fact, the ratio of market capitalization to GDP, though increasing slightly from 11.6% in 2005 to 12.3% in 2006, remains far below the Middle East estimated average of 67.0% and the emerging markets estimated average of 84.7%.

The low stock market contribution to the economy underlines its remarkable growth potential. Sudanese authorities could actually seize the golden opportunity of the currently robust economic activity in Sudan and the ongoing oil bonanza in the MENA region at large that is increasingly generating liquidity at hand, and modernize and improve the local stock market. The latter, especially with the progress of the privatization program that entails new diversification opportunities for investors at large, and expands the shareholders' base to foreigners, could very well have a major role in channeling domestic and foreign resources, which should translate into enhanced equity market indicators, and ultimately add to increased financial modernization and economic performance.

context of a rapid acceleration of the economy. As a matter of fact, the 12-month rate of inflation nearly tripled from 5.6% in 2005 to 15.7% in 2006. It is believed that a substantial portion of the price surge was linked to an increase in administered prices (fuels) in the third quarter of 2006, which was followed by a decrease in inflation in the year-to-date performance. As to Sudan's monetary situation, broad money growth ended the year at 27%, bolstered by strong economic growth and further monetization. The dinar appreciated by 13% in nominal terms relative to the US dollar, due to the fiscal expansion and strong capital inflows.

Despite the improvement in economic activity and its expected positive direct effects on government revenues, the fiscal position weakened in 2006. The overall deficit for the year was estimated at over 4 percent of GDP. This reflected mostly oil revenue shortfalls – mainly linked to Dar blend crude. But non-oil revenues reported also shortfalls, largely due to the wide use of tax exemptions, notably in the value added tax, customs and business profit tax.

In parallel, the current account deficit deteriorated in 2006, displaying a deficit of roughly 13% of GDP. Imports surged over the course of the year, reflecting an increase in foreign investment at large that translated into significant imports of capital goods. On the other hand, non-oil exports declined by some 11 percent in dollar terms in 2006. In parallel, while exports of crude oil rose by some 70% in volume terms, the extremely low price received for Dar blend resulted in an increase of only 22% in value terms as suggested by the latest IMF Article IV Consultation report.

It is important to mention that sustained economic growth requires deeper financial intermediation, while the IMF has expressed concerns about the deterioration in financial sector indicators at large. The Fund called on the Central Bank to actively enforce prudential standards and ensure that banks comply with regulations on capitalization and provisioning. It also called for a restructuring strategy for the State-owned Omdurman Bank based on the results of the forthcoming independent audit.

In its last IMF Article IV Consultation report, the IMF welcomed the authorities' recent efforts to tighten fiscal policy mainly through the reduction of fuel subsidies. The IMF also welcomed the authorities' decision to allow greater exchange rate flexibility and to rebuild reserves, in addition to the intention to eliminate the exchange restriction and multiple currency practices. The fund yet stressed on the challenges facing monetary policy in the context of higher and more volatile capital inflows and oil revenues.

Equity Market Indicators

SD million	2003	2004	2005	2006	Var 04/03	Var 05/04	Var 06/05
Market capitalization	192,985	539,821	747,327	931,018	179.7%	38.4%	24.6%
No. of listed companies	47	48	49	52	2.1%	2.1%	6.1%
Price index (Dec. 2002 = 100)	97.7	148.2	205.3	196.3	51.7%	38.5%	-4.4%
Trading value	17,403	33,864	120,428	206,642	94.6%	255.6%	71.6%
Trading volume (in millions)	4,366.6	2,147.3	1,730.5	7,582.9	-50.8%	-19.4%	338.2%
Turnover ratio	9.0%	6.3%	16.1%	22.2%	-2.7%	9.8%	6.1%
Market capitalization/GDP	4.6%	10.1%	11.6%	12.3%	5.5%	1.5%	0.7%

Sources: Arab Monetary Fund, International Monetary Fund, Bank Audi's Research Department

CONCLUSION

With a 9.3% real GDP growth and a 9.2% non-oil real GDP growth in 2006 (respectively 12% and 10% as per the IMF), Sudan's economy is considered among the fast growing economies of the developing markets arena. Despite a lower growth in oil production than previously projected, economic activity is buoyed by a continued recovery in agriculture and strong recovery in manufacturing, construction and services.

It was normal that inflation would jump to a double-digit rate within the

The most significant for Sudan remains the implementation of structural reforms aimed at strengthening competitiveness, reducing poverty and bolstering non-oil growth. Beyond structural adjustment reforms, successful implementation of the peace agreement will be crucial for the social and economic advancement of Sudan.