MACROECONOMIC INSTABILITY, FINANCIAL REPRESSION AND ISLAMIC BANKING IN SUDAN

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Abstract

This article examines the practice, problems and potential of Islamic banking in Sudan. The study demonstrates an unprecedented decline in both financial and real variables. It argues that the activities of Islamic banks in the country are constrained by the macroeconomic environment in general and repressive monetary and credit policy in particular. The paper concludes that when such constraints are removed only then the Islamic banking system may make a meaningful contribution to financial and economic growth in Sudan.

1. Introduction

Theoretical questions about how well an Islamic financial system can be and the role of monetary and fiscal policies were extensively analyzed by Khan and Mirakhor (1990). It is often contended that the Islamic “profit-and-loss-sharing” instruments are

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likely to reduce savings due to increased risk. It is argued that whereas savers in the conventional financial system face only inflationary uncertainties, those in the Islamic counterpart are subject to uncertainties pertaining to both the rate of inflation and the nominal rate of return on deposits. However, it has been counter argued that, the question of whether uncertainty lowers the rate of savings relies on the assumptions made about the utility function and its risk properties; the degree to which the future is discounted, the income and substitution effects and on the relationship between uncertainty and returns. It was consequently concluded that the effect of Islamization on savings is at best ambiguous.

As regards investment, the Islamic banking system is assumed to operate as an equity-based market with depositors representing shareholders and banks as partners who provide no guarantee on the rate of return or shares value. As a result, it is hypothesized that there will be a tendency of decreasing risk-aversion on the part of the Islamic banks since their income becomes a function of investment’s yield. The Islamic system may also be more adaptive to the requirements of new and innovative entrepreneurs since there is less need for collateral. Meanwhile, project monitoring implied by Islamic mechanisms will ensure that banks either act as entrepreneurs themselves or provide valuable technical and managerial support to investors. This would undoubtedly enhance the growth of entrepreneurial talents and hence fosters real growth.

However, Islamic financial arrangements may restrict investors’ choice of project, raise the cost of intermediation, and reduce the array of indirect monetary instruments available to monetary authorities to control bank credit and money supply. Moreover, as Sattar (1989) observes conceptually Islamic finance implies the absence of interest-based government bonds and thus eliminates an important source of debt financing of budget deficit. Since all interest-based instruments of monetary management do not exist, monetary and fiscal policy may no longer be independent and budget deficits become synonymous with monetary expansion.
In Sudan, the first Islamic bank commenced operations in 1978 and as from 1990 the entire financial system has been legally bound to adhere to Islamic principles of finance. This paper describes the experience of Islamic banking in Sudan, and attempts to analyze the constraints imposed by deteriorating macroeconomic environment and restrictive monetary and financial policy on the activities of the banking sector during the period 1970-1995. The analysis is conducted within a “before and after” framework that does not involve formal testing of the direction of causation between macroeconomic instability and Islamic banking practices. This approach is nonetheless justifiable because theoretically Islamic banking is believed to be conducive to financial stability and at least consistent with Keynesian or Classical macroeconomic models in terms of the link between financial variables and macroeconomic stability. Indeed, in a model of an Islamic macroeconomic system, Sattar (1989) shows that macroeconomic instability is likely to originate from the real sector, especially the government sector, rather than the financial sector.

The next section contains a brief discussion of the evolution and main financial instruments used by Islamic banks in Sudan. This section also examines the impact of Islamic banking on financial deepening and widening as well as on the saving-investment process. The nature of macroeconomic environment and monetary and credit policy and their possible influence on the behavior of banking institutions in Sudan are examined in Sections 3 and 4 respectively. Finally section 5 gives some conclusions and policy recommendations.

2. The Evolution and Performance of Islamic Banking in Sudan

The emergence of Islamic banks in Sudan has been associated with certain economic and political developments. The banking sector which was dominated by government-controlled and foreign banks used to offer little access, especially to new and relatively small scale, indigenous enterprises. Thus, local business groups were eager to
penetrate the banking sector not only as a form of investment per se, but also for the services and credit facilities they expect to have in the future. At the same time, political developments in the country have been increasingly overshadowed by revival of Islamic ideals, which were then manifested in the establishment of Islamic enterprises, including banks. The first bank, The Faisal Islamic Bank, was incorporated in 1978, and its immediate business success provided the impetus for five other Islamic banks to be opened between 1982 and 1987. As from 1990 onward, the entire financial system of Sudan has been instructed to observe the Islamic principles of finance. By 1988, there were 23 commercial banks compared to just 5 commercial banks in 1972. After the full adoption of Islamic banking principles and relaxation of bank branches licensing policy in the 1990s, the number of banks decreased due to amalgamation of some joint banks, but the number of bank branches almost doubled from their 1990 total of 320, with many of the new branches being established in rural areas. To assess the experience of Islamic banking in Sudan, we first discuss the evolution of Islamic financial instruments. Second, we examine the impact of such instruments on the process of financial development in the country. Finally, we analyze the potential of Islamic banks to influence real development by bringing about a conducive structure of financial resources.

2.1 Islamic Financial Instruments in Sudan

In accordance with the Islamic principle of participation, Islamic banks in Sudan have introduced an array of financial instruments to facilitate transactions on both sides of the balance sheet.

2.1.1 Sources of Funds

In addition to their own capitals and equities, Islamic banks raise funds by creating three basic forms of liabilities viz demand deposits, saving deposits and investment deposits. Demand deposits
are similar to current account deposits of conventional commercial banks. They bear no returns, but their holders receive a variety of services such as checking facilities. Although some Islamic banking models have argued for a 100% reserve requirement on demand deposits, Islamic banking in Sudan and elsewhere operates on partial basis.

Saving deposits differ from demand deposits in that they carry no service charges, their holders may be entitled to special borrowing facilities, and they earn profit/loss subject to certain maturity limitations. Investment deposits are normally held for the purpose of earning income and may not be withdrawn before the lapse of a certain period of time. They closely resemble business shares since their nominal value is not guaranteed and the returns on them are uncertain and variable. The bank acts as a financial trustee that accepts deposits and invests them on behalf of depositors in any form of financial arrangement that satisfies Islamic requirements. The only thing agreed upon in advance to the employment of funds in this deposits category is the basis on which profit/loss is distributed between the bank and the borrower, and between the bank and its depositors. The basis of distribution in the former case is normally the net profit/loss realized by the investor, and in the latter case is that realized by the bank, given the profit-and-loss sharing ratios as determined by the authorities. Since saving and investment deposits represent the base for medium and long-term or more generally development financing, their share in total bank deposits is critical to the success of Islamic banking in effecting real development.

2.1.2 Lending Instruments

Over the years Islamic banks in Sudan have used a variety of lending instruments some of which have been abandoned or changed in terms of significance. Therefore the list below is by no means exhaustive.

The first lending instrument is *Mudarabah*, which is a financial arrangement in which the bank provides all the necessary financial
capital while the investor provides all human capital needed. The two parties share the uncertain profit according to an agreed formula. In the case of project failure, the bank and its depositors bear the entire financial loss, whereas the entrepreneur loses his time and effort invested in the project. In the life time of the project, the bank is the sole owner of it, and the borrower is the manager. *Murābāh* has traditionally been confined to commercial activities of short duration. Banks can make loans to customers directly or indirectly through a *Murābāh* (equity) company, the capital of which is provided by banks in the form of direct equity or through loans with equity features. The second instrument is *Mushārakah*, which is a joint venture in which there is more than one contributor to the financial capital. The profits and losses are to be shared according to the respective capital contribution of each party.

The third lending instrument is deferred payment sale or mark-up (*Murāba*) sale, which provides one of the means for banks to purchase a product and resell it on the basis of deferred payment, in instalment or lump-sum. The borrower (buyer) and the bank agree on the price of the product plus a profit margin. The fourth lending mechanism is purchase with deferred delivery (*Bay' al-Salām*), which enables banks to purchase goods at negotiated price, but to be delivered at some future date. The bank pays the seller the full amount at the time the contract is signed. *Bay' al-Salām* has been the most important instrument of formal lending in agriculture in the 1990s. It is extensively used by farmers to obtain the funds they need for agricultural operations against the promise of delivering an agreed amount of their future output to the bank. The assets of the farmer can be used as collateral or security against fraud and negligence, but the lender would bear all due financial losses incurred in the operation.

The fifth instrument is leasing or hire-purchase, according to which the bank can purchase a commodity, and lease it to a borrower for a specified sum and for a certain period of time. The agreement can also provide for a lease-purchase of the commodity. In this case payments made by the borrower would include a portion which can be
 earmarked for the final purchase and transfer of ownership of the product. Over the period of the lease, both parties are subject to the risk of potential damage. Finally, service charges are legally allowed to be levied on loans or services rendered by banks. This method is particularly relevant in the case of consumption loans, overdrafts or small scale borrowing.

Besides financing investment through the above instruments, Islamic banks can undertake investment directly by establishing their own corporate enterprises. The bank will eventually be responsible for both funding and management.

2.2 Islamic Banking and Financial Development

Financial development has two components; financial widening and financial deepening. The former refers to the accessibility of financial services and the spread of banking habits among the public, which depends largely on the geographical dispersal of banks. Financial deepening is concerned with the nature, range and sophistication of financial instruments used and innovations made in the course of attracting funds and extending credit. Traditionally financial development is proxied by the ratio of narrow or broad money (M1 and M2 respectively) to Gross National Product (GDP). However, as King and Levine (1993) and Demirguc-Kunt and Levine (1996) note this ratio indicates the ability of financial institutions to provide liquidity and not necessarily their role to allocate credit efficiently. For example, while a low M2/GDP ratio may indicate a high degree of sophistication of financial markets which allows individuals to economize on their money holdings (Bencivenga and Smith, 1991), it may also reflect financial dis-intermediation or portfolio shift from financial to real assets. The latter normally occurs under conditions of high inflation rates and macroeconomic uncertainty. In view of this, the literature has suggested the use of a number of additional indicators of financial development. These indicators are, first, the ratio of Quasi-money to M2 (or GDP), which was used by Demirguc-Kunt and Levine (1996)
as an indicator of the degree of financial efficiency. For the financial system to raise increased longer term liabilities it has to be efficient and conducive to public confidence. The ratio of quasi-money to M2 (i.e. the Financial Interrelation Ratio, FIR) is particularly important in the context of economic development because it reflects the ability of the banking sector to create medium and long-term credit. Therefore, financial development is more likely to be growth-promoting, if it is accompanied by an increasing FIR.

Second, the ratio of total claims of deposits in banks to GDP (TBCGDP) is a measure of the level of development of the banking system. Third, the ratio of private sector credit to total domestic credit (PSCTC) or GDP is an indicator of both the degree of financial intermediation and efficiency in credit allocation. The share of the private sector in domestic credit is supposed to rise as the financial system develops and/or becomes more liberalized. Finally, the difference between bank lending and deposit rates (SPREAD) is considered as a measure of banking efficiency. This subsection discusses the evolution of the broad money to GDP ratio and the Quasi-money to M2 ratio, whereas the TBCGDP ratio and the PSCTC ratio are examined in the next subsection in connection with resource mobilization. The spread variable is not considered because of paucity of information on effective bank lending and borrowing rates.

It was indicated earlier that the advent of Islamic instruments and relaxation of bank branches’ licensing policies stimulated a notable increase in bank branches especially in rural areas. This reflects a rising degree of financial widening in Sudan. As in Figure 1, the period 1970-95 witnessed substantial changes in financial development in Sudan as manifested in the ratio of broad money (M2) to GDP and the ratio of quasi-money to M2. M2 is defined as the sum of cash outside banks plus demand deposits of commercial banks plus quasi-money. For the period prior to the incorporation of Islamic banks, quasi-money is defined as time and saving deposits of commercial banks. For the period when the banking system was partially Islamic, quasi-money included both time and saving deposits of traditional banks and saving and
investment deposits of Islamic banks. For the post-Islamic banking period, quasi-money consisted exclusively of saving and investment deposits of commercial banks.

**Figure 1: Some Indicators of Financial Development**

The M2-GDP ratio grew steadily between 1970 and 1980, rising to the maximum of 40% in 1985 after a notable decline in 1983. Over this period, monetary policy was less repressive despite nominal interest rate fixing. Accordingly domestic credit and broad money grew rapidly. With accelerating inflation rate and strict private credit controls, the M2-GDP ratio declined sharply since 1985 reaching 24% by 1995. This notable dis-intermediation was accompanied by similar FIR behavior. The most remarkable drop in the two ratios occurred in 1992 as a result of an unprecedented tightening of credit policy in 1991. However, the ratio of profit-bearing deposits to total deposits, and hence
FIR, has been increasing since then. This rise was possibly due to high bank profits, resulting from the adoption of Islamic lending instruments, which also benefited depositors. Unfortunately, non of available publications gives data on profit/loss rates earned by banks or depositors, but survey information attests that bank profit rates were substantial in real terms.12

2.3 Islamic Banking and Resource Mobilization

To see how key banking performance indicators behaved after the abolition of fixed interest rates, Tables 1 and 2 report constant price and relative magnitudes of bank deposits and loans. Table 1 shows a continuous decline in bank liabilities and total deposits in both fixed 1987 price and relative to GDP, since the mid 1980s. This decline followed impressive increases in bank liabilities and deposits between 1970 and 1985. The average volume of total commercial banks’ deposits in the period 1990-94 was about 52.4% of that in 1980-84, but the decline in total commercial banks’ assets was less accentuate. This decline in private sector deposits is in contrast with the experience of Iran and Pakistan, where Islamic instruments resulted in an increase in such deposits.13 The only notable positive element in Table 1 is the rise in the share of saving and investment deposits. This share rose from the annual average of 24.4% for 1970-74 to 38% for 1990-94.

Table 2 reports some interesting features of the growth and type of commercial banks’ credit. In line with broad money and total assets and deposits, total commercial bank loans have fallen in both real and relative terms after reaching a peak around 1985. Tight credit policy since 1986 is at least partly to blame. In efforts to contain growth in money supply and inflation, ceilings on overall private credit have always been imposed. Under these ceilings, restrictions on the volume of individual bank’s credit is also dictated on the basis of the bank’s credit-resource14 ratio, its cash-reserve ratio, and the extent to which it is involved in the financing of priority sectors over and above the minimum level set by the central bank. Meanwhile the required reserves
Table 1: Growth, Origin and Type of Commercial Banks’ Deposits: 1970-1995

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<tr>
<td>1. Assets/Liabilities of Commercial Banks:</td>
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</tr>
<tr>
<td>a. in constant price</td>
<td>3053.1</td>
<td>5873.0</td>
<td>9056.9</td>
<td>8346.7</td>
<td>6365.4</td>
<td>-</td>
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<tr>
<td>b. as % of GDP</td>
<td>15.91</td>
<td>23.02</td>
<td>35.22</td>
<td>32.30</td>
<td>32.30</td>
<td>-</td>
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<td>2. Total Commercial Banks’ Deposits:</td>
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<tr>
<td>a. in constant price</td>
<td>2098.3</td>
<td>4019.7</td>
<td>5635.1</td>
<td>5544.6</td>
<td>2954.2</td>
<td>2133.8</td>
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<tr>
<td>b. as % of GDP</td>
<td>10.9</td>
<td>15.75</td>
<td>21.90</td>
<td>21.45</td>
<td>14.73</td>
<td>14.03</td>
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<td>3. Composition of Commercial Banks’ deposits:</td>
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<tr>
<td>a. Demand Deposit</td>
<td>75.62</td>
<td>75.95</td>
<td>70.74</td>
<td>63.02</td>
<td>62.18</td>
<td>37.76</td>
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<tr>
<td>b. Time and Saving Deposit* as % of total</td>
<td>24.38</td>
<td>24.05</td>
<td>29.26</td>
<td>36.98</td>
<td>37.82</td>
<td>62.24</td>
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<td>4. Origin of Deposit</td>
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<tr>
<td>a. Government</td>
<td>1.61</td>
<td>2.86</td>
<td>1.81</td>
<td>12.1</td>
<td>4.11</td>
<td>4.36</td>
</tr>
<tr>
<td>b. Private Sector</td>
<td>98.39</td>
<td>97.11</td>
<td>98.19</td>
<td>87.9</td>
<td>95.89</td>
<td>95.64</td>
</tr>
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Notes: * Includes saving and investment deposits of Islamic banks, and consists entirely of these deposits in the post-Islamic banking period.
Base year 1987=100.
Table 2: Growth and Type of Commercial Banks' Credit and the Loan-Deposit Ratio: 1970-1995

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<tr>
<td>1. Total Credit:</td>
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<tr>
<td>a. in constant price</td>
<td>2615.6</td>
<td>4266.0</td>
<td>4788.5</td>
<td>2960.8</td>
<td>1284.2</td>
<td>683.31</td>
</tr>
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<td>b. growth rate*</td>
<td>16.02</td>
<td>28.63</td>
<td>24.16</td>
<td>25.43</td>
<td>77.81</td>
<td>46.5</td>
</tr>
<tr>
<td>c. as % of total domestic credit</td>
<td>48.56</td>
<td>41.36</td>
<td>45.61</td>
<td>30.87</td>
<td>24.69</td>
<td>-</td>
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<tr>
<td>2. Type:</td>
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<tr>
<td>Private sector (% of total)</td>
<td>73.86</td>
<td>73.69</td>
<td>81.67</td>
<td>96.67</td>
<td>97.61</td>
<td>98.76</td>
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<tr>
<td>Public sector (% of total)</td>
<td>26.14</td>
<td>26.31</td>
<td>18.33</td>
<td>3.33</td>
<td>2.39</td>
<td>1.24</td>
</tr>
<tr>
<td>3. The loan-deposit rate (%)</td>
<td>127.17</td>
<td>107.84</td>
<td>85.52</td>
<td>53.3</td>
<td>44.46</td>
<td>n.a.</td>
</tr>
<tr>
<td>4. Medium and long-term credit** (% of total)</td>
<td>-</td>
<td>14.75</td>
<td>23.96</td>
<td>24.63</td>
<td>23.10</td>
<td>n.a.</td>
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Source: as in Table 1.
Notes: *Nominal growth rates; **include real capital formation and working capital financing in all sectors.
ratio reached 30% by 1993 from the low level of 10% or less between 1970 and 1985. As a result, the credit-deposit ratio of commercial banks (line 3) decreased from 127% in 1970-74 to 44.46% in 1990-94.

However, Table 2 shows two positive developments. First, the share of medium and long-term lending in total bank credit has increased in the post-Islamic banking period. This was perhaps due to the fact that credit policy continued to encourage such type of credit while restricting the volume of other as well as total loans. Indeed, when much of bank lending capacity remained unused, the volume of medium and long term loans fell dramatically in real terms. Second, although total real bank lending was shrinking due to tight overall credit ceilings and selective credit controls, easy government borrowing from the central bank meant high private sector share in commercial banks’ credit. This share amounted to about 98% between 1990-95. It is nonetheless arguable that the policy of restraining bank credit is neither conducive to economic growth nor effective in lowering inflation. In fact, healthy increased lending to the private sector may in the long run lower inflation rate through increased investment and output.

There had been a considerable shift in the sectoral distribution of bank credit. Although since mid 1980s and up to date, credit policy has been designed to raise the share of priority sectors in total credit, it is only in the 1990s that this share increased significantly. Agricultural operations received the most remarkable rise in credit share, from less than 2% before 1990 to 36% in 1993. Several factors have contributed to this increase. The agrarian credit market has been influenced by macroeconomic strategies and policies which call for revitalization of agriculture and agro-industrial sectors to raise their contribution to national income. Increased demand for private credit initiated by these strategies was reinforced by the pull-out of the Central Bank from financing large public agricultural corporations. The notable horizontal expansion of banks, the initiation of consortium financing to agriculture by commercial banks, the widening of the activities of the Agricultural Bank of Sudan and the incorporation of the Farmers’ Bank were all influenced by the strategies that led to increased agricultural loans since
1991. Moreover, it is believed that Islamic financial instruments such as Bay' al-Salām allow banks to make rewarding profits from increased lending to farmers. The real periodic rate of return on such loans was found to be 56% in 1995.\textsuperscript{15} However, rural finance has focused almost exclusively on crop production.\textsuperscript{16}

Although it has the status of a priority sector, the manufacturing sector failed to attract any notable increase in credit since the substantial decline in its share from 30% in 1975-79 to 17% in 1985-89. The export sector has maintained a stable share in total credit, while imports and local trade borne the brunt of restrictive credit policies.

3. Macroeconomic Setting, Instability and Implications

The key macroeconomic indicators\textsuperscript{17} are set out in Table 4. Each of the five-year sub-periods of this table shows substantial current account deficit relative to GDP, particularly during 1990-1994. This deficit was notably small in the period 1984-89, because of austerity measures supported by an IMF stabilization program. The balance of payments position of Sudan is clearly critical, and as the country has always maintained low levels of foreign reserves (line 2), this position has frequently resulted in mounting internal imbalances, and rising prices. The rate of inflation\textsuperscript{18} has well exceeded 100% for much of the 1990s. Up to late 1970s, the inflation rate was generally moderate. Following frequent devaluations (see line 4), falling terms of trade, and changing commodity composition of domestic consumption,\textsuperscript{19} the rate of inflation rose to an average of 28% for the period 1980-84 and 42% for 1985-89. These factors added to unchecked government expenditure and borrowing from the domestic financial system. As a result, the inflation rate was raised to 116% in 1994.

The government finances in lines 7 and 8 depict worsening current budget deficit, let alone overall budget deficit. With the exception of the sub-period 1975-89, this deficit ranged between 1.34% and 6% of GDP, resulting in remarkably high rates of government borrowing from the banking system ranging between 11.3% and 18.2%
### Table 3: Distribution of Commercial Banks’ Credit by Economic Sector (%)

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<tbody>
<tr>
<td>Agricultural Crop Production</td>
<td>0.030</td>
<td>0.040</td>
<td>1.19</td>
<td>4.43</td>
<td>18.87</td>
<td>34.01</td>
<td>35.37</td>
<td>29.25</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>30.41</td>
<td>23.84</td>
<td>17.17</td>
<td>18.71</td>
<td>18.39</td>
<td>13.75</td>
<td>15.68</td>
<td>18.27</td>
</tr>
<tr>
<td>Exports&lt;sup&gt;a&lt;/sup&gt;</td>
<td>29.53</td>
<td>24.1</td>
<td>35.43</td>
<td>24.85</td>
<td>17.97</td>
<td>17.23</td>
<td>21.88</td>
<td>22.41</td>
</tr>
<tr>
<td>Imports</td>
<td>9.48</td>
<td>16.10</td>
<td>5.88</td>
<td>2.82</td>
<td>1.98</td>
<td>1.12</td>
<td>0.01</td>
<td>1.10</td>
</tr>
<tr>
<td>Local Trade, Professional and Other loans</td>
<td>15.47</td>
<td>11.74</td>
<td>15.57</td>
<td>23.53&lt;sup&gt;b&lt;/sup&gt;</td>
<td>19.43</td>
<td>11.57</td>
<td>6.03</td>
<td>5.62</td>
</tr>
<tr>
<td>Medium and Long-term Loans&lt;sup&gt;c&lt;/sup&gt;</td>
<td>14.75</td>
<td>23.96</td>
<td>24.63</td>
<td>25.67</td>
<td>23.36</td>
<td>22.35</td>
<td>20.20</td>
<td>23.62</td>
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| Total (av.)<sup>d</sup> | 296.64  | 1099.80 | 3530.65 | 7417.71 | 14001.61 | 33107.7 | 52726.1 | 10072.6 |


**Notes**: <sup>a</sup>Include agricultural exports; <sup>b</sup>include capital investment by banks and some other medium and long-term credit; <sup>c</sup>encompass capital investment and working capital financing in various sectors; <sup>d</sup>Ls million. Totals may not add up to 100 because of rounding.
### Table 4: Macroeconomic Indicators: 1970-1995

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<tr>
<td><strong>Balance of Payments:</strong></td>
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<tr>
<td>2. External reserves* (% GDP)</td>
<td>1.96</td>
<td>0.54</td>
<td>0.33</td>
<td>0.25</td>
<td>0.55</td>
<td>2.92</td>
</tr>
<tr>
<td>3. Current private transfers% (% GDP)</td>
<td>0.49</td>
<td>3.04</td>
<td>5.01</td>
<td>3.27</td>
<td>1.55</td>
<td>0.02</td>
</tr>
<tr>
<td>4. Exchange rate%</td>
<td>0.35</td>
<td>0.35</td>
<td>0.99</td>
<td>3.25</td>
<td>111.56</td>
<td>526.32</td>
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<tr>
<td><strong>Inflation:</strong></td>
<td></td>
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<tr>
<td>5. Rise in GDP deflator (% p.a.)</td>
<td>10.9</td>
<td>14.38</td>
<td>26.45</td>
<td>41.92</td>
<td>81.32</td>
<td>108.1</td>
</tr>
<tr>
<td>6. Rise in CPI (% p.a.)</td>
<td>7.8</td>
<td>18.62</td>
<td>28.07</td>
<td>44.37</td>
<td>101.75</td>
<td>116.75</td>
</tr>
<tr>
<td><strong>Public Finances:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Government current budget balance (% GDP)</td>
<td>-1.37</td>
<td>2.70</td>
<td>-1.96</td>
<td>-5.99</td>
<td>-3.94</td>
<td>-0.97</td>
</tr>
<tr>
<td>8. Public sector borrowing from the banking system (% GDP)</td>
<td>11.23</td>
<td>18.34</td>
<td>17.26</td>
<td>18.44</td>
<td>18.18</td>
<td>n.a.</td>
</tr>
<tr>
<td><strong>Monetary Indicators:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9. Broad money (M2) (% GDP)</td>
<td>20.43</td>
<td>25.08</td>
<td>33.56</td>
<td>34.26</td>
<td>25.44</td>
<td>22.47</td>
</tr>
<tr>
<td>10. Growth in broad money (M2) (% p.a.)</td>
<td>19.67</td>
<td>28.82</td>
<td>30.97</td>
<td>41.24</td>
<td>80.24</td>
<td>15.41</td>
</tr>
<tr>
<td>11. Growth in total domestic credit (% p.a.)</td>
<td>20.23</td>
<td>33.06</td>
<td>24.22</td>
<td>41.11</td>
<td>69.63</td>
<td>n.a.</td>
</tr>
<tr>
<td>12. Growth in credit to the public sector</td>
<td>16.71</td>
<td>40.37</td>
<td>31.14</td>
<td>51.00</td>
<td>75.78</td>
<td>-</td>
</tr>
<tr>
<td>13. Share of private sector in total domestic credit (%)</td>
<td>35.87</td>
<td>30.51</td>
<td>36.76</td>
<td>29.86</td>
<td>24.11</td>
<td>-</td>
</tr>
<tr>
<td><strong>Investment, Saving and Income:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>16. Real GDP growth rate (% p.a.)</td>
<td>5.32</td>
<td>6.87</td>
<td>2.56</td>
<td>0.58</td>
<td>5.85</td>
<td>-2.41</td>
</tr>
<tr>
<td>17. Fixed price per capita GDP (1987=100)</td>
<td>1167.5</td>
<td>1515.3</td>
<td>1423.4</td>
<td>1238.1</td>
<td>1257.1</td>
<td>1070.0</td>
</tr>
</tbody>
</table>

**Source**: All financial and balance of payments data is obtained from the *IMF International Financial Statistics* (Various issues), real data is extracted from the *World Tables* (1990 and 1996) and the *Economic Survey* (1991, 1994 and 1995), Ministry of Finance, Khartoum.

**Notes**: *excluding gold reserves; †as from 1979 these are identical to workers’ remittances; ‡period average Sudanese Pounds per USS; *calculated for 1990-91 only; Base year = 1987. Unless otherwise indicated, all figures represent period averages.
of GDP. This may be compared to the rate of similar government borrowing of less than 1.7% in Kenya over the period 1969-88.\textsuperscript{20} The government is apparently unable to curtail its current spending, although social and economic expenditure has fallen dramatically in recent years. The 1990s witnessed massive retrenchment of civil servants. Yet the unstable political and administrative structures, frequent establishment and change of states, and the civil war in the South have contributed to mounting public spending. Thus the notable improvements in the tax system, where tax revenue rose at the average annual rate of 23% in the 1990s, failed to reduce public deficits to sustainable levels.

Line 10 of Table 4 shows an increase in the nominal growth rate of M2 from the average of 19.67% in 1970-74 to 80.24% in 1990-94. This rate was quite similar to that of total domestic credit (line 11), which in turn, show an ever rising share of government borrowing. The rate of growth in government domestic borrowing (line 12) is even more closer to M2 growth rate. Meanwhile, although the private sector assumed an increasingly important role in the economy over the period considered, its share in total domestic credit dropped from 36% in 1970-74 to 24% in 1990-94. This drop was the consequence of repressive credit policy (see section 4).

Finally, Table 4 displays the national accounting indicators in lines 14-17. The Gross Domestic Investment (GDI) rate declined from 17% in 1975-79 to 13.34% in 1990-94. In addition to the effect of falling income and saving, this possibly reflects deteriorating investment environment and heightened uncertainty, especially during the 1990s period, due to unstable macroeconomic policy, high public deficits, high inflation rate, collapsing domestic currency market, and political instability. Subsequent low income and perhaps also low incentives led to record low Gross Domestic Saving (GDS) rates between 1985 and 1995. The GDS rate declined from 11.88% in 1970-74 to the average of 1.95% in 1990-91, and was even negative in 1985 and 1991 drought years.\textsuperscript{21}

The average real GDP growth rate conceals considerable year-to-year fluctuations. This rate rose from -1.5% in 1990 to 11.3%, 7.5%
and 5.4% in 1992, 1993 and 1994 respectively. The only plausible explanation of these changes in GDP growth is in terms of rainfall as the economy is dominated by agriculture and agricultural output is largely rain-driven. However, the ups and downs in GDP growth rate have failed to halt steady decline in real per capita income (line 17) since the 1975-79 period. In constant 1987 US dollars per capita GDP fell from the annual average of 474 in 1970-74 to 354 in 1995.

To sum up, over the last decade the economy of Sudan was characterized by severe macroeconomic instability as indicated by high and accelerating internal and external imbalances, rapid exchange rate depreciation, phenomenal rates of growth of money supply and hyper-inflation. Macroeconomic instability has influenced lenders behavior in the direction of short-term loans, while at the same time reduced the volume of resources mobilized by banks through lower income and negative real rates of return. This can be a major cause of observed trend of financial disintermediation. The performance of the economy suggests a limited role for the financial system unless it is equipped to play, in Patrick’s (1966) terms, a strong supply-leading rather than a demand-following role. Even in such a case, however, the banking system was subjected to a possibly more binding constraint in the form of restrictive monetary and credit policies.

4. Monetary and Credit Policy

Monetary and financial policy has, since the early 1980s, been increasingly used in developing countries to meet the challenges of both short-term stabilization and long-term adjustment. In Sudan, however, monetary policy was consistently used to simultaneously attain both stabilization and growth objectives. Yet, these objectives may not be complementary. For instance, while stabilization requires containment of bank credit, growth requires increased mobilization and efficient utilization of financial savings.

The emphasis and tightness of monetary and credit policies have changed over time, from loosely stated objectives and lax control
in the 1970s to comprehensive regulation during much of the 1980s and 1990s. The array of usually available instruments consisted of nominal interest rates and later PLS ratios, qualitative and quantitative credit control, cash reserve ratios of commercial banks, and cash margins on certain loans and bills. Because of the underdeveloped nature of the money market the interest rate was not considered as an important instrument of monetary policy. Changes in the reserve ratio were quite infrequent. Consequently, credit rationing and issue of directives were the main instruments used by the bank of Sudan to implement its monetary policy. In fact, credit ceilings and selective credit control techniques were the most important means of monetary management in Sudan; when bank lending and lavish private spending were seen by government in mid-1991 as the main causes of accelerating inflation and deteriorating standards of living, drastic measures were introduced to facilitate direct control of the financial market in particular. This policy, however, shook public confidence in the financial system culminating in a run on banks, which forced the government to partially reverse some of its policy measures. By early 1992, several price controls, including exchange rate controls were eased, and the government embarked on a home-grown stabilization program. Nevertheless, economic instability and uncertainty remained to be high, while monetary and credit policy continued to be repressive.

Interest rate policy had, prior to 1984 relied on fixed nominal rates of interest, which were falling in real terms. Up to 1990, deposit rates varied between 6% and 24% while lending rates ranged between 10% and 27%. The inflation rate during this period ranged between 1% and 67%, resulting in negative real rates for most of the period. In 1990, interest rates were replaced with profit and loss sharing ratios that specify the manner in which profit realized from bank-financed activities are to be divided between banks and borrowers on the one hand and banks and depositors on the other. The banks’ share in borrowers’ profits was fixed at 48%, of which 44% to be distributed to depositors. The exact rate of return to each party cannot be determined ex-ante. There is no available information on the exact returns on
deposits during 1990-94, but it has been argued that bank lending was focused on short term loans with real rates of return that are higher than those prevailed prior to 1990.  

Credit policy has since the early 1980s been progressively restrictive concerning the size and sectoral allocation of credit. Quantitative credit control consisted of direct ceilings on bank lending to the private sector, with the hope of curtailing money growth and inflation. Meanwhile, selective credit control was implemented to enhance economic growth by means of channelling credit to perceivably more productive sectors and related activities. The priority sectors encompassed agriculture, manufacturing, export, and transport, for which medium and long-term loans were particularly encouraged to finance working as well as fixed capital.

In the late 1970s, and as part of a stabilization program inspired by the International Monetary Fund, commercial banks were directed to extend at least 10% of their total advances in the form of development loans. As from 1986 onward, this policy was further tightened to limit commercial banks’ advances under the ceiling as follows: 30% to the export sector; 25% to working capital in industry; 35% in the form of development loans; and the maximum of 10% to local trade and other types of lending. To reduce the risk inherent in agricultural credit in particular, consortium financing was encouraged. In 1990, monetary policy stipulated 80% of total bank ceiling for priority sectors, with 40% of the ceiling for agriculture alone. Priority sectors share was further raised to 90% and agriculture to 50% in 1993. This policy continued although overall credit ceilings were relaxed in October 1994.

Reserve requirements policy had also been restrictive. Thus, while the reserve requirement ratio remained below 10% throughout the 1970s, it was raised to 12.5% in 1985, 18% in 1988, 20% in 1990 and 30% in 1993, but reduced to 25% in 1994. With effective credit ceiling the reserve ratio is in practice redundant. Similarly, other instruments of indirect monetary control such as open market operations and the discount rate, which work through the reserve money side are also virtually redundant. For the former policy to work, there needs to
exist a relatively well organized financial and securities market, and the bank rate was hardly used since commercial banks often suffered from excess liquidity rather than the reverse. Under these circumstances, monetary authorities have frequently referred to additional methods of direct monetary control including prohibition of inter-bank lending.

The discussion in the previous section indicated that government borrowing was the major source of macroeconomic instability, whereas the analysis in this section blames restrictive monetary policy for significant contraction in development and other financing in the private sector in the 1990s. The effect of these policies on financial intermediation, private investment and aggregate demand, may in the long run defeat both the stabilization and growth objectives. This effect is believed to be exacerbated by institutional rigidities that do not permit enough flexibility for banks to introduce innovative instruments especially in relation to rural finance.

5. Conclusions and Policy Recommendations

The analyses in this paper indicated a negative trend of financial development and intermediation since the full adoption of Islamic banking principles in 1990. There has been a decline, in either real or relative magnitudes or both, in all key indicators of banking performance. Poor banking performance was associated with an unprecedented decline in real economic activity, a highly unstable macroeconomic environment, and repressive monetary and credit policy. However, these policies have only circumcised banking and finance within the private sector, while massive inflationary finance of public deficits seems to be a major source of economic instability and uncertainty.

Of paramount importance to the success of Islamic banking in particular and achievement of sustainable growth in general is macroeconomic stabilization and structural adjustment. A moderate and stable inflation rate and reduction of public deficits are the major prerequisites. Exchange rate and trade liberalization should be deepened
in order to increase trade, and production efficiency in various sectors. This study calls for the following main policy measures. First, curtailment of the high levels of inflation thwarting the efforts of banks to mobilize saving and engage in medium and long term lending. Second, the dismantling of direct credit controls. (To counter possible adverse consequences of this policy, banking supervision ought to be strengthened.) Third, increased mobilization of savings especially in rural areas through horizontal expansion of banking services. Fourth, market-based policies and measures has to be designed to encourage lending to sectors other than agriculture. Finally, encouragement of innovative lending arrangements such as group lending in rural areas which are part of the traditions of rural communities. However, as many observers suggest “national economic and social reforms will not induce the needed positive impacts without peace and political stability.”

Endnotes

4. Since the paper focuses on the impact of macroeconomic instability and repressive monetary policy on the performance of Islamic banking institutions and as argued hereunder the use of econometric techniques such as the Granger test is not theoretically warranted. It is also empirically not meaningful because of the short experience of Islamic banking in Sudan.
7. For a detailed discussion of the political and economic factors behind the appearance of Interest-free banking in Sudan see Shaeldin and Brown (1988).
8. In addition to these there are 4 specialized banks and a post office savings deposit bank.
9. These deposits are known as Qard Hasan deposits in Iran and as Trust Deposits in Jordan.
12. ibid.
14. Resources include total deposits, paid-up capital, reserves, and margins on letters of credit.
17. The real sector data shows some unexplained changes in some years, but the financial data is generally more reliable, particularly when long-term trends are covered.
18. It is often argued that official records underestimate the rate of inflation. If we take exchange rate depreciation as an example we note that the domestic price of the US$ increased by an annual average of 500% between 1990 and 1995.
22. ibid., 33.
24. These measures included restrictions on withdrawals even from private demand deposits.
27. As Ulhaque and Mirakhor (1987) demonstrate this market might be a necessary condition for Islamic banks to avoid liquidity problems. The Government of Sudan has passed the Act for a securities market in 1994, and its operations started in 1995. It remains to be seen if it can get off the ground.
29. ibid., 6.

References

Attia, G. “Financial Instruments Used by Islamic Banks.” In Islamic Banking and Finance, edited by Butterworths Editorial Staff.


