International Monetary Fund

Sudan and the IMF

Sudan: Staff-Monitored Program: Letter of Intent

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October 22, 2008

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SUDAN: LETTER OF INTENT

October 22, 2008

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
700 19th Street, N.W.
Washington, D.C. 20431

Dear Mr. Strauss-Kahn:

1. In June 2007, we negotiated an 18-month Staff-Monitored Program (SMP) with IMF staff for the period July 2007 through December 2008. Notwithstanding difficult circumstances, much has been accomplished during this period. Pressing expenditure needs engendered under our peace agreements along with volatility in oil revenues complicated macroeconomic management and contributed to the accumulation of domestic arrears. Still, we have taken decisive actions to reduce these arrears and stop new accumulation, including by implementing important expenditure control measures and adopting the GFSM 2001 framework for the 2008 budget. Bold steps were also made with respect to reining in tax exemptions, widening the tax base, and improving tax administration. As a result, we have been able to preserve macroeconomic stability and maintain strong economic growth.

2. Performance under the SMP has improved. We are pleased to inform you that all but one of the quantitative targets set for June 2008 were observed. In particular, the ceilings on net domestic assets of the Bank of Sudan and on domestic financing of the central government, as well as the floors on net international reserves and on the reduction in the stock of domestic arrears were met by comfortable margins. We have also repaid the Fund US$18.3 million in the first half of the year, short of the US$25 million target, although we have subsequently accelerated our payments, and will meet the end-2008 target of US$50 million.

3. We have met two of the four structural measures set for June 2008. In particular, we have (i) required remaining problem banks to submit a time-bound action plan to accumulate sufficient provisioning to reduce net nonperforming loans; and (ii) shared with IMF staff a risk-based audit strategy providing for comprehensive joint income tax-VAT post audits of self-assessed corporate tax returns. We will, before end-year, submit to parliament a modified Customs Law that provides valuation guidelines for questionable assessments, which has already been approved by the Council of Ministers and is currently being vetted by the Ministry of Justice. We will also extend (before end-year) Tax Identification Numbers (TIN), already in place by the tax offices, to the customs agency.

4. Our most immediate challenge is to avoid high inflation becoming entrenched, putting at risk the gains from our earlier policies, and to protect the most vulnerable from high food prices. Over the past nine months or so, Sudan, like many other countries, has been adversely affected by the sharp rise in international food prices. This has resulted in an acceleration of inflation, to 13.7 percent by end-September 2008—and has particularly impacted the poor. The increase in inflation has so far been largely due to external price increases (mainly wheat) as the rate of inflation excluding food has been modest. The new CPI, which was released in September and which covers rural areas for the first time, suggests that high imported food price has affected rural areas more than urban areas. We are determined to contain the second round effects and to avoid price expectations being adjusted upward. We, therefore, are closely watching the current imported price inflation developments and will take necessary steps to minimize its negative welfare effects. We have already halved the effective import duty rate on wheat in February 2008. We now expect end-of period inflation to be 12 percent in 2008, assuming that international food prices fall as expected in the last quarter of 2008.

5. Notwithstanding a surge in food and fuel imports and weak capital inflows, strong oil export performance, resulting from a sharp increase in international oil prices, has supported the balance of payments during 2008. The increase in export receipts is expected to contribute to nearly halving of the current account deficit to 6 percent of GDP, down from 12 percent in 2007, assuming that world oil prices do not substantially decline below current levels. At end-2008, gross international reserves are estimated to rise to nearly 2 months of imports.

6. We have prepared a comprehensive plan to boost non-oil production by utilizing untapped resources of the country. The main focus is on development of the agriculture sector with the help of strategic foreign partners. The plan includes easing structural rigidities, removing distortions, liberalizing investment policies and the labor market, reducing cost of doing business, reforming the legal system, providing necessary infrastructure, and improving the business environment.

7. To achieve macroeconomic stability, the Central Bank of Sudan (CBOS) is targeting a broad money growth rate of 21 percent and reserve money growth rate of 20 percent in 2008—consistent with our GDP growth and inflation objectives, and an increase in money demand reflecting the reintegration of the South. We will closely monitor monetary developments to ensure that broad money growth remains in line with the revised inflation target. We note, however, that the impact of monetary policy is limited given that most of the inflation is imported. The exchange rate will be allowed to move in line with fundamentals and foreign exchange interventions will focus primarily on smoothing lumpy payments and serving government needs. However, in light of the need to rebuild foreign exchange reserves to prudent levels, the central bank will avoid resisting sustained pressures on the pound.

8. Fiscal policy will be supportive of the monetary stance. It will strike a balance between reducing inflation on the one hand, and protecting economic growth in the face of increased downside risks related to oil revenues and mitigating the effects of higher price levels on the poor on the other hand.

9. Fiscal performance in 2008 has been good, aided by higher oil revenues in the first half of the year and the limiting of expenditure to budgetary ceilings. The cash balance, savings in the oil revenue stabilization account (OSA), and arrears clearance are projected to be in line with or higher than programmed. Commitment controls have considerably strengthened; there has been no new arrears accumulation and, as noted above, a substantial reduction in the existing stock of arrears. Higher oil revenues, however, have necessitated offsetting increases in expenditures related to oil transfers and the fuel subsidy. While we are aware of the slow execution rate for national and subnational capital expenditures, these should pick-up in the remainder of the year, facilitated by the increased availability of domestic and foreign resources.

10. The adoption at the beginning of this year of the GFSM 2001 system for budgetary reporting has improved our ability to monitor domestic arrears and track domestic financing. Domestic debt reporting is also expected to be strengthened considerably by the recent establishment of an operational domestic debt unit. Starting December 2008, this unit will prepare detailed monthly domestic debt reports. These reports will serve as a vital input for monthly budget execution reporting. We also expect to resolve, by year-end, software problems experienced earlier with implementation of the zero balance feature of the Treasury Single Account (TSA).

11. On tax administration, the introduction of self-assessment marks the beginning of a new era of mutual trust and cooperation between taxpayers and the government. In the remaining months of 2008, we intend to consolidate this relationship by (i) operationalizing the recently approved functions-based headquarters structure of the taxation chamber; (ii) developing an IT strategy that can serve clearly defined short- and long-run objectives of a modern tax chamber; (iii) submitting legislation to parliament to modernize customs through the adoption of WTO guidelines on suspect valuations, simplified and effective appeals procedures, and measures aimed at reducing clearing times for exporters and importers.

12. We recognize, however, that the above measures will not be enough to raise the revenue yield, unless supplemented by serious efforts to improve tax compliance. To this end, we intend to commence, before year-end, risk-based joint income tax/VAT post-audits of at least 20 self-assessed corporate tax returns submitted earlier this year; a plan for these audits has already been shared with staff.

13. The 2009 budget is still under preparation and remains subject to the evolving outlook on world oil prices. However, we will be guided by the following broad parameters:

(i) an overall deficit of 3 - 3½ percent of GDP;[1] (ii) an improvement in the non-oil cash primary balance and tax revenues; (iii) further reduction in the remaining stock of domestic arrears inherited from 2007; (iv) a prudent level of OSA accumulation to guard against the risk of falling oil prices or production; (v) an increase in capital expenditures on priority social and infrastructure projects; and (vi) limiting the size of the fuel subsidy and/or looking into the possibility of sharing with subnational governments the fuel subsidy burden, presently borne mainly by the central government.

14. Building on recent measures to raise revenues, we are considering a number of possible tax policy reforms, including: reducing VAT exemptions with a view to capping the share of VAT exempt-imports (currently 65 percent) to no more than 40 percent of total imports; and applying a minimum import tariff of 3 percent to about half of all customs-duty exempt imports. The timing, sequencing, nature and extent of these measures are, of course, still under discussion.

15. We are committed to wide-ranging Public Financial Management (PFM) reforms for the general government, covering the GNU and the Government of Southern Sudan, various government-owned funds and universities, as well as Northern state treasuries to improve the quality of budget preparation and execution. We request the IMF to provide technical assistance in this area in 2009, including a visit to the South.

16. The introduction of the GFSM 2001 system has highlighted the need to strengthen our statistical systems. In this context, we intend to set up a GFS unit in the Ministry of Finance and National Economy (MOFNE) that will both liaise on statistical issues with the Central Bureau of Statistics (CBS) and the CBOS, as well as pioneer the extension of GFSM 2001 to the Northern states with a view to facilitating functional reporting of state-level expenditure. We are also considering changing the reporting basis of oil revenues to market prices rather than budget prices, in line with GFSM 2001 conventions.

17. Much progress has been made in strengthening the financial sector. We have required problem banks to submit a time-bound action plan to accumulate sufficient provisions to reduce net nonperforming loans and to raise their capital adequacy to meet existing prudential standards. These reforms have already translated to an improvement in financial sector indicators. The NPLs have declined to 18 percent at end-June 2008 from 22 percent at end-2007 while provisioning has increased to 21 percent from 15 percent during the same period. Importantly, the independent audit of Omdurman Bank has now been completed. We will now prepare, by end-March 2009, a restructuring/privatizing plan for the bank based on the results of the audit. We also intend to strengthen commercial banks' compliance with the

[1] This is based on oil revenues and fuel subsidy evaluated at budget prices, and expenditures excluding the clearance of domestic arrears.

Central Bank's supervisory regulations, including by expediting enforcement of corrective procedures when banks fall short of meeting prudential requirement.

18. We remain committed to limiting the contracting or guaranteeing of new nonconcessional borrowing to US$700 million in 2008. To demonstrate our continued cooperation, we will make payments to the IMF of at least US$50 million in 2008.

19. We would hasten to point out, however, that these payments—while demonstrating our good intentions—are not a solution to Sudan's arrears to the IMF. We ask the international community in this context to recognize our accomplishments, act in accordance with the principle of equality of treatment, and work toward a rapid resolution of Sudan's external debt and arrears problem. We hope to see progress in this area before end-2008.

20. We believe that with these policies we will be able to achieve our objectives, but we are ready to take any additional measures. In this regard, we will maintain a close dialogue with IMF staff and look forward to our continued close cooperation with the IMF, including by negotiating a new SMP in 2009. We agree to publication on the IMF's website of the staff report, the Public Information Notice, and this letter.

Sincerely yours,

/s/

Dr. Awad Ahmed Al-Jaz
Minister of Finance and National Economy
Ministry of Finance and National Economy

/s/

Dr. Sabir Mohamed Hassan
Governor
Central Bank of Sudan