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Southern Sudan: Monetary and Financial Policies and the Case for a Separate Currency

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Introduction

Money is anything a society accepts as a means of payment. It is accepted universally in the community as a medium of exchange, a store of value, and a unit of account to measure the value of transactions. Money is important to the smooth functioning of an economy. The development of money facilitates trade, which in turn facilitates specialisation and the division of labour; consequently, promoting economic development. The amount of money in the economy has influence on economic growth, employment, inflation, exchange rate, and balance of payments. Hence, monetary policy should be judiciously managed by an independent central bank. The issuance of fiat money has a substantial revenue component for the national treasury. This consists of seigniorage and inflation tax. While caution should be exercised on the amount of inflation tax, the seigniorage revenue is a net benefit of issuing a national currency. Channeled to productive sectors such as the rural economy, seigniorage can substantially contribute to the growth of a predominantly subsistence economy.

Monetary policy is the regulation of money supply and the amount of credit by the central bank so as to influence the level of economic activity. Its effectiveness varies from economy to economy, depending on the existence of a developed financial infrastructure. The financial system should be well intergraded and flexible to changes initiated in any of the economic sectors. Currently, there is hardly any financial infrastructure in Southern Sudan.

The building of a financial infrastructure should take precedence over the pursuance of a narrow monetary policy. Monetary policy should be conducted in consistence with the state of development of Southern Sudan.

If, after separation, the two Sudans will have a common currency, they will effectively be in a monetary union. This will have consequences for their fiscal policies as no one country will be able to use monetary policy to regulate its own economy given the fixed exchange rate of the common currency vis-a-vis the two countries. The use of a common currency by a number of countries in a region is based on the theory of optimal currency area.[1] But is Sudan an optimal currency area?

The Revenue Component of a Currency

Government derives significant amount of revenue from the use of fiat money. The cost of printing the currency is very insignificant compared to its market value. This difference is referred to as seigniorage. Seigniorage is the most important fiscal factor in the desire to issue a separate national currency (Buiter 2007: 1-4, Fry 1995: 393-404). The seigniorage revenue is equal to the amount of goods and services that the government obtains by printing money in a given period. It is equal to the differences between the value of the printed amount of money and the cost of printing it. For example, if it costs $0.06 to print a $1.00 or a $100.00 note, the seigniorage value of each note is $0.94 or $99.94 respectively. A country at its early stage of development, with a very narrow tax base needs this source of revenue. A government that cannot control itself in issuing currency might want the discipline of using foreign money. But in such a case, the seigniorage will go to the foreign country issuing the currency.

In many countries, the central bank prints the money and credits the government account less the central bank's cost of operations. Where open market operations are effective, as in many developed countries, the central bank buys secondary securities with the new printed money. The interest on the securities the Treasury would have paid to the public is now owed to the central bank and is written off (retired) from the central government's domestic debt. The interest the central bank is paid for its loans to the financial intermediaries is also another source of seigniorage. The more cash the central bank sells to the financial intermediaries, the larger the amount of seigniorage.

If the currency is used in other countries, it represents a large gift of seignioprage to the issuing country. This is how countries with hard currencies that are used internationally as foreign exchange acquire real foreign resources by just printing more of their currencies. The foreign banknote is retained because it is valued as a store of value as a result of mistrust of the local currency.

A larger economy has more capacity to generate greater amount of seigniorage. However, if the larger economy is formed of different political entities, the cooperating groups must have a high degree of trust among themselves. They should trust that any agreement on issues such as agreed formulae of seignorage sharing is faithfully implemented. The experience between Northern and Southern Sudan, as evidenced in their revenue sharing in accordance with the 2005 Comprehensive Peace Agreement (CPA) is not encouraging (Global Witness). Given the many urgent funding needs of both governments of Northern and Southern Sudan, divergences in monetary and fiscal policies will be inevitable. Hence, let each country issue its own currency, at least in the early years of disengagement.

Furthermore, a common currency automatically means a common market for the two countries. But given the fact that all the manufacturing industry is currently concentrated in central Sudan, Northern Sudan will be the beneficiary of the common market. The backwash (negative) effects of the established industry in Northern Sudan will kill any effort towards industrialisation in Southern Sudan. Usually, infant industries are far less efficient than already established ones. Unless Southern Sudan expects a radical change in the mindset of the Khartoum policy-makers, a common market is not the immediate arrangement Southern Sudan should enter into with Northern Sudan.

In addition to seigniorage, many governments obtain inflation tax as another form of revenue by issuing more printed money than the amount that can be issued at a zero rate of inflation (Fry 1995:206-255, Gills et al. 1987: 323-340). The inflation tax reduces the purchasing power of the currency for the general public. However, the inflation tax cannot be generated indefinitely. The inflation tax will rise with inflation up to a certain point, beyond which it actually can decrease. This occurs when inflation rises so high that the societal demand for money falls. This point is reached when people place vast amounts of their wealth into hard currencies, or when cash incomes are rapidly converted into real goods, hoarding critically needed goods for self-consumption, or for bartering and avoiding cash transactions altogether.

Falling real balances require larger infusion of cash, and higher inflation levels for the government to finance the same levels of fiscal deficits. This could precipitate an upward spiral as the inflation tax rises even as the tax base falls. Hyperinflation can be the result. This could lead to the collapse of the currency and the whole financial system. Beyond a certain point, as real balances fall, the real trade-off between inflation and inflation revenue becomes increasingly unfavourable to the government and the country.

Optimal Currency Areas

Mundell developed the theory of optimal currency area in the 1960s (Mundell). A number of countries that use a common currency experience both advantages and disadvantages. The area that maximizes the net benefits of using a single currency is referred to as an optimal currency area. The potential benefits of using a common currency include reduced transaction costs, and enhanced policy credibility. Uncertainty about future changes in exchange rates may discourage international trade and financial activity between the member countries if they were to use separate currencies. A common currency eliminates this uncertainty and allows firms to specialise according to comparative advantage and to plan imports and exports without worrying about losses due to future exchange rate movements and without having to hedge in forward markets. A common currency eliminates the fees paid to banks or to currency brokers that arrange the conversion of currencies. It simplifies accounting and book-keeping, and it enables consumers and investors to compare prices across international boundaries more accurately. A single currency eliminates price fluctuations that are caused by changes in the exchange rate (Gerber: 237-242). A common currency also can provide an advantage to policy makers by allowing them credibility commitment to a future course for monetary policy. However, an important cost of a common currency is that countries lose the ability to pursue independent monetary policies. A common currency also eliminates exchange rate devaluations or revaluations as a policy instrument in the currency area.

The criteria for an optimal currency area include synchronised business cycle, complete factor mobility, regional development programmes for lagging areas, and a desire to achieve a higher level of economic and political integration. A region is likely to gain from a common currency if (i) a large share of members' trade occurs with other members, (ii) the region is subject primarily to common shocks that affect the entire area similarly and not to shocks that affect sub-regions differently, (iii) labour is mobile within the region, and (iv) a tax-transfer system exists to transfer resources from sub-regions performing strongly to those performing poorly.

The higher the share of intra-group trade the greater the transaction-cost saving of a single currency. If different shocks buffet sub-regions, policy-makers in those sub-regions may need to follow different monetary policies or to allow their exchange rate to move to offset the shocks' short-run effects. When some sub-regions of a currency area grow quickly and others grow much more slowly, movements of labour between sub-regions represent another possible adjustment mechanism. If cultural or institutional factors restrict such labour flows, then differential monetary policies and exchange rate realignment may be needed, ruling out a common currency. An alternative means of dealing with differential regional growth involves fiscal transfers from growing regions to stagnant ones (Yarbrough 2006:695-697).

Even as one country, Sudan fell short of a single currency area. The border states of Northern and Southern Sudan may have approximated an optimal currency area. As one country, labour mobility was relatively free, although at times migrants from the periphery were deported to their home regions from the cities of central Sudan. There were no regional development programmes for poor regions when Sudan was still one country. Infrastructural links between the various regions are weak or absent. While underdeveloped countries have usually experienced similar economic conditions, these experiences can be altered in the long-run depending on the long-term development strategies of a country. An opportunity was lost for creating an integrated Sudan economy that could have led to strong interdependencies and thus creating, as closely as possible, an optimal currency area.

Monetary and Financial Policies

For developed industrial economies, the terms financial and monetary policies are synonymous as the financial sector is well developed and integrated into virtually all sectors of the economy. However, for underdeveloped counties, the two concepts mean quite different things. Financial policy embraces all measures intended to affect the growth, utilization, efficiency, and diversification of the financial system. It also includes measures intended to encourage the growth of savings in the form of financial assets, to develop money and capital markets, and to allocate credit between different economic sectors (Fry 1995:299-313; Gills et al. 1987:323-362).

On the other hand, monetary policy means changes in the growth of money supply and credit aimed at reducing instability induced by cyclical fluctuations arising from either internal or external markets. The instruments of monetary policy include open market operations, changes in legal-reserve requirements of commercial banks, changes in central bank (re)discount rates to commercial banks, and moral suasion. Hence, for an underdeveloped economy, the term financial policy has a broader meaning. Monetary policy is only a part of financial policy.

A country's financial system consists of a variety of interconnected financial institutions, both formal and informal. In most countries, a central bank lies at the core of the formal financial system. The central bank is responsible for the control of the money supply and the general supervision of the formal financial activities. Virtually in all countries, and particularly in underdeveloped countries, the commercial banking system is the most visible and vital component of the formal financial system, as acceptor of deposits and grantor of shorter-term credit. Other elements of the formal financial system include savings banks, insurance companies, pension funds, development banks, and nascent securities markets. Coexisting with the formal sector are the informal and largely unregulated systems of finance, including local moneylenders, trade credit, family lending, and cooperative credit (Fry 1995:344-352; Todaro and Smith 2006:741-759).

In many underdeveloped countries, substantial portion of economic activity is conducted through barter. The monetisation ratio is relatively low in many underdeveloped economies. The effective use of monetary policy instruments for combating cyclical fluctuation is difficult enough in monetised economies. In largely subsistence economies it would hardly work. While the use of monetary policy in developed countries is aimed at influencing the utilisation of existing capacities through changing aggregate demand, the main problem of underdeveloped economies is the creation of productive capacities through long-term investment. Hence, the traditional functions and tools of monetary policy applied in developed countries have to be considerably adjusted to be consistent with the development issues of underdeveloped economies.

The financial system is a vessel for mobilising and allocating funds, and gathering savings from numerous savers and channelling them to investors, a process called financial intermediation. The system provides a means of transferring and distributing risk across the economy. Finally, a well developed financial system allows for an effective monetary policy to be pursued by providing a set of policy instruments for stabilisation of economic activity.

Thus, in an underdeveloped economy such as the one of Southern Sudan, the building of a sound financial infrastructure should be one of the major focuses of the central bank. The financial system consists of financial markets and financial institutions. Financial markets are the markets where surplus spending units (SSUs) lend their funds directly to the deficit spending units (DSUs). Examples of these are markets for bonds and stocks (Stock Exchanges). Financial institutions provide financial services to SSUs and DSUs. The most important financial institutions are the financial intermediaries such as banks, credit unions, microfinance institutions, etc. They serve as go-between the SSUs and the DSUs (Cecchetti 2008:39-59, 172-192,247-268).

The process of financial intermediation involves the gathering of savings from multitudinous savers and channelling them to a smaller but still sizable number of investors. At early stages of economic development a preponderant share of intermediation activities tends to be concentrated in one type of institution: *commercial banks*. As development proceeds, new forms of financial intermediaries begin to appear and gradually assume a growing share of intermediation function. These include development banks, insurance companies, and ultimately, securities markets (Fry 1995:393-419; Gills et al. 1987:323-362). Plentiful intermediaries, however, do not always guarantee successful intermediation.

The effects of monetary policy on economic growth, employment and income are transmitted to the economy through an integrated financial system. As the money supply changes, the key interest rate changes leading to general changes in interest rates and spending levels and patterns in the whole economy. Without an integrated financial system, the effects of monetary policy will be localised as there is no flexibility in the system. Consequently, the economy may become prone to inflation. Idle funds may not be channelled to productive undertakings as SSUs may not be aware of such opportunities or they may not be willing to risk their surpluses. Financial markets and intermediaries' pool funds, take risks, and channel these funds to productive ventures, large and small.

Monetary Policy and Fiscal Policy

Responsible fiscal policy is a precondition for successful monetary policy in a monetary union. For a common central bank to do its job effectively, all member countries' governments must behave responsibly and not play of games. However, central banks remain independent at the pleasure of politicians. Fiscal policy is the responsibility of elected officials, and is not controlled by the central bank. Instead the central bank, in most underdeveloped countries, is under the politicians through the ministry of finance and the presidency. When conflict arises between them, it is usually the politicians who win, thus sacrificing the basic objectives of the central bank.

Fiscal policy-makers are responsible for providing national defense, education, health, building and maintaining transportation, etc. They need resources to pay for these services. Thus, funding needs create a natural conflict between monetary and fiscal policy-makers. Central bankers, in their effort to stabilise prices and provide the foundation for high sustainable growth, take a long-term view, imposing limits on how fast the quantity of money and credit can grow. On the other hand, fiscal policy-makers tend to ignore the long-term inflationary effects of their actions. Their time horizon often extends only until the next election.

Fiscal management is especially important in the context of a monetary union because once a common currency is adopted fiscal policy will be the main macroeconomic policy available to individual countries after giving up independent national monetary policy. Excessive spending in one country may cause inflationary pressure on the common currency that would negatively impact the other country as well. Thresholds on government deficits and debt have been instated in all the existing monetary unions to address the negative externality and moral hazard issues.[2] However, such thresholds are challenging to implement in practice. Whether fiscal commitments are implemented through self-discipline, surveillance and persuasion, or centralised enforcement, the examples of monetary unions around the world are replete with unsuccessful efforts to prevent excessive deficits and debt crises (Anand et al. 2011:6).

In underdeveloped economies, some governments simply order the central bank to print more money, even if the level of money supply would not be consistent with the health of the economy. This would result in inflation or even hyperinflation. This led to the idea of independent central banks. The independence of central banks is to ensure that such a key national policy-making body is run on sound professional economic judgment of the health of the national economy. The independence of the central bank would leave fiscal policy-makers two options of financing government spending: taxation and borrowing. Because politicians fear angering the electorate by raising taxes, they tend to rely on borrowing. But in most underdeveloped countries, bond markets are either non-existent or at their infancy with hardly any secondary component. Hence, the government will sell new bonds directly to the central bank, thus expanding the money supply, even up to inflationary levels.

In the European monetary union, before a country can join the common currency area and adopt the euro, it must meet a number of conditions. Two of the most important are that the country's annual deficit cannot exceed

3 per cent of its gross domestic product (GDP) and the government debt cannot exceed 60 per cent of GDP (Yarbrough 2006:691). Once the country gains membership in the monetary union, failure to maintain these standards can lead to pressure from other member countries and possibly even to substantial penalties. Yet in such a monetary union of developed economies, with elaborate and well integrated financial systems, the convergence criteria are still very difficult to adhere to.

However, fiscal limits must be realistic and in line with recent and current deficit levels. Furthermore, underdeveloped countries depend on foreign borrowing for their investments and development. Hence, the fiscal deficit criteria have to include grants to best account for the realities of domestic revenue generation challenges and reliance on donor support in such countries.

Aid flows indicate that budget assistance can have significant and volatile effects on domestic liquidity. Both Northern and Southern Sudan receive foreign aid flows, including budget support, limiting discretion in spending of budget aid for them can help ensure that problems managing aid flows do not have negative economic consequences for either country. How will both countries address these issues? Should an automatic tax be applied to a country that runs excessive deficits, surpassing agreed upon-deficit levels? How will they meet such penalties if they cannot meet their budgetary expenditures? Will oil revenues last and be shared to take care of each other's budgetary requirements?

Sudan's Budgetary Performance

Until 1958, Sudan financed most of its operations with domestically generated revenue. However, from the late 1950s to the beginning of the twenty-first century the Sudan Government increasingly depended on foreign finance and bank credit for most of its operations. The country accumulated a lot of unspent balances during the Second World War. Britain granted Sudan L S 2.0 million (L S – Sudanese Pound) at the end of the war. From 1947 to 1951, Sudan experienced an unprecedented boom, brought about by a rise in the value of cotton exports. The already high cotton prices rose sharply in 1951/52 as a result of the war in Korea. However, from 1958, the country began to experience financial crisis. Cotton exports began to experience problems in the midand late 1950s. Official foreign capital inflow began to play an important role in financing Sudanese development. For example, an American aid programme to Sudan was started in 1958 with grants of L S 1.1 million. This amount was increased to L S 3.1 million and L S 4.1 million in

1959 and 1960 respectively. As a result of the construction of the Aswan High Dam, Sudan received compensation from Egypt for the flooding of Wadi Halfa and the subsequent resettlement of its inhabitants in Khasm el Girba (Yongo-Bure 2002).

Available figures for 1965/66-1969/70 indicate that external finance was L S 72.2 million, public sector savings financed L S 16.8 million, and deficit finance constituted L S 48.7 million.The dependence of Sudanese development, and even current operations, on foreign resources intensified from the 1970s until the late 1990s when Sudan became an oil exporter. The available data on the degree of Sudanese financing on foreign resources and deficit financing is summarized in Table 9.1.

From the early 1970s, it became increasingly difficult for the government to provide adequate funds for the public sector. Foreign aid and borrowing from the banking sector, largely from the Bank of Sudan, became the main ways of meeting public sector operations. Foreign commodity aid became the main non-inflationary means of generating local currency for public sector operations. Commodity aid was sold in the local market to generate local funds for the government. Even public corporations that were supposed to remit profits to the public treasury came to rely on credit from the Bank of Sudan.

With an external debt of approximately $40 billion, foreign aid and borrowing will be crucial in Sudan's fiscal policy and consequently on monetary and exchange rate policies. How the two Sudans will resolve the issue of debt repayment will have important bearing on any agreement they may make on convergence criteria should they decide to have a common currency.

Table 9.1: Actual Central Government Operations (L S millions)

Items	1970/71-72/73	1973/74-75/76	1976/77-78/79	1979/80-81/82	1982/83-84/85	1985/86-87/88	1993-94/95	1994/95-1996	1997-1999
Revenue	168.0	270.7	448.9	734.9	1,410.6	2,922.8	252,000	426,700	1,569,700
Current Expenditure	149.0	236.9	440.4	768.2	2,211.8	5,722.0	268,300	460,300	1,537,700
Development Expenditure	21.1	85.7	168.6	275.5	501.8	1,078.2	42,300	61,000	190,300
Other Expenditures	0.0	0.0	24.9	181.0	0.0	0.0	19,300	63,300	0.0
Total Expenditure	170.1	322.6	633.9	1224.4	2,713.6	6,800.2	347,000	604,700	1,728,000
Overall Balance	-2.1	-51.9	-184.9	-489.8	-1,303.0	-3,877.1	-93,700	-178,000	-158,300
External Financing	-4.1	65.6	71.5	347.6	1,003.2	2,490.9	32,000	32,300	48,300
Central Bank Financing	11.5	20.4	139.4	155.1	286.4	1,334.5	63,700	145,000	110,000
Other Financing	-5.4	-33.4	-26.0	-12.8	13.3	51.7	2,000	700	0.0
Deficit as % of GDP	0.2	12.0	6.1	9.3	9.9	12.3	3.0	2.8	0.5

Figures for the 1990s were originally recorded in billions of Sudanese pounds (L S). The three-year moving averages are calculated from the given sources.

Source: IBRD, Reports on Sudan Economy, 1982, p. 223, 1985, p. 152, &1990, p. 113; *and IMF, Reports on the Sudan Economy, 1998, p. 6, 1999, p. 63, &2000, p.19.*

The Sudanese Financial System

The Sudanese financial system is not well developed. Commercial banks dominate it. It is heavily concentrated in the urban areas of central Sudan and Port Sudan. It has been characterised by heavy government interventions and regulations. Apart from establishing its own public sector banks, the Bank of Sudan lends directly to public corporations. Table 9.2 gives an overview of the geographical and political spread of Sudan's banking network.[3]

Table 9.2: The Distribution of the Banking Network in Sudan (%)

Province	1959	1981	1991	1994	1997	1998	1999	2000	2001
Khartoum	41	34	30	29	32	32	32	33	33
Central	25	21	22	22	23	24	23	22	23
Eastern	19	17	13	14	14	13	15	14	11
Northern	6	8	14	13	12	11	12	11	10
Kordofan	6	8	9	11	9	9	8	9	10
Darfur	0	7	8	8	7	8	7	8	7
Southern*	3	7	4	3	3	3	3	3	3
Total	100	100	100	100	100	100	100	100	100

*Southern Sudan was composed of three provinces, each comparable to each of the six original provinces of the North as at independence. The Southern provinces were Bahr el Ghazal, Equatoria, and Upper Nile.

Source: Bank of Sudan, Annual Report (various years) and UNDP, *Macroeconomic Policies for Poverty Reduction: The Case of Sudan*, (2006), p.63.

The uneven distribution of the banking services, both private and public, has not changed over the last fifty years of independence. Even in favoured areas, bank branches are concentrated in the urban areas of Atbara, El Obeid, Khartoum, Port Sudan, and Wad Medani; and their surrounding satellites. The rural areas and small towns have no banking facilities. Even the Agricultural Bank of Sudan (ABS) is urban-based; mainly lending to absentee landlords whose hired workers do the entire farm work.

A relevant feature of the Sudanese financial system to the issue of common or separate currencies for Northern and Southern Sudan is the Islamisation of the financial system of Northern Sudan while Southern Sudan operated on the conventional banking system during the Interim Period of the Comprehensive Peace Agreement (CPA) (2005-2011). The Islamic Instruments of monetary policy such as *murabaha* and *musharaka* are equity-based with a variable yield according to profit and loss sharing, unlike the interest-based securities of a conventional financial system.[4]

According to Bekkin, Sudan is the only country in the world that has a wholly Islamic financial sector. The Islamisation of the Sudanese financial system started in the late 1970s with the setting up of the Faisal Islamic Bank in 1977. In 1992, the government established a High Shariah Supervisory Board (HSSB) to oversee the progress of economic and financial reforms and their compliance with Shariah. This body comprised scholars, jurists and economists, including the governor of the central bank (the Bank of Sudan). The members of the HSSB can combine their membership in the board with membership of the Shariah boards of commercial banks. Their appointments were not term-limited. The HSSB also acts as an appeal authority for disputes between various Islamic banks, Islamic banks and the Bank of Sudan, and an Islamic bank and its customers.

However, like the conventional banks, the Islamic banks concentrated their loans on trade and other short-term commercial activities. They hardly extended much of their services to the agricultural and livestock sub-sectors. Specialised banks were set up to lend to the farming community, but agriculture did not receive any better services from the Islamic banks than under the conventional banking system. In addition to the Agricultural Bank of Sudan (ABS), the Farmers' Commercial Bank and the Animal Resources Bank were set up in the 1990s to focus on the two sub-sectors (crop and animal production).

The Islamised ABS did not perform any better than before it was Islamised. From its inception in 1957 to its Islamisation in the 1990s, the ABS was supposed to focus its activities on the achievement of self-sufficiency in the production of basic food crops, raising the standard of living of the peasant farmers and equitable regional development. Instead, the ABS concentrated its resources on financing large-scale mechanised farms, owned by absentee landlords resident in the cities of central Sudan. The ABS has been characterised by its absence in the areas with sufficient rainfall for reliable rain-fed agriculture (Yongo-Bure 2005).

In addition to extending direct loans to public corporations, the Bank of Sudan extended short-term loans and foreign aid funds to the ABS for extension to farmers. The ABS expended the bulk of these public resources on funding large-scale mechanised farming. In 2001, total lending to the agricultural sector in Sudan amounted to SD 44 billion (Sudanese Dinar): (1US$= SD 260). The irrigated scheme received about 60 per cent, the mechanised schemes received about 39 per cent, and the peasant sub-sector received only about one per cent (Mohamed :7; Yongo-Bure 2005:84).

Sudan's insurance sector has also been Islamised. Faisal Islamic Bank initiated the idea of establishing an Islamic Cooperative Insurance Company in 1977 (Bekkin; UNDP). In 1979, the new venture, Islamic Insurance Company of Sudan, obtained public company status. The Islamic banks needed Islamic insurance; hence, they promoted the Islamisation of the insurance sector. In 1992, the government passed a decree on the control and supervision of the insurance sector, making all insurance operations in Sudan comply with Shariah principles. In 2001, more detailed legislation was adopted, and in 2003, the government expanded it further and passed an Islamic Law of Insurance. In 1990, the first Islamic bond was issued.

In 1994, the Khartoum Stock Exchange was set-up, operating on Islamic principles (Ali 2007; Hearn et al.: 15-18). The central bank created the Central Bank Musharaka Certificate (CMC) as a market-oriented instrument compatible with Shariah law.[5] The Sudan Financial Services Company (SFS) on behalf of the Bank of Sudan and government ownership in commercial banks issued these securities in July 1998. The authorised primary bidders are all the commercial banks having accounts with the Bank of Sudan. The CMC can be traded in the secondary market.

In 1999, the Ministry of Finance and National Economy (MoFNE) issued Government Musharaka Certificate (GMC) with the primary goal of financing the budget.[6] Part of the GMC was transferred to the Bank of Sudan in 2000 to be used as additional tools for open market operations. Most securities are being marketed, and new ones issued, most notably the newly issued Government Investment Certificate (GIC). GICs are a form of Murabaha issued by the government to finance particular outlays for ministries of education, health and department of medical supply.

The Financial Infrastructure of Southern Sudan

Before the outbreak of the second war in 1983, there were about ten branches of the Khartoum-based Unity Bank in Southern Sudan (Yongo-Bure 2007:144). These bank branches mainly collected savings from the South and channelled them for utilisation in the North. The Bank of Sudan had a branch in Juba, which became the Bank of Southern Sudan in 2005. However, the Bank of Sudan extension of credit to agriculture and public corporations was confined to the North where public corporations operated the irrigated schemes. The Agricultural Bank of Sudan (ABS) had branches in Juba, Renk, and Wau in the South. But most of the ABS's lending in the South was concentrated in Renk,where the mode of mechanised farming had extended from the North. For example, between1982-1984, the total agricultural credit extended by the ABS was L S 72 million. The share of the South out of this total was L S 9.6 million. Renk received 82 per cent of the share of the South, Wau17.7 per cent, and Juba 0.3 per cent (Yongo-Bure 2005:82-83). There was only one insurance company in the South, performing a limited number of functions such as motor vehicle insurance. By then motor vehicle ownership was very limited in the South.

During the war, Faisal Islamic Bank and Omdurman National Bank were established in Southern Sudan. From the 1990s to 2005, these Khartoum-registered banks, operating in the government-garrison towns in the South, were also Islamic. In 2007, these Islamic banks were told by the Bank of Southern Sudan to either change to conventional operations or quit the South. They chose to quit. By February 2009, Faisal Islamic Bank, Omdurman National Bank, and the Agricultural Bank of Sudan announced the closure of their branches in the South.

By 2011, a rudimentary financial system had been established in Southern Sudan. The Nile Commercial Bank, created during the war, plus the Buffalo Bank, Ivory Bank, and the Sudan Microfinance Institution (SUMI) are local banks now operating in Southern Sudan. Other banks operating in Southern Sudan include subsidiaries from neighbouring countries such as the Kenya Commercial Bank, Equity Bank, and Ethiopia Commercial Bank. Three insurance companies from Eastern African countries provide insurance services in Southern Sudan. These are the National Insurance Corporation, the Renaissance Insurance Company, and UAP Insurance (www.gurtong.com 2011).

Monetary and Exchange Rate Policies in Sudan

Sudan adopted a fixed-exchange rate regime from 1957-1978, first pegged to Pound Sterling until 1971 and then to the United States Dollar. From 1978 to 1987, a series of devaluations, controls, and multiple exchange rates were pursued, each unsuccessfully. As part of liberalisation policy in 1992, there were attempts to unify the official and parallel exchange rates. With further deterioration in the country' balance of payments, more devaluations were undertaken through 1996 when another unification effort was pursued until 1997. Commercial banks and private exchanges continued to fix the selling and buying rates, while the central bank calculated a weighted average of the private sector rates as its own rate.

In 1998, a more comprehensive strategy exchange rate reform was introduced to unify the rate. The official rate was replaced by a moving average of market rates and exchange controls were progressively lifted. The mandatory immediate surrender of foreign exchange receipts from exports was extended to six months. Existing restrictions on means of payments for foreign trade and on financing imports were lifted. In May 2002, the Sudanese dinar was changed from a de-facto fixed rate to a managed-float. A formal band of ±1.5 per cent was introduced and later broadened to ±2.0 per cent around the official rate. The Bank of Sudan began to auction its foreign exchange within this band.

Sudan's monetary policy has been drawn and executed to achieve macroeconomic objectives, which included raising the growth rate of GDP and maintaining monetary and exchange rate stability through controlling monetary aggregates. The Bank of Sudan takes monetary policy decisions in coordination with the Ministry of Finance and National Economy (MoFNE). While the stated policy of the Bank of Sudan is that the target of monetary policy is to maintain price stability and low inflation, in actual fact the operations of the central bank have been to finance the government budget deficit, including lending to public enterprises, and to prescribe credit ceilings for priority sectors. To attain these objectives, the Bank of Sudan uses a set of direct and indirect instruments of monetary and credit control. In addition to moral suasion and quantitative measures, the Bank of Sudan experimented with several instruments: Statutory Reserve Ratio (SRR); Internal Liquidity Ratio (ILR); Financing Windows, Credit Ceilings; Open Market Operations; Foreign Exchange Operations; and Setting Minimum Rates (UNDP:55).

The SRR was raised from 20 per cent in 1992 to 30 per cent in 1997, but steadily declined after that. Sub-ceilings were maintained for credit to priority sectors, but were then gradually abandoned in the wake of liberalisation of 1997, except for the imposition of 10 per cent of total private sector credit for social development activities.

From the early 1990s, all sectors were subdivided into priority sectors, non-priority sectors, and sectors excluded from credit. In 1996, the government issued a list of 13 priority sectors, which were intended to receive 90 per cent of total credit. Up to 40 per cent of commercial banks' total credit was to be allocated to agriculture, and within agriculture certain amounts were prescribed to various subsectors. In addition, the cost of credit was regulated and differentiated depending on the nature and financial adequacy of the lending institution. (UNDP 2006:53-56).

But against the escalation of inflation to historically unprecedented levels during the first half of the 1990s, accompanied by a sharp deterioration in the balance of payments, a strengthened programme focusing on macroeconomic and price stabilisation was formulated for the period 1997-2001. This was supported with a tight fiscal policy from 1997, which restricted central government resort to deficit spending from the central bank. The Bank of Sudan became more active in conducting a market-oriented monetary policy and started engaging in open market operations using indirect instruments based on Islamic modes of finance. The Islamic open market operations instruments included central bank Musaraha certificates (CMCs) and government Musaraha certificates (GMCs). A strengthened economic reform programme aimed at consolidating and modernising the macroeconomic management regime, was activated in 2002 as Sudan switched to indirect Islamic monetary policy management and broad monetary targeting, and introduced a managed float exchange rate system.

The main aim of monetary and credit policy during this reform period centred around achieving positive rates of growth in real GDP and stabilising prices to acceptable levels, concomitant with a general reduction in the rate of growth of broad nominal money supply to specified levels. The CMCs were used for both liquidity control and increasing government revenue, while the GMCs and GICs were basically aimed at meeting government need for revenue.

After the signing of the CPA, the country moved to a dual banking system: an Islamic system for the North and a conventional one for the South. From 2005, the Dinar continued to function anywhere in Sudan while other currencies operated side-by-side with the Dinar in the South, until 2007, when a new unified Sudanese Pound (SP) was introduced to replace the

Dinar at an exchange rate of 1US$=2SP. Hence, just before its split, Sudan implemented one monetary policy under two different financial systems. Was this willingly accepted by Juba? Or did Juba tolerate it just because it was sure the South would soon separate and have its own system?

Foreign exchange operations were used as a monetary policy instrument during 1997-99 for the purpose of controlling liquidity. With oil, foreign exchange operations lost their liquidity control function but continued to be used to stabilise the exchange rate. The Bank of Sudan stood ready to buy and sell foreign exchange on demand, targeting exchange rate stability. Banks were also instructed to ensure that the total amount of credit advanced to rural areas, at any given time by any of their branches, was not less than 50 per cent of total deposits received from these areas.

With increases in petroleum exports, the persistent exchange rate crisis of the Sudanese currency was somehow resolved. Soon the Comprehensive Peace Agreement (CPA) was signed in 2005. Then a new currency was issued in 2007. With all the foregoing experiences, can the two Sudans sustain a common currency or should each one have its own currency?

Conclusion

From the historical experiences of Sudan with monetary, exchange and fiscal policies, it will be extremely difficult for the two Sudans to manage a common currency. Their financial systems are at different levels of development. Although the North's system is relatively more developed, it is still far from the ideal integrated system. The South has just started to set up a financial system. Each of the two Sudans aims at developing a different financial system: a conventional one for the South and an Islamic one for the North. The enthusiasm of the North for an Islamic system and Southern Sudan's persistent opposition to a religious system makes it unfeasible for them to manage a common currency. They hardly worked cooperatively during the six years they were implementing the Comprehensive Peace Agreement (CPA). They quarreled over the sharing of oil revenue. Will they cooperate on sharing of the seigniorage revenue? Will they be able to agree on convergence criteria and cooperate on their enforcement?

As one country, they did not devise polices for regional development. How will they address their marked economic inequalities in their development policies as separate countries? A common currency also means a common market. In a united Sudan, it was the Northern industry that benefited from the common market as Southern Sudan had no industrial products to export to the North. It is always very difficult for a new industry to compete with established ones unless there is a deliberate policy to alter the historical relationship. In the case of a united Sudan it would be an uphill battle for Southern Sudan to overcome Northern Sudan's early-start advantages due to the backwash effects of the established Northern industry. The same backwash effects will operate if the two countries continue to have a common currency. A common currency is only useful in a relationship in which the partners do care for each other's welfare and therefore institute measures that can bring about justice and equality through balanced regional development.

Countries that have sought to establish a monetary union have initially been separate. Their quest for adoption of a common currency has been in the process of moving towards cooperation and even integration. But the two Sudans are moving in the opposite direction. Will the forces that pull them apart politically withstand the maintenance of a single currency? Would confederation not have been the preferred political arrangement, if maintenance of a single currency was seen as crucial?

Therefore, Northern and Southern Sudan should have a separate currencies and monetary policies, given their different levels of development and degree of mistrust. This mistrust will not allow for harmonious handling of the major economic challenges the two separate countries will be encountering. The central bank in a developing economy plays more and difficult roles. The Bank of Sudan has experienced many problems throughout its history, especially from 1978. Northern Sudan and Southern Sudan will undergo many economic challenges before they eventually stabilise. It is preferable that each one addresses these initial challenges individually otherwise their mistrust of each other will be deepened in the process of antagonistically managing difficult situations jointly. As their economies develop and stabilise, they may be able to see their mutual benefits of working cooperatively as neighbours with a very long border. That will be when they may pursue common policies cooperatively.

At the present level of development of Southern Sudan, the major component of money supply consists of cash. Demand deposits are limited as the habit of banking is not widespread. Financial institutions such as commercial banks, development banks, insurance companies, social security and pension schemes, that play an important role in development, are either in their infancy ornon-existent. Therefore, the effects of monetary policy on sustained economic growth and development will be very limited. Consequently, policy-makers for an independent Southern Sudan should continue to focus on the building of a financial infrastructure and spreading the habit of banking throughout the population instead of spending time on fruitless negotiations and management of a common currency with a never-caring supposed partner.

Through judicious use of its *seigniorage*, Southern Sudan will benefit from having its own currency before it is able to diversify its tax base. Of course, the Bank of Southern Sudan (BoSS) should not over-print the currency because of the inflationary consequences of an overprint. Macroeconomic stability, particularly price stability, is essential for sustained economic growth and development. Inflation tax should not become a significant part of the revenue of the Government of Southern Sudan (GoSS) regardless of how hard-pressed the country is with financial difficulties.

The South should allocate its *seigniorage* to cash purchases of crops from the peasant farmers as the crop production will liquidate the inflationary consequences of the newly printed money. *Seigniorage* channelled to rural development will generate production and will have minimum inflationary consequences. It will also increase employment, income, and reduce abject poverty as the bulk of the population will share in it.

As much as a number of foreign financial institutions are providing services in Southern Sudan, the South needs to develop its own financial infrastructure, which in the longrun will dominate its financial industry. Considerable efforts must be made to develop such a vital sector. It will take time before the habit of banking becomes widespread. Therefore, it must be consciously developed. The persistent problems that the Nile Commercial Bank has been experiencing must be resolved permanently and the lessons learned from it must be used to help in the development of other financial institutions.

Each state should establish its own bank(s) with the initial capital contributed by GoSS and the state governments. More capital should be raised from county governments and the citizens of each state by selling shares to them. Such a policy will reduce future complaints about the functioning of the national financial system. At least a national insurance and re-insurance company/corporation must be set up. States may also establish their own insurance companies, again with shares from the counties and citizens of the state. Counties should establish credit unions. The cooperative movement should establish a bank with branches in all counties and payams in medium and the longrun. The Government of Southern Sudan, the Bank of Southern Sudan, and the Southern universities should cooperate in devising plans to educate and train human resources for the establishment of the nucleus of a financial system. About 15-20 per cent of intake to highereducation should be in the disciplines of economics, commerce and statistics.

Although a larger developing economy has more potential for development than a smaller one, which is extremely dependent on changes in the world economy, cooperation and integration has to be among countries with common aspirations and goals. Can South Sudan develop its financial sector along the East African lines, with the hope of realizing the benefits of a common currency under future East African Monetary Union? Unlike North Sudan, which is developing an Islamic financial system, the East African Community member countries have operated on the conventional financial system. Furthermore, the East African economies, especially the Kenyan and Ugandan ones, and the South Sudanese economy have become closely integrated since 2005.

Notes

1. The concept of optimal currency area is discussed in the following pages.
2. A moral hazard arises as some members of the monetary union borrow unsustainably with the hope that other members of the union or the union central bank would bail them out in case of debt crisis.
3. Southern Sudan is approximately three times each of the original provinces of the North. For the figures on Southern Sudan to be comparable to those of the six provinces of the North at independence, the figures of the South should be decomposed to the three comparable original provinces of Bahr el Ghazal, Equatoria, and Upper Nile.
4. Both instruments of Islamic finance are based on profit-loss-sharing. The investor (Islamic Bank) shares profits or loss generated by funds invested in an enterprise. There is no automatic interest earned by lending to an undertaking. Under a Mudaraba contract, the bank contributes the capital and the borrower provides labour and expertise. The borrowers do their best to make productive use of the funds. The lender and borrowers share profit in predetermined percentages. Any loss is borne by the lender unless the borrower causes it through willful acts, negligence, or breach of contract.
   Musharaka is similar to a partnership. Each of the party to the contract contributes a percentage of the capital and her/his obligations toward any liability are stated. Profits and losses are shared according to a partner's contribution of capital, service, or expertise to the enterprise.
5. The Central Bank Musharaka Certificates (CMCs) were shares in a special fund composed of government investments in nine commercial banks. The CMCs allow their owners to share with the Bank of Sudan and the Ministry of Finance the benefits of investing in banks wholly or partially owned by them. If the Bank of Sudan wants to reduce liquidity of the commercial banks, it will sell certificates up to the amount of money it wants to withdraw from the banks. If it wishes to increase liquidity in the economy, it will buy certificates accordingly.

6. The Government Musharaka Certificates operate in a similar manner as the CMCs. They allow their buyers to share the profit or loss resulting from the operation of government corporations and companies whose equity capital constitutes the fund from which these certificates are issued. The GMCs work as open market operations, managing overall liquidity in the economy. They also contribute to covering part of budget deficit instead of printing money by the Bank of Sudan. The Government Investment Certificates (GICs) also play the same role as the GMCs, except that they are limited to particular ministries whose services are considered essential.

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