Sudan: Uncharted waters

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Sudan's status as a pariah state has rendered the Sudanese market off-limits for many investors in recent years. However, the U.S. government's decision in Q3 2017 to put an end to two decades of economic sanctions removed a key barrier to investment, and perceptions of the Sudanese investment climate are changing amidst a partial rapprochement between Khartoum and western diplomatic partners.

Yet significant operational, financial and integrity risks remain in a market that is facing a growing currency crisis which may threaten overall political stability. This briefing assesses the near-term and medium-term outlook for Sudan's investment climate, and the implications for investors seeking to enter the market.

Lifting of U.S. Sanctions

The United States in October 2017 lifted economic, trade and financial sanctions on Sudan. The decision, taken according to the so-called "five-track framework" agreed between the two countries in December 2016, represents the culmination of a process initiated in 2009, under President Obama. It is a milestone in the rapprochement between Sudan and the U.S, and a first step toward full normalization of diplomatic relations. President Omar al-Bashir's National Congress Party (NCP) regime has also seen relations with Europe improve in recent years, with E.U. funding secured in exchange for the promise to curb migrant flows from the Horn of Africa.

The lifting of economic sanctions eliminates a key obstacle that had formerly prevented companies with any exposure to the U.S. market from doing business in or with Sudan. Not all sanctions have been lifted, however. The U.S. maintains targeted sanctions against regime figures suspected of involvement in crimes against humanity in Darfur, and Sudan remains on the U.S. list of state sponsors of terrorism; but these measures have few direct consequences on investment and trade.

Imports of goods such as pharmaceutical drugs, machinery, and FMCG will certainly benefit from the end of economic sanctions, and transactions (including trade finance) with banks with an exposure to the U.S are now more straightforward, thus easing operational risks for investors. Sudanese authorities are also actively promoting investment prospects in agriculture, energy and mining as part of a drive to boost Foreign Direct Investment.

At first glance, the mining sector appears especially attractive. Since 2013, Sudan has witnessed a gold rush, but production, which reached 105 tons in 2017, has remained largely artisanal and small-scale. The authorities are keen to attract foreign investors into the sector: larger-scale industrial production of gold would offer a reliable way to bring in fresh cash and hard currency to government coffers, compensating for the decline in oil revenues caused by South Sudan's secession in 2011.

Spiralling economic crisis

In the short term, however, the end of sanctions has had the perverse effect of hurting Sudan's economy, prompting a crisis more serious than the one caused by South Sudan's secession. By stimulating opportunities for trade and thus the demand for foreign currency, the lifting of sanctions has exacerbated existing economic woes, sending the country into a spiral of inflation that poses a significant currency risk to foreign investors and a serious threat to political stability.

Traders seeking foreign currency for imports have sold their Sudanese pounds, exacerbating the yawning spread between the official, fixed exchange rate and the black-market rate. This has forced the government, whose foreign exchange reserves are dangerously low, to devaluate the pound twice since the beginning of 2018, bringing the official rate to 30 pounds to the dollar by mid-February, down from 6.67 pounds to the dollar in late December.

These dynamics have sent inflation through the roof: according to one expert estimate, between December 2017 and January 2018 the implied annual inflation rate shot from 40% to 122%, making it the world's second highest after Venezuela.[1]

This level of inflation is virtually unprecedented. Combined with the banking sector's acute shortage of U.S. dollars, the situation poses a key challenge to foreign investors whose earnings are in Sudanese pounds, and who will struggle to preserve their value.

The spiralling crisis is also stirring social and political resentment, with consequences that are already visible. Following the government's January devaluation and removal of subsidies on wheat, which doubled the price of bread and other food staples, opposition parties called for demonstrations. Unrest escalated across major cities throughout the month, until the authorities brought it to an end by clamping down on demonstrators and arresting opposition leaders, activists and journalists. This security crackdown has done little to quell growing unrest and a deepening resistance to Bashir's government.

[1] Inflation rate calculation for Sudan published by Prof. Steve Hanke of Johns Hopkins University; cited here.

Long queues are reported at ATM machines across Sudan as poor network issues are exacerbated by the restrictions introduced by the central bank on commercial banks in mid-February. Customers are now permitted to withdraw SDG 200 ($11) instead of SDG 1,000, forcing several small withdrawals. The director of the Bank of Sudan, Hazim Abdelgadir has committed to focussing on the provision of local liquidity to the commercial banks and ATMs in the coming months, as ATMs run out of cash in the states of Khartoum and Al Jazirah.

Because Sudan remains on the U.S. list of state sponsors of terrorism, the country does not have access to the IMF or World Bank financing that would restore confidence in its ability to shore up its currency. To manage the crisis, the Bashir regime will seek financing from Gulf countries, as it has done in recent years. On 13 March, the Central Bank in Khartoum received a deposit of $1.4 billion from the United Arab Emirates to support liquidity and bolster its foreign exchange reserves. This could buy time, but it won't be enough to restore rapidly collapsing confidence in the Sudanese pound. We therefore believe that hyperinflation is a credible threat, and further devaluations in the Sudanese Pound are likely in the coming months. The authorities will likely be forced into floating the pound before the end of the year, which could trigger further unrest as the pass-through effect of rising prices for daily essentials kicks in.

Uncharted territory

The economic crisis comes as the political scene enters a phase of renewed uncertainty. The NCP regime in recent years has surprised many observers by weathering both the South Sudanese secession and the Arab Spring, sometimes through force. In 2013, the authorities ended a wave of protests in bloodshed, killing nearly 200 demonstrators, and in 2015 President Omar al-Bashir secured another five-year presidential mandate.

Yet with the 2020 presidential elections on the horizon, it remains to be seen whether, after more than a quarter century in power, Bashir will be able to defend himself from internal threats to his rule. He is taking steps to protect himself: in February 2018, for example, he puzzled observers by reinstating as intelligence chief Salah Gosh, who'd been arrested in 2012 on suspicions of plotting to overthrew the President. The move comes in the context of growing competition among regime insiders vying for Bashir's succession. Former presidential adviser and security strongman Nafie Ali Nafie, who remains influential within the ruling party, poses a rising threat to the President. Hence Bashir is seeking the support of other strongmen, including former Vice-President Ali Osman Taha, who'd fallen out of favour in 2013 but remains a leader of the civilian Islamist movement (which forms one of the pillars of the current regime, alongside the security services and the military), and his ally Salah Gosh, to counteract Nafie's manoeuvres.

Bashir remains under a warrant of the International Criminal Court for war crimes, crimes against humanity and genocide in Darfur. For other regime figures, giving Bashir away to the ICC would be an easy and symbolically rewarding way to restore Sudan's stance in the world, particularly with western countries. This makes it hard for Bashir to leave the stage, as he has good reasons to be sceptical of any promise of immunity coming from his potential successors. The situation gives Bashir an incentive to remain President until he's forcibly removed from power.

Whether Bashir retires on his own or is pushed out against his will, a managed transition from within would leave the presidency to a regime insider who would likely continue the normalization with the west, paving the way for debt relief. Such an orderly transition would have little impact on the current political and economic system.

However, the current economic crisis makes such an orderly transfer of power increasingly unlikely. While opposition protests in response to rising costs of living are unlikely to pose a direct threat to the regime, widespread, sustained demonstrations in the capital city could lead to a political crisis whose consequences are difficult to predict. While the security and armed forces have so far remained loyal in the face of unrest, widespread demonstrations in the capital could prompt a military coup comparable to the one that brought down President Gaafar Nimeiri in 1985 in a context of hyperinflation.

Given the tight interweaving between ruling elites and the companies that dominate the local economy, regime change could have far-ranging consequences for the business environment.

Should the military and security apparatus remain loyal, sustained unrest would prompt a long cycle of protests and repression, and would exacerbate tensions within the ruling elite ahead of the 2020 elections.

External Relations

Facing an economic crisis at home, there was optimism in Khartoum that Washington's removal of economic and trade sanctions would lead to a normalising of relations with the US, thus providing Sudan with relief from its $50 billion international debt, while attracting external investment to rescue the economy. The U.S. has been clear, however, that improved relations are contingent on further reform from Bashir's government, including improvements to its human rights record.

Bashir has looked elsewhere for support and earlier this year secured a deal with Vladimir Putin to buy Russian wheat at a discounted rate. He further undermined U.S.-Sudanese relations by declaring his support for Russia's intervention in Syria, and by criticising U.S. Middle East policy.

Bashir has also secured economic support from his Arab neighbours. In 2014, Khartoum abandoned its longstanding alliance with close ally Iran, shifting its allegiance to the Arab Gulf bloc. This involved dispatching thousands of troops to Yemen to join the Saudi-led coalition fighting the Huthi rebels. In return, the government in Khartoum benefited from Saudi lobbying of the U.S. over the repeal of sanctions, but has otherwise been underwhelmed by the financial benefits of this relationship. The United Arab Emirates and Qatar have, however, pledged money for infrastructure and agricultural development, and made deposits in the Sudanese Central Bank.

Sudan's relations with Egypt, its neighbour to the north, are strained over various issues, particularly the Grand Ethiopian Renaissance Dam, and the disputed border area of Halayeb. The two governments suspect each other of supporting domestic opposition groups. Their different positions over both the crisis with Qatar, and relations with Turkey over plans to build a military base on Suakin Island, have exacerbated tensions.

Frictions between Egypt and Sudan came to a head in January 2018 when Egypt reportedly deployed troops in Eritrea. In response, Khartoum closed the border with Eritrea, declared a state of emergency in the region and deployed additional militia forces. Tensions have since de-escalated, but the underlying disagreements remain.

Given the complexity and flux of existing foreign relations, Bashir is likely to continue an opportunist foreign policy agenda. This will be driven by an immediate need to address Sudan's failing economy, rather than long-term and considered relationship building.

Outlook

Beyond the risks posed by political instability, inflation and a looming currency crisis, the investment climate in Sudan will remain challenging even under the best-case scenario. Firstly, corruption and integrity risks pose major threats to foreign investors. Corruption is rampant at the highest level of the state, whether through demands for bribery, embezzlement of public funds, selective enforcement of regulations, or the involvement in procurement of the extensive networks of parastatal companies controlled by military and intelligence figures.

Secondly, there are indirect integrity and reputational risks stemming from an association with a government that holds a poor human rights record, including accusations of genocide. The government remains involved in low intensity civil conflict in Darfur, Southern Kordofan, and Blue Nile, where its forces have been accused of war crimes. Human rights and Sudan-focused NGOs have greeted the willingness of the U.S. and Europe to normalize relations with Khartoum with scepticism, and the regime's heavy-handed management of growing discontent will continue to attract the attention of such NGOs, as well as the global media.

Integrity risks are particularly salient for the extractive industries, which are strategic for the authorities. Oil and gold provide crucial sources of income to finance the government's war efforts, and the security of extractive-sector project sites falls under the purview of the National Intelligence and Security Service (NISS), which has a track record of opening fire on demonstrators using live ammunition. There is little, if anything, oil and gas or mining companies can do to mitigate the reputational risks inherent in any association with the NISS.

Nevertheless, the negative implications for investors of the corruption, integrity, political and macro-economic risks highlighted above should not be over-stated. With sanctions lifted only recently, few global brands are present in the Sudanese market and most sectors remain less saturated than regional African peers, creating a significant opportunity for first-movers. Integrity risks are also lower for companies operating outside of the extractives sector in consumer-facing or B2B sectors.

It remains possible for foreign investors to operate successfully and profitably in Sudan, though we advise new market entrants (i) to conduct extensive pre-investment due diligence; (ii) to develop robust risk management safeguards to protect against corruption threats and indirect integrity threats stemming from association with government agencies or companies; and finally, (iii) to model the likely impact of severe on-going currency volatility, high inflation and limited availability of hard currency on the business case, and to proactively mitigate such risks to the fullest extent possible.

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