FINANCIAL MARKETS: THE RECENT EXPERIENCE OF A DEVELOPING ECONOMY

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Abstract

The financial sector plays a crucial role in economic growth; it allows an efficient transfer of resources from those who save to those who invest. This sector comprises financial institutions, markets and instruments. This study highlights the fact that change has always been the hallmark of financial markets and the regulatory board of the Sudanese financial market. The Sudanese capital market, although an infant, could follow the route of other well-established capital markets of developing countries, keeping in view the so called globalisation, privatisation and liberalisation phenomena of the Sudanese corporate sector and securities market. There is a need for a more responsive and effective regulator to guide primary as well as secondary securities markets. This paper seeks to extend the literature by exploring the issue related to a small emerging capital market; the paper examines the current practices of Khartoum Stock Exchange (KSE) in trading of shares and evaluates the efficiency of the capital market in Sudan, as this area is still virgin in the Sudanese context, since financial markets are not generally the object of such scrutiny.

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1. INTRODUCTION

Financial institutions, markets and instruments that constitute the financial sector, play a crucial role in the financial development and economic

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growth of a developing economy. This paper examines the evolution of Sudanese financial markets in general and infant capital markets in particular. This article covers the period 1995-2004; an Act was endorsed to establish the Khartoum Stock Exchange in June 1994. This study is divided into seven sections. In the second section, savings mobilization and economic growth are reviewed. The third section deals with the financial reform process in Sudan. In section four, financial markets are analysed in general. The fifth section reviews briefly money markets in Sudan. The sixth section examines the development of capital markets. The seventh section studies the functioning of the Khartoum Stock Exchange (**KSE**) and its performance. Lastly, findings and policy recommendations are presented in the eighth section.

2. THE ROLE SAVINGS MOBILISATION IN ECONOMIC GROWTH

For most of the less-developed countries, the 1980s has been a decade of unsatisfactory economic growth and slow economic development. Given the immense burden of servicing their external debt and the poor prospects of increasing the inflow of foreign capital, developing countries are now in the process of reshaping their growth and development. Economic growth depends upon the mobilisation of resources. Financial institutions play a very useful and dynamic role in the economy of any country. They are important constituents of the money market, and their demand deposits serve as money in the modern community. Thus, they have considerable part of the stock of money; in fact, their lending and investing activities cause changes in the quantity of money circulating which in turn influences the nature and character of production in any country. Financial institutions, instruments and markets that constitute the financial sector, play the crucial role of channelling the transfer of financial resources from net savers to borrowers, that is, from those who spend less than they earn to those who earn less than they spend (Jadhav, 1996, p. 211). Hence, growth is related to the rate of investment. Functionally, banks are both the repositories of the society's savings as well as the purveyors of credit for economic activity; they also provide convenient avenue for investment of surplus funds to the saver and, to the investor, they provide a source of finance.

Therefore, money-saving implies real saving of goods when people deposit their savings in banks and when banks lend these savings to borrowers who invest in agriculture, industry, trade etc. This investment then turns into capital formation that helps increase the productive capacity of people, which ultimately, gives rise to economic growth. Thus, banking and financial institutions help the process of economic growth of the country by gathering the savings of people and directing savings to the productive channels (Wai, 1972, p. 47). As Wai states, the savings units accumulate financial claims on investment or financial intermediaries: "*there are three major ways in which efficient financial intermediation helps in development process: by the allocation of additional savings, by the allocative function, and, by redistributing the benefits of larger returns in capital investment.*" (Wai, 1972, p. 31). Mobilised funds are then transmitted to the investment units, which lead to an ever-growing ratio of financial assets of all kinds, to income and wealth with a concomitant rise in savings and investment ratios. Savers and investors, who hitherto had been scattered and isolated from each other, are joined together by various kinds of credit instruments, markets and financial institutions. If the growth and development of economy are to be accelerated, it is essential that the resources saved by surplus units be put to the most productive uses and be increased.

As a matter of fact, without banks and other financial institutions, savers would have kept their savings in the form of cash at home, gold and silver, land, or would have used them to hoard goods, ultimately wasting them in undue consumption, which does not help producing other goods, or building up productive capacity. In the absence of banking institutions, investors could face difficulties in the expansion, modernisation and diversification of their business projects because their own funds are insufficient. Banks bring savers and productive investors together so that more investment and greater build-up of productive capacity of the people take place. Thus, banks continue to dominate the financial system of most developing countries, and contribute a great deal to the economic growth of the country; consequently, they help improve the standard of living of all classes of society, as well as the eradication of poverty and the removal of unemployment (Car-Johan, Garcia, and Saal, 1996).

3. FINANCIAL SECTOR REFORMS

Sudanese financial institutions (banking sector), which operate under the principles of Islamic laws (profit-loss-sharing scheme), since the year 1992 have been the object of extensive reforms. There are twenty six commercial banks operating in the country, comprising four dominant state-owned and a handful of well-established privately owned banks that serve the interest of local business groups trying to get around the tortuously bureaucratic and slow state-owned banks. The banking policies and financial reforms in

Sudan were intrrupted by political interference. During the socialist regime (1969-1983) Sudan was a textbook case of financial repression. The financial system reached its worst situation in the1980s and 1990s and, as a reaction to the financial crisis, the government had a conflict with the International Monetary Fund (IMF); subsequently, Sudan was declared as a non-cooperative member and was suspended for almost seven years (1993-1999). The financial reforms started gradually in 1970/1971, when the government nationalised all foreign and domestic commercial banks. Recently, due to the globalisation of the economy, the liberalisation process and the application of Basle Committee's recommendations, the Bank of Sudan has adopted the following steps to promote and develop a healthy banking system: (a) Development of a Banking System and Financial Reforms, (b) Development of a Foreign Exchange Market, (c) the Liquidity Management, (d) Development of Banking Operations and Technology and, (e) Islamisation of Banking Activities.

4. THE FINANCIAL MARKETS

A financial market is simply a place or a mechanism for the exchange of assets (Henning, Pigott, Scott, 1975, p. 2). Financial markets play a vital role in allocating funds to economic activities so as to achieve the highest rate of return. Therefore, they perform and reflect the underlying state of the economy (Auerbach, 1989; p. 264). Financial markets, i.e. money and capital markets, have two main functions, both badly needed in Sudan. They give more flexibility to the short-term credit structure, while on other hand they can promote the saving habit by making instruments available. Many financial institutions considered so far operate in an increasingly complex set of financial markets, which create either new financial claims, or are concerned with buying and selling financial claims, such as stock markets. Financial markets consist of groups of financial institutions (FIs), which are homogenous groups, and non-bank financial institutions (NBFIs), which are a heterogeneous group of financial institutions other than commercial banks (Hanson, 1983, p. 103). The Sudanese economy is currently living an historic transition, due to globalisation and international competition.

In the 1990s significant policy initiatives have been taken concerning mining and manufacturing, agriculture, trade, exchange rate and direct foreign investment. After more than seven years of conflicts with international monetary institutions, the emerging market-orientation is aimed essentially at attaining competitive effects in the real sector of the economy. It is widely recognised that the process of liberalization of the real sector needs to be complemented by a corresponding reform of the financial sector. It is the financial sector that provides the necessary framework for mobilisation and allocation of savings in the economy. Structurally, the short-term credit market is a separable, under-organised and unorganized sector. The organised financial market comprises the Bank of Sudan, commercial banks and non-bank financial institutions; it is defined as 'organised' because the Bank of Sudan systematically coordinates its parts. The unorganised financial market in Sudan is largely made up of indigenous bankers and professional money-lenders and the authority does not systematically coordinate non-professionals of this market, (Awad, 1971). In the following sections we study the performance and functioning of various components of the financial markets in Sudan, such as money, capital markets and the Khartoum Stock Exchange.

5. THE MONEY MARKET

There have been major changes in financial markets during the 1990s, with the massive increase in trading instruments such as repurchase agreements and the introduction of options and future contracts on financial assets. Financial markets are classified according to the maturity of the instruments traded (Hanson, 1983, p. 127). Hence, many economists have defined the money market as a market for short-term high liquidity, easily marketable, which are used to finance the needs of consumers, businesses, agriculture and government. Crowther describes the money market as: "*the collective name given to various forms and institutions that deal with the various grades of near money*." (Crowther, 1959, p. 66). And in the words of Culbertson: it is a "*network of markets that are grouped together because they deal in financial instruments that have similar functions in the economy and are, to some degree, a substitute from the point of view of holders*." (Culbertson, 1972, p. 99). Thus, money market consists of call market, commercial paper and treasury bills, inter-bank market and certificate of deposit market which is considered as a wholesale market where large numbers of financial assets or instruments are traded. A money market is a mechanism through which short-term funds are loaned and borrowed and through which a large part of the financial transactions of a particular country or of the world are cleared. While the system of financial and credit in Sudan is still rudimentary, it is also clear that it has been a fast growing system in recent years. Indeed, these years have witnessed what is now recognizable as the beginning of the creation of a local money market. A nucleus of an indigenous money market was created in Sudan and started working since November 1960, when quarterly (three months) Treasury bills and promissory notes were traded. During the 1960s six foreign commercial banks operating in the country joined the Sudanese Commercial Bank, which had begun operations on November 5th, 1960. The Bank of Sudan had provided credit to commercial banks and permitted them to charge the same bank rate (according to section 41 of Bank of Sudan Act 1959), accept discount of bills and promissory notes. The establishment of Khartoum Bankers' clearing House on December 28th, 1960 has cemented the money market in Sudan. Table 1 shows that the banking clearance and settlements were completely a successful story with banks' clearance of millions SDD 42,244 at a daily rate of SDD 1,656 in the year 1995, to a clearance of SDD 376,040 millions at a daily rate of SDD 15,042 in December 2004[2].

The establishment of a money market marks an important development in the economy. It provides a source from which the government can borrow money from the public. Secondly, it provides a place where idle funds can be invested locally, which would have otherwise been invested abroad or remained idle and unused. Thirdly, the paper dealt with within this market gives commercial banks a suitable investment as they can seek accommodation from the Bank of Sudan, should the need arise. This also means that the Bank of Sudan serves as a clearing house for the commercial bank to discount their Treasury Bills, Promissory Notes and Musharkah and Mudarabah Certificates wherever necessary[3]. There is of course, a long way to go before a large and broad-based money market can be created. The markets are divided into modern segment and a traditional segment, each with an independent characteristic and apparently unrelated structure of rates of return (profit–loss-sharing scheme). In the modern segment there are still few specialised institutions that feature a well-developed money market. For instance, there was no stock of exchange until the year 1994, when the Khartoum Stock Exchange was established to deal with equities in the 1990s. There was still little business of medium and long-term debt. In the next portion we examine the development of capital market in the Sudanese context.

[2] The Sudanese Pound (LS - 1957) is replaced by the Sudanese Dinar (SDD) in the year 1998.

[3] Mudarabah is a special kind of partnership, as a profit-loss-sharing principle, in which one partner provides its capital (Rab-ul-Mal = Financier) while the other one (Mudharib = Agent) uses the capital for the purpose of investing in commercial enterprises. Musharakah means sharing, a temporary equity participation agreement between a bank and a client for effecting a certain operation within an agreed period of time; (these definitions are derived from Bank of Sudan, and Iqbal and Mirakhor (1987), IMF).

Table 1: Khartoum Banks' Clearings House: 1995-2004
(in millions of Sudanese Dinars)

Period	Total Clearings	Daily Rate	Total Settlements	Daily Rate
Oct.-Dec 1995	42,244	1,656	7,290	0285
Oct.-Dec 1996	60,386	2,406	14,072	0549
Oct.-Dec 1997	82,450	3,294	15,942	0638
Oct.-Dec 1998	99,309	3,899	23,557	0927
Oct.-Dec 1999	121,328	4,494	26,531	0983
Oct.-Dec 2000	134,680	5,180	31,580	1,215
Oct.-Dec 2001	161,150	7,325	32,912	1,496
December-2002	213,776	4,825	54,872	1,139
December-2003	288,345	14,417	73,557	3,678
December-2004	376,955	15,042	103,394	4,136

Sources: Bank of Sudan.

6. DEVELOPMENT OF CAPITAL MARKET

Private savings have been hit by problems that haunted the monetary sector and the vital shortage of foreign exchange during the first half of the 1990s. These problems manifested themselves with rising inflation rates, the deterioration of the exchange rate and the weakness of the banking sector. However, the stability achieved in both the exchange rate and prices and the expansion that is taking place in investment and development shall eventually lead to an improvement in the saving environment, an enhancement of private saving opportunities and a redirection of resources to the productive sectors. Repealing of financial, legal and administrative hurdles and the contraction of tertiary activities are necessary steps taken to achieve a healthy environment. Then comes the role of financial markets and, in particular, of the capital market. Capital market plays a fundamental role in the mobilization of funds and the process of channelling them into productive investments, to develop commerce and industry. The main function of financial markets is to transfer current purchasing power from savers to borrowers in exchange for promise of greater future purchasing power and to allocate those funds among potential users on the basis of return. The consequence of well-functioning financial markets is that more and better projects get financed.

The most international financial centres in the world are London, Tokyo and New York, and financial centres in the developing countries are Cairo, Kuala Lumpur, Mumbai, Seoul, etc. Also there is the capital market, that is concerned with medium and long-term finance and credit to business enterprises (Gupta, 2001, p. 47). The capital market supplies industry with fixed working capital and finances medium-term and long-term borrowings of the government. Capital market deals in ordinary stocks, shares and debentures of corporations and bonds and securities of the government. The capital market is sub-divided into a primary market which is concerned with the issue of new financial claims, and a secondary market that deals with the existing securities (Hanson, 1983, p. 127) Hence, capital market is the market for all the financial instruments: medium and long-term as well as commercial, industrial and government paper. The capital market should be capable of meeting the needs and requirements of credit and finance of the business community. The pace of economic development is conditioned, among other things, by the rate of long-term investment and capital formation, which is in turn conditioned by the mobilisation, augmentation and canalization of investible funds. Therefore, the capital market as financial intermediary serves a very useful purpose by pooling the capital resources of the country and making them available to the investors. A developed capital market can solve the problem of paucity of funds. The Sudanese money and capital markets have been experiencing metaphoric changes due to advent liberalisation.

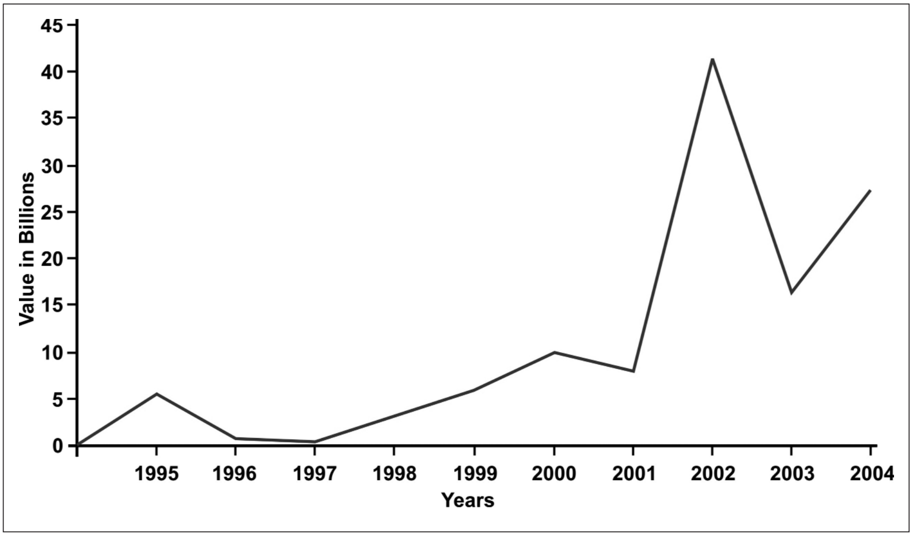
7. KHARTOUM STOCK EXCHANGE

One pertinent issue is the role of the financial deepening and widening of the financial sector. These works mainly refer to fast developing economies with well-organised financial systems, but may also be considered relevant to our study. Many economists and economic writers, perhaps inspired by the empirical work of Goldsmith (1969), have contributed to the need of the financial markets, instruments and institutions in the countries. Jucker-Fleetwood (1964) first advocated the establishment of a stock market in African countries, especially in Sudan. Among others, Arowolo (1971) discussed the role of capital markets in Africa in general and Kenya and Nigeria in particular. He concluded that all capital markets in Africa were due to the presence of European communities, with the exception of Nigeria, where the participation by Nigerians in share-issues was encouraged and well-maintained. Wai and Patrick (1973) have designed two measures to develop capital markets in less-developed countries: the first encourages an appropriate general economic and political environment, the second sets specific measures that make it more attractive for investors to issue new securities and savers to purchase them. Drake (1977) uses the narrow concept of securities market, whether or not evidenced by the creation of negotiable instruments. He justified the introduction of measures to promote securities markets. In recent research, Bart and Jovanovic (2001) have studied the impact of the information technology on capital market and described the capital model that teaches us that technical change (IT) destroys old capital: "*the vintage capital market model teaches us that technological change destroys old capital. We have gone further and argued that major technological change-like the Information Technology (IT) revolution-destroys old firms*." (Bart and Jovanovic, 2001, p. 1219).

The stock market is one of the most important components of the capital market. It deals with long-term securities and also creates markets for the new short-term and long-term government bonds (Jucker-Fleetwood, 1964, 173). The stock market comprises several distinct markets, one for corporate securities and another for government securities, and it provides separate arrangements for the new issues of securities and for buying and selling old securities, (Gupta, 2001, p. 59). Culbertson (1972) on the other hand, has given the following definition of stock markets: "[…] [they] *are the most conspicuous secondary markets for corporate equity securities. These are auction markets with complex institutionalized facilities for brokerage, for the auction execution of buy and sell orders from the public, for dealing, and for the operations of specialists who take a position in securities and thus contribute to the breadth of the market*." (Culbertson, 1972, p. 101). Yet, the story of an infant stock market in Sudan is somewhat different. In the following paper we would like to study the Khartoum Stock Exchange. The stock exchange is expected to effectively participate in the privatization process and in raising the level of savings and investments. The Khartoum stock exchange enables the private sector to contribute in financing development projects, which required long-term financial resources. It also organises and monitors the issuing and dealing in financial securities, it promotes investment awareness of public, and provides the necessary conditions to divert private investment towards financial securities.

The idea of establishing a securities market in Sudan was first introduced in 1962; an Act for securities market was passed in 1982 after a gap of twenty years, and in 1990 serious steps were taken to bring the idea to fruition within the framework of the required liberalisation policies of the time. In November 1992 the government approved an amendment of the Securities Market Act of 1982. A new Act was prepared to establish the Khartoum Stock Ex-

Figure 1: Primary Market (Shares) 1995-2004



change in June 1994, and finally became an independent entity. The work of the Primary Market (Issue Market) started on the 10th October 1994, and the Secondary Market (where shares are traded) started in 1995; the stock exchange operates on the basis of the directives of the Islamic laws (Shariy'ah) and its objectives as follows:

- organizing and supervising the issue of securities;
- encouraging savings and raising capital for public companies;
- promoting and encouraging investment in securities;
- creating the necessary investment environment;
- establishing a code of conduct and fairness among the various investors;
- guaranteeing equal opportunities for those dealing in securities.

Table 2 and Figure 1 explain trading in the primary market (KSE), therefore, in the year 1995 the value of the shares stands at SDD 5,434 millions, while sharply declined to SDD 766,890,000 and SDD 353,519,000 in 1996 and 1997 respectively. The year 2002 registered the highest-ever value of shares in the market that stands at SDD 41,427 millions but it decreased to SDD 16,395 millions, that is, by SDD 250,032 millions (60.42%). Then, in the year 2004, the value of shares increased to SDD 27,425 millions (67.72%) from the year 2003.

Table 3 reflects a rise in total transactions in the Khartoum Stock Exchange (secondary market) for a value from SDD 294 millions (115,726,000

Table 2: Primary Market (Shares): 1995-2004

	(SDD)
Year	Value of Shares
1995	5,434,600,000
1996	766,890,000
1997	353,519,000
1998	3,258,950,000
1999	5,880,000,000
2000	9,861,687,240
2001	7,929,554,100
2002	41,427,000,000
2003	16,395,000,000
2004	27,425,000,000

Source: Bank of Sudan, Annual Reports (1996-2004).

Table 3: Volume of Trading in Khartoum Stock Exchange (1995-2004)

Year	Number of Shares	Volume of Deals (millions of SDD)
1995	115,726,000	0294
1996	024,909,000	0099
1997	164,817,952	0569.70
1998	11,673,970	0237.40
1999	98,540,013	1,551.80
2000	14,169,188	5,831.60
2001	08,772,964	15,362.60
2002	04,060,237,013	24,905.50
2003	63,323,100	23,357
2004	174,855,347	4,063

Sources: Bank of Sudan, Annual Reports.

Table 4: Distribution of Shares, Companies-wise (1996-2003)

Companies	1996	1997	1998	1999	2000	2001	2002	2003
Banks	19,770	162642.702	N.A	86606.947	8.011	8764.716	1926.566	8950.989
Insurance	116	75.790	N.A	9.827	97	40	6.7	0.4
Industry	4,733	305.247	N.A	109.804	248	68	16.4	54.5
Agriculture	111	51.188	N.A	214	46	00	n.a	n.a
Trade	___	1.2512.644	N.A	9.362.741	4.259	3.503	2.130.592	790228.0
Others	179	487.381	N.A	2.450.480	1.521	4.635	3055.30	4184.4

Sources: Bank of Sudan, Annual Reports.

shares) in 1995 to SDD 4, 063 millions (174,855,347 shares) in the year 2004, with only two sharp traded decreases in 1996 and 1998.

Table 4 shows that in the year 1996, the banking sector ranked first with SDD 82 million forms 83% of the first total treated shares. The second sector was the insurance sector with 8%, while the third was the industries sector with 5%. And the number of executed contracts amounted to 1,249 contracts, of which 58% were those of the banking sector.

8. FINDINGS AND POLICY RECOMMENDATIONS

The Sudanese financial system has the same characteristics of under-developed countries. It has never facilitated the formation of productive capital, and reforms are now needed. Reforms need to be implemented so as to overcome the deficiency. Financial markets are over-the-counter markets, the major exception being the stock market. The central monetary authority, that is, the Bank of Sudan, should have provided positive steps, because Government Musharakah Certificates (GMCs) and Central bank Musharakah Certificates (CMCs) finance the government deficit. The financial markets working under the interest-free system need a lot of care. Khartoum stock is an infant autonomous body, but indirect political interference still affects its functioning; here, a national securities and exchange board is needed along with regional stock exchange markets in the country so as to broaden the chances of trading in the securities and bringing in more investors. The interest rate is replaced by the profit-loss-sharing scheme (following the Islamic system), but the interest, which is considered as usury, needs to be redefined so as to cope with the Islamic system. The regulatory body of the capital market in Sudan, through the work of intermediaries, is expected to solve the liquidity problem, promote competitiveness of business as well as increase transparency, fairness, honesty and accountability. Proper guidance of investors of the securities and protection of their interests is needed. The capital market body should provide the basic sources of information to the investors regarding capital market activities. Financial markets are the wheels of the financial system. In order to develop and grow a healthy financial sector, there is a need of proper co-ordination and match between the policies of both segments of the financial system as well as a strong regulatory body that can regulate these financial markets. Also government must play a vital positive role in the growth and development of financial markets through different relief, rebates in taxation and no political interference in the functioning of these markets.

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Résumé

Le secteur financier joue un rôle décisif dans le domaine de la croissance économique ; il permet un transfert efficace des ressources de ceux qui épargnent à ceux qui investissent. Ce secteur inclut les institutions financières, les marchés et les instruments. Cet étude souligne que le changement a toujours été le signe distinctif des marchés financiers et de l'autorité de réglementation du marché financier Soudanais. Le marché des capitaux Soudanais, même si encore au début, peut suivre la route d'autres marchés des capitaux bien installés des pays en voie de développement, en tenant compte des phénomènes de mondialisation, privatisation et libéralisation du secteur entrepreneurial Soudanais et du marché des valeurs mobilières. Il est nécessaire d'établir un régulateur plus sensible et plus efficace afin de guider le marché primaire et secondaire des valeurs mobilières. Cet article vise à étendre la littérature en analysant l'aspect concernant le petit marché des capitaux émergeant ; l'article examine les pratiques actuelles de la bourse de Khartoum dans ses transactions et évalue l'efficacité du marché des capitaux au Soudan, du moment que ce domaine est encore intacte dans le contexte Soudanais, vu que les marchés financiers ne sont pas généralement l'objet d'étude d'une telle analyse.