

CAPITAL ACCOUNT LIBERALISATION

THE UGANDAN EXPERIENCE

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I. Introduction

Over the past two decades, fundamental structural change in the world economy has been realised on account of increasing globalisation of financial markets and issues relating to the movement of capital among countries have become central in the international monetary system. This increased integration has been fostered by the relaxation of capital controls and broader financial liberalisation in most countries as well as by new telecommunications and computer technologies that have facilitated the cross-border transfer of funds. For Uganda, the move onto a fully liberalised capital account was realised in July 1997. It is then that Uganda, among other things, allowed free flow of capital between Uganda and the rest of the world, permitted both residents and non-residents to hold foreign exchange denominated accounts in the domestic banking system and permitted residents to hold foreign exchange denominated accounts and instruments outside the country. Liberalisation of the capital account was carried out as part and parcel of a series of stabilisation and reform policies that have been undertaken since 1987.

Prior to liberalization, parallel markets accounted for a significant proportion of economic transaction. More than half of the country's main export, coffee, was for instance being smuggled to Kenya. On the other hand agents engaged in arbitraging between the official and parallel markets not only in financial assets and foreign exchange, but also in goods. This resulted into efficiency losses for the economy. In this context, the idea of liberalization was to remove such distortions in the economy. Important to note is that even prior to adoption of liberalisation policies, full enforcement of the existing controls was not possible. The country therefore had a *de facto* open current and capital account and by the time government announced liberalisation, it was a way of formalising what already existed. The distortions that characterised the period of controls resulted from the failure by the authorities to fully enforce the administrative provisions and efforts of the private sector to circumvent these controls through creation of parallel markets. Judging from such efficiency losses, the control model had failed as early as the 1980s. Therefore, the debate gradually moved from the choice of regime to the appropriate sequencing and speed of the reform process. In 1987-1992, a more gradual approach to the liberalisation process was pursued as opposed to the big-bang liberalisation process in the post-1992 period when most of the stakeholders in the economy broadly embraced the reform process. It was during the later period when both the current and capital accounts of the balance of payments were liberalised.

In order to assess Uganda's experience with capital account liberalization, this paper is organized in five sections. In section II, we briefly review the macroeconomic situation of Uganda since 1987, while in section III, we look at the motivation of the government's liberalization, and in section IV, a review of the accompanying policy packages that were adopted and implemented is presented. Section V analyses the impact of liberalization so far, while Section VI presents the challenges that have been associated with the liberalization of the capital account in Uganda. We also raise debatable issues as to whether there is need for further capital account liberalization or re-imposition of some capital controls in light of the experience.

II. Macro-economic Context

Uganda has since 1987 been pursuing policies aimed at stabilizing and changing the structure of the economy with financial support from the World Bank, IMF, and other multilateral and bilateral donors. For this reason the ERP focused on macroeconomic stability, liberalization of the foreign exchange system, trade, prices, and marketing systems, improving the incentive structure and business climate to promote savings mobilization and investment, and rehabilitating the country's economic, social and institutional infrastructure. As earlier alluded to, prior to 1992, there was lack of consensus on strategy for revival of the economy, which slowed the speed of implementing policies contained in the ERP. However, following the resurgence of instability in early 1992, government adopted a big-bang approach resulting in accelerated implementation of both stabilization and structural reform policies. The exchange and trade regime was fully liberalized, price controls were abolished (except for utilities and petroleum products), and a cash-budget approach was introduced in the management of government expenditure.

The foreign exchange system had been significantly liberalized in 1990 with the introduction of forex bureaus to allocate non-coffee foreign exchange receipts to a variety of uses according to market demand. This was further strengthened with the introduction of a weekly foreign exchange auction to allocate resources to strategic industries. However, the economy was still fragile and highly vulnerable to external shocks. Savings and investment remained very low (1 per cent and 11 per cent of GDP respectively), and inflation was still high and uncertain to encourage long term business and other initiatives needed for sustained economic development. More importantly, the financial sector had major weaknesses and the inefficiencies associated with it contributed significantly to macroeconomic instability.

In order to address these problems, government implemented a financial sector reform program. The reform aimed at the removal of interest rate controls, reducing barriers for the entry of new private banks into the system, restricting the direct role of government in the allocation of financial resources including crop financing and divestiture of the government's ownership in commercial banking. This process was complemented by parallel measures to strengthen bank supervision and foster financial discipline through new legislation and regulations, and policies to improve the efficiency and profitability of financial institutions. These measures preceded capital account liberalization of July 1997, to ensure that the financial sector was strong enough to counter any shocks arising out of any capital surges.

III. Motivation of Capital Account Liberalization

Achievement of macro-economic stabilisation objective was followed with second generation reforms to eliminate any bottlenecks to constraining supply response to the stable macro-economic environment. It was certain that if the latter were not achieved, problems of macro-economic instability would re-emerge. Consequently, over the period 1995-97, much of the internal debate focussed on the following issues:

- Inability to effectively enforce the capital controls,
- The need to attract resources for investment to sustain high growth rates since the

private savings rate of 1% as share of GDP was low even for an investment rate of 11% of GDP,

- The objective of supporting private sector led growth, with privatization, as one of the means to achieve this, and
- The possibility of designing an exit strategy, in case things did not go well.

It was basically on the above issues that considerations for capital account de-regulations were hatched. Economic literature has it that the key objective for capital controls had generally been to retain domestic savings and insulate the domestic economy from external shocks. In fact, theoretical and empirical research still indicates that capital account liberalisation can increase the vulnerability of financial markets to instability. However, abstaining from the controversial issues of sequencing of the identifiable policies related to its implementation, capital account liberalisation is generally accepted. This also coincides with the realisation by most developing countries policy makers that not only are there no savings to retain but that open capital account would facilitate the flow of urgently needed resources from the external surplus to deficit units within the country.

The capital account liberalisation in Uganda was hence justified on having the savings-investment gap closed in order to promote sustainable long-term growth. By 1997, Uganda had completed 10 years of consistent implementation of stabilization and reform policies. The fruits were evident in the positive growth averaging above 7 per cent and the low and stable inflation. The challenge facing government then was how to sustain the high levels of growth and hence enhance the per capita income. As was also noted by Collier and Bevan (1997), the objective of higher rates of growth requires higher levels of investment. As a strategy, government increased its fiscal deficit to finance infrastructure, with the support of external aid resources. The aim was to raise the rate of return in private sector investment through improved infrastructure and institutions. On the other hand, while government needed to raise investment, the existing domestic savings would not sustain such investment. Consequently, external financing, including capital flows, was expected to fill the existing saving-investment gap.

Uganda, like many other African countries still relied primarily on official development aid (ODA) flows to close the savings-investment gap. As seen in table 1 below, official aid in the form of Balance of Payments and Project Support has grown over time, and there was no mechanism to facilitate transfer of these resources to the private sector. Opening up the capital account would facilitate a direct transfer of resources from external sources to the domestic private entities to boost investment.

Table 1: Composition of Official Development Assistance (ODA) to Uganda:

FY	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99
Bop Support	165.1	154.8	178.9	86.2	110.8	166.4	127.8

Project	307.8	331.8	419.0	446.2	419.1	475.8	405.9
Total Inflows	472.9	486.6	597.9	532.4	529.9	642.2	533.7
Inflows as ratio of GDP (in percentages)	15.7	13.1	11.3	9.7	9.3	10.4	9.2

Source: Balance of Payments:

As noted by Calamitsis and Dhonte (1996), “..to achieve gains in real per capita GDP, an expansion in private savings and investment is key”. In this respect, the Consultative Group meeting of 1989 agreed that more efficient production would be realized through the private sector and hence sought to reduce the role of government in direct production. Consequently, the process of privatization and divestiture of state owned enterprises had to be implemented in order to achieve this objective. To date, over 85 per cent of state enterprises have been either divested or privatized, and this has partly accounted for the increased FDI and return of flight capital.

The opening up of the capital account provided incentive for attracting additional private sector savings from external sources which were needed for augmenting domestic private savings. Such flows could be in the form of portfolio or foreign direct investment. The former seeks higher short-term returns in domestic money markets while the latter includes the flow of resources to expand capacity and technological transfer. However, we also recognize that it is difficult to attract capital to developing countries without an exit strategy and its the ease of entry and exit of flows under a liberal capital account which causes volatility in flows.

IV. The Policy Package: Liberalisation of the Capital Account and Related Reforms

In Uganda, capital account liberalisation has been part and parcel of a series of economic reforms the country has gone through since the launching of the Economic Reform Program (ERP). Issues of sequencing are very crucial in any policy-making process including capital account liberalization. Given the Mackinon (1973) and Shaw (1973) hypothesis on financial sector liberalization, and the issue capital flows, how then should financial liberalization in open developing economies be sequenced? The literature on sequencing has two main concerns i.e.,

- (i) determine the optimal order for liberalizing the domestic sectors i.e. domestic financial sector, the external, real and financial sector. The issue here is whether all these should be liberalized simultaneously or some kind of optimal path should be followed.
- (ii) determining how the order of financial liberalization (including external financial sector transactions) should fit into the stabilization program.

An agreed issue however, is that the domestic financial sector should be liberalized before external financial sector liberalization. Should the contrary obtain, a significant amount of capital flight may occur. The indigenous banks would also find it difficult to compete with foreign banks largely on the grounds of regulations that lead to increased costs of intermediation. Correct sequencing of capital account liberalization with other measures

(especially stabilization and internal financial sector strengthening and liberalization) is crucial. The most consistent sequencing recommended in the adjustment literature is that capital account liberalization should be one of the last steps in the adjustment of an economy (see Kasekende and Martin, 1995). Thus it should not be undertaken prematurely in countries with weak domestic financial systems, merely in order to influence private capital inflows. Fischer and Reisen (1992) have also argued that capital account liberalization can be facilitated if capital controls are gradually phased out. They suggested, in particular that controls should first be removed on foreign direct investment and trade related flows and that those on other flows should be removed only after extensive progress has been made on the stabilization and reform programs. In reality, the economic environment of a country should influence internal debates on the sequencing of reforms. The reform program of Uganda is here below presented:

(a) *Fiscal, Monetary and Exchange Rate Policies*

One of the key macroeconomic preconditions in the opening of the capital account was fiscal reform that significantly reduced the fiscal deficit and ensured financing of the remaining deficit in a non-inflationary manner. Sustaining an open capital account would mean that the inflation tax could not be used as an important source of revenue. Furthermore, in order to minimize costs associated with large capital surges, monetary policy ought to be managed in such a way that interest rates and exchange rates could be broadly consistent with underlying fundamentals and market conditions. Domestic interest rates on "traded" financial instruments had to be comparable to those prevailing in international financial markets. Short-term inflows, in particular, are highly sensitive to macroeconomic policy reversals or failures. Countries that establish prudent macroeconomic, financial and fiscal policies stand to obtain the greatest efficiency and risk-diversification benefits from an open capital account.

From the outset of the adjustment program in 1987, price stability has been one of the major macro-economic objectives. Consequently, intervention strategy has taken into account domestic liquidity considerations that would otherwise be inflationary and has also been mindful of the competitiveness of Uganda's exports. The converse is also true in that attempts to stem depreciation pressures through intervention on the sale side and the accompanying monetary tightening results in higher interest rates, and may subsequently contract output. Concerns related to the conflict between the inflation and exchange rate objectives as a result exists.

Anti-inflation policies to remove internal imbalances were adopted in 1987 and were mainly directed at aligning aggregate demand with real output. These were mainly achieved through a combination of prudent monetary expansion and restrained government spending. On the

other hand, the adjustment process was also aimed at addressing supply constraints. Consequently, inflation that was recorded at 250% per cent in 1987, came down to 30% in 1992, then to 10% in 1995 and has been contained at below 10% over the last five financial years. In 1999/2000, inflation was 5%. The low inflation combined with the gradual financial sector reform policies has created confidence in the banking system.

Part of the success in controlling inflation is attributable to prudent fiscal management during the post 1992 period. The infancy of the financial system, did not only mean that there were few instruments as authorities moved from the direct control to indirect monetary management, but also that effectiveness of monetary policy was constrained. Therefore, since there was limited potency for monetary policy, flexibility in fiscal policy was supposed to respond to volatile movements in the foreign exchange market, unrealized revenue performance and shortfalls in the external budgetary support. Notable examples of this flexibility was the surrendering of the treasury bill instrument to the monetary authorities, the imposition of a coffee stabilization tax during the 1994-95 coffee price boom and expenditure cuts whenever there were shortfalls in programmed revenues as was the case in 1998/99. The concern over the impact of these actions on the fiscal programs was outweighed by the benefits that were to arise from a stable macro-economic environment. Several measures aimed at improving the efficiency of the tax administration and tax policy reforms have been under taken in order to enhance revenue performance. In this effort, the introduction of value added tax (VAT) in 1996 was followed by reforms in the Income Tax Act in 1997, streamlining exemptions and introduction of accelerated depreciation allowances for investments in plant, machinery and equipment. It is on account of these measures that revenue performance has increased from the low ratio to GDP of 4.5 per cent in 1986/87 to 7.2 per cent in 1990/91 to the current levels of 12 per cent.

On the exchange rate and trade policy reform front, government was more than committed to conform to the obligation of Article VIII of the IMF agreement prohibiting imposition of restrictions on current account transactions. Consequently, in July 1990, the authorities legalised the buying and selling of foreign currencies in the foreign exchange bureaus at a market determined rate. Further reforms in the financing of international trade were implemented in January 1992 following government's replacement of Open General License (OGL) and Special Import Program (SIP) with the weekly foreign exchange auction of donor Import Support Funds. What is important to note here is that the donor aid flows provided the needed foreign exchange for the private sector weekly foreign exchange auction, hence boosting private sector confidence. Finally in 1993, the auction and the surrender requirements were abolished, and replaced with a unified foreign exchange system with the commercial banks and foreign exchange bureaus as the key institutions on the market. In addition, in July 1997, the capital account of the balance of payments was opened up in an attempt to increase private capital inflows.

(b) *Prudential Supervision and Market Information*

In addition to the freeing interest rates and credit allocation, liberalization of the financial system also allowed freer entry of institutions into the system, which saw a fast expansion of the banking and non-banking sector after 1994. However, the lack of an effective exit strategy for insolvent institutions, segmentation within the system that limited competition, asymmetrical information and lack of capacity to supervise a liberalized system paused major constraints to the development of the financial sector. Indeed, the high spread between the deposit and lending rates is symptomatic of the structural problems within the banking system.

Maintaining capital account convertibility requires strengthening the prudential supervision and regulation of financial institutions, especially in the area of foreign exchange risk exposure. To

this end, both the Financial Institutions (FIS) and Bank of Uganda (BOU) Statutes were revised in 1993, to give the Central Bank autonomy in conducting monetary policy, supervision and regulation of all financial institutions. This was to ensure that against the background of a liberalized capital account, the financial system in particular and the economy in general, could withstand the effects of external shocks. There was need to carefully formulate financial policies that would establish more flexible interest rates, restructure and recapitalize domestic financial institutions, and more clearly define the scope of the protection offered by the official safety net that underpins the domestic financial systems. The FIS (1993) provided for enhanced capital adequacy requirements for all financial institutions and strengthened prudential supervision which are necessary to offset some of the moral hazard problems created by the existence of an official safety net and thereby reduce the need for official assistance.

Furthermore, banks are required to document all capital inflows and outflows and file periodic reports thereof to the Bank of Uganda for statistical purposes. The proposed Foreign Exchange Statute (2000) contains details concerning capital account transactions. In light of the expectations that the liberalization of capital account may result in increased foreign exchange transactions and the risks inherent in most types of foreign exchange dealings, banks were required to establish their own systems, controls and limits to enable them manage the risks. As a guideline, the computation of overnight exposure limits for all banks as a ratio of core capital was set at 25% in addition to adoption of internationally accepted accounting principles and disclosure norms.

(c) *Debt Restructuring*

Uganda being a heavily indebted poor country, *debt reduction operations* were important for improving her perceived creditworthiness and for facilitating renewed access to international financial markets. This would also help reduce the borrowing costs faced by her residents. This would also ensure the credibility of the reform process and the country's credit rating. Debt restructuring was also needed to ease long-run foreign exchange constraint and therefore enhance the sustainability of foreign exchange inflows. The major stages of the debt restructuring included:

- Uganda formulated a Debt Strategy in 1991 that accompanied earlier efforts to restructure debt through rescheduling and debt forgiveness and hence was among the first countries to qualify for each of the advances in Paris Club terms – Toronto, London and Naples;
- In 1993, Uganda received a commercial debt reduction through debt buybacks and debt swaps that were funded by IDA and other co-financing;
- On account of the fact that multilateral debt accounted for 72% of Uganda's debt stock, a Multilateral Debt Fund (MDF) designed and run by Uganda, was created during the July 1995 Consultative Group meeting financed by external grants. By November 1995, the MDF had succeeded in mobilizing resources to a tune of US \$ 75 million to service multilateral debt.

- In April 1998, Uganda became the first country eligible for the Highly Indebted Poor Countries (HIPC) Debt Initiative and later in March 2000 qualified for the Enhanced HIPC Initiative. Key implications of these facilities are a substantial reduction in Uganda's debt stock and debt service burden. The HIPC initiative approved in 1998 is expected to save an average of approximately US \$ 37 million per year over the next 10 years, US \$ 22 million per year during 2010-2019, and US \$ 3.5 million per year during 2020-2038. In addition, the Enhanced HIPC will provide an additional saving of US \$ 50 million per year over the next 26 years. This also translates into a reduction in the Debt-to-GDP ratio from 28% to 11% in NPV over the next 10 years, while on the other hand, the debt service-to-government expenditure ratio will decline from 12% to 5%. Aggregated, total HIPC assistance now amounting to US \$ 2.0 billion would relieve Uganda between 2/3 and 3/4 of its debt service.

(d) *Institutional Development, Political and Governance System:*

The restoration of economic growth was largely supported by the adoption of prudent macro-economic policies that increased the utilization of the existing capacity. However, as has been observed by Kasekende and Atingi-Ego (1999), this kind of growth will taper off as spare capacity diminishes and therefore requires that either new capacity be generated or Incremental Capital Output Ratios (ICORs) be raised in order to generate more growth with the same levels of investment. This therefore calls for increased investment-GDP ratios and ICORs to sustain the high growth rates. In addition to the above, the growth process has to be facilitated by efficient service delivery both in public and private sector. In line with this, some institutional reforms have been undertaken in an attempt to increase the effectiveness of service delivery through building relevant institutions as discussed in the following sections.

i. Private Sector Development

In line with the recommendation that the role of government in the production and allocation of productive resources be reduced, some institutional reforms were undertaken to increase the effectiveness of the private sector. These include among others;

- The adoption of the investment Act (1992), that replaced the Foreign investment Act (1977) and the Industrial Licensing Act (1969). This was to attract, promote and facilitate investment by providing fiscal incentives, protecting investors and introducing a mechanism for repatriation of dividends.
- The creation of the Uganda Investment Authority (UIA) in 1991, also known as a one-stop-investment center to facilitate both foreign and local investors. These moves marked a turning point in the country's investment policy. In addition, Uganda's membership of the Multilateral Investment Guarantee Agency (MIGA) also increased the attractiveness of the country as an investment center.

The sectors that have attracted investment include tourism, agriculture, horticulture, agro-processing, fish processing, construction, manufacturing, energy, mining, and financial services. This also augurs well with Uganda's ambitious program of privatization which to-date has seen 85 per cent of the state-owned enterprises wholly or partially sold off to private entities. The process has also been on track with a total of 47 public enterprises divested between 1992 and 1997 and more being restructured in preparation for privatization.

Government also realized the need to strengthen the provision of appropriate legal framework to provide commercial jurisdiction, reinforce property rights and facilitate settlement of business disputes. In fact, the return of the departed Asian properties was a strong re-affirmation of government's commitment for the respect of private property rights. The entire process of verifying claims and returning property to original owners had been completed by 1996.

High utility costs have normally been noted as a serious constraint to production in Uganda and hence loss of competitiveness. To address this constraint, utility reforms have been undertaken in areas of power generation and telecommunication. It is expected that while an additional 200 megawatts of power will be generated by the year 2001, a new power dam, with capacity of 250 megawatts, is to be constructed by a private investor, AES Power Project. This will be ready for operation by 2004. On the other hand, the liberalization of the communications sector has seen entry of two private operators and removal of Uganda Telecom Limited monopoly.

ii. Policy Dialogue Development

A number of institutions and organisations have become active in the policy dialogue. These include the Parliament, the Economic Policy Research Centre (EPRC) at Makerere University, Uganda Manufacturers Association (UMA), the Private Sector Foundation (PSF), Unions such as National Organisation of Trade Unions (NOTU), Uganda Debt Network and Uganda Farmers Association. The Parliament acts as a useful instrument and watchdog.

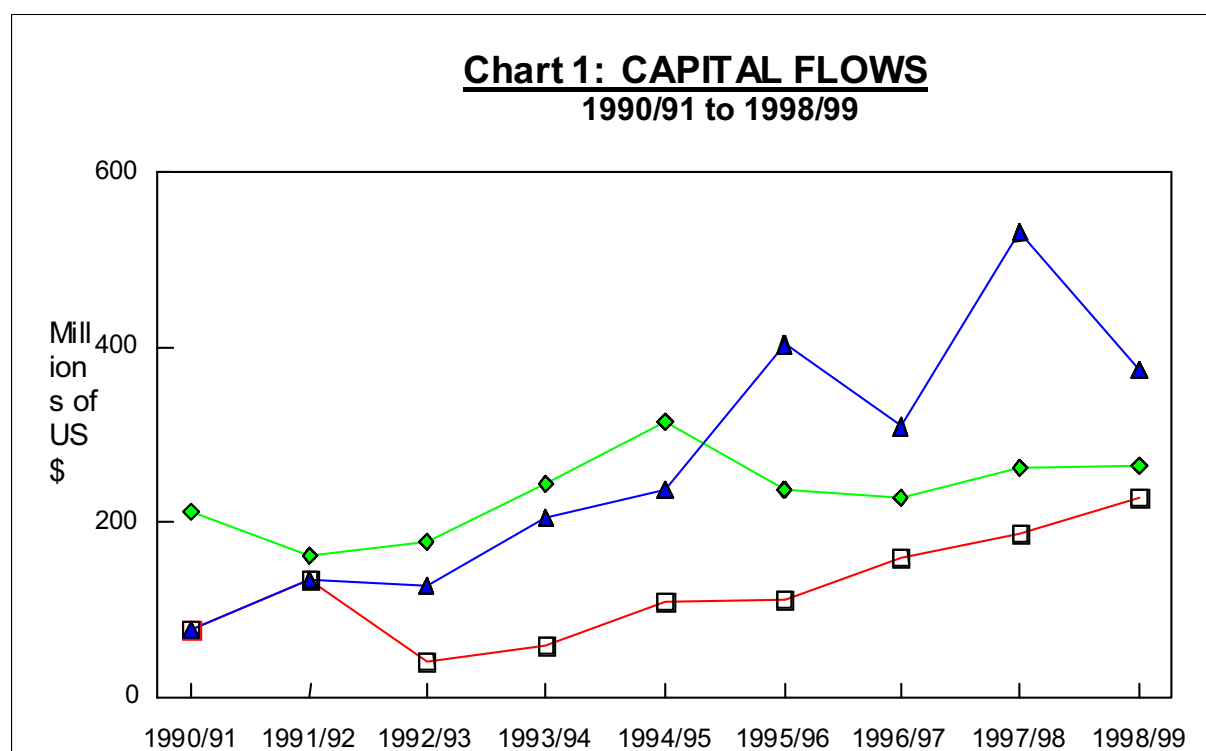
Major economic policy changes are now being reviewed and adopted by the parliament. The parliament has been especially active in the field of privatisation. It has also exposed cases of corruption and this has led to enhanced transparency and accountability in public administration.

V. Assessing the Impact of capital Account Liberalization

As noted earlier, capital account liberalisation was a formalisation of what already existed because, transactions of capital nature were already being executed in the parallel markets. Efficiency gains were therefore expected from resources that were previously used for evading controls and could now be used more productively. However, the main benefit of capital account liberalisation for developing countries is that it can enhance access to external private capital and thereby raise the investment rate, given that domestic savings in most

developing countries are limited. Related to this, capital account restrictions will impede the ability of developing countries to attract capital because foreign investors will be reluctant to invest unless they can be confident of being able to repatriate profits, interest payments and capital. Strong inflows of private external finance have supported increased private investment rates and helped to sustain strong economic growth rates in the Latin America and Asian economies during the 1990s.

Ever since the initiation of the reform process in 1987, inflows into Uganda have to a large extent increased. The significant proportion of these inflows is related to FDI, which have been relatively constant. Consequently, Uganda has not experienced volatility in inflows, as would have been the case if portfolio investment had dominated total capital inflows. Chart 1 below, shows developments in FDI and other Inflows from FY 1990/91 to FY 1998/99.



FDI inflows into Uganda rose from US\$ 2 million recorded in FY 1991/92 to US\$230 million in FY 1998/99. Similarly, private transfers increased from US\$ 80 million in 1990/91 to US \$ 415.2 million in 1995/96 but suffered a drop in 1996/97 to US \$ 308.3 million. In the subsequent year, private transfers recovered to a record level of US \$ 539.0 million. Unfortunately, the recovery was short-lived, as private transfers of US \$ 375.0 million recorded for 1998/99 are much lower than levels recorded in both 1997/98 and 1995/96. Therefore private transfers have been very volatile since FY 1994/95 while FDI has maintained a steady rise since FY 1992/93 and is projected to grow in FY 1999/2000.

Another positive development is the foreign participation in the domestic capital market, for which initial response reveals some interest by foreign fund managers in shilling denominated assets. The recent issue of EADB bonds attracted foreign participation. Similarly, the promissory notes issued by government to domestic creditors have attracted

foreign interest.

The experience of Uganda with a liberal capital account cannot therefore be compared to that of the South-East Asian countries. This is largely because Uganda's financial markets are not well developed and as a result, the markets are not liquid enough to facilitate the development of financial instruments that could attract portfolio investment. Moreover, while the stock exchange is in its infancy stage, the financial system as a whole is not yet well integrated into the international financial markets. The proportion of portfolio investment is negligible as most of the strong inflows have been in form of returning capital flight, capital inflows by returning Asians and trade financing in the form of export pre-financing.

It would be correct to state that Uganda has not witnessed huge short-term inflows following the capital account liberalization. Therefore the arsenal of policy instruments are yet to be tested as to their effectiveness in face of surges in capital flows. However, the country has suffered periods of instability in the foreign exchange market. The instability in the foreign exchange market has usually manifested itself in widened trading margins, sustained pressure on the exchange rate to either appreciate or depreciate. To a large extent, this instability been associated with trade-related-flows (i.e. the coffee price boom of 1994 and the coffee price slump of 1999/2000) arising from shifts in terms of trade. Other important factors have included the seasonality of coffee export-related inflows and changing perceptions of market participants on the sustainability of the reform process. Just like most other liberalized markets, the foreign exchange market has been subjected to movements triggered off by rumours and speculation. The bubbles have usually been short lived but without doubt, causing losses to investors, creating uncertainty in the market and denting the credibility of the central bank. The single most important effect of large inflows has been the appreciation of the exchange rate plus the associated erosion of export competitiveness. The burden of foreign exchange market stabilization was, in 1994, shared between monetary and fiscal policy. However, policy response to terms of trade shocks in 1999/2000 has leaned more on the monetary policy adjustment. In fact, this saw a shift from domestic price stability objectives to establishment of stability in the foreign exchange market.

A related consequence of capital account liberalization has been the holding of local currency deposits relative to foreign exchange deposits in the domestic banking system. By June 1997, the foreign exchange accounts held by residents amounted to 12.8% of broad money (M3). One year after the liberalization of the capital account, this ratio increased to 14.4% and further rose to 17.9% and 23.4% as at end-June 1999 and April 2000 respectively. It is difficult to disassociate the exchange rate developments from the observed shift from shilling denominated accounts to dollar denominated ones, although speculative tendencies could have a hand in the enhanced preference for foreign deposits throughout this period. This added another degree of complexity in management of liquidity as intermediation is allowed both in shillings and foreign currency assets and liabilities.

Another development is the increased role of the private sector in spearheading investment given the low domestic savings ratios. Following the liberalization, Uganda has experienced increased levels of private sector investments. In the period 1997 to 1999, private sector investment rose from 11.5 per cent of GDP in FY 1996/97 to 12.8 per cent in FY 1998/99

and is projected to grow to 13.0 per cent in FY 1999/00 (see Table 2 below). This was largely on account of the significant reform efforts and the policy package that was put in place to attract new inward foreign direct investments and return of flight capital to close the savings-investment gap, together with the considerable pick-up in private transfers noted above. Today, Uganda presents a case where high investments over and above the savings rate are largely financed by both private and public foreign savings. It is also noted that the country largely survived the negative impact of the East-Asian crisis on inflows, due to the limited integration of her financial institutions into the global capital markets. The issue then is how does Uganda prepare itself for higher levels of volatility that may be associated with a deeper integration into global capital markets.

Table 2: Private Savings and Private Investment (% of GDP)

Period	1995	1996	1997	1998	1999	2000 proj.	2001 proj.	2002 proj.	2003 proj.
Savings	9.1	6.9	8.4	8.5	8.6	8.7	8.9	9.1	9.4
Investment	8.3	9.6	11.5	12.3	12.8	13.0	13.1	13.2	13.5
M2/GDP	10.2	10.9	11.7	12.3	12.1	11.4	11.8	12.1	12.2

Source: 1/Bank of Uganda

2/Uganda Authorities; and Fund staff estimates and projections.

VI. Challenges faced under Capital Account Liberalization:

(i) *Monetary Management:*

Increased foreign exchange inflows under a liberal capital account have presented challenges to stability in the foreign exchange market and the management of liquidity. In the period prior to capital account liberalisation, both fiscal and monetary policy instruments were used to combat any disruptive effects of capital inflows. In the recent past, however, monetary policy instruments have borne the largest burden of adjustment associated with disruptive effects of capital inflows. This has mainly been through increased issuance of government and Bank of Uganda securities and adjustment of margins on the policy rates. The impact of this has been to affect a wider spectrum of interest rates with the consequence that lending rates have risen to the detriment of the real sector. This has led to a reduction in the demand for credit especially by prime borrowers and has consequently, increased the level of commercial bank excess reserves thus creating further room for speculation and difficulties in liquidity management.

Consequently, the conflicts in the conduct of monetary policy resulting from increased capital inflows deserve further analysis to contain the damaging fall out effects. Furthermore, monetary management has been complicated following shifts in portfolio behavior by the both the banks and non-bank public. This largely lies in the

ability of the residents holding foreign accounts to have unlimited freedom in what they can do with such resources thereby increasing the scope for speculation. Such a situation tends to complicate monetary management in an environment where authorities have limited instruments

(ii) Macro-economic Management under Fund Programs:

It would be prudent for the authorities to pursue every effort to maintain stability in the exchange rate, which might of course be difficult in a market-determined regime. This calls for a proper analysis and assessment of factors that trigger off an intervention by the Central Bank. To the extent that the factors are temporary, tightening liquidity and increased intervention in the forex market beyond what is consistent with Net International Reserves (NIR) would be called for in order squeeze out any speculative tendencies. On many occasions, the authorities are constrained in their efforts to deal with inflows known to be of a temporary nature due to program requirements of achieving a floor on NIR. Typically, a floor on the NIR of the Central Bank is set at a level which precludes any substantial use of foreign reserves to support the exchange rate, even for countries which have very healthy levels of foreign reserves. This is intended to protect reserves from being depleted through intervention.

It would be prudent if the NIR target in the Fund programs were designed more flexibly to allow Central Banks increased scope for intervention to support the exchange rate, provided that this is accompanied by monetary tightening and does not allow an offsetting expansion of domestic credit. In addition, the authorities together with international financial institutions could also create a pool of reserves to protect those economies that come under speculative attacks for reasons not associated with poor macro-economic management. A particular fear associated with increased intervention on the sale side would be the failure to fully adjust for any erosion in export competitiveness, especially when the depreciation pressures are arising from fundamental factors.

iii. Data collection for policy formulation:

Liberalization of the capital account has removed the requirement by agents to seek official approval before a transaction. The authorities can only get access to information on capital account related transactions, through imposing reporting requirements on firms or surveys. The system for holding regular surveys and reporting requirements is not developed. Consequently, inflows have been poorly recorded and this has been exacerbated by the absence of a recording system. For example, in Uganda, private transfers reached as high as 4 per cent of GDP (Helleiner 1998), but it has been difficult to break them down into their constituent parts. Lack of information that is greatly needed for policy formulation poses a risk to the competence of policies to yield positive results. In addition, the capacity to understand all sophisticated issues associated with capital liberalization is still lacking both in banks and among agents. To tackle this problem, a bill on foreign exchange operations is before parliament for enactment. We believe that once it is in place, it

will help to improve data collection.

iv. *Prudential Regulation and Supervision of the Financial System:*

Financial institutions are also exposed to risk arising from a highly liberalized capital account. They open unfunded letters of credit, extend guarantees to clients and offer banking services to both residents and non-residents in both domestic and foreign currencies. Liberalization of the capital account created new forms of risks for the domestic banks, which they had little experience in managing. The large accumulation of short-term foreign liabilities by banks was a major source of distress in the problem banks. To the extent that capital inflows were channeled through the banking system, there was substantial increase in the volume of financial resources at risk. In some cases, this created currency mismatch and transfer of exchange rate risk into credit risk. Furthermore, some banks were able to keep most of these Transactions classified under the off-balance sheet items. This was a major challenge to supervisory role of the central bank. Cases mentioned include ICB and Greenland Bank, which imprudently classified vast resources under off-balance sheet items including guarantees and fictitious letters of credit.

With a liberalized capital account it is essential that the regulators ensure that banks accurately report their foreign currency exposures and comply with exposure limits, and that banks' pursue prudent exchange rate risk management policies. This would mean additional capital for commercial banks as they indulge in more foreign exchange transactions. The regulators must also ensure that banks' liquidity management takes cognizance of the potential volatility in short-term foreign borrowing.

v. *Regionalism:*

In as much as there are gains associated with creating large and efficient regional stock markets, there are some risks inherent in it also. Currently, the South African Stock Market has many leading companies that have invested in South, Central and East Africa listed in it. The challenge and danger, however, is associated with the volatility of inflows that could hit South Africa, for whatever reason, and consequently could affect investment in the region. In Uganda, a number of South African companies have to date invested in communications, radio and television services, manufacturing and tourism sector. These companies raise substantial amount of resources from the South African stock market.

In addition, the possibility of contagion effects could cause massive outflows of capital from the country. A case in point is the recent occupation of the white-owned farms by war veterans in Zimbabwe, which has sparked off exchange rate depreciation in the region, as investors tried to re-locate their investments. There is therefore need to co-ordinate policies at a regional level in order to hedge against

political and policy risks.

(vi) *Private Sector (Non-Bank) Exposure*

The challenges that Uganda faces as a result of capital account liberalisation are largely associated with the seasonality of export receipts and the associated speculative behaviour making the management of the exchange rate difficult. The problem is further complicated by the unlimited purchases and holding of foreign exchange by both residents and non-residents. Transactions relating to unfunded letters of credit, private sector debt and panic behaviour are normally a source of problems. To the extent that the monetary authorities are constrained by availability of enough instruments to contain speculative behaviour of individuals and firms, exchange rate management under a liberal capital account is made difficult. This tends to cause a herd behaviour resulting in reduced transactions as agents opt to withhold sales of foreign exchange from the market, while at the same time buyers bring forward purchases as depreciation pressures are reigning. The converse is true when there are appreciation pressures.

The resulting volatility in the exchange rate exposes firms that have taken unhedged positions in foreign exchange, e.g. firms that have opened letters of credit or borrowed from external sources. There is, therefore, need to develop instruments to deal with private sector (non-bank) exposure and this could probably be done through commercial banks advising their clients. Education on issues such as currency matching of assets and liabilities, fully covering L/C's, etc would be a positive step.

VII. Conclusion

The paper has shown that capital account liberalization may present problems especially on macroeconomic stability. However, a more open capital account may offer some efficiency gains when preceded by careful sequencing and consistency. Uganda's experience demonstrates that for successful implementation, capital account liberalisation should occur late in the sequencing of the stabilisation and structural reform programs. Furthermore, capital account convertibility requires a policy mix that is all-encompassing, including adjustment at a macroeconomic level, as well as important institutional and microeconomic reforms, to ensure the efficient functioning of domestic financial markets and pave way for their smooth integration into the global markets. Strong leadership and good governance are needed above all to ensure that policy reversals do not happen in order to restore confidence in the macroeconomic policy management and to attract more capital inflows.

Currently, the Fund supported programs can not handle emergency financing such as release of additional resources to handle exchange rate crises. There is need to create a pool of reserves which could act to protect those economies that come under speculative attacks for no reason associated with poor macro-economic management. This could be negotiated with international financial institutions.

The experience with capital account liberalisation over three years, shows that capital account liberalisation is desirable for Uganda in the current economic environment but is a source of major challenges in macro-economic management. As a first step, Uganda should brace itself for possible instability in the foreign exchange market arising from variability in capital flows and should urgently conduct research into the design of instruments and measures that promote more effective ways of managing a fully liberal market economy.

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