SPEECH

By:

Dr Louis Kasekende
Deputy Governor, Bank of Uganda

at

FOREIGN PRIVATE CAPITAL 2004 SURVEY CLOSING WORKSHOP

2 DECEMBER 2004
GRAND IMPERIAL HOTEL
KAMPALA, UGANDA

Honourable Minister of Finance, Planning, and Economic Development,
Mr. Gerald Sendaula
Executive Director, Uganda Investment Authority
Executive Director, Uganda Bureau of Statistics
Distinguished Guests
Ladies and Gentlemen

On behalf of the Bank of Uganda, I am glad to welcome you to the third dissemination workshop of the Foreign Private Capital Survey series. You may recall that similar workshops were held for surveys carried out in 2001 and 2003. These surveys provided useful insights and lessons and a better understanding of foreign direct investment in this country. During this workshop, the findings of the third survey will be disseminated and discussed.

The surge in international capital flows has been one of the most significant developments in the world economy in the twentieth century. These flows have largely emanated from factors, including the trend towards economic liberalization and globalization of trade, improvements in information and communication technologies, emergence and proliferation of institutional investors like mutual and pension funds, and a wave of financial innovations. A number of studies have confirmed that financial globalization can contribute significantly to promoting growth in developing countries by augmenting domestic savings, reducing the cost of capital, transferring technology, and developing the financial sector. However, it has also been recognized that sudden and large capital flows can be a source of concern for macro-economic management. They can cause an expansion in monetary aggregates, engender inflationary pressures, destabilize the exchange rate, exacerbate current account positions, adversely affect the domestic financial system and disrupt economic growth. The countries playing

host to capital inflows are also vulnerable to a sudden reversal in flows and consequently a financial crisis. Consequently, the capital account of the balance of payments, which captures the flows of capital and financial resources (debt, portfolio investment, and direct investment) between one country and others, has come to receive increasing attention in policy making. To this extent, therefore, the need to record, monitor, and analyze all flows of capital (official and private) is very crucial for the balance of payments and overall macro-economic management. This is additional to ensuring that sound macroeconomic policies are put in place, the financial system is well regulated and supervised, and appropriate legal and regulatory frameworks operate internally accepted standards for accounting, auditing are followed, and information disclosure is adopted.

Foreign direct investment (FDI) inflows into Uganda rose from US$2 million recorded in the financial year 1991/92 to US$175.6 million in 1997/98 and then to US$193.6 million in 2002/03. According to the 2003 Private Sector Investment Survey Report, the stock of FDI in Uganda stood at US$962 million, of which US$658 million (68 percent) was equity, US$240 million (25 percent) long-term borrowing from related companies/shareholders, US$22 million (2 percent) short-term borrowing from related companies/shareholders, and US$43 million (5 percent) was re-invested earnings. The fact that most of the FDI stock was in form of equity signifies long term commitment and investor confidence in the economy. All economic sectors attracted FDI participation, with manufacturing, wholesale and financial sectors accounting for slightly over 70 percent of the total reported stocks. Past survey findings indicated that the general domestic environment was conducive to investment, although a number of constraints were identified, namely high production costs, low market share, unfair

competition due to smuggling and corruption, power fluctuations, and high cost of borrowing.

The liberalization of the capital account did not, however, result into any significant portfolio inflows during the first 5 years of liberalization as earlier anticipated, though foreign direct investment generally increased. However, towards the end of 2002, Uganda started experiencing significant portfolio inflows mainly in form of investments in government debt securities, in response to the widening interest rate differential between Uganda and the rest of the world. Portfolio inflows, as measured by investments of offshore players in our securities markets, increased from US$1.23 million in the year 2002/03 to US$10.21 million in 2003/04. Other inflows and outflows have been on two fronts: participation by offshore players in the foreign exchange market and trade credits, especially for export pre-finance.

A related consequence of capital account liberalization has been the holding of both local currency and foreign exchange deposits in the domestic banking system and the fact that domestic banks can extend credit in foreign exchange. By June 1997, the foreign exchange accounts held by residents amounted to 12.8 percent of broad money (M3). One year after the liberalization of the capital account, this ratio increased to 14.4 percent and further rose to 17.9 percent as at end-June 1999 and has since stabilised at 25-26 percent as at end-June 2004.

There are challenges associated with the liberalisation of the capital account especially designing macroeconomic safety nets for a sudden reversal in inflows. We are committed to tackling emerging challenges and adopting appropriate measures to ensure macroeconomic stability. Allow me to mention three of the challenges that Bank of Uganda has been faced and the measures taken.

(i) *Monetary Management*

To the extent that most of the non-debt creating inflows have over time been in form of foreign direct investment, which are stable in nature, the conduct of monetary and exchange rate policy in Uganda has not had a long historical experience of managing short term capital flows to the degrees experienced by other countries, say, in East Asia, Russia, and Latin America. The major challenge for monetary policy management so far has been to control inflation, given the large volumes of liquidity injections associated with government's expenditures to finance poverty reduction programs. BOU has used a combination of steady sales of foreign exchange and net issues of government securities to sterilize excess liquidity injections arising from fiscal operations. However, during the last financial year, there were increased portfolio inflows in response to the widening interest rate differentials, coupled with higher export earnings and current private transfers that put appreciation pressures on the exchange rate, with attendant complications for monetary policy management. BOU had to adjust the instrument mix in favor of domestic instruments, which contributed to exerting upward pressures on the interest rates during the first half of the year. Interest rates on Treasury Bills gradually declined during the second half of the year when BOU re-oriented its instrument mix to include longer-term treasury bonds, introduced at the beginning of January 2004 in addition to higher sales of foreign exchange.

Despite the minimal portfolio flows, monetary management has been complicated following shifts in portfolio behavior by both the banks and non-bank public with respect to their deposit holdings and credit transactions which can be denominated in both domestic and foreign currencies. The portfolio shift between shilling to foreign exchange accounts affects the exchange rate. These have to be monitored apart

from the spot transactions. This added another degree of complexity in management of liquidity as intermediation is allowed both in shillings and foreign currency assets and liabilities. In this regard, BOU has closely monitored developments in monetary and credit aggregates and in financial markets and taken appropriate actions to ensure stability of the financial markets in a manner that does not jeopardise the inflation objective.

ii) Prudential Regulation and Supervision of the Financial System

Financial institutions are also exposed to risk arising from a highly liberalized capital account. This can take the form of un-funded letters of credit, extension of guarantees to clients and offer of 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 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 a 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 the supervisory role of the central bank.

ii) Data Collection for Policy Formulation

The system for holding regular surveys and reporting requirements is being developed and improved to strengthen the balance of payments statistics and enhance our understanding of issues associated with capital account liberalization. The law on foreign exchange transactions

has just been enacted; and hopefully, with the continued collaboration and cooperation from all the stakeholders, it will help to improve data collection. Given that these surveys are going to be an annual exercise, I appeal to the providers of data to always provide the required data in a timely manner when approached, since the benefits accruing from the data compiled are mutual. I therefore specifically appeal to any enterprise that has not responded to do so as the data is still required. I would like to confirm that the individual firm returns will be kept confidential.

Finally, let me take this opportunity to thank all those who contributed towards the success of the survey for all their efforts. In particular, Development Finance International (DFI) and Macro Economic and Finance Management Institute (MEFMI) for their continued provision of technical assistance. Last but not least, our appreciation goes to all the enterprises that participated in this survey, to our partners: the Uganda Investment Authority and the Uganda Bureau of Statistics. With these remarks, I welcome you all to this closing workshop of the Foreign Private Capital 2004 Survey.