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Capital Account Liberalisation: The Ugandan Experience

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Following full liberalisation of the capital account in 1997, Uganda realised increasing private capital flows. However, this has posed enormous challenges and risks. Macroeconomic management has been complicated because of the limited range and potency of available instruments. Moreover, not only are the financial institutions exposed to more risk and hence need stronger regulation and supervision, but the private sector also needs to develop instruments to hedge and manage the increasing risks in an open economy. This article argues that policy-makers should strengthen regulations, reporting requirements and data collection systems, and design market-friendly instruments to facilitate more appropriate management of a liberalised economy, while reducing volatility.

Introduction

Over the past two decades, fundamental structural change in the world economy has been achieved with the 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 to a fully liberalised capital account was realised in July 1997. It was then that the government, 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 liberalisation, parallel markets accounted for a significant proportion of economic transactions. For instance, by the mid-1980s, more than half of Uganda's main export, coffee, was being smuggled to Kenya. At the same time, agents engaged in arbitrage between the official and parallel markets not only in financial assets and foreign exchange, but also in goods. It is important to note that full enforcement of the

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control regime was not possible. Agents were able to avoid taxation under the regime and to enjoy economic rents. This resulted in efficiency losses for the economy.

The shift from a controlled economy to a liberal regime was intended to remove such distortions. The debate gradually moved from the choice of regime to the appropriate sequencing and speed of the reform process. In the period 1987-92, 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 latter period that both the current and capital accounts of the balance of payments were liberalised, interest rates were fully decontrolled and major steps in the reform of the financial sector were undertaken.

This article is organised in six sections. After a brief review of the macroeconomic situation, the next section looks at the motivation for liberalisation of the capital account in Uganda. This is followed by a review of the accompanying policy packages that were adopted and implemented. The next section analyses the impact of liberalisation so far, followed by a presentation of the challenges that have been associated with the liberalisation of the capital account in Uganda and what policy-makers ought to do to address these issues in the light of Uganda's experience. The final section presents the conclusions and a proposed course of action.

The motivation of capital account liberalisation

Since 1987 Uganda has been pursuing policies aimed at stabilising and reforming the structure of the economy with financial support from the World Bank, the IMF, and other multilateral and bilateral donors. For this reason, the Economic Recovery Programme (ERP) focused on macroeconomic stabilisation, liberalisation of the foreign-exchange system and the trade and marketing systems, improvement of the incentive structure and the business climate to promote savings mobilisation and investment, and rehabilitation of the country's economic, social and institutional infrastructure.

Prior to 1992, there was lack of consensus on a strategy for revival of the economy, which in turn slowed the pace of implementing policies contained in the ERP. However, following the resurgence of instability in early 1992, the government adopted a big-bang approach resulting in accelerated implementation of both the stabilisation and structural reform policies. The exchange and trade regime was fully liberalised, price controls were abolished (except for the utilities and petroleum products), and a cash-budget approach was introduced in the management of government expenditure.

Achievement of the objective of macroeconomic stabilisation was followed by second-generation reforms to address the increased supply response to the stable macroeconomic environment. It was clear that if the latter objective was not achieved, problems of macroeconomic instability would re-emerge. Consequently, over the period 1995-7, much of the internal debate focused on the following issues:

- the inability to enforce the capital controls effectively;
- the need to attract resources for investment to sustain high growth rates, since the private savings rate of 1% as a share of GDP was low even for an investment rate of 11% of GDP;

- the objective of supporting private sector-led growth, with privatisation 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 deregulation were hatched.

Economic literature has it that the key objective of capital controls is to retain domestic savings and insulate the domestic economy from external shocks. Theoretical and empirical research still indicates that liberalisation of the capital account can increase the vulnerability of financial markets to instability. However, while abstaining from the controversial issues of the sequencing of the identifiable policies related to its implementation, capital account liberalisation is generally accepted. This also coincides with the realisation by most policy-makers in developing countries that not only are there no savings to be retained but that an open capital account will facilitate the flow of urgently needed resources from foreign savings.

Liberalisation of the capital account in Uganda was hence justified on the grounds of closing the savings-investment gap in order to promote sustainable long-term growth. By 1997, Uganda had completed 10 years of consistent implementation of stabilisation and reform policies. The fruits of this were evident in the positive growth rates averaging over 7% and the low and stable rate of inflation. The challenge then facing the government was how to sustain the high levels of growth and hence enhance per capita income. As also noted by Collier (1998), the objective of higher rates of growth requires higher levels of investment. The government's strategy was to increase its fiscal deficit to finance the infrastructure, with the support of external aid resources, the aim being to raise the rate of return in private sector investment through improved infrastructure and institutions. At the same time, while the government needed to increase investment, the existing domestic savings were insufficient to sustain such investment. Consequently, external financing, including capital flows, was expected to fill the existing savings-investment gap.

Like many other African countries, Uganda still relied primarily on official development aid (ODA) flows to close this gap. As seen in Table 1, official aid in the form of balance-of-payments and project support has grown over time, and there was no mechanism to facilitate the 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.

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 realised through the private sector; it therefore sought to reduce the role of government in direct production. Consequently, the process of privatisation and divestiture of state-owned enterprises had to be implemented in order to achieve this objective. To date, over 85% of state-owned enterprises have been either divested or privatised, and this has partly accounted for the increased Foreign Direct Investment and the return of flight capital.

Table 1:Official Development Assistance (ODA) to Uganda, 1992/3 – 98/9 (US$m.)

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 (%)	15.7	13.1	11.3	9.7	9.3	10.4	9.2

Source: Bank of Uganda, *Official Statistics on the Balance of Payments*.

The opening up of the capital account provided the incentive for attracting additional private sector savings from external sources, which were needed to augment 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 recognise that it is difficult to attract capital to developing countries without an exit strategy, and it is the ease of entry and exit of flows under a liberal capital account which causes their volatility.

The policy package: Liberalisation of the capital account and related reforms

As already noted, capital account liberalisation in Uganda has been part and parcel of a series of economic reforms the country has gone through since the launching of the Economic Reform Programme. Issues of sequencing are crucial in any policy-making process, including capital account liberalisation. Given the McKinnon (1973) and Shaw (1973) hypothesis on financial sector liberalisation, plus issues relating to a fully convertible capital account, how should financial liberalisation in open developing economies be sequenced? The literature on sequencing raises two main concerns:

(i) the determination of the optimal order for liberalising the domestic financial sector, and the external real and financial sectors. The issue here is whether all these should be liberalised simultaneously or some kind of optimal sequencing should be followed;

(ii) the determination of the order of financial liberalisation (including external financial sector transactions) and how it should fit into the stabilisation programme.

An agreed point, however, is that the domestic financial sector should be liberalised before the liberalisation of the capital account. Experience in places where the contrary has obtained has depicted a correspondingly significant amount of capital flight. 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 liberalisation with other measures (especially stabilisation and internal financial sector strengthening and liberalisation) is crucial. The sequencing most consistently recommended in the adjustment literature is that capital account liberalisation should be one of the last steps in adjustment policy (see Martin and Kasekende, 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 liberalisation can be facilitated if capital controls are phased out gradually. They suggest, 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 in the stabilisation and reform programmes. In reality, the economic environment of a country should influence debates on the sequencing of reforms. The reform programme of Uganda is presented below.

Stabilisation policies: fiscal, monetary and exchange-rate policies

One of the key macroeconomic preconditions for the opening up of the economy was fiscal reform which significantly reduced the fiscal deficit and ensured financing of the remaining deficit in a non-inflationary manner. Sustaining an open economy would mean that the inflation tax could not be used as an important source of revenue. The conduct of monetary policy has gradually moved from the use of direct controls to indirect monetary control (IMC). The array of instruments for managing liquidity and enhancing monetary policy effectiveness has been widened to include: the use of open market operations-type instruments such as net Treasury Bill issues and net Bank of Uganda Bill issues, a market-based rediscount rate and bank rate as policy signals, Bank of Uganda spot intervention in the foreign-exchange market (IFEM), the Lombard (discount) facility, the Rediscount Window facility and Repurchase Agreements (Repos). A quantity-based policy-oriented reserve money programme (RMP) has guided the choice of the policy stance. Later efforts at strengthening the monetary framework by deepening the financial markets have included the introduction of a Central Depository System for the management of government securities and facilitation of a transition into electronic storage and transfer of securities, which has in turn allowed the introduction of Repurchase Agreements as monetary instruments.

In order to minimise the costs associated with large capital surges, monetary policy was to be managed in such a way that interest rates and exchange rates were broadly consistent with the 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.

During the post-1992 period fiscal management has had a very significant role to play. The infancy of the financial system meant not only that there were few instruments as the authorities moved from direct control to indirect monetary management, but also that the effectiveness of monetary policy was constrained. With such limited potency for monetary policy, in-built flexibility was needed in cash-budget management to allow fiscal policy to respond to volatile movements in the foreign-exchange market, unrealised revenue performance and shortfalls in the external budgetary support. Notable examples of this flexibility were the surrendering of the Treasury Bill instrument to the monetary authorities, the imposition of a coffee stabilisation tax during the 1994-5 coffee price boom, and expenditure cuts whenever there were shortfalls in programmed revenues, as was the case in 1998/9. The concern over the impact of these actions on the fiscal programme was outweighed by the benefits that were to arise from a stable macroeconomic environment.

Several measures aimed at improving the efficiency of the tax administration and reforming tax policy have been undertaken in order to enhance revenue performance. To this effect, in addition to setting up an autonomous revenue collecting body, the Uganda Revenue Authority (URA), the introduction of Value Added Tax (VAT) in 1996 at a revenue-neutral rate of 17% was to replace the Sales Tax and Commercial Transaction Levy (CTL). This was followed by reforms in the Income Tax Act in 1997, streamlining exemptions and introducing accelerated depreciation allowances for investments in plant, machinery and equipment. As a result of these measures revenue performance has increased from the low ratio to GDP of 4.5% in 1986/7 to 7.2% in 1990/91 and to the current level of 12%.

On the exchange-rate and trade policy reform front, the government's objective was to graduate to IMF Article VIII status regarding the prohibition of restrictions on current account transactions. In July 1990, the authorities legalised the buying and selling of foreign currencies in the foreign-exchange bureaux at a market-determined rate. Following this measure, the premium between the bureaux (retail) market and the official exchange rate based on the inter-bank (wholesale) market almost vanished.

Further reforms in the financing of international trade were implemented in January 1992 following the government's replacement of the Open General Licence (OGL) and Special Import Programme (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 bureaux as the key institutions on the market. However, the economy was still fragile and highly vulnerable to external shocks.

Financial sector policies, prudential supervision and market information

The first years of stabilisation, 1987-91, also laid the foundation for financial sector liberalisation, as the reduction in inflation resulted in achieving the positive real interest rates that were vital in stimulating savings. Effective in July 1988, nominal interest rates were adjusted in line with changes in inflation in order to maintain positive real interest rates.

The key liberalisation measures were introduced in 1992, but controls on both interest rates and credit allocation were removed in several steps over a two-year period. In 1992, the removal of interest-rate controls affected the Treasury Bill rates, as the Treasury Bill market changed from one of ad hoc issues addressed by the government to a market-based auction to determine interest rates. From then on, the key rates were linked to the weighted average of the Treasury Bill rate as determined in the four preceding Treasury Bill auctions. This move also affected bank lending and deposit rates, and was accompanied by a removal of credit ceilings and directed credit and a reduction in compulsory reserves at the Central Bank. The rates payable on time deposits, however, were subject to minimum limits while those applicable to agricultural and development lending were subject to a ceiling. All other rates were left to market forces.

In 1994, the Bank of Uganda fully liberalised interest rates and began to manage them through indirect monetary policy instruments with the Treasury Bill rate as the anchor. While the main focus was on the removal of controls on interest rates, some institutional reforms were also initiated; in particular, a number of legislative changes were enacted by parliament.

While the full liberalisation of interest rates was completed in July 1994, the government recognised that the weak financial system had constrained gains from the ERP. The financial system was still characterised by a high level of non-performing loans (over 50% of the total loan portfolio), high intermediation margins, violation of capital adequacy and/or insider lending limits by more than half of the commercial banks, and a lack of adequate provision of financial services outside the capital city. Savings and investment remained very low (1% and 11% of GDP respectively), and inflation was still high and too unstable to encourage the long-term business and other initiatives needed for sustained economic development. More importantly, the financial sector suffered from major weaknesses, with the resultant inefficiencies greatly constraining its role in intermediating resources efficiently.

In order to address these weaknesses, the government changed strategy and focused on institution-building measures. These included the strengthening of the Central Bank to enable it to enforce the regulatory framework developed in the previous phases of the reforms, an expedited programme of divestiture of government holdings in the commercial banks, and a mechanism for resolving the problem of bad debts. The reform aimed at removing interest-rate controls, reducing the 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 stake in commercial banking. This process was to be complemented by parallel measures to strengthen bank supervision and foster financial discipline by means of new legislation and regulations, and policies to improve the efficiency and profitability of financial institutions. These measures preceded the capital account liberalisation of July 1997, to ensure that the financial sector was strong enough to counter any shocks arising out of possible capital surges.

In addition to the freeing of interest rates and credit allocation, liberalisation of the financial system also allowed freer entry of institutions into the system, with the main objective of enhancing competition and efficiency. This brought a rapid expansion of the banking and non-banking sector after 1994. With the objective of reducing the role of the state in the allocation of credit, the government's stake in bank equity has been reduced through the sale of shares. In 1997, after attempting to restructure the Uganda Commercial Bank for about three years, the government put the UCB up for sale on an 'as is' basis and sold 49% of its shareholding to a private strategic partner who was also given management control.

The deal later broke down and the government is in the process of re-privatising the UCB. While competition increased, 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 liberalised system effectively presented major constraints to the development of the financial sector. Indeed, the wide spread between 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 the financial institutions, especially in the area of exposure to foreign-exchange risk. 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 the conduct of monetary policy and authority to license and regulate designated financial institutions. There was need to formulate carefully financial policies that would establish more flexible interest rates, restructure and recapitalise domestic financial institutions, and more clearly define the scope of the protection offered by the official safety-net in case of bank failures. The FIS (1993) Statute provided for enhanced capital requirements for all financial institutions and strengthened prudential supervision, both of which are necessary to offset some of the moral hazard problems created by the existence of an official safety-net.

The bank closures witnessed in 1998 and 1999 were a result of subjective, but often unavoidable, mistakes. The financial sector had remained weak, but transforming a weak segmented system into a strong, efficient and globally competitive financial sector was a lot to expect in only 10 years. Banks were practically the only institutions to mobilise savings and hence had the responsibility of carrying out a successful economic transition. Indeed, given the prevalence of non-performing assets, it was the banks which bore the major cost of transition as a result of the obvious inexperience of the shareholders, managers and supervising agencies in some instances; and they are now venturing into a new unstable environment to provide credit to unknown firms and projects. Judging by the high intermediation margins, the banking system was, by the late 1990s, still burdened with structural constraints that hindered further improvement in intermediation. High operating costs (utilities, transport, communications, etc.), the incidence of non-performing assets and the segmentation of the banking system, all led to high lending rates.

In order to address this problem, the authorities are undertaking a number of measures, namely:

- raising the minimum capital requirement to a uniform level for both indigenous and foreign banks. According to the revised Financial Institutions Statute, banks are expected to have increased their capital base gradually to Shs 2 billion by January 2000, and further to Shs 4 billion by January 2003. (A statutory instrument was issued to effect the amendments in capital requirements, but the Revised Financial Institutions Statute will be presented to parliament in 2001.) This will continue to be reviewed to meet international best practice, as guided by the CAMEL[1] approach;

1. The CAMEL approach to supervision of financial institutions ensures that banks are properly managed by closely monitoring the status of their Capital, Assets, Management, Earnings and Liquidity. In Uganda, the

- encouraging the strengthening of the legal system and, in particular, improving the commercial courts in order to enforce contracts, improve loan recovery and reduce forgeries and fraud;
- encouraging the establishment of a credit-rating bureau to improve the dissemination of information about borrowing entities and strengthen the credit culture;
- requiring banks to display all interest rates and charges in order to reduce asymmetry of information between the banks and their customers;
- setting up the Non-Performing Assets Recovery Trust (NPART) to collect the UCB's bad debts and creating incentives for the repayment of bank loans; and
- strengthening specialised institutions for intermediating long-term finance (Development Finance Company of Uganda (DFCU), Uganda Securities Exchange (USE), restructuring of the Uganda Development Bank (UDB), etc.)

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 Foreign Exchange Statute (2000) contains details concerning capital account transactions. In view of expectations that the liberalisation of the capital account may result in increased foreign-exchange transactions and the risks inherent in most types of foreign-exchange dealings, banks are required to establish their own systems, controls and limits to enable them to manage these risks. However, the Central Bank set the overnight exposure limit for all banks as a ratio of core capital at 25%, in addition to the adoption of internationally accepted accounting principles and disclosure norms.

Debt restructuring

Uganda being a heavily indebted poor country, debt reduction operations were important for improving its perceived creditworthiness and for facilitating renewed access to international financial markets. This would help reduce the borrowing costs faced by Ugandan residents. It 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 constraints and enhance the sustainability of foreign-exchange inflows. The major stages of the debt restructuring included:

- the 1991 Debt Strategy, which followed earlier efforts to restructure debt through rescheduling and debt forgiveness. Uganda was thus among the first countries to qualify for each of the advances in the Paris Club terms – Toronto, London and Naples;

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minimum capital required to open a bank is currently Shs 2 billion, to increase to Shs 4 billion by January 2003, while as a going entity, a bank must maintain core capital of at least 8% and 12% of its risk-adjusted assets for Tier 1 and Tier 2 capital respectively. Asset quality, measured in terms of the ratio of non-performing assets to total assets, is supposed to be below 10% and adequacy of earnings is indicated by the return on assets, which must be at least 1%. The overall picture on capital, asset quality, earnings and liquidity gives guidance to the authorities on the quality of management of an institution and the type of intervention if need be.

- in 1993, Uganda was granted a reduction in its commercial debt through debt buybacks and debt swaps funded by the International Development Association and other co-financing agencies;
- 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 set up during the July 1995 Consultative Group meeting, financed by external grants. By November 1995, the MDF had succeeded in mobilising resources to the tune of US$75 million to service multilateral debt;
- in April 1998, Uganda became the first eligible member of 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 its debt stock and debt-service burden. The original HIPC Initiative was expected to save an average of approximately US$37 million per year over the next 10 years, US$22 million per year during 2010-19, and US$3.5 million per year during 2020-38. The Enhanced HIPC Initiative assures the country of 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, at the same time, 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 of between two-thirds and three-quarters of its debt service.

Institutional development and the political and governance system

The restoration of economic growth was largely supported by the adoption of prudent macroeconomic policies which enhanced the utilisation of existing capacity. However, as observed by Kasekende and Atingi-Ego (1999), this kind of growth will taper off as spare capacity diminishes. This therefore calls for increased investment-GDP ratios and incremental capital-output ratios (ICORs) that can sustain the levels of investment attained and the high growth rates. In addition to the above, the growth process has to be facilitated by efficient service delivery in both the public and private sectors. In line with this, some institutional reforms have been undertaken in an attempt to increase the effectiveness of service delivery by building the relevant institutions as discussed in the following sub-sections.

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), which 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 the repatriation of dividends;

- the creation of the Uganda Investment Authority (UIA) in 1991, as a one-stop investment centre to assist 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 enhanced the country's attractiveness as an investment centre.

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

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

High utility costs have normally been noted as a serious constraint to production in Uganda, leading to loss of competitiveness. To address this constraint, reforms have been undertaken in the areas of power generation and telecommunications. While an additional 200 megawatts of power will be generated by 2001, a new power dam, with a capacity of 250 megawatts, is to be constructed by a private investor, the AES Power Project. This will be ready for operations by 2004. At the same time, the liberalisation of the communications sector has seen the entry of two private operators and the removal of Uganda Telecom Ltd's monopoly.

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

The Parliament acts as a useful instrument and watchdog, and major economic policy changes are now being reviewed and adopted. It 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 the public administration.

Assessing the impact of capital account liberalisation

As noted earlier, capital account liberalisation was a formalisation of what already existed, since transactions of a capital nature were already being executed in the parallel markets. Efficiency gains were therefore to be 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. At the same time, 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 in the Latin American and Asian economies during the 1990s. What is important to note, though, is the fact that the quality of investment is as important as the quantity. As country experiences show, increased flows of capital to a country may not necessarily lead to higher investment-to-GDP ratios.

In addition, the possibility for consumption smoothing and risk sharing under an open capital account is an important benefit, especially in countries like Uganda with marked seasonality in foreign-exchange flows. To this effect, while the country can borrow in times of shortage in foreign currency flows, it can at the same time invest for future consumption where there are excessive flows.

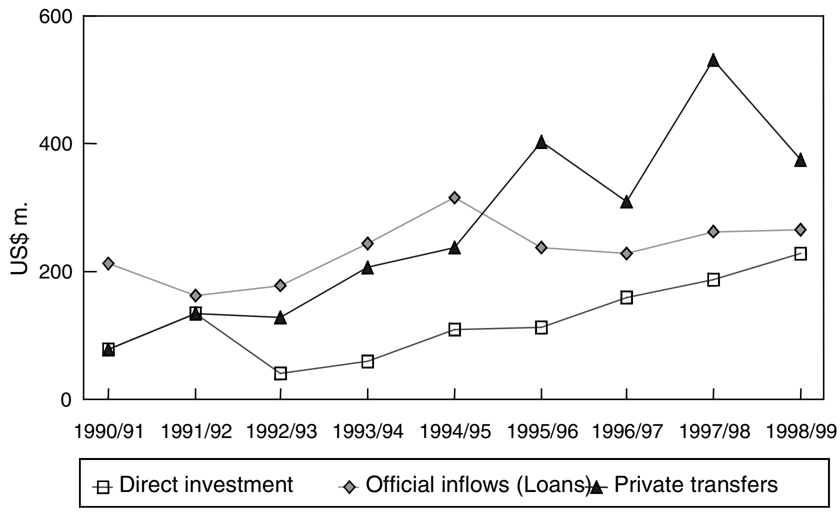
Full liberalisation of the economy allowed free accessibility to foreign currency and free movement of capital in and out of Uganda, and wide-ranging measures have been implemented to remove both tariff and non-tariff barriers to trade and foreign investment. The realisation that agents could exchange their foreign currency at market-determined rates restored confidence, especially for those people who had preferred to keep their assets outside the country. This resulted in a huge inflow of foreign exchange in the form of returning flight capital. Consequently, the balance of payments has been strengthened and relations with most external creditors have been normalised.

A relatively large inflow of foreign capital, largely in the form of trade flows, transfers, and investment flows, has been recorded. Fortunately, while the bulk of these inflows was in the form of returning flight capital, the proportion of foreign direct investment (FDI) in these inflows has gradually increased. Uganda has therefore so far suffered only limited volatility in inflows, as compared with what would have been the case if portfolio investment had dominated the total capital inflows.

Figure 1 shows developments in FDI and other inflows from 1990/91 to 1998/9. FDI inflows into Uganda rose from US$2 million recorded in 1991/2 to US$230m. in 1998/9. Similarly, private transfers increased from US$80.5m. in 1990/91 to US$415.2m. in 1995/6 but suffered a drop in 1996/7 to US$308.3 m. In the subsequent year, private transfers recovered to a record level of US$539.0m.

Unfortunately, the recovery was short-lived, as private transfers of US$375.0m. recorded for 1998/9 are much lower than levels recorded in both 1997/8 and 1995/6. Private transfers have been very volatile since 1994/5, while FDI has maintained a steady rise since FY 1992/3. At the same time, official loans for projects and balance-of-payments support rose from US$218.4m. in 1992/3 to US$642.7m. in 1997/8, while the gross reserve position for the country has expanded. In terms of months of import cover, gross reserves rose from 2.4 in 1992/3 to 4.95 in 1997/8 and stood at 4.37 in 1999/2000.

Figure 1: Capital flows
1990/91 to 1998/9



Another positive development is foreign participation in the domestic capital market, where the initial response reveals some interest by foreign fund managers in shilling-denominated assets. The recent issue of East African Development Bank bonds attracted foreign participation. Similarly, the promissory notes issued by the 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 East Asian countries. This is largely because Uganda's financial markets are not well developed and, as a result, are not sufficiently liquid to facilitate the development of financial instruments that could attract portfolio investment. Moreover, while the stock exchange is in its infancy, 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 the form of returning flight capital, capital inflows from returning Asians and trade financing for export pre-financing.

It would be correct to say that Uganda has not witnessed huge short-term inflows following the capital account liberalisation. The arsenals of policy instruments are therefore yet to be tested as to their effectiveness in the face of surges in capital flows. However, the country has suffered periods of instability in the foreign-exchange market. This has usually manifested itself in widened trading margins and sustained pressure on the exchange rate to either appreciate or depreciate. To a large extent, this instability has been associated with trade-related flows (i.e. the coffee price boom of 1994 and slump of 1999/2000) arising from shifts in the terms of trade. Other important factors have been the seasonality of coffee export-related inflows and the changing perceptions of market participants about the sustainability of the reform process.

Like most other liberalised markets, the foreign-exchange market has been subject to movements triggered by rumours and speculation. The bubbles have usually been short-lived but doubtless have caused losses to investors, creating uncertainty in the market and denting the credibility of the Central Bank.

The single most feared effect of large inflows has been the appreciation of the exchange rate, plus the associated erosion of export competitiveness. Among different measures of exchange-rate misalignments are the magnitude of premiums between the official and parallel exchange rates and the deviation of the exchange rate from an equilibrium value dictated by the fundamentals. To explore this issue, Atingi-Ego and Sebudde (2000) measured the misalignments by estimating the equilibrium exchange rate and analysed the impact of the misalignment on the non-traditional export sector. Their research, which covers the period 1972-99, establishes a clear negative relationship between over-valuation of the shilling and the performance of the non-traditional export sector. However, it also shows that, by the time of the capital account liberalisation in 1997, over-valuation of the exchange rate had been eliminated and that for the period thereafter (i.e. 1998 and 1999), the exchange rate has displayed some degree of under-valuation, a scenario that augurs well for export sector competitiveness.

Therefore, the fear that capital account liberalisation leads to loss of export sector competitiveness has not yet materialised in Uganda. This could be explained, on the one hand, by the fact that capital flows have not been excessive, while on the other, appropriate macroeconomic management, and in particular exchange-rate policy geared to maintaining export sector competitiveness, has minimised the likelihood of over-valuation of the shilling. This was also witnessed in the era prior to capital account liberalisation when the coffee boom of 1994/5 was not allowed to create excessive misalignments in the exchange rate. Furthermore, while large amounts of foreign aid have flowed into the country to finance the adjustment programme, the 'Dutch Disease' effects of such flows have not been realised.

A related consequence of capital account liberalisation 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 accounted for 12.8% of broad money (M3). One year after the liberalisation of the capital account, this ratio increased to 14.4% and rose further 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 had a hand in the enhanced preference for foreign deposits throughout this period. This added another degree of complexity to the 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 low domestic savings ratios. Following liberalisation, Uganda has experienced increased levels of private sector investment. In the period 1997-9, private sector investment rose from 11.5% of GDP in FY 1996/7 to 12.8% in FY 1998/9 and was projected to grow to 13% in FY 1999/00 (see Table 2). This was largely on account of the significant efforts at reform and the policy package that was put in place to attract new inward foreign direct investment and the return of flight capital, together with the considerable pick-up in private transfers noted above.

Table 2: Private savings and investment (% of GDP)

Year	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

Sources: Bank of Uganda and the Uganda authorities, plus IMF staff estimates and projections.

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 noteworthy that the country largely survived the negative impact of the East Asian crisis on inflows, due to the limited integration of its financial institutions into the global capital markets. The issue now is how Uganda is to prepare itself for the higher levels of volatility that may be associated with a deeper integration into global capital markets.

Challenges faced under capital account liberalisation

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 the 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 the disruptive effects of capital inflows. This has mainly been through the increased issuance of government and Bank of Uganda securities and the adjustment of margins on policy rates. The impact of this has been to affect a wider spectrum of interest rates, with the result 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 problems in liquidity management.

In consequence, the conflicts in the conduct of monetary policy resulting from the increased capital inflows deserve further analysis. Means need to be found to contain the damaging fall-out effects. Furthermore, monetary management has been complicated following shifts in portfolio behaviour by both the banks and the non-bank public. This largely lies in the ability of the residents holding foreign accounts to exercise 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 the authorities possess limited instruments

Macroeconomic management under IMF programmes

It would be prudent for the authorities to make every effort to maintain stability in the exchange rate, which might of course be difficult in a market-determined regime. This calls for proper analysis and assessment of factors that trigger an intervention by the Central Bank. To the extent that the factors are temporary, tightening liquidity and increased intervention in the forex market to beyond what is consistent with the Net International Reserves (NIR) would be called for in order to 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, because of the programme 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 that have very healthy levels of foreign reserves. This is intended to protect the reserves from being depleted through intervention.

It would be prudent if the NIR target in IMF programmes 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 the international financial institutions, could also create a pool of reserves to protect those economies that come under speculative attacks for no reason associated with poor macroeconomic management. A particular fear associated with increased intervention on the sales side would be the failure to fully adjust for any erosion in export competitiveness, especially when the depreciation pressures arise from fundamental factors.

Data collection for policy formulation

Liberalisation of the capital account has removed the requirement that agents must seek official approval before a transaction. The authorities can get access to information on capital account-related transactions only by imposing reporting requirements on firms or conducting surveys. The system of regular surveys and reporting requirements is not well developed. Inflows have been poorly recorded and this has been exacerbated by the lack of a recording system. For example, in Uganda, private transfers reached as high as 4% of GDP (Heillemer, 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 the sophisticated issues associated with capital account liberalisation is still lacking in both banks and agents. To tackle this problem, a Bill on foreign-exchange operations is now before Parliament for enactment. We believe that, once in place, it will help to improve data collection.

Prudential regulation and supervision of the financial system

Financial institutions are also exposed to risk arising from a highly liberalised capital account. They open unfunded letters of credit, extend guarantees to clients, and offer banking services to residents and non-residents in both domestic and foreign currencies.

Liberalisation of the capital account created new forms of risks for the Ugandan domestic banks, which they had little experience in managing. Their large accumulation of short-term foreign liabilities was a major source of distress in the problem banks. To the extent that capital inflows were channelled through the banking system, there was a substantial increase in the volume of financial resources at risk. In some cases, this created a currency mismatch and a transfer of exchange-rate risk into credit risk. Consequently, many borrowers could not repay their loans when the exchange rate depreciated.

Furthermore, some banks were able to keep these developments hidden under off-balance-sheet items. This was a major challenge to the supervisory role of the Central Bank. Cases mentioned include the ICB and Greenland Bank, which imprudently hid vast resources under off-balance-sheet items including guarantees and fictitious letters of credit. Consequently, these institutions became insolvent and were declared bankrupt.

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

Regionalism

Inasmuch as there are gains associated with creating large and efficient regional stock markets, there are also inherent risks. Currently, the South African stock market lists many leading companies that have invested in Southern, Central and East Africa. The challenge, and the danger, 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. These companies raise substantial amount of resources from the South African stock market. A shock to the South African economy could take on a regional dimension, given the role South Africa plays as a hub for inward investments in East and Southern Africa.

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

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 resultant speculative behaviour, which makes management of the exchange rate difficult. Problems arise because speculators can freely buy and sell foreign exchange in the market. 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 the availability of sufficient instruments to contain speculative behaviour on the part of individuals and firms, exchange-rate management under a liberal capital account is made difficult. This tends to cause herd-like 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 hold sway. The converse is true when there are appreciation pressures.

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

Conclusions

As argued above, enormous benefits can be realised from liberalisation of the capital account, especially in attracting capital to close the savings–investment gap and obtaining efficiency gains. Uganda's experience also demonstrates that successful capital account liberalisation should be implemented in the latter stages of stabilisation and structural reform programmes in a developing economy, in order to avoid capital outflows that would make the reform unsustainable. 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 the way for their smooth integration into global markets. Above all, strong leadership and good governance are needed to ensure that policy reversals do not occur, and in order to restore confidence in macroeconomic policy management and to attract more capital inflows.

However, despite all the benefits resulting from liberalisation of the capital account, considerable challenges have been faced both in the macroeconomic management of the economy and at the micro level, in particular by the private sector. This in turn introduces new questions pertaining to the management of a liberal capital account. Can an open capital account be sustained without considerable costs to the economy? Can controls be re-imposed without costs of similar magnitude? How can a liberal economy best be managed? The IMF-supported programmes currently being undertaken by developing countries like Uganda cannot handle emergency financing such as the release of additional resources to cope with exchange-rate crises.

The need to adhere to fiscal and monetary adjustment, as in the recent foreign-exchange market instability in Uganda following the 1998/9-1999/2000 terms-of-trade shock, is justified. However, such adjustment will inevitably have severe implications for the real sector. Many developing countries are adopting Poverty Reduction Programmes under which poverty-reducing priority areas are protected from fiscal adjustment and are normally financed by foreign donors. In exceptional circumstances, when countries undergo an economic crisis, the protection of anti-poverty programmes may not be respected, resulting in severe effects on poverty reduction. Furthermore, the tighter policy stance adopted to address the instability will result in higher interest rates that may impact on the real sector. Where capital is flowing freely, it may also attract more capital flows, thus sparking off a vicious circle of instability.

The private sector is ill-prepared to manage the increasing risks of an open capital account. The available instruments are not sufficient for both macroeconomic and microeconomic (e.g. business) management under an open capital account. And while the reinstitution of controls would be more costly to the economy, self-assurance schemes like the accumulation of reserves provide only temporary relief to the management of risks.

In order to manage the open economy, an enabling environment for effective risk management in all sectors of the economy should therefore be created by:

- strengthening financial reporting in order to reduce information asymmetry. This should include the promotion of credit rating and reference bureaux. In addition, enhanced recording of private sector debt and capital flows and full disclosure of off-balance-sheet items would provide policy-makers with much desired information to match assets and liabilities, and assess risk exposures;
- strengthening existing and designing new market-based instruments of macroeconomic management. In the case of foreign-exchange flows and exchange-rate volatility, market-based instruments, especially at the short end of the market, can be instituted to reduce the volatility of these flows. The government should consider restricting foreign-exchange deposits to savings and fixed deposit accounts, and depositors should pay a tax for the withdrawal of foreign exchange effected before the maturity of savings/fixed deposits. Such measures would reduce the volatility of these deposits and thus stabilise the exchange rate. The shortcoming, however, is that they may also have important implications for the choice of location of foreign deposits. Agents who prefer more flexibility in the way they manage their accounts may prefer to place their deposits in countries where such restrictions do not apply or to change their asset portfolio from bank deposits to cash holdings. The latter move makes macroeconomic management even more complicated. Moreover, some agents may see the imposition of restrictions as a gradual return to controls;
- encouraging the development of hedging instruments like debt-equity swaps and commodity-linked bonds for commodity risk management, and the growth of a vibrant and profitable private sector that can access commodity futures and options markets on the international market;
- creating a pool of reserves to act as emergency funding for economies that suffer from speculative attacks for reasons other than poor macroeconomic management. This could be negotiated with the international financial institutions. The demerit of such a facility is that it may create problems of moral hazard. The availability of such resources may tempt countries not to make appropriate and timely adjustments in response to shocks. This means that management of this pool of resources should also involve strict conditionalities, such as ensuring the pursuit of appropriate macroeconomic policies and undertaking the necessary adjustments in response to the shock, before being allowed access to the resources.

In conclusion, it would be more valuable for Uganda to enhance the benefits arising from a liberal capital account through the adoption of more appropriate management and design of instruments rather than reverse what it has achieved by the re-imposition of controls. In fact, the planned development of the securities and capital markets, the strengthening of the financial system through stronger laws, the capitalisation of institutions and the design of new financial instruments are steps in the right direction. Such measures will ensure that Uganda can sustain the benefits of an open capital account and is well braced for possible instability in the foreign-exchange market arising from variability in capital flows.

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