BANK OF UGANDA

Capital Account Management

Macroprudential policy regulation for financial stability and growth

Session on Global liquidity and financial contagion

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I. Introduction

- Global liquidity and financial contagion have become increasingly important issues for macroeconomic and financial management.

- This is more evident in frontier markets of Africa as they have been a favorite destination for offshore investors.

- This presentation aims to provide the key lessons that Uganda has learnt from the recent increase in capital inflows. It also highlights the policy responses going forward.

II. Magnitude of capital flows to Uganda

- Following the removal of barriers to capital flows in 1997;
  - Uganda's capital and financial account rose from 4.7 percent of GDP at the start of the century to 12.9 percent of GDP in 2011/12.
  - Foreign direct investment (FDI), the largest single component of capital, rose from US$186 million in 2002/03 to US$1,176 million in 2012/13 (5.6 percent of GDP).
  - Net portfolio capital flows peaked at US$264 million in 2011/12.

II. Magnitude of capital flows to Uganda

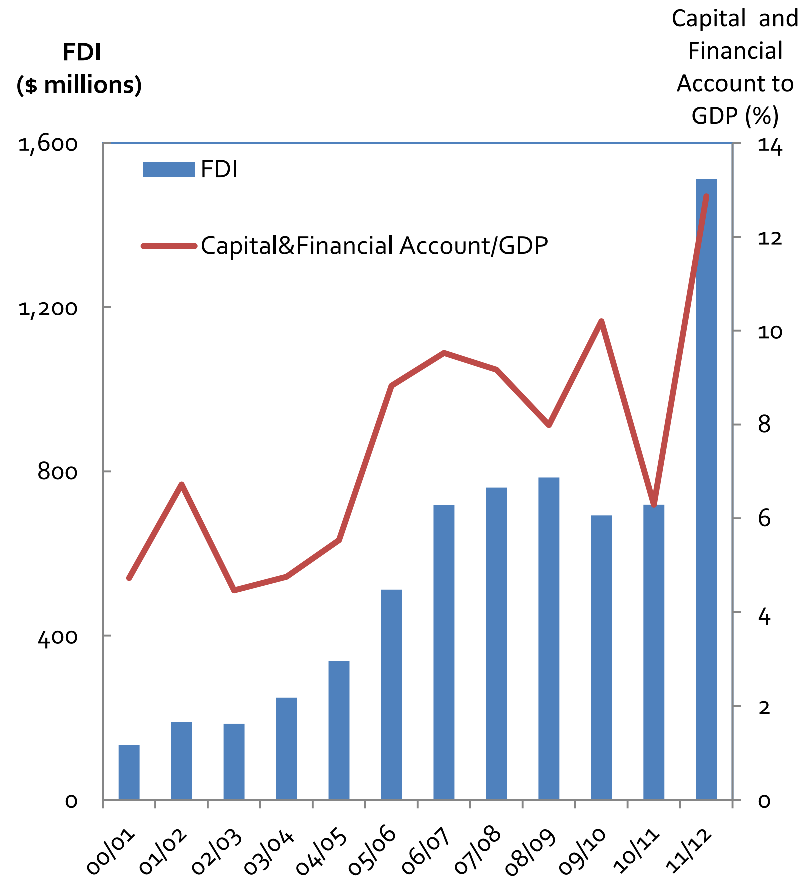
- Real rates of return to capital are much higher in Uganda than in the advanced economies, resulting in a large interest rate differential.

- The structural factors driving capital flows to frontier markets such as Uganda are unlikely to be reversed in the medium term;

  - despite the tapering of quantitative easing in the advanced economies, and

  - provided the economies of the frontier markets continue to be well managed and politically stable.

Figure 1: Capital Flows to Uganda



Source: Bank of Uganda

II. Magnitude of capital flows to Uganda

- In the long term, challenge of managing the risks from capital flows to frontier markets will most probably intensify.
- FDI inflows benefit economies of frontier markets, because FDI raises the private investment rate which is essential for accelerating structural transformation.
- In Uganda, portfolio capital flows are predominantly invested in swaps and deposits with the banking system or in government securities.

II. Magnitude of capital flows to Uganda

- In June 2008, offshore holdings of government securities, as a share of the total securities, peaked at 25 percent. At the end of June 2013, they accounted for 15 percent of the total.

- While portfolio capital flows have helped to boost liquidity in the domestic market, their impact is not very significant;
  - most of the secondary market trading in the domestic securities market is between domestic investors.

- The form that portfolio flows take creates potential problems and risks for both macroeconomic management and financial stability.

III. Consequences for economic and liquidity management

- Portfolio capital flows have implications for economic management, related to their impact on the exchange rate and on financial system.

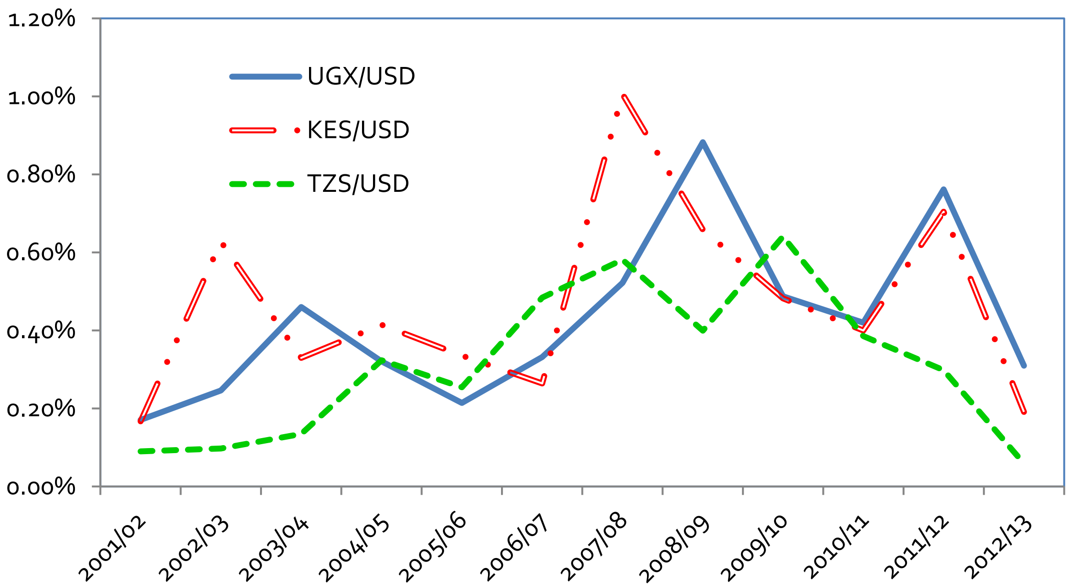
- Portfolio capital flows have had a significant impact on the volatility of the exchange rate in Uganda.

- In the East Africa region, Uganda's annualized exchange rate volatility has averaged 0.43 percent, 0.04 percent lower than Kenya and higher than Tanzania which averaged 0.31 percent over the same period.

III. Consequences for economic and liquidity management

- The Uganda shilling has been more volatile than the Tanzanian shilling which has more controls placed on capital flows. (figure 2)

Figure 2: Annualized Exchange rate volatilities for select East Africa countries



Source: Bank of Uganda

III. Consequences for economic and liquidity management

- Gross portfolio capital flows can be large enough to dominate other flows given thin foreign exchange markets.

- Short term volatility of the nominal exchange rate and persistent overvaluation of the real exchange rate are potentially damaging;
  - for the competitiveness of traded goods industries, and
  - for incentives for private investment.

- The implications for financial stability arise because a large share of offshore portfolio investment is invested directly in domestic banks.

III. Consequences for economic and liquidity management

- The main risk to financial stability is liquidity risk.
  - portfolio investment in bank liabilities is a form of short maturity non-core wholesale funding which is inherently more volatile than customer deposits.
- Short term offshore portfolio funding currently accounts for less than 5 percent of total banking system liabilities.

- If Uganda attracts larger portfolio capital flows, domestic banks may become more dependent on short term external capital which would heighten liquidity risk.

IV. Policy Responses

- The first priority for countries that face strong capital inflows is to preserve domestic monetary stability and minimize exchange rate misalignment and asset price volatility.

- The Bank of Uganda (BOU) has implemented a more active management of the exchange rate.

- This is aimed at smoothing out volatility and avoiding sustained appreciation of the real exchange rate which would damage competitiveness.

IV. Policy Responses

- The main tool of Uganda's exchange rate management is sterilized intervention in the foreign exchange market;
  - intervention is fully sterilized to ensure that monetary policy can be focused exclusively on domestic policy objectives.
- The BOU has aimed to build up international reserves, to provide a buffer to stabilize the exchange rate in the event of a sudden capital outflow.
- However, sterilized intervention is problematic if undertaken on a large and sustained scale.

IV. Policy Responses

- If portfolio capital flows become larger and are sustained, it may be necessary to consider alternative policy instruments, such as the imposition of Cash Reserve Requirements on banks' offshore liabilities.

- At the very least, portfolio capital investment should not be given favorable treatment relative to similar investment by domestic investors, in terms of tax or reserve requirements.

- Addressing liquidity risks to financial stability requires deployment of effective Macroprudential instruments.

IV. Policy Responses

- The first requirement for the central bank is to compile accurate high frequency data to monitor these risks.
  - The Bank of Uganda is now compiling banks' exposures to offshore investors, and the currency composition and maturity of these exposures, on a weekly basis.

- The BOU is addressing liquidity risk to banks through the application of the Basel III Liquidity Coverage Ratio (LCR), separately to both the domestic currency and foreign currency exposures of the banks.

IV. Policy Responses

- Prudential limits are also in place limiting banks' foreign currency mismatches by capping foreign currency positions to +/-25 percent of their capital.

- Foreign currency business rules limit banks' foreign currency lending to 80 percent of their foreign currency deposits.

- Uganda has become the first country in East Africa to compile real estate price indices aimed at keeping track of risks from lending to the real estate market.
  - we are now in the final stages of compiling a bank-wide loan to value ratio.

THANK YOU