BANK OF UGANDA

Recent trends and behaviour of Capital flows to Uganda; Challenges posed by the flows

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Outline

- Trends, Composition and Characteristics of Flows
- Motivations for recent Capital Flows to Uganda
- Challenges for Macroeconomic Management

Trends in Capital Flows

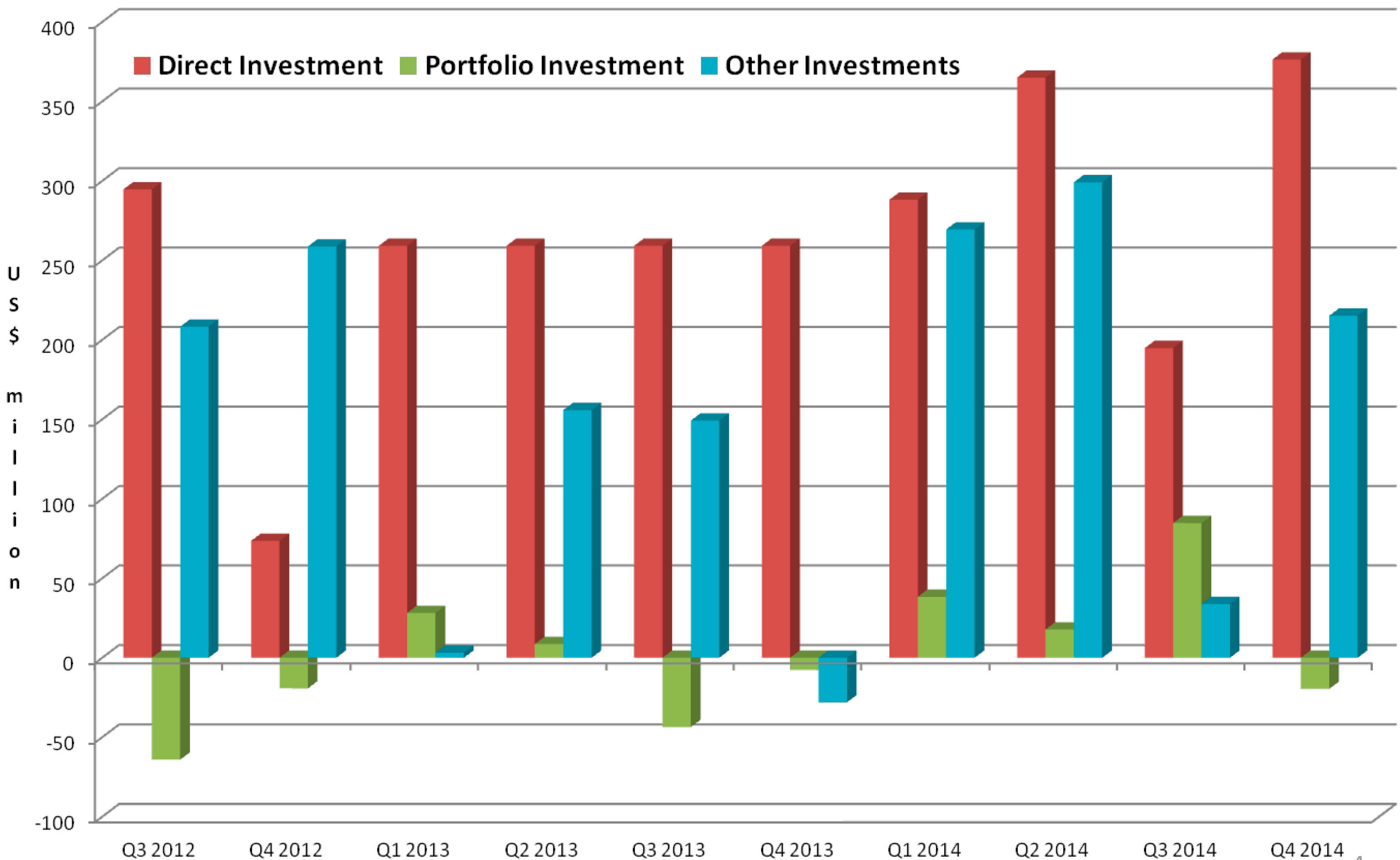
- Net capital flows (inflows on the financial account) have risen from an average of $930 million annually in the five years to 2008/09 to an average of $1,723 annually in the five years to 2013/14

- Net capital inflows were the equivalent of about 7% of GDP in 2013/14

- FDI accounted for 70% of net financial account inflows in the last two fiscal years, followed by other investments (mainly official and private loans) which accounted for 28%.
- Net portfolio capital accounted for only 2 percent of net inflows on the financial account.

- Uganda imposes no restrictions on any components of the financial account

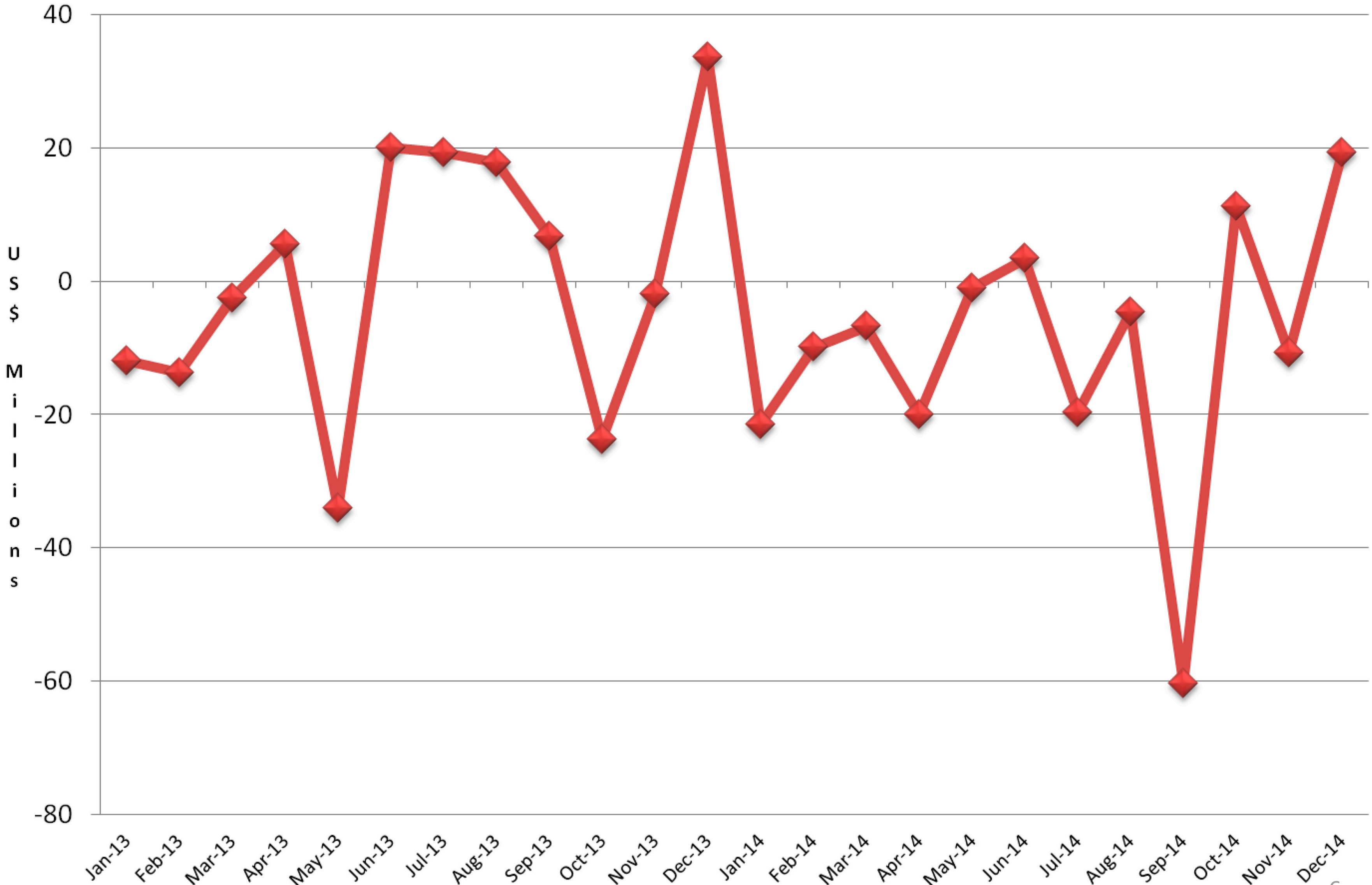
Major Components of the Financial Account: net flows, millions of dollars per quarter; Q3 2012-Q4 2014



Nature of Portfolio Capital Flows

- Despite being relatively small on a net basis over the long term, short term portfolio flows can be significant and are volatile
- Portfolio capital flows are much more volatile than other components of the financial account
- The value of the stock of domestic assets held by offshore portfolio investors at the end of 2014 was approximately $750 million

Monthly Net Portfolio Inflows: millions of dollars, January 2013 to December 2014



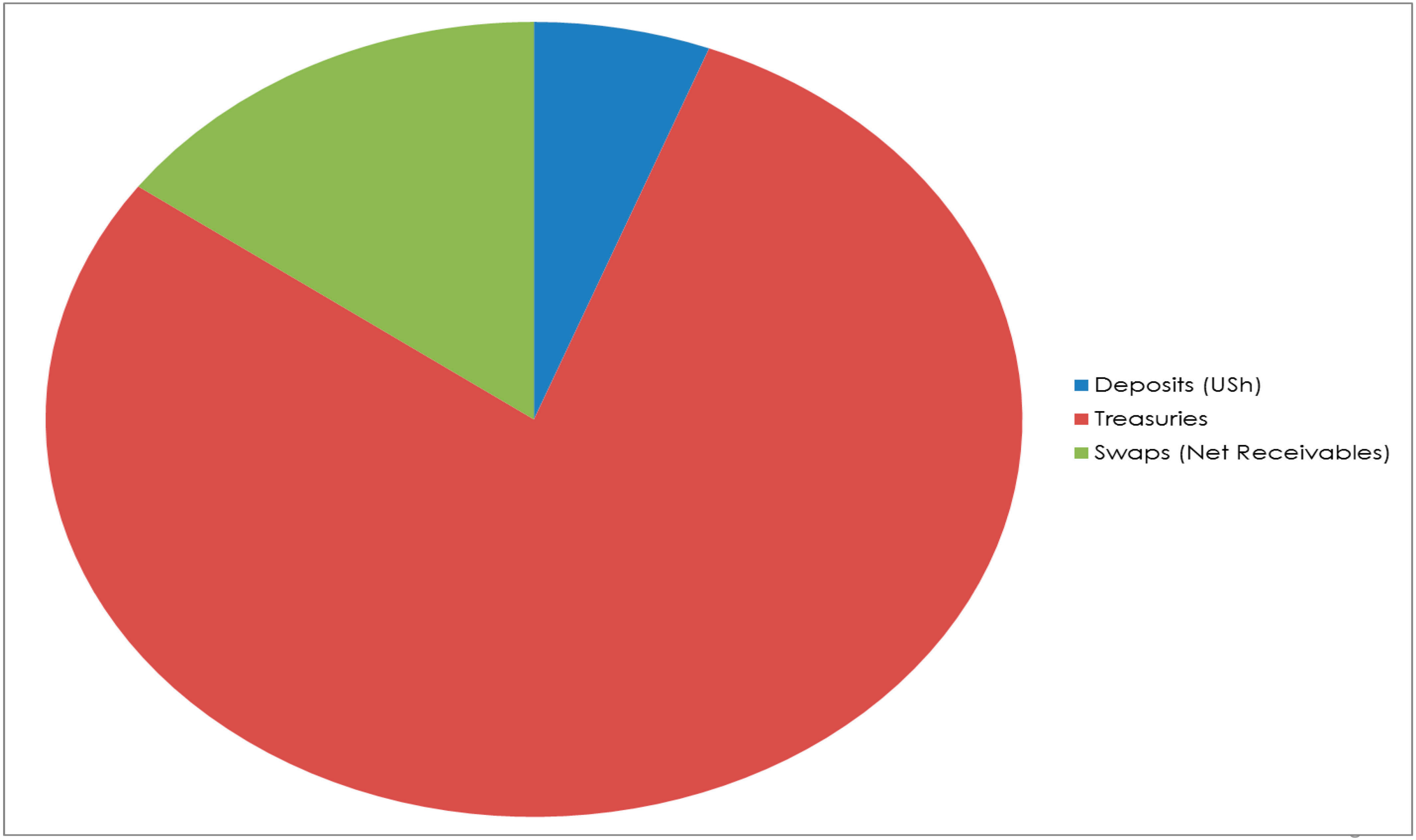
Characteristics of Portfolio Capital Investments

- The bulk of offshore investment is in government securities, followed by Shilling denominated SWAPS and bank deposits

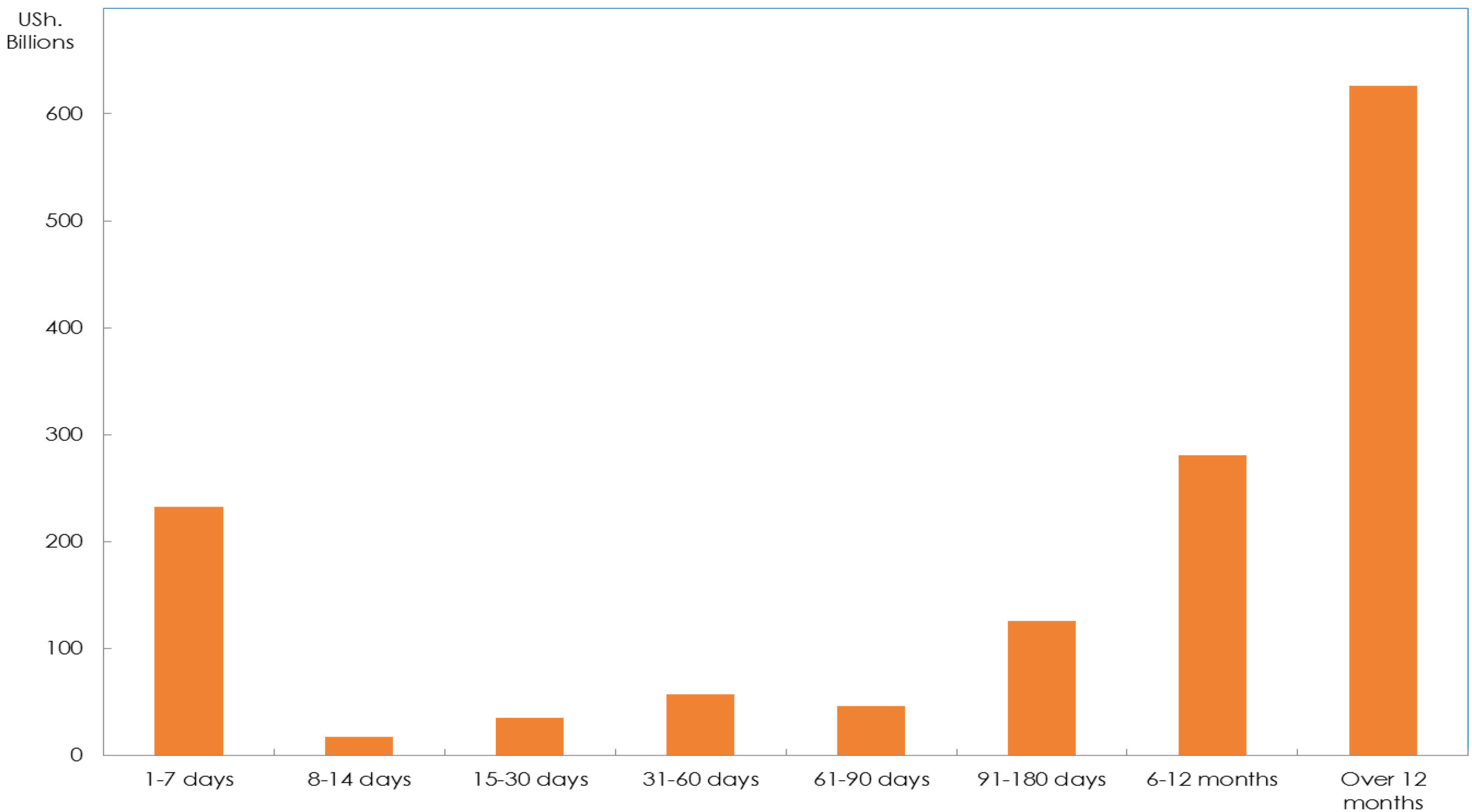
- Offshore investors invest in SWAPs because of favorable tax treatment and, for banks, a lower capital charge than applies to other types of asset.

- **Maturity profile of assets held by offshore investors.**
  - Almost half (44%) have a maturity of over 12 months.
  - However, most of the assets with maturities of 6 months or more are government securities, which can be traded on the secondary market, so long maturities are not a guarantee against capital outflows

Composition of Holdings of Shilling Denominated Assets by Offshore Portfolio Investors: percent shares 2014



Maturity Profile of Assets Held By Offshore Portfolio Investors (Ug Shilling Billions)



Motivations for Portfolio Capital Investments

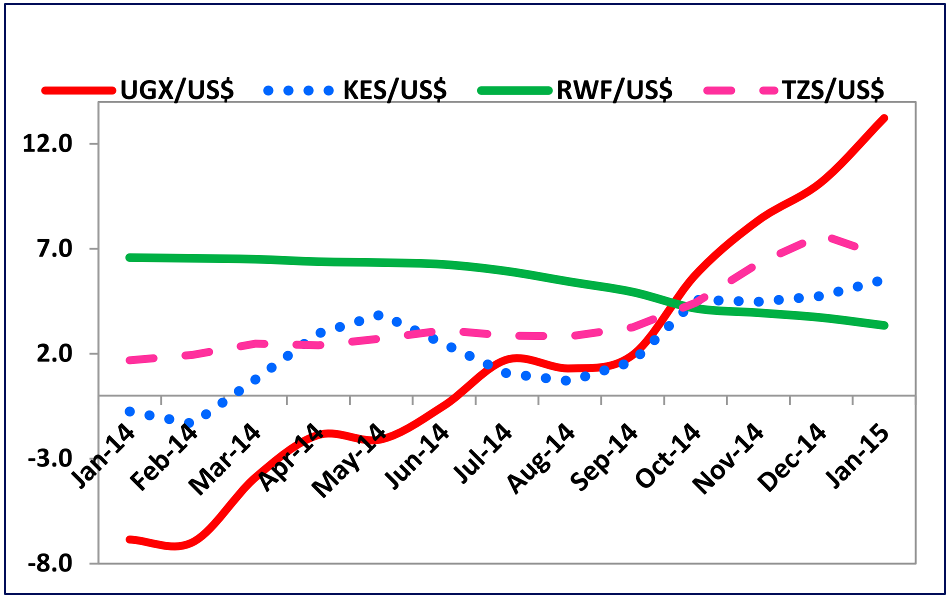
- Portfolio capital inflows are driven mainly by the large interest rate differential between Uganda Shilling assets and US dollar assets in advanced economies:
- *This differential has been in excess of 10 percentage points since the global financial crisis*

- Over the long term, portfolio investors assume the interest rate differential will exceed any bilateral UGX/$ exchange rate depreciation (because of Balassa Samuelson effects and prospects for oil production)
- However, if portfolio investors expect sharp nominal depreciation in the short term, capital flows may be reversed, as occurred in 2014 and in January 2015)

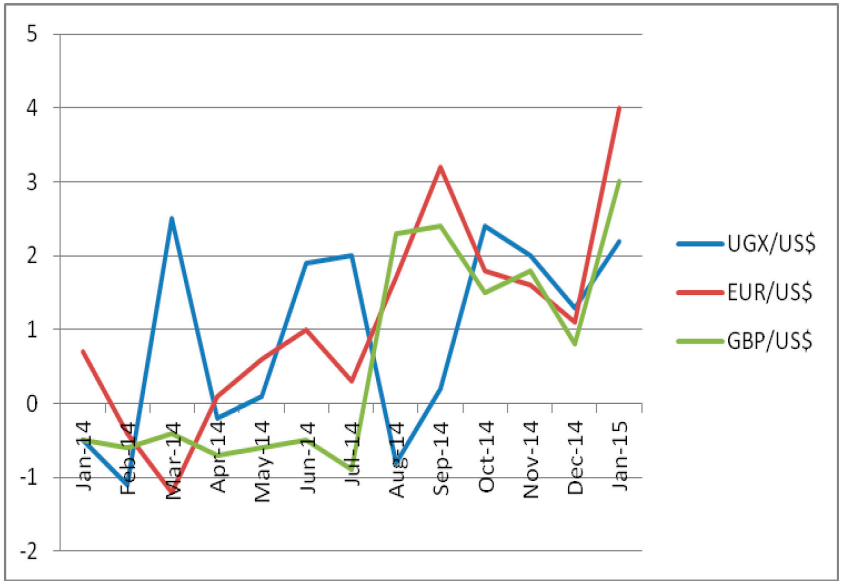
Exchange rate developments

- UGX depreciation (Y-o-Y; 13% in Jan 2015)
- Similar trend for EAC Currencies, BUT more intense for UGX

Annual percentage changes ; Jan 2014-Jan 2015



Monthly Changes Per USD: Euro, GBP & UGX



Source: Bank of Uganda

Challenges of Capital Inflows (1)

- The aggregate magnitude of net capital inflows (7% of GDP) raises the real effective exchange rate and damages long term competiveness; the counterpart to the financial account surplus is a huge trade deficit (almost 10 percent of GDP in 2013/14)

- The volatility of portfolio capital flows is transmitted to the nominal exchange rate through two channels;

  - *Over short periods, portfolio flows can be much larger than all other transactions in the foreign exchange market;*

  - *Portfolio flows can influence the behavior of domestic agents, thereby amplifying their impact on the exchange rate*

Challenges of Capital Inflows (2)

- Capital flows pose dilemmas for macroeconomic management under floating exchange rates.

  - *Whereas exchange rate adjustments to current account movements are usually also stabilizing for internal balance; this is not necessarily the case for exchange rate movements arising from capital flows.*

- **Hence a macroeconomic policy response is more likely to be needed** to stabilise the economy from the impact of a capital account shock.

  - ✓ *Create the policy space (Foreign exchange reserves)*
  - ✓ *Buttress the Information and Analysis toolkit;*

(E.g. High frequency data on short-term capital flows; short term capital exposures to the liquidity of the domestic banking system)