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

- Direct Investment
- Portfolio Investment
- Other Investments
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.
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
The aggregate magnitude of net capital inflows (7% of GDP) raises the real effective exchange rate and damages long term competitiveness; 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.
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)