Emmanuel Tumusiime-Mutebile: The global financial crisis – impact on Uganda and the policy response

Speech by Prof. Emmanuel Tumusiime-Mutebile, Governor of the Bank of Uganda, at the EABC Workshop, Arusha, Tanzania, 4 March 2009.

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Let me say how pleased I am to be at this EABC regional conference on the global financial crisis. By responding to the challenges we are facing today and by acting together regionally and internationally like at this forum for our economies, we policy makers can replace uncertainty by clear action, hope and confidence. Only this way can we be certain of tomorrow's financial stability and robust economic growth. The starting point, however, is to ensure that we understand fully the genesis of the problem so that we can prescribe the right solutions for our national financial systems and economies.

The global financial crisis in perspective

It is impossible either to identify a single cause for the current financial crisis nor to explain it in a linear fashion. Rather the crisis reflects a confluence of several developments: loose monetary and fiscal policies in the United States, global macroeconomic imbalances, and poor financial system supervision and regulation.

- Poor policies: It should be noted that the USA pursued excessively loose monetary and fiscal policies in recent years, which stoked two price bubbles (the high technology company stocks, 1999-2000; and the massive housing price bubble which spread from the USA to Europe and Middle East. The sustained period of low interest rates encouraged excessive risk-taking and indebtedness by individuals and enterprises.
- Inadequate regulation: Financial innovation under the subprime mortgage facilities fostered the creation of marginal assets under the cover of securitization. Under this arrangement, lenders split their loans into numerous small pieces, which they in turn sold to unsuspecting individuals throughout the economy. This created the burden of nonperforming assets, especially among the purchasers of the securitized loans, which went unrecognized by the regulators
- Global imbalance: resulted from excessive demand in USA, which created unsustainable balance of payments deficits. This deficit was funded largely from abroad, especially with large savings from China and India which resulted from increased exports earnings to the USA.

After a relatively long period of macro-economic stability, interest rates fell to very low levels by recent historical standards in the United States. There was a marked decline in market volatility and risks spreads narrowed which encouraged complacency about risks. Mr. Greenspan, the former Chairman of the Federal Reserve Board's opposition to the regulator of over-the-counter derivatives which form the bulk of the counterparty risk "encouraged" bankers to remove credit risk from the balance sheets of Banks by packaging the loans into new securities and selling them on capital markets.

Sub-prime mortgages to high risk borrowers were repackaged and sold on as securities – and when the house prices began to fall below the underlying values of properties held as collateral the subprime mortgage crisis broke out. Participants in the capital markets could not know which of the assets they held were "toxic" assets from sub-prime mortgage lenders.

According to Ben Bernanke, the Chairman of the Federal Reserve "far too much lending in recent years was neither responsible nor prudent ..... In addition, abusive unfair or deceptive lending practices led some borrowers into mortgages that they would not have chosen knowingly".

So there was a lack of market discipline, poorly aligned incentives and lack of regulatory monitoring of attendant risks.

The sub prime mortgage crisis reached a critical stage during September 2008, characterized by severely contracted liquidity in the global credit markets and insolvency threats to investment banks and other institutions. A broadening of credit quality concerns and unanticipated contagion to other financial assets further exacerbated this crisis. With a high leverage and rising uncertainty about the ultimate distribution of risk, low confidence in the banking sector ensued leading to a virtual closure of interbank and money markets and a sharp retrenchment of credit.

Beginning with failures of large financial institutions in the United States, it rapidly evolved into a global credit crisis, fear of deflation and sharp reductions in shipping resulting in a number of European bank failures and declines in various stock indices, and large reductions in the market value of equities (stock) and commodities worldwide.

It is worth noting that Uganda's financial sector has not been affected by these sub-prime mortgages, since the economy was not exposed in any way to these sub-prime mortgages. However, the credit crunch together with other global imbalances led to real economic effects, resulting into a global economic down turn and a recession in the developed countries of the Western World. It is this global recession which is having a lagged impact on the Ugandan economy.

What have been the observed effects on Uganda's economy so far?

The global economic meltdown could have an effect on Uganda's economy through several channels:

- o Global recession could prompt lower world demand and lower prices for Uganda's exports, resulting in lower fiscal revenues as trade slows down.
- o Tight global credit conditions could lower external financing through reduced foreign direct investment (FDI) as well as lower borrowing to meet the needs of the economy.
- o Uncertainty and genuine needs abroad, could imply capital flight and related pressure on the exchange rate and interest rates.
- o However, the financial sector remains resilient, and there is no evidence of its exposure to the toxic wastes.
- o As a result, real GDP growth in Uganda could slowdown to 6-7% in 2008/09, which by any standards is still remarkable.

The ensuing economic recession in the developed world is having knock on effects on the Ugandan economy. In particular, the following changes have been observed in recent months:

- **Trade**. Uganda's exports for the period up to August 2008 were remarkably robust exceeding 2006 and 2007 values. The high growth was due to, among other things, the peace dividend in the region (Sudan and Congo). Imports too had risen on account of rising domestic demand for both consumption and investment goods But since around September 2008, both exports and imports have recorded lower growth rates and in some instances, they have stopped growing. However, looking at the composition of informal cross border exports, demand for domestically produced exports (mainly agricultural commodities) has remained robust relative to demand for re-exports (mainly manufactured commodities). This provides an opportunity for harnessing benefits from the regional trade if the supply response were to be improved to compensate for falling international demand for formal exports. Uganda, however, will need to keep monitoring the effect of oil price declines that might impact revenues of Sudan and subsequently its demand for Uganda goods.

- **Private flows**. In 2006/07 and 2007/08, there was a sharp increase in other foreign inflows comprised of aid (loans and grants), workers remittances and NGO inflows, income earnings, foreign direct investment, portfolio flows, and private sector credit. But since around October 2008, inflows have dropped-off with two direct effects: depreciation of the Uganda shilling and an increase in domestic interest rates.
  - The Uganda shilling-U.S. dollar exchange rate has depreciated by around 20% relative to its September 2008 value reflecting lower inflows and even some outflows by portfolio investors. (It is estimated that foreign portfolio investors held around US$ 400 million in GOU Treasury Bills and Bonds as of September 2008 and about US$193mn as at end December 2008.)
  - Interest rates on government treasury bills and bonds have consequently also increased, with some knock-on effects on bank lending rates.
- **Stock market.** The Uganda securities Exchange (USE) all share index in the period July-October 2008 lost 39 percent. The month of October 2008 alone recorded the biggest loss of 28 percent. The fall in the share prices on the cross-listed stocks, which account for 61 percent of total shares explains the fall in the USE all share index. The high percentage of foreign investors exiting, accounted for most of the decline in the USE index as investors exited to the so-called Safe heaven. The dip in the index, however, appears to have been primarily driven by panic and uncertainty among foreign investors rather than the change in macroeconomic fundamentals of the listed companies. Indeed the fall was temporary and the index recovered mainly because the institutions listed on the USE remain fundamentally strong.
- **Donor flows**. Aid from donors has remained fairly stable though in December 2008, it fell short of amounts observed for the same month in 2006 and 2007. However, we are yet to establish whether this is due to delayed disbursements and not a cut in donor flows.
- **Taxes**. While the tax collections appear to perform well in nominal terms, adjusting for the impact of inflation shows that revenue appears to have declined somewhat starting from July 2008 to January 2009. The preliminary indications of a decline in real tax revenues, if sustained, could have implications for Uganda's fiscal consolidation strategy.
- **Inflation**, which has for a long time been stabilized at low single digit rates, has since mid 2008 crept to double-digit levels. This has been due to exogenous factors associated with high imported inflation from Uganda's major trade partners (e.g. Kenya, South Africa, India and China), high demand for Ugandan goods from neighboring countries, as well as low supply response in the domestic economy. In addition, the high costs of fuel and food on the world market exerted upward pressures on Uganda's inflation. The recently observed slow-down in prices of these items on account of slowing global economy, however, could if sustained contribute to reducing the inflation and the cost of doing business in Uganda. The challenge however lies in the apparent decoupling of domestic pump prices from world price trends, partly attributed to high specific tax on fuel, as well as high costs of logistics.[1]

[1] It is noted that the direct world cost of fuel contributes only 30% of Uganda's total pump prices, while logistics account for 40%.

- **Relationship of multinational enterprises with their subsidiaries**. At the micro level, there are potential risks on to the real sector arising from the propagation of shocks experienced by parent enterprises on their subsidiaries. Parent companies based in developed economies facing subdued demand and/or financial constraints due to the global financial crisis and recession that could force them to wind up operations globally are a potential source of risk for the economy. Closure of their subsidiaries operating in Uganda would have adverse effects on employment, demand for domestically produced inputs, asset quality of banks for those accessing domestic credit, taxes etc. At the policy level, monitoring of such large multinationals has been increased.

As a result of these developments, Uganda's overall economic growth this year and next is likely to be lower than in recent years.

Financial sector

Given its centrality for economic activity, recent developments in Uganda's banking sector are worth further elaboration.

Uganda's banking sector remains sound and stable. The banks' capital adequacy ratios are well above the regulatory requirements. Although Uganda is a home to subsidiaries of International banks, the local subsidiaries had no exposures to the subprime products of other toxic debts. Thus, for example, while Citi Bank International and Barclays Bank PLC have a lot of such impaired assets, their Uganda subsidiaries, Citi Uganda Ltd, and Barclays Bank (U) Ltd. have their own capital base and no exposure to the toxic assets. The two subsidiaries have standalone capital requirements and are decoupled from the parents.

But while solvency is not an issue, the local banking system has not wholly escaped being affected by the global financial crisis. In particular, the abrupt decline in capital inflows has contributed to the reduction of liquidity in the banking system in recent weeks.

There is also some anecdotal evidence that some large local companies' access to credit abroad has been curtailed causing an increase in domestic demand for credit. This rebalancing of credit portfolios by large local companies has contributed to higher interbank rates and higher than normal recourse to borrowing from the central bank. This is also indicated in the higher bidding rates for government of Uganda securities particularly in the months of October, November and December 2008. The challenge this poses is in finding a balance between maintaining sufficient liquidity in the banking system as well as keeping inflation at bay. Measures are being taken to ensure that government spending agencies effectively and efficiently absorb all budgeted funds on the specific programs to ease liquidity conditions.

What policy measures have been taken so far and what needs to be done going forward?

As the global financial centers seemingly headed towards a meltdown in September/October 2008 and this manifested through depreciation pressures on the Uganda shilling/dollar exchange rate, government of Uganda adopted a number of measures, including:

- The review of the fiscal program to accommodate lower domestic revenue compared to the June/July 2008 budget time. The view was that provided the revenue shortfall was moderate, it would be manageable albeit translating into a higher fiscal deficit and thus pressure on interest rates. But any additional spending pressures would need matching spending cuts in other areas so that the public finances would not be an additional source of strain on the economy at this difficult time.

- Re-calibrating the government's liquidity management program to assume lower private capital inflows than in recent years.
- Revising the inflation and balance of payment outlook consistent with the latest developments.
- Adjusting the sterilization mix to emphasize preserving Uganda's foreign exchange reserves. Official reserves currently stand at US$2.2 billion a level that is sufficient to cover over 5 months of future imports of goods and services.
- Given the uncertainty about the safety of some banks abroad, the Bank of Uganda also took precautionary measures by investing in instruments issued by G7 governments and multilateral institutions. In addition, the bulk of reserves are being held with central banks rather than commercial banks.

Policies going forward

The global world recession is a threat to Uganda's strong economic growth performance of recent years as well as its plans to scale-up infrastructure spending. But reflecting the prudent policies of recent years, we are in a good position to weather the storm including on account of the planned increase in public investment.

Specifically, development expenditures are targeted to increase from U Sh 1,400 billion actual spending in 2007/08 to close to U Sh 2, 900 billion that was provided for in the 2008/09 budget. If effectively implemented fully, this would translate into a 4 percentage points of GDP increase in public investment – a much bigger stimulus to the economy than, say, the stimulus package in the United States which amounts to less than 1 percentage point of GDP.

But the only way that Uganda's economy can benefit from the planned increase in investment is if spending agencies efficiently absorb the allocated funds and use them effectively. The key sectors of agriculture, transport and energy are now being urged to step up their absorption capacity if fiscal policy is to have the intended effect of cushioning the expected decline in domestic demand on account of lower private capital inflows.

With respect to monetary policy, the Bank of Uganda will continue to pursue the objective of preserving foreign reserves and maintaining macroeconomic stability. This is important because the outlook for capital inflows of all forms (FDI, portfolio, remittances) is declining. Specifically, the Balance of Payments (BOP) shocks are partly being allowed to be absorbed via exchange rate adjustments, strengthening and broadening financial stability including cross border cooperation to ensure sound international financial rules and systems to minimize financial contagion.

Other issues

Lastly, there is need to take a step back and discuss how policies in Uganda may differ from the approach adopted in some of the advanced economies.

Why can't Uganda rely on borrowing much as the U.S. is currently doing?

We should note that by maintaining the current spending profile in the face of a decline in revenues, the government of Uganda is going to end-up with a higher fiscal deficit path over the medium-term. So Uganda, too, will be relying on borrowing, albeit at a much smaller degree than the United States of America.

Second, unlike the U.S.A, Uganda is financially constrained. To wit, the global financial crisis has led to lower borrowing rates for the U. S. government, notwithstanding the mounting fiscal imbalances. In contrast, interest rates on government securities in Uganda have drifted upwards. This is partly because some investors sold local Ugandan government securities to instead hold U. S. Treasuries.

Why shouldn't the Bank of Uganda flood the Ugandan financial market with liquidity much as the Federal Reserve has done?

First and foremost, the inflation rate which remains in the double digits in Uganda is a major concern, while in the U.S. the risk is of deflation. Second, supplying more shillings will likely entail increases in inflation rate and reserve losses (unless the exchange rate is of no concern). And as discussed above, preserving foreign reserves to the extent possible should be one of the anchors of monetary policy in this highly uncertain environment.

Concluding remarks

In conclusion, Uganda's macroeconomic framework guiding public policy under the Policy Support Instrument (PSI) framework for 2008/09 appear to be appropriate as it took into account the likely impact of the global financial crisis. The impact so far is not too big to warrant a major policy shift.

While the global financial and economic crisis appears to be severing among industrial countries, the limited integration of the Ugandan banking sector and overall economy into the global economy provides some safety net for the economy.

Prudent and flexible macroeconomic management together with smarter financial market regulation and risk-based banking supervision will enable Uganda to maintain sound economic fundamentals and to adjust to the current harsh global environment. Finally, there is need for an effective and focused communication strategy of “hope” on the part of the government that conveys the same message so as not to undermine the performance of the economy.