Emmanuel Tumusiime-Mutebile: Global financial crisis, recent macroeconomic developments and performance of private investments in Uganda

Speech by Prof Emmanuel Tumusiime-Mutebile, Governor of the Bank of Uganda, at the Workshop on "Dissemination of Results of the Private Sector Investments Survey (PSIS) 2008 and Launch of the PSIS 2009", Kampala, 18 June 2009.

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The Guest of Honour, the Honorable Minister of Finance, Planning and Economic Development
The Executive Directors of Uganda Investment Authority;
The Executive Directors of Uganda Bureau of Statistic;
Representative from MEFMI;
The representatives of the various Private Sector Entities and Organizations in Uganda,
Distinguished Guests, Ladies and Gentlemen

Let me take this opportunity to welcome you all to this workshop for the dissemination of the results of the 2008 Private Sector Investment Survey and to launch the cycle for the 2009 Survey. I would especially like to thank the Honorable Minister for accepting our invitation to preside over this important event. Honorable Minister, you are most welcome.

Private investment surveys are a valuable tool for enhancing our understanding of the economy and of some of the factors which determine economic growth. Their success depends on the participation of firms in the private sector: hence I wish to thank all of our partners from the private sector for their continued cooperation in this exercise. I am also grateful to all the members of the Uganda Working Group on Private Investments for the work they have done to prepare the findings that will be presented here today.

Global financial crisis, recent macroeconomic developments and performance of private investments in Uganda

I would like to share with you my views on the global financial crisis and its impact on our economy. Our economy is integrated into the global economy. Not surprisingly, the breadth and depth of the global crisis that has been unfolding since 2007 leaves many people in this country wondering whether our economy can emerge unscathed when so many others around the world are taking such a hammering. This is, of course, particularly, important for private investors because uncertainty is a major factor affecting investment decisions: the more uncertain are economic prospects, the more likely it is that private investors will put off decisions to commit resources to investment. It is, therefore, important to understand the nature of the global economic crisis, the channels through which it will affect the Ugandan economy and how our economy can adjust to meet the challenges it faces.

The genesis of the global financial crisis

The global crisis was triggered by rising defaults in the sub-prime mortgage sector of the USA which seriously weakened the balance sheets of numerous financial institutions, not only in the USA, which were exposed to the US sub prime market through their purchase of mortgage backed securities or the various derivatives of these securities.

Over the course of 2008 and the current year, the losses incurred in the US subprime mortgage sector were amplified several fold because they occurred in a context of much broader financial vulnerabilities. These vulnerabilities stemmed from an unsustainable expansion of financial intermediation in developed economies, an unsustainable accumulation of private sector debt in some developed and transition economies and unsustainable macroeconomic imbalances at the global level. In turn, the rapidly increasing financial fragility in the financial sector, in the non financial corporate sector and the household sector has led to a sharp decline in private sector consumption and investment spending and thereby induced recession in most of the developed economies and in some transition and developing economies.

I would like to elaborate briefly on these issues.

At the global level, the 2000s were characterized by huge macroeconomic imbalances. The USA, the UK, Spain and many countries in Eastern Europe experienced booms in private consumption, mostly fuelled by easy credit, and incurred large current account deficits. In contrast, many emerging market economies, with China being the most obvious example, and a few developed economies enjoyed rapid growth of exports alongside high savings rates. As a result they accumulated large current account surpluses. These current account surpluses were invested in the economies of the current account deficit countries, thereby allowing the latter to continue financing their profligate spending.

It is arguable that macroeconomic policy, particularly in some of the developed economies such as the USA and UK, was too expansionary in the mid 2000s and thereby contributed to the build up of these unsustainable imbalances. Moreover the low interest rates which characterized many economies in the 2000s induced investors to seek higher returns by diversifying their portfolios into riskier assets. In doing so, investors often assumed risks the nature of which was poorly understood even by sophisticated financial investors.

The financial sector played a central role in the spending booms which took place in many countries. The financial sector was itself transformed: it both expanded very rapidly and became increasing dominated by market based transactions, such as the trading of asset backed securities, as opposed to more traditional relationship banking. It also developed an array of complex new financial instruments such as derivatives, from which large profits could be generated while the risks were often regarded, wrongly, as negligible. This transformation of the financial sector was facilitated by the “light touch” regulation practiced especially in the USA and UK. Light touch regulation was partly motivated by a belief in the efficiency of financial markets that now looks naïve, partly by the desire of governments to attract globally mobile financial services to their own territories and partly by regulatory capture.

However, rapid expansion of balance sheets and the assumption of risks that were not properly understood created financial fragility in many financial institutions, including those which had been bastions of the financial establishment. Furthermore, the complexity of the modern financial system and opacity of many new financial instruments created enormous uncertainty among investors as to where risks were actually held. Allied to the increasing importance of transactions in securities markets, for example to source funds for bank lending and the growth of a shadow banking sector, this served to increase the vulnerability of the financial system to systemic risk. It was the systemic risk to the financial system that forced governments in several countries to risk huge sums of public money to bail out distressed financial institutions, even though the problems faced by these institutions were largely of their own making.

Impact of the global crisis on Africa

In contrast to some of parts of the world, most countries in Africa, including Uganda, have not suffered direct contagion from the financial crisis in the developed economies. Although there are substantial capital flows between Africa and the rest of the world, banks in Africa have virtually no exposure to the developed worlds’ toxic assets. Nor do African banks depend on wholesale securities markets for funding, unlike many banks in the developed world. As a consequence, neither the asset quality nor the liquidity of most African banks has been directly impaired by contagion from the financial crisis in the developed economies. Furthermore, most African economies have not funded large current account deficits with short term external private borrowing. Hence they are not at risk of a capital account crisis, in contrast to some of the transition economies in Eastern Europe. For these reasons most African economies have not suffered systemic failures in their financial systems as a result of contagion from the global crisis not have they been forced to adjust to sudden stops in their capital accounts through draconian expenditure reduction.

Nevertheless, the impact of the global crisis is being felt in Africa, although it is somewhat more muted than in some other parts of the world. The sharp slowdown in global growth affects Africa, including Uganda, through its impact on demand for the continent's exports of goods and services such as tourism, on transfers of remittances from Africans working abroad and on inflows of foreign capital, both direct investment and portfolio capital. As a consequence, foreign exchange inflows will be reduced and the growth of private sector spending will fall. This will inevitably reduce economic growth in Africa. The IMF's latest Regional Economic Outlook projects real GDP growth in the oil importing sub-Saharan African countries, excluding South Africa, falling from an average of 6.1 percent in 2008 to 3.3 percent in the current calendar year, before recovering partially next year to 5.1 percent.

The prospects for Uganda

I would like now to focus on the prospects for the Ugandan economy. In terms of real growth of output, Uganda has performed better than the average for sub Saharan Africa in the 2000s. There are solid grounds for believing that the economy is well placed to weather the challenges posed by the global crisis and that strong real output growth rates can be maintained, although at slightly lower rates than in recent years, for the reasons I have already mentioned. We are currently forecasting real GDP growth of 6 percent in the 2009/10 fiscal year. This is approximately two percentage points lower than the average GDP growth of 8 percent over the last three fiscal years, but is nevertheless still above the forecast regional average.

The grounds for optimism are the following.

First, the supply side of our economy has been strengthened in the 2000s. Private investment has risen steadily to relatively high rates of 17 percent of GDP in 2008/09. Exports have been diversified with, in particular, vibrant growth of exports of manufactured products to Sudan and other neighbouring countries.

Secondly, sound macroeconomic management has been pursued in Uganda for the best part of two decades. As a result, the fiscal position is strong, with relatively low fiscal deficits and public debt. Inflation has been controlled at moderate levels despite the fuel and food price shocks which hit the economy last year and is now falling back as these shocks subside. Consumer price inflation has fallen from 14.8 percent in February 2009 to 12.4 percent in May 2009. The Bank of Uganda has also accumulated a substantial stock of foreign exchange reserves, in excess of 2.25 million dollars, which can provide a buffer for our balance of payments. For these reasons it will possibly to pursue moderately countercyclical macroeconomic policies during the forthcoming fiscal year which will help to sustain aggregate demand in the economy without jeopardising fiscal sustainability, the control of inflation or external stability.

Thirdly, part of the adjustment to the much less favourable international economic environment will be facilitated by exchange rate depreciation. The exchange rate of the Uganda Shilling against the dollar has depreciated in nominal terms by almost 35 percent since September 2008. Although this makes imports more expensive, it will help our economy by improving the competitiveness of our exports and inducing consumers to switch demand from imports to non tradeable domestically produced goods. It thereby enables the economy to adjust to maintain external balance without having to undergo a painful recession to reduce import demand. In some countries, where the private sector has borrowed heavily in foreign currency denominated loans, exchange rate depreciation has been damaging because of its negative impact on private sector balance sheets, but this is not a major cause for concern in Uganda. Exchange rate flexibility is an important tool to help the economy adjust to an external shock. However, the Bank of Uganda will ensure that exchange rate adjustment is smooth and avoids disruptive volatility which would be harmful to users of foreign exchange in our economy.

Fourthly, the Ugandan banking sector has proved to be resilient in spite of the global financial crises. It is well capitalized with no indication of direct exposure to distressed financial institutions or toxic financial assets in other parts of the world. The banking sector has grown and diversified, with 21 commercial banks now offering a wide-range of financial products. The non-bank financial institutions and microfinance companies have also continued to expand their products and operations to the countryside.

Conclusions

The current global financial crisis is largely attributable to the mismanagement of financial institutions in developed economies, weak financial regulation, and to macroeconomic policies in the industrialised economies which contributed to large global macroeconomic imbalances.

The direct contagion affects of the global financial crisis on the Ugandan financial sector are not significant, because of the limited exposure of banks in our economy to problem assets and distressed financial institutions in the developed world. Nevertheless, the secondary effects, of the global economic recession pose a threat to Uganda’s economy through reduced demand for export products, lower remittances and tourism earnings and a reduction of foreign capital inflows. As a result, real economic growth will slow to some extent but will remain strong. Uganda will continue to maintain prudent and flexible macroeconomic policies management in order to adjust to the global crisis.

Finally, both the private and public sector must act together by sharing vital data and information to guide macroeconomic monitoring and policy. It is therefore important to get your support in collecting more frequent, timely and accurate data on developments in the economy. I want to take this opportunity to appeal to private investors to continue to cooperate and provide timely and accurate data. I also wish to thank those who have responded to our previous surveys.