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Capital flows and current account sustainability in African economies

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Capital Flows and Current Account Sustainability – Uganda's Experience 1994-2004

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The views and opinions expressed herein are those of the author and do not purport to represent those of the United Nations Economic Commission for Africa

Abstract

This paper analyzes the composition, magnitudes and trends of capital flows and current account deficit in Uganda over the 1994- 2004 period. The results reveal that the pattern of capital flows fluctuated over the period mainly on account of official flows, the basis on which the magnitude of Uganda's external debt stock grew substantially during the period. Private capital flows also increased steadily over the period, with the bulk being in the form of foreign direct investment that appeared to be more stable than other identified flows. Additionally, these flows appeared to have provided some impetus for positive and significant growth in output. However, the current account deficit excluding grants proved to be consistently large. The size of the deficits seemed to suggest that it might continue to remain unsustainable in the medium term. This is because total imports tended to grow at a faster rate compared to exports of goods, hence inducing a sustained widening of the current account gap that has translated into a form of a chronic imbalance. The challenge for policymaker in Uganda is to therefore to seek measures aimed at addressing the imbalances through increased growth of the capital stock via increased national savings and investment in order to boost output, which may, given appropriate conditions, contribute to narrowing the deficit to sustainable levels.

KEYWORDS: Sustainability, capital flows, FDI, current account deficits, investment, macroeconomic stability

Table of Contents

	Pages
Abstract	1
1. Introduction	3
2. Background	4
2.1 The economic reforms and achievements 1994-2004	4
2.2 Policy challenges	5
3. Capital Flows and Current Account Balances in the Ugandan Economy: Composition, trends and Developments	6
3.1 Capital flows and stock in Uganda	6
3.2 the current account balance (CAB): Trends and development 1994-2004	10
4. Proposed Recommendations and Conclusions	15
4.1 Proposed recommendations	15
4.2 Conclusion	17
References	25

1. Introduction

The Ugandan economy received substantial capital inflows between 1990 and 2004. However current account deficits persisted. Net capital flows¹ averaged 5.1 percent of GDP, whereas the current account deficit² was 5.5 percent of GDP during the period under review. Persistent current account deficits were largely explained by strong import growth against a background of weak export performance. However, official transfers which included budget support, import and project support resources redeemed under the Heavily Indebted Poor Countries (HIPC) Initiative, and private transfers together helped to finance the deficit. Both exports of goods and current transfer (inflows) averaged 8.7 percent of GDP between 1994 and 2004. Nevertheless, the persistence of current account deficits posed concerns in the context of external sector viability in Uganda. In addition, the policy makers were faced with a number of challenges in respect of how to manage the effects of capital flows in order to, generate a sustainable current account deficit and avoid any related macroeconomic instability.

As pointed out in Borensztein and Lee (1998), capital inflows can lead to substantial benefits for the recipient country and promote economic development, but different types of these flows generate different effects. It is commonly argued that Foreign Direct Investment (FDI) can facilitate the transfer of new technology, help enhance workers' skills, and improve market access; thus it is generally considered to be the most resilient form of private capital flows in the event of crises³. FDI inflows may facilitate export diversification and strengthen earnings or lead to import substitution on the other. These effects of foreign investment could therefore help to improve the resource balance and in turn reduce the level of current account deficits. In contrast, sudden shifts in market sentiment may however lead to large reversals of portfolio flows, which in turn, can cause detrimental economic effects.

There is a large and growing body of literature on the determinants of capital flows to developing countries. Most analysts have tended to focus their interests either on FDI⁴ or portfolio flows yet much less, research has been carried out on attempts to link capital flows with often notional concepts of current account sustainability.

This paper attempts to identify the norms and magnitudes of capital flows and their relationship with current account balance in Uganda. It examines why the current account deficit has been persistent. The analysis also investigates whether the persistent current account imbalances do have any effect on economic growth and development of the economy. The paper then suggests policies for sustaining capital flows and for improving current account position.

The remainder of this paper is organized as follows: Section II presents a brief background to Uganda's economy and discusses the understanding of the interplay between capital flows and current account position, while highlighting responses by the authorities on this issue. Section III discusses capital flows and the current account balance in the Ugandan economy and Section IV ends with the proposed recommendations and conclusion.

¹ Refers to net inflows—that is, gross inflows minus repatriation (outflows).

² Including Grants, (Excluding Grants average from 1994 to 2004 is 12.8 percent of GDP)

³ The Composition of Capital Flows: Is South Africa Different? Faisal Ahmed, Rabah Arezki and Norbert Funke1 IMF Working Paper WP/04/216

⁴ Kamaly, 2002; and Rogoff and Reinhart, 2003, Portes and Rey, 2000

2. Background

2.1 The economic reforms and achievements 1994-2004

Over the past decade, Uganda experienced its longest period of rapid, sustained economic growth since independence. Between 1994 and 2004, the annual rate of growth of real GDP averaged 6.6 percent, while inflation rate averaged 5.1 percent. Poverty levels dropped from 55.7 percent to 37.7 percent in 1992 and 2003 respectively. Much of this success was due to the implementation of economic reforms involving the liberalization of markets, privatization and rationalization of the public sector. The liberalization measures enabled the private to sector play a leading role in enhancing economic growth. During this period, the government focused on ensuring macroeconomic stability through prudent fiscal and monetary policies, provision of reliable infrastructure and establishing prudent and conducive regulatory framework to facilitate growth and development in the different sectors in the economy.

Uganda's economic performance in the last five years has been relatively good. Strong sectoral performance was registered in transport & communications (averaging 12.0 percent per annum), hotels & restaurants (11.9 percent per annum), construction (8.5 percent), electricity & water (6.6 percent), and mining & quarrying (5.8 percent). The strong expansion in these sectors was characterized by economic diversification away from traditional industries, which reflects the government's initiative to lessen Uganda's dependence on primary sectors (*UBOS⁵, 2004*). Similarly, the share of coffee as a percentage of exports declined from 56 percent in 1999 to 17 percent in 2004. Merchandise exports increased over the same period, due to a steady increase of foreign exchange earnings in the non-traditional exports particularly Fish and Fish products and Flowers, while merchandise imports increased even faster during the same period partially on account of increased prices of crude oil on the world market.

Uganda's external current account deficit steadily declined from 5.8 percent to 1.7 percent of GDP in 1999 to 2004 respectively, although significant improvement was observed in 2004, mainly due to increases in current transfers, budget support grants and remittances. The surplus on the external financial account continued to strengthen over the period (except in 2002), due to increased inflows related to balance of payment (BOP) support, private sector external debt, and increased trade financing. On a net basis, trade financing has had little impact on the financial account, while FDI in particular increased from US \$180.8 million in 2000 to US \$222.7 million in 2004. As a result, Uganda's international reserve cover improved to average 6.4 months of imports of goods and non-factor services over the period under review. Uganda's track record on economic and structural reforms has boosted donor and investor confidence resulting in increased flows of foreign aid, FDI, and debt relief. This has helped in improving the BOP position over time.

Gross domestic investment as a percentage of GDP grew from 18.7 percent to 21.1 percent in 2000 and 2003 respectively, of which public investment averaged 5.3 percent. Total investment in Uganda averaged about 20 percent of real GDP from 2000 to 2003. Encouragingly, government efforts to lay the foundations for strong private sector-led growth were also taking effect. Both savings and investment indicators improved remarkably over the period. Gross national savings as a percentage of GDP grew from 10.7 percent to 17.6 percent in 2000 and 2003 respectively. This has resulted in a moderate narrowing of the savings-investment gap during 2000 and 2003, thereby reflecting an improvement of the external current account balance.

⁵ Uganda Bureau of Statistics

However, for Uganda to meet its development needs and targets, the challenge partly remains for the country to continue attracting quality FDI to augment national savings (*UBOS 2004*, and *FitchRatings, 2005*). For a typical developing country like Uganda, which has continuously faced constraints on availability of financial savings and other resources to support its economic and social programmes, investments mainly through FDI become an essential element for supplementing available resources in order to meet the medium-term national development programmes and objectives. Inward foreign private capital helped reduce the national savings to investment gap and increased the resource envelope required for financing economic growth.

Policy reforms carried out in the 1990s have attracted capital flows into Uganda. However, the liberalization measures which culminated in the lifting of controls on current and capital accounts in 1993 and 1997 respectively, made compilation of information required for appropriate policy formulation, the BOP and the IIP difficult since the flow of information from the existing administrative system ceased to be available. This weakness was amplified by developments in information technology which made it increasingly difficult to monitor and measure private capital and current account transactions movements worldwide apart from the official flows. To overcome this problem, since 2000 the authorities have attempted to develop a system of recording and monitoring these flows and stock levels. It is anticipated that, with this system in place and once fully developed, authorities will be better placed to monitor the flows and report more reliable BOP and the international investment position (IIP). The current system focuses on better recording of capital flows through non-survey methods using the authorised foreign exchange dealers and also regular surveys, and it is hoped that the system will serve as an effective early warning system for the financial and external sectors. Survey findings have been incorporated in the BOP and IIP estimates effective from 1999. In spite of these difficulties, there exist some measures through which transactions to and from Uganda have been generated

2.2 Policy challenges

Notwithstanding the achievements registered, there are several remaining challenges that Government faces in respect of economic management which include the following:

- To achieve high GDP growth of least 7 percent per annum.
- Reduce income inequality.
- Maintain price stability.
- Improve domestic revenue as a percentage of GDP.
- Achieving external debt sustainability.
- Attract new and retain existing domestic and foreign private investment, to boost private sector-led economic growth.
- Increasing exports earnings as a share of GDP.
- Good governance and security.
- Strengthening the regulatory framework.
- Enhance data collection systems
- Improve on infrastructure

These policy challenges if addressed adequately are anticipated to contribute to increased capital flows and current account sustainability.

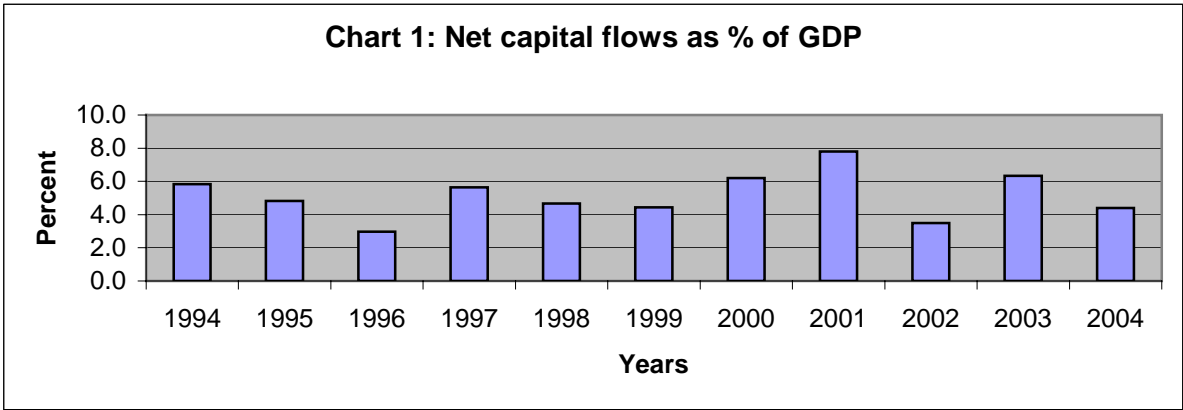
3. Capital Flows and Current Account Balances in the Ugandan Economy: Composition, Trends and Developments

This section describes the composition, and trends of the flows as provided in the BOP and IIP as well as survey findings for PCF⁶ 2001, PSIS⁷ 2003 and FPC 2004⁸.

3.1 Capital flows and stock in Uganda

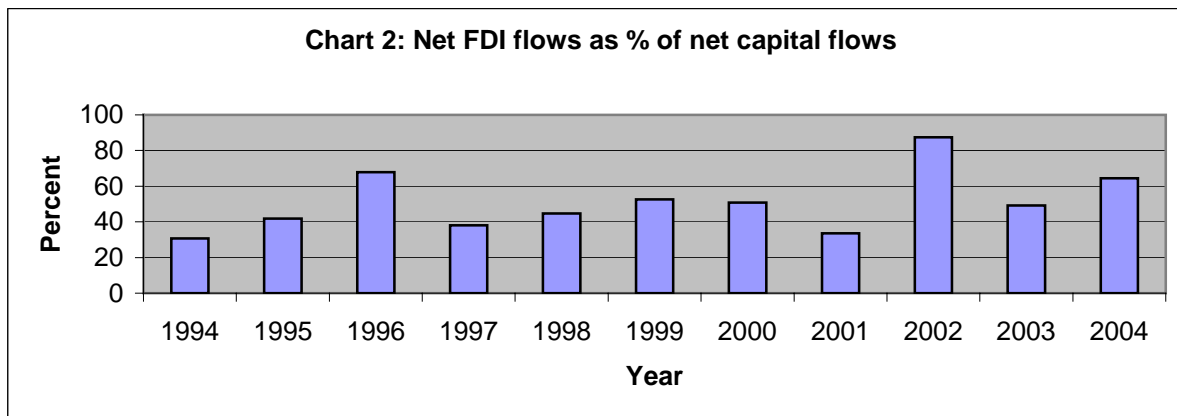
In order to determine the sustainability of Uganda’s current account, it is important to decompose the components of capital flows and stock levels, these estimates are recorded in the financial account of BOP and IIP respectively. Components include: Flows reported from 1994 to 2004 as indicated in Table 1 and stock levels from 1999 to 2004 (see details in Table 2).

Capital flows are recorded in BOP in three major categories, FDI, Portfolio Investment (PI), and Other Investment (OI). The net position of capital flows as a percentage of GDP averaged 5.1 percent and fluctuated in the range of 3.0 percent to 7.8 percent of GDP from 1994 to 2004. Net flows to Uganda as a percentage of GDP dropped between 1994 and 1996 and increased in 1997 mainly due to official borrowings in respect of funding structural adjustment programs. From 1998 to 1999 flows dropped due to limited activity, as the authorities were endeavouring to qualify for HIPC relief, then rose in 2000 on account of increased loan disbursements and FDI and further increase in 2001 on account of increased official borrowings which fell in 2002 as a result of declined official disbursements despite increased FDI. In 2003 a significant increase in net capital flows was recorded on account of continued borrowing to finance government and poverty reduction/ eradication programs. The net change between total disbursements and total debt service has been positive over the period 1994-2004. Therefore, total debt stock has, as a result, been growing partly due to the positive net debt flows.

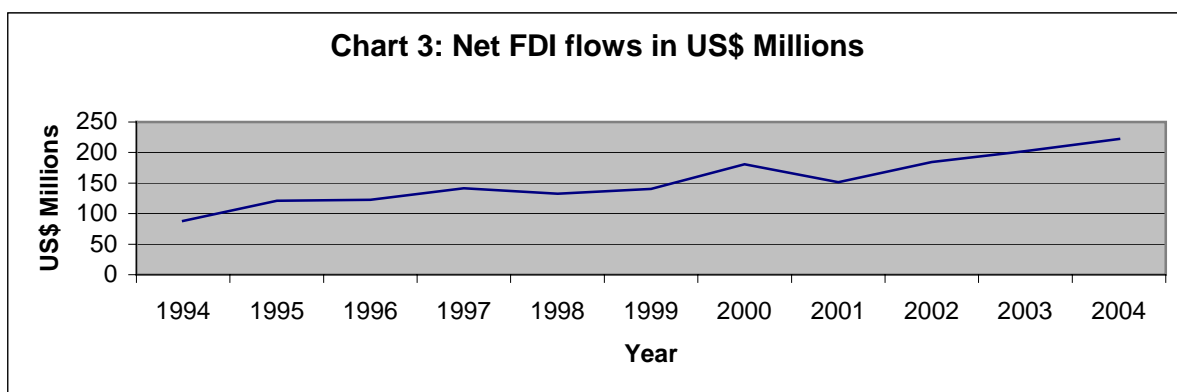


Net FDI flows on average accounted for 51 percent of net capital flows as estimated in the BOP during the period under review. FDI flows as percentage of capital flows have fluctuated between 31 percent and 87 percent during the period.

⁶ Private Capital Survey 2001
⁷ Private Investment Sector Survey 2003
⁸ Foreign Private Capital 2004



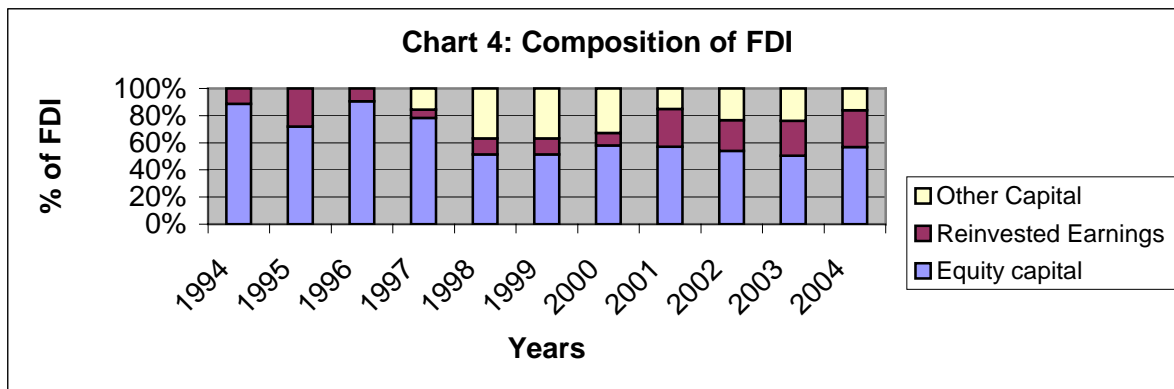
In term of magnitude, FDI flows have been increasing except in the years 1998 and 2001. The decline in 2001 may be attributed to the national elections held during the year.



The bulk of FDI flows are equity related and averaged 80.4 percent of the total FDI flows. Increased FDI flows adds to accumulation of capital stock that can be utilized to improve inflows on the current account through export of goods and services earnings and probably reduce on outflows through import substitution. Reinvested earnings and externalization of dividends are indicators of profitability for investors who undertake business in Uganda. The FPC 2004 survey revealed⁹ that in general FDI investors reinvested at least 40 percent of net profits in 2002 and 2003 while dividends externalized in the same period increased by 59.4 percent. This is a sign of long-term commitment and investor confidence in the economy which by any measure is critical for sustainability.

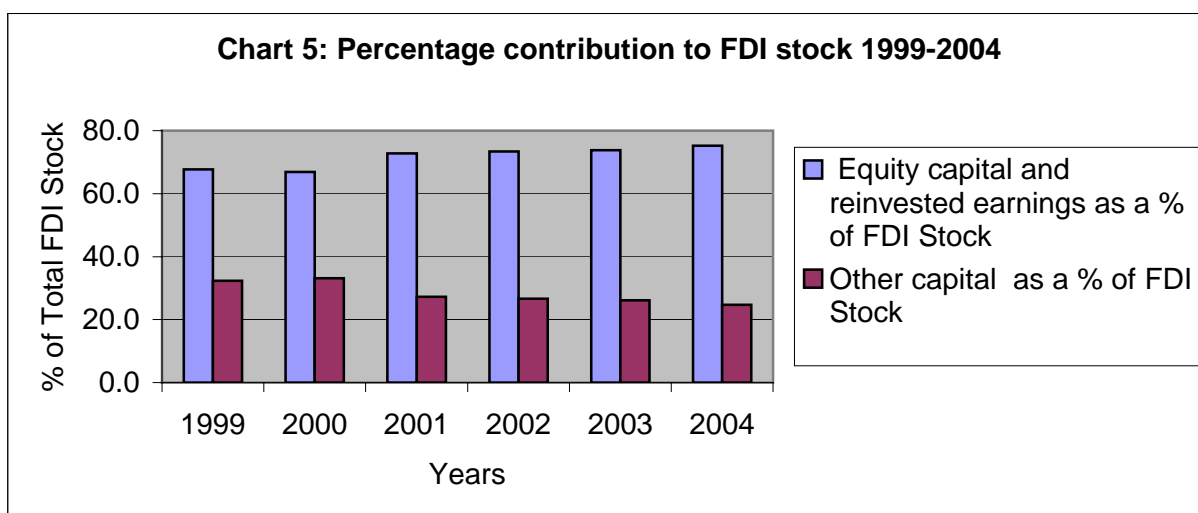
After 1997, other forms of capital that include borrowings from related sources have been recorded as indicated in the table 1 and Chart 4. The decomposition of FDI is based on survey findings, although before the surveys, it was believed that inflows were mainly in form of equity from foreign direct investors.

⁹ Similar trends are recorded in PCF 2001 and PSIS 2003 for 2000 and 2001



Most survey findings have revealed that other forms of capital (borrowing) from related sources in the year 2001 were of short-term nature¹⁰ and, therefore such flows are unstable, consistent with economic theory. The trend in these flows changed in 2002 and 2003 during which a substantial portion of other capital turned up to be of long-term nature accounting for 80.2 percent and 95.3 percent of the total borrowings from related sources.¹¹ The related long term borrowings are mainly used as project finance to increase output which is in some respects is critical for sustainability.

To determine Uganda's external sustainability, it is important to decompose stock levels of FDI. FDI stock levels have consistently increased from US\$ 451.3 million in 1999 to US\$ 1,182.6 million in 2004. In the last five years, equity related stock accounted for a larger component of FDI and this trend did steadily improve as indicated in Chart 5 below. Equity stocks that represent long-term and lasting investment in an economy, normally increase capital stock, and provide the least threat of reversibility, which is a positive indicator when addressing issues related to sustainability.



For purposes of sustainability of flows and retention of existing stock, it is often important to identify the sources of capital for purposes of investment protection and promotion. Major sources of FDI in the recent past have been United Kingdom (UK), United States of America (USA), Mauritius, Kenya, and Ethiopia. The authorities in Uganda have instituted investment protection and promotion agreements with France, Belgium, China, Sudan, Ethiopia and

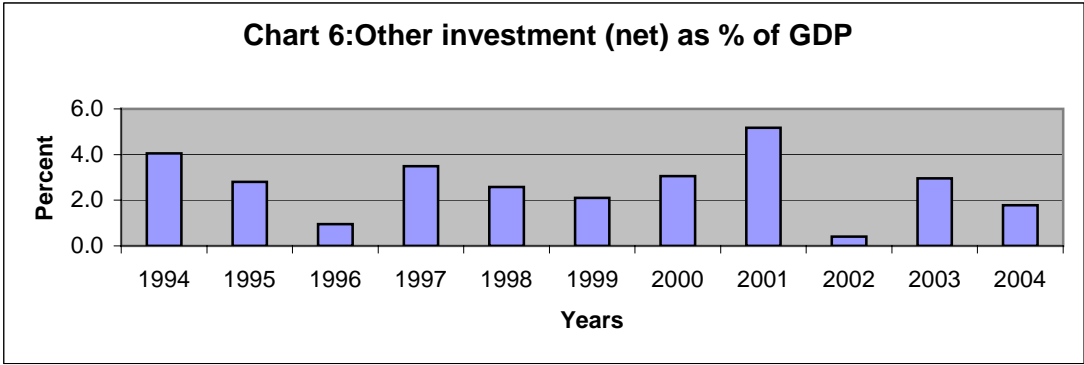
¹⁰ A Report on Private Sector Investment Survey (PSIS) 2003 Page 36

¹¹ FPC 2004 Report *forthcoming*

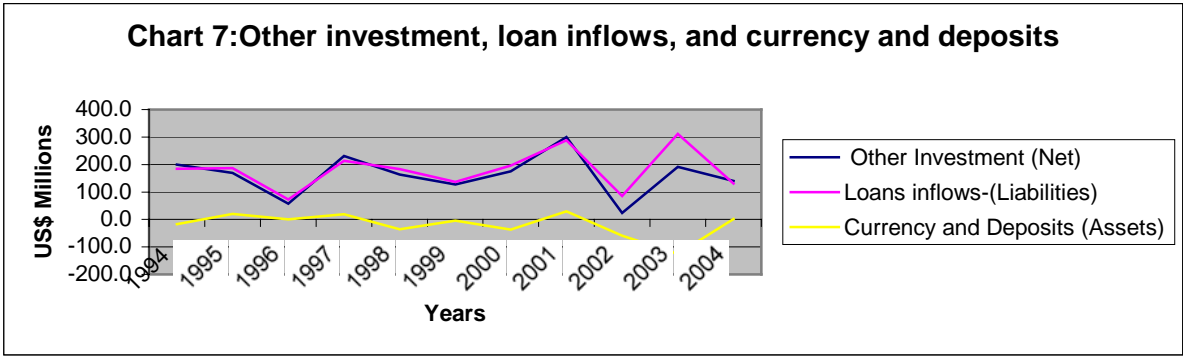
Mozambique. Furthermore, the current Investment Code is being revised to bring it up to date with the prevailing global business environment.

Empirical literature suggests that the development and efficiency of financial markets are key determinants for a country’s success in attracting portfolio flows. Consistent with the literature, portfolio investments are negligible when compared to FDI in Uganda due to lack of developed capital structures. However, minimal flows are recorded from 2001 to 2004, details of which are shown in Table 1. The Government of Uganda has embarked on wide-ranging policy initiatives aimed at strengthening the development and efficiency of the financial market, which include: establishment of Uganda Securities Exchange, and prudent regulatory framework for the development of the financial markets to address inherent weakness.

Other investments on a net basis over the period 1994 to 2004, exhibited a fluctuating trend from 0.4 percent to 5.2 percent of GDP as shown in the graph 6 below. The biggest components of flows are the official sources funded by International Finance Institutions (IFIs) in form of loans.

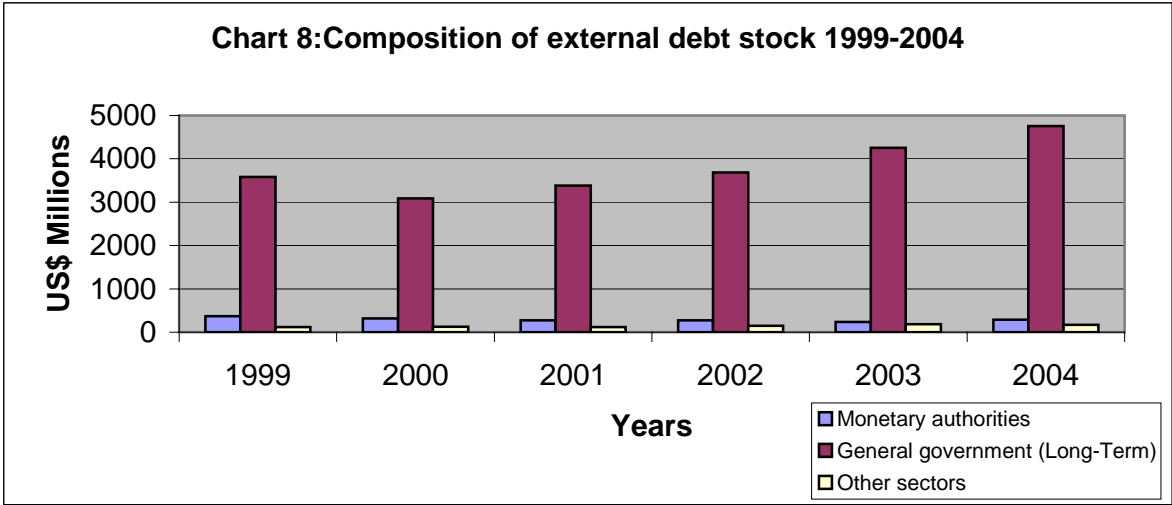


Over the period 1994 to 2004, total external debt disbursements have fluctuated. Total disbursements dropped from US \$ 187.3 million in 1995 to US \$ 72.7 million in 1996 because of decreased borrowing under the framework of Uganda’s structural adjustment programs. From 1997 to 2001 inflows fluctuated between US\$136.8 million and US\$ 288.2 million mainly on account of borrowing to finance government poverty reduction/eradication programs. In 2002 loans disbursed dropped to US\$ 84.4 million and rose to US\$316.9 million before decreasing to US\$ 139.5 million in 2004. Flows on account of other investments have been driven over the years by official borrowings (government) while the impact of currency and deposits flows was pronounced in the years 2002 and 2003 as indicated in chart 7 below.



The net change in official borrowing between total disbursements and total debt service was positive over the period 1994-2004. Chart 8 shows the composition of external debt stock with

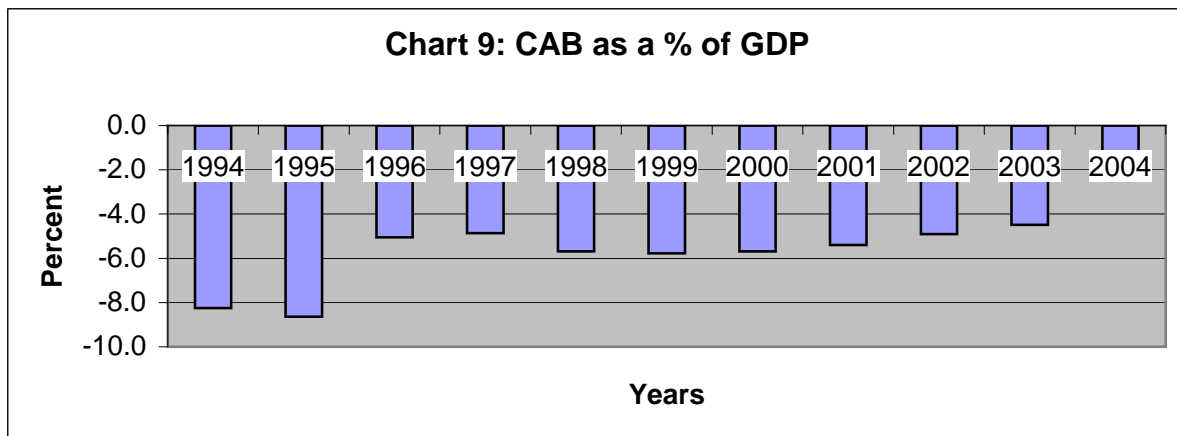
the biggest component being public external debt. Public external debt stock has, as a result been growing by US\$ 217 million per annum from 2001 to 2004 on average due to the positive net debt flows. This trend has as a matter of course raised concerns about external debt sustainability.



3.2 The Current account balance (CAB): Trends and developments 1994-2004

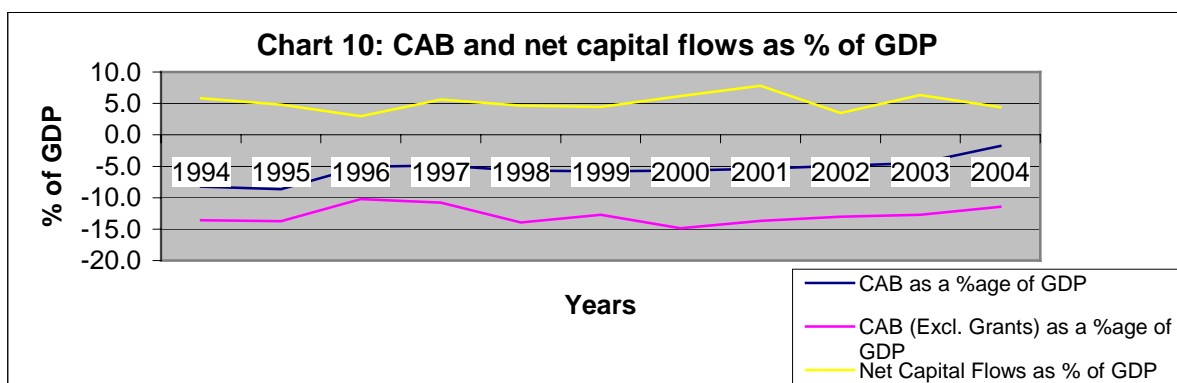
Current account is the difference between exports and imports. It should therefore reflect the totality of domestic residents transactions with foreigners in the markets for current goods and services. The current account balance also determines the evolution over time of a country’s stock of net claims on (or liabilities to) the rest of the world, reflecting intertemporal decisions of domestic and foreign residents, their behavior with respect to saving, investment, the fiscal position and demographic factors. For this reason, it is natural for policy makers to focus on the current account as an important macroeconomic variable, to endeavor to explain its movements, to assess its sustainable level, and to seek to induce changes in the current account balance through policy actions.

Over the last decade the current account deficits including grants oscillated between 8.6 percent and 1.7 percent of GDP. The level of the imbalance on the current account has steadily decreased since 1999 from 5.8 percent to 1.7 percent of GDP in 2004 as indicated in the Chart 9. Uganda’s track record on economic and structural reforms boosted donor and investor confidence resulting in increased flows of foreign aid and debt relief. This helped to improving the current account balance position over time. Donor funding as a share of GDP increased from 5.4 percent in 1994 to 9.7 percent in 2004 or an average of 7.6 percent over the period under review. At the same time, goods export earnings as a percentage of GDP decreased from 10.5 percent in 1996 to 8.0 percent in 1998, while it marginally increased to 8.2 percent in 2001 and slightly dropped 8.0 percent in 2002. Goods exports earnings improved to 8.7 percent and 9.0 percent of GDP in 2003 and 2004 respectively.

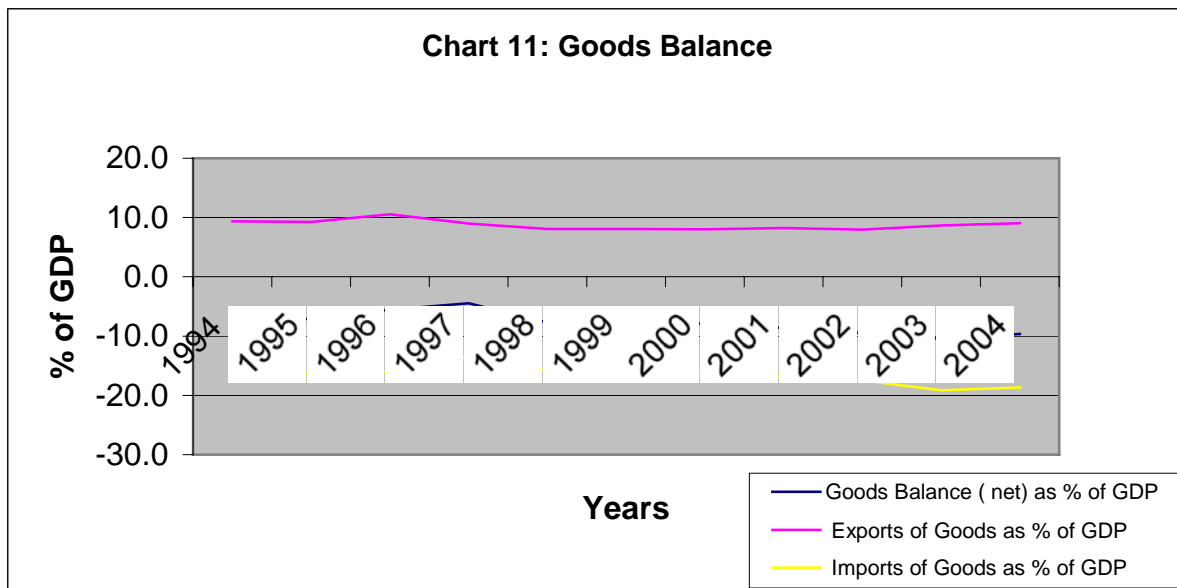


For purpose of sustainability, it is also prudent to examine the current account balance excluding grants. Current account balance (CAB) deficits excluding grant averaged 12.8 percent of GDP which is large indicating that the deficit is likely to be unsustainable in the long run because the implied shortfall is scaled down by grants which financing is not of a permanent nature. Net capital flows are far less than the CAB deficit as a percentage of GDP as shown in Chart 10. It is anticipated the increased growth of capital flows especially in the form of FDI will contribute positively toward bringing the deficit to sustainable levels through increased national savings and investments.

The CAB under the period under review is decomposed into four components; namely goods, service, income and transfer balances.



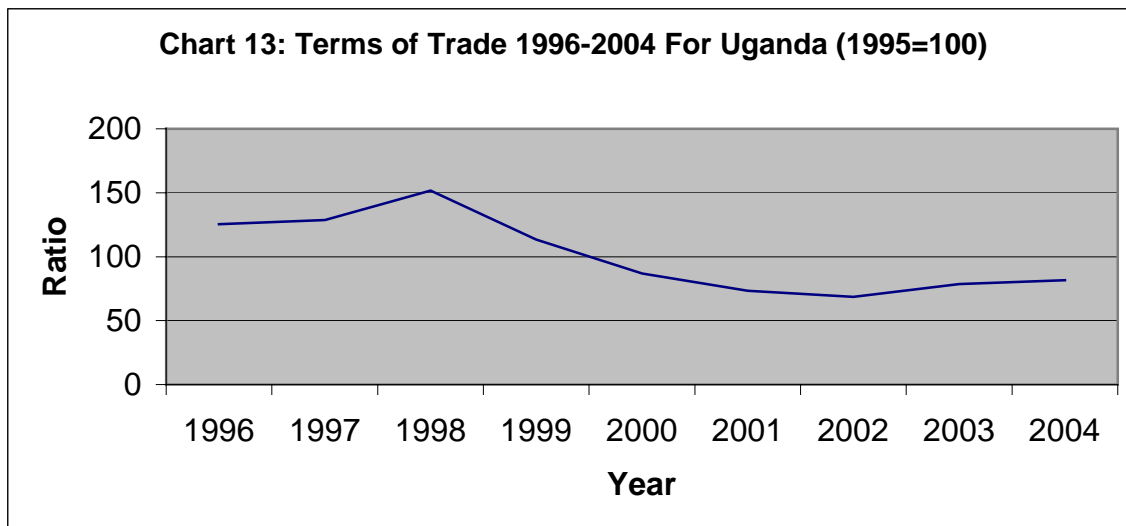
The goods balance indicated that the growth rates for exports and imports values averaged 5.1 percent and 7.1 percent respectively. Imports of goods grew at a faster rate than exports of goods therefore widening the deficit on the goods balance. The goods balance, as a component of the current account balance, is the key source of the deficit. On average, exports and imports accounted for 8.7 percent and 16.4 percent of GDP, which shows the key source of the imbalance on the CAB.



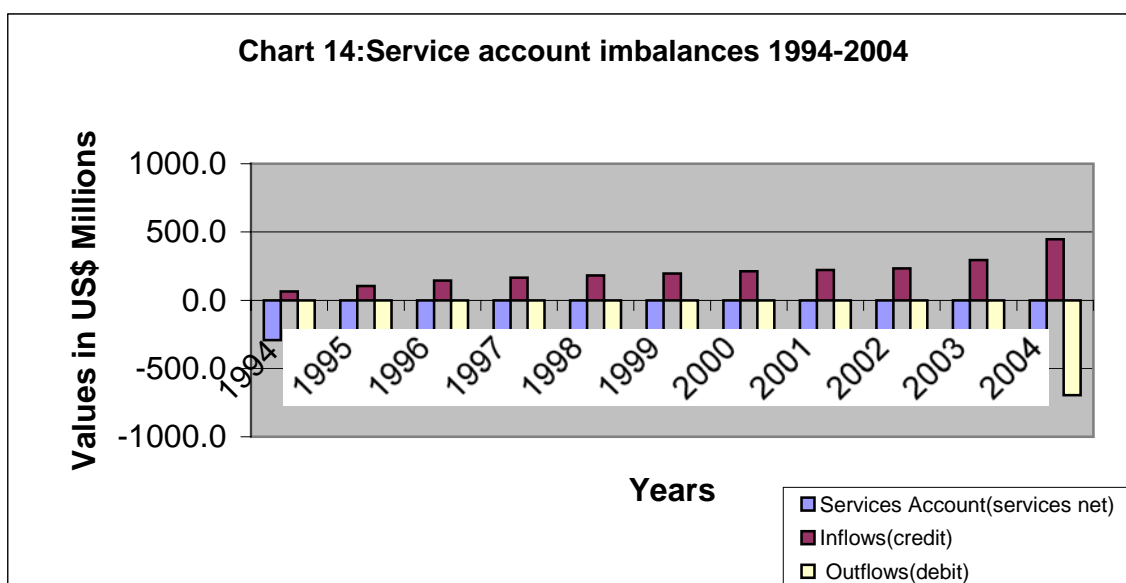
Growth rates of exports steadily declined from 1995 until 2000 due to the collapse of international coffee prices that was the single main export commodity. Export earnings recovered in 2001 to 2004 due mainly to export diversification measures which were being pursued. Imports of goods declined between 1995 and 1997 in value terms import, while imports grew sharply in 1998 and thereafter declined up 2000 and grew progressively from 2001 to 2004.



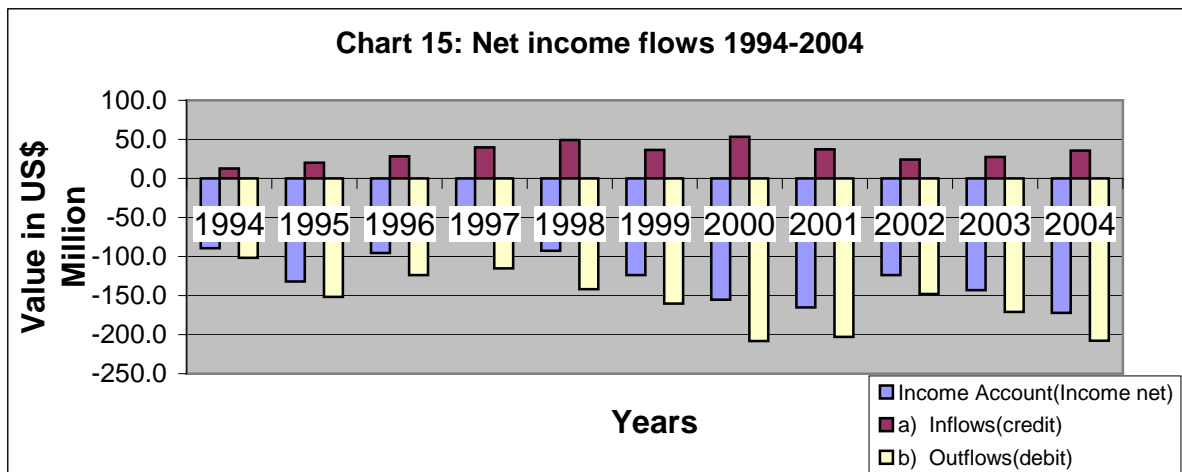
Deterioration in the terms of trade, which is caused by external shocks, may have induced loss of confidence in the economy and contributed to chronic imbalances in the goods balance. The economy has been experienced a deterioration in the terms of trade over the years except in 1998, mainly driven by falling international coffee prices and increasing world oil prices.



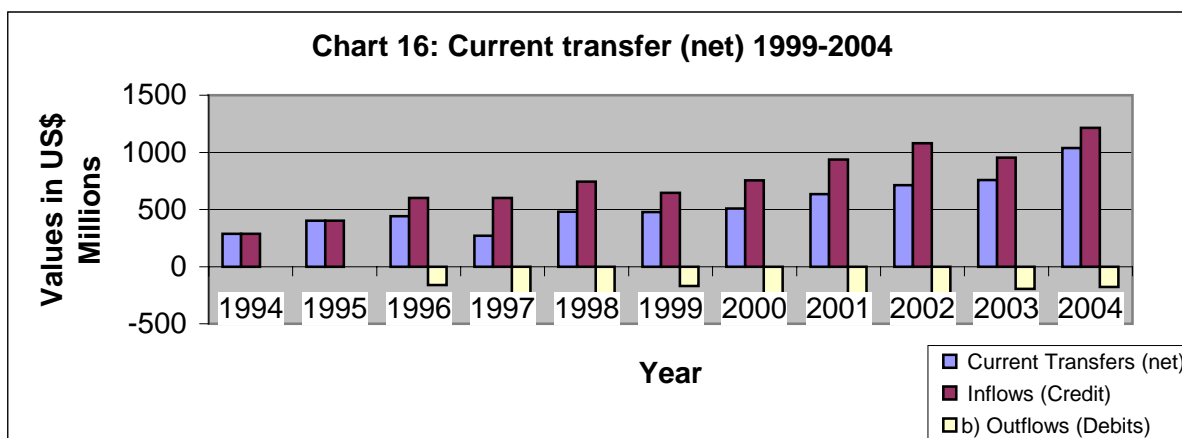
The service account remained perpetually in deficit for most of the period under review. However, it is interesting to note over the period service inflows recorded an average growth rate of 22.9 percent with steady growth while related outflows averaged 7.9 percent. Overall the deficit in this area has diminished steadily when compared to the trade balance which is a good indicator required for a sustainable CAB.



The income account balance had a similar pattern as the service account balance. Growth was recorded on the inflows side averaged 16.2 percent and 9.7 percent on the outflows, thereby contributing positively to sustainability objectives. However, the major difference between the income and service account were attributed to the size of fluctuations in the magnitudes as shown in Charts 14 and 15.

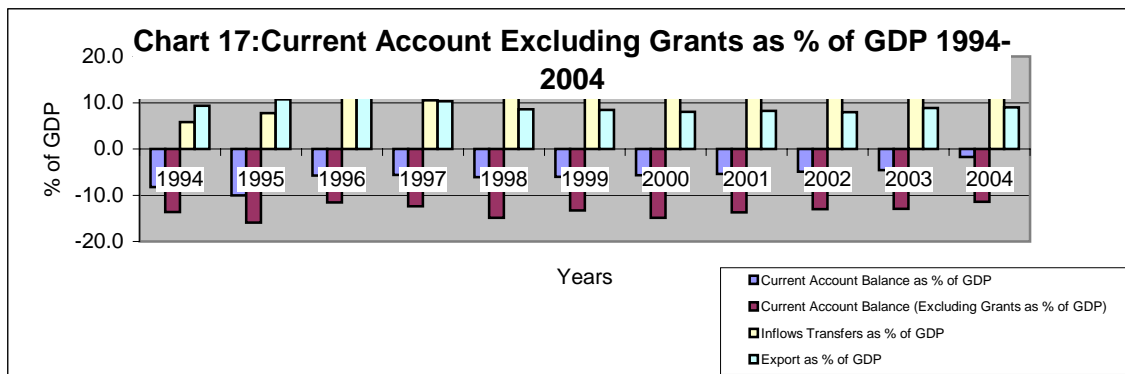


The current transfer balance that forms the portion of the CAB recorded surpluses for the period under review with an overall average growth rate of 17.2 percent and 10.4 percent on the inflows and outflows respectively. This is particularly interesting to note since it reflects a picture of inflows growing at higher rates than outflows. The result is that surpluses are applied to significantly decrease deficits recorded in the overall CAB.



CAB deficits significantly increase when grants¹² are excluded. The deficits oscillated between 10.2 percent and 14.9 percent of GDP with an average of 12.8 percent. In terms of percentage contribution of export earnings, from 1994 to 1996, the CAB increased from 9.4 percent to 10.5 percent of GDP on account of high international coffee prices which was the main export at that time. Transfer inflows in 1994 and 1995, as a percentage of GDP were 5.8 percent and 6.7 percent respectively and dropped to 4.1 percent in 1997. Transfer Inflows grew steadily from 1997 to 2002 from 11.8 percent of GDP before decreasing to 11.4 in 2003 and rose to 13.3 in 2003 as percentage to GDP. Foreign aid and workers remittances have grown considerably on the transfer inflows that have contributed significantly to the reduction on the overall deficit on CAB in the face of declining contribution of export earnings dropped. Benefits of diversification and export value addition are notable from 2002 to 2004, as percentage contribution of exports to GDP increases from 8.2 percent to 9.0 percent respectively.

¹² Grants include budget support and project and HIPC



4. Proposed Recommendations and Conclusions

Countries that have been major recipients of capital flows have experienced difficulties with managing these capital inflows in general. In circumstances where investor confidence was lost, large capital outflows and policy reversals have been reported. It is simply not just the volume of flows that matters in those circumstances, but rather the speed at which such flows change direction. The inherent volatility resident within the flows may cause disruptive effects in the economy including triggering unsustainable current account deficits. Worse still as the economy loses capital stock and national output may be affected. Based on data available, on the composition and trends of capital flows and the behaviour of current account deficits in Uganda, the following recommendations could be made with the view to quantifying appropriate measures for understanding the impact of the movement of these sustainability indicators:

4.1 Proposed recommendations

a) Statistics for the BOP and the IIP to Meet International Standards and Codes

It is imperative to enhance appropriate monitoring mechanisms for capital flows and current account transactions. Credible tracking is essential so that the impact of the flows on the economy can be clearly discerned given the volatility of these flows. Assessing the impact of capital flows and current account sustainability requires credible data. To enhance data reliability, it is important to share experiences of partner countries.

As to the conduct of data collection, it is also vital to strengthen Private Public Partnerships (PPP) in carrying the process; this can be implemented through increased sensitisation of the uses and benefits of quality data in a private sector led economy. To achieve this, it may require promoting electronic reporting and feedback.

African countries need to establish effective monitoring systems for private transfer receipts and payments. In addition, it is important to mobilize adequate funding and human resources for data collection and formalize arrangements for capacity building at regional and international levels for purposes of improving data collection.

b) Macroeconomic stability

The authorities in Uganda have long anticipated that there are potential benefits of capital account liberalization. It was perceived at the onset of the capital account liberalization that capital would flow to areas of the economy with higher returns, sharpen incentives to save and invest, and help to maximize economic growth. It would also expose firms and individuals to new and better means of spreading and managing risks, while encouraging

transfer of technology and management skills. This apart, capital liberalization was also expected to compel the authorities to maintain or achieve discipline within macroeconomic management. This is because under a liberalized system, capital flows respond rapidly to differences in perceived rates of return. In effect, the elimination of controls would require that the authorities manage economic policies in a manner that is consistent with the need to ensure that rates of return on assets remain compatible with those of competing countries to promote sustainable economic growth and development. Some of the measures would include the following:

- Low inflation
- Reduction of the fiscal deficit, raising the domestic revenue to GDP ratio and improving external public debt sustainability
- Reducing the Government's dependency on aid.
- Increasing private investment as a share of GDP, to boost private sector led economic growth.
- Increase employment levels and per capita income
- Increasing exports as a share of GDP and export diversification
- Improve the security situation in Northern Uganda
- Address outstanding governance issues.

Authorities should continue maintaining macroeconomic stability and achieving economic growth through creation of a stable environment for encouraging growth.

c) **Investment policies**

It is vital to continuously assess the impact of the investment climate and constraints faced by investors both local and foreign to promote increased output, which is key to sustainability. The investment promotion strategies and regulatory framework need to be regularly fine tuned to attract and retain investors to increase the magnitude of investment. Governments would therefore need to establish bilateral agreements with specific countries to attract specific investment on favourable terms. In addition, legal frameworks should be developed to reduce corruption activities for increased productivity. It is important for countries to ensure that the cost of transacting business are competitive and enables investors to realize acceptable returns on investment and to build of investors confidence.

d) **Financing**

The underdeveloped and shallow nature of the domestic capital financial market reduces the attractiveness of domestic financial assets and acts as an incentive to acquire foreign assets. In such an environment, a shortage of liquidity is experienced in the economy because private wealth is invested and stored abroad leading to net losses in total real resources available for investment and growth.

Low levels of portfolio investment reported, implies that deepening of the financial markets still requires attracting portfolio investors. It is important to implement policies that would therefore enhance the availability of long-term financing at lower cost.

Developments in infrastructure such as electricity, gas, water, transport, accommodation, communication and financing should be concretised in an effort to place the country at the forefront of international competitiveness. Prudent policies aimed at promoting to a stable and sound financial system.

e) **Regional integration**

The East African Customs Union (EACU), comprising Kenya, Uganda and Tanzania, was launched on 18th January 2005. The EACU will increase regional and global trade as it effectively establishes a single market of more than 90 million people, with a combined GDP of about US \$30 billion. Investors will have access to this large market, and it is hoped that individually the countries will diversify their production and export bases. Removing barriers to trade and allowing movement of people shall facilitate money and capital, economic activity facilitated in the region. These conditions are required to attract and retain capital inflows for investment. Foreign investment will lead to an in the production of capacity goods and services that are required for export diversification and import substitution. Increased exports earnings will significantly reduce the resource gap on the current account balance

4.2 Conclusion

Over the past decade, much of the success in Uganda's was due to the liberalization of markets and privatization of the public sectors. These measures enabled the private sector to begin to play a leading role in enhancing economic growth. During this period, the government retained a facilitating role in the process of ensuring macroeconomic stability through prudent fiscal and monetary policies, provision of improved infrastructure and regulatory framework. Private capital flows and donor funding played a pivotal role in financing the current account deficit given the low level of export. Growth in real GDP over the medium term will be largely driven by investment, and increased labour productivity. These are the key drivers that will lead to current account sustainability.

It is important for the government to continue with fiscal consolidation in the medium term. This should be done through limiting the amounts of annual new external borrowings and overall aid financed expenditure. The focus for government should be on enhancing domestic revenue mobilization and ensuring efficiency in public spending that is required for sustainability. The reduction in the fiscal deficit would allow for increased private sector credit by reducing Government borrowing from the banking system. This will in turn lead to increased investment and high GDP growth.

While in the medium term, aid continues to play a leading role in development efforts for Uganda; the focus should be on quality rather than quantity of aid. This means that Government should encourage more of grant aid in the form of budget support as opposed to borrowing as a way of financing the deficit, as the current levels of external debt stock may not be sustainable. This aid should be supportive of the Government's export led growth strategy.

The causes of current account sustainability are several. They may include an unstable political environment, macroeconomic instability, relatively high and uneven tax rates, insolvent financial and banking systems, shallow financial markets, increased incomes by some residents, and low or negative real interest rates. Domestic financial development is generally regarded as a necessary condition for liberalization since residents would be free to borrow and save abroad. Underdevelopment of the domestic capital market reduces the opportunities for investors. The financial markets are still in the embryonic stage and offers limited instruments to investors. The narrowness of the capital and money market is a key feature in the economy. Therefore, if there were constraints in the financial sector, it would deter investors. Furthermore, it can be argued that as residents accumulate more wealth amidst a shallow financial market, there will be a tendency to diversify their portfolio by investing abroad. As a result of these possibilities,

investors turn elsewhere for portfolio investment to store and protect their wealth. Availability of funds from IFIs, deterioration in terms of trade, corruption and weak protection of property rights may trigger off capital flight that causes the loss of productive capacity, tax base, and control over monetary aggregates. These factors altogether could impose a substantial burden on the economy, and render policy-making problematic and generate undesirable effects on the CAB.

While capital inflows are associated with economic benefits to developing countries, if not properly managed, these flows can cause economies to overheat, increase exchange rate volatility, and lead eventually to large outflows. To address these problems, policymakers have used a combination of countercyclical and structural policies, as well as other measures designed to reduce net capital inflows or change their composition or maturity and decrease their volatility. A careful sequencing of appropriate policies, therefore, is important in mitigating the risks associated with capital inflows.

Table 1: BOP CAB & CF Amounts in US\$ millions											
Years	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Goods Balance (net)	-313.7	-429.1	-336.9	-293.4	-488.9	-444.8	-453.9	-499.9	-573.8	-677.8	-753.6
a) Total Exports (fob)	462.9	556.4	641.8	592.6	510.2	485.8	460.0	475.6	480.7	563.0	705.3
b) Total Imports (fob)	-776.6	-985.5	-978.7	-886.0	-999.1	-930.5	-913.8	-975.4	-1054.5	-1240.8	-1458.8
Services Account (services net)	-291.4	-360.7	-317.5	-222.2	-259.2	-255.8	-225.2	-281.1	-310.4	-210.9	-248.9
a) Inflows (credit)	64.2	103.9	144.6	164.6	180.8	196.0	213.2	222.6	232.8	312.9	447.6
b) Outflows (debit)	-355.6	-464.7	-462.2	-386.8	-440.0	-451.9	-438.4	-503.7	-543.2	-523.8	-696.4
Income Account (Income net)	-89.2	-131.8	-95.3	-75.7	-92.5	-123.7	-155.3	-165.2	-124.0	-143.2	-172.3
a) Inflows (credit)	12.7	19.9	28.5	39.6	49.2	36.5	53.1	37.5	24.2	27.6	35.7
b) Outflows (debit)	-101.8	-151.7	-123.8	-115.3	-141.7	-160.2	-208.4	-202.7	-148.1	-170.7	-207.9
Current Transfers (net)	287.2	402.3	441.8	270.3	479.9	477.0	507.3	633.8	711.8	740.6	1038.2
a) Inflows (credit)	287.2	402.3	602.1	601.1	744.3	646.2	754.3	938.0	1078.9	936.4	1214.5
b) Outflows (debit)	0.0	0.0	-160.3	-330.7	-264.4	-169.3	-247.1	-304.2	-367.1	-195.8	-176.3
Capital Account											
a) Direct Investment	88.2	121.2	122.5	141.5	132.6	140.2	180.8	151.5	184.6	202.2	222.0
i) Direct investment abroad	0.0	-3.3	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Equity capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Reinvested Earnings	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other Capital	0.0	-3.3	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
ii) Direct investment in Uganda	88.2	124.5	121.5	141.5	132.6	140.2	180.8	151.5	184.6	202.2	222.0
Equity capital	78.2	89.5	110.0	110.8	68.0	71.9	105.1	86.5	99.6	102.1	126.4
Reinvested Earnings	10.0	35.0	11.5	8.6	15.8	16.7	16.6	42.1	42.1	51.9	60.1
Other Capital	0.0	0.0	0.0	22.1	48.8	51.6	59.2	22.9	42.9	48.2	35.4
b) Portfolio Investment	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.4	2.2	16.7	-16.9
Assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.5	-4.3	0.0
Equity Securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.5	-4.3	0.0
Debt Securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Money market instruments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.4	0.7	21.0	-16.9
Equity Securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.4	0.7	0.6	0.6
Debt Securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	20.3	-17.5
Money market instruments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	20.3	-18.2

e) Other Investment		199.7	168.9	58.0	230.8	163.6	126.8	175.4	300.1	24.3	192.0	139.7
Assets		-16.6	20.0	0.8	18.8	-36.0	-4.0	-37.1	29.4	-59.1	-124.9	0.1
Trade credits		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.4
Currency and Deposits		-16.6	20.0	0.8	18.8	-36.0	-4.0	-37.1	29.4	-59.1	-124.9	1.6
Other Assets		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-1.1
Liabilities		216.4	149.0	57.2	212.0	199.6	130.8	212.5	270.7	83.4	316.9	139.5
Trade credits		14.2	-11.5	-21.8	-0.5	-1.6	-1.8	-5.2	-10.7	-10.5	3.3	13.0
Loans		184.9	187.3	72.7	213.3	182.7	136.8	196.5	288.2	84.9	311.4	131.2
Currency and Deposits		17.3	-26.8	6.4	-0.9	18.5	-4.2	21.2	-6.7	9.0	-5.9	11.9
Other liabilities		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	8.1	-16.6
Net Capital Flows		287.9	290.2	180.6	372.3	296.2	267.1	356.2	452.0	211.1	410.8	344.7
Net Capital Flows as % of GDP		5.8	4.8	3.0	5.6	4.7	4.4	6.2	7.8	3.5	6.3	4.4
End Period exchange rate (US\$ per 1 US\$)		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	988.3	1738.6
Average exchange rate (US\$ per 1 US\$)		972.2	968.9	1046.1	1083.0	1240.2	1455.6	1644.5	1755.7	1797.0	1963.7	1810.7
CAB as a %age of GDP		-0.1	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0
CAB (Excl. Grants) as a %age of GDP		-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Total external Debt Stock (end of period)		0.0	3237.0	3464.0	3618.0	3492.0	3580.0	3404.8	3654.1	3961.4	4485.6	0.0
o/w External arrears		0.0	0.0	0.0	242.4	242.4	242.4	208.0	268.0	268.0	0.0	0.0
Total Debt Stock (end of period) as a %age of GDP		0.0	57.2	60.8	54.9	55.2	59.7	59.4	63.2	65.7	0.0	0.0
Total external reserves -bop transactions- (end of period) in future months of imports of goods & services		2.6	3.8	5.0	5.2	6.3	6.8	6.5	7.4	6.3	6.0	5.8

TABLE 2: International Investment Position (IIP)

Reporting currency: US dollars Million						
Period	1999	2000	2001	2002	2003	2004
International Investment Position, net	-3812.8	-3323.9	-3553.2	-4142.3	-4659.2	-5131.4
Assets	960.6	1070.1	1230.1	1171.1	1464.2	1728.7
Direct investment abroad	0.0	0.0	0.0	0.0	0.0	0.0
Equity capital and reinvested earnings	0.0	0.0	0.0	0.0	0.0	0.0
Claims on affiliated enterprises						
Liabilities to affiliated enterprises (-)						
Other capital	0.0	0.0	0.0	0.0	0.0	0.0
Claims on affiliated enterprises						
Liabilities to affiliated enterprises (-)						
Financial derivatives, net	0.0	0.0	0.0	0.0	0.0	0.0
Claims on affiliated enterprises						
Liabilities to affiliated enterprises (-)						
Portfolio investment	0.0	0.0	0.0	0.0	0.0	0.0
Equity securities	0.0	0.0	0.0	0.0	0.0	0.0
Monetary authorities						
General government						
Banks						
Other sectors						
Debt securities	0.0	0.0	0.0	0.0	0.0	0.0
Bonds and notes	0.0	0.0	0.0	0.0	0.0	0.0
Monetary authorities						
General government						
Banks						
Other sectors						
Money-market instruments	0.0	0.0	0.0	0.0	0.0	0.0
Monetary authorities						
General government						
Banks						
Other sectors						
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0
Monetary authorities						
General government						
Banks						
Other sectors						
Other investment	199.8	265.6	248.6	240.1	388.7	421.3
Trade credits	0.0	0.0	0.0	0.0	0.0	0.0
General government	0.0	0.0	0.0	0.0	0.0	0.0

Long-term						
Short-term						
Other sectors	0.0	0.0	0.0	0.0	0.0	0.0
Long-term						
Short-term						
Loans	0.0	0.0	0.0	0.0	0.5	1.0
Monetary authorities	0.0	0.0	0.0	0.0	0.0	0.0
Long-term						
Short-term						
General government	0.0	0.0	0.0	0.0	0.0	0.0
Long-term						
Short-term						
Banks	0.0	0.0	0.0	0.0	0.5	1.0
Long-term					0.5	1.0
Short-term						
Other sectors	0.0	0.0	0.0	0.0	0.0	0.0
Long-term						
Short-term						
Currency and deposits	199.8	265.6	248.6	240.1	388.2	419.3
Monetary authorities					26.0	13.5
General government						
Banks	199.8	265.6	248.6	240.1	362.2	410.2
Other sectors						-4.4
Other assets	0.0	0.0	0.0	0.0	0.0	1.1
Monetary authorities	0.0	0.0	0.0	0.0	0.0	0.7
Long-term						0.7
Short-term						0.0
General government	0.0	0.0	0.0	0.0	0.0	0.4
Long-term						0.4
Short-term						0.0
Banks	0.0	0.0	0.0	0.0	0.0	0.0
Long-term						0.0
Short-term						0.0
Other sectors	0.0	0.0	0.0	0.0	0.0	0.0
Long-term						0.0
Short-term						0.0
Reserve assets	760.8	804.5	981.5	931.1	1075.5	1307.4
Monetary gold						
Special drawing rights						
Reserve position in the Fund						
Foreign exchange	760.8	804.5	981.5	931.1	1075.5	1307.4
Currency and deposits	0.0	0.0	0.0	0.0	1075.5	1307.4
With monetary authorities						

With banks					1075.5	1307.4
Securities	0.0	0.0	0.0	0.0	0.0	0.0
Equities						
Bonds and notes						
Money-market instruments						
Financial derivatives ,net						
Other claims						
Liabilities	4773.5	4394.1	4783.3	5313.5	6123.4	6860.2
Direct investment in reporting economy	666.9	807.1	962.3	1146.9	1349.1	1571.1
Equity capital and reinvested earnings	451.3	539.9	700.3	842.0	996.0	1182.6
Claims on direct investors (-)						
Liabilities to direct investors	451.3	539.9	700.3	842.0	996.0	1182.6
Other capital	215.6	267.2	262.0	304.9	353.1	388.5
Claims on direct investors (-)						
Liabilities to direct investors	215.6	267.2	262.0	304.9	353.1	388.5
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0
Claims on affiliated enterprises						
Liabilities to affiliated enterprises (-)						
Portfolio investment	0.0	0.0	0.0	0.0	22.4	11.1
Equity securities	0.0	0.0	0.0	0.0	0.0	0.6
Banks						0.0
Other sectors						0.6
Debt securities	0.0	0.0	0.0	0.0	22.4	10.5
Bonds and notes	0.0	0.0	0.0	0.0	0.0	0.7
Monetary authorities						
General government						0.7
Banks						
Other sectors						
Money-market instruments	0.0	0.0	0.0	0.0	22.4	9.7
Monetary authorities						
General government					22.4	9.7
Banks						
Other sectors						
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0
Monetary authorities						
General government						
Banks						
Other sectors						
Other investment	4106.6	3587.0	3821.0	4166.5	4751.8	5278.0
Trade credits	0.0	0.0	0.0	0.0	0.0	0.0
General government	0.0	0.0	0.0	0.0	0.0	0.0
Long-term						

Short-term						
Other sectors	0.0	0.0	0.0	0.0	0.0	0.0
Long-term						
Short-term						
Loans	4069.4	3528.5	3769.3	4105.8	4672.9	5208.6
Monetary authorities	371.7	315.6	275.1	274.9	235.1	285.2
Use of Fund credit & loans from the Fund	371.7	315.6	275.1	274.9	235.1	285.2
Other long-term						
Short-term						
General government	3580.0	3088.7	3378.9	3686.5	4250.5	4753.8
Long-term	3580.0	3088.7	3378.9	3686.5	4250.5	4753.8
Short-term						
Banks	0.0	0.0	0.0	0.0	0.0	0.0
Long-term						
Short-term						
Other sectors	117.7	124.2	115.2	144.4	187.3	169.7
Long-term	117.7	123.4	114.3	139.9	172.2	144.6
Short-term	0.0	0.8	0.9	4.5	15.1	25.1
Currency and deposits	37.3	58.5	51.7	60.7	64.9	65.1
Monetary authorities						
General government						
Banks	37.3	58.5	51.7	60.7	64.9	65.1
Other sectors						
Other liabilities	0.0	0.0	0.0	0.0	14.1	4.3
Monetary authorities	0.0	0.0	0.0	0.0	0.0	2.4
Long-term						
Short-term						2.4
General government	0.0	0.0	0.0	0.0	0.0	0.0
Long-term						
Short-term						
Banks	0.0	0.0	0.0	0.0	14.1	1.9
Long-term					14.1	1.9
Short-term						
Other sectors	0.0	0.0	0.0	0.0	0.0	0.0
Long-term						
Short-term						

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