

THE FINANCIAL SYSTEM OF UGANDA

Bank of Uganda

This paper starts with an account of the monetary developments which led to the adoption in 1987 by the Ugandan authorities of the Economic Recovery and Rehabilitation Programme and of the resulting improvements in the banking system at the institutional, management and performance levels. It continues with an introduction to the financial system of Uganda with an emphasis on the Central Bank, the tools of monetary policy, the credit system, the exchange rate regimes and the foreign currency accounts. It ends with a listing of depository, financial service and other financial service institutions.

1. MONETARY DEVELOPMENTS (1989 - 1993)

Monetary Developments over the last three years (1989-1992) indicate an overall deceleration in monetary expansion arising from developments in both Total Domestic Credit and in Net Foreign Assets of the banking system. Prior to the launching of the Economic Recovery Programme in 1987, the economy was characterised by severe macro-economic imbalances caused by high inflation levels, low negative growth rates, persistent fiscal deficits and unsustainable balance of payment problems.

The above imbalances were mainly attributed to the existence of a weak and inefficient financial system due to a lack of confidence in the financial sector associated with poor management, capital inadequacy, poor asset quality, poor liquidity and low earnings. Secondly, lack of authority and autonomy by Bank of Uganda. Thirdly, fiscal and political factors that had largely influenced and weakened monetary control and discipline in achieving price stability over time. Fourthly, the Gulf war crisis that caused price hikes coupled with the adverse effects of the drought during 1991. Fifthly, shortfalls in import support disbursements and lower than anticipated coffee export prices.

In order to restore macro-economic stability and to promote economic growth, the government launched an economic recovery and rehabilitation programme with the major objective of

- (1) achieving a real rate of economic growth of at least 5%;
- (2) reduce the rate of inflation;
- (3) strengthen the underlying balances of payments including a reduction in the external current account deficit.

During the period under review, (1989-1992), M2 broadly defined as currency in circulation, private demand deposits and private time and savings deposits registered an increase of 48.17%, from USh79.1 billion in December 1989 to USh117.2 billion in December 1990. It followed an upward trend and rose by 63% to USh191.2 billion in December 1991, and finally rose by 30% to USh248.8 billion by December 1992, reflecting annual growth rates of 101.9%, 48.2%, 63.1% and 30.1%, respectively.

Total Domestic Credit increased from USh63.9 billion in December 1989 to USh205.3 billion in December 1992, reflecting annual growth rates of 122.9%, 59.2%, 64.2% and 22.9%, respectively. The erratic movement was largely due to an almost eightfold increase in net claims on government, rejuvenating from huge sums of government borrowing through ways and means.

Net foreign asset during the period registered annual growth rates of 113.4%, 88.3%, 73.7% and 10.2%, respectively.

2. DEVELOPMENTS SINCE JANUARY 1993

There has been a tremendous improvement in monetary aggregates since the last quarter of 1992 compared to those outlined above. M2 since January 1993 has registered a sharp slowdown in growth rates of 14.5%, 6.8%; 2.5% and 1.6% in the respective months.

The proportionate contribution by different components of broad money indicates that the share of currency in circulation slightly decreased from 41.3% in January 1993 to 36.3% in May 1993, reflecting the shift away from currency to demand and time and savings deposits. The proportionate share of private time and savings deposits in M2 increased from 23.3% in January 1993 to 24.5% in May 1993 reflecting increased mobilisation of domestic savings and increased confidence in the banking system.

The proportionate share of government in domestic credit has tremendously declined from 25.7% as at end December 1992 to 1.54% as at end May 1993, reflecting the active participation of government in the Treasury Bill market relative to the heavy borrowing from Bank of Uganda through ways and means and reduced crowding out effect of Government on the Private Sector.

Credit to the private sector registered percentage growth rates of 82.1, 91.4, 94.4, 96.0 and 98.5 in January 93, February 93, March 93, April 93 and May 93, respectively.

Since the launching of the economic recovery and rehabilitation programme, the annual inflation rate has declined from two digit levels of an average of about 57.0 percent in 1989/90 reaching a low of -1.5 percent in May 1993. The inflation rate however increased in the intervening period from 22.6 percent in March 1991 to 66.3 percent in May 1992, following the Gulf war in November/December 1991 that caused price hikes coupled with adverse effects of the drought and monetary expansion that ensued from fiscal indiscipline.

The success in the monetary policy management outlined since end December 1992 is attributed to the implementation of several monetary policy instruments by the monetary authority. These include:

- (1) Open Market Operations through the sale and purchase of Treasury Bills (Domestic OMO) and through sales of foreign Exchange at an auction and purchases of foreign exchange from Commercial Banks (Foreign OMO);
- (2) Change in Liquidity ratios;
- (3) Target for Net Credit to Government;
- (4) Change of statutory reserve requirement ratio for commercial banks to influence liquidity;
- (5) Liberalisation of interest and exchange rates;
- (6) Strengthening the prudential powers of Bank of Uganda over commercial banks;

- (7) Strengthening the regulatory role of Bank of Uganda;
- (8) Restructuring and capitalisation of problem banks;
- (9) The deregulation of internal crop marketing system which has alleviated the crop finance constraint, especially in the coffee sub-sector.

3. OUTLOOK FOR 1993/94

The outlook for 1993/94 appears to be bright. The capital base of commercial banks will be strengthened and financial intermediation deepened. A new Financial Institutions Statute is in place so is a new Bank of Uganda Statute which give Bank of Uganda autonomous powers over monetary policy and bank prudential supervision. The Foreign Exchange Statute is in place and an Interbank Market is being instituted. Improvements in management and the strengthening of competition in a liberalised climate are expected to bear more fruit in the future.

4. THE BANKING SYSTEM

A. THE CENTRAL BANK

1. Tools of Monetary Policy

i) Reserve requirement ratios

The reserve assets acceptable are commercial banks' deposits with Bank of Uganda (BOU). The reserve requirement ratio had been at 10% of total deposits from 1977 up to December 1992 when changes were made. In December 1992 the cash reserve ratio was lowered from 10% to 7% on time and savings deposits and again in March 1993, the cash reserve ratio on demand deposits was lowered to 8% from 10%. Compliance with this ratio is supposed to be on a daily contemporaneous basis. However, information on commercial banks' deposit base is available on a weekly basis with minimum delay. The penalty for non-compliance is 0.1 per cent per day on the amount of deficiency.

Minimum Liquid Assets Ratio

Bank of Uganda also imposes a minimum liquid assets ratio on banks' deposits. Since 1972 the ratio has been 20% on demand and 15% on time and savings deposits. Compliance requirements and penalties for non-compliance are the same as for the reserve requirement.

The ratio as an instrument for monetary policy purposes is limited. It is used more as a prudential supervision ratio.

ii) Open Market Operations

One of the instruments used in the Open Market Operations is the auction of Treasury Bills. In the past, treasury bills sales were not effectively used for monetary policy purposes in Uganda and interest rates were administratively determined. Instead they were used as means of financing fiscal deficits. Since 1992 the treasury bills auction has been integrated into the monetary management framework and it is an important instrument of BOU monetary policy.

Auctions are held weekly to determine market-based interest rates. The issues are for 91, 180 and 270 days maturities.

iii) Discount Rate

The types of securities eligible for rediscount are specified in the BOU Act. In the past there has been no clear limits on the use of central bank money via rediscount or simple advances. Rediscount was mainly used for crop finance bills when BOU was still empowered to lend for the purposes of crop financing. The formal application was submitted to BOU and decided on a case-by-case basis depending on the commercial bank's ability to repay.

Advances from BOU have on the other hand tended to be automatic. A negative clearing account automatically results in borrowing from the central bank.

It is envisaged that with the central bank playing a leading role in monetary policy formulation and management, these tools will be effectively employed.

In this respect, the central bank has revised both the bank rate and rediscount rate with effect from February 1993. The bank rate was lowered from 31 per cent per annum in December 1992 to 26 per cent per annum in February 1993. Similarly the rediscount rate was revised from 30 per cent per annum to 25 per cent per annum. The bank rate on central bank advances to commercial banks is thus 1% higher than the rediscount rate.

iv) Selective Credit Control

The BOU requires that commercial bank advances do not exceed 82.5 per cent of their deposits (maximum lending ratio). Compliance with this ratio is not strictly adhered to.

v) Interest Rate Setting

Before November 1992, interest rates in Uganda used to be administered and remained negative in real terms for most of the period. In November 1992, the interest rates were liberalised and key lending and deposit rates were market-determined and linked to the auction-determined Treasury Bill rate.

Thus interest rates paid on demand deposits are no longer subject to any minimum rate.

Interest rates on savings and on time deposits with maturities up to one year are also linked to the reference rate which is a moving average of the annualised discount rate on three-month treasury bills in the four preceding auctions.

Interest paid on savings deposits is nine percentage points below the average yield on treasury bills. Time deposits with less than six-month maturities, the minimum interest rate paid is six percentage points below the treasury bills (TB) reference rate.

For deposits with terms ranging from 6 months to one year, the minimum rate paid is five percentage points below the reference rate on TBs. Interest rates on time deposits with maturities longer than one year are negotiated.

Commercial banks' lending rates are set at three percentage points above the reference rate.

2. Credits by Central Banks

i) To Banks

Credits to commercial banks are extended by the central bank for the following reasons:

a) Short-term loan: This is specifically lent to the commercial bank to meet the deficiency on the statutory reserve account. This loan is automatic and applies for a maximum of two weeks by which the bank concerned is expected to normalise its position with the central bank, failure of which may lead to suspension from the clearing house.

b) Long-term loan: This is meant for banks with structural problems and is intended for medium term use and is considered on a case-by-case basis. The terms and conditions are negotiated between the respective commercial bank and BOU.

ii) Credit to State Economic Enterprises

The central bank used to extend credit to government parastatals like Coffee Marketing Board (CMB), Lint Marketing Board (LMB) for the purpose of purchasing export crops like coffee and cotton during the peak crop season. But this practice was stopped in 1990.

iii) Net Credit to Government

Government borrowing from BOU used to be in substantial amounts to finance its fiscal deposits. This practice used to fuel inflation. During the fiscal year 1992/93, Government made a substantial repayment to BOU instead and this facilitated monetary policy implementation. The net borrowing target for the fiscal year 1993/94 is zero.

3. Exchange Rate Regimes and Foreign Currency Accounts

i) Before February 1986, Uganda has adopted a system of weekly auctioning of foreign exchange but this was abolished and replaced by a fixed allocation system based on the official rate of Uganda of US\$ 1470 per US\$ but Sh 5000 per US\$ for nonessential imports. The purpose was to enable authorities to allocate foreign exchange consistently with government priorities.

ii) May 1987 witnessed a currency reform exercise with a substantial devaluation. The official exchange rate was adjusted from US\$ 14 per US\$ to US\$ 60 per US\$. The nominal rate of US\$ 60 per US\$ was held constant for over a year and the inflation rate still remained high.

iii) Between June 1988 and November 1989, the shilling depreciated from US\$ 60 per US\$ to US\$ 370 per US\$. In July 1989 the Special Import Programme II (SIP II) was launched to cover a wider import range than SIP I. Under this programme the dollar price was fixed at US\$ 400 per US\$ and the official rate maintained at US\$ 200 per US\$. The SIP II targets were the reduction in money supply, increased availability of goods and reduction in inflation. This programme was terminated in September 1989.

iv) In October 1989, a more attractive exchange rate policy was pursued. The shilling was devalued in October and November. The measures taken reduced the premium between the official exchange rate and parallel market rates. In 1990, exchange rate management was more

extensive and aimed at maintaining Uganda's export competitiveness with trading partners. The exchange rate was therefore adjusted on a monthly basis to offset the difference between the domestic rate of inflation and that of the trading partners.

v) July 1990 marked the move towards market-based exchange rates. Non-coffee exporters were allowed to retain all foreign exchange receipts from such exports. A parallel market was legalised in the form of Foreign Exchange Bureaux. The bureaux dealt in spot transactions at freely determined rates. Private demand for foreign exchange had to be channelled through the bureaux.

The emergence of the bureaux helped in narrowing the gap between the official exchange rate and the bureaux rate (drop in market premium).

The policy of regular devaluations continued to support the export sector.

vi) In January 1992 the foreign exchange auction of donor funds was introduced under the import support programme. The auctions were conducted weekly and the rate struck at the auction was automatically the official rate (official rate in Mid-January was USh 970 to 1 US\$)

vii) March 1992 the official rate stopped to be market-determined and the weighted bureaux rates adopted.

viii) In October 1992 virtually all transactions were transferred to the bureaux including government travel abroad, education, medical and remittances to foreign missions abroad.

ix) The number of bureaux operating stood at 78 by June 1993. Out of these 25 are bank-owned and 53 private-owned.

x) Residents are allowed to hold foreign exchange account deposits with their banks.

B. DEPOSITORY INSTITUTIONS

i) State Banks

The following banks:

- a) Uganda Commercial Bank Ltd.
- b) Co-operative Bank Ltd.

are what one would call government-owned banks because of the major share the government has invested in them.

The two banks and the other indigenous banks capture between 60-64% of the total deposits.

ii) Privately-owned Banks

The following banks are owned by indigenous Ugandans:

- a) Sembule Investment Bank Ltd.
- b) Nile Bank Ltd.

- c) Greenland Bank Ltd.
- d) International Credit Bank Ltd.
- e) Kigezi Bank of Commerce
- f) Centenary Rural Trust Bank

iii) There are six foreign-owned banks, namely:

- a) Barclays Bank
- b) Grindlays Bank
- c) Standard Chartered Bank
- d) Bank of Baroda
- e) Libyan Arab Uganda Bank
- f) Orient Bank

Their share of the market is between 36-38 per cent of total deposits.

C. FINANCIAL SERVICE INSTITUTIONS

Stock Exchange

Presently Uganda has no stock exchange market in operation. Steps are being taken to establish one.

D. OTHER FINANCIAL SERVICE INSTITUTIONS

1. State Banks

- (1) U.C.B.
- (2) Cooperative Bank

2. Development Banks

- (1) East African Development Bank
- (2) Uganda Development Bank
- (3) Development Finance Company, Uganda

3. Credit Institutions

- (1) Diamond Trust of Uganda Ltd.
- (2) Grindlays Bank International (U) Ltd.
- (3) Housing Finance Company of Uganda Ltd.
- (4) Mercantile Credit Bank Ltd.
- (5) Rapid Finance Company of Uganda Ltd.,

4. Insurance Companies

- (1) Uganda American Insurance Company
- (2) State-wide Insurance Company
- (3) Goldengate Insurance Company
- (4) Transtate Insurance Company

- (5) Platinum Insurance Company
- (6) Cooperative Insurance Company
- (7) Global Insurance Company
- (8) National Insurance Company
- (9) East African Insurance Company
- (10) United Assurance Company
- (11) Midland Insurance Company
- (12) Universal Insurance Company
- (13) Pan World Insurance Company
- (14) Interstate Insurance Company
- (15) Rio Insurance Company
- 16) Greenland Insurance Company
- (17) Jubilee Insurance Company

5. Others: Building Societies

- (1) Alliance Building Society