

## “Global Liquidity and Financial Contagion”

### Transcript of the comments by Louis Kasekende, Deputy Governor, Bank of Uganda

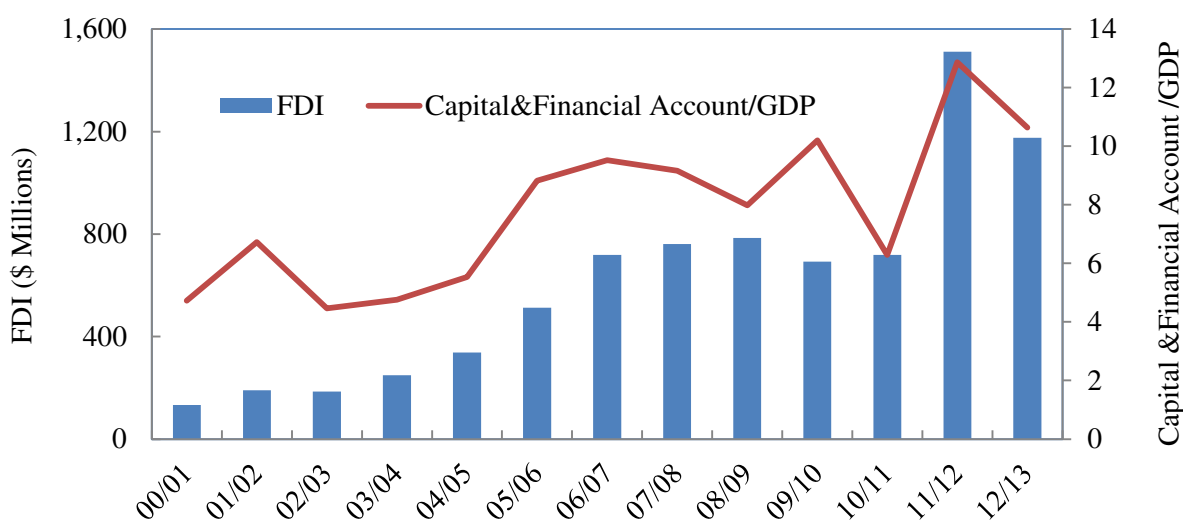
#### *Introduction*

Global liquidity and financial contagion have become increasingly important issues for macroeconomic and financial management, not just in the emerging market economies but also in the frontier markets in Africa which over the last decade have begun to attract external portfolio capital flows into their government securities markets and their banking systems. I want to sketch out the key lessons of the increased capital flows to frontier markets such as Uganda and the policy responses we have made to these challenges.

#### *The magnitude of capital flows to Uganda*

Following the removal of barriers to capital flows in 1997, Uganda’s capital and financial account balance rose from 4.7 percent of GDP at the start of the century to 11 percent of GDP in 2012/13. The largest single component of capital inflows is foreign direct investment (FDI) which rose from US\$186 million in 2002/03 to US\$925 million in 2012/13 (4.3 percent of GDP), while net portfolio capital flows peaked at US\$270 million in 2011/12. Although annual net portfolio capital flows are relatively small as a share of GDP (just over 1 percent at their peak), they are much more volatile than FDI. This volatility poses problems for economic management.

**Figure 1: Uganda: Foreign Direct Investment in US dollar millions (lhs) and capital and financial account surplus as a percent of GDP (rhs)**



Source: Bank of Uganda

The reasons for portfolio investment in Uganda are similar to those in other frontier and emerging markets. With strong economic growth and a relatively labour intensive economy, real rates of return to capital are much higher in Uganda than in the advanced economies; consequently there is a large interest rate differential between Uganda and the advanced economies. The one year Treasury Bill yield in Uganda is currently around 12 percent. The structural factors driving capital flows to frontier markets such as Uganda – the large interest rate differentials and their strong growth prospects - are unlikely to be reversed in the medium term, even with the tapering of quantitative easing in the advanced economies, provided that the economies of the frontier markets continue to be well managed and that political stability is maintained. Hence the challenge of managing the risks from capital flows to frontier markets will most probably intensify over the long term.

Policy makers are not indifferent to the composition of capital flows. FDI inflows clearly benefit the economies of frontier markets, because these economies need the technology and expertise that accompany FDI flows and because FDI raises the private investment rate which is essential for accelerating structural transformation. However, it is much less evident that portfolio capital flows generate significant benefits for frontier markets. Portfolio capital flows to Uganda are predominantly invested in swaps and deposits with the banking system or in government securities. Offshore holdings of government securities, as a share of the total holdings of these securities, peaked at 25 percent in June 2008 (just before the global financial crisis erupted) and now account for 15 percent of the total. While portfolio capital flows have helped to boost liquidity in the domestic market, their impact is not very important; most of the secondary market trading which takes place in the domestic securities market is between domestic investors.

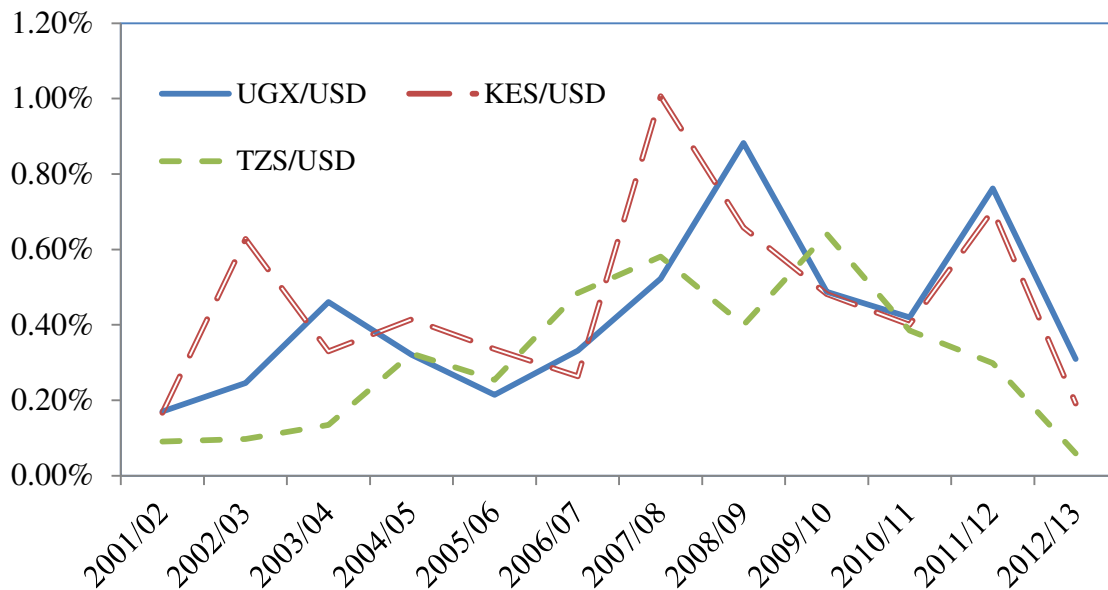
Portfolio investment flows include foreign currency flows and are predominantly short-term investments, and highly volatile. This creates potential problems and risks for both macroeconomic management and financial stability.

### ***The consequences for economic management***

Portfolio capital flows have implications for economic management, related to their impact on the exchange rate and on financial system liquidity. Portfolio capital flows have had a significant impact on the volatility of the exchange rate in Uganda. Figure 2 below shows that the Ugandan

and Kenyan exchange rates have been relatively more volatile than the Tanzanian exchange rate. Both Uganda and Kenya have open capital accounts whereas Tanzania imposes some controls on capital flows.

**Figure 2: Daily Exchange rate volatilities of the Kenyan, Tanzanian and Ugandan currencies**



Exchange rate volatilities are measured as the standard deviation of daily exchange rates during each year

Source: Bank of Uganda

Given thin foreign exchange markets, gross portfolio capital flows can be large enough to dominate other flows on a daily basis. If portfolio capital flows are sustained over several months, they can also cause persistent movements of the real exchange rate away from its equilibrium level. Both the short term volatility of the nominal exchange rate and persistent overvaluation of the real exchange rate are potentially very damaging for the competitiveness of traded goods industries and for incentives for private investment in these industries, which is clearly deleterious for long term economic development.

The implications for financial stability arise because a large share of offshore portfolio investment is invested directly in domestic banks, in the form of swaps and deposits, both in domestic and foreign currency denominated deposits. The main risk to financial stability is liquidity risk, because portfolio investment in bank liabilities is a form of short maturity non-core wholesale funding for the banks; funding which is inherently far more volatile than customer deposits. Short term offshore portfolio funding currently comprises less than five percent of total

banking system liabilities in Uganda and hence the liquidity risk that this poses for the banking system is relatively small. Nevertheless it is possible that, if Uganda attracts larger portfolio capital flows in the future, domestic banks may become more dependent on short term external capital, as has been the case for banks in other developing regions of the world, which would heighten liquidity risk.

### *Policy responses*

What are the implications for policy? The first priority for countries that face strong capital inflows is usually to preserve domestic monetary stability and minimize exchange rate misalignment and asset price volatility. To address the adverse exchange rate consequences of portfolio capital flows, the Bank of Uganda (BOU) has maintained an essentially floating exchange rate, while interventions in the market are conducted with the aim of smoothing out volatility and avoiding sustained appreciation of the real exchange rate which would damage competitiveness.

The main tool of Uganda's exchange rate management is sterilized intervention in the foreign exchange market; intervention is fully sterilized to ensure that monetary policy can be focused exclusively on domestic policy objectives (inflation and output). The BOU has also aimed to build up international reserves, to provide a buffer to stabilize the exchange rate in the event of a sudden capital outflow. It would be optimal for frontier markets to formulate targets for the level of foreign exchange reserves which they hold which are linked, not just to months of import cover, but to the economy's exposure to short term foreign capital.

However sterilized intervention is also problematic if undertaken on a large and sustained scale, not least because of the costs incurred by central banks. The interest rate paid on the domestic securities used for sterilization is currently around 12 percent, whereas the BOU receives a very low interest rate on the investment of its foreign exchange reserves. Consequently, if portfolio capital flows become larger and are sustained, it may be necessary to consider alternative policy instruments to discourage such flows or to mitigate their risks, such as the imposition of cash reserve requirements on banks' offshore liabilities. At the very least, portfolio capital investment should not be given favourable treatment relative to similar investment by domestic investors, in terms of tax or reserve requirements. In principle a variety of capital flow management measures could be a useful part of the central bank's tool kit, but the challenge is to identify which specific measures can be effective in reducing volatility or discouraging large and sustained inflows of portfolio capital.

Despite the destabilizing nature of portfolio flows to the stability of countries like ours, recent studies have shown that making the economy more closed through capital controls may be largely ineffective.<sup>1</sup> Some countries have substituted prudential instruments for capital controls.<sup>2</sup>

To address the liquidity risks to financial stability requires deployment of effective macroprudential instruments. The first requirement for the central bank is to compile accurate high frequency data to monitor these risks. The BOU is now compiling data on banks' exposures to offshore investors, and the currency composition and maturity of these exposures, on a weekly basis.

The BOU is addressing the liquidity risk to banks entailed in their relying on short term wholesale funds from offshore investors through the application of the Basel III Liquidity Coverage Ratio (LCR), separately to both the domestic currency and foreign currency exposures of the banks. Under the LCR, banks are required to cover all of their short term wholesale liabilities (with maturities of 30 days or less) with liquid assets. Prudential limits are also in place limiting banks' foreign currency mismatches by capping foreign currency positions to +/-25 percent of their capital. Furthermore, the foreign currency business rules limit banks' foreign currency lending to 80 percent of their foreign currency deposits. Uganda has also become the first country in East Africa to compile real estate price indices aimed at keeping track of risks from lending to the real estate market and we are now in the final stages of compiling a bank-wide loan to value ratio.

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<sup>1</sup> Fratzscher M., 2011 "Capital flows, push versus pull factors and global financial crisis" ECB Working Paper 1364/July 2011

<sup>2</sup> Subbarao D., 2013 "Capital Account Management" paper presented at Rethinking Macro Policy conference.