# Balance of Payments Deficits in Uganda: Should they Concern Us?

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## Abstract

*This article uses the International Monetary Fund (IMF) external vulnerability assessment framework to analyze Uganda's Balance of Payments (BoP) data to ascertain whether*

*BoP is largely sustainable based on external vulnerability assessment, persistent current*

*instead of more sustainable FDI is steadily leading to a build-up of debt. Further,*

*reserves falling below sustainable levels. While addressing persistent current account*

*to improve Uganda's BoP position. Here, addressing causes of imbalances in the current account will be critical. Towards this end, ensuring value for money in public investments will be crucial in not only reducing build-up of debt but also providing the economy wide*

*decades, it may be necessary for Uganda to take transitory measures to manage the BoP.*

**Key words: Balance of Payments Deficits, Current Account, External Vulnerability**

## Introduction

A Balance of Payments (BoP) is a record of all economic transactions between the residents of the country and the rest of the world in a particular period such as a quarter of a year or, more commonly, over a year. These transactions include payments for the country's exports and imports of goods, services, financial capital, and financial transfers. When all components of the BoP accounts are included they must sum to zero with no overall surplus or deficit.

A BoP is an important issue, for a few reasons. First, the BoP provides detailed information concerning the demand and supply of a country's currency. Second, a country's BoP data may signal its potential as a business partner to other countries of the world. Third, BoP data can be used to evaluate the performance of the country in international economic competition. Persistent trade deficits may signal that the country's domestic industries lack international competitiveness and vice versa (Cheol and Bruce, 2013; Sloman, 2004).

While the overall BoP accounts will always balance when all types of payments are included, imbalances are possible on individual elements of the BoP, such as the current account, the capital account excluding the central bank's reserve account, or the sum of the two. Imbalances in the latter sum can result in surplus countries accumulating wealth, while deficit nations become increasingly indebted. The term BoP often refers to this sum: a country's balance of payments is said to be in surplus by a specific amount if sources of funds such as export goods sold and bonds sold exceed uses of funds such as paying for imported goods and

paying for foreign bonds purchased by that amount and vice versa. A BoP surplus or deficit is accompanied by an accumulation or decumulation of foreign exchange reserves by the central bank.

In general, there is concern over deficits in the current account (Aleksander, 2006). Countries with deficits in their current accounts will build up increasing debt or see increased foreign ownership of their assets. Three types of deficits typically raise concern (Sloman, 2004): a trade deficit; an overall current account deficit; and, a basic deficit which is the current account plus foreign direct investment, but excluding other elements of the capital account like short-term loans and the reserve account.

The debate on whether BoP deficits matter has been mixed and is still evolving. The Washington Consensus period saw a swing of opinion towards the view that there is no need to worry about imbalances. Opinion swung back in the opposite direction in the wake of financial crisis of 2007-2009. Mainstream opinion has returned to the view that large current account imbalances do matter. Some economists do, however, remain relatively unconcerned about imbalances (Krishna, 2009), and there have been assertions that nations need to avoid the temptation to switch to protectionism as a means to correct imbalances (Michael, David, & Garber, 2009).

The debate withstanding, large and persistent BoP deficits can lead to a BoP crisis, also called a currency crisis. A BoP crisis occurs when a nation is unable to pay for essential imports or service its debt repayments. Typically, this is accompanied by a rapid decline in the value of the affected nation's currency. Crises are generally preceded by large capital inflows, which are associated at first with rapid economic growth (Eirc & Louis, 2005). However, a point is reached where overseas investors become concerned about the level of debt their inbound capital is generating, and decide to pull out their funds. The resulting outbound capital flows are associated with a rapid drop in the value of the affected nation's currency. This causes issues for firms of the affected nation who have received the inbound investments and loans, as the revenue of those firms is typically mostly derived domestically but their debts are often denominated in a reserve currency.

In late the 1990s and early 2000s Uganda had faced constraints in servicing its external debt obligations (Guloba, 2000). In early the 2000s, the country qualified for debt relief and forgiveness under the Highly Indebted Poor Countries (HIPC) and Multilateral Debt Relief (MDRI) initiatives respectively. These initiatives greatly improved Uganda's external debt and BoP position. Nevertheless, due to persistent current account deficits since then, the country's debt position has steadily increased, with implications on BoP sustainability.

Over the 2008/09 to 2015/16 period, Uganda's overall BoP has been characterized by persistent trade deficits. The trade deficit has averaged 9.4 per cent of GDP, as a result of lower exports growth that averaged at 11 per cent compared to imports that averaged 21 per cent during the same period. As a result, the current account has persistently been in deficit during this period, averaging 7.1 per cent of GDP. Driving this deficit is a persistent government fiscal deficit, aimed at financing public investments necessary to address the high infrastructure deficits. The large savings-investment gap (averaging 7.1 in the past five years) in Uganda

has implied that the country runs current account deficits so as to bridge the large investment deficit. The capital account financed part of the current account deficit on average by 5.6 per cent of GDP, leaving an overall BoP deficit averaging 1.5 per cent of GDP. The overall BoP deficit was largely financed by reserves leading to a decline in gross international reserves from 6 months of export cover (in 2007/08) to 4.5 (in 2015/16).

Uganda's persistent current account deficits do not necessarily make the BoP unsustainable, although several factors could make it susceptible to a BoP crisis. The capital account is largely dominated by external loans as foreign direct investments on average (2008/09-2015/16) contributed 49 per cent of the capital account. As such, the BoP heavily relies on external financing, which is creating a steady build-up of external debt. Total external debt has steadily risen from 11.4 per cent in 2008/09 to 21 per cent of GDP in 2015/16. Uganda's BoP is susceptible to external viability of Uganda's debt. Therefore, several factors could make the BoP unsustainable such as: high vulnerability to shocks (particularly weak economic growth shock), policy deficiencies, weak institutions, limited debt-management capacity and political risk (Ngobye & Guloba, 2017).

Against this background, the article analyzes Uganda's BoP data to ascertain whether BoP deficits should be a cause of concern for the country. The article uses the external vulnerability assessment framework developed by the International Monetary Fund (IMF) to ascertain whether BoP deficits should matter in Uganda.

The rest of the article is structured as follows: Section two provides literature on BoP crisis and causes. Section three provides the methodology used. Section four assesses Uganda's BoP data for external vulnerability. Section five provides policy implications and recommendations. Section six provides the conclusion.

## Literature

### History of the Debate on Whether BoP Deficits Matter

Historically, developing countries that chose to allow the market to determine their exchange rates would often develop sizeable current account deficits, financed by capital account inflows such as loans and investments, though this often ended in crises when investors lost confidence (Eirc and Louis, 2005; Heakal, 2009; Eswar, Raghuram, and Arvind, 2007). The frequency of crises was especially high for developing economies from 1973 to 1997. Emerging economies suffered 57 BoP crises and 21 twin crises. For advanced economies, there were 30 BoP crises and six banking crises.

A turning point was the 1997 Asian BoP Crisis, where unsympathetic responses by western powers caused policy makers in emerging economies to re-assess the wisdom of relying on the free market and, by 1999, the developing world as a whole stopped running current account deficits while the current account deficit of the United States of America (USA) began to rise sharply (Wolf, 2009). This new form of imbalance began to develop in part due to the increasing practice of emerging economies, principally China, pegging their currency against the dollar, rather than allowing the value to freely float. The resulting

state of affairs has been referred to as Bretton Woods II (Michael, David, and Garber, 2009). China circumvents the market mechanism by intervening in exchange markets and keeping the value of the yuan depressed (Chan, 2011). In contrast to the changed approach within the emerging economies, USA policy makers and economists remained relatively unconcerned about BOP imbalances. In the early to mid-1990s, many free market economists and policy makers argued that the growing US deficit was not a major concern (Wikipedia, 2016). While several emerging economies had intervened to boost their reserves, and assist their exporters from the late 1980s, they only began running a net current account surplus after 1999. This was mirrored in the faster growth for the US current account deficit from the same year, with surpluses, deficits and the associated buildup of reserves by the surplus countries reaching record levels by the early 2000s and growing year by year. Some economists (Wolf, 2009; Carmen and Kenneth, 2010) began warning that the record imbalances would soon need to be addressed from as early as 2001, but it was not until about 2007 that their concerns began to be accepted by the majority of economists.

Since the crisis, government intervention in BOP areas such as the imposition of capital controls or foreign exchange market intervention has become more common and in general attracts less disapproval from economists, international institutions like the IMF and other governments (Dani, 2010).

## Causes of BoP imbalances

There are conflicting views as to the primary cause of BoP imbalances. The conventional view is that current account factors are the primary cause (Duncan, 2008). These include the exchange rate, the government's fiscal deficit, business competitiveness, and private behaviour such as the willingness of consumers to go into debt to finance extra consumption (Wolf, 2009).

Theoretically, it is important to establish links between private and public savings, current accounts, real interest rates differentials and exchange rates. In particular, the question of the extent to which changes in the fiscal position either 'crowd-in' or '-out' the private sector should be addressed. An expansionary fiscal policy alters the domestic savings investment gap and spurs an excess world demand for savings (only partially offset domestically). The increased home demand for savings must be satisfied by the inflow of foreign capital, but the only way for this capital to be effected is by a move of the home country's current account into a deficit, a movement that is accomplished by a real appreciation of the domestic currency. In the longer term, the build-up of external debt resulting from a home country's fiscal expansion will cause the initial exchange rate appreciation to be reversed. As external debt service rises, the balance on net exports must improve steadily over time to maintain the same current account deficit, and this will require a gradual depreciation in the home country's real exchange rate. These longer-term stock-flow interactions can be analyzed by taking account of the effect of net investment and current account flows on the stocks of productive capital and total wealth (partly provided by the IIP), respectively (BoU, 2003).

## Sustainability of Current Account Deficits

Theoretical considerations raise practical issues such as the sustainability of the persistent deficits on the current account of the balance of payments. The following are some of the prerequisites for sustaining current account deficits (BoU, 2003):

1) If the deficit is to be financed from the foreign reserves of a country by means of reserve-related borrowing, the deficit would obviously be unsustainable. If, on the other hand, it were financed with direct equity investment, it would pose less of a threat to solvency because the dividends paid on such investments would depend on the success and profitability of the investments. Moreover, direct investments would bring along with it advantages such as technological transfer, employment creation and managerial skills. The other option for a sustainable current account deficit as has already been alluded to is a commensurate increase in the external debt of a country, especially if it is of a long-term nature with low interest rates.

2) The sustainability of a country's current account deficit is also possible if the foreign savings recipient country is investing in order to enhance its future earnings. However, the form of investments financed by foreign funds is of importance here. If the funds were invested in non-traded sectors, the deficit on the current account would be unsustainable at least in the medium term compared to if they were channelled into traded sectors. In the case of the former, the country's domestic terms of trade might deteriorate further, worsening developments on the current account.

3) The real interest cost of the capital inflows should be equivalent to the return on the additional investment that has resulted from the inflow. The real interest rate refers to the real rate of interest adjusted for exchange rate changes.

## Balance of Payments Problems in Uganda

In the late 1960s, Uganda faced various balance of payments problems caused by both external and internal factors. These include deteriorating terms of trade, oil price hikes, droughts, civil strife and wars, rampant insecurity and uncertainties, and so on. The fixed foreign exchange rate regime then, mounting payments problems, and dwindling foreign exchange reserves, resulted in a steady rise in the overvaluation of the Uganda shilling. One of the consequences of the overvalued currency in the face of administered exchange controls was the emergence of the parallel (*kibanda*) market in foreign exchange during the 1970s (Hyuha, 2017).

While currency devaluations and depreciations were generally avoided until the 1980s, the government tried to lessen the over valuation of the Uganda shilling through a variety of foreign exchange policy regimes. The official exchange rate depreciated from Shs 7.14 per US dollar in 1970 to Shs 5,000 in June 1986 in terms of the old currency; or from Shs 60 per US dollar in 1987 to Shs 800 per dollar in July 1991 in terms of the new shilling.

As the official exchange rate depreciated over time, two things occurred. First, the unofficial or parallel (*kibanda*) foreign exchange rate also depreciated. For instance, in terms of the old currency, the *kibanda* rate depreciated from Shs 970 per US dollar in January 1985

to Shs 14,393 in April 1987; and from Shs 106 in July 1987 to about Shs 950 in June 1991 in terms of the new currency. Second, devaluations and depreciations went hand in hand with rising inflation rates in the country. For instance, inflation rose from about 5 percent in the late 1960s to four-digit figures by 1985. In terms of the new era (after 1986), it hovered around 300 percent per annum before dropping to 23 percent in December 1990 and 38.7 percent in June 1991.

While the current and capital accounts were liberalized in 1994 and 1997 respectively, like other SSA countries, Uganda has faced external financing constraints with the current account position and the sustainability of external debt representing the overriding considerations for the formulation of economic policy (BoU, 2003). To ease BoP financing challenges, the World Bank and IMF provided debt relief under the HIPC Initiative in 1997 and the Enhanced HIPC in the 2000s. Further, under the Multilateral Debt Relief Initiative (MDRI) in 2005, Uganda received 100 per cent debt relief on eligible debt from three multilateral institutions. This significantly improved Uganda's BoP position. Nevertheless, due to persistent current account deficits since then, the country's debt position has been increasing steadily, with implications on BoP sustainability.

In this regard, therefore, this article uses the International Monetary Fund (IMF)-developed external vulnerability assessment framework to analyze Uganda's BoP data to ascertain whether BoP deficits should be a cause of concern for the country.

## Methodology

To assess whether Uganda's BoP deficits matter, a methodology developed by the International Monetary Fund (IMF) is used. This methodology assesses indicators of External Vulnerability to ascertain the sustainability of BoP deficits and the extent to which they may lead to a BoP crisis.

In countries like Uganda that maintain restrictions on private international financial flows or have limited access to world capital markets, current account deficits are financed mainly through changes in gross foreign reserves. Movements in reserves are also the main tool to support a fixed exchange rate regime. In such countries, a traditional indicator of external vulnerability compares the country's stock of international reserves to its monthly import bill. A general rule of thumb is that reserves should be equal to at least three months of imports of goods and services (IMF, 2007).

In countries with access to world capital markets, on the other hand, current account imbalances can be financed not only through changes in official reserves, but also through foreign borrowing, portfolio inflows, or direct foreign investment. In these countries, current account imbalances reflect not only an excess of imports over exports, but also payments related to interest on foreign debt or repatriation of dividends. In addition, amortization of outstanding loans or bonds or divestments by foreign investors can place pressure on the BoP. For these countries, the ratio of reserves to imports is a poor indicator of external vulnerability, and is hence usually complemented by other indicators. Several notable indicators are employed:

1) The ratio of broad money to reserves indicates the extent to which the demand for converting highly liquid domestic financial assets into foreign currency can be met

through reserves. This ratio is a useful indicator of the ability of the central bank to withstand a speculative attack, particularly under a fixed exchange rate regime.

2) The ratio of short-term debt to reserves measures the ability of reserves to cover amortization payments on external debt coming due within the next year. It is useful for assessing the likelihood that a country might have to default or reschedule its debt in the near future. Short-term debt ideally should include both debt issued with an original maturity of less than one year and debt issued with longer maturity but coming due within the next year.

3) The recent behaviour of the exchange rate is also an indicator of confidence in the domestic currency and the health of the country's external position, as are ratings assigned by international credit rating agencies to foreign-currency-denominated government debt.

4) The interest rate spread, or the differential between interest rates paid by the government (or highly rated private domestic borrowers) and a suitable reference rate, is also a signal of the perceived creditworthiness of the country.

If the country issues international bonds that are actively traded in secondary markets, the prices of those bonds are also an indicator of the perceived creditworthiness of that country. An advantage of this indicator is that it is available at high frequency (often on a daily basis), and not just on those dates at which the country actually issues securities. Movements in secondary market bond prices (or spreads, computed as the difference between the interest rate implied by the price and a risk-free interest rate) provide a useful yardstick to measure how investors' view of the country's creditworthiness evolves over time, and how it reacts to domestic developments, such as policy changes or macroeconomic shocks. Sudden, sharp increases in spreads typically signal a loss of confidence by foreign investors, and may precede or accompany a currency crisis or a sudden stop.

The article uses these measures to assess Uganda's BoP deficit sustainability.

## Analysis of Uganda's BoP Deficits

### Uganda: Analysis Deficit Trends in BoP, 2001-2016

Uganda has faced persistent current account deficits, averaging 6.4 per cent of GDP in the last 10 years (Figure 1). Large trade deficits, averaging 9.4 per cent of GDP, are the main drivers of this current account deficit. They have been largely financed by capital and financial inflows leading to build up of adequate reserves.
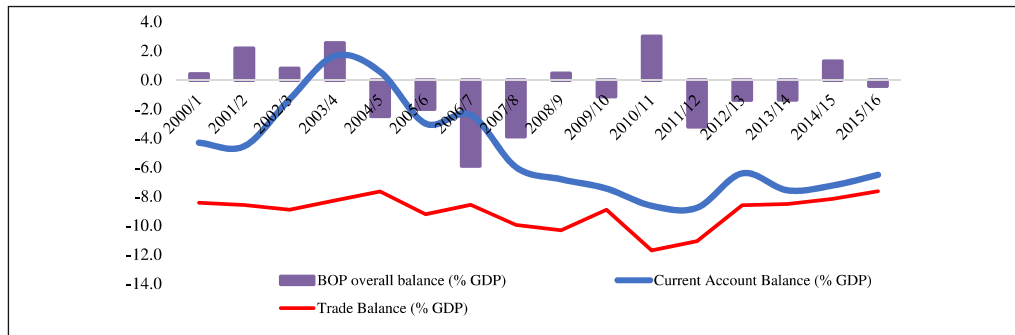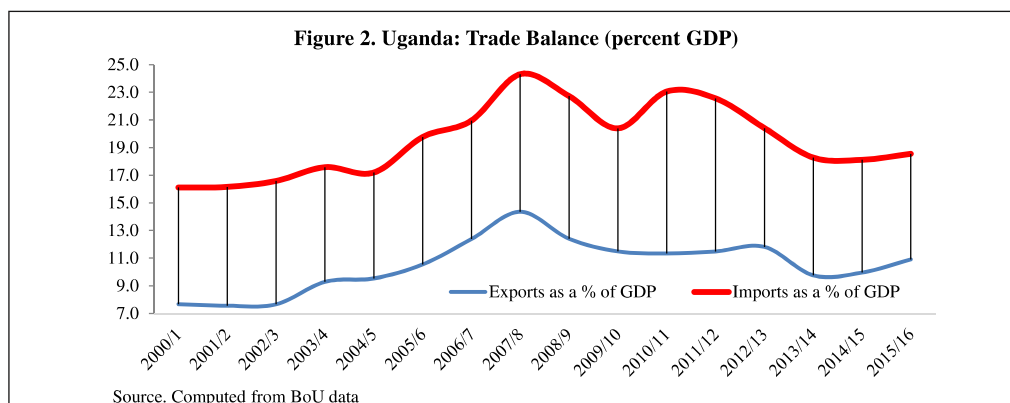
*Source. Computed from BoU data*

Uganda's persistent current account deficits are largely due to persistent savings-investment gap, that has averaged 7 per cent of GDP in the last 5 years. Particularly, the public sector has accounted for 72 per cent of the savings gap. As such, closing Uganda's current account deficit will largely depend on public sector behaviour, productivity and savings. While government's policy priority of addressing Uganda's current infrastructure deficit is commendable and key to the country future growth prospects, efficiency and value for money in execution of this policy direction is critical for the sustainability of the current account and BoP deficits.

years. That is basically due to the still weak export capabilities while the economy has many and diverse demands for imported goods. Evidence shows that several countries at this stage

2013).This pattern means that Uganda may need to take a long-term view in perceiving and

exportables and their upgrading in value-addition.

*Figure 2. Uganda: Trade Balance (percent GDP)*



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Source. Computed from BoU data

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Exchange rate policy has not been significant in narrowing the trade deficit. Despite the depreciating exchange rates of the Uganda currency (Figure 5), exports response has been similar to that of imports. This situation is not that surprising because competitive exchange rates would work only in an economy with a strong manufacturing basis (Ramanayake & Lee, 2016). Depreciation often tends to exert countercyclical effects of recovering exports and growth in economies with strong manufacturing base (or non-negative effects on average), which is not the case in primary commodity exporting economies.

Part of this persistent trade deficit is Uganda's weak terms of trade that deteriorated by 2.8 per cent in 2016/17. This shows low value addition in the country's exports that are largely primary commodities, mainly coffee, fish, tea and tobacco. Trying to increase the volume of exports faces the so-called 'Adding-up' problem (Spence, 2011) which refers to the situation of developing countries exporting the same goods and thus flooding the market, leading to ever lower prices of the goods. This problem is also called the fallacy of composition, which is real in Africa, given the situation that many neighboring countries in Africa export similar products like coffees or flowers to advanced economies, mostly in Europe.

potential (NPA, 2017). The main driver of this low productivity is lack of cheap

## Uganda: Measures of External Vulnerability

Uganda's Capital inflows are fostered by a policy of floating real exchange rate and high domestic interest rates caused by persistently large budget deficits. The capital inflows are generally sufficient to cover the current account deficits (Figure 1 and Table 1) and accumulate official reserves (Figure 4).

*Figure 3. Uganda: Net Capital Flows*



**Figure 3. Uganda: Net Capital Flows**
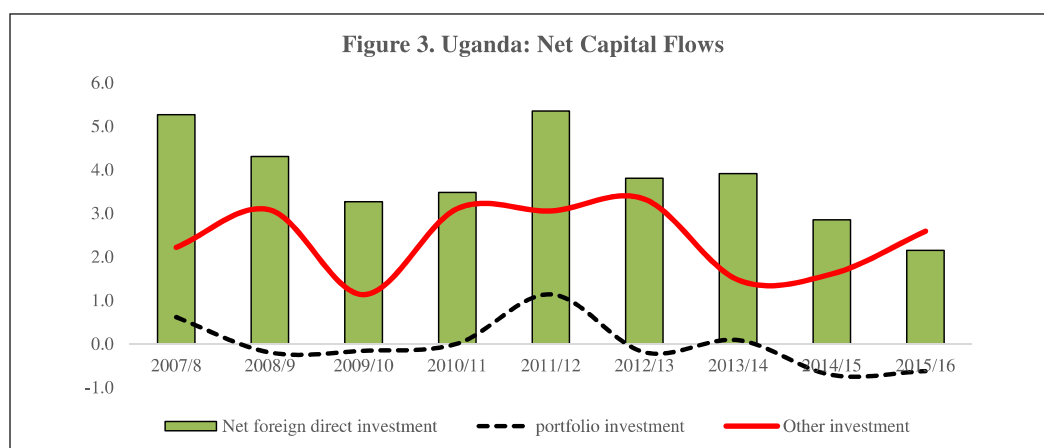
During 2007-2015, capital inflows were generally sufficient to finance the current account deficit and maintain adequate foreign exchange reserves (Table 1). Net foreign direct investment flows were significant, covering on average 50 per cent of the current account deficit. However, this has declined in recent years (Figure 3). Most of the capital inflows are loans, resulting in the build-up of external debt. Uganda's external debt grew from US$1.5

billion (12 per cent of GDP) in 2006/7 to US$5.3 billion in 2015/16 (21 per cent of GDP). A significant portion of this debt (90 per cent) is public debt. While Uganda's international reserves also increased markedly in the 2000s, the growth of external debt generally threatens to outstrip the increase in official reserves.

However, the increasing reliance on debt and reserves financing as FDIs decline is not sustainable. On one hand, debt financing is gradually leading to a build-up of debt, while reserve financing could lead to deterioration of reserves cover to unsustainable status. However, if on the other hand it were financed with direct equity investment, it would pose less of a threat to solvency because the dividends paid on such investments would depend on the success and profitability of the investments.

Among private sector non-financial firms, only a select few have sufficiently high credit quality to access international capital markets directly. Hence, foreign capital inflows are mainly to the government and domestic financial firms.

*Figure 4. International Reserves and Debt Trends*
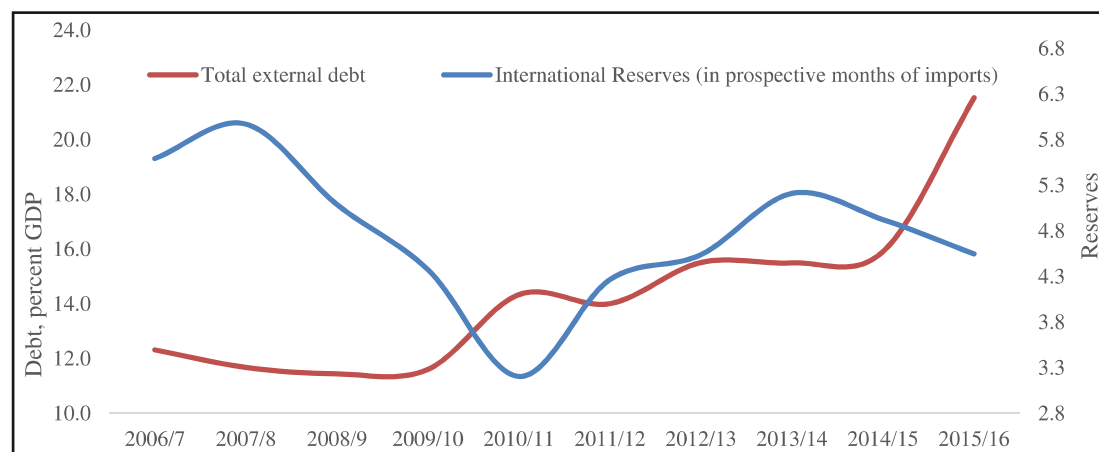


*Source. Computed from BoU data*

Averaging over 4 months of export cover, Uganda's foreign exchange reserves have been adequate to provide cushion to BoP pressures. However, the declining reserve cover as a result of BoP financing is not sustainable (Figure 5). Despite persistent current account deficit, capital inflows driven by a conducive macroeconomic environment and high interest rates have been adequate to finance the deficit and help a buildup of adequate reserves. Nevertheless, persistent current account deficit has to be supported by more sustainable financing in the current account so as to sustain adequate reserve cover.

*Figure 5. Uganda: Exchange rate Behavior*
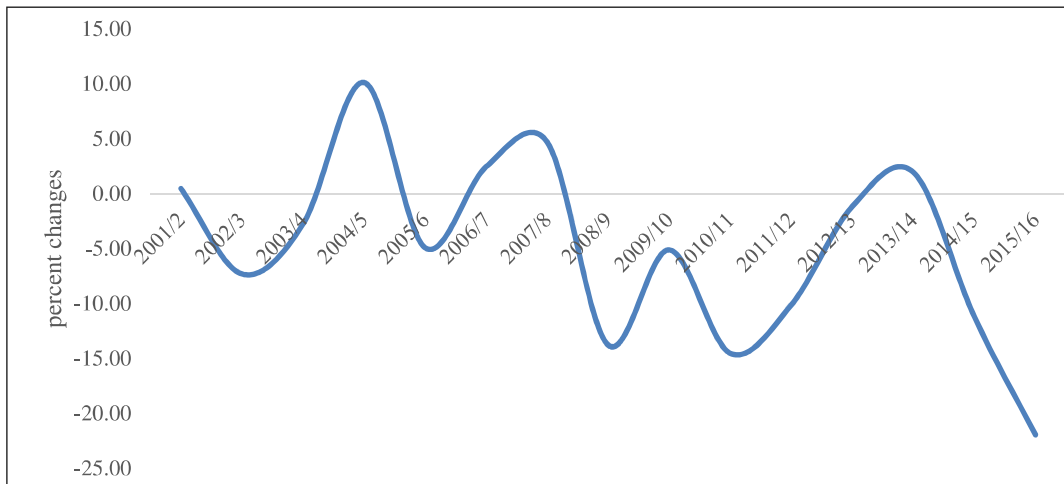


*Source. Computed from BoU data*

Uganda's nominal foreign exchange rate story is that of a depreciating trend (Figure 5). However, while this depreciating trend has largely been insignificant, the recent depreciation (2015-16) pointed to weakened confidence in the domestic currency. The election period and weakened economic fundamentals led to loss in confidence in the domestic currency and weakened Uganda's external position.

Foreign exchange reserves are also adequate to domestic currency crisis. Except in 2009/10 (1.5) and 2010/11 (1.9) the ratio of broad money to reserves averaged 1.2 per cent or lower (Table 1). This meant that foreign reserves approximated one to one with the domestic currency available and as such, the country could withstand a speculative attack on the domestic currency.

Table 1. Uganda: Indicators of External Vulnerability, 2001-16

| | 2000/1 | 2001/2 | 2002/3 | 2003/4 | 2004/5 | 2005/6 | 2006/7 | 2007/8 | 2008/9 | 2009/10 | 2010/11 | 2011/12 | 2012/13 | 2013/14 | 2014/15 | 2015/16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Current Account Balance | -4.3 | -4.6 | -1.3 | 1.6 | 0.6 | -3.0 | -2.4 | -6.0 | -6.8 | -7.5 | -8.7 | -8.8 | -6.4 | -7.6 | -7.3 | -6.5 |
| Capital and financial account balance | 4.7 | 6.7 | 4.0 | 5.0 | 5.3 | 6.1 | -49.2 | 7.9 | 6.5 | 7.5 | 4.0 | 9.0 | 5.9 | 5.9 | 2.7 | 3.3 |
| o/w: portfolio investment | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 | -0.1 | 0.7 | 0.6 | -0.2 | -0.2 | 0.0 | 1.1 | -0.2 | 0.1 | -0.7 | -0.6 |
| Other investment | 2.8 | 4.0 | 4.0 | 2.5 | 1.2 | 1.0 | -26.0 | 2.2 | 3.1 | 1.1 | 3.1 | 3.1 | 3.3 | 1.5 | 1.6 | 2.6 |
| Net foreign direct investment | -2.3 | -3.1 | -2.8 | -3.4 | -3.7 | -5.1 | -6.0 | -5.3 | -4.3 | -3.3 | -3.5 | -5.4 | -3.8 | -3.9 | -2.9 | -2.1 |
| Net Foreign Assets (NFA) of commercial banks ( US$ millions) | 195.9 | 269.3 | 327.6 | 326.1 | 351.0 | 256.7 | 277.1 | 441.5 | 314.6 | 296.3 | 221.0 | 428.2 | 64.2 | -223.6 | -148.2 | -78.6 |
| International Reserves (US$ millions) | 663.4 | 862.8 | 894.1 | 898.7 | 1,055.0 | 1,129.4 | 1,548.8 | 2,305.5 | 2,287.9 | 2,098.5 | 1,826.9 | 2,730.4 | 2,866.4 | 3,363.8 | 3,203.3 | 2,663.1 |
| International Reserves (in prospective months of imports) | 5.8 | 6.8 | 6.9 | 6.4 | 6.0 | 5.1 | 5.6 | 6.0 | 5.1 | 4.4 | 3.2 | 4.3 | 4.5 | 5.2 | 4.9 | 4.5 |
| Broad money to reserves (ratio) | 1.1 | 1.0 | 1.0 | 1.1 | 1.2 | 1.2 | 1.1 | 1.0 | 1.1 | 1.5 | 1.9 | 1.1 | 1.2 | 1.2 | 1.2 | 1.3 |
| Total external debt (US$ millions) | 3,395.2 | 3,825.2 | 4,215.5 | 4,464.9 | 4,416.3 | 4,464.4 | 1,466.8 | 1,687.0 | 2,046.4 | 2,343.4 | 2,904.9 | 3,254.1 | 3,825.2 | 4,300.7 | 4,380.1 | 5,309.2 |
| Total external debt | 58.1 | 61.5 | 63.8 | 61.8 | 47.9 | 44.8 | 12.3 | 11.7 | 11.4 | 11.6 | 14.3 | 14.0 | 15.5 | 15.5 | 15.9 | 21.5 |
| Average Ex-change rate | 1,762.9 | 1,754.6 | 1,882.9 | 1,934.9 | 1,739.2 | 1,824.9 | 1,780.0 | 1,696.5 | 1,930.0 | 2,028.9 | 2,323.4 | 2,559.1 | 2,588.9 | 2,538.3 | 2,823.2 | 3,443.0 |

## Conclusion, Policy Implications and Recommendations

While the BoP is largely sustainable based on external vulnerability assessment, persistent current account imbalances need to be addressed. Increased reliance on external loan financing instead of more sustainable FDI is steadily leading to a build-up of debt. Further, international reserve financing of recent BoP deficits risks reserves falling below sustainable levels. While addressing persistent current account deficits may not be possible in the short-term, a long-term policy perspective is necessary to improve Uganda's BoP position. Here, addressing causes of imbalances in the current account will be critical.

As debt is steadily building up to finance the current account deficits, risks to debt sustainability have increased. The scaling-up of investment spending and related increases in semi-concessional borrowing lead to increased vulnerabilities. In turn, failure to realize the envisaged growth dividend from the increased investment is a key risk as the historical scenario illustrates. The muted export performance remains another important risk, with the large impact of the shock scenario relative to the baseline being due to the significant volatility in export growth, which exceeds the historical average growth rate of exports. This highlights the importance of enhancing the country's competitiveness to boost exports over the medium term, including through effective public investment to fill infrastructure gaps. If growth and exports prospects were to be revised down in the future, this could adversely affect Uganda's risk rating, as could additional reliance on non-concessional borrowing that would not lead to higher growth rates.

Addressing causes of imbalances in the current account will require dealing with trade deficits. Given that getting out of the trade deficits may take several decades, it may be necessary for Uganda to take transitory measures to manage the BoP. One of the policy choices is exchange rate policy that has to deal with the fact that export promotion and free capital mobility cannot go together because export promotion often involves under-valuation of currencies (or because typical economic conditions in emerging economies tend to involve frequent depreciation) which works as a signal or incentive for people to take their money abroad (or put their money in foreign currency-dominated bank accounts). As such, a critical policy choice is how open should the capital account be for Uganda to pursue an export promotion policy? A depreciation policy without corresponding addressing of the supply-side constraints in Uganda may have negative effects on the economy and can worsen the BoP instead of correcting the imbalances.

A long-term trade policy that encourages production and discourages consumption will be critical. The trade policy should incentivize capital goods while discouraging consumer goods imports. Countries have used 'asymmetric protection' (see Shin and Lee, 2013) towards this end.

Uganda being a low-income and thus low-domestic saving country must look for ways of achieving and maintaining a higher investment rate sustainably beyond relying on foreign capital. Towards this end, the low interest rate policy becomes key. The current interest rates in Uganda are very high, over 24 per cent, in contrast to very low interest rates to savings. This situation is not good for private investment and reflects the asymmetric power and dominance

of the lender over borrower, and also the banking sector over the real sector. If both sides have equal power, saving interest rates should also be high. In other words, financial markets seem to be oligopolistic and imbalanced in power of the supply and demand side, and cannot be said to be an effective competitive market, which may justify some form of government intervention.

Efficiency, value for money and boosting public sector savings are critical to the long-term health of Uganda's BoP position. While government's policy priority of addressing Uganda's current infrastructure deficit is commendable and key to the country future growth prospects, efficiency and value for money in execution of this policy direction is critical for the sustainability of the current account and BoP deficits.

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