IMF Country Report No. 18/10

UGANDA

January 2018

UGANDA—TECHNICAL ASSISTANCE REPORT—MONETARY AND FOREIGN EXCHANGE OPERATIONS, RECAPITALIZATION, AND ACT REVISION

This Technical Assistance report on Uganda was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed on March 2015.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

UGANDA

March 2015

TECHNICAL ASSISTANCE REPORT—MONETARY AND FOREIGN EXCHANGE OPERATIONS, RECAPITALIZATION, AND ACT REVISION

Prepared By
Monetary and Capital Markets Department

This technical assistance (TA) report was prepared by the mission to Uganda during March 13–25, 2015, led by Ms. Veronica Bacalu. The mission comprised Asad Qureshi, MCM; Alain Vandepeute, Advisor, East AFRITAC; Kenneth Sullivan and Darko Bohnec, both Experts.

CONTENTS

BOXES

FIGURES

TABLES

APPENDICES

Glossary

BOU	Bank of Uganda
CBR	Central Bank Rate
FX	Foreign Exchange
FMOC	Foreign Exchange Operations Committee
FERMPC	Foreign Exchange Reserve Management Policy Committee
FEOL	Foreign Exchange Open Limit
FMDCS	Financial Markets Development Committee Secretariat
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GMRA	Global Master Repo Agreement
GOU	Government of Uganda
IFEM	Interbank Foreign Exchange Market
ILF	Intraday Liquidity Facility
IMF	International Monetary Fund
ITL	Inflation Targeting Lite
ISDA	International Swaps and Derivatives Association
IFRS	International Financial Reporting Standards
LOLR	Lender of Last Resort
MCM	Monetary and Capital Markets Department of the IMF
MOFPED	Ministry of Finance, Planning and Economic Development of Uganda
MRA	Master Repo Agreement
OMO	Open Market Operations
PD	Primary Dealer
PSI	Policy Support Instrument
RTGS	Real Time Gross Settlement System
TA	Technical Assistance
TSA	Treasury Single Account
UCF	Uganda Consolidated Fund
UGX	Ugandan shilling

PREFACE

At the request of the Bank of Uganda (BOU), a technical assistance (TA) mission from the Monetary and Capital Markets Department (MCM) of the International Monetary Fund (IMF) visited Kampala on March 13–25, 2015, to assess and provide recommendations on monetary and foreign exchange operations, Bank of Uganda recapitalization, and Bank of Uganda Act revision (March 13–25, 2015).[1]

In carrying out its work, the mission met with Governor Prof. Emmanuel Tumusiime-Mutebile, Deputy Governor Dr. Louis Kasekende, Executive Directors, and other senior staff of relevant departments of BOU; Director of MoFPED Lawrence Kiiza, senior staff of the Ministry of Finance (MOFPED), chief executive officers and senior staffs of several commercial banks, management of the Ugandan Banking Association, and business representatives.

The mission would like to express its gratitude to Governor Prof. Emmanuel Tumusiime-Mutebile , staff of the BOU, the MOFPED, and all its other counterparts for the excellent cooperation, kind hospitality as well as the time and attention provided to the mission. In addition, the mission would also like to express its appreciation to the staff of the Senior Resident Representative Office in Kampala for the outstanding arrangements made to facilitate mission's work.

[1] The mission comprised Veronica Bacalu (Mission Chief) and Asad Qureshi both from MCM; Alain Vandepeute (Advisor, East AFRITAC); Kenneth Sullivan and Darko Bohnec, both Experts. Ms. Ana Lucia Coronel, Senior Resident Representative (AFR Mission Chief) in Kampala participated in the concluding meeting. Javier Chang from MCMCO provided administrative support. The mission would like to express its gratitude to the staff of the Bank of Uganda and of the Senior Resident Representative's Office for organizing all the mission's meetings and for providing assistance to the mission team.

EXECUTIVE SUMMARY

The BOU has been successful in guiding core inflation close to target in recent years in line with its Inflation Targeting Lite (ITL) monetary framework adopted in mid-2011. The experience since then demonstrates that the BOU has been committed to maintain Uganda's floating exchange rate regime and to conduct monetary operations aiming at firmly anchoring inflation expectations by using the seven-day REPO to steer the seven-day interbank rate as close as possible to the central bank policy rate (CBR).

Despite ensuring low inflation, the presence of sizable precautionary and involuntary reserves and excessive short-end volatility has weakened the transmission mechanism. The key challenge remains to enhance monetary and fiscal policy coordination and to ensure that institutional and operational arrangements are robust and conducive to efficient monetary operations framework.

The BOU should raise the effectiveness of the monetary and foreign exchange (FX) operations framework. To foster further market development there is need to anchor short-term interest rates by using various fine-tuning instruments to ensure improved operational efficiency and strengthen transmission of policy signals across the curve. This can be achieved first by an improved liquidity forecasting and better communication to market participants of aggregate liquidity positions. Several technical changes to the existing operational framework will help stabilize the overnight interest rate. These include the need to (i) synchronize the required reserves maintenance period and Open Market Operations (OMOs); (ii) allow all reserve maintaining banks access to BOU's operations by reorganizing the Primary Dealer (PD) System; (iii) modify the Intraday Liquidity Facility (ILF) and the Lombard facility to improve their usage; (iv) introduce competitive FX auctions for conducting reserve accumulation purchases; and (v) introduce FX Swaps as an alternative monetary management tool to address short-term domestic liquidity and tackle misalignments existing in various market curves. In addition, putting in place an appropriate mechanism to ensure efficient coordination of fiscal and monetary operations is critical given the persistent government overdraft and a shortage of resources that constrains its monetary operations choices. A combination of these measures will help over time to effectively manage future pressures on the BOU's balance sheet.

The BOU's ability to sustain its operations without constraint is affected by its deficit balance sheet position. The cumulative deficit from losses since 2009 has resulted in a monetization of these losses and the need for the BOU to receive recapitalization injections. The government's agreement to meet half of the recommended UGX 1,600 (billion) recapitalization injections will reduce the cumulative deficit, but will not restore the BOU's capital by the time they are completed in 2017.

The BOU should consider a range of options to strengthen its balance sheet and capital framework and restore its policy solvency.[2] These include continuing BOU savings in operating expenses, raising levels of non-interest income, and raising interest from policy-related financial instruments. Modernizing the BOU Law will strengthen its capital framework and improve the ability to discharge its core functions. Considerable work remains to complete the law's amendment and review process.

Adhering to the BOU's medium-term business plan will be important for enhancing the BOU's perceived transparency. Continuing the trends of operational savings identified and making the annual update and publication of this document an integral part of the BOU's communication strategy will support its quest for additional income generating assets.

[2] Policy solvency is referred to in terms of the financial strength of the institution to enable it to carry out long-term policy obligations without being constrained or limited in terms of the resources at its disposal (see Peter Stella and Åke Lonnberg, IMF WP/08/37).

Key Recommendations and Action Plan	
Recommended Action	Timeline
Monetary Operations	
Use the liquidity forecasts of the BOU as the tool to manage open market operations. Market intelligence techniques should only be used to understand the money market dynamics.	Short term
Coordinate closely with the MOFPED to enhance the quality and reliability of forecasts of the Government net spending.	Short term
Use ARIMA model to forecast currency in circulation.	Short term
Improve communication to market regarding aggregate liquidity position.	Short term
Rearrange the 14-day reserve maintenance period to avoid volatile end of period.	Short term
Synchronize OMO operations and maintenance period cycle.	Short term
Introduce a new fine tuning instrument in order to neutralize unexpected liquidity shocks.	Short term
Abandon the PD system for Central Bank operations by allowing all banks access to BOU operations, while leaving the PD's system to service the MOFPED's primary issuance of government securities.	Short term
Define the BOU's Lender of Last Resort (LOLR) function and distinguish it from BOU's monetary policy activities.	Short term
Remove the 25 percent limit on the use of Lombard facility and limit the use of Lombard facility to overnight.	Short term
Communicate to remove the stigma attached to the use of Lombard facility.	Short term
Systematize the access to the Lombard facility removing administrative impediments.	Short term
Make the use of the Intraday Liquidity Facility mandatory for all eligible institutions and banks with lower reserve requirement than their clearing amounts.	Short term
Transform automatically any shortfall in the Intraday Liquidity Facility into Lombard facility.	Short term
Introduce a deposit facility to put a floor on the overnight rate.	Medium term
Abandon the discount window or change its features to be conducive of the development of secondary Government bond market.	Medium term
Develop the horizontal repo market.	Medium term
Design a separate LOLR framework (More TA needed).	Medium term
Foreign exchange operations	
Define distinction between the modes used for interventions for discretionary purposes and for reserve accumulation. Use discretionary interventions to manage market volatility and establish triggers linked to internally defined volatility thresholds.	Short term
Introduce rule-based Competitive FX Auction mode for reserve accumulation purchases with defined frequency and volume target.	Short term
Introduce three-month forward purchases in reserve accumulation FX auctions to facilitate BOU's managing the domestic liquidity better, and provide avenue to the exporters to lock in their forward receivable.	Short term

Introduce FX Swap Auctions as an additional monetary management tool to address short-term liquidity fine tuning operations, and also to serve as an effective mode to tackle any arbitrages or misalignment in the market curves.	Short term
Supporting Market Development	
Introduce standardized documentation – Master Swap Agreement or ISDA light. Introduce GMRA or localized MRA for repo market development.	Medium term
Develop the horizontal repo market.	Medium term
For improvement in credit and collateral risk management, consider introducing Credit Support Annex.	Medium term
PD system for Debt Securities needs to be re-vamped.	Medium term
Improve the Advance Calendar of debt securities auction to include volumes, tenors and dates with re-opening of long-term T-bonds for full financial year, to ensure benchmark issues are liquid across sovereign yield curve.	Medium term
Develop a "Hand-book on Investment in GOU Securities". Such a hand-book may include operational guidelines pertaining to description of type of securities, auction process & pricing methodology, payment & settlement processes and description of debt market structure.	Medium term
Balance Sheet Management	
Continue to press for government adoption of proposal to introduce direct charging for BOU services provided to government	Short term
Convert part of the UGX 1,700 (billion) of the Uganda Consolidated Fund (UCF) receivable into marketable securities. and issue them to the central bank	Short term
Negotiate further tranches of "recapitalization" bonds to provide realized income to close realized income deficit.	Short term
Negotiate replacement of "repo" securities with marketable securities for use in market operations.	Short term
Bank of ganda Law Amendment	
Complete development of the BOU's future capital structure and gain BOU Board and MoFPED agreement.	Medium term
Specify the new capital arrangements in the amendments to the BOU law.	Medium term
Proceed with completing the proposed amendments to the BOU law, forward it to the Fund's legal department for final review, and sign off.	Medium term
Plan to complete consultations and reviews to be able to submit the amended law for April 2016 in time for the new Parliament.	Medium term
Accounting, Capital Structure, and Planning	
Have the Board pass the necessary motions to classify the recapitalization bonds as part of general reserves.	Short term
Start accounting for interest on the recapitalization bonds as interest in the profit and loss.	Short term
Amend capital disclosures in the financial statements to separate core capital from unrealized revaluation reserves.	Short term

Implement the refinements to capital presentations in the financial statements discussed in the report.	Short term
Enhance the presentation of the medium term business plan as suggested and integrate it into the strategic planning process as an annual output.	Short term
Ensure development of the Petroleum Revenue Investment Reserve is consistent with the BOU's role as management agent.	Medium term

BACKGROUND AND INTRODUCTION

1. **Economic activity in Uganda remains strong supported by a recovery in private consumption and low international oil prices.** GDP growth over the period 2009–14 averaged 5.2 percent and medium-term prospects remain favorable. At 3 percent in February 2015, annual core inflation remains low within the lower limits of the inner and outer inflation consultation bands agreed under the Fund's Policy Support Instrument (PSI) in line with the ITL framework adopted in mid-2011. Annual headline inflation at 1.4 percent in February 2015 was subdued by declining food and oil prices. The current account has widened recently on account of weaker exports affected by a depressed demand in regional partners and higher dividend payments to foreign shareholders reflecting improved corporate profits. The shilling has depreciated by 6 percent since end-December 2014, as it came under pressure against the strengthened U.S. dollar, exacerbated by some nervousness over the election cycle. The BOU has kept the monetary policy stance unchanged in February 2015 mainly on account of the expected exchange rate pass-through to domestic prices.

2. **The BOU has achieved an impressive progress in developing its monetary operations framework, but more needs to be done to strengthen it.** The BOU has achieved a four-year-low inflation, despite the fact that it conducts the monetary policy in the context of a structural surplus of liquidity, resulting from the accumulation of international reserves, persistent government overdraft from its account with the BOU, and a shortage of resources that constrains its monetary operations choices. The CBR, announced by the BOU every two months to signal its monetary policy stance, has been maintained at 11 percent following a ½ percentage point reduction in June 2014. The BOU conducts open market operations to steer the monthly weighted average 7-day interbank rate, within a band of +/– 2 percentage points around the CBR. This objective has been successfully met, although volatility at the short end of the curve has been persistent. Welcome progress has been made in strengthening the capital position of the BOU by adopting a medium-term plan of its recapitalization and starting its implementation.

3. **FX intervention continues to play an important role in the conduct of monetary policy aimed at achieving low inflation.** The BOU maintains a flexible exchange rate regime along with an open capital account. During the recent depreciation pressures, the BOU intervened more heavily than usual in the FX market to dampen excessive exchange rate volatility. The BOU has been also conducting purchases of FX for international reserves build-up.

4. **Financial deepening is increasing slowly and efforts to remove impediments to financial intermediation and strengthen the transmission mechanism of monetary policy are ongoing.** Credit to the private sector has been recovering after the Global Financial Crisis (GFC), driven mainly by personal and household loans for consumption. But financial intermediation remains low by all measures.[3] While time deposit rates have declined (from 20 percent in mid-2012 to 11 percent in January 2015), lending rates have declined much less (from respectively 27 to 22 percent). The increases in provisioning as cost of dealing with nonperforming loans affected profitability and partly explain the weak transmission to lending rates, but there are structural rigidities that remain to be addressed. The largest impediments relate to legal enforcement of the existing regulations and developing new ones in the areas of property registry and verification, collateral enforcement, confirmation of identity, etc. Interbank market transactions remain largely unsecured and the effectiveness of the BOU's transactions on the repo and secondary securities markets is weakened by a structural liquidity overhang. While the interbank and government securities markets are well established, the effectiveness of the interest rate channel can be further improved.

5. **The BOU's commitment to reforms outlined in its medium-term business plan is welcome.** Several areas of reform need early attention. These include (i) reviewing the BOU Act to ensure an appropriate level of capital to support central bank's operational independence; (ii) separating and coordinating monetary and fiscal instruments to ensure effective liquidity management; (iii) ensuring that FX operations framework and the accumulation of reserves are consistent with the ITL objectives; (iv) taking measures to support the efficient functioning and development of the financial markets; and (v) effective forecasting of factors driving liquidity conditions, in particular government cash flow and borrowing.

6. **The purpose of the current TA is to facilitate the BOU's efforts to strengthen its monetary and FX operations, capital position, and the Bank of Uganda Act.** The mission took stock of progress in the BOU's operations, including in implementing the earlier TA advice, aiming at increasing the effectiveness of monetary policy and operations and strengthening the financial position of the BOU. The mission reviewed the legal and institutional frameworks and central bank capital arrangements.

[3] In mid-2014, credit to GDP ratio stood at 14 percent, M2 to GDP was 16 percent, and loan/deposit interest rate margin exceeded 10 percent.

Box 1. Past Recommendations Implementation: Main Results

The authorities have made commendable progress in implementing many recommendations from the earlier missions.[1/]

- The BOU has further improved communication with banks, economic agents, and with general public to enhance their understanding of monetary policy in the ITL regime. In line with its communication strategy, the BOU continues to disseminate information to general public through press briefings, the website, media, and other outreach. A new structure of the Monetary Policy report was adopted with the policy horizon of 12 months. Now, there is a clearly communicated distinction between MPC Meeting at which policy rate is set, and MPC Review Meeting at which economic developments are reviewed.

- In accounting procedures, the BOU has amended its procedures for accounting for realized and unrealized revaluation gains. As part of the process it has reviewed its revaluation reserves and identified previously realized gains that were still held with the unrealized revaluations.

- The BOU has also amended its accounting for Uganda's IMF membership to better reflect the status of the country's membership.

- While short of the full recapitalization of the BOU recommended by the previous mission, the authorities issued sufficient securities to slow the rate of erosion of BOU capital.

- Supporting the request for additional resources, the BOU developed a Medium-Term Business Plan. Part of this plan was the implementation of a recommendation to identify chargeable services that has identified UGX 42 (billion) of potential non-interest revenue.

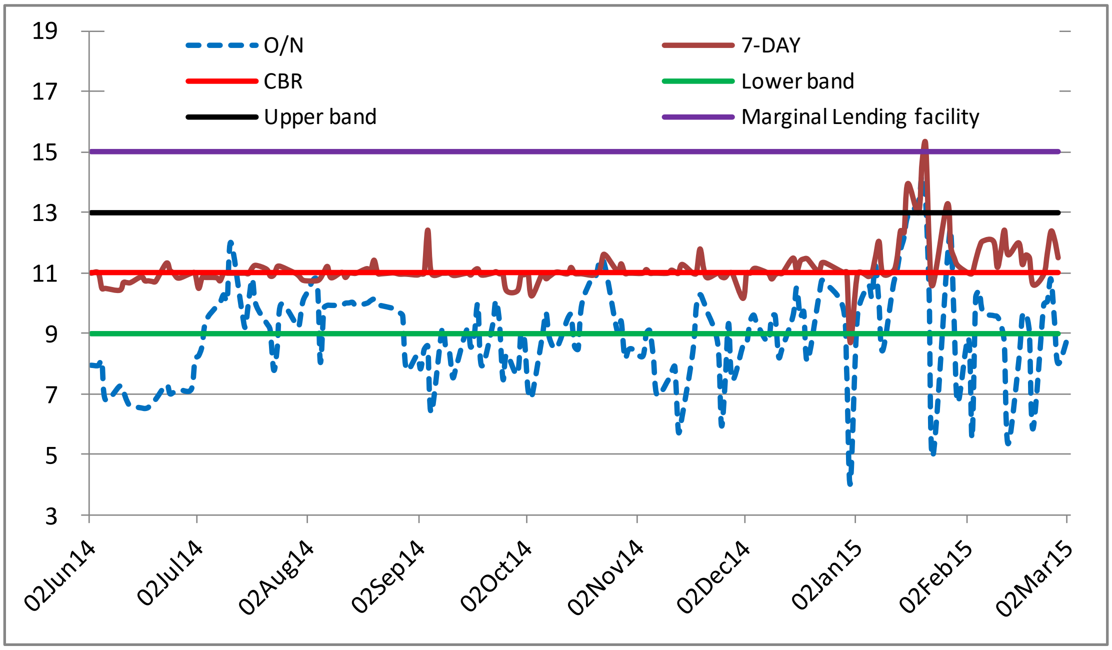
[1/] Appendix VI contains a detailed BOU's response to earlier missions' recommendations.

INCREASING THE EFFICIENCY OF MONETARY OPERATIONS FRAMEWORK

A. Reducing the Overnight Interest Rate Volatility

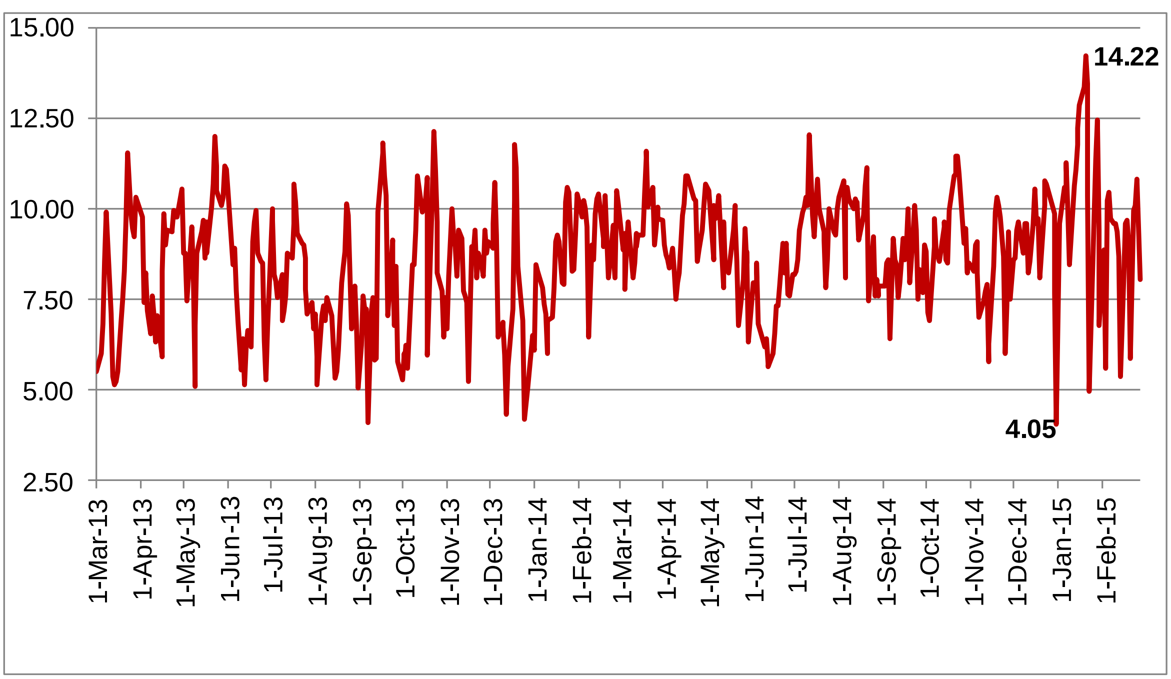
7. **While the BOU's operational target —the seven-day interbank money market rate—is following closely the CBR policy rate, the overnight interest rate is extremely volatile.** Since the introduction of the ITL framework in July 2011, the turnover in the overnight market has significantly increased while conversely seven-day interbank transactions have decreased. During the time of the mission, the volume in the interbank market on overnight was much higher than on the seven-day, while the latter is not traded every day, but the overnight is.

Figure 1. Overnight and 7-Day Interest Rates Compared to CBR Rates (in percent)



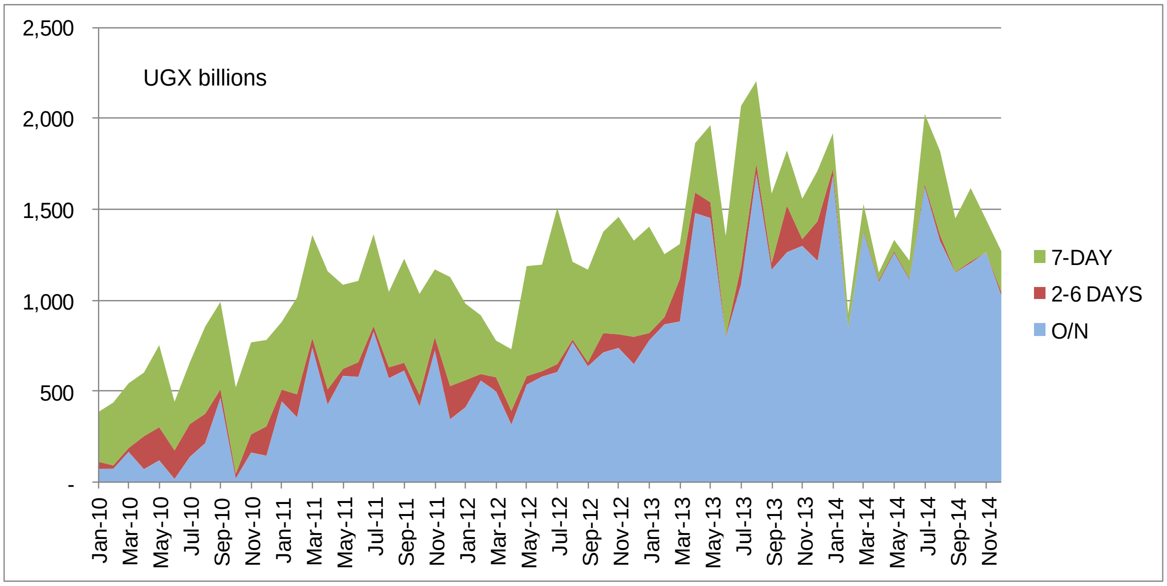
Source: Bank of Uganda.

Figure 2. Daily Interbank Overnight Money Market Rates (in percent)



Source: Bank of Uganda.

Figure 3. Interbank Bank Turnover by Tenors



Source: Bank of Uganda.

8. **The BOU manages short-term liquidity through seven-day repo/reverse repo operations which are not conducted on a regular and systematic basis.** The 7-day repo and reverse repo transactions are the only tools used to manage liquidity reflecting short-term impact on the system liquidity position. Repo and reverse repo are always conducted with a tenor of 7-day and there is no fine-tuning instrument.

9. **Before 2012, the BOU was absorbing structural liquidity via treasury bills (T-bills).** This policy has been abandoned in 2012 after the government drew down on the balance of the sterilized account in order to address budgetary pressures. The MOFPED then decided to use government securities for the exclusive use of the financing needs of the Government leaving the BOU without instruments for sterilizing structural liquidity.

10. **After the recapitalization plan has been agreed in 2011, the MOFPED has issued marketable treasury bonds (T-bonds) of different tenors amounting to UGX660 Trillion that were used to replenish the BOU's capital.** The BOU has been using outright sales of T bonds in order to manage structural liquidity. It has also bought back a part of earlier sold bonds.

11**.** **Although the 7-day interbank rate is the BOU's operational target, the overnight volatility reduces the effectiveness of the transmission mechanism from short-term interest rates to longer term rates**. The overall cost of funding and lending is key to define the lending and deposit rates. Overnight transactions are a key part of this cost, that are also reflected in widening margin between lending and deposit rates. Overnight transactions volumes are becoming more important than 7-day transactions (see paragraph 13 and Figure 3). To avoid this and strengthen the current operational target, the report recommends active fine-tuning of the overnight rate. As an example, during the mission, due to tight liquidity conditions created by unsterilized FX sales, the interbank overnight interest rate traded as high as 25 percent. This is much higher than the existing CBR rate of 11 percent and the Lombard facility rate of 15 percent. Therefore, the outcome of the T-bill auctions led to much higher interest rates than in the previous auction (see table below).

Table 1. Uganda: T-bill Auctions Outcomes (March 2015)

March 4, T-bill Auction			
Maturities	91 days	182 days	364 days
Wap Effective yield	12.399	14.991	16.026
Offered amount	10,000,000,000	20,000,000,000	145,000,000,000
Tendered:	10,150,300,000	43,400,300,000	204,170,800,000
Accepted bids:	9,389,700,000	19,026,200,000	141,480,500,000
Bid to cover ratio	1.076	2.219	1.432
March 18, T-bill Auction			
Wap Effective yield	14.161	15.087	15.961
Offered amount	10,000,000,000	20,000,000,000	145,000,000,000
Tendered:	9,531,100,000	34,907,200,000	121,514,400,000
Accepted bids:	6,531,100,000	9,732,200,000	6,775,800,000
Bid to cover ratio	0.983	1.776	0.866

Source: Bank of Uganda.

12. **To improve the transmission mechanism, the BOU should be concerned by any volatile short-term interest rate; it is therefore important for the BOU to help stabilize the overnight interest rate.** This can be achieved first by an improved liquidity forecasting and improved understanding by market participants of aggregate liquidity positions (see following section). Several technical changes to the existing operational framework that are discussed in the following sections will also help stabilize the overnight interest rate. These changes include (i) a synchronization between the required reserves maintenance period and OMOs; changes in the Intraday Liquidity Facility and the Lombard facility; and the abolition of the PD system for central bank operations (while preserving the function for government securities issuance).

B. Liquidity Forecasting[4]

Current situation

13. **The BOU executes its open market operations based on a hybrid framework which combines a standard short-term liquidity forecasting exercise, and short-term market analysis.** The Financial Market Department is responsible for the formal short-term liquidity forecasting exercise, but also liaises with banks to assess their liquidity needs on a daily basis.

14. **The Financial Market Operation Committee (FMOC), which convenes every morning, decides whether the BOU should be present in the market on that day and determines what action needs to be undertaken (i.e., direction of the interventions and amounts).** As explained to the mission, most of the time the decision is not based on the liquidity forecast and the mode deployed mostly is of full allocation.

15. **The FMOC heavily relies on short-term market intelligence information and the path of the monthly average for the 7-day money market rate.** For example, if the liquidity forecast points to an excess of liquidity, but the market interest rate does not show signs of drifting outside of the BOU upper/lower band, the FMOC might decide not to absorb the excess liquidity. It should be noted that when the Central Bank liquidity forecasts differ from information on liquidity conditions received from market participants, the decision on open market operations tends to rely more on the latter.

16. **The BOU does not publish any data regarding aggregate liquidity position.** Market participants do not have a clear view of the aggregate liquidity situation.

Assessment

17. **A well designed short-term liquidity forecast should be preferred to any market intelligence techniques as the main tool to manage open market operations.** The central bank always has more information than the commercial banks. Therefore, it should be the one who decides the amount of money market interventions based on its own forecasts. Moreover, the use of the information provided by commercial banks in terms of liquidity may be misleading because banks may have different incentives than the BOU. Therefore, the information obtained using market intelligence should be treated with caution and should only be used to understand market dynamic.

18. **The reliability and robustness of the BOU short-term liquidity forecast should be improved so that it becomes the main tool to decide on open market operations.** The BOU

[4] Liquidity forecasting and management within the operational framework context as discussed in this report, should be distinguished from the liquidity forecasting tools based on different analytical models, such as FPAS or DSGE, developed with assistance from Research Department of the IMF.

should improve the techniques it uses to forecast liquidity. Specifically, regarding its forecasts for government net spending, the BOU should have close coordination with the MOFPED.

19. **Stronger coordinating arrangements with the MOFPED are needed to enhance the quality and reliability of the BOU liquidity forecasting and analysis exercise.** Among the autonomous factors, the operations of the Treasury are always those which present the central bank with the greatest challenge. Although the BOU is correcting data provided by the government, effort should be put by the MOFPED to improve its cash management and data provided to the BOU (see Appendix I).

20. **The BOU should also put emphasis on improving its forecasting on currency in circulation.** In the current liquidity forecasting framework, the BOU does not take into account the estimate of demand for currency in circulation for its liquidity projections. In a cash economy like the one in Uganda this autonomous factor may be the most important factor affecting liquidity. An ARIMA-type model for the forecasting of currency would address the seasonal demand for currency in circulation.

21. **In order to improve the targeted amount for the OMO, the BOU should also take into account the demand for excess reserves.**[5] Currently, the BOU does not take into consideration the demand for excess reserves by banks or the estimate of the customary cushion excess reserves while calculating the neutral allotment. This will be a learning process based on past data analysis and market intelligence as identification of demand for excess reserves will change over time.

22. **The BOU should communicate, on a daily basis, information regarding the aggregate liquidity situation.** The BOU could publish on its website, each morning, the T-1 daily reserve position of banks against CRR amount and the cumulative average fulfillment (or, cumulative long or short reserve position from the first day of the period to the T-1 day). The BOU could also give details regarding flows that were the cause of changes (like central bank operations net, change in government position net, sliced to debt management and revenue and expenditure net flows).

Recommendations

- Use the liquidity forecasts of the BOU as the tool to manage BOU's open market operations. Market intelligence techniques should only be used to understand the money market dynamics.
- Coordinate closely with the MoFPED to enhance the quality and reliability of forecasts of the Government net spending.
- Use ARIMA model in order to forecast Currency in circulation.
- Improve communication regarding aggregate liquidity position.

[5] The mission wasn't able to conduct a detailed analysis of excess reserves. The data provided by the BOU was limited to the aggregate excess reserves on a daily basis. It was not synchronized by the maintenance period and was not bank-by-bank or groups of banks.

C. Synchronization Between Maintenance Period and OMO Operations

Current situation

23. **Currently, the timing of the BOU's Open Market Operations and the reserve period are not synchronized. The end of the maintenance period for the fulfillment of the reserves requirements is not conducive to a stable overnight interest rate.** Currently, the reserve maintenance period starts Monday and 50 percent averaging is allowed on a daily basis. However, due to this cycle, the last day of the period is in fact three days, Friday being the last working day. Hence, any liquidity shock on the last day of the period has an impact for three days on the interest rates, contributing to volatility. The end of the period is also corresponding to the settlement of T-bills issuance which could have consequences for the outcome of the T-bills auction and on the market volatility as the liquidity at the end of the period is affected.

Assessment

24. **A rearrangement of the 14-day reserve maintenance period calendar could smooth liquidity conditions at the end of the period and help stabilize the overnight interest rate.** The period could start on Thursday of the settlement of T-bills, which could improve the participation to the T-bills issuance. This would also allow the period to finish on a Wednesday limiting the end of the period to one day instead of the three days currently.

Table 2. Uganda: Current Maintenance Period

1	2	3	4	5	6	7	8	9	10	11	12	13	14
Monday	Tuesday	Wednesday	Thursday	Friday	Saturday	Sunday	Monday	Tuesday	Wednesday	Thursday	Friday	Saturday	Sunday
										T-bill issuance	Lat day of period		

Source: Bank of Uganda.

25. **OMO operations and maintenance period should be also synchronized.** Currently, the 7-day repo/reverse repo operations overlap between the end of the maintenance period and the beginning of the new maintenance period. This complicates the BOU operational work and creates unnecessary volatility in the overnight rate.

26. **The BOU should have two 7-day repo/reverse repo operations synchronized with the reserve maintenance period.** This would imply conducting one 7-day operation the first day of the maintenance period and one 7-day on the 8 day of the period. This would ensure smooth and predictable liquidity conditions during the maintenance period, reduce demand for excess reserve, improve the functioning of the interbank market and reduce the overnight volatility.

Table 3. Uganda: Proposed Maintenance Period and Timing of Open Market Operations

1	2	3	4	5	6	7	8	9	10	11	12	13	14
Thursday	Friday	Saturday	Sunday	Monday	Tuesday	Wednesday	Thursday	Friday	Saturday	Sunday	Monday	Tuesday	Wednesday
Settlement T-bill issuance						*T-bond issuance*	*Settlement T-bond issuance*						*T-bill issuance* and Last day of period
7-Day OMO							*7-Day OMO*						

Source: IMF Staff.

27. **The BOU should also consider introducing a new fine-tuning instrument in order to neutralize unexpected liquidity shocks and accumulated forecast errors.** Fine-tuning operations aim to manage the liquidity situation in the market and to steer interest rates, in particular in order to smooth the effects on interest rates caused by unexpected liquidity fluctuations in the market. Fine-tuning operations are typically conducted on the last day of a reserve maintenance period, though can be conducted as needed, to counter liquidity imbalances which may have accumulated since the last OMO.

28. **The potential need for rapid action in the case of unexpected market developments makes it desirable to retain a high degree of flexibility in the choice of procedures and operational features in the conduct of these operations.** The operational features of the fine-tuning reverse operations can be summarized as follows:

- They can take the form of liquidity-providing or liquidity-absorbing operations;
- Their frequency is not standardized;
- Their maturity is not standardized; and
- Liquidity-providing fine-tuning reverse transactions are normally executed through quick tenders.

Recommendations

- Rearrange the 14-day reserve maintenance to avoid volatile end of period.
- Synchronize OMO operations and maintenance period cycle.
- Introduce a new fine-tuning instrument in order to neutralize unexpected liquidity shocks.

D. Marginal Lending Facility (Lombard Facility)

Current situation

29. **The BOU has a Lombard facility but its usage is limited.** Banks' access to the Lombard facility is limited to 25 percent of banks' reserve requirement. The Lombard can be used for up to 3 months. Additional funding above the 25 percent limits are available but at the discretion of the BOU. There is an important stigma attached to its access and the administrative process is burdensome.

Assessment

30. **The current Lombard facility framework should be improved in order to better fulfill its function.** Currently, the Lombard facility does not provide an effective ceiling to overnight interest rate and it does not distinguish the BOU LOLR function from BOU monetary policy activities. Moreover, the Lombard facility and LOLR are not defined clearly and are perceived to be identical.

31. **The current Lombard facility does not provide an effective cap to the overnight interest rate.** Several reasons can explain this situation: (i) the use of the Lombard facility is first limited to 25 percent of banks' reserve requirement; (ii) there is a stigma attached to it; and (iii) its access is manual and administratively complicated. During the mission, due to tight liquidity conditions, the overnight rate was trading close to 25 percent while the Lombard rate was at 15 percent.

32. **The BOU should clearly define and adapt the features of the Lombard facility in order to provide an effective cap to the overnight interest rates.** This implies limiting the access to Lombard facility to overnight while removing the 25 percent cap on its use, ease the administrative process and communicate to the market in order to remove the stigma attached to its use.

33. **The Financial Markets and National Payment Systems Subcommittees (FMNPS)[6] already recommended communicating appropriately on the usage of standing facilities by commercial banks to avoid stigmatizing the use of the facilities.** One of the FMNPS' recommendations on harmonization of standing facilities was to remove the stigma attached to its use. A clear separation between the Lombard and the Emergency Liquidity Assistance (ELA) framework will help to remove the stigma attached to the Lombard. The automatic conversion of the ILF into Lombard facility will also contribute (see below).

34. **In line with the proposed new Article 43 of the Central Bank Act regarding the BOU's capacity as the lender of last resort, the BOU should establish an appropriate LOLR framework, distinct from its monetary policy activities.** ELA is provided by central banks at a rate above the rate of the Marginal Lending Facility (MLF) with the purpose to provide liquidity to solvent but illiquid banks and is used if banks are no longer eligible for operations or do not have eligible collateral.

35. **An LOLR framework should be based on the principles of solvency, viability, supervisory intrusion, and conditionality.** An LOLR framework should be established in order to respond to the idiosyncratic needs of sound institutions. As outlined in Appendix I, the BOU should establish internally clear counterparty and collateral eligibility criteria and appropriate risk control measures, along with defined internal coordination and appropriate binding agreements to allow for increased supervision and conditionality.

[6] The Financial Markets and National Payment Systems Subcommittees of the EAC Monetary Affairs Committee (MAC) Meeting on Harmonization of Standing Facilities and Collateral Management Frameworks in January 2013.

Recommendation

- Define the BOU's LOLR funct5ion and distinguish it from BOU's monetary policy activities.
- Design a separate LOLR framework.
- Remove the 25 percent limit on the use of Lombard facility.
- Limit the use of Lombard facility to overnight.
- Communicate in order to remove the stigma attached to the use of Lombard facility.
- Systematize the access to the Lombard facility removing administrative impediments.

E. Intraday Liquidity Facility

Current situation

36. **The BOU offers a non-mandatory Intraday Liquidity Facility (ILF) to banks.** Currently, the use of the ILF needs to be requested by a bank and is not automatic. Its use is collateralized and free of charge. There is a penalty for any shortfall at the end of the day and there is no automatic conversion from ILF to Lombard Facility.

Assessment

37. **Not all banks are participating in the ILF facility and this may create unnecessary queues in the payments system**. This in turn constrains banks' liquidity management, increase banks' demand for excess reserves and results in overnight volatility.

38. **In order to improve the flow of payments, the ILF should be mandatory for all eligible institutions and banks with lower reserve requirement than their clearing amounts, automatically opened and backed by a standby pool of collateral deposited at the BOU.**[7] This would reduce queues, would improve banks liquidity management and reduce overnight volatility. Collateral requirements can be determined based on bank's historical clearing amounts.

39. **The BOU should also automatically transform any shortfall in the ILF at the end of the day into Lombard facility.** This would smooth also the sequencing of payment and liquidity flows and help remove the stigma attached to the Lombard facility.

[7] If non-banks are part of the payment system, they should be eligible for ILF.

Recommendation

- Make the use of the Intraday Liquidity Facility mandatory for all eligible institutions and banks with lower reserve requirement than their clearing amounts.
- Transform automatically any shortfall in the ILF into Lombard facility.

F. Overnight Deposit Facility

Current Situation

40. **Due to cost constrains, the BOU does not have an overnight deposit facility.** There is no facility which is currently putting a floor on the overnight interest rate.

Assessment

41. **The implementation of an overnight deposit standing facilities would improve the framework by limiting further the overnight volatility.** Under this facility, the BOU should always be willing to accept overnight deposits from commercial banks. The rate paid for these deposits should be below the CBR.

42. **It is important to mention that the rate set for the facility should not be too close to the CBR in order to avoid financial intermediation by the BOU**. How low this rate should be, must be defined by the BOU based on its experience about the money market. This rate sets a floor for interbank interest rates since all the commercial banks know that they can deposit their excess liquidity in the central bank at this rate. The better the liquidity forecasts of the BOU, the less commercial banks will use the overnight standing facilities.

43. **This facility should be established once the other measures proposed in this report have been implemented and the demand for excess reserve is reduced**. Under an optimal operational framework, the recourse to this facility should be marginal. In order to avoid important monetary policy cost, the BOU might only implement the deposit facility once the other measures proposed have reduced the current demand for excess reserve.

Recommendation

- Introduce a deposit facility to put a floor on the overnight rate.

G. Primary Dealer System

Current situation

44. **In Uganda, only PDs in government securities have direct access to central bank operations.** Other commercial banks need to put their bids through the six Primary Dealers to participate in central bank operations (repo/reverse repo). This system was created as an incentive for banks to operate as PDs in the government securities market. These commercial banks deal directly with the PDs and not with the BOU impacting the respective credit lines.

Assessment

This system has a number of disadvantages for the conduct of monetary policy and financial stability.

- It impacts significantly commercial banks credit line reducing the scope for interbank activity.
- It gives informational advantages to primary dealers, which is against the level playing field that central banks should give to all commercial banks. This can also, lead to dominant position in the aggregate liquidity positions giving them a pricing power in the market. This creates additional overnight volatility.
- It contradicts the principle that central bank should give direct access to its operations to all financial banks fulfilling reserve requirements.
- In the case of reverse repo, it could impede financial stability as liquidity injection conducted by the BOU would be constrained by PDs credit line with other commercial banks rather than their collateral.
- It limits the BOU absorption capacity as non-primary dealer would be constrained by their credit line with the PD and PDs would be constrained by their credit line with the BOU.
- It impedes the transmission mechanism and increases intermediation margins as PDs require a margin of up to 25 basis points on the liquidity absorbed or injected.
- It increases the demand for excess reserve complicating liquidity management, reducing smooth liquidity circulation and increasing commercial banks intermediation margin.
- In line with the draft proposal prepared by the BOU Financial Market Department, the mission recommends to give access to the BOU operations to all commercial banks.

Recommendation

- Abandon the Primary Dealer system for Central Bank operations by allowing all banks access to BOU operations, while leaving the Primary Dealers system to service the MOFPED's primary issuance of government securities.

FOREIGN EXCHANGE OPERATIONS AND MARKET

A. Foreign Exchange Operations

Current Situation

45. **The stability of the foreign exchange markets is important with the exchange rate following a consistent path with BOU's primary objective of containing inflation**. The de jure exchange rate arrangement is free floating and is a key component of BOU's monetary policy framework. The current account deficit and reliance on foreign funding and investments make Ugandan foreign exchange market susceptible to potential volatility by shifts in sentiments, flows, and attractiveness of other regional markets. Recent volatility can also be linked to portfolio shift of around UGX 1.0 trillion by the National Social Secrity Fund to Kenya and Tanzania during the first quarter of 2015. Therefore, deep and resilient foreign exchange markets should be an important financial objective. An efficient market price discovery mechanism for the exchange rate is needed to avoid unsustainable balance of payments developments. At the same time, BOU needs effective tools to deal with potential excess volatility in this market.

46. **The historical volatility seen in Ugandan Shillings is broadly similar to that of regional currencies and to other emerging markets that operate a relatively flexible exchange regime.** Hence, UGX exchange rate volatility, on an average basis, does not seem overly excessive compared to peer countries (Table 4).[8] However, the exchange rate has experienced a few incidents of excessive volatility (Figure 4), which can be attributed to structural market deficiencies, segmentation driven by limited number of active market players, and smaller volume of transactions skewed towards spot. In this regard, putting up of market making arrangement by BOU between banks for tradeable quoted prices up to USD 0.25 million in spot is a welcome step and will result in improving spot liquidity and probable efficient usage of foreign exchange open limits over time.

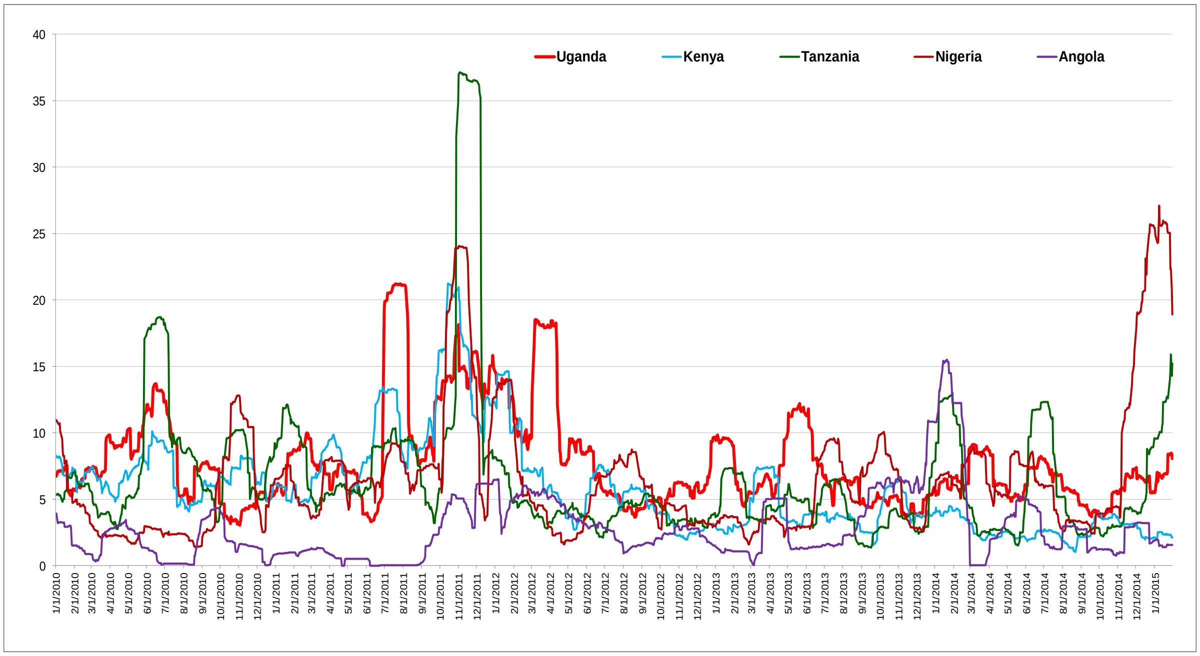
[8] A 4–6 percent volatility is considered to be healthy for a developing country with de facto floating ER regime.

Table 4. Uganda: Average Currency Volatility—in Selected Countries (in percent)

Period	Uganda	Kenya	Tanzania	Ethiopia	Nigeria	Angola
2014	6.2	2.7	5.5	1.9	7.5	3.8
2013	6.6	4.1	4.4	1.1	5.0	3.5

Source: Haver Analytics.

Figure 4. Exchange Rate Volatility Against USD (in percent)



Source: Haver Analytics.

Assessment

47. **The BOU's discretionary interventions in foreign exchange market have predominantly been directed towards dampening short-term excessive volatility that could jeopardize orderly functioning of the market.** The BOU's mode of foreign exchange interventions can be classified into three categories: (i) discretionary interventions, aimed at dampening excessive market volatility; (ii) daily purchase program of pre-determined amounts to accumulate international reserves; and (iii) targeted interventions catering to specific lumpy payments. The main thrust of interventions though has been aimed at accumulation of international reserves. BOU intervenes in the interbank FX market at the banks' quoted rates using the best bid-ask principle. BOU publishes information on its interventions with a lag in its quarterly and annual reports, including all three categories of amounts purchased and sold through discretionary interventions, targeted transactions, and the reserve build-up program (Table 5).

Table 5. Bank of Uganda FX Market Intervention (USD million)

Current Year [1/]	Discretionary	Targeted (UETCL)	Reserve Build-up	Net Intervention
2015	-374	-31	148	-257
2014	-87	-164	850	599
2013	42	-184	633	491
2012	-175	36	806	667

[1/] 2015 figures until March 18, 2015.

Source: Bank of Uganda.

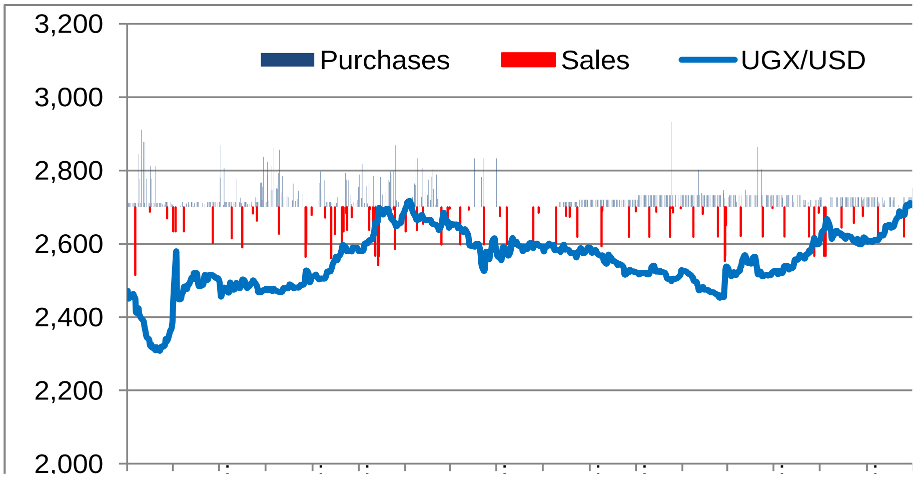
48. **Consistent with fundamentals, UGX has followed a gradual depreciation path, while the discretionary interventions have been infrequent, until recently.** Observed patterns indicate that amount of purchases to accumulate reserves have increased in the recent past and remained somewhat inconsistent with the communicated amounts to the market. In addition, the recent pressures on the exchange rate has also resulted in BOU's frequent presence in the market through discretionary interventions and in few occasions in the reverse direction during a single day or the subsequent day.

49. **The mode of interventions deployed for discretionary and reserve accumulation interventions are quite similar**, **i.e., conducted using bid-ask principle by hitting banks on their quoted prices as displayed on the Reuters page UGX1=, which had been instituted to establish a market making mechanism in the IFEM.** However, the targeted specific sale interventions are predominantly conducted for UETCL on weighted average rate derived by using traded volumes of banks times their respective quoted price.

50. **Resultantly, usage of similar modes and instruments to achieve different objectives of interventions and recent frequent presence** have caused some confusion in the market about the underlying objectives of BOU's interventions. (Figure 5).

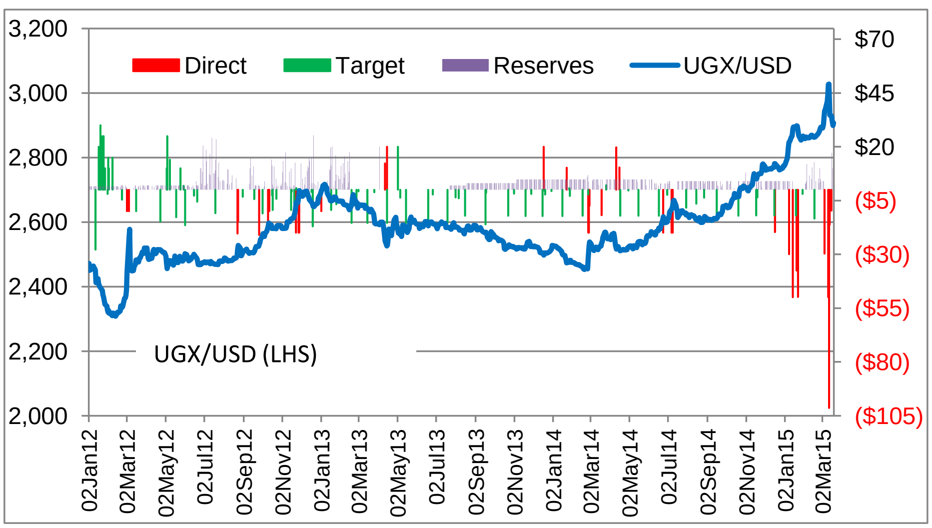
51. **In addition, it appears that the conduct of these FX interventions is not appropriately integrated with domestic currency monetary operations**. The impact of any reserve build-up due to additional purchase on domestic liquidity should remain consistent with monetary policy stance and is expected to be sterilized accordingly. The reserve build-up purchases have contributed to structural excess liquidity and has further confused market participants.

Figure 5. UGX Exchange Rate Trends and FX Interventions



Source: Bank of Uganda.

Figure 6. UGX Exchange Rate Trends and Mode of FX Interventions



Source: Bank of Uganda.

Recommendations

52. **A simplified, prioritized, and rule-based intervention policy framework has a number of advantages, both from clarity of objectives and effectiveness of the BOU's market management.** There should be a marked distinction in its approach towards different forms of foreign exchange interventions that BOU undertakes. For instance, its discretionary or direct interventions should be aimed at addressing any excessive volatility or market dysfunction and should not be amalgamated with its desire to accumulate international reserves. A simplified

product suite with clear communication of objectives would also help build market capacity, improve price discovery, reduce market segmentation, and create incentives for the large and medium-size banks to further strengthen market making agreement among them.

53. **To facilitate clarity of objectives and deepen FX market, it is pertinent to rationalize the way the BOU interacts with market in terms of the instruments and modes it deploys and the frequency of market presence**. This will eventually facilitate market participants to trade among themselves and allow BOU to function as a back stopper rather than the liquidity provider in the market. Specific actions include:

- Consolidating the mode of interventions into two (rather than three) types:

    a. Discretionary interventions (less frequent) only directed at managing market excessive volatility; and

    b. A rule-based Competitive FX Auction strategy with the objective of gradual accumulation of international reserves.

54. **"Discretionary Intervention" should be used under excessive market volatility, which may warrant immediate action.** However, the modus operandi for conduct of such interventions should be reviewed for effectiveness and provide the market with ample space to manage itself. BOU may continue to intervene at the banks' tradeable quoted rates using the best bid-ask principle with standard lot sizes. However, an internal intervention policy framework at FMOC level may need to include establishing volatility thresholds consistent with market and de jure exchange rate regime, observed normal bid/ask spreads, as well as an analysis on whether consistent unidirectional pressures are seen in the market. In this context, a number of factors that may need to be considered to refine internal policy framework, include:

a. Clear internal distinction should be instituted as to what is deemed as normal healthy volatility and what could be regarded as excessive. In reference to comparable regional and emerging market countries (Tables 4 and 6), 4 to 6 percent volatility can be considered healthy and BOU's intervention internal threshold can be set if market consistently on a close-to-close basis tests this threshold. It is important to bring clarity to market on intervention rationale and accustom market to some healthy volatility, which eventually will improve market's ability to absorb temporary pressures with efficient utilization of their Foreign Exchange Open Limits (FEOL).

Table 6. Uganda: Average Currency Volatility—Selected Emerging Market Countries

Period	India	Malaysia	Philippines	Thailand	Pakistan	Indonesia
2014	6.1	5.0	4.7	4.0	4.7	7.2
2013	10.8	6.9	5.1	5.2	3.6	9.2

Note: Average close-to-close daylit volatility last quote (10, 365)

Source: Haver Analytics.

b. Efforts should be made using several banks and switching among them could help reduce market segmentation, even during closed or announced BOU presence in the market.

c. Direct intervention should be conducted using spot transactions.

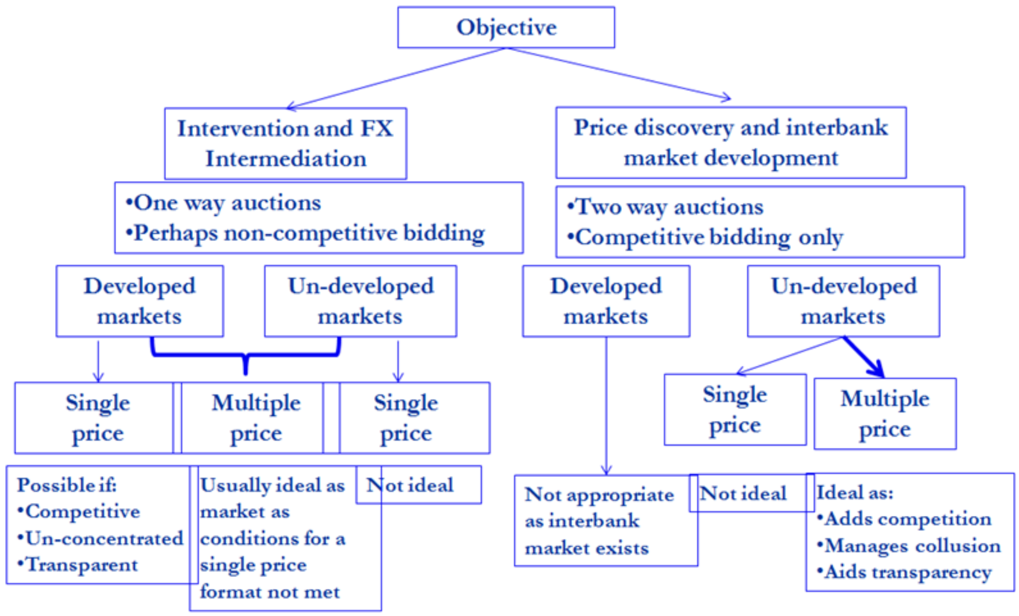
d. Such interventions should aim to convey a clear signal about central bank's intentions. The clear communication policy of intervention should be stepped up to influence market participants' expectations about the future development or behavior towards volatility of the exchange rate.

55. **A rule-based Competitive FX Auction strategy with clear objective of gradual accumulation of international reserves may be introduced.** To ensure the clarity of objectives to market, the modus operandi for conduct of such interventions should be distinct from discretionary interventions and should be: (i) rule based; (ii) follow a consistent approach; and (iii) be market neutral, without having significant impact on exchange rate. It should be conducted to create a competitive price discovery within the market with willing sellers approaching the BOU. [9]

56. **FX Auctions are currently used by 31 central banks as per AREAER with varying objectives including (a) FX Intervention vehicle; (b) Vehicle for intermediating or accumulating FX reserves; and (c) Market development and price discovery tool.** Based on country experiences the objectives and design choices for auction can be summarized in Figure 7.

[9] Multi-price auctions can give rise to an MCP based on the potential for a deviation of more than 2 percent between buying and selling for spot exchange rates, which may require further consultation with the Fund under the Article VIII.

Figure 7. FX Auction Objectives and Design



Source: IMF Staff.

57. **Based on best practices, some suggestions to formulate rules governing these competitive auctions for reserve accumulation are summarized below:**

a. The frequency of the auction schedule needs to be standardized, initially on a weekly or twice a week basis. A mid-week day may be chosen as a standard practice;

b. Auction Volume Target and dates should be pre-announced at start of the week on T+1 basis in which BOU plans to conduct such auction. Volume target for each auction may be set at a range between USD 5–10 million, but such volume targets have to be kept consistent for each forthcoming auction. At a later stage, once the market gets accustomed to the process, a proper advance calendar on a monthly basis could be announced.

c. The amount accepted at auction should be kept closer to the announced volume with probable variance of , for example, not more than +/-10 percent. This resultantly would bring confidence to market participants and enhance central bank credibility.

d. The bidding mechanism should be standardized: minimum and maximum bid volume limits may be applied. For instance, the volume of each bid could range between US$0.25–US$1.5 million, in multiples of US$ 0.25 million. Each commercial bank may be allowed to propose a maximum number of three bids each at their determined prices. To avoid concentration, the cumulative volume of bids from any single bank should not exceed 25 percent of the announced target, thus not affecting market clearing liquidity;

e. Outright forwards in three-month tenor may be used when buying USD from market for reserve accumulation, thus helping entice exporter-related forward flows and let market manage the interim tenor gap through swaps developing market capacity. Additionally, using forwards would also reduce the need to immediately sterilize the UGX liquidity created through such purchases; and

f. The Bank of Uganda should publish the results of these auctions in a standardized format at the latest by 3:00 p.m., on the auction day on its website.

58. **The determination of annualized purchase target needs to be prudently made on the basis of realistic BoP projections.** However, such targets when translating into quarterly or monthly volume targets, need to be appropriately seasonally adjusted. In addition, as a rule, these targets once derived, shouldn't be significantly adjusted during the course of financial year.

59. **BOU can also consider introducing FX Swap Auctions as an additional monetary management tool with standardized format, tenors, frequency, and volumes**. FX Swaps are effectively used by number of central banks across the globe with several variations and have served as an effective monetary management tool especially in markets with constrained collaterals. Accordingly, several Central Banks include Foreign Exchange Swaps among their Monetary Instruments (Table 7).

Table 7. List of Countries that include FX Swaps in their Monetary Operations

Australia	New Zealand	Kyrgyz Republic
Belarus	Norway	Latvia
Brazil	Pakistan	Malaysia
Croatia	Romania	Morocco
European Central Bank	Russia	South Korea
Ghana	Singapore	Thailand
India	South Africa	United Arab Emirates
Indonesia	Sri Lanka	United Kingdom
Israel	Sweden	

Sources: ISIMP

60. **FX Swaps can be used by the BOU as an additional monetary management tool to address short-term liquidity management fine tuning operations**, but would also serve as an effective mode to tackle arbitrages or misalignment existing in various market curves, which could be susceptible to speculative tendencies. Additionally, considerable part of the structural excess liquidity created in Uganda has been due to accumulation of international reserves, thus FX swaps can also serve as an effective tool in this context. Accounting treatment of FX Swaps on the BOU balance sheet in covered under Appendix IV. FX Swaps can be introduced in two phases as follows:

Phase one

a. The frequency of the FX Swap Auction schedule needs to be standardized, to once a week, i.e., every Wednesday with T+1 settlement as a standard practice.[10]

b. FX Swaps should be offered in standardized tenors of 1 and 3 months. Hence, trading in the intermediate tenors would pick-up by banks with incentive to warehousing their client hedging transactions as well as interbank trading.

c. The number of bids allowed per bank may be kept to maximum two in standardized bid lot sizes with multiple thereof. This would help cultivate active trading afterwards and minimize dispersion and compliancy by banks.

d. Volume targets and allocation need to be standardized. The allocation at auction should be kept closer to the announced target with probable variance of, for example, not more than +/-10 percent and cut-off consistent with monetary stance. This would bring confidence to market participants and enhance central bank credibility.

e. FX Swap Auction results should be announced and disseminated on the BOU's website. This would help bring awareness of trends in forward levels, guide corporates in their hedging decisions, and serve as a transparent benchmark.

Phase two

a. An advance monthly volume target calendar should be pre-announced for forthcoming auctions. This will provide market confidence in active trading being cognizant of consistent offering.

b. BOU may consider conducting two-way FX Swap Auctions, which would be a very effective tool in market development and improving efficiency of monetary management.

c. The maximum exposure for net outstanding short forward position of BOU should be capped within 10 percent of liquid monthly FX reserves (excluding gold).

B. Market Benchmarks

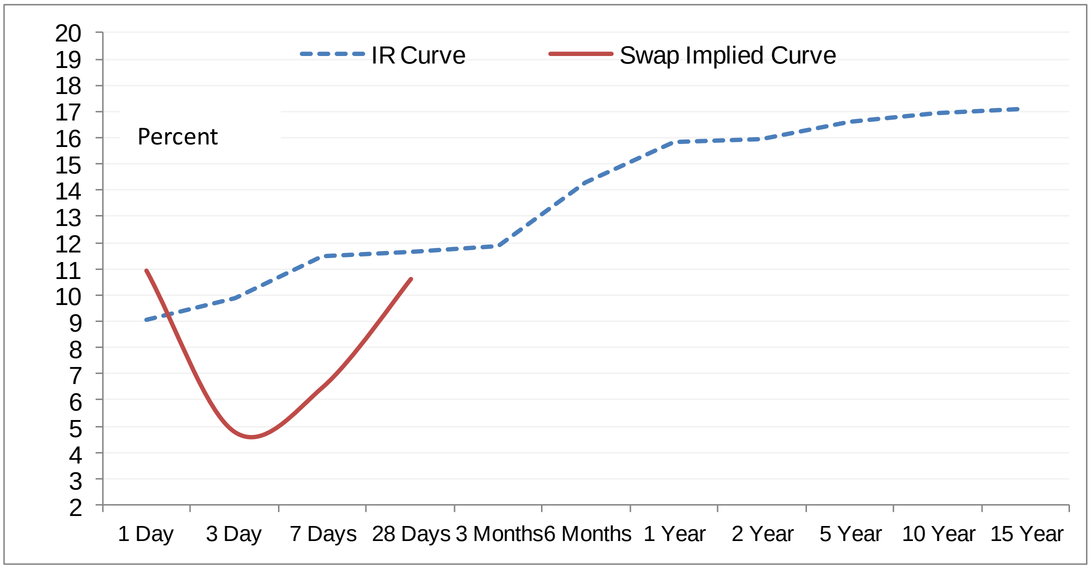
Assessment

61. **Lack of credible benchmarks across maturities also serves as an impediment to market development**. Thus, most FX transactions are skewed towards one month or less. Absence of credible benchmarks makes local corporate shy away from hedging their open exposures. The lack of benchmark serves also as an impediment in development and pricing of foreign exchange derivative and creates arbitrage opportunities with misalignment between various market curves. As

[10] The pricing of the forward leg of the swap should ensure that the implied domestic currency interest rate must be consistent with market interest rates, otherwise a potential for an MCP can arise. This is especially the case in fixed rate swap facilities/operations as the central bank and not the market is determining the swap margin. Auctions of FX swaps are more robust to this problem.

can be observed from below figure, there is a distinct misalignment between the IR Market Curve and the Swap Implied Curve, thus creating an arbitrage to raise shilling liquidity cheaper from the swap market versus the money market.

Figure 8. Uganda: Interest Rate Curve versus FX Swap Implied Yield Curve



Source: Bank of Uganda

Recommendation

- With the introduction of FX Swap Auctions, BOU can introduce market FX swap curve across standard maturities of 1, 3, and 6 months, which could serve as a transparent benchmark and would also help BOU to monitor for any misalignment in the curves. As banking liabilities have a significant portion denominated in foreign currency, swap could also serve as an effective tool of monetary management as discussed earlier. Non-banks and SOEs could also benefit from using such a benchmark to evaluate their hedging decisions.

POTENTIAL FORWARD-LOOKING MARKET DEVELOPMENT

A. Discount Window

Current situation

62. **The BOU has a discount window available to rediscount government securities of 91 day and less.** Although the window has not been used, it serves as reference for the Supervision department to define liquid assets to be taken into consideration for the liquidity coverage ratio.

Assessment

63. **The limitation to 91 days removes the usual incentives for a central bank to have a discount window.** Indeed, the main purpose of a discount window is to encourage the development of the secondary market by having a buyer of last resort.

64. **This limitation has an impact on the liquidity coverage ratio imposed by banking supervision.** Indeed, only T-bills of 91-day and less are considered as liquid assets for the purpose of liquid coverage ratio. The international best practice is that all government securities are generally accepted for the purpose of the Lombard facility, especially up to 1-year tenors.

65. **The mission recommends removing the discount window from the BOU toolbox.** The reference to the discount window seems to have been already removed from the new central bank act. An alternative would be to adjust the features in order to be conducive to the development of the secondary bond market.

Recommendation

- Abandon the discount window or change its features to be conducive to the development of secondary government bond market.

B. Development of the Horizontal Repo Markets

66. **The interbank market in Uganda is active but not vibrant as it is limited by credit lines (see comments on the PD system).** Interbank loans of short maturity are unsecured transactions limited by reciprocal credit lines. As of now, interbank market does not use repos as they are known in international practice. Although in process, there is no Master Repurchase Agreement at the level of the Ugandan interbank market.

67. **BOU has taken welcome initiatives to develop the horizontal repo market.** This will be beneficial for the Ugandan market as a true repo has many advantages including easier regional integration:

- True repo provides **stronger risk mitigation than simple pledge-based collateralized deposits/loans** and not just of credit risk but also of liquidity risk. This includes greater ease of netting in the event of counterparty default. Netting loans against pledged collateral can be problematic since in case of default the Creditor might have to compete with other creditors. The superiority of true repo over pledge-based collateralized borrowing and lending is reflected in preferential capital treatment under the Basel regime.

- By allowing the re-use of collateral, true repo circulates and makes more efficient use of collateral, which **supports money market liquidity**.

- In due course, repo will also provide a pillar to **support liquidity in the secondary market for government securities** by providing finance and short-covering for market makers. Some of the supply of government securities for short-covering could be drawn from pension funds, which will be able to earn incremental income for lending securities. And their presence in the repo market will help equilibrate the supply and demand of securities, enhancing the efficiency of the secondary market in securities.

- A true repo market is the most appropriate vehicle with which to make a long-term shift away from unsecured lending in order to **enhance financial stability**, a structural process that has been under way for some time in many markets and has been accelerated by the GFC.

- A true repo market will be the safest way of **integrating EAC money markets**. Whereas the law on security interests tends to differ widely between jurisdictions, the concept of a true sale is more uniformly understood. The latter therefore makes cross-border trading easier. So, for example, a Kenyan bank is likely to feel much safer lending to a Ugandan counterparty if it receives outright legal title to Ugandan collateral.

- Receiving pledged collateral would require familiarity with local processes of 'perfection' and, in the event of the Ugandan counterparty's default, the local bankruptcy process becomes an uncertain contest with local creditors for access to the collateral.

- Moreover, a domestic secured borrowing and lending market is trapped by its domestic procedures and infrastructure. While foreign lenders and borrowers can use it, as long as they are allowed to become direct members of the local securities depository, secured borrowing and lending is not as flexible as true repo. For example, true repo is settled across the standard security settlement system, which allows collateral to be held through custodial agents, who could be pan-regional entities.

68. **A true repo market will depend on a robust Master Repo Agreement (MRA).** There is no Master Repo Agreement in Uganda. Uganda does need to draft one from scratch; there are plenty of MRAs available across the markets that can be used as examples for Uganda and tailored as needed.

69. **While drafting a domestic MRA, it is critically important to stay as close as possible to the (International) General Master Repo Agreement, which is the reference of the other MRAs**. The question of a MRA at the level of the 5 EAC countries should also be raised in the perspective of the future regional integration, and the sooner, the better. East AFRITAC will organize a regional workshop on the topic next year.

C. Development of Standardized Documentation

70. **The International Swaps and Derivatives Association (ISDA) can be engaged with Ugandan financial market association** providing the required expertise to transpose the ISDA Swap Agreement for Ugandan Market. This document encompasses swaps, forwards and options.

ISDA has already carried out outreach of that nature in several emerging countries, working jointly with the authorities to disseminate expertise and information aBOUt the introduction of standardized documentation in the local market.

71. **At the inception, the market can adopt ISDA Light or localized Master Swap Agreement with regulatory cover from BOU.** This could be in line with the experience acquired with the Master Repo Agreement (MRA) for the local repo market. For credit & collateral risk management, localized agreement can be complemented by Credit Support Annexure (CSA).

D. Development of Primary Dealer System for Government Securities

72. **In line with our earlier recommendation to revamp the current PD System and limit it towards development of Government of Uganda (GOU) Securities Market, the authorities should seek to** (i) improve liquidity and price discovery in the secondary debt market; (ii) improve diversification of investor base and channelize the savings of end investor directly to governments debt instruments; (iii) bring efficiency to bank intermediation process; and (iv) gradually narrow the gap between the savings and lending rates within the Ugandan economy. Resultantly, over the medium term these measures would also bring efficient cost of borrowing to the government of Uganda. Hence, there is a need to create a balance between privileges and obligations of PDs to achieve such objectives.

73. **Bank of Uganda has been working on a revised draft in this context.** The newer draft guidelines having ten sections and can benefit from being shortened and issued in form of a regulation broadly covering six main sections for clarity and consistency, which may include as follows:

a. Objectives
b. PD Selection Criteria & Process
c. Roles and obligations of Primary Dealers
d. PD Privileges
e. Other Requirements and Obligations
f. Performance Criteria and Reporting Requirements

74. **In addition to the existing user-friendly concise flyers, it would also be beneficial to develop a "Hand-book on Investment in GOU Securities" separate from PD Regulations**. Such a hand-book may include operational guidelines pertaining to description of type of securities, auction process, and pricing methodology, payment and settlement processes, and description of debt market structure. In addition, it may also include rules governing debt instruments, information on taxation, investment process, as well as description of market conventions along with custodial arrangements. Standardization of application forms for non-qualified or retail customers along with pre-and post-trade confirmation process should also be well defined and documented. This

handbook would be an immensely beneficial tool in creating awareness among investors and widening of the investor base.

75. **Minimum/maximum bid amount in competitive as well as non-competitive bids needs to be defined and clarified.** Similarly, maximum bid lot size and total consolidated bids amount in case of competitive bids need to be clearly defined to reduce concentration risk and ensure that no single Primary Dealership should be able to corner any single auction (e.g., consolidated total bid amount of any single PD should not exceed 25 percent of the offered amount in that auction).

76. **Commission, fees and charges either paid for underwriting, client flows, and/or non-competitive bids need to be rationalized with envisaged objectives.** Similarly, the underwriting commitment by PD needs to be clearly documented, to be clarified as to how much share each PD be exposed to vis-à-vis the announced auction target if it is under subscribed for prudent risk management.

77. **Other Suggestions for improvement of GOU Securities Market:**

a. The reporting of securities held by customers should be defined and processed to ensure that the reconciliation and audit of such balances could be instituted.

b. Reporting requirements, both in case of non-competitive bids and PD activities, may be standardized.

c. It is recommended that the auction of government securities (both T-bills and T-bonds) be paced out and synchronized, so that PDs have time to buy, hold, and distribute the securities.

d. Long-term bond issues should be re-opened for full financial year; this will ensure benchmark issues are liquid across the curve. PD's may also be allowed to run short securities positions in long-term bonds between auctions covered through repos. This will also improve pricing spreads and liquidity in the bond market.

e. Overall duration of the sovereign debt outstanding portfolio should be be managed and should be in line with regional and global practices, generally observed to range between 3.5 to 5 years.

f. Introduce advance primary auction calendar, initially one quarter in advance, for GOU Securities, that should include volumes, tenors and auction dates. This will also help in the development of efficient debt market and liquid yield curve.

CENTRAL BANK RECAPITALIZATION AND BANK OF UGANDA ACT

A. Balance Sheet Trends

78. **The BOU continues the accumulation of foreign currency assets on its balance sheet both in absolute terms and as a percentage of total assets.** Table 8 illustrates the trend in the

balance sheet and the composition of its assets. The stability of the level of foreign currency liabilities means that the increase in proportion of foreign currency assets has increased the size of the BOU's open FX position, with material impacts on operating income and exchange rate exposure.

Table 8. Bank of Uganda: Trend in Balance Sheet Composition
UGX(Mil)

	2009	2010	2011	2012	2013	2014
Foreign Financial Assets	5,143,471	5,761,171	6,896,972	7,493,808	8,994,945	10,165,482
Domestic Financial Assets	2,877,630	3,576,823	5,537,737	6,634,603	7,266,441	3,054,684
Sub total	8,021,101	9,337,994	12,434,709	14,128,411	16,261,386	13,220,166
Other	82,844	83,574	106,979	113,959	351,226	457,721
Total	8,103,945	9,421,568	12,541,688	14,242,370	16,612,612	13,677,887
Foreign assets [1/]	64.12	61.70	55.47	53.04	55.31	76.89

[1/] As percent of total
Source: Bank of Uganda.

79. **The accumulation of foreign reserves balances is consistent with the BOU's objective of accumulating 4.5 months of imports worth of foreign reserves, the EAC's common objective.** This accumulation carries two costs, a greater exposure to the historically low yields of reserve currency sovereign assets, and increased valuation volatility from exchange rate movements.

B. Impact on Bank of Uganda's Performance

80. **The increase in BOU's foreign currency exposure created the dual impacts of reducing interest income while increasing interest expenses.** Table 9 shows the trend in BOU net interest margin that reflects the declining interest income, a consequence of lower yields overcoming higher amounts invested. The interest expense reflects the increased costs of sterilizations, a consequence of the BOU's accumulation of foreign exchange reserves.

Table 9. Bank of Uganda: Trend of Interest Income and Expenses
UGX (Mil)

	2009	2010	2011	2012	2013	2014
Interest income	114,804	38,254	129,532	60,773	82,723	84,233
Interest expense	(1,279)	(1,297)	(2,648)	(1,612)	(37,700)	(59,997)
Interest Expense as percent of interest	1.11	3.39	2.04	2.65	45.57	71.23

Source: Bank of Uganda.

81. **The material increase in interest expenses from 2012 to 2013 represents the transfer of sterilization costs from the MOFPED back to the BOU once the MOFPED ceased issuing treasury bonds to absorb excess liquidity.** The MOFPED ceased issuing these securities but

offered the BOU a series of non-tradable, unremunerated "securities" to use as collateral in repo transactions. These "securities" have the characteristics of guarantees and transfer the cost of monetary operations onto the BOU's already stressed balance sheet.

82. **It is important to note that the convergence of interest income and expenses arises from the BOU fulfilling its policy mandate as required in its law.** Discussions on central bank finances are full of references to good losses and bad profits arising from the central bank's meeting its policy mandates. The global financial crisis has resulted in a prolonged reduction of real interest rates in reserve currency sovereign instruments, compounded by capital inflows as investors seek additional yield. These capital inflows require sterilization, so the virtuous actions of raising foreign reserves and controlling reserve money results in adverse financial outcomes as reported in the financial statements.[11] Such is the scale of the costs attaching to these two policy developments that only efforts to address asset composition or transfer costs will address the situation. Despite that, the mission notes that the BOU has taken significant steps to control its operating expenses, a situation discussed in Section VIII.

83. **The result of the convergence of interest income and expenses has been a sustained series of operating losses since 2009.** Table 10 presents the trend of net interest margins, operating costs and realized deficits. This table excludes the effect of the unrealized revaluation gains that have enabled the BOU to report a positive operating result in most years. Unrealized revaluation gains have no impact on a central bank's "policy solvency".

Table 10. Bank of Uganda: Realized Surplus/Deficit
UGX(Mil)

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
Net Interest & Commissions	137,750	62,773	138,156	142,660	65,856	97,283
Total Operating Expenditure	(138,134)	(202,997)	(386,477)	(241,119)	(311,313)	(280,876)
Realized Surplus/(Deficit)	**(384)**	**(140,224)**	**(248,321)**	**(98,459)**	**(245,457)**	**(183,593)**

Source: Bank of Uganda.

84. **The table presents realized surpluses, as this is the closest approximation to a state of policy solvency that standard financial statements can present.** A central bank reporting positive realized surplus demonstrates its ability to withdraw sufficient realized resources from the economy to cover its realized operating expenses. Sustained reporting of realized deficits means that the bank has withdrawn insufficient resources from the economy to cover its expenses. To cover the earnings shortfall the bank must monetize its deficit. This increases the excess liquidity that the central bank

[11] Starting in October 2014, the BOU dropped the base money-related indicator from its indicative targets list.

must mop up the next round of monetary operations. The continued reporting of unrealized revaluation gains, arising from the weakening UGX, disguises this process of realized losses.

85. **The eventual consequence of continued losses is to raise the cost of monetary policy operations and government borrowing costs as commercial banks demand higher interest to compensate for what they perceive as a more problematic policy framework.** Central banks generally enjoy a reasonable time horizon before facing this situation but the current shortage of realized income is influencing the BOU's freedom of choice of instruments and level of sterilization for monetary operations.

C. Government Loss Compensation Injections

86. **The level and timing of government injections into the BOU represent more a move to compensate the BOU for operating losses than a coordinated effort to recapitalize the bank.** This may be appropriate until the eventual amendment of the BOU Act and the implementation of a more appropriate capital framework (see a capital framework discussion). Table 11 presents the projected cumulative level of the BOU operating losses from 2009 (when the BOU reported its first loss in this recent trend of realized losses) to 2017, and the projected outcome net of loss covering injections.

87. **As demonstrated, even with the expected UGX 1,210 (billion) injections from the government, the BOU will continue to accumulate realized operating losses at least until 2017.** The loss covering injections will reduce but not prevent the growth of the cumulative deficit. This is a worrying trend as the longer the BOU must operate under an impaired core capital position, the more limited it will perceive its monetary instruments and scale of operations to be and the further will be the deterioration of the balance sheet. Obviously, the figures for 2015–17 are estimates but they represent the BOU's best estimate of future trends.

88. **The focus of attention is the recurring realized deficit that indicates that the BOU will continue to be unable to generate sufficient income to cover their policy and operating costs over the medium term.**

Table 11. Bank of Uganda: Trend in Realized Deficit [1/]
UGX (Mil)

	Realized Surplus/ (Deficit)	Loss Covering Securities	Cumulative Deficit
2008/09	**(384)**		**(384)**
2009/10	(140,224)		(140,608)
2010/11	(248,321)		(388,929)
2011/12	(98,459)		(487,388)
2012/13	(245,457)		(732,845)
2013/14	(183,593)	410,000	(506,438)
2014/15	(-264,858)	250,000	(521,296)
2015/16	(-291,120)	200,000	(612,416)
2016/17	(-106,844)	350,000	(369,260)

[1/] The BOU Business plan provided the estimated expenditure totals for 2015–17.
Source: Bank of Uganda

89. **The large open foreign currency position between assets and liabilities exposes the BOU to the impact of the negative carry between foreign asset and domestic liabilities.** While this situation has persisted longer than desirable, the expectation is that a decision of the US Fed to raise interest rates on 2015 will start the process of closing the spread and return holders of US sovereign financial instruments to positive yields. Given the current strength of the US dollar and the modest rate of US economic recovery this may not happen quickly. Hence, central banks need to be prepared to manage a continuation of the negative carry but with a trend towards recovery over the medium term. This suggests that a combination of short and long term solutions maybe appropriate for the BOU.

90. **The essence of the solution is to improve the BOU's supply of realized income to cover their continued high level of interest expenses.** The key element in this solution will involve the use of financial instruments denominated in national currency, with each option having strong policy implications. The solutions do not require an automatic recapitalization of the BOU, though capital injections provide one option. The authorities may consider the range of options in isolation or in various combinations:

- A restitution of MOFPED's securities purchase program (that program to mop up an agreed pool of excess structural liquidity) would reduce the BOU's level of interest expense. The parties could schedule this to continue until the earlier of the recovery of yields on the foreign securities or a reduction in the excess liquidity.
- Implement charging regime on debit balances on UGF. An amendment in the BOU law prevents netting of government account balances so that any use of temporary advances will incur interest charges.
- Convert all or part of the UGX 1,200 (billion) current "repo" securities into marketable securities. MOFPED could treat these securities as a deposit or capital injection.
- Convert part of the UGX 1,700 (billion) of the Uganda Consolidated Fund receivable into marketable securities and issue them to the central bank.
- Increase the level of planned "recapitalization" securities to generate enough income to close the realized deficit.

91. **Ideally, the combination of these balance sheet adjustments should target an additional UGX 160 (billion) of additional income, or decrease in expenditure if the MOFPED resumes its bond purchase program.**[12] This increase in income will create a matching increase in interest costs to the fiscal budget and so may require some phasing. The sooner the BOU is able to achieve a realized surplus; the lower should be the total cost of restoring policy solvency.

92. **Beyond the financial instruments options is the opportunity for the BOU to increase its non-interest income.** The BOU has already made considerable progress on this and has identified

[12] The UGX 160 (billion) derives from an expected average realized deficit of UGX 200 (billion) reduced by the budgeted additional UGX 42 (billion) from an increase in noninterest income.

chargeable services to the government totaling UGX 42 billion. Agreement of these charges are awaiting approval as part of the next budget, 2015/16. Initiatives in this area will increase income at the margin but cannot substitute for a coordinated adjustment of the balance sheet and policy options in discussions with the MOFPED.

93. **From a balance sheet strength perspective, the outright sale of financial instruments weakens the central bank's financial strength.**[13] While the sale is probably cost neutral (or cheaper) than other options in the short term, and may reduce the administrative overheads, it removes the asset and associated income stream from the central bank's books. On maturity of the sold bond, the liquidity returns to the market but the bank now lacks the instruments to sterilize. A better strategy is to retain the security and renew it on maturity with the MOFPED, rather than needing to return to the MOFPED and ask for new issues of securities. The mission is aware that some deemed the sale of the securities as disruptive to the MOFPED's debt sales. The BOU's repurchase of UGZ of 80 (billion) of the previously sold securities seems to support the argument for retention. However, in this area the mission acknowledges that policy considerations take priority

Recommendations

- Continue to press for government adoption of proposal to introduce direct charging for BOU services provided to government.
- Negotiate further tranches of "recapitalization" bonds to provide realized income to close realized income deficit.
- Convert part of the UGX 1,700 (billion) of the Uganda Consolidated Fund receivable into marketable securities and issue them to the central bank.
- Negotiate replacement of "repo" securities with marketable securities for use in market operations.

D. Bank of Uganda Capital Arrangements

94. **The current law's capital framework is inadequate and inappropriate for a modern central bank.** A literal application of the law would provide the BOU with maximum core capital of UGX 90 (billion) that is just 0.68 percent of BOU's current financial assets. The law defines maximum authorized capital of UGX 30 (billion) of which the government has issued UGX 20 (billion). The other element of prescribed capital is a General Reserve Fund that has a non-binding upper level of twice the amount of the paid-up capital of the bank. In addition to these legal elements, the BOU has created additional elements of its capital structure so that the current capital structure contains multiple elements not covered in the narrow legal definition.

[13] The mission received late information that the "outright sale" of these bonds may be a form of long term repo as the MOFPED will replace the bonds on maturity. Such a situation changes both the nature of the accounting for the "sale" of the bonds and the long-term effectiveness of the transaction.

Table 12. Bank of Uganda: Trend in Core Capital 2009–14 (Mil of UBX)

	2009	2010	2011	2012	2013	2014
Authorized Capital	20,000	20,000	20,000	20,000	20,000	20,000
BOU Recapitalization securities					410,017	410,017
General Reserve	20,175	20,175	20,175	20,175	257,971	269,225
Revenue Reserve	167,467	25,834	(208,546)	(306,713)	(530,357)	(643,532)
Earmarked Funds	19,072	21,232	4,375	4,375	0	0
Total Core Capital	**226,714**	**87,241**	**(163,996)**	**(262,163)**	**157,631**	**55,710**

Source: Bank of Uganda

E. Defining a New BOU Capital Structure

95. **The proposed amendments to the law will provide the BOU with a capital structure appropriate for a modern central bank.** The key element will be a dynamic capital structure that defines core capital and allows it to grow in alignment with the bank's balance sheet. The capital structure will have a clear separation of realized and unrealized revaluation elements that ensures the integrity of all the elements. The law will define the concept of distributable earnings, their calculation and the basis for their distribution to core capital or the government. The law incorporates procedures for central bank recapitalization.

96. **Proposed provisions within the law makes increases in capital, issues of distribution and recapitalization formulaic, automatic, and non-discretionary**. This attempts to resolve the issues of the perverse incentives for stakeholders to demand more distributions and central bank boards to seek ever greater reserves. Appendix III discusses the detail relating to defining the BOU's dynamic capital structure within the law.

97. **A bank's capital framework is only as good as the quality of assets on the balance sheet and their ability to generate income.** Hence, a robust capital definition requires an equally robust accounting framework to ensure the appropriate recognition and measurement of assets and liabilities in the banks' balance sheet. If assets are impaired, then the accounting must reflect this.

F. Amends to the Existing Capital Structure

98. **In the 2013/14 financial statements the external auditors required the presentation of the recapitalization securities as a separate item in equity.** This is correct in a narrow reading of the law and requires the Board to pass a motion to have it allocated to an appropriate element of capital. Under the existing legislation, this can only be the general reserve. Once passed, the BOU can start accounting for any income on the recapitalization bonds as interest income.

99. **The existing BOU law seems to only allow authorized capital and a general reserve.** This is consistent with the common central bank capital structure. Within its existing arrangements, the BOU has a range of other reserves. It could usefully combine the general, revenue and

recapitalization bonds into a single general reserve. The revenue reserve equates to the old retained earnings account, a suspense account, which the bank should always clear to zero at period end.

100. **Presentation in the equity section of the financial statements should separately disclose core capital and revaluation reserves.** The notes to the accounts would disclose the individual reserves in each group. Such an approach would illustrate when core capital is negative thus triggering recapitalization, thus highlighting the existence of the realized deficit discussed earlier.

Recommendations

- Have the Board pass the necessary motions to classify the recapitalization bonds as part of general reserves.
- Start accounting for interest on the recapitalization bonds as interest in the profit and loss.
- Amend capital disclosures in the financial statements to separate core capital from unrealized revaluation reserves.

AMENDMENTS TO THE BANK OF UGANDA LAW

101. **The mission recommends that the BOU's seeks to complete all its consultations and reviews by April 2016 in time for submission to the new parliament.**[14] In conjunction with the legal counsel and her team, the mission reviewed two sets of comments from the Fund on proposed changes to the law and the BOU's response to them. As discussed, several areas will require extensive consultation with a range of external parties. Completing these, finalizing amendments and submitting for IMF review will be a time-consuming process that will require tight project management to keep to the schedule.

102. **Material items that will require substantive discussion are, specifying who and how defines the meaning of price stability, the definition of the amended capital arrangements and issues emerging from an evolving understanding of the financial system stability mandate.** Appendix VI summarizes these discussions that the BOU will consider before sending a final draft of the law to the Fund's legal department. Discussions on the law took account of the requirements into the East African community Monetary Union Protocol.

103. **A specific amendment prevents the netting of any advances to government against other government balances.** This will make any temporary advances to government subject to interest from origination until repayment of the final balances. This serves the dual purposes of ensuring the remuneration of more BOU domestic assets, while providing an incentive to the government in their development of the single treasury account. Obviously, the advance of the treasury single account will make the remuneration of the overdraft a transitional benefit.

Recommendations

[14] A PSI structural benchmark is aligned with the proposed timing of the BOU Act approval by parliament in April 2016.

- Complete development of the BOU's future capital structure and gain BOU Board and MoFPED agreement.
- Specify the new capital arrangements in the amendments to the BOU law.
- Proceed with completing the proposed amendments to the BOU law, forward it to the Fund's legal department for final review, and sign off.
- Plan to complete consultations and reviews to be able to submit the amended law for April 2016 in time for the new Parliament.

ACCOUNTING AND PLANNING

104. **The BOU financial statements received a clean audit opinion and represent a good example of central bank adoption of International Financial Reporting Standards (IFRS).** Since the 2013 mission the BOU have worked to implement all mission's recommendations and the Appendix IV presents some detailed BOU's discussions on accounting and should be read in conjunction with the earlier comments on the presentation of capital.

105. **To enhance its accountability the BOU developed a four year Medium Term Business that it presented to the MoFPED.** This proved effective in demonstrating the BOU's control over its planning and expenditures. Despite the lack of formal sign off of the document from the MOFPED, the department is aware of the document, a situation that supports BOU's continuation and refinement of the process.[15] BOU may consider making a clearer separation between those expenses that it has internal control of and those that are exogenous. This is a split between operational and policy costs. The bank could integrate its publication as an annual output in its strategic planning process and provide annual updates that show both forward looking costs and a comparison of actual to project. This will enhance the document's integrity.

106. **BOU management of the proposed Petroleum Revenue Investment Reserve will impact BOU's balance sheet.** While it should not impact BOU's capital requirements a number of issues remain outstanding on how BOU will integrate it into its financial structure. A key issue is the decision that the BOU will manage it as agent as this will determine the accounting framework. Consequential issues are elaborated in Appendix IV regarding governance and reporting flow from this decision.

Recommendations

- Implement the refinements to capital presentation in the financial statements discussed in the report.
- Enhance the presentation of the medium term business plan as suggested and integrate it into the strategic planning process as an annual output.
- Ensure development of the Petroleum Revenue Investment Reserve is consistent with the BOU's role as management agent.

[15] In discussions, the MoFPED recognized the BOU's achievements in controlling its operating expenses and expressed stronger conceptual support for BOU recaptrialization than in previous missions.

Appendix I. Coordination Between the BOU And Mofped In the Field of Government Cash Management

1. **Close coordination between the BOU and MoFPED has been established, with information and projections on government cash flows shared in the weekly meetings of Macroeconomic Steering Committee.** According to the Memorandum of Understanding between the BOU and MOFPED the Macroeconomic Steering Committee has been established. Weekly meetings, chaired by MOFPED, deal with the issues important for coordination of fiscal and monetary policies (recent developments in the economy and their implications on liquidity management, preparation for the monthly cash flow meetings, reaction on emerging economic developments etc.). However, with the decentralization of payments, forecasting the cashflows and the exact timing of government payments remains difficult.

2. **Cash planning is still a top down process in Uganda.** Government cash flow plan envisages allocating quarterly cash limits based on the cash resources, so that it follows the cash rationing rather than cash forecasting principle. The quarterly cash flow plan is then sliced to monthly cash flow plans and for the need of projecting daily flows that affect banks' reserves, the BOU estimates, by itself to the best experience and available information, daily flows of government sector revenues and expenditures.

3. **In the top down quarterly budgetary planning process, based on each budget for the financial year, the Consolidated Fund plays a central role.** All domestically raised revenues and proceeds from debt financing flow into the Consolidated Fund. Also, all domestically funded budget releases for spending are made from the Consolidated Fund. In terms of cash flow, all the monies, related to revenues and other means of budget financing are paid in to the Consolidated Fund Account at the BOU, and all the monies needed to pay expenditures are withdrawn from it. The Consolidated Fund Account is a current account, which can be over drafted by the government according to the rules and in extent that is not entirely under control of BOU.

4. **The Consolidated Fund Account remains out of Treasury Single Account (TSA) framework.** Government of Uganda has introduced a TSA framework with effect from October 2013. In the first stage, the initial TSA covers only part of operational accounts at the Bank of Uganda; in the second stage, the coverage will be further extended and many existing accounts shall be closed. The main account in the TSA framework is TSA Holding Account which represents the sum of each vote's unpaid out amount on each accounting warrant and the sum of pooled balances from TSA Sub Accounts at the end of the day. Subsequently, the GoU has largely improved the capacity to aggregate cash balances and it has improved efficiency in terms of transaction costs, control and monitoring of funds released. On these grounds there is scope for better coordination between fiscal and monetary policy implementation but it is not enough to achieve clear separation of fiscal and monetary operations.

5. **Net government position, as presented by the BOU, is in credit, but fluctuates considerably.** It represents the total of government deposits (together with project funds), the balance of Oil Tax Revenue Fund and the total drawdown (most of it relates to the Uganda Consolidation Fund).

6. **The following set of data is being exchanged between the MOFPED and the BOU (by period):**

- Government Cash Flow—quarterly
- Treasury Auction Issuance Calendar—monthly
- Treasury Auction Performances—per every auction
- Revenue Performance—monthly
- Fiscal operations—monthly
- Government Position—daily from Accounts Department

7. **The government daily cash flow projections are important for the quality and reliability of the BOU liquidity projections which serve as background information for monetary operations decisions by the Financial Market Operations Committee.** Financial Markets Department prepares the "Short Term Liquidity Forecast Report and Proposal" for the day T and presents it to the Financial Market Operations Committee, which decides to intervene or not, and also the direction and the amount of intervention. The table covers injections to and withdrawals from the BOU's accounts that affect liquidity of the banking system. These flows show monetary policy operations, fiscal policy operations (debt management, tax revenues, and public spending), FX transactions (buildup of reserves purchases, sales to BOU customer and interventions) and other autonomous transactions. For the day T-1, the table compares projected and outturned amounts of flows and states the opening and closing excess reserves position of the banking sector. As a memorandum item, the surplus or deficit of the cumulative average reserves position of banks from the beginning to the T-1 day of maintaining period is calculated. As market intelligence based information, the aggregated amounts of anticipated supply and demand for banks balances for the day T are derived from individual bank projections.

8. **One of the previous IMF technical assistance missions (FAD TA report "A Concept Paper for the TSA and Improving Cash Management", May 2013) extensively dealt with the issue of cash flow planning on the side of the government. Its recommendations still hold.** Due to recently accepted new Public Finance Management (PFM) Act it is important to follow them in the current process of drafting sub law regulation, preparing new Memorandum of Understanding and defining Service Level Agreements for providing services by BOU to MoFPED.

9. **Within the year, cash shortages in executing the budget for the current financial year should be financed by fiscal operations, i.e., by issuance of T-bills.** According to the new PFM Act the government still has access to the overdraft facility at the BOU. The government should refrain to use the overdraft facility unless there is a problem with the T-bill market. In such a case, the debt should be paid off within shortest possible time, by the end of fiscal year the latest. The mixing of fiscal operations with monetary operations affects efficiency of liquidity forecasting of the BOU and thus also efficiency of monetary operations aiming at price stability.

Recommendations

- A dedicated Cash Management Unit in a newly formed Directorate for Debt and Cash Management within the Treasury Department of MOFPED should be established.
- Such a cash management unit should start producing on a regular basis (at least on a weekly basis) formalized daily projections of cash flows on government accounts, taking into account revenue and expenditure plans of ministries, departments and agencies.
- The Cash Management Unit could improve the accuracy of its cash flow projections through time under the Cash Flow Committee, in which representatives from BOU and MOFPED at the more operational level would participate.
- In case of forecasted shortage of cash resources to meet planned expenditures the Cash Management Unit would have to recourse to the T-bill market to raise needed funds.

Appendix II. Principles of LOLR

1. **LOLR** is provided by a central bank, in exceptional circumstances to systemically important and solvent institutions and in response to idiosyncratic short-term needs for liquidity, when all other market-based sources of funding have first been explored. LOLR lending is always temporary and at the discretion of the central bank.

2. **Legal basis.** Legal acts should have scope for the central bank to provide lending outside of its monetary policy framework. Some countries choose to complement the legal basis and outline to the market their requirements and the operational parameters relating to LOLR in a guideline or other communication ("rules-based" approach), while in the case of others, the pre-conditions and operational arrangements are not known to the outside world ("constructive ambiguity").

3. **Solvency.** In order to avoid institutions taking on excessive risks (creation of moral hazard risks), LOLR is generally provided to solvent institutions. If a central bank is to use public funds and provide credit against nonstandard collateral (which may be hard to value), it should be satisfied as far as possible that the bank in question is solvent. A solvency assessment should be an ongoing assessment and include the entirety of the period for which liquidity support is given.

4. **Viability.** While an institution is solvent, it may have not had a business model or purpose or be subject to liquidation in the near future. It is prudent for the central bank not to lend to such nonviable entities, as there is little chance the monies lent will be recouped. A viability assessment should not just be at a point, but also needs to be forward looking.

5. **Counterparty access.** LOLR access is generally limited to institutions which are subject to prudential supervision by the central bank or competent authority, which allows for the imposition of prompt correction action as required.

6. **Systemic importance.** In general, LOLR is provided to systemically important institutions only, those institutions that are large, interconnected in the economy, and difficult to replace. Regarding non-substitutability, this could apply to either the financial institution as a whole or specific functions/services it provides (e.g., a certain financial infrastructure). Some central banks, on the other hand, lend to all banks as comfort is gained from the prudential supervision and therefore the ability to impose conditionality.

7. **Supervisory intrusion and conditionality.** Institutions in receipt of LOLR should be subject to enhanced supervision and conditionality so that the central bank has comfort that the monies lent can be repaid and that the funding is being used for appropriate means. Direct or indirect supervisory powers allow the central bank to impose prompt corrective actions, should certain counterparty actions not be in line with expectations. Such conditionality could include management replacement, asset sales, retention of profits, or at an extreme, mergers or resolution.

8. **Collateral.** As institutions will have explored all other options for funding, including monetary policy operations, it is generally expected that the collateral will be illiquid and in the majority of cases, possibly loan collateral. Collateral taken into consideration should still be adequate in order to protect the BOU from default.

9. **Risk control measures.** The approaches taken can be similar to that outlined for monetary policy operations, but given the expected liquidity of the collateral involved (e.g., loans), the haircuts are expected to be higher and valuations lower.

10. **Penal interest rate.** When calculating the appropriate rate, a central bank should be trying to strike a balance between incentives for a distressed institution to seek alternative funding and moral hazard. In general, central banks apply a fixed spread over the overnight lending facility.

11. **Maturity.** LOLR involves the temporary provision of liquidity and should not be provided for longer than absolutely necessary; that is, just long enough to address underlying liquidity difficulty. Should the liquidity need be prolonged, this could indicate more acute difficulties, such as insolvency or nonviability.

12. **LOLR is not a facility.** LOLR is at the central bank's discretion which avoids the perception that the central bank always stands ready to support the institution (moral hazard).

13. **Exit plans are a key requirement.** All institutions drawing LOLR should be subject to a detailed and binding funding plan. From this plan it should be clearly evident, on an ongoing basis, that the institution is able to repay the funding, or if additional liquidity needs or the requirement for other solutions arise.

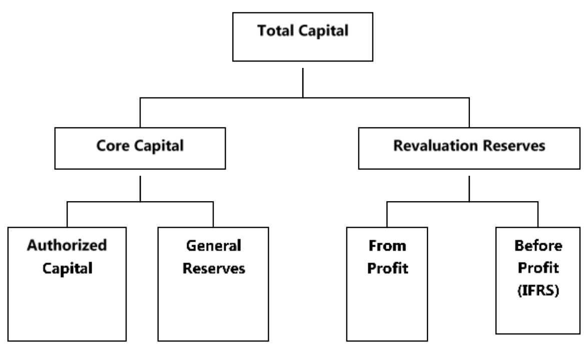
14. **Internal understanding and co-ordination is a necessary prerequisite.** The provision of LOLR involves a number of key areas—banking, operations, and legal—with reliance on key areas for input into the process. In general, central banks establish an internal working group to facilitate the sharing of information and to ensure all parties involved have a clear understanding of their roles.

Appendix III. Amendments to Bank of Uganda Law Regarding Capital

1. **A key element in the BOU's amendments of its law is the updating of its capital framework to provide financial independence for a modern central bank.** The different elements are (i) the bank's accounting framework; (ii) the structure and level of capital; (iii) the configuration of revaluation reserves; (iv) the definition of distributable earnings; (v) the basis for distributions to reserves and stakeholders; and (vi) the arrangements for recapitalization. It is MCM's preference to strictly limit the discretionary powers of the minister and board on issues of capital, defining all actions as automatic functions of provisions within the law. The amendments discussed in this section apply to part III Capital, Reserve and Currency of the current BOU Act.

2. **Central bank capital consists of two elements, core capital, commonly referred to as statutory capital due to is definition within the law, and revaluation reserves.** Figure I presents the common structure of central bank capital. Under modern configurations of capital core capital may costs of a single core capital account, while the revaluation reserves may comprise multiple accounts depending on how finely the bank classifies its unrealized revaluations. For example, the ECB has a separate revaluation reserve for each financial instrument and each currency.

Figure 1. Elements of Central Bank Capital Framework



Source: Fund Staff

Core Capital

3. **Core capital consists of realized capital. Traditionally, this has comprised authorized capital and the general reserve formed by the retention of realized earnings held to provide income generating assets and to cover losses.** The general reserve may subsume other reserves of realized income, such as the revenue reserve or asset replacement reserve. These reserves should only ever consist of realized income.

4. **Core capital comprises a minimum and maximum level that may apply to the single capital account, thus combining the authorized and general reserves capital accounts.**

Discussions with the BOU suggest that this framework is appropriate for its new dynamic capital framework. As an example, the law could specify core capital as having a maximum and minimum percentage (to be specified) of monetary liabilities (that will require definition). The minimum percentage will represent the traditional authorized capital and the difference between the minimum and maximum will equate to the sum of all other realized capital reserves (general reserve, revenue reserve and recapitalization bonds for the BOU).

5. **The model requires definition of both the percentages of the levels of core capital and of the dynamic denominator, monetary liabilities.** These definitions should be fixed and only adjustable by a further amendment of the law. The current draft suggests that maximum core capital be 30 percent of reserve money. The mission endorses the concept but offers the following advice on the constructs.

6. **Reserve money may be too narrow a denominator for core capital as it excludes other material elements that affect the BOU's obligations.** The critical element excluded from the definition is BOU liabilities issued as part of its monetary operations. This includes repos, deposit auctions and FX swaps, should the BOU adopt these instruments. The growth of these liabilities increases the BOU's need for assets to fund them and for capital buffers to cover potential losses. Hence, the mission advises a broadening of the core capital denominator from reserve money to include BOU own liabilities. This definition is broadly consistent with the MCM definition of monetary liabilities.

7. **Table 1 illustrates the level of required core capital under different definitions of the denominator**. The presentations use assumptions of 10 percent of monetary liabilities, the MCM default starting position, the proposed 30 percent of reserve money, and 30 percent of monetary liabilities. Material variances exist between the core capital levels under the various definitions so the BOU needs to be able to justify their preferred level. The MoFPED will justifiably challenge the basis as it affects the level of resources they need to supply or forgo to ensure the BOU's capital adequacy.

Table 1. Examples of Denominators For Determining Core Capital (UBX million)

	2009	2010	2011	2012	2013	2014
Monetary Liabilities						
Other foreign liabilities	94	94	94	94	6,187	12,675
Currency in circulation	1,468,641	1,738,981	2,189,817	2,204,471	2,450,857	2,746,092
Commercial bank deposits	506,237	863,025	867,982	828,286	1,116,386	1,371,783
Repos	-	-	69,535	29,880	543,101	910,854
Total Monetary Liabilities	1,974,972	2,602,100	3,127,428	3,062,731	4,116,531	5,041,404
10 Percent of Monetary Liabilities	197,497	260,210	312,743	306,273	411,653	504,140
30 Percent of Reserve Money	592,463	780,602	917,340	909,827	1,070,173	1,235,363
30 percent of Monetary Liabilities	592,492	780,630	938,228	918,819	1,234,959	1,512,421

Source: Bank of Uganda and Fund Staff calculations.

8. **Table 2 presents the effect on the level of capital shortfall under the various scenarios.** The negative figures illustrate the amount of additional capital, beyond the UGX 410 (billion) already provided; the MOFPED will need to provide to meet the minimum core capital level.

Table 2. Core Capital Performance

	2009	2010	2011	2012	2013	2014
Core Capital		**UBX (mls)**	**UBX (mls)**	**UBX (mls)**	**UBX (mls)**	**UBX (mls)**
Authorized Capital	20,000	20,000	20,000	20,000	20,000	20,000
BOU Recapitalization securities	0	0	0	0	410,017	410,017
General Reserve	20,175	20,175	20,175	20,175	257,971	269,225
Revenue Reserve	167,467	25,834	-208,546	-306,713	-530,357	-643,532
Earmarked Funds	19,072	21,232	4,375	4,375	0	0
Total Core Capital	**226,714**	**87,241**	**-163,996**	**-262,163**	**157,631**	**55,710**
Actual Core Capital as percentage of denominator (33.3 percent proposed minimum)						
10 percent of Monetary Liabilities	115	34	-52	-86	38	11
30 Percent of Reserve Money	38	11	-18	-29	15	5
30 percent of Monetary Liabilities	38	11	-17	-29	13	4
Statutory Capital Shortfall						
10 Percent of Monetary Liabilities	**29,217**	**(172,969)**	**(476,739)**	**(568,436)**	**(254,022)**	**(448,430)**
30 Percent of Reserve Money	**(365,749)**	**(693,361)**	**(1,081,336)**	**(1,171,990)**	**(912,542)**	**(1,179,653)**
30 percent of Monetary Liabilities	**(365,778)**	**(693,389)**	**(1,102,224)**	**(1,180,982)**	**(1,077,328)**	**(1,456,711)**

Source: Bank of Uganda and Fund Staff calculations.

9. **When determining the appropriate level of its core capital the BOU will need to model the different scenarios and arrive at one that sufficient to provide financial strength to enable it to discharge its functions.** It can do this by modeling the income the assets from the different scenarios will generate in long term scenarios covering normal interest rate assumptions both domestically and on its foreign reserves portfolios. The report showed that the UGX 800 (billion) additional capital will not cover the realized deficit, but as noted in the report the recovery does not all need to come from additional capital. The problem for the BOU is the stakeholder's indifferent record to date of ensuring that the BOU's holdings of its obligations are remunerated at market rates.

10. **Any proposed core capital framework must be accepted by its stakeholder as being reasonable.** This will require the BOU to include the MOFPED in its modeling and discussions.

Unrealized Revaluation Reserves

11. **The law should contain provisions for the creation of the two classes of revaluation accounts identified, revaluations before profit (IFRS) and as allocations from profits.** The law should not be too specific as the bank may wish to create sub accounts for classification of totals in each of these sections. A general provision allowing the bank to create those unrealized revaluation reserves it needs to be able to report in compliance with its law and accounting framework is sufficient.

12. **A critical characteristic of all revaluation accounts are that they only hold unrealized revaluations.** BOU's amendment of its policy for realized and unrealized gains implemented since the last mission addresses this condition.

Distributions

13. **BOU should amend the current article 16 on distribution of profits and loss to address three issues, i) BOU's financial reporting framework, ii) the definition of distributable earnings, and iii) the basis for allocating distributable earnings to statutory capital and as dividends.** The current law broadly follows this approach but the evolution of IFRS, the BOU's reporting framework, mandates some amendments. The article should identify that BOU prepares its annual financial statements in accordance with IFRS. As this comprehensive framework covers all aspects of financial reporting there is no need for any qualifications relegating it to central banks or identifying specific items for consideration.

14. **As central banks should only ever distribute realized income, the Act should define distributable earnings.** This involves adjusting net income under IFRS for unrealized and realized revaluation gains and losses to produce a pool of realized earnings, net of unrealized losses for which no revaluation reserves exist to cover, that BOU may allocate to realized capital or distributions. Determining distributable earnings starts with net income as calculated under IFRS and makes the following adjustments:

- Transfer all unrealized revaluation gains from foreign currency and fair value price movements from net profit to the relevant unrealized revaluation reserve.
- Transfer unrealized revaluation losses to the relevant revaluation reserve until that balance is zero. Remaining unrealized losses remain in net profit.
- Identify any revaluation gains in the revaluation reserve realized during the year and transfer them back to the current year's profit. This prevents the accumulation of realized profits in the revaluation reserve as current occurs in the translation reserve.
- The adjusted IFRS operating profit now represents distributable earnings.

15. **The third part of the article should specify the allocation of distributable earnings between statutory capital and dividends.** This is a matter for agreement between the BOU and MoFPED and covers the time core capital is between the prescribed minimum and maximum levels. Below the minimum, the MoFPED receives no dividends and above the maximum the MoFPED will receive 100 percent of distributable earnings. The current arrangements allocate earnings on a 75/25 percent in favor of the MoFPED. The mission prefers a reverse split of a 75 percent retention as this would accelerate BOU's accumulation of core capital. As a minimum, BOU should retain at least 50 percent of distributable earnings until meeting the limit.

Recapitalization

16. **Article 14(4) makes a general reference to recapitalization but it lacks the required detail.** The recapitalization arrangements should provide for:

- Trigger point for recapitalization. This should be when the sum of all capital accounts reported in the audited annual financial statements are less than the authorized capital. This means that the authorized capital is impaired.
- Recapitalization Instruments. Instruments for recapitalization should be interest bearing marketable government securities.
- Level of recapitalization. The level of recapitalization will be to make the sum of all capital accounts equal to authorized capital.
- Timing of recapitalization. Recapitalization should occur within three months of the BOU publishing the financial statements that identify the need for recapitalization.

17. **Basis for external investigation of the causes for recapitalization.** The government may commission a public inquiry to determine the causes of the recapitalization. The inquiry should not be able to delay the recapitalization process. Alternatively, the BOU may consider preparing, with an advice of an external auditor, a report to explain the causes of capital shortfall and submit it to the government.

Appendix IV. Bank of Uganda: Accounting Issues

1. **The BOU has established a sound accounting framework based on IFRS that produces quality financial statements and supporting performance commentaries in the annual report and Medium Term Business Plan.** Hence the following comments seek to enhance what is already a good product and align it with proposed changes in the BOU's legal framework.

Treatment of Recapitalization Bonds

2. **The BOU Board needs to pass a resolution classifying the recapitalization bonds as part of equity.** While the mission acknowledges the external auditors view that the bonds represented a capital transaction between the BOU and its owners, the appropriate treatment in this situation is to allocate the value of the bonds to offset a negative balance in a realized revenue reserve. The mission's twenty years' experience with recapitalization transactions for a large number of other central banks suggests that this is the appropriate treatment.

3. **The current BOU act is unclear regarding the reserves the BOU is able to maintain.** The law only creates authorized capital and the general reserve and article 14(4) provide a vague definition of criteria for recapitalization;

> "Where the capital of the bank is impaired at any particular time the Government will furnish securities to the bank to make good the impairment."

The BOU maintains a range of other realized and unrealized reserves uncovered within the law, of which the revenue reserve carries a large negative balance. From a legal perspective this leaves the situation unclear.

4. **Discussions with the auditors agreed that a board resolution allocating the full recapitalization to offset the negative amount in the revenue reserve would be the appropriate manner to regularize the treatments of the recapitalization.[1]** Retaining the allocation as recapitalization bonds makes little sense as the BOU has already sold many of these as a part of monetary operations, one of the intentions when the BOU received the bonds.

5. **Once the BOU reclassifies the bonds as an element of the general or revenue reserve, the BOU needs to amend the treatment of income attaching to these bonds**. To date the treatment is to treat any income attaching to these bonds as other comprehensive income (OCI). In the interim the BOU has sold many of these bonds and so are no longer accruing income. However, interest attaching to these bonds while held by the BOU remains held in OCI. The BOU needs to transfer this income from OCI to the revenue reserve. Also, once the board has passed the resolution to reclassify the recapitalization bonds the BOU can return to accruing interest on the remaining bonds as interest income through profit and loss.

[1] An alternative treatment would be to allocate the balances of both the revenue and recapitalization bonds reserves to the general reserve.

6. **The BOU will need to consult with its new auditors on how to treat the interest income accrued in OCI.**[2] Probably the correct treatment is to recognize it through profit and loss in compliance with the available for sale classification under IAS39. This will direct it to the revenue reserve and would be consistent with the resumption of recognizing interest on the remaining bonds through profit and loss and will save any restatement of previous year's totals. The mission realizes that this is a sensitive issue and one the BOU will need to discuss with its new auditors.[3]

7. **Concerns regarding distributions to the MOPFED should not feature in the consideration of the accounting for the recapitalization bonds.** Firstly, under IFRS, issues of distributions do not feature in determining accounting treatment. Second, as the report demonstrates the BOU's capital position is so precarious that the prospects of any BOU distributions is a distance prospect.

Presentation of Capital in the Financial Statements

8. **Refinements to the presentation of the BOU equity position in the financial statements would enhance understanding of its financial position.** The amendment would be consistent with the proposed structure of the new law and would use the basis of realized and unrealized capital to format the presentation. The current presentation, shown below, combines, rather than separates, realized and unrealized elements of capital.

Table 3. Realized and Unrealized Elements of Capital

	June 30, 2014	30-June 30, 2013
	UGX (m)	UGX (m)
Equity		
Issued Capital	20,000	20,000
BOU recapitalization funds	410,017	410,017
Reserves	1,335,755	1,182,792
	1,765,772	**1,612,809**

Source: Bank of Uganda and Fund Staff calculations.

9. **A separation of equity into its core capital and revaluation elements will more clearly present the elements of capital defined by the law and those that serve as revaluation buffers.** The reclassification requires the movement of the reserves for interest accrued on the recapitalization bonds and the actuarial reserves from core capital to revaluation reserves. Both these totals arise as revaluation reserves through the application of IFRS and as such fall outside the definition of core capital.

[2] KPMG, the previous auditors concluded their three-year contract with the 2013/14 statements. Ernst and Young will replace them for the 2014/15 audit.

[3] The mission notes that it disagreed with the auditor's approach to the treatment of the recapitalization bonds and the attached interests. The substance of the transaction was to provide the BOU with financial instruments to perform its functions and a MoFPED deposit at the BOU to cover the bonds would achieve the same result.

10. **An amended representation, given below, presents both the face of the balance sheet and notes to the accounts.**

Table 4. Balance Sheet

	June 30, 2014	June 30, 2013
	UGX (m)	UGX (m)
Equity		
Core Capital	19,362	161,829
Revaluation Reserves	1,746,410	1,450,980
	1,765,772	**1,612,809**

Source: Bank of Uganda and Fund Staff calculations.

The notes to the accounts would appear as follows and would cover existing notes 35–37.[4]

Table 5. Core Capital and Revaluation Reserves

	June 30, 2014	June 30, 2013
	UGX (m)	UGX (m)
Core Capital		
Authorized capital	20,000	20,000
Revenue Reserve	(679,880)	(526,159)
General reserve	269,225	257,971
BOU recapitalization securities	410,017	410,017
	19,362	**161,829**
Revaluation Reserves		
Asset revaluation reserve	142,405	143,875
Post-Employment Benefits	36,348	(4,198)
Unrealized translation reserve	1,567,657	1,311,303
	1,746,410	**1,450,980**

Sources: Bank of Uganda and Fund Staff calculations.

[4] Reclassification to unrealized revaluation reserve

Other Comprehensive Income	(36,348)	4,198
Post-Employment Benefits	36,348	(4,198)

11. **The statement of distribution at the bottom of note 37 is a good beginning and the BOU could consider enhancing it to become an additional statement following the Statements of Changes in Equity.** The Reserve Bank of Australia's financial statements provide a good example of this statement. (see http://www.rba.gov.au/). While it will be several years before the BOU is in a position to make any distributions, the development of the statement would contribute to, already substantial, transparency of the BOU's financial statements

Rationalization of Capital Accounts

12. **The BOU could consider rationalizing the treatment of its capital accounts to reduce the number requiring disclosure in the financial statements.** The passage of the board resolution will remove the recapitalization bond account to the revenue reserve. An amendment in procedures to treat the revenue reserve as a retained earnings account will see its closure at the end of each year to a zero balance with the transfer of any remaining balance to the general reserve. This will mean only the authorized capital and general reserve require disclosure in the annual financial statements. This could reduce to just a single core capital account under the new law. Such presentation makes it easy to understand the recapitalization arrangements detailed in the law.

Treatment of Repo Securities

13. **The MoFPED issued the BOU up to UGX 1,200 (billion) of "securities" for use in the BOU's market operations.** These securities carried no interest flows and while they had maturity dates consistent with the other, remunerated, government securities they were not tradable. Commercial banks accepted them as part of the "repo" deal but were unable to rehypothecate them.

14. **The external auditors made the correct decision not to recognize these "securities" as a tradable financial instrument.** Rather they classified them as advances from government. The mission believes that the financial statements were in error in not recognizing them at their fair value as required under IAS39. Having recognized them at face value in the accounts, the failure to disclose the fair values of these "securities" in note 41 appears to compound this omission. Neither the arguments of materiality and netting with the matching liability in government deposits justify the non-disclosure of fair value.

15. **The mission raises this issue as the BOU's treatment of the securities perpetuates the misconception that the current BOU "repo" operations are true repurchase.** Though called 'securities' these instruments demonstrate characteristics of government guarantees. If the repo failed, the holder of the security could not sell the security. They could only return it to the MOFPED for redemption and then only for the capital amount, and at a timing at the MOFPED's discretion. The security provides no coverage for the interest element of the repo**.**

16. **The "repo" securities appear to be another example of the fiscal domination that the BOU faces.** The current "repo" securities represent a reluctance of the MOFPED to assume the costs of fully resourcing the BOU to enable it to discharge its functions. The need to use these substantive guarantees as collateral in its sterilization operations limits the development of the market and this collateral is unattractive to market participants, as they cannot on use it in their own liquidity

management operations. As the main report recommends the solution to this is to convert the repo securities into full marketable securities and so provide the BOU with sufficient financial assets to effectively discharge its functions.

17. **The BOU should reconsider its accounting for these repo securities.** While it is probably unrealistic to expect the BOU to be able to account for them as guarantees, the bank should reconsider the disclosures to more accurately reflect their economic substance. Also, it can disclose their fair value as mandated under IFRS, despite their "immateriality".

Petroleum Revenue Investment Reserve

18. **The passage of the Public Finance Management Act, 2015 (PFM) details the establishment of the Petroleum Fund and Petroleum Revenue Investment Reserve.** This specifies the BOU's role in managing the investment fund but leaves a number of issues needing clarification.

19. **From a balance sheet perspective, the BOU and authorities need to ensure that the establishment of the Reserve conforms with the intentions for the BOU to manage it on an agency basis.** As an agent, the Reserve will exist as a separate entity outside the BOU's balance sheet. The agency approach is consistent with the PFM requirement for the BOU to present separate financial statements for the Reserve. Also, on an agency basis the Reserve will have no direct impact on the BOU's capital requirements.

20. **Discussions with the BOU identified a number of issues requiring resolution:**

- Calculation of management fees—the BOU and authorities need to agree a format for calculating these fees that include a recovery of establishment costs.
- Clarification of distributions from the Reserve. The PFM is unclear regarding the mechanism for distributions from the Reserve. Investment strategies require a clear outline of future inflows and outflows, so any distributions need to identified and authorized early.
- Determination of what happens when Parliamentary estimates for receipts exceed actual receipts for the Petroleum Fund.
- The provisions of articles 59 and 62 cover transfers to the consolidated fund but appear to conflict with each other. A clarification and reconciliation of these two articles will be needed.[5]

21. **The assumption of the Petroleum Fund and Petroleum Revenue Investment Reserve will have a range of implications on the BOU's operational and governance frameworks.** The

[5] Articles 59 and 62 refer to the requirement for parliamentary approval to transfer money from the petroleum fund to the consolidated fund and from the petroleum fund to the Petroleum Revenue Investment Reserve. Article 59(4) introduces a Petroleum Revenue Holding Account that is not defined elsewhere in the Act but implies that parliament has the power to appropriate money from this account to the consolidated fund, though 59(1) only empowers appropriation from the Petroleum Fund. Art 62(1) states that parliament shall appropriate money from the Petroleum Fund to the Petroleum Revenue Investment Reserve but 62(3) says that any money not appropriated to the consolidated fund shall be transferred to the Petroleum Revenue Investment Reserve.

Petroleum Fund will be an additional government deposit used to receive and disburse petroleum receipts, managed by the Accounting General this should not raise issues for the BOU apart from ensuring it remains excluded from the TSA project. The Petroleum Revenue Investment Reserve carries material management and governance responsibilities for the BOU. This includes developing clear reporting and accountability frameworks with both the Investments Advisory Committee established under the PFM and the MOFPED. The mission notes that the BOU has established its petroleum fund unit that is working on establishing the operating framework. The mission supports the BOU's actions and encourages an early resolution of the issues raised in the discussions.

Accounting for FX Swaps

22. **The mission's report recommends that the BOU consider adopting FX swaps as a policy instrument**. For central banks the accounting for FX swaps as policy instruments is the same as for other entities who use them for hedging or trading purposes. The standard accounting is as specified in IAS 39 or IFRS 9 concerning derivative financial instruments.

Accounting Entries for FX Swaps

23. **From an accounting perspective, an FX swap is a two-legged transaction that consists of a spot and a forward transaction**. The spot is a purchase/sale of the currency on day T. The distance of T from today depends on your settlement rules, but is usually Today +2. The forward is the reverse of the spot at the maturity date.

24. **Contemporary accounting rules require the simultaneous recognition of both transactions in the books of both parties.** In this transaction, the central bank sterilizes the local rupee through an FX swap of USD 500,000 for 30 days.

Table 6. CBS sterilizes at USD 5000,000 for 30 days

	Bid	Offer
Amount tendered	500,000	500,000
Spot USD per Local Currency (LC)	0.0819	0.0826
Forward points for one month forward	18	15
One month forward rate	0.0801	0.0811

Source: Fund Staff calculations.

Accounting on Origination

Spot transaction

	LC	LC	
DR Commercial; Bank	6,053,269		500,000 / 0.0826
CR USD Account		6,053,269	Days spot rate for euro

Need to calculate the forward leg.
Swaps payable will be the USD 500,000 converted at the forward rate inclusive of the swaps points. This will be 500,000 / 0.0811 or LC 6,165,228.
The difference between this and the LC 6,053,269 is the swap discount of LC 111,959 that the bank must amortize.
In memorandum accounts, the bank should record the value of the forward.

DR	USD Receivable	6,053,269	
DR	FX Swap Point Accrued Expense	111,959	
CR	FX swap payable		6,165,228

Recognition of Swap Expenses (Income)

25. **During the life of the swap the bank will need to accrue interest and valuation changes.** The central bank can achieve this via regular recalculations of the swap points for each valuation date. How the bank manages this is a matter for its internal organization. The bank should request its finance function to calculate or download these swap points difference at each accrual date and calculates the accrual. The formula for calculating the swap value are available in any finance handbook. The amount to be recognized at each valuation date would be the difference between the original valuation at the swap origination and the latest valuation. Alternatively, the bank can allocate the value of the swaps points on a linear basis over the life of the swap and revalue the swaps points. This approach should work so long as the swap durations are not long.

26. **The flowing table is a hypothetical example of accrued expense and valuation changes that provides the journal entries required.**

Table 7. Accrued Expense and Valuation Changes

	Swap Points	Effective Swap Exchange Rate	Principal	Local Currency	Interest to Accrue	Cumulative Interest
	15.00	0.0811	500,000	6,165,228		
7	11.90	0.0814	500,000	6,141,752	23,476	23,476
14	8.90	0.0817	500,000	6,119,202	22,550	46,026
21	4.90	0.0821	500,000	6,089,392	29,810	75,836
28	1.00	0.0825	500,000	6,060,606	28,786	104,622
30	0.00	0.0826	500,000	6,053,269	7,337	111,959

The journal entries for the seven day into the swap life are:

DR	Swap Expense	23,476	
CR	FX Swap Point Accrued Expense		23,476

Repeat this for each period until maturity after which the bank will have accumulated a total of LC 111,959 in the FX Swap Point Accrued Expense.

On Swap Maturity

On the maturity of the swap the closing entries are:

Table 8. Swap Maturity

DR	FX Swap payable	111,959	
CR	Commercial bank		111,959
DR	USD Account	6,053,269	
CR	Commercial bank		6,053,269

Recognition of exchange rate gains and losses

27. **The FX unrealized revaluation gains and losses arising from a swap are essentially the same as those arising on the FX retained in the bank's portfolio and as such should be treated in the same way**. This is important as the frequent processing of swap transactions as a realization of FX gains will consume the unrealized revaluation gains reserve buffer, thus weakening the bank's ability to withstand future exchange rate shocks should they occur.

28. **From the perspectives of central bank balance sheet strength and the economic substance of a swap transaction it is difficult to see where the central bank has realized any foreign exchange gains or losses from the transaction.** At the end of the transaction the central bank ends up with the same amount of foreign exchange that it had at the beginning of the transaction. It retains the same exchange rate risk on this amount of currency that it retained on currency that it did not swap out and yet it has realized gains and losses on the swap that it did not realize on the currency that it retained. This asymmetric outcome suggests that the BI's treatment of its swap accounting may be inappropriate.

29. **The best way to view a swap is as a loan in national currency that is collateralized by foreign currency.** The swap's origin was from market demands for short term hedged FX funding, supported by the central bank's desire to strengthen its foreign reserves position. The covered interest rate parity concept shows an historically close correlation between interest rates and exchange rate movements over the short term. Hence using the swap points approach (plus the interest earned on the USD collateral deposit) offers an effective estimation of the interest cost that avoided volatility on the return of the collateral (FX) on maturity of the transaction.

30. **If a central bank accepts that the FX leg of the swap is the exchange of collateral then it will be able to treat the forward leg of the transaction as the return of collateral matched by the repayment of the local currency leg of the swap.** Treating the two legs as part of single transaction avoids the need to treat the forward leg as a sale of FX for a receipt of national currency, thus avoiding the need to recognize realized gains.

31. **Adopting this approach means that on the spot leg of the swap the central bank does not recognize any gain or loss on the notional sale of the FX.** When the swap matures and the FX is returned, the bank books it back in at the same rate as the day of its sale, thus capturing any gains (or losses) in the unrealized revaluations reserves. This requires administrative changes that will be specific to each central bank.

32. **This approach does not prevent the central bank from applying its derivative accounting rules to the swap transaction, it just reallocates the gains between interest and unrealized revaluation gains in a manner that preserves the economic substance of the arrangement.** The importance of this approach is that it preserves the unrealized revaluation reserve to cover material changes in exchange rate and the changes in foreign exchange stocks that may accompany it.

Appendix V. Bank of Uganda: Issues Relating to Amendments of the BOU Law

1. **The BOU is working on a set of amendments to its law to enhance its integrity in the evolving financial market environment and changing expectations.** This appendix relates to and elaborates on issues identified in the main report. The mission undertook the discussions with the BOU on the basis that the BOU will send a further draft of its proposed amendments to the fund's Legal Department (LEG) before submitting the legislation. There seemed to be a miscommunication at the start of the meetings as the BOU legal counsel were of the understanding that they had submitted a further draft outlining their response to LEG's earlier review comments and were waiting a response. The discussions advanced on the basis that there would be no further comments from LEG until the BOU submitted the results of discussion with this mission for review.

2. **The mission agrees with that the BOU's intention not to submit their proposed BOU law amendments to the Parliament until after the 2016 election.** While reducing the risks of political interference the BOU will require additional time to finalize the framing of its amendments, particularly in the area of the proposed financial stability function affecting the technical changes proposed.

Financial System Stability Function

3. **The proposed amendments identify that the BOU has a function to "foster a sound financial system", but currently has no detail regarding what the financial system stability (FSS) function contains, its hierarchy in relation to the monetary policy function or its interface with other regulatory bodies and the MOFPED.** Each of these elements are important for the BOU to consider and incorporate in its draft law. The concept of the FSS function has undergone considerable development arising from the GFC and different countries are adopting it in different ways. How Uganda adopts the FSS will have implications for the BOU's functional and institutional autonomy and hence its law.

4. **The BOU already has elements of an FSS in place that will require integration into any law amendments.** Beyond its own internal configurations, a Financial Sector Surveillance Committee chaired by MOFPED is defining its role in the FSS function. Also, the BOU has a Memoradum of Understanding with MOFPED covering the resolving financial crises. It is important that the BOU legal amendments fully reflect the substance of other elements of the FSS function and that the BOU law in this area is consistent with the laws of all the other regulatory authorities with a role in the FSS function. Finally, the final role of the Financial Sector Surveillance Committee will affect how the BOU designs its law. Such committees can have a monitoring, advisory, or directive role, each configuration requiring a different response within the BOU law.

5. **Any development of the FSS function has an interface with the BOU's role as LOLR.** This requires the BOU to have a clear understanding with other regulators and the MoFPED as to the extent and criteria for its LOLR role, and what would trigger any extension of this role and the transfer of liability for loss from the BOU to the MOFPED.

6. **The mission advises that the BOU takes time to clarify how Uganda will configure its FSS function and ensures that its law is consistent with this framework.** This will involve discussions with other regulators and the MOFPED. Consultation with other central banks within the EAC or greater Africa will help clarify the issues. Also, the BOU may seek assistance from other specialists in this area.

Defining Price Stability

7. **A three level hierarchy exists when defining central bank monetary policy autonomy, policy, target and instrument.** The policy mandate defines the object of monetary policy. In Uganda, article 162 of the constitution defines this to be price stability. Section 28, in the current BOU act defines the instrument that the BOU may use in its monetary operations. The piece missing is a definition of the target, what does price stability mean. Item (s) of the Preliminaries defines price stability as "low and stable inflation over a period of time".

8. **Low and stable are concepts subject to varying interpretations and so exposes the BOU to attacks over its definition of these terms.** The mission discussed the different approaches available across the spectrum of having the minister specify it in terms of policy targets or leaving it to the central bank board to define it. The mission provide the attached example of the different approaches. The BOU acknowledged that this is an issue for inclusion in the review of its law.

9. **The definition of price stability should define the level of inflation, the time period targeted, and the measure of inflation used.** Inflation can be a point, e.g. 2 percent, or a band, e.g.,, 1–3 percent. The time period can be a specific time, e.g. one year or a concept, e.g., over the medium term. Likewise, many statistical bases for measuring inflation exist and the appropriate one is a technical choice. A further element that the law may consider including is to identify what form of accountability incurs when the bank fails to meet its inflation target.

Defining Central Bank Capital

10. **Appendix V provides a detailed discussion of this complex topic but this section offers some further details.** The preliminaries section of the law may need to amend the definitions of "capital", "core capital" and "monetary liabilities", add a definition of "distributable earnings" and if not used elsewhere in the law, delete the definition of "reserve money". Depending on how the amendments of the capital section turn out it may be possible to delete reference to "capital" and use only "core capital".

11. **When defining distributions, the law should not define any elements included in profit.** IFRS defines profit and any reference in the law to elements of profit could place the BOU in conflict with the requirements of IFRS. When defining distributable earnings, the law will define those elements that the BOU will remove from IFRS profits to arrive at the pool of realized earnings, net of uncovered unrealized losses that are available for distribution.

BOU Law and the Ugandan Constitution

12. **The BOU can accommodate LEG review comments without amending the constitution.** Earlier LEG review comments on the draft law contained comments that the BOU found conflicted with the constitution. One example was the suggestion that the governor not chair the board. The constitution specifically identifies eh governor as chair of the board. However, LEG's comments had merit as they were seeking that the governor did not chair board meetings that considered aspects of his performance. Discussions covered these issues and the BOU identified solutions that addressed LEG's concerns while remaining consistent with the condition. The next draft will reflect these changes.

Temporary Advance to Government

13. **The MoFPED and BOU are working to remove the need for the government access short term financing form BOU.** The MOFPED is working toward organizing its operational accounting around a treasury single account (TSA). Once operational, the MOFPED will be able to monitor and plan its cash flows without recourse to the BOU and the advances facility. This will be a positive outcome for both efficient management of fiscal policy and facilitation of monetary operations.

14. **To align the incentives to encourage the MOFPED to expedite its move to the TSA the BOU proposes to ensure any use of the temporary advances incurs market based interest costs.** It will achieve this by including in its revised law a clause that prevents the netting of balances for interest charging purposes. This means that once passed, any advances to government will be subject to interest costs until repaid, regardless of how the parties treat them in a TSA environment. The objective is to encourage a substantive, rather than notional move to the TSA environment.

Lender of Last Resort

15. **The proposed amendments to section 43. Credit clarifies to whom the BOU may act as LOLR.** The section states that the BOU may lend to illiquid but solvent financial institutions as defined under the Financial Institutions Act of 2004. The section creates a tiered approach to collateral and duration to cover critical situations. It is important that, as mentioned, the BOU reconcile its obligations under this section with those arising from an FSS function.

Other issues

16. **Discussions covered a large number of issues concerning details of wording and expression that the BOU will incorporate in their next draft.** The discussions reflected a mature understanding of the issues relating to central bank governance and independence, with the meetings providing an effective forum for the BOU legal team to clarify their understanding of the various issues.

Box 1. Examples of Price Stability Target Definition.

Reserve Bank of New Zealand

"Policy targets

- (1) The Minister shall, before appointing, or reappointing, any person as Governor, fix, in agreement with that person, policy targets for the carrying out by the Bank of its primary function during that person's term of office, or next term of office, as Governor.
- (2) In the case of a person who is deemed to have been appointed as Governor under section 191(1), policy targets for that person's term of office shall be fixed by the Minister, in agreement with the Governor, within 30 days after the commencement of this Act.
- (3) Policy targets may be fixed for the term of office of the Governor, or for specified periods during the term of office of the Governor, or for both.
- (4) The Minister and the Governor may, from time to time, —
    - (a)review or alter any policy targets fixed under this section; or
    - (b)substitute new policy targets for targets fixed under this section.
- (5) Where policy targets are fixed under this section, —
    - (a)the Minister shall ensure that they are recorded in writing; and
    - (b)the Governor shall ensure that they are tabled at the first Board meeting held after the date on which they are fixed; and
    - (c)the Minister shall, as soon as practicable after they are fixed, publish them in the *Gazette* and lay a copy of them before the House of Representatives.

European Central Bank
The definition of price stability
Quantitative definition

While the Treaty clearly establishes the primary objective of the ECB, it does not give a precise definition of what is meant by price stability.

The ECB's Governing Council has announced a quantitative definition of price stability:
"Price stability is defined as a year-on-year increase in the Harmonized Index of Consumer Prices (HICP) for the euro area of below 2 percent."

The Governing Council has also clarified that, in the pursuit of price stability, it aims to maintain inflation rates below, but close to, 2 percent over the medium term.

Appendix VI. Status of Implementation of Earlier Recommendations and Action Plan

Central Bank Financial Strength and Recapitalization: Recommendations and Action Plan

Action	Responsible Party	BOU actions
Restoring Income Sufficiency		
Agree framework for income restoration and structure and timetable of securities for issue.	BOU/MoFPED	BOU developed a medium term business plan showing how financial viability will be restored. It was submitted to MOFPED. Feb 2013
Issue first tranche of securities	MoFPED	Recapitalization securities were issued to BOU so far two tranches, 410 bn and 250 bn. February 2013
Establish process to identify opportunities to charge for BOU services	BOU	Opportunities were identified and documented in the medium term business plan. The aspects that related to charges for services rendered to Government are contingent on signing the MOU between MOFPED and BOU. April 2013
Establish procedures to further control expenditures, especially payroll	BOU	Done in the medium term business plan. Staff costs were capped and recruitment frozen since 2012. April 2013
Agree mechanism for monitoring expenditure	BOU/MoFPED	Medium term business plan addresses all major expenditure aspects for the Bank. May2013
Implement expenditure monitoring process	BOU	Quarterly management reports are prepared and discussed by BOU board and management. May 2013
BOU Recapitalization		
Agree the elements of a new capital framework: statutory capital, revaluation reserves, distributions and recapitalization	BOU/MoFPED	This was agreed under the MAC framework for capital adequacy for central Banks that was approved by the EAC central Bank Governors in January 2015. April 2013

Develop accounting procedure to identify and capture realized revaluation gains to avoid accumulation in translation reserves	Accounting	Procedure was developed and has been implemented for the last two Financial years. 2013/14 and 2012/13. This is based on the Modified LIFO framework as advised by the IMF team led by Ken Sullivan. May 2013
Develop procedure to identify realized gains already held in translation reserves	Accounting	Procedure was developed and has been implemented for the last two Financial years. 2013/14 and 2012/13May 2013
Amend law to reflect new capital structure	BOU	Draft amendment proposals were finalized (LC and EDR can confirm). June 2013
Implement new law and post realized revaluation gains to general reserve	Accounting	Posting is done although law not yet changed. July 2013
Implement new accounting procedures to prevent realized gains from remaining in translation reserve.	Accounting	Done on annual basis since 2012/13 as seen in the statement of Changes in Equity. July 2013
Accounting and Reporting		
Agree accounting for increased Quota and reporting of reserve tranche position	BOU/MoFPED	March 2013
Rename "Statement of Strategic Objectives" to "Statement of Functional Expenditures" in the annual report and present on that basis.	Accounting	Implemented June 2013
Refine disclosures on expenditure management	Accounting	Implemented June 2013
Develop a "Statement of Distributions" to present determination and allocation of distributable earnings	Accounting	Will be resolved once the new law is amended to address distribution of earnings. August 2013

Establishing the Building Blocks of an Inflation Targeting Regime: Recommendations and Action Plan

	IMF mission Assessment	Mission Recommendation	BOU actions
I	**Institutional Framework**		
1.	The BOU has been constantly subjected to an extreme version of fiscal dominance that could also endanger the implementation of IT, and the coordinating framework has proven not to be sufficiently robust to withstand such pressures.	1. Amendment of the BOU Act to rule out any advances to the government. In the meantime, all advances should be fully sterilized, and the MoFPED must assume full responsibility for cash flow and public debt management and build capacity in these areas 2. Agree on the operational arrangements for the implementation of a separation between monetary and fiscal policy instruments. This requires that BOU is fully recapitalized. 3. Draw up and design of a new Memorandum of Understanding between the BOU and the MFPED as a matter of urgency to establish a set of operational arrangements for the coordination of macro policies under the new framework.	• Work on amendments of the BOU Act is already in progress. • Since July 2012 MFPED & BOU agreed to use treasury securities in the primary market for only fiscal policy purposes. • Monetary policy is conducted through the secondary market. • A revised MOU between BOU and the MFPED was drafted by BOU and is currently before the MFPED for review
II	**Central Bank Communication Policy**		
1.	BOU has significantly improved its communication in some aspects, but it needs to do further work to support the new IT regime.	The following actions were recommended: 1. The MPS' should be structured to be more effective: • Improve the structure of ideas/paragraphs; • Inclusion of signals of possible future monetary policy movements. 2. The MPR or the future Inflation Report should consider the following recommendations: • The report should be released on a quarterly basis; • The inflation projection should not consider a :passive projection"; • The time horizon of the inflation projection should be consistent with the policy horizon; • At the end of the horizon (in the fan charts), the projection should be equal to the target of 5 percent; • The risk balance analysis should be better explained.	• This is work in progress • A new structure of the Monetary Policy Report (MPR) was adopted. The report is forward looking and with a clear policy horizon of 12 months. • The frequency of the MPR was reduced to bi –monthly in line with the announcement of the new policy rate

		3. Economic agents would benefit from an active communication with BOU authorities and staff. This includes: • Website that focus on monetary policy, especially on the new regime; • Conferences/seminars to release the MPRs or future ISs; • Regular speeches by authorities both in Kampala and other districts; • Off the record meetings with journalists and economists; • Publication of a light brochure of BOU's monetary policy; • Activities for students (e.g. visits to BOU, school competitions on economic issues, etc); • Regular publication and dissemination of working papers.	• BOU continues to disseminate information to the general public to improve their understanding of monetary policy in line with the approved communication strategy of the BOU. This has been done through, press briefings, media houses, the website, social media and school seminars
III	**Monetary Policy design and Implementation**		
1.	The decision making process in the MPCMs is based on the discussion only among the Governor, Deputy Governor and the BOU staff. The MPCMs should be refined for higher effectiveness	• MPCMs should be renamed to differentiate between the monetary policy meetings and the other ones. • The MPCMs should be scheduled in an annual rolling basis. To avoid any uncertainty related to monetary policy decisions and its implementation the BOU should release annual rolling calendars	• The MPC meeting to set the policy rate are known as MPCs while the weekly meetings to review economic developments are named MPCR i.e. MPC review • A 12 month's rolling calendar for the Issuance of the MPS is published on the BOU website.
3.	The BOU should also consider adjusting its organizational structure and adopt an allocation of the key monetary policy functions better aligned with the demands of its new monetary framework.	While there is no universal mode of organization, central bank best practices suggest that the Research and Operations Departments of the BOU would benefit from an allocation of their respective roles and responsibilities along the following lines: 1. Operations Department. This department should be responsible for all the activities having to do with the financial operations undertaken by the central bank including: (i) short term liquidity forecasting	• The Financial Markets Department does the daily liquidity forecasting. The Economic Research Department continues to provide any additional information to FMD for the short term liquidity forecasting.
IV	**Foreign Exchange Policy and Operations**		
1.	Interventions in	To strengthen the flexible exchange rate	• The recommendations were

	the forex market need to be formalized to ensure full consistency with the ITL regime.	regime, the BOU should make its FX operations more transparent and market oriented. It is strongly recommended that: 1. The BOU should publicly announce the main objectives of its forex interventions (e.g. to accumulate international reserves or to dampen exchange rate volatility), the duration of the program, the amount of US Dollars to be brought on a daily basis and the specific rules that will trigger an intervention. 2. The rules-based mechanisms for forex intervention should be executed through interactive competitive auctions where banks can change their initial bid/offer to make it more competitive to assure that they receive an allotment. 3. Result of the forex auctions, once finished, should be published on BOU's website. This will give more clarity to market participants and will enforce the perception of the commitment of the authorities to the flexible exchange rate regime. 4. The BOU reserves the right to realize unannounced interventions in the forex market. However, these interventions should only be used under very extreme circumstances in order to avoid confusion. Moreover, these interventions, once executed, should be explained to the public. The explanation can be done with a time lag.	adopted by the MPC and continue to be implemented
V	**Monetary and Fiscal Policy Coordination**		
1.	The BOU has not yet developed a robust macro modeling capacity. There is still need	During the transition, the authorities should still rely on the financial programming exercise to coordinate macro policies. While narrow monetary aggregates (i.e., reserve money) may have lost their usefulness as policy instruments or information variables for monetary policy conduct, broader monetary aggregates may retain a useful role. It is therefore suggested for the BOU to conduct empirical evaluation of the relevance of such aggregates as information variables for monetary policy conduct.	1. To improve economic analysis and forecasting the Directorate is in its final stages of adopting the Forecasting and Policy Analysis System (FPAS) Tool. FPAS provides an environment for collecting, analyzing, and processing information and assumptions for policy formulation using models, forecasting processes, and software.
2.	The BOU is not sufficiently capitalized to face a framework in which it has to	Under a framework, in which the BOU will be the institution facing the sterilization costs, it is strongly recommended to sign a MoU between the BOU and the MFPED to address the problem. Further technical assistance is recommended to address the specific details of	• The Government has to date issued recapitalization securities worth Shs. 660 billion

	pay the cost of sterilization.	this issue. In particular, MCM has made arrangements for a follow-up mission by Kenneth Sullivan on the BOU recapitalization during January 23–February 5, 2013.	
	The BOU lacks longer-term instruments to accommodate changes in the structural liquidity of the banking system.	At the operational level MFPED and the BOU have to decide which instruments will be used for fiscal financing needs, and for sterilization purposes for BOU : 1. The first best option would be for the BOU to auction government securities to sterilize excess liquidity. 2. The second best option would be for the BOU to issue its own securities. To avoid market fragmentation, the BOU and the MoFPED should coordinate the main characteristics aBOUt the securities (e.g., terms, amounts, type of interest rates, etc.)	