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Policy Applications of Balance of Payments and IIP Statistics

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ABSTRACT

A number of sub Saharan African (SSA) countries have recently obtained debt relief on account of the Highly Indebted Poor Countries (HIPC) Debt Initiative to fund their poverty reducing expenditures. In addition, other OECD countries have also increased donor funding towards the poverty reducing sectors. The impact of these developments has been to re-structure the stock of debt and the associated flows in the balance of payments (BoP). In addition, the increased donor financing of poverty reduction has increased the budget deficits of the benefiting SSA countries, which in turn has had both monetary and exchange rate policy Implications. This paper uses the example of Uganda to highlight some of these developments and more specifically the policy implications on the BoP .

In addition, following the freeing of both the current and capital accounts in 1994 and 1997 respectively, Uganda like most developing countries lost readily accessible data sources on foreign exchange transactions involving the private sector with non-residents. The loss of these data sources together with the need to conform to new international standards (BPM5 and IIP), which called for different, and in most cases detailed data collection has posed a challenge for Balance of Payments Statisticians in Uganda. This paper therefore identifies some of these challenges, steps taken and lessons learnt with specific reference to compilation of flows that are relevant for the BPM5 and IIP.

Policy Applications of Balance of Payments and IIP Statistics

1. Introduction

Economic policy formulation is mainly intended to achieve sustainable economic growth, full employment, price stability and balance of payments position. However, price stability and balance of payments equilibrium are sometimes regarded as secondary objectives to satisfactory economic growth and full employment. This is mainly because countries can achieve satisfactory growth and employment under an environment of moderate inflation and balance of payments disequilibria. However, like in the case of price instability, continuous balance of payments disequilibria will eventually affect economic growth, employment and price stability. This therefore justifies the case for considering balance of payments equilibrium an important objective of economic policy.

Balance of payments (BoP) statistics together with the international investments position (IIP) have continuously become important inputs in the process of economic policy formulation. In general, movements in the current account of the BoP generally convey information about the actions and expectations of market participants in an economy. IIP on their part provide very comprehensive information for monetary authorities that should guide policy formulation in the event of a persistent surplus or deficit in the net IIP of a country. In addition, the monetary authorities should for any given net IIP, be able to have sufficient arsenal of policy instruments to deal with shocks arising from domestic or foreign sources otherwise such shocks could degenerate to a crisis proportion for the economy. For these reasons, policy makers have found it important to read into the BoP and IIP statistics in order to explain external sector developments, their sustainability and impact on the domestic sector and to induce any necessary changes through policy actions.

This paper therefore considers the relevance of BoP and IIP statistics in the provision of guidance to policy makers in shaping their analysis and setting their policy stance. This is done in the context of countries that have recently attracted highly indebted poor countries (HIPC) debt initiative resources and other donor inflows to reduce their poverty levels. In addition, these are countries that have undertaken far-reaching liberalization policies including the freeing of both their current and capital accounts. Consequently, developments in the BoP would have implications for the monetary and exchange rate policies for these countries and Uganda is chosen as a case study.

The organization of this paper is as follows; section 2 summarizes the theoretical relationships that affect the BoP and IIP, and monetary and exchange rate policy variables. In section 3, the extent to which BoP and IIP are used in Uganda are identified while section 4 the treatment of donor funded expenditures in the BoP is presented and section 5 discusses the macro-economic implications of the evolution of BoP and IIP statistics in Uganda In section 6, shortcomings of the use of IIP are discussed and data collection efforts to conform to the BPM5 and IIP reporting are presented in section 7. Section 8 concludes.

2. *Balance of Payments, International Investment Position and Monetary and Exchange Rate Policy*

A lot of research has focused on the establishment of a dynamic relationship between changes in the current account balance on the one hand and movements in the real exchange rate, levels of economic activity at home and abroad, and the stance of monetary, fiscal and other policies. Lately, this focus has been broadened to include the important concept of sustainability of the macroeconomic framework over time, mainly through the inter-temporal aspects of the current account imbalances and why they induce changes in international stocks of assets and liabilities.

Economists have been involved in the search for detailed explanations of the current account developments in the wake of persistent real exchange rate misalignments associated with deficits and surpluses under floating exchange rate regimes. Consequently, a lot of emphasis has been placed on the identity between the savings – investment gap and the current account balance. This is represented as follows:

$$S – I = (Sp - Ip) + (Sg - Ig) = CAB………………………………………………1$$

Where S and I represent savings and investment, Sp and Ip private savings and investment and Sg and Ig government savings and investment while CAB the current account balance.

It has been observed that in countries where the opportunities for investment are sizeable relative to savings, current account deficits result. This provides the analysis of current account dynamics which gained prominence in the 1980's (Knight and Masson, 1986), when it became apparent that shifts in the fiscal policies of some developed countries (USA, German and Japan) had induced large movements in the medium term patterns of exchange rates and current account balances among the largest industrial countries.

2.1 Theoretical Considerations

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

investment and current account flows on the stocks of productive capital and total wealth (partly provided by the IIP), respectively.

(a) Sustainable Current Account Deficits

The theoretical considerations however raise practical issues such as the sustainability of the persistent deficits on the current account of the balance of payments. The following are some of the prerequisites for sustaining current account deficits:

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

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

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

(b) The Balance of Payments in Economic Policymaking

Both unsustainable deficits and surpluses on the current account pose challenges for policy makers. Although these are less likely for developing countries compared to the developed countries, it is not entirely impossible for this to occur. The discovery of large mineral deposits or an improvement in the terms of trade could for example dramatically reverse the deficits on the current account. Nevertheless, the danger for developing countries is usually of a temporary surge in the surplus of the current account causing over spending which requires to be corrected at a later stage. Van der Merwe, (2002) argued that it might be wise to neutralize surpluses on the current account owing to sharp improvements in terms of trade by encouraging capital outflow given the difficulties that could arise in the management of domestic liquidity. What is clear though is that the likely appreciation of the real effective exchange rate of the domestic currency may hamper the price competitiveness of traded goods that do not benefit the improvement in the country's terms of trade.

In instances of unsustainable deficits on the current account, monetary policy should ensure that the level of domestic expenditures comes into line with the productive capacity of the economy to avoid price instability. Under persistent surpluses on the current account, an accommodative monetary policy stance would be appropriate. However, in both instances, monetary policy would need the support of the fiscal sector and other macroeconomic as well microeconomic policy measures to solve these problems. The policy makers problem is therefore one of determining a set of policies that will yield reasonable economic performance, price stability, sustainable fiscal position[1], and balance of payments equilibrium[2].

Large fiscal deficits tend to produce wide savings-investment gaps and to cause real exchange rates to move sharply. If the market deems the fiscal position to be unsustainable, the currency will tend to weaken and the volatility will increase especially in times of uncertainty e.g. in periods prior to election or passage of budgets. In such circumstances, the underlying current account balance may indicate an under valuation of a currency, which nevertheless would be justified once the uncertainty over the future policy is taken into account. This is a case that highlights the need for accurate anticipation of private sector expectations in the policy formulation process.

2.2 The International Investment Position

(a) Exchange rates and the IIP

A lot of research on the implications for net foreign asset position following changes in a country's monetary policy instruments has been done. Lane and Milesi-Ferretti (2002), show that larger liabilities lead to higher net payments – interest, dividends- to the rest of the world, which must be financed by a trade surplus. This normally requires a lower currency value. Conversely, the exchange rate has also an impact on the net IIP. A depreciation of a country's currency increases the country's share of external assets and liabilities denominated in foreign currencies compared to national wealth. The valuation change of external assets and liabilities would then induce changes in the behavior of economic agents, which in turn would affect the net foreign asset position. Subsequently, it is important to have a detailed breakdown of assets and liabilities forming the IIP to estimate the impact of the exchange rate on the IIP. However, this is only true if economic agents perceive the depreciation to be of a long-term nature or if the investments are of a short-term nature. In addition it is important to asses the volume of hedging operations on foreign exchange positions vis-à-vis other countries initiated by local agents (either via spot transactions or via derivatives).

(b) Interest rates and the IIP

In the case of countries with a fixed exchange rate system, the net IIP can considerably influence exchange rates. A country whose net liabilities are high in addition to a deficit on the current account may need to increase its interest rates to improve its foreign currency liquidity. This would contract domestic demand thus reducing the trade deficit, and eventually restoring

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[1] This may be in terms of ensuring that the ratio of government debt to GDP is stable at an appropriate level.
[2] The balance of payments equilibrium is in terms of a sustainable current account balance.

the current account equilibrium. In such a situation, monetary authorities may be concerned with the impact of the short-term interest rates over which central banks should have control. Changes in monetary conditions applied to the domestic market would impact on domestic banks' activities through say a slow down in credit demand by residents prompting banks to extend more loans to non-residents or vice-versa. However, this depends on the extent of local banks' ability to operate in external markets, although this ceases to be a limitation in the case of multinational banks with a considerable number of subsidiaries.

(c) Wealth effects and the IIP

Wealth effects linked to asset price variations are not obvious because of conflicting behaviors of economic agents. While some economic agents may react to negative wealth effects by disinvesting, other may reinvest in order to maintain the same balance in the composition of portfolios highlighting the role of expectations in their behavior. In addition, different agents may react differently, for instance companies (whose actions are accountable to their shareholders) may limit their future investments abroad to reduce their loss while household may either increase their savings rate to rebuild their wealth or on the contrary reduce their savings to maintain consumption.

3   Use of the BOP and IIP in Uganda's Policy Formulation Process

Like other SSA countries, Uganda has faced external financing constraints with the current account position and the sustainability of external debt representing the overriding considerations for the formulation of economic policy. The external sector performance of the Ugandan economy since the early 80's has presented policy makers with a number of challenges on account of a number of factors. The poor policy environment in the mid-1980's and the erratic performance of agricultural exports due to weather and erratic terms of trade have been at the forefront of these challenges. In response to deteriorating economic conditions, the authorities formulated a program of reforms, with the advice, guidance and assistance of the IMF and the World Bank. These reforms included among others the realignment of the external value of the shilling resulting in a depreciation the unit, dismantling of price controls, the provision of incentives through the upward adjustment and realignment of producer prices. These measures however achieved some short-term success in reviving the economy and collapsed in June 1984 mainly because the programme performance criteria and structural benchmarks were breached. These affected the external finances that were dependant on the continuity of the program with the Fund and consequently the economic performance deteriorated, as the country had not developed sufficient capacity to stand on its own.

In May 1987, the new government of Museveni launched another economic recovery program (ERP) funded by the World Bank and the IMF, followed by a second economic recovery credit in 1990. The IMF/World Bank and assistance from other multi-lateral and bilateral donors supported the ERP. This phase of implementation was much closely adhered to than the earlier one launched in 1981, hence more successful. It included reforms such as the devaluation of the Uganda shilling; liberalization of the exchange rate and reduction of the fiscal deficit.

In the period that followed, Uganda experienced strong economic growth with an average GDP growth of about 7 percent. In US dollars, GDP grew by over 10 percent between 1990 and 1999. Export earnings, which benefited from the terms of trade developments during the mid 1990's most especially the boom in international prices of robusta coffee, grew by about 17 percent per year on average. Similarly government revenues increased from 7.5 percent of GDP in 1990 to about 11.7 percent in 1999. Along with these positive developments inflation was brought under control, averaging about 5 percent per year.

However, following the decline in coffee prices in the post 1998 period, real GDP growth slowed although this was partially mitigated by stepped up donor flows mainly for poverty reduction programs. Uganda's large current account deficit (excluding official grants) in recent years has continued to be largely financed by donor inflows and to a lesser extent by FDI.

3.1 The HIPC Debt Relief Initiative

The World Bank and the IMF in 1996 conceived the HIPC initiative as a multi-lateral mechanism for extending debt relief to the heavily indebted poor countries that were pursuing prudent macro economic polices. The key guiding principles of the initiative included additional debt relief, maintenance of the financial integrity of the multilateral financial institutions and burden sharing on a fair and equitable basis. Uganda's consistency in pursuing sound polices and its commitment to structural reforms enabled her to become the first country to qualify for debt relief under the HIPC initiative in April 1998. Relief was based on the Net Present Value (NPV) of debt to exports with the sustainable level of debt assessed at 202% of exports. To reach this level, the amount of relief required was US$ 347 million in NPV terms, which is equivalent to total saving of US$ 650 million, spread over a thirty year period. In the first year, 1998/99, Uganda received US$ 45 million in debt relief and US$ 40 million was expected to be received annually for three successive years.

The first HIPC was expected to provide an "exit strategy" from the debt rescheduling process or, leave beneficiary countries with sustainable debt levels. Post-HIPC, a country would be expected to service its debt and still be able to direct sufficient resources to poverty reduction. However, because of some unforeseeable factors such as the El Nino weather phenomenon, changes in global interest rates and a decline in international commodity prices, it was difficult for Uganda to have post-HIPC sustainable debt levels. Other heavily indebted poor countries also faced varying calamities, which prevented them from achieving debt reductions to sustainable debt levels. The HIPC Debt relief Initiative was then reformed (hence the Enhanced HIPC) to enable it benefit more countries and deliver deeper debt relief more quickly. The key elements of the Enhanced HIPC Debt Initiative are:

- Lowering the debt sustainability thresholds to a Net Present Value (NPV) of Debt of no more that 150% of exports of goods and services. This is to provide greater safety cushion and increased prospects for permanent exit from unsustainable debt.
- Faster debt relief starting from decision points
- Floating completion points; and
- A strong link between debt relief and poverty reduction

In order to meet the last element of the Enhanced HIPC package, countries are expected to prepare national poverty reduction strategies. Uganda did accomplish this, and the international financial institutions and the donor community, accepted her strategy as a viable and comprehensive one. Uganda then became the first country to benefit from the enhanced HIPC initiative in April 2000. Annual debt relief is estimated at US$ 55 million in addition to the US$ 40 million from the original initiative. Table 1 summarizes the Debt relief under the first HIPC and the enhanced HIPC initiative.

Table 1   Debt Relief Under the HIPC Initiative

	Nominal Debt Service Relief Million US$	HIPC Debt Relief, NPV Terms (Million of US$)	Completion Point
A. HIPC Initiative	650	347	April 1998
Multilateral		274	
Bilateral		73	
B. Enhanced HIPC Initiative	1,300	656	May 2000
Multilateral		546	
Bilateral		110	
Total Debt relief	**1,950**	**1,003**	

3.2 Use of Debt Relief

Resources from both the HIPCs are channeled to poverty reduction programs through the Poverty Action Fund (PAF). At the advent of HIPC debt initiative, the Uganda Government established a Poverty Action Fund (PAF) through which savings made from debt relief would be channeled to finance poverty reduction programs in accordance with the Poverty Eradication Action Plan (PEAP) and Poverty Reduction Strategy Paper (PRSP) priorities. Although the original intention was to create transparent mechanisms for ensuring that the resources saved from the HIPC initiative are channeled fully to poverty reducing programs, the PAF has attracted additional donor support for similar programs over and above the regular programs of some donors. HIPC debt relief funds one third of the total resources in PAF. The PAF resources are spent on PEAP/PRSP priority programs such as primary education, primary health care, agriculture extension, rural road programs, rural water supply and sanitation services and enhanced accountability. The share of the PAF in total spending rose rapidly from 17% in 1997/98 to 31% in 2000/2001. Government has pledged to continue increasing this share over time.

All PAF expenditures are an integral part if the government's budget, as envisaged by the PEAP/PRSP, which provides a framework for sector wide plans and investment programs, which in turn are translated into actual budgets as contained in the Medium Term Expenditure Framework (MTEF). The contribution of savings from HIPC debt relief to the PEAP/PRSP priority spending on the provision of social services and support to activities aimed at enhancing the ability of the poor to increase their incomes, channeled through PAF are shown in Table 2 below

4.0 Treatment of HIPC and Other Poverty Reducing Donor Money In the Balance of Payments

The assistance provided under the HIPC initiative since July 2000 has been instrumental in dealing with problems related to debt sustainability. Despite these measures, the stock of debt has continued to rise although there has been an improvement in the overall BOP on account of the assistance provided by some of Uganda's creditors under this initiative. The different components of HIPC have affected different accounts in Uganda's BOP. Total HIPC delivery has therefore been treated differently for each sub-category subdivided as follows:

Table 2:   PEAP Expenditures (Billions of Ushs.)

	1997/98	1998/99	1999/00	2000/01	2001/02
Total Expenditure (Excluding arrears)	141.38	231.84	302.69	439.8	624.61
Of which:					
PAF		97.84	193.98	298.8	400.4
HIPC		44.64	65.55	159.16	127.3
% Contribution of PAF to Total expenditure		42.2	64.1	67.9	64.1
% Contribution of HIPC to total expenditure		19.3	21.7	36.2	20.4
% Contribution of HIPC to PAF resources		45.6	33.8	53.3	31.8
Measures to increase incomes	8.96	20.39	31.78	35.79	65.63
Rural Roads	8.42	20.18	24.58	28.67	42.7
Implementation of the Land Act			2.7	3.0	7.93
Agriculture Extension	0.54	0.21	4.49	4.12	15.6
Micro Finance/ Restocking Programmes	0.47	0.49	7.29	11.64	12.54
Measures to Improve Quality of Life	128.25	203.28	251.06	349.96	459.46
Primary Health Care	4.16	20.24	21.42	57.17	104.43
Water and Sanitation	3.86	12.34	17.57	35.33	53.13
Primary Education	120.23	169.83	211.57	254.66	293.7
Other		0.87	0.5	2.8	8.2
District Grants			2.0	24.71	53.28
Monitoring and Accountability	3.7	7.68	10.57	17.67	26.01
Exchange rate UShs per US$	1150	1362	1512	1762	1773

Source: Ministry of Finance, Planning and Economic Development

- Grants: The grant component of HIPC is captured in the current account under the line item HIPC assistance as a credit. The rationale for this kind of treatment is that all HIPC provided in form of grants is used to fund current expenditures on poverty reduction programmes. Multi lateral donors provide the grant component of HIPC and these are split into IMF and other multilateral creditors. Accordingly, all IMF HIPC is treated as grants and is under current transfers in the current account. The contra entry to the credit entry in the current account is a debit item reflected within amortization.

- Cancelled loans: The cancelled loans component of HIPC is reflected in form of a reduction in the maturities for both interest and principle. The rationale here is that the creditor has canceled once a loan, the debtor country's stock of debt should reduce by the cancelled amount. This in turn implies that working out a new amortization schedule, which excludes the cancelled loans, should restructure the overall debt stock

- Consequently, both principle and interest maturities falling due should be reduced in line with the cancelled loans. As a result, the BOP does not directly reflect data on cancelled loans anywhere although this is implicitly taken account of by reduced maturities for both interest and principle of loans (excluding IMF).

- Rescheduling: The Rescheduled loans component of HIPC is maintained in amortization together with the grant component while a contra entry (credit) is reflected in the financing items as one of the components of exceptional financing.

The implications of the HIPC assistance on Uganda's BOP have been far reaching affecting both the current and financial accounts of the BOP and the financing items. In general there has been an improvement in the overall BOP despite other developments in the external sector which have negatively impacted on Uganda's BOP.
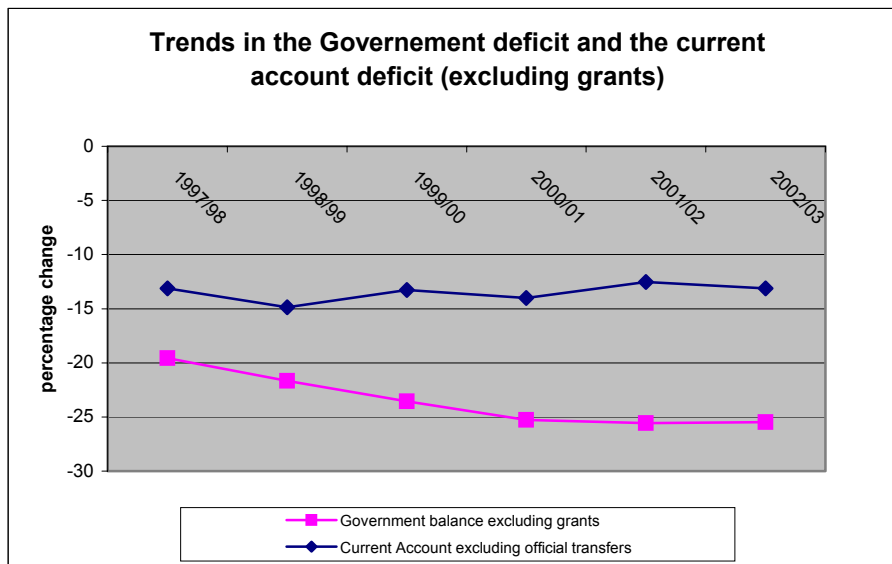
The specific impact of HIPC assistance on Uganda's BOP has been as follows:

- Income Account: The income account improved by the amount of reduction in interest maturities of public debt resulting from the restructuring of the public debt following the HIPC cancellation. Consequently, the resulting debt repayment profile comprised of lower maturities for both interest and principle, explaining the improvement in the income account.

- Current Transfers: The current transfers also improved on account of the inclusion HIPC grants in addition to Budget Support grants. Due to the fact that HIPC grants are intended to fund recurrent expenditure, they were moved to the current account increasing current transfers to government in this account.

- Financial Account: For a similar reason explained in the case of the income account, the public debt component of medium and long-term loans reduced on account of lower maturities.

- Financing Items: The item of exceptional financing was reduced by the amount of HIPC grants and cancellation. The reason here is that grants have contra entries in the current and financial account while cancellation is excluded from all items above the line. Inclusion of HIPC cancellation and grants among the exceptional financing items would therefore lead to double counting. Details are attached in Appendix Table 2.

The treatment described above on HIPC in Uganda's BOP shows different and better ratios compared to those that were used in earlier Debt Sustainability Analysis (DSA) exercises. However, the stock of debt has continued to grow mainly due to new borrowings, which poses

a challenge for policy formulation when the analytical ratios comprised of a component of debt stock are considered in the DSA.

Today Uganda is heavily dependent upon donor assistance to finance government budget deficit, which for example amounted to 12 percent of GDP (when grants are excluded) in 2002/03. The implications of these developments on the current account balance are shoen in chart 1 below.

Trends in the Governement deficit and the current account deficit (excluding grants)

Legend:
- Government balance excluding grants
- Current Account excluding official transfers

5.0 Implications of Increased Government Spending on Macro economic variables

(a) Increased Money Supply.

The increase in Government spending on poverty reduction since HIPC became operational in the late 1990's and the associated rise in the fiscal deficit, certainly generated some important benefits in that debt relief had enabled GOU to increase expenditure in poverty reducing sectors and this has contributed significantly to the poverty reduction efforts. However it also complicated macro economic management through the intermediation process of these resources. This because the poverty reduction expenditures are largely directed at non-traded sectors in the economy implying that there is need to sterilize the resultant liquidity as government spends on this sectors, although this expenditure is funded by donor aid. The liquidity must be mopped up (sterilized) by the Central Bank if it is not to lead to large inflationary money supply increases.

	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03
	In percentage of GDP					
Exports	6.9	9.2	7.8	8.1	8.1	8.1
Imports	-14.6	-17.3	-16.1	-16.8	-18.2	-18.8
Current Account Including official transfers	-5.4	-7.5	-7.0	-5.7	-5.6	-5.9
Current Account excluding official transfers	-13.1	-14.8	-13.2	-14.0	-13.0	-12.9
External Public Debt	55.0	59.0	61.0	60.0	63.0	69.0
Private Sector Gap	-1.1	-1.7	-1.9	-2.8	-3.0	-3.2
Gvt balance excluding grants	-6.0	-7.0	-10.0	-11.0	-13.0	-12.0
	In millions of US Dollars					
Gross reserves	751	748	719	739	873	964
Gross reserves in months of imports	6.7	6.2	6.3	6.4	6.6	6.9
Foreign Exchange sales	-5	25	117	174	199	247
	In billions of shilling					
Liquidity created by fiscal	63	58	212	418	664	460
Net treasury bill issues	37	36	133	168	268	176
Stock of treseary bill issues	112	148	281	449	717	893
Base Money at the start of the Year	332	373	433	442	550	658.1
	percentage change					
Real exchange rate	-2.6	17.4	-0.6	5.9	-0.3	13.8
Non-Traded/Traded goods (production)		10.6	7.7	10.3	3.5	7.6
External	18.6	-6.2	-15.1	-21.9	-15.1	14.2
Private Sector Credit Growth	24.8	33.6	6.2	9.4	4.2	28.0
	Terms of Trade					
Non-Traded/Traded goods (production)	100	110.6	119.1	131.4	136	146.3
External	100	93.8	79.68	62.23	52.844	60.342

As shown in table 1 above, the fiscal deficit almost doubled between 1997/98 and 2001/02. The widening of the fiscal deficit led to tenfold increase in the liquidity created by Government's fiscal operations – that is Government expenditures in the domestic economy minus domestic revenues. Liquidity created by programmed fiscal operations increased from Ushs.68 billion in 1998/9 to Ushs.664 billion in 2001/2.

(b) Sterilization of Liquidity

The increased liquidity resulting from increased government spending has to be mopped up by BOU if it was not to cause inflation using a combination of foreign exchange sales to the Inter-bank Foreign Exchange Market (IFEM) and net issued of treasury bills. Net foreign exchange sales have thus increased very rapidly over the last five years rising from US$ 5 million in 1998/99 to the programmed level of almost $254 million in 2001/2. However, actual foreign exchange sales were much lower at US$198 million, partly because of concerns by the BOU over the level of foreign reserves in the face of sharply lower than programmed disbursements of budget support, and because of concerns for the stability of the exchange rate and potential exchange rate appreciation. With foreign exchange sales being lower than programmed, TB sales had to increase to control the rise in base money.

Sales of foreign exchange and treasury bills in order to mop up excess liquidity caused by increased government expenditure have implications on macroeconomic variables including the BoP and these are as follows;

1. Increased foreign exchange sales have inevitably appreciated the real exchange rate. This in turn has damaged the competitiveness of private sector exporters, which is crucial for boosting economic growth. As shown in appendix Table 1, the RER appreciated as sales of foreign exchange in the market increased. This encouraged more private sector outflows at the expense of inflows thus contributing to the deterioration of the current account balance. In addition, examining the trends in the price indices for the major components of GDP shows that prices for non-traded goods in Uganda have grown much faster than prices for traded goods as depicted by appendix Figures 1 (a) and (b). This implies that price incentives within the domestic economy have shifted away from traded goods production and towards non-traded goods production in the last few years. This arises on account increased demand for non-traded arising from increased government expenditures. On the other hand, the supply for these goods is fixed in the short-run, which results into their prices increasing.

    The increased fiscal deficits since 1997/98 took place at the same time that Uganda's external terms of trade fell sharply, by 35% between 1997/98 and 2001/2, largely because of a fall in world market coffee prices. Compared to 1997/98 prices for exports and imports, the terms of trade shock cost Uganda around 6% of GDP in 2001/2, which is of roughly the same magnitude as the increase in government spending funded from increased donor aid. Therefore in terms of aggregate spending in the economy, the external terms of trade shock acted to offset the impact of the fiscal expansion, although the terms of trade shock and the fiscal expansion did not have symmetrical effects at the sectoral level. The aid funded fiscal expansion led to an increased trade deficit from 10.1% of GDP in 1997/98 to 15.6% of GDP in 2001/2. Because of the terms of trade loss however, the trade deficit measured in constant prices actually declined marginally between 1997/98 and 2001/2.

    We cannot ignore the fact that a shift in relative prices from tradable to non-tradable will undermine the GOU objective of creating a dynamic export led economy. Private sector led-export promotion is central to the Medium Term Competitiveness Strategy (MTCS) and this objective should not be compromised by an excessive fiscal deficit.
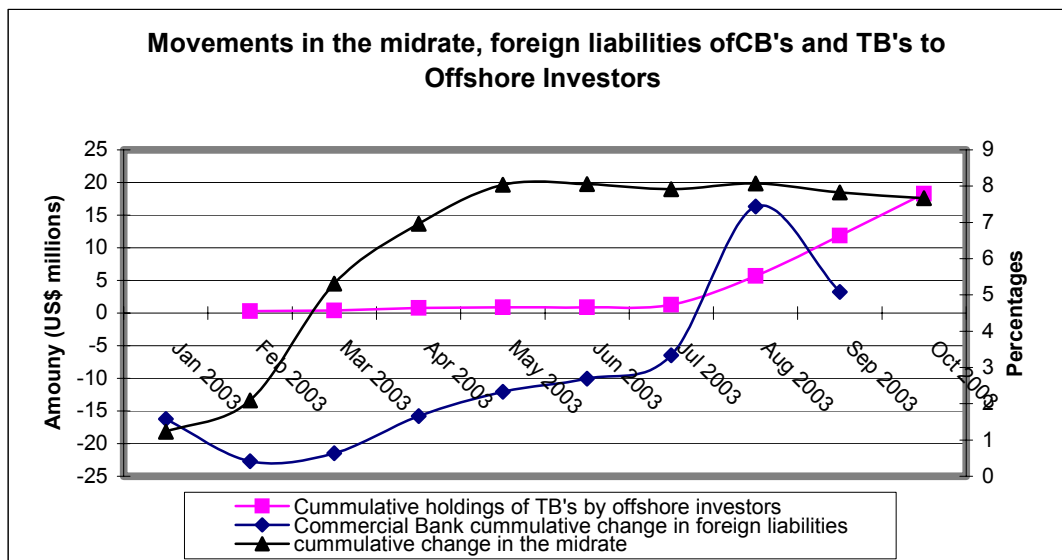
    Sterilization of the fiscal deficit through the sales of foreign exchange is not a sustainable policy since it would mean that the whole economy, and not just the Government budget, would inevitably become over-dependent on a continuous large inflow of donor funds intermediated through the Central Bank. This will affect the structure of both production and demand in the economy. Yet from experience, actual disbursements of donor aid usually fall short of what has been programmed – the reality over the last few years is that disbursements in each year have averaged less than 60% of what had been programmed at the start of that year. The reliance on donor funds to finance activities in Medium Term Budget Framework will be setting the economy up for a serious crisis if, for any reason, these donor funds did not materialize in full. Moreover, this crisis would not be confined to the Government budget, but it would spill over into the foreign exchange markets and into the wider economy.

2. The huge increase in Treasury bill sales has also squeezed the funds available in the banking system for lending to the private sector – hence the fiscal deficit is directly crowding out private sector borrowing. At the margin almost all additional TB issues have to be held by the commercial banks because non-bank demand for TB's is very limited. The net issuance of Treasury Bills also climbed very quickly from the late 1990's amount of Ushs.37 billion in 1997/98 and by 2001/2, the net issuance of Treasury Bills increased to a massive Shs.268 billion leading to volatile treasury bill interest rates.

Commercial Bank holdings of TB increased from 23% to 32% of their asset portfolio between June 2000 and June 2002. This was a period in which Private Sector Credit (PSC) slowed down over the period 1999/00 and 2001/2 combined while bank loans to the private sector fell from 30% to 23% of the banks asset portfolios. They may have been other reasons independent of the widening fiscal deficit, for the stagnation of PSC over the recent past (except for last year) such as weak demand for credit from credit worthy borrowers, but it is difficult to escape the conclusion that even if demand for private sector credit had been strong enough to support the programmed PSC growth, the banks would not have had the resources to supply this credit because of their increased holding of TB's and therefore growth in PSC would have still been chocked off.

As part of the liberalization process, the restrictions on the capital account were removed in 1997. These meant that Ugandans could now hold foreign denominated financial assets in financial both locally and abroad while non-residents could also hold shilling denominated assets in Uganda. Following the world wide decline of interest rates in the recent past, the interest rate differential in favor of the Uganda shilling denominated financial assets has continued to widen given the manner in which the liquidity generated by the donor poverty reducing government expenditure is sterilized. As a result, the country has begun to record portfolio inflows into its domestic money markets as shown in chart 2 below.

Chart 2

Movements in the midrate, foreign liabilities ofCB's and TB's to Offshore Investors

Legend:
- ■ Cummulative holdings of TB's by offshore investors
- ◆ Commercial Bank cummulative change in foreign liabilities
- ▲ cummulative change in the midrate

There is cause for concern about the potential disruption to the prices that can be caused by an abrupt withdrawal of participation from the portfolio markets by this increasing number of external players. In conclusion the autonomous flow of available external financing has continued to be a determinant of a sustainable savings investment gap and the associated current account deficit. The problem confronting policy makers therefore has been one of adjusting policies, particularly the fiscal balance to keep the current account deficit at a level consistent with the available financing.

6.0 The International Investment Position.

Prior to the liberalization of the economy, there were restrictions on both the capital and current account. These called for surrender requirements of all foreign exchange inflows and outflows, including highly bureaucratic procedures of centralized export and import licensing in the line trade ministry[3] and all remittances were effected with prior sanctioning by BoU. Data used for balance of payments compilation was therefore obtained as a bi-product of the administrative exchange control procedures at the time and supplemented by other administrative sources such as customs through customs declaration forms. As part of the measures to improve the payment and exchange system in the country, the current and capital accounts were freed in 1993 and 1997 respectively.

However one weakness identified in the process of liberalizing the external sector was that the emphasis on data collection was underplayed. The removal of restrictions on both the capital and current accounts was interpreted to mean that there was no need to disclose information concerning foreign exchange transactions by the private sector, which completely undermined

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[3] Ministry of Commerce

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the importance of the monitoring role by the BOU. This led to the loss of information on imports and other outflows for payments of services. To the extent that it was relatively easier to capture exports, the trade account improved (given the loss of information on imports of goods) together with the services account. The improvement in the services account was largely due to a methodological approach in which the residual was placed in the services account. The lesson learnt here was that the speed of the liberalization process of the payment and exchange system was not adequately matched by the revision of the then current data collection procedures or by the creation of alternative data collection procedures.

Flaws in the traditional sources that had been used for statistical purposes apparently became evident. At about the same, the need for comprehensive and timely statistics and conformity to new international standards (BPM5 and IIP) called for different and in most cases more detailed data. The response to some of these problems has been to develop new data compilation methodologies and to opt for alternative sources of data. While this response has been slow a number of challenges have been dealt with and new lessons have been learnt.

Consequently, the IIP has not been a major source of data for policy formulation in Uganda mainly because of lack comprehensive data. Two surveys on private capital flows have been carried out between 2001 and 2003, however, their findings based on samples, have not provided any conclusive data on the stock of assets and short-term liabilities held by Ugandans although data on long-term liabilities and FDI was comprehensive. Other serious problems encountered were those related to valuation – market value versus book value – and procedures for arriving at market values. In addition, the problems of up-rating the survey results since the issues of non-response and sampling have to be dealt with if one is to get the population number. Consequently, the use of the IIP in Uganda has been limited to the analysis of long-term liabilities and FDI stocks. However, efforts to beef up information from the surveys with other data sources such as the Uganda Securities exchange, commercial banks and the domestic financial markets department in the Bank of Uganda are underway and already there indications of substantial stocks of portfolio assets held by non-residents.

7.0 Progress Towards Conforming to BPM5 and IIP Reporting

Some progress has been made in recent years to ensure that the BOU conform the reporting of trade in services statistics with the BPM5 in terms of adopting new data sources and. Nonetheless, some lessons have been learnt and the following challenges remain:

Need to ensure high-quality data - Because it is not possible to conduct as many surveys as we would have liked, emphasis has been placed on the collection of data through the banking system. This has been done through development of new forms consistent with the BPM5, but the data need to be analysed and crosschecked against other sources frequently to ensure their quality.

Importance of good coverage - Improving the rate of response mainly by persuasion is necessary, especially in surveys, which are conducted on a voluntary basis. Effecting penalties is an option, which can be invoked through the Statistics Act although this has not yet been exercised in preference to the use of moral suasion to obtain the data. This is a slow process and posses a big challenge in ensuring the timeliness of data.

Training of the human resource - This is necessary to improve efficiency and the quality of data. This is reinforced further by the fact that collection of statistics under liberalisation requires a matching change in the skills of the staff receiving the data to carry out consistency checks, provide answers to queries raised by the respondents on concepts used and any other matters. There is need for continuous assessment of response rates, quality of data, respondent burden, use of data, possible duplication and others. Another aspect is that of examining other country's systems of data collection.

Improving communication – This is important to ensure that respondents are provided with explanations on the purposes and details of data requirements. For this meetings and workshops have been held with respondents and business associations during the development of new forms through which dialogue has been established. Detailed manuals for filling in the forms have been prepared but these require continuous upgrading as new products come onto the market. These activities are time consuming but necessary.

Balance between Data requirements and Respondent Burden: Important in avoiding duplication and making use of information provided by other sources outside the BOU. For this agreements with other institutions for data sharing have been used and may need to be improved and broadened. An additional challenge that arises is that of adopting uniform concepts and definitions for the data collected under such arrangements, which meet the different data users needs. BoU now intends to carry out its own surveys on large enterprises with foreign assets and liabilities in order to address the IIP and some items necessary to conform to the BPM5 reporting.

Improving surveys - For this, it is important to develop and use adequate sampling frames. It is also important in the application of these surveys, to use adequate forms while keeping them as simple as possible, developing follow-up processes, improving response rates and treating non-responses appropriately and up rating the data from samples. This is a relatively new activity and requires considerable expertise, coordination and resources. Experience from past surveys shows that obtaining data from resident companies with parent companies located outside Uganda has been very difficult. This is because in most cases, the resident entities have to send copies of the forms to their parent companies for express permission to release the information sought and in some cases the forms are filled in abroad. This has led to delays in obtaining data and contributes a significant portion to non-response and remains a big challenge.

On IIP, the compilation of accurate information on short-term borrowings and compilation of non-bank assets remains a big challenge in the case of Uganda. In-sufficient monitoring of financial openness subjects a country to un-preparedness in dealing with a financial crisis .The previous private capital flows survey did not adequately capture data on IIP and as a result these are derived using crude estimates. The use of commercial banks and forex bureaux forms for recording of transactions by source for inflows and purpose for outflows in the case of commercial banks is hampered by the inability to accurately determine in some instances the source of inflows, especially when funds are inwardly remitted for credit to client's forex accounts. This affects the credit side of our services account as holders of these accounts may at times disclose the source only when they are converting these proceeds to Uganda shillings after withdrawing them from the accounts.

National Regulators: The use of national regulators has proved useful in collecting some of the available data. Financial institutions, communications, insurance and securities exchange have been of great assistance.

8.0   Conclusion

BoP statistics are employed in many ways with different objectives by the both the private and the public sector. These statistics reveal the extent to which countries are living within their means. If current account deficits are unsustainable, it is important to take corrective action as soon as possible. For the external financing constrained developing economies, ensuring that the current account position is consistent with the available sources of financing is essential.

For some time now, the formulation of policy using the BoP statistics has been focused on projecting the evolution of the current account or altering it in order achieve certain a sustainable position. However, as globalization proceeds in both goods and financial markets, the production and financing process is becoming far more diversified geographically. The integration of financial markets is creating a variety of portfolio investment opportunities leading to a situation where current account imbalances will be financed to even a larger extent than in the past by foreign sources. Consequently, movements in the current account are bound to have much less ultimate significance for policy makers than has been the case to date although this would affect the net IIP of the country.

The IIP (despite its lack of detail such as currency breakdown, trading partners) provides statistics useful in *ex post* analysis. It makes it possible to understand the origins and developments of financial crises. Their use as an ex ante indicator for the implementation of corrective measures remains an issue of debate. Practical experience shows that IIP statistics are more prone to long computation lags and low frequency data, which may be a limiting factor for their use for early warning purposes. Moreover, often time there are valuation problems to deal with in their compilation such as establishing market value of equity capital. Despite several proposals that have been put forward on how to address some of these issues, developing countries have continuously encountered numerous constraints in compiling accurate and reliable IIP statistics. In the case of Uganda, we need to obtain better statistics on the IIP before we can effectively make use of it for policy purposes.

Table 2. Selected Items of the Balance of Payments - ANALYTICAL PRESENTATION

|	'97/98	98/99	99/00	00/01	01/02	02/03
	Without HIPC Assistance			With HIPC Assistance		
	US Dollar Millions					
CURRENT ACCOUNT BALANCE	-356.35	-451.13	-414.32	-320.47	-325.87	-370.23
Goods Account(Trade Balance)	-507.75	-490.28	-494.43	-495.04	-588.55	-669.18
Total Exports (fob)	458.41	549.14	459.90	458.30	474.04	507.48
Total Imports (fob)	-966.16	-1039.42	-954.33	-953.34	-1062.59	-1176.66
Services Account(net)	-202.04	-229.56	-208.77	-205.75	-293.81	-224.43
Income Account(net)	-85.13	-107.70	-139.79	-141.52	-116.87	-133.86
Inflows(credit)	41.35	47.24	42.09	46.15	29.47	20.26
Outflows(debit)	-126.48	-154.94	-181.88	-187.67	-146.34	-154.12
Interest on public debt	*-42.33*	*-40.04*	*-43.55*	*-31.87*	*-28.83*	*-29.12*
Current Transfers	438.57	376.42	428.67	521.84	673.36	657.24
General Government	507.04	438.46	366.79	475.25	435.06	437.14
Grant disbursements	507.04	438.46	366.79	420.82	375.33	368.52
HIPC assistance				*54.43*	*59.73*	*68.61*
CAPITAL AND FINANCIAL ACCOUNT BALANCE	365.93	330.47	307.45	337.38	433.10	422.97
Capital Account	40.55	0.00	0.00	0.00	0.00	0.00
Financial Account; excluding financing items	325.38	330.47	307.45	337.38	433.10	422.97
Direct Investment	120.00	145.27	176.55	143.76	145.71	153.99
Portfolio Investment	0.00	0.00	0.00	0.00	0.00	0.00
Other Liabilities/other Investment	205.38	185.20	130.90	193.61	287.39	268.97
Medium and Long-term (net)	225.97	196.63	109.81	214.14	327.21	311.95
Short-term (net)	-20.59	-11.43	21.09	-20.52	-39.82	-42.98
OVERALL BALANCE	9.58	-120.66	-106.87	16.90	107.23	52.74
FINANCING ITEMS	-9.58	120.66	106.87	-16.90	-107.23	-52.74
Monetary Authorities	0.00	0.00	0.00	0.00	0.00	0.00
Use of IMF Credit (Net)	-4.63	-34.22	-15.54	-20.86	-32.94	-41.76
Change In Gross Reserves	-131.22	10.18	40.58	-33.30	-96.18	-18.65
Exceptional Financing	14.93	57.67	77.86	37.69	22.85	8.34
On Current maturities	29.11	68.17	79.97	7.07	2.63	-8.95
Rescheduling	1.67	0.00	0.00	2.34	2.75	3.72
Cancellation	0.00	15.33	50.64	0.00	0.00	0.00
Accumulation of Arrears	27.44	52.84	29.33	4.73	-0.12	-12.67
On Old Arrears	61.70	20.38	0.00	0.00	0.00	0.00
Rescheduling	11.55	0.00	0.00	0.00	0.00	0.00
Cancellation	7.63	0.00	0.00	0.00	0.00	0.00
other forms of forgiveness	42.52	20.38	0.00	0.00	0.00	0.00
Arrears settlement	-75.88	-30.88	-2.11	-1.95	-9.34	-6.12
BOU short-term borrowing net	0.00	0.00	0.00	0.00	0.00	0.00
Other	0.00	0.00	0.00	32.57	29.56	23.41
Errors and Omissions	111.34	87.03	3.97	-0.43	-0.96	-0.67
FINANCING GAP						

Source: Bank of Uganda

Figure.1(a)
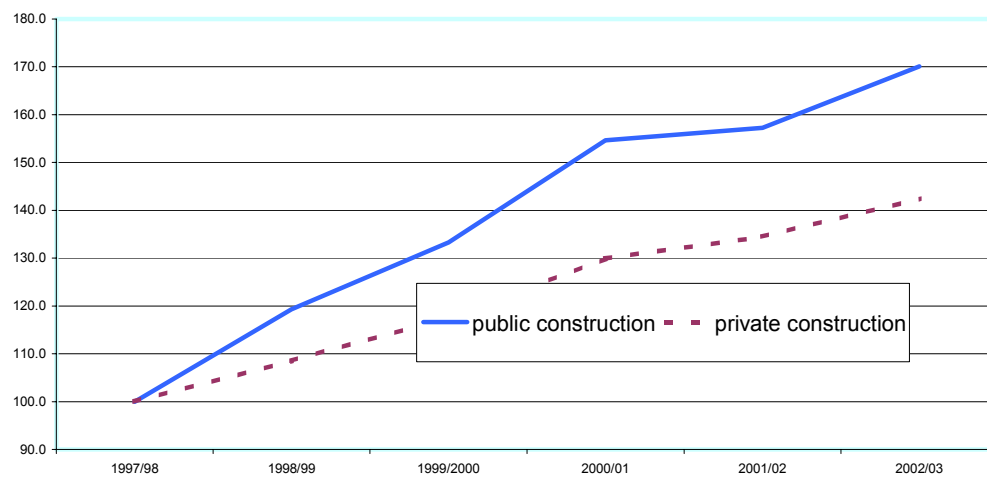
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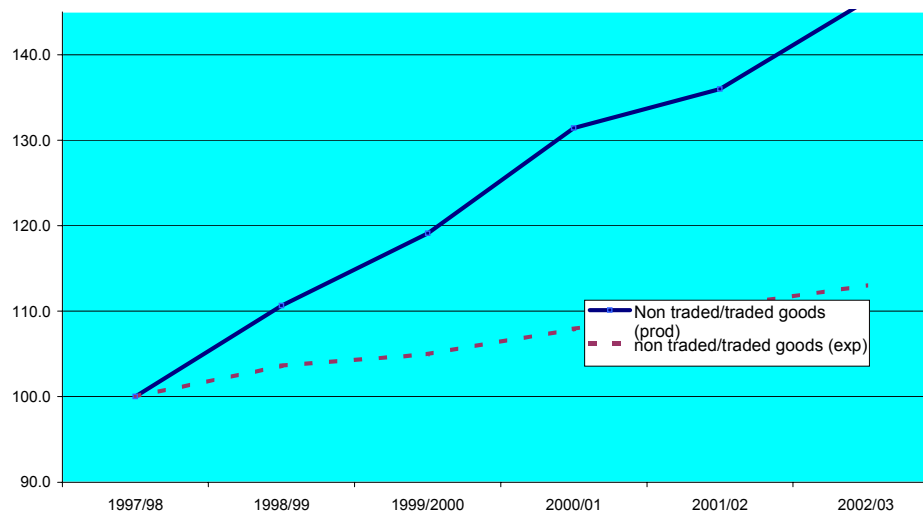
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