

# **Financial Sector Deregulation As A Response To Stabilization And Structural Adjustment Policies In Uganda.**

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## **Abstract**

This article analyzes the impact of Stabilization and Structural Adjustment Policies on the deregulation of the financial sector and in turn what effects that had had on the Ugandan economy in general. The overall performance of the financial sector and export competitiveness has improved significantly during the adjustment period. Better security, domestic demand, and increased imports of inputs have been key factors in the growth process. It is argued that the Stabilization and Structural Adjustment Policies initiated by the World Bank, IMF and the Ugandan Government have been successful for the financial sector in particular and for the Ugandan economy in general.

## **Introduction**

Following a severe balance of payments crisis in the late 70s [1], in June 1981 the Government of Uganda, embarked on a far reaching Stabilization and Structural Adjustment Program (SAP) [2]. Unlike the traditional demand management approach to solving Uganda's balance of payments disequilibrium (which holds that with fixed exchange rates, an expansion of domestic credit induces the public to dispose of excess cash balances by buying foreign goods, leaving domestic goods unchanged), this time they applied supply side (structural adjustment) policies [3]. This change in policy was a result of several studies undertaken by United Nations Center for Trade and Development; United Nations Development Program; and International Labor Organization indicating that external factors contribute as much as the internal factors to the balance of payments crisis in developing countries and so economic growth under demand

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[1]For an excellent discussion of the Ugandan economy during this period, see Hansen and Twaddle (1988), Wiebe and Dodge (1987), Brett (1994), and Sathyamurthy (1988). The economy during this period was characterized as "The 1972 economic war against Ugandans of Asian origin."

management approach was not sustainable. To provide support in this effort of supply side adjustment policies the World Bank, the International Monetary Fund<sup>2[4]</sup>, and some bilateral donors, over the years, have provided substantial financial assistance to the Government of Uganda.

These structural adjustment policies are aimed at opening up the economy and promoting its reliance on market forces; deregulation is the buzz word emphasized by the World Bank and the IMF. They openly say that most of Uganda's problems are due to corrupt regulators and ineffective regulations. SAP is based on the following instrumental changes: broad based price deregulation, flexible determination of interest rates, financial sector reforms, nonfinancial public sector reforms, tax reforms, privatization of state owned enterprises, maintenance of specified levels of international reserves, a lowering of trade barriers and real exchange rate depreciation, among others. The reasoning that underlay the adjustment and stabilization policies assumed that excessive government spending "crowded out" private investment and made inefficient use of the funds it did spend; that state subsidies greatly distorted factor and product prices and that the legacy of import substitution policies had left official exchange rates over-valued and tariff barriers too high. The government plans to use these different instruments in varying degrees are not only to increase output and export competitiveness of the economy, but also to improve productivity, create new employment opportunities, alleviate poverty, improve environment quality, and improve the overall social standards of the Ugandan people. Hence, for the first time, through these supply side policies, the government plans to achieve sustainable economic development in Uganda.

Though the implementation of SAP was halfhearted until 1987 (mainly due to political instability<sup>3[5]</sup>), over the past 8 years, Uganda has experienced a consistent<sup>4[6]</sup> improvement in

<sup>2[4]</sup>IMF provided Uganda with two standby arrangements of Special Drawing Rights (SDRs) of 155.7 million and 112.5 million in 1981/82 and 1982/83 respectively.

<sup>3[5]</sup>From 1984 to 1986 there was civil unrest hence all the previous efforts from 1981 to 1984 were watered down.

<sup>4[6]</sup>Most of the indicators did improve consistently, but if they did not then it was due to external factors like: drop in international prices of cash crop and rise in oil prices.

most economic indicators. To mention some; during 1994/95 the economy grew by 10 percent as compared to 6.3 percent in 1988/89, during 1994/95 agricultural production increased by 6.1 percent as compared to 6.3 percent in 1988/89. The overall budget deficit improved and was registered at 2.3 percent of GDP in 1994/95 as compared to 59.6 percent in 1988/89<sup>[7]</sup>, the annual inflation was reduced to 2.9 percent in 1994/95 as compared to 200 percent in 1988/89, and the overall balance of payment recorded a deficit of 104 million dollars in 1994/95 as compared to a deficit of 125.7 million dollars in 1988/89. For a detailed analysis of the overall macro economic indicators see Table 1.

In view of these encouraging indicators, the medium and long term goals of the government are: to promote sustainable economic growth and reduce poverty; to sustain macroeconomic stability; and to improve the effectiveness and efficiency of government and publicly provided services. In order to achieve the above mentioned goals the government has in place some ongoing programs to provide incentives for private investment and a strong export growth supported by high public and private savings. In addition, the government needs to provide physical and social infrastructure coupled with adequate human capital.

In principle, we can measure the impact of SAP in either of the below mentioned sectors: real or financial. The response of adjustment policies as they pertain to real sector has already been examined by Dr. Kasekende and Dr. Semogerere (1994). This paper will focus on the impact of SAP on the deregulation of the financial sector in general and the exchange rate and foreign exchange allocation in particular. The paper is divided into two parts: the first part analyzes the impact of SAP on the deregulation of the financial sector and the second part analyzes the merits and problems of this deregulation on this sector.

In view of the above general framework, this article attempts to answer some basic questions such as: How is SAP influencing the deregulation of the financial sector? Have the constraints facing the financial sector deregulation been adequately addressed? Is the argument that deregulation leads to socio-economic gain but political losses being realized in Uganda? And most importantly is financial sector deregulation going to lead to sustainable economic growth. In what follows, section 2 will focus on the relationship between SAP and financial sector

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<sup>5[7]</sup>These figures do not reflect grants, otherwise the deficit is 7% and 69% respectively.

deregulation. Then the concluding section will give some closing argument and the predictions on the future of the deregulated financial sector of Uganda.

Table 1. The Macro Economic indicators for Uganda.

Year	88	89	90	91	92	93	94	95
Real GDP Growth (%)	6.5	5.5	4.4	2.6	7.2	4.0	5.5	10.0
Budget Deficit as % of GDP	-	-	8.1	8.1	5.8	4.6	2.3	2.3
Exchange Rate (Ushs/US\$)	105	223	429	734	1134	1195	920	928
Balance of Payments Deficit –ve \$m	195	261	249	188	133	141	104	-
Agriculture Production Growth (%)	5.6	6.6	7.0	5.5	2.4	9.8	4.2	7.1
Manufacturing Production Growth (%)	17.1	9.2	6.5	7.3	15.7	7.0	15.2	17.7
Consumer Price Index (%)	168	82.4	45.4	28.0	52.3	28.4	16.0	3.3

Source: Ministry of Finance and Economic Planning, Background to the Budget 1995/96 and 1994/95.

All figures for 1995 are provisional.

Ushs = Ugandan Shillings

US\$ = United States Dollars

## **Sap And Financial Sector Deregulation**

It is perhaps instructive to give a brief background to the events that preceded the adjustment program in order to provide the context within which to judge the success and failure of deregulation. By the time the National Resistance Movement (NRM) government assumed power in January 1986, it inherited an economy with a serious external debt. This debt was a result of declining total productivity and exports, accelerated inflation, and overvalued exchange rates. The economy was thus characterized by an acute shortage of essential goods and services.

Then over the next eight years Uganda implemented policies of foreign exchange deregulation and import rationalization. Hence, the determination of the exchange rate evolved from an administratively determined system to a market based system. Similarly the foreign exchange management allocation system was also changed to a "market" based system. The trade control regime has also been greatly deregulated; importers are currently issued with six-month certificates to transact international trade.

In 1987 the NRM government adopted a definitive and comprehensive Economic Recovery Program (ERP). The ERP was designed to restore economic growth in a more deregulated financial environment through the stimulation of policies that would over the next 8 years completely deregulate the "fixed exchange rates system" and "currency management system". The currency reform was the most important measure to bring about internal financial stability and to lower the rate of inflation. Under the reforms the currency and bank deposits were converted into new shillings at a rate of 100 shillings to 1 new shilling.

### *Exchange Rate Policy*

Nowhere else was the willingness to give free reign to market forces under ERP exhibited more than in the field of exchange rate and foreign exchange management policy. In May 1987, the exchange rate was kept at Shilling 60 per US dollar for more than a year. While the official rate remained the same despite an inflation rate of over 239 percent, the parallel rate adjusted to the inflation with the premium between the two increasing to over 600 percent. Then in 1988 the shilling was devalued by 60 percent. Despite this devaluation the real exchange rate remained overvalued.

Then in 1989 the government adopted a more active stance on the management of the official exchange rate. The policy rule was to adjust the exchange rate in line with the difference of inflation between Uganda and the principal trading partners - the United States, United Kingdom and Kenya. This rule as expected brought down the premium from 205 percent to about 164 percent.

Prior to deregulation, the import regime that existed in Uganda was characterized by ubiquitous foreign exchange controls and administratively determined allocations and exchange rates. The overvaluation of the shilling meant that import licensing and foreign exchange allocation became the effective systems of restricting official imports. Hence, deregulating the trade without addressing overvaluation of the shilling would have been futile, as the level of foreign exchange reserves could not sustain the demand for import financing. In addition, protection for import competing industries would solely depend on effectiveness of tariff barriers. Given the state of the tax administration, the policy would have been unadvisable. In view of this background the government cautiously but successively deregulated the foreign exchange management system: exchange controls were progressively relaxed through the establishment of the Open General License (OGL) Scheme of importation for selected key industrial sectors; introduction of the dual licensing scheme; institution of the Special Import Programme (SIP); and establishment of Foreign Exchange Bureaux.

#### *Open General License (OGL)*

In January 1988, to further its prioritization process, the government established OGL scheme of importation, whose objective was to facilitate growth in the industrial sector by making foreign exchange available on a continuous basis, to selected manufacturing establishments, for raw materials and spares. The initial criteria for selection of the broad industrial sub-sector to enjoy the OGL were: (i) that the establishments in such a sub-sector contributed - or could potentially contribute - significant tax revenue to the budget; and (ii) that they produced essential mass consumption goods or inputs to other priority industries<sup>6[8]</sup>. This provision was meant to ensure that OGL funds are solely used for procurement of raw material and spare parts and not as

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<sup>6[8]</sup>Under these criteria, 25 companies were issued with licenses, in the soap industry, beer, soft drinks, cigarette, mattresses, textile fabrics, fishnets, blankets, gunny bags and the cement sub-sector.

venture capital as the major aim at the time was for macroeconomic stabilization.

Then in the early 1990, the criteria was expanded to include companies which (iii) had low usage of imported inputs; (iv) produced exports; or (v) produced incentive goods to encourage agriculture production. Access to OGL was expanded to 63 firms, to include the new sub-sectors of pharmaceutical, corrugated iron sheets, aluminum, nails, and sugar.

In evaluating OGL, one could conclude that this was the first step in a very long road to completely deregulating the financial sector. OGL also contributed to a sizable increase in the tax revenue. However, it also subsidized firms through the overvalued exchange rate.

#### *Special Import Programme I*

In order to expedite the deregulation of the financial sector and the exchange rate controls, the government launched SIP I whereby foreign exchange was sold on a first-come-first-served basis at the official rate for a broad range of imports within indicative sectoral allocations. Applicants would, through their bankers indicate their ability to take up any funds allocated. However, importation was subject to a negative import list. This list was comprised of prohibited imports and imports which required special permits before importation. The legally prohibited imports were those goods which, either by act, decree, or statutory instrument, were not to be imported into the country. They included items such as used motor vehicles, used tyres, pornographic literature and imports from South Africa. The other imports that required special permits were beer, cigarettes, soaps, and auto parts. They were banned because the government wanted to protect the local industry.

The immediate effect of SIP I was to alleviate part of the excess demand at the overvalued official rate, the parallel market rate fell, and the premium declined. The premium was further reduced by a 33 percent devaluation of the official rate in March 1989. A good comparison of the OGL and SIP I is shown in Table 2.

#### *Special Import Programme II (July to September 1989)*

By June 1989, the country had mobilized some resources outside ERC I which it decided to sell to the public very quickly and at special rates in order to dampen the huge overhang of liquidity which had built up over the 1988/1989 fiscal year. SIP II was viewed as a temporary mechanism to raise fiscal revenue and mop up excess liquidity. The absorption of excess liquidity in the

economy through the sale of SIP II funds reduced inflation as well as alleviated excess demand in the parallel market with the premium stabilizing around 200 percent over the following months.

*Special Import Programme III (February 1990 to March 1991)*

As a complementary measure to reduce the premium, SIP III was launched in February 1990 as the part of an agreement with World Bank on ERC II. It was envisaged as the major liberalization window because SIP II had disbursed faster and had wider eligibility than OGL.

Under SIP III, funds were sold at the official exchange rate and, in contrast to SIP II, importers were allowed to seek bank credit from the commercial banks in order to finance their imports. However, the Central Bank monitored the levels of commercial banks advances to ensure that they adhered to their statutory limits. The launching of SIP III followed closely on the enlarging of the OGL scheme in January 1990 to cover more industrial sub-sectors. The launching of SIP III and the expansion of the OGL scheme had the effect of reducing excess demand for foreign exchange in the parallel market, in effect showing some positive signs of deregulation.

In the overall evaluation of SIPs, it is argued that they maintained the flow of goods and services and assisted in controlling monetary expansion resulting in a fall in the annual rate of inflation to only 26.7% by the end of June 1990 from a level of 163% in December 1987.

*Foreign Exchange Auction (January 1992 to October 1993)*

Towards the end of January 1992, government instituted an auction system for the official foreign exchange with the objective of further deregulating the exchange and payments regime while permitting market determination of the official exchange rate. Participation in the auction was initially limited to all authorized dealer banks, provided they were in good standing with the Bank Of Uganda and accountability was made for the use of funds won through the auction within a specific period of time. At the start the auction did not work as well as expected, In the period of March to October 1992, out of 3.5 million dollars available for auction, only 3.1 million dollars were actually acquired. But the auction in effect reduced the parallel market premium from 22.2 percent to 11.2 percent.

*Dual Licensing Scheme (1988-1989)*

In 1988, as a move to promote exports of non-traditional commodities, exports were permitted to retain all their earnings for importation of any commodity not on the government negative list.



Under this scheme, the private sector exporter would effectively engage in barter trade, applying for an export license and an import license at the same time, and contracting with the supplier to pay him in goods equivalent to the value of the export. This scheme, though was intended to deregulate the trade sector seemed to be misused by the local traders, hence it was a failure on the whole.

#### *Foreign Exchange Bureaux (Since 1990)*

The final lag in the deregulation of the financial sector was brought into effect with the legalization of the parallel market in July 1990. This sanctioned the establishment of Foreign Exchange Bureaux, which were permitted to buy and sell foreign exchange at rates freely determined by market forces. An export certificate was introduced following the legalization of the forex bureaux. All foreign exchange retention account holders and earners were required to open forex accounts. These funds were then to be sold to the bureaux for shillings or be used for importation of commodities that were not on the country's negative list. Importers eligible to purchase funds for visible imports from the Central Bank were free to choose between the official and the bureaux channels.

This also led to the abolition of the import licensing and being replaced by a more liberalized certificate system. Importers are now free to obtain an import certificate which is valid for six months for importation of any goods of their choice not on the negative list. The import documents have also been vastly simplified. The functioning of the forex bureaux market has been very encouraging with import transactions increasing steadily. The volume of business transacted by bureaux increased from US\$3 million per month at inception to US\$43 million by July 1994. There has also been a reduction and stabilization of the premium between the bureaux and the official exchange rate from 44.9% to around 6% over the same period.

Throughout this section, the various stages of financial sector liberalization were examined, starting from the very tight control of the government to the final and the current stage where the exchange rates and the trade is freely determined, except for some of the restricted items.

Overall, deregulation has helped the country in enormous ways; the economy has moved from one being stagnant to one, which has the highest growth rate in the continent. This does suggest

that deregulation, if done at the right time and the right steps, will help improve the consumer welfare.

Table 2. SIP and OGL approvals (in US Dollars)

Months	Ordinary Applications	OGL	Monthly Total
Dec (1988)	13,515	-	13515
Jan (1989)	11,567	-	11,567
Feb	6,136	-	6,136
March	6,658	2,418	9,076
April	0,013	2,946	2959
May	4,561	3,956	8,517
June	7,808	2,524	10,332
July	2,083	0,686	2,769
August	3,083	0,516	3,599
Sept	1,263	1,058	2,321
Oct	0,929	0,199	1,128
Nov	2,599	2,424	5,023
Dec	1,964	0,353	2,317
Jan (1990)	6,723	2,228	8,951
Feb	2,723	-	2,723
Total	71,655	19,308	90,963

Source: "Bank of Uganda"

## **Conclusion and Policy Implications**

In this article, I analyzed the impact of SAP on the deregulation of the financial sector and in turn what effects that had on the economy in general. The overall performance of the financial sector and export competitiveness has improved significantly during the adjustment period. Better security, domestic demand, and increased imports of inputs have been key factors in the growth process. However, the growth has been uneven, partly due to different levels of demand growth, but mainly due to the supply deficiencies. Infrastructure, human capital shortage, lack of entrepreneurship, and liquidity constraint have contributed to the supply side deficiencies. Another reason has been the dominance of public owned enterprises, and a conscious effort of the government to support them. The Government of Uganda, and various other institutions are working very hard to provide an enabling environment for sustainable growth. In conclusion, it is evident that deregulation has helped the country at both the micro and the macro levels.

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