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Capital Market Development in Uganda

Damoni Kitabire

The focus of Brian Kahn's chapter is on the problem of "original sin", which is the inability of developing countries (in particular governments) to borrow abroad in domestic currency (narrow definition) and the difficulty faced by developing countries in borrowing at home at long maturities (broad definition). The chapter argues that bond market development can play a critical role in overcoming this problem (for governments, this means financing fiscal deficits), as well as contributing to financial market deepening and providing information to the market on benchmark long-term interest rates across a maturity spectrum (yield curve).

Uganda's Experience

In the late 1990s, both the Bank of Uganda and commercial banks in Uganda supported the introduction of long-term government bonds. The Bank of Uganda was keen to develop a benchmark yield curve to promote capital market development and stimulate long-term bond issues by the private sector, while commercial banks hoped to boost profits from higher rates of interest income on longer-maturity low-risk government securities, at a time when interest rates on shorter-term securities were low.

Since 2004, the Bank of Uganda has issued 2-year, 3-year, 5-year and 10-year government bonds. For a number of years beforehand, the Ministry of Finance, Planning and Economic Development deferred the issuance of long-term government bonds and still have some

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concerns for the following reasons:

Establishing a yield curve requires a critical number of competitive investors in the market for long-term securities to develop a functioning market – Uganda still lacks that critical number. This means that the proposed benefits are at best marginal and will not materialise until there are a sufficient number of competitive investors (which will require pension sector liberalisation).

The government of Uganda does not have a domestic borrowing requirement and specifically plans its budget to avoid domestic borrowing so as to create more room for private sector borrowing from the financial system. (Uganda's high fiscal deficit is financed by donor aid, not domestic borrowing. The rapid expansion in the issuance of treasury bills has been for purposes of liquidity management, not to finance the deficit). The IMF recommended that the government of Uganda should not issue long-term bonds unless these are needed to finance the fiscal deficit.

In conducting monetary policy, yields on government bonds issued are generally higher than on treasury bills reflecting the premium required for longer-maturity securities, therefore the introduction of bonds will increase the budgetary cost of liquidity management.

The market for long-term bonds in Uganda is very shallow, meaning that the supply curve for long-term funds is inelastic; hence no bond interest rate is independent of the demand for funds from bond issuers. (In other words, bond issuers are not price-takers and a reliable yield curve is difficult to establish; a yield of 15 percent on a 5-year government bond does not mean private issuers can assume a similar yield). Bond market development requires financial institutions that hold long-term liabilities, because only by holding long-term liabilities can a financial institution invest in long-term assets. Uganda has no such institution except for NSSF (pension monopoly), which invests its long-term assets in short-term assets or real estate. The issuance of government bonds should not have preceded the reform of the supply-side of the capital market (including liberalisation of the pension sector and introduction of private sector pension institutions).

Issuing a government bond crowds out private sector issuers of securities (both in volume and cost terms), damaging long-term productive investment in the economy. Due to the absence of long-term saving institutions in Uganda, there is a very limited supply of funds for investment in long-term securities, yet potential high demand for long-term funds from companies such as Stanbic Bank, UTL and

BAT etc. Government issuance of long-term bonds simply exacerbates the imbalance between supply and demand.

Following the introduction of bonds, one-third of total domestic debt is now longer-dated, which poses a considerable rollover risk (especially in the event of a withdrawal of donor aid). Further, the government of Uganda operates a three-year macroeconomic framework, so the timing of maturities is not consistent with the liquidity management time profile.

Summary

Uganda does not face the "original sin" problem as it is able to finance its fiscal deficit through donor grants and concessional loans.

The development of bond markets and issuance of government bonds should be carefully sequenced, not preceding reforms of the supply-side of capital markets, which (i) increase the number of financial institutions holding long-term liabilities (such as private sector pension institutions) and consequently the supply of funds for investment in long-term securities; and (ii) increase the number of competitive investors in the market for long-term securities required to develop a functioning market and a reliable yield curve. Premature bond market development delivers only marginal benefits but significant costs in terms of private sector crowding out and higher budgetary costs of conducting monetary policy.

In terms of priorities for capital market development, bond market development should not be a priority, so long as long-term bonds are not needed to finance the fiscal deficit. In Uganda, priorities for capital market development are pension sector reform and expansion of microfinance provision.