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Excess Bank Liquidity in Sub-Saharan Africa: The Case of Uganda

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PREFACE

This Master's Thesis "Excess Bank Liquidity in Sub-Saharan Africa: The Case of Uganda" bases on an extensive literature research on the phenomena of excess bank liquidity in worlds developing countries as well as in Uganda in particular. Especially the field work, performed during the exchange semester between August 2007 and January 2008 at the Makerere University[1], has increased my awareness of the specific economic and social challenges in Uganda. I am extremely grateful to the many bankers, civil servants and scientists in Uganda who were willing to give me their time in several personal interviews.[2] Furthermore, I would particularly like to thank Jean-Michel Servet, advisor of this thesis, for his great support and for our inspiring discussions and Tarron Khemraj for the possibility to have access to his very interesting research results in the field of excess bank liquidity.

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[2] See ANNEX 1 for main interview partners and ANNEX 2-4 for interview questionnaires

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ABBREVIATIONS AND ACRONYMS

ASCA	Accumulating Savings and Credit Association
BOP	Balance of Payment
BOU	Bank of Uganda
CEMAC	Central African Economic and Monetary Community
COOP	Co-operative Bank
CRB	Credit Reference Bureau
DFID	Department for International Development
DRC	Democratic Republic of Congo
FDI	Foreign Direct Investment
FSAC	Bank Financial Adjustment Credit
FSSA	Financial System Stability Assessment
GBS	General Budget Support
GDP	Gross Domestic Product
HDI	Human Development Index
HHI	Herfindahl-Hirschmann Index
HIC	High-Income Country
HIPC	Heavily Indebted Poor Countries
IDA	International Development Association
IDP	Internally Displaced Person
IFC	International Finance Corporation
IMF	International Monetary Fund
LCD	Least Developed Country
LIC	Low-Income Country
LRA	Lord's Resistance Army
MDGs	Millennium Development Goals
MDI	Microfinance Deposit-Taking Institution
MFD	Multilateral Debt Fund
MFI	Microfinance Institutions
M2	Broad Money Supply
NBFI	Non Banking Financial Institution

NIM	Net Interest Margin
NPL	Non-Performing Loans
NRM	National Resistance Movement
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
OMO	Open Market Operations
PEAP	Poverty Eradication Action Plan
PGBS	Partnership General Budget Support
PRSC	Poverty Reduction Support Credit
ROE	Return on Equity
ROSCA	Rotating Savings and Credit Association
SACCO	Savings and Credit Cooperatives
SAP	Structural Adjustment Program
SME	Small- and Medium-sized Enterprise
SSA	Sub-Saharan Africa
UCB	Uganda Commercial Bank
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nation Development Programme
UGS	Ugandan Shilling
USE	Ugandan Securities Exchange
US$	US Dollar
VSLA	Village Savings and Loan Association
WAEMU	West African Economic and Monetary Union
WB	World Bank
WEF	World Economic Forum

1 Introduction

Theoretical and empirical literature argue that finance is good for growth (Levine, 1997 or Hugon, 2005) and that enduring economic growth requires a developed financial market and access to an efficient banking system (Hauner, Peiris, 2005). Shaw (1973) highlights the importance of financial institutions in providing intermediation between savers and investors. Performing such roles of intermediation, banks not only increase the rate of capital accumulation but also increase productivity, thereby boosting the economy's steady-state growth (Bencivenga and Smith, 1991).

In Sub-Saharan African (SSA) countries there is a widespread concern among authorities that the banking system is not providing enough support to new economic initiatives (Sacerdoti, 2005), even if in most countries, commercial banks hold large quantities of excess liquidity in their asset portfolio (Saxegaard, 2006). Excess bank liquidity is generally defined as the total of liquid assets above the statutory level. It can be calculated by subtracting the statutory required bank liquidity from the total bank liquidity (Saxegaard, 2006 and Khemraj, 2007a). The statutory liquidity ratio is set individually by every central bank. The ratio varies widely in SSA countries from 0 percent up to over 50 percent[3]. By setting high statutory reserve ratios monetary authorities can influence excess bank liquidity significantly. To analyse causes and consequences of excess bank liquidity from a pure perspective, i.e. eliminated by the statutory influence factor, this paper focuses on excess liquidity as total bank liquid assets before interventions by the central bank.

For the examination of excess bank liquidity the case of Uganda is of particular interest. On the one hand Uganda has undergone an incredible transformation from a failed state to one of the world's fastest growing economies in the last 20 years (WB, 2007b). Significant structural and regulatory reforms, not least in the financial sector, have been undertaken to reverse the poor economic performance. Head count poverty fell from 58 percent in the 1990 to 31 percent in 2007 and HIV/AIDS fell from 18 percent in 1995 to 6 percent in 2007.[4] On the other hand Uganda is still one of the world's poorest countries, ranked 154th out of 177 countries in Human Development Index[5] (HDI) and remains highly aid-dependent with continuously raising Official Development Assistance (ODA) and official aid amounting to 1.6 billion in 2006 alone.[6]

[3] Effective required reserve ratio in 2004: Central African Republic 0 percent; Liberia and Zimbabwe >50 percent (Saxegaard, 2006)
[4] Source: UN Millennium Development Goals Monitor, available on http://www.mdgmonitor.org/factsheets_00.cfm?c=UGA&cd=800 (Retrieved on 2008-06-05)
[5] Source: UNDP, Human Development Reports, http://hdr.undp.org/en/statistics/ (Retrieved on 2008-06-01)
[6] To compare: Foreign Direct Investments (FDI) 2006: US$ 390 million; Source ODA and FDI: WB, Uganda Data Profile, Word Development Indicators database, available on http://devdata.worldbank.org/external/ CPProfile.asp?CCODE=UGA&PTYPE= CP (Retrieved on 2008-05-05)

Uganda's financial sector is still small and underdeveloped, in absolute terms as well as relative to most African comparators (WB, 2007b): In June 2007 commercial banks loans and advances to customers accounted for only around US$ 1 billion, while disposing over high liquid assets of around US$ 850 million at the same time (IMF, 2008). Furthermore, Uganda ranked 7th in terms of capital flight in SSA with an annual outflow of over US$ 540 million between 1991 and 2004 (Salisu, 2005), and the World Bank estimates that Uganda loses about US$ 300 million per year through corruption and procurement malpractices (Olupot, 2008).

The paper is structured as follows: After the introduction, Section 2 describes the development of Uganda's financial sector from 1962 up to now, including various reforms. Status, causes and consequences of excess bank liquidity in Uganda are analysed in Section 3. Section 4 highlights the possibilities to fundamentally solve the problem of excess liquidity by addressing the underlying causes. Section 5 draws the final conclusion.

2 Financial sector development in Uganda

To classify the challenges in Uganda's financial market today, this section highlights the development of the banking sector since Uganda's independence in 1962. First of all the influence of the two major development phases - the post-independence banking reform 1962-1989 and the financial sector reforms in the 1990s - are analysed. Afterwards an overview of the financial sector today is given, leading to a short section conclusion.

2.1 Post-independence banking reform 1962 – 1989

In 1962, when Uganda became an independent nation all commercial banks were foreign-owned: The British banks Barclays, Standard Chartered and ANZ Grindlays as well as the Bank of Baroda and Bank of India, mainly serving the Indian diaspora in Uganda (Mayanja, 2000).

Similar to most of the independent African countries, the Ugandan population was largely discontent with the lending policies of the foreign banks. According to Brownbridge and Harvey (1998) the foreign banks only provided finance to companies owned from abroad or by non-African resident communities, while Africans were largely excluded from bank borrowings. The newly independent government regarded this situation as irrational and unjust and adopted large-scale interventionist policies towards the banking sector, for example: (1) introduction of interest rates controls, (2) set-up of public sector banks and equity holdings on foreign-own banks, (3) low regulatory requirements or (4) ad-hoc fiscal interventions. The impact of government's interventions on the financial market and its participation in banking were - in combination with severe economic crisis[7], civil conflicts and political instability – disastrous for the financial sector.

These very negative effects on the financial sector are reflected in Figure 1, showing the development of Uganda's financial depth. The broad money supply (M2) to the Gross Domestic Product (GDP) ratio is the simplest indicator to measure the degree of monetization in an economy and thereby the stage of development of the financial infrastructure (Outreville, 1999).

[7] Between 1970 and 1986, Uganda per capita real GDP fell by more than 30 percent (Nachega, 2001)

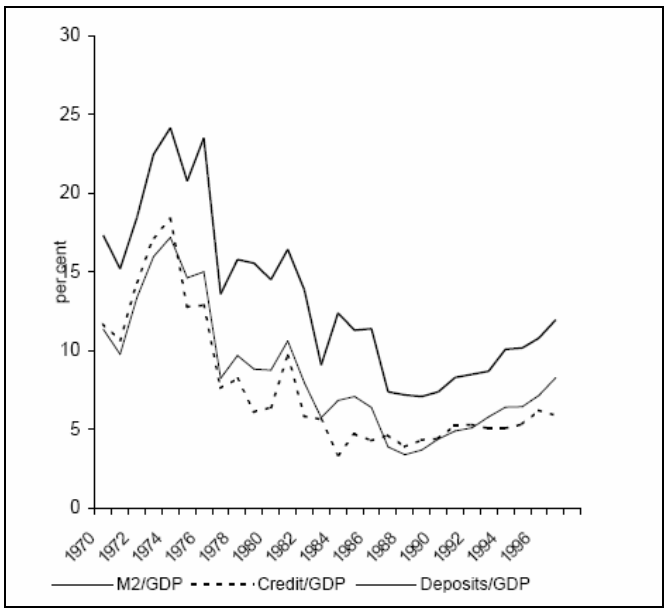

Figure 1: Uganda: Financial depth, 1970-1998 (Money, Credit and Deposits in percent of GDP) (Aleem, Kasekende, 1999)

After a peak of 24 percent in 1974, resulting from an increased financing of the trade and manufacturing sector, there was a steep decline in the financial depth of the economy in the following years.

To point out intentions and consequences of the interventionist policies, the before mentioned examples illustrating the negative impact of governments financial sector policies are described in detail:

(1) Introduction of interest rates controls

The Bank of Uganda determined the level of interest rates. The nominal interest rates for deposits as well as for lendings were held well below the consumer price inflation rate for most of the time. For instance, the consumer price inflation averaged 103 percent during 1981-1990, while the time deposit rates averaged 24 percent (Brownbridge, Harvey, 1998), resulting in a substantially negative real interest rate on average. The negative real returns on deposits contributed to a steep decline of bank deposits to GDP of 11.3 percent in 1970 to 4.2 percent in 1990 (Brownbridge, Harvey, 1998).

(2) Set-up of public sector banks and equity holdings on foreign-own banks

The strong government influence on the financial sector was reflected in its equity holdings in the majority of the commercial banks. In the early 1990s the two largest banks the Uganda Commercial Bank (UCB) and the Co-operative Bank (COOP) – founded 1965 respectively 1972 – accounted for about 90 percent of all commercial bank branches and far over 50

percent of all bank deposits. They were state-owned and 49 percent of the equity of all foreign banks was held by the government (Aleem, Kasekende, 1999). Thus, it is not surprising, that the credit allocation was mainly done by national development objectives or personal and political interests. The result of this credit policy was an extremely high rate of bad debts.[8]

(3) Low regulatory requirements

Commercial bank legislation and supervision were neglected at this time. Furthermore, mainly in state-owned commercial banks, the enforceability of the already weak regulations was extremely limited, especially because of the parallel government influence on the lending policy. An example for the weak legislation at this time was the minimum capital requirement: In 1988 only US$ 2.000[9] were required to open a commercial bank in Uganda, a major reason for several bank failures in 1990s.

(4) Ad-hoc fiscal interventions

In this extremely difficult economic environment the expatriate commercial banks only survived by applying a very conservative lending policy. This restricted lending policy was the major reason of excess bank liquidity at this time. In order to reduce the excess bank liquidity of foreign banks and to increase tax revenues the government imposed a tax of 30 percent on holdings of currency and bank deposits in 1987. This resulted in a further loss of public's confidence in the financial system and in another reduction of financial depth (Brownbridge, Harvey, 1998).

In conclusion, according to Brownbridge and Harvey (1998) the problems of Uganda's banking system today, one of the weakest in Sub-Saharan Africa, are largely attributable to the financial policies between the mid-1960s and the late 1980s. This view is in-line with the financial repression theory developed by McKinnon (1973) and Shaw (1973), which considers the role of government intervention in the financial markets as a major constraint. The government's role in controlling interest rates and directing credit to priority sectors inhibits savings mobilization and therefore impedes capital formation, investment and economic growth. Consequently financial liberalisation is the only solution to increase savings and shift them from low and unproductive projects to high productive investments.

2.2 Financial sector reforms in the 1990s

The takeover of Youweri Museveni in 1987 can be seen as major turning point in the economic policy of Uganda. In corporation with the World Bank (WB) and the International Monetary

[8] Ratio of Non-performing advances to total advances ratio as of September 30, 1994: 52,5 percent (Byaruhanga, 2006)
[9] According to the 1969 Banking Act (Brownbridge, Harvey, 1998)

Fund (IMF) Uganda has embarked on Structural Adjustment Programs (SAPs) designed to reverse the poor economic performance.

After a first phase (1987-1991) of macroeconomic measures to stabilize the economy (e.g. currency reform, control of budget deficit and stabilization of the consumer price inflation), Uganda realized that the SAPs cannot succeed without a well functioning financial sector mobilizing financial resources for investment and private sector growth (Tomusange, 2003).

Therefore, in a second phase (1992-1994) the following key liberalisation measures were introduced: In 1992, all interest rates were allowed to become market-determined while in 1993 prudential regulations on licensing requirements, minimum capital adequacy and liquidity requirements were introduced (Hauner, Peiris, 2005).

A third phase (1995-2004) focused on the development and strengthening of institutions to complement the policy and legal reforms made in the second phase: On the one hand, a World Bank Financial Adjustment Credit (FSAC) of US$ 100 million was used to finance institutional capacity building, logistical support and training of staff from the Bank of Uganda and commercial banks in order to strengthen the financial system (Byaruhanga, 2006). On the other hand, in 1998 and 1999 four illiquid banks (accounting for 12 percent of total bank system's deposits) were closed by the Bank of Uganda. And the state-owned UCB (accounting for 22 percent of the total system's deposits) was declared insolvent, privatized and finally sold to Stanbic Bank, a leading South African bank (Hauner, Peiris, 2005).

In conclusion, according to the latest Uganda Financial System Stability Assessment (FSSA) conducted by IMF (2003) many positive effects can be stated from the financial liberalisation programs: a sustained high rate of economic growth, low consumer price inflation, positive real interest rates and a substantial reduction in non-performing loans. Due to foreign bank entries the concentration in the banking system decreased. And finally, the role of the government in terms of allocating and intermediating financial savings as well as in terms of equity holdings in commercial banks is now marginal. But despite a thorough program of economic and financial liberalisation opening out into a step in the right direction the banking system in Uganda is still among the weakest in Sub-Saharan Africa as the following section outlines.

2.3 Financial sector today

To analyse the development and depth of the financial sector in Uganda today, four analysis perspectives can be used: (1) M2/GDP and Bank credit to private sector/GDP, (2)

Deposits/GDP, (3) Net interest margins and (4) Bank liquidity/Deposits and Credit to private sector/GDP.

(1) M2/GDP and Bank credit to private sector/GDP

Despite the financial liberalisation, the financial intermediation expressed by the ratio of broad money M2 to GDP remains at 19 percent. This is still much lower than most Sub-Saharan African and Low-Income Countries (LICs) (Figure 2). Something similar can be regarded looking at the ratio of bank credits to private sector, which also is significantly lower with around 8 percent.

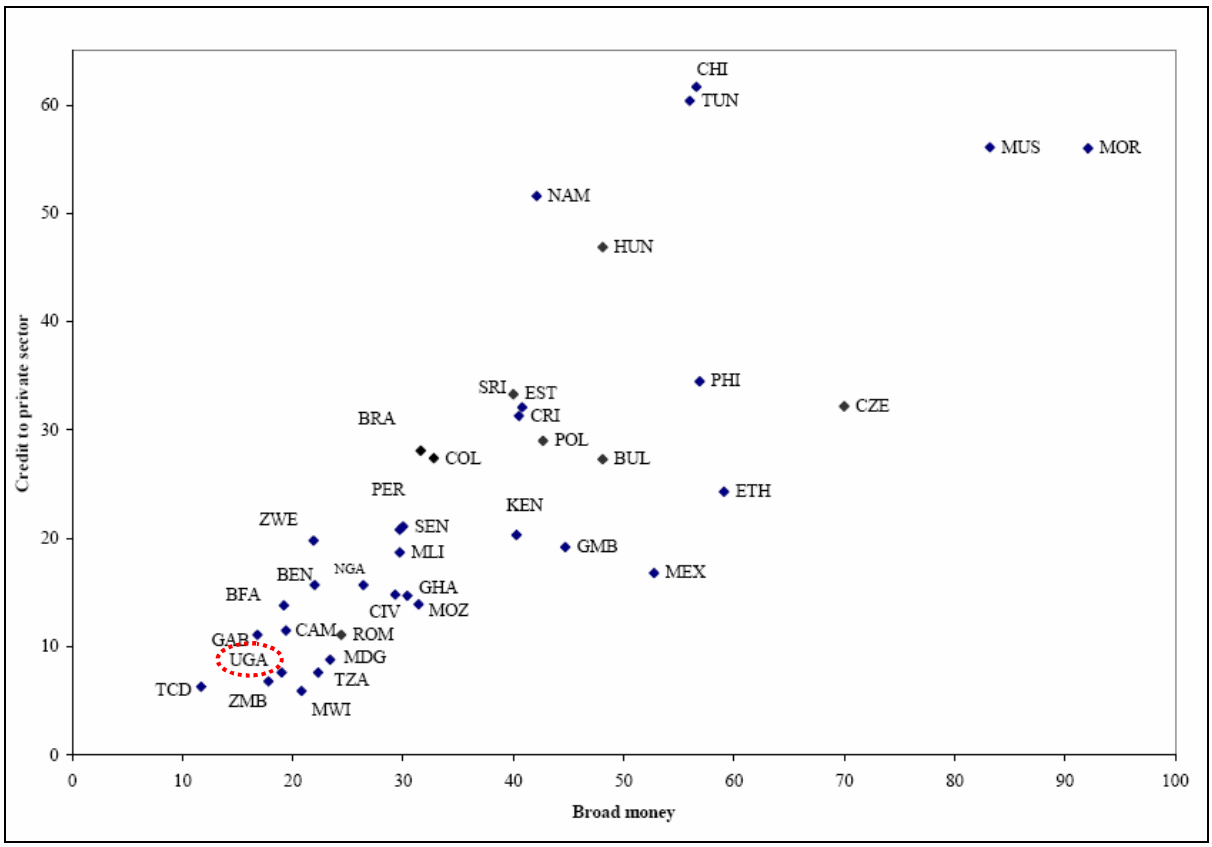

Figure 2: SSA countries and selected other developing countries: Money and bank credit to private sector, 2003 (in percent of GDP) (Sacerdoti, 2005)

Furthermore, Figure 2 shows a linear relationship between the two ratios, meaning that a deepening of the financial sector leads to an increase in private sector financing in relation to the GDP.

Figure 3 shows the development of the bank credits to private sector in Uganda since the financial liberalisation.

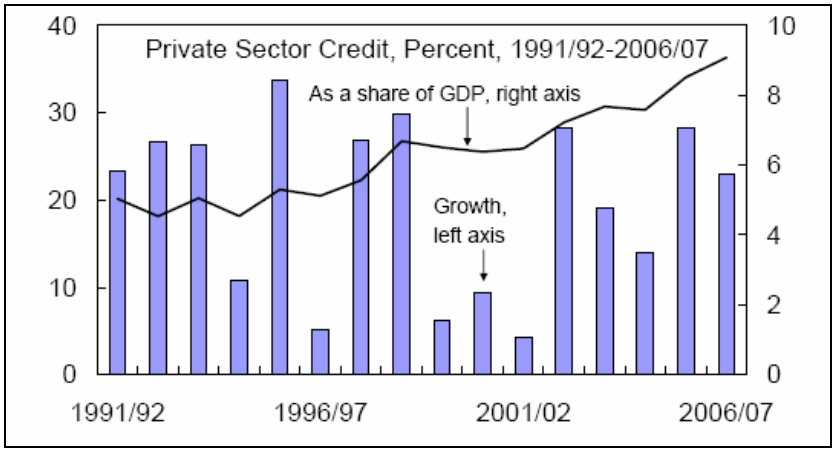

Figure 3: Uganda: Growth of Private sector credit, 1991/92-2006/07 (in percent of GDP) (IMF, 2008)

IMF (2008) recognises the increased support of Uganda's banking system to the private sector as an indication that the restructuring of the commercial banks and the financial liberalisation is paying off. Furthermore, the theory of a linear relationship between M2 and private sector credit development can be verified by the Ugandan case: Within the last 15 years the M2/GDP ratio increased by around 100 percent[10] while the private sector credit/GDP ratio raised by around 80 percent.

(2) Deposits/GDP

The deposits-to-GDP ratio measures the ability of the banks to attract financial savings. Figure 4 shows the bank deposits of SSA countries in percent of GDP with a very low mean value of only 13.4 percent (Saab, Vacher, 2007) and an even lower value for Uganda.

[10] Ratio M2/GDP 1992/93: 8.3 percent (Mugume, 2002); 2006/07: 16.7 percent (Bank of Uganda (BOU), Report & Financial Statements of the Year Ended 30 June 2007)

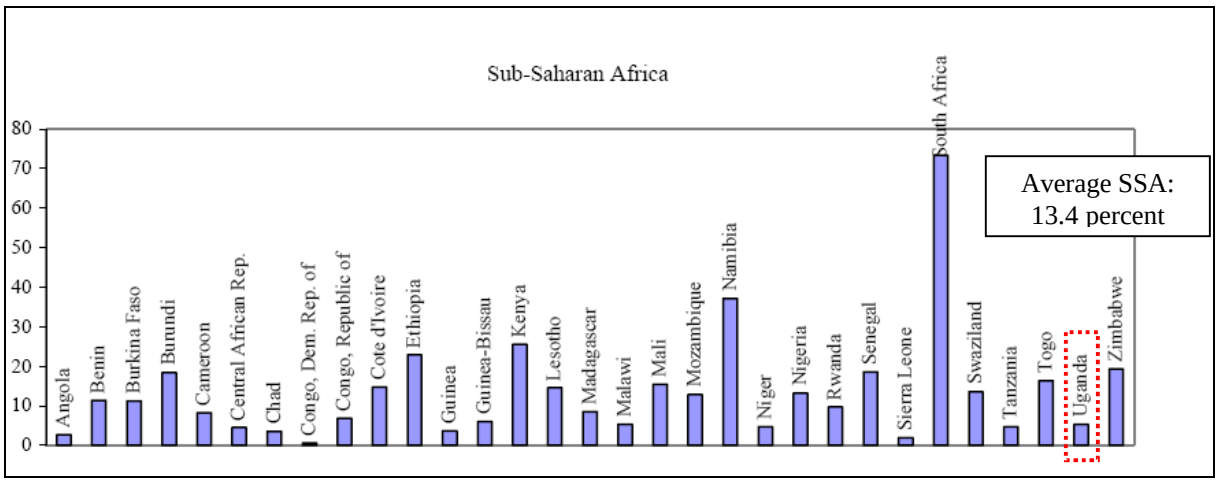

Figure 4: Sub-Saharan Africa: Bank deposits, 2003 (in percent of GDP) (Detragiache et al., 2005)

This indicator stresses the very low possibility of the Ugandan population to formally save money in commercial banks. A recent study about Ugandans saving behaviour supports this statement (The Steadman Group, 2007): 71 percent of all Ugandans are currently saving, but 90 percent of them save in a secret hiding place or with friends and only 22 percent save with formal financial institutions. Nevertheless, the low deposits to GDP ratio is not the reason for limited credits support to the private sector in Uganda: In 2007 only 56 percent of the deposits were used for loans and advances (IMF, 2008) while in the EU the ratio loans/deposits was 123 percent in 2003 (Sy, 2006).

(3) Net interest margins

The net interest margin (NIM) is the difference between interest earned on assets and interest paid on liabilities. Banking systems with high operating costs and high risk of customer default must earn high net interest margins to cover these costs. Therefore NIM is used as an efficiency measure of the financial sector (Detragiache et al., 2005). As disclosed in Figure 5, the NIM in Uganda is among the highest in Sub-Saharan Africa, reflecting low efficiency of the financial sector.

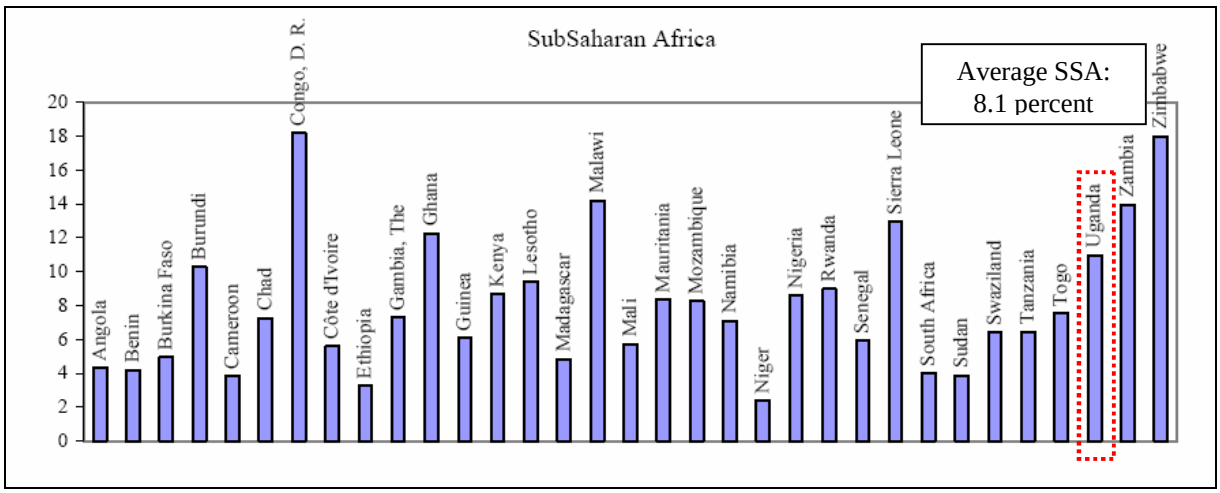

Figure 5: Sub-Saharan Africa: Banking System Net Interest Margin, 2003 (in percent of interest earning assets) (Detragiache et al., 2005)

The cross-country comparison of Cihak and Podpiera (2005) further supports the thesis of low efficiency in the Ugandan banking market: In 2002, Uganda shows a NIM of 12.7 percent, while the average NIM in SSA countries was 8.1 percent and in OECD countries 3.6 percent.

(4) Bank liquidity/Deposits and Credit to private sector/GDP

The financial liberalisation hypothesis holds that allowing the market determination of real interest rates would mobilize savings (Fry, 1997) and banks would channel theses savings to the best investors who earn the highest rate of return. We can assume that in an efficient banking market liquidity is only held for precautionary reasons respectively to meet the required statutory liquidity ratio set by the central bank. But Figure 6 shows, that the intermediation role between savers and investors countries is not accomplished by SSA commercial banks.

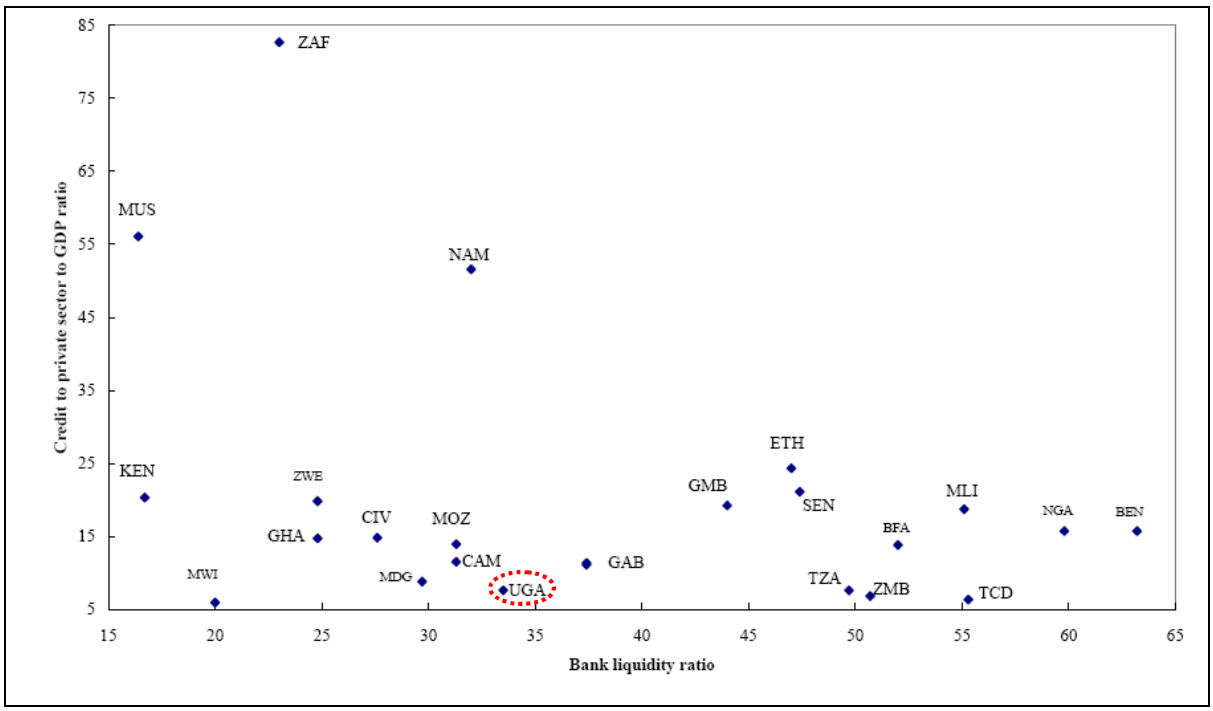

Figure 6: SSA countries and selected other developing countries: Bank Liquidity Ratio[11] and Credit to Private Sector, 2003 (in percent of GDP) (Sacerdoti, 2005)

Most of the SSA and LICs analysed by Sacerdoti (2005) were highly liquid, but provided only minor support to the private sector. According to Saxegaard (2006), at the end of 2004, 41 of all 44 SSA countries were in a status of excess bank liquidity. In 2003 for example, Uganda's commercial banks have provided credits to the private sector in the amount of 7.6 percent of GDP, while holding liquidity of 33.5 percent in relation to the deposits (see Figure 6).

2.4 Conclusion

Uganda's financial sector has recovered from the negative impact of government's control, economic crisis and civil conflicts during the first 30 years after independence (1962). As the result of far reaching reforms conducted in 1990s, Uganda's banking sector has become more competitive and efficient. The increase of the financial depth can be seen as benefit of the interest rate liberalisation, the closure and privatisation of weak banks and the strengthening of the regulatory and supervisory framework. Nevertheless, several indicators used to analyse the financial sector today shows that Uganda's financial market is still far from being efficient.

A major concern is that the financial liberalisation has not successfully removed the situation of excess bank liquidity in Uganda and thus not led to an efficient allocation of the liquid

[11] Defined as liquid reserves, including reserve requirements, plus foreign assets of banking institutions over demand and time deposits of such institutions (Sacerdoti, 2005)

resources. Therefore the following section focuses on the analysis of the causes and consequences of Uganda's excess bank liquidity.

3 Excess bank liquidity in Uganda

This section examines the status of excess bank liquidity in Uganda and replies the following questions: why is excess liquidity a problem, what causes a surplus of liquidity, what prevents excess funds from being lent or invested and what are responses to address excess liquidity. Various findings from Uganda will be analysed and concepts and ideas tested in other SSA and LICs will be applied on the specific situation of Uganda. In conclusion the section summarizes the causes and consequences of excess liquidity in Uganda.

3.1 Status of excess bank liquidity in Uganda

As already mentioned commercial banks in Sub-Saharan Africa are highly liquid. Figure 7 shows the ratio of excess liquidity in 2004 for the SSA countries.

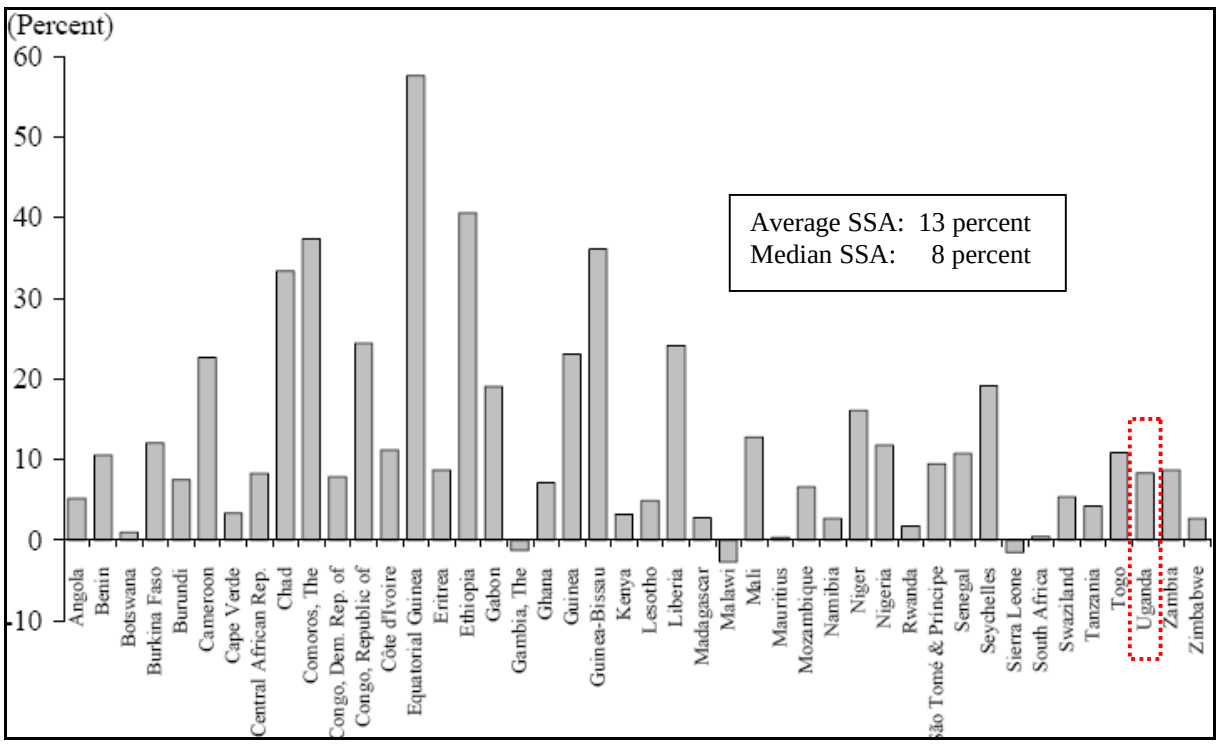

Figure 7: SSA countries: Ratio of excess reserves to total deposits, end of 2004 (Saxegaard, 2006)

Excess liquidity is calculated as commercial banks' holdings of cash and deposits at the central bank in excess of the statutory requirements. With exception of Gambia, Malawi and Sierra Leone, all countries are in a situation of excess liquidity. On the average countries in SSA had excess reserves amounting to around 13 percent of the total deposits. Uganda's excess liquidity was with 8 percent very close the median value of the sample (Saxegaard, 2006).

It is important to note, that the excess liquidity ratios calculated in Figure 7 base on very different statutory reserve requirements for every single country which makes a professional statement difficult. While Central African Republic demanded a reserve ratio of 0 percent, in Liberia and Zimbabwe the reserve ratio was above 50 percent. The average reserve ratio in SSA countries in 2004 was below 10 percent as well as in Uganda with 9.5 percent (Saxegaard, 2006). This means that for example in Zimbabwe the ratio of excess liquidity is only below the average due to the high statutory reserve requirements.

To analyse causes and consequences of excess bank liquidity from a pure perspective, it is important to focus on excess liquidity as total bank liquid assets before interventions by the central bank, for example statutory requirements. Therefore, the following analysis of this paper base on the liquid asset ratio of the commercial banks' financial statements published by Bank of Uganda.

Figure 8 shows this degree of liquid assets in Uganda's commercial banking system from this perspective.

Figure 8: Uganda: Loans & advances in percent of total assets and liquid assets (in percent of total assets) (own calculations)[12]

[12] Source: BOU, Annual Supervision reports 1999, 2002, 2005 and 2006

The liquidity in Uganda's commercial banking system reached its peak in 2002 with a liquid assets ratio of 64 percent and declined subsequently to a ratio of 34 percent in 2006. At the same time Uganda moved from a very low ratio of loans and advances to customer of 26 percent in 2001 to a ratio of 38 percent in 2006, exceeding thereby the ratio of liquid assets for the first time since 1999.

In following this paper examines the reasons behind the major period of high excess liquidity in Uganda's commercial banking system between 1999 and 2002.

It is important to note, that in absolute terms loans and advances to customers increased in the last ten years (Figure 9), showing a significant development since 2002. However the annual growth rate of loans and advances from 1998 to 2002 was only 10.5 percent while liquid assets increased by 41 percent annually in the same period.

Figure 9: Uganda: Loans & advances to customer and liquid assets (in billion UGS) (own calculations)[13]

Still today, the structure of Ugandan banks' balance sheets reflects their strong preference for liquid, low-risk assets. A comparative study about the banking behaviour in the East African countries (Cihak, Podpiera, 2005) is supporting this statement: In 2002, Kenyan banks were showing the double percentage of loans and advances to customers than Ugandan banks and consequently a much lower degree of excess bank liquidity.

[13] Source: BOU, Annual Supervision reports 1999, 2002, 2005 and 2006

To summarize: When calculating excess liquidity as a ratio of excess reserves/total deposits based on commercial banks' holdings of cash and deposits at the central bank in excess of the statutory requirements, Uganda is showing a below average percentage of excess liquidity in 2004 (see Figure 7). However, by analysing the single assets components of the commercial banks' financial statements, a phase of very high liquidity from 1999 to 2002 becomes transparent (see Figure 8). And still today liquid assets count for about one third of total commercial bank assets.

3.2 Why is excess bank liquidity a problem?

Heenan (2005) describes excess liquidity as a symptom whose underlying causes are structural problems in the financial system or macroeconomic imbalances. The concerns related to excess liquidity can be divided into static and dynamic issues.[14] Static issues arise if banks' balance sheets remain in an ongoing status of excess liquidity, while dynamic issues arise from the potential of a sudden expansion in the credit or foreign exchange market.

The main problems of static nature are: (1) a reduction of the bank profitability and (2) an ineffectiveness of the monetary policy.

(1) Reduction of the bank profitability
Excess liquidity in form of deposits at central bank or as cash in vault is in most of the cases non-remunerated. In SSA only 8 out of 44 central banks pay interests on deposits of commercial banks. Furthermore, if interest rates are paid, they are low (from 0.5 to 4 percent) and mostly limited on required statutory reserves (Saxegaard, 2006). A high amount of non-remunerated assets reduces banks earnings. To achieve the required earnings to cover the expenses for interest payments, staff, provision for bad debts etc. the bank has to rely on other income sources as higher lending-deposit rate spreads or increased bank charges to achieve profitability.

(2) Ineffectiveness of the monetary policy
By using monetary policies government and central bank are trying to support the economic growth and stability of a country. Expansionary monetary policies are traditionally used in situations of unemployment or recession while contractionary monetary policies are used to combat consumer price inflation.

Many authors have discovered that excess liquidity limits the influence of monetary policy to stabilize the economy. Agénor, Aizenman and Hoffmaister (2000) found out, that if banks already hold liquidity in excess of requirements, attempts to increase the liquidity in order to

[14] Differentiation between static and dynamic issues bases on Heenan, 2005

stimulate the aggregate demand will prove largely ineffective. Or Nissanke and Aryeetey (1998) have shown that in the presence of excess bank liquidity, it becomes difficult to regulate the money supply using the required reserve ratio, so that the use of monetary policy for stabilization purposes is undermined. In general, it can be said, that the monetary policy transmission mechanism is weakened if the banking system is in a situation of excess liquidity.

Dynamic issues of excess bank liquidity arise when the banks suddenly decide to use the excess liquidity to finance an expansion in lending. It is important to note that banks rarely change their lending behaviour unless something else changes. For example the recent improvement of economic outlook in many SSA countries (Saxegaard, 2006) or the positive effects of the financial sector reforms have increased the fear that banks could expand their lending. This fear is not limited to Africa. As well in developed countries excess liquidity in the economic system can cause severe negative economic damage. The main problems of dynamic nature explained in the following are (1) macroeconomic destabilization and (2) deterioration in the loan quality.

(1) Macroeconomic destabilization
An increase of banks lending, in order to reduce the excess liquidity, leads to an increase of the money in circulation. If the economy is not stable enough to increase the output at an equal ratio, the increased bank lending may lead to consumer price inflation. Furthermore, the growth of monetary aggregates could lead to a deterioration of the balance of payment, if the economy faces resources constraints (Heenan, 2005). Another option is that banks could use the excess liquidity to buy foreign exchange on their own account (Heenan, 2005), which leads to pressure in the foreign exchange market and can depreciate the local currency.

(2) Deterioration in the loan quality
In a situation of excess liquidity there is a certain risk, that banks are ready to take higher risks in order to reduce non-remunerated liquid assets. A rapid increase in lending is usually associated with a deterioration of the loan quality, which leads - with a certain time lag - to an increased credit default ratio.

3.3 What causes a surplus of liquidity?

After the explanation why excess liquidity is a problem, this section analyses the causes of a surplus of liquidity in the banking system. On the one hand excess bank liquidity can be caused by a surplus of international money inflow from capital or current account transactions. On the other hand it can be a creation on national level by a monetization of the fiscal deficit, by floors on deposit rates or other controls that increase the supply of deposits. All possible causes will be analysed on its relevancy on the situation of Uganda.

Between 1997 and 2004 in Sub Saharan Africa the amount of liquidity has been growing rapidly[15] as a result of large capital inflows, particularly owing to increases in aid inflows and revenues from export of oil (Saxegaard, 2006). In Uganda, aid and exports are representing the most important financial inflows (Figure 10).

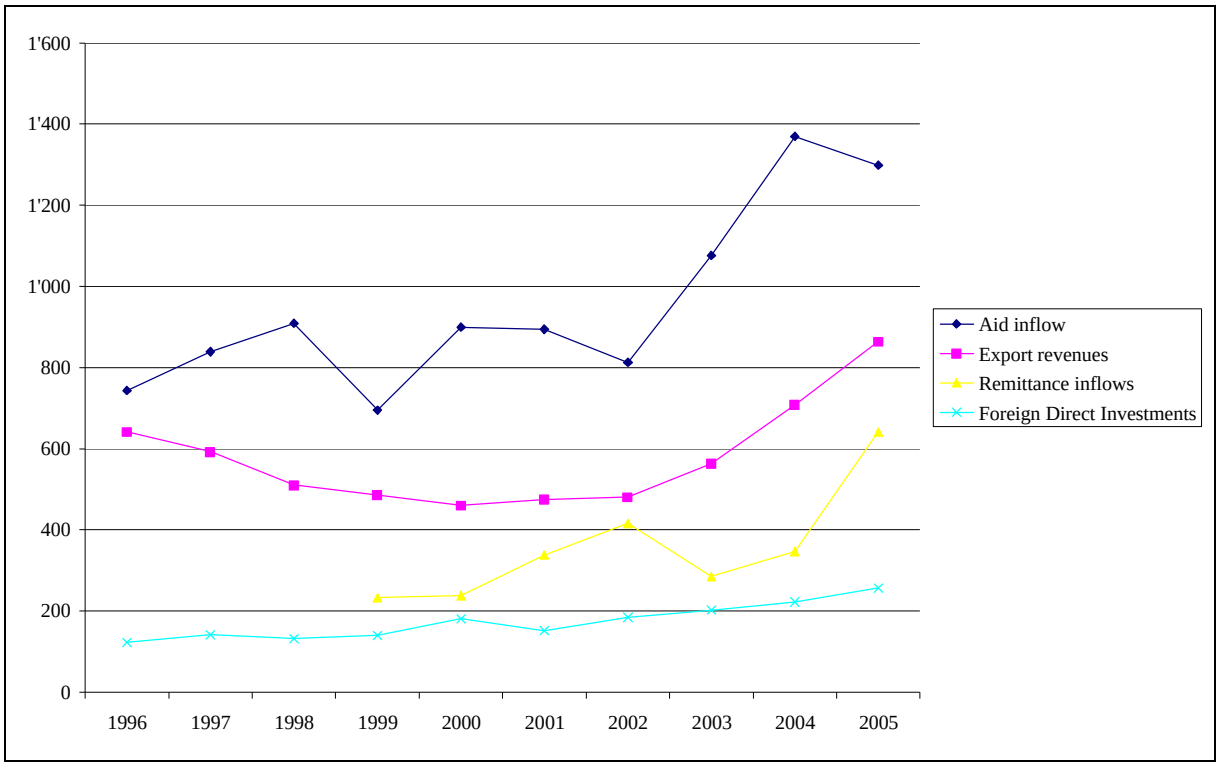

Figure 10: Uganda: Aid inflow, exports revenues, remittance inflows and Foreign Direct Investments, 1996-2005 (in million US$) (own calculations)[16]

Interestingly to note is the nearly steadily growing impact of remittance inflows in Uganda, which is higher than the inflow from Foreign Direct Investments (FDIs). In the following the four main sources of international financial inflow will be analysed in detail along their current importance, starting with the most important one. Afterwards the local causes of a surplus of liquidity will be discussed.

3.3.1 Foreign Aid inflow

Uganda is a highly aid-dependent country and since Museveni took over presidency in 1987 and started stabilisation reforms, Uganda became a favoured aid recipient with a triplication of donor aid inflows from 1987 until 2005. From 1994 on aid inflows averaged 11 percent of the GDP and 50 percent of the public expenditure. Furthermore, Uganda is described as pioneer of

[15] Broad money supply (M2) rose by 21.3 percent a year on average between 1997 and 2004 (Saxegaard, 2006)
[16] Sources: Aid, Exports, FDIs: BOU, Annual Report 2005/06
Remittances: Gupta et al., 2007

many innovations in the aid management (Lister et al., 2006). It was the first country which qualified for the Heavily Indebted Poor Countries (HIPC) debt relief, developed its own poverty reduction strategy and was the first recipient of a World Bank Poverty Reduction Support Credit (PRSC).

The recovery of Uganda's economy can be seen in the change of the aid structure: In the early 1990s Uganda attempted to stabilise the macroeconomic situation and aid was mainly delivered for balance of payment (BOP) support. As SAPs were successfully implemented, there was less need for BOP support. Therefore the decline in BOP support was followed by increased debt relief from bilateral donors through the Multilateral Debt Fund (MFD) and from the Highly Indebted Poor Country debt relief.

From 1999 on, there has been an ongoing increase in aid inflow, mainly due to increasing donor confidence in government's reforms and the emergence of the Partnership General Budget Support (PGBS). The PGBS emerged in the late 1990s as a response to the dissatisfaction with the earlier aid instruments. The term Partnership should contrast with the imposed conditionality of the structural adjustment era. General Budget Support (GBS) is aid funding to government that is not earmarked to specific projects or expenditure items (Dom, 2007). It is disbursed through the government's own financial management system.

The most interesting part is to analyse the effect of the shift from aid used for the BOP support until 1998 to aid used for on-budget projects and PGBS on excess bank liquidity. Aid in form of BOP support has if at all only a minor effect on the excess bank liquidity as the financial means are used for imports. However, aid used for on-budget projects and PGBS might increase the excess bank liquidity within the country: large aid inflows for long lasting development projects were not immediately used, but placed at commercial banks in the meantime and thereby increasing the excess bank liquidity.

Saxegaard (2006) analysed the excess liquidity of SSAs highly aid dependent countries and concluded that there is no evidence that these countries have in general higher excess reserves than other countries.[17] Countries like Mozambique and Uganda, which receive a lot of foreign aid, are given as examples. Both countries have successfully implemented structural reform programs which have contributed to the development of the financial sector. Furthermore the successful completion of several donor funded projects in these countries is seen by Saxegaard (2006) as a sign, that the absorption constraint - which is likely to cause excess liquidity following large aid inflow - is not as important in these countries.

[17] In Ethiopia and Guinea-Bissau rapidly raising aid inflow has been a major cause of excess liquidity (Saxegaard, 2006)

But comparing the commercial banks liquidity ratio (see Figure 8) with the aid inflow (see Figure 10) seems to be contradictionary to Saxegaards (2006) analysis. The ratio of liquid assets to total assets increased from 31 percent in 1998 to 64 percent in 2002. This period represents as well the time, when donor aid was switched from balance of payment support to on-budget projects and PGBS. Accordingly a substantial part of the increased liquidity in Uganda's commercial banks might be caused by the high donor inflow and the specific aid modalities at this time.

3.3.2 Export revenues

The second major sources of high excess liquidity in SSA countries are revenues from exports, particularly resulting from the export of oil. The analysis of Saxegaard (2006) in SSA suggests that the excess liquidity in the oil-producing countries has been higher than in the remaining countries since the middle of the 1990s. For example in Equatorial Guinea and Chad, the oil sector contributed 21.4 and 40.2 percent to the overall growth in the real GDP in 2004. The revenues from the oil companies and the limited investment opportunities for commercial banks have caused huge excess reserves in these countries.

In Uganda, four different arguments support the thesis that the influence of exports on excess bank liquidity is from minor importance. First of all, Figure 10 shows that the total exports inflows are on average about 40 percent lower than the aid inflow at the same time

Secondly, during the time of high excess liquidity in Uganda from 1999-2002 (see Figure 8) export revenues were on the lowest level in the last ten years (see Figure 10). The decline in export earnings in the 1990s was mainly caused by the drop of the price of coffee, Uganda's main export product at this time. The recovery of the export earnings since 2000 reflects the fact that Uganda has managed to diversify its export portfolio away from only coffee to fish, gold, flowers, tobacco and tea (Figure 11).

Figure 11: Uganda: Composition of export revenues, 1995/96-2005/06 (in million US$) (own calculation)[18]

Thirdly, 87 percent of all exports revenues are gained by agricultural products; mineral resources as gold and cobalt are from minor importance.[19] Due to generally low return on investment in agricultural production, it seems unlikely that these capital inflows are saved on commercial banks and not directly reused for production, consumption or investment purposes.

The last argument is related to cross border transactions which are not officially recorded by customs. In 2006, Uganda Bureau of Standards estimated the share of informal cross border transactions on nearly 20 percent of the total exports revenues.[20] Over 50 percent of these informal exports were transported by head/hand, bicycle, push carts and wheel chairs which might indicate, that the relevant part of these exports are done by retail dealers or street hawkers, who hardly dispose over excess liquidity.

In conclusion, exports have played a minor role as source of excess bank liquidity in Uganda in the last years. This situation might completely change in the near future, because impressive oil reserves were found in the Lake Albert Valley recently and Uganda expects to reach a fully-fledged oil production within the next five years. A production between 40.000 and 60.000

[18] Source: BOU, Annual Report 2005/06
[19] Source: BOU, Annual Report 2005/06
[20] Source: BOU, Reports & Financial Statements of the Year Ended 30 June 2007

barrels of oil a day is estimated. The required investment to establish the Petroleum Authority of Uganda and the National Oil Company is up to US$ 5 billion (Bariyo, 2008). The capital inflow from FDIs and later export revenues will definitively influence the liquidity situation in Uganda in the future.

3.3.3 Remittance inflows

The flow of remittances into developing countries is attracting increased attention: In 2005, totally US$ 188 billion remittances were transferred – reflecting twice the amount of the Official Development Assistance the developing countries received (Gupta et al., 2007). Moreover, there is strong evidence that remittances inflows are underreported.

Figure 12 shows a further advantage of remittances: The analysis of Gupta et al. (2007) suggests that remittance inflows show less fluctuation than FDIs or aid flows in SSA countries and represents therefore a more stable source for development.

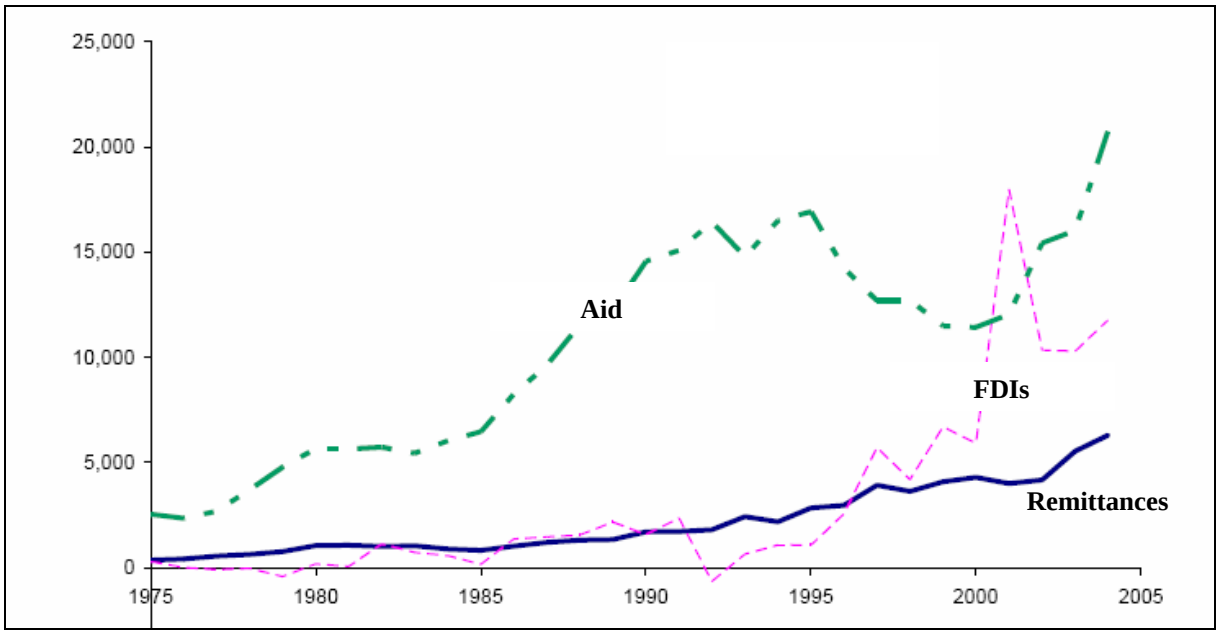

Figure 12: SSA countries: Inflows, 1975-2004 (in million US$) (Gupta et al., 2007)

In Uganda, remittances reflect the third important inflow and an important source of foreign exchange (see Figure 10). In SSA only Lesotho and Cape Verde are showing a higher ratio of remittances to export earnings. In Lesotho, Mauritius, Nigeria, Swaziland, and Togo remittances are even higher than ODA (Gupta et al., 2007).

Uganda's high remittance inflows base on the large exodus of skilled workers over the past decades. It is estimated that during the rule of Idi Amin from 1971 to 1979 Uganda lost more

than half of its professional and technical manpower. This means not only foreigners as Asians had to leave the country (Uganda 1970: 953.000 immigrants; 1980: 678.000) but also skilled Ugandans left the country under Amin's regime. Furthermore Russell et al. (1990) claim that the education expanded faster than the absorptive capacity of the economy, so that trained workers were unable to find jobs at home. By 2005 most of Uganda's emigrants were living in the United Kingdom (40 percent), Tanzania (24 percent), the United States (9 percent) and Canada (8 percent). In 2000 about 37 percent of Uganda's highly-educated persons have been living in OECD countries, which can be seen as substantial brain drain (Shaw, 2007).

The positive effects of the emigration are the substantial inflow of remittances. Since the first publication of data in the year 1999 remittance inflows nearly quadrupled to US$ 890 million in 2005/06.[21] As theses figures might be as well underrepresented, several initiatives of the Bank of Uganda and the World Bank are trying to improve the statistics and the understanding of the volume and characteristics of remittances received from Ugandans living in the Diaspora.

In SSA only a very small part of the sums remitted by migrant workers are transferred through the formal system. The fees of the formal system are much too high for the small sums of money, which the migrants can send back home. An example from an analysis made by British Department for International Development (DFID) (2005) underlines this statement: A remittance transfer of £100 sent through Western Union from the UK to Kenya costs a fee of £14. Therefore migrants rely more on import-export operators, retail shops or currency dealership. These informal providers offer numerous client-friendly features, such as anonymity, minimal paperwork and speed (Gupta et al., 2007). Most of the remittances seem to be used to finance consumption or investment in human capital, such as education, health or better nutrition (Gupta et al., 2007). As remittances are received and used at the micro level, they directly address the most important challenge in SSA – the reduction of poverty.

The impact of remittances on the real exchange rate, export competitiveness or excess bank liquidity is a matter of debate. By comparing the remittance inflows (see Figure 10) and banks liquidity (see Figure 8), a certain influence of remittances on excess bank liquidity seems to exist, mainly in the 2002. But as remittances are dispersed over a large number of poor households, only a limited part of the sources are transferred by formal channels and most of the beneficiaries are not served by formal banks the effect on excess bank liquidity might be of minor importance. However, the further rise of remittance inflows will motivate commercial

[21] Source: BOU, Reports & Financial Statements of the Year Ended 30 June 2007

banks to provide more services to the nowadays unserved remittance-receiving households. Thus, the impact of remittances on excess bank liquidity is expected to rise.[22]

3.3.4 Foreign direct investments inflow

World FDI inflows exceeded US$1.3 trillion in 2006, while total Africa attracted inflows of US$ 36 billion (or 2.8 percent of global inflow) (UNCTAD, 2008). Interestingly to note that the region's largest natural resources producers, such as Angola, Algeria, Libya, Mozambique, Nigeria and South Africa, which account for roughly three quarters of Africa's commodities exports, also receive about 75 percent of Africa's FDI's. Furthermore countries not traditionally known for large reserves of natural resources as Ethiopia, Kenya and Uganda have become exploration hot spots, with foreign companies investing billions of dollars in their projects (UNCTAD, 2008).

In Uganda in the 1970s and 1980s there was substantial capital flight out of the country. Mainly during the area of Idi Amin the investment climate for foreigners was quite hostile. In the early 1990s capital outflows ceased and since 1997 FDIs are exceeding US$ 100 million a year and foreign investors sentiments have gradually improved (Cotton, 2004). In 2006, Uganda received US$ 307 million of FDI, representing about 1 percent of Africa's total inflow (UNCTAD, 2008). The development of Uganda's FDI from 2000 to 2006 is positive, but far from impressive: Uganda achieved an average annual increase of 9 percent, while the peer group of the Least Developed Countries (LCDs) in Africa achieved an annual increase of 18 percent (UNCTAD, 2008). Furthermore, Uganda's FDI figure not only consists of investments in new businesses: A part of the recorded inflow bases on privatization, while another part belongs to the return of businesses disseized from foreigners under the Amin regime to their former owners (Nkusu, 2004).

Nevertheless, FDIs have supported Uganda's fairly remarkable economic transformation and contributed as well to its poverty reduction strategy. For instance, in the telecommunications sector FDIs have increased the efficiency in Uganda's poor network and thereby helped to ease a bottleneck to private sector development (Reinikka, Svensson, 2001).

Neither in the literature nor from comparing the FDI inflow (see Figure 10) with commercial banks' liquidity (see Figures 8) a strong impact of FDI on excess bank liquidity can be assumed regarding the past. But the establishment of the Petroleum Authority of Uganda and the

[22] Already today the impact of remittances on excess liquidity can be seen in Ethiopia or Nepal:
According to Gilmour (2005, in: Saxegaard, 2006) the build-up of excess bank liquidity in Ethiopia has been associated with an increase of private sector deposits, partially due to an increase in deposits by individuals benefiting from remittance inflows from abroad.
In 2006, Nepal's central bank announced that the domestic market disposed over an excess liquidity of around US$ 257 million mainly due to continued double-digit growth in remittance income (People's Daily Online, 2006)

National Oil Company - as mentioned above - and the therefore required FDI of up to US$ 5 billion will definitively influence the commercial bank liquidity in Uganda in the future.

3.3.5 Local causes

Besides of capital and current account inflow from abroad, excess liquidity can also be created by local measures and policies.

The first possibility, the monetization of the fiscal deficit is described in the following: The government runs a deficit and finances its spending by issuing government bonds to the private sector. Afterwards the central bank increases the money supply and repurchases with newly created money the government bonds from the public. This monetization of the fiscal deficit can lead to an increase of commercial banks liquidity and to a rise in consumer price inflation.

In Uganda, mainly two arguments disprove the hypothesis that monetization of the fiscal deficit is a cause of excess liquidity in the last decade. Firstly, since 1993 the consumer price inflation has always been below 10 percent (Figure 13).

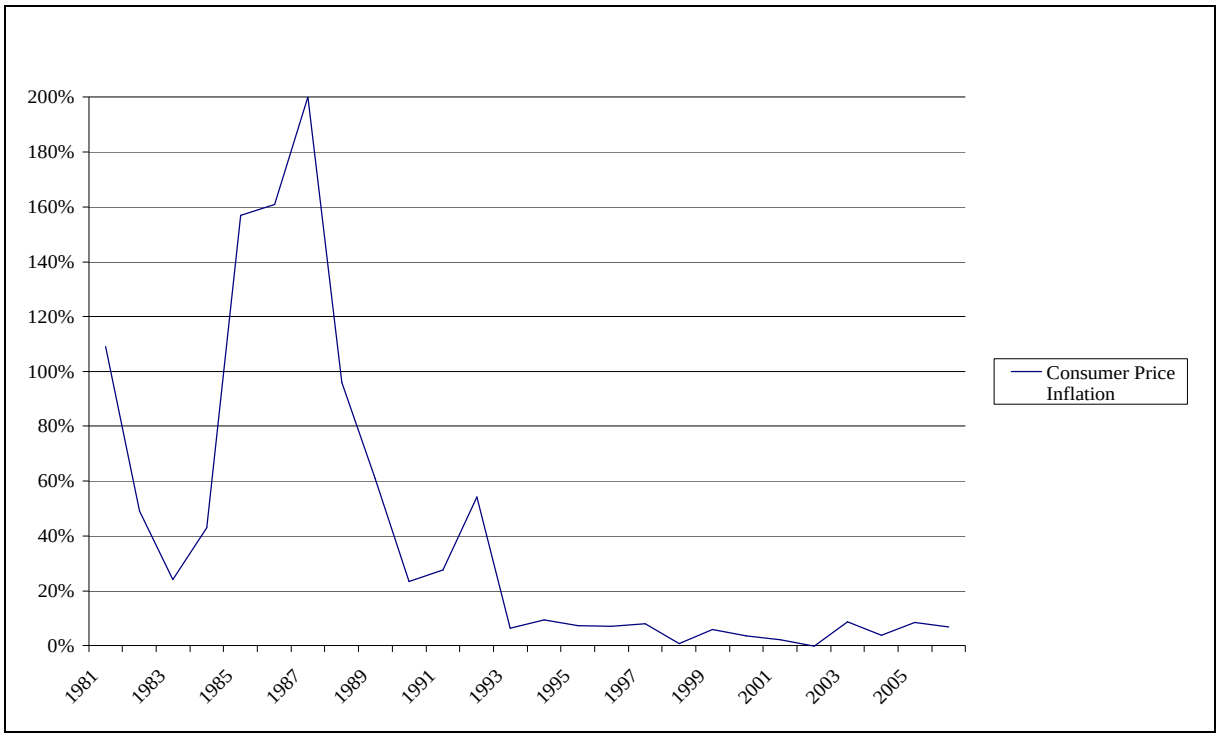

Figure 13: Uganda: Consumer Price Inflation, 1981-2006 (in percent) (own calculation)[23]

Secondly, the IMF Financial System Stability Assessment (2003) stated that Treasury bills were issued solely for monetary policy purposes.

[23] Sources: Brownbridge, Harvey, 1998; BOU, Annual Report 2005/06; BOU, Reports & Financial Statements of the Year Ended 30 June 2007

Another cause of a surplus of liquidity is floors on deposit rates and other controls that artificially increase the supply of deposits. For Uganda, this cause is not valid. In 1992, the interest-rate controls of the government were removed as a measure of the financial liberalisation. The result was a sharp drop of the savings deposit rate from 15 percent in 1992/93 to 2 percent in 1993/94 (Brownbridge, Harvey, 1998).

To summarize: The high aid-inflow is the main cause of a surplus of liquidity in Uganda's commercial banks during the last decade. Furthermore, there is support for the assumption that banks' high ratio of liquid assets during the period of 1999 to 2002 was at least partially caused by the switch of donor aid from BOP support to on-budget projects and PGBS. Large aid inflows for long lasting development projects in the country were not immediately used completely, though the whole amount is placed at commercial banks which increase the excess bank liquidity. Since the financial liberalisation, a "homemade" surplus of liquidity (monetization of the fiscal deficit or controls) is less likely.

3.4 What prevents excess liquidity from being lent or invested?

This section poses the question why excess liquidity in banks is not lent nor invested. As already mentioned before, Shaw (1973) highlights the importance of the financial institutions in providing intermediation between savers and investors. Excess bank liquidity is therefore a sign that the channel between investors and savers is broken and the deposits are not transferred into credits or productive investments.

In the following, several possible constraints in the transmission process are analysed: the economic risk, the political risk, the structure of the commercial banking market, the earning structure of commercial banks and the competitiveness of the private sector. If the excess liquidity can not be lent, the question remains why banks do not use alternative investment opportunities to place the non-remunerated excess liquidity. Therefore this section will be closed with a short analysis of alternative investment opportunities.

3.4.1 Economic risk

Economic stability is the basis for lending activities of commercial banks. Therefore, a major reason, which may prevent banks from lending funds, is the high risk associated to this activity in SSA. In the 1980, many African economies experienced an acute economic crisis, which had its origins in a combination of external shocks and mistaken polices (Brownbridge, Harvey, 1998). These two factors led to a substantial banking crisis in SSA with high credit loss rates and several bank failures.

At this time, on the one hand the government-owned commercial banks were mostly insolvent, mainly due to corrupt lending to uncreditworthy borrowers, and had no more resources to lend. On the other hand the surviving expatriate commercial banks frequently had excess liquidity. However they had no interest to change the conservative lending policy, which had enabled them to survive (Brownbridge, Harvey, 1998).

Figure 14 shows that in 2004 the banking system in SSA was in a better condition, but still vulnerable with average Non-Performing Loans[24] (NPL) of over 15 percent (Gulde, Pattillo, 2006).

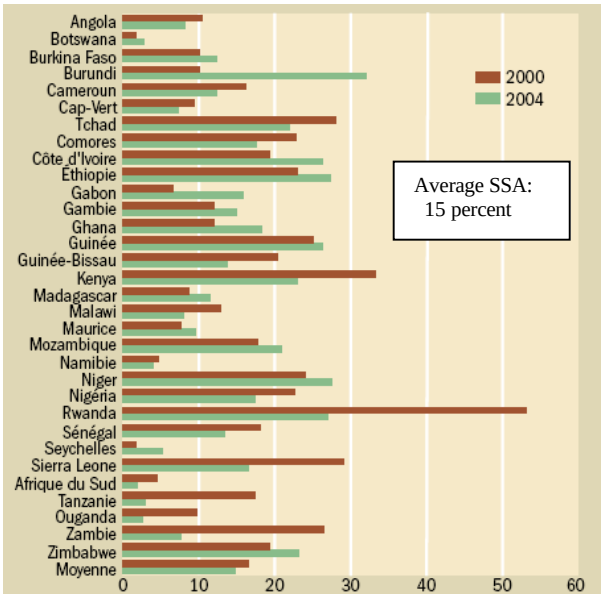

Figure 14: SSA countries: Non-performing loans, 2000/04 (in percent of total loans and advances) (Gulde, Pattillo, 2006)

A reference value for adequate asset quality of commercial banks is 5 percent NPL to total loans and advances.[25] Uganda is one of the few SSA countries which reached a value of non-performing loans below the 5 percent.

Uganda's low percentage of NPL since 2000 is result of a painful restructuring process the commercial banking sector was forced to undertake (Figure 15).

[24] Non-performing loans: Interest rates and loan repayment are not fulfilled by debtor

[25] The Banque Central des Etats de l'Afrique de l'Ouest (BCEAO) for example defines the benchmark of 5 percent as a measure for "adequate" asset quality (Sy, 2006)

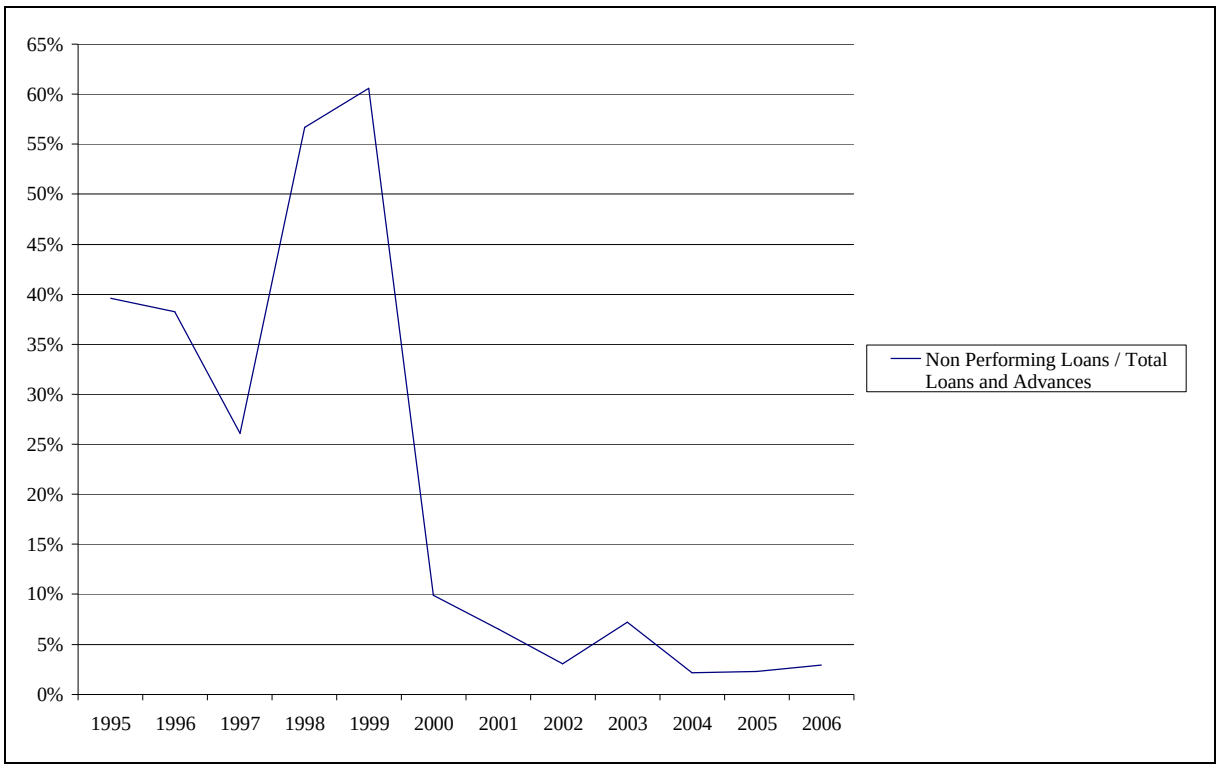

Figure 15: Uganda: Uganda: Non-performing loans and advances, 1995-2006 (in percent of total loans and advances)[26]

In 1994, more than half of Uganda's commercial banks experienced losses and seven out of fifteen banks were insolvent (Aleem, Kasekende, 1999). The following improvement of the asset quality of Ugandans commercial banks bases mainly on the closure of four relatively large banks in 1998/99 and the cleaning up of the portfolio of Uganda's largest commercial bank UCB (IMF, 2003). By the early 1990s, the UCB held around 50 percent of commercial bank deposits and operated 190 of 237 bank branches in the country. Due to political influence on the lending policy and high corruption around 75 percent of its loan portfolio was non-performing at this time. To illustrate the gravity of the situation: In the early 1990s, UCB's wage bill alone exceeded its income (Brownbridge, Harvey 1998).

Therefore, since 1999 half of the improvement in the NPLs in Uganda's commercial banking sector can be accounted on UCB's portfolio cleaning up (IMF, 2003). This improvement of the balance sheet, which was a precondition for a privatization, was accompanied by an understandably very limited involvement of the UCB in the credit market (Katarikawe, Musinguzi, 2001).

[26] Source: BOU, Annual Supervision reports 1999, 2002 and 2006

The foreign banks were as well forced to make substantial provisions of their lending portfolio. Particularly Barclays suffered a heavy loss in 1994 (Brownbridge, Harvey 1998). Thus it is not a big surprise that foreign banks still rely on a conservative lending policy.

Therefore, the restricted lending behaviour of Uganda's commercial banks can be seen in context of the painful correction phase at end of the 1990s. Today, most commercial banks have very low NPLs but some smaller banks in Uganda are still struggling with NPLs over 30 percent (IMF, 2003).

3.4.2 Political risk

Another explanation for the conservative investment behaviour of banks is given by Fielding and Shortland (2005), analysing the determinants of excess bank liquidity in Egypt. Despite the liberalisation of the foreign exchange and credit markets and the removal of financially repressive interest rate controls, Egyptian banks still hold large amounts of excess liquidity.

Fielding and Shortland (2005) conclude that reform packages, concentrating solely on financial and economic factors are unlikely to be effective in promoting confidence in the economy if they do not also deal with the causes of the political conflicts. Consequently, in Egypt the measures to reduce violence had a greater effect on the reduction of excess bank liquidity than the financial and economic reforms.

Two effects can be observed in a period of increasing violence. Firstly, the risk of loan default increases during crisis, leading to a reduction in lending as precaution measure and thus to an increase in liquidity. Secondly, for countries like Egypt without an official deposit insurance scheme, which - at least partly - protects depositors in case of a bank default, depositors tend to withdraw their savings. Therefore, in times of political turmoil, when depositors suspect a possible bank default, very high bank liquidity may be the only way of preventing banking runs (Fielding, Shortland, 2005).

Uganda suffered several political conflicts since its independence. Kreimer et al. (2000) noted several peaks of conflicts: In 1971, the overthrow of Milton Obote through a military coup led by Idi Amin. More or less the whole following area of Amin was marked by high civil violence and exceptional brutality and strife. In 1979, Amin was military overthrown by a combined force of the Tanzanian Army and Ugandan exiles. The last peak was the military overthrow of the second rule of Obote in 1985. This marked the end of the widespread civil strife Uganda had to struggle with since 1971.

The National Resistance Movement (NRM), in power since 1986, has a much better human rights record than its predecessors, but internal and external conflicts have not completely disappeared.

The most important conflicts have been caused by the Lord's Resistance Army (LRA) in Northern Uganda, still representing an unsolved problem. The LRA has killed, tortured and sexually abused thousands of civilians and has abducted an estimated 25.000 children, forcing them to serve as porters, sex slaves and child soldiers (Lister, 2006). Between 1.5 and 2 million people have been displaced from their homes and had to live in Internally Displaced Person (IDP) camps (Lister, 2006). Chronic violence and the displacement of almost the whole population in the Northern area have caused the collapse of the local economy.

In 1998, Uganda became actively involved in the conflict in Democratic Republic of Congo (DRC). And during 1999/2000 clashes between Ugandan and Rwandan troops took place.

The impact of the political conflicts on the lending activity of Uganda's commercial banks respectively on their excess liquidity has not been quantified so far. However, Cihak and Podpiera (2005) mention the civil disturbances combined with financial repression as reason of the limited development of the financial system in Uganda.

The impact of political conflicts on excess bank liquidity might be slightly different in Uganda than in Egypt, mainly due to the fact that Uganda disposes an official deposit insurance scheme. The deposit protection fund, managed by the Bank of Uganda, was established to compensate all depositors in case of a bank failure. In 1998/99, during the time of the closure of the International Commercial Bank, the Greenland Bank and the Cooperative Bank the deposit insurance limit was UGS 3 million[27]. However, the government decided to fully compensate all depositors as well above the insurance limit in order to stabilise the financial market (IMF, 2003). Because of the insecurity about the behaviour of depositors of other banks, surviving banks might have increased their liquidity in order to prevent a further bankruptcy (see increase of liquidity in 1999; see Figure 8).

In the subsequent cases of bank closure (Trust Bank and TransAfrica bank) the depositors were only secured until the insurance limit of UGS 3 million and incurred losses for deposits above (IMF, 2003). This was an important sign for the credibility of the Bank of Uganda and the government policies in the financial market.

[27] About US$ 1.780 (exchange rate UGS – US$ as of April 30, 2008: 1.700)

3.4.3 Structure of the commercial banking market

A completely different explanation about banks preference to hold excess liquidity is given by Khemraj (2007a) by analysing the bank liquidity preference curve for eight less developed countries,[28] all of them with a very liquid banking sector. His conclusion is that excess liquidity is a structural phenomenon rooted in the oligopoly nature of the banking market. An oligopolistic banking sector is not competitive and commercial banks are able to require a minimum mark-up interest rate before they lend to the marginal borrower.

Figure 16 shows the loan rates Uganda's commercial banks offered between 1988 and 2006, depending on the amount of liquidity in the financial market.

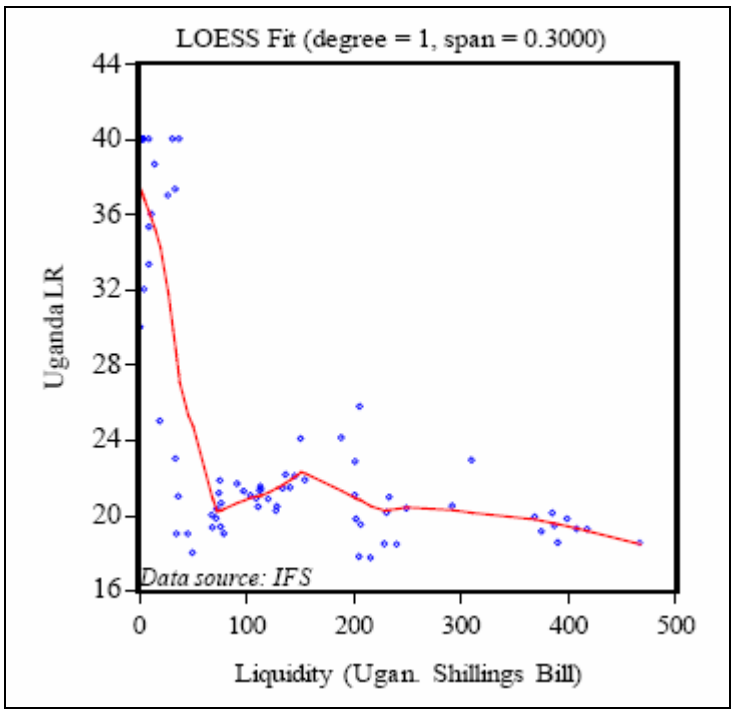

Figure 16: Uganda: Bank liquidity and loan rate, quarterly data 1988Q1-2006Q3 (in billion UGS/in percent) (Khemraj, 2007a)

The bank's liquidity preference curve becomes flat at approximately 20 percent. This means a borrower in Uganda will hardly receive a credit if he is unwilling to pay an interest rate of around 20 percent. Or in other words, Ugandan banks prefer to hold liquidity if the borrower is unable to pay the demanded interest rate, meaning unproductive excess liquidity and loans become nearly perfect substitutes at a very high loan rate (Khemraj, 2007a).

[28] Guyana, Barbados, Jamaica, Bahamas, Trinidad and Tobago, Namibia, Uganda and Egypt

The assumption, that the financial liberalisation leads to a perfectly competitive loan market, where excess liquidity and bank loans should become substitutes at a zero loan rate, has failed for Uganda (Khemraj, 2007a). This implies also that indirect monetary policy, e.g. in order to reduce the liquidity in the banking market, can only be effective at high lending interest rates.

Several indicators underline the oligopolistic structure of the banking sector in Uganda. Firstly, figures from 2003 show that the banking sector in Uganda is dominated by four foreign-owned banks which accounted for 68 percent of the loans and 75 percent of the deposits (IMF, 2003). Another instrument to measure the concentration of the banking market is the Herfindahl-Hirschmann Index (HHI). Due to the merger of UCB with Stanbic the HHI for assets increased from about 1.434 in 2002 to close to 2.000 afterwards, which signifies a relatively high concentration (Cihak, Podpiera, 2005).[29] To compare: the HHI for assets in Kenya in 2002 was only 947, expressing a relatively low banking system concentration (Cihak, Podpiera, 2005).

Therefore, it is interesting to see whether the low competition in Uganda is reflected in the calculation of the interest rates (Table 1).

	Ugandan Banks	Kenyan Banks
Lending rate	21.7	17.5
Deposit rate	2.2	3.4
Total spread, of which:	**19.5**	**14.1**
Overhead costs	9.0	5.1
Loan loss provisions	2.1	1.7
Reserve requirements + deposit insurance premium	0.4	0.4
Tax	2.3	2.1
Profit margin	**5.7**	**4.8**

Table 1: Uganda and Kenya: Decomposition of Interest Spread, 2003/04 (Uganda) and 2002 (Kenya) (in percent) (Hauner, Peiris, 2005)

Table 1 shows that the total spread in Uganda is higher than in Kenya (19.5 to 14.1 percent). This is much higher than the average in SSA (11.5 percent) and in OECD countries (4.1 percent) (Cihak, Podpiera, 2005). Hence, according to Hauner and Peiris (2005) there are rising concerns that the high interest spread may also reflect weak competition.

Accordingly it can be concluded that the banking system in Uganda is still characterized by an oligopolistic market structure that may impede financial intermediation.

[29] HHI values between 1.000 and 2.000 indicating a moderate level of concentration; values above 2.000 indicate high levels of concentration. The index is calculated by summing up the squared relative market shares of all the banks (Saab, Vacher, 2007)

3.4.4 Earning structure of commercial banks

An analysis of the earning structure of Uganda's commercial banks offers another explanation why excess liquidity is not being lent. Figure 17 reflects the development of the main income components of Uganda's commercial banks.

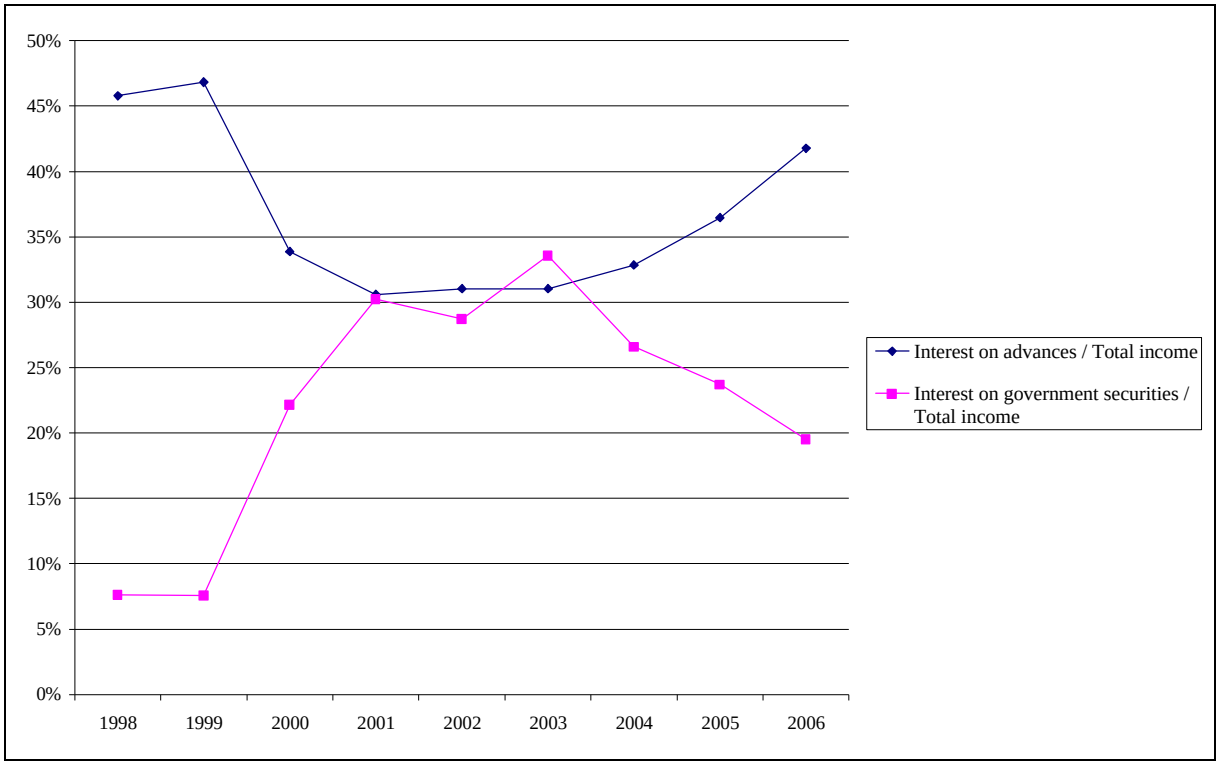

Figure 17: Uganda: Interest on advances and interest on government securities, 1998-2006 (in percent of total income)[30]

The banks' income structure has completely changed during the last 10 years: Before the period of high excess liquidity in Uganda, nearly half of the banks income was based on interest on advances.

During the period of high liquidity 1999-2002, the massive issuance of Treasury bills by the Bank of Uganda in order to buy-out the excess liquidity had an important impact on the income structure. In absolute terms from 1999 to 2002, interest income on loans and advances increased by 9 percent while interest income on government securities rose by 525 percent.[31] Interest receipts from Treasury bills, which accounted for 8 percent of the income in 1998, reached 34 percent in 2003. Since 2003 interest on advances has been increased, while the importance of interest on government securities has been declined. To conclude: the banks'

[30] Source: BOU, Annual Supervision reports 2002 and 2006
[31] Source: BOU, Annual Supervision reports 2002 and 2006

reliance on government securities as steady stream of revenues might have crowded out private sector lending from 1999 to 2002.

A second change in the structure of the revenue is addressed by Hauner and Peiris (2005): The income from charges and fees increased by 408 percent[32] from 2002 to 2004, reflecting, in addition to the income from Treasury bills, another substantial new source of income.[33] The high fees and commissions characterize once again the oligopolistic market structure that impedes financial intermediation. Prohibitive bank charges for deposits and withdrawals[34] can potentially discourage the development of a saving culture especially for the medium and small income earners and small savers. On the lending side, financial institutions are currently advertising that they lend at 1 percent per month. But there are a lot of visible charges (interest charges, arrangement, application and legal fees, insurance and taxes) as well as invisible taxes (e.g. interest penalties for late payment, additional ledger and loan restructuring fees) resulting in an interest charge of at least three times higher.[35] To force banks to reduce their high and insincere charges the Bank of Uganda is publishing the charges of all commercial banks regularly in the press, aiming to increase transparency and competition among financial institutions (Oketch, 2007a).

The conclusion of Hauner and Peiris (2005) is that a reduction in the net Treasury bill issuance may reduce the dependence of banks upon low-risk, high-yielding government securities and increase the competition, as banks would have to identify new lending opportunities and expand their customer base in order to generate income.

3.4.5 Competitiveness of the private sector

Weak bank lending is seen as one of the main reasons for the build-up of excess liquidity. This view is not only limited to the SSA area. Wyplosz (2005), for example, identified weak bank lending due to poor growth prospects as the reason for the increased excess reserves in the euro area in 2005. In Uganda, poor growth perspectives on national level can not be seen as the limiting factor: economic growth increased by 6 percent on average over the last 15 years (Lister et al., 2006) and according IMF (2008) estimations real GDP growth will increase by 7 percent on average between 2007/08 and 2012/13, and 6 percent for the following period until 2019/20.

[32] To compare: from 2002 to 2004, growth of interest on loans +74 percent and interest on treasury bills +33 percent (Hauner and Peiris, 2005)

[33] To illustrate: sources of income of Uganda's commercial banks: interest on loans 34 percent; interest on treasury bills 26 percent; charges and fees 20 percent; others 20 percent (Hauner and Peiris, 2005)

[34] E.g. US$ 1.75 for a withdrawal from a savings account at Diamond Bank. Source: BOU, Commercial banks charges as of 30 June 2007.

[35] Example: Borrowing of UGS 1.000.000 (around US$ 600) for 1 percent per month as advertised by commercial banks. The following charges are due: UGS 20.000 for account opening, UGS 20.000 for insurance, UGS 30.000 for loan processing. Furthermore, UGS 400.000 have to be placed on a deposit account and UGS 100.000 have to be put in shares of the commercial bank. This leads to an amount of only UGS 400.000, which is freely disposable, but interests of 1 percent per month have to be paid on UGS 1.000.000 resulting in an annual interest payment of UGS 120.000 or 30 percent in relation to the truly borrowed amount of UGS 400.000 (Ndiwalana, 2007)

However, a more detailed examination of the overall economic performance discloses a very different development on a sectoral level. Figure 18 discloses the sectoral shares of the GDP in 2006 compared to 1997, while Figure 19 shows the annual growth rates of the four sectors since 1997/98.

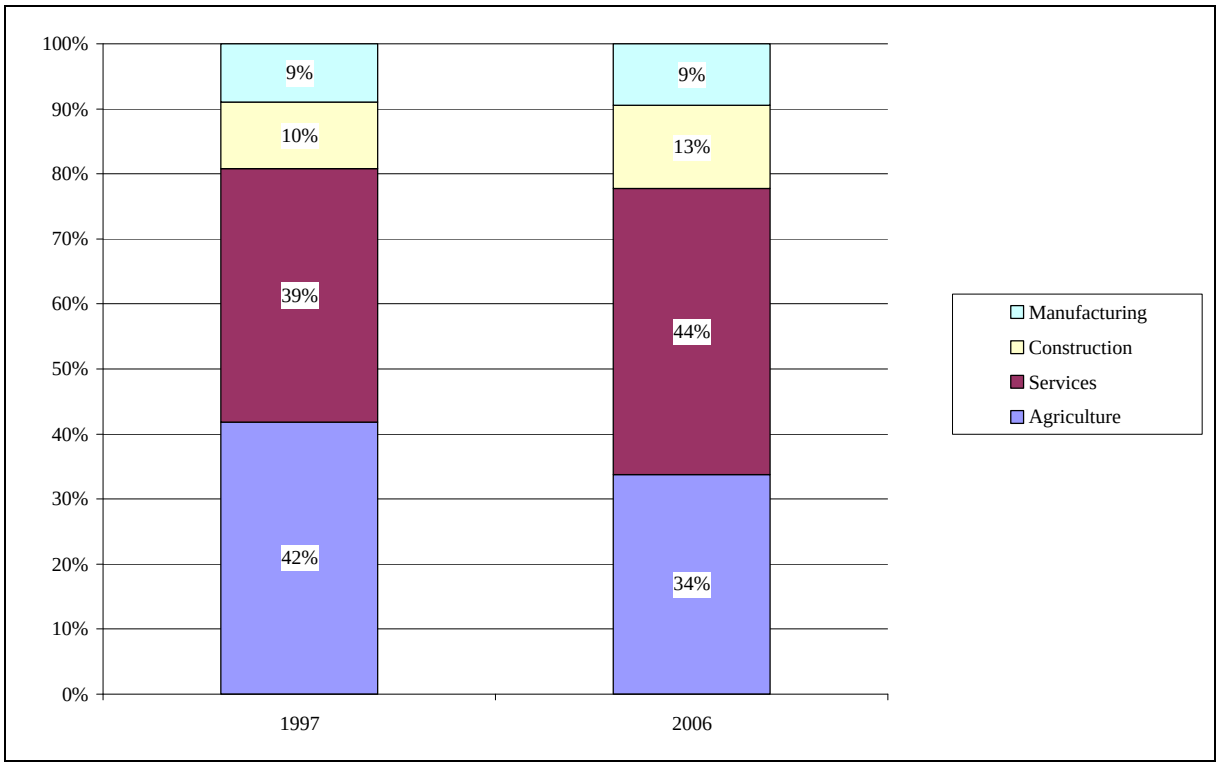

Figure 18: Uganda: Sectoral shares of GDP, 1997-2006 (in percent) (Bank of Uganda, Annual Report 2005/06)

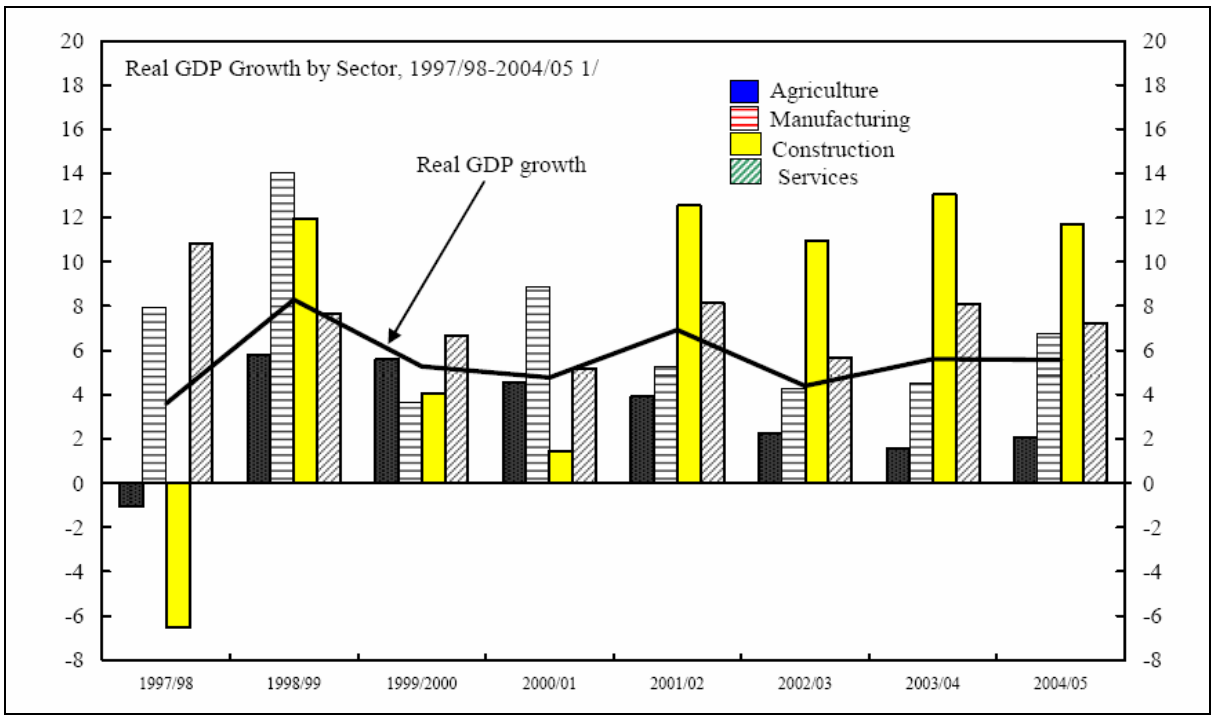

Figure 19: Uganda: Real GDP Growth by Sector, 1997/98-2004/05 (in percent) (IMF, 2006)

The agricultural sector's share in percentage of the GDP has declined consistently in the last 10 years, due to an average growth rate of 2.7 percent, which is much lower than in other sectors. The structural transformation process, prolonged droughts, poor soils and attacks from pests and diseases have contributed to the slow down of the agricultural sector.[36] At the same time, the services sector, which consists of wholesale and retail, hotels and restaurants, transport and communication, and community services has grown to the most important sector of Uganda's economy.

The low performance of the agricultural sector affects most of Uganda's population: 87 percent[37] are living in rural areas and around 80 percent[38] of the population live from subsistence agriculture, most of them in poverty. Figure 20 shows that the interest of commercial banks on the agricultural sector is of minor importance.

[36] Source : BOU, Annual Report 2005/06
[37] Source: Lister et al., 2006
[38] Source: Slezak, Tillmann, 2006

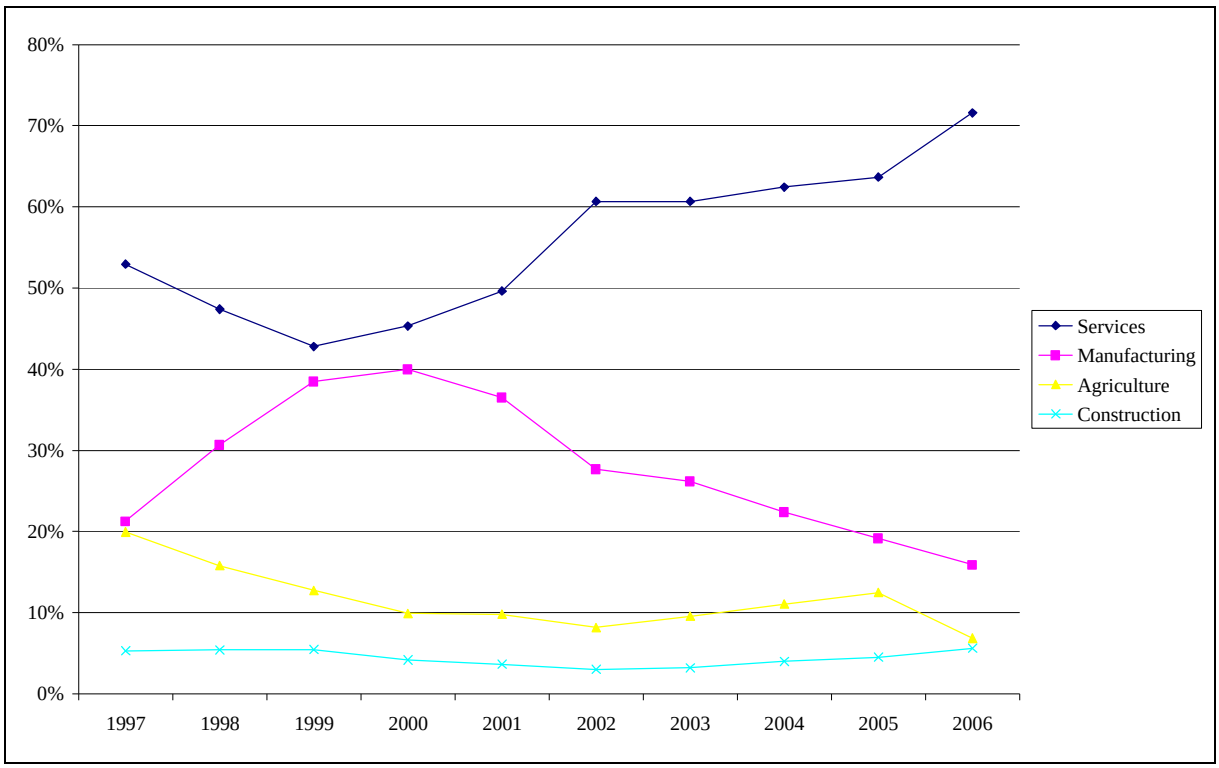

Figure 20: Uganda: Sectoral distributions of commercial banks' credit, 1997-2006 (own calculations)[39]

In 2006, only 7 percent of the total commercial bank credit volume was lend to the agricultural sector, a sector which generates one third of the GDP and feeds 80 percent of the population. Brownbridge and Harvey's (1998) statement that the economy throughout the country is underdeveloped, incomes are too low and lending opportunities are too few to provide sufficient incentive for private banks to compete for business in rural areas is still valid today.

Accordingly, in 2006 over 70 percent of the commercial banks financing volume was allocated to the services sector. Within this sector, there is an intense competition for the top tier of customers and a very high loan concentration. In June 2002, the aggregated loans to the top five borrowers for each bank represented about 40 percent of all loans in Uganda. On the other hand customers without a long established track record are likely to have difficulties in accessing financing (IMF, 2003).

The explanation of commercial banks for the cause of their excess liquidity is simple: They are liquid as they perceive a lack of bankable projects. Additionally, entrepreneur's inability to produce formal financial statements, the lack of Credit Reference Bureaus (CRBs) and legal shortcomings as problems with enforcing credit contracts and seizing collaterals make a large private sector financing by commercial banks impossible (Heenan, 2005).

[39] Source: BOU, Annual Supervision reports 2001 and 2006

To conclude: In combination with institutional factors, the current private sector absorption capacity for commercial bank credits is limited to only a few formal enterprises, mainly in the services and trade and commerce sector. From this point of view, excess bank liquidity is a result of the weak development of the private sector.

3.4.6 Alternative investment opportunities

If banks are unable to lend, we would still expect that they invest their excess liquidity into national or international alternative investment opportunities. This section analyses why this is not or only partially done by commercial banks in Uganda. Apart from loans and advances, commercial banks have the following alternative investment opportunities: (1) lending at the local interbank market, (2) investment in the domestic capital and stock market and (3) investment abroad.

(1) Lending at the local interbank market

During the period of high liquidity in Uganda the use of the interbank market was limited: Measured in terms of commercial banks' total deposits, the annual turnover in the market was only 0.1 – 0.2 from 1997 to 2000, a remarkably low level, and even lower in 2001 and 2002 (IMF, 2003). There are two reasons why the interbank market in Uganda remains thin. Firstly, as most of the banks are in a situation of excess liquidity, there is only limited demand for liquidity on the interbank market. Secondly, domestic banks, which might have needed liquidity, were limited on creditworthiness. Therefore, the interbank transactions with most of the domestic banks were only done on a collateralized basis, representing a chief impediment for the development of the interbank market (IMF, 2003).

(2) Investment in the domestic capital and stock market

The Ugandan Securities Exchange (USE) opened trading in January 1998 with the East African Development Bank bond as the first listed security. Today, ten years later the USE trades nine listed local and East African companies[40] - of which two are commercial banks - and government and corporate bonds from three companies (USE, 2008).

Figure 21 shows the substantial increase of the USE market capitalization in the last years.

[40] British American Tobacco Uganda, Bank of Baroda Uganda, Development Finance Company of Uganda Ltd, East African Breweries Limited, Jubilee Holdings Limited, Kenya Airways, New Vision Printing and Publishing Company Ltd, Stanbic Bank Uganda, Uganda Clays Limited

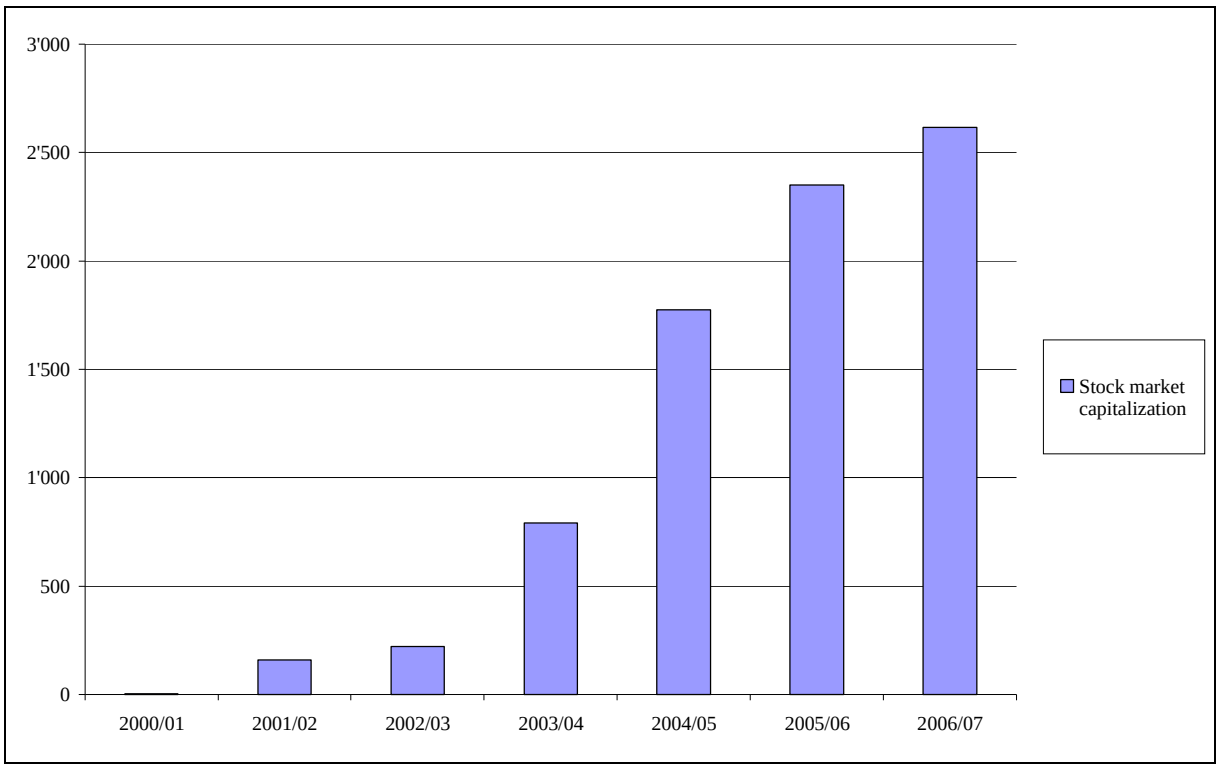

Figure 21: Uganda: Stock Market capitalization, 2000/01-2006/07 (in million US$)[41] (USE, 2008)

Nevertheless, during the time of high liquidity in Uganda (1999-2002) the stock market represented no big investment option: In 2002/03 the market capitalisation was still only US$ 220 million from three listed companies and only 437 deals were performed during the whole business year. For comparison, at the Kenyan stock exchange an average of 57 companies were listed during the period of 1996-2002 (Yartey, 2006).

In 2003, IMF (2003) described the stock exchange in Uganda as economically not viable: The USE is very costly due to a relatively sophisticated infrastructure for the small capital market with a negligible turnover and a modest pipeline of new companies, which might have the potential to become listed at the stock exchange. As well the capital market is still small: in June 2007, only US$ 480 million[42] fixed income securities were outstanding (USE, 2008).

The proposition of IMF to create a combined East African market with the Nairobi Stock Exchange in Kenya and the Dar-es-Salaam Stock Exchange in Tanzania has not been realized so far, but there are great efforts towards the harmonisation and integration of these three stock markets (USE, 2008). A regional stock exchange and capital market would lead to a larger and deeper market and offer more investment possibilities, also for commercial banks.

[41] Exchange rate UGS – US$ 1.700 as of April 30, 2008
[42] Exchange rate UGS – US$ 1.700 as of April 30, 2008

(3) Investment abroad

If the local interbank, the capital and stock market are not enough developed to absorb the excess bank liquidity, one would still assume that commercial banks invest all excess liquidity in safe interest-earning foreign assets.

Figure 22 shows Uganda's banking sector lending to foreign banks, named as asset position "Due from banks outside Uganda", is constantly high with about 15 to 20 percent of the total assets. This reflects mostly the propensity of large foreign banks to place the funds at foreign banks' institution, mainly their parent companies.

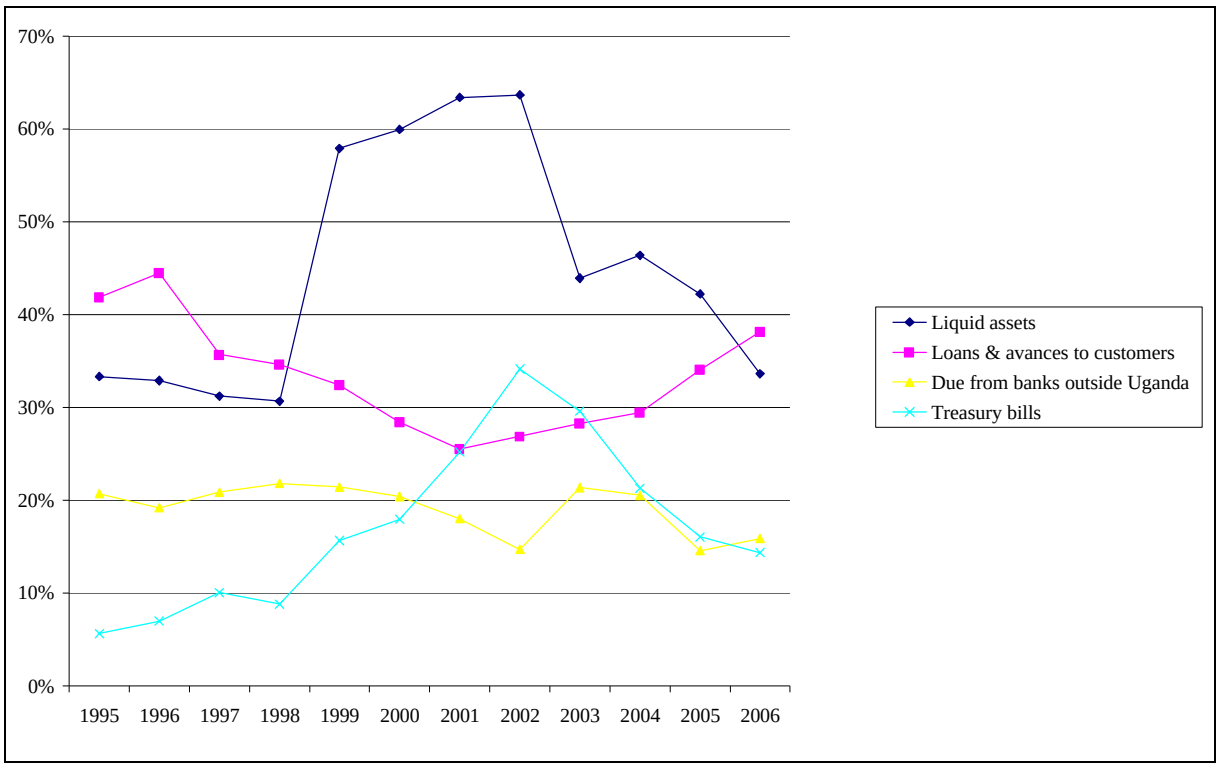

Figure 22: Uganda: Liquid assets, Loans and advances to customers, Due from banks outside Uganda and Treasury bills, 1995-2006 (in percent of total assets) (own calculations)[43]

The question is why the relative importance of investments abroad decreased during the period from 1999 until 2002, when high capital inflow produced high liquidity in Ugandan commercial banks. As the official legal barrier in Uganda which could limit investments was abandoned in 1979 with the opening of the capital account, regulatory reasons for not investing in foreign countries can be excluded.

Khemraj (2008) analysed why commercial banks in Guyana with high non-remunerated excess reserves do not invest all their excess liquidity in safe foreign assets. His findings suggest that

[43] Source: BOU, Annual Supervision reports 1999, 2002, 2005 and 2006

commercial banks in Guyana hold excess reserves because the central bank maintains an unofficial foreign currency constraint by accumulating international reserves in order to achieve its objective of price stability. On the one hand the central bank buys the foreign currency from the local market. This prevents banks from investing all excess reserves in safe foreign assets. On the other hand the central bank mops up the excess liquidity in the market by selling Treasury bills to the commercial banks. The commercial banks, therefore, are in a comfortable position: The Treasury bills offer a nearly risk free, remunerated investment possibility for the excess liquidity. Hence, banks are in no hurry to compete against each other for private sector loans by bidding down the loan rate.

Figure 22 strongly supports the hypothesis that Khemraj's (2008) findings for Guyana are as well valid for Uganda. During the time of high liquidity inflow from 1999 to 2002 the government issued large amounts of Treasury bills while the relative importance of investments abroad decreased. Nevertheless, investments abroad have always represented a valid investment option, mainly for foreign-owned commercial banks - in contrast to the domestic interbank market, which is nearly irrelevant (IMF, 2003).

In conclusion, the reasons why excess liquidity is not being lend or invested, mainly during the period 1999-2002, are multifaceted:

- The banks were recovering from a period of high credit loss rates and several bank failures. Therefore it is not surprisingly, that commercial banks applied restricted lending policies after the painful correction phase.

- Political instability and conflicts from the 1970's until the 1990's are major causes for the low development and depth of the financial system in Uganda. Still today, civil disturbances, mainly in the North of Uganda, have an effect on the private sector development in the area and thereby on the lending possibilities of commercial banks.

- The commercial bank sector in Uganda itself behaves in oligopolistic manner and banks are unwilling to grant credits if the borrower is unable to pay an interest rate of around 20 percent. If the interest rate can not be paid the banks prefer to hold excess liquidity.

- Uganda's commercial banks earned more and more from Treasury bills as well as charges and fees. This reduces the pressure to compete for private sector investments.

- The private sector in Uganda is another limiting factor: The lack of bankable projects, entrepreneurs' inability to produce formal financial statements, the lack of credit bureaus and legal shortcomings limit the private sector financing.

- Alternative investment opportunities to absorb the excess liquidity are rare in Uganda. The domestic interbank, capital and stock market were hardly developed at this time. Only investments abroad represent a viable option for mainly the foreign-owned commercial banks, as long as the central bank is not intervening massively in the foreign exchange market.

3.5 What are common responses to address excess liquidity?

The main target of Uganda's current monetary policy is to ensure price stability and overall macroeconomic stability.[44/45] This represents a challenging task for the Bank of Uganda due to large and unpredictable donor aid inflow, population's high propensity to hold and transact in cash as well as uncertainties of government injections of funds (IMF, 2003). To avoid raising consumer price inflation and macroeconomic instability, resulting from a situation of excess bank liquidity, measures have to be taken to address the imbalance.

Until 1993, the Bank of Uganda has addressed excess liquidity by applying direct monetary policies, such as controls on interest rates and credit allocation by the government. As described by Katarikawe and Musinguzi (2001), direct monetary policies led to misallocations of resources and caused inefficiencies in the financial intermediation with knock-on effects on savings mobilization, investments and economic growth. Therefore, Uganda shifted from direct to indirect monetary policy control as part of the financial sector liberalisation process undertaken under the SAPs. When using indirect instruments, the central bank is dealing with the market as a whole, not with each individual institution (Gray, Talbot, 2007).

In Uganda, indirect monetary policies base mainly on Open Market Operations (OMO), reserve requirements and discount facilities (Katarikawe, Musinguzi, 2001). Discount facilities, namely rediscount and short-term lending facilities from the Bank of Uganda are seldom used in Uganda and it is furthermore an instrument to close commercial banks short-term liquidity gaps. Therefore the following sections will concentrate on the efficiency of the indirect monetary instruments open market operations and reserve requirements. Additionally alternative measures will be disclosed.

3.5.1 Usage of open market operations

The major instrument to remove excess bank liquidity is the usage of open market operations. With OMO the central bank reduces the money in circulation mainly by selling securities or foreign exchange. The challenge of this policy in developing countries is described by IMF for

[44] Source: BOU, Monthly Economic Review, April 2008
[45] Since 2002, the aim of the central bank is to achieve annual consumer price inflation below 5 percent (Saxegaard, 2006)

the case of Tanzania (Lister et al., 2006), which is equally applicable to the situation in Uganda.

Figure 23 shows the trilemma central bank authorities are facing in managing high donor inflow.

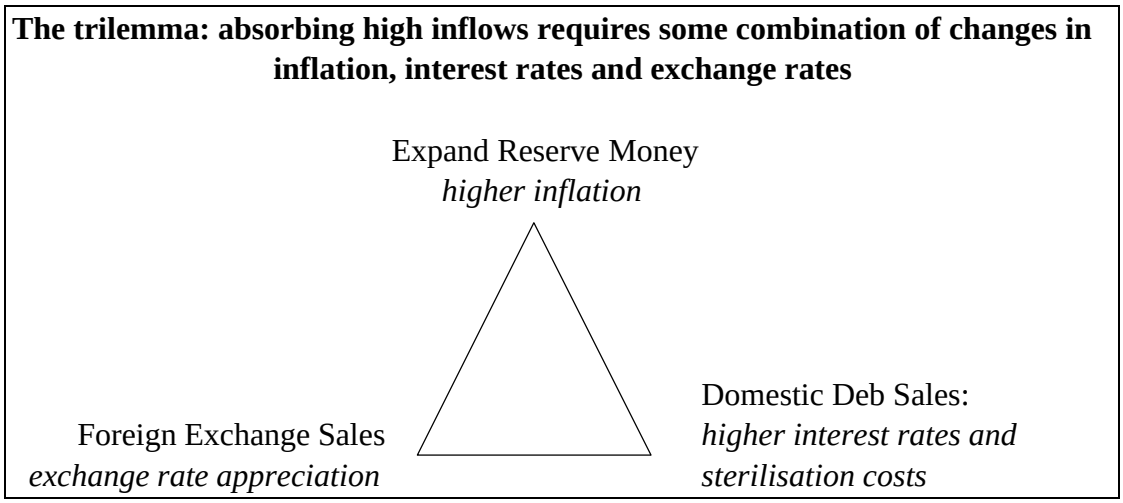

Figure 23: Trilemma open market operation: Inflation, interest rates and exchange rates (Lister et al., 2006)

On the one hand aid inflow is highly needed in Uganda, as it allows poverty reduction measures and infrastructure investments. On the other hand, the rise in liquidity threatens the central bank's ability to meet its reserve money target. The sterilisation of the excess liquidity can be done by selling foreign exchange. This results in an appreciation of the exchange rate and reduces Uganda's export competitiveness. If the reduction of the excess liquidity is done by raising the domestic debt, interest rates will rise and discourage or crowding out domestic private sector lending as well as incurring debt service costs for the government. Thus the mix between selling securities and foreign exchange has consequences on prices, exchange rates and/or interest rates, and ultimately on growth and macroeconomic stability. In this sense, a successful monetary response on excess liquidity is one that avoids a jump in interest rates, an overshooting of the exchange rate or a surge in inflation (Lister et al., 2006).

In Uganda, the sterilization of excess liquidity is effected through a combination of sales of Treasury bonds, Treasury bills and foreign exchange. However, the Bank of Uganda has judged that problems of adverse terms of trades (via exchange rate effects) are more serious than the effect of higher interest rates on the private sector. This means, the Bank of Uganda has chosen a strategy which relies to a relatively high degree on sterilization through the issuance of Treasury bills, relative to selling foreign exchange (Lister et al., 2006).

Figure 24 shows the development of issuance of Treasury bills and development of loans and advances to customers over the last decade.

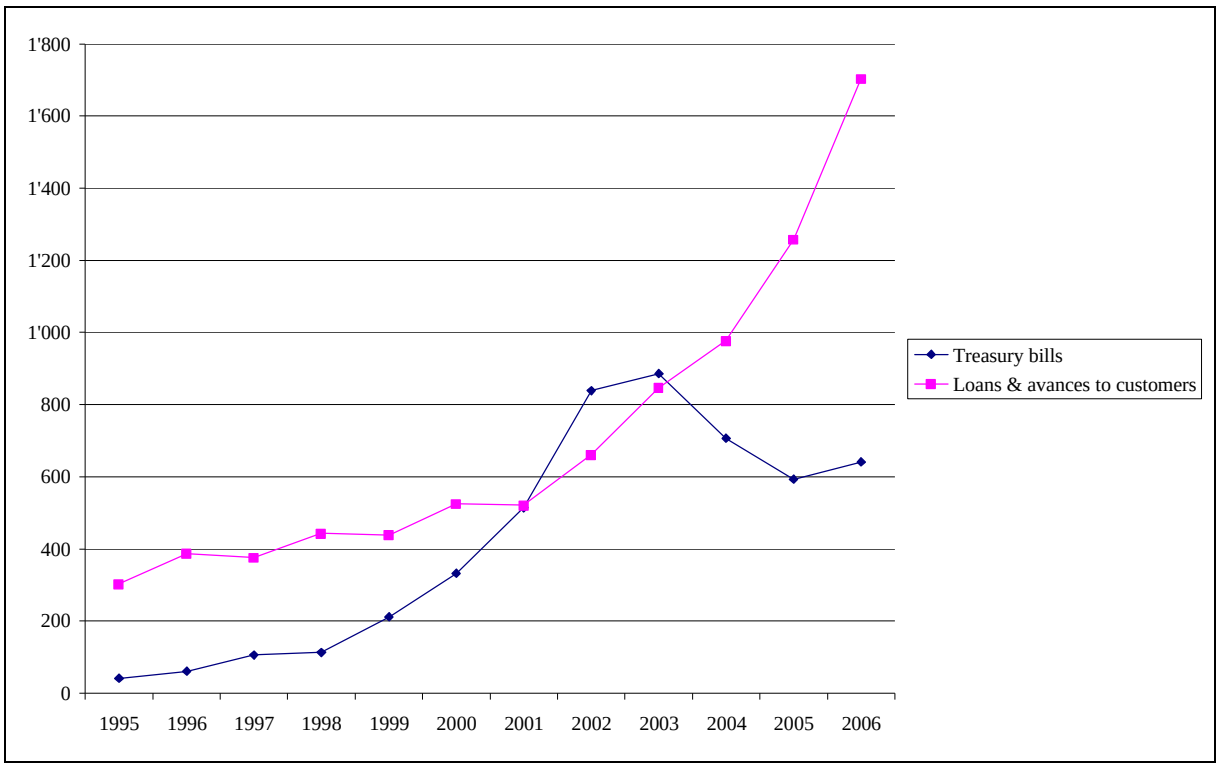

Figure 24: Uganda: Loans & advances to customer and Treasury bills, 1995-2006 (in billion UGS) (own calculations)[46]

From 1995 to 2002 the commercial bank lending has more than doubled, but commercial banks holdings in government securities have increased twenty times and overtook the lending to the private sector in 2002 and 2003 momentarily. According to Lister et al. (2006) commercial banks lending to the private sector might have been even higher if there had been less sterilisation activity. And furthermore, Lister et al. believes that the export volume would have continued to grow even in the absence of the sterilization policy.

The positive effects of the OMO conducted by the Bank of Uganda in the last 15 years are obvious: Uganda has succeeded in stabilizing the inflation at single-digit level (see Figure 13), has reached, in combination with a strong macroeconomic management, an economic growth rate of over 6 percent annually and a significant reduction of the headcount poverty (Lister et al., 2006).

Allen (2005) and Nkusu (2004) analysed whether the large aid inflow between 2000 and 2004 led to a Dutch disease.[47] According to both studies, it is immediately apparent that there was

[46] Source: BOU, Annual Supervision reports 1999, 2002, 2005 and 2006

no Dutch disease effect on exports via real appreciation of the exchange rate in Uganda. In fact, there was a depreciation of the exchange rate of 6.3 percent from 2000 to 2004 supporting economic growth of the export industry. The authors conclude that Uganda has dealt well with the large aid inflow with respect to the threat of the adverse effects of a Dutch disease.

However, there are several critical voices concerning Uganda's monetary policy in the last ten years. A major concern is the costs of the increased sterilisation activity. Figure 25 shows the raising government expenditure for interests, mainly domestic ones.

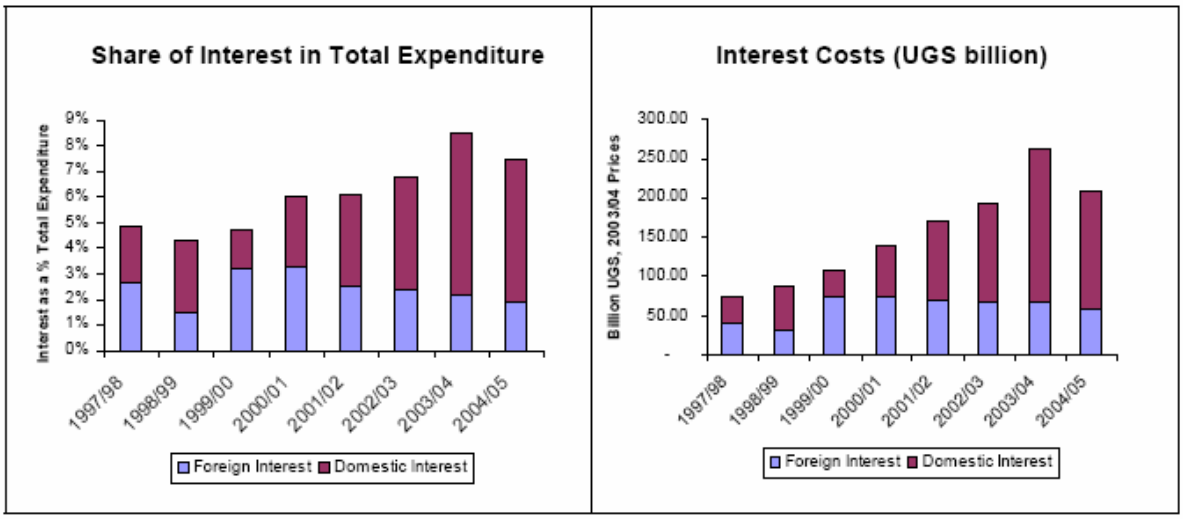

Figure 25: Uganda: Share of interest in total expenditure and interest cost, 1997/98-2004/05 (in billion UGS) (Lister et al., 2006)

In 2004/05 nearly 75 percent of all interest payments were for domestic debt and the payment for domestic interests was greater than the expenditures on the total health sector (Lister et al., 2006). Alone in 2004/05 the interest costs for the sterilization activities were above US$ 100 million.

Christensen (2005) found out, that the domestic interest payments present a significant burden to the budget, despite the much smaller domestic than foreign indebtedness. Additionally, the issuance of large amounts of Treasury bills can crowd out private sector credit with adverse consequences for the private investment. The result of Christensen's (2005) studies support this thesis: for all analysed SSA countries an expansion of the domestic debt of 1 percent

[47] The Dutch disease is related to the idea, that increased donor inflow (or FDI inflow or raising revenues from natural resources) will deindustrialise the economy by raising the exchange rate, which makes the manufacturing less competitive. According to the theory, aid inflow could have an adverse effect on the economy and might cause more pain than gain (Nkusu, 2004)

relative to the board money causes a decline of the ratio of private sector lending to board money by 0.15 percent.

Saxegaard (2006) has discovered that OMO in Uganda are not very effective. A contractionary monetary policy will simply cause banks to reduce their unwanted reserves[48], while efforts to stimulate the economy by an expansionary monetary policy will be largely ineffective. Hence, one of Saxegaard's (2006) proposition is to put greater emphasis on countercyclical fiscal policy to stabilize the economy, well knowing, that fiscal policy is not well suited for this purpose, because of decision and implementation lags as well as the obvious political constraints.

Khemraj's (2007a, 2007b) findings also question the relevance of the indirect monetary policy in economies with an oligopolistic banking sector and underdeveloped money and capital markets, as it is the case in Uganda. The central banks are selling significant quantities of Treasury bills to mop up the excess liquidity, which is the result of the oligopoly pricing of the interest rates. To remember, banks prefer to hold excess liquidity if the borrower is unable to pay the demanded interest rate (see Figure 16). The policy of mopping up excess liquidity means that commercial banks have an alternative channel of investment instead of providing business loans.

Khemraj's conclusion (2007b) is meaningful: it is a contradiction that the banking sectors in poor countries, in which large percentage of farmers and small businesses are excluded from credit, can hold assets that are unproductive. His proposition is to use more direct tools of monetary policy. However, these tools might conflict with the IMF stabilisation programs.

Hauner and Peiris (2005) argue that banks reliance on government securities, as a steady stream of revenues, appears to have potentially crowded out the private sector, although this effect may have dissipated recently (see Figure 24). The reduction in net Treasury bill issuance may, according to the two authors, reduce the dependence of banks upon government securities as source of low-risk, high-yielding assets. This could lead to an increase of the competition between banks as they would have to identify new lending opportunities and expand their customer base in order to generate income.

3.5.2 Increase of statutory reserve requirements

The bank reserve requirement or statutory liquidity ratio is a bank regulation that defines the minimum reserve each bank must hold to demand deposits, time and saving deposits and

[48] Of course, if the central bank is able to remove all involuntary excess liquidity, the contractionary monetary policy could be successful. But according to Gray and Talbot (2006) it is commonplace for central banks not to drain the entire surplus. In part this reflects difficulties in forecasting liquidity accurately; but in many cases it reflects a reluctance to pay the cost of draining the excess.

foreign currency deposits (Saxegaard, 2006). Historically, central banks regarded reserve requirements more as a prudential instrument in order to ensure that banks kept sufficient liquidity to meet withdrawal demands from customers (Katarikawe, Musinguzi, 2001). Today, central banks in SSA countries often use reserve requirements as a tool in monetary policy.

Figure 26 shows a substantial increase in the average reserve requirements in SSA countries from about 4 percent in 1990 to over 11 percent in 2004.

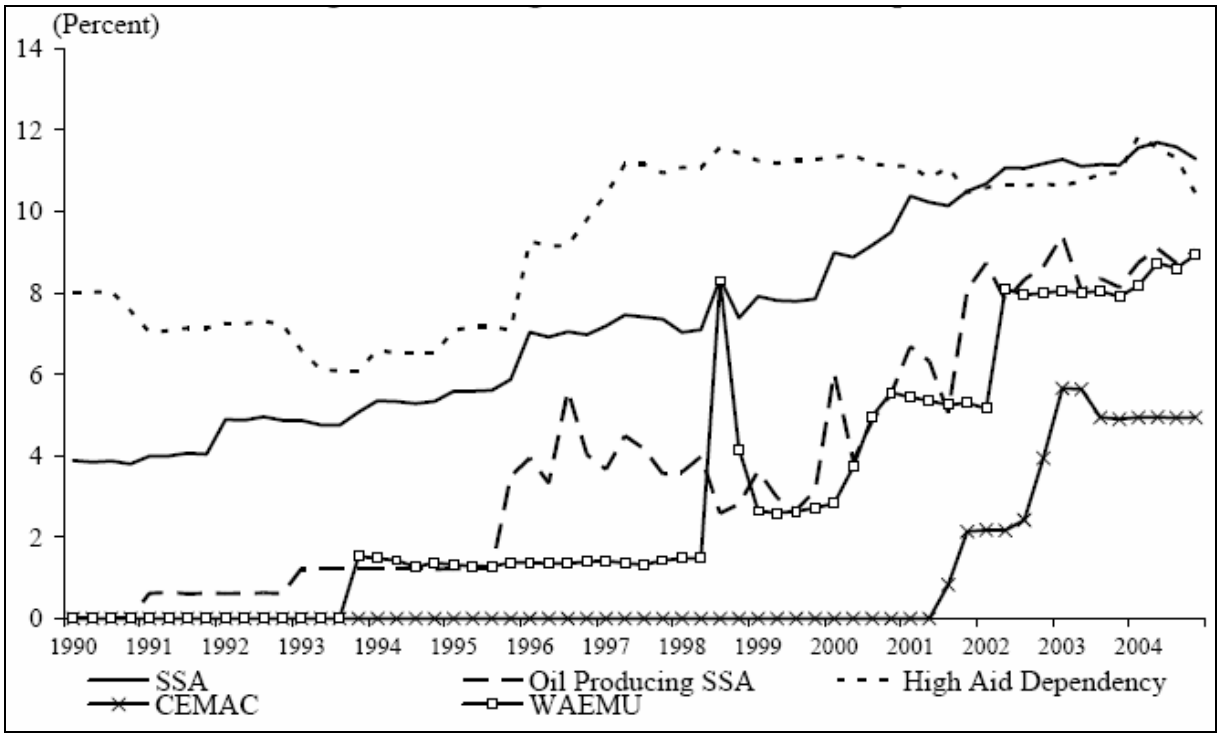

Figure 26: SSA countries: Average effective reserve requirement, 1990-2004 (in percent) (Saxegaard, 2006)[49]

The increase of the reserve requirements is in sharp contrast to the tendency to reduce reserve requirements in most of the member countries of the OECD (Saxegaard, 2006). According to Saxegaard (2006), the use of rule-base instruments, such as reserve requirements, is a result of the increased focus of SSA countries on consumer price stability. The increased inflow from aid and oil revenue has forced central banks to increase reserve requirements in order to combat inflationary pressure. Furthermore, reserve requirements were introduced because of a lack of open market policy instruments or because of their failure to achieve consumer price stability by itself.

In Uganda, the reserve requirements ratio is currently at 9.5 percent and therewith slightly below the SSA average. The reserve requirements were already introduced in 1977 and

[49] CEMAC: Central African Economic and Monetary Community
WAEMU: West African Economic and Monetary Union

remained fairly stable at a ratio between 7 and 10 percent over the last thirty years (Katarikawe, Musinguzi, 2001).

Compared to open market operations, reserve requirements are an easy and low-cost instrument to reduce excess liquidity. The establishment of a well functioning financial market or the issuance of Treasury bills are not necessary. The costs for the central bank are negligible, as in most countries reserve requirements are non-remunerated.[50] This raises the question if reserve requirements therefore are the optimal response to address excess liquidity. The answer is no. The deposit of required reserves with the central bank imposes a significant burden on the balance sheet of commercial banks, particularly in countries where the reserve requirements are high. For example in 2004, the ratio of required statutory reserves to deposit was above 50 percent in Liberia and Zimbabwe (Saxegaard, 2006) – without any remuneration well understood. This means that commercial banks in these two countries do not earn any return on more than 50 percent of their deposit base, which can be a significant threat for the viability of the commercial bank sector.

According to Katarikawe and Musinguzi (2001), the Ugandan monetary authorities are aware of the potential distortional effects of reserve requirements on the banking sector. Nevertheless, the reason why Uganda still uses reserve requirements on a moderate level is because of the inherent weakness in the financial sector and because the market instruments are not yet fully developed.

3.5.3 Establishment of alternative instruments

Other responses to address excess liquidity are evaluated by Heenan (2005). On the one hand, quantitative credit controls can be implemented by monetary authority, limiting excess liquidity from going to the credit market and thereby reducing the risk of consumer price inflation. However, at the same time this approach impedes the development of an efficient banking sector. Therefore it is more appropriate to strengthen prudential controls in order to ensure that banks only lend to customers with a high degree of creditworthiness.

On the other hand, exchange controls can limit the inflow of liquidity from abroad in form of aid or FDI. But this strategy simultaneously limits investments in poverty reduction measures or infrastructure projects and is therefore no appropriate solution. The idea, that commercial banks' excess liquidity could successfully substitute the foreign donor aid inflow by providing financial resources to the private sector is misleading. In 2006, the total official development

[50] Only Cameroon, Central African Republic, Chad, Comoros, Republic of Congo, Equatorial Guinea, Gabon and Nigeria remunerate reserve requirements at small interest rates (0.55 percent - 4.00 percent) (Saxegaard, 2006)

assistance and official aid accounted for US$ 1.6 billion[51], while in 2004 the entire single-borrower capacity of the banking system totalled only about US$ 34 million and the single largest borrowing capacity of any one bank was only about US$ 7 million (Hauner, Peiris, 2005). Thus, it is unrealistic that substantial initiatives, such as large infrastructure projects, can be financed through the local commercial bank system.

Saxegaard (2006) analyses the question why banks, unable to lend their excess liquidity, do not reduce the size of their deposit base. The idea, that banks stop taking deposit from the public until the whole excess liquidity is properly invested might be on first sight economically advisable, but in reality not very suitable. Firstly, if the depositor is the government, it may be difficult for banks to refuse accepting the deposits. And secondly, most of the governments in SSA are concerned about the promotion of financial deepening in the economy and may therefore use moral suasion to make commercial banks accept deposits even if this leads to excess liquidity.

In conclusion, all described possibilities to remove or limit the build up of excess liquidity, as sterilization, reserve requirements and credit, deposit and foreign exchange controls entail substantial costs or drawbacks. The first-best response is, as Heenan (2005) points out, to address the underlying causes of excess liquidity, by improving the efficiency of the financial system. This could be reached by increasing competition in the financial sector, enhancing the absorption capacity of Uganda's private sector and by addressing institutional and legal impediments.

However, such reforms have a significant implementation time lag. Hence, in the meantime, it seems prudent to use methods as sterilization, reserve requirements and prudential controls relating to the loan quality to limit excess liquidity in order to ensure that the risk of increased inflation does not materialize (Saxegaard, 2006).

3.6 Conclusion

Even if excess commercial bank liquidity is not a new or unusual phenomenon in Uganda, the period between 1999 and 2002 outreached the previous dimensions. In 2002, two-third of commercial banks' assets were held in liquid assets. The main cause of the surplus of liquidity in Uganda's banking system was the high inflow of donor aid. Furthermore, the modality of aid switched from mainly BOP support to on-budget project aid, resulting in an increase of liquidity within the country.

[51] Source: WB, Uganda Data Profile, Word Development Indicators database, available on http://devdata.worldbank.org/external/CPProfile.asp?CCODE=UGA&PTYPE= CP (Retrieved on 2008-05-05)

The reasons why Uganda's commercial banks were unable or unwilling to lend or invest the excess liquidity are multifaceted. Some authors argue that economical and political instability, high credit loss rates and the subsequent bank failures have prevented commercial banks to change their lending behaviour, which was the basis to survive in the past. Other authors see the uncompetitive, namely oligopoly nature of the banking market as reason of excess liquidity. Banks are unwilling to lend, if a borrower is unable to pay a minimum interest rate around 20 percent. Commercial banks claim that the restricted lending and investment opportunities, due to the limited absorption capacity of the private sector and the low development of the interbank, capital and stock market in Uganda, force banks to hold excess reserves.

The situation of excess bank liquidity bears the risk of consumer price inflation, if the banks suddenly decide to increase their lending and if the economy is unable to increase the output at an equal ratio. To avoid this risk the central bank can remove the excess liquidity from the system by sterilization, reserve and prudential requirements. But these are only corrective measures without solving the fundamental problem of excess liquidity.

The only way to fundamentally solve the problem of excess liquidity is to address the underlying causes which will be the focus of section 4.

4 Fundamental underlying causes of excess liquidity and key responses

Addressing the underlying causes of excess liquidity is a major task in a countries successful development. Interactions between access to credit, economic development and poverty reduction are well analysed and understood: inadequate access to credit by the private sector could impede poverty reduction since small firms and poor population are more likely to be subject to credit rationing (Beck, Hesse, 2006).

To achieve the desired economic growth and poverty reduction, Uganda needs a comprehensive strategy to promote private sector credit (Abuka, Egesa, 2007a). Therefore, the following section analyses the strategies which target the promotion of private sector credit, and, at the same time, reduces the excess bank liquidity. The key levers are: an efficiency increase of the financial sector, an improvement of the institutional and legal framework and an enhancement of the private sector absorption capacity.

4.1 Efficiency increase of the financial sector

Several firm surveys[52] have disclosed that "access to financing" and "cost of financing" are beside "tax rate" the most severe constraints in Uganda's business environment. Furthermore, bank products are often not well adapted to meet the financing needs of the economic operators (Sacerdoti, 2005).

To reinforce the crucial link between the financial and the private sector, the focus has to be on improvement of access to financial services, reduction of cost of finance and increase in efficiency of commercial banks and design of customer specific products. By addressing access, efficiency and product variability the financial sector improves the conditions for an increase of the private sector support and – in the long run – reduces its excess liquidity.

4.1.1 Improvement of access to financial services

Throughout Africa, Uganda is one of the most severely under-banked countries (Emaasit, 2004). The Finscope study (The Steadman Group, 2007) discloses that only a minority of the Ugandans (38 percent) have access to financial institutions, leaving the majority of the population "unserved" (Figure 27).

[52] E.g. Poverty Eradication Action Plan (Lister et al., 2006) or World Bank study (Reinikka, Svensson, 2001)

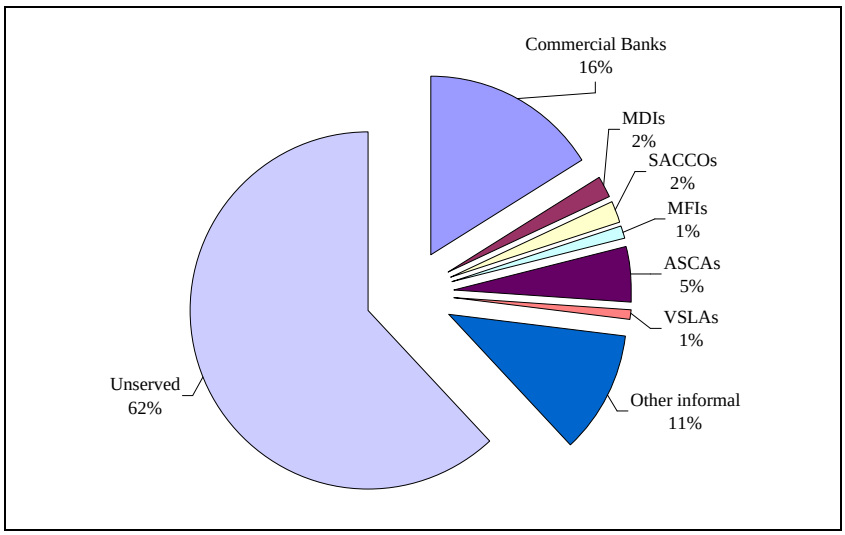

Figure 27: Uganda: Access to different types of financial institutions of Ugandan population, 2007 (in percent) (Finscope study; The Steadman Group, 2007)[53]

The assumption, that Uganda's population has no need for financial services, as most of the people live in poverty, is misleading. It is a myth that Ugandans do not have a saving culture: over 70 percent of the people are currently saving and even poor people are willing to save except that they do not know where to save (Oketch, 2007b). Accordingly, over 70 percent of the savers deposit the money in a secret hidden place or with friends, neighbours or relatives (The Steadman Group, 2007).

While most of the savings are accumulated to meet the everyday household needs (82 percent), the second most important reason is already saving for unforeseen emergencies such as sickness and death (70 percent).[54] And people borrow for the same reasons as they save: to meet households' needs (61 percent) and for emergencies (32 percent) (The Steadman Group, 2007). The high propensity to save for and to borrow in emergency situations shows the high need for insurances to guard against any likely events or uncertainties. However, only 6 percent of the adult population in Uganda currently has any insurance cover (The Steadman Group, 2007). This leads to a further problem in terms of access: Nearly half of the population are not knowledgeable about how insurances work.

[53] MDI: Microfinance Deposit-taking Institution
SACCO: Savings and Credit Cooperatives
MFI: Microfinance Institutions
ASCA: Accumulating Savings and Credit Association
VSLA: Village Savings and Loan Association
ROSCA: Rotating Savings and Credit Association

[54] To compare: the third most important saving reason "education for yourself and children" is with 35 percent only half as important as savings for unforeseen emergencies with 70 percent (The Steadman Group, 2007)

In order to find out methods to reduce commercial banks excess liquidity in the long run, the lending behaviour of the Ugandan population and the sources of credit should be analysed more closely. Figure 28 discloses the relevance of the different sources of credit in relation to the total number of borrowers in Uganda.

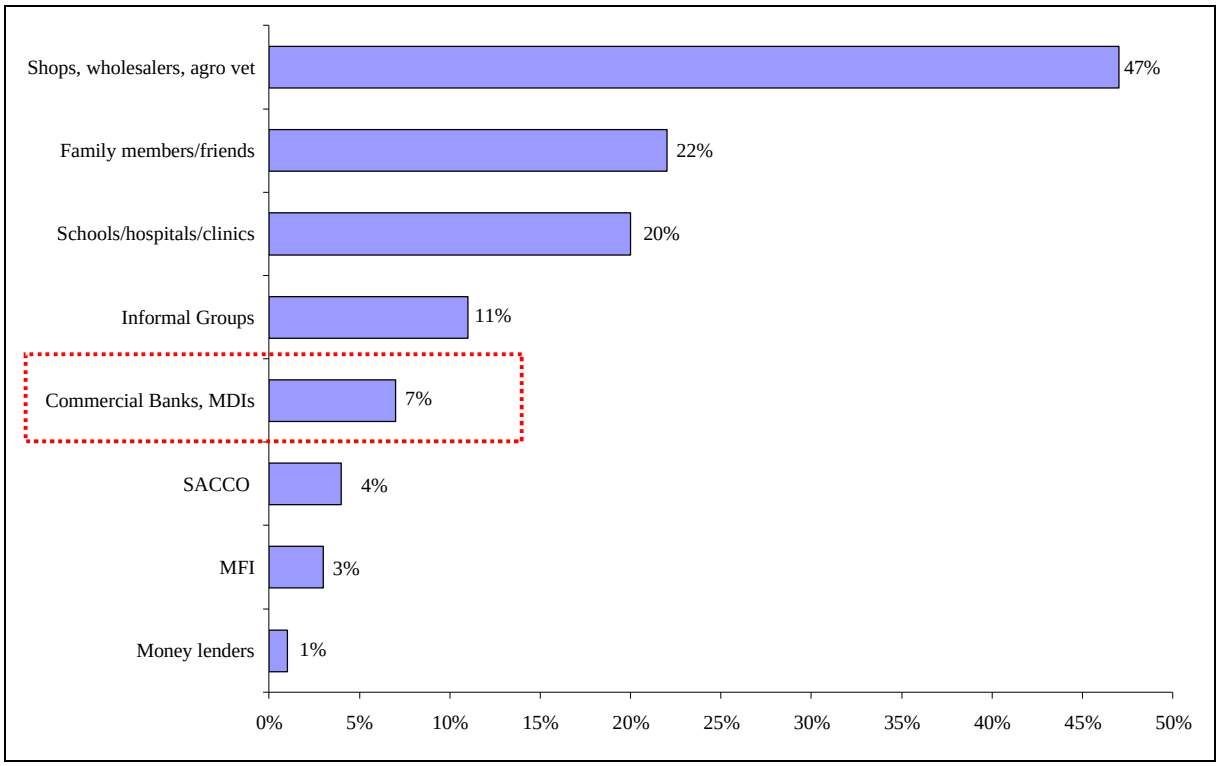

Figure 28: Uganda: Sources of credit, 2007 (in percent of total number of borrowers) (Finscope study; The Steadman Group, 2007)

Only 7 percent of all borrowers dispose over a credit from a formal financial institution. The reason for this very low value is – like in other parts of Africa – Uganda's highly dualistic financial market.[55] According to Mpuga (2004) the causes of Uganda's financial dualism are rooted in the long period of financial sector controls. In the 1970s and 1980s, Uganda's government imposed fixed interest rates, credit ceilings and some major banks were owned and operated by the government. This restricted the deepening of the formal bank sector. Nevertheless, the development of the informal financial institutions may be seen as a healthy reaction to the limited credit opportunities during the periods of financial sector controls. But even nowadays, years after the financial liberalisation, the reliance on informal sources is still omnipresent, and families, rural smallholder farmers and traders rely on informal financial institutions as their major source of credit.

[55] Generally defined, economic dualism refers to the coexistence of two sectors which are basically asymmetrical, and thus dualistic, in terms of both product and organisational characteristics. In the context of the financial sector, dualism exists where both the formal and informal financial providers exist side-by-side (Mpuga, 2004)

Therefore it is not surprising, that the informal sector with its several thousands of institutions serves more clients than the formal sector (Figure 29).

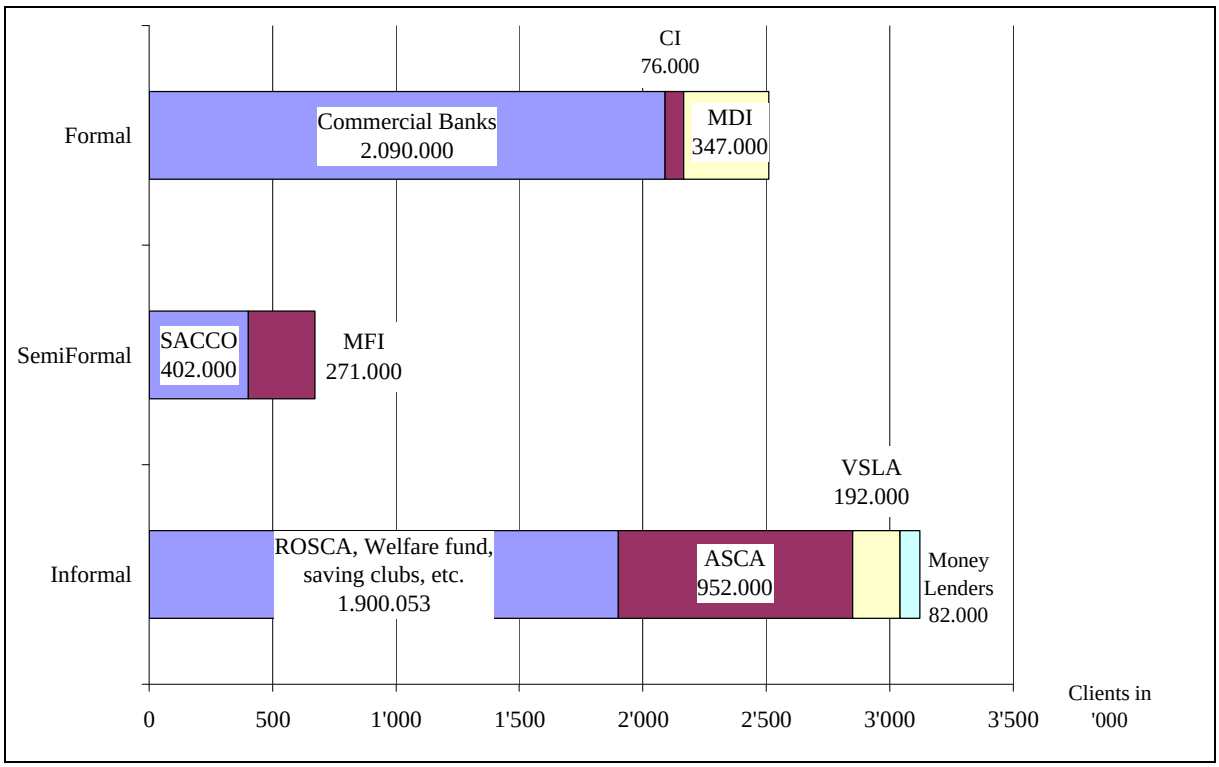

Figure 29: Uganda: Individuals with account in different types of financial institutions (Finscope study; The Steadman Group, 2007)[56]

Furthermore, the semi-formal Microfinance Institutions are one of the fastest growing industries in Uganda (Nuwagaba, 2007) and a key instrument in Uganda's poverty alleviation.[57]

Nevertheless, in order to achieve a future reduction of excess commercial bank liquidity, the influence of the semi-formal and informal sector is of minor importance. Despite the large number, Savings and Credit Cooperatives (SACCOs) and Microfinance Institutions (MFIs) account only for 1 percent of the financial markets assets, while the informal institutions account for about 7 percent (IMF, 2003).

[56] MDI: Microfinance Deposit-Taking Institution
SACCO: Savings and Credit Cooperatives
MFI: Microfinance Institutions
ASCA: Accumulating Savings and Credit Association
VSLA: Village Savings and Loan Association
ROSCA: Rotating Savings and Credit Association

[57] The government Poverty Eradication Action Plan (PEAP) has put emphasis on the role of microfinance as an instrument for poverty alleviation, especially in the light of the fact that a high percentage of the population has no access to financial services (IMF, 2003)

Therefore, the access to the 16 commercial banks in Uganda, holding 82 percent of the financial market assets, has to be improved. A measure to express the accessibility of the commercial banks is the number of inhabitants per bank branch. The ratio of 34.000 per branch in 1972 worsened to 80.000 in 1980 and 164.000 in 1999 (Mpuga, 2004). Uganda's extraordinary population growth is only a part of the explanation: at the beginning of the commercial banking sector reform in 1992, the number of branches was 237 (Byaruhanga, 2006), while six years later, 1998, the number of branches was reduced by half to only 118.

The closure of the Greenland Bank and Cooperative Bank, the merger of the TransAfrica Bank with the Orient Bank and the takeover of the Trust Bank were largely responsible for the reduction of the branch network (Byaruhanga, 2006). Today, Uganda again counts over 200 commercial bank branches, resulting in a further low bank branch coverage ratio of 1:140.000.[58/59] About 80 percent of the newly opened branches in the last 10 years were set up in Kampala. Outside of Kampala, there are only 21 out of 56 districts with at least two commercial banks and 9 districts with at least 3 different banks (WB, 2007b). This leaves most of the rural areas with limited access to formal banking services. In traditional thinking, the reason for the absence of the formal banking in the rural area has always been the high cost of operations in these areas.

4.1.2 Reduction of cost of finance and increase in efficiency of commercial banks

In addition to the limited physical access to commercial bank branches, the cost of finance represents a major hurdle for the private sector. Even if interest rates of MFIs or informal sources are still higher, the interest rate spreads of commercial banks in Uganda are much higher than in the average Sub-Saharan African country (see as well Table 1).

Interest rate spreads can be seen as good indicator of the efficiency and the productivity of a financial market. In the neo-liberal economic view, greater competition, efficiency and productivity in the bank system leads to financial stability, product innovation, wider and cheaper access to financial services and finally a positive effect on economic growth. According to Abuka and Egesa (2007b), Uganda's financial sector liberalisation was therefore carried out with the objective of boosting efficiency and productivity of banks. The main mechanism for efficiency improvement was to allow competition by limiting state interventions and thus enhancing the role of the market.

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[58] Own calculations. Sources:
Branch figure 2006: BOU, Annual Supervision Report 2006;
Population figure 2006: WB, Uganda Data Profile, Word Development Indicators database, available on http://devdata.worldbank.org/external/CPProfile.asp?CCODE=UGA&PTYPE= CP (Retrieved on 2008-05-05)

[59] For comparison: Kenya: 65.000 people per branch in 2005 (WB, 2007b);
EU: 2.200 people per branch in 2005 (Deutscher Bundestag, 2006)

Nevertheless, summarising the findings of Abuka and Egesa (2007b) the results of the financial liberalisation programs in the world have been mixed: On the one hand in India, Turkey and Taiwan the liberalisation led to higher efficiency of the banking sector. On the other hand in Norway, Spain and in the US the productivity of the banking sector declined after the liberalisation.

Abuka and Egesa (2007b) analysed the change of productivity among Ugandan banks after the financial liberalisation for the period between 1994 and 2004. The results show that at industry level there was modest decline in the productivity. However, at an individual bank level, eight banks registered slight improvements while three banks registered more important declines in productivity.

Beck and Hesse (2006) examined the high interest rate spreads in Uganda from 1999 to 2005 and concluded that the low competitiveness of the banking sector bases mainly on the single bank characteristics as bank size, operating costs or composition of the loan portfolio. The influence of privatization, foreign bank entry or macroeconomic variables can explain only little of the variation in bank spreads.

As the two studies conclude that efficiency gains or losses mainly base on the individual characteristic of the bank, an analysis of an average Ugandan commercial bank could shed light how to improve productivity and thereby reduce costs of finance.

Following criteria have been used to select an average Ugandan commercial bank: total assets, return on equity and business model.[60] With total assets of US$ 141 million, a Return on Equity (ROE) of 29 percent, around 560.000 depositors and 27 rural and urban branches[61] the Centenary Rural Development Bank Limited meets the criteria of the average Ugandan retail bank perfectly.

The Centenary Bank's main objectives include to finance, promote and enhance the business of rural farming, small scale industries, fishing, processing of agricultural produce and to administer funds for loans or assistance to rural farmers to promote modern farming and marketing methods (Emaasit, 2004). The Centenary Bank is the only commercial bank in Uganda which uses microfinance lending methodologies to serve economically disadvantaged people (WB, 2007b) and proved that, commercial orientation and commitment to improving the welfare of the poor population, are not necessarily contradictory but complementary

[60] Average size of a Ugandan bank (in assets): US$ 155 million
Average Return on Equity (ROE): 29,6 percent
Business model criteria: Retail bank with rural and urban customer base and branches
Selection based on annual report analysis and personal interviews with representatives of Ugandan commercial banks

[61] Source of figures: Centenary Bank Annual report 2006

(Emaasit, 2004). The shareholders of the Centenary Bank are: Uganda Catholic Secretariat and nineteen catholic dioceses with a total of 61 percent, while 39 percent are held by two foreign companies, Solidarité Internationale pour le Développement et l'Investissement (SIDI), a French investment company, and Stiching Hivos-Triodos Fonds, an investment fund[62] managed by the Triodos Banking Group in the Netherlands.[63]

In the following the components of the profit and loss statement 2006 of the Centenary Bank are compared to a Swiss retail bank, disposing with US$ 135 million nearly of the same amount of total assets. The details of the analysis are attached as ANNEX 5. Of course, the Swiss banking market, one of the most advanced in the whole world, and the high living conditions in Switzerland (HDI[64] of 0,955) are completely different to Uganda with a very low developed financial market and an HDI of 0,505.[65] Thus, a comparison of these two banks of similar size, operating in very different economic areas allows disclosing the reasons for high cost of finance for customers in Uganda.

The Ugandan commercial bank customers have to pay about five times more for a loan, while they receive around the same interest rate for their deposits as the Swiss customers. The fees and commissions for bank services in Uganda are over 20 times higher than in Switzerland. This leads to an operating income in percent of total assets, which is over 17 percent points higher than in Switzerland.

The reasons for the very high costs of finance for customers in Uganda can be seen at different positions in the analysis. Firstly, personnel expenses are 13 times higher than in the Swiss regional bank. This is not surprising as banking in Uganda is very labour intensive: The Centenary Bank employs 956 employees, while the Swiss bank manages the same amount of assets with 8 employees.[66] Secondly, the other operating expenses are 9 times higher, mainly due to 27 branches countrywide in comparison to only 1 branch of the Swiss regional bank. Many of Centenary Bank's 27 branches are in rural areas with limited infrastructure which increases the costs of operations significantly.

The common view on banking in SSA countries is that the high lending risk leads to high provisions on credits. But contrary to the common view, Centenary Bank's provisions/losses on credits are with 0.72 percent of total assets not significantly higher than in the Swiss regional bank with 0.18 percent of total assets.

[62] Further similar investment funds: Profund, Société coopérative oecuménique de developpement, Dexia Mirco Credit Fund and Internationale Micro Investitionen Aktiengesellschaft (Servet, 2007b)
[63] Source of figures: Centenary Bank Annual report 2006
[64] Source: UNDP, Human Development Reports, http://hdr.undp.org/en/statistics/ (Retrieved on 2008-06-01)
[65] Source: UNDP, Human Development Reports, http://hdr.undp.org/en/statistics/ (Retrieved on 2008-06-01)
[66] Source of figures: Centenary Bank: Annual Report 2006; Swiss regional bank (Sparkasse Männedorf): Annual Report 2006

Finally, the after tax return on equity is significantly higher in the Ugandan bank than in the Swiss (29 percent to 4.7 percent). But not only in comparison with Swiss banks, but also comparative to other SSA countries profit margins in Uganda are much higher. Subsidiaries of foreign-owned banks in Uganda show significantly higher return on assets than subsidiaries of the same bank in other SSA countries (WB, 2007a).

This supports the thesis that Uganda's commercial banking market, with four foreign-owned banks dominating the sector, lacks competition. Accordingly, attracted by the favourable banking market conditions, three foreign-owned banks[67] opened branches in Uganda, and several others are planning to enter the market. Whether this foreign bank entry is a help or a hindrance for the financial sector development in Uganda respectively in poor countries in general is a controversial discussion among policymakers and academics.

Proponents claim, that foreign banks can achieve better economies of scales and larger risk diversification, introduce more advanced technology, import better supervision and regulation and finally increase the competition (Detragiache et al., 2006). Results in Burkina Faso support this theory: The interest spread fell considerably by about 2 basis points between 1998 and 2000 when the number of banks in the country increased from five to seven (Sacerdoti, 2005).

Despite these advantages, the effect of foreign bank entries in SSA countries is often contrary: International banks have cost advantages in lending to larger customers providing "hard information" (e.g. accounting information and collateral values), as multinational corporations, large domestic firms and governments. Otherwise, foreign banks do not lend to smaller customers, not least due to a lack of local market knowledge and due to the missing relationships with Small- and Medium-sized Enterprises (SMEs) (soft information). This has two consequences: Firstly, international banks are serving the credits to the solvent and larger clients, a behaviour of foreign banks which can be seen as "cream-skimming" (Detragiache et al., 2006). Secondly, local banks, losing "good risks" to international banks, are more than ever not able and willing to increase credits to small firms. Detragiache et al. (2006) conclude that these findings are clearly at odds with hopes that foreign banks might replace inefficient and corrupt state domestic banks and boost financial development in poor countries.

Overall, solely opening the banking sector to foreigners does neither solve the problem of banks' efficiency nor transform the banking sector into an engine of economic growth (Cihak, Podpiera, 2005), which automatically reduces the excess liquidity in the financial system. Besides structural issues, which will be discussed in section 4.2, commercial banks have to adapt their products and services on the specific needs of their customers.

[67] Kenya Commercial Bank Uganda (KCB), Dyer & Blair Investment Bank and Fina Bank (Were, 2007)

4.1.3 Design of customer specific products

A strategy to reduce excess liquidity is to provide specific products which meet the financing needs of today's excluded population. In order to enlarge financing activities, commercial banks should focus on the following key business areas: (1) agricultural financing, (2) SME financing, (3) Housing financing and (4) Remittances banking.

(1) Agricultural financing

For around 80 percent[68] of Uganda's population agriculture is the primary source of income and generates around one third of the GDP. But in 2006 only 7 percent[69] of the total commercial bank credit volume was lent to the agricultural sector. This might indicate not utilised investment opportunities. Furthermore, agriculture plays a very critical role in growth and poverty reduction. According to the World Bank (2007b) agricultural growth remains the engine of growth for poverty reduction in low income countries.

Figure 30 shows the impact of agricultural growth on poverty. In Uganda around 1 percent of growth in the agricultural sector reduces the rural poverty by over 3.5 percent.

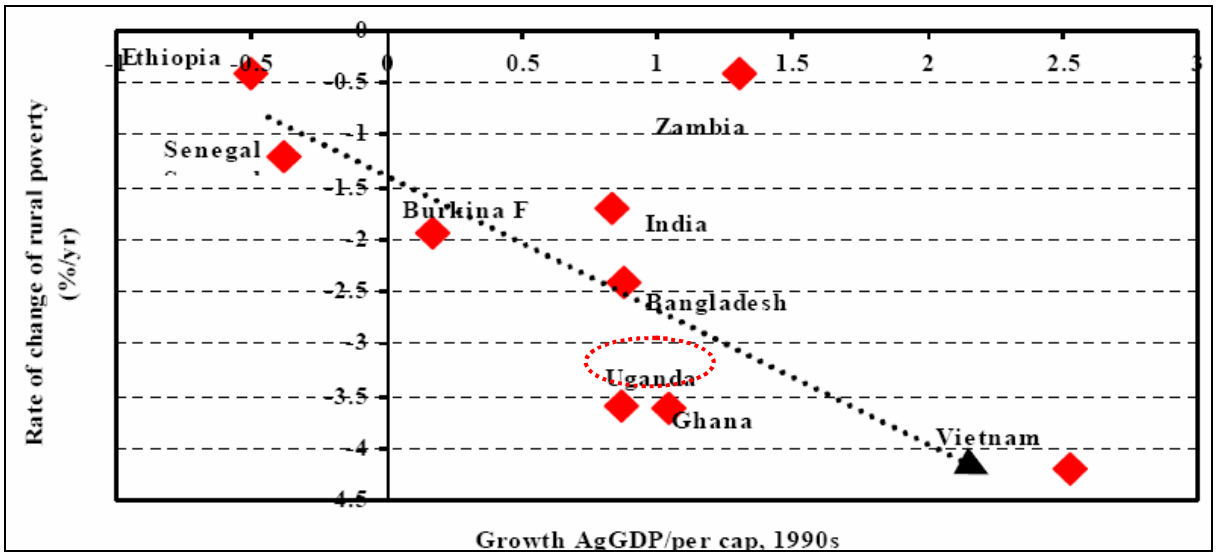

Figure 30: Low-Income Countries (LICs): Agricultural growth remains the engine of growth for poverty reduction (WB, 2007b)

The examples of Sacerdoti (2005) show, that agricultural finance can be a successful strategy to reduce excess liquidity. In the Western African Monetary Union a significant part of the excess bank liquidity in the whole region has been used during the cocoa export campaign to finance the purchase of the crop. In successful agricultural exporting countries, such as Côte

[68] Source: Slezak, Tillmann, 2006
[69] Source: BOU, Annual Supervision report 2006

d'Ivoire, banks financing is plentiful for bringing export crops to the market, and to finance the production and the processing phase. However, in all these countries no finance is available for small-scale farmers without collaterals. In order to obtain credits, one strategy is to promote the establishment of farmers' cooperatives and to set up warehouses by the farmers (Sacerdoti 2005).

In Uganda, the importance of credit for the agricultural sector development is under debate. Mpuga (2004) stresses the importance of rural credit services by pointing out that many agricultural activities are spread over the time of the year and the adoption of new techniques or a new crop require an investment in the current period with a payoff in the future. Mugume (2003) analysed commercial banks credit supply to different sectors and concludes that firms in agricultural sector are less likely to obtain a credit.

In contradiction, the results of the 2004 National Service Delivery Survey do not support the widespread concern of severe credit constraint for Uganda's farmers. 72 percent of 16.000 interviewed households had no additional need for credit during the preceding 12 months. Only 11 percent of the rural households applied for a credit, and just 3 percent of the applications were agriculture-related (WB, 2007a).

One explanation for the limited credit demand of the poor rural population is given by Servet (2007a): The population just above the poverty line has to save a considerable part of their income to protect themselves against emergencies and periods of no or low earnings. This excess liquidity on a microeconomic level is a precondition for the poorest to survive. Accordingly, savings and insurance products are often of higher importance than access to credit.

The following two insurance products could mitigate the risks of small-scale farmers in Uganda. Banks in Malawi agreed to lend farmers the money necessary to purchase certified seed if the farmers bought weather insurances. About 900 farmers borrowed an average of about US$ 40 to pay for the seed including US$ 3 for insurance (WB, 2007b). In Tanzania, a local bank has initiated price risk insurances for agricultural products as coffee and cotton. This hedging product reduces the risk exposure for Tanzanian farmer and increase credit supply by commercial banks (WB, 2007b).

(2) SME financing

SMEs[70], nowadays with limited access to finance, are representing the second investment opportunity for liquid commercial banks. The lack of finance bases on the higher risk in SME

[70] The abbreviation SMEs is used for companies whose headcount, turnover or total assets are below certain limits. The definition differs among countries and economic areas. The South African definition of SMEs, including all companies with up to 200 employees, can be used as an orientation for SSA countries (Nieuwenhuizen and Kroon, 2003)

banking than in lending to the government and to larger established firms with adequate return records (Sacerdoti, 2005). Apart from an improvement of the regulatory and fiscal framework, the stimulation of SME lending can be reached by offering SME-specific bank products, mainly for customers without collaterals, as the following examples show.

Firstly, leasing, discounting and factoring services could provide working capital financing against inventories or other movable assets receivables for firms lacking collaterals (Sacerdoti, 2005).

Secondly, commercial banks could adapt financing policies from MFIs and offer larger loans to small start-up companies. But the potential for commercial banks to reach "down market" seems not to have been exploited in Uganda. According to the World Bank (2007b) only the Centenary Bank uses microfinance lending methodologies and accepts customary ownership, untitled land, livestock and household items (of low market value but high use value) as security. Results from other countries show that rural microfinance can represent a serious and substantial business for commercial banks.[71]

Thirdly, the International Finance Corporation (IFC) and the International Development Association (IDA) have developed innovative ways to supply SMEs with risk capital, including products as performance-based lending or local currency portfolio guarantee products together with local financial institutions (IFC, 2007).

(3) Housing financing

Housing financing has huge potential. Today, the lack of land titles and the slowness in issuing them impede a rapid development of mortgages in many countries in SSA. In Tanzania, more than 80 percent of the land is still not titled (Sacerdoti, 2005); in Uganda the percentage might be similar high.

Even though, Uganda's commercial banks see the future potential in this business and are massively advertising to popularise the recently launched mortgage products.[72] Countries as Senegal, where land titles in urban areas are common, mortgages have developed rapidly and housing financing is an attractive investing option for commercial banks (Sacerdoti, 2005).

(4) Remittances banking

Gupta et al. (2007) suggest that the steadily growing remittance flow to SSA can serve as an effective access point for "unbanked" individuals and households. The flows received from migrants present an opportunity for low income households to access formal financial services.

[71] Examples are Banco Noreste in Brazil, Banco Caja Social in Colombia (WB, 2007b) and BRI in Indonesia (Servet, 2006)
[72] Stanbic Bank, dfcu Bank and Standard Chartered Bank are leading the campaign to popularise mortgages (Mbanga, 2007)

This most likely begins with savings products and can lead to a small business start-up capital for individuals previously excluded from the formal sector (Gupta et al., 2007).

By bundling financial services like savings and entrepreneurial loans for remittance-receiving households, banks can develop a new investment opportunity. Furthermore, the market is dominated by specialised money transfer organisations like Western Union which do not offer ancillary financial products to their clients (Gupta et al., 2007).

In conclusion, increasing the access to financial services, enforcing efficiency within the banking sector and adapting products and services to the needs of the customers can deepen Uganda's financial sector and thereby reduce the excess liquidity in the system. Though, as long as the institutional and legal framework is showing weaknesses the expansion of the financial sector will always be limited.

4.2 Improvement of the institutional and legal framework

A large number of countries in SSA have reached an acceptable degree of macroeconomic stability, reined in inflation and contained fiscal deficits – all factors that constitute an obstacle to the financial deepening (Sacerdoti, 2005). As a next step, the focus has now moved to the institutional and legal weaknesses, which deter banks from taking more risks and extend credit to less credit worthy borrowers.[73] This means banks need financial information on borrowers that are reliable and controllable, collaterals should be sufficiently available and enforceable and creditors' rights should be adequately protected through an effective judicial system (Abuka, Egesa, 2007a). Studies disclose a strong impact of improvements of the legal security on the increase of private credits in relation to GDP (Gulde, Pattillo, 2006 and Detragiache et al., 2005).

The institutional and legal situation in Uganda is challenging. The World Bank (2007c) annually investigates and compares worldwide the regulations that enhance or constrain business activities.[74] Overall, Uganda ranked 118 out of 178 economies - an acceptable result for one of the least developed countries in the world (IDH 154 of 177 countries[75]). However, in the category "Getting credit regulations", which measures how well credit markets function in terms of credit registers and in terms of legal rights of borrowers and lenders, Uganda is ranked on position 158 out of 178 countries. That significantly better credit regulation

[73] All personal interview partners (see ANNEX 1) have attached the greatest importance to the improvement of the institutional and legal framework in order to expand credit support to SMEs

[74] The World Bank Study Doing Business 2008 measured the regulations affecting the 10 stages of business's life: (1) starting a business, (2) dealing with licenses, (3) employing workers, (4) registering property, (5) getting credit, (6) protecting investors, (7) paying taxes, (8) trading across boarders, (9) enforcing contracts and (10) closing a business

[75] Source: UNDP, Human Development Reports, http://hdr.undp.org/en/statistics/ (Retrieved on 2008-06-01)

frameworks are not only achievable in developed countries is shown when looking at the ranking of Kenya (No. 13) and Botswana (No. 26).

The following section highlights three main institutional and legal barriers that hamper bank credits to private sector and reviews reforms that have proven useful for credit promotion: quality enhancement of financial statements, enforcement of property rights and increase in efficiency of judicial authority.

4.2.1 Quality enhancement of financial statements

Loan commitments of commercials banks are restricted to the financial condition of the borrower. Only if banks have the possibility to examine the good credit worthiness of the borrower a loan approval is possible.

Accurate information on the financial status of the borrower can be disclosed by adequate financial statements. However, in most SSA countries, SMEs are not able to produce formal financial statements and audited accounts (Sacerdoti, 2005). Additionally, the accounting profession is not well regulated, and auditor's controls are often affected by political interests, which weaken the significance of financial statements (Gulde, Pattillo, 2006). The lack of financial statements reflects as well the very low interest of many firms to formalise, which allows them to by-pass controls and taxes, but simultaneously inhibits to respect terms and conditions of commercial banks (Hugon, 2006).

In Uganda, improvements in the accounting standards have been introduced (Sacerdoti, 2005). But despite these improvements, reliable information on borrowers remain often elusive and are not shared among lenders. To address this information asymmetry between lenders and borrowers the Bank of Uganda established a Credit Reference Bureau (CRB), which will go operational in June 2008[76]. The CRB provides information on borrowers' debt profile and repayment history, which limits the risk of multiple borrowing and over-indebtedness of customers. Based on recent experiences in several countries across the globe[77], the Bank of Uganda expects that the establishment of the CRB will lead to an improved access to financing, an increased lending volume and a reduction in commercial banks lending rates.[78] Furthermore, the introduction of the CRB can lead to an improvement of the credit culture and

[76] Source: BOU quoted in East African Business Week (Ahabwe, 2008); available on http://www.busiweek.com/index.php?option=com_content&task=view&id=5033&Itemid=9 (Retrieved on 2008-06-04)

[77] e.g. Singapore, Iraq, China, Romania, Vietnam, Cambodia, Brazil, Hong Kong
An entire list of credit reference bureaus in world was established by Rozycki (2006)

[78] Source: BOU; available on http://www.bou.or.ug/bouwebsite/opencms/bou/regulation_supervision/credit_reference_bureau.html (Retrieved on 2008-06-04)

to a reduction of the default rates, as the borrowers seek to protect their "reputation collateral" by meeting their obligations in a timely manner.[79]

4.2.2 Enforcement of property rights

"Reputation collateral" is an important precondition for potential borrowers but not sufficient in most cases. Today 90 percent of the loans in East Africa require collaterals, compared to a worldwide average of 81 percent (Abuka, Egesa, 2007a). And even if a household or a firm possess collaterals, e.g. in form of real estates, a bank credit might not be easily accessible. In many countries the issuance of titles is extremely slow, due to inadequate procedures and resources in property registration offices (Sacerdoti, 2005).

In Uganda, as in many other African regions, titling programs were futile because people bought and sold property informally and neglected to update the title records in the property register. The reason is given by the World Bank (2007c) study "Doing Business": a property transfer in the largest business city of not named African country costs 12 percent of the value of the property and takes more than 100 days on average. In Uganda, the costs are with 4.6 percent of the value of the property below the African average, but it takes around 227 days to register a property (WB, 2007c), which is as well for African standards[80] extremely long. Worse, in many countries property registers are so poorly organized that they provide little security for the ownership (WB, 2007c). Due to these weaknesses once formalized titles quickly go informal again.

As long as the procedure to register property rights is inefficient and expensive, a substantial part of the private sector has no access to commercial bank financing. As rich businesses can afford to invest in security systems to defend their property, small entrepreneurs cannot and remain excluded. Therefore, in order to deepen the financial sector, strengthening of the property rights has to be a key priority for the Ugandan authorities.

4.2.3 Increase in efficiency of judicial authority

When commercial banks are finally financing against collateral, the credit recovery rate in case of insolvency of the borrower is important. On the one hand the recovery rate depends on the value of the collateral itself, on the other hand on the court efficiency, measured in average process duration and costs for the claim. Where courts are efficient, commercial banks are more likely to engage with new borrowers. In countries with no access to efficient courts, lenders must rely on other mechanism, as social networks, credit reference bureaus, ethnic

[79] Source: BOU; available on http://www.bou.or.ug/bouwebsite/opencms/bou/regulation_supervision/credit_reference_ bureau.html (Retrieved on 2008-06-04)

[80] To compare: days to register a property: Botswana 30, Mozambique 42, DRC 57 and Kenya 64 days (WB, 2007c)

origin, previous transactions, etc., to decide with whom to do business, leading often to a conservative lending approach (WB, 2007c). In Uganda, court efficiency is moderate with position 117 out of 178 (WB, 2007c).

A key element of the court efficiency is the process of closing businesses. An inefficient corporate bankruptcy process is detrimental to increase private lending, while efficient processes will decrease borrowers moral hazard, increase banks' willingness to lend, and decrease the interest charged on loans (Abuka, Egesa, 2007a).

A key indicator of court efficiency is the duration of the bankruptcy process. Figure 31 shows that a bankruptcy process takes an average of 3.6 years in SSA countries, compared with around 1.8 years in High-Income Countries (HICs).

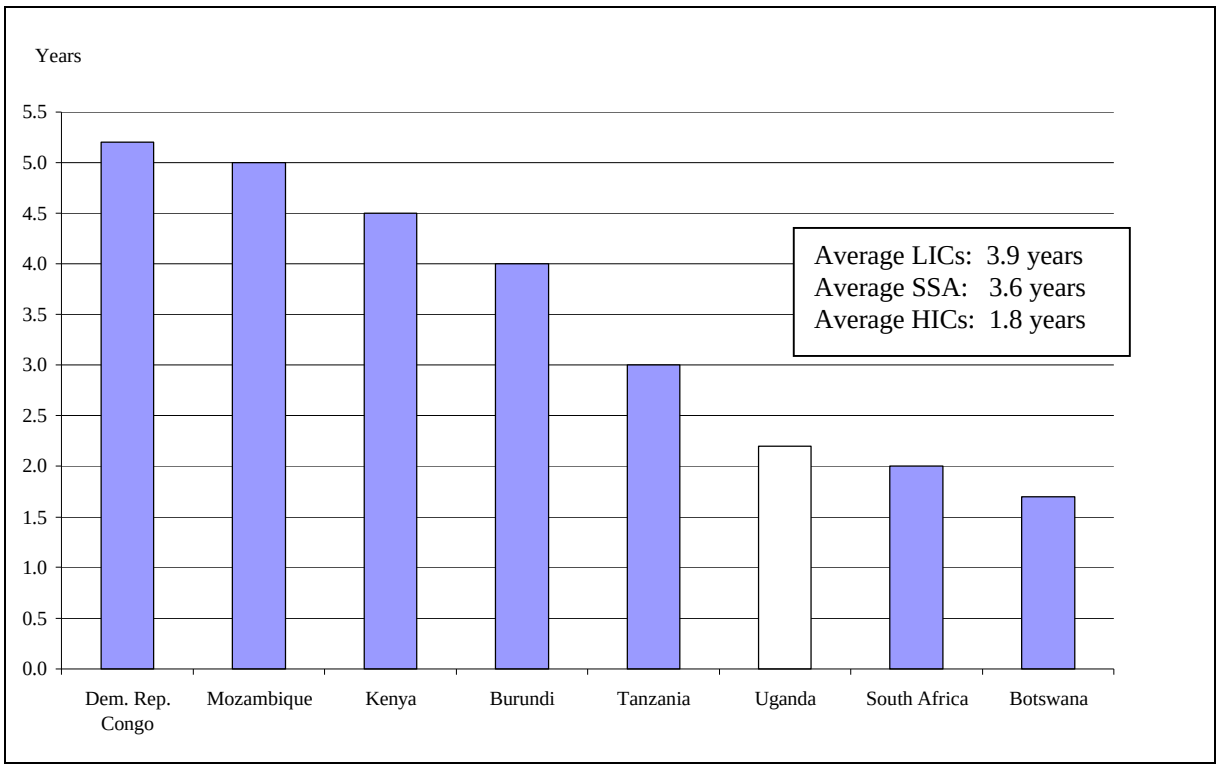

Figure 31: Selected African countries: Time to resolve insolvency, 2007 (in years) (WB, 2007c)

Uganda's bankruptcy process can be described as efficient with an average of 2.2 years (WB, 2007c). Only the costs impede a better ranking: It takes an average of 30 percent of the bankrupt estate to resolve a bankruptcy case in Uganda, compared with 19.5 percent on average in SSA countries (Abuka, Egesa, 2007b). Furthermore, the number of accountants and lawyers in Uganda competent in insolvency issues is low, and the resources of the Official Receivers Department are inadequate (Sacerdoti, 2005).

To improve the functioning of the judiciary, to accelerate enforcement procedures and reduce the costs, Sacerdoti (2005) proposes to develop out-of-court enforcement procedures or summary enforcement proceedings.

4.3 Enhancement of the private sector absorption capacity

An efficiency increase of the financial sector and an improvement of the legal and institutional framework can support private sector credit. However, a significant hindrance in the lending process and therefore a major underlying cause of excess bank liquidity is the limited absorption capacity of the private sector. To increase commercial banks opportunities to invest into the private sector the following areas have to be addressed: increase in competitiveness of the private sector, improvement in infrastructure and living conditions of the population and establishment of regional integration.

4.3.1 Increase in competitiveness of the private sector

Uganda's economy is not internationally competitive. In the Global Competitiveness Survey 2007/08, conducted annually by the World Economic Forum (WEF), Uganda ranked 113 out of 125.[81] The productivity of Uganda's workforce trails far behind the productivity of both regional and international competitors.[82] As in most African countries, Uganda's SMEs show a lack in skills and technology to compete with the increasing pressure from multinational operators or low-cost imports, from Asia in particular (Business Africa, 2000).

Commercial banks often claim a lack of bankable projects of entrepreneurs. This can be highlighted by the fact that the majority of the liquid local companies prefers to invest into rentable financial assets instead of risky new business projects (Hugon, 2006). A lack of entrepreneurship by the local population might be shown by the fact that half of the small-size formal enterprises with more than 10 employees are owned by residents of Asian and Middle Eastern descent (McDade, Spring, 2005). Furthermore, a rather low business ethic limits the access to credits: The culture of non-repayment is well rooted and justifies commercial banks' insistence on collaterals (Mayanja, 2000).

An increase of the competitiveness and readiness for commercial bank support could be achieved by trainings in how to manage enterprises or prepare financial statements, by

[81] Source: WEF (World Economic Forum), Global Competitiveness Survey 2007-2008, available on http://www.gcr.weforum.org/ (Retrieved on 08-06-04)

[82] Annual productivity per workforce: Uganda US$ 1.085, Tanzania US$ 2.061, Zambia US$ 2.680, India US$ 3.432, Kenya US$ 3.457 and China US$ 4.397 (Sseezicheeye, 2007)

employing professional international staff and by government start-up support, e.g. by providing sites for industrial companies.[83]

These short-term measures might mitigate the weak competitiveness. Though, to boost Uganda's economy and to increase its absorption capacity, a fundamental improvement of the living conditions, in terms of poverty, health, education and infrastructure, are needed.

4.3.2 Improvement of infrastructure and living conditions

A precondition to increase the absorption capacity of the economy, for both foreign aid and commercial bank lending, is the improvement of the manufacturing capability. The manufacturing capability is mainly determined by the food situation as well as by the health care and education system (Servet, 2007a).

The Millennium Development Goals (MDGs), consisting of eight goals[84] including hunger, education and health, can be seen as framework to measure the development of a country in terms of its manufacturing capability.

Uganda has made progress on mainly three MDGs: poverty (from 58 percent in 1992 to 31 percent in 2007), universal primary education (in 2006 84 percent of school-age children are going to school) and HIV/AIDS (from 18 percent in 1995 to 6.4 percent in 2005).[85] However, Uganda still faces major development challenges: child mortality and maternal health are completely off target and poverty and food insecurity are still present, mainly in Northern Uganda. Furthermore, Servet (2007c) analysing the MDGs criticises first of all the missing consideration of the inequality within the framework and claims that addressing inequality is a central measure to reduce poverty substantially. As well as in most of the countries worldwide, inequality in Uganda expressed by the Gini coefficient increased significantly from 0.36 to 0.43 between 1992 and 2003.[86] A further major concern is the population growth rate, with 3.2 percent annually[87] one of the highest in the world. Combined with the high dependency ratio, especially amongst poor families, the high population growth could limit domestic savings and so provide a brake on national welfare unless Uganda can hasten to a demographic transition (WB, 2007b). To conclude, all measures which support the living conditions and the MDGs have as well a positive influence on the absorption capacity of Uganda's economy.

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[83] Based on personal interviews with representatives of Ugandan commercial banks (see ANNEX 1)

[84] The eight goals are: (1) eradicating extreme poverty and hunger, (2) achieving universal primary education, (3) promoting gender equity and empowering women; (4) reducing child mortality; (5) improving maternal health; (6) combating HIV/AIDS; (7) ensuring environmental sustainability; (8) developing global partnership for development. Source: UN Millennium Development Goals; available on http://www.un.org/millenniumgoals/ (Retrieved on 2008-06-05)

[85] Source: UN Millennium Development Goals Monitor, available on http://www.mdgmonitor.org/factsheets_00.cfm?c=UGA&cd=800 (Retrieved on 2008-06-05)

[86] The Gini coefficient is a measure of statistical dispersion; in this case used as a measure of inequality of income distribution. A low Gini coefficient indicates a more equal income distribution. Source figures: Okidi et al., 2004

[87] Source: WB, Uganda Data Profile, Word Development Indicators database, available on http://devdata.worldbank.org/external/CPProfile.asp?CCODE=UGA&PTYPE= CP (Retrieved on 2008-05-05)

Development investments, for example in the education system, have a significant time lag until the results are visible in an economy. Therefore, in the meantime, the problem of scarcity of finance, mainly in the rural area, has to be addressed. In the past, rural firms were financed based on government decisions, using the government-owned rural banks to directly lend to the firms, leading to disastrous effects for commercial banks and the overall economy. Today, according to the World Bank (2007b), the new approach to rural finance focuses on identifying the binding constraint to rural development and on using a privately-based rural financial system to solve only finance-related problems.

In case of Uganda's rural economy, the lack of physical infrastructure is a major binding constraint to financial institutions. The relatively better infrastructure in Uganda's capital Kampala explains why the bulk of the bank credit is channelled to urban as opposed to rural borrowers. Abuka and Egesa (2007a) argue that the structural impediments related to infrastructure, as deficiencies in transportation, communication and power explain the high costs of financial service delivery in the rural area.

In Uganda, infrastructure deficiencies are in comparison with an average LIC obvious: only 7 percent of the roads are paved (LICs: 27 percent), 9 percent of the households have access to electricity (LICs: 35 percent) and 7 percent of the population are fixed-line or mobile phone subscribers (LICs: 17 percent) (WB, 2007a). Abuka and Egesa (2007a) conclude that investments in the improvement of the infrastructure services will encourage the growth of private sector credit in Uganda.

Busharizi (2007) accepts the urgent need for massive investments in infrastructure. However, he also points out that the fight against corruption has to be strengthened and that study after study has shown that no matter how much money is poured into a country to build roads, dams and railways, if the culture of trust and respect of property rights, contracts and public goods is non-existent, good money will be thrown after bad.

4.3.3 Establishment of regional integration

Even if large infrastructure investments improve the growth prospects of Uganda's financial sector, it will remain small in size. Bossone et al. (2001) state that financial services in small systems tend to be limited in scope, more expensive and poorer in quality compared to the service in large systems. Abuka and Egesa (2007a) conclude in their analysis that a regional integration of the financial infrastructure in East Africa could enhance credit delivery to the private sector. By combining the individual financial sectors of Burundi, Kenya, Rwanda, Tanzania and Uganda a financial market of around US$ 10 billion assets would result, about six times the size of Uganda's financial market alone.

An integrated financial market offers cost and risk reduction opportunities. Cooperation in regulation and supervision, payment systems, legal frameworks, accounting and credit reporting could lower the costs for the individual market and banks. Furthermore, the commercial banks could benefit from risk diversification effects through investments in all five countries and from the advantages from pooling risk at a regional level (Abuka, Egesa, 2007a).

According to the World Bank (2007b) a regional integration will certainly not provide an immediate remedy for the problems of Uganda's small banking system, but should be further explored as option for the future.

4.4 Conclusion

The best policy to deal with excess liquidity from a long term perspective is to eliminate the fundamental underlying causes in order to empower a country by itself. In Uganda, significant institutional and legal barriers hamper commercial banks lending to the private sector. Higher transparency about borrower's creditworthiness due to financial statement trainings or the newly established CRB reduces the asymmetry between lenders and borrowers. As for almost all commercial bank credits in Uganda collaterals are required, too. Therefore, the strengthening of property rights is crucial: mainly the extremely long duration to register a property has to be resolved. The recovery rate in case of an insolvency of the borrower affects commercial banks willingness to engage with new borrowers. Overall, Uganda's court efficiency is moderate, while for SSA-standards its bankruptcy process is efficient.

Besides improvements of the legal and institutional framework, efforts to achieve the MDGs and investments into infrastructure projects increase the absorption capacity of Uganda's economy and are therefore as well of major importance from the point of view of excess liquidity.

Improvements in the regulatory and economic environment are supposed to increase the competitiveness and efficiency of financial sector, which leads to better access, lower costs and higher quality of financial products. This again, increases the access to financial services for large, so far financially excluded population groups and offers commercial banks new investment opportunities for the excess liquidity.

5 Final Conclusion

Excess commercial bank liquidity is not a new phenomenon in Uganda. Already in the mid-1970s until the late 1980s, characterised by political instability, civil conflicts and severe economic crisis, expatriate commercial banks could only survive by applying conservative lending policies and thereby amassing excess liquidity. Today, after radical structural and financial adjustment programs, Uganda's financial market is in much better shape, even if far from being efficient. Today, a major concern is that the financial liberalisation has not successfully removed the situation of excess commercial bank liquidity in Uganda and in 41 of 44 countries in Sub-Saharan Africa.[88]

Excess bank liquidity is a sign for the dysfunctionality of the channel between investors and savers; commercial banks do not transfer their deposits into credits or productive investments. On the one hand it can lead to a reduction of banks' profitability and to an ineffectiveness of the monetary policy. On the other hand excess liquidity possesses the risk of macroeconomic destabilization, mainly consumer price inflation, and can potentially lead to a deterioration of the loan quality if the banks suddenly decide to expand their lending activities.

In the last ten years, the liquidity in Uganda's commercial bank system has always been above 30 percent of banks total assets, with a peak in the period between 1999 and 2002 with up to 64 percent of the total assets in liquid assets. The main cause of the substantial increase of liquidity during this period was the high aid-inflow combined with the switch of donor aid from BOP support to on-budget projects. Export revenues, remittance inflows and FDIs were only of minor importance at this time. But their influence on excess liquidity will rise in the future: since 1999 remittance inflows nearly quadrupled and are still rising. FDIs and exports will most likely influence the bank liquidity in the future: The establishment of the National Oil Company to exploit the impressive oil reserve in the Lake Albert Valley requires an investment of around US$ 5 billion, while a future production of around 50.000 barrels of oil a day is estimated.

The explanations why excess bank liquidity has not been lent or invested, mainly between 1999 and 2002, are manifold: Just recovered from a very painful correction phase of high credit loss rates and several bank failures, the commercial banks still applied a very restricted lending policy. The political instability and conflicts during the 1970's until the 1990's are a major cause of the low depth of financial system and the limited absorption capacity of the private sector. The financial sector itself behaves in an oligopolistic manner and is unwilling to lend if the borrower is unable or unwilling to pay a high interest rate of around 20 percent. Furthermore, banks high income from Treasury bills and charges reduces the pressure to

[88] Source: Saxegaard, 2006

compete for private sector investments. All the more, banks claim a lack of bankable projects and entrepreneurs inability to meet formal lending requirements, as for example financial statements. But as well alternative investment options to absorb the excess liquidity are rare: The domestic interbank, capital and stock market are hardly developed and investments abroad are limited due to the intervention of the Bank of Uganda.

The multifaceted and structural causes of excess commercial bank liquidity challenge Uganda's monetary policy. In order to ensure price stability, the Bank of Uganda removes or restricts the free flow of excess liquidity by applying reserve requirements and open market operations. Mainly the second instrument is a matter of considerable debate. The proponents of the indirect monetary policy refer to Uganda's price and macroeconomic stability, the strong economic growth of over 6 percent annually in the last 15 years and a significant reduction of the headcount poverty. However, major concerns of critical voices are the high costs of issuing Treasury bills with interest payments of up to US$ 100 million yearly, the potential crowding out of private sector lending or fundamentally, the ineffectiveness of indirect monetary policies in an oligopolistic banking market. Accordingly, there is board consensus that the first-best and only substantial solution against excess bank liquidity from a long term perspective is to address the underlying causes.

Improving the weak institutional and legal framework has a demonstrable positive effect on private sector access to finance: commercial banks need financial information on borrowers that are reliable and controllable, collateral that is sufficiently available and enforceable and creditor's rights which are adequately protected through an effective judicial system. The manufacturing capability determines the absorption capacity of the economy and therewith the degree of excess liquidity which can be lent to the private sector. Therefore every improvement of the food, health and education situation of the population and efforts to remove deficiencies in the infrastructure will encourage the growth of Uganda's private sector. The progress of the economic and regulatory framework will further increase the competition among commercial banks, which leads to better access, lower costs and higher quality of the financial products, which has once again a positive effect on the reduction of excess liquidity.

The degree of excess bank liquidity can be seen as an image of Uganda's development. Successfully addressing excess bank liquidity implies at same time the improvement of the economic, regulatory and social conditions in Uganda.

ANNEX 1: List of Personal Interviews

ASIIMWE Godfrey B., Ph.D
Head, Development Studies
Makerere University
Kampala

DDUMBA-SSENTAMU John, Prof.
Dean Faculty of Economics and Management
Makerere University
Kampala

GILES John
Managing Director
Centenary Bank
Kampala

LARSEN Jillian
Project Associate
Innovations for Poverty Action (IPA)
Kampala

LUMALA Solome Muwanga
Assistant Director, Research Department
Bank of Uganda
Kampala

MALIKI Harton
General Manager, SME Banking
Standard Chartered Bank
Kampala

MAYANJA Abubaker B.
Research Fellow
Economic Policy Research Centre (EPRC)
Kampala

OBWONA Marios, Ph.D
Principal Research Fellow
Economic Policy Research Centre (EPRC)
Kampala

OMARA Dick
Head of Risk & Credit
Orient Bank Ltd
Kampala

OPIO Anthony
Director, Non Banking Financial Institutions
Bank of Uganda
Kampala

SSEBUKULU Godfrey Jjooga
Transformation & Consolidation Consultant
DFID Financial Sector Deepening Project
Kampala

SSERUNKUMA Chris
Business Development Manager
Dfcu Limited
Kampala

ANNEX 2: Questionnaire – Commercial Banks (1/3)

BANK

_____

Name

_____

Function

_____

Phone Nr

_____

email

_____

Name Yves Buehrer
Phone No + 256 77 347 58 12
Phone No + 41 76 535 85 15 (Switzerland)
email ybuehrer@gmx.net

Academic degree
Bachelor of Business Administration, University of Zurich
Master Student Development Studies, University of Geneva
Exchange Student DES, Makerere University, Kampala

Work experience
Banker, Bank of Zurich
Auditor for banks, Arthur Andersen
Senior Management Consultant for Banks, zeb/

RESEARCH SUBJECT - MASTER THESIS

Excess Bank Liquidity in Sub-Saharan Africa
Causes and consequences

DECLARATION OF CONFIDENTIALITY

All gathered information are treated as strictly confidential and are solely accessible to the author
Information is only used in this master thesis and in an aggregated form.
No information or figures are disclosed in connection with banks or persons names

I BANKS KEY FIGURES

1. Established: _____
   Ownership _____
   Business purpose _____
2. No of branches _____
3. No of employees _____
4 No of private clients _____
5 No of institutional clients _____

II FINANCIAL STATEMENTS		**2004**	**2005**	**2006**	**Actual 06.2007**
Balance Sheet					
Total Assets / Liabilities					
Loans and Advances to Customers					
thereof to	individuals				
	small enterprises*				
	medium enterpr.*				
	large enterprises*				
Collateralized loans/advances to cust.					
Customer Deposits					
thereof from	individuals				
	small enterprises*				
	medium enterpr.*				
	large enterprises*				
Equity					

** Please indicate your definition of small-, medium- and large-sized enterprises*

Questionnaire – Commercial Banks (2/3)

Income statement				
Net interest income				
Fee and commission income				
Other income				
Total Operating income				
Operating expenses-staff costs				
Operating expenses-administration costs				
Loss on loans / advances to customers				
Profit before tax				
Additional Information				
Excess liquidity (%)				
Cost-Income Ratio				
Return on Equity				
Rate of nonperforming loans (%)				
Annual credit default rate (%)				
Average age of bad debts				

III LENDING POLICY AND PROCESS

1 Which SME branches of industry do you finance and which not? Which is roughly the finance volume and risk associated to these branches of industry?

Date: _____

Type of industry	*Tot. Credit vol.*	*Ø Credit vol.*	*Ø Credit period*	*Ø Interest rate*	*Ø Default rate*
1. Agriculture					
2. Catering trade					
3.					
4.					
5.					
6.					
7.					
8.					
9.					
10.					

No credits to the following types of industry: _____

2 Can you briefly describe the financing process? Which kind of documents do you demand from potential borrowers? Which forms and instruments do you use during the process of checking borrowers credit-worthiness?

3 What kind of collaterals do you accept? What is the maximum LTV (loan to value)? Do give out credits to SMEs without collaterals?

Questionnaire – Commercial Banks (3/3)

4 How do you calculate the interest rate? Please list and explain the components?

5 How can the lending volume be increased (e.g. after 1 year punctual payment of interest and repayments)?

6 Please explain the monitoring process

IV Areas of improvement

1 In your opinion what is the main factor in terms of SMEs limited access to bank credits?

2 Which improvements (legal, institutional, by commercial banks or SMEs itself) could lead to an enlargement of credit support for SMEs?

V Contacts or actual studies which might be helpful for my research

Many thanks for your support!

ANNEX 3: Questionnaire – Bank of Uganda (1/2)

BANK OF UGANDA

Name _____

Function _____

Phone Nr _____

email _____

Name Yves Buehrer
Phone No + 256 77 347 58 12
Phone No + 41 76 535 85 15 (Switzerland)
email ybuehrer@gmx.net

Academic degree
Bachelor of Business Administration, University of Zurich
Master Student Development Studies, University of Geneva
Exchange Student DES, Makerere University, Kampala
Work experience
Banker, Bank of Zurich
Auditor for banks, Arthur Andersen
Senior Management Consultant for Banks, zeb/

RESEARCH SUBJECT - MASTER THESIS

Excess Bank Liquidity in Sub-Saharan Africa
Causes and consequences

DECLARATION OF CONFIDENTIALITY

All gather information are treated as strictly confidential and are solely accessible to the author.
Information are only used in this master thesis and in an aggregated form.
No information or figures are disclosed in connection with banks or persons names.

I BoU KEY FIGURES

1	Established	_____
2	No of employees	_____

II	UGANDA'S FINANCIAL KEY FIGURES	2004	2005	2006	Actual
1	Annual growth rate of GDP				
2	Rate of inflation				
3	Budget deficit				
4	Money M2 in circulation/GDP ratio				
5	Ratio of excess liquidity in banking system				
1	% population with access to bank services				
2	Liquidity bypasses the retail banking				
3	Bank deposits invested outside of Uganda				
4	Bank deposits in % of GDP				
5	Bank credits to private sector in % of GDP				
1	No of commercial banks				
2	thereof no of foreign banks				
3	Average size of banks (assets)				
4	No of small banks (assets < $ 1 billion)				
5	No of big banks (assets > $ 1 billion)				

Questionnaire – Bank of Uganda (2/2)

6	Average nonperforming loans in %				
7	Average return on equity (ROE)				
1	GDP of Uganda				
2	Share of GDP contributed by SME				
3	No of SMEs in Uganda				
4	No of SMEs with access to bank credits				

III DECOMPOSITION OF INTEREST SPREAD

	2003/4*	**Actual**	**for SMEs**
Lending rate	21.7		
Deposit rate	2.2		
Total spread, of which	*19.5*		
Overhead costs	9.0		
Loan loss provisions	2.1		
Reserve requirements + deposit insurance premium	0.4		
Tax	2.3		
Profit margin	*5.7*		

* Source: WB / IMF FSAP 2004

IV Areas of improvement

1 In your opinion what is the main factor in terms of SMEs limited access to bank credits?

2 Which improvements (legal, institutional, by commercial banks or SMEs itself) could lead to an enlargement of credit support for SMEs?

3 What kind of measures has the BoU carried out (or intends to carry out) to improve the credit support to SMEs in the last 3 years?

V Contacts or actual studies which might be helpful for my research

Many thanks for your support!

ANNEX 4: Questionnaire – General (1/2)

QUESTIONNAIRE

Research subject
Excess Bank Liquidity in Sub-Saharan Africa
Causes and Consequences

General instructions
The questionnaire covers the main areas which might support or hamper sufficient credit support to SMEs.

Please indicate for every factor / statement
a) to what degree it is a driver (very weak, weak, neutral, strong, very strong) for granted SME financing volume *(IMPORTANCE)*
b) the status quo of the factor/statement (not given, partly given, given, well given) *(CONDITION TODAY)*
c) whether you think there might be a positive improvement for the factor / statement within the next 5 years *(CONDITION in 5 YEARS)*

SUBJECT	DRIVER?					STATUS QUO of FACTOR/STATEMENT?				IMPROVE-MENT?	
	VERY WEAK	WEAK	NEU-TRAL	STRONG	VERY STRONG	NOT GIVEN	PARTLY GIVEN	GIVEN	WELL GIVEN	Yes	No
	1	2	3	4	5	1	2	3	4		
I FINANCIAL MARKETS											
1 Macroeconomic stability											
2 Low inflation rate											
3 Low fiscal deficits											
4 Highly developed financial markets (e.g. money in circulation/GDP ratio)											
5 High usage of banks (savings/loans) by population											
6 Small amount of bank deposits invested outside of Uganda											
7 Size of banks at least $1 bn assets (-> lower overhead costs and lending rate)											
8 Low poverty rate (10% of population below nat. poverty rate); 2005: 38%											
9 Low corruption index											
10 ……											

SUBJECT	DRIVER?					STATUS QUO of FACTOR/STATEMENT?				IMPROVE-MENT?	
	VERY WEAK	WEAK	NEU-TRAL	STRONG	VERY STRONG	NOT GIVEN	PARTLY GIVEN	GIVEN	WELL GIVEN	Yes	No
	1	2	3	4	5	1	2	3	4		
II INSTITUTIONAL AND LEGAL FRAMEWORK IN FINANCING MATTERS											
1 Enforceable property rights											
2 High contract reliability											
3 Efficiency of judicial authority (e.g. credit recovery/collateral realisation processes)											
4 Sufficient resources in the juridical system (e.g. period of legal proceedings)											
5 High reliability of the objectivity of processes conducted by tribunal											
6 ……											
III FINANCIAL INSTITUTIONS											
Financial sources for SMEs											
1 Informal finance as source for SME lending											
2 MFIs as source for SME lending											
3 Commercial banks as source for SME lending											
4 Foreign banks as source for SME lending											
5 Foreign direct investment (FDI) as source for SME lending											
6 ……											
Competition											
1 Competitions among banks in SME financing											
2 Competitions between banks and MFIs in SME financing											
3 Increase of competition due to foreign banks entry (e.g.. after GATS)											
4 Reduction of interest margins due to foreign banks entry											
5 No reduction of lending power of local banks due to foreign bank entry (e.g. due to "cream-skimming" of int. banks or losing "good risks" to them)											
6 ……											
MFIs											
1 Advantage of competitiveness due to no demand of conventional bank criteria's in SME financing (e.g. no financial statements)											
2 Advantage of competitiveness due no obligation to fulfil statutorily requirements											
3 ……											

Questionnaire – General (2/2)

SUBJECT	DRIVER?					STATUS QUO of FACTOR/STATEMENT?				IMPROVE-MENT?	
	VERY WEAK	WEAK	NEU-TRAL	STRONG	VERY STRONG	NOT GIVEN	PARTLY GIVEN	GIVEN	WELL GIVEN	Yes	No
III FINANCIAL INSTITUTIONS (PART II)	1	2	3	4	5	1	2	3	4		
Banks											
1 Low level of interest rates for SMEs											
2 Low level of average nonperforming loans from SMEs											
3 High Return on Equity (RoE) of commercial banks in SME financing											
4 High availability of bank services in rural environment											
5 No discrimination of SMEs without adequate collateral											
6 ……											
SME-specific finance instruments and products											
1 Mutual guarantee associations (MGAs) as solutions for SMEs without collaterals											
2 Guarantee funds provided by NGOs or private investors											
3 Leasing companies (e.g. legal constraints in reg. of security liquidation/tax issues)											
4 "Traditional" loans and advances											
5 Leasing through working capital financing (e.g. inventories/other movable assets)											
6 Venture capital lending (means equity financing for start-up companies)											
7 Local currency portfolio guarantee products											
8 Performance-based lending											
9 …… (Others SME-specific bank products/instruments)											
10 …… (Others SME-specific bank products/instruments)											
IV SMALL- AND MEDIUM-SIZED ENTERPRISES (SMEs)											
1 Innovation of SMEs											
2 Long-term competitiveness of SMEs											
3 High quality of skill-set of SMEs (e.g. management, technology, craft)											
4 Interest to formalize of SME											
5 Ability to respect terms and conditions of commercial banks											
6 Entrepreneur-sprit among local population											
7 Quality of financial information (e.g. formal financial statements/audited accounts)											
8 Payback morality of SMEs											
9 SMEs are big enough for bank credits (e.g. > 10 employees)											
10 ……											

SUBJECT	DRIVER?					STATUS QUO of FACTOR/STATEMENT?				IMPROVE-MENT?	
	VERY WEAK	WEAK	NEU-TRAL	STRONG	VERY STRONG	NOT GIVEN	PARTLY GIVEN	GIVEN	WELL GIVEN	Yes	No
V OTHERS BARRIERS	1	2	3	4	5	1	2	3	4		
1 ……											
2 ……											
VI FINAL ASSESSMENT (CONSOLIDATION)											
1 Financial markets											
2 Institutional and legal framework in financing matters											
3 Financial institutions											
4 Small- and medium-sized enterprises (SMEs)											
5 Others barriers											

In 5 years time what will the financial support of commercial banks for SMEs look like?

If you could therefore improve one key condition - which one would it be?

Many thanks for your support!

ANNEX 5: Analysis of profit and loss statement of Centenary Bank

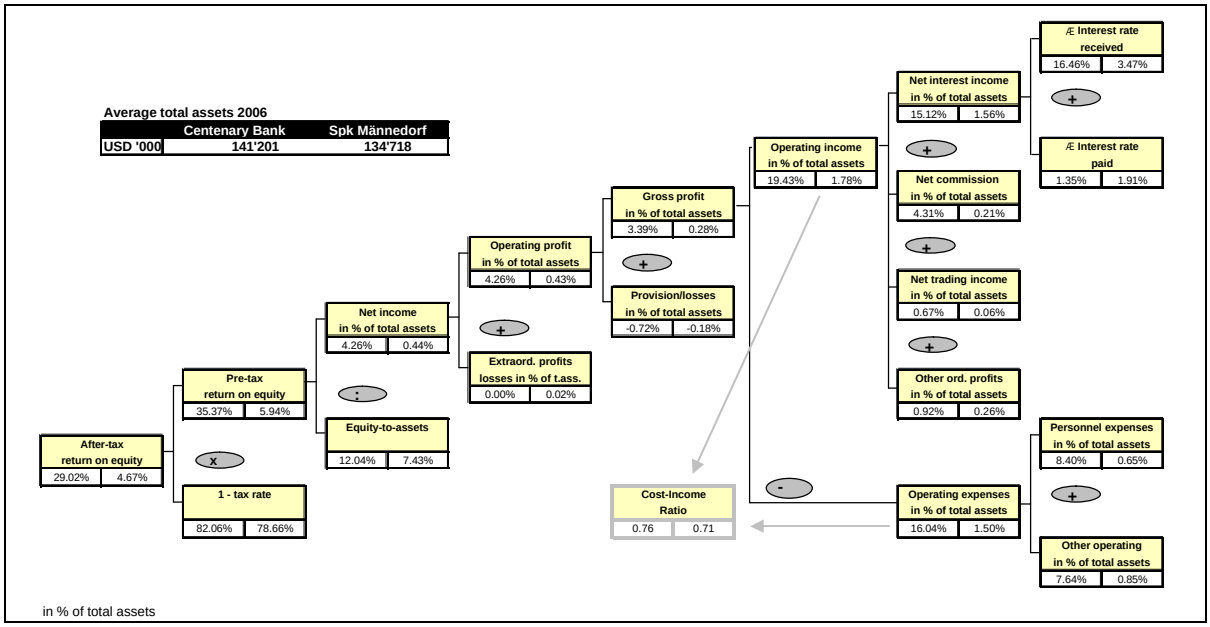

Figure 32: Centenary Bank Uganda: Decomposition of Profit and loss statement, 2006 (in percent) (own calculations)[89]

[89] Sources of figures: Centenary Bank: Annual Report 2006; Swiss regional bank (Sparkasse Männedorf): Annual Report 2006
All income and expenses positions are expressed in percentage of the total assets of the respective bank, which allows comparing banks of different sizes.

ANNEX 6: Final Presentation (1/5)[90]

THE GRADUATE INSTITUTE | GENEVA

INSTITUT DE HAUTES ETUDES
INTERNATIONALES ET DU DÉVELOPPEMENT

GRADUATE INSTITUTE OF INTERNATIONAL
AND DEVELOPMENT STUDIES

Mémoire de Master en études du développement

Excess Bank Liquidity in Sub-Saharan Africa
The case of Uganda

Présenté par:	Yves Buehrer
Directeur de mémoire:	Jean-Michel Servet
Juré:	Daniel Fino

Genève, le 30 Julliet 2008

The analysis of excess bank liquidity in Uganda tries to answers four key questions

Overview Master's Thesis

Subject	• Excess Bank Liquidity in Sub-Saharan Africa: The Case of Uganda
Questions	• Why is excess bank liquidity a problem? • What causes the surplus of liquidity? • What prevents excess liquidity from being lent or invested? • What are responses to address excess liquidity?
Methodology/ Approach	• Interviews with representatives of commercial banks, Bank of Uganda and Makerere University • Application of concepts and ideas tested in other Low-Income Countries • Merger of relevant studies performed in Uganda
Period	• October 2007 – January 2008: (Uganda, field study during exchange semester at • Makerere University in Kampala) and March 2008 – July 2008 (Geneva)

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[90] Charts used for final presentation of Master's Thesis (Geneva, 30th July 2008)

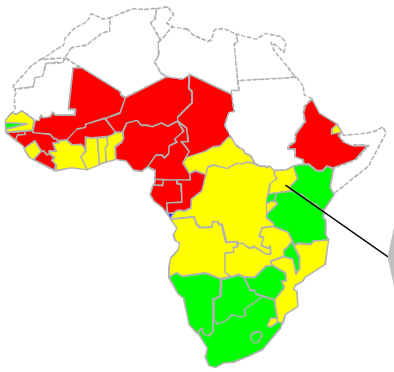
Final Presentation (2/5)

Nearly all African countries dispose over excess bank liquidity – in Uganda nearly 50 percent of the total bank assets are held in liquid assets

Overview Excess Liquidity SSA and Uganda

Overview (2004):
Excess bank liquidity in SSA after intervention of central bank

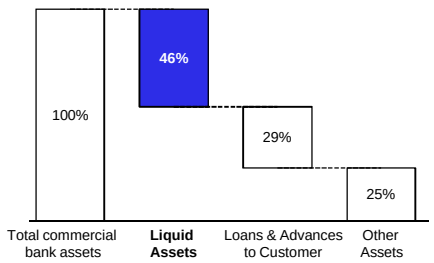
Excess bank liquidity in % of total deposits, end of 2004		
1	Equatorial Guinea	58%
2	Ethiopia	41%
3	Comoros	37%
4	Guinea-Bissau	36%
5	Chad	33%
6	Republic of Congo	25%
7	Liberia	24%
8	Cameroon	23%
9	Guinea	23%
10	Gabon	18%
11	Niger	16%
12	Seychelles	13%
13	Bukina Faso	12%
14	Mali	12%
15	Nigeria	12%
16	Benin	11%
17	Cote d'Ivoire	11%
18	Togo	11%
19	Senegal	10%
20	Sao Tomé & Principe	9%
21	Central African Rep.	8%
22	Eritrea	8%
23	Uganda	8%
24	Zambia	8%
25	Burundi	7%
26	Dem. Rep. Of Congo	7%
27	Ghana	7%
28	Mozambique	7%
29	Swaziland	6%
30	Angola	5%
31	Lesotho	5%
32	Tanzania	4%
33	Cape Verde	3%
34	Kenya	3%
35	Zimbabwe	3%
36	Madagascar	2%
37	Namibia	2%
38	Rwanda	2%
39	Botswana	1%
40	Mauritius	1%
41	South Africa	1%
42	Gambia	-2%
43	Sierra Leone	-2%
44	Malawi	-3%



Definition of excess liquidity:Total of liquid assets above the statutory required level

Statutory liquidity ratio varies widely in SSA countries from 0 percent (Central African Republic) up to over 50 percent (Liberia, Zimbabwe)

Uganda (2004):
Excess bank liquidity before interventions



To analyse the causes and consequences of excess bank liquidity, the focus has to be on total bank liquid assets before interventions by the central bank (e.g. statutory reserve requirements or open market transactions)

Sources: Own calculations, Saxegaard (2006), Bank of Uganda

Uganda has undergone an incredible transformation from a failed state to a fast growing economy – but still remains one of the least developed countries in the world

Uganda's key figures

Key figures of Uganda

Population (million)	27.8
Population growth (annual %)	3.5
Life expectancy at birth (in years)	48.9
HIV prevalence (% of population)	6.0
GPD per capita (in USD)	315
GPD growth (annual %)	5.4
Head count poverty (% of population)	31
Human Development Index (Ranking)	154
Official Dev. Assistance (USD million)	1,600
Annual capital flight (USD million)	540
Annual corruption (USD million)	300

Uganda has undergone an incredible transformation from a failed state to one of the world's fastest growing economies in the last 20 years, but still remains one of the least developed countries in the world

Key figures of commercial banking sector

Number of commercial banks	16
holding financial assets (% of total assets)	82
Loans to customers (USD million)	1,000
Liquid assets (USD million)	850
Credit to private sector (% of GDP)	8
Saving rate of Uganda's population (% of pop.)	70
thereof at secret place (% of pop.)	90
Ugandan with bank account (% of pop.)	8.6
People per branch	140.000
Average Return on Equity (% of equity)	29.6
Non-performing loans/advances (% of tot . L/A)	2.9

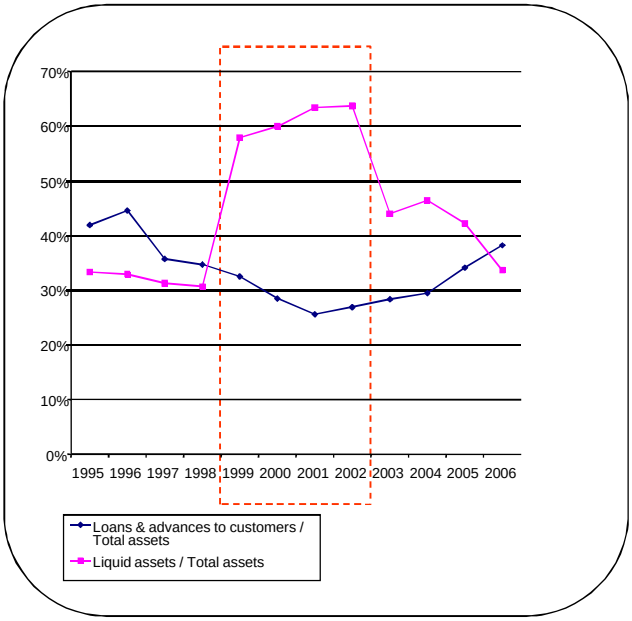
Uganda's financial sector is small, highly liquid and profitable. A major concern is that the financial liberalisation has not successfully removed the situation of excess liquidity and not led to an efficient allocation of the liquid resources

Sources: UNDP, World Bank, IMF, Bank of Uganda; latest available figures

Final Presentation (3/5)

Why is excess bank liquidity a problem?

Excess Liquidity between 1995 and 2006



Problems:

Static issues:

- Reduction of the bank profitability
- Ineffectiveness of the monetary policy

Dynamic issues:

- Macroeconomic destabilisation
- Deterioration of the loan quality

Development perspective:

Contradiction that the banking sectors in poor countries, in which large percentage of farmers and small businesses are excluded from credit, can hold assets that are unproductive.

Excess bank liquidity is a sign that the channel between investors and savers is broken and the deposits are not transferred into credits or productive investments.

Source: Own calculations, Bank of Uganda

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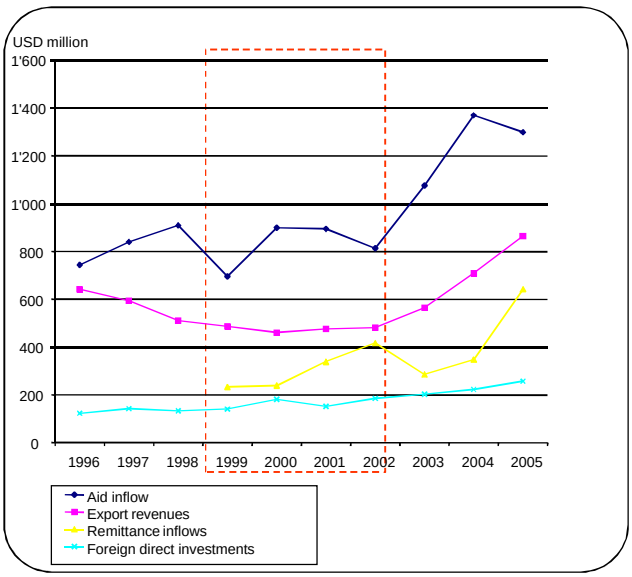
What were causes of excess liquidity in Uganda?

Inflow of sources between 1996 and 2005



Causes of excess liquidity in Uganda between 1999 and 2002:

1. Aid inflow
2. Exports revenues ↗
3. Remittance inflows ↗
4. Foreign direct investments ↗
5. Local causes

High relevance ● ◕ ◑ ◔ ○ Low relevance

Trend in the future ↗

Source: Own calculations analysis, Bank of Uganda, Gupta et al. (2007)

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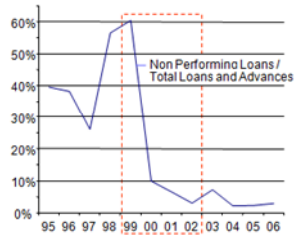
Final Presentation (4/5)

What has prevented the excess liquidity from being lent or invested?

Analyses of factors

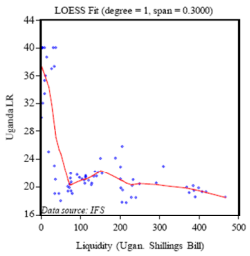
Economic risk



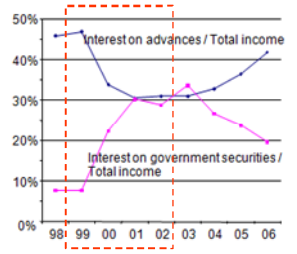
Political risk

- 1998 conflict with Democratic Rep. of Congo
- 1999/2000 clashes between Uganda/Rwanda
- Lord's Resistance Army (LRA)
- 1.5 and 2 million Internally Displaced Person
- Collapse of local economy in the North
- Deposit protection fund

Oligopolistic banking market



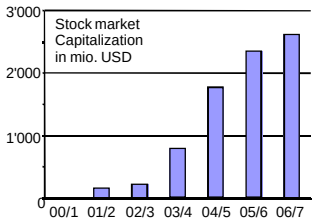
Bank's earning structure



Development of the private sector

- Limited absorption capacity of private sector
- Few formal enterprises, low interest to formalise
- Low performance of agriculture (80% of population; 7% of commercial bank credit)
- Weak legal and institutional framework and poor payment practice

Alternative investment opportunities



Source: Own calculations analysis, Bank of Uganda, Khemraj (2007)

High relevance Low relevance

What are the common responses to address excess liquidity?

Common responses

Alternative Instruments

- Quantitative credit controls
- Limiting aid or FDI inflow
- Stop taking deposits
- No application in Uganda

-> Reduction in resources for poverty reduction projects and undermining of financial deepening

Direct monetary policies

- Controls of interest rates
- Credit allocation by government on in Uganda

:ation of resources, inefficiency in financial intermediation

Open Market Operations

- Sterilisation by selling treasury bills and foreign exchange through central bank
- Major instrument in Uganda

-> low level of inflation and economic (export) growth, but also very high costs (USD 100 million in 04/5); potential crowing-out effect

Statutory reserve requirements

- Minimum reserve ratio in relation to deposits
- Uganda: 9.5%; slightly below average of SSA countries

-> Easy and low-cost instrument, but burden to banks as non-remunerated

All responses entail substantial costs or drawbacks - The only way to fundamentally solve excess liquidity is to address the underlying causes

Final Presentation (5/5)

What are the key responses to fundamentally remove excess bank liquidity?

Key responses

Key responses to excess bank liquidity

Promotion of private sector credit as key to address excess liquidity, economic development and poverty reduction

Efficiency increase of the financial sector

1. Improvement of the access to financial services
2. Reduction of cost of finance and increase in efficiency of banks
3. Design of customer specific products

Improvement of the institutional and legal framework

1. Quality enhancement of financial statements
2. Enforcement of property rights
3. Increase in efficiency of judicial authority

Enhancement of the private sector absorption capacity

1. Increase in competitiveness of the private sector
2. Improvement of the living conditions
3. Establishment of the regional integration

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Conclusion

Conclusion

Conclusion	• The degree of excess bank liquidity can be seen as an image of Uganda's development. Successfully addressing excess bank liquidity implies at same time the improvement of the economic, regulatory and social conditions in Uganda
Difficulties	• Access to bank specific figures as financial statements in Uganda • The subject "Excess bank liquidity" in Uganda and in the developing world in general is only limited analysed • Consistency of figures from different sources
Further research	• Impact on a micro-/household level • Statistical significance of findings
Highlights	• Field study in Kampala (slum dwellers, bankers, scholars, consultants, Governor of Bank of Uganda, entrepreneurs, …) • New subject and holistic approach

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ABSTRACT

This paper examines the causes and consequences of excess bank liquidity in Uganda and the responses to address theses imbalances after the financial sector liberalisation in the 1990s. The paper merges the results of relevant studies performed in Uganda and applies concepts and ideas tested in other Low-Income Countries, mainly in Sub-Saharan Africa, to the specific situation in Uganda. By analysing the period between 1999 and 2002, representing the highest liquidity in Uganda's banking system, there is evidence that high aid inflow combined with the switch from balance of payment support to on-budget project was the major cause of excess liquidity. Further examined causes as export revenues, remittance inflows and foreign direct investments were only of minor importance at this time. The study identifies a multitude of reasons (political and economical instability, oligopolistic banking sector, lack of bankable projects, institutional and legal weakness) which are preventing the lending and investment of excess bank liquidity and concludes that only addressing these underlying causes can mitigate the situation from a long term perspective.

Keywords: Excess Liquidity, Financial Sector Reform, Absorption Capacity, Oligopolistic Banking Sector, Uganda

RÉSUMÉ

La surliquidité des banques de l'Afrique sub-saharienne - Le cas de l'Ouganda

Ce travail traite les causes et conséquences de la surliquidité des banques en Ouganda et les possibilités d'éliminer ces déséquilibres après la période de la libéralisation du secteur financier dans les années 1990. Le travail résume les résultats des études signifiantes conduites en Ouganda et applique les concepts et idées testées dans d'autres pays à la situation particulière de l'Ouganda. L'analyse de la période avec la plus grande liquidité dans le système financier d'Ouganda (de 1999 à 2002), a permis de découvrir que l'augmentation du flux de l'aide de développement en combinaison avec le changement de l'utilisation de cette aide étaient les majeurs causes de la surliquidité des banques. Les autres causes possibles d'une surliquidité, comme les recettes d'exportation, les transferts financiers des migrants et les investissements directs étrangers n'avaient qu'une faible importance à cette époque. Ce travail a identifié une multitude de raisons (instabilité de l'économie et de la politique, secteur bancaire oligopolistique, manque de projet attractif à financer, déficiences du milieu juridique) qui empêchent le prêt et l'investissement de la surliquidité bancaire. L'étude conclut que seule l'amélioration de ces raisons fondamentales peut réduire la surliquidité bancaire à long terme.

Mot-clés: Surliquidité, réforme du secteur financier, capacité d'absorption, secteur bancaire oligopolistique, Ouganda