

BANKING AND CURRENCY

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Roots of Current Problems

Tables 26.1 and 26.2 show the main monetary changes in Uganda over the past eight years, and the monetary position at the outset of the 1979 war. Government borrowing from the banking system, primarily from the Bank of Uganda, took a steadily increasing share of total domestic credit as the private sector stagnated, tax revenues failed to keep pace with governmental demands, and financial discipline collapsed. (See paper on financial administration). While at year end of 1970, government borrowing from the banking system (including the Bank of Uganda) had amounted to no more than 39% of total domestic credit outstanding, by March 1979 it had reached 72%. The vast bulk of central bank financing of government, Shs.5,357 m. by late March 1979, was achieved through low-interest 'ways and means' loans which were far above the legal limit of 18% of recurrent budget revenues (and strictly repayable within three months of the end of the budget year in which they were made). The Central Bank thus virtually relieved the regime of the necessity to exercise any restraint on spending in the Central Government departments.

2. This orgy of financial indiscipline culminated in the last part of 1978 and the first quarter of 1979, when the Government employed credit from the Bank of Uganda to finance its requirements to a wholly unprecedented degree. In the last half of 1978 government borrowing from the Central Bank increased by 30% (by Shs. 1 bill.); in the first quarter of 1979 it rose by another 45% (another Shs. 2 bill.). From mid-1978 until the end of March, 1979, government borrowing from the Central Bank accounted for 87% of the total expansion in domestic credit over the period. The money supply in March 1979 exceeded that of a year previously by 35%. All of this monetary expansion occurred at a time when the economy was already severely disrupted, and overall economic activity was actually in decline.

3. The enormous monetary expansion through deficit financing in the face of economic decline is also reflected in the change in the relative role of currency in circulation in the money supply. Table 26.3 shows that up until 1974 currency accounted for a declining share of the money supply; indeed this share declined much more rapidly than is typically the case in developing economies. Thereafter, however, the trend was reversed and currency in circulation assumed a progressively greater role again. In March 1979, currency in circulation made up 51% of the total Ugandan money supply; the corresponding figures in Kenya and Tanzania at this time were 28% and 36% respectively. By itself, such a trend could be interpreted as a gradual reversion back to the levels of development of ten years previously, and a relative decline in the importance of 'modern sector' activity. In the Ugandan context it also indicates the presence of substantial liquidity in the 'informal' or illegal sectors.

Table 26.1

Indicators of Monetary Expansion and the Role of the Bank of Uganda 1970-79

	<u>Dec. 1970</u>	<u>Dec. 1974</u>	<u>March 1979</u>
Government borrowing from the banking system as % of total domestic credit outstanding	39	65	72
Government borrowing from Bank of Uganda as % of total government borrowing from banking system	59	58	78
Government borrowing from Bank of Uganda as % of total domestic credit outstanding	23	37	56
Money supply (Dec. 1970 = 100)	100	272	707
Government borrowing from Bank of Uganda (Dec. 1970 = 100)	100	497	1921

Source: Calculated from data supplied by the Bank of Uganda.

Table 26.2

Monetary Survey, end March 1979 (preliminary)

	(Shs.m)
Foreign assets (net)	263.7
Monetary authorities (net) ¹	153.6
Commercial Banks (net)	110.1
Domestic credit (net)	11,463.2
Claims on Government (net)	8,257.2
Bank of Uganda	6,457.2
Commercial Banks	1,800.0
Claims on private sector ²	3,206.0
Money	7,807.6
Currency outside banking system	4,007.6
Demand deposits ³	3,800.0
Quasi-money ⁴	2,440.0
Other items (net)	1,479.3

Notes

- ¹ Includes Treasury foreign exchange holdings.
- ² Includes commercial bank loans to regional and local governments.
- ³ Includes demand deposits of regional and local governments with commercial banks.
- ⁴ Includes private sector deposits with Bank of Uganda.

Source: Bank of Uganda.

Table 26.3

Currency's Role in the Money Supply¹

	Dec. 1970	Dec. 1974	March 1979
Currency* as % of Money Supply	54	36	51
Currency* as % of Money plus Quasi-money Supply	36	28	39

Notes

¹ Figures from 1970 to 1973 are not strictly comparable with those from 1974 to 1979, but the differences are slight.

Source: Bank of Uganda

* Outside banking system (i.e. in circulation).

Source: Bank of Uganda

4. The banking system is also suffering from the consequences of a protracted period of indiscipline and mismanagement. Government pressure was exerted upon the wholly-owned banks (Uganda Commercial Bank - UCB - and the Uganda Development Bank - UDB) and the Cooperative Bank (owned by its 43 member unions) to extend advances to enterprises and for purposes which would not have met conventional tests of creditworthiness. On the declaration of the economic war (in 1972) all public and parastatal bodies receiving grants from the Government were directed to transfer their accounts from expatriate banks to the Uganda Commercial Bank. Most of these were already bad and doubtful accounts. By 1978 the total of loans which this Bank had been required to take up had risen to over Shs.600 m. and the General Manager protested that this huge accumulation of mostly irrecoverable debt was threatening the stability of the Bank. The Government's response was his arrest and removal from his post!

5. War damages and looting reduced further the financial viability of many debtors of the commercial banks. The departure of supporters of the military regime also created 'abandoned' advances which substantially exceeded their deposits (by about Shs.10 m.) in the cases of UCB and the Cooperative Bank. (This imbalance was not found with Barclays, Grindlays or Standard Banks). At the end of May, doubtful debts of the commercial banks made up over Shs.700 m. of their total claims on the nongovernmental sector of Shs.3,000 m. This probably unrecoverable debt was particularly concentrated in the UCB, which alone accounts for about 70% of the country's commercial bank business; UCB has estimated its size at as much as 35% of its total advances.

6. Some of this doubtful debt - about a third of it - is that of cooperative unions. The bulk of the remainder is the debt of parastatal bodies to which loans were made primarily by the UCB, as a result of government pressure or directives.

7. Similar problems of bad debt, resulting from governmental pressures, financial mismanagement and war/looting damage, afflict other financial institutions in Uganda. Particularly seriously affected was UDB which provides short, medium and long-term finances; and offers managerial and technical assistance for firms engaged in agricultural, industrial, housing, tourist and commercial development projects. UDB was used by the previous regime as a 'lender of first approach', being required to finance people totally without business experience whom the Government wished to assist. It has been obliged to lend to the parastatal bodies and Government Corporations into which the Government converted private businesses. Large sums have gone into Uganda Airlines, Uganda Sugar Company, the Uganda Times and Lake Victoria Bottling Company, into maize mills, oil mills, beach villas, produce marketing, and paper bag manufacture - often in the form of forced loans, some of which it will be impossible to recover in full. The Bank was sometimes required to finance the same enterprise over and over as the regime reallocated the business to a new operator. (Combined Paper Bags of Jinja has been re-allocated four times). At the end of April, 1979, the amount of indebtedness to the Bank was Shs.185 m. with Shs. 62 m. in arrears, some of which is owed by clients who have fled the country since the war began.

8. Seasonal crop finance has been provided to the cooperative unions and private processors principally by the Uganda Commercial Bank, which is best placed to provide it because of its network of upcountry branches. Other banks provided modest finance to particularly creditworthy unions or processors; and, in recent years, contributed to a governmentally administered and guaranteed crop financing fund which, particularly in the case of the cotton crop where processors' margins have been especially hard hit, spread bank risks while ensuring that crops were moved. Less creditworthy coffee processors (unions and private processors) were in recent years also financed - at subsidised rates of interest - by the Coffee Marketing Board out of its abundant boom-years liquidity. Even before the war and looting losses of 1979, many of the cooperative unions and private processors were in serious financial difficulty; and payments on crop finance loans were substantially in arrears. At present, the total bad debt of the cooperative unions appears to be in the order of Shs.400 m. - over Shs.200 m. to the commercial banks (mainly UCB with some to the Cooperative Bank), Shs.200 m. to the Coffee Marketing Board. At current prices, the average requirements of crop finance are about Shs.500 m. (The raising of grower prices would obviously increase this figure). The machinery of crop movement is at present clogged because of the shortage of the financial lubrication necessary for its smooth functioning. There is an urgent need to rebuild that part of the financial system that relates to cash crop finance.

The Task Ahead

9. It is impossible to exaggerate the importance of the banking system to the national

reconstruction effort. It will be the task of the system to provide the short and medium term finance which is needed for the revival of trade, restocking of retail stores, and re-equipment of workshops. They must have a major role in providing finance to agriculture both to rehabilitate the processing plants in the cooperative unions and for taking off the crops in coffee, cotton and tea. Long term finance for rebuilding commercial and residential property must ultimately come from insurance and housing companies but the initial finance to set rebuilding in motion must come from the banks. Management in the banking system seems to be fully aware of its responsibilities in this regard and ready to discharge them.

10. The new Government can scarcely devote resources to relieving the UCB or the UDB of the burden of the questionable loans which were made under pressure from the Amin regime. The solution to the banks' irrecoverable loan problems will therefore be a long-term affair extending beyond the rehabilitation period. What is not recovered will have to be written off against profit over a number of years. All of the bad debt of the UCB and the UDB however cannot legitimately be held against the banks which were required by the Government to undertake the loans. Some accommodation will have to be worked out as part of the entire reorganisation of the parastatal sector and its finances. For the present, a moratorium on this debt should be declared, while a special task force or commission begins work on the latter task. This debt must not be permitted to paralyse the lending activities of the relevant commercial banks (particularly the UCB) or, in consequence, to inhibit the basic economic activities conducted by other parastatal bodies and the private sector. Working capital is urgently needed for the activities of productive enterprises, and the commercial banks should be encouraged to provide it while at the same time imposing strict creditworthiness conditions and supervision. The Bank of Uganda should let it be known that this is the policy it favours, provide discounting facilities for the local bank-held government stock, and stand ready to offer further credit to the two troubled domestic banks if required. It should also consider the relaxation of its present controls over advances, and retreat for the present to a loan monitoring posture.

11. The UDB will have no prospects of profits, and hence no hope of survival, unless:-

- (a) it is immediately left free to apply independent banking judgments to new loan applications, and
- (b) it is supplied with additional funds in the shape of both equity and loan capital.

The Government should increase the paid up capital to the authorised limit in the coming year, and should try to negotiate external loan funds for the Bank from the IFC, IBRD or the African Development Bank. The UDB estimates that it can usefully employ about Shs.250 m. in the next two years. For the longer term, the possibility of establishing a Small Business Division of this Bank or a separate small business lending institution should be considered.

12. The commercial banks will happily provide current crop finance for those they believe to be creditworthy. Loan supervision would be substantially enhanced if only one bank were to engage in crop financing with each union, although this could sometimes result in more concentration of bank lending than is permitted under the Bank Act. The difficulty is that - even allowing for substantial diversions of the crop, analogous to those recently occurring in the direction of neighbouring countries, towards those buyers with money to pay for it - the total volume which can be handled by objectively creditworthy unions and processors falls far short of current productive capacity in the coffee sector (or potential capacity in cotton). The provision of supervised development finance for the rebuilding of the processors' vehicle fleet and facilities, would allow the problem to some extent, to solve itself. Crucial to such an 'automatic' solution, however, is a review of the size of the stipulated processor/cooperative margin. Its size should henceforth be determined according to a more flexible formula which takes into account individual differentials in transport and other input costs, and in expected throughput; it should not, however, be so closely related to these factors as to remove all incentives for productivity improvement. If it is politically necessary to retain a uniform grower price everywhere, the differences in margins should be absorbed at the Marketing Board level; it would otherwise be preferable to permit the grower price more accurately to reflect the cost of moving the crop from alternative locations and through alternative channels.

13. There remains the problem of the large 'overhang' of cooperative union bad debts, and the immediate needs of unions which could profitably handle the current crop (particularly if their margins were increased) but which are unlikely to attract commercial bank loans because of their heavy outstanding liabilities. It is important that this 'overhang' quickly be removed by the declaration of a payments moratorium (by the Government), pending a case-by-case review of the distribution of the burden of the required write off among banks, Government and debtors.

14. The Bank of Uganda should monitor the adequacy of crop finance. It should be prepared to discount Government bills or advance credit to the UCB or the Cooperative Bank for the purpose of crop finance, if it perceives that such finance is not forthcoming in adequate amounts.

15. The virtues of coordinated bank monitoring and supervision of individual borrowers are such that consideration should be given to the bringing together of crop and development financing functions within the Cooperative Bank. An externally financed cooperative assistance programme could then be channelled effectively through the latter Bank.

16. One constraint on the ability of the system to respond to the challenge will be a shortage of foreign exchange. Many of the expatriate banks have already come forward, we understand, with offers to the Government of loans in foreign exchange. We consider that expatriate banks can properly be required by the Government to supplement their offers by providing a supply of overseas credit to their own local customers during the period of reconstruction. The hard pressed reserves in the Bank of Uganda would thereby be provided some welcome relief. The lines of credit would no doubt have to revolve on a six-monthly basis, but extension of the credit for not less than two years is recommended. If an approach on these lines is made to each of the expatriate banks the response is likely to be favourable. The two non-bank credit institutions with external affiliations - Grindlays International and National Industrial Credit - which offer finance of a different type should be asked to do the same for their customers.