

FOREIGN EXCHANGE POLICY

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Introduction

1. It is impossible to consider the issues surrounding foreign exchange and exchange rate policy without placing them in the context of overall policy objectives and constraints. The economy of Uganda is at present afflicted with a severe shortage of imported goods and services: agricultural and industrial inputs, spare parts, essential consumer goods, machinery and equipment. This shortage has not only caused vast underutilisation of productive capacity but has also generated high prices, together with the dissatisfaction and low labour productivity associated with the lowered real incomes. Government attempts to hold down prices for scarce products through price controls have merely generated high magendo profits for favoured buyers who resell on thriving free markets. It must therefore be a major objective of Government to find means of paying for the increased imports which the economy so desperately requires. At the same time it should seek to reduce the opportunities for and incomes from magendo activities.

The Earning of Foreign Exchange

2. Every effort must be made to acquire official development assistance and to borrow from other sources at reasonable terms. It is also to be hoped that world prices for Ugandan exports will rise, and - though this seems very unlikely - that the prices of Ugandan imports will fall. But there is ultimately very little which Uganda can do either about the decisions made by potential foreign sources of capital or about its external terms of trade. The only area for major independent initiative by the Government of Uganda in its struggle for expanded means of acquiring crucial imports is its export policy.

3. The Ugandan export volume has fallen drastically in recent years. Vast quantities of Ugandan coffee (an estimated 50,000 - 60,000 tonnes per year) have been smuggled across foreign borders, thus earning the country lower earnings and depriving the Government of needed revenues; reduced picking, abandoned acreage and accumulation of unsold stocks have been further causes of declining coffee exports. Similar declines have occurred in the exports of tea and cotton, which would have declined even more had the Government not provided them with subsidies to offset their rising costs. (At the same time declining production in the sugar, tobacco and other industries have led to unnecessary increases in the demand for imports). There is at present substantial unutilised or underutilised capacity in the agricultural sector, particularly in the export crops.

4. It should therefore be Ugandan policy:

- (i) to move into official marketing channels all produce now being smuggled across the borders, particularly coffee (but also some cotton and cattle);
- (ii) to provide adequate incentives for the full utilisation of under-utilised and low-cost agricultural resources (including those in processing facilities), the rehabilitation of socially productive agricultural assets which are currently abandoned (11,000 ha. in tea; 25,000 ha. in sugar, and unknown areas in coffee), and the adoption of socially profitable innovations in export crop production.

5. These objectives can be attained by substantial increases in the real returns offered to agricultural export producers, notably those in coffee, tea and cotton. The analysis in the Commonwealth Team's report on agriculture shows the precise extent of the real grower price increases which are needed. The timing of these increases must be considered in the light of possible physical constraints on transport and processing capacity for the expected volume expansion.

6. How are the increases in real grower prices to be realised and how are they to be financed? We have encountered two basic approaches to the first of these questions. The first seeks to lower the money prices for farm inputs and the consumer-goods which growers purchase with their earnings. The second seeks to raise the money prices for grower outputs - of coffee, tea and cotton.

7. The lowering of input prices implies government subsidies, which immediately raises the question of how they are to be financed (see below). It also restricts the benefits to that minority of Ugandan farmers which at present employs such off-farm inputs, and the subsidised inputs create the potential for magendo activities and abuse of administrative discretion. The lowering of consumer good prices would, if it were possible, be a desirable way of increasing incentives for both urban and rural productive activities, and might eventually even help to bring down uncontrolled wage rates. But it is the underlying scarcity of consumer goods which is responsible for their high prices. Lowering control prices will achieve nothing. Unless some new and continuing source of foreign exchange appears which can be employed to increase consumer good imports and restart Uganda's factories, there is no prospect of reducing these prices. Even if that were achieved - and there is no evident means through which it could be - it would still not alter the structure of relative agricultural prices, and would not necessarily therefore achieve the reallocation of effort toward agricultural exports (and some import-substituting cash crops like sugar and tobacco) which is sought. Indeed, downward 'stickiness' of prices might even limit absolute price reductions.

8. The raising of prices for grower output (and, in the case of cotton, the margins for processing) - the second approach - requires analysis of how it could be financed. The team has calculated that the prices required in order for the major agricultural exports to be effectively revived are Shs.6 per kg. seed cotton (up from Shs.5); Shs.7 per kg. kiboko (robusta coffee) (up from Shs.3.50); and Shs.2 per kg. green leaf tea (up from Shs.1.25). The payment of these higher prices implies increased subsidies to tea and cotton exports, and the lowering of the export tax on coffee. The effects would be as follows:

- As exports activity revived in response to these incentives, volumes would increase and the size of the subsidies - particularly in the case of cotton, would soon become very large. With high world coffee prices it might be possible to retain significant export taxes on coffee exports, but grower prices would still have to be kept roughly in line with Kenya ones, while the Ministry of Finance would chafe at the resultant foregone revenues. The only possible sources of the increased tax revenues which could offset these subsidies and tax losses are import duties and sales taxes. Since these would be paid only by those who import at official exchange rates, such increased taxes could have the extra benefit of cutting somewhat into the potential magendo margins between the prices paid by importers - with preferential access to Foreign exchange - and free market prices. But the political implications of raising taxes steeply for the purpose of subsidising particular groups of farmers could be serious.

9. Another means of financing higher grower prices for coffee, tea, cotton and other exports is an increase, by the Bank of Uganda, of the value of foreign exchange earnings in terms of Ugandan shillings, i.e. devaluation. This would provide explicit and obvious recognition of the high value which Uganda must at present place upon foreign exchange, recognition which is implicit in the present tight foreign exchange controls. It also quickly generates large tax revenues. Table 25.1 shows the implications of varying degrees of devaluation for the total governmental surplus or subsidy (per kg. at the grower level) in the external marketing of coffee, cotton and tea at current (or proposed) grower prices. (The calculations are those of D.G.R. Belshaw. Their methodology is discussed in Paper 3). It should be evident that devaluation provides a convenient possible means of providing the necessary incentives to agricultural exporting without placing new burdens upon the revenues of the Ministry of Finance. To the contrary, it could provide substantially expanded coffee export tax revenues. With a grower price for kiboko of Shs.7 per kg., a 50% devaluation with a world price of \$1.70 per lb. raises Government revenues by about Shs.18,000 per tonne; or, on expected volumes of export, by Shs.2,000 m. or more.

Table 25.1  
 Producer Prices, Subsidy/Surplus and Devaluation

	No Devaluation	20% Devaluation*	33% Devaluation*	50% Devaluation*
<b>A. COFFEE</b>				
(Shs. per kg/kiboko)				
<u>Required grower price: 7.00+</u>				
Net export price**	13.80	17.20	20.60	27.60
Producer price++	<u>7.00</u>	<u>7.00</u>	<u>7.00</u>	<u>7.00</u>
Surplus	6.80	10.20	13.80	20.60
<b>B. COTTON</b>				
(Shs. per kg., seed cotton)				
<u>Required grower price: 6.00+</u>				
Net export price**	3.00	3.75	4.50	6.00
Grower price++	5.00	5.00	5.00	<u>6.00</u>
Surplus/Subsidy***	-2.00	-1.25	-0.50	-
<b>C. TEA</b>				
(Shs per kg)				
<u>Required grower price: 2.00 (green leaf) +</u>				
Auction (Made tea price)**	9.00	11.25	13.50	18.00
Grower price, green leaf ++	1.25	1.80	2.00	<u>2.00</u>
Surplus/Subsidy, made tea***	-3.75	-3.75	-2.50	2.00

Notes:

\* This percentage refers to the percentage decrease in the value of the Ugandan shilling in terms of foreign currency. For example, if one shilling now costs 1/8 of a US dollar, whereas after devaluation it costs 1/16, a devaluation of 50% is said to have occurred.

\*\* Net of processing, selling costs, etc.

\*\*\* Minus sign indicates subsidy.

+ Required to induce full utilisation of potential.

++ Where the required grower price for full utilisation of potential can be paid without a subsidy this is shown, and the figure is underlined. Otherwise, the current actual price is shown.

Source: Commonwealth Team Estimates.

## The Use of Foreign Exchange

10. The extreme scarcity of foreign exchange implies that there may be very high rewards to those fortunate enough to acquire it. The black market price of foreign currency in terms of Ugandan currency is substantially higher than that at which the Bank of Uganda makes it available to licensed importers. Were it not for the follow up activities of the foreign exchange control authorities the Bank's allocations could indeed immediately be sold on 'free' markets at a huge profit. The shortages of imported products within Uganda obviously offer profit opportunities to licensed importers and their friends which are not inherently different from such currency profiteering. Where there is no control price, the opportunity for profit is provided directly to the importer by giving him the right to purchase at a low price that which is selling at a high one. (This obviously is as true of goods supplied by foreign aid donors as of those supplied from commercial sources). Where the Government of Uganda has fixed the prices of imported goods there exists a thriving 'uncontrolled' market in which prices for the same items are much higher. It follows that whoever is given access to the scarce goods at the control prices can earn an enormous profit by selling on the uncontrolled market; and the importer can decide who the lucky ones are. In some recent cases, imports intended for Uganda have quickly found their way into foreign countries because the importers who have obtained them cheaply found that the highest profits could be earned by selling them elsewhere. Thus the opportunities created by import licensing and foreign exchange controls for magendo profits can be very large. This type of profiteering is not in the national interest. It is therefore important that the system of import allocation and the eventual distribution system be carefully planned.

11. There are different ways in which the opportunities created for magendo profits on imports (or, for that matter, on locally produced goods) can be reduced or eliminated. All of them depend ultimately on the reduction or elimination of the differential between control prices and free market prices; for as long as a differential exists there will be strong motivation for profiteers to take advantage of it. And all of them involve a transfer of potential magendo profits to the Government of Uganda, which certainly needs the revenues in the present time of national crisis.

12. One way is to impose a tax - an import duty or a sales tax - on the imports which the favoured (licensed) importer acquires with the foreign exchange which he is allocated. He may try to pass such a tax on to the consumer by raising his price, but there are limits to his capacity to do so because consumers can always continue to buy the same item on the free market; thus the differential between the cheap control price at which he buys (because of his access to foreign exchange at the official rate) and the free market price at which he (or his friends) sell is reduced. Another device which may be employed is public sale by the Government through competitive bidding (auctioning), of the cheap imported goods or the licenses to import them, or the foreign exchange itself - either to wholesalers or retailers. Since traders know that they can make easy profits on these items by selling them at free market prices they will bid up their price, creating revenues for the Government with the same effect as if the Government had imposed a tax on them in the first place. An auction system may sometimes be manipulated, however, by powerful interests or organised groups who conspire to keep their offer prices low. Publicity in respect of the auction prices would at least make consumers aware when they were transferring large profits to such traders; but there is no guarantee that they could do very much about it. A third device, which achieves the same effect, and which is administratively the simplest, is to increase the price of the foreign exchange which is made available to licensed importers, i.e. a devaluation of the Ugandan currency.

13. Certainly the riskiest system of import licensing and foreign exchange allocation is one which combines administrative decision-making with large differences between official prices (whether of foreign exchange or of goods) and free market prices. In such circumstances the temptations for improper exercise of influence, corruption, and profiteering are usually too great to resist. Where, as in Uganda, many have grown accustomed to earning substantial shares of their incomes through magendo activities, and where national rehabilitation depends upon the creation of a whole new work ethic, it seems to us foolhardy to retain a system with such powerful elements of temptation in it. There may be considerable reluctance within the civil service to abandon the influence, power, and income-earning opportunities with which the present arrangements provide some of its members; but it must be resisted in the national interest. Administratively the most simple means of reducing magendo opportunities and the improper use of influence is unquestionably devaluation. As has been seen, it is also

a convenient means of achieving the increases in export volume which are also sought, without burdening government revenues.

14. We recognise that, for the present, even with a devaluation, there would be no alternative but to retain very tight administrative controls upon the use of foreign exchange. But we would urge against erecting a permanent administrative apparatus - which might, once vested interests had been created, be difficult later to dismantle - for the management of what we hope will be a temporary crisis situation. While erecting a sound foreign exchange management system for the purpose of crisis control it should already be possible to move some way toward the longer-run objective of a freer economy, operating with exchange rates which do not offer incentives for improper activities.

#### The Management of Foreign Exchange Scarcity.

15. Crucial to the effective management of the use of scarce foreign exchange is the machinery through which it and the imports which it purchases are allocated and distributed. There are essentially three functions which the government authorities need to perform:-

- 1) the preparation of a foreign exchange budget, setting out the flows of foreign exchange expected to be available and the broad sectoral and functional allocations for their use, determined on the basis of national economic priorities;
- 2) the licensing of specific importers of specific goods and services, under the broad allocation headings established by the foreign exchange budget;
- 3) foreign exchange control, the provision of foreign exchange in the requisite amounts to licensed importers for authorised uses, and the follow-up activities to ensure that it is used for the correct purposes.

16. The foreign exchange budget must be reassessed on a regular basis, as earnings expectations change and priorities are reconsidered. An interministerial committee chaired by the Ministry of Finance or the Bank of Uganda should draw up such a budget at, say, three to six month intervals on the basis of information provided to it by the relevant government ministries and parastatals. It is usual to allow room for some unexpected contingencies so as not overly to restrict those who administer the system and to avoid the need for overfrequent review; but in present Ugandan circumstances any contingency provisions will have to be unusually small and the budget will have to be reviewed more frequently. Such a budget has already been put together in this way. It now remains to ensure that the priorities there identified and the allocations already agreed are firmly adhered to, and to systematise its implementation and regular review.

17. The administrative function of import licensing can eventually be undertaken by the Ministry of Commerce and Industry on the basis of its knowledge of the relevant sectors and with continual reference to the foreign exchange budget's allocations. At present, this function is being undertaken by the Bank of Uganda at the same time as it provides the requisite foreign exchange. This centralisation of the two functions of licensing and foreign exchange control became necessary after the breakdown of the previous licensing arrangements, the delay in the establishment of new administrative arrangements, and the urgent need for effective controls. While the Bank is performing its combined role well, it imposes a heavy extra administrative burden on an institution with important other responsibilities, and creates an undue concentration of control in one location. As soon as administrative capacity elsewhere is restored, therefore, consideration should be given to relieving the Bank of Uganda of its licensing responsibilities.

18. As has been seen, foreign exchange controls are the responsibility of the Bank of Uganda. Eight other African countries, including Tanzania and Kenya, employ the services of an international firm which specialises in the pre-shipment inspection of goods destined for export; the foreign exchange control authorities in these countries will not release foreign exchange to importers until they have evidence that the shipments destined for their ports are of appropriate quality, quantity and price, as certified by the firm in question. The Bank of Uganda should consider employing such foreign services as well; in doing so, it should be careful to pay only for inspection on major items, since there is some evidence to suggest that other African countries

have paid for more such services than they really need for effective foreign exchange control. Equal care must be taken to monitor other expenditures of foreign exchange, such as those on foreign interest, dividends, royalties, and fees.

19. None of this foreign exchange budget and control machinery will function unless the correct procedures are rigorously followed. Because of the wanton disregard of established channels and the widespread abuse of power within the Amin regime's system (if it can ever be called a system) of foreign exchange allocation, it is particularly important quickly to re-establish confidence in the new system. Its restoration deserves and requires firm support at the highest political level.

20. As soon as is practicable, the foreign exchange budget and licensing system should be eased in order to increase opportunities for the socially profitable use of foreign exchange by innovative Ugandans. It should be possible to make special provision at an early date for small and medium-sized local businesses which are sometimes forgotten in centralised planning exercises.

21. The increased taxes on imports or devaluation - one or the other of which is required for the expansion of export volume and the effective management of imports - is unlikely significantly to change the cost of living for the average wage and salary earner. These policy measures will simply decrease magendo trading while leaving legal prices more or less in the region of current free market prices. The only major losers would be those who now have preferred access to controlled prices. But the real returns from ordinary legal wage and salary employment have fallen to such low levels in recent years that early consideration will have to be given to their improvement, particularly at the lowest income levels. The overall economic decline of the Ugandan economy and the need to restrict spending to levels commensurate with total production makes it impossible to consider their restoration to previous real levels for some time; but, particularly at the bottom end, some relief is required to permit the realisation of the most basic needs, and to maintain labour productivity. It should be the object of wage policy, as of other price policies, to reduce the differential between controlled and 'free market' rates of return for equal labour inputs.

22. The precise mix and sequencing of Uganda's foreign exchange earning and management policies, require careful consideration and planning at the highest level. Whatever the policy mix chosen, adjustment and restructuring will be much easier to accomplish if there is programme (balance of payments) assistance from abroad while it is undertaken. Programme assistance is usually only made available, if at all, when recipient governments can demonstrate that they have instituted effective economic planning and financial controls. Uganda is unlikely to be treated any differently in this respect. This provides a further reason for the early development of effective planning and control systems.