Has the Privatization of Uganda Commercial Bank Increased Competition and Extended Outreach of Formal Banking in Uganda?
Abstract:

Financial sector development can reduce poverty and promote economic growth by extending access to financial services in developing countries. Traditionally, banking in Sub-Saharan Africa has been conducted by state-owned banks. Although, evidence has shown that severe government involvement in the banking sector has proved to cause low profitability and inefficiency. During 2001, Uganda Commercial Bank, the dominant provider of banking experienced financial problems; as a result, the government had to privatize the bank. The aim of this thesis is therefore to investigate if the privatization prevented the banking sector from collapse and if it made the sector more competitive and outreaching. The main conclusion is that the privatization strongly prevented the banking sector from collapse. Since privatization, competition has increased sufficiently in urban areas of Uganda while rural areas have not experienced any significant increase in competition. Finally, we conclude that the outreach of banking has increased somewhat since the privatization, but it is still relatively poor.

Key Words: Sub-Saharan Africa, Uganda, Financial Development, Financial Structure, Access to Finance, Banking, Bank Competition, Bank Privatization, Outreach of Banking
Abbreviations Mentioned in the Essay:

ATM – Automated Teller Machine
BOU – Bank of Uganda
CERUDEB – Centenary Rural Development Bank
CGAP – The Consultative Group to Assist the Poor
CPI – Consumer Price Index
GDP – Gross Domestic Product
IDA – International Development Association
IMF – International Monetary Fund
NBFI – Non Bank Financial Institution
NGO – Non Governmental Organization
OECD – Organisation for Economic Co-operation and Development
Stanbic – Standard Bank of South Africa
UCB – Uganda Commercial Bank
UNCDF – United Nations Capital Development Fund
UNCTAD – United Nations Conference on Trade and Development
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1. Introduction

Half of the world’s population, 3 billion people are by definition considered poor, meaning that they live on less than 2 US$ a day.¹ One thing that most of them have in common is that they lack access to financial services. Sub-Saharan Africa is a region that suffers from extreme poverty, constrained by political unrest and lack of functional economic institutions.² One of the largest flaws in African finance is poor outreach of basic bank services to low-income citizens such as savings, credits and insurances.³ This is the reality for the vast majority of Africa’s population. In fact, only 20 percent of the African households have access to formal banking services.⁴ Historical evidence shows that the emergence of sustainable economic institutions can initiate and enhance economic growth. Formal banking institutions often serve as catalysts for growth, and historically, the banks have had an essential part in the early stages of economic development.⁵

By connecting savers and entrepreneurs, financial systems reduce risks and open up opportunities. Functional banking institutions can reduce the barriers to entry for entrepreneurs and thereby create vast benefits for the economy as a whole. Given access to banking services, farmers can achieve higher productivity and output. Savers can simultaneously benefit from the returns of enhanced flows of investments. The banking system also enables people to borrow and lend in order to start up businesses, finance their accommodation, or save for retirement.⁶ Without a functioning banking system, these stages in a person’s life might be impossible; consequently this affects the entire economy’s ability to grow and prosper. A strong financial infrastructure serves as a prerequisite for economic growth, and banking sector development is therefore highly prioritized to sustain and enhance economic growth in a developing region like Sub-Saharan Africa.⁷

² Helms, B. *Access for All – Building Inclusive Financial Systems*. p.15
⁴ Ibid.  p.35
⁵ Fälting, L. Liljefrost, E. & Petersson T. *The Microfinance Revolution Revisited: Experiences from the Savings Banks History in Sweden*. p. 34
⁷ Hauner, D. Shanaka P. *Bank Efficiency and Competition in Low-Income Countries: The Case of Uganda*. p.17
Theoretically, the importance of a well functioning network of financial intermediaries is supported by neo-classical growth theory which states that increased saving is a vital aspect that leads to economic growth.\textsuperscript{8} Increased capital accumulation is a necessity for growth to take place, but the practical problem, which is the main bottleneck in Africa today, is to find a sustainable source for the accumulation of capital. Traditionally, Sub-Saharan countries have mainly relied on banking systems consisting of one state owned bank, facing little or no competition.\textsuperscript{9} After independence, the African banking system was dominated by foreign banks that mainly had their interests overseas. To overcome the insufficient access to finance, the governments founded their own commercial banks.\textsuperscript{10} However, heavy government involvement has proved to be a source of low profitability and lack of efficiency.\textsuperscript{11} Therefore, the strategy advocated by the IMF and the World Bank regarding banking in developing countries relies to a large extent on market forces. The consensus is that countries should abandon the inward-oriented model of bank provision and instead aim for international financial market integration that enhances competition.\textsuperscript{12}

Empirical evidence from research on Sub-Saharan African countries indicates that since the 1980s, the most successful way of structuring the formal banking sector is through moderate or even very little government intervention; where the banking sector consists of a number of private formal commercial banks that sustain a high level of competition. This way, interest rates will be determined by market mechanisms, less corruption occurs than under government provision and the sector stays solvent and sustainable due to each private operator’s incentive for profit maximization.\textsuperscript{13} During the last decade, several African countries have started to show tendencies of increased political stability and stronger economic institutions.\textsuperscript{14} One of these countries is Uganda, which has shown proof of progress when it comes to the establishment of sustainable economic institutions.\textsuperscript{15} Historically, the Ugandan banking sector has been highly dominated by the state owned Uganda Commercial Bank, which has been the back-bone of the banking sector in the country ever since the 1960s.

\footnotesize
\textsuperscript{8} Blanchard O, *Macroeconomics*. p.243
\textsuperscript{9} Perkins D, *Economics of Development 6th Ed.* p.21
\textsuperscript{10} Daumont R, Le Gall F, Leroux F, *Banking in Sub-Saharan Africa: What Went Wrong?* p. 28
\textsuperscript{11} Ibid. p.5
\textsuperscript{12} Callier P (ed.), *Financial Systems and Development in Africa*. p.77
\textsuperscript{13} Brownsbridge M, Harvey C, *Banking in Africa*. p. 220
\textsuperscript{15} Deshpande R, Pickens M, Messan H, *Uganda Country-Level Savings Assessment*. p. 3
In the 1990s, UCB suffered from severe insolvency which caused the government substantial costs. However, the bank was essential for the entire nation, so the government simply had to privatize it. The purpose of the privatization was to save the banking sector in Uganda from collapse and to make the sector more competitive, but also to extend outreach of financial services.\textsuperscript{16} We think that the privatization process in Uganda is an interesting case to study in order to strengthen the knowledge concerning the effects of private provision on the banking sector in developing countries.

1.1 Purpose

Our point of departure is that economic development can be promoted by viable and stable financial institutions such as the formal banking system. As we have already stated, lack of access to financial services is an obstacle that hinders development of the Ugandan economy. Although, during the end of 2001, an important event occurred within Uganda’s banking sector. UCB, the single largest provider of banking was transformed from being a state owned bank to becoming a privately held company, owned by the South African bank Stanbic Ltd. The purpose of this essay is therefore to analyze if the privatization of UCB prevented the formal banking sector in Uganda from collapse and to investigate if the privatization has increased competition and outreach of formal banking in Uganda.

In order to draw comprehensive and satisfying conclusions concerning the main problem, we will answer the following sub-questions:

- How has Stanbic performed since the privatization?
- How has Stanbic’s performance affected the market for formal banking in Uganda in terms of competition?
- How has Stanbic’s performance affected the outreach of formal banking?

1.2 Limitations

In Sub-Saharan Africa, the informal banking sector is important for the poor population, mainly serving those who are not profitable customers for the corporations that conduct formal banking services. The informal banking sector consists of NGOs, NBFIs, cooperatives, private moneylenders and other organizations that conduct microfinancial services. By definition meaning that they act as financial intermediaries that give poor people access to

\textsuperscript{16} Bank of Uganda, \textit{Press Statement on Uganda Commercial Bank, 30 May 2000}
small scale financial services such as saving, lending and insurance.\textsuperscript{17} There are certainly many positive aspects related to informal banking because it serves the unbanked poor that do not have access to formal banking. At the same time, one must be cautious because the informal sector is not subject to the same rules and regulations as the formal banking sector. Therefore, there is a high risk of fraudulent behaviour and usury.\textsuperscript{18}

The focus of our analysis will be on formal banking, meaning that we are aware of the informal banking sector, but it will not be covered in our analysis. We have chosen to limit our analysis to the formal banking sector because it is first of all very influential, and it is also more structured and therefore easier to measure than the informal sector. As a result, we find the formal sector being a more reasonable objective to analyze with regards to our time constraint and standard of attainment. The informal sector is certainly important, but we think that a thesis of this proportion will not be sufficient to fully cover such a complex issue. Therefore, our focus throughout the analysis will be directed towards the formal banking sector.

2. Theory

2.1 The Nexus between Financial Development and Economic Growth

Traditionally, economists have had different opinions concerning the importance of a financial system for economic growth to emerge. Some believe that the financial sector emerges along with the expansion of enterprises while others simply do not believe that there is an essential relationship between financial development and economic growth at all. Hence, the dominant theoretical consensus among economists today is that there is a clear positive relationship between financial sector development and economic growth.\textsuperscript{19} In fact, several indicators point out that financial sector development serves as a prerequisite that has to be fulfilled in order for economic growth to take place. The financial sector can influence economic growth through two channels; either through increasing the capital accumulation within an economy or through nurturing technological innovation.\textsuperscript{20} The financial sector also eases the handling and pooling of risk and can contribute to lowering transaction costs within

\textsuperscript{17} Microfinance Information Exchange
\textsuperscript{18} Ibid.
the economy by mobilizing savings and allocating resources from those who have excess capital to those who are in need of capital for investments.

One of the pioneers concerning research on this topic was Goldsmith (1969), who pointed out the relationship between financial sector development and economic growth. Another economist who earlier had made progress within this area was Schumpeter (1912), describing the role of the financial system and particularly the banking system in the following way:

“Well-functioning banks spur technological innovation by identifying and funding those entrepreneurs with the best chances of successfully implementing innovative products and production processes.”

In a market economy, individuals and firms have the opportunity to exchange consumption across time by borrowing or lending. The transactions of funds between borrowers and lenders are helped by functioning financial markets. Henceforth, we assume that everyone can borrow or lend unlimited amounts at the market interest rate, $r$. The market rate works as a signal for making optimal consumption and investment decisions; this means that market disturbances which create interest wedges hinder an effective allocation of resources. Thus, a market with a strong competitive climate, where supply and demand are the driving forces for the interest rate, is a necessity for an optimal and efficient allocation of resources. The exchange of consumption bundles across different time periods is illustrated in figure 1.

![Figure 1: Intertemporal Exchange of Consumption Bundles:](image)


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The endowment point $A$ shows the firm’s initial level of consumption at the utility level $U_0$, let $y$ denote the income for a single firm on the market. By borrowing or lending the firm can move freely along the capital market line. In our figure, point $B$ represents a consumption bundle on a higher indifference curve that can be attained through increased saving. The reason why the firm, in our case, maximizes its utility in point $B$ is that the market lending rate is higher than the lending rate associated with our preferences in point $A$. In other words, the marginal utility rate of return on an invested dollar is greater than the cost of making the investment, considered the preferences in the endowment point. The preferences vary along with each firm’s wish for saving or borrowing in order to maximize utility, by being able to shift consumption across time periods.\(^{24}\)

In the endowment point $A$, the horizontal intercept is defined as:

$$W_0 = y_0 + \left(\frac{y_1}{1 + r}\right). \quad (1)$$

and the vertical intercept is defined as:

$$W_1 = y_1 + y_0(1 + r), \quad (2)$$

where $W_0$, our current wealth, is the present value of the consumption in the endowment point. In point $B$ we get that:

$$W_0 = C^*_0 + \left(\frac{C^*_1}{1 + r}\right), \quad (3)$$

a rearrangement gives us the equation for the capital market line:

$$C^*_1 = W_0(1 + r) - (1 + r) C^*_0. \quad (4)$$

Another rearrangement tells us that $W_0(1 + r) = W_1$, equation (4) can then be written:

$$C^*_1 = W_1 - (1 + r) C^*_0. \quad (5)$$

The ability to borrow or lend gives a single firm the opportunity to consume more than its share of current production, meaning that we can consume more today or more in the future depending on our time preferences. A functional capital market is indeed important for an efficient allocation of resources and utility maximization. Financial intermediaries like formal banks are institutions that lower the transaction costs associated with borrowing and lending on the capital market. If the banking sector is run in an inefficient way, the transaction costs will increase, in other words, the wedge between the borrowing rate and the lending rate will increase. This follows because the interest wedge represents the fee charged by formal banks for services provided. Thus, increased transaction costs i.e. a larger interest wedge leads to an inefficient allocation of resources, explained in figure 2.25

As a consequence of the transaction costs, the borrower and the lender will face different interest rates; the lender is forced to charge a higher price for the services provided which in turn leads to a larger interest wedge. As we see in figure 2, this leads to a lower utility for the two firms than at a common market-determined interest rate. The optimal capital market line is illustrated by the crosshatched line.26

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26 Ibid. p. 13
2.2 The Interest Wedge as a Measure of Market Efficiency

A large interest wedge is a sign of an inefficient allocation of resources. Thus, developing countries do benefit from satisfying efficiency according to the World Bank:

“A basic benefit of enhanced efficiency is a reduction in spreads between lending and deposit rates. This is likely to stimulate both greater loan demand for industrial investment (and thus contribute to higher economic growth) and greater mobilization of financial savings through the banking system.” 27

The fact that it is increased transaction costs that leads to a larger interest wedge is not sufficient as the sole foundation of an empirical analysis. To be able to draw concrete conclusions about a specific situation, we need a more profound theory concerning the mechanisms that influence the wedge. McKinnon (1991) states that the two strongest forces behind a larger wedge between commercial banks’ lending and deposit rates are an increasing inflation rate and higher reserve requirement:

let \( \pi \) denote the actual and expected inflation, and let \( i_d \) and \( i_l \) denote the nominal deposit and lending rate. The real deposit rate, \( r_d \), and the real lending rate, \( r_l \), will then be defined as:

\[
\begin{align*}
    r_d &= i_d - \pi, \\
    r_l &= i_l - \pi.
\end{align*}
\]  

(6)

Further, let \( k \) denote the average percentage reserve requirement that is imposed on commercial bank deposits, \( D \). The private loans, \( L \), are then:

\[
L = (1 - k)D.
\]  

(7)

McKinnon presumes that the reserve requirements are non-interest-bearing, which means that \( k \) percent of commercial bank assets earn no return. This forces the banks to carry out severe reductions of their deposit rates. It is more clearly expressed in equation (8), where the nominal deposit rate is only \((1 - k)\) of the assets received from borrowers:

\[
    i_l = i_d / (1 - k).
\]  

(8)

27 Vittas D, Measuring Commercial Bank Efficiency, Use and Misuse of Bank Operating Ratios. p. 1
Equation (8) expressed in real terms gives us:

\[ r_l = \left( r_d / (1 - k) \right) + \left( \pi k / (1 - k) \right), \]  

(9)

it shows that the difference between lending and deposit rate is affected by the inflation rate, \( \pi \), the reserve requirement, \( k \), and the real deposit rate, \( r_d \).

McKinnon’s model states that when inflation increases, the interest wedge increases as well in order for the banks to maintain their level of profitability. This means that when the inflation rate decreases, the interest wedge should decline. We can now conclude that a given level of reserve requirements and a low inflation rate, ceteris paribus, should lead to a low interest wedge.\(^{28}\)

2.3 Bank Privatization in Developing Countries

State owned banks, holding a large share of the banking sector has traditionally been very common in developing countries, especially in Sub-Saharan Africa. Many of the state-owned banks have suffered from financial distress due to bad debt caused by mismanagement, weak internal controls, bad accounting procedures, corruption and political pressure from the governments to lend to unbankable borrowers in rural areas, leading to high transaction costs.\(^{29}\) This has forced governments in many developing countries to restructure the organizations through privatizations. Private provision of banking tends to lower the level of corruption within the organization, strengthen the incentives for strong internal control, and increasing the awareness of profitability, which lead to lower transaction costs.\(^{30}\) However, some negative effects are associated with private provision of formal banking. First of all, it rejects some hard served groups from banking. Another dilemma with privatizing state-owned banks that have large market shares is that the private operator that acquire the bank does not have any economic incentives to be concerned for the maintenance of a competitive market climate for banking.\(^{31}\)

On a monopolistic market, the sole provider of a service or good has market power and therefore holds the ability to make excessive profits (illustrated by the shaded area in figure 3.

\(^{28}\) McKinnon R, *The Order of Economic Liberalization*. p. 48f

\(^{29}\) Rogers M, *Corporate Governance and Financial Performance of Selected Commercial Banks in Uganda*. p. 2


\(^{31}\) Ibid. 220
below). Even though the aim with bank a privatization is increased and more efficient provision of banking, privatized monopolies might have the opposite effect.

As we can see, the monopoly is under-producing since the monopolist can set price and quantity at a level that maximizes its profits due to market power. In order for the providers of banking to maximize profits, they choose to produce the amount found in the intersection of marginal revenue (MR) and marginal cost (MC). At this price ($P_1$) and production ($Q_1$), the providers are under-producing, meaning that the optimal output for society would be at a higher quantity ($Q_3$) and at a lower price ($P_3$). In the situation illustrated in figure 3, the firm would produce output equal to the level in the intersection of the average total cost curve (ATC) and the demand curve (D). Even though the production level at $Q_3$ would be optimal, it is not a realistic because the firm would make economic losses at this level.

**Figure 3: Quantity of Banking Services Produced Under Monopolistic Conditions:**

A privatization that was supposed to lead to increased efficiency and outreach under competitive conditions, might instead become the market’s weakness, if it is signified by monopolistic market power. This is because the private provider that acquires the monopoly lacks the incentives to expand its operations to low-profitable areas. Instead, it takes advantage of the market power that the governmentally managed bank had before the

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privatization; simply by exploiting the profitable areas and leaving unprofitable areas unbanked in order to maximize profits.

Evidence from Africa has shown that even though the intentions of governmentally owned banks are good, the long term results achieved by private providers of banking are stronger and more sustainable. In fact, governmentally held banks tend to run into financial problems more often. Consequently, it seems like the most successful way of structuring the banking sector is through moderate or even very little government intervention where the banking sector consists of a number of private, formal commercial banks that sustain a high level of competition. This way, interest rates will be market-determined; less corruption occurs than under government provision and the banking sector stays solvent and sustainable due to each private operator’s incentive for profit maximization.

We recall that according to theory, an efficient market results in a small interest wedge. However, as we have shown, a market characterized by lacking competition leads to an inefficient allocation of resources. A low inflation rate, and a banking sector that is characterized by a high level of competition, implicates that the difference between lending and deposit rate should be low. The presumption that a large difference would be a sign of lacking competition is based on the fact that if the competition would be fair, the formal commercial banks would be forced to set lending rate as low as possible and deposit rate has high as possible to avoid losing customers to competitors.

Conclusively, the contemporary theoretical consensus concerning banking in Africa is that the most sustainable way of structuring the banking sector in developing countries is through private provision of formal banking.

34 Beck T, Creating an Efficient Financial System: Challenges in a Global Economy. p. 28
35 Hauner D, Peiris S, Bank Efficiency and Competition in Low-Income Countries: The Case of Uganda. p 3
36 McKinnon, R, The Order of Economic Liberalization. p. 48f
3. Method

3.1 Indicators

To be able to answer our main question, we will study a number of parameters that we consider relevant as indicators of contingent changes of formal banking, in terms of competition and outreach. Before we go further into our method, we would like to make clear that our analysis concerns two geographical areas. We define these two areas as rural and urban. In this context, we mean the capital of Uganda, Kampala, when we refer to urban. Therefore, the remaining parts of the country will altogether be defined as rural.

By studying the development of the number of bank offices, both by corporation and on an aggregated market level, we will get a clear overview of the changes in outreach and market share for each operator. In this context it is also important to take the population and the population growth rate into consideration. Combining data on the number of bank offices with population statistics will give us an overview of the market, not only in absolute terms, but also in per capita-terms. It is important to realize that an increase in bank offices in absolute terms not necessarily correlates with an increase in bank offices per capita. However, relying solely on data on the number of bank offices would not be enough to determine whether the formal banking sector is showing tendencies of increasing outreach or if it is just showing tendencies of an increasing concentration to any specific area. To overcome this problem, we will conduct a sector specific analysis where we will study how much each sector in the economy contributes to total GDP. These results will be compared to a sectoral breakdown of loans, which will make it easier to identify whether the outreach of formal banking services stands in proportion to each sector’s part of the economy.

According to theory, a large interest wedge is a sign of an inefficient allocation of resources and lack of competition. In the case of formal banking in Uganda, lacking competition has traditionally been the main cause of market inefficiencies.\footnote{Hauner D, Shanaka P, \textit{Bank Efficiency and Competition in Low-Income Countries: The Case of Uganda}. p. 1ff} To be able to draw more far-reaching conclusions about the competitive climate, we are going to study the development of the interest wedge between lending and deposit rates. Our point of departure is that we expect that a small wedge correlates with a high level of competition and vice versa because of the theoretical framework that we have presented earlier. However, we are aware of the fact that
the competitive climate is not the only factor that influences the lending and deposit rate. To overcome this problem we are going to apply our data on McKinnon’s theory concerning the interest wedge. McKinnon (1991) shows that inflation rate and reserve requirement impact the interest wedge. By comparing the development of the inflation rate and the interest wedge, we will be able to determine how well the two rates correlate. If we find large discrepancies between the expected theoretical value and the observed value, we conclude that an external factor is creating the wedge, presumably lacking competition. To estimate and isolate the impact that the competitive climate has on the wedge, we are going to calculate an estimated interest wedge for the observed time period which will be compared to the actual values. The estimated line tells us at what level the wedge is expected to be given the inflation rate, reserve requirement and deposit rate.

3.2 Criticism of Sources

We are aware of the fact that our purpose and method force us to rely on secondary data to a large extent. Even though bank specific data for every single provider of banking from the primary source would be desirable, we think that secondary data is sufficient for an analysis of our main problem. It would of course be optimal to conduct a field study; since it would ease the collection of data and give access to primary sources.

Being aware of shortages in the statistical material is essential, especially when studying a developing country like Uganda. It is important to realize that access to relevant data is often limited and not always completely reliable. We will most likely experience difficulties along the formation of this thesis due to lack of data and statistics, but our question seems answerable according to the material that we have studied. Our analysis will mostly be based on secondary data, collected from working papers conducted by the IMF, the World Bank and the United Nations along with data collected from Uganda Ministry of Finance, Planning and Economic Development, The Bank of Uganda and The South African Department of Trade and Industry. While working with a developing country like Uganda, it is essential to keep in mind that statistics and data must be analyzed carefully, even though the availability of data is improving, the quality-measures are still lagging behind. This enlightens the importance of a careful and profound analysis of the statistical material that we are going to present throughout this thesis.39

39 International Development Association, Measuring Results – Improving Statistics in IDA-countries, p. 5 f
4. Introduction to Uganda

Uganda is located in the Eastern parts of Africa, north of Lake Victoria. Its neighbouring countries are Kenya, Sudan, Congo and Tanzania. The capital of Uganda is Kampala. Uganda belonged to United Kingdom during colonialism and it became independent in 1962. After Idi Amin and Milton Obote’s dictatorship during the 1970s and 1980s, Uganda has experienced political stability and economic progress with declining poverty rates and increased economic growth.\(^\text{40}\) Since the 1980s, Uganda has had an annual average growth of GDP above 5 percent and the proportion of people living below the poverty line has decreased from 56 percent of the population in 1992, down to 38 percent in 2002.\(^\text{41}\) Approximately 30 million people are living in Uganda and, as mentioned recently are 38 percent of them are living below the national poverty line, meaning less than 2 US$ per day. Poverty is doubtless a major constraint for the Ugandan economy. HIV/AIDS is also a severe problem in Uganda, approximately 530 000 people are living with HIV/AIDS, causing a low life expectancy of approximately 50 years and a median age of only 15 years.\(^\text{42}\) Another challenging feature for Uganda is the fact that only 13 percent of the population lives in urban areas, a very low number compared to other Sub-Saharan African countries.\(^\text{43}\) This makes the population highly dependent on the agricultural sector which employs 82 percent of the population.\(^\text{44}\) Also, the rural parts of Uganda are hard to serve due to lack of sufficient infrastructure. For example, around 80 percent of all roadways in the country are unpaved and only 108 000 telephone lines are available.\(^\text{45}\) Even though the use of mobile cellular services is increasing rapidly, as well as the number of Internet-users, the infrastructure in the country is still highly insufficient. This makes it hard to establish any kind of business activity in rural areas, and banking is certainly not an exception. For example, estimates show that only 12.5 percent of the economically active population in Uganda has got access to a bank account, mostly because of the fact that they live far from the nearest bank office which causes high transaction costs.\(^\text{46}\)

Ultimately, one can conclude that Uganda has experienced economic growth and progress since the 1980s, although the country still suffers from high poverty rates, insufficient

\(^\text{40}\) CIA - The World Factbook
\(^\text{42}\) Ibid.
\(^\text{43}\) The World Bank, Uganda at a Glance
\(^\text{44}\) CIA - The World Factbook
\(^\text{45}\) Ibid.
infrastructure and demographical obstacles that hinders further economic development in
general, and banking in particular. Hence, the banking sector is a constructive sector to
remodel since it affects many other sectors in a positive way. For example, in order to reduce
poverty, the Ugandan government aims to enhance economic growth by focusing on the
following measures: remove bureaucratic barriers to investment, improve infrastructure,
modernize the agricultural sector and improve access to rural finance.47 As a matter of fact,
most of these measures can be improved through development of the banking sector.

4.1 The Privatization of Uganda Commercial Bank

The first banks in Uganda were established in the early 1900s, as parts of the British colonial
banking system. The sector was highly influenced by the British during the first half of the
20th century. After World War II, commercial banking in Uganda was mainly conducted by
three major British banks; Barclays, Standard, and National & Grindlays, which was the
leading bank operators in the country at the time.48 The British dominance affected the market
conditions to a large extent, in reality meaning that African entrepreneurs seldom got access
to formal banking services since the banks at the time often discriminated people on the basis
of racial or economic grounds.49 In practice, rural farmers and entrepreneurs had no access to
formal banking services, but had to rely solely on informal finance in order to fulfil their
financial needs. As a consequence, African farmers and entrepreneurs started to organize
themselves in order to create their own banking system during the 1920s, simply by creating
cooperatives that where controlled by the members. In 1950, the Coop Credit and Savings
Bank was established as a government controlled bank that mobilized loans and deposits to
farmers and business operators in rural parts of Uganda and in 1965, Coop Credit and Savings
Bank transformed to become Uganda Commercial Bank. In 1971, Idi Amin came into power.
The political and economic setback that followed his ascendance became devastating for the
Ugandan economy in general and the banking sector in particular.50 The number of banks in
the country declined severely. Especially the rural areas were abandoned, while the most
necessary financial operations were conducted in the capital, Kampala. During the same time,
inflation escalated, corruption was swelling and the political situation was highly instable.51 In
the first years after Amin’s resignation, the state owned UCB operated 186 out of 231

49 Ibid. p. 17
branches in the country, making it highly dominant. During this time, the number of competitors declined despite the social liberalization that took place in Uganda. The reason for this was a bank crisis which caused solvency problems for the entire sector during the mid 1990s. Further capital injections from the government were necessary in order to keep UCB in business. The problems were mainly due to poor portfolio management, but also because of UCB’s ambition to extend outreach by opening even more rural branches which had been very costly for the organization.

UCB was the backbone of the entire banking system in Uganda, so liquidation or closure were no realistic options since it would have been financially disastrous for the entire economy. As a consequence, the government had to reduce the number of employees in the bank, liquidate branches that made losses and sell noncore assets in order to save the bank. Despite these actions, the government finally had to sell 49 percent of the shares in the bank to the Malaysian company Westmond Land in 1999. The Ugandan government soon realized that the Malaysian company was not a particularly good owner of the bank, so they decided to reprivatize the bank in 2001. The Ugandan government was now looking for a competent company that could take over a bank in crisis on a long-term basis. The Bank of Uganda, the authority in charge of UCB presented the main objectives with the privatization in a press statement conducted in May 2001:

“The first objective is to ensure that UCB is managed in a professional and prudent manner in order to fully safeguard its deposits [...] The second objective is to ensure that UCB maintains a nationwide branch network, and in particular, that it maintains branches, and a full range of banking services, in areas of the country which are not served by other banks.”

In late 2001, the Ugandan government sold the majority of UCB to the South African bank Stanbic which already operated one branch in the country. Stanbic was allowed to buy 80 percent of the shares for 19.6 US$ millions. The remaining 20 percent of the shares were

later sold to the residents of Uganda through the Ugandan Stock Exchange.\footnote{Hauner D, Peiris S, \textit{Bank Efficiency and Competition in Low-Income Countries: The Case of Uganda}. p. 3ff} Also, as a part of the contract, Stanbic had to keep all the 67 branches open for at least two years, thereafter they were allowed to close branches that were not profitable. Instead, Stanbic expanded its operations so that it contained 74 branches in the year of 2005.\footnote{Clarke G, Cull R, Michael F, \textit{Bank Privatization in Sub-Saharan Africa: The Case of UCB}. p. 7}

4.2 Previous Research Concerning the Privatization of UCB

“Bank Efficiency and Competition in Low-Income Countries: The Case of Uganda” is a report, published by the IMF intended to “analyze the impact of the far-reaching banking sector reforms undertaken in Uganda to improve competition and efficiency.”\footnote{Hauner D, Peiris S, \textit{Bank Efficiency and Competition in Low-Income Countries: The Case of Uganda}. p.1} The main focus of the report is the privatization of UCB and it states that Stanbic can present several concrete improvements of their banking services since privatization such as: increasing number of ATMs, reduced delays in money transfers and an increased activity in agricultural lending. There are also a growing number of private saving accounts issued each year, even though the proportion of accounts to the entire population is still very small.\footnote{Ibid. p 1ff} The main conclusion of the report is that the banking sector as a whole has increased its level of efficiency since the privatization and that banking systems dominated by state owned banks is feared to be inefficient and a major hindrance to economic growth. As a consequence of increased competition, eliminations of less effective providers have occurred, but there are still some words of caution that should not be neglected. The market structure is identified as monopolistic competition, and even though the banks profits have increased, there are no clear signs of increased access to banking services according to the IMF-report.\footnote{Beck T, Heiko H, \textit{Bank Efficiency, Ownership and Market Structure – Why are Interest Spreads so High in Uganda}? p. 6}

In 2007, The World Bank presented a report named “Bank Privatization in Sub-Saharan Africa: The Case of Uganda Commercial Bank” which summarizes the immediate effects of Stanbic’s acquisition of UCB. The analysis is based on data that covers a wide range of parameters, such as number of bank offices, return on assets for Stanbic, share of lending devoted to agriculture and manufacturing etc. The report concludes that the privatization of UCB was successful because the organization has become solvent and more efficient since the privatization. It also concludes that the sale of UCB improved the access to banking for some parts of the population and that Stanbic has shifted its strategy towards agricultural lending while lending to the government and the
manufacturing-sector has decreased. The report is specifically focused on the privatization-process, but it does not put much emphasis on the aggregated effects on the market structure caused by the privatization. It is certainly interesting to state whether the privatization has been successful in the specific case of Stanbic or not, but we also find it important to address how the entire banking sector has been affected by the transformation of the sector’s largest operator.

Both the IMF report and the World Bank report conclude that Stanbic has made several improvements which has increased the level of efficiency and outreach. However, the formal banking sector in Uganda is still characterized by monopolistic competition, and neither the IMF nor the World Bank discusses the privatization’s impact on urban and rural areas separately. Therefore, we find it interesting to study the differences between urban and rural areas. As stated in our theory, a monopoly has got economic incentives that might lead to under-provision of banking. Considering that the transaction costs on the Ugandan market are relatively high, we fear that Stanbic’s market power forces competitors to increase lending rates and avoiding expansions to low-profitable, rural areas. Our point of departure is therefore that even though Stanbic has made improvements, it is not certain that this will lead to a more competitive climate and increased outreach of banking; instead it might just lead to an increased dominance of Stanbic after the privatization. That would be harmful for the entire market and thereby resulting in a larger interest wedge.

5. Empirical Findings

According to the contemporary theoretical consensus described earlier, banking in Sub-Saharan Africa should be provided by a number of private firms that conduct formal banking services. In reality, banking in Sub-Saharan Africa has often been provided by one large, state-owned bank. During the past years, many of the state-owned banks in Sub-Saharan Africa have been privatized, and one of them is UCB. In this section, we will analyze the sub-questions described in the purpose-section in order to conclude whether there are any discrepancies between theory and practise.

5.1 Number of Bank Offices in Uganda – A Measure of Outreach

In order to gain some understanding of how the banking sector has developed in Uganda since the privatization of UCB, we will observe the number of bank offices before and after the

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63 Hauner D, Peiris S, *Bank Efficiency and Competition in Low-Income Countries: The Case of Uganda*. p. 27
merger in order to state whether the outreach of banking has increased or decreased as a consequence of Stanbic’s acquisition of UCB. As we see in figure 4 below, the number of bank offices in Uganda has increased in absolute terms, especially in the urban areas of the country.

**Figure 4: Bank Offices in Uganda – Urban and Rural Areas. Year 2000 and 2005:**

The number of bank offices in urban areas has increased rapidly with 166 percent between the years of 2000 and 2005, in absolute terms going from 39 bank offices in the year of 2000 to 104 in the year of 2005. Simultaneously, the rural areas of Uganda have experienced some modest growth of 11 percent in the number of bank offices, going from 84 in the year of 2000 to 93 in the year of 2005.\(^{65}\)

The difference between rural and urban areas in terms of growth in the number of branches has been significant since the acquisition, and it is a clear indicator of increased access to banking in urban areas compared to rural.\(^ {66}\) On the other hand, in rural parts of the country, the number of bank offices is principally unchanged. This has led to increased financial dualism in Uganda during the last few years since the urban population has experienced improved access to banking services while the rural population has not experienced any significant progress.\(^ {67}\) The improvements in urban areas are certainly positive, but the

\(^{65}\) Clarke G, Cull R, Michael F, *Bank Privatization in Sub-Saharan Africa: The Case of Uganda Commercial Bank*, Appendix – Fig 8


\(^{67}\) Clarke G, Cull R, Michael F, *Bank Privatization in Sub-Saharan Africa: The Case of UCB*, Appendix – Fig 8
aggregated effects for the entire nation are quite modest due to the fact that only 1.3 million people live in Kampala, while the entire population of Uganda is approximately 30 million.68

**Figure 5: Bank Offices per 100,000 Inhabitants – Urban and Rural. Year 2000 and 2005:**

![Graph showing bank offices per 100,000 inhabitants in urban and rural areas for the years 2000 and 2005.](image)


The tendency towards dualistic access to financial services between urban and rural areas gets more obvious when we observe the change in bank offices in relative terms, meaning bank offices per 100,000 inhabitants, in figure 5 above. Once again, we can conclude that the population of Kampala has experienced progress in bank accessibility, while the rural population has experienced even a slight decrease in the number of bank offices per 100,000 inhabitants since the year of 2000.69 In 2005, there were approximately 0.37 bank offices per 100,000 inhabitants in rural parts of Uganda, compared to the urban areas where the equivalent ratio was approximately 7.65. This indicates that the outreach of banking is still very poor in Uganda.70

Before the privatization process took effect, UCB had 67 branches in Uganda, and a majority of them were located in Kampala. Totally, UCB had 55 percent of the bank offices in the market during 2000. In 2005, after the acquisition Stanbic had grown to include 74 branches while the market share in terms of number of bank offices had declined to 38 percent. As we see in figure 6 below, three banks, CERUDEB, Nile and Crane grew considerably during this

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68 CIA - The World Factbook  
69 Ibid.  
70 Clarke G, Cull R, Fuchs M, *Bank Privatization in Sub-Saharan Africa: The Case of UCB*. Appendix – Fig 8
period. Four corporations, Transafri, Cairo, Diamond and Citibank did draw back their operations in Uganda while the three banks mentioned before strengthened their presence between the years of 2000 and 2005. At a glance, this might look like evidence of increased competition in the entire market, but as we have stated earlier, the development has been highly concentrated to the capital.

**Figure 6: Bank Offices in Uganda by Corporation. Year 2000 and 2005:**

When observing Stanbic’s competitors, we see that Crane opened 23 new branches in Kampala between 2000 and 2005, Nile opened twelve new branches and CERUDEB opened ten new branches in the capital, while their number of rural bank offices actually declined. Stanbic strengthened its presence in Kampala during this period by opening six new offices. They also opened a number of branches in rural parts of the country, but at the same time, Stanbic closed down an equivalent number of offices in these areas as well, resulting in an unchanged net effect.  

Stanbic has lost market shares in Kampala since the privatization due to the fact that its competitors have expanded their number of branches, but in rural parts of the country, the position as the single largest provider of banking is basically unchanged. The only competitor that truly designates resources to rural banking is CERUDEB which has kept its growth rate.

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71 Clarke G, Cull R, Fuchs M, *Bank Privatization in Sub-Saharan Africa: The Case of UCB*. Appendix – Fig 8
72 Ibid. Appendix – Fig 8
in number of bank offices at the same rate as Stanbic.\textsuperscript{73} In reality meaning that Stanbic’s market power in rural areas is significant even after the privatization. In 2001, the two largest banks accounted for 77 percent of the rural branches. In the year of 2005, Stanbic accounted for 56 percent of the rural bank offices, while the second largest provider of rural banking, CERUDEB accounted for 23 percent of the branches. Altogether, in 2005 they accounted for 79 percent of the rural market while ten other corporations shared the remaining 21 percent. This indicates that the rural formal banking sector in Uganda still suffers from insufficient competition and outreach, even after the privatization.\textsuperscript{74}

### Table 1: Market Shares - Four Largest Bank Operators in Percentage. Year 2005:

<table>
<thead>
<tr>
<th></th>
<th>Urban</th>
<th>Rural</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stanbic</td>
<td>20,5</td>
<td>56</td>
</tr>
<tr>
<td>CERUDEB</td>
<td>14</td>
<td>23</td>
</tr>
<tr>
<td>Crane</td>
<td>24,5</td>
<td>2</td>
</tr>
<tr>
<td>Nile</td>
<td>12</td>
<td>4,5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>71</td>
<td>85,5</td>
</tr>
</tbody>
</table>

*Source: Clarke G, Cull R, Fuchs M, *Bank Privatization in Sub-Saharan Africa: The Case of UCB, Appendix – Fig*

As we observe in table 1 on the previous page, the situation is different when it comes to the urban areas where the largest corporation in terms of bank offices is Crane Bank which accounted for 24,5 percent of the branches in the urban market in 2005. Stanbic accounted for 20,5 percent, Nile Bank for 14 percent and the fourth largest bank, CERUDEB stood for 12 percent of the urban market. It means that the four largest banks altogether accounted for 71 percent of the market in 2005, meaning that the competitive climate for formal banking in urban areas of Uganda is relatively fair, and it has become better since the privatization.\textsuperscript{75}

One parameter which indicates that the formal banking sector in Uganda is relatively competitive compared to other African nations is the total banking assets ratio, which measures how much of the total bank assets that the three largest operators in the market

\textsuperscript{73} Clarke G, Cull R, Fuchs M, *Bank Privatization in Sub-Saharan Africa: The Case of UCB, Appendix – Fig* 8
\textsuperscript{74} Ibid. Appendix – Fig 8
\textsuperscript{75} Ibid. Appendix – Fig 8
holds. In 2003, the three largest formal commercial banks in Uganda accounted for 65 percent of the total banking assets, to compare with an average rate of 82 percent for the entire African continent.\textsuperscript{76}

5.2 The Level of Competition within the Formal Banking Sector

According to theory, a low interest wedge indicates that the formal banking sector is well functioning and signified by an efficient allocation of resources and a competitive climate for formal banking. As we see in figure 7 below, the wedge between lending and deposit rate is relatively high for Uganda and it has been so during the entire time period observed.

\textbf{Figure 7: Interest Wedge between Commercial Bank Lending Rate and Deposit Rate:}

At a first glance, we conclude that there are no signs of a strong competitive climate for formal banking in Uganda due to the large interest wedge. However, if we look at the wedge for the privatization year, 2001, it was at a level of 14,2 percent, to compare with the level of 2006, when it had dropped to 9,6 percent.\textsuperscript{77} Applying our empirical findings on the theoretical foundation, which states that a decreasing interest wedge may implicate increased competition, hints that something in the market has changed.

We conclude that the competition in the market has increased, forcing providers of formal banking to lower their marginal incomes in order not to lose customers to competitors. Although the difference is still relatively high, we can observe a trend towards declining differences between lending and deposit rates. Presuming that the privatization at least to

\textsuperscript{76} Clarke G, Cull R, Fuchs M, \textit{Bank Privatization in Sub-Saharan Africa: The Case of UCB}, p. 33

\textsuperscript{77} Data can be found in \textit{Appendix 2}. 


Bank of Uganda
some extent caused the change gives us an indication of increased competition in the market for formal banking. Figure 8 below gives a more thorough overview of the changes in the difference between the lending and deposit rate since the privatization. Even though we do not have access to a large number of observations, the scatter plot confirms that the trend is actually declining.

**Figure 8: Difference Between Lending and Deposit Rates 1999-2006(%)**:

![Graph showing the difference between lending and deposit rates from 1998 to 2007.](image)

*Bank of Uganda*

However, only looking at the observed interest wedge is not enough. Recalling McKinnon’s theory, we remember that inflation and reserve requirement were the two main forces behind the development of the interest wedge. (In the following analysis, we will take the reserve requirement as given since it has been fixed at 10 percent in Uganda during the time period observed.)

According to theory, when the inflation rate increases, the interest wedge increases as well in order for the banks to maintain their level of profitability. This means that a decreasing inflation rate, ceteris paribus, should be followed by a decreasing interest wedge. As we can see in figure 9 below, that was not the case between 1997 – 1999 and 2000 – 2002.

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Since the banks were able to maintain a considerable wedge between lending and deposit rate even though the inflation decreased, we conclude that McKinnon’s model fails to explain the observed interest wedge. As we stated in our theoretical framework; given a low inflation rate, a competitive market climate should result in a small wedge. We keep in mind that the observed period was highly influenced by governmental provision of banking with significant market power and general turmoil within the formal banking sector. Hence, an insufficient level of competition often leads to a large interest wedge. However, the privatization of UCB in 2001 opened up for a more competitive climate in the market for banking. Consequently, one can observe a decline of the wedge between the lending and deposit rate shortly after the privatization. The decline was followed by an instant recoil which makes it difficult to draw any concrete conclusions about the competitive climate only by observing figure 9. We are therefore going to calculate an estimated interest wedge for 1995 to 2006, to compare with the observed values. The estimated line tells us at what level the wedge should be, given the inflation, deposit rate and reserve requirement. If the observed values differ from our estimation, we conclude that lacking competition influence the interest wedge.

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**Figure 9: Interest Wedge Compared to Inflation Rate:**

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Bank of Uganda

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80 The calculations can be found in Appendix 3
As we observe in figure 10 above, the estimated interest wedge varies between 0.63 and 1.31 percent between the years of 1995 and 2006. In a world of perfect competition, the observed interest wedge should correspond to these numbers, or at least be close to them. Instead, as we will see, the observed interest wedge is significantly higher which makes us conclude that the market for formal banking in Uganda has suffered from lack of competition during the entire time period observed. Although, just after the privatization took effect, the interest wedge declined severely from 14.2 percent in the year before the privatization, down to 9.1 percent in the year of 2003, after the privatization.

Even though the sharp decline in the first years of the decade was followed by a recoil, the net effect on the interest wedge thus far is clear, declining from 14.2 percent before the privatization down to 9.6 percent in the year of 2006. After conducting a one-sample T-test on the interest wedge data, we conclude that the development is significant according to our preset level of significance. (Further details concerning the T-test are presented in Appendix 4.) We can thereby ascertain that the competition in the market for formal commercial banking in Uganda has increased because a considerable number of new bank offices were established after Stanbic’s acquisition of UCB.81 However, we need to wait a few years before we have enough observations to state the final results, but the initial indications

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81 Clarke G, Cull R, Fuchs M, *Bank Privatization in Sub-Saharan Africa: The Case of UCB*. Appendix – Fig 8
To get an understanding and context for the values presented above, we will compare Uganda’s interest wedge with other Sub-Saharan African countries wedges. We have also decided to use a developed country as a benchmark; therefore we looked at the values for Sweden. By making these comparisons we conclude that the interest wedge for Uganda in 2003/2004 corresponds to the level of its neighbouring countries, Kenya and Tanzania. When compared to Angola, Uganda’s interest rate is actually significantly lower for the time period observed. However, when we compare the values with wealthier nations in the region, such as Nigeria and South Africa, the results are somewhat different. The wedge for Nigeria and South Africa in 2004 was 5.48 and 4.74 percent respectively. We therefore conclude that Uganda’s banking sector is still relatively underdeveloped, compared to the region’s leading nations. This is obviously also the case when compared to the Swedish values, where the wedge for 2004 was at a level of 3 percent, compared to the Ugandan wedge which was 12.9 percent. The Ugandan interest wedge might not be as low as South Africa’s and Nigeria’s, but compared to less developed countries in the region is Uganda’s banking sector relatively competitive and it is making important progress.\textsuperscript{82}

Even though the difference between the estimated and the observed interest wedge has declined in Uganda, as we described in figure 10 before, it should be substantially lower given the observed inflation rate, reserve requirement and deposit rate. The fact that the wedge deviates from our calculated value indicates that the market is still signified by market power concentrated to some operators, and therefore lack of competition. Consequently, we specify our analysis further by observing the interest wedge for each operator in Uganda for the year of 2005. The results can be observed in figure 11 below, where the crosshatched line indicates the aggregated average interest wedge.\textsuperscript{83} We conclude that the largest banks in terms of branches; Stanbic, Nile and Crane have among the lowest interest wedges in the market, except of another large bank, CERUDEB, which has an interest wedge clearly above the average.

\textsuperscript{82} Complete values for 1995-2004 can be found in Appendix 5

\textsuperscript{83} Data for Barclay Bank and Standard Bank was unavailable since their interest rates are negotiable
The largest banks have in common that they have substantial market shares in urban areas and they experience relatively high transaction volumes, which means that they benefit from economies of scale. We therefore make the presumption that they can undercut the small competitors’ interest wedges, so that the minor operators are forced to maintain high interest spreads in order to cover their costs. Among the large banks, CERUDEB is an exception since it is has a high interest wedge. The reason for this is most likely because the majority of CERUDEB’s branches are located in rural areas. Therefore, CERUDEB faces higher transaction costs than other large competitors, so in order to stay profitable, they need to maintain a high interest wedge. An interesting aspect is that Stanbic has got a considerable share of the branches located in rural areas, and it simultaneously has the lowest interest wedge of all operators along with Crane, which is entirely an urban bank.

The fact that Stanbic can maintain low spreads even though large extents of its operations are located in rural areas indicates that Stanbic benefit from economies of scale in urban areas which enables the company to subsidize rural banking operations. This means that the profits that are made in urban areas compensate for the high transaction costs in rural areas. Stanbic’s rural customers might therefore experience lower barriers to banking than the customers of CERUDEB; which is a bank that is entirely dependent on rural profits and therefore has to maintain high interest spreads that excludes potential rural customers. We therefore conclude

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84 Clarke G, Cull R, Michael F, *Bank Privatization in Sub-Saharan Africa: The Case of UCB*, Appendix – Fig 8
85 Ibid. Appendix – Fig 8
that a general lesson from the case of Uganda is that a desirable formation of the banking sector is achieved by having operators with diversified presence, meaning that they conduct both urban and rural banking. This way, they are able to maintain a low interest wedge even in hard to serve rural areas, compared to banks that focus solely on rural banking.

5.3 Formal Banking by Sector

In Uganda, agriculture employs 82 percent of the labor force; at the same time are only 11 percent of the bank loans in the country directed towards agriculture, while the service sector accounts for 62 percent of the loans, but only 13 percent of the labor force.86

<table>
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<tr>
<th>Table 2: Sectoral Statistics. Year 2005:</th>
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<tbody>
<tr>
<td>Production by Sector as part of GDP (%)</td>
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<tr>
<td>Labor Force by Occupation (%)</td>
</tr>
<tr>
<td>Sectoral Breakdown of Loans (%)</td>
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</tbody>
</table>

Source: The World Bank, *Uganda at a Glance*
CIA, The World Bank Fact Book
IMF - *Bank Efficiency and Competition in Low-Income Countries*. p.6

Services is the largest sector in the Ugandan economy, accounting for 43 percent of total GDP, but the agricultural sector which accounts for 32 percent of the production in the economy is also essential, especially in the rural areas of the country.87 The agricultural sector in Uganda is considered low-productive and this is a major obstacle that hinders further economic growth for the entire nation since a majority of the households' welfare depends on this sector. A modernization of agriculture, which is a key productive sector to poverty eradication, is therefore highly necessary according to the Ugandan Ministry of Finance, Planning and Economic Development.88 Hence, lack of access to financial services is considered the single most severe constraint for further development of the agricultural sector, due to the fact that more productive technological equipment is highly needed to increase the productivity within the sector.89 For most farmers, living in rural parts of the country without

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86 Hauner D, Shanaka P, *Bank Efficiency and Competition in Low-Income Countries: The Case of Uganda*, p.6
87 The World Bank, *Uganda at a Glance*
89 Flygare S, *The Cooperative Challenge*. p. 56
access to formal finance, the necessary capital investments that might improve the production process is inaccessible due to proximity, security and affordability reasons.\textsuperscript{90}

In fact, the barriers to formal banking are currently so high that approximately 80 percent of the rural population in Uganda prefers to keep their savings in cash or in kind while just above 10 percent of the rural population saves through a formal provider of banking. The situation is better in the urban parts of the country where approximately 55 percent of the population keep their savings in the hands of a formal provider of banking.\textsuperscript{91} The main reasons for these severe differences are first of all that the rural population faces high transaction costs in order to make their deposits. A typical rural saver in a formal commercial bank faces an average transportation cost of 3.90 US$ per transaction, over five days of per capita income in Uganda.\textsuperscript{92} Secondly, there are basically only two formal banks in Uganda that truly put emphasis on serving the low-income population who lives in the rural parts of the country, Stanbic and CERUDEB who all together account for 79 percent of the rural branches.\textsuperscript{93}

The competition within the banking sector in urban parts of Uganda is better, even though most of the urban operators are focused on the middle- and upper-income brackets.\textsuperscript{94} The supply of formal banking is therefore highly insufficient in rural parts of Uganda compared to the urban parts of the country.\textsuperscript{95} Consequently, the agricultural sector which is concentrated to rural areas faces proportionally low levels of bank interaction.\textsuperscript{96} Industry and Services employs a comparatively small share of the population and both sectors receive a relatively proportional amount of bank loans to their share of GDP. The agricultural sector, which employs a majority of the population, living in rural areas, has a bank loan ratio which is considerably disproportionate to its share of GDP. This is a sign of under-provision of banking to the agricultural sector, mainly due to high transaction costs, low levels of competition and insufficient outreach of formal banking.\textsuperscript{97}

\textsuperscript{90} Deshpande R, Pickens M, Messan H, \textit{Uganda Country-Level Savings Assessment}. p.6
\textsuperscript{91} Ibid. p. 7
\textsuperscript{92} Ibid. p.6
\textsuperscript{93} Clarke G, Cull R, Fuchs M, \textit{Bank Privatization in Sub-Saharan Africa: The Case of UCB}. Appendix – Fig 8
\textsuperscript{94} Deshpande R, Pickens M, Messan H, \textit{Uganda Country-Level Savings Assessment}. p.8
\textsuperscript{95} Ibid. p.8
\textsuperscript{96} Hauner D, Shanaka P, \textit{Bank Efficiency and Competition in Low-Income Countries}. p.6
\textsuperscript{97} Ssewankambo E, Hindson D, Ssengendo M, \textit{Concept Paper (Decentralization) Follow-on Programme to District Development Programme II}. p. 22
During the end of the 1990s, UCB suffered from insolvency and the government was forced to take action in order to save the bank from bankruptcy. One of their actions was to pull back much of UCB’s agricultural lending, which was highly undermined by a large share of non-performing loans at the time, in fact, 60 percent of all loans in UCB were non-performing in the year of 2000. In reality, this meant that UCB’s share of lending devoted to agriculture dropped from about 20 percent of total lending in 1996, down to almost nothing in the year of 2001. Since the privatization has Stanbic increased their share of lending devoted to agriculture to approximately 4 percent of total lending. Also, as a consequence of increased computerization within Stanbic since the privatization, all the offices are now connected through an internal information system which has decreased the time to clear checks from 21 days before the privatization, to 4 days in the year of 2004. Conclusively, agriculture which is a key production sector for Uganda still suffers from insufficient access to banking because the sector is rural-based. Since the privatization of UCB, some positive changes has been made in order to strengthen the accessibility for the agricultural sector concerning banking, but the bank interaction is still relatively low.

100 The Banker
101 Ssewankambo E, Hindson D, Ssengendo M, *Concept Paper (Decentralization) Follow-on Programme to District Development Programme II*. p. 22
6. Conclusions

Financial sector development through privatization of state-owned banks is considered the leading contemporary strategy in order to achieve a more efficient allocation of resources within the formal banking sector in developing countries. UCB, the dominant provider of banking in Uganda was privatized in 2001 due to financial distress. Therefore, the aim of this thesis has been to investigate if the privatization prevented the banking sector from collapse and if it made the sector more competitive and outreaching.

In order to solve the main problem, we founded a theoretical framework upon which our analysis was conducted. First of all, we established the nexus between financial development and economic growth; thereafter we showed the benefits of an efficient financial system. We stated that an efficient financial market, signified by a low interest wedge leads to utility maximization and an efficient allocation of resources. We also showed that market inefficiencies i.e. increased transaction costs, for example under situations of monopolistic market power and lack of competition, leads to an increased interest wedge. Finally, we stated that banking in developing countries theoretically ought to be conducted by a number of private providers of formal banking in order to achieve a high degree of competition and thereby a low interest wedge. According to the theories presented above, our hypothesis is that the privatization of UCB saved the banking sector from collapse and that it increased competition and outreach of formal banking in Uganda.

There is no doubt that Stanbic has performed well since the privatization and the Ugandan government certainly succeeded in saving the banking sector from collapse; mostly due to the fact that Stanbic managed to turn the troubled UCB into becoming a profitable organization. It did so without closing down a large amount of branches; in fact it opened seven new branches between 2001 and 2005. Stanbic’s profitability-increase is attributable mainly to the fact that they managed to lower the level of non-performing loans significantly. The increased profits were also achieved by undertaking initial investments in restructuring the bank. The majority of the costs that they undertook during 2002 aimed at rebranding and improving the service standard within the bank, which resulted in the introduction of ATMs into the Ugandan market, computerization and, later on, increased profits.
The competitive climate for formal banking in Uganda has become better since the privatization of UCB. As mentioned recently, Stanbic has shown strong financial results since the privatization. Simultaneously, Stanbic has lost market shares in the urban parts of the country. This is a result of the fact that the formal banking sector in Uganda has become more competitive overall since the privatization, but the aggregated increase in competition is mostly due to a severe increase in competition in urban parts of the country. However, Stanbic has maintained its position as the single largest provider of banking in rural parts of the country. The number of bank offices has increased severely in urban areas, while the number of branches in rural parts of the country has basically stayed unchanged. Overall, most of the increase in the number of branches comes from other banks than Stanbic. CERUDEB, Nile and Crane have all increased their number of urban branches substantially while Stanbic has increased its number of urban branches at a moderate pace. The competition has therefore increased in urban areas, and as consequence, customers have started to experience a wider range of available services and a lower wedge between the banks’ lending and deposit rate. Thereby, the interest wedge has been declining due to increased competition nationwide.

The privatization of UCB has marginally increased the outreach of formal banking in Uganda. Stanbic has ever since the privatization maintained its operations in rural parts of the country while the main competitor, CERUDEB has increased its number of rural branches. After the privatization, Stanbic has increased its lending to the agricultural sector, introduced ATMs and created an internal communications system which has increased the outreach of formal banking services by lowering transaction costs and increasing the accessibility for rural customers. Even though these aspects might have had positive effects on the outreach of banking in Uganda, it is still relatively poor.

Overall, the Ugandan banking sector shows tendencies of increased competition since the privatization of UCB. The privatization has mainly increased the competition of formal commercial banking in urban areas of Uganda. The rural parts of the country have not experienced any significant improvements in terms of competition or outreach as a consequence of the privatization. According to the theoretical consensus presented earlier, the advocated strategy for increased competition and outreach of banking in Sub-Saharan Africa is privatization of large, state-owned banks such as UCB. According to our study of the banking sector in Uganda, our hypothesis is valid for urban areas where the banking sector gets more competitive and efficient as a consequence of the privatization of a dominant state-
owned bank. For rural areas, the hypothesis does not seem to be valid according to our study since the rural areas are signified by non-existence of markets, mostly due to high transaction costs. This means that private providers of banking simply do not have the economic incentives to expand their operations in non-profitable and hard to serve areas. It means that neither competition nor outreach seems to have increased significantly in rural parts of Uganda since the privatization, while the competition in urban areas has improved. Thus, our study concludes that privatizations of formal banking tends to result in an increased concentration of banking services to urban areas where the transaction costs are lower than in rural areas. It implicates that urban areas are relatively profitable, while the rural areas still have to rely on the informal sector and on in-kind transfers as sources of financing.

Prior research concerning Stanbic’s acquisition of UCB has been highly focused on how the company has performed since the privatization and less on how the entire banking sector has been affected by the privatization. We think that our essay fulfils an important purpose since it gives a broader picture of the problem than most of the prior research that we have taken part of. For example, previous studies have not analyzed the differentiated results between the urban and rural parts of the economy sufficiently, in our opinion. We have therefore chosen to put a lot of emphasis on elucidating how these differences have affected the outcome of the privatization. Our study has shown some initial tendencies concerning the effects of the privatization of UCB, but we must keep in mind that it is a dynamic process that is not completed yet. Therefore, it would be interesting to conduct this study a few years from now, when all the long-term effects of the privatization have entirely taken effect. Thus far, we have only had access to a few observations after the privatization, so conducting this study a few years from now might indicate more significant and distinct results than those that we have found.

We have not been able to observe the long-term effects of the privatization yet, but we can conclude that the competition has increased in urban areas. Eventually, this might lead to a future situation where the urban market, which is most profitable today, might become economically saturated due to heightened competition. Some operators might therefore find it more profitable to focus their business operations on rural areas where they face less competition. This way, outreach might also increase in the future, as a consequence of the privatization. We would therefore find it interesting to see the results of future research projects concerning formal banking in Uganda since they might point out significant long-term effects on outreach and competition that has not been observable for us thus far.
The problem with under-provision of banking still remains in rural parts of Uganda even after the privatization, and we believe that there is a number of different ways of approaching this problem. One way to increase rural banking is to use legislative methods, for example by regulating the market so that for every urban branch established, one must establish one rural branch too. This might theoretically be a satisfying solution, but it is probably far from practically implementable. Another solution is more market-oriented and it consists of an increased integration between the informal banking sector and the formal banking sector. This is an interesting issue to study in the future. According to the results of our study, we find this being a potential way of developing the financial sector and increasing outreach of banking in Uganda. We believe that formal banks may consider acquisitions of informal operators in order to reach out to rural customers. The informal banking sector has the necessary presence and personal relations in rural areas while the formal banks have got the technological equipment and financial resources to be able to establish efficient financial institutions that can nurture economic growth and development, even in rural areas.

Finally, in order to summarize the conclusions of this thesis, we would like to point out that in the case of Uganda, the privatization of UCB was positive in general, especially in urban areas while the positive effects on rural banking were limited. We therefore conclude that it seems like privatizations of state-owned banks can be recommended in order to increase competition and outreach within financial sectors in developing countries.
References

Literature


Internet


Appendices

Appendix 1

Table 3: Bank Offices and Interest Wedge in Uganda by Corporation, Year 2000 and 2005:

<table>
<thead>
<tr>
<th>Bank</th>
<th>Offices 2000</th>
<th>Offices 2005</th>
<th>Difference</th>
<th>Interest Wedge 2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>UCB</td>
<td>67</td>
<td>0</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>DFCU</td>
<td>4</td>
<td>8</td>
<td>4</td>
<td>7</td>
</tr>
<tr>
<td>Nile</td>
<td>3</td>
<td>18</td>
<td>15</td>
<td>10</td>
</tr>
<tr>
<td>Allied</td>
<td>3</td>
<td>5</td>
<td>2</td>
<td>14,5</td>
</tr>
<tr>
<td>CERUDEB</td>
<td>16</td>
<td>34</td>
<td>18</td>
<td>13</td>
</tr>
<tr>
<td>NBC</td>
<td>2</td>
<td>2</td>
<td>0</td>
<td>10</td>
</tr>
<tr>
<td>Orient</td>
<td>3</td>
<td>7</td>
<td>4</td>
<td>11,5</td>
</tr>
<tr>
<td>Barclays</td>
<td>2</td>
<td>6</td>
<td>4</td>
<td>-</td>
</tr>
<tr>
<td>Baroda</td>
<td>5</td>
<td>6</td>
<td>1</td>
<td>8</td>
</tr>
<tr>
<td>Standard</td>
<td>6</td>
<td>8</td>
<td>2</td>
<td>-</td>
</tr>
<tr>
<td>Tropical</td>
<td>3</td>
<td>3</td>
<td>0</td>
<td>12</td>
</tr>
<tr>
<td>Transafri</td>
<td>4</td>
<td>0</td>
<td>-4</td>
<td>-</td>
</tr>
<tr>
<td>Crane</td>
<td>2</td>
<td>26</td>
<td>24</td>
<td>6</td>
</tr>
<tr>
<td>Cairo</td>
<td>1</td>
<td>0</td>
<td>-1</td>
<td>8</td>
</tr>
<tr>
<td>Diamond</td>
<td>1</td>
<td>0</td>
<td>-1</td>
<td>12,5</td>
</tr>
<tr>
<td>Citibank</td>
<td>1</td>
<td>0</td>
<td>-1</td>
<td>12</td>
</tr>
<tr>
<td>Stanbic</td>
<td>1</td>
<td>75</td>
<td>74</td>
<td>6</td>
</tr>
<tr>
<td><strong>Total:</strong></td>
<td><strong>129</strong></td>
<td><strong>198</strong></td>
<td><strong>69</strong></td>
<td><strong>-</strong></td>
</tr>
</tbody>
</table>

Source: Bank of Uganda
Clarke G, Cull R, Fuchs M, *Bank Privatization in Sub-Saharan Africa: The Case of UCB, Appendix – Fig 8*
### Appendix 2

Table 4: Commercial Bank Deposit and Lending Rate, Interest Wedge, Inflation Rate. 1995 - 2006:

<table>
<thead>
<tr>
<th>Year</th>
<th>Commercial Bank Lending Rate (%)</th>
<th>Commercial Bank Deposit Rate (%)</th>
<th>Interest Wedge CPI (%)</th>
<th>Inflation Rate (%)</th>
<th>Real Deposit Rate (%)</th>
<th>Estimated Real Lending Rate (%)</th>
<th>Estimated Interest Wedge</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>20,2</td>
<td>7,6</td>
<td>12,6</td>
<td>8,61</td>
<td>-1,01</td>
<td>-0,17</td>
<td>0,84</td>
</tr>
<tr>
<td>1996</td>
<td>20,3</td>
<td>10,6</td>
<td>9,7</td>
<td>7,25</td>
<td>3,35</td>
<td>4,53</td>
<td>1,18</td>
</tr>
<tr>
<td>1997</td>
<td>21,4</td>
<td>11,8</td>
<td>9,6</td>
<td>6,94</td>
<td>4,86</td>
<td>6,17</td>
<td>1,31</td>
</tr>
<tr>
<td>1998</td>
<td>20,9</td>
<td>11,4</td>
<td>9,5</td>
<td>0,07</td>
<td>11,33</td>
<td>12,60</td>
<td>1,27</td>
</tr>
<tr>
<td>1999</td>
<td>21,55</td>
<td>8,7</td>
<td>12,85</td>
<td>6,41</td>
<td>2,29</td>
<td>3,26</td>
<td>0,97</td>
</tr>
<tr>
<td>2000</td>
<td>22,9</td>
<td>9,8</td>
<td>13,1</td>
<td>2,83</td>
<td>6,97</td>
<td>8,10</td>
<td>1,09</td>
</tr>
<tr>
<td>2001</td>
<td>22,7</td>
<td>8,5</td>
<td>14,2</td>
<td>2,11</td>
<td>6,39</td>
<td>7,33</td>
<td>0,94</td>
</tr>
<tr>
<td>2002</td>
<td>19,1</td>
<td>5,6</td>
<td>13,5</td>
<td>-0,31</td>
<td>5,91</td>
<td>6,53</td>
<td>0,62</td>
</tr>
<tr>
<td>2003</td>
<td>18,9</td>
<td>9,8</td>
<td>9,1</td>
<td>7,85</td>
<td>1,95</td>
<td>3,04</td>
<td>1,09</td>
</tr>
<tr>
<td>2004</td>
<td>20,6</td>
<td>7,7</td>
<td>12,9</td>
<td>3,31</td>
<td>4,39</td>
<td>5,24</td>
<td>0,86</td>
</tr>
<tr>
<td>2005</td>
<td>19,6</td>
<td>8,8</td>
<td>10,8</td>
<td>8,2</td>
<td>0,6</td>
<td>1,58</td>
<td>0,98</td>
</tr>
<tr>
<td>2006</td>
<td>18,7</td>
<td>9,1</td>
<td>9,6</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Department of Trade and Industry – Republic of South Africa
Bank of Uganda
Appendix 3

Table 5: Calculations of Estimated Interest Wedge in Table 3:

<table>
<thead>
<tr>
<th>Year</th>
<th>( (r_d ÷ (1 - k)) + (\pi k ÷ (1 - k)) = r_l )</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>(-0.0101 ÷ (1 - 0.1)) + (0.0861×0.1 ÷ (1 - 0.1)) = -0.0017)</td>
</tr>
<tr>
<td>1996</td>
<td>((0.0335 ÷ (1 - 0.1)) + (0.0725×0.1 ÷ (1 - 0.1)) = 0.0453)</td>
</tr>
<tr>
<td>1997</td>
<td>((0.0486 ÷ (1 - 0.1)) + (0.0694×0.1 ÷ (1 - 0.1)) = 0.0617)</td>
</tr>
<tr>
<td>1998</td>
<td>((0.1133 ÷ (1 - 0.1)) + (0.0007×0.1 ÷ (1 - 0.1)) = 0.1260)</td>
</tr>
<tr>
<td>1999</td>
<td>((0.0229 ÷ (1 - 0.1)) + (0.0641×0.1 ÷ (1 - 0.1)) = 0.0326)</td>
</tr>
<tr>
<td>2000</td>
<td>((0.0697 ÷ (1 - 0.1)) + (0.0283 ×0.1 ÷ (1 - 0.1)) = 0.0810)</td>
</tr>
<tr>
<td>2001</td>
<td>((0.0639 ÷ (1 - 0.1)) + (0.0211×0.1 ÷ (1 - 0.1)) = 0.0733)</td>
</tr>
<tr>
<td>2002</td>
<td>((0.0591 ÷ (1 - 0.1)) + (-0.0031×0.1 ÷ (1 - 0.1)) = 0.0653)</td>
</tr>
<tr>
<td>2003</td>
<td>((0.0195 ÷ (1 - 0.1)) + (0.0785×0.1 ÷ (1 - 0.1)) = 0.0304)</td>
</tr>
<tr>
<td>2004</td>
<td>((0.0439 ÷ (1 - 0.1)) + (0.0331×0.1 ÷ (1 - 0.1)) = 0.0524)</td>
</tr>
<tr>
<td>2005</td>
<td>((0.0060 ÷ (1 - 0.1)) + (0.0820×0.1 ÷ (1 - 0.1)) = 0.0158)</td>
</tr>
</tbody>
</table>

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Appendix 4

As we have stated, the Ugandan statistical capacity is relatively insufficient. Therefore it becomes extra uncertain to approach collected data concerning the interest wedge without a relevant test of significance. Not conducting a significance test can lead to an incorrect analysis and misdirected efforts. The result received from the data material does not necessarily correspond with the true population mean, and as a consequence of the important role that the observed interest wedge has in our analysis; we think that it is important to test the level of significance for our data. Because of the fact that the standard deviation of the true population is unknown, we find the one-sample t-test to be the best test of significance.\(^{102}\)

The statement being tested is:

\[ H_0: \mu = \mu_0 : \text{There is no difference in the true means} \]
\[ H_1: \mu \neq \mu_0 : \text{The true means are not the same} \]

If the p-value is as small as or smaller than \(\alpha = 0.05\), we conclude that the data is statistically significant at level \(\alpha\). In other words, meaning that if the p-value is larger than \(\alpha = 0.05\) we reject the null hypothesis at level \(\alpha\).

The one-sample t statistic is defined as:

\[
t = \frac{\overline{x} - \mu_0}{s/\sqrt{n}} \tag{10}\]

and has the t distribution with \(n - 1\) degrees of freedom.

The mean is defined as:

\[
\overline{x} = \frac{1}{n} \sum x_i \tag{11}
\]

and the standard deviation is defined as:

\[
s = \sqrt{\frac{1}{n-1} \sum (x_i - \overline{x})^2} \tag{12}\]

The relevant data for the following calculations can be found in Appendix 2; Table 3; Column 4.

Calculating the unknown parameters in equation (10) give us the following values:

\[
\bar{x} = \frac{1}{n} \sum x_t = 11,454, \tag{13}
\]

and

\[
s = \sqrt{\frac{1}{n-1} \sum (x_t - \bar{x})^2} = 1,896. \tag{14}
\]

Given the mean and the standard deviation, the t statistic will have the following value:

\[
t = \frac{11,454 - 0}{1,896/\sqrt{12}} = 20,927. \tag{15}
\]

We recall that the t distribution had \( n - 1 \) degrees of freedom:

\[
df = n - 1 = 12 - 1 = 11, \tag{16}
\]

this tells us that the t(11) distribution with a t statistic of 20,927, results in \( P < 0,0005 \). We conclude that we cannot reject the null hypothesis at the significance level of \( \alpha = 0,05 \).
## Appendix 5

<table>
<thead>
<tr>
<th>Year</th>
<th>Angola</th>
<th>Kenya</th>
<th>Nigeria</th>
<th>South Africa</th>
<th>Tanzania</th>
<th>Sweden</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>80,33</td>
<td>15,2</td>
<td>6,70</td>
<td>4,36</td>
<td>18,20</td>
<td>4,95</td>
</tr>
<tr>
<td>1996</td>
<td>70,75</td>
<td>16,2</td>
<td>6,78</td>
<td>4,61</td>
<td>20,38</td>
<td>4,91</td>
</tr>
<tr>
<td>1997</td>
<td>8,50</td>
<td>13,53</td>
<td>10,63</td>
<td>4,62</td>
<td>18,44</td>
<td>4,51</td>
</tr>
<tr>
<td>1998</td>
<td>8,12</td>
<td>11,09</td>
<td>8,07</td>
<td>5,29</td>
<td>15,14</td>
<td>4,03</td>
</tr>
<tr>
<td>1999</td>
<td>43,73</td>
<td>12,83</td>
<td>7,48</td>
<td>5,76</td>
<td>14,14</td>
<td>3,88</td>
</tr>
<tr>
<td>2000</td>
<td>63,58</td>
<td>14,24</td>
<td>9,58</td>
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<td>14,19</td>
<td>3,68</td>
</tr>
<tr>
<td>2001</td>
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<td>8,18</td>
<td>4,40</td>
<td>15,45</td>
<td>3,45</td>
</tr>
<tr>
<td>2002</td>
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<td>12,96</td>
<td>8,1</td>
<td>4,98</td>
<td>13,14</td>
<td>3,38</td>
</tr>
<tr>
<td>2003</td>
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<td>6,49</td>
<td>5,20</td>
<td>11,43</td>
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</tr>
<tr>
<td>2004</td>
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<td>5,48</td>
<td>4,74</td>
<td>9,72</td>
<td>3,00</td>
</tr>
</tbody>
</table>

**Source:** IMF, *International Financial Statistics Yearbook 2006*