Overseas Development Institute

Global Financial Crisis Discussion Series

Paper 9: Uganda

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Acronyms

AfDB	African Development Bank
AKFED	Aga Khan Fund for Economic Development
BoU	Bank of Uganda
DFID	Department for International Development (UK)
EPRC	Economic Policy Research Centre
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
ILO	International Labour Organization
IMF	International Monetary Fund
MDG	Millennium Development Goal
MoFPED	Ministry of Finance, Planning and Economic Development
NAADS	National Agricultural Advisory Services
NGO	Non-governmental Organisation
ODA	Official Development Assistance
PAF	Poverty Alleviation Fund
PRDP	Peace, Recovery and Development Plan
UBoS	Uganda Bureau of Statistics
UDB	Uganda Development Bank
UDC	Uganda Development Corporation
UK	United Kingdom
UN	United Nations
UNHS	Uganda National Household Survey
UPE	Universal Primary Education
URA	Uganda Revenue Authority
US	United States
USE	Uganda Stock Exchange
VAT	Value Added Tax
WFP	World Food Programme

Abstract

Uganda has recorded strong economic growth since 1992, driven mainly by the services, manufacturing and construction sectors. However, there are still challenges in terms of economic transformation, exemplified by persistent high poverty levels and inequality. The recent global economic crisis presents further challenges for the economy which, if not mitigated, may slow economic growth and exacerbate these ills. It was originally thought that Uganda would not suffer from the financial contagion on account of the limited linkages of its financial system to the global financial system, but the signs are that the impacts have already been felt. Pre- and post-crisis analysis of the main economic indicators shows that there are not only direct impacts, albeit not very significant, but also significant secondary impacts touching a number of sectors of the economy. Direct impacts include the negative impact on the stock exchange and on portfolio flows. Export volumes and prices have gone down: even regional-bound exports that were thought to cushion the economy have not been spared. Imports have shot up on account of the depreciation of the Uganda shilling, cutting into the profits of domestic firms. With foreign capital and other inflows like aid (at least non-official development assistance (ODA)) and remittances going down, coupled with reduced revenue collections, the budget deficit will increase and expenditure on priority areas may be affected. To mitigate these problems, it is important that the government reduces wasteful spending and targets its expenditure at productivity-enhancing sectors that may fiscally stimulate the economy.

1. Introduction

Uganda has recorded strong economic growth since 1992, driven mainly by the services, manufacturing and construction sectors. In the recent past, the share of value added contributed by the services sector was almost half of total gross domestic product (GDP) and that of agriculture diminished steadily, to about 16% in 2007/08. However, agriculture continues to employ nearly 68% of the workforce (UBoS, 2007). There has been growth in employment opportunities but this remains below that of labour supply. In 2002, the unemployment rate, based on the International Labour Organization (ILO) conventional definition, stood at 2.8%, relatively low for a developing country like Uganda.

The proportion of Ugandans living below the absolute poverty line declined from 56% in 1992/92 to 31% in 2005/06 (Ssewanyana and Okidi, 2007). Other distributionally sensitive poverty measures also improved. However, inequality of income increased by 11.8% during the same period. In Uganda, income poverty reduction is more responsive to changes in growth than to changes in distribution (Ssewanyana, 2008). To this end, Uganda is projected to achieve Millennium Development Goal (MDG) 1 of halving poverty to 28% by 2015, but household incomes need to grow by at least 4% per annum and income has to be distributed more equitably.

Uganda, like most sub-Saharan African countries, is challenged by the impact on development of multiple, interrelated global crises and challenges, including high food prices, climate change, fluctuations in commodity prices and the global financial crisis. Beyond these external factors, internal factors such as supply constraints and high population growth, to name a few, partly explain Uganda's performance since 2006.

This paper provides an analysis of how the global financial crisis may affect Uganda and how the government could respond. It is clear that any impacts will not show up all at the same time, and in most cases it remains too early to net out empirically the impact of the crisis on the economy. That said, the analysis focuses on the visible impacts of the crisis so far and its effect on growth, employment, debt, poverty and inequality.

The main findings of the paper are as follows. Although the effects of the crisis on the financial sector remain limited, other macro indicators seem to suggest hard times ahead. Exports have been falling since August 2008 whereas imports have shown an increasing trend. On a positive note, in the short term, regional trade is still cushioning the Ugandan economy from the adverse effects of the crisis, although we cannot predict how long this will last. GDP growth projections suggest a slowdown in the economy in the range of 5-7% in FY2008/09,[2] although these projections are impressive relative to International Monetary Fund (IMF, 2009) projections of 3.5% for sub-Saharan Africa as a whole.

The paper is structured as follows. In the next section, we briefly discuss the genesis of the global financial crisis. Section 3 discusses the manifestations of the crisis in Uganda. The broad macro effects are discussed in Section 4 prior to possible policy responses.

2 Uganda's financial year runs from July to June.

2. Understanding the shock at global level

The ongoing global financial crisis is a major concern for almost all the countries in the world. Although the crisis became very visible in September 2008, with the failure and/or merger and takeover of several US-based financial firms, its actual genesis is in the sub-prime lending practices of the financial sector in the US, mainly in the past 10 years, which resulted in a great deal of 'toxic assets' choking the banks. The result was the failure of large financial institutions, first in the US, later spreading to the rest of the world and rapidly evolving into a massive credit crisis, the scale of which has not been seen since the Great Depression. Many financial institutions, under heavy debt burdens, scaled down their lending, and cash-strapped households reduced their consumption. The aftermath of the crisis has seen reduced domestic sales, layoffs and rising unemployment, declining stock markets, reduced bank lending and falling equity prices.

Consequent to this financial crisis, which has evolved into an enormous economic crisis, the IMF has revised its growth forecasts downwards and, together with the World Bank, is projecting a possible contraction of the world economy for the first time since World War II, after growing at 3.7% in 2008 and 5% in 2007. More specifically, sub-Saharan African countries are expected to grow by more than 3% in 2009 (IMF, 2009).

The major cause of the crisis, broadly speaking, is speculative behaviour by financial institutions, attributed to trading in mainly derivatives. Unregulated non-secured derivatives offered substantial incomes for financial institutions dealing in them, and until recently were thought to pose little risk. Financial institutions traded in mortgage-secured loans under insurance and made money without waiting for the redemption of the loans. Buyers of such loans were comforted by the mortgages, whose prices were assumed to rise. Although such financial innovations offered financial institutions enormous profits, the behaviour encouraged risky lending by investment banks: the banks would pass on the risk to other financial institutions that would buy the loans. When house prices in the US declined, holders of these mortgages could no longer recover their money, and financial institutions that had guaranteed these assets suffered enormous financial losses, marking the beginning of the global financial crisis.

3. Manifestation of the shock at the national level

Owing to weak financial market linkages between Uganda's financial sector and the global financial system, some commentators have argued that Uganda is unlikely to suffer from financial contagion. But there is evidence that the financial sector in the country has not completely escaped the crisis. Financial contagion to Uganda could be classified into two categories: i) spillovers through financial market linkages; and ii) pure contagion. Spillovers through financial market linkages include spillovers through stock markets and financial intermediaries.

3.1 Banking sector

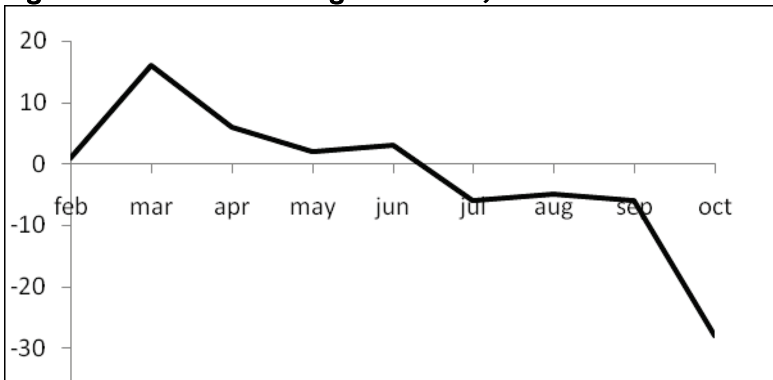
Whereas it is true that much of the damage to financial institutions in the major economies was a result of the sharp decline in the value of the complex securities they were trading in, and it was thought that Ugandan institutions that did not get involved would be spared, the slowdown in economic activity may impact on their loan portfolios. It is likely that non-performing loans will increase and damage the bank balance sheets. The other impact of the crisis on the financial sector in the country has been the drop in demand for government securities, as investors retreat to safer destinations like the US. For example, the Bank of Uganda (BoU) had to suspend a number of Treasury bill auctions in the first quarter of 2009. In order to encourage lending, the BoU recently cut its lending rate to the commercial banks by 3.4 percentage points, from 19.3% to 15.8%. Another point of concern is the structure of Uganda's banking sector: about 80% of the banking business is foreign-owned (mainly South Africa, the UK, Nigeria and Kenya), which poses a potential risk to the economy, since local banks may face difficulty as a result of their parent companies withdrawing funds to support operations abroad (IMF, 2009). However, as of now, there is not much evidence that any domestic banks have been affected in this respect, partly because most local banks are licensed subsidiaries of foreign banks, rather than branches, which makes it easy to detect potential risks of capital withdrawal through central bank supervision. Strong supervision by the BoU has in recent times ensured a sound financial sector, and this will come in handy in these times of crisis.

3.2 Financial markets

Even amid the global recession, the BoU has been increasing interest rates (by 2% in January 2009), motivated mainly by rising inflation, which hit a peak of 15.8% by end-August 2008. This was only reversed after a realisation that the economy was deteriorating, with the government cancelling Treasury bill auctions, as discussed. The local stock market, the Uganda Stock Exchange (USE), was also affected: the retreat of investors from financial markets in the developing world has affected not only government securities but also stock exchanges. For example, companies listed on the USE are not heavily reliant on foreign financing and will be only minimally affected by the credit crunch, but the high percentage of foreign investors exiting (e.g. between June and October 2008, 7.5% of institutional investors exited from Stanbic Bank, which accounts for nearly half of the location market capitalisation) may deprive the bourse of capital.

The all share index of the USE fell by 30% in February-June 2008 before losing 39% in July-October 2008, with the month of October 2008 recording the biggest loss of 28% (Figure 1). In addition to the impacts of the Stanbic Bank situation, this was a result also of the fall in the share prices of cross-listed firms including East African Breweries Ltd, Kenya Airways Ltd and Jubilee Holdings Ltd, accounting for 61% of the total market capitalisation of the USE. Data from the USE show that, more than the exit of foreign investors, the dip in the stock market was a result mainly of panic sales by local retail investors, with the number of local investors decreasing by 26%, compared with a 5% decrease by foreign investors. It should be understood, however, that even if the number of foreign investors exiting the market appears small, most of these are large institutional investors, which cumulatively add up to a big capital withdrawal.

Figure 1: All share index growth rate, Feb-Oct 2008

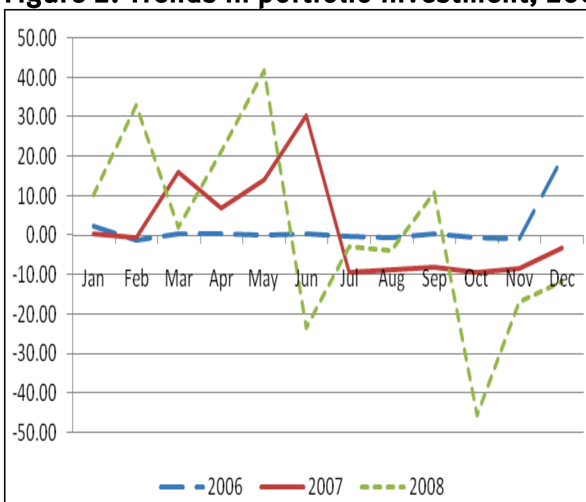


Source: Capital Markets Authority (2008).

In spite of the seemingly large dip of trading in the USE, it is still in its infancy and hardly characterised by secondary trading in equities: its role in the economy is still very minor. Similarly, secondary trading in financial instruments, particularly loan securities, is almost non-existent in Uganda. These factors make the local stock market a minimal player in the Ugandan economy.

Some of the impacts on portfolio investment in the country, and indeed most of the developing world, may arise from the recent strengthening of the US dollar and the attractiveness of US Treasury bills. This has been aggravated by the massive stimulus packages the US government is committing to the US economy. Consequently, investors that would have invested in Ugandan government Treasury bills or in the USE are looking to US Treasury bills, which are considered less risky than Ugandan ones. Indeed, there is evidence that portfolio investments in Uganda have suffered a sharp decline, which was steepest towards the end of the third quarter (Figure 2). The crisis has also impacted the ability of the government to issue bonds. For example, the government has postponed its intention to issue the Eurobond to fund infrastructure investments.

Figure 2: Trends in portfolio investment, 2006-2008 (US$m)



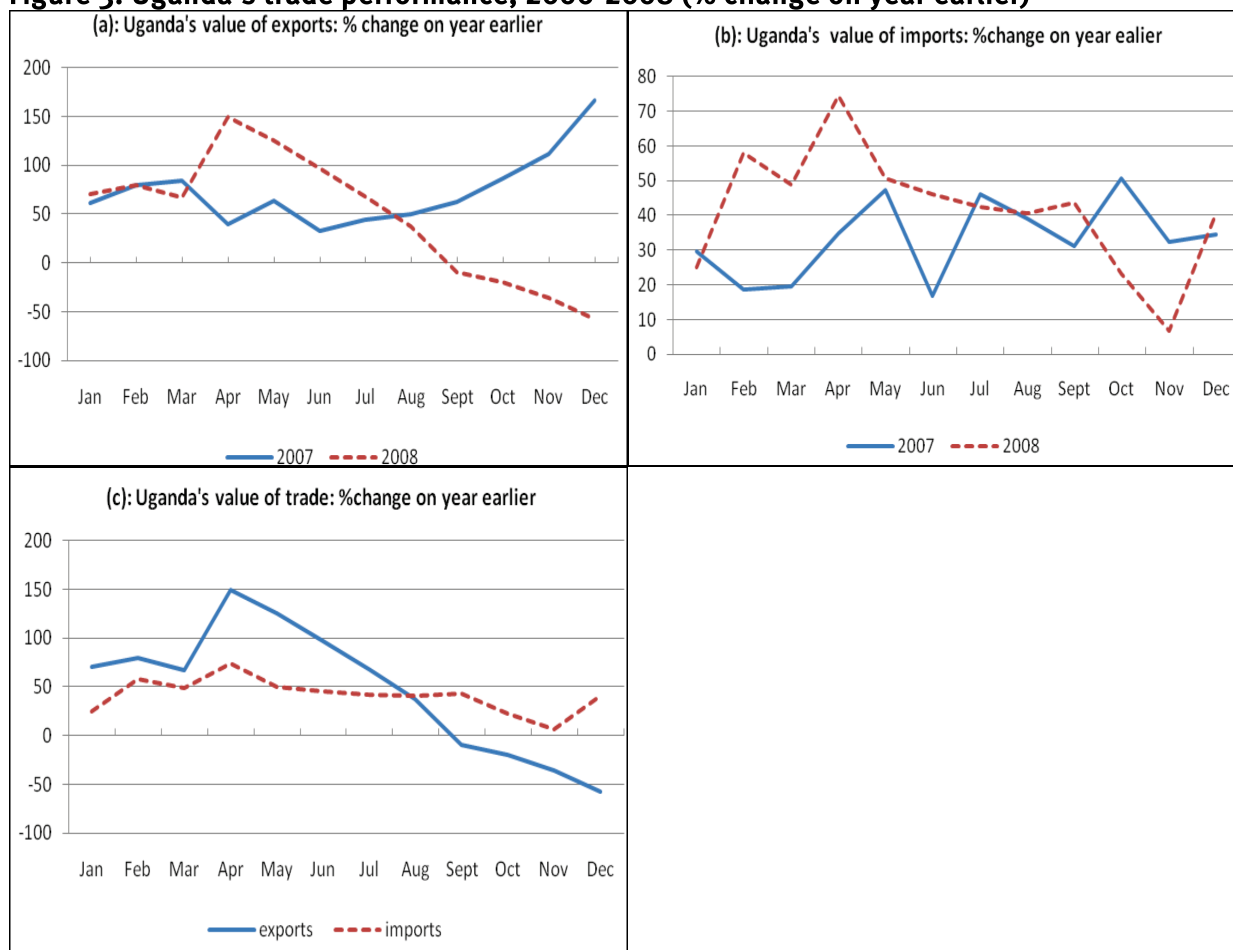
Source: BoU (2008b).

Moreover, while the linkage between the global and the Ugandan financial sectors is weak, the Ugandan economy is heavily dependent on developed economies that are suffering from the adverse effects of the global financial crisis. The result is that, although the country may suffer from only minimal primary impacts of the crisis, it is likely to suffer from the secondary impacts. The adverse effects of the crisis are likely to manifest themselves through the following channels.

3.3 Trade

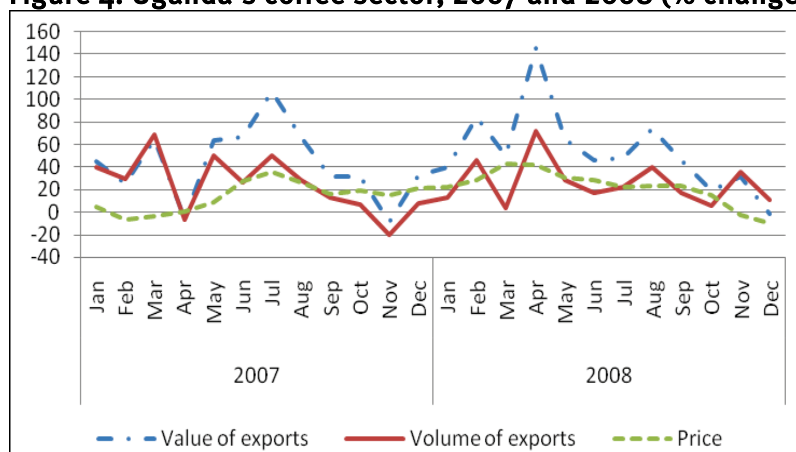
The global economy is now linked more than before because of globalisation, and decreases in demand in developed countries will have a major impact on the economies of the developing world that supply mainly primary products. Consequently, although Uganda's trade has been improving recently (12.8% of export to GDP in 2007/08), there was a marked reduction in exports in 2008 compared with the past two years, signifying the effects of the crisis (Figure 3a). Uganda's exports fell by 10.3% in September 2008 compared with a year earlier, with sharp declines continuing through December 2008. What has happened to Uganda's top exports? The performance of the coffee sector, which contributes nearly 20% of total exports, has gone down. Europe is the main destination for Uganda's coffee, and worst hit by the crisis after the US. The value of coffee exports fell by 0.8% in December 2008 compared with a year earlier, with declines explained largely by the drop in export prices (of 9.4%) rather than changes in volumes (Figure 4).

Figure 3: Uganda's trade performance, 2006-2008 (% change on year earlier)



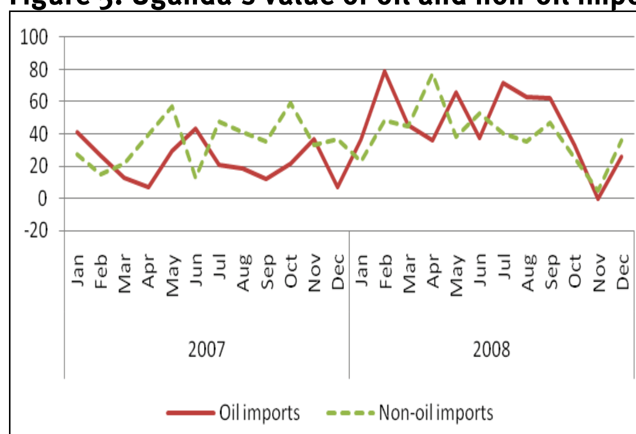
Source: BoU (2008b).

Figure 4: Uganda's coffee sector, 2007 and 2008 (% change on year earlier)



Source: BoU (2008b).

Figure 5: Uganda's value of oil and non-oil imports, 2007 and 2008 (% change on year earlier)



Source: BoU (2008b).

In the recent past, fish exports (fish and its products) peaked as one of the main exports from Uganda. Uganda exports fish within and outside the region, with regional trade accounting for more than half of the volume. Both volumes and prices were more volatile in 2008 than in the previous two years (Figure 6a). More noticeably, volumes exported declined faster relative to declines in prices, to both international and regional markets, towards end-2008, with a greater effect on international than on regional markets. That said, fishing activities have gone down, owing partly to the depletion of fish stocks from the lakes, and a number fish factories have closed down.

On the other hand, regional trade, especially in non-traditional exports such as maize, beans and cement, was expected to cushion Uganda from adverse effects of the crisis. Indeed, in the last quarter of 2008, Uganda witnessed significant increases in non-traditional exports, owing partly to relatively higher food prices. Exports to the regional market accounted for 45% of all Uganda's foreign trade (regional trade is mainly in food crops, which do not usually go to the international market). Yet, towards the end of the fourth quarter of 2008, prices of non-traditional exports to regional markets reduced significantly and so did the volumes traded – suggesting low demand in importing countries. Consequently, low demand in importing countries may limit the extent to which regional trade cushions Uganda against the adverse effects of the crisis in the medium and long term. For instance, in November 2008, regional export prices reduced by 26% relative to same month in 2006, compared with 22.6% in other markets. Figures 6c and 6d depict a significant drop in both volume and export prices of maize and beans, with volumes dropping faster than prices.

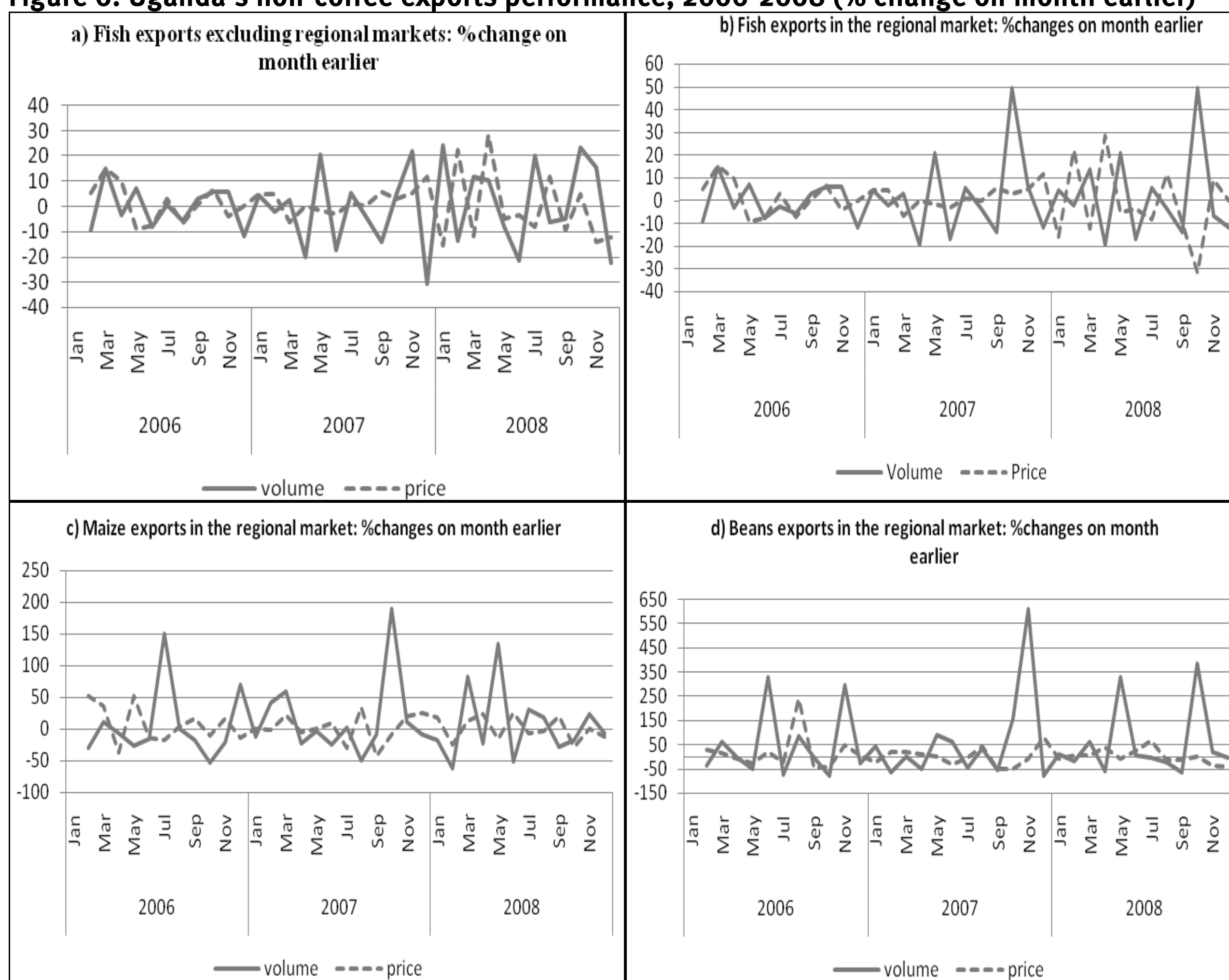
Figure 6e depicts more volatility in the flower export market in terms of volumes and prices in 2008 relative to the past two years. The increase in volumes during the first quarter of 2008 was short-lived. In December 2008, export prices declined by 39.8% and volumes traded by 27.3% compared with a

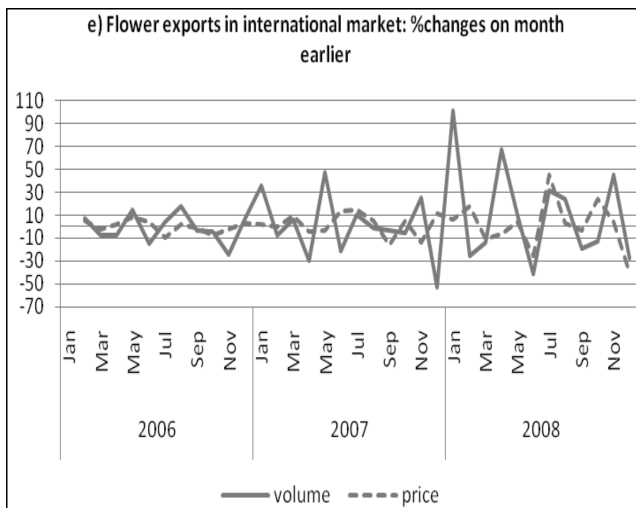
month earlier. Like coffee exports, the reduction in export prices rather than the reduction in volume explains the changes in value of non-coffee exports. Thus, the drastic decline in export growth has implications for the international reserves of the central bank and revenue collection from international trade. To date, Uganda has foreign exchange reserves enough to finance more than five months imports of goods and service.

As share of GDP, the value of imports has increased over time – fluctuated between 18% and 25% during the period 2002/03 and 2007/08. More importantly, the value of imports has been increasing, arising from the depreciation of the shilling, which has made imports more expensive. Monthly data suggest that imports for the year 2008 have been generally higher than for 2007 (Figure 3b). The exception was in the September-October period, when the Kenyan government reduced the maximum axle rate weight for oil haulers, which led to a reduction in oil imports. However, from November 2008, there was a sharp increase in imports relative to a year earlier, as a result of the sharp depreciation of the Ugandan shilling arising from the crisis (Figure 7). The trade balance worsened. Indeed, imports only surpassed exports in the later months of 2008, after a sharp increase (Figure 3c). Imports increased by 43.7% in the same period. But the marked drop observed in November 2008 (of 6.8%) is a result of the decrease in volumes arising from decreased demand in the country and other structural problems in the import route through Kenya.

The share of oil imports in total imports remains at about 16%. Uganda imports all its oil products and, in spite the plummeting of world oil prices, pump prices in Uganda remain high. This is attributed partly to high depreciation of the shilling against the dollar (see Figure 7), poor infrastructure and the cost of doing business. The value of oil imports fell in November 2008 by a fifth relative to a year earlier (Figure 5).

Figure 6: Uganda's non-coffee exports performance, 2006-2008 (% change on month earlier)





Source: BoU (2008b).

Besides trade in goods, trade in services is also bound to be affected by the global economic crisis. For example, it is conceivable that tourism will decline. Most tourists in Uganda come from Europe. According to officials from the Ministry of Finance, Planning and Economic Development (MoFPED), the effect on tourism, hotels and conference destinations has already been felt, as their performance is declining. The ministry expects this to translate into unemployment.

3.4 Private capital inflows

3.4.1 Foreign direct investment

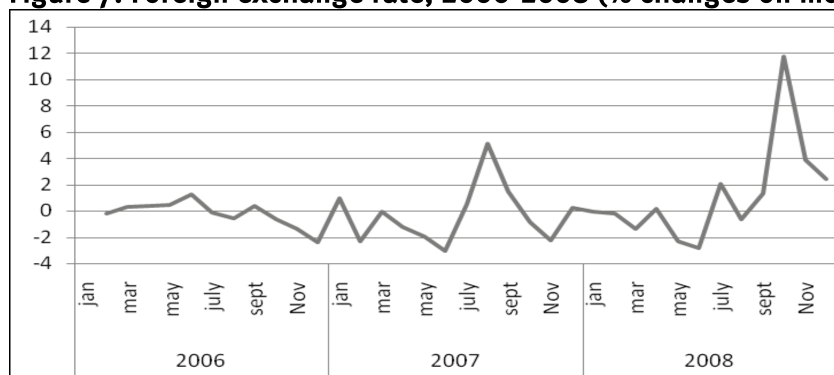
Because of the difficulty in raising capital, it is conceivable that the levels of foreign direct investment (FDI) may decline as foreign firms look inwards to solve domestic challenges. In the recent past, FDI flows to Uganda have been directed to natural resources, including oil exploration and electricity generation. For instance, the Bujagali Hydropower Project, funded by the Aga Khan Fund for Economic Development (AKFED), the African Development Bank (AfDB) and the World Bank, begun in 2007 and expected to be completed by January 2011, has been running ahead of schedule, and the impact of the financial crisis does not seem to have slowed construction. Similarly, investments in oil exploration do not seem to have been slowed by the crisis. Exploration work is being undertaken mainly by four firms: Heritage Oil and Gas Ltd, Tullow Oil, Dominion Petroleum and Tower Resources, UK. As of end-2008, more than US$500 million had already been invested in the exploration of oil and gas, representing 30% of possible exploration areas in the country. These firms have been increasing their investment even as the crisis deepens.

Other sectors that have continued to attract FDI include telecommunications. There is no indication of a slowdown here as the crisis deepens. This is evident from the launch of a new mobile telephone provider (Orange Telecom) in March 2009. Therefore, although it is likely that FDI will be affected by the financial crisis, so far it seems that big investments that were already under consideration may not be affected. In the banking sector, Stanbic Bank reported a reduction in dividends to be paid to each shareholder – the shareholders will temporarily forego at least Shs20 billion as the bank moves to cushion itself against spillover effects (The New Vision, 27 March 2009).

Capital inflows dropped, with two direct effects: i) depreciation of the shilling against the dollar (Figure 7); and ii) increase in domestic interest rates (Figure 8). The exchange rate depreciated by nearly 12% in October 2008 and is continuing: it stood at Shs2020 to US$1 by mid-march 2009. Speculation in the foreign exchange market has exacerbated this. The intervention of the BoU in the foreign exchange market, buying nearly $2.6million during the fourth week in March 2009, caused panic in the market – with the exchange rate to the dollar increasing from Shs25-50. It is too early to predict the effect of this intervention, especially on the private sector. On the other hand, interest rates on government Treasury

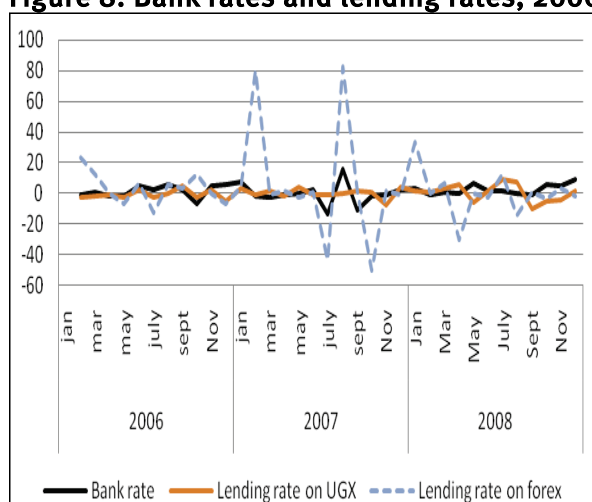
bills and bonds have increased. While the central bank in March 2009 cut the bank rate by 3.4 percentage points, we are yet to see a response from commercial banks.

Figure 7: Foreign exchange rate, 2006-2008 (% changes on month earlier)



Source: BoU (2006-2008).

Figure 8: Bank rates and lending rates, 2006-2008 (% changes on month earlier)



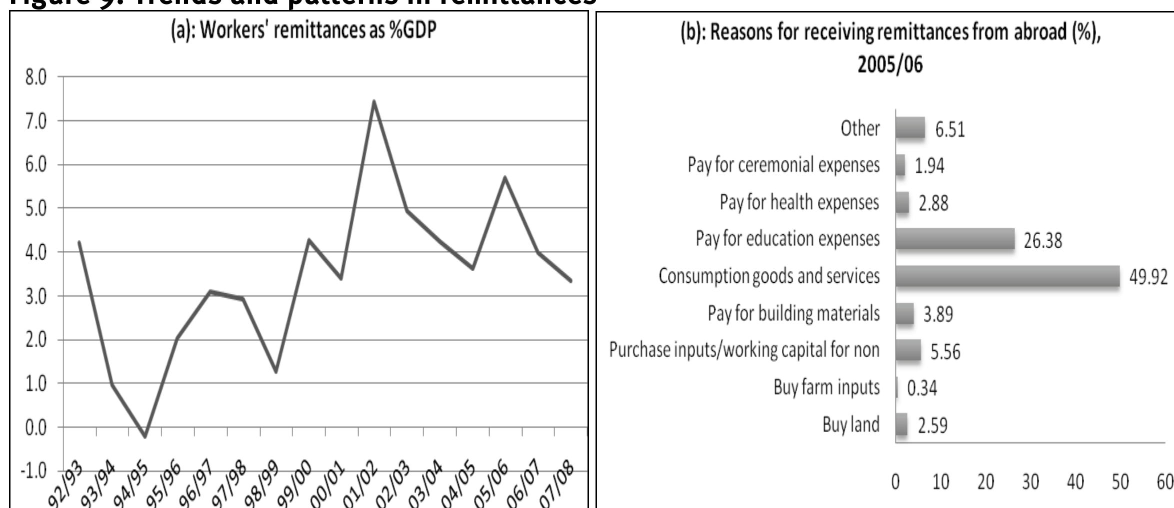
Source: BoU (2006-2008).

3.4.2 Remittances

Remittance flows, according to the World Bank, are a sum of workers' remittances, compensation of employees and migrant transfers. However, the last two components are not captured in available official data. Workers' remittances are estimated as a residual in the balance of payments. Reliable data are not available on a monthly or quarterly basis: this analysis is based on annual data. Remittances have increased in absolute terms over time, as share of GDP remittances registered a decline from 4% in 2006/07 to 3.4% in 2007/08 (excluding informal remittances). It is evident that the size of remittances relative to Uganda's GDP is quite low compared with Kenya. That said, the share of remittances to GDP is nearly half the share of exports of goods to GDP. The main origins of the remittances are the UK, South Africa, the US and Sweden. According to Aapa-Okello and Anguyo (2006), remittances to Uganda are pro-cyclical – they increase during periods of economic boom and fall during periods of economic downturn.

According to official information from the BoU, Ugandan diaspora inflows are invested in property. In addition, remittances to households have played an important role in improving their welfare. Empirical evidence at household level shows that nearly 2% of Ugandan households received remittances from abroad in 2005/06. As a share in total consumption expenditure of Ugandan households, remittances accounted for nearly 10% during the same time. Further analysis of household data suggests that much of the remittances is – in order of importance – for smoothing consumption and human development (see Figure 9b).

Figure 9: Trends and patterns in remittances

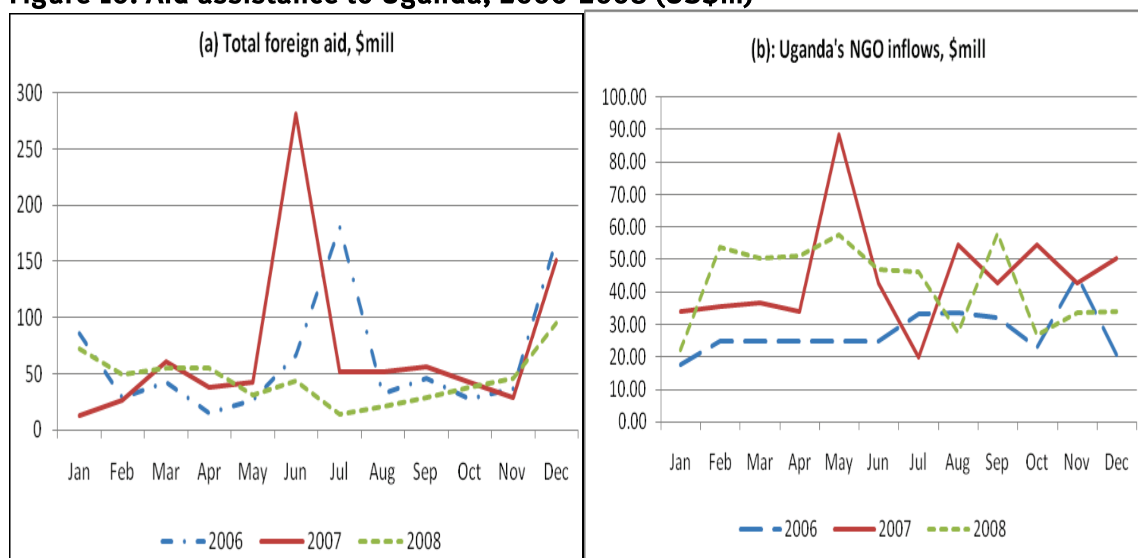


Source: i) Authors' calculation based on official statistics from BoU (2008b) and ii) UBoS (2006).

3.5 Aid

Foreign aid to Uganda decreased from US$223.29 million during Q4 2007 to $178.9 million in Q4 2008, with budget support recording a greater reduction relative to project support. This decline is evident in Figure 10. Since 2001, donor budget support has surpassed project aid, largely as a result of an emphasis on basket funding. That said, donor budget support has been declining over time. In 2008, it stood at 40.3% of total foreign aid, compared with 59.8% in 2007. Broadly speaking, donor inflows continued to come in as loans rather than grants. The share of grants in total aid was almost half in 2006/07 but increased to about 62.3% in 2007/08, mainly in project support. The share of budget support in total loan aid reduced from 44.2% in 2006/07 to 24% in 2007/08. Overall, Uganda is more likely to register further declines in official development assistance (ODA), although there is no indication of this as yet from donors. An official from the UK Department for International Development (DFID) indicated that the UK's aid to Uganda would continue in the post-crisis period because of earlier commitments, but stressed a need for the government to strengthen its governance.

Figure 10: Aid assistance to Uganda, 2006-2008 (US$m)



Source: i) BoU (2008b) and ii) UBoS (2006).

Non-governmental organisations (NGOs) continue to play a key role in Uganda's development, especially in terms of humanitarian assistance (e.g. World Food Programme (WFP), World Vision). Although ODA flows may not decline owing to the nature of the contractual commitments with donors

and their vested interests in keeping the status quo, it is possible that inflows through, for example, NGOs may decline as donors begin to tighten their budgets as a result of the crisis. Indeed, inflows to NGOs declined by 5.3% between 2007 and 2008, with the decline more pronounced since October 2008 (Figure 10d). Humanitarian assistance could also decline as UN agencies register a reduction in the amount of resources they mobilise. This trend threatens the humanitarian and development efforts in the country.

4. Broad macro effects

This section looks at the likely broad macroeconomic effects of the crisis, particularly the national budget (including public sector debt), growth, investment, employment, poverty and inequality. To the extent possible, trend analysis of financial inflows such as government revenue, aid, private capital inflows and remittances, looked at in Section 3, is used to assess the likely impact of the crisis on the real economy.

4.1 Growth, investment and employment

In the past five years, Uganda has continued to enjoy impressive growth (Table 1). Sector contributions to GDP have changed over time, with the contribution from agriculture declining from 21% in 2003/04 to 15.6% in 2007/08, growing the least despite being the main source of employment for Ugandans. The shared of value added contributed by the industry sector has stagnated at around 25% since 2005/06, with nearly half of the percentage share from construction. The services sector contributes nearly half of total GDP and grew at 13% in 2007/08. The growth in the services sector in this period was driven largely by financial services, at 29.9%. In addition, peace in southern Sudan has impacted positively on the services sector: Sudan has become the single biggest destination for Uganda's exports among its regional partners.

Table 1: Sectoral contribution to GDP and growth rate at market prices, 2003/04-2007/08 (2002/03=100) (%)

	2003/04	2004/05	2005/06	2006/07	2007/08
Sectoral contribution to GDP					
Agriculture	21.1	20.2	18.3	17.0	15.6
Industry	22.8	24.0	24.8	25.3	24.5
Service	49.1	49.0	49.6	50.1	51.5
Adjustment	7.0	6.8	7.2	7.7	8.4
Growth rates					
GDP	6.8	6.3	10.8	7.9	9.8
Agriculture	1.6	2.0	14.7	0.1	0.7
Industry	8.0	11.6	12.2	9.9	6.4
Service	7.9	6.2	7.9	8.8	13.0

Source: UBoS (2003/04-2007/08).

As noted, the crisis will adversely affect the Uganda economy through its adverse effect on capital inflows, particularly remittances, aid, FDI, exports, exchange rates and interest rates. As these resources decrease, investment, employment and economic growth will likewise be adversely affected. Therefore, Uganda seems to face a high probability of decreased economic growth arising from the crisis. This is in line with the projections by MoFPED of reduced growth, from 8.9% to 6-7% in 2008/09. The slowdown in economic growth is also evident from growth projections carried out at the Economic Policy Research Centre (EPRC), which stand at 5.6%. However, these projections remain higher than the IMF projections of 3.5% for sub-Saharan Africa. Reductions in growth will come mainly through reductions in export growth and lower private consumption and investment. Reductions in growth in manufacturing, construction and trade sub-sectors, the main drivers of growth, will impact overall growth.

Uganda has remained steadfast on control of inflation as the overarching macroeconomic policy objective. However, the country witnessed inflation at a double-digit level from May 2008, reaching a peak in August 2008 (of 15.8%) before declining to 14% in January 2009. A weaker shilling will result in higher inflation, especially when coupled with pressure on food prices in the East African region. Much of the inflation is said to be imported inflation from Kenya, South Africa, China and India. Because of

high inflation, the BoU continued to operate a tight monetary policy stance (including an increase in the bank rate), whose effects include high interest rates and thinly spread private sector credit which, if implemented for a long time, could have adverse effects on economic growth. Uganda's central bank has faced considerable pressure to put in place measures that would lower lending interest rates of commercial banks and increase private sector credit. Partly in response to these pressures, the central bank in March 2009 cut the bank rate by 3.4 percentage points, from slightly over 19% to about 16%. Commercial banks are yet to respond to this.

Government financing for economic growth could suffer adversely owing to lower than projected tax revenue and/or aid. The reduction in international trade has contributed to poor performance in tax revenue collection, which has suffered significant shortfalls. Overall, revenue collection fell by 12.8% in July-December 2008 from the same period in 2007. Other contributory factors to low revenue collection include low local demand and expansion plans by companies in telecommunications and manufacturing (beer and clay), to name a few. This has affected mainly performance of corporate tax and value-added tax (VAT), as will be discussed in the next section.

The majority of Ugandans derive their livelihood from agriculture, which will continue to provide employment to the biggest proportion of the population in the near future. However, declining commodity prices towards the end of 2008 could be a disincentive to persons engaged in Uganda's top agricultural exports. The services and industry sectors, which drive the economy, offer the fewest employment opportunities. But these sectors seem to be contracting, owing to low business, which is partly reflected in a reduction in domestic revenue collection. Overall wage employment in the private sector is bound to reduce as long as business in this sector remains low. The continuing depreciation of the shilling is already hurting industries that depend on imported raw materials. Combined with low world aggregate demand, this will have an impact on level of employment, especially for formal employees. On the other hand, with remittances decreasing, which previously boosted the construction sector in Uganda and created a good number of jobs, the country is likely to witness a contraction of jobs in the construction sector. To this end, without any intervention, growth in jobs in Uganda in the near future seems to be low or even negative.

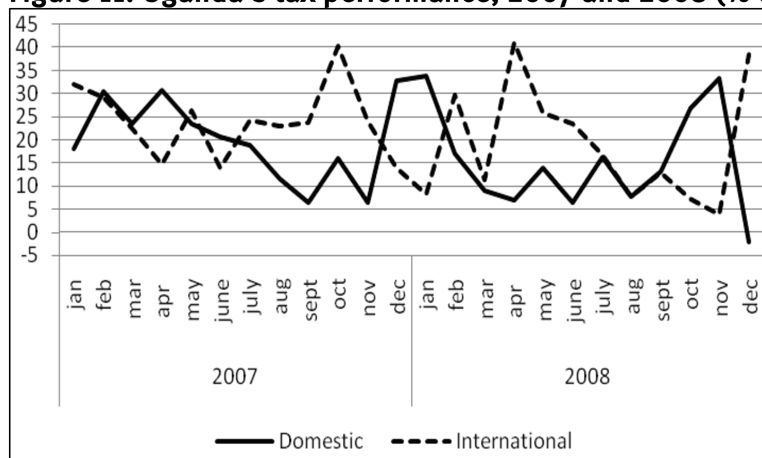
In the real sector, there are reported cases of closure of some firms, with adverse implications for loss of jobs; the closure of fishing factories, the closure of Gateway Television (a cable TV service provider with a parent company in the UK), the downsizing of Warid Telecom and Barclays Bank (200 employees) are cases in point in this regard. Nonetheless, the plethora of production constraints, such as poor infrastructure, inadequate power supply and costly credit, which make Uganda a high-cost producer, remain a major concern, one which the country was already facing even before the crisis started. Indeed, reductions in the cost of doing business by removing these constraints remains Uganda's priority as far as promoting economic growth is concerned.

4.2 Public and private debt

Tax collection as a share of GDP has remained at about 13%. International trade constituted 56.7% of total tax collection in 1997/98 and declined to 48.7% in 2006/07, with petroleum duty contribution dropping from 22% in 1997/98 to 16% in 2006/07. There is already enough evidence to suggest a shortfall in revenue collection by the Uganda Revenue Authority, and there is limited scope for increasing tax revenues in the short run to offset declining financing from other sources. Uganda's slowdown in tax collection only partly reflects the poor performance of international trade. Some of it owes to poor performance in revenue collection from domestic sources as a result of a slowdown in economic activity. Monthly data show that, in December 2008, tax collection from international trade was 38.6% higher compared with 14.1% in the same month in 2007 (Figure 11). On the other hand, domestic revenue dropped by 2.1% in December 2008 on a year earlier, partly as a result of a sharp decline in indirect taxes, especially VAT collections. VAT being a consumption tax, its reduction is indicative of low domestic demand/consumption. This confirms the concerns of the private sector – that this will in turn result in low investment. Thus, restoring private sector and household confidence

is an immediate action. More important, the reduction in tax revenue affected budget allocations to sectors in Q3 2008/09. Nonetheless, in February 2009 a recovery in revenue collection was reported by the Uganda Revenue Authority. It is still early to predict future revenue collections.

Figure 11: Uganda's tax performance, 2007 and 2008 (% change on a year earlier)



Source: Author's calculations based on official data from URA (2007-2008).

With a desire to maintain the same level of expenditure, the government is facing pressure to increase public sector debt. Domestic debt as a percentage of GDP has increased steadily, from 0.3% in 1992 to 9.7% in 2006; foreign debt declined from 96.8% in 1992 to 47.3% in 2006. These figures suggest limited room for increasing public sector debt from current levels. Increased grants from donors would ease the pressure, but donors are focusing more on solving their own domestic problems. On the domestic front, Uganda still maintains its policy of limiting borrowing from the domestic market that could crowd out the private sector from the credit market. Accordingly, data do not indicate any significant changes in public sector debt. With decreasing revenues and insignificant increases in public sector debt, government is left with only one option – to cut public expenditure by cutting budgets of some ministries and departments. This happened in Q3 2008/09. Such actions will have an adverse effect, not only on financing of ministries and government departments, but also on service delivery, economic growth, jobs and ultimately quality of life.

Will private sector credit decrease as a result of the crisis and increased borrowing by the government? The answer to this question is that both the quantity and distribution of private sector credit does not suggest such compensation. Private sector credit available from the commercial bank has registered growth, however, from 23.2% in 2007 to 56.7% in 2008. Private sector credit became even more concentrated among 'other services and personal loans', which includes real estate, personal loans and others, and continued to account for the largest share of credit from commercial banks, at 44.7%, followed by the manufacturing sub-sector at 16.3% and trade and commerce at 13.2% (BoU, 2008a). However, during the fourth week of March 2009, Stanbic Bank increased the interest rate on loans to individuals from 26% to 36%, citing increased cost of doing business as the number of potential loan seekers is reducing.

4.3 Poverty and inequality

In this section, we endeavour to provide preliminary indications on how these national shocks impact on poverty and inequality at household level. In other words, what are the potential poverty and inequality implications of these national shocks?

Uganda is one of the few sub-Saharan African countries that have recorded impressive reductions in poverty and are expected to achieve MDG 1 of halving poverty by 2015. The proportion of the population living below the absolute poverty line declined from 56% in 1992/93 to 31% in 2005/06. However, in absolute numbers, income poverty remains a key development challenge, with the number of persons

declining marginally from 9.8 million 1992 to 8.9 million in 2005/06 – largely attributed to high population growth. The majority of people suffering from consumption poverty are rural dwellers, especially crop farming households. Nearly 61% of the population in northern Uganda lived in poverty, followed by eastern Uganda, with a poverty headcount of about 36% in 2005/06. Increasing unequal distribution of income has slowed down the speed of poverty reduction, and this may make it more difficult to attain high growth. The Gini coefficient, a measure of inequality, increased from 0.37 in 1992 to 0.41 in 2005/06. For every 1% decrease in growth, the percentage of people living below poverty line will increase by 2%, holding distribution constant (Ssewanyana, 2008). To this end, the economy has to grow by at least 7% and consumption at household level by at least 4% if Uganda is to attain MDG 1 by 2015.

The social sector has attracted more donor support than the real sector, with DFID and the World Bank the main actors, among others. During 2008/09, the government allocated 19.9% to health and 28.6% to education as shares of total government expenditure. A greater percentage is funded through donor support. Uganda is one of the sub-Saharan African countries with higher dependence on donors for budget support – estimated at 35% in 2007/08. There is empirical evidence that public spending on health and education sectors has benefited the poor, especially in rural areas, and has in turn led to a reduction in gender inequality (Deininger and Mpuga, 2005). This crisis might interrupt the provision of third party drugs, including antiretroviral and malarial drugs, and in turn escalate drug shortages in health facilities. Thus, reductions in aid flows (if it does happen) and in tax revenue will have profound effects on the provision of social services.

The increasing cost of living is already having negative implications. We earlier pointed out that inflation reduced by 0.1 percentage point, from 14.4% in January to 14.3% in February 2009. Core inflation, which excludes food crop items, fuel, electricity and water, fell by 0.8 percentage points, from 13.4% in January to 12.6% in February 2009. As evident from the reduction in VAT collections from domestic sources, domestic demand is low. This has affected not only households but also private firms. On a positive note, Ugandans could have reaped rewards from high food prices (Benson et al., 2008) within the region, but food prices started to fall in the first quarter of 2009, as discussed earlier.

Previous studies show that performance of the coffee sector has strong implications for the rate of poverty reduction in Uganda (Okidi et al., 2007). In other words, reductions in world coffee prices are likely to affect incomes and in turn consumption. Similarly, reductions in volumes of maize and beans exported might impact negatively on those households involved. In addition, high paraffin prices and high costs of transport owing to high domestic fuel prices will negatively affect household welfare, especially that of rural households.

Reductions in remittances and possibly in ODA will result in less private consumption, higher levels of consumption poverty and greater deprivation, and will exacerbate existing inequities. Reductions in remittances to households will reduce private consumption, since the majority of households use such remittances for smoothing their consumption. The extent of the impact may be limited, given that a small proportion of households reported having received remittances in the past 12 months prior to the survey. More importantly, this will affect social programmes and interventions in lagging areas, especially northern Uganda, and those targeting the most vulnerable groups.

5. Scope for policy responses: Actual, potential and optimal policy direction

Uganda's overarching objective is to achieve strong real GDP growth of at least 7.0%, inflation below 5.0%, a competitive exchange rate and adequate foreign reserves. The need to balance these aims has shaped the nature of the response to the crisis by the economic policy authorities. As already alluded to, the beginning of the financial crisis in the latter half of 2008 coincided with high inflationary pressures in the economy, arising mainly from fuel and food price hikes. After an initial period of denial and of 'wait and see', the continuous spike in the level of inflation forced the authorities to increase the bank rate by 2% at the beginning of 2009 in order to stem inflation pressures. After a realisation that the economy was deteriorating, there was a policy reversal, as the BoU moved to cancel some auctioning of Treasury bills and also reduced the bank rate at which it lends to commercial banks in March 2009 by 3.4%, from 19.3% to 15.8%, and the discount rate by the same margin, from 18.27% to 14.8%. It is not clear whether these measures will be enough to spur growth in lending and invigorate business operations that had begun to slacken.

According to some officials in MoPFED, the government has put mechanisms in place to mitigate the impact of the crisis. These include a fiscal stimulus in infrastructure; strengthening regional trade through infrastructure development, especially for those routes with higher potential; and massive support to the agriculture sector through the National Agricultural Advisory Services (NAADS). They further pointed out that it is now time for the government to be more inward-looking than before – relying on the external sector is not prudent.

5.1 Social sector policies in the wake of the crisis

Prior to the global crisis, Uganda's focus on the social sectors, as measured by the proportion of budgetary resources going towards funding the sectors, was very high. It remains so even after the onslaught of the global financial crisis. Uganda has not made any significant change in this regard that could be interpreted as a response to the global financial crisis. However, the impact of the crisis on the budget, particularly on revenue, is beginning to be felt. Without increases in public sector borrowing to finance the budget, Uganda is likely to be left with hardly any option but to cut spending. However, the budget for Poverty Alleviation Fund (PAF) priority areas – including health, education, water and sanitation and agriculture – is protected from budget cuts in the event of revenue shortfalls, suggesting that the government is unlikely to cut the budget in these areas. The biggest proportion of the social sector budget is conditional spending of debt relief money on social sectors, which includes financing of the Universal Primary Education (UPE) programme.

While public sector resources to PAF priority areas may have remained unaffected, or increased to cater for the increasing demands of these activities, there are concerns about decreasing private financing of the social sector arising from decreased remittances from abroad, decreased household incomes attributed to lower prices of coffee on the international market and decreased household incomes attributed to loss of jobs arising from such things as decreased FDI, closure of firms and low demand. Uganda is yet to implement any policies that would be geared towards ensuring that the private sector continues to play its due role in financing the social sectors by implementing policies that would accelerate growth and increase incomes of the private sector.

5.2 Policies for accelerating growth

The two main options to spur growth in the wake of this crisis are a short-term monetary and/or fiscal stimulus to generate enough business and ensure optimal tax revenues to fund government expenditure. The government is, however, limited in fiscal resources to stimulate the economy in the

short run without exacerbating the budget deficit and worsening the inflation rate. Moreover, although it is conceivably possible for the authorities to use monetary tools to stimulate the economy, they are limited by how much lower they can go with the interest rate. It is also not clear whether the transmission mechanism between the central bank and the commercial bank is healthy enough to translate into lower costs of borrowing for the private sector. Moreover, the authorities' reluctance to destabilise the macroeconomic fundamentals that have sustained the impressive growth rates over the years has led them to operate a tight fiscal and monetary policy. This austerity only works in a normal global environment: it is important that there be a relaxation of these policies in order to increase demand and spur economic growth.

The recent lowering of interest rates, together with the setting-up of the Credit Reference Bureau to reduce credit risk, is a step in the right direction. Given the small resource envelope and the inability of the government to borrow from the public, the authorities' fiscal stimulus choices are limited. The best option available is to reduce wasteful spending by channelling the limited resources into mainly productive sectors of the economy and those areas that will ensure social protection of the vulnerable. Albeit in limited ways, the government can do some things in the short run to mitigate the impact of this crisis. It should ensure that businesses that are providing most of the tax revenue and employment are not allowed to fail. A rescue package should be prepared to ensure that struggling businesses, especially financial firms, are not allowed to file for bankruptcy. The alternative would be devastating for the economy. In addition, the government should use its resources to help the private sector start mass employment businesses. Recent moves to revitalise the Uganda Development Corporation (UDC) and to recapitalise the Uganda Development Bank (UDB) will help in these endeavours. In the medium and long term, the government should continue to prioritise investments in areas that will lead to increased agricultural productivity, considering that is where the majority of the population derives its livelihood. It is also important that infrastructural constraints be removed in order to spur growth and generate employment. A detailed response to the crisis is given in the following section.

5.3 Mitigation measures

Mitigation measures with regard to the global financial crisis are short-term measures that would limit adverse effects on the Uganda economy. This section looks at possible mitigation measures, structured along three key areas of interest, which include economic policies, social sector policies and economic growth policies.

5.3.1 Economic policies

Monetary

On the monetary policy front, Uganda needs to implement measures that would increase private sector credit and recover demand in the economy. The challenge lies in how to do this within a framework that prioritises the control of inflation. However, there is a need for the monetary authorities to explore the extent to which the so called 'excess liquidity' that the central bank mops out of circulation is really a threat to inflation. One way of doing this is to exclude commercial banks from the primary market of Treasury bills until the excess liquidity proves to be really so. In practical terms, the BoU should offer Treasury bills for sale to the public without the participation of commercial banks. This would increase the volume of money commercial banks can lend to the public and possibly bring down lending rates.

The drive for expansion of private sector credit calls for the development of secondary trading in securities and financial instruments – financial innovations similar to those in Western countries. However, the BoU would need to implement measures to regulate secondary trading in securities and financial instruments to avoid the primary causes of the crisis. Expansion of private sector credit geared towards more investment, job creation and economic growth is the correct way to go, as this would spur investment, consumption, employment and economic growth. This could entail development of an appropriate legal framework to promote secondary trading in securities and financial instruments.

Uganda has done well in the past to focus on ensuring that commercial banks meet the Basel indicators, which include: capital adequacy, assets, management, earnings and liquidity. As commercial banks continue to make new innovations in the financial sector that are not covered under this framework, the central bank will need ways of regulating new innovations, particularly secondary trading in securities and financial instruments. The Credit Reference Bureau Uganda has put in place is a good start in terms of assessing risk in lending, but the measure should be expanded to cover secondary trading in securities and financial instruments.

The role of the central bank should be revised to include achievement of economic growth, employment and investment. In this regard, the BoU should use a two-pronged approach to control inflation: demand management in the short run and enhanced production through increased private sector credit in the medium to long run.

Fiscal

On fiscal policy, given the high debt to GDP ratio, Uganda's public expenditure should be well targeted, focusing more on investment, job creation and economic growth. For instance, there is a need to give incentives to firms that create jobs. Furthermore, government should support production of non-traditional exports within the region that have the potential of cushioning Uganda from adverse effects. Government needs to speed up investment in infrastructure and accelerate interventions in the agriculture sector. Investment in infrastructure connecting Uganda to the rest of the region, especially southern Sudan and the Democratic Republic of Congo, should be sped up. In addition, there is a need to harmonise trade rules and regulations within the region to boost trade. Uganda should also venture into diversifying its trading partners in the developed world.

Above all, as a short-term mitigation measure, the government should find ways of increasing spending to curb the adverse effects of the crisis on demand. Cutting government expenditure because of revenue shortfalls is not the correct way to go when the economy is in a recession. Fiscal space can be created within the budget so that wasteful expenditures are reduced and resources invested in sectors with high multiplier effects. For instance, cutting public administration costs would be a step in the right direction, as would budget reallocation, putting more emphasis on sectors with higher multiplier effects.

In terms of dwindling domestic revenue collection, there is limited scope for increasing revenue from existing sources. There is a need to mobilise revenue from non-tax revenue sources and to improve the efficiency of tax collection.

5.3.2 Social policies

Uganda has done well to protect its social sector budget from budget cuts in the event of shortfalls in tax revenue. This policy should continue. The country should focus more on improving delivery of social services, particularly to vulnerable groups (rural areas, children, orphans and elderly) and regions that are more likely to be hard hit by a reduction in the resource envelope. This calls for enhanced inspection of implementation of government programmes to ensure efficient use of public resources. A focus on people, particularly improvements in the quality of their lives, should be put at the centre of the country's development policy priorities. Growth that fails to translate into improvement of quality of life is meaningless. There are no signs yet of development partners withdrawing their commitments to support the Peace, Recovery and Development Plan (PRDP) to revive the economy of war-ravaged northern Uganda. This was reiterated by the DFID country office. Government should also speed up the pending pension reforms.

5.3.3 Accelerating normal growth and development policies

Uganda's focus on the private sector as the engine of economic growth is the right way to go. However, the crisis has brought several challenges to the private sector, which threaten its leadership in economic growth. Government spending should focus on addressing constraints to private sector

participation in the economic growth process in both the short and medium term. Highest on the agenda is increasing access to credit. Reducing interest rates *per se* is not enough: commercial banks should reduce this investment in Treasury business and scale up lending at favourable rates to the private sector. Also vital is making public sector investments that reduce the cost of doing business in Uganda to enhance the country's competitiveness in external markets. In addition, the private sector has to re-examine its efficiency in doing business.

As the saying goes, the greatest resource of a nation is its people. Uganda needs to focus more on using its people and domestic firms as a source of economic growth. There should be no complacency in terms of unemployment and support should be given to firms that employ people. While macroeconomic stability will remain a necessary condition for investment, employment and economic growth, it is increasingly being realised that it is not a sufficient condition, especially in crisis circumstances. It is imperative that government focuses on utilisation of all its resources – human and non-human – to drive the country's growth and development process.

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