

UGANDA ECONOMIC UPDATE

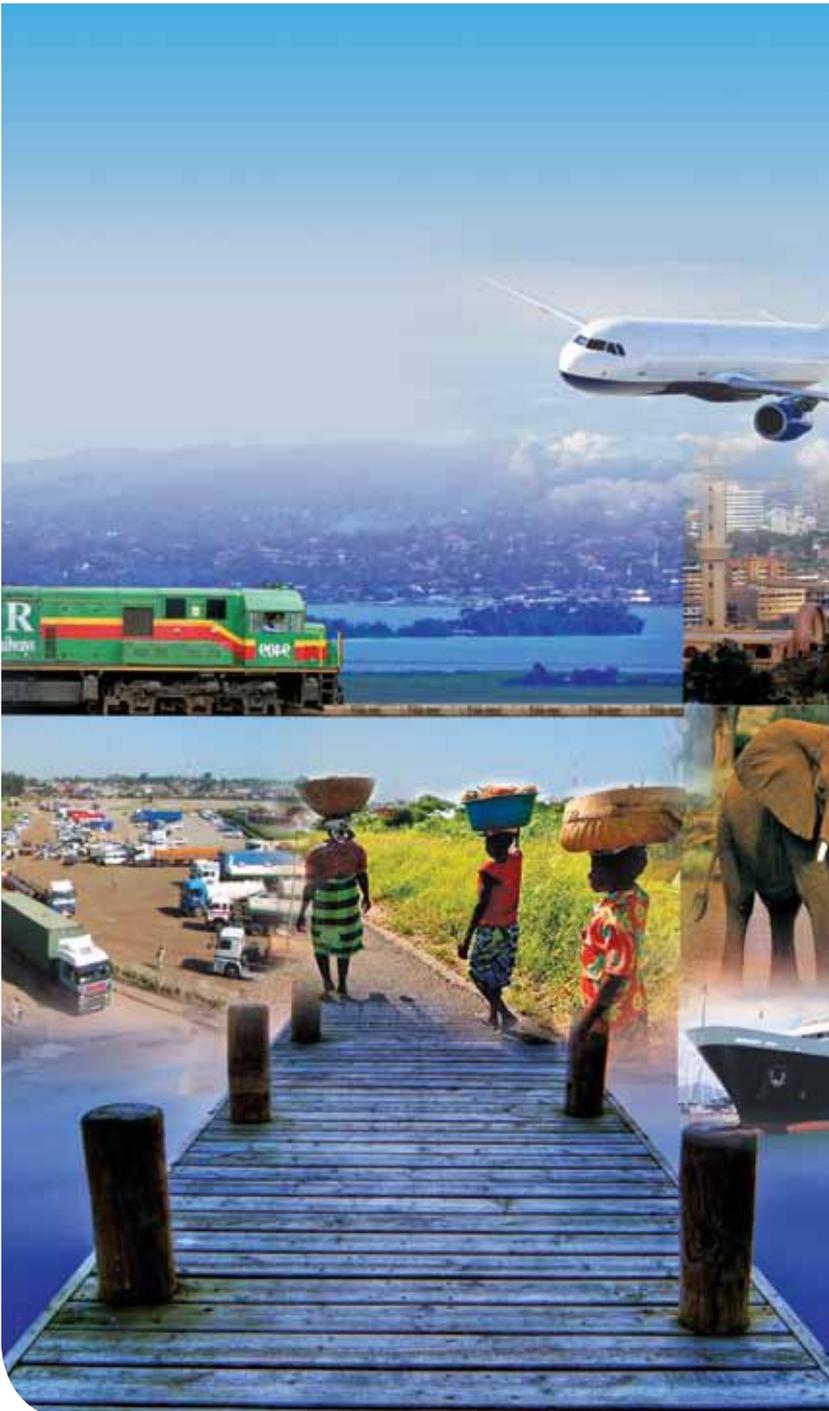
BRIDGES ACROSS BORDERS

Unleashing Uganda's Regional Trade Potential

Overview

Despite having one of the world's highest rates of population growth, Uganda has an impressive record of economic growth and poverty reduction. Over a period of approximately 20 years, from the 1990s until around 2010, the average annual rate of economic growth stood at around 7 percent. During this same period, the proportion of the population living below the poverty line declined from 56 percent in 1992 to 24 percent in FY10.

In sub-Saharan Africa, Uganda was a pioneer of liberalization and pro-market policies in the 1980s. This established the foundation for the country's remarkable economic performance in the 1990s and the 2000s. During this period, the country diversified its exports, mainly through fisheries and tourism, with high levels of private investment. Exports of agricultural commodities (particularly innovative crops such as flowers, tobacco and maize, on top of the traditional exports of coffee, tea and cotton) grew by 16 percent per annum during most of the 2000s. Private investment, which increased to an average of 18 percent of GDP at the end of the century from 11 percent in the 1990s, was mostly driven by construction.



Overview

However, in recent years, the rate of growth has slowed down and has been characterized by increased volatility. From an average of 9.3 percent per annum in the period from FY01 to FY08, the rate of growth declined to 7.2 percent in FY09 and to 5.9 percent in FY10. There was a short-lived recovery in FY11, with the rate increasing to 6.7 percent, before falling again to 3.4 percent in FY12. Developments in first half of FY13 suggest that the rate of growth will remain around 4.5 percent. Uganda, which used to have the best performing economy of the nations in the East African Community, now lags behind all the others, with all the other member nations recording rates of growth of at least 4.5 percent per annum since FY12.

The global economic crisis of FY09 and its after effects have resulted in the deterioration in Uganda's terms of trade, with commodity prices declining while oil prices increased. This had a negative impact on exports and investment, leading to a decline in the rate of growth. The prolonged drought in Uganda has had a significant negative impact on the performance of the agricultural sector. This, combined with poorly directed government spending and poor financial management, has had a negative impact on the macro environment. In turn, this has resulted in a slowing down of the services and industry sectors. The slowdown in private investment and exports was followed by a weakening external current account, driven by a dramatically increased import bill. While the combined impact of efforts to achieve stabilization, good weather and receding shocks might have facilitated a recovery in FY13, uncertainties created by governance-related aid cuts and a decline in investor confidence are continuing to stifle growth. The World Bank forecasts that the rate of growth of the Ugandan economy in FY13 will be in the range of 4.3-5.0 percent, a modest increase com-

pared to FY12 and far lower than the country's recent historical rates. From a longer perspective, vulnerabilities have also become evident over the past five years, when public investments have become the key driver of growth. Exports remain driven by the agricultural sector, which is sensitive to climate change.

If Uganda is to achieve middle income status, it must rebuild a more resilient economy. Such resilience will be achieved through a more rapid diversification of the economic base, characterized by the production of higher value products and the judicious exploitation of the country's oil resources. This has the capacity to boost the economy, including the non-oil sector, and to close current external and fiscal imbalances. Intensified regional trade will be the catalyst for a market-oriented growth strategy to accelerate this process.

To harness the potential of regional trade, Uganda needs to adopt a multi-pronged approach to raise productivity and to get the products to markets. In this regard, interventions that create incentives for farmers, firms and services providers are vital measures to raise productivity. Farmers can then produce outputs in sufficient quantities and quality. Firms can invest in higher value export products. And service providers can invest in quality enhancement to enable Uganda to tap into the regional market. Transport costs must be reduced through the development of better quality infrastructure and improved logistics, non-tariff barriers to goods trade must be addressed, and restrictions to services trade must be eliminated. Deeper regional integration is the main means to ensure the establishment and implementation of interventions that promote a high volume and quality of trade and technology transfers.

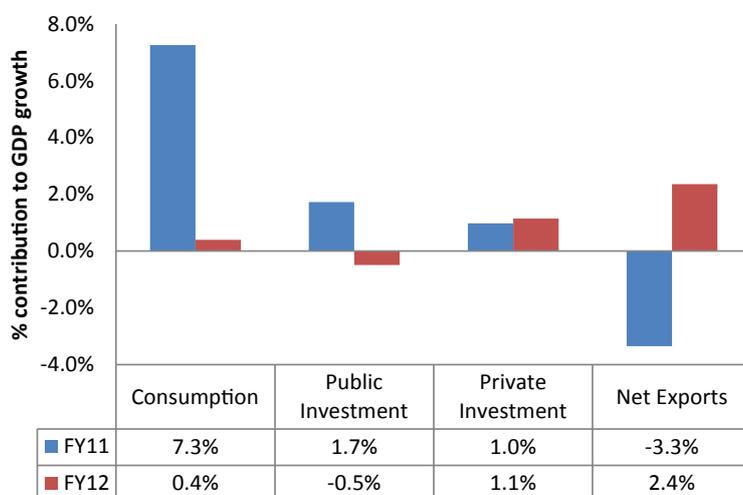


Good infrastructure, like this Masaka-Mutukula road to enable economic recovery, (Charles Kunaka) May 2011)

Part I: State of the Economy: Recent Economic Developments and Economic Outlook

In FY12, Uganda experienced the double blow of a high rate of inflation and a slump in growth, with inflation averaging 23.5 percent and growth declining to 3.4 percent. These two phenomena had not occurred concurrently since 1992, when the economic stabilization and reform process began. The causes for this double whammy were the global economic turbulence that resulted in a decline in exports and investment, higher food and oil prices, together with slippages in fiscal and monetary policy originally meant to counter the global crisis effects, the implementation of which was affected by the February 2011 elections and security spending pressures.

Squeeze in Domestic Demand as Investments Decline and Consumption Shrinks



In FY13, tight management of monetary policy, and in support prudent fiscal policy, has stabilized the economy. The economy has also benefited from a decline in food and energy prices due to external factors, from improved weather, and from the appreciation in the value of Uganda's currency. With the combined impact of these factors, inflation came down to below the 5 percent target by the end of the first half of FY13. Fiscal adjustments that reduced the deficit by more than 3 percent during FY12 also supported efforts to reduce inflation. However, both policy measures also contributed to a slower rate of economic growth.

In FY13, Uganda had high expectations for a recovery of the economy, supported by macroeconomic stability. With the restoration of stability, both increased government spending and a moderate easing of monetary conditions were expected to stimulate overall demand in the economy. At the same time, the Central Bank Rate was cut by 8 percentage points, to 12 percent as of December 2012. As a result, the level of lending to the private sector began to gradually increase during the second quarter of FY13. The FY13 budget had demonstrated the Ugandan government's intention of utilizing spending and taxation as the main instrument to stimulate aggregate demand and supply, particularly through a large investment program. Up to 29 percent of the FY13 budget was allocated to support major road works, the rehabilitation of water ferries, the first stages of a design of a standard gauge rail, and the commencement of construction of the 600MW Karuma hydro-electricity dam.

Despite these expectations, recovery has been constrained by lower than expected expenditure resulting from failure to achieve tax revenue collection targets, budget execution problems, and the recent uncertainty arising from governance scandals and corresponding aid cuts. During the first quarter of FY13, the level of tax revenue collection was 3.8 percent below target. The rate of absorption for the development budget stood at a mere 69.6 percent, compared to 94.2 percent for the recurrent budget. This has undermined the public expenditure program, even as security and public administration budgets were overrun. Key investment projects, such as the construction of the 600MW Karuma hydro-electricity dam, have also been delayed.

Finally, the governance scandals involving the Office of the Prime Minister and the Ministry of Public Service during the second quarter of the year resulted into a freeze of aid estimated at US\$ 300 million (4-6 percent of the national budget or 0.9 percent of GDP). This has not only impacted fiscal operations, but it has also resulted in increased economic uncertainty, with implications for planning and investment, even in the private sector.

Uganda's external transactions position improved during FY12 on account of short term portfolio inflows and increased foreign investment in oil exploration. However, the current account position deteriorated further, following the downward trend experienced in the past five years. In FY13, the balance of payments has been threatened by lower interest rates that have reduced the short-term portfolio and by the governance scandals that have resulted in aid cuts and increased uncertainties amongst investors.

Uganda's short term economic outlook remains mixed, as the economy maneuvers the uncertainties surrounding governance-related disruptions to aid and the decline in investor confidence. Maneuvering these uncertainties is vital if the country is to sustain recovery following the dip in FY12. A positive growth outlook is highly dependent on restored macroeconomic stability, characterized by lower inflationary pressures and looser monetary and fiscal policies to stimulate aggregate demand in the short term. Favorable weather will also boost agricultural output, allowing the agricultural sector to regain its importance. However, the services sector will remain the key driver of economic growth.

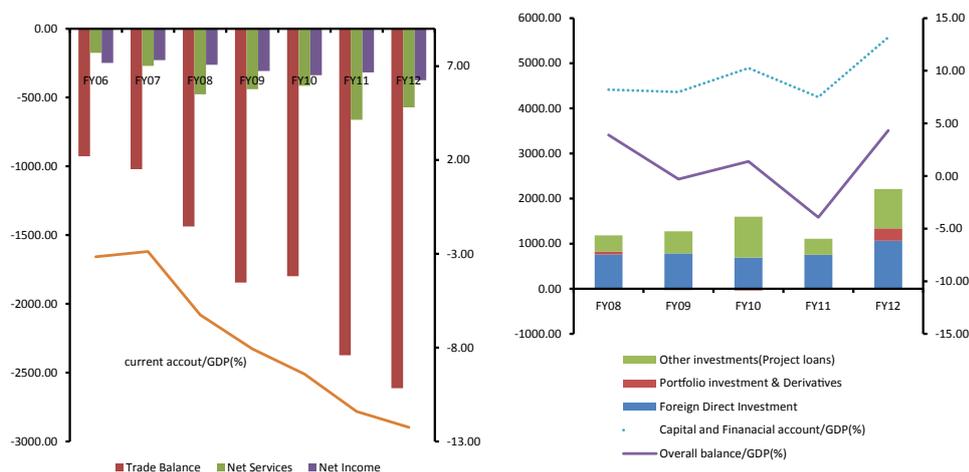
The World Bank forecasts that the rate of growth of the Ugandan economy in FY13 will be in the range of 4.3-5.0 percent, a modest increase compared to FY12 and far lower than the country's recent historical rates. With curtailed momentum as a result of the governance scandals and ensuing disruptions to aid, the economy is expected to recover only modestly in the second half of the FY13 financial year. Facing these problems, the Ugandan government is expected to reduce its level of expenditure, including expenditure in the key transport sector. Hence, while agricultural output is expected to improve as projected, the reduction in government spending is expected to curtail economic activity, even if aid assistance may resume later in the year, following a government commitment

to corrective actions regarding the misappropriation of funds. However, if the strategies of the medium term expenditure program and efficiency reforms are sustained and if aid disbursement resumes, economic recovery may gain momentum in FY14.

As a result of the slowdown in the global economy, Uganda's external position is expected to remain weak, with increases in exports failing to offset the rapidly increasing growth in imports. Consumer imports, mainly consisting of foodstuffs such as dairy products, fruits and vegetables from Kenya and South Africa, and clothing and household items from China, Europe and USA, are increasing. The weak external current account will also continue to reflect the large gap between the country's increasing investment needs and its low level of domestic savings, which currently stands at a value equivalent to 13 percent of GDP, compared to the average level of 17 percent for sub-Saharan Africa.

In the medium term, Uganda's economic performance is expected to improve as a result of the government's pro-growth policies, which involve reforms to enhance fiscal efficiency and to generate productivity improvements in private activities. In addition, revenues derived from the production of oil will make an increasingly significant contribution. With these factors, the growth of GDP could revert to the rate of approximately 7 percent, consistent with recent historical performance. The spending geared at alleviating constraints to growth, particularly constraints related to energy supply and transport infrastructure, should, in the medium term, revive private investments, boost agriculture production, and energize the light manufacturing sector. The new oil economy will dramatically change Uganda's economic outlook through stepped-up investment in production infrastructure. In future years, when production facilities become active, actual oil revenues could double the country's current level of fiscal revenue. The experience of other

Worsening Current Account, but Inflows on Capital Account Turned Around Overall External Position



countries shows that the oil development preparation phase is often characterized by a high level of foreign investments that significantly impact economic performance, at least in the regions implementing those investments. Developing institutions to ensure transparency and the prudent management of revenue will facilitate the optimal utilization of the country's oil resources.

However, Uganda's economic prospects could be negatively impacted by either external or internal developments or both. In the short term, external turbulence from Europe, where the Euro Zone is struggling, instability due to the Arab Spring, poor relations with donors, and rising food and oil prices could destabilize the domestic economy and slow down growth. Government expenditure remains vulnerable to implementation constraints and lack of political will to enforce discipline in the utilization of limited financial resources. The short-term prospects for increased domestic revenue remain slim, as measures to eliminate the leakages resulting from tax exemptions are still either lacking or are poorly enforced. Uganda's large public investment program continues to be funded through external financing, as collected domestic revenue, equivalent to 13 percent of GDP, is barely enough to cover the recurrent expenditures. Furthermore, corruption and related scandals may result in the diversion of public resources and the derailment of the public investment program, 50 percent of which was expected to be financed with external resources.

In this period of transition to becoming an oil producing nation, poor relations with donors could exacerbate instability. By January 2013, the cuts in aid announced by donors amounted to 4 percent of the total FY13 budget. These cuts could be managed through cuts in some non-priority expenditures. However, lack of progress in improving spending efficiency and a failure to entrench good value-for-money practices in government operations could worsen donor relations and result in further declines in investor confidence. This in turn could result in ongoing negative impacts for Uganda, whose international rankings for transparency and good governance remain poor.

In the medium term, the challenge remains for Uganda to utilize its oil resources to create economic opportunities. The manner in which oil resources are utilized will be a major factor in mapping the country's medium- and long-term development path. Oil revenues can substitute for aid, but the transition could be a source of macro risk if these revenues are not managed properly. Elsewhere in the world, the prospect of increased revenues from oil has often been associated with increased levels of corruption. If corruption continues to increase in Uganda, further reductions in aid are likely, making the transition towards a well-managed oil economy more difficult.

Uganda will require a significantly increased rate of economic growth to achieve its vision of reaching middle income status in the next 10 years. With the medium-term projection of 7 percent, which is based on a high-growth scenario, Uganda's per-capita income could reach US\$ 814 by 2025. To achieve a per capita income of US\$ 1000 within a decade, Uganda must achieve a rate of growth in excess of 10 percent per year. Faster diversification of the economy and appropriate use of resources, including oil, must be the engine to facilitate the renewed growth momentum required to achieve this figure. In addition to having the potential to close the current account deficit, oil can boost the capacity of the economy, particularly the non-oil sector, enabling it to grow at a more rapid rate.

Regional trade may be the catalyst to ensure rapid economic growth. To achieve this, Uganda's economy must undergo a fundamental transformation. This transformation must affect what the country produces, how it produces it, and where it finds markets for its outputs. Policies to improve the business environment, to develop human capital, and to raise the stock of infrastructure will remain the key drivers of this transformation. To overcome implementation challenges, improving the efficiency of fiscal policy, including factors that influence it, such as good governance, cannot be overlooked, particularly when the country makes the transition to becoming an oil producer. However, international experience suggests that it is hard for a small landlocked country such as Uganda to move alone along the path of economic development. Improved levels of openness and transparency can help ensure the achievement of these goals by facilitating access to new markets (demand side) and by pushing firms to become more competitive (supply side). This leads to an expansion in production, diversification and increased employment opportunities.

Part II: Harnessing the potential in regional trade to help Uganda's economy expand and diversify

If a typical African village is used as a metaphor for the Great Lakes region, Uganda is in the position of a typical villager who can only grow by developing deeper links with neighbors and members of surrounding communities. In Uganda's case, it must develop deeper links between domestic producers and external markets. Uganda has been at the forefront of regional integration, which is a key means of facilitating intensi-

fied regional trade. It has entered into a number of regional agreements, including the EAC and COMESA.

Uganda must tap the remaining underutilized opportunities within the region. Amongst other measures, this involves exploiting its position as a land bridge linking other landlocked countries to the coastal economies; diversifying the export base within the agricultural sector and out of agriculture into higher value products; and tapping the potential of services trade. To achieve this, working together with others, Uganda has to build the bridges to facilitate intensified regional trade. While this agenda involves regional cooperation, Uganda must pursue a re-energized policy action that focuses on what the country can do on its own. Uganda cannot afford to wait. This economic update proposes an action plan to achieve these goals, as follows:

(i) Beyond the East African Community: Uganda as a land bridge for the Great Lakes region

The first opportunity to exploit the dynamic regional market lies within the EAC. However, beyond that, Uganda must position itself as a land bridge to connect other nations within the Great Lakes regions with coastal nations. In the period from 2001 to 2010, the EAC was the second-fastest growing economic bloc in the world. The Community has a rapidly expanding population and rapidly expanding levels of intra-regional trade. Uganda's level of trade within the EAC has grown more rapidly than its trade with the rest of the world. However, Uganda has the potential to almost double its trading space through an expansion of trade with nearby nations in the Great Lakes region, such as South Sudan and the Democratic Republic of Congo. In such nations, Uganda's private sector has already established trading partnerships, mainly through informal means. Building on these existing trade relations, Uganda must play a stronger strategic role in coordinating and harmonizing policies relating to trade between EAC and non-EAC Great Lakes countries, especially through the development of better infrastructure and institutions to support trade.

(ii) Boosting Uganda's regional trade by moving beyond food crops

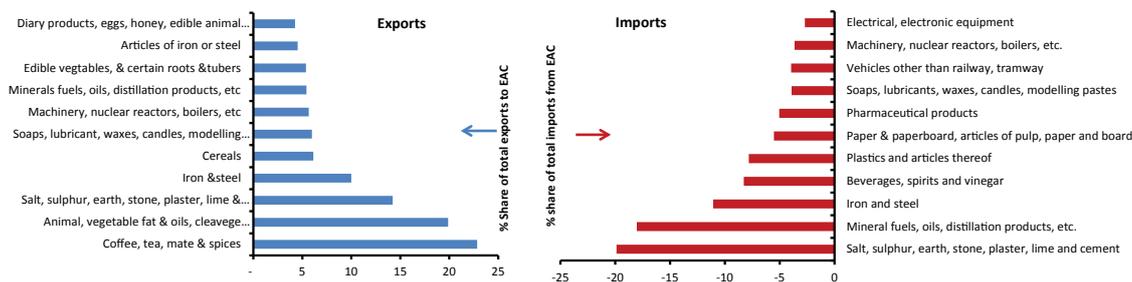
Uganda must continue to harness its agricultural potential to feed the region. However, the full benefits of regional trade will only be realized by climbing the value export ladder and by exporting services. Facilitating intensified regional trade must involve three strategic pillars, as follows:

PILLAR 1: Harnessing the agricultural sector to feed the region: Uganda has a flexible climate and fertile soils. This gives it prospective comparative advantages as a food basket zone for the EAC, principally Kenya. Agricultural exports, particularly the export of food commodities, will buttress export growth and facilitate diversification if productivity improves to meet the rising demand associated with the growth of regional economies and the urbanization of their populations. The challenge lies in ensuring farms produce outputs in sufficient quantities and of sufficiently high quality at competitive prices and are able to

PILLAR 2: Climbing the export value ladder by expanding Uganda's range of outputs: This will be achieved by building on what Uganda already produces and by participating in regional production chains. Moving from low to higher value exports requires building production capabilities and capacities. In the EAC, Uganda has made the fastest transition from low value primary product exports to higher value primary products; resource based manufactures; and low technology manufactures. This has expanded its opportunities to develop other products of similar and substitutable or adaptable capabilities. Uganda can also participate in regional production chains and trade in "parts" or "tasks". For instance, by exporting plastics, Uganda has built capabilities to assemble and/or manufacture toys. It could build upon these capabilities to produce car parts or higher level outputs. Beating the stiff competition from the more economically developed Kenya will remain a challenge, given that Uganda is a small landlocked country, far from the coast, and its industrial sector lags behind Kenya's, with less established businesses and a lower level of access to technologies and skills. Better connectivity and the removal of non-tariff barriers will be vital if Uganda is to leverage these trade opportunities optimally.

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Uganda's Top 10 Regional Trade Goods in 2012 - Exports Concentrate in Agricultural produce, Many of the Manufactured Goods Exports are also Imported



PILLAR 3: Promoting the export of services:

Amongst other benefits, this may be one means for Uganda to overcome distance disadvantages associated with its landlocked status. Although the services sector accounts for more than 45 percent of GDP, Uganda remains a net importer of services, with exports accounting for 9 percent of GDP while imports account for 14 percent. About 55 percent of the service imports are in the transport services sector, while 56 percent of exports are in the travel and tourism sector. This situation could improve if trade constraints are removed in strategic sectors including tourism, transport, and logistics. The situation could also improve if Uganda is able to build on recent trends that have made it a growing regional hub for education and transit for goods in the Great Lakes region.

(iii) A waiting game will be a losing game: Uganda can do a lot on its own to enhance regional trade.

Harnessing the potential of regional trade will not be easy, given that many of the constraints to such trade lie beyond Uganda's borders and are beyond its control. However, Uganda cannot afford to wait for others to act. There is still much that it can do on its own initiative. To stimulate regional trade, Uganda has to implement a multipronged approach that ranges from raising productivity to getting outputs to the market at a competitive price. Action must focus on the following three priorities:

To reduce transport costs, more efficient modes of transport will need to be developed and to become operational. Uganda has made commendable progress towards improving roads in the trade corridors. These efforts must be sustained and complemented through government-led initiatives to work with neighbors to maintain these roads and to improve ports. In the short-to-medium term, rail and

water transportation systems must be made more viable through the rehabilitation of existing lines. The EAC has already committed to the installation of a standard railway gauge network. This is an important measure towards facilitating regional connectivity both within and beyond the EAC, encompassing nations including Ethiopia, Somalia, Zambia and Malawi. Improving lake transport will also improve the efficiency of railway transport, reducing distances and easing connections, compared to use of rail-road intermodal transport.

Improvements in physical infrastructure must be accompanied by improvements in logistics services. There is evidence that reductions in transport costs are driven by improving both infrastructure and transport logistics, including improvements to the trucking, freight, and storage industries. Heavy taxation and high operational costs exacerbate distance disadvantages, with Uganda still being required to import transit services, as the regional fleet is dominated by Kenya and Tanzania. Introduction of a regional customs bond will reduce constraints on forwarding businesses, especially the small freight forwarders, who form the bulk such operators. Breaking down "cartel" practices in the trucking business to improve trade competitiveness will require renegotiating road-user fees with EAC partners; accelerating improvements in key strategic border operations, including those connecting Uganda to South Sudan, DRC, and Congo; and increasing the capacity of bonded storage facilities.

A solution must be found to the problem of non-tariff barriers. The ineffectiveness of past efforts to eliminate NTBs cannot be an excuse for inaction. Efforts to intensify trade are self-defeating unless they are accompanied by efforts to reduce or eliminate non-tariff barriers (NTBs). Such NTBs are currently mainly manifested through rules and regulations. Although these rules and regulations are sometimes legitimate, they are often inappropriately implemented. Common NTBs include standards regulations and weigh bridges. In addi-

tion to creating delays for traders, NTBs also result in increased cost through the imposition of illegal fees and charges. NTBs raise the prices of traded goods in the same manner that tariffs would. Uganda and Kenya's NTBs have the most significant negative impact on regional trade. Building on previous efforts to raise awareness and improve transparency in the management of the NTBs, Uganda must enter into bilateral negotiations with strategic partners to harmonize trade policies. A strong commitment to remove its numerous trade-related rules and regulations would assist in negotiations with partner states to remove theirs. Regionally, the introduction of a mutual recognition of conformity-assessment procedures and a sanctions system of the sort implemented by other regional blocs, such as ASEAN and the EU, would help. Such measures must be accompanied by the introduction, through the EAC framework, of regional sanctions, as well as strengthened sanitary and phyto-sanitary testing and verification capabilities. In addition, efforts must be made towards mutual recognition of conformity assessment procedures.

To unleash the potential of the service exports, a number of restrictions must be eliminated. Uganda needs to prioritize specific sector interventions in the area of tourism, education and professional services, and transportation and logistics services for the greater hinterland. In the tourism sector, for instance, in addition to improving human resources, the public sector can play an important role by developing the appropriate infrastructure to reduce the cost of access to tourist centers and potential tourist attractions. In the business and professional services sector, more flexible immigration regulations are crucial to ensuring the mobility of service providers. The challenge is to develop and implement an adequate regulatory framework to support existing engagements in education, regulation, trade policy, and labor mobility.

To conclude, while developing other factors of growth, Uganda needs to sustain its efforts to deepen regional integration as a means of facilitating greater trade opportunities, but primary agenda remains in its own hands. The first point of action is to address constraints to productivity growth in sectors that have the highest potential for regional expansion, including the agriculture, manufacturing and services sectors. Uganda must 'advocate by setting an example' by removing its own NTBs as a means of encouraging neighboring countries to address theirs. However, it also needs to use its position to persuade the coastal countries to do their part, since they will also benefit from such programs. In addition, Uganda must seize every opportunity to promote peace and tranquility in the Great Lakes regions. Without peace, there can be no trade.

Deeper regional integration will facilitate the development of regional public goods such as roads and railways; reduce transaction costs and create economies of scale; provide a regulatory environment in which goods and services can flow freely; and support cross-border production networks. It will also reduce the constraints faced by many local firms in accessing the essential services and skills that are needed to boost productivity and further diversify into higher value-added production and trade. Implementing this regional agenda will not be easy. However, as a landlocked country, Uganda cannot afford to forget her neighbors. Therefore, the country must choose its strategic positioning carefully.



Improved water transport to remain the key to lowering transport costs (Charles Kunaka), April 2011