UGANDA

About the 8th economic update

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1 What is the of Uganda's economy?

In financial year 2016/17, the Ugandan economy has grown at a much slower pace than in the past. Growth declined by 0.2 percent in the first quarter of 2016/17, and overall growth for the year is expected to be lower than the originally projected growth rate of 5.8 percent. The decline also contrasts the positive growth rate of 0.6 percent recorded in the previous quarter, indicating a reversal of the recovery that had begun to become apparent after the completion of the election cycle in February 2016. Due to the prolonged drought conditions, agriculture declined by 1.1 percent during the first quarter. Services, which in the past have been the main driver of growth, also stagnated. With manufacturing and trading activities declining strongly due to disruptions to the main market in South Sudan, the growth of industry was mainly driven by the expansion of construction activities, which was largely driven by government projects. On the upside, the Government has kept inflation in single digit levels in spite of the national elections held early 2016. This is a sharp contrast to what transpired in the previous election cycle in 2011.

2 What are the key changes and trends since the last update in June 2016?

In June 2016, when the seventh Uganda economic update was published, the economic outlook was upbeat. Uganda had appeared to have weathered the earlier domestic and political uncertainties that normally follow an election. Despite the negative effects of a weak global economy, it had been anticipated that investors would take advantage of the low cost of imported inputs to intensify investments in the economy, particularly in oil-related activities. In addition, the Government's extensive infrastructure development program was expected to boost local economic activity. However, the economy is still yet to pick up momentum as it adjusts to a number of unexpected new shocks. The two most significant ones are the continued unrest in South Sudan, and the decrease in the value of credit from the banking system that have crippled many businesses. Moreover, unanticipated bad weather conditions also reduced agricultural production.

Both the slowdown in external inflows and the increasingly stringent conditions of acquiring credit from the commercial banks left the economy with very little liquidity. On the external side, the disruption of trade with South Sudan, combined with the volatility of commodity and fuel prices led to a decline in exports, foreign exchange earnings, fall in equity market, and a decline in foreign direct investment and remittances from abroad. Exports to South Sudan declined to US$ 33 million during the first quarter, which was less than half of the US$ 76 million recorded in the prior quarter. Adding to that, the more stringent conditions for borrowing occasioned by worsening quality of loans resulted into decline in private sector credit by 1.6 percent by September 2016, compared to the corresponding period of 2015. This prevented the financial sector to support economic activity, making the actions by the central bank impotent in its effort to raising the liquidity in the economy and in stimulating economic activity. In regard to public spending, the Government released funds, but actual implementation of projects remained low. These developments helped sustain a stable macroeconomic environment through most of the first half of financial year 2016/17, and helped to keep inflation at 4.7 percent, and the shilling temporarily stable, before it begun depreciating rapidly in November 2016.

3 What is the outlook for the economy?

AS BOTH COMMERCIAL BANKS AND BORROWERS ADJUST TO THE NEW CREDIT CONDITIONS, THE AMOUNT OF CREDIT INTO THE SYSTEM CAN BE EXPECTED TO INCREASE AND STIMULATE SOME ECONOMIC ACTIVITY. THE ECONOMY CAN BE EXPECTED TO GROW AT BETWEEN 4 AND 5 PERCENT PER ANNUM DURING FINANCIAL YEAR 2016/17, IF THE GLOBAL ECONOMIC ENVIRONMENT DO NOT WORSEN

The performance of the Ugandan economy is expected to improve during the second half of financial year 2016/17, especially if no major civil distractions occur in South Sudan and trade re-starts. Improvement in weather conditions would be a big boost and ensure a better agricultural output. As both commercial banks and borrowers adjust to the new credit conditions, the amount of credit into the system can be expected to increase and stimulate some economic activity. The economy can be expected to grow at between 4 and 5 percent per annum, if the global economic environment do not worsen. This rate would be about the same as the 4.8 percent realized during financial year 2015/16. As the effects of the shocks wear off, the economy is expected to continue picking up pace, and could reach 5.2 percent in FY 2017/18 and 6.0 percent in the subsequent year.

The risks facing this outlook are both domestic and external. On the domestic front, the most immediate and critical risk relates to the liquidity crunch and how the financial system will re-adjust to balance the need to increase lending for private sector investments and to minimize credit risk within the banking system. The way fiscal management can accommodate new spending pressures in the context of the low revenue base could also have implications for financing the investment program. On the external front, sustained instability in South Sudan threatens Uganda's export prospects, which could decline further, while continued security tensions in the Rwenzururu region, a major tourist destination, and the recent outbreak of avian flu could put a further dent in revenue collections from export of goods and services. Other risks relate to the evolution of the geo-politics and its impact on the global economy; as well as the adverse weather and climate related changes, which could distort Uganda's agriculture and export prospects further.

4 Why is financial inclusion important?

A characteristic of successful emerging countries that have been achieved rapid, equitable economic growth is that they develop deep financial systems that effectively mobilize savings and intermediate resources to productive activities. Access to financial services enables individuals, households, and businesses to efficiently balance income and expenses over time; to manage shocks; and to invest in the development of their human and physical capital. Most critically, efficient intermediation encourages saving, eases access to credit for borrowers, and lowers the costs of credit, which in turn reduces the overall transaction costs for enterprises, making them more competitive. Therefore, a well-functioning financial system encourages the emergence of new businesses, supports existing businesses to grow, and ensures business sustainability. For these reasons, over 50 countries around the world, including Uganda, have made commitments to improve financial inclusion or to implement national financial inclusion strategies as part of their broader national development plans.

5 How is the financial sector structured in Uganda?

Institutions providing financial services include banks, credit institutions (CIs), microfinance depository institutions (MDIs), SACCOs, insurance companies, and pension schemes. Commercial banks, CIs, and MDIs belong to the first three tiers of the financial system and are regulated by the Bank of Uganda (BoU). The fourth tier of financial institutions includes savings and credit cooperatives, non-governmental organisations, for-profit monetary financial institutions, and informal institutions such as rotating savings and credit associations, village savings and loan associations, and burial societies. These are not regulated and supervised by the BoU (with the exception of large SACCOs, which will now fall under supervision BoU) but are either regulated through other means or through self-regulation. A range of non-bank financial institutions also offer financial services. These include insurance companies, pension funds, securities industry, mortgage institutions and development banks.

SINCE THE EXPIRATION OF A MORATORIUM ON NEW BANK LICENSES IN 2007, THE NUMBER OF COMMERCIAL BANKS IN UGANDA INCREASED FROM 14 TO 25 IN 2014. BUT THE NON-BANK DEPOSIT TAKING FINANCIAL INSTITUTIONS STILL HELD LESS THAN 4% OF THE BANKING SYSTEM'S TOTAL VALUE OF LOANS AND 2% OF DEPOSITS IN 2014

6 What are the opportunities for citizens and the informal sector to benefit from the financial system?

There are many benefits for ordinary people. They can save or borrow from financial institutions, instantaneously transact with one another, receive their salary or pension in an account, and insure their lives or businesses. Introduction of agent banking will be equally beneficial and expand the financial services to rural areas. With agent banking, a retail or postal outlet can be contracted by a financial institution to offer financial services. Mobile financial services also offer great opportunities for the rural population, and other unbanked segments such as the informal sector and women to obtain access to financial services.

7 What are the major challenges for financial inclusion in Uganda?

As the Update shows, the high cost of credit is a major constraint. Only a very small proportion of Ugandan businesses and households have access to a bank loan and/or a line of credit. The overall domestic credit to GDP ratio in Uganda has stood at the average level of 13 percent of GDP over the past decade, far lower than the figures recorded by regional neighbors such as South Africa and Kenya, and lower when compared to peers in other regions. Uganda ranks in 120th place out of 138 countries in affordability of financial services, according to the Economic Forum Global Competitiveness Report (2016-2017). The recent instability in the banking system has further undermined confidence of the population in financial institutions while long-term savings products such as pensions and insurance also remain largely undeveloped, as is the undeveloped mobile service infrastructure.

8 How important are interest rates to improving access and financial inclusion?

Overall, there is a high rate of variation between the lending rates offered by different banks in Uganda. For instance, in June 2016, lending rates ranged from about 32 percent to about 9 percent. This causes many people to shy away from loan products as these rates are considered too costly. The differences in variations are generally the result of diverse bank business models and strategies. For example, banks targeting top-notch corporate clients will generally charge lower interest rates than those targeting retail clients, especially in rural areas. This is partly because it is much easier for banks to assess credit risk of large corporate borrowers. Assessment of risk of individuals and micro, small, and medium enterprises is much more challenging and requires much more effort on the banks' part, as there is little information readily available (for example, at credit bureaus). High operating costs (due to lack of qualified professionals and high staff remuneration) also contribute to high interest rates in Uganda.

9 What are the measures required to bring down lending rates in Uganda?

Reducing lending rates and spreads requires long-term investments and major structural reforms to fundamentally lower the cost of doing business in Uganda. These would involve a restructuring of the economy and the banking system. However, policy measures to address the factors contributing to high lending rates and spreads could help in the short to medium term. These measures could include making more information available on borrowers by ensuring that more credit providers report data to the credit bureaus; institutionalizing the development of financial sector skills; developing payment systems; maintaining macroeconomic stability; stimulating demand for financial services in rural areas; and implementing reforms that reduce the costs of doing business, for example, by making it easier and cheaper for the lender to get money back when the borrower goes bankrupt. To be effective, these measures need to be combined with efforts on other fronts, including efforts to improve the business environment more generally.

10 What has government and private sector done to strengthening the financial system?

COMMERCIAL BANKS ARE NOW REQUIRED TO HOLD MORE CAPITAL WHICH WILL OFFER GREATER PROTECTION FOR ACCOUNT HOLDERS, IN LINE WITH THE BASEL III REFORMS AND THE AGREEMENTS REACHED BETWEEN THE CENTRAL BANKS OF THE EAST AFRICAN COMMUNITY

Bank of Uganda (BoU) has spearheaded the implementation of a number of significant regulatory reforms. In particular, it advocated and facilitated amendments to the Financial Institutions Act 2004 in January 2016. These amendments set out a path for the implementation of agent banking, Islamic banking, bancassurance, the creation of a stand-alone Deposit Protection Fund, and the revision of capital requirements. Commercial banks are now required to hold more capital, which will offer greater protection for account holders, in line with the international and regional agreements. BoU's Financial Stability Department is also undertaking measures to strengthen the identification of systemic risks. In order to protect the savings of the depositors, to limit predatory lending practices and to build confidence in the system and thereby to promote financial inclusion, Parliament recently enacted the Tier IV Microfinance Institutions and Moneylenders Act (2016). All these are significant and positive achievements that will not only strengthen the formal banking sector, but also deepen financial inclusion.


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