

Uganda—A Tale of Two Economies?

The Ugandan economy grew 6.2% in 2001/02 (July–June), slightly above the 5.9% growth a year before. The solid growth has been accompanied by substantial poverty reduction—lifting more than 4 million people from poverty (22% of the population) in a decade. But there is no room for complacency. One Ugandan in three still lives below the poverty line. More disturbing: the national poverty numbers mask vast regional disparities. The central and western areas of the country have grown more rapidly than the northern and the eastern, with the high levels of poverty in the northern region of grave concern. Uganda’s economic performance may thus be a tale of two economies, with excellent national growth and poverty numbers masking huge swaths of the economy that have not enjoyed the benefits.

Inequalities between the more affluent central crescent area around Lake Victoria and the drier, more disadvantaged northern part of the country have been exacerbated by the pattern of development in the last 10 years. The north has lagged largely due to a civil war that has dragged on for two decades. Having one region lag far behind can engender bitterness and ultimately foster rebellion. Thus fear of civil conflict along regional or ethnic lines is reason for genuine concern over Uganda’s spatial pattern of development.

Despite higher spending on social services, most social indicators are still below the average for such comparators as Ghana, Kenya, and Zambia. This reflects systemic problems in public service delivery at the district level and specific problems associated with HIV/AIDS. Improving the quality of social services, especially in education and health, remains crucial for further gains.

Prudent macroeconomic management coupled with good weather kept inflation at single digit levels in 2001/02. Financial sector reforms have helped deliver financial stability. Savings and domestic investment rates remain lower than in other Sub-Saharan countries but are trending upward.

The fiscal programme, while exercising restraint, has delivered priority expenditures as outlined in the Poverty Reduction Strategy. But the government still relies on donor funding for close to 60% of the development budget, showing the high aid dependency of the economy. The fiscal deficit, excluding grants, rose slightly from 11.2% of GDP in 2000/01 to 12.6% in 2001/02.

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During 2001/02 monetary policy achieved stable and low inflation rates. And sterilization actions by the Bank of Uganda diverted pressure on the Ugandan shilling to appreciate. Overall, the movement in monetary aggregates has been in line with the monetary policy stance. Net foreign assets of the banking system grew by 28.2% in 2001/02 to a comfortable \$992 million, around six months of imports.

The export sector remains highly concentrated in commodity exports. But the share of coffee, 59% of export earnings in 1997/98, declined to 19% in 2001/02. The current account balance has been persistently in deficit, rising over the years to \$476 million in 2001/02. Even so, the external position showed some strengthening in 2001/02, with an overall deficit of \$2.8 million, far less than the \$55.6 million in 2000/01.

Despite strategies to reduce the debt burden, the total debt stock continues to rise. In 2001/02 the debt stock stood at \$3.8 billion, with a debt stock to GDP ratio of 68.2%.

Most of the potential for economic growth and poverty reduction through macroeconomic reforms has been exploited. Further impetus to growth requires deeper reform to create an enabling environment for the private sector. It also requires reducing regional disparities to unleash the full potential of the population. It is farmers, traders, and the rest of the private sector that can lift Uganda’s growth one notch up from an average of 6% a year to the 7% required to achieve the government’s goal of reducing income poverty to 10% by 2017.

But the private sector has many concerns, ranging from corruption to inadequate infrastructure, poor public service provision, and low access to financial services. Reforms thus have to deal with difficult governance issues and fundamental structural changes to the economy.

Recent economic performance

Even in the midst of a difficult international environment and with deteriorating terms of trade, Uganda’s economic performance has been solid. In 2001/02 the economy grew 6.2%, slightly above the 5.9% in 2000/01 (figure 2.1). The resilience of the economy to external shocks is a product of prudent macroeconomic policies leading to macroeconomic stability. GDP per capita grew 3.9% in 2001/02.

Developments in the real sector

The fastest growing sector in 2001/02: transport and communications, up 10.2%, compared with growth of 8.1% the previous year. This was followed by mining and quarrying, manufacturing, construction, wholesale and retail trade, and electricity and water services. The agricultural sector grew 5.1% in 2001/02, up from 4.6% the previous year. Overall, monetary GDP grew 6.7%, up from 6.1% in 2000/01, and nonmonetary GDP grew 4.3%, up from 5.4%.

Agriculture dominates the Ugandan economy, at 41% of GDP in 2001/02 (down from 72% in the late 1970s). It provides employment to about 80% of the labour force and generates almost all the country's exports. Given agriculture's importance, the country's economic growth depends on its modernization and diversification. Broader access to rural credit and better public service delivery, particularly good infrastructure, need attention.

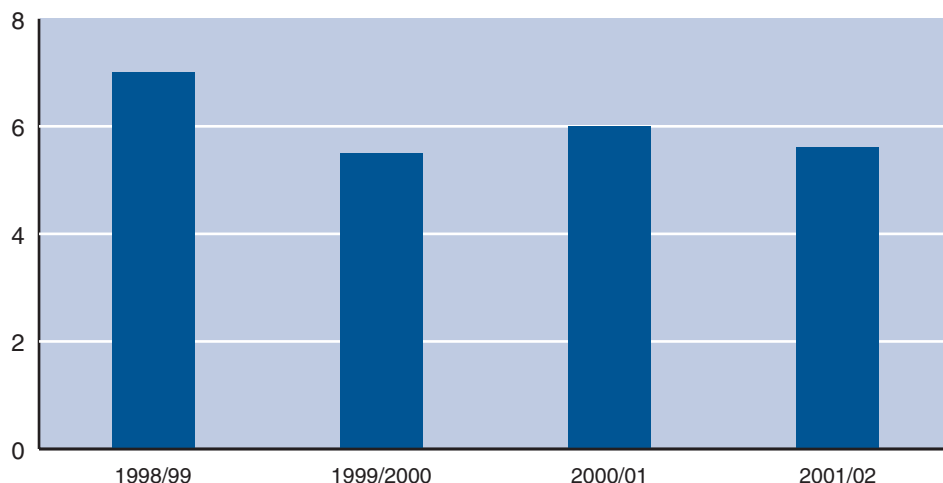
The Plan for Modernization of Agriculture envisions eradicating poverty through a dynamic agricultural and agro-industrial sector—profitable, competitive, and sustainable. The plan identifies six core areas for government action: research and technology, advisory services, access to rural finance, education in the sector, access to markets, and sustainable natural resource management.

Mining, representing only 1% of GDP, remains largely untapped. Recent efforts to attract foreign investment have resulted in some exploration activities in gold, phosphates, and petroleum.

Manufacturing, accounting for about 10% of GDP, is based largely on processing sugar, cotton, and food crops. A recent survey financed by the World Bank found tremendous foreign investor interest in agro-processing (EIU 2002). Government strategy for manufacturing emphasizes agro-based and small and medium-size industries. Building managerial and technical skills and increasing private participation through privatization are a big part of the strategy. The Uganda Investment Authority has been aggressively promoting horticulture and food processing and packaging.

“A recent survey found tremendous foreign investor interest in agro-processing”

Figure 2.1
Growth is robust
GDP growth, 1998/99–2001/02 (annual percentage change)



Source: Economic Commission for Africa, from official sources.

“The financial sector’s recovery shows up in the higher private shilling deposits at banks, up by 30%”

Savings still low

Savings remain low, but on an upward trend. Gross domestic savings rose from 4.6% of GDP in 1997/98 to 7.3% in 2001/02. Gross national savings, which includes private transfers and grant financing of the government budget, rose from 10.4% of GDP to 13.6%. Private savings have been on an upward trend, while public savings have been declining (figure 2.2).

The upward trend in private savings is in line with the financial sector’s recovery from the bank failures in 1998. Its recovery shows up in the higher private shilling deposits at banks, up by 30% from \$461.5 million in June 1999 to \$601 million in June 2002. Even so, other unproductive savings—such as real estate and foreign currencies held for wealth and speculative motives—still impede the growth of urban household financial savings. Because of the limited access to financial services, the assets of rural households are in commodity stocks, livestock, and land—the nonmonetary economy, an efficiency loss to the economy.

The recent decline in public savings comes from higher spending on poverty reduction programmes. The government’s medium-term fiscal programme aims to reconcile this spending with fiscal sustainability, with the deficit targeted to fall gradually as a result of better revenue performance, increasing public savings.

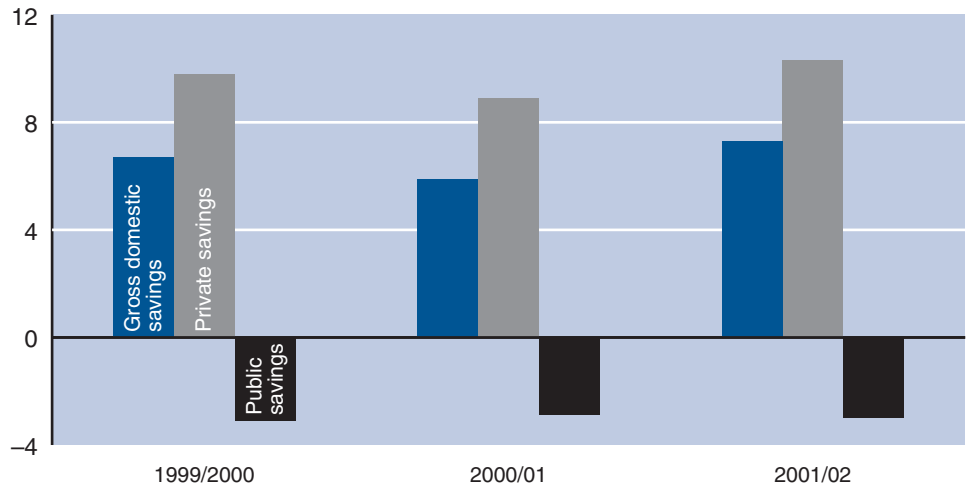
Private investment sluggish

Despite major improvements in the policy environment, private investment remains low (10%) and close to the Sub-Saharan average (figure 2.3). Why the sluggish investment

Figure 2.2

Private savings up in 2001/02—public down

Gross domestic savings, private savings, and public savings, 1999/2000–2001/02 (% of GDP)



Source: Economic Commission for Africa, from official sources.

response to the improved policy environment? Greater competition, due to economic liberalization, has put pressure on firms to cut costs. But many of these costs (related to utility services, transport, and corruption) are not under a firm's control. Erratic infrastructure services, arbitrary tax administration, and crime also affect perceptions of the risks of investing in partly irreversible capital (Reinikka and Svensson 2000). Firms, particularly small ones, are also liquidity constrained, able to invest only when internal funds are available.

Gross domestic savings fell short of gross domestic investment by about 13% of GDP from 1997/98 to 2001/02. The gap has been financed by highly concessional loans from the African Development Bank and the International Development Association.

“The monetary policy stance adopted during 2001/02 was cautious”

Monetary policy—targets achieved

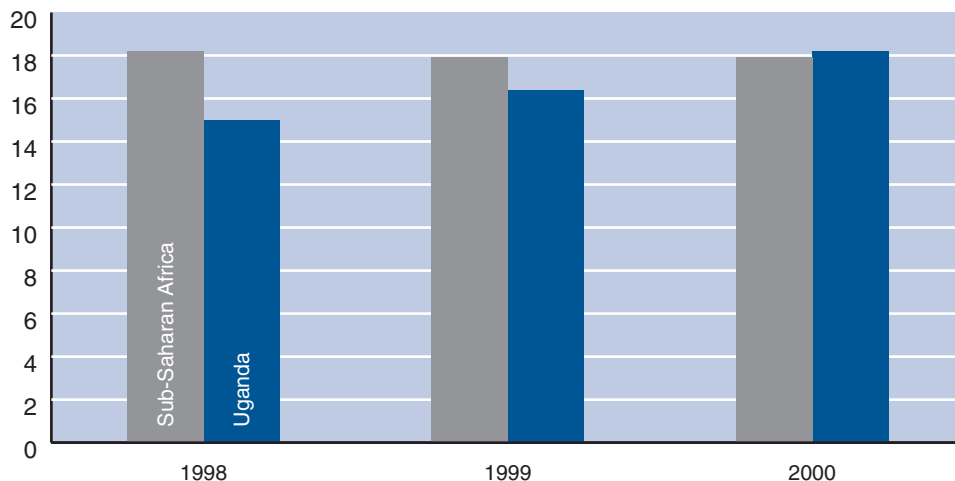
The major objective of monetary policy is to achieve price stability conducive to growth. In response to the negative headline inflation rates registered in 2001/02 (for the prices of all goods and services), the monetary policy stance was eased.¹ Overall, the monetary policy stance adopted during the year was cautious, creating few disturbances on the domestic and foreign exchange markets.

Monetary policy has moved gradually from reliance on direct to indirect instruments. Initially, largely on account of the rudimentary financial system and the limited array of instruments, coordination with fiscal policy was an important part of monetary policy,

Figure 2.3

Investment close to Sub-Saharan average

Gross domestic investment, Uganda and Sub-Saharan Africa, 1998–2000
(% of GDP)



Source: Economic Commission for Africa, from official sources.

evident in the surrendering of treasury bill issuance by the Ministry of Finance, Planning, and Economic Development to the Bank of Uganda. But by June 2002 the array of instruments for managing liquidity and enhancing monetary policy had been widened.

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Developments in monetary aggregates

The annual growth rate of M3 for the period ending June 2002 was almost 22%, up from 18% for the period ending June 2001 and 16% for the period ending June 2000.² Developments in M3 have been largely a result of the accelerated growth in all components of M3. M2 grew 25%, 10 percentage points above the rate in June 2001.³ On the supply side, net foreign assets of the banking system grew 28% in 2001/02, compared with 34% in 2000/01. Net domestic assets remained unchanged, after declining 15.5% in 2000/01 (table 2.1).

The Bank of Uganda’s external assets rose nearly 22%, while its liabilities declined 3.4%. Foreign liabilities declined largely because of repurchases with the International Monetary Fund (IMF). Assets increased because of higher budgetary support by donors.

Noteworthy in net domestic assets is the slow growth in private sector credit. Private sector credit grew only 1.8% in 2001/02, down from 9.4% in 2000/01. The decline is partly a result of increased recoveries, as reflected in the decline in nonperforming assets to about 5% of private sector credit.

Table 2.1

Determinants and components of broad money, June 2001 and 2002 (US\$ millions)

Aggregate	End-June 2001	End-June 2002	Absolute change	Percentage change
Net foreign assets	773.3	991.5	218.2	28.2
Bank of Uganda	505.9	696.4	190.5	37.6
Commercial banks	267.3	295.1	27.8	10.4
Net domestic assets	238.0	238.0	0.0	0.0
Claims on government	294.1	317.5	23.4	7.9
Claims on private sector	405.4	412.8	7.3	1.8
Claims on other public entities ^a	7.2	4.9	(2.3)	(31.9)
Other items net	-468.8	-497.2	(28.4)	(6.1)
Broad money (M3)	1,011.3	1,229.5	218.2	21.6
Foreign exchange deposits	249.2	277.7	28.5	11.4
Currency in circulation	223.6	260.0	36.4	16.3
Demand deposits	308.4	394.3	86.0	27.9
Savings and time deposits	230.1	297.5	67.4	29.3

Note: U.S. dollars using end-period exchange rate for June 2000.

a. Includes state-owned enterprises and local governments.

Source: Economic Commission for Africa, from official sources.

Domestic price developments—good weather turns inflation negative

The inflation outturn in the 1990s was impressive, maintained on average in single digits—a big change from the volatile consumer prices in the 1980s, with headline inflation of 250% in 1987. The success in managing inflation is due to the simultaneous strengthening of liquidity and budget management, especially since 1992.

From September 2001 to June 2002 the economy's headline inflation rate was negative (figure 2.4), largely because of the sharp drop in food prices, the result of good weather. Annual food crop inflation declined from -3.7% in July 2001 to -28.5% in December 2001 before rising to -13.0% in June 2002. Since October 2001 annual underlying inflation (for all goods and services minus food crops) has been positive, but well below 5%.

Interest rates—heading downward

The annualized 91-day treasury bill rate declined from 12% in September 2001 to a low of 3% in March 2002, with the rediscount rate and the bank rate following a similar pattern (figure 2.5). This decline is due mainly to a reduction in the volume of treasury bills, as the Bank of Uganda curtailed their use for sterilization of inflows. Since March 2002, however, the treasury bill rate has been on the rise.

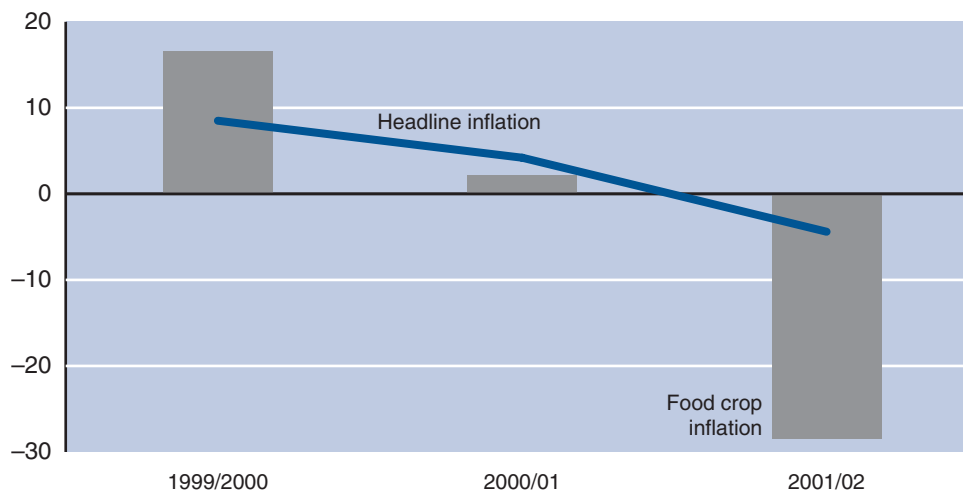
Commercial bank deposit and lending rates registered only a marginal decline. For shilling-denominated deposits, the weighted time deposit rate was 3.6% in June 2002, down from 6.6% in June 2001. The weighted lending rate also declined, to 17.6% from 21.7%. Despite monetary easing, private credit did not respond. Nor has

“Private sector credit grew only 1.8% in 2001/02, down from 9.4% in 2000/01”

Figure 2.4

Inflation plummets

Inflation in December 1999/2000–2001/02 (%)



Source: Economic Commission for Africa, from official sources.

“*The financial sector has undergone considerable reforms—to strengthen, broaden, and deepen the financial system*”

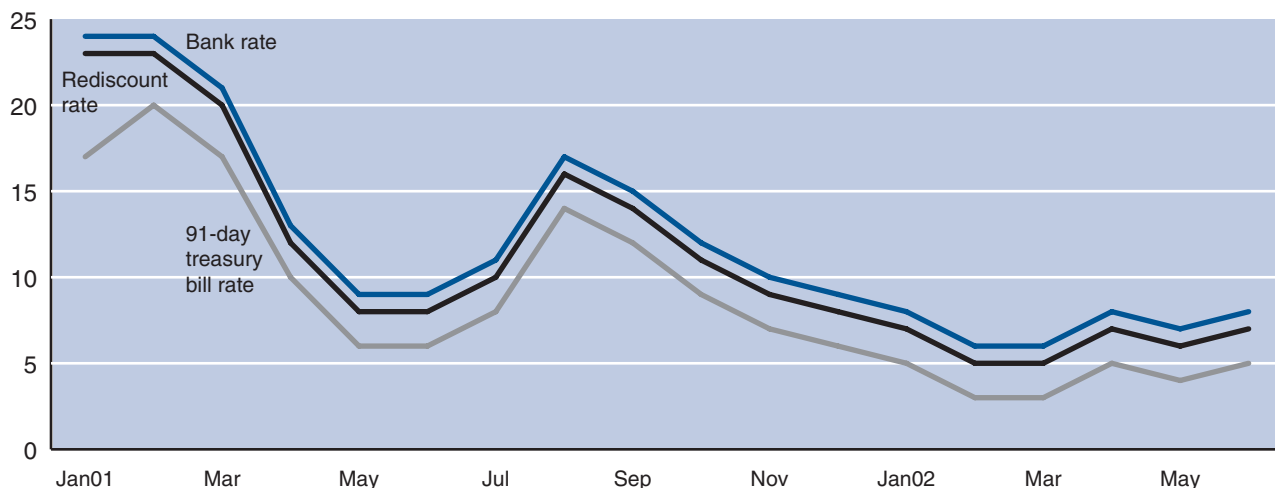
the large spread between the lending and deposit rate changed, despite the impressive drop in nonperforming loans. Contributing to the wide spreads are the cost to banks of meeting prudential requirements and the high cost of doing business, particularly for communication, electricity, rents, and security services (Kasekende and Atingi-Ego 1996, 1999). Stringent collateral requirements add to these costs. With legal property titles not clear-cut, the banks have to investigate property deeds offered as collateral by the borrowers and several guarantors, costly in staff time and effort. Yet another reason for the wide spread is the inability of the Bank of Uganda to signal its intentions to the market, given the high volatility in treasury bill volumes.

Banking sector—considerably stronger

Uganda’s financial sector has undergone considerable reforms—to strengthen, broaden, and deepen the financial system and to encourage competition within it. Full liberalization of interest rates and relaxation of entry requirements brought in new banks and other financial institutions. The Bank of Uganda has also instituted a framework for more effective supervision and enforcement of prudential regulations, including the recent increase in minimum capital requirements for financial institutions. As evidence of its strict surveillance of the financial sector since 1998/99 and its intolerance of unethical practices, the Bank of Uganda has closed four insolvent banks due to fraud and mismanagement.

A new Financial Institutions Bill, presented to parliament, strengthens licensing, specifies corporate governance requirements, tightens restrictions on insider lending and large loan exposures, and requires prompt corrective action for distressed banks.

Figure 2.5
Interest rates declining
Indicative policy rates, January 2001–May 2002 (%)



Source: Economic Commission for Africa, from official sources.

The financial sector is trying to reduce the cost of doing business. An electronic clearing system, inaugurated in May 2002, is expected to reduce the time to clear a cheque from three working days to two. To attract savers, most commercial banks have also introduced debit cards, cash cards, automatic teller machines, and specially packaged accounts. And to deepen the financial sector, enhance competition, and ensure a wider financial product range, the Bank of Uganda has allowed the entry of foreign banks.

The government has finally divested itself of banking business through the Bank of Uganda's sale of the state-owned Uganda Commercial Bank (box 2.1). To continue to improve confidence in the banking sector it would help to create credit rating bureaus, strengthen bankruptcy laws, and quickly resolve nonperforming assets.

The reforms have improved Uganda's financial indicators (table 2.2). But it is too early to gauge how much confidence these reforms have generated among investors, domestic and foreign. But weaknesses remain in access to credit by smaller enterprises.

“The government has finally divested itself of banking business”

Fiscal policies and developments—pursuing prudent policies

Prudent fiscal management has had a big role in keeping inflation in single digits. With the limited potency of monetary policy, cash-budget management allowed fiscal

Box 2.1

Successful resolution of the Uganda Commercial Bank

An initial attempt to privatize the Uganda Commercial Bank to a Malaysian firm, Westmont, failed because of the poor handling of the divestiture and serious concerns raised by parliament on the process, prompting the Bank of Uganda's intervention.

Four banks were subsequently invited to conduct due diligence checks on the bank, two submitting bids to purchase it. The Bank of Uganda decided that selling the Uganda Commercial Bank to the international Stanbic would best meet its objectives. Stanbic bought 80% of the shares while the government retained 20%, available to the general public through the Uganda Securities Exchange.

There were various allegations of irregularities in the deal with Stanbic, particularly that the sale price was lower than the value of assets (*New Vision* 2003). But the U.K. auditors that investigated the allegations gave the all-clear sign to the deal.

The sale of Uganda Commercial Bank achieved the government's long-standing goal of getting out of the ownership and management of commercial banks. More important, the Bank of Uganda attracted a major international bank—with operations in 17 African countries, assets of \$38 billion, and capital of \$2.3 billion—to purchase the Uganda Commercial Bank and assume responsibility for its branch network and countrywide retail banking operations.

Source: Bank of Uganda press releases: February 20, 2001; May 30, 2001; August 8, 2001; October 15, 2001; July 12, 2002.

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policy to respond to volatile movements in the foreign exchange market, unrealized revenue performance, and shortfalls in external budgetary support. Notable examples of the built-in flexibility: surrendering treasury bills to the monetary authorities, imposing a coffee stabilization tax during the 1994/95 coffee price boom, and cutting spending whenever there were shortfalls in programmed revenues, as in 1998/99. The negative impact of these actions on fiscal programmes was offset by the macroeconomic stability.

Fiscal policy geared to poverty reduction

The government’s medium-term fiscal programme has the dual aim of sustaining financial stability and supporting poverty reduction programmes. The medium-term expenditure framework is the main mechanism for linking the Poverty Reduction Strategy to the budget (box 2.2).

The fiscal deficit has been on the rise because of higher government spending on poverty reduction programmes. The fiscal deficit, on a cash basis, rose from 1.4% of GDP in 1997/98 to 5.5% in 2001/02, while the deficit, excluding grants, rose from 6.5% to 12.6%. The 2001/02 deficit was financed largely by donor assistance, which amounted to 11.7% of GDP, mainly reflecting budgetary support from the World Bank for a Poverty Reduction Support Credit (IMF 2002b).

Recurrent spending remained fairly constant throughout 1997/98 to 2000/01, rising significantly only in 2001/02. The rise was mainly due to higher spending under the Poverty Action Fund (channeling part of the debt relief under the Heavily Indebted Poor Countries Initiative), remuneration to members of parliament, and allocations for the state house, missions abroad, local government elections, and defense (Uganda, *Background to the Budget 2001/02*).

Defense spending is estimated to have risen to 5.3% of GDP in 2001/02, from 4.2% in the previous three years. The growth in the defense budget—especially the spending over and above the budget—is raising concerns for some donors. The government deems it necessary to address security in northern regions, where the poor identify insecurity as their main concern.

Table 2.2

Financial sector indicators, 2001 and 2002 (%)

Indicator	End-June 2001	End-June 2002
Financial depth (M2/GDP)	8.2	15
Private sector deposits (share of GDP)	5.0	11.0
Assets of the banking system (share of GDP)	12.1	26.7
Nonperforming assets (share of outstanding loans)	50.0	5.0

Source: *Economic Commission for Africa, from official sources.*

Meanwhile, development spending has been rising, financed mainly from external sources, which accounted for 71% during 1997/98 to 2000/02. Bolstering the domestic financing of development spending will be important for reducing this aid dependency.

Revenue performance—sluggish

Despite efforts by government to enhance collection, revenues have been sluggish, hampered by deficiencies in tax administration, a narrow tax base, noncompliance, and corruption. This weak revenue performance also puts the medium-term expenditure framework process in disarray.

Several measures have been taken to improve the efficiency of tax administration and reform tax policy. In 1997 and 1998 the Income Tax Act streamlined exemptions and introduced accelerated depreciation allowances for investments in plant, machinery, and equipment.

Box 2.2

Linking the Poverty Reduction Strategy to the budget

Before 1992 Uganda produced yearly budgets. Fiscal policy was not linked to development planning, and changes in expenditure allocations were based on incremental adjustments to the previous year's budget.

Since 1997/98 the government has used the medium-term expenditure framework to allocate resources in a framework that ensures consistency with overall resource constraints and to align expenditure priorities with Poverty Reduction Strategies. The medium-term expenditure framework sets sector and district spending ceilings within a rolling three-year framework, considering macroeconomic developments and the prospects for resource mobilization, both domestic and external. District and sectoral working groups, comprising the Ministry of Finance and line ministries, then help develop sectoral priorities within the expenditure limits, ensuring that these are in line with Poverty Eradication Action Plan/Poverty Reduction Strategy priorities. The process culminates in working groups preparing sectoral and district Budget Framework Papers that get incorporated into the medium-term expenditure framework.

Within the medium-term expenditure framework the government initially created a Poverty Action Plan to earmark savings from debt relief under the HIPC Initiative for basic social services. Since then, the plan has attracted additional donor funds.

The medium-term expenditure framework has significantly improved the budget and planning process. It has also increased the harmonization of donor financing plans with Poverty Eradication Action Plan/Poverty Reduction Strategy objectives. But its success depends on the government's realizing the financing assumptions. For external funding, the timeliness and predictability of aid flows are crucial. Equally important is realizing domestic revenues as projected. More progress is needed on both fronts.

Source: ECA 2001.

“ *The fiscal deficit has been on the rise because of the higher government spending on poverty reduction programmes* **”**

“Poverty reduction efforts require that a large share of government expenditures be at the local government level”

In 2001/02, for the first time in three years, fiscal revenues increased, to 12% of GDP, mainly due to higher revenues from income and value-added taxes. But Uganda's revenue performance is still lower than the 20% for other Sub-Saharan African countries. Efforts are under way to expand the tax base, enhance tax compliance, and improve tax administration by stamping out corruption in the Uganda Revenue Authority. Only a thorough anticorruption programme will improve revenue collection in the medium term. The government recently granted ad hoc investment incentives to some entrepreneurs, a practice that could lower the already-low revenue performance.

Weak capacity hinders fiscal transparency and service delivery

Measures to monitor and control spending have been introduced at central and local government levels. Domestic development outlays have been brought under the Commitment Control System to monitor, report, and enforce government spending commitments. Under the extensive decentralization that began in 1993, the government has also transferred a large volume of budgetary resources to districts, consistent with shifting the delivery of most public services to the districts.

There has been good progress in monitoring spending in education and health. But overall enforcement has been weak, because of low capacity in line ministries and local governments. It appears that local governments are not fully capable of coping with the decentralization of fiscal responsibilities, even less so now that poverty reduction efforts require that a large share of government expenditures be at the local government level. Tracking local government activities and expenditures has been problematic, with accounts not timely. Weak capacity thus hinders the main objective of decentralization—efficient service delivery.

External sector policies and developments

Exports are mostly agricultural products, with coffee the main export crop, and imports are mostly manufactured goods. The share of coffee in total export revenues fell from 59% in 1997/98 to about 19% in 2001/02, reflecting fluctuations in international prices. Revenues from nontraditional exports (fish, cut flowers, and gold) have grown steadily in recent years, showing progress in export diversification.

The persistent fall in international commodity prices has led to a downward trend in the terms of trade. Import prices were generally stable, while realized export unit values declined almost across the board (figure 2.6). The trade and current account balances have been in persistent deficit, widening over the years, a symptom of how much Uganda relies on donor assistance to finance its import bill.

Even so, the external position strengthened somewhat in 2001/02. The overall deficit was \$2.8 million, down from \$55.6 million in 2000/01. This was financed largely through

exceptional financing consisting mainly of debt cancellations under the HIPC Initiative and deferred debt payments to countries that have not accepted HIPC terms. Exceptional financing in 2001/02 stood at \$105.1 million, with \$72.2 million for debt cancellation under the HIPC Initiative and \$32.9 million for repurchases made to the IMF.

Merchandise exports rose marginally

Merchandise exports rose slightly from \$441.8 million in 2000/01 to \$444.2 million in 2001/02, largely because of noncoffee exports. Coffee export receipts were down from \$109.7 million in 2000/01 to \$85.3 million in 2001/02 because of the drop in world market prices from \$0.64 per kilogram to \$0.45 (figure 2.7).

Noncoffee export receipts were up 8% in 2001/02, rising to \$358.9 million from \$332.1 million. Fish exports rose to \$80.9 million, up from \$50.1 million (table 2.3). The increase was due to higher volumes and prices. Uganda's export destinations are now more balanced, with the European Union absorbing 29%, the Common Market for Eastern and Southern Africa (COMESA)⁴ 20%, and Asia 19%. If sustained, this shift would reflect some success in market diversification, reducing overreliance on a few markets.

Merchandise imports on the rise

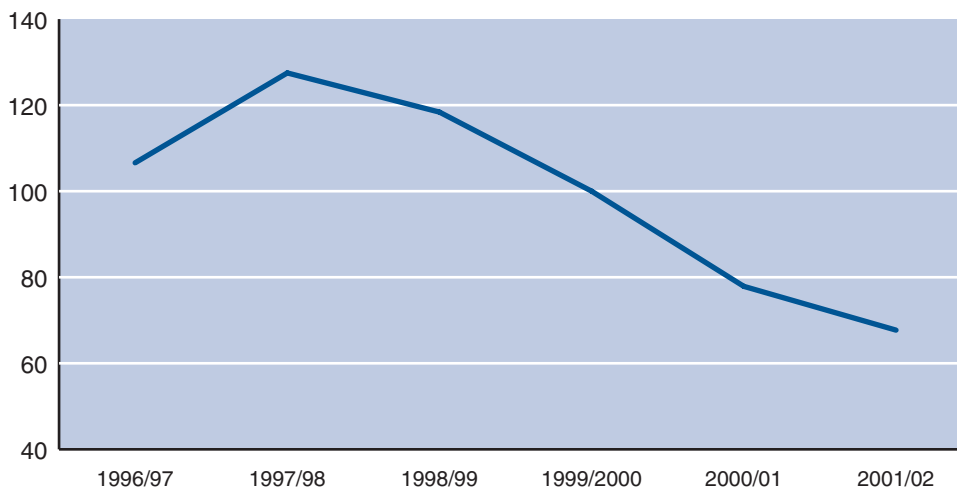
Total merchandise imports rose from \$973.3 million in 2000/01 to \$1,221.1 million in 2001/02, partly because of the increase in private nonoil imports, which were up 11% (table 2.4). Government imports also rose—from \$121.9 million in 2000/01 to \$136 million in 2001/02. With world oil prices lower, oil imports dropped from \$136.1 million in 2000/01 to \$124.7 million in 2001/02.

“Coffee export receipts were down from \$109.7 million in 2000/01 to \$85.3 million in 2001/02 because of the drop in world market prices”

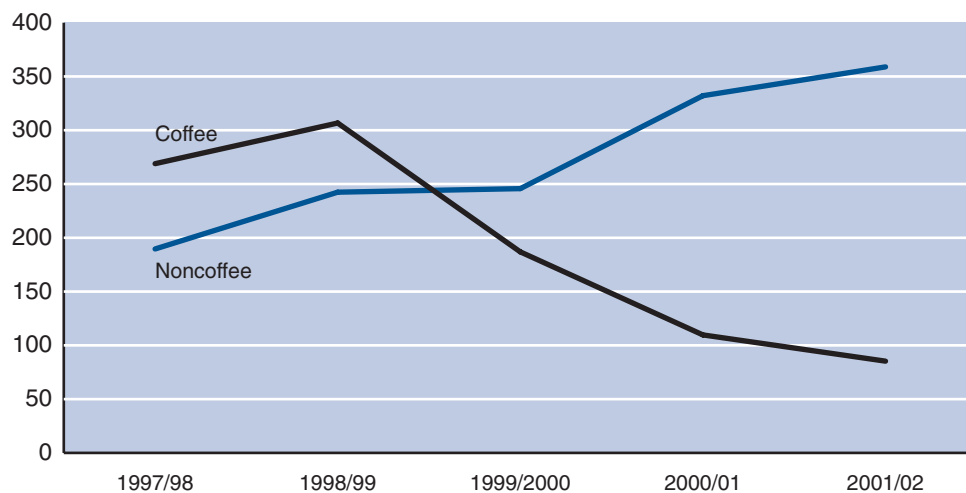
Figure 2.6

Terms of trade trending downward

Terms of trade, 1996/97–2001/02 (Index 1999/2000 = 100)



Source: Economic Commission for Africa, from official sources.

Figure 2.7*Exports diversifying away from coffee**Coffee and noncoffee export earnings, 1997/98–2001/02 (US\$ millions)**Source: Economic Commission for Africa, from official sources.***Table 2.3***Trend and composition of exports, 1997/98–2001/02 (US\$ millions)*

Exports	1997/98	2000/01	2001/02 ^a
Coffee	268.9	109.7	85.3
Total noncoffee	189.6	332.1	358.9
Cotton	11.4	14.1	13.3
Tea	35.0	35.9	26.9
Fish	28.0	50.1	80.9
Beans	2.2	2.0	1.5
Maize	8.1	6.1	13.1
Flowers	6.8	13.2	15.9
Gold	25.5	58.5	56.7
Tobacco	10.8	27.7	32.3
Simsim (sesame)	0.0	0.7	0.5
Electricity	12.0	16.7	13.9
Hides/skins	7.8	22.7	19.7
Cobalt	0.0	12.8	11.0
Others	42.0	71.6	74.0
Grand total	458.5	441.8	444.2

*a. Estimated.**Source: Economic Commission for Africa, from official sources.*

About 29% of imports come from COMESA, with Kenya, still the main source, accounting for 18%. Asia accounted for 27%, the European Union 24%, and the Middle East 10%.

Service exports and transfers—up marginally

Service exports rose from \$187.7 million in 2000/01 to \$193.4 million in 2001/02. Tourism, showing some recovery after the Bwindi National Park murders in 1999, accounted for 82% of nonfactor service exports. Payments for services abroad also increased, leaving Uganda a net importer of nonfactor services.

Private transfers continued to be a significant part of foreign exchange inflows, with net private transfers rising from \$166.4 million in 2000/01 to \$474.6 million in 2001/02, close to half from nongovernmental organizations. Official transfers to Uganda declined to \$375.2 million in 2001/02, from \$420.8 million the previous year.

The capital and financial account improves

Uganda removed all restrictions on international capital transactions in 1997 (box 2.3), and the capital and financial account recorded surpluses for the last five years, mainly because of donor funding. In 2001/02 the surplus was \$473.2 million, up from \$309.5 million the year before. Donor and private loan disbursements more than offset debt repayments. Foreign direct investment also grew, if marginally, from \$143.8 million in 2000/01 to \$145.7 million in 2001/02 (table 2.5).

Exchange rate policy—shilling remains stable

Uganda now operates a flexible exchange rate regime, allowing the value of the shilling to change against all other currencies in line with market conditions and the underlying economic fundamentals. Bank of Uganda intervention aims to reduce wide fluctuations, without targeting any predetermined level or trend. Its exchange rate policy is geared at creating a viable and sustainable external sector.

Table 2.4

Trend and composition of imports, 1997/98–2001/02 (US\$ millions)

Imports	1997/98	2000/01	2001/02 ^a
Total	966.2	973.3	1,221.1
Government imports	193.4	121.9	136.0
Project	170.8	89.6	108.8
Nonproject	22.6	32.3	27.1
Private sector imports	572.3	737.7	791.3
Oil	70.3	136.1	124.7
Nonoil	502.0	601.6	666.6
Other imports	200.4	113.7	293.8

a. *Estimated.*

Source: Economic Commission for Africa, from official sources.

“About 29% of imports come from the Common Market for Eastern and Southern Africa, with Kenya, still the main source, accounting for 18%”

The Ugandan shilling remained relatively stable against the dollar during most of 2001/02. The interbank weighted-period average mid-rate appreciated by 0.5%, compared with a depreciation of 16.5% in 2000/01, largely because of donor inflows and stronger noncoffee exports. On a few occasions during the year the Bank of Uganda increased net sales of dollars in the foreign exchange market to mop up excess liquidity. It was feared early on that lumpy and significant donor resources would appreciate the nominal and real exchange rates, hurting exports. But sterilization by the Bank of Uganda ensured that the exchange rate remained competitive.

The average nominal effective exchange rate appreciated by 2.3%, while the real effective exchange rate depreciated by 0.4% during 2001/02. But on an end-period basis, both rates depreciated, by 6.9% and 9.8% (figure 2.8).

Table 2.5

Balance of payments, 1997/98–2001/02 (US\$ millions)

Balance of payments	1997/98	2000/01	2001/02 ^a
Current account balance	-251.7	-365.1	-476.0
Exports (fob)	458.4	441.8	444.2
Imports (fob)	-966.2	-973.3	-1,221.1
Service (net)	-202.0	-293.0	-447.2
Income (net)	-83.9	-127.9	-101.7
Current transfers (net)	542.0	587.3	849.8
General government	507.0	420.8	375.2
Private transfers (net)	35.0	166.5	474.6
Capital and financial account	351.9	309.5	473.2
Capital transfers	40.6	0.0	0.0
Financial account	311.4	309.5	478.4
Foreign direct investment	120.0	143.8	145.7
Other liabilities	191.4	165.8	332.7
Medium and long-term loans	212.0	181.7	362.4
Debt amortization	-68.5	-81.9	-80.9
Short-term loans (net)	-20.6	-15.9	-29.7
Errors and omissions	18.1	-14.0	62.4
Overall balance	100.2	-55.6	-2.8
Financing items	-100.2	55.6	2.8
Use of IMF credit (net)	-4.6	-20.9	-37.0
Change in gross reserves	-128.6	-19.3	-127.7
Exceptional financing	14.9	109.7	105.1

a. Estimated.

Source: Economic Commission for Africa, from official sources.

Box 2.3

Liberalizing the capital account: a lesson for other countries?

Liberalization of the capital account in 1997 was preceded by successful macro reforms. These reforms reduced the fiscal deficit significantly and ensured financing of the remaining deficit in a noninflationary manner. They strengthened the prudential supervision and regulation of financial institutions, especially in foreign exchange risk exposure. They liberalized the domestic financial sector. And they restructured debt.

Uganda's experience with a liberal capital account cannot be compared with those of south-east Asian countries because Uganda's financial markets are not well developed and its markets are not liquid enough to facilitate the development of financial instruments that could attract portfolio investment.

Results so far are positive

The inflow of foreign capital—largely in trade flows, transfers, and investment flows—has been fairly large. Uganda has:

- Elicited participation in the domestic capital market, with some interest from foreign fund managers in shilling-denominated assets. The recent issue of East African Development Bank (EADB) bonds attracted foreign participation. And the promissory notes issued by the government have attracted foreign interest.
- Increased private sector investments.
- Shifted from shilling-denominated to dollar-denominated accounts, opening avenues for diversification of savings and borrowing for domestic agents.
- Ensured continuing fiscal discipline and prudent conduct of monetary policy.

But there may be challenges in the future

Foreign exchange inflows under a liberal capital account challenge the stability of the foreign exchange market and the management of liquidity.

- On many occasions, the authorities are constrained in their efforts to deal with inflows known to be temporary because of programme requirements to achieve a floor on net international reserves.
- The capital account was liberalized before a system was put in place to collect data on capital account transactions. The system for holding regular surveys and reporting requirements has just been developed. Laws revoking the Exchange Control Act of 1969 and liberalizing foreign exchange transactions have yet to be passed.
- Liberalization of the capital account created new forms of risk for domestic banks, which they have little experience managing.
- The vulnerability to speculative attacks and the possibility of contagion effects could cause massive outflows of capital.
- Instruments need to be developed to deal with the exposure risks and the uncertainty the private sector faces in a situation where markets and hedging instruments are lacking.

Source: Economic Commission for Africa, from official sources.

“
**Even with debt relief
 under the HIPC
 Initiative, Uganda's
 debt sustainability has
 not improved much**
 ”

External debt management strategies and trends

Uganda's pursuit of sound macroeconomic policies and commitment to structural reforms enabled it to become the first country to qualify for debt relief under the HIPC Initiative. The usual three-year interval between the decision and completion points was reduced to one year, with a decision point set in April 1997 and the completion point reached in April 1998, when Uganda received \$347 million in debt relief. Uganda also became the first country to benefit from the enhanced HIPC initiative in April 2000, when it secured \$656 million in debt relief.

Even with debt relief, Uganda's debt sustainability has not improved much. Its stock of outstanding and disbursed external debt at the end of June 2002 was estimated at \$3.8 billion, an increase of 11.5% over June 2001. The total debt stock as a ratio of GDP also rose to 68% in June 2002, from 65% a year before. In line with Uganda's debt strategy, which requires new borrowing on highly concessional terms, about 82% of external debt is owed to multilateral institutions (figure 2.9).

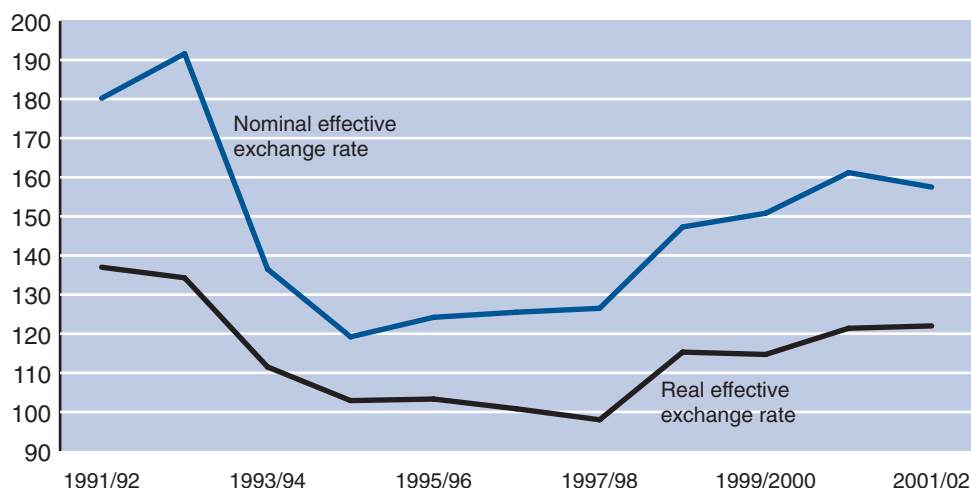
The ratio of debt service (including IMF maturities) to total exports of goods and non-factor services was 24% in June 2002, down from 27% in June 2001. This was largely a result of increasing exports and a decline in debt service from \$167.2 million to \$153.8 million (table 2.6).

The debt and debt service indicators in net present value terms also show that Uganda's debt sustainability has not improved since it received HIPC debt relief. The net present

Figure 2.8

Shilling fairly stable against the dollar in 2002

Nominal effective and real effective exchange rates, period average, 1991/92–2001/02 (1990=100)



Note: Downward movement is appreciation. An upward movement is depreciation.

Source: Bank of Uganda.

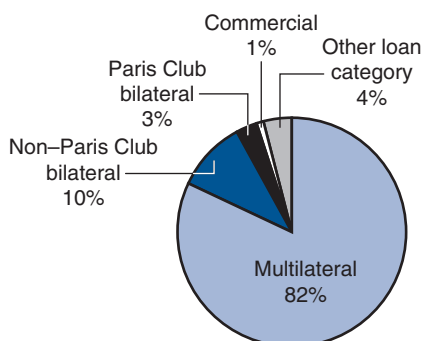
value of the debt to exports ratio increased from 171% in 2000/01 to 199% in 2001/02—and it is projected by the IMF to increase to 208% in 2002/03. Compare that with the threshold of 150% established under the enhanced HIPC framework. Similarly the net present value of the debt to GDP ratio is projected to increase from 20% in 2000/01 to 22% in 2000/03 (table 2.7). Improving debt sustainability is a priority for the medium term, but any external shocks to real GDP and exports or a severe depreciation of the shilling could easily derail Uganda’s efforts.

“Improving debt sustainability is a priority, but any external shocks to real GDP and exports or a severe depreciation of the shilling could easily derail efforts”

Figure 2.9

Most debt is multilateral

Share of outstanding public debt, by creditor, 2002



Source: Economic Commission for Africa, from official sources.

Table 2.6

Outstanding public debt, by creditor, June 1998–June 2002 (US\$ millions)

Creditor category	End-June 1998	End-June 2001	End-June 2002 ^a
Total debt stock	3,631.0	3,395.2	3,782.9
Multilateral	2,826.8	2,892.9	3,102.7
Non-Paris Club bilateral	423.6	341.3	371.7
Paris Club bilateral	324.4	122.9	115.0
Commercial	33.4	18.0	34.6
Other loan category	22.6	20.1	158.9
Debt service	173.7	167.2	153.8
Debt service to export of goods and nonfactor services (%)	27.4	26.6	24.1
Debt service to GDP (%)	1.4	0.7	0.6
Debt stock to GDP (%)	58.8	64.7	68.2

a. Estimates.

Source: Economic Commission for Africa, from official sources.

Social sector developments

“*The proportion of people living in poverty declined from 56% in 1992 to 35% in 2000—but one in three Ugandans still lives below the poverty line*”

Sound macroeconomic management that generated higher growth in the last decade enabled Uganda to improve the living standards of the population (table 2.8). The proportion of people living in poverty declined from 56% in 1992 to 35% in 2000. And thanks to higher public spending on basic services, most key education and health indicators improved. The government made tremendous progress in improving the efficiency of public spending on social services through the public expenditure tracking system (box 2.4).

These impressive gains aside, one in three Ugandans still lives below the poverty line. The overall poverty numbers also hide vast regional and urban-rural disparities. And despite the substantial increases in public spending on basic services, most social indicators are below the average of such comparator countries as Ghana, Kenya, and Zimbabwe. The HIV/AIDS epidemic, though now under control, has also taken a toll on social indicators.

Table 2.7
Debt sustainability indicators, 2000/01–2002/03 (%)

Indicator	2000/01	2001/02	2002/03
Net present value of debt to exports ratio ^a	170.9	199.0	208.7
Net present value of debt to revenue ratio	186.9	180.1	181.8
Net present value of debt to GDP ratio	20.3	21.2	22.4

a. In relation to the average of three consecutive years of exports of goods and services ending in the recent year.

Source: IMF 2002b.

Table 2.8
Social indicators, latest years

Region/country	Infant mortality rate (per 1,000 live births) 2000	Under-five mortality rate (per 1,000) 2000	Life expectancy at birth (years) 2000	Combined gross enrolment rate, primary, secondary, and tertiary (%) 1999 ^a	Adult literacy rate, ages 15 and older (%) 2000
Sub-Saharan Africa	107	174	48.7	42	61.5
Uganda	81	127	44.0	45	67.1
Ghana	58	102	56.8	42	71.5
Kenya	77	120	50.8	51	82.4
Nigeria	110	184	51.7	45	63.9
Tanzania	104	165	51.1	32	75.1
Zambia	112	202	41.4	49	78.1
Zimbabwe	73	117	42.9	65	88.7

a. Preliminary UNESCO estimates subject to revision.

Source: UNDP 2002.

Poverty reduction is at the heart of the country's development strategy. The Poverty Eradication Action Plan/Poverty Reduction Strategy sets out to reduce income poverty to 10% of the population by 2017 by creating a better enabling environment for economic activities and by directly increasing living standards.

Spatial dimensions of poverty

Mean consumption per adult equivalent rose by 4.6% a year between 1992 and 2000, but the growth was much higher in urban areas (6.2%) than in rural (3.9%). Within rural areas, regions with higher initial incomes grew faster—in rural central by 5.2% a year, in rural western by 4.5%, in rural eastern by 3.9%, and in rural northern by only 0.5%.

A similar disparity can be observed in the dynamics of poverty. Of urban households that were poor in 1992, 61% moved out of poverty by 1996, but of rural households only 39% did (Okidi and Mugambe 2002).

The north is significantly poorer. The largest reduction in the proportion of people in poverty was reported in the central region (from 46% in 1992 to 20% in 1999), where the initial incidence of poverty was the lowest in 1992 (figure 2.10). Both the eastern and western regions also saw poverty decline, though to a lesser extent. But in the northern region the incidence of poverty increased to 65% in 1999 from 59% two years earlier. A similar picture emerges when comparing poverty dynamics across regions. In the northern regions only 27% of the households that were poor in 1992 moved out of

“*The largest reduction in poverty was reported in the central region*”

Box 2.4

Public funds finally reach schools

In 1996 Uganda became the first country to apply a public expenditure tracking system. Its use was prompted by the observation that despite a substantial increase in public spending on education since the late 1980s, officially reported primary enrollment remained stagnant.

The survey quantified the adverse effects of asymmetric information on the flow of funds. It found that 87% of nonwage funds allocated to districts either disappeared for private gain or were used by district officials for purposes unrelated to education. Following publications of the survey findings, the central government began publishing the monthly intergovernmental transfers of public funds in major newspapers and broadcasting the information on radio, and required primary schools to post information on inflows of funds for all to see. This not only made information available to parent and teacher groups, but also signaled to local governments that the center had resumed its oversight function, creating incentives for increased accountability among local agencies.

Initial assessments of these reforms a few years later, through two locally implemented follow-up surveys, show that the flow of intended capitation grants improved dramatically, from 13% (on average) reaching schools in 1991/95 to about 80–90% reaching schools in 1999 and 2000.

Source: Economic Commission for Africa, from official sources.

poverty by 1996, far less than in eastern (37%), western (60%), and central (63%) regions (Okidi and Mugambe 2002). The north has disadvantages of remoteness, continuing civil conflict, unfavourable agroclimatic conditions, low population density, and many internally displaced people (box 2.5).

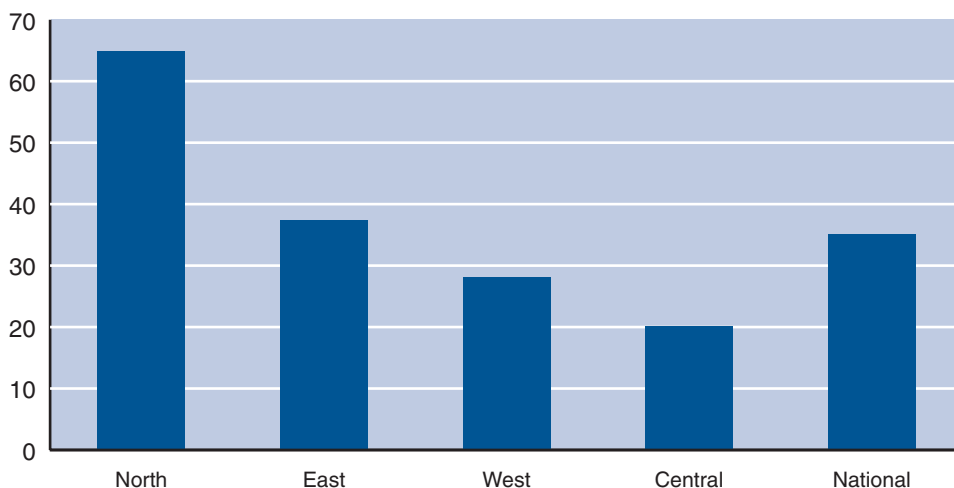
“*In the northern region the incidence of poverty increased to 65% in 1999 from 59% two years earlier*”

Several factors may explain these spatial variations in growth and poverty reduction. First, Uganda’s growth in the 1990s reflects its recovery from disaster. By 2000 the economy was just returning to the income per capita of the early 1970s. Disastrous economic policies, invasions, and civil war had undermined the formal economy and caused “a retreat to subsistence”. This hit urban areas more than rural areas. So when security and a stable economic policy framework were restored, there was more scope for the formal economy to bounce back, and economic opportunities improved more in urban areas. This may also explain the better performance of central rural areas, likely to have benefited from proximity to major urban centres.

Second, the restoration of security has been uneven. The slow growth of northern rural areas—and to some extent eastern—reflects not only distance from the cities but also poor security. Indeed, it is possible that security did not improve in some parts of the country—four districts were excluded from the 1999/2000 poverty survey due to insecurity, up from two in 1992/93 and none in 1993/94.

Third is the local impact of the coffee boom in 1994/95, when unit values for Ugandan coffee exports rose to \$2.55 a kilogram from \$0.82 in 1992/93. Coffee accounts for a sizable share of income only in the western and central regions—it is not grown in the

Figure 2.10
Poverty incidence highest in the north
Proportion of population in poverty, by region, 1999/2000 (%)



Source: Appleton and others 1999; Appleton 2001.

north. It is likely that much of the windfall was saved, resulting in a permanent rise in income (Collier and Gunning 1999).

Poverty in food crops sector. There are wide disparities in the ability of various socio-economic groups to benefit from economic opportunities created by the stable macro-economic environment. The food crop sector, mainly subsistence farming, was the poorest in 1992, with poverty declining from 64% in 1992 to 58% in 1996 (Okidi and

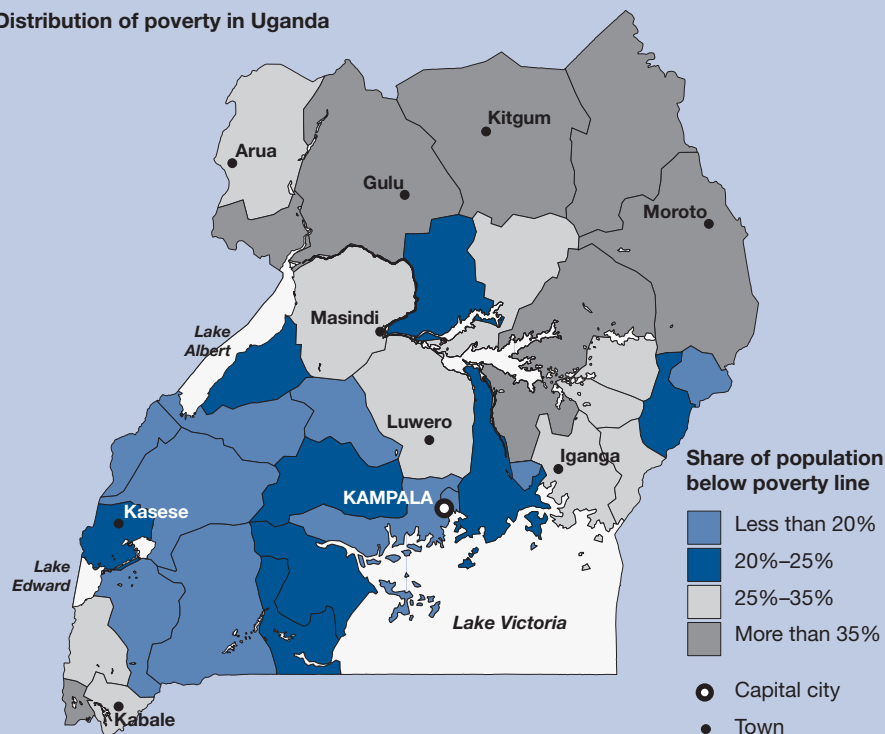
Box 2.5

The untold side of the success story

The benefits of Uganda's high growth have not been evenly distributed across the country. There are still great inequalities between the more affluent central crescent around Lake Victoria and the drier, more disadvantaged northern region. The north lags far behind the rest of the country in food security, health, and education.

The northern districts have suffered deaths, torture, abduction of children, disruption of livelihoods, and displacement. More than 800,000 people have been displaced by civil war and live in squalid camps. Another 150,000 refugees in 66 settlements in eight districts are also in need of food. According to the World Food Programme 108,000 tons of food were needed for the first six months of 2003 to avoid famine in the war-torn north.

Distribution of poverty in Uganda



Source: Economic Commission for Africa, from official sources.

Mugambe 2002). Compare that with cash-crop farming, the second poorest in 1992, with 60% in poverty, but that then dropped to 41% in 1996. The removal of market controls on coffee benefited smallholder coffee farmers, enabling them to get better farmgate prices, especially with international coffee prices high in the mid-1990s.

“
The downward trend in poverty emanated from faster economic growth, not from a redistribution of wealth
”

National welfare inequality has not changed much over the years. So the downward trend in poverty emanated from faster economic growth, not from a redistribution of wealth. Those who remained poor have not had access to the economic opportunities created by high growth. They may be subsistence farmers, who do not operate in the formal economy. They may lack human and technical skills to benefit from new opportunities. They may belong to vulnerable groups—women, children, refugees. And they may be subject to disruptions from war and natural disaster.

The government is working to improve fiscal decentralization, equalization grants, social spending, targeted intervention programmes, and agricultural development programmes. But more commitment is necessary to address the deep pockets of poverty by concentrating on the priorities identified by the poor themselves: improving security, curbing corruption, and increasing access to basic social services, infrastructure, and markets (Uganda, Ministry of Finance, Planning, and Economic Development 2000). Establishing political stability and ending the economic alienation of the north region should be a key priority for the government.

Poverty-sensitive distribution of resources

The pattern of government expenditures through various fiscal transfer mechanisms may not adequately redress regional inequalities. (The analysis here draws on Uganda 2002.) The transfer formula allocates 85% of transfers according to district population and 15% according to geographical area. This formula applies to the Local Government Development Programme, the Unconditional Grant, the Plan for Modernization of Agriculture Grant, the National Agricultural Advisory Services Grant, and the Agriculture Extension Grant.

The regional distribution of transfers to local governments indicates that of 501.9 billion Ugandan shillings (around a quarter of the budget for 2001/02), the western region received the largest share (27%), followed closely by the eastern (26%), the central (25%), and the northern (22%).

On the basis of recent trends in economic growth and regional inequality, the Ministry of Finance, Planning, and Economic Development has analyzed the geographical pattern of government expenditure under the medium-term expenditure framework and come up with a weight that would be poverty-sensitive, using three factors to determine transfers:

- *Population size:* Districts with a higher population should receive more resources because they carry a higher burden of service delivery.

- *Geographical area:* Larger districts should receive more resources, because it is more costly to provide services to a geographically disbursed and isolated population.
- *Poverty level:* Poor districts should receive more transfer payments, because with their limited economic activity, they have a lower tax base than rich districts.

For illustrative purposes, the ministry gives the following weights—population (60%), area (20%), and poverty (20%)—and using these weights it develops a poverty sensitive distribution.

The central and western regions have bigger populations (28%) than the eastern (25%) and northern (19%). The northern region is the largest in area (42%), followed by the western, central, and eastern. The central region has the biggest share of total household expenditure (39%), followed by the western (27%), eastern (23%), and northern (11%).

Given the weights in this example, a poverty-sensitive distribution would allocate 29% to the northern region (up from 23%), 26% to the western, 23% to the central, and 22% to the eastern. Increasing the allocation to the north could be done only after displaced people are resettled in their home villages and provided decent homes.

Education—primary education for all

Government policy on education is to increase the access to primary education. In 1997 the government launched the Universal Primary Education (UPE) programme, entitling up to four children per family to free primary education (the president recently announced its extension to every child). Primary education now receives about 70% of the education budget. The public expenditure tracking system, introduced in 1996, made sure that 80–90% of funds actually reached schools in 1999/2000 (see box 2.4).

The programme has the potential to be one of the most important poverty reduction strategies in Uganda. Estimates of the direct impact of education show that universal primary education would increase agricultural production by about 15%, more than the agricultural productivity gains from access to roads and extension services (Deininger and Okidi 2001). The improvement in primary education indicators has been substantial (table 2.9).

Table 2.9

Primary education indicators, 1994/95 and 2001/02

Indicator	1994/95	2001/02
Public expenditure on education (% of government expenditure)	15.0	24.4
Enrolment rate in primary schools (%)	55	98
Ratio of girls to boys	45:55	45:55
Primary school dropout rate (%)	70	6.6

Source: Economic Commission for Africa, from official sources.

“Primary education now receives about 70% of the education budget”

With tremendous achievements in quantity, greater efforts are now needed in improving quality indicators, such as the number of qualified teachers and the pupil-teacher and pupil-classroom ratios. The government is also reforming higher education, with enrolment already rising.

“*Uganda became one of the first countries in Africa to reverse the HIV prevalence rate in the adult population—from 15% in 1993 to about 7% in 2002*”

Health—fighting illness on all fronts

The Uganda (2002) Participatory Poverty Assessment identified ill health as the most frequently cited cause and consequence of poverty by the poor. The government has responded by allocating more resources, increasing the number of health facilities across the country, and re-orienting health services from curative to preventive, with particular attention to health education and information and to public health programmes.

Uganda’s aggressive response to HIV/AIDS shows the government’s commitment to fighting ill health on all fronts. The government’s first policy actions were to open a public debate on HIV/AIDS, taboo at the time, and to call for international assistance. The government then increased civil society participation in HIV/AIDS programme planning and design, to build awareness across the country. Most important, the government took a multisectoral approach to AIDS, involving 12 line ministries.

The strategy paid off. Once number one in the world for HIV infections, Uganda became one of the first countries in Africa to reverse the HIV prevalence rate in the adult population—from 15% in 1993 to about 7% in 2002. The largest decline was observed among adolescents (ages 15–19)—from 32% in 1992 to 10% by 1998. But tackling the issue of AIDS orphans—8% of Africa’s children orphaned by AIDS live in Uganda—remains a priority.

Other performance indicators have improved as well (table 2.10). Infant mortality has declined from 88 per 1,000 births in 1995 to 81 in 2000. The percentage of one-year-olds fully immunized rose from 66% in 1995 to 83% in 2000 and more than 90% in

Table 2.10
Health indicators, 1995 and 2000

Indicator	1995	2000
Public expenditure on health (% of GDP)	1.6	7.0
Infant mortality rate (per 1,000 live births)	88	81
Under-five mortality rate (per 1,000)	141	127
Maternal mortality ratio (per 1,000 live births)	12	5
Life expectancy at birth (years)	40.5	44.0
Share of people with access to safe water (%)	46	50
Share of people with access to sanitation (%)	57	80
Share of one-year-olds fully immunized (%)	66	83

Source: UNDP 2002; Economic Commission for Africa, from official sources.

2002. Accessibility to health care improved from 49% in 1995 to 70% in 1999 and about 80% in 2001. The challenge now is to ensure improvements in the quality of medical care.

Unleashing the private sector—many challenges to surmount

The potential of macroeconomic reforms to increase growth and reduce poverty has now been largely exploited. Providing further impetus to growth requires a deeper reform agenda to create an enabling environment for the private sector—reforms to make difficult governance and structural changes.

The average real GDP growth rate of 6% over the last decade, though impressive, is still below the target 7% a year required to achieve the government's goal of reducing income poverty to 10% by 2017. Lifting growth by one notch thus falls squarely on the private sector. For a predominantly rural agrarian economy, private sector-led growth hinges on modernizing and diversifying agriculture. Since the majority of the poor make a living out of agriculture, such policies would also reduce poverty.

Throughout the last decade the government has undertaken a series of reforms to address private sector development and create an investor-friendly environment: removing controls on agricultural products, particularly for coffee, liberalizing trade and international capital flows, and privatizing state-owned enterprises.

So far the domestic sector has not responded strongly. Even though inflows of foreign direct investment increased steadily from about \$54 million in 1993 to about \$145 million in 2002, they are not an adequate response to Uganda's impressive economic management.

The private sector identifies the high price and low quality of utility services and high taxes and interest rates as major constraints to investment (figure 2.11). Corruption, access to finance, tax administration, and the cost of raw materials are next in line as leading constraints.

The government is trying to tackle some of these constraints. The Uganda Electricity Board—a 100% government-owned monopoly since 1964—was unbundled into separate generation, transmission, and distribution entities and privatized. Generation capacity increased from 260 MW in 2000 to 300 MW in 2002 with the addition of two turbines at Kiira Power/Owen Falls extension.

In December 2001 the World Bank Group agreed to support the Bujagali Hydropower Project in Uganda, describing it as a key investment in poverty reduction for a country in which less than 3% of the population has access to grid-supplied electricity. The

“*Infant mortality has declined from 88 per 1,000 births in 1995 to 81 in 2000*”

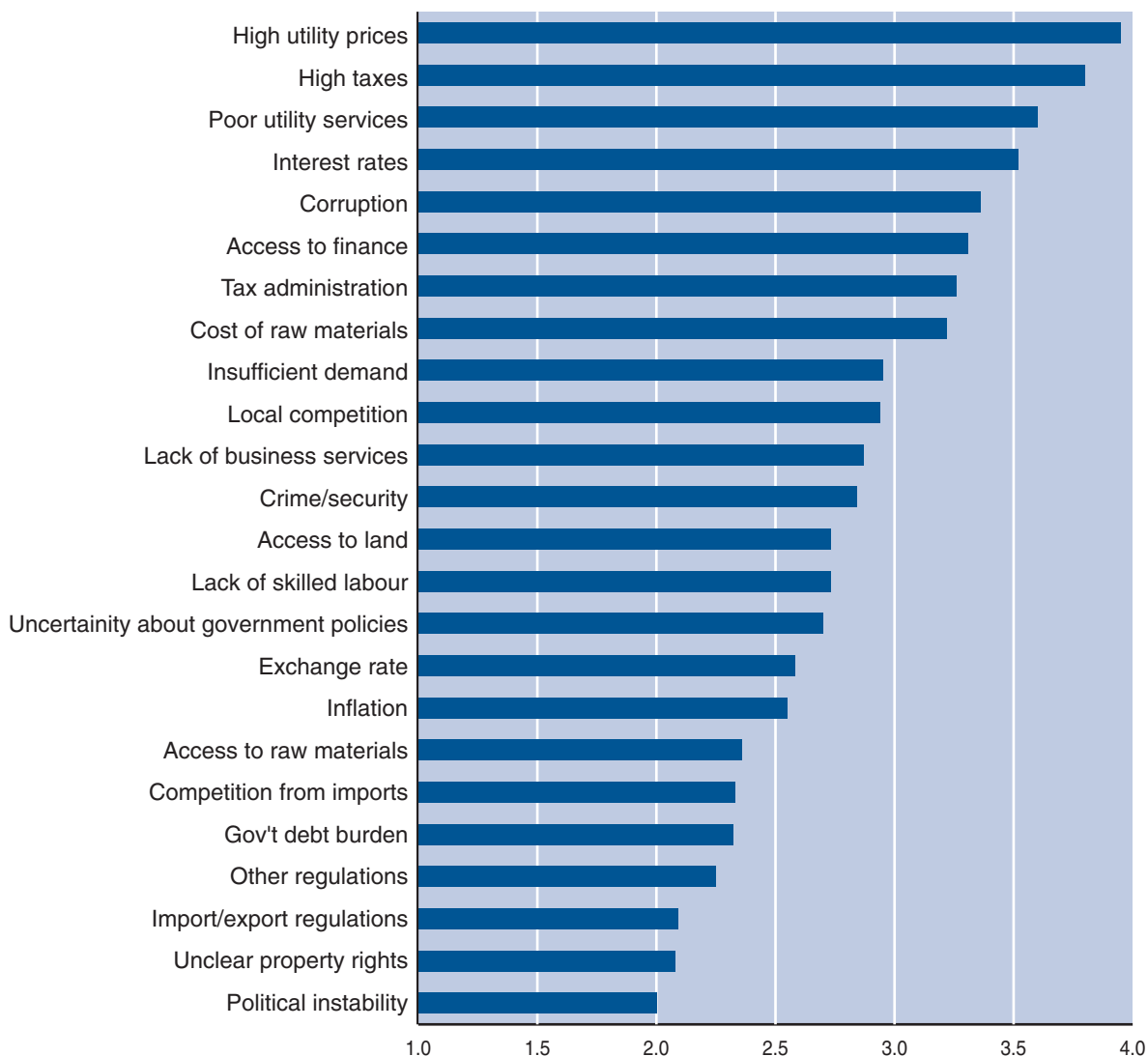
hydropower station will be built, owned, and operated by AES Nile Power Limited, a private firm. The sponsor is the AES Corporation, a public corporation headquartered in Arlington, Virginia.

Telecommunications prices have declined and access has greatly improved with the entry of two additional mobile telephone providers—MTN of South Africa and Telecel of Switzerland. Attempts have been made to strengthen tax administration by changing the senior management of the Uganda Revenue Authority. Security concerns have also been

Figure 2.11

High utility prices, taxes, and interest rates top constraints to investment

Private sector-identified constraints to investment



Note: 1=no obstacle, 2=minor, 3=moderate, 4=major, 5=severe

Source: Reinikka and Svensson 1999.

addressed with Operation Wembley—a zero-tolerance crackdown on armed robbers in June 2002. While the government has tried to improve the business environment, more needs to be done, particularly in the financial sector, infrastructure, and governance.

Improving access to the financial sector

Uganda's financial sector, after many reforms, has emerged much stronger in recent years. But weaknesses still exist in access to credit. Commercial bank lending rates are still prohibitively high. Limiting the ability of small enterprises to borrow are high collateral requirements by banks and the fact that land is not accepted as collateral. Most small firms have access to credit only through microfinance institutions, which operate in a regulatory vacuum.

With the majority of poor people in rural areas and engaged in agriculture, strengthening microfinance should be a priority. Reform will address the problem of outreach. It will minimize the risk of exposure for clients. It could offer a reliable institutional setup to mobilize savings in rural areas (Kasekende 2002). And it could improve the health of the financial sector.

Improving infrastructure

The government is developing and maintaining infrastructure facilities to reduce the cost of services and improve quality and accessibility. Limiting itself to a regulatory role, the government aims to increase private participation in the operation, financing, and ownership of infrastructure services. Already, there are signs of greater competition and efficiency.

The government is also overhauling postal, telecommunications, energy, water, and transport services, long a major constraint. The benefits of liberalizing the telecom sector are already being felt, but the benefits from other utility privatizations have yet to be seen. Regulatory structures need to be improved along with privatization to realize the benefits.

With significant budget increases over the last four years, the main road programme is funded at 90% of the Poverty Reduction Strategy requirement. But the rural road programme, also crucial, is still underfunded (UN 2002).

Transport and other import-related costs add about 50% on average to the cost of imported inputs (Reinikka and Svensson 1999). Being landlocked makes transportation more expensive. Processing time and unexpected delays create additional burdens. It takes 30 days on average for imported inputs to reach the nearest port (typically Mombasa), another 30 days to reach Ugandan customs, and another 9 days to reach the firm.

Addressing governance—some way to go

Concerns about governance, particularly corruption and insecurity, are high on the list of constraints to private participation in economic activities. These are also highlighted by the poor as impediments to their livelihoods.

“Uganda’s financial sector, after many reforms, has emerged much stronger in recent years—but weaknesses still exist in access to credit”

“
The government has taken several steps to enhance the integrity and accountability of its institutions
”

Corruption—strong commitment needed. Corruption in Uganda, prevalent in the highest levels on down, significantly increases the cost of doing business. Firms and households identify police and the judiciary as the most corrupt. The Uganda National Integrity Survey of 1998 reveals that 63% of respondents paid bribes to police officers and 50% had bribed court officials. Corruption in the police forces is well documented in the Sebutinde report that investigated police corruption in 2001 (box 2.6).

On the positive side, corruption is now discussed openly, particularly in the media, and government inquiries are launched on several cases. The population is becoming less tolerant of corruption in high places. The government, partly pressed by donors over the misuse of their funds, has taken several steps to enhance the integrity and accountability of its institutions. Recent measures:

- Strengthening anticorruption institutions—the Inspector General, the Auditor General, and the Department of Public Prosecution—through capacity building and additional budgetary resources.
- Establishing a Ministry of Ethics and Integrity to set standards and inquire into matters related to corruption.

Box 2.6

Poor governance widespread in the public sector

According to the Transparency International corruption perception index of 102 countries for 2002, Uganda ranks 92. A national survey on corruption in the public sector, conducted in 1998, partly explains why Uganda still has such a bad ranking. About 70% of households interviewed reported corruption in public services to be very high, especially among the police and judiciary.

Based on the percentage of service users who paid a bribe, Mbale District was found most corrupt, with an amazing 73%, and Kisoro District the least corrupt, with only 11%. Users who pay bribes reported that they do not even get better services.

The factors leading to the spread of corruption are deep-seated, dating to independence and Idi Amin's years in power.

By the time President Museveni came to power, Uganda had experienced virtually every kind of corrupt practice imaginable. The new administration made clear that it viewed corruption as one of the evils inherited from the past and a key obstacle to progress. But the fight against corruption is still difficult. For instance, the Sebutinde report on corruption in the Uganda Revenue Authority shows how staff acquired wealth by helping importers evade taxes. The corruption indicator of the *International Country Risk Guide* also shows that perceived corruption has become worse in the past five years.

The press has been of great importance in curbing corruption and providing the public with information about reforms. The government recognizes the value of a free press, with the state-controlled media fairly free to report on abuses of public office.

Source: Transparency International 2002; Uganda 1998.

- Initiating inquiries into corruption in public services, including investigations of police forces and employees of the Uganda Revenue Authority.
- Introducing a leadership code for declaring assets and incomes of government officials and parliamentarians.

As voiced by the Minister of Ethics and Integrity, the government has so far failed to address corruption effectively (EIU 2002). The challenge is to muster political will at the highest levels to implement the anticorruption strategy. That would stamp out corruption and reassure investors, both domestic and foreign, about the prevailing business climate in the country.

Insecurity persists in many parts of the country. The poor security situation in many parts of the country remains a serious constraint to private activities and overall development. Armed conflicts have severely impaired livelihoods in the north and some parts of the west and east. The north, where a bush war has been waged for the last 10 years, has suffered the most. In the west, Uganda's involvement in the Democratic Republic of Congo was a major concern. A UN panel recently reported alleged looting of Congolese wealth by members of the Ugandan armed forces (UN 2001).

Persistent conflicts do not bode well for maintaining political and fiscal stability or attracting external funding from donors and foreign investors. Poor people living in conflict-ridden regions, the biggest losers, identify ongoing wars, rebel activity, cattle raiding, and theft as their biggest concerns (Uganda, Ministry of Finance, Planning, and Economic Development 2000). This is telling indeed.

Medium-term outlook—promising

The medium-term outlook is promising. GDP is projected to grow at an average of 5% in 2002/03 and 6% over the next two years, and the annual underlying and headline inflation rates are expected to remain below 5%. Gross domestic investment is expected to rise to more than 22% of GDP, while domestic and national savings will remain within the current range. Revenue is also projected to rise to about 13% of GDP, and gross reserves to remain at about six months of future imports. With stronger revenues the fiscal deficit is projected to decline to about 11% of GDP (excluding grants) in 2002/03 and 10% in 2003/04. Export receipts are projected to increase by about 10% a year, with the terms of trade improving as the diversification drive gains momentum.

But significant risks lie ahead. The aid dependence of the budget and development programmes and the high military expenditures are concerns. Moreover, negative shocks to GDP growth or exports could severely affect the external debt profile. So sustaining macroeconomic stability and high economic growth rates should be the key objectives of economic policy in the medium term. Any policy slippage would compromise the national development objective of reducing poverty.

“**The challenge is to muster political will at the highest levels to stamp out corruption and reassure investors about the prevailing business climate in the country**”

Despite commendable gains in poverty reduction, one in three Ugandans still lives below the poverty line, and most social indicators are still below the average for comparator countries. Improving poverty and social indicators requires faster growth, from 6% a year to 7% to achieve the country's goal of reducing poverty to 10% by 2017. Having now largely exploited the potential for economic growth through sound macro-economic policies, the medium-term challenge would be to find a new source of growth: the private sector.

Creating an enabling environment for the private sector requires deeper structural and governance reforms. The government has to deepen financial reforms, improve the provision of public services, and address widespread corruption and insecurity in many parts of the country. Uganda has a challenging task ahead before taking off.

Notes

1. Headline inflation is based on relative changes in prices of all goods and services. All conversions from Ugandan shillings to U.S. dollars are based on the end period exchange rate for June 2000.
2. M3 includes currency in circulation and private sector deposits, including foreign currency deposits.
3. M2 includes currency in circulation and private sector deposits, excluding foreign currency deposits.
4. COMESA member countries include: Angola, Burundi, Comoros, Democratic Republic of Congo, Djibouti, Egypt, Eritrea, Ethiopia, Kenya, Madagascar, Malawi, Mauritius, Namibia, Rwanda, Seychelles, Sudan, Swaziland, Uganda, Zambia, and Zimbabwe.

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