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Uganda Economic Outlook 2018

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Uganda's economy is projected to grow by 5.0% to 5.50% this financial year 2017/18 and the outlook for the future is even more positive

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Uganda's economic outlook for 2018 is a lot more positive thanks to a recovery in private sector credit, favorable weather conditions, increase in Foreign Direct Investment (FDI) and the continued robust government investment in infrastructure.

According to Bank of Uganda's most recent Monetary Policy Statement (MPC), there are very good signs of recovery and revival of the private investment activity in the economy.

FDI has rebound from the slump of 2016, and is estimated to have increased by 18.5% during the 2017 calendar year.

There has been a year on year increase in private sector credit, with local currency credit extension up by 10.8% in December 2017 compared to the modest growth of only 7.9% in December 2016[1].

The manufacturing sector is also showing signs of recovery with an increase in the export of manufactured goods particularly construction materials such as iron and steel products. Export of processed consumer goods and agricultural items such as dairy products and edible oil is also on the rise.

In addition to this, there has been an increase in imports of raw materials and capital goods, registering growth of 17.4% in the calendar year 2017 compared to a decline of 21.1% in 2016.

On the basis of this positive outlook, economic activity in Uganda is expected to accelerate this financial year 2017/18 with the economy projected to grow between 5.0% and 5.5%

All these positive developments, together with the continued improvements in the global economic outlook, indicate that 2018 will definitely be a better year for businesses in Uganda.

This is all very good news. The ongoing recovery in the economy has also been noticed by Standard & Poor Financial Services LLC, a global economic rating firm. As a result of this, S&P has rated Uganda's economic outlook for 2018 as "stable", and also affirmed the country's "B/B" long and short term sovereign credit rating[2].

According to S&P's report, in the next twelve months, Uganda's fiscal and external metrics will remain broadly in line with projected forecasts. The report says that its projected stable economic outlook assumes that government will stay on track with its Policy Support Instrument with the International Monetary Fund (IMF) and with its wider relations with official creditors.

We, in PwC also share this optimism. Overall, we expect a very positive outlook for the financial 2017/2018 and beyond.

[1]Bank of Uganda – Monetary Policy Statement February 2018

[2]Standard & Poor's Financial Services LLC

The government's positive sentiments about the economy are shared by the World Bank and the IMF

This positive economic outlook is collaborated by the latest data on the economy published by the Uganda Bureau of Statistics (UBOS). According to the latest UBOS report on the Key Economic Indicators, real GDP for the first quarter (Q1) of FY 2017/18 grew by 1.3%.

Although this is lower than the 2.5% GDP growth of the fourth quarter (Q4) of FY 2016/17, it represents a year on year quarterly GDP growth of 7.5% compared to the growth of 2.5% registered in Q1 of 2016/17[3].

According to the report, all sectors of the economy grew in the first quarter of the current FY 2017/18 compared to the same period last financial year.

For example, value added in the agriculture sector grew by 9.0%, year on year quarterly GDP compared to the decline of 2.0% in the first quarter of FY 2016/17. This was mainly due to an increase in food crop growing activities that grew at 11.0%, thanks to the more than normal rainfall and the generally favorable weather conditions we have had over the last six months.

Likewise, year on year industry activities value added grew by 5.0% in the first quarter of FY 2017/18, compared to the growth of 4.2% in quarter one of FY 2016/17. The main drivers of this growth were manufacturing and construction activities which grew by 3.7% and 5.6% respectively.

Year on year quarterly growth of the services sector value added was 8.7% in the first quarter of FY 2017/18, compared to the growth of 3.7% in quarter one of FY 2016/17.

The main drivers of growth in the services sector were Information & Communication (2.9%), Financial services & Insurance (2.6%), Public Administration (1.4%), Education (3.3%) and Health (0.5%).

The increase in information & communication activities was mainly due to the growth in Telecommunication services. The increase in value added in financial and insurance activities was largely from increased activity within commercial banks[4].

[3]UBOS 107th Issue – Economic Indicators for Q1

[4]UBOS Press Release on Quarterly GDP

The sluggish growth of the economy in the last three years has resulted in a slight deterioration of the poverty levels in the country

21.4%

The recent slowdown in the economy, together with Uganda's rapid population growth has resulted in an increase in the poverty levels with 21.4% of the population living in poverty

The recent slowdown of the economy has constrained growth on a per capita basis, resulting in a deterioration of the poverty levels in the country. Ten years ago, when the economy was growing at an average of 7.0% per year, the proportion of Ugandans living below the national poverty line declined from 31.1% in 2006 to 19.7% in 2013.

However, the recent slowdown in growth of the economy has resulted in an increase in the proportion of people living in poverty[5].

According to the revised National Household Survey Report published by UBOS in February 2018, the proportion of people living in poverty now stands at 8 million. In percentage terms that means that 21.4% of Ugandans are living in poverty.

The key reason for the increase in poverty is that growth has slowed down, while at the same time the population is increasing. In addition, to this, the modest growth we have been having over the last five years has been driven by the services sector. This sector employs a small proportion of the population compared to agriculture and manufacturing sectors that have very strong forward and backward linkages and spill-over effects in the economy.

In fact, the recent slowdown in economic growth is attributed mainly to productivity losses in the agriculture sector. These losses arise mainly because of lack of access to market, lack of affordable agricultural financing, weather vagaries and associated climatic changes.

Looking ahead, real GDP is expected to grow by 5.5% in 2018 and then accelerate to between 5% to 7% per year, during the period 2018 to 2022.

However, despite the projected recovery in growth of the economy, wealth levels measured by GDP per capita are likely to remain below the magic number of USD 1,026 that is required to attain middle income status. This means we will most likely not attain middle income status by our target date of 2020.

[5]UBOS National Household Survey Report

Private sector credit which remained subdued throughout FY2016/17 is beginning to show some signs of recovery

Uganda's banking system is very sound and strong. All banks are comfortably meeting their minimum core capital requirements of 8% risk weighted assets.

In addition, all the banks have adequate liquidity buffers as reflected by the ratio of their liquid assets to total deposits. As of June 2017, the ratio of liquid assets to total deposits across the industry was an average of 50.1%. This is two and a half times the minimum requirement of 20%.

Credit risk management has also improved greatly. Currently the average non-performing loan across the industry is below 5%. This is a major improvement from the rate of 10.5% as of December 2016. The Manufacturing sector was the best performing where NPLs declined considerably. Agriculture still remains as one of the sectors with the highest NPLs[6].

5.6%

The rate of non-performing loans across the banking sector has dropped from a high of 10.5% in December 2016 to a low of 5.6% in December 2017

As a result of these improvements, we are beginning to see signs of recovery in the private sector credit and borrowings. The recovery is being driven mainly by growth of credit to agriculture, trade and personal loans. Credit to the mortgaging, building and services sector remains subdued, although it is also showing some signs of recovery compared to the negative trends we saw in FY2016/17.

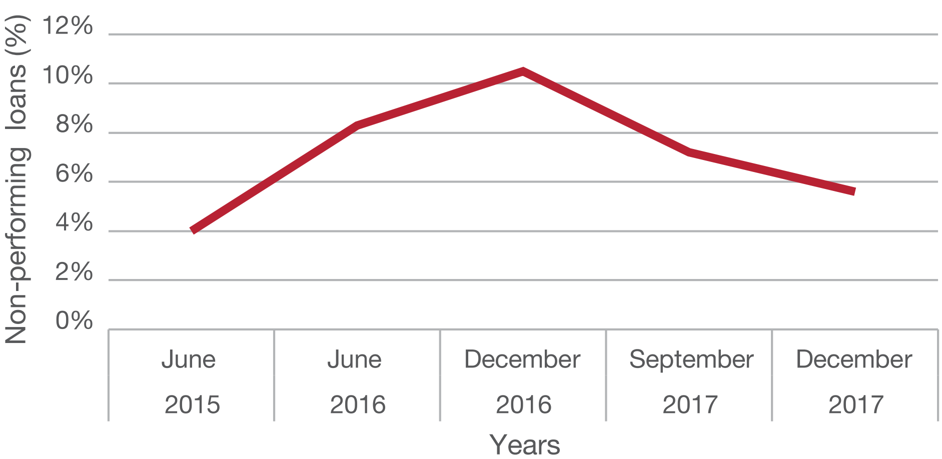
Despite these signs of improvement, the commercial bank prime lending interest rates continues to show rigidity towards responding to the downward BOU central Bank Rate (CBR) movements. This rigidity may be further proof that the CBR is simply a signal rate, and has little effect on commercial banks' decisions. Therefore, commercial banks are also being cautious and mindful of the prevailing market conditions and future economic expectations.

This, coupled with the fact that the banking sector is still recovering from its poor performance due to the economic slowdown of FY2016/17 partly explain the slowdown in credit growth especially in the first half of 2017. Structural rigidities within the banking sector translate to high costs of borrowing and continue to weigh down credit growth.

Banks in Uganda are very vital to the country's financial system and economic growth. They are the main source of credit and have a direct impact on the level of investment and expenditure in the economy.

Therefore, in order for the government's current expansionary monetary policy to result in a boost in economic growth through increased private investment, the reduction in the CBR must translate to a reduction in the cost of credit.

Trend of Non-Performing Loans in Uganda



Source: *Bank of Uganda*

[6]BOU State of the Economy report - March 2018

The latest data on inflation released by UBOS indicates that both headline and core inflation declined to 2.1% and 1.7% respectively

The government's monetary policy objective is to achieve low and stable inflation defined by the medium core inflation target of 5%. During FY2016/17 headline and core inflation averaged 5.7% and 5.1% respectively.

As of now, the most recent data on inflation released by UBOS indicates that both headline and core inflation declined in the month of February 2018 to 2.1% and 1.7% respectively[7]. The decline in core inflation is mainly attributed to other goods inflation that declined to 1.6% in February compared to 2.3% for the year ending January 2018. Other goods was predominately driven by sugar which dropped by -11.5% in February compared to -4.0% in the year ended January 2018.

Bank of Uganda is forecasting the near term inflation to remain within the target of 5% or below, assuming no sharp fluctuations in local currency, and the food prices remain stable.

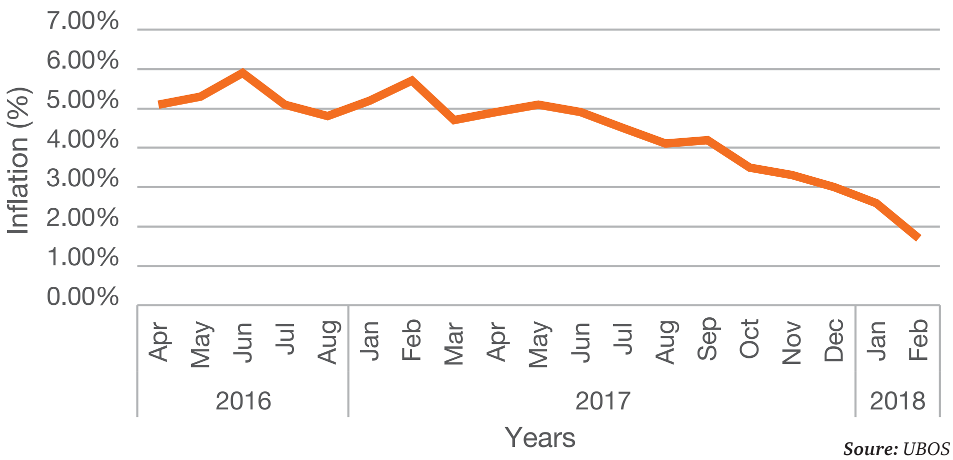
As the economy strengthens, consumption increases and the current upward trend of the international crude oil prices continue, inflation is expected to rise gradually especially around the second half of 2019.

However, Bank of Uganda is not worried about this, as they believe that on the basis of the very stable inflation since April 2016, there is still spare capacity within the economy to absorb any inflationary pressures.

On account of an outlook of inflation of lower than 5%, coupled with weak domestic demand in the economy, BOU has continued to ease monetary policy by reducing the CBR over the last two years.

The objective is to support the recovery in private sector credit growth and strengthen the economic growth momentum. Over the last two years, the CBR has been cut by a cumulative 7.0 percentage points from 16% in July 2016 to the current prevailing rate of 9.0%.

The core inflation trend over the last two years



Soure: *UBOS*

The Bank of Uganda CBR rate trend for the last 2 years

Source: *Bank of Uganda*

[7]UBOS CPI publication for February 2018

The easing of monetary policy by Bank of Uganda through reduction of the CBR has not resulted in lower commercial bank lending rates as expected

Whereas the CBR has fallen by a cumulative 7.0% since April 2016, commercial bank lending rates have fallen by only 5.0%, from an average of 24% in June 2016 to the current average lending rate of about 19% for shilling denominated loans.

On the other hand the average deposit rates have declined from 12% in December 2016 to 8.5% today. This means that the spread between lending and deposit rates has ranged at about 11.5% over the same period.

A key indicator of financial performance and efficiency in our banking sector is the spread between the lending and deposit rates. If the spread is large, it works as an impediment to the expansion and development of financial intermediation. This is because it discourages potential savers due to low returns on deposit and thus limits financing for potential borrowers.

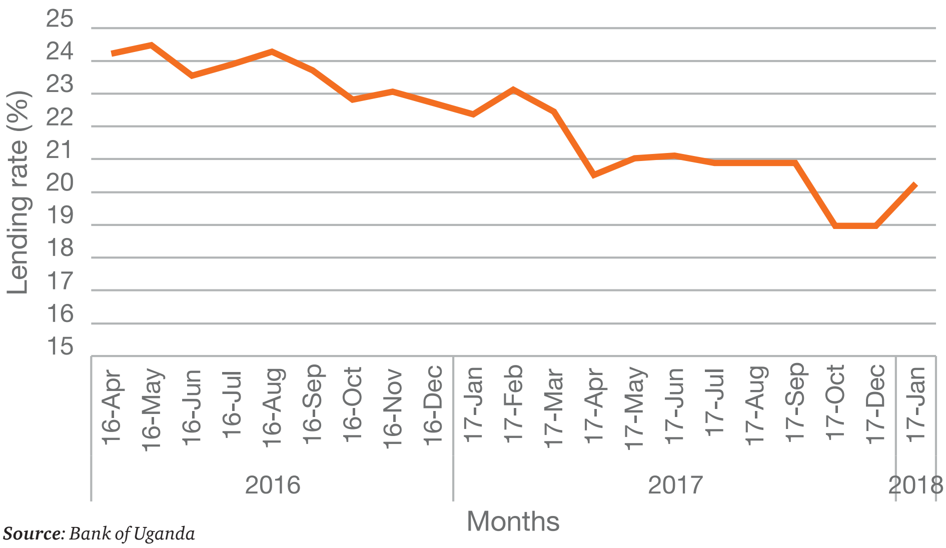
Put differently, if the spread is large, it results in low credit availability due to depressed savings. On the other hand, high lending rates also lead to a reduction in credit demand and the money supply as a result of the high cost of borrowing.

The prevailing high lending rates in the market in part reflect the country's high cost of doing business as well as the heightened risk aversion in banks caused by high levels of non-performing loans (NPL).

The structural rigidities within the banking sector result in proportionately high costs of doing business compared to other sectors.

However, banks are expected to embark on increasing credit supply by adjusting their pricing in line with monetary policy. This should in turn reduce the cost of borrowing to business.

Commercial Bank Prime Lending rate (%)



Source: *Bank of Uganda*

20%

Commercial bank prime lending rate currently at 20% needs to be more responsive to reductions in the CBR if we are to witness significant growth in private sector credit

Despite the optimism, there are a number of risks that may affect growth of the economy

Despite this optimism, the prevailing low business confidence, the ongoing political situation in South Sudan and its impact on particular segments of the country's exports sector, as well as the high cost of credit will continue to weigh in on private domestic investment.

Reliance on rain-fed agriculture remains a major downside risk to real GDP growth. This is because of the importance of agriculture to the economy as a whole.

Agriculture is the main source of income to the majority of the population, it is very critical to the food security in the country as it is the main source of export revenue for the country.

Weaknesses within the public investment management framework mean that government execution of development expenditure remains a challenge. Delays in the completion of public investment projects prevent the productivity that could be gained by the economy from enhanced infrastructure, which in turn slows down growth.

Low domestic revenues have resulted in challenges in the funding of these public infrastructure projects. As a result the government has been forced to increase its domestic borrowing to finance the government budget. This is having an adverse impact on private investment and may worsen the credit challenge by crowding out private sector borrowing, thus delaying the growth benefits of public investment.

Overall, Uganda's medium-term growth potential remains positive. We forecast growth to rise to 6.0% and above in FY 2018/19. The planned development of the oil sector and the accompanying increase in infrastructure investments have the potential to drive growth to 6.5% by FY 2019/20 and above 7.0% when oil production begins.

The government currently estimates first oil by the end of 2020 and the private sector oil companies currently operating in the sector are expected to make their final investment decision by the end of this financial year.

Weaknesses within the public investment management system, poor project implementation and execution are affecting growth as the economic benefits expected from these projects are delayed.

The increasing public debt levels is now a major concern as it may put a drag on the economy if not managed well

Uganda's public debt burden as a percentage of GDP has risen by 12.7% in the last four years from 25.9% in FY 2012/13 to 38.6% as at the end of FY 2016/17. This figure is expected to continue rising and is projected to peak at 42.6% in FY 2019/20 before declining to 28.4% by FY 2024/25.

This is in accordance with the projections contained in the Ministry of Finance's Debt Sustainability Analysis Report (DSA) of December 2016. The projected decline in this ratio after the medium term will be due to lower borrowing following the completion of key infrastructure projects, as well as higher GDP growth as the economy becomes more productive[8].

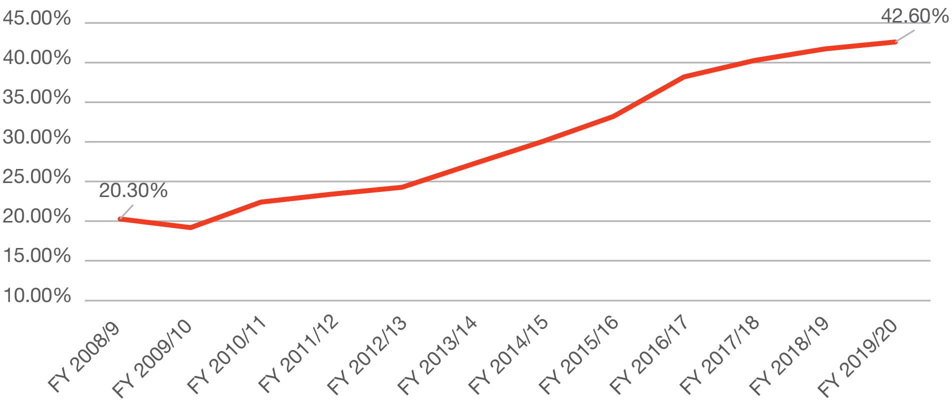
The debt burden has been growing faster than the government's own resources. Debt as a percentage of revenues has risen by 54% since 2012 and is expected to exceed 250% in 2018[9].

The deteriorating debt situation is reflected in government budget, where interest payments are now the government's second biggest expenditure item after the Works and Transport sector. For example, interest payments are to consume 12.3% of the total government's budgeted expenditure for FY 2018/19[10].

Stress tests done by the government on the public debt have indicated significant risks to the economy. The risks arise from the already high interest costs in the budget, which currently account for more than 12% of government expenditure, as well as the risk of the exchange rate depreciation.

The other risk that was identified was the slow growth in exports, which is the main source of foreign exchange for the country with which government meets its external debt service obligations. In addition, there are perceptions in the market that Uganda may not be able to service its rising debt levels.

Uganda's Public Debt to GDP trend over the last ten years



Source: *Ministry of Finance*

[8]Ministry of Finance – Debt Sustainability Analysis Report December 2016

[9]Bank of Uganda – State of the Economy December 2016 Report

[10]National Budget Framework Paper for 2018/19

For debt to remain sustainable, the real GDP has to grow at a rate higher than the average real interest rate on government debt

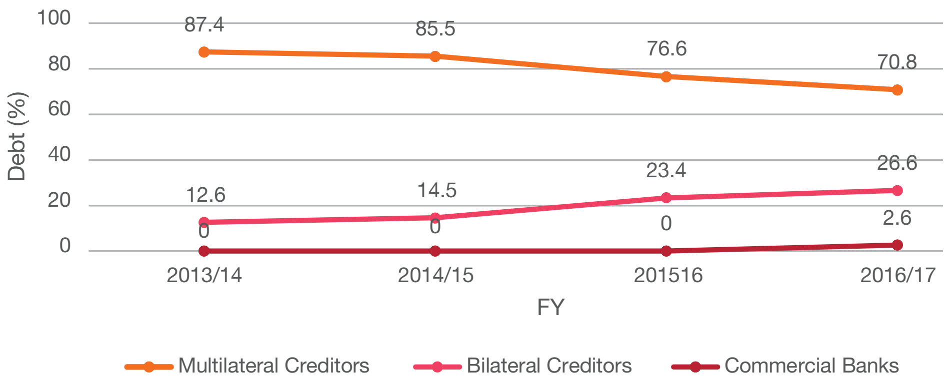
While too much debt in general poses risks to the country's economy with regards to its ability to repay the debt, external debt is of more concern as it exposes the country to external as well as internal risks. Uganda's current debt mix comprises of both concessional loans and non-concessional loans.

Concessional loans are those extended on more favorable terms than the market rates and are usually extended by International Financial Institutions such as the World Bank, IMF, African Development Bank. On the other hand, non-concessional loans are normally on commercial terms reflecting the market rates, taking into consideration the country's risk premium.

As at the end of FY 2016/17, out of the total external disbursed and outstanding debt, 70.8% is owed to multilateral creditors, while 26.6% and 2.6% is owed to bilateral and commercial creditors respectively. Multilateral lenders are dominated by the International Development Association (IDA), a concessional lender.

IDA`s share in total public debt has been on a downward trend since FY2013/14, from 58.3% to 45.2% as at the end of FY2016/2017. China a non-concessional lender currently dominates the bilateral creditors. Its share in total public debt has been increasing since FY2013/14 when it was 7.7% and to a high of 20.3% as at the end of FY2016/17.

Trend of Uganda's external debt mix over the last four years



Source: *Ministry of Finance*

Uganda, like many countries in sub-Saharan Africa, is experiencing a shift from highly concessional social sector borrowing from international development banks and organizations to non-concessional / commercial borrowing, in order to fund its public infrastructure projects.

Non concessional borrowing is proving very costly for the country as it is affecting the resources available to other sectors

Non-concessional borrowing is typically more costly and offers shorter grace and repayment periods. This in turn increases the debt service burden on the budget. This is what we are currently experiencing in Uganda. The high cost of this non concessional borrowing is also affecting the resources available to other sectors, such as health and education[11].

An ideal mix for a country should be more concessional debt, as a lot of non-concessional debt is likely to affect the economy as foreign financing from commercial banks is relatively expensive, leading to an increase in the country's debt servicing costs.

In addition, the ideal debt mix should contain more of domestic debt rather than reliance on external debt, in order to ensure long term economic stability.

Likewise, for debt to remain sustainable, it is critical that real GDP continues to grow at a rate higher than the average real interest rate on government debt.

An increase in the average real interest rate or a decline in real GDP growth would pose a serious risk to debt sustainability.

[11]Ministry of Finance – Debt Sustainability Analysis Report December 2016

Despite the recent increase in the debt to GDP ratio, the risk of debt stress in Uganda is low

Short-term debt (treasury bills) constituted 27% of the total domestic debt stock, while medium to long-term debt (treasury bonds) amounted to 73%. Commercial banks held the largest share of treasury bills while pension and provident funds held the largest share of treasury bonds.

Despite these risks, Uganda remains at low risk of debt distress. This is because most of the debt is of concessionary and near-concessionary debt. This underscores the need to borrow on concessional terms as much as possible.

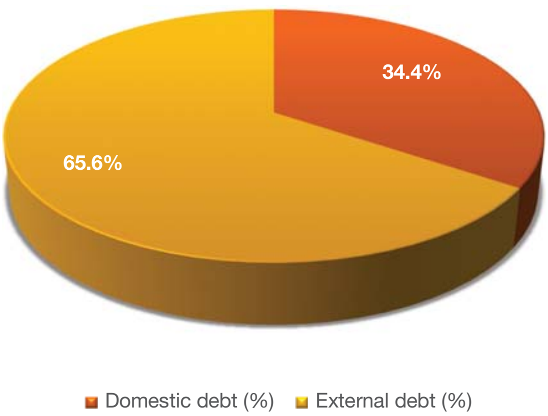
Most of this debt has been obtained from external sources and has been used, or will be used to finance various infrastructure development projects. Since these projects have high medium-to long-term multiplier effects on growth, a careful sequencing of these projects is necessary in order to avoid undesirable consequences of unsustainable debt.

Whereas we agree with the government that infrastructure spending is vital for national development and poverty alleviation, it should be done in an approach that is sustainable. Projects should be done in a phased and sustainable manner that reflects the existing capacity within the country.

Poor project implementation across the entire project cycle, especially with respect to preparation of high quality feasibility studies and proper, timely management, implementation and execution of the projects has resulted in so much waste, project delays and cost overruns.

As a result, this does not only lead to a delay in the implementation of the projects themselves but most importantly it delays as well as reduce the social and economic benefits of the infrastructure projects, which in turn undermines the country's economic growth, thereby affecting the country's ability to repay its debts.

Uganda's current debt mix



In FY2016/17, external debt comprised 65.6% of the total public debt, with domestic debt accounting for 34.4%, representing a slight decline from the 37.9% figure of 2015/16.

Delays in project implementation also lead to cost overruns as well as reducing the benefits of infrastructure projects, which undermines economic growth and affects the country's ability to repay its debts.

In conclusion, whereas we share the government's optimism about the economy - we are concerned about the level of public debt

To ensure that the burden of public debt does not hinder the growth of economy, we recommend that the government should...

a) re-affirm its commitment to ensuring that the public debt to GDP remains below the 50% threshold prescribed by both the EAC Monetary Union Protocol and the Public Debt Management Framework (PDMF),

b) resource, support and build capacity in the Project Monitoring Unit in the Office of the Prime Minister to ensure that the Unit oversees the proper, timely and efficient implementation of all government public infrastructure projects across the entire project cycle including the carrying out of high quality feasibility studies, proper and timely procurement and contracting procedures, funds allocation, project selection, monitoring and evaluation,

c) restructure the public debt mix wherever possible by either reducing on the external foreign borrowing, or having a larger percentage of external borrowing on concessional loans,

d) take concrete steps to reduce budget deficit through better domestic revenue mobilization, by continuing with the ongoing improvements in tax administration as well as introducing targeted measures aimed at widening the tax base by bringing the very large informal sector into the tax net,

e) borrow only for development expenditure, and not for recurrent expenditure such as public sector salaries and wages,

f) wherever possible and practical, involve the private sector in project identification, development and if possible funding through the PPP model, as this will reduce the strain on the public finances,

g) improve governance and accountability, take measures to reduce wastage and corruption, prosecute all corrupt public officials and confiscate all wealth obtained through corrupt means,

h) partner with the various private sector organisations and commit to provide all the support needed by the private sector to diversify the economy as well as build an export driven economy,

We are of the view that if these measures are implemented they will help to reduce the public debt levels, while at the same time boosting growth of the economy.

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Our purpose is to build trust in society and solve important problems.

In an increasingly complex world, we help intricate systems function, adapt and evolve so they can benefit communities and society – whether they are capital markets, tax systems or the economic systems within which business and society exist.

We help our clients to make informed decisions and operate effectively within them.

Our values define who we are, what we stand for, and how we behave.

While we come from different backgrounds and cultures, our values are what we have in common. They guide how we work with our clients and each other, inform the type of work we do, and hold us accountable to do our best. They govern our actions and determine our success.

Our values help us work towards our Purpose of building trust in society and solving important problems.

The trust that our clients, communities and our people place in PwC, and our high standards of ethical behaviour, are fundamental to everything we do.

Our values underpin our Code of Conduct which is our frame of reference for the decisions we make every day. It's how we do business.

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Value is a product of trust. The trust your clients have in you. The trust you have in your people, strategies and systems. And the trust you have in your business advisers.

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No matter how big you are, public or private, and in what industries or sectors you do business, we can help you work smarter and reach your goals.

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