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Uganda: revising the growth model while preserving debt sustainability

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ÉDITIONS AFD
AGENCE FRANÇAISE DE DÉVELOPPEMENT

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Summary

From 1990 to 2010, Uganda, a country in the Great Lakes region and a member of the East African Community (EAC), experienced two decades of strong growth and structural transformation that enabled it to significantly improve its social indicators. However, the Ugandan economy is still confronted with a high level of informality, a concentration of jobs in the agricultural sector, which is not very productive, and a banking sector that provides little financing to the private sector.

In 2020, the economic downturn caused by the international health crisis resulted in a -2% recession that had serious social consequences. The gains of more than a decade's worth of poverty reduction could be erased. The COVID-19 crisis has also exacerbated the vulnerabilities of public finances. Public debt (which stood at 46% of GDP in 2020) has been growing steadily for a decade. Although the profile of this debt—most of which is external but still concessional and long-term—remains favorable, it is proving increasingly costly. As a result, debt servicing reduces budgetary space and could generate significant liquidity risks in the medium term. On the other hand, the banking sector, which is generally robust and well supervised, should be able to cope with the rise in the number of non-performing loans. Finally, external balances are holding up, thanks to the support of the international community in the form of budgetary aid.

In the medium term, Uganda will have to ensure that private investment flows take over from donors financing. The challenge for the country will be to take advantage of these investments to bring young people into the labor market, by bolstering its human capital and supporting the development of activities that generate skilled jobs. If it does not address this issue, Uganda will not be able to meet its ambitions to achieve lower-middle-income-country (LMIC) status by 2025 and upper-middle-income-country (UMIC) status by 2040.

This report was completed in late 2020. Partial updates have been made to incorporate the data published by the IMF in its April 2021 edition of the World Economic Outlook (WEO), and by local institutions at the end of April 2021.

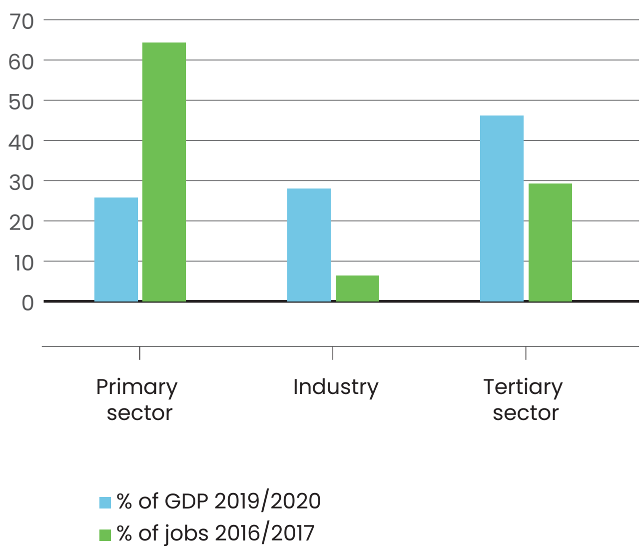
1. More inclusive growth is needed to meet the country's prosperity ambitions

After two decades (1990–2010) of strong growth and structural transformation, Uganda's economy is still confronted with a high level of informality and a concentration of jobs in agriculture—a sector that is not very productive. In this context, bringing young people into the labor market is a major challenge for the country. Without substantial investment in human capital or the development of activities that will lead to skilled employment, Uganda will not be able to achieve its development and poverty-reduction goals.

1.1 – A labor force not sufficiently involved in the country's economic development

The Ugandan economy is diversified. The tertiary sector has occupied a predominant and stable place over the last decade, producing 46% of value added. At the same time, the share of the economy held by agriculture has contracted by 6 percentage points to the benefit of industry (28%), which is now the country's second-largest sector. However, **one-third of the economy is still based on informal activities,** which comprise almost all of agriculture and half of the manufacturing industry.

Figure 1 – A low-productivity primary sector



Source: Uganda Bureau of Statistics (UBOS)

In terms of employment, **65% of the working population is employed in the primary sector.** The sector's low productivity is shown by its GDP contribution of 26% (see Figure 1). Another feature of the Ugandan labor market is the predominance of self-employment. **The country is thus described as a "champion of entrepreneurship"** with highly dynamic business creation despite a half-hearted business climate, which ranked 116th out of 190 in the World Bank's *Doing Business* 2020 ranking. This undoubtedly reflects, in part, the lack of alternative employment prospects. As a result, Ugandan firms are small. The latest census, in 2010, indicated that 97% of businesses had fewer than 10 employees and that these accounted for two-thirds of formal employment.

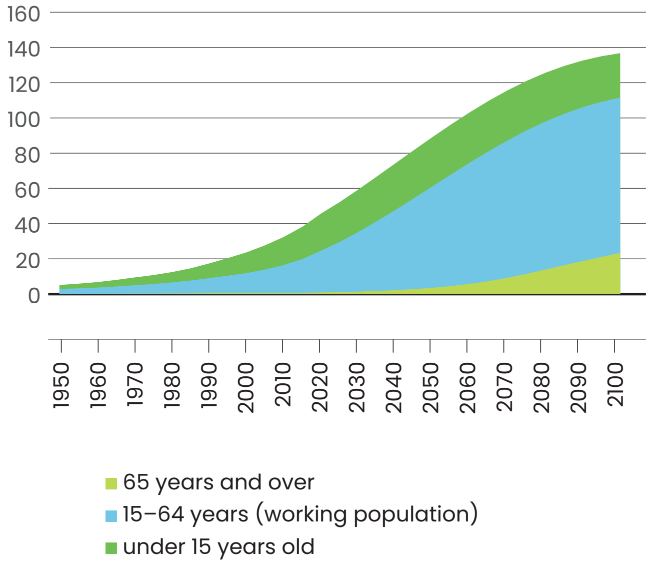
The concentration of jobs in the agricultural and informal sectors, as well as the small size of businesses, are obstacles to the country's economic development, and explain the relative stagnation of labor productivity[1] over the last decade (+5% between 2011 and 2019, as against +55% between 2000 and 2011). It should be noted that Uganda, far behind Kenya (x 0.6), has a productivity level that is comparable to Tanzania's and higher than Rwanda's (x 1.3).

1.2 – The challenge of bringing young people into the labor market

Uganda's population has been growing at an average of 3% per year since the 1950s. Although World Bank projections suggest a gradual slowdown of this rate, the population will still double by 2050. With an average age of 15.8 years in 2015, **Uganda has one of the youngest populations in the world,** a distinction it shares with Niger and Chad. And the number of young people could even be 1.4 times what it is now within 30 years. For this reason, the 2015 working population is expected to have doubled in 2035, tripled in 2050, and quadrupled in 2070 (see Figure 2).

1 Measured as GDP (in USD at purchasing-power parity (PPP) in constant prices) per job.

Figure 2 – Strong growth in the working population (in millions)

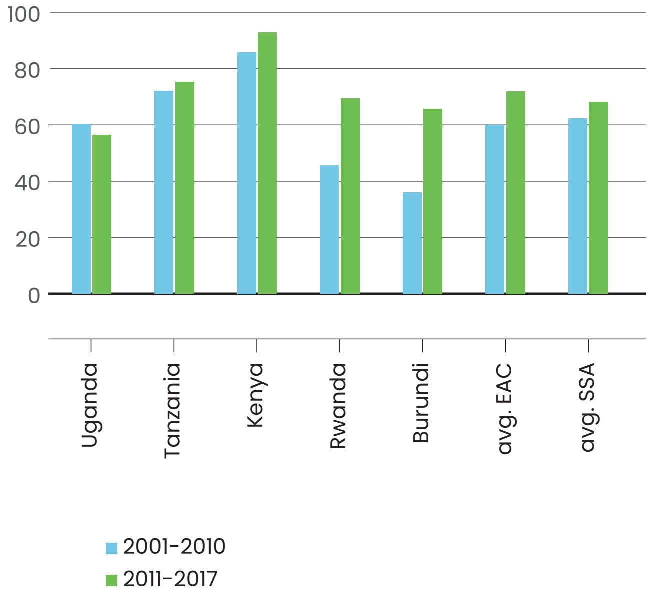


Source: United Nations (Medium Fertility scenario)

The labor market will have to respond to this strong demographic growth. **Uganda will need to create more than 600,000 jobs a year until 2030, and then 1 million jobs a year up to 2040, to enable the inclusion of youth in the labor market** (World Bank 2019a). Yet Uganda's economic growth generates no more employment than the average for sub-Saharan Africa (SSA) (IMF 2019). Only 75,000 new jobs are created each year[2] in the country. In addition, young people are struggling to gain access to employment. According to the 2016–2017 employment survey, 41% of 18- to 30-year-olds are neither employed nor taking training of any kind. That applies significantly more to women (51%) than to men (29%). When 18- to 30-year-olds do manage to find employment, the majority (70%) work in the informal sector.

Education is a major determinant of access to the labor market and then to the formal market. The employment rate is 37% among young people with no education, 48% for middle school graduates, and 63% for high school graduates. The poor level of educational attainment is an issue of concern. Almost half of young people are considered to be educated below the level required for employment: while 58% of 18- to 30-year-olds have a middle school diploma, only 26% of them have a high school diploma, and only 2% have a bachelor's degree or higher. In addition, the percentage of children who complete primary education is on the decline, so that Uganda now lags behind other EAC countries and is below the SSA average (see Figure 3).

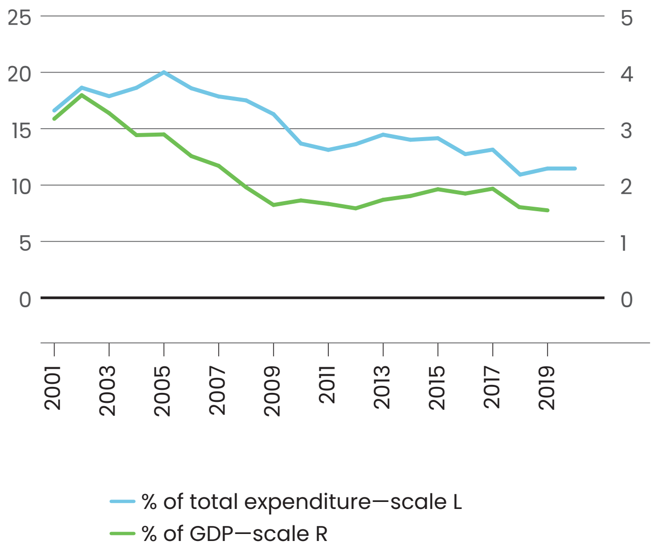
Figure 3 – A declining primary-education completion rate (in %)



Source: World Bank, World Development Indicator (WDI)

2 Under its Third National Development Plan (NDP III) 2020/21–2024/25, the country aims to create 520,000 jobs a year, with an average economic growth of 7% over the period covered by the report.

Figure 4 – Declining central-government spending on education



Sources: IMF, Government Finance Statistics, Ugandan Ministry of Finance, Planning and Economic Development (MoFPED)

This demographic trajectory requires Uganda to invest heavily in education and health in order to strengthen its human capital. The country's Human Capital Index[3], which is comparable to the average for SSA and low-income countries (LICs), puts Uganda in 137th place out of 157 countries. A Ugandan child can expect to complete 7 years of schooling, but this is, on average, only equivalent to 4.5 years of quality schooling. Therefore, a child born in 2017 in Uganda will be only 38% as productive as a child who has had a full education and is in perfect health. This issue is taken account in the national strategic documents but, until now, public spending in these sectors has remained limited and has been financed mainly by donors. Spending on education has actually been on the decline since the 2000s (see Figure 4), whether relative to total central-government spending—10% in 2019–2020,[4] as against 18% on average in the 2000s)—or to gross national income (GNI): 2% since 2014, as against 3.4% on average between 2002 and 2008. With regard to this last indicator, Uganda again lags behind the EAC average (3.8% in 2018) and the SSA average of 3.5%. The World Bank estimated in 2019 that a gradual increase in the share of public spending on education to 16% by 2025—the SSA average—will be needed to ensure that all children acquire the skills in elementary and middle school to enter high school.

1.3 – A sustained but insufficient growth rate?

Two decades of sustained growth from 1990 to 2010 enabled Uganda to significantly improve its social indicators. The poverty rate[5] dropped from 63.8% in 1992 to 35.7% in 2012, falling below the SSA average from 2010. Uganda was even among the few countries on the continent to have halved the rate of extreme poverty by the 2015 target set in the Millennium Development Goals.

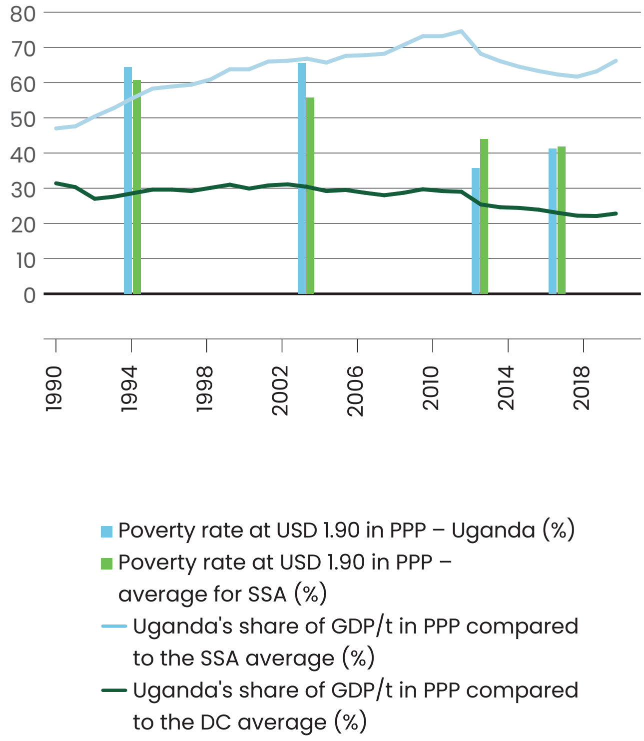
However, over the last 10 years, the living conditions of the population have stagnated because of a less dynamic economy. **The country's social progress is no longer distinguishable from that of its peers.** Between 2010 and 2018, the movement of Uganda's GDP per capita towards the continental average stalled: in 2019, it fell to 62% of the SSA average, standing at USD 916 (see Figure 5).

3 The World Bank's Human Capital Index measures the contributions that health and education make to the productivity of the next generation.

4 This data is presented by fiscal year, which runs from July in year N to June in year N+1.

5 Defined as the ratio of the population living on less than USD 1.90 a day (2011, at PPP).

Figure 5 – Improvements in social indicators are stalling



Source: World Bank

In recent years, the volatility of social indicators in relation to climate conditions has underlined the need for the country to **create growth that is more resilient to climate shocks** (see Box 1). Indeed, with a population still heavily dependent on agriculture, these indicators fluctuate with the performance of a sector that is at the mercy of disruptive weather conditions and pest infestations. While the poverty rate at the national threshold had fallen to 19.7% of the population in 2012–13 (UBOS 2018a), the latest household budget survey shows a slight increase to 21.4% in 2016–17—which still means that 1.4 million people fell into poverty. This is mainly because of the increase in rural poverty: 2016 and 2017 were marked by droughts and pest infestations. In terms of spatial distribution, 2012 to 2016 witnessed a rise in poverty rates in the east of the country, which was affected by severe drought, but a decline in the north, which had normal rainfall. The absolute poverty rate has shown a similar trajectory. It increased from 35.7% in 2012 to 41.5% in 2016. Overall, 44% of the population is vulnerable (World Bank 2019)—that is, likely to fall into poverty or food insecurity under adverse conditions.

Box 1: An economy vulnerable to moderate physical climate risk

Uganda is moderately exposed to the physical risk associated with climate change. According to the Global Climate Risk Index (GCRI) 2021 developed by Germanwatch, the country was the 66th most heavily exposed in the world (out of 181 countries surveyed) over the 2000–2019 period. The main channels of exposure are: an increase in extreme and average precipitation (already up by 17% over the last 30 years); to a lesser extent, an increase in average temperatures (+1°C over the last 3 decades); and an increase in drought over the largest swath of the country, in the north (where 10% of the population is exposed to it). On the other hand, Uganda is the 14th most vulnerable country to climate change and the 48th most poorly prepared for it, according to the Notre Dame Global Adaptation Initiative (ND-GAIN) resilience indicator (155th out of 181 in 2016—a ranking comparable to that of other countries in the region). Uganda's agro-pastoralism—there is very little use of irrigation—exacerbates vulnerabilities to droughts, floods, and pest infestations. However, the sector represents 23% of GDP, 60% of the country's exports[6] (including agroindustry), and 65% of the actively employed population. Food independence and security are therefore under threat, particularly in the Northern and Eastern regions, which are the poorest and most heavily affected by variations in climate. Drought causes average annual losses of USD 20 million. A 10% decrease in rainfall results in a 38.3% reduction in agricultural income in the north, compared to 8.7% in the east (World Bank 2016 and 2019c). For example, the drought that lasted from October 2016 to February 2017 is estimated to have cost the country 0.5 percentage points of growth in 2016–2017 and exposed 11 million people to food insecurity (IMF 2017). The damage caused by climate change could amount to 2–4% of GDP annually between 2010 and 2050 (IrishAid 2016). Since then, the country has put in place voluntary adaptation and mitigation plans and programs. However, whether they can be implemented will depend on what external financing the country will manage to secure. Adaptation needs are estimated at USD 2.4 billion (or 6.6% of 2019 GDP).

Sources: The Climate Policy Initiative (CPI), AFD climate fact sheet, Food and Agriculture Organization (FAO), World Bank, Germanwatch, ND-GAIN, the European Commission

In the medium term, economic growth in the order of 6 to 7% is expected. Although sustained, this pace of growth may not be enough to meet Uganda's ambitions to achieve prosperity. According to its third development plan (NDP III 2020/21–2024/25), released in June 2020, Uganda is aiming to achieve LMIC status by 2025 and UMIC status by 2040. However, the World Bank (2020a) estimates that, given the country's demographic trends, growth will have to exceed 8% if this is to be achieved. Such a pace would seem difficult to achieve in view of constraints on productivity. The challenge for Uganda will be to use considerable budgetary investments in infrastructure to bring about returns on investment and create jobs.

The COVID-19 crisis could also have lasting residual effects, on the one hand by slowing down the structural transition of the economy from subsistence agriculture to industrial and service activities that have been responsible for reducing poverty in recent decades, and on the other by exacerbating inequalities in access to education as well as reducing the opportunity for Uganda to benefit from a demographic dividend in the coming decades.

6 Coffee (Arabica and Robusta) is Uganda's main export (16% of exports). Climate change could significantly reduce how much land is suitable for this crop.

2.
Will the COVID-19 crisis have lasting residual effects?

The economic downturn caused by the COVID-19 crisis resulted in a recession of -2.1% in 2020 that has had serious social consequences. Because social safety nets are limited, the COVID-19 crisis could erase the gains of more than a decade of poverty reduction. The extent of the economic recovery remains uncertain in 2021, as does the contribution that the oil production—a flagship project for the country—could make to maintaining sustained growth over the medium term.

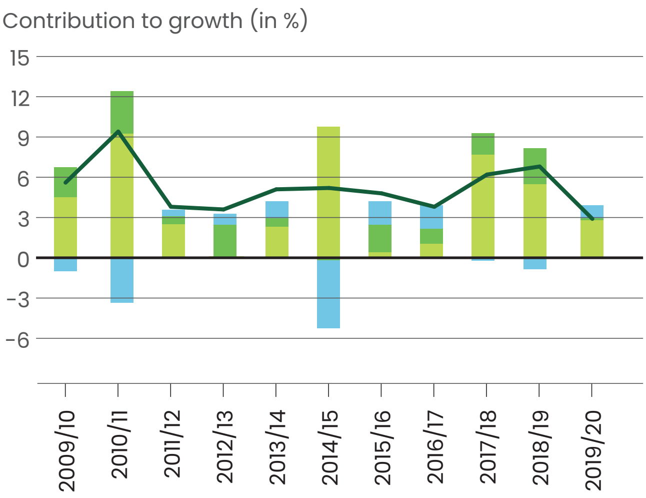
2.1 – A halt to the revival of economic growth

After two decades of strong growth from 1990 to 2010 (on average 6.3% and 7.5% per year respectively), the Ugandan economy lost momentum in 2011 and 2012, impacted by a sharp tightening of monetary policy, a precipitous reduction in official development assistance (ODA), and low productivity in the agricultural sector, which was also hit by two severe droughts and a pest infestation.

It then gradually recovered until it **returned to vigorous growth:** +6.2% in 2017–2018, and +6.8% in 2018–2019. This recovery was supported by household consumption, but also by public investment in infrastructure and private-sector investment, which accounts for three-quarters of investment. Gross fixed-capital formation thus contributed to almost 40% of GDP growth in 2018–2019 (see Figure 6). The construction and real-estate sectors were the main beneficiaries of these investments. They have grown by an average of 11% per year over the last few years. As a result, industry is providing more support for growth (see Figure 7). At the same time, the agricultural sector is recovering, growing at an average rate of 5% since 2017–2018, twice the average for the previous 8 years, thanks to more favorable weather conditions.

But the recovery remains fragile. While the country experienced dynamic growth in the second half of 2019 (+9%), the double shock from the health crisis and extreme weather events halted this momentum in early 2020. **Preliminary data suggest that the economic impact from the international health crisis on the Ugandan economy is and**

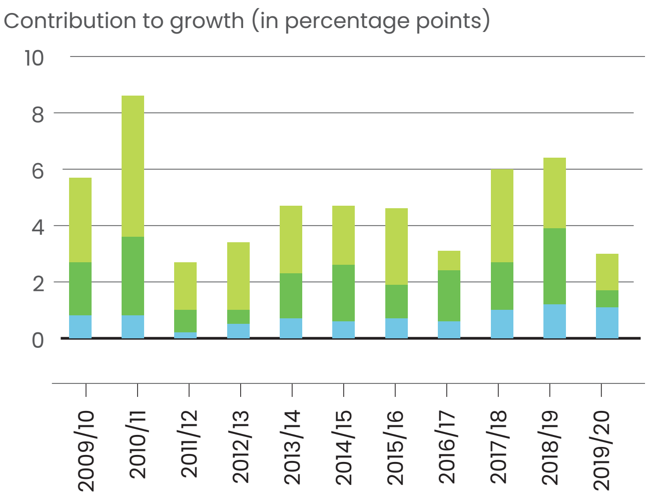
Figure 6 – Pre-crisis investment supported renewed growth



External demand (X-I of g. & s.)
Investment (gross fixed-capital formation)
Private consumption
Growth of GDP

Source: UBOS, AFD calculations

Figure 7 – Industry is providing more support for growth



Primary sector
Industry
Services sector

Source: Uganda Bureau of Statistics (UBOS)

will be significant. Thus, GDP contracted by 0.7% in the first quarter of 2020 year-on-year, before contracting by 6.3% in the second quarter, and 2.2% in the third. The economy grew by only 1.6% in the last quarter of 2020. As a result, according to IMF projections, the Ugandan economy was expected to experience **a 2.1% recession in calendar year 2020,** having grown by 6.7% in 2019. The magnitude of the shock is comparable to that of the shock to the SSA economy as a whole (-2% on average).

Uganda had only a limited number of COVID-19 cases in 2020: less than 41,800 cases and 340 deaths as at the end of April 2021, even though the virus spread faster in the second half of 2020. However, the international health and economic crisis makes itself felt through multiple channels. The measures that have been taken—both globally and locally—to contain the pandemic, including lockdowns and border closures, and the disruption of regional supply chains, have impacted the tertiary (transport and tourism) and secondary sectors in particular. In Uganda, the restrictions introduced were among the most severe in the region: an urban lockdown lasting more than four months was imposed in late March 2020 and gradually relaxed from July 2020.

According to UBOS's October 2020 estimates, **growth would have been limited to 2.9% in 2019–2020[7],** as against an initial projection of 6.2%. While the agricultural sector has maintained its dynamism (+4.8%) thanks to a strong performance recorded in 2019, industry—and primarily manufacturing—were affected by the lockdown (+2.2%, as against +10.1% in 2018–2019). Finally, the information and communication sector (+21.9%) is doing well, while the public sector (+16.2%) is compensating for the less dynamic private sector, thus allowing the services sector to record a growth of 2.9%. On the demand side, growth is driven mainly by private consumption, which is not that dynamic (+2.3% for households, after +7.8% on average over the preceding two years). While private investment is resilient (+9.6%), public investment fell by 20% because fewer construction projects were undertaken.

2.2 – A health crisis with serious social consequences

High-frequency indicators and initial surveys indicate significant income losses for the population, while food insecurity was exacerbated.[8] In urban areas, lockdowns led to a temporary decline in employment[9] and in domestic cash remittances, thus bringing about a drop in income for 91% of non-agricultural households. In response, 16% of respondents who worked in the services sector before March moved back to the countryside and to working the land. (World Bank 2020e). This trend was observed with workers from other sectors, too. But almost all rural households also had fewer resources, and faced a shock both in terms of supplies—farm inputs were less readily available and more expensive—and reduced access to markets (Muliika et al 2020). In total, 65% of the population faced significant losses of income, equivalent overall to 9% of GDP according to the International Growth Centre (IGC) 2020.

Despite emergency aid programs, this crisis could erase the gains in poverty reduction that have been made over the last 15 years, because of limited social safety nets. From April to June 2010, the focus was on food distribution, particularly in Kampala, but material aid was then redirected to basic health products in the poorer regions in the northeast of the country. Cash transfers, on the other hand, were very low, although it should be pointed out that the government is considering expanding coverage under certain social programs. As a result, **the poverty rate could increase by 8 percentage points** nationally. This would mean that 3.3 million more people would be thrust into poverty. The phenomenon would be particularly exacerbated in urban areas: the poverty rate, which in Kampala was less than 3% before the crisis, could reach 19% there, while it would increase from 9% to 22% in other urban areas (IGC 2020). School closures have also exacerbated inequalities. While access to education was relatively equal in terms of spatial and income

7 It should be noted that the fiscal year runs from July to June. The COVID-19 crisis thus affected the second half of the year, and especially the last quarter of FY 2019–20.

8 According to the FAO's Integrated Food Security Phase Classification, 2 million people (17% of the population studied) were subject to severe food insecurity between September 2020 and January 2021.

9 In March and April 2021, more than half of the institutions actually cut their bill for salaries (UBOS 2020a; World Bank 2020c). After the lockdowns, employment has recovered, although only partially in urban areas.

distribution before the crisis, the gap is widening by 30% between the richest and poorest households, while there are numerous barriers to the continuation of homeschooling in rural areas (World Bank 2020e).

2.3 – Is investment the engine of economic recovery?

In the short term, the growth outlook is uncertain. 2021 will be marked by a rather prolonged change to the economy in the face of the COVID-19 pandemic. In its April 2021 issue of *World Economic Outlook* (WEO), the IMF forecasted growth of 6.3%.

In the medium term, economic growth of around 6% to 7% is expected, driven by consumption and increased public and private investment in infrastructure to support the country's industrialization. The start of oil production, initially planned for 2022, has already been postponed to 2025, and the risks associated with the project could further affect these forecasts (see Box 2).

Box 2: A petroleum project whose profitability could be at risk

Oil exploration in northwestern Uganda, which began in 2004, has led to the discovery of a large oil field under the waters of Lake Albert. The estimated reserves are in the order of 6 billion barrels, of which 1.4 billion could be produced in the space of about 20 years. The project is particularly ambitious, both in terms of production—which could reach 220,000 barrels per day—and transport, with the construction of a pipeline[10] of almost 1,500 km through Uganda and Tanzania to reach the port of Tanga at an estimated cost of USD 3.6 billion. Pipeline and local refinery investments aside, oil production will require an investment of USD 13.4 billion. Following the sale of Tullow's shares, Total now owns the majority of the project (called Tilenga), while the rest belongs to the China National Offshore Oil Corporation (CNOOC) (Kingfisher South project). The project is already considerably behind schedule. The final investment decision was initially expected to be made in December 2017, and production was expected to start 3 years later. It was due to be signed in April 2021.

Uganda could generate USD 6.7 billion, or 18% of its 2019 GDP, from oil production over 20 years, according to a recent CPI report. The construction of a refinery[11] could be a substantial gain in terms of the Ugandan balance of payments. Indeed, with an energy-independence rate of less than 15% in 2017, oil accounts for a growing share of goods imports (17% on average since 2010, as against 13% over the preceding decade). Despite

10 Total has a 62% stake in the East African Crude Oil Pipeline (EACOP), the Ugandan and Tanzanian national oil companies 15% each, and the CNOOC 8%.

11 The Hoima refinery is expected to process 60,000 barrels a day, but its economic viability is questionable, particularly because of its location—which could lead to high operating costs—and the lack of economies of scale, with a current Ugandan market of only 30,000 barrels a day.

the prospect of higher government revenues in the long run, the project could, all the same, entail risks to the country's finances—risks that are difficult to assess—should contingent liabilities associated with government guarantees materialize.

Above all, however, the project's profitability could be threatened in the short term by low commodity prices, and in the medium term by the low-carbon transition the world economy is going through. Low oil prices, exacerbated in the context of the international COVID-19 crisis, are challenging the profitability of liquid crude oil production projects, whose break-even points are at prices well above current prices per barrel and those forecast for the coming years. For Uganda, this threshold has been estimated at between USD 40/barrel (Rystad Energy 2020) and USD 60/barrel (Patey 2015).[12] For comparison, the IMF's April 2021 price projection is USD 58.5/barrel for 2021 and USD 54.8/barrel in 2022, well below the levels that were envisaged at the beginning of 2010. That said, Total insists that the project would remain sustainable at a price of USD 30/barrel. The CPI estimates that structural changes in the oil industry have already reduced the value of Uganda's reserves by 70% over the estimate that was made in 2013. However, the risk to the project's profitability is further exacerbated if we take into account the transition risk[13] that the world oil market is being exposed to, through lower demand and prices that will remain low in the future. Finally, the banking sector's commitments to supporting the low-carbon transition could complicate the project's financing. Adjustments may, therefore, be necessary.

Sources: Total (press releases), World Bank (2020), Patey (2015), Rystad Energy (2020), IMF (WEO October 2020), Huxham M., Anwar M., Strutt E. and Nelson D. (2020), IEA data

12 Rystad Energy estimated the break-even point for the Tilenga project (825 million barrels equivalent) at USD 40.35/barrel in March 2020, and that for Kingfisher South (195 million barrels) at USD 48/barrel.

13 Transition risk is defined as the exposure to changes induced by the transition to a low-carbon economy.

3.
Public finances are increasingly vulnerable

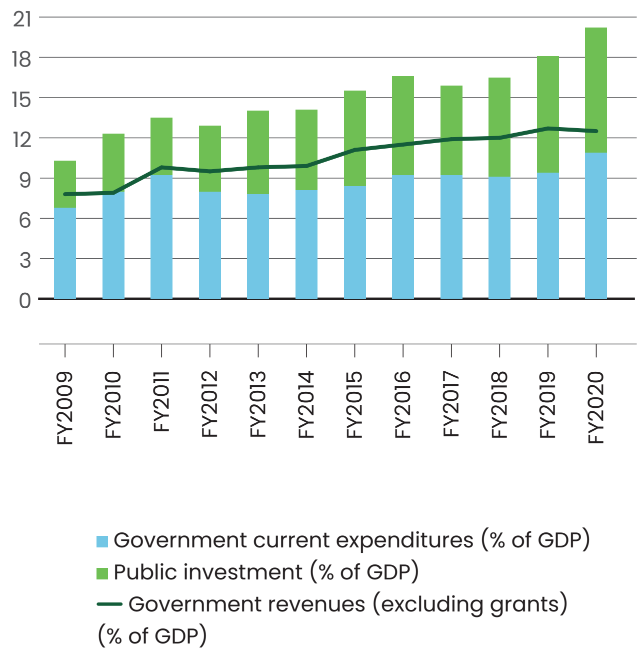
Uganda's public finances are becoming more and more vulnerable as the COVID-19 crisis exacerbates imbalances. The worsening of a persistent public deficit (-7.4% of GDP in 2019–2020) reflects high public investment and the limited efficiency of tax collection. Public debt (which stands at 46% of GDP) has been growing steadily for a decade. Although the profile of this debt—most of which is external but still concessional and long-term—remains favorable, it is proving increasingly costly. As a result, debt servicing is imposing a growing burden on public expenditures, and could constitute a significant liquidity risk in the medium term.

3.1 – Investment efforts face limited absorptive capacity

With capital expenditures at over 7% of GDP since 2015, the Ugandan authorities have made significant efforts in public investment (see Figure 8). Capital expenditures have been consuming an average of 63% of central government revenues since 2012–2013, up sharply from the preceding period (49% between 2008–2009 and 2011–2012). However, the authorities' ability to pursue public policies and advance the major infrastructure projects launched at the start of 2012 has been limited by severe absorption constraints, leading to chronic under-implementation in terms of the budget—a phenomenon that has been exacerbated by the COVID-19 crisis., As a result of the pandemic's impact on supply chains and of the disruption of project financing, capital expenditures reached 8.7% of GDP in 2019–2020, a level that, while high, is below the 11.8% set in the budget. The 2020–2021 budget provides for investments of 10.8% of GDP.

The investment guidelines do not benefit the social sectors. The construction and transport sector is the main beneficiary of public spending (16%), while spending on security has been rising sharply since 2018, so that it now accounts for 12.5% of the 2020–2021 budget. These amounts far exceed those dedicated to the education and health sectors—10% and 8% respectively. Moreover, in view of the challenges facing the country, certain projects financed from local resources seem to have a lower priority, such as the purchase of aircraft further to the revival of the national airline (accounting for up to one-fifth of capital expenditures in 2019–2020) and the purchase of land.

Figure 8 – Growth in capital expenditures since 2015



Sources: FMI (WEO, Article IV report), MoFPED

Low government revenues constrain the country's investment capacity and make it harder to balance the budget. Government revenues have averaged 13% of GDP since 2015. Tax revenues remain relatively low, including in comparison with peer countries, thanks to significant crowding-out effects that are associated with the informal sector and the inefficient collection of taxes in the formal sector, even if this is improving. Customs duties (40%) and direct taxes (33%) are the main sources of revenue.

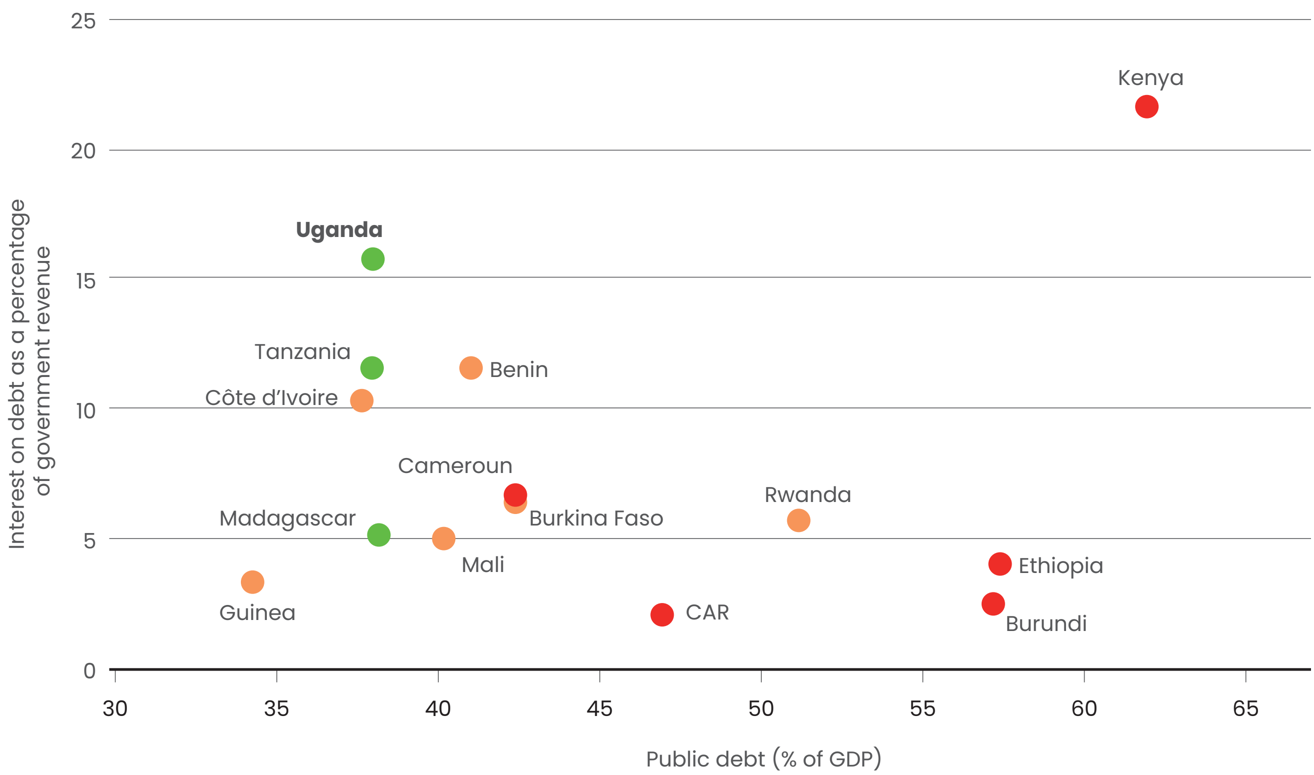
In 2019–2020, the health crisis exacerbated the challenges facing efforts to collect taxes. The health crisis is affecting domestic revenues via two channels. First, the lower consumption and economic activity would have cost 1 percentage point of GDP in revenue in the first half of 2020, through value-added tax and excise duties. Second, it is estimated that the tax exemptions and deferrals introduced in the last quarter of the fiscal year come to 0.2% of GDP. The fall in indirect taxes (-22%) and customs duties (-16%) was largely responsible for the drop in revenues, although direct taxes were also impacted (-10%). Donations are also declining, because the projects they were associated with are not being implemented. Overall, government revenues came to 13.3% of GDP in 2019–20, as against the 16.1% of GDP initially budgeted.

While the Ugandan authorities have embarked on tax-collection reforms, the targets that have been set will not be met because of the COVID-19 pandemic. In the pre-crisis period, Uganda's Ministry of Finance, Planning and Economic Development (MoFPED) targeted an improvement in tax collection of 0.5 point of GDP per year by 2025, which would have been achieved mainly through efficiency gains, notably thanks to the digitization of certain procedures. But this ambition also led the authorities to introduce taxes on mobile money and social networks—the relevance of these steps has been questioned.

3.2 – High debt-servicing costs are worsening fiscal balances

A high level of debt service in relation to the country's level of indebtedness—a level that is set to increase further—is a major constraint on budgetary resources. Interest payments have been on the rise in recent years, from 1.3% of GDP in 2014–2015 to 2% in 2017–2018 and 2018–2019. This trajectory is driven by both the domestic segment (from 1.2% to 1.6% of GDP) and the external segment (from 0.1% to 0.4% of GDP). Interest alone is now eating up 16% of revenues, which is equivalent to expenditures for infrastructure investments. Interest payments on domestic debt alone exceed combined expenditures on education and health, not counting those financed by donors in 2019–2020 (World Bank 2020b).

Figure 9 – High interest rates in relation to the level of debt to GDP



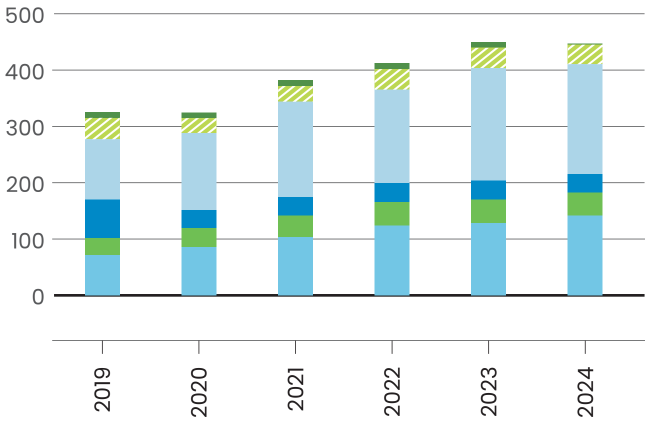
N.B.: Data from 2019. High, moderate and low debt levels of overindebtedness are in red, orange, and green, respectively, according to IMF and World Bank debt-sustainability analyses as at the end of November 2020.
Source: IMF (WEO, debt sustainability analysis DSA)

Finally, debt service[14] already accounting for 40% of revenues in 2019–2020, and the high financing needs expected in the coming years will bring this ratio to more than 50% in 2020–2021. This trajectory is worrying, given that Uganda's debt service to revenue ratio—which is higher than that of more indebted countries (see Figure 9)—already makes it stand out among peer countries.

In the medium term, the strong upward trajectory of debt service could represent a risk in terms of liquidity and even sustainability. In the absence of additional revenues—oil revenues are not expected to come in before 2025—servicing the debt at this level would force the country to resort to significant indebtedness to refinance itself. Moreover, the breakdown of external debt service should gradually change in the coming years, reflecting an increasing share of less-concessional indebtedness to China. If multilateral donors—primarily the World Bank—were to continue to account for almost half of the amounts owed, the share going to China would reach 44% in 2024, as against one-third in 2019 (see Figure 10).

While Uganda had been running public deficits of around 3% of GDP since 2010, **the health crisis has worsened fiscal balances (see Figure 11) and widened the deficit: 7.4% in 2019–2020, and a projected deficit of 8.6% in 2020–2021.** In addition to the denominator effect, which entailed lower-than-expected growth, the increase in the deficit in 2019–2020 was driven by high current expenditures and lower revenues.

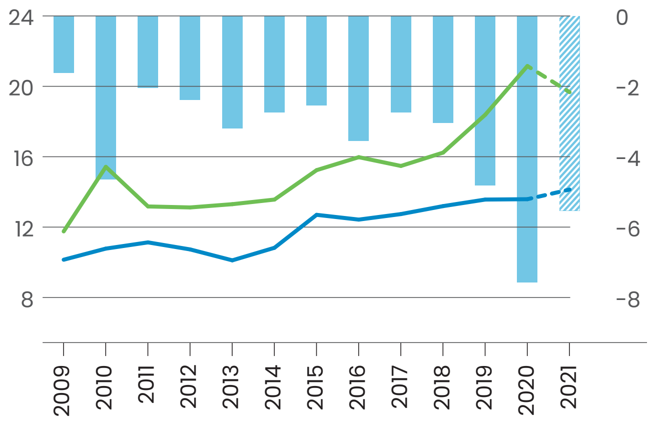
Figure 10 – Breakdown of external debt service due by 2024 (in millions of USD)



World Bank
African Development Bank
Other multilaterals
China
Other bilaterals
Unofficial lenders

Sources: World Bank, MoFPED (mid-June 2020)

Figure 11 – Sharp increase in the government deficit caused by the COVID-19 crisis (in calendar years)



Budget balance (% of GDP) - scale R
Budgetary revenues (% of GDP) - scale L
Total expenditures (% of GDP) scale L

Source: IMF (WEO).

14 Debt service is defined as the sum of interest, medium- and long-term amortization, and short-term debt.

The government has announced its intention to rationalize investments in the period after the crisis, postponing some lower-priority infrastructure projects. However, these announcements did not actually make it into the 2020–2021 budget, which forecasts a further increase in the deficit to 8.6% of GDP. This increase can be explained by the high expenditures needed at the moment to cope with the crisis, and by the expectation of a sharp drop in income. However, the deficit could be lower than planned, given the financing difficulties that the country may face and the history of underperformance by capital expenditures. The World Bank is thus forecasting a deficit of 7% to 8% of GDP.

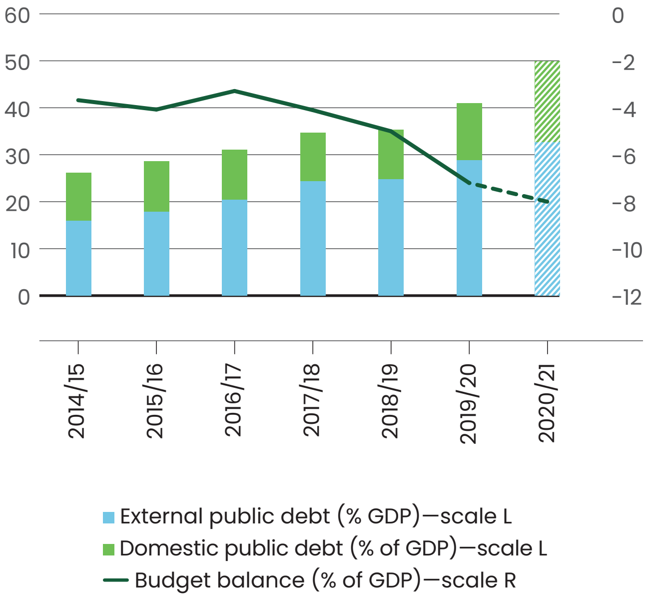
Public gross financing need is expected to grow significantly in the coming years. Estimates put it at 6% of GDP in 2018–2019 and 8.7% in 2019–2020. It could reach more than 10% in 2020–2021, and up to 15% in the medium term, according to DSA forecasts in 2020.

In the absence of short-term fiscal consolidation, Uganda's public debt will continue to grow. Therefore, maintaining access to concessional financing will be crucial to limiting the debt-service burden. While Uganda benefited from significant donor funding in 2020, bi- and multilateral donor support was expected to continue in 2021 as the health crisis continued. In early 2021, the Ugandan authorities were negotiating with the IMF in this connection. In the longer term, continued donor support will depend on the political context and on the progress of reforms in the management of public policy.

3.3 – A debt that is growing but still favorable in its composition

Public indebtedness has been growing steadily for a decade. From 26% of GDP in 2014–2015, the debt has risen to 41% of GDP in 2019–2020 (see Figure 12). The COVID-19 crisis is exacerbating this trend. According to MoFPED data, public debt grew by 27.3% in 2020. Excluded from the scope of the analysis is the debt owed by public enterprises, exclusively domestic in nature but not guaranteed by the central government. In February 2020, the World Bank put the debt of public enterprises at 7.6% of GDP, and public and private partnerships at 2.3% of GDP.

Figure 12 – A growing majority of external public debt

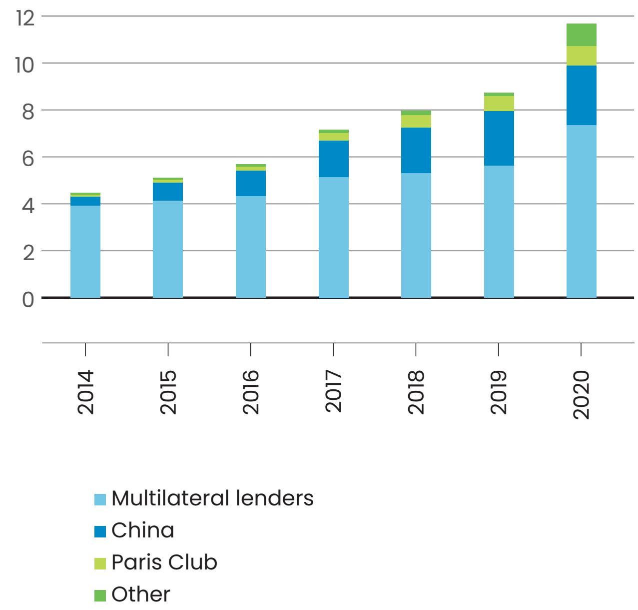


Sources: IMF (WEO, Article IV report), MoFPED, AFD calculations

Uganda's public debt remains predominantly external and concessional (see Figure 12). Indeed, 70% of the public debt, equivalent to 29% of GDP, was held by non-residents in 2019–2020. External debt was due to increase by 33% in 2020. The maturities of this external debt are long: 14 years on average. Uganda was the 7th-largest recipient of ODA in SSA in the period from 2015 to 2018. However, these flows have decreased significantly over the last 20 years. They represented 6.1% of GNI in 2018, a rate that has been broadly stable since 2010 but still well below the 13.6% average between 2000 and 2009 (see Figure 19).

Over the past decade, there has been a significant shift in sources of funding. Although multilateral donors remain the country's main financiers, they now account for only 64% of external public debt (see Figure 13). At the same time, China has become a major financier: its share of debt rose from 3% at the beginning of the last decade to 22% by the end of 2020. In terms of bilateral debt, Exim Bank of China now accounts for three-quarters of outstanding debt. On the other hand, Uganda has not issued Eurobonds, which will avoid bullet repayment structures and will limit refinancing risk.

Graph 13 – External debt still held mostly by multilateral donors (in USD billion)



Sources: MoFPED, Debt Management Performance, World Bank

In the context of the COVID-19 crisis, **the authorities have increased their recourse to local debt (+32% in 2020) to finance non-budgeted expenditure, but this is costly and has been contracted over relatively short maturities.** Three-quarters of the domestic debt is composed of treasury bills. The average maturity of the stock is 4 years, but the authorities are striving to obtain longer-term financing. Until recently, the longest bond maturity was 15 years (with a yield of 15% at the end of November 2020), but at the end of November 2020 the government issued a 20-year bond with a 17.5% yield and a face value equivalent to USD 170 million at the end of December 2020. Local debt is held equally by pension funds and commercial banks, each of which has a 40% share (including 81% of T-bills and 27% of treasury bills at the end of June 2020). Foreign investors hold only 6% of these. The domestic debt is also made up of arrears that amounted to 3% of GDP as at the end of June 2020. The government has started along a path to clear these arrears at a rate of about 0.3% of GDP per annum, in order to support liquidity in the private sector.

Despite an upward trend and high debt service, the latest IMF/World Bank DSAs had concluded that the risk of over-indebtedness remained low. By 2019, the new DSA framework had led to a reclassification of the country's debt capacity from medium to high, the effect of which was to raise the public debt threshold to 70% in net present value (NPV)[15], as well as the 4 thresholds related to external debt. In 2020, an upward revision of GDP from 18% in 2016–2017 in a rebasing exercise had brought the debt down to 38% of GDP by the end of 2019. Because the COVID-19 crisis affected economic growth—and thus the country's debt capacity—and because it made increased recourse to borrowing necessary in order to finance a worsened government deficit, it may be that the assessment of the risk of over-indebtedness could be revised upwards from 2021 onward. Thus, the DSA conducted by the Ugandan authorities in December 2020 concludes that the risk of over-indebtedness is moderate. Lower growth, an export shock, and the materialization of contingent liabilities are the main sources of vulnerability on Uganda's debt trajectory. Increased recourse to commercial or local debt would further increase the risks involved.

15 At the same time, the largely concessional nature of the external debt significantly reduces the NPV of the public debt.

4.
The banking sector plays a limited role in the country's economic development

Commercial banks play a limited role in the financial inclusion of the population, and provide little financing to a largely informal private sector comprising mainly small businesses. The banking sector[16] started 2020 with satisfactory overall indicators of soundness. This strength, coupled with good supervision by the Bank of Uganda (BoU), should enable it to weather the crisis.

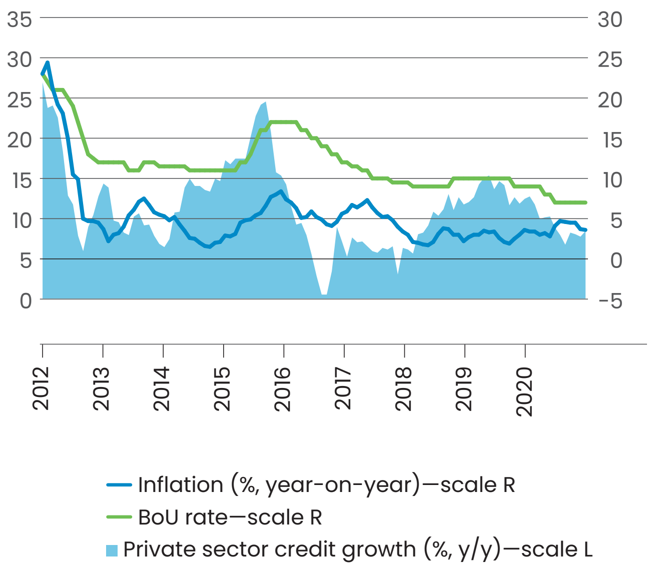
4.1 – A strong and well-supervised banking sector

The BoU has been running an accommodative monetary policy since autumn 2019. In order to stimulate the economy in the context of the COVID-19 crisis, the Central Bank twice lowered its key rate by 100 base points, in April and June 2020, until it reached an all-time low of 7%, which has been maintained ever since. This turnaround has been facilitated by limited inflation: +2.9% on average in 2019, +3.8% in 2020 (see Figure 14), and in particular by core inflation that was in line with the target of 5%. In 2020, the Central Bank also put in place tools to support the liquidity of banks. USD 24 million was thus made available to commercial banks.

However, measures to ensure market liquidity and support credit or the reduction in key rates **will not allow the renewed dynamism brought about by loans granted to the private sector since 2018 (+9.2% on average in 2020) to be maintained.** This is due to concerns about the economic environment, the process of restructuring existing loans—the equivalent of 45% of the loan portfolio had been restructured by the end of December 2020, and that process was underway for 29% of these loans—and a lower risk appetite.

The financial indicators from the Ugandan banking sector are satisfactory at the aggregate level, in terms of liquidity, solvency, and profitability (see Figure 15). **Over the last few years, the quality of assets has tended to improve,** and the rate of non-performing loans (NPLs) has been less than 5% since June 2018. This decline in the rate of NPLs was caused by both a denominator effect, with the resumption of credit growth, and a numerator effect. The decline in the number of impaired loans is associated with (1) the resolution of Crane Bank's toxic assets, (2) the improvement in the macroeconomic environment, and (3) the loosening of monetary policy. **The profitability of banking institutions also started recovering in 2017,** thanks to the improved quality of assets on the one hand and, on the other, the rebalancing of banks' balance sheets, with shifts away from bond issues to more loans.

Figure 14 – An accommodative monetary policy



Source: BoU

Although the sector began 2020 under satisfactory conditions, **the COVID-19 crisis poses a risk to the stability of the financial sector as a result of the slowdown in economic activity and increased pressure on liquidity.** The quality of assets deteriorated in the first half of 2020, with a 30% increase in the number of non-performing loans, before recovering as the lockdown eased. Most banking institutions and sectors have been affected. While the NPL rate stood at 5.2% at the end of the year, the deterioration in the quality of assets has yet to materialize, given that measures to relieve and restructure credit will be ending in October 2021. The profitability of banking institutions also deteriorated in 2020, as a resut of the decline in revenues associated with these relief measures.

16 The banking sector dominates the financial sector (which accounts for 44% of GDP) with 69% of assets, compared to 22% for pension funds at the end of 2018. Commercial banks hold 95% of banking assets.

Table 1 – Satisfactory financial soundness indicators (FSIs) at the aggregate level

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Solvency ratio												
Risk-weighted capital ratio (%)	20.9	20.2	20.3	21.9	22.9	22.2	21.0	19.8	23.2	21.6	21.0	22.2
NPLs net of provisions (% of capital)	6.2	2.8	4.0	7.8	7.0	6.9	10.5	15.0	7.4	4.7	8.1	8.6
Profitability												
Return on assets (%)	4.0	3.6	5.2	5.3	3.1	3.6	3.6	2.4	3.9	3.6	4.0	3.2
Return on equity (%)	25.1	24.6	36.1	33.0	18.5	22.2	22.6	14.7	22.8	20.6	23.0	18.9
Composition and quality of assets												
NPLs (% of loans)	4.0	1.9	2.0	4.1	5.8	4.0	5.1	10.4	5.5	3.3	4.7	5.2
Liquidity												
Liquid assets on short term deposits (%)	46.0	44.9	40.7	45.0	46.7	47.4	50.0	66.8	55.4	46.3	49.0	51.0

Sources: BoU, IMF (FSIs)

That said, the sector appears resilient to short-term shocks. It is sufficiently liquid, with a ratio of liquid assets to deposits of 51%, well above the regulatory threshold of 20%. The institutions also have enough capital. Finally, affected by the disruptions of 2011 and 2016, the banking sector has shown resilience in the past.

This overall view of the sector masks the difficulties of nearly a dozen small banks that are suffering losses, but that account for only one-tenth of total assets. However, the number of institutions on the market[17] seems high given that their assets total USD 8 billion. The sector is also concentrated, with the 5 largest banks accounting for 60% of assets held. **A consolidation of the sector is thus expected.** The tightening of macroprudential standards should generate a movement towards consolidation, accelerated by the COVID-19 crisis.

4.2 – High level of banking inclusion but difficulties in gaining access to formal finance

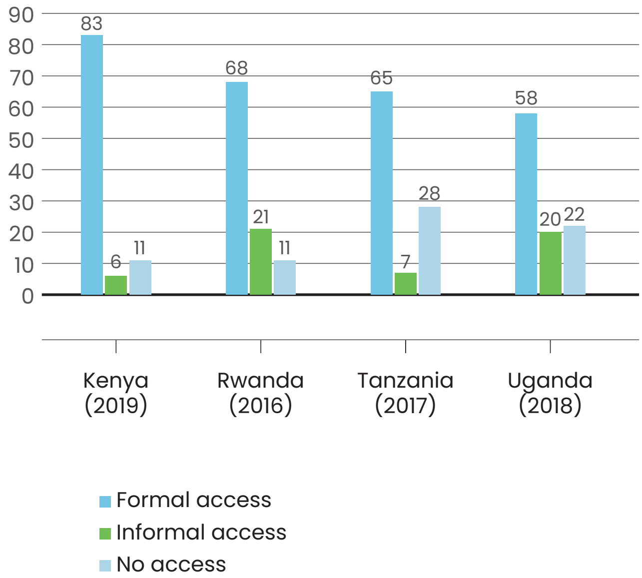
While financial inclusion in the broad sense is high, access to formal financial services—mostly provided through mobile money[18]—is still lagging behind at the regional level. Only 58% of the Ugandan population had access to formal financial services in 2018, according to the Finscope survey, as against 83% in Kenya (see Figure 16). Mobile money is the main means of access (56% of the population benefits from these services), far ahead of commercial banks (11%) and microcredit institutions (2%). The main barrier to banking is on the demand side, because of the widespread notion that income is too limited to allow for it. On the supply side, high rollout costs in the country-

17 As at mid-2020, the banking sector consisted of 25 commercial banks in tier 1, 5 credit institutions in tier 2, 4 micro-deposit institutions in tier 3, and more than 1,500 institutions in tier 4, including more informal structures such as cooperatives.

18 Money transfers via mobile phone.

side limit the incentives of banking institutions. As a result, only 7% of rural adults have access to these services, as against 24% in urban areas (and up to 42% in Kampala). The informal sector thus plays an important role in Uganda, in a proportion comparable to that in Rwanda and unlike that in Tanzania. These informal services take the form of traditional self-managed savings groups at the village level, whether within cooperative organizations or rotating credit associations.

Figure 15 – The level of financial inclusion in Uganda is lagging behind
(% of the population)



Sources: Finscope surveys

The banking sector contributes little to the financing of the economy. Credit to the private sector came to 14% of GDP in 2019, a level that has been stable since 2015. **Access to finance for businesses is particularly limited, with one of the lowest bank-penetration rates in SSA.** For example, only 10% of Ugandan firms held a bank loan or line of credit in 2013 (World Bank 2013), which is half the average for LICs (22%). For comparison, in that year 36% of Kenyan firms, and 17% of Tanzanian ones, held a bank loan or line of credit. Small and medium-sized enterprises are mainly offered short-term financing, which exposes them to refinancing risks and can slow down their long-term investments. Given the predominance of small businesses in the economy, the difficulties in gaining access to credit are a **substantial obstacle to the formalization of the economy.**

In addition, **the competitiveness of Ugandan firms is affected by borrowing rates that are higher than those in the rest of the region.** Despite a downward trend over the last few years, rates remain structurally high, averaging 20% in 2020. High bank overheads, high yields on bond issues, and difficulties associated with credit recovery all contributed to this picture. These tariff conditions are higher than those that obtain in the region as a whole. Rates of around 17% obtain in Rwanda and Tanzania.

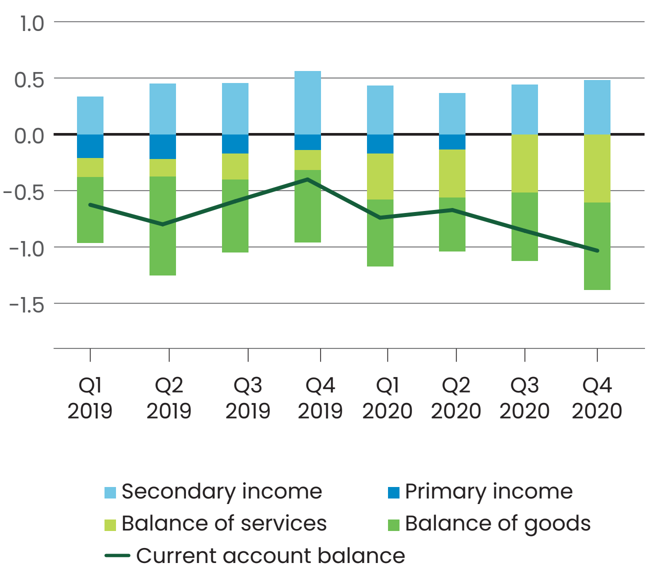
5. External balances are resilient to the COVID-19 crisis, but the sustainability of funding sources is a point of attention

While Uganda entered 2020 with a structurally high current account deficit, covered in equal proportions by foreign investment and lender financing of projects, the COVID-19 crisis created a financing gap that was largely covered thanks to support from the international community in the form of budgetary aid. The resulting accumulation of reserves was expected to meet financing needs in 2021, so the country will not face external liquidity risks in the short term. In the medium term, Uganda will have to ensure that private investment flows take over from lender financing. Finally, the high level of debt service could expose the country to liquidity risks in the event of an export shock or a significant depreciation in currency.

5.1 – The ability to cover a high current account deficit relies on donor support until investments recover

The current account balance is structurally in deficit, averaging -5.9% of GDP in 2010–2019. This deficit reflects the country's efforts to invest in infrastructure, boosting imports and contributing to a trade deficit in goods that has averaged 8% of GDP over the past two decades. The balance of trade in services and the primary income balance are slightly in deficit, averaging 2% of GDP since 2002. Net private transfers (4% of GDP—a figure that has been stable since 2002), including those from migrants, generate a surplus in the secondary income account (an average 5% of GDP since 2009).

Figure 16 – Expected increase in the current account deficit in 2020 (in USD billion)



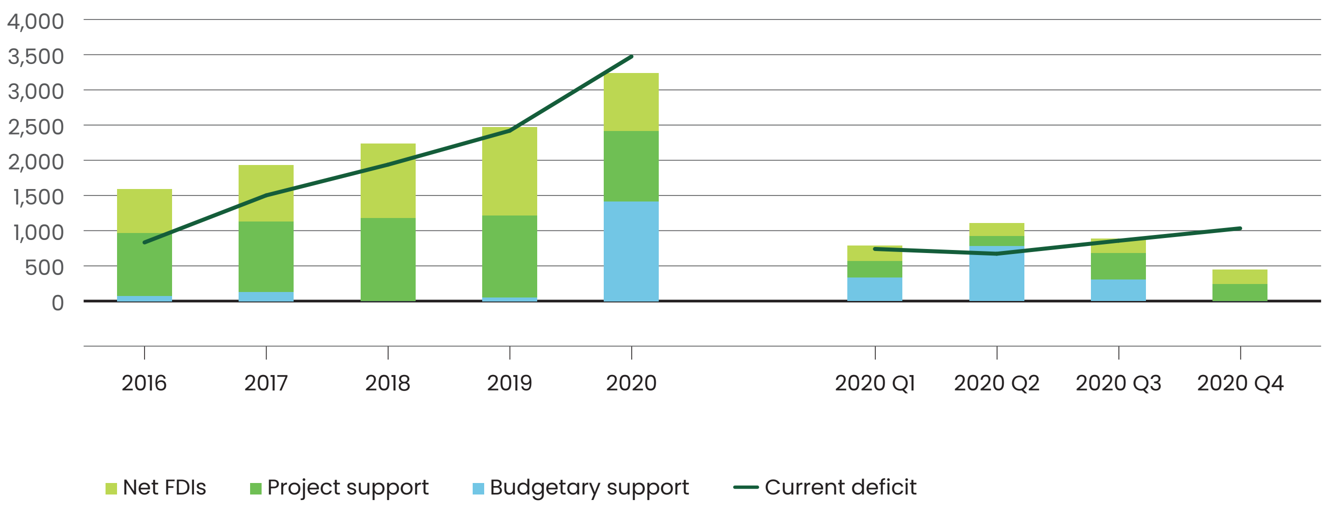
Source: BoU

Despite more sluggish economic activity, the current account deficit was set to grow to 9% of GDP in 2020, according to IMF projections. The current account deficit grew by 60% in the space of one year, as a result of a deficit in the services balance that was 2.7 times higher. This deterioration cannot be offset by the improvement in the balances in the trade in goods and in primary income (see Figure 17). The reduction in the trade deficit in goods (-11%) reflects, on the one hand, the strong performance of coffee exports (+18% in 2020), which is the main Ugandan export (14% of exports in recent years). On the other hand, the drop in imports is explained by lower consumption, the halt in infrastructure projects, and the fall in oil prices. The balance of services has been affected by a two-thirds drop in income from tourism, which had stood at 3% of GDP over the past 20 years, thus accounting for more than half of the country's services exports. The balance of secondary income remained fairly stable at -4%, with donation inflows from non-governmental organizations (+33%) offsetting the drop in migrant remittances (-26%).

The external financing requirement (EFR)[19] was put at 6.5% of GDP in 2018, and was expected to grow significantly in 2019 in the context of the COVID-19 crisis. In the spring of 2020, the IMF estimated that the health crisis would generate an increased EFR for Uganda of USD 1.3 billion in 2020, equivalent to 3.6% of its estimated GDP at the time. At the same time, repayments of external public debt are also expected to increase from USD 190 million in 2019–2020 to USD 300 million in 2020–2021. Uganda made a request of the G-20/Paris Club in June 2020 for a moratorium under the Debt Service Suspension Initiative (DSSI). As the memorandum of understanding (MoU) was not signed, the country did not benefit from what would have represented limited relief, estimated at 0.2% of GDP. On the other hand, the country has signed an MoU for the extension of the DSSI for the first half of 2021, for amounts totaling around USD 100 million, or 0.3% of GDP.

19 The EFR is defined as the sum of the current account deficit, the amortization of the external debt, and the maturing short-term debt.

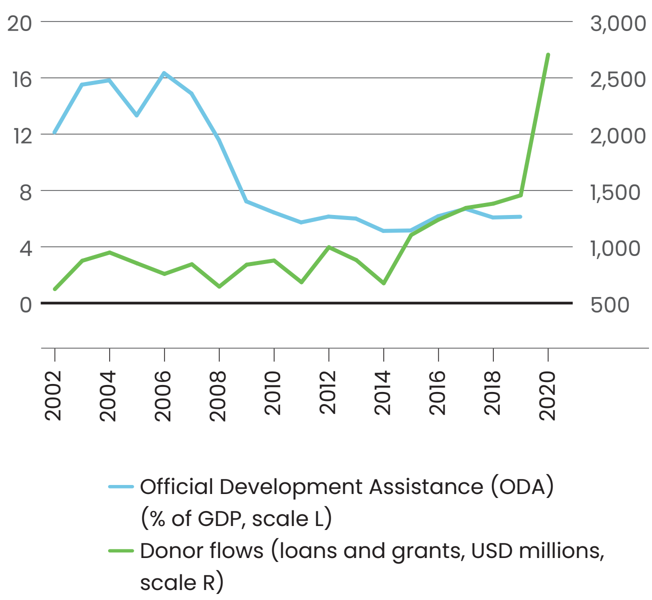
Figure 17 – Budgetary support covered the EFR in 2020 (in USD millions)



Sources: BoU, World Bank

Historically covered by foreign direct investment (FDI) (3% of GDP on average over the decade, rising in 2018 and 2019) **and project loans from donors** (3.2% of GDP on average since 2015, compared to 1.3% over the previous 5 years), **the EFR was covered in 2020 mainly by budgetary aid** (see Figure 18). Uganda has received USD 490 million in IMF financing under the IMF Rapid Credit Facility (0.4% of GDP), and USD 300 million in budgetary support from the World Bank. Overall lender support came to USD 2.7 billion in 2020 (+86% in the space of a year), including grants (see Figure 19). In addition to this financing, the recourse to non-concessional debt increased. Thus, for instance, a USD 700-million syndicated loan in foreign currency was taken out with local banks in March, followed by loans of up to 800 million at the closing of the 2019–2020 fiscal year. The debt-generating flows (+117% for the central government) thus largely compensate for the lower net FDI inflows (-35%), and for limited capital outflows.

Figure 18 – Strong lender support in the face of the COVID-19 crisis

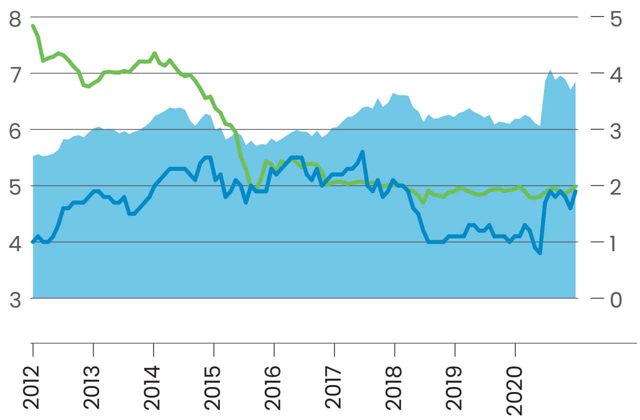


Sources: BoU, World Bank

5.2 – Sustainable external balances, but liquidity concerns

Donor support has enabled Uganda to cope with external liquidity constraints in the context of the COVID-19 crisis. Their financing has **consolidated foreign-exchange reserves at levels not seen since 2017** (up to USD 4 billion as at the end of July 2020). Relative to the 2021 projections, the reserves represent almost 5 months of future imports of goods and services, a level equivalent to the average that has been recorded since 2014 (see Figure 20). This adequate level of foreign exchange reserves allows the Central Bank to intervene in the foreign-exchange market to absorb shocks and limit volatility, as it was the case in March 2020, when it sold USD 200 million. **But for a small, open economy that is vulnerable to capital outflows, this level is not all that comfortable.** The use of reserves is indeed anticipated in order to cover the country's external financing needs—as was the case in the last quarter of 2020—in the absence of the strong recovery of investments that had been expected for 2021, and in a context of uncertainty around the rebound of the world economy.

Figure 19 – Maintaining foreign exchange reserves through donor support



Source: BoU

Despite volatility at the start of the health crisis and in the pre-election environment, **the Ugandan shilling held up in 2020,** when it was up 0.8% against the US dollar. While the currency has lost much of its value over the long term, from UGX 600/USD in 1996 to UGX 3,650/USD today, it has been broadly stable (see Figure 20) since 2017 (-1.4%). In 2021–2022, the persistent current account deficit (-8.4%, then -5.7% of GDP according to IMF projections), with the resumption of infrastructure projects and pending the recovery of tourist flows, could lead to a slightly depreciative trend (Economist Intelligence Unit 2020).

The increased use of debt-generating flows to cover the EFR is reflected in the continued rise in the country's external debt. The latter has significantly increased since 2014, and stood at 40% in 2019. It is expected to rise further, driven by the government's increasing reliance on debt to finance its budget. As a result, the public sector accounts for a growing share of the country's external debt (from 47% in 2013 to 62% in 2019). In the medium term, the IMF predicted in May 2020 that the external debt will peak at 50% of GDP over the next few years before declining again, assuming that there is a return to growth rates of over 6% in 2022–2023. The debt trajectory is vulnerable to an export shock or depreciation and, in the longer term, to further delays in the oil project discussed above.

To preserve its debt sustainability, Uganda will have to ensure that private investment flows take over from lender financing. Investor appetite will depend first on developments in the political context and the business environment, second on the country's capacity to carry out its infrastructure development projects, and third on the strengthening of regional integration.

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List of acronyms and other abbreviations

AFD	Agence française de développement, French Agency for Development
BoU	Bank of Uganda
CPI	Climate Policy Initiative
DRC	Democratic Republic of the Congo
DSA	Debt sustainability analysis
DSSI	Debt Service Suspension Initiative
EAC	East African Community
EFR	External financing requirement
FAO	Food and Agriculture Organization
FDI	Foreign direct investment
FSI	Financial soundness indicator (IMF database)
GDP	Gross domestic product
GNI	Gross national income
HDI	Human Development Index
IMF	International Monetary Fund
LMIC	Low-to-middle-income country
MoFPED	Ministry of Finance, Planning and Economic Development of Uganda
MoU	Memorandum of understanding
NDP	Uganda's national development plan
NPL	Non-performing loan
ODA	Official development assistance
DC	Developing country
PPP	Purchasing power parity
SSA	Sub-Saharan Africa
UBOS	Uganda Bureau of Statistics
UGX	Ugandan shilling
UMIC	Upper-middle-income country
USD	United States Dollar
VAN	Net present value
WEO	World Economic Outlook (IMF semi-annual report on the world economy)

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