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BUDGET SUPPORT, AID DEPENDENCY, AND DUTCH DISEASE: THE CASE OF UGANDA

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Abstract

Uganda is a country that is heavily dependent on budget support to finance nearly 50% of its total expenditures, a bulk of which is largely spent on non-traded goods and services. This results into substantial Ugandan shilling liquidity injections into the economy. To avoid inflationary pressures, the monetary authorities have to reduce the resultant shilling injections arising from the increased spending on poverty reducing sectors to levels consistent with demand conditions in the economy. However, on account of the thin financial markets and limited range of monetary policy instruments, upward pressure is exerted on the prices of the few instruments available i.e. interest and exchange rate. The lesson clearly emerging is that large-scale sterilization in thin financial markets is detrimental for the economy in terms of competitiveness thus raising fears of a Dutch disease.

However, recent studies on Uganda seem to downplay the fears of the Dutch disease and that it may not be founded. Some of them have argued that there is idle capacity in Uganda which could be drawn upon in order satisfy the demand for non-tradables that is induced by increased aid inflows. The simulation results of some of these studies show a sufficiently strong increase in the supply of non-tradable goods that is able to almost entirely offset the demand effects of increased aid flows. Consequently, exchange rate appreciation pressures are reduced or even reversed which enhances export sector performance. Others studies have however, acknowledged that there is a limit to the amount of aid that can be managed by the monetary authorities beyond which it could exceed the sterilization capacity and render macroeconomic management difficult or even undermine the growth prospects.

The above studies notwithstanding, this paper highlights the fact that unless the domestic resource costs are coming down, appreciation pressures on the exchange rate will erode the profitability, reduce investment and could also lower the income of the rural poor engaged in the export sector. The latter runs counter to the reason for why government expenditures have been increased i.e. to reduce poverty. In addition, the relative increases in non-traded prices also raises some questions about the utilization of idle capacity in the economy that should have offset the demand for non-tradables induced by increased aid inflows.

1.0 Introduction

In the immediate post independence era, Uganda emerged as one of the success stories of the newly independent countries of Sub-Saharan Africa (SSA). The period 1962-1966 saw the country pursue market friendly policies with emphasis highly placed on the role of private sector driven growth. This however changed in the second half of the 1960's with the role of the public sector in economic growth increasing. Nonetheless the annual average rate of GDP growth in the decade of the 1960's was no less than 6 per cent mainly driven by the utilization of the abundant natural resources such as fertile land, mineral deposits and rainfall and the prudent policy environment.

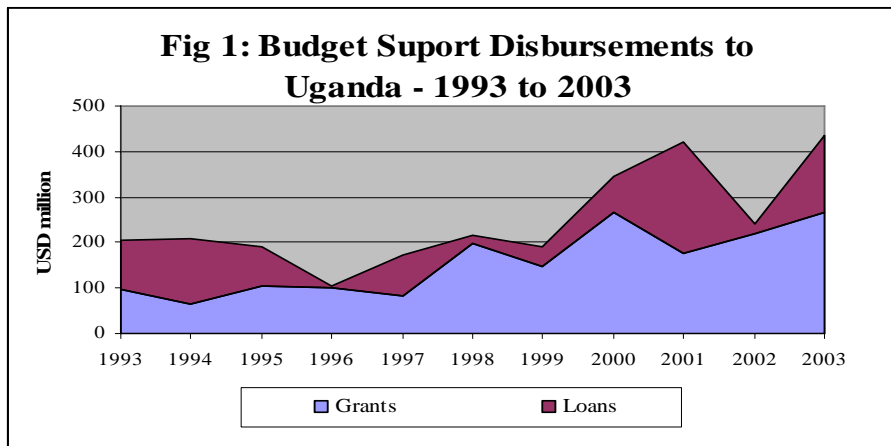
Political instability however crept in the second half the 1960s, following the abrogation of the 1962 Constitution and the policy shift from a private to public sector led economic growth. These events culminated in a military coup in 1971 by Idi Amin and marked the beginning of unprecedented economic chaos characterized by a poor macroeconomic policy environment. By 1979 when the military government was toppled, the annual growth rate of GDP was at its lowest (estimated at about -11 percent), inflation (GDP deflator) rose to over 200 percent and money supply growth was at about 52 per cent per annum. Since 1980, a number of attempts to kick start economic recovery on a sustainable basis have put been put in place and three main phases are identified i.e. the first phase of economic reform spanning the period 1980-85; while the second phase covers the period 1986-91 where reforms were implemented half-heartedly and the period of full commitment to reforms that began in 1992 to date.

Although the implementation of the economic reforms in the first two periods did bear some fruits, structural and financial bottlenecks remained and these constrained reforms to only adjustment and stabilizations efforts. In 1991 and 1992, the government implemented wide-ranging policies intended to eliminate these structural bottlenecks. (Holmegren *et al*, 2000). As a result of these reforms, inflation was contained at low levels and with the coffee boom of the mid-1990's the economy recorded the highest economic growth rate averaging 10 percent in the period 1994-1995. This led to the restoration of macroeconomic stability and kick started a new phase of increased flows of donor aid notably among which were the three-year ESAF program with the IMF and the second Structural Adjustment Credit of the World Bank (both in 1994), later followed by a new ESAF in 1997 and the approval of a third Structural Adjustment Credit by the World Bank in the same year.

The commitment Uganda showed towards economic reforms and macroeconomic stability led to increased confidence among major donors and resulting in an increase in donor flows in the form of project aid, budget support, food aid, emergency relief etc. It is therefore the objective of this paper to analyse the growth of budget support during this period and its implications for the economy. In section 2 of the paper, the patterns and composition of budget support to Uganda are discussed. This is followed by an analysis of the implications of increased budget support inflows to the economy and for macroeconomic policy in section 3. Section 4 discusses the evolution of the traded and non-traded prices in Uganda and what this could mean for export sector competitiveness. In section 5 of the paper, summary findings of the recent Uganda shilling appreciation and its impact on exports are presented while in section 6 conclusions and policy recommendations are provided

2.0 Patterns and Composition of Budget Support to Uganda 1993-2003

The overall trend of Budget Support to Uganda reflects donor support for the country's economic reform effort. Until the year 1999, Budget Support flows to Uganda were relatively small, averaging less than USD 200 million per annum (Figure 1). This represented about 3 percent of Uganda's total GDP. However, after 1999, this started to change with the total budget support almost doubling from a level of about 3 percent as a ratio to GDP in 1999 to 6 percent in 2000 and peaking in 2001 at about 8 percent as a ratio of GDP. The increase was a result of the development of the first PEAP (1997/98) which led to the, introduction of the Poverty Action Fund (PAF) in 1998/99 in support of the PEAP, and the resulting qualification of Uganda for HIPC in 1998/99. In terms of the ratio of budget support to total donor aid, there has been a marked increase since 2000 from an average of about 28 percent during the previous decade to a current level of about 42 percent. This change in the trend of budget support to Uganda has been largely due to the government's continued efforts towards the achievement of the Millennium Development Goals¹ (MDG's) as embodied in the PEAP.

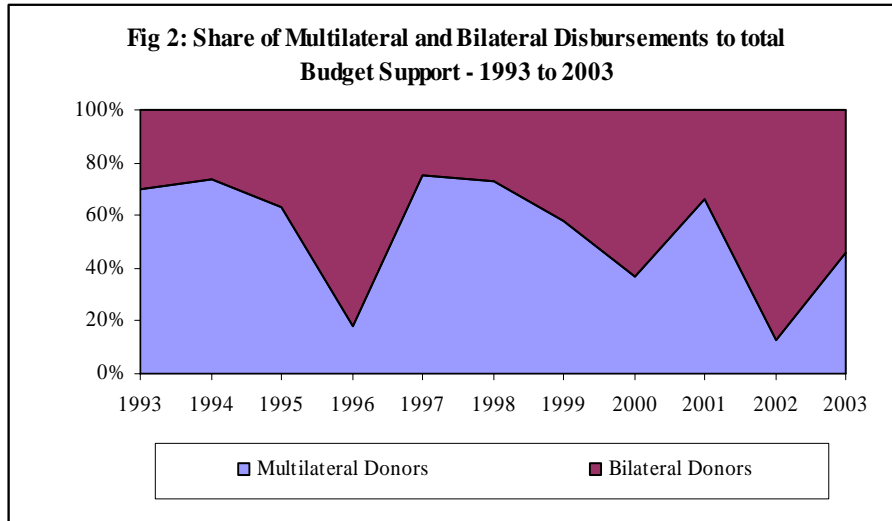


Loans constituted the largest share (about 56 percent) of budget support until 1996, when grants became the main and preferred form of budget support. The ratio of grants to total budget support increased from an average of 44 percent to 73 percent partly to address the increasingly worrisome high growth of Uganda's stock of external debt and partly to address the future debt sustainability of the country. To date, government has set a ceiling on how much aid (both budget support and project aid) can be sourced for in form of loans, which further emphasizes the continued preference of budget support in form of grants. In addition to the ceiling, it is only after assessing that both domestic revenues and grants are insufficient to finance the national budget that government has contracted loans that are highly concessional.

Figure 2 indicates that bilateral budget support as a ratio of total budget support has risen from about 20 percent in 1993 to 60 percent in 2003 and vice-versa for multilateral budget support. The major bilateral donors include the United Kingdom, Ireland, Denmark, Japan, Netherlands, Germany, Sweden, Norway, Austria, and USA etc. However, the United Kingdom has consistently been the largest donor accounting for over 40 percent of total budget support from

¹ With effect from 1999/00 the government of Uganda achieved the 20/20 initiative under the MDGs which stipulates that an average of 20 percent of budgetary expenditure and 20 percent of aid flows should be allocated to basic social services which include education, health and water infrastructure.

bilateral creditors. In general, the trend in the disbursements of budget support between the multilateral and bilateral creditors is partly explained by the large initial support from multilateral creditors towards the achievement of HIPC relief and the subsequent resources received towards the PAF with the bilateral donor contribution towards this fund increasing.



Among the multilateral donors, the World Bank has consistently been the largest donor of budget support, peaking at USD 225 million (current prices) in 2001, equivalent to over 50 percent of the total budget support disbursements that year. However, IMF credits, which were also quite high in the early 90's, have dropped from an average of USD 53 million (in the last decade) to an average of USD 7 million (in the early part of this decade). This is partly explained by the conclusion of the Structural Adjustment Credits.

As in most HIPC countries, the amount of budget support commitments compared to actual disbursements has generally been higher in the case of Uganda. Only 27.4 percent of the loans committed were disbursed in 1999/00. The disparity between the low disbursement levels compared to higher commitment levels can be primarily attributed to delays due to the different donor disbursement procedures and conditionalities. Nonetheless, there has been a marked improvement over time and in 2002/03 (see table 1); actual disbursements exceeded commitments for the first time, by about 6 percent.

The general improvement in the ratio of donor disbursements to commitments has been the result of the streamlining of donor disbursements procedures as well as the depreciation of the US dollar (the reporting currency) against other currencies in 2002/03 and 2003/04. In terms of the components of budget support, the loans have generally had a lower disbursement ratios compared to grants with the exception of fiscal year 2002/03.

The sectoral allocation of aid has been characterized by the channeling of a large portion of budget support towards poverty reducing expenditures through the PAF, which has directly benefited poverty-reducing sectors such as the health, education, agriculture, water and sanitation, roads, and works sectors. The increase in the budget support resources have therefore resulted in an increase in the share of PAF in total spending from 17 percent in 1997/98 to 23.5 in 2002/03.

Table 1: Budget Support Commitments/Disbursements in USD Millions – 1999/00 to 2003/04

	1999/00		2000/01		2001/02		2002/03		2003/04	
	Projection	Output	Projection	Output	Projection	Output	Projection	Output	Projection	Output
Loans	140.60	38.50	180.40	83.40	373.80	198.90	179.44	191.20	187.76	30.67
Grants (excl HFC)	181.50	109.90	156.10	153.00	193.30	154.60	177.39	173.90	245.76	358.97
Total	322.10	148.40	336.50	236.40	567.10	353.50	356.83	365.10	433.52	389.64
Ratio of Loans Output to Commitments (%)		27.38		46.23		53.21		106.55		16.34
Ratio of Grants Output to Commitments (%)		60.55		98.01		79.98		98.03		146.06
Ratio of Total Output to Commitments (%)		46.07		70.25		62.33		102.32		89.88

3.0 Implications of the Increase in Budget Support

3.1 Aid Budget Support and Dutch Disease: Review of Literature on Uganda.

The issue of whether increased budget support to finance Uganda's poverty reduction has resulted in a Dutch disease has been the subject of much discussion. Adams and Bevan (2003) developed a simple model of aid and public expenditure where public infrastructure capital generates inter-temporal productivity spillover for both tradable and non-tradable sectors. Contemporary conditions in Uganda were calibrated in this model to simulate the effect of increased aid. The results show that public expenditures, whose productivity effects are skewed towards the non-tradable sector, deliver the highest growth in exports and total output besides sustaining high aggregate real income. The bias in productivity effects increases the supply of non-tradable goods, which is sufficiently strong to almost entirely offset the demand effects of increased aid flows. The results also show that exchange rate appreciation is reduced or even reversed, enhancing export sector performance. However, in terms of poverty reduction, the results show that income gains largely accrue to urban skilled and unskilled households leaving the rural poor relatively worse off.

Given that the increased grant component of ODA used to finance government expenditure results in higher disposable national incomes for the recipient countries, the effects of the on the real exchange rate (RER), and subsequently the trade balance largely depend on the supply- and demand-elasticities with respect to income (see for example Adams and Bevan (2003), and Nkuzu (2004)). If the income elasticity of demand for non-tradables is high, a large appreciation of the RER could result, while both a higher price elasticity of supply and demand for non-tradeables would result in a smaller RER appreciation.

Both studies point to the fact that the fears for a Dutch disease in Uganda may not be founded. Nkuzu (2004) specifically advances three factors that explain the observed weak applicability of the predictions of the core Dutch disease model to Uganda - (i) the Ugandan economic structure departs from the key assumptions of the Dutch disease model (ii) the economic liberalization and the deteriorating terms of trade observed in the recent past and (iii) the prudent monetary and exchange rate management. On (i), the existence of unused or inefficiently used factors of production could combine with the increased financial flows to support the increased and more efficient use of these factors and should not necessarily generate a resource transfer that degenerates into a Dutch disease as assumed by the theory. The probability of Uganda producing within the production possibility frontier (PPF) is therefore high. The large scale of unutilized land resources supports this² while imperfections in the labor market and its

² 1997 version of Uganda's PEAP estimated only one-third of available land currently under utilization.

segmentation weaken the likelihood of a meaningful upward real wage flexibility. The combination of a relatively stable political environment and (ii) above encouraged crop production and investment in various sectors of the economy. The widening trade balance that has been observed since the ODA flows increased basically mirrors an increased demand for foreign exchange that has been satisfied partly by drawing down on ODA flows. In addition, the increased ODA flows to a large extent did offset the shortfall that emanated in export proceeds following the deterioration in the terms of trade. It could however, be argued that the ODA flows played a mitigating role in terms of slowing down the rate of depreciation that would have otherwise resulted on account of a deterioration in terms of trade. On (iii), the prudent macroeconomic management has resulted in low and stable inflation, which has exerted depreciation pressures on the REER.

Nkuzu (2004) concludes that Uganda's experience confirms the idea that the Dutch disease need not materialize in many developing countries if these can (a) draw down on their idle productive capacity to satisfy the demand for non-tradables that is induced by ODA inflows, (b) undertake structural reforms that support structural transformation so that resources move into areas where they can earn a higher rate of return and (c) pursue prudent macroeconomic policies that deliver low and stable inflation in order to support the depreciation of the REER. However, she acknowledges that there is a limit to the level of aid that can be managed beyond which it could exceed the sterilization capacity of the monetary authorities and render macroeconomic management difficult or even undermine the growth prospects. She also cautions on whether this successful experience with large ODA flows masks weaknesses that could be storing up trouble for the years to come needs to be substantiated.

The next sections is reviews the developments on the ground by taking stock of the build up of upward pressures on the exchange and interest rates that began in 1998/99 and specifically the recent developments in the export sector performance in 2003/4. A number of issues raised by the above authors will also be examined in this context.

The Build Up of Upward Pressures on the Exchange and Interest Rates

The increasing budget support disbursements geared toward reducing poverty levels have resulted in a widening budget deficit. The increase in budgetary allocations towards the poverty reducing sectors has led to a reduction in the population living below the poverty line from 56 percent in 1992 to 44 percent in 1997 and to 35 percent in 2000 before rising to 38 percent in 2002. Whereas these developments are welcome, there are concerns that the resultant complications in macro-economic management could easily negate these benefits. This is largely because the poverty reduction expenditures have been directed towards non-tradable goods in the economy resulting in the need to sterilize the resultant shilling liquidity. The sterilization of this liquidity has been carried out by the central Bank mainly to ward of inflationary pressures on account of the increase in money supply.

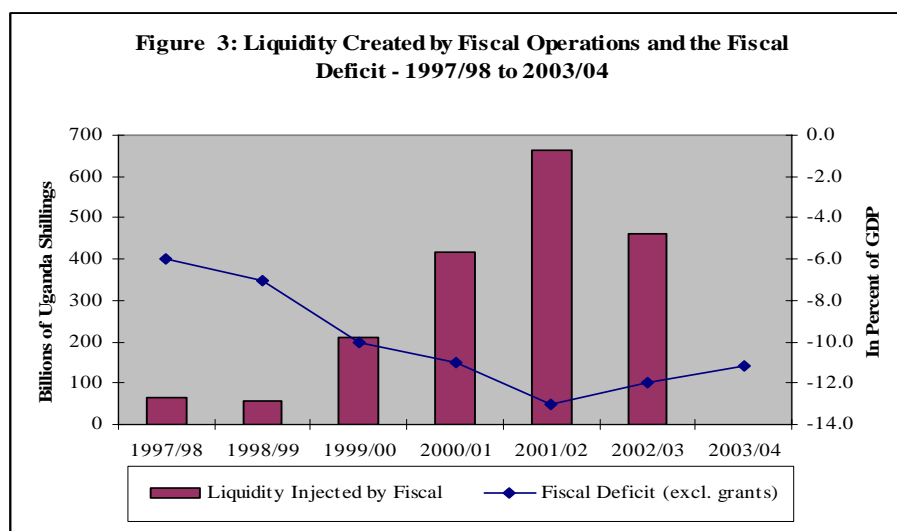
3.2 Fiscal Deficit

The increase in government expenditure and the associated fiscal deficit has become a contentious issue in Uganda. Six measures³ of fiscal deficits revealed that this had risen and the increase is largely attributed to the increased availability of donor aid, mainly in form of budget support, including debt relief, which has been used to expand the Government of Uganda budget (see the a paper “Is Budget Deficit Reduction Necessary?”⁴). Large aid-funded increases in expenditure, equivalent to some 8% of GDP, occurred from 1999/00 while revenues rose by barely 2% of GDP. As a result, the fiscal deficit excluding grants – mainly budget support and HIPC debt relief – doubled from 6.3% to 12.8% of GDP.

To date, donor support of one form or another accounts for nearly one half of government total expenditure. This reveals how Uganda’s budget is vulnerable because the government has no direct control over its financing and any interruption to this flow can be very disruptive to the budget and the broader economy. Realizing the implications of such donor dependence, Uganda’s Long-Term Expenditure Framework (MTF) envisages a gradual fiscal consolidation, which should ease the upward pressure on the exchange and interest rates and thereby *crowd-in* the private sector in the medium terms. Appendix table 1 summarises the evolution of the fiscal deficit.

3.3 Shilling Liquidity Injections

Figure 3 below shows the impact of growing donor resources (a large portion of which is budget support) on the fiscal deficit excluding grants and the shilling liquidity injections on account of fiscal operations.



³ Overall deficit (including grants), Primary deficit (including grants but excludes domestic and external interest payments), Overall deficit (excluding grants) Current deficit (Current revenue minus current expenditure), GOU Budget Deficit (excludes the externally financed development expenditures and is defined as domestic revenue minus the GOU budget), Domestic deficit (defined as the GOU deficit excluding the interest payments on external debt and government imports financed directly through the BOU but including arrears and Promissory Notes payments).

⁴ Martin Brownbridge (2000)

As shown in figure 3 above, the fiscal deficit as a ratio of GDP has been rising since 1997/98 and by 2001/2 it had more than doubled before slightly improving in the years thereafter. With the rise in the fiscal deficit, governments net liquidity injections created by fiscal operations – government domestic expenditure less domestic revenues have risen massively from a mere Uganda Shs. 63 billion in 1997/98 to Uganda Shs 640 billion in 2001/02 and down to an average of shs400 billion in the last two financial years. This has resulted in a big burden on the Bank of Uganda in terms of ensuring that all this liquidity is sterilized to ensure price stability.

3.4 Monetary and Exchange Rate Policies

3.4.1 Monetary Aggregates

The large fiscal deficits that have averaged 10-11% of GDP in the last four financial years have been funded through budget support in the form of external loans and grants. This has continued to present significant challenges to monetary and exchange rate management, resulting not only in upward pressures but also in the volatility of the exchange and interest rates. To the extent that the monetary authorities use a monetary targeting framework, sterilizing shilling liquidity of anything up to 6% of GDP is a tall order. This is necessary in order to prevent the injections of liquidity translating into inflationary increases and as such the Bank of Uganda (BOU) has engaged in a combination of open market type operations and foreign exchange sales to manage liquidity in order to contain underlying inflation to 4-5%. Sterilising this magnitude of liquidity in thin financial markets is difficult and this is the problem the Ugandan authorities find themselves in. Consequently, because money demand has not risen as fast as money supply (being injected through government expenditures) interest rates have been higher and more volatile than they might otherwise have been, commercial banks have to be enticed into taking growing quantities of Treasury bills, while increased sales of foreign currency to the domestic market have caused the exchange rate to appreciate.

Subsequently, on account of the increasing injections by government, the stock of treasury bills has grown rapidly from Uganda shillings 45.8 billion in 1993/94 to Uganda shillings 1,247.96 in 2003/04 (see table 2 below) while the stock of treasury bonds, which were introduced in January 2004, had already hit Uganda Shillings. 105.00 Billion by June 2004.

Table 2: Outstanding stock of Treasury Bills and Bonds and Forex Sales to the IFEM –1993/94 to 2003/04

	93/94	94/95	95/96	96/97	97/98	98/99	99/00	2000/01	01/02	02/03	03/04
Total Stock of Treasury Bills (USHS billions)	45.80	62.80	93.83	95.01	143.24	214.48	361.77	589.44	928.50	1,202.60	1,247.96
o/w Holdings by Commercial Banks	32.71	42.94	70.36	73.25	109.14	144.68	273.77	466.12	721.18	880.80	819.04
Total Stock of Treasury Bonds (USHS billions)											105.00
Forex Sales (USD millions) /1	25.79	6.91	44.47	41.53	5.44	-24.84	-117.25	-174.28	-198.99	-246.59	-140.85

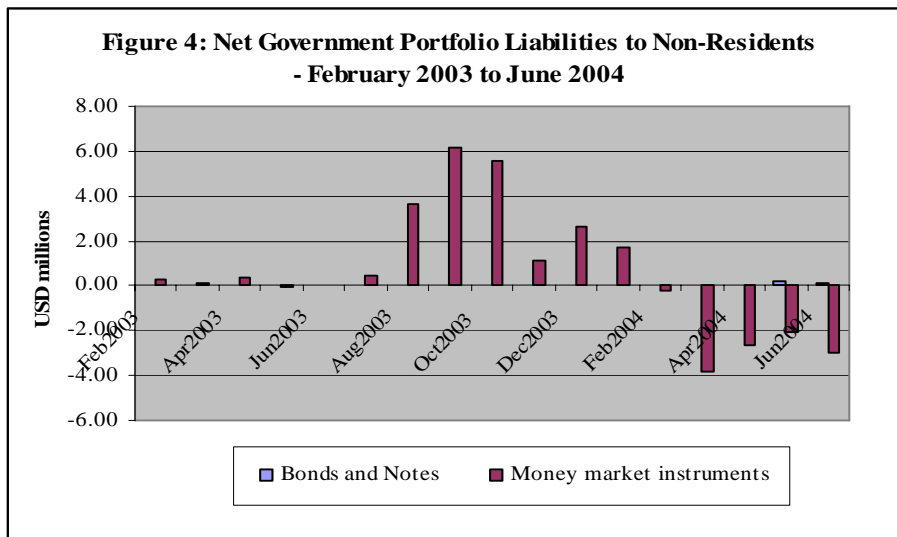
1. A plus is a purchases and a minus is a sale

Source: *Bank of Uganda*

As the stock of treasury bonds and bills continues to grow, there is a growing worry of the impact of domestic interest costs on the fiscal deficit in addition to other macroeconomic effects. The huge increase in Treasury bill sales has also squeezed the funds available in the banking system for lending to the private sector – hence the fiscal deficit is directly crowding out private sector borrowing. A large share of the stock of TB's is held by the commercial banks because non-bank demand for TB's is very limited. As a result, the holding of TB's by commercial banks has risen in tandem with the net TB issues. Consequently, commercial banks holdings of TB's as a share of their assets, increased from 23 percent to **32** percent between

June 2000 and June 2002. This period was marked by slow growth in Private Sector Credit (PSC). There may have been other reasons independent of the widening fiscal deficit, that could explain the stagnation of PSC over the recent past (except for last two years) such as weak demand for credit from credit worthy borrowers. However, it is logical to arrive at the conclusion that even if demand for private sector credit had been strong enough to support the anticipated PSC growth, the banks would not have had the resources to supply this credit because of their increased holding of TB's and therefore growth in PSC would have still been chocked off.

As part of the liberalization process, the restrictions on the capital account were removed in 1997. These meant that Ugandans could now hold foreign denominated financial assets both domestically and abroad, while non-residents could also hold shilling denominated assets in Uganda. Following the world wide decline of interest rates in 2003, the interest rate differential in favor of the Uganda shilling denominated financial assets widened due to the high government expenditures that had to be sterilized by the BOU. As a result, that year the country began to receive portfolio investment flows in the domestic money markets to acquire government securities (see figure 4 below). This continued through 2004, although on a smaller scale compared to the second half of 2003, and has raised concern for policy makers about the potential disruption to the foreign exchange market. In general, we see portfolio inflows beginning in August 2003 until February 2004, and thereafter outflows.



Both the upward pressure on the exchange rate and high interest rates are inconsistent with the government's development objectives of increasing exports and increasing the role of the private sector in economic growth. The long-term solution to this policy conflict lies in a gradual fiscal consolidation while in the near term, the best the BOU can do is try to pursue a more balanced approach to T-bill and foreign exchange sales. Getting the right balance however, can be very challenging. Improvements in liquidity management together with the introduction of longer dated government paper have been successful in lowering and reducing volatility in the money market interest rates in the recent months, However, the nominal exchange rate appreciation of over 11% year-on-year in 2004, not all of which could be blamed on a weaker USD is a source of concern.

3.4.2 Exchange Rate Effects

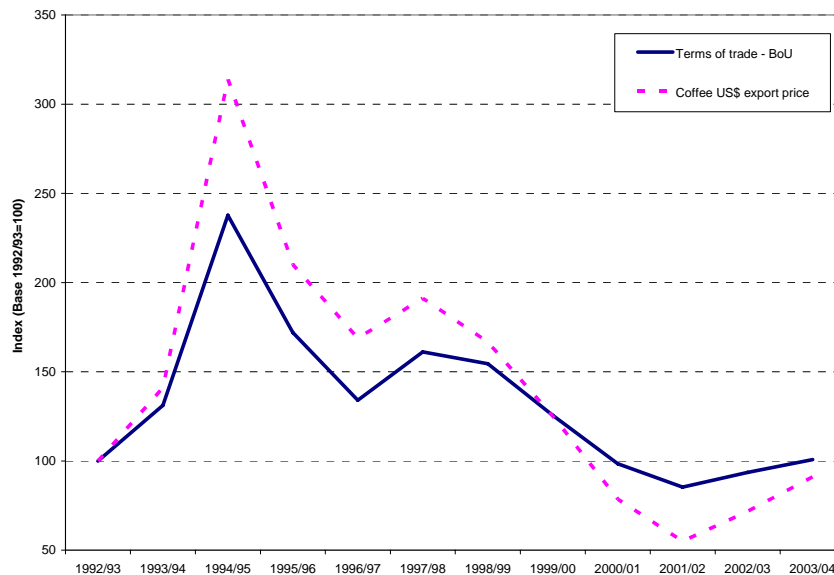
The mopping up of shilling liquidity using sales of forex to the inter-bank foreign exchange market (IFEM) has had its shortcomings despite its increased use since 1999/2000. From 1993/94 to 1997/98, BOU participation in the IFEM was on the buy side. Since 1998/99 however, BOU presence in the IFEM reversed partly on account of the unwinding of the coffee boom but largely because of the need to sterilise the shilling liquidity injected by budget support government expenditure. These developments are summarised in table 2 above. Specifically, in 1998/99, the BOU sterilized the equivalent of USD 24.84 million, which has since risen to about USD 140.85 million in 2003/04 having peaked at USD 246.59 million in 2002/03. The decline in 2003/04 was due to the growing appreciation pressures on the Uganda shilling limiting its use as an instrument for mopping up shillings.

To fully appreciate the impact of the recent increase in shilling liquidity sterilization using foreign exchange sales, a discussion of the historical evolution of exchange rate in relation to terms of trade, and performance of exports is necessary.

3.5 Terms of Trade

The continued decline in coffee price in the post coffee price boom in 1994/95 has seen a general decline in Uganda's terms of trade (see figure 5 below).

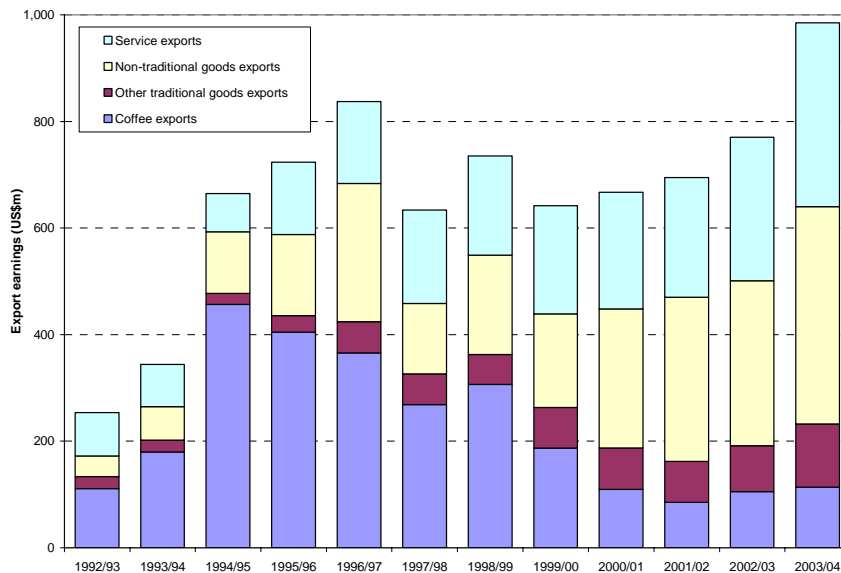
Figure 5: Uganda's Terms of Trade and Coffee US\$ Export Price, 1992/93-2003/04



Source: *Bank of Uganda*

The decline in terms of trade⁵ on account of world coffee prices highlights Uganda's over-dependence on a single export-commodity and exposes its vulnerability to external shocks. The Government has since taken strong policy measures to diversify exports by reviving other traditional export such as cotton, tea and tobacco while promoting non-traditional export such as fish, flowers and vanilla, and tourism services. As seen in figure 6 below, these efforts have paid off as total exports of goods and services have increased from US\$665m in 1994/95 to almost US\$1bn in 2003/04. The extent of export diversification is seen when looked at in terms of the contribution of coffee to total exports which has fallen from over 50% in the mid 1990s to just 12% today. The export developments to the year 2003/4 could to a large extent support the findings of Adams and Bevan (2003) and Nkuzu (2004) that increased spending on non-tradables in the presence of idle productive capacity need not result in a Dutch disease. However, the continued sterilization using foreign exchange sales in 2003/4 is revisited in section 5 and the caution by Nkuzu (2004) that there is a limit to the amount of aid that could exceed the sterilization capacity and render macroeconomic management difficult or even undermine the growth prospects is strongly considered.

Figure 6: Uganda's Export Diversification, 1992/93-2003/04



Source: *Bank of Uganda*

⁵ Terms of trade are defined as the ratio of export prices to import prices and measure the volume of imports that can be bought with one unit of exports. The unfavorable movement in Uganda's terms of trade indicates that fewer imports can be bought for a given level of exports, in other words, the purchasing power of Uganda's exports (in terms of imports) has fallen.

The progressive decline in prices paid for agricultural commodities such as coffee is one of the major reasons why Uganda is focusing on value addition. Exports of simple commodity products such as Robusta coffee, which are undifferentiated and undistinguishable to customers, are normally sold to markets with sole purchase criteria of minimum acceptable quality and low cost. Such commodity products are also vulnerable to a long-term decline in prices when new entrants start producing, i.e. impact of large scale Robusta coffee production in Vietnam. In value addition markets, determining purchase factors go far beyond simply providing commodities at the lowest cost. An industry that provides a high value differentiated product can generally obtain higher or at least more stable prices and profit margins, and finds it easier to defend their competitive position.

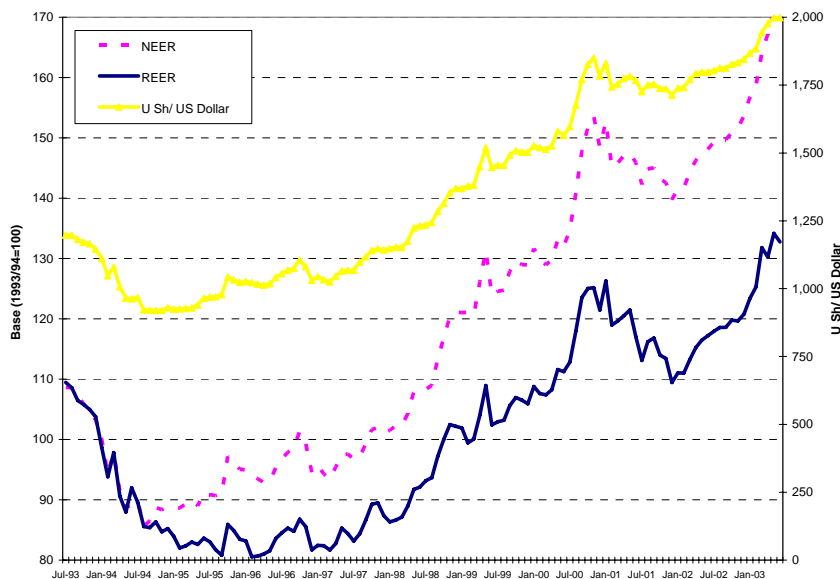
A number of measures are credited with this performance and these include the pursuance of prudent macroeconomic policies and reforms in the marketing, payments and exchange system. Increased competition in marketing significantly reduced the distortions in resource allocation and increased incentives for increased production. Farm gate prices received by farmers increased which subsequently raised the production to profitable levels. This was in addition to the restoration of peace in the greater part of the country, which resulted in more production. Productivity enhancing measures such as increased availability of seeds and fertilizers, progress in planting practices, and the replacement of old coffee trees with new, clonal ones with higher yields have had a cost-reducing impact on coffee production.

As the terms of trade deteriorated, the market determined exchange rate depreciated, and given the low inflation rates in the economy, the real effective exchange rate depreciated thus making Ugandan non-coffee exports more competitive. Consequently, maintaining low and stable inflation has been crucial to ensuring that the cost of inputs is maintained low thereby increasing profit margins as the exchange rate depreciates. This is in line with the observation made by Nkuzu (2004), which urges aid recipient countries to pursue prudent macroeconomic policies that deliver low and stable inflation in order to support the depreciation of the REER

3.6 Historical Exchange Rate Movements

The competitiveness of the Shilling, as measured by the real effective exchange rate (REER), has improved since 1995/96, depreciating by approximately 50% up to 2002/03 largely on account of deteriorating terms of trade and, low and stable inflation. Over this period the nominal effective exchange rate (NEER) and Shilling/ US Dollar exchange rate (NER) depreciated by 68% and 86% respectively (see figure 7)

Figure 7: Uganda's NEER, REER and Shilling/ US Dollar Exchange Rate, 1992/93-2002/03



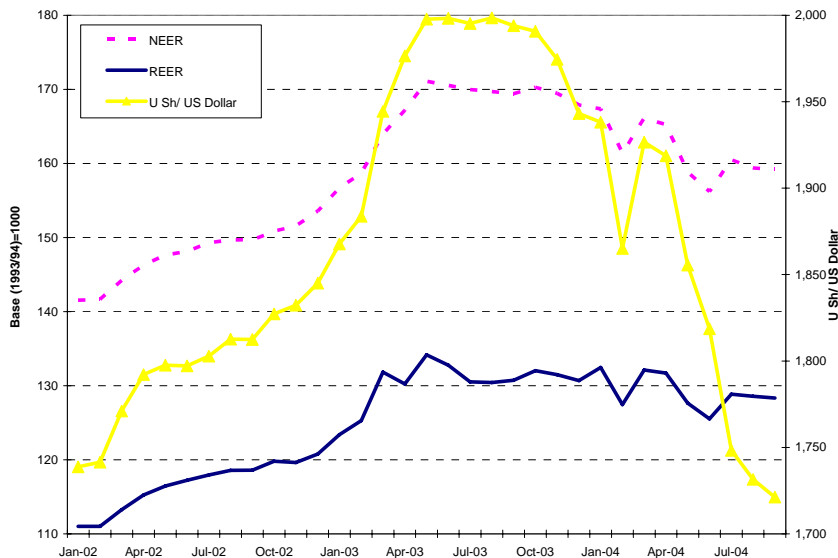
Source: Bank of Uganda

However, in 2003/04, both the trend in the Uganda/ Dollar nominal exchange rate and the REER that had generally been depreciating reversed. Between August 2003 and September 2004, the Shilling appreciated against the US Dollar from a level of Shs 1,998/US\$1 to Shs

1,721/US\$1, marking an overall appreciation of 13.9%. Although the Shilling appreciated in all months of this period (except for March 2004), the appreciation was most marked between April and July 2004, moving sharply from a level of Shs 1,919/US\$1 to Shs 1,748/US\$1. Between July 2003 and June 2004, the REER appreciated by 4% to its least competitive level since February 2003. These developments are summarized in Figure 8 below.

To a large extent, one can not fail to partly attribute the recent appreciation pressures to the strong sterilization effects on account of the shilling injections resulting from the donor flow financed Government's fiscal deficit.⁶ As discussed above, an upsurge in offshore investor inflows to purchase Treasury Bills, attracted by high returns and widening interest rate differentials against global government securities was witnessed in the first half of 2003/04. These inflows placed addition appreciation pressures on the exchange rate, causing Bank of Uganda to increase its sales of securities and reduce its sales of foreign exchange. This however created a vicious circle as interest rates rose which further attracted more inflows of from offshore investors and exerted more pressure on the exchange rate.

Figure 8: Uganda's NEER, REER and Shilling/ US Dollar exchange rate, January 2002 to September 2004



Source: *Bank of Uganda*

A re-constitution of monetary policy instrument mix for liquidity management that involved increased sales of foreign exchange and scaling back sales of Government securities but with more emphasis on longer dated bonds in the second half of the year was needed to halt these portfolio inflows. BoU sold in excess of US\$120m in H2 2003/04, which is three times the amount sold both in H1 2003/04. Coupled with strong private transfer inflows in H1 2003/04 and 28% growth in export earnings in 2003/04 appreciation pressures became inevitable.

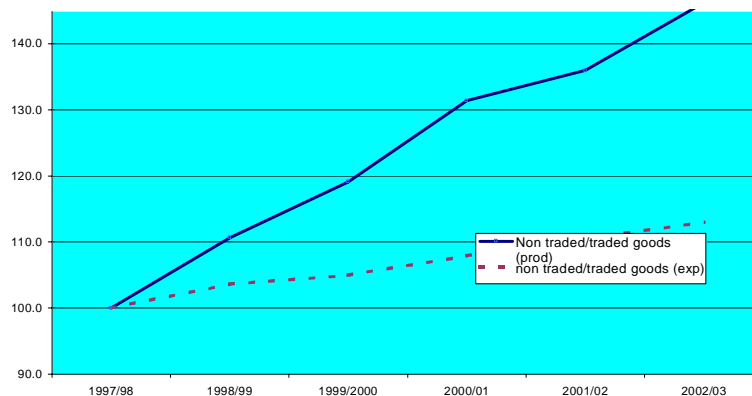
⁶ Exporters point out that the current strength of the Shilling does not reflect the export performance of the economy but the high level of aid dependency.

4.0 Traded versus Non-Traded Prices

Examining the trends in the price indices for the major components of GDP shows that prices for non-traded goods in Uganda have grown much faster than prices for traded goods as shown in figure 9. This implies that the price incentives within the domestic economy have shifted away from traded goods production towards non-traded goods production in the last few years on account of the increased demand for non-traded arising from increased government expenditures. Given the fixed supply of these goods in the short-run, price increases have been the inevitable. In addition, we may not be able to rule out the fact that the aid-funded fiscal expansion has therefore led to an increased trade deficit from 7.2 percent of GDP in 1997/98 to 10.1 percent of GDP in 2003/4. It would also be difficult to ignore the fact that a shift in relative prices from tradable to non-tradable will undermine the GOU objective of creating a dynamic export led economy. Private sector led-export promotion is central to the Medium Term Competitiveness Strategy (MTCS) and this objective should not be compromised by an excessive fiscal deficit.

The developments in the tradable and non-tradable prices shown in figure 9 seem contrary to the findings of Adams and Bevan (2003) who show that if public expenditures are skewed towards the non-tradable sector, these could deliver productivity effects, which increase the supply of non-tradable goods. The increased supply of non-traded goods could sufficiently offset the demand effects of increased aid flows such that exchange rate appreciation pressures are reduced or even reversed to enhance export sector performance. It may be then that donor funded increases in Government expenditures have generated high income elasticity of demand for non-tradables resulting into appreciation pressures in the REER witnessed in 2003/4. These price developments could also highlight that both price elasticity of supply and demand for non-tradables is inelastic thus REER appreciation experienced on account of increased Government expenditures.

Figure 9: Traded versus Non-Traded Prices



To the extent that the price elasticity of supply of non-traded goods appears low in Uganda, the observations by made by Nkuzu (2004) need to be revisited. The appreciation pressures arising from the relative increases in non-traded prices raise some questions about the utilization of idle capacity in the economy that should have satisfied the demand for non-

tradables that is induced by ODA inflows. However, Nkuzu's (2004) acknowledgement that there is a limit to the level of aid that can be managed beyond which it could exceed the sterilization capacity of the monetary authorities and render macroeconomic management difficult and even undermine the growth prospects is well noted.

5.0 Exchange Rate and Export Sector Competitiveness

As earlier noted, the nominal exchange rate appreciated from an average of Shs1998 per US\$ in June 2003 to an average of Shs1700 per US\$ in August 2004. On account of these sharp appreciation pressures in 2003/04 and subsequent concerns of competitiveness raised by the exporters sector, a joint study was undertaken by the Macroeconomics Department of the Ministry of Finance, Planning and Economic Development (MFPED) and the Research Department of Bank of Uganda (BoU) to investigate the impact of the appreciation on a number of key export sectors. A break even exchange rate⁷ for each of the major export items was calculated and the study showed that at an exchange rate of shs1700 per US\$ a number of export items were not breaking even. These included fish, tea, tobacco and maize. The study found the general negative consequences of the recent appreciation to be:

- Reduction in export profitability (and even large losses in some sectors) and/ or reduction in farm gate prices, with reduced incentives having major implications for future production and value addition;
- Reduced export competitiveness and loss of major contracts to foreign competitors; and
- Reduced investment in the export sector.

These results are summarized in appendix table 1.1.

These short-term consequences also have significant longer-term implication for the wider economy in that a permanently appreciated REER will discourage export diversification and export-led growth in general, in addition to shifting incentives towards the non-tradable sector and encouraging imports. Lower farm-gate prices also reduce rural incomes and thus reduce demand for locally manufactured goods and services. The increase in poverty between 2000 and 2003 is partly attributed to falling farm-gate prices of several export crops and coincides with a slowdown in formal manufacturing growth. It should be borne in mind that the resources of the rural poor in Uganda engaged in the production of export crops are limited and therefore cannot easily substitute into other profitable crops. Should they be left on their own, poverty levels are likely to increase further.

These findings partly contributed to the suspension of substantial sterilization using foreign exchange sales in 2003/4 which is in line with the caution by Nkuzu (2004) that there is a limit to the amount of aid that could exceed the sterilization capacity and render macroeconomic management difficult or even undermine the growth prospects is strongly considered.

⁷ The calculation of break-even exchange rates is an extremely difficult task, partly because the quality of data provided by each export sector varied significantly. As such, the figures presented in Table 1.1 should be treated with caution, but still serve as a useful guide on how vulnerable sectors are to adverse exchange rate movements. Refer to Section IV for the assumptions made for individual sectors in arriving at the break-even exchange rates.

6.0 Policy Recommendations and Conclusions.

The experience of Uganda shows that a country that is heavily dependent on budget support to finance nearly 50% of its total expenditure which is largely spent on non-traded goods and services is more likely to suffer from the Dutch Disease. To avoid inflationary pressures, the authorities attempt to reduce the resultant local currency injections arising from spending on poverty reducing sectors to levels consistent with demand conditions in the economy. However, on account of thin financial markets and limited range of monetary policy instruments, upward pressure is exerted on prices of the few instruments available i.e. interest and exchange rate. The lesson clearly emerging is that large-scale sterilization in thin financial markets is detrimental for the economy in terms of competitiveness.

The case of Uganda also highlights the fact that unless the domestic resource costs are coming down, appreciation pressures on the exchange rate will erode the profitability, reduce investment and could also lower the income of the rural poor engaged in the export sector. The latter runs counter to the reason for why government expenditures have been increased i.e. to reduce poverty. The relative increase in the prices of non-traded prices could highlight the fact that donor funded increases in Government expenditures have generated high income elasticity of demand for non-tradables resulting into appreciation pressures in the REER witnessed in 2003/4. Alternatively, these price developments could also highlight that both price elasticity of supply and demand for non-tradables is inelastic thus REER appreciation experienced on account of increased Government expenditures. The relative increases in non-traded prices also raises some questions about the utilization of idle capacity in the economy that should have offset the demand for non-tradables induced by ODA inflows.

From the above, the following key recommendations could be considered;

- For the short-run, aid recipient countries should consider taking only aid amounts that would not overwhelm the sterilization capacity of the monetary authorities and compromise export and private sector growth.
- Productivity enhancing public expenditures designed to increased output through the provision of public goods, raising the productivity of the rural poor through measures such as increased availability of higher yielding seeds, progress in planting practices and fertilizers have a cost-reducing impact on production thus competitiveness of the producers.
- Lowering the domestic resource cost through increased investments in public goods with a high import content e.g. power generation, water harvesting, improving transport and communications. Automatic sterilization through imports here would not exert pressures on monetary policy instruments but would go a long way in reducing the cost of doing business.
- Deepening the financial sector, though long-term would increase the demand for money thus sterilize some of the increased money supply. This calls for continued financial sector reforms.
- In addition, institutions to increase absorption capacities of donor recipient economies should be strengthened, as these would increase value for money. Increased absorption and value for money would also lower the cost of doing business and ultimately contribute to factor productivity. These gains would on their own increase the profitability of the producers without requiring depreciation in the exchange rate.

Appendix Table 1.1: Summary of the impact of the Shilling appreciation on Uganda's major export sectors

Export sector	Export earnings 2003/04 (US\$m)	Impact on exporters/ processors	Impact on Rural farmers	Break-even exchange rate (U Sh: US\$1)
Tourism	214.3	<p>Large-scale multinational establishments: Minimal impact on profitability due to high import share of input costs (hedged against adverse exchange rate movements).</p> <p>Small-scale establishments: Reduced profitability for establishments with US\$ revenue (lower Shilling revenue) and small import share of input costs (minimal offsetting reduction in Shilling input costs).</p> <p>Uganda Wildlife Authority: Large share of income received in US\$ and small import share of input costs offset by ability to increase prices (price-maker) and maintain operating surpluses.</p>	-	1,446
Fish	118.1	<p>Reduced profitability due to low import share of input costs, inability to reduce landing site prices (need to utilise processing capacity), inability to hold stocks and constrained by contractual agreements.</p> <p>Reduced competitiveness vis-à-vis Kenya and Tanzania (currencies have depreciated against US\$).</p>	Minimal/ no reduction in landing site prices. (Fisheries Department at MAAIF has deliberately promoted the expansion of processing facilities to increase demand for raw fish and ensure fair prices for fishermen)	1,760
Coffee	114.1	<p>Productivity enhancing measures such as increased availability of seeds and fertilizers, progress in planting practices, and the replacement of old coffee trees with new, clonal ones with higher yields have had a cost-reducing impact on coffee production thus currently able to break- even.</p> <p>However, small short-term reduction in profitability due to low import share of input costs but exporters able to reduce farm gate prices (as coffee is a perennial crop and short/medium-term production is less price sensitive than other cash crops).</p> <p>Payment of lower farm gate prices in long-term will reduce quality and yields.</p> <p>Evidence that strong Shilling is discouraging investment.</p>	<p>Substantial reduction in farm gate prices (approx. 20% fall in Robusta farm gate price) leading to reduction in rural incomes and increase in poverty.</p> <p>Reduced incentives for current management and maintenance of crop and future production.</p>	1,604

Cotton	42.8	<p>Small short-term reduction in profitability due to low import share of input costs but exporters/ ginners able to reduce farm gate prices (few alternative crops to grow in cotton districts). However, world price projected to fall by approx. 30% in 2004/05 due to increased production in China.</p> <p>Payment of lower farm gate prices in long-term will reduce quality and yields.</p>	<p>Substantial reduction in farm gate prices (CDO indicative minimum price for 2004/05 50% lower than 2003/04) leading to reduction in rural incomes and increase in poverty.</p> <p>Reduced incentives for current management and maintenance of crop and future production.</p>	1,675
Tea	39.3	<p>Reduced profitability due to low import share of input costs, inability to reduce out grower prices (need to utilise processing capacity, labor unions and high cost of temporarily abandoning crop) and inability to hold stocks.</p> <p>Reduced competitiveness vis-à-vis Kenya (Kenyan Shilling has depreciated against US\$).</p>	<p>No reduction in out grower price due to presence of labor unions (infrequent negotiations and expectations of price increases).</p>	1,747
Tobacco	36.2	<p>Reduced profitability due to low import share of input costs and inability to reduce farm gate prices (farmers can switch between crops in tobacco districts, contractual agreements made with farmers with expectations of additional quality bonus and need to give price incentives to maintain and increase production to ensure viability of future investments).</p>	<p>No reduction in farm gate price due to contractual agreements and expectation of bonus for higher quality tobacco.</p>	1,750
Flowers	27.2	<p>Minimal impact on profitability due to high import share of input costs (hedged against adverse exchange rate movements) and strength of Euro (currency of export earnings) against US\$ (currency of large share of input costs).</p>	-	1,016
Maize	18.8	<p>Reduced profitability due to low import share of input costs and inability to reduce farm gate prices (farmers can switch between crops in maize districts and need to fulfill large contractual obligations).</p> <p>Reduced competitiveness vis-à-vis Kenya and Tanzania (currencies have depreciated against US\$), inability to compete at prevailing price despite high demand.</p>	<p>No reduction in farm gate price as maize production is highly price sensitive.</p>	1,756

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