Performance of the Economy, FY 2001/02

Introduction

The economy grew by 5.7 percent in 2001/02, equalling the rate of growth achieved in 2000/01. These growth rates have been achieved in spite of a significant deterioration in Uganda's terms of trade, whereby coffee export prices have declined by 55 percent over the past two years, with prices declining by 30 percent in FY 2001/02 alone. The fact that Uganda has been able to maintain the pace of its GDP growth in 2001/02 demonstrates the underlying strength of the economy and the positive impact of ongoing supply side reforms and policy initiatives, such as the drive to increase and diversify exports, on growth.

Whilst the economy grew by 5.7 percent, underlying inflation was contained at 3.5 percent on average during the year, which is within the Government's target of a maximum of 5 percent. Controlling inflation is a key objective of Uganda's macroeconomic management, and has contributed to a stable economic environment conducive to private sector investment, which in turn has sustained the level of GDP growth. Private sector investment rose by more than a percentage point of GDP in 2001/02, and now stands at 14.6 percent of GDP, almost double the level a decade ago.

The average Shilling/dollar exchange rate appreciated by 0.5 percent in 2001/02 compared to a 17 percent depreciation in the previous year. The Shilling faced appreciation pressures in the first half of the financial year, with the rate rising by 0.8 percent from its opening position, before depreciating by 5 percent over the second half. Treasury Bill rates rose at the beginning of the year, but then fell back to their lowest levels for over three years as a result of excess liquidity in the financial system. In spite of the excess liquidity, credit to the private sector grew by just 1.8 percent.

A. REAL SECTOR DEVELOPMENTS

Gross Domestic Product (GDP)

Uganda Bureau of Statistics (UBOS) has re-based its GDP series from 1991 to 1997/98 prices and improved its statistical methodology. Using the new methodology, real GDP is calculated to have expanded by 5.6 percent in 2001/02 against the target of 7 percent. The lower than targeted growth can be attributed in part to a below average performance from cash crops and manufacturing. Coffee production is yet to recover from the set backs caused by drought and the coffee wilt disease. Manufacturing production appears to have run into constraints imposed by the small size of the domestic market. Future rapid growth in the manufacturing sector will depend on the sector expanding into the export markets. Coffee prices fell by 30 percent in 2001/02 alone, and have fallen by 67 percent since 1997/98. Despite the terms of trade shock, economic performance in 2001/02 remained robust, with all sectors registering growth rates of above 4 percent. Transport and Communication remained the highest growing sector, at 10 percent. The growth in Mining and Quarrying, Construction, Electricity and Water was 7.8 percent, 6.6 percent and 6.4 percent, respectively.

In terms of contribution to GDP, agriculture remains the dominant sector, and accounted for 41 percent of total output in 2001/02. The sector grew by 4.8 percent last FY as compared to 4.6 percent in 2000/01. There was increased production in the food crops, cash crops, livestock, fish and forestry sub sectors. The increase in food crop production is due to good harvests following good weather conditions in most parts of the country, whilst the fish sub sector continued to benefit from the lifting of the ban on fish exports to the European Union. The GDP-by- sector performance for the last three years is shown in the table below;

Percentage Growth in Sectoral GDP

Sector	**1999/00**	**2000/01**	**2001/02**
Agriculture	5.6	4.6	4.8
Industry	3.1	6.5	5.7
Services	6.5	7.2	6.4
GDP at Market Prices	**5.3**	**5.7**	**5.7**

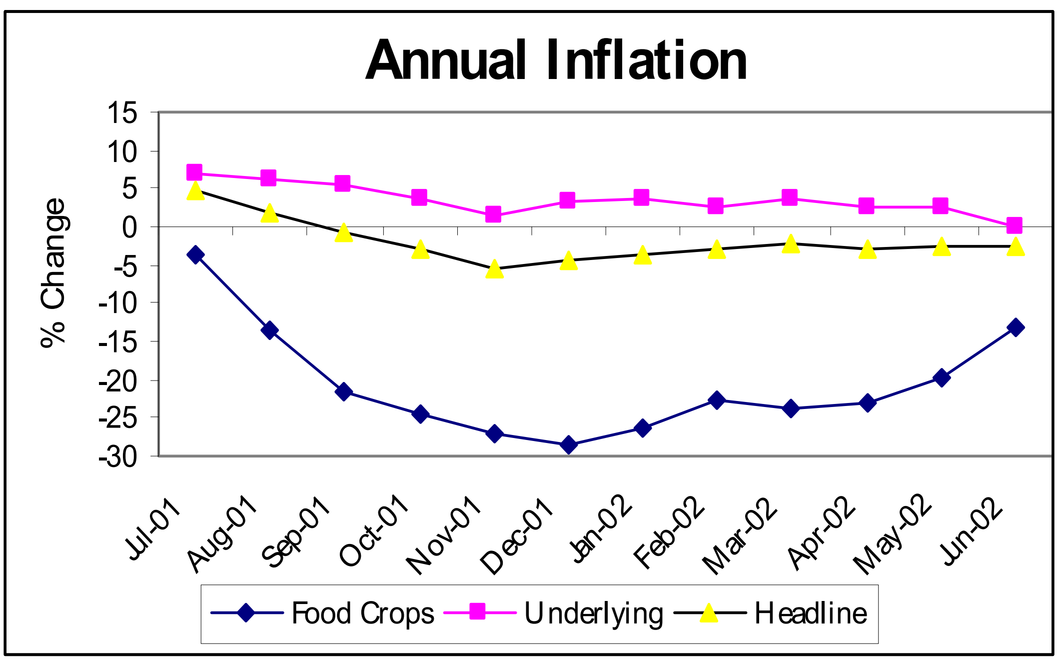
Investment

The restoration of macroeconomic stability since 1992 has created an attractive environment for the private business sector and enhanced private investors' confidence in the stability of the economy. In addition, investment in the rehabilitation of physical infrastructure has further boosted private investment in the country. As a result, private investment as a percentage of GDP increased from 8.5 percent in 1991/92 to 14.6 percent in 2001/02, while public sector investment has averaged about 5.9 percent of GDP.

The low levels of investment, despite an improvement in the investment climate over the last few years, can be attributed to a number of factors. These include the high cost and unreliability of infrastructure and utility services, the weakness and corruption in tax administration, the high cost of accessing capital, all of which lead to high production and transaction costs. In addition, insecurity, low technology, and the low labour productivity have resulted into high production costs. Consequently, the cost of production in Uganda remains high in comparison to the other countries in the region.

Inflation

Having ended the financial year 2000/01 above 5 percent, inflation consistently declined over the course of the 2001/02 financial year. Annual headline inflation was negative from Sept 2001 to June 2002, while annual underlying inflation was contained below 5 percent. Both headline and underlying inflation fell on a year on year basis from 5.9 percent and 7.9 percent respectively in June 2001 to negative 2.6 percent and 0.1 percent in June 2002. Average headline inflation for the financial year was negative 2.0 percent, whilst average underlying inflation was 3.5 percent. The annual inflation developments can be seen on the graph below;

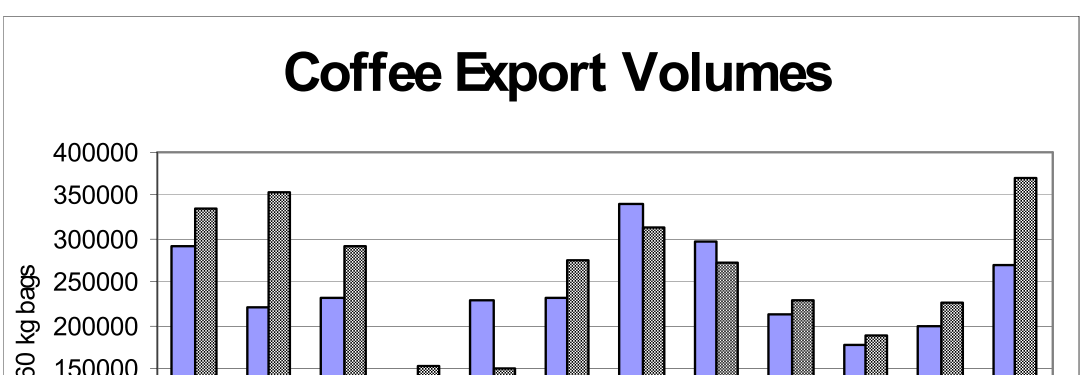


The scale of the reduction in headline inflation is largely attributable to substantial reductions in the prices of food crops since the beginning of the FY 2001/02, due to good rains and hence good harvests in most parts of the country; average food crop inflation for FY 2001/02 was negative 21 percent. The reduction in underlying inflation is attributable to relatively low price levels for certain goods such as manufactured foods, clothing, footwear materials, and services such as transport, as compared to the FY 2000/01. In addition, the appreciation of the exchange rate in the first half of the financial year and the stability in fuel prices during the period also helped ease the pressure on the domestic price levels.

Coffee Exports

Coffee export volumes over the financial year amounted to 3,155,721 bags, representing a 11.2 percent increase compared to the previous year, but the corresponding value of exports fell by 22.2 percent, as a result of a 30 percent decline in coffee prices over the financial year. Exports in FY 2001/02 totalled US$ 85 million at an average price of US$ 0.45 per kilo as compared to US$ 110 million at an average of price of US$ 0.64 per kilo in 2000/01. The increase in volumes can be attributed to good weather conditions and better crop harvests in the main growing areas. In addition, the relatively high price of coffee in the internal market as compared to the other produce such as matooke, acted as an incentive for the farmers to release previously held stocks. However, the international price remains low because global supply of coffee continues to outstrip demand.

The monthly comparison of coffee exports by volume, for FY 2000/01 and FY 2001/02 can be seen in the graph below;



Non-Coffee Exports

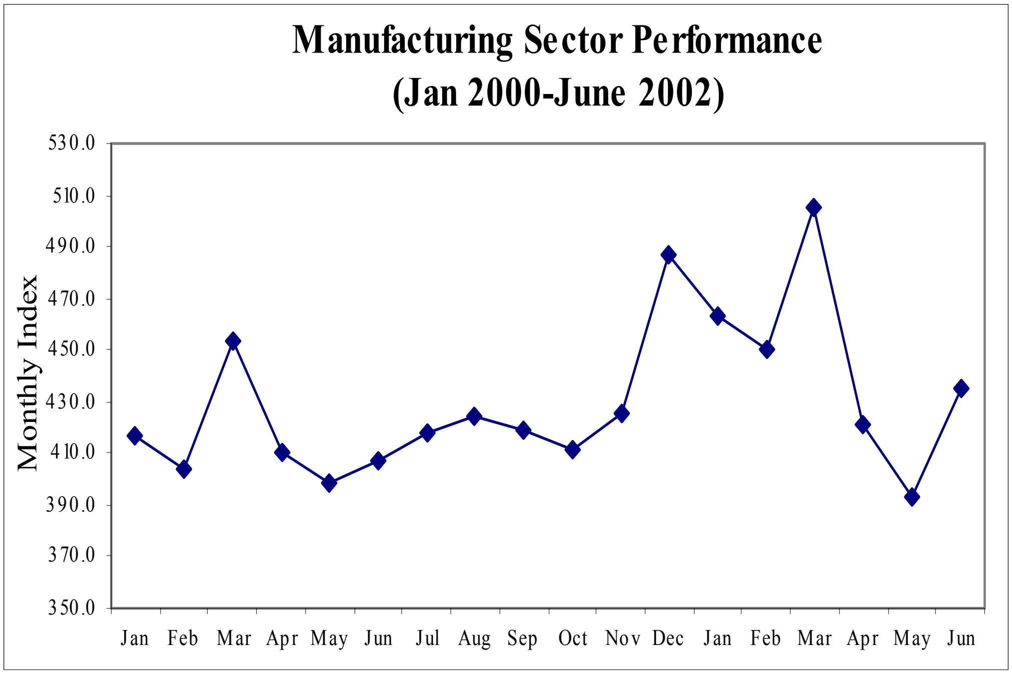
The strong performance of non-coffee exports continued during 2001/02. Exports of Maize, Cotton, Tobacco, Fish, Hides and Skins, Simsim and Flowers, all increased markedly in both volume and value during the financial year. This indicates the export base is diversifying and the dependence on coffee for export earnings is being reduced.

Non-coffee export receipts in 2001/02 grew by 12 percent compared to the previous year. Maize export volumes performed particularly well, increasing by 282 percent to 113,000 metric tonnes between July 2001-June 2002. The corresponding value more than doubled from US$ 6 million in 2000/01 to US$ 14.8 million in 2001/02. This performance is attributable to increased demand for maize in Southern Africa following the drought conditions there together with the formation of a consortium of local grain traders to procure maize from markets in Uganda and export it to food deficit countries in Southern Africa. There were also strong performances by Cotton, Tobacco, Hides, Fish and Flowers, with export volumes increasing by 75 percent, 90 percent, 43 percent, 32 percent and 24 percent respectively, compared to FY 2000/01. The increase in Fish exports can be attributed to the rebound in the fish sub sector following the lifting of the ban on fish exports to the EU market last year, while the good performance by the other non-coffee exports is attributable to increased access to regional and international markets.

Index of Major Manufacturing Establishments

Production in the manufacturing sector is reviewed using the monthly Index of Major Manufacturing Establishments (IMME). There are 15 major establishments included in the Index, manufacturing 9 commodities namely: sugar, beer, soft drinks cigarettes, textiles, soap and oil, and cement. The establishments account for about 45% of all industrial production in the country. According to the latest index released by the Uganda Bureau of Statistics (UBoS), the performance of the manufacturing sector as measured by the index of industrial production increased, with the all-items index (excluding electricity) increasing by 6.9 percent between June 2001 and June 2002. The increase was largely driven by a 42 percent rise in the textiles sub group index, which accounts for 15% of the total index. The performance by the textiles sector can be attributed an increase in local demand for textiles, while the AGOA initiative has attracted substantial investments to the sector. There were strong performances by the soft drinks, cement and sugar sub groups, where the indices rose by 69.8%, 17.6% and 21% respectively. This is attributed to an increase in production levels due to a rise in consumer demand for these products. On the other hand, there was a decline in the production levels of beer, cigarettes and soap and oil, with production declining by 5.7%, 42.3% and 9.7%, respectively. The decline is attributed a scale back in production due to lower consumer demand and increased smuggling.

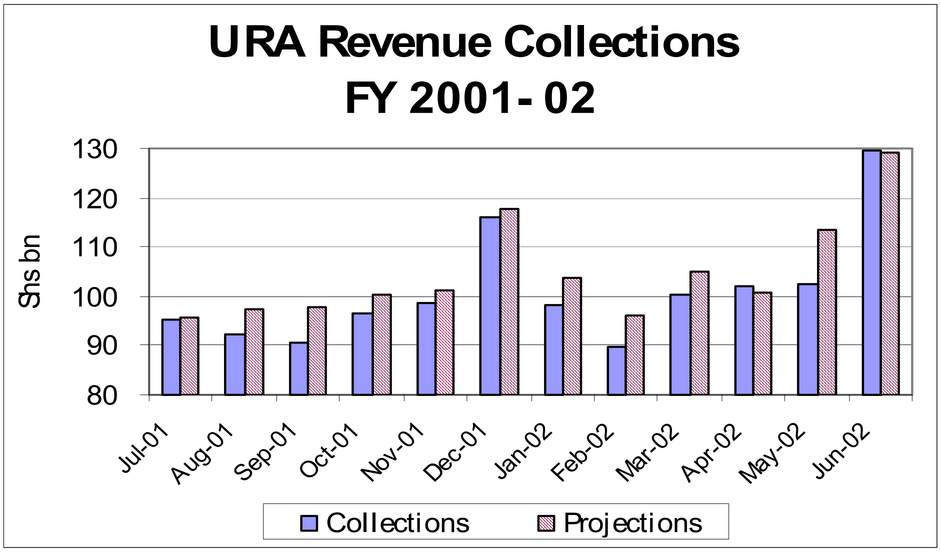
The graph below shows the monthly trend in the manufacturing sector as measured by the IMME for the period Jan 2002 to June 2002.



B. FISCAL DEVELOPMENTS

Revenue

Total URA revenue collections for FY 2001/2 amounted to Shs 1212.4 billion against the budget of Shs 1259 billion, leaving a shortfall of Shs 46 billion or 3.7 percent. Revenue collections were affected by the poor performance of non oil import duty, excise duty, and VAT on services and imported goods, caused by the removal of duty on raw materials and an appreciated level of the exchange rate relative to the projected level at the start of the FY, coupled with the inefficiencies in tax administration. However, the overall revenue collections were 12.8 percent higher than the previous year. The graph below is a monthly comparison of revenue collections for FY 2001/02 against the projections;



Income tax collections were above projections by Shs. 21.7 billion or 8 percent, with particularly strong performances by PAYE and corporation tax, which respectively were 19.3 percent and 37.2 percent higher than expected, whilst withholding tax performed as projected. The strong performance by Corporation tax is attributed to improved compliance by companies and is also a reflection of the robust economic growth seen during the FY. There was a weak performance by excise duties, particularly on imported goods, which were 12.2 percent below the projected level. This was attributed to smuggling, a lower than expected demand for excisable goods and an appreciated exchange rate relative to the budget. The performance of custom duties was fairly poor, at 89.4 percent of the projected level and was largely attributed to a dismal performance by tax on non-oil imports. Non oil import revenues were affected by the remission of duty on selected imported raw materials and an appreciated exchange rate, but were partly offset by a strong performance of import duty on petroleum products. VAT collections were almost in line with projections, at 99 percent of the projected collections. A strong performance by VAT on locally produced goods offset the weak performance by imports and services. VAT exemptions on hotels affected collections under this tax head.

Non Tax Revenue

Effective July 2001, non-tax revenue collected by Ministries/Departments and other Government agencies are no longer spent at source but remitted to the Consolidated Fund through the Treasury Office of Accounts (ToA). The cumulative non-tax revenue as reported by ToA for the FY 2001/02 amounted to Shs 41 billion, which was in line with the projections. However, this performance is attributable to larger than expected dividends from Bank of Uganda, supplemented by dividends from DFCU Ltd, Kinyara Sugar Works and New Vision, amounting in total to Shs. 24.4 billion. The non-tax revenue collected by Ministries and Government departments, performed below expectations.

Grants

Budget support grants performed below expectation in the last financial year. Out of the Shs. 487 billion expected, including debt relief through the Heavily Indebted Poor Countries (HIPC) initiative, Shs 401 billion, or 82 percent was received. There were several reasons for the shortfall in grants. Some donors delayed disbursement of earmarked sector budget support until certain sector specific issues are resolved, whilst other disbursements were delayed for reasons related to the donors' own internal processes. In addition, some of the pre conditions attached to certain grants were not fulfilled. This mainly affected grants to PAF, which performed at 72 percent of the budgeted level.

Project support grants were estimated at Shs 363 billion in 2001/02. The numbers remain estimates because the donors are yet to remit accurate outturn data on externally funded projects for the FY. However, Government is undertaking a comprehensive exercise of compiling project support and expenditure data, both outturn and projections, which will be incorporated in the sector ceilings in the MTEF and used to improve Government's estimates of its fiscal operations.

Expenditure

Total GoU expenditures and net lending amounted to Shs. 2,455 billion or 97.2 percent of the projected expenditure levels, of which recurrent expenditures amounted to Shs 1,224 billion, or 101 percent. This was attributed to over performances by the non-wage defence and statutory expenditures, compared to the budget. The overshoot in statutory expenditures was mainly due to expenditure pressures from the Electoral Commission and Parliament. However, this was offset by low than budgeted expenditures on interest payments and the domestic development budget. Total PAF expenditures amounted Shs. 593 billion, equivalent to 97 percent of the total PAF budget.

Government expenditure has expanded strongly over the last three years and has been supported by large increases in the levels of donor assistance, mainly in the form of budget support. The justification for increasing Government spending has been to strengthen public services and in particular, to expand basic social services such as primary health care and education, which make a direct contribution to reducing poverty. The rapid increase in Government spending coupled with the relatively poor revenue performance has widened the fiscal deficit.

The Budget Deficit

Because of the rapid increase in Government expenditures, the overall budget deficit before grants rose to Shs 1204 billion, or 11.3 percent of market price GDP in 2001/02, up from 10.3 percent the previous year.

Because the large deficit was financed through increased donor resources, it did not require any excessive domestic borrowing and therefore did not jeopardise the inflation goals. However, this has led to an increase in the amount of foreign exchange sold on to the domestic foreign exchange market to sterilise the money created by increased Government spending out of donor funds. Because the BoU is constrained by the amount of foreign exchange it can sell – due to the risk of misalignment of the exchange rate and the effect on the competitiveness of the exports sector – the burden of sterilisation has been borne by Treasury bills.

Financing

External financing amounted to a net borrowing of Shs 482 billion, or 58 percent of the programmed level. This is attributable to delays by the World Bank and the African Development Bank in disbursing the projected budget support loans. The PRSC II was later presented and approved by the Board of the IDA while the ADB loan proposal is yet to be presented to their Board for approval. Consequently, Government borrowing from the domestic banking system in 2001/02 amounted to Shs 36 billion against a programmed saving of Shs 324 billion. This was due to lower than programmed disbursement of budget support and a larger than programmed run down of the check float.

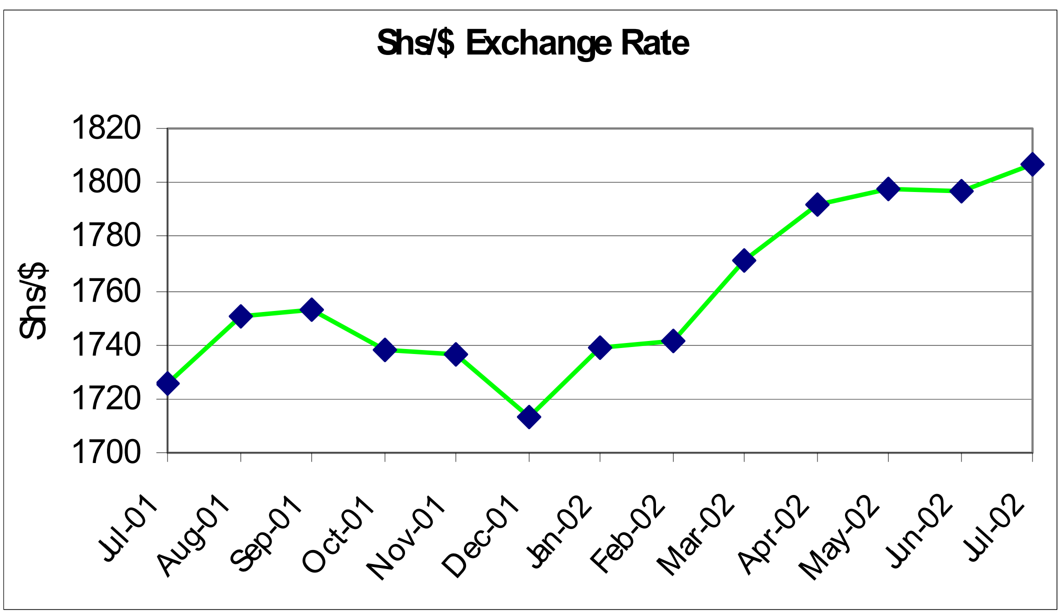
C. MONETARY DEVELOPMENTS

Exchange Rate

The exchange rate faced appreciation pressures in the first half of the 2001/02 financial year, but then depreciated in the second half, such that on an annual average basis, it remained stable, appreciating by 0.5% as compared to 2000/01, from Shs 1763/$ to Shs 1755/$. Having ended FY

2000/1 at Shs 1723/$, the exchange rate appreciated to a monthly average inter bank mid rate of Shs 1726/$ in July as a result of strong Bank of Uganda (BoU) intervention on the sell side. The rate depreciated to Shs 1753/$ by the end of the first quarter as the inter bank foreign exchange market corrected for the overshooting that took place in July 2001. However, the prevailing market conditions of weak corporate demand for dollars coupled with BoU intervention and stronger non-coffee export receipts led the Shilling to appreciate again in the second quarter, with the inter bank mid-rate ending the first half of the financial year at Shs. 1713/$.

The developments in the foreign exchange market over the FY can be seen in the graph below;



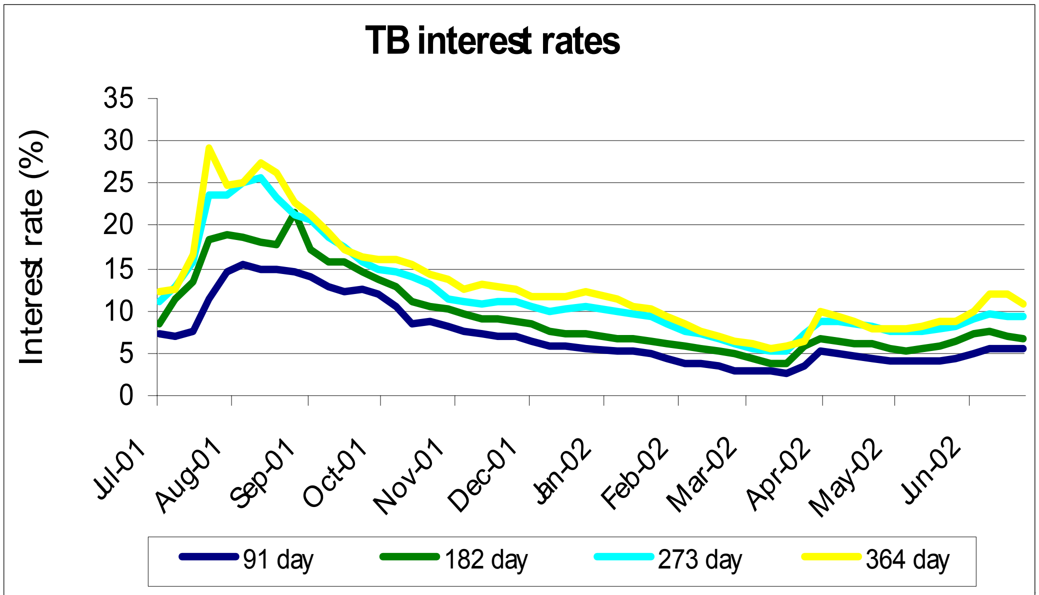
The appreciation trend was reversed during the second half of the financial year, as a rebound in corporate demand for dollars amidst a limited supply, led to a sustained depreciation of the exchange rate. Consequently, the average inter bank mid rate depreciated by 4.9% during the second half of 2001/02 and ended the FY at Shs.1797/$. With limited sources of dollar inflows, the foreign exchange market relied heavily on the Bank of Uganda (BoU) intervention for dollars. Over the course of the financial year, BoU interventions in the forex market amounted to US$ 198 million and were aimed at eliminating volatilities in the foreign exchange market and mopping up liquidity.

Domestic Money Market and Interest Rates

Treasury bill rates ended 2000/01 at their lowest levels of the financial year. However, as liquidity conditions tightened at the start of 2001/02, the money market rates increased considerably in the first six weeks of the new financial year and remained high throughout much of August. The rate on the benchmark 91-day TB rose from 5.7 percent in June 2001 to 15.3 percent in August 2001, whilst the rate on the 182-day, 273-day and 364-day papers rose from 8.8 percent, 10.9 percent and 11.3 percent in June 2001 to 21.5 percent, 25.7 percent and 29.2 percent, respectively in August 2001. Thereafter, these rates gradually declined over the course of the financial year as liquidity conditions eased in the market. The rates rose in April 2002, with quite sharp rises in the 273 and 364-day papers. Consequently, the 91-day TB ended the financial year at 5.64%, just below the level seen at end June 2001, whilst the longer-dated 364-day rate was 10.76% compared to 11.26% at the end of June 2001.

In response to the decline in TB rates, commercial banks' shilling denominated lending rates declined over the course of FY 2001/02, with prime lending rates falling from an average of above 20 percent at the start of the financial year to between 12 percent and 15 percent in June 2002. The decline in the prime lending rates may also be partly attributable to increased competition in the financial sector following the Bank of Uganda's successful resolution of its intervention in UCBL.

The trends in the TB interest rates, over the FY can be seen in the graph below;



Bank of Uganda's net issuances of securities amounted to Shs 288 billion during FY 2001/02, an increase of 59 percent on the previous FY. The rapid increase in TB sales was aimed at mopping up the liquidity generated by GoU expenditures out of donor resources, to avoid an excessive rise in money supply. As most of the TBs are held by commercial banks, this has constrained the volume of funds available for funding bank lending to the private sector and this partly explains the dismal performance by private sector credit last FY.

Base Money and Broad Money

Base money as at end June 2001 stood at Shs 553.6bn, or 6.5 percent above the desired base money path. The desired base money path refers to the level of base money which is projected to be consistent with the targets for broad money aggregates, and by implication for the 5 percent inflation target. On average, the level of base money remained 5 percent above the desired path during 2001/02, although it dropped back towards the desired level right at the end of the FY. Base money ended the FY at Shs 633.5 billion, an increase of 14.4 percent over the June 2001 level. The growth in broad money aggregates was consistent with the overshoot in base money, as the multiplier remained stable for much of the year. Consequently, M3 growth was 22 percent as compared to the projected growth of 15 percent.

The persistent overshoot in base money during FY 2001/02 is likely to have a lagged impact on the level of underlying inflation although it remains to be seen how large the impact will be in the first half of 2002/03.

Credit to the Private Sector

Credit to the private sector (PSC) by end June 2002 stood at Shs. 646 billion, which was Shs 11.5 billion, or 1.8%, above the June 2001 level. Whilst foreign currency denominated loans extended by the commercial banks grew by 31.6%, shilling denominated lending by commercial banks declined by 5%. The low overall growth in PSC is partly attributable to the high level of risk averseness amongst commercial banks with respect to private sector lending, and also due to changes in prudential regulations regarding classification and provisioning for bad loans. In addition, the amount of TBs commercial banks purchased as a result of the BoU's open market operations to sterilise GoU expenditures during FY 2001/02 reduced the commercial banks' scope for private sector lending. Commercial banks' holdings of Government Securities rose by Shs 265 billion during the financial year, whilst their levels of excess reserves remained almost unchanged.

D. EXTERNAL SECTOR DEVELOPMENTS

Overall Balance of Payments

According to provisional estimates, the current account deficit deteriorated from US$ 365 million in FY 2000/01 to US$ 475 million in 2001/02, reflecting Uganda's widening trade deficit. The continued decline in the current account is due to the fall in the value of coffee exports and an increase in imports. However, these factors were partially offset by increased private transfers, which remained buoyant during the financial year. The capital and financial account surplus improved from US$ 309 million in 2000/01 to US$ 475 million in 2001/02, mainly on account of increased loan disbursements and inflows of foreign direct investment.

Imports

Imports of goods increased by 10.2 percent to US$ 1.072 billion in FY 2001/02 compared to US$ 973 million in the previous FY. The increase in imports can be largely attributed to increased private sector imports. Private sector imports in 2001/02 increased by 7.3 percent to US$ 791 million while Government imports increased by 11.6 percent, over the previous year. Oil imports declined by 8.4 percent to US$ 125 million compared to 2000/01, while non-oil private sector imports increased by 10.8 percent. The decline in the value of oil imports can be partly attributed to a reduction in the international price of oil compared to the previous year.

Current Transfers

Total transfers, which include both private and official grants, are estimated to have increased from US$ 587 million in FY 2000/01 to US$ 598 million in FY 2001/02. The increase was due to increased net inflows of private transfers by 34 percent, to US$ 223 million compared to the previous year. Government transfers (including project grants) declined by 10.8% to US$ 375 million and this was attributed to the lower than programmed level of budget support.

Foreign Direct Investment

Investment is the key to stimulating growth and development. However, due to the low levels of national savings and high poverty rates, Uganda has continued to rely heavily on foreign direct investment (FDI). According to the World Investment Report, FDI in Uganda in 2001/02 amounted to US$ 229 million. Most of the FDI was directed towards the telecommunications and manufacturing industries.

The ability of any country to attract FDI is dependent upon a number of factors including the risk perception of investors, availability of resources and markets, infrastructure, and the capacity of Government institutions to assure certainty and predictability of the business environment, including security of life and property. Most of these continue to be addressed through the MTCS for the private sector.

External Debt Payments

During the year 2001/02, the Government's actual external debt payments – which exclude payments to IMF amounted to US$ 34 million in 2001/02 as compared to US$ 37 million in the previous financial year. The decline in debt repayments can be attributed to an increase in debt cancellation through the HIPC initiative.

The debt service/exports ratio declined from 15 percent in 2000/01 to 12.2 percent in 2001/02. The nominal external debt stock as at end June 2002 was US$ 3.1 billion or 52 percent of market price GDP.

HIPC Relief

The expected HIPC relief - excluding IMF - during the period was US$ 77.6 million but the actual relief realised was US$ 80.7 million. The performance can be attributed to increased debt cancellations through the HIPC initiative. The relief was channelled through the budget to the poverty reduction sectors, which directly contribute poverty reduction.

Exceptional Financing

Because some non-OECD creditors are currently unwilling to extend debt relief on HIPC terms, their loans are not being serviced, in line with the commitments that Government has made to all its creditors under the HIPC Initiative. Therefore, all maturities due to these creditors are not paid but are recorded as exceptional financing. Exceptional financing for the FY 2001/02 amounted to US$ 30 million.