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Kenya and Uganda: An Assessment of Macroeconomic and Debt Sustainability Prospects

Summary

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Kenya and Uganda: An Assessment of Macroeconomic and Debt Sustainability Prospects

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Summary

I. Kenya

1. **After a long period of stagnation, Kenya achieved an impressive economic recovery with accelerating growth rates during 2003-07.** This recovery was broad based across sectors, and supported by a stable political environment, macroeconomic stability and slow but encouraging progress in structural reform (particularly in public finance management, privatization and regulatory reforms). Growth was accompanied by rising trends in the ratios of savings and investment to GDP and substantial growth in exports, tourism receipts, inward private remittances and inflows of foreign direct investment (FDI). Kenya was also able to appreciably reduce its external public debt (through net repayments) and increase its gross official foreign reserves. Unlike its neighbors – Tanzania and Uganda – this impressive economic performance was achieved without any debt forgiveness and with little or no foreign aid (due mainly to continued donor concerns about pervasive corruption).

2. **Unfortunately, soon after the December 2007 Presidential elections the economy was buffeted by a combination of external and domestic shocks.** Dispute over the election results led to a political crisis marked by widespread violence that triggered severe economic dislocation. Poor rainfall caused a severe drought, which sharply reduced agricultural output and hurt the livestock sector. Subsequently, the global financial turmoil and economic slowdown has led to declines in exports, tourism receipts, inflows of private remittances and net capital inflows (especially FDI). These shocks have caused sharp drops in savings and investment ratios to GDP, weakened the external current account and the external reserve position. As a result of rising fuel and food prices, the external terms of trade declined, and inflationary pressures-- already aggravated by the drought and the lagged effects of lax monetary policy-- reached high double-digit levels.

3. **Thus far the international global crisis has had limited impact on the banking system and the capital market.** The authorities have succeeded in strengthening significantly the financial soundness of the banking sector over the period 2002-2008. Bank capital increased well above the recommended minimum (of 8 percent) and the ratio of non-performing loans to total loans has declined.

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Nonetheless, the quality of the loan portfolio is likely to deteriorate somewhat for banks exposed to the export and tourism sectors. Although the effects of the economic downturn are not as yet reflected in the available banking data, the latter do suggest that the banking system may have strengthened its ability to cope with future adverse developments due to the improvements observed through 2008. In the capital market, equity prices fell by some 40 percent in the second half of 2008 as portfolio investor confidence declined. While broadly in line with developments in major international exchanges, developments on the Nairobi exchange was also influenced by allegations of fraud among certain stockbrokers. The exit of foreign investors from the stock market was particularly pronounced in the last quarter of 2008. More recently, stock prices have trended moderately upwards.

4. **Although a coalition Government has been in office for some time, internal dissension appears to have stalled decision making on key issues such as constitutional reform and accountability of senior political figures for the post-election violence.** Uncertainties resulting from this as well as continued concerns about corruption have made it difficult for Kenya to mobilize external donor support for its economic recovery strategy (ERS) and public investment program (IP). The political situation is also clouded by the risks of regional conflicts in Somalia and potentially also in Sudan. The former could lead to an increase in the influx of refugees and armed thugs that would disrupt both the already scarce supplies of food and firewood and worsen the law and order situation. The latter would disrupt Kenya's exports of manufactured and agricultural products to that country.

5. **On the economic front the authorities face several daunting challenges.**

- With the slump in the economy and domestic savings and investment, there is a pressing need to increase public expenditures for health, education, key infrastructure and domestic relief operations in areas affected by the drought and the post-election violence. Unfortunately, resources are lacking for two reasons. First, given the weak growth environment for 2009/10 it was not considered prudent to have any increase in tax rates or in non-tax rates; in fact there were selective reductions in some excise and customs duty rates and some food grain products were exempted from VAT. Second,

there is little or no firm commitment that larger amounts of foreign aid would be forthcoming to meet the needs of Kenya.

- As the existing inflationary pressures have been aggravated by the depreciation of the exchange rate in recent months, the monetary authorities are facing the difficult task of dealing with two conflicting objectives – stimulating economic recovery and reducing inflationary pressures. This task has been made even more difficult by a rising fiscal deficit and the resulting increase the domestic public debt.
- The coalition Government needs to address more actively in a united endeavor to act decisively on several issues. These include further credible actions to tackle corruption at high levels, press ahead with the privatization program and fast track regulatory reforms to boost investor confidence and reduce the costs of doing business.

6. **If the coalition Government can be nudged by domestic civil society groups, responsible elderly statesmen, African leaders and the international community to forge a more cooperative governing team, Kenya has the potential to stage another impressive economic recovery.** We see this potential recovery for the following reasons:

- There could be progress in implementing pending structural reforms as was the case during the last period of political stability (2003-07).
- Some measure of confidence would return with progress towards political stability and that could complement the effects of reforms to trigger the recovery of FDI inflows, inward private remittances and tourism receipts.
- The hesitancy of donors to be forthcoming with aid commitments would most likely be somewhat reduced, more so if some measures are also taken to deal with corruption. Indeed, even if some donors initially responded by providing the necessary support for capacity building and technical assistance in key areas of public sector project management (for example, the evaluation, selection, implementation and monitoring of essential infrastructure projects), progress could be made towards alleviating key bottlenecks to launching infrastructure projects.
- As ratios of GDP, exports and revenues, Kenya's external debt stock (in present value terms) and debt service payments are currently relatively low (in fact, well below the

relevant policy/CPIA- based thresholds for these indicators used for IMF/IDA DSAs). Hence, there is certainly ample scope for donors to provide concessional loans, particularly if the institutional capacity for productively using the increased resources can be concurrently developed.

7. **Assessments of Kenya's macroeconomic medium- and long-term outlook have had to be repeatedly revised by both the Kenyan authorities and the IMF, given the uncertainties surrounding the severity and duration of the global financial turmoil and economic slowdown.** Initially, the Government had formulated an ambitious long-term investment program in the context of its Vision 2030 plan. It envisaged raising the investment/GDP ratio to 32.6 percent and the savings/GDP ratio to 27.7 percent by fiscal year 2012/13 to achieve a growth rate of 10 percent by that year. The implicit ICOR (the incremental capital-output ratio) was assumed to be only 3.3 based on projected gains in productivity due to infrastructure investments and structural reforms aimed at developing the private sector. The external current account deficit would be reduced by 2 percentage points to 5 percent over the same period. Inflation would be reduced to 5 percent by 2009/10. Once the authorities had assessed the effects on the economy of the post-election crisis, the drought and the global economic slowdown, they prepared much less optimistic macroeconomic forecasts, including a 6 percent growth rate underpinned by much lower ratios of savings (19 percent) and investment (23.3 percent) to GDP. The revised growth forecast implied a noticeably higher ICOR (of 4.3). Although the IMF's initial macroeconomic forecasts in its 2008 DSA were roughly in line with the authorities' revised forecasts, it made major revisions to its macroeconomic forecasts for the 2009 DSA. Its May 2009 forecasts for the ratios of investment, savings, exports and imports to GDP were noticeably lower than those used for its previous (2008) DSA exercise.

8. **Faced with the same uncertainties, we were cautious in developing our baseline macroeconomic scenario which differs from the IMF** in the following respects:

   - Our growth forecasts are lower because the long rains in April to June 2009 have been poorer than earlier expected and as a result agricultural recovery will be hurt.

- We expect the global economy to be somewhat weaker than earlier expected (in line with IMF and World Bank assessments). This is likely to result in slower growth rates in exports and real GDP and hence, a slower pace of economic recovery than assumed in the IMF scenario. We expect higher current account deficits than in the IMF DSA, even though we have assumed a slower growth rate of imports in line with our lower GDP growth assumption.
- Finally, while the IMF assumed a moderate depreciation of the Ksh against the US dollar (to about Ksh84/$) in 2009 it projected a subsequent appreciation of the Kenyan Shilling to Ksh 74.3/$. We have used the more depreciated exchange rate throughout the projection period in our scenario. In deciding to do this we took into account several factors including (i) emerging cost pressures in the coffee sector, (ii) the non-negligible cumulative real effective appreciation of the exchange rate (even if one applies a reasonable discount to the over-estimated domestic inflation data), and (iii) the pressures on the exchange rate that are very likely to arise due to the generally weak outlook for the external current account, FDI and other private and official capital inflows in the current global environment. In these circumstances, the authorities would have to imprudently use its foreign reserves to defend the exchange rate against likely market pressures. We have assumed that the authorities will not try to defend the rate against market pressures. (This being said, under Kenya's managed floating rate system, an appreciation of the exchange rate would be considered a normal outcome if the external current and capital were to improve noticeably.)
- We project larger budget deficits during 2011-12, because we expect expenditure/GDP ratios to remain high as a result of populist expenditure measures emerging in the years leading up to the 2012 elections.

9. **Despite the above differences in baseline scenarios, we agree with the IMF/IDA assessment that Kenya faces a low degree of debt distress.** This is because in our less optimistic scenario the time paths of all projected external debt indicators are well below the applicable CPIA-based thresholds under the baseline as well as the alternative scenarios and related stress tests. Accordingly, the notable difference between our and the IMF's DSA results is that the external DSA results show that over the projection period (2009-29)

the key debt stock ratios to GDP, exports and revenue, and the debt service ratios to exports and revenues resulting from our baseline scenario are all generally higher than those resulting from the IMF baseline scenario. The same is true for the alternative scenarios and stress tests. This is because in our scenario the time paths for the growth forecasts are lower, the ratios of the fiscal deficits and external deficits to GDP are higher, and the exchange rate is more depreciated.

10. **In general these results suggest that the Government has a very manageable external debt burden.** This is mainly because it has had very limited support from the international donor community and has made net repayments over the years. Also, most of its debt is owed to multilateral and bilateral official creditors; only about 2 percent is owed to commercial creditors (basically disputed claims that are currently under negotiation). As a result, the average interest rate is very low, and the average grace and maturity periods are fairly long reflecting the highly concessional terms of loans from bilateral and multilateral creditors. Consequently, the external debt service burden is quite low. As Kenya's external debt burden was assessed to be sustainable, it did not have access to HIPC and MDRI debt relief. It is also worth noting that, the currency composition of the external debt is well diversified.

11. **Kenya has an ample margin for new foreign borrowing.** Since the relatively positive results of both our and the IMF's external DSAs were obtained after including a long stream of annual drawings of commercial foreign loans, it is worth noting that reasonable amounts of commercial foreign borrowing would not jeopardize Kenya's debt sustainability. Nonetheless, the justification for such borrowing would need to be carefully assessed with due regard to exploring less costly alternatives. We assessed the impact on the external DSA results of replacing the annual amounts of commercial loan disbursements with similar amounts of concessional Yen loans (with the same disbursement profile). The latter would yield some savings because the time paths of the debt stock and debt service indicators with commercial loans included in the DSA are noticeably higher than the corresponding time paths of these indicators derived with yen loans replacing the commercial loan.

12. **While Kenya's external debt burden is clearly very manageable, the results for public debt sustainability suggest some need for caution in managing the total public debt (including both external and domestic).** This is mainly because a relatively large share of revenues is being used for debt servicing at the expense of development outlays. Both commercial foreign borrowing and domestic borrowing (which is all on commercial terms) would increase debt service payments more than an equivalent amount of concessional foreign borrowing. There is also some need to be cautious in increasing the domestic public debt so as to avoid pushing domestic interest rates to levels that would begin to crowd out the private sector. It is also worth noting that the domestic debt service burden may worsen when (i) there is a final determination of the contingent liabilities for 24 parastatals and the National Social Security Fund (now being studied by a consultant firm), and (ii) the Government decides on steps to deal with the accumulated claims against the Government's pay-as-you-go pension scheme for civil servants. In these circumstances, it would make sense to adopt some prudent fiscal guidelines for public sector borrowing.

13. **These guidelines could usefully focus on sound management of public debt and public expenditure:**

- Foreign borrowing, especially commercial foreign borrowing, should be justified in terms of their contribution to productive or productivity-enhancing projects, and accompanied by adequate safeguards against the misuse of funds.

- It would be important for the authorities to persevere with their efforts to improve efficiency of public expenditure and revenue collection, and better prioritize the use of existing public resources.

- Relying on concessional foreign borrowing could provide multiple benefits for Kenya. In addition to providing concessional financing for projects, donors could assist with capacity building and technical assistance to address the absorptive capacity constraints and develop the project management institutions and skills that Kenya needs. Access to concessional assistance would also help Kenya's efforts to prudently manage the domestic public debt, as it could be helpful in containing upward pressures on domestic

interest rates, improving public debt dynamics, increasing the fiscal space for priority public expenditures, and avoiding "crowding out" the private sector.

- Kenya's foreign borrowing should be consistent with its Medium-term Budget forecasts and Development Expenditure Programs. This is essential because they provide a framework for effective coordination among government, donors and creditors and for mobilizing the necessary financing from the international donor community.

- Finally, Kenya would also have to guard against the risk of falling prey to private lenders who might find it opportune to benefit from free-riding (by lending on non-concessional terms while IDA and bilateral creditors are disbursing concessional loans). To address such free-riding concerns, consideration should be given to putting in place an appropriate legal framework that provides clear criteria for limiting the public sector's access to non-concessional loans from either commercial or official creditors.

14. **While the Government sees a need to substantially scale up its development spending, it faces significant institutional and capacity constraints to achieve such a scaling up.** It needs to (i) build an adequate capacity to assess the viability of potential public investments, (ii) establish a value-for money function within the government, (iii) develop the skills and internal governmental processes to ensure that project selection is based on a careful cost-benefit analysis, and (iv) put in place well trained staff who can manage, monitor and evaluate the implementation of major development projects. Moreover, the capacity to implement some productivity-enhancing projects, especially large infrastructure projects, is often constrained by problems in mobilizing the required financing, engaging the necessary managerial and technical know-how and obtaining the appropriate policy assurances and regulatory safeguards required for their successful implementation.

15. **To address these constraints, Kenya could benefit from the following:**

- The authorities could approach the donor community, including the World Bank and JICA, to obtain the much needed support for creating the institutions and capacities for managing its development projects and programs.

- When there are constraints (as noted above) to implementing large productivity-enhancing projects, especially infrastructure, a joint involvement of the Kenyan Government, the private sector and official and bilateral donors could be an efficient way of addressing the constraints and moving ahead with the project. This is because the various stakeholders in the project can contribute to removing the constraints. Each participant in the project can contribute to the necessary financing and be involved in fair risk sharing. The Government can provide assurances regarding its policies with regard to the pricing of the services or goods derived from the project, and the regulatory environment. Private investors could provide a part of the financing as well as the managerial and technical know-how required for implementing the project. Multilateral development financing institutions such as the World Bank could help the Government explore ways to use IFC, IDA and MIGA guarantees, and options for leveraging private finance for infrastructure investments. Bilateral official agencies could also help to catalyze financing from a variety of sources for such projects, if they are deemed to be a financially viable long term project.

- Kenya should work with the IFC to boost foreign direct investment in the private sector.

16. **In addition, Kenya should seek help from donors -- especially multilateral aid agencies -- who can provide concessional loans for not only financing public sector projects but also for supporting private investment.** The latter could involve the following:

- As noted above, such loans could facilitate much needed foreign direct investment through co-financing, equity participation and/or guarantees. This being said, because of perceived weaknesses of governance of many private sector entities in Kenya, it will be important to ensure that the private entities to be considered for such loans have strong internal governance, accurate and reliable accounting, and complete transparency.

- Such loans could catalyze funding from a variety of sources (potentially through syndicated lending, parallel lending and other forms of concerted international lending operations) for essential infrastructure and major sectoral and regional development projects.

17. **Given its large financing needs and the difficulties of mobilizing substantial resources in the current global environment, Kenya would be best served by adopting a balanced external financing strategy for its investment program.** In addition to mobilizing concessional foreign aid, this should include parallel efforts to encourage inward private remittances, and attract FDI through further improvements in the business environment and investment climate. These external resource mobilization efforts would have to be complemented by concrete steps to improve the efficiency of public expenditure and revenue mobilization, advance the privatization program, and boost domestic private savings.

18. **Kenya has a good payments record.** Following the Paris Club's 2004 debt treatments, the rescheduled claims including the rescheduled arrears were all fully repaid after the agreements on debt treatments were in place. Although Kenya's low-income level led it to be considered under the Enhanced HIPC initiative, it was deemed not to qualify because of the sustainable level of its debt. It has regularly met its obligations to creditors, except for disputed arrears to commercial creditors (of about $91 million at end-2008). These arrears stem from non-payment on commercial export credits for security-related contracts, many of which have been found by Kenya's Comptroller and Auditor-General to be fraudulent or deeply flawed (these projects are often referred to as the "Anglo-Leasing" scandal). The authorities disputed the validity of the claims based on the contracts not being fulfilled. To provide a basis for the resolution of the disputes, they are having an external audit done by PricewaterhouseCoopers to determine the value of the goods and services supplied.

II. Uganda

1. Uganda has been one of the best performing countries in Sub-Saharan Africa for several years. For the period 1997-2007, Uganda enjoyed a rate of growth of 6.6 percent versus an average rate of growth for Sub-Saharan African countries as a whole of 5.1 percent. In spite of a high rate of population growth (3.4 percent) Uganda's high rate of economic growth translated into improved living conditions and poverty reduction. Currently, on 31 percent of Ugandans live in poverty, as compared with a poverty rate of 55 percent in 1992. Uganda's economic performance was only slightly affected by the global crisis of 2008/2009. This crisis had the effect of slowing Uganda's rate of growth for the year 2008/09 from a rate of 7.4 percent originally anticipated to an estimated 7.1 percent.

2. This strong performance has been in the face of persistent imbalances, both internal and external. Uganda's investment rate, while improving in recent years, is still only about 24 percent of GDP. Much of this investment, roughly 40 percent, is financed by foreign savings. Similarly, Uganda has had a persistent deficit in its fiscal accounts, on the order of 6-10 percent of GDP. This deficit reflects weak domestic revenue mobilization, which has been only about 12 percent of GDP in recent years, and not excessive government spending. Government spending has remained at around 20 percent of GDP. The fiscal deficit has been largely financed by foreign assistance, though, requiring only limited recourse to domestic financing, less than 0.4 percent of GDP.

3. Uganda has also had a large deficit in its external accounts. The current account deficit (exclusive of grants) has averaged 7-9 percent of GDP in recent years. This deficit has, though, typically been offset by large transfers from abroad in the form of official grants and workers' remittances, and capital account surpluses resulting from drawdown of donor loans and credits. The result has been the accumulation of external reserves, which now stand at 7months import coverage.

4. Uganda's external situation was affected only marginally by recent international events. The main affects were a slowdown in export growth to the European and North American markets. However, this slowdown in growth was offset in part by strong growth of exports to regional markets which were relatively unaffected by the unfavorable international developments. In particular, Uganda enjoyed strong growth in informal exports (primarily foodstuffs) to neighboring countries, as these markets became more accessible. Exports of these goods rose 70 percent in value terms in the first three quarters of 2008/09. The crisis also had an effect on the capital accounts, leading to a withdrawal of short term capital which had been attracted to Uganda to invest in short term Government debt. This outflow did not affect commercial banks, however. The net effect of all these factors was a modest deterioration in Uganda's overall balance, by about $300 million, which was partly offset by a modest drawdown in international reserves. However, in recent months the situation appears to have stabilized and Uganda is reverting to its traditional position of reserve accumulation.

5. The external environment has had a more significant affect on Ugandan inflation. Inflation, which has been in the range of 5-6 percent, began accelerating in 2008 in response to higher fuel and food prices. The increase in food prices was exacerbated by the growing Ugandan exports of foodstuffs to neighboring countries. More recently, food price increases have been sustained by supply shortfalls due to unfavorable climatic conditions. The result is that inflation is currently running at 12-13 percent, well above the Government's 5 percent target. However, this inflation is expected to moderate in the coming year with the stabilization of fuel and food prices and the appreciation of the Ugandan shilling.

6. The Uganda shilling was also buffeted by external factors over the last year. After remaining roughly stable at 1500/1600 shillings to the dollar for several years, the exchange rate depreciated rapidly in the latter part of 2008 and the first part of 2009 to above 2000 shillings to the dollar, reflecting the reversal of short term capital inflows. However, as the situation stabilized, recent months saw an appreciation in the exchange to a level of

1800-1900 shillings to dollar. With Ugandan inflation relatively high, there has been a significant appreciation in the real exchange rate, which is now 25 percent above its level of 2000. To date this appreciation does not appear to have had a negative impact on Uganda's exports, given Uganda's strong export growth in sub-regional markets.

7. Uganda's financial system was largely unaffected by the negative external developments. This reflects in large part the lack of sophistication of this sector, which is dominated by commercial banks whose behavior is very conservative. Non-performing assets of the banking system are currently less than 5 percent of total lending.

8. Thanks to its consistently strong macroeconomic management, Uganda is well-positioned for continued strong growth over the medium term. Contributing to this is the recent discovery of significant oil deposits. While exploitation of these deposits is several years away and required some key policy decisions by the Government, notably the amount, if any, of the oil to be refined locally, these resources, if well-managed could give a further boost to Uganda's economic prospects.

9. The domestic political situation is generally stable and is dominated by President Museveni. While there are growing tensions between the Government and some key groups, notably the Baganda the dominant tribe in Central Uganda, they are not expected to be sufficient to lead to a regime change. However, the upcoming Presidential elections, scheduled for 2011 could be flashpoint for civil unrest which, depending on how it's managed, could affect Uganda's relations with the donor community.

10. Uganda's performance on governance indicators is mixed. While its strong macroeconomic management is recognized, it performs relatively poorly in areas relating to quality of public administration. In particular, corruption remains a problem, in spite of Government efforts to combat it. The quality of public administration is also a factor in

Uganda's relatively poor ranking in international indices of competitiveness. Here again, Uganda's ranking is in spite of persistent efforts to improve the business climate. There is a danger that improvements in this area may be limited both because of the complexity of the problems as well as the lack of urgency given the large oil revenues that are anticipated.

11. Uganda had a severe debt sustainability problem throughout the 1990s and the first half of the 2000s, which continued despite a long series of Paris Club rescheduling and considerable relief under the original and enhanced Heavily Indebted Poor Countries (HIPC) initiatives.

12. The restoration of political stability in Uganda during the late 1980s saw a substantial increase in the willingness of the international community to lend to Uganda to support reconstruction and recovery programs. In the initial years there was no effective strategy or discipline in the management of external debt. Much of it was poorly used as line ministries contracted new loans on their own behalf, often on unfavorable terms. At the same time, Government guaranteed loans, to various private sector players, whose subsequent failure to service these loans increased Government's external debt liability further. By the mid-1990s a debt management strategy started to emerge, which focused on obtaining highly concessional loans and grants. By the end of the 1990s donor support to the budget in the form of grants and concessional loans financed about half of Uganda's budget expenditure.

13. Serious debt sustainability problems continued during the period from1995-2003 despite the fact that a growing proportion of donor assistance was in the form of grants and Uganda received about one billion dollars in debt relief in net present value (NPV) terms under HIPC and the enhanced HIPC. Immediately following the second completion point, the export price of coffee dropped precipitously. This, combined with a considerable increase in new foreign loans resulted in the ratio of the NPV of debt to exports rising to 263 percent in 2003, and the ratio was projected to remain over 200 percent. Uganda started to follow a

policy of reducing its high fiscal deficits and its reliance on foreign assistance. Fortunately for Uganda, the Multilateral Debt Reduction Initiative had a major impact in reducing Uganda's debt and debt service by the end of the 2006/07 fiscal year. As a result, all of Uganda's debt burden indicators dropped well below their policy-based thresholds. The external public debt was reduced from US$ 4.5 billion (52 percent of GDP) at end 2005/06 to US$ 1.5 billion (15 percent of GDP) at end 2006/07; and as a ratio of exports, debt service on public external debt was reduced from 7.7 percent in 2005/06 to 2.2 percent in 2006/07. Although there was some increase in the dollar amount of debt in the next two years the above debt sustainability ratios continued to improve.

14. Both Moody's and Standard and Poor's now give Uganda a "B+" sovereign credit rating, which is the same as Ghana and better than the "B" rating given to a number of other African countries. They both indicated that this relatively strong rating was based on Uganda's strong economic growth rates, macroeconomic stability, low foreign debt levels, and good oil production prospects in the near future. The Ministry of Finance, Planning and Economic Development (MFPED) formulated its new foreign and domestic debt strategy in a paper issued in December 2007. This reflects the strategy of budget deficit reduction and reduced dependence on aid which the government began implementing in 2002/03. The overriding aim of the external debt strategy is to ensure medium to long-term debt sustainability. The second main objective is to ensure consistency between the level of external financing and the wider macroeconomic objectives of fiscal consolidation and reduced aid dependence. The third main objective is to achieve the desired level of external financing at minimum cost to Government. The fourth main objective is to prioritize borrowing for productive sectors. The preference for grants first and then concessional borrowing continues. The Government will continue to refrain from providing guarantees to private sector borrowing, except for infrastructure and in particular for the power sector and transport investment projects. Under the new debt strategy it is proposed to limit external project borrowing to the following priority sectors: Works & Transport, Agriculture, Water and Energy.

15. During 2011 and 2012, the Ugandan Government is likely to consider commercial borrowing to finance its investment in the development of the *oil* sector. Other countries in similar circumstances decided to make use of a sovereign bond issue to raise funds. The other major possibility would be to borrow from a commercial bank or a consortium of banks. The primary advantage of sovereign bond issue is that it might have a slightly lower total cost (interest and various fees) compared to borrowing directly from commercial banks. Its main disadvantage is that the minimum amount that can be efficiently marketed has been US $500 million and that this total amount must be taken at one time and also be repaid at one time. Uganda will probably not need this amount at one time and its investment earnings of the unused balance would be well below the interest cost of servicing the debt. In addition, as the time for the bullet repayment approached at the end of the maturity of the bond, the Government would need to start accumulating funds. The advantage of a borrowing from commercial banks is that it could be for a series of smaller amounts which would reduce the high cost of paying for money that was kept sitting waiting for the implementation of projects and less would have to be accumulated in anticipation of a bullet payment at the end of the maturity period. It would probably be possible to phase both the borrowing and the repayment to meet the Government's needs.

16. The guidelines on debt sustainability have focused entirely on formulating debt and debt service thresholds for foreign debt. Nothing similar has been formulated for domestic debt or total public debt. However, in its Debt Strategy Paper Uganda has formulated its own debt sustainability thresholds to provide some guidance for the medium term. It has indicated that the domestic debt to GDP ratio should be below 15 percent (currently it is about 10 percent) and that the domestic debt service to revenue ratio should also be kept below 15 percent (currently it is about 8 percent). Uganda's current domestic debt levels are relatively low and do not pose a debt sustainability issue. Uganda's debt levels would be easily sustainable even if the thresholds intended for foreign debt alone were to be applied to total public debt (See footnote 1 above).

17. Unpaid government bills for purchases of goods and services are in effect a form of government debt, although they have not been included in the measure of public debt. The Ugandan Government has recognized that pending bills or arrears are a form of debt which is particularly undesirable and has tried to reduce them. There was considerable progress in reducing the stock of arrears in 2008/09 and at the end of the year they were equal to less than 3 percent of total budget expenditure. Domestic arrears result from poor public expenditure management. The Government has attempted to address the problem of domestic arrears

through a number of public expenditure management reforms that include the introduction of the Commitment Control System (CCS), adoption of a prepayment system for utilities, and the introduction of an Integrated Financial Management System (IFMS). Despite these measures, there has only been modest progress in reducing arrears. The main problem has been the unwillingness of the PS/Secretary to the Treasury to make use of his powers to punish Administrative Officers in spending units who do not follow the appropriate budget procedures. However it is expected that there will be some improvement in curtailing new arrears as a result of the recently introduced performance contracts that were signed by all AOs.

18. Uganda's prospects of having 1-3 billion barrels of oil reserves and of benefiting from oil production for at least three decades starting in 2011 has significantly improved its macroeconomic outlook. The macroeconomic forecasts in our baseline scenario show significant improvements in key macroeconomic variables relative to the macroeconomic forecasts included in the IMF's last DSA which were prepared without including prospects of oil production. The most notable improvements relative to the last IMF/IDA DSA and the related baseline macroeconomic scenario would be:

- A surge in real GDP growth rates in the first decade of oil production and as a result significantly higher levels of nominal and real GDP.
- There would be higher levels of exports and substantial amounts of new oil revenues for the budget. There would be scope for higher rates of growth of public expenditure in real terms, to develop much needed infrastructure and build a stronger economic base.
- Reliance on foreign aid would be gradually reduced as a ratio of GDP.
- Even abstracting from likely oil production, the last IMF/IDA DSA had concluded that Uganda faces a low risk of debt distress. The key indicators for external debt and the total public debt as well as for the corresponding debt service burden would be improved considerably under a DSA that includes oil revenues in the baseline macroeconomic scenario. Uganda's external and total public debt would be even more sustainable than it was already without the oil. There would be ample scope for new foreign borrowing because all the external debt indicators would be substantially below the CPIA-based thresholds used under IMF/IDA DSA to assess debt sustainability.

19. To examine the impact of oil production prospects on debt sustainability, we developed a new baseline macroeconomic scenario, assuming that altogether about 1.8 billion barrels of oil would be produced over our projection period ending in 2028. We assumed oil production would rise from 15,000 barrels per day in 2011 to 440,000 barrels per day in 2028. In our baseline scenario we used an average of the CME futures price for Brent crude and the World Bank's considerably lower forecasts of oil prices, which yield a path of oil prices that would rise from US$ 71/barrel in 2011 (the first year of oil production) to US$ 93/barrel in 2028 (the end-year of our projection period).

20. Significant amounts of investments are likely to be made in the oil sector over the next 3 years for a pipeline, a refinery and other developmental outlays. Available information suggests that about US$ 7.5 billion is likely to be spent during 2011-2012 for the pipeline (US$ 3 billion), a refinery (US$ 3.5 billion) and other developmental outlays (US$ 1 billion). FDI inflows are assumed to cover fully the cost of the pipeline and a major part (US$ 2.8 billion) of the cost of the refinery, and the remaining costs of the refinery (US$ 0.7 billion) are assumed to be covered by the Government. While the oil companies are also assumed to cover a major part of the other developmental outlays, the Government is also expected to cover a portion (US$ 0.4 billion) of these outlays which would have to be included in the development budget and covered by budgetary resources (including financing). To finance its share of expenditure on the refinery, the Government is assumed to borrow abroad the amount of US$ 0.7 billion on commercial terms.

21. Our projections of oil revenues indicate that gross oil revenues increase from about US$ 441 million in 2011 to US$ 14,938 million by 2028 (which is close to the 2008 GDP of Uganda), and the Government's share of these revenues goes up from US$ 74 million in 2011 to US$ 10,380 million by 2028. We used preliminary information gathered in the field on the likely parameters of taxation for the oil companies, including rates of royalty payment, profit sharing , and a profits tax applied after deducting "cost oil" (to recoup past investment costs) and other production and operating costs. The oil sector's net cash flow

(left after deducting costs) increases from US$ 91 million in 2011 to US$ 13,691 in 2028. A major share of this (on average about 76 percent) goes to the Government.

22. To develop macroeconomic forecasts for the economy as a whole we used as a proxy for the non-oil economy the IMF's macroeconomic forecasts that were done without taking oil production into account, and combined these with our oil sector projections. One notable difference, however, is that whereas the IMF had assumed a gradually depreciating exchange rate throughout the projection period, we assumed that given the prospects of oil revenues, the exchange rate would appreciate from about USh 1937/US$ to USh 1300/ US$ by the end of the projection period (2028). Annually the nominal US dollar value of the Ugandan Shilling (USh) is assumed to appreciate by 2 percent. However, we project Uganda's inflation rate to exceed the US inflation rate by about 10.5 percent annually during 2010-11 and by about 3 percent annually over the rest of the projection period (2012-2028). Three key effects of our exchange rate assumption are noteworthy: the local currency value of a dollar of oil revenues shrinks as the exchange rate appreciates, and the latter has a dampening effect on domestic inflation and on relative price incentives for the tradable goods sector.

23. The notable trends emerging from our forecasts are the following:

- The share of oil revenue in GDP rises quite sharply in the first decade of production and then begins to decline. The real GDP growth rate (inclusive of oil revenues) reaches a peak of 12.4 percent in 2016 and then gradually declines to 5.4 percent in 2028. It initially rises and remains above the non-oil GDP growth rate until about 2020 and then trends below the non-oil GDP growth rate.
- The external sector forecasts show more sharply rising trends in the US dollar values of exports and imports of goods and services than the corresponding non-oil export and import projections (which are based on the IMF forecasts). After initial deficits, the external balance in goods and services (with oil related flows) improves sharply into

surpluses. The improvement is much more significant than the goods and services balance without oil. The current account balance reflects the same improvement.

- Oil revenues as a ratio of GDP are expected to rise for a decade starting in 2011 and then gradually decline. In addition, the reliance on foreign official grants is projected to decline as a ratio of GDP. These trends cause the total revenues to GDP ratio to rise initially and subsequently decline.
- Despite successive fiscal surpluses during 2016-26, the cumulative sum of the fiscal balances over the entire oil production period is a small cumulative deficit of USh 2,916 billion (0.8 percent of projected 2028 nominal GDP). This is mainly because of the deficits in the early years of the projection period when a substantial increase in public investment (for the oil sector and infrastructure) is expected.
- As Uganda's foreign donors are expected to continue to provide grants and concessional loans to cover a part of both the current and development expenditures included in the Medium-term Expenditure Framework (MTEF), the combined amount of these foreign aid inflows plus the projected domestic fiscal revenues would exceed total public expenditures from 2013 onwards. The cumulative sum of the resulting annual surpluses would total a net amount of USh 23,040 billion by the end of the projection period (6.5 percent of 2028 GDP). The cumulative sum of net foreign borrowing is USh 25,957 billion (7.3 percent of GDP)

- These surpluses could be used to reduce the stock of domestic debt or to build up the Government's assets position. Under our baseline scenario, a part of the cumulative surplus funds is used for the *net repayment* of domestic debt (about 3.1 percent of 2028 GDP) and the remainder for a net build up of assets (about 3.4 percent of 2028 GDP). **The former could include saving some of the surplus funds in an oil fund for future use.** A part of the surplus funds could also be used to increase the Government's assets position with the Bank of Uganda, which is essentially its working balances for budget operations, which normally increase as the budget increases.

24. Our external DSA results show that Uganda's external debt would remain sustainable throughout the projection period. The debt stock ratios rise initially as a result of the

commercial borrowing planned for 2011-2012, but all external debt indicators decline in later years and remain well below the CPIA-based thresholds even under the standard stress tests. The ratios of external debt service to exports and revenue are well below their respective thresholds under the baseline and the most extreme stress test.

25. *Under our baseline scenario, the key present value (PV) of total public debt stock ratios to* GDP and revenue decline sharply over the projection period. This result is significantly different from the results of the last IMF/IDA DSA which indicated that these debt stock ratios would rise sharply over the latter half of the projection period. The ratio of total public debt service to revenue declines steadily to about 10 percent, after an initial rise (which is due to the servicing of commercial foreign loans).

26. We looked at an alternative scenario that has the lower oil price forecasts of the World Bank, which are about US$ 10 /barrel below the path of the oil price in our baseline scenario. The *DSA with lower oil price forecasts showed the following:*

    - All the external debt indicators are somewhat worse than those from our baseline scenario; but all of the indicators are well below their corresponding CPIA-based thresholds.
    - Similarly, the total public debt indicators yielded weaker results than that derived from our scenario.

27. Finally, we looked at the issue of whether oil-inclusive scenarios yield lower and more sustainable debt indicators than the IMF's last DSA (which is based on a non-oil macroeconomic scenario). Our results show that the external debt indicators for the two oil-inclusive scenarios discussed above are far lower and better than those of the last non-oil baseline and IMF/IDA DSA. As regards the total public debt indicators, those derived from the oil-based scenarios are initially higher than those of the last IMF/IDA DSA but by 2018 the oil-based scenarios yield much lower indicators. The worse indicators of the oil-based

scenarios in the early years may be explained by the commercial borrowings and related debt service which are included in our DSA and not in the IMF/IDA DSA.

28. Our DSA results indicate that the commencement of oil production in Uganda – if well managed -- is likely to improve considerably what is already a sustainable and very manageable debt burden. In the new environment with oil, there would be scope for scaling up public spending as well as for saving for future generations. The main challenge would be **how to effectively use or spend the expected oil revenues and anticipated foreign borrowing in an efficient manner.** Public spending decisions will have to be phased and sequenced based on careful assessments of the absorptive capacity of the economy and the likely impact of public spending on economic growth. The authorities will need to strengthen the necessary macro analytic capacity to mange the burden that the spending of the oil revenue will impose on the domestic economy, including through inflation and the exchange rate. The considerations that would be important to making spending decisions would be the following:

- **Spending decisions in various priority sectors would need to take into account the respective sectoral capacity constraints,** including shortages in skilled labor and the adverse impact that supply bottlenecks in one sector can have on another sector. This would affect the likely pace at which each sector can absorb additional spending without encountering supply bottlenecks. For example, there is a need for infrastructure outlays to facilitate the development of the oil sector. One would also have to take into account the capacity to spend on imports and to get these imports into the country, which is itself a function of the sequencing and efficiency of infrastructure investments. If critical inputs are in short supply and cannot be replaced by imports or resources that are in abundant supply, Dutch disease effects are likely to be stronger.
- On the other hand, **public investments in (physical) infrastructure (in sectors such as roads, railways and energy) could increase the productivity of the private sector** and enhance the supply response of non-traded goods, and hence, moderate the Dutch disease effects and enhance growth performance. There would also be a need to make adequate provisions for current expenditure to support the projected increases in

investments over the medium term and to properly operate and maintain both the existing and the new facilities created by the public investments.

- The Government will have to send clear and **strong signals of its ability and firm commitment to ensure full transparency and disclosure of all the production sharing agreements signed with the oil companies and all the investment, production and financial operations of the oil sector, as well as to account for how *the increased revenues are spent. In addition, strengthening the institutions of* public expenditure management and public auditing and reducing corruption would be essential for ensuring that public sector resources are effectively channeled to productive uses. JICA as well as other donors need to urge the Ugandan authorities to take decisive steps to address these governance issues.**

In making their lending decisions, JICA along with other donors should follow up in the field to ascertain how the Ugandan Government is addressing these issues, because that will determine the structure, sequencing and overall effectiveness of government expenditures.

29. In addition to improving governance and public institutions, **strengthening the investment climate and developing the financial sector would help to encourage private investment and saving,** and thus help to expand and diversify the non-oil production base. The investment climate could be strengthened by improving the legal and regulatory environment and trade facilitation services. These efforts could stimulate both domestic and foreign investment (including FDI). Continued efforts to increase competition in the financial sector, improve its supervision, and expand and make financial services more accessible across the country would also be beneficial. **It will be important for JICA to take into account progress in these areas of private sector and financial sector development in deciding on its lending operations, because it will affect the long term economic growth and export prospects (especially in the non-oil sectors) , the resilience of the economy to adverse shocks and debt sustainability.**

30. There is a good case to maintain the existing level of foreign assistance as a percentage of GDP until significant oil revenue starts coming to the budget, which will probably be in

about 5 years. Substantially increased levels of foreign financing may be necessary for a few years in order to make it possible to obtain the huge oil revenue increases in the medium term. While most of the cost of investment in developing the oil and natural gas fields, the pipeline and the refinery would probably come from private foreign investors, it is likely that the foreign investors will desire some government participation in investment in such projects. Hence, the Government may need to raise something like one billion dollars for its share of investment in the oil sector during the next five years. It would need to borrow this money from some foreign source. Donor financing to cover the Government's share in what is essentially a commercial proposition is highly unlikely, and even if some donors may be willing to provide some financing for this purpose, it would probably be on a mildly concessional basis.

The other alternative would be to borrow in the commercial market through a sovereign bond issue or some form of consortium bank lending. Attempting to borrow large sums from the domestic market would be undesirable because it would significantly raise the already high interest rates on bank lending to the private sector.

31. In addition, Uganda confronts sizable domestic investment requirements, particularly in the infrastructure area, which will need to be addressed before the oil revenues start flowing in the medium term. Donor concessional financing for these would also be advisable.

32. Most important of all will be capacity building assistance aimed at improvement in the quality of the officials working on infrastructure project selection and implementation. This is a relatively weak area at present and in need of urgent strengthening before the Government greatly increases its expenditure in this area. It will also be desirable to help improve the quality of the civil service in general. At present, outside of macroeconomic management, Uganda performs poorly on indicators which relate to the quality of public administration. In about 5 years, Uganda will be able to afford a much more capable civil service, but it would be a mistake to wait until then to start the process of improving the

civil service. It is desirable to start doing this soon and to make this a major focus of donor assistance.

33. With the increasingly comfortable revenue situation there will be no need for domestic financing of the budget in the future. However, once the government spends the oil revenue it will be adding to the liquidity in the economy and there probably will be a need for the BOU to take offsetting liquidity absorption policy measures. As a result, the BOU will be forced to either permit an appreciation in the exchange rate or to increase the stock of government securities sold for monetary policy purposes. The fiscal cost of such sales will show up as an increase in the share of domestic interest payments as a percentage of GDP and of total budget expenditure. Over time the outstanding stock of government debt could become large relative to GDP and to government revenue. While these ratios could reach levels that have been considered to raise debt sustainability concerns, it is not clear that this will really be the case. This is because the Government will have growing levels of revenue from oil and the interest on its financial savings to meet this rising domestic interest cost contained in the budget. The sustainability of domestic debt also depends on the Government's stock of financial assets.

34. The current thinking of the Ministry of Finance policymakers is that it will be desirable to keep the total level of budget expenditure to GDP about the current level of 20 percent of GDP even when high levels of revenue from oil are forthcoming. The surplus oil revenue would simply be saved and invested outside the budget and outside the country, which would minimize the monetary policy problems. Thus, in their view an increase in budget expenditure for infrastructure investment as a percentage of GDP should be offset by a reduction in the current expenditure to GDP ratio. This conservative fiscal policy is likely to be difficult to sustain in the face of political pressures to simultaneously increase infrastructure investment and expand and improve social welfare expenditure on health and education.

35. In light of this, a somewhat softer version of the policy favored by the MOF officials is likely to be necessary, namely that the budget expenditure to GDP ratio should be increased only gradually. This gradual change is desirable in order to put in place the administrative talent to make and implement efficient expenditure policy decisions and to make it possible for monetary policy to contain inflation without excessive increases in interest rates on government securities and excessive and rapid appreciation of the currency.

36. Seeking the right balance between the inflation target and the interest rate and exchange rate adjustments necessary to achieve the desired inflation target is likely to become even more difficult in the future. One issue which will have to be studied is whether in the new circumstances the 5 percent inflation target will be optimal or whether policies which require some lower interest rate and exchange rate reduction but lead to a somewhat higher single digit rate of inflation could enhance private sector growth, employment and investment. Experience from other countries with inflation in the 5 to 10 percent range gives no clear guidance as to what is the optimal target. Uganda will probably need to undertake an iterative process of experimenting within this range to try to find the right balance.

37. Improving the quality of government expenditure and increasing the import content of expenditure would help to mitigate the adverse macroeconomic consequences of higher levels of expenditure to GDP. Increasing the share of infrastructure and maintenance of infrastructure investment relative to current expenditure will help to improve the productivity of private sector activity, provided the additional expenditures are productive. Improving the efficiency of all government expenditure, reducing corruption and improving the legal and regulatory environment affecting the private sector will all help to improve the competitiveness of the private sector. It will also be important to explore ways to shift government expenditure towards items with higher import content, without distorting the efficiency of budget allocations. Such expenditure reduces the need to put in place offsetting sterilization policies.

38. In the medium term the increase in oil revenue will make increases in non-oil tax rates unnecessary. However, it makes sense to continue to improve the quality of the tax administration that will ensure that taxpayers are treated equally and may also increase revenue somewhat. It is also worth considering whether there are tax structure changes that would have important incentive effects on the private sector. As indicated earlier the liquidity absorption policy of the BOU over the medium term is likely to continue to keep real interest costs of borrowing and investment relatively high and the exchange rate is likely to continue to appreciate. Thus it is worth considering what realignment of the non-oil tax structure would help the private sector. However, it should also be noted that there has been a trend in recent years to make domestic tax rates among the East African countries quite similar. Thus it would cause some concern about distortions if Uganda were to levy significantly different domestic tax rates.

39. It is useful to start thinking in advance how best to invest the surplus money that accumulates in a special Government oil fund. Most of the money will have to be invested in foreign financial assets because the domestic market will not be able to absorb such large sums. Maintaining a fairly high level of liquidity is important with regard to international reserves that may need to be utilized on fairly short notice. The oil fund will be able to invest in much longer-term instruments, which should enable it to get a higher rate of return. The options to consider in a well-diversified fund would be the following:

- Most of the money should probably be invested in a well-diversified portfolio of government securities issued by both major industrial countries and by third world countries (including African countries), which have higher returns and perceived levels of risk that are not too high.
- If Uganda ends up issuing its own foreign currency sovereign bonds at commercial market interest rates to finance investment in the oil sector, repurchasing some of these bonds in the market may be one of the best returns when Uganda has excess funds of its own to invest.
- Uganda may also wish to use some of its money to sell oil futures contracts to ensure that the Government has an adequate or more stable flow of revenue. Uganda may also wish

to purchase the common stock of prominent foreign corporations and some gold or other commodities.