

Part II Uganda

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Summary and Conclusions

Section I: Overview of Recent Macroeconomic Developments and Outlook

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, 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.

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.

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 7 months import coverage.

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.

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.

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.

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.

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.

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.

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.

Section II: Developments in External and Total Public Debt and Debt Management Policy

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.

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.

Serious debt sustainability problems continued during the period from 1995-2003 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.¹ 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.

¹ The World Bank's Country Policy and Institutional Assessment (CPIA) ranks Uganda as a strong performer. Debt burden thresholds for the latter are NPV of debt-to-GDP ratio of 50 percent, NPV of debt-to-exports ratio of 200 percent, NPV of debt-to-revenue ratio of 300 percent, debt service-to-exports ratio of 25 percent, and debt service-to-revenue ratio of 35 percent.

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.

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 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.

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).

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.

Section III: Macroeconomic Prospects and Debt Sustainability Analysis (DSA)

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.

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).

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.²

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 million in 2028. A major share of this (on average about 76 percent) goes to the Government.

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 US\$

² The production sharing agreements with the oil companies are not publicly available and were not accessible. Hence, it was not possible to validate our assumptions about the investments to be undertaken by the Government and the oil companies as well as our assumptions of the taxation of oil companies...

1937/US\$ to US\$ 1300/ US\$ by the end of the projection period (2028). Annually the nominal US dollar value of the Ugandan Shilling (US\$) 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 to 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.

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 US\$ 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 US\$ 23,040 billion by the end of the projection period (6.5 percent of 2028 GDP). The cumulative sum of net foreign borrowing is US\$ 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.**³ 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.

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 2011-2012,⁴ but all external debt indicators decline in later years and remain well below the CPIA-based thresholds⁵ 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.

³ Because the IMF/IDA DSA template does not have an explicit provision for saving in an oil fund, this is shown in our DSA as a reduction in domestic debt. It is highly unlikely that the Government would actually choose to reduce the amount of domestic debt from its already relatively low level.

⁴ The DSA includes commercial borrowing of US\$ 0.115 billion in 2009, US\$ 0.3 billion in 2011 and US\$ 0.4 billion in 2012. These loans are assumed to have a grace period of 1 year, a maturity period of 6 years and an interest rate of 8 percent.

⁵ The World Bank's Country Policy and Institutional Assessment (CPIA) ranks Uganda as a strong performer. Debt burden thresholds for strong performers are NPV of external debt to GDP ratio of 50 percent, NPV of external debt-to-exports ratio of 200 percent, NPV of external debt-to-revenue ratio of 300 percent, external debt service-to-exports ratio of 25 percent an, and external debt-service-to-revenue ratio of 35 percent.

Under our baseline scenario, the key present value (PV) of total public debt stock ratios⁶ 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).

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.

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).⁷ 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.

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

⁶ The total public debt stock includes both the external and the domestic debt.

⁷ The IMF's last DSA is in the IMF Country Report No. 09/79 of March 2009, which also includes the IMF Staff Report on the 2008 Article IV Consultation and Fourth Review under The Policy Support Instrument (PSI).

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 manage 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.

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.**

Section IV: Impact of Oil revenue on Donor assistance and the need for Domestic debt

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.

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.

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.

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.

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.

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.

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.

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.

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.

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.

Section I: Overview of Recent Macroeconomic Developments and Outlook

1. Recent Macroeconomic Developments⁸

(a) Growth performance

1. After several decades of civil strife, Uganda's economic performance turned around in 1987 with the coming to power of the NRM government. This government launched a program of economic reforms which focused initially on restoring macroeconomic stability and getting key price signals right (e.g., the exchange rate). The result was a sharp acceleration of economic growth which has been sustained for over 15 years. For the period 1997-2005, Uganda averaged real rates of growth in excess of 6 percent a year. In more recent years, Uganda's rate of growth has accelerated to over 8 percent a year in real terms. These rates of growth have made Uganda one of the best performers in the sub-region as well as in Africa as a whole (see Table below):

Section I Table1

Real Rates of Growth of GDP for Selected African Countries: 1997-2008

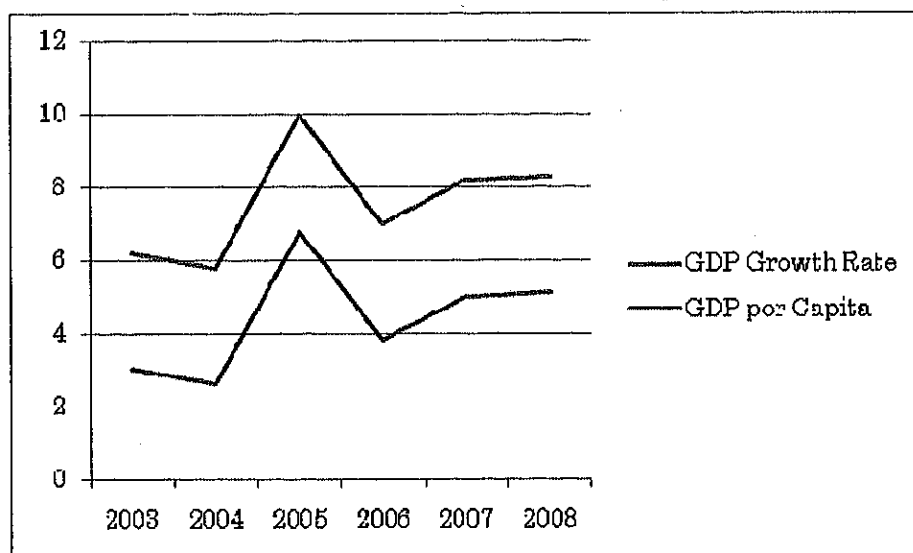
	1997-2002	2003-2007	2003	2004	2005	2006	2007	2008
Kenya	1.9	5.3	2.8	4.6	5.9	6.4	7.1	1.7
Tanzania	4.8	7.2	6.9	7.8	7.4	6.7	7.1	7.4
Uganda	6.1	7.7	6.2	5.8	10.0	7.0	8.2	8.3
Sub-Saharan Africa	4.1	6.3	5.1	7.2	6.2	6.4	6.9	5.5

Source: IMF; Regional Economic Outlook for Sub-Saharan Africa; October 2009, Ugandan Government Estimates

⁸ Ugandan economic policy has been articulated since the late 1990s by series of multiyear strategic frameworks. The first of these, the Poverty Eradication Action Plan, dates from 1997 and was succeeded by similar such plans in 2001 and 2004 (PEAPs II-III). These strategic frameworks set out macroeconomic and poverty reduction objectives and the associated policy frameworks designed to achieve these objectives. These frameworks were explicit in terms of both objectives to be achieved and the associated policies and were developed through a wide-ranging consultative process. The budgetary policies supportive of these objectives were set out in a multiyear budget framework, characterized by a medium term expenditure framework. Currently, the Government is working on a four year National Development Plan, which will cover the period 2010/11 to 2014/15.

2. This high rate of economic growth has translated into significant improvements in well-being, in spite of high rates of population growth (see chart below)

Section I Chart 1
Real Rates of Growth of GDP and GDP per Capita



3. During the period 1997-2003, GDP per capita increased by over 40 percent. The high rate of growth of GDP per capita in turn contributed to a sharp decline in poverty. The percentage of population living in poverty, measured by a consumption-based poverty basket, decreased from 51 percent in 1992/92 to 31 percent in 2005/6. This reduction in poverty has made Uganda one of the few countries on track to achieve the Millennium Development goal of reducing poverty levels by one half by 2015.

4. Leading growth sectors in recent years have been: construction (which grew 65% between 2004 and 2008); posts and telecommunications (which grew 161 percent over the same period) and wholesale and retail trade (which grew 55% between 2004 and 2008). Growth in these sectors reflected primarily increased domestic demand in Uganda which resulted in increased demand for such items as housing. Posts and telecommunications growth reflected the rollout of wireless networks. By contrast, the agriculture sector essentially stagnated over this period, with output increasing less than 5 percent between 2004 and 2008. Agriculture growth was constrained by continued low productivity for the main food crops (maize and matooke) and generally weak external demand for the main cash crops (coffee and cotton). The fishing sub –

sector, which had grown rapidly during the 1990s, basically stagnated during the period 2004-2008 due to depletion of fish stocks from over-fishing. Manufacturing growth was strong, growing 30 percent in real terms between 2004 and 2008, with production largely destined to local or sub-regional markets, where Uganda enjoys a strong comparative advantage.

5. Uganda's strong growth performance since 1992 was based in the early years on a strong supply response to improved economic and political stability after 20 years of civil unrest, and was associated with relatively low rates of investment. With the return of political stability and improved economic policies, both at the macroeconomic and sector level, producers had incentives to bring long idle assets into production, allowing large increases in production with relatively low rates of investment. However, since 2004, economic growth has been driven by more fundamental factors and reflects longer term confidence in the economy as shown in higher private investment levels, which is currently on the order of 20 percent of GDP (see below).

6. Uganda's growth performance since 2008 has been only marginally affected by the international economic crisis. The main vehicle for transmission of the crisis was through lower growth in its formal exports⁹. During the fiscal year 2008/09¹⁰, formal export growth slowed from 35% in the first quarter to -9% in the third quarter, based on data from the Bank of Uganda. As roughly one-third of Uganda's exports are destined for Europe or North America, the slowdown in economic activity in these areas had a negative effect on demand for Ugandan exports. However, this slowdown in exports to developed countries was compensated by an increase in informal exports, which accorded to Bank of Uganda data increased by over 70 percent in value terms in the first three quarters of fiscal year 2008/09¹¹. Informal exports are typically foodstuffs such as maize and beans and these exports grew rapidly to DRC, Rwanda and Southern Sudan. As one of the few net food exporters in the sub-region, Uganda benefited from the sharp increase in food prices in 2008/09. The Southern Sudan

⁹ Formal exports are those officially recorded by custom.

¹⁰ Uganda's fiscal year covers the period July 1 to June 30 and most data is expressed in terms of fiscal years. Hence, fiscal year 2008/09 covers the period July 1, 2008 to June 30, 2009.

¹¹ Informal exports are estimated by survey methods.

market, in particular, became important as improved security conditions in Northern Uganda led to both an increase in agricultural production as internally displaced refugees returned to their farms in the North and improved access to Southern Sudanese markets. In addition to the sharp increase in informal exports, formal exports to the COMESA region, which was relatively less affected by the global slowdown, also remained strong; through the first three quarters of FY2008/09, exports were 93 percent of their level for the entire fiscal year 2007/08.

7. As a result of these competing factors, growth in exports of goods, which had increased by over 100 percent in real terms in 2007/08, is estimated to have slowed down to 17.6 percent in 2008/09, lower but still positive. The affect was that real GDP growth in 2008/09, which had originally been projected at 7.4 percent¹², is estimated to have declined only slightly to 7.1 percent.

(b) Investment and Savings' Developments

8. Uganda's investment levels have shown some modest growth in recent years.

**Section I Table 2 Investment in selected African countries 1997-2008
(In percent GDP)**

	1997-2002	2003-2007	2003	2004	2005	2006	2007	2008
Kenya	13.4	16.3	13.1	14.4	16.4	19.0	18.9	17.7
Tanzania	15.3	24.8	19.2	22.6	25.1	27.6	29.6	29.8
Uganda	18.8	23.5	21.0	21.7	23.9	24.8	26.5	24.4
Sub-Saharan Africa	18.7	20.4	19.3	19.9	19.9	21.1	22.0	22.2

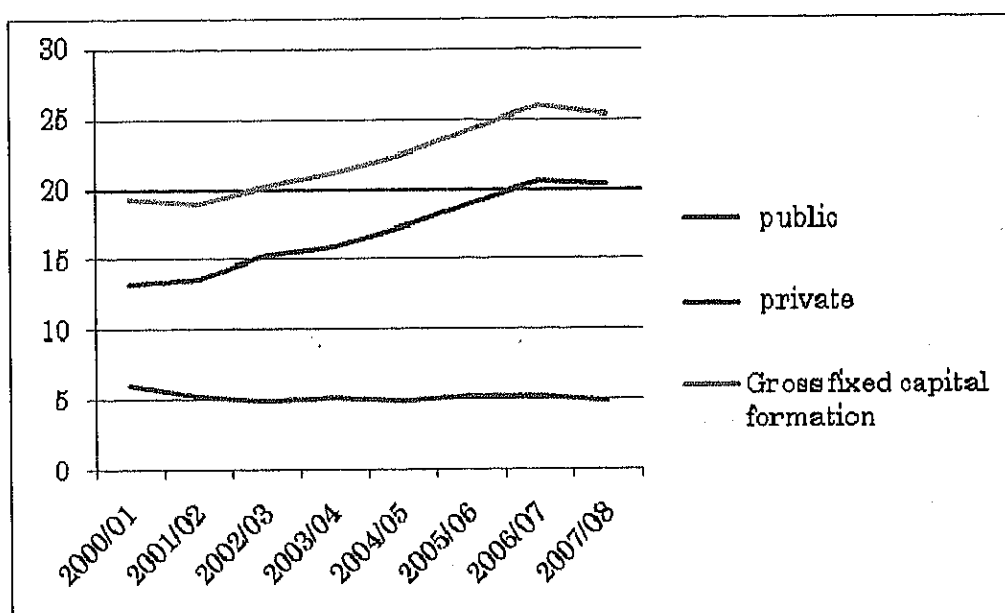
Source: IMF: Regional Economic Outlook for Sub-Saharan Africa; October 2009, Uganda Bureau of Statistics.

9. Uganda's investment ratio has increased by roughly 5 percentage points of GDP over the last ten years. This increase has been due to a sharp increase in private gross

¹² IMF Staff Report for Article IV Consultation and Fourth Review under the Policy Support Instrument, December 18, 2008.

fixed capital investment, which increased from 13.3 percent of GDP in 2000/01 to 20.4 percent of GDP in 2007/08¹³. This higher level of private investment reflected, inter alia, inflows of foreign direct investment (see below). This increase in private gross fixed investment was primarily in construction, which grew by 6.4 percentage points of GDP between 2000/01 and 2007/08. By contrast, private investment in manufacturing remained flat at just under 4 percentage points of GDP.

Section I Chart 2
Fixed Capital Formation as a Percent of GDP



Source: Uganda Bureau of Statistics

10. The bulk of Uganda's investment was financed by foreign savings, as domestic savings, while growing, has remained low.

¹³ Total investment is the sum of public and private investment in fixed capital and change in inventories. The latter is relatively small, e.g., 0.2 percent of GDP in 2007/08.

Section I Table 3
Domestic savings in selected African countries 1997-2008
(In percent GDP)

	1997-2002	2003-2007	2003	2004	2005	2006	2007	2008
Kenya	6.0	7.0	6.2	6.6	7.4	8.3	6.7	4.5
Tanzania	7.7	14.9	14.9	16.2	16.2	14.5	12.8	16.2
Uganda	7.7	14.4	7.2	11.8	13.8	10.7	14.6	13.9
Sub-Saharan Africa	18.3	22.7	19.3	21.3	22.8	25.5	24.5	25.0

Source: IMF: Regional Economic Outlook for Sub-Saharan Africa; October 2009; Ugandan Bureau of Statistics

11. Uganda's savings rate has increased over the last ten years, but still remains significantly below the Sub-Saharan African average¹⁴. With domestic investment as a share of GDP on the order of 24 percent in recent years, this has implied that foreign savings have financed about 40 percent of domestic investment, a rather high figure and reflective of Uganda's dependence on foreign financing.

12. Uganda has enjoyed for many years substantial levels of donor assistance. Net donor inflows, including HIPC relief, in 2006/07 were \$788 million, equivalent to 6.7 percent of GDP. The comparable figure in 2007/08 was \$708 million, equivalent to 4.8 percent of GDP. In 2008/09 donor financing is estimated at \$973 million, or roughly 6.3 percent of GDP. The variations in levels of donor support reflect the variability in levels of donor budget support, which varied from \$623 million in 2006/07 to \$235 million in 2007/08.

13. This relatively high level of donor financing reflects Uganda's status as a high performing developing country. The World Bank's Country Performance and Institutional Assessment (CPIA) rates Uganda at 3.9, putting it among the best performers in Africa. This evaluation has in turn led to high levels of donor assistance,

¹⁴Uganda's low savings rate can be explained by its low income per capita. According to the World Bank, Uganda has a gross income per capita of \$410 well below the Sub-Saharan Africa average of \$951.

much of it in the form of budget support¹⁵. Donor support, while high, has declined as a share of GDP over the last ten years. This has reflected not a diminution of donor support, but rather the rapid rate of economic growth which exceeded the growth in donor financing.

14. Hence, a significant part of the gap between investment and savings has been covered by donor assistance. The remainder of this gap has been provided through high levels of remittances, which have been on the order of \$600-800 million per year and foreign direct and portfolio investment, which has averaged about \$800 million per year over the last several years.

15. The net effect of these sizable foreign inflows, both official and private, has been to permit investments levels considerably in excess of domestic savings and a buildup in foreign exchange reserves (see below).

(c) Inflationary pressures

16. Inflation in Uganda has traditionally been low but has spiked in recent years in response to exogenous shocks

Section I Table 4
Inflation in Selected African Countries (in percent)

	1997-2002	2003-2007	2003	2004	2005	2006	2007	2008
Kenya	7.0	11.2	9.8	11.6	10.3	14.5	9.8	13.1
Tanzania	8.9	5.4	4.4	4.1	4.4	7.3	7.0	10.3
Uganda	3.7	6.2	5.7	5.0	8.0	6.6	6.1	12.1
Sub-Saharan Africa	13.3	8.4	10.9	7.6	8.9	7.3	7.1	11.6

Source: IMF: Regional Economic Outlook for Sub-Saharan Africa; October 2009, Ugandan Bureau of Statistics

¹⁵ The World Bank calculates that Uganda receives in net ODA around \$40 per capita, one of the highest figures in the World.

17. Uganda's overall inflation¹⁶ accelerated in 2008 due to sharp increases in food prices, which in August 2008 were 33.7 percent higher than the August level in the preceding year. This reflected the impact of higher food prices internationally and growing regional demand for Ugandan food exports. Traditionally, food production in Uganda is destined almost entirely for the local market, which is effectively delinked from the international market because of high transport costs. However, with growing inter-regional trade in foodstuffs, Uganda's domestic food prices are now more closely linked to regional developments, resulting in higher domestic food prices. More recently, drought conditions have kept food prices high by limiting supply.

18. Similarly, fuel prices increased sharply in the first half of 2008, driven by higher international prices of fuel.¹⁷ However, the recent moderation in international prices together with the appreciation of the Ugandan shilling have had the effect of moderating the impact of fuel prices on overall inflation. Overall inflation peaked in August 2009 at 15.9 percent year over year. Since then inflation, while remaining high, has moderated and is currently on the order of 12-13 percent per year.

19. Core inflation also trended upward throughout 2008, peaking at 13.7 percent in August 2008. The increase in the core index was led by increases in household and consumer goods, but was relatively broad-based across most items. More recently, core inflation has decelerated to less than 10 percent, year over year.

20. Government policy has been to contain inflation at 5 percent a year, something that has proved difficult in the face of these external shocks. However, future inflation prospects look relatively good, as much of the recent pressures are of a once and for all nature (e.g., the upward adjustment in domestic food prices) and should not persist over time. In addition, the recent sharp appreciation of the Ugandan shilling (see below), should also serve to attenuate inflationary pressures.

¹⁶ Uganda measures inflation on two bases: headline inflation which includes all items and core inflation which excludes food and fuel prices. As food and fuel prices are particularly volatile, historically driven by exogenous supply factors (for food) and international prices (for fuel), core inflation is thought to provide a better measure of fundamental inflationary pressures.

¹⁷ All of Uganda's fuel is imported, and there are no controls on fuel prices. As a result, international price developments and exchange rate movements affect fuel prices directly.

(d) Fiscal performance

21. Uganda traditionally has a significant structural fiscal deficit, on the order of 6-10 of GDP.

Section I Table 5

Fiscal Balances in Selected African Countries in Percentage of GDP

	1997-2002	2003-2007	2003	2004	2005	2006	2007	2008
Kenya	-2.2	-3.1	-3.6	-1.3	-3.0	-3.6	-4.1	-5.7
Tanzania	-5.5	-9.5	-8.8	-10.6	-11.0	-9.7	-7.6	-10.1
Uganda	-9.1	-7.7	-10.3	-9.2	-8.0	-5.3	-5.6	-6.1
Sub-Saharan Africa (oil importers excl. South Africa)	-6.1	-6.0	-6.9	-6.4	-6.0	-5.7	-5.4	-6.6

Source: IMF: Regional Economic Outlook for Sub-Saharan Africa; October 2009, Ugandan Ministry of Finance, Planning and Economic Development

22. Uganda's relatively large fiscal deficit can be attributed to continued weaknesses in domestic revenue mobilization. Uganda's fiscal receipts essentially collapsed during the 20 years of civil strife. While revenue performance has since improved, it still remains low, even by Sub-Saharan African countries' standards. Government tax revenues were roughly 12 percent of GDP¹⁸ in 2008/09. While the Government has sought to raise revenues as a share of GDP, they have remained in the range of 10-12 percent of GDP for the last ten years.

23. This lack of domestic resource mobilization has been compensated, though, by donor inflows. Donor finance, in the form of grants and concessional loans, is a significant source of finance to the budget, either as budget support or as project financing, enabling the Government to fund its budget with minimal recourse to domestic financing. As a result, Uganda has been able to meet its public expenditure requirements without crowding out private investment. Because a significant portion of development expenditures are financed directly by donors (typically around 50 percent), the Government's fiscal rule has been to seek to finance other expenditure (basically recurrent expenditures and domestic development expenditures) through its

¹⁸ By way of contrast, Kenya has consistently had a domestic revenue effort of 20 percent or more.

own expected domestic revenues and anticipated donor budget support. The effect of this has been to have expenditure levels closely aligned with domestic receipts¹⁹.

Section I Table 6
Uganda Deficit: Donor Financing (Shilling Billions)

	2005/06	2006/07	2007/08	2008/09
fiscal deficit exclusive of grants	-1234.8	-1578.4	-1136.1	-2323
Grants	897.6	1194	662.4	1288.6
Budget	484.4	692.4	475.2	663.1
project support	413.2	501.6	187.2	625.5
loan disbursements	426.2	861.6	498.9	953.9
Budget	36.3	394.1	4.1	178
Project	389.9	467.5	494.8	775.9
Amortization	-155.7	-113.9	-86.7	-110.3
net donor flows	1168.1	1941.7	1074.6	2132.2

Source: Ugandan Ministry of Finance, Planning and Economic Development

24. Government fiscal policy has been dictated by the desire to minimize reliance on domestic finance, to avoid crowding out private sector investment. While there was some modest domestic financing in 2005/06, 2007/08 and 2008/09, this was relatively small, on the order of 0.1-0.4 percent of GDP and was fully outweighed by the net domestic saving which occurred in 2007/08.

25. Key to Ugandan fiscal management has been tight control over expenditures, which have been held at 20 percent of GDP or less each year over the period 2005/06 to 2008/09. While expenditure control has remained key to budgetary management, the Government has in recent sought to increase the proportion of development

¹⁹ Another aspect of GOU fiscal management has been close control of expenditures through a system of monthly (now quarterly) releases. This has permitted the Government to reduce expenditures in the event of shortfalls in receipts.

expenditures, particularly in the area of infrastructure (i.e., roads and energy). The result has been a decline in the share of recurrent spending as a proportion of GDP²⁰.

Section I Table 7
Expenditure Composition as Share of GDP

	2005/06	2006/07	2007/08	2008/09
Total Expenditure ²¹	19.6	20.2	17.7	20.6
Recurrent expenditures	11.9	11.3	11.7	10.9
Development expenditures	6.7	8.0	5.6	8.8

Source: Ugandan Ministry of Finance, Planning and Economic Development

(e) External Performance

26. Uganda has a persistent structural trade deficit which has been financed primarily by transfers and capital account surpluses.

Section I Table 8
Uganda External Accounts (\$ millions)

	2004/05	2005/06	2006/07	2007/08	2008/09
Current Account (exclusive of transfers)	-1135.8	-1380.1	-1549	-1731.5	-2019.3
trade balance	-698.3	-926.5	-995.3	-913.5	-1045.6
services balance	-437.5	-453.6	-553.7	-818	-973.7
Transfers	1136.4	1037.3	1178.5	1274.3	1258.4
Current Account (including transfers)	0.6	-342.8	-370.5	-457.2	-760.9
Capital Account	495.4	880.6	1037	1202.98	1197.3
FDI+Portfolio	349.1	506.4	771.7	844.58	630.6
Other	146.3	374.2	265.3	358.4	566.7
Overall Balance	496	537.8	666.5	745.78	436.4
Reserves and Related Items ²²	-496	-537.8	-666.5	-745.78	-436.4
Reserve change	-182.2	-24.1	-662.5	-638.9	61.3

Source: Bank of Uganda

²⁰ The resulting squeeze on recurrent expenditures has led to concerns that this has hampered the quality of government services and that these expenditures should be increased. (IMF Article IV Report and Fourth Review Under the Policy Support Instrument, March 2009.

²¹ Total expenditures include net lending and arrears repayments in addition to Recurrent and Development expenditures.

²² Reserves and related items include, in addition to reserve change, such items as use of Fund credit, exceptional financing and errors and omissions.

27. Historically, Uganda has enjoyed large surpluses on the transfer account, on the order of \$1 billion per year. These inflows reflect receipts from workers' remittances (on the order of \$500 million in 2007/08) and official transfers to the Government in the form of budget support and project grants. Uganda's capital account has been in regular surplus due to inflows of foreign direct and portfolio investment of \$500 and \$600 million per year and net disbursements of official loans of about \$200-300 million per year. This capital account surplus has, in turn, financed the current account deficit (inclusive of grants) permitting an overall surplus, which in turn has permitted a buildup in external reserves. Uganda's external reserves were \$2.4 billion as of March 2009, equivalent to 7 months import coverage and a very comfortable level.

28. Uganda's external position was only slightly affected by the global events of 2008/09. The current account deficit (including grants) deteriorated by roughly \$300 million. This deterioration was due to higher import levels by some \$766 million, reflecting continued strong demand in the domestic economy. Export growth was positive, growing by \$127 million over 2007/08, but significantly below the rate of increase the preceding year, \$489 million. As noted above, this export growth reflected the combined effects of a slowdown in export growth to Europe and North America, reflecting in part weaker demand in these regions, and rapidly growing exports to the region, including informal exports²³. The net effect was a deterioration in the trade balance of \$639 million which was in turn partly offset by increase in official transfers of \$261 million. The services account also deteriorated slightly relative to 2007/08, by \$113 million, primarily because of higher transport costs associated with the higher import bill. By contrast, the transfers account remained essentially unchanged, with workers' remittances actually increasing by roughly \$200 million relative to 2007/08.

29. The international crisis also affected Uganda's capital account, primarily through repatriation of short term foreign capital. In 2007/08, there had been significant short-term capital inflows of \$119 million, mainly consisting of purchases of Ugandan

²³ For the second half of 2008/09, informal exports increased by 81.0 percent. Informal exports are primarily exports of foodstuffs to neighboring countries such as Sudan. As noted earlier, these exports have grown rapidly in recent years.

government debt attracted by Uganda's relatively high domestic interest rates. However, with the growing crisis, investors disinvested in these assets, leading to an outflow of capital on the portfolio account of \$109 million. Much of this reversal occurred in the third quarter of 2008/09. This foreign exchange outflow in turn led to some intervention by the Bank of Uganda in the foreign exchange market, resulting in a net loss in foreign exchange reserves of \$61.3 million for the year 2008/09 as a whole.

(f) Monetary, financial and exchange rate developments

30. Uganda's relatively comfortable fiscal position has meant that Ugandan monetary policy has focused on supporting the domestic economy while seeking to contain inflation below 5 percent. However, monetary management has been made more complicated by external developments²⁴, as developments in the foreign exchange market have affected monetary policy management. Broad money growth remained restrained during 2005/06 and 2006/07, averaging about 17-18 percent per year. With real growth during this period relatively high, on the order of 9.6 percent per year, the growth rate in real money was consistent with relatively low inflation, which averaged around 7 percent over this period.

Section I Table 9
Money Supply (Shillings Bln)

	June 2005	June 2006	June 2007	June 2008	June 2009
M2	2157.9	2565	2993.9	3895.4	4920.7
M3	2811.1	3271.6	3842	5037.9	6297.6

Source: Bank of Uganda

31. Broad money expanded more rapidly in 2007/08, growing by 30.1 percent. The main factor affecting this strong growth was large increases in foreign exchange holdings by the Bank of Uganda, which grew by Uganda shillings 1.0 billion. The Bank of Uganda did not fully sterilize all these inflows, resulting in some expansion in broad money.

²⁴ Uganda has no controls on either short term or longer term capital flows. As a result, external flows affect directly monetary policy management.

32. In 2008/09, by contrast, monetary policy was primarily oriented towards sustaining domestic demand in the face of unfavorable external developments. Broad money growth for the year as a whole averaged 26.3 percent, with much of this growth concentrated in the period November 2008 to June 2009. During this period, the Bank of Uganda sought to offset the deflationary effect of lower inflows of external portfolio investment, by accelerating the growth in broad money. As noted above, this policy was largely successful in sustaining domestic demand at the expense of some modest drawdown in external reserves.

33. Capital markets in Uganda are relatively underdeveloped. Virtually all financial intermediation occurs through commercial banks²⁵. The legacy, prior to 1992, of poor economic policies combined with civil unrest limited the growth of financial markets. While Uganda has a nascent stock exchange, the Kampala stock exchange, there are few listings, less than 10 and a number of these are bond issues. As a result, there are few risks posed to the economy by the non-bank financial sector, which remains relatively underdeveloped²⁶. Similarly, while recent years have seen some financial deepening in Uganda, Uganda is still relatively unmonetized, a legacy of its 20+ years of civil unrest.

Section I Table 10
Broad money/GDP ratios in selected African countries 1997-2009
(excluding grants, percent of GDP)

	1997-2002	2003-2007	2003	2004	2005	2006	2007	2008
Kenya	38.3	40.0	39.5	40.1	39.3	40.3	41.1	43.6
Tanzania	16.5	23.3	20.7	21.2	22.2	26.0	26.7	26.7
Uganda	14.6	17.9	19.1	16.9	17.5	18.0	18.1	20.5
Sub-Saharan Africa (excl. Nigeria and South Africa)	24.0	27.5	26.8	26.4	25.7	28.4	30.2	31.8

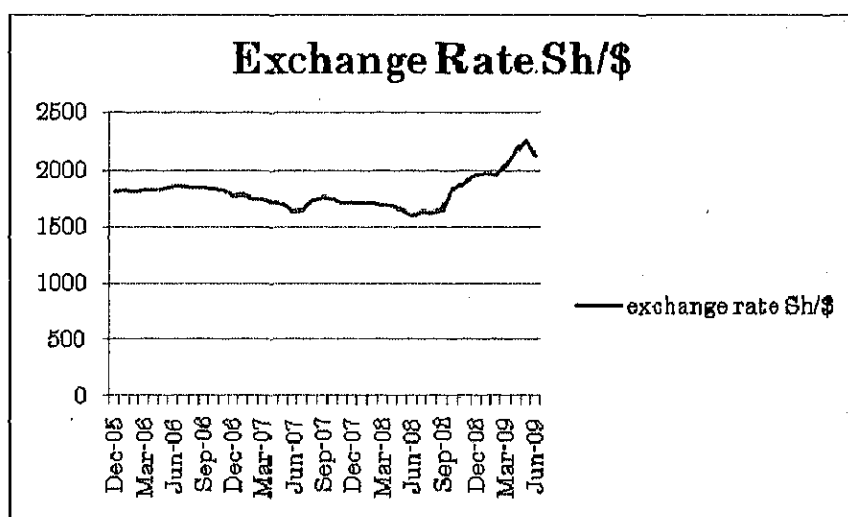
Source: IMF: Regional Economic Outlook for Sub-Saharan Africa; October 2009

²⁵ Commercial bank advances and discounts, which are almost exclusively credit to the private sector, have grown rapidly in recent, increasing almost threefold between June 2004 and June 2008. However, these advances and deposits still represented in June 2008 on 42 percent of total assets of commercial banks.

²⁶ Social security which covers only a fraction of the labor force is a defined contribution scheme, limiting financial risks.

34. The Bank of Uganda has no exchange rate target, allowing the exchange rate to be determined by market forces. There has been limited intervention in the foreign exchange market (most notably in October 2008 and June 2009), when widening of spreads between buy and sell rates suggested excessive market volatility. While the shilling/dollar rate remained relatively steady at 1600-1700 shillings to the dollar during the period December 2005 to September 2008, turbulence in international credit markets has led to volatility in the Uganda shilling exchange rate post-September 2008. The exchange rate first depreciated rapidly, reflecting large outflows in private capital. This was followed by a period of exchange rate appreciation, as these flows were reversed and the Bank of Uganda intervened in the foreign exchange market. The exchange rate has continued to appreciate and is currently on the order of 1800/\$, i.e., about the level prevailing during the period December 2005 to September 2008²⁷.

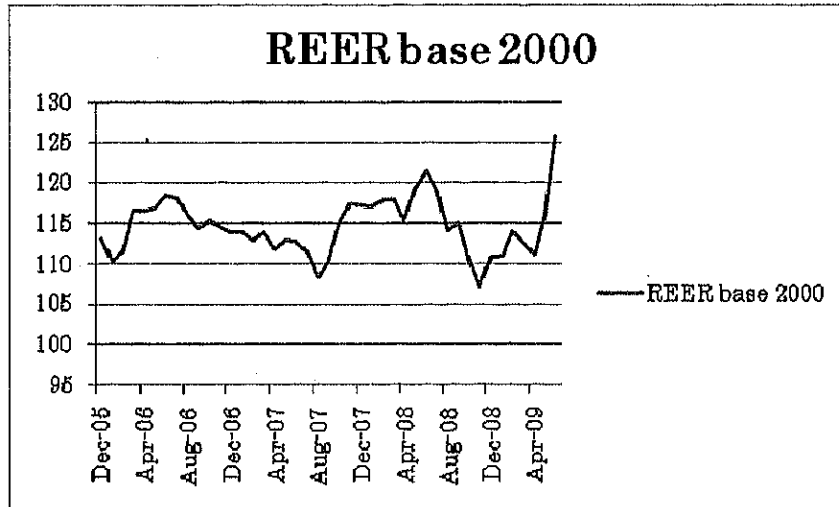
Section I Chart 3



35. There has been a significant appreciation in the exchange rate in real terms over the last year as can be seen below.

²⁷ With the dollar itself depreciating since the beginning of 2009, the Ugandan appreciation is even greater in trade-weighted terms.

Section I Chart 4



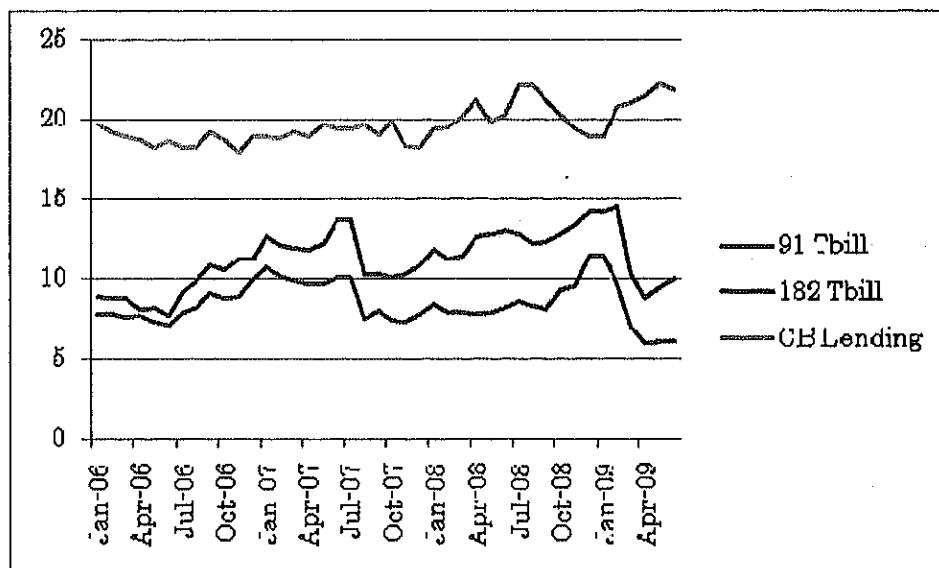
36. The recent sharp real exchange rate appreciation reflects the combined effects of a strengthening of the Ugandan shilling in nominal terms and continued high rates of inflation. With the nominal exchange rate continuing to appreciate and Ugandan inflation continuing to remain relatively high, this real appreciation has continued since June, 2009, further eroding Uganda's competitiveness. The current real effective exchange rate is more than 25 percent higher than its level in 2000.

37. As noted above, this real appreciation does not appear to have affected the level of Ugandan exports. Uganda export growth overall continued to remain positive in 2008/09 in the face of relatively weak demand, growing by 17.6 percent in value terms in 2008/09. However, the real exchange rate appreciation may be a factor in the relatively sluggish growth of exports to Europe and North America over the last year²⁸. While appearing manageable to date, further continued real appreciation can be expected to erode Ugandan competitiveness even in these nearby markets, pointing to the need for renewed Government efforts to reduce the costs of doing business.

²⁸ The recent strong growth in Ugandan exports to regional markets is largely due to the strong competitive advantage Uganda enjoys in these markets. Ugandan exports were probably always relatively competitive in these regional markets but access to these markets was constrained by other factors, e.g., the civil unrest in Northern Uganda.

38. Because the Government's fiscal deficit is largely or entirely covered by foreign inflows, interest rates in Uganda are primarily influenced by monetary objectives as opposed to fiscal financing requirements. The main policy instrument has been the issuance of Treasury bills, generally of 91 days or 182 days maturity. Treasury bills are issued by the Bank of Uganda to absorb liquidity in the market and variations in T bill rates reflect the BOU's policy stance. The T bill rates set the effective floor for commercial bank lending, however commercial bank rates are typically well above T bill rates by 10-15 percentage points as can be seen below.

Section I Chart 5
Ugandan Interest Rates



Source: Bank of Uganda

39. During the period January 2006 to June 2008, 91 day T bill rates fluctuated around 7-8 percent with the comparable rates for the 182 T bill fluctuating around 12-13 percent. Since late 2008, T bill rates have declined, reflecting an easing in the BOU monetary stance to support the economy in the face of negative external factors. Commercial bank lending rates have remained relatively sticky, fluctuating moderately around 20 percent.

40. When account is taken of the relatively high rate of inflation, on the order of 10 percent (see above), short term T bill rates are currently effectively negative in real

terms, with 182 T bill rates only slightly positive in real terms. However, this development is regarded by the BOU as temporary, reflecting one off price movements, and is not a sign of lax monetary policy²⁹. Commercial bank lending rates are strongly positive in real terms.

41. The relatively high levels of commercial bank interest rates have been a subject of some concern among policy officials, particularly when account is taken of relatively low deposit rates (currently averaging less than 2.5 percent per year). This provides commercial banks with a substantial intermediation margin, in excess of 15 percent³⁰. This relatively high spread is thought by the BOU to be the result of insufficient competition the market and the BOU has sought to address this by licensing several new banks. This stance has apparently had some effect on lowering commercial bank lending rates, as rates are currently below 20 percent for the best borrowers.

42. The commercial bank system is generally sound, with non-performing assets accounting for less than 5 percent of total assets of commercial banks³¹. This reflects in part the conservatism of most commercial banks, much of whose lending is relatively short term, trade credits, and which in many cases is backed by deposits of the borrower. Relatively little lending is for longer term investments such as mortgages³². In addition, Treasury bills are risk-free and typically offer an attractive rate of return, providing commercial banks with an easy alternative to more risky domestic lending³³.

43. This conservative posture has ensured, though, that Ugandan banks have been largely unaffected by the turmoil of the last few years. Ugandan banks' exposure to the more, risky "toxic assets" was virtually non-existent, leaving them unaffected by

²⁹ The BOU targets broad monetary aggregates and does not have an interest rate or exchange rate target.

³⁰ Larger depositors are able to negotiate higher rates, reducing the intermediation margin, however.

³¹ Non-performing loans were only 2.2 percent of total loans outstanding and were fully covered by loan-loss provisions in 2008 (IMF Article IV staff report, March 2009).

³² Loans for Construction and Property, which includes mortgages, were only 10.9 percent of total commercial bank lending in 2008. (IMF Article IV staff report, March, 2009)

³³ As of end 2008, commercial banks held Ush 1464.7 billion in Ugandan Government assets, equivalent to 21.9 percent of their total assets.

the shakeout in these markets. Ugandan commercial banks were only indirectly affected by deterioration in the quality of some of their domestic assets (e.g., flower exporters) which had been affected negatively by the slowdown in external demand. However, as noted above, the extent of this deterioration was limited due to the generally cautious lending policies of Ugandan commercial banks³⁴.

(g) Ugandan Oil Prospects

44. Significant oil reserves have recently been discovered in western Uganda, in the Lake Albert area. Based on preliminary exploration, a minimum of 700-800 million barrels are thought to exist, but this level is based on exploration covering only a portion of the potential petroleum basin³⁵. Further exploration is underway, both in Uganda and in the Democratic Republic of Congo on either side of Lake Albert. While more definitive figures should emerge from this on-going exploration, it is reasonable to think that total reserves could eventually be as much as several billion barrels, making Uganda potentially one of the larger African oil producers

45. However, commercialization of this oil is complicated by several factors. The fields themselves are in a relatively inaccessible area, far from major markets, necessitating expensive infrastructure, e.g., a pipeline, to move the oil to market³⁶. In addition, the oil itself has high wax content, making its transport by pipeline technically more complicated and costly, as the pipeline would need to be continuously heated for the crude to flow through it. Costs of such a pipeline have been estimated as high as \$3.5 billion.

46. In addition to these technical factors, there remain several key policy decisions that need to be made that will affect the commercialization of the oil. The most important of these is the decision as to how much of the oil, if any, should be refined in Uganda. The Ugandan Government has indicated its preference that significant

³⁴ This assessment is confirmed by the IMF in its most recent Article IV review (March 2009).

³⁵ Exploratory drilling has occurred in only about one-third of the areas under license.

³⁶ The closest export port is Mombasa, Kenya, over 1400 kilometers away. There is currently an oil product pipeline which runs from Mombasa to Eldoret in Western Kenya. However, this pipeline is not currently suitable for transport of the Ugandan crude, necessitating construction of a new pipeline.

amounts be refined in Uganda rather than exported as crude. This stance is dictated by the wish to maximize domestic value-added from this windfall. However, a refinery would be relatively costly, as much as \$ 4-5 billion dollars for a refinery capable of processing 100,000-150,000 bbls per day, and the market for refined products is relatively limited in the sub-region. The Ugandan market for refined products is currently only 13,000 barrels per day. Neighboring markets in Eastern DRC and Rwanda are even smaller as is that of Southern Sudan, which itself is talking of putting a place a refinery to process its own crude. The Kenyan market is bigger, but is currently served by a refinery in Mombasa which covers about half of domestic needs and imported refined products from the Gulf. It is not clear whether Kenya would countenance the closing of the Mombasa refinery and, in any case, its refined product imports are very competitive, having been brought in from very efficient refineries in the Persian Gulf. Hence, in spite of the Government preference that large amounts of the crude be refined in Uganda, market considerations may dictate otherwise. A study is currently underway examining options for refining Ugandan crude and this study may provide the basis for a formal decision as to the size of a refinery.

47. Significant exploitation of the oil resources is several years away, given the need for policy decisions (e.g., amount to be refined locally) and the time necessary to put in place the consequent infrastructure (e.g., pipeline and/or refinery). However, once these resources begin flowing they will have a major impact on the Ugandan economy. Even at 700-800 million barrels total, these resources would be valued today at roughly \$50 billion, i.e., over 3 times the size of the Ugandan economy as a whole. Exploitation of these resources will have major impacts on the Ugandan GDP and its external position. In addition, it will have major impacts on management of the economy. Monetary management will be further complicated and the Government's fiscal position will be significantly impacted. The Government's share of these receipts is determined through the Production Sharing Agreements it has signed with the private oil companies responsible for development of these fields³⁷. While the

³⁷ These Production Sharing Agreements are not publically available. This reflects a general opacity with respect to information about the sector (Harnessing Oil for Peace and Development, International Alert, 2009). This seems to reflect a Government policy choice; to date the Government has not expressed its intention to adhere to the Extractive Industries Transparency Initiative (EITI) which would require greater transparency.

Government has not made public the terms of these agreements, key parameters which are known indicate that the Government's share of these receipts is likely to be relatively high³⁸. The question arises then as to how much of these additional resources will be incorporated into the budget, allowing either higher expenditures or reducing the need for other financing (e.g., donor finance), and how much will be saved for future use. The Government is conscious of the risks associated with the misuse of this windfall and has said that it will be prudent in the use of these resources, but has not yet developed a clear fiscal rule governing the use of these resources. Historical experience in other African countries (e.g., Nigeria or, and more recently Ghana) points to the potential problems associated with mismanagement of oil windfalls. On the other hand, Uganda has a tradition of over ten years of prudent fiscal management and has managed well sizable donor inflows. A paper setting out key principles governing the use of these resources is being prepared for Cabinet consideration³⁹. Once approved, this would be the basis for legislation to be presented to Parliament.

2. Political Developments and Risks

(a) Domestic Political Risks

48. President Museveni has dominated Ugandan politics since first taking power in 1986⁴⁰. While himself from a small tribe (the Ankole) he enjoyed broad popular support among most Ugandan tribe, particularly the largest, the Baganda, who account

³⁸ See Section IV which discusses the various sources of government revenues from oil production and their likely impact on fiscal receipts.

³⁹ The Government has indicated its intention to present to Parliament new legislation governing exploitation of the oil sector, including revenue management, during the current FY 2009/10.

⁴⁰ President Museveni took power by overthrowing the Government of Milton Obote (Obote II), after an armed rebellion of several years. Obote, in turn, had returned to power after the defeat of Idi Amin in 1979, by Tanzanian forces and Ugandan exile groups (including those of President Museveni). Idi Amin for his part, had overthrown the first government of Milton Obote (Obote I) in 1971. For the period from the late 1960s to the late 1980s, Uganda was in state of virtually chronic political turmoil.

for about 35-40 percent of the total Ugandan population⁴¹. This popularity was due in large part to the fact that Museveni, for the first time in over 15 years, was able to ensure a measure of stability in Uganda⁴².

49. For much of the time since 1986, Uganda was governed under a “no party” system. Parties were formally proscribed as they were thought to be at the roots of the civil unrest which had rocked Uganda more or less continuously since independence in 1962. While there were elections, candidates were to be elected based on their individual merit and not their party affiliation. In practice, however, politics was dominated by the National Resistance Movement (NRM) which owed its allegiance to President Museveni⁴³.

50. After governing for 10 years, President Museveni was first elected President in 1996, in an election that was judged free and fair by most observers. He was subsequently reelected President in 2001 to a second five year term. This election, unlike that of 1996, was characterized by some political intimidation and violence against supporters of the President’s opponent. However, this violence was not widespread, being largely restricted to Western Uganda, and the outcome of the election was judged to be broadly representative of the popular will.

51. Under the terms of the Constitution, presidents were limited to two consecutive terms only. However, the constitution was subsequently amended in 2005 to eliminate this restriction, permitting President Museveni to run again which he did in 2006. This election was marked by a higher level of political violence and intimidation than that of 2001. Nonetheless, the reelection of President Museveni was accepted by the

⁴¹ The tribes in Northern Uganda, chiefly the Acholi, have remained chronically disaffected from Museveni, however, These tribes accounted though for a relatively small percentage of the Ugandan population, on the order of 10 percent.

⁴² The Baganda’s affiliation was deeper, however, as they had actively supported Museveni during his guerrilla struggle against Obote, in large part because of his promises to restore the Baganda king (the Kabaka) who had been exiled by the Obote I government.

⁴³ This restriction on parties was lifted in 2001. However, party activities remain severely restricted. For example, parties, other than NRM, are not allowed to have offices outside the capital. Hence, in practice, the NRM enjoys a virtual monopoly of power.

international community as meeting minimal democratic standards. The next Presidential elections are scheduled for 2011.

52. There is evidence of growing disaffection with President Museveni's rule. Because of the monopoly on political power enjoyed by the President and his NRM, this disaffection is not expressed overtly through political structures, however, but rather through less structured channels. Most recently, for example, there was an outbreak of riots in Kampala, resulting in the deaths of over 20 citizens. These riots were triggered by the Government's restrictions on movements of the Baganda king, the Kabaka⁴⁴. This restriction triggered riots in Kampala. The ostensible reason for these riots was the restrictions on "their king" but they also reflected growing disaffection in Kampala with President Museveni⁴⁵.

53. With the key institutions of Government firmly in the hands of the President and the NRM, this opposition poses no serious threat to the President's authority. However, this dissatisfaction can be expected to manifest itself from time to time in the form of some civil unrest, particularly in Kampala. In particular, the existence of this unhappiness could well be a factor affecting the 2011 Presidential elections. As noted above, these elections have been characterized by increased levels of political violence in response to perceived threats to the President. With the Baganda increasingly alienated from the Government, the levels of political intimidation can be expected to increase further in 2011. In addition, with this growing disaffection, the President may be tempted to undertake more populist policies in the run up to these elections in order to enhance his popularity, particularly given the prospect of future oil revenues.

⁴⁴ The role of the Kabaka in Uganda is complicated. He is formally chief of the Baganda and as such enjoys considerable veneration from this group. At independence in 1962, the Buganda kingdom enjoyed special status and the Kabaka's role as king was recognized by the Constitution. The Kabaka was subsequently exiled by the Obote I government and President Museveni's promise to allow him to return was a key factor in generating Baganda support for his insurrection against the Obote II government. With Museveni's seizure of power in 1985, the Kabaka was allowed to return, but he was given no political role and the Buganda kingdom was not recognized. However, there remains some interest among Baganda in restoring the Kabaka's political role and this has been a source of tension between the Government and the Baganda.

⁴⁵ Since 1999, Kampala has regularly elected opposition leaders as Mayor.

54. The prospect of large oil revenues is also a potential source of tension within Uganda, particularly in the next few years. There are already overt conflicts as to the division of future oil revenues. At present the bulk of these resources accrue to the Central Government. However, some groups in the West, where the oil reserves are located, are seeking a larger share of these resources, setting up a possible conflict between the oil “haves” and “have nots”⁴⁶. At the local level, there is also evidence of greater tensions between local groups and new arrivals over land, a problem that can be expected to increase as oil development accelerates⁴⁷.

55. The Government to date has been able to manage these tensions reasonably well by making small compromises without putting at risk its overall authority. However, electoral violence at the time of 2011 elections cannot be excluded and this violence, depending on its scale, could affect donor attitudes toward Uganda.

56. As noted above, Northern Uganda has remained largely alienated from the current Museveni Government. This alienation led early on to a series of armed rebellions, the most recent being carried out by the Lord’s Resistance Army (LRA). While the LRA never succeeded in seriously threatening the regime, it was able for many years to destabilize Northern Uganda through systematic terrorization of the local population⁴⁸. As a result, much of the population of Northern Uganda was forced into refugee camps, which at one point sheltered over one million internally displaced people, where they were under the protection of the Uganda Army. However in spite of persistent efforts, the Ugandan army was never able to quell fully the LRA, in part because it enjoyed the implicit support of the Sudanese government which permitted it safe havens across the border in Southern Sudan. After years of largely unsuccessful efforts to defeat the LRA militarily, the LRA was eventually forced out of Uganda 18 months ago when the Sudanese Government withdrew its tacit support for the group. The LRA was forced them to leave Uganda and its remnants are currently hiding out in Eastern Congo. For the first time in 20 years, peace now prevails in Northern Uganda and northerners are leaving the refugee camps and returning to their villages.

⁴⁶ This problem is expected to be addressed in the new Petroleum law which will be submitted to Parliament in 2010.

⁴⁷ See *Harnessing Oil for Peace and Development*, International Alert, 2009.

⁴⁸ Among the tactics of the LRA was the kidnapping of young children for use as child soldiers or, in the case of young girls, sex slaves.

(b) International Risks

57. In recent years, Uganda's relationship with most of its neighboring states has improved. Uganda enjoys good relations with Kenya and Tanzania, relations that have benefited from deepening integration through the East African Community (EAC), of which all three countries are members⁴⁹. The EAC has an ambitious program of regional integration, up to and including full political and monetary union. To date, implementation of this ambitious agenda has been limited to the economic sphere and there is an effective economic union covering the EAC states, with most goods and factors of production circulating freely within the EAC.

58. Uganda's relationship with Sudan and Rwanda, which in the past has been rocky, is now generally good. Relations with the Sudanese government have improved in the wake of the accord governing North and South Sudan, which removed a major source of tension between the two countries⁵⁰. These improved relations have permitted, inter alia, the expulsion of the LRA from Northern Uganda. However, the relationship remains fragile, depending as it does, on successful implementation of the accord between North and South Sudan. A renewal of conflict in Southern Sudan could be expected to have spillover effects into Uganda.

59. Uganda's relationship with Rwanda improved dramatically with Uganda's military disengagement from eastern DRC in the early 2000s. The simultaneous presence of Ugandan and Rwandan military forces in eastern DRC had led to growing tensions which culminated in fighting between the two armies in Kisangani and the mobilization of forces on both sides of the Ugandan/Rwandan border in 1999. A subsequent meeting between the two heads of state led to the withdrawal of Ugandan forces and substantially eased tensions between the two states.

60. The one point of on-going tension with Uganda's neighbors is the DRC. While formal relations between the two governments are correct, tensions persist in the border region. This problem is exacerbated by the Congolese government's limited

⁴⁹ There are currently four members of the EAC: Uganda, Kenya, Tanzania Rwanda and Burundi.

⁵⁰ During the North/South conflict Uganda was accused of providing support to the main Southern rebel group, the SPLA, and the Sudanese Government was accused of supporting dissident groups in Uganda, notably the LRA.

effective control in the eastern area abutting Uganda. Anarchy in this area has inevitably spilled over into Uganda, which has had to absorb some of the fallout of the current unrest in that region. The discovery of oil in the Lake Albert region has added to these tensions, as the oil bearing areas are thought to be on both sides of the border. With the stakes high, the Governments have maneuvered to maximize their advantage in a poorly demarcated frontier. As recently as 2007, there was an armed clash between the Ugandan and Congolese forces over a disputed island in the middle of Lake Albert. This was subsequently settled after a high level meeting between the two heads of state. However, continued tensions are likely in this area, given the potential stakes and the lack of control in the region of the central Congolese government.

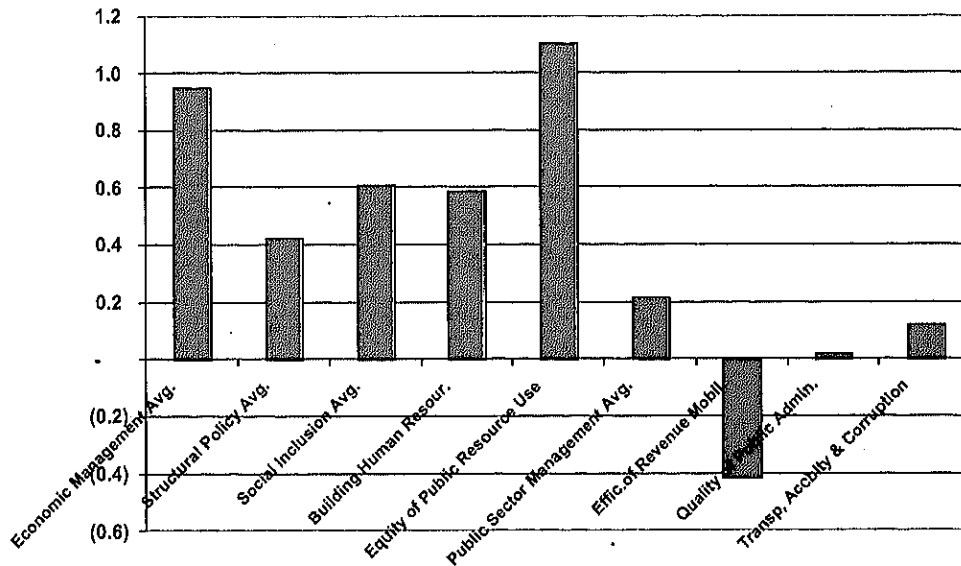
61. While the tensions between the Congolese and Ugandan governments can be expected to persist, it is unlikely that they will spill over into a full scale conflict. Both sides have an interest in avoiding such an eventuality, which can only jeopardize oil revenues which both are counting on. However, this tension could lead to delays in the development of some of the oil fields, as private operators may hesitate to make sizable investments until there is complete clarity as to how the oil will be shared between the two states.

3. Governance and Investment Climate

62. Governance indicators for Uganda present a very mixed picture. While Uganda's rating under the World Bank's Country Performance and Institutional Assessment (CPIA) is quite high, 3.9 which places Uganda among the highest performing Sub-Saharan African countries, there are significant variations across areas of assessment (see below).

Section I Chart 6

Uganda's Performance Relative to IDA by CPIA Sub-Component



Source:

World Bank

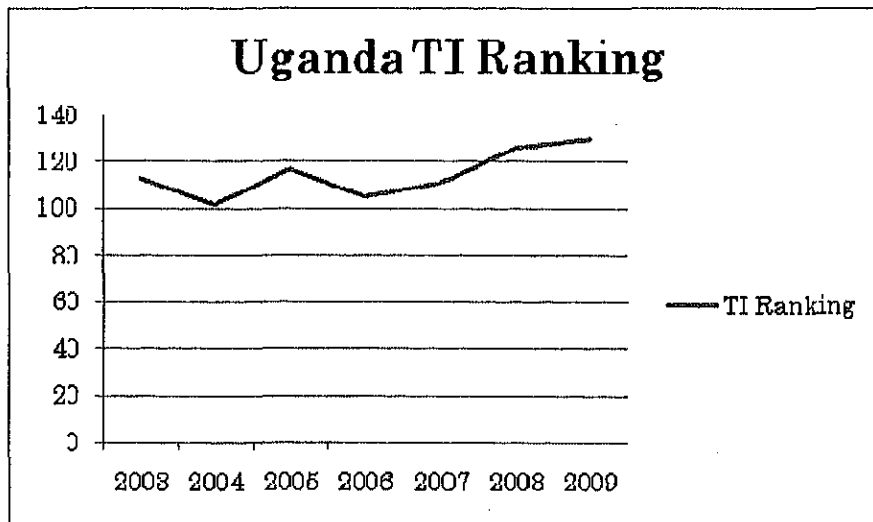
63. Uganda scores very well on the quality of economic management and equity of resource use. This reflects Uganda's strong record of macroeconomic management and efforts to focus Government spending on poverty reduction expenditures. Under the early PEAPs, Uganda was in the vanguard of developing countries in aligning its budget to reflect poverty reduction objectives⁵¹.

64. By contrast, Uganda performs less well on efficiency of revenue mobilization (reflecting its low revenue to GDP ratio) and on quality of public administration and transparency, accountability and corruption, the latter two sub-groups which broadly measure governance.

⁵¹ One of the key instruments in this regard was the Poverty Action Fund (PAF). The PAF is a "virtual fund" which was set in the late 1990s as a way to account for poverty reduction expenditures. This was particularly important to show that the debt relief provided through the various international initiatives (the Highly Indebted Poor Countries Initiative (HIPC) and the Multilateral Debt Reduction Initiative (MDRI) of the early 2000s) were fully absorbed in increased poverty reduction expenditures.

65. Corruption in Uganda is perceived as a growing problem. Uganda's ranking in the Transparency International index has significantly worsened in the last several years.

Section I Chart 7
Uganda Ranking in TI Corruption Perception Index



Source: Transparency International

66. Uganda consistently ranks among the more corrupt countries in the world. This is in spite of Government efforts to put in place a strong anti-corruption legal framework. This framework includes the creation of an Inspector General of Government office, with power to investigate corruption; a requirement that Government officials declare assets; and the putting in place of a new public procurement code. The problem resides less in the formal framework for dealing with corruption, but in its application⁵². Prosecutions for misuse of public resources are rare and there is a sense that well-placed individuals are largely untouchable. In addition, efforts to decentralize

⁵² The application of the declaration of assets is an interesting example in this regard. When this was put in place initially in 2002, the asset declarations were available publically, and the results were reported in the press. However, over time these declarations have been more and more restricted and there is now little public scrutiny of these declarations.

decision-making through decentralization of resource use and decentralization of public procurement to individual government agencies are perceived to have worsened corruption.

67. The need to improve public sector performance has been a common theme in the dialogue between donors and the Government. The main areas of improvement that donors have identified are the quality of the public sector, which remains low. This is partly due to ineffectiveness and/or absence of key systems, such as human resources, which are central to a professional civil service. The other problem is the pay scale, which provides few incentives to attract technically qualified staff. The judiciary has also been identified as particularly weak and the absence of an effective judiciary is cited as one of the negative factors affecting the business climate (see below). Finally, the donors cite the interference by political leaders in technical decisions, as a negative factor affecting public service performance.

68. To address corruption, donors are working with the Government on a set of benchmarks which can be monitored to measure progress in this area. It is hoped that by grounding assessments of progress in this area on facts rather than anecdotes it will be possible to improve Uganda's performance in this area.

69. Uganda also ranks poorly in international assessments of competitiveness. The Global Competitiveness Report for 2009/10 ranks Uganda 108 (out of 133 countries total) in competitiveness. This ranking, while low, represents some improvement over previous rankings. In 2008/09 Uganda ranked 128 (out of 134 countries) on the same scale. Its comparable ranking in 2007/08 was 120 (out of 131 countries). There are, though, significant differences in Uganda's ranking by competitiveness sub-categories. In the most recent assessment, Uganda ranks relatively well on macroeconomic stability (73 out of 133) and labor market efficiency (30)⁵³. By contrast, Uganda ranks poorly in the quality of public institutions (106 out of 133 countries), infrastructure (119 out of 133 countries), health and primary education (116 out of 133), higher

⁵³ This latter rating reflects the relative lack of government regulation governing the labor market.

education and training (123 out of 133 countries), goods market efficiency (114 out of 133 countries), technological readiness (118 out of 133) and business sophistication (108 out of 133 countries).

70. Even more revealing are the principal factors affecting competitiveness as perceived by businessmen themselves. Access to financing was cited as a major factor by 19 percent of all respondents. Corruption was cited as a major negative factor by 17 percent of all respondents and inadequate infrastructure by 13 percent of the respondents (13.0 percent). That access to financing is perceived as a problem is not surprising, given the lack of development of the financial system in Uganda. Similarly, inadequate infrastructure can be attributed to the degradation of the physical infrastructure during the period of civil unrest. In both these areas, there is some reason for optimism as the Government has been making considerable efforts in recent years to improve infrastructure and the financial system has been becoming more innovative over time, albeit at a slow pace.

71. As noted above, however, addressing corruption is more complicated as the problem lies less in the laws and regulations, which are relatively easy to change, and more in their enforcement and/or fundamental in public administration.

72. These weaknesses in public administration are confirmed in the most recent doing business indicators⁵⁴. These indicators compare across countries the ease of complying with government laws and regulations. Here Uganda performs relatively poorly. In the overall assessment, Uganda ranks 112 out of 183 countries. The main areas of regulatory burden identified in the study are the costs associated with starting a business (Uganda ranks 129th), registering property (Uganda ranks 149th), getting credit (Uganda ranks 113th), protecting investors (Uganda ranks 132th), trading across borders (Uganda ranks 145th), and enforcing contracts (Uganda ranks 116th). Uganda's poor performance in protecting investors and enforcing contracts points to fundamental problems in the judicial system which is primarily responsible in these areas.

⁵⁴ Doing Business 2010 Uganda, IFC.

73. The Government is conscious of the need to ensure a better investment climate and to promote its competitiveness. It has sought to address these weaknesses in its Competitiveness and Investment Strategy (CICS) 2006-2010. This strategy, which dates from December 2006, sought to:

- Address factors affecting the competitiveness of key productive sectors;
- Remove/mitigate the factors within the domestic business environment which currently constrain economic growth and competitiveness and
- Address Uganda's international and regional competitiveness.

74. The Strategy called for a series of actions of both a cross-sectoral and sector specific nature to enhance competitiveness. As can be seen from the assessment above much of this agenda still remains relevant. However, it is increasingly clear that many of the problems associated with Uganda's lack of competitiveness can be traced to weak public administration. As such, progress in this area will require a more wide ranging effort to improve public service to increase its professionalism.

75. As noted previously, these weaknesses have not been sufficient to prevent Uganda from enjoying higher levels of private investment. However, this growing private investment has been in spite of and not because of an improved business climate. As noted above, much of the increase has been generated by rising domestic demand in areas which because of their nature (e.g., construction) foreign competition is limited. Investment in manufacturing, which is more sensitive to international competitive pressures, has remained flat as a share of GDP.

76. There is therefore a need for Uganda to continue its efforts to enhance its competitiveness, particularly given the likelihood of future real exchange rate appreciation. However, there is a danger that with large additional resources expected from the exploitation of oil, efforts to improve Uganda's investment climate may not receive the priority they deserve.

Section II: Trends in Public Debt and Debt Policy

1. Evolution of External Debt

77. 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. The origins of the debt sustainability problem went back to policies pursued in the 1980s.

78. 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. Previous sanctions were first relaxed and then reversed as loan-based aid flowed in to support reconstruction and recovery programs. This occurred in the absence of any effective strategy or discipline in the management of external debt. 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. The external debt crisis peaked in 1990 when, as a result of a sharp decline in the terms of trade from the falling world coffee prices, the Government ran out of foreign exchange for servicing its external debt obligations.

79. This crisis prompted the development of the first External Debt Strategy (EDS) in 1991, which focused on the pursuit of debt relief. The main aspects of the strategy were analysis of the external debt profile and debt service cost projections, and recommendations on how to approach each creditor for rescheduling. The early 1990s saw the first round of relief. In a bid to improve debt sustainability, the World Bank organized a commercial debt buy-back of all commercial loans at 12 per cent on the US dollar in 1992/93, which helped to clear almost all commercial debts. In addition, Government received relief on its bilateral Paris Club debts through traditional debt relief mechanisms. EDS 1991 contained provisions for limiting overall borrowing, prioritizing grant financing and improving concessionality. However, the Government's undisciplined approach to new borrowing continued much as before. As a result, the strategy and the subsequent debt relief failed to achieve sustainability. Debts, many still on non-concessional terms simply, re-accumulated.

80. In 1995, Government revised its external debt strategy, with much greater emphasis on reduction of the debt burden through improved concessionality and increased grant support. New institutional arrangements were also introduced to streamline procedures for contracting new loans, including centralization of the process in the MFPED and better monitoring and reporting of the debt portfolio. A Multilateral Debt Fund (MDF) was introduced, which attracted contributions of US\$135m between 1995 and 1998 from bilateral donors, and was used to service IMF, IDA, ADB and ADF external debt which could not be rescheduled. In April 1998 Uganda became the first country to benefit from the HIPC initiative. Pre-HIPC (1996/97), the nominal value of Government's external debt stock was US\$3.7 billion and the NPV of debt to exports ratio was 243 percent. Under HIPC, Uganda received debt relief amounting to about US\$650 million or about \$347million in net present value (NPV) terms^{55 56}, of which 79 percent was due from multilateral creditors. This relief reduced the ratio of the net present value (NPV) of Uganda's external debt to exports in 1998 to 196 percent.

⁵⁵ Debt relief is frequently expressed in both nominal and net present value terms. Most estimates of Africa's debt are in nominal terms as it is easier to add up the "face value" of various obligations entered into by governments. Debt, however, takes many forms and varies considerably in its terms; but its economic impact is best expressed in NPV terms. For example, the World Bank's lending affiliate for the poorest countries (IDA) offers credits which are repayable over a period of forty years with up to 10 years grace and with an annual service charge of three quarters of one percent. By the time these credits are repaid, their "net present value" will be only 20 percent of the face value of these obligations. In other words, they amount to 80 percent grants. Analysts and creditors prefer NPV figures for the simple reason that these are the more relevant for discussions of actual debt and debt reduction and to allow for a proper comparison among debts contracted on different terms.

⁵⁶ / At this point, it is also useful to note that the HIPC methodology for DSAs (HIPC-DSAs) differed from the more recent DSA methodology developed for low-income countries (LIC-DSAs). First, the LIC-DSAs use the current year exports as denominator for estimating the debt-to-exports ratio rather than the backward-looking 3-year moving average of exports used in HIPC-DSAs. Second, the former uses the exchange rate projections of the IMF's World Economic Outlook while the latter uses the exchange rates at the end of the base year. Finally, in the HIPC-DSA, the NPV of the debt stock is calculated using currency specific discount rates, while a 5 percent discount rate is used in LIC-DSAs.

81. Following the sharp post-HIPC deterioration in the NPV of debt to exports ratio, because of unfavorable terms of trade developments, Uganda received further debt relief totaling US\$656 million in NPV terms under the Enhanced HIPC initiative. This additional debt relief reduced the 2000 ratio of Uganda's NPV of external debt to exports to 138 percent. Immediately following the second completion point, the export price of coffee dropped precipitously. As a result of the falling coffee price, the depreciation of the dollar, and a lower discount rate, the NPV of debt to exports—instead of improving gradually relative to the HIPC target of 150 percent—deteriorated. The ratio rose to 171 percent in 2001 and 263 percent in 2003 and, as of January 2005, was projected to remain at 210-225 percent for the next 10 years. Around two-fifths of the increase was due to new multilateral debt, another two-fifths to exchange and interest rate changes, and the remaining one-fifth to the lower export base. Even though Uganda's external debt ratio remain high, its debt-service obligations after the HIPC Initiative debt relief were manageable. Debt service in relation to exports - a cash-flow indicator - improved from 19.1 percent in 2000 to 10.9 percent in 2003.

82. Uganda was successful in its efforts to increase grant financing of the budget and the proportion of grant financing in total donor aid increased significantly, from 50% in 1995/96 to 82% in 2004/05. However, continued large-scale borrowing to finance the implementation of the Poverty Eradication Action Plan (PEAP), as well as another unforeseen strong decline in world coffee prices, led to a further marked deterioration in Uganda's external debt sustainability following the enhanced HIPC initiative. Moreover, several loans were slow to disburse, suggesting that borrowing was not aligned with sectors' absorptive capacity and resulting in costly commitment fees on un-disbursed debt. From a wider macroeconomic perspective, the large scale of new external borrowing also failed to take into account the critical need for Government to reduce the size of its fiscal deficit, which peaked at 12.3% of GDP in 2001/02.

83. 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. Total MDRI relief (including future interest) delivered during 2005/06-2006/07 was about US\$ 3.6 billion. As a result, all of Uganda's debt burden indicators dropped well below their

policy-based thresholds.⁵⁷ The external public debt was reduced from US\$ 4.5 billion (51.7 percent of GDP) at end 2005/06 to US\$ 1.5 billion (14.7 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. Table 1 shows the recent evolution of Uganda's foreign debt from June 2006 to June 2009. It shows that the nominal dollar value of the foreign debt stock increased somewhat during 2007/08 and 2008/09, but that the ratio to GDP declined further from 14.7 in June 2007 to 13.0 in June 2009.

84. The ratio of foreign debt service to exports also declined further to 1.6 percent in June 2009. There was a similar reduction in the ratio of debt service to revenue, from 8.1 percent in 2005/06 to 2.3 percent in 2008/09.

⁵⁷ The World Bank's Country Policy and Institutional Assessment (CPIA) ranks Uganda as a strong performer. Debt burden thresholds for the latter are NPV of debt-to-GDP ratio of 50 percent, NPV of debt-to-exports ratio of 200 percent, NPV of debt-to-revenue ratio of 300 percent, debt service-to-exports ratio of 25 percent, and debt service-to-revenue ratio of 35 percent.

Section II Table 1
Status of Uganda Public External Debt: 2005/2006-2008/2009
(US\$ Million, unless otherwise stated)

Fiscal Years	2005/2006	2006/2007	2007/2008	2008/2009
Debt	4,464	1,468	1,792	1,904
o/w Multilateral Institutions	4,147	1,180	1,527	1,654
o/w Bilateral Creditors	310	281	265	250
Total Debt Service (after Debt Relief)	117	61	62	54
o/w Principal	90	50	52	42
o/w Interest	27	11	10	12
Debt Relief	78	152	118	129
o/w Multilateral Debt Relief Initiative	n/a	74	85	80
Memorandum Items:				
Debt Sustainability Ratios (%)				
Debt stock / GDP	51.7	14.7	13.1	13.0
Total Debt Service/Exports	7.7	2.2	2.2	1.6
Total Debt Service/Domestic Revenue	8.1	2.8	3.2	2.3

Source: Ministry of Finance, Planning and Economic Development

2. Uganda's Sovereign Credit Ratings

85. In its initial sovereign long-term foreign and local currency default rating of Uganda in December 2008, Standard & Poor's gave it a "B+" with a stable outlook. S&P highlighted that the country's strong economic growth rates, macroeconomic stability, and low foreign debt levels as the main reasons for its favorable rating. It also indicated that economic growth was expected to be sustained by infrastructure investment over the long-term and that the relatively high foreign exchange reserves were expected to support debt sustainability. However, it pointed to a lack of democratic credentials and a high dependence on foreign assistance to finance the fiscal deficit as factors that would continue to weigh on the country's creditworthiness over the medium term.

86. Since 2005 Fitch had continued to give Uganda a sovereign long-term foreign and local currency default rating of “B”. However in August 2009 it increased its rating of the financial outlook for Uganda from “stable” to “positive”. Citing Uganda’s single-digit inflation and 7 percent average economic growth rate over the past decade, Fitch praised the Ugandan government’s steady macroeconomic performance through the global recession. It also indicated that the country’s rising oil industry would significantly lift Uganda’s economic growth potential in the next few years. In November of 2009, Fitch increased its rating of Uganda to “B+”, which is better than Kenya, with a stable outlook.

3. Foreign Debt Strategy

87. The MFPED formulated its new foreign and domestic debt strategy in a paper issued in December 2007. As background to this debt strategy, it is useful to review how the Government’s approach to foreign aid and fiscal deficits has evolved during the past ten years. During the period starting in the mid 1990s the Government had a policy of generally not relying on domestic financing of the budget and financing the budget through concessional foreign aid. Between the late 1990s and 2001/2002 both government spending and the fiscal deficit before grants increased by about 5 percentage points of GDP, funded by increases in donor grants, loans and debt relief. This sharp increase in the fiscal deficit led to difficult macroeconomic management problems and increased concern about the fiscal sustainability of the increasing dependence on foreign aid. The macro policy makers in Uganda were concerned that a heavy reliance on donor assistance would make the budget expenditure difficult to adjust quickly if there were to be a sudden reduction in donor aid. As a result of these concerns in 2002/2003 the Government began implementing a strategy of budget deficit reduction and reduced dependence on aid.

88. Behind this shift was the view that because rapid economic growth was likely to be more sustainable if it was driven by private sector investment and exports, fiscal policy should provide room for growth in private sector credit and allow price incentives to shift in favor of the export sector. The increase in the fiscal deficits and the use of foreign financing, to the extent that the money was spent domestically, lead to an increase in the volume of domestic liquidity in the form of base money. This would need to be sterilized by the Bank of Uganda to maintain control of monetary aggregates,

so that inflation did not increase much above target levels. The two main means of sterilization of liquidity in Uganda were the sale of Government securities and foreign exchange to the market. However, increases in the supply of Government securities in the market, significantly raised interest rates on these securities and on bank lending to the private sector, while increases in the supply of foreign exchange in the market resulted in an appreciation of the nominal and real exchange rate. There was concern that the private sector was being adversely affected by the increased cost of credit and the reduced local currency return from exports. By reducing the level of expenditure and foreign aid the government sought to reduce the extent to which the Bank of Uganda needed to absorb liquidity in the market and lessen the pressure on interest rates and appreciation of the exchange rate.

89. The overriding aim of the external debt strategy is to ensure medium to long-term debt sustainability. It is recognized that external debt financing will continue to constitute an important part of budget financing as long as domestic revenues fall significantly short of expenditures and donor grants alone cannot meet the shortfall.

90. The second main objective of external debt strategy 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 and appropriate level of external financing at minimum cost to Government, in terms of budget impact and contribution to the net demand for foreign exchange. The fourth main objective is to prioritize borrowing for productive sectors.

91. The government's preferred modality of aid financing is grants, which had formed an increasing proportion of overall aid over recent years up to receiving MDRI. The Government plans to continue with this preferred mode of aid financing through grants before considering loans. However, one of the consequences of the MDRI relief and the fact that Uganda was rated by the World Bank as a strong performer is that Uganda is no longer eligible for grants from IDA and is only eligible for loans from the World Bank and AFDB with the implication that the overall share of loans in total external financing will unavoidably increase. Nonetheless, Government will continue to prioritize budget over project support because it gives the Government greater flexibility with regard to its budget expenditure.

92. For project financing, the preference for grants will be made more explicit. Project loan proposals will be required to show that all possible channels of grant financing have been exhausted prior to approval.

93. Government has long recognized the importance of borrowing on concessional terms; this has formed part of external debt policy since the 1990s, as well as quantitative performance criteria in successive IMF programs. The Government will continue to only borrow externally on concessional terms, which it now proposes to define by “a minimum of 80 per cent of new borrowing on IDA terms or better (40 year maturity, 10 year grace period, 0.75% interest) and the remaining 20 per cent on less favorable concessional terms (23 year maturity, 6 year grace period and 2 per cent interest)”. This restriction applies equally to borrowing for project and budget support purposes.

94. The Government will continue to refrain from providing loan guarantees to the private sector, except for infrastructure and in particular for the power sector and transport investment projects. The provision of Government guaranteed loans to various private sector players, which subsequently failed to service them, was another contributing factor to the external debt crisis in the late 1980s. The IMF quantitative performance criteria on non-concessional borrowing also include the condition of no new guarantees to private sector borrowing from either Government or Bank of Uganda: the only exception under the current PSI program being for US\$400m for hydro power development. At present the Government is providing a guarantee for about \$110 million of borrowing for the Bujagali project.

95. Under the new debt strategy for the 2008-2012 periods, it is proposed to limit external project borrowing to the following priority sectors: Works & Transport, Agriculture, Water and Energy. It is believed that external borrowing for investment projects in these sectors should enhance asset formation, productivity and competitiveness. In the past, external loans have been contracted across a wide range of sectors for both development and consumption expenditures, resulting in upward pressure on the size of debt stock, and without any link to improved ability to service the debt.

96. The debt strategy also proposes introducing an annual borrowing cap for the medium term. A fundamental weakness of previous external debt strategies was that

they were open ended with respect to the amount of external debt Government could contract in any one year. This resulted in excessive levels of external borrowing and made it very difficult to maintain external debt sustainability.

97. It was proposed to have the Minister of Finance announce the maximum borrowing limit every year in the annual budget speech on a rolling five-year basis. It was proposed that the total loan disbursement in each fiscal year in the Medium Term Expenditure Framework be made consistent with the programmed path of the fiscal deficit. So far this idea has not been implemented although the budget speech does identify the sectors that will have foreign project funding during the budget year. In order to ensure debt sustainability the debt strategy proposes keeping the NPV of foreign debt to exports ratio to less than 150 percent. However since this is presently at about 50 percent maintaining debt sustainability will not be a problem by this measure.

4. Issues with regard to Commercial Borrowing

98. 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. It is generally believed that a sovereign bond issue might have a slightly lower total cost (interest and various fees) compared to borrowing directly from commercial banks. The sovereign bond idea has also considered attractive because it would establish a base rate upon which to price foreign currency bond issues by private sector firms. The main disadvantage of the sovereign bond 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. The interest rate which the Ugandan Government would be likely to get if it needed to temporarily invest part of the receipts of the sovereign bond issue would probably be only about half of what it would be paying in interest and other charges. This would be a significant cost. 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. Again, the

Government would get a much lower interest rate on the funds being accumulated for redemption expense than what it was paying for the loan.

99. In comparison with a sovereign bond issue, 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. This being said, in assessing the relative advantages of borrowing from banks, one would also have to take into account the commitment fees that the government would have to pay to the banks. It would probably be possible to phase both the borrowing and the repayment to meet the Government's needs. It appears likely that even if the actual cost of the loan might be somewhat higher, this would be offset by a reduced need to invest temporarily part of the borrowed amount until it was needed to pay for project implementation and part of the amount to be repaid at the end of the bond maturity. In addition to probably being cheaper, borrowing from commercial banks could more easily be structured to permit a smooth repayment of the borrowing which would be less disruptive to budget planning. That being said, the Government should also explore whether there are ways to better tailor a bond issue or other forms of market borrowing to their specific needs. If the Government decides to undertake commercial borrowing it will need to carefully assess the kind of issues mentioned above and explore all available alternatives to ensure it obtains the most suitable form of borrowing.

5. Structure of Domestic Debt and Domestic Debt Strategy

100. As domestic debt was issued almost entirely for liquidity absorption purposes, up until 2004 the only treasury securities issued were treasury bills with no maturity exceeding one year. However, there was some concern that this meant that since the entire stock of debt had to be turned over more than once each year there was a high risk that if interest rates were to become very high for a year the entire stock of debt would become subject to high interest rates. Hence, it was decided to start issuing treasury bonds in January 2004 and to gradually increase the average maturity of the stock of Treasury securities in the market. Initially two-year bonds were issued and gradually three-year, five-year and ten-year bonds have been issued. By June of 2007 the average maturity had increased to 1 year and the ratio of bonds to total treasury

securities outstanding had increased to 43 percent. By June 2009 the ratio of bonds to total securities increased further to 49 percent and the average maturity increased to 1.4 years. As shown in Table 2, as of June 2009 the total stock of treasury securities outstanding was Shs 2.8 billion. Out of the Ush 1.44 billion of treasury bills outstanding, 64 percent were held by commercial banks, 20 percent were held by the Bank of Uganda and the remaining 16 percent were held by non-banks, including insurance companies and pension funds. Commercial banks held 65 percent of treasury bonds, while non-banks held 32 percent and the Bank of Uganda held 3 percent.

Section II Table 2
Government Securities Outstanding by Holder
(Billions of Shillings at end-period)

End June of Year	2006	2007	2008	2009
Government Bonds	903	1,257	1,365	1,362
Bank of Uganda	29	30	42	41
Commercial Banks	455	760	851	884
Non-Banks ^{1/}	420	466	472	327
Treasury Bills	1,042	1,528	1,368	1,444
Bank of Uganda	232	255	284	282
Commercial Banks	609	730	756	923
Non-Banks ^{1/}	201	544	328	240
Total	1,945	2,785	2,733	2,806
Banks	1,324	1,774	1,934	2,129
Non-Banks	621	1,011	800	677

Source: Annual Report, Bank of Uganda

^{1/} Includes insurance companies, pension funds and Social Security Fund and others

101. Domestic debt has represented a relatively small proportion of Uganda's total debt in the past, but with the sharp reduction in the stock of foreign debt as a result of the MDRI, the stock of domestic debt is almost as large as the stock of foreign debt. Thus, for the first time it was deemed important to formulate a deliberate strategy with

regard to domestic debt. Uganda is highly unusual in that almost the entire stock of domestic debt has emerged from liquidity management operations rather than from financing of the budget deficit. Hence it is useful to discuss liquidity management in some detail to fully understand the domestic debt management strategy.

102. The target growth rate of money supply is agreed in conjunction with the IMF and depends on the rate of economic growth and other economic developments, which are exogenous to Government policy in the short term. Net injections from Government financed by donors form the major component of total net injections of liquidity. Expenditure that is financed by an inflow of foreign grants and loans results in an increase in liquidity in the economy, to the extent that the money is spent locally rather than on imports. The extent to which Government expenditure on local items (injections) exceeds domestic Government revenue (contractions) is the main determinant of the necessary volume of liquidity absorption measures.⁵⁸ As indicated earlier the Bank of Uganda has two major instruments to absorb liquidity; the sale of treasury securities⁵⁹ and the sale of foreign exchange to the market. In recent years as the reliance on foreign aid to finance the budget has declined, there has been increased reliance on the sale of foreign exchange to absorb liquidity as it has come to be felt by the officials that at the margin a somewhat stronger exchange rate would do somewhat less harm to the private sector than slightly higher interest rates. The sterilization mix at any given time depends to a large extent on other pressures in the foreign exchange and credit markets, which frequently are largely exogenous to Government policy. Some further research on the relative impacts of exchange rates and interest rates on private sector growth would be useful in striking the best balance between these two instruments of monetary policy.

103. The three main strategic objectives of domestic debt management policy in Uganda are indicated as follows in the debt strategy paper:

⁵⁸ Donor budget support goes mainly to local purchases, while project support goes mainly to foreign purchases.

⁵⁹ *When the Bank of Uganda issues treasury securities it makes a deposit of the funds received in a special Treasury Bills Account. However no interest is paid to the Treasury on the balances in this account and the Treasury pays the interest on the treasury securities issued to the market by the BOU.*

1. Provide a stable and sustainable source of domestic funding for liquidity absorption policy and modest levels of deficit financing in the future.
2. Minimize interest cost subject to keeping the turnover risk of the debt portfolio at an acceptable level
3. Support development of a well functioning market for Government of Uganda securities and facilitate development of the financial sector in general.

It is recognized that attaining these objectives requires appropriate policies and coordination between the Ministry of Finance and the Bank of Uganda. The following macro-level sustainability benchmarks were suggested to ensure the level of domestic debt is consistent with the stated Government objectives of pursuing fiscal consolidation and private-sector led economic growth.

Section II Table 3
Macro-level Sustainability Benchmarks

	Suggested Benchmark	Current
Domestic Debt stock/ GDP	<15 %	10 %
Annual domestic interest cost/revenue	<15 %	8 %
Domestic debt stock/ private sector credit	<100 %	130 %

104. The current level of the domestic debt to GDP ratio and the annual domestic interest cost to revenue ratios are already well below the suggested benchmarks. However the ratio of the domestic debt stock to the stock of private sector credit is considerable above the suggested benchmark. It is realized that it may take a number of years to meet this benchmark. At present the banking system loans more money to the government than to the private sector and it is seemed desirable to alter this ratio in order to encourage private sector lead growth. This is consistent with the government's goal of reducing the budget deficit and the dependence on donor flows.

105. The debt strategy paper suggested gradually increasing the share of treasury bonds to 60 percent and increasing the weighted average maturity of outstanding treasury securities to 1.5 years over a number of years. In fact, considerable progress has already been made towards meeting these objectives as of the middle of 2009. It is

recognized that the interest cost of longer maturities of treasury securities is generally considerably higher than the interest rate on treasury bills, but it is deemed desirable to lower the turnover risk. Another objective of issuing bonds of different maturities is to provide the market with information about the yield curve that can be used for issuing private sector financial securities with longer maturities and facilitate increased investment by the private sector. Most of the outstanding treasury bonds are for two or three years and there has been limited demand for longer-term securities. Hence the government seeks to liberalize the pension sector and is in the process of passing legislation setting prudent standards for pension fund manager. This is expected to significantly increase the demand for longer-term securities, which at present mainly comes from insurance companies.

106. The debt strategy also indicates the desirability of pursuing fiscal and monetary policies which result in increased stability of interest rates and avoids the sharp fluctuations which occurred in the 2002 and 2003 periods. It was largely successful in this until interest rates spiked sharply higher in early 2009 as a result of the global financial disturbances and the flight by foreign investors from their investments in the Ugandan treasury market as a result of perceived increase in risk.

6. Arrears or Unpaid Bills

107. 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. Although pending bills, or arrears, are not officially recorded as part of public debt, the Ugandan Government has recognized that they are a form of debt, which is particularly undesirable and has tried to reduce them. Domestic arrears refer to bills remaining outstanding beyond the fiscal year in which they are incurred.

108. Domestic arrears result from poor public expenditure management. It is recognized that the accumulation and continued non-payment of arrears poses significant risks to the economy. Firstly, the accumulation of arrears distorts budget implementation. As arrears constitute off-budget expenditures, they may easily channel resources to non-priority areas. Secondly, domestic arrears arising from non-payment of bills and invoices threaten the survival of private firms by undermining their liquidity positions. Businesses are likely to impose a premium on their charges to mitigate risks associated with delayed payments, increasing the fiscal cost of doing

business with the private sector. 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).

109. The CCS provides guidelines that prohibit Accounting Officers (AOs) from committing Government in excess of the quarterly expenditure limits and cash releases. It also requires AOs to settle all commitments within 30 days. The Public Finance and Accountability Act (2003) empowers the Secretary to the Treasury to take punitive action against AOs who violate the CCS. Initially, there was a significant a reduction of CCS domestic arrears but they increased sharply during 2003/2004 and 2004/05. Arrears increased because of lax enforcement of CCS and related penalties and because of the practice of accommodating the spending needs of powerful ministries by cutting cash releases to other Government units. The control, clearance and verification of arrears on spending on wages and pensions, which are not included in CCS, remained weak. As of June 2006 the stock of verified arrears was Shs 540 billion. In addition, there were believed to be a considerable amount of arrears for military pensions and local governments.

110. A prepayment system for utilities was announced in 2002/03, under which utilities would cut off Government units which did not pay in advance for their services. So far only the telephone company has effectively implemented this and it has recently been introduced for fuel purchases from Oil companies.

111. During 2003/04 there was a resurgence of arrears even in categories covered by the CCS. The increase in post-CCS arrears showed non-compliance by AOs to the system, thus undermining the existing strategy. In addition, there had been evidence of under-budgeting of expenditure categories that were not covered by CCS resulting in further accumulation, while budgeted arrears resources to cover pre- and non-CCS arrears were being diverted. In addition whilst IFMS was intended to support the domestic arrears strategy, accounting officers bypassed the system. As a result the Government sought to modify its approach to curtailing arrears. The modified approach sought to clear the existing stock of verified arrears within the medium term, to put in place measures to prevent the diversion of budget allocations to clear arrears, and to strengthen the existing initiatives to diminish the creation of new arrears.

112. The stock of arrears was broken up into two categories. The first, category A arrears, included those incurred before 30th June 2004, in addition to all arrears that are not covered by CCS. It was planned to pay Category A arrears by providing special arrears budget based on age and cost. Category B arrears consist of arrears in expenditure categories covered by CCS, It was planned to clear the stock of Category "A" arrears of Shs 524 billion during the three years starting in 2006/07. It was planned to clear the existing stock of category B arrears by 2007/08 through AOs using their budget resources to make sure their arrears were eliminated.

113. While there has been considerable progress in reducing category A "old" arrears, the level of new arrears has increased from Shs 28 billion in 2006/07 to Shs 61 billion in 2007/08 and Shs 149 billion in 2008/09. The arrears for State House of over Shs 100 billion in 2008/09 mainly related to the purchase of a Presidential Jet. A commercial loan from a foreign bank was provided over a number of years and the remaining balance has been treated as an arrear. If this was more appropriately treated as a loan, there would be some reduction in the new arrears in 2008/09. The total stock of arrears at the end of 2008/09 was less than 3 percent of the total expenditure during the year. While this is a relatively modest level and would not have much impact if it were included as part of public debt, the Government remains committed to making further progress in eliminating budget arrears.

114. The CCS and IFMS system has not helped much so far to curtail new arrears, mainly because the AOs in the ministries have not followed proper budget procedures and were not punished for their accumulation of new arrears. 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. In addition some improvement in curtailing arrears is expected from recent changes in expenditure management procedures, which have been improved by requiring ministries to develop and submit their work plans and procurement plans up front. This would facilitate the tracking of budget outlays. A Budget Monitoring and Accountability Unit has been formed and will monitor the implementation of work plans in the different sectors. These plans are to be provided prior to the first quarterly release of funds. Subsequent quarterly releases would then be based on the pace of execution of the work plans. In addition, all project accounts have been moved from commercial banks and consolidated at the BOU and payments from these accounts will only be made on the

basis of invoices received. An Expenditure Financing and Tracking System has been put in place to provide electronic transfer of funds from the BOU based on these invoices and these payments will allow MFPED staff to track expenditure better. In addition to curtailing arrears and illegitimate expenditures, it is expected that this closer monitoring will ensure more timely implementation of project expenditure and lessen the large shortfalls in this expenditure which have become normal in the annual budget.

Section III: Macroeconomic Prospects and Debt Sustainability (DSA)

1. Macroeconomic assessment and the last IMF/IDA DSA

115. The last IMF/IDA debt sustainability analysis (DSA) for Uganda, which was prepared in December 2008, was based on an assessment of the macroeconomic outlook that did not include the prospects of oil production.⁶⁰ Moreover, subsequent IMF missions have revised their macroeconomic projections to less optimistic scenarios than that underlying their last DSA (abstracting from oil production prospects) but they did not update their DSA.⁶¹ This basically meant that they expected the non-oil economy to be weaker over the medium term than what they had earlier expected.

116. Even abstracting from likely oil production, the last IMF/IDA DSA had concluded that Uganda faces a low risk of debt distress. It is useful to review the IMF's macroeconomic assessments – both at the time of its last DSA and its later missions – because it will provide a useful perspective to how differently we have developed our macroeconomic scenario for our DSA. It will also provide a better understanding of the impact of oil production and exports on debt sustainability..

117. The main macroeconomic assumptions of the last IMF/IDA DSA were the following:

- *The real GDP growth rate was expected to decline from 9.5 percent in 2008/09 to 7 percent over the subsequent two years before increasing to 8 percent in 2011/12.* This took into account the expected completion of the Bujagali hydro-electric project in 2009/10 (work on which began, after a long delay, in 2007/08), the subsequent increase in energy production and higher

⁶⁰ This DSA is in the IMF Country Report No. 09/79 of March 2009, which also includes the IMF Staff Report on the 2008 Article IV Consultation and Fourth Review under The Policy Support Instrument (PSI).

⁶¹ The IMF's revised macroeconomic projections are contained in IMF Country Report No. 09/202, which includes the IMF Staff Report on the Fifth Review under the PSI. No update of the DSA was done in this report.

investment in infrastructure. Activity was also expected to be boosted by construction projects and the recovery of production in conflict-affected areas (in the North and elsewhere) due to improvements in infrastructure.

- ***The growth rate of the GDP deflator was projected to decline from 16.3 percent to about 5-6 percent***, reflecting the containment of domestic liquidity expansion and decreases in import prices.
- ***Export growth was expected to slow down from 2008/09 onwards due to the falling demand for Uganda's exports and lower export unit values.***

Nonetheless, with an assumed depreciation of the exchange rate over the entire projection period, exports of goods and services were forecast to grow 13 percent per year on average between 2007/08 and 2027/28 because of increases in the export volume of non-traditional exports. (At an average growth of 10 percent between 2008 and 2013, export growth was expected to be much lower than about 17 percent assumed under the earlier 2007 DSA.)

- ***The current account deficit would be above its historical norm by 1.5 percentage points on average between 2007/08 and 2012/13*** (peaking at 5.5 percent of GDP in 2007/08) because of higher imports related to the construction of the Bujagali dam, shrinking global demand for exports, and lower private transfer receipts. ***The expected growth in non-traditional exports would help to stabilize the current account deficit (including grants) in the outer years at about 3 percent of GDP***; and ***excluding grants, the current account is projected to average 3.2 percent of GDP over the 20-year projection period.***⁶²
- ***Fiscal revenues are assumed to rise from 12.5 percent of GDP in 2006/07 to 15 percent of GDP in 2012/13 and be maintained at 18 percent beyond 2020***, because the tax base is expected to expand as tax administration improves, and the shares of manufacturing and service sectors in GDP increases.

⁶² The goods and services deficit shows a significant decline from 12.5 percent of GDP in 2008 to 8.3 percent by 2018 and 5.1 percent of GDP by 2028. This helps to offset the impact of a decline in the ratio of grants to GDP.

- *Budgetary official grants were projected to decline to 2.3 percent of GDP in 2018 and to 1.3 percent of GDP by 2028.*
- *Non-interest public expenditures were assumed to taper off to 20 percent of GDP, consistent with achieving a zero primary balance in the long term.*

While the expenditure forecast took into account provisions for the construction of the Karuma hydroelectric plant (0.6 percent of GDP over four years) and stepped up investment in roads, they did not take into account outlays related to the Government's investments in the oil sector.

- *Official external loans were assumed to increase threefold over 20 years from about US\$ 500 million in 2008/09. Multilateral creditors were expected to scale up their support, with Uganda benefiting from IDA lending operations throughout the projection period. Multilateral and bilateral official debt would, on average, be contracted on concessional terms.*⁶³

118. Under the above baseline scenario, the IMF/IDA DSA concluded that **total external debt (public and private) would remain well below the CPIA-based thresholds over the medium and long term, with public debt showing stable debt dynamics.** Even under the most extreme stress test, the PV of public external debt would not exceed 30 percent of GDP over the projection period. Stress tests did not indicate any potential debt servicing problems. However, the historical scenario (which captures past lower performances) points to the risk of a deterioration of debt indicators over the entire projection period. Nonetheless, the *peak levels of all the debt stock and debt service indicators would remain well below the corresponding policy-dependent thresholds.* The more detailed results of the external DSA are as follows:

- *The PV of external debt-to-GDP ratio* was expected to rise from 14.9 percent in 2006/07 to 17.2 percent in 2009/10 due to the financing of the Bujagali project and IDA loans; subsequently, this ratio declines to 12.4 percent.

⁶³ During 2009-14 the inflows of concessional loans annually average about 0.6 percent of GDP. Thereafter, the ratio of concessional loans to GDP increases to 0.8 percent of GDP by 2018 and to 1.1 percent of GDP by 2028.

- *The PV of debt-to-exports ratio* was projected to rise from 89.6 percent in 2006/07 to 141 percent in 2012/13, reflecting increased borrowing and slower export growth on account of the global slowdown.
- *The debt service-to-exports ratio* was expected to increase between 2007/08 and 2012/13 to a peak of 14.1 percent (2 percentage points higher than in 2006/07) before declining as a result of repayments for Bujagali-related loans and the delivery of HIPC and MDRI assistance.⁶⁴
- *Under all the standardized stress tests*, the debt-to-GDP, debt-to-exports, and debt service-to-exports indicators of the public and publicly guaranteed (PPG) external debt remained below their threshold values throughout the 20 year projection period. However, a large macroeconomic shock could worsen the PV of debt-to-exports ratio significantly. *Lower export growth* (export value growth at historical average minus one standard deviation in 2008/09-2009/10) would raise the PV of debt-to-exports ratio to a peak of 130 percent of GDP in 2012/13. *A combined shock* (by one standard deviation) to real GDP growth, exports, GDP deflator, and non-debt creating flows over the period 2008/09-2009/10 would increase Uganda's PV of debt-to-GDP ratio to a peak of 22 percent in 2011/12 and its PV of debt-to-revenue ratio to 156 percent in 2009/10. Despite these increases in the debt stock indicators, Uganda's debt service indicators were expected to remain well below their policy-dependent thresholds. *Historical scenarios*, which capture past fluctuations in GDP and export growth, inflation, transfers and FDI inflows, also pointed to risks of a marked increase in debt ratios.⁶⁵

119. The IMF/IDA DSA for total public debt (including domestic and external debt) showed that public debt would remain sustainable under the baseline

⁶⁴ The delivery of the debt relief occurs when the debt repayments covered by the debt relief fall due.

⁶⁵ However, historical scenarios would not be appropriate for assessing Uganda's debt sustainability if one takes into account – as we do later --the prospects of substantial oil revenue and its widespread economic impact.

scenario. However, the DSA also indicated that if the growth rate generated by the envisaged investment effort falls short of expectations in the baseline scenario, the *total public debt* burden - - including domestic and external --could deteriorate markedly. The results of the DSA of total public debt (domestic and external) were as follows:

- Under the *baseline scenario*, the PV of public debt was projected to worsen, but stabilize at 21 percent of GDP. The debt service-to-revenue ratio was also expected to stabilize over the medium term.
- However, *sensitivity analysis* suggested that if growth were to be lower than the baseline by 1 percentage point, the debt-to-GDP, debt-to-revenue and debt service-to-revenue ratios would all show an increasing trend even in the long run. The lack of adjustment in the nominal public expenditure path in this situation would result in a primary deficit that would be, on average, 2.2 percentage points of GDP higher than the baseline over the period 2009-2028.

120. The medium-term macroeconomic forecasts underlying the above DSA were revised in early 2009 by the IMF in the context of the fifth review (of the program) under Uganda's Policy Support Instrument with the IMF.⁶⁶ However, no new DSA was done based on the revised macroeconomic forecasts. The revised forecasts did not take into account the prospects of oil production and mainly reflected an updated assessment of the effects of the global economic slowdown on key macroeconomic variables. The main revisions were the following:

- (i) *The growth rate of real GDP was revised down and the headline inflation rate was increased from 2008/09 onwards. The core inflation rate was increased for 2008/09 – 2009/10.*

⁶⁶ The IMF Staff Report was issued on May 13, 2009.

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Table 1: Growth and Inflation rates, 2008/09 -2012/13

	2008/09	2009/10	2010/11	2011/12	2012/13
Nominal GDP (USh billions)- DSA	30782	34950	39363	44687	51287
Nominal GDP (USh billions)- latest	30496	34489	39240	44284	50597
Real GDP (% change) - DSA	7.4	7.3	7.1	8	8
Real GDP (% change) - latest	6.2	5.5	6.7	7	7
Headline Inflation rate (% end-of-period)- DSA	7.7	5	5	5	5
Headline Inflation rate (% end-of-period)- latest	10.3	6.2	5.4	5.6	5.9
Core Inflation rate (% end-of-period)- DSA	7	5	5	5	5
Core Inflation rate (% end-of-period)- latest	10.3	6	5	5	5

(ii) *The ratios of domestic investment and national savings to GDP were reduced substantially from 2008/09 onwards.*

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Table 2: Investment and Savings Ratios, 2008/09 - 2012/13

In percent of GDP:	2008/09	2009/10	2010/11	2011/12	2012/13
Domestic investment - DSA	27.3	29.7	30.3	30.2	31
Public	9.2	11.1	11.2	10.6	10.9
Private	18.1	18.6	19.1	19.6	20.1
National savings - DSA	17.7	20.2	21.3	20.9	22.2
Public	2.3	4.1	4.3	3.6	4.2
Private	15.4	16.1	17	17.3	18
Domestic investment - latest	25.3	26.3	26.2	25.6	25.7
Public	7.7	8.7	8.3	7.2	6.8
Private	17.6	17.6	17.9	18.4	18.9
National savings - latest	14.6	15.5	18.3	19.6	20.3
Public	0.7	1.8	2.4	2.2	2.9
Private	13.9	13.7	15.9	17.4	17.4

(iii) The external current account deficits (excluding grants) are larger in 2008/09 -2009/10 and smaller during 2010/11 -2012/13 compared with the deficits in the last DSA scenario. Compared with the DSA scenario, the net donor inflows are slightly higher in the latest scenario during 2008/09 -2009/10 and lower in the later years. The ratio of external debt to GDP was expected to rise above the DSA projections from 2008/09 onwards. The overall balance of payments was projected to show larger deficits during 2008/09 -2009/10, and the foreign reserve cover for imports would drop to lower levels than projected in the December DSA scenario. The reserve cover will still remain above 4

months of imports, however. These revisions reflected a more realistic assessment of the impact of global shocks and the authorities' policy of relying on borrowing and use of reserves to cover the larger deficits.

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Table 3: Selected External Indicators, 2008/09 - 2012/13

	2008/09	2009/10	2010/11	2011/12	2012/13
DSA (In percent of GDP, unless otherwise indicated):					
External current account balance (including grants)	-6.3	-5.9	-5.5	-5.8	-5.4
External current account balance (excluding grants)	-9.6	-9.5	-9	-9.3	-8.8
Net donor inflows	7	6.5	6.4	6.3	6.1
Overall balance of payments (US\$ millions)	-92	91	-78	-3	61
Gross foreign reserves:					
(months of next year's imports of goods & services)	5.7	5.6	5	4.7	
External debt (including IMF)	13.9	15.6	17.1	18.3	19
External debt service:					
(% of exports of goods & non-factor services)	1.8	1.6	1.2	1.3	1.1
Latest - (In percent of GDP):					
External current account balance (including grants)	-6.2	-6.5	-4.6	-2.9	-2.6
External current account balance (excluding grants)	-10.7	-10.8	-7.9	-6	-5.4
Net donor inflows	7.3	7.1	5.2	4.1	3.5
Overall balance of payments (US\$ millions)	-100	-144	-31	37	124
Gross foreign reserves:					
(months of next year's imports of goods & services)	5.2	4.9	4.6	4.4	4.2
External debt (including IMF)	17.3	20.5	22.4	24.1	25.2
External debt service:					
(% of exports of goods and non-factor services)	1.8	1.6	1.1	1.1	0.9

(iv) Compared to the scenario in the earlier DSA, the fiscal deficit (excluding grants) is smaller during 2008/09 -2009/10, but with lower grants in 2008/09 the deficit (including grants) is larger in the latest scenario. The deficits in the latest forecasts are lower and declining over the rest of the projection period, indicating a strong fiscal adjustment effort. Since the revenue path is weaker in the latest forecasts, the adjustment is expected to be achieved by reducing the expenditure/GDP ratio.

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Table 4: Selected Fiscal Indicators, 2008/09 - 2012/13

	2008/09	2009/10	2010/11	2011/12	2012/13
DSA (In percent of GDP):					
Revenues	12.9	13.4	13.9	14.4	14.9
Grants	4.1	3.1	3	3	3
Total expenditure and net lending	-20.6	-20.4	-20.8	-21.4	-21.6
Overall fiscal balance (including grants)	-3.5	-4	-3.9	-4	-3.8
Overall fiscal balance (excluding grants)	-7.7	-7	-6.9	-7	-6.8
Stock of domestic debt	7.7	7.2	5.9	5.2	4.5
Treasury bill yield (%)					
Latest - (In percent of GDP):					
Revenues	12.4	12.3	12.6	12.8	13.6
Grants	3.2	3	2.9	3	2.7
Total expenditure and net lending	-19.4	-19.1	-18.6	-17.8	-17.5
Overall fiscal balance (including grants)	-3.7	-3.9	-3.1	-2	-1.2
Overall fiscal balance (excluding grants)	-7	-6.9	-5.9	-5	-3.9
Stock of domestic debt	8.6	7.2	5.8	5	4.1

2. Baseline macroeconomic scenario and DSA of the CGH team

a. Baseline macroeconomic scenario

121. A new DSA exercise would be timely and useful given the changes in the medium-term macroeconomic outlook since the IMF's last DSA as well as the prospects of substantial oil revenues. In developing our baseline scenario, we updated some elements as well as retained some others in the IMF's last DSA forecasts to project developments in the non-oil economy and combine them with our forecasts of the oil sector developments. In this regard, the main points to note are the following:

- We used the most recent 2008 official data⁶⁷ as the base year of our projections for exports, imports, the external current account, and nominal and real GDP of the non-oil economy. The series for exports and imports of the non-oil economy were then derived by applying to the base year data the growth rates assumed in the IMF DSA for projecting exports and imports. Similarly, the

⁶⁷ Bank of Uganda and the Uganda Bureau of Statistics.

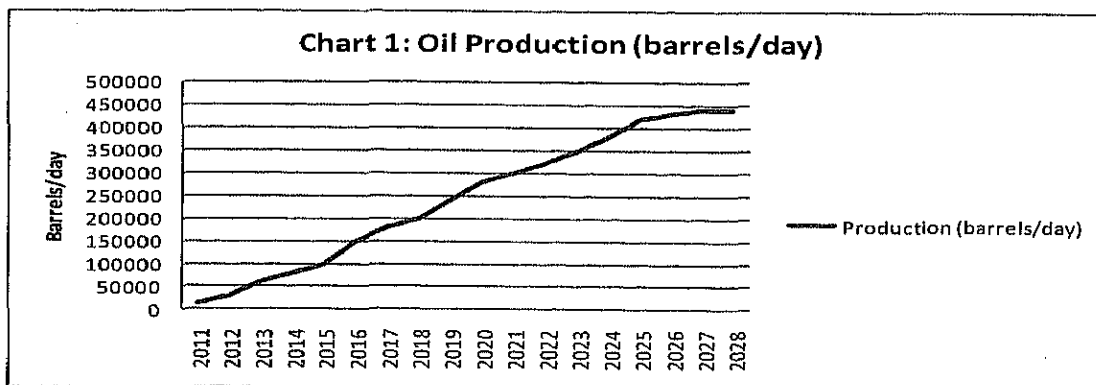
- IMF's assumptions for real GDP growth and the inflation rate were used to derive forecasts of real and nominal non-oil GDP.
- Our forecasts of FDI inflows were derived by adding the likely new inflows for the oil pipeline and refinery (discussed below) to the last IMF DSA forecasts. The IMF DSA forecasts for total net current transfers and official transfers were retained in our baseline.
 - For our fiscal projections, we used the authorities' most recent medium-term budget and expenditure forecasts (MTEF) for the fiscal years 2008/09-2013/14, after converting them to a calendar year basis. However, we revised the public expenditure forecasts of the MTEF to include the Government's likely investments in the oil sector during 2010-11. For projections beyond the MTEF projection period, we assumed non-oil revenues to grow in line with non-oil GDP and non-interest public expenditure to grow at an average annual rate of about 7 percent in real terms (which is well above the historical average and the assumptions of the last IMF DSA).
 - Finally, we replaced the IMF's assumption of a gradually depreciating exchange rate throughout the projection period with the assumption that the exchange rate would gradually appreciate. Given the prospects of oil revenues, we assumed that the exchange rate would appreciate from about US\$ 1937/US\$ to US\$ 1300/ US\$ by the end of the projection period. Annually the nominal US dollar value of the Ugandan Shilling (US\$) 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).

122. Our baseline scenario is a preliminary attempt to build future oil production into the macroeconomic baseline projections and do a DSA on that basis. This exercise is at best preliminary because at this stage (i) there are major uncertainties surrounding the likely amounts of future oil production, (ii) the details of the tax regime applied to the oil companies are confidential and unavailable to the public, and (iii) plans for future investments in the oil sector are yet to be fully finalized. When one considers these factors, it seems reasonable for the IMF to have decided to begin its next DSA exercise

for Uganda at the time of its next mission in March 2010.⁶⁸ Nonetheless, there is merit in doing a preliminary DSA based on hypothetical assumptions at this stage, mainly to highlight some of the policy challenges likely to emerge as a result of oil revenues coming on stream.

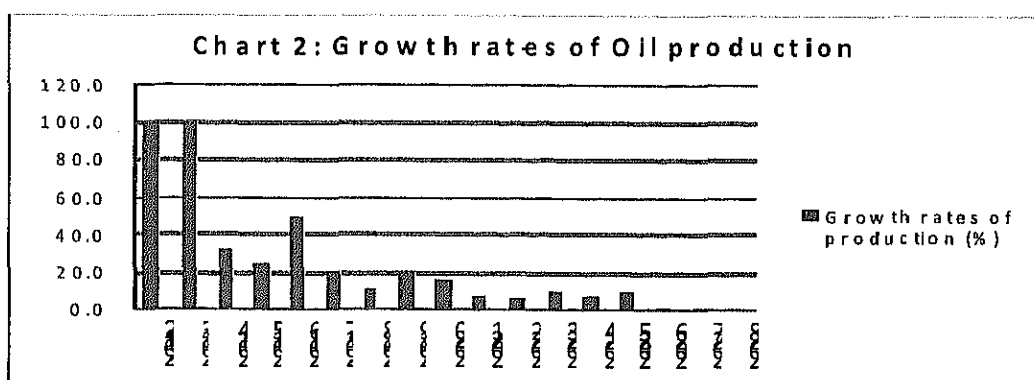
123. From our discussions with the Ugandan authorities and the private investors in the oil sector (especially Tullow and Shell), we understand that **oil reserves might eventually amount to 1-3 billion barrels** and that production could commence by 2011 and be spread out over 30 years. For our baseline we have assumed that **altogether about 1.8 billion barrels of oil would be produced over our projection period ending in 2028**. Oil production is assumed to rise from 15,000 barrels per day in 2011 to 440,000 barrels per day in 2028. Production levels rise fast initially and begin to slowdown later in the projection period. The future time profile of oil production is shown in Charts 1 and 2, and the related data are shown in Annex Table 1.

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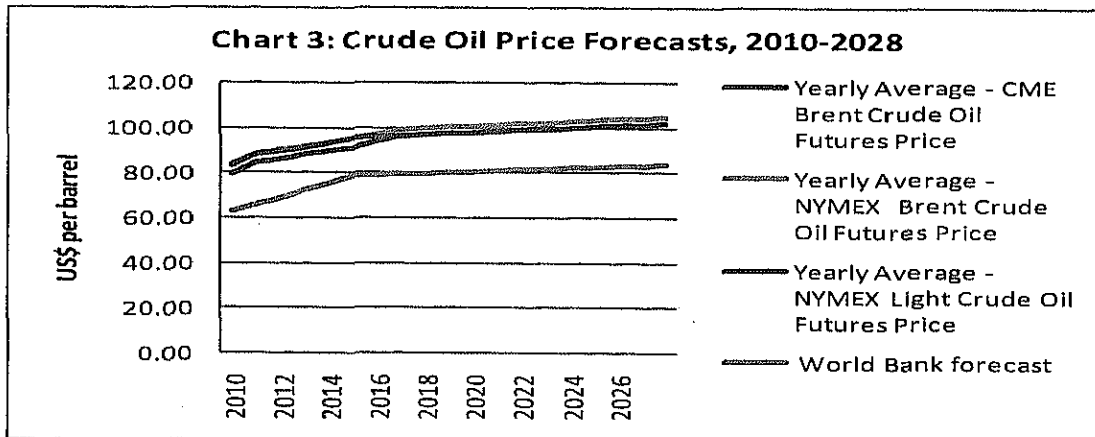
⁶⁸ The IMF and IDA are planning to do a new DSA taking into account these elements in March, 2010.

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124. For oil price projections we considered data on oil futures prices from three sources: the Chicago Mercantile Exchange (CME), the New York Mercantile Exchange (NYMEX) and the World Bank's oil price forecast (taken from its recent publication on **Global Commodity Markets**). These data are graphed in Chart3 below and the related time series are contained in Annex Table 2. Interestingly, the World Bank price series is significantly below the CME and NYMEX series. Since Uganda's crude oil is of the heavy type, it is expected to sell at a discount from Brent crude oil prices which are tracked by the CME and NYMEX series shown in the charts below. At the same time, we felt that the World Bank's price forecasts would be an underestimate for the price of Uganda's crude oil, because it would imply an unusually large discount (US\$ 20/barrel) from Brent crude prices. **Under the circumstances, we used an average of the World Bank and the CME Brent crude oil price forecasts, which still implies a big discount (about US\$10/barrel) for Uganda's crude oil relative to the CME price series.**

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125. At a meeting with the Ugandan Ministry of Energy and Mines, we obtained very preliminary information on the taxation of the oil sector.⁶⁹ The taxation of the oil companies has the following key elements:

- **Royalty payments to the Government:** a rate of 7.5 percent of gross revenues would be applied for low production levels and a higher rate of 12.5 percent would be applied for high production levels. We assumed the lower rate to apply for production levels below 100,000 barrels/day and the higher rate to apply otherwise.
- **Profit sharing:** The Government gets its share (around 60 percent on average) of profits after deducting from gross revenues the royalty payments, “cost oil” or past investment costs which the oil companies would recoup each year, and regular operating costs. Annual “cost oil” payments are assumed to be in the range of US\$ 300-500 million and annual operating costs are assumed to account for about 5 percent of revenues.
- **Profits tax:** A profits tax of 30 percent is applied to the oil companies’ share (around 40 percent on average) of profits.

⁶⁹ The production sharing agreements with the oil companies and the related details of taxation of oil companies are not publicly available and were not accessible.

Given the unavailability of detailed information on most of these parameters, we have adopted relatively conservative assumptions to avoid overestimating the government's earnings from the oil sector.

126. We also obtained some **indicative estimates from Tullow and Shell of the investments needed for the planned pipeline and a refinery, and of other development outlays relating to the oil sector.** We used this information to update forecasts of public expenditure and its financing and of private investment and related FDI inflows. From the latter, we derived rough estimates for the annual "cost oil" payments collected by the oil companies. This 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.⁷⁰ 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 from its budgetary resources. 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. These investment data and their breakdown for the two years 2011-12 are shown in Annex Table 3.

127. We derived projections for the oil sector financial flows using the above assumptions for oil production, oil prices, oil sector taxes, "cost oil" and oil companies' operating costs. These projections are shown in Annex Table 4, and they show 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. Table 5 shows the projections of gross revenues and its breakdown between the Government and the oil companies.

⁷⁰ Although the issue of constructing a refinery is still being studied by the authorities, the above cost estimates that were provided to us suggest that a refinery will be built with a fairly large capacity (of about 100,000 barrels of refining capacity). We have assumed these costs in preparing our baseline scenario.

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Table 5: Division of gross revenue (US\$ million)

Years	Total gross revenue	Government	Oil companies
2011	411.36	74.01	337.35
2012	851.81	384.52	467.28
2013	1756.22	1022.14	734.09
2014	2413.53	1485.54	927.99
2015	3103.53	1935.99	1167.54
2016	4747.92	3161.75	1586.17
2017	5781.11	3868.62	1912.49
2018	6457.58	4355.00	2102.58
2019	7787.94	5239.53	2548.41
2020	9131.24	6205.38	2925.88
2021	9832.77	6709.76	3123.01
2022	10541.12	7219.07	3322.06
2023	11587.44	7971.37	3616.07
2024	12644.03	8731.08	3912.97
2025	14045.39	9738.63	4306.75
2026	14452.25	10031.17	4421.08
2027	14862.85	10326.39	4536.46
2028	14937.73	10380.23	4557.50

128. 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. Table 6 shows the projections for the net cash flow generated by oil production and its breakdown between the Government and the oil companies.⁷¹

⁷¹ It should be noted that the difference between total gross oil revenue and total cash flow is deducted from the gross revenue of the oil companies to derive their cash flow figures.

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Table 6: Cash flow (US\$ million)

Years	Total Cash flow	Gouvernement	Oil companies
2011	90.80	74.01	16.78
2012	509.21	384.52	124.69
2013	1368.41	1022.14	346.28
2014	1992.85	1485.54	507.31
2015	2598.36	1935.99	662.37
2016	4160.52	3161.75	998.77
2017	5092.05	3868.62	1223.44
2018	5734.70	4355.00	1379.70
2019	6898.54	5239.53	1659.01
2020	8174.68	6205.36	1969.32
2021	8841.13	6709.76	2131.37
2022	9514.07	7219.07	2295.00
2023	10508.07	7971.37	2536.70
2024	11511.83	8731.06	2780.77
2025	12843.12	9738.63	3104.48
2026	13229.64	10031.17	3198.47
2027	13619.71	10326.39	3293.32
2028	13690.84	10380.23	3310.62

129. Our derivation of the impact of oil revenues on GDP and other macroeconomic variables was based on the following steps:

- The **oil revenues accruing to the Government were added to the non-oil GDP projections**, the gross oil revenues were included under exports and the gross receipts of the oil companies (covering their costs and their after tax income) were treated as imports of goods and services. In effect, this ensured that the oil sector's net external surplus in goods and services matched up with the assumed addition of oil revenues to non-oil GDP.⁷²
- To obtain the **impact of oil revenues on real GDP**, we deflated the nominal oil revenues by the DSA projections of the US GDP deflator (which is used here as a proxy for world inflation). The resulting estimates of oil revenues at

⁷² We adopted this approach, because the necessary detailed information on the likely breakdown of the oil sector's external inflows and outflows and domestic transactions was not available.

constant prices were then added to estimates of non-oil GDP at constant prices.⁷³

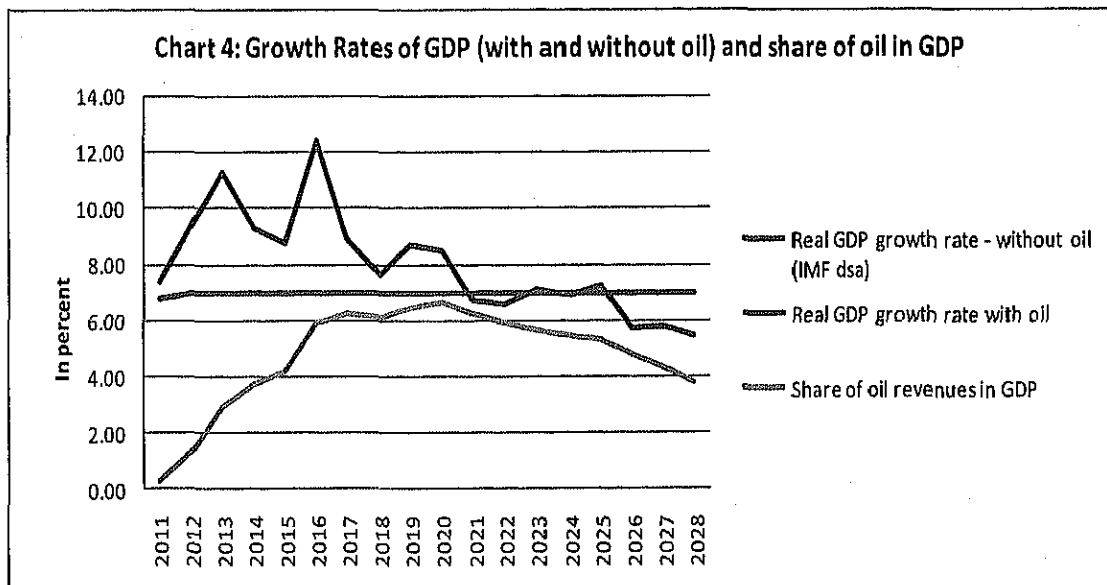
- The conversion of all US dollar values to the local currency (Ugandan Shilling) was based on **the assumption that the Shilling would gradually appreciate against the US dollar from USh 1937/ US\$ in 2009 to USh 1300/ US\$ by the end of the projection period (2028)**. We thought that this was likely to happen because of the substantial oil revenues. This is different from the IMF's assumption in its last DSA which forecast a steady depreciation of the USh vis-à-vis the US dollar (in a non-oil environment). 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.
- The domestic **inflation was projected to decline** from its current double-digit level to 5 percent by 2011, and stay at that level for the rest of the projection period. This is not different from the IMF's forecasts. The upward pressures on prices will most likely intensify once oil revenues fuels increased domestic expenditures on non-tradable goods. However, the authorities (especially the Bank of Uganda) expressed their firm determination to reduce the inflation rate from its current double-digit level and ensure that it does not exceed their target level of 5 percent.
- Moreover, to offset some of the potentially adverse effects of real exchange rate appreciation, the authorities plan to strengthen competitiveness through stronger efforts to reduce the costs of doing business. To this end, they intend to make the regulatory environment for the private sector less burdensome and address infrastructure constraints as a top priority.

⁷³ This is tantamount to valuing oil exports in terms of its real purchasing power (or capacity to import). Also, this measure of the real value of oil exports would capture the effects of both oil price and import price shocks on income from oil revenues..

130. With the addition of oil revenues, the GDP projections⁷⁴ show the following trends:

- The share of oil revenue in GDP rises quite sharply in the first decade of production and then begins to decline (Chart 4). The real growth rate of non-oil GDP (a steady 7 percent rate) is the same as the IMF's DSA assumption. By contrast, 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.
- Chart 4 also shows that the fluctuations in the growth rates of real GDP (inclusive of oil) are largely due to the fluctuations in the growth rates of oil revenues at constant prices. The spikes in the growth rate of GDP are due to the jumps in oil production as new oil fields enter the production phase. However, our measure of oil revenues at constant prices would also capture the impact of terms of trade shocks on the oil sector's income.

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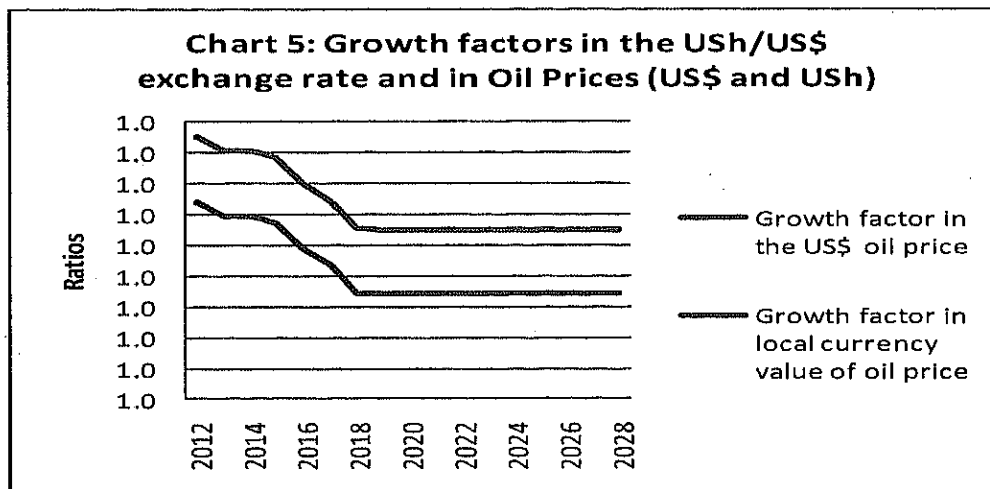


131. As a result of the assumed gradual but steady appreciation of the US\$ relative to the US\$, the ratio (or growth factor) of the current period's exchange rate to that

⁷⁴ The data underlying the GDP forecasts are shown in Annex Table 5.

prevailing in the preceding year is a constant fraction less than one (between 0.96 and 0.98). This means that for the same US\$ amount of oil revenues, the corresponding revenues in local currency shrinks over time. Chart 5 shows this.

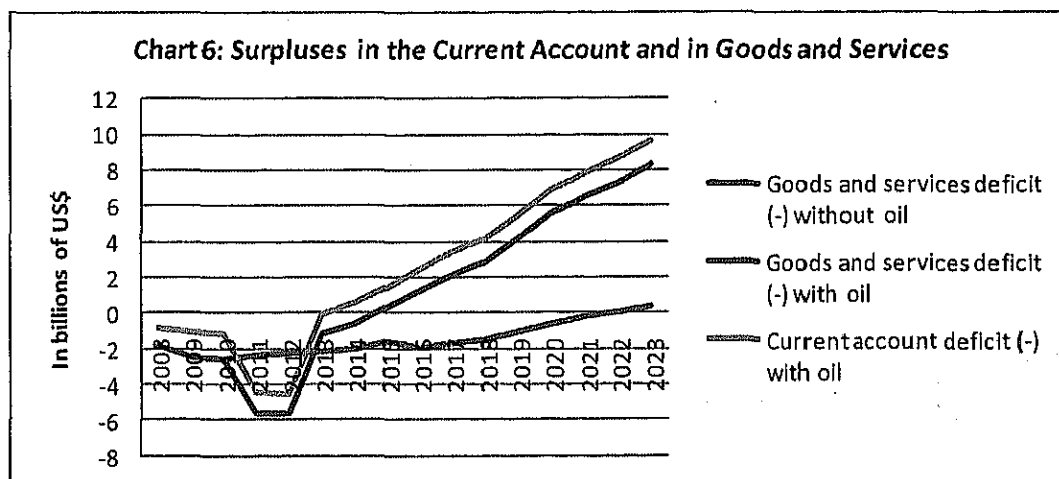
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132. After initial deficits, the external balance in goods and services (with oil related flows) improves sharply into surpluses (Chart 6).⁷⁵ The initial deficits result mainly from the imports related to the investments in the oil pipeline and the refinery. As a result of oil exports, the improvement in the goods and services deficit is much more significant than the goods and services balance without oil. The current account balance reflects the same improvement.

⁷⁵ The data underlying the external sector forecasts are shown in Annex Table 5.

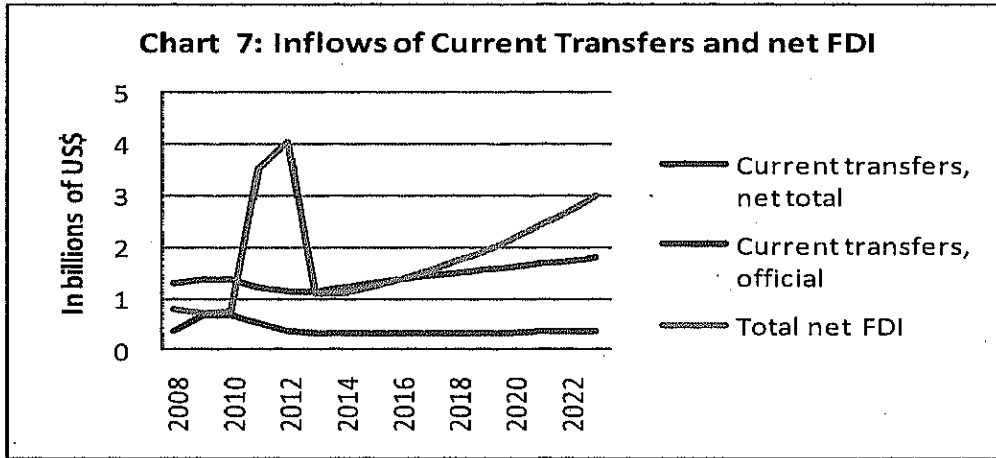
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133. The inflows of official grants are projected to decline and level off, but total **net inflows of current transfers increase largely due to the expected growth in private remittances (Chart 7)**. Like oil revenues, these flows are also expected to strengthen the current account balance. Another important source of private flows is **FDI which shows a strong rising trend with a temporary surge above the trend during the years of investment in the oil pipeline and the refinery.**⁷⁶

⁷⁶ As noted earlier, our FDI forecasts were derived by adding the oil sector investments financed by FDI to the FDI estimates in the last IMF DSA.

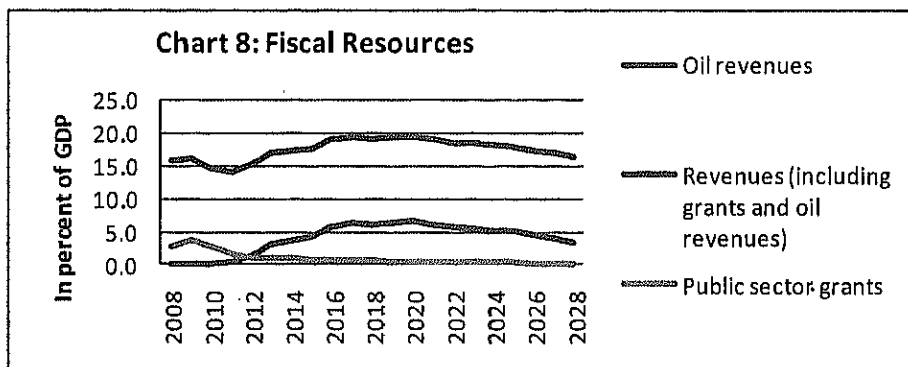
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134. The fiscal projections⁷⁷ were developed on the basis of the following considerations:

- Oil revenues as a ratio of GDP are expected to rise for a decade starting in 2011 and then gradually decline (Chart 8). This explains the initial rise in the total revenues to GDP ratio and its subsequent decline. The reliance on foreign official grants is projected to decline as a ratio of GDP.

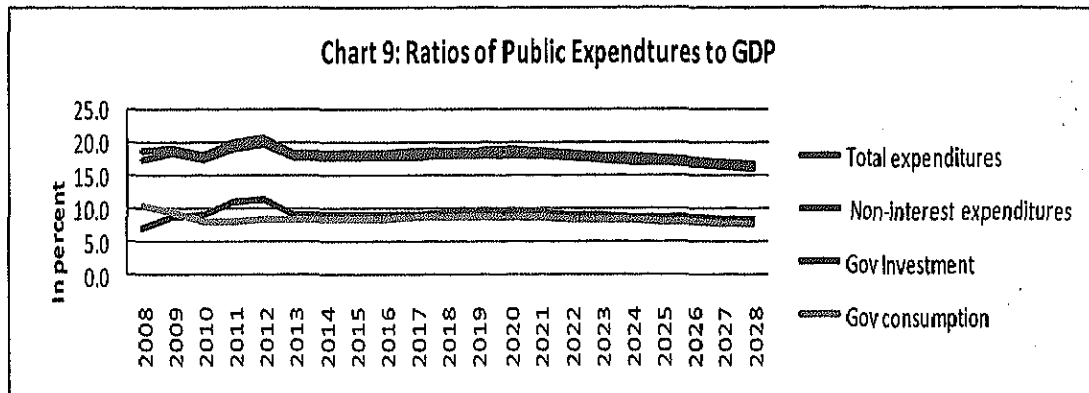
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⁷⁷ The fiscal data are shown in Annex Table 6

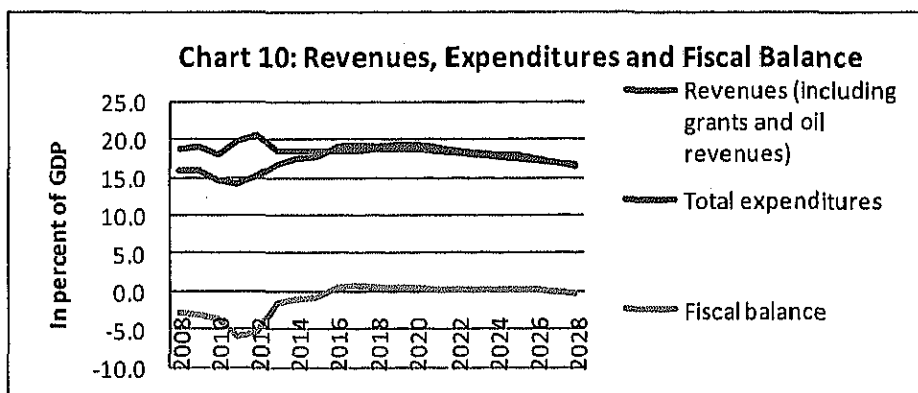
- The ratio of total public expenditures to GDP rises with the initial increase in oil sector investment, then drops and stays stable for a few years before declining over the later years when the ratio of oil revenue to GDP declines (Chart 9). However, the real growth rate of non-interest expenditures averages 6.6 percent over the period 2014-28 and never falls below 5 percent.

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- After an initial period of deficits, the fiscal position shows small surpluses as a ratio of GDP from 2016 onwards (Chart 10 and Annex Table 6).

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135. Over the period of oil production (2011-2028), developments in the fiscal balance and the resources available for its financing (Chart 11 and Table 7) point to the following interesting conclusions:

- 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 US\$ 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.

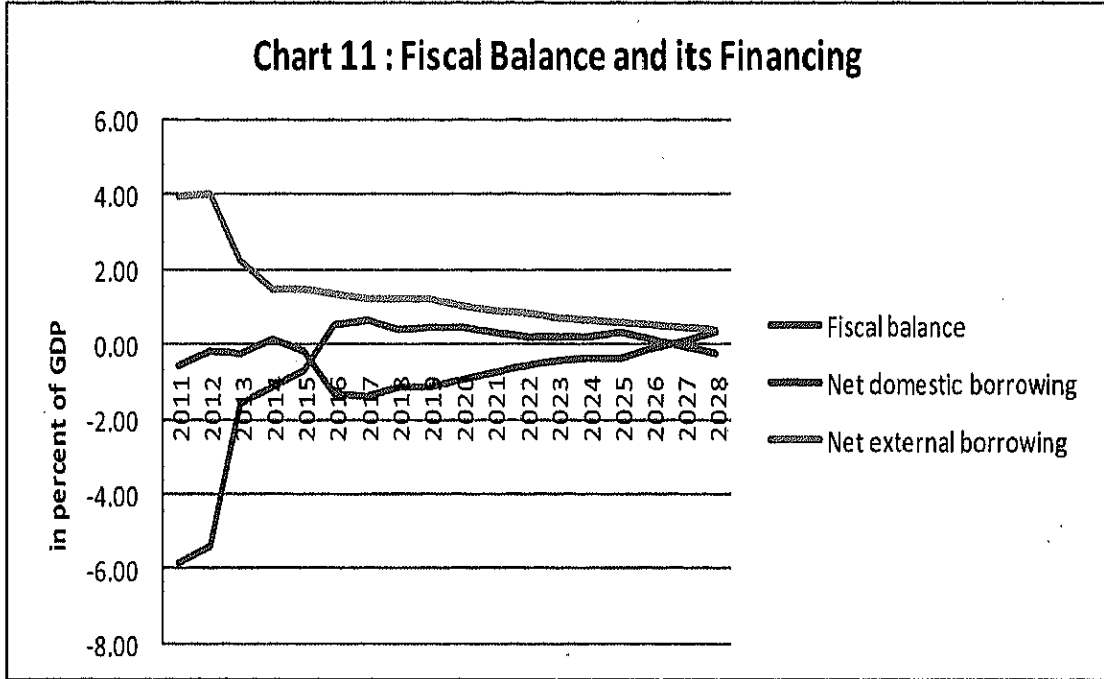
- As Uganda's foreign donors are expected to continue to provide grants and concessional loans to cover a part of both the current and development expenditures included in the Medium-term Expenditure Framework (MTEF), the combined amount of these foreign aid inflows plus the projected domestic fiscal revenues would exceed total public expenditures from 2013 onwards. The cumulative sum of the annual surpluses (which result when revenues plus grants and net foreign financing exceed total public expenditure) would total a net amount of US\$ 23,040 billion by the end of the projection period (6.5 percent of 2028 GDP).⁷⁸ Table 7 shows that the cumulative sum of net foreign borrowing is US\$ 25,957 billion (7.33 percent of GDP) and the cumulative fiscal deficit is US\$ 2,916 billion (-0.8 percent of GDP).
- These surpluses could be used to reduce the stock of domestic debt or to build up the Government's assets position. Table 7 shows that 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)⁷⁹ 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.**⁸⁰ 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.

⁷⁸ In Table 7, these surpluses are the sum of the fiscal balance (which includes grants) and net foreign financing.

⁷⁹ Table 7 shows domestic debt repayments with a negative (-) sign.

⁸⁰ Because the IMF/IDA DSA template does not have an explicit provision for saving in an oil fund, this is shown in our DSA as a reduction in domestic debt. It is highly unlikely that the Government would actually choose to reduce the amount of domestic debt from its already relatively low level.

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Years	Fiscal balance	Net external borrowing	Sum of fiscal balance and net external borrowing	Net domestic borrowing	Changes in assets (- = drawdown)	Cumulative net build-up of assets	Cumulative net build-up of assets (bl US\$)
2011	-2720.7	1836.3	-884.4	-259.5	-1143.9	-1143.9	-0.6
2012	-2864.3	2135.1	-729.1	-83.2	-812.4	-1956.3	-1.1
2013	-966.2	1366.5	400.3	-161.8	238.6	-1717.7	-1.0
2014	-774.3	1050.5	276.1	100.1	376.2	-1341.5	-0.8
2015	-559.7	1138.3	578.7	-162.9	415.7	-925.7	-0.5
2016	487.1	1219.1	1706.2	-1184.6	521.6	-404.2	-0.2
2017	682.2	1252.4	1934.5	-1403.1	531.5	127.3	0.1
2018	474.0	1412.0	1886.0	-1313.3	572.6	700.0	0.4
2019	589.1	1535.3	2124.3	-1457.1	667.2	1367.2	0.9
2020	650.0	1457.2	2107.2	-1361.5	745.8	2112.9	1.4
2021	534.7	1511.1	2045.8	-1250.3	795.5	2908.4	1.9
2022	381.2	1485.1	1866.3	-976.7	889.6	3798.0	2.6
2023	471.0	1450.6	1921.6	-910.2	1011.4	4809.4	3.3
2024	531.3	1464.9	1996.2	-866.2	1129.9	5939.3	4.2
2025	829.5	1442.4	2271.9	-993.2	1278.8	7218.1	5.2
2026	328.5	1425.6	1754.1	-371.2	1382.9	8601.0	6.3
2027	-147.0	1452.0	1305.0	247.7	1552.7	10153.7	7.6
2028	-842.6	1322.2	479.6	1249.2	1728.8	11882.5	9.1
Total	-2916.3	25956.6	23040.4	-11157.9	11882.5		
% of 2028 GDP	-0.8	7.3	6.5	-3.1	3.4		

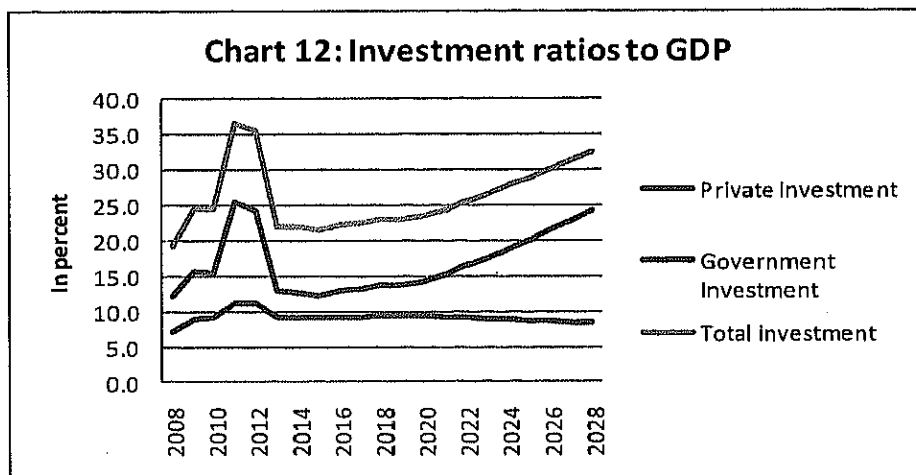
136. The above trends in the financing of the fiscal balance raises the important **policy issue of whether the Government would be better off increasing its expenditures to a higher ratio of GDP (to build much needed infrastructure and a stronger economic base) rather than saving the amounts shown in the above fiscal projections (which is about 9 percent of the cumulative government cash flow receipts from oil sector operations)**. As regards public spending decisions, these would need to take into account both the absorptive capacity of the economy and the relative rate of return on foreign investment of the saved oil revenue and from real domestic investment. The absorptive capacity itself is a function of the efficiency of past investments in capacity building and critical infrastructure and what can be done to address the related constraints. Investment decisions will require a careful evaluation of the net returns both from spending on potential projects and programs (including those aimed at alleviating the absorptive capacity constraints) and from saving oil revenues abroad. Our view is that the authorities will have to find an appropriate mix

of spending and saving based on such an evaluation of the relative returns from these two options.

137. The national accounts⁸¹ related to the above macroeconomic forecasts have two key features:

- A temporary sharp increase in the ratios of private and total investment to GDP during 2011 and 2012, followed by a sharp fall in 2013 and then a rising trend from 2014 onwards. (Chart 12).

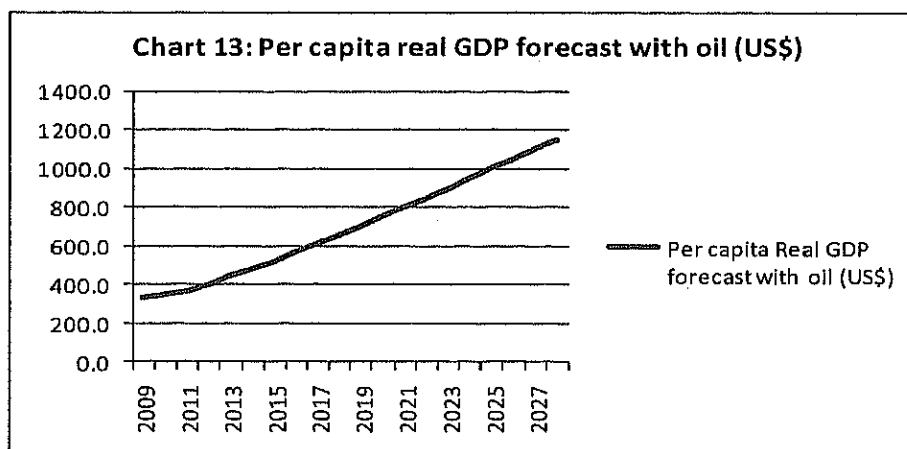
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- A potentially significant increase in per capita real GDP (Charts 13).

⁸¹ The national accounts forecasts are shown in Annex Table 7.

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b. DSA results⁸²

138. In this section we present first the DSA results based on our baseline scenario (under the new macroeconomic assumptions and with the oil revenues). We then compare the results of our DSA with the DSA results from an alternative baseline scenario that assumes a lower oil price forecast (namely, the World Bank's oil price forecasts discussed earlier). After that we will compare the DSA results of the oil-based scenarios with those of the last IMF/IDA DSA which does not take into account oil production.

139. The **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 2011-2012,⁸³ but all external debt indicators decline in later years and remain well below the CPIA-based thresholds⁸⁴ even under the standard stress tests.**

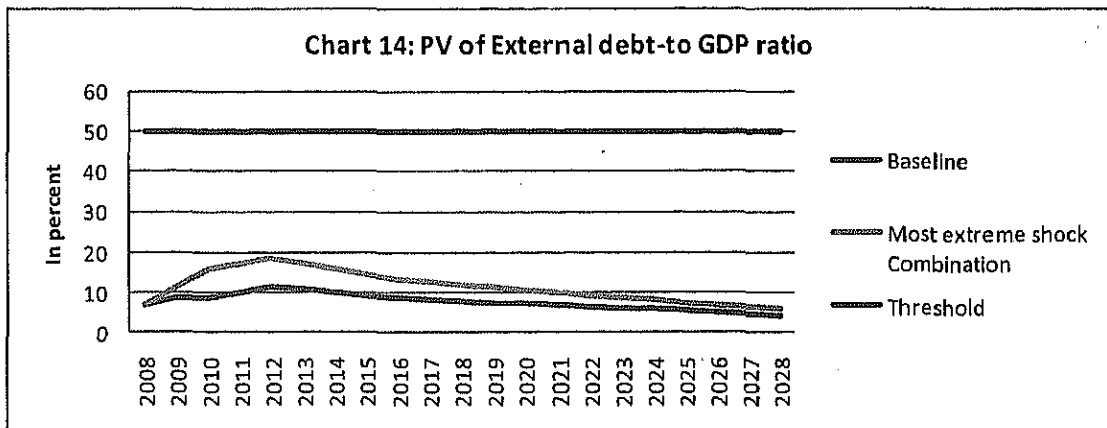
⁸² The results of the DSA for external debt and the total public debt (domestic and external) are shown in Annex tables 8 and 9.

⁸³ The DSA includes commercial borrowing of US\$ 0.115 billion in 2009, US\$ 0.3 billion in 2011 and US\$ 0.4 billion in 2012. These loans are assumed to have a grace period of 1 year, a maturity period of 6 years and an interest rate of 8 percent.

⁸⁴ The World Bank's Country Policy and Institutional Assessment (CPIA) ranks Uganda as a strong performer. Debt burden thresholds for strong performers are NPV of external debt to GDP ratio of 50

- Charts 14-16 below show that the ratios of the PV of external debt to GDP, exports and revenue are well below their respective CPIA-based thresholds throughout the projection period under both the baseline scenario and the most extreme shocks⁸⁵. The trajectories of the three debt stock ratios under the most extreme shock do not diverge significantly from the corresponding trajectory under the baseline scenario. (It should be noted that we did not consider a *historical scenario* which captures past external imbalances relevant for our DSA, because new oil revenues would substantially change the macroeconomic environment from that prevailing before the arrival of oil revenues.)

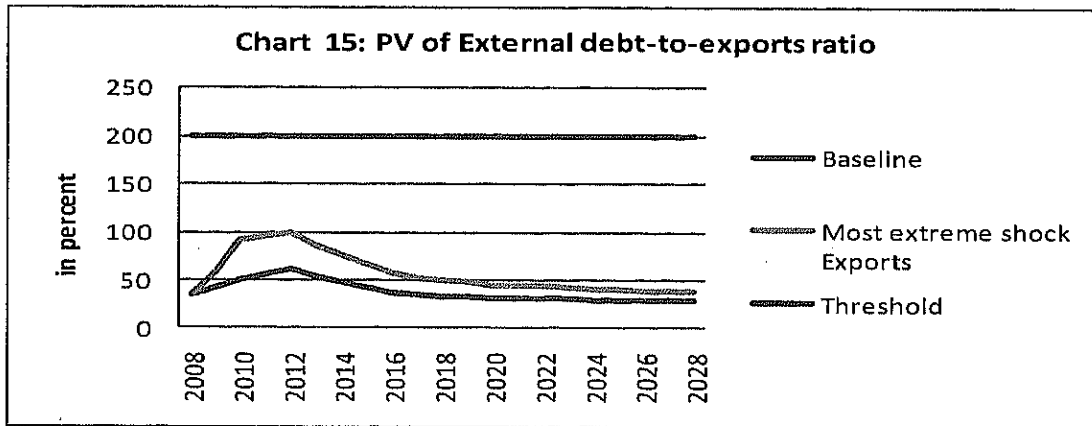
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percent, NPV of external debt-to-exports ratio of 200 percent, NPV of external debt-to-revenue ratio of 300 percent, external debt service-to-exports ratio of 25 percent an, and external debt-service-to-revenue ratio of 35 percent.

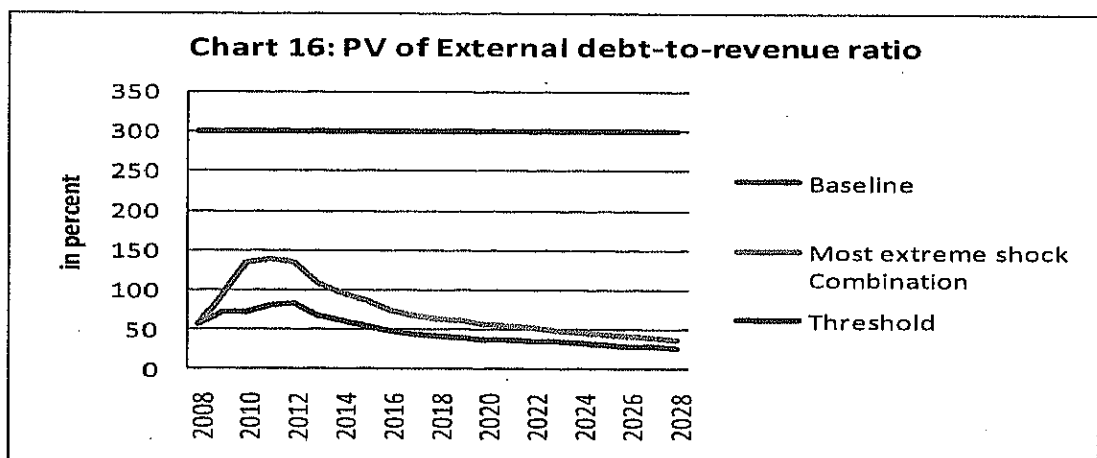
⁸⁵ The most extreme shocks are a *combined shock* in the case of the PV of external debt/GDP and external debt service/ revenue ratios and an *export shock* in the case of the PV of external debt/exports and external debt service/export ratios. The former assumes a combination of (i) real GDP growth at the historical average minus one-half standard deviation, (ii) export value growth is at historical average minus one-half standard deviation, (iii) net non-debt creating flows are at historical average minus one-half standard deviation. These shocks are applied in the first two years of the projection period.

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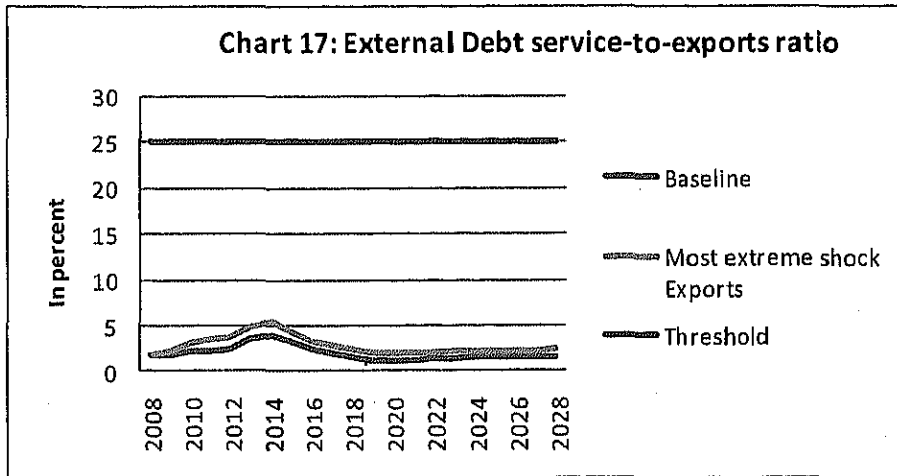


- Charts 17-18 show that the ratios of external debt service to exports and revenue are well below their respective thresholds under the baseline and the most extreme stress test. Again the graphs of the extreme stress test are not much higher than those of the baseline scenario.
- Unlike the last IMF/IDA DSA results (without oil), the impact of the stress tests on the debt indicators is substantially more subdued because of oil revenues.

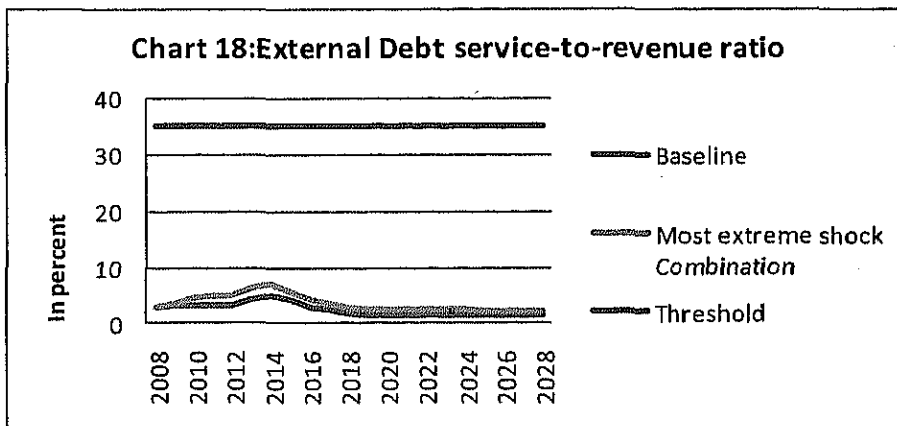
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140. Under the baseline scenario, the key PV of total public debt stock ratios⁸⁶ to GDP and revenue decline sharply over the projection period (Charts 19-20). This result is significantly different from the results of the last IMF/IDA DSA which indicated that these debt stock ratios would rise sharply over the latter half of the projection period.⁸⁷ However, like the last IMF/IDA DSA results, the **stress tests show** that the debt stock ratios of PV of public debt to GDP and revenue rise

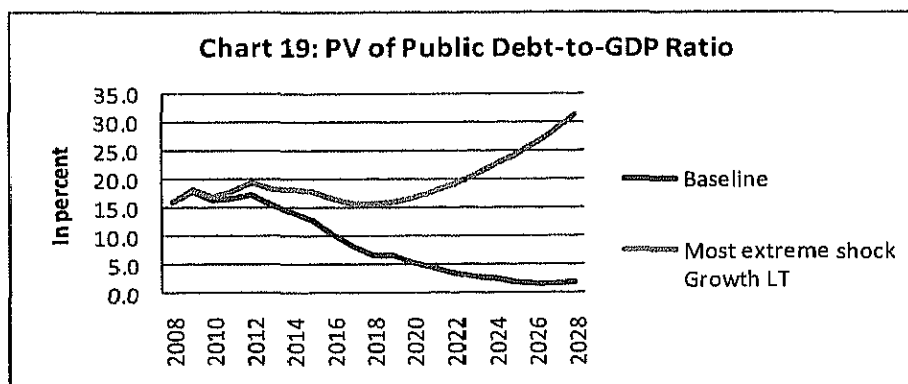
⁸⁶ The total public debt stock includes both the external and the domestic debt.

⁸⁷ This issue is discussed later when the results of our DSA are compared with those of the last IMF/IDA DSA.

quite sharply under a long term (LT) growth shock , namely, when throughout the projection period the real GDP growth is assumed to be permanently lower.

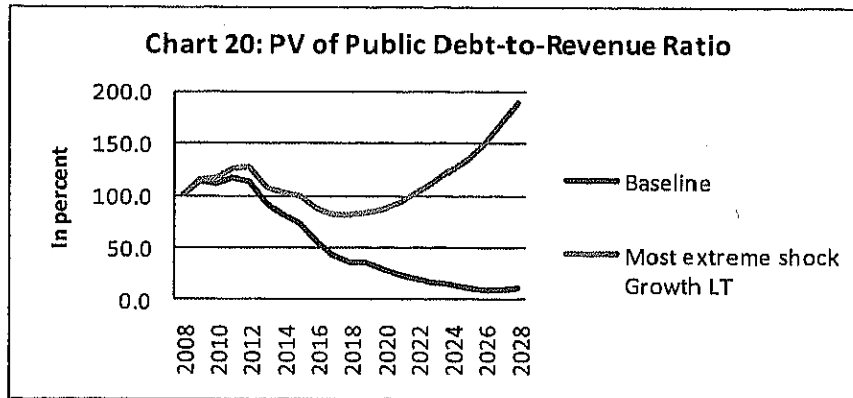
However, we would note that oil production would make debt more sustainable for Uganda. When the same stress tests are applied to a baseline scenario without oil and an oil-inclusive baseline scenario, the debt burden ratios derived from the latter will be lower and more sustainable than those derived from the former. Thus, permanently lower oil production and/or lower growth in the non-oil economy than assumed in our baseline would not weaken the debt indicators more than a baseline scenario without oil. This is because the non-oil economy is assumed to be the same and equally affected by the shock in the two baselines, and there would be some oil production remaining after the shock in our baseline and none in the non-oil baseline scenario.⁸⁸ We did not carry out stress tests which involve either a historical scenario or require holding the primary balance unchanged at a level prevailing before the start of oil production because they are highly unlikely scenarios in the context of the new oil revenues and would not be relevant for assessing Uganda’s debt sustainability. The ratios of the PV of public debt to GDP and revenues are shown in Charts 19-20. (It should be noted that in the IMF/IDA DSA framework there are no policy-based thresholds set for either the public debt stock or the public debt service ratios.)

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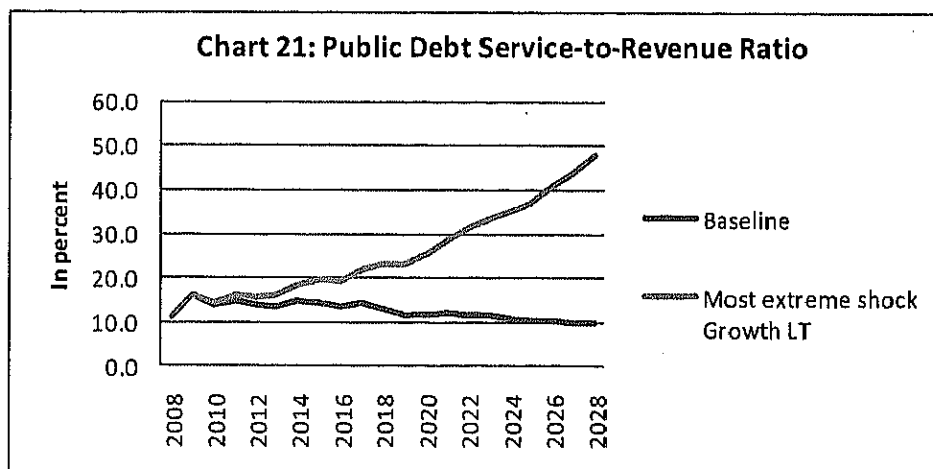
⁸⁸ A more relevant stress test would be to assess the impact of a lower price of oil on our DSA results, and this is discussed later in this section.

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141. 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) (Chart 21). However, under the most extreme shock (a long term growth shock) the ratio of public debt service to revenue rises rapidly to more than 30 percent of revenues. *When such a large share of revenue is absorbed by public debt service, it would imply a sharp curtailment of budgetary resources than would otherwise be available for developmental priorities.*

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142. Next, we looked at an alternative scenario that has the lower oil price forecasts of the World Bank in place of the higher oil price forecasts used in our scenario. The World Bank oil price forecasts are about US\$ 10 /barrel below

the path of the oil price in our scenario. The results of a DSA on the external debt are shown in Table 8 below, where the results of the scenario with the World Bank oil price forecast are indicated by WB in parentheses. This table shows that all the external debt indicators are somewhat worse than those from our baseline scenario (CGH); also all of the indicators are well below their corresponding CPIA-based thresholds.

143. We also looked at the total public debt indicators derived from the two scenarios noted above. The comparison of the indicators for total public debt (domestic and external) is contained in Table 9 below. These indicators also show that a scenario based on World Bank oil price forecasts yields weaker results than that derived from our scenario.

144. **Finally, we looked at the issue of whether oil-inclusive scenarios yield lower and more sustainable debt indicators than the IMF's last DSA.** Tables 10 – 14 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. Tables 15 – 17 show that the public debt indicators of 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. This may be explained by the commercial borrowings and related debt service which are included in our DSA and not in the IMF/IDA DSA.

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Table 8: Comparison of External Debt Ratios from our Baseline and Baseline with World Bank Oil Price

Years	PV of debt-to GDP ratio		PV of debt-to-exports ratio		PV of debt-to-revenue ratio		Debt service-to-exports ratio		Debt service-to-revenue ratio	
	Baseline	Baseline	Baseline	Baseline	Baseline	Baseline	Baseline	Baseline	Baseline	Baseline
	(WB)	(WB)	(WB)	(WB)	(WB)	(WB)	(WB)	(WB)	(WB)	(WB)
2008	7.12	7.12	34.23	34.23	57.09	57.09	1.79	1.79	2.98	2.98
2009	8.75	8.75	41.88	41.88	71.54	71.54	1.89	1.89	3.22	3.22
2010	8.71	8.71	50.25	50.25	72.94	72.94	2.20	2.20	3.19	3.19
2011	10.16	10.15	56.55	55.91	82.34	81.39	2.28	2.25	3.32	3.28
2012	11.56	11.53	62.57	61.47	83.96	82.55	2.47	2.43	3.32	3.26
2013	10.79	10.75	55.21	53.80	69.43	67.86	3.54	3.45	4.45	4.35
2014	9.98	9.94	50.09	48.78	61.93	60.53	4.09	3.98	5.06	4.94
2015	9.33	9.29	43.91	42.88	56.37	55.19	3.28	3.21	4.22	4.13
2016	8.70	8.65	38.14	36.86	48.75	47.31	2.46	2.37	3.14	3.05
2017	8.21	8.16	35.75	34.37	45.43	43.93	2.19	2.10	2.78	2.69
2018	7.89	7.84	35.06	33.71	43.82	42.44	1.66	1.59	2.07	2.01
2019	7.61	7.56	33.54	32.21	41.76	40.45	1.14	1.10	1.42	1.38
2020	7.27	7.22	32.23	30.91	39.55	38.35	1.21	1.16	1.49	1.44
2021	6.95	6.91	32.05	30.77	38.41	37.36	1.29	1.23	1.54	1.50
2022	6.60	6.56	32.05	30.79	37.08	36.18	1.40	1.35	1.62	1.59
2023	6.23	6.19	31.53	30.28	35.27	34.51	1.48	1.42	1.66	1.62
2024	5.85	5.82	30.99	29.77	33.49	32.86	1.54	1.48	1.67	1.64
2025	5.47	5.44	30.20	28.99	31.49	30.99	1.57	1.51	1.64	1.61
2026	5.11	5.08	30.18	29.02	30.13	29.76	1.62	1.56	1.62	1.60
2027	4.76	4.74	30.08	28.96	28.70	28.45	1.67	1.61	1.60	1.58
2028	4.39	4.38	29.88	28.83	27.14	26.99	1.73	1.67	1.57	1.56

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Table 9: Comparison of Indicators of Public Debt with our baseline and baseline with World Bank oil price

	Ratio		Revenue Ratio		Debt service-to-revenue ratio	
	Baseline (WB)	Baseline	Baseline (WB)	Baseline	Baseline (WB)	Baseline
2008	16.02	16.02	100.68	100.68	11.13	11.13
2009	17.97	17.97	112.63	112.63	16.17	16.17
2010	16.28	16.28	111.57	111.57	13.88	13.88
2011	16.54	16.52	118.65	117.43	15.16	15.01
2012	17.27	17.23	116.05	114.25	14.05	13.83
2013	15.47	15.42	93.60	91.60	13.88	13.59
2014	14.60	14.18	85.58	81.62	15.12	14.80
2015	13.54	12.81	77.83	72.44	14.73	14.44
2016	11.54	10.39	62.10	54.58	13.73	13.34
2017	9.89	8.30	52.74	43.09	14.64	14.17
2018	8.75	6.79	47.00	35.58	13.50	13.09
2019	8.75	6.79	46.60	35.29	12.12	11.75
2020	7.76	5.47	41.09	28.33	12.07	11.72
2021	6.95	4.40	37.49	23.23	12.29	11.97
2022	6.35	3.59	34.82	19.33	12.11	11.82
2023	5.92	3.03	32.81	16.53	11.82	11.57
2024	5.51	2.55	30.94	14.14	10.95	10.75
2025	5.13	2.15	29.03	12.05	10.37	10.21
2026	4.69	1.74	27.21	10.04	10.32	10.20
2027	4.49	1.61	26.65	9.53	9.92	9.83
2028	4.57	1.96	27.84	11.90	9.87	9.82

Table 10: PV of External debt-to GDP ratio

	Baseline (IMF)	Baseline (WB)	Baseline (CGH)
2008	15.7	7.1	7.1
2009	17	8.8	8.8
2010	17.2	8.7	8.7
2011	16.9	10.2	10.1
2012	16.4	11.6	11.5
2013	15.9	10.8	10.7
2018	14.7	7.9	7.8
2028	12.4	4.4	4.4

Table 11: PV of External debt-to-exports ratio

	Baseline (IMF)	Baseline (WB)	Baseline (CGH)
2008	79.5	34.2	34.2
2009	99.9	41.9	41.9
2010	121.1	50.3	50.3
2011	127.7	56.5	55.9
2012	134.3	62.6	61.5
2013	141.0	55.2	53.8
2018	106.0	35.1	33.7
2028	75.1	29.9	28.8

Table 12: PV of External debt-to-revenue ratio

	Baseline (IMF)	Baseline (WB)	Baseline (CGH)
2008	118.0	57.1	57.1
2009	135.6	71.5	71.5
2010	126.8	72.9	72.9
2011	121.5	82.3	81.4
2012	113.9	84.0	82.6
2013	107.4	69.4	67.9
2018	87.0	43.8	42.4
2028	67.7	27.1	27.0

Table 13: External debt service-to-exports ratio

	Baseline (IMF)	Baseline (WB)	Baseline (CGH)
2008	7.7	1.8	1.8
2009	8.3	1.9	1.9
2010	10.2	2.2	2.2
2011	12.2	2.3	2.3
2012	12.7	2.5	2.4
2013	14.1	3.5	3.4
2018	12.0	1.7	1.6
2028	12.8	1.7	1.7

Table 14: External Debt service-to-revenue ratio

	Baseline (IMF)	Baseline (WB)	Baseline (CGH)
2008	11.7	3.0	3.0
2009	11.2	3.2	3.2
2010	10.6	3.2	3.2
2011	11.8	3.3	3.3
2012	10.8	3.3	3.3
2013	10.7	4.4	4.3
2018	9.7	2.1	2.0
2028	11.7	1.6	1.6

Table 15: PV of Public Debt-to-GDP Ratio

	Baseline (IMF)	Baseline (WB)	Baseline (CGH)
2008	18.4	16.0	16.0
2009	16.2	18.0	18.0
2010	16.4	16.3	16.3
2011	15.7	16.5	16.5
2012	15.4	17.3	17.2
2013	15	15.5	15.4
2018	20.2	8.7	6.8
2028	21.2	4.6	2.0

Table 16: PV of Public Debt-to-Revenue Ratio

	Baseline (IMF)	Baseline (WB)	Baseline (CGH)
2008	117.6	100.7	100.7
2009	94.9	112.6	112.6
2010	99.4	111.6	111.6
2011	92.5	118.7	117.4
2012	88.4	116.1	114.2
2013	84.2	93.6	91.6
2018	106.2	47.0	35.6
2028	108.3	27.8	11.9

Table 17: Public Debt Service-to-Revenue Ratio

	Baseline (IMF)	Baseline (WB)	Baseline (CGH)
2008	12.8	11.1	11.1
2009	16.3	16.2	16.2
2010	13.8	13.9	13.9
2011	14.4	15.2	15.0
2012	13.4	14.0	13.8
2013	13.2	13.9	13.6
2018	18	13.5	13.1
2028	18.9	9.9	9.8

145. As oil production is likely to improve what is already a sustainable and manageable debt burden, the main challenge facing Uganda is **how to effectively use or spend the expected oil revenues and anticipated foreign borrowing in an efficient manner**. Decisions on public spending will need to be based on careful assessments of the absorptive capacity of the economy and the likely impact of public spending on economic growth. The considerations that would be important to making these 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, we have noted earlier that there is a need for developmental 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.

- Public investments in (physical) infrastructure (in sectors such as roads, railways and energy) could increase the productivity of the private sector and the supply response of nontraded goods, and hence, enhance the impact on growth (even over the medium term). There would also be a need to make adequate provisions for current expenditure to support the projected increases in investments over the medium term as well as to properly operate and maintain both the existing and the new facilities created by 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 their investment, production and financial operations, as well as to account for how the increased revenues are spent. 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.

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. JICA as well as other donors should urge the Ugandan Government to decisively address the governance issues.

146. In addition to improved governance and well-functioning 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. Improvements in the legal and regulatory environment and trade facilitation services would stimulate both domestic and foreign investment (including FDI). Efforts to

increase competition in the financial sector, improve supervision, and make financial services more accessible across the country would foster the development of the financial sector. **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.**

Section IV: Impact of Oil Revenue on Donor Assistance and the Need for Domestic Debt

1. Role of Donor Assistance and Domestic Debt in the Future

147. In about 10 years it is likely that revenue from oil will increase sharply and Uganda will be able to collect its own revenue to fully cover its Government expenditure, even if it is increased somewhat from the current level of about 20 percent of GDP, and still have money left over to increase its international reserves or government financial savings. The question arises as to how the Government of Uganda's policy towards foreign aid might change and how donors might adjust the level and nature of their aid in light of this drastic change in the Uganda's fiscal position.

148. The Government has just initiated a study on what kind of oil refinery would be appropriate. 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 (especially the refinery). 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, possibly 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. Thus, much higher levels of foreign financing may be necessary for a few years in order to make the government investments required to obtain the huge oil revenue increases in the medium term. There will also be pressure to increase the level of current expenditure during the period leading up to the elections in 2011. It will be desirable for the donors to support the efforts of the Ministry of Finance to resist such pressures as much as possible. However, it does not appear realistic to expect any significant reduction in such expenditure to facilitate a shift towards increased infrastructure expenditure.

149. 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. The Government investments to address infrastructure bottlenecks and for facilitating the development of the oil sector are likely to require increased spending on imports. Hence, It would probably make sense to support the Government's plan to address these immediate needs. Most important of all will be assistance aimed at improving the capacity 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. There will also be a need to further strengthen the macro policy area, which has been a strong point of Uganda's policy making, but will face new challenges in terms of how to use the oil revenue in a phased prudent way so as to maintain a favorable environment for non-oil economic activity. It will also be desirable to help improve the quality of the civil service in general. In about 5 years, Uganda will be able to afford a much more capable civil service, but there is a need to start doing this soon and to make this a major focus of donor assistance.

150. It is likely that new foreign aid, as a percentage of GDP will decline sharply as oil revenue increases sufficiently to allow the Government to raise enough revenue of its own to meet the desired budget expenditure. However, the outstanding stock of foreign debt is likely to only decline slowly because the average period of repayment of the loans is very long. In Uganda shilling terms the stock of debt will decline more rapidly, because of the appreciation of the currency. With the increasingly comfortable revenue situation there will be no need for domestic financing of the budget in the future. However, the stock of Treasury securities outstanding as a percent of GDP and the amount of interest payments on domestic debt included in the budget as a percentage of GDP are likely to continue to rise rapidly. This is because the BOU will probably have to continue to increase the outstanding amount of Treasury securities sold to the market as part of its liquidity absorption policy.

151. The literature on fiscal debt sustainability has largely ignored how to treat domestic debt issued for monetary policy purposes. The impact of oil revenue is likely to be more similar to that of foreign aid than it is to non-oil revenue in terms of its impact on domestic liquidity. Once the government starts spending part of 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 measures, in the form of selling Government securities or foreign exchange to the market. 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. Especially if the level of budget expenditure increases as a percentage of GDP and increasingly exceeds the level of non-oil revenue, there will be a need for a continuing increase in 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 on which interest must be paid 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.

2. Fiscal Policy with Oil Revenue

152. 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. This is because they recognize the importance and difficulty of preserving macroeconomic stability and continuing with fiscal and monetary policies which seek to keep inflation at a rate of about 5 percent. The surplus oil revenue would simply be saved and invested outside the budget and outside the country. 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. Virtually all of the other countries which have experienced a sharp increase in revenue from oil and natural gas, have increased both the level of budget expenditure to GDP ratio and reduced the ratio of non-oil revenue to GDP. Thus a somewhat softer version of the policy favored by the Ministry of Finance 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. 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 non-oil 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.

153. 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. 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 whether there are ways to shift government expenditure towards items with higher import content, without distorting the efficiency of budget allocations. Such expenditure does not increase domestic liquidity, which needs to be offset by monetary policy measures.

3. Level of Non-oil Revenue

154. Once the level of the expenditure to GDP ratio and its composition is decided, there remains an **interesting issue of the appropriate composition of revenue**, especially as the oil revenue gradually increases to a size which could cover most or all of the budget expenditure. Once the level of the oil revenue becomes significant it is likely to lead to a reduction of the level of foreign aid, because donors are unlikely to wish to have aid levels which merely contribute to Uganda increasing its level of

foreign exchange reserves and Government financial savings. It would appear to make sense to continue the policy of the past few years to avoid increases in tax rates to increase revenue. There has been a concern that increases in tax rates would have an adverse impact on the private sector. 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. As was mentioned earlier, almost all countries, which have experienced a sharp increase in oil revenue, have reduced the revenue to GDP ratio from other revenue. While this is not necessarily desirable, it is 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.

155. It will not be possible to increase tax incentives for exports because the existing tax system already provides the traditional favorable treatment, which is given under most tax systems. There might be a case to increase the rate of import duties on consumer products to offset the windfall to importers coming from an appreciation of the exchange rate, which reduces the competitiveness of local producers of competing consumer products. However, import duties will be determined for the East African Community as a whole now that there is a common customs structure.

156. The important domestic taxes are the corporate income tax, the personal income tax, VAT, and excises. The competitiveness of firms engaged in non-oil economic activity could be improved by reducing the rates of any of these taxes. Since all of these taxes apply to some extent to the oil sector, it may prove difficult to change them in a manner which has a significant impact on the non-oil sector without having a significant impact on the oil sector. Since a considerable amount of revenue will come from the corporate income tax on the profits of oil companies it does not appear desirable to lower the general corporate income tax rate from its present level of 30 percent. It is not common to have different corporate tax rate on particular sectors. Reducing the general VAT rate from its current level of 18 percent to somewhere between 12 and 15 percent might be an appealing option to help the domestic economy,

although it would benefit importers and local producers equally. It would also help the oil companies, but any reduction in the VAT rate could be offset by having an increase in the excise on oil products. Most excises are levied on products which are considered to have adverse effects on the consumers, such as liquor and tobacco, or on oil products which have an adverse impact on the environment and the use of which involves considerable expenditure on the construction and maintenance of roads. There appears to be little case for reducing such excises. However, there are also a few excises levied in Uganda for revenue reasons or because the products are considered to be luxuries, such as the tax on mobile phone air time and the tax on bottled water. Consideration could be given to abolishing such taxes, although these products do not have any problem of competitiveness with imports. The main point to be made here is that it is worthwhile to study the entire non-oil tax structure to see if there are reductions in taxes that would have particularly favorable impacts on private sector economic activity. 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.

4. Issues with regard to Investing the Excess Oil Revenue.

157. Eventually Uganda will get levels of revenue which greatly exceed its capacity to spend them productively through the budget. **It is useful to start thinking in advance how best to invest the surplus money that accumulates in a special Government 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 and it would complicate monetary management. The starting point for thinking how best to invest is to study how Uganda presently invests its foreign exchange reserves. One difference is that 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 saving fund will be able to invest in much longer-term instruments, which should enable it to get a higher rate of return. Most of the money should probably be invested in the government securities issued by other countries. A diversified portfolio of securities issued by both major industrial countries and by third world countries, which have higher returns and perceived levels of risk that are not too high, will be desirable. It may be attractive to make some purchases of the sovereign bonds issued by other

African countries. 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. Some consideration should also be given to buying the common stocks of some major foreign corporations and to buying some gold or other commodities. Somewhat paradoxically probably the highest rate of return might be obtained by buying its own local currency treasury securities. However, this would undermine the monetary policy liquidity absorption reasons why they were issued in the first place. Even the purchase of Ugandan private sector financial instruments would both tend to raise the interest rate on them and also inject liquidity into the market that would need to be absorbed. Thus, it does not appear easy to find ways of investing in Ugandan financial assets. Even investments in real assets such as real estate will tend to bid up the prices of such assets and also cause liquidity absorption problems. However, Uganda may be able to get very favorable returns by investing in the local currency treasury securities of other African countries, especially longer term securities that tend to have relatively high yields in Africa. 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.

