

# **BANK OF UGANDA**



**Remarks by Dr. Louis Kasekende, Deputy Governor, Bank of  
Uganda**

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## **The fiscal stance of the 2015/16 budget and its impact on the macro-economy**

The macroeconomic impact of the Government budget – the fiscal stance - depends on the extent to which it adds to, or subtracts from, aggregate demand in the economy and on the borrowing requirements of the budget.

### **How much will the budget add to aggregate demand in 2015/16?**

The most commonly used measure of the fiscal stance is the overall fiscal deficit, as a share of GDP. The latest projection for the 2014/15 fiscal year budget is that the overall fiscal deficit will be 4.5 percent of GDP. This is lower than the 6.8 percent of GDP that was budgeted primarily because expenditures on the two hydropower projects (HPPs) have proceeded more slowly than expected this fiscal year.

In the 2015/16 budget presented yesterday, the overall fiscal deficit is projected to rise to 7 percent of GDP; an increase of 2.5 percentage points of GDP on the forecast 2014/15 outturn. Hence compared to the outturn for this fiscal year, next year's budget will clearly be more expansionary. The overall deficit will be larger next year mainly because of higher capital expenditures, including spending on the HPPs, of about 3 percent of GDP, which is only offset to a small extent by a 0.5 percent of GDP rise in domestic revenues.

A more pertinent measure of the impact of the budget on the domestic economy is the domestic fiscal deficit, which strips out all external sources of funds (e.g. donor grants) and spending on imported goods and services. Although it is difficult to estimate precisely what proportion of spending is allocated to imports rather than domestic goods and services, we can make some estimates based on patterns in previous years. Our estimate of the domestic fiscal deficit is that it will be 2.2 percent of GDP in the current fiscal year and 3.8 percent of GDP in 2015/16. Hence the fiscal stance, using the domestic deficit as the measure, is forecast to increase by 1.6 percentage points of GDP. This is smaller than the rise in the overall fiscal deficit because of the high import content of some of the capital expenditures in the budget.

Consequently, compared to the outturn in the current fiscal year, aggregate demand in the economy – that is demand for goods and services produced in Uganda – will receive a modest

boost from the budget in 2015/15, of approximately 1.6 percent of GDP. A fiscal impulse of this magnitude will provide some support to GDP growth but it should not be large enough, by itself, to create substantial inflation pressures.

### **How much will Government borrow to finance its budget?**

The Government's financing requirement is equivalent to the overall fiscal deficit (with an opposite sign). Hence Government must mobilise net finance amounting to 7 percent of GDP to finance the 2015/16 budget. The impact on the domestic economy depends not just on the magnitude of the financing requirement but on how Government mobilises this finance.

There are two main sources of finance for the budget; domestic finance which comprises the net sales of Government securities in the primary securities auctions, and external finance which comprises external borrowing from concessional, semi concessional and commercial sources. The financing requirement of 7 percent of GDP is composed of domestic financing of 2 percent of GDP and external financing of 5 percent of GDP.

In nominal terms, the net issuance of Government securities in 2015/16 will be the same as in the current fiscal year; Shs 1.4 trillion. This implies that the total holdings of Government securities by investors, including banks, NSSF and external portfolio investors, will need to rise by about 14 percent (the current outstanding stock of securities is Shs 9.8 trillion). Given that we forecast that the liabilities of domestic financial institutions will grow by almost 20 percent in 2015/16, it should be possible to accommodate a domestic financing requirement of this magnitude without pushing up interest rates on Government securities any further or crowding out private sector borrowing.

The financing requirement of the budget also matters for public debt sustainability. A borrowing requirement of 7 percent of GDP will raise total nominal public debt to about 34 percent of GDP in 2015/16 from about 30 percent of GDP in 2014/15, excluding any valuation changes to the stock of external debt. The present value of the public debt stock is lower than the nominal value because a large share of the debt has been contracted on concessional terms, and it is the present value which provides a better measure of the debt burden. In terms of debt sustainability, the projected level of public debt in 2015/16 is well within the threshold of 50 percent of GDP for the present value of public debt set out in the Government's Public Debt Management

Framework As such, there are no immanent threats to debt sustainability from the higher borrowing requirements in the 2015/16 budget.

### **Fiscal performance in 2014/15**

The performance of the 2014/15 budget, so far this fiscal year, has improved in two important respects compared to previous years, and this augurs well for the prospects of maintaining fiscal discipline in 2015/16, despite the pressures which will arise in an election year.

First, revenue collections have risen strongly. After 11 months of the fiscal year, net URA revenue collections have risen by 21.7 percent compared to the first 11 months of 2013/14 and were almost fully on target. In 2013/14, there was a domestic revenue shortfall of nearly Shs 600 billion, so this fiscal year's performance reflects a huge improvement, for which URA deserve a lot of credit.

Second, after 10 months of the fiscal year, Government expenditures have not exceeded the budget on a pro-rata basis, which offers grounds for optimism that expenditures for the full year can be kept within the overall budget.

### **The exchange rate**

The exchange rate has been the most volatile aspect of Uganda's macroeconomy in 2014/15. Since the start of the fiscal year it has depreciated by 20 percent against the US dollar and by 11 percent on a trade weighted basis. To some extent, the weakness of the Ugandan Shilling is mirrored in the region. Since the end of June 2014, the Tanzanian Shilling has fallen by 27 percent against the dollar, the South African Rand by 17 percent and the Kenyan Shilling by 11 percent.

The factors underlying the depreciation of the Ugandan Shilling reflect weaknesses in the balance of payments. Compared to 2013/14, we project that the current account deficit will be about \$500 million larger in 2014/15, mainly because of a fall in tourism and other service related receipts, very slow growth in merchandise exports, partly because of lower global

commodity prices as well as the balance of payments crisis currently afflicting South Sudan, our largest export market, and relatively buoyant non oil imports. At the same time, our capital account surpluses have been reduced by lower foreign direct investment in the oil sector as a result of the fall in global oil prices and by lower portfolio capital outflows. Foreign direct investment during the first 10 months of this fiscal year was \$160 million lower than in the equivalent period in 2013/14. The lower cost of oil imports has provided some respite for the BOP but the impact of this is small relative to the combined effect of the negative factors. The Shilling/dollar exchange rate has also been affected by the strengthening of the dollar on global markets (the dollar index – a measure of the dollar against global currencies - has strengthened by almost 19 percent since the beginning of the current fiscal year).

Looking forward, I do not envisage that the external economic environment will improve substantially in the near term. This implies that the Ugandan economy must adjust to ensure external sustainability, through a narrowing of the current account deficit. Real exchange rate depreciation is probably unavoidable to help bring about such an adjustment although how much more the exchange rate will need to adjust is very difficult to forecast.

### **Private sector credit and interest rates**

Bank lending to the private sector has recovered quite strongly in 2014/15. At the end of April 2015, the latest month for which we have data, private sector credit (PSC) had risen by 17 percent over the previous 12 months. The current weighted average lending rate for Shilling denominated loans was 21 percent in the first 10 months of this fiscal year while that for foreign currency denominated loans is just under 10 percent.

The prevailing bank lending rates are not out of line with historic averages in Uganda over the last 10 years. Although lending rates appear to be high in comparison with those in other countries, they reflect the real costs of banking in Uganda. In particular, banks face very high operating costs – annual bank operating costs are equivalent to about 7 percent of their assets - because the banking system is not yet large enough to allow banks to attain optimal economies of scale as well as because many of the other costs of doing business – utilities, salaries for professional staff, etc – are high. In pricing their loans banks must also take into account the cost of possible loan default which is not negligible given that the current rate of non-performing loans is 4.3 percent of total loans and that loan recovery is expensive.

High bank lending rates have not deterred very rapid real growth in bank lending over the long term. Over the last 10 years, bank lending to the private sector has expanded four and half times in real terms. Hence there is a much larger volume of credit being made available to the private sector than was the case 10 years ago. The fact that borrowing can expand so rapidly while the rate of non-performing loans remains at relatively moderate levels suggests that there is no shortage of creditworthy borrowers who can afford to borrow and service their loans at the prevailing bank lending rates and still remain profitable. If we were to try to force banks to reduce their lending rates to accommodate borrowers whose businesses cannot generate sufficient income to service their loans at the current market determined interest rates, the consequence would be to restrict lending growth, because lending would become less profitable for banks. This would be damaging for the business sector, whose access to credit would inevitably be reduced.