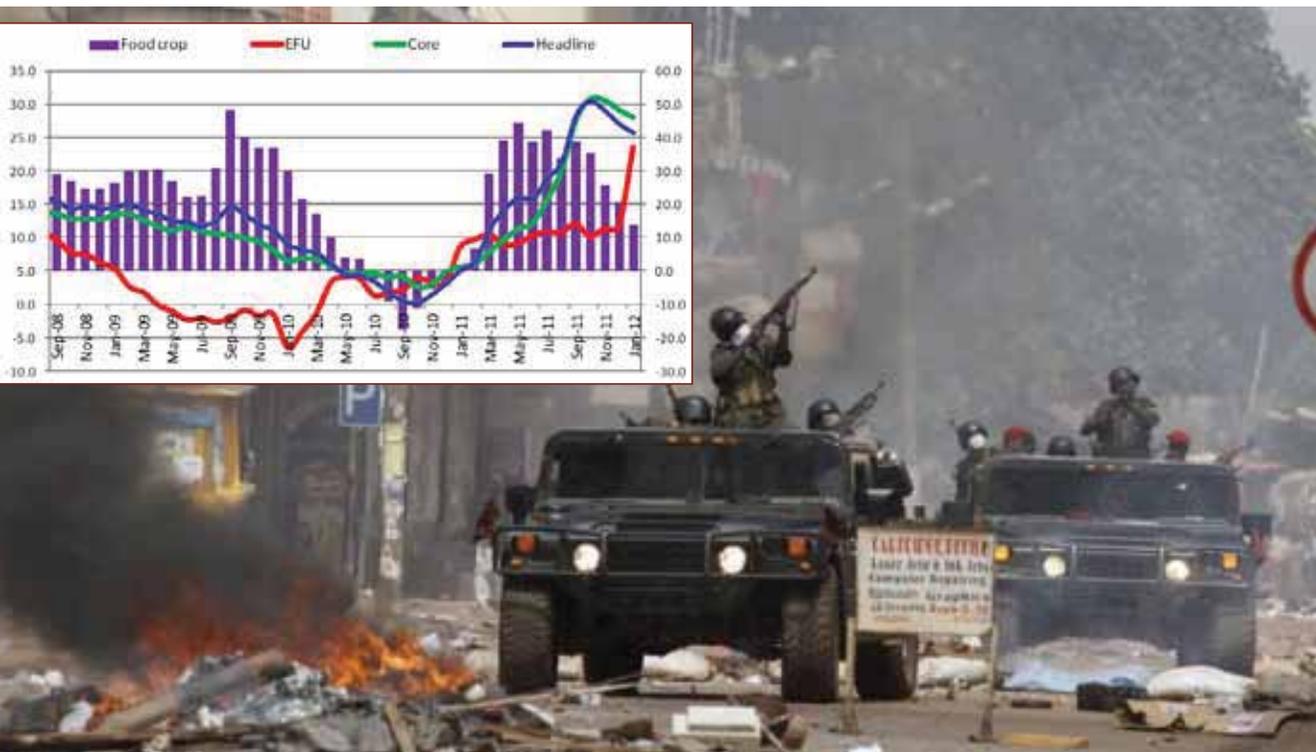
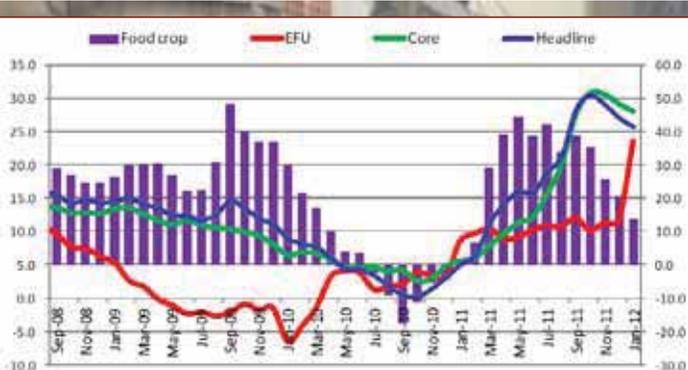




# The Way Forward:

## Short- and Long-Term Policy Responses to Uganda's Current Economic Crisis



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# List of Acronyms

ACODE	Advocates Coalition for Development and Environment
AD	Aggregate Demand
AS	Aggregate Supply
BOU	Bank of Uganda
GDP	Gross Domestic Product
NDP	National Development Plan
OECD	Organisation for Economic Co-operation and Development
UGX	Ugandan Shilling
USD	United States Dollar
EAC	East African Community
CBR	Central Bank Rate

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# 1. Introduction

In July of 2011, Bloomberg News called the Ugandan shilling “the world’s worst performing currency,” a dubious honour based on the shilling’s rapid depreciation over the course of the past year (Ojambo 2011). Unfortunately, the title may again become relevant: after a brief reprieve at the end of 2011, the recent decline of the shilling this past February and March has some people worried that it may well be headed towards a replay of last year.

Beginning in the first quarter of 2011, Uganda experienced a series of spikes in fuel, commodity, and food prices. In March of 2011, headline inflation surpassed single-digits; by October of that year, it had reached 30.4 percent, the highest on record since 1993. Almost a year later, in February of 2012, headline inflation, though subdued, remained high at 25.4 percent. The data for food crop inflation is not much better. In January of 2012, it had fallen to 13.4 percent, but jumped back up to 21.3 percent the following month.

Reactions to these developments have been mixed, to say the least. Almost a year ago, when prices first began to rise, certain segments of the population embraced the Walk-to-Work protests (something that opposition politicians have attempted to restart recently). Later, others followed suit with worker strikes. Meanwhile, the private sector called on the government to review its tax policy and non-tariff barriers to tame the country’s rising fuel and commodity prices. Others argued that the government needed to improve its discipline in spending, while working to restore the credibility and capacity of key institutions such as the central bank—challenges that are political as much as economic.

Back in 2011, government officials responded to this commentary by pointing out that, given the surge in oil prices worldwide, along with the spectre of drought in certain regions of the country, the government’s hands were essentially tied. These officials further argued that Uganda’s current inflationary trends were not particularly new, that the country has experienced food shortages in the past—shortages that caused food prices to rise—but that prices have always dropped during the harvest season. According to these officials, a bumper harvest (which eventually arrived) usually alleviates the country’s food woes. Unfortunately, though, Uganda’s food problems have continued to linger, despite some improvements in late 2011 and early 2012. Yet, the government has yet to implement any meaningful short-term interventions to address these problems beyond monetary policy and the suspension of tariff barriers against the importation of sugar (which reduced the price of this commodity considerably). The tight monetary policy in response to inflation appears to have slowed down the economy, which is not without its own costs.

This brief argues that, contrary to the mixed response of the government policy apparatus, given the current state of affairs, it is not only tenable but necessary for the

government to develop a coherent set of short- and long-term policy interventions to stabilize the economy and support its growth, while lessening the hardships of the most vulnerable and preparing for future economic shocks.

In the short-term, there are both fiscal and monetary policies available to address any rapid increases in inflation. For the past many months, the Bank of Uganda has pursued a tight monetary policy reinforced by the introduction of a monthly Central Bank Rate (which reached 22% in February of 2012). Yet, monetary policy can only go so far, especially given the fact that certain variables are exogenously determined. In terms of fiscal policy, government expenditure (which is a key element of aggregate demand and a driver of inflation) has remained bullish despite the crisis. Last year, the government could have alleviated the impact of its tight monetary policy by reducing its own expenditure, particularly on consumption. This would have made other policy response options—such as varying taxes on fuel prices to dampen the rate of inflation—more feasible.<sup>1</sup>

In the long-term, however, all of these efforts will amount to stop-gap measures if the fundamentals of Uganda's economy are not addressed, from strengthening the export sector and reducing the country's dependence on imported goods, to increasing efficiency in government spending and reducing production and transaction costs. Certainly, the issue of government spending has been a political lightning rod, especially over the past year. In September of 2011, different factions within Parliament were unable to agree to any budgetary cuts that would free up money to meet the demands of striking workers (teachers, in particular). As a result, the body passed a record budget of UGX 10 trillion, which left various activities and obligations unfunded (Mugerwa 2011). A few months later, in February 2012, the government went on to request a supplementary budget of UGX 92 billion, most of which was earmarked to cover the cost of expenditures already incurred.

Some of what we argue here will be familiar to many readers. Indeed, the issue of government spending has been the subject of intense political debate for quite some time now. (Famously, back in June of 2011, Uganda's central banker, Emmanuel Tumusiime-Mutebile, was quoted in the UK-based *Financial Times* complaining about a spate of government expenditures—like the purchase of fighter jets last year—that were financed with foreign exchange reserves [Manson 2011].) What we do in this brief is shed some light on the economic dynamics at play, while offering a number of short- and long-term recommendations to guide both policy-makers and public debate.

The remainder of the brief proceeds as follows: Section Two provides an analysis of Uganda's economic situation in the recent past with an emphasis on fuel, commodity, and food prices, as well as developments in the domestic foreign currency market. Section Three highlights the possible drivers of inflation and exchanges rates. Section Four offers short- and long-term recommendations. Section Five concludes.

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<sup>1</sup> Fuel prices have a substantial impact on food prices in developing economies like Uganda, and yet these prices weigh heavily in the CPI basket (27%).

## 2. Economic Developments in Uganda's Recent Past

Uganda's economy has performed well over the last 20 years, growing rapidly (above 5%) and posting single-digit inflation for most of the period (with the notable exceptions of 2008 and 2009). Table 1 shows the performance of GDP-related macroeconomic variables for Uganda over the past six financial years.

Table 1: Performance of GDP-related Indicators

	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
GDP at market prices (UGX Bn)	18,172.3	21,212	24,497.4	30,101	34,811	38,798
Real GDP -2002 (UGX Bn)		16,685	18,145	19,461	20,525	21,825
As a percentage of GDP						
Tax revenue (%)	12.3	12.4	12.9	12.2	12.1	12.9
Expenditure (%)	19.5	19.8	18.1	17.2	19.6	23.7
Deficit excluding grants and oil capital gains tax revenue (%)	-6.8	-7.0	-4.9	-4.6	-7.2	-10.5
Deficit including grants and oil capital gains tax revenue (%)	-1.9	-1.9	-1.9	-1.7	-4.7	-4.8
Current account (US\$ million)			-902.7	-1,216.6	-1,439.9	-1,559.8

**Source:** *The Background to the Budget FY 2011/12. MFPED*

Between 2005/6 and 2010/11, both the budget and current account deficit continued to grow (although the situation has recently been alleviated by grants and capital gains taxes, which have contained it to less than five percent of GDP). The budget deficit has been caused by an increase in government expenditure, while the recent increases in the current account deficit have been caused by a reduction in exports. This reduction in exports has two important and interlinked causes, the first of which has been the slowing down of the international economies whose demand for Uganda's products has reduced. The second cause has been an increase in prices in those same economies. Indeed, these two factors together have conspired to weaken the Ugandan shilling.

Since December 2010 Uganda has experienced a continuous rise in inflation, which hit double-digit figures in March 2011. By July, food crop inflation hit 42 percent, declining somewhat in August to 33.6 percent. Amid these developments, there are lingering concerns that this level of inflation threatens to undermine the country's once-confident economic outlook (BOU, April 2011). Table 2 depicts recent developments in domestic inflation and other important economic indicators over the past year. Inflation (particularly food crop inflation) has adversely affected the economy's overall performance.

Table 2: Selected Economic Indicators – Uganda

	Apr 09	Apr 10	Jan 11	Feb 11	Mar 11	Apr 11	May 11	Jun 11	Jul 11	Aug 11	Sep 11	Oct 11	Nov 11	Dec 11	Jan 12	Feb 12
Headline Inflation	13.4	6.0	5.0	6.4	11.1	14.1	16.0	15.7	18.8	21.4	28.3	30.4	29.0	27.0	25.7	25.4
Core Inflation	11.1	5.7	5.6	5.4	7.8	9.7	11.3	12.2	15.6	20.1	27.5	30.8	30.6	29.2	28.1	26.3
Energy, Fuel and Utilities Inflation	1.6	3.3	8.6	9.7	10.4	9.0	9.1	10.3	10.8	10.7	12.1	10.1	11.4	11.6	23.5	23.1
Food Crop Inflation	29.9	10.0	1.5	6.9	29.1	39.3	44.2	39.0	42.3	33.7	38.8	35.3	25.8	20.4	13.7	21.3
T/Bills (91-days) Rate	6.1	4.1	9.1	9.3	8.2	9.2	10.6	12.3	13.4	14.6	15.7	18.7	20.5	20.0	23.1	
Bonds (2-year) Bid		7.0	10.1	11.5	11.1	11.2	11.1	13.3	14.7	14.9	16.3	18.0	18.8	19.8	19.7	
Lending Rate (Nominal)	21.4	22	19.7	19.6	20.0	20.0	19.9	20.0	21.7	20.4	23.3	23.6	25.4	26.7		
Deposit Rate	2.2	2.4	2.4	2.4	2.4	2.4	2.4	2.3	2.3	2.3	2.4	2.4	2.4	2.3		
Exchange Rate (UGX/USD)	2,177	2,083	2,317	2,342	2,393	2,368	2,387	2,461	2,587	2,753	2,814	2,805	2,582	2,447	2,447	
International Reserves (Months of Import Cover)	4.9	5.3	4.2	4.1	3.9	3.8	3.7	3.5	4.1	3.9	3.6	3.7	3.7	3.7		
Trade Balance (US\$ Mill)	38	-194	-207	-239	-412	-255	--293	-322	-265	-324	-266	-292	-313	-299		
(Ratio of Exports to Imports)	(1.1)	(0.39)	(0.51)	(0.48)	(0.39)	(0.43)	(0.43)	(0.42)	(0.46)	(0.41)	(0.47)	(0.39)	(0.40)	(0.42)		
Monthly Average Pump Price (Motor Spirit Premium)	2,257	2,953	3,110	3,170	3,382	3,484	3,495	3,576	3,622	3,694	3,864	3,878	3,827	3,869	3,808	
Monthly Average Pump Price (Diesel)			2530	2702	2923	3007	3196	3262	3285	3382	3489	3511	3491	3567	3576	
Credit to the Private Sector (UGX Bill)	3,676.7	4,274.5	5,539.6	5,709.0	5,818.2	5,906.0	6,136.2	6,512.0	6,558.6	6,831.9	7,069.7	6,965.4	6,981.6	7,038.6		
Time and Savings Deposits (UGX Bill)	1,833.0	2,479.2	2,867.1	2,858.3	2,984.1	3,001.8	3,019.4	3,220.8	3,397.4	3,182.5	3,150.7	3,078.6	3,099.5	3,068.3		
Tax Revenue Performance (UGX Bill)		328.9	506.3	346.4	402.1	347.6	405.6	423.8	499.5	413.6	417.2	421.5	390.1	474.4		
Domestic Expenditure		293.9	400	556	525	418										

Source: Bank of Uganda Reports (various). Blank areas in the table indicate places in which data were unavailable from the BOU.

The sustained depreciation of the Ugandan shilling (UGX) against the U.S. dollar (USD), meanwhile, has been unprecedented (save for a minor reprieve at the end of 2011). While some might argue that domestic currency depreciation favours exports, in the long term such depreciations are more useful in economies that have a strong export base and rely less on imports for both consumption and production. In Uganda, a sustained and rapid depreciation of the exchange rate is not good, given the country's heavy dependence on imports for consumption and inputs for production. The data bear this out; ironically, even given the depreciated shilling, the trade balance has not worked in Uganda's favour. The ratio of exports to imports has been less than 1 since December 2010 (meaning that the country imported more than it exported), and since February 2011, has remained below 0.5.

When examining other indicators beyond inflation, exchange rates, and the trade balance, the outlook is generally not favourable for long-term, sustained, positive economic performance. The credit extension to the private sector has continued to expand over the past several months, but the performance is rather subdued. Similarly, the nominal value of time and savings deposits has continued to increase, but their performance has also been subdued, with a modest decline since August 2011.

Other indicators such as lending rates and tax revenue have not been spectacular either, and their continued high levels (in the case of lending rates) and poor performance (in the case of tax revenue collection) may inhibit investment, and therefore economic growth. Nominal lending rates peaked at 26.7 percent in December 2011—quite high for borrowers. Tax revenue performance relative to expenditure has also not been favourable, given that through April 2011—when the last official figures were released by BOU—government expenditure was consistently higher than tax revenue. High government expenditure in the first quarter of 2011 coincided with the general elections, which perhaps explains some surge in inflation levels during that period.

On the exchange rate front, the shilling was in free fall back in September 2011, reaching UGX 2,814 against the dollar before recovering somewhat in November 2011. The appreciation of the shilling has been attributed to a series of domestic factors: an increased inflow of dollars, increased earnings from coffee exports, tight liquidity, and low corporate demand. At the same time, however, the declining value of external reserves within the Bank of Uganda, as measured by the number of months of import cover, has been fronted as an indication of the limited capacity by the central bank to intervene in the foreign exchange market to even out short-term volatility. According to the latest available data from December 2011, the level of external reserves remains below four months. No doubt, if this current state of affairs continues, it may increase the shilling's susceptibility to speculation, further compounding volatility.

## 3. Drivers of Inflation

The increasing rate of inflation and the depreciated shilling can be attributed to high aggregate demand in the domestic economy, and supply shocks within and outside the economy. Based on the available information, there is strong evidence to suggest that inflation drivers include increased government expenditure, exchange rate depreciation, surges in international oil prices, food shortages, and speculation.

### Drivers of Inflation:

- Increasing government expenditure
- Exchange rate depreciation
- Surges in international oil prices
- Food shortages
- Increases in currency issued (attributed to increase in demand and escalating prices)
- Growth in credit to the private sector
- Speculation

Exchange rate drivers include faster growth in imports than exports, net capital outflows (capital flight to safety), low aid inflows, speculation, and imports from government projects, including general election materials (which increased government expenditure last year). This last factor feeds in through an increased demand for foreign currency by the government to meet its import bill. There are even suggestions that what Uganda has undergone since the end of 2010 is overheating.<sup>2</sup>

While there has been no rigorous study to establish the *extent* to which each of these various drivers have contributed to the current economic state of affairs, the interaction between demand and supply forces, as well as global factors, is a good place to begin.

### 3.1 Aggregate Supply (AS)

Simply described, in any market there are two major sides: the side that brings good and services to the market, and the side that buys goods and services from the market. The total of all goods and services that producers are willing and able supply and sell at a given price, all other factors held constant, is called Aggregate Supply (AS). Factors that affect AS are generally called supply factors, while factors that inhibit AS are supply constraints. Rising food prices, which are also key drivers of inflation, have been blamed on low levels of agricultural production due to droughts in various parts of the country. Droughts are thus a supply constraint.

According to the Famine Early Systems Network (January to June 2011), in Uganda the performance of the first season rains (March-July) was mixed, with significantly below-average rainfall in Acholi and West Nile, and near-normal rainfall in the rest of the country. The below-normal rains delayed planting in northern Uganda, raising concerns about the possible deterioration in food security levels beyond June. Generally, the

<sup>2</sup> Overheating is a situation in which aggregate demand in the economy outstrips its productive capacity, thereby leading to high inflation.

prices of staples have continued to increase and remain above the 2010 and five-year-average levels, reducing access for poor households that depend on the markets for a large portion of their food needs. The observed price trend was expected to persist until June/July, when the first season harvest was due and supplies went to markets. Indeed, the eventual data bear this out: between July and December 2011, food crop inflation dropped by approximately a half. Since that time, however, food crop inflation has fluctuated, reaching 21.3 percent in February 2012 (BOU, February 2012).

An enduring challenge for Uganda is how to get food from areas of plenty to areas of scarcity, given the fact that the severity of the problem of low agricultural production (supply constraints) does not cover the entire country. This is where the cost of transport comes into the equation.<sup>3</sup> According to the World Bank (2008), "for many low-income countries, transport and logistics costs are a key component of food prices and are generally far higher than OECD benchmarks of around 9 percent." While it is not yet known the *extent* to which increases in fuel prices are affecting food inflation in Uganda, there is anecdotal evidence in support of the postulated relationship. Table 3 (below) shows the average retail prices of selected commodities across seven market centres in Uganda in April 2011, near the height of food crop inflation (39.3%), and January 2012, when we see a drop in the same (13.7%).

Table 3: Average Retail Prices (UGX) for Selected Commodities (April 2011 and January 2012)

Commodity	Date	Market Centre							
		KHI	KML	Jinja	Mbale	Masaka	Mbarara	Gulu	Arua
Matooke (Bunch - Kg)	Apr '11	719	642	674	556	610	499	-	500
	Jan '12	549	531	570	721	355	261	-	506
Cassava (Fresh - Kg)	Apr '11	683	569	504	261	356	274	404	322
	Jan '12	859	792	694	659	585	645	458	692
Maize Flour (5Kg)	Apr '11	10303	1692	1600	1477	1466	1602	1613	1602
	Jan '12	12901	1671	1500	1497	1500	1731	1533	2137
Motor Fuel (Petrol - Litre)	Apr '11	3484	3484	3500	3496	3500	3521	3607	3587
	Jan '12	3808	3808	3802	3895	3872	3877	3964	4009
Motor Fuel (Diesel - Litre)	Apr '11	3007	-	-	-	-	-	-	-
	Jan '12	3576							

Source: Uganda Bureau of Statistics

Key: KHI = Kampala High Income; KML = Kampala Middle and Low Income.

A number of hypotheses can be drawn from the table above, the most obvious of which is that non-processed food crops are cheaper in centres near their respective

<sup>3</sup> The cost of transport also includes the quality and reach of roads.

production areas. For example, the unit price of matooke for both periods is lowest in Mbarara, which is located near the main matooke producing areas and is the source of the same commodity in urban areas. The variation is even greater for fresh cassava, which is more widely grown: for low-income consumers in Kampala, the price of fresh cassava was almost twice as high as in Mbarara and Masaka in April 2011, with prices converging somewhat in January 2012. The relatively high price of cassava in Gulu, meanwhile, can be attributed to scarcity of the commodity in the surrounding areas.<sup>4</sup> Certainly, the variation in prices across these different centres is probably affected by different levels of demand. (For example, there exists a high demand for food in Kampala due to the fact the centre is a net consumer of food and is also a source of food for other areas). That said, levels of demand, by themselves, likely cannot explain all the variation in food prices that Uganda has experienced.

Indeed, in Uganda—as in many developing countries—the supply of agricultural outputs (i.e., foodstuffs) to urban areas is significantly hampered by poor infrastructure, especially poor roads. Here, the divide between areas that are net producers and those that are net consumers can be defined along two related tracks. The first is the general prevalence of food insecurity, particularly in the Northern, Teso, and West Nile regions. This is especially relevant to rural areas that produce most of their own food (net producers), and generally do not have the finances to buy food off the market.

The second track concerns the recent surge in food prices and how it has affected net consumers, especially low-income groups. The debate about food prices has centred around two issues, namely low food production, which creates upward pressure on prices, and the effect that high transport costs have had on food prices, as postulated above. This latter point is especially important. While most households in Uganda spend a relatively small amount of their income on fuel, fuel prices can nevertheless have a profound effect on the indirect costs of other goods. The geographical disparity in prices is at least partly due to the proximity of different communities to food producing areas.

Such anecdotal information lends credence to two related arguments: first, that food shortages do not apply to the entire country, but are concentrated in areas that have been hit with droughts, and in areas in which people possess little money to purchase food off the market; and second, that the variation in food prices that we continue to see is due, in part, to input costs like fuel for transportation. (No doubt, in certain areas, middlemen—i.e., traders and speculators—have been able to extract abnormal profits from this current state of affairs.) What all this means is that, *even if drought conditions improve throughout the country, those areas that are net consumers of*

<sup>4</sup> This table also shows an interesting phenomenon regarding processed foods, such as maize flour. Because processed goods like flour are often produced in individual locales throughout the country, we don't see huge variations the prices of these goods, because the goods don't need to be transported across the country to different markets. Rather, they're produced separately within individual markets. Indeed, when it comes to processed foods, we see a relatively uniform elevation in the prices of these goods across the country, due to the fact that fuel—in the form of energy to power manufacturing plants—is still needed to process them (the assumption being that utility rates for manufacturing plants are relatively uniform throughout Uganda).

food—especially urban communities—may still experience elevated food costs if fuel prices remain high, and if efforts are not made to control or regulate the activities of certain food traders.

It is for this reason that many countries adopted *market-based automatic price adjustment mechanisms* between 2004 and 2008—ranging from targeted price subsidies and tax reductions to government involvement in fuel procurement—to control the build-up of inflation in the economy due to rising fuel prices. The Ugandan government should pursue such policies, as well (see Section 4.1 for further details), which ought to be accompanied by disclosing as much information as possible about prices—linking domestic prices to world prices; showing at least a representative price build-up; making historical prices available; and comparing prices with those in other countries.

### 3.2 Aggregate Demand (AD)

Aggregate Demand, or AD, is the total demand for final goods and services in an economy, usually measured by the Gross Domestic Product (GDP). Aggregate demand can be seen as constituting four components: private consumption expenditure, private investment expenditure, government expenditure, and net exports. Excess demand in an economy often results in higher prices, or inflation, a situation known as overheating. While there is a dearth of information on the level of AD

in Uganda's economy, we can garner information through the monetary policy of the government and other indicators related to the components of AD above.

When inflation started gathering momentum in March 2011, some people suspected that it was fuelled, in part, by high liquidity in the economy (due to large amounts of money spent during the general elections last February). While the *source* of this excess liquidity is difficult to ascertain, we nevertheless know that prior to the crisis, the Bank of Uganda issued more currency (1) in response to demand for it, and (2) in response to rising prices (BOU Report, April 2011). The current tight monetary policy, as evidenced by the central bank's issuance of more T-bills and increases in base lending rates, is a testament to this excess liquidity, which the central bank has since been trying to mop up.<sup>5</sup>

#### Exchange Rate Drivers:

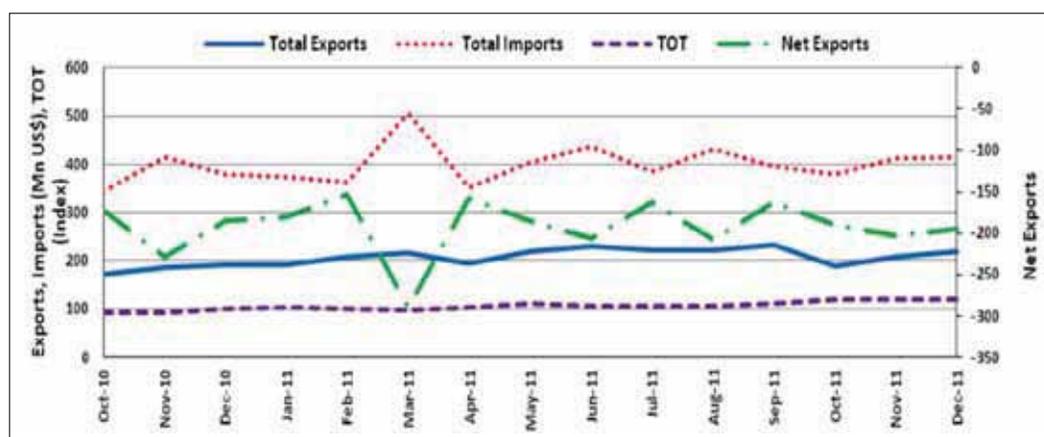
- Faster growth in imports than exports
- Net capital outflows (capital flight to safety)
- Low aid inflows
- Speculation
- General elections / increased government expenditure (through increased demand for foreign currency by the government to procure election materials and other election inputs)

<sup>5</sup> Base money, which is comprised of the deposits of commercial banks at the central bank along with the total cash in circulation, grew by 1.9 percent in the first quarter of 2011, compared to a growth of 14.1 percent in the last quarter of 2010. The growth of base money is attributed to demand for currency.

Currently, there are indications that aggregate demand in the economy is slackening. The central bank reported that there has been a continuous decline in currency in circulation to an annual growth rate of minus seven percent in December 2011, down from minus three percent in November 2011. This suggests that there has been a reduction in the level of private consumption expenditure, given that Uganda is largely a cash based economy. At the same time, there has been a decline in the rate of growth of credit to the private sector (despite a nominal increase in credit to the private sector), which suggests a reduction in investment expenditure—another component of aggregate demand.

According to BoU, there was an increase in exports over 2011, growing at 18.7 percent. This growth was attributed to continent-wide growth in Africa, particularly in the COMESA region, which is the main market for Uganda's exports. Over the same period, the import bill rose by 9.6 percent. The rise in the import bill is largely attributed to increased government project imports. The figure below shows the trends in trade balance and terms of trade between October 2010 and December 2011.

Graph 1: Trade Balance and the Terms of Trade (May 2010 – July 2011)



Source: Bank of Uganda Monetary Policy Report (February 2012)

### 3.3 Global and Regional Factors

Global factors are important in determining prices in Uganda because of their effect on the domestic prices of imported goods and services. Currently, the global economic outlook continues to be dominated by developments in the Euro Zone, where the risk of a recession has reportedly increased. Elsewhere, business and consumer confidence in most advanced economies (except the United States) have continued to decline. Inflation in the OECD area stood at 2.9 percent in December 2011, down from 3.1 percent in November of the same year. The drop in inflation rates is attributed to a slow economic recovery, rising unemployment, expectations of a recession, and moderation in energy prices. There has been a decline in inflationary pressure in emerging economies, too, which is expected to continue for most of 2012.

Regionally, East African economies continued to grow despite shocks, with countries pursuing tight monetary policy. Kenya and Uganda experienced tempered growth, while Tanzania, where metals account for more than 40 percent of all exports, saw its foreign earnings rise due to higher international prices. Inflation reduced in all countries in the region except Burundi, where it rose to 22 percent in January 2012, up from 14.9 the preceding month. Rwanda still recorded the lowest levels of inflation at 7.8 percent in January 2012, down from 8.34 percent the month before.

The currencies of the EAC appreciated month-on-month due to tight monetary policy, but depreciated on an annual basis, mainly on account of widening current account deficits (BOU February 2012). On a monthly basis, between December 2011 and January 2012, the Kenya shilling and Tanzania shilling appreciated by 0.6 and 3.6 percent respectively, while Rwanda's franc depreciated by a mere 0.1 percent.

According to the BOU, the global outlook will affect the Ugandan economy through capital flows and foreign exchange earnings. There is a fear that financial stress in advanced economies could cause sudden reversals in capital flows by way of a decline in trade volumes (due to low demand), a freezing up of funding, and a reduction in remittances from migrant workers. The price of oil on the international market may also create upward inflationary pressure.

Given the foregoing outlook, prudent and effective management of the country's exchange rate has a major role to play in attaining greater economic stability within Uganda. The central bank continues to intervene on both sides of the foreign exchange market, primarily to smoothen the exchange rate movements and to build up Uganda's foreign exchange reserves.

### 3.4 Speculation

Since the 2007/08 price-spike, the role of speculation in food prices has received greater attention within the public imagination. Speculation itself is fuelled by the anticipation of shocks. For instance, the impact of the much delayed announcement by the Office of the Prime Minister at the beginning of 2011 urging Ugandans to store food (off-season) in the face of an anticipated prolonged dry season could have signalled to traders and consumers the possibility of an imminent shock (food shortage). This, in turn, may have triggered greater demand in anticipation of higher future prices, even in places where no shortage existed. The result, however, would still be the same; prices would rise.

At the same time, the distortionary effects of such a warning might have been dampened if such information had been released in a timely manner at the beginning of the planting season, which would have encouraged farmers to plant more in anticipation of higher prices, especially in areas not hit by rainfall shortage. Indeed, while speculators can play an important role in markets by evening out prices, they can also harm the economy at times, especially if their activities go unregulated.

## 4. Recommendations

The policies put forward below are a response to the state-of-affairs described above. While we recognize that global trends will continue to create very real constraints on the government's ability to manoeuvre, there are several reasons why it is imperative that the government considers the following options. First, short-term inflation can have long-term consequences that are detrimental to the wellbeing of the country's low-income earners, who are also its majority. In recent years, Uganda has made great strides in poverty alleviation. Higher food prices may not only eliminate recent successes, but can worsen poverty among those still living below the poverty line (World Bank 2008c). Second, short-term shocks can deplete the human and physical capital of the poor, which has negative economic consequences that outlast the duration of the inflationary shock. If people are forced to sell off labour implements, for example, or consume the seeds that would otherwise have been used for planting, their labour productivity will be constrained even after the inflationary crisis has ended (World Bank 2008a). And third, temporary government interventions can yield social and political benefits by decreasing the likelihood of violent unrest, especially in urban areas (Commins 2011). Indeed, targeted economic interventions are used the world over—even in free-market economies—not only to show that leaders are responsive to the economic grievances of their constituents, but also to promote urban security through non-military means.

Given the situational analysis of Uganda's economy described in the previous pages, the policy response to these shocks should target the sources of the shocks directly (where possible) or indirectly. The recommendations range from short- to long-term and should mitigate or pre-empt the re-occurrence of such crises. While the containment of government expenditure is at the core of many of the proposed policy options (or is implied), increases in the efficiency of government expenditure (value for money) and prioritization will ensure that these options do not translate into wider, socially detrimental austerity measures.

Table 4: Short- and Long-Term Interventions

ISSUE	SHORT-TERM INTERVENTIONS	LONG-TERM INTERVENTIONS
Food Shortages and High Food Prices	<ul style="list-style-type: none"> <li>• Provide timely and accurate market information to the general public about food prices.</li> <li>• Manipulate taxes on fuel—particularly diesel—to slow down the rate of inflation and its effect on food prices.</li> </ul>	<ul style="list-style-type: none"> <li>• Strengthen early warning systems to provide credible information on weather changes.</li> <li>• Build food reserves at national and local levels.</li> </ul>
High Fuel and Commodity Prices	<ul style="list-style-type: none"> <li>• Build food reserves at national and local levels.</li> <li>• Continue pursuing tighter monetary and fiscal policies to contain aggregate demand in the economy.</li> </ul>	<ul style="list-style-type: none"> <li>• Establish fuel reserves to manage temporary supply shocks.</li> <li>• Devise a mechanism to enable the government to strategically intervene by varying taxes to smoothen fuel prices (particularly diesel).</li> </ul>
Depreciation of the Ugandan Shilling	<ul style="list-style-type: none"> <li>• Continue to intervene in the foreign exchange market to stabilize the exchange rate.</li> <li>• Continue to pursue a tighter monetary policy and fiscal policy to contain the elevating level of aggregate demand.</li> </ul>	<ul style="list-style-type: none"> <li>• Promote value-added exports while substituting for imports. (Outside manufacturing, the promotion of tourism has been found to have a relatively high rate of return and a short gestation period.)</li> </ul>
Social Unrest	<ul style="list-style-type: none"> <li>• Sensitize the population about the causes of rising commodity, food, and fuel prices, and the measures being undertaken by the government to combat this inflation.</li> <li>• Trim central government consumption-based expenditure to meet at least some of the salary demands put forward by the groups currently striking.</li> </ul>	<ul style="list-style-type: none"> <li>• Pursue the above short- and long-term interventions.</li> <li>• Create programmes that support the development of quality jobs for youth in both urban and rural communities.</li> </ul>

## 4.1 Food Shortages and High Food Prices

Despite recent reductions in annual food crop inflation, the lingering high price of several food commodities in Uganda is due to a combination of factors, from supply shocks (low yields) to high fuel prices. Indeed, *any reduction in the price of food commodities will manifest itself to the extent that food prices were caused by low yields*. Given the persistence of high fuel prices, which are expected to remain high in the short term, transport costs will continue to exert upward pressure on both domestically produced and imported foodstuffs. The other factor responsible for high food prices (as mentioned earlier) is middlemen, who often extract extremely high profits from the current crisis. While many of the worst offenders may either be business speculators or institutional buyers who sell to foreign aid organizations, evidence suggests that traditional traders are also at fault. A recent study on distortions within Uganda's banana market, for example, found that most farmers marketed their produce through middlemen, but received an average of only 28 percent of the price for which their produce was sold in nearby trading centres (Ngambeki et al. 2008). The profit margin was even smaller for farmers who sold their produce to markets further away.

## Short-Term Interventions

- *Provide timely and accurate market information to the general public about food prices.* Among other things, such information can reduce the ability of middlemen to extract abnormal profits.
- *Manipulate taxes on fuel—particularly diesel—given the role of fuel prices in elevating the production and distribution costs of food prices.* In other energy sub-sectors, particularly electricity distribution, the government has varied tariff rates and even (until recently) used subsidies to stimulate productivity among manufacturers and businesses, while easing burdens among household consumers. In this instance, we propose something *marginally* similar with fuel taxes. This policy option—which has been used to great effect in other countries (see Section 3.1)—can be guided by the rate of food price inflation in the economy whereby a temporary reduction in fuel taxes matches what would otherwise be the proportion that fuel prices contribute to food inflation in the absence of tax cuts. *Any tax cuts on diesel should coincide with the price of basic food commodities, so that the tax cut would be incrementally eliminated once food prices begin to fall (at the beginning of harvest season), thus preventing food prices from dropping too low and creating unintended distortionary effects of their own.* The idea here is to use the tax rate on fuel to *dampen* the inflationary effect of fuel prices on food prices.

This option would certainly affect government revenue, although temporary reductions in the tax rate may not necessarily require concurrent reductions in government expenditure, especially if short-term tax cuts trigger short-term increases in fuel demand. It is also worth noting that over the past five years, the volume of diesel imported into Uganda has been increasing. Given this trend, increases in volumes imported could, under certain conditions, make up for the income lost due to temporary reductions in tax rates. But as we mentioned in the introduction, any alterations to the tax code—however brief—are best countered with increases in efficiency within public expenditure. *And certainly, this recommendation will be most effective if the government can counter the practices of middlemen who drive up food prices by engaging in speculation.*

## Long-Term Interventions

- *Strengthen early warning systems to provide credible information on weather changes.* If farmers had been warned earlier about the prolonged dry season that Uganda experienced last year, more farmers might have been able to plant more and perhaps engage in different post-harvest handling methods—something which, no doubt, could have alleviated food shortages in certain districts. Unfortunately, though, Uganda currently has inadequate systems in place to create and publicize early warning weather forecasts.
- *Build food reserves at both national and local levels to secure the nation during periods of scarcity.* The Food and Nutrition Bill of 2009 mandated the creation

of a national food reserve to meet any shortfalls in the country's food supply and mitigate the negative effects of natural disasters like droughts or floods. Unfortunately, though, the bill was never passed and (perhaps as a result) such a reserve has yet to be created, despite the existence of a scattered array of silos throughout the country, several of which are insufficiently stocked and/or not under the direct control of the government (Tenywa 2011). Costing assumptions from 2009 estimate that the creation of a national food reserve would require an investment of approximately UGX 20.6 billion (and possibly more now, given the depreciated shilling) (Ministry of Health 2009). Yet, a reserve of this kind is a cost that Uganda must incur, not only from a humanitarian perspective, but also to support the long-term health and economic productivity of the country's work force. One can also imagine a national security argument in favour of the development of food reserves. Indeed, being dependant on international organizations like the World Food Programme does little to strengthen Uganda's autonomy, which should be on strong display in times of crisis. The recent food shortages and subsequent inflation were not the first time Uganda experienced such shocks, nor will they be the last.

## 4.2 High Fuel and Commodity Prices

The high cost of fuel, which exacerbates commodity prices, is caused by a number of factors: the increasing price of oil on the world market; inflation within the world's exporting economies; the devaluation of the Ugandan shilling; and high aggregate demand in Uganda's domestic economy. These drivers of inflation are interrelated and for Uganda, they appear to have formed a vicious cycle that continues to spiral.

### Short-Term Interventions

- *Reduce and prioritize government expenditure, which is a key component of aggregate demand.* Owing to the fact that Uganda is a net importer, high levels of aggregate demand in times like these increase the economy's susceptibility to external shocks, particularly imported inflation. The issue of government expenditure has become increasingly fraught in the wake of statements made last year by Uganda's central banker, Emmanuel Tumusiime-Mutebile, in an interview published in the Financial Times (Manson 2011). Among other things, Mutebile complained about certain government purchases that were financed with foreign exchange reserves. Uganda also failed an IMF stress test earlier in 2011, which further threaten the country's fiscal credibility.<sup>6</sup>

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<sup>6</sup> The current levels of government expenditure run counter to the goals put forward within Uganda's National Development Plan, which prioritizes "prudent fiscal management" and "new spending on sectors that have the greatest potential to contribute to economic growth" (National Development Plan 2010). The NDP also stated: "the Bank of Uganda will restrict its intervention in the foreign exchange market mainly to curbing volatility in the exchange rate and building up international reserves. To deal effectively with unexpected external shocks, the Bank of Uganda will raise the level of gross international reserves towards the target of 6 months of import cover over the course of the plan period." Over the course of this past year, though, government expenditure appears to be moving against the grain of the NDP's goals. Based on the latest available data (through December 2011), Uganda's international reserves cover less than four months of imports.

It's certainly true that reducing government expenditure may have adverse effects on the real economy and limit growth. However, one way to lessen the intensity of these adverse effects is to limit government consumption, which in 2009 hit US\$1.8 billion (World Bank National Accounts Data and OECD National Accounts Data). Ideally, a portion of such spending—especially in the areas of public sector management and administration, both of which are costly in Uganda (Lukwago 2010)—should be redirected to the country's productive sectors. Indeed, we are not alone in advocating for an overhaul in the priorities that guide current government expenditure.<sup>7</sup> No doubt, this kind of restructuring would require substantial reserves of political will, but would go far in stabilizing government expenditure, reducing public unrest, and setting a strong foundation for the creation of badly needed jobs.

- *Continue pursuing tighter monetary and fiscal policies to contain aggregate demand in the economy.* This means reducing the money supply and increasing interest rates, which would reduce the level of investment and with it, the level of aggregate demand. The central bank has, since July 2011, instituted measures to contain aggregate demand through the Central Bank Rate (CBR). However, while there are indications that this tool has been effective in controlling inflation, there are two primary threats that may derail it. The first is the current high level of government expenditure, which will eventually translate into the monetization of the fiscal deficit or the erosion of public debt through devaluation followed by high inflation. The second is the transmission loop through which monetary policy affects inflation outcomes. This problem is worsened by errors in the central bank's forecast, which are common in situations involving the reduction of inflation from very high levels. Also, it goes without saying that caution has to be exercised while pursuing tight monetary policy, as it may crowd out private investment. The CBR for February 2012 reached 22 percent, and seems likely to hold steady for a while.

### Long-Term Interventions

- *Establish fuel reserves to manage temporary supply shocks, and construct a pipeline from Eldoret to Jinja.* The recent spike in fuel prices has, once again, highlighted Uganda's vulnerable position vis-à-vis petroleum supplies. The country's earlier plans to construct a pipeline from Eldoret to Jinja (an extension of Kenya's Mombasa to Eldoret line) recently fell by the wayside, but should be renewed and prioritized, especially in light of the current unrest. While a pipeline that extends only to Jinja would certainly not curtail all fuel transport costs (especially those incurred domestically, throughout Uganda), it would still provide some economic relief.

<sup>7</sup> ACODE has made these arguments in previous reports. See, for instance, Lukwago, D. "Increasing Agricultural Sector Financing: Why It Matters for Uganda's Socio-Economic Transformation." ACODE Policy Research Series (2010). Available at [http://www.acode-u.org/documents/PRS\\_40.pdf](http://www.acode-u.org/documents/PRS_40.pdf). See also: Tumushabe, G. "Trends in Public Administration Expenditure in Uganda: The Cost of the Executive and Its Implications on Poverty Eradication and Governance." ACODE Policy Research Series (2009). Available at [http://www.acode-u.org/documents/expenditure\\_executive.pdf](http://www.acode-u.org/documents/expenditure_executive.pdf). Likewise, economists at EPRC have made similar points in the pages of Uganda's dailies. See: Muhumuza, Fred Kakongoro. "Like Europe, Uganda needs major economic reforms." *Sunday Monitor* (August 28, 2011). Available at <http://www.monitor.co.ug/News/Insight/-/688338/1226378/-/m0jxp/-/index.html>.

Furthermore, Uganda needs to build new fuel tanks and refurbish its already existing ones to restock its national reserves. National fuel reserves are usually used to augment sudden shortages in supply, which is not the cause of Uganda's current spike in fuel prices. Nevertheless, if the country had a robust national reserve, the government would have some short-term flexibility in subsidizing fuel prices, especially given the current unrest. Indeed, in late June 2011, the United States, South Korea, Japan, and Germany—all free-market economies—agreed to release 60 billion barrels of oil from their strategic reserves in an effort to temporarily lower the global price of oil, whose continually high prices “threaten[ed] to undermine the fragile global economic recovery,” according to the International Energy Agency (Robinson 2011). On a smaller scale, Uganda could do something similar if it had national reserves, wielding a modicum of control over prices within local markets throughout the country.

- *Devise a mechanism to enable the government to strategically intervene by varying taxes to smoothen fuel prices (particularly diesel). (See 4.1)*

### 4.3 Depreciation of the Ugandan Shilling

#### Short-Term Interventions

- *Continue to intervene in the foreign exchange market to stabilize the exchange rate, which has implications for the real economy.* This requires, among other things, building up the country's currently depleted foreign reserves. The continued intervention in the foreign exchange market would also mitigate the excesses of speculation and its adverse effects.
- *Continue to pursue a tighter monetary policy and fiscal policy to contain the elevating level of aggregate demand, particularly in relation to consumption expenditure.* Given that Uganda is a net importer, increased levels of consumption expenditure can lead to higher inflation through imported inflation and devaluation. On the other hand, the acquisition of productive assets should not be stifled, which could push the economy into a recession.

#### Long-Term Interventions

- *Promote value-added exports while substituting for imports.* While interventions in the foreign exchange market can address short-term fluctuations in the forex market, in the long-term, the fundamentals of the economy—specifically, Uganda's unfavourable terms of trade—have to be systematically addressed and altered. This would involve making the kinds of investments that would add value to exports, and fostering those industries that could produce many of the country's currently imported goods, especially in areas where Uganda has a comparative advantage. One way to do this is through import substitution policies that provide *temporary* assistance to certain industries that the country wants to develop. (Needless to say, the ultimate goal of such policies is to foster competitive and efficient domestic industries. Many countries have fallen into

the political trap of allowing import substitution policies to extend indefinitely over a given industry, which can have adverse affects on the long-term strength and agility of the domestic economy.) This kind of industrialization requires high capital development costs, especially in the early stages, which would add to demands for foreign currency. However, in the long-term, domestic technological advancement has the capacity to greatly reduce the costs of future capital development.

It is therefore important that in the long-term, we focus on technological development through research, curriculum reform, the rejuvenation of technical schools, the provision of incentives for value-added enterprises, and support for the commercialization of innovations. As mentioned above, though, such interventions will require a massive overhaul in the kinds of budgetary priorities that currently guide government spending. Such overhauls mean that for the foreseeable future, the country will have to make hard choices about trade-offs—that is, which current consumption sectors can be sacrificed in the short-to-medium term in order to free up funds for the kinds of investments that the economy needs.

- *Enact a money laundering law.* Such a law, if comprehensive in its scope, will go far in stamping out insider trading, which is a main feature of speculation.

#### 4.4 Social Unrest

The recent increase in commodity prices has many causes, some of which (like imported inflation) have been discussed at length by government officials, while others (like government expenditure) have received relatively little public attention. Ideally, government officials within the ruling party should be more forthcoming about the myriad causes of inflation. At the same time, this responsibility also falls to opposition leaders, who have tended to emphasize the negative effects of government spending to the exclusion of other inflationary pressures.

All that said, it is important to note that, beyond illuminating the *causes* of the crisis, the government has a dual responsibility to craft proactive *responses* to the crisis. Over the past year, though, the government's response has been, at various points, confused, muddled, passive, and (in the case of Walk to Work) violent. Responding to last year's food shocks by assuring hungry, cash-strapped citizens that the rains will soon come (as some officials did) is no serious policy proposal, and fails to inspire confidence in the economic and bureaucratic agility of the state. Instead, the government should adopt a collection of meaningful policy interventions (like those put forward here), and *communicate them clearly and unequivocally to the public*. By doing so, the government will show itself to be taking concerted action to stem the tide of the crisis, while taking an important step in dampening the country's lingering political discontent.

## Short-Term Interventions

- *Sensitize the population about the causes of rising commodity, food, and fuel prices, and the measures being undertaken by the government to combat this inflation.*

## Long-Term Interventions

- *Pursue the previously mentioned short- and long-term interventions.* Given the economic roots of the current crisis, pursuing the above interventions will no doubt help alleviate some of the grievances that amplified Uganda's current social unrest.
- *Create programmes that support the development of quality jobs for youth in both urban and rural communities.* Last year, the specter of rioting in Uganda's urban enclaves only served to underscore the urgent need to implement policies that address youth unemployment and under-employment. Indeed, the link between civil conflict and young populations—especially those with poor educational and job opportunities—is a subject of ongoing discussion and debate among social scientists (Collier 2000; Goldstone 2002). Sadly, in Uganda today, opportunities for young people are slim. According to the National Development Plan, "50 percent of the economically active youth are not engaged in income generating employment (paid employment or self-employment)," something that the NDP blames on Uganda's "inappropriate educational and training system." As the NDP puts it, "The current education system prepares graduates to become job seekers rather than job-creators. Little emphasis is placed on entrepreneurship development, vocational training and skills development at all levels. Most of Uganda's employees have inadequate technical and professional qualifications."

Fortunately, the NDP has a number of official policies that can guide government action. The issue, though, is one of government priorities. Given the recent bouts of urban unrest, implementing strategies that address urban employment should rise as a top priority for the state (although it goes without saying that rural employment is equally important, given the fact that most urban youths migrate from rural areas that lack concurrent opportunities). Certainly, designing concrete programmes will be a challenge for law and policy makers—especially given the sparse data on the long-term impact of entrepreneurial programmes on youth employment in developing countries (Bennell 2000; Knowles and Behrman 2003). But despite these challenges, there are also myriad opportunities for creativity, especially when promoting youth entrepreneurialism. However, taking advantage of any opportunities for policy innovation will require that the government "create an enabling environment for increasing high quality employment," as the NDP puts it, which means implementing Uganda's already existing policies, regulations, guidelines, and laws, the likes of which will become the basis upon which any successful jobs and skills development effort will be anchored.

## 5. Conclusion

Many of the policy recommendations put forward in the previous sections are neither new nor unfamiliar to Uganda. Indeed, they reflect the letter and spirit of the proposals articulated within the National Development Plan. One of our concerns, which we have tried to give voice to throughout this briefing, is that many of the actions undertaken by the government over the course of the past year have not been aligned with the principles of the NDP, nor have they been consistent with sound macroeconomic management. As such, we wish to reiterate two of the central points made in the introduction to this briefing, namely that *the government must check its expenditure and make concerted investments in areas that enhance food security and job creation*. We recognize the immense political will and difficult trade-offs that such restructuring entails; indeed, this is an uphill battle for the government and the country as a whole. But we see no viable alternative to this path, and no means through which the current state can survive in the long-term without instituting these reforms.

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