



UGANDA DEBT NETWORK

Debt Dynamics and Management Challenges in Uganda



October 2015

Cover Photo:

Cross - section of participants during the Debt Symposium, August 2015 at Hotel Africana

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Ugandan appointed Vice president of StarTimes Uganda.
StarTimes Uganda has appointed Mr Aldrine Nsubuga Sr (with shades) to the position of Vice President. Before this appointment, Mr Nsubuga was serving the Pay TV Company as the marketing director. When asked whether he saw this promotion coming, he said: "I didn't suspect it this soon." [Israel Musa Lusu, Monitor]

More debt: Parliament has approved loans worth Shs1.2 trillion from international lenders.

BY MARK KEITH MUHUNUZA
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Debt payment to cost Uganda Shs2trillion

KAMPALA. The depreciating Shilling and rise in yields on government debt are piling pressure on Uganda's debt obligations.

The National Budget Framework Paper 2016/17 approved by Cabinet indicates that government will pay interest on debt worth Shs2 trillion up from Shs1.65 trillion in the current financial year.

This represents a rise of Shs350b, which will be funded from tax collections.

According to the framework paper, the rise in interest payments was due to exchange rate depreciation.

"Interest rates have increased on all tenors of Treasury instruments over the last year which increases the costs of domestic borrowing," the framework paper reads.

Domestic borrowing costs have been rising since the start of 2015, with government paying interest as high as 20 per cent on some tenures on about 14 per cent in 2014.

PHOTOGRAPHY: The rising pressure on the government to lead to a rise in interest rate payments.

"With the current interest rates the range of 20-24 on one-year treasury bills, plus the external debt interest payment of about Shs500b annum this would result in the interest payment of about Shs2 trillion," Dr Adam Mugume, the Bank of Uganda (BoU) director of research *Daily Monitor* on Monday.

The strengthening of the US dollar against the Shilling depreciates the Shs100 to 10.8 per cent since government revenue is

Mr Stephen Kaboyo, managing partner Alpha Capital Partners, said: "The depreciation of the Shilling affects the external debt stock, external debt service and the nation's economic growth. The cost of debt service rises and this could potentially erode the country's ability to service its foreign debt."

He added: "The repayment of foreign denominated debt also increases the demand for foreign currency and this puts more pressure on the shilling."

Last week, Standard and Poor's (S&P) affirmed outlook for Uganda's ability to borrow at a rating of B+, noting that: "The stable outlook on Uganda, over the next six months, reflects our view that these public works will boost Uganda's growth and improve the country's fiscal and external metrics over time."

Uganda's public debt is projected to rise to 33 percent of GDP in 2015 from 27 percent in 2014 to finance infrastructure. These increments, according to S&P will be as a result of borrowing from external sources like China Eximbank. "On the downside, the World Bank Group has cancelled funding for road works, due to inadequate investments in infrastructure," S&P says.

THE NUMBERS

Shs1.65 trillion

The interest on debt that government paid in the last financial year, lower than Shs2 trillion expected to be paid this financial year.

17.5 per cent

The percentage points that the Shilling depreciated against the US dollar in 2015.

L-R: Presidents Yoweri Museveni of Uganda, Paul Kagame of Rwanda and Salva Kiir of South Sudan launch the Standard Gauge Railway construction project in Munyonyo, Kampala, in 2014. Such projects worsen the debt crisis. (N.A. MUYO)

In Shillings, "Uganda's external debt is estimated at \$4.5b as of November 2015.

Going by the current exchange rate, that is an equivalent of Shs15.3 trillion. "If the exchange rate was to depreciate to say Shs4000 per dollar, the same external debt would rise to Shs18.5 trillion," Dr Mugume said.

Even with the pressure on interest payments, Parliament in a space of two days, approved loans worth \$350.77m (Shs1.2trillion) from international lenders for various projects.

Additionally, government is expected to finalise plans to borrow trillions for the construction of the Standard Gauge Railway and Kampala - Jinja expressway.

Uganda's External public debt exposure stood at USD 6.27 billion at end of February 2015 with USD 4.18 billion disbursed and USD 2.09 billion undisbursed. Between Financial Year (FY) 2012/13 – FY 2014/15 Government borrowed about USD 3,359.7 million from development partners to fund new projects. (Source: Auditor General Report, 2015)

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ACRONYMS

ADF:	African Development Fund
AfDB:	African Development Bank
BOU:	Bank of Uganda
CPIA:	Country Policy & Institutional Assessment
DRA:	Debt Relief Analysis
DSA:	Debt Sustainability Analysis
EAC:	East African Community
EU:	European Union
FDI:	Foreign Direct Investment
FY:	Financial Year
G8:	Group of Eight
GDP:	Gross Domestic Product
GDP:	Gross Domestic Product
GFSM:	Government Finance Statistics Manual
GFSM:	Government Finance Statistics Manuel
HIPC:	Heavily Indebted Poor Countries
IDA:	International Development Association
IFAD:	International Fund for Agricultural Development
IMF:	International Monetary Fund
LIC-DSF:	Low Income Country Debt Sustainability Framework.
MDG:	Millennium Development Goals
MDRI:	Multilateral Debt Relief Initiative
MDRI:	Multi lateral Debt Relief Initiative
MFPED:	Ministry of Finance, Planning and Economic Development
NDP:	National Development Plan
OECD:	Organization for Economic Co-operation and Development
PEAP:	Poverty Eradication Action Plan.
PIIGS:	Portugal, Italy Ireland, Greece and Spain
PPPs:	Public Private Partnerships
PRSP:	Poverty Reduction Strategy Paper
PV:	Present Value
SDRs:	Special drawing rights
UDN:	Uganda Debt Network
WAIR:	Weighted Average Interest Rate

EXECUTIVE SUMMARY

The global economic crisis has not only persisted longer than expected but also revived the debt debate as both developed and developing countries move closer or into the default zone. All the aspects of debt including definition, structure, rate of acquisition and utilization, and service obligations require detailed analysis to avoid recent developments in countries such as Portugal, Ireland, Italy, Greece, and Spain (PIIGS). In countries such as Uganda, which only became debt compliant after massive debt write-offs under HIPC and MDRI, there is every reason to believe that an incomplete analysis based on a narrow range of parameters can mask an underlying debt crisis.

The debate should range from definition of debt to whether the use of indicators such as debt-to-GDP ratio, in a country with a large informal and subsistence sector, is sufficient for analysis of debt sustainability. Regarding the definition, According to the IMF (2013), a debt instrument should be defined as a financial claim that requires future payment(s) of interest and/or principal by the debtor to the creditor. In this regard, debt instruments should include: debt securities; loans; insurance, pension, standardized guarantee schemes; and other accounts payable.

The paper also raises concerns about the rate at which the debt is rising, especially the relatively short-term domestic debt related to issuance of fiscal bonds. By the end of FY 2015/16, debt through issuance of domestic bonds was budgeted to increase to Shs. 4,545 billion or 6.1% of GDP from zero at the beginning of FY 2013/14. This would imply that a single source of debt would account for close to 20 percent of the entire debt stock in just three years.

Furthermore, the future debt service obligations that are increasing at a rate that is faster than economic growth rate, raise questions on how the economy will generate enough tax or export revenues despite the generous thresholds in this regard. For example, in FY 2015/16, the debt service obligation was 58.6 percent of total expected revenue collections. In a related matter, the increasing component of domestic debt service, estimated at 85 percent of

the total greatly undermines the use of the debt-export ratio as domestic debt is paid through local currency.

The use of relatively short-term debt to finance long-term investments (mainly roads and energy projects) will result in a debt-asset mismatch problem. It is likely that debt will mature before sufficient returns are realized from the investments in infrastructure, which take long to execute and yield results. Besides, the ability of planned and actual investments to generate a return is a critical factor in assessing future debt sustainability. It is argued that, for an economy to gain debt sustainability over time, it should grow at a rate higher than interest rate of the debt. Uganda needs to grow at average of 8 percent per annum to maintain debt-to-GDP ratio of less than 35 percent in the medium term. Such growth should be backed by a strong rise in business investment and exports. None of these conditions is being fulfilled in light of growth rates of 5 percent and the recent depreciation of the shilling related to decline in exports.

The fiscal strategy guiding debt acquisition, utilization and management that includes assumptions that improved infrastructure will lead to competitiveness and future revenue from extractives – notably oil – will increase ability to service the debt should be revisited. For example, the NDP II is premised on widening the budget deficit to nearly 9% of GDP for three years from FY 2015/26 before it reduces to about 7% in FY 2018/19. The deficit is largely driven by the need to address the infrastructure deficit and consolidating human capital development. There is an indication that the discovery of oil, gas and other extractives has increased the country's appetite to contract debt or increase its future financial obligations. A significant number of oil-development related projects are being financed on a reimbursement basis (recoverable costs) while decisions on other infrastructure projects is also related to future oil revenues. The failure of oil projects to start as planned and recent declines in the international price of oil demands fresh debate and reconsideration of earlier assumptions.

The recommendations from this study span a range of aspects including those with a direct and indirect relationship to the quantity and quality of the national debt. The following four specific recommendations are worth highlighting at this point. It is recommended that governance and institutional management matters if the economy is to realize the trajectory required for

1.0 INTRODUCTION

debt sustainability. The economy needs to grow at a minimum rate of 8 percent as opposed to current averages of 5 to 6 percent.

The role of the private sector in increasing, poverty reduction, increasing taxes and raising future debt sustainability should not be undermined by the excessive domestic borrowing by Government. Apart from reducing the stock of available loanable funds, Government borrowing from the domestic market raises the interest rate and distorts incentives for capital flows towards financial instruments.

The Government is encouraged to adopt sound fiscal and prudent monetary policies that reinforce each other to provide a conducive investment climate. An expansionary fiscal policy in an economy with a shallow financial sector, means that the corresponding restrictive monetary policy will be too harsh to the private sector in terms of cost of critical investment capital. The country is encouraged to adopt more strict discipline through implementation of the necessary fiscal rules and strengthening of the medium-term expenditure framework.

Finally, the appropriate debt sustainability analysis framework should be adopted. Specifically, consideration should be given to the Heavily Indebted Poor Country (HIPC) Debt Relief Analysis (for comparison with past trends when Uganda was a HIPC) and the Low Income Country Debt Sustainability Framework (LIC-DSF). This would enable projections of intended borrowings and economic variables over a maximum of 20 years and use of ratios that compare debt stock, present value or service with GDP, exports or budget revenue to assess payment capacity.

1.1 Introduction

Matters of debt acquisition, structure, usage and sustainability have increasingly come to the fore following the financial crisis of 2008 that triggered an economic crisis and global recession that has persisted longer than predicted. Memories of previous economic crises such as the Mexican

crisis of 1994 and the Asian crisis of 1997 demand a review of current conditions in order to draw parallels and differences for relevant policy implications. The implications of the crisis on countries such as Portugal, Italy Ireland, Greece and Spain (PIIGS) raise fresh concerns about economic resilience in light of global shocks and turbulence. The situation has not been helped by potential risks associated with the exchange rate depreciation and volatility, lower global growth trends and the persistent decline in global commodity prices (including oil on which Uganda had hinged a lot of hopes).

Current debt trends in Uganda have close resemblance with the late 1990s when local and international efforts led to debt forgiveness and cancellations at the time that the country was faced with significant debt service costs. While debt service is still on track, there are growing concerns about the cost of keeping up with the pace as shown by recent public discussions on the energy/electricity tariff use to pay for private debt in the Bujagali Hydropower Project. The required return of about 19% has stirred discussions of government borrowing to buy out the private investor¹. More so, government has largely managed private debt to the financial sector largely through restructuring duration, which keeps increasing both the principle and interest due. The limited possibility of future forgiveness implies that Uganda engages in debt analysis that enables government to manage debt over time including gradual reduction of the stock of debt before it reaches critical proportions.

Concerns about the growing debt problem in Uganda have been amplified by the policy to use debt finance to increase the stock of infrastructure without a corresponding reduction in existing public sector expenditure outlays in areas of social sectors (mainly education and health), security and public administration. The sustainability of debt in Uganda has become a contested issue for a number of reasons. First, the emphasis of the Government to use the debt/ GDP ratio of less than 40% or 50% in communicating sustainability does not reflect the clear picture as it disregards other parameters such as stock, structure and ability to meet repayment schedules using tax revenue. Debt sustainability encompasses a broader definition: “The ability of a country to meet its debt obligations without requiring debt relief or

¹<http://www.reuters.com/article/2015/06/04/uganda-electricity>

accumulating arrears”². Accordingly, the sustainability indicator used by the Government, notably the debt/ GDP ratio, needs to be augmented by other indicators such as debt/export ratio and debt/ tax revenue ratio.

Second, there is contest related to the vagueness in definition and hence compilation, measurement and analysis of the actual stock and dynamics of debt. The compilation of public sector debt statistics and their analysis is important for better discussion and undertaking of effects and impacts on public debt. According to the International Monetary Fund (IMF) (2013)³, the definitions of debt, together with the definitions of the public sector and its subsectors, should allow for defining debt for the public sector and any of its subsectors. It is recommended that total gross debt – often referred to “total debt liabilities”, should consist of all liabilities that arise from the different types of debt instruments.

A debt instrument is defined as a financial claim that requires future payment(s) of interest and/or principal by the debtor to the creditor. The emphasis on repayment of principal and/or interest related to the debt is because of the vulnerability and liquidity challenges it faces. In view of the above, debt instruments include: (i) Special Drawing Rights (SDRs); (ii) currency and deposits; (iii) debt securities; (iv) loans; (v) insurance, pension, standardised guarantee schemes; and (vi) other accounts payable.

The above categories imply that debt should cover all liabilities in the Government Finance Statistics Manual (GFSM) balance sheet, except the liabilities in the form of equity and investment fund shares and financial derivatives and employee stock options. In the case of Uganda, the bulk of the domestic debt in the category of arrears including pensions due to civil servants, unpaid service providers and court awards are not adequately captured. Yet a credible debt strategy for a country would require a comprehensive debt database, including projected stock and service payments for external and domestic debt and contingent liabilities of the Government and other government agencies, as well as private sector debt. Much as the Government will not have to provide for contingent liability,

²See www.development-finance.org

³IMF (2013), Public Sector Debt Statistics: Guide for Compilers and Users, International Monetary Fund, Washington D.C.

an additional scenario including this variable would argue the analysis and consideration of possibilities given the portion of this component in the current Government budget⁴.

Third, there are concerns about the rate at which the debt is rising, especially the relatively short-term domestic debt through issuance of fiscal bonds. By the end of 2015/16, domestic debt through issuance of bonds was budgeted to increase to Shs. 4,545 billion or 6.1% of GDP from zero at the beginning of 2013/14. This would imply that a single source of debt would account for close to 20% of the entire debt stock in just three years. There are significant implications for high debt service costs given that this is non-concessional debt, with an average weighted interest rate of over 14%, no grace period, and mostly for less than 10 years.

Fourth, the utilisation of debt whereby relatively short-term debt is used to finance long-term investments (mainly roads and energy projects) will result in a debt-asset mismatch problem. It is likely that debt will mature before sufficient returns are realised from the investments in infrastructure, which take long to execute and yield results. More so, efficiency and effectiveness of debt has been undermined by limited value for money related to poor governance and corruption. According to Ncube and Zuzana (2015), improvements in debt sustainability requires better links between investments and growth as African countries need to aim at higher growth, which calls for reduction in leakages and inefficiency.

Finally, the ability of planned and actual investments to generate a return is a critical factor in assessing future debt sustainability. It is argued that, for an economy to gain debt sustainability over time, it should grow at a rate higher than the interest rate of the debt⁵. Preliminary findings by Lakuma (2015)⁶ indicate that Uganda needs to grow at an average of 8% per annum

⁴In 2011, Government guaranteed payment of compensation to a private businessman – Basajabalaba – worth UGX 142 Billion (nearly USD 56 million). In addition, press reports indicated that pending court cases could cost government Shs. 4.2 trillion (US\$ 1.43 billion). See, The East African (March, 2015) “Kampala faces \$1.43b debt over cattle theft by NRM soldiers” <http://www.theeastafrican.co.ke/news/Kampala-faces--1-43b-debt-over-cattle-theft-by-NRM-soldiers/-/2558/2660948/-/q3amvs/-/index.html>.

⁵Petrovick Katarina, (2013), “Government debt: Why has the Government debt increased? An analysis of what factors influence the long-term interest rates. A Panel study of the 27 EU member states for the period 1995-2011. Masters thesis, Karlstad Business School, Karlstad, Sweden

⁶Lakuma Computations for this report, based on Ugandan data. $(D/G)_t (D/G)_t = \left[\frac{(1+i_t)}{(1+g_t)} (D/G)_{t-1} \right]$

to maintain debt-to-GDP ratio of less than 35% in the medium term. Such growth should be backed by a strong rise in business investment and exports. While the borrowing rates for Uganda's concessional debt, mainly from multilateral lenders such as the World Bank and African Development Bank (AfDB), is below 1%, more recent borrowing from bilateral countries and institutions is in the range of 4-6%. Perhaps more significantly is the domestic borrowing that ranges from 14-18% compared to the average GDP growth rate that has reduced to an average of less than 6% since 2009.

1.2 Objectives

The main objective of this report is to support the advocacy strategy of UDN to invigorate the discourse of the debt question and overcome debt management challenges for improved and sustainable economic development.

Specifically governments must achieve the following:

- a) Plan and align any new borrowing and financing options to funding economic development, growth and poverty reduction.
- b) Ensure low and sustainable debt costs and risks over the short and long-term.
- c) Assess potential risks arising from private sector debt and contingent liabilities.

The paper supports UDN's advocacy work on debt issues nationally, regionally/ EAC and globally, but mostly to demonstrate the impact of debt on Uganda's growth and development efforts. A specific advocacy message is to highlight the problem of unsustainable debt levels, and make proposals for effective debt acquisition, management and utilisation.

$\left[\left(\frac{1+i_t}{1+g_t} \right) (D/G)_{t-1} \right] - Pb_t Pb_t$ where: $(D/G)_t (D/G)_t$ = Projected public debt to GDP ratio for the next period; i_t = an average of risk free long run interest rate on Uganda's external debt and interest rate on domestic debt; g_t = Nominal GDP growth forecast; $(D/G)_{t-1} (D/G)_{t-1}$ = Current public debt to GDP ratio; and $Pb_t Pb_t$ = Primary balance (% of expenditure) fiscal balance excluding interest payment.

1.3 Methodological approach

The report is largely based on evidence from documents obtained from the Government, donor and multi-lateral development agencies, and review of academic literature. The purpose of the reviews was mainly to understand the global terminology and practice of debt measurement, analysis, monitoring, and inference from observation. In addition, the study included a review of selected economic crises in the world and their implications on national debt and general economic performance.

The report presents an examination of the effectiveness of the policy, legal and institutional framework for borrowing and management of debt acquisition and effective utilisation. In addition to reviewing statistical trends in debt, the report presents qualitative assessment of associated policies and strategies. The developments underlying the quality and quantity of debt in Uganda range from local political and economic factors as well as global trends such as HIPC and Millennium Development Goals (MDGs). Many of these factors have had short- and/ or long-term implications on the debt and ability of the economy to incur more debt.

Specifically, the report identifies a number of themes for purposes of informing and guiding the analysis and related recommendations. These include: the rate of debt acquisition; structure and quality of the debt; relevancy of debt sustainability and tracking; as well as the relationship between debt and economic growth.

2.0 THE HISTORY OF DEBT IN UGANDA

2.1 Historical trends in debt, debt service and advocacy

Uganda has had a troubled history of national debt, which has led to deterioration of other economic variables like the stock of foreign exchange reserves and inability to deliver critical services due to debt service obligations. Unsustainable debt levels can also lead to instability in key macroeconomic variables such as inflation and exchange rates by imposing pressure on foreign reserves and budget resources. For example, in 1996, debt service had increased to 24.6% of total government spending when total spending on social sectors was 34.2%, with education at 18.4% and health 9.8% (see Table 2.1). It is clear that after debt relief from HIPC, the total debt service costs as a percentage of total government expenditure declined considerably to 3.6% in 2002.

Table 2.1: Budget outturn as a % of total expenditure

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total social sector (Education and health)	34.3	34.2	37.4	36.0	39.8	34.5	35.2	37.1	35.0
Total debt service	22.0	24.6	21.0	21.7	21.2	11.1	4.7	3.6	4.6

Source: Background to the Budget Series, in Obwona and Ndahye (2004)

From the foregoing, one can see that debt service can affect delivery of vital services to the population especially the very poor who have to depend on Government systems. It was such concerns that triggered a wave of advocacy for debt relief that culminated into the HIPC, and later the Multilateral Debt Relief Initiative (MDRI)⁷. In fact, Uganda was one of the few countries that had two stages of the HIPC initiative, and was the first country to qualify under the original HIPC Initiative in 1998. After the launch of the enhanced

⁷Under Jubilee campaign movement efforts for external debt cancellation for developing nations across the world, including those in Sub-Saharan Africa, like Uganda, the Uganda Debt Network (UDN) was born in 1996.

HIPC initiative in 1999, Uganda's debt sustainability was reassessed. The country was then granted access to debt relief under the enhanced HIPC initiative in 2000 without further conditionalities since it had posted satisfactory economic performance and presented a full Poverty Reduction Strategy Paper (PRSP) or the Poverty Eradication Action Plan (PEAP).

The original HIPC assistance was valued at US\$ 650 million in nominal value or US\$ 347 million in net present value. The enhanced HIPC assistance, on the other hand was valued at US\$ 1,300 million in nominal value or US\$ 656 million in net present value. The HIPC initiative undoubtedly contributed to the reduction of the burden of external debt service to the extent that, measured as a percentage of exports, external debt service declined from 15.4 per cent in 2004/05 to 13.1% in 2005/06.

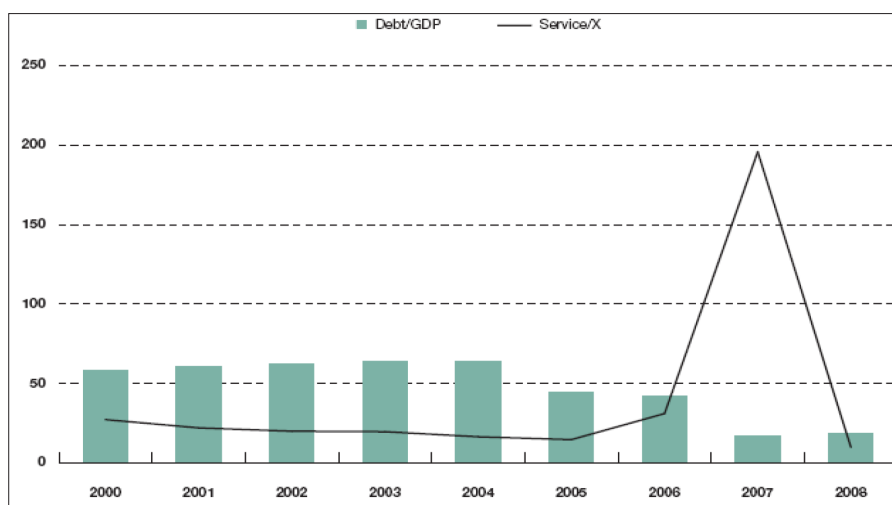
Following the two HIPC Initiatives, the MDRI was launched at the July 2005 during the G8 Summit in Gleneagles, Scotland, where the G8 leaders pledged to cancel the debt of the world's most indebted poor countries, most of which are located in Africa⁸. The proposal required full debt cancellation by the International Development Association (IDA), the International Monetary Fund (IMF) and the African Development Fund (AfDB) to countries that have completed the HIPC Initiative. The MDRI provided irrevocable, upfront debt stock cancellation. The objective was to provide additional support to HIPCs to reach the MDGs, while preserving the financing capacity of the international financial institutions. Thus, from 2006, Uganda benefited from debt relief under the MDRI, which cancelled 100% of the debt owed to the African Development Bank, the International Monetary Fund (IMF), and the World Bank. Full implementation of the MDRI reduced the country's stock of external debt by about 65%. In terms of value, the total debt relief from IDA (World Bank) alone was estimated at US\$ 3,764 million as of 1st July 2006.

Despite the two rounds of HIPC debt forgiveness in 1998 and 2000, the debt stock as a percentage of GDP remained above 50% until 2005, while

⁸Initially, the following 19 countries were expected to receive 100 percent cancellation of their eligible debt: Benin, Bolivia, Burkina Faso, Cameroon, Ethiopia, Ghana, Guyana, Honduras, Madagascar, Mali, Mauritania, Mozambique, Nicaragua, Niger, Rwanda, Senegal, Tanzania, Uganda and Zambia. The remaining HIPC countries would be eligible for debt cancellation once they had completed the requirements of the HIPC Initiative.

debt service too remained significant in the range of 20-30% (see Figure 2.1). In fact, debt service, as a percentage of exports of goods and services increased to nearly 200% in 2007, despite a significant write-off under the MDRI, largely on account of poor export performance. However, the country was able to stabilise and revert to the normal trend within a year (by 2008), partly on account of the debt write-off.

Figure 2.1: Stock of total external debt (% of GDP) and debt service (% of exports of goods and services)



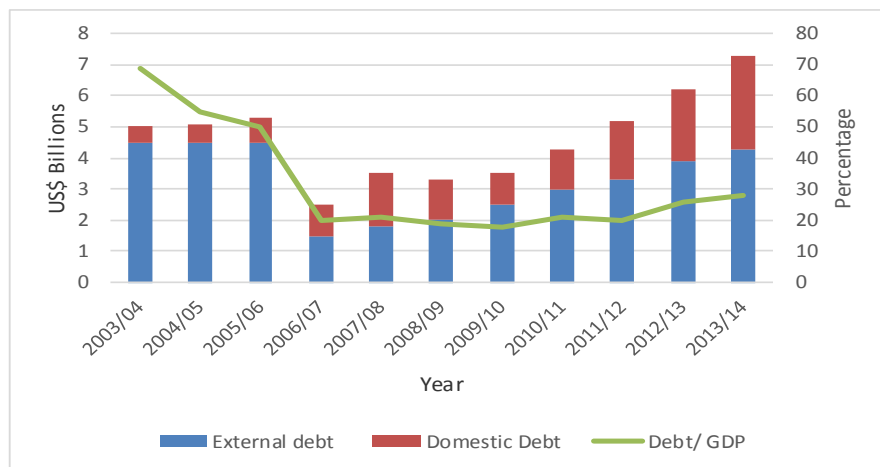
Source: AfDB/ OECD, African Outlook (2009)

The reduction in the debt burden increased the Government ability to stabilise the economy by improving the current account. For example, debt relief arising from the HIPC initiative and the MDRI increased foreign reserves by over \$75 million in 2005/06, which enabled the country to cover 6.6 months of imports of goods and services⁹.

More recently, debt has increased at a faster rate and has taken on a new structure that shows an increase in the domestic debt component. Figure 2.2 below shows a rapid increase in the stock of debt from the low levels experienced after 2006/07 following write-offs by multilateral creditors.

⁹AfDB/OECD (2007) Africa Economic Outlook

Figure 2.2: Trends in debt stock for Uganda, 2003/04 – 2013/14



Source: MFPED, 2015

2.2 Trends in the stock of external debt

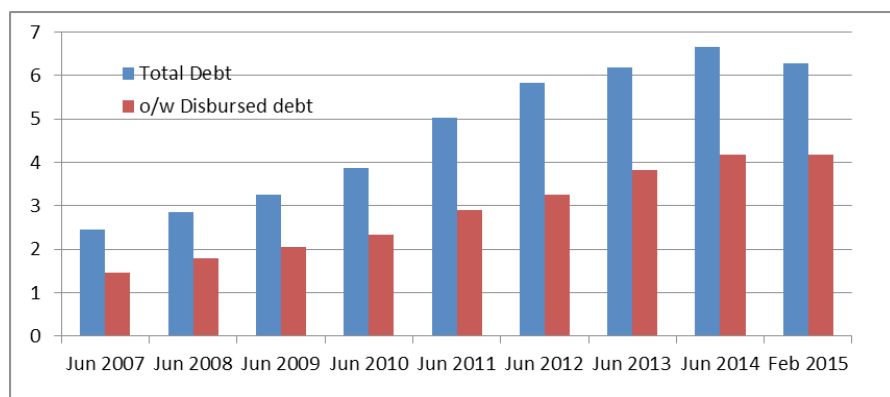
The stock of Uganda's external debt (disbursed and outstanding) was 28.6% of GDP in June 2012 and had increased further to 30.4% in June 2013. Concessional debt accounted for 59.5% of the total debt implying that the debt service costs were being mitigated by the fact that the bigger portion of the debt was contracted on favourable (concessional) terms from IDA (World Bank) and ADF (AfDB). In fact, it was noted that the Weighted Average Interest Rate (WAIR) of the entire debt portfolio was being maintained at a relatively low rate of 5.4% as of June 2013 because of the large component of concessional debt¹⁰.

The stock of external debt continued to increase and was estimated at US\$ 6.27 billion as at the end of February 2015, with US\$ 4.18 billion having been disbursed. This excludes loans amounting to US\$ 2.74 billion that were approved by Parliament in 2014/15 but had not yet been disbursed by February 2015. When these additional debts are factored into the debt stock, the level increases to US\$ 9.97 billion. Considering that the stock of

¹⁰MFPED (2013), Uganda Debt Sustainability Report, November 2013. Ministry of Finance, Planning and Economic Development.

domestic debt at the time was US\$ 3.10 billion (see Section 2.3), it follows that the total stock of debt was US\$ 13.07 billion, which is 52.3% of GDP. It follows that, by Government's own assessment, the debt levels above 50% should raise serious sustainability issues.

Figure 2.3: Trends in annual external public debt (total and disbursed) US\$ billions



Source: MFPED (2015)

The bulk of the external debt, about 85%, comes from the multilateral lenders (see table 2.2 below) and is dominated by the World Bank (IDA) at about 57% and Africa Development Bank (ADF) at 21%. On the other hand, China, at US\$ 404.4 million, was the third largest creditor to Uganda as at the end of February 2015 and topped the list of the bilateral non Paris Club creditor for 2014/15.

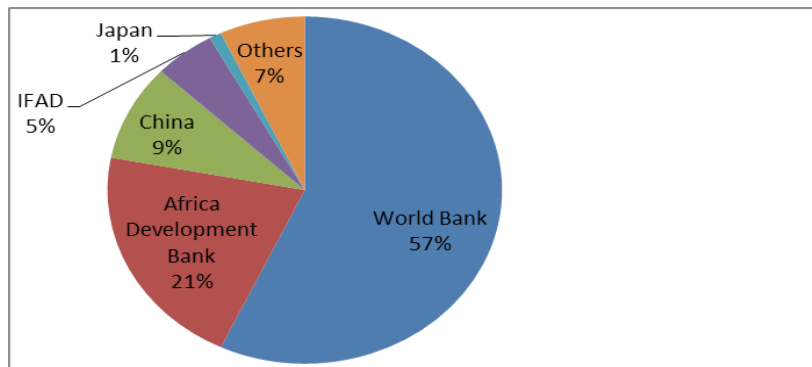
Table 2.2: External debt stock by source (US\$ Billions)

	Debt disbursed	Undisbursed debt	Total debt
Multilateral	3.59	1.65	5.24
Bilateral	0.58	0.44	1.02
o/w Non Paris Club	0.50	0.21	0.71
o/w Paris Club	0.08	0.23	0.31
Total	4.18	2.09	6.27

Source: MPFED and BoU in MFPED (2015)

The top five creditors of the country include World Bank (57%), Africa Development Bank (21%), China (9%), IFAD (5%) and Japan (1%). The others accounted for 7% of total debt as at end of February 2015.

Figure 2.4: Top creditors by debt disbursed as of end of February 2015



Source: MFPED, 2015

To conclude the discussion of external debt, there should be concerns about the increase in external debt of nearly 318% from 2006, when the MDRI that reduced the total external debt to just below US\$1 billion. The argument that new debt being contracted, which is largely committed to infrastructure, will increase productivity and economic growth by bridging the infrastructure gap, appear to be simplistic as it assumes that infrastructure is the only driver of productivity. More so, the Government seems to assume that productivity will increase uniformly across the traded and non-traded sectors¹¹. In the event that productivity in the non-tradable sector increases faster or is the only one increasing, which is often the case in countries with sustained budget deficit, both tax revenues and exports are likely to grow less than expected.

Reviews of Uganda's capital accumulation process have indicated that it was erratic, inadequate in scale, biased towards construction rather than

¹¹Tradable sectors may refer to the industry sector whose output in terms of goods and services are traded internationally while non-tradable sectors refer to locally rendered services e.g. health, education, retail and construction among others.

equipment and had a positive but weak impact on productivity¹². Borrowing, especially short- to medium term that is intended for increasing productivity, should target presence of excess capacity and not investments of a long-term nature, which should be built using long-term debt. Otherwise, a stronger impact of capital accumulation on productivity depends on government use of domestic tax revenues and long-term debt to finance public investment, as well as reform of the financial sector to mobilize domestic savings and channeling them into private sector investments. Domestic savings would include remittances from citizens working abroad.

2.3 Domestic debt

The total stock of outstanding Government domestic debt, at cost, as at the end of February 2015 was Shs. 9 trillion (US\$ 3.10 billion) compared to the stock of Shs. 7.215 trillion (US\$ 2.824 billion) at the end of June 2014. This represents an increase of 24.8% in the first 8 months of 2014/15, which should be a concern knowing that part of the previous domestic debt was not being retired but rescheduled – rolled over. The near exponential increase in domestic debt raises concern of debt sustainability, more so when the conditions responsible for the increase, mainly financing the government budget deficit, are still ongoing.

2.3.1 Structure of domestic debt

At the end of February 2015, the short-term borrowing comprised of treasury bills of not more than one year (364 days) amounted to Shs. 2.29 trillion (US\$ 1.09 billion). On the other hand, what is termed as long-term instruments or treasury bonds of two years and above, amounted to Shs. 4.483 trillion (US\$ 2.36 billion). It is worth noting that what is categorized as long-term instruments do not amount to long-term debt since the bulk of it (51.3%) has a maturity of not more than five years, and is contracted at weighted average interest rates of almost 14%. Only 16% of domestic debt (10 and 15 year bonds) can be termed as long-term debt, but is still non concessional given the high interest rates and short-repayment period compared to 40 years of most of the IDA loans.

¹²Hasusira (2004).

Table 2.3: Stock of domestic debt by type and tenure as at end of February 2015

	Maturity	Stock (Shs)	Stock (US\$)	% of total stock
Treasury Bills	91 days	69,071,327,632	23,824,435.7	0.80
	182 days	250,577,353,539	86,430,422.93	2.80
	364 days	2,612,382,445,105	901,076,319.89	29.00
	Sub-total	2,932,031,126,276	1,011,331,178.57	32.60
Treasury Bonds	2 years	1,602,668,259,355	553,145,461.60	17.80
	3 years	1,147,373,799,305	395,758,041.69	12.70
	5 years	1,869,578,077,050	644,864,436.51	20.80
	10 years	1,091,031,667,429	367,324,255.27	12.10
	15 years	356,726,001,613	123,043,577.76	4.00
	Sub total	6,068,377,804,752	2,093,135,922.83	67.40
Grand Total		9,000,408,931,028	3,104,467,101.40	100.00

Source: MFPED (2015)

The structure of domestic debt indicated in table 2.3 portrays a reality of heavy concentration of debt under 5 years, as well as a significant portion under treasury bonds, which are largely contracted for monetary purposes. In terms of debt repayment, the information described in the table shows that, nearly US\$ 3 billion or 12% of GDP, of debt will be due in the next 10 years. This excludes interest repayment on this and any new short-term debts to be contracted within the same period.

3.0 THE NEED TO INVIGORATE THE DEBT DEBATE

3.1 Is the history of the debt burden repeating itself?

The debt stock, service, rate of acquisition, and many other aspects threaten to raise the bitter experiences of debt burden that heavily undermined service delivery, growth and eradication of poverty. In this section, some points of concern are highlighted as a precursor for renewing the debt debate. The importance of such a debate is increased by the fact that current conditions do not mirror what led to debt forgiveness under HIPC and MDRI. Accordingly, countries like Uganda have to be quite realistic in both acquisition and use of debt. The analysis considers the effectiveness of debt management frameworks (institutional, policy e.g. former and current Debt Management Strategies and legal instruments) amidst rapid debt accumulation which is threatening the hitherto gains at the economic, social transformation and prudent debt management levels.

Uganda's domestic debt buildup, servicing, repayment challenges and implications to the economy are analysed to establish the relevance, purpose, timing and sequencing. When a government runs deficits for a long time, it builds up a stock of debt, which affects the economy's output and wealth that are dependent of the available stock of capital. Since deficits reduce investments they generate a slower growth rate of capital stock. The economy's capacity to produce goods and services is therefore reduced even further.¹³ The report shows that the debt sustainability analysis (DSA) threshold indicators seem grappling with harder economic outturn, with the increasing possibility of economic downturn.

3.2 Weaknesses in the debt sustainability framework

The debt sustainability thresholds for Uganda are based on general LIC-DSF indicators, but leave a lot to be desired when one considers the local

¹³Ball and Mankiw (1995)

context and outcomes on the assumptions overtime. For example, Uganda is considered a “strong performer” under the Country Policy and Institutional Assessment (CPIA) framework of the World Bank. On the basis of the CPIA rating, Uganda’s debt burden thresholds are: (i) Present value (PV) of debt-to-GDP ratio of 50%; (ii) PV of debt-to-exports ratio of 200% (the debt reference ratio is set at 150%). (iii) PV of debt-to-revenue levels of 300%; debt service-to-exports ratio of 25%; and (iv) debt service-to revenue-ratio of 35%.

The debt-sustainability framework that is currently under use in Uganda is largely hinged on World Bank parameters. Despite the widespread use of this framework, recent developments in debt stress across countries, following the global economic downturn calls for a reassessment of the validity and relevance of the framework. This section presents a discussion of a few areas for consideration during future debate of the framework.

3.2.1 Limited scope of the framework

The reliance on a policy assessment set by one institution, which is also a lender, has inherent weaknesses. Categorization of Uganda as a “strong performer”, under the CPIA, which is then used to set the threshold points, exposes the country to a possibility of using unrealistic parameters that are not collaborated by alternative ideological approaches. The critical importance of debt sustainability, more so in light of current experiences of many countries following the global economic downturn, should not be anchored on a single framework derived by the World Bank – a lending institution. Recent debt experiences by European countries, which are supposed to have been under the close watch of strong institutions like the European Union, and found themselves under severe debt stress in a very short time, points to a need for diversified approaches to debt analysis¹⁴.

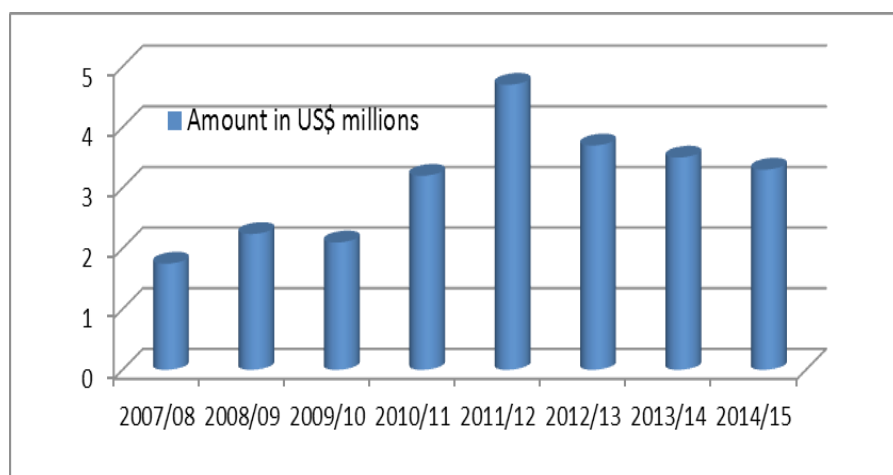
3.2.2 Inability to capture implementation challenges

Uganda has significant policy and institutional weaknesses even within debt utilisation itself. A lot of debt has not been disbursed on time while disbursed debt has not been utilised. Failure to utilise the debt within the planned

¹⁴Debt crisis in Portugal, Italy, Ireland, Greece and Spain (PIIGS), still lingers on six years from the onset of the global financial and economic crisis.

time, coupled with corruption, undermines the capacity of the economy to meet future debt obligations related to the same debt. According to MFPED (2013), “the low absorption capacity of resources has increased the cost of government debt due to commitment charges on committed but undisbursed loans. Between 2007/8 and 2014/5, commitment fees paid on undisbursed loans was more than US\$ 24.4 million. The charges increased by 164% from US\$ 1.75 million in 2007/08 to US\$ 4.7 million in 2011/12. Accumulated undisbursed loan amounts increased from US\$0.98bn in 2006/07 to US\$ 2.47bn by end of March 2014, representing 56%. An additional US\$ 3.5mn was paid out in form of commitment fees over the same period (MoFPED, 2014). Payment of commitment fees/ penalty on undisbursed loans results into financial loss to Government, yet such money could have allocated other development and social programmes.

Figure 3.1: Commitment fees paid by Government on contracted but undisbursed loans



Source: MFPED 2013. (Figures for 2014/15 end in February, 2015)

The bulk of the charges, 53% are associated with the Exim Bank of China followed by the AfDB. In this regard, the Exim Bank, which is often preferred as being fast in loan processing and approval compared, seems to encounter delays in disbursement arising from within Uganda. Such delays have been highlighted in the Auditor General’s reports (2010 – 2014)

including; diversion of counterpart funding, Non fulfillment of counterpart funding, poor project planning and appraisal/ designs, delayed procurement, poor monitoring and evaluation of projects as well as floating existing legal frameworks¹⁵ among other constraints.

In light of weak conversion of policies and budgets into tangible economic benefits, it would appear that the economy is not realising the anticipated levels of GDP, exports and tax revenue. For example the debt-service-to revenue ratio for 2015/16 for domestic debt alone, before planned rescheduling, is 58.6%, which is far above the threshold ratio of 35%¹⁶, set for external debt only. The current depreciation of the shilling against the US dollar, estimated at 38% in the last 12 months ending June 2015, signals a drastic change in foreign exchange revenues (exports of goods and services) and expenditures (imports). Total export revenue for the period April 2014 to March 2015 were estimated at US\$ 2,702 million, compared to imports of US\$ 5,049 million over the same period. Consequently, the current account deficit for 2014/15 was projected to widen to 8.5% of GDP compared to 7.2% in 2013/14. More so, during the 12-month period ending March 2015, the overall balance of payments position was estimated to be a deficit of US\$ 475 million, compared to the surplus of US\$ 287.4 million that was recorded in the previous 12-month period ending March 2014. These changes reflect possible fundamental deviations from the assumptions that informed the setting of thresholds.

3.3 Changing debt structure

The changing structure of the debt, whereby the domestic, short-term and non-concessional debt is dominating the portfolio, should be a concern. Already, the current structure shows that nearly 85% of the debt service is on non-concessional domestic debt. Prudent debt management for sustainability demands that interest rates are far below the real economic growth rate. Uganda has an average growth rate of less than 6% over the last decade, from 2005, yet the weighted interest rate on its debt profile, given the increase in domestic debt, is skewed above 10%. Uganda's past debt

¹⁵New loans agreements being signed before parliamentary approval.

¹⁶According to the budget speech, debt due payment is about 6.6 trillion compared to tax revenues of 11.3 trillion.

was more sustainable when the country was still committed to acquiring concessional debt, and evidence shows that the debt is still highly sensitive to non-concessional debt. In this regard, the Government should not only be concerned about the debt to GDP ratio but also on the structure in terms of what portion of the debt portfolio is concessional or otherwise.

The structure of the debt in terms of disaggregation between external and domestic as well as time to maturity raises concerns given the increasing volume of domestic short- to medium-term debt. For purposes of debt sustainability, it is often better to have a larger component of long-term debt that offers less stress on the economy in terms of repayment of both interest and the principle. The planned debt repayment for 2015/16 budget indicates a large focus on short-term domestic debt of Shs. 4,787 billion (72.1%) out of the total debt service of Shs. 6,643 billion.

Not only is domestic debt costing the country much more, it is also growing very fast. In the last two financial years, when the Government officially introduced domestic borrowing as a form of budget financing, borrowing through Government/ treasury bonds has amounted to Shs. 3,161 billion (4% of GDP). A total of Shs. 1,775 billion was borrowed in 2013/14 and Shs. 1,386 billion in 2014/15. An additional Shs. 1,384 billion is due to be borrowed in 2015/16, which will raise the portion of domestic debt from issuance of treasury bonds to Shs. 4,545 billion or 6.1% of GDP in just three years. Going forward, as the proportion of domestic debt increases, debt sustainability will become a serious concern for the country.

Much as the Government recognises the need to maintain a large component of debt under concessional terms, it seems to disregard its importance. Government has indicated that, over the medium-term, more non-concessional borrowing is going to increase and will dominate in the long-term due to the need to scale-up public investments (MFPED, 2013). The government needs to fully respond and implement the recommendation that it should define the acceptable level of non-concessional borrowing. In 2013, debt that included US\$ 6 billion for the Standard Gauge Railway could only remain below the sustainability threshold when the indicators were raised above the baseline. Yet, the likelihood of experiencing an increase in the baseline indicators was not assessed.

3.4 Rate of debt acquisition

Additional concerns relate to the speed at which the debt is rising and its utilization. For example, external borrowing increased by 82% in 2014/15 compared to 2013/14¹⁷. The rapid trend of increase can still be tracked over a longer horizon given the fact that the total reported external debt for end of February 2015 was US\$ 6.27 billion compared to about USD 0.99 billion in 2006. This represents an increase of 500% over a period of 9 years. At that time, June 2006, the total outstanding debt was US\$ 2.3 billion given the additional amount of domestic treasury securities of US\$ 1.0 billion and domestic non-security arrears of US\$ 0.3 billion¹⁸. The total debt exposure for mid-2015 was over US\$ 9 billion.

3.5 Debt sustainability tracking and relevancy

In light of observations on structure, size and rate of debt increase, it becomes pertinent to review the debt sustainability framework and indicators in terms of relevancy to building a resilient economy that cannot only withstand different shocks but also grow to meet current and future debt and welfare obligations. The use of debt-to-GDP ratio as a measure of debt sustainability is quite vulnerable to exchange rate movements whereby a depreciation of the local currency translates into less GDP and a higher ratio. For example the total debt of US\$ 7.6 billion, or a debt-to-GDP ratio of 30.4%, based on an exchange rate of US\$ 1 for Shs. 3000, could ease increase to 34.4% with a depreciation of the shilling to US\$ 1 for Shs. 3,400. Secondly, GDP includes inventories and slow-rolling stock whose productivity may be zero and hence not able to contribute towards debt repayment. In this regard, it is more appropriate to use flow indicators such as debt-to-export ratio and debt-to-tax revenue ratio.

Furthermore, the debt-sustainability indicator for liquidity burden shows that Uganda may be approaching or has reached a critical level. The indicator, which measures government's ability to finance external and domestic debt

¹⁷MFPEP (2015), Report on Public Debt (Domestic and External Loans), Guarantees, Other Financial Liabilities and Grants for Financial Year 2014/15, Ministry of Finance, Planning and Economic Development

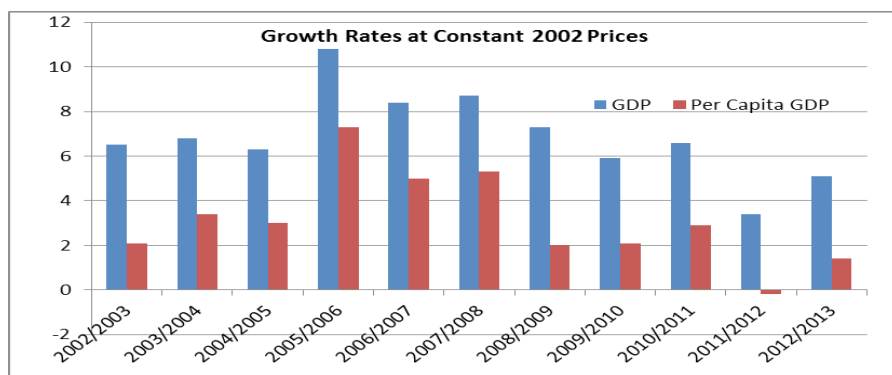
¹⁸Kajubu Y. Wasswa (2006), Challenges in Debt Management: Uganda's Status. Paper presented at the 1st OECD Forum on African Public Debt Management, Amsterdam Netherlands. Kajubi was then a Director at Bank of Uganda in charge of Trade and External Debt.

service from domestic resources, is close to 60%. Uganda's total debt payment plus interest for 2015/16 is Shs. 6,643 billion, which is 58.6 percent of the anticipated domestic tax revenues of Shs. 11,333 billion¹⁹.

3.6 Growth rate versus interest rate on debt

Governments may never need to raise taxes or cut spending to reduce the deficit; they can pay off interest and maturing debt by issuing new debt. This can only occur if the economy is able to grow its way out of the debt by a higher growth rate of GDP than the interest rate, making the debt-to-GDP ratio fall over time. With the debt shrinking relative to the size of the economy, the Government can roll over the debt forever. Unfortunately, this is not the case of Uganda where the average cost of debt (interest rates) is trending upwards – more so with the introduction of domestic debt and other non-concessional debts. Much as domestic debt is estimated at 40% of total debt, it accounts for nearly 85% of debt servicing largely because of its high cost in the range of 14-17%. In this regard, future debt sustainability would require the economy to grow at the same rate (to say the least) for the next 15 years when some of these debts are due to be retired. Figure 3.2 shows that the economic growth rate over the last decade has trended downwards (from 2005/06) with an average of 6.9% that is far below a possible average interest rate of 10-12%.

Figure 3.2: Growth rates for GDP and GDP per Capita



Source: MFPED (Various Years) Background to the Budget

¹⁹MFPED (2015), Budget Speech 2015-16. Ministry of Finance, Planning and Economic Development

3.7 Failure to carry out austerity

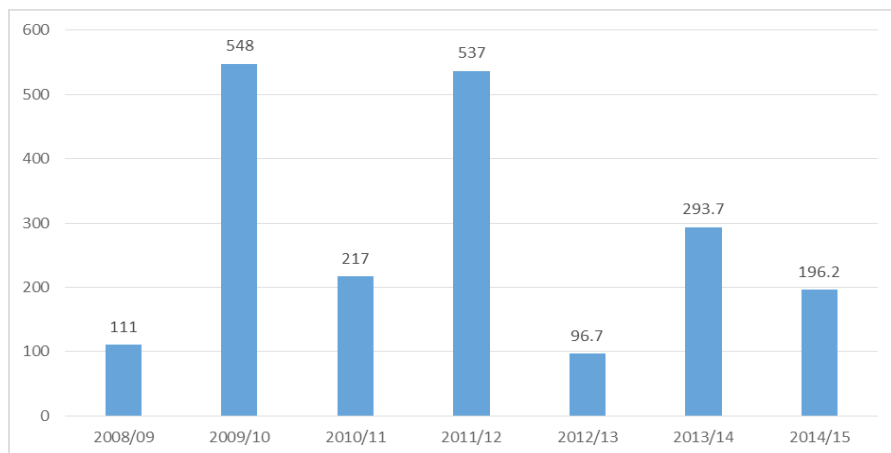
Existing debt stock aside, the actual value of the debt can increase with risk raising the variable interest rate (e.g. one pegged to $\text{Libor} \pm \text{Labor}$ is a benchmark rate that some of the world's leading banks charge each other for short-term loans.) or depression reducing the growth rate below the interest rate for a sustained period. More so, when the economy is in a recession or experiencing a slowdown in growth, the tax revenue falls as households and firms have lower income. This in turn can cause higher expenditure as the Government has to support the social sectors even more to maintain the average household welfare. In this case the debt will rise faster than national income and eventually become so large leading to a need for tax increases or spending cuts. The deficit can be affected by short- and long run factors.

The necessary adjustments of more taxes and less government spending (austerity) can be quite painful more so as they come at a time when the economy is already shrinking (depression), which will have initiated the increase in the debt-to-GDP ratio. Yet, the failure of Government to respond by either increasing the tax effort in any meaningful way, or by cutting expenditure, is a signal of a high potential for debt stress in the coming years. In the end, it will trigger a reverse flow of international resources through both reduced investments in Government bonds and FDI as investors predict a high tax regime in the future.

3.8 Change related to origin of debt

Uganda has experienced a significant shift from traditional creditors e.g. Paris Club creditors etc. to new bilateral creditors such as China, India and states in the Middle East. More so, the traditional lenders such as the World Bank and AfDB have reduced the grant component of their development support on the basis that Uganda is no longer a HIPC and the subsequent good performance of the country. Figure 3.3 below shows a declining trend in value of grants over the last 7 years.

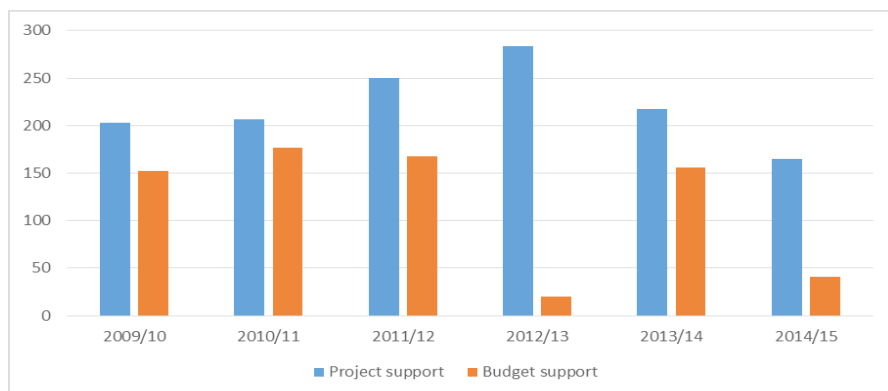
Figure 3.3: Trends in grants to Uganda (US\$ Millions)



Source: MFPED, 2015

The reduced allocation of grants to Uganda implies more debt obligations even for activities that are precursor, to allow planning and preparations, for the main planned intervention. The bulk of the grants for 2015/16 came from IDA (58.5%), Germany (20.1%) and Japan (10.8%). It should be noted that much of the grants are disbursed through project support and may appear as off-budget expenditures (see figure 3.4).

Figure 3.4: Grants by mode of support (US\$ Millions)



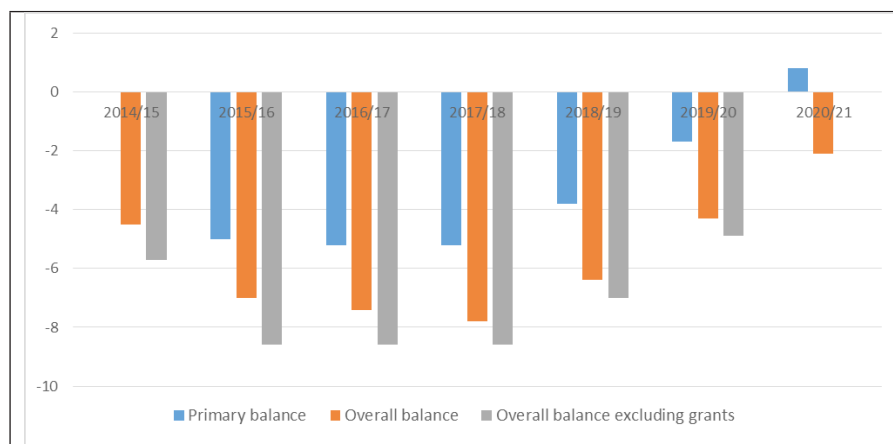
Source: MFPED (2015)

While grants may, in themselves require no service charges or costs, they, quite often, come with counterpart funding requirements that impact the size of the official Government budget and deficit. Quite often, the related Government contribution towards project support is not adequately captured in the mainstream budget thus increasing the distortion through supplementary budgets that are largely funded by way of issuing new public debt.

3.9 Planned deficits for financing the NDP II

The debt implications from the financing strategy for NDP I & NDP II are quite significant given the magnitude of the planned deficit and respective investments in the infrastructure. The fiscal strategy of the NDP II is expected to widen the budget deficit to nearly 9% of GDP for three years from 2015/26 before it reduces to about 7% in 2018/19. The deficit is largely driven by the need to address the infrastructure deficit and consolidating human capital development. Figure 3.5 below shows the various components of planned fiscal deficit as a percentage of GDP. The overall spending over the NDP period will average at 22% of GDP with a peak of 23% in 2016/17.

Figure 3.5: Planned fiscal deficit 2014/15 – 2020/21 (% of GDP)



Source: Source: NPA (2015), National Development Plan 2015/16 – 2019/20

The financing strategy is skewed towards non-concessional borrowing as illustrated in 11 key infrastructure projects that are to cost US\$ 8.1 billion - to be raised from non-concessional borrowing (US\$ 6.542 billion) and domestic finance (US\$ 1,560 billion) – largely local borrowing. The total cost of the NDP II is estimated at UGX 196.7 trillion with UGX 113.7 trillion (or 61%) funded by the public sector. The Government funding will come from external finance (concessional and non-concessional borrowing) and domestic finance (tax revenues, central bank and domestic borrowing). Additional non-public funding through PPPs will be used in a number of cases.

The proposed forms of financing are inclined to investments in stock of low-yielding public assets that have to be complemented by private sector investments. In the absence of corresponding private investments, it will certainly be difficult to generate enough regular income flows and tax revenue to finance the debt as it falls due.

3.10 Possible frontloading of debt on the basis of revenue from extractives

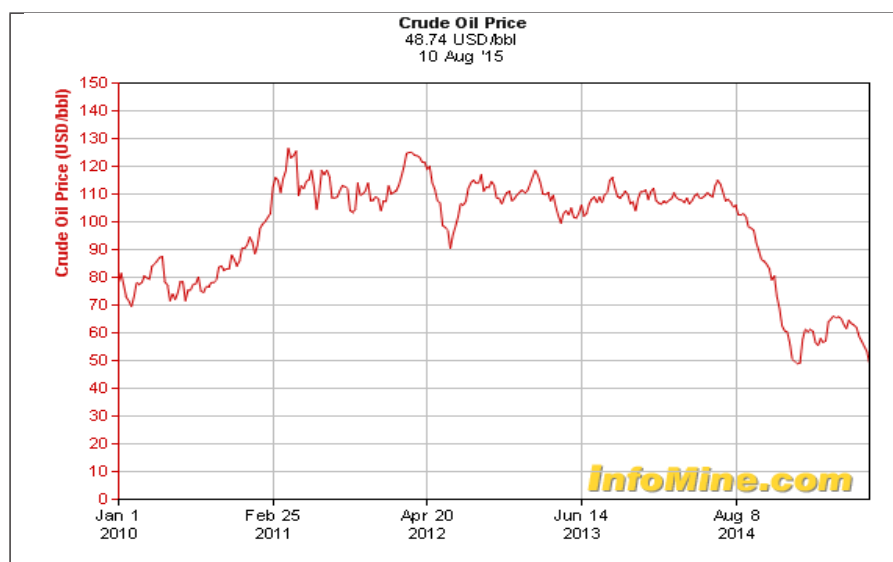
There is an indication that the discovery of oil, gas and other extractives has increased the country's appetite to contract debt or increase its future financial obligations. A significant number of oil-development related projects are being financed on a reimbursement basis (recoverable costs) while decisions on other infrastructure projects is also related to future oil revenue. For example, discussions on possible reduction of electricity costs arising from the related financing charges have hinted on use of oil revenue to restructure the loan by acquiring alternative debt. For example, on Bujagali, which is a 250MW hydropower plant that cost was nearly US\$ 900 million, the President, in his State of the Nation Address to Parliament in 4th June 2015 said "We are going to engage the developers to find ways of refinancing this project. With our oil money, this should be no problem."²⁰

The fact that there is no clarity on both the actual date when the oil will begin to flow and the barrel price at the time, raises uncertainty about the use of future oil revenues with regard to debt management. Recent trends in the international price for a barrel of oil indicate a downward movement,

²⁰<http://www.parliament.go.ug/new/images/stories/speeches/son15.pdf>

which if not reversed substantially, will greatly undermine oil-related debt sustainability.

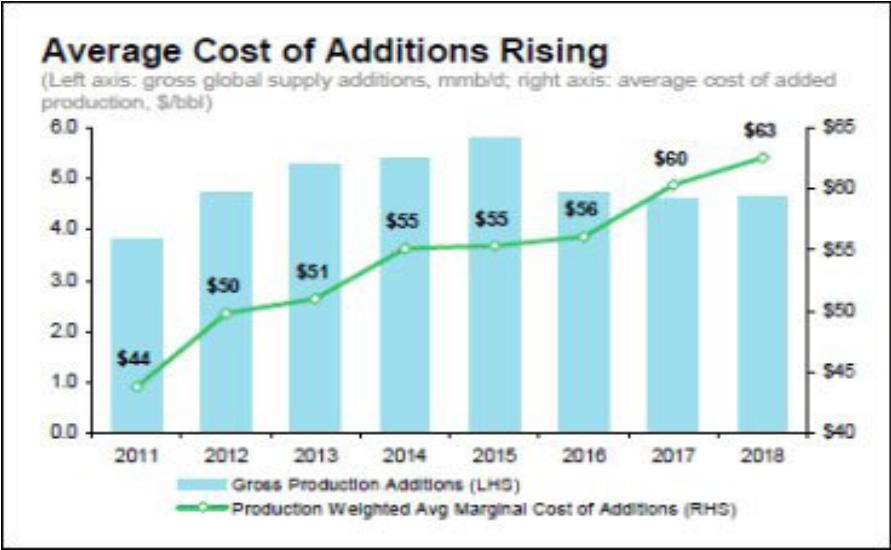
Figure 3.6: Trends in global prices for crude oil



Source: www.InfoMine.com

The reliance on future revenue from oil and other natural resources such as gas to service already acquired debt needs to be factored into the analysis of debt sustainability since it is already driving debt acquisition. In the event that the revenue delays, or does not come at planned levels, the country may end up with an unsustainable debt burden. Uganda should incorporate a scenario of current and future oil price analysis into its Debt Sustainability Analysis (DSA). Otherwise, the burden of debt repayment is highly probable to compromise the wellbeing of future generations in Uganda. The situation may not be helped by the fact that oil production costs are projected to continue rising have been rising thereby reducing the profit margin in the industry (see Figure 3.7 below). Depending on the location and technology being deployed, some oil production processes may become unviable – something that Uganda has to watch closely and factor into its debt sustainability analysis.

Figure 3.7: Average cost of producing additional oil is on the upward trend



Source: <https://www.google.com/search?q=oil+production+costs>

An upward trend in the cost of producing oil is likely to undermine Uganda’s expected ability to manage both oil and non-oil related debt in the future.

4.0 DRAWING LESSONS FOR POTENTIAL SOLUTIONS

Uganda can draw lessons on similarities and or differences of debt crises which could lead the nation into debt stress and unsustainability from other countries/ regional blocks e.g. the Mexican crisis in 1994 and the Asian crisis in 1997.

4.1 Lessons from the Greece crisis

Greece is quite relevant in terms of large government spending and social orientation with no political commitment to invoke early austerity. The free flow of trade from other EU states reduced production in the country while fuelling consumption of imports on the basis of same currency. More so, the entry of the country into the Euro zone had been enabled by non-disclosure of the country's true debt. Uganda, too has elements of uncertainty about the actual stock of debt due to non-incorporation of such debts as domestic arrears including pensions due to retired civil servants, unpaid service providers and court awards.

4.2 Lessons from the Mexican financial crisis – the Tequila

- The Mexican crisis arose from conditions that are not so different from what Uganda has undergone over the last two and a half decades. The exception is that Uganda never got so integrated into the global financial system partly due to limited role of capital markets and the securities exchange that remains largely local. Otherwise, Uganda, like Mexico, liberalised external trade, privatised public companies, and produced a legislation that was highly friendly to foreign investors.
- In the case of Mexico, favourable expectations, abundant liquidity, low world interest rates and an exchange-rate band led to large capital inflows that allowed a rapid increase in consumption and investment, particularly in the non-tradeable goods sector.

- In Uganda, there was no such huge inflow of private capital instead the inflows came from concessional loans and grants. In addition, Uganda did not impose as much restriction on exchange rates instead went on to liberalise both the current and capital accounts. Furthermore, Uganda introduced no interest rate controls allowing the rising rate to limit excessive borrowing.
- However, the effect in terms of fuelling high consumption and investment in non-tradable sectors (education, health, real estate etc.) was similar to a large extent. An extra benefit for Uganda was the fact that non-traditional exports increased to compensate for the early increase in non-tradeables but could not deter the onset of the balance of payments deficit in the later years partly due to long-term effects of a persistent government deficit. Overtime, there has been a widening of the trade balance and capital account indicating an underlying structural distortion that may further undermine exports, depreciate the shilling and worsen the debt sustainability as measured by the debt/export ratio.

4.3 Lessons from the Asian economic and financial crisis

- This was largely a result of the Asian Miracle that had attracted a lot of short-term capital amidst non liberalised foreign exchange regime. Accordingly, when Thailand liberalised its current account on 2nd July 1997, the confidence of external investors was eroded, triggering an avalanche of capital outflows that was replicated in other countries that investors believed to be similar.
- Uganda portrays fewer lessons given its fully liberalised current and capital accounts and fairly poor integration in global capital markets.

If there is uncertainty about a state's ability to pay back the money when the bond matures, the bondholders tend to ask for higher interest rate, which generates higher costs and debt to the state.²¹ Since financial crises reduce liquidity available to firms, households and countries, the widening budget deficits increase bank borrowing and trigger sentiments of higher default

²¹Ekonomin fakta (2010),.

rates, which again translate into prospects of higher interest rates. For example, on the onset of the crisis of 2008, firms and households financed their expenditures by issuing large amount of debts. By the end of that year, the banking sector had lent too much money and the states increased their budget deficits, increasing the risk premium on the Government bonds as the financial markets began to doubt if EU would stick together.²²

Contrary to theoretical expectations, the high interest rates in Uganda have not led to appreciation of the shilling as no significant external resources have come into the country outside the normal channels of exports, FDI, loans and grants. The recent depreciation (almost 38% over the last FY 2014/15) seems to signal a more serious structural problem. One plausible explanation is the possibility that external potential investors in the Government papers are beginning to foresee future debt stress and inability of Government to repay debts as they mature. In the current budget, 2015/16, government has a total debt repayment of maturing domestic debt amounting to Shs 4,787 billion, which is meant to be restructured and ploughed back into the books. While this is good management of the annual budget, it is likely to signal inability to pay domestic debt as it matures.

²²Petrovick Katarina, (2013), "Government Debt: Why has the government debt increased? An Analysis of what factors influence the long-term interest rates. A Panel study of the 27 EU Member states for the period 1995-2011. Masters Thesis, Karlstad Business School, Karlstad, Sweden

5.0 CONCLUSIONS AND RECOMMENDATIONS

This section provides some key messages by way of conclusions and proposals of recommendations for future management of sovereign debt and sovereign debt restructuring strategies with reference to the global and regional debt accumulation trends.

5.1 Key messages

- a) While there is general agreement that an increase in finance will be critical for future development of the country, there is a growing consensus, and rightly so, that governance and institutions do equally matter or are even more important. Delivery of international and local development finance does not automatically translate into development outcomes. Strong State and institutional capacities are needed. This has raised a fallacy of extremes whereby some previous donors believe governance is even more important than funding (See Greenhill et al, 2015, pp 9)²³.
- b) While sustainable poverty reduction will largely depend on private investments, there is still a significant need for public investments. However, these have to be done more strategically and in the most critical areas that both catalyze and trigger more private investments. Thus, Uganda's strategy of using the limited domestic resources, crowds out private sector both quantitatively and qualitatively. First, the quantitative aspect is that resources are limited and hence cannot adequately serve both the public and private sector. Secondly, the increase in interest rates raises the risk profile of both country and projects thereby lowering the quality of investments.

The key message is for the Government to increase tax revenue, reduce leakages through corruption, and amplify the effectiveness of its budget through better priority setting, better targeting and better sequencing.

²³Greenhill Romilly, Carter Paddy, Hoy Chris, and Manuel Marcus, 2015. Financing the Future: How international public finance should fund a global social compact to eradicate poverty, Overseas Development Institute (ODI)

The balance between pursuit of growth and social developments is critical. Much as growth is the major driver of sustainable poverty reduction, investments in social development (mainly education and health) are a major component of the growth and poverty reduction agenda.

There is need for institutional realignment, from excessive costs of administration and facilitation at the centre, to actual elements of service delivery at the lower local governments. Improving service delivery both for social and development related interventions funded through debt, will enable the country to raise its growth rate to levels that are in line with future debt repayment obligations.

- c) The framework used to compute debt sustainability is undermined by the limited scope it adopts and assumptions that do not seem to be realistic in terms of capturing liquidity flows required to service the debt. For example, the framework does not take into consideration the limited capacity to absorb and utilise the public debt effectively as well as potentially deleterious effects of corruption. The country will benefit from greater efficiency of public expenditure and reducing ineffective expenditures like over-sized wage bills related to large Government and non-wage but human resource-related costs by way of allowances and maintenance of vehicle fleets.
- d) The government should adopt sound fiscal and monetary policies that are designed to reinforce each other in order to pursue a comprehensive set of growth-enhancing public investments. Given the limited development of financial systems in Uganda, the Government has limited options in the area of using a non-restrictive monetary policy but to ensure complementary fiscal policy. Caution should be made against contracting commercial debt for long-term projects that can be financed by either concessional debt or domestic revenue.
- e) In order to manage the expenditure trajectory, Uganda should reintroduce more strict discipline in the implementation of the macro framework through application of fiscal rules and medium-term expenditure framework. This approach will facilitate transition to counter-cyclical policies that ensure continuity of core investments

supporting growth while adjusting investments in non-core areas to allow for funding of seasonal activities such as elections.

5.2 Requirements for relevant and effective debt sustainability analysis

The main inputs needed to conduct a relevant debt strategy analysis should include the following:

- 1) A comprehensive debt database, including projected stock and service payments for external and domestic debt and contingent liabilities of Central Government and other Government agencies, as well as private sector debt.
- 2) Analysis of the risks and costs of debt, including its interest rates and other fees, its maturity, and its composition by currency and by type and level of interest rate.
- 3) Analysis of the options for mobilising new finance (domestic and external).
- 4) Analysis of the options for restructuring existing debt in case of shocks or any other occurrences that endanger sustainability.
- 5) Making of comprehensive macroeconomic projections including a baseline scenario and optimistic or pessimistic scenarios for GDP, balance of payments and budget.
- 6) Making of forecasts of the unmet financing needs for national development and poverty or general welfare improvement.

The above inputs should be used jointly to assess debt sustainability, risks, and costs in order to design a comprehensive and versatile national debt strategy. The relevant debt sustainability assessment methodologies for Uganda would be the (HIPC) Debt Relief Analysis (for comparison with past trends when Uganda was a HIPC) and the Low Income Country Debt Sustainability Framework (LIC-DSF). These analyses involve making projections of intended borrowings and economic variables over a maximum 20-year period, and then using ratios comparing debt stock, present value or service with GDP, exports or budget revenue to assess payment capacity²⁴.

The dynamism involved in real economic and political environments, which

²⁴ www.imf.org/external/pubs/ft

feed into changes of priorities and assumptions, demand that Government updates the strategy on an annual basis. The updated version should be submitted along with the national budget to the legislature, advocacy groups in the private sector and civil society as well as donors/ funders. There is no doubt that fiscal sustainability will critically depend on increased transparency and improved communication using a range of the most efficient and effective technology.

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UDN Vision

A prosperous Uganda with sustainable, equitable development and a high quality of life of the people

UDN Mission

UDN works to promote and advocate for poor and marginalized people to participate in influencing poverty-focused policies, demand for their rights and monitor service delivery to ensure prudent, accountable and transparent resource generation and utilization.



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