APRI

COVID-19

Briefing Series 1

THE MACRO ECONOMIC IMPLICATIONS OF COVID-19

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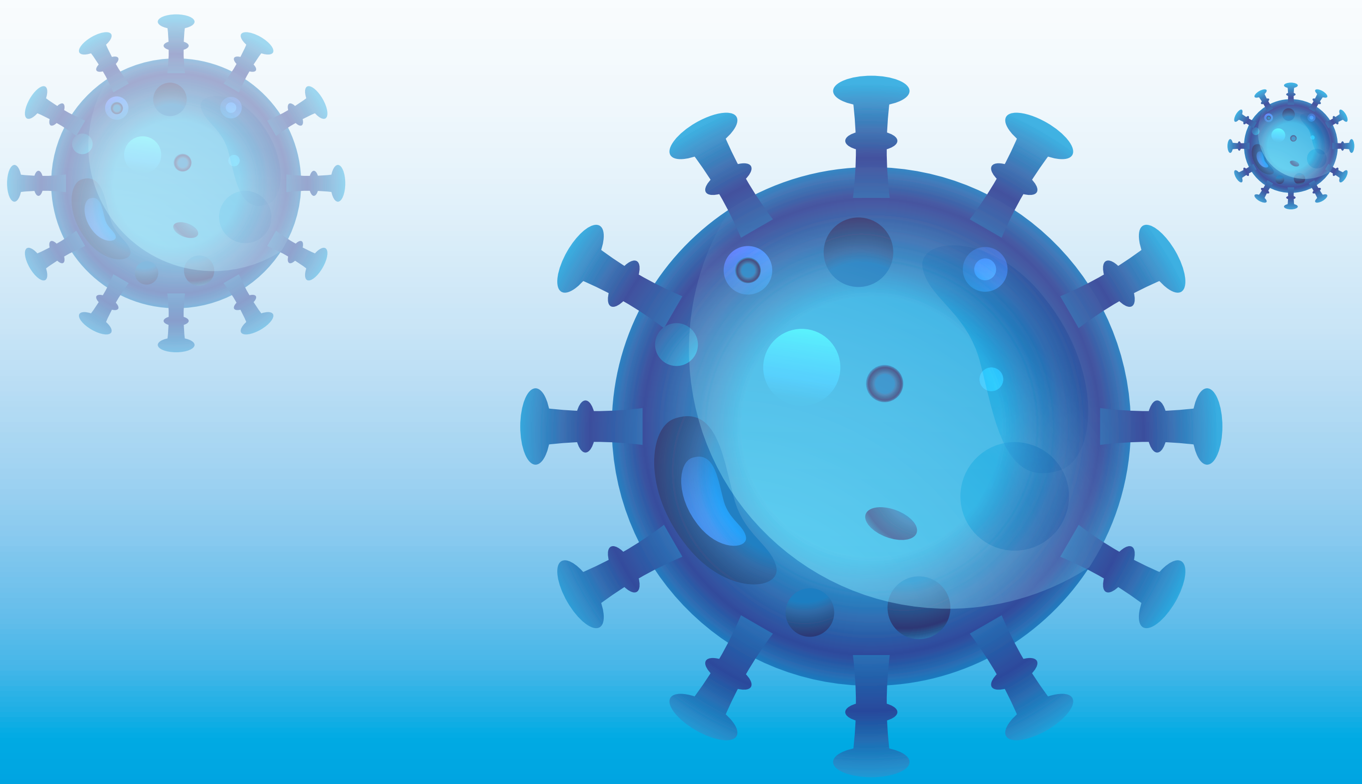

INTRODUCTION

This paper examines the likely implications of the COVID-19 pandemic on Uganda's macro-economic performance, and proposes the required interventions to hedge the economy against the likely negative impacts of the pandemic.

The world is in the throes of a global pandemic, the COVID-19, hitting a world high of more than 2.4 million cases as of mid-April 2020. The dreaded pestilence has so far claimed more than 315,000 lives. Whereas this pandemic has had far-reaching health impacts in the short-run, it is poised to trigger more medium to long-term macro-economic implications for Uganda and Sub-Saharan Africa in general. The biannual economic update by the World Bank on 9th April, 2020 highlights that growth in Sub-Saharan Africa is forecast to plummet from 2.4% in 2019 to -2.1 to -5.1% in 2020 which shall be the region's first recession over the past 25 years! Indeed, the report projects a loss of $37 - $79 billion in output losses for 2020 due to a combination of reasons. The concomitant effects are expected to be through a number of channels, notably: trade and value chain disruption; reduced financing flows from tourism, remittances, FDI and capital flight; and increased public spending on social protection and health care.

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Therefore, these implications have been highlighted alongside the four sectors of the economy, including the real sector, fiscal sector, monetary sector, and external sector. The intention is to identify options for ensuring economic recovery in the short-term to medium-term, and economic resilience in the medium to long-term.

REAL SECTOR

With regard to growth, Uganda's economy has been expanding and starting to experience the required structural transformation towards industry right before the COVID lockdown measures. For example, in 2018/19, the economy grew by 6.5 percent from a growth of 6.2 percent in 2017/18 (UBOS, 2019). The projected growth for FY 2019/20 was at 6.3 percent. The recent expansion in economic activity up to the third quarter of FY 2019/20 is attributed to increased agricultural production due to improvements in weather, increase in both public and private sector economic activity, as well as a relatively stable external economic environment. Overall, the economy before the COVID-19 pandemic had started to experience a structural transformation towards the expansion of the industry sector, driven by the construction and mining & quarrying industries respectively, much as there has been a reduction in the contribution of both the services and agriculture sector to the GDP.

IMF forecast that real GDP will contract by 0.5% in 2020

However, despite the impressive growth numbers, the economy was still facing both internal and external bottlenecks that can only be exacerbated by the existing COVID-19 pandemic. With the pandemic, the economy is susceptible to external shocks that are likely to increase global tensions that will, in turn, negatively impact on global trade and FDI inflows. This may worsen the already existing internal challenges of public investment management. The Economist Intelligence Unit of the IMF forecast that real GDP will contract by 0.5% in 2020, reflecting the negative impact of the coronavirus-induced measures – like lockdowns – on trade and tourism. The country is expected to slide into a mild recession in 2020, largely due to the risks of locust invasion affecting agricultural production, and disruptions of the global economy affecting ability to import agricultural inputs. Growth is expected to rebound during the NDPIII period, averaging 5.5% a year; way below the earlier projected 6%-7% driven by services and industry.

Even before the COVID19 pandemic, the growth ratio in exports to GDP from 10.6 percent in 2016/17 to 11.5 percent in 2018/19 was not high enough to offset the increase in imports from 15.5 percent to 19.7 percent during the same period

To ensure faster economic recovery and resilience, the country has to pursue both hedging and other interventions that boost efficiency. Among the key hedging measures, strengthening internal capacity to handle similar pandemics, and pursuing ambitious import replacement is critical to reduce susceptibility to global value chains. Even before the COVID19 pandemic, the growth ratio in exports to GDP from 10.6 percent in 2016/17 to 11.5 percent in 2018/19 was not high enough to offset the increase in imports from 15.5 percent to 19.7 percent during the same period. The trade deficit can only be worsened by the pandemic, thus the need for a twofold approach that expands existing export opportunities in the medium to the long-term as the country pursues a cautious and comprehensive import replacement strategy in the short to medium term. Among the approaches geared towards improving efficiency, there is need to quickly deal with the challenges in public investment management to increase returns from public investment. It is the right time, for example, to pursue any lagging investments by putting in place a strong system to ensure completion of all externally funded projects.

Even with the lack of adequate labor market statistical estimation, the impact of the current lockdown measures on unemployment are far reaching and will thus require demand stimulating policies to rekindle the economy. The current lockdown measures have affected informal and formal sector employment, especially for those classified under non-essential services. In the face of the current slowdown, agriculture and industry will be key to the sustainability of the economy, but they will depend highly on effective demand. Therefore, undertaking social security and fiscal reforms that help stimulate and sustain demand will be key going forward. Further, policies that address agricultural production and productivity for the entire value chain of priority commodities are critical.

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FISCAL SECTOR

Government of Uganda's fiscal deficit has been on the increase owing to an expansionary fiscal policy largely driven by the Five Year Second National Development Plan, ending June 2020, that pursued a strategy for frontloading spending on strategic projects to drive economic transformation. The size of the fiscal deficit has increased from about Uganda shs. 4,079 billion for the FY 2015/16, to about Uganda shs. 6,428 billion for the FY 2018/19. The deficit is expected to increase further in the FY 2019/20 as Government continues to pursue expansionary spending on the health sector in the face of the pandemic, and investments in other strategic projects. Even so, the 5% fiscal deficit of FY2018/19 (MFPED, 2019) fell below the 6.5% planned in the country's Second National Development Plan. What is critical is to evaluate whether the government actually increases in spending targeted priority investments in line with the National Plan. Maximizing returns from the investments already made and future investments should be prioritized through strict public investment management reforms.

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The pandemic is likely to further stifle government revenue efforts with the current revenue to GDP ratio at about 12.6 percent as the country's tax base is reasonably

narrow with more than half of the economy largely informal; this coupled with excess VAT exemptions. Generally, the country needs to push its revenue to GDP ratio to about 16% – 20% in the medium-term to sustainably finance its plans. With the current lockdown measures and slowdown of economic activity and trade, tax collections are projected to fall further. As more resources are channeled towards addressing healthcare and other emergencies, there is need to sustain financing for development projects. Further, the tax base must increase, thus deliberate and incentivized formalization of the informal sector is critical. Government needs to be decisive during this period to review all and remove unnecessary VAT exemptions to minimize revenue leakages.

Much as Uganda's debt situation is sustainable, albeit with some risks, the pandemic is expected to have a big impact on this position. According to the most recent Debt Sustainability Analysis (DSA) report for Uganda for 2018/19, the stock of total public debt grew from USD10.74 billion at the end of June, 2018, to USD12.55 billion (UGX 46.36 Trillion) by end June 2019. Of this, external debt was USD8.35 billion (UGX 30.85 Trillion), while domestic debt was USD4.2 billion (UGX 15.51Trillion). Nominal total public debt is projected to increase to 40.9 percent of GDP in FY 2019/20, before peaking at 49.5 percent in FY 2023/24 (MFPED, 2019).

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The critical risk now is the increasing debt servicing burden. Interest payments are now about 11% of the national budget, and they continue to crowd out public spending on priorities. With reducing revenue collections, Government is expected to meet its spending pressures through domestic and external borrowing. However, Government needs to rationalize domestic borrowing as it continues to crowd out private sector credit that is critical for unlocking the industrialization agenda that the country seeks to pursue.

EXTERNAL SECTOR

For the previous two Financial Years, 2017/18 and 2018/19, Uganda's external position deteriorated. The Balance of Payments (BoP) surplus reduced from USD160.68 million (0.5% of GDP) in FY 2017/18, to a deficit of USD68.7 million (negative 0.2% of GDP) in FY 2018/19. The deficit is largely explained by an increase in trade deficits that were largely financed by project aid loans and foreign direct investments. In particular, The Current Account deficit increased from USD1776.39 in FY 2017/18 to USD, 3.343.53 in FY 2018/19, largely driven by the increase in the value of merchandise imports without a matching increase in the value of merchandise exports. With the pandemic, the country's exports are expected to decline further, hence worsening the current account balance. This is due to overall reduction in global demand and prices for exports in the final quarters of FY 2019/20 as countries pursue lockdown measures globally. Nonetheless, the value of goods imported is also expected to fall in the last quarter of FY 2019/2020. This is largely due to a decline in global oil prices, and the overall disruption of global supply chains by the pandemic.

Therefore, there is need to pursue an ambitious export-oriented strategy while replacing imports sustainably; with imports largely remaining for strategic capital goods. The fast-tracking of oil exports is critical to expanding the country's exports and simultaneously reducing oil imports. Further, the country needs to strengthen export promotion efforts in line with priority commodities in agriculture, and minerals (largely gold), among others. The current draft of the third National Development Plan, as approved by parliament, already identifies a number of commodities that are suitable for import replacement. Government should have an ambitious investment strategy through the capitalization of the Uganda development corporation (UDC) and the Uganda development bank (UDB) to quickly support the required industrial transformation. These commodities that Uganda can quickly pursue for import replacement are highlighted in the table below.

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Table 1: List of Imports with High Potential for Substitution by Uganda

DESCRIPTION		VALUE OF IMPORTS				
		2013	2014	2015	2016	2017
AGRO-BASED PRODUCTS						
1.	Textile yarn, fabrics, made-up articles, & related products	113.74	106.9	94.03	126.73	15.75
2.	Cereals and cereal preparations	260.18	293.8	216.03	208.70	288.83
3.	Fixed vegetable fats and oils, crude, refined or fractionated	223.15	258.4	202.99	225.42	270.70
4.	Sugars, sugar preparations, and honey	148.52	111.3	104.2	84.43	126.22
5.	Beverages	44.90	48.89	43.69	33.47	25.76
6.	Vegetables and fruit	21.41	29.78	32.68	41.02	54.93
7.	Coffee, tea, cocoa, spices, and manufactures thereof	14.59	37.80	27.50	22.41	32.42
8.	Crude animal and vegetable materials	6.36	6.99	11.56	10.34	11.16
9.	Feeding stuff for animals (not including un-milled cereals)	4.06	4.76	7.15	8.27	11.48
10.	Oil-seeds and oleaginous fruits	3.54	4.19	5.71	6.13	9.56
11.	Fish, crustaceans and molluscs and preparations thereof	3.07	4.15	2.91	3.96	13.50
12.	Dairy products and bird's eggs	7.52	7.50	5.56	3.59	3.77
13.	Hides, skins and fur skins, raw	2.57	4.48	5.71	2.58	3.58
14.	Live animals other than animals of division 03	2.16	4.06	3.97	3.66	4.37
15.	Meat and meat preparations	2.58	2.71	2.87	2.21	2.99
16.	Processed anim. or veg. fats & oils; animal or veg. waxes	3.02	5.01	2.19	1.74	0.97
17.	Animal oils and fats	0.42	0.16	0.50	0.38	0.60
FORESTRY and TIMBER PRODUCTS						
18.	Furniture & parts thereof; bedding, mattresses and supports etc.	19.94	21.77	20.21	19.20	17.59
19.	Cork and wood	1.20	4.77	2.05	1.82	1.33
MINERAL-BASED IMPORTS						
20.	Iron and steel	259.06	252.2	276.17	207.81	282.02
21.	Manufactures of metals,	106.45	131.0	85.99	101.98	79.16
22.	Fertilizers manufactured (other than those of group 272)	49.74	23.26	32.86	33.48	26.45
23.	Crude fertilizers & minerals (excl. coal, petrol, precious stones)	28.42	5.62	40.20	45.80	43.72
24.	Metalliferous ores and metal scrap	6.46	2.15	15.52	14.45	16.27
OIL AND GAS BASED IMPORTS						

DESCRIPTION		VALUE OF IMPORTS				
25.	Petroleum, petroleum products and related materials	1,311.4	1,416	1,009.4	776.32	1,017.76
26.	Gas, natural and manufactured	14.35	15.92	9.67	8.51	9.91
ASSEMBLY AND LIGHT MANUFACTURED GOODS						
27.	Electric current	11.02	7.18	8.98	5.72	1.94
	Total for import substitutable commodities **(USD mil.13,074.7)**	2,823.6	3,020	2,420.0	2158.2	2,653.04
	Total Value of all imports for five years (USD Mil. 28,173.8)	5,871.6	6,139	5,592.3	4,894.3	5,676.58

NPA:2020

MONETARY SECTOR

Since FY 2018/19, the Central Bank has pursued an accommodative monetary policy. The Bank has been reducing its policy rate over time and, recently, the rate was reduced to 8% from 9% with the intention of stimulating economic activity after the disruption of the economy caused by the recent lockdowns due to the coronavirus pandemic. In its policy statement or April 2020, the bank also highlighted support measures to ensure the financial sector stability through the economic slowdown. However, the bank's foreign exchange reserves in excesses of more than 4 months of imports are expected to reduce further to about 3.5 months of imports, and this is likely to limit the bank's ability to finance the financial sector support strategies.
What remains most critical is the level of private sector credit. Over the years, Government has crowded out private sector credit with increased domestic borrowing as commercial banks continue to prefer lending to risk free government securities, other than lending out to the private sector. As a result, a small amount of private sector credit is being channeled to the productive areas of agriculture and manufacturing. This greatly limits the potential for economic transformation. Therefore, Government should cautiously limit domestic borrowing in the medium to long-term to allow more financing for the private sector to drive growth.

RECOMMENDATIONS

1. Quickly deal with the challenges in public investment management to increase returns from public investment. It is the right time to pursue any lagging investments. For example, putting in place a strong system to ensure completion of all externally funded projects. It is also the right time now to institute a mechanism and financing framework for fast-tracking readiness for implementation of all strategic public projects.

2. Limit external borrowing to only finance critical projects with maximum economic returns as identified in the country's national development agenda. This is to manage the fiscal risk of growing interest payments that crowd out development expenditures.

3. As more resources are channeled towards addressing health care and other emergencies,

there is need to also sustain domestic financing for development projects. Thus, the tax base must increase and, therefore, deliberate and incentivized formalization of the informal sector is critical. Government needs to be decisive during this period, minimize revenue leakages by reviewing them all, and remove unnecessary VAT exemptions.

4. Government needs to rationalize domestic borrowing as it continues to crowd out private sector credit that is critical for unlocking the industrialization agenda that the country seeks to pursue. Therefore, Government should cautiously limit domestic borrowing in the medium to long-term to allow more financing for the private sector to drive growth.

5. Undertaking social security and fiscal reforms that help stimulate and sustain demand will be key going forward. In particular, there is need for a balance between food distribution and cash handouts to also help stimulate demand for essential non-food items such as utilities, housing, clothing, and medical care among others. Further, fast tracking the National Health Insurance scheme and the review of the National Social Security legal provisions to allow mid-term access to social security benefits are long overdue.

6. With the increasing inflow of off-budget resources to the Health sector to support the COVID-19 response, a system should be designed to capture and integrate all off-budget support into the national budget process. This is to ensure that resources are streamlined to avoid wastage and diversion from implementing other key health sector priorities.

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7. Policies and investments that address agricultural production and productivity for the entire value chain of priority commodities are critical. Support to UDC to drive investments in regional medium to large scale value addition facilities for priority commodities, and increase support to UDB to offer affordable finance for small-medium enterprises involved in value addition.

8. Pursue an ambitious export-oriented strategy, while replacing imports sustainably; with imports largely remaining for strategic capital goods. This should be in line with priority commodities in agriculture, minerals (largely gold), among others. In this endeavor, pursuing regional integration remains critical for increased market access.

9. With the current volatility in external tourism, there is need for more effort towards promoting domestic tourism. It’s the right time to start promoting domestic flights to key tour destinations to increase timely connectivity.

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