POLICY BRIEF

Dr. Fred K. Muhumuza

MACROECONOMIC EFFECTS OF COVID-19:
Fiscal and Monetary Policy Options for Recovery in Uganda



JUNE 2020

FRIEDRICH EBERT STIFTUNG

About the author:

Dr. Fred K. Muhumuza is a development policy analyst and researcher committed to formulation of public policies and implementation frameworks that ensure inclusive growth. He works closely with Governments, Civil Society and Development Partners/Donors. He lectures at the School of Economics, Makerere University.

Acknowledgement:

The author wishes to thank Friedrich-Ebert-Stiftung in Uganda for the financial support towards the development of this Policy Brief.

Disclaimer:

Friedrich-Ebert-Stiftung, Uganda Office, John Babiiha (former Acacia) Avenue 5B, Kololo, P.O Box 3860 www.fes-uganda.org

Introduction

Economic crises, regardless of the cause, often manifest though several interrelated macroeconomic variables such as growth rates, inflation, aggregate demand, interest rates, exchange rates and unemployment. These variables are manipulated through use of fiscal and monetary policies with the later mainly focusing on price and financial sector stability as a means of realizing investment, full employment and economic growth. Fiscal policy relates to government revenues and expenditure and includes policy choices for taxation and borrowing with a view of causing growth and employment. This Policy Paper, reviews the options of fiscal and monetary policy actions available that Government of Uganda (GoU) can undertake to manage the macroeconomic challenges posed by the Covid-19 pandemic.

The assumption is that an expansionary fiscal policy will increase the aggregate output of the economy as higher government expenditure and low tax rates stimulate consumption and investments (both public and private). This is also expected to increase the supply of goods and services, create employment and eventually expand the tax revenue base. Monetary policy, on the other hand impacts the financial asset markets by moderating money demanded for both consumption and investment. A lower rate of interest, representing an accommodative monetary policy, would stimulate borrowing for investments and consumption thereby triggering economic growth, jobs creation and welfare improvements.

The rationale for policy coordination derives from the interrelations and potential contradictions during application. For example, Government can pursue an expansionary fiscal policy through issue of fiscal bonds in order to increase aggregate demand, simulate investment and eventually increase growth and employment. On the contrary, this can increase interest rates and negate an expansionary monetary policy that is aimed at increasing investment, aggregate demand, growth and employment through lower interest rates. A coordinated effort is critical if Government is to realize these multiple goals by managing the potential contradictions.

Impacts of Covid-19 on the economy

The economic crisis associated with the pandemic was initially 'masked' by the health crisis, which took top priority and led to introduction of preventive lockdown measures that disrupted production, distribution, aggregate demand, employment and growth. The measures resulted in massive unemployment (through both layoffs and furlough) as production units were forced to close or scale down operations leading to unemployment, lower demand, and growth, reduced tax revenues, and increased need for borrowing. Economic growth for 2019/20 is estimated at 3.1 percent down from the target of 6.0 per cent and lower than the average of 5.4 per cent for the last for years. According to MFPED (2020)[i], the agricultural sector is the only one expected to experience an increase in the growth from 3.8 per cent to 4.2 percent. Industry grew by 2.3 percent from an average of 7 percent over the last four years, while services grew by 3.6 percent compared to an average of 5.6 percent over the last four years.

The slowdown in economic activity was also reflected by other key indicators of economic activity including the Composite Index Economic Activity (CIEA) and value of total imports (Figure 1) both of which are directly dependent on the internal strength of the economy. The slowdown is expected to translate into a shortfall in net revenue collections for FY 2019/20 of about Shs 3.64 trillion given collections of Shs 16.81 trillion against the target of Shs 20.45 trillion. The shortfall in revenue was partly covered by significant government borrowing amounting to Shs 8.48 trillion in FY 2019/20 out of which Shs 5.91 trillion was towards refinancing of the old debt and hence did not translate into a new resource for increasing goods and services[ii].

Figure 1: Decline in Economic activity and imports during the Covid-19 months

Source: Bank of Uganda, www.bou.or.ug

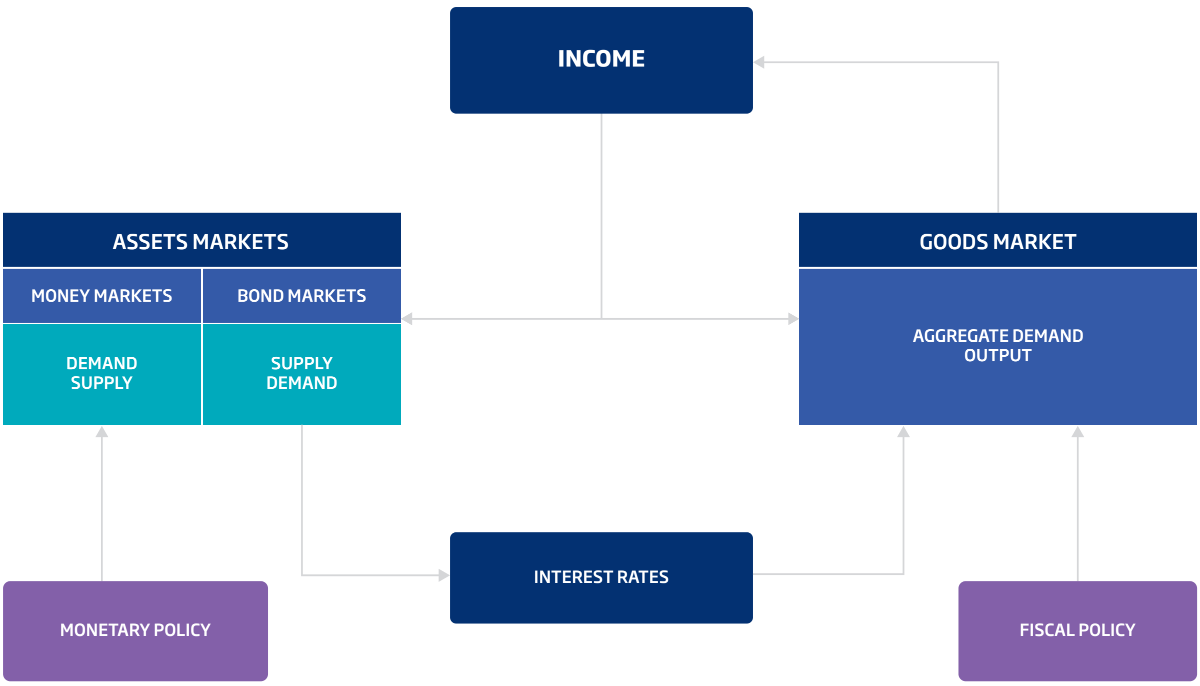
Macroeconomic choices for recovery of the Covid-19 economy

Going forward, the Government is left with defining parameters for a new normal of what has been termed as the "Covid-19 Economy" - that includes 'living with the pandemic.' The country has to shift attention to both management of the pandemic as well as economic recovery by establishing a business environment that will revive production by firms and farms as well as create opportunities for more income generation activities by households. The question of life and livelihoods is no longer an issue of either or but rather a combination of the two goals, which requires Government to pursue policy choices with potential conflicts. The pending question is the choice of monetary and fiscal policies for rebuilding the economy in the short, medium and the long-term.

On the fiscal side, there is increased pressure for government to spend on preventing the disease and treating the sick, not only from Covid-19 but other causes. In addition, the government has to support the most vulnerable persons such as street vendors and hawkers, low income employees who had no substantial savings, teachers in schools that were closed for months and are yet to reopen, drivers/conductors of commuter taxis and riders of motorbikes (boda boda) used for public transport, and employees in hotels and saloons among others. While the pressure to spend has gone up, the government revenues have declined prompting emergence borrowing needs that cannot be taken lightly given the high debt levels that are already being experienced by the country.

The ratio debt service to local/domestic revenue for 2019/20 was 22.6 compared to the recommended threshold of 20, while the debt-to-GDP ratio was projected by IMF to rise from 45.1 in 2019/20 to 51.5 in 2020/21 and 54.4 a year lateriii. The increase in borrowing is likely to raise interest rates and bias resources towards the financial sector assets at the expense of real sector investments that create growth and employment (See Chart 1).

Chart 1: Income growth and role of interest rates in linking fiscal and monetary policies



Source: Dornbusch, et al. (See Endnote iii)

Uganda's debt management costs that include: interest payment, external debt service, domestic debt (new borrowing and refinancing of the old), and part of domestic arrears to the private sector, is expected to increase from 28.4 per cent of the total budget in 2019/2020 to 31.4 per cent in 2020/21 (Table 1). Costs associated with domestic borrowing alone amount to 25.4 per cent of the entire national budget for 2020/21 and yet it is only 35.6 percent of the total debt for Uganda as on December 2019.

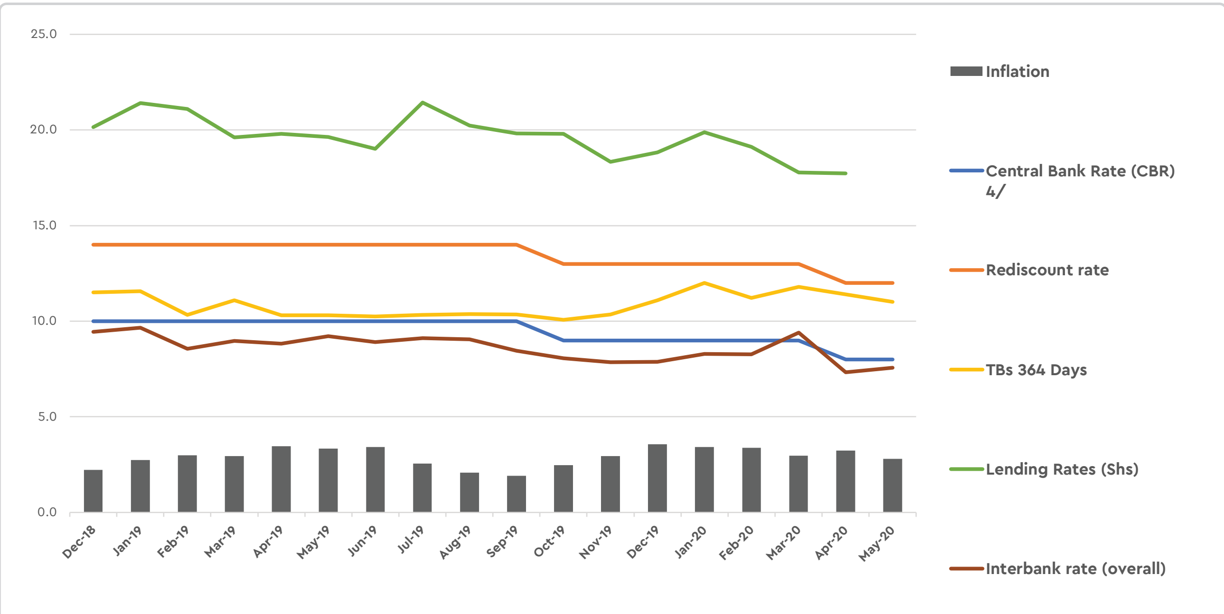
Table 1: Debt Management Items (Billion Shs)

DEBT MANAGEMENT ITEMS	2019/20	%	2020/21	%
INTEREST PAYMENTS	3,145.2	9.6	4,049.5	11.2
EXTERNAL DEBT REPAYMENT	723.3	1.8	1,228.9	2.7
DOMESTIC BORROWING	2,829.8	7.0	3,560.3	7.8
DOMESTIC DEBT REFINANCING	6,452.6	15.9	7,486.1	16.5
DOMESTIC ARREARS	449.5	1.1	450.0	1.0
TOTAL DEBT MANAGEMENT ITEMS	10,770.7	28.4	13,214.5	31.4
TOTAL BUDGET	40,487.9		45,493.7	

Source: MFPED, Budget Speeches for FY 2020/2021

The monetary policy has greatly focused on controlling inflation below single digit and was largely restrictive although in the recent past, the monetary authorities have consistently lowered the central bank rate (CBR) in order to signal an accommodative monetary policy. Figure 2 shows the downward trend of inflation and the CBR over the last 17 months. However, the treasury bills (TB) rates, which reflect the cost of price stability through reduction of excess liquidity and, to an extent an expansionary fiscal policy, went up slightly.

Figure 2: Inflation and selected interest rates



Source: Bank of Uganda, www.bou.or.ug

The need for close coordination and harmonization of fiscal and monetary policies is rooted in the close relationship between the financial assets market and goods/services market that runs through interest rates to influence output and employment. A higher interest rate attracts resources from growth-enhancing investments into financial assets thereby undermining the production of goods and services as well as employmentiv. For example, the interest rate payment of Shs 4.05 trillion on GoU domestic debt is a clear indicator of the high return on investments in financial assets that carry low operational costs compared to real sector investments in agricultural production and manufacturing.

The expansionary fiscal policy that government has pursued for decades has also undermined the independence of monetary policy that is confined to higher interest rates as a means of controlling inflation through mopping of excess liquidity that is amplified by the need to borrow through issuance of treasury bonds. Thus, despite signaling of an accommodating monetary policy through a lower CBR, the active signal on the cost of credit remain the TB and bond rates, rediscount rates and inter-bank rates (See Figure 2).

Options for a fiscal policy stimulus

The fiscal approaches would involve reducing income taxes to increase disposable incomes of households, which would improve welfare by increasing real incomes given the decline in prices for a number of consumer items such as basic foods. While this has potential to be very effective, there is a possible drawback given the limited scope as most people earn from the informal economy where they do not pay income but rather consumption taxes. Additionally, a sizeable number of people are already out of employment and earning little or no income.

Income tax reduction is not recommended as an effective tool if Government is to realize impacts among the most vulnerable. The current status low incomes that are already below the income tax threshold of Shs 235,000 compared to average wages of Shs 200,000, provide an automatic insulation for many of the poor and vulnerable who rely in employment income.

The commendable fiscal policy choice was to increase liquidity for firms by deferring the transfer of pay as you earn (PAYE) for three months as well as enhancing payment of receivables to private firms in form of VAT refunds and other arrears. Government has also deferred payment of corporation and presumptive taxes for selected firms mainly in the tourism sector and any associated penalties.

Additional fiscal policy approaches being considered include increasing government spending rather than austerity, in order to boost demand through increased public investments and consumption as well as grants of cash and food to vulnerable households. The government has recently used supplementary budgets to increase spending for a number of sectors in areas of health (both prevention and treatment), security, public administration, and relief. The efficacy of this approach is likely to be partly constrained by the poor targeting, costly delivery mechanisms as well as leakages through corruption.

The targeting of beneficiaries is constrained by lack of data on who is exactly in need as well as means to deliver the support. Experience from the Social Assistance Grant for Empowerment (SAGE) that supports the elderly above 80 years and the recent efforts to provide food (mainly posho/maize brand and beans) in the urban areas of Kampala and Wakiso district highlights the difficulties in identification and management of social protection and safety net schemes in Uganda.

In order to enhance access to affordable credit by the private sector the Government intends to increase the pool of loanable funds through further capitalization of the Uganda Development Bank (UDB) and leveraging private sector through the Uganda Development corporation – a public sector investment arm of Government. The effectiveness of this approach requires critical evaluation given the history of underperformance directed credit in the country. A number of Government agencies and strategies for channeling direct credit facilities and support to the private sector leave a lot to be desired.

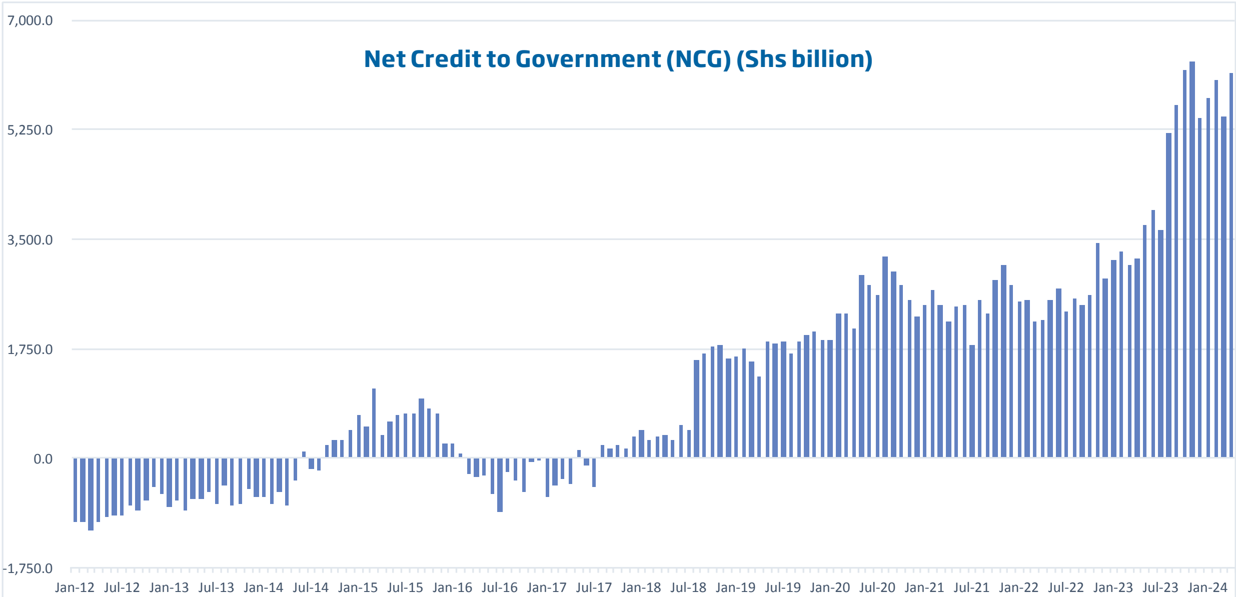
The Agricultural Credit Facility (ACF) in the Central Bank and the Microfinance Resource Centre (MSC) that channels public funds to SACCOs and other strategic private sector projects continue to struggle due to alleged political interference, limited resources, poor design of execution channels and targeting.

The government has also emphasized the fiscal policy option of increasing borrowing from external and domestic sources given reduction in tax and other sources of public revenues. This is driven by the need to continue the provision of basic services more so at an enhanced level given the emergency health and security spending. The Government has so far realised US$ 491.4 million from the IMF and US$ 300 million from the World Bank. This is in addition to earlier borrowing from Stanbic Bank equivalent to Euro, 600 million. Furthermore, Government plans to borrow Shs 3.5 trillion from the domestic market to finance FY 2020/21.

However, the trend of domestic borrowing from the financial system (Figure 3) raises some concerns about the cost of this option both in terms of refinancing and service costs as well as implied crowding out of the private sector.

The private sector suffers either through reduction of loanable funds that triggers credit rationing as well as higher interest rates offered by government, which are used as the risk-free base-rate.

Figure 3: Net Credit to Government by the Financial Sector (Shs Billions)



Source: Bank of Uganda, May 2020. www.bou.or.ug

Table 2: Issuances of Government Securities (Shs billions)

2019/2020	TOTAL ISSUANCE (1)	REFINANCING (2)	CASH AVAILABLE (3)	% OF CASH AVAILABLE
1st Quarter	2,190.83	1,662.40	528.44	24.1
2nd Quarter	2,198.77	1,051.91	1,146.86	52.2
3rd Quarter	2,332.56	2,040.17	292.39	12.5
4th Quarter	1,757.85	1,155.71	602.13	34.3
Total	8,480.01	5,910.19	2,569.82	30.3

Source: MoFPED (See Endnote ii)

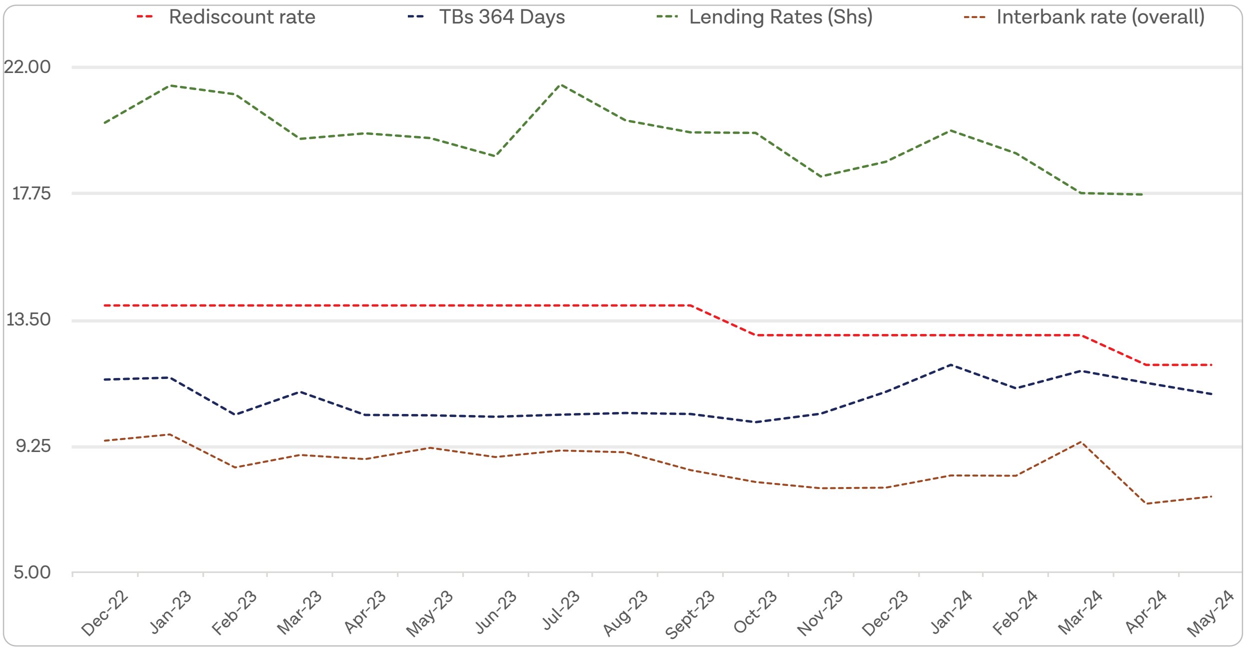
Furthermore, the issuance of government securities is increasingly yielding less in terms of new resources for service delivery as the bulk of it is considered as debt refinancing or rollover. Table 2 shows that, in FY 201920, out of the total issuance of Shs 8,480 billion, only Shs 2,569.8 (30.3%) was available for service delivery and the rest was for refinancing. The situation was even worse in the 3rd quarter when Corona related measures were effected and hence government needed more resources. During this quarter, out of Shs 2,332.6 billion issued, only Shs 292.4 billion (12.5%) was available for service delivery and the remaining Shs 2,040.17 billion was used for debt refinancing.

The basic assumption is that fiscal spending will improve the investment climate through physical infrastructure, better social services, as well as increasing aggregate demand. This would stimulate private sector investment and consumption with a possibility of creating multipliers that will resuscitate the economy. Policy makers continue to rely on the supply-based models of facilitating private sector through provision of physical infrastructure including specialized hardware such as industrial parks, incubation centres, and credit facilities. However, an expansionary fiscal policy approach without strong institutions and appropriate balance with monetary policy has resulted in slow traction and growth, limited economic transformation and high unemployment. Yet, there is every indication that Uganda will continue using such a policy framework during the Covid-19 period by raising taxes and spending backed by borrowing, which is creating persistent debt sustainability concerns.

Options for a monetary policy stimulus

The monetary policy approach to reviving the economy would involve a reduction of interest rates especially the bank rate, the rediscount rates with a view of lowering the inter-bank and lending rates. Figure 4 shows a high level of several basic rates that cannot support sufficient credit to stimulate economic recovery. Despite the continuous reduction of the CBR, lending rates have not responded significantly for a number of reasons that include the influence of fiscal policy whereby the large deficit signals significant government borrowing that puts an upward pressure on lending rates. Furthermore, the cost of resource mobilization and operations are high as shown by the rediscount and the inter-bank lending rates.

Figure 4: Selected interest rates related to credit



Source: Bank of Uganda (June 2020). www.bou.or.ug

The continued high cost of credit has prompted the Central Bank to caution commercial banks against disregarding the downward trend in the CBR. In response, the banks made a cautions response promising to review their rates downwards subject to assessment of their individual cost structures and for each segment of loans. They have also asked Government to deal with cost drivers and the budget deficit that are contributing to high lending rates.

Additional concerns on the effectiveness of the banking system to finance the stimulus and recovery of the economy arise from the inbuilt gender bias against women given the need for collateral in form of assets such as land, buildings and fixed salaries. The patriarchal system that dominates the social cultural fabric in Uganda does not allow many women to access credit since they lack acceptable collateral.

Although the government's medium term debt strategy indicates preference for concessional external debt as opposed to domestic borrowing, the latter is expected to increase from Shs 3.56 trillion in 2020/21 to Shs 4.86 trillion in 2021/22. This is partly due to delays and conditions that fail to match the urgency and flexibility required carry out a number of public sector operations. The borrowing for fiscal purposes has undermined the use of accommodative monetary to stimulate economic recovery.

One of the fundamental messages coming out of the Covid-19 pandemic is the fact that local and global economies and economic agents are so inter-twined that a negative shock on one can systemically affect the others. Thus, management of the economy in light of Covid-19 requires innovative approaches that balance government's direct (fiscal) and indirect (monetary) actions. The general focus should be aimed at restoring rather than replacing market functions but with more focus on ensuring effectiveness, inclusiveness and resilience of both households and businesses.

The following policy options are recommended for consideration:

1. At the aggregate or macroeconomic level, the focus should be on reinforcing both fiscal and monetary policy signals coming out tax policy, public expenditure and interest rates. At the meso and micro levels, the government should target to address specific markets, businesses and persons since the pandemic has affected certain sectors differently with tourism, hotels, airlines and education being among the worst affected. While it is important to ensure stability of prices of commodities, exchange rates, interest rates as well as the entire financial sector, there is need for specific policy interventions to level the ground for the recovery and survival of different sectors. The fiscal policy provisions of tax relief for companies and SMEs that was provided for the first quarter of FY 2020/21 should be monitored with a view of adjusting it to effectively address peculiarities of each individual sector and size of firms.

2. Fiscal policy should focus on jumpstarting the economy through targeted stimulus spending that offers protection and treatment against the all diseases including Covid-19. The policy should also ensure continued provision of basic public services such as health and water as well as relief food to the most vulnerable households identified earlier.

3. The policy should also support income generation activities especially small business ventures that not only provide income to millions of people but also act as the building blocks for the economy.

4. The improvement of household demand will be central to the recovery as it is the main driver of business functionality and continuity. Resumption and sustainability of employment in the formal economy will heavily depend on increased general aggregate both in the country and the region. Since the bulk of the population in Uganda derives income from subsistence farming and informal economy activities, reviving household income and hence consumption will depend on the rejuvenation of the informal economy and agricultural sectors. Specifically, the policies for supporting the recovery of agriculture should focus on provision of agricultural inputs, recapitalization of Savings and Credit Cooperatives (SACCOs) and other Microfinance institutions (MFIs) focused on rural areas as well as re-opening of weekly village markets. As already noted, the option of relying on increasing public sector consumption is likely to come at a cost since it is linked to excessive borrowing that increases economic risks.

5. The informal sectors of the economy require easing the restrictions especially on travel and trade activities while agriculture will need reactivation of input and produce markets. Since the agricultural sector was only partially locked down (mainly weekly markets for livestock) and actors are expected to have run down their savings, it will require financing from both the public and private sector. The challenge of weak financial markets that are also incomplete and ineffective in terms of reaching out to the low income farmers needs to be addressed through strengthening the sector and continuous evaluation and renewal on a continuous basis.

6. The fiscal authorities have often relied on taxation and borrowing to complement private finance through formal and informal financial sector institution. Unfortunately, government seems to worsen the situation through increases in interest rates and inherent inefficiencies in its institutions that range from political interference, favoritism to corruption. A more feasibly solution is to limit domestic borrowing by the public sector so as to allow financial markets to target the private sector and effective provision of agricultural inputs.

7. Efforts to improve support from the financial system including the restructuring of loans, waivers of payment costs, and readiness of the Central Bank to offer liquidity require additional measures to effectively support the private sector. First, the duration for restructuring needs to be extended given the length of the lockdown that has not allowed businesses to recover fully or even to restart. Second, the financial sector has natural biases against women given the need for collateral and the patrilineal cultural inhibitions in the

ownership of property. More so, the value of the properties, especially real estate has been downgraded by the pandemic, resulting in loss of quality of existing loans. Finally, the continued accrual of interest on restructured loans may not provide adequate relief to enable quick and/or full recovery.

8. Concessional external borrowing and grants should be a preferred option for dealing with the budget deficit that is likely to remain elevated given the historical debt costs and decline in domestic revenues. Alternate sources of finance from restructuring of the current public debt including cancelation are not likely to be a reality given the nature of the debt and its creditors. The bulk of the burden is from the domestic debt and will require Shs 11.54 trillion (25.4%) of the entire national budget for 2020/21 and yet it is only 35.6 percent of the total debt for Uganda as on December 2019. Second, much of the external debt stock whose repayment (amortization) in the 2020/21 budget is Shs 1.23 trillion includes loans from Exim banks that is considered an export from the lender and hence not easily available for renegotiation.

9. The government must seek cost reduction and efficiency measures within the budget execution by improving targeting of expenditures and elimination of corruption. In the short-term, the Government should pursue actions with quick results such as provision of agricultural inputs and extension services that promise quick results for crops such as maize, rice and beans. These can then be complimented by actions geared towards continued investments in coffee and tea, which will largely bear results in the medium to long-term. Besides, such crops require a significant portion of land, which is not available for many households given the average landholdings of smallholder farmers that is less than 2.5 hectares. Yet, such households are critical in rejuvenating the economy through increased incomes as well as reducing vulnerability due to lack sufficient food and income. The distortions of policy and targeting of public interventions have a large bearing on corruption and rent seekers within the economic system of the country.

i MFPED (2020), Budget Speech for 2020/2021

ii MFPED (2020), Performance of the Economy Report, June 2020

iii IMF (2020). Uganda. Request for disbursement under the Rapid Credit Facility. IMF Country Report No. 20/165. International Monetary Fund

iv Dornbusch R, Fischer S., and R. Startz (2008). Macroeconomics. (Pg. 223) McGraw Hill

Friedrich-Ebert-Stiftung
UGANDA OFFICE,
JOHN BABIIHA (FORMER ACACIA) AVENUE 5B, KOLOLO,
P.O BOX 3860 • WWW.FES-UGANDA.ORG