Fundamentals

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Macroeconomic update | Trip Notes | Key take-aways | Uganda

# Nuggets from the Pearl


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## IN BRIEF

- Local folklore goes like this, 'If you throw anything on the ground, it grows the next day'. That is what makes Uganda, the pearl of Africa
- We spent the week of 12th – 16th September in Kampala meeting policymakers; financial services' regulators and professionals; multilateral creditors; and the media. This note highlights our 5 take-aways from our Uganda trip
- An IMF mission is underway in Uganda for combined second and part-third reviews, with operational challenges delaying the second review (initially scheduled for June 2022).
- A monkey wrench has been thrown on Uganda's oil project with last week's resolution by the European Union seeking East African Crude Oil Pipeline (EACOP) to delay construction works by a year citing environmental concerns.
- Uganda has a credible (relative to its peers) liberalized FX regime, which although painful against the current global macroeconomic environment, is comforting to offshore investors
- We expect the BoU to maintain its tightening stance in the upcoming October MPC, to wade off the inflationary pressures whose second-round effects has catapulted core inflation from 2.9% (December 2021) to 7.2% (August 2022).
- The back-end of the curve (10 years and above) offers an attractive entry point with the reversal of the upward rates shift as environment normalizes. We see the 10-year (2032 maturities) offering the best risk-reward exposure, with c. 300bps downward rate adjustment to March 2022 levels.

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## Kampala: Did you know?

Kampala is the capital city of Uganda. According to our driver-cum-guide, the British explorers in search of River Nile's source were awestruck with numerous impalas inhabiting a hilly area. They set camp in that hilly area and started hunting impalas for game. Kampala derived its name from the merger of "camp" and "impala". The city initially comprised 7 hills, but the hill count is now around 21 following its gradual outward expansion over the years.

Nothing gets sporadic as the Kampala weather, at least that's the sense we had. The clear bright sky in one moment ushers in a heavy downpour the next moment. Security is tight in the city. Private security guards armed with long rifle guns is a common sight. Sniffing dogs can also be found in luxury hotels and VIP places. Our international audience may find this high-level of security perturbing. But against the context of a past militant state and terrorist-prone East Africa region, the caution sort of adds up.

*Boda bodas* - motorcycle taxis – are ubiquitous in Kampala streets and presents a chicken and egg conundrum. Either the many *boda bodas* are the cause of occasional Kampala traffic (chicken), or the occasional Kampala traffic led to the mushrooming of *boda bodas* (egg). The jury is still out on this particular issue. Food is served in exaggerated portions, at a cheaper price to boot. Local folklore goes like this, 'If you throw anything on the ground, it grows the next day'. That is what makes Uganda, the pearl of Africa.

We spent the week of 12th – 16th September in Kampala meeting policymakers; financial services' regulators and professionals; multilateral creditors; and the media. This note highlights our 5 take-aways from our Uganda trip.

Please note that the fiscal year in Uganda starts in July and ends in June. "FY23" means fiscal year ending June 2023

## 1. IMF's program second review delayed

Uganda entered into a 3-year USD 1.0bn IMF program in FY21, focused on fiscal consolidation, social spending and anti-corruption reforms. An IMF mission is underway in Uganda for combined second and part-third reviews, with operational challenges delaying the second review (initially scheduled for June 2022). Although Uganda has in place a Domestic Revenue Mobilization Strategy, we think that the underlying fragile macro-economic environment is challenging for its ambitious tax revenue target of UGX 23.8bn (14.0% y/y) in FY23.

The government penciled in lower spending in the current first quarter of FY23 (UGX 4.7tn against initial projected UGX 8.1tn) which is partly a co-ordination effort with the tightened monetary policy regime. Domestic arrears – symptomatic of fiscal indiscipline in previous fiscal years - in FY23 have been frontloaded with the entire budget allocation of UGX 661.9bn disbursed in the first quarter. That said, the numerous supplementary budgets – with an upward tilt – are seen as the proximate cause of the arrear build ups.

Public debt stood at UGX 78.8tn (c. 52.0% of GDP) as of June 2022, inclusive of Bank of Uganda (BoU) advances to the government that stands at UGX 4.0tn. The buildup in advances arose from seemingly conflicting legal clauses. Whereas the Bank of Uganda caps advances at 18.0% of current year's revenue during any fiscal year, the Public Finance Management (Amendment) Act 2015 limits advances to 10.0% of previous year's revenue. Furthermore, advances (and external debt service payments) made by the BoU are to be reimbursed within any financial year, with the government falling behind in settling these BoU advances. The BoU applied market interest rates on the advances that fell due. That said, the BoU and the Ministry of Finance signed off a Service Level Agreement in February 2022 capping advances at 10.0% of current year's revenue in any given fiscal year.

All in, we see the IMF program positively to rein in the fiscal indiscipline and see fiscal consolidation into reality (-5.4% in FY23, down from -9.0% in FY21).

## 2. Execution risks a drag on key government initiatives

The touch-and-go political-oriented policies that the government has pursued of late seems to face some hurdles. The Parish Development Model (PDM) was fully rolled out in the current FY23 and seeks to move 3.5m households from the subsistence economy to the money economy. Budgetary allocation to each parish (10,549 in total countrywide) is UGX 100m, with disbursements made as revolving funds to established target Savings and Credit Co-operative Societies (SACCOs) in the parish. The feedback is that the implementation of the PDM has been disappointing; with lack of funds cited as a major headwind. Furthermore, whereas the intention of the PDM was a direct intervention to boost the micro-economy, it has the hallmarks of a pivot towards transfers.

The derailing of the oil project poses the biggest risk in our view. The commercial oil production was to kick off with the Final Investment Decision (FID) signed off in early February. The overall USD 10bn oil project is dubbed the Lake Albert Development and comprises of Tilenga and Kingfisher upstream oil projects in Uganda, and the construction of the East African Crude Oil Pipeline (EACOP) linking landlocked Uganda to Tanzanian port of Tanga. [*Shareholding structure of EACOP comprises of Total Energies (62.0%), Uganda National Oil Corporation (15.0%), Tanzania Petroleum Development Corporation (15.0%) and China National Offshore Oil Corporation (8.0%)*]. Although there is a budgetary allocation for the EACOP project totaling UGX 904.1bn in the current FY23, the construction is yet to kick off. Further, a monkey wrench has been thrown with last week's resolution by the European Union seeking EACOP to delay construction work by a year citing environmental concerns. This will be a drag on oil commercialization, expected to come online in FY25 and a boost on GDP (c. 10.0% once the project is optimal) in outlier years.

## 3. Liberalized FX, a bright spot

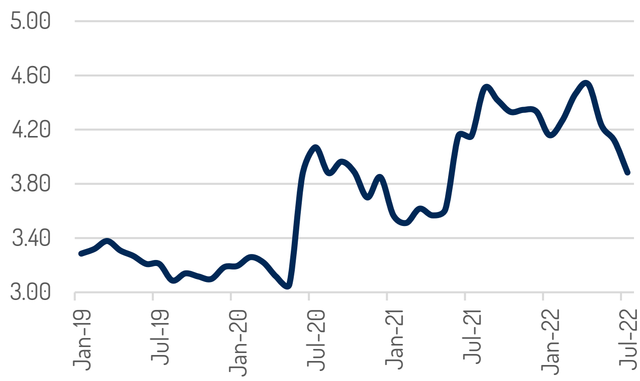
One thing that stood out for us is the liberalized FX regime in Uganda, compared to some of its peers in our Africa coverage. The Uganda Shilling (UGX) has weakened 6.8% YTD, against an average 0.2% yearly strength in the prior 5-year period. The negative spillover effect of the Russia-Ukraine war coupled with the US tightening cycle led to the sharp UGX weakness in April-June period. The BoU intervened in the May and June 2022 period, selling a combined USD 260.0mn and anecdotal evidence from our meetings is that the Bank has not intervened this quarter.

**Evolution of the US dollar/Ugandan shilling (spot rate)**


Source: Bank of Uganda (BoU)

Uganda has a credible (relative to its peers) liberalized FX regime, which although painful against the current global macroeconomic environment, is comforting to offshore investors. Although there was initial nervousness amongst offshore investors, they still hold a sizable 12.0% - 15.0% of local debt and are still active in the market. Over and above the direct entry into the securities market, offshore investors express their convictions via the short-term FX swap market. FX Reserves are healthy at USD 3.9bn (end July), equivalent to 4.1 months of import cover.

**Evolution of FX Reserves (USD, bn's)**

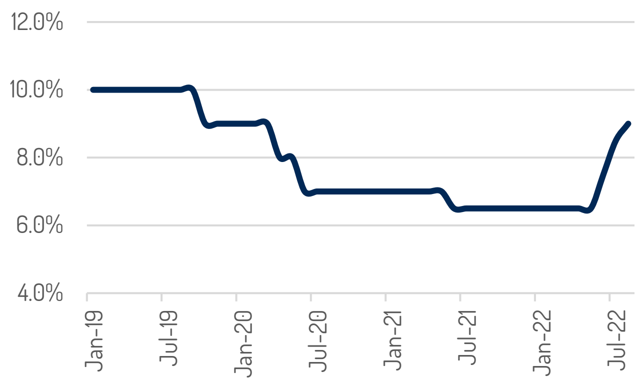



Source: BoU

## 4. Pre-emptive rate hikes; pain now, gain later

The BoU delivered a combined 250bps rate hike in three consecutive MPC meetings, including an emergency meeting in July, with the benchmark policy rate now at 9.0%. The BoU has shown the courage to act with its preemptive rate hikes to tackle the ugly face of inflation. Headline inflation, hitherto subdued at low 3.0% levels, has flared up to 9.0% (August 2022). This has been attributed to the acceleration in food and fuel inflation, fueled by the negative spillover effect of the Russia-Ukraine war and FX pass-through. The policy adjustment has not been a costless exercise with the real sector bearing the brunt of the aggressive monetary policy stance.

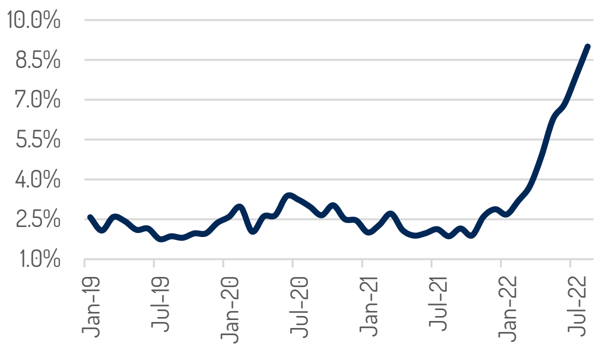
**Evolution of the Central Bank Rate**




Source: BoU

As the BoU expects inflation to average 7.4% throughout the year, this translates to an average print of 11.1% in the remaining four months of the year. As such, we expect the BoU to maintain its tightening stance in the upcoming October MPC meeting, to wade off the inflationary pressures whose second-round effects has catapulted core inflation from 2.9% (December 2021) to 7.2% (August 2022). We expect headline inflation to come back to target range (5.0% +/- 2.0%) from second quarter of 2023 majorly due to base effects, which should see a policy pivot back to accommodative stance.

**Evolution of Headline Inflation**

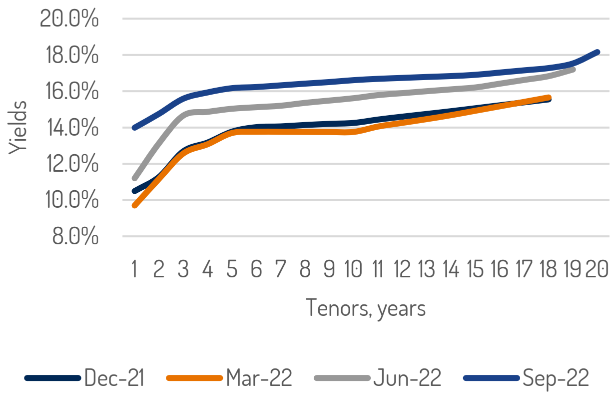



Source: Uganda Bureau of Statistics (UBOS)

## 5. 10-year offers a sweet spot for local rates exposure

The yield curve has shifted upwards by an average 98.6bps across the tenors – an average 150bps in the front-end of the curve – this quarter in response to the benchmark policy adjustment. Market participants expect some further upward adjustments on the curve, particularly at the back-end with the anticipated rate hikes. Furthermore, the auctions conducted quarter-to-date have not been satisfactory. Whereas the market tendered a combined UGX 2.3tn against an offered UGX 1.65tn (UGX 550.0bn per month's T-bond auction), the Debt Management Office accepted UGX 936.4bn with most of the rejections at the lower segment of the curve.

**Evolution of the local rates curve**




Source: BoU

As such, the run-rate this fiscal year is lagging and the market expects upward yield adjustment in future auctions. If FY22 is anything to go by, the twin combination of lower-than-expected revenue collection coupled with supplementary budgets with upside bias should give birth to unscheduled auction(s) – and/or private placement(s) - at the tail end of the fiscal year as the government meets its borrowing target. That notwithstanding, the overarching theme is that the back-end of the curve (10 years and above) offers an attractive entry point with the reversal of the upward rates shift as environment normalizes. We see the 10-year (2032 maturities) offering the best risk-reward exposure, with c. 300bps downward rate adjustment to March 2022 levels.

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