Emmanuel Tumusiime-Mutebile: Uganda's potential as an economy for the next five years

Presentation by Mr Emmanuel Tumusiime-Mutebile, Governor of the Bank of Uganda, at the Mineral Wealth Conference, Kampala, 1 October 2012.

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1. Introduction

The next five years are likely to be a period of transition for the Ugandan economy; a transition which will encompass three dimensions. First, there will be a transition to an economy in which non renewable natural resources – oil and minerals – could make a substantial contribution to export earnings and Government budget revenues. Secondly, the Ugandan economy will become progressively more integrated into the regional economy, with the implementation of the common market and customs union in the East African Community (EAC). The third dimension of the transition will be a transition from an economy which is predominantly factor driven, based on its endowments of natural resources and unskilled labour, to one in which economic growth is driven more by improvements in factor efficiency; i.e. by growth in productivity. These three prospective economic transitions are related in important ways, which I shall elaborate on later.

Whether Uganda can gain maximum benefit from these opportunities depends to a large extent on the economic policies which we pursue over the medium to long term and the quality of our economic management and governance. It is not axiomatic that Uganda will benefit from our oil and mineral resources that Uganda will be able to exploit the opportunities presented by East African economic integration and that Uganda will generate sustained and dynamic productivity growth. These benefits will only occur if the policy choices we make are the right ones. This is the main message of my presentation this morning.

2. Opportunities for an economic transition in Uganda

For the last two decades Uganda has recorded robust economic growth, averaging about 7 percent per annum in real terms. As a result, the size of our economy, again in real terms, has quadrupled since the early 1990s, although real per capita incomes have only doubled in this period because population growth rates have exceeded three percent per annum. Sustaining rapid economic growth consistently over two decades is an impressive achievement, not matched by most other developing countries. However, this growth has not yet brought about a major structural transformation of the economy. The majority of the workforce, around 70 percent, is still employed in smallholder agriculture where productivity per worker is very low; average value added per worker in agriculture is only $200 per year. In large parts of the economy, which are still dominated by traditional, informal activities, productivity is stagnant.

The Global Competitiveness Index, which is produced by the World Economic Forum, the African Development Bank and the World Bank, distinguishes three stages of economic development which are related to competitiveness. In the first stage, which characterises most low income countries, economies compete on the basis of their endowments; unskilled labour and natural resources. The second stage is an efficiency driven stage of development, in which economies compete by continuously raising their productivity. Improvements in factor productivity are the main driver of economic growth in this second stage of development.

It is on the threshold of the second stage of development that the Ugandan economy now stands. In industries such as food processing, construction materials, telecommunications and financial services, modern, high productivity industries have been set up and are expanding, although they still employ only a relatively small share of the workforce. If we can make the transition to an efficiency driven economy successfully, Uganda can accelerate the structural transformation of its economy and move towards middle income status.

The commercial exploitation of hydrocarbon and mineral deposits offers both opportunities and challenges for Uganda. The opportunities arise because oil and minerals will generate substantial increments to public revenue and to foreign exchange earnings; resources which could be used to invest in the physical and human capital needed to strengthen competitiveness and thus help to create the foundation for productivity driven economic growth. The World Bank's Doing Business Indicators report that an inadequate supply of infrastructure is cited by firms as the third most problematic factor for doing business in Uganda (the most problematic factor is corruption and the second most is access to finance). Strengthening the transport and power infrastructure could reduce significantly the costs of doing business in Uganda and thereby help to promote private investment in modern, high productivity, industries. Better infrastructure is also necessary to enable Uganda to export minerals or to process them in the country. Productivity growth also requires investment in human capital. Uganda has made great progress in making access to primary education virtually universal across the country, but we now need to build on this and expand access to secondary education and to provide the workforce with the vocational skills needed for modern industries.

Unfortunately, oil and minerals can also impede development, as demonstrated by the experience of many developing countries which are rich in resources. Natural resource revenues are often very volatile because of the inherent volatility of global prices and sometimes because production volumes may also be erratic, and this volatility can be transmitted to the macroeconomy, creating a cycle of resource led booms and slumps. The export of natural resources and the spending of the revenues thus generated in the domestic economy can also cause real exchange rate appreciation, which damages the competitiveness of the non resource traded goods sectors of the economy, such as agriculture and manufacturing; this is a phenomenon called "Dutch disease". Avoiding the pitfalls of natural resource dependency – the so called "resource curse" – is only possible with sound economic policies and good economic governance, a subject I will return to shortly.

The EAC is now implementing the second stage of its regional economic integration project; the common market which will allow for trade in services within the EAC, including the right of establishment of firms in the service sectors, and the free movement of capital and labour. The EAC customs union has already yielded major benefits for Uganda. Uganda's exports to our EAC partner states have risen from only $68 million in 2001/02 to $676 million in 2011/12. Intra-EAC exports now comprise 25 percent of Uganda's total exports, compared to 14 percent 10 years ago.

Regional economic integration can help to accelerate Uganda's transition to an efficiency driven economy in several ways. First, it will expand the size of the market for domestic firms, allowing them to realise economies of scale and become more efficient. In terms of value, the combined GDP of the EAC partner states is the equivalent of nearly $90 billion, which is four times the size of the Ugandan economy alone. Secondly, it will strengthen competitive pressures in the national market, by exposing domestic firms to greater competition from firms from other EAC partner states. Competition provides the best incentive for firms to increase their productivity.

Thirdly, regional integration will provide a stepping stone for industries which are not yet competitive globally to begin exporting, and thus stimulate the improvements in productivity which will eventually enable them to compete on global markets. This is likely to be especially important for the domestic food sector, which could produce substantial surpluses for export. In turn, the opportunity to sell on regional export markets will give farmers in Uganda incentives to focus on production for the market and to produce higher value products. Finally, cooperation at the regional level is necessary to develop the infrastructure to support growth in the region's economies; for example road and rail links from landlocked countries to the coast. This will be particularly important for the development of the mining industry.

What policies are essential to bring about the economic transitions?

Macroeconomic policy

The foundation of Uganda's economic growth over the past two decades has been the priority accorded to macroeconomic stability, and in particular the control of inflation. This will be equally important in the future, to support the transitions which I have discussed above, not least because the transition to an efficiency driven economy depends on attracting higher rates of private investment in modern industries. A stable macroeconomy is a prerequisite for private investment on a large scale.

The two key components of sound macroeconomic management are a monetary policy which has as its primary policy objective the maintenance of low inflation, implemented by a central bank which has the operational independence to set interest rates to achieve this objective. The BOU has modernised its monetary policy, introducing an Inflation Targeting Lite monetary policy framework, which employs a policy interest rate – the Central Bank Rate (CBR) – to influence demand in the economy. The new framework has already proved to be effective in bringing inflation down. Inflation was driven up sharply last year by supply price shocks, but the BOU's strategy of raising the CBR has brought about rapid disinflation. The latest inflation data, released last week, show that core inflation has fallen to 4.8 percent. The BOU intends to hold core inflation as close as possible to its policy target of 5 percent over the medium term, using the policy interest rate to counter any shocks which threaten to drive inflation above the target in a persistent manner.

Fiscal policy will become even more important as a tool for maintaining macroeconomic stability once production of oil and minerals begins on a commercial scale. A large part of the rents accruing from natural resources take the form of Government budget revenues and hence flow into the domestic economy through the Government budget. How the Government spends these revenues will have a crucial impact on macroeconomic stability and on the extent to which Dutch disease affects the economy. A sound fiscal policy must be formulated in a forward looking medium to long term framework. It must ensure that revenues derived from natural resources are not spent in an unsustainable manner, leading to a short lived consumption and construction boom, followed by a bust once the resources run out. It must ensure that any expansion of domestic demand arising from the use of natural resource revenues is carefully matched to the available supply capacities, for example in the construction industry, to avoid driving up prices. Fiscal policy must also ensure that public spending is delinked from the volatility in resource revenues, to avoid imparting cyclical volatility to the economy. This requires formulating fiscal policy using a medium term fiscal anchor, such as a non oil fiscal balance target.

Public financial management

Uganda's ability to benefit from the public revenues generated by oil and minerals will depend on the quality of public financial management. It is imperative that public revenues are spent in an efficient manner, which requires both very careful selection of public projects and effective project implementation. Uganda must be especially vigilant to avoid allocating public funds to white elephant projects, which cannot generate positive social rates of return. Ensuring that only high quality projects are selected for the Government budget will only be possible if the technical skills of public officials involved in project appraisal are improved and if the project selection process is very thorough, transparent and open to public scrutiny. The current capacities in the public sector for implementing public investment projects are weak; the backlog of projects for which funding has already been secured but implementation has been delayed is evidence of serious absorption capacity constraints. Consequently, before Uganda attempts to scale up public spending on public infrastructure, it is essential that the capacities in the public sector for managing all aspects of public investment projects are strengthened.

Improve the climate for private investment

Raising the rate of private investment in modern, labour intensive industries is a prerequisite for a transition to an efficiency driven economy. In some respects, Uganda has a conducive business environment for the private sector. We have a record of macroeconomic stability and provide liberalised factor and product markets. In the Global Competitiveness Index, Uganda scores relatively well on the indicators for the macroeconomic environment, labour market efficiency and financial market development.

Nevertheless, Uganda's private investment rate, which stood at an average of 18 percent of GDP over the last five years, does not compare favourably with the fastest growing developing economies, such as those in Asia, where private investment rates of over 30 percent of GDP are the norm. The World Bank's Doing Business Indictors reveal some of the reasons why Uganda does not attract higher rates of private investment. I have already mentioned that firms cited the inadequate supply of infrastructure as one of the most problematic factors affecting their business, and the policy implications of this. However, the problem most frequently cited by firms in the Doing Business Indicator Surveys is corruption. Corruption raises the costs and the risks of doing business. Curbing corruption is, therefore, essential to improve the business climate in Uganda and attract higher levels of private investment.

Accelerating the demographic transition

Uganda has one of the highest total fertility rates in the world, at 6.7 births per women, and is yet to undergo a demographic transition. As a consequence, Uganda also has a very high dependency ratio, with 110 dependents for every person of working age. The high dependency ratio is a major obstacle to improving productivity, because it impedes domestic savings and reduces the real resources per head which are available for human capital formation, such as per pupil education expenditures. The developing countries which have been most successful in sustaining rapid economic growth and structural transformation of their economies have achieved this in the context of a demographic transition to low fertility rates and dependency ratios which has enabled very high rates of investment to be financed and the quality of human capital formation to be improved substantially. To replicate this success, Uganda must implement policies to bring down the total fertility rate, by strengthening female education, improving maternal and child health care, providing wider access to contraceptives and through public campaigns to promote smaller families.

Conclusions

Uganda faces exciting challenges in the years ahead. The economy has delivered, over the last 20 years, consistent and robust real economic growth which has led to a doubling of per capita incomes. We now have the opportunity to build on this platform and accelerate structural transformation. The focus of our efforts should be to strengthen the incentives for raising productivity, so that continuous increases in efficiency become the driving force of growth and development. Competitive markets and a stable macroeconomy provide the foundations for such a transition. The resources earned from the production of oil and minerals can make a vital contribution to enhancing productivity in the economy, but only if they are managed and invested in a very sound manner. The exploitation of natural resources raises the premium on economic management and economic governance.