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Low inflation, consumer confidence sustain favourable business conditions

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1. Executive Summary

The Uganda business climate continued to improve. The index for the current quarter (July - September 2014) is 117.2 and has improved by 24.2 points on a year-on-year basis and by 13.5 points on a quarter-on-quarter basis. The rise in the index suggests continued favourable conditions for doing business in Uganda. The continued improvement in the business climate was driven largely by: low inflation which ensured favourable input and product prices and stronger consumer confidence, which in turn drove business expectations of improved profitability. Despite these positive sentiments, production capacity remained well below potential thus constraining labour demand to a significant degree. Indeed, both indices for capacity utilization and employment improved only modestly indicating underlying risks to business expansion and employment creation. Business perceptions and expectations for the next quarter (October – December 2014) remain favourable on account of expected continuity in price stability. However, persistent challenges due to electricity outages, access to finance and the proliferation of substandard and counterfeit products pose serious risks for doing business.



Electricity has re-emerged as a top obstacle for doing business in Uganda

2. Data

The data used in computing the business climate index were collected from 187 business establishments sampled from the 450,000 businesses recorded in the 2011 Uganda Bureau of Statistics business register. The probability proportional to size sampling technique was used

to select businesses into the sample. The different business sub-sectors were treated as sampling strata. The largest two firms in each stratum were automatically selected to ensure that influential business players are included in our sample. The rest of the businesses were selected using simple random sampling within each stratum. Sample weights were used in the computation of the results. The respondents are business managers. We keep following the same businesses every quarter. The distribution of respondents is presented in Table 1.

Table 1: Distribution of the sampled business, %

Business					
Size ^a	%	Sub sector	%	Location	%
Micro	7.5	Agriculture and agro processing	16.3	Kampala	42.6
Small	31.9	Hotels, recreation and tourism	15.8	Central	25.5
Medium	37.8	Industry and manufacturing	18.5	West	12.2
Large	22.9	Mechanical services	11.4	East	10.1
		Retail and wholesale trade	19.0	North	9.6
		Finance, IT and other services	5.4		
		Social Services	13.6		
Total	100		100		100

Notes: ^a The classification of businesses by size was guided by the World Bank Enterprise Surveys that classify a business as Micro if it employs no greater than 4 people; Small if it employs 5-19; Medium if it employs 20-99; and large if it employs more than 100 people.

3. Evaluation Methods

The business climate index is computed based on the following business evaluation indicators: level of business activity, turnover, profitability, incoming new business, capacity utilisation, average costs for inputs, price of produced goods, business optimism, number of employees, and average monthly salary. For each of the evaluation indicators, respondents are asked to express their perceptions on a Likert scale as follows: “improved”, “did not change”, “declined” or “above normal for quarter”, “normal for quarter”, “below normal for quarter” or “more favourable”, “unchanged”, “less favourable”. These responses are coded as 0, 1, and 2 respectively. In this case, if a respondent’s perception of the business environment

is that it deteriorated, such a response would be coded 0, it would be coded 1 if business climate did not change and 2 if business climate improved.

It is worth noting that the index does not consider the magnitude of change in the data but considers the general direction of movement in the key indicators. As such, the index is sensitive to the direction as opposed to the magnitude of the change in business conditions. During the data collection process, the business managers were asked to assess the general economic environment for the current (July – September 2014) quarter relative to the previous quarter (April - June 2014); and their expectations for the next quarter (October - December 2014). Based on the business evaluation indicators explained earlier, the business climate index is then computed as the weighted arithmetic mean of indices of the individual business evaluation indicators. The indices range from 0 – 200. The interpretation of the business climate index is such that scores above 100 point to an improving business climate. Scores below 100 imply that the general business conditions are getting worse. And, a score of 100 points to unchanged business conditions.

4. Results

Business climate remains favourable in the current quarter

Results indicate that the general perceptions about the business environment have improved in the current quarter (July – September 2014), having recovered from a general decline over the last two quarters (Figure 1). The business climate index is 117.2 and has improved by 13.5 and 24.2 points on a quarter-on-quarter and year-on-year basis respectively. The rise in the index is a good indicator of the continued favourable conditions for doing business in Uganda. The continued improvement in the business climate was sustained by, among others: low inflation which ensured favourable input and product prices and stronger consumer confidence reflected in higher than expected consumer demand. In particular, the headline inflation rate averaged 2.8% during July-September 2014 and this was less than the averaged registered for the quarter April-June 2014—an average of 5.7%. In turn more favourable prices and a resurgent consumer confidence drove business profitability. Despite the positive sentiments, production capacity remained well below

potential thus constraining labour demand to a significant degree. Indeed the index for capacity utilization declined slightly while the index for employment improved only modestly indicating underlying risks to business expansion and employment creation.

The Business Climate Index by Sector

There were improvements in business sentiment across all sectors (Figure 2). The services sector continues to account for most of the positive sentiment in the business climate in the current quarter. The current services sector business climate index is 118.7 and is 13.4 points higher than the previous quarter when the index was 105.3. The growing business confidence in the service sector was largely attributed to favourable input and output prices and improved business activity that ensured a rebound in profitability.

In the manufacturing sector, the business climate index improved by 12.56 points to 107.63 in the current quarter from 95.06 in the previous quarter. When evaluated on a year-on-year basis, the business conditions in the manufacturing sector have improved by 8.08 points. The data suggest that the rebound in business sentiment is due to favourable input and product prices, turnover and improved confidence about the overall business situation in the sector generally.

Consistent with forecasts in the last quarter, the perceptions about business conditions in the agricultural sector have improved. The current index in the sector improved by 29.28 points to 96.83 in the current quarter from 67.55 in the previous quarter. However, when evaluated on a year-on-year basis, the business conditions in the agricultural sector have improved by only 7.64 points. The rebound in business activity in the agricultural sector was due to improved confidence about the overall business situation in the sector generally, favourable product costs, and improved supply due to favourable weather. However, the perceived improvement in the agricultural sector was not good enough to ensure normalcy considering that the index still falls short of the 100 points threshold for favourable business conditions. This suggests that there are sector specific constraints that stifle growth in the agricultural sector. These constraints have been identified as: the high input costs and low capacity utilisation.

Figure 1: The Business Climate Assessment

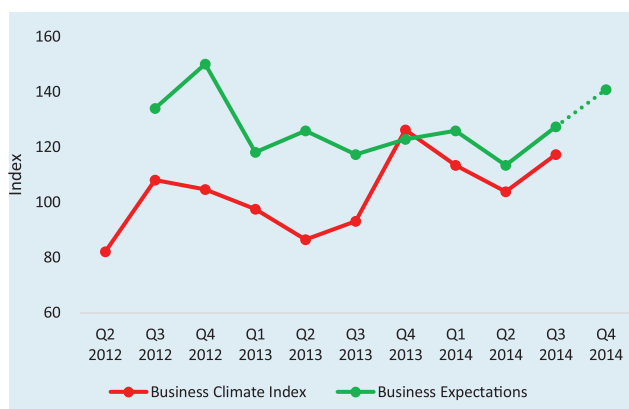
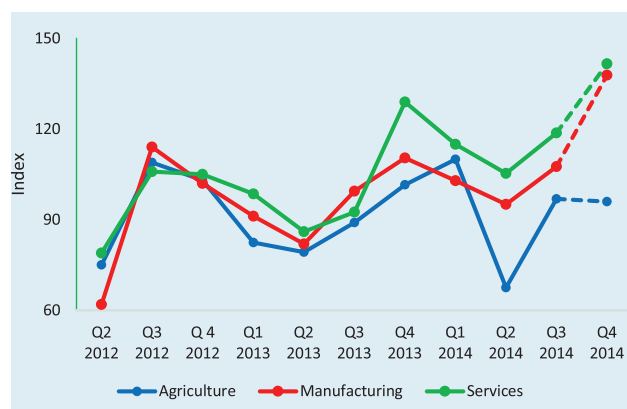


Figure 2: Business Climate Index by Sector



Of concern, however, is that some evaluation indicators such as capacity utilisation and labour demand (employment) are persistently below potential across all sectors. This suggests that despite improvements in the business environment, there are underlying factors that inhibit businesses to fully operate at optimal capacity and this has important implications for firm level employment creation. Therefore, any policy that seeks to improve employment outcomes should explore the reasons behind the persistently low capacity utilisation.

What explains the favourable business climate assessment?

The top three reasons for favourable business sentiment are largely unchanged from the previous quarter and they are: improved consumer demand (26.5 percent), stable macroeconomic environment (11.1 percent), and favourable regional export demand (9.7 percent). Other reasons include: more favourable product prices (8.7 percent), improvements in physical infrastructure (5.4 percent), favourable international export demand (5.4 percent), and improvements in the use and access to information and communication technology (5.3 percent) among others. In the discussion that follows, we explain the three most important reasons for an improving business environment.

Figure 3: Reasons for an improving business climate, %



i) Improved demand

As indicated in Figure 3, improved consumer demand (26.5 percent) continues to be the major driver of business climate improvement. Our results show that the indices for sales turnover (113.2), business activity (111.6), and incoming new business (118.6) have all improved relative to the previous quarter. The pickup in business activity restores some hope in the performance of the entire economy.

ii) Macroeconomic Stability

The weighted responses indicate that at least 11.1 percent of the businesses attribute the favourable sentiments to stable macroeconomic environment. The indices for input prices (116.8) and product prices (164.1) indicate that prices in both the product and input markets are stable and favourable. This is consistent with the low inflation recorded during the current quarter which stood at 2.8 percent lower than during the previous quarter when inflation was 5.7 percent. The only uncertainty in the macroeconomic environment arises from the foreign exchange

markets where the shilling depreciated by as much as 2.9 percent against the dollar between the April-june 2014 quarter and July-September 2014 quarter.

iii) Regional and international market dynamics
Despite uncertainties in the global economy, particularly in the Euro Zone and South East Asia, business opportunities in the regional and international market remained robust in this quarter due to a strong demand for Ugandan goods.

Future business outlook: July – September 2014

Business perceptions and expectations for next quarter (October – December 2014) remain favourable and business conditions are expected to continue on the upward trajectory. The expected index for October – December is 140.7 (figure 1) and is higher than the current quarter's expectation which was 127.3 points. Business conditions are expected to improve generally across all sectors, except for agriculture where business conditions are expected to remain largely unchanged or deteriorate slightly. The favourable future business outlook is on account of expected continuity in price stability, improved capacity utilization and an expected upturn in general business activity which should drive improvements in employment creation prospects.

Challenges in doing business

The top five constraints in doing business for the current quarter have evolved to reflect the current major policy and regulatory constraints to doing business in Uganda. The reliability of electricity supply (16.0 percent) has risen to be a major business obstacle, up from number three in the previous quarter to number one in the current quarter. Competition (14.6 percent) moved up four places into second position. Substandard products (14.1 percent) moved up one position into third. Macroeconomic factors (10.5 percent) dropped three places into fourth. And, demand factors (9.3) moved up one place into fifth position. The falling importance of macroeconomic factors is not surprising considering that inflation is low and stable.

i) Electricity challenges

From the ranking of constraints in figure 5, it is evident that the increase in electricity outages is re-emerging as the most critical challenges constraining business growth and competitiveness. This calls for efforts to stabilise electricity supply while reducing cost. In the medium term, diversification of Uganda's energy sources (other than hydro-electricity) and reducing tariffs will not only meet the growing demand, but also cut business cost.

ii) Competition

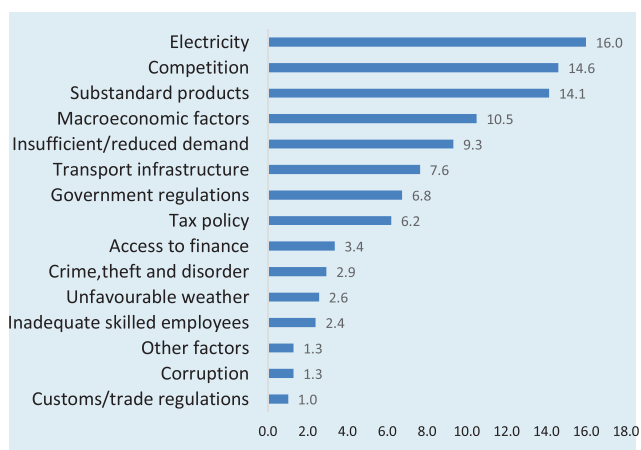
Increased competition, especially in the wholesale and retail trade sector, was the second most reported driver of reduced business climate index. In the last few years, there has been increased struggle by both foreign and domestic retail stores for a share of Uganda's retail business market. This has resulted into increased competition, especially for the middle class consumers who are key to the growth and expansion of retail businesses. The competition has slashed the margins for the big and small retail stores, and

could probably explain the challenge of reduced demand (9.3 percent) across many businesses.

iii) Substandard and counterfeit products

The proliferation of cheap substandard and counterfeit products on the market is a major constraint to business growth and competitiveness. Counterfeiting in particular stifles the growth of genuine businesses because of the unfair competition. Substandard and counterfeit products are usually cheaper and therefore can easily drive genuine business out of the market.

Figure 4: Business Constraints, %



The quarterly ranking of “challenges in doing business” does not imply that a specific element is improving or deteriorating. Such ranking only reflect the elements that are currently deemed more relevant to firms.

5. Question of the Quarter

In this quarter we sought to understand the most important sources of energy for daily business operations. Specifically, firm managers were asked the following question

“In order of importance, please rank the three most important sources of energy used in this business enterprise (for example rank 1, 2, 3)”. The responses were weighted by rank. Results in table 2 indicate that the top three most important sources of business energy are: electricity from the grid (46.4), personal generators (25.8) and solar (9.1 percent).

Table 2: The most important sources of energy in Ugandan businesses, %

	Percentage Score			Weighted Score
	Rank 1	Rank 2	Rank 3	
Electricity from Grid	82.9	8.2	13.3	46.4
Personal Generator	4.9	60.3	19.5	25.8
Solar	4.9	10.3	19.5	9.1
Liquid Petroleum Gas	2.4	3.4	9.7	4.0
Charcoal		4.8	9.7	3.2
Community Electricity	1.2	4.1	5.3	2.9
Paraffin lamp/lantern	1.2	1.4	8.9	2.5
Others	2.4	0.7	3.5	2.0
Firewood		2.7	6.2	1.9
Candles		2.7	4.4	1.7
Biogas		1.4		0.5

Notes: The applicable weights were: 0.5, 0.333 and 0.167 for ranks 1, 2 and 3 respectively

6. Conclusions

Perceptions about the business environment in Uganda have continued to improve over the last four quarters. This has been on account of strong consumer demand, stability in the macroeconomic environment, and robust export demand. Future prospects are largely favourable subject to a significant degree of uncertainty in the domestic, regional and global economy.

The Economic Policy Research Centre (EPRC) has been producing the Business Climate Index (BCI) for Uganda since June 2012. The BCI reflects the perceptions of Ugandan business managers on the current and near future (expected three months ahead) business conditions. The BCI is a perceptions indicator of economic activity and the general business environment in which businesses operate. It can be used to forecast turning points in economic activity and thus provides critical information for policy makers both in Government and the Private Sector.

About EPRC

The Economic Policy Research Centre (EPRC) is an autonomous not-for-profit organization established in 1993 with a mission to foster sustainable growth and development in Uganda through advancement of research –based knowledge and policy analysis.

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