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Elevated macroeconomic risks hurt business environment perceptions

Executive Summary

The Uganda business climate index declined by 22.4 points to 94.8 during the July – September 2015 quarter from 117.2 during the July – September 2014 quarter. This indicates a remarkable slowdown in the conditions for doing business in Uganda. This is the first time in five survey rounds that the index points to an uncertain business environment and elevated business climate risks. The slowdown in business perceptions was largely driven by some persistent challenges in doing business and some new emerging ones. In particular, the business environment suffered on account of volatility in the macroeconomic environment characterized by the weakening of the Uganda Shilling, rising interest rates and an unfavorable inflationary outlook. Moreover, macroeconomic factors, substandard products, and tax policy were considered more of a problem in the current period than in the previous. At the sectoral level, business sentiment in the agricultural sector was particularly downcast due to falling international commodity prices particularly for coffee, tea and cotton. Business perceptions and expectations for the next quarter (October – December 2015) remain subdued on account of the forthcoming general election, rising inflation and interest rates, low global demand for commodities, and fragility of the regional political environment.



Business sentiment in the agricultural sector was particularly downcast

Data and Methods

The data used in computing the business climate index were collected from 173 business establishments sampled from the 450,000 businesses recorded in the 2011 Census of Business Establishment conducted by the Uganda Bureau of Statistics. Throughout the surveys we keep following the same businesses. This enables us to construct comparable indices through time.

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 of 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 the business climate did not change and 2 if the 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 2015) quarter relative to a similar period a year earlier; and their expectations for the next quarter (October - December 2015). Based on the business evaluation indicators explained earlier, the business climate index is 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.

In addition, the index analyses the evolution of challenges facing businesses over the last quarter, by identifying which business constraints are more of a problem and less of a problem. The survey respondents were asked to indicate how each of the identified business constraints have evolved over the last full year. For each of the business constraints we asked if it was “more of a problem”, “unchanged”, or “less of a problem”. These responses were coded, 1, 0, and -1 respectively. We then computed the weighted average response for each of the constraints, the interpretation of which is such that scores above 1 point to a constraint that is more of a problem; scores below 0 imply that a constraint is less of a problem; and zero scores point to unchanged business constraint.

Results

Business Climate Perceptions Indicate Elevated Risks

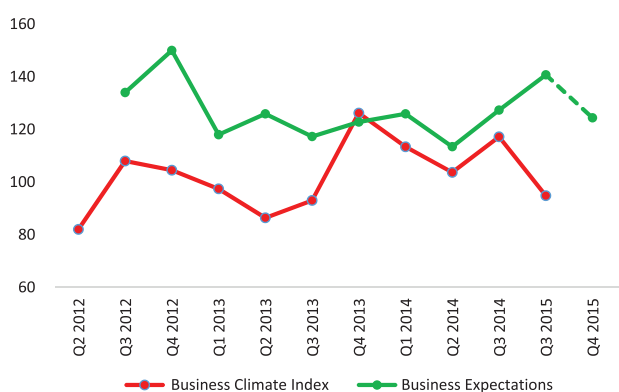
Results indicate that the general perceptions about the business environment have deteriorated in the current quarter (July – September 2015), having slumped from a generally optimistic trend over the previous four quarters (Figure 1). The business climate index is 94.8 and has declined by 22.4 index points on a year-on-year basis from 117.2 during (July – September 2015). The drop in the index is an indicator of deteriorating conditions for doing business in Uganda during the period under review. In particular, the sub-indices for business activity (86.7), turnover (89.3), profit (82.6) and incoming new business (88.8) were all below normal. This indicates that the economy is operating at less than full potential.

The deterioration in the perceptions about the current state of the business environment in Uganda was occasioned by, among others: volatility in the macroeconomic environment,

insufficient demand for products and services, and elevated external risks owing to the slowing demand for exports, and falling capital inflows associated with the delayed investments in the oil and gas sector—due to both low oil prices and regulatory hurdles. In addition, the onset of the domestic political election cycle has elevated the perceived risks for doing business.

The headline inflation rate averaged 5.8 percent during July-September 2015 and this was higher than the 4.5 percent inflation rate registered during the quarter April-June 2015. The sub index for current input prices is 79.7 indicating that current prices are less favorable. In turn a lukewarm consumer confidence inhibited economic activity. In addition, the nominal exchange rate continued to depreciate by 15 percent quarter-on-quarter and 34 percent year-on-year. The depreciation of the local currency further strengthened the inflationary outlook prompting the Bank of Uganda to raise the central bank rate from 13 percent in June 2015 to 16 percent by September 2015.

Figure 1: The Business Climate Assessment



The Business Climate Index by Sector

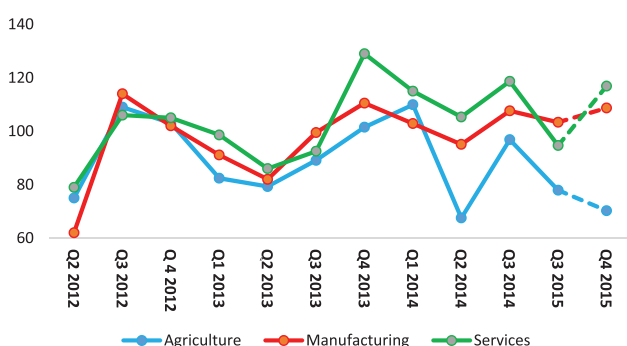
Business sentiment deteriorated across all sector (Figure 2). In the services sector, the business climate index dropped by 24 points to 94.7 from 118.7 points and accounted for the largest drop in the perceptions about the business environment. The deteriorating confidence in the service sector was largely attributed to the less favourable input and output prices that affected business profitability.

Consistent with forecasts in the previous survey, the perceptions about business conditions in the agricultural sector have deteriorated. The current index in the sector declined by 18.93 points to 77.9 in the current quarter from 96.8 in the previous survey. The unfavourable perceptions about the business climate in the agricultural sector was primarily driven by the deteriorating perceptions about business activity, turnover, profit, incoming new business, unfavourable input and product prices, and an unusually

low optimism due to falling international commodity prices particularly for tea, coffee and cotton. This indicates that there was no significant change in the overall economic activity within the agricultural sector during the quarter under consideration. However, capacity utilisation in the agricultural sector was on average above normal.

In the manufacturing sector, the business sentiment remained marginally upbeat despite dropping by 4.3 points to 103.3 in the current quarter from 107.6 in corresponding quarter a year earlier. Similar to developments in the agricultural sector, the unfavourable perceptions about the business climate in the manufacturing sector was primarily driven by the deteriorating perceptions about business activity, turnover, profit and incoming new business.

Figure 2: Business Climate Index by Sector

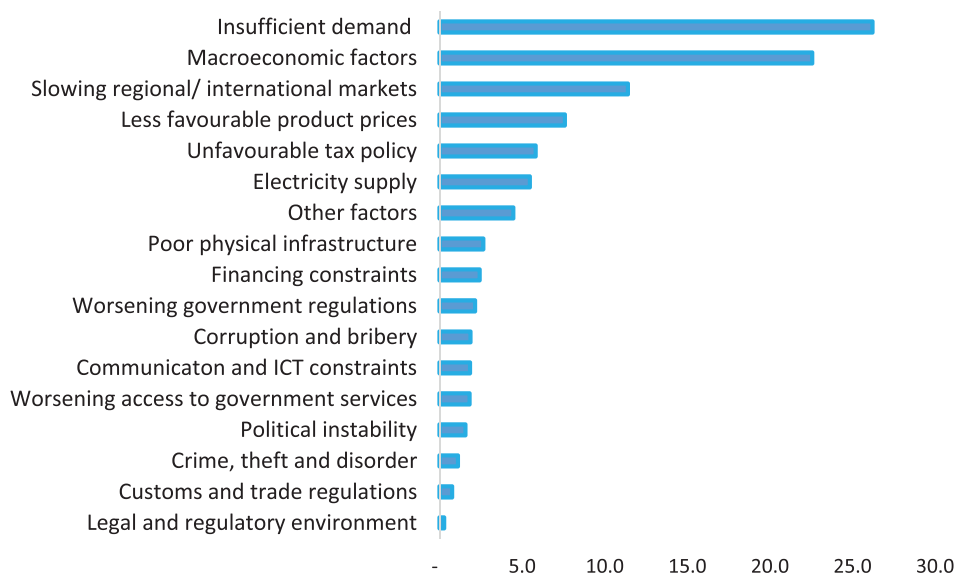


What explains the deteriorating business climate?

i) Insufficient consumer demand

As indicated in figure 3, insufficient demand (26.5 percent) driven by waning consumer sentiment continues to be the major driver of a deteriorating business climate. Our results show that the indices for sales turnover (89.3), business

Figure 3: Reasons for a deteriorating business climate, %



activity (86.7), and incoming new business (88.8) are below potential and have all declined relative to this quarter last year. The slowdown in these indices indicates that the economy did not expand by as much as its potential.

ii) Macroeconomic instability

The economy suffered multiple macroeconomic shocks during the current quarter under review (July – September 2015). As explained earlier, the economy experienced elevated risks due to rising consumer prices, weakening currency and rising interest rates that raised the cost of finance. These shocks have affected competitiveness and increased the cost of doing business.

iii) Regional and international market dynamics

There have been multiple shocks arising from instabilities in the external environment. Uncertainties in the global economy, particularly in the Euro Zone area coupled with sluggish growth in China have resulted in reduced demand for Uganda’s exports. Also, despite the signing of a peace deal in August 2015 conflict persists in South Sudan—a key market for Ugandan products. In addition, the falling global oil prices have resulted in slowed capital investments in the domestic oil sector with negative consequences for the local private sector.

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 macroeconomic instabilities particularly exchange rate, inflation and interest rates (25.1 percent) has risen to be a major business obstacle in current quarter, up from number

Figure 5: Business Constraints, %

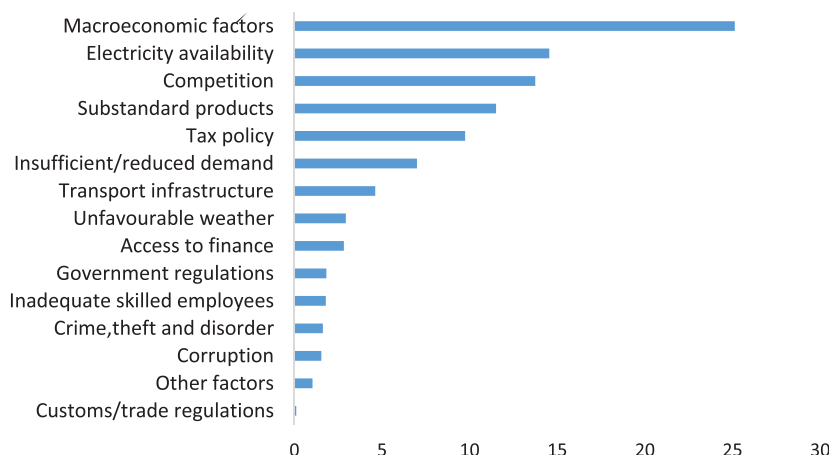
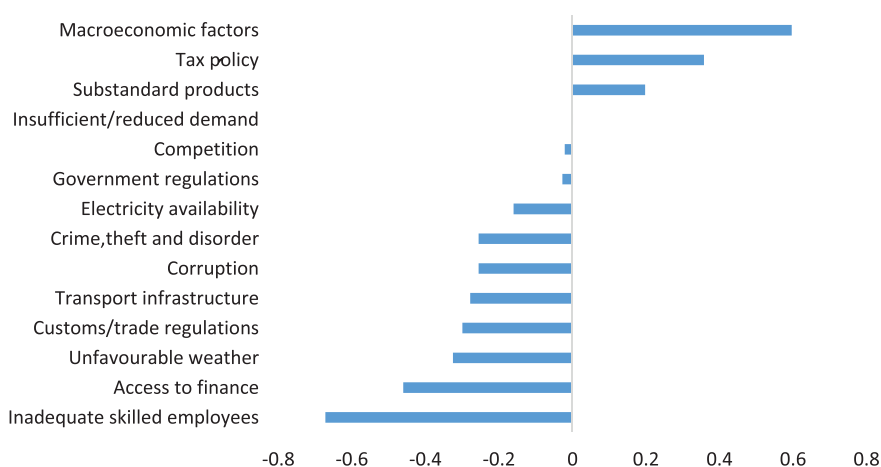


Figure 6: The evolution of business constraints



four in the previous quarter to number one in the current quarter. Reliability of electricity supply (14.6 percent) drops to second position from first in the previous period. Competition (13.8 percent) drops to third from second position. Substandard products (11.5 percent) moved down one position into fourth. Tax policy (9.7 percent) rose three places from eighth to fifth position.

How have the business constraints evolved over the last period?

The results (Figure 6) indicate that the macroeconomic environment, tax policy and substandard products are more of a problem in the current quarter than they were one year before. All other factors were reported to be less of a problem indicating some improvements in some business constraints.

Future business outlook: September - October 2015

Businesses are less optimistic about the near term developments than they were one year ago. The expected index for October – December 2015 is 124.4 (figure 1) and is 16.4 index points lower than the current

quarter’s expectation which was 140.7 points. Generally improvements in business conditions are expected to remain tepid across all sectors, with lower business indices than expected in the previous period. The expected indices are 70.2, 108.7, and 116.9 for agriculture, manufacturing and services respectively. In particular, the index for the agricultural sector is not only lower than was expected in the previous period, it is also below normal expectations indicating that real growth in the sector might be significantly below potential. The unfavourable sentiment with regard to Uganda’s future business climate is anchored on expected unfavourable input costs particularly in the manufacturing sector and lower than expected incoming new business in the agricultural sector. In particular, business outlook for the next quarter is significantly weighed down by the expected poor performance in the agricultural sector.

Question of the Quarter

Use of Mobile money in financial transactions

In this quarter we sought to understand the extent to which Ugandan businesses have adopted the use of mobile

money services in their regular financial transactions. In particular, we asked: “In its current operations, does this establishment use mobile money for any of its financial transactions?” Results in Table 1 indicate that majority of businesses (68 percent) have adopted mobile money as a medium for effecting certain types of transactions with significant differences across business classifications, location and sector.

Table 1: Extent of mobile money use, %

	Use Mobile Money	Do Not Use Mobile Money	Do Not Know
All Businesses	68	30	2
Size classification of business establishments			
Micro Enterprises	75	25	0
Small Enterprises	74	24	2
Medium Enterprises	69	29	2
Large Enterprises	52	44	4
Location of business establishments			
Kampala	79	19	2
East	82	15	3
West	21	75	4
North	72	28	0
Central	59	41	0
Business Sector			
Agriculture	68	23	9
Manufacturing	56	39	3
Services	71	29	0

Table 2: Reasons for using Mobile Money, %

Reduce costs	27.27
Save time	23.23
Satisfy customers' request	14.14
Satisfy suppliers' request	12.12
Reduce risks of handling cash	10.1
I don't know	10.1
Align with competitors' use	3.03

Conclusions

Perceptions about the business environment in Uganda have deteriorated for the first time in five survey rounds. In particular, the business environment suffered on account of volatility in the macroeconomic environment owing to the weakening local currency, rising interest rates and inflationary outlook. In addition, challenges relating to the tax policy and substandard products persist, exacerbating the business index decline.

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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