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The business environment mood lifts but remain cautious

Executive Summary

The Uganda business climate index (UBCI) improved by 4.9 index points to 99.7 during the October – December 2015 quarter from 94.8 during the July – September 2015 quarter. This indicates a modest improvement in the conditions for doing business in Uganda on a quarterly basis. The improvement of business perceptions was largely driven by favourable product prices and consumer demand particularly for manufactured goods which improved the prospects for job creation. Specifically, strong Gross Domestic Product (GDP) growth, increased demand for agricultural and manufactured goods during the Christmas and New Year festivities and the stabilization of the Uganda shilling supported the improvement of the UBCI.

Consistent with ranking in the previous year, macroeconomic factors and reliability of electricity supply are perceived to be the two most potent business obstacles in the current quarter. Tax policies, substandard products and competition were also cited as major challenges. At the sectoral level, business sentiment in the agricultural sector were less optimistic than the previous quarter, consistent with a rising input price index. In addition, there were downside risk to the business expectations for next quarter, including those emanating from macroeconomic volatility and persistent slowdown of the agriculture sector. In this regard, the UBCI is expected to decline in January – March 2016.



Performance in the manufacturing sector lifts business sentiment

Data and Methods

The data used in computing the Uganda Business Climate Index (UBCI) were collected from 188 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, the UBCI follows the same businesses. This enables the UBCI to construct comparable indices through time.

The UBCI 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 UBCI does not consider the magnitude of change in the data but considers the general direction of movement in the key indicators. As such, the UBCI 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 (October– December 2015) quarter relative to a similar period a year earlier; and their expectations for the next quarter (January- March 2016). Based on the business evaluation indicators explained earlier, the UBCI 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 UBCI 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 UBCI analyses the evolution of challenges facing businesses over the last quarter by identifying which business constraints are more of a problem or 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, the UBCI then asked if it was “more of a problem”, “unchanged”, or “less of a problem”. These responses were coded, 1, 0, and -1 respectively. The UBCI then computes 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

Uganda Business Climate Perceptions Improve

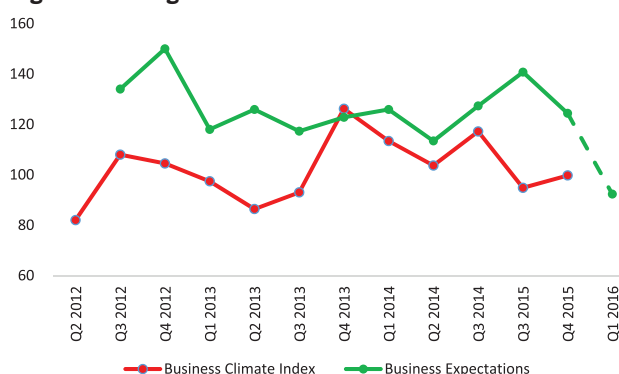
Figure 1 indicates that the general perceptions about the business environment in Uganda have improved in the current quarter (October–December 2015). The UBCI is 99.7 a 4.9 index points improvement from the last quarter. This points to improving conditions for doing business in Uganda during the period under review. In particular, the sub-indices for product prices (120.2), employment (102.5) and salary (103.6) were above normal. These indices suggest that the economy is normalizing from a somewhat less optimistic sentiment in the last quarter (July – September 2015).

In addition, the following factors also played a significant role in stabilizing the perceptions about the current state of the business environment in Uganda: strong Gross Domestic Product (GDP) growth of 5 percent in the face of weakening global growth; increased demand during the Christmas and New Year festivities; and the stabilization of the Uganda shilling by close to 50 shilling after a sustained depreciation pressure since the beginning of 2014. The nominal exchange rate improved by 1.6 percent quarter-on-quarter basis. The strengthening of the local currency further suppressed the inflationary outlook, curtailing the scope for tighter fiscal and monetary policy. Indeed, maintenance of the benchmark (Central Bank Rate) rate at 17 percent boosted domestic demand and private sector credit in this quarter.

While headline inflation edged up by 2.7 percentage point to 8.1 percent, the average monthly core inflation stabilized to an average of 0.5 percent in this quarter (October- December 2015) after accelerating earlier in the year. The stabilization was partially due to curtailment of the effect of exchange rate depreciation on monthly core inflation by increased supply in the manufacturing and services sector. This alludes to the market confidence in the ability of the economy to withstand inflationary pressure in this

quarter.

Figure 1: The Uganda Business Climate Assessment

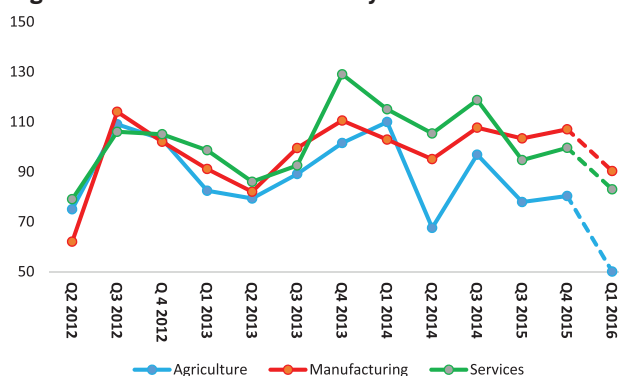


However, business are expected to fall below potential in January – March 2016 with an index of 92.3 (figure 1). It is likely that the uncertainty about the lagged effects of the persistent exchange rate depreciation on prices may have curtailed the optimism. In addition, the forecasted El Nino weather conditions could affect food prices in January – March 2016 exacerbating the heightened inflationary pressure. Other factor such as increase in electricity tariffs, possible outcomes of the general election, slower demand for Uganda’s exports, decline of global commodity prices and reduced capital to developing countries due to perceived risk could have dampened the optimism for the next quarter

The Business Climate Index by Sector

Business sentiment normalised across all sector including agriculture (Figure 2) in this quarter (October – December 2015). In the manufacturing sector, the UBCI was above normal by 3.7 points to 107 from 103.3 points and accounted for the largest improvement in the perceptions about the business environment. Further analysis of the UBCI suggest that optimism within the manufacturing sector is largely attributed to favourable input and product costs supported business profitability leading to favourable employment prospects.

Figure 2: Business Climate Index by Sector



Similarly, business sentiments significantly improved in the service sector by 4.9 points to 99.6 in the current quarter from 94.7 in the last quarter. The favourable perceptions in the service sector were primarily driven by favourable input prices and improved product prices. However, firms project that the UBCI for manufacturing and service sectors may not perform as well (figure 2) in the next quarter (January – March 2016) due to perceived

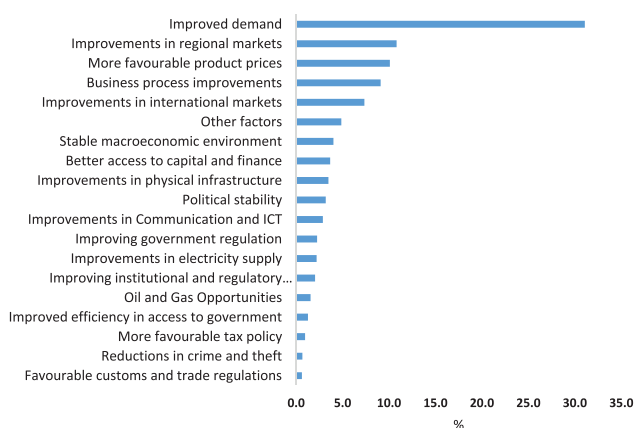
expected risk partially driven by slow activity, low turnover and constrained profitability.

Meanwhile, the UBCI for the agriculture sector improved marginally by 2.3 point to 80.3. However, the UBCI was still below potential due perceptions of unfavourable profits (33.4) and product cost (56.6) amongst other factors. The caution applied to the sector could be ascribed to subdued global demand for commodities; particularly for tea, coffee and cotton and high input prices. Nevertheless, businesses perceived labour conditions (151.5) to be favourable in the agriculture sector. This suggest that there is scope for improvement for the agricultural sector.

What explains the improvement of the business climate?

From figure 3, the top three reasons for the improvement of UBCI are: improved demand (31.1 percent), improvement of regional markets (10.8) and more favourable prices (10.1). Other important factors include: improvement in business process (9.1 percent) and improvement in international markets (7.3 percent) (figure 1). 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 consumer demand

As earlier mentioned, consumer demand was reported higher in this quarter (October – December 2015) than the previous quarter, partially due to the increased demand during the Christmas and New Year period. The stabilization of the shilling and the delayed impact of El Niño on food prices could have spurred consumer demand during the quarter. Also, it is likely that improved business activity, and favourable input and product cost in the manufacturing and service sectors augmented consumer demand.

ii) Improvement in Regional Market

Even though exports marginally recovered by 2 percent during the quarter under review (October–December 2015), Uganda sold good worth US\$ 644.3 after a 7 percent slump in the previous quarter (July – September 2015). In particular, the recovery of

export was largely supported by trade with Kenya, which bought goods and services worth US\$ 144.5 million from Uganda. It is also likely that the resumption of robust export performance is linked to the strengthening of the Uganda shilling during the quarter.

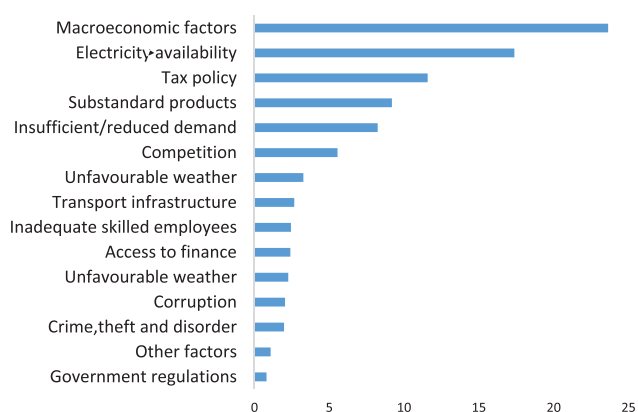
iii) More favourable product prices

Business conditions improved in this quarter (October – December 2015) at the strongest pace in 6 months, with product prices and demand for output reminiscent of the respective highs seen in October and December 2013. The favourable expansions in activity in the agricultural sector and favourable input cost and product prices in the manufacturing and service sector meant that businesses bought inputs at a faster rate this quarter, and held higher stocks of pre-production items in their inventory. In addition, a weaker Uganda shilling against the dollar over the year may have made imports expensive encouraging domestic consumption with a significant trickledown effect on performance of local businesses.

Challenges in doing business

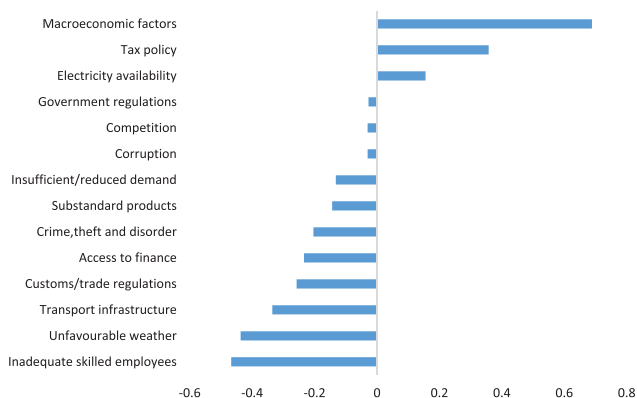
The top five constraints to doing business for the current quarter have evolved to reflect the current major policy and regulatory constraints to doing business in Uganda. Figure 5 illustrates the UBCI ranking of constraints. Consistent with ranking in the previous quarter, macroeconomic instabilities, particularly exchange rate, inflation and interest rates (23.6 percent); and Reliability of electricity supply (17.4 percent) have persisted as the two most potent business obstacle in the current quarter. Tax policies (11.6) took the third position, up from fifth. Substandard products (9.2 percent) retained the fourth position fourth. Competition (9.7 percent) settled for the fifth position, down from third.

Figure 4: Business Constraints, %



How have the business constraints evolved over October – December 2015?

The results (Figure 6) indicate that macroeconomic environment and Tax policies constraints persist in the face of favourable product prices and consumer demand in this quarter. On the other hand, electricity availability became more of a problem in this quarter than it was in the previous quarter. All other factors were reported to be less of a problem indicating improvements in some business constraints.

Figure 5: The evolution of business constraints

Future business outlook: January – March 2016

As earlier mentioned, businesses are less optimistic about the near term developments than they were in last quarter. The expected index for January –March 2016 is 92.3 (figure 1) and is 32.1 index points lower than the current quarter's expectation which was 124.4 points. Generally, improvements in business conditions are expected to remain subdued across all sectors, with lower business indices than expected in the previous period. The expected indices are 50.2, 90.3, and 83 for agriculture, manufacturing and services respectively. In particular, the index for the agricultural sector is unusually lower than was expected (70.3) in the previous period. The below potential performance of agriculture sector could be consequences of high cost of imported agricultural inputs (fertilizer and seeds) brought about by the depreciation of the shilling. Other possible determinants of the unfavourable sentiment with regard to Uganda's future business climate are: lower than expected incoming new business, lower business activity and lower profitability, especially in the agricultural sector. Consistent with the last quarter, business outlook for the next quarter is significantly weighed down by the expected poor performance of the agricultural sector. Furthermore, uncertainty about the future performance of export prevails, including the future path of exchange rates, which will be determined by domestic and external factors.

Question of the Quarter

Use of Insurance Products

In this quarter we sought to understand the extent to which Ugandan businesses use insurance product to secure their businesses against uncertainty. In particular, we asked: "In its current operations, does this establishment use insurance products?" Table 1 indicates that majority of businesses (62 percent) use insurance product to secure their businesses against uncertainty with significant differences across business classifications.

Table 1: Extent of Insurance Products use, %

	Use Insurance	Do Not Use Insurance	Do Not Know
All Businesses	62	36	2
Size classification of business establishments			
Micro Enterprises	37	63	0
Small Enterprises	61	39	0
Medium Enterprises	73	25	2
Large Enterprises	67	28	5
Sector classification of business establishments			
Agriculture	40	60	0
Manufacturing	72	24	4
Services	67	31	2

Why are firms not using Insurance Products use?

The major reasons that hinder businesses from using insurance product are given as: Insurance products are not accessible (8.6 percent), insurance is not important for business (25.9 percent), Insurance products are expensive (31.1 percent), insurance companies do not compensate for a loss (12.1 percent) and do not know what insurance is (10.3 percent).

Conclusions

Perceptions about the business environment in Uganda have improved supported by strong consumer demand, significant performance by manufacturing and services sector and relatively stable macroeconomic environment. However, sporadic volatility of the macroeconomic environment owing to the political cycle, weakening local currency and inflationary outlook cannot be ruled out in the coming quarter. In addition, challenges relating to the agriculture sector are expected to persist, exacerbating the UBCI 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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