Towards Sustainable Development

The Uganda Business Climate Index

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Business climate deteriorates further as fears of the South Sudan conflict grips businesses in Uganda

Executive Summary

The Uganda business climate index (UBCI) declined to 79.2 from 93.5, a persistence of the negative sentiment registered in last quarter (January – March 2016) and the worst decline since 2012. The negative sentiment in the business environment could be emanating from a number of sources such as; lag effects of the electoral cycle, the adverse effects of exchange rate depreciation and the re-ignition of political strife in South Sudan - a major export destination. In addition, less than favourable prices for goods and services, regional trade barriers, drought and poor regulatory environment were cited as possible drivers in the decline in business climate perceptions in the current quarter. The top five most important constraints to doing business for the current quarter changed marginally from the last quarter. The macroeconomic factors, particularly exchange rate volatility and high interest rates, challenges with electricity availability and cost, tax policy, substandard products, and insufficient demand for products and services continue to constrain businesses in the current quarter. However, the severity of constraints, especially electricity reduced significantly. Business sentiment in agriculture remained upbeat, while that in manufacturing and services was downcast. Businesses climate prospects remain optimistic in the next quarter (July – September 2016) on account of expected recovery in domestic demand and capacity utilization in the agricultural sector and favourable input and product cost in the manufacturing and service sector.

Uganda police evacuate traders from South Sudan

Data and Methods

The data used in computing the Uganda business climate index (UBCI) were collected from 181 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 (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" and "less favourable". These responses are coded as 0, 1, and 2 respectively. 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.

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 (April - June 2016) quarter relative to a similar period a year earlier; and their expectations for the next quarter (July – September 2016). 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 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.

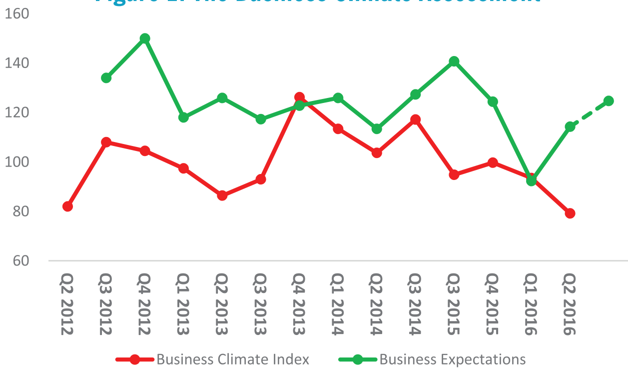
3. Results

Business Climate Perceptions Indicate Deterioration of Perceived Risk

Results indicate a significant decline in conditions for businesses in the current quarter (April–June 2016), a persistence of the pessimism observed (Figure 1) in the last quarter (January – March 2016). The business climate index suffered the worst slide since 2012, having declined to 79.2 points from 93.5 points in the previous quarter. For the broader sub-indices, the negative sentiment registered in the last quarter deteriorated, when turnover (67.9), profit (66.6), new business (63.7) and capacity utilization (63.8) were perceived by businesses to have worsened.

Other than the traditional challenges to doing business, the negative sentiment in the business environment could emanate from the lag effects of the electoral cycle, adverse effects of exchange rate depreciation and the re-ignition of political strife in South Sudan - a major export destination. In particular, low demand for goods and services and uncertainty in macroeconomic conditions have elevated the perceived risks for doing business in the current quarter. In addition, low prices, regional trade barriers, post-election tension, drought and poor regulatory environment were cited as possible drivers in the decline in business climate perceptions. Indeed, several companies, especially in the steel industry, failed to meet their debt obligation and were placed under receivership in the quarter. However, the Uganda Business Climate Index (UBCI) notes that the debt stress could have emanated from long-term structural problem such as non-payment from customers in Uganda and Sudan, for sales made in previous quarter and over the year.

Figure 1: The Business Climate Assessment



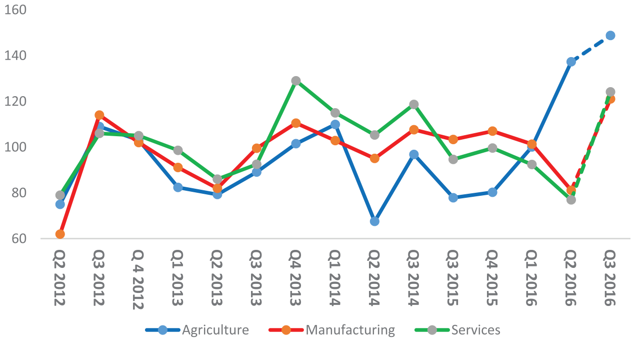
Yet, most businesses remain resilient and the future expectation (figure 1) are that the business climate will rebound in the next quarter (July – September 2016). The UBCI is expected to close at 125 index points in July – September 2016 with product cost (131.2), business activity (117.7), turnover (166.7) and input cost (114.7) the top contributors to the expected recovery. Businesses expect to ride on the favourable headline inflation outlook, which declined to 5.1 in the current quarter, stabilizing the exchange rate. However, the outlook for domestic and foreign prices remain uncertain given the recovery of crude oil prices and an increase in fuel tax and this could be a source of upward inflationary pressure in July – September 2016 dampening business prospects further. Nevertheless, further easing of monetary policy could be greeted positively by businesses, especially those constrained by credit cost. Private sector credit growth has significantly fallen in the last two quarters: from 17 percent in October – December 2015 to 11 percent in April –June 2016.

The Business Climate Index by Sector

For the second consecutive quarter, business improved in the agricultural sector, but deteriorated in the manufacturing and services sectors (Figure 2). In the agricultural sector, the business climate index improved by 37.2 points to 137.3 from 100.1 points. The indices for manufacturing worsened by 20.2 points to 81.2 from 101.3 in the last quarter and accounted for the largest drop in the perceptions about the business environment. Similarly the index for services worsened by 15.4 points to 77.0 from 92.4 in the previous quarter. The deteriorating confidence in the manufacturing and service sector was largely attributed to the less favourable business activity, and subdued demand that constrained profitability.

Consistent with the last quarter, the favourable perceptions on the business climate in the agricultural sector were primarily driven by favourable product and input costs, as well as incoming new business. These shored up capacity utilization whose index improved to 143.3 in the current quarter from 109.3 in the previous quarter. Equally important, the positive sentiment in the agricultural sector was shored by favourable rains and relatively higher prices for export, particularly tea, coffee and cotton. Export earnings were partially supported by low inflation. Indeed, inflation remained subdued in the quarter with "food crop and related item" component of the Consumer Price Index (CPI) declining by 0.8 percentage point buoyed by more favourable rains than would normally be expected during the quarter.

Figure 2: Business Climate Index by Sector

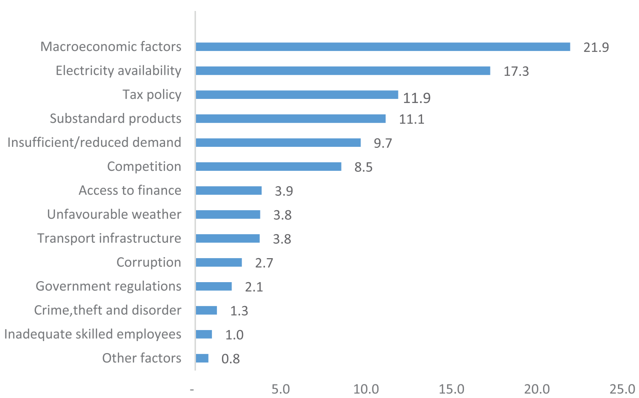


Business sentiment in the manufacturing and the service sector significantly dropped for the second consecutive quarter. However, the decline in confidence in the service sector was perceived to be relatively less than that of the manufacturing sector. As earlier stated, the loss of confidence in the two sectors was largely explained by less than expected profitability due to lack of new business activity leading to underutilization of capacity. These could largely be due to waning domestic demand, effects related to the civil strife in South Sudan, and lagged effect of Ugandan Shilling depreciation against most major currencies and post-election tension.

Challenges in doing business

The top five most important constraints in doing business for the current quarter changed marginally from the last quarter. Owing to the nature of these challenges, there is a scope for policy and regulatory adjustment to constraints facing Ugandan businesses. The macroeconomic factors particularly exchange rate volatility and high interest rates (21.9 percent) continue to be the number one business constraint in the current quarter. Challenges with electricity availability and cost (17.3 percent) continue to take second place. Even with an abundant electricity supply in the country in the last two years, the quality/stability and the cost continue to constrain businesses. Tax policy (11.9 percent) take third position. Substandard products (11.1 percent) and insufficient demand for products and services (9.7 percent) complete the list of the top five business obstacles in the current quarter.

Figure 3: Business Constraints, %

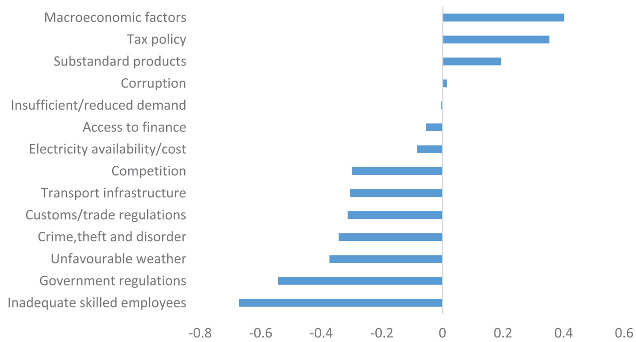


How have the business constraints evolved over the last period?

The perceived severity of perennial constraints such as macroeconomic environment, tax policy, substandard products and electricity cost reduced substantially in the current quarter (figure 4). In particular only 49.9 percent of all business executives in our sample indicated that the macroeconomic environment deteriorated an improvement from 77.2 percent registered in the last quarter, 29.2 percent indicated that the macroeconomic environment was easier for businesses a rise from 10.8 percent in the last quarter. These changes could be on the backdrop of effectiveness of economic policies carried out in the last quarter. Key among these policies is the downward adjustment of the Central Bank Rate (CBR) to 15 percent in response to reduced inflationary pressure. However, there is a scope to continue easing monetary policy and improving business environment given that macroeconomic factors are still the top most important constraint to doing business for the current quarter.

Perceptions on tax policies improved in the current quarter relative to the previous quarter. Tax policy was reported to be a problem by 38.6 percent of business executives in the current quarter an improvement from 59.2 percent recorded in the previous quarter. Also, the threat of unfair competition due to the proliferation of substandard products was perceived to be less relative to the previous quarter (figure 4). As indicated in the previous quarter, perceptions on electricity availability continue to significantly improve (figure 4). The production and supply of electricity has significantly improved in the last two years. However, there is a scope for improving the quality of the power supplied and reduction in power tariff. Comparatively in the region, the United Nations Economic Commission estimates that Kenyans pay $0.15 per kWh, Ugandan $0.17 per kWh while Tanzanian enjoy the lowest electricity tariffs $0.05 per kWh.

Figure 4: The evolution of business constraints



Future business outlook: July - September 2016

As earlier discussed, firms are optimistic that business prospects will improve in the next quarter relative to the current quarter. The expected index for July – September 2016 is 124.7 (figure 1) and is 10.4 index points higher than the current quarter's expectation which was 114.3 points. Improvements in business conditions are expected to be largely driven by new business activity and capacity utilization in the agricultural sector. The manufacturing and service sector are also expected to improve on backdrop of favourable input and product cost.

However, perceptions of lower than potential new business order may affect profitability in the manufacturing and industry. The rebound of the agriculture sector to be a driver of expected business prospects could be related to stabilization of the exchange rate in the last two quarters. Stable domestic currency eases the importation of agricultural inputs such as fertilizer. Nevertheless, the potential of the agricultural sector to drive positive business perception in the next quarter may rely significantly on the realisation of favourable weather and pacification of South Sudan.

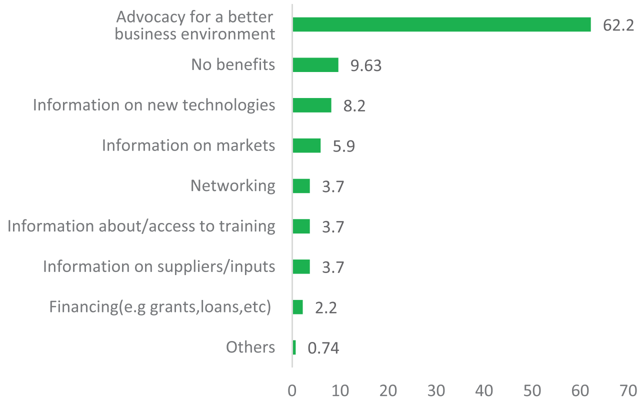
5. Question of the Quarter

Membership to a Business Association

In this quarter we sought to understand the extent to which Ugandan businesses are members of a business association. In particular, we asked: a) "Is this business establishment a member of any business associations?" b) "If the firm is a member to a business associations, what benefits does it receive?" Results indicate that majority of businesses in our sample (71.2 percent) are members of business association. In regard to benefit of membership to a business association, most firm use business association for "advocacy for a better business environment" (62.2 percent) and receive "Information about new technologies" (8.2 percent) as indicated in Figure 5. Other benefits include: information on markets (5.9 percent), networking (3.7 percent), information on training (3.7 percent), and information on supplier inputs (3.7percent). It should also be noted that a significant proportion of firm (9.63 percent) indicated that they do not derive any benefits from business associations.

Results further indicate the membership to business association may differs by size: more large firms (85 percent), medium businesses (58 percent) and Small firms (75 percent) are likely to be members of a business association, while one half of micro firms (50 percent) are likely not to join a business association.

Figure 5: Perceived benefits from business association membership, %



6. Conclusions

Perceptions on Uganda's business environment deteriorated for the second consecutive quarter. The negative sentiment about the business environment could emanate from the lag effects of the electoral cycle, pass through effects of exchange rate depreciation and the re-ignition of political strife in South Sudan a major export destination. Lower than potential domestic demand and uncertainty in macroeconomic conditions have elevated the perceived risks for doing business in the current quarter. For the second consecutive quarter, business sentiment in agriculture was positive, while business sentiment in the manufacturing and services sector was downcast. A recovery is expected in the next quarter owing to sustained performance by the agriculture sector and a recovery of manufacturing and service sector shored by lower input and production cost improving profitability and capacity utilization. However, the recovery will depend on improved domestic demand, favourable weather, and pacification of south Sudan.

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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