1.7 FISCAL RISK STATEMENT (Extraction from the BFP FY2021/22)

A comprehensive analysis of fiscal risks is key to prudent fiscal management. Therefore, the Government prepares a fiscal risk statement annually to assess risks that can affect the achievement of the set fiscal strategy. The risk framework is categorised into macroeconomic risks, budget sensitivity, risks related to public debt and Natural disasters.

1.7.1 Macroeconomic Risks

Changes in macroeconomic assumptions create risks to both revenue and expenditure projections as they play a key role in the formulation of the budget. This section assesses two important sources of macroeconomic risks:

Global and regional economic and trade environment

Currently, the global economy faces threats from the impact of the COVID-19 pandemic. The first source of risk relates to the path of the pandemic, the needed public health response, and the associated domestic activity disruptions, most notably for contact-intensive sectors. Subsequently, the extent of global spill overs from subdued demand, weaker tourism and lower remittances are likely to pose a risk to economic activity thereby posing a risk to the national budget. Lastly, financial market sentiment is likely to have implications for global capital flows.

Estimation of Macroeconomic Indicators

Volatility and optimism bias in growth projections can have negative effects on tax revenues and public debt. This has been exacerbated by the uncertainty brought about by the COVID-19 pandemic. These challenges could negatively affect economic growth outturns going forward and in turn affect tax revenues and public debt.

1.7.2 Budget Sensitivity

Variations in macroeconomic conditions can have an impact on the fiscal accounts. Revenue estimates are mainly sensitive to these variations given the effect on the tax base while expenditure is generally sensitive to changes in prices. Table 7 summarises the sensitivity of the key fiscal forecasts to changes in real GDP growth, inflation, exchange rate and price of imports.

Table: Fiscal Sensitivity to Key Macroeconomic Variables, FY2021/22 (UShs Bn)

Percentage of the Baseline GDP - FY 2021/22			
	Revenue	**Expenditure**	**Budget Balance**
One Percentage Point reduction in Real GDP (%)	-229.5	0.0	-229.5
One Percentage Point increase in Inflation Rate (%)	180.4	131.2	49.2
10% depreciation in Exchange Rate (Ushs/US$)	180.4	852.6	-672.2
10% depreciation in the Price of goods Imports	-229.5	393.5	623.0
All shocks combined	131.2	983.7	-852.6

Source: MoFPED

- A one percentage point reduction in real GDP would lead to a decrease in revenue by UShs 229.5 billion in FY 2021/22. The resulting deficit would have to be financed through expenditure adjustments or domestic/external borrowing. However, a recourse on borrowing also has budgetary implications in the form of interest payments.
- Depreciation in the average period exchange rate by 10 percent results into higher expenditure (UShs 852.6 billion), which offsets an increase in revenue (UShs 180.4 billion). This would lead to a widening of the fiscal deficit by UShs 672.2 billion. Expenditure lines which would mostly be affected by such a shock include; external interest payment and amortization and the import component of development spending.
- A 10 percent increase in the price of merchandise imports, would result into lower import volumes and hence lower revenues (UShs 299.5 billion), and higher Government expenditures (UShs 393.5 billion), and subsequently a wider fiscal deficit of UShs 623.0 billion. This shock reduces revenue receipts from import duty while at the same time increasing the Government import bill.

a. Risks related to public debt

Risks associated with external and domestic debt, include: -

1) Refinancing risks due to a high composition of short-term instruments in the financing mix
2) Materialization of contingent liabilities: Contingent liabilities are payment obligations that only arise if a particular event occurs. Currently, the main contingent liabilities stem from loan guarantees and public corporations' debt.

3) Increased cost of debt especially if we are increasingly borrowing on non-concessional or commercial terms
4) Interest rate risk: Commercial loans are sometimes contracted at a variable interest rate, which is linked to benchmark lending rates such as LIBOR and EURIBOR. Variable rate loans expose future debt service to upward movements in the benchmark lending rates.
5) Foreign exchange rate risk: Borrowing more externally increases Uganda's exposure to foreign exchange rate risk. In the event of sharp and sustained deprecation, external debt service would increase drastically posing a significant impact on sustainability of the debt.
6) Downgrade in the credit rating: If there is a deterioration in debt sustainability, it can lead to being downgraded by international credit rating agencies.
7) Increase in the cost of private sector credit: Increasing costs of Government debt will feed through to interest rates charged by commercial banks to the private sector, making it more costly for the private sector to borrow.
8) Increase in budgetary allocations to debt service: The high level of debt particularly on non-concessional terms requires an increase in budgetary allocation to debt service thereby affecting provision of Government services.

b. Projected reduction in external financing flows specifically grants. External financing flows are likely to reduce following the negative impact of the Covid-19 pandemic on the global economy. This may create challenges to effective implementation of infrastructure projects

c. Natural disasters

Due to climate change, the frequency of natural disasters like drought, flooding, landslides have increased. These disasters have significant consequences on the National Budget in case unplanned or emergence funding is required. Despite the PFM Act 2015 providing for a contingencies fund to cater for such unforeseen occurrences, these could be of greater magnitude than the provision, hence posing a fiscal risk.

The Government recognizes these risks and works to ensure that prudent management of public finances provides a buffer to changes in the global economic environment.