BANK OF UGANDA

STATE OF THE UGANDAN
ECONOMY DURING 2008/09

Research Function

Prepared for the meeting of the Board of Directors of the Bank of Uganda

Introduction

This brief report reviews developments in the economy and the conduct of monetary policy in Uganda for the 2008/09 period. Generally the economy remained resilient and is estimated to have grown by 7 percent in 2008/09 despite the effect of the recession in the advanced and emerging market economies. The resilience of Uganda's economy stems from the sound macroeconomic management, robust regional and diversified trade and economic reforms undertaken in the past two decades.

Conduct of Monetary policy

During 2008/2009, the conduct of monetary policy remained focused on maintaining price stability, providing a conducive environment for financial intermediation, thus supporting robust private sector growth. Policy was implemented in a cautious manner to minimize instability in the money and foreign exchange markets. Sterilization of excess liquidity was done through a combination of sales of treasury bills, treasury bonds, and foreign exchange in the interbank foreign exchange market (IFEM). In addition, repurchase agreements (repos) were used to manage liquidity in the intra-auction periods. The liquidity management efforts were supplemented by adjustments of the rediscount and bank rates to ensure a consistent monetary policy stance.

Base money, which is closely regulated to control inflation, increased by 21.5 percent between June 2008 and May 2009, compared to the growth of 26.9 percent registered in the corresponding period June 2007 to May 2008. The lower growth in base money reflects the tight monetary policy stance pursued in support of the disinflation process. M3 grew by 23.9 percent as foreign currency deposits increased by 22.9 percent over the same period.

Inflation

The annual headline inflation rate averaged 14.1 percent in 2008/09 up from 7.3 percent in the corresponding period to June 2008, mainly on account of higher food prices and imported inflation. However, the annual headline inflation rate dropped steadily from August 2008 through March 2009, partly due to tight monetary policy and the reduction in international commodity prices, especially petroleum products associated with the global financial crisis and economic recession. The decline in prices was, nevertheless, offset by the strong regional demand for domestic output notably food. The onset of rains is likely to support increased agricultural production and consequently reduce prices of food crops.

The annual core inflation averaged 12.5 percent in 2008/09, up from 8.0 percent in 2007/08, largely on account of exogenous factors associated with imported inflation from major trading partners. The annual Energy, Fuel, and Utilities (EFU) inflation, however, on average fell from 11.6 percent to 4.0 percent over the review period, partly reflecting the slight downward adjustment of fuel prices that followed the decline in world oil prices.

Exchange rate

Like most other currencies in the region, the exchange rate of the Uganda shilling against the U.S. dollar registered sustained depreciation during 2008/09. The shilling depreciated by 30.8 percent against the U.S. dollar from an average of Shs. 1,633.9 per US$ in July 2008 to Shs. 2,137.2 per US$ in June 2009. The weakening of the shilling was due to the sustained demand for foreign currency from both corporate and offshore players coupled with general strengthening of the U.S. dollar against major currencies in the international markets for the larger part of the year.

In pursuit of exchange rate stability, Bank of Uganda intervened occasionally to smoothen the high volatility that characterised the market between July 2008 and June 2009. The actions of the central bank in the IFEM resulted in a net sale of US$ 235.2 million on account of sterilization and intervention operations during the period under review.

Interest rates

The commercial banks' weighted average lending rates remained high in the range of 19 to 24 percent through most of 2008/09. This was attributed to the high costs of doing business in the country as commercial banks extend their branch networks, poor information sharing amongst banks regarding borrowers, inadequate legislation on matters of property rights, contracts, and collateral registries, increased investment in foreign assets. In addition commercial banks prefer to invest in government securities due to the low credit risks therein.

The Bank of Uganda, together with the Government of Uganda, have made the following efforts to bring down interest rates : - Establishing the Credit Reference Bureau; Licensing additional commercial banks to increase competition; Publishing interest rates and charges by different financial institutions on a quarterly basis; and Maintenance of macro-economic stability. Efforts are also being made by Government to computerize the land registry, as well as develop the economic, social and physical infrastructure.

Balance of Payments

Preliminary estimates indicate that during the twelve months to May 2009, the overall balance of payments position deteriorated to a deficit of approximately US$ 262.6 million from a surplus of US$923.2 million recorded in the previous corresponding twelve months ending May 2008. The decline in the overall balance was on account of deterioration of both the Current and the Capital & Financial accounts. The deficit on the current account increased to US$ 993.6 million in the twelve months under review from US$431.3 million registered in the previous period largely due to lower current transfers and higher private sector imports that more than offset the rise in export receipts. Exports increased by 19 percent to US$ 2,975.6 million in the year to May 2009 on account of strong regional demand for Uganda's produce particularly food and industrial products. The capital and financial account also declined to a surplus of US$730.9 million in the period June 2008 to May 2009 from a surplus of US$1,354.6 million recorded in the previous twelve months. The decline was mainly attributed to a decrease in portfolio liabilities following exit of some offshore investors from the government securities market.

The foreign reserves at the Bank of Uganda decreased from US$2,684.4 million at end June 2008 to US$2,477.4 million at end May 2009 largely on account of central bank actions aimed at fostering stability in the money markets. As at end of May 2009, Bank of Uganda's foreign reserves were estimated at 5.3 months import cover of goods and services.

Financial sector developments

The banking sector remains stable and sound despite the on-going global financial crisis. During the period under review, Bank of Uganda licensed two new commercial banks namely, Ecobank Uganda Limited and Equity Bank Uganda Limited, bringing to 7, the number of new banks licensed since lifting of the moratorium against licensing new banks in 2005. The entry of new banks enhanced broadening of competition in the banking sector. The number of banks in the banking sector increased to 21 with a total network of 332 branches (inclusive of sub branches and agencies) at the end of March 2009, from 194 branches at the end of December 2007.

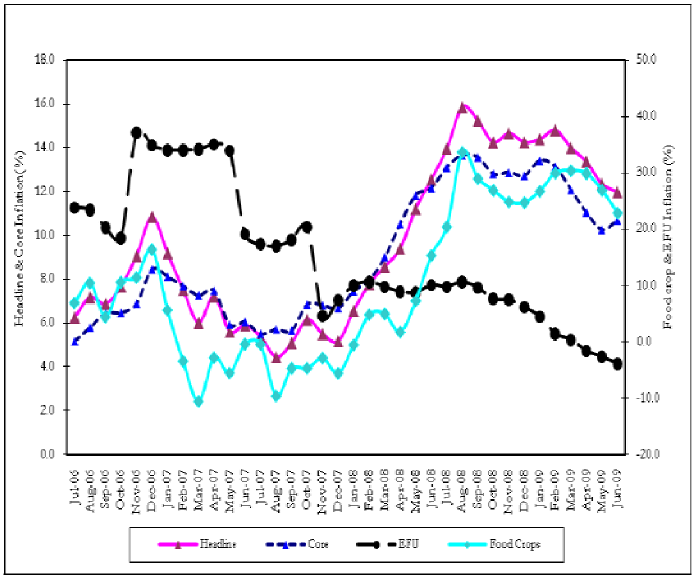
The net foreign assets of the banking system were estimated to have increased from an equivalent of Shs. 5,016.1 billion as at end May 2008, to Shs. 6,130.5 billion as at the end of May 2009. Over the same period, credit to the private sector from the banking sector is estimated to have increased by about 41.5 percent to Shs. 3,725.1 billion from Shs. 2,632.9 billion. This represents a slowdown compared to growth of 52.9 percent recorded in between May 2007 and May 2008. Similarly, deposit mobilization by the banking system from the resident private sector over the year to May 2009 is estimated to have grown by 40.9 percent for time and savings deposits and 26.1 percent for demand deposits. The percentage of total non-performing loans to total private sector credit was below 3 percent by end of period under review indicating an improvement from 3.9 percent as at end of March 2008.

The banking sector witnessed the continued roll-out of innovative products including mobile money banking, e-banking, SMS-banking, internet banking, and mortgage products. Mobile Money Transfer (MMT) using mobile phones is now functional, with MTN collaborating with Stanbic Bank to ensure services are fully compliant with financial services regulation. The Bank of Uganda has received partnership applications for the MMT from DFCU with UTL, Standard Chartered Bank with Zain, and Crane Bank partnered with Warid and E-Fulusi of Tanzania. The MMT is part of the ongoing initiatives to extend financial services throughout the country. The attached Charts highlight the developments in the economy.

Short-term and medium term outlook

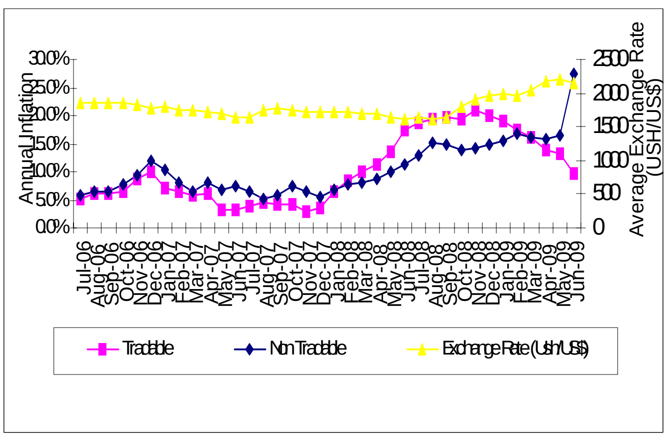
Bank of Uganda is committed to continued monetary policy prudence geared towards price stability. Inflation is projected to continue heading south towards single digit levels by end June 2010 while real GDP growth will remain above the regional average at 6 percent before rebounding to higher levels in the outer years. Domestic revenues are projected to increase only moderately while donor flows are expected to remain within the current levels in view of the global economic environment. Fiscal prudence is thus expected to be strengthened in 2009/10 and the outer years to foster overall macroeconomic stability. The reserve cover however is expected to remain above 5 months of imports of goods and services.

Chart 1: Annual Inflation Developments: July 2006-June 2009



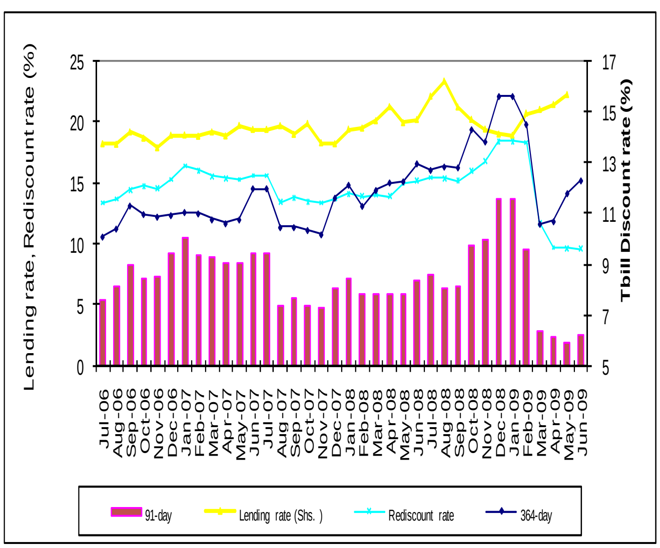
Source: Uganda Bureau of Statistics

Chart 2: Tradable and Non-Tradable Inflation July 2006-June 2009



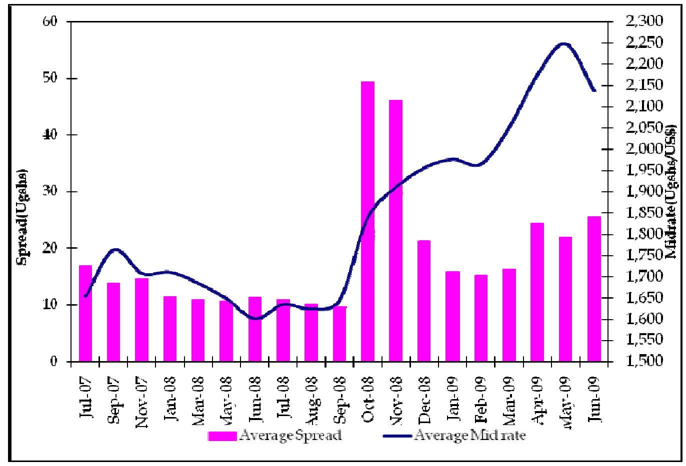
Source: Bank of Uganda

Chart 3: selected interest rates July 2006 – June 2009



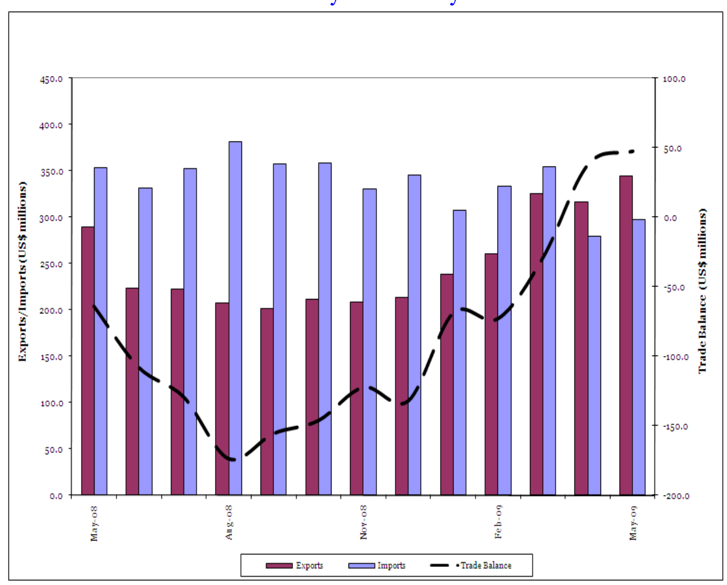
Source: Bank of Uganda

Chart 4: Exchange rate developments: July 2007-June 2009



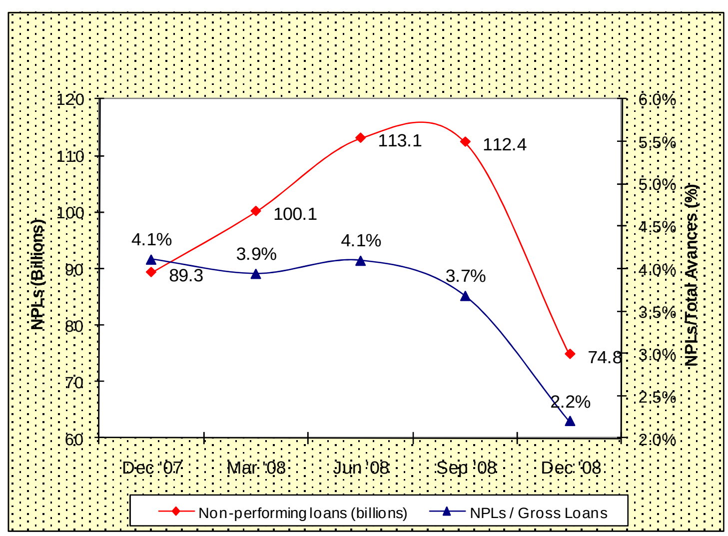
Source: Bank of Uganda

Chart 5: Trade Performance May 2008 – May 2009



Source: Bank of Uganda

Chart 6: Asset Quality indicators for Uganda's banking system



Source: Bank of Uganda