BANK OF UGANDA

STATE OF THE UGANDA
ECONOMY

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Research Function

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1. Introduction

This brief report reviews developments in the economy and the conduct of monetary policy in Uganda for the period July to October 2009. Generally, not withstanding the slowdown in aggregate demand, the economy remains resilient and is expected to grow by more than 6 percent in 2009/10, a remarkable feat by international standards given the turbulent global economic environment. The resilience of Uganda's economy stems from the sound macroeconomic management, robust regional and diversified trade regime and economic reforms undertaken in the past two decades. The brief also reports on the Monetary Program and reviews developments in relation to the Program.

2. Recent Global Economic Developments

Recent indicators show that the worst of the global recession is over; however, complete recovery is bound to be gradual. According to the July 2009 World Economic Outlook (WEO) report, global GDP is expected to fall by 1.4 percent in 2009, but turn around to register growth of 2.5 percent in 2010. In the advanced economies, GDP is expected to drop by 3.8 percent in 2009 and to grow by 0.6 percent in 2010. According to the Central Plan Bureau (CPB) Netherlands Bureau for Economic Policy Analysis, global world trade has consistently risen since June 2009 although it still trends below pre-crisis levels and it will only fully recover in 2012 assuming consistent growth of average rates observed in the 2000 – 2007 period. While financial markets, world trade and market confidence are steadily recovering, housing markets and bank balance sheets are yet to register noticeable improvement. Also bank lending and external financing conditions are still tight and will remain tight for some time to come.

While the worst of the crisis is over, there is still gloom hanging over especially the developed countries. Specifically, the level of unemployment remains high in the advanced economies and is expected to continue along this trend, holding back wages and household spending further impacting the recovery of consumer demand, which, as reflected by numbers on retail sales, has remained weak.

According to the July 2009 WEO report, global inflation stood at 1.7 percent in May 2009, down from 6 percent registered in May 2008. In the advanced economies, headline inflation fell below 0 percent in May 2009 while core inflation stood at 1.5 percent, down from 2 percent over the same period and this was mainly on account of relatively lower oil prices.

The road ahead looks positive as the upturn is expected to continue for the time being, although there are adjustments that have to be made if complete economic recovery is to be achieved. Specifically, in the banking systems of the developed world, balance sheets still have to be cleaned up and financial regulation and surveillance has to be strengthened. In introducing tighter regulations, however, care has to be taken in order not to stifle credit provision. In the US, the level of consumer debt has to be significantly brought down and fiscal policy has to be directed towards budget consolidation, following the deficit-financed stimulus spending that took place in most of the industrialized countries. Consequently, governments will have to either cut back on spending or raise taxes in order not to increase the risk premium that may stem from expectations of payment defaults tempting another kind of crisis.

3. Policy Support Instrument (PSI) targets and Monetary Programme

June 2009 Performance

The two assessment criteria on BOU's Net International Reserves (NIR) and Net Domestic Assets (NDA) under the PSI for June 2009 were met. After applying the adjusters from the outturns of cash debt service payments and budget support, NIR and NDA were within target by US$ 87.6 million and Shs. 182.8 billion, respectively. The ceiling on base money, as an indicative target, was missed by a small margin of Shs. 0.8 billion.

Monetary Program for 2009/10

The aim of monetary policy in 2009/10 is to ensure that core inflation declines to 7.5 percent in June 2010 and to provide sufficient liquidity to allow the economy to grow at 6.3 percent in 2009/10. To achieve this level of core inflation, BOU will restrict broad money (M2) growth to 21.2 percent and reserve money growth to 21.0 percent. However, BOU will tighten the monetary targets for June 2010 if the shock to food prices feeds through to core inflation to the extent that the target of 7.5 percent might not be met. The target for core inflation remains at 5.0 percent in 2010/11.

Table 1: PSI program targets for BOU for 2009/10

	Dec 2009	March 2010	June 2010
Cumulative change in base money (Shs billion)	261	335	410
Cumulative change in NDA (Shs billions)	187	237	288
Cumulative change in NIR (In US$ millions)	263	276	288

4. Conduct of Monetary policy

During the first four months of 2009/2010, the conduct of monetary policy was focused on providing liquidity to the financial system in an effort to support aggregate demand in the economy. This was, however, done without losing sight of the price stability objective. Flexibility was also introduced in the implementation of the Reserve Money program with a clear distinction between structural (long-term) liquidity and short-term liquidity needs of the market. Sterilization of structural liquidity was done through a combination of sales of treasury bills, treasury bonds, and foreign exchange in the interbank foreign exchange market (IFEM), while the repurchase agreement (repos) and reverse repos were the main instruments used in managing short-term liquidity. In an effort to further ease the monetary policy stance, the margin on the rediscount rate was reduced from 3.4 percentage points to 3.0 percentage points on November 9, 2009.

Despite BOU's slightly eased monetary policy stance during the period under review, base money increased by only 6.4 percent between end June 2009 and end October 2009, compared to a higher growth of 9.8 percent observed in the corresponding period of 2008. The lower growth in base money is partly explained by the contraction in currency issued by 2.2 percent in the first 4 months of 2009/10, compared to an increase of 4.9 percent registered in the period June to October 2008. The reduction in currency issued coupled with a widening trade deficit and slowed credit growth point to subdued aggregate demand in the economy during the 2009/10 period so far.

5. Recent Economic Developments

Inflation

The annual headline inflation averaged 13.0 percent in the first four months of 2009/10, down from 14.9 percent in the corresponding period to October 2008, mainly on account of lower prices of non-food items associated with lower imported inflation. Imported inflation was lower in the review period than in the corresponding period a year ago largely on account of reduced international fuel and commodity prices, following the global financial and economic crisis. The impact on domestic prices of the decline in international fuel and commodity prices was nevertheless offset by the strong regional demand for domestic output notably food, and the drought experienced for most of 2009. Food crop inflation averaged 35.8 percent in the first four months of 2009/10 compared to 27.5 percent in the corresponding period of 2008.

The annual core inflation averaged 9.8 percent in the period July 2009 to October 2009, compared to 13.3 percent in the corresponding period of 2008. The annual Energy, Fuel, and Utilities (EFU) inflation, also, decelerated from an average of 9.4 percent to minus 3.5 percent over the review period, partly reflecting the downward adjustment of international fuel prices that followed the global economic meltdown.

Exchange rate

The exchange rate appreciated by about 10 percent against the US dollar between July 2009 and October 2009, compared to a depreciation of 12.5 percent observed in the corresponding period of 2008. The appreciation of the Shilling against other major currencies was however less pronounced than against the US dollar, because the dollar itself weakened on international currency markets.

The main factors driving the appreciation of the Shilling in the last four months was a rebound in the key components of the Balance of payments, which had suffered a negative shock in the first half of 2008/09 as a result of the global economic crisis. The current account balance generally improved in 2009 compared to 2008, with small trade surpluses recorded in the last quarter of 2008/09, although the trade balance slipped back into deficit in August 2009. Remittance inflows doubled in July and August 2009, from the depressed levels observed in the first six months of 2009. Net portfolio flows from offshore institutional investors and short term capital flows from commercial banks also turned positive since June, after about nine months of net outflows.

Interest rates

The commercial banks' weighted average lending rates on shilling denominated loans remained high in the range of 19 to 24 percent through out most of 2008/09 and the first quarter of 2009/10. This was partly attributed to the high cost of doing business mainly on account of poor infrastructure and inadequate legislation on matters of property rights, collateral registries and contract enforcement.

The Bank of Uganda, together with the Government of Uganda have made considerable efforts to bring down interest rates, including:- establishing the Credit Reference Bureau, licensing additional commercial banks to increase competition, increasing transparency by publishing interest rates and charges by different financial institutions on a quarterly basis, and maintaining 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 to reduce the cost of doing business.

Balance of Payments

Total export earnings for the first quarter of 2009/10 were recorded at US$864.1 million compared to US$632.0 million recorded in the corresponding period of the previous year. However when compared to the fourth quarter of 2008/09, the level of exports fell by US$130.4 million, largely on account of reduced Informal cross border trade (ICBT) exports. ICBT exports declined by 25 percent between June 2009 and September 2009 due to establishment of some manufacturing plants like Nile breweries in Juba, penetration of the Sudan market by Kenya and South Africa, closure of three key retail markets in Juba in June 2009, and the introduction of import and value added taxes on imports by South Sudan.

The import bill (free on board) was estimated at US$983.0 million during the same period compared to US$1,120.6 million recorded in the quarter that ended September 2008. The decline in the import bill is partly a result of the fall in the prices of imports that followed the global financial crisis.

Official aid (excluding project aid but including resources from the HIPC Initiative) inflows in the first quarter of 2009/10 amounted to about US$159.9 million, an increase of US$120.0 million from the aid inflows received in the quarter that ended September 2008. By end-September 2009, the level of gross foreign reserves amounted to US$ 2,757.6 million, which was US$ 104.8 million and US$ 216.2 million higher than the level in August 2009 and September 2008, respectively. The September 2009 reserve level was equivalent to 5.6 months of future imports of goods and services.

Financial sector developments

The banking sector remained safe and sound, arising from the continuous rigorous regulation and supervision by the Bank of Uganda. The ratio of non-performing assets to gross loans in banking system remained low at about 4 percent in September 2009, as was the case in June 2009. There was also increased confidence in the banking system as the ratio of time and savings deposits to total deposits of the non bank public rose from 35.8 percent in September 2008 to 37.6 percent in September 2009.

The net foreign assets of the banking system are estimated to have increased by 3.4 percent to Shs. 5,908.0 billion between June 2009 and September 2009. This was in contrast to a reduction of 11.1 percent observed in the corresponding period of 2008.

Over the same period, credit to the private sector is estimated to have increased by about 2.6 percent to Shs. 3,691.6 billion. This represents a slowdown compared to growth of 11.7 percent recorded between June 2008 and September 2008. This is partly attributed to increased risk averseness and tightening of credit extension conditions by banks. On the other hand, deposit mobilization by the banking system over the year to September 2009 was estimated to have grown by 37.7 percent for time and savings deposits and 23.2 percent for demand deposits. This is compared to 30.6 percent and 20.0 percent, respectively for the year to September 2008.

The banking sector continued to witness the roll-out of branch service net work and innovative products including mobile money banking, money transfer using mobile phones, e-banking, SMS-banking, internet banking, and mortgage products. Some of the innovations in the banking sector are not sufficiently covered by the existing financial sector laws and regulations and, as such, the Bank of Uganda is currently working on a revision of these laws and regulations.

Fiscal Developments

One of the goals of the 2009/10 budget is to provide a fiscal stimulus. This year's budget, if fully implemented, is expected to have a net impact on aggregate demand of 1.4 percent of GDP. Domestic revenues, domestic expenditures, and the domestic fiscal balance are shown in Table 2. Over the first quarter of 2009/10, actual government spending fell short of budgeted expenditures by about 28 percent, mainly on account of delays in the implementation of projects under the development program. Expenditures on the development budget amounted to 9 percent of the 2009/10 allocation. The delays in program implementation mainly stemmed from the new budgeting system, which moved from the incremental to the zero-based approach of budgeting and accountability. As a result, the fiscal stance was contractionary, by 2.2 percent of GDP. Consequently, fiscal performance in the first quarter of 2009 was to reduce aggregate demand, rather than to provide a fiscal stimulus. However, it is expected that, government spending will pick up in the following quarters of 2009/10 to provide the fiscal stimulus.

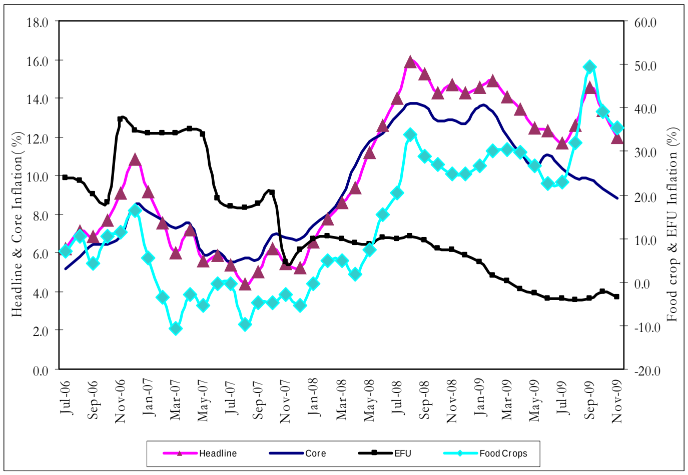
Table 2: Domestic Fiscal balance and Fiscal Stance (Shs billions)

	2009/10 Budget	July-Sep09 Prov. outturn
Domestic revenue	4520	989
Domestic expenditure	5034	790
Domestic deficit	-514	199
Fiscal position/GDP (%)	1.4	-2.2

6. Short-term and medium term outlook

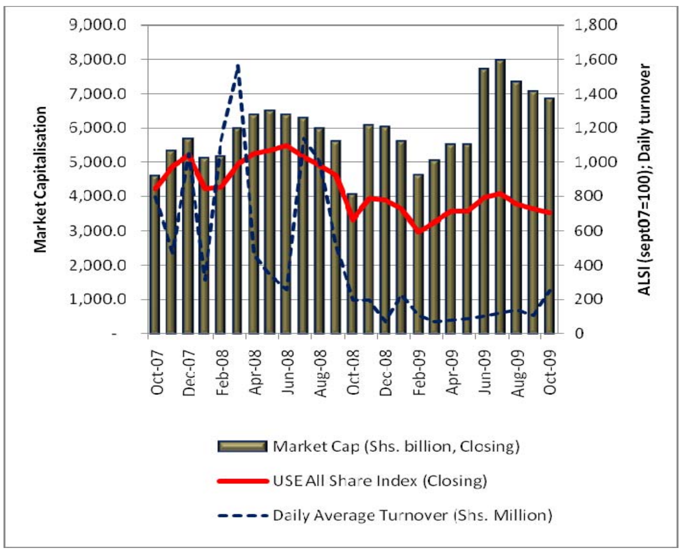
Given the widening trade deficit, the slowed growth in private sector credit, contractionary domestic fiscal balance, and currency issued, all indicators point to sluggish aggregate demand in the economy in the 2009/10 period so far. Monetary policy will continue to support aggregate demand in every sensible way possible in the short-run, without jeopardizing the objective of low and stable inflation in the medium and long term.

Chart 1: Annual Inflation Developments: Oct 2007-Oct 2009



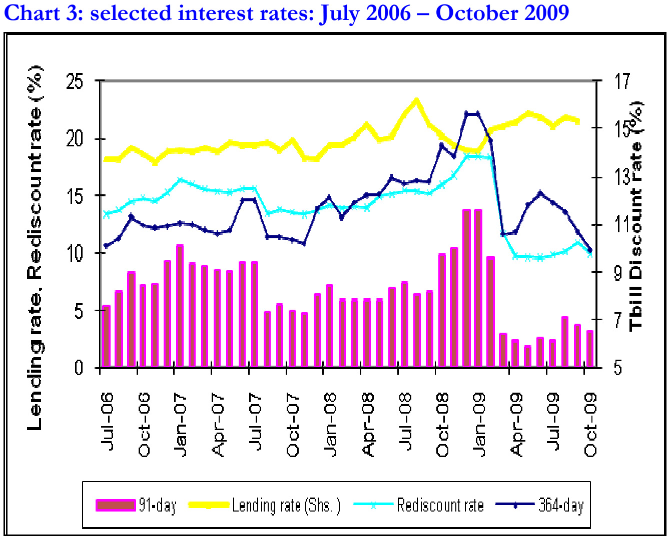
Source: Uganda Bureau of Statistics

Chart 2: Uganda Securities Exchange (USE): Oct 2007-Oct 2009



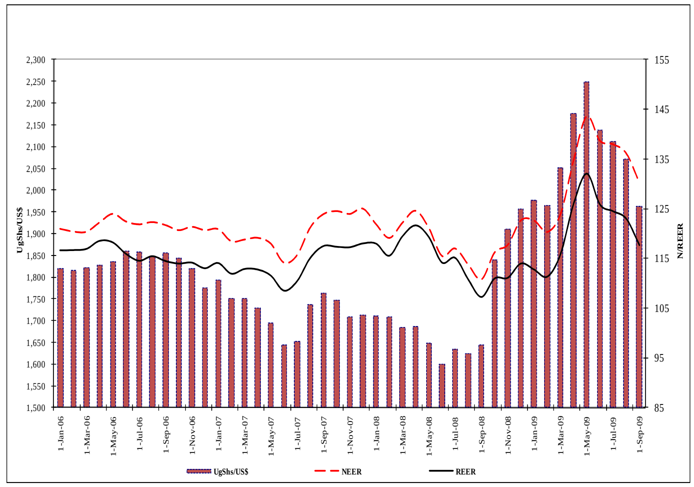
Source: Bank of Uganda

Chart 3: selected interest rates: July 2006 – October 2009



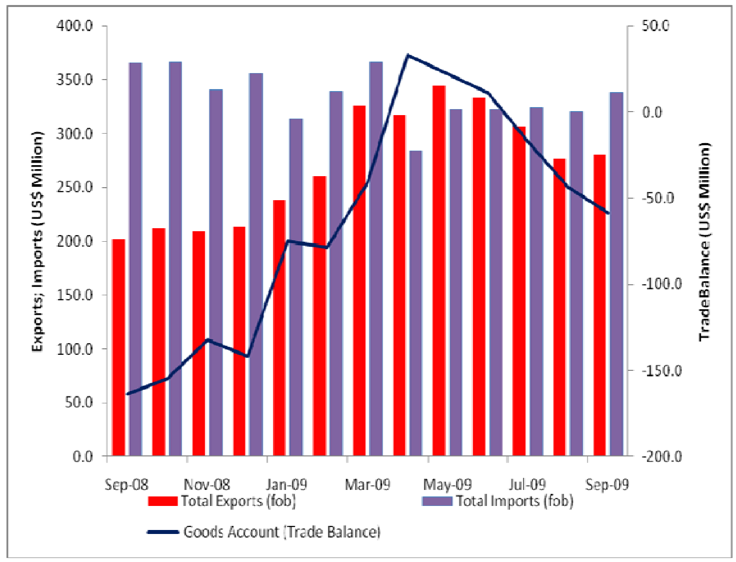
Source: Bank of Uganda

Chart 4: Exchange rate developments: Nov 2007-October 2009



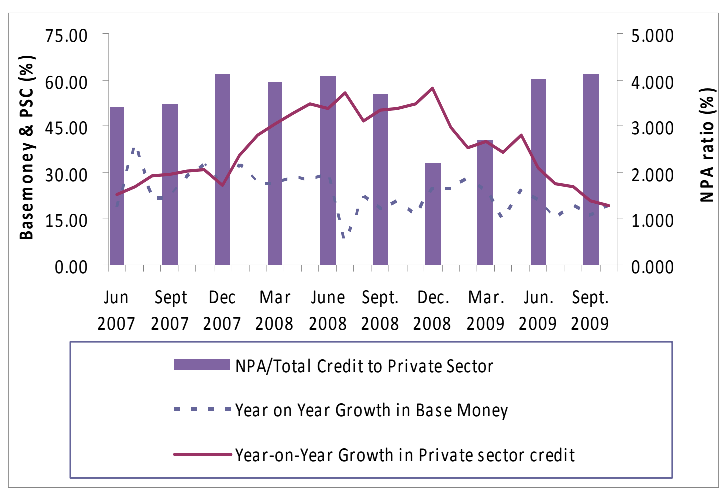
Source: Bank of Uganda

Chart 5: Trade Performance: September 2008 – September 2009



Source: Bank of Uganda

Chart 6: Banking Sector indicators: June 2007-October 2009



Source: Bank of Uganda

UGANDA SELECTED ECONOMIC AND FINANCIAL INDICATORS: 2007/08-2013/14								
MACROECONOMIC INDICATOR	2007/08	2008/09		2009/10	2010/11	2011/12	2012/13	2013/14
	Est.	Prog.	Prel.	Proj.	Proj.	Proj.	Proj.	Proj.
GDP and prices (percent change)								
Real GDP (at Basic price)	8.7	6.2	6.7	6.3	6.6	7.0	7.0	7.0
Headline inflation (end of period)	12.5	10.3	12.3	12.2	5.9	5.5	5.0	5.0
Core inflation (end of period)	12.1	10.3	11.1	7.9	5.0	5.0	5.0	5.0
External sector (percent change)								
Terms of trade (deterioration -)	-1.1	...	3.9	-2.7	-6.5	-4.1	-2.6	0.1
Real effective exchange rate (depreciation -)	-1.3	...	....	...	...	...	...	...
Money and credit (percent change)								
Broad money (M2)	30.1	20.9	26.3	21.2	17.1	17.7	17.4	17.1
Domestic credit	19.1	17.8	24.1	13.7	11.7	12.5	12.2	11.9
Credit to the central government [2]	-4.8	1.3	6.8	1.0	2.1	2.9	2.4	2.1
Private sector credit	50.9	29.6	31.6	22.2	16.6	16.8	17.3	17.1
Savings and investment (percent of GDP)								
Domestic investment	23.7	25.3	23.1	24.9	26.4	27.1	27.5	28.0
Public	5.5	7.7	5.4	7.2	8.4	8.6	8.5	8.5
Private	18.2	17.6	17.7	17.7	18.0	18.5	19.0	19.5
National savings (excluding grants)	17.5	14.6	15.7	15.7	18.2	19.2	19.9	21.5
Public	0.4	0.7	1.1	2.1	2.4	3.0	3.4	3.9
Private	17.1	13.9	14.7	13.6	15.8	16.2	16.5	17.6
External sector (percent of GDP)								
Current account balance (including grants)	-3.2	-6.2	-4.8	-6.7	-6.0	-5.9	-5.6	-4.5
Net donor inflows	-6.2	-10.7	-7.4	-9.2	-8.3	-7.9	-7.5	-6.5
Current account balance (excluding grants)	4.9	7.3	4.2	6.1	5.0	4.3	3.9	3.5
External debt (including Fund)	--	17.3	15.9	14.3	16.3	17.9	18.7	19.2
External debt-service ratio [3, 4]	1.4	1.8	1.6	1.0	1.0	1.7	2.1	2.4
Government budget and debt (percent of GDP)								
Revenue	12.8	12.4	12.5	12.8	13.2	13.7	14.2	14.7
Grants	2.7	3.2	2.6	2.6	2.2	2.0	2.0	2.0
Total expenditure and net lending	-17.9	-19.4	-16.9	-17.9	-19.2	-19.2	-19.2	-19.3
Overall balance (including grants)	-2.4	-3.7	-1.7	-2.6	-3.8	-3.6	-3.1	-2.6
Overall balance (excluding grants)	-5.1	-7.0	-4.4	-5.1	-6.0	-5.5	-5.0	-4.5
Stock of domestic debt	10.7	8.6	8.4	6.7	6.0	6.0	5.7	5.5
Memorandum items:								
Nominal GDP (U Sh billions)	24,497	30,496	29,972	36,330	41,479	46,388	53,093	60,010
Average exchange rate (U Sh per US$)	1,696	...	1,930	...	...	...	...	...
Treasury bill yield (percent)	8.3	...	6	...	...	...	...	...
Overall balance of payments (US$ millions)	563	-100	-46	291	75	175	202	225
Gross foreign exchange reserves								
(months of next year's imports of goods & services)	5.9	5.2	4.7	4.9	4.7	4.7	4.8	4.7

Sources: Ugandan authorities; and IMF staff estimates and projections (October 2009)

[1] *Fiscal year begins in July.*

[2] *Percent of M3 at start of the period.*

[3] *Percent of exports of goods and nonfactor services.*

[4] *Including Fund obligations; reflects actual debt service paid, including debt relief.*