BANK OF UGANDA

STATE OF THE UGANDA ECONOMY

November 2010

Research Function

1. Introduction

The report comprises of the recent economic developments in Uganda for the period ending October 2010, the Policy Support Instrument (PSI) targets and Monetary Program June 2010 Performance and the outlook. The recent economic developments include inflation, exchange rates, interest rates, balance of payments, financial and fiscal developments. The economy remains resilient and is expected to grow at about 6-7 percent in 2010/2011 compared to 5.2 percent[1] in 2009/2010. The 2009/10 growth performance, though lower than the previous years' outturn, was well above the Sub-Saharan average of about 3.5 percent.

1.1 Conduct of Monetary policy

Monetary Policy has been largely accommodative for the 2010 period so far to support aggregate demand and economic activity. This coupled with a larger stimulus from government spending in the second half of the year 2009/10, account for the recovery in most measures[2] of aggregate demand in 2010. Consequently, the interest rates on Government securities remained relatively low (see Chart 3 on Treasury Bills) with an expected positive impact on private sector lending. Indeed, annual growth rates of private sector credit have risen to average 22.4 percent in the period February 2010 to August 2010, from 18.7 percent in the four months to January 2010 (see chart 5). The commercial banks' weighted lending rates however, remained high. In order to meet the EAC convergence criteria on international reserve accumulation, , BOU suspended the daily sales of US dollars for liquidity sterilization purposes and implemented the strategy of buying US$ 0.5 million on a daily basis starting August 19, 2010.

[1] Revised from 5.8 percent by Uganda Bureau of Statistics
[2] Real currency in circulation, private imports and private sector credit; evolution of government expenditure, exports and foreign exchange earnings to capture other components of aggregate demand

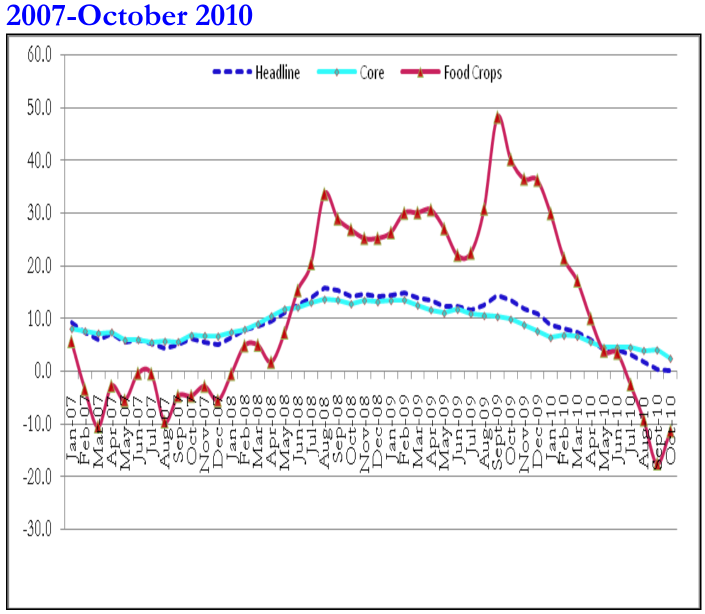
2. Recent Economic Developments

Inflation

Annual Headline and core inflation have been declining since September 2009, reaching record low levels of 0.1 percent and 2.5 percent in October 2010, respectively. The inflation trend was largely on account of reduced food crop prices and negative output-gap. Lower mobile charges also account for the declined inflation in the 2010/11 period so far, away from the double digit inflation recorded throughout 2008/09. Supply of food crops in the domestic economy has increased substantially in the economy leading to a reduction in food crop prices. Annual Food crop inflation averaged 4.5 percent in the ten months of 2010, compared to 31.8 percent in the corresponding period of 2009, and is estimated at minus 11.4 percent in October 2010.

The annual Energy, Fuel, and Utilities (EFU) inflation, however, rose to an average of 2.3 percent in the four months of 2010/11 so far, compared to an average of minus 1.0 in 2009/10, partly reflecting the moderate rebound of the global economy and the attendant international prices.

Chart 1: Annual Inflation Developments: Jan 2007-October 2010



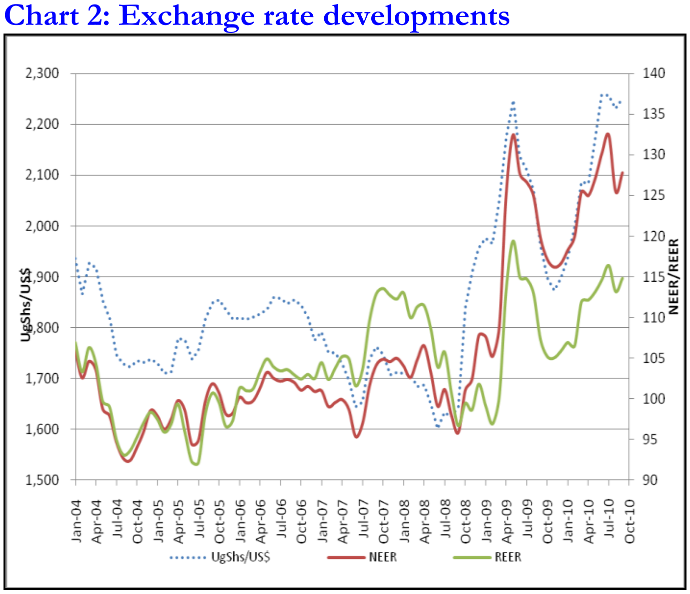
Source: Uganda Bureau of Statistics

Exchange rate

The Uganda Shilling recorded a depreciation of 17 percent against the US dollar between January 2010 and October 2010, in contrast to an appreciation of 4 percent between January 2009 and December 2009. The shilling depreciation against the greenback was highest in May 2010, owing to the uncertainty in the Euro Zone, which led to the global weakening of the Euro and strengthening of the US dollar. In addition, the shilling depreciation was driven by strong dollar demand by the manufacturing, energy and telecommunication sectors as well as commercial banks demand for dollars to cover their short dollar positions. The Real Effective Exchange Rate (REER), which measures the competitiveness of domestic traded goods relative to Uganda's trading partners, also depreciated in line with the Nominal exchange rate, albeit at a much less magnitude, due to the decline in domestic inflation relative to foreign inflation for most of the review period.

BOU continued to occasionally intervene on the sale and purchase side in the inter-bank foreign exchange (IFEM) market, to smoothen out volatility. The net effect of BOU's actions in the IFEM in the ten months of 2010 was a net purchase of US$ 43.9 million on account of intervention and reserve build up, compared to a net sale of US$ 21.8 million in the year 2009, as a whole.

Chart 2: Exchange rate developments



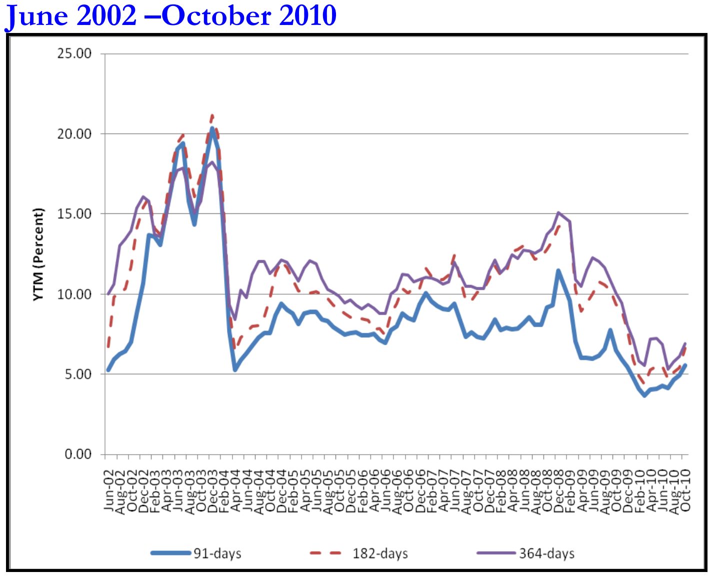
Source: Bank of Uganda

Interest rates

Interest rates on Treasury securities have fallen for most of the 2010 period so far, owing to the monetary policy easing and the very low inflation. The yield on the 91, & 364-day Treasury bill papers declined from 12.5 percent and 18.5 percent at end December 2008 to 6.8 percent and 9.8 percent in November 2010, respectively. The Rediscount and bank rates, as a result, also reduced to 9.2 and 10.2 percent in November 2010, from 18.4 and 19.4 percent, at end December 2008, respectively.

The commercial banks' weighted average lending rates on shilling denominated loans continued to be in the high range of 19 to 23 percent. However, BOU has undertaken several measures to influence lending rates downwards including the full operationalisation of the Credit Reference Bureau, licensing of new financial institutions to increase competition; and moral suasion through the monthly meetings with the chief executives of commercial banks.

Chart 3: Treasury bill Yield to maturity rates: June 2002 –October 2010



Source: Bank of Uganda

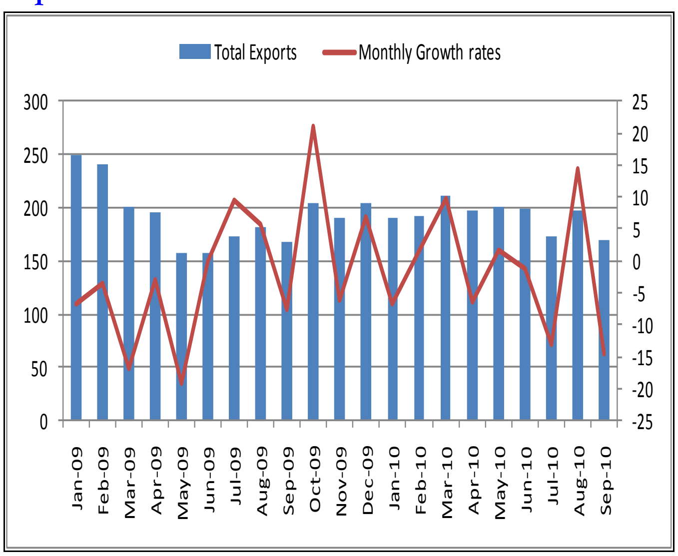
Balance of Payments

Exports

The performance of exports has not been very promising. After stagnating at about US$ 200 per month in March 2010 to June 2010, exports declined to about US$ 125 million in July 2010, rose in August, but declined further in September 2010 as shown in chart 4. Total export proceeds in September 2010 are estimated at US$ 168.7 million; which is 14.7 percent less than the export earnings of US$ 197.7 million recorded in August 2010, but 0.4 percent more than what was realized in September 2009. The decline in exports has been widespread across all categories of exports. In particular, coffee seems to have been hit most with a decline of about 22 percent in volume although the unit price has been rising. Other exports like cotton and Informal cross border trade (ICBT) have also weakened

ICBT exports are also estimated to have declined to US$ 51.91 million in September 2010 from US$ 56.19 million in August 2010.This was however an increase of 6.8 percent, compared to what was realized in September 2009.

Chart 4: Evolution of formal exports, Jan 2009 – September 2010



Source: Bank of Uganda

Foreign Reserves

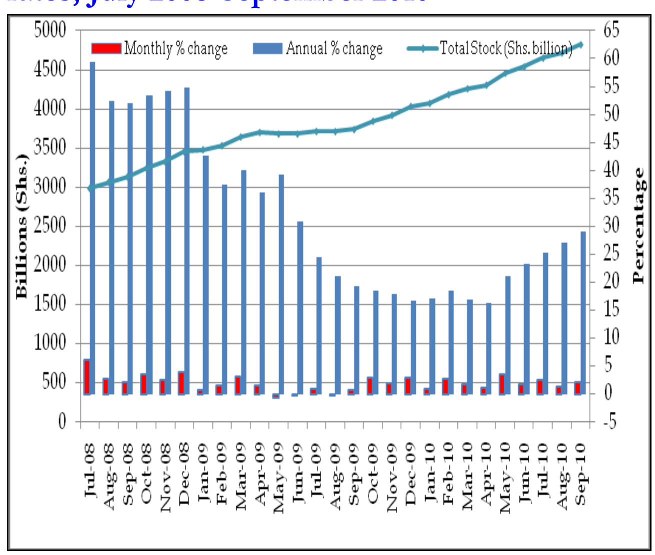
The level of gross foreign reserves stood at US$ 2,711.7 million at end September 2010; US$ 17.9 million more than the preceding month's level. This reserve level is sufficient to cover 4.7 months of future imports of goods and services

Financial sector developments

Growth in terms of product innovation and branch outreach, and soundness of the banking sector continued unabated, partly attributable to vigilant risk-based supervision by the Bank of Uganda. Tier 1 capital to risk weighted assets remained at about 19 percent, well above the statutory minimum of 8 percent and non performing loans as a share of total assets are estimated at about 3 percent. Deposit mobilization by the banking system rebounded from its low levels in 2009. Monthly growths in shilling deposits averaged 3 percent in the eight months to August 2010, compared to 1.7 percent in 2009.

In order to align Uganda's minimum capital requirements with those of EAC partner states, government gazetted a statutory instrument in October 2010, to raise the minimum paid up capital for operating a commercial bank in Uganda to Shs.25 billion, from the current level of Shs.4 billion. BOU also intends to impose a capital charge for market risk for consistency between Uganda's capital requirements and the Basel1 accord. Also amendments to the Financial Institutions Act (FIA 2004) to allow Commercial Banks to offer banc assurance and Islamic banking products are in the offing.

Chart 5: Private sector credit: Stock and growth rates; July 2008-September 2010



Source: Bank of Uganda

Fiscal Developments

According to the Background to the Budget 2010/2011, the projected outturn for total government revenue and grant disbursements for 2009/10 amounted to 15.4 percent of GDP, compared to 15.5 percent of GDP in 2008/09 and the budgeted amount of 16.5 percent to GDP. The underperformance relative to budget was attributed to an under performance in URA international trade tax collections, associated with lower import activity.

Total government expenditures and net lending for 2009/10 was projected at 18.3 percent of GDP, which is an underperformance of 1.7 percent relative to the budgeted amount. This performance was attributed to slow execution of key projects, and in particular in the roads and energy subsectors.

The underperformance in government expenditure mitigated the shortfall in government revenue, culminating into a projected overall lower budget deficit including grants of 3.0 percent to GDP, relative to an estimated deficit of 3.6 percent to GDP in the budget. Similarly, the budget deficit / GDP ratio excluding grants was 5.7 percent relative to an estimated deficit of 7.2 percent. Table 2 below gives a summary of the fiscal developments for the fiscal year 2009/10.

Table 2: Summary of Fiscal Operations 2008/9-2009/10

	2008/09 outturn	2009/10 Budget estimate	2009/10 projected outturn
Total Revenue and Grants	15.5	16.5	15.4
Expenditure and Lending	16.4	20.0	18.3
Overall fiscal balance (including grants)	1.7	3.6	3.0
Overall fiscal balance (excluding grants)	4.6	7.2	5.7

Source: Background to the Budget 2010/2011

3. Policy Support Instrument (PSI) targets and Monetary Program June 2010 Performance

The assessment criteria on BOU's Net International Reserves (NIR) and Net Domestic Assets (NDA) under the PSI for June 2010 were met. Also base money as an indicative target was within the allowable limits by Shs. 5.6 billion.

Monetary Program for 2009/10

The aim of monetary policy in 2009/10 was to ensure that core inflation declines to an annual average of 7.5 percent in 2009/10 and 5.3 percent by end June 2010 and to provide sufficient liquidity to allow the economy to grow at 6.4 percent in 2009/10. Core inflation as at end June 2010 stood at 4.6 percent while the economy grew by 5.8 percent. The lower than anticipated growth was on account of the slump in aggregate demand that occurred during the first half of 2009/10.

Table 3: PSI program targets for BOU for 2009/10

In Shs. Millions (unless otherwise stated)	**Program**	**Outturn**	**Deviation**
June 2010			
Cumulative Change in Base Money (BM)	410,000	404,396	-5,604
Cumulative Change in Net Domestic Assets (NDA)	289,000 601,751[3] (***adjusted***)	-185,723	-474,723 -787,474 (***adjusted***)
Net International Reserves (NIR) (US$ millions)	123.51 (adjusted)	267.78	144.27

Source: Bank of Uganda

[3] Adjusters used are highly tentative pending receipt of firm budget support and cash debt service numbers from MFPED

Outlook

Economic activity appears set to continue on its upward track, although the trend is likely to be bumpy. Real GDP growth for 2010/11 is forecast to rise from last year's 5.2 percent to stand at between 6-7 percent and over 7 percent in the medium term years. However, considerable uncertainty surrounds the course of growth including the possibility of a slowdown of the recovery in major countries and fiscal problems in European countries. Uganda's balance of payments is expected to weaken in 2010/11, resulting from worsening external terms of trade and higher imports leading to current account deterioration. The Bank of Uganda will conduct monetary policy in such a way as to help the economy maintain price stability and prevent core inflation from rising above the 5 percent target, while at the same time supporting the continued recovery of aggregate demand and sustaining sound growth.