Bank of Uganda
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Executive Summary

1 Recent Global Economic Developments and Outlook

The global economic outlook remains gloomy and uncertain due to the continued EURO debt woes and weak economic recovery in developed countries. Temporary factors, such as supply chain disruption caused by natural disaster in Japan have also contributed to the slack in global economic recovery. The index of manufacturing in China, which has been registering robust growth, has declined below projection, which signals further slackening of the global economy. In the euro zone, real GDP growth decelerated to 0.2 percent quarter-on-quarter, in the second quarter of 2011 from 0.8 percent in the previous quarter. In the US however, annual growth rate in the third quarter of 2011 accelerated to 2.5 percent, up from 1.3 percent in the previous quarter. The sustainability of this growth however remains questionable, given the unresolved debt ceiling woes in the US. Japan seems to have recovered from the supply constraints following the earthquake, while the UK growth rate has remained subdued posting a meagre 0.5 percent growth in the third quarter 2011. In the medium term, while the waning of some of the adverse transitory factors should support global economic activity in the second half of the year, structural headwinds, particularly in advanced economies, as well as the renewed tensions in global financial markets are expected to dampen medium-term growth dynamics. Global recovery is however expected to continue in 2012, but divergences in the strength of recovery across countries will continue to persist.

Because of the weakening global economy, commodity prices are forecast to decline by 9.9 percent in 2012. Crude oil prices and prices of manufactured products are forecast to decline by 9.2 percent and 4.5 percent, respectively. Financial instability and the vulnerability of the international financial system has increased on account of the continuing Euro debt crisis and weak global economic recovery and outlook. On the upside therefore, global recovery might be influenced by lower commodity prices going forward.

The global economy faces a much more complicated situation that is rapidly turning into a systemic crisis. The European sovereign-debt problem and the toxic combination of a sudden economic slowdown, potential interconnectedness between the slowdown and the financial risk, and an absence of obvious solutions to these problems constitute an alarming signal of systemic risk. In addition, there seem to be an absence of obvious policy solutions to the rapid slowdown of the real economies in the United States and Europe, as well as to the consequences of these slowdowns to financial markets and from financial markets back to the real economy.

2 Recent Domestic Economic Developments and prospects

The Ugandan economy remained resilient despite bouts of both domestic and external shocks. After declining to 5.9 percent in 2009/10, largely on the backdrop of the global economic crisis, the economy recovered in 2010/11, with real GDP growing by 6.7 percent. This growth was registered despite the dismal performance of the agricultural sector, which was adversely affected by drought. Growth is however expected to about 5 percent in 2011/12. In the first and second quarter of 2011, GDP growth decelerated from 10.4 percent in Q4 of 2010 to 7.4 percent and 5.0 in Q1 and Q2 of 2011, respectively.

The risks and uncertainties surrounding the near term macroeconomic outlook are however on the upside. The gloomy global economic environment could spill over into the Ugandan economy. The country is facing new policy challenges, stemming from a difficult combination of global financial turmoil, global economic slowdown, and volatility in the international commodity markets, uncertainity in the domestic foreign exchange market and inflation pressures. Under the overlapping effects of adverse domestic and external shocks, inflation expectations remain elevated. However, growth could surprise on the upside if the government's infrastructure development programme is expeditiously implemented. As the major domestic spending drive by both the government and private sector is concentrated on extending output capacity, the Ugandan economy is not expected to experience over-heating pressures that could affect the sustainability of growth. In turn, although high deficit levels for the current account are forecast for the coming years, these will mainly be determined by the higher capital spending and will be widely be financed by foreign direct investment and medium and long-term borrowing. Overall, the economy is likely to continue to grow in the next two years, but there are many pitfalls still to negotiate along what is likely to be a long and bumpy road to optimal economic growth.

1 Introduction

The Ugandan economy remained resilient notwithstanding a series of both domestic and exogenous shocks. Despite the gloomy performance of the agricultural sector due to drought which affected production, the economy recovered in 2010/11, with real GDP growing by 6.7 percent after declining in 2009/10 at the backdrop of the delayed impact of the global economic crisis. The economy is going through supply-side shocks which induced inflationary pressures, exchange rate depreciation and volatility stemming from the turbulence in the international financial markets. The Financial Year 2011/12 begun with elevated global uncertainty and policy challenges to contain the upsurge in inflation and exchange rate depreciation. Annual headline inflation accelerated rapidly from 5.0 per cent in January 2011 to 30.5 per cent in October 2011 before declining to 29.0 percent in November 2011. This high inflation is likely to continue exerting pressure on household disposable income and will remain a major challenge to the macroeconomic stability objective. Consistent with the domestic and global developments and the elevated upside risks to inflation, BOU has implemented a tight monetary policy stance since January 2011. During this period, the policy objective has been to restrain the second round effects of the supply-side inflationary pressures and to anchor medium-to-long-term inflation expectations at levels consistent with the BOU's inflation target. Because of the tight monetary policy stance, economic growth is expected to slow to about 5.0 percent in 2011/12 as demand restrain is anticipated to reduce real growth in output of the industrial and services sectors. This report presents an overview of the recent global and domestic economic developments, in relation to macroeconomic performance and outlook in the near term and challenges and implications for monetary policy going forward.

2 Global Economic Developments and Prospects

2.3 Global Financial Markets

The global financial markets uncertainty remains entrenched mainly on account of the higher volatility and rising yields on European government bonds and a loss in investor confidence which has weakened investor base and further driven up funding costs. Financial market uncertainty has further been fuelled by the fragile growth prospects around the world and more so in the US. In October and early November 2011, yields on AAA-rated long-term euro area government bonds and comparable yields on US government bonds increased. During this period, the developments in government bond yields were largely driven by market expectations that the meeting of the euro area Heads of States held on October 26th would improve market conditions. Indeed initially, market sentiments and yields on long-term securities improved following the announcement of the decisions taken by the euro area Heads of States. However, parts of the increases in the long-term yields were quickly reversed as market sentiments deteriorated sharply after the surprise announcement by the Greek Prime Minister of a vote of

no confidence on the Greek government and a Greek referendum. On the positive side, apart from developments related to the euro area sovereign debt crisis, some better than expected economic data for the US eased investors' fears of a global economic slowdown and contributed to upward pressure on long-term government bond yields. As the tensions related to the euro area sovereign debt crisis continued to be severe, uncertainty about future bond market developments, as measured by implied bond market volatility increased and intra-euro area sovereign bond yield spreads widened further for most countries.

2.2 Global Economic Outlook

Overall, in 2011/12, the global policymakers face a much more complicated situation that is rapidly turning into a systemic crisis. First, the European sovereign-debt problem and the toxic combination of a sudden economic slowdown, potential interconnectedness between the slowdown and the financial risk, and an absence of obvious solutions to these problems constitute an alarming signal of systemic risk. While attempting to deal with the financing needs of Greece, Ireland, and Portugal, European authorities neglected to address the intensifying problems in Spain and Italy. The exposure of the European banking system to these two large countries is substantial. Second, as Europe's debt crisis has intensified, so too has that of the United States. Indeed, the cloudy economic outlook has resulted in a rush away from currencies and into gold. Another problem facing the global economy in 2011/12 is the absence of obvious policy solutions to the rapid slowdown of the real economies in the United States and Europe, as well as to the consequences flowing from these slowdowns to financial markets and from financial markets back to real economies through an adverse feedback loop.

2.3 Implications for the Ugandan Economy

Uganda, being a small open economy is exposed to developments and prospects in the global markets. The current global economic outlook threatens the economic stability of Uganda at the same time as it provides it with opportunities. The slowdown in global recovery implies slower export growth for Uganda, with implications for the overall economic growth. The slowdown in global recovery will sharply reduce the profitability of exporting to the advanced economies, particularly Europe and will also increase competition from Europe in sectors such as agriculture and garments, in which Uganda enjoys relative comparative advantage. At the same time, a lower euro may provide opportunities for domestic consumers and firms to import from Europe at lower cost and would reduce the purchasing power of European tourists in Uganda as well as the value of remittance inflows. These forces combined, could lead to a widening of the external current account deficit, with implications for the domestic exchange rate stability. The turbulence in the financial markets will add greatly to the volatility of financial markets, leading to sharp bouts of risk-aversion. This, in turn, increases the level and volatility of spreads on emerging market and developing country bonds and will make currencies more volatile across

the globe. The good news though is that commodity prices and overall inflationary pressures, particularly in advanced economies and some emerging markets have started to wane. This may feed through to domestic inflation, and would cause domestic costs of production to reduce as input costs decline, in turn, leading to an easing in domestic inflationary pressures in the near-term.

The most important policy lesson from the current financial markets volatility is one that reinforces the message that strictly pegged or fixed exchange rates together with open capital accounts and the ability to borrow abroad in foreign currencies are often a dangerous combination. To deal with the current financial market turbulence, therefore, a flexible exchange rate regime, which Uganda has continued to deploy appear to be the most appropriate policy option. Although there are sometimes costs in the adjustments process in the short run, a flexible exchange rate is better for the long term resilience of the economy, as it provides a mechanism for the economy to adjust to macroeconomic shocks, via the use of monetary policy without significant strains on economic growth.

3 Domestic economic developments

3.1 Real Economic Activity

The Ugandan economy remained resilient despite a sequence of both domestic and external shocks. After declining to 5.9 percent in 2009/10, largely on the backdrop of the global economic crisis, the economy recovered in 2010/11, with real GDP growing by 6.7 percent. This growth was registered despite the dismal performance of the agricultural sector, which was adversely affected by drought. Growth in 2010/11 was in line with the economy's long term potential growth of 6-7 percent per annum.

The services sector, which has remained the dominant sector in the Ugandan economy, contributing over 50 per cent to total output remains the main driver of economic growth, registering 8.4 per cent growth compared to the industrial and agricultural sectors, which grew by 7.9 per cent and 0.7 per cent, respectively as shown in Table 1. The impressive growth in the services and industrial sectors were largely due to the good performance of manufacturing, construction, and wholesale and retail trade. The slow pace of growth in the agricultural sector was a result of poor performances of the cash crops and fish sub-sectors, on account of adverse weather conditions experienced during the year.

Table 1: Real GDP growth, percent by sector

	2008/09	2009/10	2010/11	2011/12
Total GDP at market prices	7.3	5.9	6.7	5.0
Agriculture, forestry and fishing	2.9	2.4	0.7	2.1
Industry	5.8	6.5	7.9	5.5
Services	8.8	8.2	8.4	6.0

2011/12 is a projection

Source: Uganda Bureau of Statistics and MOFPED

Growth is however expected to decline to about 5.0 percent in 2011/12 partly because of the tight monetary and fiscal policy stance that have been implemented to curtail growth in aggregate demand. This demand restraint will reduce real growth of both the industry and services sectors, but in both cases, the growth will not turn negative. The agricultural sector's output however, is expected to recover, growing by about 2.0 percent in 2011/12, in line with the long-run average growth for the sector. The weak outlook of the current account balance for the 2011/12 and the associated exchange rate volatility could have additional adverse effects on real economic activity. The exchange rate volatility and the associated uncertainty affect the value of international trade and domestic investment as agents respond to uncertainty by reducing the volume of international transactions and delay investments, respectively. This could also involve a change in the composition of output and investment, as investors endeavour to minimise risks.

3.2 Financial sector developments

3.2.1 Liquidity Conditions and money market rates

Consistent with the tight monetary policy stance, the liquidity in the banking system has largely been tight since January 2011. Consequently, the 7-day weighted interbank rate averaged 26.02 per cent in November 2011 from 24.99 per cent in October 2010, while the overall interbank rate rose from 23.87 per cent to 28.20 per cent in the same period. Average excess reserves, a measure of liquidity in the banking system averaged Shs. 17 billion in November 2011 down from Shs. 47 billion in October 2011. This rise reflects a change in the monetary conditions indicating that this is the beginning of a process of rising interest rates, as has been anticipated. When the Bank has drained sufficient liquidity from the money market, the overall market funded by repo auctions involving different categories of securities. The developments in the interbank rates and excess liquidity are shown in Figure 1

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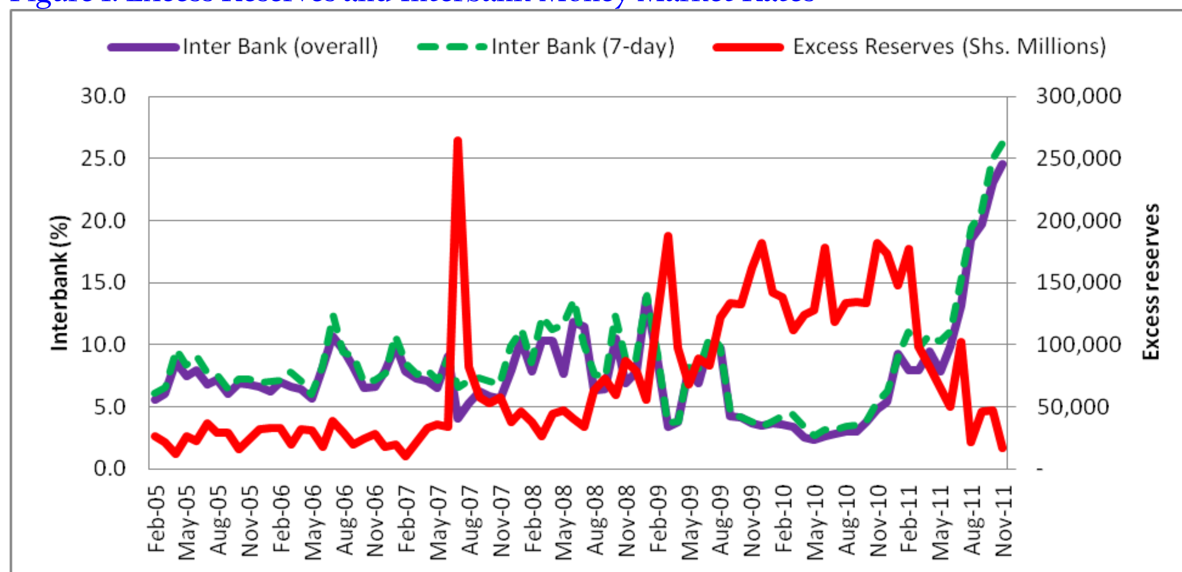
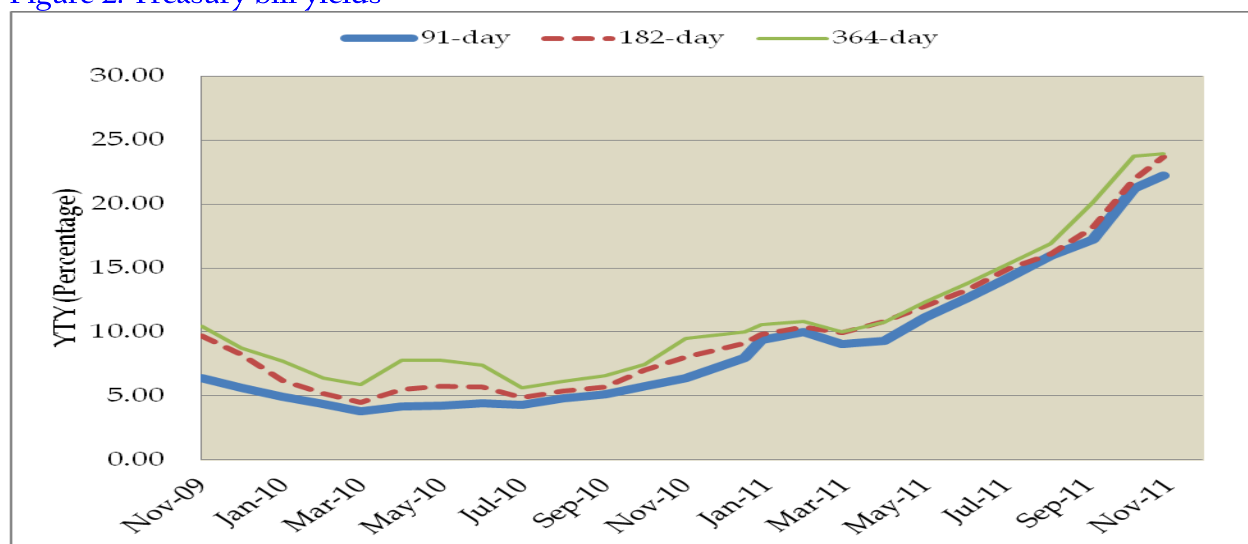
Figure 1: Excess Reserves and Interbank Money Market Rates



Source: Bank of Uganda

In line with the tight monetary policy stance, Treasury securities were issued to mop-up excess liquidity in the system. Consequently, the respective monthly weighted annualized yields on the 91-day, 182- day and 364-day debt instruments rose, partly reflecting the tight monetary policy stance and high inflation expectations going forward. The monthly weighted annualized yields on the 91-day, 182- day and 364-day Treasury bills on average increased to 22.24, 23.69, and 23.93 per cent, respectively in November 2011 from 21.23, 21.92 and 23.71 per cent in October 2011 and 6.4 percent, 8.04 percent and 9.46 percent in November 2010. Developments in Treasury bill yields are shown in Figure 2. Similarly, yields on government treasury bonds rose.

Figure 2: Treasury bill yields



Source: Bank of Uganda

3.2.2 Monetary aggregates

The tight monetary policy stance has to some extent curtailed the growth in monetary aggregates. Although the rate of growth in monetary aggregates in October 2011 remained robust, it was substantially lower than the rate of growth in September 2011. In the four months to October 2011, the annual growth in M1, M2 and M3 averaged 21.7 percent, 20.6 percent, and 25.1 percent, respectively down from respective growth rates of 27.4 percent, 32.0 percent and 35.0 percent in the corresponding period of the previous year. On a Month-on-month basis, M3, M2 and M1 growth rates were *minus* 1.7 percent, 0.1 percent and 1.8 percent, respectively, in October 2011 compared to 1.6 percent, 3.0 percent and 4.3 percent growth rates in September 2011. Going forward, the decline in the rate of growth in monetary aggregates may suppress aggregate demand, which may help rein in the second round effects of inflation at the same time as non-food inflation. However, it may also suppress private investment and economic activity, thus leading to less than optimal growth in output in the short-run.

Notwithstanding the tight monetary policy stance, private sector credit remained robust. The growth in private sector credit in the last four months averaged 42.6 percent compared to an average growth rate of 44.6 percent in the preceding four months. On a month-on-month basis, the growth in private sector credit slowed to 37.0 percent in October 2011, down from 46.8 percent in September 2011. The persistent decline in growth in private sector credit in the months ahead implies that the tight monetary policy stance that BOU has implemented since January 2011 has started to take effect. However, whereas the year-on-year growth in real CIC significantly fell to *minus* 1 percent in October 2011, it is still higher than the levels observed in 2009/10.

Table 2: Annual private sector credit growth (percent)

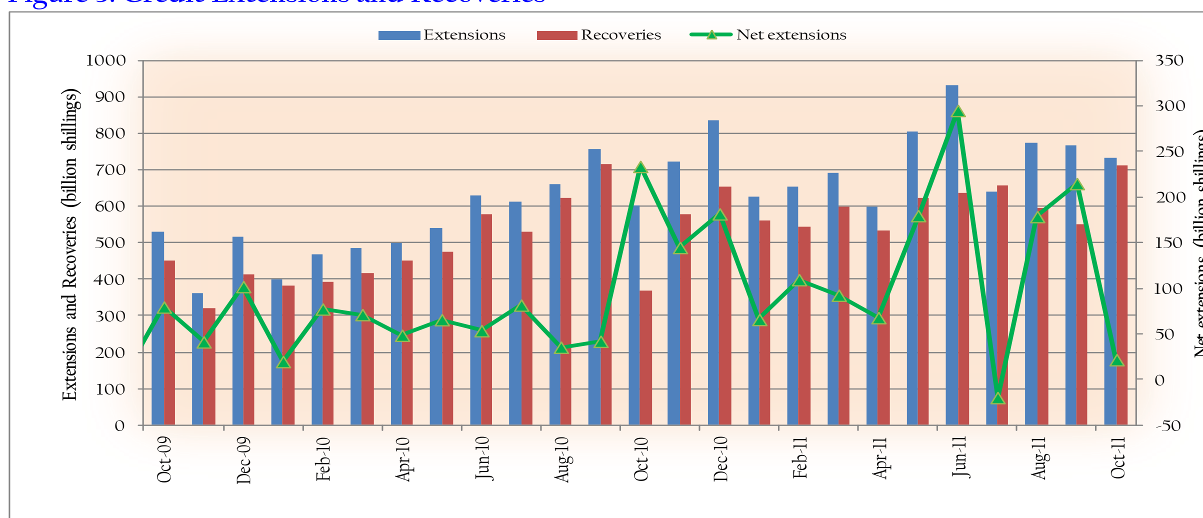
Sector	Apr-11	May-11	Jun-11	Jul-11	Aug-11	Sep-11	Oct-11
Agriculture	55	57	45	30	37	53	42
Manufacturing	52	54	49	33	42	43	20
Trade	56	57	61	53	55	36	32
Transport & Communication	29	37	43	50	45	34	24
Building, Construction & Real Estate	39	53	58	59	61	53	49
Personal Loans	-2	7	7	15	22	47	47
Shilling loans	30	32	35	32	35	36	32
Forex loans	64	56	70	71	74	78	50
Total (shs equivalent)	37	38	44	41	45	46	37

Source: Bank of Uganda

Net credit extensions also remained robust as shown in Figure 3. In the last three months to October 2011, net credit extensions averaged Shs. 111.94 billion per month compared to Shs. 103.73 billion in the corresponding period of 2010. The strong growth in private sector credit partly reflects strong demand for money to procure commodities for production and for

undertaking aggregate expenditure in the economy. It is also partly reflective of the high inflationary condition, which necessitates agents to hold money for transaction purposes. However, impact of the tight monetary policy stance is already being reflected in the decline in the negative net extension for October 2011.

Figure 3: Credit Extensions and Recoveries



Source: Bank of Uganda

3.3 Balance of payments

The current account of the balance of payments deteriorated further in the last three months to October 2011 as import growth continues to outstrip the growth of exports, tourism receipts and remittance inflows. Imports increased from US$1,205.3 million in the previous three months to June 2011 to US$1,225.1 million in the three months to October 2011, partly on account of the high international oil prices, exchange rate depreciation and growth in the domestic aggregate demand. Similarly, total exports increased from US$641.8 million to US$678.3 million, on account of higher coffee export earnings. Uganda's exports continue to be hindered by the low external demand arising from the slow pace of economic recovery in advanced economies, particularly the euro zone. The improvements in total export earnings resulted in an improvement in the trade deficit from US$563.5 million to US$546.7 million during the same period of time. In the years before the global financial crisis, Uganda was able to finance its current account deficits with large inflows of foreign capital. However, the delayed impact of the global financial and economic crisis that erupted in 2008/09 coupled with the current slow pace of recovery of the global economy and turbulent global financial markets have caused capital flows to Uganda to be intermittent and fester, with implications for the exchange rate stability. Indeed, current transfers which significantly depend on economic conditions of the source countries have decelerated rapidly in the last three months to October 2011, standing at US$ 227.3 million from US$ 564.4 million in the last three months to June 2011.

In 2011/12, trade deficit is expected to remain substantial, in part a result of the higher cost of imported oil and other investment goods. Exports are projected at US$ 2.6 billion, while imports are projected at US$ 5.1 billion, resulting in a worsening trade balance by about US$ 400 million. In addition, both foreign direct investment and donor inflows are likely to decline, due to the weak global outlook and uncertainty. These developments are likely to put pressure on the exchange rate. Developments in the current account of the BOP are presented in Table 3 and appendix 2.

Table 3: The current account of the balance of payments in million dollars

	2009:Q2	2009:Q3	2009:Q4	2010:Q1	2010:Q2	2010:Q3	2010:Q4	2011:Q1	2011:Q2	2011:Q3
Current Account Balance	-271.5	-313.2	-267.6	-412.0	-502.2	-425.9	-319.9	-701.8	-365.8	-686.3
Trade Balance	-352.4	-372.5	-332.3	-415.0	-577.9	-503.4	-604.2	-638.0	-563.5	-546.7
Total Exports (fob)	556.0	559.1	647.4	587.4	523.4	504.4	548.8	615.9	641.8	678.3
Total Imports (fob)	-908.4	-931.6	-979.7	-1,002.4	-1,101.3	-1,007.7	-1,153.0	-1,254.0	-1,205.3	-1,225.1
Services Account (net)	-97.6	-103.7	-141.7	-157.2	-130.3	-245.1	-23.3	-199.8	-272.8	-275.4
Inflows	217.1	282.2	259.7	286.6	367.8	228.0	472.9	389.9	319.5	255.8
Outflows	-314.7	-385.9	-401.3	-443.8	-498.1	-473.0	-496.2	-589.7	-592.3	-531.1
Income Account (net)	-99.4	-108.2	-87.8	-94.2	-92.0	-84.7	-95.0	-95.9	-93.9	-91.5
Inflows	16.2	6.3	8.7	4.6	4.3	4.0	8.4	4.0	4.7	5.6
Outflows	-115.6	-114.5	-96.6	-98.7	-96.3	-88.7	-103.4	-100.0	-98.6	-97.1
Current Transfers (net)	277.9	271.1	294.1	254.3	298.0	407.2	402.6	231.9	564.4	227.3
Inflows	350.1	361.6	405.5	370.2	340.8	467.7	433.3	349.0	660.1	321.2
Outflows	-72.2	-90.5	-111.3	-115.9	-42.8	-60.6	-30.7	-117.0	-95.7	-93.9

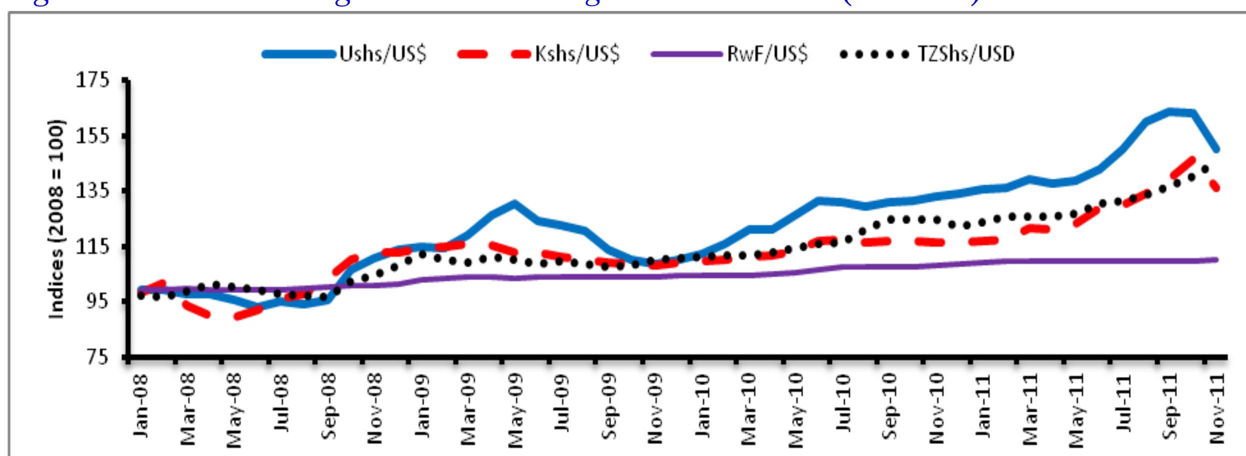
Source: Bank of Uganda

3.4 The exchange rate

On an average basis, the Uganda Shilling appreciated by 8 percent but depreciated by 12.8 percent, on monthly and annual basis, respectively, to an average midrate of Shs. 2,582.18 per US dollar, in November 2011. The appreciation of the Shilling on monthly basis was mainly due significant dollar inflows from offshore investors, NGOs and coffee export proceeds, amidst tight liquidity conditions and low corporate demand. The significant offshore dollar inflows that have been recorded since the beginning of October 2011 are mainly on account of the attractive interest rates occasioned by BOU's tight monetary policy, aimed at bringing down inflation.

In the region, while the Kenya Shilling appreciated by 7.9 percent to an average midrate of KES 94.05/US$ in November 2011, the Tanzania Shilling depreciated by 3.6 percent to an average midrate of TZS 1,742.17/US$, and the Rwanda Franc remained relatively stable at an average midrate of RWF 601.78/US$. Developments in regional currencies are shown in Figure 4.

Figure 4: Trend of the Regional Currencies against the US dollar (2008=100):

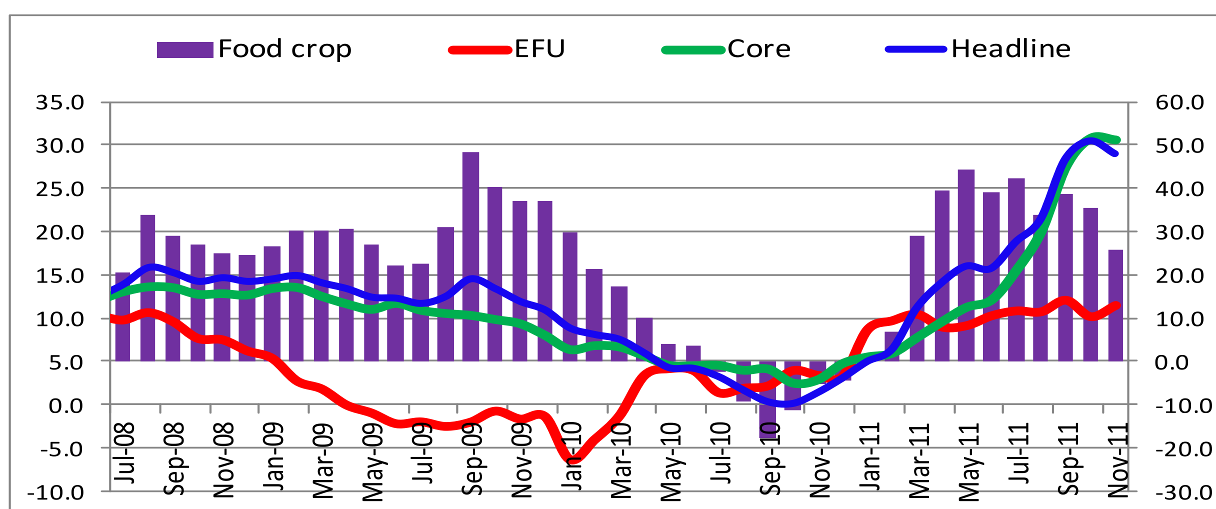


Source: Bank of Uganda

3.3 Inflation and its determinants

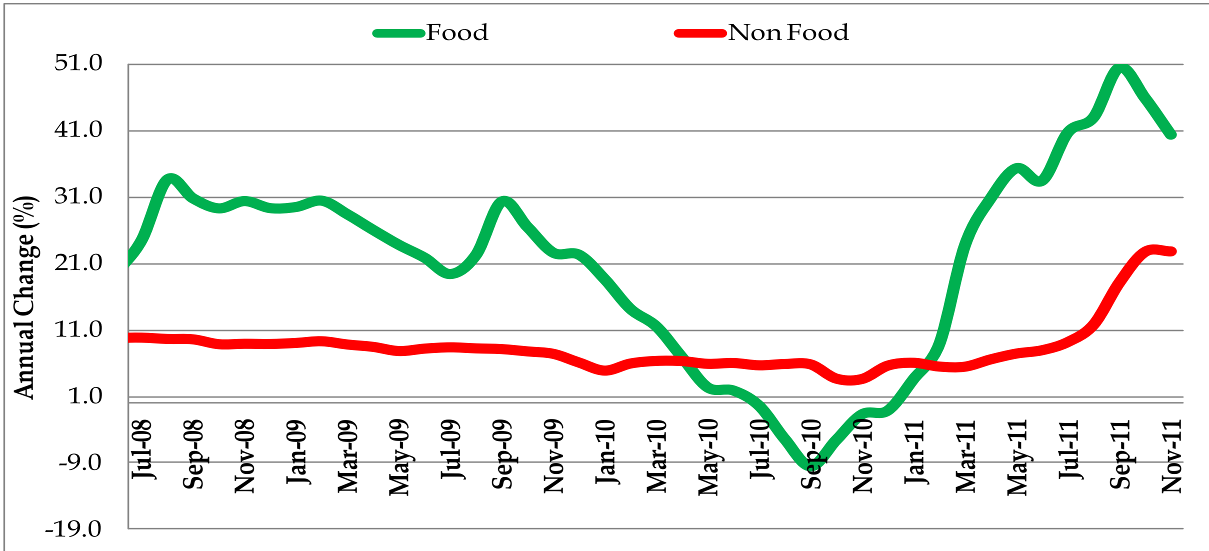
Inflationary pressures continue to persist, both on the domestic and global scene. On the domestic scene, inflationary momentum slightly decelerated in November 2011. Annual headline inflation declined to 29 percent in November 2011 from 30.4 percent in October 2011. The decrease in headline inflation was mainly driven by the decline in food prices, while non-food CPI inflation also moderated slightly. Similarly, annual core inflation marginally declined to 30.6 percent from 30.8 percent in October 2011. Annual food inflation dropped to 40.3 percent from 45.8 percent, in tandem with the food crops inflation which dropped by about 10.0 percentage points to 25.8 percent in November 2011 from 35.3 percent in the previous month. This is the first decline in inflation in since June 2011. Inflation developments are shown in Figure 5.

Figure 5: Annual inflation developments: July 2008 – November 2011



High food prices, which had been the main driver of domestic inflation, have started to decline as harvests and food supplies improve. Annual food price inflation declined to 40.3 percent in November 2011 from 45.8 percent in October 2011. However, non-food inflation, which is mainly driven by demand conditions, remains high at 22.9 percent in November 2011 up from 22.8 percent in October 2011 as shown in Figure 6. On a month-on-month basis, however, non-food inflation decreased to 0.4 percent in November 2011 from 2.0 percent in October 2011 compared to food inflation which declined to *minus* 0.3 percent in November 2011 from 0.0 percent in October 2011.

Figure 6: Annual food and non-food inflation (per cent): July 2008-November 2011



Source: Uganda Bureau of Statistics

The disaggregation of commodities in Table 4 reveals relative slowdown in the annual food price in November 2011. However the main drivers of food inflation remain sugar, tea and spices, fish, staples and meat & poultry, whose indices increased by 109.3 percent, 34.9 percent, 44.2 and 44.1 percent, respectively. The relative slowdown in the inflation momentum during the month may be attributed to the exchange rate appreciation and increased food supply to the markets as reflected by a further downward trend in a number of key categories (such as staples, dry vegetables and fresh fruits) since July 2011.

Table 4: Annual percentage increases in prices of some commodities in the CPI basket

	weight	2010 M11	2010 M12	2011 M01	2011 M02	2011 M03	2011 M04	2011 M05	2011 M06	2011 M07	2011 M08	2011 M09	2011 M10	2011 M11
Food	27.2													
staples	6.6	-18.8	-21.5	-13.8	-1.3	28.6	47.0	65.9	69.5	93.6	83.7	82.0	66.6	44.2
Fresh Fruit	1.1	9.5	26.7	21.6	11.8	24.2	22.7	37.1	33.7	37.6	30.2	29.6	19.1	16.2
Fresh Vegetables	1.8	8.6	22.7	30.7	8.8	22.5	35.5	12.5	-1.1	-11.0	-11.7	17.9	22.8	27.3
Dry Vegetables	2.5	4.0	7.2	10.9	14.3	28.3	30.2	31.8	32.2	25.0	18.9	15.4	12.5	10.9
Meat & poultry	3.2	8.1	9.1	15.0	17.4	20.4	24.2	32.2	32.3	33.4	39.2	43.4	47.4	44.1
Fish	1.6	39.5	37.8	39.1	41.1	37.1	49.8	43.3	33.8	27.8	35.8	30.0	23.9	34.9
Milk & eggs	2.1	9.6	7.9	8.2	10.8	28.9	25.3	25.5	18.8	13.2	6.9	5.2	7.3	12.0
Oils & fats	0.99	8.5	13.4	21.3	28.2	34.4	36.5	38.1	36.2	39.9	36.2	42.5	42.1	37.4
Sugar, tea & spices	2.7	3.0	2.97	3.7	7.3	9.4	8.6	15.0	3.0	32.8	76.7	138.0	112.9	109.3
Rent,fuel & utilities	14.8													
HH Repair & Main.	7.8	-1.6	0.5	6.2	9.0	12.8	13.9	15.9	18.3	20.8	23.0	25.6	27.7	29.0
HH. Personal goods	4.5													
Soap,toiletries etc	2.4	7.4	8.8	13.2	14.0	19.0	21.3	23.8	26.8	28.6	29.8	34.4	35.1	36.3
HH textile & furniture.	1.1	11.4	12.4	12.3	12.5	13.1	16.2	21.7	20.5	22.6	23.4	26.3	26.1	26.6
Other HH. goods	0.9	0.2	2.9	3.9	8.38	7.9	9.5	12.4	14.1	15.5	17.9	20.4	22.3	23.5
Transport & communication	12.8													
Transport fares	4.4	3.0	10.6	6.6	9.3	14.1	15.5	14.2	18.8	19.5	21.2	25.2	22.6	24.7
Communication	5.59	-46.1	-46.1	-45.6	-45.6	-66.5	-66.5	-66.5	-66.5	-66.5	-66.5	-45.2	1.7	1.7
Other transport & communication costs	2.79	12.6	13.1	15.1	16.6	17.5	16.2	18.8	20.5	21.8	21.4	23.0	20.5	26.3
Health, Entertainment & others	16.83													
Meals in Restaurants	8.28	11.7	15.9	15.9	15.5	16.8	17.5	19.2	15.8	15.6	17.9	22.1	22.0	23.1

Source: UBOS

Uganda being a small open economy is highly susceptible to developments in the global financial markets, with implications for exchange rate stability. Therefore a depreciation of the shilling against foreign currencies results in significant pass-through to consumer price inflation. The correlation coefficient between consumer price inflation and the annual rate of nominal exchange rate depreciation between October 2008 and August 2011 was 0.29 compared to a correlation coefficient of 0.13 between January 1996 and October 2011, suggesting that the pass-through to inflation could have increased due to elevated inflation pressures. But a salient feature of the data is that this correlation was negative between 1996 and 2008. Many of the basic facts of the behaviour of inflation dynamics in the pre-global crisis period of 2008-less persistence of inflation, less responsiveness of inflation to shocks to energy prices and the exchange rate-can all be explained by recognizing that, in this period, expectations of inflation

were much more solidly anchored. Moreover, with expectations of inflation anchored, real shocks arising from various channels-whether from aggregate demand, energy prices, or the foreign exchange rate-had a smaller effect on expected inflation and hence on trend inflation. An important observation is that low exchange rate pass-through will only occur if the BOU anchor's the public's expectations that it will continue to respond aggressively to shocks that have potentially persistent adverse effects on inflation.

3.4 Monetary Policy

Since January 2011, BOU pursued a tight monetary policy stance in line with the domestic and global developments, and the persistent upside risks to domestic inflation. The objective of this policy was to curb the second round effects of the supply-side inflationary pressures and to anchor medium-to-long-term inflation expectations at levels consistent with the BOU's inflation target. In addition, the tight monetary policy stance was expected to help tame the depreciation pressures.

Since July 2011, monetary policy has been implemented under the Inflation Targeting Lite (ITL) framework. Under this framework, the implementation of monetary policy involves setting the Central Bank Rate (CBR), defined as a target for the 7-day interbank interest rate on a monthly basis. Monetary policy is implemented by influencing interest rates in the money market through targeting the range for the 7-day interbank. When the ITL started, the target range extended over two percentage points but this was increased to four percentage points in September 2011 in response to the high volatility in the interbank money market rates. BOU has been using repos and reverse repos to influence the supply of funds in the interbank money market to keep the interbank rate within the tolerable bands of the CBR.

As shown in Table 5, the BOU policy rate (the Central Bank Rate) has been raised from 13 percent in July 2011, when it was first introduced to 23 percent in November 2011. In line with the monetary policy stance, BOU issued Treasury securities to keep structural liquidity in line with the programme levels and fine tuned daily liquidity in interbank using Repos and Reverse Repos. The BOU's strategy of raising the CBR is to curb growth in bank credit in order to dampen the growth of aggregate demand. Dampening aggregate demand will not directly prevent inflation emanating from supply side shocks, such as drought, but it will prevent inflation from spilling over and becoming entrenched in prices throughout the economy. Consequently, as the supply shocks begin to dissipate, inflation will abate.

Table 5: Central Bank rate

	CBR (Percent)	Band (+/-)
Jul-11	13	2
Aug-11	14	2
Sep-11	16	4
Oct-11	20	4
Nov-11	23	4

Source: Bank of Uganda

Consistent with the tight monetary policy stance, yields on government securities rose significantly since the beginning of 2011 as shown in Figure 3. Commercial bank lending rates have consequently hedged up since June 2011. It is likely that they will rise further because most banks have now increased their prime lending rates to between 22 and 30 percent. The weighted average lending rates on domestic currency denominated loans increased by 210 basis points and from 23.34 percent in September 2011 and 23.55 percent in October 2011. Because of competition for funds within the banking sector, time deposit rate decreased to 12.85 percent in October 2011 from 14.43 percent in September. Consequently, the spread widened to 10.7 percentage points in October 2011 from 8.91 percentage points in September 2011.

3.4.1 Monetary Policy Challenges

Going forward, inflation is forecast to remain in the double-digit levels in the second half of 2011/12 mainly due to the base effects, uncertainty in the foreign exchange market, high inflation expectations, and high inflation in Uganda's major trading partners. In addition, uncertain commodity prices, especially crude oil and grain prices remain a risk as their movements have been volatile throughout the year. If the recovery in the advanced economies picks up, there may be an upward pressure on the global commodity prices. Supply side inadequacies could also keep prices inflated. Possible additional supply-side shocks that could energise the inflation dynamics in the near term are particularly worrying. This cannot be ruled out given the supply-side problems in the agricultural sector that have persisted within a context of high regional food demand, relatively low productivity of both agricultural and food-processing sectors, high vulnerability of farming output to weather conditions. The existence of some structural dysfunctions and inefficiencies in the local food market, coupled with some inadequacies in price-setting behaviour of the business community also add to the upside risks to inflation.

Given the multi-faceted causes of inflation, BOU is encountering monetary policy dilemma in trying to contain inflation pressures. Monetary policy works by influencing the level of aggregate demand in the economy. Faster growth of aggregate demand relative to aggregate supply tends to lead to higher inflation and vice versa. The supply side driven inflationary

pressures and external supply disruptions caused domestic inflation to rise above the BOU target of 5 per cent. Monetary policy therefore cannot prevent increases in food prices when these increases are the result of supply side shocks such as drought and the external supply chain disruptions. Given that monetary policy is effective only on the demand side, the BOU monetary policy thus focused at preventing supply side shocks to food prices from triggering higher prices in the non-food inflation.

There seem to be very few options for BOU in the face of this multi-faceted inflation that is causing problems in Uganda. Monetary tightening has almost reached a plateau, whereby any further tightening could severely undermine economic growth. In terms of the classic policy "trilemma" of open economies, the option for inflation targeting means that Uganda chose to have an independent monetary policy, free capital flows, and a floating exchange rate. However, because the exchange rate is an important determinant of inflation, as the change in the domestic price of tradable goods in Uganda is basically determined by foreign inflation and exchange-rate variations. On the other hand, the prices of some key non-tradable goods in Uganda are also tied to the exchange rate because of transportation costs and the fact that some commodities follow an implicit price index that is heavily influenced by the exchange rate. The inevitable result is that a major part of the Ugandan inflation is linked to the exchange rate. Given the centrality of the exchange rate for Ugandan inflation, taming inflation might involve at least a loose exchange-rate targeting. This option is however constrained by declining foreign exchange reserves which BOU could use to fight the depreciations.

4 Implications for Monetary Policy Going Forward

The risks and uncertainties surrounding the near term macroeconomic outlook are still significant. The continued restrain on the medium-term global growth outlook is mainly due to the renewed financial markets stresses particularly in advanced economies. This gloomy global economic environment could spill over into the Ugandan economy. However, growth could surprise on the upside if the government's infrastructure development programme is expeditiously implemented. As the major domestic spending drive by both the government and private sector is concentrated on extending output capacity, the Ugandan economy is not expected to experience over-heating pressures that could affect the sustainability of growth. In turn, although high deficit levels for the current account are forecast for the coming years, these will mainly be determined by the higher capital spending and will be widely financed by foreign direct investment and medium and long-term borrowing. On the flip side, however, the potential stalling of infrastructure development momentum could further drive down growth prospects. In summary, the economy is likely to continue to grow in the next two years, but

there are many pitfalls still to negotiate along what is likely to be a long and bumpy road to optimal economic growth.

The risks to both domestic and global inflation are still on the upside. One risk in the current situation is that the higher inflation will have a more tangible – and unwarranted – impact on long-term inflation expectations. The BOU is facing policy challenges, stemming from a difficult combination of global financial turmoil, possible global economic slowdown, volatility in commodity markets, uncertainity in the foreign exchange market, and inflation pressures. The risks arising from the pass-through of the supply shock factors into future inflation via inflation expectations and the need to avoid second-round effects of the supply shocks require a continued tight monetary policy stance.

The current inflationary scenario that exists in Uganda is not unique. A significant number of the developing countries are struggling to come to grips with rising inflation. Although in the past BOU has managed to bring down inflation without compromising economic growth, inflation has probably become the most troublesome problem for the BOU at present that bringing down could cost economic growth significantly. This concern is certainly not misplaced, especially on account of sustained increases in energy and food prices over the past year, coupled with the exchange rate depreciation.

Appendix 1: Balance of payments

	05/06	06/07	07/08	08/09	09/10	10/11
A. Current Account Balance (A1+A2+A3+A4)	-314.5	-342.0	-902.7	-1,258.1	-1,532.7	-1,808.4
A1. Goods Account (Trade Balance)	-927.7	-1,021.3	-1,437.4	-1,845.8	-1,697.6	-2,284.7
a) Total Exports (fob)	1,041.2	1,473.8	2,073.0	2,216.4	2,317.3	2,307.2
b) Total Imports (fob)	-1,969.0	-2,495.2	-3,510.4	-4,062.2	-4,014.9	-4,591.9
A2. Services Account (services net)	-175.4	-270.6	-477.5	-439.7	-526.9	-696.7
a) Inflows(credit)	523.4	556.4	644.7	884.3	1,210.7	1,407.0
b) Outflows(debit)	-698.7	-827.0	-1,122.2	-1,324.0	-1,737.6	-2,103.6
A3. Income Account (Income net)	-248.7	-228.6	-262.1	-307.4	-382.2	-364.1
a) Inflows(credit)	53.5	87.9	115.7	92.9	23.9	17.7
b) Outflows(debit)	-302.2	-316.5	-377.8	-400.4	-406.1	-381.8
A4. Current Transfers (net)	1,037.3	1,178.5	1,274.3	1,334.8	1,074.0	1,537.1
a) Inflows (Credit)	1,236.3	1,324.8	1,520.2	1,754.0	1,552.0	2,037.5
b) Outflows (Debits)	-199.0	-146.3	-245.9	-419.2	-478.0	-500.4
B. Capital & Financial Account Balance (B1+B2)	879.0	1,060.6	1,185.7	1,254.3	1,659.1	1,070.1
B1. Capital Account	126.8	3,428.1	0.0	0.0	0.0	0.0
B2. Financial Account; excl. financing items	752.2	-2,367.5	1,185.7	1,254.3	1,659.1	1,070.1
a) Direct Investment	512.0	718.3	760.6	785.2	837.8	913.3
i) Direct investment abroad	0.0	0.0	0.0	0.0	0.0	0.0
ii) Direct investment in Uganda	512.0	718.3	760.6	785.2	837.8	913.3
b) Portfolio Investment	-5.6	77.6	66.3	-34.7	-31.3	-4.8
Assets	0.0	0.0	-12.1	0.0	0.0	0.0
Liabilities	-5.6	77.6	78.4	-34.7	-31.3	-4.8
c) Financial derivatives, net	0.0	0.5	-0.1	6.3	-5.3	1.3
Monetary authorities	0.0	0.0	0.0	0.0	0.0	0.0
General government	0.0	0.0	0.0	0.0	0.0	0.0
Banks	0.0	0.5	-0.1	6.3	-5.3	1.3
Other sectors	0.0	0.0	0.0	0.0	0.0	0.0
d) Other Investment	245.7	-3,163.9	359.0	497.5	857.9	160.3
Assets	107.5	-156.0	75.5	-78.7	-24.6	-280.5
Liabilities	138.2	-3,007.9	283.5	576.2	882.5	440.8
C. Errors and Omissions	-366.3	-14.7	279.9	-42.0	84.5	156.9
D. Overall balance (A+B+C)	198.2	703.8	563.0	-45.7	210.9	-581.4
E. Reserves and related items	-198.2	-703.8	-563.0	45.7	-210.9	581.4
a) Reserve assets	-24.1	-682.5	-538.9	61.3	-198.3	584.5
b) Use of Fund credit and loans	-138.8	0.0	0.0	0.0	0.0	0.0
c) Exceptional Financing	-35.3	-21.4	-24.1	-15.6	-12.6	-3.1