Bank of Uganda

Current State of the Ugandan Economy

Research and Policy Function

December 2013

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EXECUTIVE SUMMARY

Although global economic activity is continuing to recover gradually, it remains heterogeneous across economic regions, with growth momentum firming up in advanced economies but losing some vigour in emerging markets. Overall, the global outlook continues to be surrounded by considerable uncertainty and the balance of risks remains tilted to the downside.

Given the large output gaps, inflation pressures will remain subdued in advanced economies and they have recently subsided somewhat in many emerging economies. Policy rates in advanced economies are firmly held close to the zero lower bound, while emerging economies have considerable leeway to accommodate a deceleration in economic activity if necessary.

Global inflation is expected to remain low amongst the advanced economies in 2013 as any pick-up in activity is not expected to close the negative output gaps. However, inflation is expected to remain slightly elevated in emerging market and developing economies due to domestic capacity constraints and the exchange rate depreciation pressures.

The global outlook continues to be surrounded by considerable uncertainty and the balance of risks remains tilted to the downside. Developments in global money and financial market conditions and related uncertainties may negatively affect Uganda economic conditions. Other downside risks include higher commodity prices and weaker than expected global demand.

The European sovereign debt continues to pose downside risks. Other downside risks to global activity include the US Federal Reserve's Asset Purchase Program; as the program is unwound global financial markets are expected to tighten, large-scale capital flows are expected to occur from emerging to advanced economies and emerging economies are expected to suffer heightened exchange rate volatility and slow growth. Whilst Uganda might suffer some capital outflows, it is likely to suffer more from the slowdown in emerging economies. Developments in global money and financial market conditions and related uncertainties may negatively affect Uganda economic conditions.

Crude oil prices have stabilized however wide price swings are expected in the near term due to uncertainties in the global economic recovery and possibly supply disruptions. Fears of possible supply disruptions in the MENA region have subsided and this points to a potential weakening of crude oil risk premia in the coming months, with the crude oil price trading more in line with supply and demand fundamentals. The forecasts for Brent price are in the range of $100-106/barrel for 2013 and 2014. However, energy price forecasts are highly uncertain, and prices could differ significantly from the forecast levels.

Uganda's growth rate recovered in 2012/13 and the near term outlook appear to suggest that Uganda's real GDP growth should remain buoyant, at around 6.2 percent in 2013/14 and around 6.7 percent in 2014/15. Of course achieving a growth rate of 7 percent or higher may happen from time to time, but the trend might not rise *to a sustained growth at that level largely because the only path to rapid growth is through export led development and so far exports growth remains weak reflecting subdued global output growth. In addition, in the short to medium term, the unpredictable behavior of commodity prices and international capital market conditions will continue to be a deterrence to Uganda's rapid economic growth. In the near term, domestic demand is supported by expansionary fiscal policy although its contribution to GDP growth could decrease over time due to the fast increasing public debt. In 2014/15, stronger bank loan supply to the non-financial private sector and the recovery of global economy could contribute positively to overall economic growth.*

The Ugandan Shilling has stabilized along an appreciation trajectory since January 2013. A stronger shilling has been disinflationary via import prices. The current exchange rate trend may be a result of improved confidence, when compared to the drop in confidence triggered by the suspension of donor budget support in 2012 Q4, and thus may be expected to continue.

In September 2013, the Bank of Uganda responded to rising food prices and raised the Central Bank Rate (CBR) from 11.0 per cent to 12.0 per cent to prevent any second-round effects and to anchor inflation expectations. The increase in the CBR was immediately transmitted to interbank and other wholesale market interest rates. In October 2013, annual core and headline inflation declined and month on month inflation indicated a deceleration, driven by decline in food and food crops inflation. Declining monthly inflation indicates that the prevailing inflation pressures may have weakened and that Uganda may be entering a period of disinflation, although it is still early to be definitive. Nonetheless, food prices continue to keep inflation risks elevated.
As in a result of balance of risks to higher inflationary pressures, in October and November 2013, the BOU took a neutral monetary policy stance, maintaining the CBR at 12 percent. The outlook of low annual inflation reflects slowdown in energy and commodity prices and appreciation of the shilling.

Going forward, consumer prices can be expected to rise only modestly for now, partly because domestic demand is still subdued. Food prices remain the main source of inflation, while the contribution of tax changes has decreased. However, inflationary pressures will re-emerge only slowly over the forecast horizon, with import prices contributing to rising costs in the second half of the financial year in particular. The inflation outlooks expect a falling trend in oil prices over the forecast horizon.

The period ahead is likely to bring fresh shocks and bouts of CPI volatility that need to be handled carefully. For the most part, monetary policy and flexible exchange rates will provide the right tools to cope with such shocks. However, in case of sudden large pressures for capital outflows, the BOU should stand ready to use foreign exchange interventions to preserve orderly market conditions. BOU should not try to defend exchange rates at fundamentally unsustainable levels, or to use interventions as a substitute for a necessary tightening of macro policies. More broadly, there is no better insurance against market pressures than maintaining credible policy *frameworks and strong foreign exchange buffers.*

1 Recent International economic Developments

1.1 Global growth

The global economy continues to expand at a moderate pace with a persistent divergence between weak performance in mature economies and solid performance in emerging economies. Although global economic activity is continuing to recover gradually, it remains heterogeneous across economic regions, with growth momentum firming up in advanced economies but losing some vigour in emerging markets. The latest survey indicators continue to point towards improved growth prospects for the global economy in the fourth quarter. The global Purchasing Managers' Index (PMI) for all-industry output increased substantially to 55.5 in October, from 53.6 in September, driven by an acceleration in the global services sector, while the output index for the global manufacturing sector decelerated slightly. Excluding the euro area, the all-industry output PMI also increased sharply to 56.3 in October, from 53.9 in September. Recent releases of hard data confirm the gradual pick-up in advanced economies' output growth, underpinned by strengthened short-term prospects in the United Kingdom and relatively robust economic activity in the United States and Japan. In the emerging markets, China's growth appears to have regained some traction in the third quarter on the back of a modest policy stimulus, but in most other emerging countries economic activity continues to be muted, hampered by structural impediments and tighter financial conditions.

Overall, the global economic activity remains weak, marked by slowed growth amongst the major emerging market economies (EMEs) particularly India, China and Brazil. In line with subdued global economic activity, the world economic activity forecasts for 2013 have been downgraded. Global growth is projected at 2.9 percent in 2013, this is less than the 3.1 percent and 3.3 percent forecast in the July and April 2013 World Economic Outlook (WEO) and expected to recover to 3.6 percent in 2014 (***table 1***).

As the global growth momentum shifts from the emerging to the advanced economies, the strength of domestic economic policies will be crucial for how countries can cope with the combination of lower commodity prices and tighter external financing conditions. Meanwhile, longer-term U.S. interest rates have started to rise, with knock-on effects for emerging markets. Across all of the financially integrated economies of Latin America, bond yields have increased, equity prices have fallen, and currencies have depreciated since May, when the U.S. Fed first mentioned the possibility of tapering its bond purchases later this year. Financial conditions remain fairly benign for now, but the strong tailwind from ultra-low external financing costs may also be gone for good.

Table 1: World economic growth projections (per cent)

	Annual GDP growth		July 2013 WEO projections		October 2013 WEO projections		Difference from July 2013 WEO	
	2011	2012	2013	2014	2013	2014	2013	2014
World	3.9	3.2	3.1	3.8	2.9	3.6	–0.3	–0.2
Advanced Economies	1.7	1.5	1.2	2.1	1.2	2.0	0.0	0.0
United States	1.8	2.8	1.7	2.7	1.6	2.6	–0.1	–0.2
Euro Area	1.5	–0.6	-0.6	0.9	–0.4	1.0	0.1	0.0
Japan	–0.6	2.0	2.0	1.2	2.0	1.2	-0.1	0.1
United Kingdom	1.1	0.2	0.9	1.5	1.4	1.9	0.5	0.4
Canada	2.5	1.7	1.7	2.2	1.6	2.2	-0.1	–0.1
Other Advanced Economies	3.2	1.9	2.3	3.3	2.3	3.1	0.0	–0.2
Emerging Market and Developing Economies	6.2	4.9	5.0	5.4	4.5	5.1	–0.5	–0.4
Central and Eastern Europe	5.4	1.4	2.2	2.8	2.3	2.7	0.2	-0.1
Commonwealth of Independent States	4.8	3.4	2.8	3.6	2.1	3.4	–0.7	–0.3
Developing Asia	7.8	6.4	6.9	7.0	6.3	6.5	–0.6	–0.3
Latin America and the Caribbean	4.6	2.9	3.0	3.4	2.7	3.1	–0.3	–0.3
Sub-Saharan Africa	5.5	4.9	5.1	5.9	5.0	6.0	–0.2	0.1
European Union	1.7	–0.3	-0.1	1.2	0.0	1.3	0.2	0.1
Middle East and North Africa	3.9	4.6	3.0	3.7	2.1	3.8	–0.9	0.0

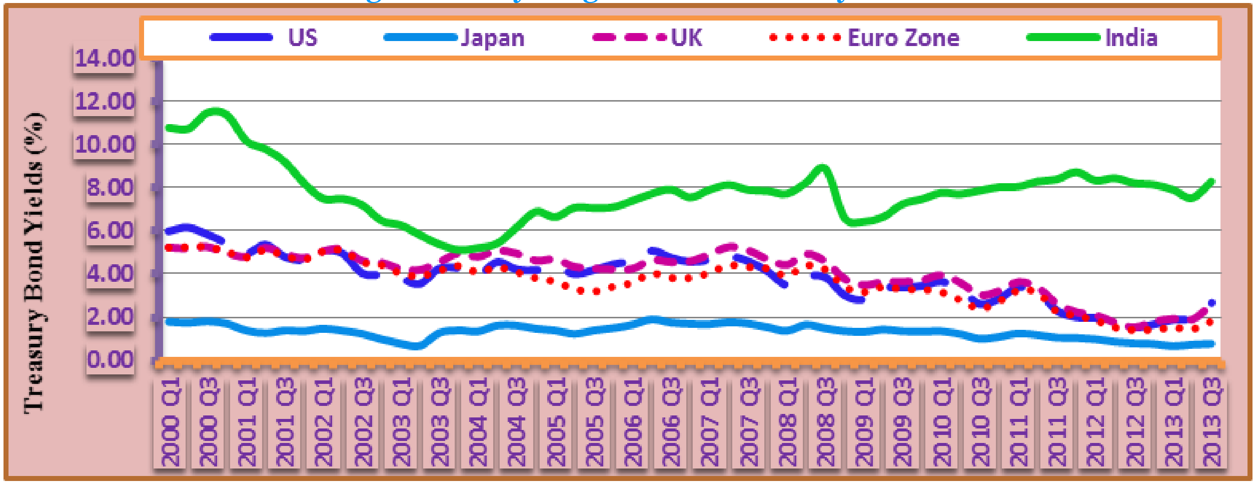
Source: Would Economic Outlook, October 2013

1.2 Global financial markets

Global financial markets remained jittery during Q3 2013 though some stability was noted in October 2013, following the passing of the deal to end the 16 day US Federal government shut down and allow for an increase in the debt ceiling. The stability is also attributed to the US Federal Reserve's decision to stay its Large Asset Purchase program, continuing to inject liquidity into the financial system in order to boost economic activity. The initial announcement that the US Federal Reserve could taper the large asset purchase program had led to an increase in long term yields in the US and other advanced economies and strengthened the US Dollar. Ten year government bond yields in the US rose from an average of 2.0 per cent in Q2 2013 to 2.7 per cent in Q3 2013. Similarly, ten year government bond yields rose in the UK and Eurozone. ***Figure 1*** below shows the trend of 10-year government bond yields in selected advanced and emerging market economies.

The rise in long term yields in the advanced economies led to both desirable and undesirable adjustments in the emerging market economies. One of the desirable adjustments included a correction of the exchange rate as some currencies such as the Brazilian Real, which were thought to be overvalued depreciated following the strengthening of the US dollar against most world currencies. The undesirable adjustments included selloffs of risky assets, leading to capital outflows in some emerging economies as investors sought safe haven in the advanced economies. Emerging market economies are now facing a period of more volatile external conditions and higher risk premiums. The outlook for the global financial markets is for continued financial market volatility until a point when there is certainty about the US Federal Reserve Large Asset Purchase Programme.

Figure 1: 10 year government bond yields



Source: Bloomberg

1.3 Global inflation

Overall, global inflation remains contained, on account of prevailing spare capacity in advanced economies. In the OECD area, consumer price inflation was 1.5 percent year on year in September 2013, compared with 1.7 percent in August. This decline was driven by markedly lower energy price inflation and a slight decrease in food price inflation. Decline in annual headline inflation was observed in most OECD countries and large emerging economies, with the exception of Japan and China, where it increased. In a number of countries, however, inflation remained above the targets announced by the respective monetary authorities. Turning to commodity price developments, Brent crude oil prices were broadly stable during October, before declining by 2 in early November. On 6 November, they stood at USD 106 per barrel, approximately the same as their level one year ago. Global oil demand is forecast to remain flat in the fourth quarter of the year, while non-OPEC oil supply, particularly in the United States, is expected to pick up strongly. This notwithstanding, Brent crude oil prices were robust, owing to the impact of large supply disruptions in several countries in the Middle East and Africa (Iraq, Libya and Nigeria). Over the medium term, market participants anticipate slightly lower oil prices, with December 2014 futures prices trading around USD 102 per barrel.

Global inflation pressures remained low due to subdued global demand. In Q3 2013, the advanced economies inflation was low due to weak economic conditions while in some emerging and developing economies, inflation remained relatively high on account of domestic demand pressures and domestic supply-related shocks. ***Table 2*** below shows the trend of inflation in selected countries.

Table 2: Consumer price inflation

	2012	Q4 2012	Q1 2013	Q2 2013	Jul 13	Aug 13
Japan	0.0	-0.2	-0.6	-0.3	0.7	0.9
United Kingdom	2.8	2.7	2.8	2.7	2.8	2.7
United States	2.1	1.9	1.7	1.4	2.0	1.5
Euro zone	2.5	2.3	1.9	1.4	1.6	1.3
Brazil	5.4	5.6	6.4	6.6	6.3	6.1
China	2.6	2.1	2.4	2.4	2.7	2.6
India (WPI)[1]	7.5	7.3	6.7	4.8	5.8	6.1
South Africa	5.7	5.7	5.8	5.6	6.4	6.4

[1] WPI (Wholesale Price Index) is the price of a representative basket of wholesale goods

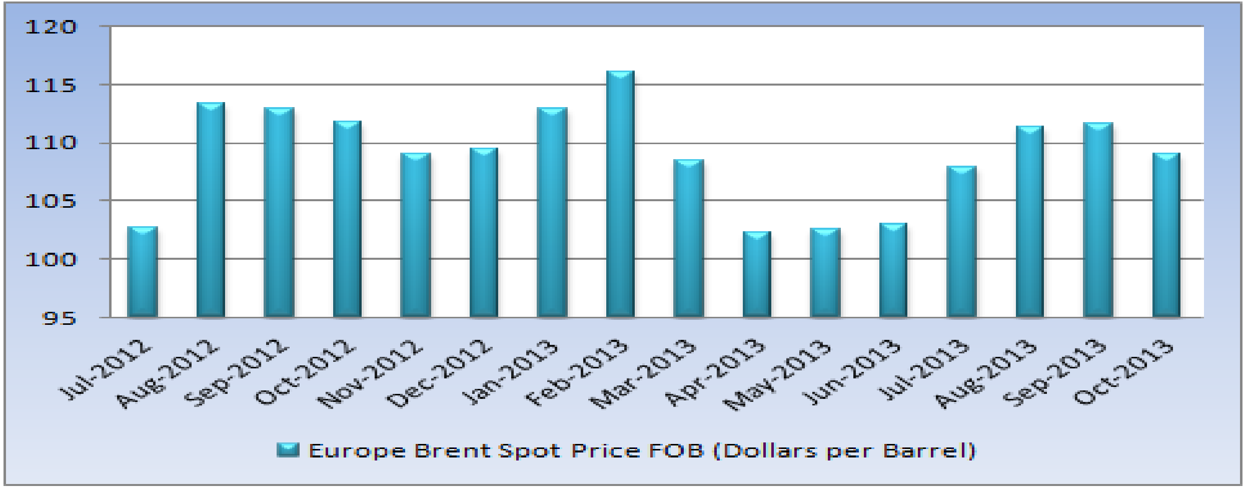
Source: OECD & Euro Stat

Global inflation is expected to remain low and declining in advanced economies in 2013 as the projected pick-up in activity is not expected to close the negative output gaps. However, in emerging market and developing countries, inflation is expected to remain slightly elevated driven by domestic capacity constraints and projected depreciation pressures. As observed in ***table* 2**, annual inflation continued to be relatively high in India, one of our main trade partners. India accounts for 25 per cent of our main import source. Therefore, there is a likelihood that this high inflation might pass through to Uganda in the form of imported inflation.

1.4 International commodity prices

Crude oil prices averaged $107/bbl during 2013Q3, up 2 percent since 2013Q2 and 4 percent higher than a year ago. Spillover fears of Syria's conflict to the Gulf and large output reductions by Iraq and Libya (almost 1 million barrels/day each) weighed in. Food prices continued their weakness, down 4 percent from 2013Q2 and 11 percent lower than a year ago, as better supply conditions will bring stocks closer to historical levels. Assuming no macro-economic shocks or supply disruptions, oil prices are expected to average $105/bbl in 2013, identical to the 2012 average and about $106/bbl in 2014. Agricultural prices are projected to decline 7.8 percent in 2013 under the assumption that the improved crop conditions already in place will continue. There are a number of risks to the baseline forecasts. Downside risks include weak oil demand if growth prospects in emerging economies (where most of the demand growth is taking place) deteriorate sharply. Over the long term, oil demand could be dampened further if substitution between crude oil and natural gas intensifies. On the upside, a major oil supply disruption in the Gulf due to the ongoing conflict could add $50 or more to the price of oil. However, the severity of the outcome depends on numerous factors, including the duration of the disruption, policy actions regarding emergency oil reserves, demand curtailment, and more importantly, OPEC's response. Figure 2 below shows the trend of Brent Crude oil price per barrel.

Figure 2: Crude oil price



Source: World Bank and FAO Statistics

The outlook for crude oil prices remains uncertain. The main driver for future commodity prices is the pace of economic activity in the emerging market economies, particularly China as these economies are the main consumers of commodities. Being net oil importers, future oil price developments have a direct impact on Uganda's domestic pump prices and sequentially domestic inflation. World-level inflation is still low, partly explained by recent declines in commodity prices. The central banks of the main economies have confirmed their decision to maintain their expansionary monetary policies for a prolonged period. In particular, the ECB lowered its monetary policy rate and renewed some measures to inject liquidity, while the Federal Reserve has held on to its asset purchase plan. The dollar has appreciated across the board in international markets, albeit more intensely against the currencies of emerging economies.

1.5 Outlook and impact on Ugandan economy

Global economic developments will continue to influence Uganda's economic developments through international capital flows, commodity prices and trade. In addition, higher anticipated inflation in developing and emerging economies could pass through to Uganda and pose an upside risk to domestic inflation. However, expected low oil prices might contain domestic inflation. Furthermore, given that oil prices tend to affect wider commodity prices to market, it is likely that low oil prices will suppress the prices of many of Uganda's main export commodities, which would in turn further worsen the trade balance. The main downside risk to the global economic outlook is pegged on the possibility that the tapering of the US Federal Reserve's Asset Purchase program might tighten global financial conditions. This cut back is likely to also lead to capital outflows from emerging and developing economies, thus leading to exchange rate overshooting and slower economic activity in these economies. Being a small open economy, Uganda is likely to be affected by the continued volatility in the global financial markets. There is likelihood that the volatility in the global financial markets could spill-over to the domestic financial market, resulting in domestic exchange rate volatility.

2 DOMESTIC ECONOMIC DEVELOPMENTS

2.1 Monetary policy

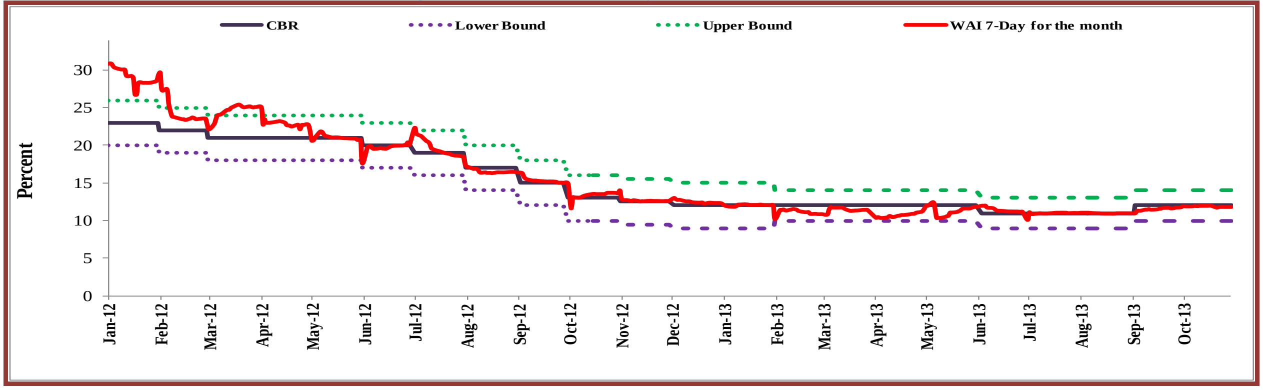
Overall, 2013 has so far been characterized by easing of monetary policy. As evidenced by increasing private sector credit, the cumulative easing in monetary policy is supporting activity in interest-sensitive sectors. Monetary policy acts with a lag, and so the effects of the reductions in the CBR on activity still have further to run. The stimulus is clearly evident in the personal loans, where consumer loans after contracting at an average rate of 9.3 percent in 2012/13 has grown by 9.7 percent in the first quarter of 2013/14. However, credit to trade and construction sectors, the two predominant sectors that constitute about 45 percent of the total private sector credit remain subdued. The two sectors also dominate the non-performing loans, suggesting that the banks remain risk averse. So although growth is forecast to remain a bit below trend for a time, there is a reasonable prospect that private demand will strengthen over time.

2.1.1 Domestic Financial Markets

In August 2013, the country experienced supply side shocks to agriculture which caused higher food prices. Subsequently, the risks to core inflation increased because the shocks to food prices directly affect commodities in the core CPI basket, and indirectly feed through to the general price level through cost-push effects and inflation expectations. The Bank of Uganda therefore raised the Central Bank Rate (CBR) from 11 percent in August to 12 percent in September 2013. The objective of this monetary policy stance was to rein in the second round effects of higher food prices and anchor inflation expectations. The increase in the CBR was immediately transmitted to the interbank rates and other whole sale market interest rates. This resulted in the weighted average 7-day interbank rate increasing from 10.99 percent in August 2013 to 11.76 percent and 11.80 percent in September and October, respectively. Despite the increase, the 7-day interbank money market rate trended within the CBR band.

Commercial banks’ activity in the interbank money market increased by 18.0 percent to Shs. 6,019 billion in the three months to September 2013 from Shs 5,102 billion in the three months to June 2013. Trading activity was dominated by the 1-day trades, which accounted for about 66 per cent over the quarter, increasing to Shs. 3,959 billion from Shs. 3,690 billion in the previous quarter. The 7-day tenor, which had a share of 29 per cent of total trades, increased to Shs. 1,764 billion from Shs. 1,233 billion during the same period. The increase in the overnight trade is due to the prevalence of structural liquidity surplus in the banking system. ***Figure 3***, below, presents the evolution of the 7-day interbank money market rate with the monetary stance.

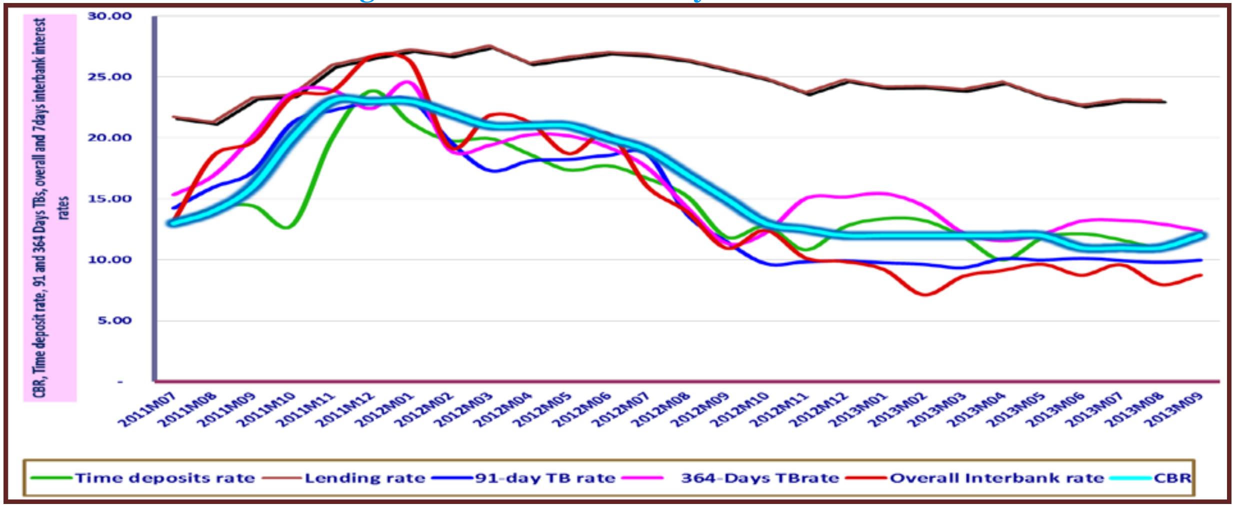
Figure 3: The 7-day interbank rate



Source: Bank of Uganda

Interest rates on Government securities responded to the increase in the CBR in the month of September 2013 (***Figure** 4*). Yields on Government securities continue to pick up with increased Government borrowing and securities issuance. A persistent increase in yields could attract short-term capital inflows, which in turn could support the shilling in the short-term. However, a continued increase government domestic borrowing could keep commercial banks' lending rates elevated with adverse consequences for private sector credit.

Figure 4: The CBR and key interest rates



Source: Bank of Uganda

The lending rates on shilling denominated loans have continued to be sticky downwards, mainly due to risk aversion, high fixed costs and difficulties embedded in assessing credit worthy borrowers. However these rates have declined by 4.32 percentage points in September 2013 from the peak of 27.24 percent in March 2012. Despite the decrease in lending rates, the spread has remained persistently high over the period implying the existence of inefficiency in the Ugandan financial sector. In terms of sectoral disaggregation, lending rates declined across sectors, save for trade, other personal, residential and commercial mortgages. Rates on personal and household loans and electricity and water recorded significant decreases from respective rates of 26.0 percent and 27.9 percent in the previous month to 24.0 percent and 20.1 percent in September 2013. Rates on other services (SMEs inclusive), have fallen but are still the highest at 26.1 percent in September 2013.

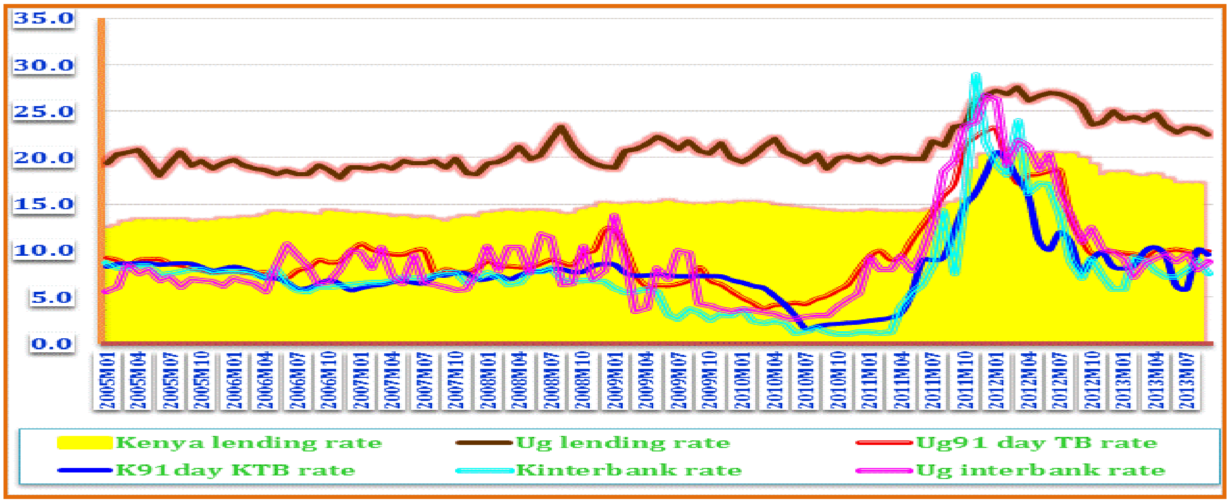
Table 3: Commercial bank interest rates

Quarterly interest rates (per cent)						
	Local Currency			Foreign Currency		
	Lending	Time Deposit	Spread	Lending	Time Deposit	Spread
Sep 11	22.12	13.64	8.48	9.72	2.81	6.90
Dec 11	25.41	18.48	6.93	9.95	4.12	5.83
Mar 12	27.24	20.32	6.92	10.25	5.14	5.11
Jun 12	26.61	19.83	6.78	8.66	4.42	4.24
Sep 12	26.32	14.95	11.37	8.97	4.13	4.84
Dec 12	24.08	12.09	11.99	10.08	4.05	6.03
Mar 13	24.15	12.96	11.20	9.69	5.51	4.18
Jun 13	23.62	11.39	12.23	10.04	4.79	5.25
Sep 13	22.92	11.28	11.64	9.47	4.11	5.36
Monthly interest rates (per cent)						
Jul 13	23.15	11.63	11.52	9.18	4.38	4.80
Aug 13	23.10	10.84	12.26	9.57	4.00	5.57
Sep 13	22.52	11.39	11.13	9.65	3.96	5.69

Source: Bank of Uganda

A comparison of Uganda and Kenya key interest rates **(Figure 5)** indicate notable similar trends. Uganda's lending interest rates have largely been high averaging about 20 percent in the period 2000 to 2010. This was higher than Kenya's which averaged about 15.6 percent. It might be difficult for lending interest rates in Uganda to decline below 20 percent in the near future: Uganda's financial sector development is inhibited by several structural factors, e.g. low penetration, economies of scale, risks associated with the nature of business and historical factors, low savings. Between January 2012 and October 2013, the CBR was reduced by 11 percentage points. In the same period, the average lending interest rates declined by about 4.7 percentage points. The pass-through to lending interest rates has been asymmetric. Costly and restricted access to credit reinforces economic weakness-spiral effect.

Figure 5: A comparison of Uganda and Kenya key interest rates



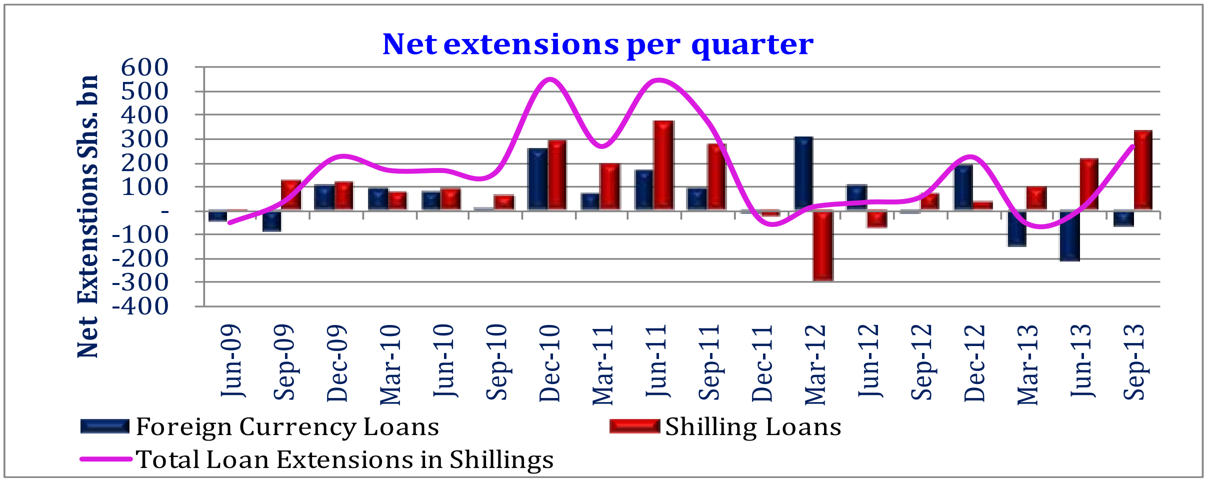
2.1.2 Private sector credit

The annual growth rate of loans to non-financial corporations (NFCs) continue to reflect mild recovery after a sharp contraction in most of 2012. This reflected subdued economic activity, as well as the high lending rates and still high level of non-financial sector indebtedness, which led to low demand for loans. The stock of non-financial private sector declined from an average year on year growth of 33 percent to 4.5 percent in September 2012 has since picked up sluggishly to about 8.8 percent as of September 2013. Sluggish recovery of bank credits to the industrial sector, especially to the manufacturing, could prolong the slackness of economic activity.

Given the incipient recovery of economic activity, the question arises as to whether the banking sector will provide enough funds to firms for the upturn to become self-sustained. This question has a number of dimensions. First, there is a time dimension. Because of uncertainty regarding the extent of recovery, firms could take recourse to internal sources of funding, rather than to bank loans, in the initial phase of the recovery. Thereafter, a lasting recovery remains dependent on support from bank lending to NFCs. Second, in an environment of deleveraging needs and restructuring, it is not only the overall development of bank loans to NFCs that matters, but also the loan quality (i.e. loans to productive sectors versus the "ever-greening" of loans to currently less productive sectors) and the loan composition by industry that provide valuable insights into the appropriateness of lending to the economy.

As shown in Figure 6, Bank credit to NFCs have been characterized by net extension in the first quarter of 2013/14. Net loan extensions have been on an upward trend since March 2013. Net shilling loan extensions amounted to Shs. 335billion in 2013/14 Q1 and increase of about Shs.120 billion from Shs. 215 billion in 2012/13 Q4. The foreign currency denominated loans, however, continue to have net redemptions since March 2013. Overall, looking at the trend of net extension, NFC is on a recovery trajectory as shown in *figure* 6.

Figure 6: Net Credit extension

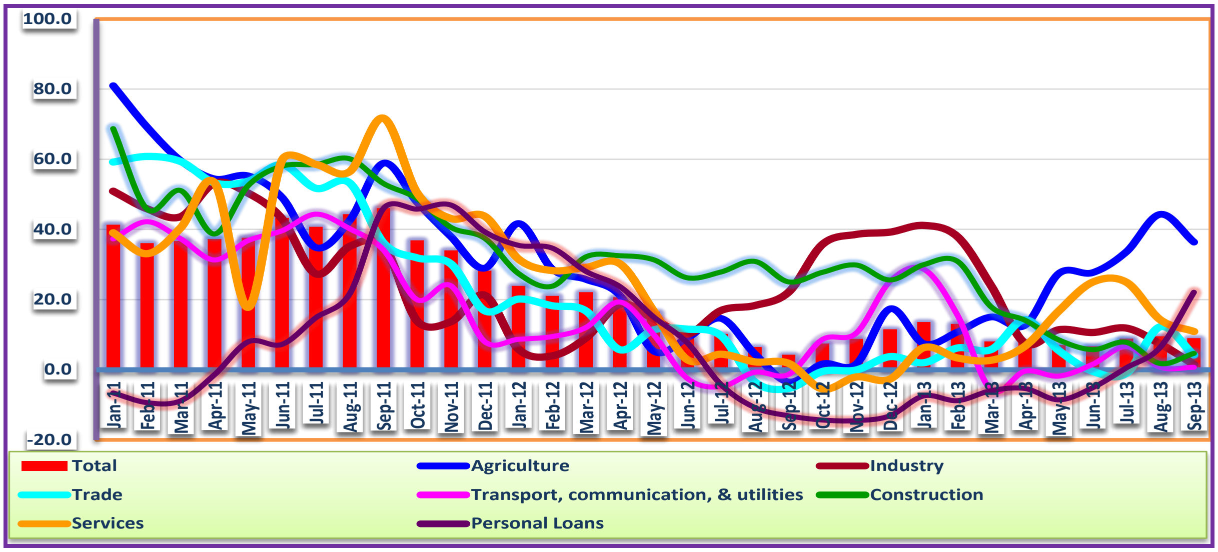


Source: Bank of Uganda

From a sectoral perspective, the decline in the annual growth rate of total lending to NFCs in 2012 and the first quarters of 2013 was broadly based across the main sub-sectors, but was particularly marked in the case of personal and construction-related loans. Growth in loans to NFC in the construction, real estate services and trade sectors has been a drag on total NFC loans since early 2013. Loans to the trade sector have persistently shown no recovery, this combined with subdued growth in private sector imports suggests that private sector demand remains subdued.

The sectoral credit allocation perspective as indicated in Figure 7, suggests that the correction of past excesses in lending to the real estate-related sectors is still ongoing and remains a significant driver of overall NFC loan growth. At the same time, lending to industrial and services sectors continued to grow at a subdued pace. Personal loans and credit to agricultural sector seem to have gained momentum. Looking ahead, if historical regularities continue to hold, the projected recovery in economic activity may eventually be reflected in a recovery of NFC loan growth as from 2014, although the strength of credit expansion will depend on the progress made in correcting for past excesses in some sectors.

Figure 7: Sectoral Credit allocation



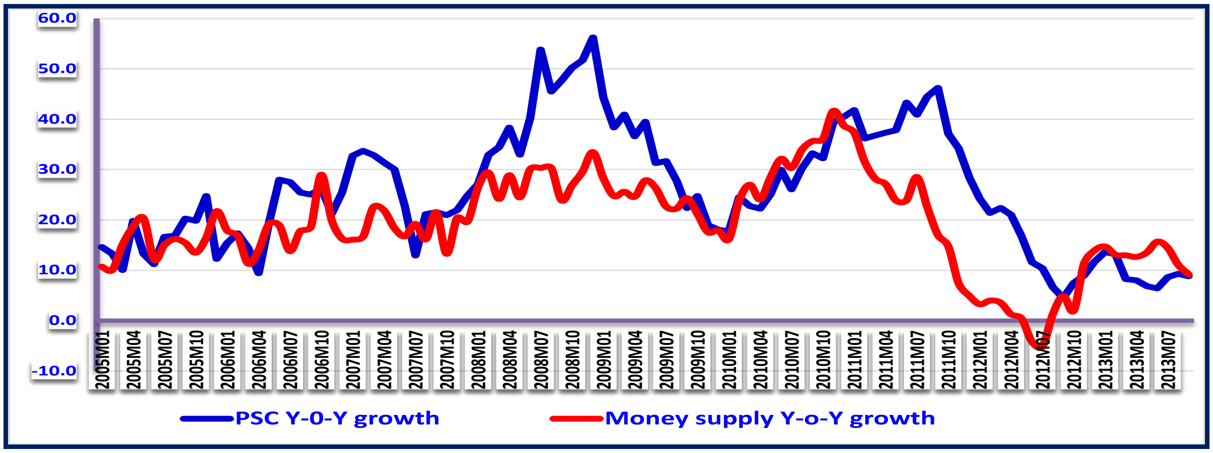
Source: Bank of Uganda

2.1.3 Monetary aggregates

The slower monetary expansion has been marked due to reduction in bank lending **(Figure 8)**. Broad money has continued to recover although at a subdued pace. On an annual basis, monetary aggregates M1, M2 and M3 grew by 10.1 per cent, 9.2 per cent and 7.5 per cent respectively in September 2013 compared to the respective growth rates of 14.3 per cent, 11.1 per cent and 9.8 percent in the previous month. The annual growth in monetary aggregates is to a large extent being driven by Net Foreign Assets (NFA), particularly NFA of the central bank.

On a quarterly basis, M1, M2 and M3 increased by 0.4 per cent, 0.6 per cent and 0.5 per cent respectively in the quarter to September, compared to respective rates -1.4 per cent, 1.6 per cent and 1.2 per cent respectively in the three months to June. The recovery in growth of monetary aggregates in the quarter was driven by increases in demand deposit, time and saving deposits and foreign currency deposits. Part of the increase in monetary aggregates is a result of BOU's unsterilized intervention in the foreign exchange market which is equivalent to QE, as it increases base money.

Figure 8: Monetary aggregates



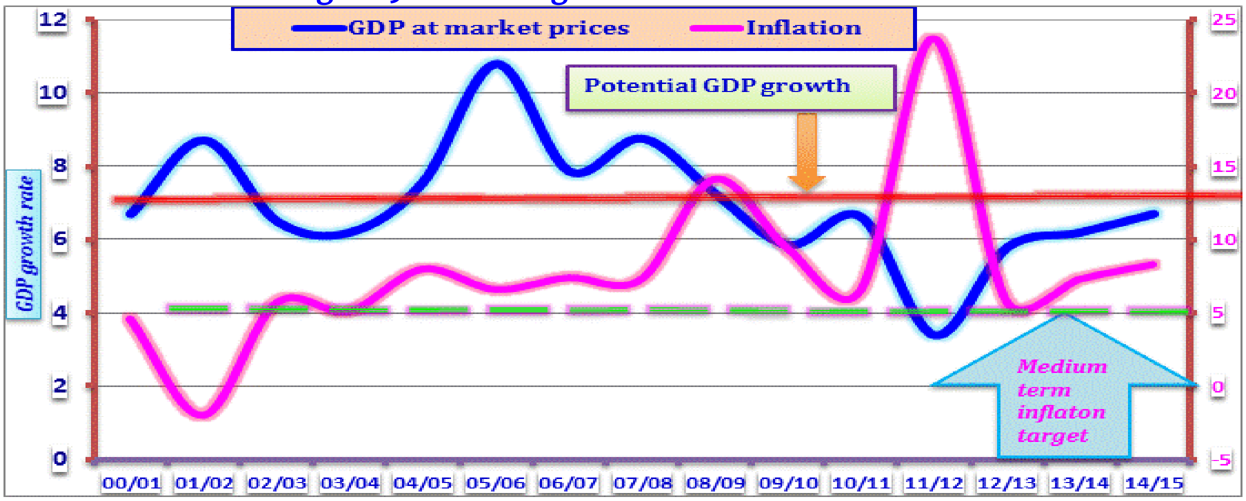
Source: Bank of Uganda

3 Domestic economic Conditions:

3.1 Real Economic Activity

As shown in *Figure 9*, economic growth slowed down 2006/07, with a sharp decline in FY11/12 reflecting a combination of the impact of weak global economic environment; supply side shocks; tight monetary policy to rein in the inflation spike and the associated increase in the cost of funds; and the overall uncertainty environment.

Figure 9: Real GDP growth and inflation trade-off



Growth rebounded in FY2012/13 and could remain strong in 2013/14, close to 6 percent. In the recent years, growth has been below the trend moreover with inflation that has been above trend *Figure 9*. In addition, the economy registered a moderate average quarterly growth rate of 1.4 percent (year on year of 5.6 percent) in the period 2010/11 to 2012/13. This is below the quarterly average of about 1.9 percent (year on year of 7.6 percent) in the period 2005/6 to 2009/10. The recent growth rate is clearly below the potential output growth.

Growth in 2012/13 was boosted by higher spending on public investments. Public investment grew by 13.9 percent compared to a decline of 12.3 percent in 2011/12. Growth driven by public investment and consumption is unlikely to provide the required support for continued expansion in aggregate domestic demand. However, as growth in credit to private sector gains momentum, both private investment and consumer expenditure could pick up. In addition, the expansionary fiscal policy, with a bias towards public investment, could result in improved economic activity, especially in the medium term.

3.2 Fiscal policy

The fiscal stance in FY2013/14 and 2014/15 as shown in Table 4 is expansionary in part to support a recovery of growth to its potential through key infrastructure projects including roads, energy and agriculture. Some of the public investment expenditures could lock-in higher government expenditures going forward. The public investment program with emphasis on energy and transport infrastructure is highly productive and complements private capital. All else being equal, higher public capital stock could lead to increased private capital investment and could serve as a catalyst to boost long-term growth. There is no free lunch, however; the borrowing to invest will increase the stock of debt which— if not managed properly—may become unsustainable, thus curtailing the positive effects of public investment and increasing the country's exposure to external shocks. Achieving an appropriate balance among public investment, growth, and debt sustainability has become a priority. In addition, public investment could generate much higher recurrent costs in the form of operations and maintenance expenditures in addition to direct depreciation costs (where failure to maintain recurrent expenditures may erode the productivity of public capital). Moreover, with the forecasts implying that growth of public demand over the next few years will continue to be strong, it is possible that with-trend growth in the economy in the near term, government expenditure could generate demand pressures.

Table 4: Fiscal-current account deficits (% age of GDP)

	09/10	10/11	11/12	12/13	13/14	14/15
Government expenditure/GDP	19.6	22.8	18.5	18.9	22.5	20.7
Fiscal deficit/GDP	-4.9	-4.3	-3.0	-4.1	-7.4	-5.7
Domestic debt/GDP	9.3	13.4	13.7	15.4	15.0	14.4
External debt/GDP	9.3	13.4	12.8	14.7	14.1	14.9
Current account balance/GDP	-9.5	-11.8	-13.3	-9.9	-13.4	-12.4

As shown in Table 4, scaling up public investment widens the fiscal deficits. This could require sharp macroeconomic adjustments, crowding out private investment and consumption and delaying the growth benefits of public investment. Covering the fiscal gap with domestic borrowing is not helpful either: higher domestic interest rates increase the financing challenge and private investment and consumption would be crowded out.

Supplementing with external commercial borrowing, on the other hand, could smooth these difficult adjustments, reconciling the scaling up with feasibility constraints on increases in tax rates or spending cuts. But borrowing in external commercial terms may be also risky. With poor execution (e.g., low public investment efficiency), sluggish fiscal policy reactions, or persistent negative exogenous shocks (e.g., terms-of-trade shocks or natural disasters), this strategy could easily lead to unsustainable public debt dynamics. The confluence of ambitious, front-loaded public investment programs and weak structural conditions (poor execution of investments) make the fiscal adjustment more challenging and the risks greater.

Furthermore, the fiscal deficit in Table 4, exclude about US$2billion borrowing from China to finance Karuma and Isimba hydro power projects and about US$ 2.3 billion already borrowed but not yet disbursed. In the next 2 to 3 years estimates suggest further borrowing which include about US$ 2 billion for Agago I and II hydro power dam; US$ 4 billion for railway line construction, and about US$ 2 billion for oil refinery. This would bring total external debt to between US$15 and 17 billion; about 50 percent of GDP assuming the economy growth at an average rate of 7 percent. Excluding undisbursed loan commitments, this would be equivalent to about 44 percent of GDP. Including projected domestic debt, the total debt to GDP would be about 60 percent. This borrowing suggest that Uganda would still be above the EAC macroeconomic convergence criteria ceiling of a public debt of about 50 percent in 2022-24.

3.3 External sector developments

The global economy has had tremendous impact on Uganda's economy through trade and financial flows. This is in part is reflected in the widening of Uganda's current account deficit. For instance, average monthly current account deficit was about US$46.7 million for the period January 2005 to December 2008, compared to a monthly average of US$141.3 million in the period January 2009 to September 2013. Destination of exports changed following Europe's recession; Africa and COMESA region in particular, is the main destination of Uganda's exports.

The balance of payments improved somewhat in 2013 Q3, despite the widening current account deficit. The overall balance of payments position stood at a surplus of US$ 2.6 million in 2013 Q3, from a deficit of US$ 31.5 million the previous quarter, which enabled a reserve build-up of US$ 5.7 million over the quarter. The current account deficit, which had been narrowing since 2012 Q2, began to widen in 2013 Q2 and continue to in 2013 Q3. The deficit grew to US$ 559.2 million in 2013 Q3 (*table* 6), compared to a deficit of US$ 380.4 million in 2013 Q2. The growing current account deficit has been driven by deterioration in the trade balance, lesser remittances and increased 'other business services' payments. The goods account also experienced an increased deficit over the quarter to US$583.4 million, from US$ 515.8 million in the previous quarter. However, the decline was restrained to some degree by weak private sector imports, which fell by 17.6 per cent over the quarter and may have been discouraged by the exchange rate appreciation. Export values fell by 11.9 per cent over the quarter or by 4.5 per cent on an annual basis; both coffee and non-coffee export values declined: by 12.9 per cent and 14.9 per cent respectively over the quarter. Coffee export values declined primarily due to a global price decline on account of excess coffee supplies in Brazil and Vietnam. Part of the deterioration is due to the increase in international oil prices. Oil imports comprise about 20 percent of imports and the increases in the international oil prices directly widens trade and current account imbalances.

The financial account continues to hold the Balance of Payments; it is now forecast that Uganda will need to attract a cumulative capital inflow of US$ 17 billion over the next four years solely to balance the current account deficit. At present, the BoU purchases US$ 3.1 million a day for reserve build-up purposes. However this may not be sufficient given the current level of capital inflows; if the current stance were maintained over the financial year there would be a net drawdown in reserves of US$ 350 million and import cover would equal 3.5 months by the end of the financial year.

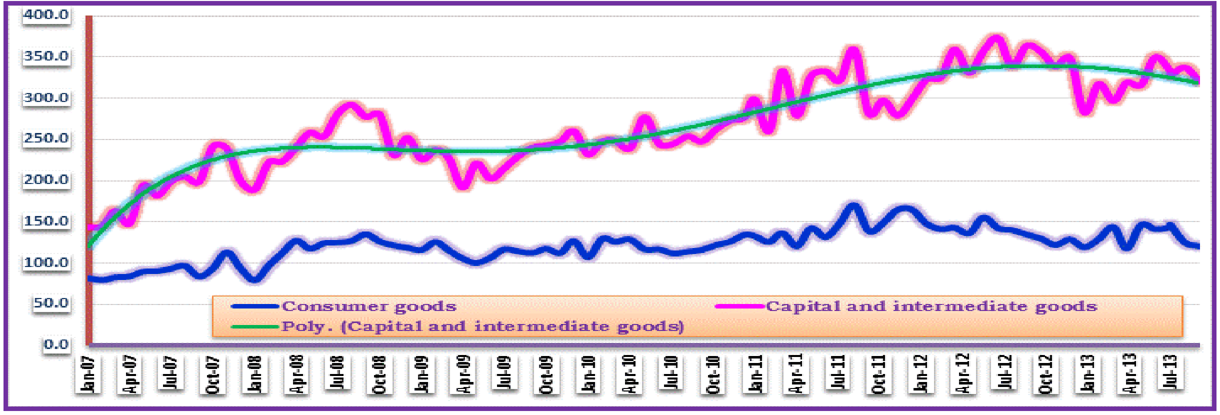
Table 5: Balance of payments (USD millions)

	Jul to Sep 2012	Apr to Jun 2013	Jul 13	Aug 13	Sep 13	Jul to Sep 2013
Current account balance	-523	-380	-208	-181	-170	-559
Goods account (trade balance)	-569	-518	-200	-200	-183	-583
Total exports (fob)	719	780	236	230	222	687
General merchandise	681	744	224	218	211	635
Coffee	96	122	45	36	25	106
Total imports (fob)	-1289	-1298	-436	-430	-405	-1271
Government imports	-79	-114	-15	-49	-39	-102
Private sector imports	-1199	-1169	-417	-377	-362	-1156
Services and income	-334	-214	-84	-104	-63	-251
Services account	-130	-95	-52	-64	-27	-144
Income account	-204	-119	-31	-40	-36	-107
Current transfers (net)	380	352	75	124	76	275
Capital and financial account	608	541	281	305	227	814
Overall balance	211	-31	52	-17	-32	3
Reserve assets	-208	34	-54	19	29	-6

Source: Bank of Uganda

Overall, private sector imports have remained subdued over the last 12 months as shown in Figure 10. As economic activity strengthens, import demand will pick up and this is weaken the BOP further. The trade deficit in goods and services is forecast to widen by more than US$700 million in 2013/14, from $2.5 billion to $3.3 billion. In addition, as domestic demand recovers in the near term, as it is forecast to do, import growth will follow. Export growth should also increase with the global economic recovery, however import growth is forecast to outpace export growth and thus the trade balance may deteriorate further. The increasing trade deficit combined with reduced net current transfers, somewhat driven by lesser aid, are expected to exacerbate the current account deficit from 9.4 per cent of GDP in 2012/13 to 12.0 per cent of GDP in 2013/14.

Figure 10: Private sector Imports



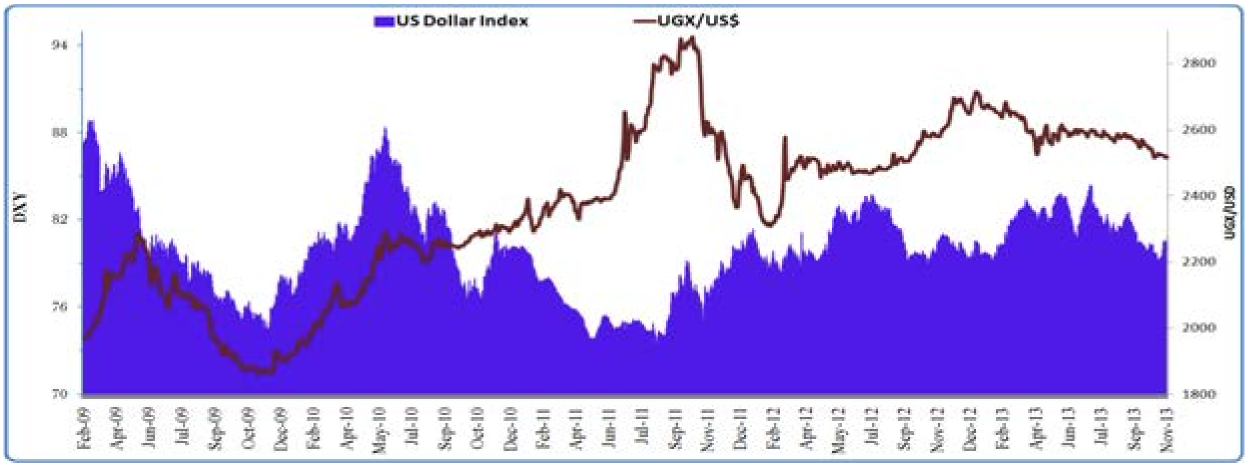
Source: Bank of Uganda

The stock of reserves as at end of September 2013 was US$ 2,959.0 million, equivalent to 4.0 months of future import cover. Whilst the capital and financial account boasts a surplus, and is expected to continue to, there are signs that Uganda may not meet the PSI NIR target for 2013/14 and may need to purchase additional dollars from the market. To offset the tendency to appreciate the central bank buys dollars driving up the foreign exchange reserves. However, this tends to keep prices higher than they would be if the exchange rate were allowed to appreciate. In the short run this means that actions to reduce inflation [allow the nominal exchange rate to appreciate] would have an adverse impact on exports and hence economic growth. Second, the powerful influence of the regional economies on food prices undermines central bank policy. The virtually open border means that food prices in Uganda are largely determined by food prices in region. Appreciation of the Uganda shilling reduces food prices but the food prices may be moving in any direction according to what is taking place in the region.

3.4 Exchange rates

The path of the exchange rate is also a significant source of uncertainty for the domestic economy. The Ugandan shilling has appreciated by 5.5 percent between January and October 2013. In October 2013 the Shilling appreciated by 1.3 per cent month-on-month, compared to only 0.4 per cent in September and August 2013. On an annual basis, the Shilling appreciated by 1.7 per cent in October to an average midrate of UGX/USD 2,534.39. The appreciation is largely attributed to a weakening dollar, which depreciated by 1.8 per cent in October 2013 month-on-month *(figure 10)*.In part, the appreciation helped to shift demand to external sources, which enabled domestic capacity to accommodate the increase in public investment.

Figure 10: UGX/USD exchange rate and the USD index

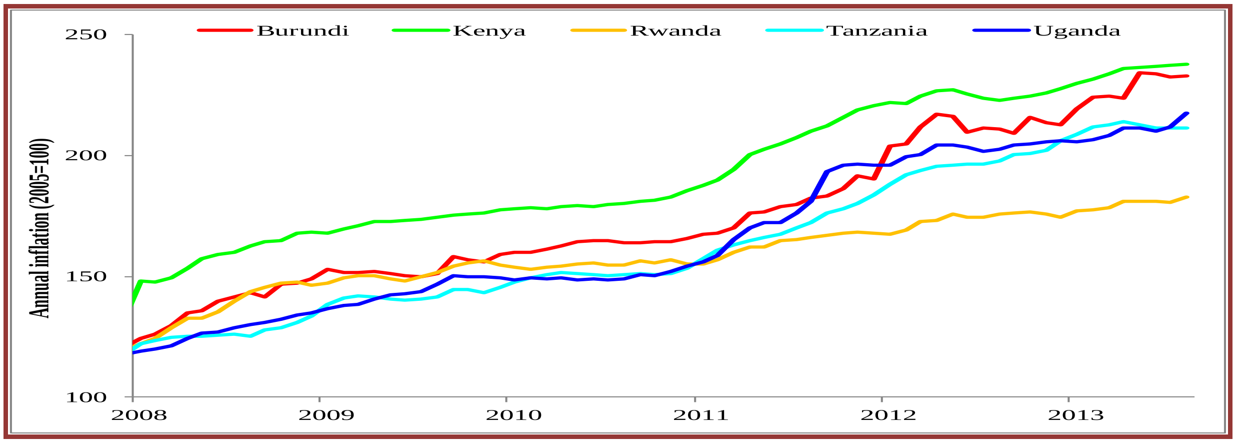


Source: Bank of Uganda

The Nominal Effective Exchange Rate (NEER) continued to appreciate over the quarter. However, the extent of appreciation fell to 2.3 per cent in 2013 Q3, compared to 3.6 per cent in 2013 Q2, thereby signalling that the prevailing appreciation pressures in the economy may be weakening. On an annual basis, the NEER was more or less stable relative to 2013 Q2 (*figure 13*). The quarterly appreciation was more driven by a weakening of external currencies rather than stronger domestic fundamentals; in particular the Indian Rupee, South African Rand and Indonesian Rupee all weakened considerably over the quarter from sizeable capital flow reversals triggered by the announcement of imminent tapering of the US Federal Reserve's quantitative easing program. In October, the NEER appreciated by 2.1 per cent over the month or by 6.8 per cent on an annual basis, depicting a similar trend to the quarterly figures. In line with the NEER, the Real Effective Exchange Rate (REER) also appreciated by over 2.0 per cent over the quarter, largely due to the strengthening of the Shilling against major trading partners' currencies and due to higher domestic than overseas inflation.

In comparison to the other EAC currencies, Figure 11 indicates broadly similar depreciation trend but with a bias for more stability in Rwandese Franc. The Uganda shilling and Burundi Franc seem to depict higher volatility than the other currencies. On quarter on quarter developments, the Kenyan Shilling depreciated by 3.1 per cent over the quarter and by 3.5 per cent over the year; while the Tanzanian Shilling depreciated by 2.2 per cent over the quarter and by 2.5 per cent over the year. The Rwandan and Burundi Francs both depreciated by 1.5 per cent over the quarter and depreciated by 5.6 per cent and 7.0 per cent respectively over the year. However, it may be important to note that the current Shilling appreciation is a recent phenomenon and Uganda has experienced larger depreciations than its neighbours over the recent past.

Figure 11: Movements of EAC currencies



Source: Bank of Uganda

Going forward, the front-loading of public investments, recovery in consumer and private sector investment demand and subdued growth in exports could cause the exchange rate to depreciate in the near term. In addition, with the terms of trade forecast to decline in near term, the exchange rate could depreciate much faster than currently projected over the forecast horizon. However, higher capital inflows associated with the prospects for oil investment could act to reduce the exchange rate. The depreciation of the shilling exchange rate is could place some upward pressure on inflation for a time.

4 Recent Developments in Inflation

Headline inflation crept up, rising persistently from the lowest of 3.5 percent in February 2013 to 8.4 percent in September 2013 but edged down to 8.1 percent in October 2013. Core inflation also edged up above the 5 percent target to 7.4 percent in September 2013 before declining to 7.2 percent in October 2013 (table 6). The rise in headline inflation was largely attributed to higher food crop prices and the rise in core inflation was an indication of some second round effects, especially through inflation expectations. Cost push factors also played their part with significant mark-up in costs, triggered by slight increase in metered water, fuel and communication taxes in July 2013. Food prices have started easing but the trend remains uncertain. While the rise is food prices is temporary, how fast food prices will decelerate given the erratic weather patterns remains a source of price spikes that could impact on generalised inflationary pressures that could require monetary policy tightening. Overall, month on month inflation decelerated in October 2013, driven by a marked fall in food and food crops inflation. A stronger shilling is also supporting disinflation process.

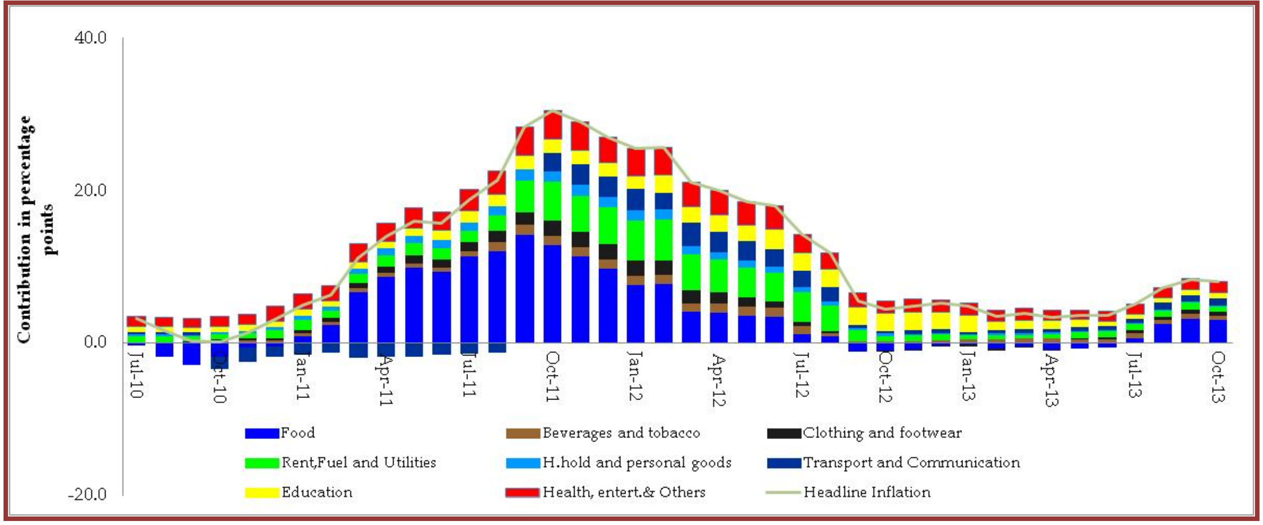
Table 6: Annual and monthly inflation developments

	2012			2013									
	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	June	Jul	Aug	Sep	Oct
Annual inflation (per cent)													
Core	4.0	3.9	4.6	5.6	5.6	6.8	5.8	5.6	5.8	6.4	6.6	7.4	7.2
Headline	4.4	4.9	5.3	4.9	3.5	4.0	3.4	3.7	3.6	5.1	7.3	8.4	8.1
Food crops	4.4	7.5	7.3	3.0	-6.2	-8.5	-7.4	-5.2	-6.2	-0.3	12.9	16.2	14.3
EFU	12.8	13.8	9.0	-2.1	-3.3	-2.0	1.8	1.3	1.0	0.3	1.6	2.1	1.6
Food	-2.5	-2.0	0.0	0.0	-2.0	-0.9	-2.6	-2.1	-1.4	2.8	9.1	11.7	10.9
Non-food	8.3	8.6	8.0	7.2	6.0	6.5	6.6	6.8	6.5	6.5	6.8	7.1	6.8
Monthly inflation (per cent)													
Core	0.3	0.4	1.4	0.9	0.9	0.3	0.2	0.1	0.6	0.4	0.4	1.2	0.1
Headline	0.3	0.6	0.2	-0.3	0.5	0.9	1.4	0.2	-0.5	0.6	2.6	1.8	0.0
Food crops	0.6	1.5	-4.5	-6.9	-2.2	3.9	8.8	0.9	-6.0	0.0	15.8	5.3	-1.0
EFU	0.5	0.8	-4.1	0.4	-0.2	0.9	0.1	0.1	-0.6	4.2	0.0	0.2	0.0
Food	0.4	0.2	-2.0	-2.4	0.2	2.3	3.7	0.4	-2.6	0.4	7.5	3.4	-0.3
Non-food	0.4	0.7	1.2	0.6	0.6	0.3	0.4	0.1	0.6	0.6	0.4	1.0	0.1

Source: Bank of Uganda

Slowing inflation, particularly declining monthly inflation figures, indicates that the prevailing inflation pressures may have weakened and that Uganda may be entering a period of disinflation figures albeit it is too early to be definitive. However, it is important to highlight that whilst food prices are weakening, they still remain a significant contribution to inflation (*figure* 12).

Figure 12: Inflation decomposition



Source: Bank of Uganda

4.1 Inflation outlook and risks

With projected rates of real GDP growth barely faster than the expected potential output growth rates of about 7 percent over the next two years, slack in the Ugandan economy would diminish only gradually. The economy would still be in a state of excess supply at the end of 2014/15 and therefore overall domestic demand conditions remain weak and might not result in high inflationary pressures. Inflation forecast indicate headline and core inflation in the range of 7-8 percent and 6-7 percent, respectively, for most of 2014. In the medium term horizon, inflation is projected to stabilise around the 5 percent. However, although domestic inflation has been downcast, upside risks remain: exchange rate depreciation, driven by a global economic recovery and monetary policy normalisation amongst the advanced economies, increased domestic demand or a lack of stabilisation in food prices, may all push inflation above forecast. Furthermore, a normalization of global monetary policies might create financial market volatility and complicate domestic monetary policy decisions.

Further, while the exchange rate has appreciated since the January 2013, it could start depreciation early 2014. Accordingly, higher import prices are expected to add to inflation over the course of the next year. Accordingly, higher import prices are expected to begin to exert an upward influence on tradables prices in the next few quarters, with increasing prices for tradables items likely to become the norm, in contrast to the minimal change in these items experienced in recent months. Altogether, the forecasts anticipate that inflation could slightly edge up but with deflation of food and oil prices, the import prices could contribute marginal increases to the annual rate of inflation over the forecast period. These identified, and other unknown, risks mean that the path for GDP and inflation may well differ from the forecasts presented. Inflation could likely remain above the 5 percent target to the end of 2015 and there could be pressure to raise the CBR if further inflationary pressures emerge.

5. Economic outlook

Between December 2012 and May 2013, inflation outlook indicated some mild inflationary pressures building up but with inflation projected to remain around the 5 percent target. With low domestic demand pressures, BOU maintained a neutral monetary policy and maintained the CBR at 12 percent. In the first two months of FY2013/14, inflationary pressures eased slightly and in effort to support economic activity, BOU reduced the CBR by 100 basis points to 11 percent. Inflationary pressures re-emerged in September 2013 and the balance of risks pointed to further CPI increases as a result of drought and tax increases on metered water, telecommunication and fuel. With inflation projections indicating that inflation could exceed the BOU target by about 3 to 5 percentage points until the mid-2015, the BOU increased the CBR by 100 basis points to 12 percent to counter the inflationary pressure and anchor inflation expectations. In October and November 2013, the BOU balance of risks were well balanced and BOU took a neutral monetary policy stance and maintained the CBR at 12 percent. Taking into account the uncertain external environment, constrained credit access and intermittent inflationary pressures, domestic demand is expected to remain moderate in 2013/14.

Supply-side inflationary pressures along with the prospects of oil prices increases due to geopolitical factors, remain a challenge, to BOU's monetary policy-Monetary policy tools are geared towards demand side. Higher inflationary pressures driven by food prices could re-emerge given the rapid population growth amidst low agricultural productivity. The private sector investment climate remains weak and risk aversion continues to stall investment plans. Moreover, another round of power deficit expected to begin in 2014 could weaken private sector investment further and this combined with uncertainty usually associated with the presidential elections due in 2016 could limit FDI inflows and therefore growth.

Uganda with its large current account deficit and dependence on external flows for financing it, will remain vulnerable to the confidence and sentiment in the global financial markets. The large and widening current account deficit, is a formidable structural risk factor. Furthermore, the growing vulnerability in the external sector reinforces the importance of a credible fiscal stance. Whereas Uganda's flexible exchange rate regime will act as a useful buffer for shocks, significant exchange rate pass-through to inflation might complicate BOU's monetary policy. In addition, with fiscal balances are generally weaker than they were in the last two fiscal years, reflecting expansionary policies, Uganda may not be able to respond to a slowdown in economic activity with fresh stimulus.

The period ahead might bring fresh shocks and bouts of volatility that need to be handled carefully. For the most part, monetary policy and flexible exchange rates will provide the right tools to cope with such shocks. However, in case of sudden large pressures for capital outflows, BOU should stand ready to use foreign exchange interventions to preserve orderly market conditions. BOU should not try to defend exchange rates at fundamentally unsustainable levels, or to use interventions as a substitute for a necessary tightening of macro policies. More broadly, there is no better insurance against market pressures than maintaining credible policy frameworks and strong buffers.

In particular, given the relatively high exchange-rate pass-through, a key element in stabilizing CPI inflation is exchange-rate stability (given the prevalence of fairly low rates of global inflation). The exchange rate interacts with pricing behaviour, so that open-economy inflation targeting automatically need to take the exchange rate into account in setting monetary policy. Therefore, to resist fast depreciation pressures, the BOU might have to supply foreign exchange to the market. On the other hand, the case of capital inflows and appreciation pressures is asymmetric, because the BOU can supply unlimited domestic currency to cap its price provided the central bank is willing and able to sterilise the foreign exchange purchases, there need be no consequences for the inflation rate. The instrument of intervention in the foreign exchange market (or at least an extra half-instrument) should give the BOU an extra instrument of policy, which enables it not only to target inflation but also to have some influence on the behaviour of the exchange rate. However, to have some influence on the behaviour of the exchange rate is not to defend a specific target level or band through intervention, independently of the interest rate.

In conclusion, the short-term outlook is mixed. In the short term as the policy environment becomes more stable, the global economy recovers and confidence returns, Uganda's opportunities for growth will expand. In the near term, with less supportive external conditions in the offing, the strength of domestic economic policies will be crucial for how Uganda will cope going forward. Moreover, the external demand that provided support to growth in 2012/13 is unlikely this FY2013/14 due to sharp decline in coffee prices and constrained exports to the regional market.

Overall, BOU's monetary policy stance remains generally conditioned by the growth-inflation balance in forward looking manner. BOU will continue to assess the outlook and adjust policy as needed to foster sustainable growth in demand and inflation outcomes consistent with the medium term inflation target.