Bank of Uganda

Current State of the Ugandan Economy

June 2013

Contents

Executive summary

The IMF's April 2013 forecasts show that global economic growth prospects for most parts of the world have slowed down. Its forecasts see global growth of 3.3 per cent this year, and 4 per cent in 2014. Lower commodity prices and the impact on terms of trade have been an important driver of growth deceleration among many EM commodity exporters. However, global economic prospects remain positive but risks in the Euro zone continue to blur earlier optimism for stronger economic recovery in 2013. Indeed, the economic growth outlook for the advanced economies except Japan worsened slightly in first two months of the second quarter of 2013 compared to the first quarter.

On balance, growth of the global economy in 2013 is expected to be slightly below its average pace, and to strengthen a little in 2014. Activity in the advanced economies continues to be restrained by ongoing balance sheet repair and fiscal consolidation but is expected to pick up gradually through 2014. Growth in developing economies is also expected to be stronger in 2014 and is forecast to remain considerably higher than in the advanced economies. Uganda trades more with regional economies, which are currently experiencing better economic conditions. As a result, growth in Uganda's major trading partners is expected to be around its average pace and continue to exceed that for the world as a whole.

Global inflation remains subdued on account of economic slack in advanced economies, improvement in central bank credibility and declining commodity prices. Subdued inflation expectations provide central banks with room to support economic activity. However, the inflation outlook in emerging economies anticipates a pick-up in inflation.

Interest rate outlooks still indicate that rates in both the euro area and the USA will show very modest growth across maturities during 2014. The US dollar should appreciate slightly, not only against the euro and other reserve currencies, but also against other currencies including the Ugandan shilling over the one-year horizon. Dollar prices of oil and natural gas still indicate a slight decline until the end of 2014. The outlook for food commodity prices is falling until the end of 2014.

The positive interest rate differential between emerging and developed economies, and the resultant portfolio flows, presents both an opportunity and a risk to Uganda. Inflows could be used to build foreign exchange reserves and could lead to an improvement in the balance of payments, but they also present a risk to exchange rate stability if an unexpected reversal occurs.

Uganda's GDP growth is expected to be slightly below trend, at between 5 to 6 per cent over 2013, before largely returning to trend over 2014. Uganda's real economic growth in 2012/13 was heavily driven by growth in exports and public investment, with private investment and general government consumption providing impetus to a lesser extent; the contribution of household consumption to real growth was negative. Overall, the subdued outlook over the next two years continues to reflect spill over effects from global economic challenges, the effects of fiscal consolidation and the lagged impact of the tight monetary policy stance in the first half of 2011/12. Although growth in aggregate domestic spending is forecasted to remain largely unchanged, growth in imports is expected to strengthen while the outlook for exports remains weak. Subdued export growth is sustained by continued weak demand from Europe and other developed economies. Beyond the medium term, it is likely that investments in the oil sector will grow sharply. Growth in public demand is also expected to strengthen over the next two years or so. The ratio of total government expenditure to GDP is projected to rise to 20 per cent in 2013/14, from about 19 per cent in 2012/13 and 2011/12.

The outlook for domestic inflation is a little softer in the near term. To a large extent, this reflects the impact of a stable exchange rate and the decline in the oil prices. Indeed, tradable items in the CPI have continued to experience stability in the last two months. This reflects the impact of the exchange rate, which appreciated by 3 per cent in the two months of Q2 2013 compared to Q4 2012. The profile for headline inflation will be affected by a number of one-off factors in the remaining half of 2013. Annual headline inflation is expected to rise slightly above core inflation in the second half of 2013, largely because of the effects of food crop prices and possible tax increase on fuel, electricity and metered water. However,

headline inflation is expected to remain in the inflation tolerance band of plus/minus 3 per cent, before returning to the target rate of 5 per cent in the medium term. Once these effects pass, headline inflation is expected to fall to around 5 per cent.

The outlook on the exchange rate is for continued depreciation pressures resulting from the weak external sector. Export growth is projected to remain relatively subdued due to weaknesses in the global economy. In May 2013, the shilling depreciated against the US dollar by 4.3 per cent on an annual basis to an average mid-rate of Shs. 2,586.11/ US$. The trade-weighted exchange rate, the Nominal Effective Exchange Rate (NEER) appreciated by 1.8 per cent year-on-year.

Monetary policy has largely been more accommodative since February 2012. The BoU's accommodative monetary policy: the gradually reduction of the policy rate from 23 per cent in January 2012 to 11 per cent in June 2013 and the reduction of the corridor band around the CBR, have resulted in falling short-term money market rates: the 7-day interbank rate has declined from a peak of 29 per cent in January 2012 to 11 per cent in the first week of June, while the overall interbank rate has declined from 26 per cent to 9 per cent in the same period. However, the adjustment of bank lending rates to monetary policy easing has been sluggish. Lending interest rates have not adjusted proportionally to the change in the policy rate.

In summary, the persistently weak current account balance could continue to cause exchange rate volatility amidst a depreciation trend throughout 2013/14 and beyond, which may continue to pass through to consumer prices. Short-term variations in fuel prices will continue to reflect developments in international oil market conditions. Other price increases, such as on consumer goods, will continue to reflect seasonal factors but also inflation expectations due if the exchange rate continues to depreciate. The recent price decreases for food crops, which were driven to a large extent by good weather and harvests, may be reversed if adverse weather conditions materialise. In addition, global food prices remain vulnerable to upside risks as supply conditions remain tight, which could result in higher import and domestic food prices.

Therefore, the BoU will maintain an accommodative monetary policy, at least in the near-term, but will remain observant of future inflationary developments and new information, and will stand ready to intervene to foster price stability. The BoU will also intervene in the foreign exchange market in both directions, in order to stem exchange rate volatility.

1. International economic developments

This section on Global Economic Outlook presents regular overview of recent and expected developments in selected advanced and emerging economies, focusing on key economic variables such as GDP, inflation, interest rates, exchange rates and commodity prices.

1.1 Global economic developments and prospects

Global economic indicators have been somewhat mixed in early 2013, and suggest that growth in the March quarter was not as strong as it was in the December quarter. The reverberation of China's deceleration on other Asian countries and commodity exporters elsewhere and the decline in terms of trade due to lower commodity prices are some of the explanations for the weaker-than-expected Q1 growth outturns across EM.

The International Monetary Fund's (IMF) April 2013 *World Economic Outlook* (WEO) characterises the current global trend as a three-speed recovery, whereby Europe has the lowest economic growth, the US displays modest growth and emerging and developing economies drive global growth. The IMF revised downwards its world economic growth forecast for 2013 to 3.3 per cent, from 3.5 per cent projected in January 2013 and 3.6 per cent projected in October 2012. In particular, the advanced economies are showing very different economic growth trends. The US, on the back of unprecedented monetary and fiscal stimulus, continues to grow close to its trend rate of 2 per cent. Nonetheless, the US' modest growth is expected to be sufficient to fuel employment growth, as may be demonstrated from the 1.9 million new jobs created over the past 12 months. Meanwhile, the euro area remains in recession on account of problems in the periphery states and weaknesses throughout the larger core countries also. According to the IMF WEO, GDP in the Euro area will contract by 0.3–0.5 per cent in 2013, while USA GDP will grow by 1.9 per cent. However, in 2014 GDP growth in the Euro area should turn positive and growth in the USA may reach 2.7–3.0 per cent. In Japan, quantitative easing, a new inflation target and structural reforms should boost growth in the short term, but growth is expected to slow within one year. The WEO anticipates that Japanese growth will weaken to 1.4 per cent in 2014.

Weak global demand, especially from European countries, is reflected in the growth forecasts for emerging economies. The outlook for economic growth in BRIC countries has accordingly been revised downwards in the most recent IMF WEO; nonetheless these economies are still projected to exhibit buoyant growth rates on account of pro-market policies, robust domestic demand and relatively healthy financial sectors. In China, annual GDP growth slowed to 7.7 per cent in Q1 2013 mainly due to weak external demand. Consequently, China's growth forecasts have also been revised downwards, by 0.2 percentage points, to project 8 per cent growth in 2013, which is expected to remain largely unchanged into 2014. India, which is major source for

Ugandan imports, is forecast to grow by 5.7 per cent in 2013. ***Table 1,*** below, portrays global growth forecasts, and revisions, since October 2012.

Given the mixed global picture, Sub-Saharan Africa stands out as a success story; in the five years following the 2008 financial crisis, growth in Sub-Saharan Africa has outstripped its earlier growth outturns. Regional output grew by 5.1 per cent in 2012, and is forecast to accelerate to 5.4 per cent in 2013 and 5.7 per cent in 2014. Growth has been strongest in the oil-exporting and low-income countries as middle-income African countries have been more affected by the weak European demand and, at times, by domestic problems. The recent growth in Sub-Saharan African as occurred following substantial investment, favourable commodity prices and prudent macroeconomic management, practiced by many countries. This is a considerable achievement because it demonstrates improved institutional capacity, a new standard of governance and thus greater long-term potential growth.

Table 1: IMF World Economic Outlook projections: annual GDP growth

	Oct 2012 Projections		Jan 2013 Projections		Apr 2013 Projections	
	2013	2014	2013	2014	2013	2014
World	3.6	4.2	3.5	4.1	3.3	4.0
Advanced economies	1.6	2.3	1.4	2.2	1.2	2.2
US	2.1	2.9	2.0	3.0	1.9	3.0
Euro zone	0.1	1.1	-0.2	1.0	-0.3	1.1
Japan	1.2	1.1	1.2	0.7	1.6	1.4
UK	1.1	2.2	1.0	1.9	0.7	1.5
Emerging and developing economies	5.6	5.9	5.5	5.9	5.3	5.7
China	8.2	8.5	8.2	8.5	8.0	8.2
India	6.0	6.4	5.9	6.4	5.7	6.2
Brazil	3.9	4.2	3.5	4.0	3.0	4.0
Sub-Saharan Africa	5.8	5.7	5.8	5.7	5.6	6.1
South Africa	3.0	3.8	2.8	4.1	2.8	3.3

Source: IMF WEO Update April 2013

Overall the global economy is expected to grow below average throughout 2013, largely on account of the ongoing balance sheet repairs and fiscal consolidation within the advanced economies, but to pick up in 2014. Furthermore, growth in the developing economies is expected to continuously outstrip advanced economies. As Uganda conducts greatest trade on a regional basis, and because the locality is experiencing favourable economic conditions, both Uganda and its local trading partners are expected to sustain GDP growth rates beyond the global average over the next two years.

1.2 Global inflation

Inflationary pressures are well contained on a global basis. Across developing countries over the three months to April, annual inflation fell further to average 6 per cent on account of falling commodity prices and only moderate economic activity, particularly when compared to the previous healthy rebound. Inflation pressures have also abated in Sub-Saharan Africa, where previously tight monetary policies are deemed to have passed-through to the wider economy, helped by low commodity price inflation. Across high income countries, inflation has picked up over the three months to April; however this is compared to decelerating inflationary pressures beforehand.

The inflation outlook across the advanced economies is benign; inflation in the Euro area and the US is projected at 1.5–2.0 per cent in 2013, whilst Japanese inflation is projected at 0.1-0.6 per cent over the year, rising to 1.9–3.2 per cent in 2014. Inflation in the BRICs also has global implications, due to the sheer size of their economies, yet it is forecast to mostly remain stable over the near- and medium-term. In Brazil inflation is expected to remain just above the Central Bank target of 4.5 per cent, although to stay within the target tolerance band of plus/minus 2 percentage points. Similarly, the Bank of Russia has set an inflation target of 5-6 per cent in 2013 and 4-5 per cent in 2014, although inflation is forecast to fall above target in the medium-term. Despite a sharp pick-up in inflation to 2.4 per cent in China in April, driven by food price inflation, inflation still remains below the Central Bank target of 3.5 per cent for 2013. Finally, India, which has previously experienced the highest inflation out of the BRICs, has recently experienced considerable falls in inflation to 4.7 per cent in May; however, Indian inflation is expected to increase over the policy horizon owing to a dramatic currency depreciation and a current account deficit.

The IMF congratulates central banks with largely achieving their inflation targets over the recent period and stipulates that increased central bank credibility will contain inflation expectations and consequently allow central banks greater room to support economic growth in the near-term. ***Figure 1,*** below, presents inflation developments in selected countries since 2011.

Figure 1: Consumer price inflation developments

Source: OECD Statistics & Eurostat

Within the East African Community, annual inflation typically fell in May. Inflation in Rwanda and Tanzania declined to 3.0 and 8.3 per cent respectively in May, from respective rates of 4.4 and 9.4 per cent in April. Similarly, inflation in Burundi declined to 3.0 per cent in April, from 5.9 per cent in March. Inflation in Kenya remained stable at 4.1 per cent for April and May. Falling food prices were the main drivers behind the recent inflation developments in East Africa.

1.3 Global financial markets

The policy actions by major central banks continue to have a significant effect on global financial markets. In particular, new policy measures announced by the Bank of Japan at the beginning of April have had a significant impact on asset prices and have contributed to a further depreciation of the Japanese Yen (JPY). Developments in Europe also remain a source of potential market volatility, although the recent banking crisis in Cyprus and the political uncertainty in Italy have reassuringly generated minimal lasting market reaction.

Financial market conditions in emerging and developing countries have eased, as evidenced by expanding equity markets and declining sovereign bond yields, which have subsequently enabled lower policy interest rates and thus an improvement in anticipated economic performance for 2013 and 2014. However, government bond yields remain elevated in emerging countries compared to the advanced economies, reflecting the comparatively elevated inflation and policy rates and the inherent risk associated with these countries as perceived by global investors.

Furthermore, although real economic activity decelerated in Q1, financial flows to emerging and developing countries remain robust. Driven by increased investor appetite for higher yields, gross capital flows to Uganda reached US$ 65.8 billion in April, an increase of 42 per cent over the year and 13 per cent over the month. The increase in capital flows was largely driven by bond issuances, which reached an all-time high of $44.4 billion in April. Bond market access for non-investment grade borrowers also improved over the month as Rwanda issued its first bond; bond market access is expected to continue to expand as both Ghana and Nigeria also launch sovereign bonds over the coming months. Overall, capital flows increased by 50 per cent over the first four months of 2013 when compared to 2012.

Notwithstanding strong capital flows, developing-country sovereign spreads have risen by 31 basis points (bps) since January 2013, when they reached this year's low of 245 bps. Furthermore, developing-country bond spreads have widened amid rising benchmark U.S. long-term Treasury yields and despite the continued improvement of developing-country credit quality. Indeed, the cost of international bond financing has gone up this year after reaching a record low level in early January 2013. For instance, while Treasury bond yields average 2 per cent in advanced economies, in emerging market countries they average about 7 per cent. This positive interest rate differential is an attraction for portfolio inflows and as a result, emerging economies have become major destination markets for investors as improving financial market confidence spurs greater risk appetite. This however poses a downside risk associated with the reversal of these flows.

This development could possibly reflect market expectations that the pace of quantitative easing in the United States may ease soon, even though the Fed has reassured markets that they will remain accommodative. Alternatively, these developments could also be due to increasing concern on the part of investors about asset price inflation in some developing countries and the recent easing of commodity prices. Overall, there has been a remarkable trend for developing country spreads to decline over the last five years, which is partly explained by their improved credit quality. However it also reflects the very low policy rates and quantitative easing in high income countries, with easy monetary conditions having suppressed the price of risk globally.

Foreign exchange markets have been primarily influenced by developments in Japanese monetary policy. Extreme monetary policy easing in Japan caused the yen to depreciate by 21 per cent in real effective (REER) terms between September 2012 and April 2013. In the same period, the US dollar appreciated by 2 per cent in REER terms and the euro by 4 per cent. The Euro has been largely resilient to developments including the recent political uncertainty in Italy and concerns surrounding the Cypriot banking sector and currently lies 7 per cent above its 2012 low. The ongoing weakness in real economic activity seems to have the largest effect on the Euro, causing it to weaken by 1.3 per cent since February.

Emerging market currencies have appreciated in REER terms in recent months as financial market stabilization and US QE pushes capital flows towards high-yielding emerging market assets, and the yen's depreciation exerts upwards pressure on Japan's trade-partner currencies. The GDP-weighted average REER for developing countries appreciated by 4.7 per cent since September2012, a considerably faster pace compared with the 1.5 per cent appreciation experienced over the previous 24 months.

Going forward, financial market conditions are expected to ease further largely on account of anticipated strong global economic growth in the latter half of 2013. In the World Economic Outlook of April 2013, the IMF forecasts a continuance of low policy rates in advanced economies while emerging market and developing countries are expected to either hold or cut their policy rates. Such behaviour would further ease credit and financial market conditions. The major downside risks relate to economic overheating and financial stability issues arising from excessive credit extension. Finally, the untimely revision of the US debt ceiling at its review in May 2013 may also negatively impact financial market sentiments, especially in Q2 2013.

1.4 Commodity prices

The average price of Brent crude oil and the overall average price of crude oil fell by 11.6 per cent and 7.7 per cent respectively in May, when compared to the recent peaks observed in mid-February. Oil demand appears weak at a time when oil supplies are plentiful from both OPEC and non-OPEC sources; as a result US crude oil inventories have risen to an all-time record high of 395 million barrels (in data going back to 1982). The Brent oil price fell to USD 100 a barrel in April 2013, reflecting the risk of slowing global economic growth. In 2013, the price of Brent crude oil is projected to decrease by about US$10 when compared to 2012, to a price range of US$100-110 a barrel. Compared to Q1 2013 forecasts, the whole outlook for Brent crude oil prices has shifted downwards by about 8 per cent. In January and the first half of February 2013, the price of Brent crude oil rose as optimism surrounding the global economy picked up, tensions surmounted in the Middle East and the dollar weakened. In mid-February the price of Brent oil price fluctuated around a nine-month high of US$118 a barrel. However, as optimism surrounding global economic recovery fades, and the Chinese data outturns fall below that expected, the price of Brent oil has similarly fallen.

1.5 Impact of the global economic development on Ugandan economy

Major Central Bank actions have successfully minimized financial market volatility, improved sentiment and boosted returns. Underpinning these gains are the major Central Banks who continue to inject massive amounts of liquidity into the global financial system. With volatility at a five year low, investors are increasingly willing to take on risk. Given that growth forecasts remain subdued, this will remain a key factor in driving returns.

Furthermore, low inflationary pressures and disappointing growth have laid the foundation for loose monetary policy in the advanced economies; however, the Federal Reserve appears poised to begin stepping away from its bond buying program in support of a stronger US$ and higher bond yields. Nevertheless, slowing the pace of bond purchases (QE) is not the same as tightening policy, leaving investors still on the hunt for rising yields and potentially fueling bubbles across a host of emerging markets asset classes as well as in non-US housing and global equities. For the US$ to continue to strengthen, the Fed will need to step away from QE and witness strong employment growth. Accordingly in the near-term, exchange rate developments for major currencies will be data dependent. Beyond that, projections indicate that the EUR, JPY and GBP could weaken against the USD towards the year-end mainly on relative central bank policy and growth outlooks. These developments within the international financial system will impact upon the shilling and consequently upon the rest of the economy.

In addition, although there has been no clear effect yet, concerns around inflation persist. Continued easing helps businesses, but may hurt consumers. Households are most at risk from rising inflation, which has depressed real wages in many countries in recent years, notably the UK. Good quality corporates are in a strong position; with strong cash flows and access to cheap finance, the resources are there to increase earnings. On the other hand, continued loose monetary conditions enables 'zombie' firms who would otherwise fail to survive, hoarding capital that could be more effectively deployed elsewhere and so delaying a sustainable economic recovery.

Escalating money supply in the advanced economies, caused by exceptionally expansionary monetary policies, may also increase the pace of capital inflows to Uganda. Whilst increased portfolio inflows may provide increased investment opportunities within Uganda, they also necessitate some form of protection against the potential harm that may be caused by sudden reversal in the future. Furthermore, the lesser returns currently received upon previously deemed low risk investments in advanced economies might erode the capability of the Bank of Uganda to protect Uganda from sharp portfolio outflows; in the future it may be worthwhile for the Bank of Uganda to investigate new investment opportunities in potentially safer emerging markets that promise higher returns.

The continued weakness in economic activity in the Euro Zone, one of Uganda's major trade partners might imply that export demand, earnings and sequentially current account balance may continue to decline. This might indicate a need for the Bank to support domestic demand as a means to sustaining economic growth. The decline in global inflation and oil prices could contain domestic inflation going forward. If this happens then the Bank of Uganda would employ monetary policy in such a way as to boost domestic economic growth. The positive interest rate differential between emerging and developed economies and resultant portfolio flows presents both an opportunity and a risk to the country. These inflows could be used to build foreign exchange reserves and also lead to an improvement in the balance of payments, but they also present a risk to exchange rate stability if an unexpected reversal occurs.

In summary, given the uncertainty in the global economy, financial instability cannot be overlooked. Developments in Europe also remain a source of potential market volatility. Although Central Banks have taken bold policy actions that have reduced banking sector vulnerabilities and stabilized financial markets, these policies may have undesirable side-effects that could threaten financial stability the longer they are in place.

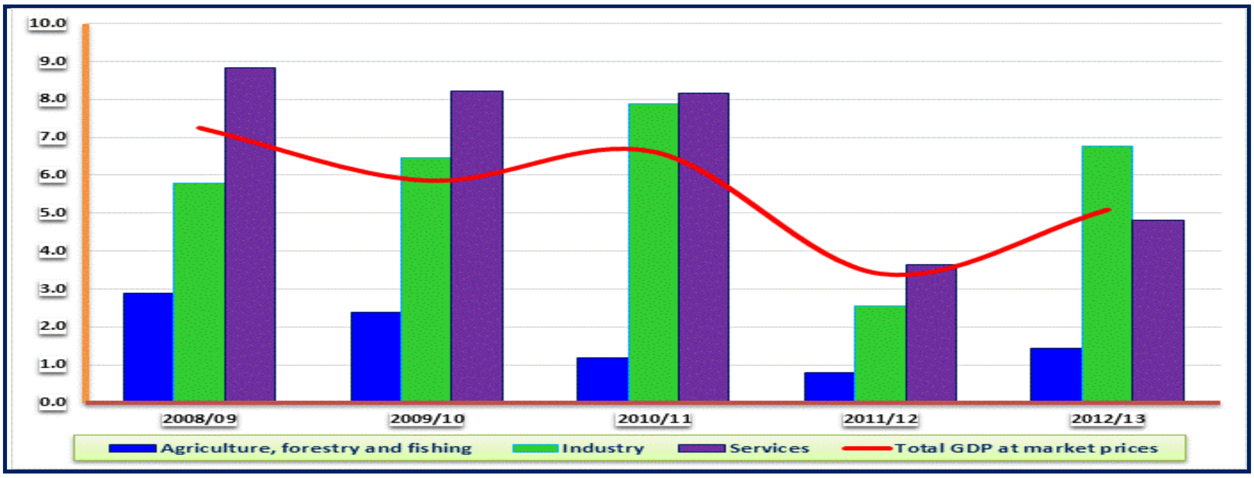
2. Domestic economic conditions

2.1. Real economic activity

The Uganda Bureau of Statistics revised upwards their estimate for 2012/13 GDP growth to 5.1 per cent, from 4.3 per cent previously. Real economic growth in 2012/13 is thought to be primarily driven by growth in exports and public investment and, to a lesser extent by growth in private investment and general government consumption. Household consumption is expected to make a negative contribution to GDP growth, declining by 1.4 per cent in 2012/13 (*Table 2*) and is expected to make only a marginal contribution in 2013/14 as nominal and real disposable income, especially wages and salaries, remain low; public real wages are expected to decline by 1-2 per cent in 2013/14. Fiscal consolidation and persistent uncertainty surrounding future economic developments are expected to continue to hamper economic growth.

Figure 2, below, decomposes GDP growth by sector and indicates that the industrial sector was the main driver of growth in 2012/13; the industrial sector comprises approximately 25 per cent of GDP and grew by 6.8 per cent in 2012/13. Yet note that even industrial growth is highly concentrated to the public construction subsector, which grew by over 30 per cent over the year. The services sector, which accounts for 52 per cent of GDP, is estimated to have grown by 4.8 per cent and to be driven by the transport and communications subsectors. Meanwhile, agriculture, which comprises 14 per cent of GDP, is expected to have only grown by 1.4 per cent in 2012/3.

Figure 2: GDP growth by economic activity



Source: Uganda Bureau of Statistics

GDP growth is expected to fall slightly below trend over 2013, at 5-6 per cent, but is expected to recover by 2014. The subdued economic outlook reflects the spill over from the global economy, the effects of fiscal consolidation and the lagged impact of the tight monetary stance in the first half of 2011/12. Furthermore, the trade balance is expected to deteriorate and play down upon economic growth, as import growth outstrips export demand.

Table 2: Real GDP growth

	2010/11	2011/12	2012/13
Total GDP at market prices	**6.6**	**3.4**	**5.1**
Final consumption expenditure	**8.2**	**3.4**	**-1.3**
Household final consumption expenditure	8.4	6.1	**-1.4**
Government final consumption expenditure	7.4	-15.4	**-0.6**
Gross capital formation	**10.3**	**3.0**	**9.0**
Public	***28.8***	***-12.3***	***13.1***
Private	***4.9***	***8.6***	***7.8***
Changes in inventories	0.6	-8.2	**2.8**
Exports	0.5	15.6	**18.6**
Imports	11.5	8.6	**-2.5**

Source: Uganda Bureau of Statistics

The most recent data available highlights that quarterly growth slowed in Q2 2012/13, to 0.8 per cent, from 3.3 per cent the previous quarter (***table 3***). However, note that Q2 2011/12 also demonstrated the lowest, and negative, growth outturn over the year despite the data being seasonally adjusted. Quarterly growth slowed in the services sector, from 5.0 per cent in Q1 to 1.5 per cent, and contracted in agriculture, from 5.3 per cent in Q1 to *minus* 4.1 per cent. The industrial sector grew slowly, by 0.9 per cent, but this represents an improvement upon the contraction experienced in the previous quarter.

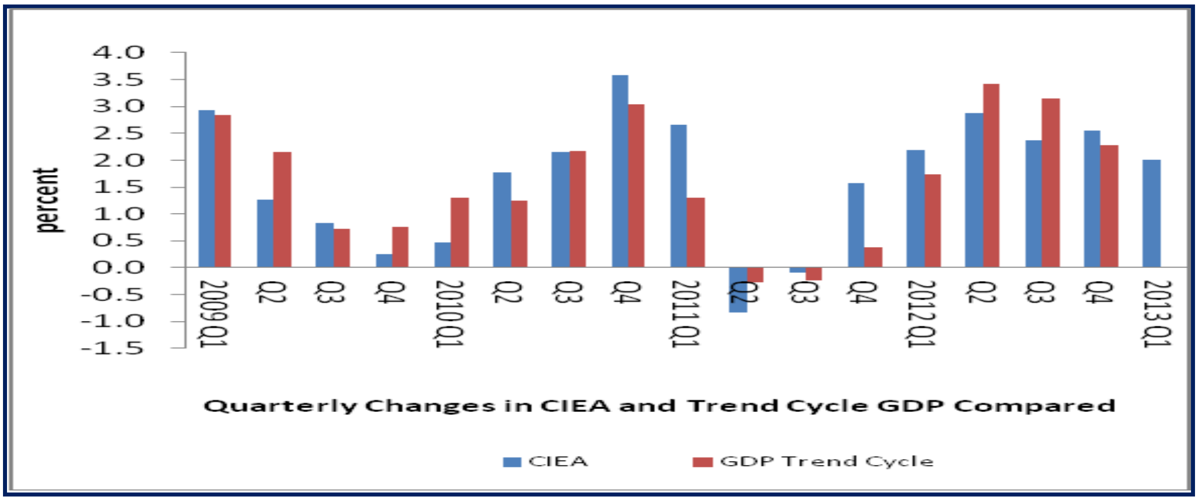
Table 3: Quarterly GDP growth (Seasonally Adjusted)

	2011/12				2012/13	
	Q1	Q2	Q3	Q4	Q1	Q2
GDP at market prices	0.5	-0.9	2.5	3.1	3.3	0.8
Agric., forestry and fishing	8.1	-4.1	-0.3	2.3	5.3	-4.1
Industry	-2.9	1.2	3.5	4.4	-0.1	0.9
Services	-0.3	-1.2	1.8	3.6	5.0	1.5

Source: Uganda Bureau of Statistics

The composite index of economic activity (CIEA) provides information on economic developments on a more timely and frequent basis than GDP data. In April, the CIEA grew by 0.4 per cent, which is slightly lower than the 0.5 per cent growth recorded in March, yet growth is expected to continue throughout the year (*figure 3*). Over the quarter ending March 2013, economic activity is estimated to have increased by 2.0 per cent, compared to 2.2 per cent in the same time frame last year; the growth experienced was mainly a result of growth in the services sector, particularly wholesale and retail trade.

Figure 3: Composite Index of Economic Activity



Source: Bank of Uganda

Forecasts for the Ugandan economy anticipate a shift from public to private sector investment. However, high lending rates and low credit availability may stifle private sector and household investment, causing focus to shift more upon cost reduction and lesser risk exposure. Thus despite largely favourable investment conditions, it is possible that investment may decline over the coming year and affect economic growth. If investment is sufficiently stifled then it may risk economic recovery.

2.2. Monetary policy

The Bank of Uganda started easing the monetary policy stance in February 2012 given the downward trajectory of inflation. Inflation peaked at 30.5 per cent in October 2011; by February 2012 inflation had declined to 26.0 per cent, but was forecast to rapidly fall into single digits and to stabilise close to the BoU medium term target in 2013. Furthermore, subdued economic activity provided further support for monetary policy easing. From February 2012, the BoU policy rate, the CBR, has been reduced by 12 percentage points: from a peak of 23 per cent throughout November 2012 to January 2013 to 11 per cent at present. The reduction of the CBR is envisaged to similarly lessen interbank interest rates and thus the marginal cost of funds for commercial banks, which in turn should lessen commercial bank lending rates and stimulate a recovery in private sector credit. The BoU forecasts that core inflation will stabilise around its medium-term target of 5 per cent over the next 12 months, with the balance of risks being roughly neutral.

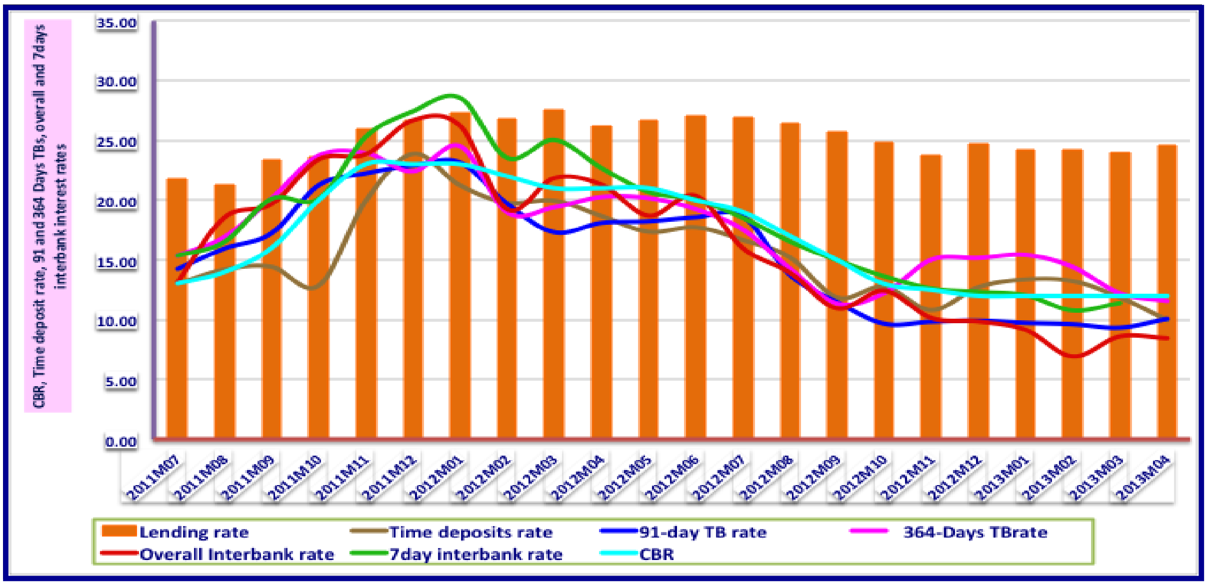
The BoU have carried out Treasury bill and bond auctions in the primary market in line with fiscal financing needs. Yields have been rising across all tenors' as a result of increased government borrowing; the 91-day Treasury bill is an exception, whereby rates declined marginally to 10.0 per cent in May from 10.1 per cent previously. Weighted average annualized yields for the 182-day treasury papers remained stable at 11.1 per cent in April and May while the weighted average annualized yields for the 364-day treasury papers rose to 12.1 per cent in May from 11.6 per cent in April. The 2-year Treasury bond yields rose to 13.0 per cent in May, from 12.3 per cent in April, while the 3-year Treasury bond yield rose to 13.3 per cent from 12.3 over the same period.

2.3 Interest rates

Since January 2013, the Ugandan financial market has been characterised by considerably eased liquidity conditions. Money market rates, which peaked in January 2012 when the CBR was set at 23 per cent, have declined in line with the reduction in the CBR (*Figure 3*). The 7-day interbank rate has trended comfortably within the CBR band throughout the 12 months to May 2013; while the overnight, and consequently the overall, interbank rates have fallen sharply to slide below the lower bound of the CBR since November 2012 as a result of the structural liquidity surplus in the financial system.

The accommodative monetary policy stance has led to a downward trend in interest rates since early 2012; however the adjustment of market interest rates in response to changes in policy rates is expected to be reflected with some lag. In Uganda, the impact of the monetary transmission mechanism has been different upon the various sections of the financial market. While the transmission mechanism has been more rapid in the money and government securities markets, it has been relatively muted in the credit market on account of several structural rigidities. The reduction in the CBR has to a large extent been transmitted to all interest rates in the economy. For instance, the overall interbank rate declined from 26.7 per cent in December 2011 to 9.3 per cent in May 2013. The domestic currency time deposit rate has also eased from 23.9 per cent to 10 per cent in April 2013. The yields on Government securities have also evolved in line with the reduction of the CBR. The 364-day Treasury bill rate declined from 24.5 per cent in January 2012 to 12.1 per cent in May 2013. However, although time deposit rates are declining, lending rates have been sticky downwards and there is clearly more space to cut lending rates given the low inflation outlook. Commercial banks' lending rates have been persistently sticky and elevated, declining on average by only 3 percentage points from a weighted average of 27 per cent in January 2012, to 24 per cent in March 2013. Furthermore, lending rates edged up to 24.6 per cent in April 2013 ***(Figure 4)*** and lending spreads have widened in the five months to May 2013. The adjustment in lending interest rates, which is less than proportional to the change in the policy rate (i.e. incomplete pass-through), has been disproportionally responsive to a monetary policy reduction and increase (i.e. asymmetric pass-through).

Figure 4: Interbank interest rates



Source: Bank of Uganda

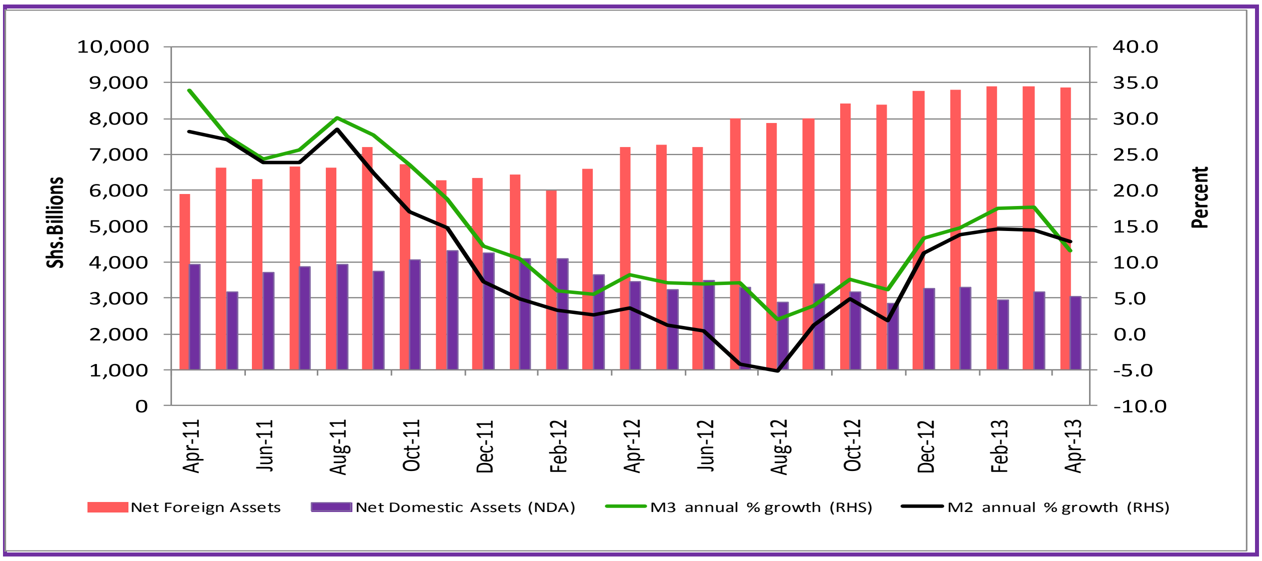
In addition to the marginal decline in lending interest rates, the loan-to-deposit ratio has also declined; the average ratio was 78 per cent from July 2012 to April 2013, compared to 80 per cent in the FY 2011/12. The slow credit extension is in large part due to the procyclical behaviour of credit and the recent increase in non-performing loans. Non-performing loans rose from Shs. 105 billion (equivalent to 1.6 per cent of total credit) in June 2011 to Shs 342 billion in September 2012 (equivalent to 4.7 per cent of total credit), but declined to Shs 329 billion (equivalent to 4.2 per cent of total credit) in April 2013. In addition, the high credit demand for shorter maturities usually prompt banks to raise time deposits at higher rates to ensure longer term access to liquidity. This, in turn, limits the banks' ability to rapidly cut lending rates. Going forward, while lending rates are expected to decline, increased financing of the fiscal deficit through the issuance of treasury bills/bonds in the domestic market is likely to lead to elevated rates on government securities.

2.4 Monetary aggregates and private sector credit:

Monetary aggregates have expanded from July 2012 onwards, which resembles a recovery from the policy-led decline previously experienced.

Figure 5 presents how M2 hit a local peak of 28.5 per cent in July 2011, when inflation also peaked, declined to minus 5.2 per cent in July 2012, when monetary policy was at its most contractionary, and has largely stabilised at a mid-point throughout 2013; M2 grew by 12.6 per cent in April 2013. Similarly, base money has grown from minus 2.2 per cent in July 2012 to 12.0 per cent in April 2013, whilst M3 growth has expanded from 7.2 per cent in April 2012 to 11.6 per cent in March 2013, although it declined slightly to 11.1 per cent in April. Broad money growth over the 12-months to April 2013 was driven by 18.9 per cent growth in depository corporations' NFA, which more than offset the 6.3 per cent contraction in the sector's NDA.

Figure 5: Growth in monetary aggregates



Source: Bank of Uganda

Table 4: Monetary aggregates annual percentage changes

	Annual Percentage Change (%)			
	Mar-12	Apr-12	Mar -13	Apr -13
NFA	**22.09**	**9.7**	**23.1**	**18.9**
O/w BOU	22.3	9.5	26.2	23.7
O/w ODCs	20.5	11.4	-6.0	-28.0
NDA	**-12.4**	**2.1**	**-12.1**	**-6.3**
O/w NCG	-123.1	-176.8	25.2	38.9
O/w PSC	22.5	21.1	8.1	7.9
M3	**8.2**	**7.2**	**11.6**	**11.1**
O/w FC deposits	23.3	26.9	8.0	7.1
O/w M2	3.6	1.2	13.0	12.6
	Annual Contribution to M3 growth			
NFA	***13.2***	***6.5***	***15.0***	***13.4***
NDA	***-5.0***	***0.7***	***-1.9***	***-4.3***

Source: Bank of Uganda

Lending activity improved by Shs. 27 billion in April 2013, as Shilling loans experienced a net extension of Shs. 90 billion and foreign exchange loans a net recovery of Shs. 63 billion. As a result, the loan-to-deposit ratio has also declined; the loan to deposit ratio from July 2012 to April 2013 averages 78 per cent, compared to 80 per cent over the FY 2011/12. Weak economic performance has tended to increase non-performing loans, thus weakening the associated provisions, and has put banks' earnings and balance sheets under pressure; consequently deteriorating balance sheet positions have caused banks to stifle credit supply, which has had a circular effect to further reinforce weak economic activity.

As predicted above, private sector credit (PSC) growth has been subdued when compared to earlier years; PSC growth averaged 39 per cent in 2011, but has since declined to average 14 per cent in 2012 and 11 per cent over 2013 to date. Over the FY 2012/13 to date, PSC growth has averaged 9 per cent, however this has been almost entirely driven by 39 per cent growth in foreign currency denominated loans, whilst Shilling denominated loans have declined by 0.3 per cent. Reassuringly, PSC is expected to pick up in 2013/14, reflecting monetary policy expansion and economic recovery.

Table 5: Monetary aggregates growth rates

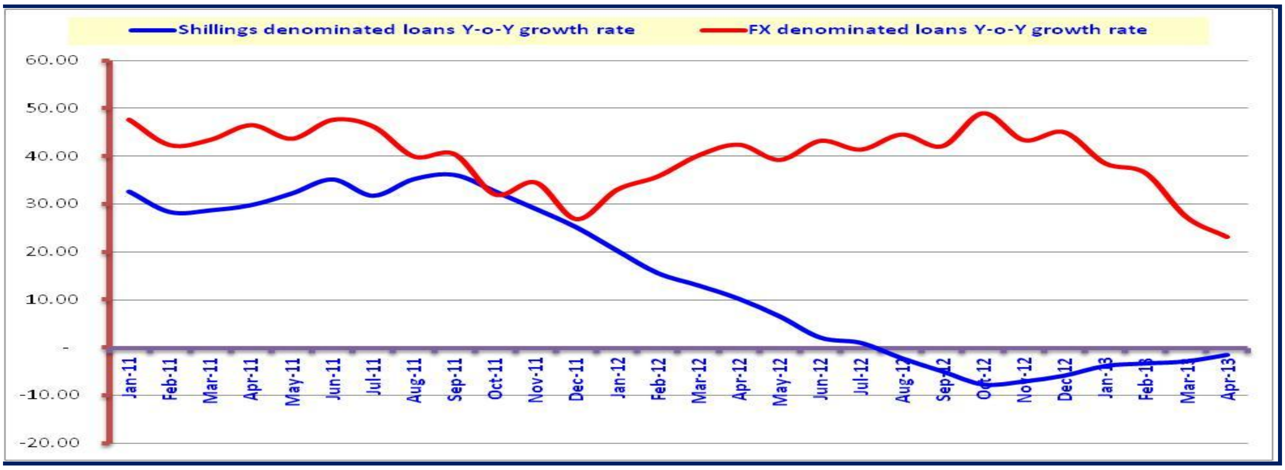
	Monthly				Annual			
	PSC	Shilling loans	Forex loans (Shs.)	Forex loans (US$)	PSC	Shilling loans	Forex loans (Shs.)	Forex loans (US$)
Jul-12	-0.3	-0.2	-0.4	-0.6	10.4	1.0	34.2	41.4
Aug-12	0.6	0.0	1.9	0.7	6.6	-2.2	28.5	44.5
Sep-12	1.3	-0.3	4.4	2.9	4.4	-5.0	27.1	42.1
Oct-12	1.7	-1.5	8.0	6.3	7.5	-7.7	48.5	48.9
Nov-12	2.5	1.0	4.9	0.8	9.0	-7.1	50.2	43.3
Dec-12	1.7	0.2	4.2	4.3	11.8	-5.9	56.3	45.0
Jan-13	-0.2	0.4	-0.5	0.3	13.4	-3.9	58.6	38.5
Feb-13	0.0	-1.3	1.9	2.8	12.9	-3.3	52.1	36.5
Mar-13	-1.5	-0.4	-3.3	-1.5	8.1	-2.9	31.2	27.3
Apr-13	0.2	1.0	-1.2	-1.3	7.9	-1.5	27.7	23.2

Source: Bank of Uganda

The robust growth of foreign currency denominated loans, which reflects sizeable capital inflows and global liquidity surpluses, may be of particular policy concern.

An appreciation of the Uganda shilling, when combined with the already high interest rates charged upon Shilling denominated loans relative to forex denominated loans, would further favour preference of, and expansion in, US$ denominated loans. Further expansion of US$ denominated credit risks macroeconomic and financial instability, particularly following a currency depreciation; both rapid foreign currency denominated loans growth and excessive appreciation of the exchange rate distort the resource allocation within the economy and negatively affect macroeconomic stability.

Figure 6: The trend of shilling forex denominated private sector credit.



Source: Bank of Uganda

Between April 2012 and March 2013, credit distribution has been largely inclusive of the various economic sectors. Transport and communications greatly increased their share of total PSC, at the cost of the manufacturing, trade and construction sub-sectors. The share of total PSC appropriated by the transport and communications sector grew by 0.8 percentage points between March 2012 and April 2013. The building, mortgage, construction and real estate sector continued to appropriate the largest share of PSC, equal to 22.6 per cent of the total, whilst trade and commerce similarly appropriated 22.1 per cent of total PSC. Personal and household loans and manufacturing also received considerable proportions of total credit in the economy, equal to 13.4 per cent and 13.6 per cent of total PSC respectively.

2.5 Fiscal policy

Government expenditure during the third quarter of 2012/13 amounted to Shs. 1,849.1 billion, a lower level compared to the previous quarter and the corresponding quarter in 2011/12. Lesser government expenditure mainly arose from lesser purchases of goods and services, which suffered the largest cutbacks in the externally funded development expenditure component. Government operations in the third quarter of 2012/13 balanced a net borrowing of Shs. 448.1 billion, which reflects greater borrowing than in both the previous quarter and the corresponding period of 2011/12. The increased net borrowing was a consequence of disappointing government revenue performance; government revenue for the third quarter of 2012/13 amounted to Shs. 1,959.3 billion, which resembles a lower resource inflow for government relative to both the previous quarter and the comparable quarter in the previous year (***Table*** **6**). Weak performance in government revenue resulted from reduced collections of direct taxes and cuts in donor funding.

The net borrowing position was 10.5 per cent, or Shs. 38.8 billion, financed by domestic sources and 88.8 per cent, or Shs. 329.4 billion, financed by foreign inflows. The third quarter of 2012/13 registered the highest net foreign inflows and the lowest net domestic financing over the financial year. The stock of domestic debt (net of government deposits) at the end of Q3 2012/13 stood at Shs. 3,570.2 billion, which represents a 5.2 per cent decline over the quarter but a 16.7 per cent increase over the year. The overall government deficit is estimated to be 3.9 per cent of GDP in 2012/13, compared to 3 per cent in 2011/12; it is projected to decline to 3.6 per cent in 2013/14, but rise to over 5 per cent in 2014/15 and onwards.

Table 6: Fiscal operations (UGX billions)

	Q2 2012	Q3 2012	Q4 2012	Q1 2013
Revenue	**2,037.30**	**1,760.60**	**2,428.80**	**1,959.30**
Taxes	1,864.50	1,555.40	1,821.10	1,767.60
Social contributions	-	-	-	-
Grants	142.4	160.4	530.1	161.4
Other revenue	30.4	44.9	77.6	30.3
Expense	**1,921.00**	**1,759.40**	**1,925.40**	**1,849.10**
Compensation of employees	326.9	323.8	357.3	355.3
Purchase of goods and services	496.3	349.1	418.4	390
Consumption of fixed capital	-	-	-	-
Interest	155.7	221.5	225.4	228.9
Subsidies	120.8	15.5	12	1.5
Grants	695.7	748.9	778.1	765.3
Social benefits	68.4	64	45.1	42.6
Other expense	57.3	36.6	89.2	65.4
Gross operating balance	***116.3***	***1.2***	***503.4***	***110.2***
Net operating balance	***116.3***	***1.2***	***503.4***	***110.2***
Transactions in nonfinancial assets:	-	-	-	-
Net Acquisition of Nonfinancial Assets	542.4	524.7	837.1	558.3
Fixed assets	530.2	512.9	821.1	542.8
Change in inventories	-	-	-	-
Valuables	-	-	-	-
Non-produced assets	12.1	11.7	16	15.5

Net lending / borrowing	*-426.1*	*-523.4*	*-333.7*	*-448.1*
Transactions in financial assets and liabilities (financing):	-	-	-	-
Net acquisition of financial assets	**1,313.00**	**280.6**	**15.8**	**584.6**
Domestic	1,313.00	280.6	15.8	584.6
Foreign	-	-	-	-
Monetary gold and SDRs	-	-	-	-
Net incurrence of liabilities	**1,350.40**	**473.8**	**491**	**952.8**
Domestic	1,148.10	321.1	316.1	623.4
Foreign	202.3	152.8	174.9	329.4
Errors and Omissions	-388.7	-330.3	141.5	-80

Source: Ministry of Finance, Planning & Economic Development

The stock of government securities is projected at Shs. 7.2 trillion for the end of the FY 2012/13. Almost 50 per cent of the current domestic debt stock is due to mature in the next FY and is expected to be rolled over in addition to the new domestic government borrowing needs, which are projected at Shs. 1,040 billion in 2013/14. By the end of the FY 2013/14, the stock of domestic debt will be about Shs 8.8 trillion, equivalent to 14 per cent of GDP. Assuming interest rates of around 13 per cent, the interest payments on domestic debt alone will amount to Shs 1.1 trillion, equivalent to 1.7 per cent of GDP or 8.4 per cent of total government spending. Total public debt will rise to about 43 per cent of GDP. Given the limited grants, government domestic debt ratios are expected to remain at high levels in the medium to long term. Therefore, raising funds domestically at lowest cost, with acceptable roll-over risk, remains a great challenge for the government. There is need to rebalance the profile of debt portfolios by issuing more long-term instruments and moderating bill issuance.

The public debt expansion is likely to significantly raise interest rates for government debt, thereby increasing interest costs for future generations. Moreover, this could increase interest rates for all private debt such as home mortgages, consumer loans, and business loans. The near-term consequences of the debt expansion present weaker economic recovery. The higher interest costs are also usually associated with higher real money market rates and higher expected inflation rates. It is important that the government borrowing is done at the lowest possible long-term borrowing costs, subject to a prudent degree of risk. Furthermore, it should also aim to support a well-functioning domestic financial market and to facilitate the central government's access to financial markets in the long term. Therefore there must be an ongoing evaluation of the trade-off between cost and risk, supported by liquid benchmark series.

In addition, although about Shs. 585 billion of the total stock of government debt (about 8 per cent) is held by offshore investors, this could rise as yields edge up. The danger with this is that, whereas offshore investors are usually attracted by high yields on the government debt, any negative change in perception regarding the riskiness of the government debt will result in quick outflow. This often causes a lot of instability in the exchange rate. However, with the improved foreign reserve cover, this might not be of immediate danger until the portfolio inflows significantly increase. Higher public borrowing to finance higher public expenditure may increase economic growth, without causing inflation since the economy is growing below trend at present. However, given that a higher proportion of government expenditure will be on infrastructure projects, which have a higher import content, the contribution to GDP is likely to be minimal in the near term. Overall, the government could face unprecedented challenges due to heavy borrowing amidst a highly uncertain economic environment, particularly considering the pace of recovery and surging borrowing costs. However, if used efficiently, increased government borrowing could boost the economy in the medium to long term.

2.6 External sector developments

Uganda's current account deficits have risen sharply since 2008. The current account deficit to GDP ratio averaged only 3 per cent between 2004 and 2008, yet this has risen to an average of 11 per cent in the period 2009-2013. Furthermore, the outlook predicts that the current account deficit will widen further. As the trade imbalance widens, and current transfers and foreign direct investment diminish, the exchange rate will need to adjust through depreciation in order to preserve some foreign exchange reserves.

A broad set of economic factors determine the widening current account deficits. Productivity developments, population demographics and the age structure, in addition to time preferences, are all factors that exert a significant influence on the current account positions and may induce large swings in Uganda's external balance over time. These factors thus determine what the natural or "balanced" current account position should be. In addition, the current account is the difference between national (both public and private) savings and investment. Therefore, current account deficits reflect low levels of national savings relative to investment. Uganda's gross investment as a percentage of GDP between 2008 and 2013 is estimated at 23.1 per cent, while gross national savings as a percentage of GDP is 12.1 per cent. This suggests a savings-investment gap of 11.0 per cent of GDP, which matches the average current account deficit over the period. Therefore in a country like Uganda, which is capital-poor and has more investment opportunities than it can afford to undertake due to low levels of domestic savings, a higher current account deficit is natural. In these circumstances, a current account deficit potentially spurs faster output growth and economic development. In addition, from an intertemporal perspective, a temporary increase in the current account deficit may be justified since Uganda has grown faster than its main trading partners. In this case, Uganda's higher productivity growth implies larger returns on investment, which in turn has attracted foreign capital averaging about US$

750 million per annum in the period 2008-2012 and allowed the country to finance its current account deficits.

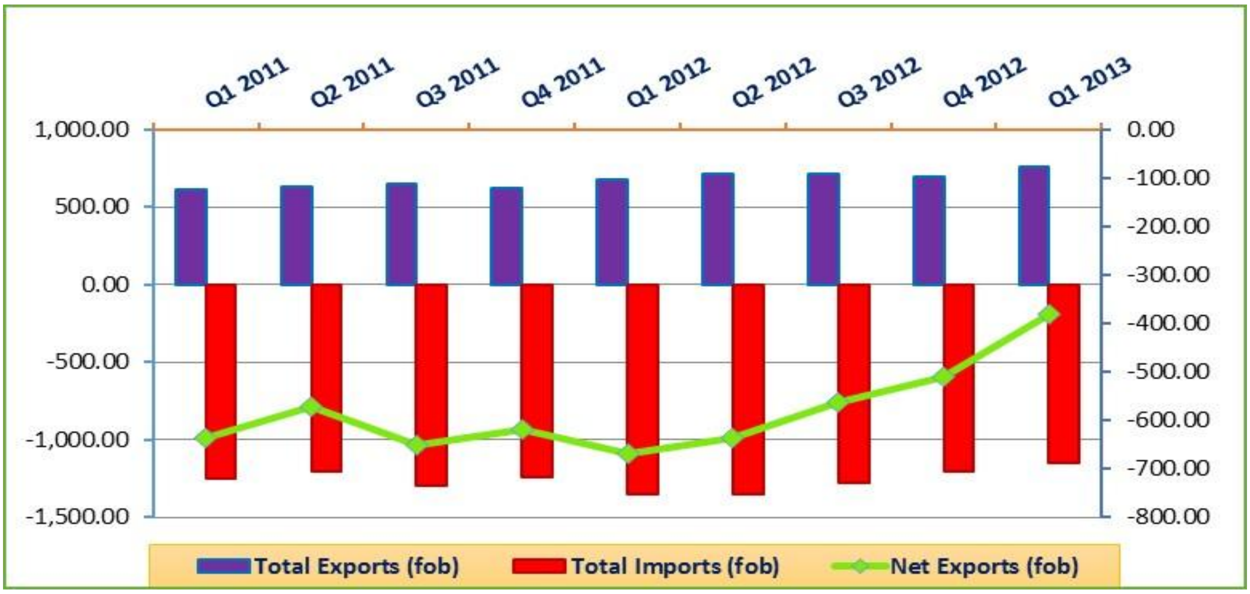
However, the challenge with current account deficits is that they tend to be long-lasting and that a market-driven process to correct the imbalance may lead to "overshooting", i.e. a situation in which prices and quantities, demand and supply, cannot persist at existing levels without increasing the risk of abrupt changes in flows of trade and finance. There is a risk that a purely market-determined adjustment may be abrupt, with serious adverse effects for economic growth and for financial stability. Thus, policy may have an important role to play in preventing the market from overshooting, or should at least smooth the adjustment process and ensure that it does not take an abrupt course with damaging effects for the economy. Policy would thus not be the cause of such an imbalance, but could still have an important role to play as an instrument used to address it.

Furthermore, when Uganda runs a current account deficit, it builds up liabilities to the rest of the world that are financed by flows in the financial account, which eventually need to be paid back. Therefore, if Uganda uses borrowed foreign funds in investments that yield no long-term productivity gains, its ability to repay—its basic solvency—might come into question. Solvency requires that the country be willing and able to (eventually) generate sufficient current account surpluses to repay what it has borrowed. Therefore, whether Uganda should run a current account deficit (borrow more) depends on the extent of its foreign liabilities (its external debt) and on whether the borrowing will be financing investment that has a higher marginal product than the interest rate that the country has to pay on foreign liabilities.

The Ugandan economy continues to experience a persistent deficit in the external current account due to a mix of weak external demand coupled with strong domestic demand growth, particularly for imports. In 2012/13, the current account deficit was estimated at US$ 2,250 million, which is equivalent to 10.4 per cent of GDP. This was a slight decrease from the deficit of US $ 2,334 million in 2011/12, which resembled 12.0 per cent of GDP. Furthermore, the current account deficit is expected to rise to US$ 2,874 million in 2013/14. However, the current account deficit is more than offset by the capital and financial account balance, which is estimated at US$ 2,664 million in 2012/13 and is forecast to be US$ 3,104 million in 2013/14, or 12.2 per cent of GDP.

On average, non-oil imports declined by 5.2 per cent in the period July to December 2012, and declined further by 7.6 per cent in Q1 2013, compared to Q4 2012. Yet, private sector imports have risen from January 2013 to April 2013 by a monthly average growth rate of 3.0 per cent. Exports have comparatively grown by 0.1 per cent, month on month in the same period. On the whole, the contribution to growth from net external trade has weakened over 2013 to date ***(Figure 7).***

Figure 7: Goods account (*USD millions*)



Source: Bank of Uganda

In 2012/13, the BoP surplus (*Table* 7) is estimated to reach US$ 414 million, which is much less than the US$ 747 million surplus in 2011/12. The stock of reserves stood at US$ 2,998.6 million in April 2013, which is equivalent to 4.4 months of import cover.

As aforementioned, the current account deficit equals to the difference between national savings and investment. Therefore, a rise in the current account deficit reflects a low level of national savings relative to investment. Uganda's gross investment, as a percentage of GDP, is estimated at 26.1 per cent in 2012/13 and at 27.7 per cent in 2013/14; while gross national savings as a percentage of GDP are estimated at 15.4 per cent and 15.3 per cent in 2012/13 and 2013/14 respectively. The much greater investment opportunities, beyond what national savings may provide for, naturally lead to a current account deficit. Over the long term, both goods and services export volumes are expected to grow more strongly, largely driven by a rise in global demand as global recovery picks up, productivity improvements following infrastructure investments, increased energy supply and possibly from oil exports.

Table 7: Balance of Payments (USD millions)

	2012				2013
	Q1	Q2	Q3	Q4	Q1
A. Current Account Balance	-437.2	-649.3	-645.1	-365.1	-183.6
A1. Goods Account (Trade Balance)	-669.3	-635.7	-562.2	-509.1	-380.6
a) Total Exports (fob)	681.1	711.7	719.4	698.3	764.8
Coffee	100.1	94.3	95.6	82.6	123.0
b) Total Imports (fob)	-1,350.4	-1,347.4	-1,281.6	-1,207.3	-1,145.4
Government Imports	-148.4	-105.6	-71.7	-96.2	-80.7
Private Sector Imports	-1,186.3	-1,229.0	-1,199.0	-1,097.8	-1,050.5
A2. Services Account (services net)	-88.7	-119.8	-178.3	-51.1	-43.6
A3. Income Account (Income net)	-125.3	-134.3	-206.4	-121.6	-99.4
A4. Current Transfers (net)	446.1	240.5	301.8	316.7	340.0
B. Capital & Financial Account Balance	483.8	790.7	527.6	486.0	724.4
B1. Capital Account	3.2	2.3	16.7	8.9	29.6
B2. Financial Account; excl. financing items	480.6	788.4	510.8	477.1	694.8
a) Direct Investment	428.6	635.6	360.7	296.2	465.6
b) Portfolio Investment	58.1	29.8	-66.4	-19.1	43.2
c) Financial derivatives, net	3.5	1.4	0.6	-1.7	1.7
d) Other Investment	-9.7	121.6	216.0	201.6	184.3
C. Errors and Omissions	46.6	41.3	314.6	-71.7	-440.3
D. Overall balance (A+B+C)	93.2	182.7	197.1	49.3	100.4
E. Reserves and related Items	-93.2	-182.7	-197.1	-49.3	-100.4

2.7. The exchange rate

In an open economy, the exchange rate and monetary policy are inextricably linked, i.e. domestic and foreign interest rates, inflation rates, and exchange rates are highly linked because exchange rates will move to equilibrate demand and supply in markets for both internationally traded goods and services and financial assets. Consequently, the exchange rate is affected by underlying factors influencing both tangible and intangible financial markets; typically shifts in international demand or domestic supply of goods and services will create long-term movements to the bilateral exchange rate, whilst financial market developments tend to exacerbate short-term volatility to the exchange rate.

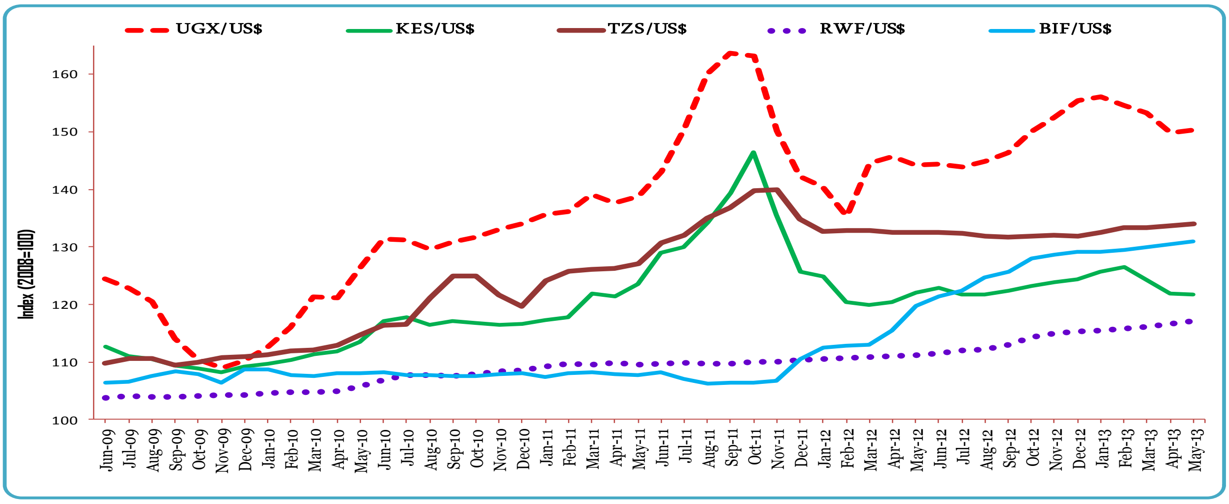
The policy challenge is thus what degree of exchange rate volatility should be tolerated. For instance, an exchange rate appreciation due to short-term capital flows could cause the exporting sector to contract, which would hold real economic consequences and thus poses a policy concern; a smaller tradable sector would undermine potential economic growth

The BoU's response has been to stabilise the exchange rate, but with no directional preference. However, exchange rate intervention may have an allocative effect in the economy, between exporters and importers. Whilst exchange rate stabilisation can prevent a contraction of tradable production below the efficient level, it may also influence aggregate demand through the terms of trade and hence increase macroeconomic volatility. For instance, whereas an exchange rate appreciation could have resulted in loss of competitiveness and consequently an economic slowdown, intervention may bring higher inflationary risks. Furthermore, if the BoU are seen to be controlling the exchange rate in a biased manner then it may erode their credibility and thus monetary policy effectiveness.

In May 2013, the shilling depreciated against the US dollar by 0.3 per cent over the month and by 4.3 per cent over the year to an average mid-rate of Shs. 2,586.11/US$. The trade-weighted exchange rate, or the Nominal Effective Exchange Rate (NEER), depreciated by 0.1 per cent over the month, but appreciated by 1.8 per cent over the year. The Bank of Uganda's action in the domestic foreign exchange market in May 2013 oversaw targeted purchases of US$ 20.0 million to stem volatility, but also a targeted sale of US$ 15.4 million; as a result net BoU actions resulted in a net purchase of US$ 4.6 million.

Within the region, since 2009, the Ugandan, Kenyan and Tanzanian Shillings have all experienced sharp depreciations against the US dollar, possibly on account of the global financial crisis and contractionary monetary policies. Over the recent period, the Ugandan Shilling has experienced greater volatility than its East African counterparts. Over 2013 to date, the Ugandan and Kenyan Shillings have appreciated against the US dollar, while the Tanzanian Shilling and Rwandan and Burundi Francs have depreciated slightly. *Figure8* traces the evolution of regional currencies vis-à-vis the United States dollar.

Figure 8: Regional exchange rates



Source: Bank of Uganda

The outlook for the exchange rate is for depreciation pressures to prevail, resulting from the weak external sector. Export growth is projected to remain relatively subdued due to weakness in the global economy. In particular, the European Union's GDP growth is projected to contract by 0.4 per cent in 2013 following a contraction of 0.6 per cent in 2012; it is not expected to recover until 2014 as the economic drag from fiscal consolidation lessens and credit begins to flow to the real sector. Since Europe accounts for approximately 20 per cent of Ugandan exports, 23 per cent of workers remittances and 24 per cent of foreign direct investment, Europe's poor economic performance will continue to weaken the balance of payments and therefore constrain Uganda's economic growth in the near to medium term.

3 Recent developments in inflation

Inflation appears to have stabilised over the year to date, indicating that the inflationary pressures experienced in 2011 have been curtailed and that economic agents may have increased confidence in the Bank of Uganda's ability to bring inflation to target. Indeed, since September 2012, when annual core inflation fell from 11.4 per cent to 4.9 per cent and annual headline inflation similarly fell from 11.9 per cent to 5.5 per cent, annual core and headline inflation have averaged 5.2 per cent and 4.4 per cent respectively. The decline in inflation is attributed to relatively stable and subdued commodity prices, a healthy food supply following good weather conditions, exchange rate stability and more established inflation expectations in recent months.

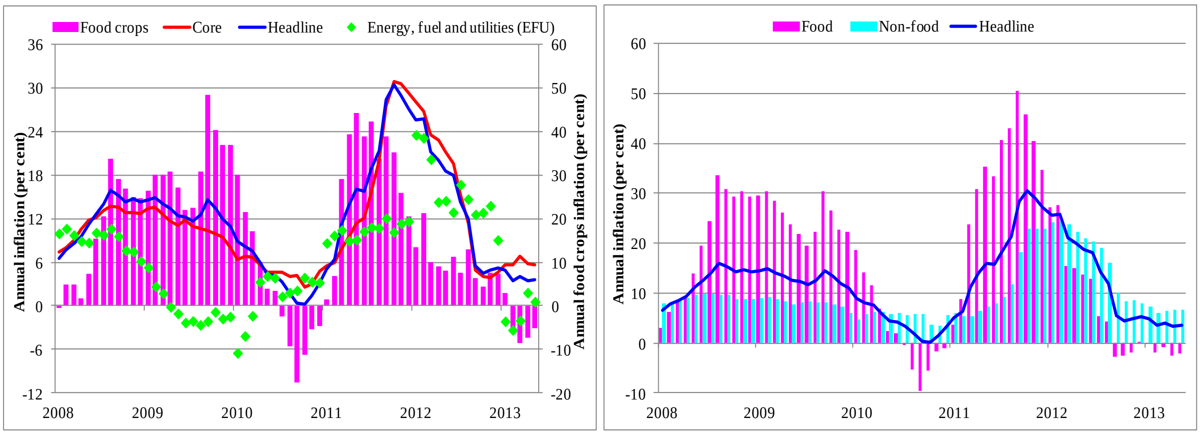
Headline inflation reached its lowest level since the onset of the inflation targeting lite regime in April, at 3.4 per cent, however it picked up marginally in May to 3.6 per cent. Nonetheless a gap has emerged between core and headline inflation over 2013, predominantly driven by disinflation in food crops and energy, fuel and utilities (EFU).

Food crops have experienced negative annual inflation since February, falling to *minus* 8.5 per cent in March, and have averaged *minus* 6.8 per cent during the same period. Favourable climatic conditions have produced healthy harvests and consequently improved food supply to markets, which is the main driver behind falling food crops prices. However, it may be important to note that climatic conditions are subject to change unexpectedly and may not be predicted, thus the influence of food crops prices upon headline inflation permanently remains an upside risk.

Low, and at times negative, EFU inflation has resulted from stable and subdued global energy prices and base effects. The first three months of 2013 experienced constant EFU annual deflation averaging minus 2.5 per cent compared to the first three months of 2012, where EFU inflation was continuously elevated above 20 per cent. Whilst this base effect may have fallen out of the calculations in April, EFU inflation has remained suppressed in April and May, which is likely to be the result of an alternative base effect: the removal of VAT on metered water at the end of 2012.

Indeed, core and headline inflation appears to only be kept positive by the non-food component since September 2012, which has averaged 7.6 per cent over the period. In particular the beverages and tobacco, education and health, entertainment and others categories have been the largest positive drivers of inflation. ***Figures 9a*** and ***9b*** present the recent divergence between core and headline inflation and the role of non-food inflation in keeping headline inflation positive since September 2012.

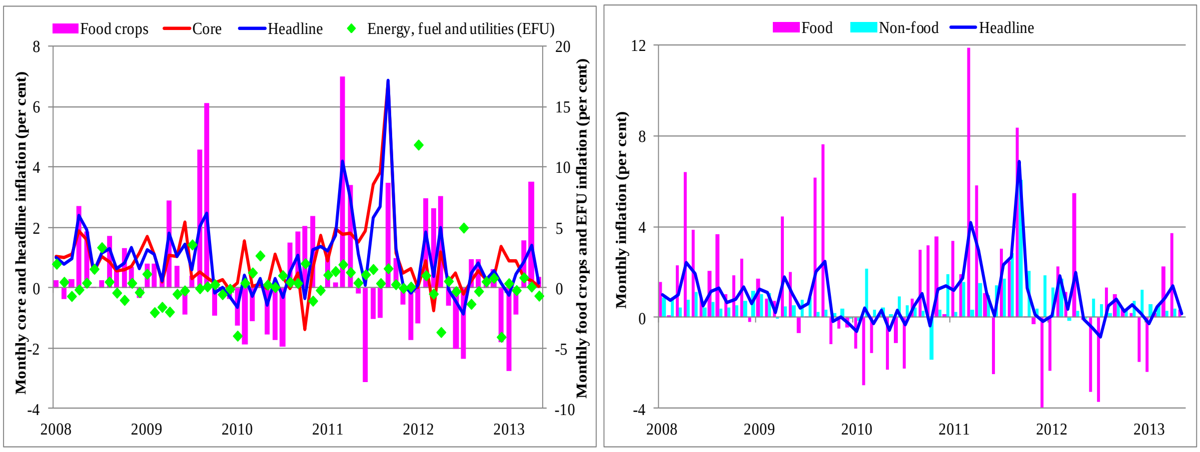
Figures 9a and 9b – Annual inflation developments



Source: Bank of Uganda

Figures 10a and ***10b*** present the monthly inflation figures, which depict any underlying inflationary pressures that may feed through to annual inflation.

Figures 10a and 10b – Monthly inflation developments



Source: Bank of Uganda

Interestingly, the monthly food crops figures have been typically greater than the annual inflation figures, which may hint at the re-emergence of inflationary pressures in the economy. Most dramatically, in March and April monthly food crops inflation rose to 3.9 and 8.8 per cent respectively before falling significantly to 0.9 per cent in May. The potential inflationary pressures were however absent in the core inflation basket, which saw monthly core inflation fall from 0.9 per cent at the start of the year to 0.0 per cent in May.

Table 8, below, presents annual and monthly inflation developments over the past 6 months, and over March to May 2012 for comparison. The table further decomposes the annual headline inflation figure and illustrates how volatile the monthly outturns are when presented on an annualised basis.

Table 8: Inflation developments

	2012			2012	2013				
	Mar	Apr	May	Dec	Jan	Feb	Mar	Apr	May
	Annual percentage changes								
Headline	21.1	20.0	18.6	5.3	4.9	3.5	4.0	3.4	3.6
Core	23.6	22.8	21.2	4.6	5.6	5.6	6.8	5.8	5.6
Food crops	10.1	9.1	8.0	7.3	3.0	-6.2	-8.5	-7.5	-5.2
Energy, fuel and utilities (EFU)	20.2	14.3	14.5	9.0	-2.1	-3.3	-2.0	1.8	0.6
Food	15.4	15.0	13.7	0.0	0.0	-2.0	-0.9	-2.6	-2.1
Non-food	23.7	22.3	21.0	8.0	7.2	6.0	6.5	6.6	6.7
Beverages and tobacco	23.6	23.2	25.1	8.5	12.0	12.6	14.0	13.7	12.3
Clothing and footwear	39.0	34.9	27.0	-4.0	-4.4	-4.8	-2.9	-1.0	1.4
Rent, fuel and utilities	31.8	29.1	27.0	6.0	3.9	3.9	3.8	4.8	6.1
Household and personal goods	24.5	22.3	19.4	4.4	5.4	4.4	4.5	4.9	4.1
Transport and communication	24.1	20.8	20.4	5.5	2.5	4.0	4.7	4.2	4.0
Education	14.9	14.7	14.4	16.2	15.8	8.1	8.2	8.2	7.9
Heath, entertainment and others	19.2	19.4	19.0	10.3	9.9	9.8	10.1	9.0	8.0
	Monthly percentage changes								
Headline	0.4	2.0	-0.1	0.2	-0.3	0.4	0.9	1.4	0.1
Core	-0.8	1.2	0.2	1.4	0.9	0.9	0.3	0.2	0.0
Food crops	6.5	7.6	-1.5	-4.5	-6.9	-2.2	3.9	8.8	0.9
Energy, fuel and utilities (EFU)	-0.5	-3.7	0.6	-4.1	0.4	-0.2	0.9	0.1	-0.7
Food	1.1	5.5	-0.1	-2.0	-2.4	0.2	2.3	3.7	0.4
Non-food	-0.2	0.3	0.0	1.2	0.6	0.6	0.3	0.4	0.0

Source: Bank of Uganda

3.1 Inflation outlook and risks

The most recent inflation projections present an improved outlook successfully in line with the inflation target. Core inflation is expected to lie between 5.0 and 6.0 per cent in June 2013 and between 4.5 and 5.5 per cent at the one-year horizon, whilst headline inflation is expected to be subdued at between 3.5 and 4.5 per cent in June 2013. Core inflation is expected to fall in line with the target over both the immediate and medium time horizons on account of relative exchange rate stability, stable and subdued commodity prices, in particular oil prices and subdued global demand. Yet headline inflation is expected to rise marginally in the near term if tax increases are observed upon electricity, fuel and metered water, but should subsequently fall once the tax hikes fall out of the inflation basket.

The profile for headline inflation will be affected by a number of one-off factors in the remaining half of 2013. Year-ended headline inflation is expected to rise slightly above core inflation in the second half of 2013, largely because of the effects of food crop prices and possible tax increase on fuel, electricity and metered waterbut is expected to remain in the tolerance band around the target inflation of plus/minus 3 per cent. Once these effects pass, headline inflation is expected to fall to around 5 per cent.

However, inflationary pressures from import prices remain positive, albeit subdued, as the effect of exchange rate depreciation is being partly offset by a continued decline in world commodity prices. The overall upward pressures on consumer prices could increase in the near future as the inflationary effect of import prices strengthens due to a weakened exchange rate of the shilling and the anti-inflationary effect of the domestic economy starts to subside gradually. Subdued domestic economic activity and external demand are other factors that could foster a weaker exchange rate in 2013/14. At the longer end of the forecast, a positive interest rate differential and a recovery in external demand, reflected in rising net exports, could lead to very gradual appreciation of the exchange rate. In light of the outlook for a gradually appreciating US dollar against other reserve currencies, this implies a slight depreciation of the shilling-dollar rate over the forecast horizon. The effect of the domestic economy, approximated by intermediate goods price inflation, is anti-inflationary due to subdued economic activity accompanied by low wage growth. In the longer term, the inflationary effect of import prices will weaken again owing to stable foreign producer price inflation and appreciation of the shilling. The effect of the domestic economy will be slightly anti-inflationary until early 2014.

The risks to the inflation outlook comprise commodity price and exchange rate volatility and global aggregate demand and food price shocks, the latter emanating from unpredictable weather conditions. These risks are nonetheless expected to be calmed over the coming period. Inflation could turn out to be higher than forecast if the oil prices and exchange rate were to increase more than anticipated and aggregate demand was to strengthen more than projected. Some moderation of tradable inflation will be required for aggregate inflation to remain in line with the forecasts if the inflationary pressures on non-tradable items increase, especially if food prices increase significantly. The recent price decrease for food crops, which were driven to a large extent by good weather and harvests, could easily be reversed given that they depend upon uncontrollable weather patterns. In addition, global food prices remain vulnerable to upside risks as global food supply conditions remain tight; this may result in higher import and domestic food prices. The identified and other unknown, risks mean that the path for GDP and inflation may well differ from the forecasts presented.

4 Economic outlook and policy implications going forward

Uganda has made remarkable strides amidst difficult global economic challenges. Overall, inflation remains subdued and economic growth seems to be recovering. After a sharp downturn in 2011/12, the economy is poised to grow by 5.1 per cent in 2012/13 and by 6.0 per cent in 2013/14, and is expected to return to trend thereafter. Overall, the subdued outlook over 2013/14 continues to reflect spill overs from the global economy, fiscal consolidation and the lagged impact of the tight policy stance in 2011/12. Notwithstanding little change to forecast growth in aggregate domestic spending, growth in imports is expected to strengthen while the outlook for exports remains weak. Subdued exports growth is expected on account of weak demand from Europe and other developed economies. *Overall, the negative output gap still remains* *and looking forward, aggregate demand may face more constrains that initially anticipated.*

Increasing global financial market integration has increased the impact of shocks – including monetary policy actions - originating in a particular country or economic region upon the wider global economy. While international liquidity conditions may influence market interest rates and thus the transmission of monetary policy to real activity and inflation, BoU retains the ability to control short-term interest rates, which should influence the domestic cost of credit and long-term interest rates. However, the BoU's success in conducting monetary policy is dependent upon its ability to properly adapt its analysis in line with the rapidly changing environment, taking into account, among other things, the potential impact of financial innovation on the monetary policy transmission channel. It is also highly important for BoU to analyse developments in areas such as external prices, international trade, financial flows and the exchange rate. In particular, a weak external sector, earlier than expected QE tapering by the Fed and the ensuing likely strengthening of the US dollar may exert depreciation pressures on the Shilling, which would potentially limit the further monetary policy easing. The pass through from a weakened currency to domestic inflation is a further risk that may complicate BoU's reaction function. To limit near-term exchange rate volatility BoU must intervene in the foreign currency market; however, it is important to stress that the exchange rate should not be given special status but should instead be taken into account only to the extent that it has an impact on price stability in the medium term.

Monetary policy has so far been countercyclical, thus highlighting the success of BoU's policy projections.

However, monetary easing alone cannot be the sole driver of Uganda's economic growth; neither can monetary policy alone ensure low and stable inflation. The economy's long term growth must be driven by private investment and improvements to labour productivity and competitiveness. Long-term growth stems from prudent monetary and fiscal policies, sound banking sector, and a combination of bold public and private investments in infrastructure, skills, and cutting-edge technologies. Furthermore, none of the aforementioned factors are constrained by monetary policy. Nonetheless, any combination of crises – the Euro zone debt crisis, war in the Middle-East, uncontrollable world oil or food prices – could create another round of macroeconomic instability.

In addition, Uganda has benefited from the flow of capital to emerging markets in recent years. This is a tribute to the country's financial openness: the sum of external assets and liabilities equals about 94 per cent of GDP. But Uganda's very openness—and its high need for external financing—expose the country to the risk of capital outflows. A sudden outbreak of global risk aversion or market turbulence could trigger an unwelcome turn of events. That would make the financing of the country's twin deficits—budget and current account—much more difficult. A global downturn also brings risks to Uganda's regional trade partners. Uganda must be on guard against another global slowdown, and should build fiscal buffers. Yet care should be taken to avoid reducing productive public investment. Widening the tax base may be the best strategy to maintain public investment, yet this might not be possible in the near term. In the short-term, one obvious solution is to reform inefficiently run government programs. Whilst from a longer-term perspective, pressing policy challenges will involve resolving infrastructure bottlenecks and enhancing labour productivity.

Food price shocks are likely to intensify and their inflationary effects today are more serious than in previous decades because of the larger population, both domestically and at a regional level. There is broad agreement that severe price volatility benefits neither producers nor consumers. But attempts to fix or stabilise prices have a poor history. There is little that monetary policy can do about the potentially sudden increase in the relative prices of food and commodities, but to accommodate its first-round effect on headline inflation. Therefore, BoU must carefully monitor price dynamics to anchor inflation expectations and prevent any second-round effects. This may require that the BoU analyse aggregate price developments as opposed to just a core basket, in order to quickly identify long-lasting trend dynamics. The ultimate impact of increases in the prices of oil and commodities – including food – on inflation and output dynamics depend crucially on the reaction of economic agents, which are influenced by inflation expectations and monetary policy credibility. Preventing the second-round effects from escalating food and commodity price pressures depends upon anchoring inflation expectations in line with the BoU's objective. Furthermore, relatively uncontrollable food and commodity price pressures continuously threaten to destabilise inflation expectations. Given the high cost of curbing inflation expectations, BoU should react in a timely and pre-emptive manner to stabilise inflation, following a comprehensive analysis of the shocks to headline inflation.

In summary, given the continued weakness in the global economy, imported inflation will be generally benign. However, the persistent weak current account balance could continue to cause exchange rate volatility along a depreciation trend in 2013/14 and beyond, and this will continue to pass through to consumer prices. Short-term variations in fuel prices will continue to reflect developments in international oil market conditions. Other price increases, such as on consumer goods, will continue to reflect seasonal factors but also perhaps inflation expectations, especially if the exchange rate depreciates going forward. The recent price decreases for food crops, which were driven to a large extent by good weather and harvests, could easily be reversed as these depend on weather patterns. In addition, global food prices remain vulnerable to upside risks as global food supply is tight, global food price inflation is likely to result in higher import and domestic food prices. Therefore, BoU should maintain an accommodative monetary policy, at least in the near-term, but remain observant to future inflationary developments and new information, and stand ready to timely intervene to foster price stability. The BOU should also be ready to intervene in the foreign exchange market in both directions, in the case of unhealthy exchange rate behaviour.

Finally, ongoing negotiations surrounding the protocol for establishing EAC monetary union and the harmonisation efforts towards a single market have made the East

African region more visible as single economic block on the international financial market. However, harmonisation of statistics still faces many problems and adherence to macroeconomic convergence criteria based on incompatible statistics could force economies to converge along an incorrect trajectory. Nonetheless, there is increasing cooperation between EAC countries' Central Banks to exploit the similarities between their economies and monetary policy formation, with a view towards establishing an environment of regional monetary stability.

5 Appendix.

Appendix 1: Macroeconomic indicators and projections

				Projections		
	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
Real GDP	6.7	3.4	5.3	6.0	7.0	7.0
Headline inflation	6.5	23.5	6.0	6.2	5.0	5.1
Core inflation	6.3	24.6	6.8	6.3	5.0	5.0
Terms of trade	4.3	1.8	-0.5	-1.7	-2.4	-2.0
Broad money (M2)	23.9	-4.3	13.8	22.6	20.7	17.8
Private sector credit	44.4	11.1	14.5	19.4	19.8	19.3
Domestic investment	25.0	24.7	26.1	27.9	28.6	28.6
Public	5.9	5.8	5.8	8.1	8.4	8.6
Private	19.1	18.9	20.2	19.8	20.1	20.0
Current account balance (including grants)/GDP(per cent of GDP)	-11.7	-12.0	-10.4	-12.2	-14.1	-14.3
Current account balance (excluding grants)/GDP(per cent of GDP)	-13.0	-13.1	-10.7	-12.6	-14.4	-14.6
Net donor inflows/GDP (per cent of GDP)	3.0	3.4	3.6	2.2	1.9	1.6
Gross public external debt/GDP (per cent of GDP)	25.2	24.3	25.5	28.8	31.7	33.3
External debt-service ratio (per cent of exports of goods and nonfactor services)	1.4	1.4	1.6	1.8	1.9	1.9
Revenue (per cent of GDP)	16.2	13.3	13.0	15.0	14.5	14.9
Grants (per cent of GDP)	2.3	2.3	1.7	1.5	1.3	1.0
Total expenditure and net lending(per cent of GDP)	22.8	18.6	18.6	20.2	21.2	21.7
Overall balance (including grants)(per cent of GDP)	-4.3	-3.0	-3.9	-3.6	-5.4	-5.7
Overall balance (excluding grants)(per cent of GDP)	-6.6	-5.3	-5.6	-5.2	-6.7	-6.8
Gross foreign exchange reserves (US$ millions)	2,044	2,644	3,044	3,264	3,514	3,764

Gross reserves (months of next year's imports of goods and services)	**3.2**	**4.2**	**4.2**	**4.1**	**4.1**	**4.1**

Appendix 2: Regional comparison

	Inflation						Exchange Rate Movement (Domestic Currency to the US Dollar, Y-o-Y)					
	Ug.	Kenya	Tanzania	Ghana	Nigeria	Zambia	Uganda	Kenya	Tanzania	Ghana	Nigeria	Zambia
Nov-12	4.9	3.3	12.1	9.3	12.3	6.9	1.6	-8.6	-5.6	22.1	-0.8	3.4
Dec-12	5.3	3.2	12.1	8.8	12.0	7.3	9.3	-0.8	-2.2	19.7	-4.3	1.8
Jan-13	4.9	3.7	10.9	8.8	9.0	7.0	11.2	0.6	-0.2	16.6	-3.8	3.1
Feb-13	3.5	4.5	10.4	10.0	9.5	6.9	14.2	5.1	0.3	13.3	-2.1	2.2
Mar-13	4.0	4.1	9.8	10.4	8.6	6.6	6.1	3.5	0.3	11.1	-1.6	1.9
Apr-13	3.4	4.1	9.4	10.6	9.1	6.5	2.9	1.2	0.9	12.2	-1.4	2.3
May-13	3.6	4.1				7.0	4.3	-0.4	1.2	10.9	-2.0	2.1

	Policy Rates						One Year Investment Rate (e.g. 364-day treasury bill, 12 month time deposit rate)					
	Uganda	Kenya	Tanzania	Ghana	Nigeria	Zambia	Uganda	Kenya	Tanzania	Ghana	Nigeria	Zambia
Nov-12	12.50	11.00	-	15.00	12.00	9.25	15.0	11.9	13.3	22.9	6.2	13.0
Dec-12	12.00	11.00	-	15.00	12.00	9.25	15.2	11.7	13.7	22.9	10.6	11.7
Jan-13	12.00	9.50	-	15.00	12.00	9.25	15.4	11.7	14.5	22.9	6.1	10.2
Feb-13	12.00	9.50	-	15.00	12.00	9.25	14.4	11.7	14.1	22.9	5.7	12.1
Mar-13	12.00	9.50	-	15.00	12.00	9.25	12.2	12.5	13.7	22.6	6.1	12.5
Apr-13	12.00	9.50	-	15.00	12.00	9.25	11.6	12.5	14.2	22.2	6.5	12.5
May-13	12.00	8.50	-	16.00	12.00	9.50	12.1	11.3	14.3	22.0		12.9