Bank of Uganda

Current State of the Ugandan Economy

March 2013

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Executive summary

1. The global economy continues to grow at a slow pace, driven largely by robust growth in emerging and developing economies. The global manufacturing sector in particular took a positive turn, which establishes a positive outlook for other economic sectors, and was largely driven by China, the UK and US. However, the euro zone and Japan remain major drags on the global manufacturing sector, and wider global economy.

2. Uganda's economic growth declined from an average of 6.7 per cent in the period 1994- 2011 to 3.4 per cent in 2012. Going forward, the economy is expected to recover, but the negative output gap of about 2 to 3 percentage points will persist, at least up to 2015. There are domestic and external factors associated with this slack in domestic economic activity. The external-oriented sectors of the economy will continue to be dampened by the pullback in global demand and heightened risk aversion in global financial markets, which will continue to weigh on the sentiment-driven financial sector. The domestic-oriented sectors, which are usually relatively more insulated from the swings in global economic cycles, will not provide support to growth since these are driven by government expenditure, which is now constrained by limited fiscal policy space, which was further worsened by the aid suspension.

3. Export demand, financial contagion and heightened uncertainty are the principal channels through which the weaknesses of the global economy, particularly in the euro zone, may depress the Ugandan economy. The Euro zone's share of Uganda's merchandise exports has decreased considerably since the onset of the financial crisis, as has workers' remittances and foreign direct investment from the monetary union. Another concern is that financial distress resulting from losses on euro assets could limit lending by European financial institutions to the Ugandan enterprises, such as through call deposits, swaps, and other short-term flows. Furthermore, the uncertainty surrounding Euro zone sovereign debt sustainability may worsen the flight to quality, incentivize investors to hold back, and depress current aggregate demand.
4. Whilst heightened risk aversion remains a serious threat to the Ugandan economy, Uganda does not yet appear to be experiencing reduced capital inflows. Indeed, at present the Capital and Financial Account is largely responsible for the improved Balance of Payments position. Nonetheless, it is important to note that capital inflows are volatile and may be reversed instantaneously, and thus should not be relied upon to secure a sustainable Balance of Payments position. The current account remains weak and continues to face a heavily unbalanced ratio of imports to exports. January witnessed an improvement in the current account, particularly within the goods and services accounts, whereby reduced import and an improvement in the terms of trade acted to lessen the trade deficit. However, the fall in imports was driven by lesser non-oil private sector imports, which might reflect weak private sector demand in the economy.

5. The Shilling noted a small appreciation of 1.0 per cent in February 2013, although the exchange rate depreciated by 14.2 per cent compared to February 2012; the monthly

appreciation was on account of increased coffee receipts and is most likely to be a temporary reversal of the exchange rate trend. However on an annual basis the shilling continued to depreciate, fuelled by the weak current account position, and thus may be expected to continue in the near-term given the outlook of the external current account balance. The consequence of the Shilling depreciation may welcome greater capital inflows into the country, though it also risks exerting inflationary pressures as imports become more expensive domestically. Furthermore, future developments in the exchange rate may rely upon exogenous factors such as the development of the US economy, which fall outside of the control of domestic policy.

6. The contractionary monetary policy that has been in place throughout 2012 has successful brought inflation under control. Inflation has fallen from 30.5 per cent in October to 3.4 per cent in February 2013. The rapid fall in inflation has allowed the Bank of Uganda to slightly ease its monetary policy stance in order to support economic activity, without detracting from the Banks' medium-term inflation target of 5.0 per cent. Looking forward there appears to be minimal global inflationary pressures; lacklustre global economic activity has largely suppressed global inflation, and oil prices are expected to fall further in 2013 as non-OPEC oil producing countries expand their output. Some domestic inflationary pressures may be emerging, as demonstrated through the increase in core inflation to 5.5 percent February; however any pick-up in inflation is not expected to be sustainable given the current economic environment and thus should not affect the medium-term inflation target. Given the general lack of inflationary pressures, the Bank of Uganda may sensibly seek to boost economic activity over the short-term without risking credibility, especially given the apparent limited response of lending interest rates to monetary policy.

1. International Economic Developments

1.1 Global growth

Towards the end of 2012 the global economy appeared to improve somewhat, driven by expansionary monetary policies, improved market confidence and greater economic activity within the US and China. However, the most recent IMF World Economic Outlook revised the projected global economic growth marginally downwards in 2013 and 2014. In 2013, global growth is expected to increase to 3.5 per cent, driven largely by growth in emerging and developing economies. Growth in advanced economies is expected to average 1.4 per cent while in growth in emerging and developing economies is projected at 5.5 per cent, rising to 2.2 per cent and 5.9 per cent, respectively in 2014.

The performance in advanced economies remains the major drag on global growth, both in terms of their domestic output and the reduced external demand they exert upon international markets. Despite committing to highly expansionary monetary policies designed to boost growth and improve investor confidence, annual GDP fell in the EU and Japan in Q4 2012. Over the latter half of 2012, the ECB committed to long-term expansionary monetary policy, the recapitalisation of European banks and to the creation of a banking supervision authority across the Union. Nonetheless, markets remained nervous as to how the debt crisis might be settled, especially given the Spanish corruption scandal and the downgrading of Italy to a BBB+ credit rating by Fitch, owing to continued political uncertainty following the election. Consequently, annual GDP growth in the euro area deteriorated further to -0.9 per cent in Q4-2012, compared to -0.6 per cent in Q3-2012. The US extended the deadline surrounding the fiscal cliff at the end of 2012. However the solution, was only temporary as a complete resolution of the fiscal cliff has still not been agreed upon. Financial markets were somewhat comforted by the short-term solution, and by the Federal Reserve's commitment to expansionary monetary policy. While the UK noted a small pickup in growth in Q4-2012, annual GDP growth in the UK remains very low, affected by a large negative output gap, rising unemployment and inflation and weak market confidence. Furthermore, the recent credit downgrading by Moody's from AAA to AA1 standard, owing to 'subdued growth and a high and rising debt burden', threatens the UK's future growth prospects.

Whilst poor growth amongst the advanced economies has reduced global growth potential, emerging and developing economies are beginning to recover before their advanced counterparts and look set to expand further over 2013 and 2014. China's growth increased from 7.4 per cent in Q3-2012 to 7.9 per cent in Q4-2012, largely driven by expansionary monetary policy designed to improve access to bond markets and to inject short-term liquidity into domestic money markets, which has in turn boosted infrastructure investment and the domestic housing market. As improved economic activity exerts increasing inflationary pressures within China, monetary policy may be forced to become less expansionary and thus less conducive to growth; indeed Chinese GDP growth is forecast to fall from 9.3 per cent in 2012 to 8.2 per cent and 8.5 per cent in 2013 and 2014, respectively. Similarly in India, growth is expected to remain high over the next two years, but at a lower level than the previous forecasts. However, growth is expected to pick-up in Brazil and Sub-Saharan Africa over the short-term due to better perceived macroeconomic policies and improved market sentiment; in

Sub-Saharan Africa growth is expected to improve from 5.3 per cent in 2012 to 5.8 per cent in 2013 and 5.7 per cent in 2014.

In the long-term, emerging and developing countries are projected to grow at 3.3 per cent, driven largely by structural transformations of the economies of these countries. As China, India, Brazil, and others mature from rapid, investment-intensive 'catch-up' growth to a more balanced model, the structural 'speed limits' of their economies are likely to decline, thereby slowing down global growth despite the recovery that is expected in advanced economies after 2013. ***Table 1***, below, presents a short-term forecast for global economic activity.

Table 1: IMF WEO Growth forecasts

	2012	October 2012 Forecasts		January 2013 Forecasts		Deviation	
		2013	2014	2013	2014	2013	2014
World	**3.2**	**3.6**	**4.2**	**3.5**	**4.1**	**-0.1**	**-0.1**
Advanced economies	**1.3**	**1.6**	**2.3**	**1.4**	**2.2**	**-0.2**	**-0.1**
US	2.3	2.1	2.9	2.0	3.0	-0.1	0.1
Euro area	-0.4	-0.5	1.1	-0.2	1.0	-0.3	-0.1
Emerging and developing economies	**5.1**	**5.6**	**5.9**	**5.5**	**5.9**	**-0.1**	**0.0**
China	9.3	8.2	8.5	8.2	8.5	0.0	0.0
India	7.9	6.0	6.4	5.9	6.4	-0.1	0.0
Brazil	2.7	3.9	4.2	3.5	4.0	-0.4	-0.2
Sub-Saharan Africa	5.3	5.8	5.6	5.8	5.7	0.0	0.1

Source: IMF WEO Update January 2013

1.2 Global inflation

The weak global growth prospects have largely stemmed global inflationary pressures throughout 2012 and are expected to do so over 2013, with the exception of potential food shocks. Oil prices are expected to fall from an average of US$105.08 per barrel in 2012 to average US$99.70 per barrel in 2013. Whilst oil supply shocks may arise from geopolitical tensions between the US, EU and Middle East, oil supply is expected to increase considerably from oil producers outside of the OPEC community, which may continue to moderate increases in oil prices.

1.3 Impact of global economic development on domestic economy

Being an open economy, Uganda is prone to suffer the impact of the global economic slowdown. One of the main channels of susceptibility is through trade. A leading trade partner to Uganda is the European Union, which has been severely affected by the global financial crisis. Prolonged European weakness may have a substantial impact on Ugandan export prices and volumes, which may exacerbate Uganda's weak export earnings, current account imbalance and subsequently output growth.

On the monetary policy front, the unfavourable global economic developments complicate the conduct of monetary policy because the shifting global economic conditions cause sharp swings in risk aversion and investor sentiments and as volatility in global asset prices increases, capital flows into Uganda become more uncertain and often lead to unexpected reversals in the exchange rate trends. Furthermore, since the beginning of the 2012/13 financial year the shilling has depreciated by about 6 per cent in part because of capital outflow as a result of perceived decline on returns on government papers.

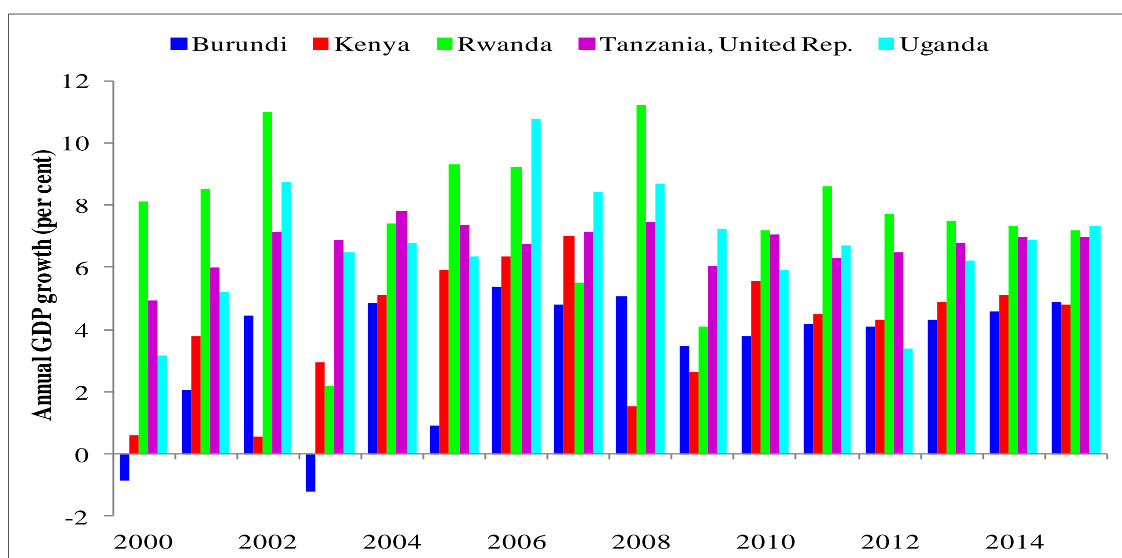
Another channel by which Uganda may suffer from the global slowdown is through commodity prices. Being net oil importer, Uganda is vulnerable to volatility in global oil markets. Global oil inflation reverberates through the economy, through higher retail pump prices, which cause higher transportation, production and ultimately output costs, thereby stoking domestic inflation.

2. Domestic Economic Conditions

2.1 Real economic activity

Since the onset of the global financial crisis, Uganda maintained annual GDP growth rates within the economy's long-term potential growth rate of 6-7 per cent; yet the most recent outturn marks a considerable slowdown in economic activity, far below that previously anticipated of 5.0 per cent. In 2011/12, GDP growth declined to 3.4 per cent per annum. The decline is in part explained by the contractionary fiscal and monetary policies that were adopted in order to rein in the second round effects of the supply-side generated inflationary pressures. The slackening of Uganda's economic growth is in part reflecting the impact of global economic crisis. Over this period, the economy was faced with subdued foreign demand, increased financial risk premia and tendencies of several financial market agents to reduce exposure to the Ugandan economy. However, the economy is expected to recover in the medium-term and regain the potential real GDP growth rate of 6-7 per cent. ***Figure 1*** shows a comparative analysis of GDP performance in the East African Community and the outlook to 2014.

Figure 1: GDP growth in EAC countries



Source: World Bank World Economic Outlook

On a quarterly basis, real GDP recorded positive growth over 2012. In Q3-2012, quarterly GDP growth accelerated to 2.0 per cent compared to a growth rate of 0.6 per cent recorded in Q2- 2012. The performance in the first three quarters of 2012 gives an annualised GDP growth rate of 5.2 per cent. The accelerated growth in Q3-2012 was driven by agriculture and services sectors, which grew by 1.6 per cent and 3.7 per cent, respectively. Given that the services sector accounts for approximately half of all economic activity, development of this sector will have considerable consequences for the wider economy. The industrial sector however contracted by 0.3 per cent over the quarter, posing questions surrounding the sustainability of any recovery in real economic activity. ***Table 2*** shows developments in quarterly GDP.

Table 2: Sectoral quarterly GDP growth

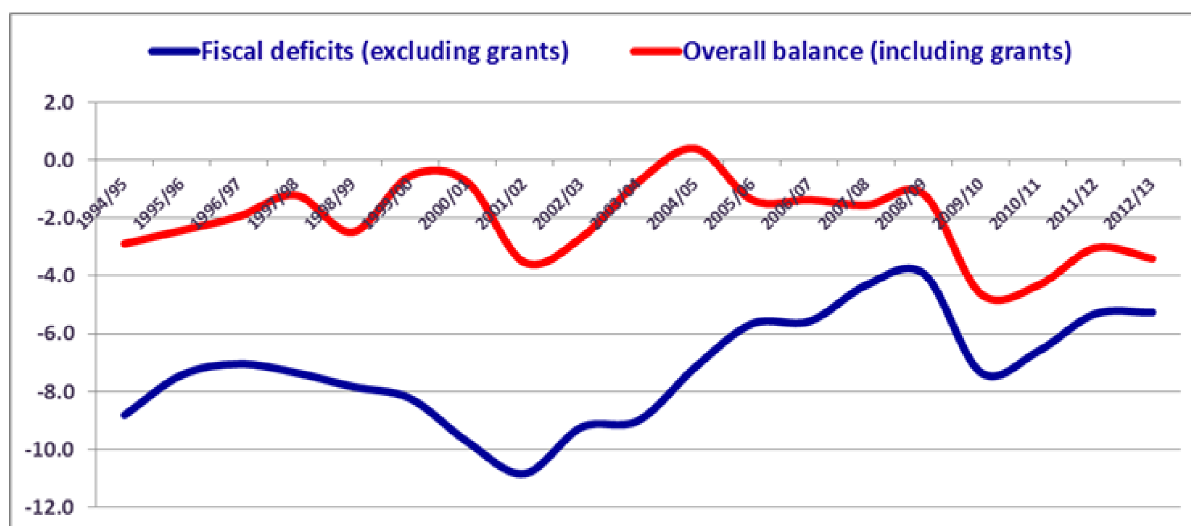
	GDP	Agriculture	Industry	Services
2011 Q1	0.84	0.05	-0.05	2.23
Q2	1.22	-0.19	-0.69	2.14
Q3	0.68	-0.13	2.31	-0.30
Q4	-0.14	0.70	-0.56	-0.25
2012 Q1	1.32	-0.93	1.90	0.22
Q2	0.58	1.59	0.76	0.52
Q3	1.97	1.59	-0.32	3.69

Source: Uganda Bureau of Statistics

2.2 Fiscal policy

Fiscal policy was relatively loose in the financial years 2009/10 to 2010/11 as shown in ***figure 3.*** This was largely motivated by the slowdown in economic activity in the aftermath of global recession. In the financial years 2011/12 and 2012/13 however, the economic slowdown finds the economy depleted of room for fiscal stimulus. Fiscal consolidation is reflected by the decline of government purchases of goods and services as a share of GDP, which fell by 4 percentage points in 2011/12 compared to 2010/11 and is projected to decline by a further 1 percentage point in 2012/13. To exacerbate the weak fiscal position, total government expenditure only totalled 86.1 per cent of that projected in H1 2012/13. Such a trend will have negative effects on economic growth.

Figure 3: Fiscal deficits

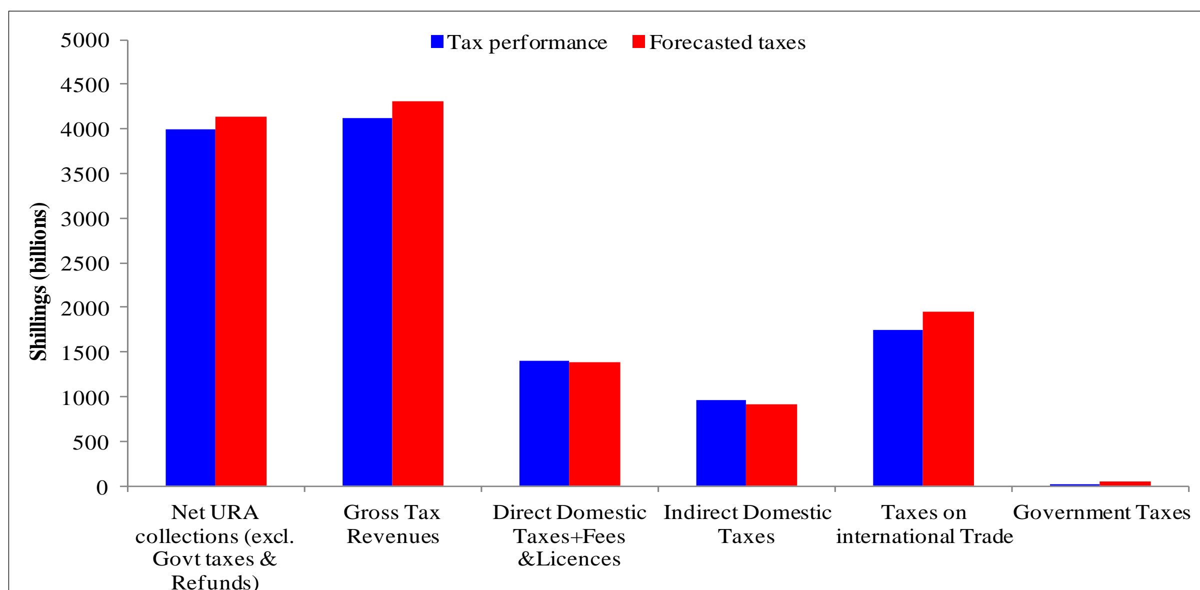


Source: MFPED

Net URA collections during the first seven months of 2012/13 were slightly below what was projected. Collections amounted to Shs. 3,997 billion against a projected amount of Shs. 1,144 billion, which was a performance of about 96.5 percent. Taxes on international trade amounted to Shs. 1,744 billion relative to the forecast Shs. 1,978 billion, while direct and indirect taxes were above target, recording a collection of Shs 1,398 billion and Shs 960 billion against a projection of Shs. 1,390

billion and Shs. 912 billion, respectively. ***Figure 4*** compares tax revenue performance and projection during the first seven months of 2012/13.

Figure 4: Tax revenue performance in 2012/13 to date

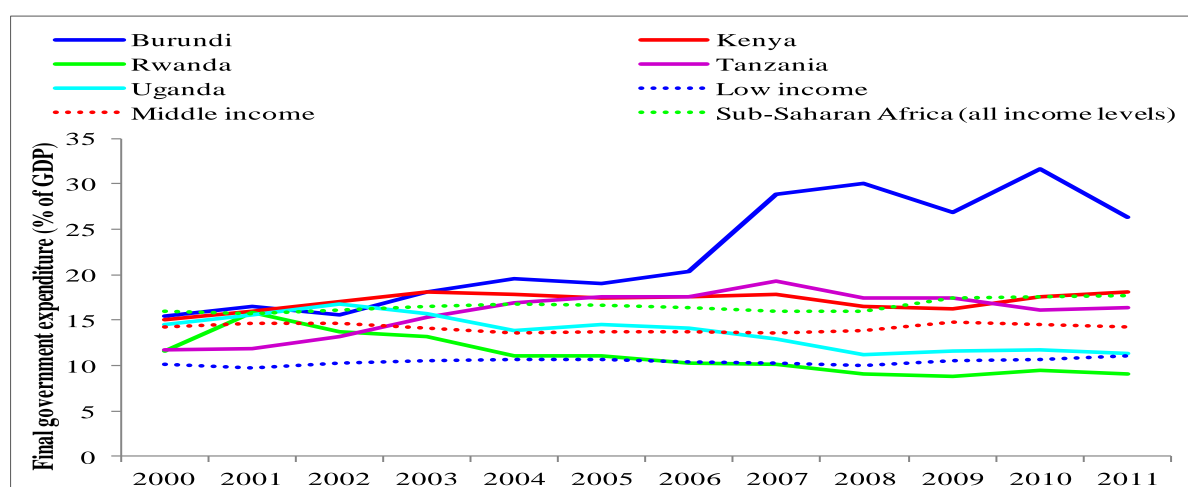


Uganda's public debt remains relatively low in comparison with the SSA levels. However, the ratios of of government expenditure and tax revenue to GDP are also low. This reflects a debt that is sustainable but also that growth could be constrained in the medium to long term. ***Table 3*** illustrates the relatively low position of Uganda's public debt, whilst ***figure 5*** presents the equally low final government expenditure. Both indicators might justify greater government borrowing and investment.

Table 3: Total government debt to GDP

	Burundi	Kenya	Rwanda	Tanzania	Uganda	Low income	Middle income	Sub-Saharan Africa
2007	128.5	46.0	26.9	36.3	23.6	53.5	28.3	30.1
2008	111.5	45.6	21.4	36.0	22.1	51.2	27.3	28.9
2009	36.9	47.5	23.0	39.0	22.2	48.6	31.5	32.3
2010	36.7	49.9	23.2	42.7	27.0	42.9	34.9	31.5
2011	35.3	48.5	24.0	45.4	33.3	45.0	37.8	33.1

Figure 5: Final government expenditure



Source: World Bank World Economic Outlook

2.3 External sector developments

The impact of slower growth abroad is evident in weak exports growth. No country can count on export growth if is trading partners are not economically healthy. Since the global balance of trade must by definition balance, it is impossible for every country to run a trade surplus and export their way to better economic health. In the post-global financial crisis period, the economy was faced with slow foreign demand growth, increased financial risk premia and tendencies of several financial market agents to reduce exposure to Ugandan economy and this resulted in widening of current account deficit as shown in ***table 4*** and ***Figure 7.***

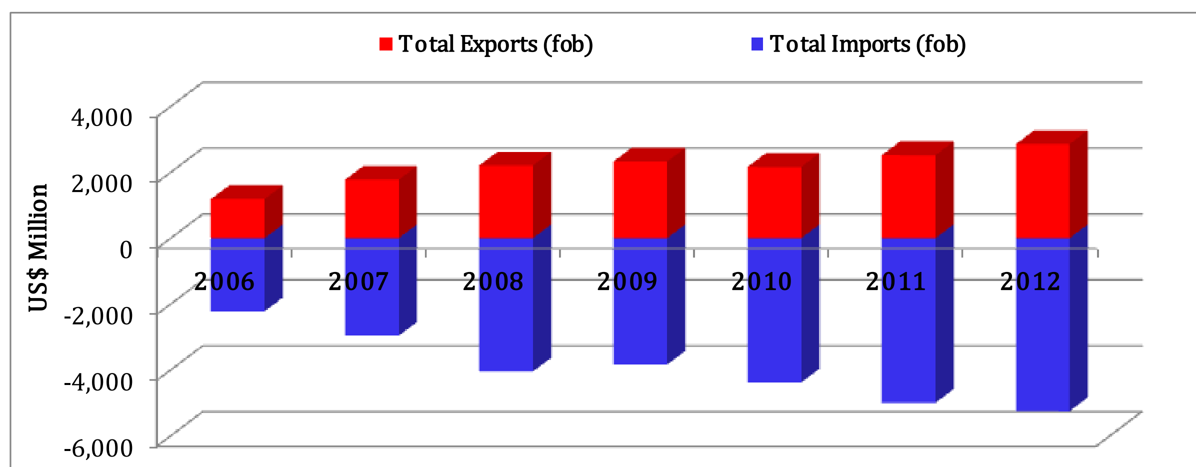
Table 4: Uganda's external sector (US $ millions)

	2007	2008	2009	2010	2011	2012	2012/13 Projection
A. Current Account Balance	-632.5	-1,267.3	-1,089.6	-1,698.5	-2,014.8	-2,028.6	-2,110.4
-Exports	1,776.2	2,207.6	2,326.6	2,164.0	2,519.1	2,857.2	2,794.0
-Imports	-2,958.2	-4,042.8	-3,835.2	-4,375.7	-4,996.7	-5,248.8	-5,398.9
B. Capital Financial Account Balance	1,392.5	1,169.5	1,720.5	1,052.9	1,594.3	2,268.6	2,190.3
C. Overall Balance	767.1	17.3	365.5	-162.9	-74.8	522.2	85.7
D. Reserve Assets	-748.5	2.2	-353.3	165.4	79.6	-515.4	-70.2
-Reserves (Months of Import Cover)	5.8	5.3	5.4	4.0	3.7	4.3	3.9

Source: Bank of Uganda

In 2012 the current account position deteriorated to -US$.2,029 million, compared to -US$ 633 million in 2007, largely on account of a slow growth in exports relative to growth in imports as shown in ***Figure 6***.

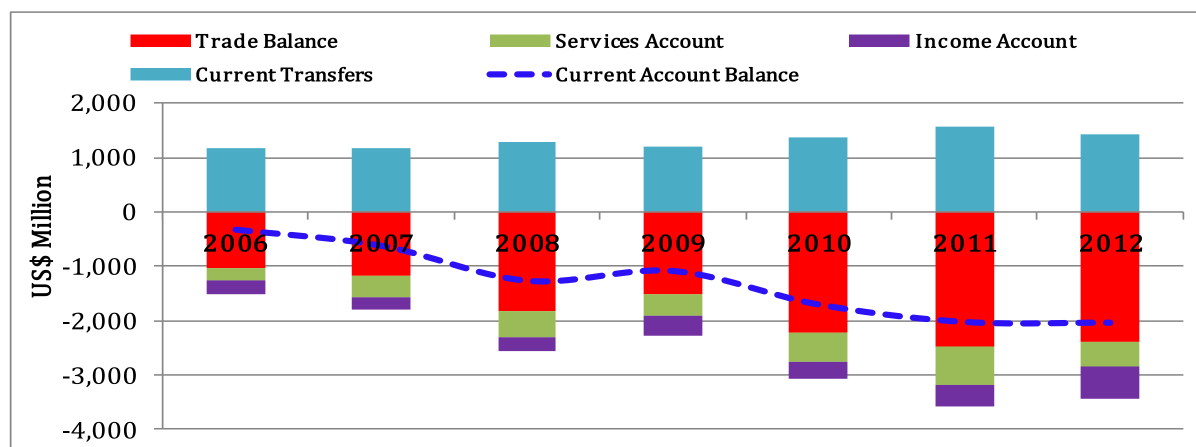
Figure 6: Developments in the Trade Account



Source: Bank of Uganda

The current account deficits have also been driven by the poor performance of the other components of the current account. Current transfers have virtually stagnated on account of subdued growth the developed countries. The service and income accounts continue to be in deficit. The combined impact of the factors has been the widening of the current account balance as shown in Figure 7.

Figure 7: The current account



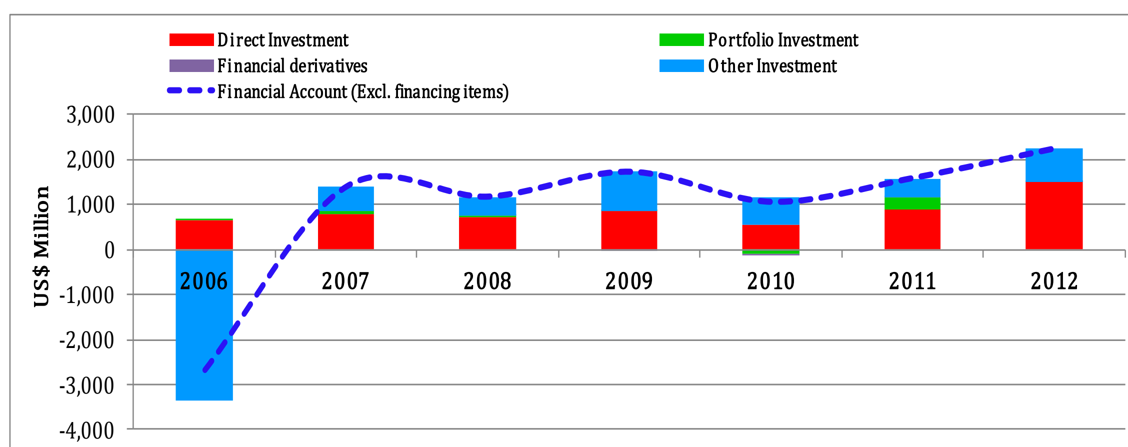
Source: Bank of Uganda

The current account deficits have however, in part, been used to finance private and public investment goods, whose returns presumably have been low given the infrastructure gaps and little value addition in Uganda's exports. It is likely that as the economy's growth slows down, the imports of investment goods will decline in line with reduced borrowing from abroad to finance investments, and therefore the current account deficit may shrink, with little disturbance to the exchange rate. Since the current account deficit as a percentage of GDP has deteriorated by 5.4 percentage points since 2006/7 and 2011/12, and yet the fiscal deficit has remained on average at around the same level as a percentage of

GDP, this increase reflects an increase in the private sector consumption and investment relative to savings.

The persistent deficits in the current account have largely been funded by inflows in the capital and financial account of the balance of payments. Foreign direct investment has remained robust, increasing to about US$ 1,500 million in 2012 as shown in Figure 8. Overall, the balance of payments remains an indicator deserving of attention due to the potential volatility in the financial account and the persistent current account deficit.

Figure 8: The financial account



Source: Bank of Uganda

2.4 The exchange rate

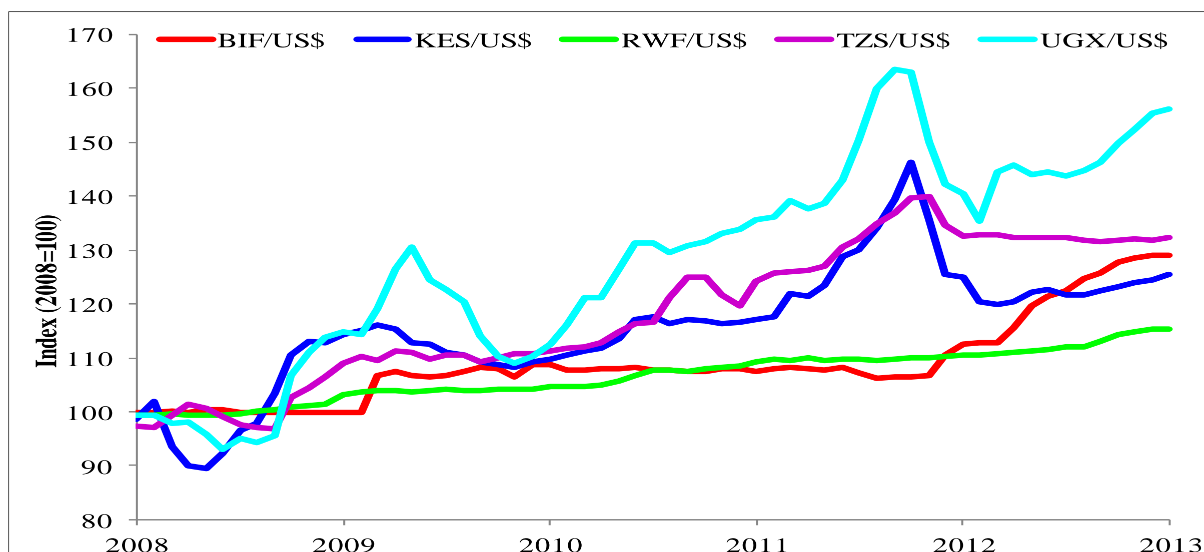
The global financial crisis of 2008 and its subsequent prolonged effects have brought to the fore problems faced by small open economies. The ensuing sudden changes in investor confidence can induce destabilizing capital flows and high interest rates on the economy even when prudent macroeconomic policies are in place. In an open economy, domestic and foreign interest rates, inflation rates, and exchange rates are highly linked. BoU's tight monetary policy stance resulted in a liquidity squeeze in the banking sector, which consequently led to an increase in domestic interest rates relative to global interest rates. This attracted portfolio inflows which helped to stabilise the exchange rate, which in the first quarter of 2011/12 had depreciated on average by 21 per cent on annual basis.

Under flexible exchange rate regime, the exchange rate is an endogenous variable - it is policy variables that lead to exchange rate to depreciate or appreciate. Thus, the high interest rates, among other things, attracted foreign portfolio investment inflows into the domestic securities market and increased non-residents' liabilities in other depository institutions. Consequently, Uganda experienced sharp exchange rate appreciation in response to the tight monetary policy stance. Uganda however continued to attract portfolio investments, even after the policy of cautious easing was adopted. This helped keep the exchange rate stable given the huge current account deficit. This in part reflects investor confidence in the Ugandan economy. Nonetheless, it is important to note that short-term

flows, could give rise to large externalities because of their effects on exchange rates. They are very unpredictable and pro-cyclical, and not countercyclical, and thus almost inevitably exacerbate, not dampen, fluctuations, at least in the short-term.

On average, the Ugandan shilling depreciated at faster rate, reflecting both structural and policy differences. In comparison, all currencies of Uganda's key regional trading partners experienced a slow long-term trend of depreciation. The main concern here is instability in the exchange rate because if the rate of depreciation was stable, then it would not upset business or investor confidence, and it would enhance the profitability of Uganda's export sector, which could in turn improve the trade balance. For instance, in the period February 2008 to February 2013, the average monthly rate of depreciation has been 0.8 per cent, equivalent to 9.6 per cent depreciation per annum. ***Figure 9*** traces the evolution of regional currencies vis-à-vis the United States dollar.

Figure 9: Regional exchange rates

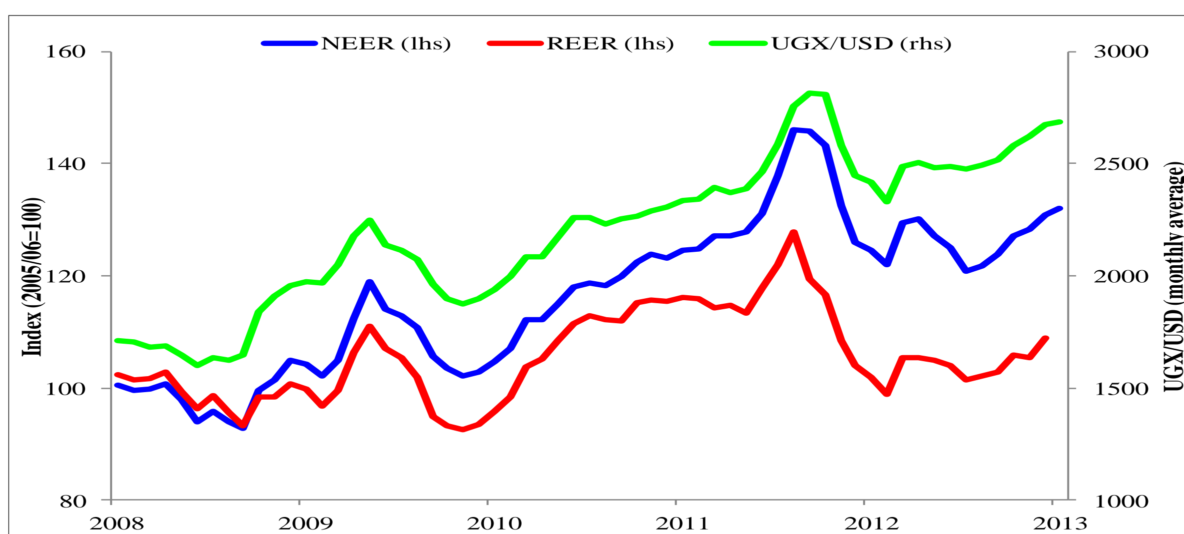


Source: Bank of Uganda

As would be expected, movements in the bilateral exchange rate are typically reflected in the real and nominal effective exchange rates. Over the past two months, the exchange rate has broadly fallen in line with its long-term trend. A slow depreciation may be optimal for the Ugandan economy as it should not harm business confidence, but could improve Uganda's international competitiveness and trade balance. The Nominal Effective Exchange Rate (NEER) appreciated by 1.1 percent on a monthly basis but depreciated by 6.1 percent on an annual basis in February 2013. The Real Effective Exchange Rate (REER) depreciated by 0.8 percent on a monthly basis and by 6.2 percent on an annual basis in February 2013, indicating an increase in the competitiveness of Uganda's exports. The REER depreciation followed that observed in the NEER as shown in ***Figure 10***.

The REER depreciation was further driven by the foreign price level, which increased at a faster rate than the domestic price level. Given that Uganda is a permanent net importer of goods and services, inflated global prices may well afflict domestic prices in the immediate future. Nonetheless, global inflation is expected to remain relatively stable in the near-term. If inflation and the exchange rate remain stable in the immediate future, then it is likely that the NEER will follow a stable path of depreciation, which may improve profitability in the export sector. However, low, controlled inflation is also likely to suppress the REER and consequently increase import demand. Therefore, the overall effect on the trade balance is indeterminable and dependent upon whether increased import or export demand is greater.

Figure 10: Real vs. nominal exchange rates



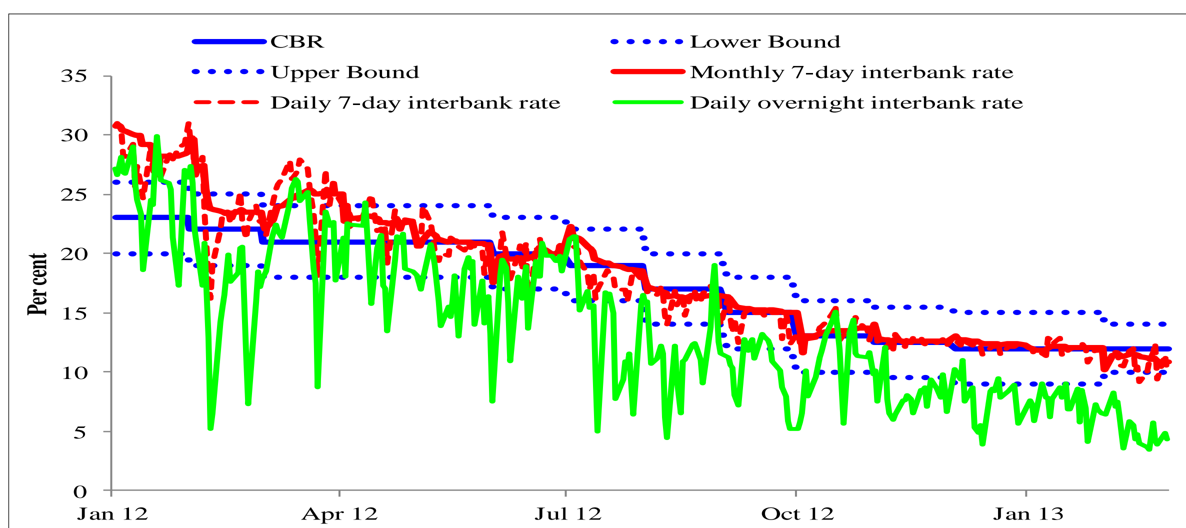
Source: Bank of Uganda

2.5 Domestic Financial Markets

2.5.1 Liquidity conditions and money market rates

The financial market was characterised by eased liquidity conditions. Although money market rates peaked in January 2012 supported by an elevated CBR that had been maintained at 23.0 percent for three consecutive months to slay inflation, they declined thereafter in line with a reduction of the CBR as shown in ***Figure 11***. The 7-day interbank rate trended comfortably within the CBR band for the 12 months to February 2013 while the overnight and overall interbank rates fell sharply, slipping off the lower bound of the CBR in November 2012 due to the existence of structural liquidity surplus in the financial system.

Figure 11: Interbank interest rates



Source: Bank of Uganda

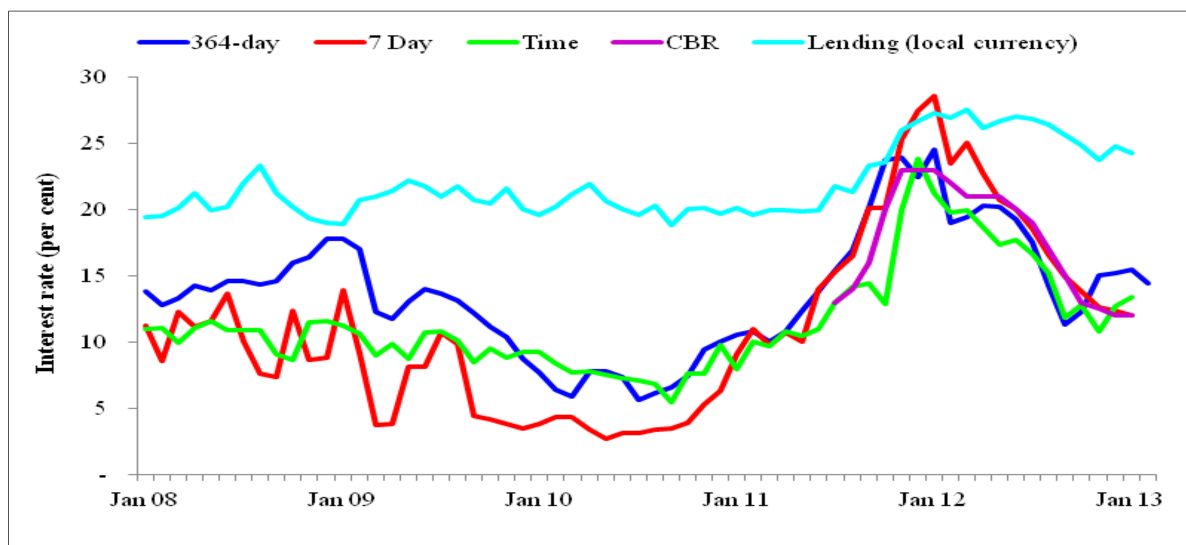
Increase interbank activity helped intermediate resources within the financial system. Increased interbank activity shows that there is scope for dependence on the interest rate channel of monetary transmission as well as gradual development of the money market. The lowering of the central bank rate also led to a decline in the yields on government securities. However, the decrease in policy rates was not met with a proportionate cut in lending rates, as banks only adjusted lending rates marginally downwards. Hovering uncertainty coupled with slow adjustment of credit risk may have forestalled deeper cuts in credit rates.

2.5.2 Monetary policy

Since February 2012 with inflation on a downward trajectory, BoU started implementing a cautious easing of the monetary policy stance. The policy rate, the CBR has now been reduced by 11 percentage points since February 2012. IN February 2013, the CBR was maintained at 12 per cent because the macroeconomic outlook had remained virtually unchanging notwithstanding the upside risks to inflation. Given the relatively stable inflation at about the BoU's medium-term target of 5.0 percent, BoU remains committed to stimulating aggregate demand in order to boost real economic activity. Nonetheless, this will be done without jeopardizing the medium term inflation objective.

The accommodative monetary policy is reflected in the downward trend in interest rates as shown in ***figure 12***. As can be seen from the figure, 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 19.2 per cent in February 2012 to 9.2 per cent in February 2013. Similarly, the domestic time deposit rate eased from 21.2 percent in January 2012 to 13.4 per cent in January 2013. Nevertheless, the easing of financial costs was not fully transmitted to private sector credit. In particular, additional costs required by banks to anchor the new credit remain tight, in response to the perceived uncertainty and their reaction mechanism for credit risk reduction.

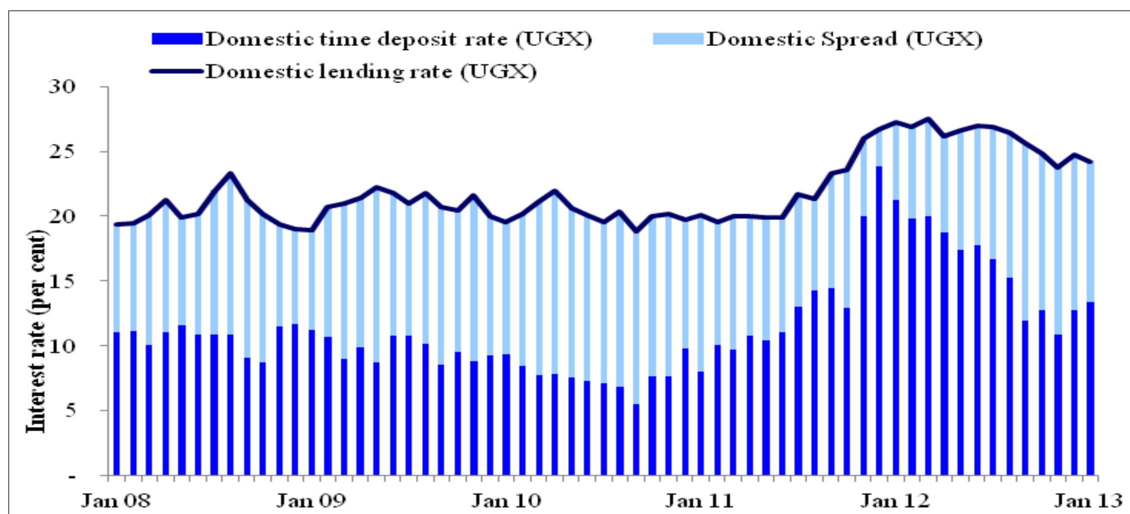
Figure 12: Interest rate developments



Source: Bank of Uganda

However, since the onset of the accommodative monetary policy stance, commercial banks' lending rates have been persistently sticky at an elevated level. Domestic currency lending spreads widened in the six months to January 2013, (***figure 13***) implying rising risk perceptions due to rising levels of non-performing loans, among others.

Figure 13: Domestic currency interest rates

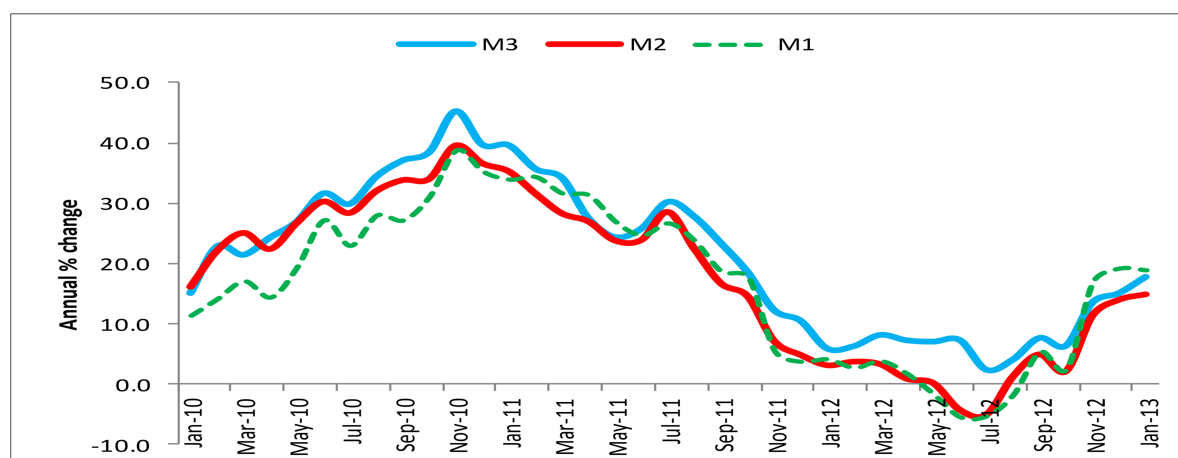


Source: Bank of Uganda

The growth of monetary aggregates has picked up since the beginning of Q4-2012 as shown in Figure 14. Notwithstanding this recovery, private sector credit remains subdued. With inflation contained to low single digits, monetary easing was necessary to spur economic activity that had started sinking.

On an annual basis, M1, M2, and M3 increased by 19.0, 14.7, and 17.5 percent in January 2013 as compared to annual growth rates of 4.0, 3.2 and 6.0 percent in January 2012, respectively (***figure 14***). As the balance of risks shifted from inflationary to recessionary trend, the recovery in money growth was justified in order to boost consumption and investment subject to price stability.

Figure 14: Growth in monetary aggregates



Source: Bank of Uganda

The growth in private sector credit has remained subdued, notwithstanding the accommodative monetary policy stance. Nonetheless, some recovery in growth can be observed especially after November 2012 as shown in Table 5. This growth is however not sufficient to deliver the potential GDP growth of 6-7 percent per annum.

Table 5: Growth in Private Sector Credit

	Jan-12	Feb-12	Mar-12	Apr-12	May-12	Jun-12	Jul-12	Aug-12	Sep-12	Oct-12	Nov-12	Dec-12	Jan-13
	Monthly												
PSC	-1.75	0.41	3.02	0.24	0.27	1.22	-0.26	0.64	1.33	1.72	2.52	1.73	-0.18
Shilling Denominated loans	-1.68	-1.90	-0.80	-0.37	0.33	-0.83	-0.22	-0.03	-0.25	-1.47	1.03	0.18	0.42
Forex denominated loans (Shs.)	-1.92	6.36	12.08	1.51	0.13	5.29	-0.39	1.87	4.38	7.95	4.85	4.20	-0.47
Forex denominated loans (US$)	5.00	4.31	5.59	2.03	0.84	5.95	-0.64	0.66	2.87	6.27	0.84	4.30	0.31
	Quarterly												
PSC	-1.30	-2.11	1.63	3.69	3.54	1.88	1.24	1.60	1.71	3.74	5.68	6.09	4.11
Shilling Denominated loans	-2.44	-4.63	-4.32	-3.04	-0.84	-0.87	-0.72	-1.08	-0.50	-1.74	-0.71	-0.28	1.63
Forex denominated loans (Shs.)	1.79	4.41	16.93	21.01	13.92	7.02	5.01	6.84	5.92	14.79	18.15	17.95	8.75
Forex denominated loans (US$)	13.45	12.94	15.65	12.37	8.64	9.01	6.16	5.97	2.89	10.05	10.24	11.77	5.50
	Annual												
PSC	23.90	21.06	22.14	20.67	16.57	11.48	10.37	6.57	4.43	7.46	8.97	11.81	13.38
Shilling Denominated loans	16.30	11.66	9.11	6.35	2.81	2.06	0.96	-2.24	-4.99	-7.73	-7.11	-5.89	-3.88
Forex denominated loans (Shs.)	34.39	36.52	47.21	50.22	44.89	34.95	34.22	28.50	27.10	48.48	50.16	56.33	58.64
Forex denominated loans (US$)	32.99	35.76	40.13	42.38	39.21	43.18	41.36	44.51	42.07	48.94	43.34	44.99	38.50

Source: Bank of Uganda

2.5.3 Current challenges to monetary policy implementation

Financial market conditions demonstrate a structural liquidity surplus, which consequently entail significant costs to absorb and sterilise. The necessity to accumulate reserves combined with erratic government expenditure (***Table 6***), that is frequently misaligned with tax revenue performance; all act to inject liquidity into the financial system. This excess liquidity has to be sterilised through open market operations, otherwise it risks not only damaging the effectiveness of the monetary transmission mechanism but may also fuel inflation.

The only available instrument for Bank of Uganda is the REPO. Most of the REPO issuances are 7-day, given that the CBR is benchmarked on the 7-day interbank money market rate. The REPO/reverse REPO instrument is primarily designed for short-term liquidity management – liquidity fine-tuning operations. Yet a structural liquidity surplus requires a longer-term instrument to mop excess liquidity; using REPOs on a weekly basis results in lumpy maturities, which only exacerbate the structural liquidity management problems.

Table 5: Factors driving liquidity

	Net OMO (Tbills, Tbonds, Repo, Reverse Repo)	Net Forex Operations	Net Fiscal Actions (Govt Expenditure-Taxes)	Net Liquidity (+ = Injections; -= Withdrawals)
Jul-12	-69.69	485.98	-111.44	304.85
Aug-12	-107.53	34.18	454.94	381.59
Sep-12	35.45	89.66	-112.64	12.47
Oct-12	225.35	-27.38	-113.20	84.77
Nov-12	-134.95	18.14	355.37	238.55
Dec-12	44.86	304.05	194.71	543.62
Jan-13	8.02	233.95	-474.68	-232.71
Feb-13	-607.50	219.31	318.42	-69.77
FY 2012/13 So far	-605.99	1357.88	511.47	1263.37

Source: Bank of Uganda

3. Recent Developments in Inflation

The inflationary pressures that started in 2011 have generally abated. As evident in ***table 7***, as of February 2013, headline inflation declined from a peak of 30.5 per cent in October 2011 to 3.4 per cent, while core inflation declined from 30.8 per cent to 5.5 per cent in February 2013. Food and non-food inflation also declined from 50.4 per cent and 24.3 per cent to *minus* 2.0 per cent and 6.0 per cent, respectively in February, 20113. The disinflation process was largely driven by easing international commodity prices, improvement in general domestic food supply, the exchange rate stability, tight monetary policy stance, and improving inflation expectations. The relatively stable exchange rate; the depressed aggregate demand, arising from contractionary fiscal and monetary stances earlier in the year; weak credit and money growth; and the suppressed exogenous external demand, fostered a continuous decline in the inflation throughout 2012. However, if inflation continues to fall it may actually risk lowering investment incentives, since transactions may be delayed in anticipation of minimal costs, which will be detrimental to growth.

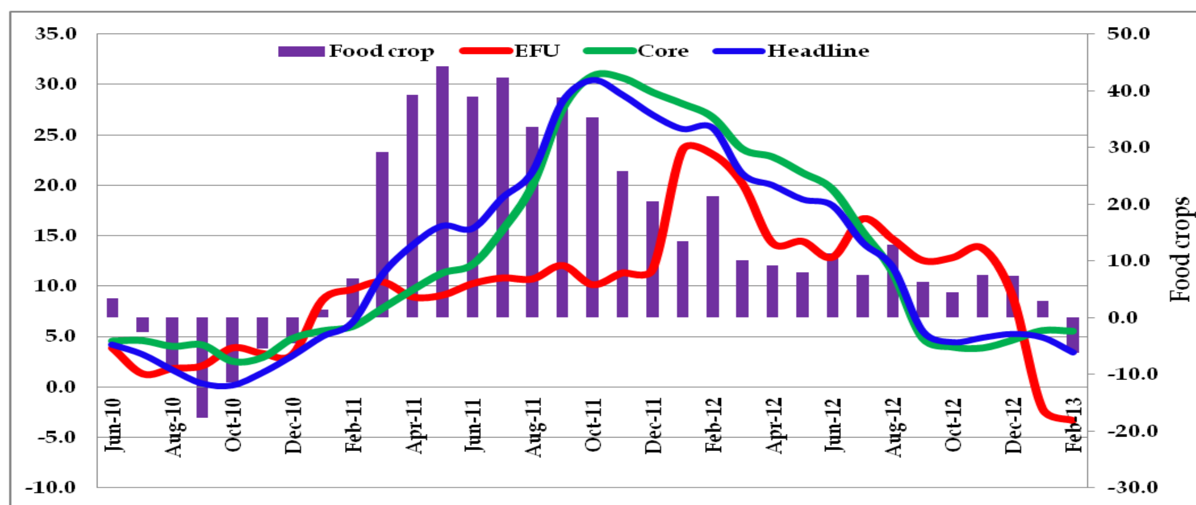
Table 7: Inflation developments

	Jul 12	Aug 12	Sep 12	Oct 12	Nov 12	Dec 12	Jan 13	Feb 13
	Annual							
Headline	14.3	11.9	5.5	4.5	4.9	5.3	4.9	3.4
Core	15.4	11.5	4.9	4.0	3.8	4.6	5.6	5.5
EFU	16.7	14.7	12.6	12.8	13.8	9.0	-2.1	-3.3
Food crop	7.5	12.8	6.3	4.4	7.5	7.3	3.0	-6.2
Food	5.4	4.2	-2.8	-2.5	-2.0	0.0	0.0	-2.0
Non-food	19.1	16.0	10.1	8.4	8.6	8.0	7.2	6.0
Beverages and tobacco	23.6	9.9	6.1	6.2	5.2	8.5	12.0	12.6
Clothing and footwear	12.5	6.4	2.3	-2.7	-1.2	-3.9	-4.4	-4.8
Rent, fuel and utilities	26.9	23.3	10.3	6.0	6.4	7.4	3.9	4.0
Household and personal goods	15.9	13.1	9.7	7.6	6.3	4.5	5.4	4.4
Transport and communication	17.4	15.9	4.0	3.6	4.7	5.6	2.5	4.1
Education	16.9	16.5	16.5	16.5	16.5	16.2	15.8	7.5
Health, entertainment and others	15.9	13.9	12.2	11.2	11.5	10.2	9.9	9.9
	Monthly							
Headline	-0.9	0.5	0.8	0.3	0.6	0.2	-0.3	0.4
Core	-0.2	0.2	0.5	0.3	0.4	1.4	0.9	0.8
EFU	5.0	-1.3	-0.3	0.5	0.8	-4.1	0.4	-0.2
Food crop	-5.9	2.3	2.4	0.6	1.5	-4.5	-6.9	-2.2
Food	-3.7	1.3	1.0	0.4	0.2	-2.0	-2.4	0.2
Non-food	0.6	0.2	0.7	0.4	0.7	1.5	0.6	0.5

Source: Uganda Bureau of Statistics

Food crop inflation declined to -6.2 per cent in February 2013 from a peak of 39 per cent in September 2011. The onset of the harvest season resulted in an improvement in the general food market supply, thus lowering prices across a wide range of food crops. The decline in food crops inflation is also partly attributed to base effects. EFU inflation declining from a peak of 23.5 per cent in January 2012 to *minus* 3.3 per cent in February 2013. ***Figure 17*** shows the evolution of inflation in the recent period.

Figure 17: Annual inflation rates



Source: Uganda Bureau of Statistics

Going forward, inflation is expected to remain stable as the base effects that were responsible for a faster disinflation have waned. Inflation is therefore expected to stabilise around Bank of Uganda's medium term target of 5.0 percent on account stable food production and global commodity prices, subdued domestic and global demand and relative exchange rate stability. The risks around the outlook for inflation reflect the usual mix of factors pertaining to aggregate demand, commodity prices, global economic factors and the exchange rate. The decline in inflation over the last few months has mainly been driven by a decline in food crops inflation which is largely determined by domestic and regional weather conditions. Therefore any change in these conditions could rapidly drive food crops inflation upwards and inflation in general. In addition, as growth recovers, a subsequent rise in food product demand may also pose an upward inflation risk if demand outstrips supply. The outlook for global commodity prices is dependent on global economic recovery and stronger recovery in the global economy could fuel increase in commodity prices and trigger high import costs and hence domestic inflation.

4. Economic outlook and policy implications going forward.

Uganda's economic growth declined from an average of 6.7 per cent in the period 1994- 2011 to 3.4 per cent in 2012. Going forward, the economy is expected to recover, but the negative output gap of about 2 to 3 percentage points will persist, at least up to 2015. There are domestic and external factors associated with this slack in domestic economic activity. The external-oriented sectors of the economy will continue to be dampened by the pullback in global demand and heightened risk aversion in global financial markets, which will continue to weigh on the sentiment-driven financial sector. The domestic-oriented sectors, which are usually relatively more insulated from the swings in global economic cycles, will not provide support to growth since these are driven by government expenditure, which is now constrained by limited fiscal policy space, which was further worsened by the aid suspension. Avoiding procyclical fiscal contraction would have provided a lifeline but only if the slippage in deficit levels can be financed on a sustainable basis. Clearly, to strengthen the economy's resilience to external shocks, Uganda needs to strengthen the domestic revenue base both to finance increased public investment and to build a cushion against a potential erosion of foreign aid from fiscally constrained advanced country donors.

The current account deficit is expected to persist. Export growth will remain relatively subdued due to the projected weakness in the global economy. With Eurozone's GDP growth projected at a contraction of 0.4 per cent in 2012 and expected to contract further by 0.2 per cent in 2013, exports are likely to remain sluggish in the near to medium term. Import growth meanwhile is likely to remain robust, implying widening of trade imbalance. With diminishing current transfers and foreign direct investment, under a flexible exchange rate regime, the exchange rate will need to adjust through depreciation so that foreign exchange reserves are not used up; but, of course, the changes in the exchange rate may themselves have a highly disruptive effect, and the magnitude of the equilibrium could be aggravated by the currently high risk aversion in the global financial markets.

Looking forward, domestic inflation is forecast to remain stable at BoU's medium-term target of 5.0 percent. Commodity prices are expected to remain relatively stable during 2013 and therefore do not pose a serious upside risk to inflation. It is however important to note that the risks around the outlook for inflation reflect the usual mix of factors pertaining to aggregate demand, commodity prices, global economic factors and the exchange rate. The decline in inflation over the last few months has mainly been driven by a decline in food crops inflation which is largely determined by domestic and regional weather conditions. Therefore any change in these conditions could rapidly drive food crops inflation upwards and inflation in general.

Food prices continue to be erratic and although food constitutes 27.2 per cent of the CPI basket, spill over effects associated with food price increases are substantial. In addition, further inflationary pressures could originate from the international commodity prices, especially oil prices. Supply side problems in the agricultural sector and high regional food demand, relatively low productivity of both agricultural and food-processing sectors, and high vulnerability of farming output to weather conditions suggest that supply side inadequacies could bring another round of food prices spike. Uganda's agricultural labour productivity growth has been very weak, attributable to lack of irrigation facilities, lack of fertilizers, shrinking land use, and infrastructure constraints. Therefore, raising

agricultural productivity should be policy focus for Uganda to remain on the path of macroeconomic stability.

The macroeconomic environment that has improved will provide a stimulus to private consumption, which we believe will be the engine of accelerating economic activity. Not only will inflation decline improve consumers' real income but lower interest rates could also give a boost to private household borrowers. Weak domestic and international aggregate demand, depressed economic activity, and diminishing inflationary pressures support accommodative monetary policy. It is worth acknowledging that expansionary monetary policy, through relatively low interest rates, could risk repelling international portfolio inflows, which then would aggravate the exchange rate depreciation pressures and subsequently higher inflation risks could regain momentum. Nevertheless, portfolio outflows could increase in the near term because the continued uncertainty in the global financial system on account of the unresolved US debt ceiling woes and the financial fragility in the Euro zone. In the short-run, with the elevated global uncertainties, the possibility of a lumpy capital outflows cannot be ruled out and therefore the need to build strong foreign currency reserve buffers to call upon in case of the need to stabilize the exchange rate and also for Uganda to be well positioned to cope with any further external shocks is crucial. Moreover, since Uganda has become more sensitive to the risks associated with inadequate reserves relative to short-term indebtedness, it should build strong foreign exchange buffers.

The accumulation of foreign exchange reserves is not without costs. The costs of holding foreign currency reserves include sterilization costs, opportunity costs, and potential BoU's balance sheet losses. The cost of sterilisation is currently borne by the BoU because effective July 1st 2012, all new government securities have been issued only for fiscal purposes. The BoU has conducted monetary policy, both sterilising of structural liquidity and fine tuning of liquidity in the banking system, through the secondary market using the repurchase agreements (REPOs) but this is not an effective way since these instruments are for short-term fine tuning purposes and not for sterilising structural liquidity injected through the foreign exchange purchases.

In conclusion, the expected inflation and economic outlook support the maintaining of an accommodative monetary policy, at least in the near-term. However, Bank of Uganda will remain attentive to future developments and new information, and stands ready to timely intervene to foster price stability. Furthermore, with the potential dangers of protracted economic decline lying ahead, it is essential that a combination of fiscal and monetary policies be used to bolster the resiliency and vibrancy of the economy.