Bank of Uganda

State of the Economy

September 2013

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Acronyms and Abbreviations

AEs	Advanced Economies
BoP	Balance of Payments
BoU	Bank of Uganda
CAB	Current Account Balance
CBR	Central Bank Rate
EAC	East African Community
ECB	European Central Bank
EMDEs	Emerging Market and Developing Economies
EFU	Electricity, Fuel and Utilities
EMEs	Emerging Market Economies
FAO	Food and Agriculture Organization
FDI	Foreign Direct Investment
FOB	Free on Board
FY	Financial Year
GDP	Gross Domestic Product
IFEM	Interbank Foreign Exchange Market
MENA	Middle East and North Africa
NDP	National Development Plan
NEER	Nominal Effective Exchange Rate
NPLs	Non-Performing Loans
OPEC	Organization of the Petroleum Exporting Countries
pp	Percentage Points
PSC	Private Sector Credit
QE	Quantitative Easing
REER	Real Effective Exchange Rate
REPOs	Repurchase Agreement
Shs	Shillings
SSA	Sub-Saharan Africa
UETCL	Uganda Electricity Transmission Company Ltd
UK	United Kingdom
URA	Uganda Revenue Authority
US	United States
US$	United States Dollar
US	United States
WALR	Weighted Average Lending Rate
Y-o-Y	Yea-on-Year

Executive Summary

(i) The global economic recovery is still struggling to gather momentum. In July, the IMF downgraded its projections of global economic growth to 3.1% for 2013. This is now their fifth consecutive downgrade of 2013 global growth prospects since early 2012. While still outpacing growth in advanced economies, a slowdown in Asia and other emerging markets is contributing to this deteriorating outlook. Global inflationary pressures remain subdued, in part because of subdued global demand. Overall, global inflation remained well contained in all major regions and commodity prices have generally declined in recent months. Furthermore, global inflationary pressures are expected to remain in check on account of subdued global demand.

(ii) On the domestic scene, the disappointing performance in the global economy has had a negative impact on the economy in Uganda through the trade channel and financial channel. The national economy is growing more slowly than previous forecast as a result of the global economic slowdown and rising domestic inflation. In 2012/13, economic growth was recorded at 5.1 per cent (yoy), down from 6.5 per cent (yoy). Exports, although growing positively, remain insufficient to bolster economic growth as a result of persistently weak global economic demand. Looking forward, Uganda's economic growth for 2013/14 is predicted to reach the lower end of the 5.4-6 per cent range. This forecast is based in part on the impact of slowing economic growth in emerging economies and escalating inflationary pressure. Nevertheless, public investment and preparations for holding the 2016 national elections are expected to provide a renewed boost to economic growth in 2014/15.

(iii) To support economic growth, the Bank of Uganda eased monetary policy since February 2012. The central bank rate which was raised to a peak of 23 per cent in November 2011 was progressively reduced to 11 per cent as of June to August 2013. BOU has successfully managed to influence the interbank money market rate, especially over the first half of the financial year. The 7-day interbank rate trended within the bands of the CBR and close to the policy rate. Despite the fall in the marginal cost of capital for banks in line with the reduction in the CBR, commercial banks' lending interest rates have remained sticky downwards, declining by only 5 percentage points over the year to 23 per cent, compared to a 12 percentage point reduction in the CBR.

(iv) Although the Balance of Payments improved in 2012/13 and have continued to show surpluses up to at least July 2013, current account deficit is projected to

increase substantially in the short term to medium term. Gains in the balance of payments were supported by a significant surplus in the capital and financial account. Despite the wide current account imbalance, the shilling remained relatively stable, appreciating marginally by 3.9 percent between January and September 2013.

(v) Short-term price pressures have increased significantly since the summer with headline inflation rising to 7.3 per cent in August due to rising food prices. In line with the fuel tax increase, increasing crude oil prices and expected energy prices are expected to exert upward pressure on inflation over the forecast horizon. Food prices increases are forecast to remain important in the second half of 2013 in view of a negative base effect. Given the modest recovery of the economy, global inflation is likely to remain subdued. Going forward, annual inflation is projected to average between 8 and 10 per cent in 2013 and 6 to 8 per cent in 2014. The upside risks relate to a weakening of the shilling's exchange and higher unanticipated rises in commodity prices. Conversely, a slower-than-expected recovery in the economy would have disinflationary effects.

(vi) By far, the biggest risk to the macroeconomic outlook stems from the external sector. Financial markets around the world went into a flash turmoil on the perception of an earlier than expected tapering of quantitative easing by the US Fed. Uganda with its large current account deficit and dependence on external flows for financing it, will remain vulnerable to the confidence and sentiment in the global financial markets. The large and widening current account deficit, is a formidable structural risk factor. Furthermore, the growing vulnerability in the external sector reinforces the importance of a credible fiscal stance. The private sector investment climate remains weak and risk aversion continues to stall investment plans. The outlook for investment is inhibited by cost and time overruns, weak cash flows, erosion of asset quality and muted credit confidence.

(vii) The economy faces considerable obstacles to growth amid weaker global expansion, inflationary pressures originating from supply side and the possible spike in fuel prices. Current account deficits, the result not only of weak export earnings but also domestic private demand remains a concern. While the short-term risk of a sudden stoppage of capital inflows sparking a currency and balance-of-payments crisis is low, addressing these large external imbalances is key for reducing external vulnerabilities. As external growth drivers are weak, domestic demand expansion and policy have become more relevant to the growth outlook. Fiscal position is weak and although foreign currency reserves are still strong, the rapid increase

external deficits suggest that they are becoming structural and they will eventually become unsustainable. Future growth remains contingent on building diversified productive capacities with reduced dependence on rain fed agriculture. Investment in infrastructure, human capital, and reform of government spending, are key to high rates of sustainable growth.

(viii) Policy trade-offs are difficult because of a combination of subdued growth, rising inflation and the need to finance a growing current account deficit. Raising policy rates may prevent excessive and inflationary currency depreciation and may sustain the financing of the current account deficit, but this move would undermine growth. Vice versa, if sustaining growth becomes the key policy objective and monetary condition is not tightened (or are even eased), the currency may depreciate too much and cause excessive inflation; low rates will also make it harder to finance the growing external deficit that requires large capital inflows. To maintain an easier monetary policy that boosts flagging growth while not causing a massive currency depreciation, capital controls on outflows and subsidy incentives for capital inflows may become more prevalent as a means to contain depreciation pressures. On the other hand, the anticipation of capital controls may lead to further capital flight; given this complexity, it remains unclear if countries like Brazil will decide to implement further capital controls.

1. External Economic Environment

1.1 Global growth

Global growth remains subdued averaging about 2.75 percent in the first half of 2013, but its underlying dynamics are changing. Global growth remains subdued but its underlying dynamics are changing. At the global level, major economies are seeing increasingly different growth dynamics and their relative cyclical positions are changing. Recent indicators point to stronger underlying activity in several advanced economies while key Emerging Economies (EMEs) have slowed. The impulse to global growth is expected to come mainly from the United States in the near term.

Downside risks remain and some have become more prominent. Momentum in the global economy is shifting away from EMEs and back to advanced economies after years in the doldrums. Attention has heightened recently on risks related to recent growth disappointments in emerging economies that could interact with risks related to unwinding of unconventional monetary policies in some advanced economies. Widespread loss of momentum in EMEs makes for sluggish near term growth prospects for the world economy. While the quarterly growth of industrial production had risen to an annualised rate of 5 per cent in the group of 7 largest advanced economies, factory output growth rates had fallen to zero in EMEs. EMEs suffering from large trade deficits, capital flights and depreciating currencies would have little choice but to raise interest rates to stem money flowing out of their economies even though their growth rates were slowing. This raises more serious risks for certain emerging economies with higher macroeconomic and financial vulnerabilities. Although policymakers continue to show resolve to keep the global economy away from the precipice, the greatest worry may well be a prolonged period of sluggish global growth (a plausible downside).

In the July 2013 World Economic Outlook, the IMF project that global economic growth will decelerate by 0.2 percentage points **(Table 1)** to 3.1 per cent, from 3.3 per cent forecast in April 2013. The downcast is largely attributed to increasingly weak domestic demand, slower than expected expansion in key emerging economies and the prolonged depression in the Euro area. At 3.1 per cent, real GDP is lower than the average of 4.0 per cent that was registered in the period 2000-07. Reduced growth in key emerging market economies is likely to have a significant and adverse effect upon growth in Sub-Saharan Africa.

Table 1: World economic growth projections

Region	Year over year		July 2013 Projections		Difference from April 2013 WEO Published	
	2011	2012	2013	2014	2013	2014
World	3.9	3.1	3.1	3.8	−0.2	−0.2
Advanced Economies	1.7	1.2	1.2	2.1	−0.1	−0.2
United States	1.8	2.2	1.7	2.7	−0.2	−0.2
Euro Area	1.5	−0.6	−0.6	0.9	−0.2	−0.1
Japan	−0.6	1.9	2.0	1.2	0.5	−0.3
United Kingdom	1.0	0.3	0.9	1.5	0.3	0
Canada	2.5	1.7	1.7	2.2	0.2	−0.2
Other Advanced Economies	3.3	1.8	2.3	3.3	−0.1	−0.1
Emerging Market and Developing Economies	6.2	4.9	5.0	5.4	−0.3	−0.3
Central and Eastern Europe	5.4	1.4	2.2	2.8	0	0
Commonwealth of Independent States	4.8	3.4	2.8	3.6	−0.6	−0.4
Developing Asia	7.8	6.5	6.9	7.0	−0.3	−0.3
Latin America and the Caribbean	4.6	3.0	3.0	3.4	−0.4	−0.5
Sub-Saharan Africa	5.4	4.9	5.1	5.9	−0.4	−0.2
European Union	1.7	−0.2	−0.1	1.2	−0.1	−0.1
Middle East and North Africa	4.0	4.5	3.0	3.7	−0.1	0.1

Source: Would Economic Outlook, July 2013

1.2 Global financial markets

Global financial conditions have been tighter and market pressures have become acute for some emerging economies. Emerging economies were hardest hit following Fed "tapering" remarks and disappointing news about their growth. More recently, market pressures have been concentrated in certain emerging economies with important vulnerabilities. Both push and pull factors appear at work with respect to capital flow reversals and continued heightened market volatility for some—driven by changing expectations of monetary tightening in advanced economies and weaker fundamentals locally in key emerging economies.

Emerging economies were hardest hit following Fed "tapering" remarks and external financing pressures remain heightened in some economies (e.g., Brazil, India, Indonesia, Turkey and South Africa). Initially, portfolio outflows from emerging markets in May-June 2013 was more broad based, while more recently market pressures have been more

concentrated on particular economies with important financial or macroeconomic vulnerabilities.

As economic fundamentals in the US improve, the potential for monetary tightening will increase; low-risk financial instruments, such as government bonds, in advanced economies are therefore also expected to offer higher yields in the near future, which could lead to some on-shoring of capital from emerging market economies to advanced economies, exerting downward pressure on emerging market exchange rates. Evidence of the above may already be seen in some countries and long-term advanced economy Treasury bond yields continued to rise in July 2013, most notably in the US and the UK. Turbulence and continued market pressures in some economies appear to be driven by both push and pull factors. On the push side, global financial conditions have tightened as market conviction has increased that U.S. monetary policy is approaching a turning point and expectations of policy rate hikes have been brought forward. Fed “tapering” is now seen as a possibility as early as September. U.S. 10-year yields are up by 80 bps to nearly 3 percent since late May 2013. Capital is being attracted to major developed markets by higher nominal yields. In Europe, long-term interest rates have increased modestly in the U.K. and core euro area countries, while periphery spreads (excl. Portugal) have stabilized since June.

On the pull side, deteriorating fundamentals in some emerging economies (e.g., Brazil, India, Indonesia, Turkey and South Africa) have also played a role. Recent indicators point to lower growth driven by weaker domestic and external demand. Increases in interest rates (i.e., changes in risk premia) and exchange rate depreciation pressures have been differentiated across countries, with high inflation or high external deficit economies being most affected. Some continue to see heightened market pressure. In particular, the situation has been exacerbated by disappointing news about emerging market growth and existing or rising domestic financial and/or macroeconomic vulnerabilities (e.g., high inflation, balance of payment pressures, India, Brazil, Indonesia, Turkey, South Africa; still rapid credit growth, Brazil, China, Turkey).

In May and June, many emerging markets adopted policies to counter the capital outflows and associated depreciation pressures. In Brazil, the government cut taxes on fixed income investments to encourage greater capital inflows; the Indonesian central bank increased its benchmark rate by 25 basis points to 6.0 per cent to slow the rate of depreciation of the rupiah; whilst the Indian rupee reached an all-time low against the US dollar in June. The currencies of emerging economies, including the BRIC countries, have typically experienced a pronounced depreciation against the dollar and reduced currency

confidence over recent months; some central banks have responded with foreign exchange intervention.

Financial market volatility has in turn dampened current prospects for a rebound in global economic activity by exacerbating the impact of uncertainty on economic growth. As a result, the global economic outlook remains highly uncertain. The euro zone sovereign debt crisis is perhaps the key challenge for the global economy, holding the greatest adverse effects for global economic activity.

1.3 Global Inflation

Global inflationary pressures remain subdued **(Table 2)**, in part because of subdued global demand. Overall, global inflation remained well contained in all major regions and commodity prices have generally declined in recent months. Furthermore, global inflationary pressures are expected to remain in check on account of subdued global demand. World commodity prices remain stable but elevated. In July 2013, average spot Brent and West Texas Intermediate (WTI) crude oil prices stood at US$107.9/barrel and $104.6/barrel, respectively.

Table 2: Annual Consumer Price Inflation

Country Group Name	2011	2012	2013	2014 (proj)
World	4.87	3.92	3.82	3.85
Advanced economies	2.69	1.96	1.69	1.95
Euro area	2.72	2.50	1.73	1.51
Major advanced economies (G7)	2.57	1.87	1.58	1.92
Other advanced economies (excluding G7 and euro area)	3.08	2.02	2.10	2.39
European Union	3.08	2.59	1.94	1.78
Emerging market and developing economies	7.19	5.93	5.92	5.65
Central and eastern Europe	5.33	5.79	4.36	3.61
Commonwealth of Independent States	10.08	6.46	6.76	6.55
Developing Asia	6.37	4.46	5.03	4.97
ASEAN-5	5.90	3.91	4.47	4.54
Latin America and the Caribbean	6.61	5.97	6.14	5.68
Middle East and North Africa	9.22	10.71	9.58	9.02
Sub-Saharan Africa	9.29	9.07	7.21	6.28

Source: World Economic Outlook, July 2013

1.4 Outlook and impact on Ugandan economy

Global growth is expected to recover from approximately 3.0 per cent in 2013 to 3.8 per cent in 2014; nonetheless this is some 0.25 per cent weaker in both years than earlier projected. The outlook for many commodity exporters has also deteriorated as commodity prices have fallen. Growth in sub-Saharan Africa has also been downcast as some of the largest economies struggle with domestic problems and persistently weak external demand. Growth in parts of the Middle East and North Africa remains weak owing to difficult political and economic transitions. Consequently, the risk of a prolonged growth slowdown in emerging market economies has now increased, due to the protracted effects of domestic capacity constraints, slowed credit growth, and weak external conditions.

The WEO outlook projects continued uncertainty in global financial markets, with developments in Europe being the main source of potential market volatility. Although many Central Banks have taken bold policy actions, which have so far successfully reduced banking sector vulnerabilities and stabilized financial markets, these policies may have undesirable side-effects that could ironically risk financial stability the longer they remain in place. There also remains concern that the prolonged period of low interest rates has encouraged banks to roll over non-performing loans rather than repair their balance sheets.

Inflation is expected to remain subdued over 2013 and 2014, largely on account of low commodity prices. The IMF projects that inflation in emerging market and developing economies will decline to 5.9 per cent in 2013 and 5.6 per cent in 2014. Meanwhile, in advanced economies the inflation outlook is benign; inflation in the Euro zone is projected to be 1.7 per cent in 2013 and 1.5 per cent in 2014; in the US inflation is expected to be 1.8 per cent in 2013 and 1.7 per cent in 2014; whilst in Japan inflation is projected to pick up to 0.1 per cent in 2013 and 3.0 per cent in 2014. The low global inflation outlook indicates that imported inflation is expected to remain generally benign in Uganda. However, the persistently weak current account balance could exacerbate exchange rate volatility and trigger depreciation pressures throughout 2013/14, which in turn could be passed through to consumer prices. Nonetheless, low imported inflation should provide the Bank of Uganda with room to support real economic growth.

2. Domestic Economic Developments

2.1 Monetary policy and financial sector developments

2.1.1 Interbank money markets

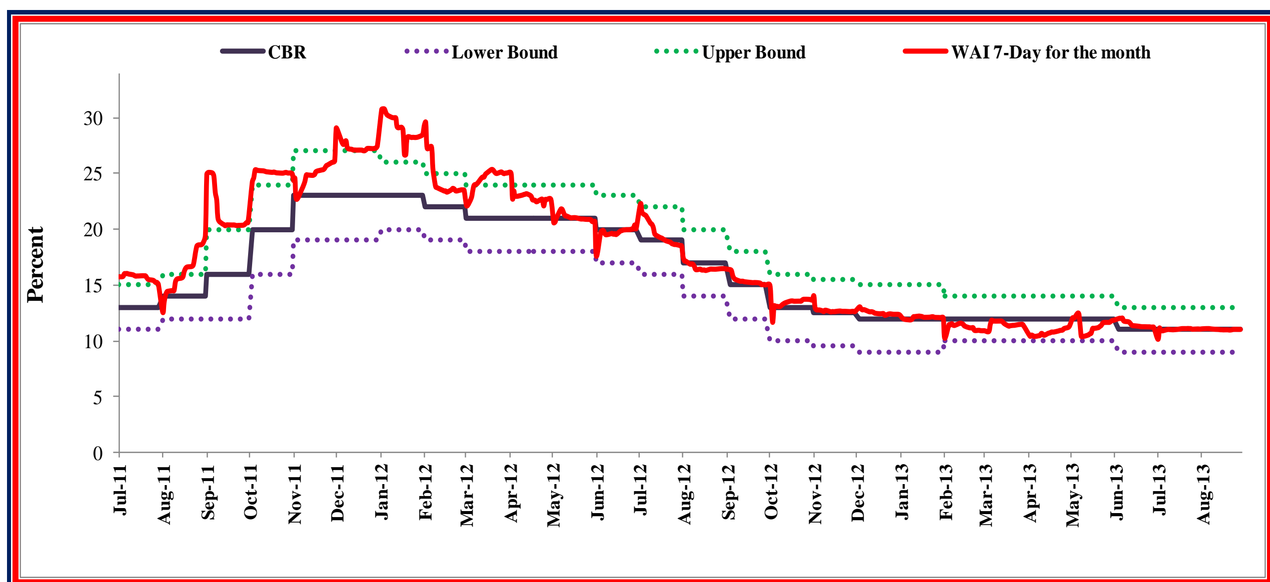
In line with reduced inflationary pressures, the Bank of Uganda eased monetary policy since February 2012. The central bank rate, which was raised to a peak of 23 per cent in November 2011, has since been reduced to 11 per cent. In August 2011, the Monetary Policy Committee maintained the CBR at 11 per cent given that the outlook for inflation and economic activity remained unchanged. Inflationary pressures remained muted and although core inflation is expected to rise in the short run it is projected to fall back towards the BOU's medium-term target of 5 per cent by June 2014.

The reduction in the Central Bank Rate (CBR) was envisaged to cause a decrease in the marginal cost of funds for commercial banks, which was deemed necessary to stimulate a recovery in private sector credit. Indeed, decreases in the policy rate, the CBR, were quickly passed on to the interbank rates and other wholesale market interest rates. The weighted average 7-day interbank rate decreased from 20.1 per cent in June 2011 to slightly above 10 per cent in August 2013.

In implementing the ITL framework, the BOU relies on the repurchase agreement as the main tool to manage short-term liquidity and to keep the 7-day interbank money market rate within the CBR band. The BOU has issued REPOs largely of 7-day tenors to align the interbank money market rate; however, given a sizeable build-up in structural liquidity and the lack of longer-dated instruments, BOU introduced the Deposit Auction instrument to mop up excess liquidity in money markets from March 2013. The tenor of the deposit auction is a minimum of 30 days.

BOU has successfully managed to influence the interbank money market rate, especially over the first half of the financial year. The 7-day interbank rate trended within the bands of the CBR and close to the policy rate until the third quarter of the financial year, where the build-up of structural liquidity caused interbank rates to decline substantially. **Figure 1** shows the evolution of the 7-day interbank money market rate with the monetary stance.

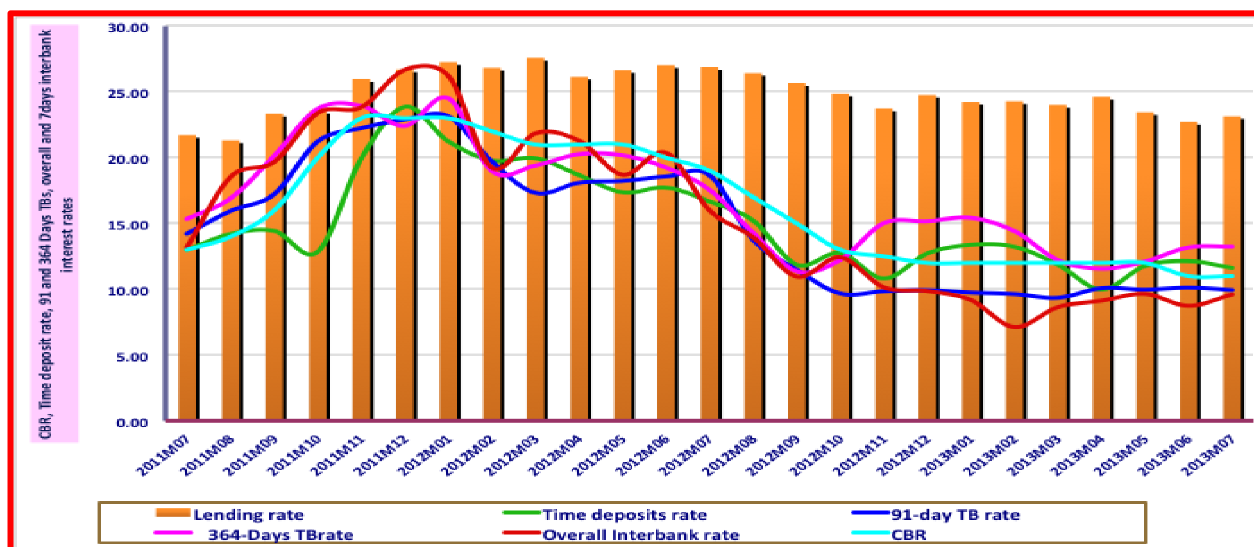
Figure 1: Evolution of the 7-day interbank rate



Source: Bank of Uganda

Rates on government securities declined in line with the CBR over the first half of the financial year, but yields have recently picked up with increased government borrowing and securities issuance. Figure 2 shows the evolution of the CBR and other interest rates. Despite the fall in the marginal cost of capital for banks in line with the reduction in the CBR, commercial banks' lending interest rates have remained sticky downwards, declining by only 4.3 percentage points over the year to 22.6 per cent, compared to a 12 percentage point reduction in the CBR.

Figure 2: Evolution CBR and Other Interest Rates



Source: Bank of Uganda

Lending rates on shilling loans have continued to demonstrate downward rigidity, on account of high fixed costs, heightened risk aversion and similarly difficulties in assessing creditworthiness. The weighted average lending interest rates peaked at 28 per cent in March 2012 and have since declined by 5 percentage points to 23 per cent as of July 2013. The weighted average time deposits rate on the other hand peaked at 24 per cent in December 2011 and has since then declined by 12 percentage points, proportionate to the decline in the CBR in the same period. Time deposit rates and yields on government securities seem to track the CBR more closely compared to the lending interest rates. There are several reasons for this stickiness. Lending rates have been slow to fall and banks are granting loans only to their most creditworthy clients, thereby slowing the recovery in private sector credit and economic growth. Furthermore, foreign currency credit is beginning to demonstrate a net loan recovery, which is most likely for prudential purposes as some commercial banks had exceeded the 80 per cent threshold.

The response of interest rates to monetary policy easing, particularly the cost of credit, and ultimately impacts the investment and consumption decisions of economic entities is an important aspect of monetary policy effectiveness. Apart from market rates, expectations about future outcomes play an important role. There could also be transmission lags. Moreover, the magnitude of change in market interest rates may be different, ranging from money market rates to lending rates. While policy rate changes do matter, it is not that straight forward as to how they impact lending rates in the transmission chain. In this context, how policy rate changes, impact bank deposit rates become important as banks rely on cost plus pricing of their loan products. Apart from cost of deposits, banks also load a risk premium, which may change in different phases of the business cycle, and therefore, the lags could be longer. Hence, how fast the banks are able to change these parameters would largely determine the changes in their lending rates. Thus, nominal lending rate determination in the market is a complex process, and how changes in lending rates impact overall growth is even more uncertain. This is the reason why monetary policy transmission is often dubbed as a "black box". Hence, explaining monetary transmission is a constant challenge for every central bank.

A notable feature of monetary policy transmission in Uganda is the asymmetry one observes during different phases of a monetary policy cycle. Usually, during a phase of rising policy rate, banks may be quick in raising their lending rates while in a phase of falling policy rate, banks may be slow in reducing their lending rates as cost of deposits does not adjust commensurately given the fixed nature of deposit contracts. This pattern reflects that loans, being mostly at variable rates, can be re-priced at a quicker pace than the fixed rate bank deposits. The asymmetric transmission also needs to be seen in relation to overall liquidity conditions. For example, in a tight liquidity condition, even if the policy

rate is reduced banks may not be in a position to reduce deposit rates and hence lending rates with the apprehension of losing deposits. Another consideration in a falling interest rate scenario could be that banks might want to protect their profit margin through a more sluggish adjustment of their lending rates.

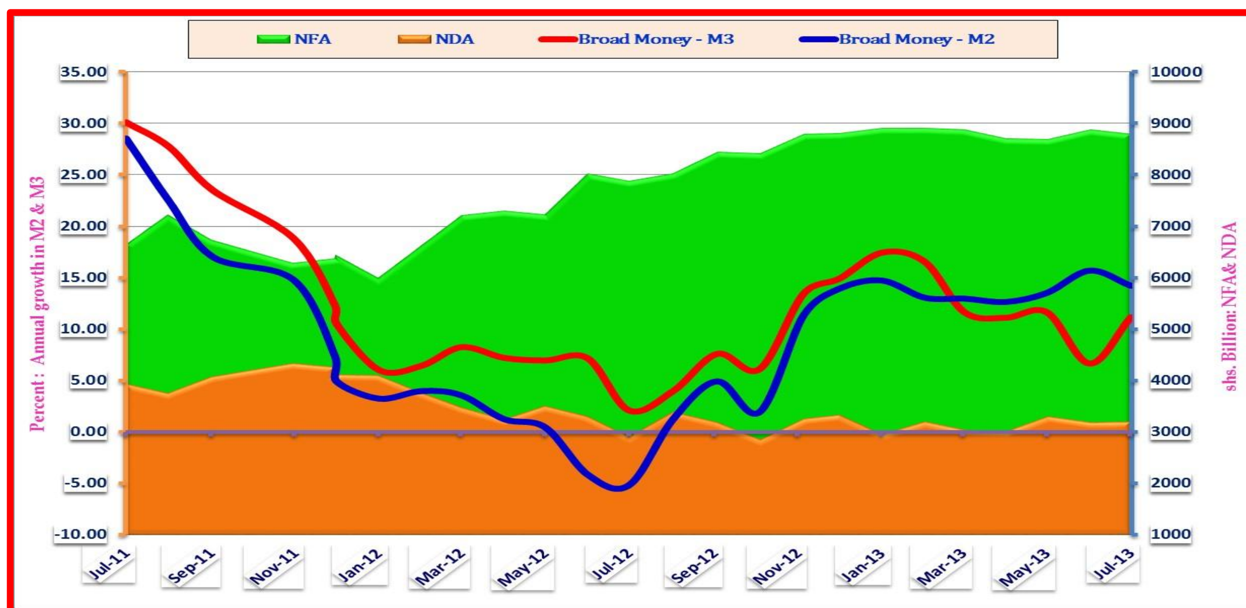
Furthermore, the interest rate on loans depends positively on expectations on real GDP and inflation. Better economic conditions improve the number of projects becoming profitable in terms of expected net present value and, therefore, increase credit demand. However, only increases in permanent income have a positive influence on loan demand, while the effect due to the transitory part could also be associated with a self-financing effect that reduces the proportion of bank debt. Therefore, monetary policy easing, and the lag associated with the pass-through to real activity, suggests that lending rates and credit supply might be affected with time. In addition, the costs of intermediation (screening, monitoring, etc.) have a positive effect on the interest rate on loans and a negative effect on that of deposits. These costs rise with slackness in economic activity. The interest rate on lending also depends on the riskiness of the credit portfolio; banks that invest in riskier project will have a higher rate of return in order to compensate the higher percentage of bad loans that have to be written off. Banking interest rates are also influenced by interest rate volatility. A high volatility in the money market rate should increase lending and deposit rates. There is a positive correlation between interest rate volatility and the spread.

2.1.2 Monetary aggregates and private sector credit

Annual growth in monetary aggregates has been largely driven by growth in Net Foreign Assets (NFA). In June, Base money, M1 and M2 grew by 17.5 per cent, 18.5 per cent and 15.7 per cent on a year-on-year basis, compared to 1.5 per cent, -5.7 per cent and -4.2 per cent respectively in the previous financial year. However, the growth rates for monetary aggregates were lower than the PSI projections; Projections from the sixth PSI review anticipated growth in base money and M2 of 24.4 per cent and 20.2 per cent respectively. Weak growth in monetary aggregates reflects low credit growth, as does the decline in the money multiplier by 1.5 per cent. The trend of base money versus the banking system's NFA and NDA is shown in **Figure 3**.

Annual growth in Net Foreign Assets (NFA) has been driven almost entirely by the Bank of Uganda's accumulation of NFA, equal to an increase of 21.0 per cent over the year; however Other Depository Corporations (ODCs) NFAs has contracted by 51.6 per cent over the period. The growth in NFA at the BoU is on account of an increase in foreign reserves. On the other hand, total Net Domestic Assets (NDA) has contracted by 3.4 per cent over the year, owing to the continued decline in BoU's NDAs, which fell by 10.9 per cent over the year despite an expansion in ODCs NDAs of 4.7 per cent.

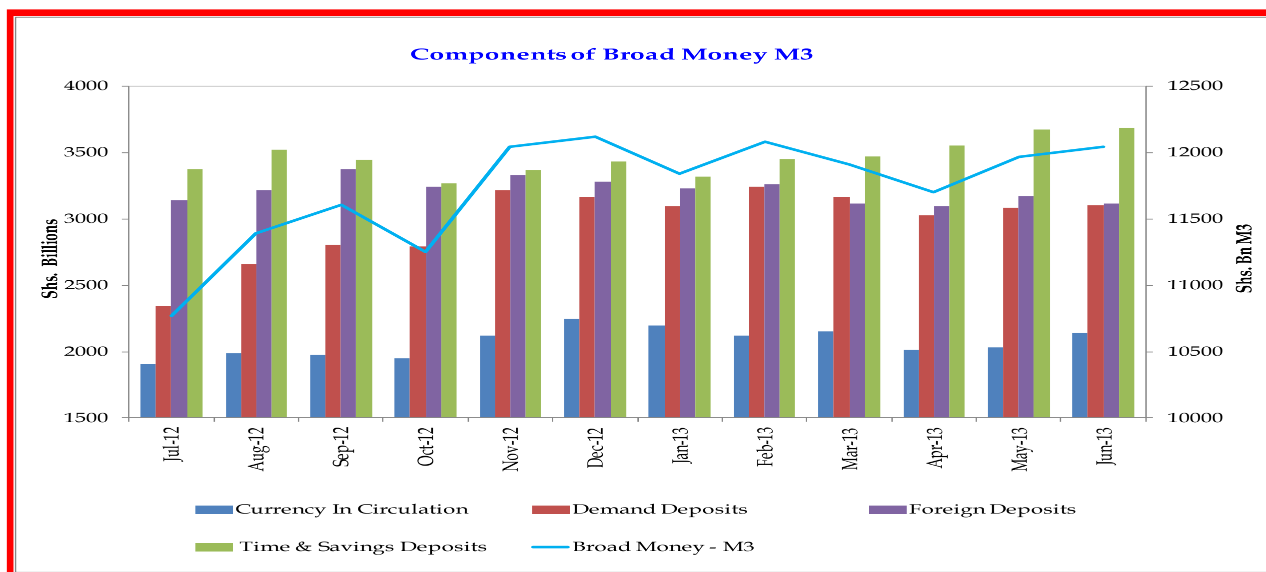
Figure 3: Developments in Monetary Aggregates



Source: Bank of Uganda

Time and saving deposits have been growing on a monthly basis throughout 2013 to date and grew by 6.2 per cent in June **(Figure 4)**. The continued growth in time and saving deposits is driving the increase in monetary aggregates. Comparatively, the increases in demand deposits and currency in circulation in June was minimal and has not been sustained over the year. Consequently, any expected increase in private sector credit is expected to emanate from growth in time and saving deposits.

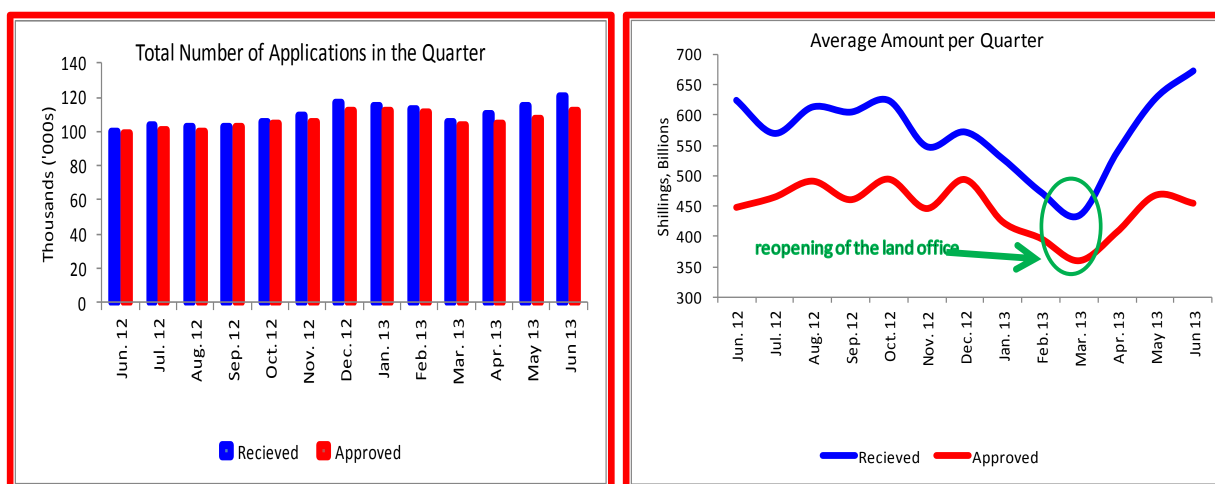
Figure 4: Monetary and Financial Developments



Source: Bank of Uganda

Changes in the willingness and ability of banks to extend credit have implications for aggregate economic activity. Credit demand and supply has followed an upward trend since March **(Figure 5)**. However, this is largely due to the reopening of the Land Registry Office and so may only represent a temporary readjustment. Credit demand, as judged by loan applications, has grown faster than supply, as judged by loan approvals, in recent months. Increased credit demand may indicate improved economic activity; however this may be impeded by low credit supply, which may be attributed to more risk averse behaviour of commercial banks as they realise increased loan defaults on their balance sheets.

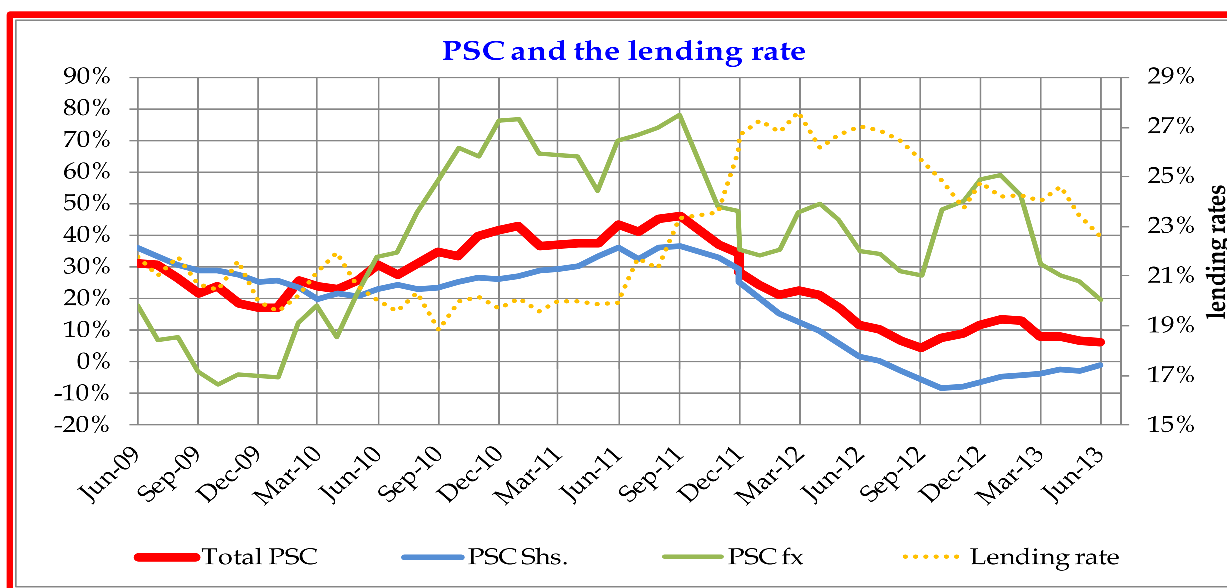
Figure 5: Demand and Supply of Credit



Source: Bank of Uganda

As aforementioned, private sector credit (PSC) growth remains constrained. The stock of PSC grew by 6.4 per cent on an annual basis in 2012/13, lower than the 11.6 per cent growth registered in 2011/12 and less than the PSI projection of 14.5 per cent. Furthermore, annual growth in PSC is entirely driven by foreign currency denominated lending, which grew by 19.5 per cent over the year, as shilling denominated lending declined by 1.1 per cent over the year. However, reassuringly the trend was reversed in quarterly PSC growth; on a quarterly basis, shilling denominated lending increased by 0.3 per cent over the last quarter of the financial year, whilst foreign currency denominated lending decreased by 1.9 per cent. **Figure 6** shows PSC growth by currency.

Figure 6: Distribution of Private Sector Credit by Currency



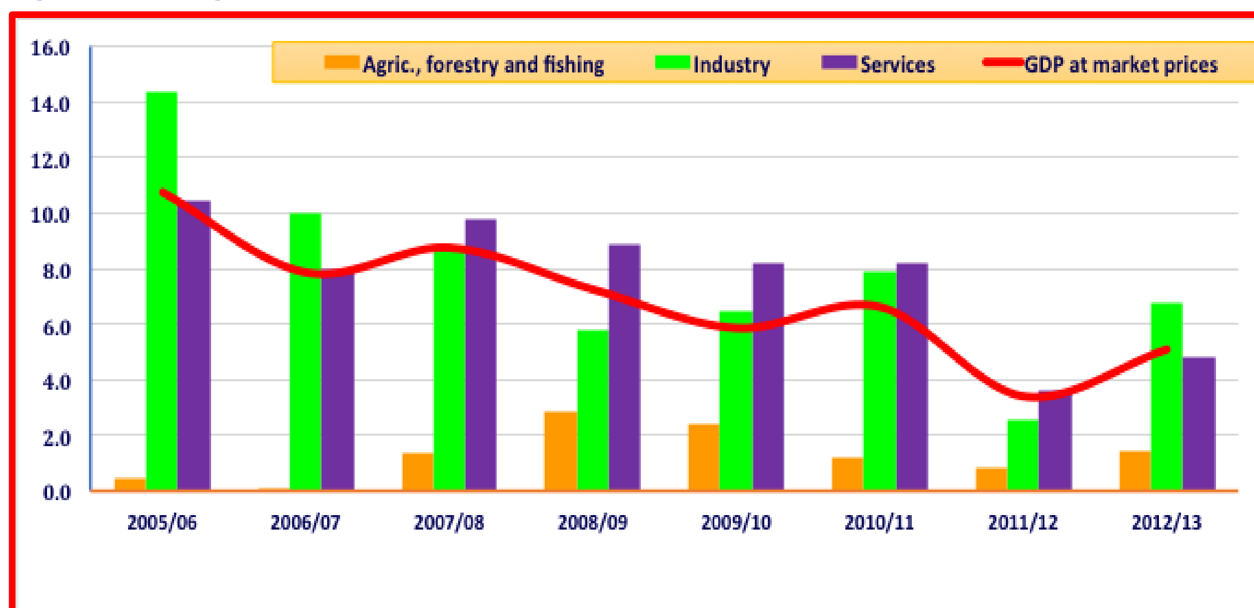
Source: Bank of Uganda

Sluggish recovery of bank credits to the industrial sector, especially to the manufactu ring, could prolong the slackness of economic activity. Factors contributing to the slower monetary expansion has been marked reduction in bank lending. This has been partly in reaction to the decline in credit demand, likely exacerbated by high levels of debt of many private sector borrowers. However, it also appears that banks have become less willing to supply credit in association with deterioration of assets quality and weak economic activity.

2.2 Real GDP growth

Uganda's economy, slowed markedly in the past two years. Annual growth declined from more than 6.5 per cent in 2010 to 2.8 per cent in 2012 as shown in **Figure 7**. The slowdown reflected weaker consumption and investment demand as a result of high inflation and high nominal interest rates, and spill over from the global recession. These factors will likely continue to impact economic growth in the next two years even as a moderate recovery is expected. Downside risks to the economic outlook are related to continued global weakness and to domestic vulnerabilities. A further economic downturn in the United States or Europe or a hard landing of China's economy would further weaken Uganda's exports, while also reducing inflows from FDI and workers' remittances. Widening current account deficits, coupled with lower portfolio capital inflows, could add pressure on the balance of payments, possibly requiring contractionary policy adjustment.

Figure 7: GDP growth by sector



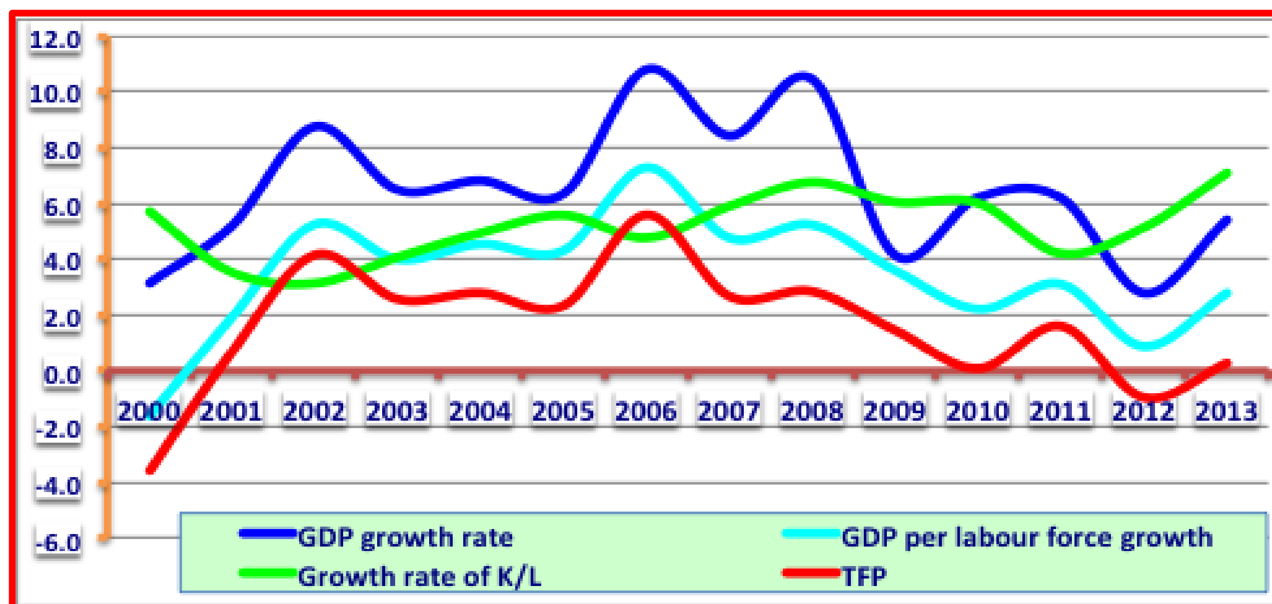
Source: Bank of Uganda

The unfavourable weather could have adverse impact on agricultural output in FY 2013/14, which could continue to constrain economic growth. The agricultural sector contributes about 24 percent of GDP. Over the last five years, its growth rate has averaged 1.7 percent, with an average contribution to GDP growth ranging from 0.2 to 0.7 percentage points. Therefore, poor performance of the agricultural sector has the potential of reducing GDP growth by as much as 0.5 percentage points. Therefore, against a subdued global backdrop and fairly soft domestic economic conditions, the near-term growth outlook for Uganda could remain subdued in the range of 5 to 5.5 per cent in 2013/14. While an improved external economic setting will eventually translate into stronger growth, the timing for this positive turn could be in 2014/15. GDP growth in Uganda could accelerate to 6.0 to 7 per cent in 2014/15, as a result of stronger growth of capital investment. Investment demand is expected to respond to a more accommodative monetary policy stance and slightly improved business confidence.

Policy concern is whether the deceleration of growth in recent years, as shown in Figure 8 is the new reality, especially after the global recession. There is no doubt that aid flows to Uganda positively contributed to Uganda's growth in the period before the global recession. The new reality is that following the recent global challenges, these flows could dwindle and with Uganda's infrastructure deficit, financing fiscal deficits through commercial borrowing, both external and domestic could have a negative effect on growth. As shown in **Figure 8**, Uganda's productivity has been declining and this is likely to persist in the medium to long term. In particular, over the next five years, Uganda will continue to record

large and widening current-account deficits. Inflationary pressures driven by food prices could remain an issue given rapid population growth amidst low agricultural productivity. These factors, in combination with large fiscal deficits, could suggest that the scope for monetary policy easing in response to slow economic growth could be limited.

Figure 8: Growth decomposition.



Source: Bank of Uganda

2.3 Fiscal Policy, Developments and Public Debt

2.3.1 Fiscal Developments

The fiscal stance is set to be relaxed in FY 2013/14 to support a recovery of growth to its potential. The budget has allocated significant resources to development spending on key infrastructure projects including roads, energy and agriculture. Government consumption has undergone more rapid expansion in the last four months, increasing by 21.1% in the quarter ending July 2013 consistent with the pattern of government budget absorptions. Government consumption posted 16.6 per cent (yoy) growth in 2012/13 and is projected to increase by 20 per cent in 2013/14. In the quarter ended July 2013, expenditure was 21.3 per cent higher than the quarter ended April 2013. However, disaggregated by component, the rise in government consumption is explained by increased roads and works, which had significant import content.

The government's net position at the BOU as at end of August 2013 was a saving of Shs. 3,002.1 billion, which was a decrease in governments' savings by Shs. 71.6 billion between

June and August 2013 **(Table 3)**. However, the fiscal deficit, excluding grants, is expected to increase by 1.1 per cent of GDP over the year to 6.7 per cent, and so will require readjustment in the long-term. Given the suspension of budget support loans, the government will adopt domestically issued securities and non-concessional external borrowing to provide the necessary financing to support their ambitious fiscal program.

Expansion in public investment may complement private capital accumulation, generating positive medium and long-run effects. However, there is a serious challenge in ensuring that the scaling-up of public investment is affordable, consistent with public debt sustainability and translates into increased effective public capital and sustainably higher GDP levels. The projected increase in capital expenditure demands lumpy large-scale investment that will substantially increase government expenditure in the short run. Given that a sizeable proportion of government expenditure will be on imports, fiscal expansion might only generate a limited response in output, whereby the resultant multiplier may be less than one, which could trigger a procyclical impact under the current economic environment.

Table 3: Government position

	Aug-12	Dec-12	Jun-12	Jul-13	Aug-13
Total Deposits	**10,190.5**	**9,739.1**	**10,340.4**	**11,176.2**	**10,817.2**
O/w Oil tax revenue	1,589.5	1,622.1	1,606.3	1,604.6	1,605.8
O/w Project Account Deposits	1,131.1	1,027.6	1,927.8	1,683.0	1,625.2
Total Advances	**7,073.2**	**7,129.8**	**7,266.7**	**7,635.2**	**7,815.0**
NGP With Treasury Instruments	**2,929.7**	**2,609.3**	**3,073.7**	**3,541.0**	**3,002.1**
Change in NGP with Treasury Instrument.	-509.3	-260.5	203.9	467.3	-71.6

Source: Bank of Uganda

The increase in government capital expenditure will be reflected in a widening of the current account deficit, at least in the short run, and will most likely increase the traded goods price index. Therefore, the expansionary fiscal stance poses real short-term exchange rate depreciation and consequently inflation risks; however as the economy is expected to improve in the medium- to long-term, increased domestic demand should restore the exchange rate to an equilibrium level. Overall, the limited impact of the fiscal stance to immediate growth outturns and the likely exchange rate depreciation and inflation pressures resulting from the fiscal stance, combined with current prevailing high

interest rates and low credit extension, is likely to limit short-term economic growth. Public debt developments are shown in Table 5.

2.3.2 Public debt

Uganda has used foreign borrowing to finance development expenditure. As a consequence, external debt which was US$1.5 billion as of June 2007, rose to US$ 3.8 billion as of June 2013, equivalent to an annual growth of 15.5 per cent. In addition, in 2013/14, Government will borrow US$ 1,937 billion on non-concessional basis from China Exim Bank to finance Karuma and Isimba hypo power dams. Further borrowing of about US$2billion for construction of Ayago hydro power dam is expected in 2014/15. This will bring external debt to about US$8 billion, equivalent to about 33 per cent of GDP. Domestic debt is expected to increase by about Ushs 1,040 billion this financial year to Shs. 7,790 billion, equivalent to 12 per cent of GDP **(Table 4)**. Other infrastructure projects include road, railways, oil refinery and oil pipeline. Overall, indications point to a fast build-up of debt.

An increase in external debt creates problems since whenever a country has debt accumulation, a high proportion of public expenditure and foreign exchange earnings are absorbed by the debt burden with heavy opportunity costs. Furthermore, inclining of external debt may have negative effects on investment through debt overhang and credit-rationing. Similarly, external debt service (in contrast to the total debt stock) can also potentially affect growth by crowding out private investment or changing the composition of public spending.

Table 4: Public Debt Indicators

	External debt stock	Disbursed external debt stock	External debt stock/GDP (%)	Disbursed external debt stock/GDP (%)	Domestic debt/GDP (%)
Jun-07	2,505.36	2,093.43	18.78	11.1	9.9
Jun-08	2,925.73	2,802.74	19.34	11.9	11.4
Jun-09	3,310.19	2,606.03	22.70	14.0	8.7
Jun-10	4,020.03	2,778.27	26.29	15.3	8.0
Jun-11	5,034.76	3,820.52	33.79	19.5	9.8
Jun-12	5,853.80	5,677.98	29.07	16.3	11.4
Jun-13	6,168.12	6,750.26	28.42	17.6	12.0
Jun-14	*10,143.00*	*7,789.66*	*43.15*	*33.0*	*12.3*

Source: Bank of Uganda

2.3.3 Domestic Debt Stock and Portfolio

The ratio of the stock of treasury bonds to treasury bills is gradually converging towards the annual target of 70:30, which aims to encourage the issuance of longer dated maturities, and thus better hedge against interest rate risk. The stock of domestic debt is presently concentrated in the 364-day Treasury bill and in the 3-year Treasury bond, which combined account for 55.9 per cent of total domestic debt **(Table 5)**.

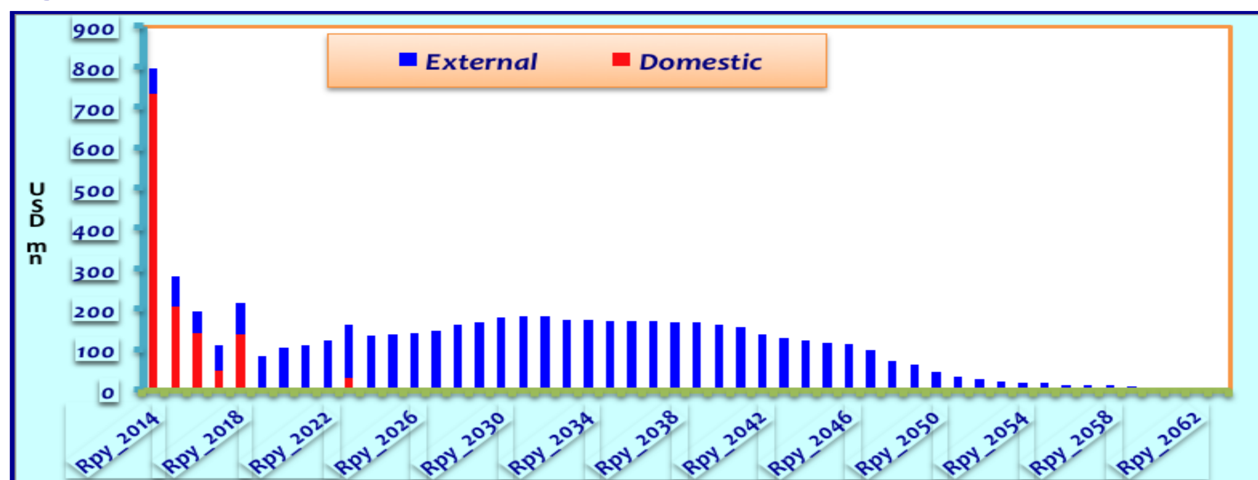
Table 5: Stock of Government Securities by Instrument (Shs. Billion, end period)

Instrument	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13
Treasury Bonds	3,199.9	3,249.9	3,411.5	3,666.5	4,202.2
2-year	900.0	950.0	1,030.0	1,045.0	1,150.4
3-year	1,140.0	1,190.0	1,190.0	1,230.0	1,380.4
5-year	755.0	705.0	745.0	945.0	1,125.0
10-year	404.9	404.9	446.5	446.5	546.5
Treasury Bills	2,478.08	2,547.22	2,583.59	2,396.02	2,548.03
91-day	53.64	60.33	107.71	44.13	92.53
182-day	183.38	220.83	321.88	353.46	335.00
364-day	2,241.06	2,266.06	2,154.00	1,998.44	2,120.49
Percentage Distribution					
Treasury Bonds	100.0	100.0	100.0	100.0	100.0
2-year (%)	28.1	29.2	30.2	28.5	27.4
3-year (%)	35.6	36.6	34.9	33.5	32.8
5-year (%)	23.6	21.7	21.8	25.8	26.8
10-year (%)	12.7	12.5	13.1	12.2	13.0
Treasury Bills	100.0	100.0	100.0	100.0	100.0
91-day (%)	2.2	2.4	4.2	1.8	3.6
182-day (%)	7.4	8.7	12.5	14.8	13.1
364-day (%)	90.4	89.0	83.4	83.4	83.2
Ratio of bonds/bills	56/44	56/44	57/43	60/40	62/38

Source: Bank of Uganda

The redemption profile outlines when various debt repayments will fall. It may be used to highlight specific periods when a country may experience large debt service repayments and thus heightened vulnerability. The redemption profile for Uganda's public debt stock as at end June 2013 indicates that 16.1 per cent of total public debt will fall due over the next financial year, which is comfortably below the recommended benchmark of 20 per cent. However, 56.7 per cent of total domestic debt will mature in the next financial year, which presents yet another risk associated with the stock of domestic public sector debt.

Figure 9: Redemption Profile of the Central Government Public Debt (UGX billions)



Source: Bank of Uganda

Overall, the risk indicators show that Uganda's public external debt portfolio is relatively well insulated against interest and refinancing risks, but may be highly susceptible to exchange rate risk given higher debt denominated in a foreign currency. However, given the borrowing requirements in this financial year and in two to three years ahead, Uganda's public debt presents more of a cause for concern and may require close monitoring and prudent management looking forward. Although Debt Sustainability Analysis (DSA) for 2012 indicated that Uganda's external debt was sustainable over the projection period, the new and projected borrowing suggest that Uganda's external debt, although still sustainable, is rising fast and the rising of non-concessionality component of the external debt are making it more likely to exceed the debt limits. Moreover, the increase in debt on non-concessional terms, with a grace period of about 5 years, suggests that Uganda will not achieve the EAC macroeconomic convergence criterion on fiscal deficit of 3 percent of GDP and public debt of 50 percent of GDP by 2020. Therefore, although public investment expansion could complement private capital, generating positive medium and long-run effects. The challenge is to ensure that the scaling up of public investment is affordable, consistent with public debt sustainability, and effectively translates into an increase in the stock of effective public capital and sustainably higher GDP levels.

The increase in the government capital expenditure will be reflected in the increase in the widening of the current account imbalances at least in the short run. The increase in capital expenditure also means a rise in the traded goods price index. This has real exchange rate depreciation consequences at least in the short run which could add to the inflationary pressures in the short run but in the medium to long term as the as the economy improves,

the demand for non-tradables could increase resulting in the exchange rate appreciation. In addition, the higher government expenditure geared towards capital expenditure, means that the multiplier effect of the increase in government expenditure will be limited hence subdued economic growth. A combination of high interest rates, low credit extension, depreciation of the exchange rate and consequently the increase in inflationary pressures and limited impact from the expansionary fiscal policy stance could constrain the economy at least in the short run.

2.4 Balance of Payments and Exchange Rates

2.4.1 Balance of payments

Uganda's current account deficit narrowed by 21 per cent in the last fiscal year on account of decline in government imports, which declined by 26 per cent, decline in non-oil private sector imports, which declined by 7.8 per cent, and strong growth in exports, by 10 per cent despite of weak external demand. Despite weak external demand, export performance continues to be strong and resilient. Exports grew at 6.4 percent during the first 6 months of 2013 after achieving a growth rate of 10 per cent in 2012. While earnings from commodity exports, especially coffee are declining, due to falling prices, exports of non-coffee exports continue to sustain moderate growth; growing by 9.5 per cent in 2012 and by 5 per cent in the first 6 months of 2013. However, exports growth seems to have tapered, reflecting weakening of economic activity at the regional level.

The value of import growth slowed considerably in 12/13, declining by 6.9 per cent. Private sector non-oil imports declined by 7.8 per cent in 12/13, while oil imports increased 8.6 per cent reflecting high oil prices. In the first 6 months of 2013, private sector non-oil imports have declined by 6.1 per cent. This could be a reflection of softening demand. Lower demand for capital investment and intermediate goods, as well as weaker private consumption, caused import values to decrease by 4.8 per cent and 10 per cent in the first 6 months of 2013 in comparison to 6 months to Dec.12 and by -5.5 per cent and -21.5 per cent, respectively in comparison to the first 6 months of 2012. In 12/13, whereas capital investment and intermediate goods remained almost unchanged, growing by 0.6 per cent, the decrease in the first 6 months of 2013 could suggest further softening of aggregate demand.

A capital account surplus of $2.3 billion in 2012/13 more than offset the current account deficit of $1. 86 billion; hence the overall BOP surplus was just over $349 million **(Table 6).** At the end of 2012/13, the BOU had gross foreign exchange reserves of $2,931 million, which was equivalent to 4.2 months of imports of goods and services. However, capital

account surplus decreased by 6.8 per cent as a result of decline in FDI, (by 22 per cent) and portfolio outflow, from inflow of US$ 264 million to an outflow of US$71 million. While overall BOP position although still a surplus, declined substantially. The surplus in the balance of payments helped in building up its international reserves.

Table 6: Balance of Payments (US$ millions

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Current Account Balance	-902.8	-1257.3	-1550.3	-1812.1	-2136.9	-1683.0
Goods Account (Trade Balance)	-1437.4	-1845.8	-1799.5	-2382.7	-2604.1	-1975.4
Total Exports (fob)	2073.0	2216.4	2317.3	2297.8	2660.4	2925.7
Total Imports (fob)	-3510.4	-4062.2	-4116.8	-4680.5	-5264.5	-4901.1
Services and Income	-739.7	-746.3	-868.4	-1019.8	-912.4	-914.9
Current Transfers (net)	1274.3	1334.8	1117.6	1590.5	1379.7	1207.3
Capital & Financial Account Balance	1134.1	1245.5	1559.6	938.0	2540.4	2368.9
Direct Investment	760.6	785.2	690.7	717.5	1511.9	1176.2
Portfolio Investment	90.1	-34.7	-31.3	2.1	263.6	-70.9
Overall balance	563.0	-45.7	210.9	-581.2	746.6	349.0
Exports as a % of GDP	14.4	14.2	15.2	15.4	13.6	13.9
Imports as a % of GDP	-24.3	-26.0	-26.9	-31.4	-27.0	-23.2
Current Account Balance as a percentage of GDP	-6.3	-8.1	-10.1	-12.2	-11.0	-8.0
BOP overall balance as a percentage of GDP	3.9	-0.3	1.4	-3.9	3.8	1.7
Total Aid to GDP (%)	3.5	3.6	4.2	3.9	3.3	3.1
Total external reserves (end of period) in future months of imports of goods & services	6.0	5.1	4.4	3.2	4.2	4.2

Source: Bank of Uganda

The Balance of Payments worsened by 69 per cent in quarter II 2013 compared to the previous period. Worsening was largely due to government imports, which increased by 22 per cent. Exports grew by 6.4 per cent, non-oil private sector imports declined by 6 per cent while capital account balance remained largely the same. Foreign exchange reserves at the end of July 2013 totalled US$2.96 billion, equivalent to 4.2 months of imports, which is slightly below the EAC convergence target of 4.5 per cent but about international adequacy standards. Looking ahead, the external side pressures will continue to bear down on the national economy as the balance of payments is expected to weaken further, because of

weak current account in line with the impact of weaker exports that will far be exceeded by imports even as domestic demand remains weak.

The BOP is expected to be weaker in 2013/14, because of a widening of the trade and current account deficits. The former is attributable to an increase in expected demand for imports, both from Government and the private sector. The trade deficit in goods and services is forecast to widen by more than $700 million in 2013/14, from $2.5 billion to $3.3 billion. Nevertheless, the BOU is still intending to build up foreign exchange reserves in 2013/14 (hence there must be an overall BOP surplus of similar magnitude), but this will require the BOU to purchase 3.1 million on a daily basis throughout the fiscal year.

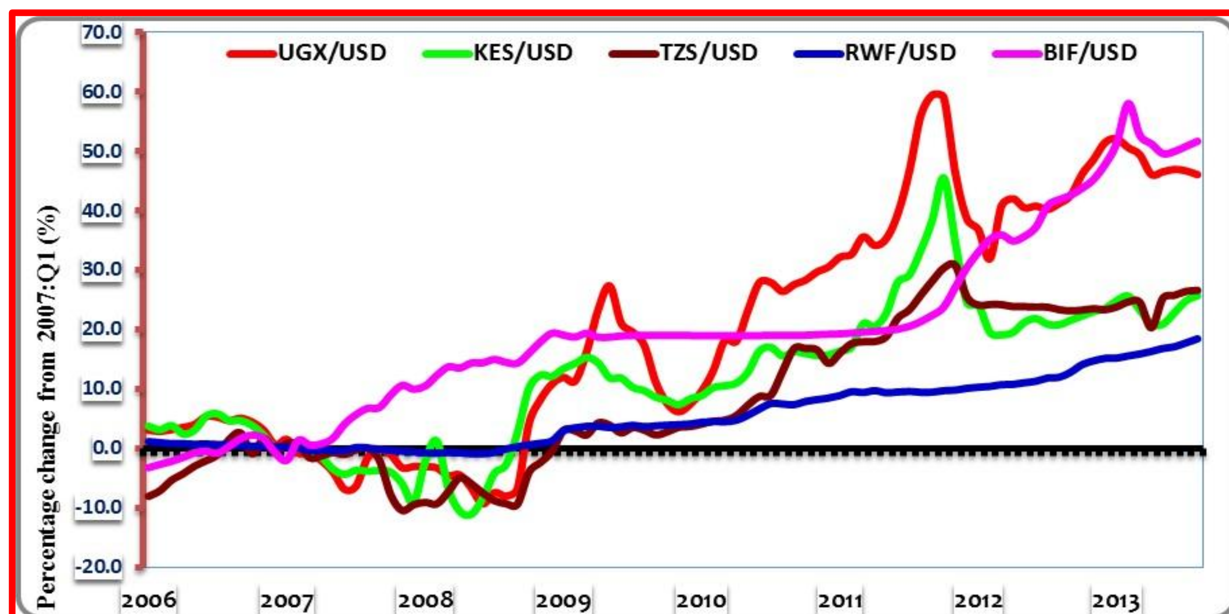
2.4.2 Exchange rate developments

The shilling exchange rate depreciated by 3.45 per cent in August 2013 (yoy) congruous with economic fundamentals. However, the shilling appreciated by 0.4 per cent (mom) to a level of 2577.9 per US dollar compared to the previous month. Looking forward, we expect the shilling to depreciate, consistent with fundamental conditions, this could support external rebalancing as well as catalyse healthier economic growth. The appreciation was largely attributed to subdued demand for foreign exchange, partly due to reduced government expenditure. The relative stability of the Ugandan Shilling over the month did not necessitate any BOU intervention in the foreign exchange market. As a result, all BOU IFEM intervention over the month were either for reserve build-up, BOU totalling purchases of US$14.0 million, or were targeted sales to UETCL, amounting to US$15.4 million, to meet their monthly foreign currency demand. Consequently, BOU's monthly net action in the foreign exchange market was a net sale of US$ 1.4 million.

The nominal effective exchange rate (NEER) appreciated by 0.6 per cent on a monthly basis and by 0.8 per cent on an annual basis in June. The real effective exchange rate (REER) depreciated by 0.7 per cent on a monthly basis and by 1.3 per cent on an annual basis in May 2013, reflecting a similar movement in the NEER. The foreign exchange activity has accelerated in recent years, with the average turnover in the FX market rising from 62 percent of GDP in 2006/7 to about 71.4 per cent of GDP in 2012/13. With the average of monthly trade in goods averaging about US$700 million per month in the last 12 months, the monthly average turnover in the FX market was double showing the significance of the market. This is a result of globalisation of financial markets. Consistent with globalisation and the liberalisation of the goods and financial markets, together with the adoption of freely floating exchange rate regime has cross border capital flows swift and effortless. These developments have heralded an era of increased exchange rate volatility in currencies that are more open. As shown in **Figure 10**, in comparison to the regional

currencies exchange rates against the US dollar, Uganda shilling has been more volatile, with except of Burundi Franc, which is consistent with Uganda's higher degree of openness.

Figure 10: Regional exchange rate developments



Source: Bank of Uganda

2.5 Domestic Inflation Developments and Outlook

2.5.1 Inflation Developments

Inflation picked-up in August 2013, as shown in **Table 7**. The rise in annual inflation may be attributed to food prices; annual non-food inflation remains completely unchanged at 6.5 per cent. Indeed, non-food inflation has averaged 6.6 per cent over 2013 to date. Food inflation emanated largely from processed food. Annual core inflation has been in single digits, since September 2012, averaging 5.4 percent over the last 11 months. However, core inflation has been slightly above the Bank of Uganda's medium term target of 5 percent since the start of 2013, and is likely to exceed 6 percent in the first quarter of 2013/14. Because domestic demand pressures are moderate, core inflation is expected to gradually fall back towards 5 percent in 2014, provided that there are no major supply price shocks (such as higher food or energy prices). However, the risks of higher inflation cannot be dismissed, in particular because of the potential for food price shocks or faster depreciation of the nominal exchange rate.

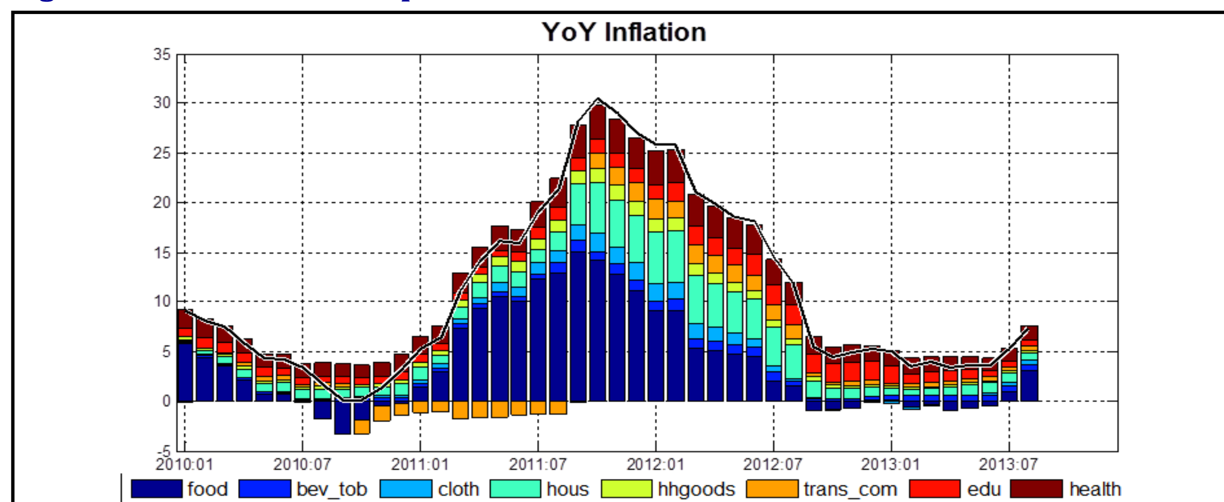
Table 7: Annual and Monthly inflation developments

	Oct-12	Nov-12	Dec-12	Jan-13	Feb-13	Mar-13	Apr-13	May-13	Jun-13	Jul-13	Aug-13
Annual											
Headline	4.5	4.9	5.3	4.9	3.5	4.0	3.4	3.7	3.6	5.1	7.3
Core	4.0	3.9	4.6	5.6	5.6	6.8	5.8	5.6	5.8	6.4	6.6
EFU	12.8	13.8	9.0	-2.1	-3.3	-2.0	1.8	1.3	1.0	0.3	1.6
Food Crops	4.4	7.5	7.3	3.0	-6.2	-8.5	-7.4	-5.2	-6.2	-0.3	13.0
Food	-2.5	-2.0	0.0	0.0	-2.0	-0.9	-2.6	-2.1	-1.4	2.8	9.1
Non Food	8.3	8.6	8.0	7.2	6.0	6.5	6.6	6.8	6.5	6.5	6.8
Monthly											
Headline	0.3	0.6	0.2	-0.3	0.5	0.9	1.4	0.2	-0.5	0.6	2.6
Core	0.3	0.4	1.4	0.9	0.9	0.3	0.2	0.1	0.6	0.4	0.4
EFU	0.5	0.8	-4.1	0.4	-0.2	0.9	0.1	0.1	-0.6	4.2	0.0
Food Crops	0.6	1.5	-4.5	-6.9	-2.2	3.9	8.8	0.9	-6.0	0.0	16.0
Food	0.4	0.2	-2.0	-2.4	0.2	2.3	3.7	0.4	-2.6	0.4	7.5
Non Food	0.4	0.7	1.2	0.6	0.6	0.3	0.4	0.1	0.6	0.6	0.4

Source: Bank of Uganda

Headline inflation accelerated in August 2013, largely on account of a rise in food prices, caused by the current drought. Consumer price inflation (CPI) edged up 7.3 percent year over year in August 2013. Supply constraints, particularly in food and infrastructure, the resulting food price rise, and high dependence on fuel imports could drive inflation further. As shown in figure 11, food prices, in the past few months a sharp increase in food prices, has been the driver of headline inflation. Food prices rose by 7.5 percent on month on month in August 2013 and by 9.1 percent on year on year basis. Food crops prices rose by 13 per cent y-o-y and 16 percent m-o-m. Core and non-food inflation remained relatively stable. Food insecurity outcomes will continue to prevail in the remaining quarter of this calendar year due to the adverse weather conditions.

Figure 11: Inflation decomposition



Source: Bank of Uganda

At the regional level, food insecurity has declined in many parts of East Africa. Nevertheless, Food insecurity in South Sudan is expected to deteriorate through December due to a combination of heightened conflict, the current heavy rains which may disrupt agricultural production, constrained household food supplies, and increasing staple food prices. These factors may cause food prices to edge up in the remaining months of this year. The impact of the adverse weather conditions is expected to be temporary. Overall, there is high uncertainty regarding the trajectory of food prices in the near future and in the worst case scenario headline inflation could edge up to 15 percent in the near-term.

2.5.2 Inflation outlook and Risks

The near-term inflation outlook has picked up over the last three months in line with increased risk of food inflation caused by the drought. Oil price uncertainty, due to increased geopolitical tensions in the MENA region, further complicates the inflation outlook. Both the headline and core inflation are expected to rise slightly in the near-term, but are forecast to remain within the inflation band of +/- 3 percentage points from target, provided second round effects are controlled. Once the effect of the drought on food prices dissipates, headline inflation is expected to stabilise at around 5.0 per cent in 2014/15. However, upside risks to higher inflation remain. The growing inflationary pressures originating from supply-side, along with the prospects of oil prices increases due to geopolitical factors.

On the world scene, the biggest risk to the macroeconomic outlook, and global inflation, stems from the global financial markets; financial markets were sent into immediate turmoil on the anticipation of earlier than expected tapering of QE by the US Federal Reserve. Given its large current account deficit (CAD) and dependence on external flows for finance, Uganda is highly vulnerable to financial market developments, including general confidence and sentiment. The large and widening CAD is undoubtedly a formidable structural risk factor when interest rates do pick up in the advanced economies.

Inflation had declined in part due to the slow increase of imported input goods. Global market prices for goods imported to Uganda are closely following developments in global economic activity. If international developments were to improve faster than expected, commodity prices could rise more than what the forecasts have assumed. In addition, if this is accompanied by the weakening of the shilling, this would strengthen the impact of import prices on domestic inflation in the short-term perspective. In this case, it might be necessary to raise the CBR rate faster.

An additional factor is the oil prices. International oil prices have been rising in recent months due to concerns in the Middle East (Syria's violence escalating, and Libya showing oil exports and production at the lowest levels since the civil war in 2011), and in Nigeria, where industrial-scale oil theft, sabotage and technical problems have hit output massively. While Syria is not a major oil producer, it straddles a region that is. The possibility of a wider conflict, one that could interrupt production and shipping routes in the region, has pushed oil prices higher in recent months. The average crude oil prices surged 5.5 percent (mom) in July while Brent crude oil prices rose by about 6 per cent between July and August 2013. However, this has not been transmitted through to domestic pump prices, in part, because of the shilling appreciation. Should the shilling depreciate and international oil prices rise further, this will be transmitted to all prices.

On the domestic scene, aggregate demand is expected to continue to be constrained in 2013/14, resulting in a continuation of the prevailing negative output gap. However, food prices are expected to pick-up over the next 3 to 6 months and uncertainty surrounding food security is expected to exert food price pressures throughout 2013 owing to relatively weak harvests, a prolonged dry spell and erratic weather patterns.

2.5.3 Monetary Policy stance and supply shocks.

The inflationary consequences of rising commodity prices represent an important challenge for monetary policy. Rising commodity prices result in an increase in inflation, but at the same time have negative consequences on economic activity. Their implications for monetary policy are less straightforward than those of demand shocks. For example, a positive demand shock, that increases inflation and output, calls for monetary tightening in order to stabilize both. However, the implications of commodity price shocks are less clear-cut.

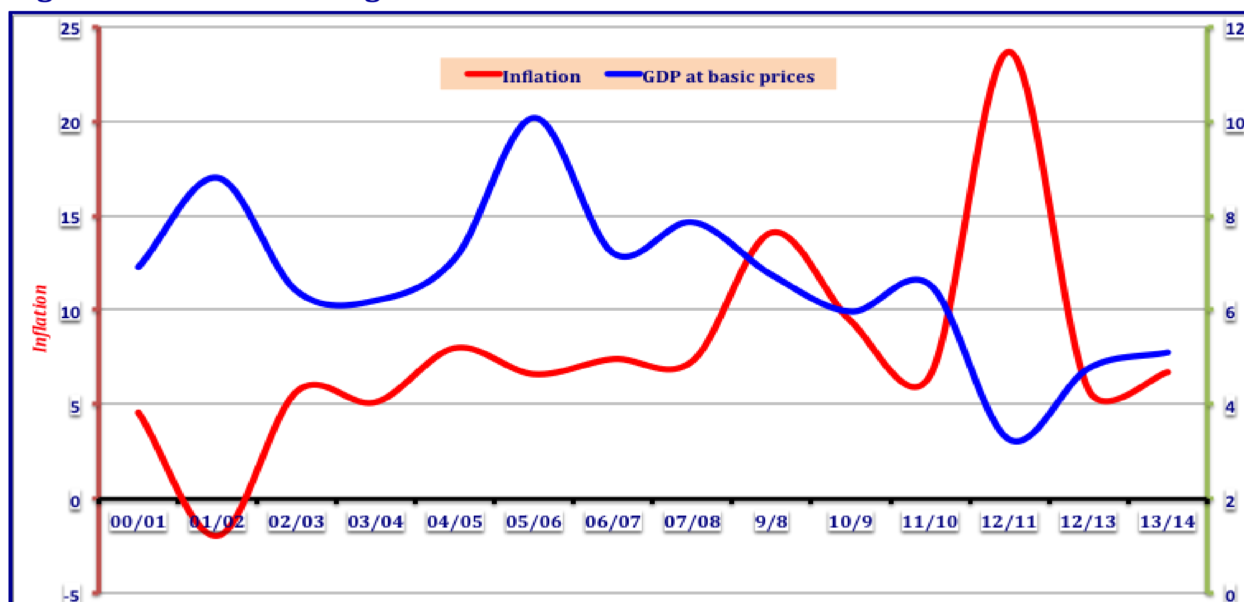
Inflation rises through the direct effects on gasoline prices and indirectly through a rise in costs. In addition, an oil price shock is analogous to a negative productivity shock. Therefore inflation rises and output slows down. Although in principle one could think that the implications for monetary policy are ambiguous, they are not. Some degree of accommodation may be needed, and this depends on the output effects, and the size and duration of the shock, but the direction of monetary policy is to reduce the monetary impulse. In the particular case of energy, the first thing that comes to mind is that it is a key intermediate good, and hence, a rise in oil prices should have an impact on the sticky price sector, so stabilizing headline inflation may prevent excessive second round effects. In the case of food three aspects are worth to mention. First, many food products, for example grains, are intermediate inputs.

Second, despite agricultural commodities having deep world markets, there are enough distribution costs that make difficult to think of those goods as having fully flexible prices. Indeed, distribution costs have been one of the main reasons why there is only partial pass-through from exchange rates to domestic prices. Finally, food prices are very important in the consumption basket, and therefore they have significant effects on other prices pressures, which also impinged on the overall price level. For all of these reasons, BOU cannot ignore for ignoring commodity prices from the central bank target. Given, the growing inflationary pressures originating from supply-side, along with the prospects of oil prices increases due to geopolitical factors, BOU's short-term inflation projections have deteriorated. Inflation is forecast to edge up to between 10 and 12 per cent in 2013/14 from previously 5-6 per cent. Therefore, BOU decided to cautiously tighten monetary policy. This policy stance is intended to continue to address the heightened risks to growth while guarding against buildup of inflation pressures.

Overall, BOU's monetary policy stance remains generally conditioned by the growth-inflation balance, the outlook for growth-inflation in a forward-looking context and an assessment of macroeconomic risks. Essentially, monetary policy aims at attaining high growth in a non-inflationary manner. But at times high growth in excess of potential growth could trigger inflation putting the sustainability of the very growth path to risks. Hence, monetary policy tends to do a careful balancing act so that it is not too accommodative of growth in excess of its potential and at the same time not too stimulative of inflation. However, in recent period, there has been rising inflation and falling growth below its potential. This could be arising from several sources such as the lagged impact of tight policy stance from earlier phases and adverse supply shocks, both domestic and external, which persist. The challenge of rebalancing growth and inflation is evident from Figure 12. In the first phase (2000-2007), high growth coincided with low inflation.

In the second phase (2008-2011), reflecting the impact of global financial crisis, growth decelerated. With a sharp increase in commodity prices coupled with sharp exchange rate depreciation, inflation too caught up rapidly. The anti-inflationary thrust of monetary policy became unavoidable to contain inflation and anchor inflationary expectations. In the third phase (2012-todate), the decline in inflation created the space for monetary easing. However, growth is yet to pick up reflecting weak global demand, domestic consumption and slowdown in private investment. In this context, the role of monetary policy has also come to the fore: the question being to what extent monetary policy has played a role in the growth slowdown?

Figure 12: Inflation and growth trade-off



Source: Bank of Uganda

In conclusion, the short-term outlook is mixed and complicated by political uncertainties, however there are no major risks at present and inflation is expected to stabilise at target over the medium–term. Food and energy account for a relatively larger share of the consumer price index. A sharp rise in prices of these commodities not only raise short run inflation, by virtue of their high weight in the consumer price index, but also can lead to a sustained rise in the inflation rate if it raises inflation expectations. Second, to the extent that supply shocks are accommodated by monetary policy they give rise to demand-driven inflationary pressures. There is no consensus on how monetary policy should respond to a permanent supply shock.

An important question, then, is to ask whether the cost of monetary tightening (from a reduction in aggregate demand) can be justified by the benefit of achieving low and stable prices. This involves a critical assessment of the nature of a shock and economic conditions. If BOU were to wait until the price movement is actually afoot before applying remedial measures, it would be too late. A policy of benign neglect could fuel inflation expectations and trigger a price spiral. True, BOU may not respond to temporary supply shocks such as weather disruptions or unanticipated supply hiccups. Events today, however, are far more complex and cannot be easily ascribed to domestic or global supply constraints alone. Evidence points to a confluence of cyclical and structural factors; domestic and global trends; and supply and demand shocks mutually reinforcing each other. The key to anchoring future inflation expectations is to prevent second-round price effects from burrowing through the economy.

3. Outlook and Implications for Policy

There are both external and domestic risks to economic growth, stemming from a subdued global economy and domestic capacity constraints. Externally, a decline in external demand, heightened global oil prices, a reversal of capital inflows or a suspension of FDI all pose adverse risks to domestic growth. Whilst on the domestic side, increased food prices, a widening current account deficit and the associated depreciation pressures and limited private sector credit also pose adverse risks to growth.

Going forward, the prospects for looser monetary policy are restricted by wide current account deficit and weaker currency. A weaker currency could drive up the cost of imports, fuel inflation, and therefore tighter monetary policy might become necessary going forward since inflationary is already on upward trend. Even if inflation was rebound at a slow pace, the phasing out of U.S. stimulus could bring the monetary policy easing cycles to an end and therefore a tightening bias and possibly defensive interest rates hikes. With weaker growth prospects and potential problems from prolonged high interest rates and low credit growth, the monetary policy framework must prepare to handle possible further weakness in economic activity, volatility of the exchange rate and risks to inflation. Overall, the economic outlook demonstrates increased downside risks and thus monetary policy may have to place increased importance upon the effects of economic growth, inflation expectations and external sector stability in order to achieve the inflation target and macroeconomic stability.

The BOU's monetary policy will continue being guided by the need for adequate reserve cover to enable BOU to respond pro-actively to risks to the economy from external developments, especially those stemming from global financial markets, while managing the trade-off posed by increased downside risks to growth and continuing risks to inflation and inflation expectations. In this way, monetary policy will be credible. The more credible monetary policy is, the less costly the disinflation process will be because greater credibility will make it easier for the BOU to affect market expectations, thereby reducing fluctuations in inflation and output.