Bank of Uganda

State of the Economy

June 2014

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(i) The fundamental outlook for global economic activity has remained unchanged since April 2014. Global growth is still projected to strengthen, growing by 3.4 per cent and 3.9 per cent in 2014 and 2015 respectively, from 3.0 per cent in 2013. Global inflation remains subdued on account of relatively stable food and energy prices. Food prices have been relatively calm for an extended period, yet they declined in April as the outlook for food crop harvests in 2014/15 appeared increasingly positive. There is however an upside risks from El-Nino conditions.

(ii) Financial markets within advanced economies have adapted to an expected steady tapering of US quantitative easing and financial market nervousness and volatility appears to be largely contained. Indeed, the Federal Reserve Bank has published more expansive information surrounding the pace and timing of monetary policy normalization in an attempt to reduce uncertainty and contain volatility within financial markets.

(iii) The BOU held the CBR at 11.5 per cent between December 2013 and May 2014 in order to maintain resilience of the economy against uncertainties surrounding the inflation trajectory and to support growth. In June 2014, however, the CBR was reduced to 11.0 per cent in order to stimulate economic activity owing to the persistent negative output gap.

(iv) Uganda's current account balance continues to deteriorate largely driven by higher import growth, which more than offset growth in exports. The stock of reserves at the end of April 2014 amounted to US$3,401.57 million, equivalent to 4.5 months of future imports of goods and services cover.

(v) Annual core inflation has continued to be subdued, averaging 3.8 per cent between January 2014 and May 2014 and is below the Bank of Uganda's medium term target of 5 per cent. At the same time, the risks associated with slow growth remain elevated. With the negative output gap in the range of 1 per cent to 2 per cent expected to persist in the next 2 years, accommodating growth considerations becomes crucial. Therefore, the Banks' decision to slightly ease the monetary policy stance is prudent.

(vi) The Bank of Uganda inflation forecast shows that headline inflation could decrease further due to the expected good crop harvest, but would increase later due to increases in taxes and the expected weaker shilling, which will affect inflation through higher import prices. At the same time, food price inflation will increase in the fourth quarter in part due to seasonal factors.

(vii) The outlook for growth is mixed. The economy in the second half of 2013/14 seem to have has lost its earlier momentum. Softer external demand and weak credit extension are likely to weigh on activity during 2014. In 2015, GDP growth is projected to rise somewhat, with persistent supply constraints, including a possible tight monetary policy stance in 2015, could hold back domestic demand. Growth is projected to remain below the historical average until 2018/19.

1 External Economic Environment

1.1 Global economic activity

The fundamental outlook for global economic activity has remained unchanged since April 2014. Global growth is still projected to strengthen, growing by 3.4 per cent and 3.9 per cent in 2014 and 2015 respectively, from 3.0 per cent in 2013. Increased economic activity amongst the advanced economies has been the main contributor to improved global growth over the recent period, driven by accommodative monetary policies, supportive financial conditions and a fading drag from fiscal consolidation in the aforementioned economies.

Most of the advanced economies however remain fragile and are therefore particularly sensitive to adverse shocks. Some emerging economies are in a similarly fragile condition, albeit for different reasons: fiscal and current account deficits, weak domestic demand, depreciation pressures and financial market nervousness. Furthermore, some emerging economies are experiencing political tensions that pose a risk of both contagion and depressed economic outlooks. Consequently, growth is expected to underperform in some of the larger economies, in particular Argentina, Brazil, India, Russia, Thailand and Turkey, and to pose a threat to global GDP growth.

1.2 Global commodity prices and inflation

Global inflation remains subdued. Global inflation eased to 2.3 percent in Q1 of 2014 from 2.7 percent in Q4 2013. In high-income economies inflation eased to 1.1 percent from 1.3 percent in the same period. With the exception of a few middle-income countries where price pressures have persisted (reflecting capacity constraints), inflationary pressures in developing countries remain somewhat benign. Inflation in developing countries eased to 3.8 percent from 4.1 percent. Moderation of activity, tighter policies and appreciating exchange rates, in the benign commodity price environment, contributed to easing of price pressures for the developing country group. However, price pressures persist in a number of large Middle-Income economies and in SSA in general reflecting capacity constraints. Inflation in SSA edged up to 6.0 percent in the Q1 of 2014 from 4.5 percent in Q4 of 2013. Crude oil prices were up on account of geopolitical tensions stemming out of Ukraine and could edge up further with the conflicts in Nigeria, Iraq, Libya and South Sudan. However, global inflation is expected to remain low and contained throughout 2014. Nonetheless, the largest risks to the inflation outlook are both on the upside: El-Nino weather conditions may push up global food inflation, whilst exchange rate depreciations due to financial market speculation may push up inflation amongst the emerging market economies.

1.3 Global financial markets

Financial markets within advanced economies have adapted to an expected steady tapering of US quantitative easing and financial market nervousness and volatility appears to be largely contained. Indeed, the Federal Reserve Bank have acted to publish more expansive information surrounding the pace and timing of monetary policy normalization in an attempt to reduce uncertainty and contain volatility within financial markets. Policy rates are expected to gradually increase, with improved economic activity, in the UK and US throughout 2015. Whilst in the Euro zone and Japan, further monetary easing is a real possibility if deflation and subdued economic activity persist.

Following the financial turbulence in the second half of 2013 and first quarter of 2014, a number of developing-country central banks hiked interest rates to fend off currency pressures and maintain price stability. The largest increases were in Argentina and Turkey at the start of 2014, but policy also tightened significantly in Brazil and Indonesia, and to a lesser extent in South Africa and India. In parallel, other countries slowed or ended their policy easing after mid-2013. Overall, more developing countries tightened policy during the first quarter of 2014 than relaxed, a first since the end of 2011. However, this trend towards tighter policy stalled in May 2014 and was reversed in the case of Turkey, while a number of central banks in other developing Eastern Europe (Hungary, Armenia, Serbia) resumed policy rate cuts. This shift towards looser policies coincided with a decline in global bond yields and a sharp fall in financial market volatility across developing countries. Renewed capital inflows have allowed previously depreciating currencies to regain some of their past losses and hence reduced the perceived urgency for central banks to tighten policy.

Furthermore, notwithstanding earlier tensions and downgrades in credit ratings, developing countries are benefitting from the current favorable environment, with the cost of lending falling by 111 basis points between February and May and the cost of insuring against credit defaults also declining by some 142 basis points, as yield-hungry investors plough into riskier assets. Among non-investment grade sovereigns to have issued in recent weeks include Pakistan, Zambia, and Ukraine. In April 2014, developing-country sovereign and corporate borrowers raised an all-time record high bond issuance of USA $42.7 billion, with some 77 percent of issuances going to investment grade borrowers. The interest in developing country assets is also reflected in the recent surge in emerging market equities by some 9.8 percent between mid-March and mid-May, out-pacing the 1.9 percent gain in high-income country shares.

Similarly, developing country currencies that were battered by earlier tensions have recovered and continue to appreciate, in part supported by policy tightening. This easy financing environment has also helped relieve pressure on countries with significant external financing needs. However, despite the favorability of the current environment, questions need to be asked on its sustainability as markets still remain sensitive to unexpected developments. Weaker-than-expected growth in high-income countries or escalation in geo-political tensions could turn sentiments quickly, with much riskier assets likely to bear the brunt of the reversal and yields on bench-mark high-income securities falling even further.

2 Domestic Economic Developments

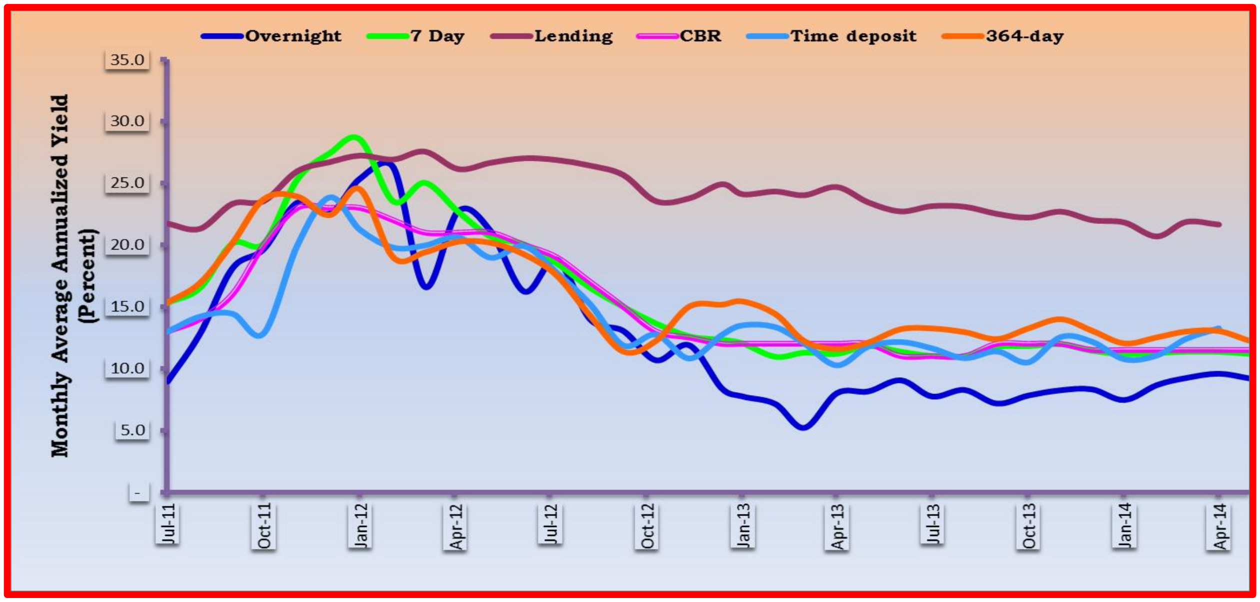
2.1 Monetary policy

The Bank of Uganda (BoU) targets short-term interest rates in its implementation of monetary policy, and in doing so has maintained core inflation at an average of 5.4 percent over the financial year to date, which is close to the BoU's target of 5 per cent. The currency depreciation worries and the associated elevated inflation forecasts, and the high degree of uncertainty surrounding the inflation forecasts given the exchange rate outlook, in adjacency to concerns surrounding the level of economic activity, which is believed to be below potential, has encouraged a cautious monetary policy stance over the past six months to May 2014. During this period, a substantial amount of uncertainty also existed around the GDP outlook: although economic activity is expected to expand over the next financial year, boosted by large-scale government infrastructure investments, it may be constrained to some degree by the prevailing shortfall in government revenue. Consequently, the CBR has been held at 11.5 per cent from December 2013 to May 2014.

The unchanged monetary policy stance resulted from mixed forecasts that presented an upside risk to inflation, yet a downside risk to growth, and thus was intended to strike a balance between the two. However, in June 2014 it was forecast that the upside risks to inflation were less than previously expected, whilst downside risks to economic activity remained. The negative output gap, and sizeable spare capacity, is currently expected to be sufficient that the economy may grow without exerting inflationary pressures. Therefore, an expansionary monetary policy stance was judged most appropriate and the CBR was reduced to 11.0 per cent in June 2014.

Since the implementation of the inflation targeting lite framework, the CBR has become increasingly effective in signaling the monetary policy stance and has consequently been reflected through both wholesale and retail domestic interest rates, with the exception of commercial bank lending rates. **Figure 1**, below, presents how the weighted average 7-day interbank rate and the weighted average time deposit rate have typically reacted in alignment with the monetary policy stance, shown by the CBR.

Figure 1: CBR and other interest rates in the economy



Source: Bank of Uganda

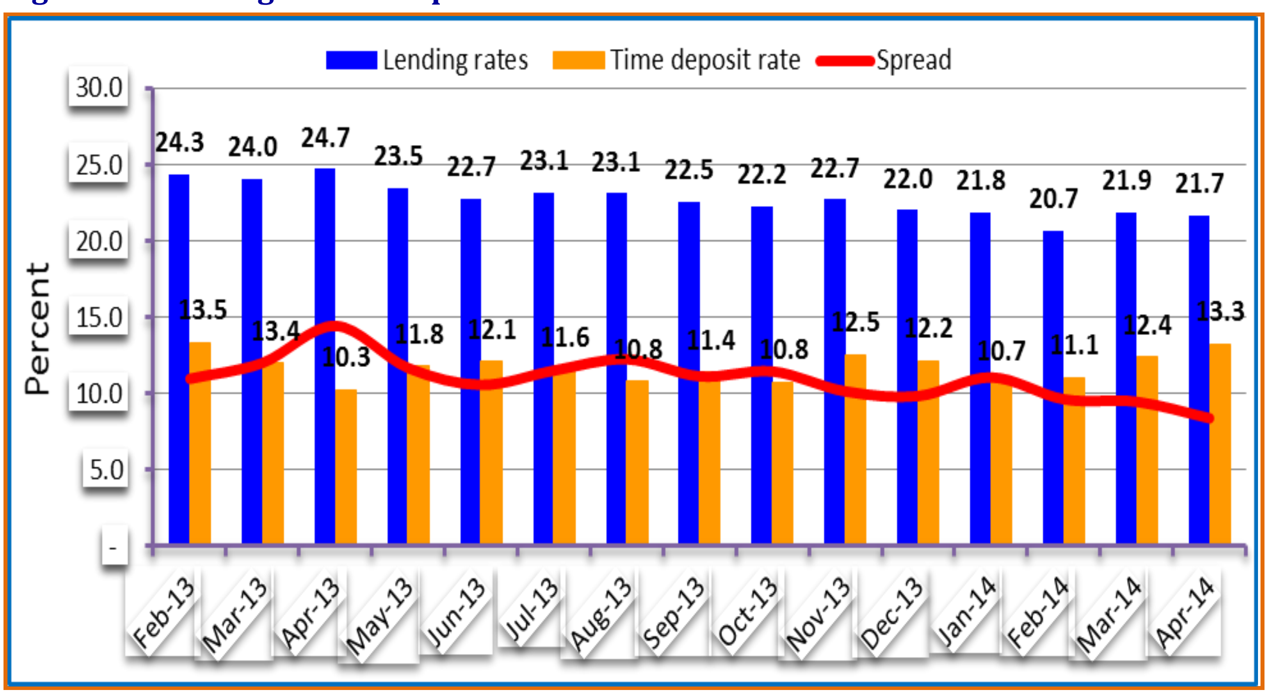
In order to better align the interbank market, presented above by the weighted average 7-day interbank rate, with the monetary policy stance, the Bank of Uganda exerts influence on the domestic liquidity levels through issuance of REPOs and reverse REPOS. In most parts, since the implementation of the inflation targeting lite framework, however, a liquidity surplus has typically prevailed in the Ugandan financial system, which has caused a net REPO issuance. The stock of outstanding REPOs stood at UGX 447 billion at the end of May 2014. Yet continuous REPO issuance is costly and necessitated recapitalization of the Bank of Uganda; consequently, UGX 120 billion of recapitalization securities were also outstanding at the end of May 2014.

2.2 Interest rates

Yields on government securities on both the short and long ends of the yield curve have declined indicating that monetary policy stance has been transmitted to interest rates. Yields on 15 year bonds declined from 15.25 percent in December 2013 to 13.27 percent in the last auction in May 2014, a decline of 198.2 basis points. Similarly, the yields on a 2-year bond declined from 14.17 percent in November 2013 to 12.85 in May 2014, a decline of 131.7 basis points. The decrease in longer-term interest rates should result in a decrease in the cost of borrowing and thus increase the demand for interest-sensitive expenditures. However, lending rates on Shilling denominated loans have not fallen in line with the monetary policy stance, and remained stubbornly elevated whilst the CBR fell throughout 2012. Whilst some asymmetrical lag is to be expected, lending rates remain elevated into mid-2014.

The weighted average lending rate hit an all-time low, over the ITL period, in February 2014 of 20.7 per cent, but rebounded closer to the 22.0 per cent mark in March. In April 2014, however the weighted average lending rate on Shilling denominated loans decreased to 21.7 per cent from 21.9 per cent in March, while the time deposit rate increased to its highest level in 12 months, to 13.3 per cent from 12.4 per cent in March, to narrow the lending rate spread to it' lowest level since June 2012, to 8.4 percentage points **(Figure 2)**. The sticky nature of lending rates is attributed to higher risk premiums in commercial banks on account of deteriorating banks' asset quality (indeed the ratio of non-performing loans to total loans has increased significantly from a low of 1.6 per cent in June 2011 to 6.2 per cent at end March 2014. In addition, there are structural rigidities in the financial sector, which have contributed to high overhead costs for banks. Nonetheless, the narrowing interest spread may signal future optimism surrounding the monetary transmission mechanism.

Figure 2: Lending & Time deposit rates



Source: Bank of Uganda

2.3 Private sector credit

Although there is a notable recovery in banks credit to the private sector, it has been growing sluggishly. The 12-months growth in total loans and advances to the private sector was 10.8 per cent in April 2014 driven by a 18.9 per cent increase in credit extension to agricultural sector, 8.2 per cent to manufacturing, 9.8 per cent to trade, 13.2 per cent to Building, Mortgage, Construction and Real Estate and 38 per cent to households. In the three months to April 2014, credit extension recovered robustly with exception of credit to transport and communication.

The growth in credit to the private sector is largely driven by foreign currency denominated lending, which rose by 12.9 per cent year-on-year, in March 2014. As shilling denominated lending continues to improve, we expect credit to rise closer to the projected growth rate of 15 per cent. The rebound in credit to the private sector is expected to bode well with private consumption and investment activity, which should in turn support economic growth going forward.

Table 1: Average Annual growth rates of Private Sector Credit by Sector

	November 2013-January 2014	February - April 2014
Agriculture (8.3%)	26.8	16.0
Manufacturing (7.9%)	-6.0	9.2
Trade (20.5%)	-6.7	5.8
Transport and Communication (3.4%)	12.7	-6.8
Building, Mortgage, Construction and Real Estate (18.5%)	-8.7	11
Business Services (4.4%)	8.5	12.2
Personal Loans and Household Loans (26.9%)	43.2	38.5

Source Bank of Uganda

2.4 Fiscal Developments

During the Financial Year 2013/14 fiscal operations are projected to be more expansionary than what was presented in the annual budget due to revenue shortfalls of Shs.490billion and supplementary government expenditure of about Shs.200 billion. Part of the deficit is to be financed by drawdown from BOU by Shs90 billion. Fiscal Budget for Financial year 2014/15 is estimated to be more expansionary than the 2013/14 Budget (adjusted, excl. Karuma) due to government infrastructure projects – overall deficit is to increase from 5.0 percent to 7.2 percent of GDP **(Table 2)**: with tax reforms and sound fiscal policies to lead to 0.5 percent increase in revenue share of GDP from12.6 percent to 13.1 percent in 2014/15. Government could draw down their savings on the energy fund in 2014/15 and this could lead to additional structural liquidity.

Table 2: Fiscal stance

	2011/12	2012/13	2013/14	2014/15	2015/16
Expenditure and net lending/GDP	18.5	18.9	19.5	22.6	20.7
Overall balance/GDP	-3.0	-4.1	-5.0	-7.2	-5.4
Domestic financing/GDP	0.0	1.2	2.6	3.6	1.7

Source Bank of Uganda

As shown in the **Table 3**, depository corporations' holdings of government securities and government interest cost indicators have continued to rise, a likely indication of increased government interest cost and crowding out of PSC.

Table 3: Public domestic debt

Public Domestic Debt Indicator	Jun'13	Mar'13	Apr'13
DCS holdings of govt	36.9%	41.9%	43.3%
Interest cost/domestic	10.7%	11.8%	11.9%
Interest cost/total expenditure	7.5%	8.0%	8.3%

Source Bank of Uganda

Fiscal deficits are projected to continue rising and remain a source of vulnerability. Ambitious public investment program, coupled with weak revenues, have contributed to a deterioration of fiscal balances, resulting in low fiscal buffers that have limited the scope for policy response in the event of exogenous shocks. To finance the rising level of expenditure, the government could continue to borrow heavily on the domestic market causing interest rates to remain at elevated levels. The deterioration of fiscal position continues to be a major challenge for the conduct of monetary policy in the medium-term.

In 2014/15, PSI program capped issuance of domestic debt at Shs.1.4 trillion and this includes a contingency reserve of Shs200 billion and an increase in Deposits at BoU by Shs138 billion. Any issuance of debt above Shs1.4 trillion or change in deposits different than an accumulation of Shs138 billion will constitute a breach of the PSI program. It's doubtful that fiscal policy will stick to this given the expenditure pressures and ambitious tax measures. However, increase in infrastructure investment is needed to raise potential growth.

2.5 Balance of payments

Uganda's current account balance continued to deteriorate mainly on account of higher import growth, which more than offset growth in exports. Imports recorded a strong expansion in the three months to April 2014, growing at an average rate of 6.7 percent month-on-month, equivalent to annualized rate of 26.7 percent, compared to an average growth rate of 1.3 percent in the three months to January 2014 and -3.7 percent in the three months to October 2013. This reflects a considerable rebound of economic activity in the first half.

The fall in international commodity prices negatively affected the net export performance contributing to a widening of current account deficits. The fall in commodity prices combined with weak external demand weighed on export receipts even though on a volume basis exports increased. Meanwhile, imports rose strongly, driven by robust demand for capital goods, as the government ramped up spending on infrastructure investment. As a result, the current account deficit is projected to increase from 8 percent of GDP in 2013 to 10 percent of GDP in 2014. The contribution of net exports to growth is projected to significantly reduce in 2014.

The current account balance deteriorated by US$ 486 million to a deficit of US$ 755.3 million in the three months to April from US$ 269.3 million in the previous quarter. However, the trade deficit deteriorated by 30.8 per cent to US$ 717.1 million during the quarter mainly on account of lower transfer receipts. In the three months to April 2014, the export earnings increased by 4.1 percent to US$ 680.6 million on account of increased coffee exports with COMESA region and EU being the main destinations of the exports. Conversely, these earnings were more than offset by the import bill which increased by 14.1 per cent to US$ 1,397.8 million. The main driver of import growth has been imports for private investment, which amounted to US$ 1,004.8 million, accounting for 71.9 per cent of total private sector imports **(Table 4)**. The government grants in form of capital transfers declined leading to a deterioration in the capital account balance to US$9.5 million during the 3 month period ending April 2014 from 42.9 million registered in the previous quarter.

The financial account balance shrunk by US$105.4 million, driven mainly by reduction in direct investment inflows and lower inflows of other investments. The net incurrence of other investment liabilities decreased from US$336.1 million in the previous quarter to US$162.8 million during the 3 month period ending April 2014. However, there was an increase in net incurrence of portfolio investment liabilities. The overall balance, thus, was a surplus of US$9.9 million resulting in a net reserve build-up of US$8.0 million excluding valuation changes during the 3 month period ending April 2014. The stock of reserves at the end of April 2014 amounted to US$3,401.57 million, equivalent to 4.5 months of future imports of goods and services cover. This was an increase from US$3,240.19 million at the end of January 2014.

In terms of the outlook, the current account balance is expected to deteriorate further, driven by higher private sector imports, which is expected to more than offset export earnings on account of off-season effects for some commodities, particularly coffee and reduced remittance inflows due to off season effects. The deficit on the current account is expected to be financed by the surplus on the financial account.

Table 4: Balance of payments (US$ millions)

	Q4 2012/13	Q3 2013/14	Feb-14	Mar-14	Apr-14	Q4 2013/14
Current account	**-472.42**	**-269.35**	**-221.42**	**-217.28**	**-316.64**	**-755.34**
Capital account	**20.61**	**42.88**	**3.84**	**2.17**	**3.53**	**9.55**
Credit	20.61	42.88	3.84	2.17	3.53	9.55
Debit	0.00	0.00	0.00	0.00	0.00	0.00
Balance from current and capital account	-451.81	-226.47	-217.58	-215.11	-313.10	-745.79
Financial account	**-529.22**	**-489.19**	**-79.07**	**-96.16**	**-208.59**	**-383.82**
Net errors and omissions	**-94.96**	**4.30**	**123.45**	**135.19**	**113.25**	**371.89**
Overall Balance	**17.55**	**-267.01**	**15.06**	**-16.24**	**-8.74**	**-9.92**
Reserve assets	**-19.82**	**266.44**	**-16.97**	**16.12**	**8.88**	**8.04**

Source: Bank of Uganda

2.6 Exchange Rates Developments and Foreign Exchange Reserves

2.6.1 Exchange rates Developments

The BOU implements the flexible exchange rate regime, but occasionally intervenes in the foreign exchange market to stem wide volatility in the market. The Uganda Shilling has uniquely continued to appreciate on an annual basis relative to other currencies in the region such as the Kenya Shilling, Tanzanian Shilling and Zambian Kwacha **(Table 5)**. The shilling however depreciated in May 2014 on a month on month basis. The appreciation of the Uganda Shilling is on account of sustained capital inflows, particularly for portfolio investment, driven by higher real returns (higher interest rate differentials) and inflows for investment in the oil sector.

Table 5: Regional comparison of inflation, exchange rates and interest rates

Annual Inflation Rate (%)						
	Uganda	Kenya	Tanzania	Ghana	Nigeria	Zambi
Feb-14	6.8	6.9	6.0	14.0	7.7	7.6
Mar-14	7.1	6.3	6.1	14.5	7.8	7.7
Apr-14	6.7	6.4	6.3	14.7	7.9	7.8
May-14	5.4	7.3				7.8

Exchange Rate Annual % Changes (Local Currency/US$)						
	Uganda	*Kenya*	*Tanzania*	*Ghana*	*Nigeria*	*Zambia*
Feb-14	-7.0	-1.3	1.9	29.7	3.9	6.7
Mar-14	-3.9	0.8	2.5	36.6	3.8	13.3
Apr-14	-1.9	3.0	2.4	43.8	2.5	15.6
May -14	-2.2	3.8	2.7	48.7	N.Av	23.9

Policy Rates (%)						
	Uganda	*Kenya*	*Tanzania*	*Ghana*	*Nigeria*	*Zamb*
Feb-14	11.5	8.5	N.A	18.0	12.0	9.75
Mar-14	11.5	8.5	N.A	18.0	12.0	10.2
Apr-14	11.5	8.5	N.A	18.0	12.0	12.0
May-14	11.5	8.5	N.A	18.0	12.0	12.0

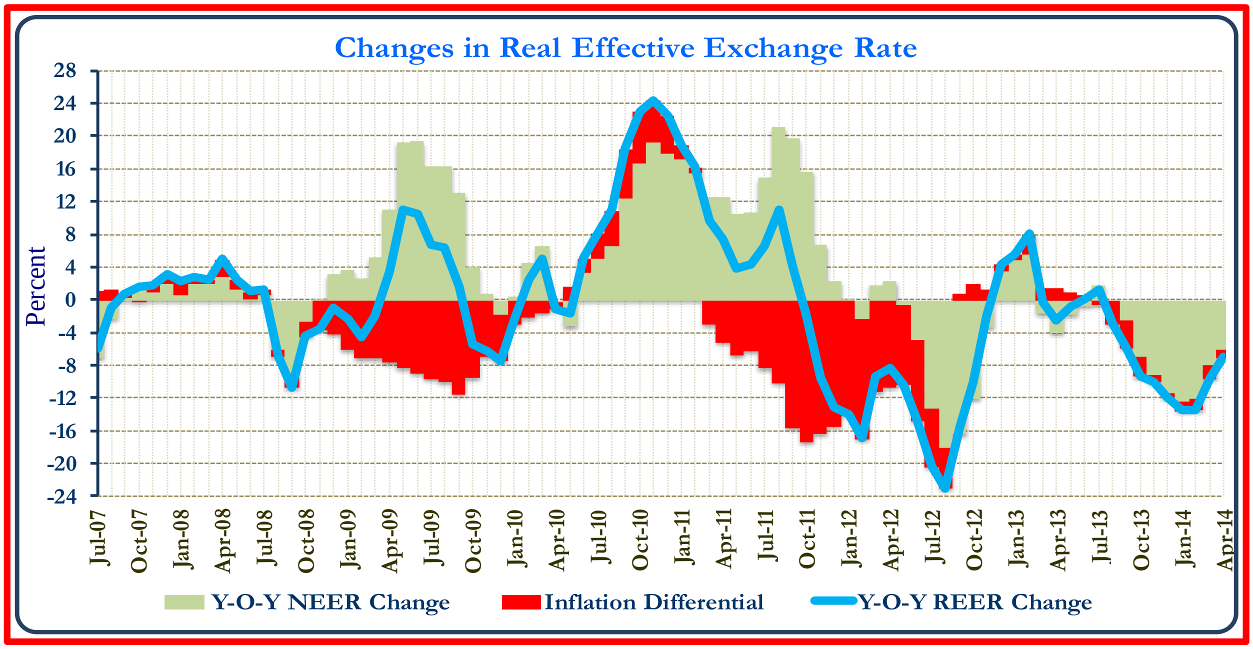
1-Year Investment Rate (%) (364-day Treasury Bill Rates)						
	Uganda	Kenya	Tanzania	Ghana	Nigeria	Zambia
Feb-14	12.5	10.7	13.8	17.0	14.6	15.3
Mar-14	13.0	10.5	13.4	20.9	15.7	15.5
Apr-14	13.0	10.2	13.3	22.5	14.5	16.5
May-14	12.2	10.1	13.2	22.5	12.0	17.7

Source: National Statistics Offices and respective Central Banks

The Uganda Shilling maintained an appreciation trend with effect from July 2013, through February 2014 to Shs. 2471.96 per US$. However, due to market sentiments the shilling experienced depreciation pressures, reaching Shs. 2,534.22 per US$ in March 2014. Bank of Uganda responded by staying purchase of foreign currencies for reserve build-up during the period of heightened volatility and supplying the market with US dollars. However, in April 2014, a rebound of inflows from offshore players especially to the securities market caused the exchange rate to resume appreciating. The recent depreciation, however, in May 2014 is a reflection of changing global risk perceptions rather than a specific re-assessment of Ugandan fundamentals with domestic factors also having an impact on the shilling.

The Nominal Effective Exchange Rate (NEER), which is a trade weighted index depreciated slightly month-on-month, in May 2014 by 0.2 per cent, but continued to appreciate year on year by 5.6 per cent. The Real Effective Exchange Rate (REER) on the other hand appreciated by 0.4 per cent month on month and by 6.8 per cent year on year (**figure 3**).

Figure 3: Nominal and Real Effective Exchange Rate Indices (2005/06 = 100)



Source: Bank of Uganda

2.6.2 Foreign Exchange Reserves

Bank of Uganda continued to carry out purchases of foreign exchange for reserve build-up such that the net BOU purchases as per 2013/14 stood at US$ 667.49 million by May 2014. In terms of the outlook, the exchange rate is likely to remain sensitive to domestic factors including developments in the current account of the balance of payments and perceptions of its sustainability. The shilling is also expected to remain vulnerable to changing global perceptions of US monetary policy and associated capital flows.

Foreign exchange (FX) reserves connect the external sector to the monetary and financial sector of the economy. Although Uganda operates a floating exchange rate regime, strong buffers of international reserves are fundamental in reducing exchange rate volatility, either by strategically intervening in foreign exchange market, or merely by virtue of the availability of foreign currency reserves providing the ability to intervene to dampen volatility. Moreover, based on the currently elevated global economic uncertainties, the widening current account imbalance and the need for Uganda to maintain macroeconomic stability, higher FX reserves becomes paramount although reserve accumulation entails costs-monetary, financial, and fiscal.

The total stock of foreign currency reserves as at June 30, 2013 was US$ 2.9 billion equivalent to 4.6 months of import cover. However, this included US$ 181.4 million from the energy fund and the US$171.8 million BoU purchased from the Uganda Energy Rural Development Fund Account with the proviso that the Bank will reimburse, on request, the stated amount at no loss to the Government of Uganda. The required funds for the commencement of Karuma and Isimba hydropower dams sum to about US$ 400 million in 2014/15. The projected net cash flow for 2013/14 is US$ 178.6million with a reduction of the FX daily purchases to US$3 million from US$4.9 million. Change in the international reserves will be US$197.8 million against the PSI target of US$180 million. Reducing the daily purchases of foreign exchange reserves to US$ 3.0 million implies, lower purchases by US$ 28.5 million. While this may still be within the PSI program target, it leaves a buffer of US$17.8 million in the event that BoU is compelled to intervene in the FX market.

In 2014/15, the just concluded PSI program stipulates a maximum drawdown of US$ 108 million from the international reserves to achieve a reserve cover of 4.0 months of import cover. To achieve this, the minimum daily FX purchases consistent with this would be US$3.5 million. However, this would allow a marginal room for BoU to intervene in the FX market in event of high volatility on the depreciation side. Given the uncertainties in global financial markets, the likelihood of interventions on the sale side is higher. In addition, the government expenditure in the foreign currency could be stronger than we are currently projecting and the market conditions might not allow the daily purchases throughout the year. Therefore, the BoU decided to purchase US$ 4 million on a daily basis. This would result in the international reserves buildup of a maximum US$ 61.8 million.

The FX daily purchase of US$ 4million will result in injection of about Shs.212 billion per month and about Shs.2.5 trillion in the financial year 2014/15. This liquidity must be sterilized and the cost of this would be approximately Shs.305 billion. The available monetary policy instruments are not sufficient to manage this liquidity.

In order to manage the surplus liquidity problems, the policy options include:

a) stopping the purchase of foreign exchange for reserve build-up;
b) suspending some of the government infrastructure projects;
c) increasing the cash reserves requirement and/or
d) issuing of government securities in the primary market for monetary policy purposes.

If BoU was to cancel the daily FX purchases, the FX reserve holding would decline to about US$2500 billion by end of June 2015, equivalent to about 3 months of import cover. The decline in FX reserves would be disadvantageous because adequate reserves boost investors' confidence and enhances Uganda's ability to borrow abroad; attract foreign capital and promote domestic private investment as a result of strengthened external position and reduced vulnerability to external shocks. In addition, adequate reserves make the economy more resilient to crisis situations and volatile capital flows, and help in increasing policy flexibility, for example, if exchange rate was to deviate significantly from its equilibrium. Therefore, the first best policy option is for the BoU to purchase FX for reserve build-up even if it is costly. Purchases of FX for reserve build-up are costly because it requires sterilization of the resulting shilling liquidity. It is also costly because domestic interest rates would remain elevated in the short run, constraining credit extension and private sector investment and consumption at least in the short term.

The BoU should not allow incomplete sterilization because the resulting excess liquidity reduces monetary policy effectiveness. Already, to the extent that accumulation of FX reserves has increased permanent sources of liquidity, the overall interbank money market interest rate has been lower than the CBR. Thus, the role of the CBR as a monetary policy signal has been weakened. The CBR is the level of interest rate compatible with the inflation target. . Therefore FX purchases that causes the interbank money market interest rates to be lower than the CBR violates the medium inflation target consistency. Besides, the BoU has now become a net liquidity borrower and this could result in monetary policy becoming more volatile.

2.7 Economic Activity

According to the World Bank Global Economic Prospects report for June 2014, Uganda's GDP is projected to have grown by 6.5 percent in 2013, second to Tanzania in the EAC, led by recovery in domestic demand **(Table 6)**. However, Uganda Bureau of Statistics (UBOS) projects output growth for Financial Year 2013/14 at 4.7 per cent. The outlook for 2014/15 is positive with growth projected between 5.8 percent and 6.2 per cent supported by scaling up of public investment in infrastructure (particularly roads and energy). Private domestic demand is expected to strengthen. Rising household wealth and improving growth conditions are projected to drive consumer spending. This pickup in demand should, in turn, result in greater business investment.

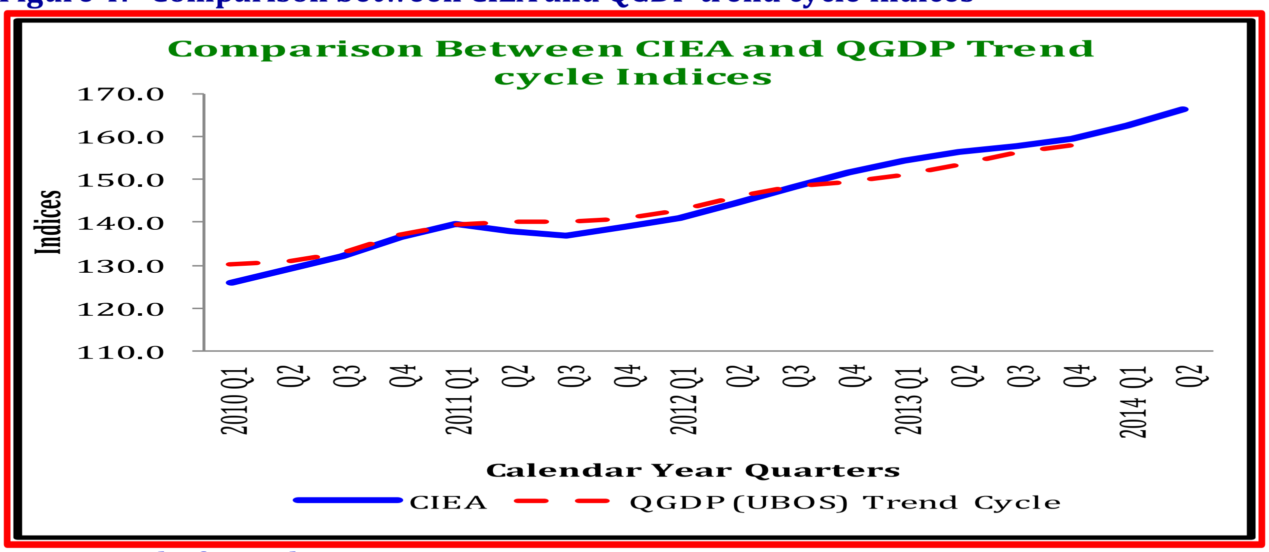
Table 6: Growth comparison between EAC countries and some other SSA countries

	00-09	2010	2011	2012	2013	2014	2015	2016
Burundi	2.9	3.8	4.2	4.0	4.5	4.0	3.7	3.0
Kenya	3.6	5.8	4.4	4.6	4.7	5.0	4.7	4.0
Rwanda	7.2	7.2	8.2	8.0	5.0	7.2	7.4	7.4
Tanzania	6.2	7.0	6.4	6.9	7.0	7.2	7.2	7.1
Uganda	6.9	6.2	5.0	4.7	6.5	7.0	6.8	6.8
Ghana	5.0	8.0	15.0	7.9	7.1	5.0	7.3	7.5
Mozambique	7.1	7.1	7.3	7.4	7.1	8.1	8.6	8.4
Nigeria	5.7	7.8	6.8	6.5	7.0	6.7	6.5	6.1
Zambia	4.8	7.6	6.8	7.2	6.4	7.0	6.8	6.5

Source: World Bank, Global Economic Prospects, June 2014.

Economic Activity as measured by the CIEA grew by 2.3 per cent in the quarter to April 2014 compared to 1.1 per cent growth in the quarter to January 2014 on account of the services and industrial sectors. Agricultural production continued to decline. Business owners in the quarter to May 2014 were positive with a CI of 59.0 points, lower than 60.2 points recorded in the quarter to Feb'14, indicating relative slowdown in economic activity. Business project improvement in activity across all sectors except for the Agricultural sector, on account of increased order volumes and declining future selling price.

Figure 4: Comparison between CIEA and QGDP trend cycle indices



Source: Bank of Uganda

The contribution of next exports to growth is projected to remain modest in 2014 but to improve thereafter as exports expand, buoyed by a strengthening of external demand from high income countries and emerging markets, and import growth slows as investment projects mature. This improvement will not, however, be sufficient to rein in current account deficits, projected to rise to 11.2 percent of GDP in 2014/15.

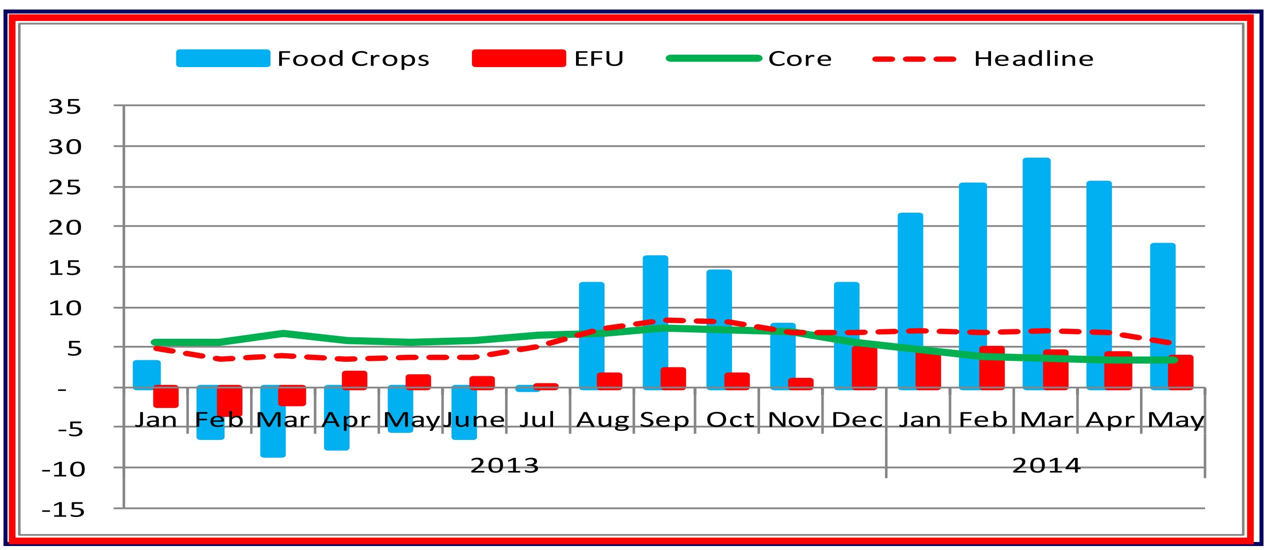
Despite emerging challenges, the medium-term outlook remains positive. Supported by investment in the oil sector, public infrastructure, and agriculture, GDP growth is projected to rise to 6.8 percent in 2015 and 2016. External demand is also expected to be supportive of growth. The strengthening recovery in high-income countries bodes well for export demand and investment flows. The impact of tighter global financing conditions is likely to be limited partly because foreign direct investment, the dominant type of capital inflows for Uganda, tends to be less sensitive to global interest rate hikes than short-term portfolio flows. Still, owing to weaker commodity prices and slower growth in emerging markets, FDI flows are expected to slow. The outlook is sensitive to downside risks from lower commodity prices, tightening global financial conditions, and political instability.

2.8 Consumer Price Inflation

2.8.1 Inflation Developments

Inflation continued to ease at an accelerated rate. Annual core inflation has continued to be subdued, averaging 3.8 per cent between January 2014 and May 2014 **(figure 5)**. This is below the Bank of Uganda's medium term target of 5 per cent. Annual headline inflation was recorded at 5.4 per cent in May 2014 while core inflation was recorded at 3.3 per cent. The continued fall in core inflation is mainly a result of exchange rate appreciation as other goods inflation has averaged 1 per cent over the last 3 months. Services inflation remained stable over the months of April and May 2014 reflecting strong domestic demand.

Figure 5: Annual Inflation Developments



Source: Uganda Bureau of Statistics

Core inflation continues to remain near the lower end of the Policy Support Instrument (PSI) band (5 % ± 2%) but is expected to edge up slightly in the latter part of 2014. The persistence of core inflation being below 5 per cent could pose risks to economic performance because at low inflation rates, adverse economic developments could easily push the economy into deflation. Also, lower inflation translates into a higher real value for the CBR, limiting the capacity of monetary policy to support the economy. On the positive note, the low rate of core inflation seems temporary, driven by the exchange rate appreciation and outright declines in core import prices.

2.8.2 Inflation outlook, Risks and Implications for Monetary Policy

The BoU forecasts that as the effects of the transitory factors subside, core inflation will gradually move towards 5 per cent. However, this effect will gradually fade from the third quarter of 2014 onwards. The inflation forecast shows that headline inflation could decrease further due to the expected good crop harvest, but would increase later due to increases in taxes and the expected weaker shilling, which will affect inflation through higher import prices. At the same time, food price inflation will increase in the fourth quarter in part due to seasonal factors. Given the aforementioned factors, the BOU inflation forecasts are as follows:

- Headline Inflation is forecast to edge-up slightly to 6.5 -7.5 percent in the second half of 2015.
- Core Inflation is expected to increase to 5.5 – 6.5 percent in the second half of 2015.
- In the two year policy horizon, the forecasts show higher inflation, with core inflation rising to a range of 7-8 percent while headline would be 8-9 percent.

The outlook for inflation is subject to several risks emanating from both the external environment and the domestic economy. ***The most important risks to inflation are:***

a) In light of reduced policy and economic uncertainty, there is an upside risk that consumers and businesses could increase spending at a more rapid pace than projected. With a stronger-than-expected demand, inflation could threaten to rise substantially *above* 5 percent. At present, the chances of this happening are slightly higher than the chances of inflation persisting below 5 percent. The increased growth in demand in the near term will require increases in the CBR.

b) Continued underperformance of Ugandan exports. A slower recovery in exports would also translate into slower growth in business investment, particularly investment in machinery and equipment. Together, weaker exports and business investment would pose a downside risk to inflation. But could also cause exchange rate depreciation and therefore inflation.

c) External shocks such as increased political uncertainty in some EMEs, and/or uncertainty surrounding the impact of the normalization of U.S. monetary policy could trigger larger capital outflows and tighter credit conditions. Oil prices could head a bit higher due to civil conflicts in Iraq, Nigeria, Libya, and South Sudan. These shocks could have negative spillover effects on the global economy and would be transmitted to the Ugandan economy through weaker exports, lower commodity prices and a deterioration in the terms of trade.

d) In May 2014, the probability for 2014 becoming an El Niño year was assessed at 65 to 70 percent. The El Niño phenomenon could cause extensive crop damage. Under a strong El Niño scenario, international food commodity prices could climb as much as 15 percent in the coming months, which could alter the trajectory of the current benign inflationary environment.

e) *Fiscal Policy:* Uganda's budget framework over the medium-term is swarmed with infrastructure projects. Government expenditure pressures continue to mount and this will be amplified by the election cycle. Spending on infrastructure has the benefit of boosting aggregate demand, but fiscal expansion will further worsen the external balance – The problem of the twin deficits. The expansionary fiscal stance also poses a challenge on interest rates: as yields on securities have continued to edge up. This may constrain growth in PSC – crowding out the private sector in the domestic credit marker – which may constrain growth. The fiscal outlook is therefore daunted with challenges with profound implications for monetary policy, which calls for a cautious monetary policy stance.

f) *Exchange rate:* The appreciation of the Ugandan shilling over the past year has put some temporary downward pressure on inflation. In an open economy such as Uganda's, exchange rate movements influence business conditions through a number of channels, including foreign and domestic sales, costs, profitability, and investment costs and decisions. Although the immediate pressures from the exchange rate are lower than was the case earlier in the year, the exchange rate remains a significant source of upside risk to the inflation forecast. The respite from the stronger exchange rate could be temporary and respond quickly to changes in both domestic and external conditions. Depreciation pressures emerged in May 2014. The uncertainty regarding the path of the exchange rate remains a major upside risk to inflation in the near term.

3 Conclusion

The central tendency for core inflation 12 months ahead is 5.5 to 6.5 per cent but headline inflation could edge up higher to between 6.5 and 7.5 percent. The projected core inflation is within the PSI program target band of 5 percent +/- 2 percentage points. In the near term, keeping inflation expectations anchored will require firm monetary policy action. At the same time, the risks associated with slow growth remain elevated. With slow productivity growth, disinflation will have costs in terms of growth.

The economy in the second half of 2013/14 seem to have has lost its earlier momentum. Softer external demand and weak credit extension are likely to weigh on activity during 2014. In 2015, GDP growth is projected to rise somewhat, with persistent supply constraints, including a possible tight monetary policy stance in 2015, could hold back domestic demand. In the best possible scenario, real GDP growth for 2014/15 is forecast to be in the range 5.8 percent to 6.2 percent and to between 6.0 to 6.4 percent in 2015/16 on account of public investment in infrastructure, domestic demand and the recovery in global economic activity. This growth is projected to remain below the historical average until 2018/19. With the negative output gap in the range of 1 per cent to 2 per cent expected to persist in the next 2 years, accommodating growth considerations becomes crucial. Therefore, the BoU decided to ease monetary policy by 50 basis points in June 2014 to stimulate economic activity.

The BOU will continue to set a monetary policy stance that will ensure that:

- core inflation is as close as possible to 5 per cent in the medium term;
- economic growth is consistent with the inflation objective;

Going forward, the degree of monetary accommodation may need to be adjusted to ensure that the risks arising from both the global and domestic economy do not undermine outlook of domestic inflation and growth prospects of the Ugandan economy. The BoU will continue to improve its monetary policy formulation and ensure that the monetary policy decision-making process incorporates recent developments in the economy and economic modeling and forecasting.