Bank of Uganda

State of the Economy

March 2014

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EXECUTIVE SUMMARY

World real GDP growth is projected to pick up gradually over the projection horizon, rising from 3.2 percent in 2013 to 4.1 percent in 2016. While growth gained some momentum in advanced economies in the second half of 2013, growth in emerging markets softened, owing to weak domestic demand, limited leeway for further supportive domestic policies and tensions in financial markets. In the short term, global sentiment indicators suggest favourable business conditions, which is consistent with a progressive strengthening in global activity. The global recovery is projected to continue gaining strength gradually. In advanced economies, diminishing private sector deleveraging and less fiscal consolidation should bolster confidence and support domestic demand, although labour markets are expected to improve only slowly. Stronger growth in advanced economies should support frontier and emerging market economies.

The global inflation outlook remains subdued, as global spare capacity remains large. While financial tensions in some emerging market economies occurred recently, overall global financial market conditions have remained broadly stable following the US Fed's decision to start the tapering of asset purchases, in contrast with the turmoil in mid-2013, when the Fed announced the possibility of tapering asset purchases for the first time.The recent episode of financial market volatility had varying impacts on developing countries. Furthermore, the currencies of some large middle-income countries, with sizable current account deficits and external financing needs, came under pressure prompting these countries' central banks to respond by tightening monetary policy.

On the domestic scene, Real GDP growth is projected to remain moderate in 2014, gaining pace from 2015. A gradual recovery in domestic and external demand is expected to be the driving factor behind the projected increase in activity. External demand will benefit from the global recovery gradually gaining strength. Domestic demand is expected to benefit from improving confidence in an environment of declining uncertainty, the very accommodative monetary policy stance and falls in oil prices that should support real disposable incomes.

Domestic demand should also benefit from a less restrictive fiscal policy stance in the coming years and from gradually improving credit supply conditions. At the same time, the adverse impact on the growth outlook, stemming from the need for further adjustment of private sector balance sheets, is expected to diminish gradually over the projection horizon. Compared with the macroeconomic projections in the December 2013 state of the economy, the real GDP growth projection for 2014 indicate slightly lower growth. Real GDP is projected to increase by 5-6 percent in 2014, 6-7 in 2015.

The public expenditure has been expansionary hence stimulant to demand. The current fiscal framework entails significant downsizing of resource but increasing expenditure side, which suggests increased government domestic borrowing. Though a substantial portion of government expenditure is on infrastructure projects, one needs to be mindful that they may not yield immediate growth impulse and financing these projects could suggest persistent high interest rates and therefore derail private sector investment.

The gradual strengthening in demand and an ongoing decline in excess capacity in the context of anchored inflation expectations are expected to lead to an increase in inflation over the projection horizon. Inflation is projected to be in the range of 7-8 percent in 2014 and 6-7 percent in 2015. Core inflation on other hand is projected to be in the range of 5-6 percent in 2014. This moderate core inflation outlook is expected to be mainly due to the declining path of oil price, exchange rate stability with a bias towards an appreciation and the existing slack in the economy.

Given the rising, but still moderate, domestic cost pressures, against the background of the expected gradual recovery in economic activity, core inflation is projected to increase to 6-7 percent in 2015 which is slightly higher than the BoU's medium-term target. However, there are substantial risks around the projected output and inflation path and there is considerable uncertainty regarding the likely evolution of the exchange rate. On the other hand, real economic growth is slightly below potential. As such, maintaining a cautious monetary policy stance is critical to the resilience of the economy against current uncertainties to support growth.

1 GLOBAL ECONOMIC DEVELOPMENTS

1.1 Global growth

Global economic activity registered an upturn in 2014, with economic growth projected at 3.2 per cent relative to 2.4 per cent in 2013 (World Bank, March 2014). The upturn is attributed to economic growth accelerations amongst the advanced economies and to a modest improvement by the emerging economies. Global growth is anticipated to continue on a recovery trajectory both in 2015 and 2016 (***table 1***). While growth gained some momentum in advanced economies in the second half of 2013, growth in emerging markets softened, owing to weak domestic demand, limited leeway for further supportive domestic policies and tensions in financial markets. In the short term, global sentiment indicators suggest favourable business conditions, which is consistent with a progressive strengthening in global activity. Overall, the global recovery is projected to continue gaining strength gradually. In advanced economies, diminishing private sector deleveraging and less fiscal consolidation should bolster confidence and support domestic demand, although labour markets are expected to improve only slowly. Stronger growth in advanced economies should support emerging market economies.

The acceleration in growth of the advanced economies is on account of monetary stimulus being implemented by most advanced economies central banks and a reduction of fiscal and deleveraging drags previously experienced in many of these economies. The US economy is expected to grow by 3.0 per cent in 2014, up from 1.9 per cent in 2013. The euro zone is expected to grow by 1.0 per cent from minus 0.4 per cent in 2013 (Roubini, March 2014). Ample spare capacity in advanced economies would suggest that output can increase without triggering inflation. Nonetheless, the world's major economies still face structural flaws and policy constraints that may hinder investment and productivity growth, making the medium-term outlook for significantly improved global growth less uncertain.

Growth in developing countries is expected to continue to improve from 4.8 per cent in 2013 to 5.3 per cent in 2014, 5.5 per cent in 2015 and to 5.7 per cent in 2016 (***table 1***). However, economic growth in developing countries is projected to be about 2.2 percentage points lower than it was during the pre-crisis boom period. Nonetheless, the slower growth should not be cause for distress, as more than two-thirds of the slowdown reflects a decline in the cyclical component of growth and less than one-third of the reduction is due to slower potential growth.

Despite recent concerns surrounding financial risks and stresses in some emerging economies, growth in emerging economies and developing countries (including Sub-Saharan Africa) is expected to be buoyed by stronger external demand from the advanced economies in 2014. Nonetheless, domestic demand has been weaker than expected in many emerging economies, reflecting in part tighter financial conditions. Overall, significant downside risks remain. Capital outflows, interest rate increases and sharp currency depreciations remain a key concern in many emerging economies. Furthermore, a persistent tightening of financial conditions could undercut investment and growth in some countries particularly given corporate vulnerabilities.

Table 1: World economic growth projections

Country	2012	2013	2014	2015	2016
World	2.5	2.4	3.2	3.4	3.5
Developing countries	4.7	4.8	5.3	5.5	5.7
High income countries	1.5	1.3	2.2	2.4	2.4
Europe and Central Asia	2.6	3.4	3.5	3.7	3.8
High income: OECD	1.4	1.2	2.1	2.2	2.3
Latin America and Caribean	2.6	2.5	2.9	3.2	3.7
Middle East and North Africa	1.5	-0.1	2.8	3.3	3.6
South Asia	4.2	4.6	5.7	6.3	6.7
Sub-saharan Africa	3.5	4.7	5.3	5.4	5.5

Source: World Bank, March 2014

Compared with the macroeconomic projections in the December 2013 state of the economy report, the global growth outlook has been hardly revised. The outlook for euro area foreign demand has been revised downwards for 2014 but remains broadly unchanged for 2015. The revisions for 2014 reflect an adverse carry-over effect from lower than previously projected trade developments in the second half of 2013, which are expected to continue in the short term.

1.2 Global financial markets

While financial tensions in some emerging market economies occurred recently, overall global financial market conditions have remained broadly stable following the US Federal Reserve's decision to start the tapering of asset purchases, in contrast with the turmoil in mid-2013, when the Federal Reserve System announced the possibility of tapering asset purchases for the first time. Global financial markets were relatively calm at the closure of 2013 and throughout the beginning of 2014. However, there was a spike in financial market volatility towards the end of January, following the devaluation of the Argentine peso by 16 per cent and the weak business sentiment data for China and consecutive disappointing employment data for the US. These episodes of market volatility have varying impacts across developing countries.

Many developing country currencies depreciated, which worsened their inflation outlook. The currencies of some large middle-income countries that had large current account deficits and external financing needs also came under pressure. For instance, the Turkish lira and South African rand sustained declines of 6.4 and 4.7 per cent in nominal effective exchange rate terms in January 2014. In response to increased inflationary pressures, tight monetary policies were adopted in these countries.

As projected by the World Bank, net private capital inflows to developing countries are expected to shrink to US$ 1.065 trillion (which is 4.2 per cent of developing country GDP) in 2014, from USD 1.078 trillion (4.6 per cent of developing country GDP) in 2013 (***table 2***). The projected limited capital inflows to developing countries are on account of the expectation of tight monetary policies in advanced economies and to the shrinking growth differential between developing and high-income countries.

Table 2: Net capital flows to developing countries (USD billions)

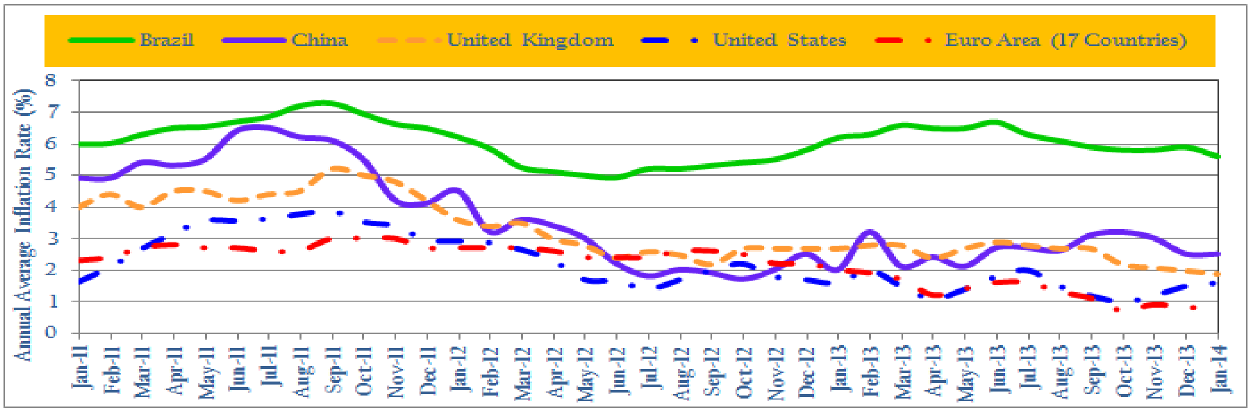
	Outturn				Expected Forecast			
	2009	2010	2011	2012	2013	2014	2015	2016
Current account balance	**167.4**	**112**	**-16.3**	**-93.4**	**-173.5**	**-180.9**	**-178.2**	**-154.6**
Capital inflows	**698.1**	**1,116.10**	**1,109.20**	**1,121.50**	**1,116.80**	**1,088.80**	**1,176.40**	**1,249.70**
Private inflows, net	604.2	1,035.90	1,077.30	1,093.60	1,078.40	1,065.20	1,149.60	1,226.00
Equity inflows net	491.3	634.9	657.4	709.7	681.1	686.2	742.7	794.6
Net FDI inflows	380.3	511.6	654.7	612.2	623.5	610.4	644.7	679.7
Net portifolio equity inflows	110.9	123.4	2.7	97.6	57.6	75.8	98	114.9
Private creditors, net	112.9	401	419.9	383.9	397.3	379	406.9	431.4
Bonds	49.9	115.5	120.6	178.7	176.7	144.8	132.9	132
Banks	16.4	28.1	129.9	95.5	100.9	90.5	117.8	126.1
Other private	-0.8	1.8	-5.7	6.3	3.8	3.3	3.1	5.4
Short-term debt flows	47.4	255.6	175.1	103.4	115.9	140.4	153.1	167.9
Official inflows, net	**93.8**	**80.1**	**32**	**27.9**	**38.4**	**23.6**	**26.8**	**23.7**
WorldBank	18.3	23	7	12.1	10.3	..	..	..
IMF	31.8	13.4	0.5	-13.3	-2.8	..	..	..
Other official	43.8	43.7	24.5	29.2	30.9	..	..	..

Source: World Bank

1.3 Global inflation

Global inflation remains subdued mainly on account of a decline in many key commodity price indices with the exception of energy. In January 2014, inflation in the UK, Euro Zone, China and India registered rates of 2.0 per cent, 0.8 per cent, 2.5 per cent and 6.2 per cent respectively. Inflation in the Euro Zone and in some Advanced Economies remains below central banks' targets thereby posing a risk that long-term inflation expectations might drift downwards, posing the risk of deflation. ***Figure 1*** below shows the trend of inflation in selected countries.

Figure 1: Consumer price inflation developments



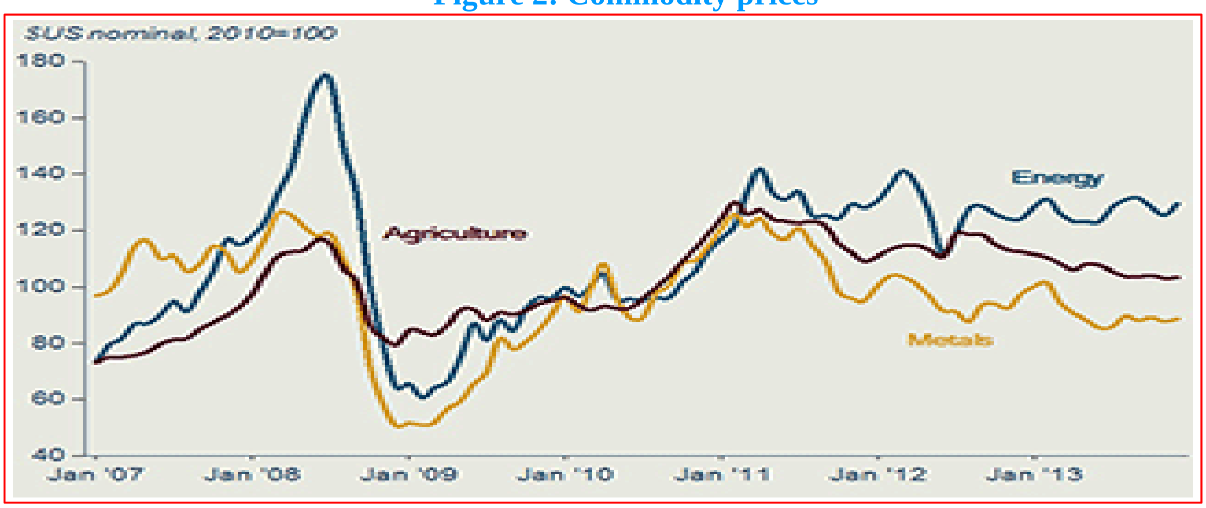
Source: OECD & Euro Stat

The global inflation outlook remains subdued, as global spare capacity remains large. In addition, crude oil prices are projected at US$ 103 per barrel in 2014, which is 1.0 per cent lower than the US$ 104 per barrel registered in 2013. Crude oil prices are expected to remain low and to decline to US$ 100 per barrel in 2015. Agricultural prices are also expected to fall further by 2.5 per cent in 2014 with food and beverage prices declining by 3.7 per cent and 2.0 per cent respectively in 2014.

1.4 International commodity prices

International commodity prices declined in 2013 with the exception of energy (See ***figure 2***). Oil prices are only expected to decline moderately in 2014, whereas agricultural and metal prices are expected to decline further in 2014 by 2.5 and 1.7 respectively.

Figure 2: Commodity prices



Source: World Bank

The main driver for future commodity prices, especially oil, is the pace of economic activity in emerging market economies and geopolitical situations in oil producing and exporting countries. The risk to metal prices will depend on the new supplies availability and on China's economic growth prospects. Uganda, being a net oil importer, faces dire consequences of increases in the international oil prices as changes in the international oil prices are directly passed-on to higher domestic pump prices and indirectly to production costs, and subsequently to domestic inflation.

1.5 Outlook and impact on Ugandan economy

The global inflation outlook remains subdued, as global spare capacity remains large. The recent episode of financial market volatility has varying impacts on developing countries. Furthermore, the currencies of some large middle-income countries, with sizable current account deficits and external financing needs, came under pressure prompting these countries' central banks to respond by tightening monetary policy.

The continued scaling back of monetary stimulus in advanced may maintain some calmness in global financial markets. However, some financial market volatility is expected in developing countries, including Uganda with implications for exchange rate stability. Nonetheless, domestically, inflationary pressures arising from global developments are expected to be subdued.

2 DOMESTIC ECONOMIC DEVELOPMENTS

2.1 MONETARY POLICY

2.1.1 Interbank money markets

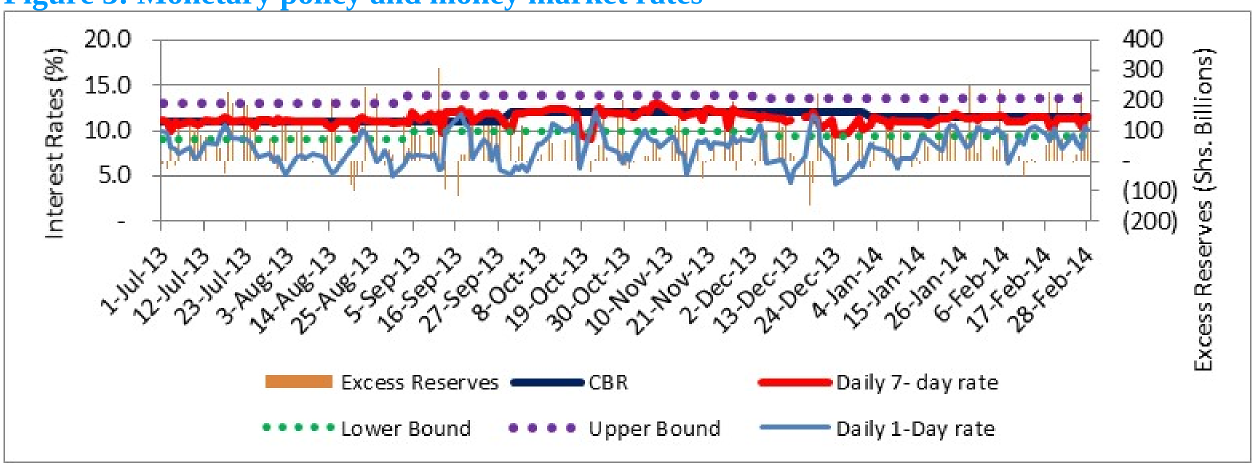
In February 2014, inflation was forecast to remain within the target range, although it is likely to increase above the target over the next 12-months. However, substantial risks to the projected inflation and considerable uncertainty regarding the exchange rate warranted a cautious monetary policy stance. GDP growth for 2013/14 is projected at 6.0-6.5 per cent, supported predominantly by increased fiscal stimulus, as private sector credit (PSC) may remain a constraint. There is also a risk of an adverse demand shock if the conflict in South Sudan persists. It is against this background that the Bank of Uganda kept the Central Bank Rate (CBR) unchanged at 11.5 per cent.

The Bank of Uganda issued REPOs and sold government securities in the primary market to ensure stable liquidity conditions to enable monetary policy efficiency over the month. In February 2014, a total of UGX 39.2 billion worth of government securities were sold, of which UGX 24.7 were Bonds and UGX 14.5 billion were Bills. So far, 265.2 billion of government securities that had been provided for recapitalization have already been sold this financial year, leaving a balance of UGX 145 billion.

The stock of T-bills currently held to issue for REPOs is UGX 800 billion. So far, as at end February 2014, the volume of outstanding REPOs was UGX 666 billion. Given the current levels of structural liquidity in the domestic money market, this stock of REPOs are insufficient to stabilize the domestic market. . Therefore, additional long-term securities would be required to manage structural liquidity over the coming months. Notwithstanding the structural liquidity surplus, the 7-day interbank money market rate trended close to the CBR throughout the month, largely on account of BoU's fine-tuning actions (see ***figure 3***).

There was an increase in the interest rate spreads in February 2014 relative to January 2014. Yields on Government securities increased largely as a result of the increase in domestic financing of fiscal deficits.

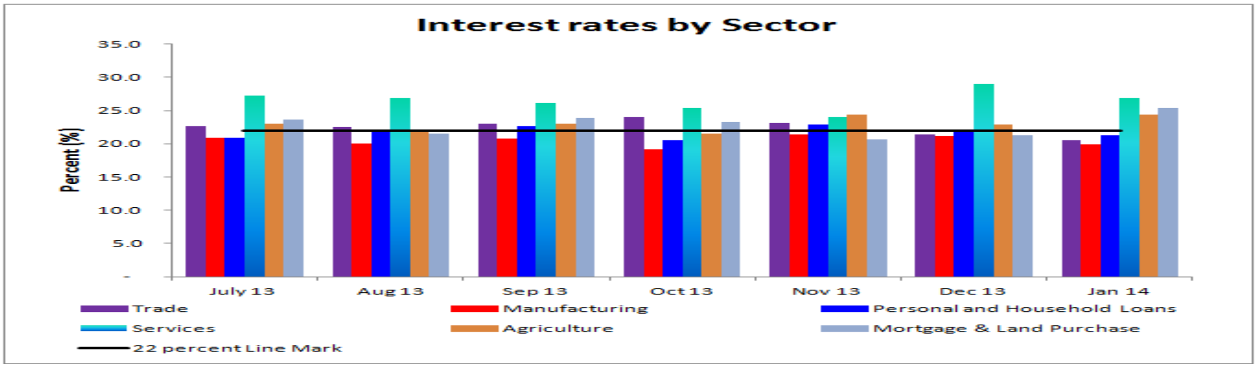
Figure 3: Monetary policy and money market rates



Source: Bank of Uganda

Largely, interest rates have declined in line with the decline in the central bank rate. However, lending rates on shilling-denominated loans have continued to be sticky and largely insensitive to the expansionary monetary policy, stabilizing at about 22 per cent since September 2013. The high lending rates and the wide interest rate spread is attributed to structural factors, such as high costs of doing business, heightened risk aversion and difficulties in assessing credit worthiness. A disaggregation of lending rates by sector shows that lending rates have declined for Trade and commerce, manufacturing and personal & household loans. Interest rates for loans to the services sector, particularly to small businesses (SMEs) however remain high and averaged 27 per cent in January 2014 (***figure 4***).

Figure 4: Commercial banks interest rates by sector



Source: Bank of Uganda

Interest rates comparison in the EAC countries in Figures 5a and 5b indicate convergence of short term interest rates but Uganda's lending rates remain outliers in comparison to those prevailing in other EAC countries, suggesting some unique structural features in Uganda's banking system.

Figure 5a: Interest rates comparison in EAC countries

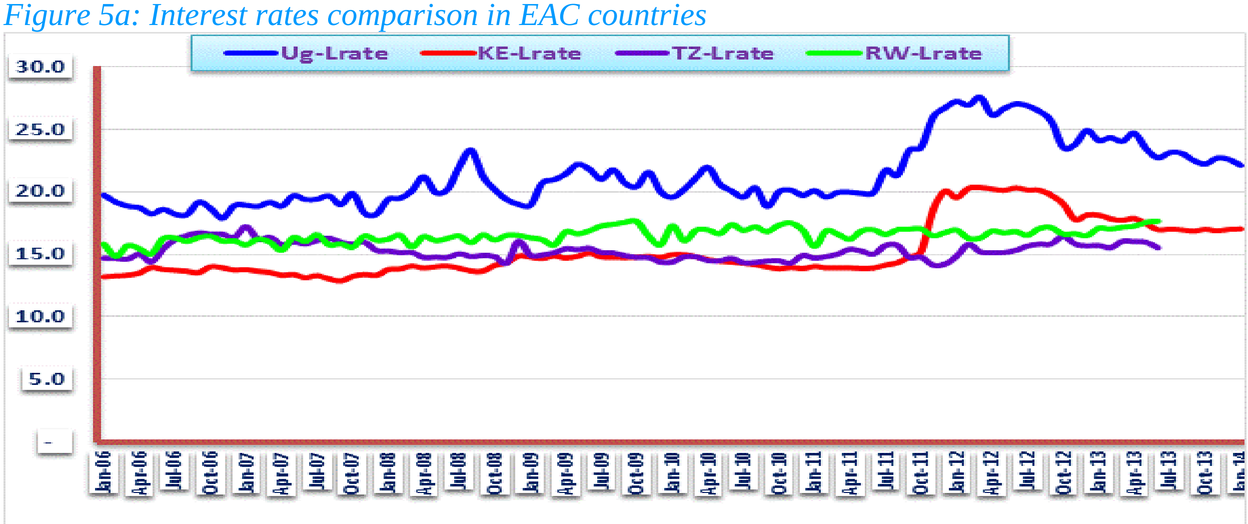
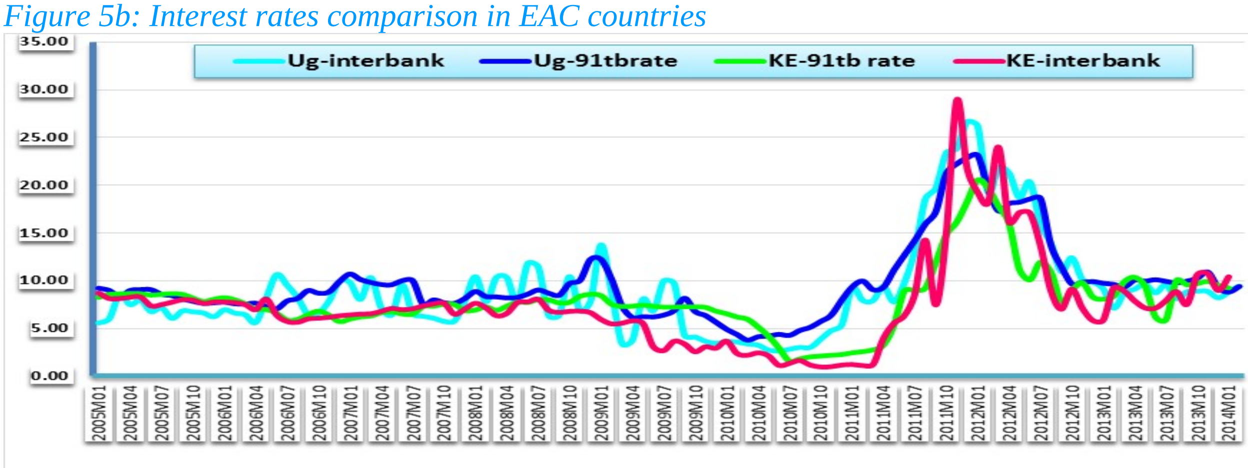


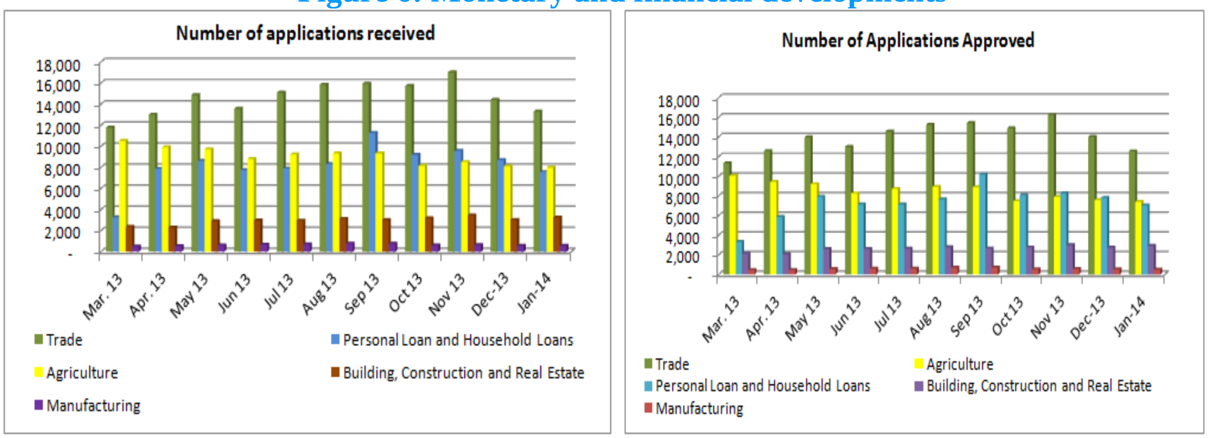
Figure 5b: Interest rates comparison in EAC countries



2.1.2 Private sector credit

Credit demand and supply has continued to increase since the second quarter of 2013. However, the number of loan applications (a proxy for credit demand) continues to outstrip loan approvals (proxy for credit supply) (see ***figure 6***). In January 2014, net loan recoveries amounted to UGX 50.4 billion, compared to a net loan extension of UGX 50.2 billion in December 2013. Whereas the net loan extensions in January 2014 amounted to shillings 60.2 billion compared to shillings 47.1 billion recovered in December 2013.

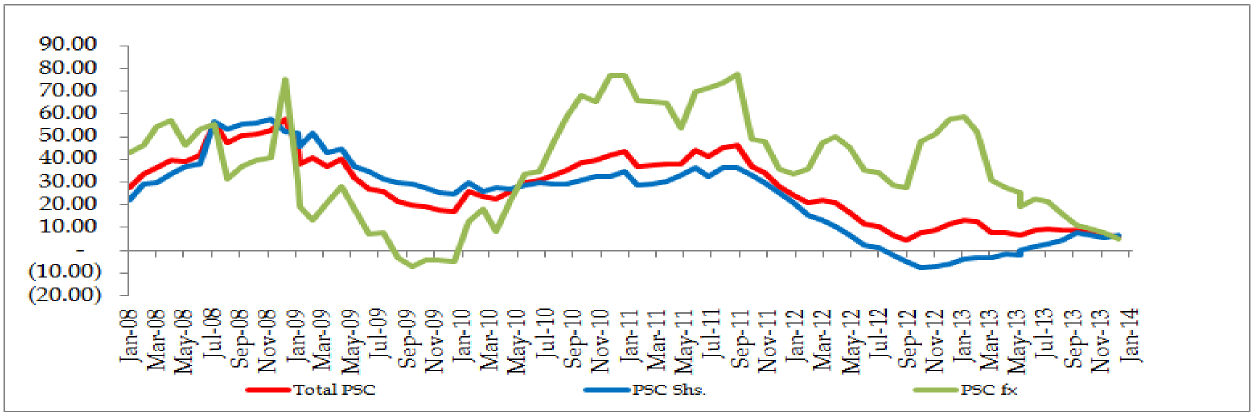
Figure 6: Monetary and financial developments



Source: Bank of Uganda

Growth in the stock of private sector credit (PSC) remains subdued, growing by 6.0 per cent year-on-year in January 2014 compared to the 6.4 per cent growth registered in December 2013. PSC growth remains below the 2013/14 projection of 15.3 per cent. Nonetheless, growth in commercial banks' shilling-denominated credit to the private sector has rebounded, since July 2013, indicating that bank lending is gaining momentum. On a monthly basis, shilling denominated lending increased by 1.2 per cent in January 2014 compared to a decrease of 0.7 per cent in December 2013, whilst foreign currency denominated lending decreased by 3.3 per cent in January 2014 compared to an increase of 2.9 per cent in December 2014. ***Figure 7*** shows PSC growth by currency.

Figure 7: Annual private sector credit growth rates by currency



Source: Bank of Uganda

The high lending interest rates couple with unfavorable financial conditions of borrowers has caused the quality of commercial banks assets to deteriorate. The ratios of non-performing loan (NPL) ratios have increased across all major business sectors. The trade and commerce sector had the highest NPL of 11 per cent at end December 2013 followed by agriculture sector with 8.5 per cent. PSC growth to sectors with high NPL ratios has been predictably dismal, and in some cases negative. The contribution of trade and commerce to PSC growth has been negative throughout the last four months. The contribution of building and construction has also been negative, as is that for mining and quarrying. It is highly likely that the subdued PSC can in part be attributed to heightened risk aversion, as shown by the high NPLs. ***Table 3*** shows NPL ratios for major sectors and sectoral contributions to private sector credit growth.

Table 3: Annual private sector credit growth rates by currency

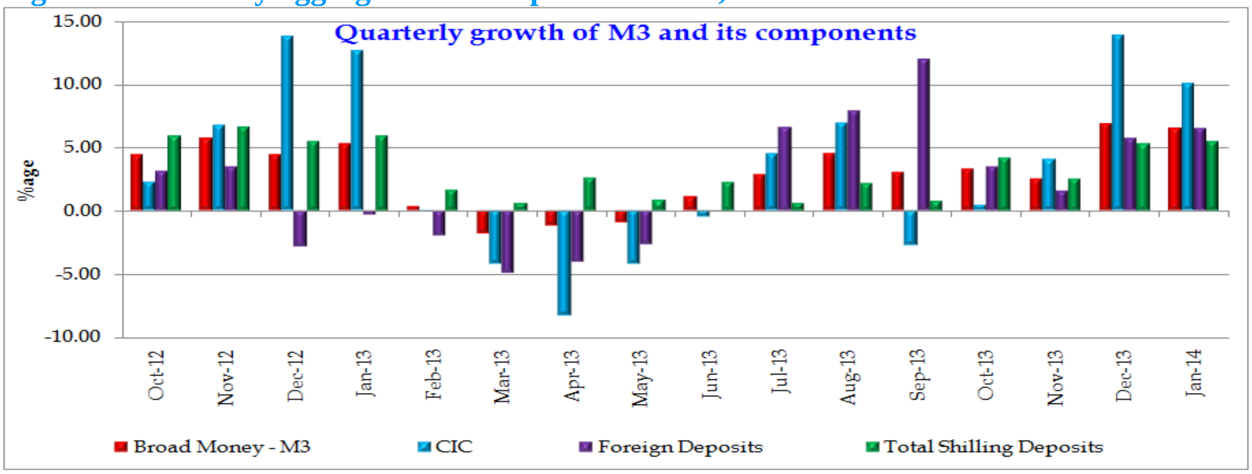
Sector	NPL ratio for major sectors (Percent)			Sectoral contribution to total growth in PSC						
	Dec-14	Dec-14	Dec-14	Jul-14	Aug-14	Sep-14	Oct-14	Nov-14	Dec-14	Jan-14
Agriculture	3.0	3.6	8.5	22.0	2.8	2.3	2.7	2.8	1.4	1.4
Mining	18.9	11.4	7.5	-0.1	0.1	-0.1	-0.1	0.0	-0.2	-0.1
Manufacturing	0.6	1.4	3.4	1.7	1.0	0.3	1.7	1.0	0.8	0.9
Trade & commerce	2.2	7.3	11.0	-0.2	2.5	0.9	-1.1	-1.6	-1.5	-1.2
Building & construction	1.9	3.6	7.0	1.8	0.4	1.1	-1.0	-2.8	-3.0	-0.3
House holds & Personal Loans	1.6	2.8	2.2	0.1	0.9	3.0	5.2	4.9	5.0	7.4
Overall NPL ratio	**2.2**	**4.2**	**6.0**							

Source: Bank of Uganda

2.1.3 Monetary aggregates

Growth in broad monetary aggregates continues to recover, driven mainly by increased investment in government securities by commercial banks. Net domestic assets (NDA) were the biggest drivers to annual growth of monetary aggregates in January 2014 followed by net claims to government (NCG) and private sector credit (PSC). NDA, NCG and PSC grew by 27.4 per cent, 10.14 per cent and 9.18 per cent on a year on year basis compared to the respective growth of 21.3 per cent, 6.4 per cent and 14.3 per cent in December 2013. In January 2014, the annual growth in M3 reached 11.8 per cent, higher than the December 2013 annual growth rate of 9.5 per cent. Developments in broad money versus the banking system's NFA and NDA are shown in ***figure 8.***

Figure 8: Monetary aggregates: developments in M3, NFA and NDA



Source: Bank of Uganda

3 REAL ECONOMIC ACTIVITY

3.1 Growth in real economic activity

The underlying growth momentum is projected to remain moderate during the course of 2014, before increasing somewhat thereafter. The main factors behind the pick-up in activity over the projection horizon are expected to be a gradual recovery in domestic demand on the back of improving confidence in an environment of declining uncertainty, the very accommodative monetary policy stance and lower oil prices (supporting real disposable incomes). Domestic demand is also expected to benefit from a less restrictive fiscal policy stance in the coming years and from gradually improving credit supply conditions. In addition, overall activity will be increasingly supported over the projection horizon by the favourable impact of a gradual strengthening of external demand on exports, albeit initially partly mitigated by the impact of the past appreciation of the effective exchange rate of the shilling. The adverse impact on the growth outlook, stemming from the need for further adjustment of private and public sector balance sheets, from high unemployment and from the still somewhat elevated uncertainty, is expected to diminish gradually over the projection horizon.

Overall, the recovery is projected to remain subdued by historical standards and real GDP is expected to exceed its historical level (the average for the period 1993-2011) only from the end of 2016 onwards. In annual average terms, real GDP is expected to increase by 5-6 percent in 2014 and 6-7 percent in 2015. This growth pattern reflects a steadily rising contribution from domestic demand combined with a small positive contribution from net exports. As growth is expected to exceed potential, the amount of slack gradually declines over the horizon.

Looking at the components of growth in more detail, exports are projected to gain momentum in the course of 2014 and 2015, reflecting the strengthening of foreign demand and the gradual fading away of the adverse impact of the past appreciation of the shilling.

Business investment is projected to pick up gradually, albeit at too moderate a pace to return to pre-2012 levels. A number of factors are expected to support business investment: the projected gradual strengthening in domestic and external demand, the declining level of interest rates, reduced uncertainty, the need to modernise the capital stock after some years of subdued investment, the disappearance of adverse credit supply effects and some strengthening of profit mark-ups as activity recovers. However, the combined adverse impact of ample spare capacity, the need for further corporate balance sheet restructuring, adverse financing conditions in some sectors like trade and real estates, and still relatively high level of uncertainty is assessed to fade only gradually over the projection horizon.

Private consumption is expected to gain some momentum in the course of 2014 and beyond, as real income as inflation remains subdued, a slower pace of fiscal consolidation and low inflation developments, moderated only partially by a slight rise in the saving ratio. Government consumption is projected to increase moderately over the projection horizon.

Economic activity, measured by the CIEA grew by 0.8 per cent during the quarter to January 2014, down from 1.2 per cent during the previous quarter and 0.2 percentage points lower than that experienced in the quarter to October 2013. The growth in economic activity over the three months to January was mainly driven by services and manufacturing sectors, which grew by 0.4 per cent and 0.1 per cent, respectively. The growth momentum in the near-term is expected to be driven by a gradual increase in foreign demand, and domestic private consumption on account of robust household credit extension, public investments and strong FDI inflows, especially in the oil sector. Both the Current Economic Conditions Index (CECI) and the Consumer Expectations Index (CEI) improved, but remained within pessimistic territory in the three months to February 2014.

The planned public investment is expected to boost economic growth in the medium to long term due to expected higher multiplier effect. However, the macroeconomic impact of both domestic and external financing the resultant fiscal deficit could crowd out private sector investment and economic growth. Meanwhile, the expected recovery in the economic activity in Europe, a destination of about 20 percent of Uganda's exports, should have a positive impact on the external demand.

3.2 Fiscal operations

The government operations in the first seven months of 2013/14 resulted in a net borrowing of UGX 1,465.9 billion on account of increased domestic financing (***table 4***).

Table 4: Fiscal operations (UGX billions)

	Approved Budget 2012/13	Cumm. Jul'12– Jan '13	% of Approved Budget	Approved Budget 2013/14	Prel. Cumm. Jul'13 – Jan '14	% of Approved Budget
Revenue	8,698.5	4,902.5	56.4	9,670.3	5,229.2	54.1
Taxes	7,455.8	3,997.0	53.6	8,760.6	4,529.7	51.7
Social contributions	-	-	-	-	-	-
Grants	1,242.8	768.7	61.9	909.7	624.3	68.6
Other revenue		136.9	-		75.2	
Total Outlay	10,926.5	5,605.7	51.3	13,064.8	6,695.1	51.2
o/w Current Expenditures	5,606.9	3,060.7	54.6	6,438.0	3,783.1	58.8
Interest payments	840.4	523.0	62.2	975.0	567.5	58.2
Development Expenditures	5,296.3	2,544.9	48.1	6,626.8	2,900.6	43.8
Net lending / borrowing	(2,228.0)	(703.1)	31.6	(3,394.6)	(1,465.9)	43.2
Financing	2,228.0	703.1	31.6	3,394.6	1,465.9	43.2
Net Domestic Financing	978.8	(31.5)	-	1,792.3	942.2	52.6
Net External Financing	1,249.1	517.6	41.4	1,602.2	520.0	32.5
Errors and omissions	-	252.6		-	(8.4)	

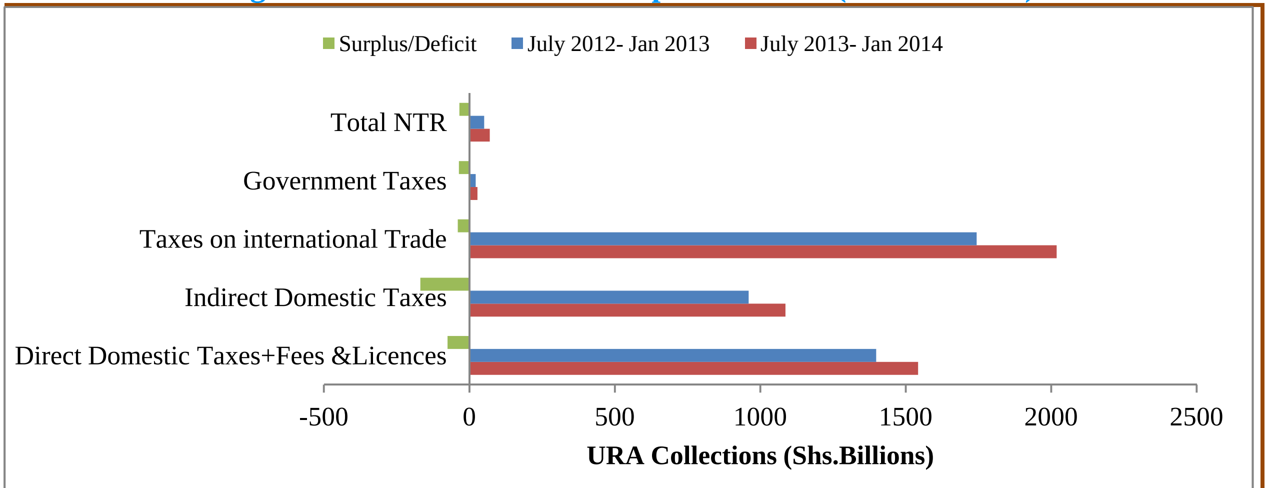
Source: Ministry of Finance, Planning & Economic Development (MoFPED)

3.2.1 Revenue performance

Government revenue as a proportion of the approved budget, underperformed over the financial year to date when compared to the previous financial year. Tax revenue receipts have been the main drag on overall government revenue.

Tax revenue collections over the first seven months of 2013/14 was UGX 289.7 billion, which was below target with all tax categories registering shortfalls against targets. Indirect taxes recorded the biggest shortfall (58.2 per cent) followed by direct domestic taxes. The underperformance in indirect tax collections was mainly in the VAT and local excise duty categories, which reflects a combination of factors, including sustained low domestic demand for goods and services, a stronger shilling and less than projected imports[1]. The underperformance in direct tax collections was mainly on account of an underperformance in corporate taxes, which among other factors was attributed to increased capital deductions due to capital investments by some of the top tax paying companies. ***Figure 9*** presents government revenue performance for July 2013–January 2014.

Figure 9: Government revenue performance (UGX billions)



Source: Ministry of Finance, Planning and Economic Development

3.2.2 Expenditure performance and financing

[1] Ministry of Finance Tax Policy Department Domestic Revenue Performance Report

Total government expenditure as a percent of the approved budget rose above that of the corresponding period of 2012/13. Furthermore, compared to 2012/13, recurrent expenditure so far, makes up a greater proportion of the budget execution, while interest payments and development expenditure accounted for a lower proportion of the budget execution. The fiscal deficit for July 2013–January 2014 was mainly financed through domestic borrowing.

3.2.3 Domestic debt stock

The stock of public domestic debt (at cost value) grew to UGX 6,799.8 billion at end January 2014, reflecting a net debt issuance of UGX 716.8 billion between June 2013 and January 2014. The outstanding stock of government securities remains concentrated in treasury bonds, in line with the government's refinancing risk mitigating strategy to maintain a higher percentage of longer dated securities, with the ratio of treasury bonds to treasury bills growing marginally from 62:38 to 63:37 between June 2013 and January 2014.

Overall, the near term fiscal framework might need substantive readjustment. The current fiscal framework entails significant downsizing of resource but increasing expenditure side, which suggests increased government domestic borrowing. Though a substantial portion of government expenditure is on infrastructure projects, one needs to be mindful that they may not yield immediate growth impulse and financing these projects could suggest persistent high interest rates and therefore derail private sector investment.

4 BALANCE OF PAYMENTS AND EXCHANGE RATES

4.1 Balance of payments

Uganda's current account improved by US$ 122.5 million to a deficit of US$ 402.1 million over the three months to January 2014, from a deficit of US$ 524.6 million recorded over the three months to October 2013. The improvement is mainly attributable to higher current transfers, which increased by US$ 103.7 million to US$ 402.4 million. However, the services deficit declined to US$ 95.2 million, while the trade balance worsened to US$ 574.8 million during the three months to January 2014.

Export receipts increased by 3.9 per cent during the three months to January 2014, from US$ 673.9 million recorded during the three months to October 2013 to US$ 700.4 million, mainly on account of higher coffee export receipts, which increased by 8.8 per cent. In addition, non-coffee export receipts increased by 3.5 per cent due to increased earnings from tea, flowers and cotton.

When compared to the three months to January 2013, total exports declined by US$ 27.9 million (3.8 per cent).

Coffee exports amounted to US$ 91.1 million during the three months to January 2014, which is an increase of US$ 7.4 million compared to the US$ 83.7 million received in the preceding three months. The increase in receipts from coffee exports was entirely due to higher export volumes as the average unit price of coffee decreased during the three months. Coffee exports totalled 913,563 bags (approximately 15,228kg) over the three months to January 2014, an increase of 160,372 bags (approximately 2,673kg) when compared to the 753,191 bags (approximately 12,553kg) exported in the preceding period. The increase in coffee export volume was due to good harvests from the second coffee season despite the increase in exports, import bills increased more than the increase in export earnings, leading to a wider trade deficit. In the three months to January, imports bill increased by 2.8 per cent to US$ 1,275.2 million from US$ 1,240.7 million in the previous period, mainly on account of higher private sector imports. Private sector imports increased by 3.6 per cent to US$ 1,150.0 million during the three months to January 2014, from US$ 1,109.6 million in the previous three months. A large proportion of private sector imports - 68.4 percent of total private sector imports were for investment. Imports for consumption purposes nonetheless were estimated to have increased by US$ 40.1 million in the three months to January 2014.

Government imports decreased by 3.6 per cent to US$ 112.0 million over the three months to January 2014, from US$ 116.2 million in the previous period largely due to lower expenditure on project imports.

In terms of the direction of trade, COMESA remained the main destination for formal exports, although its share of total exports declined to 56.2 per cent during the three months to January 2014, from 62.1 per cent over the previous three-month period. Within COMESA, the major destinations for formal exports were Kenya, The Democratic Republic of Congo, Rwanda and South Sudan, which accounted for 81.4 per cent of total exports to COMESA. The share of exports to the EU increased to 20.6 per cent in the three-month period to January 2014, from 18.3 per cent in the previous quarter.

The services account deficit improved by US$ 26.8 million (or 22.0 per cent) to US$ 95.2 million during the three months to January 2014, compared to a deficit of US$ 122.0 million recorded during the period ending October 2013, mainly due to increased receipts from travel, transportation and other business services.

The income account recorded an unchanged deficit of US$ 134.5 million between the three months to October 2013 and to January 2014, despite an increase in direct investment income expenditure. Direct investment income related payments increased by 16.4 per cent to US$ 77.0 million during the three-month period, from US$ 60.7 million.

Net current transfers increased by US$ 103.7 million to US$ 402.4 million during the three months to January 2014, from US$ 298.7 million in the previous three months period, on account of both higher official and private transfers. Total official transfers (including HIPC relief) to government amounted to US$ 83.0 million, an increase of US$ 32.2 million from the US$ 50.7 million that was received in the preceding three months. Project aid grants, the largest category within official transfers, increased by US$ 32.7 million during the period to US$ 56.3 million. Net private transfers also increased by US$ 94.9 million to total US$ 387.6 million over the three months to January, compared to US$ 292.6 million received over the three months to October 2013, largely due to higher workers' remittance inflows, which totalled US$ 310.74 million over the three months to January 2014.

In the three months to January 2014, the capital and financial account recorded a surplus of US$ 638.3 million, an increase of US$ 117.0 million from the US$ 521.3 million surplus recorded in the previous three-months. The surplus was mainly driven by higher direct investment inflows and capital transfers. In addition, net inflows of 'other' investments increased to US$ 272.3 million during the quarter owing to higher project support loans disbursements and a drawdown in financial corporations' deposit assets. Portfolio inflows however decreased to US$ 44.7 million, from a net inflow of US$ 76.4 million in the previous three months to October 2013, mainly on account of lower net foreign investment in government securities.

Capital transfers increased by US$ 31.3 million to US$ 57.9 million during the three months to January 2014. However, financial derivatives remained small and insignificant.

The developments in the current and capital and financial account resulted in an overall balance of payments surplus of US$ 263.1 million in the three months to January 2014, which in turn led to a net build-up in reserve assets of equivalent to US$ 266.3 million, excluding valuation changes.

The stock of reserves at the end of January 2014 amounted to US$ 3,225.8 million (including valuation changes), equivalent to 4.3 months of future imports of goods and services cover. ***Table 5*** presents major accounts of the Ugandan balance of payments.

Table 5: Balance of payments summary (US$ millions)

	Quarter (Nov 12 - Jan 13)	Quarter (Aug - Oct 2013)	Nov-13	Dec-13	Jan-14	Quarter (Nov 13 - Jan 14)
A. Current Account Balance (A1+A2+A3+A4)	**-215.92**	**-524.59**	**-167.58**	**-76.17**	**-158.38**	**-402.13**
A1. Goods Account (Trade Balance)	**-537.57**	**-566.84**	**-183.25**	**-203.20**	**-188.34**	**-574.80**
a) Total Exports (fob)	728.33	673.89	225.97	216.31	258.13	700.41
i) General merchandise	694.36	639.99	214.10	202.14	244.81	661.06
Coffee	101.57	83.67	26.71	25.46	38.88	91.05
b) Total Imports (fob)	-1,265.90	-1,240.73	-409.22	-419.52	-446.47	-1,275.20
Government Imports	-165.67	-116.17	-37.00	-45.04	-29.99	-112.04
Private Sector Imports	-1,085.73	-1,109.60	-368.42	-370.23	-411.31	-1,149.97
Services and Income	**-221.02**	**-256.44**	**-89.09**	**-60.73**	**-79.92**	**-229.74**
A2. Services Account (services net)	-65.09	-122.02	-61.65	-23.05	-10.53	-95.23
A3. Income Account (Income net)	-155.92	-134.42	-27.44	-37.68	-69.39	-134.51
A4. Current Transfers (net)	**542.67**	**298.69**	**104.77**	**187.76**	**109.87**	**402.40**
B. Capital & Financial Account Balance (B1+B2)	**396.11**	**521.27**	**168.45**	**95.96**	**373.91**	**638.32**
B1. Capital Account	8.98	26.61	15.75	31.83	10.30	57.88
B2. Financial Account; excl. financing items	387.14	494.66	152.70	64.13	363.61	580.44
a) Direct Investment	224.87	251.03	111.06	11.06	140.71	262.84
b) Portfolio Investment	25.46	76.40	17.85	-17.69	44.57	44.73
c) Financial derivatives, net	-0.86	0.27	0.35	-1.36	1.61	0.61
d) Other Investment	137.67	166.95	23.44	72.11	176.72	272.27
C. Errors and Omissions	**-59.98**	**-14.24**	**55.91**	**51.22**	**-80.25**	**26.88**
D. Overall balance (A+B+C)	**120.22**	**-17.55**	**56.79**	**71.01**	**135.28**	**263.07**
a) Reserve assets	**-119.27**	**19.82**	**-57.32**	**-71.78**	**-137.25**	**-266.35**

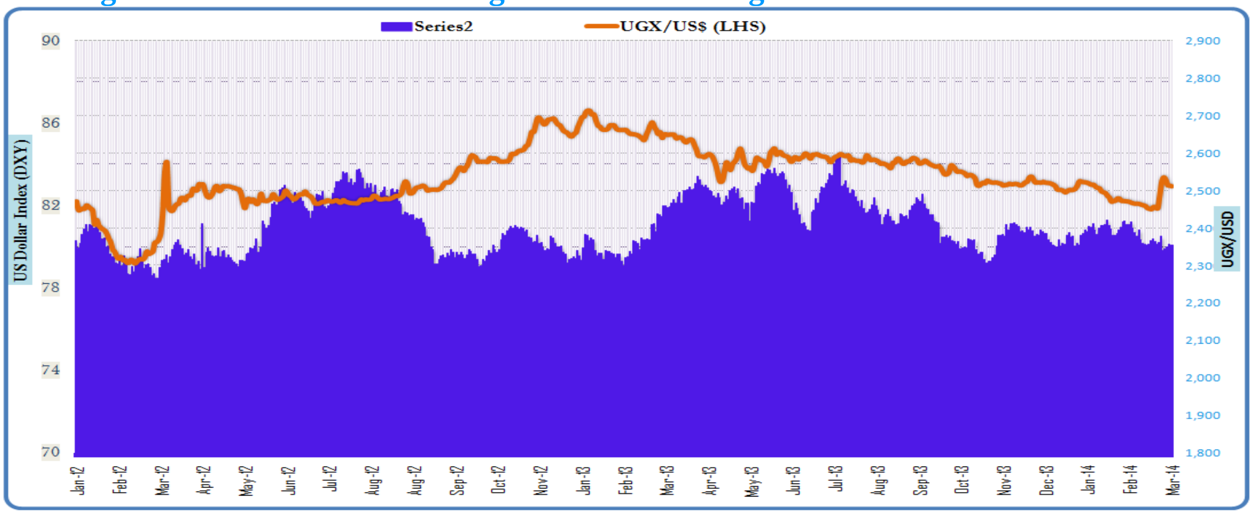
Source: Bank of Uganda

4.2 Exchange rates

Following an extended period of appreciation, depreciation pressures emerged at the end of February 2014. The shilling depreciated by 2.5 per cent in the last three days of the month, with the unit closing at UGX /US$ 2,538.07. The depreciation pressures prompted the Bank of Uganda to intervene on the sale side to the tune of US$ 47.4 million. The depreciation was triggered by market sentiments following the announcement of aid cuts on account of the enactment of the Anti-gay Law. Notwithstanding the end of month depreciation pressures, the average exchange rate for February 2014 was UGX/US$ 2,471.96, which represented an appreciation of 1.1 per cent on a monthly basis or 7.0 per cent annually. ***Figure 10*** shows the trend of the UGX/USD exchange rate and the US dollar Index.

Recent estimates show that the shilling remains overvalued by between 2.5 and 6 per cent. Given the fragile nature of the current account, expected aid cuts and less expansionary monetary policy in advanced economies, there is a high degree of uncertainty regarding the path of the exchange rate. Exports are likely to remain weak while import demand could pick up leading to increased trade deficit. A widening trade deficit would trigger shilling depreciation, which would represent a correction of the exchange rate from its currently overvalued level. The correction would be necessary because it would lower demand for imports and, by releasing resources from industry serving the domestic market may in an indirect way lead to increased exports, which in turn would lead to an improvement in the trade balance.

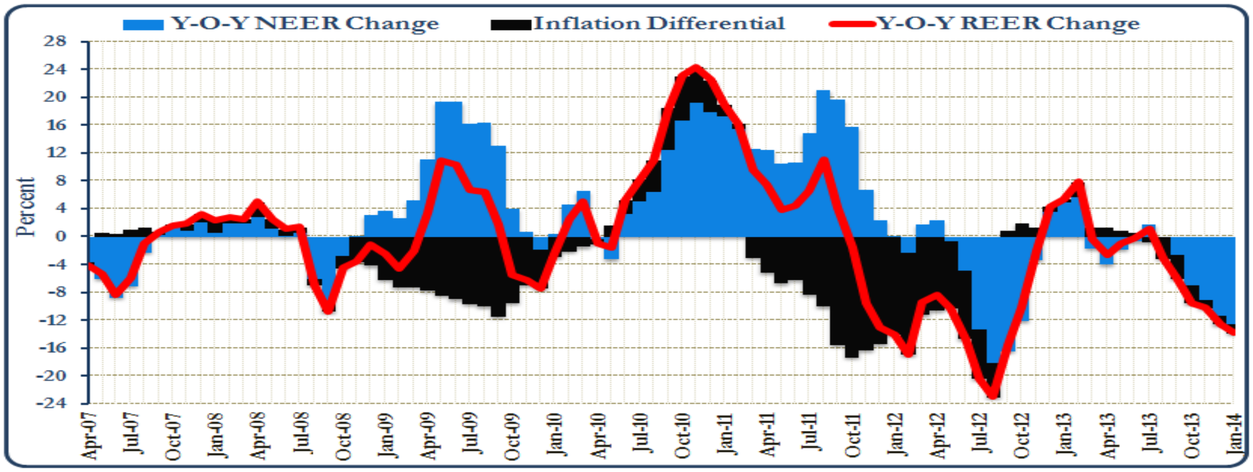
Figure 10: Trend of the Shilling/US dollar exchange rate and the US dollar index



Source: Bank of Uganda

In February 2014, the Nominal Effective Exchange Rate (NEER) appreciated by 1.2 per cent over the month and by 11.8 per cent year-on-year. In January 2014, the Real Effective Exchange Rate (REER) appreciated by 0.6 per cent on a monthly basis and by 13.9 per cent on an annual basis, compared to an annual depreciation of 5.4 per cent in January 2013. Overall, there has been a real appreciation trend since the first quarter of 2013. The REER appreciation was mainly driven by the nominal appreciation of the shilling. ***Figure 11*** shows the trend of the NEER and REER.

Figure 11: Factors driving the change in the REER



Source: Bank of Uganda

5 DOMESTIC INFLATION

The overall CPI inflation averaged 6.8 percent in the three months to February 2014, a decline of 0.9 percentage points from an average of 7.7 percent in the three months to November 2013. Core inflation declined to an average of 4.7 percent in the three months to February compared 7.2 percent in the three months to November 2013, while non-food inflation declined from an average of 6.7 percent to 5.3 percent in the same period. Food crop inflation on the other hand increased from an average of 12.7 percent to 19.7 percent in the same period. The subdued core and non-food rate of inflation reflects a combination of exchange rate appreciation, declining energy prices and moderate increases in processed food prices.

Looking ahead, inflation is expected to remain at low levels in the near term, before rising from late 2014 onwards, as activity gradually recovers. The annual inflation rate is projected to be in the range of 7-8 percent in 2014 and 6-7 percent in 2015. Core inflation on other hand is projected to be in the range of 4-5 percent in 2014. This moderate core inflation outlook is expected to be mainly due to the declining path of oil price, exchange rate stability with a bias towards an appreciation and the existing slack in the economy. Given rising, but still moderate, domestic cost pressures, against the background of the expected gradual recovery in economic activity, core inflation is projected to increase to 5-7 percent in 2015.

This moderate inflation outlook is expected to be mainly due to the stability of the exchange rate with a bias towards an appreciation, declining path of international oil prices and the existing slack in the economy. The gradual strengthening in demand and the ongoing decline of excess capacity.

In more detail, energy prices are expected to decline somewhat over the projection horizon, reflecting the assumed path for oil prices. This exerts a downward impact on inflation. The contribution of energy prices to overall annual inflation is expected to be almost negligible over the projection horizon.

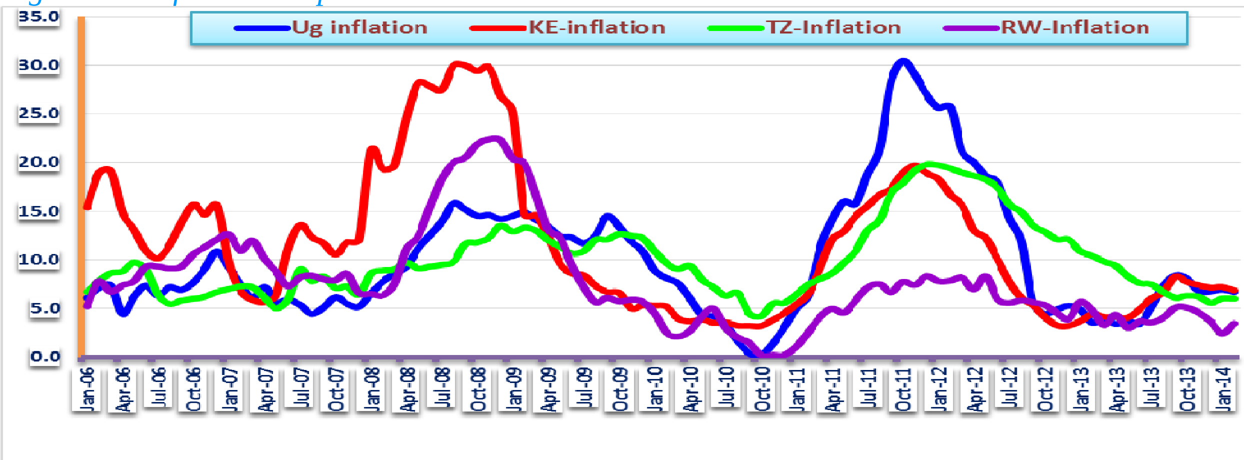
Food price inflation is expected to moderate in the coming months, owing to the decline in international food commodity and expected normal crop harvest and to downward base effects. It is projected to pick up over the remainder of the projection horizon, in line with the assumed increase in food commodity prices over this period. Core inflation is projected to increase gradually in the course of 2014, averaging about 5 percent in the year as a whole, and to rise to between 5 and 7 percent in 2015. These developments are expected to be driven by the projected gradual pick-up in economic activity and exchange rate depreciation. *Table 6* **summarizes the annual and monthly inflation developments.**

Table 6: Annual and monthly inflation developments

	Feb-13	Mar-13	Apr-13	May-13	Jun-13	Jul-13	Aug-13	Sep-13	Oct-13	Nov-13	Dec-13	Jan-14	Feb-14
Annual													
Headline	3.5	4.0	3.4	3.7	3.6	5.1	7.3	8.4	8.1	6.8	6.7	6.9	6.7 ↓
Core	5.6	6.8	5.8	5.6	5.8	6.4	6.6	7.4	7.2	7.0	5.7	4.6	3.7 ↓
EFU	-3.3	-2.0	1.8	1.3	1.0	0.3	1.6	2.1	1.6	0.8	4.9	4.4	4.7 ↑
Food Crops	-6.2	-8.5	-7.4	-5.2	-6.2	-0.3	13.0	16.2	14.3	7.7	12.7	21.4	25.1 ↑
Food	-2.0	-0.9	-2.6	-2.1	-1.4	2.8	9.1	11.7	10.9	8.1	9.2	11.1	10.9 ↓
Non Food	6.0	6.5	6.6	6.8	6.5	6.5	6.8	7.1	6.8	6.3	5.7	5.2	4.8 ↓
Services	7.4	7.6	7.9	7.8	7.1	6.8	7.4	7.5	7.5	6.7	6.2	6.6	6.6
Other goods	3.0	5.0	3.5	3.4	4.4	5.7	5.6	6.7	6.4	6.6	5.2	2.8	1.4 ↓
Monthly													
Headline	0.5	0.9	1.4	0.2	-0.5	0.6	2.6	1.8	0.0	-0.7	0.1	-0.1	0.2 ↑
Core	0.9	0.3	0.2	0.1	0.6	0.4	0.4	1.2	0.1	0.1	0.2	-0.1	0.0
EFU	-0.2	0.9	0.1	0.1	-0.6	4.2	0.0	0.2	0.0	0.1	-0.1	-0.1	0.1 ↑
Food Crops	-2.2	3.9	8.8	0.9	-6.0	0.0	16.0	5.3	-1.0	-4.3	0.0	0.2	0.8 ↑
Food	0.2	2.3	3.7	0.4	-2.6	0.4	7.5	3.4	0.1	-2.3	-1.0	-0.7	0.1 ↑
Non Food	0.6	0.3	0.4	0.1	0.6	0.6	0.4	1.0	-0.3	0.2	0.7	0.1	0.2 ↑
Services	0.1	0.3	0.7	0.3	0.9	0.8	0.6	1.2	0.3	0.1	0.7	0.4	0.1 ↓
Other goods	1.5	0.5	-0.1	-0.2	0.3	0.5	0.1	1.1	0.1	0.1	-0.3	-0.7	0.1

East African countries have maintained single-digit inflation rate since 2013 as indicated in Figure 12 in part due to good crop harvests that stabilised prices of food and drinks, and this is expected to continue in 2014.

Figure 12: Inflation comparison in EAC countries



The CPI may be decomposed into food crops, services (which can be used as a proxy for non-tradable inflation), and other goods (a proxy for tradable inflation). Services, or non-tradable, inflation (which holds a weight of 46 per cent in the CPI basket) has remained relatively elevated and stable at above 6 per cent since January 2013. 'Other' goods inflation (which holds a weight of 41 per cent in the CPI) declined to 1.4 per cent in February 2014, from 5.2 per cent in December 2013, mainly reflecting the impact of the exchange rate appreciation.

Food continues to be the main driver of inflation, contributing 3.0 percentage points in February 2014. The contribution of beverages and tobacco, rent, fuel and utilities and health, entertainment and others to overall inflation declined over the month, whilst the contribution of most other categories remained stable, as shown in ***Table 7*** below.

Table 7: Contributions to annual headline inflation

	Weights	Feb-13	Mar-13	Apr-13	May-13	Jun-13	Jul-13	Aug-13	Sep-13	Oct-13	Nov-13	Dec-13	Jan-14	Feb-14
Food	**27.2**	-0.7	-0.4	-0.9	-0.7	-0.6	0.7	2.5	3.2	3.0	2.2	2.5	3.0	3.0
Beverages and Tobacco	**4.7**	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.7	0.6	0.6	0.4	0.2	0.1↓
Clothing and footwear	**4.4**	-0.2	-0.2	-0.1	0.0	0.2	0.4	0.4	0.5	0.6	0.4	0.5	0.4	0.4
Rent,Fuel and Utilities	**14.8**	0.5	0.5	0.6	0.9	0.9	0.8	0.8	0.9	0.6	0.7	0.7	0.5	0.3↓
H.hold and personal goods	**4.5**	0.2	0.2	0.2	0.2	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.1
Transport and communication	**12.8**	0.5	0.5	0.5	0.4	0.5	0.5	0.8	0.8	0.9	0.6	0.2	0.6	0.6
Education	**14.7**	1.1	1.1	1.1	1.1	0.5	0.6	0.6	0.7	0.7	0.7	0.7	0.7	0.7
Health,entert.& Others	**16.8**	1.6	1.6	1.4	1.3	1.3	1.4	1.4	1.5	1.5	1.4	1.3	1.3	1.2↓
Overall (Headline)	**100.0**	3.5	4.0	3.4	3.7	3.6	5.1	7.3	8.4	8.1	6.8	6.7	6.9	6.7↓

Source: Uganda Bureau of Statistics

5.1 Inflation outlook and risks

5.1.1 Global economic outlook

Global economic recovery is projected to remain on track with global growth expected to rebound from 2.9 per cent in 2013 to 3.5 per cent in 2014, driven mainly by strong performance in the advanced economies. Nonetheless, global inflation remains low on account of weak commodity prices and ample spare capacity.

Economic recovery in the advanced economies may put some upward pressure on global demand, but inflationary pressures are likely to remain weak because of the existence of spare capacity.

Crude oil prices are projected to remain in the range of USD 100-110 per barrel throughout 2014. However, global financial markets are expected to remain vulnerable to volatility, which may occasionally cause exchange rate volatility in Uganda.

5.1.2 Domestic economic outlook

On the domestic scene, there is likely to be an improved growth in monetary aggregates, but this is likely to remain within programmed levels and is therefore not a major upside risk to inflation. Other risks to inflation may come from a real annual depreciation, which is expected to be between 2 and 3 per cent over the medium-term on account a weak current account.

Food prices are only expected to increase in the medium-term on account of the current dry spell and regional supply shortages, and are expected to recover with the onset of the rainy season.

In the medium-term, inflationary pressures appear to be building up. Indeed, food crops inflation has been relatively elevated for a while, driven largely by base effects. However, the increase in food crops inflation is likely to be transitory on account of the recent dry spell and the natural production cycle. The reemergence of depreciation pressures to the exchange rate particularly since February may also exert an upward pressure on the price of tradable goods and services.

Compared with the forecast in January, the revised inflation outlook for March 2014 has been slightly elevated: short-term headline and core inflation is now projected between 6.5 to 8.5 per cent and between 4.0 to 5.0 per cent respectively. The updated 12-month inflation forecast now stands at 7.0 to 9.0 per cent and 5.5 to 6.5 per cent for headline and core inflation respectively.

5.1.3 Risks to the inflations outlook

Both domestic inflation and growth forecasts are subject to an increased amount of uncertainty over the recent period. Developments in both the external environment and the domestic economy are increasingly less certain and have therefore increased the degree of risk surrounding domestic forecasts.

After a marked downturn throughout the past two years, global economic activity slowly gained momentum in the second half of 2013. It is expected to pick-up further in 2014, driven mainly by the projected robust growth in Advanced Economies. Furthermore, financial conditions in the advanced economies remain highly supportive of economic growth. Consequently, global growth is expected to strengthen over the next two years, rising from 2.9 per cent in 2013 to 3.5 per cent in 2014 and 3.8 per cent in 2015. Meanwhile, growth in most Emerging Market Economies (EME) has moderated, and the downward revisions to growth forecasts highlight continued fragilities in some economies.

Capital inflows into EMEs have moderated and reversed in some economies. Less expansionary monetary policies in Advanced Economies continue to threaten capital flows to EMEs and therefore to damage their growth prospects.

If global economic activity were to rebound strongly than expected then it may trigger an increase in commodity prices and thus global inflation, which could feed through to domestic inflation. Nonetheless, a build-up in global inflation seems unlikely given the degree of global spare capacity. Furthermore, inflation remains below target in most Advanced Economies, and in some countries, namely the Euro zone, is suitably low to threaten deflation.

On the domestic scene, despite the sharp depreciation of the Shilling in the last 3 days of February 2014, the average exchange rate in February saw an appreciation of 7.1 per cent on an annual basis. Depreciation pressures are however expected to persist over the next few months given the weak current account, the threat of aid cuts and the current over-valuation of the Shilling. The depreciation will increase import prices, which firms are expected to pass through to retail prices.

The current drought and the below-average rainfall from September to December 2013 across much of the East African region could see food prices edge up in coming months. Kenya has already issued food shortage warnings. In addition, the purchase of food to supply to the displaced South Sudanese could result in food shortages and price hikes in the coming months. Nonetheless, global commodity prices are expected to remain soft and partially counter-balance mounting food prices. Consequently, inflation is likely to rise above the 5 per cent target and to remain so over the forecast 12-month horizon.

Elevated services inflation indicates that domestic demand has increased. Buoyant domestic demand, combined with the increased fiscal stimulus, will exert upward pressure on both output and inflation. Real GDP growth is projected at 6.2 per cent in FY 2013/14 and at 6.5 per cent in FY 2014/15, which falls just below the economy's potential rate of growth. Domestic investment is also projected to remain strong, led by private sector capital spending and complemented by the ongoing public investments. Similarly, strong FDI inflows are likely to continue over the medium term, especially in the oil sector. The largest risks to growth over the coming period emanate from net exports and private sector demand.

The conflict in South Sudan will reduce net exports and remittances and thus impede growth, yet this may be offset from increased domestic demand arising from an increasingly expansionary fiscal stance. Nonetheless, higher government borrowing could crowd out private sector borrowing. Indeed, weak bank credit growth would restrain private consumption and investment, although strong FDI inflows are likely to continue over the medium term.

Lending rates remain relatively high, reflecting structural factors such as high operating costs and rising provisions for bad debt. Furthermore, the recovery in credit growth that began last year has weakened, most likely as a result of rising non-performing loans.

Uganda continues to build foreign exchange reserves on account of the surpluses in the CFA, which is funded by aid inflows, FDI and portfolio inflows. However, the current account balance continues to be in deficit. The weakness of the current account indicates the vulnerability of Uganda's external sector. Furthermore, if the global economy continues to recover and as monetary policy abroad is expected to become gradually less expansionary, foreign interest rates may pick-up thereby eroding Uganda's attractive interest rate differential, which would in turn trigger a reversal of portfolio inflows. Lesser capital inflows may consequently bring depreciation and inflation pressures to Uganda.

Government expenditure on infrastructure should boost domestic demand and also have a long-term multiplier effect upon economic activity. However, fiscal expansion threatens the weak external balance and may push treasury yields upwards, thereby crowding out private sector investment.

The risks regarding the exchange rate warrant a cautious monetary policy stance. The path of the exchange rate is a significant source of uncertainty for the domestic economy. Low core inflation is a result of the exchange rate appreciation since the beginning of 2013. However, depreciation pressures have ensued since end of February 2014, largely triggered by aid cuts on account of enactment of anti-gay laws. If depreciation pressures continue in the near-term, they may feed through to domestic inflation.

6 POLICY OUTLOOK AND IMPLICATIONS GOING FORWARD

Currently, there are substantial risks around the projected output and inflation and there is considerable uncertainty regarding the likely evolution of the exchange rate. The magnitude and timing of the decline in foreign aid over the forecast period remains an important source of uncertainty. Fiscal stimuli and public spending on infrastructure should boost both aggregate demand as well as aggregate supply through increasing potential growth. Nonetheless, growth in private sector credit remains subdued and will have a limited supportive role to growth.

Inflation, is expected to rise in the second half of 2014 due to the expected tax increases, exchange rate depreciation and food price increases. In the second half of the year, the depreciation of the shilling could cause core inflation indicators to rise particularly through the core goods group. The 12-month forecast for core inflation is 5-7 per cent, which is slightly higher than the BoU's medium-term target. On the other hand, real economic growth is slightly below potential. The extent to which aggregate demand conditions will restrict inflationary pressures in the upcoming period will depend on the length of the current economic cycle. However, inflation is expected to stabilize around 5 percent in the medium term.

Fiscal policy remains a major concern for monetary policy. Changes in domestic borrowing requirements and fast rising domestic financing of fiscal deficits could create the spectra of fiscal dominance which could lead to high and volatile inflation and elevated risk premia on government debt. The resulting high interest rate could be a source of unfavourable exchange rate dynamic, exposing Uganda to destabilising capital flows. In this kind of environment, maintaining a cautious monetary policy stance is critical to the resilience of the economy against current uncertainties. A revision of the monetary policy stance may be considered, should the fiscal stance deviate significantly from this framework, and consequently, has an adverse effect on the medium term inflation outlook.