Bank of Uganda

Current State of the Ugandan Economy

November 2014

Table of Contents

Acronyms and Abbreviations iv
1.0 EXECUTIVE SUMMARY 1
2.0 GLOBAL ECONOMIC DEVELOPMENTS 3
2.1 Global growth 3
2.2 Global financial markets 5
2.3 Global inflation and commodity prices 6
2.4 Outlook and impact on Ugandan economy 7
3.0 DOMESTIC ECONOMIC DEVELOPMENTS 7
3.1. Monetary policy stance 7
3.2. Monetary policy implementation 7
3.3. Monetary and Financial Developments 9
3.3.1 Monetary aggregates 9
3.3.2 Private sector Credit (PSC) 9
3.3.3 Interest rates 10
3.4. Fiscal Developments 11
3.5. Balance of Payments and Exchange Rates 13
3.5.1 Balance of payments 13
3.5.2 Exchange rates 14
3.6. Domestic Economic Activity 15
3.6.1 Economic growth outlook 18
4.0 CONSUMER PRICE INFLATION 19
4.1 Recent Inflation Developments 19
4.2 Inflation Outlook 20
4.3 Risks to outlook 21
4.3.1 Domestic risks 21
4.3.2 External economic outlook and risks 23
5 MONETARY POLICY DECISION 24

List of Tables

Table 1: Fiscal Operations (Shs billion)..... 14
Table 2: Balance of payments developments.. 14
Table 3: Regional exchange rate changes 15
Table 4: Some Macroeconomic indicators 18

List of Figures

Figure 1: Figure 1: CBR, Lending Rate, 7- day rate and 91-day Treasury bill rate........................9
Figure 2: Contributions to Annual Growth in Broad Money (M3) 9
Figure 3: Shilling time deposit and lending rates 11
Figure 4: GDP by economic activity constant 2009/10 prices (% change) 16
Figure 5: Expenditure constant prices, annual percentage changes... 17
Figure 6: Breakdown of CIEA by Sector.. 17
Figure 7: Recent Inflation Developments 20
Figure 8: Inflation forecasts...21

Acronyms and Abbreviations

$	Dollar
AE	Advanced Economy
BoP	Balance of Payments
BoU	Bank of Uganda
CA	Current Account
CBR	Central Bank Rate
CIEA	Composite Index of Economic Activity
CPI	Consumer Price Index
ECB	European Central Bank
EMEs	Emerging Market Economies
EU	European Union
FDI	Foreign Direct Investment
FY	Financial Year
GDP	Gross Domestic Product
H	Half
HPPs	Hydro Power Projects
IFEM	Interbank Foreign Exchange Market
M	Money supply
M-o-M	Month on Month
NIR	Net International Reserves
NPAs	Non- Performing Assets
PP	Percentage Points
PSC	Private Sector Credit
PSI	Policy Support Instrument
Q	Quarter
Q-o-Q	Quarter on Quarter
REPOs	Repurchase Agreements
Sh	Shilling
UK	United Kingdom
US	United States
WALR	Weighted Average Lending Rate
WTI	World Trade Index
Y-o-Y	Year on Year

1.0 EXECUTIVE SUMMARY

This State of the Economy report presents recent economic developments mainly in the quarter to September 2014 and where data is available up to November 2014. The report also assesses future prospects for inflation and output. The analysis and outlook underline the monetary policy decisions in recent months by the Bank of Uganda (BoU).

Global economic recovery continues on a modest and uneven path, with divergent growth trends among both Advanced Economies (AEs) and Emerging Market economies (EMEs). The growth rate is expected to remain stable at 3.3 per cent in 2014 same as in 2013, but is expected to rise to 3.7 per cent in 2015. Recovery in AEs has been uneven while growth in the faster-growing emerging economies has slowed. Several large emerging countries have seen growth decelerate in 2014. This reflected weak external demand, but also increased geopolitical tensions, domestic policy uncertainty and rising supply-side constraints.

Global inflation remains relatively low, largely on account of declining commodity prices supported by abundant supply capacity coupled with moderate demand. Outlook for global inflation is dependent on the direction of commodity prices especially oil prices. Energy and non-energy prices are projected to remain low in 2014 and 2015, supported by subdued demand and favourable supply conditions.

Volatility in global financial markets has risen over recent months, after a prolonged period of being especially low. The timing of this increase in volatility has been somewhat asynchronous across various asset classes, and there have been no obvious triggers for some of these moves. Nevertheless, a combination of persistent weakness in the European economy and further divergence in the outlook for monetary policy among the largest economies – including as a result of significant new balance sheet expansions announced by the European and Japanese central banks – have been contributing factors.

On the domestic scene, BoU continues to pursue a cautious monetary policy stance aimed at stimulating output without jeopardizing the inflation objective. The BoU reduced the central bank rate (CBR) by 50 basis points to 11 in June 2014 and kept the CBR unchanged since then, largely because of the uncertainty regarding the food prices and shilling depreciation. Inflation has remained subdued, with headline and core inflation averaging 4.6 per cent and 3.1 per cent, respectively since January 2014. Inflation is expected to be consistent with the 5 per cent target over the next two years. Given this assessment, monetary policy is appropriately configured to foster sustainable growth in demand and inflation outcomes consistent with the target.

The interest rates on average evolved in line with the CBR. Lending rates have continued to edge lower, averaging 21.6 per cent in the first ten months of 2014 compared to an average of 23.4 per cent in the same period of 2013. However, the decline has remained relatively sticky.

In the first ten months of 2014, the current account (CA) of balance of payments (BoP) deteriorated by US$ 564 million to a deficit of US$ 1,816.76 million, from a deficit of US$ 1,252.77 million in the first ten months of 2013. The deterioration in the CA was largely attributed to a higher deficit on the trade account. Overall, the BoP worsened marginally by US$46.7 million in the first ten months of 2014 compared to the same period in 2013. The stock of reserves is estimated at US$3,216.4 million at end of October 2014. In the short term, the CA deficit is likely to widen due to increase in private sector imports of consumer goods for the festive season. This could be moderated by improved commodities exports in the second harvest season; higher personal transfers in preparation for the festive season and higher inflows through travel services.

In part, as a consequence of the widening CA imbalance, the Ugandan shilling (Sh) has depreciated against most other currencies since the beginning of the year. As of November 2014, the Sh had depreciated by about 6 per cent on a trade-weighted basis and 9.1 per cent against the US$ on year on year basis. The depreciation is in part driven by noise in the market, net-outflow of portfolio investments, elevated corporate demand from mainly

telecom and energy sectors, and global strengthening of the US$.

Fiscal expenditure is estimated at Shs 6,463.0 billion in the period to November 2014. This is Shs 620.0 billion lower than the projected expenditure of Shs 7,083.0 billion. Total Government revenue is estimated at Shs 3,935.6 billion, which is Shs 142.9 billion lower than the projected amount of Shs 4,078.5 billion. The cumulative shortfall in tax collections was mainly due to shortfalls in tax collections. The fiscal balance over the period is estimated at Shs 2,242.9 billion or 3.2 per cent of projected total Gross Domestic Product (GDP). This is more expansionary that 2.6 per cent of total GDP in the corresponding period in 2013/14. The fiscal deficit was mainly financed through domestic financing.

Going forward, in the next five years, the scale of planned public investments. The discovery of oil reserves makes it possible to raise the share of public investment in output via an increase in public investment thereby raising the public capital stock.

The revised real GDP grew by 4.5 per cent in 2013/14 (at constant 2009/10 prices) compared to a revised 3.3 per cent in 2012/13, as feeble imports and stronger investment offset sluggish exports. The outlook for 2014/15 is for acceleration of growth, projected at about 6 per cent, supported by public investment in infrastructure, private domestic consumption and investment demand (recovery in private sector credit growth), increased Foreign Direct Investment (FDI); and rebound in agricultural production.

2.0 GLOBAL ECONOMIC DEVELOPMENTS

2.1 Global growth

In 2014 quarter two (Q2) and Q3, global economic activity remained moderate with rising divergence across countries and regions. US was recovering, while the euro area, including Germany and France, remained in stagnation. The global economy is expected to make a hesitant and uneven recovery over the coming two years. Global GDP growth is projected to reach a 3.3 percent rate in 2014 before accelerating to 3.7 per cent in 2015 and 3.9 percent in 2016, according to the Organisation for Economic Co-operation and Development November economic outlook. This pace is modest compared with the pre-crisis period and somewhat below the long-term average.

Recovery in AEs has been uneven while growth in the faster-growing EMEs has slowed. Several large emerging countries have seen growth decelerate in 2014 on account of weak external demand, increased geopolitical tensions, domestic policy uncertainty and rising supply-side constraints. There is a growing risk of stagnation in the euro zone that could have impacts worldwide, while Japan has fallen into a technical recession. Furthermore, diverging monetary policies could lead to greater financial volatility for emerging economies, many of which have accumulated high levels of debt.

Economic growth in the euro area had lost momentum, dragged down by structural problems in some of the member countries, persistently high unemployment and slow lending growth. Economic activity was also hampered by earlier appreciation of the euro as well as in the case of some of the euro area countries – the Russian- Ukrainian crisis, which had an adverse effect on exports and business sentiment. The euro area is projected to grow by 0.8 percent in 2014, before slight acceleration to a 1.1 per cent rate in 2015 and a 1.7 percent rate in 2016. A prolonged stagnation in the euro area could drag down global growth and have knock-on effects on other economies through trade and financial links.

Among the major AEs, activity is gaining strength in the US, which is projected to grow by 2.2 per cent in 2014 and around 3 percent in 2015 and 2016. In Japan, growth was impacted by consumption tax hikes in 2014, with expected growth of only 0.4 per cent in 2014, and rise modestly to 0.8 percent in 2015 and 1 per cent in 2016.

Growth in Emerging and Developing countries in 2014 has been revised down to 4.4 per cent from the earlier projection of 5.1 per cent in January 2014. The downward revision of growth was on account of weak first half (H1) of 2014 growth and structural factors. Other reasons include the dampening in confidence associated with the increasing number of geopolitical hotspots around the world and uncertainty about developments in key EMEs on account of the continued fragilities in these economies. The past productivity gains in EMEs seem to have faded and for growth in these economies to be sustained, a new wave of structural reforms may be necessary.

Large emerging economies are projected to show diverging performance over the coming years. Of the five BRICS economies (Brazil, Russia, India, China, and South Africa), three (Brazil, Russia, and South Africa) are close to recession. The biggest, China, is in the midst of a structural slowdown that will see GDP growth drop from a 7.3 per cent growth rate in 2014 to a 7.1 per cent rate in 2015 and a 6.9 per cent rate in 2016.

Weakness in the rest of the world implies a stronger dollar, which will invariably weaken US growth. The deeper the slowdown in other countries and the higher the dollar rises, the less the US will be able to decouple from the funk everywhere else, even if domestic demand seems robust.

Disappointing global growth together with the recent decline in inflation expectations across major economies continued to keep global interest rates low. The prospect of asynchronous monetary policies across major economies carries the risk of further bouts of volatility. Following the end of its quantitative easing program in October 2014, the US Fed is projected to start raising policy rates around mid-2015. By contrast, the European Central Bank (ECB) announced a series of new easing measures since September, which will be expanded with new initiatives should inflation expectations continue to deteriorate, or current measures prove insufficient.

2.2 Global financial markets

Volatility in global financial markets has risen over recent months, after a prolonged period of being especially low. The timing of this increase in volatility has been somewhat asynchronous across various asset classes, and there have been no obvious triggers for some of these moves. Nevertheless, a combination of persistent weakness in the European economy and further divergence in the outlook for monetary policy among the largest economies – including as a result of significant new balance sheet expansions announced by the European and Japanese central banks – have been contributing factors.

Continued market speculation on the timing of the US and United Kingdom (UK) policy rate hikes and its effect on emerging market currencies remains a major threat to global financial market stability. Further, global strengthening of the US$ may have implications for the Uganda Sh, although historically, the impact has been irregular.

2.3 Global inflation and commodity prices

Despite slight increase in Q2 2014, global inflation remains relatively low, largely on account of declining commodity prices supported by abundant supply capacities coupled with moderate demand. However, divergence in economic conditions was translating into different price developments across economies. In the US, relatively sound economic conditions were supportive of moderate price growth. In the euro area, in turn, inflation had been declining for several quarters and came down to near zero in 2014 Q3. In many EMEs, inflation has been relatively low or falling.

Oil prices have declined from a peak of US$115/barrel in June 2014 to less than US$80/barrel in mid-November 2014. Numerous factors contributed to recent developments. These included the strengthening of the US$ against major currencies, a faster-than-expected rebound in supplies from Libya and Iraq despite rebel insurgencies, weakening growth prospects in EMEs (where most growth in oil demand takes place), anemic growth in the euro area and strong supplies by the US and some Organization of the Petroleum Exporting Countries member countries. Food prices have also fallen back, due to weakening imports from China and robust supplies, respectively. This low commodity price environment is expected to carry over into 2015, putting inflation in both high-income and developing countries on a downward path, while implying significant shifts in income from commodity-exporting to commodity-importing economies. The net effect on the global economy is expected to remain mildly positive.

Outlook for global inflation is dependent on direction of commodity prices especially oil prices. Energy and non-energy prices are projected to remain low in 2014 and 2015, supported by subdued demand and favourable supply conditions. However, geopolitical tensions still pose a threat to the supply of commodities, especially oil, and therefore a risk to commodity prices and global inflation. In addition, pick-up in demand with the onset of the winter season, may increase demand and exert upward pressure on oil prices and global inflation.

2.4 Outlook and impact on Ugandan economy

The global economic outlook remains vulnerable to risks, which have the potential to affect confidence and further recovery, negatively. The main risks include slow growth in the Euro Zone, financial market instability in the European Union and geopolitical conflicts. Being a major trading partner to Uganda, slow growth coupled with weak demand in the Euro zone is likely to negatively impact export earnings, remittances and FDI from the zone going forward. However, the Euro depreciation, which is underway, is expected to support the zone's export sector and drive inflation upwards.

Tighter global financial conditions following the normalization of monetary policy mainly in the US and UK could lead to weaker financial flows or possible capital reversals especially in Emerging and Developing Economies. This could result in currency depreciations as recorded in H2 2013, with a potential to drive up domestic inflation and run down foreign exchange reserves, although the impact depends on the macroeconomic strength of the economy. Heightened geo-political risks have the potential to disrupt production of oil, disrupt trade and cause financial market volatility as investors factor in the risks associated with political instability.

3.0 DOMESTIC ECONOMIC DEVELOPMENTS

3.1. Monetary policy stance

The BoU continued to pursue a cautious monetary policy stance aimed at stimulating output without jeopardizing the inflation objective. BoU reduced the CBR by 50 basis points to 11 in June 2014 and kept the CBR unchanged since then. The monetary policy stance remained cautious despite low inflation as the inflation forecast pointed to an increase in prices on account of anticipated higher food prices, exchange rate pass through and a rebound in private sector demand.

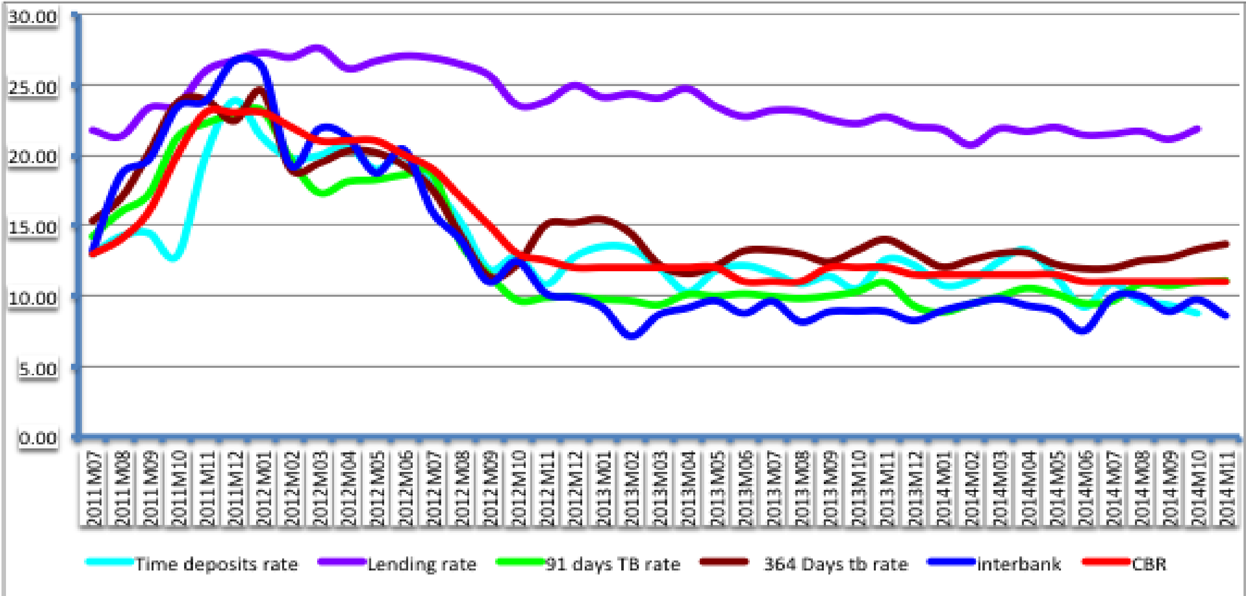
3.2. Monetary policy implementation

BoU continued to use Repurchase Agreements (REPOs), and outright sales of recapitalization securities in the secondary market for aligning liquidity conditions in the

financial system with the desired monetary policy stance. The outstanding REPO stock at end of November 2014 stood at Shs 771.6 billion. The BoU also sold recapitalization securities worth Shs 7.0 billion in November 2014. The outstanding stock was Shs399.4 billion. Additional Shs 250 billion in recapitalization securities was acquired at the end of September 2014.

The interbank money market rates remained consistent with the monetary policy stance in spite of the structural liquidity overhang, which was in part moderated using REPOs and the sale of recapitalisation securities. Overall interest rates in the economy have evolved in line with the CBR but lending rates have responded more slowly. The lending rate on Sh denominated loans has averaged 21.5 per cent since June 2014 (figure 1). Yields on government securities remain on an upward trend in the first five months of 2014/15; this in part reflects the anticipated increase in fiscal deficits.

Figure 1: CBR, Lending Rate, 7- day rate and 91-day Treasury bill rate



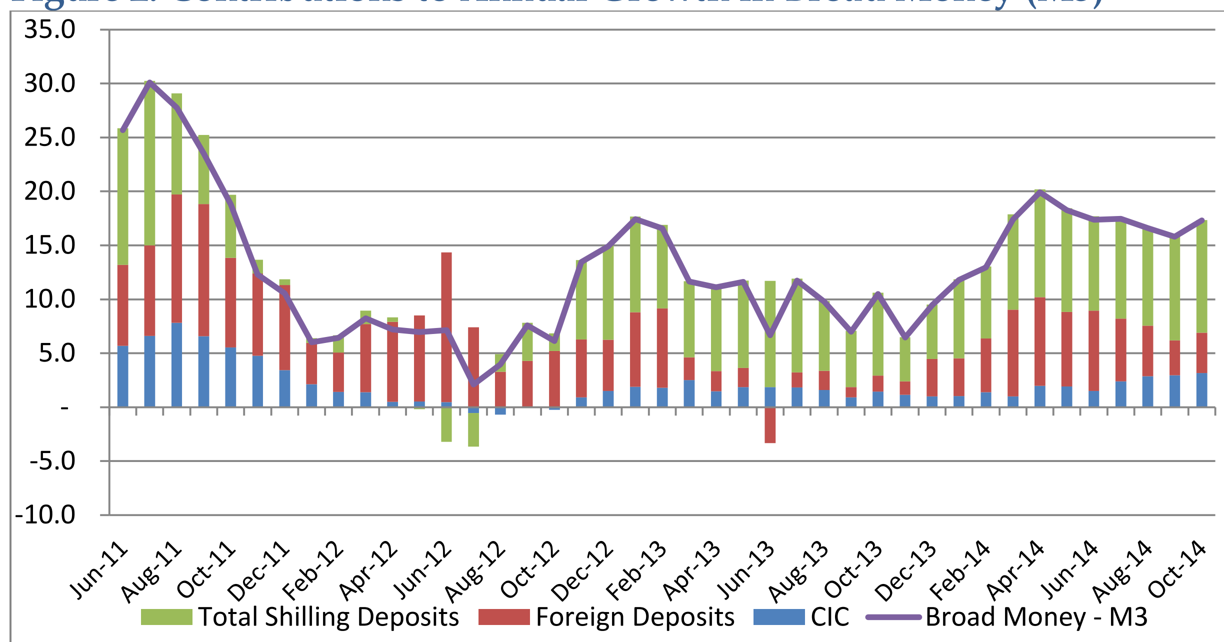
Source: BoU

3.3. Monetary and Financial Developments

3.3.1 Monetary aggregates

Growth in broad money supply (M3) continues to be robust, as shown in figure 2. Annual growth increased to 17.3 per cent in October 2014 from 15.8 per cent in September 2014. Annual growth in M3 since January 2014 has averaged at 16.5 per cent, which is well within the policy support instrument (PSI) trajectory of 17.5 per cent in 2014/15. The growth in M3 was largely driven by growth in Sh deposits and currency in circulation, which could be reflecting the strengthening of economic activity.

Figure 2: Contributions to Annual Growth in Broad Money (M3)



Source: BoU

3.3.2 Private sector Credit (PSC)

In the quarter ended October 2014, PSC rose by 3.2 per cent compared to growth of 4.5 per cent in July 2014. On an annual basis, PSC increased by 12.8 per cent in October 2014 compared to 8.7 per cent and 13.0 per cent recorded in October 2013 and July 2014, respectively. Growth in credit was mainly driven by increase in loans to community and social services, and electricity and water sectors, building and construction, business services and transport and communication sectors. PSC growth is expected to recover further as

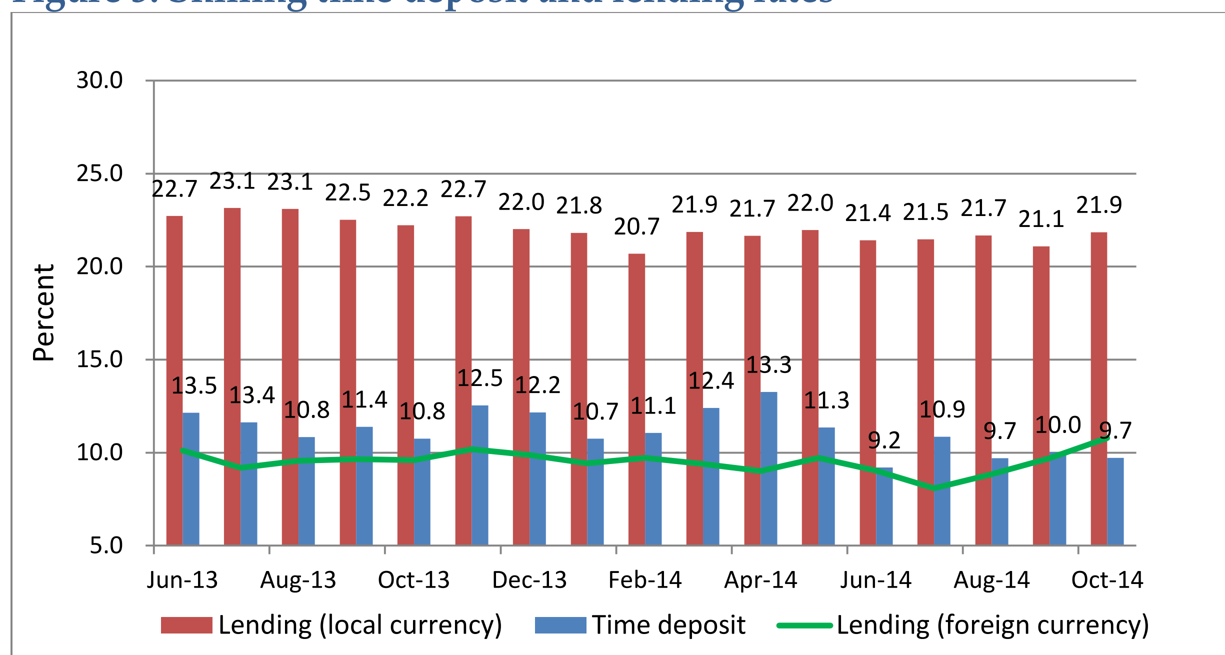
private sector activity picks up and normal growth resumes. Furthermore, the festive season is expected to increase demand for credit and supply will most likely be forthcoming as banks usually introduce end of year promotional products. PSC is now projected to grow by 15.6 per cent in 2014/15.

3.3.3 Interest rates

Yields on government bonds and bills increased in the four months to November 2014 partly due to an increase in the auction amounts and higher inflation expectations. The Weighted Average Lending Rate (WALR) on Sh denominated loans has been relatively stable at about 21.5 per cent since June 2014. In October 2014, the WALR rose to 21.9 per cent from 21.1 per cent in September 2014, mainly on account of increased rates on loans to agriculture, trade and mining and quarrying.

Lending rates remain sticky, in part reflecting high overhead costs and the provisioning for Non-Performing Assets (NPAs) and the increasing yields on government securities. The average WALR on foreign currency denominated loans also rose to 10.8 per cent in October 2014 from 9.7 per cent recorded in the previous month. time deposit rates on Sh deposits, however, fell from 9.3 per cent in September 2014 to 8.7 per cent in October 2014 (figure 3).

Figure 3: Shilling time deposit and lending rates



Source: BoU

3.4. Fiscal Developments

Table 1 shows fiscal operations for the first five months of 2014/15.[1] Fiscal expenditure is estimated at Shs 6,463.0 billion in the period to November 2014. This is Shs 620.0 billion lower than the projected expenditure of Shs 7,083.0 billion. Performance of government expenditure is partly explained by Government spending on Karuma and Isimba Hydro Power Projects (HPPs), and recapitalization of BoU, which amounted to Shs 1,149.9 billon and Shs 250 billion. Total Government revenue is estimated at Shs 3,935.6 billion, which is Shs 142.9 billion lower than the projected amount of Shs 4,078.5 billion. The cumulative shortfall in tax collections was mainly due to shortfalls in indirect and international trade tax collections. The fiscal balance over the period is estimated at Shs 2,242.9 billion or 3.2 per cent of projected total GDP. This is more expansionary than 2.6 per cent of total GDP in the corresponding period in 2013/14. The fiscal deficit was mainly financed through domestic financing including the drawdown of government energy and oil fund accounts as well as issuance of government securities amounting to Shs 571.0 billion.

[1] Includes Q1 i.e. July- September and October to November 2014.

Table 1: Fiscal Operations (Shs billion)

	Proj. Q1	**Outturn. Q1**	Deviation	Poj Oct-Nov	**outtutn Oct - Nov**	Deviation
Revenues and Grants	2,409.4	**2,341.4**	- 68.0	1,669.1	**1,594.2**	- 74.9
Revenues	*2,115.5*	***2,143.3***	*27.8*	*1,488.3*	***1,400.8***	- *87.4*
Grants	*245.1*	***198.1***	- *47.0*	*180.8*	***193.3***	*12.5*
Expenditure and Lending	4,358.1	**4,161.3**	- 196.9	2,725.2	**2,301.7**	- 423.5
Overall Fiscal Bal. (incl. Grants)	- 1,948.8	- **1,819.9**	128.9	- 1,056.1	- **423.0**	633.1
Financing:	1,948.8	**1,819.9**	- 128.9	1,056.1	**423.0**	- 633.1
External Financing (Net)	461.2	**156.3**	- 304.9	225.0	**293.6**	68.5
Domestic Financing (Net)	1,487.6	**1,663.6**	176.0	831.1	**129.4**	- 701.7
Bank of Uganda (Net)	*1,050.6*	***1,188.3***	*137.7*	*563.8*	***89.5***	- *474.3*
Issuance of Governmenr securities (Net)	*437.0*	***433.4***	- *3.6*	*407.0*	***137.6***	- *269.4*
Errors and Omissions		**42.0**	42.0	- 139.7	- **97.7**	42.0

Source: Ministry of Finance, Planning and Economic Development.

Going forward, public investment is projected to surge. The second National Development Plan projects public investments worth US$20 billion within the next five years. If these are to be implemented as projected, fiscal deficit will continue to increase and public debt will climb rapidly. Clearly, Uganda faces important choices as it looks towards oil revenues. Inadequate infrastructure holds back regional integration and limits economic growth. In response, the government has decided that investment needs to take place now, to pave the way for prosperity.

In financing public investments of this magnitude, it is infeasible to rely entirely on non-concessional borrowing in order to keep the domestic tax burden low. The cost of sovereign borrowing will become prohibitively expensive as lenders demand higher yields to compensate increased exposure to default risks. Consequently, it will require domestic revenue mobilization to increase from its current level of around 13 per cent of GDP to cover the cost of new investment to be undertaken before oil revenues kick in along with the operating and maintenance costs associated with the increased public capital stock and the debt service costs associated with the additional borrowing. Although significant revenue gains may be accrued by reducing tax exemptions and other special treatments, the substantial public investment required will likely demand increases in tax rates in the future. The increase in domestic revenue might depress consumer expenditure at least in the short run. In addition, public investments of this magnitude might bear fruit if they can be transformed into capital efficiently. Major efforts in project appraisal, design and

supervision as well as the design of public-private partnerships will be required to ensure absorptive capacity and achieve value- for-money investments.

3.5. Balance of Payments and Exchange Rates

3.5.1 Balance of payments

In the first ten months of 2014, CA of BoP deteriorated by US$ 564 million to a deficit of US$ 1,816.76 million, from a deficit of US$ 1,252.77 million in the first ten months of 2013. The deterioration in the CA was largely as a result of a higher deficit on the trade account in part reflecting weaker external demand. Export receipts decreased by 7.2 per cent from US$2,865.04 million recorded in the first ten months of 2013 to US$2,660.3 million in the same period of 2014. Imports on the other hand increased marginally by 0.22 per cent in the same period, from US$5,017.7 million to US$5,028.9 million. In part, the weak growth in imports is attributable to decline in re-exports. Overall, the BoP worsened marginally by US$46.7 million in the first ten months of 2014 compared to the same period in 2013. The BoP developments are summarized in table 2.

Going forward, domestic demand growth is projected to strengthen further and therefore demand for imports accelerate. However, due to the relatively strong decrease in export growth, the contribution of net exports to growth will continue to be negative.

Table 2: Balance of payments developments

	FY13/14 Q1	FY13/14 Q2	FY13/14 Q3	FY13/14 Q4	FY14/15 Q1	Oct-14
Total Exports	678.5	655.7	700.3	674.6	623.7	227.4
Total Imports	1,269.6	1,233.2	1,232.2	1,305.0	1,232.4	430.5
Trade balance	-591.0	-577.5	-531.9	-630.4	-608.7	-203.1
Current account	-390.4	-212.9	-396.6	-449.0	-819.2	-151.9
Net lending (balance from current and capital account)	-381.1	-158.7	-386.3	-431.8	-793.4	-138.3
Overall Balance	-20.5	-129.4	-171.4	-57.2	281.2	-215.2

Source: BoU

The stock of reserves at the end of October 2014 amounted to US$3,273.9 million, equivalent to 4.5 months of future imports of goods and services cover. This was a decrease from US$3,390.2 million at the end of June 2014 due to mainly expenditure on services for Karuma and Isimba projects worth US$243.8 million.

In the short term, the CA deficit is likely to widen —despite the significant decline in oil prices—due to an increase in imports for the energy projects and consumer goods in preparation for the festive season. This could be moderated by higher commodities exports earnings on account of the end of year harvest season and higher personal transfers in preparation for the festive season. Financing would include a combination of FDI, concessional and non-concessional borrowing, and use of savings, bringing down international reserves to 4.1 months of imports, a level that is still adequate for Uganda.

3.5.2 Exchange rates

In part, as a consequence of weak external sector, since the beginning of the year, the Sh has depreciated against most other currencies. As of November 2014, the Sh had depreciated by about 6 per cent on a trade-weighted basis and 9.1 per cent against the US$ on year on year

basis compared to January 2014. In part, the exchange rate depreciation helped to restore competitiveness, which had been lost due to the appreciation of the Sh in 2013. Going forward, the exchange rate might continue depreciating –albeit at a comparatively gentle pace-given the large CA deficit and concerns regarding the size of the budget deficit.

Regionally, the exchange rates remained relatively stable except in Ghana and Zambia. In Ghana, a US$1 billion Eurobond issuance and US$1.5 billion cocoa receivables-backed syndicated loan in August 2014 and September 2014, respectively, did not relieve exchange rate pressures to the extent earlier anticipated. Developments in the regional exchange rates are shown in table 3.

Table 3: Regional exchange rate changes

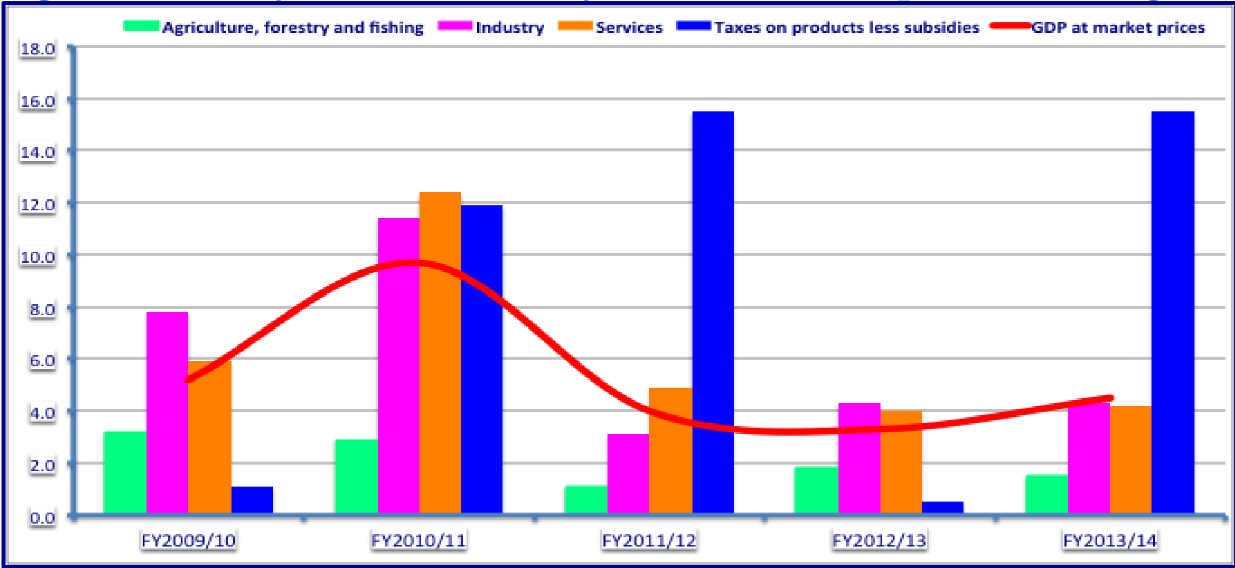
Exchange Rate Annual % Changes (Local Currency/US$)						
	Uganda	Kenya	Tanzania	Ghana	Nigeria	Zambia
Q4 2013	-3.9	0.4	1.9	9.4	1.2	5.0
Q1 2014	-5.9	-0.4	2.0	29.1	3.3	8.1
Q2 2014	-1.5	3.1	2.7	47.6	2.2	18.8
Q3 2014	1.7	1.1	3.0	54.9	0.6	13.4

Source: BOU and specific country Central Banks

3.6. Domestic Economic Activity

The GDP estimates for 2008/09 onwards have been rebased from the 2002 base year to the new 2009/10 base year, reflecting a contemporary structure of the economy in 2009/10. The revisions to the previous estimates resulted in overall GDP, at current prices, increasing by 16.5 per cent a year. As shown in figure 4, the GDP at constant 2009/10 prices grew by 4.5 percent in 2013/14 compared to a revised 3.3 per cent in 2012/13. In nominal terms GDP for 2013/14 grew by 7.0 per cent in current prices, compared to the revised 2012/13 growth rate of 7.5 per cent.

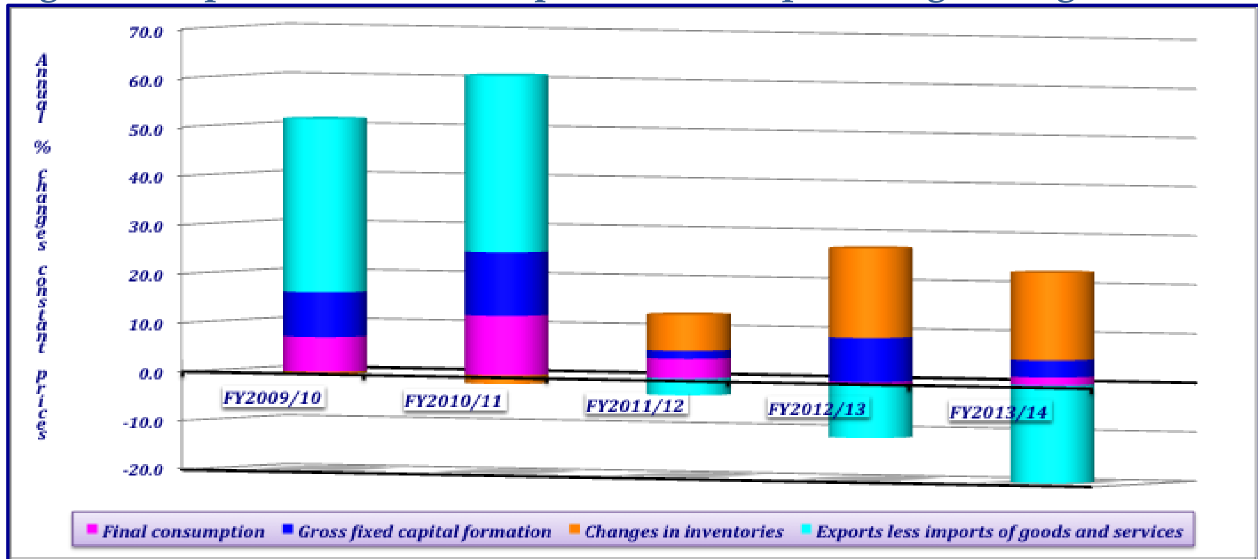
Figure 4: GDP by economic activity constant 2009/10 prices (% change)



Source: Uganda Bureau of Statistics

In terms of the GDP by expenditure, the dismal growth in final consumption, especially private consumption, and gross fixed capital formation, in part due to the slow implementation of public investments, contributed to low economic growth in 2013/14. Going forward, public investment is projected to rise and final consumption is also projected to strengthen further and this would result in improved growth prospects. Figure 5 shows GDP growth by expenditure approach.

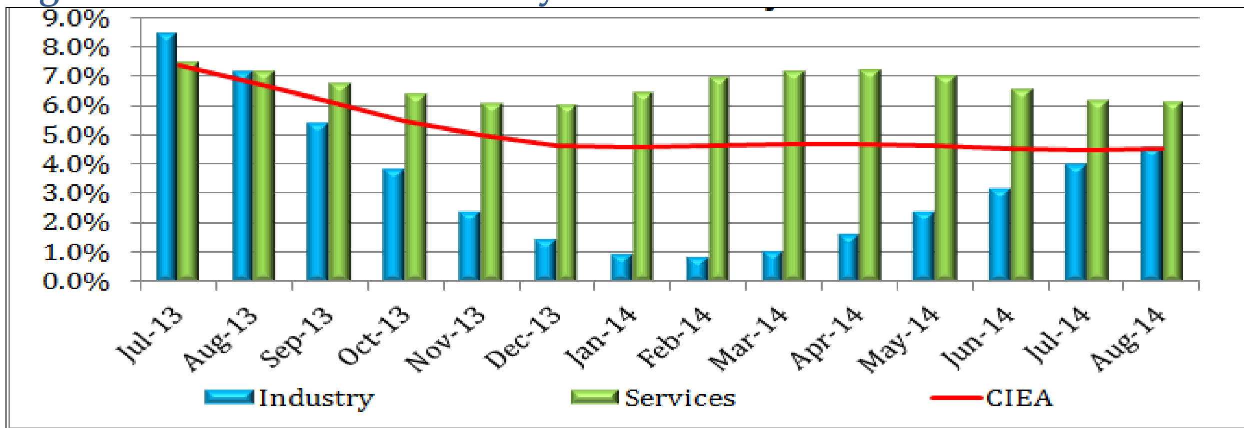
Figure 5: Expenditure constant prices, annual percentage changes



Source: Uganda Bureau of Statistics

The Composite Index of Economic Activity (CIEA) which is an estimate of GDP indicates stable economic performance since March 2014 due to sustained growth in output of the industrial sector and stable performance of the services sector as shown in figure 6.

Figure 6: Breakdown of CIEA by Sector



Source: BoU

3.6.1 Economic growth outlook

The outlook for FY 2014/15 is for acceleration of growth, projected at about 6 per cent, supported by public investment in infrastructure, private domestic consumption and investment demand (recovery in PSC growth), increased FDI; and rebound in agricultural production. There are substantial risks to growth emanating from both the domestic and external scene. Increased investment in infrastructure may require substantial domestic financing, but this may further constrain PSC.

In addition, over the projection horizon, potential GDP growth is expected to accelerate somewhat slowly, and therefore potential GDP is projected at around 6 per cent, only to increase above 7 per cent after 2018/19. The projected GDP growth in 2014/15 and 2015/16 of around 6 per cent could therefore result in the closing of output gap much faster and any further increase in aggregate demand could result in higher inflationary pressures. Table 4 indicates the likely evolution of some macroeconomic aggregates in the best-case scenario.

Table 4: Some Macroeconomic indicators

	FY2010/11	FY2011/12	FY2012/13	FY2013/14	FY2014/15
Total revenue and grants/GDP	15.3	13.1	12.9	13.0	14.4
Expenditure and net lending/GDP	18.9	15.6	16.5	16.7	21.0
Fiscal deficit/GDP	-3.6	-2.5	-3.6	-3.8	-6.5
Current account balance/GDP	-10.7	-9.1	-8.1	-5.8	-10.2
Public debt/GDP	27.8	23.3	26.6	28.9	38.4
Real GDP growth	9.7	4.0	3.3	4.5	6.1
Headline inflation	6.53	23.5	5.8	6.7	5.0
Core inflation	6.29	24.6	6.6	5.2	4.5

Source: BoU

4.0 CONSUMER PRICE INFLATION

4.1 Recent Inflation Developments

Overall, inflationary pressures have been weak as indicated in figure 7. Low current inflation results from both weaker conditions at home and abroad, as well as a number of supply-side factors. Annual inflation averaged 1.7 per cent in the three months to November 2014 compared to an average of 4 per cent in the three months to August 2014. Core inflation also edged lower, averaging to 2.2 per cent compared to 3.0 per cent in the same period. The flagging price growth was primarily driven by a decline in food prices related to good harvest of agricultural commodities at home and a drop in the global prices of agricultural produce. In the three months to November 2014 food prices declined on average by 2.4 per cent compared to an increase of 4.0 per cent in the three months to August 2014. Consumer price growth was further weakened by the easing of energy prices, due to a drop in global oil prices.

Another factor conducive to the lower inflation was the lack of demand and cost pressure, evidenced by falling prices of non-food products. Non-food inflation averaged 3.8 per cent in the last three months to November 2014 compared to 4.0 per cent in the three months to August 2014 and 4.3 per cent in the three months to May 2014.

Uganda is not the only country where inflation has fallen markedly in recent years. Inflation remains much below the inflation targets is many countries, notably in the majority of AEs and related EMEs. Indeed, part of the low inflation is due to low prices for imported consumer goods in spite of the exchange rate depreciation.

Figure 7: Recent Inflation Developments

Source: Uganda Bureau of Statistics

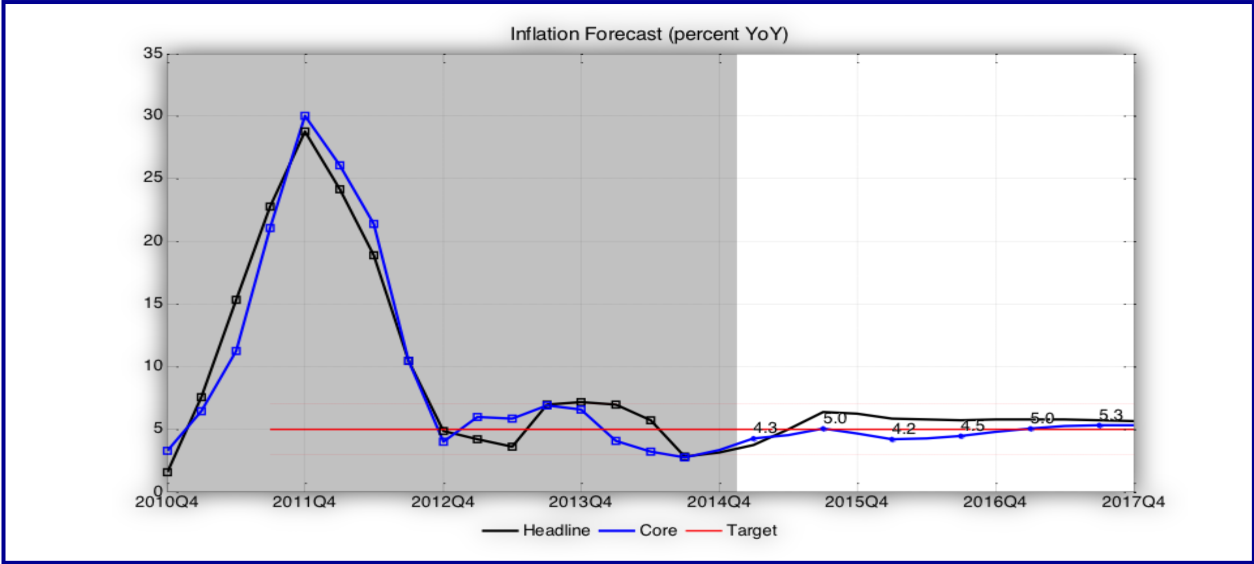
A significant fall in inflation is related mainly to external factors, such as fall in food and energy prices on the back of drop in commodity prices in the global markets. In particular, favourable weather conditions have contributed in recent quarters to higher supply of food crops and a decline in their prices. Generally, this decline in inflation is temporary. The nature of the sources of lower inflation indicates that it should not pose any risks to economic growth. Because, in spite of the broad-based price fall, it was mainly due to developments in prices of goods, with the growth in prices of services averaging 5.7 per cent in the eleven months of 2014 compared to the overall CPI average increase of 4.6 per cent. Bearing in mind that services are to a large extent non-tradables, this indicates that domestic factors might have been of less importance for disinflationary developments.

4.2 Inflation Outlook

Despite a gradual rise in subsequent quarters, inflation will run markedly below the inflation target until the second half of 2015 as shown in figure 8. In the near term, food prices will be the component with the strongest dampening impact on consumer price growth. Tax increases and the exchange rate depreciation are likely to push up inflation somewhat, but the still negative output gap would contain the impact. As the recovery in economic activity strengthens, this will gradually push up the prices of the main components of the consumer goods and services basket.

In the short to medium term, the positive supply shocks will be fading out, and consequently food crop price inflation will gradually rise. However, this rise will partly be moderated by subdued international food prices and therefore inflation would rise moderately. Inflation is forecast to edge up slightly but core inflation will remain around the target of 5 per cent in the forecast horizon.

Figure 8: Inflation forecasts



Source: BoU

4.3 Risks to Outlook

Both domestic and external risks weigh on the outlook.

4.3.1 Domestic risks

(a) Fiscal challenges

The key domestically sourced uncertainties surrounding the forecasts arise from uncertainty about public expenditure in light of the public investments in the near to medium term. The fiscal stance continues to focus on supporting economic activity by addressing the infrastructural constraints in the economy. Expenditure pressures could mount and there are indications of new commitments. Envisaged infrastructure projects include work related to hydropower dam (Ayago hydropower dam in addition to Karuma and Isimba hydropower dams), oil production (refinery, pipelines, access roads, and water and electricity access) as

well as a standard gauge railway (with a regional dimension) to facilitate access to the sea. These projects will be largely financed through non-concessional borrowing.

An increase in external debt also creates additional problems. Debt service has implied opportunity cost as a high proportion of public expenditure and foreign exchange earnings are absorbed. There is danger of using the headroom created by the improved debt indicators to increase domestic financing of the deficit as this may edge-up interest rates.

Fiscal deficit could to rise to about 7.2 per cent or higher in 2015/16 and to above 8.2 per cent in 2016/17 due to increase in public investment. Fiscal deficit (adjusted for public investment) will also rise on account of recurrent expenditure associated with public investment e.g. compensations etc. This could suggest a boost to aggregate demand and therefore a faster closing of the output gap. It could result in the increase of core inflation to about 8 per cent and this would warrant monetary policy tightening.

b) Prospects for real growth

Supported by sound policy implementation, the economic outlook is favorable with economic growth projected at 6.1 per cent, in FY 2014/15 expected to be driven by scaled-up public investment and a recovery in private demand as households and corporations deleverage and start accessing bank credit. Real GDP growth will be supported by FDI, and rebound in agricultural production. However, increased public investment in infrastructure may require substantial domestic financing, which may further constrain PSC. Exports might continue to underperform while imports could grow faster than exports, which mean that net exports will provide a negative contribution to GDP growth. Moreover, the worsening economic conditions abroad could have the strongest adverse effects on exports and gross fixed capital formation, hence, depressing economic growth. Overall, in the medium to longer-term horizon, on account of the gradual revival in global demand, the domestic economy is projected to post a stronger growth.

c) External payments position and the exchange rate

The CA continues to be weak, driven by higher import growth relative to export growth and

higher fiscal deficits. The external imbalance will continue influencing the exchange rate and as such the path of the exchange rate is an important source of uncertainty for the forecasts. The prospect of a rise in US interest rates next year, though widely anticipated, could lead to a further appreciation of the US$ and hence a depreciation of the Ugandan Sh. However, other things being equal, a further depreciation of the Sh would tend to support demand for Ugandan exports, thereby adding somewhat to growth. It would also lead to upward pressure on inflation, for a time. In addition, the increasing government foreign exchange requirements to meet public infrastructure expenditure needs may reduce foreign exchange reserves and increase the vulnerability of the BoP. There is also a risk of a build-up of private sector external debt, which could lead to the BoP vulnerability, with implications for exchange rate stability. Since May 2014, net portfolio flows have been negative, which could be indicative that the Sh may weaken further in the near-term.

4.3.2 External economic outlook and risks

The external environment remains less dynamic in terms of growth. Another main source of uncertainty to the inflation and GDP forecast are the future developments in the global economy, in particular, the recovery and sustainability in the euro area economy. Owing to structural problems, the current weakening in the region's economic activity may stretch further ahead in time. Owing to unfavourable external conditions, both GDP and inflation are more likely to run below the path envisaged by the baseline scenario.

In addition, weak global economic growth could cause equity prices to fall. This could trigger capital flight from risky assets, including those in EMEs and developing economies. Geo-political tensions and risks have led to a diversion of resources from productive activities, and may potentially disrupt oil production, cause financial market volatility and also reduce consumer confidence, which may dent prospects for global economic recovery. Thus, an environment of prolonged global economic weakness associated with persistent uncertainty remains possible.

Furthermore, there are numerous uncertainties about how events offshore will unfold, and exactly how policymakers and financial markets will respond. For example, if the flow of

data suggests that there is less spare capacity in the US economy than currently envisaged, interest rates might rise faster than markets expect, with implications for financial markets and exchange rate movements. The recovery in Japan or the Euro area could be slower than currently envisaged if the policy stimulus in these regions does not have the desired effect.

5 MONETARY POLICY DECISION

Inflation has remained subdued, with core inflation averaging 3.1 per cent between January and November 2014. Low current inflation is a result of both weaker conditions at home and abroad, as well as a number of supply-side factors. In the short to medium term, the positive supply shocks will be fading out, and consequently food crop price inflation will gradually rise. Moreover, as the recovery in economic activity strengthens, this will gradually push up the prices of the main components of the consumer goods and services basket. Outlook suggests that core inflation will fluctuate around BoU's medium term target of 5 per cent over the next two years.

In addition, the FY 2014/15 budget is more expansionary by 1.5 per cent of GDP, but budget implementation could be even more expansionary given the ambitious public investments. Real growth in FY 2014/15 is projected at 6 per cent and could result in faster closing up of the output gap. There is no strong evidence to show that demand will constrain output in the next two years.

The current monetary policy stance is broadly appropriate, but policy should remain nimble in responding to inflation risks. With the policy rate at 11 per cent, the monetary stance allows inflation to remain around the target in one to two years horizon. However, risks of higher inflation prevail due to possible: (i) larger-than-estimated pass-through and second round effects from currency depreciation; (ii) possible rebound of food crop prices (iii) larger-than-assumed fiscal impulses resulting from public investments and faster closing of the negative output gap. The BoU will continue to carefully assess developments and adapt the stance to the changing circumstances with the aim of maintaining inflation within its target.