Bank of Uganda

State of the Economy

September 2014

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Executive Summary

(i) Global economic activity remained benign in H1-2014, growing at a slower pace than earlier projected. The projected global growth for 2014 was revised downwards to 2.8 per cent - 3.4 per cent, but is expected to increase to 3.6 per cent and 3.7 per cent in 2015 and 2016, respectively. Advanced Economies remain the main source of growth, although the momentum in the Euro zone remains fragile. Growth in Emerging & Developing Economies also remains fragile.

(ii) Global inflation remains subdued in part owing to the abundant spare capacity, subdued demand, stable commodity prices as well as well-anchored inflation expectations. Notwithstanding the geo-political tensions in major oil producing regions, aaverage crude oil prices have remained relatively stable, with average Brent crude oil prices averaging US$100 - US$ 112 per barrel since the beginning of 2014.

(iii) Financial markets conditions remained relatively stable, with the ECB's 'easing' interventions providing some further relief. Notwithstanding the ongoing US tapering of its asset purchase program, monetary policy continued to be accommodative in advanced economies in general, with the ECB and Japan instituting a number of accommodative monetary policy measures in an effort to revamp output.

(iv) Bank of Uganda continued to pursue a cautious monetary policy stance aimed at stimulating output without jeopardising the inflation objective. The Central Bank Rate (CBR) was consequently reduced by 0.5 percentage points to 11 per cent in June 2014 and has since been maintained at that level. REPOs/reverse REPOs and outright sales of recapitalization securities in the secondary market were used for aligning liquidity conditions in the financial system with the desired monetary policy stance.

(v) The lending rate remained relatively stable averaging 21.7 per cent in the quarter to June 2014. Indeed, lending rates have remained sticky downward, declining only marginally in part reflecting asymmetry of the monetary policy transmission mechanism, lagged response to monetary policy impulses, structural rigidities in the financial sector and higher risk aversion by commercial banks on account of deteriorating banks' asset quality.

(vi) A notable recovery in growth of banks credit to the private sector has been observed since March 2014. For the year ending June 2014, annual growth in private sector credit rose to 14.1 per cent, which was very close to the projected growth rate of private sector credit of 14.7 per cent.

(vii) The fiscal stance in 2013/14 focussed on supporting economic activity by addressing the infrastructural constraints in the economy. However, cuts in donor disbursements coupled with an underperformance of tax revenue attributed to lower than projected growth in economic activity led to a wider fiscal deficit, which in part had to be financed increased issuance of government securities. The total stock of public debt as at end June 2014 rose to Shs. 18,877 billion, which is equivalent to 34.7 percent of GDP.

(viii) The fiscal deficit for FY2014/15 is expected to rise to 7.2 per cent of GDP on account of increased investment in infrastructure projects. Fiscal challenges though remain, as government financing requirements may be edged-up if new tax proposals and reforms instituted in the FY 2014/15 budget in attempt to increase tax revenue to match the increasing expenditure requirements do not raise the expected revenue. This will have implications for fiscal sustainability.

(ix) The Uganda Shilling appreciated by 2.0 per cent in 2014/15 compared to a depreciation of 1.4 percent in 2012/13. This appreciation during the year was largely driven by increased portfolio investment, which was supported by the positive interest rate differential given the relatively high yields on treasury securities compared to those in the international capital markets.

(x) The current account deficit, excluding official grants, narrowed to 7.8 percent of GDP during 2013/14, from a deficit of 9.6 percent of GDP recorded in 2012/13. The narrowing of the current account deficit was largely a result of an improvement in the services and income accounts. The financial account balance recorded a surplus of US$1,816.0 million from a surplus US$1,543.3 million in 2012/13. Foreign direct inflows increased from US$936.6 million in 2012/13 to US$ 1,081.0 million in 2013/14.

(xi) The overall balance of payments position was a surplus of US$387.7 million. However, the stock of reserves declined from US$3,391 million (equivalent to 4.8 months of future imports of goods and services) at end June 2014 to US$ 3,051 (equivalent to 4.1 months of future imports of goods and services) million at end August 2014, on account payment of 15 percent of the cost for the hydro-power projects.

(xii) Provisional estimates show weaker than expected growth in economic activity in 2013/14. Quarterly real GDP is estimated to have expanded at an average of 0.91 percent in the first three quarters of 2013/14, which is an annualised growth rate of approximately 3.6 percent. This is much lower than the 2012/13 growth rate of 6.0 per cent and the PSI projected rate of about 5.7 percent. The slow growth rate in part reflects the negative impact of the conflict in South Sudan and the delayed implementation of government infrastructural programs, particularly the construction of the hydropower dams. However, the outlook for 2014/15 is positive, with economic growth projected at about 6 percent, supported by scaling up of public investment in infrastructure and private domestic demand. Rising household wealth and improving credit conditions are projected to drive consumer spending and consequently business investment.

(xiii) Inflation has remains subdued, with annual headline inflation decelerating to 2.8 per cent in August 2014 from 7.1 per cent in March 2014 mainly driven by declining food prices due to improved supplies to the markets. Indeed, annual food inflation declined to minus 0.2 per cent from 12.7 per cent. Annual core inflation also remained subdued averaging 3.5 per cent since January 2014 largely on account of the relatively stable and appreciated exchange rate.

(xiv) Annual core inflation is expected to remain low over the coming months, before increasing gradually during 2015 and 2016 but remain within the Bank of Uganda' medium-term target of 5 per cent. Headline Inflation is also forecast to edge-up slightly but remain within the range of 5±3 per cent.

(xv) The outlook for inflation is subject to several risks emanating from both the external environment and the domestic economy. The global economic outlook remains subject to a considerable degree of uncertainty. The widespread weakness in the first quarter provided yet another example of disappointment regarding global growth outcomes. There are risks of oil price increases emanating from geo-political tensions in the Middle East, North Africa and Ukraine. Uganda largely depends on oil imports and therefore any price increases could feed through to domestic prices.

(xvi) Fiscal policy continues to be daunted by several challenges. Indeed, the underperformance of tax revenues and the need to finance infrastructure development remain a challenge. However, while spending on infrastructure has the benefit of boosting aggregate demand, fiscal expansion will worsen the already fragile external position. Uganda's external payments position continues to be vulnerable. Foreign exchange reserves have essentially been built from surpluses in the Capital and financial account.

(xvii) The direction of the monetary policy stance will continue to be guided by a carefully assessment of risks to the global and domestic economy and their implications for the overall outlook of domestic inflation. The BoU will continue to set a monetary policy stance that will ensure that core inflation is as close as possible to 5 per cent in the medium term and economic growth is consistent with the inflation objective.

1. External Economic Environment

1.1 Global Economic Activity

Global economic activity remained benign in H1-2014, growing at a slower pace than earlier projected. The projected global growth for 2014 was revised downwards to 2.8 per cent - 3.4 per cent, but is expected to increase to 3.6 per cent and 3.7 per cent in 2015 and 2016, respectively. Advanced Economies remain the main source of growth, although the momentum in the Euro zone remains fragile. The eurozone's economy is projected to have remained stagnant in Q2-2014, the second consecutive quarter of slowdown, and an increase of just 0.7 per cent from the corresponding quarter of 2013. The on-going fragile nature of the up-turn in economic activity in the eurozone remains too weak to encourage companies to take on additional labour in sufficiently large numbers to have any meaningful impact on unemployment, which indeed is projected to remain relatively high. Indeed, this prompted the European Central Bank (ECB) to provide additional stimulus to boost growth and inflation.

In the United States, growth rebounded 4.2 per cent year-on-year in Q2 2014, after a decline of 2.1 per cent in Q1-2014. This rebound is attributed to increased personal and government consumption, investment and exports; amidst the fading impact of temporary factors that adversely affected the economy at the beginning of 2014. In the UK growth remained buoyed by rising household confidence and the vibrant housing market.

Growth in Emerging & Developing Economies remains fragile. The projected growth in these economies in 2014 has been revised down to 4.6 per cent from the earlier projection of 4.8 per cent, in part due eventual tight global financial conditions, low commodity prices, softening growth in China, the continued economic weakness in Brazil, and the dampening in confidence associated with the increasing number of geopolitical hotspots around the world and uncertainty about developments in key emerging market economies on account of the continued fragilities in these economies. The productivity gains in emerging market economies during the last decade also seem to have faded and the global environment is increasingly becoming less supportive of growth in emerging markets. If growth in these economies is to be sustained, a new wave of structural reforms may be necessary.

1.2 Global inflation and commodity prices

Global inflation remains subdued but with diverse trends across the development divide. In advanced economies, inflation remained subdued in part owing to the abundant spare capacity, subdued demand, stable commodity prices as well as well-anchored inflation expectations. Inflation in the Eurozone and some advanced economies remains below the respective central banks' medium-term policy targets, which poses serious risks, if longterm inflation expectations drift down, raising deflation risks in the event of a serious adverse shock to economic activity.

Notwithstanding the geo-political tensions in major oil producing regions, aaverage crude oil prices have remained relatively stable, with average Brent crude oil prices averaging US$100 - US$ 112 per barrel since the beginning of 2014. Global food prices have also remained relatively soft. Global inflation is projected to remain subdued through 2015 as global spare capacity remains abundant and international commodity prices remain relatively stable.

1.3 Global financial markets

Financial markets conditions remained relatively stable, with the ECB's 'easing' interventions providing some further relief. Notwithstanding the ongoing US tapering of its asset purchase program, monetary policy continued to be accommodative in advanced economies in general, with the ECB and Japan instituting a number of accommodative monetary policy measures in an effort to revamp output. These accommodative policies drove down bond yields in these economies, which in part encouraged carry trade to relatively high-yield assets in emerging and developing market economies. Consequently, exchange rates and equity prices in emerging and developing economies remained relatively stable.

1.4 Risks to the global economy

The global economic outlook is still subject to a considerable degree of uncertainty and developing countries including Uganda remain vulnerable to the volatility in global economic environment, which has implications for growth and inflation. The international spill-overs from the future unwinding of the monetary easing by major developed economies; vulnerabilities of emerging economies on both external and domestic fronts; remaining fragilities in the euro area; unsustainable public finances in the longer run for many developed countries; and risks associated with geopolitical tensions and terrorism constitute serious challenges for the global economy.

Although relative stability in the global financial system was observed in the preceding period, financial markets remain vulnerable to instability. While the United States is gradually exiting unconventional expansionary monetary policies, the Eurozone is introducing more unconventional expansionary monetary policies. Emerging market and developing economies are likely to see more volatility in financial markets. A key concern is that current unconventional policies have allowed a build-up of financial sector imbalances and have fuelled a steep rise in asset prices. In time, these imbalances may cause sudden price reversals and sharp spikes in volatility leading to another crash at a time when the world is less capable of bearing the cost. Exchange rate volatility also poses significant risks to growth and stability of financial markets in Emerging and Developing economies. The extent of these risks will depend, in part, upon how the normalization of monetary policies in advanced economies is conducted and coordinated.

The normalization of monetary policy in Advanced Economies will reduce financial flows to emerging and developing economies, which in turn will dent investment and growth prospects in these economies. The tighter global financial conditions will lead to weaker financial flows which will raise the cost of capital in emerging & developing countries, thus impeding growth. Uganda being a small open economy with substantial financial and real linkages with the global economy is prone to these risks.

The geopolitical tensions and the threat of terrorism remain elevated, including the conflicts in the Middle East, Russia and Ukraine. This could have significant impact on consumer and business confidence, such that investors and consumers hold back on spending, which could reduce aggregate demand thereby constraining global growth with adverse implications for exports. Secondly, a physical disruption of energy supply on account of the raging conflicts may push-up international oil prices, posing a risk to global and domestic inflation and growth prospects.

2. Domestic Economic Developments

3.1 Reflections of Previous Monetary Policy

2.2.1 Monetary Policy Stance

Bank of Uganda continued to pursue a cautious monetary policy stance aimed at stimulating output without jeopardising the inflation objective. The Central Bank Rate (CBR) was consequently reduced by 0.5 percentage points to 11 per cent in June 2014 and has since been maintained at that level. The neutral monetary policy stance has delivered stable interest rates that are likely to lead to increased borrowing, as commercial banks expect to ease credit standards. This stance was premised on the projected inflation and output path. Real GDP growth for FY 2013/14 was projected at 4.7 per cent, which is below the economy’s potential, but is projected to recover over the short-to-medium term, mainly supported by the recovery in private sector credit growth and public investment on infrastructure.

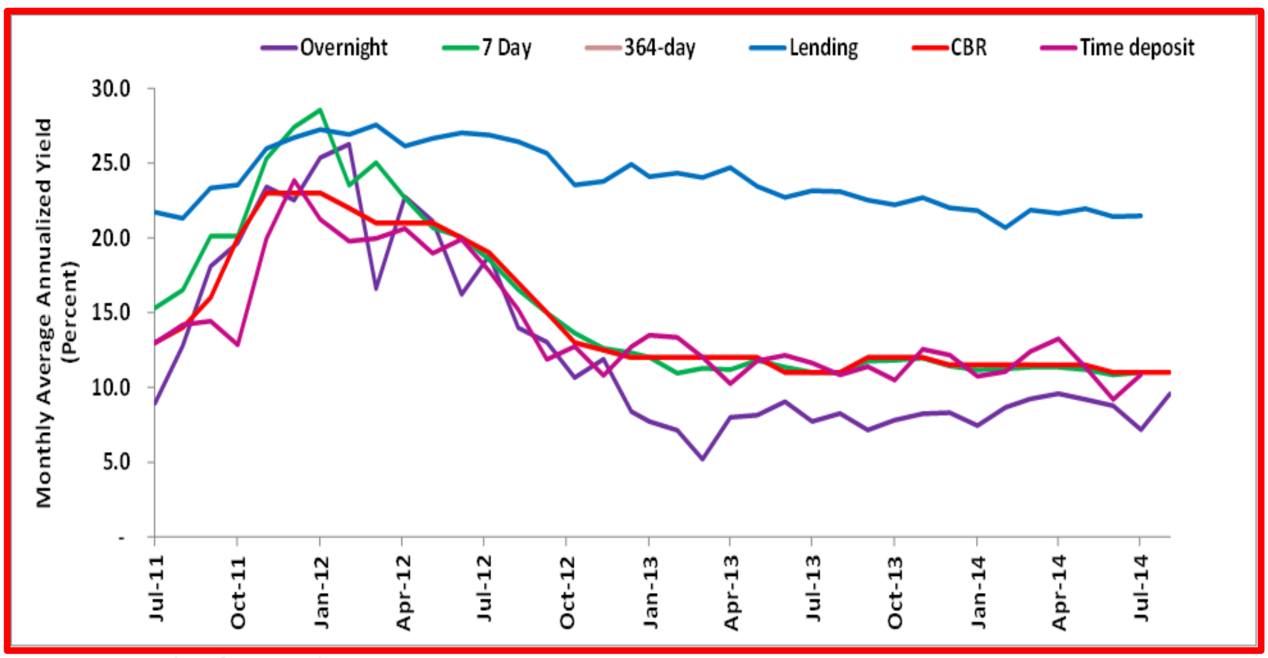
Inflation remained subdued, with core inflation averaging 3.5 per cent since January 2014 and the outlook suggests that core inflation will fluctuate around BoU’s medium term target of 5 per cent over the next two years. Nonetheless, there are potential risks of stronger inflationary pressures emanating from a mix of factors pertaining to the likely exchange rate depreciation, growth acceleration and the spill-overs from the volatile international economic environment, which may change the inflation trajectory over the near-to-short term. Maintaining a cautious monetary policy stance was therefore critical to supporting the resilience of the economy against current uncertainties and supporting growth.

2.2.2 Monetary Policy Implementation

The Bank of Uganda continued to use REPOs/reverse 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. During the three months to August 2014, the bank issued repos and also sold recapitalization securities in order to fine-tune liquidity conditions and align the 7-day interbank money market rate with the CBR. The outstanding REPO stock at end of August 2014 was Shs. 666.0 billion while the outstanding stock of recapitalization securities was Shs. 370.3 billion.

During this period, interbank money market rates remained consistent with the monetary policy stance despite the structural liquidity overhang, which was in part moderated using REPOs. Overall, the reductions in the CBR has gradually been passed through to the spectrum of other interest rates, save for the lending rate which remain sticky as shown in **Figure 1**.

Figure 1: CBR and other interest rates in the economy



Source: Bank of Uganda

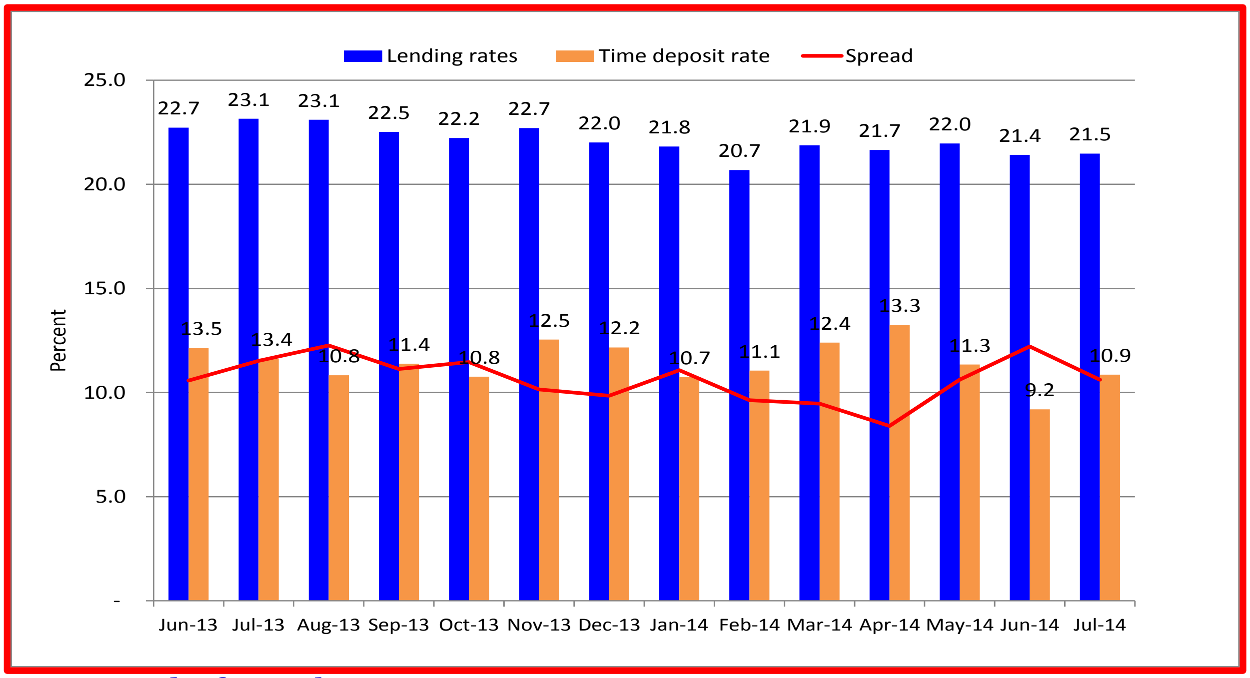
3.2 Interest rates and private sector credit

2.2.1 Interest rates

Government bond yields have declined. Growth in lending has picked up, with building, mortgage, construction and real estate; trade and personal loans credit growth increasing over recent months. The weighted average lending rate (WALR) on Shs. denominated loans remained relatively stable averaging 21.7 per cent in the quarter to June 2014. Indeed, lending rates have remained sticky downward, declining only marginally in part reflecting asymmetry of the monetary policy transmission mechanism, lagged response to monetary policy impulses, structural rigidities in the financial sector and higher risk aversion by commercial banks on account of deteriorating banks' asset quality. Nonetheless, the ratio of non-performing loans to total loans (NPL) declined to 5.8 per cent in June 2014 from 6.2 per cent in March 2014, indicating an improvement in asset quality. Interest rates on shilling time deposits also remained relatively stable, averaging 11.3 per cent since January 2014.

The WALR on foreign currency denominated loans also remained stable declining only marginally to 9.3 per cent in the quarter to June from 9.5 per cent in March 2014. Developments in lending and deposit rates are shown in **Figure 2**.

Figure 2: Lending rates and Time deposit rates



Source: Bank of Uganda

2.2.2 Private sector credit

After a prolonged period of sluggish growth, a notable recovery in growth of banks credit to the private sector has been observed since March 2014. The average annual growth in private sector credit rose to 12.7 per cent in the quarter to June 2014 from 7.8 per cent in the quarter to March 2014, mainly driven by increase in lending to households, agriculture and building & construction sectors. For the year ending June 2014, annual growth in private sector credit was 14.1 per cent, which was very close to the projected growth rate of private sector credit of 14.7 per cent. Developments in private sector credit are shown in **Table 1**.

Table 1: Sectoral Developments in Private Sector Credit

	Annual Growth Rate (Quarterly averages)		Share of total credit	NPLs
Sectors	**Jan-Mar 2014**	**Apr-Jun 2014**	**Jun 2014**	**Jun 2014**
Building, Mortgage, Construction & Real Estate	6.2	12.9	22.7	*5.7*
Trade	0.7	14.2	21.6	*6.9*
Personal Loans & Household Loans	44.1	42.8	17.2	*3.1*
Manufacturing	8.6	8.5	13.2	*4.4*
Agriculture	15.8	30.6	9.6	*7.3*
Transport & Communication	-10.8	-1.7	5.4	*2.4*
Business Services	12.4	2.5	4.4	*4.6*
Community and Social Services	12.2	21.0	3.3	*8.4*
Electricity & Water	0.7	2.8	1.2	*4.4*
Mining & Quarrying	-14.7	-3.7	0.2	*29.3*
Other activities	-45.2	-64.3	1.4	*38.9*
Total	**7.8**	**12.7**	**100.0**	***5.8***

Source Bank of Uganda

The rebound in private sector credit growth is expected to bond well with private consumption and investment activity, which should in turn support economic growth going forward.

3.3 Fiscal Developments

The fiscal stance in 2013/14 focussed on supporting economic activity by addressing the infrastructural constraints in the economy. However, cuts in donor disbursements coupled with an underperformance of tax revenue attributed to lower than projected growth in economic activity led to a wider fiscal deficit, which in part had to be financed increased issuance of government securities. Accordingly, the government stepped up issuances of government securities from the programmed Shs. 1,040 billion to Shs. 1,715 billion.

However, because of the construction of the Karuma hydropower project, the fiscal deficit as a percentage of GDP was 4.4 per cent relative to the budgeted deficit of 4.9 per cent.

The total stock of public debt as at end June 2014 rose to Shs. 18,877 billion, which is equivalent to 34.7 percent of GDP. The stock of domestic debt increased from Shs. 6,083.0 billion in June 2013 to Shs. 7,728.1 billion in June 2014. As a ratio of GDP, it rose from 11.9 percent in June 2013 to 13.8 percent in June 2014. The stock of external debt also increased from US$ 3.8 billion in June 2013 to US$ 4.3 billion in June 2014. As a ratio of GDP, it rose from 17.8 percent to 20.9 percent during the same period of time. Total external debt service of both principal and interest payments amounted to US$ 51.0 million and US$ 34.6 million respectively in 2013/14, compared to US$ 42.4 million and US$ 27.5 million in 2012/13.

The provisional total public debt stock (at nominal value) as at end July 2014 stood at Shs. 19,780 billion, an increase of 2.3 percent relative to June 2014. The debt sustainability analysis (DSA) for June 2014 indicated that Uganda remains at a low risk of debt distress. Debt service-to-revenue ratio was however high, averaging a projected 35.6 percent in 2014-2019, owing to the relatively short maturity profile of domestic debt, which poses a fiscal risks to the economy.

The budget for FY 2014/15 is more expansionary. Total expenditure during the year is projected to amount to 22.6 percent of GDP compared with 19.7 percent in 2013/14 and to about 29 percent for SSA average and about 27 percent for EAC countries. Fiscal deficit is projected at 7.2 percent of GDP. Total expenditure is projected at Shs. 15,585.0 billion [15.4% of GDP], of which Shs. 3,193.1 billion will be development expenditure excluding Karuma, which is projected at Shs. Shs. 1,096 billion. Tax revenue is projected at Shs. 9576.6 billion, about 13.1 percent of GDP. Tax to GDP ratio has averaged about 12 percent over the last 10 years.

Tax enhancing measures were introduced to broaden the tax base and additional taxes were also introduced. Domestic financing through issuance of Government securities will amount to Shs. 1,380 billion (2.0% of GDP) while foreign financing will amount to Shs 2,578 billion (3.6%). Non-wage expenditure is likely to be higher than projected as on account of the political business cycles. The net impact of this will be increased domestic financing needs. If the tax reforms do not yield the projected increase in tax revenue, then government financing requirements may be edged-up, with implications for interest costs. Indicators of fiscal operations are shown in **Table 2**.

Table 2: Fiscal Developments

	2011/12	2012/13	Proj 2013/14	Budget 2014/15
Revenue and grants	15.6	14.9	14.8	15.4
Domestic Revenue (incl. oil)	13.3	13.2	13.6	13.6
Tax revenue	12.3	12.9	13.4	13.1
Total expenditure excl. domestic arrears repayment	18	18.1	19.7	22.6
Total expenditure incl. domestic arrears repayment	18.6	18.8	19.7	22.6
Gross operating balance	1.2	1.5	0.5	0.4
Primary balance	-1.8	-2.4	-3.1	-2.7
Budget deficit excl. grants	-5.3	-5.7	-6.1	-8.9
Budget deficit incl. grants	-3	-4	-4.4	-7.2
Domestic financing (net)	0	-1.3	-2.8	-3.6
External borrowing (net)	-2.3	-2.6	-1.9	-3.6

Source: Ministry of Finance, Planning and Economic Development

New tax proposals and reforms were instituted in the FY 2014/15 budget in attempt to increase tax revenue to match the increasing expenditure requirements. If these reforms do not yield the projected increase in tax revenue, then government financing requirements may be edged-up and this will have implications for fiscal sustainability. In 2014/15, the PSI program capped issuance of domestic debt at Shs.1.4 trillion and this includes a contingency reserve of Shs. 200 billion and an increase in Deposits at BoU by Shs. 138 billion. Any deviation from these targets will constitute a breach of the PSI program. Given that the government is planning to embark on a number of ambitious infrastructural projects, it is highly unlikely that these PSI targets will be met.

3.4 Exchange Rates and Balance of Payments

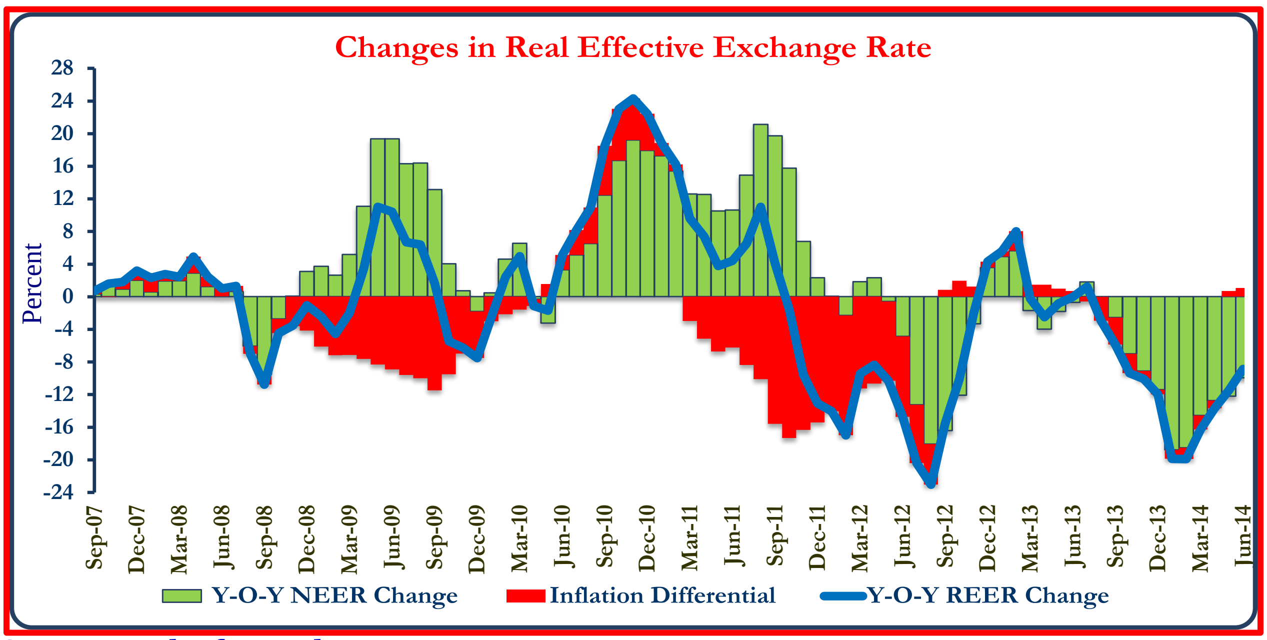
2.4.1 Exchange rate Developments

The BoU continues to operate a flexible exchange rate policy and only intervenes in the foreign exchange market in order to dampen exchange rate volatility. The Uganda Shilling appreciated by 2.0 per cent in 2012/13 compared to a depreciation of 1.2 percent in 2012/13. This appreciation during the year was largely driven by increased portfolio investment, which was supported by the positive interest rate differential given the relatively high yields on treasury securities compared to those in the international capital markets.

The Uganda shilling appreciated by 0.8 per cent in August 2014 mainly on account of inflows from offshore players, coffee proceeds and NGOs. In order to stem exchange rate volatility, BoU intervened on the sale side with US$ 40 million and suspended purchases of foreign currencies for reserve build-up purposes on days when the volatility was high. Overall BoU's actions in the IFEM during the first two months of 2014/15 resulted in a net purchase of US$ 71.1 million.

The Nominal Effective Exchange Rate (NEER), which measures the relative value of the Shilling against a trade-weighted basket of currencies of Uganda's major trading partners, also continued to strengthen, appreciating by 1.3 per cent month-on-month in August 2014 and by 1.2 per cent year-on-year, as shown in **Figure 3**. The Real Effective Exchange Rate (REER) which is derived by adjusting the NEER for inflation differentials between Uganda and its trading partners appreciated by 10.1 per cent.

Figure 3: Nominal and Real Effective Exchange Rate



Source: Bank of Uganda

The current exchange rate of Shs. 2,612 per US Dollar is slightly below the long-run steady state rate of Shs. 2,700-2800 per US Dollar. However, given a widening current account any shocks to the financial and capital account of the Balance of payments may lead to depreciation pressures that will create a major upside risk for inflation. While the recent depreciation is more a reflection of changing global risk perceptions rather than a specific re-assessment of Ugandan fundamentals, domestic factors have also affected the shilling.

The exchange rate is likely to remain sensitive to domestic factors, including developments in the current account of the balance of payments and perceptions of its sustainability and changing global perceptions.

2.4.2 Balance of payments

The current account deficit, excluding official grants, narrowed to 7.8 percent of GDP during 2013/14, from a deficit of 9.6 percent of GDP recorded in 2012/13. The narrowing of the current account deficit was largely a result of an improvement in the services and income accounts. The services account improved to a surplus of US$3.7 million in 2013/14 from a deficit of US$356.2 million in 2012/13 as a result of higher receipts from travel and other business services. The deficit on the income account improved by 32.5 per cent to US$484.8 million in 2013/14 from US$718.3 million in 2012/13 mainly on account of lower payments of dividends on FDI.

The trade deficit widened by 11.4 per cent, from US$2,123.0 million in 2012/13 to US$2,365.5 million in 2013/14 on account of lower export earnings. The widening of the trade deficit was driven by lower coffee export proceeds owing to declining coffee prices and lower earnings from informal cross border trade arising from disruptions in trade caused by the conflict in South Sudan. Net current transfers were estimated at US$1,220.08 million during 2013/14 compared to US$1,481.9 million recorded in the previous fiscal year, reflecting cuts in donor funds. The capital account balance was recorded at US$92.5 million in 2013/14 compared to US$32.7 million in 2012/13.

The financial account balance showed an improvement of US$272.7 million to a surplus of US$1,816.0 million during 2013/14 from a surplus US$1,543.3 million in 2012/13. Foreign direct inflows increased by US$144.4 million from US$936.6 million in 2012/13 to US$ 1,081.0 million in 2013/14. Portfolio investment recorded a net inflow of US$47.9 million. The other investment inflows increased by US$99.9 million during the year mainly driven by draw downs of commercial banks' foreign assets holdings. The overall balance of payments position was a surplus of US$387.7 million. This was on account of improvements in both the current and financial accounts. Developments in the Balance of Payments are shown in **Table 3**.

Table 3: Developments in the Balance of Payments

	2009/10	2010/11	2011/12	2012/13	2013/14
A. Current Account Balance (A1+A2+A3+A4)	-1,510.47	-1,753.25	-2,050.74	-1,715.61	-1,626.53
A1. Goods Account(Trade Balance)	-1,799.54	-2,373.35	-2,581.07	-2,122.96	-2,365.49
a) Total Exports (fob)	2,317.30	2,297.77	2,660.41	2,912.11	2,679.71
b) Total Imports (fob)	4,116.84	4,671.12	5,241.48	5,035.07	5,045.20
A2. Services Account (net)	-487.55	-627.29	-412.27	-356.23	3.70
A3. Primary Income Account (net)	-340.94	-342.92	-471.86	-718.27	-484.83
A4. Secondary Income Account (current transfers)	1,117.57	1,590.32	1,414.45	1,481.85	1,220.08
a) Inflows	1,478.12	1,848.29	1,622.42	1,632.22	1,441.71
b) Outflows	360.54	257.97	207.96	150.37	221.63
B. Capital Account (capital transfers)	0.00	0.00	17.60	32.74	92.48
C. Financial Account; excluding financing items	1,541.51	812.16	2,120.07	1,543.27	1,816.01
Direct Investment (net)	690.66	717.52	1,213.38	936.56	1,080.97
Portfolio Investment (net)	31.26	2.09	264.67	19.90	47.88
Financial Derivatives (net)	5.34	2.74	12.32	0.76	1.24
Other Investments (net)	887.45	95.29	629.70	586.05	685.92
D. Errors and Omissions	198.54	335.13	659.63	477.64	105.77
E. Overall Balance (A+B+C+D)	229.58	-605.96	746.55	338.05	387.72
F. Reserves and related Items	229.58	-605.96	746.55	338.05	387.72
Reserve Assets[1]	216.97	-609.56	741.09	332.29	381.70

Note:
Sign (+): increase in reserves, sign (-): decrease in reserves.

Source: Bank of Uganda

The stock of reserves declined from US$3,391 million (equivalent to 4.8 months of future imports of goods and services) at end June 2014 to US$ 3,051 (equivalent to 4.1 months of future imports of goods and services) million at end August 2014, on account payment of Karuma expenditure.

Going forward, in 2014 – 2016, imports are projected to grow faster than exports, resulting in a negative contribution of net exports to GDP growth. In the near-to-short term, the current account (CA) deficit is likely to widen due to increase in government and private sector imports, coupled with lower exports of commodities due to off-season effects. This could be however be moderated by strong inflows of FDI and remittances and positive economic growth in AEs which may improve inward personal transfers, NGO inflows and donor support inflows to government. The reserve position is projected to decline US$2,850.6 million (equivalent to 3.9 months of import cover) on account of planned Government expenditure on energy projects (US$424 million). To stem the decline in reserves the BOU will make daily foreign currency purchases of US$4.0 million throughout the FY2014/15, which will result in a build-up of about US$62 million. This will provide a buffer for intervention during periods of instability in the financial year.

The current account deficit will continue to persist over the medium term, but its impact on exchange rate stability will depend on the sustainability of the financing through the surpluses in the capital and financial account. Intermittent volatility in international financial markets and developments in regional economies, may therefore continue to cause volatility in portfolio flows which will consequently cause exchange rate volatility.

3.5 Real economic activity

Provisional estimates show weaker than expected growth in economic activity in the first half of 2013/14. Quarterly real GDP is estimated to have expanded at an average of 0.91 percent in the first three quarters of 2013/14, which is an annualised growth rate of approximately 3.6 percent. This is much lower than the 2012/13 growth rate of 6.0 per cent and the PSI projected rate for 2013/14 of about 5.7 percent. The slow growth rate in part reflects the negative impact of the conflict in South Sudan and the delayed implementation of government infrastructural programs, particularly the construction of the hydropower dams.

The outlook for domestic growth is not materially different from that presented in the June state of the economy report. It continues to reflect the opposing forces of the decline in exports on the one hand, and the strong growth in private sector credit, public expenditure, imports of goods for both consumption and investment on the other. GDP growth is expected to be a little below average over 2014/15 and then pick up gradually to the potential economic growth pace.

Economic growth for 2014/15 is projected at about 5 - 5.5 per cent, increasing to 6.0 per cent in 2016 and to the economy's potential GDP growth of 7.0 per cent in 2017-18. This growth will be supported by scaling-up of public investment in infrastructure and private domestic demand, which is expected to strengthen, as rising household incomes and improving growth conditions are projected to drive consumer spending. Over the last twelve months, lending interest rates have declined somewhat and private sector credit has picked up strongly. These stimulatory financial conditions continue to have the expected effects on the economy as reflected in the strengthening of private consumption growth-growth in import demand. Going forward, the prospects are for the growth momentum to be sustained, anchored by domestic demand and the improved external environment.

This outlook however remains sensitive to downside risks emanating from a mix of factors pertaining to uncertainty in global financial markets and the likely tightening global financial conditions, lower international commodity prices, and the continued geo-political tensions in the Middle-East and Eastern Europe. The key uncertainties for the domestic economy continue to be centred on the timing and extent of the pickup in domestic investment and how this is balanced by the weak exports. Domestic demand could be stronger than expected. In addition, there are external risks as the global economic outlook remains subject a considerable degree of uncertainty.

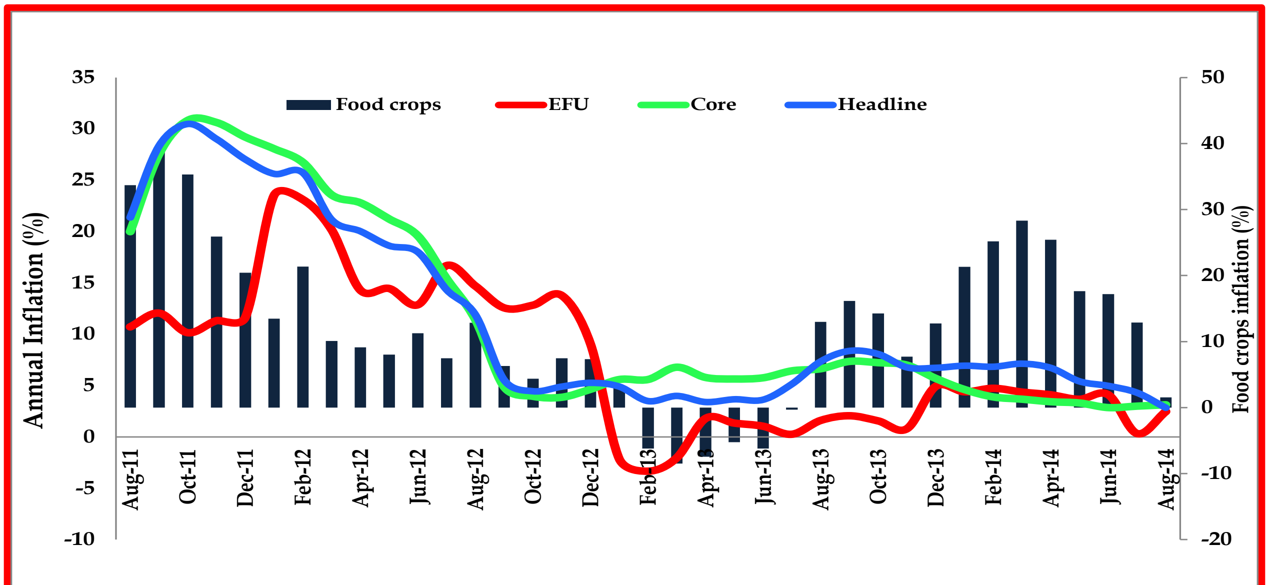
3.6 Consumer Price Inflation

2.6.1 Recent inflation developments

Inflation has remains subdued, with annual headline inflation decelerating to 2.8 per cent in August 2014 from 7.1 per cent in March 2014 mainly driven by declining food prices due to improved supplies to the markets. Indeed, annual food inflation declined to minus 0.2 per cent from 12.7 per cent over the same period. Annual core inflation also remained subdued averaging 3.5 per cent since January 2014. Core inflation has been "kept at bay" by the relatively stable and appreciated exchange rate as the "other goods" inflation which is a proxies traded inflation has remained low, averaging 1.1 per cent over the same period.

The services inflation, which can be used as a proxy for non-traded inflation has remained relatively elevated, averaging 6.2 per cent since Jan'14, possibly indicating that domestic demand may be strong. Developments in annual inflation are shown in Figure 4.

Figure 4: Annual Inflation Developments



Source: Uganda Bureau of Statistics

2.6.2 Inflation outlook

Going forward, annual core inflation is expected to remain low over the coming months, before increasing gradually during 2015 and 2016 but remain within the Bank of Uganda' medium-term target of 5 per cent. Headline Inflation is also forecast to edge-up slightly but remain within the range of 5±3 per cent. Nonetheless, there are substantial risks that may make inflation to deviate from this trajectory. The likely exchange rate depreciation, together with sector specific shocks may continue to exert upward pressure on core. However, excess capacity in the economy, on account of lower than potential GDP growth may offer some moderating impact on the up-ward pressures on inflation.

The outlook for inflation is however subject to several risks emanating from both the external environment and the domestic economy. Nonetheless, the risks to the projected output and inflation path emanating from both the global and domestic economic environment appear to be roughly balanced.

3. Risks to Outlook and Implications for Monetary Policy

3.1 External Economic Environment

The global economic outlook remains subject to a considerable degree of uncertainty. The widespread weakness in the first quarter provided yet another example of disappointment regarding global growth outcomes. A period of protracted global economic weakness associated with pervasive uncertainty, chronically deficient demand and weaker potential GDP growth would lead to lower inflation. The continued underperformance of exports on account of subdued global economic activity could translate into slower growth in business investment. Weaker investment coupled weak exports pose a downside risk to growth.

On the other hand, as the global economy rebounds, confidence could improve more rapidly, particularly in the USA, boosting investment and employment and spurring trade, leading to a virtuous circle of self-sustaining growth, which would in turn drive-up commodity prices and global inflation which would feed-through to domestic inflation.
Growth in EMEs could disappoint. There is a risk that the weakness in other EMEs will persist longer than currently expected. A sudden worsening of financial conditions and a reversal in capital flows if market sentiments change could aggravate the already fragile conditions. These shocks could spill over into the Ugandan economy through weaker exports, lower commodity prices and deterioration in terms of trade.

There are risks of oil price increases emanating from geo-political tensions in the Middle East, North Africa and Ukraine. Geopolitical events, such as the conflicts in Syria, Iraq, Libya, South Sudan and Nigeria could lead to a significant supply disruption in oil markets.

An intensification of these conflicts, or other events that could disrupt production, would put upward pressure on prices cause adverse effects on global economic growth. Uganda largely depends on oil imports and therefore any price increases could feed through to domestic prices. These downside and upside risks to the global economy would be played out in parallel in Uganda through impacts on commodity prices, Ugandan exports, terms of trade and confidence effects on private domestic demand.

3.2 Domestic economic environment

On the domestic scene, risks emanate from the current expansionary fiscal stance, weak and vulnerable external position and the fragile growth prospects. These risks are discussed below.

3.2.1 Fiscal policy challenges

The main source of uncertainty remains the fiscal side. Fiscal policy continues to be daunted by several challenges. The timing of the planned and budgeted projects and implementation of other projected not included in the budget may cause a challenge for monetary policy implementation. Indeed, the underperformance of tax revenues and the need to finance infrastructure development remain a challenge. However, while spending on infrastructure has the benefit of boosting aggregate demand, fiscal expansion will worsen the already fragile external position.

The expansionary fiscal stance also poses a challenge of crowding out private investment from the domestic credit market if it is finance through increased issuance of Government securities. Domestic financing of the FY 2013/14 budget through issuance of Government securities amounted to Shs 1.715 trillion. Domestic Financing for FY 2014/15 is planned at 1.38 trillion (2 per cent of GDP). This may constrain growth in PSC – crowding out the private sector in the domestic credit market – which may constrain growth.

3.2.2 External payments position and the Exchange rate

Uganda's external payments position continues to be vulnerable. Foreign exchange reserves have essentially been built from surpluses in the Capital and financial account – funded by aid inflows, foreign direct investment and portfolio inflows- as the CAB continues to be in deficit. The stock of reserves declined from US$3,391 million (equivalent to 4.8 months of future imports of goods and services) at end June 2014 to US$ 3,051 (equivalent to 4.1 months of future imports of goods and services) million at end August 2014, on account payment of Karuma expenditure. The reserves could actually decline further if a host of other infrastructure projects are implemented.

There is also a risk of a build-up of private sector external debt, which could lead to balance of payments vulnerability, with implications for exchange rate stability. The subdued inflation is largely a result of the appreciated exchange rate. Exchange rate depreciation could change the trajectory of inflation over the near-to-short term. The risks regarding the exchange rate therefore warrant a more cautious monetary policy stance. Furthermore, the exchange rate is now close to equilibrium and expectations are for a stable exchange rate. However, given a widening current account any shocks to the financial and capital account of the Balance of payments may lead to depreciation pressures that will create a major upside risk for inflation.

3.2.3 Prospects for real growth

For the inflation target to be achieved on a sustained basis, the economy will first have to reach and then remain at full capacity. Real GDP growth is projected to average between 5-5.5 per cent in both 2014 and 2015, rising to about 6.0 in 2016 and to about 7.0 per cent in 2017-18—the growth rate of the economy's potential output. Given the degree of uncertainty inherent in projections, the annual GDP growth will likely be within ±0.5 percentage points of the base-case projection.

Private consumption is expected to gain some momentum in the course of 2014/15, as real incomes increase on account of low inflation. Domestic demand seems to be gaining momentum, in part as evidenced by the growth in imports of consumer goods which averaged to 2.2 per cent in H1- 2014 compared with minus 0.56 per cent in H2-2013, while the imports of capital and intermediate goods rose by 5.4 per cent compared with 2.7 per cent in the same period. In the short-to-medium term, imports will grow faster than exports, which means that net exports will provide a negative contribution to GDP growth. A cautious monetary policy stance is therefore desirable.

4. Conclusion

Inflation has remained subdued with core inflation remaining within the bands of BoU's medium-term target of 5 per cent plus/minus 2 percentage points. The outlook suggests that core inflation will fluctuate around BoU's medium term target of 5 percent over the next two years reflecting the ongoing spare capacity. Nonetheless there are both macroeconomic and structural factors that could cause inflation do deviate from target. Robust recovery in aggregate demand and the possible depreciation of the exchange rate could push up import prices.

Although real growth for 2013/14 is projected to be lower than historical average, it is expected to recover over the short- to-medium term mainly supported by recovery of private sector credit and increased investment in public infrastructure. Nonetheless, there are risks to both the projected inflation and output path. However, since the risks to inflation are broadly balanced, it is important that a cautious monetary policy stance be maintained in order to support growth while at the same time cushioning the economy against uncertainties. Going forward, the direction of the monetary policy stance will continue to be guided by a carefully assessment of risks to the global and domestic economy and their implications for the overall outlook of domestic inflation. The BoU will continue to set a monetary policy stance that will ensure that core inflation is as close as possible to 5 per cent in the medium term and economic growth is consistent with the inflation objective.