Bank of Uganda

Current State of the Economy

December 2015

ACRONYMS AND ABBREVIATIONS

AEs	Advanced Economies
BoP	Balance of Payments
BoU	Bank of Uganda
CA	Current Account
CBR	Central Bank Rate
EAC	East African Community
ECB	European Central Bank
EFU	Electricity, Fuel and Utilities
EMEs	Emerging Market Economies
EMDEs	Emerging Market and Developing Economies
FAO	Food and Agriculture Organization
FDI	Foreign Direct Investment
Fed	Federal Reserve Bank
FOB	Free on Board
FY	Financial Year
GDP	Gross Domestic Product
HPPs	Hydro Power Projects
IFEM	Interbank Foreign Exchange Market
MENA	Middle East and North Africa
MoFPED	Ministry of Finance Planning and Economic Development
NDP	National Development Plan
NEER	Nominal Effective Exchange Rate
NPLs	Non-Performing Loans
OPEC	Organization of the Petroleum Exporting Countries
PPs	Percentage Points
PSC	Private Sector Credit
PSI	Policy Support Instrument
REER	Real Effective Exchange Rate

REPOs	Repurchase Agreement
Shs	Shillings
UETCL	Uganda Electricity Transmission Company Limited
UK	United Kingdom
URA	Uganda Revenue Authority
US	United States
USD	United States Dollar
WALR	Weighted Average Lending Rate
Y-o-Y	Year on Year

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Executive Summary

i. Global economic prospects declined slightly in the second quarter of 2015 as downside risks continued to impede growth. Global growth is now projected at 3.1 per cent, slightly lower than 3.4 per cent in 2014 and also lower than the initial growth projection of 3.3 per cent. The slow growth projection is mainly due to a slowdown in emerging markets and a weaker recovery in advanced economies (AEs). Relative to 2014 and July 2015 growth projections, the outlook for AEs is expected to pick up only slightly, while it is projected to decline in emerging market and developing economies (EMDEs) due to declining commodity prices, depreciating currencies, and increasing financial market volatility.

ii. On-going global economic recovery remains constrained by significant uncertainty in the global financial system. Global financial markets remain nervous as risks continue to rotate towards emerging markets. Volatility in the Global financial environment is in part due to divergent monetary policies in AEs. In August 2015, global financial markets volatility spiked following the depreciation of the renminbi, weakening currencies for many EMEs and a sharp correction in equity prices worldwide. Temporary surges in volatility had earlier been associated with events surrounding the sharp stock market decline in China and the ensuing policy measures instituted by the Chinese government. Further, prospects for the U.S. Federal Reserve interest rate hike in December 2015, although widely expected, may have adverse consequences for EMDEs, whose debts are vulnerable to rising US dollar interest rates. The ensuing capital outflows may exacerbate depreciation pressures in these economies, and thus impede growth. For Uganda, just like many EMDEs, volatility in the global financial markets is likely to reinvigorate depreciation pressures in the domestic foreign exchange market.

iii. Global inflation however, remains subdued due to the low commodity prices, slow wage growth in AEs and excess capacity in China. Inflation in AEs has continued to be low and below the respective Central Bank targets exacerbating on-going concerns of the risk of a slide into deflation. In emerging market economies (EMEs), inflationary pressures continue to surge, despite the slowing economic activity. The upward inflation pressures arise largely from exchange rate depreciation, which have more than offset gains from the declining commodity prices.

iv. In October 2015, Bank of Uganda (BoU) tightened monetary policy further to ensure that annual core inflation remains around BoU's target of 5 per cent over the medium term. Based on the projected path of inflation, the BoU raised the Central Bank Rate (CBR) by 1 percentage point (PP) to 17 per cent, up from 16 per cent in August 2015. Since

March 2015, inflation has been rising on account of the depreciation pressures, increasing prices of food crops and strong domestic demand. BOU used Repurchase Agreements (REPOs), reverse REPOs and outright sales of recapitalization securities in the secondary market in order to align liquidity conditions in the domestic financial system with the desired monetary policy stance.

v. Interbank money market rates rose in line with the increase in the CBR while growth in money aggregates declined, in line with tight monetary policy. The upward trend of yields on government securities has been maintained since the start of 2015, in part, due to tight liquidity conditions, speculative behaviour and high inflation expectations. Lending and deposit rates also rose in line with the tight monetary policy stance. Overall, the pass-through of the tight monetary policy stance to the entire spectrum of other interest rates has begun.

vi. Growth in annual private sector credit (PSC) continued to be robust, on average increasing by 23.8% in October 2015 compared to 20.2% in July 2015, mainly driven by increase in lending to building, mortgage, construction and real estate; trade; transport and communication; business services and manufacturing sectors.

vii. The fiscal stance for the Financial Year (FY) 2015/16 is centered on supporting economic growth by addressing the infrastructural constraints in the economy. The fiscal deficit is now projected at 6.6 percent of Gross Domestic Product (GDP) in FY 2015/16 as opposed to 7.0 percent presented in the budget, but is still expansionary when compared to 4.6 percent in FY 2014/15. The government has decided to reduce fiscal expansion approved in the FY 2015/16 budget by Shs. 480 billion, through lower-than-programmed capital investment expenditures on slow moving projects and lower non-essential recurrent expenditures. Since a large part of the deficit is expected to be financed from external sources to avoid crowding-out the private sector from the domestic credit market, borrowing needs in the domestic market are expected to fall not least because of the cost of borrowing.

viii. For the first quarter of 2015/16 fiscal operations are estimated to be more expansionary than programmed due to higher than programmed government expenditure, particularly current expenditure. The fiscal deficit was mainly financed from external sources. The provisional total public debt stock grew by 7.6 percent between June 2015 and September 2015, mainly driven by growth in the public external debt. The public external debt maintained a dominant share of 63.2 percent of the total public debt.

ix. The overall balance of payments (BoP) was a deficit of USD25.4 million during the quarter ended October 2015D. The stock of reserves at the end of November 2015 was estimated at USD2,760.0 million (equivalent to 3.9 months of import cover), which is an increase from USD2,716.7 million recorded at the end of July 2015. In the short- to medium-term, the Balance of payments is likely to remain fragile because of low international prices for Uganda's export commodities and high imports for government infrastructure projects.

x. The heightened depreciation pressures that ensued in early 2014 continued through to September 2015. The depreciation pressures mainly reflected global strengthening of the USD, decline in commodity prices and domestic factors, including weak current account and heightened demand for forex, and speculative tendencies in the domestic foreign exchange market. However, since the beginning of October 2015 to the first week of December 2015, the shilling gained against the USD by 9.5 per cent, from an average of Shs 3667.5/USD to Shs 3317.3/USD. The appreciation has been a result of a combination of factors. First, the correction of overshooting on the depreciation side; second, the tightening of monetary policy that has resulted in contraction of demand for imports; third, the slowing down of economic activities coupled with global disinflation has meant less demand for foreign currency.

xi. The economy has continued to grow at a moderate pace. Economic growth for 2014/15 was 5.0 per cent, a slight improvement compared to the growth rate of 4.8 per cent in 2013/14. Growth was driven by strong final consumption expenditure, which rose by 12.4 per cent. Exports performance continued to be a drag on growth, with the value of exports contracting by 7.5 per cent compared to the growth in the value of imports, which grew robustly at 15.5 per cent. Growth in FY 2015/16 is projected at 5 per cent. However, there are downside risks to the projected output path, emanating from both the domestic and external environment. Indeed, economic activity is estimated to have grown at a slower rate during the quarter to September 2015, on account of a slowdown in the services and agricultural sectors. Domestic demand is expected to weaken in the next 12 months, in part due to tight monetary policy stance. This, combined with a weak external environment manifested in slow growth in emerging markets and slow recovery in advanced economies, soft commodity prices, possible delays in commencement of public investments, and decline in private investment and consumption, could result in slowing down of economic activity during 2015/16.

xii. In the recent months, inflation has edged up significantly, with annual headline and core inflation rising to 9.1 percent and 6.7 per cent in November 2015 from 4.8 percent and 5.3 percent, respectively in August. Inflation is being driven by supply side shocks, which have significantly led to a rise in food crop inflation, a sharp increase in Energy, Fuel and Utilities (EFU) inflation, and heightening pass through of the exchange rate depreciation. Consumer prices are anticipated to increase further reflecting mainly the exchange rate pass-through and the increase in food prices, whilst output is expected to be less dynamic. With the current monetary policy stance, inflation is expected to rise to double digit levels through the rest of 2015 and 2016.

xiii. The outlook for inflation is subject to several risks the main ones being; another bout of exchange rate depreciation and its accumulated effect on costs, and a possible further increase in food prices leading to a higher than expected rise in inflation. The risks to the medium-term inflation outlook are on balance sufficient to justify a tighter monetary policy stance.

xiv. The direction of the monetary policy stance will continue to be guided by a careful assessment of the risks to the global and domestic economy and their implications for the overall outlook of domestic inflation. The BoU will continue to adjust the monetary policy stance accordingly to ensure that the core inflation target of 5 per cent in the medium term is achieved and that economic growth is consistent with the inflation objective.

1 Background

This report discusses domestic and external economic developments in the period to December 2015. It also assesses the future prospects and outlook for the global and domestic economy and provides the projected domestic inflation and output trajectory in the near-to short-term. In addition, it discusses the attendant risks to the domestic economic outlook, identifies policy challenges in the short- to medium term and the pros and cons of alternative policy options. Finally, it discusses the implications of the outlook and risks to the global and domestic economy on the future direction of monetary policy in Uganda.

2 External Economic Environment

2.1 Economic Activity

The international economic environment has become more complex, increasing the risks for commodity exporters, including Uganda. On the one hand, the rebalancing of world growth in favour of the developed economies, especially the United States, together with the imminent monetary normalization by the U.S. Federal Reserve (the Fed), has resulted in a significant strengthening of the dollar at the international level. On the other hand, the doubts about China's economy have grown, as the news of weakening activity was exacerbated by strong turbulence in the country's financial markets, and was passed through to global markets. China plays a significant role in the global economy. It is now the second largest economy, accounting for 13 per cent of global GDP in 2014.

World GDP growth has been persistently weaker than expected over the past few years. Much of that weakness has been concentrated in emerging economies, where growth has slowed more sharply than anticipated. For example, annual emerging-economy growth since 2012 has been, on average, 3/4 of a percentage point lower than International Monetary Fund (IMF) forecasts made the previous year. The IMF World Economic Outlook (WEO) estimates suggest that the global economy grew by 2.9 percent in HI-2015, about 0.3 percentage points weaker than the earlier projection. Growth was below forecast in both AEs and EMDEs. Growth in the United States (US) was weaker than expected, despite strong second quarter performance, reflecting setbacks to activity in the first quarter, partly on account of one-off factors, notably harsh winter weather and port closures, as well as much lower capital spending in the oil sector.

In the Euro Zone, growth seems to be broadly on course, as the risk of a prolonged period of deflation appears to have receded, with a pick-up in inflation expectations following the European Central Bank's quantitative easing program. Retail sales and consumer sentiments have also picked-up, in part because of the increasingly favourable financial conditions and low oil prices, which have in effect boosted real household incomes. The weaker-than-expected growth in Germany was more than offset by the stronger-than-expected growth in Italy, Ireland and Spain, leading to a sustained recovery of domestic demand. The Euro Zone continued to grow in Q3-2015, with economic activity growing at a seasonally-adjusted rate of 0.3 percent over the previous quarter, mainly supported by strong dynamics in domestic demand, as household consumption continued to be propelled by low inflation, soft financial conditions and improving labor market conditions.

In the United Kingdom, GDP expanded at an annualized rate of 2.3 percent in H1-2015, with the unemployment rate declining to its pre-crisis average of about 5.5 percent. Preliminary estimates also indicate that UK output expanded at an annualized rate of 2.0 percent in Q3-2015, slightly below the 2.8 percent annualized growth in Q2-2015. Growth was mainly driven by services output, which in part reflects buoyant domestic demand conditions. In Japan, a strong rebound in the first quarter was followed by a drop in activity in the second quarter. Over the first half of the year, consumption fell short of expectations and so did net exports.

Overall, the global economy is now projected to grow by 3.1 per cent in 2015, which is lower the July IMF-WEO growth projection for 2015 by 0.2 percentage points. This is also lower than the estimated global growth for 2014 of 3.4 per cent. However, growth prospects remain uneven, across countries and regions. While the growth projections for the AEs during 2015 and 2016 have been revised slightly downwards to 2 and 2.2 percent, respectively, they nonetheless provide most of the thrust to global economic expansion, as growth in Emerging Market and Developing Economies (EMDEs) is projected to remain soft on account of low commodity prices, depreciation pressures, and increasing financial market volatility.

Growth in EMDEs is projected to slacken further to 4.0 percent in 2015 from 4.6 percent in 2014, on account of tighter external financial conditions, lower commodity prices, depreciation pressures due to expectations of an interest rate hike in the US, the rebalancing in China, economic distress related to geopolitical factors, and structural bottlenecks inherent in most of these economies. In Sub-Saharan Africa, growth is projected at 3.8 percent in 2015, down from an earlier projection of 4.2 per cent, in the face of declining commodity prices and the after-effects of the Ebola crisis. The decline in global oil prices is likely to lead to a decline in the growth of the region's oil-exporting economies, though this might be offset by the gains made by oil-importing economies within the region. The global growth projections are presented in Table 1.

Table 1: Global Economic Growth Projections

	2013	*2014*	*2015*	*2016*
World output	3.3	3.4	3.1	3.6
Advanced economies	1.1	1.8	2.0	2.2
USA	1.5	2.4	2.6	2.8
UK	1.7	3.0	2.5	2.2
Euro area	-0.3	0.9	1.5	1.6
Japan	1.6	-0.1	0.6	1.0
Emerging and developing economies	5.0	4.6	4.0	4.5
China	7.7	7.3	6.8	6.3
India	6.9	7.3	7.3	7.5
Sub-Saharan Africa	5.2	5.0	3.8	4.3

Source: IMF, World Economic Outlook, October 2015

Overall, downside risks to global growth remain elevated. In the near-to short-term, continued exchange rate volatility, increased financial market volatility and disruptive asset price shifts, low commodity prices, higher than expected slowdown in China, and increasing geo-political tensions may continue to suppress economic activity. The subdued commodity prices while a contributing factor to the resurgence in consumption and domestic demand in AEs, also pose a risk to the economic outlook in commodity exporting EMDEs. The monetary policy normalization in the US and persistent vulnerabilities in emerging economies also constitute a downside risk to global growth.

2.2 Global financial markets

The international financial markets have experienced new episodes of distress, with a sharp increase in volatility in both equity and fixed-income markets, especially after the events in China. The Chinese stock exchange, after hitting new historical peaks in June 2015, have recorded sharp corrections. The financial volatility in China was accompanied by growing concern for the country's economic performance. In recent weeks, the Chinese authorities have taken a range of measures to mitigate the drop in the stock markets and boost output, including the depreciation of the Yuan, and a cut in interest rates. There has been a strong contagion to other world markets, with large falls in the main stock indexes. For the emerging economies, the effect was even sharper, generating substantial capital out flows, significant currency depreciation against the dollar and a rise in the cost of external financing due to an increase in credit spreads, which reached or even exceeded mid-2013 levels.

Furthermore, the steady appreciation of the dollar, deriving from the strong economic performance of the United States relative to other major economies, and the imminent rate increase by the Fed have generated additional pressure on emerging currencies. The recent release of more robust U.S. employment and output data, point to the Fed's normalization of monetary policy in the near future. The Fed has signalled that the implementation will be gradual and cautious—taking into account the inflation level and subject to the continuation of the positive output trend. These trends have accentuated portfolio reallocation. The emerging economies have been most affected mainly through sharp depreciation of their currencies and increased cost of external financing.

The global financial outlook continues to be clouded with several policy challenges and the vulnerabilities in the EMDEs. Although most EMDEs have enhanced their policy frameworks and resilience to external shocks, several key economies still face substantial domestic imbalances and external imbalances. The recent impact of slumping commodity prices and China's bursting equity bubble on exchange rates of most EMDEs indeed underscore these challenges. The likely interest rate hike in the US may also lead to further tightening of external financial conditions with adverse consequences for EMDEs.

2.3 Global inflation and commodity prices

2.3.1 Global Inflation

Given this context of limited world growth, dollar appreciation, low oil prices and a generalized drop in commodity prices, world inflation has remained low. Inflation declined in AEs, averaging 0.2 percent in the first nine months of 2015 compared to 1.5 percent during the corresponding period of 2014, reflecting the impact of softer commodity prices. Inflation also remained relatively subdued in most EMDEs, save for those with heightened depreciation pressures, such as Brazil and Russia, where sizable currency depreciations more than offset the impact of low commodity prices. In EMDEs, inflation averaged 5.4 percent during the first nine months of 2015, while in SSA it declined to 6.1 per cent compared to 6.3 per cent during the corresponding period of 2014.

2.3.2 Global commodity prices

The global appreciation of the dollar, the doubts about China's performance and the increased volatility in the international financial markets have resulted in a large drop in commodity prices. The average crude oil prices decreased by 47 per cent in the three months to November 2015 compared to the same period in 2014. Robusta coffee prices declined by about 20.2 per cent in the three months to November 2015 compared to the same period in 2014. Food prices declined on aggregate despite mixed movements among individual food items. However, the decline was of a much lower magnitude than other commodity prices. The outlook for global food prices however remains on balance high, as the current El Nino rains may disrupt food production worldwide.

Crude oil prices are projected to average USD52 per Barrel and USD50 per Barrel in 2015 and 2016, respectively. Nonetheless, there are downside risks to this outlook, including the continued strong growth of North America's shale oil production and a lifting of the economic sanctions against Iran, which may increase global crude oil output, thereby exerting a downward pressure on oil prices. The upside risks relate to the possibility of Organization of the Petroleum Exporting Countries (OPEC) cutting production and the escalation of conflicts in oil exporting countries, which may curtail global oil output.

2.4 Implications for the Ugandan Economy

The external economic environment presents both opportunities and challenges for the Ugandan economy. The main challenges include declining international commodity prices and the ensuing tighter global financial conditions. Crude oil prices have fallen sharply since mid-2014, in part reflecting important supply-side developments and lower growth in global demand and there is a risk that oil prices could fall further, especially if major oil producers continue to expand supply in the current circumstances of moderate global economic growth. While low global inflation and declining commodity prices will keep domestic inflation in check, at least in the short-term, low commodity prices may worsen Uganda's trade deficit by keeping export revenues at bay.

The persistently low oil prices could also have a material impact on investment and economic activity, as it could discourage foreign direct investment inflows to the oil sector. Given Uganda's weak current account position, which has largely been funded by surpluses in the capital and financial account of the balance of payments, a decline in FDI inflows may aggravate exchange rate depreciation pressures. This may further be exacerbated by the likely normalization of monetary policy in AEs, especially the US, which may trigger capital outflows from EMDEs including Uganda. This will not only invigorate inflation, but may also dent the growth prospects of the economy.

There is also a risk that growth in EMEs could be much slower than expected. A slowdown in EMEs growth would weigh on Uganda's economic growth through trade, financial and confidence channels, including a further downward pressure on commodity prices. The geopolitical tensions and the threat of terrorism also remain elevated. This has negative implications on consumer and business confidence as economic agents could hold back on spending, which may lead to a fall in aggregate demand, thereby constraining global growth with adverse implications for Ugandan exports.

3. Domestic Economic Developments

3.1 Monetary policy stance and Implementation

3.1.1 Monetary Policy Stance

BoU continued with the tight monetary policy stance, increasing the Central Bank Rate (CBR) by 6 percentage points with effect from March 2015. The tight monetary policy stance is premised on the projected inflation trajectory. Since March 2015, there have been heightened inflationary pressures, in part driven by exchange rate depreciation pressures that ensured in February 2015. Core inflation rose from 3.8 per cent in March to 5.4 per cent in July 2015, increasing further to 6.3 percent and 6.7 percent in October and November, 2015, respectively. Although there are indications of weaker growth, the risks to high inflation, particularly stemming from a weaker exchange rate remain tilted on the upside. Indeed, the short-term inflation forecasts suggest that core inflation could peak at 12-14 per cent in the first half of 2016 before gradually declining to 8-10 per cent by December 2016. Headline inflation is also forecast to increase to 13 - 15 per cent in H1-2016, before declining to 8-10 per cent by December 2016.

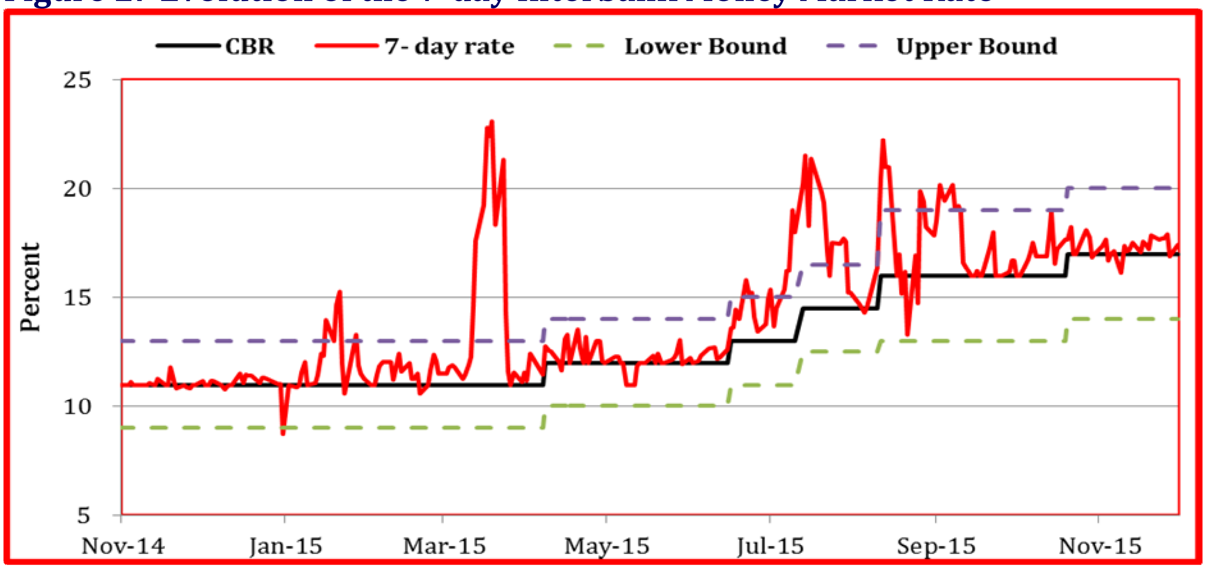
The BoU therefore decided to pursue a tight monetary policy stance in order to hold back the inflationary pressures and ensure that inflation converges back to the medium term target of 5 per cent during the forecast horizon. The CBR was consequently increased by 1 percent in April and June to 12 and 13 per cent, respectively and by 1.5 percentage points in July and August 2015 to 14.5 and 16.0 per cent, respectively. On account of the continued deteriorating inflation outlook, monetary policy was further tightened in October, when the CBR was increased by 1 percentage point to 17 per cent.

3.1.2 Monetary policy implementation

BoU continued to use Repurchase Agreement (REPOs), reverse REPOs and outright sales of recapitalization securities in the secondary market in order to align liquidity conditions in the domestic financial system with the desired monetary policy stance. As at end November 2015, the outstanding REPO stock was Shs. 340.8 billion, the while the stock of recapitalisation securities was Shs. 310 billion.

The interbank money market rates remained broadly consistent with the monetary policy stance (**see Figure 1**) despite the structural liquidity overhang, which was in part moderated using REPOs. The structural liquidity overhang was in part driven by foreign exchange purchases for reserve build-up.

Figure 2: Evolution of the 7-day Interbank Money Market Rate



Source: Bank of Uganda

3.3 Interest rates and Private Sector Credit

3.3.1 Interest rates

Interest rates have remained elevated, in part reflecting expectations about increased domestic financing and heightened inflation expectations but also due to the tighter monetary policy stance. Yields on bonds issued by government spiked close to historical highs. The annualised yields on government securities, have for example, risen by about 5 percentage points on an annual basis in the quarter to September 2015 and by about 2.5 percentage points when compared to those obtaining in the quarter to June 2015. The average annualized yields for the 91-day, 182-day and 364-day rose to 16.6, 18.2 and 19.0 per cent in the third quarter of 2015 from 14.0, 15.3 and 16.6 per cent, respectively, in the quarter ended June 2015. The yield on the benchmark 2-year Treasury bond also rose to 19.5 per cent from 16.9 per cent during the same period. The yields on the 5-year, 10-year and 15-year Treasury bonds also rose to 18.9, 18.0 and 18.2 per cent from 16.8, 17.7 and 17.5 per cent, respectively. The trend of yields in government securities is as shown in **Figure 2.**

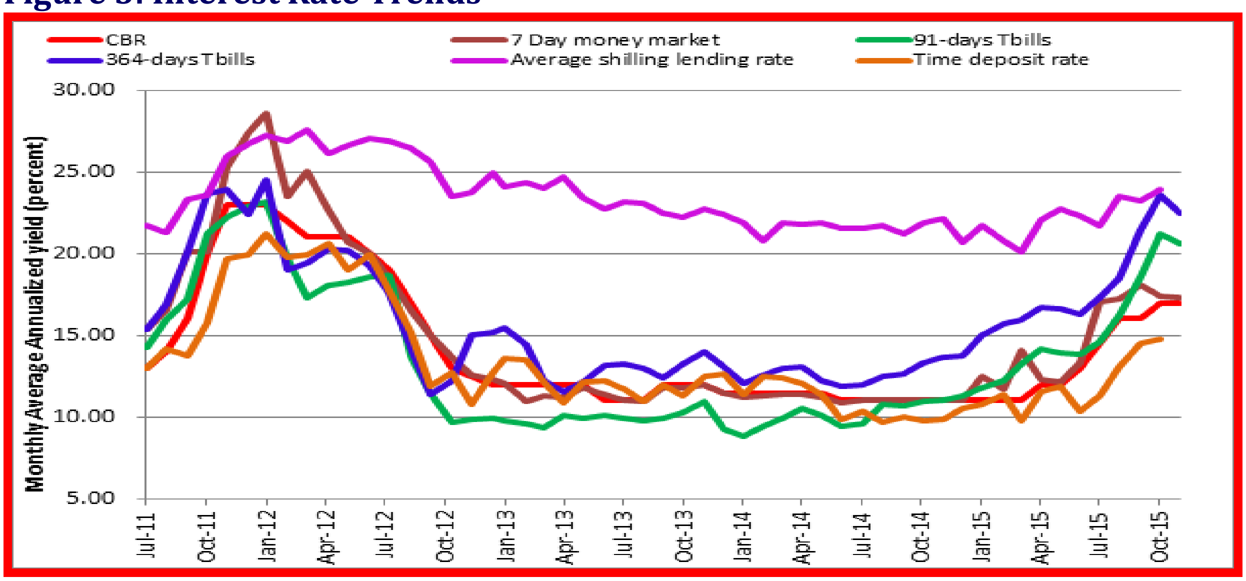
Figure 2: Yield curve analysis

Source: Bank of Uganda

Interest rates on loans are gradually rising reflecting the tightening of monetary policy and rising inflation and partly in response to this, growth in lending is expected to slow down going forward. As shown in **Figure 3,** after remaining relatively stable at about 21.0 per cent over the last 12 months, notwithstanding the neutral monetary policy stance, the Weighted Average Lending Rate (WALR) on Shs denominated loans rose to 23.9 per cent in October 2015. Overall, the lending rates have remained elevated, and sticky downwards, in part reflecting the impact of the tight monetary policy stance; structural factors, such as the high cost of doing business; and heightened risk aversion by commercial banks. Moreover, most commercial banks continue to adjust their base lending rates upwards, in part due to the increase in yields on risk-free government securities.

The deposit rates also rose in line with the increase in other interest rates in the economy. The shilling time deposit rate for example rose to 14.8 per cent in October 2015 from 10.4 per cent in June 2015. The WALR on foreign currency denominated loans however declined slightly to 8.8 percent in the quarter to October 2015 from 9.0 percent in the quarter to July 2015. The ratio of Non-Performing Loans (NPL) to total loans increased to 4.0 per cent in September 2015 from 3.8 per cent in June 2015, indicating a slight deterioration in asset quality.

Figure 3: Interest Rate Trends

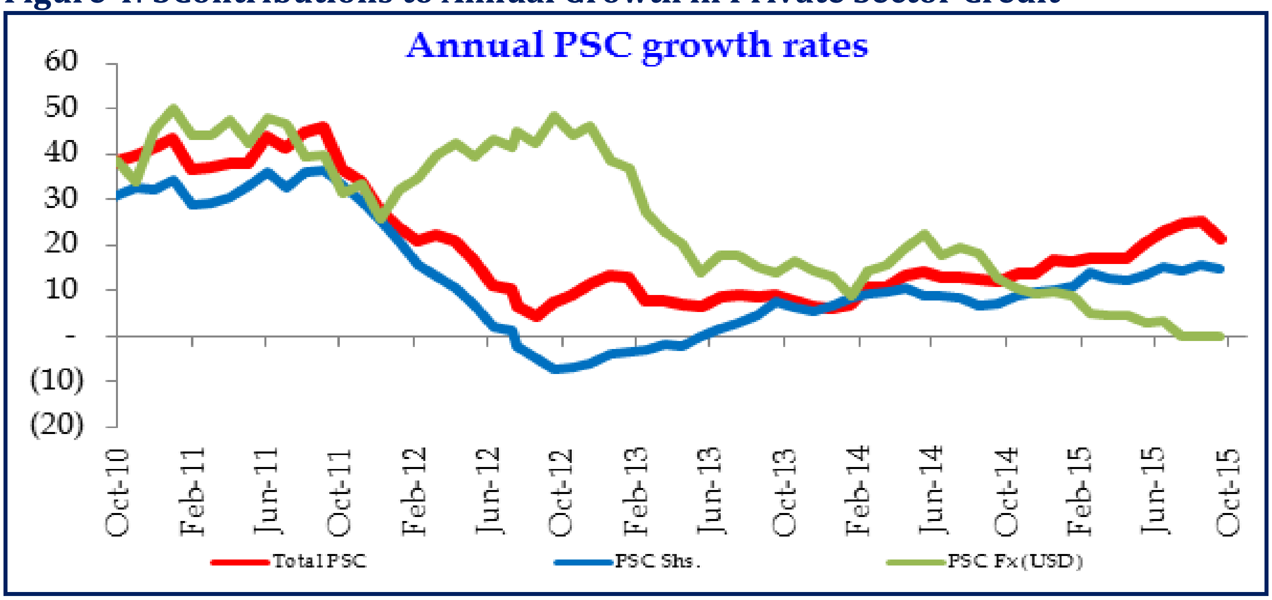


Source: Bank of Uganda

3.2.2 Private Sector Credit

In recent months, Ugandan financial markets have, experienced increased volatility in line with international developments. Nevertheless, conditions continue to support the financing of domestic activity. Growth in private sector credit (PSC), a leading indicator of the financial sector's contribution to economic activity, remained robust, in part reflecting buoyant domestic economic conditions and the impact of exchange rate depreciation. On an annual basis, PSC grew on average by 23.8 per cent in the quarter to October 2015, compared to 20.2 in the quarter to July 2015 and to 12.6 per cent in the quarter to October 2014. However, reflecting the effect of the exchange rate depreciation, the foreign currency denominated loans have been on the decline, declining by 0.1 per cent in the three months to October 2015 compared with a growth of 16.7 per cent in the same period of 2014. The shilling denominated loans have steadily risen, growing by 15 per cent in the quarter to October 2015 compared to 7.4 per cent in the same period of 2014. Developments in private sector credit are shown in **Figure 4.**

Figure 4: 5Contributions to Annual Growth in Private Sector Credit



Source: Bank of Uganda

In terms of sectoral distribution; building, construction and real estate; trade and commerce; manufacturing; and personal and household loans continued to constitute the bulk of private sector credit. Indeed, as at end September 2015, these sectors accounted for 73.2 per cent of total private sector credit. The ratio of credit to the agricultural sector in total private sector credit also rose to about 9.8 per cent, in part reflecting the positive impact of disbursements from the agricultural credit facility. Although the increase in credit to the private sector could augur well for economic growth, it nonetheless constitutes an upside risk to inflation, as it may generate demand pressures in the economy. **Table 2** shows the sectoral distribution of credit and the respective annual sectoral growth rates.

Table 1: Sectoral Developments in Private Sector Credit

	Annual Growth Rate			Share in total
Sectors	Apr-15	Jul-15	Oct-15	Oct-15
Agriculture	42.8	17.2	17.2	9.7
Mining and Quarrying	85.3	165.3	48.4	0.5
Manufacturing	31.5	52.6	45.3	15.1
Trade	2.9	21.8	16.2	20.5
Transport and Communication	21.6	28.5	32.7	5.7
Electricity and Water	27.7	38.6	27.2	1.6
Building, Mortgage, Construction and	16.5	21.6	21.8	22.7
Business Services	23.0	31.3	34.7	4.7
Community, Social & Other Services	9.3	18.3	17.6	3.1
Personal Loans and Household Loans	10.5	4.2	6.3	14.9
Other Services	-2.9	12.1	9.9	1.5
Total	16.9	23.1	21.4	100.0

Source: Bank of Uganda

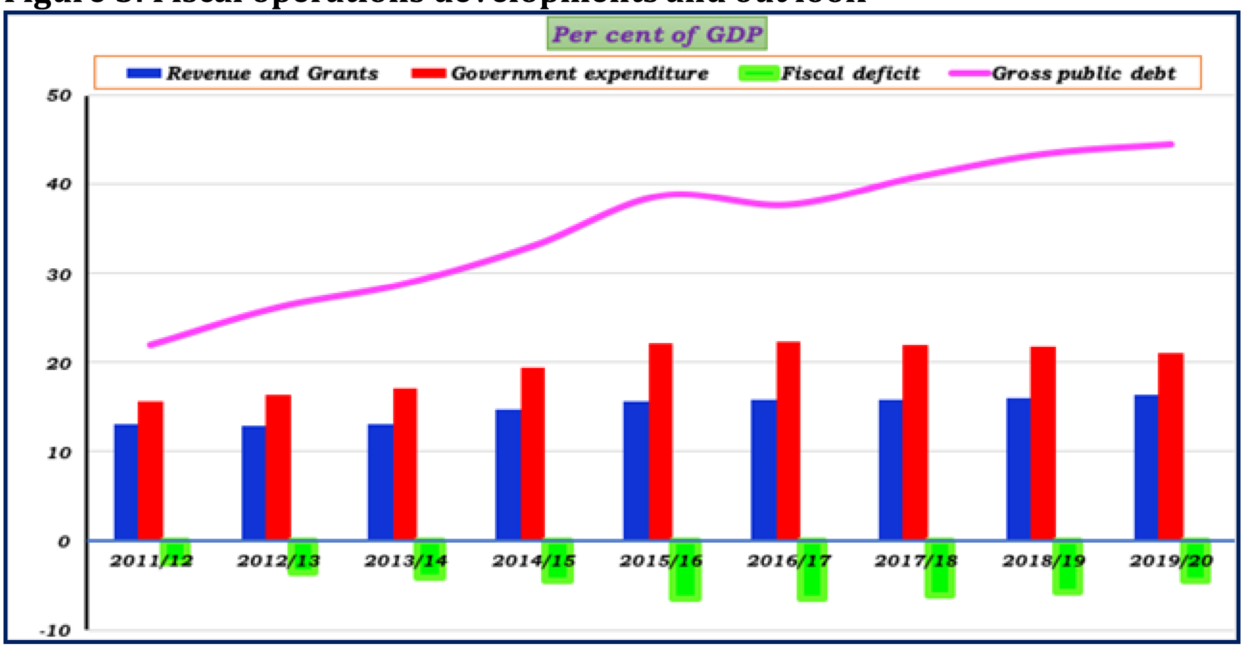
3.3 Fiscal Policy and Developments

3.3.1 Fiscal Developments

Fiscal policy plays a significant role, both as a stabilization tool and in determining the short- and long-term growth prospects of an economy. In line with the need to foster growth, increase economic efficiency and reduce the cost of doing business, the fiscal stance for FY 2015/16 focused on addressing infrastructural constraints in the economy. Given the infrastructure gap in the economy, the consequence of this policy has been the widening fiscal deficit.

The fiscal deficit for FY2015/16 is projected to widen to 6.6 per cent of GDP. Total expenditure is projected to increase by 27.8 per cent compared to FY 2014/15, with the bulk of the increase going to development expenditure. **Figure 5** summarises fiscal developments and the outlook. Domestic fiscal financing through issuance of government securities has been capped at Shs. 1.38 trillion, not only because of the rising costs of domestic borrowing but also to avoid crowding-out the private sector from the domestic credit market. Domestic financing has however underperformed so far in FY 2015/16 because of the under subscriptions in Q1-2015/15, and rejection of the high yield quotes, which were as high as 29.9 per cent for 10-year Treasury bond.

Figure 5: Fiscal operations developments and out look



Source: Ministry of Financing, Planning and Economic Development

3.3.2 Public Debt

The public debt stock continues to increase. As at end September 2015, provisional data indicates that total public debt stock (at nominal value) increased by 7.6 per cent relative to June 2015 to Shs. 26,159.5 billion. Public external debt increased by 14.4 percent to Shs. 16,521.7 billion, while domestic public debt declined by 2.4 per cent to Shs. 9,637.8 billion.

The increase in the shilling value of external debt was in part driven by the exchange rate depreciation. In USD terms, public external debt increased by only 2.2 percent. In terms of distribution, external debt continues to make up the bulk of the total public debt, accounting for 63.2 percent as at end of September 2015. Notwithstanding the increase in public debt, debt sustainability analysis still indicates that the current level of debt is sustainable.

3.4 Balance of Payments and Exchange Rate Developments

3.4.1 Balance of payments

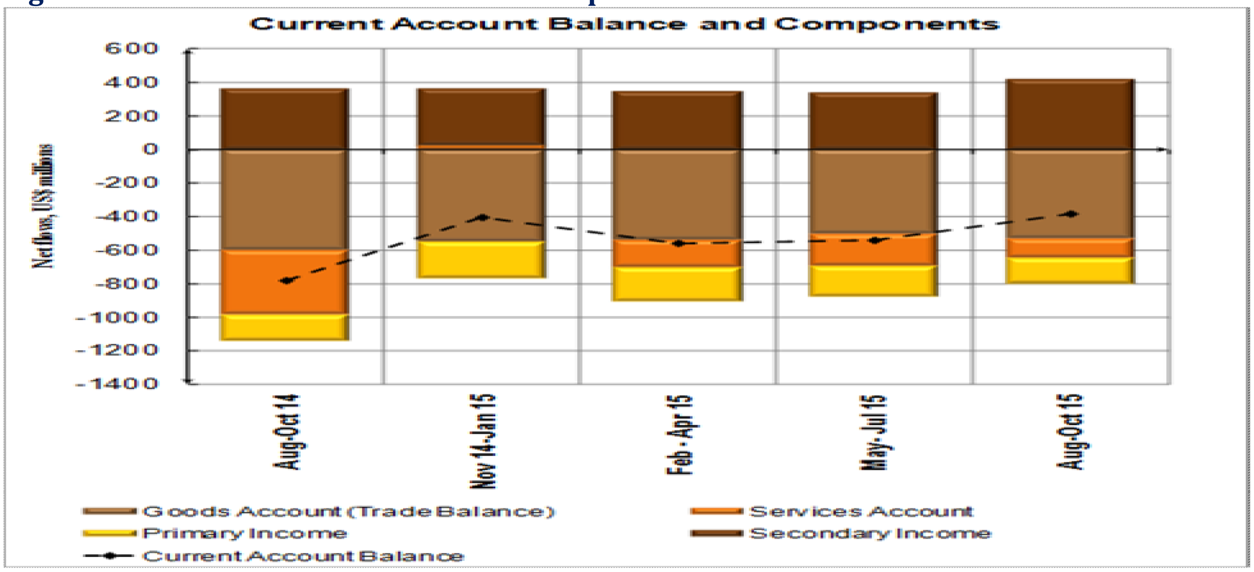
In the first four months of 2015/16, the value of goods exported fell by 4.6 per cent compared to the same period of 2014/15, due to a reduction in the price index which declined by 7 per cent as opposed to volume index which increased by 2.5 per cent. The decline in price index is reflective of the impact of the decline in global commodity prices. Indeed, compared to the quarter ended October 2014, coffee export earnings recorded in the quarter to October 2015, decreased by USD2.4 million from USD87.2 million. However, the total volume of coffee exported during the current quarter increased by 125,083 (60 Kg) bags when compared to 705,394 (60 Kg) bags exported in the same quarter during 2014.

On the import side, in the value of imported goods fell by 9.2 per cent in the same period, from USD 1680.8 million to USD1527.1 million, due to the decline in the value of oil imports, which declined by 34 per cent, reflecting the decline in international oil prices. Non-oil private sector imports declined by 8.2 per cent, from USD 1245.7 million to USD1144 million, which could be reflective of the declining private sector demand as well as the impact of global disinflation. The value of imported consumer goods declined by 20.5 per cent, while the value of private sector imported capital and intermediate goods declined by 11.2 per cent in the first four months of 2015/16 compared to same period of 2014/15.

In comparison with the same period a year ago, the current account deficit improved by USD397.4 million from a deficit of USD781.6 million registered in the quarter ended

October 2014. The trends of the current account balance and its components are shown in Figure 6 below.

Figure 6: Current Account Balance and Components



Source: Bank of Uganda

The above developments resulted in an overall balance of payments deficit of USD25.4 million during the quarter ended October 2015. The stock of reserves at the end of November 2015 was estimated at USD2,760.0 million (equivalent to 3.9 months of import cover), which is an increase from USD2,716.7 million recorded at the end of July 2015. In the short- to medium-term, the Balance of payments is likely to remain fragile on account of low international prices for Uganda's export commodities and high imports for government infrastructure projects.

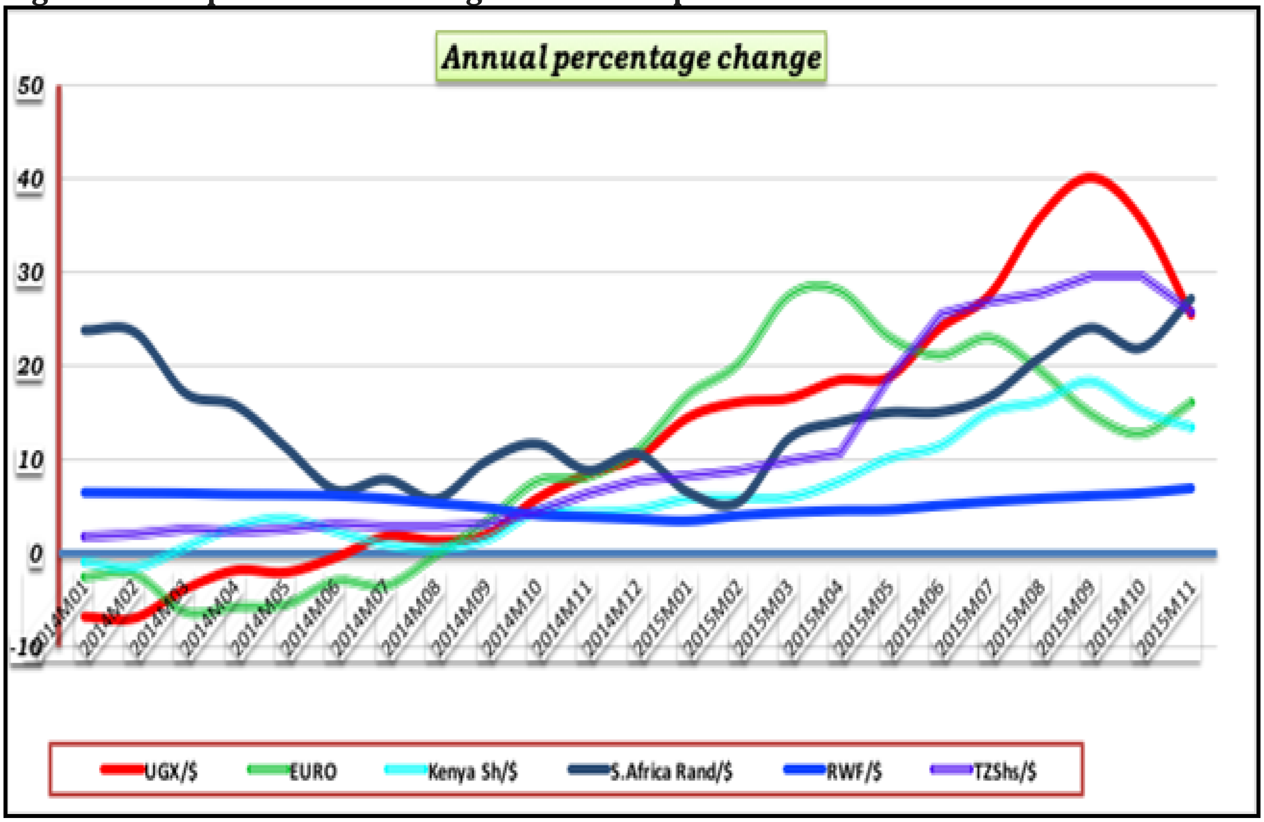
3.4.2 Exchange Rate Developments

The heightened depreciation pressures that ensued in early 2014 through August 2015 have abated since the beginning of October 2015. As evident in Figure 7, the depreciation was not exclusive to Uganda, as most of our trading partner's experienced similar depreciation pressures although until September 2015, the Ugandan shilling suffered depreciation much more intensely. On a trade weighted basis, the shilling depreciated by 28 per cent y-o-y in September 2015 and by 40 per cent against the US dollar, touching an average mid-rate of Shs. 3,668 per US dollar in September 2015.

Over this period, changes in the Ugandan shilling reflect a combination of several factors, which include widening fiscal and current account imbalances, fluctuations in global sentiment and commodity prices, which have occurred alongside increased uncertainty about the outlook for China and market participants' ongoing assessment of the likely timing of the first rate increase by the US Federal Reserve. BoU intervened in the Interbank Foreign Exchange Market during period of excessive volatility and also suspended forex purchases for reserve build-up.

However, while the exchange rate depreciation was a necessary adjustment warranted by external and domestic fundamental, the non-fundamental factors, including noise, expectations and speculative activity made it to overshoot its long-run equilibrium. Since the beginning of October 2015 to the first week of December 2015, the shilling has gained against the USD by 9.5 per cent, from an average of Shs 3667.5/USD to Shs 3317.3/USD. The appreciation has been a result of a combination of factors. First, the correction of overshooting on the depreciation side; second, the tightening of monetary policy that has resulted in contraction of demand for imports; third, the slowing down of economic activity coupled with global disinflation has meant less demand for foreign currency. Nonetheless, the current gains could be temporary, as domestic and external fundaments warrant a further depreciation of the exchange rate. The current account deficit continues to deteriorate, and this together with the widening fiscal deficit on account of public infrastructure projects with a considerable import content may necessitate a further adjustment of the exchange rate. The US Fed is also expected to hike its interest rate in December 2015, which poses a greater threat of capital outflows from EMDEs, which could trigger depreciation pressures in these economies, including Uganda.

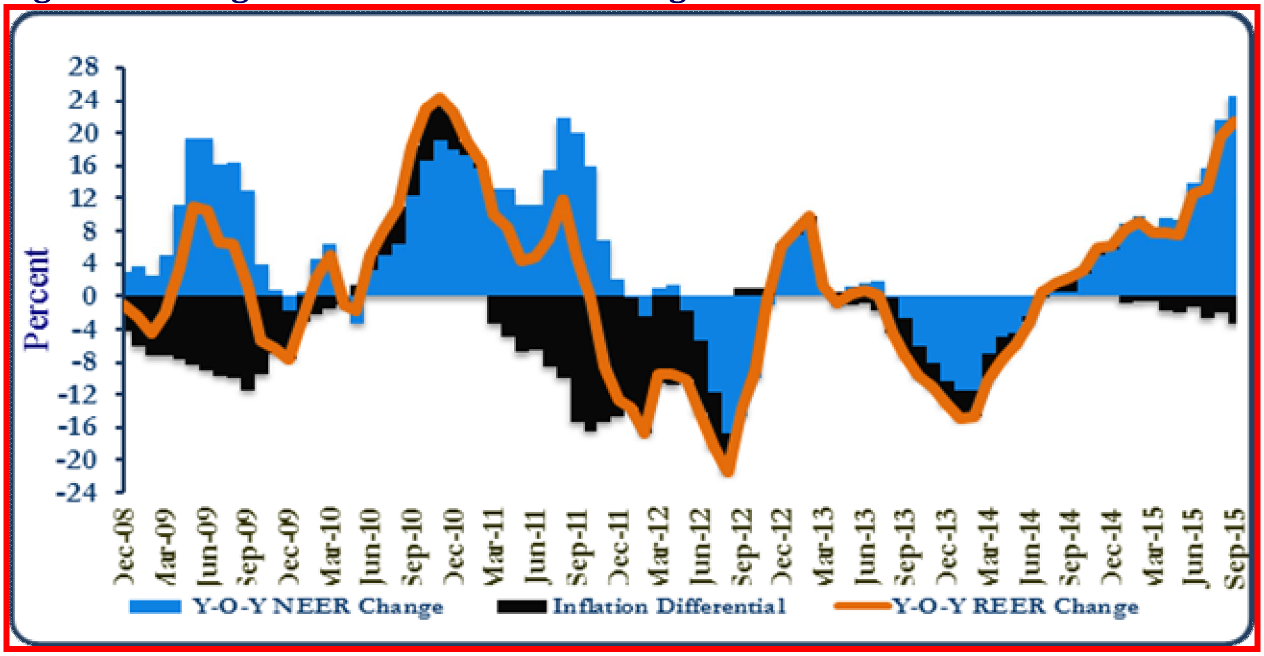
Figure 7: Comparison of exchange rate developments



Source: Bank of Uganda

The Real Effective Exchange Rate (REER) also depreciated in line with the depreciation of the trade-weighted nominal exchange rate, depreciating by 23.9 per cent y-o-y in September 2015. This compares with a real depreciation of 21.7 percent and 14.0 percent in August and July 2015, respectively. Most of the real depreciation during this period is accounted for by the depreciation of the Nominal Effective Exchange Rate (NEER), with the price differential accounting for only a small proportion as shown in **Figure 8**.

Figure 8: Changes in Real Effective Exchange Rate



Source: Bank of Uganda

3.5 Domestic Economic Activity: Output and demand

The Ugandan economy has continued to grow at a moderate pace. Economic growth for 2014/15 was 5.0 per cent, a slight improvement compared to growth rate rate of 4.8 per cent in 2013/14. Growth was driven by strong final consumption expenditure, which rose by 12.4 per cent. Exports performance continued to be a drag on growth, with the value of exports contracting by 7.5 per cent compared to the growth in the value of imports which rose robustly at 15.5 per cent. Table 3 indicates GDP growth by expenditure.

Table 3: GDP growth by expenditure

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
Final Consumption Expenditure	4.7	11.2	4.0	-0.4	2.4	12.4
Gross Fixed Capital Formation	9.8	13.3	1.4	9.2	3.3	1.0
Exports	-9.0	5.5	14.0	6.7	0.0	-7.5
Imports	-2.3	14.7	6.0	0.0	-6.4	15.5
GDP at Market Prices	5.2	9.7	4.4	3.3	4.8	5.0

Source: Bank of Uganda

Growth in FY 2015/16, is projected at 5 per cent, down from an earlier projection of 5.8 percent. This growth will be driven by a scale up in public infrastructure spending (particularly HPPs) and a rebound in private sector activity after the election. Private sector investment will be boosted by a recovery in FDI inflows linked to the expected issuance of oil production licenses and the normalization of the monetary policy stance that will provide a boost to the manufacturing and trade sectors.

There are downside risks to the projected output path, emanating from both the domestic and external environment. Domestic demand is expected to weaken in the next 12 months, in part due to tight monetary policy stance before broadening in the medium to long term. This, combined with a weak external environment manifested in slow growth in emerging markets and slow recovery in advanced economies, soft commodity prices, possible delays in commencement of public investments, and decline in private investment and consumption, could result in slowing down of economic activity 2015/16. Already, the composite index of economic activity (CIEA)—a high frequency measure of economic activity—points to a softening in activity. In addition, survey measures of business conditions are clearly below their long- run average levels, most notably for services. Businesses' outlook on the economy was less optimistic between the quarter to August 2015 and quarter to November 2015, with the index declining by 0.4 points, compared to the same period a year ago.

The international context of increased risk, higher external financing costs and capital out flows could compound the already complex situation of Ugandan economy, which has a high current account deficit. The greatest risk comes from the current account of the balance of payments. The recent depreciation will eventually help reduce current account deficits, by making exports more profitable and imports more expensive, but in the short term, improvements in the current account will come primarily from lower imports, the result of the economic slowdown.

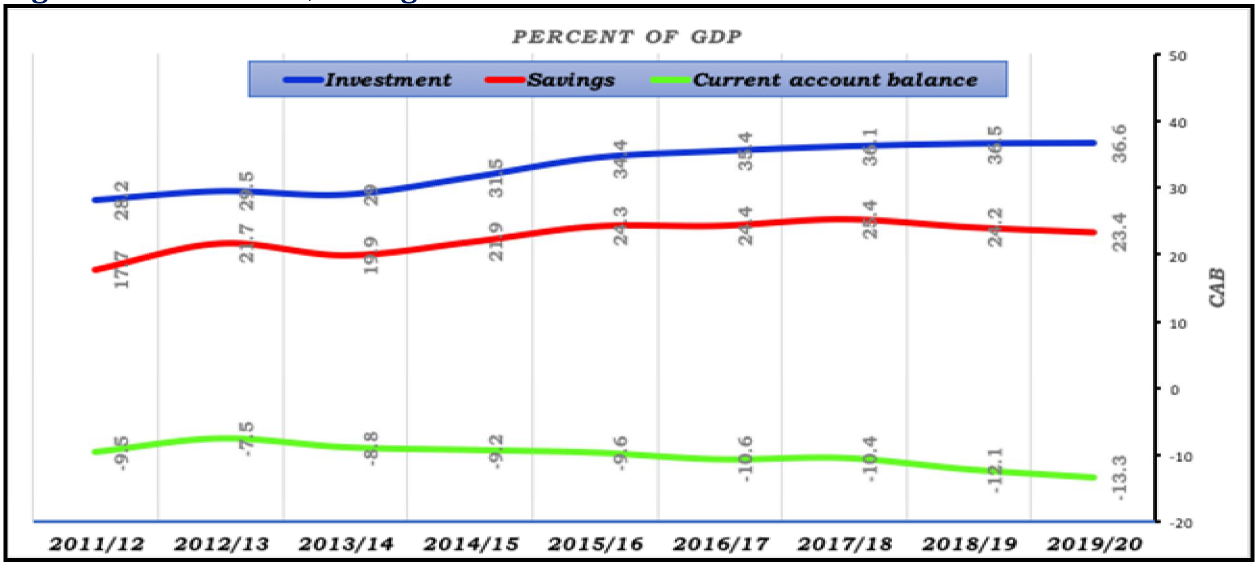
Current account, national savings, investment and growth outlook

As Figure 9 indicates, Uganda's current account deficit is projected to continue widening in the foreseeable future. When a country runs a current account deficit, it is building up liabilities to the rest of the world that are financed by flows in the financial account. Eventually, these need to be paid back. Therefore, if Uganda fritters away its borrowed foreign funds on spending that yields no long-term productive gains, then its ability to repay—its basic solvency—might come into question.

In particular, the widening current account deficit reflects a low level of national savings relative to investment. For capital-poor developing country like Uganda, which has more investment opportunities than it can afford to undertake because of low levels of domestic savings, a current account deficit may be natural. A deficit potentially spurs faster output growth and economic development. However, Uganda's sectoral growth decomposition suggests, growth continues to be driven by the services sector, which constitutes 50 per cent of GDP. However, the services sector is largely import dependent, which aggravates the already widening current account deficit. If Uganda was importing goods today (running a current account deficit) and, in return, exporting goods in the future (running a current account surplus then), then there would less concern on the widening current account deficit.

In the 1990s and the early 2000s, Uganda's current account deficit was financed by grants and this understandably supported high economic growth even when public investments were less efficient. In the current economic environment, widening current account deficits are financed with loans that are increasingly obtained at commercial interest rates and terms and this will result in lower than historical growth rates. Indeed, GDP growth is expected to remain below the historical average over the medium to long term, remaining between 6 and 6.5 for the period 2017-2021. Nonetheless, growth in advanced economies, will provide some support to Uganda's exports over the period ahead and together with the scaling up of public investment, will support growth. More generally, as inflation declines, monetary policy will become accommodative and with low global inflation and low oil prices will support growth.

Figure 9: Investment, saving and current account balance.



Source: Bank of Uganda

3.6 Consumer Price Inflation

3.6.1 Recent Inflation Developments

Headline and core inflation averaged 4.6 per cent and 4.8 per cent in the 12 months to November 2015. However, in recent months, inflation has risen much faster: in November 2015 headline CPI reached 9.1 per cent annually while core CPI rose 6.7 percent annually. The sharp depreciation of the shilling (average annual depreciation of 33.7% in three months to November 2015 in nominal terms) has been the main cause behind it and is expected to continue to drive the inflation dynamic in the coming months. The rising inflation phenomena are not unique to Uganda. Many African countries are faced with rising inflation as shown in **Table 4** and currency depreciation has been a major factor in this trend, although idiosyncratic factors have also played a role.

Table 4: Comparison of inflation developments

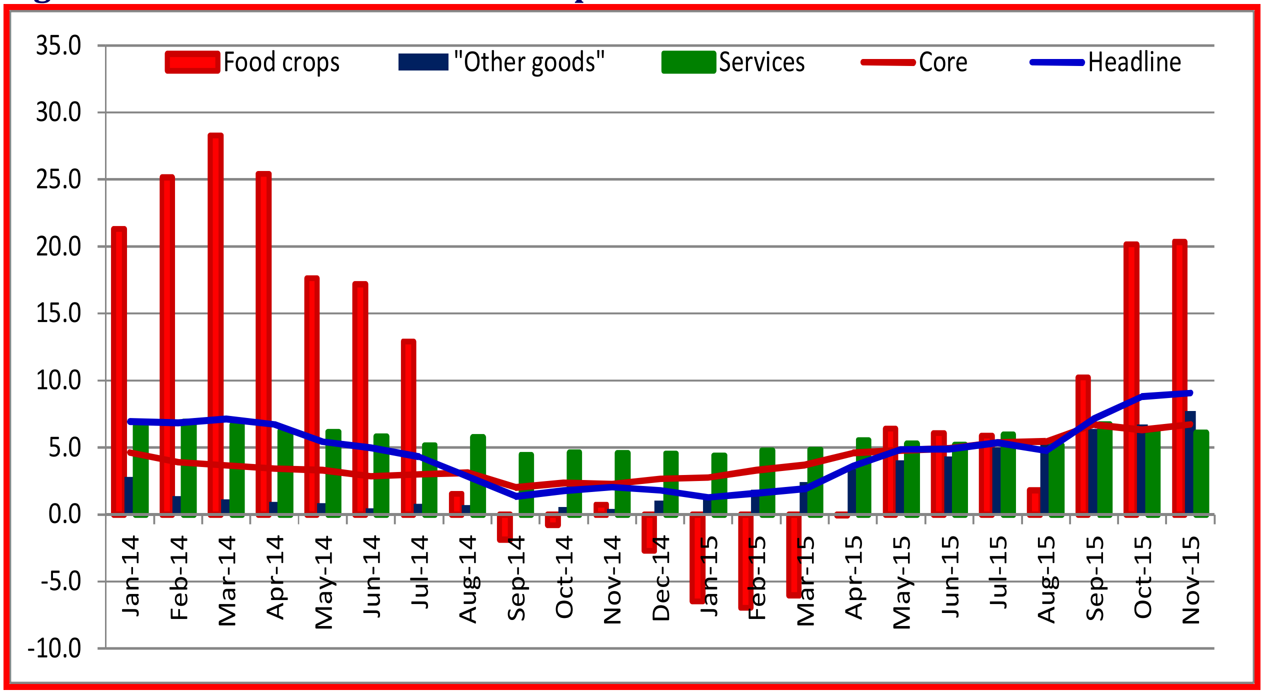
	Annual CPI inflation						
	May 15	Jun 15	Jul 15	Aug 15	Sep 15	Oct 15	Nov 15
Uganda	4.90	4.90	5.40	4.80	7.20	8.80	9.10
Ghana	16.94	17.05	17.94	17.29	17.32	17.40	-
Kenya	6.87	7.03	6.62	5.84	5.97	6.72	7.32
Nigeria	9.00	9.17	9.22	9.34	9.39	9.30	-
Tanzania	5.32	6.14	6.45	6.36	6.08	6.33	-
Zambia	6.90	7.10	7.10	7.30	7.70	14.30	19.50

Source: Bank of Uganda

In addition, the heightened inflationary pressures are also driven by supply side shocks, which have driven up food crop prices; adjustment of electricity tariffs; strong domestic demand, and base effects. Indeed, annual food crops inflation has averaged 17 percent during the last three months compared to *minus* 6.5 per cent during the first three months of 2015.

The momentum also remains high for services and "other goods" category, in part reflecting the lagged impact of exchange rate depreciation. The "other goods" inflation, which mainly reflects exchange rate changes rose from 1.4 percent in January 2015 to 7.7 percent in November 2015. Services inflation, a good proxy for "non-traded goods" inflation, which is indicative of domestic demand conditions in the economy, also remained relatively strong, averaging 6.3 per cent during the three months to November 2015. Energy, Fuel and Utilities (EFU) inflation also rose by 12.1 per cent in November 2015 from an average of 2.6 per cent during the first 9 months of 2015 largely on account of the adjustment of the electricity tariffs to account for a weaker exchange rate. Developments in domestic inflation are depicted in **Figure 10.**

Figure 10: Annual Inflation Developments



Source: Uganda Bureau of Statistics

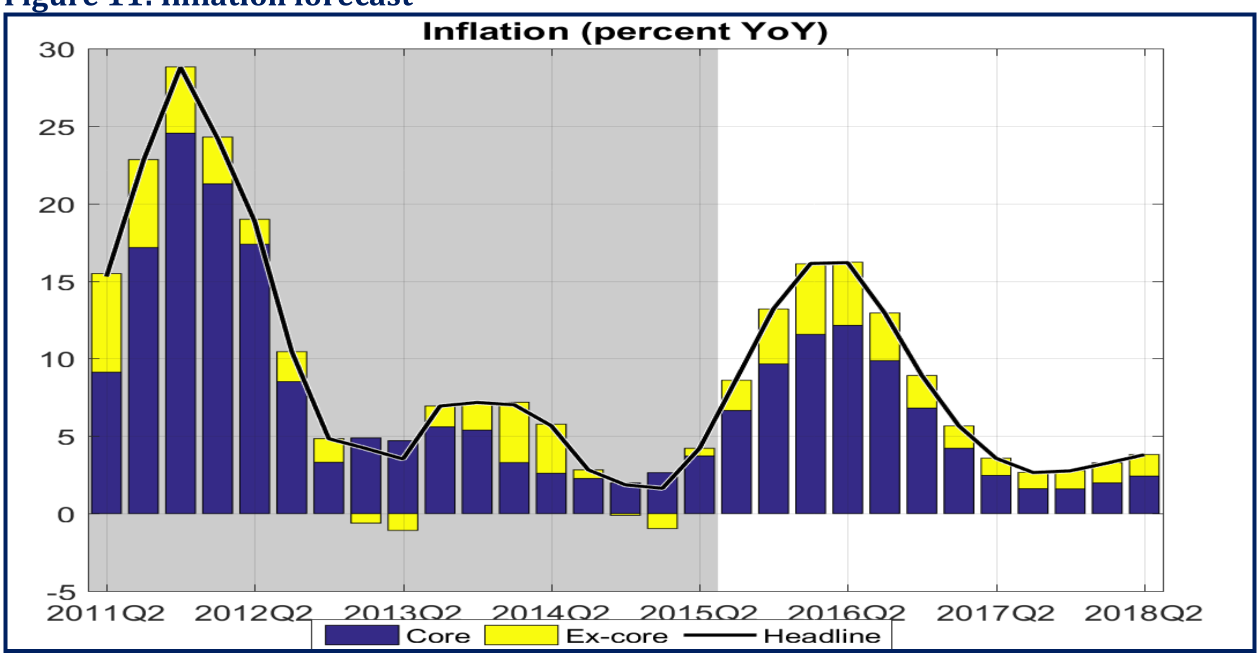
3.6.2 Inflation Outlook

Low global inflation, falling international commodity and energy prices, and a forward looking monetary policy have helped in holding back inflation despite the sustained depreciation pressures in the period to September 2015. Nonetheless, there are several upside risks that indicate that inflation will remain elevated in the coming months. Although the exchange rate has stabilised, the lagged impact of exchange rate depreciation may continue to keep inflation elevated. The future path of the exchange rate, which will be influenced by several domestic and external factors and the speed with which the recent depreciation feeds through to higher inflation remains uncertain.

The outlook for inflation reflects the balance between persistent drags from excess capacity and global disinflation and the impact of recent shilling depreciation and the El Nino weather conditions which are creating a double whammy for the inflation. A new depreciation of the shilling is one event that could trigger major changes in the trajectory and persistence of short-term inflation. As in previous quarters, it is possible for a scenario like this to respond again to movements in global conditions. The events that could drive a further depreciation of the shilling are of varied nature, and its effects on inflation could have implications on the conduct of monetary policy. The extended period in which annual inflation will be above the 5 per cent target could increase its persistence and have an impact on inflation expectations.

External sources of inflation are likely to stay generally benign, given ample supply buffers in the major commodity markets and weak global demand conditions. Oil prices are projected to remain low and increase only slightly in 2016. On the domestic front, exchange rate depreciation pressures remain, but their pass-through to consumer prices will continue to be constrained by the subdued growth environment. Meanwhile, the disinflationary effects of lower global oil prices, will begin to fade at the end of this year. As a result, as evident in **Figure 11**, inflation is forecast to continue rising over the course of 2015/2016, with headline and core inflation peaking in the ranges of 13-15 per cent and 10-12 per cent, respectively in the first half of 2016. However, this is dependent on the evolution of the exchange rate, domestic demand conditions, international commodity prices and the impact of the ongoing El Nino weather condition on the food crop prices.

Figure 11: Inflation forecast



Source: Bank of Uganda

The credibility of monetary policy in ensuring the convergence of inflation to the target is a key asset of the Central Bank. Thus, it is important to emphasize that, although inflation expectations over the short term have risen, forecasts continue to point at inflation meeting the target in two years' time. In the baseline scenario, inflation will stay above the target at least throughout the 2016. Overall, annual CPI and core inflation are expected to return to 5 percent over the course of 2017, hovering around this level until the end of the projection horizon around the third quarter of 2017.

4. Conclusion

The outlook for global growth has weakened since the September 2015 state of the economy report. Many emerging market economies have slowed markedly while growth in advanced economies has continued and broadened. There remain downside risks to the outlook, including that of a more abrupt slowdown in emerging economies.

On the domestic economy, the near term is characterised by a slowdown in economic activity, exchange rate depreciation, high cost of domestic borrowing, and external imbalances amidst a turbulent global financial system. The recent depreciation will eventually help in reducing current account deficits, by making exports more profitable and imports more expensive, but in the short term, improvements in the current account will come primarily from lower imports, the result of the economic slowdown.

Furthermore, inflation has increased sharply in the last three months, which in itself is a risk for expectations. Moreover, external risk scenarios may trigger an additional depreciation of the shilling, passing through to further inflation increases. Meanwhile, a scenario where capacity gaps increase more than expected and reduce inflationary pressures should not be ruled out. After evaluating these risks, the Bank estimates that the balance of risks for output is biased downward, while for inflation is biased upward in the short term.

As noted in the previous state of the economy report, economic conditions in Uganda are becoming more complex because of the slowdown in economic activity, rising inflation and external and fiscal imbalances. The exchange rate depreciation is a major source of vulnerability and it's pass through to domestic prices is likely to constrain domestic demand through lower income and higher cost of imported capital. This together with weak external demand as a result of modest global growth is likely to lower the growth projection for 2015/16. Moreover, it might be necessary to have a further exchange rate depreciation given the weakness in export commodity prices and the projected deterioration in the country's net external liabilities over the next four years.

In the medium to long term, the greatest risk comes from the current account of the balance of payments. Borrowings from the external sector resulting from Uganda's widening current account deficit will need to eventually be paid back. Therefore, Uganda should be able to eventually generate sufficient current account surpluses to repay what it has borrowed to finance the current account deficits. This however depends on whether the current borrowing is financing investment with a higher marginal product than the interest rate (or rate of return) the country has to pay on its foreign liabilities. The recent global financial crisis showed that there can be sharp capital reversals. Such reversals can be highly disruptive because private consumption, investment, and government expenditure must be curtailed abruptly when foreign financing is no longer available and, indeed, a country is forced to run large surpluses to repay in the short-term equivalent to what it borrowed in the past. This suggests that—regardless of why Uganda has a current account deficit (and even if the deficit reflects desirable underlying trends)—large and persistent deficits call for caution, lest Uganda experiences an abrupt and painful reversal of financing. Going forward, this calls for stronger international reserve buffers, which would allow greater room for better shock absorption.

With the rising external imbalances and inflation, the room for the BoU to maneuver is more limited. In addition, the already high government spending constrains the use of fiscal policy to support growth. Uganda's economic performance in the years to come will largely depend on its ability to adapt to adverse external conditions. The country's economic potential will only be enhanced through efficient management of public investment and reducing the cost of doing business.

The Bank will continue to assess the outlook, and to identify the stance of monetary policy that will most effectively foster sustainable growth and inflation consistent with the target. The future path of the CBR will be driven by the flow of incoming data, our assessment of the economic outlook, and judgements as to what level of interest rates is needed to achieve the BoU's price stability goal. Several factors will continue to be important in this regard including: domestic economic activity and out look; future movements in commodity prices – especially food crop prices; the degree of exchange rate adjustment that occurs and how quickly it passes through into inflation; fiscal policy operations; and whether whether inflation expectations have stabilised at an appropriate level.