Bank of Uganda

Current State of the Economy

June 2015

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Acronyms and Abbreviations

AEs	Advanced Economies
BoP	Balance of Payments
BoU	Bank of Uganda
CAB	Current Account Balance
CBR	Central Bank Rate
EAC	East African Community
ECB	European Central Bank
EMDEs	Emerging Market and Developing Economies
EFU	Electricity, Fuel and Utilities
EMEs	Emerging Market Economies
FAO	Food and Agriculture Organization
FDI	Foreign Direct Investment
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
NDP	National Development Plan
NEER	Nominal Effective Exchange Rate
NPLs	Non-Performing Loans
OPEC	Organization of the Petroleum Exporting Countries
pp	Percentage Points
PPP	Private Public Partnership
PSC	Private Sector Credit
QE	Quantitative Easing
REER	Real Effective Exchange Rate
REPOs	Repurchase Agreement
Shs	Shillings
SSA	Sub-Saharan Africa
UETCL	Uganda Electricity Transmission Company Ltd
UK	United Kingdom
URA	Uganda Revenue Authority
US	United States
US$	United States Dollar
US	United States
WALR	Weighted Average Lending Rate
Y-o-Y	Yeah on Year

Executive Summary

i. Global growth remains moderate, with uneven prospects across the main countries and regions. Global economic activity is estimated to have expanded by 3.4 per cent in 2014, and is expected to increase to 3.5 per cent in 2015. Relative to 2014, the outlook for Advanced Economies (AEs) is improving, while growth in emerging market and developing economies is projected to be lower, primarily reflecting weaker prospects for some large emerging market economies and oil-exporting countries on account of persistently low global oil prices.

ii. Much of the pick-up in global economic activity is driven by the Advanced Economies (AEs) on account of favourable policy mix and supportive financial conditions, while many in Emerging and developing economies are struggling against the backdrop of exchange rate depreciations, reduced demand particularly from China and low commodity prices. Growth in the Euro zone also remains fragile with considerable excess capacity and some countries remaining particularly vulnerable to adverse demand and supply-side shocks. Sub-Saharan Africa (SSA) has however remains relatively resilient to the global economic conditions, despite low export demand and falling commodity prices.

iii. The sharp drop in oil prices as well as lower food prices have been key factors behind weak global CPI inflation. Although the disinflationary effects of lower oil and food prices are generally expected to be transitory, core inflation in many countries has been well below inflation targets for an extended period. Persistent excess global supply has been a steady source of downward pressure on underlying inflation in the advanced economies.

iv. Global financial conditions have eased further in recent months, as many central banks have added to monetary policy stimulus in response to persistent economic slack and below-target inflation. Yields on long-term bonds have reached historical lows across most advanced economies, reflecting both market expectations for low short-term interest rates and compressed term premiums. In particular, the asset purchase programs implemented by the ECB and the Bank of Japan have lowered term premiums, with spillover effects into yields in other countries. In many euro-area countries, long-term bond yields have fallen sharply, in some cases even showing negative rates on terms beyond five years. At the same time, the gap between lending rates in the core and peripheral countries has narrowed, with the exception of Greece.

v. Domestic economic growth slackened in the third quarter of the current fiscal year. Nonetheless, the output gap for FY 2014/15 is estimated to be close to zero. Real GDP growth is projected to remain robust in 2015/16 in the range 5.5 – 6.0 per cent, mainly supported by public investment on infrastructure, recovery in private domestic consumption and investment demand, and a rebound in agriculture.

vi. Growth in Private Sector Credit continues to be robust, with annual growth averaging 14.4 per cent in the 12 month to April 2015 compared to 7.8 per cent during the corresponding period of last financial year. 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.

vii. The Current Account Balance remains fragile, with the deficit projected to widen to 8.5 per cent of GDP in FY 2014/15 from 7.2 per cent recorded in FY 2013/14, largely on account of weak export performance amidst strong import demand. Total export earnings for 12 months to April 2015 are estimated at US$ 2,732.4 million, which represents a decline of 0.42 per cent compared to the same period of the previous year. Imports (FOB) on the other hand, increased marginally by 0.07 per cent to US$5,049.4 million during the 12 months ended April 2015, from US$ 5,045.7 million in the previous period.

viii. Preliminary data indicates that the current account deficit deteriorated by US$264.7 million to a deficit of US$687.4 million during the quarter ended April 2015, from a deficit of US$422.8 million in the preceding quarter. The deterioration in the current account was largely as a result of lower personal transfer receipts and a large deficit in the services account during the three months period. The overall balance of payments was a deficit of US$91.3 million during the quarter ended April 2015, leading to a net drawdown in reserves assets of an equivalent amount. The stock of reserves at the end of April 2015 was estimated at US$2,824.8 million, equivalent to 4.2 months of future imports of goods and services.

ix. The exchange rate has depreciated, in part reflecting the weak balance of payments position, global strengthening of the US dollar, expectations and domestic economic vulnerabilities. Since July 2014, the Uganda shilling has depreciated against the U.S. dollar by 14 per cent.

x. Headline inflation edged-up significantly from 1.6 per cent in February 2015 to 4.9 per cent in May 2015. Core inflation that had remained close to the lower band of the inflation target range of **5** ± 2 per cent since the early 2014 also rose to 4.8 per cent, in part reflecting the impact of the pass-through of the exchange rate depreciation to domestic prices.

xi. Core inflation is expected to edge up further throughout the projection horizon. In the near term, the declining output gap is expected to exert additional upward pressure on inflation. If the Ugandan shilling depreciates further, then the pass through effects will continue in most of 2015 and 2016. Meanwhile, as economic growth picks up and the output gap turns positive, additional inflation pressures might require aggressive monetary policy tightening. However, as the economy reaches and remains at full capacity around the end of 2016/17, both the headline and core inflation are projected to be close to 5 per cent on a sustained basis. Short-term expectations for headline inflation remain in the range of 8-10 per cent.

xii. Overall, the convoluted global economic developments combined with uncertainties emanating from domestic economy means that the BoU conducts monetary policy more cautiously. Inflation forecast faces a number of risks, all of which are skewed towards higher inflation than currently expected. Consumer prices are now accelerating, and could breach the PSI inflation consultation upper bands during the first half of 2016 if monetary policy stance remains as it is. Food prices have picked up in response to drought conditions. Cheaper oil is having only limited effects on the prices of other goods and services. Core inflation is projected to average 6-7 per cent in the second half of 2015. For these reasons, monetary policy might need to be tightened further.

1. Background

This report reviews domestic and international developments that have affected inflation and that impact on the monetary policy stance. The report also assesses the future prospects for both domestic and global economy and identifies the probable risks to this outlook. It also provides an assessment of the factors determining inflation and the Bank's forecasts of the future path of inflation and economic growth. Finally, it presents 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 Global Economic Activity

Global growth remains moderate, with uneven prospects across the main countries and regions. As shown in **Table 1**, global growth is projected to be 3.5 per cent in 2015. Relative to 2014, the outlook for Advanced Economies (AEs) is improving, while growth in emerging market and developing economies is projected to be lower, primarily reflecting weaker prospects for some large emerging market economies and oil-exporting countries.

Table 1: Global Economic Growth Projections

	2013	*2014*	*2015*	*2016*
World output	3.4	3.4	3.5	3.8
Advanced economies	1.4	1.8	2.4	2.4
USA	2.2	2.4	3.1	3.1
Euro area	-0.5	0.9	1.5	1.6
Japan	1.6	-0.1	1.0	1.2
Emerging and developing economies	5.0	4.6	4.3	4.7
China	7.8	7.4	6.8	6.3
India	6.9	7.2	7.5	7.5
SSA	5.2	5.0	4.5	5.1

Source: IMF, World Economic Outlook, April 2015

Economic activity in the AEs continue to be buoyant, with growth estimated at 1.8 per cent in 2014 and expected to increase to 2.4 per cent in 2015, which is higher than the 1.4 per cent growth in 2013. Growth in the United States (US) and the United Kingdom (UK) performed modestly, with Gross Domestic Product (GDP) increasing by 2.4 per cent and 2.6 per cent in 2014, up from 2.2 per cent and 1.7 per cent, respectively in 2013. In 2015, growth is projected at 3.1 per cent and 2.7 per cent in the US and the U.K respectively. The growth momentum in the US was supported by increased personal and government consumption, investment and exports. Nonetheless, growth in the U.S is likely to be disappointing in the first quarter due to severe weather during the winter months, but the effect is expected to be short-lived. In the UK growth remained buoyed by rising household confidence and the vibrant housing market.

Growth in the Euro zone remains fragile with considerable excess capacity and some countries remaining particularly vulnerable to adverse demand and supply-side shocks. The Euro zone grew by just 0.9 per cent in 2014 notwithstanding the monetary stimulus and is projected to grow by 1.5 per cent in 2015; conditional on continued monetary stimuli and low global oil prices. Growth in Emerging and developing economies remain fragile. As in the previous report, growth in these economies in 2014 has been estimated at 4.6 per cent, which is a downgrade from the earlier projection of 4.8 per cent, and is expected to expand at a much lesser pace of 4.3 per cent in 2015.

Global growth is forecast to increase marginally beyond 2016, reflecting a further pickup in growth in emerging market and developing economies that would offset more modest growth in advanced economies. This pickup primarily reflects the assumption of a gradual return to more “normal” rates of growth in countries and regions under stress or growing well below potential in 2015–16 (such as Russia, Brazil, the rest of Latin America, and parts of the Middle East). On the other hand, advanced economies are projected to grow at more modest rates from 2017 onward, reflecting the gradual closure of output gaps—particularly in the euro area and the United States (where the persistence of crisis legacies and policy uncertainty play a role)—as well as the effects of demographics on labour supply and hence on potential output.

Growth in sub-Saharan Africa remains strong but is expected to slow this year to 4.5 per cent (from 5 per cent in 2014 and a substantial downward revision of 1¼ percentage points) in the face of headwinds from declining commodity prices and the epidemic in Ebola-affected countries. The oil price decline will have a severe impact on the region’s oil exporters, including Nigeria, with 2015 growth for those countries marked down by more than 2½ percentage points. In contrast, projected growth in the region’s oil importers is broadly unchanged, as the favourable impact of lower oil prices is offset to a large extent by lower prices of commodity exports. South Africa’s growth is expected to rise to 2 per cent this year, a 0.3 percentage point revision downward, and 2.1 per cent in 2016, reflecting more binding electricity supply constraints and a tighter fiscal stance in 2016 than previously expected.

2.2 Global financial markets

Global financial conditions have eased further in recent months, as many central banks have added to monetary policy stimulus in response to persistent economic slack and below-target inflation. The effects of lower prices for oil and other commodities are working their way through the world economy, boosting overall global growth, but weakening growth prospects in some countries.

Yields on long-term bonds have reached historical lows across most advanced economies, reflecting both market expectations for low short-term interest rates in the future and compressed term premiums. In particular, the asset purchase programs implemented by the ECB and the Bank of Japan have lowered term premiums, with spillover effects into yields in other countries. In many euro-area countries, long-term bond yields have fallen sharply, in some cases even showing negative rates on terms beyond five years. At the same time, the gap between lending rates in the core and peripheral countries has narrowed, with the exception of Greece. The additional policy easing in many countries in recent months has boosted stock market indexes globally, particularly in Europe, and many indexes remain at or near record highs. Credit spreads for both investment-grade and high-yield issuers have contracted further.

Uneven growth prospects across regions and expectations of diverging monetary policy paths have been reflected in higher levels of financial market volatility, particularly in fixed-income and foreign exchange markets. An increase in volatility toward more normal levels is to be expected with the re-emergence of two-way risk in policy rates. Some central banks have lowered rates to negative values—below what was previously viewed as a lower bound. In other countries, such as the United States and the United Kingdom, market prices reflect expectations of rising policy rates. These same forces have also contributed to the further appreciation of the U.S. dollar against other currencies.

2.3 Global inflation and commodity prices

Global inflation remains subdued but with diverse trends across the development divide. Headline inflation has declined in advanced economies, reflecting the decline in oil prices, softer prices for other commodities, and a weakening of demand in a number of countries already experiencing below-target inflation, such as the euro area and Japan. This decline in inflation, together with changes in the growth outlook and announcements by the Bank of Japan in October and the European Central Bank (ECB) in January of larger-than-expected asset purchase programs, has strengthened expectations of a protracted divergence in monetary policy stances across the main advanced economies, widening long-term interest rate differentials. With regard to emerging markets, lower prices for oil and other commodities (including food, which has a larger weight in the consumer price index of emerging market and developing economies) have generally contributed to reductions in inflation, with the notable exception of countries suffering sizable exchange rate depreciations, such as Russia.

Oil prices have fallen by about 47 per cent between Q3 2014 and Q1 2015 and remain volatile. After hitting a 6-year low in January 2015 at an average of US$ 47.1 per barrel, crude oil prices found some support during February 2015 rising to US$ 58.1 per barrel. The rebound reflected reports of capacity adjustments in US oil supply, with a 30 per cent decline in the number of oilrigs from early December 2014 and the announcement of sharp cutbacks in investment plans by major oil companies. This recovery was however short-lived as crude oil prices plummeted to an average of US$ 56 per barrel in March 2015, despite concerns regarding Saudi Arabia's incursion into Yemen. Nonetheless, US rig count has reduced oil production somewhat, which may trigger some upwards pressure to oil prices. However, a nuclear agreement between Iran and the US looks increasingly likely. This will eliminate some trade embargos if it materialized, introducing Iranian oil back to the global market. Moreover, oil demand from China is expected to fall as inventories in the Strategic Petroleum Reserve vaults are close to full. Therefore, oil prices are expected to remain low, averaging about US$ 53 per barrel for the most part of 2015, compared to US$ 100 per barrel in 2014 due to excess supply and large inventory accumulation. Developments in global Brent crude oil prices are shown in **Figure 1.**

Figure 1: Brent crude oil price

Source: US Energy Information Agency

Although global inflation has declined, this could be a temporary dip. The sharp fall in oil prices since June 2014 is expected to cut global inflation by around 1 percentage point (pp) this year, with major AEs seeing a period of negative inflation during 2015. The direct impact of lower energy prices should be temporary, dissipating during 2016, but the coincident fall in inflation expectations in some high- income countries and weaker growth in large oil importing EMEs might lead to more persistent effects and in some cases increased deflationary concerns.

Food prices continued their downward trajectory, which has been prevailing since April 2014, as global food supplies remain abundant. In February 2015, the Food and Agriculture Organization (FAO) food price index declined by 0.9 per cent month-on-month and 14.0 per cent year-on-year, to its lowest value since July 2010. Favourable weather conditions may continue to keep food prices relatively low in 2015. Global inflation is therefore projected to remain subdued through 2015 as global spare capacity remains abundant and international commodity prices remain relatively low and stable.

A number of complex forces are shaping the outlook. These include medium- and long-term trends, global shocks, and many country- or region-specific factors:

- In emerging markets, negative growth surprises for the past four years have led to diminished expectations regarding medium-term growth prospects.
- In advanced economies, prospects for potential output are clouded by aging populations, weak investment, and lacklustre total factor productivity growth. Expectations of lower potential growth weaken investment today.
- Several advanced economies and some emerging markets are still dealing with crisis legacies, including persistent negative output gaps and high private or public debt or both.
- Inflation and inflation expectations in most advanced economies are below target and are in some cases still declining—a particular concern for countries with crisis legacies of high debt and low growth, and little or no room to ease monetary policy.
- Long-term bond yields have declined further and are at record lows in many advanced economies. To the extent that this decline reflects lower real interest rates, as opposed to lower inflation expectations, it supports the recovery.
- Lower oil prices—which reflect to a significant extent supply factors—provide a boost to growth globally and in many oil importers but will weigh on activity in oil exporters.

- Exchange rates across major currencies have changed substantially in recent months, reflecting variations in country growth rates, monetary policies, and the lower price of oil. By redistributing demand toward countries with more difficult macroeconomic conditions and less policy space, these changes could be beneficial to the global outlook. The result would be less risk of more severe distress and its possible spill over effects in these economies.

The net effect of these forces can be seen in higher projected growth this year in advanced economies relative to 2014, but slower projected growth in emerging markets. Nevertheless, emerging markets and developing economies still account for more than 70 per cent of global growth in 2015. This growth outlook for emerging markets primarily reflects more subdued prospects for some large emerging market economies as well as weaker activity in some major oil exporters because of the sharp drop in oil prices.

2.4 Implications for the Ugandan economy

The global economic environment will continue to affect Uganda's economic developments by influencing commodity prices, the volume and direction of international capital flows, and trade. As such, risks to the global economic outlook have the potential to affect consumer and investor confidence and hold back growth in the Ugandan economy. The major forces driving the global economic outlook are soft commodity prices, persistently low interest rates but increasingly divergent monetary policies across major economies and these have implications for the Ugandan economy.

The sharp decline in oil prices since mid-2014 will both support global activity and help offset some of the headwinds to growth in oil-importing developing economies. However, it will lead to a fall in exports earnings for commodity exporters, which will heighten depreciation pressures in the domestic foreign exchange market. It could also dent Foreign Direct Investment (FDI) inflows to commodities sectors thus affecting growth. In Uganda, there are already indications that FDI inflows to the oil sector have dwindled. Given Uganda's weak Current Account (CA) position, which has largely been funded by surpluses in the capital and financial account of the Balance of Payments (BoP), a decline in FDI inflows will exacerbate depreciation pressures in the foreign exchange market.

The current global inflation outlook for 2015 has been downcast from 2.9 per cent to 2.8 per cent, largely on account of low oil and food prices and again from reduced demand from China and the Euro Area. Consequently, although half of the global economy, weighted by real GDP, already has expansionary monetary policy, more countries are expected to adopt expansionary policies in 2015. However, some emerging market and developing economies, including Uganda may instead face upwards-inflationary pressure, given severe exchange rate depreciations.

The Euro zone is a major trading partner for Uganda: its continued slow growth poses a downside risk to domestic inflation. Being a major trading partner, sluggish growth in addition to weak demand in the Euro Zone is expected to have a negative impact on Uganda's export earnings, remittances and FDI. Whereas the European Central Bank (ECB) is set to continue implementing expansionary monetary policies for an extended period, the United States Federal Reserve may begin normalizing monetary policy in the second half of 2015, as its economy continues to strengthen. The resultant tight global financial conditions following the normalization of monetary policy mainly in the US and UK might lead to weaker financial flows or possible capital reversals. This could result in further currency depreciation.

The geopolitical tensions in the Middle East, Russia and Ukraine and the threat of terrorism remain elevated with negative implications on consumer and business confidence, such that investors and consumers hold back on spending. This could lead to reductions in aggregate demand thereby constraining growth. Secondly, a physical disruption of energy supply on account of the raging conflicts, while paving way for the commencement of oil drilling in Uganda, may push-up international oil prices, posing a risk to domestic inflation and growth prospects.

3. Domestic Economic Developments

3.1 Monetary policy stance and Implementation

3.1.1 Monetary Policy Stance

In April 2015, Bank of Uganda (BoU) tightened monetary policy so as to forestall the rise in core inflation. The Central Bank Rate (CBR) was raised by 1 percentage point to 12 per cent, up from 11 per cent where it had been maintained since June 2014 so as to ensure annual core inflation remains around BoU's target of 5 per cent over the medium term. However, the band on the CBR was maintained at +/-2 percentage points and the margin on the rediscount rate at 3 percentage points on the CBR. The rediscount rate and the bank rate were increased to 15 per cent and 16 per cent, respectively.

This stance was premised on the projected inflation and output path. Although economic growth may have slackened off in the third quarter of the current fiscal year, the best estimate of the output gap for Financial Year (FY) 2014/15 is close to zero. Real GDP growth is projected to remain robust in 2015/16 in the range 5.5 – 6.0 per cent, mainly supported by public investment on infrastructure, recovery in private domestic consumption and investment demand, and a rebound in agriculture. However, real output growth may accelerate over the medium term, pushing real output even further above potential, which may exert upward pressures on inflation.

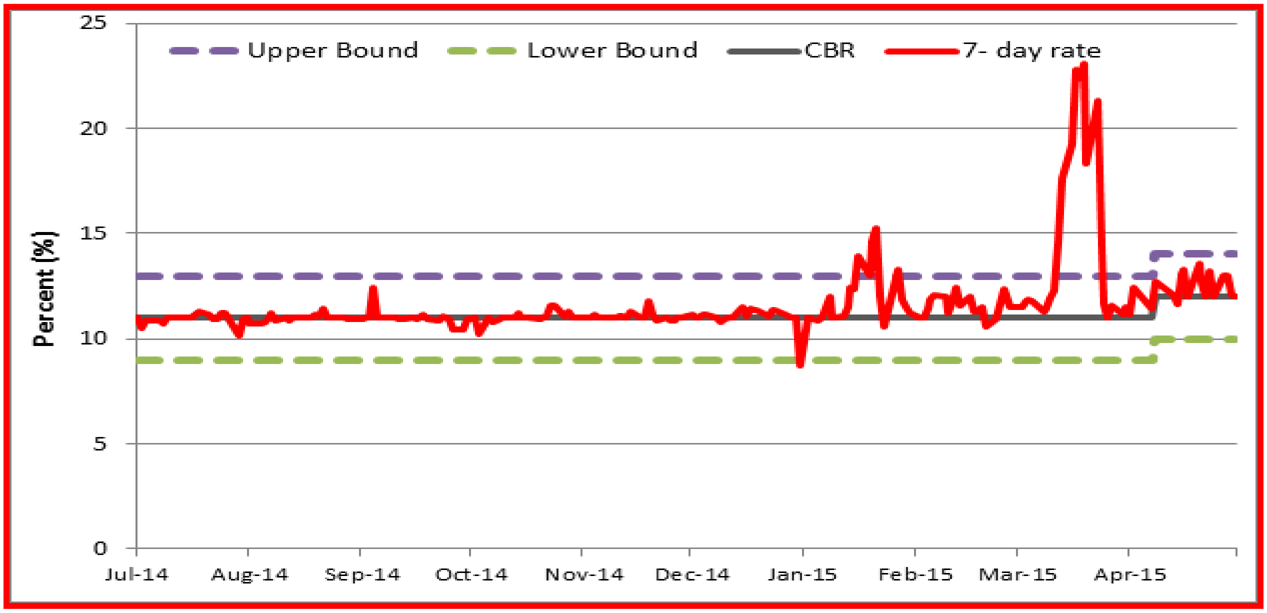
Inflation remained subdued trending below the 5 per cent bank of Uganda's (BoU) average core inflation target. In May 2015, the 12-month average was 2.7 per cent. Low inflation was largely on account of subdued food crop prices due to the good harvests and low import prices. Inflation seems to have bottomed out and the trend began to reverse in February 2015 due to increasing prices of food crops as well as the pass through of exchange rate depreciation. Core inflation averaged 4.4 per cent in the three months to May 2015 up from an average of 2.9 per cent in three months to February 2015, and increased to 4.8 per cent Year on Year (y-o-y) in May 2015 from 4.6 per cent in April 2015. Over the same time, headline inflation averaged 3.5 per cent in three months to May 2015 up from 1.6 per cent in three months to February 2015. It increased to 4.9 per cent in May 2015 y-o-y from 3.6 per cent in April 2015. The outlook for core inflation in the short- to medium term suggests slightly higher inflation, rising to 5-6 per cent and 8-10 per cent by June 2015 and June 2016, respectively. The recent oil price decline lowered the import bill and gradually passed through to domestic fuel prices. This was partially offset by the global strengthening of the United States dollar, which led to a weakened shilling and consequently higher domestic prices for many imported goods.

3.1.2 Monetary policy implementation

The Bank of Uganda continued to use Repurchase Agreement (REPOs)/reverse REPOs and outright sales of recapitalization securities in the secondary market for aligning liquidity conditions in the domestic financial system with the desired monetary policy stance. In March 2015, money market rates rose on account of the tight liquidity conditions which were necessary to contain the speculative activity in the foreign exchange market. BoU interventions in the foreign exchange market on the sell side had an effect of stemming the pace of the depreciation and the amount of liquidity withdrawn from the domestic Shilling market.

During quarter ending March 2015, structural liquidity which has been on-going for the past couple of years contracted significantly due to increased foreign currency sales by the BoU warranted by the depreciation pressures. Following the sterilization occasioned by the interventions to stem the exchange rate volatility, the behaviour of the 7-day interest rate during the financial year has been mixed. Most times, the weighted average 7-day rate trended within the CBR band while other times, it rose above and trended above the CBR upper band especially in the first and last month of the quarter ending March 2015 before declining to within the band as conditions normalized. Developments in the 7-day are shown in **Figure 2.**

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



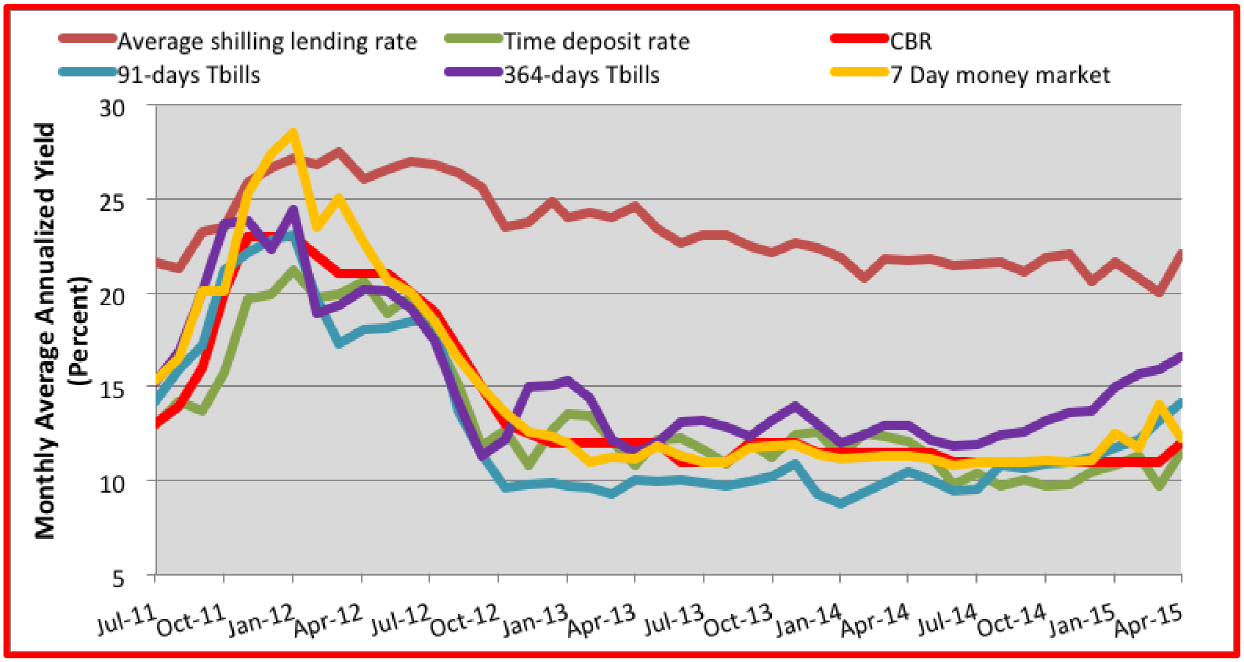
Source: Bank of Uganda

3.2 Interest rates and Private Sector Credit

3.2.1 Interest rates

Yields on government securities have maintained an upward trend since January 2015, in part reflecting increasing government borrowing requirements as depicted in amounts offered in auctions and the expectation that inflation will edge up. Nominal interest rates for various tenors have risen to levels of about 15 per cent, which when contrasted to the subdued inflation in 2014/15, implies growing borrowing costs in real terms. The rise in auction amounts was based on the need to raise resources to supplement domestic revenues in order to finance government infrastructure spending. Expectations of fiscal slippage due to increased government expenditure during election period and depreciation pressures have led to high inflation expectations and thus higher yields on government securities. The trajectory of yields in government securities vis-à-vis other interest rates is shown in **Figure 3**.

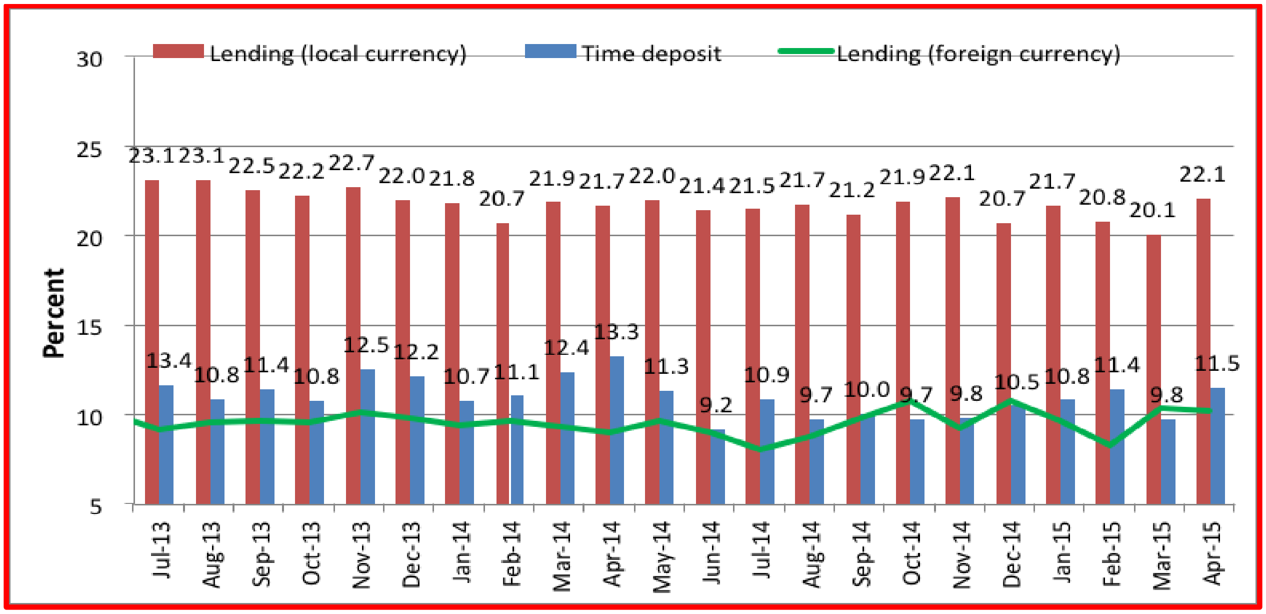
Figure 3: CBR, Lending Rate, 7- day rate and 91-day Treasury bill rate



Source: Bank of Uganda

Over the last 12 months, the Weighted Average Lending Rate (WALR) on shilling denominated loans has remained fairly stable, averaging 21.4 per cent. Interest rates on shilling time deposits have also remained relatively stable. Overall, lending rates remain high and sticky downwards, declining only marginally despite the subdued inflation and the relatively neutral monetary policy stance. This reflects asymmetry of the monetary policy transmission mechanism, structural rigidities in the financial sector and higher risk aversion by commercial banks and the high cost of doing business. Moreover, in March, most commercial banks adjusted their base lending rates upwards, in part because of the depreciation pressures in the foreign exchange market and is expected to edge-up, especially if the yields on risk-free government securities continue to rise. Nonetheless, the ratio of Non-Performing Loans (NPL) to total loans remained stable at 4.3 per cent in March 2015 from 4.1 per cent in December 2014, indicating an improvement in asset quality. The WALR on foreign currency denominated loans also remained stable during the same period. Developments in lending and deposit rates are shown in **Figure 4**.

Figure 4: Shilling Time Deposit and Lending rates



Source: Bank of Uganda

3.2.2 Private Sector Credit

Private sector credit expanded at an average of 16.8 per cent in the three months to April 2015 compared to 14.9 per cent in the three months to January 2015. It grew at an average growth rate of 14.4 percent in the 12 months to April 2015 compared with an average growth rate of 7.8 percent in the 12 months to April 2014. This reflects steadying growth in credit to manufacturing, mining trade and mortgage and construction sectors. However, growth in broad money has slacken, declining to a growth rate of 9.7 percent in the three months to April 2015 compared to 15.9 percent in the three months to January 2015.

The rebound in PSC growth is expected to bond well with private consumption and investment activity, which should in turn support economic growth going forward. Developments in private sector credit are shown in **Table 2**.

Table 2: Sectoral Developments in Private Sector Credit

	Annual Average Growth rates		Share of credit in total lending		NPLs
	Jul'13- Apr'14	Jul'14- Apr'15	Jul'13- Apr'14	Jul'14- Apr'15	Mar-15
Agriculture	28.32	37.41	8.25	9.88	6.7
Mining and Quarrying	-14.14	28.03	0.34	0.37	1.1
Manufacturing	7.96	9.44	14.12	13.43	3.4
Trade	0.74	18.06	19.83	20.30	3.9
Transport and Communication	-5.59	7.67	5.57	5.20	7.2
Electricity and Water	0.52	55.24	1.25	1.66	2.4
Building, Mortgage, Construction and Real Estate	1.69	19.26	21.89	22.68	3.6
Business Services	12.28	8.12	4.74	4.45	3.5
Community, Social & Other Services	4.92	23.64	3.13	3.37	2.1
Personal Loans and Household Loans	31.26	16.55	16.39	16.47	3.0
Other Services	15.98	-32.62	4.50	2.19	24.4
Total	8.47	14.58	100.00	100.00	4.2

Source: Bank of Uganda

3.3 Fiscal Developments

The fiscal stance in FY 2014/15 focussed on supporting economic activity by addressing the infrastructural constraints in the economy. Preliminary fiscal data for the ten months of 2014/15 indicates that total Government expenditure and net lending amounted to Shs 11,522.1 billion, which is Shs 29.6 billion, lower than the programmed expenditure for this period. The underperformance in fiscal operations during the period under review was on account of lower than programmed government expenditure on the hydropower projects (HPP's). Recurrent expenditure however amounted to Shs 6,213.7 billion, which is an over performance of Shs 59.4 billion, compared to the budgeted amount of Shs 6,154.3 billion over the same period.

Total Government revenue, including grants, amounted to Shs 8,666.7 billion, which is less than the budget amount by Shs 86.3 billion. Grants registered a cumulative excess of Shs 43.3 billion relative to the budget projection, and were Shs 169.6 billion higher than in 2013/14, mainly on account of higher budget support grants. Relative to the Uganda Revenue Authority (URA) tax and non-tax revenue targets, tax collections posted a cumulative shortfall of Shs 140.8 billion while non-tax collections posted a cumulative surplus of Shs 11.2 billion over the first ten months of FY 2014/15. Details of the developments in Government expenditure and revenue during this period are shown in **Table 3**.

Table 3: Fiscal Operations (Shs billion)

	Jul 2013 – April 2014	Prel. Jul 2014 – April 2015	PSI Prog. Jul 2014 – April 2015	variation
Revenue & Grants	**7,203.5**	**8,666.7**	**8,753.0**	**-86.3**
Revenue	6,586.1	7,879.7	8,009.3	-129.6
Tax	6,476.2	7,703.0	7,843.8	-140.8
Non- Tax	109.88	176.71	165.5	11.2
Grants	617.4	787.0	743.7	43.3
Expenditure & Lending	**9,619.4**	**11,522.1**	**11,551.7**	**-29.5**
Current Expenditure	5,490.4	6,213.7	6,154.3	59.4
Development Expenditure	4,102.7	4,002.0	4,007.3	-5.3
Net lending/repayments[1]	14.3	1,166.4	1,215.3	-48.9
Domestic arrears	12.0	140.0	174.3	-34.3
Deficit (including grants)	**-2,416.0**	**-2,855.4**	**-2,798.3**	**-57.1**
Financing (net)	**2,416.0**	**2,855.4**	**2,798.3**	**57.1**
External Financing (net)	655.6	815.8	714.3	101.4
Domestic Financing(net)	1,287.0	1,879.7	2,158.7	-279.0
Errors & Omissions	473.3	160.0	-74.7	

Source: Ministry of Finance, Planning and Economic Development

Fiscal deficit (including grants) in the first ten months of 2014/15 amounted to Shs 2,855.4 billion, which is higher than Shs 2,416.0 billion in the same period last year. The deficit was financed to the tune of Shs 1.88 trillion through domestic financing (issuance of Government securities and drawdown on Government savings with the banking system). The provisional total public debt stock (at nominal value) increased by 16.3 per cent to Shs 22,496.2 billion as at end April 2015 relative to June 2014, of which public external debt is Shs 12,691.5 billion and domestic debt is 9,801.7 billion. The Debt sustainability analysis indicates that the current level of debt is sustainable. However, there are public investment projects in the pipeline, which will require additional debt financing going forward.

During the second half of the financial year, the government issued a supplementary budget, which was financed through the reallocation of expenditure and savings. Overall, higher revenue collection and savings arising from the payroll and cash management reforms will allow the government to keep the FY 2014/15 fiscal deficit within the budget limit.

[1] Net lending constitutes recapitalization of Bank of Uganda and expenditure on the Karuma and Isimba Hydro Power Projects

Over the medium term, government plans to significantly advance the infrastructure program through projects that are necessary to improve the business environment, enhance regional integration, and develop Uganda's oil sector. Project financing is anticipated to rely mainly on external non-concessional borrowing, but also public-private partnerships, revenue enhancement and the use of government's savings. Economic growth outlook in FY 2015/16 and in the medium term are premised on successful implementation of infrastructure investment projects. Any delays in implementation of public investments will negatively impact on growth prospects. However, executing planned projects too fast could risk overheating the economy.

3.4 Balance of Payments and Exchange Rates

3.4.1 Balance of payments

The current account deficit is projected to widen to 8.5 per cent of GDP in FY2014/15 from 7.2 per cent recorded in FY2013/14, largely on account of weak export performance amidst strong import demand. Total export earnings for 12 months to April 2015 are estimated at US$ 2,732.4 million, which represents a decline of 0.42 per cent compared to the same period of the previous year. Imports (FOB) on the other hand, increased marginally by 0.07 per cent to US$5,049.4 million during the 12 months ended April 2015, from US$ 5,045.7 million in the previous period.

Preliminary data indicates a deterioration of US$264.7 million in the current account balance to a deficit of US$687.4 million during the quarter ended April 2015, from a deficit of US$422.8 million in the preceding quarter. The deterioration in the current account was largely as a result of lower personal transfer receipts and a large deficit in the services account during the three months period. The overall balance of payments was a deficit of US$91.3 million during the quarter ended April 2015, with a net draw down in reserves assets of US$103.7 million excluding valuation changes. The stock of reserves at the end of April 2015 was estimated at US$2,824.8 million, which is equivalent to 4.2 months of future imports of goods and services. This was a decrease from US$2,990.1 million recorded at the end of January 2015. The draw down in reserves was on account of BOU net intervention to stem exchange rate volatility. Developments in the BoP are shown in **Table 4**.

Table 4: Balance of Payments in Million (millions US dollars)

	Feb-Apr 14	May-Jul 14	Aug-Oct 14	Nov 14-Jan 15	Feb-Apr 15
Current account	**-716.44**	**-650.47**	**-867.12**	**-422.76**	**-687.42**
Credit	1396.50	1481.75	1621.38	1710.48	1389.74
Debit	2112.94	2132.22	2488.50	2133.24	2077.16
Goods and services	**-704.94**	**-801.75**	**-1036.62**	**-624.34**	**-748.80**
Credit	1150.39	1099.50	1203.77	1188.43	1089.17
Debit	1855.33	1901.25	2240.39	1812.77	1837.96
Goods	-593.40	-644.85	-599.90	-541.24	-531.02
Credit (exports)	688.32	669.73	660.30	710.73	691.60
Debit (imports)	1281.72	1314.58	1260.20	1251.97	1222.62
Government Imports	75.20	84.35	34.24	78.05	44.62
Private Sector Imports	1191.23	1214.88	1209.30	1152.39	1158.93
Services	-111.54	-156.90	-436.72	-83.10	-217.78
Credit	462.07	429.77	543.47	477.69	397.56
Debit	573.61	586.67	980.19	560.79	615.34
Primary income	**-221.33**	**-174.58**	**-184.10**	**-235.94**	**-200.44**
Credit	8.70	9.58	11.24	2.86	3.53
Debit	230.04	184.16	195.33	238.80	203.98
Secondary income	**209.83**	**325.86**	**353.60**	**437.51**	**261.82**
Credit	237.40	372.67	406.37	519.19	297.04
Debit	27.57	46.82	52.77	81.68	35.22
Capital account	**12.54**	**15.33**	**34.84**	**32.62**	**13.10**
Credit	12.54	15.33	34.84	32.62	13.10
Debit	0.00	0.00	0.00	0.00	0.00
Balance from Current and Capital Accounts	**-703.90**	**-635.14**	**-832.28**	**-390.14**	**-674.32**
Financial account	**-495.87**	**-547.30**	**-482.18**	**-219.50**	**-483.42**
Direct investment	-313.79	-314.65	-235.63	-268.18	-246.53
Net acquisition of financial assets	0.16	0.12	0.06	0.04	0.00
Net incurrence of liabilities	313.94	314.77	235.69	268.22	246.53
Portfolio investment	-36.81	5.68	-7.56	51.39	23.02
Net acquisition of financial assets	39.70	43.03	32.18	35.11	18.84
Net incurrence of liabilities	76.51	37.35	39.74	-16.28	-4.18
Financial derivatives (other than reserves) and employee stock options	-0.28	0.69	-1.10	-1.83	-2.33
Net acquisition of financial assets	2.51	2.74	2.96	3.53	2.73
Net incurrence of liabilities	2.79	2.05	4.06	5.36	5.06
Other investment	-144.99	-239.01	-237.89	-0.87	-257.58
Net acquisition of financial assets	-25.73	-127.68	-217.99	259.88	-60.00
Net incurrence of liabilities	119.26	111.33	19.90	260.76	197.58
Net errors and omissions	**297.53**	**79.16**	**289.37**	**53.42**	**99.61**
Overall Balance (+ Deficit / - Surplus)	**-89.50**	**8.68**	**60.73**	**117.22**	**91.29**
Reserve assets	**87.21**	**-9.67**	**-62.93**	**-110.61**	**-103.73**

Source: Bank of Uganda

3.4.2 Exchange Rates

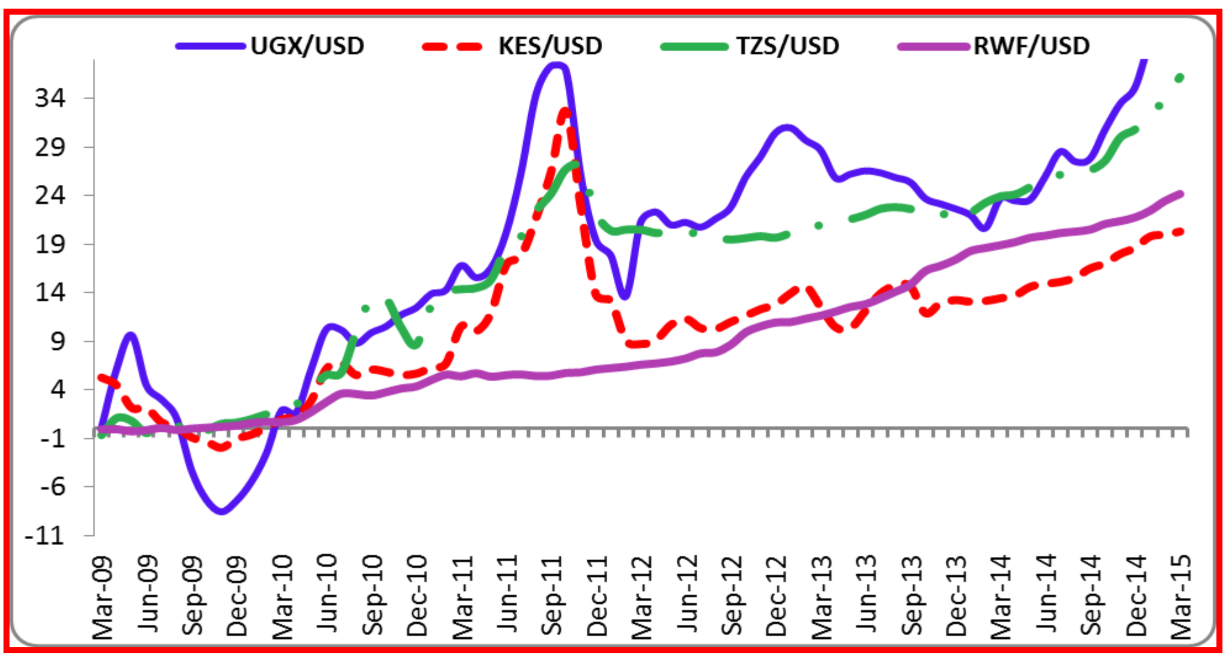
The exchange rate has depreciated since early 2014. For 12 months to May 2015, the Uganda shilling has depreciated against the U.S. dollar by 16.5 per cent. For the year ended April 2015, the shilling had depreciated by about 9.8 per cent on a trade-weighted basis. Since January 2015, the BoU has had to respond to volatile foreign exchange rate movements by intervening in the foreign exchange market and to some extent allowing tight shilling liquidity conditions. The BoU is committed to avoiding excessive volatility in the exchange rate without impeding the real exchange rate from reflecting market conditions.

Developments in the foreign exchange market are largely a reflection of the developments in the external sector. During the period under review, the developments in the market were driven by a large current account deficit, coupled with panic buying and noise in the market, corporate sector demand for foreign exchange (especially from manufacturing, telecommunications, trade and energy sectors), and the global strengthening of the US dollar against other international reserve currencies.

On year to year basis, as at end May, 2015, US dollar strengthened by 23.2 per cent against the Euro, 18.5 per cent against the Japanese Yen, 15 per cent against the South African Rand and 8.9 per cent against the British Pound on year-on-year basis. Uganda being a small open economy, experiences a relatively high pass-through of global developments, hence their impact on the Uganda Shs. Most of the regional currencies also experienced depreciations against the dollar during the same period. The Kenyan Shilling, Tanzanian Shilling and Rwandese franc depreciated by 10.3 per cent, 18.8 per cent and 4.7 per cent, respectively. Developments in the exchange rates are shown in **Figure 5**.

In order to stem exchange rate volatility, BoU stayed purchases for reserves build-up on days of excessive volatility and also intervened in the Interbank Foreign Exchange Market (IFEM). As of end of May 2015, the net BoU actions for the financial year 2014/15 was a net purchase of US$ 112.2 million relative to a target purchase of US$ 535 million.

Figure 5: Exchange Rate Movements in the EAC Countries

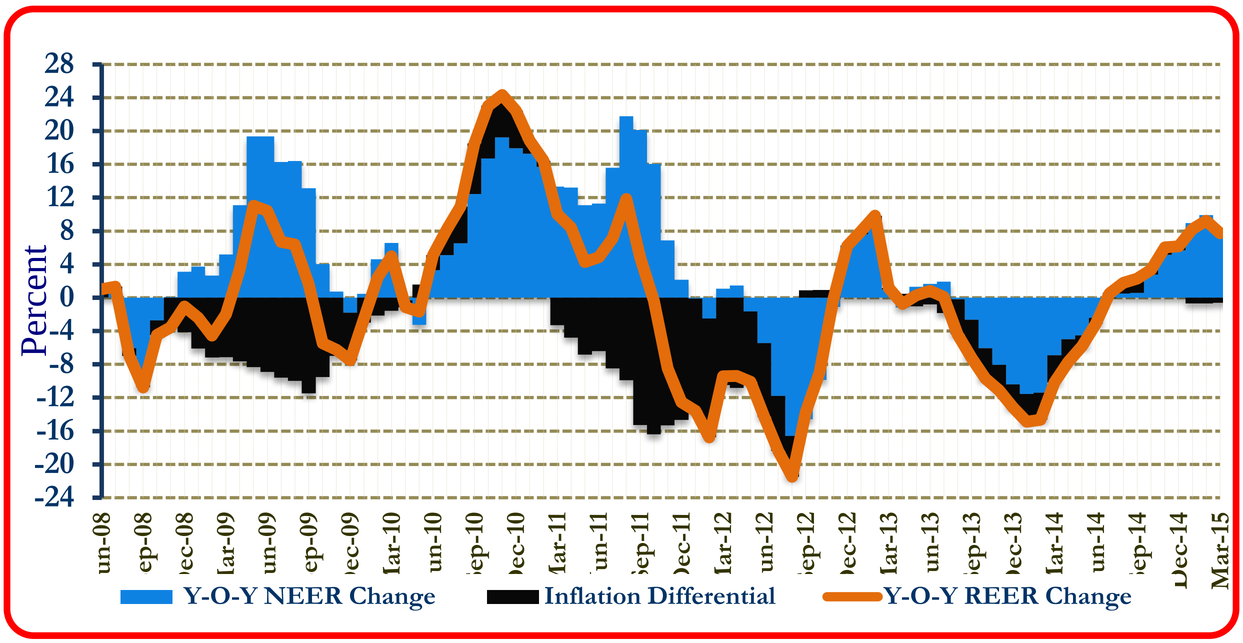


Source: Bank of Uganda

The Real Effective Exchange Rate (REER) depreciated in line with the depreciation of the bilateral Shs/US dollar rate by 8 per cent year-on-year in April 2015. The depreciation of the REER was mainly driven by the depreciation of the Nominal Effective Exchange Rate (NEER). On year-on-year basis, the NEER depreciated 4.5 per cent in Q4 2014 compared to a depreciation of 0.6 per cent in Q3 2014. These developments are shown in **Figure 6.**

Nonetheless, the exchange rate depreciation has helped restore competitiveness, which had been lost due to appreciation of the Shilling in 2013. Moreover, the depreciation is expected to improve the profitability of the tradable goods sectors, although it may fuel inflation, which may in turn undermine the sectors profitability, thus worsening the CA imbalance.

Figure 6: Changes in Real Effective Exchange Rate



Source: Bank of Uganda

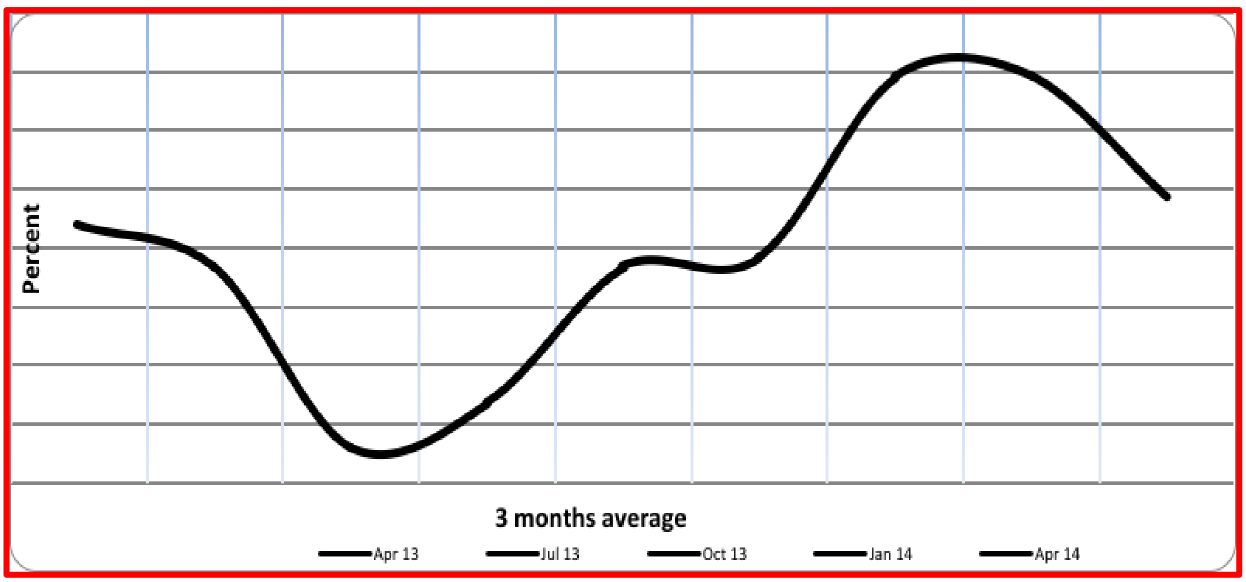
Going forward, the shilling may continue to weaken on account of the likely further strengthening of the US dollar as the US Federal Reserve's end its quantitative easing (QE) stimulus programme, which is likely to lead to further strengthening of the US dollar against other global currencies. This would mean a further weakening of the exchange rate. Other possible risks to the exchange rate include the weak CA position, as well as the increased government foreign exchange requirements to finance infrastructure development and the increase in the country's risk premium due to amplified government borrowing to finance public investments.

3.5 Domestic Economic Activity

In comparison to FY 2013/14, economic activity has picked up and is projected to improve further during the course of the year ending June 2015, largely driven by higher public expenditure. Real GDP growth is projected at 5.3 per cent in FY 2014/15 up from 4.5 per cent in FY 2013/14. There has also been an upturn in private investment supported by a rapid recovery in private sector credit. Improved business sentiment is evidenced by higher capital equipment imports and above-target revenue collections. Improved profitability of the banking sector was evident in the tax returns posted in December 2014.

However, economic activity continued to grow but at slower rate during the quarter to April 2015. The Composite Index of Economic Activity (CIEA) rose but at a slower rate of 1.9 per cent in the quarter to April 2015 compared to the 2.9 per cent growth in the quarter to January 2015 **(Figure 7).**

Figure 7: Quarterly changes in Composite Index of Economic Activity



Source: Bank of Uganda

Going forward, after stalling in the first quarter of 2015, real GDP growth is expected to rebound in the second quarter of 2015 and subsequently strengthen to average about 5.8 per cent on year-to-year basis in 2015/16. The Bank expects that the economy will reach full capacity around the end of 2016/17.

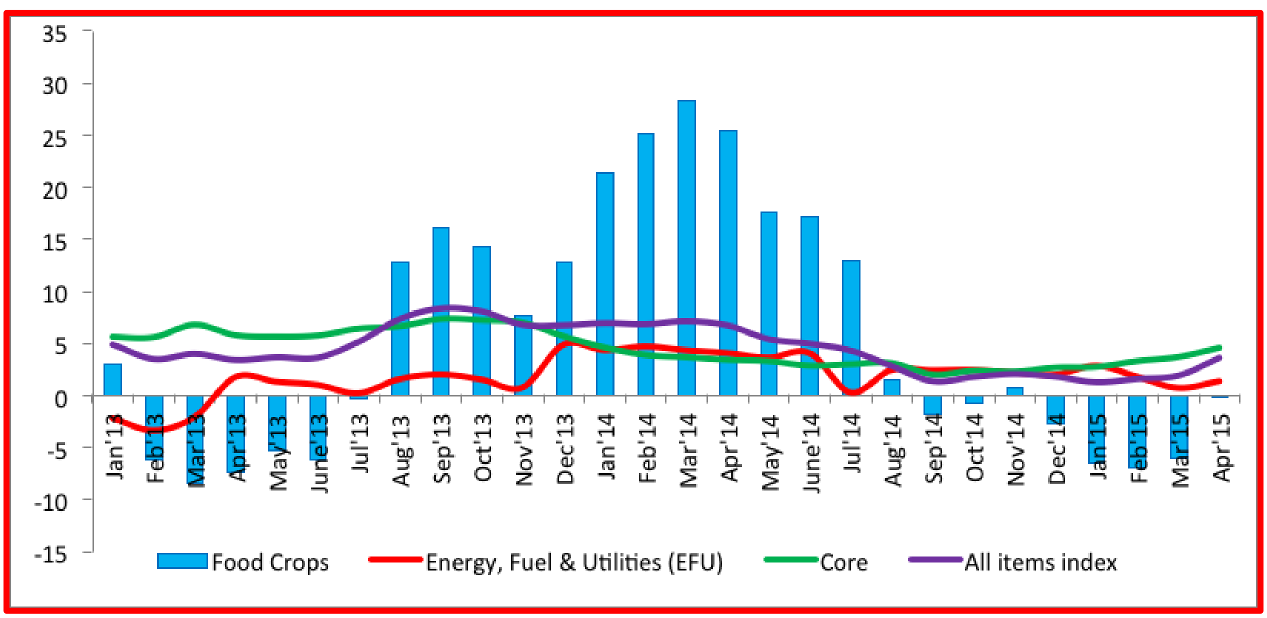
The timing and composition of growth is expected to shift somewhat relative to the historical trend. The negative impact of the exchange rate volatility, decline in FDI and uncertainty in economic outlook will deter private sector investment. The government spending will be the driver of economic growth over the projection horizon. Although the weaker value of the Uganda shilling will provide a boost to exports, by increasing the cost of imported capital, the lower shilling will weigh on investment spending. Given the degree of uncertainty in economic projections, the Bank judges that real GDP growth is likely to be within ±0.5 percentage points of the base-case projection in 2015, with a somewhat wider range in 2016 and 2017.

3.6 Consumer Price Inflation

3.6.1 Recent Inflation Developments

Headline inflation declined in 12 months to May 2015 to an average of 2.7 per cent compared to 6.6 per cent in the same period to May 2014. The decline in headline inflation can partly be explained by the temporary effects from lower food crop prices and subdued demand. While the current levels of inflation still remain low, there are signs that the low inflation trajectory has bottomed out and inflation is rising. In recent months, headline inflation has edged up significantly from 1.6 per cent in February 2015 to 4.9 per cent in May 2015. Core inflation that had remained close to the lower band of the inflation target range of **5** ±2 percent since the early 2014 has risen to 4.8 per cent in May 2015 reflecting the pass-through effects of the exchange rate depreciation. Developments in annual inflation are depicted in **Figure 8**.

Figure 8: Annual Inflation Developments



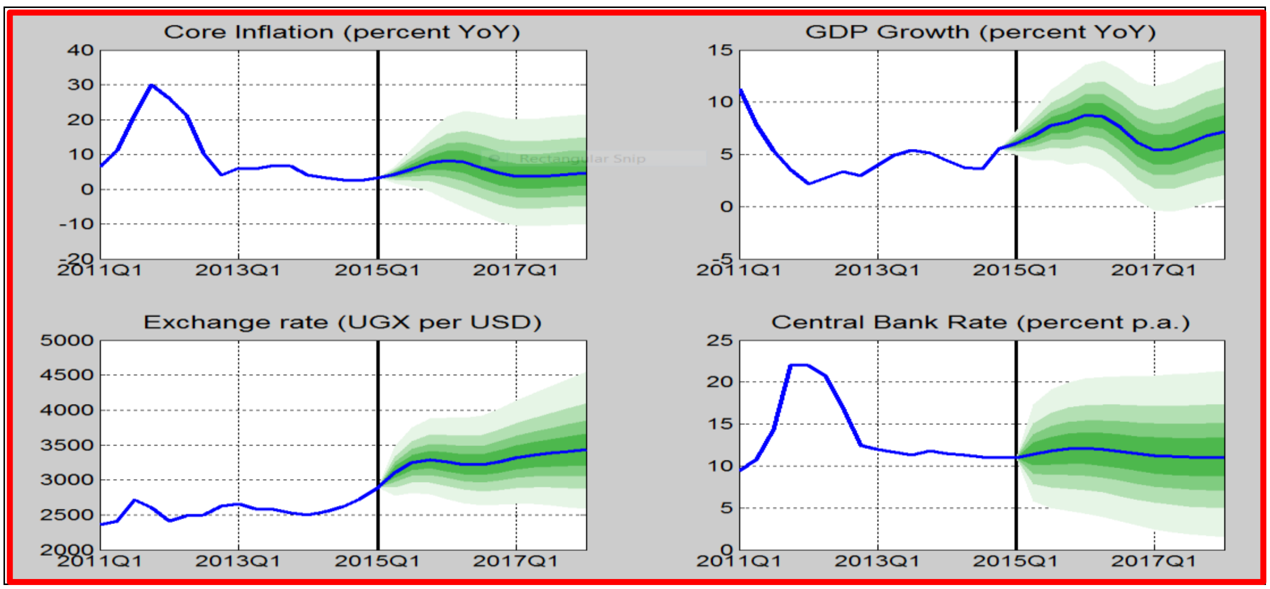
Source: Uganda Bureau of Statistics

3.6.2 Inflation Outlook

Core inflation is expected to edge up further throughout the projection horizon. In the near term, the declining output gap is expected to exert additional upward pressure on inflation. Based on the assumption that the Ugandan shilling will depreciate further, the pass through effects will continue in most of 2015 and 2016. Meanwhile, as economic growth picks up and the output gap turns positive, additional inflation pressures might require aggressive monetary policy tightening.

The exchange rate depreciation, strengthening domestic demand, projected expansionary fiscal stance, recovery in food crop prices however, may cause inflation to rise more rapidly than anticipated. There is also need to note that the steep inflation decline in 2014/15 produces a strong base effect in 2015/16, which will result in a double-digit inflation. Taking these developments into account, medium-term inflationary pressures have been revised higher with core inflation forecast to rise to 5-6 per cent and 7-9 per cent by June 2015 and June 2016, respectively. Headline inflation is forecast to reach 5-6 per cent in June 2015 and 8-10 per cent in June 2016. As the economy reaches and remains at full capacity around the end of 2016/17, both the headline and core inflation are projected to be close to 5 per cent on a sustained basis. The conditional forecast are based on the assumptions that the US dollar will continue to strengthen, and oil prices remain in the range of US$ 60- 80 per. The core inflation forecast and the trajectory of associated macroeconomic variables is shown in **Figure 9**.

Figure 9: Inflation Forecast with a modest fiscal expansion



Source: Bank of Uganda

3.6.3 Risks to the Inflation Outlook

The outlook for inflation is subject to several risks emanating from both the external environment and the domestic economy. Currently, the risks for the projected path for inflation are tilted to the upside. The most important risks to inflation are the following:

a) Considerable uncertainty remains around the future path for oil prices. There are still downside risks to oil prices in the near term, while over the medium term, risks are tilted to the upside. At present, however, a more important risk relates to the effect of the oil price shock on the investment in the oil sector. For example, there could be a larger pullback in investment in the oil and gas sector than currently anticipated and this will impact on economic growth.

b) On the other hand, the current inflation projections are based on an assumption of a gradual rise in the global crude oil prices over the forecast horizon. Oil prices could rebound faster than expected. In the event of a shock pushing crude oil prices up by about US$ 15-20 per barrel above the baseline, inflation could be higher by about 100-200 basis points (bps) by the end of 2015-16.

c) As against the normal rains assumption in the baseline, there is a risk of abnormal weather condition towards the end of the year. Global weather forecasts are indicating a severe El-nino and this could cause severe weather pattern changes in Uganda. This could lead to a lower agriculture output, which, in turn, would lower the overall GDP growth. Food prices could consequently increase, leading to inflation rising.

d) Foreign demand remains weak. Economic growth in trading-partner economies has been modest. In particular, the euro area has still to regain its pre-crisis levels of output. Growth in world trade has slowed markedly from pre-crisis averages. In this environment, and with sustained, robust growth in imports to Uganda, net exports have subtracted from gross domestic product (GDP) growth. It has also been more difficult to remedy the current-account deficit through higher exports, despite sustained currency depreciation. Moreover, regional conflicts could constrain exports and further weaken growth prospects.

e) Sustained exchange rate depreciation and its accumulated effect on costs continue to be a major source of uncertainties. The weak balance of payment continues to impact on the shilling exchange rate trend and the shilling continues to be vulnerable to the ebbs and flows of global risk perceptions and associated capital flows, particularly in response to anticipated changes to US monetary policy. Higher rates in the US should attract capital away from emerging and developing markets, especially those which have been absorbing large quantities of capital and are running correspondingly large current-account deficits. The shilling therefore remains an upside risk to the inflation outlook, although the degree of upside risk is tempered somewhat by the continued relatively low level of pass-through to consumer price inflation. The estimates suggest that the actual pass-through is still lower than what is implied in the forecast model, implying that with complete pass-through inflation would now be close to 10 per cent. Any significant weakening of the exchange rate could cause inflation to diverge even further from target, and set in motion an exchange rate-inflation spiral.

f) Despite the slackening of economic activity in since the beginning of 2015, in part due to exchange rate volatility, output gap is estimated at close to zero in FY 2014/15 and positive by end of FY 2015/16. Any further strengthening of economic activity will exert higher inflationary pressures in the economy.

4. Conclusion

The outlook for the global economy has improved slightly, anchored by a stronger recovery in the US, Euro Zone and Japan (G3). The US economy will continue to be the main driver of growth, underpinned by robust private consumption amid sustained improvement in the labour market. The Euro Zone and Japan are showing incipient signs of a turnaround, supported by monetary easing and stronger export growth. In comparison, GDP growth in China is slowing on account of sluggish domestic demand, which will have some spillovers to the Africa. Nevertheless, Uganda's growth will benefit from the G3 recovery and the resilience in private consumption.

The global economy is expanding at a moderate pace, but some key commodity prices are much lower than a year ago. The Federal Reserve is expected to start increasing its policy rate later this year, but some other major central banks are continuing to ease policy. Hence, global financial conditions remain very accommodative. Despite some increases in bond yields recently, long-term borrowing rates for sovereigns and creditworthy private borrowers remain remarkably low.

Global inflation remains benign, but the partial recovery in the international oil price has ameliorated the deflationary risks in some of the advanced economies in particular. Higher, but still low, inflation expectations contributed to a sharp rise in bond yields in some of the advanced economies, with spillovers to other bond markets. However, most central banks remain in loosening mode, with further reductions in policy interest rates in a number of countries.

Domestically, the available information suggests the economy has continued to grow. Real GDP growth is projected at 5.3 per cent for FY2014/15 and 5.8 per cent for FY2015/16, driven by scaled-up public investment and a rebound in private demand. Aggregate demand has improved though exports remain depressed, which is a key drag on private demand. However, the sustained, albeit uneven recovery in the global economy should provide a mild uplift to the external sector. Overall, the economy is operating with almost zero spare capacity. With strong domestic demand and exchange rate depreciation, inflation is forecast to exceed the target over the next one to two years. In such circumstances, monetary policy needs to be restrictive.

Accommodative monetary policy has supported borrowing and spending. Credit is recording strong growth overall, with stronger lending to manufacturing, trade, and construction sectors. However, growth in lending to the households has continued to decline over recent months. Consumer prices are anticipated to increase further reflecting the exchange rate pass-through and a strengthening of economic activity both at home and abroad. If the recent exchange rate depreciation pressures persist, inflation could rise to the range of 8-10 per cent for FY2015/16, which might require further tightening of monetary policy.

Overall, risks and uncertainties around the global economy are becoming more complex, which together with domestic challenges, present a considerable downside risk for the Ugandan economy. The BoU should continue to carefully adapt the monetary policy stance to changing economic domestic and external developments with the aim of maintaining inflation within the target. Therefore, a tighter monetary policy stance might be essential in the 2015 and 2016.