Bank of Uganda

Current State of the Economy

March 2015

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TABLE OF CONTENTS

LIST OF FIGURES

LIST OF TABLES

ACRONYMS AND ABBREVIATIONS

AEs	Advanced Economies
CA	Current Account
BoU	Bank of Uganda
CBR	Central Bank Rate
ECB	European Central Bank
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
NDP	National Development Plan
OPEC	Organization of the Petroleum Exporting Countries
PP	Percentage Point
PSC	Private Sector Credit
QE	Quantitative Easing
REER	Real Effective Exchange Rate
REPO/s	Repurchase Agreement/s
Sh/s	Shilling/s
SSA	Sub-Saharan Africa
UK	United Kingdom
US	United States
USD	United States Dollar
WALR	Weighted Average Lending Rate
Y-O-Y	Year on Year

EXECUTIVE SUMMARY

i Global growth is still soft despite lower oil prices. The footprints of sharply lower oil prices on the global economy have been increasingly visible around the turn of the year, with a significant pick-up in retail sales and falling inflation across major oil importing economies but increasing headwinds among oil exporters and heightened volatility in financial markets.

ii The divergence in global growth performance has become more marked. This has taken place at two levels: the diminishing contribution of the advanced economies (AEs) to global growth, and the wide disparities in growth within this group of countries. During 1995 - 2007 the AEs contributed around 60 per cent of global growth. Since 2008, this has reversed with the emerging Market economies (EMEs) accounting for about 70 per cent of global growth. AEs are experiencing their weakest recovery in 70 years. On the positive side, the United Sates (US) economy has finally gained momentum and has been expanding at an annualised rate of 4 per cent since April 2014, despite a weaker fourth quarter of 2014. By contrast, Japan and the 19 economies that form the Euro-area have grown by about a third as fast as the US economy, over the past 5 years.

iii Monetary policies continue to be divergent in the AEs. Whereas the US Federal Reserve completed its quantitative easing (QE) in October 2014, the Bank of Japan and the European Central Bank (ECB) have stepped up QE. Almost seven years after the onset of the global financial crisis, central banks are increasingly operating in uncharted waters. Some central banks e.g., Bank of Japan and the ECB continue to search for mechanisms to help inflate their economies and return inflation expectations to their desired ranges. This in turn is feeding through to market volatility, as reflected in exchange rate movements, interest rate spreads, and equity returns.

iv Consumer price inflation is very low and below the monetary policy target bands in several AEs. Consumer price inflation has been falling steadily in many AEs over the past four years in part due to the high levels of excess capacity, global oversupply of capital goods and manufactured products, falling commodity and energy prices, and falling prices of information technology. But the 58 per cent decline in oil prices and the 26 per cent decline in a wide range of commodity prices since the end of June 2014 mean that several countries could experience negative headline inflation over the coming year.

v Going forward, global economic prospects will largely be driven by the softer commodity prices, low interest rates and weak world trade. The sharp decline in oil prices will support global economic activity in oil-importing countries and offset barriers to growth especially in the oil-import developing economies. However, it will dampen growth prospects for the oil exporting economies. The net effect is expected to be positive. On the downside, global trade is expected to remain weak, potentially for longer than currently expected should the Euro Area or Japan experience a prolonged period of stagnation or deflation. Financial conditions could also become volatile as high-income economies tighten monetary policy on diverging timelines.

vi Developing countries face significant policy challenges in an environment of weak global growth and considerable uncertainty. Fiscal buffers need to be rebuilt to ensure the effectiveness of fiscal policy in the future. Central banks need to balance policies to support growth against measures to stabilize inflation and currencies or to bolster financial stability.

vii Developments and prospects in the external environment have important policy implications for the domestic economy going forward. The recovery in the global economy remains fragile. Uganda's exports are largely destined to Europe, which is at the same time the source of most of the foreign direct investment (FDI) and workers remittance flows to Uganda. Therefore, economic slowdown in the AEs – particularly the Euro zone - could further impair Uganda's current account (CA) balance, consequently causing further exchange rate depreciation. In addition, geo-political tensions, bouts of volatility in commodity markets, and financial stress in major EMEs have the potential to cause volatility in financial markets, leading to high risk premiums.

viii The Ugandan economy is now projected to grow by 5.3 per cent in Financial Year (FY) 2014/15, compared 4.5 per cent and 3.3 per cent in FY 2013/14 and FY 2012/13, respectively. The drivers of this growth include: continued recovery in agricultural production, strong manufacturing & construction sector performance, increase in wholesale & retail trade activities, and transport & telecommunication services.

ix Growth is projected to increase to 5.5 per cent in FY 2015/16, and to an average of 6 per cent per annum over the medium term, on account of increased public investment, continued recovery in agricultural production and productivity, increased domestic demand and FDI inflows. The down-side risks to growth include: delayed implementation of public infrastructure investment projects, the impact of rising interest rates on private sector investment activities and lower than projected external demand.

x Uganda's CA remains weak. Weaker than expected global demand and low commodity prices have continued to negatively affect our exports performance, while import growth has remained buoyant. Exports of goods declined from United States Dollar (USD) 2,828.72 million in 2013 to USD 2,657.35 million in 2014, a decline of 6.1 per cent compared with a growth of 2.5 in 2013. Imports free on board (fob) on the other hand have recovered, increasing from USD 4,974.12 million in 2013 to USD 5,028.53

million in 2014, a growth of about 1.1 per cent. Private sector imports grew much stronger, increasing from USD 4,565.75 million to USD 472.72 million, a growth of about 4.5 per cent compared with a decline of 5.2 per cent in 2013. This reflects a recovery of domestic economic activity.

xi Since January 2014, the exchange rate has come under several bouts of depreciationary pressure. As a result the Sh/USD exchange rate has depreciated by 16.1 per cent over the 12 months to February 2015, while the traded weighted exchange rate index has depreciated by 10.3 per cent. The developments in the foreign exchange rate market are driven by a large CA deficit, coupled with market sentiments relating to government finances, corporate sector demand for foreign exchange (especially from manufacturing, telecommunications and energy sectors), and the global strengthening of the USD**.**

xii Annual inflation has continued to decline since the start of this FY. The reduction in inflation was largely attributed to both domestic and external factors. Favourable weather conditions in most parts of the country have facilitated bumper harvests and increased food supplies. Another factor accounting for the weakening consumer prices is the continued reduction in the international oil prices. This has fed through to lower pump prices, which in turn has eased costs associated with production.

xiii The inflation outlook will be largely dependent on changes in domestic food prices, exchange rate and international commodity prices. Over the medium term, consumer price inflation will rise gradually on account of a rebound in food and other commodity prices. The recovery in demand is also expected to gradually push up prices of goods and services.

xiv Uganda's economic prospects are for continued steady growth and low inflation. But risks and uncertainties around the global economy are becoming more complex, presenting considerable challenges for domestic economy. Macroeconomic management faces tougher challenges in 2015 than has been the case at any time since mid-2012, because of the confluence of several factors, both domestic and external. The depreciating exchange rate will not only push up yields on government securities but will also increase inflationary pressures in the economy. In these circumstances it is imperative that both monetary and fiscal policy remain very prudent, so as to ensure that macroeconomic stability is preserved. In particular, the proposed ramped up investment while it is very crucial, should ensure macro stability, debt sustainability and capacity to implementation the projects. Further, it is crucial that we retain public confidence in the long-term stability of the Ugandan economy. A credible, fully financed medium term fiscal framework is essential to maintaining public confidence, including lenders.

1 BACKGROUND

This report discusses domestic and external economic developments in the period to March 2015. The report also assesses the future prospects for the domestic and global economy and identifies the attendant risks. Finally, it presents the implications of the outlook and risks to the global and domestic economy for the future direction of monetary policy in Uganda.

2 GLOBAL ECONOMIC DEVELOPMENTS

2.1 Global Economic Activity

The global economy is estimated to have expanded by 3.3 per cent in 2014, which is lower than the initial growth projection, a continuing trend of lower than projected outturns over the past several years. The slow growth was largely driven by the weak growth in Euro zone, Japan, China, and Russia; and the sharp drop in oil prices, which continues to be a drag on economic activities of the major oil exporting economies. Growth in the Euro zone remains fragile with considerable excess capacity and some countries remaining particularly vulnerable to adverse demand and supply-side shocks. Notwithstanding the monetary stimulus, the Euro zone grew by just 0.8 per cent in 2014. Growth in 2015 is, however, projected at 1.2 per cent; conditional on continued monetary stimuli; improved credit conditions and labour market dynamics as well as improved consumer confidence.

The US and the United Kingdom (UK) are, however, projected to have performed modestly, with Gross Domestic Product (GDP) increasing by 2.4 per cent and 2.2 per cent in 2014, up from 2.2 per cent and 1.7 per cent, respectively in 2013. The growth momentum in the US was supported by increased personal and government consumption, investment and exports; amidst the fading impact of temporary factors that adversely affected the economy at the beginning of 2014. In the UK growth remained buoyed by rising household confidence and the vibrant housing market.

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

Growth in sub-Saharan Africa (SSA) remains moderate, despite low export demand and falling commodity prices. Economic activity is projected to have increased by 4.8 per cent in 2014; supported by large public investments, particularly into infrastructure, which should provide even more long-term growth benefits. Notwithstanding the declining commodity prices, growth in SSA in 2015 is projected at 4.9 per cent.

2.2 Global financial markets

Global financing conditions have remained supportive so far this year, with the US long-term interest rates still around 2 per cent despite an approaching US tightening cycle. However, financial markets remain jittery on account of the uncertainty surrounding the future trajectory of oil prices, future growth prospects of the global economy, geo-political tensions in Ukraine and the Middle East and North Africa region. Falling oil prices have caused stock markets to fall globally as the share prices of energy firms tumble.

Almost seven years after the onset of the global financial crisis, central banks are increasingly operating in uncharted waters. For instance, the Euro zone and Japan continue to search intensively for mechanisms to help inflate their economies and return inflation expectations to their desired ranges. And they are doing so at a time when they, like financial markets, are unsure to what extent the weakness in commodity prices and particularly oil prices, reflects the possibility of weaker global growth.

Market volatility, as reflected in exchange rate movements, interest rate spreads, and equity returns has increased in recent months, and we expect the rise in volatility to be sustained through 2015. There are two main reasons for this. First, yields on long-term bonds in many AEs are now so low that the primary transmission mechanism for expanded QE is likely to be through exchange rate adjustment. Exchange rate tensions among countries could increase if market shares are affected by countries seeking lower exchange rates.

Second, USD liquidity has tightened since the Federal Reserve completed its asset purchases and will continue to do so as US interest rates start to increase. A re-rating of credit and liquidity risk is underway and lending spreads are likely to widen for countries and businesses with large international funding needs. In addition, regulatory changes in recent years have reduced the ability of banks to underwrite or intermediate risk.

2.3 Global inflation and commodity prices

Global inflation remains subdued but with diverse trends across the development divide. In AEs, inflation remained subdued in part driven by the low commodity and energy prices, abundant spare capacity, subdued demand, and well-anchored inflation expectations. Inflation in most AEs remains below the respective central banks' medium-term policy targets, which poses serious risks, if long-term inflation expectations drift down, increasing deflation risks in the event of a serious adverse shock to economic activity. Low oil prices are expected to have the greatest disinflationary effect in AEs, where the pass through to domestic prices will be more transient, which may extend the current period of expansionary monetary policy.

Oil prices remain volatile. After hitting a six year low in January 2015 at an average of USD 47.1 per barrel, as Organization of the Petroleum Exporting Countries (OPEC) continued to stand firm on its decision not to curtail production, crude oil prices appear to have found some support during February 2015, Brent (the international benchmark) gained USD9.9/barrel. The rebound reflects in part 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. Conflicting signals on US production trends in 2015 have contributed to a significant rise in oil price volatility. However, global crude oil supply continues to be ample and prices are predicted remain low in coming months, averaging between USD50-60/barrel in 2015 and 2016.

Global inflation has declined but 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 emerging economies might lead to more persistent effects and in some cases increased deflationary concerns.

Global food prices have also remained relatively soft. In February 2015, the Food and Agriculture Organization (FAO) food price index declined by 1.0 per cent month-on-month and 14.0 per cent year-on-year (Y-O-Y), 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.

2.4 Implications for the Ugandan economy

The international economic environment will continue to influence Uganda's economic developments by influencing the volume and direction of international capital flows, commodity prices and trade. Indeed, the global economic outlook remains vulnerable to risks, which have the potential to affect confidence and dent the fragile recovery of the global economy. Soft commodity prices, persistently low interest rates but increasingly divergent monetary policies across major economies, and weak world trade are the major forces are driving the global economic outlook.

The sharp decline in oil prices since mid-2014 will 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 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 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. This will not only invigorate inflation, but will also dent the growth prospects of the economy.

The continued slow growth and low inflation in the Euro Zone while a downside risk to domestic inflation, has detrimental implications for the Uganda economy. Being a major trading partner, slow growth coupled with weak demand in the Euro Zone is likely to have a negative impact on Uganda's export earnings, remittances and FDI from the Euro Zone going forward. The ECB is expected to continue implementing expansionary monetary policies for an extended period. This contrasts with the expectation that the US Federal Reserve will begin normalizing monetary policy in 2015 as the US economy continues to strengthen. Tighter global financial conditions following the normalization of monetary policy mainly in the US and UK could lead to weaker financial flows or possible capital reversals. In the same vein, anticipated differences in policy paths could put additional downward pressure on major currencies against the USD. This could result in currency depreciation.

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

3 DOMESTIC ECONOMIC DEVELOPMENTS

3.1 Monetary policy stance and Implementation

3.1.1 Monetary Policy Stance

Bank of Uganda (BoU) continued to pursue a cautious monetary policy stance aimed at stimulating output without jeopardising the inflation objective. The Central Bank Rate (CBR) has been maintained at 11 per cent since June 2014. This stance is premised on the projected inflation and output path. Real GDP growth in FY 2014/15 was projected at 5.0 - 5.5 per cent, slightly below potential but expected to recover over the short-to-medium term, mainly supported by public investment on infrastructure, recovery in private domestic consumption & investment demand, and a rebound in agriculture. Inflation remains subdued with headline and core inflation averaging 3.9 per cent and 2.9 per cent, respectively in the 12 months to January 2015 and the outlook suggests that core inflation would fluctuate around BoU's medium term target of 5 per cent over the next two years.

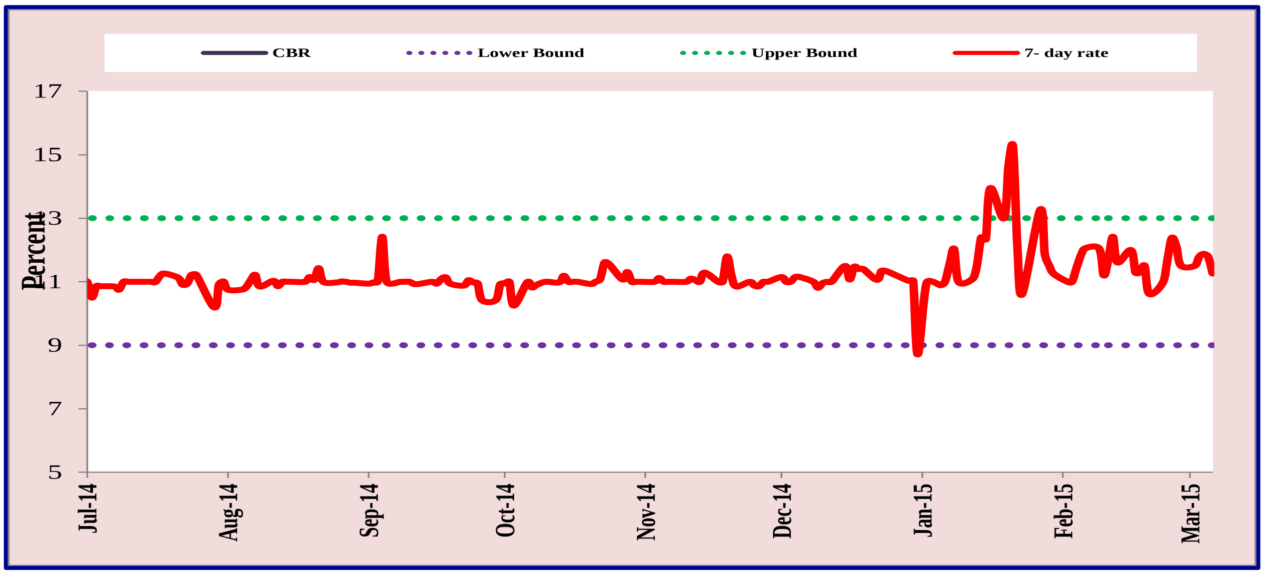
Nonetheless, there are potential risks of stronger inflationary pressures emanating from a mix of factors pertaining to the continued exchange rate depreciation, growth acceleration and the spill-overs from the volatile international economic environment, which may change the inflation trajectory over the near-to-short term. Furthermore, the domestic and external risks to the projected inflation and output path remained broadly balanced. Maintaining a cautious monetary policy stance was therefore critical, not only to support the continued recovery of the economy but also to insulate the economy from uncertainties and risks from the domestic and external economic environment.

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 for aligning liquidity conditions in the domestic financial system with the desired monetary policy stance. As at end February 2015, the outstanding stock of reverse REPOs was Shillings (Shs) 179.5 billion, while outstanding stock of re-capitalisation securities stood at Shs 392 billion.

During this period, interbank money market rates remained broadly consistent with the CBR, save for some days in January 2015, when the 7-day interbank money market rate rose above the upper bound of the CBR, in part due to the tight liquidity conditions in the domestic money market that were warranted to contain the depreciation pressures. Developments in the 7-day interbank money market rate are shown in Figure 1.

Figure 1: Evolution of the 7-day Interbank Money Market Rate



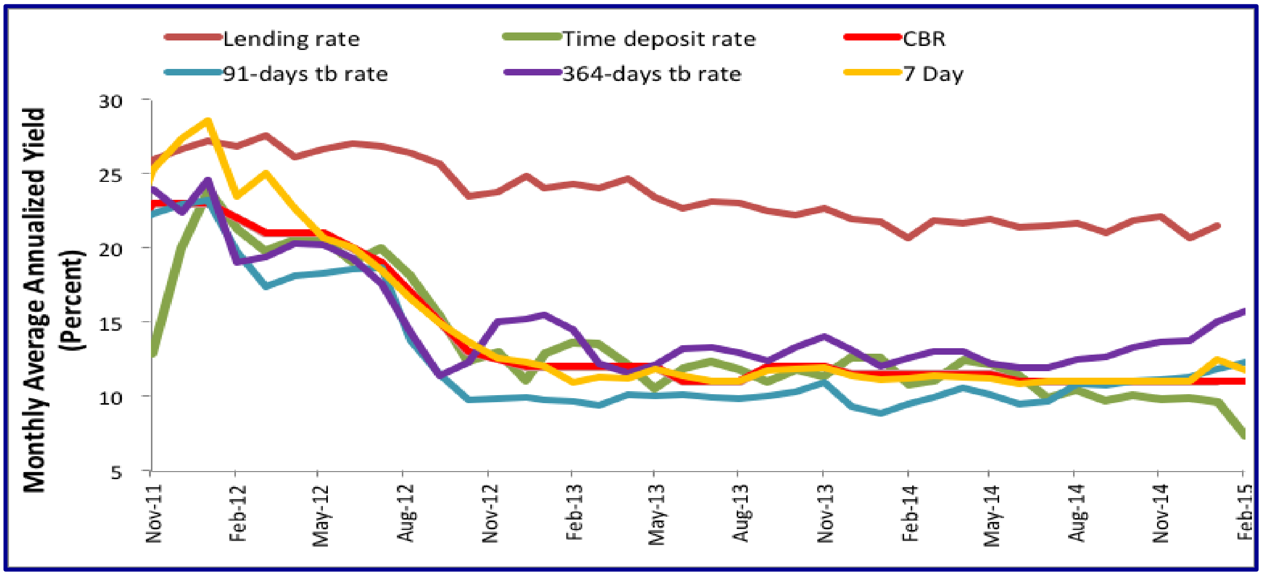
Source: BoU

3.2 Interest rates and PSC

3.2.1 Interest rates

Yields on government securities have maintained an upward trend notwithstanding the neutral monetary policy stance. This trend is in part driven by speculative behaviour, expectations of increased public expenditure to finance government infrastructure projects, and high inflation expectations largely driven by depreciation pressures and expectations of fiscal slippage on increased government consumption expenditure during the election period. The trajectory of yields in government securities vis-à-vis other interest rates is shown in Figure 2.

Figure 2: CBR, Lending Rate, 7- day rate and 91-day T-bill rate

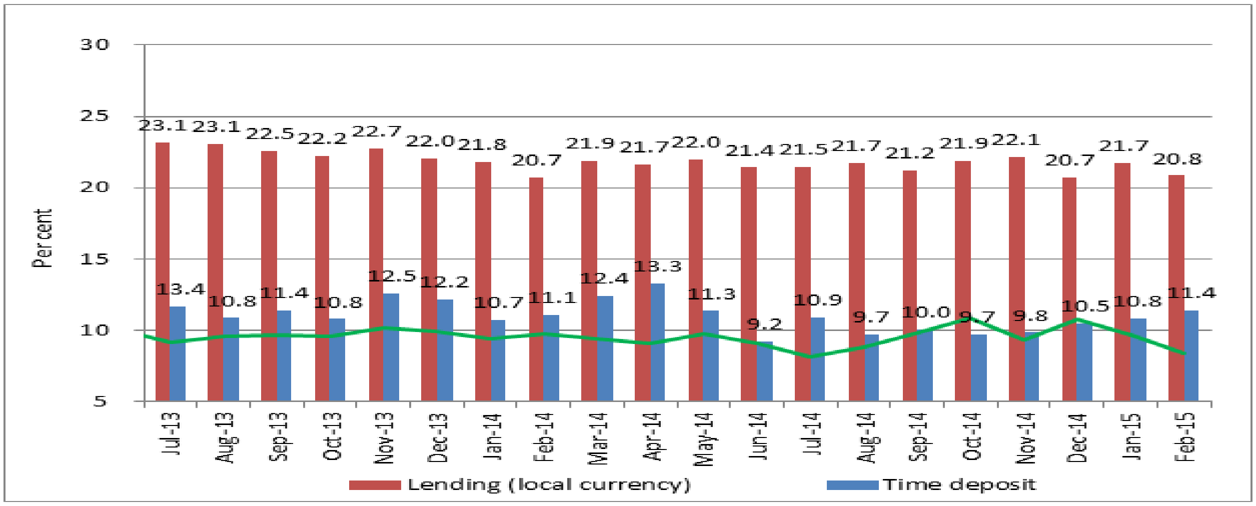


Source: BoU

Lending rates remain high and sticky downwards, declining only marginally in part reflecting asymmetry of the monetary policy transmission mechanism, lagged response to monetary policy impulses, structural rigidities in the financial sector and higher risk aversion by commercial banks on account of deteriorating banks' asset quality. Nonetheless, the ratio of non-performing loans to total loans declined to 4.1 per cent in December 2014 from 6.2 per cent in March 2014, indicating an improvement in asset quality.

The weighted average lending rate (WALR) on Sh denominated loans has averaged about 21 per cent during the last 12 months. Interest rates on Sh deposits have also remained relatively stable as shown in Figure 3. The WALR on foreign currency denominated loans also remained stable during the same period. Developments in lending and deposit rates are shown in Figure 3.

Figure 3: Shilling Time Deposit and Lending rates



Source: BoU

The yields on government securities – T-bills and T-Bonds have increased over the years, in part reflecting increasing amounts offered in auctions but also to reflect expectations that inflation will rise. The increase in auction amounts has largely been to deal with both the liquidity conditions as well as to raise resources to supplement domestic revenues in financing government infrastructure spending needs.

Whilst there has been a reduction in average commercial bank lending rates, in response to a reduction in inflation and the relatively low and unchanged CBR, they remain prohibitively high and keeping many private sector borrowers away from the credit markets. This is largely on account of structural issues – the high overhead costs and the requirement to provisioning for non-performing assets.

It is, however, important to note that in the early 1990s, lending rates were as high as 50 per cent per annum. Following the success in stabilising the economy, interest rates of all categories have been declining. Since 1996 lending rates have been relatively stable at about 20 per cent per annum. Notwithstanding this decline however, lending rates remained relatively high, which makes the cost of credit high to prospective borrowers.

The causes of high lending rates are:

a) Lack of diversity in financial institutions, a scarcity of instruments for saving and the lack of adequate long-term finance for private investments. Most of the financial institutions operating in Uganda are commercial banks, which extend only short-term credit. Lack of sufficient long-term savings to finance long-term investment needs of the private sector leads to attempts at maturity transformation by the commercial banks. This comes at a premium as reflected in their high lending rates.
b) The limited number of viable borrowers and the poor credit culture has made banks very cautious and sceptical about lending. This has led to a situation where banks have excess liquidity on which they do not earn anything but have to pay interest to the depositors. Consequently, a situation where interest rates on deposits are low while those on lending rates are quite high emerges since it is from the lending rates that interest on deposits gets paid.
c) Weak bankruptcy codes and inadequate judicial infrastructure for loan recovery.
d) Like all businesses in Uganda, commercial banks face the high costs of doing business. In general, the high costs increase the operational costs of commercial banks, which translate into higher bank charges. The operating costs of financial institutions include the cost of utilities such as telecommunications, energy, and rent; costs of security services; and human resources. Furthermore, the inefficiency of the utilities has also helped compound the operating costs of financial institutions.
e) Going forward, the high interest rates on government securities are likely to feed through to risk margins commercial banks attach while lending to the private sector. This would in turn affect credit availability and extension for private investment, which would negatively impact growth. However, we will continue to work with financial institutions to reduce the cost of loanable funds, given the importance credit availability has on driving private investments and growth.

3.2.2 Private Sector Credit

Growth in PSC continues to be robust, with annual growth averaging 13.6 per cent since July 2014 compared to 7.9 per cent during the corresponding period of last FY. On a Y-O-Y basis, PSC grew by 16.7 per cent in January 2015 up from 5.7 per cent in January 2014. 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 PSC are shown in Table 1.

Table 1: Sectoral Developments in PSC

	Annual average growth rates		Share of credit in total lending		NPLs
	Jul 13 - Jan 14	**Jul 14 - Jan 15**	**Jul 13 - Jan 14**	**Jul 14 - Jan 15**	**14-Dec**
Agriculture	33.6	35.45	8.31	9.91	5.57
Mining and quarrying	-15.57	12.70	0.36	0.35	4.92
Manufacturing	7.43	1.45	14.32	12.78	3.20
Trade	-1.45	23.36	19.18	20.74	4.23
Transport and communication	-5.09	4.09	5.72	5.22	6.94
Electricity and water	-3.90	59.49	1.14	1.58	2.33
Building, mortgage, construction & real esta	-2.25	21.14	21.34	22.64	3.32
Business services	12.31	1.05	4.79	4.24	3.31
Community, social & other services	0.57	25.31	3.05	3.37	3.32
personal loans and household loans	28.16	19.25	16.20	16.72	3.01
other services	46.41	-45.54	5.58	2.45	26.61
Total	**8.08**	**13.57**	**100.00**	**100.00**	**4.13**

Source: BoU

3.3 Fiscal Developments

The fiscal stance in FY 2014/15 focussed on supporting economic activity by addressing the infrastructural constraints in the economy. However, the fiscal stance in the first seven months of FY 2014/15 was less expansionary than projected. Government expenditure for the first seven months of FY 2014/15 was estimated to be lower than programmed, largely on account of lower than programmed expenditure on the Karuma and Isimba Hydro Power Projects (HPPs). Total government expenditure and net lending amounted to Shs 8,509.5 billion, which is Shs 1,246.9 billion, lower than the programmed expenditure for this period. Current expenditure, however, amounted to Shs 4,518.7 billion, an over performance of Shs 154.9 billion, compared to the budget amount of Shs 4,363.0 billion. Details of the developments in Government expenditure during this period are shown in Table 2.

Table 2: Fiscal Operations (Shs billion)

	Actual: Jul' 13 – Jan'14	Preliminary Jul'14 – Jan'15	Budget: Jul'14 – Jan'15
Revenue and Grants	**5,109.6**	**5,976.8**	**5,966.0**
Revenue	4,612.0	5,492.0	5,342.3
Grants	497.6	484.8	623.7
Expenditure and Lending	**6,945.0**	**8,509.5**	**9,756.4**
Current Expenditure	3,824.8	4,518.7	4,363.0
Development Expenditure[1]	3,105.0	3,644.3	5,063.4
Net lending/repayments[2]	3.8	250.0	250.0
Domestic arrears repayment	11.4	96.5	80.0
Deficit (including grants)	**-1,835.4**	**-2,532.7**	**-3,790.4**
Financing (net)	**1,835.4**	**2,532.7**	**3,790.4**
External Financing (net)	536.1	395.9	1,183.0
Domestic Financing (net)	944.6	1,836.3	2,607.0
Errors and Omissions	354.7	300.5	0.4

Notes: [1] Includes Government net lending for the Karuma and Isimba HPPs
[2] Net lending constitutes recapitalization of the BoU.

Source: BoU

Total Government revenue, including grants, amounted to Shs 5,976.8 billion, which is higher than the budget amount by Shs 10.8 billion. This represents a growth of 17 per cent over the revenue collections of the corresponding period of FY 2013/14. Grants registered a cumulative shortfall of Shs 138.9 billion relative to the budget projection. Total domestic revenue (tax and non-tax) collections were higher than the target by Shs 19.1 billion. Tax collections posted a cumulative surplus of Shs 8.2 billion while non-tax collections posted a cumulative surplus of Shs 10.9 billion.

The fiscal deficit including grants was Shs 2,532.7 billion lower than that in the corresponding period last year by 38 per cent. The fiscal deficit was mainly financed through domestic financing (bank and non-bank financing), which amounted to 72.5 per cent of the total financing. The provisional total public debt stock (at nominal value) as at end January 2015 stood at Shs 21,243.6 billion, about 30 per cent of GDP of which public external debt is Shs 11,896.9 billion and domestic debt is Shs 9,346.7 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.

The fiscal deficit (initially estimated at 7 per cent of GDP in FY 2014/15) is projected to deteriorate to 7.5 per cent of GDP in 2015/16 on account of public investment as the second phase of the National Development Plan (NDPII) projects take off. Not all these projects will be financed externally, as some of them require Private Public Partnership frameworks, and as such will require domestic financing. There is a likelihood of higher domestic borrowing by the Government above the projected amounts and yet revenue may increase by only a small amount, shifting the burden to the domestic taxpayers and domestic financial markets. This would not only worsen the debt indicators, but would also have adverse implications for private investment and consumer expenditure.

3.4 BoP and Exchange Rates

3.4.1 BoP

Uganda's CA remains weak. Weaker than expected global demand has continued to negatively affect our exports performance, while import growth has remained buoyant. Exports of goods declined from USD 2,828.72 million in 2013 to USD 2,657.35 million in 2014, a decline of 6.1 per cent compared with a growth of 2.5 in 2013. This reflects a combination of weaker foreign activity and subdued commodity prices. Imports FoB on the other hand have recovered, increasing from USD 4,974.12 million in 2013 to USD 5,028.53 million in 2014, a growth of about 1.1 per cent. Private sector imports grew much stronger, increasing from USD 4,565.75 million to USD 4,772.72 million, a growth of about 4.5 per cent compared with a decline of 5.2 per cent in 2013. This reflects a recovery of domestic economic activity.

In the first seven months of FY 2014/15, the CA deficit deteriorated to USD 1,274.6 million from USD 836.2 million in FY 2013/14. The deterioration in the CA was largely as a result of a higher deficit on the services account, which deteriorated by USD 361 million to a deficit of USD 475 million. The services balance deteriorated on account of government payments for energy projects.

The trade account also deteriorated by USD 62.8 million partly on account of a decline in exports in part reflecting weaker external demand. Export receipts declined by 3.4 per cent from USD 1,567.5 million recorded in the first seven months of FY 2013/14 to USD 1514.9 million. Imports on the other hand increased by 0.4 per cent in the same period, from USD 2,898.8 million to USD 2,909.0 million. In the short- to medium-term, the CA deficit is likely to widen due to increase in imports for public infrastructure projects. Developments in the BoP are shown in Table 3.

Table 3: Balance of Payments (million USD)

	FY 2012/13	FY 2013/14	July – January 2013/14	July – January 2014/15
Current account	**-1,478.3**	**-1,748.2**	**-836.2**	**-1,274.6**
Trade Balance	-2,123.0	-2,330.9	-1,331.3	-1,394.1
Exports	2,912.1	2,709.2	1,567.5	1,514.9
Imports	5,035.1	5,040.0	2,898.8	2,909.0
Services Balance	-415.5	-124.1	-114.3	-475.3
Capital account	**32.7**	**91.0**	**67.8**	**72.1**
Financial account	**1,434.1**	**1,860.7**	**890.0**	**817.1**
Direct investment	886.6	1,171.5	614.4	582.9
Portfolio investment	-46.5	4.8	-29.7	73.9
Other investment	593.3	683.2	303.9	157.6
Net errors and omissions	**349.5**	**174.9**	**166.9**	**200.1**
Overall Balance	**338.0**	**378.5**	**288.5**	**-185.3**

Source: BoU

The stock of reserves at the end of February 2015 was estimated at USD 3,020.8 million, which is equivalent to 4.1 months of future imports of goods and services from USD 3,273.9 million recorded at the end of October 2014. The decrease in reserves was largely caused by the BoU's net intervention in the interbank foreign exchange.

3.4.2 Exchange Rates

The depreciation pressures that started in December 2014 continued in January and February 2015. The Sh depreciated by 14.4 per cent and 16.1 per cent Y-O-Y to Shs 2,860.7 per USD and Shs 2,868.9 per USD in January and February 2015, respectively. The depreciation pressures were largely driven by the global strengthening of the USD; correction of overvaluation; noise in the market and expectations about the future direction of fiscal and monetary policy; continued exit of offshore players; and elevated dollar demand amidst lower inflows partly on account of lower international commodity prices.

Developments in the foreign exchange market are largely a reflection of the external sector developments. During the first half of this FY, the developments in the market were driven by a large CA deficit, coupled with market sentiments relating to government finances, corporate sector demand for foreign exchange (especially from manufacturing, telecommunications and energy sectors), and the global strengthening of the USD. The euro and exchange rates of most of the regional economies have also depreciated in line with the strengthening of the USD as shown in Table 4.

Table 4: Performance of Selected currencies against the USD

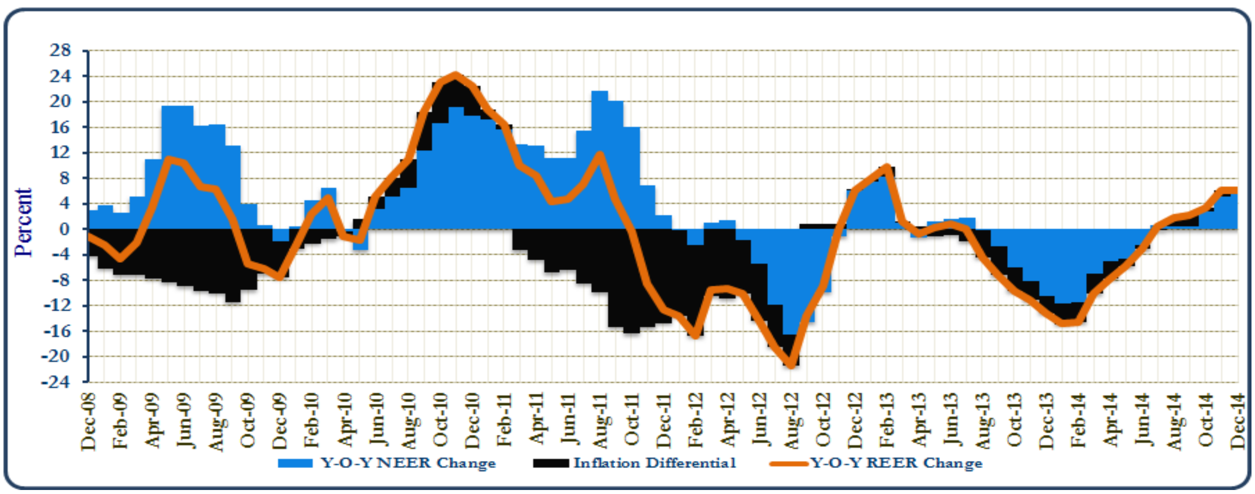
	UGX/USD	KES/USD	RWF/USD	TZSHs/USD	BIF/USD	EURO/USD	ZAR/USD	CEDI/USD	NAIRA/USD
2014M07	2,633.50	87.8	683.4	1,663.90	1,547.00	0.70	10.70	3.00	162.30
2014M08	2,612.50	88.1	684.2	1665.7	1547.6	0.8	10.7	3.1	162
2014M09	2618.8	88.8	685.4	1670	1548.3	0.8	11	3.2	162.9
2014M10	268.5	89.2	688.7	1683	1549.1	0.8	11.1	3.2	164.6
2014M11	2734.2	90	690.4	1714.2	1549.7	0.8	11.1	3.2	171.1
2014M12	2768.8	90.5	692.5	1725.4	1551.2	0.8	11.5	3.2	180.3
2015M01	2860.7	91.3	696.5	1744.8	1553.5	0.9	11.6	3.2	181.8
2015M02	2868.8	91.5	702.2	1767.2	1554.4	0.9	11.6	3.4	194.5
	Month-on-Month Percentage Changes								
	UGX	KES	RWF	TZS	BIF	EURO	RAND	CEDI	NAIRA
2014M07	2.0	0.2	0.2	0.3	0.1	0.3	-0.2	1.3	-0.4
2014M08	-0.8	0.4	0.1	0.1	0.0	1.7	0.0	1.2	-0.2
2014M09	0.2	0.8	0.2	0.3	0.0	3.2	2.8	4.2	0.6
2014M10	2.4	0.4	0.5	0.8	0.0	1.8	1.0	0.2	1.0
2014M11	2.0	0.8	0.2	1.9	0.0	1.6	0.3	0.0	3.9
2014M12	1.3	0.5	0.3	0.7	0.1	1.1	3.3	0.0	5.4
2015M01	3.3	1.0	0.6	1.1	0.2	6.0	1.0	0.7	0.8
2015M02	0.3	0.1	0.8	0.3	0.1	2.5	0.0	4.7	7.0

Source: BoU

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, selling USD 167.3 million in January 2015 and USD 29.7 million in March thus far. Since July 2014, BoU has intervened in the foreign exchange market to the tune of USD 256.7 million. In the same period, purchases for reserve build-up amounted to USD494 million. With sales to Uganda Electricity Transmission Company Ltd of USD109.4 million, net reserve build-up purchases for FY 2014/15 amount to only USD128.3 million, compared to the projected amount of USD590 million.

The NEER depreciated by 5.7 per cent and 8.9 per cent on an annual basis in December 2014 and January 2015, respectively. The Real Effective Exchange Rate (REER) also depreciated in line with the depreciation of the bilateral Shs/USD rate. It depreciated by 6.2 per cent and 8.7 per cent Y-O-Y in December 2014 and January 2015, respectively. The exchange rate depreciation has thus helped restore competitiveness, which had been lost due to appreciation of the Sh in 2013. Nonetheless, while the depreciation is expected to improve the profitability of the tradable goods sectors, it may fuel inflation, which may in turn undermine the sectors profitability, thus worsening the CA imbalance. Developments in the real exchange rate are shown in Figure 4.

Figure 4: Changes in REER



Source: BoU

Going forward, external imbalance will continue to have impact on the exchange rate. The strong rebound in the US economy and the US Federal Reserve's ending of its QE stimulus programme is likely to lead to further strengthening of the USD against other global currencies. This would mean a further weakening of the exchange rate. Whilst a weaker Sh would encourage more exports, the down side risk is an increase in domestic prices (and consequently inflation) of imported goods and services. In addition, increasing foreign exchange requirements to meet public infrastructure expenditure needs has implications for the level of foreign exchange reserves and increases the vulnerability of the external balance. Furthermore, the current level of international oil prices might have negative implications for investments into the oil sector, with implications both for the expected FDI to finance the trade imbalance as well as delay the anticipated investments in the oil sector (and subsequently production).

In addition, further depreciation pressures might emanate from a likely retreat of FDI to the oil sector on account of the fall in crude oil prices, and uncertainty about the future path of prices; increased government foreign exchange requirements to finance infrastructure development; and significant uncertainties in the global financial markets about the future direction of monetary policy in AEs. The BoU should therefore be cautious not to "lean against the wind" by intervening in the foreign exchange market**.**

3.5 Domestic Economic Activity

Real economic activity in projected to remain robust in 2015/16, supported by public investment and a rebound in PSC. The outlook for FY 2014/15 is therefore a much narrower output gap as growth is projected in the range of 5-5.5 per cent, which is close to the potential growth of the economy. Nonetheless, substantial risks to growth emanating from both the domestic and external scene continue to exist, such as a widening trade deficit, the possibility that investments in the oil sector would be delayed given the fall in global oil prices and possible volatility in global financial markets.

Recent data remains consistent with a decline in exports, in line with weak external demand and low commodity prices in spite of the depreciation of the Ugandan Sh. The realization of a downside risk to exports could have negative implications for investment. This, combined with projected decline in investment in the oil and gas sector in 2015 could depress investment activity, at least in the near to short run. Increased investment in infrastructure might result into substantial domestic financing, which could further constrain PSC and private investment, thus limiting growth.

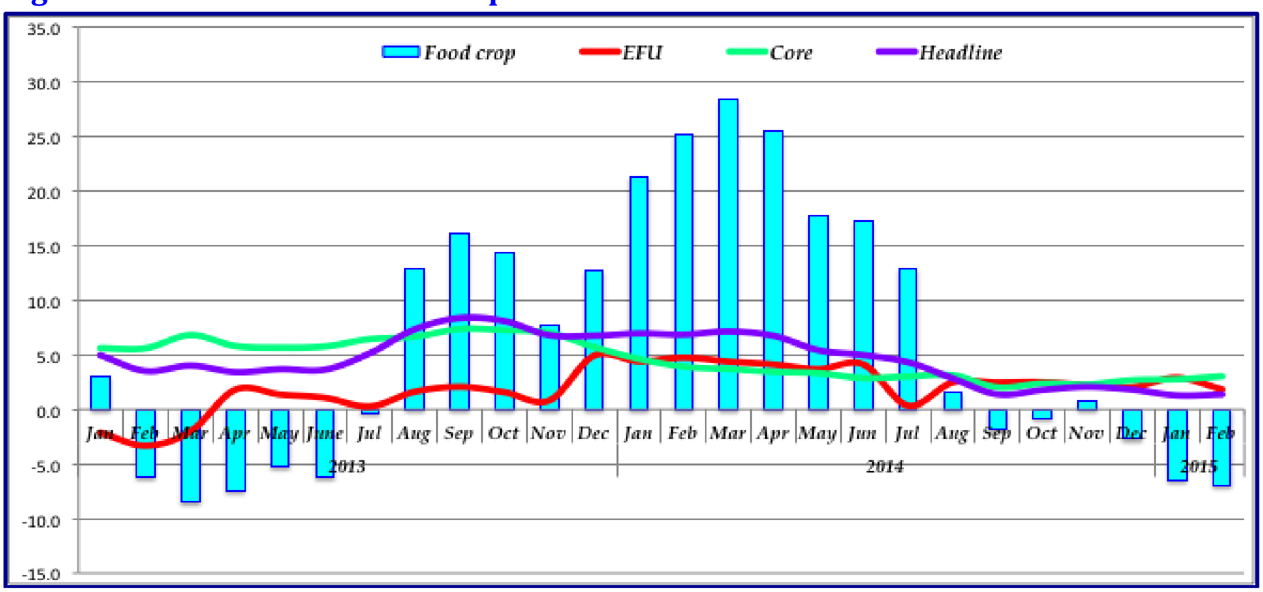
3.6 Consumer Price Inflation

3.6.1 Recent Inflation Developments

Inflation remains subdued and below the BoU's medium-term target of 5.0 per cent, with annual headline and core inflation averaging 2.1 per cent and 2.7 per cent, respectively in the first eight months of FY 2014/15. Annual headline and core inflation, however, rose marginally in February 2015, increasing to 1.4 per cent and 3.0 per cent from 1.3 per cent and 2.7 per cent, respectively, in January 2014.

The current low levels of inflation are largely driven by the decline in food prices due to a good domestic harvest, lower global inflation, and decline in crude oil prices. Annual food crop price inflation declined to ***minus*** 7.0 per cent in February 2015 from ***minus*** 2.7 per cent in December 2014. Global food prices have also continued to decline, with the FAO food price index declining by 3.7 per cent in 2014. Developments in annual inflation are depicted in Figure 5.

Figure 5: Annual Inflation Developments



Note: EFU-Energy Fuel and Utilities
Source: Uganda Bureau of Statistics

Services inflation which is indicative of domestic demand conditions in the economy has remained relatively elevated. It has averaged 4.8 per cent since July 2014, an indication that domestic demand may still be robust, notwithstanding the relatively low inflation. The "Other Goods" inflation, which is affected by exchange rate changes rose to 1.8 per cent in February 2015 from an average of 0.9 per cent in 2014, an indication that the effects of exchange rate depreciation may be beginning to take hold.

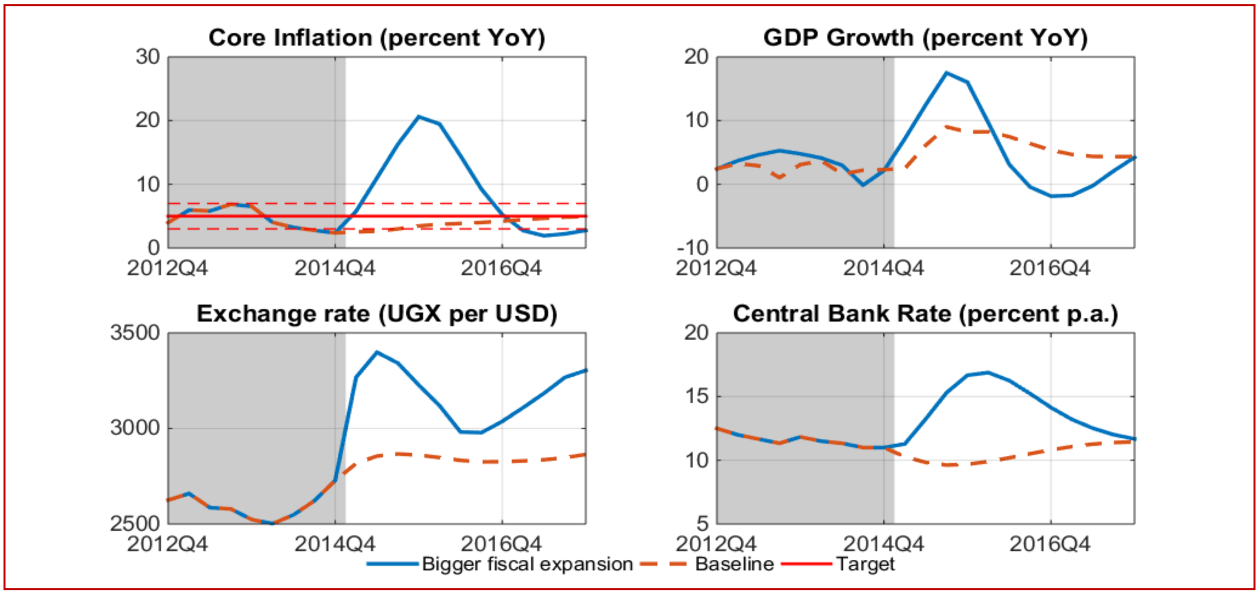
3.6.2 Inflation Outlook

Overall, the inflation landscape has changed significantly in recent months, but the outlook for food crop and international oil prices is highly uncertain. Unless a persistent food crop and oil prices decline is assumed, the impact on the inflation trajectory will dissipate over time. Therefore, disinflation pressures observed since the beginning of the FY are expected to be temporary. Even a moderate increase in both food crop and oil prices going forward will reverse the favourable inflation trajectory. Moreover, the steep decline in 2014/15, however, produces a strong base effect in 2015/16, and, when combined with a slightly higher oil price assumption, fiscal policy expansion and a depreciated nominal effective exchange rate of the Sh would result in a double-digit inflation.

Therefore, inflation is projected to gradually rise towards the 5 per cent target in the remaining part of 2015 as a direct result of pass through of exchange rate depreciation to domestic price, recovery in food crop prices and possible recovery in oil prices. The projected strength of economic activity in 2015 on account of the multiplier effect of public investment, possible faster depreciation of the Sh and a rebound in PSC nonetheless constitutes an upside risk to higher inflation beyond the 5 per cent target.

Taking these developments into account, and assuming a modest fiscal expansion, BoU forecasts that core inflation will remain subdued during the first half of 2015, but increase gradually to 5 - 6 per cent over the next 12 months, due to the pass-through effects of the depreciation. Headline inflation is also forecast to remain subdued in the first half of 2015, increasing gradually to 4 - 6 per cent over the next 12 months. The core inflation forecast and the trajectory of associated macroeconomic variables are shown in Figure 6.

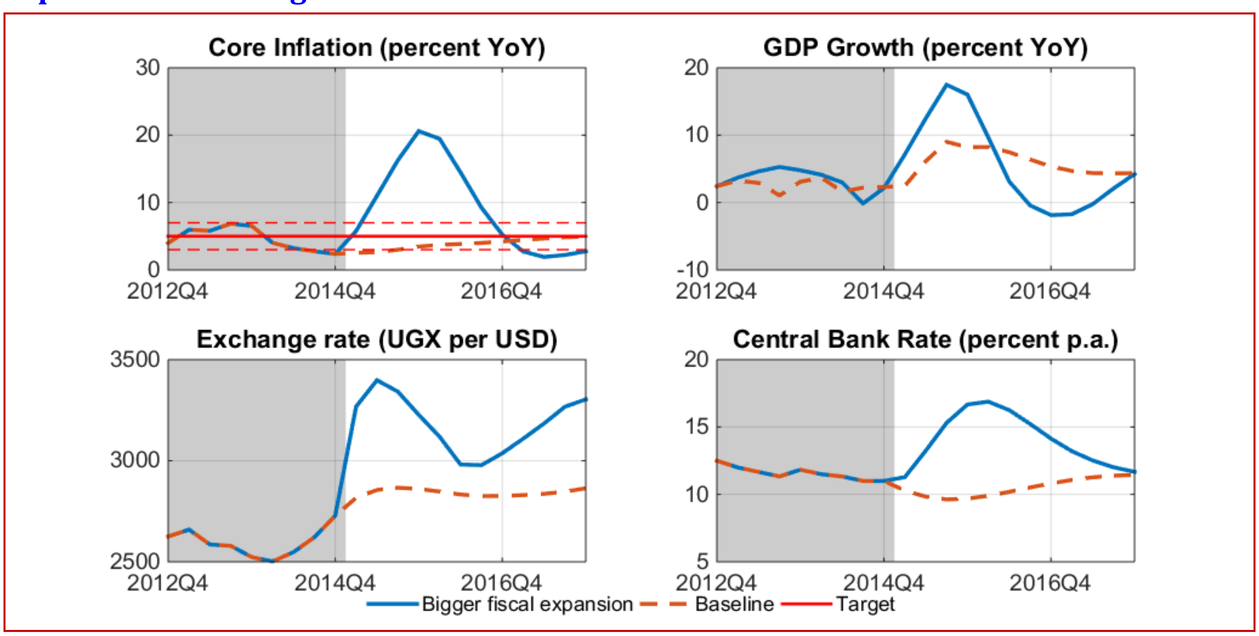
Figure 6: Inflation Forecast with a modest fiscal expansion



Source: BoU

However, assuming a higher fiscal expansion and Sh depreciation to the range of Shs 3,000-3,500 per USD, core inflation is expected to rise unprecedentedly, averaging 17.7 per cent in FY 2015/16, as shown in Figure 7.

Figure 7: Inflation Forecast with a higher than programmed fiscal expansion and a depreciated exchange rate



Source: BoU

4 RISKS TO OUTLOOK AND IMPLICATIONS FOR MONETARY POLICY

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

4.1 External economic environment

The international risk outlook has changed since December 2014, with increased uncertainty about the development of economic activity and increased volatility on the financial markets. If the situation deteriorates in, for example, Greece, Russia or Ukraine, the contagion effects in the euro area, will ultimately feed through to domestic economy, to the extent that could be greater than currently assumed. These downside and upside risks to the global economy would be played out in parallel in Uganda through impacts on commodity prices, Ugandan exports, terms of trade and confidence effects on private domestic demand. The continued underperformance of exports on account of subdued global economic activity could translate into slower growth in business investment. Weaker investment coupled with weak exports pose a downside risk to growth.

A key uncertainty is whether the global economy has moved into a new era in the global oil market. While both demand and supply factors help explain the fall in oil prices since mid-2014, there is disagreement about the exact balance and several influences are commonly cited. We put most weight on supply side explanations. A ramp up in global supply due to increased US oil production, lower than expected supply disruptions in the Middle-East, and, importantly, the OPEC decision not to change supply quotas have all played a role in pushing prices lower. Lower energy demand has also contributed, reflecting in part a weaker growth outlook in emerging Asia and Europe, and also changing demand patterns due to aging populations and on-going increases in energy efficiency.

Lower oil prices should bring several benefits to Ugandan economy in the short term but higher costs in the longer term as investments in the oil sector are affected. If supply-side factors are the major cause and oil prices remain around USD 50 per barrel, the cost of

Uganda's annual petroleum imports would fall by about USD 668 million or 2.3 per cent of nominal GDP compared with the price in mid-2014. It would represent a significant boost to household disposable income. If the main driver were weakening global demand, this would point to on-going weakness in Uganda's export incomes.

Lower oil prices pass directly and quickly into Uganda prices for petrol. For example, in February 2015 EFU prices declined by 1.1 PPs compared to the previous month and we expect a larger effect in the March 2015. Over following quarters, lower oil prices will pass through to lower input costs and lower prices for other firms – e.g. through lower freight costs. An important issue is how significant these indirect impacts of lower fuel prices might be, and to what extent they reduce households' expectations of future inflation.

There is a risk that oil prices could fall further if major oil producers continue to expand supply in a context of moderate global economic growth. On the other hand, oil prices could move higher if declining investment by higher-cost producers squeezes supply sooner than expected. While lower oil prices would benefit consumers, the effect on Uganda would, on balance, be modest, through reduction in Uganda's trade deficit.

Growth in EMEs could be much slower than expected. It is also possible that potential growth in EMEs is much lower than estimated. A slowdown in EMEs would weigh on Uganda's economic growth through trade, financial and confidence channels, and put further downward pressure on commodity prices.

4.2 Domestic economic environment

4.2.1 Fiscal Policy Challenges

On the domestic scene, risks emanate from the current expansionary fiscal stance, weak and vulnerable external position and the fragile growth prospects. Fiscal policy continues to be daunted by several challenges. The timing of the planned and budgeted projects and implementation of other projects not included in the budget may cause a challenge for monetary policy implementation. While spending on infrastructure has the benefit of boosting aggregate demand, fiscal expansion would worsen the already fragile external position.

4.2.2 External payments position and the exchange rate

Uganda's external payments position continues to be vulnerable. Foreign exchange reserves have essentially been built from surpluses in the capital and financial account – funded by aid inflows, FDI and portfolio inflows- as the CA balance continues to be in deficit. The external imbalance will continue influencing the exchange rate and as such the path of the exchange rate is an important source of uncertainty for the forecasts. If the exchange rate continues to depreciate at a faster rate, monetary policy might have to be tightened to contain the second-round effects of depreciation.

Recent data remain consistent with a decline in exports, in line with weak external demand and low commodity prices in spite of the depreciation of the Ugandan Sh. The realization of a downside risk to exports could have negative implications for investment. This, combined with projected decline in investment in the oil and gas sector in 2015 could depress investment activity, at least in the near to short run. Together, a decline in exports and business investment would pose a downside risk to growth and inflation. Moreover, reduced investment could lead to a drop in the net inflow of foreign capital, which, together with lower export revenues, would cause the Ugandan Sh to weaken further.

The depreciation of the exchange rate will eventually make imports more expensive and exports more competitive. In the short term most of the adjustment, however, has to take place through more expensive imports, because most exports are supply inelastic. If the economy is to adjust to the weakening of the BoP, aggregate consumption of imports will be reduced.

4.2.3 Prospects for real growth

Real GDP growth will be supported by FDI, and a rebound in agricultural production. However, since future developments in the global economy remain uncertain, projected FDI might be constrained. Moreover, increased public investment in infrastructure may require substantial domestic financing, which may further constrain PSC. Exports might continue to underperform while imports could grow faster than exports, implying that net exports will provide a negative contribution to GDP growth.

Recent data remain consistent with a decline in exports, in line with weak external demand and low commodity prices in spite of the depreciation of the Ugandan Sh. The realization of a downside risk to exports could have negative implications for investment. This, combined with projected decline in investment in the oil and gas sector in 2015 could depress investment activity, at least in the near to short run. Together, a decline in exports and business investment would pose a downside risk to growth and inflation.

5 CONCLUSION

The recovery of the world economy as a whole is expected to continue in the years immediately ahead, although at a slow rate. The international risk outlook has changed since December 2014, with increased uncertainty about the development of economic activity and increased volatility on the financial markets. Oil prices have fallen, which is positive for global growth but has also led to low global inflation. The economic outlook differs from country to country and region to region. This is reflected in increased differences in monetary policy between, for example, the US and the euro area, and in significant fluctuations on the foreign-exchange markets.

In essence, the Ugandan economy is performing well in many respects and the prospects are good for continued steady growth and low inflation at least in the near term. But the risks and uncertainties around the global economy are becoming more complex, and this presents considerable challenges for Ugandan economy. Weak developments abroad are slowing down economic growth, but are counteracted somewhat by the fall in the oil prices. Inflation is still low but there are signs that core inflation has bottomed out and is rising. The Sh is weaker than anticipated, which will also contribute to somewhat higher core inflation going forward. However, low energy prices are expected to somewhat hold back inflation during the remaining part of 2015 and the assessment is that it will reach 5 per cent in the second half of 2015. The lower oil prices and the uncertain outlook abroad increase the risk that inflation will not rise rapidly enough but this counteracted by domestic fiscal expansion concerns and the exchange rate depreciation.

The complex global economy combined with uncertainties emanating from domestic economy has meant that the BoU conducts monetary policy cautiously. Therefore, the CBR has been on hold while the Bank assesses the both domestic and external developments since June 2014, despite the projected decline in inflation. The direction of the monetary policy stance will continue to be guided by a careful assessment of risks to the global and domestic economy and their implications for the overall outlook on domestic inflation.