Bank of Uganda

Current State of the Economy

September 2015

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Acronyms and Abbreviations

AEs	Advanced Economies
BoP	Balance of Payments
BoU	Bank of Uganda
CA	Current Account
CBR	Central Bank Rate
EAC	East African Community
ECB	European Central Bank
EFU	Electricity, Fuel and Utilities
EMDEs	Emerging Market and Developing Economies
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
Sh	Shilling
SSA	Sub-Saharan Africa
UETCL	Uganda Electricity Transmission Company Ltd
UK	United Kingdom
URA	Uganda Revenue Authority
US	United States
USD	United States Dollar
WALR	Weighted Average Lending Rate
Y-o-Y	Year on Year

Executive Summary

i. The global economy is estimated to have expanded by 3.4 per cent in 2014, and is projected to expand further by 3.3 per cent and 3.8 per cent in 2015 and 2016, respectively. Developed countries are primarily driving growth in the global economy while several emerging economies are expected to grow more slowly in the years ahead. Even if the recovery in some regions has been weak in recent years, the prospects for higher growth in the period ahead are good. The price of oil remains low and fiscal policies are less tight than previously. At the same time, monetary policy is expansionary. The European Central Bank is continuing with expansionary monetary policy and in the United States, the Federal Reserve has communicated that its policy rate will be slowly raised. These continued monetary policy stimulation measures are supporting credit granting, which is boosting consumption and investment.

ii. The international financial markets have occasionally seen large fluctuations, which have been influenced by expectations of when the US central bank will raise its policy rate, developments in Greece and concern that the Chinese economy may be weaker than has previously been assessed. The softening demand in China due to weak economic performance has also contributed to falling commodity prices. Developments in the Chinese economy and the expected normalisation of the US Fed's monetary policy triggered investors' higher risk aversion and slower capital inflow to emerging markets. These developments pose risks to growth outlook of both the global and Ugandan economy.

iii. Global inflation has remained low over the last 12 months, averaging 3.2 per cent in 2014 and there are no clear signs that it has started to rise. Indeed, global inflation is projected to decline to 2.8 per cent in 2015. This trend is largely attributed to the sharp fall in global oil prices, which began in the third quarter of 2014. The renewed fall in oil price since May 2015 means that inflation will continue to be restrained by falling energy prices in the period ahead. On the other hand, inflation is high in many emerging markets and risks increasing further due to weaker exchange rates.

iv. Despite weak demand from abroad, Uganda's growth prospects have remained relatively good, though below historical average, largely driven by domestic demand, with strong public investments. However, domestic demand is expected to weaken in the next 12 months due to tight policy stance before broadening in the medium to long term. Indeed, the index of economic activity for the quarter ended July 2015 showed weaker domestic economic activity, with an annualized growth of 5.1 per cent compared to 6.6 per cent in the quarter ended April 2015. This, when combined with the worsening external environment, possible delays in commencement of public investment projects, and declining private investment and

consumption as result of the tight monetary policy, could result in a slowdown in economic activity in FY 2015/16. In the medium to long term, higher global growth would lead to faster export growth and robust capital inflows into Uganda, which would eventually lead to new investment opportunities. This, combined with easing domestic financial conditions should result in a stronger economic growth.

v. The Shilling depreciation pressures which started in 2014 continued through August 2015, with the Shilling depreciating by 24.1 per cent year-on-year on a trade weighted basis and by 35.8 per cent against the USD to an average of Shs. 3,548.25 per USD. The depreciation pressures were largely driven by the continued global strengthening of the USD; continued weakening of the current account deficit; reduction in FDI inflows on account of deferred investments in the oil sector because of low global oil prices; net portfolio outflows; elevated demand for foreign exchange from the key sectors of the economy including energy, manufacturing and offshore players; and bearish sentiments in the foreign exchange market

vi. Inflationary pressures remain elevated, though inflation remained close to the BoU's medium-term target of 5.0 per cent, after bottoming out at the beginning of 2015. In August 2015 annual headline inflation declined to 4.8 per cent from 5.4 per cent in July 2015, while core inflation rose marginally to 5.5 per cent from 5.4 percent. However, in the quarter to August 2015, annual headline and core inflation averaged 5 per cent and 5.3 per cent compared to 3.5 per cent and 4.4 per cent, respectively in the quarter to May 2015. The sharp nominal depreciation of the shilling in the quarter to August 2015 is the main factor driving inflation and is expected to continue to affecting inflation dynamics in the coming months.

vii. Inflationary risks are biased upward in the next 12 months because of the exchange rate trajectory. A further depreciation of the Shilling is one factor that could trigger high inflationary pressures and inflation persistence in the short-term. For instance, the uncertainty over the U.S FED's start of interest rate hike could increase turbulence in the foreign exchange market. A more rapid depreciation of the exchange rate than forecast would increase inflation, posing serious risks to the de-anchoring of inflation expectations. However, in the medium term, anticipated slowdown in activity, should allow inflation to converge to the target by mid-2017.

1. Background

This report discusses domestic and external economic developments in the period to September 2015. The report also assesses the future prospects for the domestic and global economy and identifies the attendant risks. In addition, it provides the projected inflation and output trajectory and the risks to this outlook. Finally, it identifies the implications of the outlook and risks to the global and domestic economy on the future direction of monetary policy in Uganda.

2. External Economic Environment

2.1 Economic Activity

The global economy is estimated to have grown by 3.4 per cent in 2014, and is projected to grow by 3.3 per cent and 3.8 per cent in 2015 and 2016, respectively. However, global economic growth and world trade weakened in the second quarter of the 2015. The slowdown is expected to have been a result of temporary factors. Growth however remains uneven, with most of the thrust coming from Advanced Economies (AEs), as growth in Emerging Market and Developing Economies (EMDEs) remains soft. The AEs are projected to grow by 2.1 per cent and 2.4 per cent in 2015 and 2016, respectively. Going forward, the global economy will be boosted by a strong American economy and an increasingly stable recovery in the euro area. This recovery is benefiting from expansionary monetary policy, less strict fiscal policy, less stringent credit terms and low oil prices.

The economic recovery in the Euro Zone also seems to be broadly on course, as the risk of a prolonged period of deflation appears to have receded with a pick-up in inflation expectations following the European Central Bank's Quantitative Easing program. Retail sales and consumer sentiments have also picked-up, in part because of the increasingly favourable financial conditions and low oil prices, which have in effect increased real household incomes.

Growth prospects in EMDEs remain cloudy, as economic activity is projected to slacken in commodity exporting EMDEs, in part due to falling commodity prices. Commodity-producing countries such as Russia and Brazil are being negatively affected by the low commodity prices. In China, weaker purchasing managers' indices for the industrial sector and major falls on the stock market have created unease about the strength of the economy. All in all, economic growth in EMDEs is projected to slowdown from 4.6 per cent in 2014 to 4.2 per cent in 2015 on account of tighter external financial conditions; structural bottlenecks inherent in most of these economies; the softening impact of lower

commodity prices; depreciation pressures on account of expectations of an interest rate hike in the US; the rebalancing in China; and economic distress related to geopolitical factors, particularly in the Russia, Ukraine, the Middle East and North Africa region.

Sub-Saharan Africa (SSA) is projected to grow at 4.2 per cent in 2015, down from an earlier projection of 4.6 per cent, in part due to low commodity prices and the after-effects of the Ebola crisis. The decline in global oil prices is likely to lead to a decline in the growth of oil-exporting economies, though this might be offset by the gains made by the oil-importing economies within the region subject to the impact of exchange rate depreciation pressures.

The risks to global economic activity are however tilted to the downside. While in the near-term, increased financial market volatility and disruptive asset price shifts may continue to suppress economic activity, lower potential output growth remains an important medium-term risk in both AEs and EMDEs. The subdued commodity prices while a contributing factor to the resurgence in consumption and domestic demand in AEs, also poses a risk to the economic outlook in oil exporting EMDEs. The monetary policy normalization in the US, potential spillovers from geopolitical conflicts and persistent vulnerabilities in emerging economies also constitute a downside risk to global growth.

2.2 Financial Markets

The international financial markets have occasionally seen large fluctuations, which have been influenced by expectations of when the US central bank will raise its policy rate, uncertainty surrounding the future trajectory of oil prices, future global growth prospects, geo-political tensions in Ukraine and the MENA region, developments in Greece and concern that the Chinese economy may be weaker than has previously been assessed. Notwithstanding the on-going United States (US) tapering of its asset purchase program, monetary policy continued to be relatively accommodative in AEs in general, with the ECB and central bank of Japan instituting a number of accommodative monetary policy measures in an effort to revamp their economies.

The long-term bond yields in many AEs decreased on disinflation concerns and the prospect of continued monetary accommodation. In the Euro Zone, the yields of about one-third of sovereign bonds were negative, and the prolonged low interest rate environment posed severe challenges for a number of financial institutions, with some facing a rising risk of distress. Although accommodative monetary policies have helped improve private

sector debt ratios by supporting inflation and growth, and by increasing asset prices, high private sector debt levels continue to hinder growth and financial stability in most AEs.

The expectations for monetary policy normalization in the US driven by the strong performance of the US economy and the push for additional monetary stimulus by other major economies have sparked rapid appreciation of the USD. EMDEs have been caught in this global dichotomy and face higher financial stability risks, as companies that borrowed heavily on international markets could face balance sheet problems. In addition, developments in the Chinese economy and the expected normalisation of the US Fed's monetary policy triggered investors' higher risk aversion and slower capital inflow to EMDEs. Most experienced sustained depreciation pressures, which have kept their financial markets nervous. In an attempt to moderate the inflationary impact of the exchange rate depreciation, most of the central banks in the EMDEs tightened monetary policy. These developments pose risks to growth outlook of both the global and Ugandan economy.

2.3 Global Inflation and Commodity Prices

2.3.1 Global Inflation

Global inflation has remained low over the last 12 months and there are no clear signs that it has started to rise. Global inflation averaged 3.2 percent in 2014 and it is projected to decline to 2.8 percent in 2015. This trend is largely attributed to the sharp fall in the oil price, which began in the third quarter of 2014. The renewed fall in the oil price since May 2015 means that inflation will continue to be restrained by falling energy prices in the period ahead.

In most AEs, low commodity and energy prices, abundant spare capacity, low aggregate demand, and well-anchored inflation expectations have kept inflation muted and below the respective central banks' medium-term targets. In 2014, inflation in AEs averaged 1.4 percent, and is expected to remain stable in 2015. On the other hand, inflationary pressures, ensued in some EMDEs, largely driven by the pass-through of exchange rate depreciation to domestic prices. Inflation will remain elevated in many EMDEs owing to a variety of factors, including depreciation pressures on account of the ensuing monetary policy normalization in the US, market distortions, supply shortages, and inflation inertia.

2.3.2 Global commodity prices

Global commodity prices remain soft largely driven by sustained oversupply, relatively weak global demand, and the global strengthening of the United States dollar (USD). After a protracted decline in 2014 through Q1-2015, global oil prices recovered in Q2-2015, on account of higher demand and expectations of a slowdown in the US shale oil production. The Brent oil price fell by more than 50 per cent between June 2014 and January 2015, dropping to a 5-year low of USD 47 per barrel in January 2015. They recovered moderately to fluctuate between USD 50 and USD 70 per Barrel in the period to July 2015 before declining to average USD 46 per barrel in August 2015.

Crude oil prices are projected to average USD 60 and USD 70 per Barrel in 2015 and 2016, respectively. Nonetheless, there are downside risks to this outlook including the continued strong growth of North America's shale oil production and a lifting of the economic sanctions against Iran, which may increase global crude oil output, thereby exerting a downward pressure on oil prices. The upside risks relate to the possibility of Organization of the Petroleum Exporting Countries (OPEC) cutting production and the escalation of conflicts in oil exporting countries, which may curtail global oil output.

Global food prices have also remained relatively soft, largely on account of favorable weather conditions that have boosted global food supplies. Indeed, the Food and Agriculture Organization (FAO) food price index declined on an annual basis by 21.5 per cent in August 2015. Global food prices are also projected to remain soft on account of abundant food supplies.

2.4 Implications for the Ugandan Economy

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

The persistently lower-than-assumed oil prices could also have a material impact on investment and economic activity, as it could dissuade foreign direct investment inflows to

the oil sector. There are already indications that FDI inflows to the oil sector have dwindled, and given Uganda's weak current account position, which has largely been funded by surpluses in the capital and financial account of the balance of payments, a decline in FDI inflows may aggravate exchange rate depreciation pressures. This may further be exacerbated by the likely normalization of monetary policy in AEs, especially the US, which may trigger capital outflows from EMDEs including Uganda. This will not only invigorate inflation, but may also dent the growth prospects of the economy.

There is also a risk that growth in EMEs could be much slower than expected. A slowdown in EMEs would weigh on Uganda's economic growth through trade, financial and confidence channels, including a further downward pressure on commodity prices. Furthermore, the continued slow growth in the Euro Zone while a downside risk to domestic inflation may have detrimental implications for Uganda's export earnings, remittances and FDI, which is a downside risk to growth.

The geopolitical tensions and the threat of terrorism remain elevated, including the conflicts in the Middle East, Russia and Ukraine. This could have a significant impact on consumer and business confidence, as investors and consumers could 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

The Bank of Uganda (BoU) pursued a neutral monetary policy stance from June 2014 to March 2015 during which the Central Bank Rate (CBR) was maintained at 11.0 per cent. This stance was premised on the projected inflation and output path. Inflation remained subdued during FY 2014/15, with core inflation averaging 3.3 per cent. The outlook for inflation at the time also suggested that core inflation would fluctuate within BoU's medium-term target of 5 per cent over the short – to medium-term.

Inflation trajectory however changed in March 2015, as depreciation pressures heightened. Core inflation increased from 2.7 per cent in January to 3.8 per cent in March, increasing further to 5.4 per cent in July 2015. Although there were indications of weaker growth, the risks to inflation particularly stemming from continued exchange rate depreciation

pressures and strengthening of domestic demand remained tilted on the upside. Indeed, the short-term inflation forecasts suggested that core inflation could peak at 13-16 per cent in early 2016 before gradually declining to 8-10 per cent by December 2016. Headline inflation was also forecast to increase to 12 - 15 per cent in H1-2016 before declining to 8-10 per cent by December 2016.

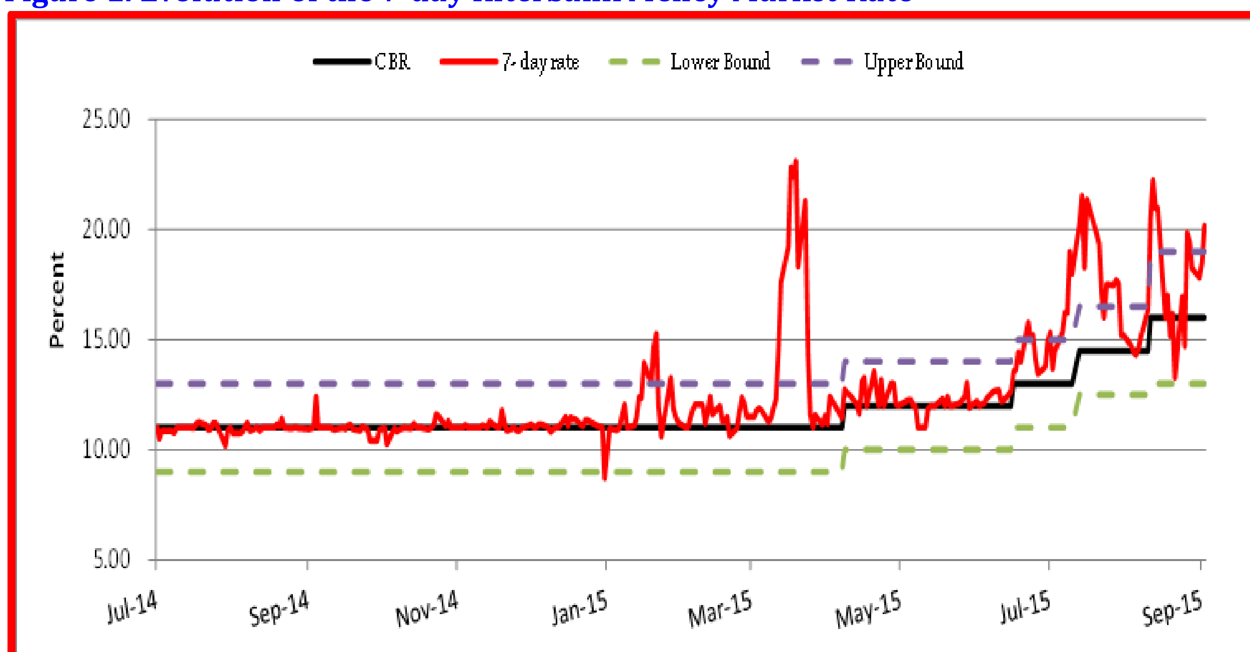
The BoU therefore decided to take pre-emptive measures to ensure annual core inflation remains around the 5 per cent target over the medium term. The CBR was consequently increased by 1 percentage point in April and June to 12 and 13 per cent, respectively and by a further 1.5 percentage points in July and August 2015, to 14.5 and 16.0 per cent, respectively.

3.1.2 Monetary policy implementation

The BoU continued to use Repurchase Agreements (REPOs), reverse REPOs and outright sales of recapitalization securities in the secondary market to align liquidity conditions in the domestic financial system with the desired monetary policy stance. In the two months to August 2015, the net impact of the REPOs/reverse REPO instruments was an injection of Shs 149.2 billion. As at end August 2015, the outstanding stock of REPOs stood at Shs 33.1 billion, while the stock of recapitalisation securities was Shs. 310 billion.

The 7-day interbank money market rate however remained relatively as shown in **Figure 1**, largely due to the tight liquidity conditions that were warranted by the depreciation pressures in the domestic foreign exchange market. Indeed, July and August, the weighted average 7-day interbank money market rate averaged 17.1 and 17.3 per cent, respectively, which was above the respective CBR's for these periods. In July in particular, it was also above the upper bound of the CBR of 14.5 per cent. Notwithstanding the tight liquidity conditions, overnight trades continued to dominate trading activity in the Interbank Money Market, accounting for about 67 per cent of the total volume of trades during the first two months of FY 2015/16.

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



Source: Bank of Uganda

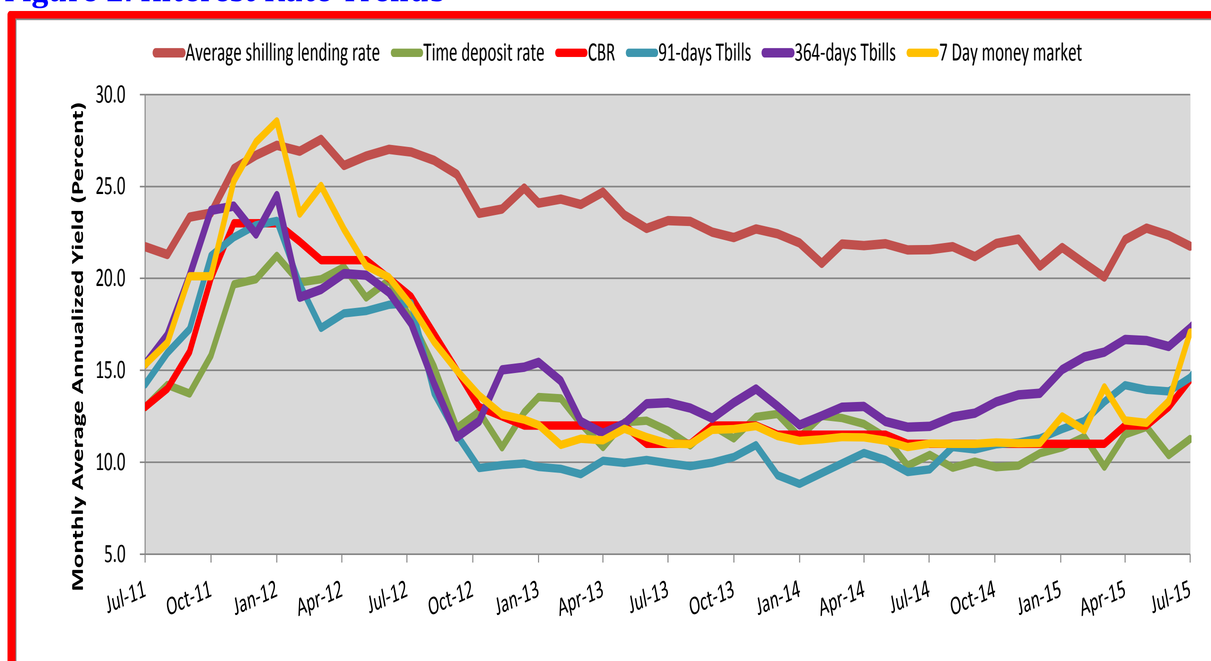
3.2 Interest rates and Private Sector Credit

3.2.1 Interest rates

Interest rates have risen in the recent past, reflecting expectations about increased domestic financing and rising inflation expectations in part driven by sustained depreciation pressures. The annualised yields on government securities, have for example, risen by about 6 percentage points on annual basis in August 2015. The average annualized yields for 91-day, 182-day and 364-day T-Bills rose to 16.2, 17.8 and 18.5 per cent in August 2015 from 11.0, 11.4 and 12.5 per cent, respectively in August 2014. The yields on T-bonds also rose in line with developments in the T-bills market. The yield on the benchmark 2-year Treasury bond also rose to 20.3 per cent in September from 13.1 per cent in September 2014.

The lending rates also remain elevated, in part reflecting structural factors such as the high cost of doing business, heightened risks aversion and difficulties in assessing credit worthiness of borrowers, and asymmetry in the monetary policy transmission mechanism. As shown in **Figure 2,** after remaining relatively stable at about 21.0 per cent over the last 12 months, notwithstanding the neutral monetary policy stance, weighted average lending rates rose about to 22 per cent in July 2015.

Figure 2: Interest Rate Trends



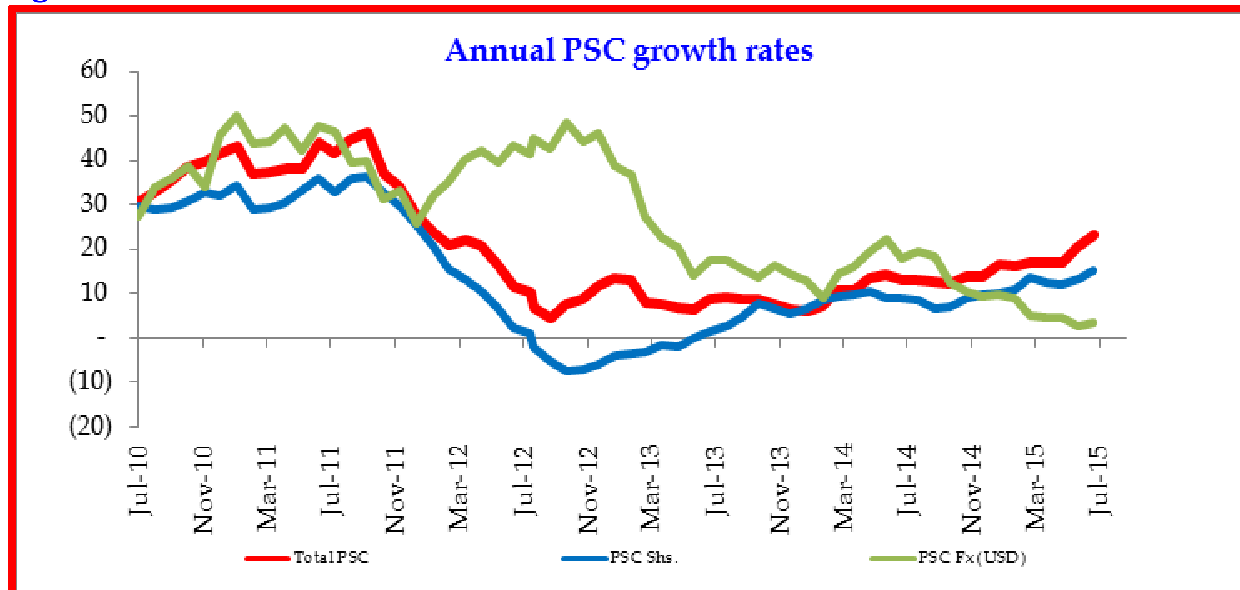
Source: Bank of Uganda

Reflecting the effect of monetary policy tightening, lending interest rate are expected to increase. Indeed, most commercial have increased base lending rates to as high as 25 per cent effective September 2015. The time deposit rates have however remained relatively stable, averaging 10.6 per cent during the past 12 months, although they edged-up slightly to 11.3 per cent in July, 2015.

3.2.2 Private Sector Credit

Growth in private sector credit (PSC), a leading indicator of the financial sector's contribution to economic activity, remained robust, in part reflecting buoyant domestic economic conditions. On an annual basis, PSC growth averaged 15.3 per cent in FY 2014/15. In July, PSC grew by 23.1 per cent on annual basis, up from 20.2 per cent in June 2015. The growth in credit is mainly driven by shilling equivalent foreign currency denominated lending, reflecting the depreciation effects. In July 2015, the shilling value of foreign currency loans grew by 34.9 per cent, while shilling denominated lending increased by 15.1 per cent. In terms of contributions to the overall growth in private sector credit in July, foreign currency lending contributed 16.1 percentage points, while shilling denominated lending contributed only 7 percentage points as shown in **Figure 3.** This largely reflects the impact of exchange rate depreciation, as foreign currency loans in US dollar terms increased by only 3.4 per cent year-on-year in July 2015.

Figure 3: Contributions to Annual Growth in Private Sector Credit



Source: Bank of Uganda

In terms of sectoral distribution; building, construction and real estate; trade and commerce; manufacturing; and personal and household loans continued to constitute the bulk of private sector credit. Indeed, as at end July 2015, these sectors accounted for 73.6 per cent of total private sector credit. The ratio of credit to the agricultural sector in total private sector credit also rose to about 9.5 per cent, in part reflecting the positive impact of disbursements from the agricultural credit facility. Although the increase in credit to the private sector could augur well for economic growth, it nonetheless constitutes an upside risk to inflation, as it may generate demand pressures in the economy.

The ratio of non-Performing Assets (NPAs) to total assets declined only marginally to 4.0 per cent in June from 5.8 per cent in June 2014. However, manufacturing and personal and household sectors saw an increase in NPLs to 4.3 and 4.1 per cent from 3.4 and 3.0 per cent in March 2015, respectively. Nonetheless, asset quality has improved relative to the previous period supported by increased monitoring and credit risk management. Underlying these overall changes were sustained improvements in shilling loan quality and worsening foreign currency loan quality. In June, the NPL ratio for foreign currency lending stood at 4.2 per cent, and for shilling lending stood at 3.8 per cent. In H1-2015, the total volume of Forex NPLs grew by over 50 per cent, likely resulting from sustained depreciation of the shilling. In the trade and commerce sector in particular, forex NPLs more than tripled during the same period. The sustained depreciation pressures in the foreign exchange market and the increase in interest rates due to the tight monetary policy stance may however worsen asset quality going forward.

3.3 Fiscal Policy and Developments

3.3.1 Fiscal Developments

Fiscal policy continues to plays a significant role, both as a stabilization tool and in determining the short- and long-term growth prospects of the economy. Indeed, the fiscal stance for FY 2014/15 focused on supporting economic growth by addressing infrastructural constraints in the economy.

Preliminary estimates indicate that in FY 2014/15, total government expenditure and net lending amounted to Shs.14,667.0 billion, which was less than the budgeted amount by Shs 1,432 billion due to the delays in conclusion of financing arrangement with China Exim bank on the financing of the Karuma and Issimba hydro power dams as shown in **Table 1**. Current expenditure exceeded budget by Shs. 141 billion, largely on account of other recurrent and interest payments. Tax and non-tax revenue exceeded the budget projection by Shs 153 billion.

Table 1: Fiscal Operations

	FY2014/15	FY2014/15	Difference
	Budget	Prel Outturn	Budget vs Outturn
Total revenue and grants	**10,944**	10,918	**(26)**
Revenue	**9,842**	9,995	**153**
Grants	**1,102**	**923**	**(179)**
Expenditures and net lending	**16,099**	14,667	**(1,432)**
Current expenditures	**7,494**	7,635	**141**
Wages and salaries	2,904	2,713	(191)
Interest payments	1,083	1,201	118
Other current spending	3,506	3,721	215
Development expenditures	**5,997**	**5,273**	**(724)**
Overall balance	**(5,155)**	**(3,749)**	**1,406**

Source: Ministry of Finance, Planning and Economic Development

The fiscal deficit of Shs. 3,749 billion was financed by both domestic and external sources. Domestic financing included a drawdown on government savings with BoU amounting to Shs. 1,060.0 billion and net issuance of Government securities of Shs. 1,386.0 billion. The drawdown of savings was specifically used to finance expenditures related to the public infrastructure projects.

The fiscal stance for FY 2015/16 is also centred on addressing the infrastructural constraints in the economy. The fiscal deficit is projected to widen in FY2015/16 and it will be largely financed by external sources. As shown in **Table 2,** total expenditure is projected to increase by 27.8 per cent compared to FY 2014/15, with the bulk of the increase going to development expenditure.

Table 2: Projected fiscal operations (Shs bn)

	2013/14	2014/15	2015/16	*%age increase*
Total revenue and grants	8,870	10,918	12,589	*15.3*
Revenue	8,168	9,995	11,133	*11.4*
Grants	702	923	1,456	*57.7*
Expenditures and net lending	11,682	14,667	18,745	*27.8*
Current expenditures	6,706	7,635	8,721	*14.2*
Wages and salaries	2,385	2,713	2,894	*6.7*
Interest payments	970	1,201	1,727	*43.8*
Other current spending	3,351	3,721	4,100	*10.2*
Development expenditures	4,937	5,273	7,401	*40.3*
Overall balance	-2,812	-3,749	-6,156	*64.2*
Domestic financing (net)	1,650	2,479	1,632	*-34.2*

Source: Ministry of Finance, Planning and Economic Development

Domestic fiscal financing through issuance of government securities has been capped at Shs. 1.4 trillion, not only because of the cost of borrowing but also to avoid crowding-out the private sector from the domestic credit market.

Tax revenue collections in the first two months of FY 2015/16 amounted to Shs 1,544.1 billion, a shortfall of Shs 38.6 billion relative to the Uganda Revenue Authority (URA) target of Shs 1,582.7 billion. Indirect and direct taxes underperformed by Shs 30.8 billion and Shs 32.5 billion, respectively. Taxes on international trade however, over performed by Shs. 9.6 billion, in part reflecting the impact of exchange rate depreciation.

3.3.2 Public Debt

The total public debt stock, in nominal terms, at end June 2015 is estimated at Shs. 24,242.0 billion, an increase of 24.2 per cent from Shs. 19.518.0 billion at end June 2014. External and domestic debt increased by 27.7 per cent and 21.1 per cent, respectively. The increase in the shilling value of external debt was in part driven by the exchange rate depreciation. Indeed in USD terms, public external debt increased by only 0.5 per cent. In terms of

distribution, external debt continues to make up the bulk of the total public debt, accounting for 59.1 percent of total public debt as shown in **Table 3**.

Table 3: Public Debt Indicators

	Jun-13	Jun-14	Jun-15
Total Gross Public Debt	16,676	19,518	24,242
External Debt (USD , Mn)	3,827	4,301	4,323
External Debt (Shs. Bn)	9,926	11,181	14,273
Domestic Debt (Nominal)	6,454	8,152	9,872
Shs./USD exchange rate	2,593	2,600	3,302

Source: Ministry of Finance, Planning and Economic Development

3.4 Balance of Payments and Exchange Rates

3.4.1 Balance of payments

The current account balance (CAB) remained fragile, registering a deficit of USD 2,391.6 million, up from a deficit of USD 2,134.9 million in FY 2013/14. As a ratio of GDP, the current account deficit, excluding official grants, deteriorates to 11.0 per cent compared to a deficit of 8.8 per cent of GDP in FY 2013/14. The deterioration of the current account deficit was largely driven by the services deficit, which deteriorated to USD 730.8 million in FY 2014/15 from USD 329.6 million in FY 2013/14 mainly on account of higher payments of government services related to infrastructure projects, particularly Karuma and Isimba hydro power projects. Tourism receipts also remained subdued, declining to USD 671.2 million from USD 685.2 million during the same period of time. The deficit on the primary income account deteriorated by 27.4 per cent to US$ 818.6 million in FY 2014/15 from USD 642.4 million in FY 2013/14 mainly on account of higher payments of dividends on foreign direct investment.

The trade deficit improved by 4.9 per cent to USD 2,251.5 million from USD 2,367.2 million in FY 2013/14, largely on account of lower government and private sector oil imports. Exports remained subdued at about USD 2,714.0 million. Net current transfers are estimated at USD 1,409.3 million compared to USD 1,194.5 million in FY 2014/15, largely driven by higher private sector receipts by both households and non-government organisations.

The surplus on the financial account declined to USD 1,270.7 million from of USD 1,911.8 million during FY 2013/14 mainly on account of the decline in FDI inflows, which fell from

USD 1,224.8 million in FY 2013/14 to USD1,028.4 million. Portfolio investment recorded a net outflow of USD 158.8 million compared to a net inflow of USD 4.8 million in FY 2013/14, mainly on account of increased acquisition of foreign portfolio assets by resident entities coupled with disinvestment in government securities by non-residents. The “other investment” inflows declined to USD 359.7 million from USD 681.0 million in FY 2013/14 driven mainly by a build-up of foreign assets of resident deposit taking corporations.

The overall balance of payments was a deficit of USD 377.3 million, leading to a drawdown in reserves of USD 379.5 million. The stock of reserves as at end June 2015 amounted to USD 2.89 billion, which is equivalent to 4.1 months of import cover. The developments in the balance of payments are shown in **Table 4**.

Table 4: Balance of Payments

Account in Millions of USD	**FY 2011/12**	**FY 2012/13**	**FY 2013/14**	**FY 2014/15**
A. Current Account (A1+A2+A3+A4)	-2,042.4	-1,593.5	-2,134.9	-2,391.6
A1. Goods	-2,574.0	-2,123.0	-2,367.2	-2,251.5
Exports	2,667.4	2,912.1	2,706.3	2,714.6
Imports	5,241.5	5,035.1	5,073.5	4,966.0
A2. Services	-412.1	-404.8	-329.6	-730.8
Inflows	2,030.8	2,139.4	2,342.3	2,258.4
Outflows	2,442.9	2,544.2	2,671.9	2,989.2
A3. Primary Income	-470.7	-538.6	-642.4	-818.6
Inflows	51.1	33.3	6.5	27.6
Outflows	521.8	571.9	649.0	846.2
A.4 Secondary Income	1,414.5	1,472.9	1,204.4	1,409.2
Inflows	1,622.4	1,632.2	1,398.5	1,607.8
Outflows	208.0	159.3	194.1	198.6
B. Capital Account	17.6	32.7	91.0	99.1
C. Financial account (Net lending (+) / net borrowing	-2,150.6	-1,487.7	-1,911.8	-1,241.0
Direct Investment	-1,243.9	-939.9	-1,224.8	-1,034.8
Portfolio Investment	-264.7	46.5	-4.8	158.8
Financial Derivatives and Employee Stock	-12.3	-0.8	-1.2	-5.2
Other Investment	-629.7	-593.6	-681.0	-359.7
D. Net Errors and Omissions	617.0	407.4	506.8	674.3
E. Overall Balance (A+B-C+D)	-742.8	-334.4	-374.8	377.3
F. Reserves and Related Items	742.8	334.4	374.8	-377.3
Reserve Assets	741.1	332.3	372.0	-379.5

Source: Bank of Uganda

In the quarter ended July 2015, current account balance deteriorated marginally by US$0.2 million to a deficit of US$567.5 million from a deficit of US$567.7 million in the preceding quarter. The deterioration in the current account was largely as a result of a higher deficit in the services account during the three months period. In comparison with the same period a year ago, the current account deficit improved by US$108.5 million from a deficit of US$676.0 million registered in the quarter ended July 2014. Merchandise export receipts decreased by 0.6 per cent from US$680.2 million recorded during the previous quarter to US$679.6 million during the quarter ended July 2015. This was largely due to a combined decrease of US$13.5 million in exports of cotton, tobacco and base metals & products, to US$37.2 million during the quarter ended July 2015.

Value of imports decreased by 2.7 per cent to US$1,189.2 million during the quarter ended July 2015, from US$1,222.1 million recorded in the previous quarter mainly on account of lower private sector imports. Private sector imports on goods decreased by US$24.6 million to US$1,152.9 million during the quarter ended July 2015, from US$1,177.5 million in the previous quarter mainly due to a decline in non-oil import expenditure. Non-oil import expenditure declined by 4.5 per cent to US$924.0 million from US$967.3 million recorded in the preceding quarter, which could be a reflection of the impact of the exchange rate depreciation.

Overall balance of payments was deficit of US$143.5 million during the quarter ended July 2015, with a net draw down in reserves assets of US$140.6 million excluding valuation changes. In the short-term, the current account deficit is likely to widen due to the effect of low international prices for Uganda's export commodities. However, dampened private sector demand due to the depreciation of the currency, could moderate the increase in the deficit.

3.4.2 International Investment Position

The international investment position indicates that Uganda's external financial liabilities continue to outstrip external financial assets. Indeed, Uganda's position as a net debtor with the rest of the world increased from USD 12,010.9 million at end June 2014 to USD 13,363.7 million as at end June 2015. The net increase in liabilities of USD 1,352.8 million was largely a result of an increase in FDI liabilities of USD 1,034.9 million. This was further exacerbated by a reduction in reserve assets of USD 497.1 million during FY 2014/15.

On a gross basis, Uganda's stock of foreign liabilities amounted to USD 18,289.0 million, up from USD 16,894.3 million at end June 2014. The stock of FDI amounted to USD 10,459.3 million, accounting for 57.2 per cent of the country's total foreign liabilities. The bulk of the FDI stock, about 80.3 per cent, was in the form of equity capital and reinvested earnings. Portfolio investment liabilities to non-residents amounted to USD 663.9 million, an increase of USD 31.4 million when compared to the end June 2014 position. *"Other investment"* liabilities amounted to USD 7,165.4 million as at end June 2015, the bulk of which were loans owed by government and the private sector to non-residents.

The stock of foreign assets amounted to USD 4,925.3 million, up from USD 4,883.5 million at end June 2014. Reserve assets estimated at USD 2.9 million dominated the foreign assets contributing 58.4 per cent of the total. The *"other investment"* assets comprising mainly currencies and deposits abroad and loans to non- residents, amounted to USD 1,495.1 million, out of which currency and deposit assets accounted for 97.5 per cent. Portfolio investment assets amounted to USD 500.1 million, with debt securities assets as the major category, accounting for 64.9 per cent of the total portfolio investment assets. There was tremendous growth in the equity and investment fund share category over FY 2014/15, driven largely by acquisition of equity assets in non-resident entities by residents.

3.4.3 Exchange Rates

The depreciation pressures which started in 2014 continued through to August 2015, with the Shilling depreciating by 24.1 per cent year-on-year on a trade weighted basis and by 35.8 per cent against the USD to an average Shs. 3,548.25 per USD. As of 14th September 2015 the shilling had depreciated by about 28.2 percent compared to January 2015.

The appreciation or depreciation in the nominal exchange rate is the economy's natural and desirable response to changes in domestic and international macroeconomic conditions. The global appreciation of the dollar, the evolution of commodity prices and the domestic factors, have significantly affected the shilling exchange rate in recent months. The currency depreciation is not exclusive to Uganda, as it is shared by most of our trading partners as shown in **Table 5**. However, the Ugandan shilling has depreciated much more intensely, in part reflecting negative sentiments originating from expansionary fiscal policy and the deteriorating current account balance. Given the projected deterioration in the country's net external liabilities over the next two years, further exchange rate depreciation might be necessary.

Table 5: A comparison of developments in major trading partners' currencies

	UGX	EURO	KES	ZAR	JPY	RWF	GBP	TZ
2014 M01	-6.9%	-2.5%	-0.8%	23.9%	17.3%	6.6%	-2.4%	1.7%
2014 M02	-7.0%	-2.2%	-1.3%	23.7%	9.6%	6.5%	-5.5%	1.9%
2014 M03	-3.9%	-6.3%	0.8%	17.1%	8.5%	6.5%	-9.1%	2.5%
2014 M04	-1.9%	-5.7%	3.0%	15.8%	4.6%	6.4%	-8.9%	2.4%
2014 M05	-2.1%	-5.5%	3.9%	11.3%	1.3%	6.3%	-8.8%	2.7%
2014 M06	-0.5%	-2.9%	2.5%	6.6%	4.9%	6.3%	-9.0%	3.1%
2014 M07	1.7%	-3.4%	1.1%	7.8%	2.1%	5.9%	-11.1%	2.9%
2014 M08	1.3%	-0.1%	0.7%	5.7%	5.2%	5.4%	-7.2%	2.8%
2014 M09	1.9%	3.5%	1.6%	9.9%	7.9%	4.9%	-2.7%	3.3%
2014 M10	5.8%	7.7%	4.6%	11.7%	10.4%	4.2%	0.3%	4.4%
2014 M11	8.4%	8.2%	4.5%	8.8%	16.1%	3.9%	2.1%	6.3%
2014 M12	10.2%	11.1%	4.8%	10.6%	15.3%	3.7%	4.8%	7.7%
2015 M01	14.4%	17.0%	5.9%	6.4%	13.8%	3.5%	8.7%	8.3%
2015 M02	16.1%	20.3%	6.0%	5.4%	16.1%	4.1%	8.0%	8.7%
2015 M03	16.5%	27.6%	6.1%	12.2%	17.7%	4.4%	11.2%	9.9%
2015 M04	18.4%	28.2%	7.8%	14.0%	16.6%	4.6%	11.9%	10.7%
2015 M05	18.8%	23.2%	10.3%	15.0%	18.5%	4.7%	8.9%	18.8%
2015 M06	24.0%	21.2%	11.6%	15.1%	21.2%	5.2%	8.5%	25.7%
2015 M07	27.6%	23.1%	15.2%	16.7%	21.2%	5.6%	9.7%	27.0%
2015 M08	32.6%	21.8%	15.1%	19.1%	20.5%	5.8%	7.0%	27.1%

Source: Bank of Uganda

In particular, over the years, government foreign expenditures have risen, partly on account of the high import requirements for the public infrastructure projects. This has come at a point when government budget support grants have also been declining. Indeed, since FY 2008/10, the Government budget has required net sales of foreign exchange from the BoU.

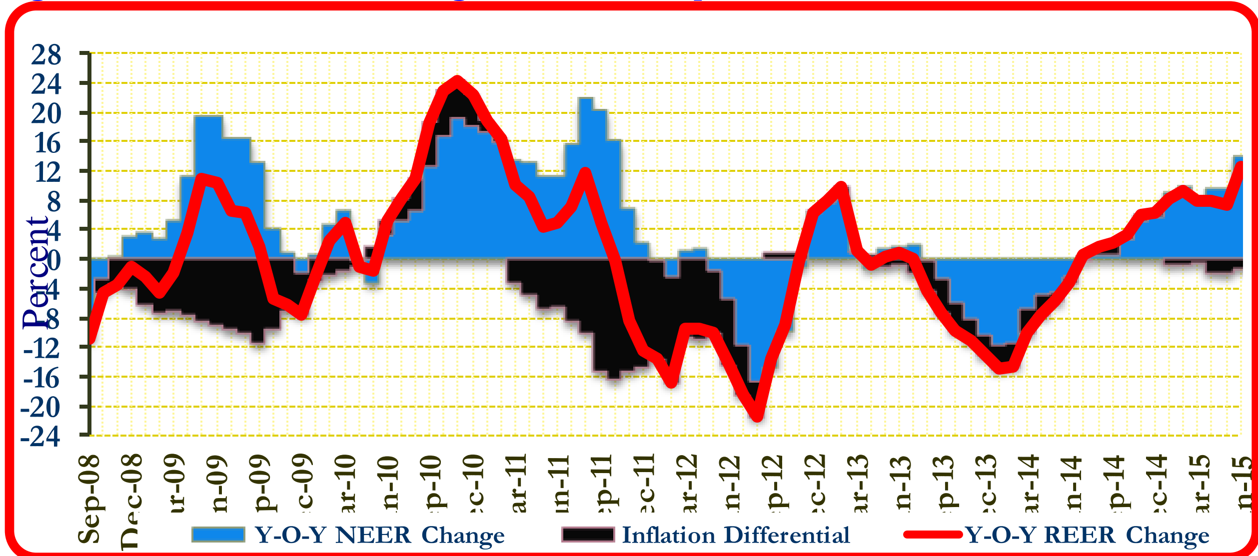
In order to meet Government's requirements for foreign exchange without jeopardising the foreign exchange reserves target, BoU has been purchasing foreign exchange from the interbank foreign exchange market. In FY 2015/16, BoU had programmed to purchase daily amounts of Shs. 4.2 million. It was anticipated that these regular purchases would minimise disruptions to the market. BoU has however had to suspend daily purchase of foreign currency for reserve build up for most of the first three months of FY 2015/16 due to the volatile conditions in the domestic foreign exchange market.

BoU also intervened in the Interbank Foreign Exchange Market during days of excessive volatility. During FY 2014/15, BOU purchases for reserve build-up amounted to USD 764.2 million. Overall, the net impact of BoU's action in the foreign exchange market during FY 2014/15 was a purchase of USD 97.1 million compared to a net purchase of USD 674.8 million in FY 2013/14. In FY 2015/2016, the BoU has so far bought US$ 133.7 million for foreign reserve build up, intervened in the IFEM selling US$ 110.5 million and made a targeted sale to UETCL of US$ 27.5 million. The net impact of the BoU's actions has resulted in a net sale of US$ 4.3 million instead of a programmed net purchase.

The Real Effective Exchange Rate (REER) also depreciated in line with the depreciation of the trade-weighted nominal exchange rate, depreciating by 6.5 per cent in FY 2014/15 compared to an appreciation of 5.5 per cent in FY 2013/14. Indeed, as shown in **Figure 5**, about 95 per cent of the real depreciation in FY 2014/15 was accounted for by the nominal depreciation of the shilling, with changes in price differential accounting for only 5 per cent of the overall real depreciation during this period. In FY 2015/2016, the REER has so far depreciated 13.2 per cent during July 2015 largely driven by the 15.8 per cent depreciation of the trade-weighted nominal exchange rate.

The Real Effective Exchange Rate (REER) also depreciated in line with the depreciation of the trade-weighted nominal exchange rate, depreciating by 12.3 per cent y-o-y in July 2015. Indeed as shown in **Figure 4,** most of the real depreciation during this period is accounted for by the depreciation of the Nominal Effective Exchange Rate (NEER), with the price differential accounting for only a small proportion.

Figure 4: Real Effective Exchange Rate and Components



Source: Bank of Uganda

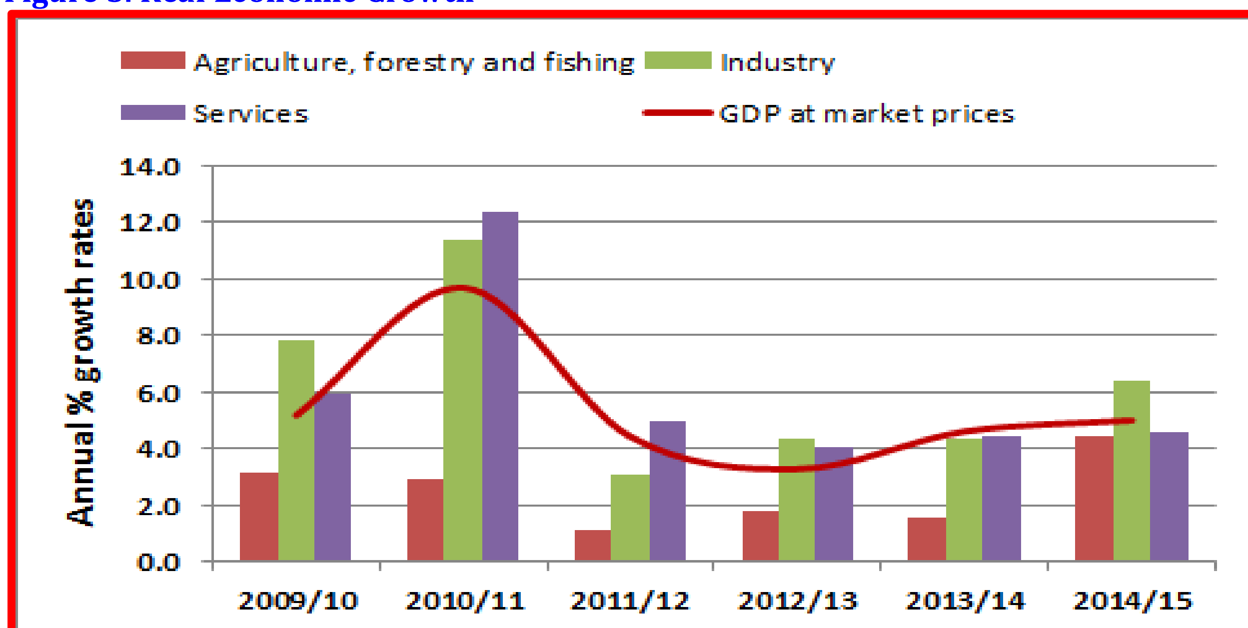
3.5 Domestic Economic Activity

Despite weak demand from abroad, Uganda's growth prospects have remained relatively good, largely driven by domestic demand, with strong public investments. Economic activity is estimated to have grown by 5.0 per cent in FY 2014/15, up from a growth rate of

4.6 per cent in FY 2013/14, and is projected to remain in the range of 5.0-5.4 per cent in FY 2015/16 FY, lower than 5.8 per cent projected at the beginning of the financial year.

In FY 2014/15, agricultural output grew by 4.5 per cent compared to 1.5 per cent in FY 2013/14. The industrial and service sectors also grew by 6.4 per cent and 4.6 per cent, compared to 4.3 per cent and 4.4 per cent, respectively in FY 2013/14. The performance of the industrial sector was mainly driven by growth in the mining, quarrying, and manufacturing sectors' output. On the other hand, growth in the services sector was largely driven by growth in financial and insurance activities, administration and support service activities, and public administration. The sectoral growth performance of respective sectors of the economy is shown in **Figure 5**. The Services sector continued to be the dominant sector, contributing 50.0 per cent to total output, while industry and agriculture contributed 18.6 per cent and 22.7 per cent, respectively.

Figure 5: Real Economic Growth



Source: Uganda Bureau of Statistics

There are downside risks to the projected output path, emanating from both the domestic and external environment. Domestic demand is expected to weaken in the next 12 months, in part due to tight monetary policy stance before broadening in the medium to long term. Indeed, the index of economic activity for the quarter ended July 2015 showed weaker domestic economic activity, with an annualized growth of 5.1 per cent compared to 6.6 per cent in the quarter ended April 2015. This, combined with a worsened external scenario,

possible delays in commencement of public investments, and decline in private investment and consumption, could result in slowing down of economic activity 2015/16. In the medium to long term, higher international growth will lead to faster Ugandan export growth and robust capital inflows growth into Uganda which will eventually also increase the need for new investments. This combined with the easing of financial conditions should result in a stronger economic growth.

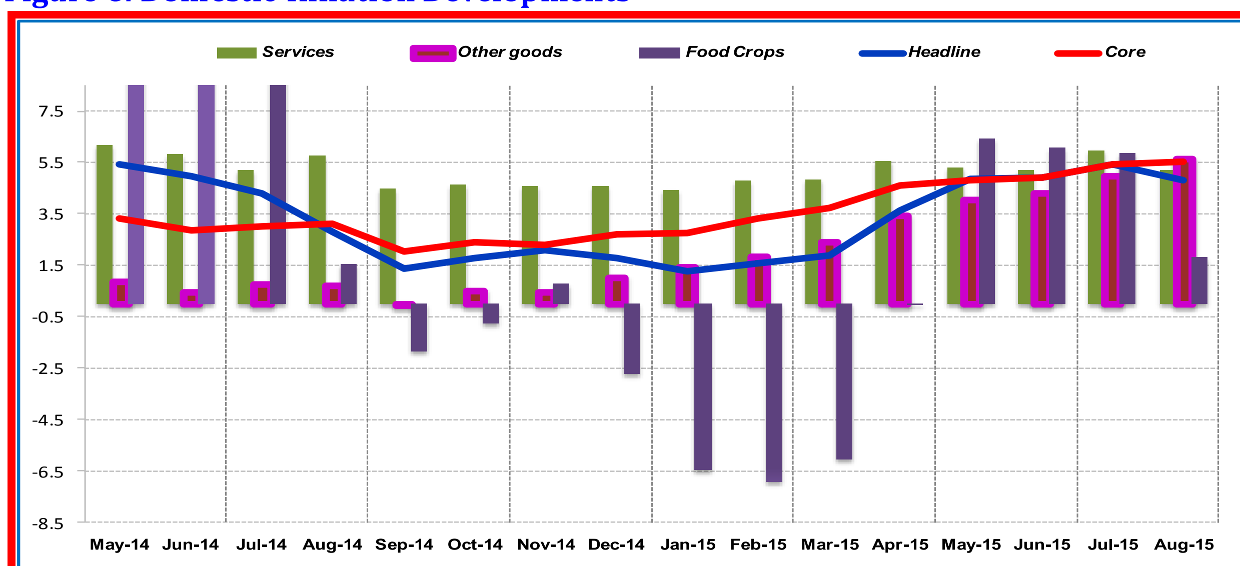
3.6 Consumer Price Inflation

3.6.1 Recent Inflation Developments

Inflationary pressures remain elevated, though inflation remains close to BoU's medium-term target of 5.0 per cent after bottoming out at the beginning of 2015. In August 2015 annual headline inflation declined to 4.8 per cent from 5.4 per cent in July 2015 while core inflation rose marginally to 5.5 per cent from 5.4 per cent. However, in the quarter to August 2015, annual headline and core inflations averaged 5 per cent and 5.3 per cent, respectively, compared with 3.5 per cent and 4.4 per cent, respectively, in the quarter to May 2015. The sharp depreciation of the shilling has been the main factor driving inflationary pressures, and is expected to continue driving inflation dynamics in the coming months, delaying its convergence to 5 per cent.

Inflation in the "other goods" category, which mainly reflects exchange rate changes, rose to 5.7 per cent in August from 1.4 per cent in January 2015. Services inflation, a good proxy for "non-traded goods" inflation, which is indicative of domestic demand condition in the economy, also remained relatively strong, averaging 5.2 per cent since the beginning of the year. This indicates that notwithstanding the relatively low inflation, domestic demand conditions may still be robust. Annual food crops inflation has however remained relatively subdued, averaging 0.1 per cent since January 2015. Energy, Fuel and Utilities (EFU) inflation has also been low, averaging 2.5 per cent since the beginning of the years partly driven by the impact of low commodity prices. Developments in domestic inflation are depicted in **Figure 6.**

Figure 6: Domestic Inflation Developments



Source: Uganda Bureau of Statistics

3.6.2 Inflation Outlook

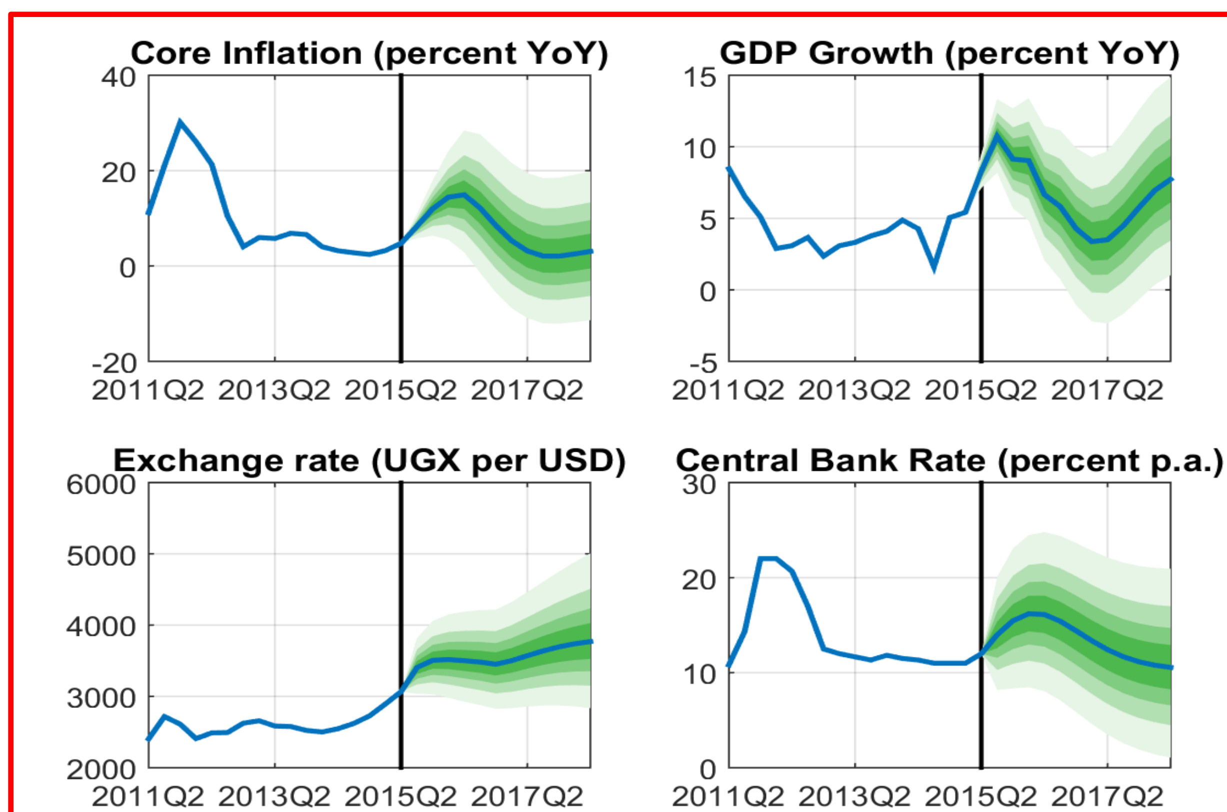
Low global inflation, falling international energy prices and a forward looking monetary policy have helped in holding back inflation despite the fast shilling depreciation experienced in the last 12 months. However, there are several upside risks indicate that inflation will continue to rise in the next 12 months. The weakening of the Uganda shilling over the last 14 months has contributed to an increasingly rapid rise in the import prices of a number of consumer products. To a certain extent, the high import prices have already affected consumer prices, for example of fuel pump prices. However, the impact on inflation of other consumer products takes place following a certain delay. As the shilling depreciates further in the period ahead, this will push inflation higher. A stronger global economy could mean higher international prices and if domestic demand was to remain strong, this will make it easier for companies to raise their prices resulting in the faster increase in consumer goods prices. In addition, international oil prices are expected to rise going forward and hence make a stronger contribution to inflation. Taking these developments into account, and assuming appropriate monetary policy reaction function, core inflation could peak at 10 - 12 per cent in early 2016, before gradually declining to 6-8 per cent by end 2016.

There are several sources of uncertainty in the forecast. Costs and prices depend on a number of factors, both domestic and external. The recent period has been characterised

by volatility on the foreign exchange markets and falling oil prices. The external environment has become more complex, partly because the process of rebalancing global growth in favor of the developed economies —especially the United States— and the likely start of monetary normalization by the Federal Reserve, which has resulted in a significant strengthening of the dollar. This is coupled with doubts about the strength and sustainability of the Chinese economy. These developments could worsen global financial conditions and declining commodity prices, and also exacerbate the depreciation of Uganda shilling. If the international economic outlook deteriorates, growth in Uganda will also be affected. This may mean lower resource utilisation and that companies will continue to find it difficult to pass along cost increases in the form of higher prices for consumers for a longer time than assumed by the forecast.

In the short term, inflationary risks are biased upward largely because of the exchange rate trajectory. The baseline scenario in **Figure 7** reflects those events that are believed to be the most likely to occur with the information at hand. Domestically, the baseline scenario continues to expect a gradual fade-out of the election cycle based autonomous shock to confidence that has negatively affected the expectations of consumers and businesses in the last few quarters. The baseline scenario assumes that going forward the exchange rate will depreciate further but at a lower pace compared to depreciation observed in the three months to August 2015. This, coupled with an expected slowdown in activity, should allow inflation to converge to the medium term target of by mid-2017. The persistence of high inflation for a long time could have an impact on inflation expectations, with implications for monetary policy.

Figure 7: Outlook based on baseline scenario.



Source: Bank of Uganda

There are however risks, which, if materialized, may reshape the macroeconomic outlook and, therefore, may alter the course of monetary policy. The events that could drive a further depreciation of the shilling are of varied nature, and its effects on inflation could have implications on the conduct of monetary policy. Should this happen, this will cause inflation persistence and subsequently inflation would remain above the target for an extended period. This would pose significant challenges in the inflation-targeting monetary policy framework, which aims at having it stand at 5 per cent by the end of the policy horizon.

As negative output gap increases in 2016/17, this will result in lower inflation inflationary pressures. However, its disinflationary influence will be limited due to the persistent shilling depreciation pressures and the elevated inflation expectations. In particular, there is considerable uncertainty about the developments in the exchange rate. The uncertainty over when the Federal Reserve will start to raise its policy rate and the recent turbulence on the foreign exchange markets constitute the main upside risks to inflation. A more rapid

depreciation of the shilling exchange rate than forecast would increase inflation, posing a serious risk to the de-anchoring of inflation expectations.

The baseline scenario provides for a decline in private sector investment in 2015/16 against the backdrop of high economic uncertainty, relatively tough lending conditions and limited external funding substitution potential. As inflation slows in 2016/2017 in line with the forecast, the BoU will gradually revise the CBR downwards and this will ease financial conditions and stimulate investment activity in 2017 and after.

4. Conclusion

The global economic outlook has improved slightly, anchored by a stronger recovery in the US, with the Euro zone showing incipient signs of recovery, supported by expansionary monetary policy. Growth however remains uneven, with most of the thrust coming from Advanced Economies, as growth in Emerging Market and Developing Economies remains soft. The global financial markets continued to be relatively jittery, in part driven by expectations of an interest rate hike in the United States, uncertainty surrounding the future trajectory of oil prices, future global growth prospects, and geo-political tensions around the world. Most Emerging Market and Developing Economies experienced sustained depreciation pressures, which have kept their financial markets nervous.

Economic conditions in Uganda are becoming more complex because of the slowdown in economic activity, rising inflation and external and fiscal imbalances. The exchange rate depreciation is major source of vulnerability and it's pass through to domestic prices is likely to wither the strong domestic demand that has been the main driver of growth in recent years through lower income and higher cost of imported capital. The higher cost of raising funds domestically will translate into a higher cost of borrowing which will impact negatively on private investment and consumption. This together with weak external demand as a result of modest global growth is likely to lower the growth projection for 2015/16. There are "no easy short-term wins" to stabilise exchange rate, except tightening fiscal and monetary policies.

Uganda's economic performance in the years to come will largely depend on its ability to adapt to adverse external conditions. The country's economic potential will be enhanced only through efficient management of public investment. This process should be facilitated by government policy measures aimed at improving business climate and ensuring higher productivity growth.