Bank of Uganda

State of the Economy

June 2016

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Acronyms and Abbreviations

AEs	Advanced Economies
BoU	Bank of Uganda
CA	Current Account
CAD	Current account deficit
CBR	Central Bank Rate
CIEA	Composite Index of Economic Activity
ECB	European Central Bank
EFU	Electricity, Fuel and Utilities
EMEs	Emerging Market Economies
EMDEs	Emerging Market and Developing Economies
FDI	Foreign Direct Investment
FY	Financial Year
GDP	Gross Domestic Product
IFEM	Interbank Foreign Exchange Market
IMF	International Monetary Fund
LIC DSA	Low Income Countries Debt Sustainability Analysis
m-o-m	Month on month
MPS	Monetary Policy Statement
NEER	Nominal Effective Exchange Rate
NPLs	Non-Performing Loans
OPEC	Organization of the Petroleum Exporting Countries
PDMF	Public Debt Management Framework
PPs	Percentage Points
PSC	Private Sector Credit
PSI	Policy Support Instrument
PV	Present Value
REER	Real Effective Exchange Rate
REPOs	Repurchase Agreement
Shs	Shillings
SSA	Sub-Saharan Africa
Std.Dev	Standard deviation
UETCL	Uganda Electricity Transmission Company Limited
U.K	United Kingdom
URA	Uganda Revenue Authority

U.S	United States
USD	United States Dollar
WAI	Weighted Average Interest rates
WALR	Weighted Average Lending Rate
WB	World Bank
WTI	West Texas Intermediate
Y-o-Y	Year on Year

Executive Summary

i Global developments continue to be a key influence on the Ugandan economy. Global growth remains weak despite very stimulatory monetary policy. Significant spare capacity in many product and labour markets and large falls in commodity prices have depressed global inflation. Interest rates, as a result, are at record lows in many countries. Since the March 2016 State of the Economy report, the outlook for global growth has remained weak. At the same time, there has been some reduction in uncertainty about the global outlook, as indicated by reduced market volatility. While uncertainty persists and the risks remain skewed to the downside, the immediate concerns about a sharp slowdown appear to have receded in light of recent economic data. This has supported a modest recovery in global commodity prices.

ii The clearest evidence of the weaker global growth outlook has been in global bond markets. Expectations that monetary policy will be easier for longer across many economies have contributed to government bond yields trending lower since the beginning of the year. The yields on 10-year bonds are around record lows in many countries. Low international interest rates, and Uganda's positive interest differential, have somewhat contributed to continued strength in the Ugandan shilling. Most major central banks are expected to maintain low policy interest rates for a prolonged period. Nonetheless, a gradual tightening in policy in the United States means the shilling is assumed to depreciate gradually over the projection period.

iii The Ugandan economy continued to grow, but at a moderate pace. The economy is projected to expand by 4.6 per cent in FY 2015/16, lower than the initial projection of 5.0 per cent and the growth rate of 5 per cent achieved in FY 2014/15. The lower growth can in part be attributed to the slow execution of public investments; the uncertainty related to electioneering, the relatively tight monetary policy stance, which was aimed at reining in the inflationary pressures that ensued in the second half of 2015; and the difficult international economic environment, including soft commodity prices, which have affected exports**.** In terms of sectoral performance, services sector is projected to grow by 6.6 per cent, agricultural sector by 3.2 percent and industry by 3.0 per cent.

iv The main drivers of growth for the services sector are information and communication services, while fishing and cash crops are the main drivers of the agriculture sector performance. Industry is projected to be largely driven by the robust construction activity, as manufacturing activity is projected to have slowed down. Indeed, the manufacturing sector is estimated to grow by only 0.4 percent, down from a growth of 11.0 per cent in FY 2014/15. Economic activity is projected to recover later in the year, but to rates that are a little below their historical average. Economic growth for 2016/17 and 2017/17 is projected at 5.5 percent and 5.8 percent, respectively.

v Modest global demand growth and strong global supply have led to declines in the prices of Uganda's commodity exports. Prices are expected to remain subdued in the near term, but gradually increase over the projection horizon. Nonetheless, export prices in real terms are projected to remain low relative to history, and weigh on growth in incomes and spending. The outlook for net export remains weak, reflecting the outlook for external demand. Private sector investment is projected to remain weak in the near term. As demand in the economy strengthens, private sector investment is expected to grow at a strong pace.

vi Reflecting the slowdown in economic activity, growth in private sector credit (PSC), a leading indicator of the financial sector's contribution to economic activity, has been slowing down since October 2015, in part driven by provisioning for bad loans. Year-on-year growth in PSC after adjusting for the exchange rate changes averaged 3.6 percent in the three months to April 2016 compared to 5.9 percent and 7.5 percent in the quarters ended January 2016 and October 2015, respectively.

vii The implementation of the budget for FY 2015/16 continues to face challenges. Preliminary fiscal data for the first ten months of FY 2015/16 indicates that the fiscal deficit (including grants) amounted to Shs. 3,582.1 billion, which is more than the programmed deficit for this period of Shs. 3,482.0 billion by Shs. 100.1 billion. Government revenue (including grants) amounted to Shs. 10,107.6, which was less than programmed by Shs. 592.4 billion. Domestic revenue was less than target Shs. 367.0 billion, in part driven by weak economic activity. Total government expenditure and net lending amounted to Shs. 13,689.8 billion, which was less than programme amount by Shs. 492.2 billion, largely on account of development expenditure which was less than programmed on account of delayed implementation of infrastructure projects. Current expenditure amounted to Shs. 7,631.2 billion, which was higher than the programmed amount by Shs. 245.5 billion.

viii For the FY 2016/17, the total approved budget is Shs. 26,361 billion, of which Shs. 18,407.7 billion is allocated for spending by Ministries, Government Departments, Agencies and Local Governments; Shs. 4,977.7 billion is for domestic debt refinancing for maturing domestic debt; Shs. 169.18 billion is allocated for external debt repayments; Shs. 2,022.9 billion is for interest payments; Shs. 111 billion for settlement of domestic arrears; and Shs. 672 billion for Appropriation-in-Aid (AIA), which is the amount of funds generated by MDAs and authorized to be spent by the same institutions. Domestic revenues are projected to increase to Shs. 12,914.3 bn up from Shs. 11,598 bn. This tax revenue increase will be achieved by improving efficiency in tax administration, increasing the tax base by reducing the size of the informal sector, and increasing investment in tax collection infrastructure. Fiscal deficit is projected at about 6.9 percent and will largely be funded by external sources as domestic borrowing by issuance of Government securities is projected at Shs. 612 billion down from Shs. 1,360 bn in FY 2015/16. The new tax measures including an additional Shs. 100 on fuel is likely to lead to further prices increases. Nonetheless, if the budget is executed as proposed, could crowd in private sector and spur growth.

ix The provisional total public debt stock, including commitments, in nominal values, as at end April 2016 stood at shs 46.1 trillion (which is about 52% of GDP). Disbursed debt was Shs. 28.1 trillion (about 31% of GDP), an increase of Shs. 5.6 trillion relative to April 2015. The growth in the stock of total public debt was mainly driven by growth in the public external debt, which over the 12 months to April 2016 increased by 18 per cent to Shs. 17. 1 trillion (US$5.1bn) from Shs. 12.7 trillion. Domestic debt as at end April 2016 amounted to Shs. 11.1 trillion. External debt cost & risk indicators were within the Public Debt Management Framework medium-term benchmarks, while most of the domestic debt cost & risk indicators remained out of line with the benchmarks.

x Preliminary data indicates that in the first 10 months of FY 2015/16, the Current Account Balance (CAB) improved to a deficit of US$1.74 billion compared to a deficit of US$1.81 billion realised in the corresponding period of FY 2014/15. The lower deficit was largely a result of the lower import bill as total imports declined by 10 percent to US$3.73 billion, compared to US$ 4.17 billion in the first 10 months of FY 2014/15, mainly driven by the fall in the oil import bill, in line with the decline in international crude oil prices. Indeed, the private sector oil import bill declined by over 30 per cent to US$ 536.97 million, while private sector oil import volumes rose by 20% over the same period. The non-oil private sector import bill also declined by 14.3 per cent to US$ 2,687million during the same period. Government imports increased to US$458.9 million compared to US$ 197.4 million in the first 10 months of FY 2014/15.

xi The value of merchandise exports declined to US$ 2,241.8 million in the first 10 months of FY 2015/16 from US$2,272.9 million in the first 10 months of FY 2014/15, largely on account of soft commodity prices. Net inflows in the financial account increased to US$ 1,342.0 million compared to US$1,074 million during the same period, largely on account of Government project support disbursements, which more than doubled to US$743.9 million. Foreign Direct Investment (FDI) net inflows declined by 4.5 per cent to US$ 867.9 million largely because of the decline in Oil sector-related.

xii The shilling exchange rate has somewhat stabilized in the second quarter of 2016 following a strengthening of 8 percent between September 2015 and March 2016. However, the medium to long term projection suggests a weakening path and continues to pose an upside risk to the inflation outlook. Since the beginning of 2016, the shilling has been favourably impacted by a narrower trade balance, improved sentiments following relatively peaceful elections and expectations of a slower pace of US Fed monetary policy tightening. However, the shilling gains could be reversed by sharp increase in demand for foreign currency by the government, which means aggressive forex purchase from domestic market amidst low forex supply.

xiii The CPI data for May 2016 indicate that there have been broad-based increases in domestic cost pressures. All sub-components of CPI inflation, except food crops increased. Twelve-month overall CPI inflation increased to 5.4 percent in May 2016 from 5.1 percent in April 2016. Core inflation increased, to 7 percent from 6.4 percent, during the same period. Other goods, services and non-food inflation increased to 7.4 percent, 6.5 percent and 6.8 percent, respectively, from values of 6.8 percent, 5.9 percent and 5.8 percent, in April 2016. Food crop inflation declined further to minus 5 percent in May 2016 from minus 4 percent in April 2016. During the three months to May 2016, in comparison to three months to February 2016, various components of CPI inflation show different trends.

xiv Headline inflation eased to an average of 5.6 percent in the three months to May 2016, compared to an average of 7.6 percent in the three months to February 2016, in large part due to decline in food crop inflation from an average of 11.9 percent in the three months to February 2016 to an average of minus 2.8 percent in the three months to May 2016. Core inflation also eased slightly, to an average of 6.8 percent in the three months to May 2016 compared to 7 percent in the three months to February 2016. Other goods inflation eased to 7.2 percent compared to 8.1 percent during the same period. However, services and non-food inflations, edged up to 6.2 percent and 6.3 percent, respectively, from 5.5 percent and 6.1 percent in the same period.

xv Low commodity prices and global inflation are dampening the outlook for the prices of goods and services that Uganda imports. The high exchange rate and low import prices weigh on tradables inflation, which has averaged 5.8 percent in the first 5 months of 2016 compared to non-tradables inflation which has averaged 6.7 percent. In the near term, tradables inflation would rise faster as the previous falls in fuel prices drop out of the annual figure, and this will be reinforced by increases in global oil prices and the shilling depreciation.

xvi Uganda's inflation and growth dynamics continue to highlight the policy dilemma facing monetary policy. Although inflation has moderated somewhat since December 2015, the respite could be temporary if fast exchange rate depreciation reemerges, and if oil price pressures continue to intensify. The inflation surprise in the May 2016, persistent non-food and services inflation above 5 percent for the first 5 months of 2016, projected worsening of food crop inflation in the second half of 2016, combined with possible faster weakening of the shilling, make the near term trajectory of inflation somewhat more uncertain. Further inflationary pressures could originate from tax increases, especially on fuel. The main uncertainties relate to the likely evolution of the exchange rate. Currently, it appears that the exchange rate is higher than appropriate given Uganda's worsening of current account and declining financial account balances. At the same time, domestic economic growth continues to disappoint. While there are signs that the economy may have reached the low point in the growth cycle, the recovery is expected to be slow with downside risks. However, the risks to the medium term growth outlook are assessed to be on the downside, despite the downward revision to the GDP growth in 2015/16. Low public and private investments are expected to weigh heavily on the growth outcome for 2016, and the outlook is therefore dependent in part on whether these sectors rebound in the 2017. Further ahead, the medium to long-term inflation projections suggest that inflation will stabilize around the target of 5 by the first half of 2017.

1 Background

This report presents domestic and external economic developments in the period to May 2016. It also assesses the future prospects and outlook for both the domestic and global economy, and provides the projected domestic output and inflation trajectory in the near-to-short-term. In addition, it discusses the attendant risks to the domestic economic outlook and identifies policy challenges in the short- to- medium term. Finally, it discusses the implications of the outlook and risks to the global and domestic economy on the future direction of monetary policy in Uganda.

2 Global Economic Environment

2.1 Economic Activity

Forecasts for global growth and inflation have been revised successively lower over the past two years. Reflecting this, further monetary policy stimulus has been provided this year in Japan, Europe and China. The United States Federal Reserve, which is the only advanced economy central bank withdrawing monetary policy stimulus, has acknowledged the fragile outlook for the United States recovery by proceeding very gradually. Over the first few months of 2016, financial markets pulled back expectations of further tightening in the United States. The clearest evidence of the weaker global growth outlook has been in global bond markets. Expectations that monetary policy will be easier for longer across many economies have contributed to government bond yields trending lower since the beginning of the year. The yields on 10-year bonds are around record lows in many countries.

According to the World Bank (WB) Global Economic Prospects (June 2016), Global GDP growth for 2016 is projected at 2.4 per cent, unchanged from the disappointing growth of 2015 and a slower pace than earlier forecasts. Global growth is however projected to pick up slowly to 2.8 per cent and 3.0 per cent in 2017 and 2018, respectively, as stabilizing commodity prices provide support to growth in commodity exporting Emerging market and developing economies (EMDEs).

Growth in AEs is projected at 1.7 per cent in 2016, 0.5 percentage points below January projections as investment continues to be soft amid weaker growth prospects and elevated policy uncertainty. Export growth has also slowed down, in part reflecting subdued external demand conditions. Notwithstanding the expected boost from lower energy and commodity prices and the ongoing improvements in labour market conditions, growth is projected to level off in 2016 rather than strengthen. The major AEs are at different stages of post-crisis recovery. Nonetheless, most of these economies are expected to stabilize around a weak growth trajectory. Rising public debt and near zero lower bound interest rates could reduce the effectiveness of counter-cyclical policies, which will further make these economies more vulnerable to domestic and external shocks. The declining productivity growth and aging populations will also exert a drag on potential growth. With inflation persistently below target and increasing downside risks to growth, the US Federal Reserve may normalize policy interest rates more slowly than earlier expected. The

European Central Bank (ECB) and Bank of Japan are pursuing further monetary accommodation, while China continues its gradual slowdown and rebalancing.

EMDEs are facing stronger challenges, including weaker growth in Advanced Economies (AEs), persistently low commodity prices, Weak global trade and capital flows. Conditions remain markedly challenging for commodity exporters, as they try to adjust to the new era of soft commodity prices. Although the commodity importers are showing greater resilience to the challenges, the expected growth windfall from low energy prices has been surprisingly weak. The decline in commodity prices has particularly affected Sub Saharan Africa (SSA), where growth is projected to decelerate to 2.5 per cent in 2016, down from 3.0 per cent in 2015. Global growth projections are presented in **Table 1**.

Table 1: Global Economic Growth Projections

Table 1. Comparison of the World Bank Global Economic Forecasts

Country	Share of Total Exports (%)	Outturn	Jan-16 Forecasts		Jun-16 Forecasts	
		2015	2016	2017	2016	2017
SSA		**3.0**	**4.2**	**4.7**	**2.5**	**3.9**
Kenya	16.3	5.6	5.7	6.1	5.9	6.1
D.R.Congo	12.9	7.7	8.6	9.0	6.3	7.7
South Sudan	12.8	-6.3	3.5	7.0	3.5	6.9
Rwanda	9.4	7.1	7.6	7.6	6.8	7.2
Sudan	5.1	3.2	3.4	3.9	3.3	3.8
Tanzania	3.1	7.0	7.2	7.1	7.2	7.1
Burundi	2.1	-2.5	3.5	4.8	3.0	3.5
Emerging Asia		**6.5**	**6.3**	**6.2**	**6.3**	**6.2**
China	2.0	6.9	6.7	6.5	6.7	6.5
Advanced Economies		**1.8**	**2.1**	**2.1**	**1.7**	**1.9**
Euro Area	6.9	1.6	1.7	1.7	1.6	1.6
USA	1.3	2.4	2.7	2.4	1.9	2.2
UK	1.1	2.2	2.4	2.2	2.0	2.1
MENA		**2.6**	**5.1**	**5.8**	**2.9**	**3.5**
UAE	5.7	3.4	3.1	3.3	2.0	2.4
World		**2.4**	**2.9**	**3.1**	**2.4**	**2.8**

Source: World Bank: Global Economic Prospects

2.2 Global inflation and commodity prices

2.2.1 Global Inflation

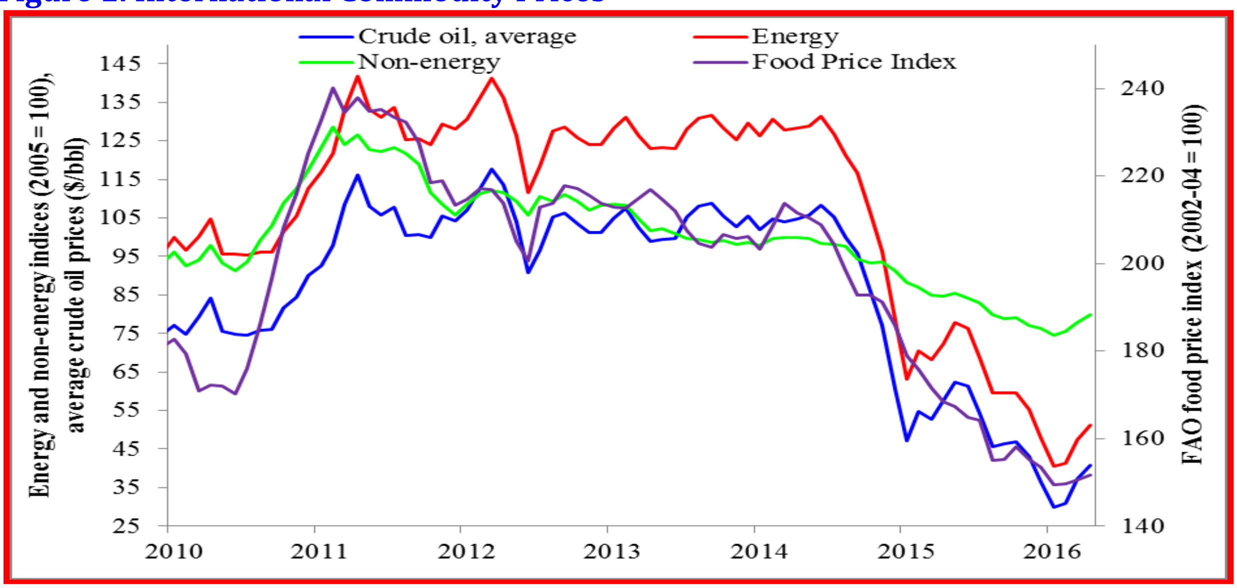
Global inflation remains subdued, in part driven by low commodity prices and subdued global demand. In April 2016, average inflation in key AEs declined to 0.2 per cent from 0.5 per cent in January 2016, while in Emerging Market Economies (EMEs) it declined to 6.3 per cent from 6.9 per cent over the same period. Nonetheless, inflation remains relatively elevated in EMDEs compared to the trend in AEs, partly as a result of the pass-through of sizeable currency depreciations that these economies experienced in 2015.

In terms of outlook, global inflation is projected to remain low in 2016, on account of the projected low commodity prices and weak global demand. In AEs, inflation is projected to average 0.7 per cent, increasing to 1.5 per cent in 2017, which still remains below the respective Central Banks medium-term targets. In EMDEs, inflation is projected to decline to 4.5 per cent in 2016, reflecting the softening commodity prices and a dissipation of the effects of past currency depreciations

2.2.2 Global commodity prices

Global commodity prices declined in 2015 and are projected to remain soft in 2016, reflecting soft global demand amidst abundant supplies. Crude oil prices averaged US$ 50.8/barrel in 2015 and the World Bank now forecasts crude oil prices to average US$ 41/barrel in 2016, increasing to only US$50/barrel in 2017. on account of weak global demand and ample market supplies as Organization of the Petroleum Exporting Countries (OPEC) continue to maintain production levels. Global food prices also remain soft. Indeed, average food prices, as measured by the Food and Agricultural Organization (FAO) food price index, increased marginally by 2.1 per cent [m-o-m] in May 2016, but declined by 7 per cent [y-o-y]. The non-energy prices are also projected to remain low in 2016/17, driven by excess supply coupled with weak global growth prospects. Developments in international commodity prices are shown in **Figure 1**.

Figure 1: International Commodity Prices



Source: West Texas Index and FAO

2.3 Global financial markets

Following bouts of volatility at the start of 2016, financial market conditions have improved but capital flows to emerging and developing economies remain vulnerable to sudden changes in investors' risk appetite. Additional monetary policy accommodation in Europe and Japan helped reduce pressures from the anticipated normalization of U.S. monetary policy, and provided additional funding opportunities through euro-denominated credit markets. The European financial markets; although strengthened by the ECB's monetary stimulus; continue to be plagued by the threat of BREXIT; tensions in Russia and Greece, which is faced with debt obligations to the IMF and the EU.

Nonetheless, risks to this relative stability remain. The prolonged period of low commodity prices could sustain declines in revenues of oil exporters, with implications for debt sustainability and credit risk exposure for creditor countries. Divergent monetary policies in the AEs also remains a major risk to financial market stability, as investors re-adjust portfolios in search for positive returns. The unclear timing of the next US Fed policy rate hike and anticipation of the result of the referendum on BREXIT could also trigger some anxiety in global financial markets. Renewed volatility in the global financial markets has the potential to trigger exchange rate instability in Uganda with implications for domestic inflation.

2.4 Implications for the Ugandan Economy

The global economic environment will continue to influence Uganda's economic developments by influencing commodity prices, the volume and direction of international capital flows, and trade. As such, risks to the global economic outlook have the potential to affect consumer and investor confidence and curtail growth in the Ugandan economy. The major forces driving the global economic outlook are soft commodity prices and the turbulence in the global financial system triggered by increasingly divergent monetary policies across AEs and these have implications for the Ugandan economy.

Modest global demand growth and strong global supply have led to declines in the prices of Uganda's commodity exports. Prices are expected to remain subdued in the near term, but gradually increase over the projection horizon. Nonetheless, export prices in real terms are projected to remain low relative to history, and weigh on growth in incomes and spending. The outlook for net export remains weak, reflecting the outlook for external demand.

Crude oil prices have fallen sharply since mid-2014, in part reflecting important supply-side developments and lower growth in global demand and it is projected that oil prices could fall further, especially if major oil producers continue to expand supply in the current circumstances of modest global growth. As we have argued before, this, on a positive side, will support global activity and help offset some of the headwinds to growth, including keeping domestic inflation in check in oil-importing developing economies. It will however further destabilise the outlook for oil-exporting countries, leading to a fall in exports earnings, which will heighten depreciation pressures in the domestic foreign exchange market and cutbacks in government spending.

Persistently low oil prices coupled with weaknesses in the global economy could also depress Foreign Direct Investment (FDI) inflows to commodities sectors, eventually affecting growth. Indeed, in Uganda, 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 (BoP), a decline in FDI inflows will exacerbate depreciation pressures in the foreign exchange market.

The Euro zone is a major trading partner for Uganda: its continued slow growth poses a downside risk to domestic inflation. Being a major trading partner, its sluggish growth in addition to weak demand is expected to have a negative impact on Uganda's export earnings, remittances and as well as FDI inflows. There is also a risk that growth in EMDEs could be much slower than expected and this will weigh on Uganda's growth through trade, financial and confidence channels.

The beginning of the normalization of the U.S monetary policy turned investor sentiments, causing a reversal of capital flows and strong pressures on exchange rate in developing economies, including Uganda. The gradual exit by the U.S from the extraordinarily accommodative monetary conditions, coupled with divergent paths of monetary policy in the rest of the AEs might increasingly tighten the global financial conditions, triggering renewed financial markets volatility and sporadic portfolio adjustments. This could heighten exchange rate depreciation pressures, passing through to higher domestic inflation. Moreover, the slowdown in China and the volatility of the Chinese stock market will continue to keep the global financial system jittery, which will have adverse implications for the domestic foreign exchange market.

The geopolitical tensions and the threat of terrorism remain elevated with negative implications on consumer and business confidence, such that investors and consumers hold back on spending. This could lead to reductions in aggregate demand and eventually constrain global growth going forward with adverse implications for Ugandan exports.

3. Domestic Economic Developments

3.1 Reflections on Monetary policy stance and Implementation

3.1.1 Monetary Policy Stance

Bank of Uganda (BoU) eased the monetary policy stance in April and June 2016, reducing the Central Bank Rate (CBR) by 1 PP to 16.0 per cent in April, and by a further 1 percentage point in June 2016 to 15.0 percent after holding it at 17.0 per cent since October 2015. The easing of the monetary policy stance was warranted by the projected inflation trajectory, which indicated an improved inflation outlook, with Headline and Core inflation forecast to converge around BoU's medium term target of 5.0 per cent in Q1- 2017 on account of relative exchange rate stability, faster decline of food prices and the subdued global economic outlook. Domestic demand conditions also remained weak, with downside risks to the projected output growth, partly emanating from the difficult external economic environment manifested in declining commodity prices and the possibility of slower growth in major EMEs.

Given the lower inflation projections, it was appropriate for monetary policy to be stimulatory to support the economic activity. Consequently, the CBR was reduced to 15 per cent in June 2016. The band on the CBR was maintained at +/-3 PPs and the margin on the

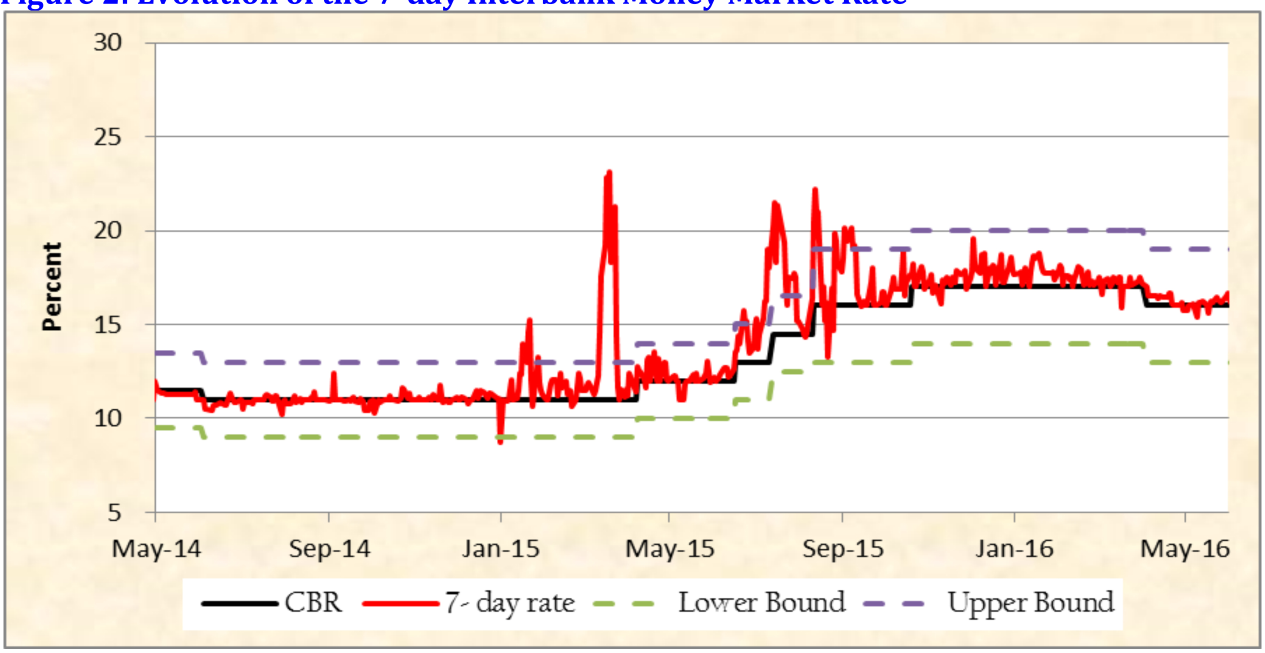
Rediscount Rate at 4 PPs on the CBR. The Rediscount Rate and the Bank Rate were therefore set at 19 per cent and 20 per cent, respectively.

3.1.2 Monetary policy implementation and Challenges

BoU continued to use Repurchase Agreement (REPOs)/ reverse REPOs and sales of recapitalization securities in the secondary market to align liquidity conditions in the domestic financial system with the desired monetary policy stance. The net impact of the REPO/reverse REPO actions in April-May 2016 was a withdrawal of Shs. 476 billion, with the outstanding stock REPOs as at the end May 2016 standing at Shs.639.7 billion.

The interbank money market rates remained largely consistent with the monetary policy stance **(Figure 2)** despite the structural liquidity overhang. Indeed, in April and May 2016, all money market rates declined in line with financial market conditions and the desired monetary policy stance. The 7-day weighted average interest rate remained within the CBR band, declining to 16.2 per cent in May 2016 from 17per cent in March 2016.

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



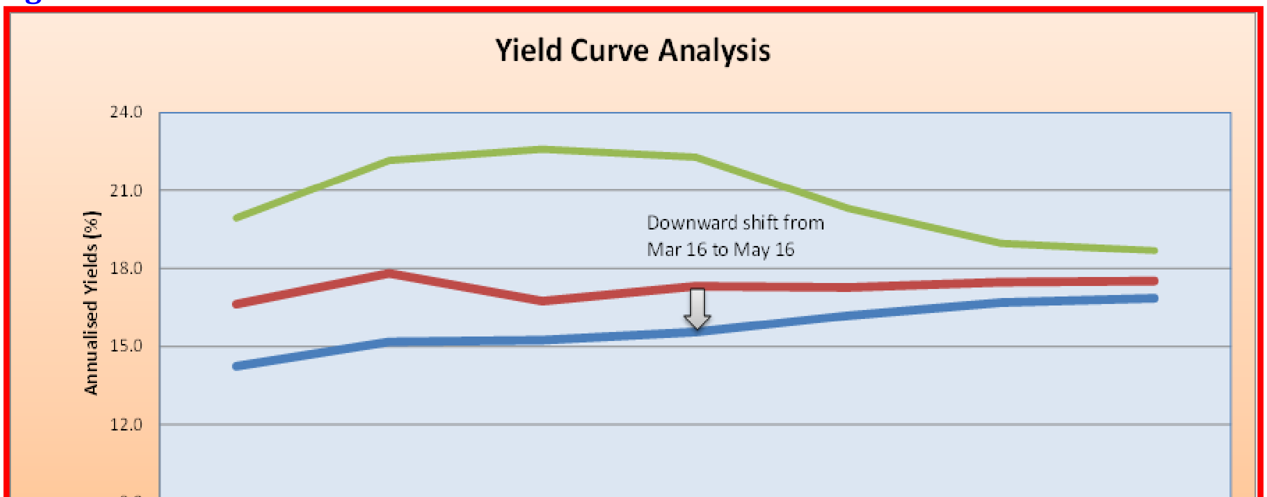
Source: Bank of Uganda

3.2 Interest Rates and Private Sector Credit

3.2.1 Interest Rates

Yields on government securities declined between February and May 2016, on account of the return to stability following the conclusion of the presidential and parliamentary elections, announced reduction in domestic financing and lower inflation expectations. A more pronounced decline was registered in the shorter dated securities, which had risen more rapidly in the past reflecting economic uncertainty in the near-to-short term. The average rates on the 91-day, 182-day and 364-day securities declined to 14.8 per cent, 15.9 per cent and 16.0 per cent in May 2016 from 21.1 per cent, 23.5 per cent and 23.7 per cent, respectively in February 2016. The yield on the 2-year benchmark bond also declined to 15.9 per cent from 16.1 per cent in March 2016. Developments in yields in Government securities are shown in **Figure 3.**

Figure 3: Yields on Government Securities

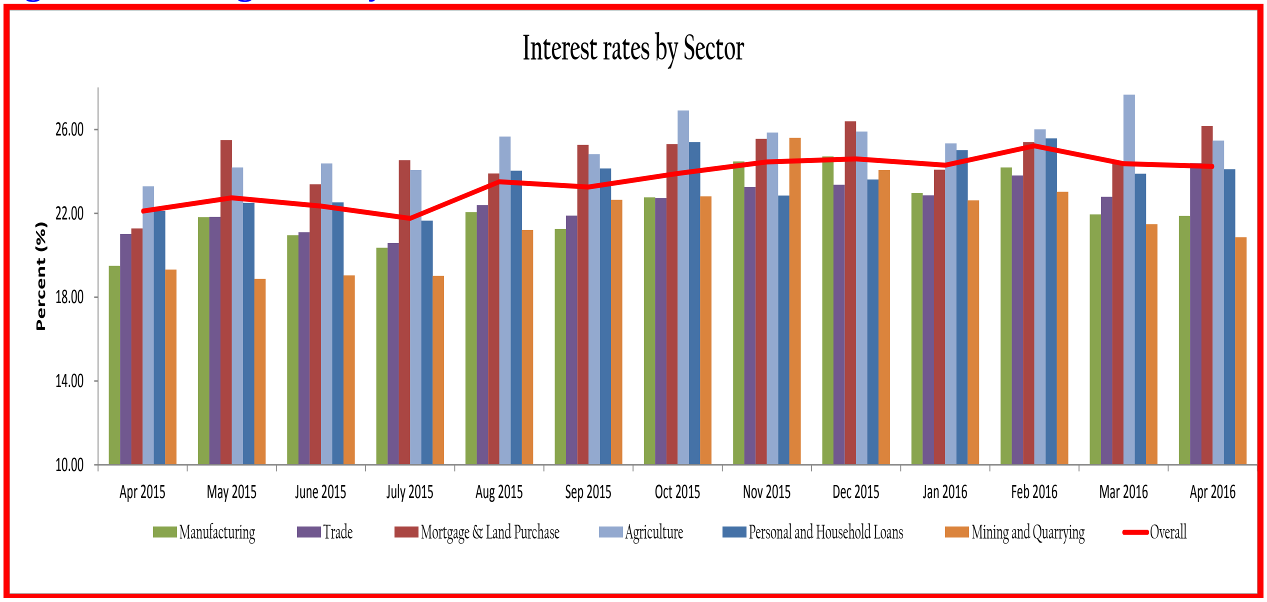


	91-days	182-days	364-days	2-years	5-years	10-years	15-years
Feb-2016	19.9	22.2	22.6	22.3	20.3	19.0	18.7
Mar-2016	16.6	17.8	16.8	17.3	17.3	17.5	17.5
May-2016	14.2	15.2	15.2	15.6	16.2	16.7	16.9

Source: Bank of Uganda

Lending rates remain elevated, notwithstanding the marginal easing of the monetary policy stance in April, in part reflecting provisioning for bad debt, lagged impact of the tight monetary policy stance and structural rigidities in the financial sector, including the high cost of doing business. Lending rates on shilling loans averaged 24.7 per cent in the three months to April 2016. Lending rates on forex denominated loans averaged 9.9 per cent during the same period of time. Lending rates however declined by 1 percentage point to a weighted average 24.2 per cent in April 2016 of 25.2 per cent in February 2016. Developments in commercial bank lending rates are shown in **Figure 4.**

Figure 4: Lending Rates by Sector



Source: Bank of Uganda

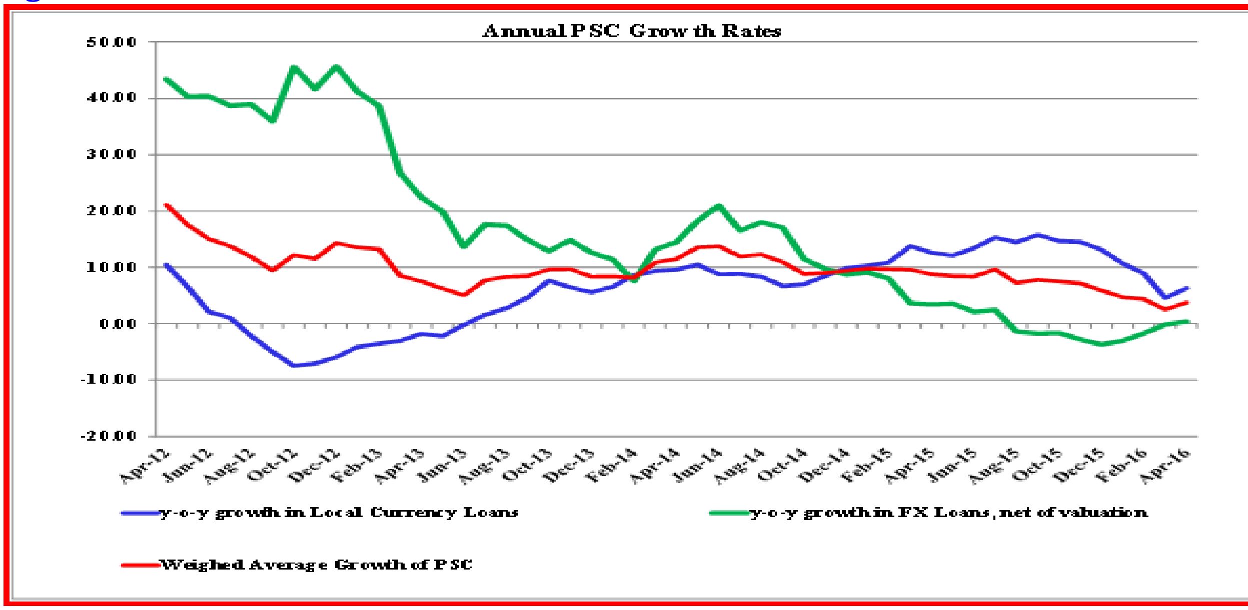
Notwithstanding this decline, high NPLs and other structural rigidities will continue to constrain the extent of lending interest rates decline even with easing liquidity conditions. The high interest rate environment if prolonged could further constrain Private sector as credit, which poses downside risks to growth.

3.2.2 Private Sector Credit

Growth in private sector credit (PSC), a leading indicator of the financial sector's contribution to economic activity, has been slowing down since October 2015, in part driven by provisioning for bad loans, the relatively tight monetary policy stance, and weakening domestic demand conditions. In nominal terms, average annual PSC growth declined from 24.4 per cent in the first 3 months of FY 2015/16 to 9.8 per cent in the 3 months to April 2016. The average annual growth in the shilling value of forex PSC declined from 37.9 per cent to 14.5 per cent. In US dollar terms however, annual growth averaged 0.6 per cent compared to -0.08 per cent during the 1st 3 months of FY 2015/16. Growth in Shilling loans also declined from 15.2 per cent to 6.6 per cent during the same period.

A clear picture of the dismal performance of PSC growth is displayed after accounting for valuation changes. Year-on-year growth in PSC after adjusting for the exchange rate changes averaged 3.6 percent in the three months to April 2016 compared to 5.9 percent and 7.5 percent in the quarters ended January 2016 and October 2015, respectively. Developments in private sector credit are shown in **Figure 5.**

Figure 5: Annual Growth in Private Sector Credit



Source: Bank of Uganda

In terms of sectoral distribution, building & construction, trade, manufacturing and personal & household loans continue to account for the bulk of private sector credit, constituting more than 70 per cent of the total stock. As a general trend however, lending to these sectors also slowed in the three months to April 2016. During this period, there was also a significant drop in loans to the Business services sector, which is largely comprised of SMEs that are deemed “riskier” customers. Lending to the manufacturing, trade and building & construction sectors also slowed significantly during the course of the year. Sectoral developments in private sector credit are shown in **Table 2.**

Table 2: Sectoral Developments in Private Sector Credit

	Annual Growth Rate							
	Oct-15	Nov-15	Dec-15	Jan-16	Feb-16	Mar-16	Apr-16	Average Share
Agriculture	17.2	16.2	17.0	18.4	15.0	15.0	15.2	10.3
Mining & Quarrying	48.4	40.0	42.6	51.2	65.4	66.7	47.8	0.6
Manufacturing	45.2	28.4	20.0	16.8	9.9	-0.7	2.4	14.0
Trade	16.2	11.7	9.9	9.2	7.4	7.4	4.8	18.5
Transport & Communication	32.7	26.2	24.9	30.1	39.7	37.3	47.2	7.0
Electricity & Water	27.2	10.7	9.7	5.2	-2.6	10.7	-0.2	1.7
Building, Mortgage, Construction & Real Estate	21.8	18.2	19.4	17.9	16.2	11.7	11.6	23.5
Business Services	34.7	22.6	20.9	7.8	-6.1	-15.7	-18.1	3.7
Community, Social & Other Services	17.6	7.9	7.2	5.6	7.0	12.9	10.4	3.4
Personal & Household Loans	6.3	6.7	7.3	7.6	5.9	6.7	6.7	15.4
Other Services	9.9	9.0	27.1	13.0	2.7	10.9	28.5	1.8
Total	21.4	16.2	15.3	13.9	11.2	8.7	9.0	100.0

Source: Bank of Uganda

3.3 Fiscal Policy and Developments

3.3.1 Fiscal Developments

Fiscal policy plays a significant role in the economy, both as a stabilization tool and in influencing the short- and long-term growth prospects of the economy. In the short term, counter-cyclical fiscal expansion can help support aggregate demand and growth during cyclical downturns. On the other hand, fiscal contraction can help cool down an economy that is growing at an unsustainable pace and thus faces the risk of overheating. In line with the need to foster growth, increase economic efficiency and reduce the cost of doing business, the fiscal stance for FY 2015/16 focused on addressing infrastructural constraints in the economy. Given the infrastructural gap, the consequence of this policy pursuit has been the widening fiscal deficit, which initially was projected at 7.0 per cent of GDP.

The implementation of the budget for FY 2015/16 continues to face challenges. Preliminary fiscal data for the first ten months of FY 2015/16 indicates that the fiscal deficit (including grants) amounted to Shs. 3,582.1 billion, which is more than the programmed deficit for this period of Shs. 3,482.0 billion by Shs. 100.1 billion. Government revenue (including grants) amounted to Shs. 10,107.6, which was less than programmed by Shs. 592.4 billion. Domestic revenue was less than target Shs. 367.0 billion, in part driven by weak economic activity.

Total government expenditure and net lending amounted to Shs. 13,689.8 billion, which was less than the programmed amount by Shs. 492.2 billion, largely on account of development expenditure which was less than programmed on account of delayed implementation of infrastructure projects. Current expenditure amounted to Shs. 7,631.2 billion, which was higher than the programmed amount by Shs. 245.5 billion. Fiscal developments are shown in **Table 3**.

Table 3: Fiscal performance in FY 2015/16 (Shs. Billions)

	Projection July 2015 – April 2016	Programme July 2015 – April 2016	Variation
Revenue & Grants	10,107.6	10,700.0	-592.4
Revenue	9,168.0	9,535.0	-367.0
Tax	8,909.6	9,030.0	-120.4
Grants	939.6	1,165.0	-225.4
Expenditure & Lending	13,689.8	14,182.0	-492.2
Current Expenditure	7,631.2	7,385.7	245.5
Development	4,430.6	4,706.0	-275.4
Overall Fiscal Bal. (excl.	-4,521.7	-4,647.0	125.3
Overall Fiscal Bal. (incl.	-3,582.1	-3,482.0	-100.1
Financing (net)	3,582.1	3,482.0	100.1
External Financing	2,380.1	2,443.7	-63.6
Domestic	941.3	1,037.0	-95.7
Errors & Omissions	260.8	0.0	

Source: Ministry of Financing, Planning and Economic Development

In line with the National Development Plan (NDP) II, the fiscal stance for FY 2016/17 also focuses on the need to address the infrastructural constraints in the economy in order to increase economic efficiency and reduce the cost of doing business. The total approved budget is Shs. 26,361 billion, of which Shs. 18,407.7 billion is allocated for spending by Ministries, Government Departments, Agencies and Local Governments; Shs. 4,977.7 billion is for domestic debt refinancing for maturing domestic debt; Shs. 169.18 billion is allocated for external debt repayments; Shs. 2,022.9 billion is for interest payments; Shs. 111 billion for settlement of domestic arrears; and Shs. 672 billion for Appropriation-in-Aid (AIA), which is the amount of funds generated by MDAs and authorized to be spent by the same institutions.

Domestic revenues are projected to increase to Shs. 12,914.3 billion up from Shs. 11,598 billion. This will be achieved by improving efficiency in tax administration, increasing the tax base by reducing the size of the informal sector, and increasing investment in tax collection infrastructure. The budget deficit is projected at 6.2 per cent of GDP compared to 6.4 per cent of GDP in FY 2015/16. The deficit will largely be funded by external sources as domestic borrowing by issuance of Government securities is projected at Shs. 612 billion down from Shs. 1,384 billion in FY 2015/16. The new tax measures including an additional Shs. 100 on fuel is likely to lead to further prices increases. Nonetheless, if the budget is executed as proposed, could crowd in private sector and spur growth.

3.3.2 Public Debt

The provisional total public debt stock, including commitments, in nominal values, as at end April 2016 stood at shs 46.1 trillion (which is about 52% of GDP). Disbursed debt was Shs. 28.1 trillion (about 31% of GDP), an increase of Shs. 5.6 trillion relative to April 2015. The growth in the stock of total public debt was mainly driven by growth in the public external debt, which over the 12 months to April 2016 increased by 18 per cent to Shs. 17. 1 trillion (US$5.1bn) from Shs. 12.7 trillion. Domestic debt as at end April 2016 amounted to Shs. 11.1 trillion. External debt cost & risk indicators were within the Public Debt Management Framework medium-term benchmarks, while most of the domestic debt cost & risk indicators remained out of line with the benchmarks. Developments in total public debt stock are shown in **Table 4**.

Table 4: Public Debt Stock and Indicators

Debt Indicators	PMMF	June 2015	April 2016 (Prov.)
Total Gross Public Debt		24,334.5	28,126.8
External Debt (US$, Mn)		4,380.1	5,133.6
External Debt (Shs. Bn)		14,462.2	17,072.3
Domestic Debt (Nominal, Shs. Bn)		9,872.3	11,054.5
Nominal Debt as a percentage of GDP		32.7	33.0
External		19.4	20.5
Domestic		13.3	12.5
PV of Total Public Debt as a percentage of GDP	<50%	23.8	23.9
External	<30%	10.4	11.4
Domestic	<20%	13.3	12.5
Domestic Debt Stock/Private Sector Credit (at nominal value)	<75%	90.0	98.4
Percentage of domestic maturing in 1 year	<40%	46.7	44.6
Percentage of domestic maturing after 1 year	<20%	15.6% [Yr 2] &5.6 [Yr 3]	11.9% [Yr 2] &5.6 [Yr 3]
Bonds/Bills [at face value]	70/30	66/34	68/32
Average time to maturity	>3 years	3.0	3.4

Source: Bank of Uganda

The estimated Present Value (PV) of total debt to Gross Domestic Product (GDP) remained well below the 2013 Public Debt Management Framework (PDMF) and the International Monetary Fund (IMF)/World Bank (WB) Low Income Countries Debt Sustainability Analysis (LIC DSA) benchmarks of 50 per cent and 74 per cent, respectively. The estimated PV of total debt to GDP as at end April 2016 stood at 23.9 per cent, a slight increase of 0.1 percentage points relative to end June 2015 mainly on account of the increases in external debt.

3.4 Balance of Payments and Exchange Rate Developments

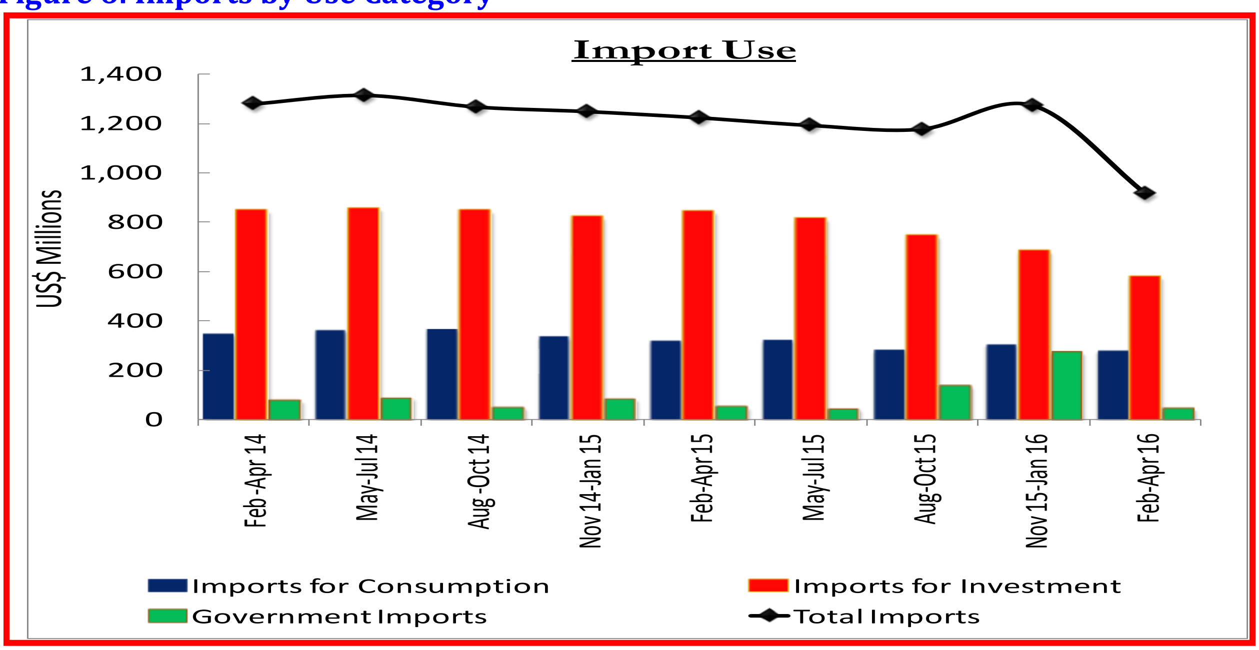
3.4.1 Balance of Payments

Preliminary data indicates that in the first 10 months of FY 2015/16, the Current Account Balance (CAB) improved to a deficit of US$1.74 billion compared to a deficit of US$1.81 billion realised in the corresponding period of FY 2014/15. The lower deficit was largely a result of the lower import bill as total imports declined by 10 percent to US$3.73 billion, compared to US$ 4.17 billion in the first 10 months of FY 2014/15, mainly driven by the fall in the oil import bill, in line with the decline in international crude oil prices. Indeed, the private sector oil import bill declined by over 30 per cent to US$ 536.97 million, while private sector oil import volumes rose by 20% over the same period. The non-oil private sector import bill also declined by 14.3 per cent to US$2,687million during the same period. Government imports increased to US$458.9 million compared to US$ 197.4 million in the first 10 months of FY 2014/15.

The value of merchandise exports declined to US$ 2,241.8 million from US $2,272.9 million in the first 10 months of FY 2014/15, largely on account of soft commodity prices. Net inflows in the financial account increased to US$ 1,342.0 million compared to US$ 1,074 million during the same period, largely on account of Government project support disbursements, which more than doubled to US$743.9 million. Foreign Direct Investment (FDI) net inflows declined by 4.5 per cent to US$ 867.9 million largely because of the decline in Oil sector-related.

In terms of quarterly developments, the current account deficit declined to US$ 302.2 million in the quarter to April 2016 compared to a deficit of US$ 758.5 million in the quarter ended January 2016. The trade deficit improved by over 60 per cent to US$ 204 million mainly on account of a lower import bill. The private sector import bill fell by 13 percent to US$855.3 million. The oil import bill declined by 21.4 per cent to US$ 132 million, in line with the decline in international crude oil prices. The non-oil import bill also declined by 11.6 per cent to US$ 723.6 million, which may be suggestive of softening of domestic economic activity. Indeed, investment imports have displayed a declining trend as shown in **Figure 6.**

Figure 6: Imports by Use Category



Source: Bank of Uganda

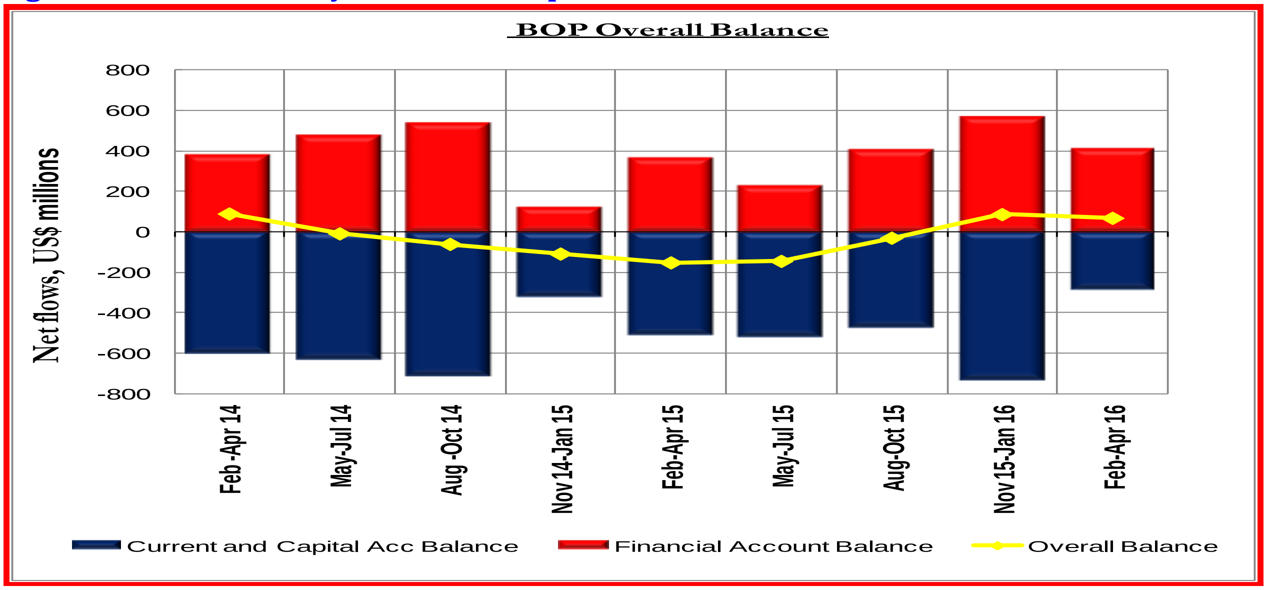
Merchandise exports remained relatively subdued, increasing only marginally, by 0.7 per cent quarter-on-quarter to US$ 709 million, mainly supported by a rise in the value of gold exports, by about 30 per cent [q-o-q] to US$ 85 million. Coffee export proceeds declined by 12.6 per cent to US$79 million due to coffee off-season effects. Total non-coffee export receipts, excluding non-monetary gold, declined by 2.7 per cent to US$447 million.

The deficit on the services account deteriorated by US$ 19 million to US$ 207 million on account of a decrease in travel receipts. The deficit on the primary income account, which records returns to factors of production, however improved by about 30 per cent to US$ 236 million, in the same period, supported by lower payments for compensation of employees and direct investment income (dividends). The balance on the secondary income account, which records private and public transfers, also improved by 3.4 per cent [q-o-q] to US$ 345 million, on account of higher inflows of personal transfers, which increased by 8.5 per cent to US$300 million.

The surpluses in the capital and financial accounts continue to fund the current account deficits. The surplus on the capital account balance however decreased by US$12 million to US$16 million during the quarter ended April 2016. The net inflows through the financial account also declined by 27.6 per cent [q-o-q] to US$ 412 million, driven by a decline in “Other Investments Inflows” (include loans, trade credits, currency & deposits), which contracted by 50 per cent [q-o-q] to US$ 155 million. Net portfolio outflows amounted to US$ 37 million compared to US$ 67 million in the quarter ended January 2016. On the other hand, FDI inflows increased, though slightly to US$ 291 million from US$ 274.3 million during the preceding quarter.

The overall Balance of Payments position was a surplus of US$ 68.1 million, with a net build-up of reserves assets (excluding valuation changes) of US$ 67.0 million. The stock of reserves at June 07, 2016 amounted to US$2, 972 million, which is equivalent to 4.4 months of future imports of goods and services. Developments in the BoP and its components are shown in **Figure 7.**

Figure 7: Balance of Payments Developments



Source: Bank of Uganda

In terms of outlook, the current account balance is likely to remain weak in the short-to-medium-term on account of subdued exports driven by low global commodity prices and a pick-up in imports, as evidenced by the moderate pick-up in March and April 2016. The revised GDP growth projections for Uganda's major trading partners suggest a decline in external demand. This coupled with the anticipated pick-up in imports implies a further deterioration of the Current Account Balance, with implications for exchange rate stability.

3.4.2 Exchange Rate Developments

The Shilling weakened in May 2016, depreciating by 0.2 per cent [m-o-m] and by 11.3 per cent [y-o-y] to an average midrate of UGX 3,348.92 per US Dollar. The depreciation was largely driven by the global strengthening of the US Dollar, correction of undershooting, and relatively strong demand mainly from the manufacturing and energy Sectors. The Nominal Effective Exchange Rate (NEER), which measures the relative value of the Shilling against a trade-weighted basket of currencies of Uganda's major trading partners however appreciated by 0.3 per cent [m-o-m] in May 2016, pointing to a more significant depreciation of the currencies of Uganda's trading partners against the US Dollar. On annual basis however, the trade weighted rate depreciated by 6.8 per cent.

The Real Effective Exchange Rate (REER), which is derived by adjusting the NEER for inflation differentials between Uganda and its trading partners depreciated by 0.5 per cent [m-o-m] and by 3.7 per cent [y-o-y] in April 2016. The REER however appreciated by 5.8 per cent relative to the beginning of FY 2015/16. Export sector competitiveness therefore remains on balance, and improvement in the competitiveness of the export sector through

REER adjustment may require some further weakening of the bilateral shilling/US dollar exchange rate.

Due to exchange rate volatility, BoU stayed purchases for reserve build-up on a number of days in May 2016. Nonetheless, BoU purchased US$ 74.55 million for reserve build-up compared to US$ 111.5 million in April 2016. Sales to Uganda Electricity Transmission Company Ltd (UETCL) amounted to US$ 28.7 million, bringing the net BoU action in the Interbank Foreign Exchange Market (IFEM) during the month to a purchase of US$ 45.85 million. For FY 2015/16 thus far, total BoU purchases for reserve build-up have amounted to US$ 813.4 million. Taking into account intervention and sales to UETCL sales amounting to US$ 279.3 million, the net BoU action was a purchase of US$ 524.8 million.

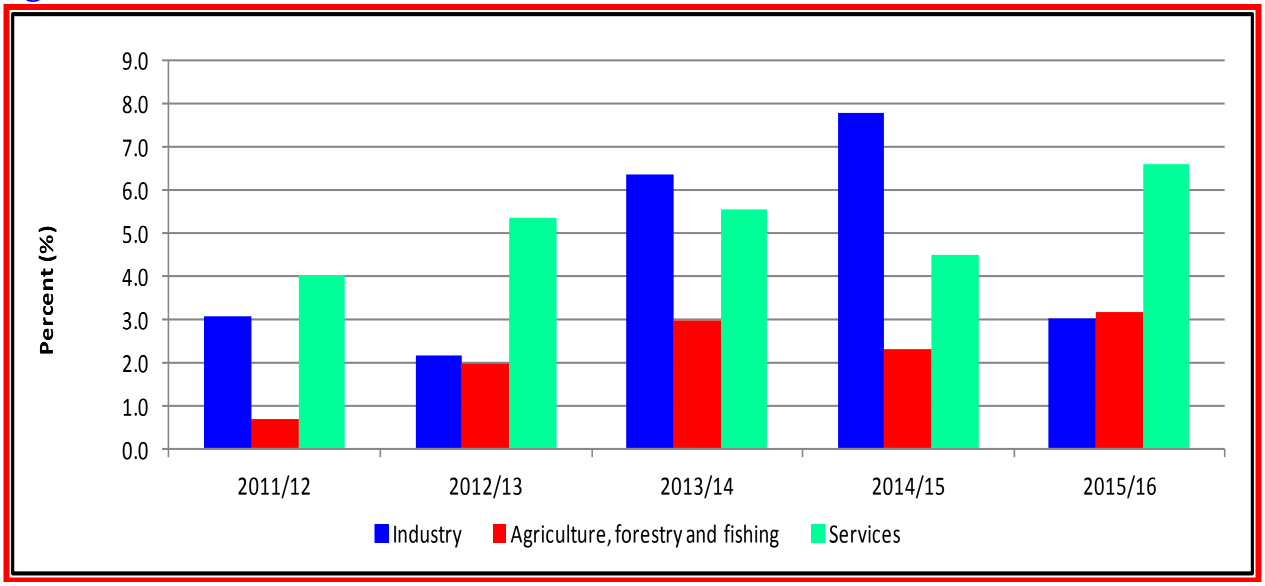
In terms of outlook, the shilling is expected to weaken over the short-to-medium-term on account of the weak current account position; volatile international economic environment; and sustained government forex demand for infrastructure projects, projected at US$ 1,500 million in FY 2016/17. This means that BoU will have to purchase about US$ 1,000.0 million from the market to meet Government forex demand without violating the reserves target. This poses a major upside risk to domestic inflation, at least in the near to short-term.

3.5 Domestic Economic Activity: Output and demand

The Ugandan economy continued to grow, but at a moderate pace. The economy is projected to expand by 4.6 per cent in FY 2015/16, which is 0.4 percentage points lower than the initial projection of 5.0 per cent and the growth rate of 5 per cent achieved in FY 2014/15. The lower growth can in part be attributed to the slow execution of public investments; the uncertainty related to electioneering, the relatively tight monetary policy stance, which was aimed at reining in the inflationary pressures that ensued in the second half of 2015; and the difficult international economic environment, including soft commodity prices, which have affected exports**.**

In terms of sectoral performance, services sector is projected to grow by 6.6 per cent, agricultural sector by 3.2 percent and industry by 3.0 per cent. The main drivers of growth for the services sector are information and communication services, while fishing and cash crops are the main drivers of the agriculture sector performance. Industry is projected to be largely driven by the robust construction activity, as manufacturing activity is projected to have slowed down. Indeed, the manufacturing sector is estimated to grow by only 0.4 percent, down from a growth of 11.0 per cent in FY 2014/15. Developments in sectoral GDP performance are shown in **Figure 8**.

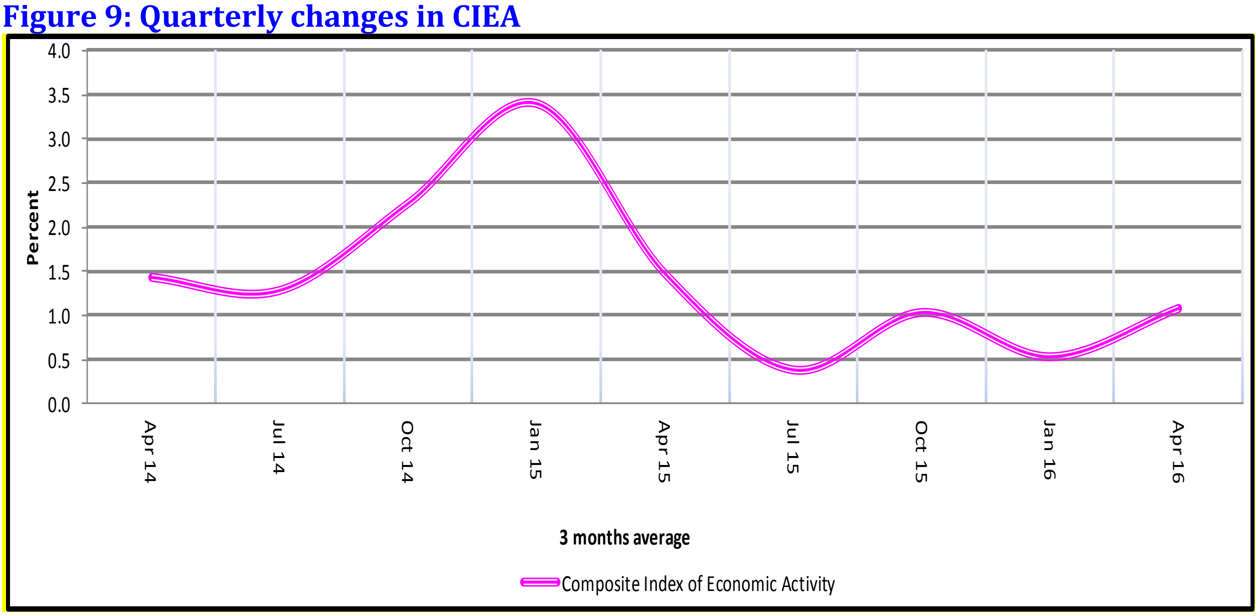
Figure 8: Sectoral Performance



Source: Uganda Bureau of Statistics

The Composite Index of Economic Activity (CIEA), an early warning indicator of economic activity, however shows signs of recovery in recent months. The CIEA increased at 1.1 per cent in the quarter to April 2016, up from a growth rate of 0.5 percent in the quarter to January 2016 as shown in **Figure 9**. It is expected that the positive trend will continue in the rest of 2016 and outer years and therefore growth is expected to recover to 5.5 per cent in FY 2016/17.

Figure 9: Quarterly changes in CIEA



Source: Bank of Uganda

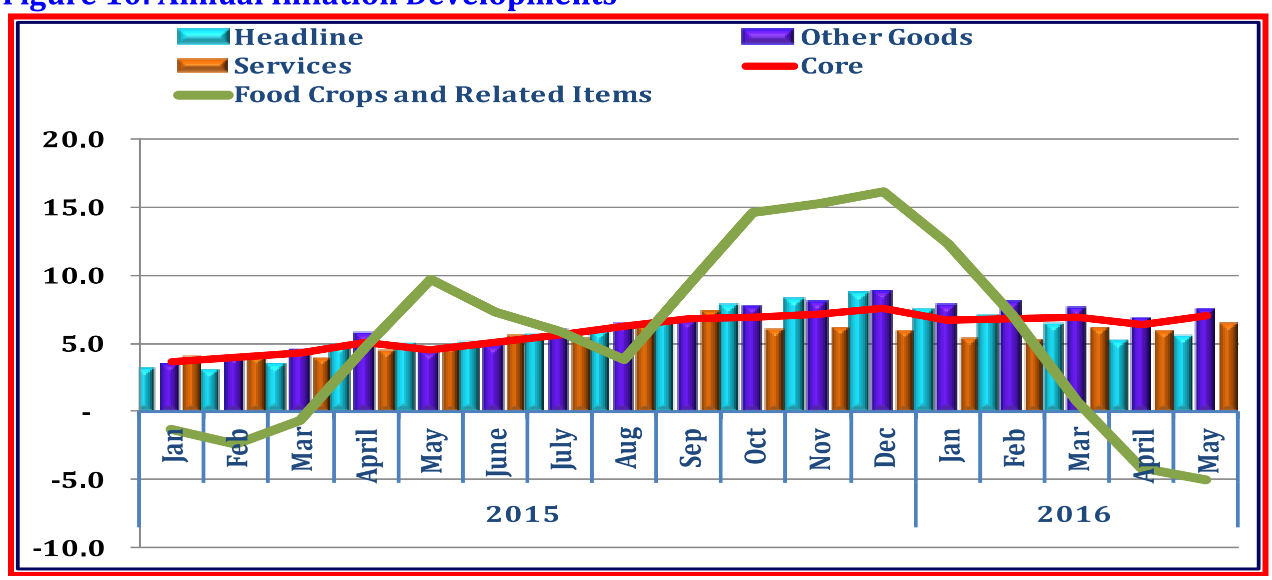
Nonetheless, the projected output path remains sensitive to downside risks emanating from a mix of factors pertaining to both the domestic and external economic environment, at least in the short-to-medium-term. On the global scene, conditions remain markedly challenging for commodity exporters, which continue to struggle to adjust to the new era of depressed prices. GDP growth, for countries to which close to 80 per cent of Uganda's exports are destined, has declined, which suggests a decline in external demand, with potential negative implications for domestic growth in the near-to-short-term. The key uncertainties on the domestic economy continue to be centred on delays on implementation of public investment projects, the lagged impact of the tight monetary policy stance and the associated high interest rates, and the weak current account position and the associated exchange rate volatility.

3.6 Consumer Price Inflation

3.6.1 Recent Inflation Developments

After peaking in December 2015 at 8.5 per cent and 7.6 per cent, annual headline and core inflation declined gradually to 5.1 per cent and 6.4 per cent, respectively in April 2016. However, both annual headline and core inflation edged up slightly in May 2016, rising to 5.4 per cent and 7.0 per cent, respectively. The Consumer Price Index (CPI) data for May 2016 indicates that there have been broad-based increases in domestic cost pressures. All sub-components of inflation, except food crops increased. The "Other goods", services and non-food inflation increased to 7.4 per cent, 6.5 per cent and 6.8 per cent from respective values of 6.8 percent, 5.9 percent and 5.8 per cent in April 2016. "Food crops and related items" inflation declined further to minus 5.0 per cent from minus 4.2 per cent in April 2016, while Energy, Fuel and Utilities (EFU) inflation declined to 5.6 per cent from and 6.5 per cent in April 2016, in part reflecting the impact of subdued international oil prices. Developments in annual inflation are shown in **Figure 10.**

Figure 10: Annual Inflation Developments



Source: Uganda Bureau of Statistics

Various components of inflation suggest persistence in inflation above the 5 per cent target despite unusually large drags from energy, food crop prices, and subdued aggregate demand, which are expected to fade over the next financial year.

In terms of 3 months averages, annual headline eased to an average of 5.6 per cent in the 3 months to May 2016 compared to an average of 7.6 per cent in the 3 months to February 2016. The decline was largely driven by the fall in "food crops and related item" inflation, which declined from an average of 11.9 per cent to an average of *minus* 2.8 per cent over the same period. Core inflation and "Other goods" inflation also eased to an average of 6.8 per cent and 7.2 per cent compared to 7.0 per cent and 8.1 per cent, respectively during the same period. Services and non-food inflations however edged up to 6.2 per cent and 6.3 per cent from 5.5 per cent and 6.1 per cent, respectively in the same period.

In terms of regional comparison, as shown in Table 5, regional inflation generally eased in April 2016 but nonetheless remains elevated in Ghana and Zambia, in part driven by the lagged impact of exchange rate depreciation. Depreciation pressures generally eased, although the level of currency weakening remains high in some economies, such as Zambia. Most of the economies have continued to pursue a neutral monetary policy stance, save for Kenya which eased monetary policy in May 2016 on account of improved inflation outlook. Yields on Treasury bills remain relatively high, in part reflecting the risk premia attached by investors. Other EAC macroeconomic indicators are shown in **Appendix 1**.

Table 5: Regional Comparisons

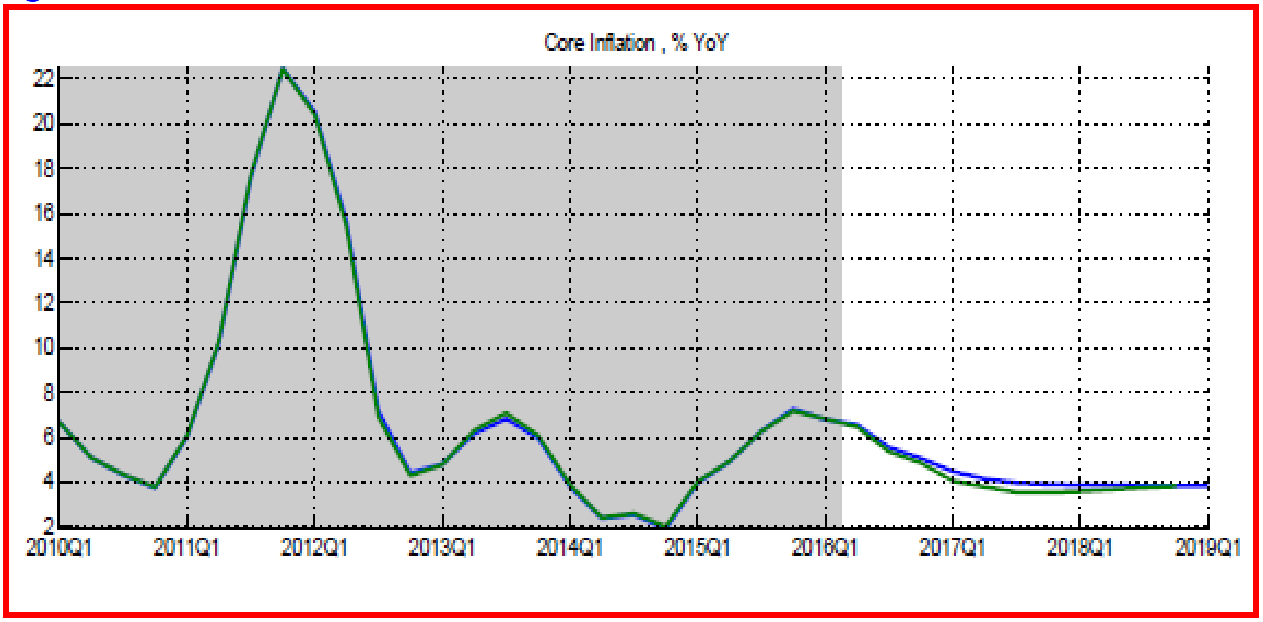
Annual Inflation Rate (%)							Exchange Rate Annual % Changes (Local Currency/US$)						
	Uganda	Kenya	Tanzania	Ghana	Nigeria	Zambia		Uganda	Kenya	Tanzania	Ghana	Nigeria	Zambia
Jan-16	7.7	7.8	6.5	19	9.6	21.8	Jan-16	20.6	12	25.2	18.3	8.4	72
Feb-16	7.7	6.8	5.6	18.5	11.4	22.9	Feb-16	19.7	11.5	23.8	14.9	1.3	67.9
Mar-16	6.2	6.5	5.4	19.2	8.7	22.2	Mar-16	14	10.6	21.9	7.2	0	54.3
Apr-16	5.1	5.3	5.1	18.7	9	21.8	Apr-16	11.6	8.3	21	0.7	0	31.8
May-16	5.4	5	N. Av	N. Av	N. Av	21.3	May-16	11.4	8.5	12.1	-2	N. Av	38.5

Policy Rate (%)							364-day Treasury Bill Yields						
	Uganda	Kenya	Tanzania	Ghana	Nigeria	Zambia		Uganda	Kenya	Tanzania	Ghana	Nigeria	Zambia
Jan-16	17	11.5	N.A	26	11	15.5	Jan-16	24.6	14.1	18.8	23	9.9	22.2
Feb-16	17	11.5	N.A	26	11	15.5	Feb-16	23.7	13.7	19	23	10.2	27.1
Mar-16	17	11.5	N.A	26	12	15.5	Mar-16	16.5	12.3	17.8	23	10.2	28
Apr-16	16	11.5	N.A	26	12	15.5	Apr-16	13.6	11.8	16.6	23.6	10.9	26.3
May-16	16	10.5	N.A	26	12	15.5	May-16	13.9	11.6	15.5	23.3	13.3	25

3.6.2 Inflation Outlook

Both headline and core inflation remain within the PSI tolerance bands of 5±3 per cent, though they have edged up slightly in recent months. Low global inflation, falling international energy and commodity prices, and the cautious monetary policy stance being implemented by the BoU have helped hold back inflation despite the lagged impact of exchange rate depreciation and the associated broad-based increases in domestic cost pressures. In the near-to-short-term outlook, both headline and core inflation are projected to gradually decline to the 5 target by Q1-2017. The core inflation forecasts are shown in **Figure 11.**

Figure 11: Core Inflation forecast



Source: Bank of Uganda

The baseline forecast reflects the assessment of the most likely economic developments during the forecast horizon. It is based on forecasts and assumptions concerning developments in the external environment of the Ugandan economy, as well as assessments of the effectiveness of markets and the transmission of monetary policy to the real economy. All of these factors are subject to uncertainty. Therefore, there continue to be many uncertainties around the outlook. Internationally, these relate to the prospects for global growth and commodity prices, the outlook for global financial markets, and political risks.

On the international scene, global financial market volatility has abated and the outlook for global growth appears to have stabilised after being revised down successively over recent quarters. There has been a modest recovery in commodity prices in recent months. However, the global economy remains weak despite very stimulatory monetary policy and significant downside risks remain.

Domestically, the inflation surprise in the May 2016, persistent non-food and services inflation above 5 percent for the first 5 months of 2016, projected worsening of food crop inflation in the second half of 2016, combined with possible faster weakening of the shilling, make the near term trajectory of inflation somewhat more uncertain. The main uncertainties relate to the likely evolution of the exchange rate. Currently, it appears that the exchange rate is higher than appropriate given Uganda's worsening of current account and declining financial account balances.

The exchange rate is a critical determinant of the inflation trajectory, given the high percentage of tradable goods in the consumption basket. Although we forecast a mild depreciation over the forecast horizon, the exchange rate remains vulnerable to changes in domestic and external fundamentals, which are tilted on the upside. The external economic environment remains volatile, with substantial upside risks. Divergent monetary policies in the Advanced Economies and the upcoming referendum in the UK to define whether they will leave or remain in the European Union could cause episodes of financial market volatility. A flight to quality in global asset markets could put further pressures on the exchange rate. On the domestic scene, demand or foreign exchange, especially for public infrastructure projects continues to grow, which may increase demand pressures in the foreign exchange market given the widening current account deficit.

An extension or steepening of the upward path of oil prices is a risk factor, because of both its direct effects on local and world inflation and its implications on global growth. As the dampening influence of past falls in energy and food prices unwinds over the next financial year, inflation could rise. There are however reasons, why oil prices could recede to its levels of recent months, thus constituting a downside risk to inflation. Although domestic food prices are forecast to remain subdued in the near term, they are nonetheless vulnerable to the Vagaries of weather. Growth has been below potential and is forecast to remain so, at least in the near-term. The negative capacity gap has been a mitigating factor to the inflationary pressures. Spare capacity in the economy is however projected to be eliminated by the end of 2017, thus increasing domestic cost pressures in the economy. Nonetheless, inflation's elasticity to the output gap remains low.

4. Conclusion

Global developments continue to be a key influence on the Uganda economy. Global growth remains weak despite very stimulatory monetary policy. Significant spare capacity in many product and labour markets and large falls in commodity prices have depressed global inflation. Interest rates, as a result, are at record lows in many countries. Since the March State of the Economy report, the outlook for global growth has remained weak. At the same time, there has been some reduction in uncertainty about the global outlook, as indicated by reduced market volatility. While uncertainty remains and the risks remain skewed to the downside, the immediate concerns about a sharp slowdown appear to have receded in light of recent economic data. This has supported a modest recovery in global commodity prices.

Uganda's growth and inflation dynamics continue to highlight the policy dilemma facing monetary policy. Economic activity has slowed, in part because of the weak external economic environment; soft commodity prices; slow execution of public investments; the uncertainty related to electioneering, and macroeconomic instability and the associated tight monetary policy stance. While there are signs that the economy may have reached the low point in the growth cycle, the recovery is expected to be slow with downside risks, as the future developments in the global economy, remain uncertain.

Although inflation has moderated somewhat since December 2015, the respite could be temporary if fast exchange rate depreciation remerges, and if oil price pressures continue to intensify. The shilling has been relatively stable over the last six months. Nonetheless, risks for further shilling weakening, including the weak current account position, the increase in foreign currency demand by the government, recovery in domestic demand and the volatile international economic environment, remain.

The outlook for domestic cost pressures is a key source of uncertainty. In particular, inflation could edge up further over the following months, reflecting tax increases, especially on fuel. Moreover, food crop prices, which have been the main factor in easing of inflation could edge up in coming months reflecting seasonal factors. The main uncertainties relate to the likely evolution of the exchange rate. Currently, it appears that the exchange rate is higher than appropriate given Uganda's worsening of current account and declining financial account balances. A tighter monetary stance might be needed if the projected near term inflationary developments materialize and spill over into the medium term inflation outlook. How much and how quickly the monetary stance must be tightened will depend on future developments.

At the same time, domestic economic growth continues to disappoint. While there are signs that the economy may have reached the low point in the growth cycle, the recovery is expected to be slow with downside risks. However, the risks to the medium term growth outlook are assessed to be on the downside, despite the downward revision to the GDP growth in 2015/16. Low public and private investments are expected to weigh heavily on the growth outcome for 2016, and the outlook is therefore dependent in part on whether these sectors rebound in the 2017.

Broadly, the near term edging up of inflation is expected to be temporary and this may not disanchor low inflation expectations. Given the low domestic demand pressures, and the medium term inflation outlook which provides a scope for a further easing in monetary policy, the BoU considered it appropriate to ease monetary policy further by reducing the central bank rate by one percentage point to ***15 per cent***. The BoU remains focused on its inflation mandate, but sensitive to the extent possible to the state of the economy. The BoU will not hesitate to act appropriately should the inflation dynamics require a response, within a flexible inflation targeting framework. Future moves, as before, will continue to be highly data dependent.

Appendix 1: Key EAC Macroeconomic Indicators

	UGANDA						RWANDA					
	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
GDP Growth (%)	3.4	3.3	4.8	5.3	4.6	5.5	8.2	8.0	7.5	6.4	6.9	6.3
Inflation	18.0	3.6	6.7	3.1	6.6	5.5	5.7	6.3	4.2	1.8	2.5	4.8
Current account deficit/ GDP	-8.8	-6.4	-8.4	-9.0	-9.7	-10.7	-7.5	-11.3	-7.4	-11.5	-13.8	-14.2
Tax Revenue/ GDP	10.1	11.0	11.4	12.8	13.1	13.6	14.0	15.0	16.5	16.7	17.6	18.7
Budget Deficit/ GDP	-2.5	-3.6	-4.1	-4.5	-6.8	-6.9	-12.5	-10.9	-11.2	-11.0	-9.6	-8.6
Public debt/GDP	23.6	24.2	27.7	31.2	35.4	37.9	23.1	20.1	26.5	29	34.6	41.5

	KENYA						TANZANIA					
	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
GDP Growth (%)	4.5	5.3	5.3	6.1	5.6	6.0	6.5	6.7	7.0	7.5	7.0	7.2
Inflation	10.1	4.4	5.0	5.0	5.0	5.0	12.7	16.0	7.9	6.1	5.6	6.1
Current account deficit/ GDP	-9.1	-8.4	-8.9	-10.4	-8.2	-8.3	-16.3	-16.2	-14.1	-14.1	-7.9	-7.5
Tax Revenue/ GDP	19.3	19.8	20.0	17.7	19.7	20.3	12.3	12.7	13.1	13.3	13.9	14.7
Budget Deficit/ GDP	-4.6	-5.5	-6.2	-8.0	-8.8	-7.7	-6.9	-7.0	-6.3	-4.7	-4.9	-4.9
Public debt/GDP	43.0	41.7	41.6	47	52.7	55.2	27.8	29.2	30.9	35.2	40.5	42.4