Bank of Uganda

Current State of the Economy

March 2016

Table of Contents

List of Tables

List of Figures

Acronyms and Abbreviations

AEs	Advanced Economies
BoU	Bank of Uganda
CA	Current Account
CAD	Current account deficit
CBR	Central Bank Rate
ECB	European Central Bank
EFU	Electricity, Fuel and Utilities
EMEs	Emerging Market Economies
EMDEs	Emerging Market and Developing Economies
FAO	Food and Agriculture Organization
FDI	Foreign Direct Investment
FY	Financial Year
IFEM	Interbank Foreign Exchange Market
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
REER	Real Effective Exchange Rate
REPOs	Repurchase Agreement
Shs	Shillings
SSA	sub-Saharan Africa
Std.Dev	Standard deviation
UETCL	Uganda Electricity Transmission Company Limited
UK	United Kingdom
URA	Uganda Revenue Authority
US	United States
USD	United States Dollar
WALR	Weighted Average Lending Rate
WTI	West Texas Intermediate
Y-o-Y	Year on Year

Executive Summary

The global economy continues to be fragile, with growth slowing down to 3.1 per cent in 2015, compared to 3.4 per cent posted in 2014. This growth was also lower than the earlier projection of 3.9 per cent. Globally, monetary policy remains very accommodative and is supportive of economic activity, although inflation remains below most central banks' targets. The United States (US) Federal Reserve raised the federal funds rate target in December 2015 for the first time in nearly 10 years, but even with this, the monetary policy stance remains very accommodative and going forward, the pace of future rate increases will be very gradual. In December, the European Central Bank (ECB) announced a package of measures designed to ease monetary policy further. More recently, the Bank of Japan also eased policy further by reducing the rate it pays on marginal reserves to –10 basis points while announcing that it would continue to expand its balance sheet over 2016 as planned.

The diverging monetary policy trends among the major central banks, concerns about the challenges facing the Chinese authorities and large declines in oil prices have contributed to an increase in volatility in global financial markets of late. Sovereign bond yields have declined noticeably since late last year, as have equity prices. Large flows associated with capital outflows from China, together with asset sales by sovereign wealth funds of oil-producing nations, also appear to have contributed to market volatility.

Global inflation remains well below most central banks' targets, in part reflecting spare capacity in many labour and product markets as well as the substantial declines in oil prices since the mid-2014. More signs of a deflationary environment are appearing in Europe and Asia, leading to concerns that stronger growth might not be forthcoming in the near future. The weak growth, large output gap, low return on capital, and a host of other economic malaise are inducing volatility in the global financial markets.

A number of Emerging Market Central banks have recently raised interest rates to stem inflationary pressure emanating primarily from a depreciation of their currencies against the US dollar (including Mexico, Chile and South Africa). In Chile and South Africa, the tightening has occurred despite subdued economic activity due in large part to the impact of lower commodity prices.

On the domestic scene, Ugandan economy expanded by 6.7 per cent year on year (y-o-y) in Q3-2015, with all sectors (agriculture, industry and services) making positive contributions. However, projections indicate growth decelerated in Q1-2016 and will only slightly increase during the remaining part of 2016. Projections indicate domestic economic growth remains modest at 5 per cent in 2015/16, but is expected to strengthen gradually through the projection horizon, reaching about 5.5 per cent in 2016/17 and 6.1 per cent in 2017/18. The growth trajectory reflects the ongoing global economic slackness and global financial turbulences. However, the outlooks for both aggregate demand and potential GDP are highly uncertain due to the on the ongoing global economic turbulences.

The Current account deficits (CAD) slightly narrowed in the first seven months of FY2015/16 to USD 1154.1 million compared to USD 1368.9 million in the same period of FY2014/15, mainly because of sharp decline in imports compared to exports. Merchandise exports fell by 3.1 per cent while imports declined by 5.0 per cent over the same period. Private sector merchandise imports fell even more steeply in the same period, by 14.2 per cent largely due to a lower oil imports, which declined by 31.5 per cent.

Overall, domestic inflationary pressures have eased. This is consistent with tightening of monetary policy since April 2015, declines in the cost of business inputs such as fuel, and the spare capacity in the economy. Meanwhile, the prices of tradable items have increased slightly over the year, suggesting that some of the price increases for imported goods and services arising from the depreciation of the exchange rate have been passed on to consumers. A gradual pass-through of the exchange rate depreciation is expected to continue to place upward pressure on the prices of tradable items over the next few years.

The downswing of inflationary pressures, sluggish domestic demand and investment growth should result in monetary policy easing. Therefore, there are reasonable prospects for continued growth in the economy, with inflation declining to the 5 per cent target by first half of 2017. As of now, the Bank assesses the risks to the inflation outlook as relatively balanced. While there may be potential for further shilling weakening in the short-term given the negative outlook stemming from turbulent global financial conditions as well as domestic factors, the lower observed exchange rate pass-through remains a mitigating factor. However, there is still uncertainty as to the sustainability of this low pass-through, particularly in the face of persistent nominal exchange rate movements.

The upside risk from the exchange rate is more or less offset by the downside risks from the international oil price assumptions and projected food price inflation. Therefore, the current setting of monetary policy remains appropriate. The Bank will will continue to assess the outlook over the period ahead. New information should allow the Bank to judge whether the economic activity is gaining momentum and whether the recent global financial turbulence portends weaker global and local demand. Continued decline in inflation should provide scope for easier policy to lend support to domestic demand.

1 Background

This report discusses domestic and external economic developments in the period to February 2016. It also assesses the future prospects and outlook for the domestic and global economy, and provides the projected domestic inflation and output trajectory in the near-to-short-term. In addition, it discusses the attendant risks to the domestic economic outlook 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

The global economy continues to be fragile, with growth slowing down to 3.1 per cent in 2015, compared to 3.4 per cent posted in 2014. This growth was also lower than the earlier projection of 3.9 per cent. The slower than expected global growth is mainly a reflection of the continued deceleration of economic activity in emerging market and developing economies (EMDEs) amid weakening commodity prices, global trade, and capital flows. While a modest recovery continued in the Advanced Economies (AEs), growth in EMDEs, which accounts for over 70 per cent of global growth, declined for the fifth consecutive year.

Growth is however, projected to improve slightly to 3.4 per cent and 3.6 per cent in 2016 and 2017, respectively. This growth will be supported by continued recovery in AEs, propped by favourable financial conditions, lower oil prices and rising real incomes. The forecast is subject to substantial downside risks though, including a sharper-than-expected slowdown in EMDEs, lower energy and commodities, prospects for a gradual tightening in monetary policy in the United States while several other AEs continue to ease monetary policy, and the gradual slowdown and rebalancing of economic activity in China away from investment to consumption. The Chinese economy continued to perform below its long-term trend, and news of weakening activity exacerbated by strong turbulence in the country's financial markets, were passed through to global markets. Brazil and Russia have been going through severe adjustments in the face of external and domestic challenges, while activity in other commodity exporting EMDEs also stagnated due to declining commodity prices.

Growth in AEs registered a modest recovery with a further narrowing of the output gaps. In the US, growth was resilient, albeit declining; in part supported by strengthened housing and labour market conditions. Nonetheless, real growth declined to 0.7 per cent y-o-y in Q4-2015, compared to 2.0 per cent in Q3-2015. The decline was due to the negative contributions from private inventory investment, exports and non-residential fixed investments. In the Euro Zone, growth seemed to be broadly on course, as the risk of a prolonged period of deflation appears to have receded. GDP grew by 1.5 per cent in 2015 and is forecast to rise to 1.7 per cent in 2016, supported by the sustained monetary stimulus, lower commodity and energy prices, easy financial conditions and a neutral fiscal stance. The current refugee crisis in the European Union (EU) is however a major challenge to the absorptive capacity of the labour markets, which may dent the recovery.

Growth in EMDEs slowed to 4.0 per cent in 2015 from 4.6 per cent in 2014, in part driven by the declining commodity prices, the rebalancing in China, tighter external financial conditions, depreciation pressures, economic distress related to geopolitical factors, and structural bottlenecks inherent in most of these economies. Growth in EMDEs is however, projected to increase to 4.3 and 4.7 per cent in 2016 and 2017, respectively. Growth in China is estimated at 6.9 per cent in 2015, and is expected to slow to 6.3 per cent and further to 6.0 per cent in 2016 and 2017, respectively in part due to weak investment as the economy rebalances. In sub-Saharan Africa (SSA), growth is estimated at 3.5 per cent in 2015, down from an earlier projection of 3.8 per cent, in the face of headwinds from declining commodity prices and the after-effects of the Ebola crisis. The protracted decline in global oil prices is posing a severe growth constraint on the region's oil-exporting economies, with no sizeable growth benefits for the region's oil-importers, as the favourable impact of lower oil prices has been dwarfed by lower prices of other commodity exports. Projections in global growth are given in **Table 1**.

Table 1: Global Economic Growth Projections

	2014	*2015*	*2016*	*2017*
World output	3.4	3.1	3.4	3.6
Advanced economies	1.8	1.9	2.1	2.1
USA	2.4	2.5	2.6	2.6
UK	2.9	2.2	2.2	2.2
Euro area	0.9	1.5	1.7	1.7
Japan	0.0	0.6	1.0	0.3
Emerging and developing economies	4.6	4.0	4.3	4.7
China	7.3	6.9	6.3	6.0
India	7.3	7.3	7.5	7.5
Sub-Saharan Africa	5.0	3.5	4.0	4.7

Source: IMF, World Economic Outlook, January 2016

The risks to the global outlook remain tilted to the downside and relate to ongoing adjustments in the global economy. The generalized slowdown in EMEs, the rebalancing in China, lower commodity prices, and the gradual exit from extraordinarily accommodative monetary conditions in the United States could derail global growth if not successfully managed.

2.2 Global financial markets

The international financial markets recently experienced renewed episodes of distress, with global financial market volatility intensifying in January 2016 following the US Fed's rate hike in December 2015, tumble in crude oil prices and the turmoil in China's stock markets. Indeed, in January 2016, the Shanghai Composite index, which tracks the daily price movements of selected shares on the Chinese stock exchange market, declined by 16 per cent, largely due to the authority's error, highlighting continued challenges with China's rebalancing. Although the Chinese authorities implemented a range of measures to mitigate the collapse in the stock markets and boost output, the contagion to other economies, particularly EMDEs was severe, with these economies experiencing substantial capital outflows, currency depreciations and a rise in the cost of external financing due to an increase in credit spreads.

Monetary easing in the Euro Zone and Japan seems to be on track, as previously envisaged, while in the US, the U.S. Federal Reserve lifted the federal funds rate from the zero lower bound in December 2015. This hike caused the US dollar to strengthen, causing volatility and depreciations on other major currencies, the world over. The firm appreciation of the US dollar, arising from the strong economic performance of the US relative to other major economies, has persistently generated additional pressure on the currencies of EMDEs. Overall, financial conditions within AEs remain very accommodative. Prospects of a gradual increase in policy interest rates in the US as well as bouts of financial volatility amid concerns about emerging market growth prospects have contributed to tighter external financial conditions, declining capital flows, and further currency depreciations in many EMEs.

The crude oil prices also continued to tumble, with the average crude oil price declining to USD 29.8 per barrel in January 2016, following the lifting of the US sanctions on Iran. The lower oil prices have strained the fiscal positions of oil-exporting economies, causing a sizable reduction in their domestic demand and investment.

The outlook for global financial markets remains fragile. The return of unconventional monetary policies in AEs, with a possibility of negative interest rates, is likely to trigger sporadic investor portfolio adjustments and capital flow reversals. Moreover, the future trajectory of the US Fed monetary policy stance continues to raise anxiety. In addition, challenges with the rebalancing in China, the prospect of the UK withdrawing from the EU (Brexit), as well as continued tumble in commodity prices will continue to keep global financial markets jittery, which may trigger renewed instability in Uganda's foreign exchange market.

2.3 Global inflation and commodity prices

2.3.1 Global Inflation

Global inflation remains subdued, largely driven by low commodity prices and negative output gaps in AEs. Inflation in AEs averaged 0.24 per cent in 2015, down from 1.6 per cent recorded in 2014, raising concerns of a risk of a deflation in some of these economies. On the other hand, inflationary pressures ensued in most EMDES, largely driven by exchange rate depreciation. Average inflation in EMDEs stood at 7.3 per cent, up from 5.7 per cent in 2014.

The Outlook for global inflation depends largely on the direction of international commodity prices, projected to remain subdued in 2016, before recovering marginally in 2017. Inflation in AEs is forecast to rise slightly, but remain below the respective Central Banks medium-term targets in 2016 and 2017. In EMDEs, inflation is projected to remain relatively stable at 5.6 per cent and 5.9 per cent in 2016 and 2017, respectively.

2.3.2 Global commodity prices

Global commodity prices have continued to tumble, in part reflecting largely abundant supplies coupled with soft global demand. Average Crude oil prices declined by 18.6 per cent m-o-m and 36.8 per cent, y-o-y to USD 29.8 per barrel in January 2016, driven by weak global demand and ample market supplies as OPEC member countries continue to protect market share by maintaining production levels. As at February 12, 2016, Brent Crude and West Texas Intermediate (WTI) prices stood at USD 27.54 per barrel and USD 31.35 per barrel, respectively. Global food prices also continue to decline, with the Food and Agricultural Organization (FAO) food price index, declining by 1.9 per cent m-o-m and 15.9 per cent y-o-y in January 2016.

Going forward, global commodity prices are expected to remain soft, driven by oversupply conditions and subdued global demand. Indeed, the World Bank projects crude oil prices to average USD 37 per barrel in 2016. Food prices are also projected to remain relatively soft notwithstanding the after effects of the El Nino weather phenomenon.

2.4 Implications for the Ugandan Economy

The external economic environment presents both opportunities and challenges for the Ugandan economy. The main challenges include declining international commodity prices and the turbulence in the global financial system. 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 low oil prices could also have a material impact on investment and economic activity, as it could discourage foreign direct investment (FDI) inflows to the oil sector. This coupled with weaknesses in the global economy, could depress FDI inflows even further. Indeed, there are already indications that FDI inflows to the oil sector have softened, and given Uganda's weak current account position, largely funded by surpluses in the capital and financial account of the Balance of Payments (BoP), a decline in FDI inflows may aggravate exchange rate depreciation pressures. In 2015, FDI inflows to the Uganda economy declined by USD 200 million from USD 1.2 billion in 2014 to just about USD 1.0 billion.

The gradual exit from extraordinarily accommodative monetary conditions in the US poses a greater threat of capital outflows. The beginning of the normalization of US monetary policy was associated with a turn in investor sentiment, a reversal of capital flows and strong pressures on exchange rate. There is also a risk that growth in EMEs could be much slower than expected. A slowdown in EMEs growth would weigh on Uganda's economic growth through trade, financial and confidence channels, including a further downward pressure on commodity prices. The 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 also remain elevated. This has negative implications on consumer and business confidence as economic agents could hold back on spending, which may lead to a fall in aggregate demand, thereby constraining global growth with adverse implications for Ugandan exports.

3. Domestic Economic Developments

3.1 Reflections on Monetary policy stance and Implementation

3.1.1 Monetary Policy Stance

Bank of Uganda (BoU) maintained neutral monetary policy stance in February 2016, maintaining the Central Bank Rate (CBR) at 17.0 per cent. Between March 2015 and October 2015, BoU increased the CBR by 6 percentage points (pps) from 11.0 per cent in March 2015 to 17.0 per cent in October 2015. The tightening of the monetary policy stance since March 2015 was because of the projected inflation trajectory, which indicated heightened inflationary pressures. Indeed, inflationary pressures heightened in the ensuing period, driven in part by the sustained exchange rate depreciation pressures. In the most recent forecast however, inflation pressures have softened. In February 2016, core inflation was forecast to peak at 6-8 per cent in Q2-2016, flattening out in H2-2016, before declining to the BoU's medium-term target of 5 per cent in mid-2017. Headline inflation was also forecast to peak at 8-10 per cent in Q3-2016, largely because of the deteriorating outlook of food prices, before declining gradually over the medium-term.

Although inflation outlook had improved somewhat compared to the previous forecasts, it was envisaged that reducing the CBR would to generate inflationary pressures in an environment already clouded with negative sentiments, including the complex external economic environment. On the other hand, increasing the CBR could complicate the economy's already weaker growth prospects. BoU therefore decided to pursue a neutral monetary policy stance in order to hold back inflationary pressures and to ensure that the annual core inflation remained within the medium-term target of 5 per cent. Consequently, the CBR was maintained at 17 per cent in February 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

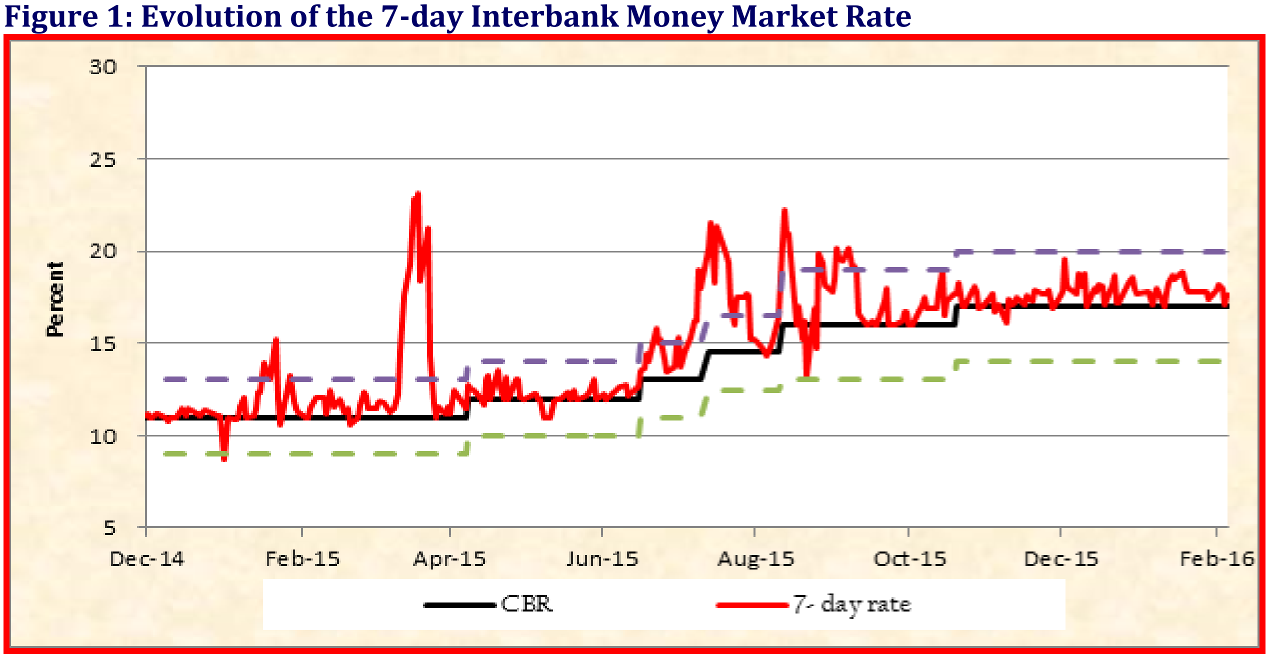
Rediscount Rate and the Bank Rate were therefore remained at 21 per cent and 22 per cent, respectively.

3.1.2 Monetary policy implementation

BoU continued to use Repurchase Agreement (REPOs), reverse REPOs and outright sales of recapitalization securities in the secondary market to align liquidity conditions in the domestic financial system with the desired monetary policy stance. The net effect of the REPO and Reverse REPO instrument in December 2015 and January 2016 was an injection of Shs 727 Billion. As at end January 2016, the outstanding stock of reverse REPOs was Shs 316 Billion.

The interbank money market rates remained broadly consistent with the monetary policy stance (**see Figure 1**) despite the structural liquidity overhang. There was a slight decline in the 7-day rate in February 2016 to 17.6 per cent from 18.2 and 18.4 per cent in December 2015 and January 2016, respectively.

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

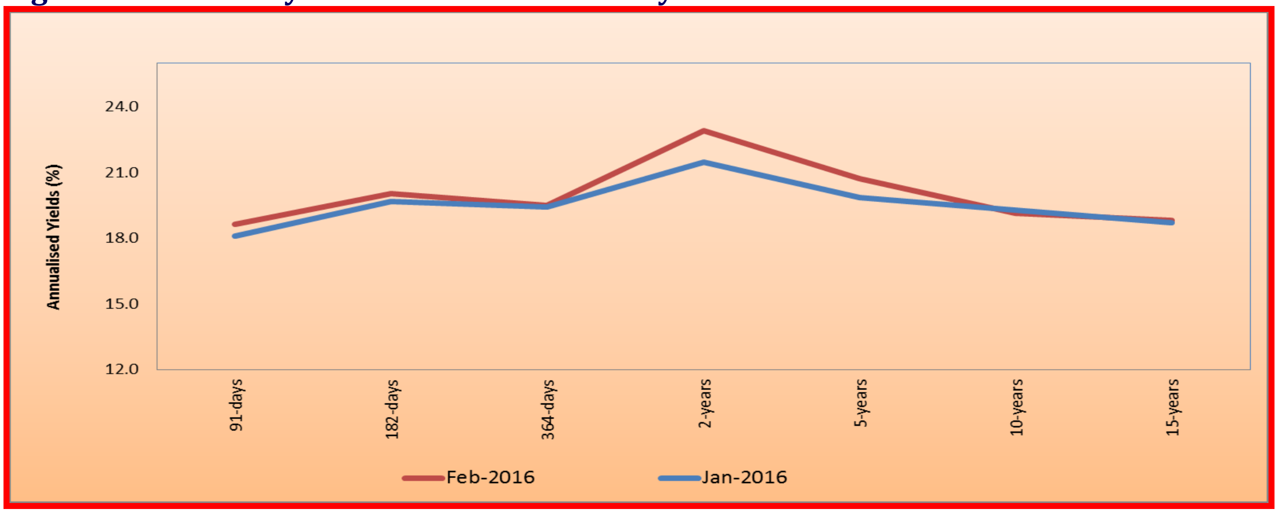


Source: Bank of Uganda

3.2 Interest rates and Private Sector Credit

In the quarter to December 2015, the yields on Government securities remained relatively stable, but elevated. There have been massive oversubscriptions in treasury auctions, since the mid-February 2016, particularly in the 364-day paper, which helped drive its yields down, arising from a notable increase in offshore participation and lower inflation expectations. By December 2015, the yields on the 91-day, 182-day and 364-day papers had on average increased by 7.7, 8.5 and 7.3 pps, respectively compared to January 2015 rates of 11.8, 14.3 and 15.0 per cent, respectively. As at February 2016, the same rates on average stood at 20.6, 22.8 and 22.4 per cent respectively, compared to 21.1, 23.5 and 23.7 per cent recorded in the quarter ended November 2015.

Figure 2: Secondary Market Yield curve analysis

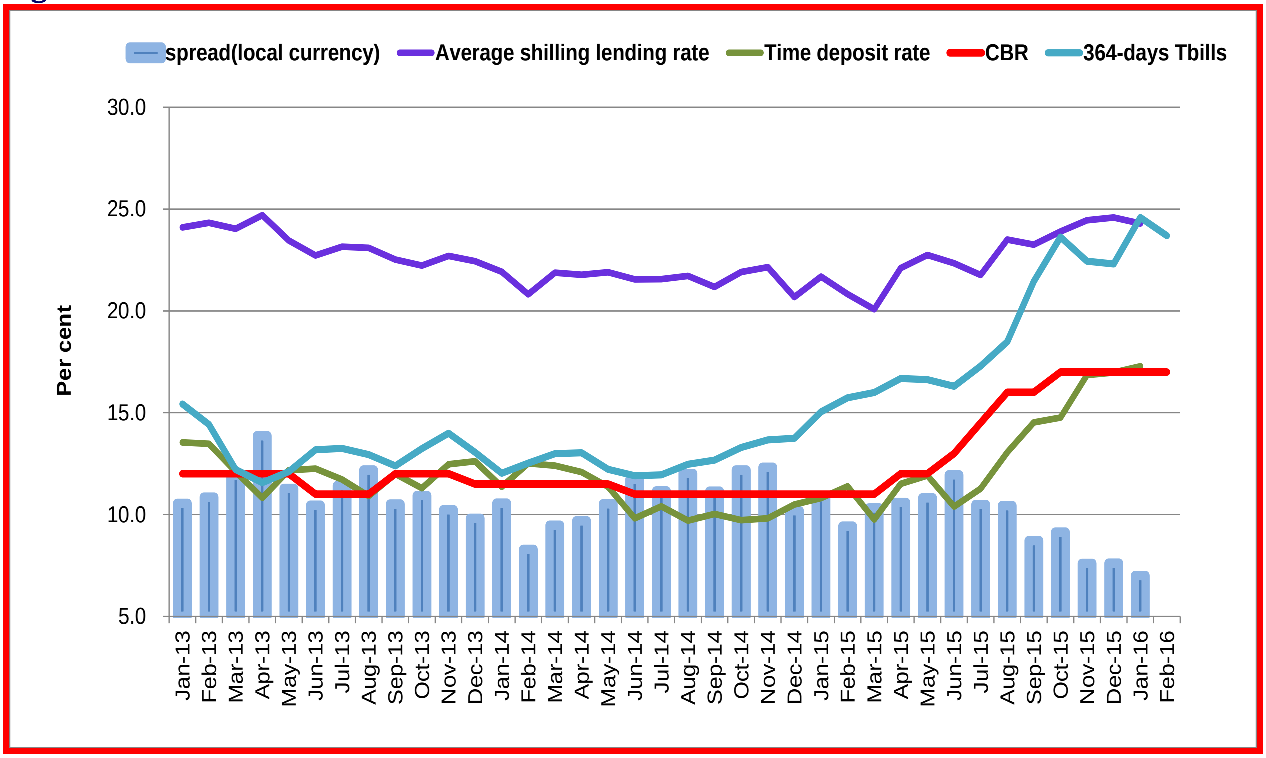


Source: Bank of Uganda

In the secondary market, the yields on the benchmark 2-year, 5-year and 10-year Treasury bonds rose to 22.9, 20.7 per cent and 19.2 per cent, respectively in February 2016 compared to 20.3, 20.1 and 19.1 per cent in November 2015. However, in the primary market, the yields in the 5-year and 10-year Treasury bonds declined to 18.3 and 19.3 per cent in February 2016 compared to 20 per cent and 19.5 per cent in November 2015. On the other hand, the yields on the 2-year Treasury bond recorded an increase to 23.6 per cent in the quarter to November 2015 compared to 20.6 per cent. The trend of yields on government securities is shown in **Figure 2.**

Similarly, interest rates on loans rose gradually over 2015. The rising of interest rates and weak economic activity has resulted in increasing of industry wide ratio of non-performing loans (NPLs). NPLs rose from 3.8 per cent in the quarter to September 2015 to 5.3 per cent in the quarter ended December 2015.

Figure 3: Interest Rate Trends



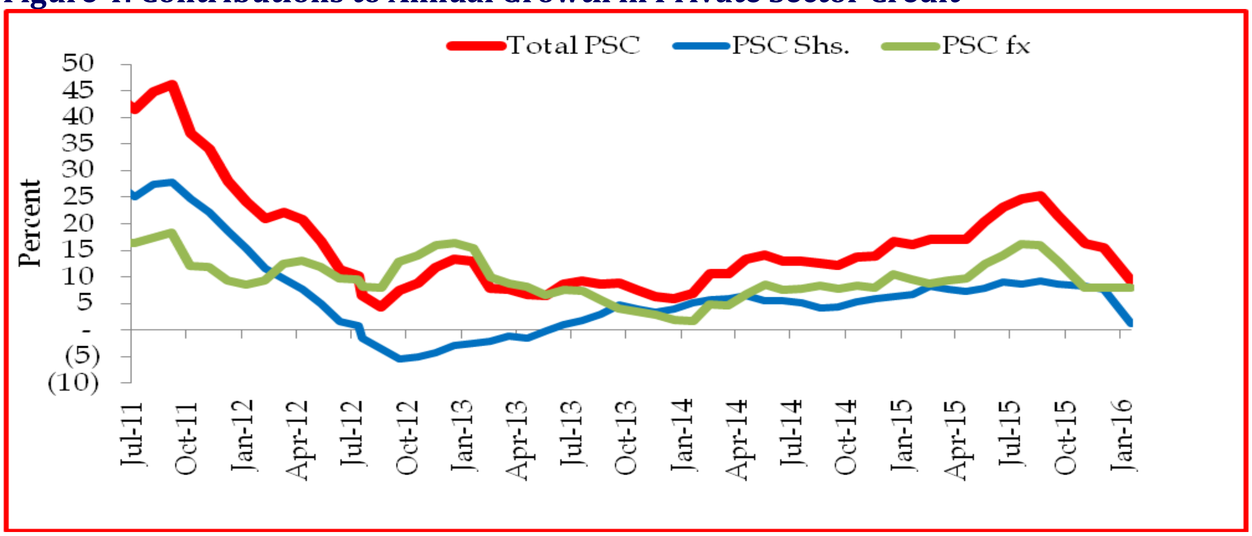
Source: Bank of Uganda

As shown in Figure 3, the Weighted Average Lending Rate (WALR) on shilling denominated loans had a slow but steady rise over the 12 months to December 2015, averaging 22.6 per cent, peaking at 24.6 per cent in December 2015. Over the same period, rates on US dollar denominated loans averaged 9.2 per cent, hitting highs of 9.4 per cent in December 2015. Overall, the lending rates have remained elevated, reflecting in part the high cost of doing business; a heightened risk aversion by commercial banks and the impact of the continued tight monetary policy stance. The deposit rates also rose in line with the increase in other interest rates in the economy. The shilling time deposit rate rose to 17.3 per cent in January 2016 from 16.9 and 14.8 per cent, respectively in November and October 2015. 2015. The dollar time deposit rate averaged 4.0 per cent over the 12 months to December 2015, peaking at 4.4 per cent in January 2016.

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 declined in recent months, in part reflecting weakening domestic demand conditions and the impact of relatively elevated lending rates. On an annual basis, PSC grew by 9.3 per cent y-o-y in January 2016 down from 25.2 per cent in September 2015. In particular, the growth in Shilling loans declined to 2.2 per cent from 15.8 per cent in September. Over the same period, growth in the shilling value of foreign denominated loans also slackened to 19.2 per cent from 39.0 per cent. In USD terms, the value of forex loans has actually been declining since August-2015. Forex loans, in particular, declined by 1.8 per cent in January 2016 alone. Developments in PSC are shown in **Figure** 4.

Figure 4: Contributions to Annual Growth in Private Sector Credit



Source: Bank of Uganda

In terms of sectoral distribution; building, mortgage and construction; trade and commerce; manufacturing; personal and household loans; and agriculture continued to constitute the bulk of private sector credit. Indeed, as at end January 2016, these sectors accounted for 82.6 per cent of total private sector credit. The ratio of credit to the agricultural sector in total PSC in particular rose to about 10.1 per cent, in part reflecting the positive impact of disbursements from the agricultural credit facility. Nonetheless, growth in PSC has slowed, in part reflecting the impact of the tight monetary policy stance and subdued domestic demand. This will continue to generate subdued demand pressures in the economy, which will dent growth in the short-to-medium-term. **Table 2** shows the sectoral distribution of credit and the respective annual sectoral growth rates.

Table 2: Sectoral Developments in Private Sector Credit

	Annual Growth Rate			Share in total
Sectors	**Oct-15**	**Dec-15**	**Jan-16**	**Jan-16**
Agriculture	**17.2**	**17.0**	**18.4**	**10.1**
Mining and Quarrying	**48.4**	**42.6**	**51.2**	**0.5**
Manufacturing	**45.2**	**20.0**	**16.8**	**14.4**
Trade	**16.2**	**9.9**	**9.2**	**19.8**
Transport and Communication	**32.7**	**24.9**	**30.1**	**5.9**
Electricity and Water	**27.2**	**9.7**	**5.2**	**1.8**
Building, Mortgage, Construction and Real	**21.8**	**19.4**	**17.9**	**23.4**
Business Services	**34.7**	**20.9**	**7.8**	**4.1**
Community, Social & Other Services	**17.6**	**7.2**	**5.6**	**3.3**
Personal Loans and Household Loans	**6.3**	**7.3**	**7.6**	**15.1**
Other Services	**9.9**	**27.1**	**13.0**	**1.5**
Total	**21.6**	**15.6**	**9.3**	**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 per cent of GDP.

However, following some fiscal consolidation and the anticipated over performance of tax revenue, the projected fiscal deficit for FY 2015/16 has been revised to 6.6 per cent of GDP.

Preliminary fiscal data for the first seven months of FY2015/16 indicates that the fiscal deficit (including grants) amounted to Shs 2,859.7 Billion, which is lower than the budget by Shs 1,237.4 Billion. Total government revenue was higher than the budget amount by Shs 96.8 Billion, largely due to over performance in tax revenue, which was higher than the target by Shs 108.5 Billion. Total government expenditure and net lending amounted to Shs 10,110.6 Billion, which was lower than the budget amount by Shs 1,140.6 Billion, largely on account of development expenditure, which was lower than the budget amount by Shs 1,060.3 Billion. Domestic and external financing amounted to Shs 523.1 Billion and Shs 1858.4 Billion, respectively. Developments in fiscal operations for H12015/16 are shown in **Table 3.**

Table 3: Fiscal performance in FY 2015/16

	Budget July'15 - Jan'16	Actual [prel.] July'15 - Jan'16	Variation
Revenues and Grants	7,154.1	7,250.9	96.8
Revenues	6,369.3	6,477.8	108.5
Grants	784.8	773.1	(11.7)
Expenditure and Lending	11,251.2	10,110.6	(1,140.6)
Current Expenditure	4,847.6	5,336.1	488.5
Development Expenditure	4,348.4	3,288.1	(1,060.3)
Overall Fiscal Bal. (excl. Grants)	(4,881.9)	(3,632.8)	1,249.1
Overall Fiscal Bal. (incl. Grants)	(4,097.1)	(2,859.7)	1,237.4
Financing:	4,097.1	2,859.7	(1,237.4)
External Financing (Net)	2,955.7	1,858.4	(1,097.3)
Domestic Financing (Net)	1,141.4	523.1	(618.3)
Issuance of Securities1	790.3	460.8	(329.5)
Drawdown on savings	351.1	62.3	(288.8)
Errors and Omissions	0	478.2	478.2
Note: 1 The budgeted amount for July 2015 to January 2016 is based on the revised 2015/16 Budget estimate of Shs 900 billion			

Source: Ministry of Financing, Planning and Economic Development

Government plans to remain within the approved budget expenditure with a fiscal deficit of 6.6 per cent of GDP.

3.3.2 Public Debt

The total public debt stock grew by 10.1 per cent in the last half of 2015 from Shs. 24,318.3 Billion in June to Shs 26,768.4 billion in December 2015. The growth in the stock of public debt was mainly due to growth in public external debt, which grew by 13.0 per cent in shilling and by 10.4 per cent in US dollar terms. The increase in the shilling value of external debt was, in part driven by the heightened exchange rate depreciation at the time. External public debt continued to make up the bulk of the total public debt, accounting for 61.0 per cent of the total public debt as at end August 2015.

3.4 Balance of Payments and Exchange Rate Developments

3.4.1 Balance of Payments

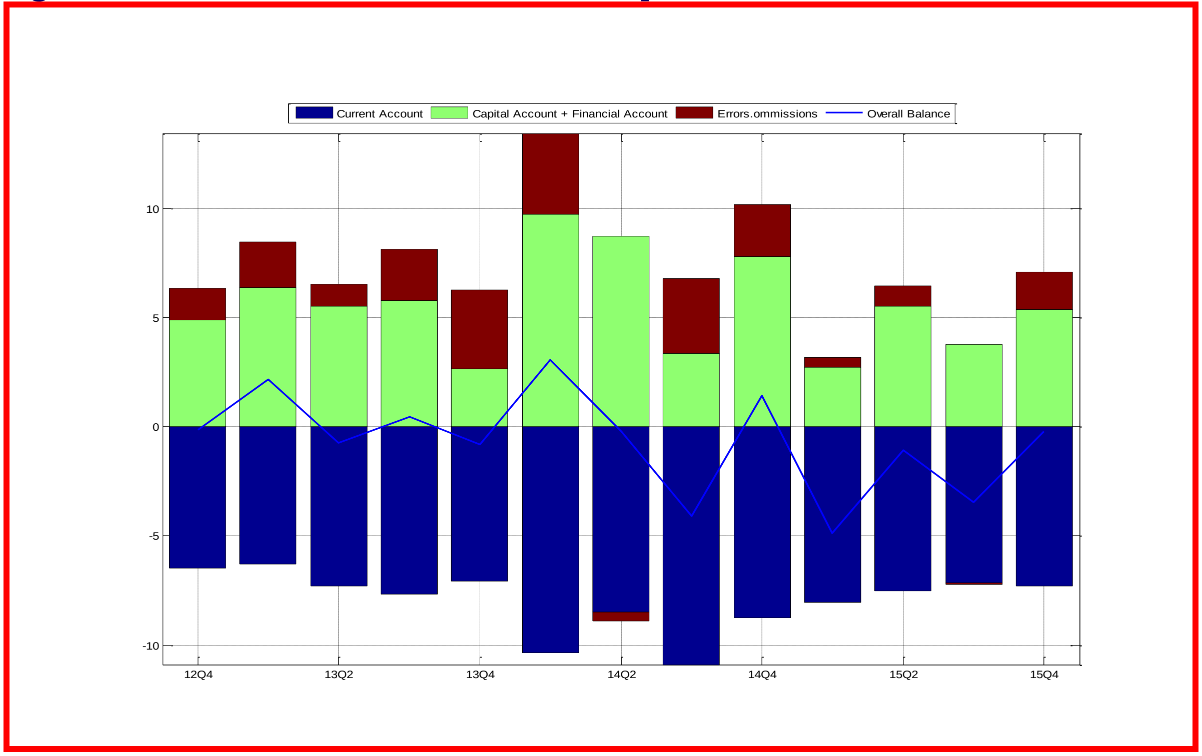
Uganda's external position continues to be fragile largely on-account of higher import growth, which has more than offset the dismal growth in exports. Nonetheless, revised projections for FY 2015/16 indicate a slight improvement in the Current Account Balance (CAB). The CAB is projected to improve from a deficit of USD 2.3 Billion to a deficit of USD 1.98 Billion, largely on-account of lower government imports. The net inflows in the financial account have also been revised downwards to USD 1,563 Million, largely due to subdued FDI inflows. In 2015, FDI inflow into Uganda declined by USD 200 Million to about USD 1.0 Billion from USD 1.2 Billion in 2014. The bulk of FDI inflows into Uganda in the recent years have been oil related. The protracted decline in global oil prices is curtailing new investment in Uganda's oil sector. This, coupled with weaknesses in the global economy, may to depress FDI inflows into the country even further.

Looking at the external performance during H1-2015/16, the main traits of Uganda's external position remain evident. The trade deficit remains persistent, although it somewhat improved to USD 437 Million, equivalent to 7.7 per cent of GDP in Q2-2015/16, from 8.7 per cent of GDP in the previous quarter. This improvement was mainly driven by the fall in the import bill. Private Sector imports also declined, in part due to the sustained decline in oil related imports arising from the tumble in oil prices. Indeed, the oil import bill has declined from an average of USD 270 Million per quarter in FY 2014/15 to about USD 170 Million in Q2-2015/16. Export earnings remain sluggish, although receipts increased slightly to USD 644 Million, equivalent to 11.3 per cent of GDP in Q2-2015/16. The increase in export receipts was mainly supported by increase in non-coffee exports receipts which increased to USD 438.5 Million, equivalent to 7.7 per cent GDP from 7 per cent in Q1- 2015/16.

The deficit on services account improved to 0.7 per cent of GDP in Q2-2015/16 from 2.4 per cent in Q1-2015/16, supported mainly by lower transport and other business services payments. The deficit on the Primary income (returns to factors of production) account remained relatively stable at 2.6 per cent as direct investment income payments (dividends) remained relatively stable. In contrast, the Secondary income (Current transfers) balance declined to USD 342 Million from USD 411 Million in Q1-2015/16 mainly on-account of lower inflows of personal and government transfers. Overall, the CAD improved to 5 per cent of GDP in Q2-2015/16 from 7.5 per cent in Q1-2015/2016.

The capital account balance stood at a surplus of USD 37 Million, equivalent to 0.7 per cent of GDP in Q2-2015/16, up from 0.6 per cent in Q1-2015/16. The financial account recorded net inflows of USD 326 Million, equivalent to 4.4 per cent of GDP, compared to net inflows equivalent to 2.6 per cent of GDP in Q1-2015/16. FDI inflows increased to USD 231 Million, equivalent to 4 per cent of GDP compared to USD 219 Million in the previous quarter. Net portfolio investment was an outflow of USD 30 Million, equivalent to 0.5 per cent of GDP compared to a net outflow of USD 55 Million [0.9 per cent of GDP] in Q1-2015/16. Other investments (mainly currency and deposits, loans, trade credits and advances), inflows remain erratic and amounted to USD 121 Million, equivalent to 2.1 per cent of GDP in Q2-2015/16. Developments in the overall BoP are shown in **Figure 5.**

Figure 5: Current Account Balance and Components



Source: Bank of Uganda

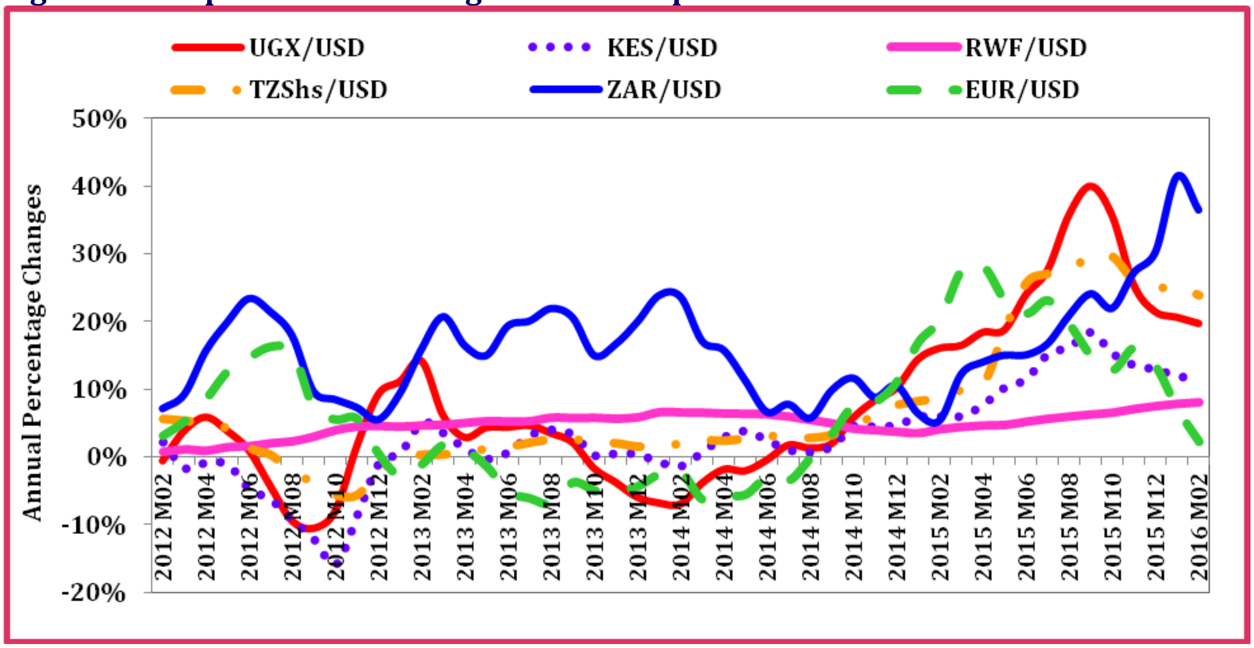
The overall BoP in Q2-2015/16 was a surplus of USD 145 Million, equivalent to 2.6 per cent of GDP. The stock of reserves at the end of December 2015 was USD 2.89 Billion, equivalent to 3.9 months of future imports of goods and services.

3.4.2 Exchange Rate Developments

The heightened depreciation pressures that ensued in early 2014, continuing through August 2015, abated somewhat throughout October to November 2015 and have since been relatively stable. The shilling depreciated by 2.6 per cent, month-on-month (m-o-m) in January 2016 to an average midrate of Shs 3,451.21/ USD, but appreciated by 0.5 per cent in February m-o-m to an average of Shs 3,435.11/USD. On an annual basis, the shilling depreciated by 19.7 per cent in February 2016 compared to an annual depreciation of 40 per cent in September 2015. While the exchange rate depreciation was a necessary adjustment warranted by external and domestic fundamentals, the non-fundamental factors, including noise, expectations and speculative activity could have caused it to overshoot its long-run equilibrium. From October 2015 to the first week of December

2015, the shilling gained against the USD by 9.5 per cent. The appreciation was, in part driven by the correction of overshooting, the tight monetary policy stance and the slowdown in economic activity, which meant less demand for foreign currency in the domestic foreign exchange market.

Figure 6: Comparison of exchange rate developments



Source: Bank of Uganda

The Shilling has also moved in line with the other regional currencies, in part reflecting the importance of the external economic environment in determining exchange rate dynamics in the region. Indeed, most of our trading partners experienced similar movements in their respective USD exchange rates. Developments in selected regional currencies against the USD are shown in **Figure 6.**

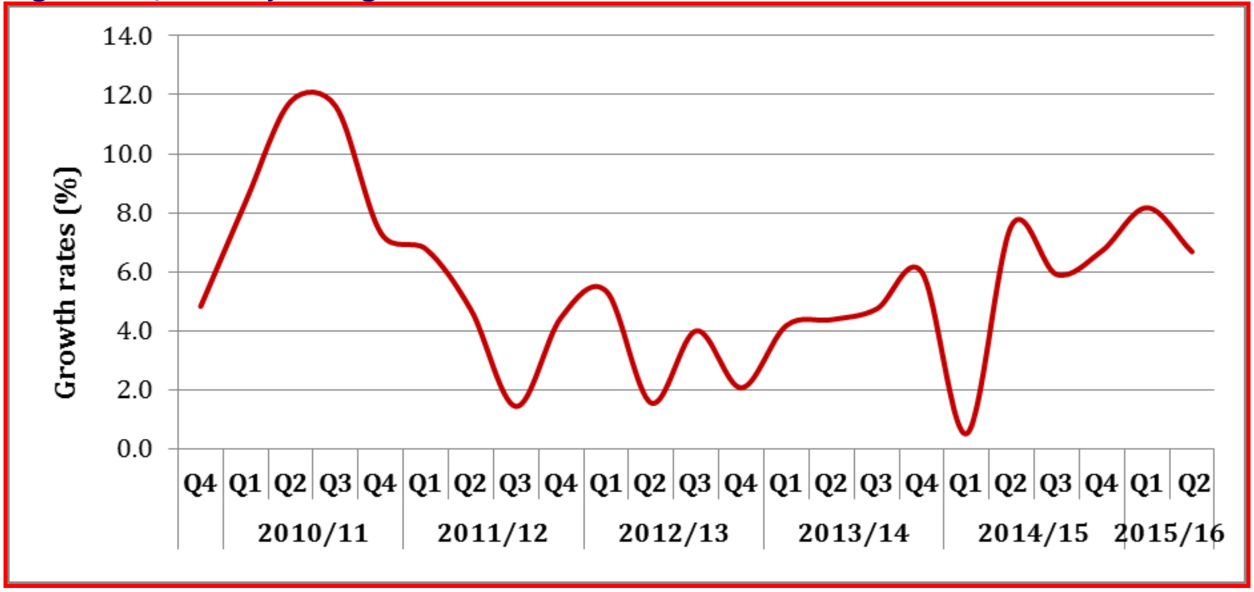
Compared to December 2015, the Nominal Effective Exchange Rate (NEER) appreciated by 6.4 per cent m-o-m, and depreciated by 8.3 per cent y-o-y. Relative to the bilateral exchange rate depreciation, the REER depreciation is not enough to improve competitiveness of the economy. The exchange rate needs to depreciate much more for Uganda to achieve competitiveness.

Notwithstanding the gains so far in February 2016, the outlook is for a further weakening of the Shilling. In the short-term, market sentiments, coupled with pick up in corporate demand mainly from manufacturing and oil sectors and subdued dollar inflows could keep the shilling under pressure. Persistent trade deficit, largely due to low international commodity prices is expected to keep export receipts low, which coupled with high import demand will likely fuel depreciation pressures. Moreover, while FDI inflows increased in the quarter to December 2015, they remain generally subdued compared to the pre-FY 2014/15 period. In addition, heightened global economic risks and vulnerabilities may continue to keep the domestic foreign exchange market jittery.

3.5 Domestic Economic Activity: Output and demand

The Ugandan economy has continued to grow at a moderate pace. Real GDP expanded by 6.7 per cent in Q3-2015(**Figure 7**), with all sectors (agriculture, industry and services) making positive contributions. However, over recent months there have been fewer indications of a near-term strengthening in growth than previous forecasts would have implied. The forecast suggests annual GDP growth have somewhat decelerated in Q1-2016 but will slightly increase during the remaining part of 2016. Overall, growth is now forecast to remain at a below trend pace for somewhat a longer time than had earlier been expected. The projected annual domestic economic growth remains modest at 5 per cent in 2015/16, down from an earlier projection of 5.5 per cent, premised, in part, on the likely adverse impact of the high lending rate and the uncertain external economic environment on private sector investment. Growth is expected to strengthen gradually through the projection horizon, with growth of about 5.5 per cent in 2016/17 and 6.1 per cent in 2017/18.

Figure 7: Quarterly GDP growth



Source: Uganda Bureau of Statistics

However, the outlooks for both aggregate demand and potential GDP growth are highly uncertain, marked by downside risks emanating from both the domestic and external environment. The external economic environment remains turbulent, and this may persist, at least in the near-to-short-term. Domestic demand conditions are also expected to remain weak in the short-term, in part due to tight monetary policy stance, before recovering in the medium-to-long-term. Therefore, the weak domestic demand conditions combined with a weak external environment manifested in slow growth in EMDEs, slow recovery in AEs and soft commodity prices are likely to hold back growth. The high CAD could further exacerbate the already complex situation of the Ugandan economy.

3.6 Consumer Price Inflation

3.6.1 Recent Inflation Developments

In line with international best practices to reflect changes in household consumption patterns and technological progress, the Uganda Bureau of Statistics (UBoS) rebased the Consumer Price Index (CPI) from base year FY 2005/06 to FY 2009/10. As shown in **Table 4**, new items and centres were introduced, and weights have changed to reflect the relative importance of the items in the new consumption basket. Kampala was decomposed into three (3) baskets as opposed to two (3) in the outgoing CPI, and Charcoal and Firewood were incorporated into Electricity, Fuel and Utilities (EFU), increasing the number of components in EFU to eight (8).

The weight for Education in the overall CPI basket dropped to 5.8 per cent from 14.7 per cent, while that for transport rose to 12.7 per cent from 7.2 per cent. Core inflation turned out to be less volatile with a standard deviation of 1.3 compared to the standard deviation of 1.5 in the outgoing CPI in the 12 months to December 2015. The difference between the consumer price inflation of the rebased CPI and the FY 2005/06 reference period CPI is about +/-1 PPs on the 2005/06 CPI inflation.

Table 4: New Features of the Rebased CPI

2005/6	2009/10
EFU computed with 6 components (Petrol, Diesel, Paraffin, Gas, Electricity and Metered water)	EFU computed with 8 components (Petrol, Diesel, Paraffin, Gas, Electricity , Metered water, Charcoal and Firewood)
276 products covered	370 products covered
7 urban centres covered	8 urban centres covered
Kampala decomposed into 2 baskets	Kampala decomposed into 3 baskets
Core more volatile -standard deviation is 1.5 between Jan-15 to Dec-2015	Core less volatile -standard deviation is 1.3 between Jan-15 to Dec-2015

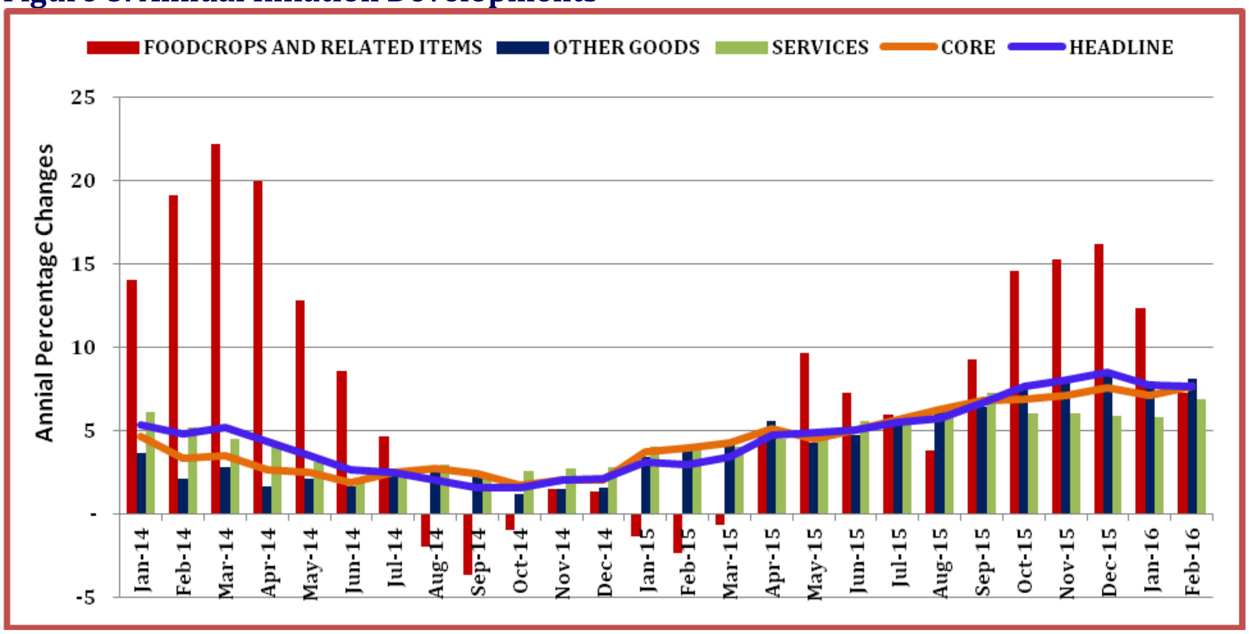
Source: Uganda Bureau of Statistics

As a result of the rebasing, annual headline inflation in December 2015 dropped to 8.5 per cent from 9.3 per cent, while annual core inflation increased to 7.6 per cent from 7.4 per cent over the same period. In January and February 2016, annual core inflation stood at 7.1 per cent and 7.6 per cent, respectively. Annual headline inflation also remained elevated but relatively stable at 7.7 per cent during the same period. In the first 8 months of FY 2016/16, annual headline and core inflation has averaged 7.2 per cent and 6.7 per cent, respectively. The relative stability in annual headline inflation reflects the decline in food crops prices, while core inflation has been kept at bay by base effects and the impact of monetary policy tightening that has taken effect. Annual food crops inflation declined to

7.3 per cent from 12.4 per cent in January 2016.

The impetus for ***"services"*** and ***"other goods"*** inflation category remains high, in part due to the lagged impact of exchange rate depreciation. The "other goods" inflation rose from 3.5 per cent in January 2015 to 8.1 per cent in February 2016. Services inflation, which is indicative of domestic demand conditions in the economy, also remained relatively strong, averaging 6.2 per cent in the first 8 months of FY 2015/16. EFU inflation also rose to 8.7 per cent in February 2016 from 5.4 per cent in October 2015 and 2.7 per cent in January 2015. Developments in domestic inflation are depicted in Figure 8.

Figure 8: Annual Inflation Developments



Source: Uganda Bureau of Statistics

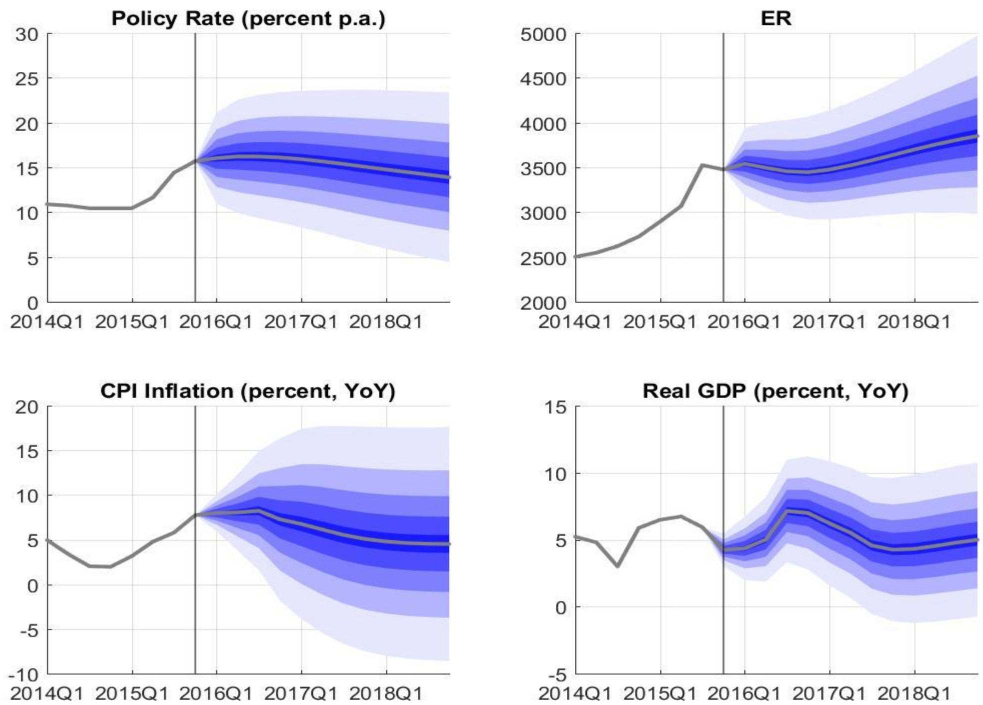
3.6.2 Inflation Outlook

Both headline and core inflation has remained within the PSI tolerance bands of 5±3per cent since January 2015 though they have edged up towards the upper boundary since December 2015. Low global inflation, falling international commodity and energy prices, and a forward-looking monetary policy have helped in holding back inflation despite the lagged impact of exchange rate depreciation. Both headline and core inflation are projected to edge lower in most 2016 (Figure 9) although with occasional spouts reflecting weather and global factors. However, they could increase in the period ahead, but remaining in the range of 7-10 per cent until mid-2016. The domestic economy will continue to foster higher costs and consequently higher consumer prices via high rising prices of capital due to financial conditions that remain restrictive, expected renewed shilling depreciation and tax rates increase in FY2016/17. At the same time, the current strongly anti-inflationary effect of import prices, stemming from a fall in global producer prices and commodity prices, will fade gradually.

Nonetheless, there are several upside risks to inflation, at least in the near-to-short-term. While external sources of inflation are likely to remain subdued, at least in the short-term given ample supply buffers in major commodity markets and weak global demand conditions, the lagged impact of exchange rate depreciation may continue to keep inflation elevated. The future path of the exchange rate, which depends on several domestic and external factors and the speed with which the recent depreciation feeds through to higher inflation also remains uncertain.

Although previous forecasts had incorporated an expectation of higher food crops price inflation due to El Nino weather, recent food crops price developments suggest that the impact could have been mild. However, the heavy rains of Q2-2015/16 could be followed by drought and therefore cause food crop prices to edge up in the remaining part of FY 2015/16. Nonetheless, headline inflation is forecast to peak at 8-10 per cent in Q1-2016/17 because of the likely deteriorating outlook of food prices. Core inflation is forecast to peak at 7-9 per cent in Q4-2015/16, flattening out in the second half of 2016 before declining to BoU's medium-term target of 5 per cent in mid-2017.

Figure 9: Inflation Out look



Source: Bank of Uganda

4. Conclusion

The global economy continues to be fragile as many EMEs continue to slowdown, while in AEs, there is only slight improvement. On the domestic scene, the economy has continued to grow at a moderate pace, with real GDP growth in FY 2015/16 now projected at 5.0 per cent down from an earlier projection of 5.5 per cent largely reflecting the likely adverse impact of the high lending rate and the uncertain external economic environment on private sector investment. Already, the Composite Index of Economic Activity - a high frequency measure of economic activity- points to moderate growth during the first half of FY 2015/16. However, while growth is forecast to strengthen over the medium term, there are nonetheless downside risks to the projected output path, emanating from both the domestic and external environment.

The external economic environment remains turbulent, and this may persist, at least in the near-to-short-term. Domestic demand conditions also remain weak, in part due to delays in commencement of public investments and the tight monetary policy stance, which will continue to depress private investment and consumption, at least in the near-term. The weak domestic demand conditions combined with exchange rate depreciation uncertainty and the weak external environment manifested in slow growth in EMDEs, slow recovery in AEs, soft commodity prices, could exacerbate the already complex situation of the Ugandan economy.

In view of the setback to the economy, largely associated with the global economic challenges, the base-case projection shows that the output gap will close in the second half of 2016, not in the first half of 2016 as in the December 2015 projections. In the December 2015 projections we had assumed that the output gap would be positive in the first half of 2016 and together with the lagged exchange rate pass-through would contribute to higher inflation. While the rapid depreciation pressures seem to have dissipated, the future trajectory of the exchange rate remains the main upside risk to domestic inflation. Nonetheless, BoU currently assesses the risks to inflation outlook as relatively balanced, at least over the near-to-short-term. While there may be potential for further shilling weakness in the short-term given the negative outlook stemming from turbulent global financial conditions as well as domestic factors, the observed slow pace of exchange rate pass-through to domestic inflation and the soft domestic demand conditions remain mitigating factors.

The downswing of inflationary pressures, sluggish domestic demand and investment growth should result in monetary easing in the remaining part of 2016. The Bank will continue to assess the outlook, and to identify the stance of monetary policy that will most effectively foster sustainable growth and inflation consistent with the target. The future path of the CBR will be driven by the flow of incoming data, our assessment of the economic outlook, and judgements as to what level of interest rates is consistent with the BoU's price stability goal. Several factors will continue to be important in this regard including: domestic economic activity and outlook; future movements in commodity prices – especially food crop prices; the degree of exchange rate adjustment that occurs and how quickly it passes through into inflation; fiscal policy operations; and whether inflation expectations have stabilised at an appropriate level.