Bank of Uganda

State of the Economy

September 2016

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Acronyms and Abbreviations

AEs	Advanced Economies
BoU	Bank of Uganda
CA	Current Account
CBR	Central Bank Rate
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
m-o-m	Month on month
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
UETCL	Uganda Electricity Transmission Company Limited
UK	United Kingdom
URA	Uganda Revenue Authority
US	United States
USD	United States Dollar
WAI	Weighted Average Interest rates
WALR	Weighted Average Lending Rate
y-o-y	Year on Year

Executive Summary

The Brexit vote, from a macroeconomic perspective, implies a substantial increase in uncertainty in the short-and medium to long run. In the short-run, the uncertainty was mirrored by volatility in the global financial markets, with stock market declines, rallies in bond prices and wide swings in major currencies. In the medium to long run, the economic consequences of the Brexit become less about financial market disruptions, but more about real economic activity. It will take at least two (2) years for the UK to negotiate the exit, leading to more uncertainty, which will hold back investment and economic activity. Indeed, global growth prospects for 2016 have continued to weaken, following the BREXIT vote. This has led to a further downward revision of global growth projections in July 2016 by the IMF.

In terms of the implications on Uganda, The Brexit will continue to pose uncertainty, holding back investment and consumption in the UK and EU with negative impact on Uganda's export earnings given that the EU is one of Uganda's major trade partners. In addition, remittances and foreign direct investment (FDI) inflows from the EU and UK could decline.

Crude oil prices have been on a decline since mid-2014, in part reflecting supply-side developments and lower growth in global demand. While this could support global activity through keeping domestic inflation in check in oil-importing economies, it could destabilize the outlook for oil-exporting countries, leading to a fall in exports earnings. Uganda, being an oil-importer, benefits from this scenario through the reduction in oil imports bill. On the other hand, the persistently low oil prices could depress oil related FDI inflows to Uganda. This is bound to adversely affect Uganda's already weak balance of payment position. In addition, the renewed volatility in the global financial markets because of the BREXIT vote could cause volatility in the domestic foreign exchange market with implications for the exchange rate.

In August 2016, Bank of Uganda (BoU) eased monetary policy further, reducing the Central Bank Rate (CBR) by 1.0 PP to 14.0 per cent from 15 per cent in June 2016. This was warranted by the softer than expected inflation outlook, which was forecast to converge around the BoU's medium term target of 5.0 per cent in Q4-2016, earlier than earlier projected on account of relative exchange rate stability and subdued domestic demand.

Despite the structural liquidity overhang in the banking sector, the interbank money market rates evolved in line with the monetary policy stance. However, lending rates remained elevated, in part reflecting provisioning for bad debt, the lagged impact of the tight monetary policy stance and structural rigidities in the financial sector, including the high cost of doing business. Indeed, Non-Performing Loans (NPLs) as a ratio of gross loans increased from 6.9 per cent in Q1-2016 to 7.4 per cent in Q2- 2016, while overhead costs continued to contributed a significant proportion—about 7 percent—to the lending spreads. Further increases in NPLs could heighten the risk aversion of commercial banks, further constraining the growth in credit to the private sector.

Growth in credit to the private sector, a leading indicator of the financial sector's contribution to economic activity, continued to slow down in Q2-2016. The slowdown in growth in PSC was driven largely by provisioning for bad loans, which has heightened risk aversion in banks, and relatively weak economic activity.

Preliminary fiscal data for FY 2015/16 indicate that the fiscal deficit amounted to Shs. 4,019.3 billion, which was lower than programmed by Shs. 1,362.7. The deficit was financed majorly from external sources (Shs. 2,458.5 billion), while domestic financing amounted to Shs. 2,078.7 billion. The fiscal stance for FY 2016/17 focused on the need to address infrastructural constraints to increase efficiency and reduce the costs of doing business. The budget deficit is projected at 6.2 per cent of GDP, largely funded by external sources as domestic borrowing by Government securities is projected to reduce to Shs. 612 billion down from Shs. 1,384 billion in FY 2015/16.

The balance of payments recorded a surplus balance of USD 80.2 million in FY 2015/16, an improvement from a deficit of USD 352.8 million recorded in FY 2014/15. The external current account deficit improved, largely driven by a decline in private sector import bill, reflecting a combination of low global crude oil prices and subdued domestic demand. In terms of the outlook, the balance of payments is likely to remain weak in the short- to medium-term because of subdued exports, a pickup in imports by government as well as the private sector.

In July 2016, the Shilling was relatively stable, depreciating slightly by 0.3 per cent m-o-m and by 0.6 per cent y-o-y to an average mid-rate of Shs. 3,375.6 per USD. The relative stability was largely because of subdued demand for imports and stronger inflows from offshore players. In the near-term, the Shilling is expected to weaken on account of sustained dollar demand for infrastructure projects, a correction of overshooting, weak current account position, and strife in South Sudan, which is likely to hold back export growth.

The Ugandan economy has continued to grow, but at a moderate pace. Preliminary data for FY 2015/16 show that GDP expanded by 4.6 per cent in real terms and by 11.6 per cent in nominal terms. The moderation in growth is largely attributed to uncertainty related to the recent electioneering, harsh international economic environment, including sluggish growth in our major trading partners and the crisis in South Sudan, and persistently soft commodity prices, which have affected exports.

The Consumer Price Index (CPI) data for July 2016 indicates that domestic cost pressures remain relatively subdued, with all components of inflation, save for food crops, declined in July 2016. Annual headline and core inflation declined to 5.1 and 5.7 per cent from 5.9 and 6.8 per cent, respectively in June 2016.

Compared to the June forecasts, the revised medium term outlook for headline and core inflation is softer. Both headline and core inflation are projected to decline to about 5.0 per cent by Q4-2016, premised on economic growth, which remains below potential. Although the exchange rate was expected to depreciate in the near term, its impact on domestic inflation is expected to be offset by the negative output gap.

The inflation outlook is highly contingent on the movements of the exchange rate, inflation expectations and the impact of weather-related risks on domestic food production. The external economic environment remains volatile, with substantial upside risks to the exchange rate. Domestically, forex demand, particularly for public infrastructure projects continues to grow and this may pose downward pressures on the exchange rate. The impact of weather-related risks on domestic food production and prices is real; there has been prolonged drought in major food producing parts of the country. Food crops inflation already reversed trend in June 2016, but the full impact of the dry spell is yet to materialise.

1 Background

This report presents domestic and external economic developments in the period to July 2016. It also assesses the future prospects and outlook for both the domestic and global economy, including projected domestic output and inflation. In addition, it discusses the 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 on the future direction of monetary policy in Uganda.

2 External Economic Environments

2.1 Global Economic Activity

On June 23 2016, the United Kingdom (UK) voted for an exit from the European Union (EU). The Brexit vote, from a macroeconomic perspective, implies a substantial increase in uncertainty in the short-and medium- to- long run. In the short-run, the uncertainty was mirrored by volatility in the global financial markets, with stock market declines, rallies in bond prices and wide swings in major currencies. The British pound dropped by a historical 7.6 per cent against the dollar, 21 times above the average daily movement in the pound-dollar exchange rate of 0.35 per cent since 2012.

In the medium- to- long run, the economic consequences of the Brexit become less about financial market disruptions and more about real economic activity. It will take at least two (2) years for the UK to negotiate the exit, leading to more uncertainty, which will hold back investment and economic activity. Global growth prospects for 2016 have continued to weaken, following the BREXIT vote, leading to a further downward revision of growth projections in July 2016 by the IMF. In the UK, growth for 2016 was downgraded to 1.7 per cent, from 2.2 per cent in 2015 and 1.9 per cent forecast in April 2016, due to the likely impact of the BREXIT vote.

The growth outlook worsened for Advanced Economies (AEs) – where growth was revised downwards by 0.1 percentage point (PP) and by 0.2 pps to 1.8 per cent in 2016 and 2017, on account of the Brexit. Growth in the Euro Area in 2016 was projected slightly higher at 1.6 per cent, given the outcomes in H1 2016 on the back of strengthening domestic demand among member countries. However, in light of increased uncertainty on consumer and business confidence due to the Brexit vote, growth in 2017 was forecast at 1.4 per cent. Growth projections in France, Italy and Spain were downgraded to 1.5, 0.9 and 2.6 per cent, respectively in 2016 and to 1.2, 1.0 and 2.1 per cent, respectively in 2017.

However, growth prospects remains broadly unchanged for Emerging Market and Developing Economies (EMDEs) at 4.1 and 4.6 per cent in 2016 and 2017, respectively. Growth in EMDEs continued to be plagued by the slow growth in AEs, the persistently low commodity prices, weak global trade and capital flows. Real activity indicators were a bit stronger in China on account of the policy stimulus, which included cutting benchmark lending rates five times in 2015, expansionary fiscal policy, and accelerated credit growth. China's growth outlook is broadly unchanged at 6.6 and 6.2 per cent in 2016 and 2017, respectively. The direct impact of the U.K referendum on China will likely be limited in light of the economy's low trade and financial exposure to the U.K and the authority's readiness to respond to achieve their growth target range. However, should growth in the European Union (EU) be affected significantly, the adverse impact on China could materialize.

Consumer and business confidence appear to have bottomed out in Brazil. Consequently, the 2016 recession was projected to be less severe, with a return to positive growth in 2017. However, the Zika virus in Latin America and Caribbean region was bound to adversely affect growth. In Russia, a rebound in oil prices was providing some relief, but prospects of a strong recovery are subdued given long-standing structural bottlenecks and the impact of sanctions on productivity and investment. In India, economic activity remains buoyant, but the growth forecast for 2016-17 was trimmed down slightly, reflecting a more sluggish investment recovery.

Growth in sub-Saharan Africa (SSA) was revised downward substantially by 1.4 pps to 1.6 per cent in 2016 and by 0.7 pp to 3.3 per cent in 2017. The downgrade reflects challenging macroeconomic conditions in its largest economies, which are adjusting to lower commodity revenues. Growth in Nigeria was projected to contract to *minus* 1.8 per cent in 2016, as the economy adjusts to foreign currency shortages because of lower oil receipts, low power generation and weak investor confidence. GDP growth in South Africa was projected to remain flat in 2016, with only a modest recovery in 2017. Climate related factors such as the drought in East and Southern Africa was also expected to adversely affect SSA growth. Global growth projections are presented in **Table 1**.

Table 1: Shifts in Global Growth Projection

	Share of Total Exports (%)	Outturn	Jan-16 Forecasts		Apr-16 Forecasts		Jul-16 Forecasts	
		2015	2016	2017	2016	2017	2016	2017
SSA		**3.4**	**4.0**	**4.7**	**3.0**	**4.0**	**1.6**	**3.3**
Kenya	16.3	5.6			6.0	6.1		
D.R.Congo	12.9	7.7			4.9	5.1		
South Sudan	12.8	-0.2			-7.8	8.2		
Rwanda	9.4	6.9			6.3	6.7		
Sudan	5.1	3.5			3.7	4.0		
Tanzania	3.1	7.0			6.9	6.8		
Burundi	2.1	-4.1			3.4	3.9		
Emerging Asia		**6.6**	**6.3**	**6.2**	**6.4**	**6.3**	**6.4**	**6.3**
China	2.0	6.9	6.3	6.0	6.5	6.2	6.6	6.2
Advanced		**1.9**	**2.1**	**2.1**	**1.9**	**2.0**	**1.8**	**1.8**
Euro Area	6.9	1.6	1.7	1.7	1.5	1.6	1.6	1.4
Switzerland	1.5	0.9			1.2	1.5		
USA	1.3	2.4	2.6	2.6	2.4	2.5	2.2	2.5
UK	1.1	2.2	2.2	2.2	1.9	2.2	1.7	1.3
MENA		**2.5**	**3.6**	**3.6**	**3.1**	**3.5**	**3.4**	**3.3**
UAE	5.7	3.9			2.4	2.6		
World		**3.1**	**3.4**	**3.6**	**3.2**	**3.5**	**3.1**	**3.4**
TOTAL	**80.1**							

Source: IMF, WEO July 2016 Update

2.2 Global Inflation

Global inflation remains subdued, particularly in AEs, in part driven by low commodity prices and subdued global demand. In June 2016, average inflation in key AEs rose to 0.5 per cent from 0.2 per cent in May 2016, with most of the increase coming from the UK on account of higher prices for services such as restaurants and hotels. In the World Economic Outlook (WEO) update for July 2016, inflation in AEs was projected to average 0.7 per cent, increasing to 1.6 per cent in 2017, remaining below most central banks targets.

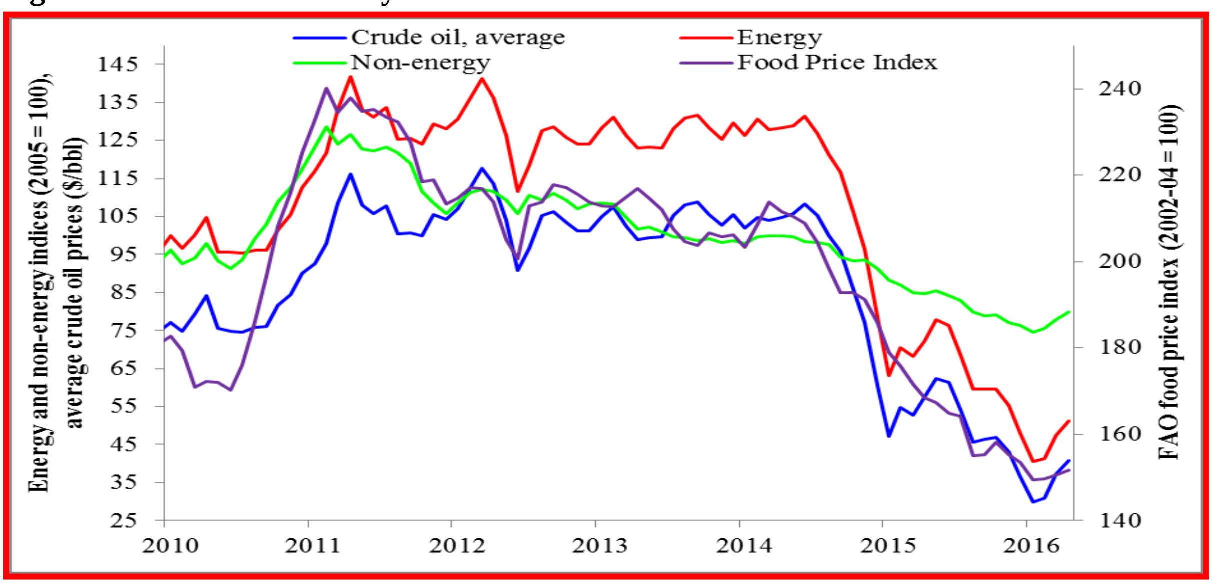
In EMDEs, inflation, which had risen to 4.7 per cent in 2015, was projected to decline slightly to 4.6 and 4.4 per cent in 2016 and 2017, respectively. Nonetheless, inflation remained relatively elevated in EMDEs compared to the trend in AEs, in part driven by the pass-through of sizeable currency depreciations that these economies experienced in 2015.

2.3 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 which averaged USD 50.8 per barrel in 2015, is now forecast to decline to USD 42.9 per barrel in 2016 but rise to USD 50 per barrel in 2017, mainly due to concerns regarding the UK referendum results and production disruptions mainly in Nigeria and Canada. However, the Organization of Petroleum Exporting Countries (OPEC) are expected to continue with high production levels, putting downward pressures on prices.

Global food prices, which had been subdued, rose in June 2016 by 4.2 per cent month–on-month (m-o-m) and by 9.4 per cent from January 2016 due to supply constraints in Brazil and EU. Food prices were expected to rise owing to drought conditions in Southern Africa and South America. The non-energy prices were 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: Global Commodity Prices



Source: World Bank and FAO

2.4 Global Financial Markets

Global financial markets had stabilized somewhat since the beginning of 2016 owing to monetary policy easing in Japan and the Euro Area, which lessened pressures arising from the normalization of the US monetary policy. The easing of monetary policy in Japan and in the Euro Area provided additional funding opportunities to markets. However, the BREXIT referendum renewed volatility in global financial markets as reflected in declines in equity prices, rallies in bond prices and wide movements of major currencies. Although the volatility in the global financial markets has subsided following the Bank of England proactive monetary policy and smooth political transition in mid-July 2016, equity valuations for UK and European banks remained lower than before. Additionally, yields on safe assets have declined further because of global risk aversion. In response to the referendum result, major central banks, particularly the European Central Bank (ECB) and the US Fed, indicated readiness to provide both domestic currency and foreign exchange liquidity, which supported investor confidence leading to relative stabilization of market conditions.

Following the Brexit, there was a general decline in yields particularly for AEs. Yields in the US, UK, Euro Area and Japan fell to 1.6, 1.1, 0.03 and -0.2 per cent in the quarter to July 2016 from 1.7, 1.4, 0.1 and -0.1 per cent, respectively, in the quarter to June 2016. The declines in yields reflected the compacted term premia, in addition to a gradual pace of monetary policy normalization.

In the currencies market, while the British Pound depreciated by 0.72 per USD in the quarter to July compared to 0.70 per USD in the quarter to June 2016, the Euro was relatively stable over the 4 months of April to July 2016 at 0.89 per USD. The Japanese Yen appreciated to 106.1/USD in the quarter to July 2016, from 108.1/USD in quarter to June 2016.

In EMDEs, asset prices and exchange rate movements were generally minimal following the Brexit vote, but capital flows have remained vulnerable to sudden changes in investors' risk appetite. The effect of the Brexit on the yields in EMDEs has so far been marginal. Yields in India, China, Brazil, South Africa and Russia declined only marginally from 7.5, 3.0, 12.9, 9.1 and 8.9 per cent in the quarter to June 2016 to 7.4, 2.9, 12.4, 9.0 and 8.7per cent, respectively in the quarter to July 2016. The South African Rand fell to 14.9/USD in the quarter to July

2016 from 15.0/USD in the quarter to June 2016. However, the Indian Rupee and Chinese Yuan depreciated to 67.2/USD and 6.6/USD in the quarter to July 2016 from 66.9/USD and 6.5/USD, respectively in the quarter to June 2016.

2.5 Implications for the Ugandan economy

The global economic environment continues to impact Uganda's economic developments. Adverse occurrences in the global arena can affect consumer and investor confidence and hold back domestic consumption and investment.

The major forces currently driving the global economic outlook are the Brexit and the soft commodity prices. The Brexit will continue to pose uncertainty, holding back investment and consumption in the UK and EU, affecting demand for Uganda's exports since the EU is one of Uganda's major trade partners. In addition, remittances and FDI inflows from the EU and UK are likely to slow down.

Crude oil prices have been on a decline since mid-2014, in part reflecting supply-side developments and lower growth in global demand. While this could support global activity through keeping domestic inflation in check in oil-importing economies, it could destabilize the outlook for oil-exporting countries, leading to a fall in exports earnings. Uganda, being an oil-importer, benefits from this scenario through the reduction in oil imports bill,. On the other hand, the persistently low oil prices could depress oil related FDI inflows to Uganda. This is bound to adversely affect Uganda's already weak balance of payment position. In addition, the renewed volatility in the global financial markets on account of the BREXIT vote could cause volatility in the domestic foreign exchange market with implications for the exchange rate.

3 Domestic Economic Developments

3.1 Reflections on Monetary Policy Stance and Implementation

3.1.1 Monetary Policy Stance

In August 2016, Bank of Uganda (BoU) eased monetary policy further, reducing the Central Bank Rate (CBR) by 1.0 PP to 14.0 per cent from 15 per cent in June 2016. This was warranted by the softer than expected inflation outlook. Inflation was forecast to converge around the BoU's medium term target of 5.0 per cent in Q4-2016, faster than earlier projected because of relative exchange rate stability and subdued domestic demand. While there were signs that economic growth had bottomed out, the recovery was expected to be slow. The BoU maintained the band on the CBR at +/-3 PPs and the margin on the Rediscount Rate at 4 PPs on the CBR. Consequently, the Rediscount Rate and the Bank Rate were set at 18 per cent and 19 per cent, respectively.

3.1.2 Monetary Policy Operations and Challenges

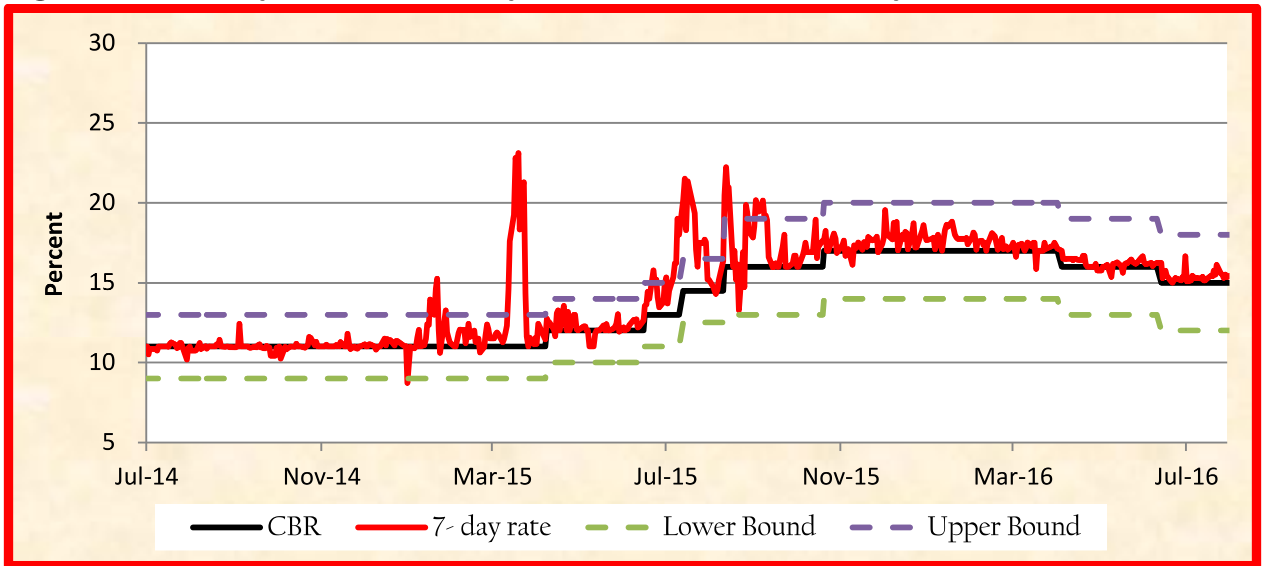
BoU continued to use Repurchase Agreement (REPOs)/ reverse REPOs and sales of recapitalization securities in the secondary market to align liquidity conditions in the domestic money market with the desired monetary policy stance. The net impact of the REPO/reverse REPO instrument in June to July 2016 was an injection of Shs. 235 billion, with the outstanding stock of REPOs at end July 2016 at Shs. 419 billion.

The remaining stock of recapitalisation securities, which the BoU uses to manage structural liquidity at end July 2016 stood at Shs. 325 billion. An additional Shs.100 billion will be acquired in the course of FY2016/17, bringing the total available stock of securities to Shs. 425 billion. Given the current state of structural liquidity in the system (about Shs. 800 billion), the available stock of securities will not be sufficient to manage structural liquidity.

3.1.3 Interbank Money Market Rates

Despite the structural liquidity overhang, the interbank money market rates evolved in line with the monetary policy stance. The 7-day money market rates declined marginally to 15.4 per cent in July 2016, from 15.7 per cent in June 2016, while the overnight weighted average interest rate (WAI) rose to 13.5 per cent in July 2016 from 11.3 per cent recorded in May 2016 and 9.9 per cent in March 2016 **(Figure 2)**.

Figure 2: The 7-day Interbank Money Market Rate and the Policy Rate



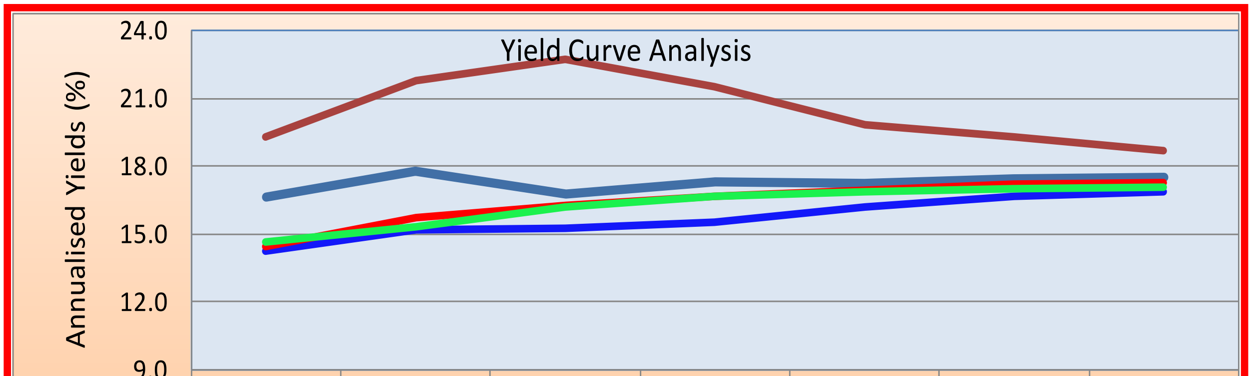
Source: Bank of Uganda

3.2 Other Interest Rates and Private Sector Credit

3.2.1 Yields on Government Securities

After a steady downward trend since the beginning of January 2016, yields on Government securities rose in June 2016, in part reflecting expectations of higher government borrowing during the close of the financial year. There were also under-subscriptions in the shorter dated securities, probably reflecting economic uncertainty in the near-to-short term. The average yields on the 91-day, 182-day and 364-day securities rose to 15.4 per cent, 16.2 per cent and 17.3 percent in the three months to August 2016 from respective rates of 14.8 per cent, 15.9 per cent and 16.0 per cent recorded in May 2016. The yield on the 2-year benchmark bond also rose to 16.6 per cent in August 2016 from 15.9 per cent in May 2016. As shown in **Figure 3,** the yield curve flattens over the horizon of the longer dated securities, in part implying stable inflation expectation over the long run.

Figure 3: Term structure of Yields on Government Securities



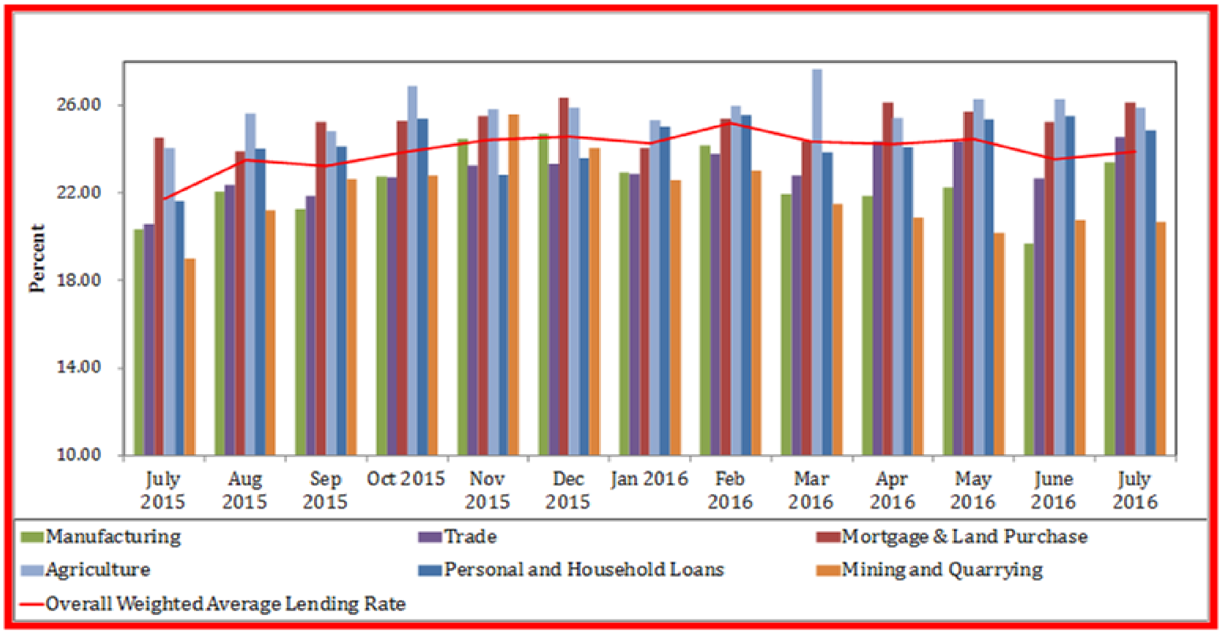
	91-days	182-days	364-days	2-years	5-years	10-years	15-years
Jan-2016	19.3	21.8	22.8	21.5	19.9	19.3	18.7
Mar-2016	16.6	17.8	16.8	17.3	17.3	17.5	17.5
May-2016	14.2	15.2	15.2	15.6	16.2	16.7	16.9
Jun-2016	14.5	15.7	16.3	16.7	16.9	17.2	17.3
Aug-2016	14.7	15.3	16.2	16.7	16.9	17.0	17.1

Source: Bank of Uganda

3.2.2 Lending and Deposit Rates

Lending rates remain elevated, in part reflecting provisioning for bad debt and structural rigidities in the financial sector, including the high cost of doing business. Lending rates however declined somewhat, following the easing of monetary policy in April and June 2016 and the decline in yields on Government securities. The Weighted Average Lending rate (WALR) for shilling denominated loans declined to 23.9 percent in July from an average of 24.5 percent during the first half of 2016. Lending rates on shilling-denominated loans declined across sectors, save for trade, mortgage & land purchase, and business services. Lending rates on forex-denominated loans also eased slightly, averaging 9.5 per cent in the three months to July 2016, down from 9.9 per cent in the three months to May 2016. Developments in lending rates on shilling-denominated loans are shown in **Figure 4**.

Figure 4: Lending Rates by Sector



Source: Bank of Uganda

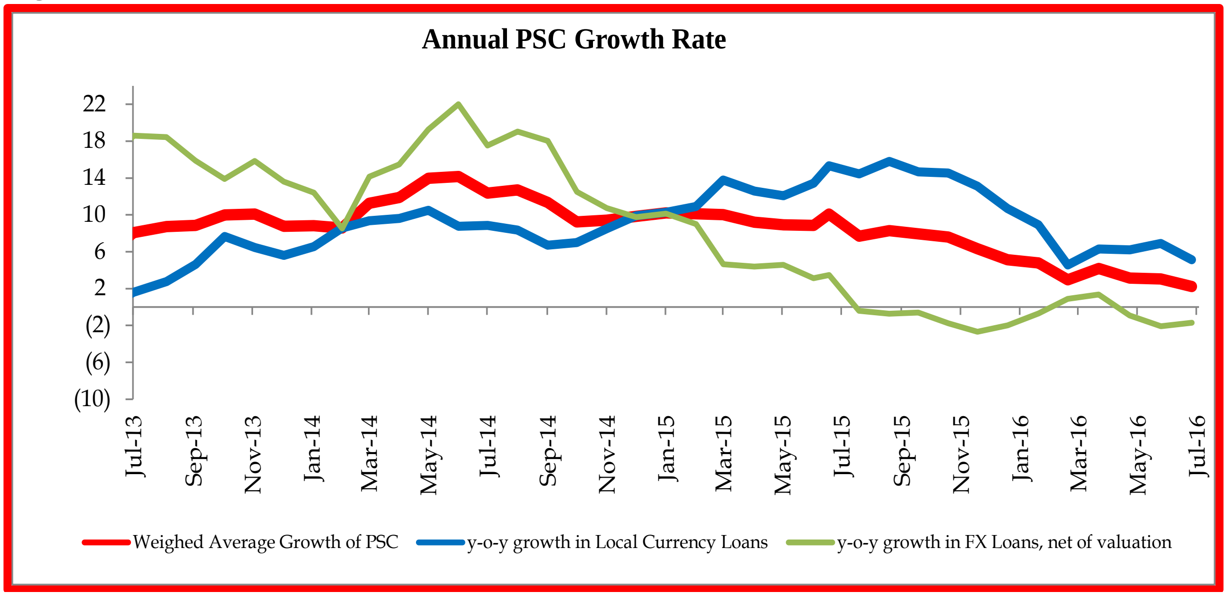
Notwithstanding the marginal reductions, lending rates remain elevated, in part reflecting provisioning for bad debt, lagged impact of the tight monetary policy stance and structural rigidities in the financial sector, including the high cost of doing business. Indeed, Non-Performing Loans (NPLs) as a ratio of gross loans increased from 4.0 per cent in June 2015 to 7.4 per cent in June 2016. 2016. Further increases in NPLs could heighten the risk aversion of commercial banks and further constrain credit growth. NPLs are likely to rise further, as assets previously classified as "under watch" are turned to Non-performing. The drastic increase in NPLs has been mainly driven by delayed payment by government to its contractors and suppliers, insufficient cash flows, diversion of borrowed funds, and the impact of political instability in South Sudan, among others. Further increases in NPLs could heighten the risk aversion of commercial banks and further constrain credit growth.

3.2.3 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 higher provisioning for bad loans as well as subdued economic activity. In nominal terms, average annual PSC growth declined from 9.9 per cent in the quarter to April 2016 to 4.5 per cent in the quarter to July 2016. The average annual growth in the shilling value of forex PSC declined from 14.5 per cent to 2.5 per cent. Growth in Shilling loans also declined from 6.6 per cent to 6.1 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 2.8 percent in the three months to July 2016, compared to 4.0 per cent in the quarters ended April 2016. Growth in foreign currency denominated loans declined by 1.6 per cent in the three months to July 2016, having grown by 0.5 per cent in the quarter ended April 2016. 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. Credit to the manufacturing, trade and business services (largely comprised of Small and Medium Enterprises (SMEs)) sectors however declined during the quarter to July 2016. Lending to all other sectors also slowed during the same period, save for electricity & water, and personal & household loans. Sectoral developments in private sector credit are shown in **Table 2.**

Table 2: Sectoral Developments in Private Sector Credit

	Annual Growth Rate							Average
	Jan-16	Feb-16	Mar-16	Apr-16	May-16	Jun-16	Jul-16	Share
Agriculture	18.40	14.99	14.99	15.16	11.49	10.41	11.07	10.36
Mining and Quarrying	51.20	65.45	66.68	47.80	48.31	39.40	46.28	0.63
Manufacturing	16.82	9.94	-0.67	2.36	-2.18	-5.47	-10.92	13.67
Trade	9.18	7.35	7.40	4.79	2.35	-3.10	-7.39	18.92
Transport and Communication	30.06	39.67	37.30	47.16	50.53	42.07	30.19	7.26
Electricity and Water	5.15	-2.62	10.68	-0.17	3.63	24.53	44.77	2.20
Building, Mortgage, Construction and Real Estate	17.87	16.15	11.66	11.63	10.40	5.47	2.23	22.53
Business Services	7.80	-6.12	-15.71	-18.06	-10.64	-15.77	-13.59	3.93
Community, Social & Other Services	5.64	6.96	12.88	10.42	11.18	7.25	8.38	3.43
Personal Loans and Household Loans	7.58	5.93	6.75	6.71	5.84	9.22	8.96	15.95
Other Services	12.98	2.67	10.93	28.47	22.92	0.19	-23.31	1.13
Total	13.90	11.20	8.69	9.02	7.59	4.41	1.54	100.00

Source: Bank of Uganda

3.3 Fiscal Policy and Operations

3.3.1 Fiscal Developments

Fiscal policy plays a critical role in the economy, both as a stabilization tool and in influencing the short-term growth prospects of the economy. A counter-cyclical fiscal expansion can help support aggregate demand and growth during 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 priorities of the National Development Plan (NDP) II the fiscal stance for FY 2015/16 focused on addressing infrastructural constraints in the economy in order to increase economic efficiency, foster growth and reduce the cost of doing business. Given the infrastructural gap, the consequence of this policy pursuit has been the widening fiscal deficit, which is now projected at 6.4 per cent of GDP.

The implementation of the budget for FY 2015/16 however faced several challenges. The fiscal data for FY 2015/16 indicates that total government revenue, including grants amounted to Shs. 12,645.1 billion, which was Shs. 562.9 billion lower than programmed, due to under performance in both revenue and grants. Domestic revenue amounted to Shs. 11,498.7 billion, Shs. 248.3 billion lower than the programme target. Grants receipts were also lower than programmed by Shs. 314.6 billion, largely due to an underperformance in project support grants. Total government expenditure and net lending amounted to Shs. 16,748.2 billion, which was Shs. 1,841.8 billion lower than programmed. The lower outturn was due to lower than programmed development expenditure, which underperformed by Shs. 1,111.2 billion. The underperformance in development expenditure was mainly due to lower than programmed expenditure on development projects. Current expenditure, on the other hand, amounted to Shs. 9,190.9 billion, which was Shs. 194.9billion higher than programmed.

The fiscal deficit (including grants) amounted to Shs. 4,103.2 billion, which was lower than programmed by Shs. 1,278.9 billion. Nonetheless, the budget was expansionary relative to the previous years. The deficit was financed from both external and domestic sources. External financing amounted to Shs. 2,493.8billion, while domestic financing amounted to Shs. 1,898.8 billion, of which Shs. 1,350.0 billion was through net issuance of Government securities and a drawdown on savings amounting to Shs. 548.80billion. Fiscal developments are shown in **Table 3**.

Table 3: Fiscal performance in FY 2015/16

(Shs. Billions)	Proj. Jul'15 – Jun'16	PSI Jul'15 – Jun'16	Diff	Proj Jul'116 – Jun'17
Revenue & Grants	**12,645.1**	**13,208.0**	**-562.9**	**15,071.0**
Domestic Revenue	**11,498.7**	**11,747.0**	**-248.3**	**13,386.0**
Tax	**11,059.1**	**11,040.0**	**19.1**	**12,585.0**
Grants	**1,146.4**	**1,461.0**	**-314.6**	**1,685.0**
Expenditure & Lending	**16,748.2**	**18,590.0**	**-1,841.8**	**20,875.0**
Current Expenditure	**9,190.9**	**8,996.0**	**194.9**	**9,656.0**
Development Expenditure	**5,905.8**	**7,017.0**	**-1,111.2**	**9,087.0**
Overall Fiscal Bal. (excl. Grants)	**-5,249.5**	**-6,843.0**	**1,593.5**	**-7,489.0**
Overall Fiscal Bal. (incl. Grants)	**-4,103.1**	**-5,382.0**	**1,278.9**	**-5,804.0**
Financing (net)	**4,103.1**	**5,382.0**	**-1,278.9**	**5,804.0**
External Financing (net)	**2,493.8**	**4,017.0**	**-1,523.2**	**4,969.0**
Domestic Financing(net)	**1,898.8**	**1,365.0**	**533.8**	**835.0**
Errors & Omissions	**-289.6**	**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 addressing the infrastructural constraints in the economy in order to increase economic efficiency, reduce the cost of doing business and foster growth. Total government expenditures and lending was projected at Shs 20,875 billion, while domestic revenues are projected to increase to Shs. 13,386.0 billion from Shs. 11,498.5 billion in FY 2015/16. The increase in domestic revenues is expected to 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 financed 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. This domestic financing requirement however seems unrealistic given the underperformance in Government Revenues in FY 2015/16. Overall, if the budget is executed as proposed, it could crowd-in private sector and spur growth because of the relatively lower domestic financing requirements.

3.3.2 Public Debt

The provisional total debt stock in nominal value terms, including commitments, as at end June 2016 stood at shs 46.1 trillion (which is about 52% of GDP). Disbursed debt was Shs. 29.0 trillion (about 34.4% of GDP), an increase of Shs. 4.7 trillion relative to June 2015.Domestic debt as at end June 2016 amounted to Shs. 11.5 trillion, while external debt amounted to US$ 5.1 billion (which is equivalent to Shs. 17,448.4 trillion). External debt cost & risk indicators were within the Public Debt Management Framework (PDMF) medium-term benchmarks. Developments in total public debt stock are shown in **Table 4.**

Table 4: Public Debt Stock and Risk Indicators

Debt Indicators	PMMF	June 2015	June 2016 (Prov.)
Total Gross Public Debt External Debt (US$, Mn) External Debt (Shs. Bn) Domestic Debt (Nominal, Shs. Bn)		24,334.5 4,380.1 14,462.2 9,872.3	28,982.7 5,124.5 17,448.4 11,534.3
Nominal Debt as a percentage of GDP External Domestic		32.7 19.4 13.3	34.4 20.7 13.7
PV of Total Public Debt as a percentage of GDP External Domestic	<50% <30% <20%	23.8 10.4 13.3	23.9 11.7 12.2
Domestic Debt Stock/Private Sector Credit (at nominal value)	<75%	90.0	100.9
Percentage of domestic maturing in 1 year	<40%	46.7	44.5
Percentage of domestic maturing after 1 year	<20%	15.6% [Yr 2] &5.6 [Yr 3]	11.3% [Yr 2] &7.8 [Yr 3]
Bonds/Bills [at face value]	70/30	66/34	66/34
Average time to maturity	>3 years	3.0	3.3

Source: Bank of Uganda

3.4 Balance of Payments and Exchange Rates

3.4.1 Balance of Payments

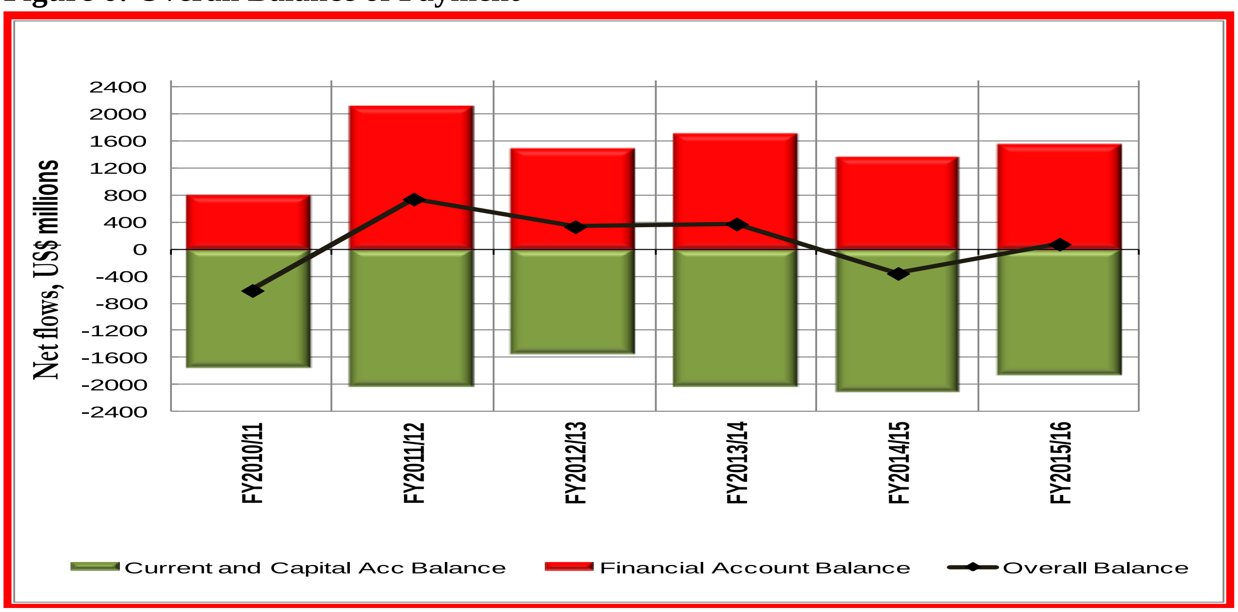
Preliminary estimates indicate that the balance of payments recorded a surplus balance of USD 80.2 million in FY 2015/16, a USD 433.0 million improvement from a deficit of USD 352.8 million recorded in FY 2014/15. The external current account deficit improved, largely driven by a decline in private sector import bill, reflecting a combination of low global crude oil prices and subdued domestic demand. Total private sector imports declined by 17.7 per cent—non-oil imports declined by 14.5 per cent—mainly driven by declines in imports of capital and intermediate goods (19.6 per cent) and consumption goods (12.9 per cent). Export growth on the other hand remained subdued, reflecting weak global demand, low commodity prices and the fragility and violent conflicts in South Sudan (the exposure to South Sudan was 11 per cent of Uganda's total exports in 2015. The deficit on the primary income account worsened by 63.9 per cent, from USD 669.8 million to USD 1,097.9 million, in FY 2015/16.

The financial account continued to be the main source of financing of the deficit in the current account. Net inflows in the financial account increased by USD 182.6 million in FY 2014/15, largely driven by project support disbursements, which more than doubled to USD 807 million compared to USD 385 million in FY 2014/15. FDI on the other hand declined by 17.0 per cent to USD 916 million largely on account of the lower oil-related investments.

In the quarter ended June 2016, net inflows (liabilities) through the financial account increased by 13.6 per cent, to USD 369 million driven by developments in portfolio outflows, which contracted by over 50 per cent to USD 20 million. As a result of a USD 62 million increase in holding of long term debt securities by non-residents, direct investment inflows increased slightly to USD 225 million, from USD 222 million and other investments inflows (that include loans, trade credits, currency and deposits), decreased by 10.8 per cent q-o-q to USD 163 million.

The overall balance of payments was a surplus of USD 116 million during the quarter ended June 2016, leading to a net build up in reserves of USD 114 million. Developments in the BoP and its main components are shown in **Figure 6**.

Figure 6: Overall Balance of Payment



Source: Bank of Uganda

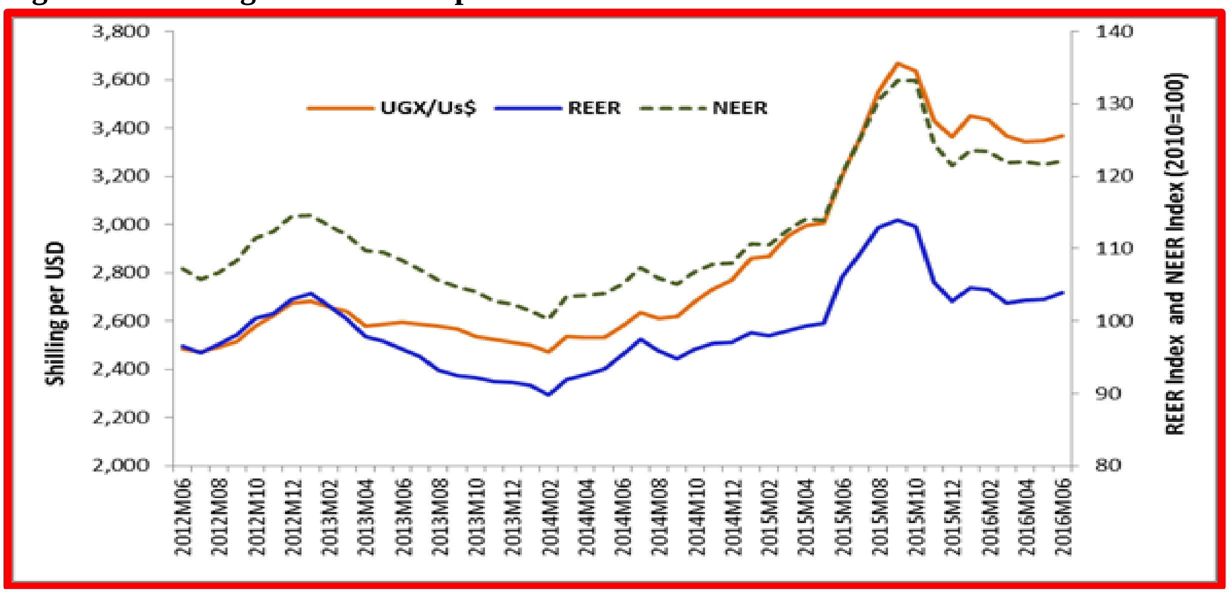
The stock of reserves at the end of June 2016 was USD 2.94 billion, equivalent to 4.3 months of future import cover. In terms of the outlook, the current account deficit is likely to remain weak in the short- to medium-term on account of subdued exports, a pickup in imports by government as well as the private sector.

3.4.2 Exchange Rate Developments

The depreciation pressures, which peaked in September 2015 when the Shilling depreciated by 40 per cent y-o-y against the USD has since reversed. In July 2016, the Shilling was relatively stable, depreciating slightly by 0.3 per cent m-o-m and by 0.6 per cent y-o-y to an average mid-rate of Shs. 3,375.6 per USD. The relative stability was largely because of subdued demand for imports and stronger inflows from offshore players. On a trade-weighted basis, the Shilling was relatively stable, depreciating by 0.1 per cent, m-o-m in July 2016, in line with movement of the currencies of Uganda's trading partners against the US Dollar.

On annual basis, the NEER appreciated by 2.2 per cent. The Real Effective Exchange Rate (REER) depreciated by 0.9 per cent, m-o-m, and appreciated by 2 per cent, y-o-y, in June 2016, mainly due to a slower pace of depreciation in the NEER (**Figure 7**). The REER appreciation has negative implications for the price-competitiveness of the export sector.

Figure 7: Exchange Rates Developments



Source: Bank of Uganda

BoU sold and bought dollars in the interbank foreign exchange market (IFEM) in a bid to stem volatility in the exchange rate market and suspended purchases for reserve build-up on days of elevated volatility. In July 2016, BoU purchased USD 93.7 million for reserve build-up, higher than USD 60.8 million bought in June 2016. Sales to UETCL amounted to USD 15.06 million, bringing the net BOU action in the IFEM during the month to a purchase of USD 78.6 million. Going forward, the Shilling is expected to weaken on account of sustained government dollar demand for infrastructure projects and other import, widening current account position, particularly in light of continued pickup in international crude oil prices, strife in South Sudan amidst volatile global financial markets. A depreciated exchange rate is likely to feed through to domestic inflation going forward and may restrict BOU's efforts to meet its foreign reserve target for FY 2016/17.

3.5 Domestic Economic Activity

The Ugandan economy has continued to grow, but at a moderate pace. Preliminary data for FY 2015/16 show that GDP expanded by 4.6 per cent in real terms and by 11.6 per cent in nominal terms (**Table 5**). The 4.6 per cent real GDP growth was slightly lower than the 5.0 per cent recorded in 2014/15, but it is in line with the average of 4.6 per cent in the last four years. The moderation in growth is largely attributed to uncertainty related to the recent electioneering, harsh international economic environment, including sluggish growth in our major trading partners, the crisis in South Sudan, and persistently soft commodity prices, which will affect net exports.

Table 5: GDP Growth Rates

Real Growth Rates			
	Average 2011/12-2015/16	2014/15	2015/16
GDP	4.6	5.0	4.6
Traded goods	2.9	5.1	2.4
Non Traded goods	5.6	4.4	6.4
Nominal Growth Rates			
	Average 2011/12-2015/16	2014/15	2015/16
GDP	10.0	11.1	11.6
Traded goods	5.3	7.5	7.4
Non Traded goods	12.4	12.0	14.6

Source: Uganda Bureau of Statistics

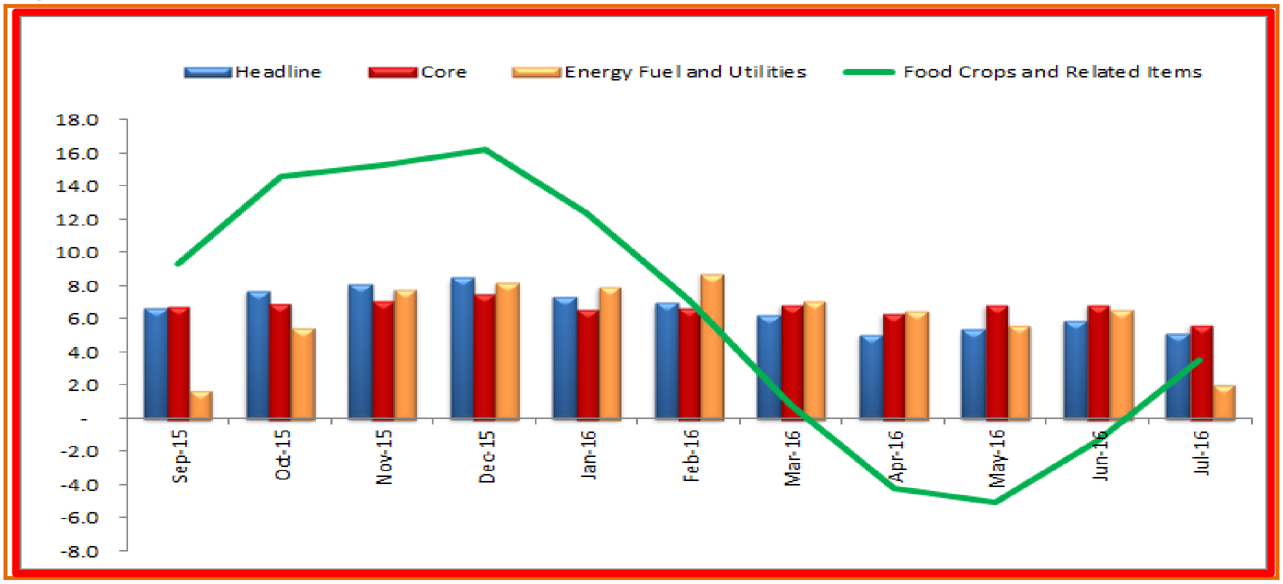
Supply side constraints have characterized the economy in recent years, including a slowdown in labour force growth (labor force growth was a major contributor to growth in the 2000s), productivity growth as most of the labour force is absorbed in micro-enterprises, and misallocation of capital in sectors with low returns such as real estate. Also, investment in the oil sector, which has comprised about half of FDI, has not yet yielded any significant contribution to GDP. Real GDP growth has been mediocre since 2008/09, averaging about 5.0 per cent, so that the performance in FY 2015/16 was not so far below the recent historical average.

3.6 Consumer Price Inflation

3.6.1 Recent Inflation Developments

The Consumer Price Index (CPI) data for July 2016 indicates that domestic cost pressures remain relatively subdued, with all components of inflation, save food crops, declined in July 2016. Indeed, annual headline and core inflation declined to 5.1 and 5.7 per cent from 5.9 and 6.8 per cent, respectively in June 2016. Similarly, annual Energy Fuel and Utilities (EFU) inflation also declined from 6.6 per cent to 2.1 per cent, and so was other goods, services and non-food inflation, which declined to 5.8, 5.5 and 5.1 per cent, from 7.4, 6.1 and 6.4 per cent, respectively. Annual Food crops inflation however jumped to 3.5 per cent from *minus* 1.3 per cent, largely driven by increases in prices of food crops and related items due to adverse weather conditions. On a monthly basis, headline inflation remained flat while all other components declined except food-related inflation, which picked somewhat. Developments in annual inflation are shown in **Figure 8**.

Figure 8: Annual Inflation Developments



Source: Uganda Bureau of Statistics

Various components of inflation suggest convergence of inflation to the 5 per cent target, largely due to subdued aggregate demand and relatively stable exchange rate. In the quarter to July 2016, overall inflation eased to an average of 5.4 per cent from 6.1 per cent in the quarter to April 2016. Over the same period, core inflation also eased, albeit slightly to an average of 6.4 per cent from 6.6 per cent. Similarly, other goods inflation eased to 6.8 per cent from 7.3 per cent. However, services and non-food inflation, edged up to 6.0 and 6.1 per cent, respectively, from 5.6 and 5.9 per cent over the same period.

3.6.2 Inflation Outlook

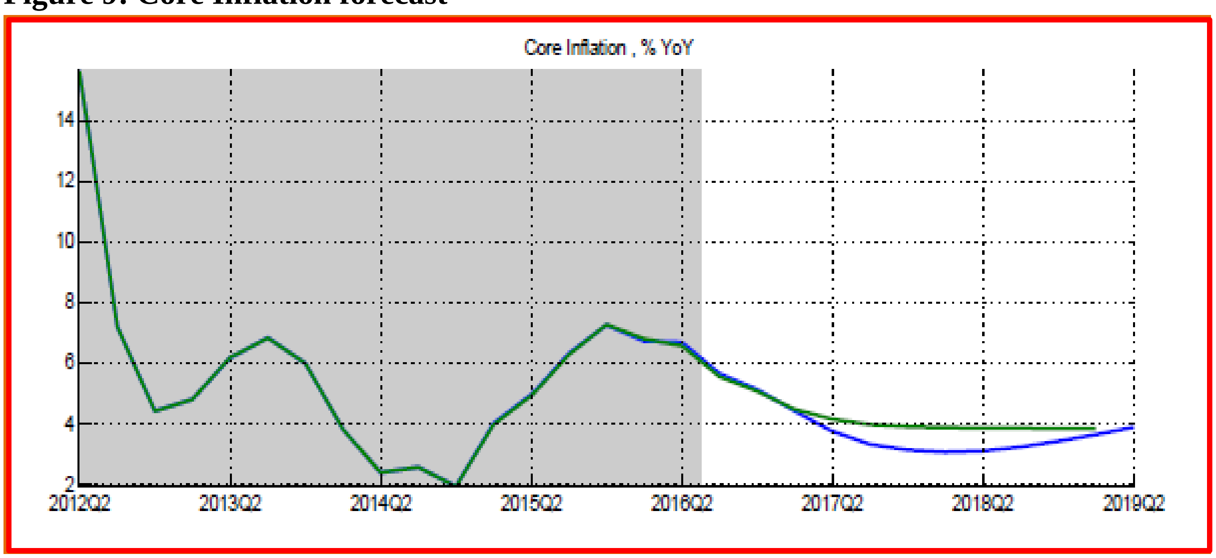
The weak external economic environment will continue to weigh heavily on inflation, both directly through persistently lower import prices and indirectly by dampening domestic economic activity. The recent Brexit has created uncertainty in the global economy with dire implications for global financial markets. Global commodity prices remain soft, and in particular, oil prices remain low and will remain below USD 60 per barrel. Global food prices also remain soft, but are expected to increase modestly on account of poor harvests due to bad weather in Latin America and Southern Africa. Global inflation is set to remain below 2 per cent on account of low commodity prices and weak global demand conditions. The global output gap remains negative and is projected to remain so, at least in the near term.

In the region, instability in South Sudan, if continued could put upward pressures on the exchange rate with negative implications for the external current account. The exchange rate continues to be a critical determinant of Uganda's inflation trajectory, given the high percentage of tradable goods in the consumption basket. If the external economic environment remains volatile, it will cause substantial upside risks to the exchange rate with the resultant pass-through to domestic inflation.

In the domestic market, demand for forex continues to grow, especially for public infrastructure projects. This may increase demand pressures in the foreign exchange market. Domestic food prices are forecast to edge-up slightly over the near-term, on account of drought over the last three months.

Economic growth remains below potential and is forecast to remain so, at least in the near-term. The negative capacity gap constitutes a downside risk to domestic inflation. Although the exchange rate was expected to depreciate in the near term, its impact on domestic inflation is expected to be offset by the negative output gap. Compared to the June Forecasts, the revised outlook for headline and core inflation is softer in the near term. Both headline and core inflation are projected to decline to about 5.0 per cent by Q4-2016, faster than earlier projected. The core inflation forecasts are shown in **Figure 9**.

Figure 9: Core Inflation forecast



Source: Bank of Uganda

4 Conclusion

The economy continues to recover at a gradual pace supported by public investment and domestic consumption. However, private investment seems to have weakened, unexpectedly, reflecting a number of factors, both global and domestic. Globally, the slowdown in growth in global demand and heightened uncertainty has contributed to the downturn in investment. Domestically, the pass-through of Q3-2015 depreciations of the exchange rate has caused a decline in investment in addition to the tight financial conditions and uncertainty related to the recent elections. Furthermore, the weak global demand is set to cause a contraction in merchandise exports and thereby dampen the contribution of the external sector to overall economic growth.

The output gap is expected to close somewhat towards the end of 2017. However, the timing of the closing of the gap is highly uncertain and dependant on the revisions to projections of both real and potential output. The profile for potential output depends on the projection for investment spending, and both are currently subject to unusual uncertainty as a result of the economy's ongoing complex structural adjustment as well as the difficult-to- forecast effects of the Brexit.

Inflation continued to decline in July 2016, mainly driven by a relatively stable exchange rate and weak global and domestic environment. Nonetheless, the decline could be temporary if the exchange rate depreciation pressures re-emerge stronger than expected. While it is assumed that the exchange rate will remain stable over the forecast period, a number of influences, both domestic and external may cause upheavals. The external economic environment remains volatile, with substantial upside risks. The instability in South Sudan could further put upward pressures on the exchange rate due to subdued export earnings.

Domestic forex demand, particularly for public infrastructure projects continues to grow. This may increase demand pressures in the foreign exchange market. The improvement in the inflation outlook is nonetheless contingent on the speed at which the exchange rate will depreciate, inflation expectations and the impact of weather- related risks on domestic food production. The Bank of Uganda judges that the risks to the projected path for inflation are roughly on the downside and inflation is projected to return to the target band slightly faster than previously assessed. The Bank of Uganda therefore considered it appropriate to ease further monetary policy to support a recovery of economic activity.

Appendix 2: Balance of Payments

	2011/12	2012/13	2013/14	2014/15	2015/16
Current account	-2,042.38	-1,582.39	-2,109.53	-2,188.55	-2,047.25
Trade Account balance	-2,574.04	-2,122.96	-2,367.18	-2,249.64	-1,712.71
Services Account balance	-412.11	-404.78	-330.52	-674.54	-689.04
Primary income balance	-470.68	-527.59	-616.19	-671.43	-1,102.52
Secondary income balance	1,414.45	1,472.94	1,204.36	1,407.06	1,457.01
Capital account balance	17.60	32.74	91.05	99.08	119.81
Current and Capital Account Balance	-2,024.78	-1,549.65	-2,018.48	-2,089.47	-1927.439
Financial Account	2,098.36	1,485.90	1,701.93	1,630.69	1,545.14
Direct investment	1,243.87	939.86	1,087.38	1,103.69	915.93
Portfolio investment	264.67	-46.52	4.77	-161.82	-174.92
Other investment	577.50	591.79	608.55	683.58	801.42
Net errors and omissions	672.98	401.80	695.03	384.23	461.09
Overall Balance	746.55	338.05	378.49	-74.55	78.78

Appendix 3: Decomposition of Merchandise Exports

	2011/12	2012/13	2013/14	2014/15	2015/16
Total Exports (US$ Mn)	**2,667.43**	**2,912.11**	**2,706.33**	**2,738.37**	**2,704.55**
A. Total Formal Exports:	**2,284.10**	**2,443.56**	**2,310.65**	**2,299.79**	**2,314.85**
1. Coffee:	**444.21**	**422.69**	**404.00**	**400.49**	**351.90**
2. Non-Coffee formal exports:	**1,839.89**	**2,020.87**	**1,906.65**	**1,899.29**	**1,962.95**
Electricity	17.28	15.57	27.19	24.43	17.10
Gold	11.47	4.94	0.25	0.23	204.26
Cotton	77.59	36.46	21.75	18.18	24.29
Tea	71.59	86.20	83.22	73.37	74.79
Tobacco	57.23	72.72	94.04	63.22	88.60
Fish & its prod. (excl. regional)	137.81	108.61	110.18	136.82	114.65
Hides & skins	39.01	47.08	74.82	67.57	55.53
Simsim	13.15	23.54	45.56	50.75	29.55
Maize	47.03	54.43	35.74	74.19	79.83
Beans	15.22	16.12	20.32	37.62	49.77
Flowers	55.55	52.99	59.05	55.28	49.10
Oil re-exports	117.59	137.34	142.04	143.33	122.52
Cobalt	13.70	15.82	3.78	0.00	0.00
Others	1,165.67	1,349.05	1,188.72	1,154.31	1,052.96
B. ICBT Exports:	**383.33**	**468.55**	**395.68**	**438.58**	**389.70**
Maize	21.39	59.51	23.84	31.48	20.23
Beans	19.41	22.06	22.70	20.95	22.70
Sugar	3.17	3.55	1.98	4.64	1.58
Other grains	7.96	8.54	4.36	5.20	3.06
Bananas	4.96	5.86	4.90	5.03	4.19
Other agricultural commodities	53.03	67.48	68.47	66.68	45.28
Fish	30.55	39.90	35.87	41.91	40.38
Industrial products	241.02	260.19	232.45	261.32	250.91
Other products	1.82	1.47	1.10	1.37	1.37