Bank of Uganda

State of the Economy

June 2017

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Acronyms and Abbreviations

AEs	Advanced Economies
BoP	Balance of Payments
BoU	Bank of Uganda
CA	Current Account
CAD	Current Account deficit
CBR	Central Bank Rate
CPI	Consumer Price Index
EU	European Union
EFU	Energy, Fuel and Utilities
EMDEs	Emerging Market and Developing Economies
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IFEM	Interbank Foreign Exchange Market
IMF	International Monetary Fund
M-o-M	Month-on-Month
NEER	Nominal Effective Exchange Rate
NPL	Non- Performing Loans
OPEC	Organization of Petroleum Exporting Countries
PDMF	Public Debt Management Framework
PPs	Per centage Points
PSC	Private Sector Credit
PSI	Policy Support Instrument
q-o-q	Quarter on Quarter
REER	Real Effective Exchange Rate
REPOs	Repurchase Agreements
SMEs	Small and Medium Enterprises
SSA	Sub- Saharan Africa
T-Bills	Treasury bills
T-Bonds	Treasury bonds
UK	United Kingdom
US	United States
USD	United States Dollar
WAI	Weighted Average Interest rate
WEO	World Economic Outlook
WALR	Weighted Average Lending Rate
Y-o-Y	Year-on-Year

Executive Summary

1) *Global growth is gaining momentum from a broad-based recovery in trade, manufacturing and investment. The IMF is projecting global growth of 3.5 per cent in 2017 and 3.6 per cent in 2018, an upward revision of 0.1 per centage point (PP) for 2017 relative to the October 2016 World Economic Outlook (WEO) and cumulative increase of ½ PPs relative to 3.1 per cent in 2016. GDP growth in major Advanced Economies (AEs) has been at or above estimates of potential growth over recent years, supported by accommodative monetary policy and, more recently, less contractionary fiscal policies. The uptick for 2017 and beyond is expected to be driven primarily by improvement in consumer and business confidence in the AEs and stronger activity in Emerging Market and Developing Economies (EMDEs) helped by easing conditions in commodity exporters due to the partial recovery in commodity prices.*

2) *Global annual inflation has edged up, particularly more strongly in AEs. The rise of energy prices in the 12 months to April 2017 helped to boost global inflation. In the quarter to April 2017, annual consumer price inflation in AEs rose to 1.7 per cent, relative to 1.3 per cent in the quarter to January 2017 and 0.8 per cent in 2016. Annual core inflation, in contrast, increased only mildly. When the contribution from increases in energy prices diminishes in the period ahead, other prices are instead expected to rise at a faster rate as a result of rising resource utilisation.*

3) *Global financial market sentiment remains generally buoyant, supported by expectations of a sustained pick-up in global economic growth and receding concerns of disruptive political developments. Long-term nominal and real interest rates have risen substantially since August 2016, especially since the US election in November 2016. As of end-March, nominal yields on 10-year U.S. Treasury bonds had increased by some 85 basis points (bps), relative to August and 55 bps compared with just before the U.S. election. Long term rates increased sharply in the United Kingdom as well, reflecting spill overs from higher US rates and expectations of a less accommodative monetary policy stance going forward, given rising inflation pressure. The increase in euro area long-term yields after August was more moderate—about 40 bps in Germany—but Italian yields rose more sharply (about 120 bps), reflecting elevated political and banking sector uncertainties. However, emerging markets are still vulnerable to rising rates. Bank of England and the European Central Bank (ECB) could follow the Fed to tighten policy and then the liquidity cushion that has comforted*

emerging markets may begin to deflate. This could spill over into fast depreciating exchange rates.

4) *On the domestic scene, in line with the continued easing of monetary policy stance, money market rates in general have declined substantially. The weighted average 7-day money market rate declined to 11.2 per cent in Q4 2016/17, down from 11.9 per cent in the quarter to March 2017 and 16.1 per cent in the quarter to June 2016. Average yields on the 91-day, 182-day and 364-day Treasury bills (T-bills) declined to 10.7, 11.9 and 13.7 per cent, respectively in the quarter to June 2017, relative to 13.0, 13.7 and 14.3 per cent in the quarter to March 2017 and 21.1, 23.5 and 23.7 per cent in February 2016. Average yield on Treasury Bonds (T-Bonds) also declined. The average yields on the benchmark 2-year, 5-year, 10-year and 15-year T-bonds declined to 15.1, 14.9, 16.1, and 16.4 per cent, respectively quarter to June 2017, from 15.6, 15.5, 16.6 and 16.9 per cent in the quarter to March 2017 and from 22.3, 20.3, 19, and 18.7 per cent, respectively in February 2016.*

5) *The easing of monetary policy stance has continued to feed through to commercial bank interest rates, though with a lag. The weighted average lending rate on shilling denominated loans has fallen by a cumulative 4.2 PPs to 21.04 per cent in May 2017, from a peak of 25.2 per cent in February 2016, which is marginally lower than the 6 PPs reduction in the CBR over the same period. Similarly, rates on the US dollar denominated loans have also declined to 8.2 per cent in May 2017 from the average highs of 9.9 per cent in Q4-2016 and 10.1 per cent recorded in February 2016.*

6) *During the FY 2016/17, growth in Private Sector Credit (PSC) remains subdued, despite the monetary policy easing. In the first eleven months of FY 2016/17, PSC recorded a growth rate of 4.2 per cent, which is lower when compared to 16.2 per cent growth rate over the corresponding period of FY 2015/16. In May 2017, annual PSC growth declined slightly by 0.6 PPs to 5.7 per cent, relative to 6.3 per cent in April 2017. On a quarterly basis, PSC growth also slowed down to 6.0 per cent, in the quarter to May 2017, compared to 6.3 per cent growth in the quarter to February 2017.*

7) *The fiscal stance for FY 2016/17 focused on addressing infrastructural constraints in the economy. The implementation of the budget however has been hampered by weak external financing due to slow execution of public investment. The fiscal deficit for 2016/17 is now projected at 3.5 per cent of GDP, which is lower that was initially*

projected at 6.6 per cent and 4.9 per cent in 2015/16 Preliminary fiscal data for the first eleven months of FY 2016/17 indicates that the fiscal deficit (including grants) amounted to Shs. 2,600.3 billion, which is substantially less than the programmed deficit for this period of Shs. 5,202.0 billion by Shs. 2,601.7 billion. Government expenditure and revenue over the period amounted to Shs. 14,910.6 billion and Shs. 12,310.3 billion, respectively, which was Shs. 3,729.4 billion and Shs. 1,127.7 billion lower than the respective programmed levels. The fiscal deficit was mainly financed by external financing.

8) *The provisional total public debt stock at nominal value stood at Shs. 33,794.9 billion, corresponding to 14.1 per cent growth in the public debt stock between June 2016 and May 2017. The growth in the public debt stock was mainly due to growth in the public external debt, which had a dominant share of 62.4 per cent of the total public debt. As at end May 2017 most of the public domestic cost and risk indicators were outside the Public Debt Management Framework (PDMF 2013) benchmarks, but improved markedly relative to June 2016.*

9) *In the twelve months to May 2017, the current account balance (CAB) improved by 29.8 per cent to US$1094.7 million from US$ 1559.9 million in the twelve months to May 2016. Trade balance improved by 26.8 per cent from a deficit of US$1921 million to US$1405.4 million in the same period. Exports increased by 16 per cent from US$ 2690.2 million in the twelve months to May 2016 to US$3121.9 million in twelve months to May 2017. On the other hand, imports of goods (FOB) declined by 1.8 per cent from US$4611.2 million to US$4527.4 million in the same period. Imports for consumption increased by 6.1 per cent while imports of capital and intermediate goods declined by 3 per cent in the same period.*

10) *Uganda's exchange rate is market determined, and is therefore vulnerable to both external and domestic shocks. In June 2017, the shilling strengthened, appreciating by 0.9 per cent, month-on-month (m-o-m), albeit depreciated by 6.6 per cent, on year-on-year basis, to an average mid-rate of UGX 3,591.17 per US Dollar. This appreciation was due to stronger inflows, particularly from NGOs, coffee receipts, forex bureaux, and NSSF receipts from offshore investments.*

11) *Real Gross Domestic Product (GDP) growth is estimated to have slowed to 3.9 per cent in 2016/17, 0.6 PPs lower than the revised projection of 4.5 per cent and 0.9 PPs lower than the outturn of 4.8 per cent in FY 2015/16. The deceleration in growth was due to a combination of domestic factors, including adverse weather conditions on agricultural output, tight financial conditions that culminated into low private sector credit growth and slow implementation of government infrastructure projects. Growth in all sectors slowed: agricultural output contracted by 1.3 per cent, from 2.8 per cent in 2015/16; industrial sector growth slowed to 3.4 per cent, relative to 4.7 per cent in the previous year, and growth in services sector slowed to 5.1 per cent, compared to 5.9 per cent in 2015/16.*

12) *The disinflationary trend observed in the greater part of 2016, reversed in Q4-2016. After annual headline inflation bottoming at 4.1 per cent in October 2016, it gradually rose to 6.8 per cent in April and further to 7.2 per cent in May 2017. Similarly, Core inflation rose to 5.1 per cent in May 2017 from 4.9 per cent in April, after lows of 4.2 per cent in September 2016. The increase in inflation was mainly driven by food crops prices at the back of the prolonged drought which engulfed the country during the first three quarters of 2016/17, the rebound in the international oil prices and shilling depreciation pressures registered during the second quarter of this financial year. In the year ended June 2017, annual headline and core inflation declined to 6.4 per cent and 4.9 per cent, respectively. The drop in annual headline inflation was due to the decline in annual food crops inflation which recorded 18.1 per cent for the year ending June 2017 compared to 23.1 per cent for the year ended May 2017. Annual core inflation declined due to a decline in services inflation, which declined to 3.9 per cent for the year ending June 2017 compared to 4.5 per cent recorded during the year ended May 2017. Overall, despite the occasional surges in food prices and exchange rate depreciation, inflation has been maintained around the target rate over the last four financial years, with headline and core inflation averaging 5.1 per cent and 4.9 per cent, respectively.*

13) *Inflation forecast indicates that inflation continues to evolve broadly as had been previously forecasted. Both annual headline and core inflation are currently forecast to stabilize around the BoU medium term of 5.0 per cent in the second half of 2017. The Bank reiterates its commitment to conduct monetary policy with flexibility, so that projected inflation is maintained at 5.0 per cent over the policy horizon.*

1 Back ground

This report presents domestic and external economic developments in the period to May 2017, extending into June 2017 where data is available. 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 Global Economic Environment

2.1 Global Economic Activity

Global growth is gaining momentum from a broad-based recovery in trade, manufacturing and investment. The IMF is projecting global growth at 3.5 per cent in 2017 and 3.6 per cent in 2018, an upward revision of 0.1 per centage point (PP) for 2017 relative to the October 2016 World Economic Outlook (WEO) and cumulative increase of ½ PPs relative to 3.1 per cent in 2016. GDP growth in major Advanced Economies (AEs) has been at or above estimates of potential growth over recent years, supported by accommodative monetary policy and, more recently, less contractionary fiscal policies. The uptick for 2017 and beyond is expected to be driven primarily by improvement in consumer and business confidence in the AEs and stronger activity in Emerging Market and Developing Economies (EMDEs) helped by easing conditions in commodity exporters due to the partial recovery in commodity prices. Global growth projections, discussed in detail hereunder, are presented in **Table 1**.

Growth in AEs as a whole is projected at 2.0 per cent in 2017 and 2018, which is 0.2 PPs higher relative to October 2016 WEO. This stronger outlook reflects a projected cyclical recovery in global manufacturing, signs of which were visible at the end of 2016, and an uptick in confidence, especially after the US elections, which are expected to fuel the cyclical momentum. Growth forecast for the US has been revised by a cumulative increase of ½ PPs to 2.3 and 2.5 per cent for 2017 and 2018, respectively, reflecting the momentum from H2 of 2016, driven by a cyclical recovery in inventory accumulation, solid consumption growth, and the assumption of a looser fiscal policy stance and an uptick in confidence, especially after the November elections. However, growth outlook over the medium term is more subdued, weighed down by an aging population and weaker total factor productivity growth.

Growth is also projected to remain broadly solid in the United Kingdom (U.K), at 2.0 per cent in 2017, before declining to 1.5 per cent in 2018, on account of spending which has proved resilient in the aftermath of the June 2016 referendum in favour of the Brexit. Though highly uncertain, medium-term growth prospects have also diminished in the aftermath of the Brexit vote because of the expected increase in barriers to trade and migration, as well as a potential downsizing of the financial services sector amid possible barriers to cross-border financial activity.

The Euro Area recovery is expected to proceed at a broadly similar pace in 2017–18 as in 2016. The modest recovery is projected to be supported by a mildly expansionary fiscal stance, accommodative financial conditions, a weaker euro, and beneficial spill overs from a likely US fiscal stimulus. Nonetheless, political uncertainty as elections approach in several countries, coupled with uncertainty about the European Union's future relationship with the U.K, is expected to weigh on activity. Output in the Euro Area is expected to grow by 1.7 per cent in 2017 and 1.6 per cent in 2018. Over the medium-term, the outlook for the Euro Area remains dim, held back by weak productivity, adverse demographics, and in some countries, unresolved legacy problems of public and private debt overhang, with a high level of nonperforming loans.

Growth in EMDEs is forecast to rise to 4.5 and 4.8 per cent, respectively, in 2017 and 2018, from 4.1 per cent in 2016. This projected upturn reflects, in part, recovery in a number of commodity exporters, some of which underwent painful adjustments following the decline of commodity prices, and strengthening growth in India. Although in the near term, growth forecast for India has been trimmed to 7.2 per cent – largely because of the temporary negative consumption shock induced by cash shortages and payment disruptions from the recent currency exchange initiative, economic activity is forecast to accelerate slightly over medium-term.

Growth in China is projected at 6.6 per cent in 2017, slowing to 6.2 per cent in 2018, reflecting to a large extent the stronger-than-expected momentum in 2016 and the anticipation of continued policy support in the form of strong credit growth and reliance on public investment to achieve growth targets. The medium- term outlook, however, continues to be clouded by increasing resource misallocation and growing vulnerabilities associated with the reliance on near-term policy easing and credit-financed investment. Overall, the outlook for EMDEs remains uneven and is subject to several factors, including China's transition to a more sustainable pattern of growth that is less reliant on investment and commodity imports; a protracted adjustment to structurally lower commodity revenues in some commodity exporters; high debt levels

everywhere; sluggish medium-term growth prospects in AEs; and domestic strife, political discord, and geopolitical tensions in a number of countries.

A modest recovery is forecast for sub-Saharan Africa (SSA), at 2.6 per cent in 2017 and 3.5 per cent in 2018, largely driven by specific factors in the largest economies, which faced challenging macroeconomic conditions in 2016. After contracting by 1.5 per cent in 2016, output in Nigeria is projected to grow by 0.8 per cent in 2017 as a result of a recovery in oil production, continued growth in agriculture, and higher public investment. In South Africa, a modest recovery is expected, with growth forecast at 0.8 per cent in 2017 as commodity prices rebound, drought conditions ease, and electricity capacity expands. The outlook for the region, however, remains subdued. Many commodity exporters still need to adjust fully to structurally lower commodity revenues because commodity prices—the recent rebound notwithstanding—remain low. Many of the largest non-resource-intensive countries will find it increasingly hard to sustain growth through higher public capital spending, as they have done in the past, in the face of rising public debt and a slowing credit cycle.

Table 1: Global Growth Projections

		Projections		Difference from Jan'17 WEO		Difference from Oct'16 WEO	
	2016	**2017**	**2018**	**2017**	**2018**	**2017**	**2018**
Sub- Saharan Africa	**1.4**	**2.6**	**3.5**	**-0.2**	**-0.2**	**-0.3**	**-0.1**
Nigeria	-1.5	0.8	1.9	0.0	-0.4	0.2	0.3
South Africa	0.3	0.8	1.6	0.0	-0.4	0.2	0.3
Emerging Market and Developing	**4.1**	**4.5**	**4.8**	**0.0**	**0.0**	**-0.1**	**0.0**
Russia	-0.2	1.4	1.4	0.3	0.2	0.3	0.2
China	6.7	6.6	6.2	0.1	0.2	0.4	0.2
India	6.8	7.2	7.7	0.0	0.0	-0.4	0.0
Brazil	-3.6	0.2	1.7	0.0	0.2	-0.3	0.2
Mexico	2.3	1.7	2.0	0.0	0.0	-0.6	-0.6
Advanced Economies	**1.7**	**2.0**	**2.0**	**0.1**	**0.0**	**0.2**	**0.2**
United States	1.6	2.3	2.5	0.0	0.0	0.1	0.4
Euro Area	1.7	1.7	1.6	0.1	0.0	0.2	0.0
Japan	1.0	1.2	0.6	0.4	0.1	0.6	0.1
United Kingdom	1.8	2.0	1.5	0.5	0.1	0.9	-0.2
Canada	1.4	1.9	2.0	0.0	0.0	0.0	0.1
World Output	**3.1**	**3.5**	**3.6**	**0.1**	**0.0**	**0.1**	**0.0**

Source: IMF, WEO Update April 2017

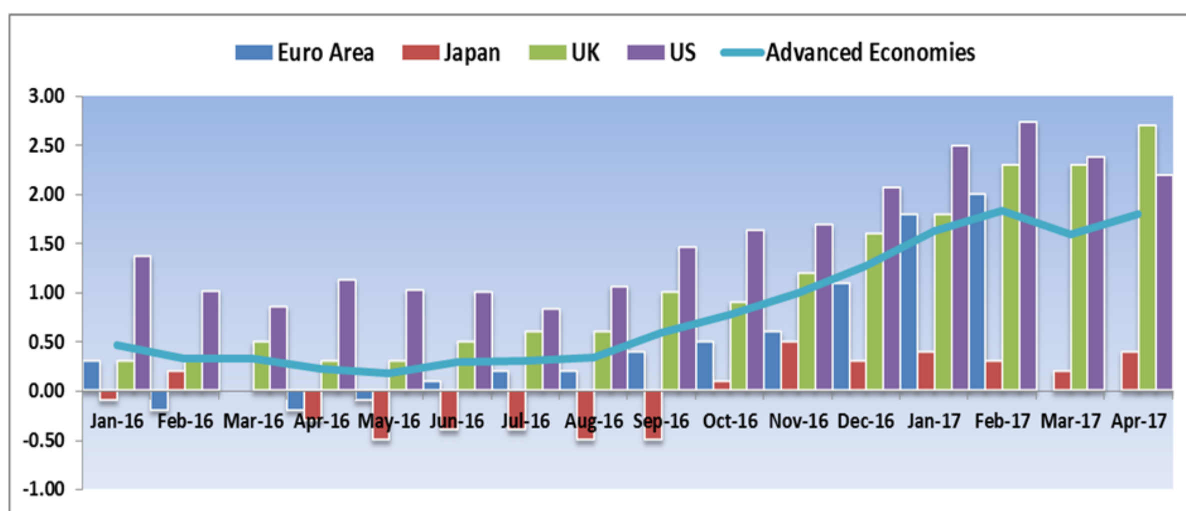
Overall, global growth is still too slow compared to the pre-2008 Global Financial Crisis and the outlook is subject to some significant risks, especially over the medium term.

Pervasive uncertainty surrounding policies - in particular policy support in the US and China are likely to be unwound down the road to avoid unsustainable fiscal dynamics; and the threat to turn toward zero-sum policy approaches could lead to trade and cross-border investment flows warfare mainly in AEs. This combined with noneconomic factors, including geopolitical tensions, domestic political discord, extreme weather events, and terrorism and security concerns could dampen medium-term global growth prospects.

2.2 Global Inflation

Global inflation has edged up, which is largely connected to the rise in energy prices over the past 12 months. In the quarter to April 2017, annual consumer price inflation in AEs rose to 1.7 per cent, relative to 1.3 per cent in the quarter to January 2017 and 0.8 per cent in 2016. Annual core inflation, in contrast, increased only mildly and remains well below most central bank targets. However, the oil price has fallen since April and is only expected to rise slowly in the period ahead, which means that the contribution by energy prices to inflation will decrease. Underlying inflationary pressures are still low in many areas, particularly in the euro area. Gradually higher resource utilisation means, however, that underlying inflation is expected to increase in the period ahead. CPI inflation abroad is expected to amount to 2 per cent on average during the forecast period. In EMDEs, inflation is beginning to gain momentum as the impact of higher fuel prices begins to outweigh the downward pressure from the fading of earlier exchange rate depreciations. Inflation dropped to 3.6 per cent in the quarter to April 2016, from 4.6 per cent in the quarter to January 2017. Global inflation developments are shown in **Figure 1**.

Figure 1: Global inflation developments



Source Organization for Economic Cooperation and Development (OECD), April 2017.

In terms of the outlook, the prospects for expected increase in underlying inflation over the next year or two is still quite gradual, because a number of forces, including low wages, are continuing to hold inflation down. Inflation is expected to increase in both AEs and EMDEs on account of the uptick in commodity prices. Inflation is forecast to rise to 2.0 per cent and 4.7 per cent in 2017 from 0.8 per cent and 4.4 per cent in 2016 in the AE's and EMDE's, respectively. In SSA, inflation in 2017 is expected to remain at double-digit levels in a few large economies of Nigeria, Angola and Ghana, largely reflecting, among other factors, the pass through of large depreciations. Near- and longer-term core inflation expectations remain benign, which suggests an outlook of benign global core inflation, which lowers the upside risks to domestic core inflation.

2.3 International Commodity Prices

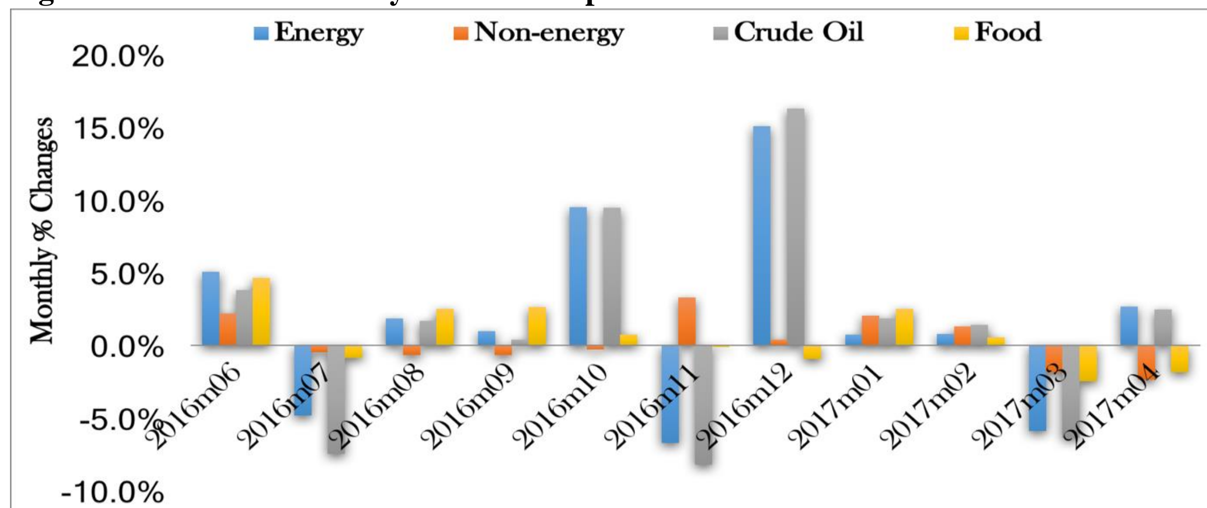
The pickup in commodity prices that started in Q4-2016 continued through the quarter ending April 2017, supported by dry weather conditions, the agreement by OPEC members and other important oil producers to curtail oil supply to support oil prices and stronger activity and expectations of more robust future global demand. Following the September 2016 OPEC agreement to reduce oil production to 32.5 million barrels per day, average crude oil prices have increased by 16.3 per cent over the period, rising from USD 44.9 per barrel in August 2016 to USD 52.3 per barrel in April 2017. In Q1-2017, oil prices rose by 8.0 per cent on account of lower production to an average of USD 52.9/bbl.

On an annual basis, average crude oil prices registered an increase of about 28 per cent in April 2017, compared to a decline of 29.2 per cent over the corresponding period a year ago. Average crude oil prices are forecast to rise to USD 51.2 and USD 53.1 per barrel in 2017 and 2018, respectively, from USD 42.8 per barrel in 2016 as the market continues to rebalance. However, going forward potentially less strict environmental regulations in the US might taper oil prices and also make them more volatile. Indeed, in May 2017, oil prices dropped below USD 50/bbl, driven by high OECD and US stocks and rising Libyan production. Non-energy prices rose by 4.0 per cent, on the back of prices of metals, which rose by 10.0 per cent, driven by strong demand and supply constraints.

Among agricultural commodities, food prices rose by 4.9 per cent as excess supply eased, especially for grains and vegetable oils. Prices have increased for most items, except for a few, including rice and cocoa beans. Recovery in food prices was mainly on account of dry weather conditions. Going forward, agricultural commodities prices are expected to rise by about 2 per cent in 2017, up from the decline of 2.7 per cent recorded in 2016, although they are then projected to decline by 0.9 per cent in 2018.

Uganda being a commodity exporting economy is likely to benefit from an uptick in the global commodity prices and hence boost its growth prospects gradually. In contrast, increased commodity prices could hamper domestic demand, leading to subdued investment and hence softer growth prospects. Developments in international commodity prices are shown in **Figure 2**.

Figure 2: Global Commodity Price Developments



Source: World Bank, Food and Agriculture Organization of the UN

2.4 Global Financial Markets

Global financial market sentiment remains generally buoyant, supported by expectations of a sustained pick-up in global economic growth and receding concerns of disruptive political developments. Long-term nominal and real interest rates have risen substantially since August 2016, especially since the US election in November 2016. As of end-March, nominal yields on 10-year U.S. Treasury bonds had increased by some 85 basis points (bps), relative to August and 55 bps compared with just before the U.S. election. Long term rates increased sharply in the United Kingdom as well, reflecting spill-overs from higher US rates and expectations of a less accommodative monetary policy stance going forward, given rising inflation pressure. The increase in euro area long-term yields after August was moderate—about 40 bps in Germany—but Italian yields rose more sharply (about 120 bps), reflecting elevated political and banking sector uncertainties.

The U.S. Federal Reserve raised short-term interest rates in December 2016 and in March 2017 as expected, but in most other AEs, monetary policy stance has remained

broadly unchanged. The widening interest differentials have been associated with sizeable exchange rate movements, with the US dollar appreciating in real effective terms by 3.5 per cent between August 2016 and March 2017, while the euro and especially the Japanese yen have weakened. Monetary policies are likely to remain divergent. The US Fed is expected to maintain its moderate pace of tightening and is expected to begin implementing a balance sheet normalisation programme, provided that the economy evolves broadly as anticipated. In most other AEs, policy rates are expected to remain low, but a reduction in Quantitative Easing (QE) is possible in the near future in the euro area.

The EMDEs currencies have faced market pressures following an increase in the U.S bond yield and appreciation of the U.S dollar against other currencies. Going forward, EMDEs are likely to face challenges on account of a large divergence in short-term interest rates and rising yields on long term securities among the AEs and continued strengthening of the US Dollar. This raises the risk of financial market tensions and volatility, notably in exchange rates, which could lead to wider financial instability.

2.5 Implications for the Uganda Economy

The external economic environment will continue to influence Uganda's economic performance given her integration to the global economy. As such, risks to the global economic outlook have the potential to affect consumer and investor confidence and curtail growth in the Ugandan economy. The main risks to global economic outlook include slow growth in China, tight global financial market conditions, and increased protectionist policy considerations particularly in AEs.

The external economic environment remains uncertain. There is considerable uncertainty regarding the US's economic policies, which is likely to increase volatility in global financial markets and result in volatile capital flows both into and out of emerging and frontier markets. This uncertainty, amidst expected dividend payments to foreign investors and other domestic forex demand pressures could accelerate the depreciation pressures on the Ugandan shilling.

Furthermore, uncertainty about the US policy agenda – clouded by a shift from globalization towards nationalism, a rising belief in the need for greater state intervention in the economy and reversal of accommodative policies, are causing

nervousness in the global economic outlook and it is difficult now to gauge the impact this will have on Ugandan economy, but could in general reduce trade and cross – border investment flows affecting both commodity importers and exporters especially the EMDE's of which Uganda is part.

In addition, the geopolitical tensions mainly in parts of the Middle East and Africa remain elevated with negative implications on consumer and business confidence, such that investors and consumers hold back on spending. In particular, the developments in the neighbouring countries of South Sudan and Democratic Republic of Congo, which are a major destination for Uganda's exports, could adversely affect Uganda. This could lead to reductions in aggregate demand and eventually constrain economic growth going forward. On a positive side, the pick-up in global economic activity, buoyant financial market conditions and recovery in commodity prices could lead to higher export receipts and increased investments, both of which are favourable for growth.

3 Domestic Economic Developments

3.1 Reflections on Monetary Policy Stance and Implementation

3.1.1 Monetary Policy Stance

Bank of Uganda (BoU) has cautiously pursued an expansionary monetary policy throughout 2016/17. The Central Bank Rate (CBR) has been reduced by a cumulative 7.0 PPs from 17.0 per cent in February 2016 to 10.0 per cent in June 2017 to support recovery of economic activity. The continued easing of monetary policy stance has been at the back of soft inflation outlook.

Although in the near-term, inflation outlook could have deteriorated especially in the first two quarters of 2017, the medium-term outlook has remained well anchored around the BoU's medium term target of 5.0 per cent. The deterioration in the near-term outlook for inflation has been due to heightened temporary supply side shocks, but their impact has been constrained by weak aggregate demand, relatively stable shilling exchange rate and the fact that they are expected to wane by Q1-2017/18. The band on the CBR was maintained at +/-3 PPs and the margin on the rediscount rate at 4.0 PPs on the CBR. Consequently, the rediscount rate and the bank rate have reduced from 21 per cent and 22 per cent, respectively in February 2016 to 15.0 per cent and 16.0 per cent, respectively, in June 2017.

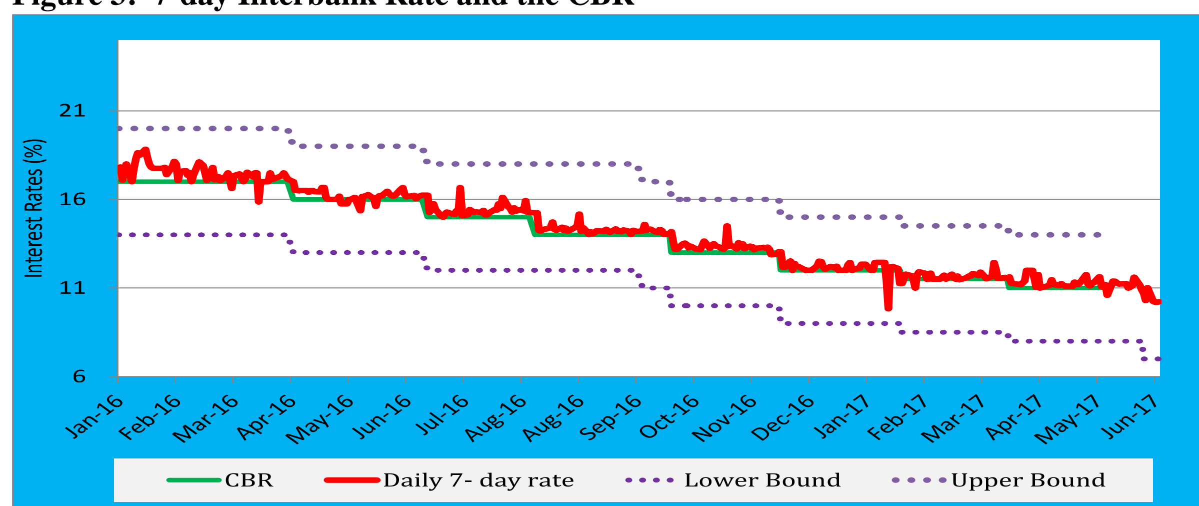
3.1.2 Monetary Policy Operations and Challenges

BoU continued to use Repurchase Agreements (REPOs), deposit auctions and sales of recapitalization securities in the secondary market to align the 7-day interbank money market rate towards the CBR. The net effect of the Deposit auction in the quarter to June 2017 was a withdrawal of Shs. 771.9 billion, with the outstanding amount of Shs. 1.2 trillion as at end June 2017. Over the same time, the net effect of the REPO instrument was a withdrawal of Shs. 122.9 billion, with Shs. 914.6 billion in outstanding stock at the end of June 2017.

3.1.3 Interbank Money Market Rates

In line with the continued easing of monetary policy stance, money market rates in general and interbank money market rates in particular have declined even further in the quarter to June 2017. The weighted average 7-day money market rate declined to 11.2 per cent in Q4 2016/17, down from 11.9 per cent in and the quarter to March 2017 and 16.1 per cent in the quarter to June 2016 (**Figure 3**).

Figure 3: 7-day Interbank Rate and the CBR



Source: Bank of Uganda

3.2 Other Interest rates and Private Sector Credit

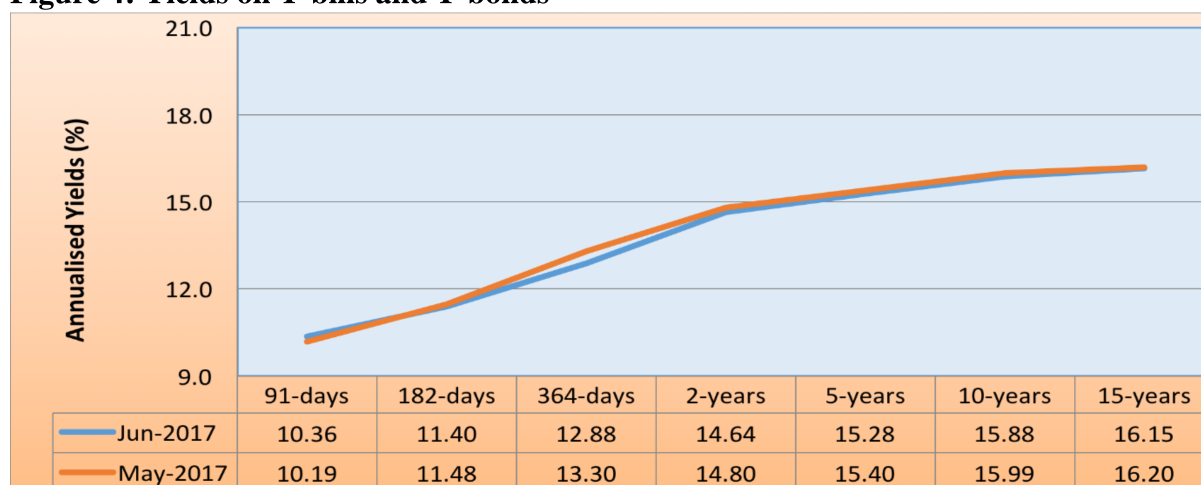
3.2.1 Yields on Government Securities

Yields on government securities have also continued to decline since February 2016, in line with continued easing in monetary policy stance. Average yields on the 91-day, 182-day and 364-day Treasury bills (T-bills) declined to 10.7, 11.9 and 13.7 per cent,

respectively in the quarter to June 2017, relative to 13.0, 13.7 and 14.3 per cent in the quarter to March 2017 and 21.1, 23.5 and 23.7 per cent in February 2016.

Average yield on Treasury Bonds (T-Bonds) also declined. The average yields on the benchmark 2-year, 5-year, 10-year and 15-year T-bonds declined to 15.1, 14.9, 16.1, and 16.4 per cent, respectively quarter to June 2017, from 15.6, 15.5, 16.6 and 16.9 per cent in the quarter to March 2017 and from 22.3, 20.3, 19, and 18.7 per cent, respectively in February 2016. **Figure 4** shows developments in yields on government securities.

Figure 4: Yields on T-bills and T-bonds



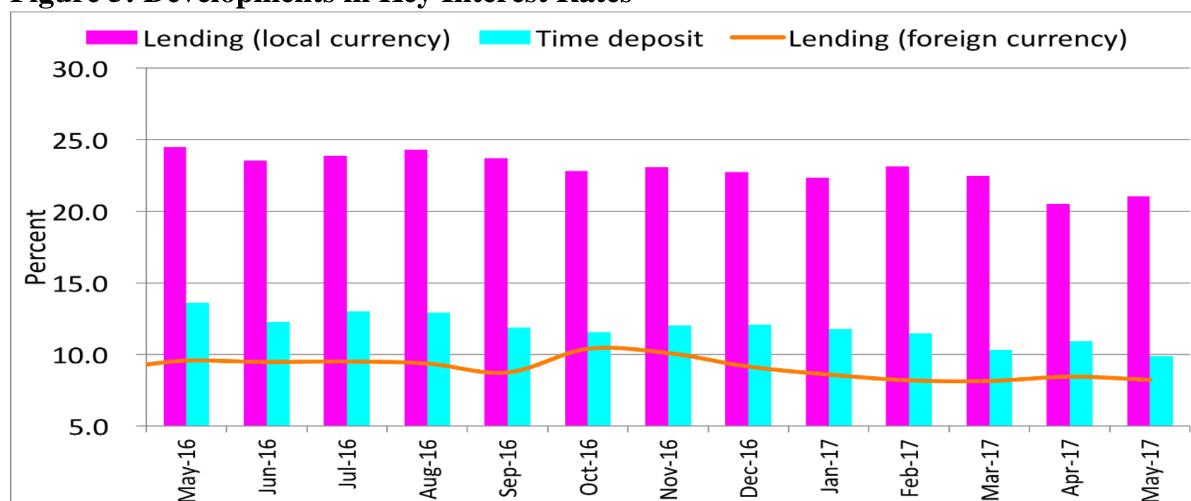
	91-days	182-days	364-days	2-years	5-years	10-years	15-years
Jun-2017	10.36	11.40	12.88	14.64	15.28	15.88	16.15
May-2017	10.19	11.48	13.30	14.80	15.40	15.99	16.20

Source: Bank of Uganda

3.2.2 Lending and deposit interest rates

The easing of monetary policy stance has continued to feed through to commercial bank interest rates, though with a lag. The weighted average lending rate on shilling denominated loans has fallen by a cumulative 4.2 PPs to 21.04 per cent in May 2017, from a peak of 25.2 per cent in February 2016, which is marginally lower than the 6 PPs reduction in the CBR over the same period. Similarly, rates on the US dollar denominated loans have also declined to 8.2 per cent in May 2017 from the average highs of 9.9 per cent in Q4-2016 and 10.1 per cent recorded in February 2016. The shilling denominated weighted average time deposit rates declined from 17.3 per cent in January 2016 to 9.9 per cent in May 2017; but the foreign currency denominated weighted average time deposit rates rose from 3.0 per cent in February 2017, to 3.1 per cent, respectively. **Figure 5** shows developments in key interest rates.

Figure 5: Developments in Key Interest Rates



Source: Bank of Uganda

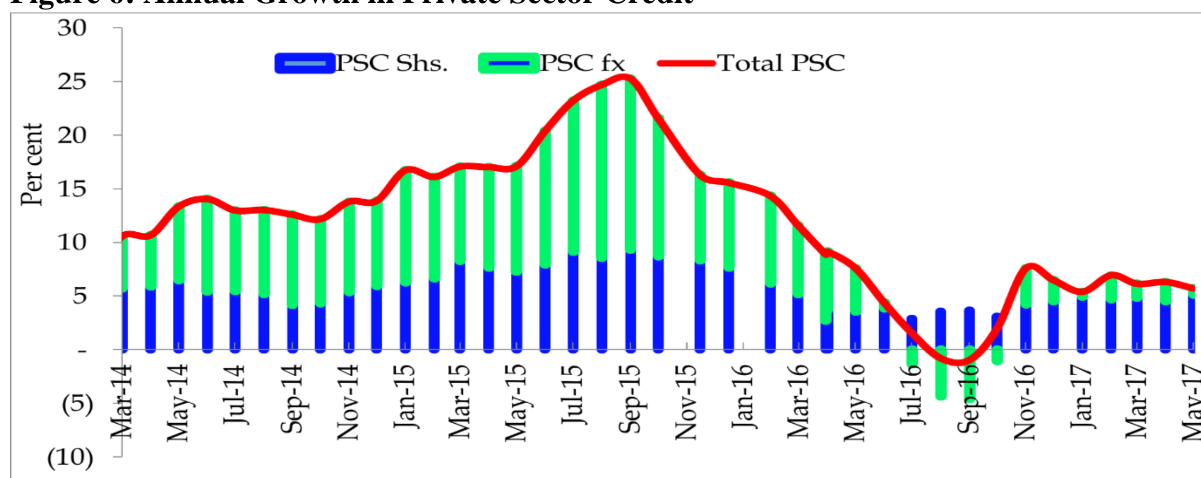
3.2.3 Monetary Aggregates and Private Sector Credit

Reflecting in part monetary policy easing, growth in monetary aggregates continues to recover. On average, M1, M2 and M3 grew by 14.1, 15.0 and 12.4 per cent, respectively in the quarter to May 2017, higher than the respective rates of 13.4, 13.1 and 10.6 per cent in the quarter to February 2017. Over the quarter under review, from the asset side, net foreign assets (NFA) have continued to drive growth in broad money since November 2016, contributing on average 12.4 per cent, compared to *minus* 0.7 per cent in net domestic asset. On the liability side, growth in M3 was mainly driven by shilling deposits, which contributed 8.31 per cent. Foreign currency deposits and currency in circulation (CIC) contributed 2.2 and 1.9 per cent, respectively. Growth in monetary aggregates has been even more remarkable when computed on annual basis. M1, M2 and M3 grew y-o-y by 12.1, 13.7 and 11.4 per cent, respectively in May 2017, much higher than the respective growth rates of 3.0, 6.9 and 9.0 per cent, in May 2016.

During the FY 2016/17, growth in Private Sector Credit (PSC) has remained subdued, despite the monetary policy easing. In the first eleven months of FY 2016/17, PSC has so far recorded an annual growth rate of 4.2 per cent, which is much lower when compared to 16.2 per cent growth rate over the corresponding period of FY 2015/16. In May 2017, annual PSC growth declined slightly by 0.6 PPs to 5.7 per cent, relative to 6.3 per cent, in April 2017. Average annual PSC growth was stable at 6.1 per cent, in the quarter to May 2017 as in the quarter to February 2017. Over the same period, Shilling denominated loans grew on average by 8.3 per cent, compared to 8.0 per cent, in the quarter to February 2017. Growth in forex denominated loans (net of valuation)

declined further to *minus* 3.4 per cent, from *minus* 4.8 per cent in quarter to February 2017 (**Figure 6)**.

Figure 6: Annual Growth in Private Sector Credit



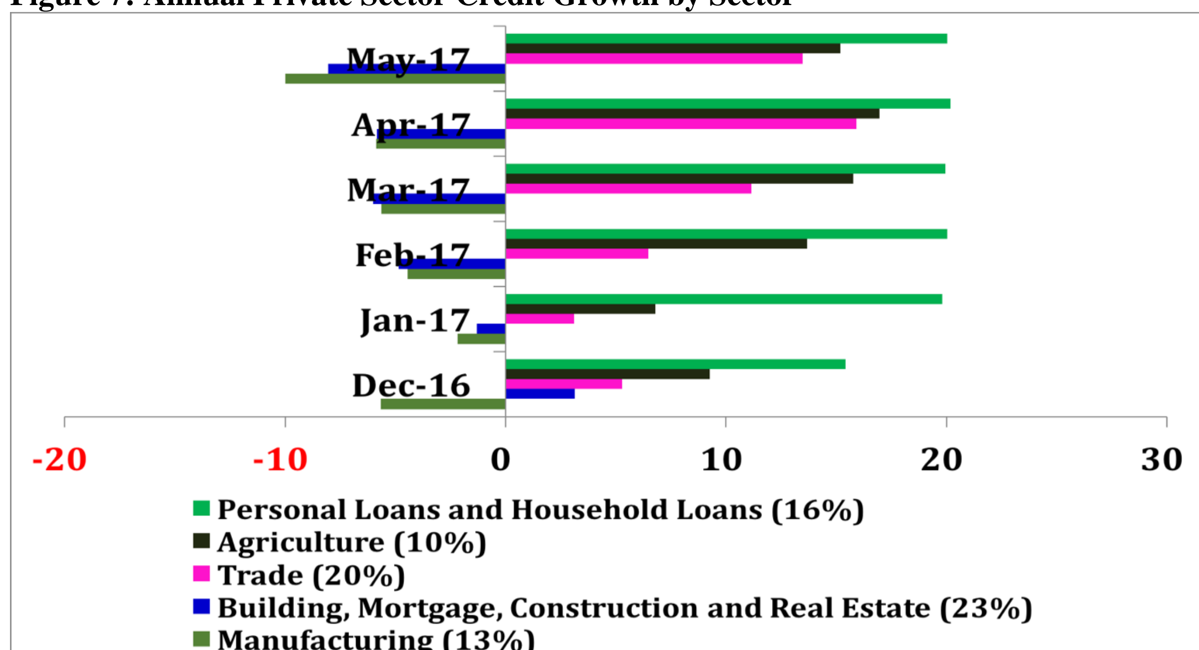
Source: Bank of Uganda

The annual PSC growth, net of valuation changes on account of exchange rate movements, declined to an average of 3.4 per cent in the quarter to May 2017, relative to 4.0 per cent in the quarter to February 2017. The slight decline in PSC growth in part highlights the supply-side constraints to credit growth. Indeed, demand for credit (as proxied by loan applications) remains robust while supply of credit (proxied by loan approvals) remains subdued. Since January 2017, value of loan applications has averaged about Shs. 1,677.6 billion, while value of approvals has averaged Shs. 810.6 billion per month. There is in particular a significant disparity between value of loan applications and approvals for the Manufacturing and Building, construction and real estate sectors.

Sector-wise, growth in PSC was mainly driven by growth of credit to the agriculture, Trade and Personal loans, which together constituted 49.6 per cent of the total PSC. Credit growth to the manufacturing, building and services other than business services sectors, which together account for 27.6 per cent of the total credit, has been negative since the start of the year (**Figure 7**), a trend that poses downside risks to private investment growth and recovery of domestic economic activity. Nonetheless, the asset quality has improved. The ratio of Non-Performing Loans (NPLs) to total loans, excluding Crane bank's NPLs that comprised almost ½ of the NPLs in December 2016, has declined to 6.3 per cent in March 2017, from 10.5 per cent in December 2016. Over

the same period however, loans in watchful category increased to Shs. 1.7 trillion, from Shs. 1.44 trillion, which could be a recipe for further increases in NPLs.

Figure 7: Annual Private Sector Credit Growth by Sector



Source: Bank of Uganda

3.3 Fiscal Policy and Operations

3.3.1 Fiscal Developments

The fiscal stance for FY 2016/17 focused on addressing infrastructural constraints in the economy. The implementation of the budget, however, has been hampered by weak external financing due to slow execution of public investment. The fiscal deficit for 2016/17 is now projected at 3.6 per cent of GDP, which is lower that was initially projected at 6.6 per cent and 4.9 per cent in 2015/16. Preliminary fiscal data for the first eleven months of FY 2016/17 indicates that the fiscal deficit (including grants) amounted to Shs. 2,600.3 billion, which is substantially less than the programmed deficit for this period of Shs. 5,202.0 billion by Shs. 2,601.7 billion.

Government revenue (including grants) amounted to Shs. 12,310.3, which was less than programmed by Shs. 1,127.7 billion. Domestic revenue underperformed by Shs. 444.7 billion due to lower international trade tax collections, specifically shortfalls in VAT on imports due to lower import volumes, which was driven, in part, by weak economic activity. Total government expenditure and net lending amounted to Shs. 14,910.6

billion, which was less than the programmed amount by Shs. 3,729.4 billion, largely on account of underperformance in development expenditure due to delayed implementation of infrastructure projects. External financing was Shs. 3,121.9 billion lower than programmed due to an underperformance in project loan receipts while domestic financing was Shs. 109.9 billion lower than programmed. Current expenditure amounted to Shs. 9,099.4 billion, which was higher than the programmed amount by Shs. 241.4 billion. Fiscal developments are shown in **Table 2**.

Table 2: Fiscal Performance

	Prel. Jul '16 – May'17	PSI Prog. Jul '16 – May'17	Variation
Revenue & Grants	**12,310.3**	**13,438.0**	**-1,127.7**
Revenue	11,447.7	11,892.3	-444.7
Grants	862.6	1,545.7	-683.0
Expenditure & Lending	**14,910.6**	**18,640.0**	**-3,729.4**
Current Expenditure	9,099.4	8,858.0	241.4
Development	5,330.7	8,189.7	-2,859.0
Net	300.5	1,456.3	-1,155.8
Domestic arrears	180.1	136.0	44.1
o/w External Expenditure[2]	1,703.6	1,841.5	-137.9
Deficit (including	**-2,600.3**	**-5,202.0**	**2,601.7**
Financing (net)	**2,600.3**	**5,202.0**	**-2,601.7**
External Financing	1,496.5	4,618.3	-3,121.9
Domestic	474.1	584.0	-109.9
Errors & Omissions	629.7	-0.4	
Memo item: Overall deficit excl. external expenditure	*-896.7*	*-3,360.5*	*2,463.8*

Source: Ministry of Finance, Planning and Economic Development (MFPED)

The fiscal stance for FY 2017/18 is focussed on improving productivity in key primary sectors such as agriculture and oil, industrialization and infrastructure development. The total approved budget for FY 2017/18 is about Shs. 29 trillion. Domestic revenues are projected to increase to about Shs. 15,062.4 billion, which is a growth of 14.6 per cent higher than 13.6 per cent estimated for 2016/17, and is 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 about 5.5 per cent of GDP in 2017/18, relative to 3.6 per cent of GDP in 2016/17. The deficit will largely be funded by external sources, which will be supplemented by domestic borrowing. Domestic borrowing has been projected at Shs. 945.2 billion (0.9 per cent of GDP), up from Shs. 612 billion (0.7 per cent of GDP) in FY 2016/17.

3.3.2 Public Debt Stock

The provisional total public debt stock (at nominal value) as at end May 2017 stood at Shs. 34.0 trillion, an increase of 14.1 per cent relative to June 2016 and 16.7 per cent in the same period a year ago. It comprised Shs. 21.1 trillion (USD 5.7 billion) in external debt, commanding a dominant share of 62.4 per cent of the total public debt, and Shs. 12.7 trillion in domestic debt. Total committed external debt (total of disbursed and outstanding plus undisbursed) at the end of May 2017 stood at USD. 11.2 billion. Undisbursed external debt stood at USD 5.3 billion, down from USD 5.5 billion as at end June 2016. **Table 3** indicates that most of the domestic debt cost and risk indicators were outside the Public Debt Medium Framework (PDMF) benchmarks and domestic debt stock continues to exhibit roll over risk.

Table 3: Public Debt Developments

Domestic Debt Risk	PDMF	May-16	Jun-16	May-17
% maturing in 1 year[1]	<40%	44.9	44.5	40.6
% maturing in any year after year 1[2]	< 20%	13.2% Yr 2 & 6.4% in Yr 3	11.3% Yr 2 & 7.8% Yr 3	8.9% Yr 2 & 12.9% in Yr 3
Tbonds/Tbills (at face value)	70/30	67/33	66/34	67/33
Avg Time to Maturity (ATM) (yrs)[3]	>3Yrs	3.3	3.3	3.6
Total Stock/PSC (at nominal value)	<75%	99.1	101.0	106.3

3.4 Balance of Payments and Exchange rates

3.4.1 Balance of Payments

In the twelve months to May 2017, the current account balance (CAB) improved by 29.8 per cent to USD 1,094.7 million from USD 1,559.9 million in the twelve months to May 2016. Trade balance improved by 26.8 per cent from a deficit of USD1,921 million to

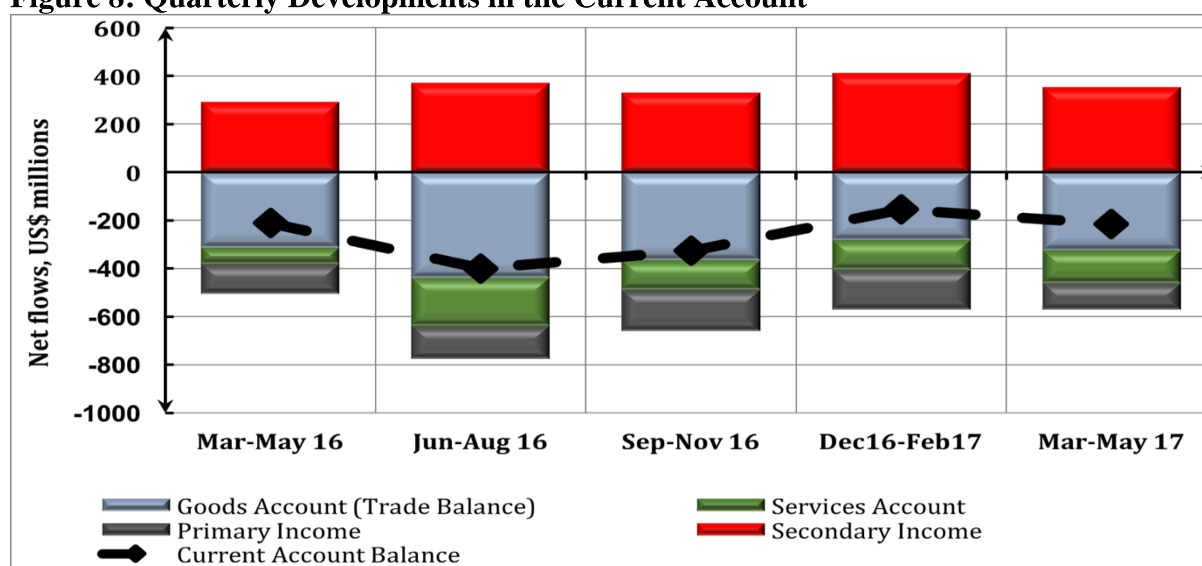
[1] This is the share of debt maturing in the next twelvemonths. High proportions are indicative of high levels of interest rate or rollover risk.

[2] To avoid refinancing requirements being particularly concentrated in any single year, it is recommended to spread maturities evenly over the maturity curve. This risk control measure helps prevent rollover risk from being simply shifted to a later period, for example from year one to year two.

[3] This provides an indicator for the average life of debt. It measures the average length of time it takes for debt instruments to mature and therefore the extent of the refinancing risk exposure. A long ATM implies lower refinancing risk exposure, and vice versa.

USD 1,405.4 million in the same period. Exports increased by 16 per cent from USD 2,690.2 million in the twelve months to May 2016 to USD 3,121.9 million in twelve months to May 2017. On the other hand, imports of goods (FOB) declined by 1.8 per cent from USD 4,611.2 million to USD 4,527.4 million in the same period. Expenditure on imports for consumption increased by 6.1 per cent while capital and intermediate goods' imports declined by 3.0 per cent in the same period. The secondary income balance also improved by 5.8 per cent to USD 1,573 million in the twelve months to May 2017. The services and primary income accounts however worsened by 4.4 per cent and 22.2 per cent to USD 577.5 million and USD 585.2 million respectively. The trends of the CAB and its components are shown in **Figure 8**.

Figure 8: Quarterly Developments in the Current Account



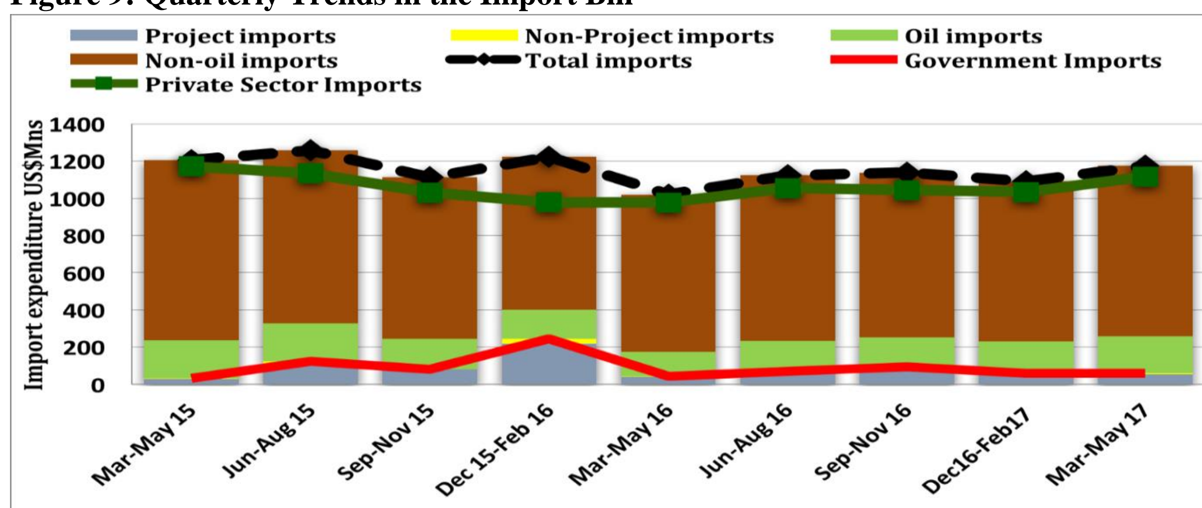
Source: Bank of Uganda

Export receipts increased on account of an increase in both coffee and non-coffee export receipts. Total non-coffee export (excluding non-monetary gold) and net exports of non-monetary gold receipts increased by 3.9 per cent and 97.3 per cent to USD 1,872 million and USD 79.1 million, respectively. Receipts from coffee exports increased by 29.5 per cent from USD 360.8 million to USD 467.4 million, as a result of an increase in the volume and price of coffee exported. The volume of coffee exported during the twelve months to May 2017 increased by 395.2 (60Kg) bags to 4,023.9 (60kg) bags, while the price increased to USD 1.92 from USD 1.65 per kg.

During the twelve months to May 2017, the total import bill decreased by 1.8 per cent to USD 4,527.3 million, largely on account of a decline in government imports. Government

expenditure on import of goods decreased by 43.0 per cent to USD 280.2million from USD 491.9 million in the twelve months to May 2016. Expenditure on private sector imports of goods (excluding non-monetary gold) decreased only marginally by 0.3 per cent to USD 3,913.1 million, driven by decreased expenditure on non-oil imports. Non-oil import expenditure decreased by 1.5 per cent to USD 3,217.6 million. Oil import expenditure increased by 5.9 per cent to USD 695.0 million. The quarterly trends in imports bill are illustrated in **Figure 9**.

Figure 9: Quarterly Trends in the Import Bill



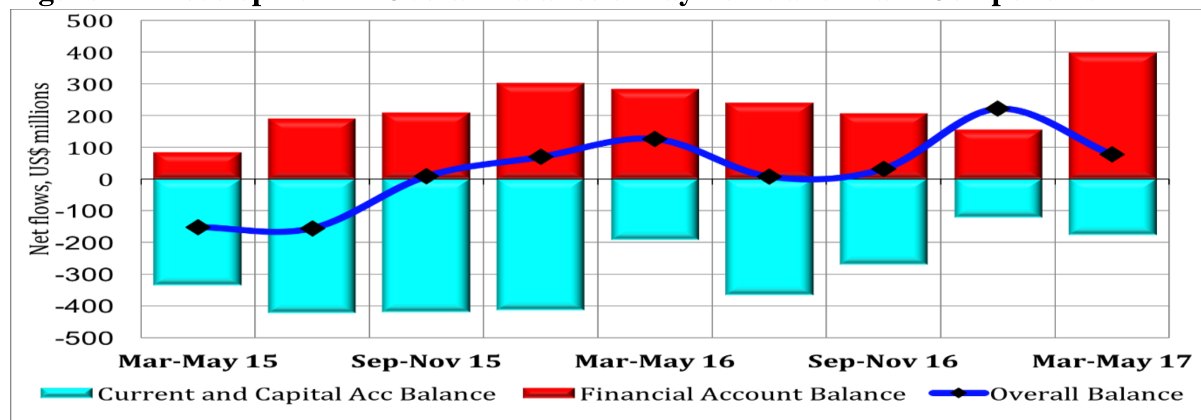
Source: Bank of Uganda

The financial account recorded a net incurrence of liabilities of USD 983.6 million during the year ended May 2017, similar to what was recorded in the 12 months to May 2016. Direct investment transactions resulted in a higher net incurrence of liabilities of USD 578.4 million compared to USD 515.0 million in the previous year. Transactions in other investments resulted in an overall net incurrence of liabilities of USD 520.7 million, lower than USD 669.2 million during the previous year, largely driven by transactions of deposit taking corporations (DTCs). Transactions in portfolio investment resulted in an overall net acquisition of assets of USD 116.2 million, which was lower than a USD 203 million relative to the previous year. The decrease in net portfolio assets was mainly due to a USD 46.6 million decreases in equity and investment fund shares by non-residents.

The developments in the external sector resulted in an overall balance of payments surplus of USD 338.3 million during the quarter ended May 2017, with a net build-up in reserves assets of USD 338.3 million excluding valuation changes. Developments in the

overall balance of payment and its components on a quarterly basis are shown in **Figure 10**.

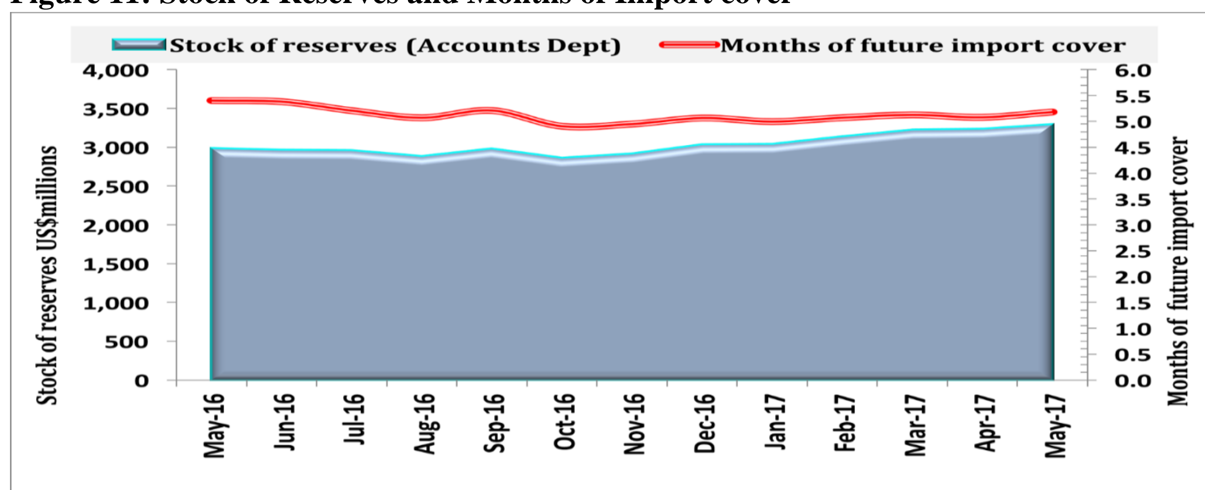
Figure 10: Development in Overall Balance of Payments and Main Components



Source: Bank of Uganda

The stock of reserves at the end of May 2017 was estimated at USD 3,294.5 million (including valuation changes), equivalent to 5.2 months of future imports of goods and services. The stock of reserves as at 28th June 2017 amounted to USD 3,362.18 million (equivalent to 5.3 months of import cover). Developments in the stock of reserves and months of import cover are shown in **Figure 11**. Going forward, in the short to medium term, the CAB is likely to worsen as private imports continues to pick up and major government projects are implemented as planned. FDI and other investments (loan disbursements) inflows are also expected to increase in line with project implementation.

Figure 11: Stock of Reserves and Months of Import cover



Source: Bank of Uganda

3.4.2 Exchange Rate Developments

Uganda's exchange rate is market determined, and is therefore vulnerable to both external and domestic shocks. In June 2017, the shilling strengthened, appreciating by 0.9 per cent, month-on-month (m-o-m), and but depreciated by 6.6 per cent y-o-y, to an average mid-rate of UGX 3,591.17 per US Dollar. This appreciation was due to stronger inflows, particularly from NGOs, coffee receipts, forex bureaus and receipts on NSSF investments in the diaspora and offshores

Both the Nominal and the Real Exchange Rates (NEER and REER) depreciated y-o-y in May 2017. The NEER depreciated by 4.2 per cent, relative to 3.5 per cent depreciation in April 2017. Over the same time, the REER depreciated by 4.0 per cent, compared to a depreciation of 4.1 per cent in April 2017. The depreciation of the REER is a pointer to increased competitiveness of the exports in the tradeable sector.

Intervention by the BoU in the Interbank Foreign Exchange Market (IFEM) is aimed at stemming disruptive volatility and not to influence the direction of the exchange rate. In June 2017, conditions in the IFEM enabled the BoU to purchase USD 60.0 million for reserve build-up, but sold USD 13.1 million to UETCL. Therefore, the total net BoU purchases in the IFEM in June 2017 amounted to USD 46.9 million. In the FY 2016/17, net BoU purchases of foreign exchange amounted to USD 647.2million, of which purchases for reserve build up amounted to USD 846.5 million.

Going forward, the shilling may remain weak on account of recovery in aggregate demand, uncertainty in global financial markets conditions stemming from an inward focus in policies, particularly protectionism causing reduced trade and cross-border investment in AEs and faster than expected interest rate hikes in the US which could trigger a sharp dollar appreciation, and structural liquidity injections given cancellation of auctions of government securities in June 2017.

3.4.3 Regional comparisons

Ministers of Finance in Kenya, Tanzania and Rwanda presented the 2017/18 national budgets to their respective Parliaments in the second week of June 2017. Like Uganda, other EAC member states experienced severe challenges to economic growth in 2016/17 including: low agricultural productivity due to adverse weather conditions;

and subdued private sector credit due low economic activity, high NPLs, and in Kenya a likely impact of the interest rate capping. These factors are expected to adversely affect the level of economic growth in 2016/17 across the region. Going forward, however, growth in 201/18 and beyond could be higher supported by increased public expenditure specifically on infrastructure developments (Kenya – transport energy & ICT; Uganda – HPPs, oil related infrastructure, Rwanda – int'l airport) a recovery in PSC and stronger domestic demand. Estimates of Growth projections and the levels of per capita GDP in Uganda remain lowest among the four economies. Kenya, Tanzania and Rwanda which are projected grow at 6.0%, 7.0% and 6.2%, in 2016/17 respectively compared to a growth of 3.9 per cent in Uganda. Economic indicators are displayed in **table 4.**

Table 4: Key economic indicators of EAC member countries

Key Economic Indicators	Kenya		Tanzania		Uganda		Rwanda	
	2016/17	2017/18	2016/17	2017/18	2016/17	2017/18	2016	2017
Tax Revenue (%GDP)	18.2	18.7	15.3	16	13.8	14.6	14.0**	16.6**
Expenditures (% GDP)	27.6	27.5	24.2	26.2	18.97	22.2	26.0**	24.5**
Development expenditure/GDP	8	8.1	7.7	9.9	7	10.1		
Domestically funded Domestic expenditure/GDP	5.3	4.9	5.9	7.4	4.7	4.3		
Budget Deficit/GDP	6.9	6.4	4.5	3.8	3.5	5.6	5.3*	4.8
Total Public debt /gdp	45.3	47.3	45	40.3**	33.2	37.0	37.6**	41.4**
GDP Current prices (USD Million)	68.9**	77.9	47.2**	53.4	25.7	28.1	8.4**	9.2
Real GDP Growth (%)	6.0	6.2	7.0	7.1	3.9	5.0	6.2	6.8
Overall Inflation rate (%)	6.3	6.3	5.2	5.0	5.5	6.1	5.7	6.6
GDP per capita	1,522.0	1,644.2	970.2**	1,066.0	637.6**	642.1**	729.1**	754.2**
Source National budget speeches	***IMF WEO*	*Updates*					**2015*	

In June 2017, developments in inflation were mixed. Inflation declined in Uganda and Kenya on account of lower food prices but rose in Zambia. Depreciation pressures have slowed in several economies. Albeit compared to Kenya and Tanzania, depreciation pressures are highest due to increased domestic dollar demand. As a way of supporting economic activity, Uganda, Ghana and Zambia eased monetary policy since May 2017. Consequently, 1-year T-Bill rates declined in most economies. Economic indicators are displayed in T**able 5.**

Table 5: Economic indicators on selected economies

Annual Inflation Rate %						
	Uganda	Kenya	Tanzania	Ghana	Nigeria	Zambia
Feb-17	6.7	9.0	5.5	13.2	17.8	6.8
Mar-17	6.4	10.3	6.4	12.8	17.3	6.7
Apr-17	6.8	11.5	6.4	13.0	17.2	6.7
May-17	7.2	11.7	6.1	12.6	16.3	6.5
Jun-17	6.4	9.2	N.Av	N.Av	N.Av	6.8

Exchange Rate Annual Changes (Local Currency/US$)						
	Uganda	Kenya	Tanzania	Ghana	Nigeria	Zambia
Feb-17	4.4	1.7	2.2	13.0	54.7	-13.8
Mar-17	6.9	1.4	2.1	16.4	55.3	-15.4
Apr-17	8.2	2.1	2.0	9.9	55.1	-3.1
May-17	8.2	2.5	2.2	12.9	54.8	-7.9
Jun-17	6.6	2.3	2.2	N.Av	N.Av	N.Av

Policy Rate %						
	Uganda	Kenya	Tanzania	Ghana	Nigeria	Zambia
Feb-17	11.5	10.0	N.Av	25.5	14.0	14.00
Mar-17	11.5	10.0	N.Av	23.5	14.0	14.00
Apr-17	11.0	10.0	N.Av	23.5	14.0	14.00
May-17	11.0	10.0	N.Av	22.5	14.0	12.50
Jun-17	10.0	N.Av	N.Av	N.Av	N.Av	12.50

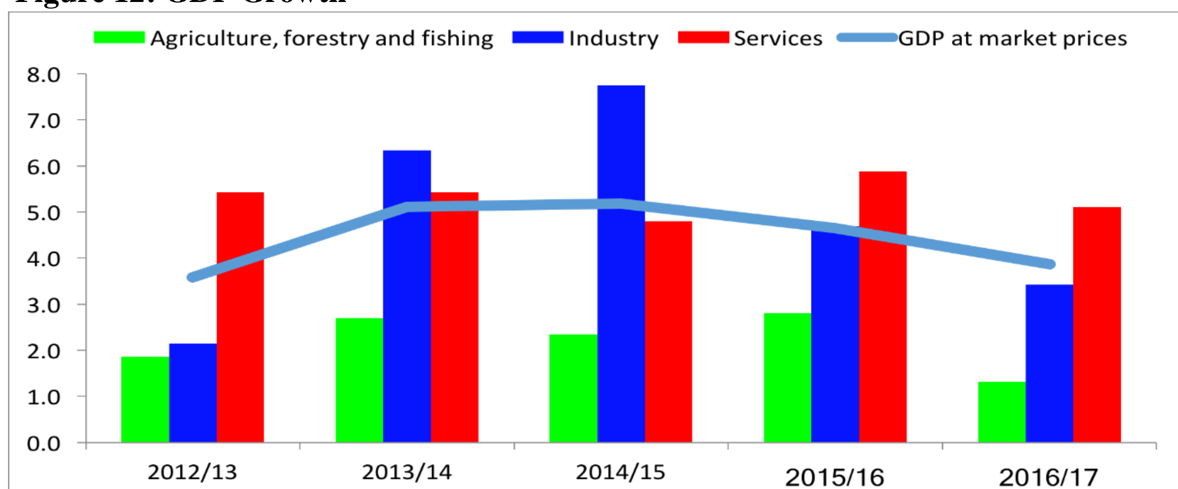
364-day Treasury Bill Yields						
	Uganda	Kenya	Tanzania	Ghana	Nigeria	Zambia
Feb-17	14.0	10.9	15.5	20.5	23.0	22.1
Mar-17	13.9	10.9	15.1	20.2	22.8	18.9
Apr-17	13.8	10.9	14.0	20.0	23.1	17.2
May-17	12.1	10.9	N.Av	19.1	21.9	17.7
Jun-17	12.9	10.9	N.Av	18.3	21.6	16.0

Source: Bank of Uganda

3.5 Domestic Economic Activity

The economy has continued to grow at a modest pace. According to the latest Real Gross Domestic Product (GDP) growth data released by the Uganda Bureau of Statistics (UBOS), the economy is estimated to grow by 3.9 per cent in 2016/17, 0.6 PPs lower than the period revised projection of 4.5 per cent and 0.8 PPs lower than the outturn for FY 2015/16 of 4.7 per cent (**Figure 12**). The deceleration in growth is mainly due to the adverse weather conditions that affected agricultural output, weak private sector credit growth and slow implementation of government infrastructure projects. Growth in all sectors slowed, with agricultural output declining to 1.3 per cent, from 2.8 per cent in 2015/16. The contraction in the agricultural sector was on account of unfavourable weather conditions which affected harvests of agricultural output. Industrial sector growth also slowed to 3.4 per cent, relative to 4.7 per cent in the previous year due to a contraction in mining and quarrying and construction subsectors. Growth in services sector also slowed to 5.1 per cent, compared to 5.9 per cent in 2015/16 on account of marginal growth in trade and repairs, and a contraction in financial and insurance activities. On the expenditure side, household consumer expenditure is estimated to have grown by 4.3 per cent in 2016/17 compared to 1.7 per cent in 2015/16 while Gross fixed capital formation declined by 1.8 per cent compared to growth of 8.9 per cent in the same period.

Figure 12: GDP Growth



Source: Uganda Bureau of Statistics, UBOS

An early warning indicator of economic activity, the Bank of Uganda's Composite Index of Economic Activity (CIEA), estimated 1.5 per cent growth in economic activity in the quarter to May 2017 compared to an expansion of 0.7 per cent in the quarter to February 2017, and an annual growth to May 2017 at 4.3 per cent. Industry and services sectors grew at lower rates, while the agricultural output is estimated to have increased. Activity in the service sector grew at the same rate as in the Quarter to February 2017, at 1.1 per cent, but grew by 5.3 per cent, y-o-y, in May 2017, relative to 5.0 per cent in May 2016. Growth in industrial activity moderated to 2.5 per cent in the quarter to May 2017, relative to 2.6 per cent in the quarter to February 2017, and expanded by 10.1 per cent, y-o-y in May 2017. Agricultural output is estimated to have slightly expanded by 0.2 per cent in the quarter to May 2017, compared to a growth of 0.1 per cent in the quarter to February 2017, growing by 1.1 per cent, y-o-y, in May 17.

Real GDP growth for FY 2017/18 is still projected to pick up to 5.0 per cent, supported by improved efficiency and effectiveness in implementation of public investments, Investments in the oil sector, recovery in PSC growth as lending rates continue declining and favourable weather conditions to support the agricultural sector.

3.6 Consumer Price Inflation

3.6.1 Recent Inflation Developments

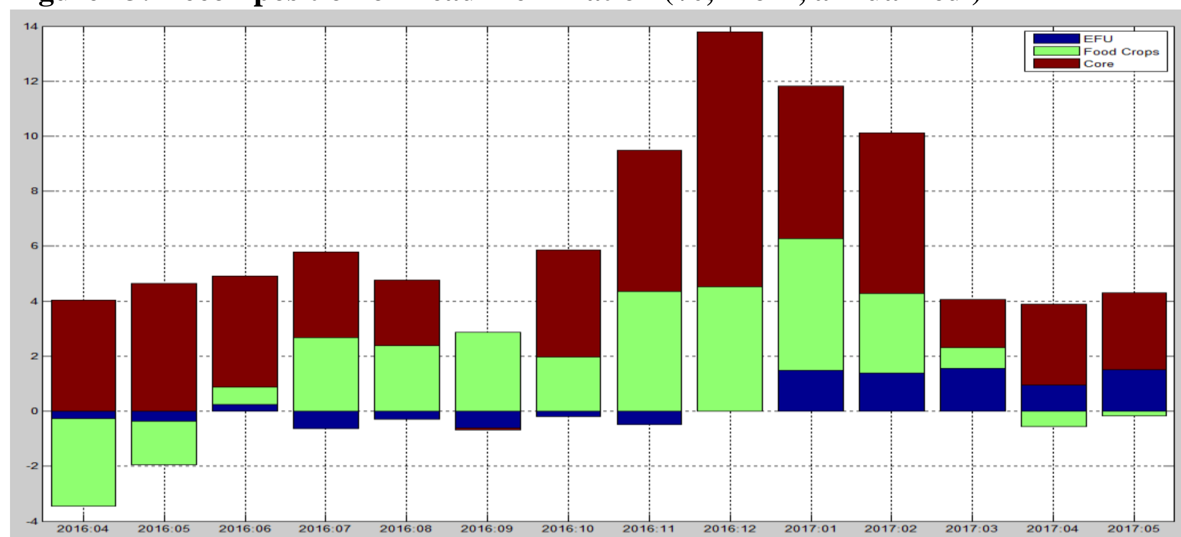
Headline and core inflation averaged 5.7 per cent and 5.1 per cent, respectively in 2016/17. The adverse supply side factors favouring higher inflation notwithstanding, 2016/17 registered lower inflation compared to 2015/16. Headline and core inflation

averaged 6.6 per cent and 6.7 per cent, respectively in in 2015/16. Despite the occasional surges in food prices and exchange rate depreciation in the last four Financial Years, inflation has largely been stable around the 5 per cent target rate, with headline and core inflation averaging 5.1 per cent and 4.9 per cent, respectively. The rise in inflation observed in the six months to May 2017 was largely temporary caused by the sharp increase in food crops prices. The surge in food crops prices was due prolonged drought which engulfed the country during the first three quarters of 2016/17.

Annual food crops and related items inflation has risen sharply from an average of 6.6 per cent in Q4-2016 to 18.1 per cent in Q1-2017, and further to 22.3 per cent in the last two months to May 2017. Annual Energy, Food and Utilities (EFU) inflation has also gained momentum, rising from an average of 2.1 per cent in Q1-2017 to 6.2 per cent in the two months to May 2017. In May 2017, annual food crops and related items, and EFU inflation rose to 23.1 and 7.0 per cent from 21.6 and 5.3 per cent, respectively, in April 2017. Indeed, controlling for seasonal effects to capture the impact of seasonal factors, annualized 3-months moving average headline inflation remained stable at 3.9 per cent, but inflationary pressures from EFU heightened, contributing about 38 per cent to the headline inflation. By the same measure and over the same period, core inflation declined to 3.5 per cent, from 3.7 per cent, on account of deceleration in other goods inflation. Decomposition of developments in inflation is shown in **Figure 13**.

The CPI data for June 2017 indicates that annual headline and core inflation declined to 6.4 per cent and 4.9 per cent, from 7.2 per cent and 5.1 per cent, respectively in May 2017. The drop in annual headline inflation was due to a decline in both annual food crops and EFU inflation. Annual food crops and EFU inflation eased to 18.1 per cent and 5.7 per cent, respectively in June 2017, from 23.1 per cent and 7.1 per cent, respectively in May 2017. Annual core inflation declined due to moderations in annual services inflation, which in June 2017, declined to 3.9 per cent, from 4.5 per cent in May 2017.

Figure 13: Decomposition of Headline Inflation (%, MoM, annualized)



Source: Bank of Uganda and Uganda Bureau of Statistics (UBOS)

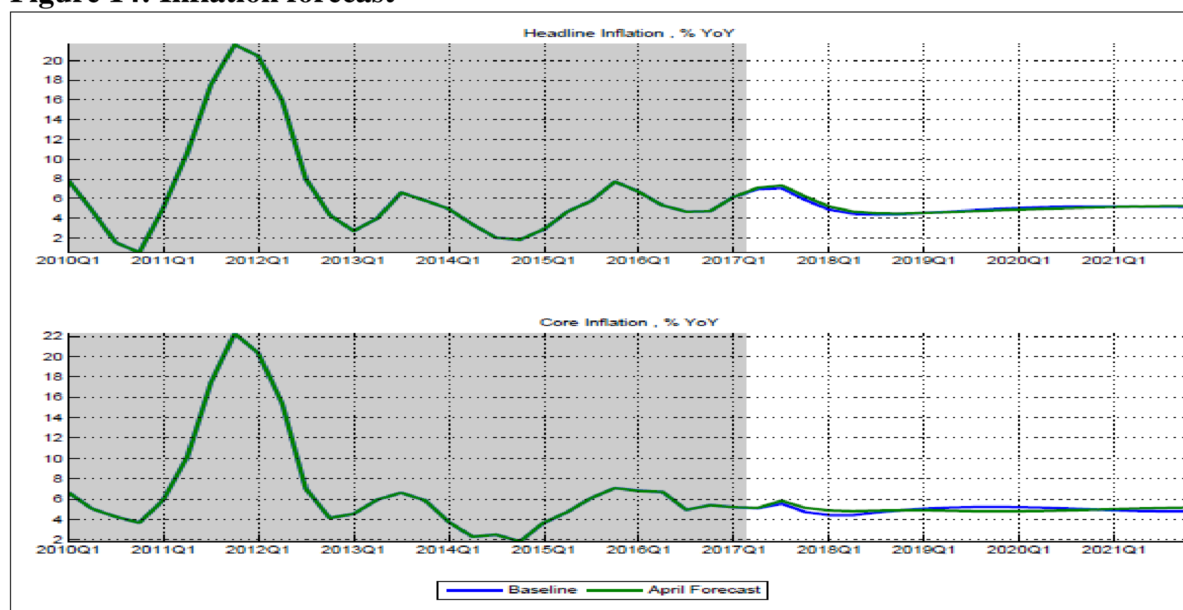
3.6.2 Inflation Outlook

The outlook for the external economic environment remains on a trajectory of broad-based improvement in the medium term specifically for the US and Euro Area while. China is headed for a deceleration in economic growth. Over the near term, however, the outlook for the US economy is softer compared to our April forecast assumptions due to weak consumer expenditures. Growth is expected to recover to levels slightly higher than 2.0 per cent and the Fed is expected to continue raising the policy rate on a regular basis in 2017. Inflation is on the rise on account of the rebound in International Oil and commodity prices and tightening of global financial conditions and the associated effects on the exchange rate and residual impact of the drought. This notwithstanding, international oil prices are forecast at about 3.5 per cent lower in 2017/18 compared to April 2017 forecast due to the increasing production in the US which has undercut the effect of the OPEC agreement. International food prices are also forecast to be lower on account of favourable weather conditions.

The temporary factors that caused inflation to edge up are expected to start diminishing in the first quarter of 2017/18 and while growth is still be below potential, it is expected to improve. GDP growth in 2016/17 is estimated at 3.5 - 3.9 per cent. However, the Composite Index of Economic Activity indicates recovery for the first 4 months of 2017 and GDP growth for 2017/18 is projected at 5.0 per cent. Looking forward, economic growth is expected to increase gradually over the next 4 to 5 years to about 6.0 - 6.5 per cent. The outlook will be supported by public investments, stable

exchange rate, and recovery in private sector credit extension. Inflation continues to evolve broadly as has previously been forecasted. Both annual headline and core inflation are currently forecast to stabilize around the BoU medium term of 5.0 per cent in the second half of 2017. Convergence of inflation to the target rate is expected sooner than previously projected due to large output gap and stronger shilling exchange rate relative to what was initially projected. These inflation forecasts are depicted in **Figure 14**.

Figure 14: Inflation forecast



Source: Bank of Uganda

Although inflation is predicted to remain within its 5 per cent target, there are risks to this outlook, albeit relatively well balanced. On one side, there are upside risks related to: the possibility of higher food prices due to poor harvest because of erratic rains and the effect of the army worm; a rise in global inflation especially in Europe and US and in EMDEs due to increased aggregate demand and higher commodity prices; the possibility of political unrest given the elections in offing in Kenya; and weakening of the exchange rate following a pick-up in aggregate demand and the uncertainty surrounding global financial markets. Nonetheless, the impact of these developments, if they materialize, could be moderated by Lower oil prices, appreciation of the exchange rate following increase inflows into the oil sector in the near- to medium- term, subdued aggregate demand as PSC may continue to be constrained due to tight credit standards and slow implementation of public investment projects.

4 Conclusion

The international economic upswing has continued. Global GDP growth is projected to pick up in 2017 and further in 2018. Although the risk of setbacks is deemed to have decreased, there is still economic and political uncertainty in many parts of the world. Pervasive uncertainty surrounding policies - in particular policy support in the US and China are likely to be unwound down the road to avoid unsustainable fiscal dynamics; and the threat to turn toward zero-sum policy approaches could lead to trade and cross-border investment flows warfare mainly in AEs. This combined with non-economic factors, including geopolitical tensions, domestic political discord, extreme weather events, and terrorism and security concerns could dampen medium-term global growth prospects.

Global inflation remains low and stable. Global inflation is projected to rise this year, which is largely connected to the rise in energy prices over the past 12 months. Although average prices gradually picked up in AEs in 2016, projections still represent an outlook of benign global inflation in 2017 and 2018. Moreover, the oil price has fallen since April and is only expected to rise slowly in the period ahead, which means that the contribution by energy prices to inflation will decrease. Gradually higher resource utilisation means, however, that underlying inflation is expected to increase in the period ahead. Global financial markets remain susceptible to intermittent episodes of volatility as U.S Fed continues with its monetary policy normalization and is expected to begin implementing a balance sheet normalisation programme this year. Indeed, going forward, EMDEs are likely to face challenges on account of continued strengthening of the U.S Dollar and rising yields on long term AEs securities.

On the domestic scene, growth outlook remains challenging, although a modest improvement is expected over the forecast period. GDP growth for FY2016/17 has been lower than expected at 3.9 per cent, with all sectors slowing down, largely due to delays in public development investment and sustained weakening of the agricultural sector which has been affected by the prolonged drought. Composite Index of Economic Activity estimated 1.5 per cent growth in economic activity in the quarter to May 2017 compared to an expansion of 0.7 per cent in the quarter to February 2017, and an annual growth to May 2017 of 4.3 per cent. It suggests a further improvement in economic activity in the quarter to June 2017, albeit at a lower rate. Overall, the impact of negative external shocks on the economy will be softened going forward and a return to reasonable growth is expected in FY 2017/18 and beyond, boosted by improved efficiency and effectiveness in implementation of public investments, investments in the

oil sector, recovery in PSC growth as lending rates continue declining and improvement in agricultural production and consumption growth.

Nonetheless, weak implementation of public investments remains a challenge to growth and monetary policy. On the one hand, the BoU has continued to purchase foreign exchange in anticipation of the fiscal implementation of infrastructural projects which has been slow. Indeed, this has contributed to the build-up in structural liquidity amidst limited longer dated securities to manage it and the need to resort to expensive short term instruments. Moreover the BoU's purchase of foreign exchange has added to the demand pressures in the IFEM leading to the depreciation of the shilling. Broadly, interest rates seem to be declining with the easing in monetary conditions. This coupled with the Government commitment to reduce issuance of government securities for purposes of financing the deficit over the medium term could boost PSC growth.

Government has also committed to faster implementation of the planned infrastructural projects. While this will support economic activity in the near- to medium- term, the large foreign currency requirements could result in the depreciation of the exchange rate which could pose upside risks to inflation. Economic activity is therefore expected to pick up next financial year to about 5.0 per cent and over the medium term to an average of 6.3 per cent, supported by both private and public sector investment especially in the oil sector and consumption. However, risks to growth outlook, including weak implementation of public investments could continue to cause subdued growth.

Inflation forecast indicates that inflation continues to evolve broadly as has been previously forecasted. Both annual headline and core inflation are currently forecast to stabilize around the BoU medium term of 5.0 per cent in the second half of 2017. Convergence of inflation to the target rate is expected sooner than previously projected due to large output gap and stronger shilling exchange rate relative to what was initially projected. The Bank reiterates its commitment to conduct monetary policy with flexibility, so that projected inflation is maintained at 5 per cent over the policy horizon. Any future changes in the monetary policy outlook will depend on the implications of domestic and external macroeconomic conditions on the inflationary outlook.