Bank of Uganda

State of the Economy

March 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	Percentage 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
WALR	Weighted Average Lending Rate
Y-o-Y	Year-on-Year

Executive Summary

1) A recent strengthening in activity indicators in advanced economies suggests the near-term outlook for global growth has improved. Global GDP growth is projected to pick up in 2017 and further in 2018, although risks to the outlook remain significantly skewed to the downside. These include the likelihood of weaker-than-projection growth in China, vulnerability to tighter global financial conditions in large Emerging Market and Developing Economies (EMDEs) compounded by domestic constraints, which may increase the severity of exchange rate adjustments, geopolitical risks mainly in the Middle East and Africa as well as increased protectionist policy considerations particularly in Advanced Economies (AEs). In particular, rising opposition to globalisation and a shift from globalisation towards more nationalism, compounded with a rising belief in the need for greater state intervention in the economy, are causing nervousness in the global economic outlook.

2) Global inflation remains low and stable. Although average prices gradually picked up in AEs in 2016, projections still represent an outlook of benign global inflation in 2017 and 2018. Global financial markets remain susceptible to intermittent episodes of volatility as faster U.S Fed monetary policy normalization is now expected. 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.

3) On the domestic scene, in line with the continued easing in the monetary policy stance, money market rates in general have similarly recorded a decline. The Central Bank Rate (CBR) has been reduced by 550 basis points (bps) since March 2016. Correspondingly, the weighted average 7-day money market rate has declined by 553 bps between March 2016 and March 2017, while average yields on the 91-day, 182-day and 364-day Treasury bills (T-bills) have fallen to 13.1, 13.7 and 14.3 per cent, respectively in Q1-2017 from highs of 19.0, 20.9 and 21.0 per cent, respectively in Q1-2016. Average yields on the benchmark 2-year Treasury bond (T-bond) also declined to 15.9 per cent in Q4-2016, from 16.6 and 19.9 per cent in Q3-2016 and Q1-2016, respectively.

4) The weighted average lending rates (WALR) on Shilling-denominated loans also declined, albeit marginally to 22.4 per cent from 25.2 per cent in February 2016. Over the same period, time deposit rates also declined to 11.8 per cent from 16.2 per cent.

5) Growth in Private Sector Credit (PSC), a leading indicator of the financial sector's contribution to economic activity, has somewhat improved. In Q4-2016, year-on-year (y-o-y) growth in PSC recovered to an average of 5.3 per cent, up from *minus* 0.1per

cent in Q3-2016. However, growth in PSC declined from an annual growth rate of 7.6 per cent in November 2016 to 6.5 per cent in December 2016 and to 5.4 per cent in January 2017. A clear picture of the pickup in PSC growth is displayed after accounting for valuation changes. After adjusting for the exchange rate changes, year-on-year (y-o-y) growth in PSC averaged 3.7 per cent in Q4-2016 compared to 2.8 per cent in Q3-2016. Over the same period, growth in foreign currency denominated loans improved to *minus* 0.8 per cent compared to *minus* 1.8 per cent in the previous quarter while Shilling denominated loans grew on average by 6.9 per cent, up from 6.1 per cent in Q3-2016.

6) Implementation of the budget for FY 2016/17 continues to meet challenges including weak revenue performance and lower-than-PSI government development expenditure, while current expenditure turns out higher than what was agreed on under the PSI. During the first seven months of FY 2016/17 total government revenue (including grants) amounted to Shs. 7,762.3 billion, representing a shortfall of Shs. 459.1 billion, while total government expenditure and net lending in the same period amounted to Shs. 10,009.9 billion, and was lower than the amount programmed by Shs. 1,932.1 billion. While revenues and grants underperformed on account of significantly lower-than-programmed project support grant receipts and a shortfall in international trade tax collections, weak expenditure performance was mainly due to low development spending, which presents a downside risk to the projected growth for FY 2016/17 which was to be supported by robust government spending on infrastructure development.

7) Debt vulnerability indicators show that Uganda's debt may be moving from a level of low to moderate risk of distress. Indeed as at end January 2017, total public debt outstanding increased to Shs. 32.45 trillion compared to Shs. 29.61 trillion recorded at the end of June 2016, mainly driven by increase in public external debt. However, the IMF's recent Debt Sustainability Analysis (DSA) indicates that total public debt based on end June 2016 public debt stock levels remains sustainable over the 20-year projection period starting 2017, although, the analysis also highlighted deviations from fiscal objectives. These deviations which relate to revenue mobilisation and expenditure reprioritisation were indicated as the main risks to debt sustainability.

8) The balance of payments recorded a surplus of USD 167.1 million during the first seven months of FY 2016/17. This was an improvement compared to the deficit of USD 66.5 million recorded in the corresponding period of FY 2015/16. During the same period, the current account balance improved to a deficit of USD 551.9 million from a deficit of USD 984.7 million, mainly driven by a lower trade deficit which significantly declined to

USD 1,047.8 million in the seven months to January 2017, from USD 1,666.5 million in the same period of FY 2015/16. Improvement in the goods account was mainly supported by higher export earnings coupled with a general decline in all imports, reflecting subdued domestic demand and reduced government expenditure on development projects for the period. During the first seven months of FY 2016/17, inflows through the financial account decreased by 7.4 per cent to USD 591.3 million from USD 550.7 million in the corresponding period of the previous financial year.

9) The Uganda Shilling has broadly remained stable, depreciating on average by 5.3 per cent in the quarter to February 2017 on year-to-year basis. However, key risks to its stability remain. Planned infrastructure projects, which if implemented, will pose a demand for foreign currency in the IFEM. In addition, exchange rate stability continues to be susceptible to the persistent fragility of the current account and the possible volatility in the global financial markets. Significant exchange rate depreciation remains a major upside risk to domestic inflation.

10) In the first half of FY 2016/17, Uganda's GDP growth was lower-than-expected, largely reflecting temporary adverse weather related factors. Quarterly GDP data released by the Uganda Bureau of Statistics (UBOS), showed that the economy contracted by 0.2 per cent in Q1-2016/17, from an increase of 0.6 per cent in Q4-2015/16, largely due to a decline in activity in the agricultural sector. Economic activity in the agricultural sector declined for the third consecutive quarter, to *minus* 1.1 per cent in Q1-2016/17, from *minus* 1.0 per cent in Q4-2015/16 and *minus* 3.8 per cent in Q3-2015/16. Consumption growth is estimated to have been subdued, especially in the second half of 2016. It is expected to recover but remain below its historical average. This is consistent with relatively weak growth in household income. The Composite Index of Economic Activity for the quarter ended January 2017 shows some recovery, with quarter-on-quarter growth of 1.06 per cent compared to 0.96 per cent in the quarter ended October 2016.

11) GDP growth projection for FY 2016/17 has been revised downwards to 4.5 per cent, largely due to delays in public development investment and sustained weakening of the agricultural sector which has been affected by the prolonged drought. Nonetheless, a return to reasonable growth is expected in FY 2017/18, boosted by improved implementation of public infrastructure investments, higher private sector investments in the oil sector and improvement in agricultural production and consumption growth. Declining interest rates are expected to support growth in private sector credit and boost investment.

12) Headline and core inflation averaged 5.2 per cent in the six months to February 2017. However, in recent months, overall and core CPI inflation has risen to an average of 6.1 per cent and 5.6 per cent in the quarter to February 2017. The rising inflationary pressures are being driven by supply side shocks, which have driven up food crop prices and services inflation. Indeed, annual food crops and related items inflation has averaged 14.7 per cent in the quarter to February 2017, compared to 6.6 and 4.1 per cent in Q4-2016 and Q3-2016, respectively. Even though Services inflation slightly declined to 6.4 per cent in the three month to February 2017 from 6.9 per cent in Q4-2016.

13) Inflation forecast indicates that inflation will temporarily increase above target in quarter four of 2016/ 2017, but remain within the target band of 5 per cent ± 3PPs. While the uptick in inflation is a cause for concern, the main drivers of this deterioration are supply side shocks including the increase in both international oil and food prices. Moreover, inflationary pressure will be constrained by weak aggregate demand. In particular, the anticipated increase in the international oil prices is not expected to be the start of a new oil price spiral and a steady decline in food price inflation is still expected despite the expectation that food prices are to rise on account of the adverse weather conditions. The more favourable shilling exchange rate has been an important factor in offsetting some of the negative impacts of supply side shocks. Despite some turbulence in last quarter of 2016, the shilling has been relatively resilient since December 2015. Furthermore, the current level of the shilling is slightly stronger than that implicit in the forecast, and pass-through to inflation continues to be relatively muted. Nevertheless, it remains vulnerable to both domestic and external shocks.

1 Back ground

This report presents domestic and external economic developments in the period to January 2017, extending into February 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 GDP growth is estimated to have slightly decelerated to 3.1 per cent in 2016 from 3.2 per cent in 2015, on the back of weaker growth in Advanced Economies (AEs) in H1-2016 and a continued slowdown in some Emerging Market and Developing Economies (EMDEs). After a feeble performance over the past few years, with annual growth in trade volumes barely keeping pace with GDP, the signs are that global trade is picking up again. Therefore, growth is projected to pick up to 3.4 per cent in 2017 and further to 3.6 per cent in 2018. Growth in economic activity in AEs is estimated to have slowed down to 1.6 per cent in 2016, from 2.1 per cent in 2015 but is projected to pick up to around 2 per cent both in 2017 and 2018. The Expectations of tax cuts, infrastructure spending and regulation from the new USA administration have invigorated animal spirits in the United States of America (U.S). In addition, in the latter part of 2016, there was a stronger-than-expected growth performance in other key AEs such as Germany, Japan and the United Kingdom (U.K). The current projections for GDP growth for AEs for 2017 and 2018 are an upward revision of 0.1 percentage point (PP) and 0.2 PP, respectively, compared to the October 2016 forecasts.

The risks to this happy prospects are manifold, however. Recent economic data in US have been mixed: consumer spending and industrial production both fell in January 2017. Meanwhile, monetary policy, which has played a big role in supporting activity since 2009, is becoming less accommodating. The US Fed raised further interest rates in March 2017 to 0.75-1.00 per cent. The ECB will scale back the volume of its monthly bond purchases in April 2017.

The pickup in global growth projected in 2017 and 2018 is partly on account of some recovery in the performance of EMDEs, which is projected at 4.5 per cent in 2017 and 4.8 per cent in 2018, largely supported by continued policy stimulus in China and recovery in key oil exporting economies such as Nigeria. Nonetheless, stronger growth in EMDEs is expected to remain curtailed by domestic constraints in large EMDEs such as India, Indonesia, Argentina, Brazil and key economies in the Middle East.

Overall, risks to the global economic outlook remain significantly skewed to the downside. Although the growth forecast for China for 2017 has been revised upwards on anticipation of a positive effect from the government's policy support, the resultant expansion of credit without commensurate corporate debt restructuring increases the risk of a disruptive adjustment to the lower growth path. In large EMDEs, vulnerability to tighter global financial conditions, given the anticipated faster increase of interest rates in the US in 2017, continues to be compounded by domestic constraints, which may increase the severity of exchange rate adjustments and trigger renewed global financial market instability. Finally, geopolitical risks mainly in the Middle East and Africa as well as increased protectionist policy considerations particularly in AEs remain potential sources of disruption to global trade and output.

Table 1: Global Growth Projections

	Outturn	Latest Jan - 2017 Forecasts		Difference from Oct -16 Forecast	
	2016	2017	2018	2016	2017
World Output	**3.1**	**3.4**	**3.6**	**0.0**	**0.0**
Advanced Economies	**1.6**	**1.9**	**2.0**	**0.1**	**0.2**
United States	1.6	2.3	2.5	0.1	0.4
Euro Area	1.7	1.6	1.6	0.1	0.0
Japan	0.9	0.8	0.5	0.2	0.0
United Kingdom	2.0	1.5	1.4	0.4	-0.3
Canada	1.3	1.9	2.0	0.0	0.1
Emerging Market and Developing	**4.1**	**4.5**	**4.8**	**-0.1**	**0.0**
Russia	-0.6	1.1	1.2	0.0	0.0
China	6.7	6.5	6.0	0.3	0.0
India	6.6	7.2	7.7	-0.4	0.0
Brazil	-3.5	0.2	1.5	-0.3	0.0
Sub- Saharan Africa	**1.6**	**2.8**	**3.7**	**-0.1**	**0.1**
Nigeria	-1.5	0.8	2.3	0.2	0.7
South Africa	0.3	0.8	1.6	0.0	0.0

Source: IMF, WEO Update January 2017

GDP growth in Sub-Saharan Africa (SSA) is estimated to have slowed to 1.6 per cent in 2016 from 3.4 per cent in 2015, mainly due to weak global economic activity, lower oil prices and disruptions to oil production particularly in Nigeria. Notably, SSA growth is projected to improve to 2.8 per cent and 3.7 per cent, in 2017 and 2018, respectively, reflecting continued recovery of international commodity prices, restoration of oil production capacity particularly in Nigeria and as countries in the group direct efforts at increasing financial resilience. However, the negative impact of the drought in eastern and southern Africa, which started in H2- 2016 extending through Q1-2017, could curtail the extent of the region's growth recovery in 2017. Global growth projections are presented in **Table 1** above.

2.2 Global Inflation

Median global inflation has risen modestly but steadily in recent months, to 1.8 per cent year-on-year in December 2016, the fourth consecutive monthly increase. The uptick is the most sustained rally since late 2010. The rise in commodity prices—particularly energy prices—is a key factor behind the increase. In the quarter ended January 2017, average annual inflation in key AEs rose to 1.3 per cent from 1.0 per cent in the quarter ended December 2016 and from 0.4 per cent in the same quarter of the previous year. Generally low inflation enabled the easing of monetary policy in majority of the AEs in support of growth. Going forward, the recent pickup in inflation could lead to lower-than-anticipated easing in monetary policy particularly in the Euro Zone, Japan and the U.K.

Despite the tightening of global financial conditions and recovery in global commodity prices in the last quarter of 2016, average annual inflation in key EMDEs continued declining to around 4.6 per cent in the quarter ended February 2017, from 4.9 per cent in the quarter ended December 2016 and from 7.3 per cent in the quarter ended January 2017. However, average annual inflation in China rose to 2.3 per cent from 2.2 per cent and 1.6 per cent over the same period, driven mainly by capacity cuts and higher commodity prices. Notably, the anticipated faster increase of US interest rates is likely to increase exchange rate depreciation pressures in EMDEs and eventually exert upward pressure on average domestic prices.

The IMF projects average inflation in AEs to rise to 1.7 per cent and 1.9 per cent in 2017 and 2018, respectively, from 0.7per cent in 2016.In EMDEs, average inflation is forecast at 4.5 per cent in 2017, the same level recorded in 2016 and at 4.3 per cent in 2018. These projections still represent an outlook of benign global inflation, which lowers the upside risks to domestic inflation.

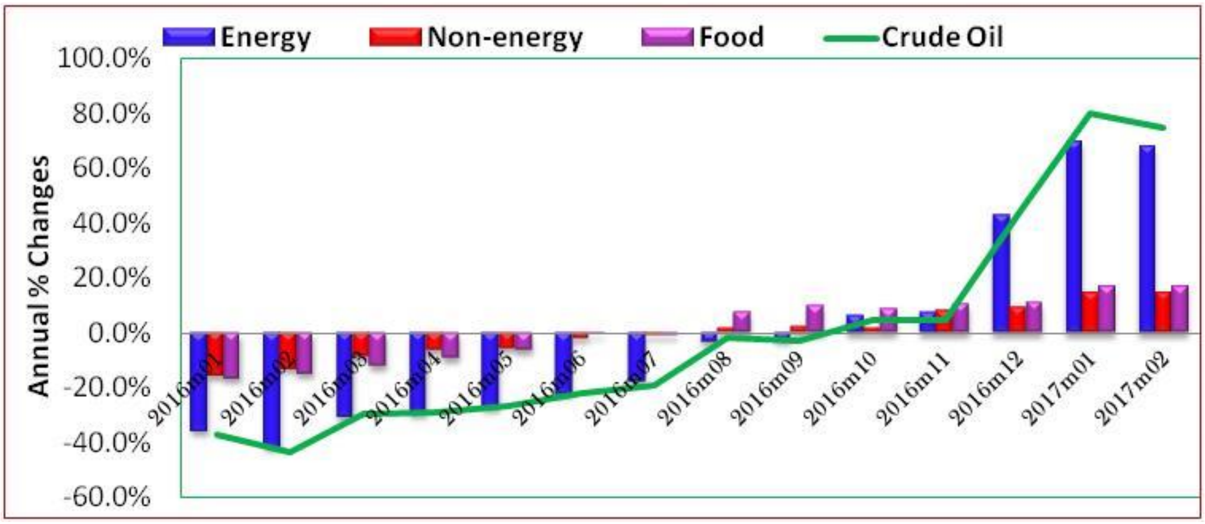
2.3 International Commodity Prices

Commodity prices picked up further in the last quarter of 2016 and are expected to continue recovering through 2017, supported both by dry weather conditions and the agreement by OPEC members and other important oil producers to curtail oil supply to support oil prices. Following the September 2016 OPEC agreement to reduce oil production to 32.5 million barrels per day, average crude oil prices rose by close to 6.0 per cent and 3.0 per cent in the quarters ended January 2017 and February 2017, respectively slower than an increase of 10 per cent registered in December 2016 and an increase compared to a decline of 14 per cent and 11 per cent registered in the quarter to January 2016 and February 2016, respectively. On annual basis, average crude oil prices registered an increase of about 75 per cent in January 2017. 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 42.7 per barrel in 2016 as the market continues to rebalance. However, going forward potentially less strict environmental regulation in the US might taper oil prices and also make them more volatile.

Similarly, international food prices rose by 0.7 per cent and 0.5 per cent in the quarter ended January and February 2017 compared to a decline of 0.1 per cent in the quarter ended December 2016. 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 1**.

Figure 1: Global Commodity Price Developments



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

2.4 Global Financial Markets

Global financial markets remained broadly stable despite the materialization of the long anticipated U.S Fed Funds rate increases in December 2016 and March 2017. In AEs, the anticipated shift in the U.S policy mix has led to positive financial markets prospects giving rise to an uptick in the long-term nominal and real interest rates since October 2016.Long term interest rates, particularly in the U.S, rose during the quarter to December 2016, mainly driven by expectations of an expansionary fiscal policy and a less gradual normalization of U.S monetary policy. 10-year government bond yields in the U.S rose to 2 per cent in the quarter ended December 2016 from 1.6 per cent in the previous quarter. In the Euro zone, rates on long term securities rose to 0.19 per cent from -0.1 per cent over the same period, mainly on account of elevated political and banking sector uncertainties.

In the currencies markets, the U.S Dollar continued to appreciate through the last quarter of 2016, with the U.S Dollar index rising by 3.8 per cent on quarterly basis and by 2.1 per cent on annual basis. Though there was a recovery in the capital inflows to the EMDEs, there has been a noted sudden tightening in the financial conditions of these markets 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 continued strengthening of the U.S Dollar, rising yields on long term AEs securities and heightened policy uncertainty associated with the new U.S government.

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.

Tighter global financial conditions could lead to weaker financial flows or possible capital reversals especially in EMDEs. The beginning of the normalization of the U.S monetary policy turned investor sentiments, causing a reversal of capital flows and strong pressures on exchange rate in developing economies, including Uganda. The anticipated faster increase of the U.S Federal Reserve policy rates in 2017, coupled with divergent paths of monetary policy in the rest of the AEs might increasingly tighten global financial conditions, triggering renewed financial markets volatility and sporadic portfolio adjustments. This could heighten exchange rate depreciation pressures, with a potential to drive up domestic inflation and run down foreign exchange reserves.

The uncertainty originating from the likely US policies continue to impact on the global economy. Already, the US government has indicated that it will cut development assistance and this is likely to adversely affect Uganda's economy.

In addition, the geopolitical risks mainly in 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 three neighbouring countries, 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. In addition, increased protectionist policy considerations particularly in AEs remain potential sources of disruption to global trade and output.

3 Domestic Economic Developments

3.1 Reflections on Monetary Policy Stance and Implementation

3.1.1 Monetary Policy Stance

In February 2017, Bank of Uganda (BoU) continued with a cautious easing of monetary policy, reducing the Central Bank Rate (CBR) by 0.5PPs to 11.5 per cent from 12.0 per cent in December 2016 and 13.0 per cent in October 2016 to support economic activity. Although at the time of its Monetary Policy Committee (MPC) meeting of February 2016 the near-term inflation outlook had deteriorated, the medium-term outlook was well anchored around the BoU's medium term target of 5.0 per cent. The near term increase in inflation is due to heightened supply side shocks, particularly increasing international oil and food prices, but their full impact is being constrained by weak aggregate demand and the more favourable shilling exchange rate. Nevertheless, the exchange rate remains vulnerable to both domestic and external shocks. 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 were reduced to 15.5 per cent and 16.5 per cent, respectively.

3.1.2 Monetary Policy Operations and Challenges

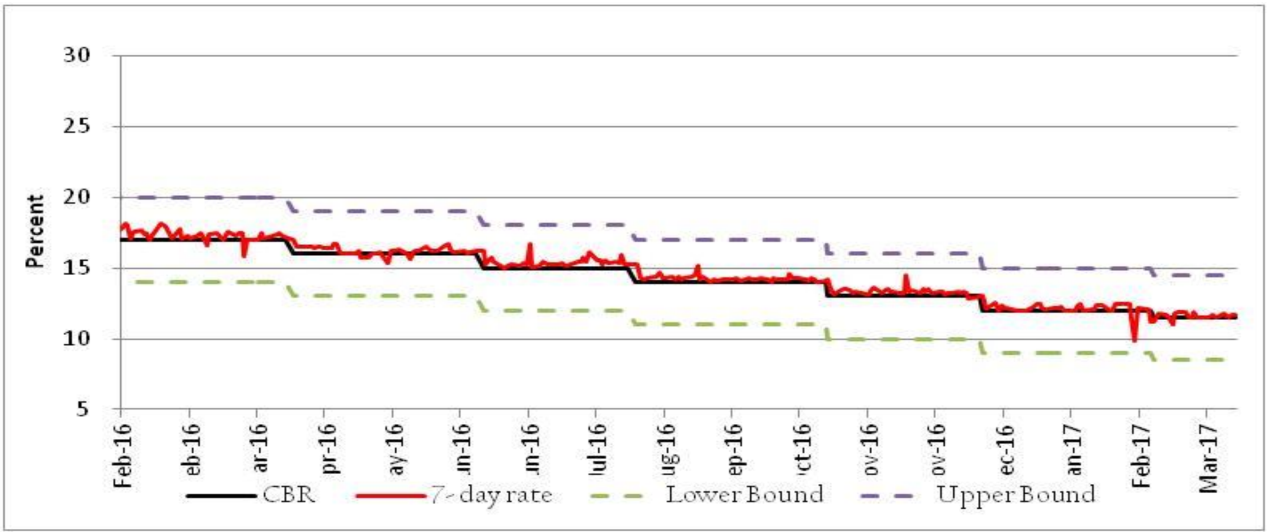
BoU continued to use Repurchase Agreements (REPOs), deposit auctions and sales of recapitalization securities in the secondary market to align domestic liquidity conditions with the desired monetary policy stance. As at March 20, 2017, a total of 9 deposit auctions had been held since their resumption in November 2016, mopping up Shs. 612 billion, with the outstanding amount of Shs. 328 billion.

The net impact of the REPO/reverse REPO instrument from December 2016 to March 20, 2017 was a net withdrawal of Shs. 179.5 billion, with the outstanding stock of REPOs as at March 20, 2017 at Shs. 939.4 billion. As at March 20, 2017, Shs. 712 billion in recapitalization securities had been sold, and the remaining stock stood at Shs. 248 billion.

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 correspondingly declined. Since April 2016, the CBR has been reduced by 550 basis points (bps) to 11.5 per cent in February 2017 from 17.0 per cent in March 2016. Over the same period, the weighted average 7-day money market rate has declined by 553 bps to 11.5 per cent as at March 20, 2017 from 17.0 per cent in March 2016 in line with the reduction of the CBR (**Figure 2**).

Figure 2: 7-day Interbank Rate and the CBR



Source: Bank of Uganda

3.2 Other Interest rates and Private Sector Credit

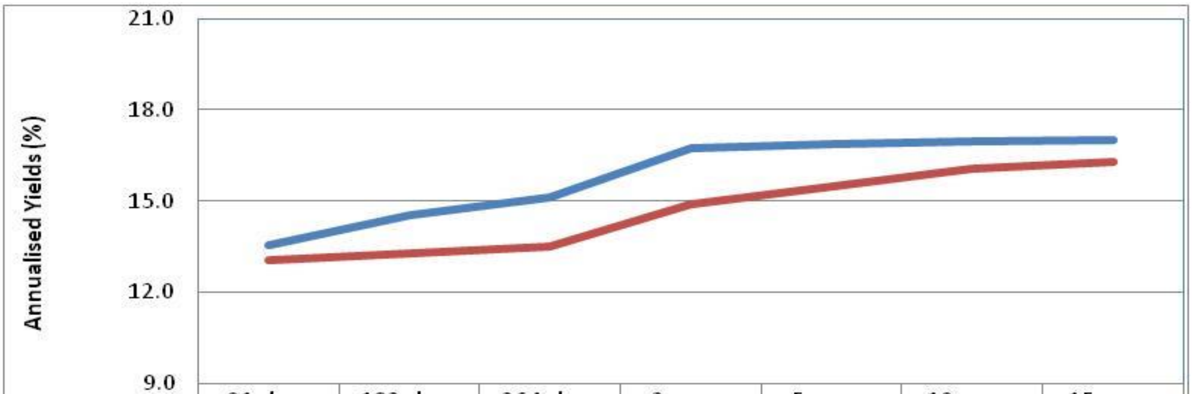
3.2.1 Yields on Government Securities

Yields on government securities have also declined, reflecting continued easing in monetary policy stance and lower domestic borrowing by the government. Average yields on the 91-day, 182-day and 364-day Treasury bills (T-bills) declined to an average of 13.1, 13.7 and 14.3 per cent, respectively over Q1-2017 compared to 19.0, 20.9 and 21.0 per cent, respectively in Q1-2016.

In line with the trend of T-bills, the average yield on the benchmark 2-year Treasury bond (T-bond) declined to 15.9 per cent in Q4-2016, from 16.6 and 19.9 per cent in Q3-2016 and Q1-2016, respectively. On the other hand, while the average yields on the 5-

year and 15-year T-bonds declined to 16.7 and 16.9 per cent, respectively, in the quarter to December 2016, the average yields on the 10-year T-bond rose to 17.3 per cent over the same period from 16.6 per cent in Q3-2016 as shown in **Figure 3**. Notably, in January 2017 yields on T-bonds remained relatively unchanged compared to their December 2016 levels.

Figure 3: Yields on T-bills and T-bonds



	91-days	182-days	364-days	2-years	5-years	10-years	15-years
Jan-2017	13.6	14.5	15.1	16.8	16.9	17.0	17.0
Feb-2017	13.1	13.3	13.5	14.9	15.5	16.1	16.3

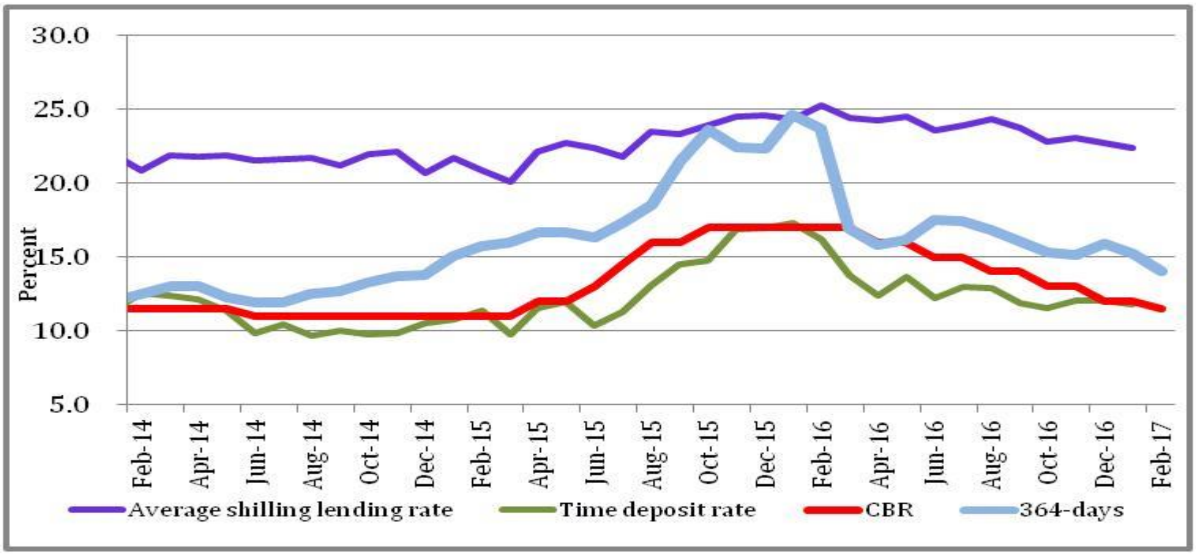
Source: Bank of Uganda

3.2.2 Lending and deposit interest rates

In line with other interest rates, the weighted average lending rates (WALR) on Shilling-denominated loans declined, though only marginally to 22.4 per cent in January 2017 from 25.2 per cent in February 2016. Over the same period of time, time deposit rates also declined to 11.8 per cent from 16.2 per cent. **Figure 4** shows developments in key interest rates.

Notwithstanding the marginal reductions in lending rates, they remain elevated and generally sticky downwards. The CBR has been reduced by 550 bps since April 2016. However, the WALR for shilling denominated loans have declined only by about 50 per cent of the reductions in CBR by 250 bps. Provisioning for bad debts, given the rising NPLs, and structural rigidities in the financial sectors largely remain the key drivers of sticky lending rates. This is amplified by the operational inefficiencies on the side of commercial banks. Overall, high lending rates pose a major constraint to growth in private sector credit (PSC), with downside implications for domestic economic activity.

Figure 4: Developments in Key Interest Rates



Source: Bank of Uganda

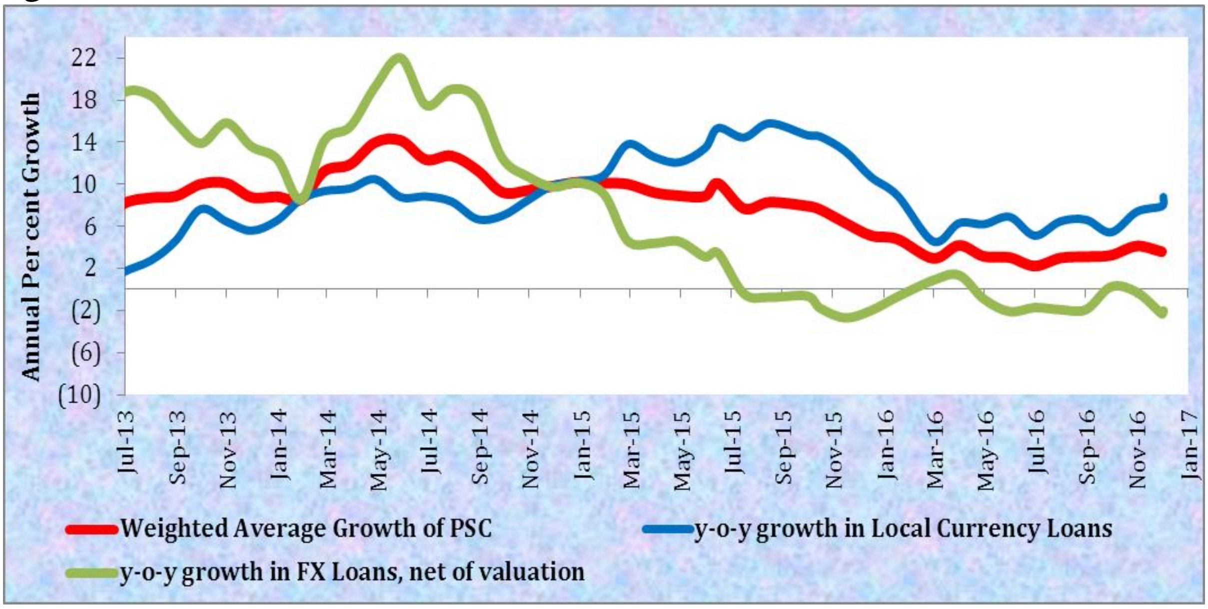
3.2.3 Monetary Aggregates and Private Sector Credit

Monetary aggregates grew robustly in the quarter to January 2017, which could be reflective of the fact that the decline in economic activity could have bottomed out. On average, M3, M2, M1 grew by 10.8 per cent, 13.8 per cent and 14.9 per cent, respectively, in the quarter to January 2017 compared with respectively growth rates 4.0 per cent, 9.7 per cent and 8.5 per cent in quarter to October 2016. This

Growth in Private Sector Credit (PSC), a leading indicator of the financial sector's contribution to economic activity, has improved somewhat. In Q4-2016, year-on-year (y-o-y) growth in PSC recovered to an average of 5.3 per cent, up from *minus*0.1per cent in Q3- 2016. A clear picture of the pickup in PSC growth is displayed after accounting for valuation changes. After adjusting for the exchange rate changes, y-o-y growth in PSC averaged 3.7 per cent in Q4-2016 compared to 2.8 per cent in Q3-2016. Over the same period, growth in foreign currency denominated loans improved to *minus* 0.8 per cent compared to *minus* 1.8 per cent in the previous quarter while Shilling denominated loans grew on average by 6.9 per cent, up from 6.1 per cent in Q3-2016 (**Figure 5)**.

Compared to history however, growth in PSC has been slowing since October 2015. Indeed, y-o-y growth in PSC averaged 6.5 per cent in December 2016, down from 15.6 per cent in December 2015.As noted in the State of the Economy Report for December 2016, the slowdown in growth in PSC was driven largely by provisioning for bad loans, which has heightened risk aversion in banks. The demand for credit (as proxied by the number and value of loan applications) has remained relatively robust. On the other hand, the supply of credit (proxied by the number and value of loan approvals) has remained subdued, an indication that the relatively subdued growth in PSC could be driven by tightening credit standards.

Figure 5: Annual Growth in Private Sector Credit



Source: Bank of Uganda

Growth in PSC was mainly driven by the agriculture, personal and household sectors. Annual PSC growth in these sectors averaged 9.6 per cent and 14.8 per cent, respectively in Q4-2016, compared to 7.4 per cent and 9.6 per cent, respectively inQ3-2016.Annual growth of credit to the manufacturing and services sectors continued to contract (**Figure 6**) by *minus* 6.5 per cent and *minus* 37.6 per cent, respectively Q4-2016, a decline that poses downside risks to private investment growth and recovery of domestic economic activity.

Figure 6: Annual Private Sector Credit Growth by Sector

Source: Bank of Uganda

3.3 Fiscal Policy and Operations

3.3.1 Fiscal Developments

Effective coordination of a country's fiscal policy with its monetary policy remains an important cornerstone for the optimization of overall macroeconomic performance and achievement of Uganda's long-term growth target. Performance of the fiscal sector, in light of the monetary policy stance pursued for the period is therefore reviewed in this Section.

Implementation of the budget for FY 2016/17 continues to meet challenges including weak revenue performance and lower-than-programmed government development expenditure, while current expenditure turns out higher than programmed. As shown **Table 2**, total government revenue (including grants) during the first seven months of FY 2016/17 amounted to Shs. 7,762.3 billion, representing a shortfall of Shs. 459.1 billion, from the amount of Shs. 8,221.3 billion programmed for the period. The underperformance was mainly on account of significantly lower-than-programmed project support grant receipts, in addition to a shortfall in international trade tax collections, arising specifically from lower Value Added Tax (VAT) on imports due to a decline in import volumes, which points to a softening of investment and may be indicative of slower economic activity in the first half of FY 2016/17.

Table 2: Fiscal Performance

(Shs. Billion)	Jul '15 – Jan'16	Jul '16 – Jan '17 Prel.	Jul '16 – Jan'17 PSI Prog.	Variation
Revenue & Grants	**7,279.8**	**7,762.3**	**8,221.3**	**-459.1**
Revenue	6,472.3	7,202.1	7,229.3	-27.3
Grants	807.5	560.2	992.0	-431.8
Expenditure & Lending	**10,396.8**	**10,009.9**	**11,942.0**	**-1,932.1**
Current	5,462.8	5,919.5	5,632.7	286.8
Development	3,342.2	3,571.0	5,268.0	-1,697.0
Net lending/repayments	1,532.5	410.6	961.3	-550.7
Dom. Arrears Repyts.	59.4	108.8	80.0	28.8
Deficit (including grants)	**-3,117.1**	**-2,247.6**	**-3,720.7**	**1,473.0**

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

Total government expenditure and net lending in the first seven months of FY 2016/17 amounted to Shs. 10,009.9 billion, and was lower than the amount programmed by Shs. 1,932.1 billion. Most of the underperformance in expenditure was concentrated in development spending which was lower than the amount programmed by Shs. 1,697 billion. This presents a downside risk to the projected growth for FY 2016/17 which was to be supported by robust government spending on infrastructure development. Clearance of domestic arrears amounted to Shs. 108.8 billion in the first seven months of FY 2016/17, which was Shs. 28.8 billion above the program.

Domestic borrowing for FY 2016/17 which was increased by Shs. 300 billion, at the time of the December 2016 monetary policy report, to Shs. 912 billion to cover projected underperformance in revenue collections, is anticipated to increase further by between Shs. 250 billion and Shs. 500 billion. This increase in domestic borrowing, if actualized, could exert upward pressure on interest rates which would be contrary to recent efforts of monetary policy to lower the cost of credit and support recovery in domestic economic activity. Further, if additional borrowing is directed to recurrent rather than development expenditure, following the spending pattern in the first half of

FY 2016/17, this will increase the downside risks to the outlook for investment and growth.

In FY 2017/18, government expenditure is projected to rise to Shs. 23.4 trillion from Shs. 19.9 trillion in FY 2016/17, while domestic revenues are projected to increase by 15.0 per cent to Shs. 14.5 trillion, which is equivalent to 14.0 per cent of GDP, driven by reforms in the tax system and efficiency gains in tax administration. External and domestic financing are projected at Shs. 6.0 trillion and Shs. 1.5 trillion, respectively, although shortfalls in domestic revenues will imply additional domestic financing, with the attendant macroeconomic implications.

3.3.2 Public Debt Stock

Debt vulnerability indicators show that Uganda's debt may be moving from a level of low to moderate risk of distress. As at end January 2017, total public debt outstanding increased to Shs. 32.45 trillion compared to Shs. 29.61 trillion recorded at the end of June 2016. Growth in the stock of total public debt between January 2017 and June 2016 was mainly driven by increase in public external debt.

As at end January 2017, external debt rose by 10 per cent to Shs. 19.89 trillion from Shs. 18.08 trillion in June 2016, while domestic debt increased by 8.9 per cent to Shs. 12.56 trillion from Shs. 11.53 trillion over the same period. Total committed external debt, stood at about Shs. 38 trillion as at end January 2017, out of which undisbursed external debt amounted to approximately Shs. 18 trillion, bringing the share of undisbursed external debt to about 47 per cent of the total committed debt and partly reflecting one of the major challenges to project implementation.

Table 3 indicates that most of the domestic debt risk indicators were outside the PDMF benchmarks and domestic debt stock continued to exhibit roll over risk. Going forward, public debt is projected to increase to US$ 9.8 billion, equivalent to 32 per cent of GDP, by June 2017 from US$ 8.7 billion as at end June 2016 and is targeted to reduce to 28 per cent of GDP in the medium term.

Table 3: Public Debt Developments

Domestic Debt Risk Indicators	PDMF	Jan-16	June-16	Jan-17
Total Stock/PSC	<75%	92.2	101.0	104.4
Percent maturing in 1 year	<40%	46.2	44.5	42.1
Percent maturing in any year after year 1	< 20%	11.2% for maturities in 2 years; 6.6% for maturities in 3 years	11.3% for maturities in 2 years; 7.8% for maturities in 3 years	8.6% for maturities in 2 years; 12.5% for maturities in 3 years
Bonds/Bills (at face value)	70/30	69/31	66/34	65/35
Average Time to Maturity (Years)	>3Yrs	3.2	3.3	3.5

Source: Ministry of Finance, Planning and Economic Development

The IMF's Debt Sustainability Analysis (DSA) indicates that total public debt based on end June 2016 public debt stock levels was sustainable over the 20-year projection period starting 2017. The analysis also highlighted deviations from fiscal objectives, relating to revenue mobilisation and expenditure reprioritisation, as the main risks to debt sustainability. Other risks to debt sustainability included exchange rate depreciation, increased non-concessional borrowing for infrastructure spending and relatively flat export earnings, which have a direct impact on the debt service burden. The current Policy Support Instrument (PSI) will be concluded in June 2017 and a new program is to be negotiated. However, IMF seems to be sceptical largely on account of the worsening debt rating. Discontinuation of the PSI programme could lead to down grading Uganda's economic rating.

3.4 Balance of Payments and Exchange rates

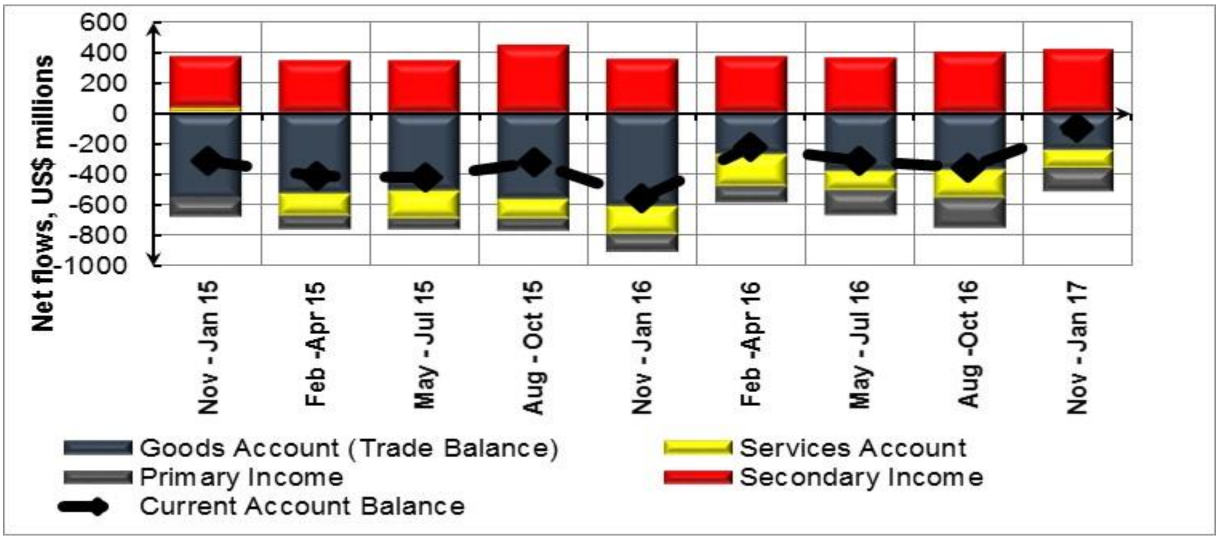
3.4.1 Balance of Payments

The balance of payments recorded a surplus of USD 167.1 million in the first seven months of FY 2016/17. This was an improvement compared to the deficit of USD 66.5 million recorded in the corresponding period of FY 2015/16. This improvement is partly due to the decline in imports, reflecting subdued economic activity.

During the same period, the current account balance improved to a deficit of USD 551.9 million from a deficit of USD 984.7 million, mainly driven by a lower trade deficit which significantly declined to USD 1,047.8 million in the seven months to January 2017, from USD 1,666.5 million in the same period of FY 2015/16. Improvement in the goods account was mainly supported by higher export earnings coupled with a general decline in all imports, reflecting subdued domestic demand and reduced government expenditure on development projects for the period. During the first seven months of FY 2016/17, inflows through the financial account increased by 7.4 per cent to USD 591.3 million from USD 550.7 million in the corresponding period of the previous financial year.

On quarterly basis, the external sector recorded a surplus overall balance for the quarter ended January 2017, on account of an improvement in the current account balance. The current account balance improved by US$262.7 million to a deficit of US$92.70 million during the quarter ended January 2017, from a deficit of US$355.39 million in the preceding quarter. The improvement in the current account balance was largely on account of an improvement in the goods account. In comparison with the same quarter a year ago, the current account deficit improved by US$464.5 million from a deficit of US$557.2 million registered in the quarter ended January 2016. The trends of the current account balance and its components are shown in **Figure 7** below.

Figure 7: Quarterly Developments in the Current Account



Source: Bank of Uganda

Export receipts increased by 13.9 per cent from US$719.6 million recorded during the previous quarter to US$819.4 million during the quarter ended January 2017, mainly supported by an increase in coffee export receipts. Coffee export proceeds continued on an upward trend, with a US$73.6 million (95.4 per cent) increase to US$150.8 million, as a result of an increase in both the volume of coffee exported and the price per kilogram. The volume of coffee exported during the 3-months under review increased by 527,672 (60Kg) bags to 1,237,151 (60kg) bags. The price of coffee increased by US$0.21 to US$2.03 per kg in the quarter under review. The increase in the value of coffee exported can be explained by the good price coupled with a shortfall in supply on international markets (Vietnam and Brazil) which led Coffee exporters to release higher volumes of their stocks on the international market.

In addition, total non-coffee export receipts (excluding non-monetary gold) increased by US$40.2million (7.3 per cent) to US$588.3 million during the quarter ended January 2017, compared to US$548.1 million received in the previous quarter. The commodities that recorded the highest increases were other pulses-Sorghum (US$17.8 million), cocoa beans (US$15.9 million), and fish (US$10.7 million). Net exports of non-monetary gold decreased by US$3.2 million to US$18.5 million during the quarter ended January 2017.

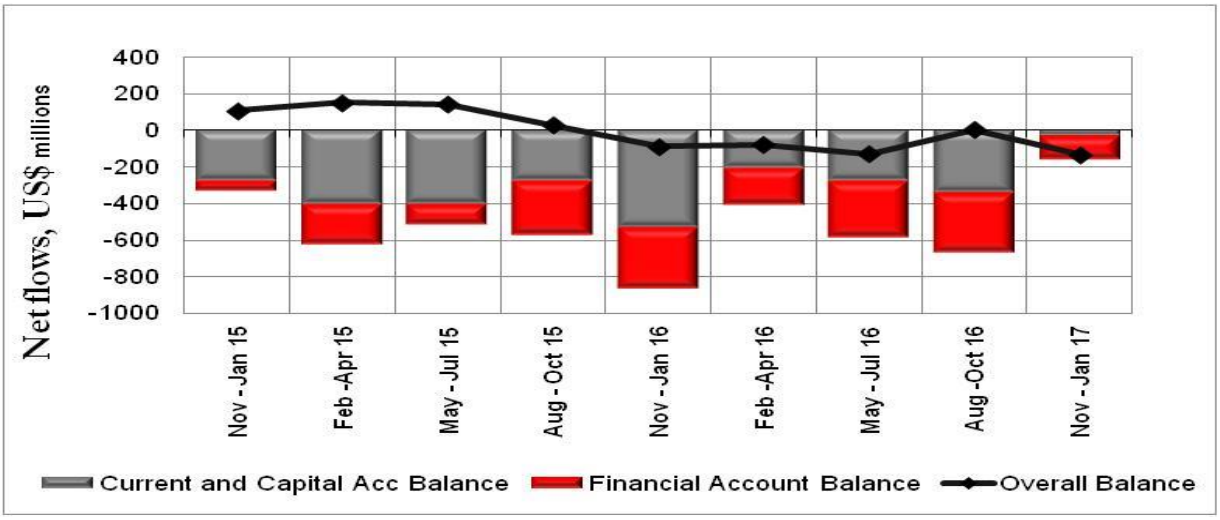
Imports of goods declined by 2.0 per cent to US$1,070.5 million during the quarter ended January 2017 from US$1,092.4 million recorded in the previous quarter largely on account of a decrease in private sector imports. Expenditure on private sector imports of goods decreased by US$29.0 million to US$962.2 million during the quarter ended January 2017, mainly on account of a decline in non-oil import expenditure.

Non-oil import expenditure declined by US$30.8 million to US$783.7 million, while expenditure on oil imports declined by US$1.5 million during the quarter. Non-oil imports that recorded the highest decline included: chemical and related products (US$13.7 million), Plastics, Rubber, & Related Products (US$7.8 million) and mineral products (US$5.7 million). The value of estimated imports increased marginally by US$0.3 million from 16.1 million in the previous quarter to 16.4 million in the quarter ended January 2017.

Government import expenditure on goods increased by US$17.9 million to US$46.4 million during the quarter ended January 2017, due to a US$21.3 million increase in project imports, which was offset by a US$3.4 million decrease in non-project imports.

The financial account recorded a net incurrence of liabilities of US$134.5 million during the quarter ended January 2017, US$192.9 million lower than a net incurrence of liabilities of US$327.5 million during the previous quarter. Direct investment net inflows (liabilities) were estimated at US$152.5 million, a decrease of US$64.1 million from US$216.6 million recorded in the previous quarter, largely owing to a US$73.3 million decrease in reinvestment of earnings. Developments in the overall balance of payments and its main components are shown in **Figure 8**.

Figure 8: Development in Overall Balance of Payments and Main Components



Source: Bank of Uganda

The stock of reserves at the end of January 2017 was estimated at US$3,041.30 million (including valuation changes), equivalent to 4.5 months of future imports of goods and services. Recent estimates of the stock of reserves as at 20thMarch 2017 amounted to US$3,154.08 million (equivalent to 4.3 months of import cover). Going forward, the current account deficit is expected to remain fragile on account of increased private sector imports in case domestic activity picks up and on higher government imports if infrastructure and energy-related projects are implemented as planned.

3.4.2 Exchange Rate Developments

Uganda's exchange rate is market determined, and is therefore vulnerable to both external and domestic shocks. Any 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. During the twelve months to February 2017, the shilling depreciated on average by 3.7 per cent compared to a depreciation of 25.3 per cent the same period February 2016.

The depreciation pressures that ensured in the last quarter of 2016 have since abated, with the Shilling appreciating by 0.7 per cent month-on-month in February 2017 to an average midrate of UGX 3,585.35 per US Dollar, an improvement compared to the depreciation of 0.3 per cent and 1.1 per cent in January 2017 and December 2016, respectively. On annual basis the Shilling depreciated by 4.4 per cent in February 2017 compared to 7.0 per cent depreciation in December 2016. The Shilling was also relatively stable on a trade-weighted basis, during the month of January 2017, depreciating only by 0.3 per cent on monthly basis and by 1.4 per cent on annual basis.

The relative stability in the exchange rate in February 2017 is mainly attributed to subdued corporate dollar demand, amidst matched inflows from Non-government Organizations (NGOs), foreign exchange bureaus and sizeable coffee export proceeds. Corporate dollar demand was low in February 2017 with net demand coming from key sectors such as manufacturing, offshores and energy, as can be seen from **Table 4**.

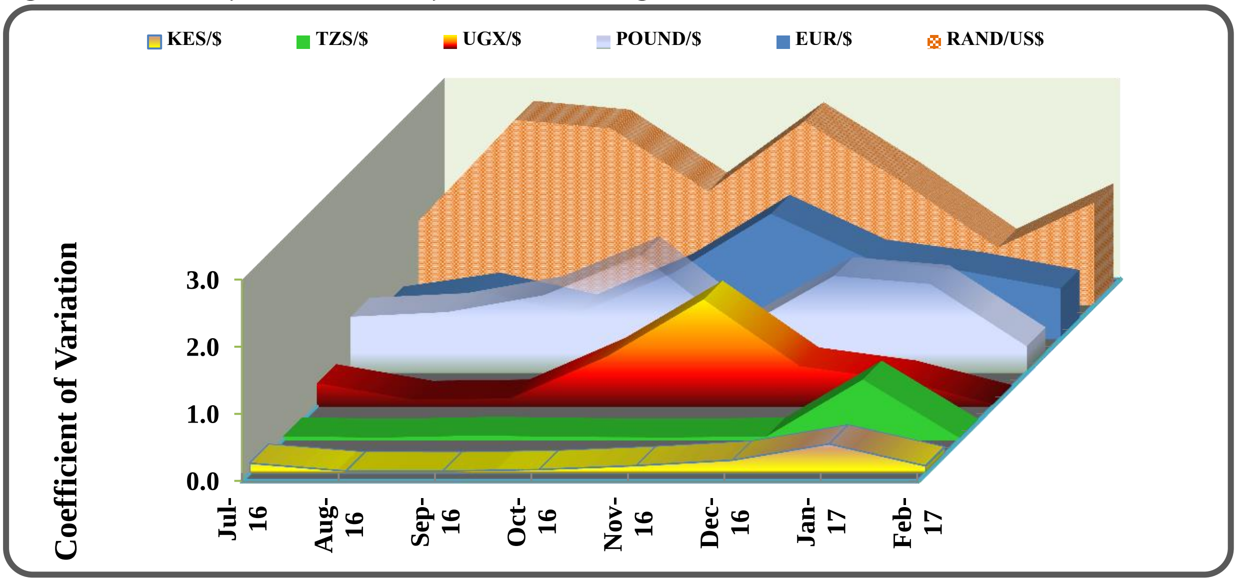
Table 4: Commercial Bank Net Supply Significant Foreign Exchange Deals: USD Millions

Row Labels	**2016 M12**	**2017 M01**	**2017 M02**
CONSTRUCTION	12.74	2.33	(1.57)
ENERGY AND POWER	(55.01)	(58.87)	(34.50)
EXPORTS	85.60	88.48	46.16
FINANCIAL INSTITUTIONS	22.65	23.52	20.40
FOREX BUREAUS	18.16	16.06	12.49
MANUFACTURING	(84.77)	(107.49)	(76.96)
NGOS AND INTERNATIONAL	34.55	44.15	35.02
OFFSHORE	53.12	12.30	3.30
OTHERS	18.84	(9.29)	8.08
TELECOMMUNICATIONS	(45.06)	(18.12)	(24.49)
TRADING	(5.18)	(22.22)	(14.63)
Grand Total	**55.63**	**(29.14)**	**(26.71)**

Source: Bank of Uganda

Analysis of volatility in **Figure 9** indeed points to Shilling stability in January 2017 compared to December 2016, although the Kenya Shilling displayed more stability, while the South African Rand remains one of the most volatile currencies in the Sub-Sahara region. However, given the now anticipated faster normalization of monetary policy in the U.S in 2017, all currencies of developing countries are at risk of facing episodes of volatility over the year, which may call for central banks' intervention in their domestic foreign exchange markets, with further risk of eroding foreign exchange reserves.

Figure 9. Volatility of Selected Key Global and Regional Currencies



Source: Bank of Uganda

Regarding BOU activity in the IFEM, in February 2017 the BoU purchased USD 110.40 million from the IFEM under the reserve build-up program, including a USD 48.5 million purchase from DFCU, bringing the amount purchased for the financial year to the end of February 2017 to USD 635.2 million. However, taking into account the Bank's intervention and targeted transactions, the net amount purchased from the IFEM in the period July 2016 to February 2017 comes to USD 493.4 million.

Going forward the Shilling is anticipated to remain stable with a bias towards a weakening of the Shilling due to an increase in corporate demand mainly on account of end-month tax payments, government demand for foreign exchange - if planned infrastructure projects remain on schedule; continued fragility of the current account - owing to the rise in crude oil prices and, increase in private sector imports - if domestic activity picks up and, volatility in global financial markets. On the other hand, an increase in supply of foreign currency is expected from non-government agencies on account of end month conversions. Significant exchange rate depreciation remains a major upside risk to domestic inflation.

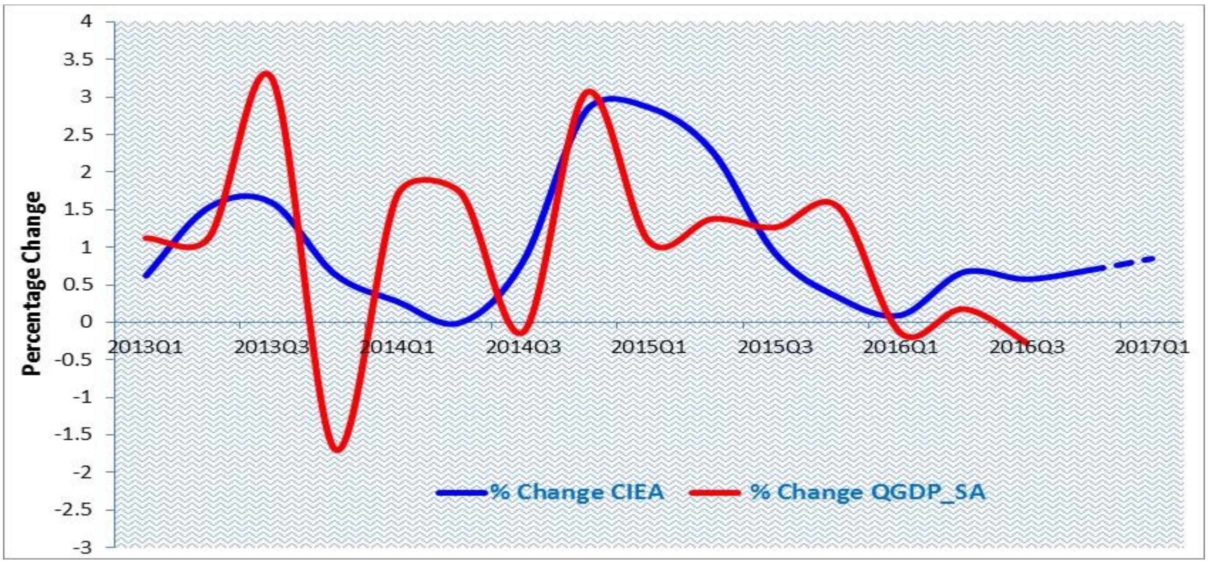
3.5 Domestic Economic Activity

In the first half of FY 2016/17, Uganda's GDP growth was lower-than-expected, largely reflecting temporary adverse weather related factors. Quarterly GDP data released by the Uganda Bureau of Statistics (UBOS), showed that the economy contracted by 0.2 per cent in Q1-2016/17, from an increase of 0.6 per cent in Q4-2015/16, largely due to a decline in activity in the agricultural sector. Economic activity in the agricultural sector declined for the third consecutive quarter, to *minus* 1.1 per cent in Q1-2016/17, from *minus*1.0 per cent in Q4-2015/16 and *minus*3.8 per cent inQ3-2015/16. Most of the decline in the agricultural sector was on account of contraction in the cash and food crop sub-sectors, arising from unfavourable weather conditions which affected harvests of cocoa, coffee, maize and beans. Consumption growth is estimated to have been subdued, especially in the second half of 2016. It is expected to recover but remain below its historical average. This is consistent with relatively weak growth in household income.

The Composite Index of Economic Activity (CIEA **Figure 10**) grew at a slightly higher rate of 1.1 per cent in the quarter to January 2017 compared to 1.0 per cent in the quarter to October 2016 and was also higher than 0.3 per cent expansion in the quarter to January 2016. Going forward, while weakness in real GDP growth so far in FY 2016/17 is due to temporary factors, economic growth could remain weak in remaining part of the financial year, reflecting the impact of a combination of domestic and external factors. Consequently, real GDP growth projection for FY 2016/17 has been revised to 4.5 per cent, which is lower than the initial projection of 5.0 per cent and the 4.8 per cent realized in FY 2015/16.

Real GDP growth for FY 2017/18 is still projected at 5.5 per cent, supported mainly by public infrastructure investment and recovery in private sector consumption and investment - in part driven by anticipated recovery in PSC. There are downside risks to the growth outlook, however, arising from both domestic and external factors both in the short and medium term. Among the domestic factors, anticipated public expenditure cuts may reduce public consumption and investment and consequently domestic demand; while private sector credit remains subdued and may continue to constrain private investment and consumption. On the external front, soft commodity prices (compared to their historical levels), may keep the contribution of net exports to growth negative.

Figure 10: Comparison of Trend of UBOS GDP and BOU's CIEA



Source: Bank of Uganda

3.6 Consumer Price Inflation

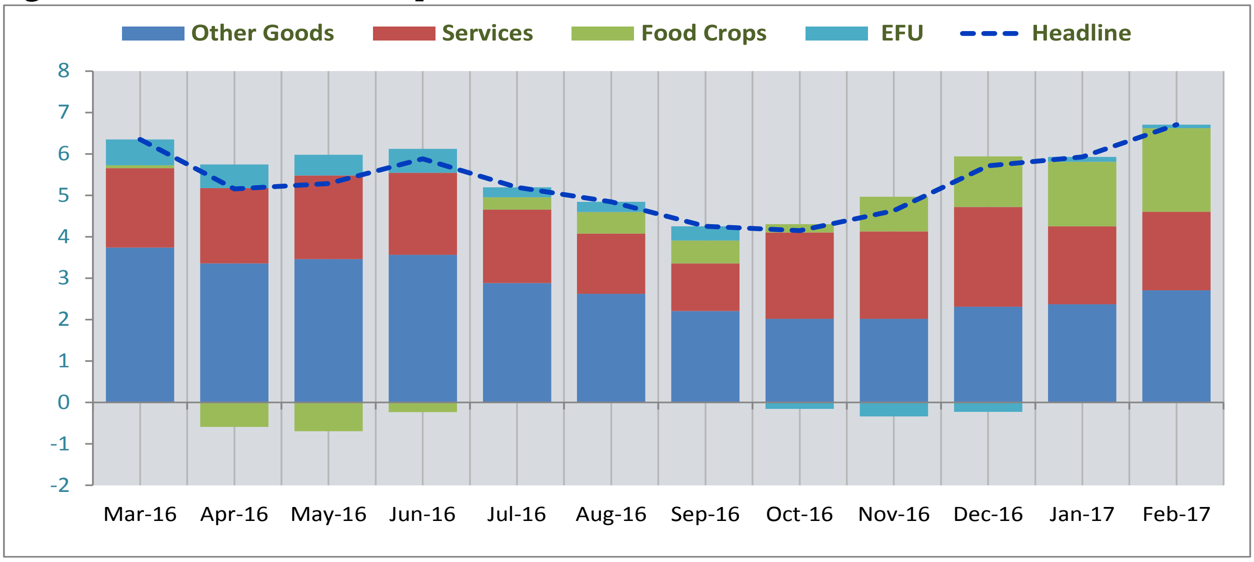
3.6.1 Recent Inflation Developments

Headline and core inflation averaged 5.2 per cent in the six months to February 2017. However, in recent months, overall and core CPI inflation has risen to an average of 6.1 per cent and 5.6 per cent in the quarter to February 2017. The rising inflationary pressures are being driven by supply side shocks, which have driven up food crop prices and services inflation. Indeed, annual food crops and related items inflation has averaged 14.7 per cent in the quarter to February 2017, compared to 6.6 and 4.1 per cent in Q4-2016 and Q3-2016, respectively. Even though Services inflation slightly declined to 6.4 per cent in the three month to February 2017 from 6.9 per cent in Q4-2016, it was much higher than the 4.5 per cent registered in Q3-2016, respectively.

The CPI data for February 2017 indicates a continuation of an upward trend for inflation components that were already on the rise and a return to an upward trajectory for those that had posted a decline in January 2017. Annual headline inflation increased to 6.7 per cent from 5.9 per cent in January 2017 while core inflation rose to 5.7 per cent from 5.3 per cent over the same period. The increase in headline inflation largely reflects the impact of higher food crops prices following the protracted drought conditions that have ravaged large parts of the country. Food crops and related items annual inflation rose to 18.8 per cent from 14.5 per cent, over the same period.

The rebound in annual core inflation was mainly on account of other goods inflation which increased to 5.6 per cent from 4.9 per cent. Services Inflation remained nearly unchanged at 5.9 per cent in February 2017 just 0.1 per centage points higher the January 2017 outturn. The trend of headline inflation and its components is shown in **Figure 11**.

Figure 11: Contribution of Components of Annual Headline



Source: Uganda Bureau of Statistics, UBOS

3.6.2 Inflation Outlook

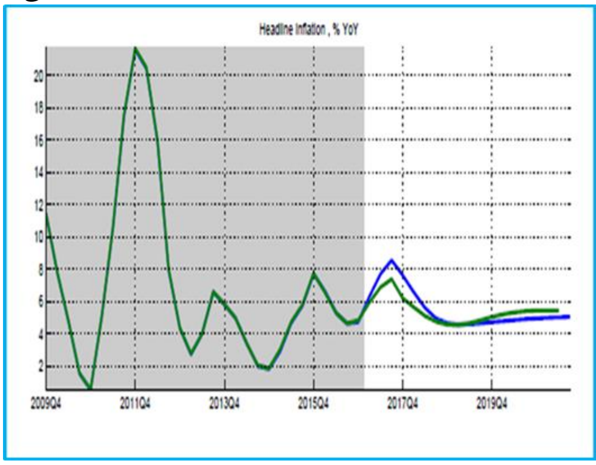
The outlook for the global environment is mixed. The prospects for the US economy have improved; those of the Euro Zone remain nearly unchanged, while in China, softening economic growth is anticipated. The U.S economy is assumed to be operating near potential with an output gap projection of -0.1 in 2017, while over the same period, inflation is projected to surpass the 2.0 per cent target to about 2.1 per cent. These factors combined with the possibility of a fiscal stimulus suggest that the U.S Federal reserve is likely to raise its policy rate to about 0.88 per cent throughout 2017, from

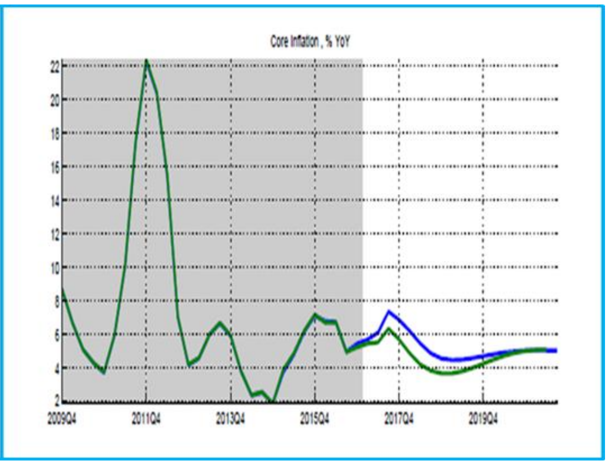
0.59 per cent projected in December 2016.Moreover, while international food prices projections remain unchanged, international oil price forecasts have been revised upwards to USD 58 per barrel in FY 2017/18, following their recent pick-up in reaction to the OPEC decision in September 2016 to lower crude oil production. Consequently, the outlook for global inflation is on the upside.

On the domestic scene, domestic food prices are forecast to remain elevated over the near-term, on account of the prolonged drought. This combined with anticipated pick up in oil pump prices following the recent rise in international oil prices would impose upward pressure of headline inflation. A major downside risk to the inflation outlook is that the economy is currently operating below potential and growth is anticipated to soften further in FY 2016/17.

Overall, risks to inflation outlook are tilted to the upside compared to the previous forecasts. Indeed, inflation is now forecast to rise slightly, but remain within the target band of 5.0 per cent ±3 PPs, returning to the target of 5.0 per cent in 12 months as potential growth is achieved. The inflation forecasts are shown in **Figure 12**.

Figure 12: Inflation forecast





4 Conclusion

The domestic growth outlook remains challenging, although a modest improvement is expected over the forecast period. Global GDP growth is projected to pick up in 2017 and further in 2018. Risks to the outlook remains substantial but they are skewed to the downside. Structural problems in a number of advanced economies – such as a fragile financial system, high public debt and low growth potential – could negatively affect the outlook. Added to this are a multitude of political uncertainties. First, it is still unclear what direction economic policy in the US will take following the presidential and congressional elections. Second, several countries in the euro area have important elections coming up in 2017. And third, exit negotiations between the UK and the EU are likely to be complex and arduous. Other risks include the likelihood of weaker-than-projection growth in China, vulnerability to tighter global financial conditions in large EMDEs compounded by domestic constraints, which may increase the severity of exchange rate adjustments, geopolitical risks mainly in the Middle East and African countries, as well as increased protectionist policy considerations particularly in AEs

Global inflation remains low and stable. Although average prices gradually picked up in AEs in 2016, projections still represent an outlook of benign global inflation in 2017 and 2018. Global financial markets remain susceptible to intermittent episodes of volatility as faster U.S Fed monetary policy normalization is now expected. 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, GDP growth projection for FY2016/17 has been revised downwards to 4.5 per cent, 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 for January 2017, shows a slight improvement in economic activity, with annualised growth of about 3.6 per cent compared to 2.3 per cent in September 2016. However, the businesses' perception on the economy remains less optimistic. 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, boosted by improved implementation of public infrastructure investments, higher private sector investments in the oil sector and improvement in agricultural production and consumption growth. Declining interest rates are expected to support growth in private sector credit and boost investment. However, net exports are not expected to increase significantly; thus, it will continue to have a negative contribution to the economic growth.

Overall, economic growth is projected to average to about 6 per cent in the next three years, must below the historical average. To stimulate economic growth, Uganda needs a boost in investment both directly, through public investment, and indirectly, by encouraging private investment, including FDI, and by undertaking measures to improve overall growth prospects and the business climate. However, there may be little scope for increased public investment or expansionary fiscal policy. What will drive growth is therefore effective use of counter-cyclical fiscal policy. To raise investment growth sustainably, countercyclical policies will need to be buttressed by structural reforms to encourage both domestic private and FDI.

The implementation of the government's budget for FY 2016/17 continues to meet challenges including weak revenue performance and lower-than-programmed government development expenditure. Underperformance of revenues which was mainly on account of lower international trade tax collections, arising from a decline in import volumes, may be indicative of slower economic activity in the first half of FY 2016/17. Similarly, lower-than-programmed government expenditure, arising mainly from delays in development expenditure spending presents a downside risk to the projected growth for FY 2016/17 which was to be supported by robust government spending on infrastructure development.

Debt vulnerability indicators show that Uganda's debt may be moving from a level of low to moderate risk of distress, although the IMF's recent Debt Sustainability Analysis (DSA) indicates that total public debt remains sustainable over the 20-year period to 2037. Nonetheless, deviations from fiscal objectives, relating to revenue mobilization and expenditure reprioritization, were identified to be major risks to Uganda's debt sustainability.

Further, the Uganda Shilling has displayed resilience in the last two months and while some of the key risks to its stability appear to have subsided for now, they could re-emerge at any stage. Over the near to short term, the exchange rate will continue to weigh significantly. However, the BoU's inflation targeting policy framework allows to absorb the effects of exchange rate fluctuations without overreacting to them. What truly matters is the impact on the medium-term inflation outlook, which depends on a number of elements, including the degree of persistence of the shocks, the state of the business cycle and the context in which the US interest rates would rise.

Inflation forecast indicates that inflation will temporarily increase above target in 2017, but remain within the target band of 5 per cent $\pm$ 3PPs. While the uptick in inflation is a cause for concern, the main drivers of this deterioration are supply side shocks including the increase in both international oil and food prices. Nonetheless, the anticipated increase in the international oil prices is not expected to be the start of a new oil price spiral and a steady decline in food price inflation is still expected despite the expectation that food prices are to rise on account of the adverse weather conditions. The more favourable shilling exchange rate has been an important factor in offsetting some of the negative impacts of supply side shocks.

The Bank reiterates its commitment to conduct monetary policy with flexibility, so that projected inflation stands at 5 per cent over the policy horizon. Any future changes in the monetary policy rate will depend on the implications of domestic and external macroeconomic conditions on the inflationary outlook.