Bank of Uganda

State of the Economy

June 2018

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Acronyms and Abbreviations

AEs	Advanced Economies
BoP	Balance of Payments
BoU	Bank of Uganda
CA	Current Account
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
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
REPOs	Repurchase Agreements
SSA	Sub- Saharan Africa
T-Bills	Treasury bills
T-Bonds	Treasury bonds
UK	United Kingdom
US	United States
WEO	World Economic Outlook

Executive Summary

According to the IMF's World Economic Outlook report for April 2018, world economic growth strengthened in 2017 to 3.8 percent, with a notable rebound in global trade. Growth was driven by an investment recovery in advanced economies, continued strong growth in emerging Asia, a notable upswing in emerging Europe, and signs of recovery in several commodity exporters. Global growth is expected to tick up to 3.9 percent in 2018 and 2019, supported by strong momentum, favourable market sentiment, accommodative financial conditions, and the domestic and international repercussions of expansionary fiscal policy in the United States. The partial recovery in commodity prices should allow conditions in commodity exporters to gradually improve. The higher rates of growth for the major global economies are expected to continue over the next couple of years, with economic growth in the major advanced economies expected to continue to exceed estimates of potential over this period. However, there are downside risks to this outlook, which include trade friction and geopolitics, and tightening global financial conditions. While global inflation remains low at present, the stronger economic conditions should see a further reduction in spare capacity and a gradual upward trend in inflation. In response, several advanced economy central banks are in the process of gradually reducing very accommodative monetary policies.

On the domestic scene, the interbank interest rates continued to decline in line with the accommodative monetary policy stance. However, yields on government securities that had declined since April 2016 when BoU started pursuing the accommodative monetary policy stance, rose during the quarter to June 2018, following an increase in the domestic borrowing requirement by government, which necessitated increasing the auction issuance amounts. Furthermore, participation in the securities market was limited as market players anticipated improved yields in the coming year on account of expansionary fiscal stance. Average primary market yields on the 91-day, 182-day and 364-day Treasury bills (T-bills) rose to 9.1, 9.9 and 10.8 percent, respectively in the quarter ended June 2018, up from 8.7, 8.8, and 9.4 percent in the quarter to March 2018. The yields in the bond market also rose in tandem with developments in the treasury bills market. The average yields for the 2-year and 5-year Treasury bonds (T-bonds), for example rose to 11.9 and 13.3 percent, respectively in the quarter to June 2018, from 11.0 and 12.6 percent in the previous quarter. Average yields on the 10-year and 15-year T-bonds also rose to 14.4 and 14.8 percent from 14.2 and 14.4 percent respectively over the same period. The weighted average lending interest rates declined to an average of 20.1 percent in March-May 2018, a decline of 5 percent compared to policy easing of 8 percent since the beginning of the easing stance in March 2016. Customers of small-sized loans however continue to get credit at higher rates, with some accessing credit at rates higher than 30 percent.

There has been a gradual recovery in growth in private sector credit (PSC), in part driven by the accommodative monetary policy stance, reduction in supply-side constraints and improving domestic demand conditions. In nominal terms, average annual PSC growth rose to 8.7 percent in May 2018, up from 2.8 percent in November 2017. The average annual growth in shilling-denominated loans rose to 13.7 percent relative to 7.7 percent, while forex denominated lending

grew by 1.7 percent relative minus 3.7 percent over the same period. Net of valuation changes – on account of exchange rate movements, annual PSC grew by 8.3 percent, compared to 3.1 percent in November 2017.

Asset quality continues to improve, with the ratio of NPLs to total loans declining to 5.3 percent in March 2018 from 7.2 percent in September 2017. A sectoral decomposition indicates that: agriculture has the highest NPLs, followed by trade and building, mortgage construction and real estate sectors. Manufacturing and Personal and Household loans have the lowest NPLs.

Preliminary data indicates that the current account balance (CAB) was relatively weaker in FY 2017/18 compared to previous financial year, largely on account of a higher trade deficit which widen by 20 percent to US$ 1,864 million from US$1,554.7 million during FY 2016/17. The widening of the trade deficit was driven by a pick-up in imports, which more than offset the increase in exports. Imports increased by US$ 692 million while exports rose by only US$ 383 million to US$ 3,547 million. Indeed, the private sector import bill rose by 17.4 percent to US$ 4,632 million. The overall BoP position is estimated to be a deficit of US$ 87.5 million from a surplus of US$438 million in FY 2016/17, implying a net drawdown in reserves. The stock of reserves declined to USD3.27 billion in FY2017/18, equivalent of about 4.6 months of imports of goods and services. Going forward, the current account position may remain weak on account of increased public and private sector imports. This may however be moderated FDI inflows, which are projected to remain robust.

The Uganda Shilling came under pressure over the period April – June 2018, in part due to weak external balance in combination with the global strengthening of the US Dollar. Speculative activity also heightened the pace of depreciation as economic agents positioned themselves in anticipation for further depreciation. By June, 2018, the Uganda Shilling had depreciated by 3.0 percent, month-on-month, to an average midrate of Shs. 3840.48 per US Dollar, compared to a 0.8 percent month-on-month depreciation in May 2018. On annual basis, the Shilling weakened by 6.9 percent in June 2018, compared to a depreciation of 2.8 percent recorded in May 2018 and 2.2 percent depreciation the previous month. Going forward, the exchange rate is likely to remain weak on account of continued strengthening of the US dollar, weak current account position on account higher import growth that is likely to continue outpacing the growth in exports.

Fiscal policy implementation in FY2017/18 was constrained by shortfalls in revenue and slow absorption by Government projects. Preliminary data for the first eleven months of FY 2017/18 indicates a shortfall in government revenue and slow absorption by Government projects. Total government revenue (including grants) was Shs. 642.6 billion lower than the budgeted amount. The revenue under performance was driven by the underperformances of both domestic revenue and grants. Relative to the approved budget, domestic revenues underperformed by Shs. 390.8 billion, due to an underperformance in almost all tax heads. Direct and indirect taxes and licenses and fees recorded shortfalls of Shs. 450.8 billion, Shs. 187.4 billion and Shs. 5.4 billion, respectively, while international taxes registered a surplus of Shs. 8.4 billion. Grant receipts during the period

underperformed by Shs. 251.8 billion, due to the continued underperformance of project support grants.

As at end of April 2018, total external debt exposure, including committed but undisbursed debt amount to US$12.2 billion, [about Shs 45.4 trillion or about 44.6 percent of GDP], up from US$2.3 billion at the end of 2006. The actual disbursed public external debt stood at US$ 7.2 billion up from US$ 1.6 billion at the end of 2006. The stock of external debt owing to multilateral creditors continued to form the bulk of the country's debt stock at US$4.8 billion (67.6 percent). The domestic component of public debt has risen at a low pace, rising from an equivalent of about US$1 billion at end of 2006 to about US$3.5 billion at end of April 2018. The estimated Present Value (PV) of total debt to GDP has kept below the IMF/WB Low Income Countries Debt Sustainability Analysis (LIC DSA) policy-dependent benchmark of 50 and 56 percent, respectively. The estimated PV of total debt to GDP stood at 28.8 percent as at end April 2018.

Uganda's total public debt however remains at a low refinancing risk. Indeed, all of the public debt risk indicators remain within the medium term public debt framework benchmarks with the exception of the ratio of the total stock of government securities to the stock of private sector credit (stock/PSC) which stood at 102.2 percent as at end April 2018, above the benchmark of 75 percent. As at end of April 2018, the public external debt average time to maturity (ATM) was about 15.3 years while that for the public domestic debt was 4.0 years. The total public debt was predominantly contracted at fixed interest rates (96.6 percent of the total public debt portfolio) and thus had a very low interest rate risk. However, there are risks to the rapid rising public debt, especially the external debt, which has risen on an annual basis at an average of 20 percent in the three financial years to 2017/18. For instance, holding more external debt denominated in foreign currency exposes Uganda to currency fluctuations. In fact, exchange rate depreciation of the Uganda shilling raises the real value and burden of debt denominated in foreign currency.

The recently released GDP estimates by UBOS for FY 2017/18 indicate that the economy grew by 5.8 percent up from 3.9 percent in FY2016/17. The easing of monetary policy has supported this outcome. Strong growth was experienced in all sectors of the economy. Agriculture sector grew by 3.2 percent from 1.6 percent in 2016/17 on account of cash crops and food crops enabled by favorable weather conditions. Industry grew by 6.2 percent compared to 3.4 percent in the previous year while services sector growth of 7.3 percent compared to 5.4 percent. Growth is expected to strengthen further in FY 2018/19 to 6.0 percent and to an average of 6.3 percent over the medium-term supported by multiplier effects of public infrastructure investments; improving agricultural productivity; recovery in FDI and easing of financial conditions as the full impact of monetary policy easing filters through to private sector credit extension. The contribution of net exports to GDP growth will be negative as a result of an acceleration in import-intensive components of domestic demand. The downside risks to growth include the exchange rate depreciation and increasing oil prices that could affect domestic demand. The continued depreciation of the exchange rate remains a challenge since about 69 percent of imports are capital and raw materials. In addition, withdrawing from the IMF PCI/PSI program could suggest Uganda's inconsistent macroeconomic management resulting in negative sentiments on the economy, hence curtailing FDI.

Inflation has remained subdued in FY 2017/18, with headline and core inflation averaging 3.4 percent and 2.7 percent compared to 5.7 percent and 5.1 percent, respectively in FY 2016/17. Although annual headline inflation increased to 2.2 percent in June 2018 from 1.1 percent in May 2018, core inflation declined further to 0.9 percent from 1.1 percent during the same period. The low inflation environment was largely a result of the stable exchange rate, favourable weather conditions which contributed significantly towards ample food supplies, and the relatively subdued aggregate demand driven by the negative output gap.

The inflation outlook in the short-term indicates that inflation will remain subdued. However, inflation is projected to rise in the medium-term, with core inflation expected to return to its 5 percent target in the medium term. The inflation developments will be shaped by several factors, including exchange rate trajectory which in part is dependent on external sector developments, foreign inflation which though lower in 2018 is projected to rise in 2019, oil prices which have risen and food prices which have been revised downwards on account good global harvests.

1 Background

This report presents domestic and external economic developments in the period to June 2018. It also assesses the future prospects for both the global and domestic economy, including the growth and inflation outlook. 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 economic growth has continued to strengthen and the negative output gap is estimated to have closed. In 2018, global economic activity is projected to expand by 3.9 percent, up from 3.8 percent recorded in 2017. Economic activity in Advanced Economies (AEs) is projected expand by 2.5 percent in 2018, up from 2.3 percent in 2017, supported by accommodative monetary policy, fiscal stimulus and strong domestic and external demand conditions. In particular, the United States (US) finished off 2017 on a firm footing, and is projected to grow at 2.9 percent in 2018, in part buoyed by the December 2017 hefty tax cuts, which are expected to encourage more investment and spending, although other pundits predict that the ballooning deficits will overtake the positive effects in the longer term.

In the Euro Zone, growth is projected to increase to 2.4 percent in 2018, from 2.3 percent in 2017, driven mainly by strong domestic demand, accommodative monetary policy, and robust external demand conditions. On the other hand, growth in the United Kingdom (UK) and Japan is projected to decelerate from 1.8 percent and 1.7 percent in 2017 to 1.5 percent and 1.2 percent, respectively in 2018. The UK will remain relatively sluggish on account of the after-effects of the Brexit referendum which means that the economy will only enjoy limited benefits from the global upsurge in growth, while in Japan, the tightening fiscal conditions and moderating export growth will cause growth to decelerate.

In Emerging Market and Developing Economies (EMDEs) growth is projected to increase to 4.9 percent in 2018, up from 4.8 percent in 2017, supported by increasing agricultural productivity, strong external demand, recovery in international commodity prices, and eased financial conditions in the global financial markets. Growth in EMDEs is projected to increase

further to 5.1 percent in 2019, and stabilize at about 5 percent in the medium term. India is projected to grow by 7.4 percent, up from 6.7 percent in 2017; while in China, growth is projected to decelerate to 6.6 percent from 6.9 percent over the same period of time. In Latin America, growth is projected to increase to 2.0 percent and 2.8 percent in 2018 and 2019, respectively, from 1.3 percent in 2017, in part reflecting the improved outlook for Mexico and Brazil driven by recovery in commodity prices, stronger business confidence and strong external demand conditions. Global growth projections are presented in **Table 1.**

Table 1: Global Growth Projections

	2016	2017	2018	2019
World	3.2	3.8	3.9	3.9
Advanced Economies	1.7	2.3	2.5	2.2
United States	1.5	2.3	2.9	2.7
Euro Area	1.8	2.3	2.4	2.0
Japan	0.9	1.7	1.2	0.9
United Kingdom	1.9	1.8	1.6	1.5
Emerging Market & Developing Economies	4.4	4.8	4.9	5.1
Russia	-0.2	1.5	1.7	1.5
Brazil	-3.5	1.0	2.3	2.5
China	6.7	6.9	6.6	6.4
India	7.1	6.7	7.4	7.8
Sub-Saharan Africa	1.4	2.8	3.4	3.7
Nigeria	-1.6	0.8	2.1	1.9
South Africa	0.3	1.3	1.5	1.7

Source: IMF, WEO Apr 2018

In sub-Saharan Africa (SSA), growth is projected to increase to 3.4 percent and 3.7 percent in 2018 and 2019, respectively up from 2.8 percent in 2017, supported by public infrastructure investment, stronger commodity prices and external demand conditions, and improved business confidence in economies such as South Africa.

There are however, upside and downside risks to this outlook. Nonetheless, risks are broadly balanced in the near-term, but skewed to the downside over the medium-term. The current trade frictions and the likely shift towards inward-looking policy platforms and protectionism may restrain global trade, the main ingredient of the current growth outlook. The geopolitical tensions, especially in the Middle East and North Africa region may constrain trade further. In

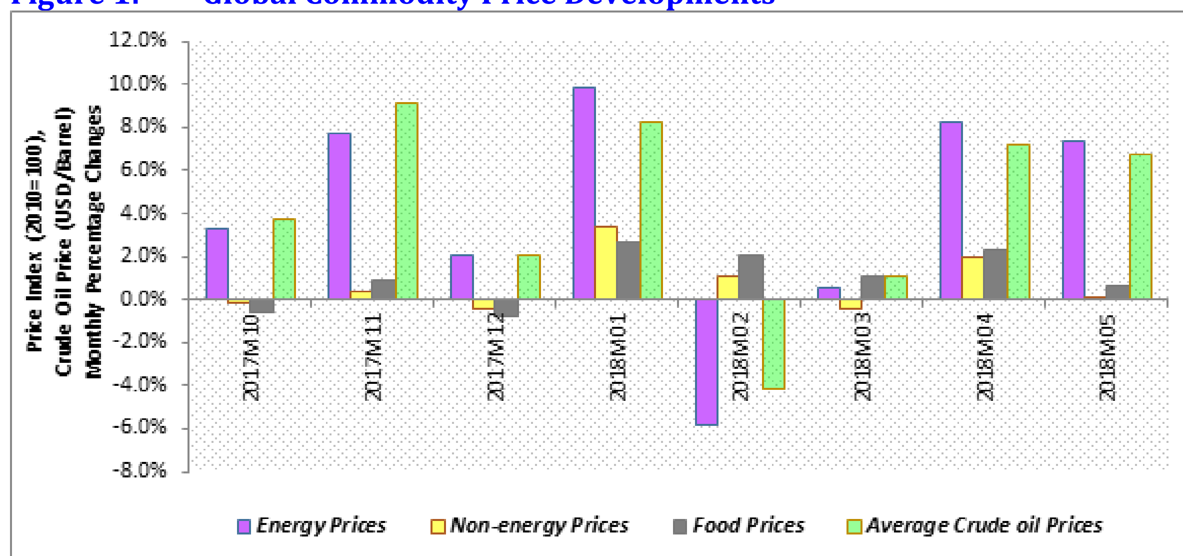
addition, the likely tightening global financial conditions on account of monetary tightening in AEs may constrain investment and trade, which will in turn restrict global output and trade.

2.2 Global Commodity Prices and Inflation

2.2.1 Global Commodity Prices

Commodity prices continue to strengthen supported largely by recovery in global economic growth. In June 2018, the Brent crude oil price stood at US$ 74.25 per Barrel, a slight decline from US$76.98 per Barrel realised in May of 2018. This compares with US$ 29.78/Barrel registered in January 2016. Indeed, Oil prices have risen in part supported by the continued efforts by Organization of Petroleum Exporting Countries (OPEC) to constrain output in order to support oil prices. In addition, the US-Iran tensions have also contributed to the recent increase in crude oil prices. Non-energy prices, on the other hand, remain relatively stable, registering only modest increases as shown in **Figure 1**. For example, food prices, measured by the United Nations Food and Agriculture Organization (FAO) food price index, increased by only 1.2 percent in May 2018.

Figure 1: Global Commodity Price Developments



Source: World Bank, FAO

Commodity prices are projected to remain robust, supported by improving global economic conditions. In addition, oil prices may be further supported by supply restraint and geopolitical tensions producing regions. However, the likelihood of continued strong US shale oil production

could moderate the oil price increases in the near-to-medium-term.

2.2.2 Global Inflation

Global inflation has edged-up, after being relatively subdued in most of 2016 and early 2017, driven by improved economic outlook and stronger commodity prices. In most of the AEs inflation is well within target. In the US and Euro Area, inflation rose to 2.8 percent 1.9 percent in May 2018 respectively. In the UK, inflation has averaged 2.6 percent since the beginning of 2018, and although it declined to 2.4 percent in in May 2018, it is still above the Bank of England target of 2 percent. The improving economic conditions are projected to increase demand pressures and thereby keep inflation elevated in most of the AEs. Consequently, these economies are expected to gradually tighten their monetary policies.

On the other hand, inflation in most of the EMDEs remains below their historical levels, but is expected to increase driven by exchange rate depreciation, stronger commodity prices and ensuing demand pressures. Inflation Developments in Selected Countries are shown in **Table 2**.

Table 2: Inflation Developments in Selected Countries

	Quarterly Averages			Monthly		
	Quarter to Jun-17	Quarter to Mar-18	Quarter to Jun-18	Mar-2018	Apr-2018	May-2018
Euro Area	1.5	1.3	1.6	1.3	1.3	1.9
Japan	0.4	1.3	..	1.1	0.6	0.7
UK	2.6	2.5	2.3	2.3	2.2	2.3
US	1.9	2.2	2.6	2.4	2.5	2.8
Brazil	3.6	2.8	2.8	2.7	2.8	2.9
China	1.4	2.2	1.8	2.1	1.8	1.8
India	1.5	4.7	..	4.4	4.0	4.0
Russia	4.2	2.3	..	2.4	2.4	2.4
South Africa	5.2	3.9	..	3.7	4.3	..

Source: OECD Statistics

A major risk to the global inflation outlook remains the higher than projected increase in international commodity prices, particularly crude oil prices which could lead to higher global inflation.

2.3 Global Financial Markets

Global financial markets remain relatively stable, although financial conditions have tightened modestly in recent months following interest rate hikes in US and expectations of further monetary policy tightening in most of the AEs in line with ensuing domestic demand pressures. In the US, for example, the federal funds rate was raised to between 1.5 percent and 1.75 percent in March but left unchanged in May. Consequently, the market-implied path has risen by around 0.25 percentage point since February, and suggests a 0.75 percentage point rise in the policy rate over the next year.

The European Central Bank (ECB), on the other hand, held its policy rate unchanged in February 2018, but the market path implies a gradual rise in policy rates from 2019 onwards. In the UK, the weaker-than-expected performance of the economy in early 2018 forced the Bank of England to put back plans for an interest rate hike, keeping its policy rate at 0.5 percent. Nonetheless, the soft patch in growth is projected to be temporary, and the Bank of England is projected to increase interest rates later this year.

In line with tightening financial conditions and higher inflation expectations, long-term bond yields rose in key global financial markets. In May 2018, yields on the 10-year U.S government bond increased by 0.11 percentage points relative to 2.98 percent in April 2018. The 10-year government bond yields also rose in most of the Emerging Market Economies, largely supported by expectations of a faster pace of US Federal Reserve monetary policy tightening, anticipated further strengthening of global growth and higher inflation expectations. In the BRICS (Brazil, Russia, India, China and South Africa) for example, yields rose by 0.26 percentage points on average to 7.51 percent during the same period. Bond yields however declined in the UK and Euro Zone in part driven by concerns about the Brexit ramifications and political uncertainty in some EU countries, such as Italy.

In the currencies market, the US dollar strengthened against most major world currencies in May

2018, driven by better than anticipated performance of the U.S. economy relative to the Euro zone and Japan. The US dollar index, which measures the strength of the US dollar against a basket of 7 major world currencies, rose by 0.4 percent month-by-month in May 2018. But this trend may last only "a fairly finite period of time" as the Euro zone and Japan are projected to catch up in the second half of 2018.

Market expectations remain for gradual increase in global interest rates owing to faster normalization of monetary policy in the US and the UK, in line with the stronger global growth outlook and the imminent pickup in inflationary pressures. However, to the extent that other AEs, such as Japan, continue to pursue easing monetary policies, the divergence in policy stance is likely to continue causing volatility in the global financial system. Furthermore, the normalisation of interest rates in AEs is also likely to expose financial vulnerabilities especially in EMDEs with high levels of foreign currency debt. Furthermore, escalating trade frictions and heightened geopolitical tensions could also continue to escalate financial markets volatility.

2.4 Implications for the Uganda Economy

The outlook for the external economic environment remains for higher, broad-based growth, projected to pick up both in 2018 and 2019, compared to 2017, supported mainly by the momentum from strong growth recorded in 2017, expansionary fiscal policy in the US, still-accommodative global financial conditions and recovery in international commodity prices. Economic growth in SSA, the destination for over half of Uganda's exports, is also expected to increase notably, although it is yet to match up to past trends. Risks to the outlook, while balanced in the near term, remain tilted to the downside in the medium term, and stem mainly from sudden tightening in global financial conditions, weakened business confidence triggered by a shift to more protectionist policies and noneconomic factors such as geopolitical tensions. The positive global and SSA growth outlook is expected to boost demand for Uganda's exports, to the extent that protectionist policies are temporary.

Although global inflation remains generally subdued, there are increased expectations for higher inflation, largely on account of anticipated price pressure arising from closing output gaps. A major risk to the global inflation outlook remains higher-than-projected increase in international commodity prices, especially crude oil, which could lead to higher global inflation, with

implications for the pace of monetary tightening especially in AEs and therefore global financial conditions. Unstable global financial conditions would trigger volatility in the domestic foreign exchange market, with implications for domestic inflation in case of sustained depreciation pressures.

3 Domestic Economic Developments

3.1 Reflections on Previous Monetary Policy Stance and Implementation

3.1.1 Monetary Policy Stance

After reducing the Central Bank Rate (CBR) to 9 percent in February 2018 from 9.5 percent in December 2017, the Bank of Uganda (BoU) maintained a neutral monetary policy stance in April 2018, keeping the CBR on hold at 9.0 percent. The band on the CBR was maintained at +/-3 percentage points and the margin on the rediscount rate at 4 percentage points on the CBR. Consequently, the Rediscount rate and the Bank rate were set at 13.0 percent and 14.0 percent respectively.

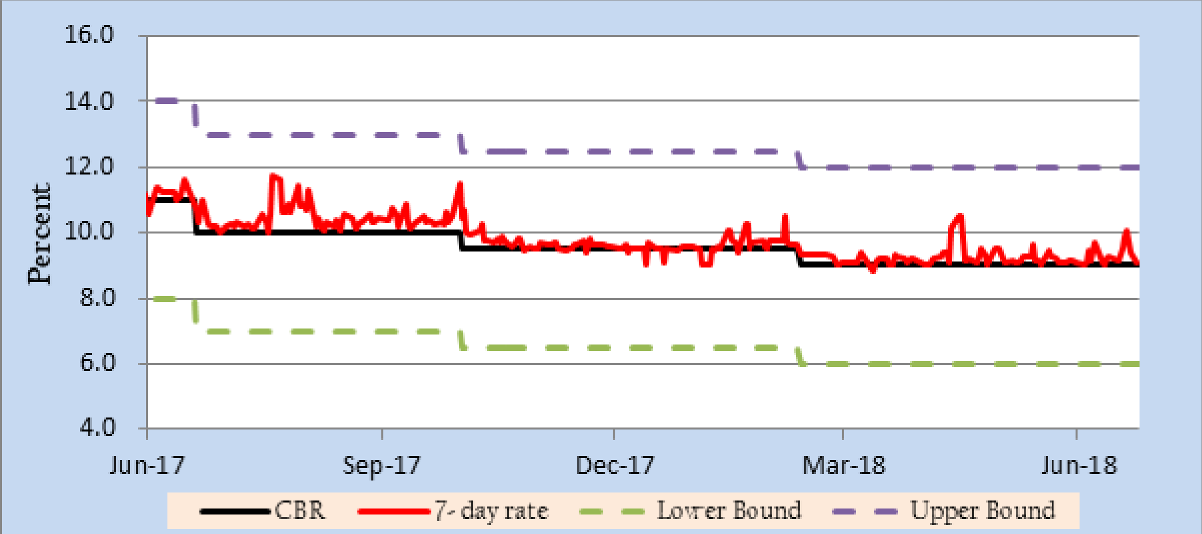
The neutral monetary policy stance was warranted by the projected inflation and output trajectory, which indicated that the upside and downside risks to the inflation outlook were relatively balanced. Inflation was below target but forecasts indicated that it would converge to the 5 percent target in the medium-term, driven by exchange rate depreciation and the impact of stimulatory monetary policy on aggregate demand. Furthermore, although the output gap was beginning to close, aggregate demand pressures were not assessed to pose significant upward threats to inflation.

3.1.2 Monetary Policy Implementation and Challenges

Bank of Uganda continued to use Repurchase Agreements (REPOs)/reverse REPOs and deposit auctions to align domestic liquidity conditions in the domestic banking system with the desired monetary policy stance. The outstanding stock of REPOs and Deposit Auctions at end June 2018 stood at Shs. 164 billion and Shs 974 billion, respectively indicating a continued build-up of structural liquidity in the banking system.

The interbank money market rates remained largely consistent with the monetary policy stance, despite the structural liquidity overhang. The weighted 7-day interbank money market rate trended within the CBR band, averaging 9.3 percent in the quarter to June 2018 (**Figure 2**).

Figure 2: Evolution of the 7-day Interbank Rate and the Central Bank Rate



Source: Bank of Uganda

3.2 Interest Rate Developments

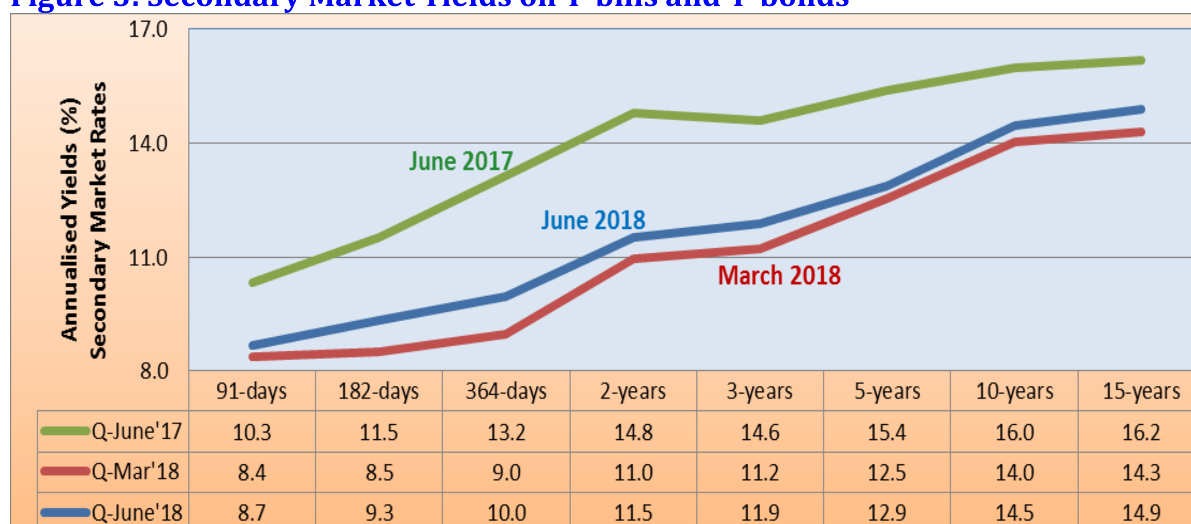
3.2.1 Yields on Government Securities

Yields on government securities that had declined since April 2016 when BoU started pursuing the accommodative monetary policy stance, rose during the quarter to June 2018, following an increase in the domestic borrowing requirement by government, which necessitated increasing the auction issuance amounts. Furthermore, participation in the securities market was limited as market players anticipated improved yields in the coming year on account of anticipated expansionary fiscal stance. Average primary market yields on the 91-day, 182-day and 364-day Treasury bills (T-bills) rose to 9.1, 9.9 and 10.8 percent, respectively in the quarter ended June 2018, up from 8.7, 8.8, and 9.4 percent in the quarter to March 2018.

The yields in the bond market also rose in tandem with developments in the treasury bills market. The average yields for the 2-year and 5-year Treasury bonds (T-bonds), for example rose to 11.9 and 13.3 percent, respectively in the quarter to June 2018, from 11.0 and 12.6 percent in the previous quarter. Average yields on the 10-year and 15-year T-bonds also rose to 14.4 and

14.8 percent from 14.2 and 14.4 percent respectively over the same period. **Figure 3** shows developments in the secondary market yields on government securities.

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



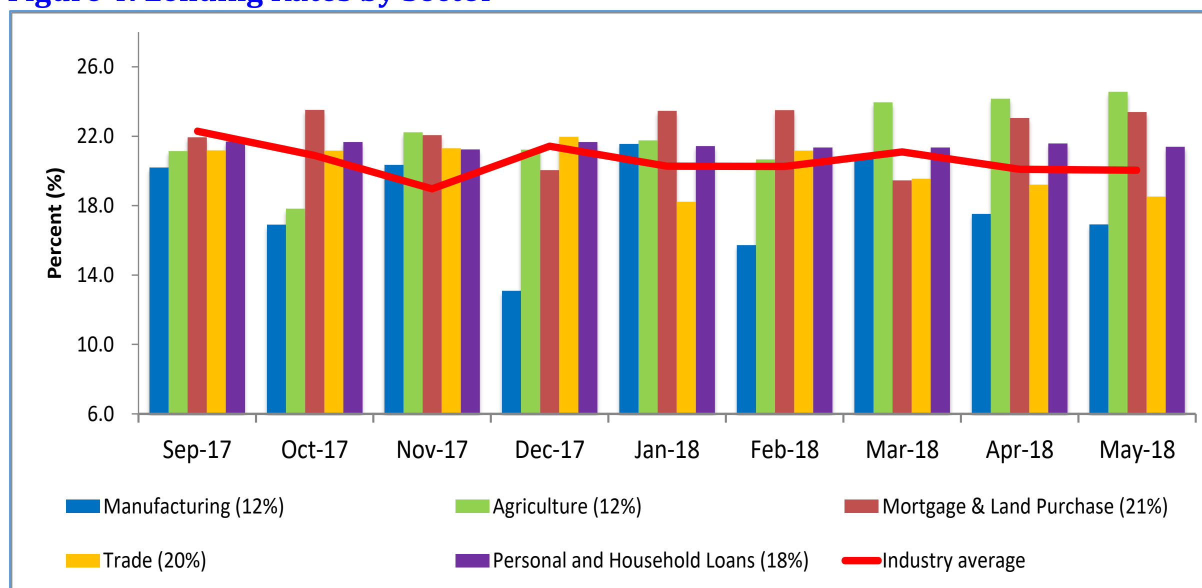
	91-days	182-days	364-days	2-years	3-years	5-years	10-years	15-years
Q-June'17	10.3	11.5	13.2	14.8	14.6	15.4	16.0	16.2
Q-Mar'18	8.4	8.5	9.0	11.0	11.2	12.5	14.0	14.3
Q-June'18	8.7	9.3	10.0	11.5	11.9	12.9	14.5	14.9

Source: Bank of Uganda

3.2.2 Lending and Deposit Rates

The weighted average lending rates on shilling-denominated loans remained relative stable, establishing a floor at about 20 percent. In the quarter ended May 2018, the weighted average lending rate on shilling denominated loans declined to an average of 20.1 percent from 20.5 percent in the quarter ended February 2018. A decomposition of lending rates by sector shows relatively higher lending rates for the agriculture, mortgage & land as well as personal and household loans as shown in **Figure 4.** The average lending rate on dollar denominated loans, also remained relatively stable at about 7.5 percent during the same period

Figure 4: Lending Rates by Sector

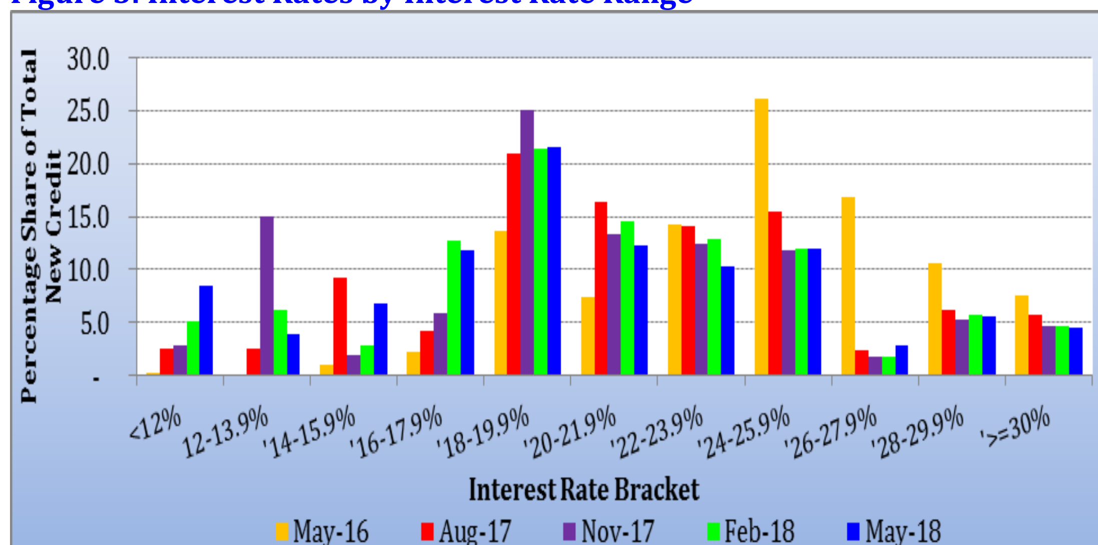


Source: Bank of Uganda

During the period March to April 2018, the high lending rates for the agricultural sector were largely driven by one large player, who had lent close to 36 percent of total new loans to the agricultural sector amounting to Shs. 128 bn. Most of these were small sized-loans of working capital nature which did not qualify for the Agricultural Credit Facility (ACF) and were lent at rates of more than 28 percent.

The downward adjustment in commercial bank lending rates on shilling loans is very slow relative to the BoU's adjustment of the CBR. The stickiness is partly driven by structural constraints in the financial sector, such as high operating costs of financial institutions coupled with heightened risk aversion, as a result of provisioning for bad debt during the year. A decomposition of lending rates shows that that over the last four months about 50 percent of new loans were disbursed at interest rates of less than 20 percent, mainly to large corporations and prime borrowers. Customers of small-sized loans however get credit at higher rates, with some accessing credit at rates higher than 30 percent as shown in **Figure 5**. The differential rates have been attributed to high transaction costs and default rate associated with small-sized loans.

Figure 5: Interest Rates by Interest Rate Range



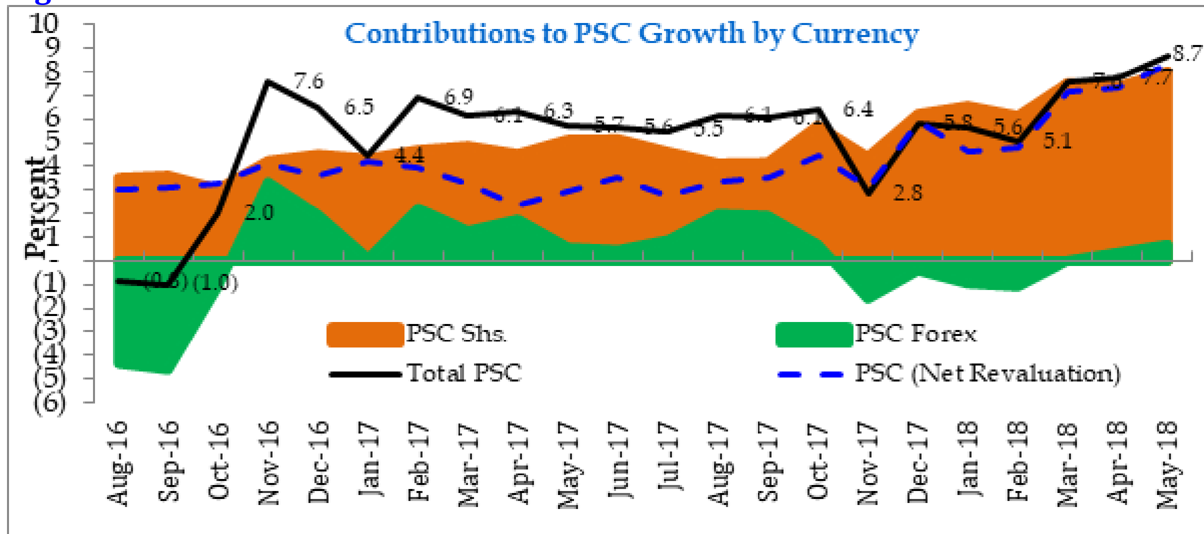
Source: Bank of Uganda

The deposit rates on Shilling-deposits also remain relatively stable, with the weighted average time deposit standing at 8.5 percent during the last 6 months having declined from about 10.0 percent in May 2017.

3.3 Private Sector Credit

There has been a gradual recovery in growth in private sector credit (PSC), a leading indicator of the financial sector's contribution to economic activity, in part driven by the accommodative monetary policy stance, reduction in supply-side constraints and improving domestic demand conditions. In nominal terms, average annual PSC growth rose to 8.7 percent in May 2018, up from 2.8 percent in November 2017. The average annual growth in shilling-denominated loans rose to 13.7 percent relative to 7.7 percent, while forex denominated lending grew by 1.7 percent relative minus 3.7 percent over the same period. Net of valuation changes – on account of exchange rate movements, annual PSC grew by 8.3 percent, compared to 3.1 percent in November 2017. Developments in private sector credit are shown in **Figure 6.**

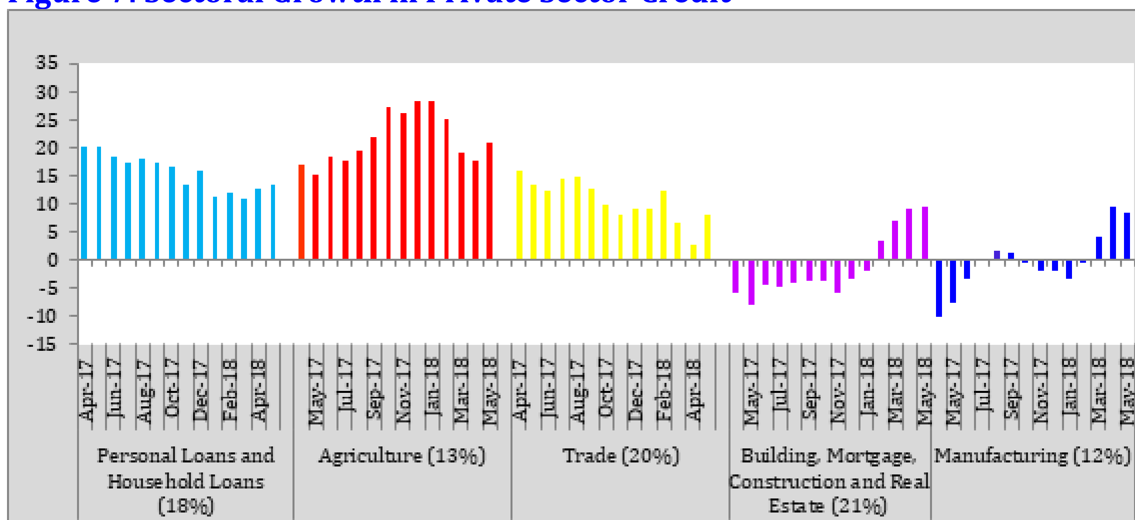
Figure 6: Annual Growth and Contributions to Private Sector Credit



Source: Bank of Uganda

In terms of sectoral distribution; building mortgage, construction and real estate; trade; personal & household loans; agriculture; and manufacturing continue to account for the bulk of private sector credit, constituting more than 70 percent of the total stock, as shown in **Figure 7.**

Figure 7: Sectoral Growth in Private Sector Credit



Source: Bank of Uganda

PSC growth continues to be supported by robust growth of credit to Personal & Household Loans, and Trade and agricultural sectors. Recovery in credit growth to the manufacturing, and

Building, Mortgage, Construction & Real Estate sectors also noted in the last three months. Going forward, PSC is expected to improve even further on account of the improving NPL ratios and expected increase in demand for credit. Banks are expected to further ease overall credit standards as the asset quality continues to improve. This increase in credit growth, if sustained, is likely to boost private investment and consumption, which should in turn boost growth.

3.4 Fiscal Policy and Operations

Fiscal policy continues to play a significant role in the economy, both as a stabilization tool and in influencing the medium-to-long-term growth prospects of the economy. In the short term, counter-cyclical fiscal expansion is used to support aggregate demand during cyclical downturns. In line with the need to foster growth, increase economic efficiency and reduce the cost of doing business, the fiscal stance for FY 2017/18 focused on addressing infrastructural constraints in the economy. Given the infrastructural gap, the consequence of this policy pursuit was a high fiscal deficit, now projected at 4.7 percent of GDP, relative to the benchmark of 3 percent in the EAC macroeconomic convergence criteria.

Preliminary data for the first eleven months of FY 2017/18 indicates a shortfall in government revenue and slow absorption by Government projects. Total government revenue (including grants) was Shs. 642.6 billion lower than the budget amount. The revenue under performance was driven by the underperformances of both domestic revenue and grants. Relative to the approved budget, domestic revenues underperformed by Shs. 390.8 billion, due to an underperformance in almost all tax heads. Direct and indirect taxes and licenses and fees recorded shortfalls of Shs. 450.8 billion, Shs. 187.4 billion and Shs. 5.4 billion, respectively, while international taxes registered a surplus of Shs. 8.4 billion. Grant receipts during the period underperformed by Shs. 251.8 billion, due to the continued underperformance of project support grants (**Table 3**).

Total government expenditure and net lending over the same period amounted to Shs. 18,321.0 billion, which was lower than the approved budget amount by Shs. 289.7 billion, due to a shortfall in current expenditure, mainly interest payments on external debt, and lower development expenditure, which is attributable to low absorption capacity of government

projects. Government had planned to borrow Shs.1,690 billion from the domestic money market to meet expenditure outlays expenditures, and had raised Shs. 1,518.3 by June 14, 2018.

Table 3: Fiscal Operations (Shs. Billion)

	Jul'16 – May'17	Prel. July'17– May'18	Adjusted Approved Budget Jul'17– May'18
Revenue & Grants	**12,371.6**	**13,481.0**	**14,123.6**
Revenue	11,476.4	12,770.8	13,161.6
Grants	895.2	710.3	962.1
Expenditure & Lending	**15,496.2**	**18,321.0**	**18,610.7**
Current Expenditure	9,100.2	9,851.0	10,213.4
Development Expenditure	5,674.9	6,777.8	6,842.2
Deficit (including grants)	**-3,124.6**	**-4,840.0**	**-4,487.1**
Financing (net)	**3,124.6**	**4,840.0**	**4,487.1**
External Financing (net)	2,070.1	3,412.1	2,568.0
Domestic Financing (net)	638.8	913.9	1,873.0

Source: Ministry of Finance, Planning and Economic Development

Total financing amounted to Shs. 4,326.0 billion (excluding errors and omissions), and was largely comprised of external financing, which was also Shs. 844.1 billion higher than programmed mainly due to strong performance in the budget and project support loan disbursements. On the other hand, domestic financing, which amounted to Shs. 913.9 billion, was Shs. 959.1 billion lower than programmed due to an underperformance in bank financing.

In terms of outlook, domestic revenue is projected to increase to 14.5 percent of GDP in FY 2018/19 from 14 percent of GDP in FY 2017/18 on account of additional tax measures and improvements in tax administration. Total government expenditure as a share of GDP is projected to increase to 22.5 percent. The fiscal deficit is projected to increase to 6.6 percent of GDP, with domestic financing initially projected at projected at Shs. 1,783 bn (1.8 percent of GDP).

3.4.1 Public Debt Stock

The provisional total public debt stock (at nominal value) as at end April 2018 stood at Shs. 39.7 trillion, about 39.3 percent of GDP. External debt stood at US$ 7.2 billion [26.5 trillion], about

26.1 percent of GDP; while domestic debt stood at Shs. 13.2 trillion, about 12.9 percent of GDP. Total external debt exposure, ***including committed but undisbursed debt,*** amounted to US$12.2 bn [45.4tn], which is about 44 percent of GDP. However, while the Present Value of total public debt to GDP is within the Public debt management framework (PDMF) benchmarks, as shown in **Table 4,** potential risks continue to mount. The present value of total public debt as a ratio of GDP stood at 28.8 percent as at the end of April 2018, which is lower than the PDMF benchmark of 50 percent. However, including committed but undisbursed loans, the ratio of total public debt to GDP is closer to the threshold.

There is also an inherent a risk of higher exposure or failure to meet external debt obligations in the event of higher exchange rate depreciation, coupled with the current slow growth in export revenues. Furthermore, the high debt burden may become a drag on economic growth by discouraging public investment due to the high public debt service costs.

Table 4: Public Debt Indicators

Public debt indiators (% of GDP)	PDMF	Jun-17	Apr-18
PV total Public Debt including undisbursed external debt		37.9%	39.7%
PV total Public Debt	<50%	26.7%	28.8%
PV Domestic Debt	<20%	12.6%	12.3%
PV external debt outstanding	<30%	14.1%	16.5%
PV external debt including undisbursed external debt		25.3%	27.4%

Source: Bank of Uganda

3.5 Balance of Payments and Exchange rates

Preliminary data indicates that the current account balance (CAB) was relatively weaker in FY 2017/18 compared to previous financial year, largely on account of a higher trade deficit which widen by 20 percent to US$ 1,864 million from US$1,554.7 million during FY 2016/17. The

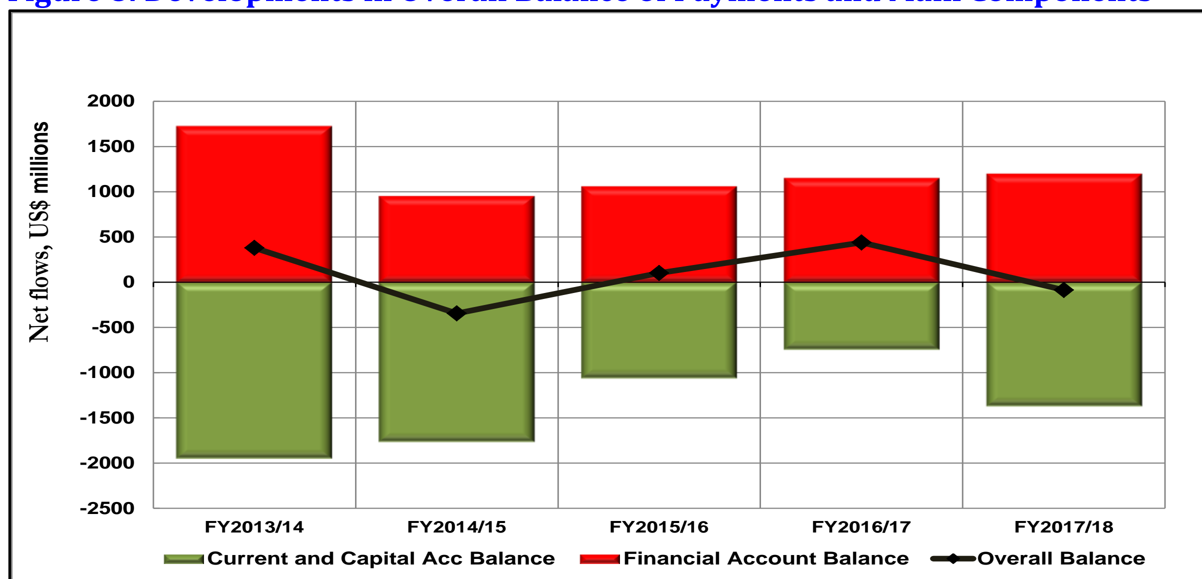
widening of the trade deficit was driven by a pick-up in imports, which more than offset the increase in exports. Imports increased by US$ 692 million while exports rose by only US$ 383 million to US$ 3,547 million. Indeed, the private sector import bill rose by 17.4 percent to US$ 4,632 million.

Specifically, the private sector oil import bill rose by 27 percent to US$ 880 million, partly on account of increase in international crude oil prices; while the private sector non-oil import bill rose by 15 percent to US$ 3,753 million. Government imports, on the other hand, remained relatively stable, increasing by only 0.3 percent to US$ 440 million. The services account deficit increased by US$ 158 million to US$ 454 million in FY 2017/18 largely on account of higher payments for transport services and other business services. Personal transfers are also projected to decline to US$ 1,134 million from US$ 1,286 million during FY 2016/17.

Net inflows through the financial account increased by 4.1 percent to US$ 1,200 million, largely on account of foreign direct investment inflows, which increased by 27 percent to US$ 826 million. Net portfolio outflows on the other hand rose by 74 percent to US$ 322 million during the same period. Other investments, including currency and deposits, loans to general government and the private sector, and trade credits remained stable at US$ 695 million. The overall balance of payments position (BoP) is projected to be a deficit of US$ 87.5 million from a surplus of US$ 438 million during FY 2016/17, largely driven by a higher current account deficit which more than offset the surplus in the financial account.

A quarterly analysis also indicates that a deterioration of the balance of payments position in last quarter of FY 2017/18 relative to the previous quarters. The current account deficit is projected to deteriorate to US$ 435 million in the quarter ended June 2018 relative to US$ 326 in the previous quarter, largely driven by the trade deficit which weakened to US$ 483 million from US$ 407 million during the same period. The net inflows through the financial account are projected to amount to US$ 334 million on account of FDI inflows of US$ 234 million, net portfolio outflows of USD$ 8 million and other investment net inflows of US$ 108 million. The fiscal year BOP developments are shown in **Figure 8.**

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



Source: Bank of Uganda

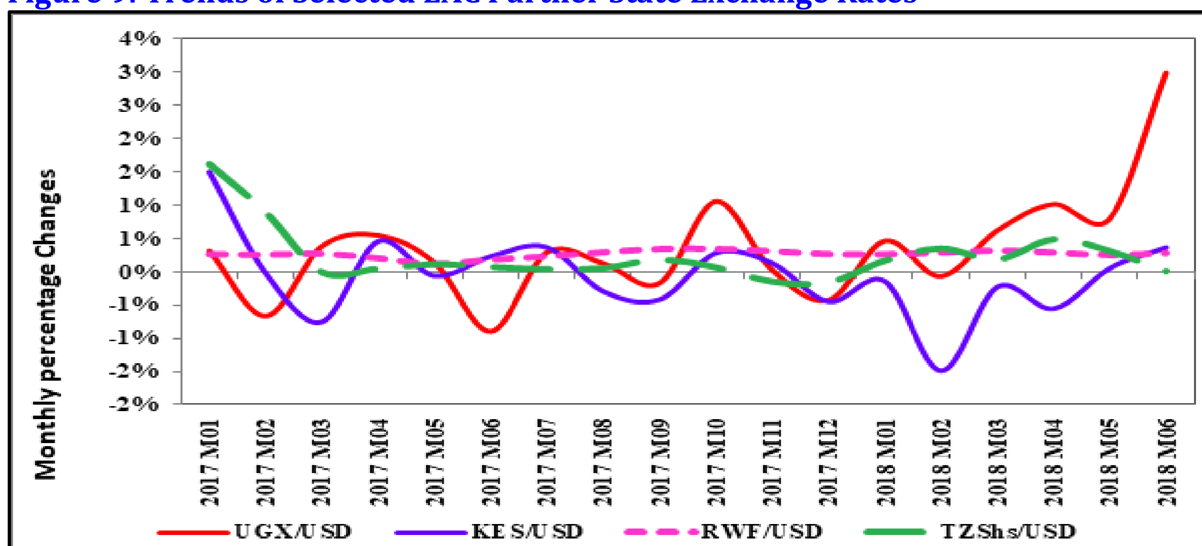
The overall BoP position is projected to be a deficit of US$ 87.5 million from a surplus of US$438 million in FY 2016/17, implying a net drawdown in reserves. The stock of reserves declined to USD3.27 billion in FY2017/18, equivalent of about 4.6 months of imports of goods and services. Going forward, the current account position may remain weak on account of increased public and private sector imports. This may however be moderated FDI inflows, which are projected to remain robust.

3.5.1 Exchange Rate Developments

The Uganda Shilling came under pressure over the period April – June 2018, largely on account of global strengthening of the US Dollar and elevated US Dollar demand mainly from oil, manufacturing and telecommunications sectors, as well as offshore investors, in the midst of subdued export receipts. Speculative activity could have also heightened the pace of depreciation as economic agents positioned themselves in anticipation for further depreciation. By June, 2018, the Uganda Shilling had depreciated by 3.0 percent, month-on-month, to an average midrate of Shs. 3840.48 per US Dollar, compared to a 0.8 percent month-on-month depreciation in May 2018. On annual basis, the Shilling weakened by 6.9 percent in June 2018, compared to a depreciation of 2.8 percent recorded in May 2018 and 2.2 percent depreciation the previous month.

The weakening of the Uganda Shilling was stronger compared to its regional counterparts, as shown in **Figure 9.** The Kenya Shilling, Tanzania Shillings and Rwanda Franc depreciated by 0.4, percent and 0.01, and 0.3 percent, respectively, month-on-month in June 2018. On an annual basis, the Kenya shilling appreciated by 2.4 percent, while the Tanzania Shilling and Rwanda Franc depreciated by 1.6, and 3.5 percent, respectively.

Figure 9: Trends of Selected EAC Partner State Exchange Rates



Source: Bank of Uganda

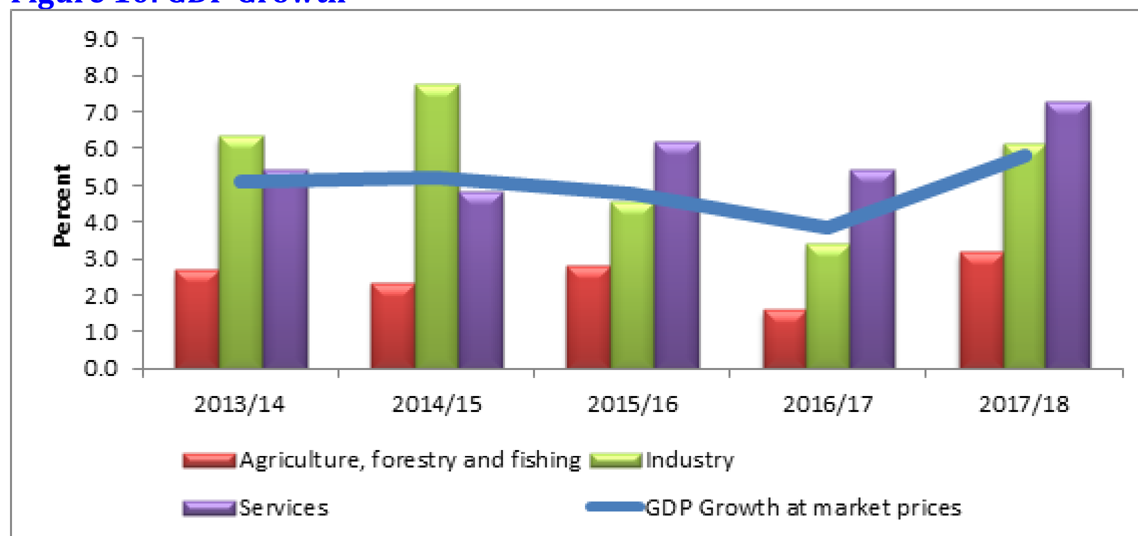
The depreciation pressures experienced during the period constrained the BoU's efforts to conduct US Dollar purchases for reserve build-up; consequently, USD 49.6 million was purchased in the period January – June 2018, compared to USD 390.1 million purchased in the corresponding period of 2017. Overall, the total amount purchased for reserve build-up, in the FY 2017/18, amounts to USD 467.3 million. Over the same period, the BOU sold USD 102.2 million and USD 114.7 million in market and targeted interventions respectively. Therefore, the net BOU action in the IFEM, in the financial year, amounted to a net foreign exchange purchase of USD 250.4 million.

3.6 Domestic Economic Activity

Economic activity continued to strengthen in FY2017/18. The recently released GDP estimates by the Uganda Bureau of Statistics (UBOS) indicate that the Ugandan economy grew by 5.8 percent in FY2017/18 from 3.9 percent in FY2016/17. This strong growth was experienced in

all the sectors and particularly the agriculture, forestry and fishing sector that grew by 3.2 percent from 1.6 percent in FY2016/17 supported by the growth in food and cash crops. Other sectors including industry, and services also expanded by 6.2 percent and 7.3 percent respectively in FY2017/18 from 3.4 percent and 5.4 percent respectively in the previous year **(Figure 10).** The growth in the industry sector was largely on account of chemical and pharmaceutical products, drinks, tobacco and construction activities while the services sector growth was driven by trade and repairs, financial and insurance activities, public administration and transportation and storage.

Figure 10: GDP Growth



Source: Uganda Bureau of Statistics

Growth is expected to strengthen further in FY 2018/19 and over the medium-term supported by the multiplier effects of public infrastructure investments, improving agricultural productivity, recovery in FDI, recovery in PSC growth as the full impact of monetary policy easing filters through, and improvements in global demand conditions which are expected to offer support to domestic economic activity. In FY 2018/19, the economy is projected to grow by 6 percent, increasing to of 6.3 percent in the medium-term.

3.7 Consumer Price Inflation

3.7.1 Recent Inflation Developments

Inflation has remained subdued in FY 2017/18, with headline and core inflation averaging 3.4 percent and 2.7 percent compared to 5.7 percent and 5.1 percent, respectively in FY 2016/17. Although annual headline inflation increased to 2.2 percent in June 2018 from 1.1 percent in May 2018, core inflation declined further to 0.9 percent from 1.1 percent during the same period. The low inflation environment was largely a result of the stable exchange rate, favourable weather conditions which contributed significantly towards ample food supplies, and the relatively subdued aggregate demand driven by the negative output gap. Developments in domestic inflation are shown in **Table 5**.

Table 5: Developments in Domestic Inflation

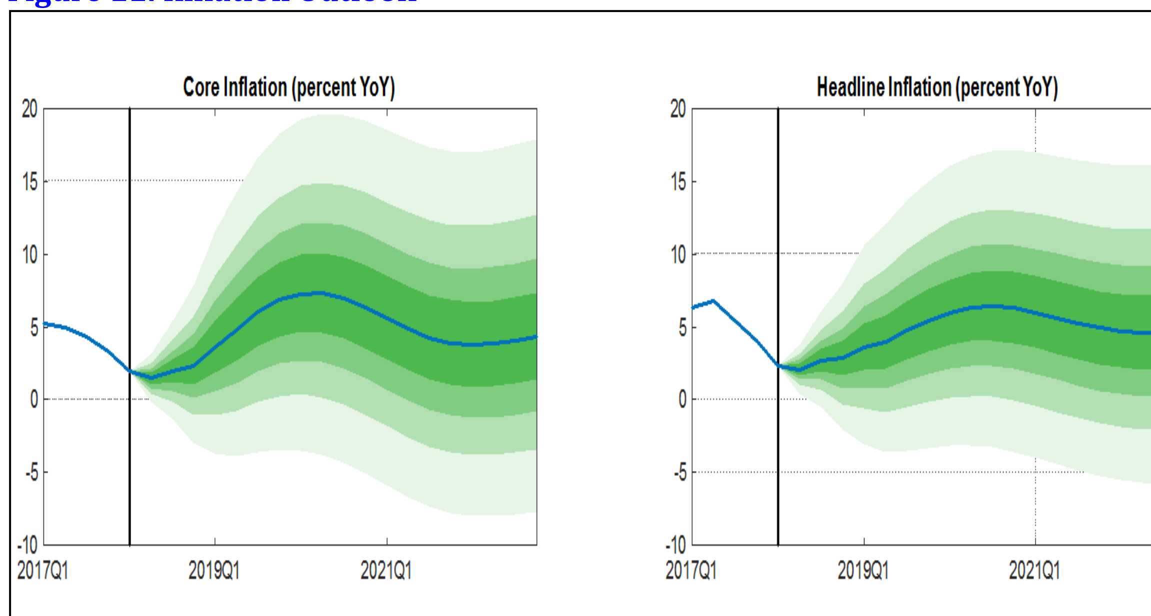
	17-Jul	17-Aug	17-Sep	17-Oct	17-Nov	17-Dec	18-Jan	18-Feb	18-Mar	18-Apr	18-May	18-Jun
	Annual Percent change											
Headline	5.7	5.2	5.3	4.8	4	3.3	3	2.1	2	1.8	1.7	2.2
Core	4.5	4.1	4.2	3.5	3.3	3	2.6	1.7	1.7	1.6	1.1	0.9
Food crops	12.9	11.7	9.6	7.9	2.3	-0.7	1.4	-0.7	-1.7	-2.1	-0.2	2.3
Other Goods	4.9	4.7	4.3	4.3	3.7	3.3	2.3	1.6	1.2	1	0.6	0.3
Services	4	3.3	4.1	2.3	2.8	2.6	3	1.8	2.5	2.4	1.9	1.7
EFU	7.8	7.8	10.6	14.1	13.7	12.5	9.8	11.2	10.3	10.4	10.3	15.1
	Quarterly moving average											
Headline	6.4	5.8	5.4	5.1	4.7	4	3.4	2.8	2.4	1.9	1.8	1.9
Core	4.9	4.5	4.3	3.9	3.7	3.3	3	2.4	2	1.6	1.5	1.2
Food crops	18	14.2	11.4	9.7	6.6	3.2	1	0	-0.3	-1.5	-1.3	0
Other Goods	5.4	5.1	4.6	4.4	4.1	3.8	3.1	2.4	1.7	1.3	0.9	0.6
Services	4.1	3.8	3.8	3.2	3.1	2.6	2.8	2.5	2.4	2.2	2.3	2
EFU	6.9	7.1	8.7	10.8	12.8	13.4	12	11.2	10.4	10.6	10.3	11.9

Source: Uganda Bureau of Statistics (UBOS)

3.7.2 Inflation Outlook

The inflation outlook in the short-term indicates that inflation will remain subdued. However, inflation is projected to rise in the medium-term, with core inflation expected to return to its 5 percent target in the medium term. The inflation forecasts are depicted in **Figure 11.**

Figure 11: Inflation Outlook



Source: Bank of Uganda

The baseline forecast reflects the assessment of the most likely economic developments during the forecast horizon. It is based on forecasts and assumptions of the developments in the external environment of the Ugandan economy, as well as assessments of the effectiveness of markets and the transmission of monetary policy to the real economy. All of these factors are subject to uncertainty.

The inflation outlook is therefore likely to be shaped by several factors, including exchange rate trajectory which in part is dependent on external sector developments, foreign inflation which though lower in 2018 is projected to rise in 2019, oil prices which have risen and food prices which have been revised downwards on account good global harvests.

The exchange rate is a critical determinant of the inflation trajectory, given the high percentage of tradable goods in the consumption basket. Although we forecast a mild depreciation over the forecast horizon, the exchange rate remains vulnerable to changes in domestic and external fundamentals, which are tilted on the upside. The external economic environment remains volatile, with substantial upside risks. On the domestic scene, demand for foreign exchange, especially for public infrastructure projects continues to grow, which may increase demand pressures in the foreign exchange market given the widening current account deficit.

An extension or steepening of the upward path of oil prices is a risk factor, because of both its direct effects on local and world inflation and its implications on global growth. The current developments in international oil prices indicate that they may constitute a significant upside risk to inflation. Although domestic food prices are forecast to remain subdued in the near term, they are nonetheless vulnerable to vagaries of the weather.

Growth has been below potential however, it is expected to pick up in FY 2018/19. The negative capacity gap has been a mitigating factor to the inflationary pressures. Spare capacity in the economy is however projected to be eliminated by the end of FY 2018/19, thus increasing domestic cost pressures in the economy. Nonetheless, inflation's elasticity to the output gap remains low.

In line with the objective of keeping inflation close to the target and given the assessment of the current and evolving macroeconomic situation, the Central Bank Rate (CBR) was maintained at 9 percent in the Monetary Policy Committee meeting of June 2018.

4 Conclusion

The overall conditions in the domestic economy have improved, in part supported by the stimulatory monetary policy. The domestic demand conditions improved in FY2017/18 compared to the previous year. GDP is now projected to grow by 5.8 percent in FY 2017/18 compared to 3.9 percent in FY 2016/17. Growth is expected to strengthen further to about 6.0 in FY 2018/19 and to 6.3 percent in the medium-term. The negative output gap is expected to close in 2018/19; and on average, the economy will be growing slightly above potential over the period 2019-2022. There are however downside risks to growth outlook, including slow execution of public investments and challenges of funding these investments could be formidable, thus delaying the growth benefits of public investment. The key challenges facing the Ugandan economy over the medium term are to boost real economic growth in a sustainable manner and to strengthen the balance of payments by boosting export earnings.

Raising real GDP growth rates above 5 percent on a sustained basis will require a strengthening of the supply side of the economy and, in particular, more robust rates of private business investment. The oil industry is likely to provide a major source of private investment over the

medium term and this will boost real growth rates when oil production begins which will probably be in the first half of the 2020s. There are also opportunities for investment to supply the regional markets with processed foods and manufactured goods such as building materials. Uganda's merchandise exports to the regional markets, comprising the East African Community and the Democratic Republic of Congo, have grown at an average of 9 percent a year over the last five years and now account for 55 percent of Uganda's total merchandise exports.

Inflation has remained subdued in FY 2017/18, with headline and core inflation averaging 3.4 percent and 2.7 percent compared to 5.7 percent and 5.1 percent, respectively in FY 2016/17. However, inflation is projected to rise faster than previously projected but to remain at 5 percent in the medium-term. There are upside risks to the inflation outlook, including future direction of food crops prices, the path of the exchange rate, which in part is contingent on external economic environment, and the evolution of international crude oil prices.

The evolution of the BOU's monetary policy over the medium term will continue to be determined by the forecasts for inflation. The latest BOU forecast indicates that core inflation will increase gradually towards 5 percent by the middle of 2019. If inflationary pressures emerge which threaten the target for core inflation, the BoU will tighten monetary.

Appendix: Key Macroeconomic Variables

	2014/15	2015/16	2016/17	2017/18
GDP Growth at Market prices	5.2	4.7	3.9	5.8
GDP Growth at Basic prices	4.8	5	4.1	6.1
Headline Inflation	2.9	6.6	5.7	3.4
Core Inflation	3.2	6.7	5.1	2.7
Nominal Exchange Rate(Shillings/US$)	2827.7	3442.97	3529.68	3659.15
Overall Balance(US$ millions)[p]	345.7	-101.5	-437.6	87.5
Current Account Balance (US$ millions) [p]	-1862.9	-1183.9	-898.6	-1481.1
Budget Deficit(incl.grants)/GDP	-4.5	-4.9	-3.9	-4.7
Total revenue and grants/GDP	14.2	15	14.9	15.3
Expenditure and Net Lending/GDP	18.9	20.1	19	20.1
Nominal Public Debt/GDP [p]	32.7	33.8	37	38.6
o/w Domestic [p]	13.3	12.8	12.7	12.3
o/w External [p]	19.4	21	24.3	26.3
PSC/GDP [p]	12.95	13.68	12.92	12.36
M3/GDP [p]	21.40	21.13	21.74	21.09
Deposits/GDP [p]	18.89	18.75	18.90	18.45
Lending Rate [p]	21.58	23.96	22.59	20.58
Time Deposit Rate [p]	10.49	14.41	11.38	8.83
91 TBILL Rate	11.98	17.81	13.2	9.12
182 TBILL Rate	13.67	19.63	14.08	9.43
Secondary Market Rates				
2 year Bond Rate	14.83	18.62	15.87	11.61
5 year Bond Rate	15.24	18.34	16.21	13.05
10 year Bond Rate	15.43	18.07	16.52	14.40

Source: Uganda Bureau of Statistics, Ministry of Finance and Economic Planning and Bank of Uganda,
[p] represents projections for FY2017/18.