Bank of Uganda

State of the Economy

March 2018

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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
WEO	World Economic Outlook
WALR	Weighted Average Lending Rate
Y-o-Y	Year-on-Year

Executive Summary

i) Global economic activity continues to firm up, with global output now estimated at 3.7 per cent in 2017, which is higher than had been projected in October 2017 and the outturn for 2016. The pickup in growth has been broad based, with upside surprises for both Advanced Economies (AEs) and Emerging Market and Developing Economies (EMDEs), broadly driven by monetary and fiscal policy stimulus and increased investment and productivity. The strong momentum is expected to carry into 2018 and 2019, supported by anticipated strong growth in AEs and the expected impact of the recently approved U.S. tax policy changes. While short-term risks are broadly balanced, medium-term risks are still tilted to the downside and stem mainly from more rapid and sizeable tightening of the currently easy global financial conditions, a shift to inward-looking policies and noneconomic factors such as terrorism, geopolitical tensions, domestic political discord and extreme weather events.

ii) Global financial market conditions remain relatively stable, supported in large part, by easy monetary conditions, albeit with some volatility in the equity and bond markets. Long-term bond yields in key global markets continued to rally, buoyed by generally strong company earnings, solid economic growth, and expectations of gradual normalization of AEs monetary policies - supported by the relatively subdued inflation environment. Market expectations remain for a gradual increase in interest rates and monetary policy normalization in most AEs. The US Federal Open Market Committee (FOMC), the Bank of England, and the Governing Council of the ECB in February 2018 reaffirmed their stance of a gradual adjustment to monetary policy as they seek to support economic activity. Going forward, this guidance is expected to largely support stability in global financial markets.

iii) On the domestic scene, in line with the easing stance of monetary policy, money market rates have continued to rally, with the 7-day interbank money market rate falling to 9.5 per cent, from 10.2 per cent in the quarter to October 2017. Yields on government securities also continued to decline during the quarter ended January 2018, although, month-on-month, the pace of decline decelerated somewhat in January 2018, following an uptick in rates in the January 31, 2018 auction. Yields on the longer term bonds also declined during the quarter ended January 2018. The significant downward shift of the yield curve across the spectrum of the maturity profile reflects transmission of the CBR cuts, owing to BOU's protracted monetary policy easing.

iv) Commercial bank interest rates continued to ease in response to the accommodative monetary policy stance albeit sluggishly and with a lag. The weighted average lending rate on shilling denominated loans eased to 20.2 per cent, from 21.4 per cent in the preceding quarter and 22.9 per cent in the corresponding quarter of the previous year. Growth in Private Sector Credit (PSC) remains relatively subdued, with average annual growth at 5 per cent in the quarter ended December 2017, down from 5.9 per cent in the quarter ended September 2017. Going forward, PSC growth is expected to strengthen on the back of the expected increase in credit supply as banks align their pricing behaviour to the eased monetary policy stance.

v) Growth in monetary aggregates remains robust although it stagnated in the quarter ended December 2017. As in the quarter ended September 2017, average annual growth in M1, M2 and M3 stood at 14.6, 15, 13 per cent, respectively, in the quarter ended December 2017. Growth in M3 was largely on account of growth in Net Foreign Assets (NFA), supported by BOU's purchases of US dollars, from the Interbank Foreign Exchange Market (IFEM), for reserve build-up. Growth in M1 was largely driven by strong growth in demand deposits, which offset a deceleration in growth in currency in circulation (CIC). While the growth in latter softened to 10 per cent from 15 per cent in in the preceding quarter, the former strengthened to 17.6 per cent, from 14.3 per cent over the same period.

vi) Preliminary data for the first six months of FY 2017/18 indicates shortfalls in revenue collection and government expenditure relative to the programed amounts. Total Government revenue (including grants) amounted to Shs. 7,346.7 billion, which is Shs. 1,135.8 billion lower than the programed amount – a shortfall mainly due to underperformances in both domestic revenue and grants. Total government expenditure and net lending also underperformed, to the tune of Shs. 1,894.8 billion, largely due to lower development expenditure driven by slow implementation of government development projects. Developments in government revenue and expenditure resulted in a fiscal deficit of Shs. 2,572.1 billion, financing of which amounted to Shs. 2,304.5 billion, out of which over 85 per cent was external.

vii) The balance of payments (BoP) continued to improve, although with a slight deceleration during the quarter under review. The BoP recorded an overall surplus of USD 94 million, compared to a surplus of USD 130 million and USD 118.8 million in the last two immediate quarters. The deficit on the current account improved to USD 272.8 million, mainly driven by improvement in the surplus on the secondary income account, which increased by 22.9 per cent, on account of increases in personal transfers and project aid receipts. Both export receipts and import bill increased during the quarter under review, resulting, overall, in a higher deficit of USD 482.2 million. Net inflows through the financial account decreased, by 3.6 per cent, mainly on account of higher portfolio outflows coupled with lower inflows of other investments. The stock of reserves at the end of December 2017 was estimated at USD 3,654.4 million (including valuation changes), equivalent to 5.3 months of future imports of goods and services.

viii) During the quarter ended December 2017, the Uganda Shilling stood at an average midrate of Shs. 3,624.2 per US Dollar, a depreciation of 0.9 per cent and 2.9 per cent on quarterly and annual basis, respectively. The weakening of the Uganda Shilling was more entrenched in October 2017 due to elevated uncertainty surrounding the political environment in neighbouring Kenya. On monthly basis, the Uganda Shilling strengthened by 0.1 per cent to Shs. 3,636.5 per US Dollar in February 2018, supported by Banks' long dollar positions amidst inflows mainly from export proceeds and NGO inward remittances. The Nominal Effective Exchange Rate (NEER) depreciated by 0.5 per cent and 3.0 per cent on quarterly and annual basis, respectively. The Real Effective Exchange Rate (REER), which takes into account the inflation differential between Uganda and its trading partners depreciated by 0.8 per cent on quarterly basis. The depreciation of the REER is a pointer to increased competitiveness of Uganda's exports.

ix) The Ugandan economy continues to show signs of recovery in FY 2017/18. The Uganda Bureau of Statistics (UBOS) recently released quarterly real GDP estimates for Q1-2017/18 indicate that the economy grew by 1.3 per cent, which though lower than 2.5 per cent in Q4-2016/17, is closer to the average growth of the entire 2016/17 of 1.6 per cent. This growth was mainly supported by growth in the industry sector. This is consistent with estimates of the BOU's early warning indicator - the composite index of economic activity (CIEA), which indicates a rebound of economic activity, driven by strong growth in industrial activity. Going forward economic growth is projected in the range of 5 – 5.5 per cent in FY 2017/18, and is forecast to average about 6.3 per cent in the medium to long term, supported by accommodative monetary policy, improvement in public investment management and an improvement in the global economy.

x) Inflation continued to moderate further, with annual core and headline inflation falling to 1.7 and 2.1 per cent, respectively, in February 2018, from 2.6 and 3.0 per cent in January 2018, and from 5.7 and 6.7 per cent, respectively, in February 2017. Overall decline in inflation was mainly driven by significant moderation of food crop prices.

Annual food crop inflation fell to (*minus*) 0.7 per cent in February 2018, from 1.4 per cent in January 2018 and from 18.8 per cent a year ago. Annual services inflation also eased to 1.8 per cent in February 2018, from 3.0 per cent in January 2018 while annual Energy, Fuel and Utilities (EFU) inflation increased to 11.2 per cent in from 9.8 per cent over the same period due to price increase in liquid and solid (charcoal and firewood) fuels.

xi) The inflation outlook remains unchanged in the near term, and is projected to improve in the medium term. Inflation was forecast to increase gradually, as the economy strengthens with both headline and core inflation converging to the 5.0 per cent medium term target by H2-2019. Nonetheless, there are risks to the inflation outlook, which are however relatively balanced. On the upside, the expansionary fiscal policy in FY 2017/18, the pickup in global economic activity and therefore commodity prices and normalization/tightening of AEs monetary policies could drive up domestic inflation. However, their full impact could be mitigated by the current low capacity utilization in the domestic economy and lower-than-expected increase in commodity prices curtailed by possible supply-side interruptions. Given the objective of keeping inflation close to the target and the estimated spare capacity in the economy, the Bank of Uganda (BoU) judged that a cautious easing of monetary policy was warranted to further boost private sector credit growth and strengthen economic growth momentum. The BoU therefore reduced the Central Bank Rate (CBR) by 50 basis points (bps) to 9.0 per cent in February 2018.

1 Back ground

This report presents domestic and external economic developments in the period to January 2018, extending into February 2018 where data is available. It assesses the future prospects and outlook for both the domestic and global economy, and identifies the risks to the outlook. The report then draws the implications of the outlook for domestic inflation and output, in the short and medium term, and lays out the direction of monetary policy in the next quarter.

2 Global Economic Environment

2.1 Global Economic Activity

Global economic activity continues to firm up, with global output now estimated at 3.7 per cent in 2017, which is 0.1 percentage point (PP) higher than had been projected in October 2017 and 0.5 PP higher than in 2016. The pickup in growth has been broad based, with upside surprises for both Advanced Economies (AEs) - particularly in Europe and Asia - and the Emerging Market and Developing Economies (EMDEs), broadly driven by monetary and fiscal policy stimulus, increased investment and productivity. The stronger momentum experienced in 2017 is expected to carry into 2018 and 2019, with global growth revised up by 0.2 PPs to 3.9 per cent for both years. For 2018 and 2019, the strong growth is forecast resulting mainly from anticipated strong growth in AEs and the expected impact of the recently approved U.S. tax policy changes. In AEs, economic activity is now anticipated to expand at an annual rate exceeding 2.0 per cent over the two-year period. Even more, growth in EMDEs is also projected to firm further, supported by strong growth in China and India and steady recovery in Brazil, Russia and Nigeria.

In the AEs, growth is estimated to have increased to 2.3 per cent in 2017 from 1.7 per cent in 2016, driven by stronger growth in the United States (U.S), Euro area, Japan, and Canada — which more than offset the deceleration in growth in the U.K. Growth in the U.S is estimated to have risen to 2.3 per cent in 2017, from 1.5 per cent in 2016, and is projected to increase to 2.7 per cent in 2018, supported by higher projected external demand and the expected effect of the recently approved U.S tax policy changes on U.S output and demand. The approved tax policy changes include reduction of income and business tax rates, among others. Growth in the U.S is projected at 2.5 per cent in 2019.

In the Euro Area, growth is estimated to have risen by 0.6 PP to 2.4 per cent in 2017 from 1.8 per cent in 2016 and is forecast at 2.2 per cent and 2.0 per cent in 2018 and 2019, respectively. These projections are 0.5 PP higher than the October 2017 projections, reflecting stronger aggregate and higher external demand. In Japan, growth is estimated at 1.8 per cent in 2017 from 0.9 per cent in 2016, with projections of 1.2 per cent and 0.9 per cent, respectively, in the next two years, supported by higher external demand and recent stronger than expected economic activity. In Canada growth is estimated at 3.0 per cent in 2017, up from 1.4 per cent in 2016, with projections of 2.3 per cent and 2.0 per cent, respectively, in 2018 and 2019. In the U.K, estimates indicate that growth decelerated to 1.7 per cent in 2017 from 1.9 per cent in 2016 and is projected to moderate to 1.5 per cent both in 2018 and 2019.

Growth in EMDEs remains relatively uneven among member country groups and is estimated to have risen to 4.7 per cent in 2017, from 4.4 per cent in 2016, with projections of 5.0 per cent in both 2018 and 2019. Growth in 2017 was supported by improved external factors including a benign global financial environment, recovery in AEs and establishment of new infrastructure in China. Support to growth in EMDEs is mainly driven by Emerging and Developing Asia where China and India are projected to grow at rates above 6 per cent in 2018 and 2019, reflecting stronger external demand. In Latin America growth remains weak although it is estimated to have turned positive at 1.3 per cent in 2017 from minus 0.7 per cent in 2016, and is anticipated to pick up to 1.9 per cent in 2018 and 2.6 per cent in 2019, highlighting an improved outlook for Mexico and Brazil, following actual and anticipated stronger US demand, higher commodity prices and easier financial conditions. Growth in Brazil is estimated to have recovered to 1.1 per cent in 2017, from minus 3.5 per cent in 2016 and is projected to firm to 1.9 per cent and 2.1 per cent in 2018 and 2019, respectively, supported by favourable effects of stronger commodity prices and easier financing conditions.

Table 1: Global Growth Projections

	Outturn		Projections		Diff. from Oct 2017 WEO	
	2016	2017	2018	2019	2018	2019
World	**3.2**	**3.7**	**3.9**	**3.9**	**0.2**	**0.2**
Advanced Economies	**1.7**	**2.3**	**2.3**	**2.2**	**0.3**	**0.4**
United States	1.5	2.3	2.7	2.5	0.4	0.6
Euro Area	1.8	2.4	2.2	2.0	0.3	0.3
Japan	0.9	1.8	1.2	0.9	0.5	0.1
United Kingdom	1.9	1.7	1.5	1.5	0.0	-0.1
Emerging Market & Developing Economies	**4.4**	**4.7**	**4.9**	**5.0**	**0.0**	**0.0**
Russia	-0.2	1.8	1.7	1.5	0.1	0.0
Brazil	-3.5	1.1	1.9	2.1	0.4	0.1
China	6.7	6.8	6.6	6.4	0.1	0.1
India	7.1	6.7	7.4	7.8	0.0	0.0
Sub-Saharan Africa	**1.4**	**2.7**	**3.3**	**3.5**	**-0.1**	**0.1**
Nigeria	-1.6	0.8	2.1	1.9	0.2	0.2
South Africa	0.3	0.9	0.9	0.9	-0.2	-0.7

Source: IMF, WEO Update January 2018

In sub-Saharan Africa (SSA), growth is estimated to have increased to 2.7 per cent in 2017, up from 1.4 per cent in 2016 and is projected to improve further to 3.3 per cent and 3.5 per cent in 2018 and 2019, respectively. The increase in outward growth (2018 and 2019) is mainly on account of recovery in economies such as Nigeria, supported by, among other factors, stronger commodity prices. The relatively lower projected growth rates for SSA, compared to their historical levels, is attributed to structural and political challenges in member economies, particularly South Africa where heightened political uncertainty weighs on confidence and investment. Global growth projections are presented in **Table 1**.

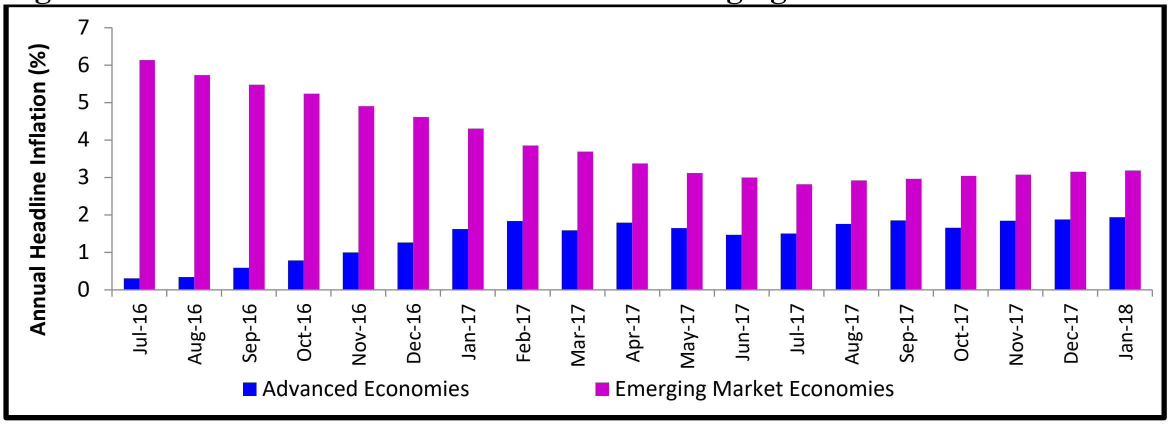
While global economic activity is projected to strengthen in 2018 and 2019, risks to the outlook are broadly balanced in the near term, but skewed to the downside over the medium term. The risks stem mainly from more rapid and sizeable tightening of the currently easy global financial conditions, a shift to inward-looking tariff and trade policies and noneconomic factors such as terrorism, geopolitical tensions, domestic political discord and extreme weather events.

2.2 Global Inflation

Global inflation remains subdued and was relatively unchanged in most key economies in the quarter ended January 2018, compared to the previous quarter ended October 2017. Positive inflation, which in AEs is now close to or above central bank targets, is mainly on account of improving global growth outlook, and higher crude oil prices – which were pushed up by severe weather in the U.S and the Organization of Petroleum Exporting Countries (OPEC) agreement to limit production. Among AEs, during the quarter under review, inflation stood at 2.1 per cent in the U.S, 1.4 per cent in the Euro Area, 3.0 per cent in the U.K and rose to 1.0 per cent in Japan.

In EMDEs, outturns were mixed, with inflation higher in some economies such as Brazil and India and lower in China, Russia and South Africa. Following the fading effect of previous EMDEs currency depreciations, there's been notable narrowing of the inflation differential between Advanced and Emerging economies (**Figure 1)**.

Figure 1: Headline Inflation – Advanced versus Emerging Market Economies



Source: Organization for Economic Cooperation and Development (OECD), March 2018.

Average inflation in AEs stood at 1.9 per cent in January 2018, up from 1.6 per cent in January 2017 and 0.5 per cent two years ago while in key EMDEs, inflation dropped to 3.2 per cent from 4.3 per cent and 6.9 per cent in the same period. Global inflation developments are shown in **Table 2**.

Table 2: Global Inflation Developments

	Quarterly Averages			Monthly		
	Quarter Ended Jan-17	**Quarter Ended Oct-17**	**Quarter Ended Jan-18**	**Nov-2017**	**Dec-2017**	**Jan-2018**
Euro Area	1.2	1.5	1.4	1.5	1.4	1.3
Japan	0.4	0.5	1.0	0.6	1.0	1.4
UK	1.5	3.0	3.0	3.1	3.0	3.0
US	2.1	2.1	2.1	2.2	2.1	2.1
Brazil	6.2	2.6	2.9	2.8	2.9	2.9
China	2.3	1.8	1.7	1.7	1.8	1.5
India	2.2	2.9	4.4	4.0	4.0	5.1
Russia	5.4	3.0	2.4	2.5	2.5	2.2
South Africa	6.9	4.7	4.4	4.4	4.5	4.3

Source: Organization for Economic Cooperation and Development (OECD), March 2018.

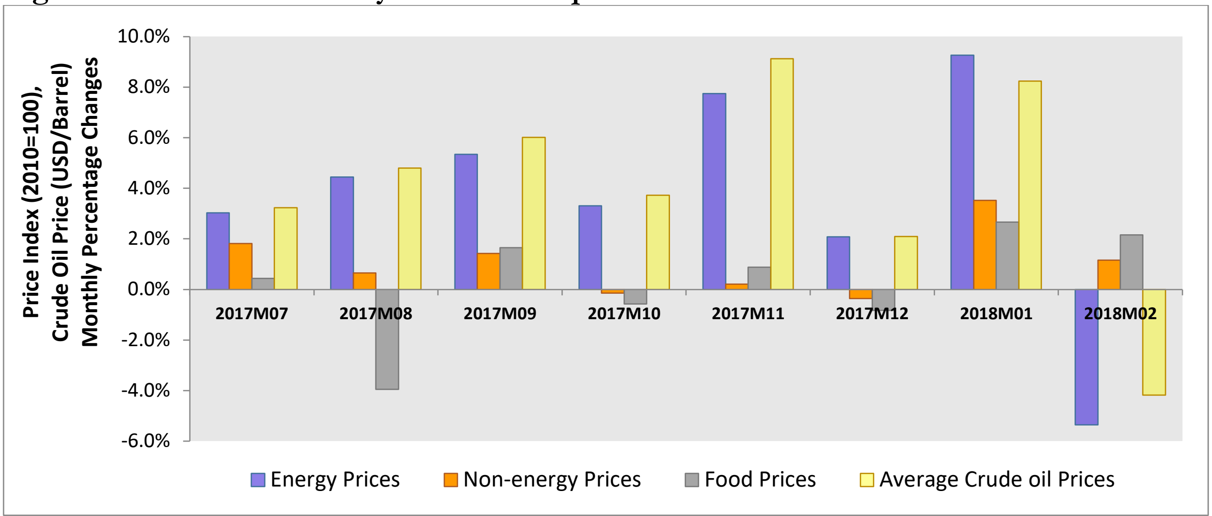
In terms of the outlook, headline inflation in AEs is expected to rise to 1.9 per cent in 2018, from 1.7 per cent in 2017 and further to 2.1 per cent in 2019. For EMDEs, headline inflation is also expected to rise to 4.5 per cent in 2018, from 4.1 per cent in 2017, and to decelerate slightly to 4.3 per cent in 2019. There is an upward revision in the projections compared to October 2017 WEO forecasts, on account of recent increases in the global oil price. A major risk to the global inflation outlook remains higher-than-projected increase in international commodity prices, especially those of crude oil, which could lead to much higher global inflation than the slight increase currently projected, with implications for the pace of monetary tightening especially in AEs.

2.3 International Commodity Prices

Commodity prices remain largely on a recovery path following their sustained pickup through 2017, although developments have been mixed between the energy and non-energy commodity prices in the first two months of 2018.

In February 2018, international crude oil prices tapered, declining for the first time in seven months. Average crude oil prices declined by 4.2 per cent to USD 63.4 per barrel, unwinding the sizeable increase recorded in January 2018, when average crude oil prices rose by 8.2 per cent from their levels of December 2017. On an annual basis, average crude oil prices increased by 16.8 per cent in February 2018, reflecting the recovery through 2017 as OPEC deliberately set out to limit production in order to support prices. On the other hand, average food prices rose by 2.2 per cent on monthly basis and by 0.4 per cent on annual basis, strengthening the gains made in January 2018 when food prices rose by 2.7 per cent on monthly basis. The decline in oil prices recorded in February 2018 was partly on account of a recovery in US oil production, following the melting of some wells that froze in January 2018, as well as price volatility in some financial markets during the month, especially in the equities and bond markets.

Figure 2: Global Commodity Price Developments



Source: World Bank

Given the political and economic circumstances in the Middle Eastern oil-rich countries, coupled with improving global economic prospects in the U.S and OPEC's agreement to limit production, oil prices are likely to stay on the upturn. Indeed the latest IMF price forecasts project the average oil price to edge up by around 11.7 per cent in 2018 on top of the rise of 23.1 per cent in 2017, to an average of USD 59.9 per barrel, mainly supported by the improving global growth outlook. Risks to the outlook include possible interruption in production from key producers on account of political strife, which would lead to stronger increase in prices.

However, the likelihood of continued strong US shale oil production could curtail further price increases. Oil prices are projected to decline slightly by 4.3 per cent to USD 56.4 per barrel in 2019. Developments in international commodity prices are shown in **Figure 2.**

2.4 Global Financial Markets

Global financial market conditions remain relatively stable, supported in large part, by easy monetary conditions, albeit with some volatility in the equity and bond markets. Long-term bond yields in key global markets continued to rally, buoyed by generally strong company earnings, solid economic growth, and expectations of gradual normalization of AEs monetary policies supported by the relatively subdued inflation environment. In February 2018, 10-year government bond yield increased by 0.28 PP to 2.9 per cent in the U.S and by 0.23 PP to 1.57 per cent in the UK and by 0.17 PP to 0.72 per cent in the Euro Zone. In EMDEs, long term bond yields largely declined during February 2018.

In the currencies market, the US dollar weakened against most AE currencies in February 2018. The Euro, British Pound and Japanese Yen gained by 1.5 per cent, 1.3 per cent and 2.8 per cent, respectively, against the US Dollar, on monthly basis. Relative appreciation of the British Pound and Euro has largely been on account of reduced ease in monetary policy stance both in the UK and in the Euro Area. In EMDEs, currency movements against the US Dollar were varied: the Chinese Yuan, Malaysian Ringgit, South African Rand strengthened against the US Dollar while others such as the Brazilian Real, Indian Rupee and currencies of most East African economies depreciated, instead, against the US Dollar.

Market expectations remain for gradual increase in interest rates and monetary policy normalization in most AEs, supported by forward guidance from the Central Banks. In the US, the Federal Reserve Board maintains its promise of gradual adjustment to the stance of monetary policy as the authorities seek to support economic activity. Similarly, the Bank of England in its February 2018 statement reaffirmed its stance that any future increases in the bank rate, which currently stands at 0.5 per cent, will be at a gradual pace and to a limited extent. In January 2018, the European Central Bank (ECB) fulfilled its October 2017 announcement and lowered its monthly net asset purchases to €30 billion from €60 billion at the end of December 2017. The ECB also announced that the current level of its asset purchases will run until September 2018. Going forward, this guidance is expected to largely support stability in global financial markets. The main risk to global financial market stability remains President Trump's piecemeal policy proposals, which are increasingly tilted towards a shift to inward looking policies.

2.5 Implications for the Uganda Economy

The external economic environment will continue to influence Uganda's economic performance given the country's integration in the rest of the world. As such, the global outlook and the risks to the global economic outlook have the potential to affect domestic inflation and output. The global outlook is for stronger economic activity, slight increase in inflation on account of higher commodity prices, continued upturn in crude oil prices and stability in financial markets.

The risks to the outlook include a shift to inward-looking policies and higher-than-projected increase in international commodity prices which could pose upside risks to global inflation leading to more rapid and sizeable tightening of the currently easy global financial conditions. Noneconomic factors such as terrorism, geopolitical tensions, domestic political discord and extreme weather events could dampen the strong global economic momentum. Risks to the outlook for international commodity prices include possible interruption in production from key producers on account of political strife and likelihood of continued strong US shale oil production. In the global financial markets, the main risk to stability remains President Trump's piecemeal policy proposals, which increasingly underscore a shift to inward looking policies.

The projected stronger economic activity globally and especially in SSA represents likely improvement in external demand for Uganda's exports and inward remittances, which could strengthen the recovery in domestic output growth, which is starting to take shape, and also support the exchange rate. However, elevated downside risks highlighted above could curtail the momentum in global growth with knockdown effects to the pace of recovery in domestic output. Increasingly, a shift to inward-looking policies, exemplified by President Trump's March 2018 proposal to introduce tariffs on imports of steel and aluminium, could result in retaliation from other countries causing disruptions which might reduce cross-border trade and investment.

The anticipated increase in global crude oil prices is expected to shave off the gains in export earnings arising from the general projected increase in international commodity prices. Higher crude oil prices could increase Uganda's total import bill there by contributing to a wider current account deficit and exchange rate volatility. In addition, the forecasted increase in global pump oil prices could result in higher pump prices raising the upside risks to domestic inflation. However this damaging effect will be moderated by the likely rise in oil related FDI into the Uganda's nascent oil sector, which will support the exchange rate, mitigating its impact on domestic inflation.

The projected slight increase in global inflation could turn out higher in case of stronger-than-expected increase in global commodity prices. Given that headline inflation in key AEs such as the US and the U.K has been on an upward trajectory and had reached close to or above the Central Bank targets of 2.0 per cent in January 2018, additional inflationary pressures may prompt the US Fed and the BoE to pursue faster and more sizeable tightening of monetary policies, leading to volatility in global financial markets and disruption to global economic activity. This could pose a risk of exchange rate volatility in the domestic market, and delay recovery of Uganda's economic growth.

3 Domestic Economic Developments

3.1 Reflections on Monetary Policy Stance and Implementation

3.1.1 Monetary Policy Stance

Bank of Uganda (BoU) continued with its cycle of easing monetary policy in February 2018, cautiously reducing the Central Bank Rate (CBR) by a further ½ percentage point (PP) to 9.0 per cent, from 9.5 per cent, in December 2017. This was aimed at further boosting growth in private sector credit (PSC) and to strengthen economic growth momentum.

At the time of the Monetary Policy Committee (MPC) meeting of February 2018, the near-term inflation forecasts were broadly similar to those of the December 2017 MPC meeting. The forecasts for the 12-months horizon were lower by about 1 PP, in large part due to lower food inflation. Inflation was forecast to increase gradually, as the economy strengthens with both headline and core inflation converging to the 5.0 per cent medium term target by H2-2019. Nonetheless, there are upside risks to this outlook, pertaining to the path of the exchange rate which, in part, is contingent on external economic environment; the future direction of food crops prices; and the evolution of international crude oil prices. However, the spare capacity which persists in the economy would dampen inflationary pressures.

Given the objective of keeping inflation close to the target and the estimated spare capacity in the economy, the Bank of Uganda (BoU) judged that a cautious easing of monetary policy was warranted to further boost private sector credit growth and strengthen economic growth momentum. The BoU therefore reduced the Central Bank Rate (CBR) by 50 basis points (bps) to 9.0 per cent. The band on the CBR was maintained at +/-3 PPs and the margin on the rediscount rate at 4 PPs on the CBR. Consequently, the rediscount rate and the bank rate reduced to 13 per cent and 14 per cent, respectively.

3.1.2 Monetary Policy Operations and Challenges

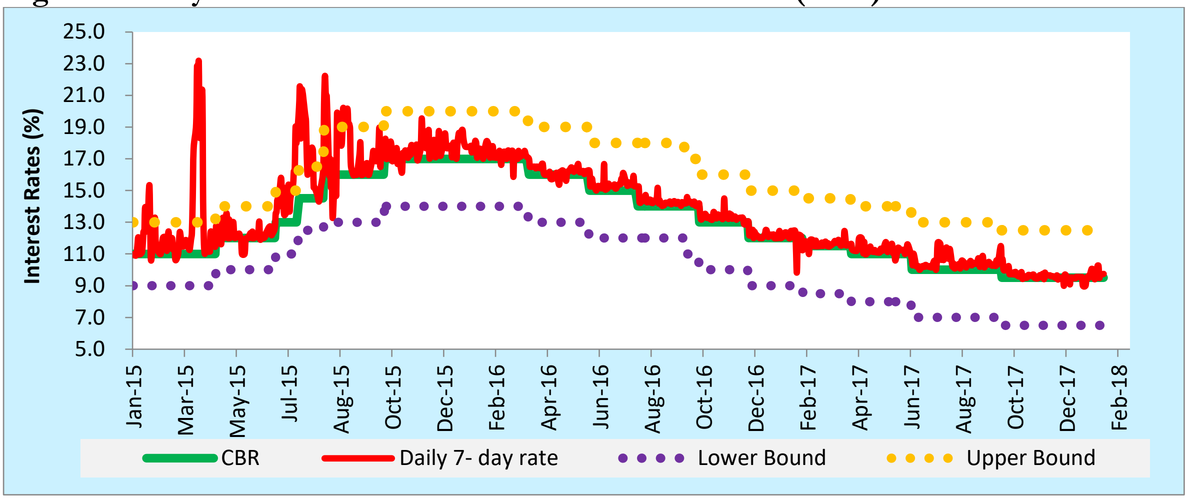
Bank of Uganda continued to use Repurchase Agreements (REPOs), deposit auctions and sales of recapitalization securities in the secondary market to align domestic liquidity conditions with the desired monetary policy stance. As at February 19, 2018, the outstanding stock of REPOs and Deposit Auctions stood at Shs. 380.7 billion and Shs 1.82 trillion, respectively, while the available stock of recapitalization securities, which are used to restrain the persistent build-up of structural liquidity, stood at Shs. 36.2 billion. This build-up of structural liquidity complicates the implementation of monetary policy because commercial banks prefer to transact on overnight basis yet the 7-day interbank rate is BOU's operating target, which causes volatilities in the money market rates. Moreover, managing this liquidity will further impair BoU's balance sheet.

BoU continues to grapple with the management of structural liquidity in the system, and in the interim, is relying more on the deposit auctions and REPOs. REPOs are however, constrained by exhaustible underlying stock of securities. BoU will continue to engage the Ministry of Finance Planning and Economic development for longer dated marketable instruments.

3.1.3 Interbank Money Market Rates

In line with the easing stance of monetary policy, money market rates declined during the quarter ended January 2018, with the 7-day interbank money market rate falling to 9.5 per cent, from 10.2 per cent in the quarter to October 2017 and 12.8 per cent in the quarter ended January 2017. Notably, however, the weighted average 7-day money market rate, although still within the CBR band, rose slightly to 9.7 per cent in January 2018, up from 9.3 per cent in December 2017, largely driven by sizeable structural liquidity (**Figure 3**).

Figure 3: 7-day Interbank Rate and the Central Bank Rate (CBR)



Source: Bank of Uganda

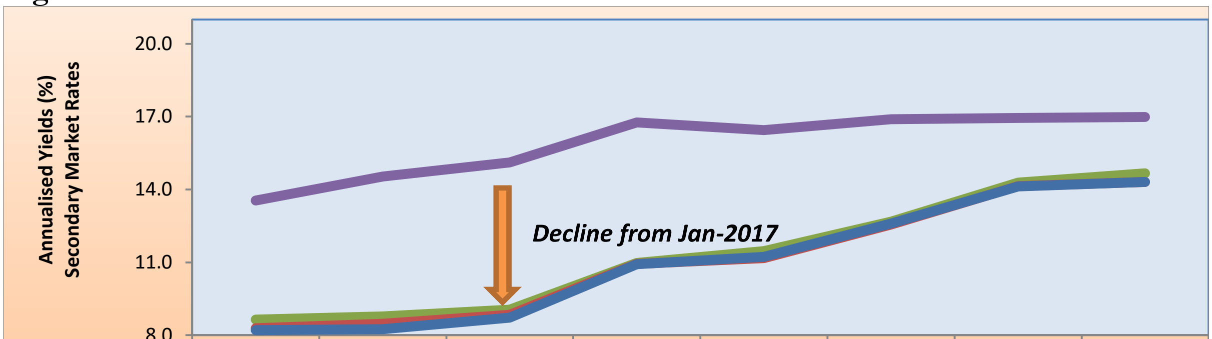
3.2 Other Interest rates and Private Sector Credit

3.2.1 Yields on Government Securities

Yields on government securities also continued to decline during the quarter ended January 2018, in line with the protracted easing of monetary policy and lower inflation expectations. However, the pace of the decline in yields decelerated somewhat in January 2018, following an uptick in rates in the January 31, 2018 auction. Average yields on the 91-day, 182-day and 364-day Treasury bills (T-bills) declined to 8.6, 8.6 and 9.1 per cent, respectively in the quarter ended January 2018, relative to 9.6, 9.7, and 10.3 per cent in the quarter to October 2017 and 14.1, 14.9 and 15.4 per cent in the quarter to January 2017.

Yields on the longer term bonds also declined, with the average yields on the 2-year, 3-year and 5-year Treasury bonds (T-bonds) declining to 10.9, 11.3 and 12.6 per cent, respectively in the quarter ended January 2018, from 12.2, 12.7 and 13.6 per cent in the preceding quarter. Average yields on the 10-year and 15-year T-bonds also declined to 14.2 and 14.4 per cent from 14.6 and 15.1 per cent, respectively over the same period. The significant downward shift of the yield curve across the maturity spectrum reflects monetary policy transmission as BOU further reduced the CBR. **Figure 4** shows developments in yields on government securities.

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



	91-days	182-days	364-days	2-years	3-years	5-years	10-years	15-years
Jan-2017	13.6	14.5	15.1	16.8	16.4	16.9	17.0	17.0
Nov-2017	8.6	8.8	9.1	11.0	11.5	12.7	14.3	14.7
Dec-2017	8.3	8.5	8.8	10.9	11.2	12.6	14.1	14.3
Jan-2018	8.2	8.3	8.7	10.9	11.2	12.6	14.1	14.3

Source: Bank of Uganda

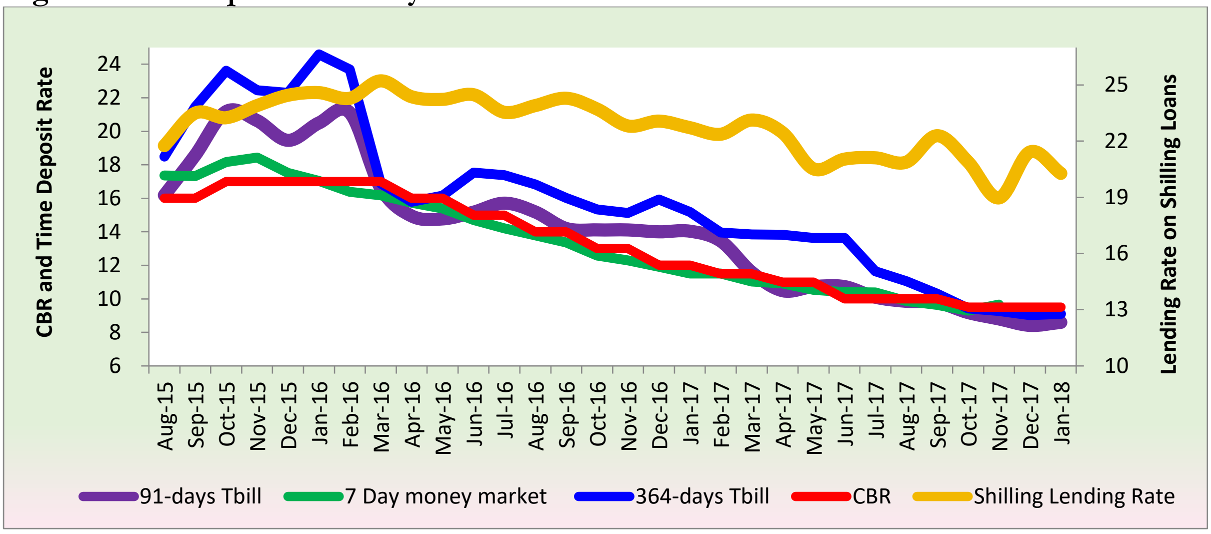
3.2.2 Lending and deposit interest rates

Commercial bank interest rates have continued to ease, in response to the accommodative monetary policy stance albeit sluggishly and with a lag. The weighted average lending rate on shilling denominated loans declined to 20.2 per cent in the quarter ended December 2017, from

21.4 per cent in the preceding quarter and 22.9 per cent in the corresponding quarter of the previous year. The decline in the average lending rate was driven by lower rates on transport and communication, business services, mining and quarrying sectors. Similarly, the average lending rate on dollar denominated loans also fell to 7.5 per cent in the quarter ended December 2017, down from 7.8 per cent in the preceding quarter and 9.9 per cent in the corresponding quarter of 2017.

Shilling-denominated weighted average time deposit rates fell to 8.5 per cent in the quarter ended December 2017, from 9.2 per cent in the quarter ended September 2017 and 11.9 per cent recorded in December 2016. Similarly, weighted average rates on foreign currency-denominated time deposits declined to 2.5 per cent from 2.8 and 4.1 per cent over the same respective periods. Consequently, the spread for both Shilling and foreign denominated loans stood at 11.7 per cent and 5 per cent, respectively, during the quarter ended December 2017. Developments in key interest rates are shown in **Figure 5**.

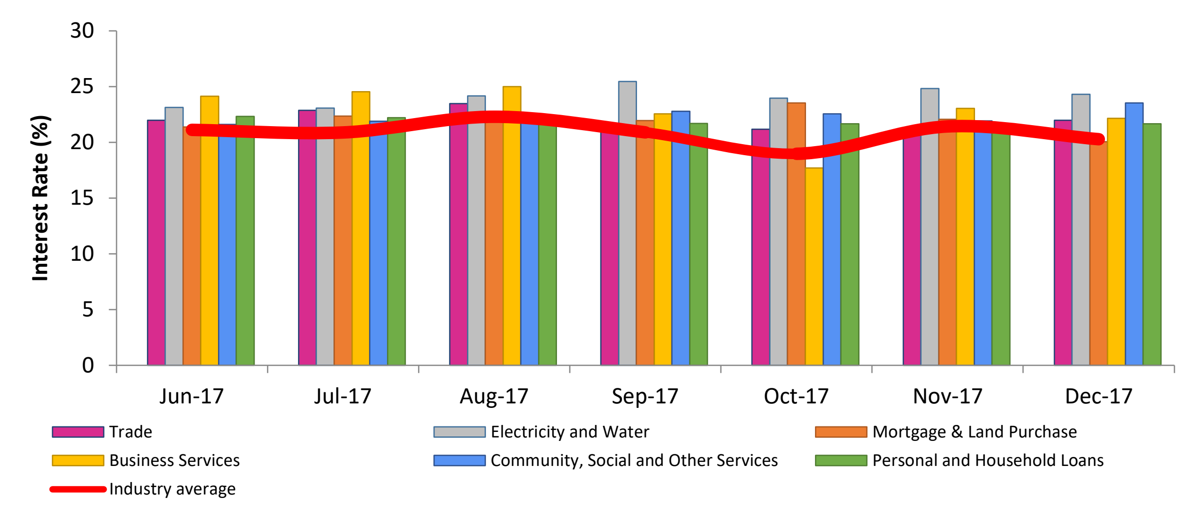
Figure 5: Developments in Key Interest Rates



Source: Bank of Uganda

In terms of sectoral interest rates, Electricity and Water, Community and Social Services, Mortgage and Land purchase, Personal and Household sectors posted the highest average lending rates in the quarter ended December 2017, at 24.6, 22.7, 21.9 and 21.5 per cent, respectively. Sectoral developments in interest rates are shown in **Figure 6.**

Figure 6: Interest rates by Sector



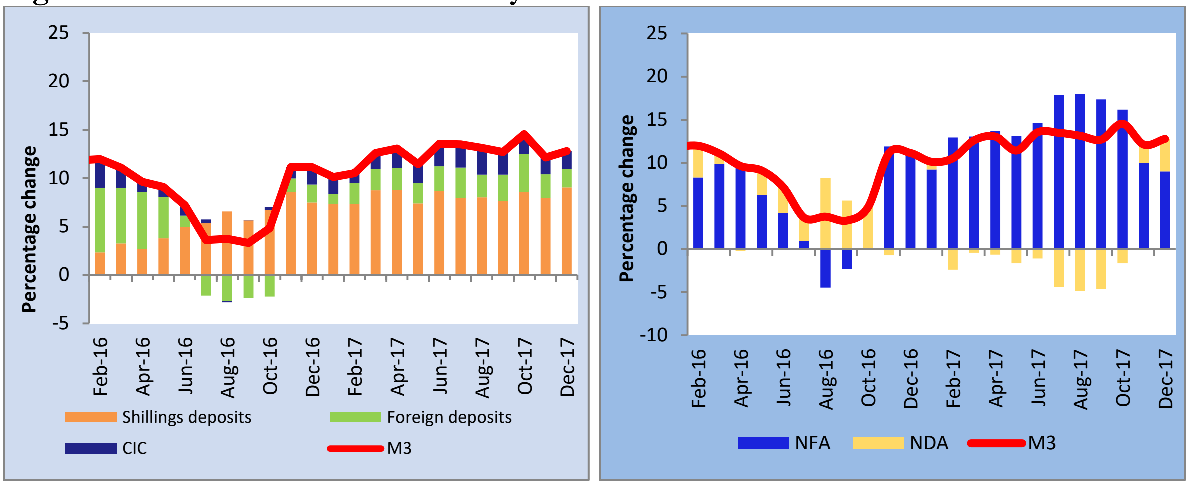
Source: Bank of Uganda

3.2.3 Monetary Aggregates and Private Sector Credit

Growth in monetary aggregates remains robust although it stagnated in the quarter ended December 2017. As in the quarter ended September 2017, average annual growth in M1, M2 and M3 stood at 14.6, 15.0, 13.0 per cent, respectively, in the quarter ended December 2017. Growth in M3 was largely on account of growth in Net Foreign Assets (NFA), supported by BOU's purchases of US dollars, from the Interbank Foreign Exchange Market (IFEM), for reserve build-up. Growth in M1 was largely driven by strong growth in demand deposits, which offset a deceleration in growth in currency in circulation (CIC). While the growth in the latter softened to 10 per cent from 15 per cent in in the preceding quarter, the former strengthened to 17.6 per cent, from 14.3 per cent over the same period. Average annual growth in time and savings deposits decelerated to 15.1 per cent in the quarter ended December 2017 from 15.5 per cent in the preceding quarter ended November 2017, moderated by a reduction in NSSF holdings. Foreign currency deposits grew by 9.2 per cent from 8.9 per cent over the same period.

On the asset side, Net Foreign Assets (NFA) continued to drive annual growth in M3, contributing on average 11.7 per cent, compared to 1.4 per cent in net domestic assets (NDA). The contribution of NFA to growth in M3 however declined **(Figure 7)**, mainly on account of slower growth in net foreign assets of other depository corporations. On the liability side, growth in M3 was mainly driven by shilling deposits, which contributed 8.5 per cent during the same period. Foreign currency deposits and CIC contributed 2.8 and 1.9 per cent, respectively.

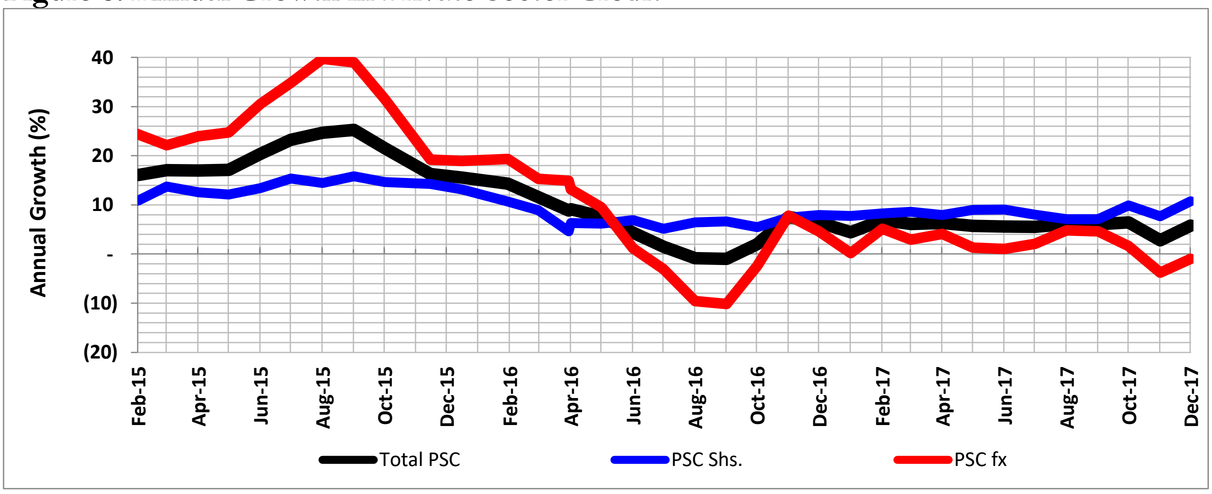
Figure 7: Contribution to M3: Liability versus Asset Side



Source: Bank of Uganda

Growth in Private Sector Credit (PSC) remains relatively subdued, but is expected to strengthen given sustained monetary policy easing. Average annual growth in PSC averaged 5.0 per cent in the quarter ended December 2017, down from 5.9 per cent in the quarter ended September 2017. This deceleration was mainly on account of foreign currency-denominated loans, which declined by 1.0 per cent, from 3.8 per cent in the preceding quarter. Over the same period, annual growth in Shilling-denominated loans strengthened to 9.5 per cent from 7.4 percent in the previous quarter. Net of valuation changes - on account of the foreign exchange rate, annual average growth in total PSC strengthened to 4.5 per cent, up from 3.2 per cent in the preceding quarter ended September 2017 (**Figure 8**).

Figure 8: Annual Growth in Private Sector Credit



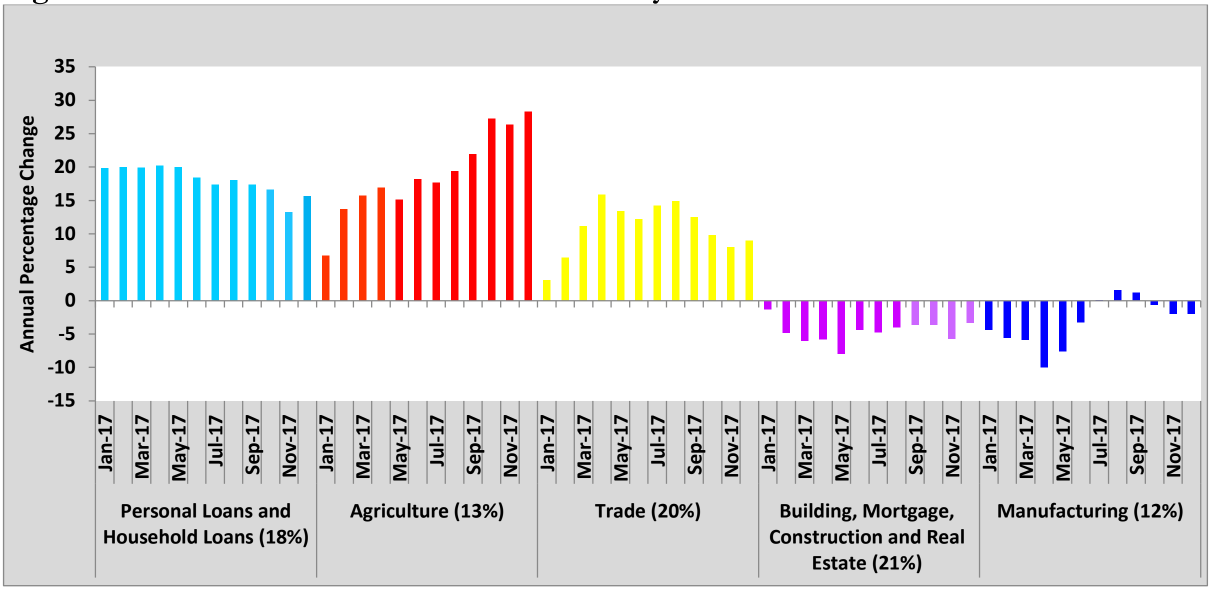
Source: Bank of Uganda

Modest PSC growth in an environment of sustained monetary policy easing in part reflects a raft of supply side constraints and implies that monetary policy alone cannot boost economic growth. The risk of Non-Performing Loans (NPLs) to PSC growth has moderated following the decline in the ratio of NPLs to 5.6 per cent in December 2017, from 7.2 per cent in the preceding quarter ended September 2017. NPLs dropped most significantly in the Manufacturing sector while Mining-Quarrying and Agriculture remain the sectors with the highest NPLs. The decline in NPLs reflects commercial banks' deliberate effort to improve their asset quality. Loans in the watchful category, however, increased in December 2017 compared to September 2017, suggesting that the level of NPLs remains a curtailing factor and therefore a risk to credit growth in the near term.

In terms of outlook, PSC is expected to strengthen going forward on the back of the expected increase in credit supply as banks align their pricing behaviour to the eased monetary policy stance, which should lower the cost of lending to enterprises and prime borrowers. In addition, credit demand is expected to increase for both enterprises and households, spurred by the stability of the exchange rate and improvements in macro-economic conditions. On the other hand however, banks expect to tighten non-price terms and conditions including, the size of the loan, collateral requirements and maturity of the loan as they implement stricter provisioning standards required under IFRS9 and guard against inadequate security. The transmission of monetary policy easing to private sector credit remains functional, but addressing collateral concerns and other structural rigidities in the banking sector would greatly improve the mechanism.

During the quarter ended December 2017, supply of credit strengthened with the ratio of the value of approved loans to value of applications rising to 64 per cent compared to 58 per cent recorded in the quarter ended September 2017. The value of loan applications totalled about Shs. 3,789.99 billion, while the value of approvals summed up to about Shs. 2,408.1 billion. The disparity between value of loan applications and approvals partly reflects supply-side constraints to growth in PSC. Growth in the supply of credit continues to be driven by robust extensions to Agriculture and Manufacturing sectors (**Figure 9**).

Figure 9: Annual Private Sector Credit Growth by Sector



Percentage share of credit to sector to total credit indicated in parenthesis in legend

Source: Bank of Uganda

3.3 Fiscal Policy and Operations

Preliminary data for the first six months of FY 2017/18 indicates a shortfall in revenue collection and government expenditure relative to the programed amounts. Total Government revenue (including grants) during the first six months of FY 2017/18 amounted to Shs. 7,346.7 billion, which was Shs. 1,135.8 billion lower than the amount programed in the approved budget, mainly due to underperformances in both domestic revenue and grants. Relative to the approved budget, domestic revenues underperformed by Shs. 306.5 billion, mainly due to an underperformance in all tax heads. Indirect and direct taxes recorded shortfalls of Shs. 188.7 billion and Shs. 95.2 billion, respectively, while international taxes fell short of the programed amount by Shs. 53.1 billion. Grant receipts during the period underperformed by Shs. 829.3 billion, mainly due to the continued underperformance of project support grants (**Table 3**).

Total government expenditure and net lending in the period July 2017 to December 2017 amounted to Shs. 9,918.8 billion, which was lower than the approved budget amount by Shs. 1,894.8 billion, largely due to lower development expenditure driven by slow implementation of government projects. On account of the shortfalls in revenues collected, the government was set to borrow Shs. 700 billion from the domestic money market to meet planned expenditures. This supplementary funding, however, was likely to result in higher yields on Treasury Securities, with the very probable risk of constraining PSC growth. In the first six months of FY 2017/18, the roads and works (31.7 per cent) and security (29.7 per cent) sectors took up the bulk of government development expenditure. Security, interest payments and education took up the bulk of government's recurrent expenditure.

Table 3: Fiscal Operations (Shs. Billion)

	Jul'16 – Dec'16	Prel. July'17– Dec"17	Approved Budget Jul'17– Dec"17
Revenue & Grants	**6,701.6**	**7,346.7**	**8,482.5**
Revenue	6,119.6	6,925.2	7,231.6
Grants	582.0	421.6	1,250.9
Expenditure & Lending	**8,885.0**	**9,918.8**	**11,813.6**
Current Expenditure	4,940.8	5,343.8	5,533.4
Development Expenditure	3,297.4	3,411.4	5,507.0
Deficit (including grants)	**-2,183.4**	**-2,572.1**	**-3,331.1**
Financing (net)	**2,183.4**	**2,572.1**	**3,331.1**
External Financing (net)	1,513.2	2,000.9	2,383.8
Domestic Financing (net)	335.6	303.6	947.2

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

The developments in government revenue and expenditure resulted in a fiscal deficit of Shs. 2,572.1 billion, which was lower than the anticipated deficit by Shs. 759 billion. Financing of the fiscal deficit amounted to Shs. 2,304.5 billion, of which 87 per cent was externally sourced. Nevertheless, external financing, which amounted to Shs. 2,000.9 billion, was Shs. 382.9 billion lower than the programmed amount, mainly due to an underperformance in project loan receipts. Domestic financing amounted to Shs. 303.6 billion, which was Shs. 643.6 billion lower than programmed mainly due to lower than programmed non-bank financing.

3.3.2 Public Debt Stock

The provisional total public debt stock (at nominal value) as at end December 2017 stood at Shs. 37.9 trillion, representing an increase of 9.4 per cent relative to June 2017. This growth in the stock of public debt was mainly on account of a 12.2 per cent growth in public external debt (in Shillings terms), which continues to have the dominant share of 66.3 per cent of total public debt. In December 2017, external and domestic debt amounted to Shs. 25.1 trillion and Shs. 12.8 trillion, respectively, which is an increase of 12.2 per cent and 4.2 per cent, respectively, compared to June 2017.

The provisional stock of public external debt disbursed and outstanding stood at USD 6,902.7 million as at end December 2017, representing an increase of 10.8 per cent from June 2017 compared to an increase of 24.6 per cent in the corresponding period a year ago. The total external debt exposure (debt disbursed and outstanding and debt committed but undisbursed) amounted to USD 11,690.6 million as at end December 2017.

The present value of total public debt as a ratio of GDP stood at 28.1 per cent as at the end of December 2017, which is lower than the PDMF benchmark of 50 per cent. However, including committed but undisbursed loans, the ratio of total public debt to GDP is closer to the threshold. This poses a risk of higher exposure or failure to meet external debt obligations in case of exchange rate volatility and slow growth in exports. In addition, high debt may become a drag on economic growth by discouraging public investment due to the high debt service costs. **Table 4** indicates that all of the domestic debt cost and risk indicators, with the exception of the ratio of the stock of government securities to PSC, were within the Public Debt Medium Framework (PDMF, 2013) benchmarks.

Table 4: Public Debt Developments

	PDMF	Jun-17	Dec-17
% maturing in 1 year	<40%	38.4	33.1
% maturing in any year in year 1	< 20%	11.2%; 11.4%, for maturities in 2 and 3 years respectively.	13.6%; 12.1%, for maturities in 2 and 3 years respectively.
T-bonds/T-bills (at face value)	70/30	70/30	74/26
Average Time to Maturity (Years)	>3Yrs	3.7	3.9
Total Stock/PSC	<75%	101.4	100.0

Source: Bank of Uganda

In terms of outlook, the medium term fiscal framework is focused on maintaining macroeconomic stability to support inclusive growth, employment and sustainable wealth creation in FY 2018/19. Domestic revenue is expected to increase by 0.3 per cent to Shs. 15.1 trillion in FY 2018/19, supported by revenue administration measures, enhanced efficiency in tax collections as well as reforms in the tax system. The share of the budget financed by domestic resources is anticipated to increase to 69 per cent in FY 2018/19, from 64.4 per cent this financial year, and to approximately 83.6 per cent by FY 2022/23. Further, total government expenditure and net lending (excluding debt refinancing) is expected to increase to Shs. 22.5 trillion in FY 2018/19, which is equivalent to 21.2 per cent of GDP. While development expenditure is estimated at 9.6 per cent of GDP in FY 2018/19, recurrent expenditure is estimated at 10.8 per cent of GDP during the same period. Following the anticipated developments in government revenues and expenditure, the overall balance is projected to decline to 5.4 per cent of GDP in FY 2018/19, from about 7 per cent of GDP in FY 2017/18. Domestic borrowing is to be maintained at 1.0 per cent of GDP over the medium term to support private sector development.

3.4 Balance of Payments and Exchange rates

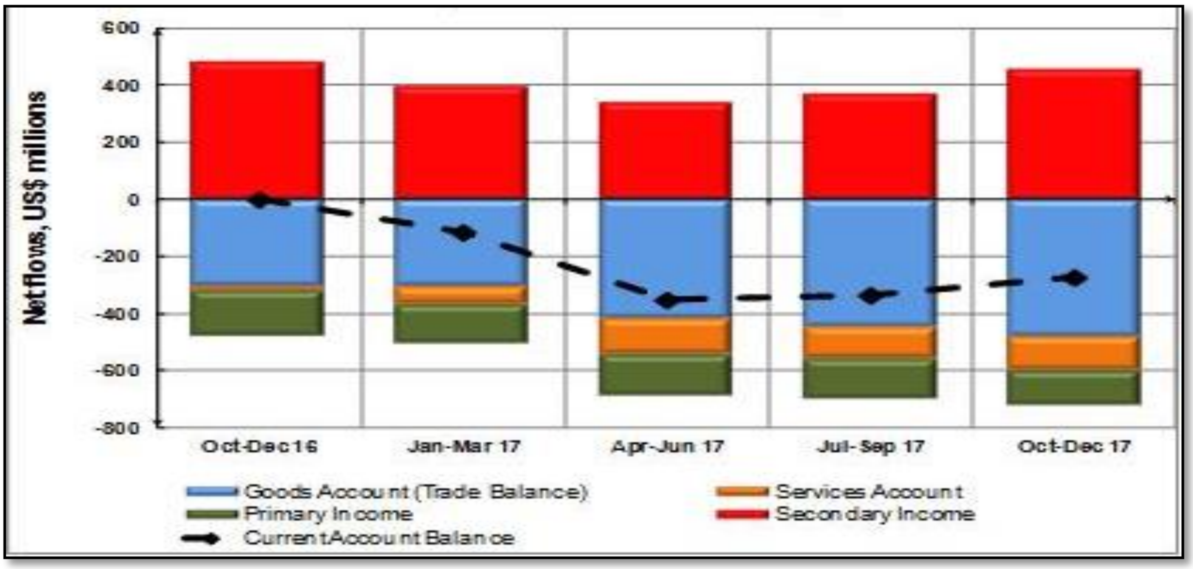
3.4.1 Balance of Payments

The balance of payments (BoP) continued to improve, albeit with a slight deceleration during the quarter under review. The BoP recorded an overall surplus of USD 94 million, compared to a surplus of USD 130 million and USD 118.8 million in the last two immediate quarters. This relative deceleration in the performance of the BoP was largely on account of lower inflows through the financial account. The deficit on the current account improved to USD 272.8 million, from a deficit of USD 335.1 million in the quarter to September 2017, mainly driven by improvement in the surplus on the secondary income account. The surplus on the secondary income account increased by 22.9 per cent to USD 453.2 million during the three months to December 2017, as personal transfers and project aid receipts rose during the period.

On the goods account, both export receipts and import bill increased, resulting, overall, in a higher deficit of USD 482.2 million relative to a deficit of USD 448.5 million in the quarter ended September 2017. Exports earnings increased by 11.2 per cent to USD 877.2 million, mainly on account of an increase in non-coffee export receipts. Total non-coffee export receipts (excluding non-monetary gold) increased by 15.1 per cent to USD 607.5 million, compared to USD 527.9 million received in the previous quarter. Tea, Tobacco and cotton recorded the highest increases in earnings. Earnings from coffee exports increased by 0.5 per cent to USD 135.8 million, on account of an increase in export volumes, amidst a reduction in export prices. Coffee export volumes increased by 23,570 (60Kg) bags to 1,210,953 (60 Kg) bags, while the price reduced to USD 1.87 per kg from USD 1.9 per kg in the three months to September 2017. Net exports of non-monetary gold increased marginally to USD 17.3 million from USD 17 million in the previous quarter.

Over the same time, the import bill increased by 9.9 per cent to USD 1,359.4 million, mainly on account of an increase in private sector imports, which rose by 12.7 per cent to USD 1,211.8 million. The increase in private sector imports during the quarter under review was largely driven by non-oil imports, which rose by 14.8 per cent to USD 983.7 million, on account of increases in imports of machinery, vehicles and accessories, petroleum products, vegetable products, beverages, fats and oils. Over the same period, private sector oil imports also increased by 6.9 per cent, to USD 209.4 million. On the other hand, the government import bill reduced by 14.1 per cent to USD 89.8 million, mainly due to a decrease in project imports over the same period. Trends in the Current Account and its components are shown in **Figure 10**.

Figure 10: Quarterly Developments in the Current Account



Source: Bank of Uganda

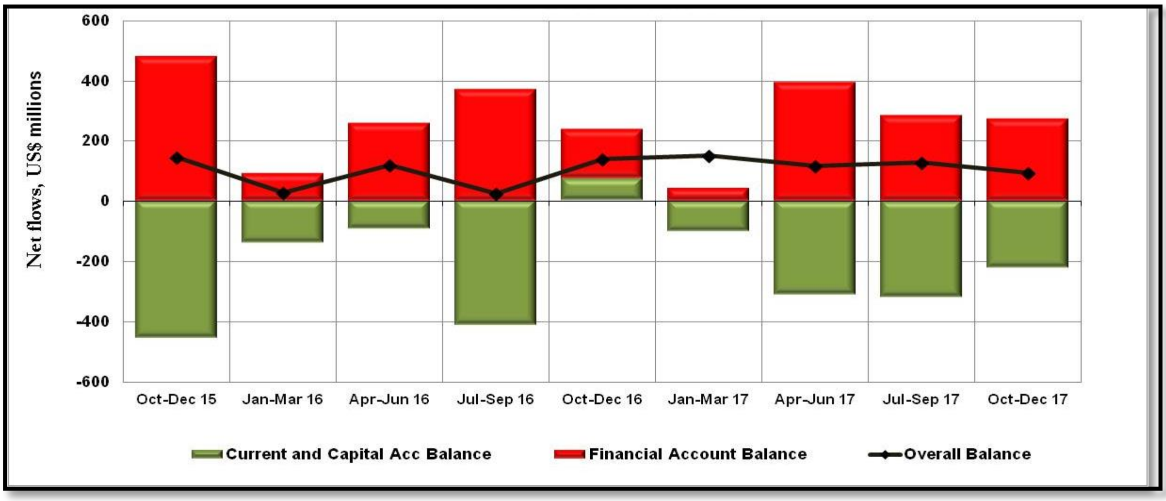
During the three months to December 2017, net inflows (liabilities) through the financial account decreased, by 3.6 per cent to USD 274.5 million, mainly driven by higher portfolio outflows coupled with lower inflows of other investments. Portfolio Investments outflows increased by 22.9 per cent to USD 155.7 million following the net outflow of USD 127 million recorded in the quarter ended September 2017, mainly driven by the continued exit by offshore investors from Uganda's debt securities market and investment in regional debt securities and equity markets by resident entities. Offshore investors reduced their stock of government securities by USD 77.1 million, and resident entities invested USD 78.5 million in regional debt securities and equity markets in the three months to December 2017.

Other investments recorded net inflows of USD 177.7 million, which was a deceleration of 38.6 per cent, compared to the inflows of USD 289.2 million, recorded in the previous quarter. The deceleration was on account of loan disbursements to the government, which decreased during the quarter, largely due to a fall in budget and project support loan disbursements.

Foreign direct investment (FDI) inflows more than doubled to USD 253.3 million during the quarter ended December 2017, compared to USD 122 million in the previous quarter, driven mainly by increase in investment in equities by non-residents.

The overall BoP position was a surplus of USD 94 million recorded during the quarter ended December 2017, which resulted in a net build-up in reserves assets of USD 89.1 million excluding valuation changes. Developments in the overall BoP and its components on a quarterly basis are shown in **Figure 11**.

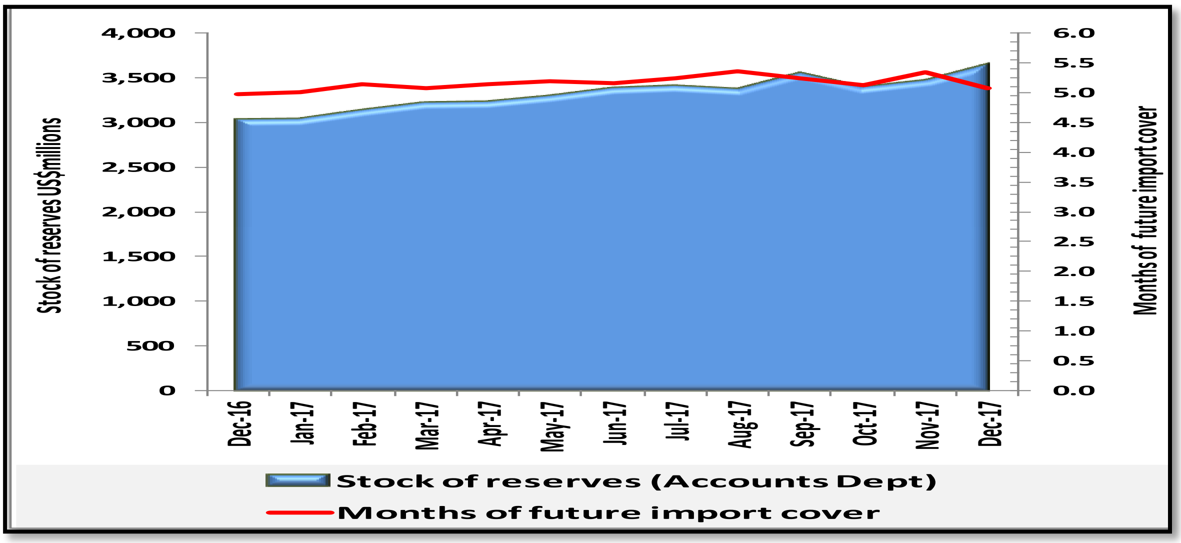
Figure 11: Development in Overall Balance of Payments and Main Components



Source: Bank of Uganda

The stock of reserves at the end of December 2017 was estimated at USD 3,654.4 million (including valuation changes), equivalent to 5.3 months of future imports of goods and services. Developments in the stock of reserves and months of import cover are shown in **Figure 12**.

Figure 12: Stock of Reserves and Months of Import cover



Source: Bank of Uganda

Going forward, in the short run, the current account deficit is expected to worsen on account of a higher private sector import bill as firms resume normal levels of production following the end of the festive season. Over the medium-term, the current account deficit is expected to widen further as the import bill rises, on account of the continued pickup in economic activity and increasing oil prices.

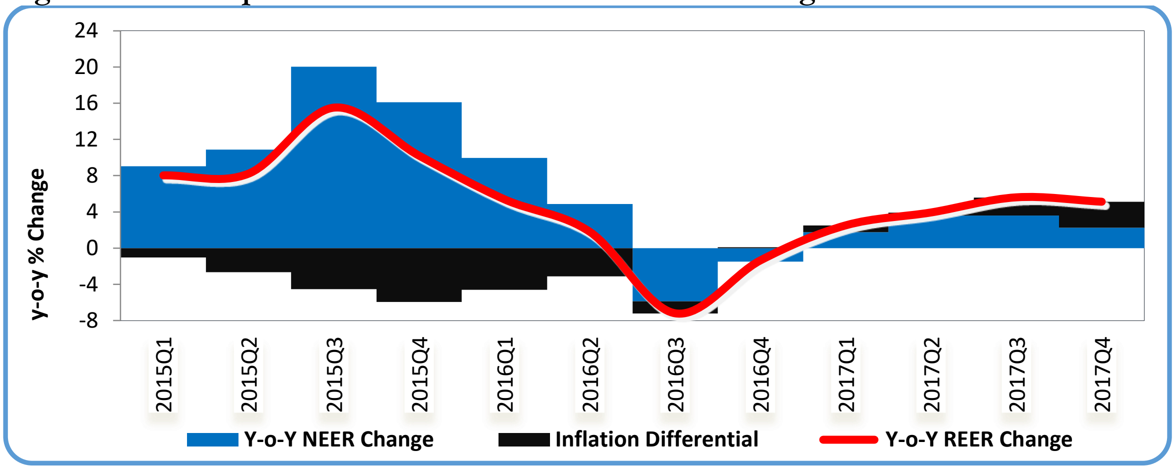
3.4.2 Exchange Rate Developments

During the quarter ended December 2017, the Uganda Shilling stood at an average midrate of Shs. 3,624.2 per US Dollar, a depreciation of 0.9 per cent and 2.9 per cent on quarterly and annual basis, respectively. The weakening of the Uganda Shilling was more amplified in October 2017 due to elevated uncertainty surrounding the political environment in neighbouring Kenya. On a monthly basis, the Uganda Shilling depreciated by 0.5 per cent to Shs. 3,640.1 per US Dollar in January 2018, and depreciated further by 0.8 per cent to an average midrate of Shs. 3,652.7 per US Dollar on February 26, 2018 from Shs. 3,625.21 per US Dollar recorded on January 31, 2018. The latest depreciation of the Uganda Shilling is mainly driven by elevated dollar demand coming mainly from offshore players, oil, manufacturing and telecommunications sectors, coupled with short dollar position covering by some banks.

The Nominal Effective Exchange Rate (NEER) also depreciated by 0.5 per cent and 3.0 per cent on quarterly and annual basis, respectively, during the quarter ended December 2017. The Real Effective Exchange Rate (REER), which takes into account the inflation differential between Uganda and its trading partners depreciated by 0.8 per cent on quarterly basis, during the quarter under review. Exchange rate developments are shown in **Figure 13**.

Conditions in the interbank foreign exchange market (IFEM) enabled the BoU to purchase USD 162.2 million in the quarter ended December 2017 for reserve build up. Overall, the total amount purchased for reserve build-up, in the first six months of FY 2017/18, amounted to USD 362.45 million. Over the same time, the BOU sold USD 31.55 million in market intervention and USD 79.86 million in targeted interventions. Therefore, the net BOU action in the IFEM, in the six months to December 2017, amounted to a net foreign exchange purchase of USD 251.04 million.

Figure 13: Developments in Effective and Bilateral Exchange Rates



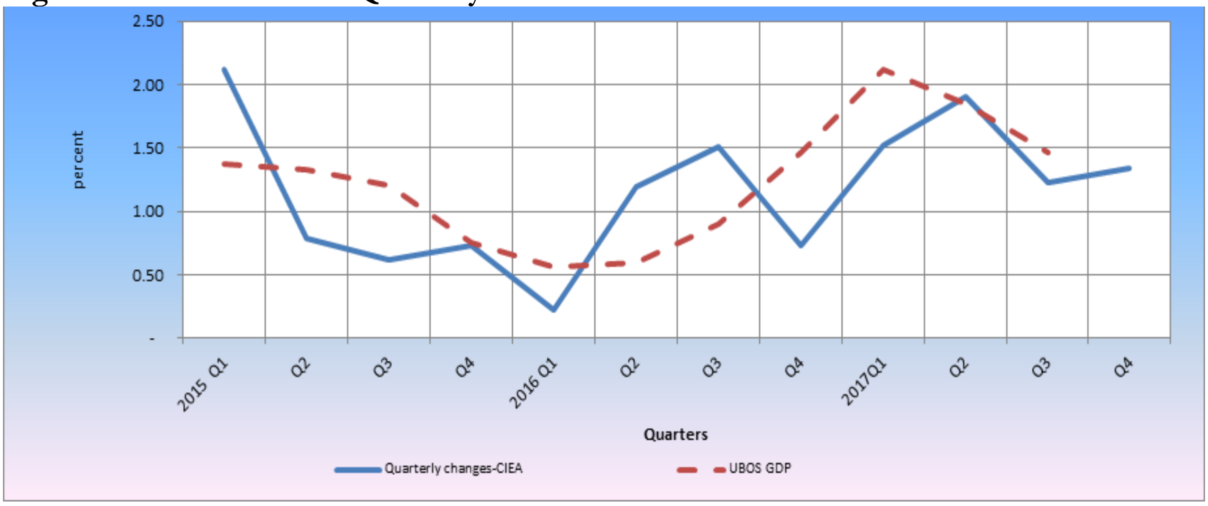
Source: Bank of Uganda

Going forward, the shilling is likely to remain stable in the short run, albeit with a bias towards depreciation. This outlook is on account of high corporate dollar demand as economic activity picks up, as well as easy global financial market conditions.

3.5 Domestic Economic Activity

The Ugandan economy continues to show signs of recovery in FY 2017/18. The Uganda Bureau of Statistics (UBOS) recently released quarterly real GDP estimates for the first quarter of FY 2017/18 indicates that the economy grew by 1.3 per cent, which though lower than 2.5 per cent in Q4-2016/17, is closer to the average growth for the entire 2016/17 of 1.6 per cent. This growth was mainly supported by growth in the industry sector, which in Q1-2017/18, grew by 3 per cent relative to 0.6 per cent in the previous quarter. Growth in the industry sector was mainly driven by higher activity in manufacturing, construction and mining. Growth in the Services and Agricultural sectors although positive, decelerated to 1.5 per cent and 0.3 per cent in Q1-2017/18, from 2.8 per cent and 0.7 per cent, respectively, in the previous quarter.

Figure 14: GDP Growth – Quarterly CIEA Growth Vs UBOS GDP



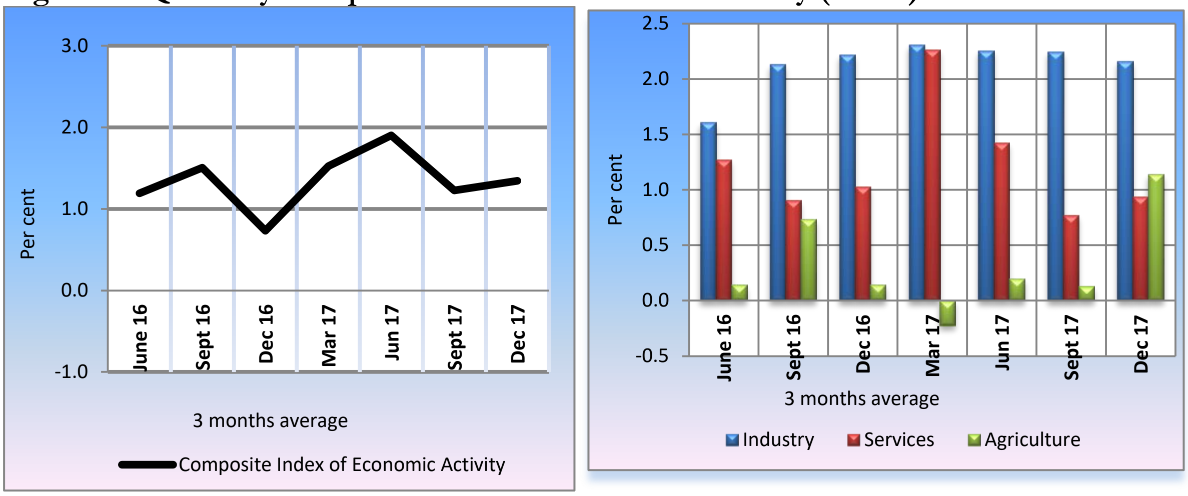
Source: Uganda Bureau of Statistics, UBOS

Similarly, the Bank of Uganda's early warning indicator, the composite index of economic activity (CIEA), estimates Uganda's economic activity at around 6.0 per cent in 2017, which, compared to 2.5 per cent in 2016, indicates a rebound of economic activity.

During the quarter ended December 2017, the CIEA grew by 1.3 per cent compared to 1.2 per cent in the quarter to September 2017, and 0.7 per cent in the quarter to December 2016. Agricultural production is estimated to have increased by 1.1 per cent in the quarter to December 2017, compared to 0.1 per cent and 0.2 per cent in the quarters to September 2017 and December 2016, respectively. Over the same period, industrial activity increased by 2.2 per cent compared to 2.3 per cent in the previous quarter, and growth continued to be generated from the manufacturing subsector. In the services sector, activity grew at a higher rate of 0.9 per cent compared to 0.8 per cent, respectively over the same period, mainly on account of growth in Transport, Communication, Wholesale and Retail trade subsectors and hotel and restaurant activities (**Figure 15**).

Consumer perceptions were more pessimistic during the quarter to January 2018, suggesting deteriorating economic conditions, and less optimistic business confidence in the economy, especially in the agricultural sector, during the same period.

Figure 15: Quarterly Composite Index of Economic Activity (CIEA)



Source: Bank of Uganda

Going forward economic growth is projected in the range of 5.0 – 5.5 per cent in FY 2017/18, and is forecast to average about 6.3 per cent in the medium to long term, supported by accommodative monetary policy, improvement in public investment management and an improvement in the global economy.

3.6 Consumer Price Inflation

3.6.1 Recent Inflation Developments

Inflation continued to moderate further, with annual core and headline inflation falling to 1.7 and 2.1 per cent, respectively, in February 2018, from 2.6 and 3.0 per cent in January 2018, and from 5.7 and 6.7 per cent, respectively, in February 2017. Overall decline in inflation is mainly driven by significant moderation of food crop prices. Annual food crop inflation fell to (*minus*) 0.7 per cent in February 2018, from 1.4 per cent in January 2018 and from 18.8 per cent a year ago. Annual services inflation also eased to 1.8 per cent in February 2018, from 3.0 per cent in

January 2018 while annual Energy, Fuel and Utilities (EFU) inflation increased to 11.2 per cent from 9.8 per cent over the same period. The increase in EFU inflation in February 2018 was mainly driven by the price increase in liquid fuels in addition to increases in prices of solid fuels (charcoal and firewood). Annual non-food inflation decreased to 2.6 per cent in February 2018 from 3.1 per cent in January 2018, while other goods inflation continued to decline to 1.6 per cent from 2.3 per cent, respectively, over the same period. Developments in domestic inflation are shown in **Table 5**.

Table 5: Developments in Domestic Inflation

	Jul-17	Aug-17	Sep-17	Oct-17	Nov-17	Dec-17	Jan-18	Feb-18
	Annual Per cent change							
Headline	5.7	5.2	5.3	4.8	4.0	3.3	3.0	2.1
Core	4.5	4.1	4.2	3.5	3.3	3.0	2.6	1.7
Food crops And Related Items	12.9	11.7	9.6	7.9	2.3	-0.7	1.4	-0.7
Other Goods	4.9	4.7	4.3	4.3	3.7	3.3	2.3	1.6
Services	4.0	3.3	4.1	2.3	2.8	2.6	3.0	1.8
Energy Fuel And Utilities	7.8	7.8	10.6	14.1	13.7	12.5	9.8	11.2
	Quarterly moving average							
Headline	6.4	5.8	5.4	5.1	4.7	4.0	3.4	2.8
Core	4.9	4.5	4.3	3.9	3.7	3.3	3.0	2.4
Food crops And Related Items	18.0	14.2	11.4	9.7	6.6	3.1	1.0	0.0
Other Goods	5.4	5.1	4.6	4.4	4.1	3.8	3.1	2.4
Services	4.1	3.8	3.8	3.2	3.1	2.6	2.8	2.5
Energy Fuel And Utilities	6.9	7.1	8.8	10.8	12.8	13.4	12.0	11.2

Source: Uganda Bureau of Statistics (UBOS)

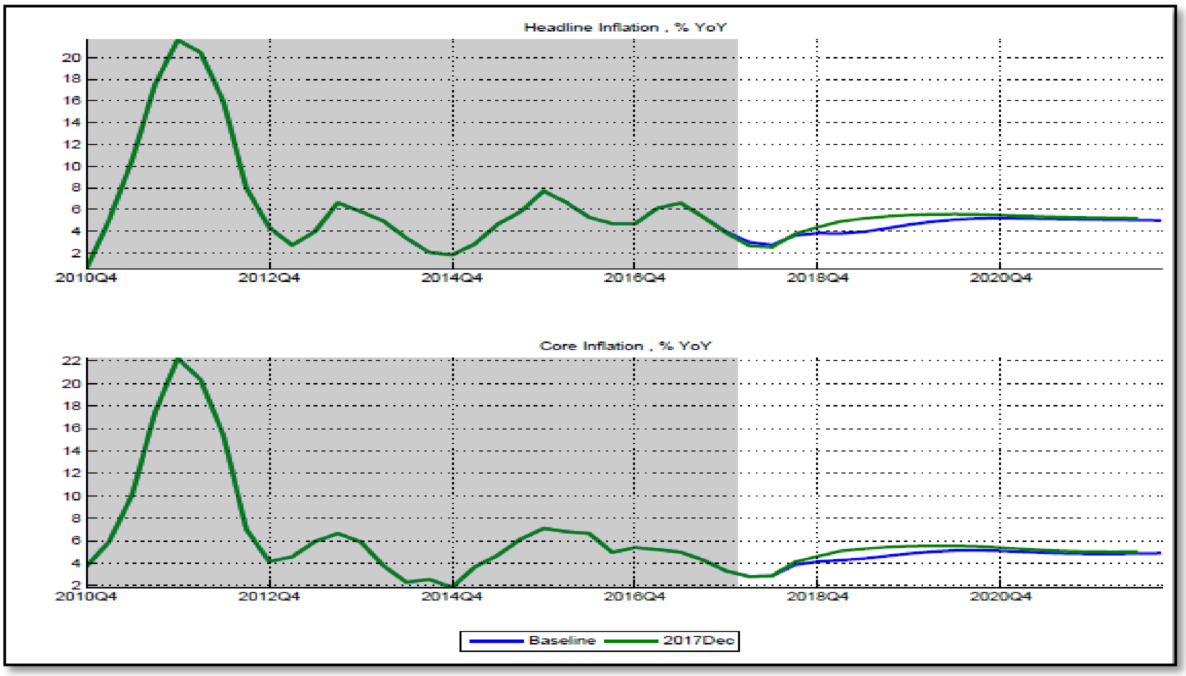
3.6.2 Inflation Outlook

The outlook for the external economic environment remains for stronger broad-based growth, projected to pick up both in 2018 and 2019, supported mainly by anticipated strong growth in AEs, where economic activity is now expected to expand at an annual rate exceeding 2 per cent over the two-year period. In addition, growth in EMDEs is also projected to firm further, supported by strong growth in China and India and steady recovery in Brazil, Russia and Nigeria. In SSA, the destination to over half of Uganda's exports, growth is expected to increase although it is yet to match up to previous trends. Risks to the outlook, while balanced in the near term, remain tilted to the downside, in the medium term, stemming mainly from more rapid and sizeable tightening of the currently easy global financial conditions, persistently low inflation and a likely shift to protectionist policies.

In the short term, global inflation expectations are generally stable although on an upward trajectory following the start of the recovery in commodity prices, particularly those of Oil. Global inflation is projected to rise in 2018 and 2019, largely supported by sustained recovery in global oil prices, with headline inflation in AEs rising slightly above 2.0 per cent and to about 4.5 per cent in EMDEs. A stable global inflation environment supports low domestic inflation.

The inflation outlook remains unchanged in the near term, and is projected to improve in the medium term. The outlook is shaped by a number of factors which include international crude oil prices which have firmed up since June 2017, global financial market conditions which affect the exchange rate and domestic weather conditions. Consequently, both headline and core inflation are forecast to converge to the 5.0 per cent target in the medium term. These inflation forecasts are depicted in **Figure 16**.

Figure 16: Inflation forecast



Source: Bank of Uganda

There are risks to the inflation outlook, which are however relatively balanced. On the upside, the expansionary fiscal policy in FY 2017/18 is likely to push up headline inflation in FY 2018/19. , The pickup in global economic activity may also continue to spur upward commodity price movements which may contribute to higher domestic inflation, and normalization or tightening of AEs monetary policies may tighten global financial market conditions resulting in net FDI outflows and domestic exchange rate depreciation. These factors would drive up domestic inflation; however, their full impact could be mitigated by the currently low capacity utilization and lower-than-expected increase in commodity prices curtailed by possible interruptions on the supply side.

4 Conclusion

Domestic inflation moderated further in the first two months of 2018, with core inflation falling below the lower band of the medium term inflation target particularly in February 2018. Annual core inflation fell to 1.7 percent in February 2018, from 2.6 per cent in January 2018 while annual headline inflation declined further to 2.1 per cent in February 2018 from 3.0 per cent in January 2018. The decline in inflation since the beginning of FY 2017/18 is largely on account of the significant moderation in domestic food crop prices over the same period. Annual food crop inflation has decelerated more strongly to (*minus*) 0.7 per cent in February 2018 from 12.9 per cent in July 2017.

Domestic economic conditions have strengthened considerably in FY 2017/18, with GDP now projected to grow in the range of 5.0 – 5.5 per cent in FY2017/18, and by about 6.3 per cent in the medium to long term, supported by favourable weather conditions expected to boost the agricultural sector, stimulatory monetary policy, improvement in public investment management and an improvement in the global economy with a boost to foreign demand. Indeed the CIEA, which is the BoU's high frequency indicator of economic activity, suggests a strengthening of economic activity in the first half of FY 2017/18. In the medium term, economic growth is projected to accelerate at a faster pace boosted by public investments, growth in consumption and the current stimulatory monetary policy. There are however, some downside risks to the economic outlook, one of which is crowding out of private financing and investment by the large government borrowing aggravated by the weak structural conditions (low returns to public capital and poor execution of investments).

The near-term outlook remains for largely subdued inflation, mainly on account of lower food inflation. Inflation is forecast to increase gradually as the economy strengthens, with both headline and core inflation converging to 5 per cent in the first half of FY 2019/20. Nonetheless, there are upside risks to the outlook, including the path of the exchange rate, the stance of fiscal policy, and the future direction of crude oil and food crop prices. Nonetheless, BoU estimates that there is still spare capacity in the economy, which will serve to dampen inflationary pressures.

Given the objective of keeping inflation close to the target and the estimated spare capacity in the economy, a cautious easing of monetary policy was warranted to further boost private sector credit growth and to strengthen economic growth momentum. The BoU therefore reduced the Central Bank Rate (CBR) by 50 bps to 9.0 per cent. The band on the CBR was maintained at +/- 3 PPs and the margin on the rediscount rate at 4 PPs on the CBR. Consequently, the rediscount rate and the bank rate were reduced to 13.0 per cent and 14.0 per cent, respectively. The Bank reiterates its commitment to conduct monetary policy with flexibility, so that projected inflation is maintained at 5 per cent over the policy horizon. If, however, the assumptions underpinning the projections prove to be inconsistent with incoming data, or if risks to the projections materialize, the policy may be reviewed.