# Bank of Uganda

# State of the Economy

## September 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

I. Global economic activity remains favourable, even though the 2017's high global economic growth rates have been followed by more subdued developments during H1-2018. The risks of the external scenario have become more present. The US-China trade conflict has intensified and together with the cyclical stage of the US economy and its difference with other developed economies, has led to a global appreciation of the US dollar and a fall in commodity prices. This has battered some emerging economies. For now, global growth projections have seen limited changes.

II. Regarding global financial conditions, the divergence of monetary policies in the developed world persists because of the different evaluations of output gaps and inflationary pressures. While the Federal Reserve raised the fed funds rate by 25 basis points in June 2018 and has signalled two more increases this year and three in 2019 — and at the same time continues to downsize its balance sheet, the European Central Bank extended its asset purchasing program and signalled that the policy rates will not be moved for a while. Meanwhile, the trade conflict between the US and China has escalated further. So far, the United States' actions and China's reprisals have been limited, but tensions have not abated and the measures adopted are already having an impact. Fears have been heightened by the further moderation of China's economic activity. China has taken measures to boost its economy, raising new fears about the imbalances that are still present. In this context, global financial conditions remain favourable from a historical perspective, but have tightened for emerging economies, particularly those perceived as having weaker macroeconomic fundamentals. Recent developments in Argentina and Turkey are good examples that illustrate the markets' sensitivity.

III. In Uganda, the strongest reaction has come from the nominal exchange rate— which plays a stabilizing role in the policy framework. In the quarter to August 2018, the Uganda shilling/US dollar depreciated at average annual rate of 5.0 percent. On a trade weighted basis, the depreciation was smaller at 3.0 percent, implying that Uganda's trading partners currencies were also depreciating.

IV. The Bank of Uganda's Composite Index of Economic Activity (CIEA) for 2018 indicated stronger economic growth at annualised growth rate of about 6.4 percent in the first seven months of 2018. However, Economic activity is estimated to have grown at a lower rate of 1.5 percent in the quarter to July 2018, compared to1.6 percent in the quarter to April 2018 and 1.8 percent in the quarter to January 2018. In addition, business confidence was less optimistic while consumers' perceptions were more pessimistic during the quarter to August 2018. Business confidence survey on the economy during the quarter to August 2018 was also less optimistic with the overall Confidence Index (CI) of 56.1 points, 0.2 points lower than 56.3 points in the quarter to May 2018. Year-on-year, the CI declined by 0.9 points. The decline in confidence between the two quarters was as a result of less optimistic views in all the sectors of the economy save for agriculture, which coupled with slight decline in the growth of monetary aggregates in the two months to July 2018 and a slower private sector credit growth, could suggest early signs of slowing down of economic activity in the coming months should the trend is sustained.

V. Regarding inflation, the overall consumer price index (CPI) rose on average by 3.5 percent on annual basis while core CPI rose by 3.0 percent in the first two months of 2018/19, largely as a result of one-off effects of taxes on communication and fuel. Although core inflation is still hovering below the medium-term target of 5.0 percent, it rose sharply from 0.9 percent in June 2018 to 3.5 percent in August 2018, but this was in line with forecasts. The inflation forecast indicates that inflation will stabilise around the medium-term target of 5.0 percent by H2-2019. The positive output gap will continue to be a key driver of inflation going forward, as will rising inflationary pressures abroad. Considering all these antecedents, the Bank estimates that inflationary pressures are consistent with inflation converging to the medium-term inflation target.

VI. As usual, there are internal and external developments that could alter these projections. From the point of view of its impact on local activity, the balance of risks in the external scenario remains biased downwards. The main risk continues to be an abrupt deterioration of global financial conditions for emerging and frontier economies. Events in the US are still relevant, in terms of both the inflation outlook and evolution, and how the trade conflict will unfold. This situation has revived the fears about China, especially because of the risks from persistent imbalances in several of its markets. In Europe, Brexit-related uncertainty stands out, among other issues. In the context of international financial conditions normalization, emerging and frontier economies which are perceived to be more vulnerable, with weaker fundamentals are likely to be severely affected.

VII. Uganda currently faces economic conditions of solid economic growth and low inflation, but with weak fiscal and external accounts. Although the floating exchange rate helps to absorb external shocks and the monetary policy framework makes it possible to act counter cyclically, vulnerabilities remain. The bias and likelihood of external risk scenarios reinforce the need for a small and open economy such as Uganda to maintain solid macroeconomic fundamentals, namely a path of fiscal consolidation, sustainable levels of indebtedness and sound financial system.

# 1 Background

This report presents domestic and external economic developments in the period to August 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 is expected to strengthen to 3.9 percent in both 2018 and 2019, up from 3.7 percent in 2017. However, the growth prospects are more uneven and less certain with increasing risk in the global environment. Given the increase in trade tensions and oil prices, tighter financial conditions, the higher yields in the US and US dollar appreciation, several economies have been affected. While growth seemed to have peaked in major economies, growth rates in the Euro area, United Kingdom (UK) and Japan have been revised downwards to 2.2 percent, 1.0 percent and 1.4 percent, respectively in 2018. Growth prospects in the US remained relatively unchanged from the April World Economic Outlook (WEO) forecast round. The US economy is expected to grow at 2.9 percent in 2018, supported by a strong fiscal stimulus and private consumption.

In Emerging Market and Developing Economies (EMDEs), growth is still projected to rise to 4.9 percent in 2018 and 5.1 percent in 2019, up from 4.8 percent in 2017. However, the outlook for the individual economies varies as the growth rates are affected by the geopolitical conflict, US dollar appreciation, high US yields and rising oil prices. For example, while China's growth is projected to decelerate to 6.6 percent in 2018, from 6.9 percent in 2017, India is projected to grow to 7.3 percent in 2018 from 6.7 percent in 2017. In addition, growth in Latin American countries such as Brazil, has been revised downwards due to the political uncertainty while countries in the Middle East especially oil exporters such as Saudi Arabia, growth was revised upwards in 2018 due to better outlook in oil prices. In sub-Saharan Africa (SSA), growth is expected to continue rising supported mainly by the increase in commodity prices. Growth is projected at 3.4 percent and 3.8 percent in 2018 and 2019, respectively up from 2.8 percent in 2017. The improved projections were mainly due to the higher growth prospects from Nigeria that grew by 2.1 percent from 0.8 percent in 2018. Global growth projections are presented in **Table 1**.

**Table 1: Global Growth Projections**

| | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|
| World | **3.2** | **3.7** | **3.9** | **3.9** |
| Advanced Economies | **1.7** | **2.4** | **2.4** | **2.2** |
| United States | 1.5 | 2.3 | **2.9** | **2.7** |
| Euro Area | 1.8 | 2.4 | **2.2** | **1.9** |
| Japan | 1.0 | 1.7 | **1.0** | **0.9** |
| United Kingdom | 1.8 | 1.7 | **1.4** | **1.5** |
| Emerging Market & Developing Economies | **4.4** | **4.7** | **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 | **7.3** | **7.5** |
| Sub-Saharan Africa | **1.5** | **2.8** | **3.4** | **3.8** |
| Nigeria | -1.6 | 0.8 | **2.1** | **2.3** |
| South Africa | 0.6 | 1.3 | **1.5** | **1.7** |

***Source: IMF, WEO update July 2018***

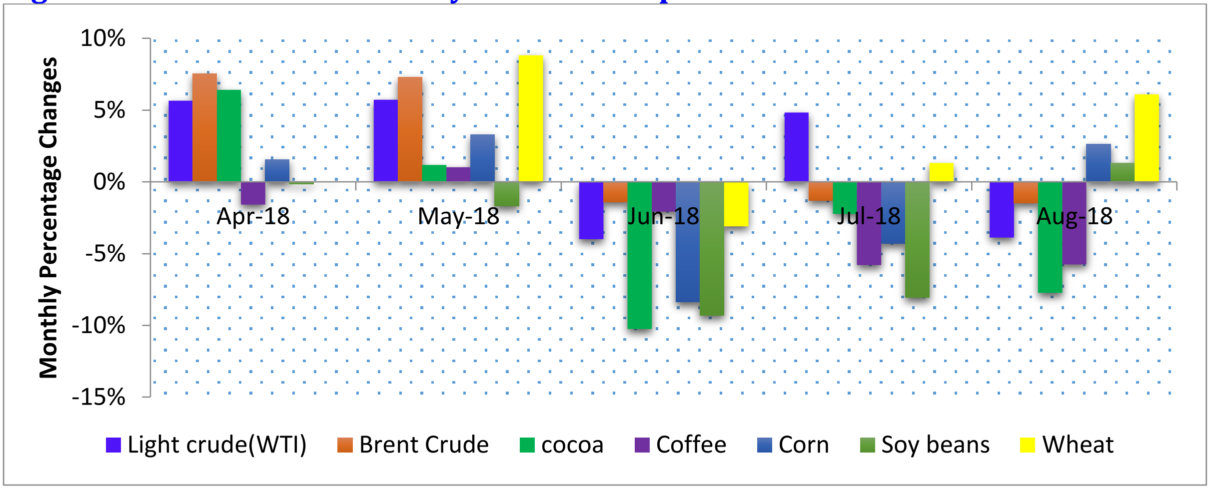
There are risks both on the upside and the downside to global growth. Overall however, the balance of risks is on the downside in both the short and medium term. Given the tighter financial conditions in vulnerable economies on account of monetary tightening and the poor first quarter outturns in AEs, it is unlikely to have higher than projected economic growth. In addition, the rise in trade tensions and escalating geopolitical tensions could constrain global trade, going forward.

## 2.2 Global Commodity Prices and Inflation

### 2.2.1 Global Commodity Prices

Commodity prices continued to strengthen in August 2018, with the exception of oil prices and cash crops. Specifically, wheat prices increased sharply compared to the previous month. In addition, major food prices such as corn and soya beans increased, but prices of cash crops such as coffee and cocoa declined (**Figure 1**). The rise in food prices is partly attributed to the dry weather conditions that have affected production. Brent crude oil prices have been on a downward trajectory since May 2018. After peaking at about USD77 per Barrel, prices decelerated to USD74.95 per Barrel in July and further to USD 73.84 per Barrel in August 2018. The falling oil price is largely being supported by the increase in production of oil from both OPEC and Non-OPEC Countries.

**Figure 1: Global Commodity Price Developments**




*Source: Reuters*

Commodity prices are expected to remain on an upward trajectory supported by improving global economic conditions. Despite the recent dip in oil prices, the trend is likely to reverse on account of escalating trade wars between the US and China, US and Iran and geopolitical tensions from countries such as Venezuela and Libya, which could depress oil production and lead to an increase in the oil prices.

### 2.2.2 Global Inflation

Global inflation remained slightly elevated driven by firm global growth prospects and increased international commodity prices, specifically food prices. In July 2018, inflation in most AEs marginally rose, with the exception of the US and the UK, exceeding the 2.0 percent central bank target. Notably, inflation in European Union and Japan rose by 0.1 and 0.2 percentage points, respectively to 2.2 percent and 0.9 percent, respectively in July 2018. Inflation in the US and the UK stayed unchanged at 2.9 and 2.3 percent, respectively as in June 2018.

Inflation in EMDEs continued to rise. In Brazil, India and South Africa, inflation rose to about 4.5 percent, 5.6 percent and 5.0 percent, respectively in July 2018, from 4.4, 3.9 and 4.4 percent in June 2018. Similarly inflation edged up in Russia to 2.5 percent and in China to 2.1 percent, respectively, from 2.3 and 1.9 percent, respectively in June 2018 (**Table 2**). There are risks to inflation going forward. The emergence of a positive global output gap could likely keep Global inflation higher in both AEs and EMDEs. However, this could be moderated by the agreement by OPEC and Non-OPEC producers to raise oil production. Should the risk of higher global inflation materialise, this could mean a pick-up in domestic inflation on account of higher imported inflation.

**Table 2: Inflation Developments in Selected Countries**

| | Quarterly Averages | | | Monthly | | | |
|---|---|---|---|---|---|---|---|
| | Quarter to Jun-17 | Quarter to Mar-18 | Quarter to Jun-18 | Apr-18 | May-18 | Jun-18 | Jul-18 |
| European Union | 1.7 | 1.5 | 1.9 | 1.5 | 2 | 2.1 | 2.2 |
| Japan | 0.6 | 1.3 | 0.6 | 0.6 | 0.7 | 0.7 | 0.9 |
| UK | 2.8 | 2.5 | 2.2 | 2.2 | 2.3 | 2.3 | 2.3 |
| US | 2.1 | 2.2 | 2.7 | 2.5 | 2.8 | 2.9 | 2.9 |
| Brazil | 2.8 | 2.8 | 3.3 | 2.8 | 2.9 | 4.4 | 4.5 |
| China | 1.8 | 2.2 | 1.8 | 1.8 | 1.8 | 1.9 | 2.1 |
| India | 3.7 | 4.7 | 4.0 | 4.0 | 4.0 | 3.9 | 5.6 |
| Russia | 2.6 | 2.3 | 2.4 | 2.4 | 2.4 | 2.3 | 2.5 |
| South Africa | 4.5 | 3.9 | 4.3 | 4.3 | 4.3 | 4.4 | 5.0 |

*Source: OECD Statistics*

## 2.3 Global Financial Markets

Although global financial conditions remain relatively accommodative supported by continued global economic strengthening, the current rise in inflation pressures, especially in AEs, is expected to trigger a faster pace of monetary policy normalisation, which could lead to tighter global financial conditions. In the US, for example, the Federal Funds rate was raised by 25 basis points to between 1.75 percent and 2.00 percent in June and there indications of additional rate hikes for the rest of 2018 and in 2019, a quicker rise than was anticipated in March. While the European Central Bank kept its key interest rates unchanged in July 2018, it planned to end its monthly net asset purchases at the end of December 2018. In the UK, despite several indicators pointing to a recovery in output growth, Bank of England kept its policy rate unchanged in June 2018 and indicated that any future hikes were likely to be limited and at a gradual pace.

In line with tightening financial conditions and higher inflation expectations, long-term bond yields rose in key global financial markets. In July 2018, yields on 10-year government bonds increased by 0.49 percentage points to 2.89 per cent in the US, and by 0.05 percentage points to 1.27 per cent in the UK, compared to their levels in December 2017. Bond yields also rose in most of the EMDEs largely supported by sustained expectations of a faster pace of US Federal Reserve monetary policy tightening, a further strengthening of global growth and higher inflation expectations. The rise in long term bond yields represents rising global borrowing costs and debt burdens, especially for the EMDEs.

In the currencies market, the US dollar strengthened in real terms against most major world currencies in early July 2018, driven by better than anticipated performance of the U.S economy relative to the UK, Euro zone and Japan. The US dollar index, which measures the strength of the US dollar against a basket of seven major world currencies, rose by 0.43 percent month-on-month in June 2018.

Market expectations remain for gradual increase in global interest rates owing to faster normalization of monetary policy in the US, in line with the stronger global growth outlook and the imminent pickup in inflationary pressures. However, 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, the growing trade tensions and heightened geopolitical tensions could also continue to escalate financial markets volatility.

As of early July 2018, the US dollar had strengthened by over 5.0 percent in real effective terms since February 2018, while the euro, Japanese yen, and British pound sterling are broadly unchanged. In contrast, some emerging market currencies had depreciated sharply. The Argentine peso weakened by over 20 percent and the Turkish lira by around 10 percent, due to concerns about financial and macroeconomic imbalances. The Brazilian real had depreciated by over 10 percent on a weaker-than-expected recovery and political uncertainty. Weaker-than-anticipated macroeconomic data for South Africa contributed to the 7.0 percent depreciation of the South African rand, unwinding part of the sharp appreciation that had occurred in late 2017 and early 2018. The currencies of the largest emerging market economies in Asia have remained broadly in line with their levels in February, with the Chinese renminbi depreciating modestly. Reflecting signs of financial stress in some more vulnerable countries and growing trade tensions, capital flows to emerging economies weakened in the second quarter (through May) after a strong start to the year, with a pickup in non-resident sales of portfolio debt securities.

### 2.4 Implications for the Uganda Economy

The external environment remains positive with robust growth projections in 2018 and 2019 especially in Sub-Saharan Africa. However these global growth prospects are more uneven and less certain as a result of escalating trade wars and geopolitical tensions in a number of economies. The positive growth outlook could enhance trade and boost economic growth in Uganda. In terms of the global financial markets, the high US interest rates and the stronger US dollar against major currencies could have implications for the Uganda Shilling going forward. The Uganda Shilling could experience depreciation pressures if investors choose to invest in countries with better returns such as the US. This could further be worsened by the geopolitical tensions in other emerging economies that could discourage investors in emerging and developing economies.

Global inflation edged up and it is expected to continue rising in the short term on account of high commodity prices. There are however upside and downside risks to this outlook. On the downside, once the drought dissipates, there is a possibility of lower inflation. However, on the upside, the recent drop in oil prices could be reversed given the uncertain global environment. Higher global prices could lead to a rise in Uganda's inflation through imported inflation. In addition, the uncertainty surrounding the financial markets could lead to depreciation pressures which could also increase domestic prices.

# 3 Domestic Economic Developments

## 3.1 Reflections on Previous Monetary Policy Stance and Implementation

### 3.1.1 Monetary Policy Stance

The Bank of Uganda (BoU) upheld its neutral monetary policy stance, maintaining the Central Bank Rate (CBR) at 9.0 percent in June 2018. The band on the CBR was kept 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 remained at 13.0 percent and 14.0 percent, respectively.

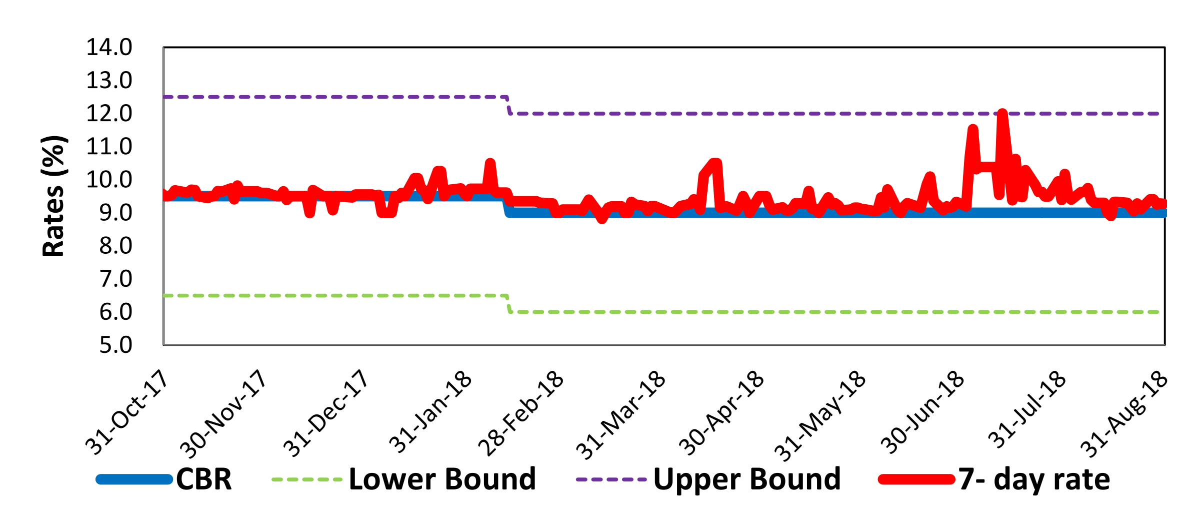
The neutral monetary policy stance was warranted by the forecast inflation trajectory and the current state of the economy. While inflation was below target, it was anticipated to rise faster, driven by rising import prices, projected cyclical recovery in food prices, and increased taxes. However, despite these upside risks, inflation was forecast to remain within the 5.0 percent target for the next 12 months. Furthermore, although the negative 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 net outstanding stock of REPOs and deposit auctions as at end August stood at Shs.1.3 trillion and Shs. 628.8 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 9.57 percent in the three months to August 2018 (**Figure 2**).

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




*Source: Bank of Uganda*

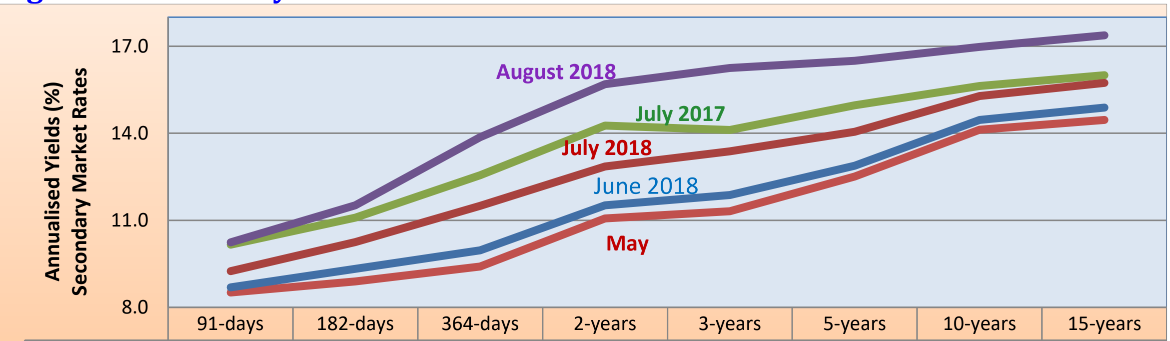
## 3.2 Interest Rate Developments

### 3.2.1 Yields on Government Securities

Yields on government securities edged up following an increase in the fiscal domestic financing requirements that came with the approval of the supplementary budget in FY 2017/18. Average yields on the 91-day, 182-day and 364-day Treasury bills (T-bills) rose to 9.7, 10.8, and 12.4 per cent, respectively, in the quarter ended July 2018, up from 8.7, 9.1, and 9.6 per cent in the quarter to April 2018. The yields in the bond market also mirrored the developments in the treasury bills market. The average yields on the 2-year, 3-year, 5-year, 10-year, and 15-year Treasury bonds (T-bonds) rose to a range of 13.2 – 17.3 per cent in quarter ended July 2018 from a range of 11.1 – 14.4 per cent quarter ended April 2018. The bid rates in the securities auctions were very high in July and August 2018, leading to a rejection of some bids.

In the secondary market, yields on Treasury Securities rose in the quarter ended July 2018 pushing the yield curve further upwards. Average yields on short term securities rose to 9.2, 10.2, and 11.5 per cent for the 91-day, 182-day and 364-day T-bills, respectively, from 8.5, 8.7, and 9.2 per cent during the quarter ended April 2018. Similarly, average yields on the longer dated securities increased to a range of 12.9 – 15.7 per cent for the 2-year, 3-year, 5-year, 10-year and 15-year T-bonds, during the quarter ended July 2018. Average yields on the same securities ranged from 11.0 – 14.3 per cent in the quarter ended April-2018. The rise in secondary market yields was reflective of the higher primary market yields. **Figure 3** shows the trend in the secondary market yields on government securities since July 2017.

**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-July'17 | 10.2 | 11.1 | 12.6 | 14.3 | 14.1 | 15.0 | 15.6 | 16.0 |
| Q-May'18 | 8.5 | 8.9 | 9.4 | 11.1 | 11.3 | 12.5 | 14.1 | 14.5 |
| Q-June'18 | 8.7 | 9.3 | 10.0 | 11.5 | 11.9 | 12.9 | 14.5 | 14.9 |
| Q-July'18 | 9.2 | 10.2 | 11.5 | 12.9 | 13.4 | 14.0 | 15.3 | 15.7 |
| Aug-2018 | 10.2 | 11.5 | 13.9 | 15.7 | 16.3 | 16.5 | 17.0 | 17.4 |

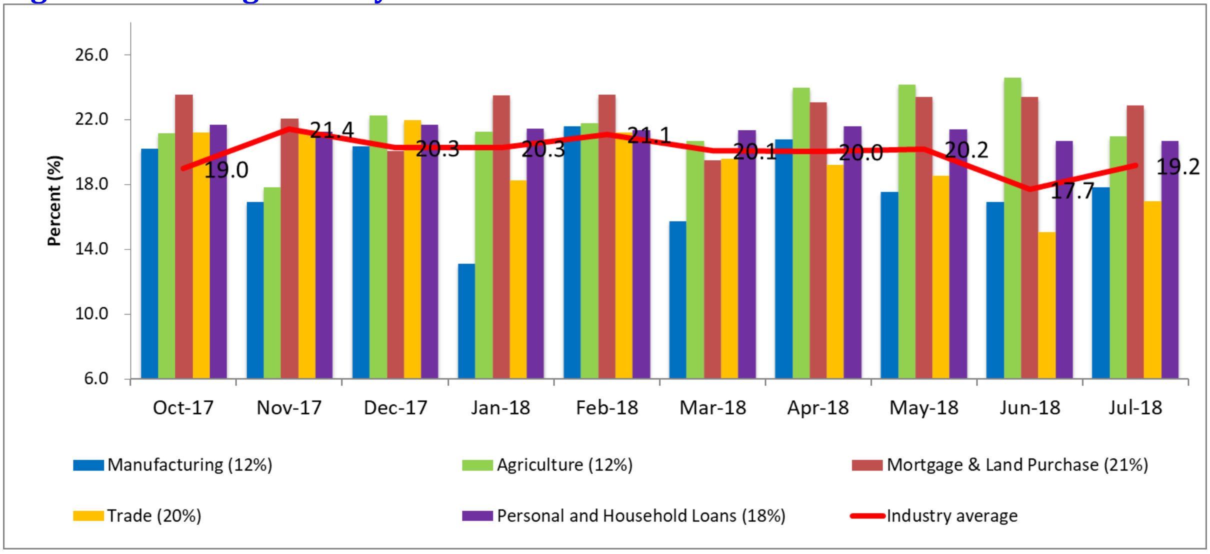
*Source: Bank of Uganda*

### 3.2.2 Lending and deposit rates

The weighted average lending rates declined in the quarter to July 2018 to 19 percent from 20.4 percent in the quarter ended April 2018. However, this decline in lending rates could be short lived given the recent increase of the shilling denominated lending rates to 19.2 percent in July 2018 from 17.1 percent observed in June 2018. The weighted average time deposit rate declined to 9.1 percent in the quarter to July 2018, from 8.7 percent in the previous quarter. Consequently, the spread for Shilling denominated loans declined to 9.9 percent from 11.7 percent, respectively, during the quarter ended June 2018. Despite the accommodative monetary policy since April 2016 and the decline in non-performing loans, lending rates have remained relatively high in comparison to the deposit rates. This could partly be explained by structural constraints such as high bank operational costs and heightened risk aversion.

A decomposition of lending rates by sector shows relatively higher lending rates for the agriculture, mortgage & land purchase as well as personal and household loans in the three months to July 2018. However, the trade and manufacturing sectors which grew by 16.96 percent and 15.8 percent, respectively, from 15 percent and 15.4 percent in the previous period were the main drivers of the rise in the July lending rates as depicted in **Figure 4.** The weighted average lending rate for the US dollar denominated loans, on the other hand, edged up slightly to 7.9 percent in the quarter to July compared to the 7.4percent in the previous period.

## Figure 4: Lending Rates by Sector



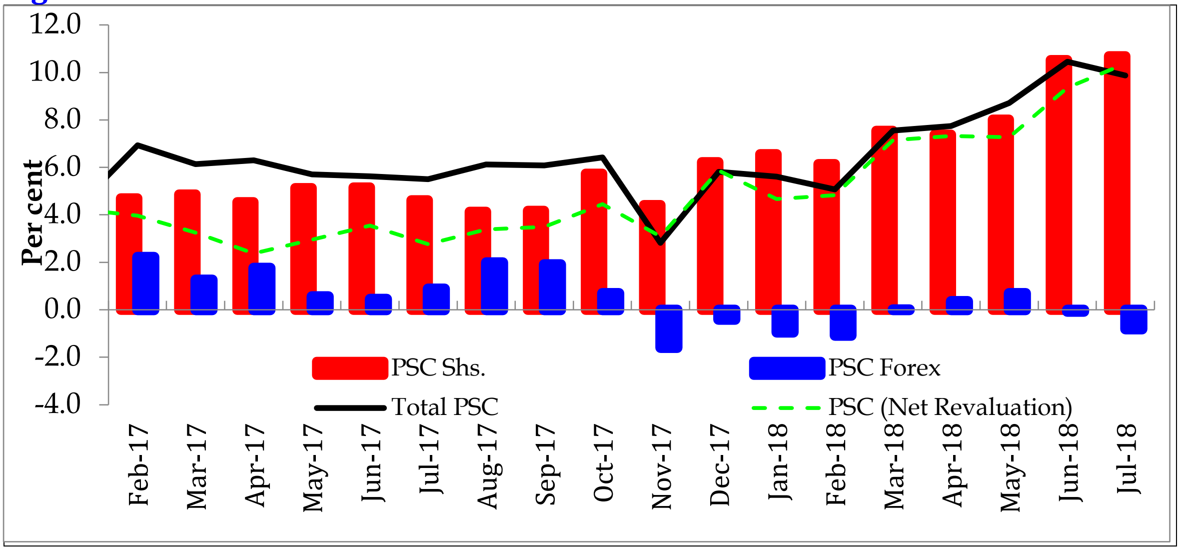

*Source: Bank of Uganda*

### 3.3 Private Sector Credit

Private sector credit (PSC) strengthened in the period March-June 2018, peaking at 10.5 percent in June 2018 on account of the accommodative monetary policy. However, in July 2018, PSC declined marginally to 9.9 percent. The fall in PSC is attributed to supply side constraints and the risk aversion for banks to lend. Although non-performing loans remain a hindrance to growth in PSC, the ratio of nonperforming loans (NPLs) to total loans have continuously declined in the last few months to 4.4 percent in June 2018 from 5.3 percent in May 2018 and from 10.4 percent in December 2018.

The average annual growth in shilling-denominated loans rose to 17.7 percent in July 2018 relative to 8.0 percent in July 2017, while forex denominated lending declined to *minus* 2 compared to 2.1 percent over the same period. Net of valuation changes – on account of exchange rate movements, annual PSC grew by 10.4 percent, compared to 2.8 percent in the same period. Developments in private sector credit are shown in **Figure 5**.

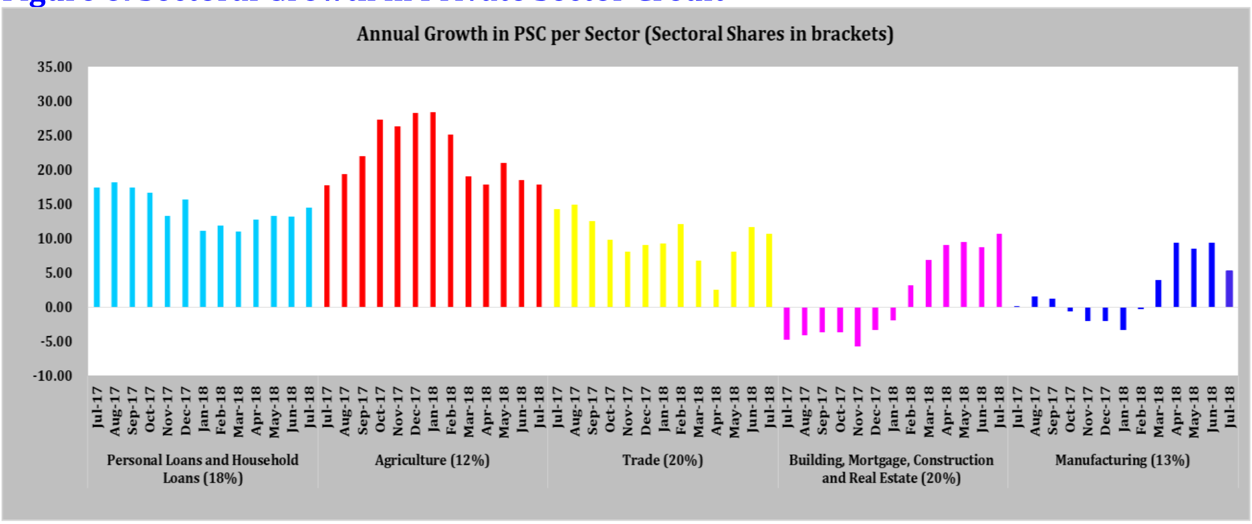
## Figure 5: Growth and Contributions to Private Sector Credit




*Source: Bank of Uganda*

A sectoral decomposition shows growth in credit growth across all sectors, and a notable recovery in Building, Mortgage, Construction and Personal & Household Loans. The sectoral decomposition is depicted in **Figure 6** shows building mortgage, construction and real estate; trade; personal & household loans; agriculture; and manufacturing sectors continue to dominate private sector credit.

## Figure 6: Sectoral Growth in Private Sector Credit




*Source: Bank of Uganda*

Despite the slight decline in PSC growth in July 2018, going forward, PSC is expected to improve given the decline in 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 in turn should support growth.

### 3.4 Fiscal Policy and Operations

The Preliminary data for the first month of FY2018/19 indicates a shortfall in government expenditure relative to the programmed amounts as shown in **Table 3**. Total Government revenue (including grants) in July 2018 amounted to Shs.1,167.4 billion, which was Shs.71.5 billion lower than the amount programmed in the approved budget due to an underperformance in grants. Grant receipts during the period amounted to Shs.7.8 billion, Shs.107.3 billion lower than programmed due to an underperformance in project support grants while domestic revenue amounted to Shs.1,159.5 billion, which was Shs.35.8 billion higher than the programmed amount in the approved budget. Relative to the Uganda Revenue Authority (URA) targets, the outturns for net tax and Non-Tax (NTR) collections for the month of July 2018 amounted to Shs. 1,124.5 billion and Shs.35.0 billion, corresponding to surpluses of Shs. 34.3 billion and Shs. 1.5 billion, respectively.

With the exception of indirect taxes, all the tax heads registered surpluses. The surplus in international trade tax collections was due to VAT on imports and Import duty while that in direct taxes and fees and licenses was due to stamp duty and embossing fees and to PAYE and Corporate tax, respectively. On an annual basis, net tax revenue and non-tax revenue grew by 22.3 percent and 24.6 percent, respectively, which was higher than 9.1 percent growth and a 9.6 percent decline in the corresponding period the previous year. Total government expenditure in July 2018 amounted to Shs.2,143.7 billion. This outturn was Shs.448.9 billion lower than the programmed expenditure, mainly due to an under performance of Shs.463.4 billion in development expenditure, attributable to lower than programmed external financing for government projects. Current expenditure and government net lending (majorly made up of government expenditure on the Hydro Power Projects), were also lower than programmed by Shs.51.1 billion and Shs.16.5 billion, respectively.

**Table 3: Fiscal Operations (Shs. Billion)**

| | July'2017 | Prel. July'18 | Proj. Budget Jul'18 |
|---|---|---|---|
| **Revenue & Grants** | **993.7** | **1,167.4** | **1,238.9** |
| Revenue | 945.9 | 1,159.5 | 1,123.8 |
| Grants | 47.8 | 7.8 | 115.1 |
| **Expenditure & Lending** | **1,340.7** | **2,143.7** | **2,592.6** |
| Current Expenditure | 869.9 | 1,104.7 | 1,155.8 |
| Development Expenditure | 453.7 | 944.8 | 1,408.3 |
| **Deficit (including grants)** | **-347.1** | **-976.4** | **-1,353.8** |
| **Financing (net)** | **347.1** | **976.4** | **1,353.8** |
| External Financing (net) | 363.5 | 320.9 | 593.2 |
| Domestic Financing (net) | -711.3 | -185.8 | 760.6 |
| Errors & Omissions | 694.8 | 841.2 | 0.0 |

***Source: Ministry of Finance, Planning and Economic Development***

The developments in government revenue and expenditure resulted in a fiscal deficit of Shs. 976.4 billion, which was lower than the programmed deficit by Shs. 377.4 billion. This performance may be attributed to the lower than programmed government development expenditure during the month. The deficit was majorly externally financed, to the tune of Shs.320.9 billion.

### 3.4.1 Public Debt Stock

The provisional total public debt stock (at nominal value) declined by 2.1 percent to Shs. 41.1 trillion in July 2018, compared to Shs.42 trillion in June 2018. The decrease in public debt stock was largely on account of a 3.7 percent decline in public external debt due to valuation changes as a result of the exchange rate appreciating in July 2018 compared to June 2018. The public debt indicators depict deterioration with the share of domestic debt maturing in one year rising to 38.3 percent compared to 36.8 recorded in June 2018 and relative to a benchmark of 40 percent. Although all the public domestic debt risk indicators were within the Public Debt Management Framework (PDMF) medium term benchmarks as depicted in **Table 4**, the ratio of stock of government securities to the stock of private sector was 102.7 percent, which is above the 75 percent benchmark.

**Table 4: Public Debt Indicators**

| | PDMF | Jul-17 | Jun-18 | Jul-18 |
|---|---|---|---|---|
| % maturing in 1 year | <40% | 37.9 | 36.8 | 38.3 |
| % maturing in any year after year 1 | < 20% | 9.4%; 10.1%, for maturities in 2 and 3 years respectively, and remainder for maturities beyond 3-years | 11.2%; 11.4%, for maturities in 2 and 3 years respectively, and remainder for maturities beyond 3-years | 13.4%; 12.0%, for maturities in 2 and 3 years respectively, and remainder for maturities beyond 3-years |
| T-bonds/T-bills (at face value) | 70/30 | 67/33 | 70/30 | 74/26 |
| Average Time to Maturity (Years) | >3Yrs | 3.5 | 3.7 | 4.0 |
| Total Stock/PSC | <75% | 104.4 | 101.4 | 102.6 |

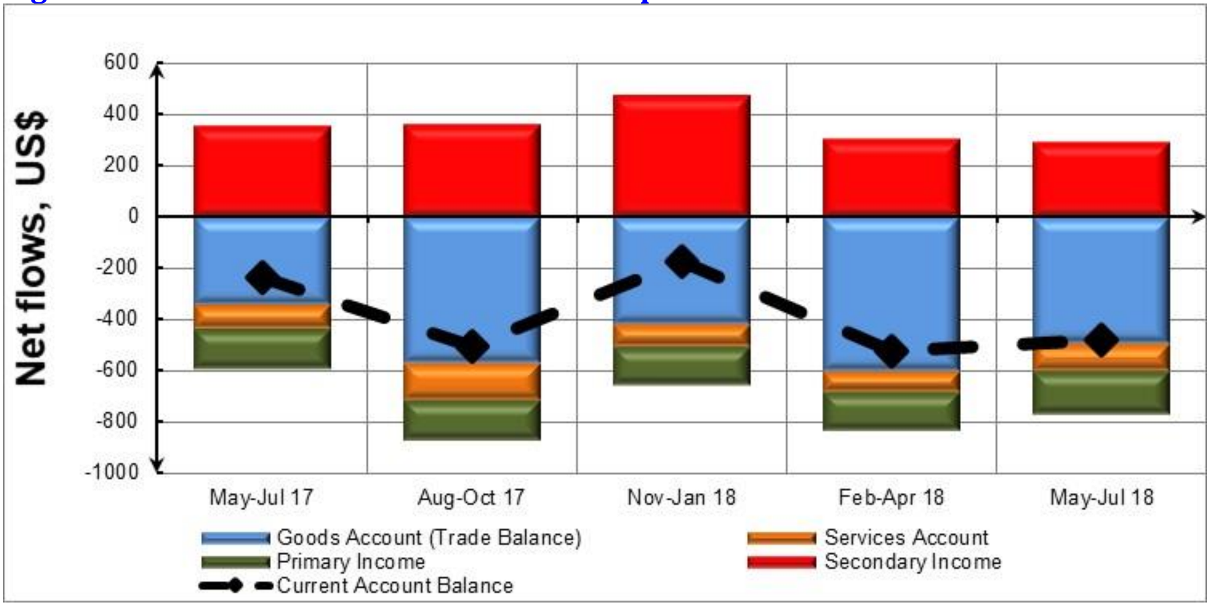
*Source: Bank of Uganda*

### 3.5 Balance of Payments and Exchange rates

The current account balance improved by 9.0 percent in the period May-July 2018. It reduced from USD 525 million in the period of Feb-April 2018 to USD 478.05 million driven by the pickup in the trade deficit as depicted in **Figure 7**. The exports increased by 7.7 percent to USD 914.28 million from USD 848.93 million, while imports declined by 3.0 percent from US$D1448.2 million to USD 1407.6 million.

The improvement in exports receipts was supported by the growth in non-coffee receipts that increased by USD 50.2 million. Specifically, Beans, Maize and Tea grew by USD 23.1 million, USD 22.16 million and USD8.4 million, respectively in the period under review. The decline of the import bill was mainly on account of a reduction in government imports that reduced by 68 percent from USD148.97 million in the quarter ended April to USD48.2 million in the quarter ended July 2018. The services account, primary account and secondary account all deteriorated in the period under review by USD22.7, USD 23.2 and USD13, respectively.

**Figure 7: Current Account Balance and Components**



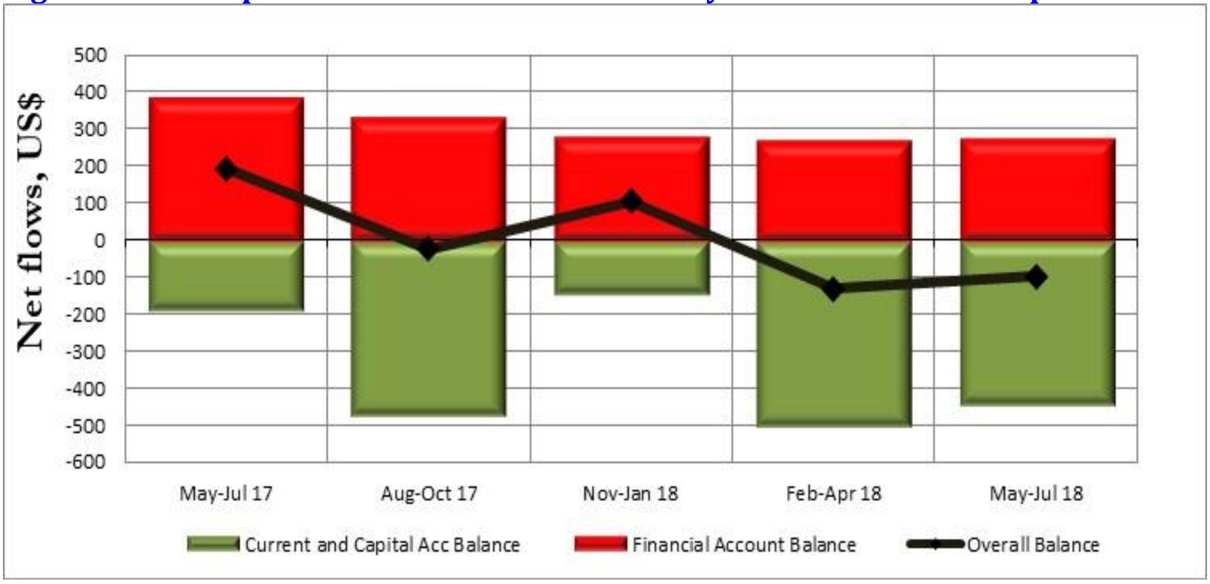

*Source: Bank of Uganda*

Net inflows through the financial account increased by 6.4 percent from USD 268.93 million in quarter ended April to USD 275.34 million in quarter to July 2018, largely on account of foreign direct investment inflows, which increased by USD 15.6 million. The growth in FDI was driven by the improved performance of foreign owned enterprises in the economy whose profits rose by USD10.5 million.

Net portfolio outflows declined by 16.5 percent from 63.6 million to 47.1 million, mainly on account of the debt securities and equity and investment shares that dropped by 37.1 percent and 23.2 percent, respectively. However, on the liability side, the portfolio inflows reduced with offshore investor's holdings in the Uganda debt securities market declining from a net inflow of USD22.9 million in the quarter to April 2018 to a net outflow of USD 20.7 million in the quarter to July 2018. While this indicates that offshore players were exiting the Uganda market during the period under review, in July 2018, offshore investor's holdings increased to USD6.4 million. Although the exit of offshore players partly explains the depreciation pressures in May and June, the rise in inflows could partly explain the exchange rate appreciation observed in July 2018. One of the reasons for this reversal in offshore players' behaviour in July could be attributed to the high interest rates on domestic debt securities compared to regional countries.  Going forward, the escalating geopolitical tensions in emerging economies such as Turkey and the recession in South Africa could negatively affect the inflows by offshore players in the Ugandan market.

The overall BOP was a deficit USD 97.16 in the quarter to July 2018 from USD 132.64 in the quarter to April 2018, implying a draw down in reserves. The BOP developments are shown in **Figure 8.** As at July 2018, the stock of reserves stood at USD3.44 billion, equivalent to 4.5 months of imports of goods and services. By 30th August 2018, the stock of reserves stood at USD3.25 billion an equivalent of 4.6 months of import cover. The stock of reserves declined to USD3.27 billion in FY2017/18, equivalent of about 4.6 months of imports of goods and services. The current account deficit is projected to remain relatively weak in the short to medium term. This could be moderated by addition FDI inflows and the expected borrowing for the infrastructural projects.

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



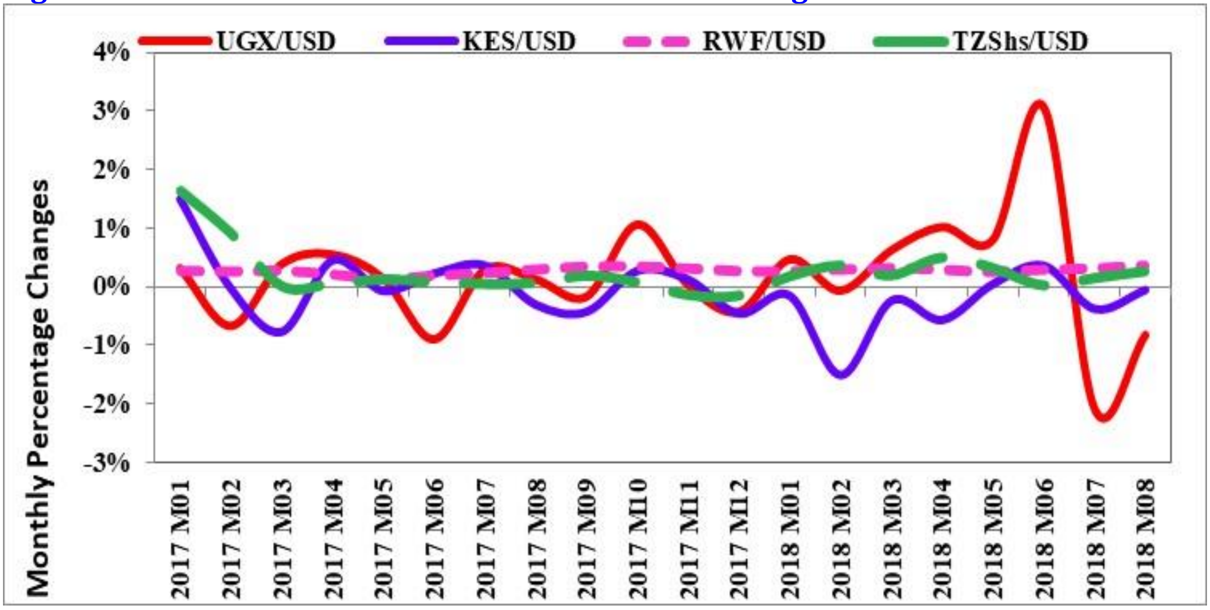

*Source: Bank of Uganda*

### 3.5.1 Exchange Rate Developments

The Uganda Shilling remained relatively stable in August 2018 as the depreciation pressures experienced in the quarter ended June 2018 dissipated. Indeed in July the shilling appreciated by 2.1 percent month-on-month and 0.8 percent in August 2018, to an average midrate of Shs. 3,729.53 per US Dollar, compared to an average midrate of Shs. 3,760.44 per US Dollar in July 2018. The appreciation was mainly driven by the increase in inflows from Export receipts, forex bureaux, offshore investors and Non-Government Organisations (NGOs) and international organisations. These could have been attracted by the high interest rates on treasury securities.

As depicted in **Figure 9**, by August 2018, the Uganda shilling had stabilized to comparable growth rates with its regional trading partners. The Kenyan shilling appreciated by 0.05 percent month-on-month in August, compared to a 0.37 percent appreciation in July 2018. Rwanda Franc and Tanzania Shilling however depreciated slightly month-on-month by 0.36 percent and 0.25 percent, respectively in August 2018, compared to 0.31 percent and 0.14 percent, respectively the previous month.

**Figure 9: Trends of Selected EAC Partner State Exchange Rates**



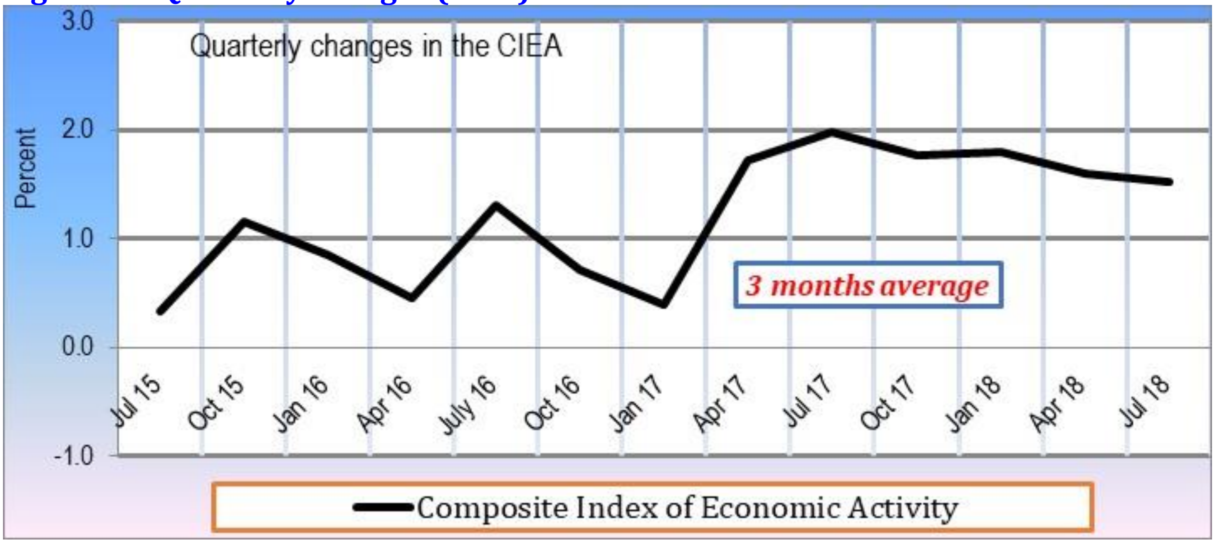

*Source: Bank of Uganda*

The BoU participated in the Interbank Foreign Exchange Market (IFEM) by carrying out purchases for reserve build up and interventions in periods of high volatility of the exchange rate. In the period June-August 2018, the BoU purchased USD 173.4 million for reserve build up, compared to USD 26.4 million purchased in the period March-May 2018. Over the same period, the BOU intervened by selling to the market 55.9 million dollars with a sale of 69.9 million in June 2018 and a purchase of 14 million dollars in July 2018. The BoU also sold 43.7 million in targeted sales. Therefore, the net BOU action in the IFEM amounted to a net foreign exchange purchase of USD 73.8 million for the period June-August 2018.

### 3.6 Domestic Economic Activity

BoU's early warning indicator of economic activity, the composite index of economic activity (CIEA) indicates that economic activity has remained relatively robust. The CIEA estimated the growth in economic activity at 1.5 percent in the three months to July 2018, only slightly lower than the 1.6 percent estimate for the three months to April 2018 (**Figure 10**). Overall, there is potential for growth going forward. Indeed Stanbic Bank Uganda's Purchasing Managers' (PMI) index released in July 2018 depicts an improvement in business activity and in the private sector. The PMI averaged about 53 in the second quarter of the year compared to 52.1 in the first quarter.

**Figure 10: Quarterly changes (CIEA)**




*Source: Bank of Uganda*

Economic growth is forecast to pick up to above 6.0 percent in FY 2018/19 from 5.8 percent projected in FY2017/18. The growth is supported by the increase in global demand, accommodative monetary policy, and increase in foreign direct investment. However, this growth prospect is also susceptible to a number of risks, including slow execution of public investments; subdued private sector credit; and the global growth momentum may be short lived given the increase in trade protectionism. This could spill over into domestic economy through increased uncertainty, trade and financial flows.

## 3.7 Consumer Price Inflation

### 3.7.1 Recent Inflation Developments

Inflation continued on an upward trajectory since June 2018 when prices started picking up. In August 2018, annual headline and core inflation rose to 3.8 percent and 3.5 percent, respectively, relative to 3.1 percent and 2.5 percent, respectively in July 2018. The rise in inflation was mainly attributed to the increase in other goods and services inflation that rose to 2.3 percent and 5.3 percent, respectively in August 2018. Services inflation was driven by the rise in communication and transport prices. The recently introduced taxes on communication services, and increased taxes on used cars, could partly explain the increase in inflation for the communication and transport services. Similarly, food crop inflation increased due to a pickup in prices of fruits and vegetables to *minus* 1.2 in August 2018 from *minus* 2.0 in the previous month. However, Energy Fuel and Utilities (EFU) dropped to 14.1 percent from 16 percent recorded in July 2018. A fall in EFU inflation was largely on account of a decline in the prices of solid fuels including charcoal and firewood. Developments in domestic inflation are shown in **Table 5**.

### Table 5: Developments in Domestic Inflation

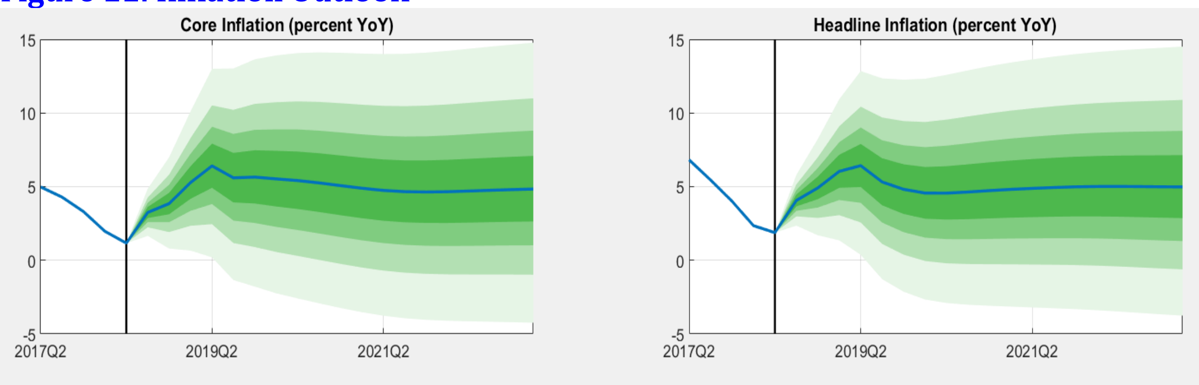
| | 2017 | | | | | 2018 | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Aug | Sep | Oct | Nov | Dec | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug |
| | Annual Per cent change | | | | | | | | | | | | |
| *Headline* | 5.2 | 5.3 | 4.8 | 4 | 3.3 | 3 | 2.1 | 2.0 | 1.8 | 1.7 | 2.1 | 3.1 | 3.8 |
| *Core* | 4.1 | 4.2 | 3.5 | 3.3 | 3 | 2.6 | 1.7 | 1.7 | 1.6 | 1.1 | 0.8 | 2.5 | 3.5 |
| *Food crops* | 11.7 | 9.6 | 7.9 | 2.3 | -0.7 | 1.4 | -0.7 | -1.7 | -2.1 | -0.2 | 2.3 | -2.0 | -1.2 |
| *Other Goods* | 4.7 | 4.3 | 4.3 | 3.7 | 3.3 | 2.3 | 1.6 | 1.2 | 1.0 | 0.6 | 0.3 | 1.5 | 2.3 |
| *Services* | 3.3 | 4.1 | 2.3 | 2.8 | 2.6 | 3 | 1.8 | 2.5 | 2.4 | 1.9 | 1.7 | 4.1 | 5.3 |
| *EFU* | 7.8 | 10.6 | 14.1 | 13.7 | 12.5 | 9.8 | 11.2 | 10.3 | 10.4 | 10.3 | 15.1 | 16.0 | 14.1 |
| | Quarterly moving average | | | | | | | | | | | | |
| *Headline* | 5.8 | 5.4 | 5.1 | 4.7 | 4 | 3.4 | 2.8 | 2.4 | 1.9 | 1.8 | 1.9 | 2.3 | 3.0 |
| *Core* | 4.5 | 4.3 | 3.9 | 3.7 | 3.3 | 3 | 2.4 | 2.0 | 1.6 | 1.5 | 1.2 | 1.5 | 2.3 |
| *Food crops* | 14.2 | 11.4 | 9.7 | 6.6 | 3.2 | 1 | 0.0 | -0.3 | -1.5 | -1.3 | 0.0 | 0.0 | -0.3 |
| *Other Goods* | 5.1 | 4.6 | 4.4 | 4.1 | 3.8 | 3.1 | 2.4 | 1.7 | 1.3 | 0.9 | 0.6 | 0.8 | 1.4 |
| *Services* | 3.8 | 3.8 | 3.2 | 3.1 | 2.6 | 2.8 | 2.5 | 2.4 | 2.2 | 2.3 | 2.0 | 2.6 | 3.7 |
| *EFU* | 7.1 | 8.7 | 10.8 | 12.8 | 13.4 | 12 | 11.2 | 10.4 | 10.6 | 10.3 | 11.9 | 13.8 | 15.1 |

*Source: Uganda Bureau of Statistics (UBOS)*

### 3.7.2 Inflation Outlook

Inflation is projected to remain within the 5.0 percent target in the medium term. While inflation is forecast to increase in the near term, the projections have been revised downwards compared to the June forecast round. This was mainly on account of a less depreciated exchange rate compared to the previous forecast round. The inflation forecasts are depicted in **Figure 11**.

### Figure 11: Inflation Outlook




*Source: Bank of Uganda*

There are a number of underlying risks to the forecasts that emanate from both the domestic and global environment. On the domestic scene, there is a risk of a higher depreciation. While the baseline projection assumes a slower pace of the exchange rate depreciation, there is a possibility of a faster pace of the depreciation supported by a weaker current account position which could lead to a rise in inflation. Similarly, food prices that were projected to remain relatively subdued could still be affected by poor weather conditions which could lead to a rise in food inflation.

On the global scene, crude oil prices could increase due to global demand, geopolitical risks and reduction in supplies by both OPEC and Non-OPEC members. The rise in oil prices could pose significant upside risk to inflation. Similarly, foreign inflation has recently been subdued on account of global bumper harvests, however with the emergence of a positive output gap in the global economy over the forecast horizon, trading partner countries inflation may exceed the current assumption in the baseline forecast and thus pose significant upside risk to inflation.

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 9.0 percent in the Monetary Policy Committee meeting of August 2018.

# 4 Conclusion

The external environment remains positive with robust growth projections in 2018 and 2019. However these global growth prospects are more uneven and less certain as a result of escalating trade wars and geopolitical tensions in a number of economies. Global inflation edged up on account of high commodity prices driven by the recent drought. However, oil prices dipped with the increase in oil production of OPEC and Non-OPEC Countries. This trend could be reversed given the uncertain global environment.

On the domestic scene, although BoU's early warning indicator of economic activity, the CIEA indicates that economic activity has remained relatively unchanged, the economic growth is forecast to pick up to above 6.0 percent in FY 2018/19 from 5.8 percent projected in FY2017/18. The growth is supported by the increase in global demand, accommodative monetary policy, and increase in foreign direct investment. However, these growth prospects are also susceptible to a number of risks including, the slow execution of public investments, subdued private sector credit growth, the fact that global growth momentum may be short lived given the increase in trade protectionism.

Inflation continued on an upward trajectory since June 2018 when prices started picking up. In August 2018, annual headline inflation and core inflation rose to 3.8 percent and 3.5 percent respectively compare to 3.1 percent and 2.5 percent record the previous month. 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 in the medium term. There are a number of underlying risks to this forecast including a higher depreciation of the exchange rate, higher oil prices and the possibility of higher food prices as a result of poor weather conditions. If inflationary pressures emerge which threaten the target for core inflation, the BoU will tighten monetary.

The risks of the external scenario have become more present. The US-China trade conflict has intensified which, together with the cyclical stage of the US economy and its difference with other developed economies has led to a global appreciation of the dollar and a fall in commodity prices. This has battered some emerging economies. For now, global growth projections have seen limited changes.

Regarding global financial conditions, the divergence of monetary policies in the developed world persists because of the different evaluations of output gaps and inflationary pressures. While the Federal Reserve raised the fed funds rate by 25 basis points in June 2018 and has signalled two more increases this year and three in 2019 —and at the same time continues to downsize its balance sheet —the European Central Bank extended its asset purchasing program and signalled that the policy rates will not be moved for a while. Meanwhile, the trade conflict between the US and China has escalated further. So far, the United States' actions and China's reprisals have been limited, but tensions have not abated and the measures adopted are already having an impact. Fears have been heightened by the further moderation of China's economic activity. China has taken measures to boost its economy raising new fears about the imbalances that are still present. In this context, global financial conditions remain favourable from a historical perspective, but have tightened for emerging economies, particularly those perceived has having weaker macroeconomic fundamentals. Recent developments in Argentina and Turkey are good examples that illustrate the markets' sensitivity.

In Uganda, the strongest reaction has come from the nominal exchange rate— which plays a stabilizing role in the policy framework. In the quarter to August 2018, the Uganda shilling/US dollar had depreciated at average annual rate of 5 percent. On a trade weighted basis, the depreciation was smaller at 3 percent. Considering all these antecedents, the Board estimates that inflationary pressures are consistent with inflation converging to the target.

As usual, there are internal and external elements that could alter these projections. Changes in the shilling exchange rate are always difficult to forecast. A more rapid depreciation of the shilling than expected could contribute to higher inflation than in the forecast. There is also considerable uncertainty about the development of domestic cost pressures in the period ahead.
From the point of view of its impact on local activity, the balance of risks in the external scenario remains biased downwards. The main risk continues to be an abrupt deterioration of financial conditions for emerging economies, especially because markets seem to be reacting more to negative news. On this matter, events in the United States are still relevant, in terms of both inflation outlook and evolution, and how the trade conflict will unfold. This situation has revived the fears about China, especially because of the risks from persistent imbalances in several of its markets. In Europe, Brexit-related uncertainty stands out, among other issues. In the context of international financial conditions normalization, investors have drawn a line between emerging economies that are perceived as more vulnerable and those with stronger fundamentals.

There are thus a number of factors that could lead to both lower and higher inflation than is now being assumed. Therefore, BoU will conduct monetary policy to ensure that inflation is close to the medium-term target of 5 percent.