Bank of Uganda

Monetary Policy Report

January 2013

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1 Overview

Domestic inflationary pressures remained under control despite the moderate rise in both headline and core inflation in December 2012. Annual headline and core inflation rose to 5.5 per cent and 4.6 per cent respectively in December, from 4.9 percent and 3.9 percent in November. Core inflation nonetheless remained within the Bank of Uganda's medium-term target of 5.0 percent. On the international scene, inflation typically declined within the advanced economies, in particular within the US and euro zone, but remained stable in the United Kingdom. Emerging economies however faced increasing inflationary pressures, most notably in China and Brazil; although inflationary pressures were experienced to a lesser extent in India, where easing fuel and manufacturing prices brought a fall in inflation. Despite the disparity in inflation movements over the month, the overall direction of global inflationary pressures remained subdued.

The global economy has continued to grow at a slow pace and prospects remain high that growth in Q4 2012 might not have improved much, although many economies may have stabilised over the quarter, thereby promising better growth prospects, or lesser downside risks, over coming quarters.

In Uganda, whilst the negative output gap is expected to remain throughout 2012/13, high frequency indicators of economic activity show that the negative output will narrow. Investment is expected to remain below levels conducive to growth, as a result of weak demand and high interest rates. Weak investment is also likely to adversely affect household consumption and labour market development, amongst other factors, and as a result household consumption is expected to be subdued throughout 2013, perhaps improving slightly by 2014. Quarterly GDP and Composite Index of Economic Activity (CIEA) data, and monthly growth in monetary aggregates all indicate that aggregate demand may be recovering, albeit at a slow pace still below the long-term average.

The Shilling continued to face deprecatory pressures in December as coffee receipts and the festive season increased the level of dollar supply to the market. Bearish sentiments and an anticipated improvement in dollar demand in January encouraged banks to build long dollar positions, which further cemented the prevailing deprecatory pressures.

Developments in the current account were consistent with those observed in the exchange rate; the current account deficit deteriorated by 5.9 per cent in November, whilst the exchange rate depreciated by 1.7 per cent. In December, the bilateral exchange rate depreciated by 1.9 per cent, thereby indicating an unlikely turnaround in current trends and developments.

2 Money and credit

2.1 Global financial markets

Financial markets have an enormous, and increasing, impact upon global economic activity. A well developed financial sector should improve the efficiency with which savings may be channelled into investment, and thereby promote economic growth. Furthermore, well developed financial markets allow enormous capital flows that suffer no national border constraints. However, financial markets are highly susceptible to investor sentiment and investments may be reversed or withdrawn immediately. Whilst the potential benefits that the financial sector promise are vital to economic growth in a globalised world, the destruction that they may also cause in terms of volatility and speculation are important to acknowledge. The following two sections will analyse the monthly developments in international (2.1) and domestic (2.2) financial markets.

Global financial market conditions have continued to strengthen irrespective of the weak global economic outlook. The Bank of International Settlements (BIS) attributes the rise in the price of risky assets to the implementation of looser monetary policies amongst the advanced economies, whose supportive monetary policies are seemingly restoring market confidence. In particular, the Federal Reserve has announced that it will continue with its quantitative easing program, whilst the Bank of Japan has announced that it will extend its asset purchase program by Japanese Yen 21 trillion before the end of 2013. Asset prices have been further supported by a perceived reduction in the major downside risks to the global economy. Specifically, the belief that Chinese growth will rebound and that the euro debt crisis will not worsen on account of the new policy measures adopted.

In the advanced economies, yields on corporate bonds fell to their lowest since before the financial crisis in 2008. In the euro area, financial market conditions have improved significantly, though distinct differences may still be observed between lending conditions in the core and periphery regions; lending conditions in the periphery remain largely strained. In the US, government bond yields have stayed low, for the present on account of the temporary resolve surrounding the fiscal cliff, whilst bank lending and mortgage rates have declined further. In Japan, quantitative easing has largely supported financial market conditions; however the appreciation of the Japanese Yen has limited the economic expansion that policy might otherwise have created.

In emerging economies, lower policy interest rates typically encouraged yields on corporate bonds to decline, equity markets to pick up and sovereign bond spreads to fall. In China, liquidity has increased, creating a noted improvement in credit conditions; however, the Chinese stock market has not yet recovered in line with the rest of the economy and experienced decline over the month.

Table 1 compares selected economic indicators amongst the immediate region and investors' favoured destinations for capital inflows. The evidence indicates that the one year investment rates have been the most competitive in Uganda and Ghana (***table 1***) for the past two months. However, the exchange rate depreciation experienced in both countries over the past two months has largely eroded their competitive edge against the countries compared. The example set by Uganda and Ghana follows the uncovered interest parity condition, whereby the attractive interest rate differential offered from government securities, no longer holds when the exchange rate is taken into account.

Table 1: Summary of regional economic indicators

	Inflation (annual per cent)					Exchange rate (annual depreciation of domestic currency against the				
	Uganda	Kenya	Ghana	Nigeria	Zambia	Uganda	Kenya	Ghana	Nigeria	Zambia
Jan 12	25.6	18.3	8.7	12.6	6.4	3.6	6.6	9.0	5.8	7.5
Feb	25.7	16.7	8.6	11.9	6.0	-0.3	2.1	10.9	3.7	9.4
Mar	21.1	15.6	8.8	12.1	6.4	3.8	-1.6	11.9	1.6	11.0
Apr	20.0	13.1	9.1	12.9	6.5	5.7	-0.8	13.1	1.8	11.5
May	18.6	12.2	9.3	12.7	6.6	3.8	-1.2	15.2	1.5	9.7
Jun	18.0	10.1	9.4	12.9	6.7	0.9	-4.8	23.3	4.3	9.1
Jul	14.3	7.7	9.5	12.8	6.2	-4.4	-6.4	24.9	5.9	0.7
Aug	11.9	6.1	9.5	11.7	6.4	-9.8	-9.4	25.2	3.4	-0.4
Sep	5.5	5.3	9.4	11.3	6.6	-10.6	-12.2	24.6	0.7	2.2
Oct	4.5	4.1	9.2	11.7	6.8	-8.0	-16.0	23.2	-1.6	4.4
Nov	4.9	3.3	9.3	12.3	6.9	1.6	-8.6	23.2	-0.8	3.4
Dec	5.5	3.2	-	-	7.3	9.2	-0.8	25.8	-4.3*	1.8*
	Policy rates (per cent)					One year investment rate (364-day Treasury Bill yield)				
	Uganda	Kenya	Ghana	Nigeria	Zambia	Uganda	Kenya	Ghana	Nigeria	Zambia
Jan 12	23.0	18.0	12.5	12.0	-	24.5	22.0	11.4	6.6	12.0
Feb	22.0	18.0	13.5	12.0	-	19.0	21.0	12.5	6.6	9.7
Mar	21.0	18.0	13.5	12.0	-	19.4	17.0	12.9	8.0	10.9
Apr	21.0	18.0	14.5	12.0	9.0	20.3	16.9	15.9	7.2	11.9
May	21.0	18.0	14.5	12.0	9.0	20.2	12.4	20.1	7.0	11.8
Jun	20.0	18.0	15.0	12.0	9.0	19.2	12.4	22.0	7.5	11.4
Jul	19.0	16.5	15.0	12.0	9.0	17.5	13.0	22.0	6.6	12.5
Aug	17.0	16.5	15.0	12.0	9.0	14.3	12.9	22.5	6.9	11.6
Sep	15.0	13.0	15.0	12.0	9.0	11.4	10.3	22.0	6.8	10.7
Oct	13.0	13.0	15.0	12.0	9.3	12.2	10.6	22.8	6.2	10.5
Nov	12.5	11.0	15.0	12.0	9.3	15.0	11.8	22.9	6.2	13.0
Dec	12.0	11.0	15.0	-	9.3	15.2	11.7	22.9	-	11.7

Source: Respective Central Bank websites

2.2 Domestic financial markets

*As previously explained, the importance of a well-developed financial system is to efficiently allocate savings and investments in order to achieve the maximum economic growth rate obtainable. In Uganda, the financial sector is highly concentrated and largely dominated by commercial banks. The domestic financial sector will therefore promote economic growth if banks are able to balance their liquidity requirements efficiently; if they have easy access to external funds through markets such as the interbank money market (**2.2.1**) or if they can invest excess liquidity in assets such as treasury securities (**2.2.2**).*

2.2.1 Interbank money markets

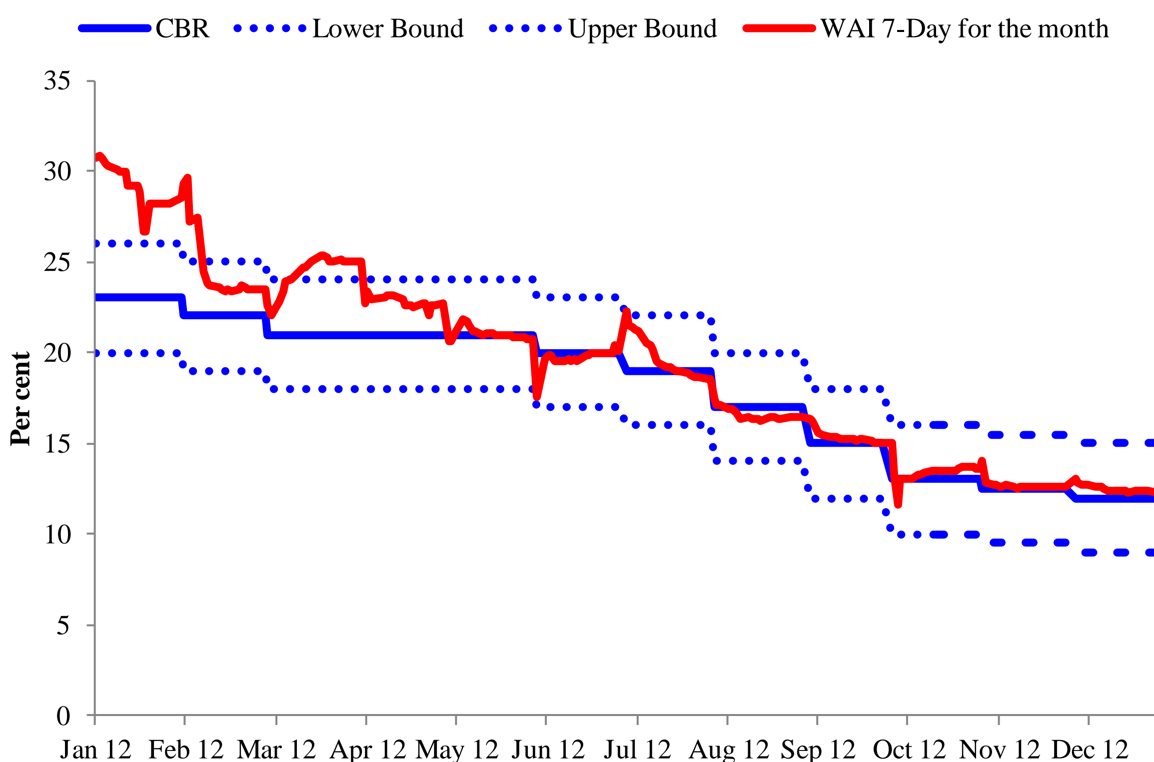
Commercial banks were more active than usual in the interbank market over the month, sourcing for funds to meet their liquidity needs. In December, total trades in the interbank money market amounted to Shs. 1,595.1 billion, up 5.0 per cent from Shs. 1,518.4 billion the previous month. Similarly, total monthly trades across the 7-day tenor increased by 2.4 per cent over the month from Shs. 646.8 billion to Shs. 662.6 billion. Greater use of the interbank market, which typically has the shortest loan tenors available, may be expected over the festive season as increased money demand forces banks to take more liquid positions, thereby minimising tenors across transactions. As a result, the apparent financial deepening over the month may only be a temporary and seasonal.

Money market interest rates remained broadly consistent with the monetary policy stance for the month, as has largely been the case over the quarter. The weighted average 7-day rate trended within the CBR band throughout the entire month, and averaged 12.3 per cent in December, down from 12.6 percent the preceding month. Additionally, the overall and overnight weighted average interbank rates declined to 9.9 per cent and 7.8 per cent, respectively in December, from 10.2 per cent and 8.4 per cent, respectively in November. The change in interbank rates over the month reflects a larger mark-up over the CBR in December when compared to November, and an increased weighting of overnight transactions.

In order to steer interbank money market rates and to smooth exchange rate volatility over the month, the Bank of Uganda conducted foreign exchange operations amounting to net liquidity injections of Shs. 44.9 billion and Shs. 304.1 billion respectively in December.

The successful guidance of the weighted average 7-day interbank rate in accordance with the monetary stance over recent months is shown in ***figure 1***.

Figure 1: Evolution of the 7-day interbank rate



Source: Bank of Uganda

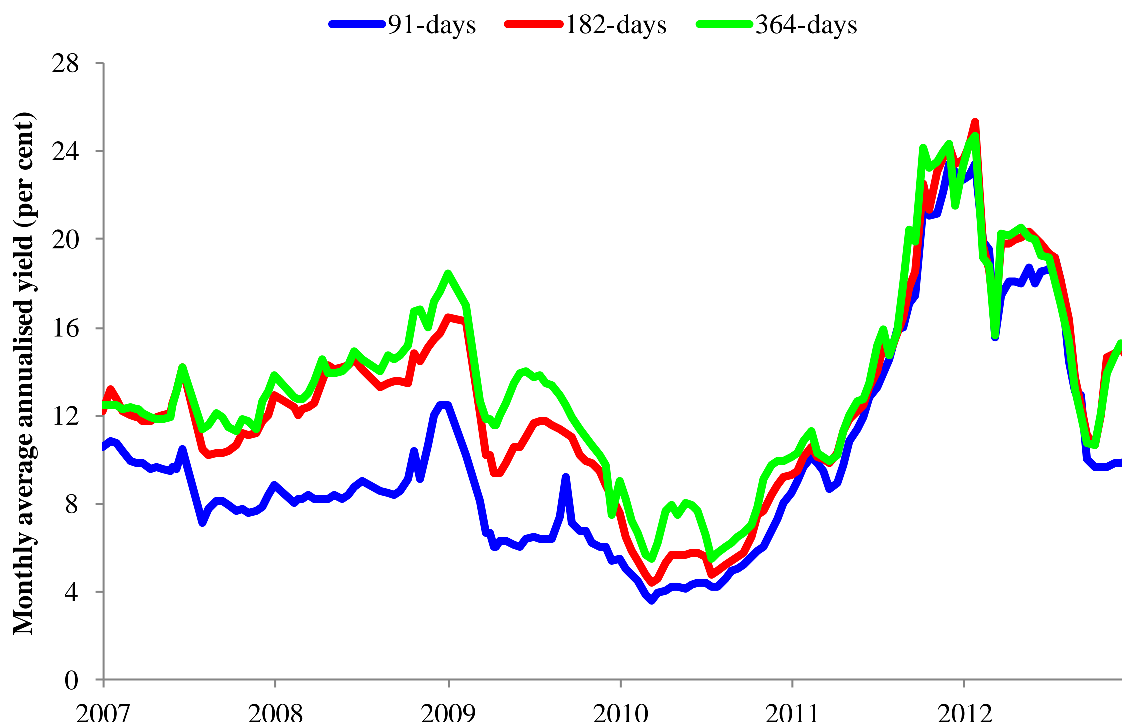
2.2.1 Treasury securities market

During December, there were two Treasury bill auctions and one Treasury bond auction in the primary market. The weighted average annualized yields for the 91-day and 364-day Treasury papers increased marginally in December to 9.9 percent and 15.2 percent respectively, from 9.8 percent and 15.0 percent the previous month. However, the annualized yield on the 182-day paper fell to 14.6 percent, from 15.0 percent in November. The monetary policy stance in December would typically have encouraged the Treasury bill yields to have fallen by approximately 0.5 per cent; therefore the rise in the 91-day and 364-

day yields may indicate some market concern, perhaps arising from the government financing position or a withdrawal of capital inflows.

Treasury bond yields also increased in December and may be expected to increase further if the government is forced to fund itself through the domestic financial markets throughout 2013. Treasury bill yields are shown in ***figure 2***.

Figure 2: Treasury bill yields



Source: Bank of Uganda

With the exception of the 91-day Treasury bill and the 10-year Treasury bond, Treasury security yields rose considerably in the secondary market in December, frequently to a far greater degree than in the primary market. The annualized rates for securities of less than 91-days remained unchanged from the previous month at 15.5 percent, while the annualized yields for the 182-day and 364-day papers rose by 1.8 and 0.7 percentage points respectively to 15.8 per cent and 15.3 percent. The average yield for the 2-year Treasury bond also increased, by 1.4 percentage points, to 14.9 percent in November. However, the average yields for the 10-year Treasury bond declined by 0.8 percentage points to 14.5 percent in December. The developments in yields signify falling preferences for government securities due to mature over the coming financial years.

2.3 Monetary aggregates and private sector credit

*Responsible credit growth is also necessary to economic expansion, as may be evaluated with respect to lending and deposit rates (**2.3.1**) and credit growth (**2.3.2**). Very low commercial bank interest rates are likely to increase credit demand, but also credit demand for risky projects, as the borrower has less to lose. However, very high interest rates will stall credit growth, and thereby investment and ultimately economic growth, by elevating the cost of borrowing. Developments in the overall stock of loans, as illustrated through private sector credit (**2.3.3**), are also*

crucial to analyse, particularly to infer the position of bank balance sheets and for the expected growth of the real economy.

2.3.1 Lending and deposit interest rates

Lending rates remained relatively high over the month; but continued along a declining trend. In November, the weighted average interest rate on shilling denominated loans declined by a far larger degree than the CBR over the month, to 23.6 percent, from 24.9 percent in October. However, the time deposit rate also fell, by 2.7 percentage points, to 10.1 per cent, which is the lowest rate recorded over the year by almost 2 per cent. Consequently, the spread between lending and deposit rates picked up to 13.4 per cent, which is far above the annual average spread of 8.9 per cent, and resembles the second greatest spread over the year, only less than that in September. As may be expected, the prime lending rates are more responsive to CBR fluctuations; between January and November 2012, prime lending rates have fallen by 15.5 percent, plus a further 4.1 percent in December, whilst average lending rates have only declined by 12.9 per cent in the same period. Commercial banks' interest rate structures are presented in ***table 2***.

Table 2: Commercial banks' weighted average rates

	Domestic currency denominated loans			Foreign currency denominated loans		
	Average lending rate	Time deposit rate	Spread	Average lending rate	Time deposit rate	Spread
Nov 11	26.0	19.9	6.0	10.3	1.6	8.6
Dec	26.7	23.9	2.9	10.1	4.1	6.0
Jan 12	27.2	21.2	6.0	10.3	5.9	4.5
Feb	26.9	19.8	7.1	10.4	5.1	5.3
Mar	27.6	20.0	7.6	10.0	4.5	5.5
Apr	26.1	18.7	7.5	8.2	4.6	3.6
May	26.7	17.4	9.3	9.3	7.4	2.0
Jun	27.0	19.9	7.1	8.4	5.2	3.2
Jul	26.9	17.8	9.1	9.0	3.0	6.0
Aug	26.4	15.2	11.2	9.1	5.0	4.2
Sep	25.7	11.9	13.8	8.7	2.7	6.1
Oct	24.9	12.8	12.1	10.7	4.5	6.2
Nov	23.6	10.1	13.4	10.4	2.3	8.1

Source: Bank of Uganda

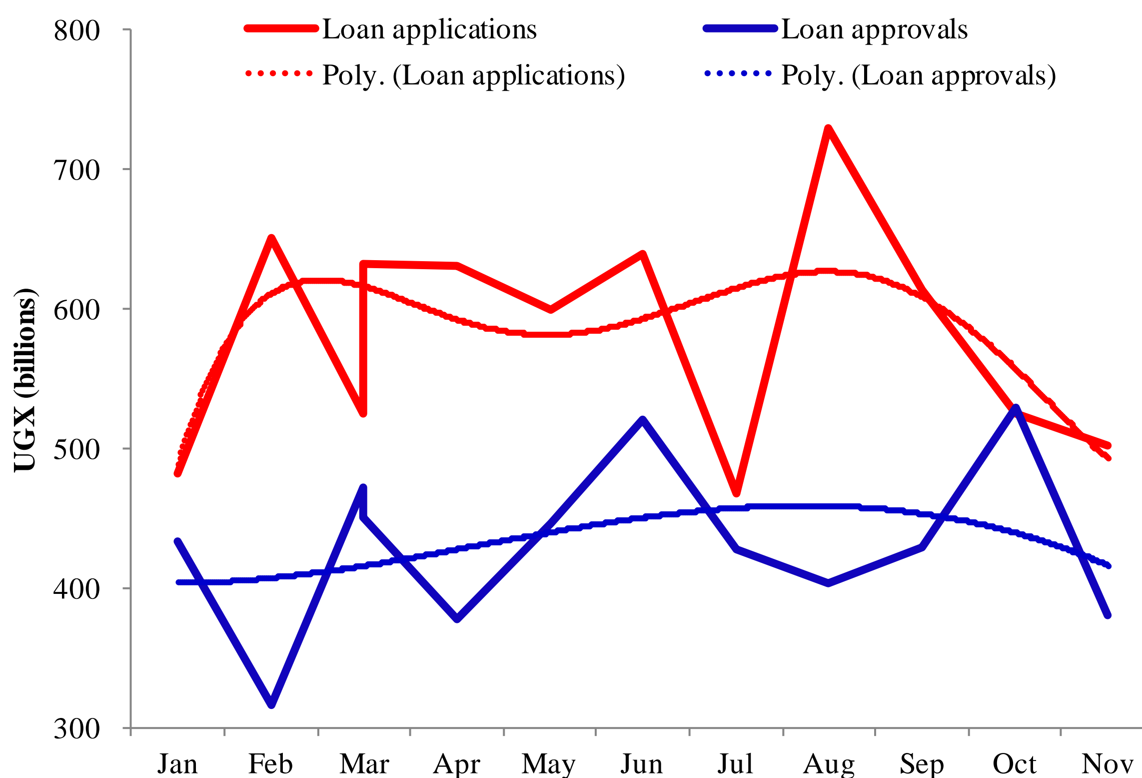
Weighted average interest rates for foreign currency denominated loans declined marginally, by 0.3 percentage points, to 10.4 percent in November. However, as with domestic currency denominated loans the time deposit rate fell by a greater degree, 2.2 percentage points, to 2.3 per cent, to increase the spread. In November, the spread on foreign currency denominated loans reached an annual peak at 8.1 per cent, up from 6.2 per cent in October. The increase in lending rates may in part be explained by the depreciation pressures on the Shilling, which has exacerbated the cost of borrowing.

2.3.2 Loan supply and demand

Using loan applications and approvals to proxy credit demand and supply suggests that weak credit growth in November may have been largely a consequence of weak credit demand. The number of loan

applications increased from 37,013 to 39,167 in November, but the value of loan applications has declined from Shs. 614 billion in September to Shs. 525 billion in October to Shs. 503 billion in November. The value of loans approved also declined in November, by Shs. 149 billion, but had increased by Shs. 100 billion in the previous month. The overall trend for credit demand and supply over the year to date is difficult to determine and the monthly outturns fluctuate considerably. Therefore, the November outturn highlights weak demand and supply in the economy over the month, but may not accurately identify future patterns. A summary of loan applications and approvals is shown in ***figure 3***, below:

Figure 3: Loan applications and approvals



Source: Bank of Uganda

The trade sector continued to demand the biggest proportion of total private sector credit in November, followed by the building, construction and real estate sector and the personal and household loan sector; the aforementioned sectors accounted for 26.1 percent, 21.9 percent and 19.1 percent of total private sector credit respectively, compared to respective proportions of 39.0 percent, 12.7 percent and 12.7 percent in October. The same sectors may also be calculated to dominate credit supply, shown by the value of loan approvals, although to slightly varying proportions. The building, construction and real estate sector, the trade sector and the personal and household loan sector received 26.5 percent, 24.4 percent and 11.5 percent of total private sector credit respectively, from respective takings of 13.3 percent, 22.1 percent and 7.5 percent recorded the previous month. A more detailed analysis of loan applications and approvals per sector is shown in ***table 3*** below.

Table 3: Amounts of loan applications and approvals by sector

	Agriculture	Mining & quarrying	Manufacturing	Trade	Transport & communication	Building, construction & real estate	Business services	Personal & household loans	Total
Value of applications received (UGX billions)									
Nov 11	32.6	0.7	67.6	161.3	111.1	51.4	196.4	56.1	723.2
Dec	32.8	1.7	79.2	110.9	93.1	63.7	12.5	58.8	481.8
Jan 12	51.6	1.4	21.2	378.4	18.8	56.2	18.8	43.4	651.5
Feb	28.1	0.9	97.9	211.4	41.8	41.3	21.1	38.7	524.6
Mar	34.3	0.6	36.7	239.7	35.3	91.2	15.8	37.5	632.5
Apr	38.2	12.6	27.6	199.1	25.0	85.0	14.3	39.1	630.7
May	41.9	13.0	168.9	147.8	30.3	89.0	19.8	47.2	599.8
Jun	53.0	6.2	197.4	150.0	42.0	67.8	28.9	53.0	639.2
Jul	41.7	0.1	60.8	111.2	30.6	99.4	10.0	50.2	467.3
Aug	48.8	6.6	147.9	232.0	29.5	116.4	31.8	57.2	730.0
Sep	45.5	2.1	63.1	232.7	23.4	97.5	36.9	65.7	613.9
Oct	33.2	4.6	27.1	204.9	15.8	66.9	30.9	66.5	524.9
Nov	32.7	1.0	69.6	131.1	12.6	110.1	23.1	96.0	502.6
Value of applications approved (UGX billions)									
Nov 11	25.5	0.5	75.8	124.5	100.0	35.0	25.8	49.2	464.5
Dec	23.1	1.2	78.8	93.9	90.5	60.8	12.8	48.4	433.8
Jan 12	35.9	0.7	18.9	133.4	14.8	44.2	16.9	34.8	316.0
Feb	33.4	0.3	91.5	199.5	36.3	35.7	13.1	30.9	472.1
Mar	18.2	0.3	12.4	147.8	21.9	70.3	16.1	28.0	450.1
Apr	30.2	0.6	32.1	102.7	17.7	54.2	11.5	31.7	377.4
May	45.0	1.3	79.8	134.7	21.5	80.9	10.1	37.5	446.4
Jun	40.5	1.9	132.8	171.2	33.6	55.0	20.4	43.3	520.9
Jul	34.8	0.0	99.1	98.3	19.3	63.4	28.9	45.1	427.6
Aug	29.4	46.0	21.6	83.6	20.4	47.8	12.2	38.9	526.0
Sep	27.0	9.6	51.4	93.4	16.9	82.4	13.9	43.0	429.0
Oct	25.1	14.5	43.9	116.9	23.4	70.5	19.4	39.7	529.3
Nov	21.2	4.7	35.4	92.8	9.1	100.8	28.1	43.9	380.7
Proportion of applications approved (per cent)									
Nov 11	78.0	71.3	112.2	77.2	90.0	68.1	13.1	87.8	64.2
Dec	70.4	73.2	99.5	84.7	97.2	95.5	102.7	82.2	90.0
Jan 12	69.7	53.4	89.3	35.3	78.7	78.6	90.0	80.2	48.5
Feb	118.8	37.6	93.5	94.4	86.9	86.5	61.8	79.9	90.0
Mar	53.1	43.7	33.9	61.6	62.1	77.0	101.6	74.6	71.2
Apr	79.0	5.1	116.2	51.6	70.8	63.7	80.6	81.1	59.8
May	107.5	9.9	47.3	91.1	70.8	90.8	50.9	79.5	74.4
Jun	76.5	30.2	67.3	114.1	80.2	81.2	70.8	81.7	81.5
Jul	83.5	44.9	163.1	88.4	63.0	63.8	288.2	89.9	91.5
Aug	60.3	697.3	14.6	36.0	69.2	41.1	38.3	68.0	72.0
Sep	59.4	461.6	81.4	40.1	72.3	84.5	37.7	65.4	69.9
Oct	75.6	312.4	162.0	57.0	147.6	105.3	62.8	59.7	100.8
Nov	64.9	449.6	50.8	70.7	72.5	91.5	121.8	45.7	75.7

Source: Bank of Uganda

2.3.3 Private sector credit

Analysis of private sector credit, a leading indicator to illustrate the financial sector's contribution to economic activity, shows that there is still space for credit to stimulate the economy and boost economic activity. From January to November 2012, private sector credit growth averaged only 0.9 per cent per month. However, private sector credit does appear to be recovering over the recent period; presenting

growth rates of 1.3 per cent, 2.0 per cent and 2.5 per cent in September, October and November respectively. As has been the recent trend, foreign currency denominated loans contributed the highest growth rate towards November's aggregate private sector credit growth figure; foreign currency denominated loans grew by 4.8 per cent over the month, mostly emanating from the trade sector. However, November's relatively high private sector credit growth, when compared to the preceding year, arises from the recovery in shilling denominated loans, which grew by 0.7 per cent following five consecutive months of contraction.

On quarterly and annual bases, total private sector credit grew by 5.8 per cent and 8.8 percent respectively in November, notably higher than the respective growth rates of 4.1 per cent and 7.7 per cent registered the previous month. Shilling denominated loans continued to decline on both quarterly and annual bases, by 1.0 per cent and 10.7 per cent respectively, while foreign currency loans in Shillings and US Dollars grew by 18.1 per cent and 9.0 per cent respectively on a quarterly basis, and by 50.2 per cent and 43.3 per cent on an annual basis. Aggregate private sector credit continues to be constrained by relatively high lending rates. Total monthly, quarterly and annual lending to the private sector is shown in ***table 4***.

Table 4: Growth rates of private sector credit

	Monthly data				Quarterly data				Annual data			
	PSC	Shilling denominated loans	Forex denominated loans (UGX)	Forex denominated loans (USD)	PSC	Shilling denominated loans	Forex denominated loans (UGX)	Forex denominated loans (USD)	PSC	Shilling denominated loans	Forex denominated loans (UGX)	Forex denominated loans (USD)
Nov 11	1.3	0.3	3.7	4.8	3.5	4.5	1.1	11.1	34.0	29.0	49.2	34.5
Dec	-0.8	-1.1	0.1	3.1	-0.7	0.7	-4.1	9.5	28.2	25.1	36.9	26.9
Jan 12	-1.7	-4.9	-1.9	5.0	-1.3	-5.7	1.8	13.4	23.9	16.3	34.4	33.0
Feb	0.4	-2.0	6.4	4.3	-2.1	-7.8	4.4	12.9	21.1	11.7	36.5	35.8
Mar	3.0	-0.9	12.1	5.6	1.6	-7.6	16.9	15.7	22.1	9.1	47.2	40.1
Apr	0.2	-0.4	1.5	2.0	3.7	-3.2	21.0	12.4	20.7	6.3	50.2	42.4
May	0.3	0.3	0.1	0.8	3.5	-0.9	13.9	8.6	16.6	2.8	44.9	39.2
Jun	1.0	-0.9	5.3	6.0	1.6	-1.0	7.0	9.0	11.1	-1.5	34.9	43.2
Jul	-0.3	-0.2	-0.4	-0.6	1.0	-0.8	5.0	6.2	10.1	-2.6	34.2	41.4
Aug	0.7	-0.1	1.9	1.8	1.5	-1.2	6.8	7.2	6.5	-5.7	28.5	46.2
Sep	1.3	-0.3	4.4	1.7	1.8	-0.6	5.9	2.9	4.3	-8.5	27.1	42.1
Oct	2.0	-1.3	8.0	6.3	4.1	-1.7	14.8	10.1	7.7	-11.0	48.5	49.0
Nov	2.3	0.7	4.8	0.8	5.8	-1.0	18.1	9.0	8.8	-10.7	50.2	43.3

Source: Bank of Uganda

2.3.4 Monetary aggregates

Growth of the financial sector may be captured through growth in monetary aggregates, as lending allows commercial banks to create money on their balance sheet portfolios. Stable growth in monetary aggregates tends to enable stable inflation and economic growth, whereby rapid money growth is likely to be reflected in elevated inflation, low money growth as well as poor economic growth.

On a monthly basis, M1, M2 and M3 all turned positive in November, and grew by 13.0 per cent, 8.9 per cent and 8.1 per cent respectively in November; November's growth may be compared to respective contractions in monetary aggregates of 0.9 per cent, 2.7 per cent and 3.1 per cent in October. Despite falling deposit rates, all measures of private sector deposits also grew over the month; demand deposits registered the biggest monthly growth rate of 15.8 percent. The growth in demand deposits during the month was driven primarily by the UMEME IPO and government releases. Stanbic bank, which held the UMEME IPO subscriptions, registered an increase of over Shs. 324 billion in private enterprise and local government deposits. A recovery in monetary aggregates growth may boost private sector credit in the coming months, and consequently investment and economic activity. Monthly developments in monetary aggregates are shown in ***table 5***.

Table 5: Monthly growth rates of monetary aggregates and private deposits

	Monetary aggregates			Currency in circulation	Demand deposits	Time & savings deposits	Foreign deposits
	M3	M2	M1				
Nov 11	0.1	-0.4	-1.1	2.1	-3.4	0.6	1.6
Dec	-0.6	-0.8	-0.6	3.1	-3.5	-1.1	-0.1
Jan 12	-4.4	-3.3	-2.2	-4.2	-0.5	-4.9	-7.5
Feb	2.8	3.9	4.2	-3.5	10.5	3.4	-0.5
Mar	2.9	-0.3	-1.4	-1.8	-1.2	1.5	12.5
Apr	-1.3	-1.9	-1.9	-1.8	-1.9	-1.9	0.4
May	1.8	1.5	-0.3	-1.3	0.5	3.9	2.8
Jun	5.3	-0.4	-1.2	6.0	-5.9	0.7	20.1
Jul	-4.6	-1.1	-3.9	-1.8	-5.8	2.6	-12.1
Aug	6.0	7.4	9.5	4.4	13.6	4.8	2.4
Sep	1.7	0.4	2.8	-0.7	5.5	-2.7	4.9
Oct	-3.1	-2.7	-0.9	-1.3	-0.6	-5.2	-4.0
Nov	8.1	8.9	13.0	8.9	15.8	3.1	6.1

Source: Bank of Uganda

Quarterly and annual growth rates for monetary aggregates also expanded over the period; M1, M2 and M3 grew by 15.1 per cent, 6.5 per cent and 6.6 per cent respectively on a quarterly basis in November, and by 17.1 per cent, 11.5 per cent and 14.6 per cent respectively on an annual basis. Whilst rapid growth in monetary aggregates may resemble an inflationary threat, at present growth in monetary aggregates does not appear reflected in credit growth, and the overall prevailing inflationary pressures appear minimal; thereby it is plausible that inflation may be temporarily resilient to above-average growth in monetary aggregates. Consequently, the improvement noted in monetary aggregates may signify a recovery in economic activity, with small downside risks.

3 Economic activity

3.1 Global economic activity

Strong global economic confidence and activity and a favourable exchange rate all tend to increase domestic export demand. Greater global demand will thus boost domestic production, create employment and encourage economic growth. Furthermore, a multiplier effect should accentuate production, employment and growth beyond that to satisfy the increased export demand.

*The remainder of this section will present international developments in real economic activity (**3.1.1**) and exchange rates (**3.1.2**) to partially account for the resultant domestic trade balance (**3.1.3**).*

3.1.1 Economic activity

Although outside the control of Ugandan policymakers and business leaders, global economic forces play a critical role within the Ugandan economy. The small size and relatively open nature of the Ugandan economy make it highly vulnerable to global economic developments, particularly via financial flows, demand, exchange-rate and inflationary pressures. The most relevant developments to Uganda will be developments in the world's largest markets: advanced markets such as the Euro zone, Japan, UK and US and increasingly in emerging economies such as Brazil, China, India and South Africa, as well as developments in the East African Community.

There have been no new data releases covering relevant global economic activity over the month. For the most recent data, please refer to the previous Monetary Policy Report, or to the previous Quarterly Economic Report for a more detailed analysis.

3.2 Domestic activity

Growth in domestic demand, as realised through an expansion in output, may be attributed to consumption, investment or government expenditure. An increase in any of the above should increase employment, as more workers are needed in the production process and more income is available to pay wages, which will in turn further increase aggregate demand. A multiplier effect should emanate from increased production, unless otherwise disrupted.

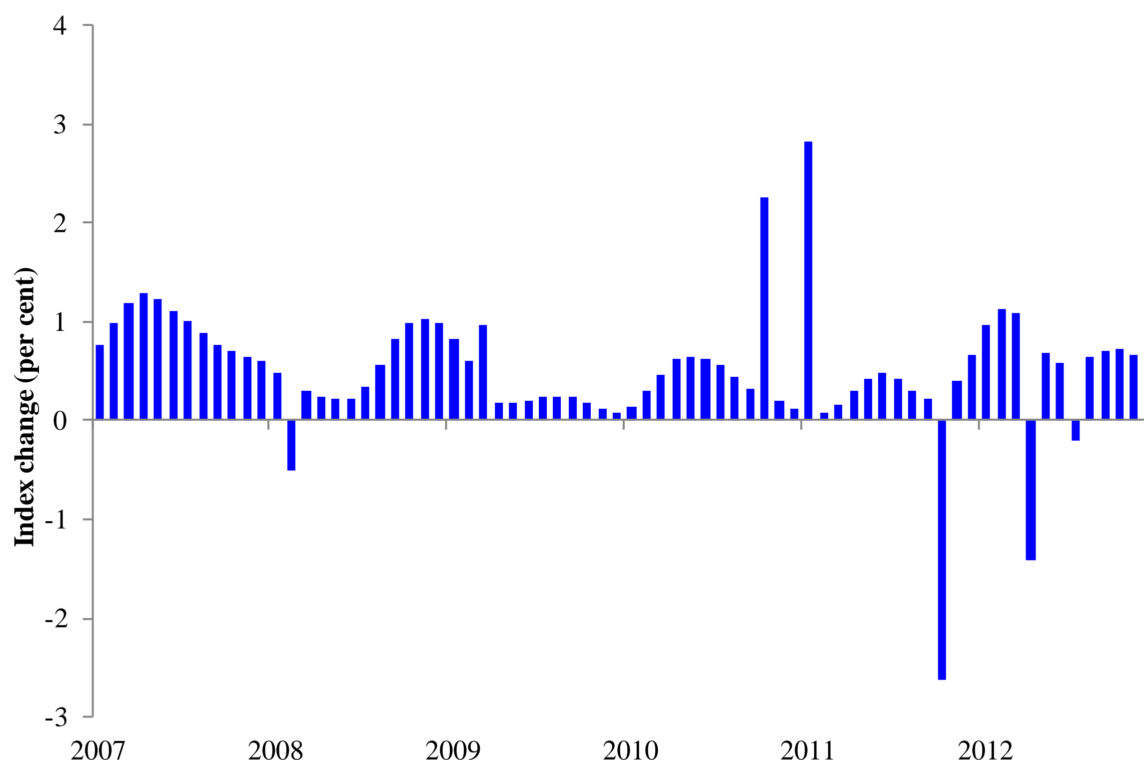
3.2.1 Economic activity

Within Uganda, the services sector is the dominant source of real economic activity, contributing to approximately 52 per cent of GDP. The industrial sector makes up approximately 25 per cent of GDP, whilst agriculture comprises approximately 14 per cent; the remaining 11 per cent arises from net taxes. Whilst agriculture is the smallest real sector, it is comparatively large when compared to other economies, and is where the majority of the population are still employed. Furthermore, it is particularly relevant to monetary policy in that it is the one sector that monetary policy is least able to affect, and because economic development is widely believed to stem from agricultural development. Therefore, this section will evaluate domestic GDP developments across all of the real sectors of the economy.

The composite index of economic activity (CIEA) is a measure that provides information on national economic developments in a more timely and frequent basis compared to actual GDP. Analysis of the CIEA indicates that growth remained broadly constant in November. The monthly CIEA rose by 0.7 per cent in November, to 149.3, from 148.3 in October, thereby indicating that annual growth may be expected to have recovered over the quarter, whilst quarterly growth may remain constant; the rate of growth in November 2012 was almost twice that reported in November 2011. The monthly economic activity was largely held up by industrial production and trade, which contributed 0.6 per cent and 0.2 per cent respectively to aggregate growth. On a quarterly basis, the level of economic activity is expected to

increase by 2.4 percent over the current quarter, compared to only 1.1 percent in the same quarter of the previous year. ***Figure 7***, below, shows monthly CIEA growth in Uganda.

Figure 7: Monthly changes in the CIEA



Source: Bank of Uganda

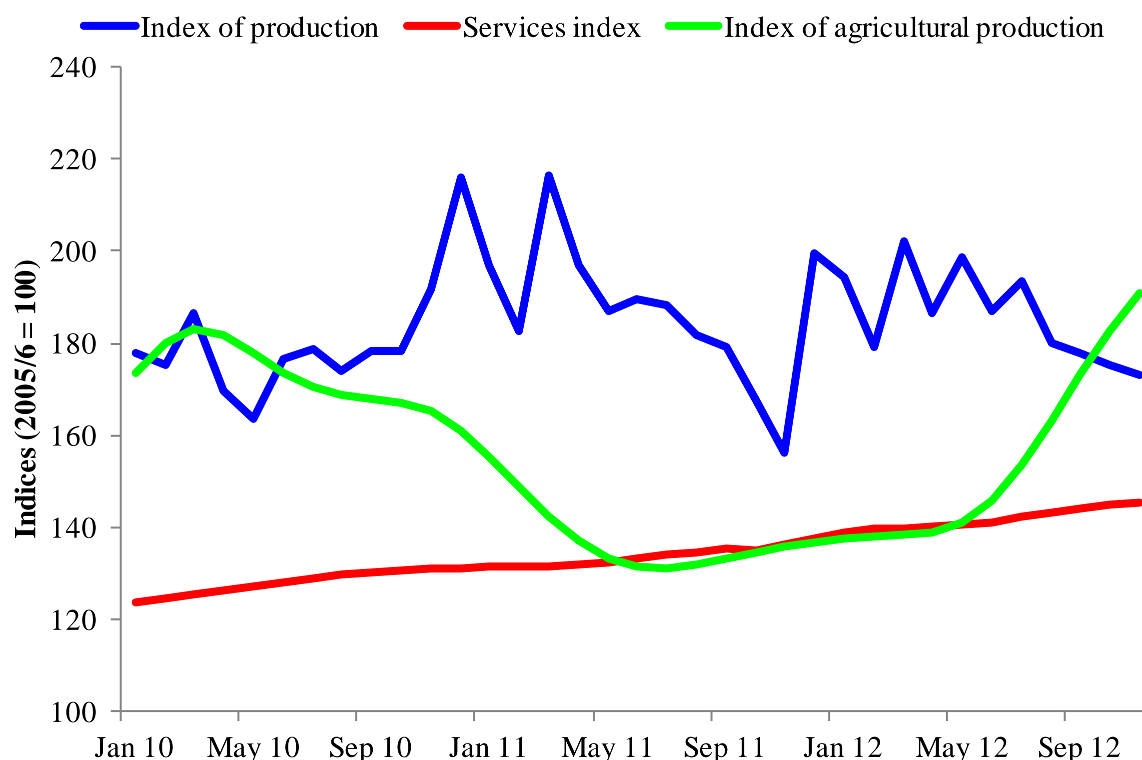
Sectoral activity growth may be analysed via their respective indices: the Services Index, Index of Output (IOP), which broadly resembles manufacturing, and Index of Agricultural Production (IAP), which are all individually seasonally adjusted for obvious reasons.

The IOP declined by 1.4 per cent in November, compared to October, but increased by 10.8 percent when compared to November 2011. The monthly manufacturing decline in November may be attributed to the beverages and tobacco, textile, clothing and footwear and chemical, paint, soap and foam products sectors, which declined by 25.3 per cent, 14.8 per cent and 9.2 per cent respectively over the month. However, production is calculated to have improved in the food processing, paper and printing, metal products and bricks and cement sectors by 69.3 per cent, 59.0 per cent, 32.0 per cent and 8.0 per cent respectively.

The monthly services index rose by 0.5 per cent in November, suggesting continued growth of the sector. The observed improvement in economic activity largely originates from the services sector, largely due to its economic dominance as opposed to high growth rates; the hotel and restaurant and wholesale and retail trade subsectors grew by 0.3 per cent and 0.2 per cent respectively. However, expansion of the monthly services index may also be explained by seasonal factors associated with the festive season in December, and therefore questions the sustainability of the observed growth.

The monthly IAP rose by 4.4 per cent to 190.8 in November, from 182.7 recorded the previous month, indicating an increase in agricultural production. Many food items, such as maize, grain, cassava, Irish potatoes, sweet potatoes and beans fell in-season of harvests and therefore noted production expansion over the month. Nonetheless, the IAP remains highly dependent on weather patterns, with strong inflationary implications arising from supply capability conditions. ***Figure 8**,* below, shows that in November only the industrial sector, estimated by the IOP, grew at a lesser rate than in the preceding month, whilst the agricultural sector experienced the greatest growth rate.

Figure 8: Sectoral indices



Source: Bank of Uganda

3.2.2 Fiscal activity

Total government expenditure on goods and services was higher than anticipated in December, for the second consecutive month. Automatic releases from Q3 were not disbursed until November, whilst December's payments were markedly prompt on account of the festive season; both of which have encouraged an increase in government expenditure over the recent months. The December outturn was approximately Shs. 50 billion higher than anticipated, at Shs. 715.3 billion. Nonetheless, total government expenditure remains below that projected; government expenditure has totalled 86.1 per cent of that projected in H1 2012/13.

Tax revenue performance picked up in December, although it continued to fall short of projections by approximately 20 per cent. Indirect domestic taxes were one dominant driver behind improved tax revenue performances; in particular, excise duty registered a 10-month high annual growth rate of 26.5 per cent, compared to solid growth of 23.4 per cent in November. Likewise, VAT collections on domestic goods and services noted an extremely high annual growth rate of 47.2 per cent, particularly compared to

the 34.5 per cent contraction experienced the preceding month. The VAT growth rate in December falls roughly back in-line with the trend range, although it may be worth highlighting that the typical range for VAT growth figures is sizeable: approximately 40 percentage points. VAT growth in December was largely driven by VAT collections upon phone talk time.

4 Exchange rates and balance of payments

4.2 Exchange rates

Exchange rate movements stem from changes to interest rates and inflation; high interest rates or inflation will create exchange rate depreciation, as explained through the interest rate parity condition. On a global basis, high international interest rates or inflation will encourage domestic appreciation. A domestic depreciation should improve competitiveness within Uganda's export sector and therefore improve the trade deficit, whilst a domestic appreciation will have the opposite effect. Furthermore, depreciation will make international goods more expensive to consumers and vice versa. The effect of the exchange rate upon net exports may also be captured through developments in the terms of trade.

Exchange rate movements may also affect Uganda through rendering other national trade partnerships more or less favourable. For example, if the Ugandan exchange rate remained stable, but the Kenyan exchange rate depreciated, then Uganda may lose trade to Kenya. Therefore, an appraisal of international exchange rates is necessary to explain international trade, and thus growth, patterns.

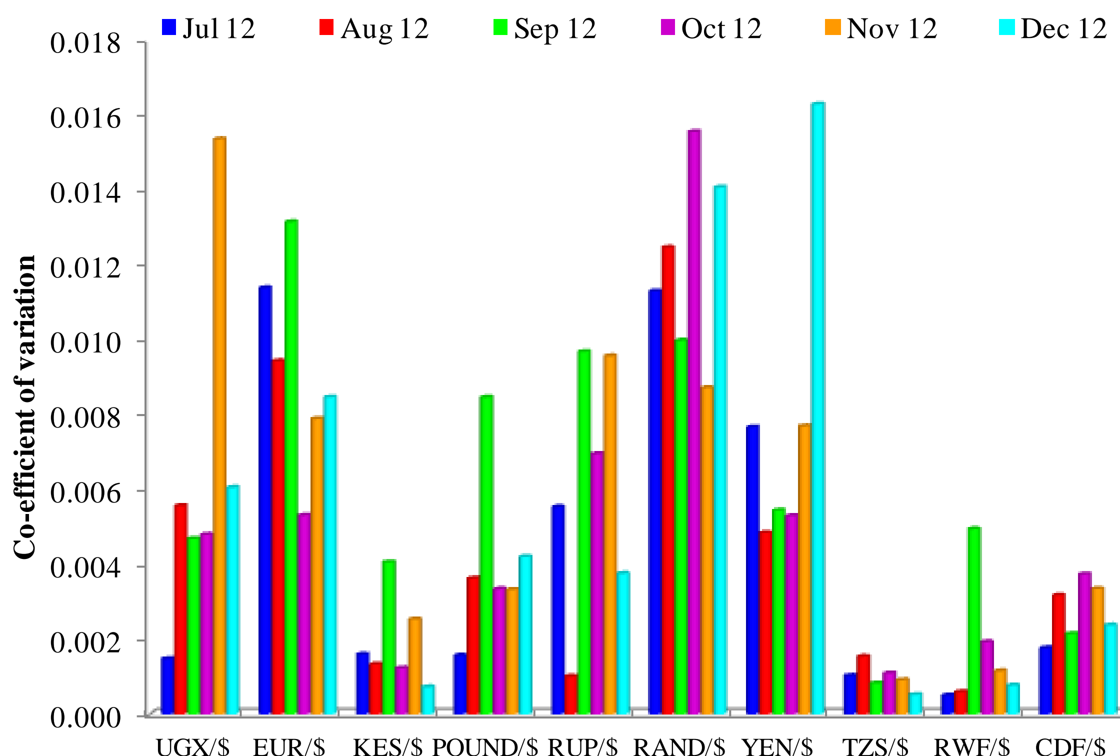
Finally, the nominal effective exchange rate (NEER) determines the cost of imports to Uganda, whilst the real effective exchange rate (REER) simply adjusts the cost for inflation. An appreciation of the effective exchange rate will increase the cost of imports, which is likely to reduce aggregate demand and thereby dampen growth. This section will review the exchange rate movements on the month.

In December 2012 the Uganda Shilling depreciated by 1.9 percent on a monthly basis and by 9.3 percent on an annual basis, to reach a monthly average mid-rate of Shs. 2,673.48 per US$. The depreciation was despite coffee receipts and festive seasonality boosting dollar supply over the month, and may be attributable to the prevailing bearish sentiment, which combined with an anticipated bullish sentiment in January has encouraged banks to build long dollar positions.

In addition, significant commercial bank purchases of foreign exchange (above US$100,000) were 26 per cent greater than sales in December, which is indicative of subdued dollar demand relative to the excess supply. By comparison, net purchases were only 3 per cent in excess of net sales in November. The Shilling is typically expected to appreciate during December, as the festive season attracts increased dollar inflows, yet the observed depreciation over the month, in contrast to the observed dollar demand and supply conditions, points towards the existence of speculative tendencies.

Figure 4 highlights that the Ugandan Shilling was far less volatile in December that November, although more volatile than all other months in the second half of 2012. It is plausible that the reduced volatility in December may solely result from foreign exchange interventions by the BoU towards the end of November. However, the reduced volatility in December permitted BoU purchases for reserve build-up, which amounted to US$124.0 million. Targeted sales were also necessary over the month, which amounted to US$ 22.5 million; consequently, the Bank's net action in the IFEM in December was a net purchase of US$ 101.4 million.

Figure 4: Volatility of selected currencies

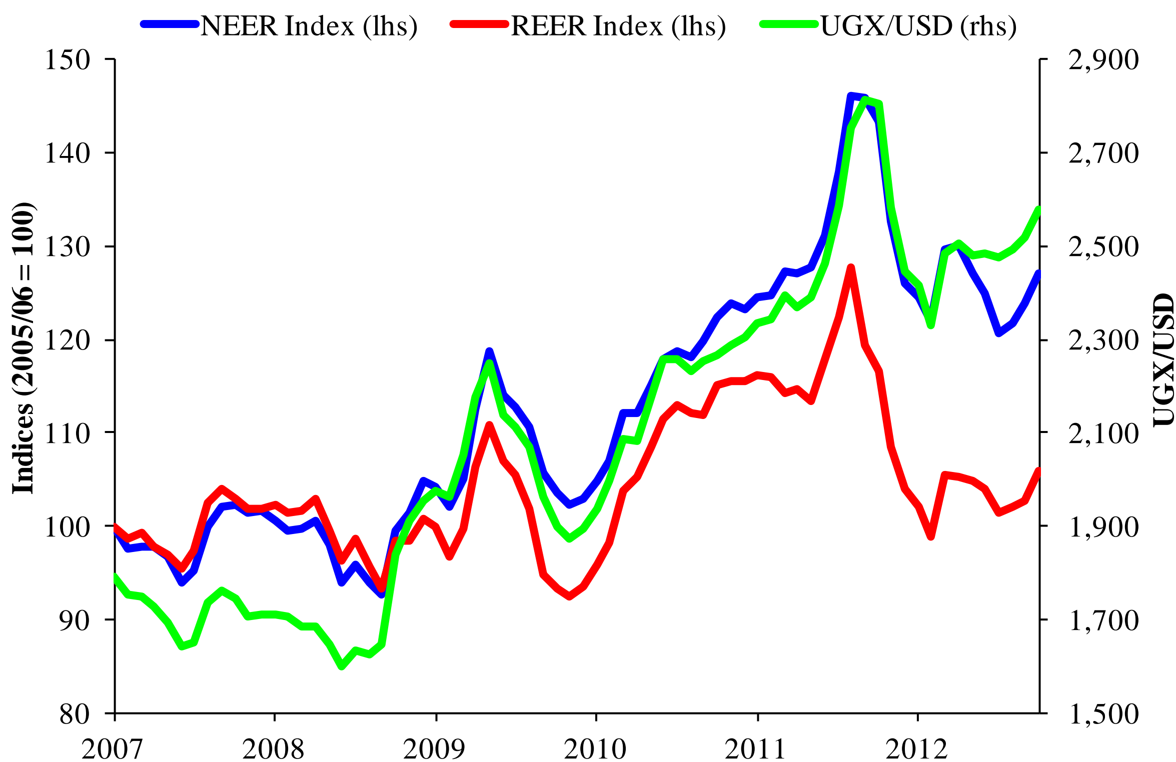


Source: Bank of Uganda

The Nominal Effective Exchange Rate (NEER), which measures the relative value of a country's currency in comparison to a weighted basket of its major trading partners' currencies, depreciated by 2.1 percent over the month of December. Yet the NEER appreciated by 3.8 percent on an annual basis in December. The apparent contradiction in NEER movements simply captures the large depreciation experienced last year, and so distorts the trend somewhat. On a monthly basis, the Ugandan Shilling depreciated against the Euro, the British Pound, the South African Rand and the Kenyan Shilling by 4.2 per cent, 2.5 per cent, 3.1 per cent and 1.5 per cent respectively.

The Real Effective Exchange Rate (REER), which measures the competitiveness of Uganda's currency as compared to its trading partners, depreciated by 0.3 percent over November, yet appreciated by 2.0 percent on an annual basis; the disparity is due to the same reasoning given for that in the NEER. Furthermore, the monthly depreciation was largely on account of the depreciation observed in the NEER. ***Figure 5***, below, illustrates the evolution of the effective exchange rates.

Figure 5: Nominal and Effective Exchange Rates



Source: Bank of Uganda

4.2 Balance of payments

Increased economic activity, deeper financial market structure, stable and positive inflation and exchange rate depreciation will act to attract capital inflows and increase export demand, thereby contributing to a balance of payments surplus. In the long-term, the balance of payments should be neutral, however short-term deviations are to be expected and a surplus is favourable to economic growth. Uganda typically suffers a trade deficit, which consequently demands a net surplus in the capital and financial accounts. However, capital and financial flows tend to be volatile and thus may not necessarily be relied upon to uphold the balance of payments. This section presents the interaction between the current, capital and financial accounts in order to present the overall balance of payments position.

Overall, the balance of payments position deteriorated to a deficit of US$ 59.5 million in November, from a surplus of US$ 14.3 million recorded in October. The deficit drew-down on the BoU's international reserves by US$ 58.1 million; November's overall reserve position equalled US$ 2,844.6 million, which is equivalent to 4.1 months cover in future imports of goods and services. The deficit arose from declines in the current account and in the capital and financial account, as presented in ***table 6*** below.

Table 6: Balance of Payments (US$ millions)

	Nov 11	Jun 12	Jul 12	Aug 12	Sep 12	Oct 12	Nov 12
Current Account Balance	-114.01	-242.71	-288.58	-102.48	-148.38	-148.00	-156.69
Goods Account (Trade Balance)	-206.27	-254.29	-156.97	-197.11	-166.88	-188.46	-198.21
Total Exports (fob)	208.27	254.25	246.79	260.37	252.19	227.62	240.46
Total Imports (fob)	-414.54	-508.54	-403.76	-457.47	-419.07	-416.09	-438.67
Services Account (net)	-32.28	-63.78	-78.21	-3.11	-45.10	-29.07	-39.69
Income Account (net)	-37.44	-51.32	-124.93	-32.78	-35.43	-32.76	-31.11
Current Transfers (net)	161.97	126.67	71.52	130.52	99.02	102.29	112.33
Capital & Financial Account Balance	250.82	262.93	383.59	112.91	101.23	227.57	5.56
Capital Account	5.73	1.48	1.58	14.82	0.34	0.00	0.70
Financial Account	245.09	261.46	382.01	98.09	100.89	227.57	4.85
Direct Investment	74.52	332.08	80.48	80.48	144.93	80.48	80.48
Portfolio Investment	52.58	8.74	-8.20	-28.40	-29.79	-19.73	-29.98
Financial derivatives (net)	1.70	1.46	0.69	-0.31	0.19	-0.24	-1.94
Other Investment	116.29	-80.82	309.03	46.32	-14.44	167.06	-43.71
Errors and Omissions	-51.81	60.88	77.32	-10.60	72.06	-65.26	91.61
Overall balance	84.99	81.10	172.33	-0.16	24.90	14.31	-59.52
Reserves and related items	-84.99	-81.10	-172.33	0.16	-24.90	-14.31	59.52

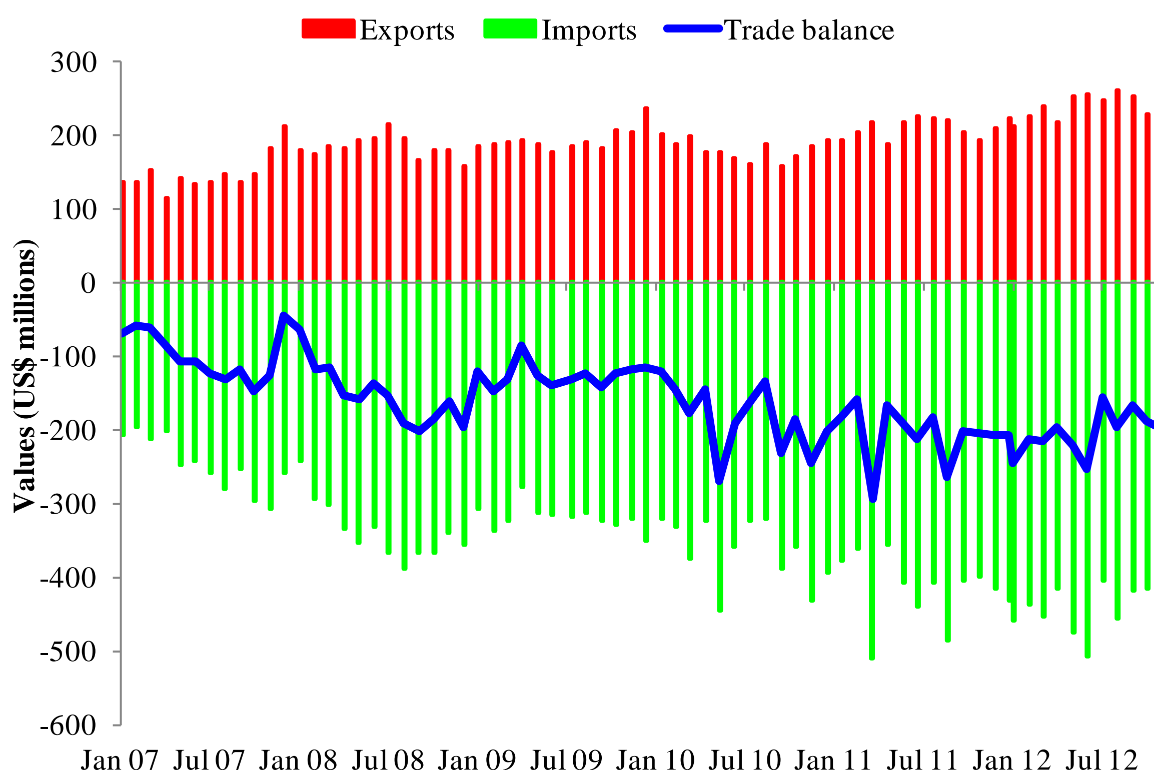
Source: Bank of Uganda

Preliminary data indicates a 5.9[1] per cent worsening of the current account to a deficit of US$ 156.7 million in November, down from the revised deficit of US$ 148.0 million recorded in October. The deterioration mostly stemmed from the capital and financial account balance, which declined by US$ 220 million over the month. Performance of workers' remittances in November is estimated to have grown by 61.1 per cent to US$ 128.1 million, and hence buoyed up the overall position of the current account balance.

Total exports of goods recovered by 5.6 per cent to US$ 240.46 million in November, from a 9.7 per cent fall suffered in October, on account of improved coffee and tobacco exports. Despite the fall in international coffee prices, total coffee exports improved by 21.7 per cent over the month to US$ 28.8 million, as the absolute volume of coffee exports expanded significantly; meanwhile, the value of tobacco exports more than doubled to US$6.3 million. The development of the goods account is shown below in ***figure 6***.

[1] However, note that the series is highly volatile and so 5.9 per cent deterioration may represent relative stability.

Figure 6: The goods account (US$ millions)



Source: Bank of Uganda

However, the total value of imports of goods similarly improved by 5.4 percent over the month, to US$ 438.7 million, which marked a greater absolute increase and thus weakened the overall position of the goods account. The increase in the import bill was mainly driven by Government imports, which more than doubled to US$ 43.2 million in November. Furthermore, whilst Uganda's terms of trade improved by 0.2 per cent in November, compared to 2.0 per cent deterioration in October, it was not sufficient to stimulate a positive correction in the trade balance.

The capital and financial account surplus declined to US$ 5.6 million in November, from US$ 227.6 million recorded for October. Over the month, commercial banks expanded their foreign currency and deposit assets with non-residents by US$ 86.3 million, which played a large role in reducing the capital and financial account; in comparison, commercial banks contracted their asset portfolios with non-residents by a broadly similar amount in October, which had the opposite effect of strengthening the capital and financial account over the previous month. The capital and financial account was further weakened by a decline in loan disbursements to Government, amounting to US$ 42.3 million, and by non-residents running down their domestic currency and deposits assets in Uganda in November.

The current account developments in November are consistent with those observed in the exchange rate. Further deterioration of the current account may exert continued deprecatory pressures on the Ugandan Shilling in the near term. However, workers' remittances are by comparison expected to demonstrate a more optimistic performance over November and December owing to the festive season, which may cushion any near-term deprecatory pressures and buoy up the balance of payments. The overall balance of

payments position over the coming months will depend on the balance between workers' remittances and the terms of trade.

5 Inflation

5.1 Global inflation

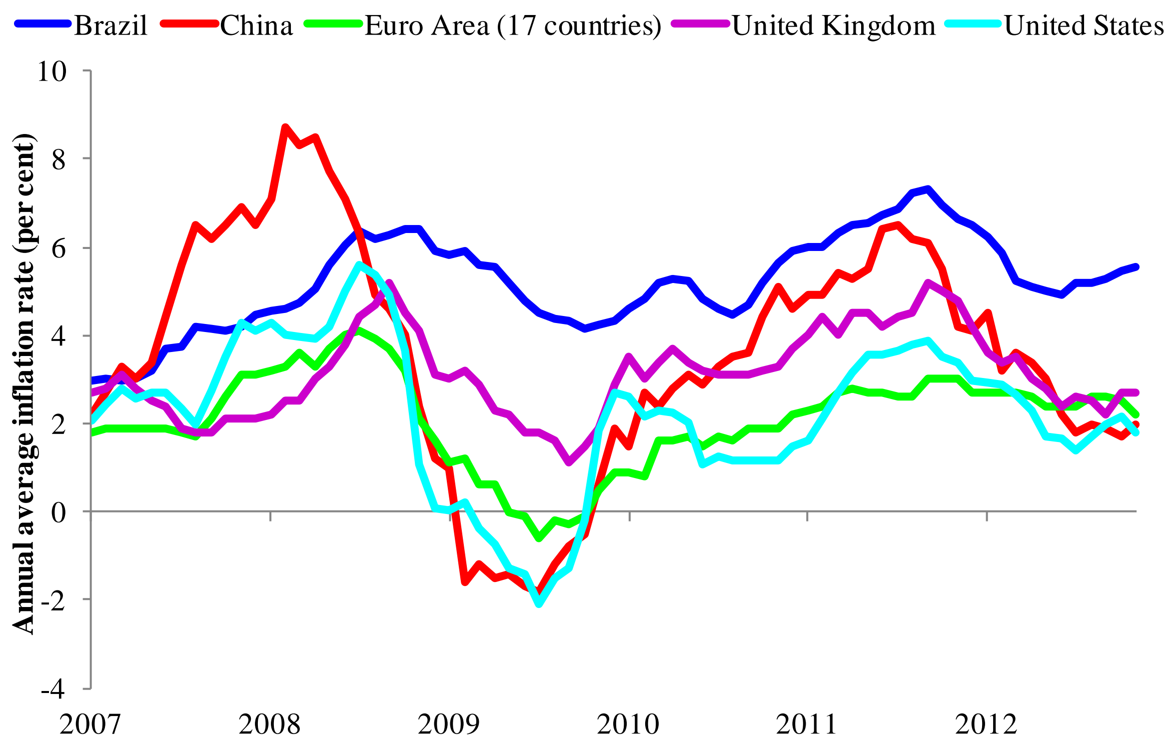
Global inflation tends to have a particularly strong effect upon Ugandan inflation, due to Uganda's trade deficit position. High global inflation may benefit Uganda if it increases the opportunity cost of holding money in domestic currencies, thereby encouraging international investment, and if it induces a depreciation of the Ugandan Shilling, according to the interest rate parity, thereby increasing international demand for Ugandan exports. However, high global inflation may also be detrimental to Uganda as it is likely to filter into import and production-input prices, thereby instigating domestic inflationary pressures. Furthermore, if high global inflation raises international interest rates, then in the short-term it may reduce the appeal of international investment in Uganda, favouring instead nations offering relatively higher interest rates.

Global inflation may also have an indirect affect upon Uganda through affecting global economic activity and investor sentiment. High and volatile inflation tends to reduce market confidence globally.

*Commodity prices are typically the largest contributor to global inflation, and may depict a sensible forecast for future inflationary pressures. Therefore, an analysis of monthly commodity prices is also important to understand global inflationary patterns. The overall effect of global inflationary developments to the Ugandan economy depends upon the underlying inflationary pressures, as will be discussed in the remainder of this section, with particular relevance to commodity prices (**4.1.1**).*

Throughout November, inflation declined within the US and Euro zone, and remained stable in the UK. Lesser inflation may be attributed to reduced fuel prices and stagnant global economic activity, though domestic food prices drove inflation in some countries. Global inflation developments are shown in ***figure 9***, below.

Figure 9: Inflation Developments



Source: Bank of Uganda

The Annual Harmonized Index of Consumer Prices (HICP) showed inflation in the euro zone to ease further to 2.2 percent in November, from 2.5 per cent in October and 2.6 per cent in September. The observed fall in inflation is synonymous with the state of the euro zone economy; as household spending remains constrained by government spending cuts and unemployment rises, disinflation pressures will tend to prevail. However, euro zone inflation remains above the European Central Bank's threshold of 2 percent, which may be further harming households' balance sheets.

Annual inflation in the US declined to 1.8 per cent in November, from 2.2 per cent in October. The fall in inflation was due to a large reduction in fuel prices by 7.4 per cent, which more than offset the 0.2 per cent rise in food prices. Furthermore, businesses largely reported that they were reluctant to raise prices on account of high unemployment and slow wage growth, which also will have helped to contain inflation. The Federal Reserve expects that inflation will remain at, or below, 2 per cent for the next three years and thus that it will have to implement policies, in adjacency with the government, to boost economic growth and to reduce unemployment. To this effect, the US Federal Reserve has recommitted to buy US$ 85 billion worth of Treasury bonds and mortgage backed securities every month in order to decrease long-term interest rates.

In the UK annual CPI inflation remained unchanged at 2.7 per cent in November, as falling fuel prices offset rising food and beverage prices. However, whilst food and beverage inflation maintained above target CPI in November, food and beverage prices actually fell by 1.1 per cent on an annual basis. Market analysts expect inflation to rise in December on account of utility price hikes.

Inflation typically increased amongst the emerging economies in November, particularly in China and Brazil. China's annual CPI inflation rose to 2.0 per cent in November, from 1.7 percent in October, due annual food inflation of 3.0 per cent and stronger economic growth. In particular, industrial output, investment in fixed assets and retail sales were noted to be supporting the stronger economic growth in November. Irrespective of the minor inflation increase, inflation remains below the 4.0 per cent benchmark set by the Chinese government.

India's Wholesale Price Index (WPI), its main measure of inflation, declined further to 7.2 per cent in November, from 7.4 per cent in October, largely because of falling fuel and manufacturing prices. In spite of the decline in inflation, the Central Bank of India is unlikely to cut interest rates as inflation remains above the 'comfort level' of 7.0 per cent. The Central Bank of India has announced that only a sustained drop in inflation might prompt a reduction in the policy rate.

Brazil's annual CPI inflation continued along its recent slow upwards trend in November; inflation rose to 5.5 per cent in November, from 5.4 per cent in October. The rise may be attributed to increased service sector and food prices; in particular, electricity and airfare prices were noted higher. Inflation has continued to trend above the benchmark of 4.5 per cent over the recent period, whilst lacklustre economic growth has made it difficult for the Brazilian central bank to formulate an appropriate monetary policy strategy.

Inflation fell across the East African Community in December, apart from in Uganda and Burundi. Kenya's annual headline inflation fell to 3.2 per cent over the month, largely due to decreases in some food product prices, such as for sifted maize flour and green grams. The most recent CPI releases for Tanzania and Rwanda indicate a downwards trend in November; CPI fell to 12.1 and 4.6 per cent respectively in November, from of 12.9, and 5.4 per cent in October. The decline in inflation is likely to

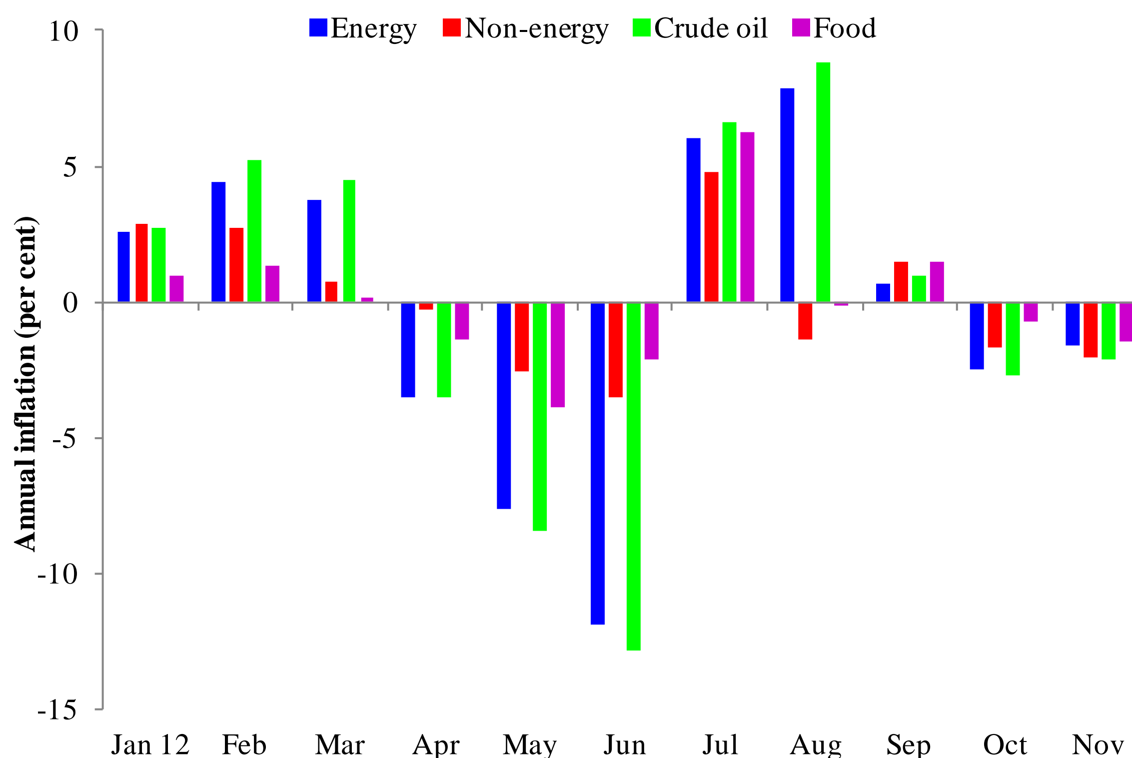
continue into December for Tanzania and Rwanda, given their current deflationary trends. In contrast, inflation in Burundi rose from 11.7 per cent in November to 11.8 percent in December.

Presently, all EAC Central Banks are operating relaxed or unchanged monetary policy stances in accordance with easing inflationary pressures. However, despite the relatively relaxed monetary stances, yields on government securities only fell in Kenya, where the monthly average weighted annualized yield for 91-day Treasury bills declined to 8.2 per cent, from 8.5 percent in November, whilst that of the 364-day tenor remained stable at 11.7 per cent. In Tanzania, the yields on the 91-day and 364-day tenors rose from 11.9 and 13.3 per cent respectively in November, to 11.9 per cent and 13.7 per cent in December. In Rwanda, the yield on the 91-day paper barely changed, rising from 12.5 per cent to 12.6 per cent in December, whilst the 364-day tenor has not been auctioned since September, at which time the yield stood at 12.7 per cent.

5.1.1 Commodity prices

Global commodity prices continued along their downwards trend in November. The World Bank energy and non-energy indices declined by 1.6 per cent and 2.0 per cent respectively, compared to respective contractions of 2.5 per cent and 1.7 per cent in October. The World Bank average crude oil price also declined by 2.2 per cent to US$ 101.1 per barrel in November, whilst Brent crude oil prices stood at US$ 109.7 per barrel, down from US$ 111.9 per barrel in October. World food prices also declined further in November; the Food and Agricultural Organisation's (FAO) Food Index declined by 1.5 per cent to 210.9. According to FAO, the prices of all the major food commodity groups (cereals, oils/fats, meat and sugar) declined, with the exception of dairy. Improved weather conditions boosted food supply, which enabled food price disinflation. According to the International Energy Agency (IEA), the downward revisions to oil demand, due to persistent worries about the global economy, are responsible for the decline in the price of oil. Reduced oil demand has more than offset the impact of the current oil supply disruptions in the Middle East, which may have otherwise generated oil price inflation. Notably, oil production in non-OPEC countries has also increased to offset any potential shortages; maintenance works in the North Sea have been completed and production in the US has expanded. Despite the current production disruptions in Iran, the IEA expects that oil supply in both OPEC and non-OPEC countries may expand. Metal prices also continue to decline due to subdued global economic activity and outlook. The continued decline in commodity prices has subdued global inflation and reduced risks to domestic imported inflation. Developments in commodity prices are shown in ***figure 10*** below.

Figure 10: Main Developments in Commodity Prices



Source: Bank of Uganda

5.2 Domestic inflation

Domestic inflation is necessary to encourage economic growth through promoting investment, employment and monetary policy efficiency. Investment should expand if inflation increases the opportunity cost of holding money. If wages rise, but at a lesser rate than inflation, firm profitability should increase, thereby firms may afford more workers and employment will grow, according to the Philip's Curve. Furthermore, inflation tends to justify slightly elevated interest rates, which creates a larger space for monetary policy to operate, and so adds to its effectiveness. Whilst inflation is necessary to growth, high and volatile inflation may be detrimental through exacerbating shoe-leather and menu costs, through eroding individual's purchasing power and through destroying international confidence in the domestic economy.

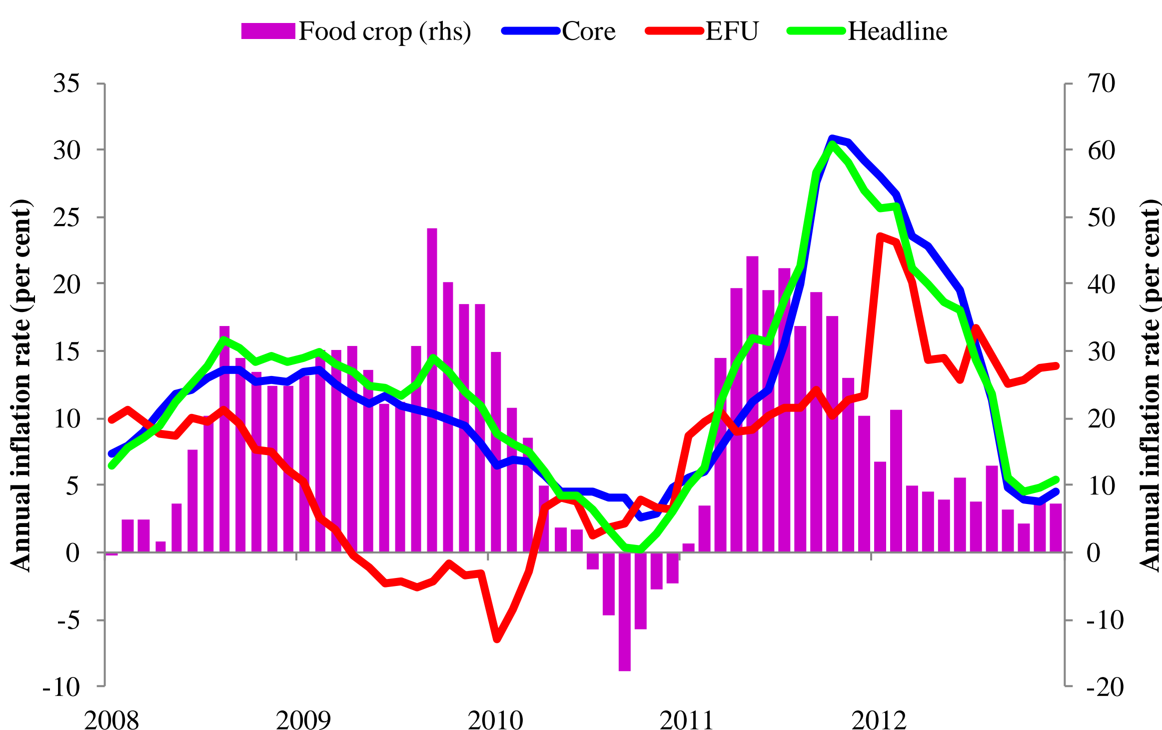
*In Uganda, 5 per cent inflation is targeted to achieve optimal economic growth. However, the stability and predictability of inflation is likely to have larger growth effects. Monetary policy may only affect demand-side inflationary influences, and is unable to alter supply-side-induced inflationary pressures, such as shocks to food production. Yet, if an inflation breakdown illustrates that monetary policy has effective control over demand-induced inflation, supply shocks may have a limited effect upon credibility allowing a stable inflation trajectory. This section will explain the domestic inflation developments upon the month according to demand (**4.2.1**) and supply (**4.2.2**) side influences.*

5.2.1 Consumer prices

Inflationary pressures picked up marginally in December, although they stayed within the BoU's long term target of 5.0 per cent for core inflation (***figure 11*** and ***table 7***). The increase in annual inflation in December remained within the forecast range for November 2012; annual headline and core inflation rose to 5.5 per cent and 4.6 per cent respectively in December, from 4.9 per cent and 3.9 per cent in

November. The prices of beverages and tobacco, rent, fuel and utilities and transport and communication were behind the increase. However, the monthly inflation pick-up may largely be explained through seasonal factors and enhanced demand associated with the festive season, and therefore is not likely to resemble underlying inflationary momentum. Similarly, annual energy, fuel, and utilities (EFU) inflation rose marginally in December to 14.0 per cent, from 13.8 per cent in November. Because international oil prices have remained largely stable, the increase in EFU inflation may partly be attributed to exchange rate movements, in addition to seasonality. However, annual food crops inflation, which had risen by 3.1 percentage points to 7.5 percent in November, decreased slightly to 7.3 percent in December. The deceleration in food crops inflation over the month may be attributed to increased supply to the market, also on account of seasonality.

Figure 11: Annual inflation developments



Source: BoU and UBOS

Despite December's annual inflation pick-up, the monthly inflation rates were lower amongst EFU, food crops and headline inflation, only higher for core inflation. Monthly headline inflation in December was only 0.3 per cent, compared to 0.6 per cent in November. However, monthly core inflation rose to 1.3 per cent in December, from 0.4 per cent in November 2012. The increase in monthly core inflation in December captures the fastest acceleration in inflation since September 2011, when core inflation reached 6.8 percent. Monthly EFU inflation rose to 0.2 per cent in December, down from 0.8 per cent in November; the inflation experienced was on account of higher prices for petrol, diesel, kerosene, and firewood. As aforementioned, the increase in domestic fuel pump prices despite globally stable oil prices may be on account of the Shilling's depreciation.

Monthly food crops inflation decreased to minus 4.5 per cent in December, compared to 1.5 percent in November. Notably, price decreases were registered for matooke, Irish potatoes, pineapples, mangoes, sweet bananas and most fresh vegetables due to the onset of the harvest season. In contrast, prices for chicken and eggplants increased over the month. Food crop prices continue to pose an upward, and uncontrollable, risk to inflation as they are totally reliant upon changing weather patterns.

Table 7: Inflation dissection (annual percentage changes)

	Jul 12	Aug	Sep	Oct	Nov	Dec
	Annual inflation					
Headline	14.3	11.9	5.5	4.5	4.9	5.5
Core	15.4	11.5	4.9	4.0	3.8	4.6
EFU	16.7	14.7	12.6	12.8	13.8	14.0
Food crops	7.5	12.9	6.3	4.4	7.5	7.3
Food	5.4	4.2	-2.8	-2.5	-2.0	0.0
Non-food	19.1	16.0	10.1	8.4	8.6	8.3
Beverages & tobacco	23.6	10.0	6.1	6.2	5.2	8.5
Clothing & footwear	12.4	6.3	2.3	-2.7	-1.2	-3.9
Rent, fuel & utilities	27.0	23.4	10.3	6.0	6.4	7.4
Household & personal goods	15.9	13.1	9.7	7.6	6.3	4.5
Transport & communication	17.4	15.9	4.0	3.6	4.7	5.6
Education	16.9	16.6	16.5	16.5	16.5	16.2
Health, entertainment & others	15.9	13.9	12.2	11.2	11.5	10.2
	Monthly inflation					
Headline	-0.9	0.5	0.8	0.3	0.6	0.3
Core	-0.2	0.3	0.5	0.3	0.4	1.3
EFU	5.0	-1.3	-0.3	0.5	0.8	0.2
Food crops	-5.9	2.4	2.4	0.6	1.5	-4.5
Food	-3.7	1.3	1.0	0.4	0.2	-2.0
Non-food	0.6	0.2	0.7	0.4	0.7	1.5

Source: UBOS

6 Economic outlook

*It takes approximately two years for the effect of monetary policy to be fully realised, and consequently policymakers require a long-term forecast in order to determine the optimal policy framework. Therefore, all economic influences to the Ugandan economy must be appraised to determine the likely economic trajectory and appropriate policy response. This chapter presents the global (**5.1**) and domestic (**5.2**) economic outlook in order to determine the optimal monetary policy response and to explain the actions taken on the month.*

6.1 Global economic outlook

6.1.1 Outlook for economic activity

The global economy has grown at a slow pace throughout 2012, and prospects look likely that growth in Q4 2012 might not have improved. However, reassuringly certain economies may demonstrate greater stability in both their economic performance and outlook. According to the European Central Bank and the Economist Intelligence Unit (EIU), growth is expected to strengthen at a gradual pace in 2013 and to pick-up midyear. Disparities are expected to continue between the advanced and emerging economies, the latter are expected to demonstrate greater resilience to global developments and stronger growth.

Growth in the US might be weighed down by the uncertainty surrounding the fiscal cliff in 2013. Even if growth in the US continues to expand at a moderate pace, it is likely that economic growth will remain below full potential. However, it is not anticipated to improve significantly until at least the second quarter of 2013. Contractionary fiscal policy might be offset by recovery in the housing market and expansionary monetary policy, as the Federal Reserve's third Quantitative Easing program is launched. The EIU have revised their 2012 growth forecast upwards to 2.2, and project that US economic growth will be 2.1 per cent in 2013 and average 2.3 per cent from 2014 to 2017. In addition to real growth concerns, the dollar is expected to face pressure emanating from market nervousness surrounding the fiscal cliff and quantitative easing. Furthermore, since the state of the global economy is expected to improve in the second half of 2013, it is plausible that investors may shift from dollar-denominated assets, to higher-risk and greater yielding assets, thereby exacerbating any existing pressures on the dollar.

In the euro zone, the economic outlook for 2013 remains gloomy; most governments are not expected to meet their 2012 fiscal targets and therefore their austerity budgets are expected to be higher than earlier anticipated for 2013. Although the euro zone's manufacturing sector was portrayed to have improved in November, the sector is in contraction. It is expected that the European Central Bank will need to support domestic demand as a means of sustaining economic growth throughout 2013. Furthermore, the euro is likely to remain under pressure, due to lack of complete resolve surrounding the debt crisis and a very prolonged recession, compared to the rest of the world.

Emerging Asian economies suffered from a combination of weak external and domestic demand throughout 2012. Growth in the region might continue to be constrained by sluggish demand and China's deflationary policies in fear of a potential housing bubble. Nonetheless, China's positive industrial production, retail sales, fixed investment and lending indicators would hint towards an improvement in GDP growth for 2013; the EIU estimate that China's GDP will grow by 8.5 percent over the year ahead.

Brazil has been marred by poor economic data, weak investment and low competitiveness over the recent period, with little signs of improvement. Growth is not expected to fully recover in 2013, and is expected to expand by 3.5 percent over the year.

Lesser oil production in Iran may constrain economic growth in the Middle East and North Africa; however it is also plausible that lesser production in Iran may allow greater oil production amongst neighbouring oil-producing nations. Oil prices are not expected to rise over the coming year due to subdued economic activity and therefore lesser oil demand. Growth in the Middle East and North Africa over 2013 is deemed to be largely a result of oil outturns.

In Sub-Saharan Africa, growth is projected to average 5.2 percent in 2013; though excluding South Africa this figure reaches 6.2 per cent. Growth in the region is expected to be driven by resilient domestic demand, on account of ongoing investment aimed at improving the productive capacity of the region. Furthermore, rising incomes, favourable demographic dynamics, higher remittance inflows, lower interest rates and increased FDI are all expected to support long-term growth in the region.

6.1.2 Inflation outlook

Global inflation has largely fallen over 2012, marked by a decline in oil prices and subdued economic demand, particularly amongst the US and the euro zone. Looking forward, inflation is likely to remain low as the contributing factors are not anticipated to change.

Inflation outturns amongst the emerging economies are less clear. Headline inflation is currently very close to, or marginally above, central bank targets in the majority of emerging economies, and energy and food prices pose a much more significant risk in causing an inflationary spiral amongst these countries than in advanced economies.

Whilst inflationary pressures continue to stabilise within the EAC, there still may only be limited space for further monetary policy to boost economic growth owing to the deprecatory trends of many exchange rates in the region. In the near-term, inflation is anticipated to remain stable throughout the region, though risks remain on the upside.

6.1.3 Key risks and uncertainties

Perhaps the largest risk to the global economy stems from the stability of the euro zone and the repercussion effects it may inflict at a global level; indeed, the EIU anticipate euro zone real GDP growth to contract by 0.2 per cent in 2013. However, other risks may arise if volatility increases in both foreign exchange and global financial markets as investors react to improving global financial market conditions by reducing their risk aversion and Iran's enforced contraction in oil production generates oil price inflation. Furthermore, the enforced oil embargo upon Iran may further deteriorate political relationships and thereby damage market stability through politically judged, irrational economic behaviour.

6.2 Domestic economic outlook

6.2.1 Outlook for economic activity

Uganda is largely a domestic demand-driven economy; there is lesser global demand for Ugandan produced goods, therefore output is typically more driven by domestic demand. Quarterly GDP and CIEA data and the current growth in monetary aggregates signal towards upwards aggregate demand pressures. Yet, the overall level of aggregate demand is expected to remain subdued over the near-term; as a result the negative output gap is expected to persist throughout 2012/13. Subdued aggregate demand and relatively weaker economic confidence is also expected to constrain consumption throughout 2013, though it is expected to improve slightly in 2014. Investment is also likely to remain weak, deterred by

weak demand and high interest rates, which may in turn further dampen labour market conditions and personal consumption.

6.2.2 Inflation outlook

Although inflation fell significantly in 2012, price developments in the last two months may reflect the re-emergence of inflationary pressures. The near-term inflation outlook is conditioned on domestic food production and supply, the impact of exchange rate pass-through and likely trends in global commodity prices. Although food crops contribution to overall inflation has substantially declined, any change in the weather conditions coupled with a rise in demand for food products in the region could reverse this trajectory.

6.2.3 Key risks and uncertainties

Although inflationary pressures are under control, some upside risks remain. The largely stable global commodity prices thus far might suffer due to the revised positive global economic outlook and the increased demand following the resolution of the US fiscal cliff. In addition, the depreciation pressures on the Ugandan shilling experienced in the last two months, if maintained, might also cause upward inflationary pressures. Furthermore, the new proposed pricing of electricity, if adopted, might intensify the exchange rate pass-through and hence exert pressures on overall inflation.

At a regional level, political unrest emanating from the Kenyan presidential elections, slated for March 2013, also bears a risk to Uganda. Domestically, shocks to food prices arising from weather conditions and external shocks to the domestic economy may also raise inflationary pressures, and remain an ongoing risk. In conclusion, inflation is projected to edge upwards slightly in the months ahead, but to remain broadly within the medium term target.

7 Monetary policy decision

The Bank of Uganda seeks to attain low and stable inflation. To achieve this objective, the Bank of Uganda sets the Central Bank Rate, which steers short-term interbank money market rates, which in turn affect long-term interest rates in the economy, subsequently determining the monetary policy transmission into prices and output. After the setting of the Central Bank Rate, the Bank of Uganda then intervenes in financial markets to address a liquidity shortage or excess, and thus improve the channel by which the Central Bank Rate determines the interbank money market rates. This section explains the Bank of Uganda's monthly policy decision given the recent data outturns and projections.

Given the outlook, which predicts moderate, but stable inflation around the medium term target of 5 per cent in 2013, the Bank of Uganda considered the current stance of monetary policy to be sufficiently accommodative and supportive to economic growth, whilst capable of anchoring inflation expectations. Therefore, the Bank of Uganda maintained the Central Bank Rate CBR at 12.0 percent. The band on the CBR was maintained at +/- 3 percentage points on the CBR and the margin on the rediscount rate at 4 percentage points on the CBR. The Rediscount Rate and the Bank Rate remained at 16.0 percent and 17.0 percent, respectively in January 2013.