Bank of Uganda

Monetary Policy Report

July 2013

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1 Overview

In the quarter to June 2013, both annual headline and annual core inflation declined to 3.5 per cent and 5.6 percent from 4.1 per cent and 6.0 per cent respectively, recorded in the quarter to March 2013. The inflation pressures eased due to improved food supply to the markets due to the favourable climatic conditions that contributed towards bumper harvests. Food inflation contributes a large percentage to the total inflation such that a reduced food inflationary pressure had a marked effect on headline inflation.

Likewise, global inflation decreased further in Q2 2013 on account of low commodity prices, weak global demand and low inflation expectations due to central banks' credibility. The WEO estimates that inflation in advanced economies will average 1.7 per cent in 2013 and 2.0 per cent in 2014 mainly on account of Bank of Japan's expansionary monetary policy which has far-reaching global consequences. Inflation in emerging and developing economies is expected to be largely contained due to lower food and energy prices.

IMF, in its July 2013 update of the WEO, revised world GDP growth downwards to 3.1 per cent and 3.8 per cent for 2013 and 2014 respectively, from 3.3 per cent and 4 per cent projected in April 2013. The downward revision was on account of slower growth in key emerging market economies and a protracted recession in the Euro zone. Similarly, growth in emerging markets and developing economies is expected to evolve at a slower pace of 5.0 per cent for 2013 and 5.4 per cent for 2014. Economic growth in China is expected to decelerate to 7.8 percent in 2013 and lower to 7.7 per cent in 2014 due to weak external demand while India is expected to grow at a moderate pace of 5.6 per cent due to infrastructure bottlenecks, supply constraints and subdued investment sentiment. Likewise, growth in Sub-Saharan Africa was revised downwards to 5.1 per cent and 5.9 per cent for 2013 and 2014 respectively, on account of weak external demand, domestic constraints and low commodity prices. Thus, Uganda's external demand is expected to decline on account of reduced external demand.

Fiscal performance was less lucrative in the quarter to May 2013 as compared to the quarter to April 2013 on account of low tax revenue collections and lower external assistance. Government significantly increased the stock of government securities to private sector credit above the 2013 draft debt strategy threshold to reinforce the low external assistance. Going forward, tax revenues are expected to improve in June on account of heightened vigilance by URA in order to bolster fiscal performance in the forthcoming quarter.

The Shilling stabilized in the quarter ending June 2013, having depreciated in May 2013 at a rate of 0.3 per cent. Appreciations at the beginning of the quarter followed reduced bearish sentiments triggered by suspension of budget support by donors, increased inflows from portfolio investors, remittances and exports. On the other hand, the depreciation in May was on account of increased import demand for investment and reversal of portfolio investments following reductions in the Central Bank rate. However, volatility in the Uganda shilling– dollar rate was subdued in June 2013due to BOU interventions and targeted purchases in the Interbank Foreign Exchange Market (IFEM). Regionally, Kenya has been experiencing volatility in the quarter under review as opposed to other EAC currencies which have been generally stable.

Preliminary data indicated an overall deficit of US$ 21.2 million in the quarter to May 2013 on account of the wider current account deficit. The services account also widened its deficit due to a sharp fall in transport receipts and an increase in payments of the same. There was also a weak capital and financial account in the period under review. In the short term, the BoP is likely to come under pressure as a result of: Slow-down growth prospects in China; Inflation in India; and Government's planned investments in the energy sector which will negatively affect the current account as well as the country's reserves as government makes payments to meet its external financing obligations.

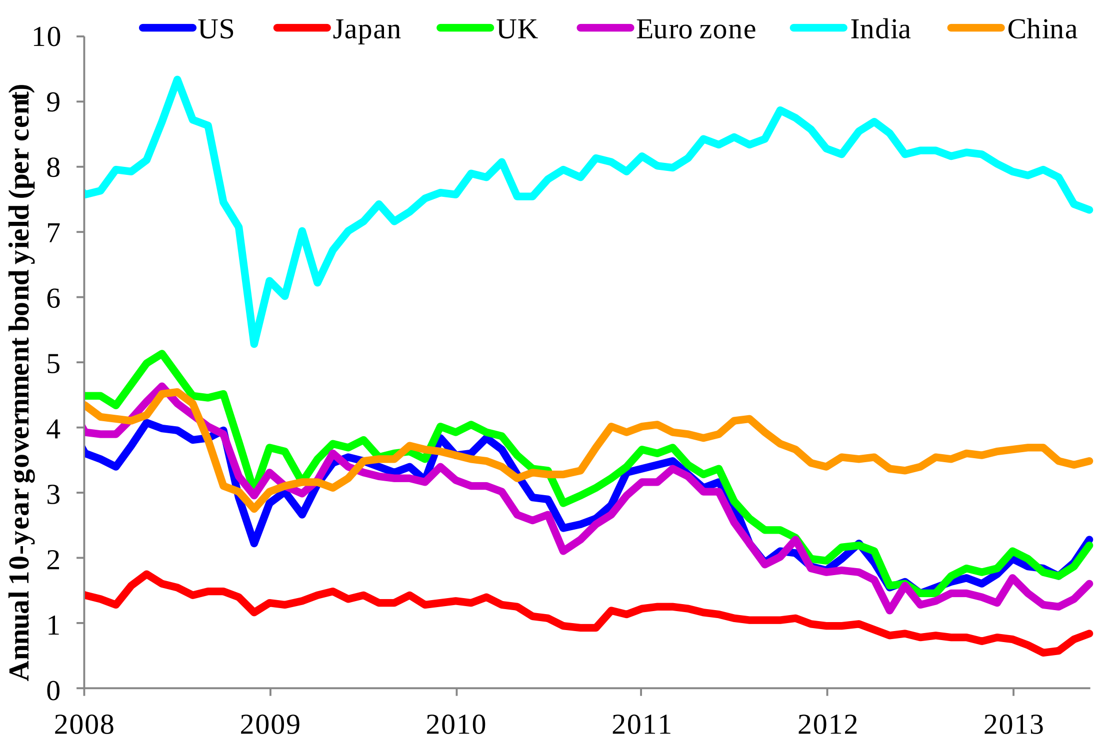
2 Money and credit

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 flow 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.

2.1 Global financial markets

Following relative stability in April and May 2013, global financial market conditions were volatile in June 2013 after the United States (US) Federal Reserve hinted at scaling back its Quantitative Easing (QE) program before the end of 2013. The announcement triggered interest rate rises in advanced economies and increases in risk averseness. Government 10-year bond yields rose in June 2013, in all economies except India, but most notably in the US, UK and the Euro zone where they rose by 0.35, 0.33 and 0.24 percentage points. 10-year Treasury bond yields also rose in Q2 2013, compared to Q1 2013, in advanced economies, driven mainly by developments in June 2013. ***Figure 1*** below shows the trend of 10-year government bond yields in selected countries.

Figure 1: 10-year Treasury bond yields



Source: Bloomberg

The announcement of monetary policy normalization in the US prompted the strengthening of the US Dollar against major world trade currencies. The US Dollar index, which measures the strength of the US Dollar against a basket of other leading global currencies strengthened by 2 per cent in Q2 2013 compared to Q1 2013.

In emerging market economies, the rising advanced economy interest rates and increased risk perception, recorded in June 2013, combined with the deceleration in domestic economic activity, triggered capital outflows as investors who had previously sought higher yields in these economies adjusted their positions. The outflows of capital and the general strengthening of the US Dollar caused a depreciation of the currencies of most emerging market economies in June 2013 and Q2 2013 as a whole. For instance, the currencies of India and South Africa depreciated by 5 per cent and 7.2 per cent, respectively, against the US$ in June 2013 and by 2.2 per cent and 6.1 per cent on quarterly basis in Q2 2013.

The rise in yields of government securities reduces the availability of low cost finance required to back the recovery in global economic activity. However, increase in interest rates in advanced economies increases the investing bank's income and its capability to respond to short term capital outflows.

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 dependent upon 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**) and private sector lending.*

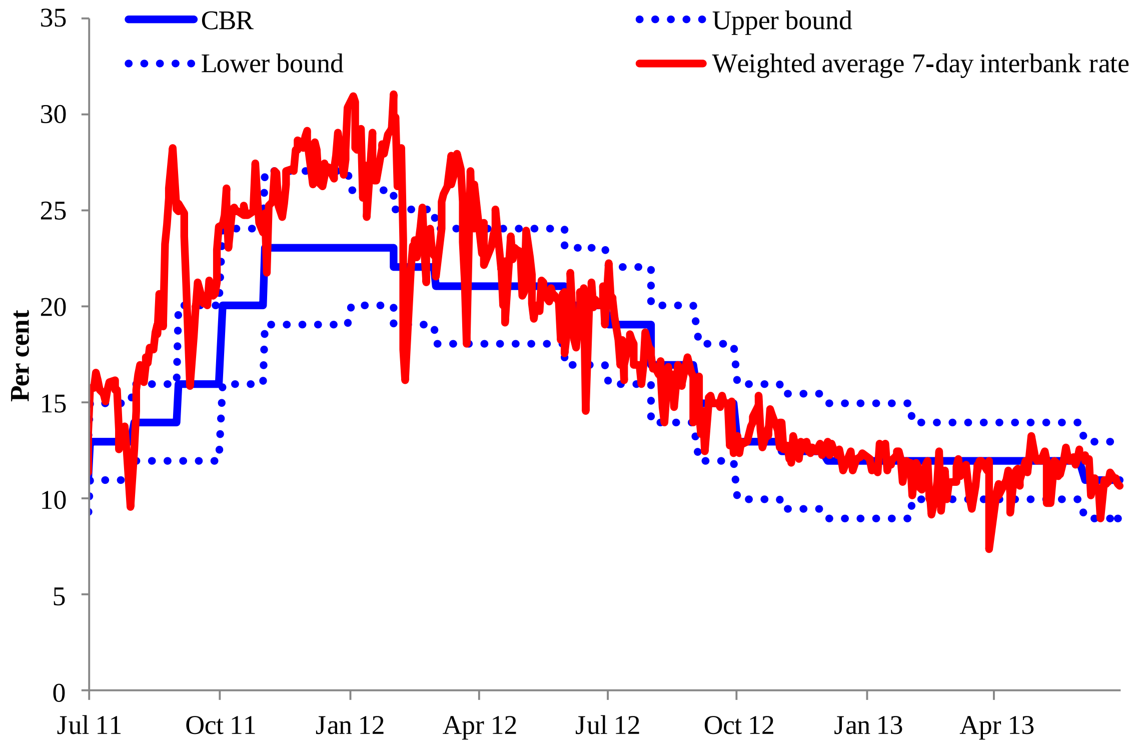
2.2.1 Interbank money markets

Commercial banks' activity in the interbank money market remained robust in the three months to June 2013 with trade volumes increasing by 27 per cent to Shs. 5,102 billion from Shs 4,025 billion in the three months to March 2013. The 1-day trades dominated the trading activity with an average share of 71 per cent over the quarter, increasing to Shs. 3,690 billion from Shs. 2,760 billion in the previous quarter. The 7-day tenor which had a share of 26 per cent of total trading increased to Shs. 1,233 billion from Shs. 1,154 billion during the same period. The dominance of overnight trading goes as far back as Q4 2012 and coincides with prevalence of structural liquidity surplus in the banking system.

In a bid to sterilize the structural liquidity surplus, BoU withdrew Shs. 4,922 billion from the market using the REPO and Deposit Auction instruments; Shs. 543 billion remained outstanding at the end of June. Nevertheless, the monetary base fell by Shs. 205 billion in the quarter to June, following a similar decline in the previous quarter. Consequently, commercial banks' excess reserves rose to Shs. 92 billion in June, from Shs. 74 billion in March.

The weighted average 7-day interbank rate trended within the lower bound of the CBR in April and May, owing to structural liquidity surplus; but was slightly above the CBR in the first week of June and trended close to the CBR thereafter. The 7-day weighted interbank money market rate averaged 11.4 per cent and 11.8 percent in April and May respectively when the CBR was 12.0 per cent. It then dropped to an average of 11.2 per cent in June against the CBR of 11.0 per cent. Similarly, the overnight interbank rates declined to an average of 7.7 per cent in June from 9.0 per cent in May and 8.1 per cent in April. ***Figure 2,*** below, presents the evolution of the 7-day interbank money market rate with the monetary stance.

Figure 2: Evolution of the 7-day interbank rate



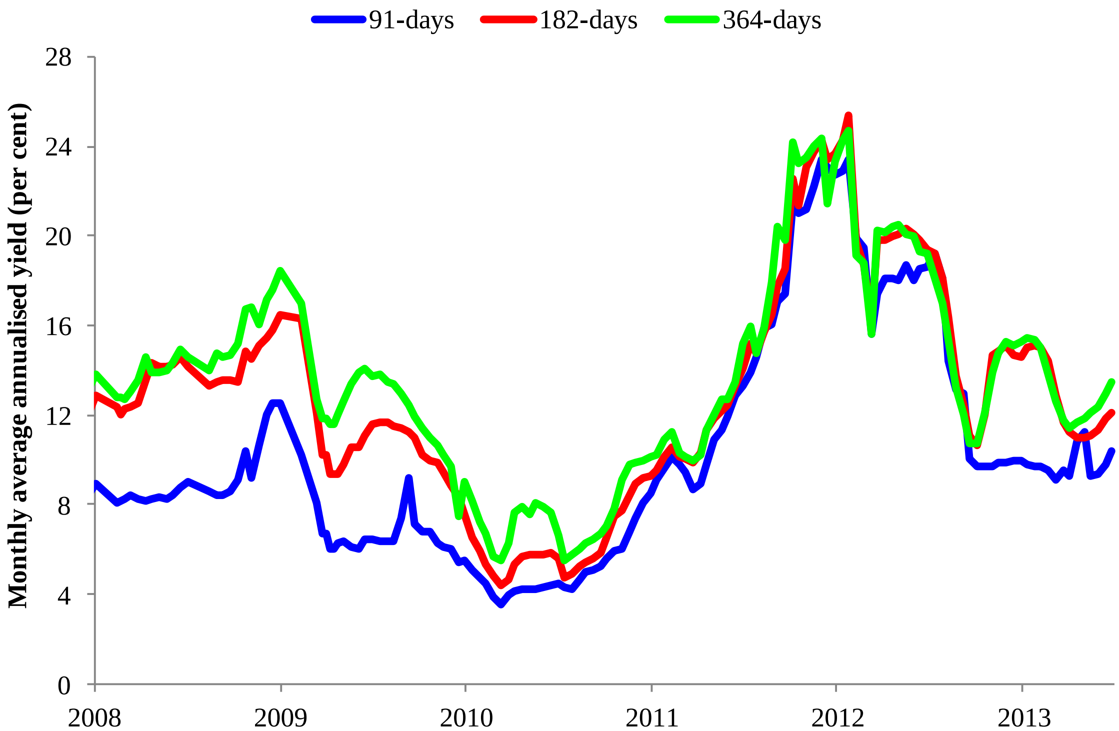
Source: Bank of Uganda

2.2.2 Treasury securities market

In line with fiscal financing needs, BOU conducted seven Treasury bill auctions and three Treasury bond auctions during the quarter ended June 2013. These auctions registered lower yields for all tenors relative to the previous quarter save for the 91-day Treasury bill which rose to 10.0 per cent from an average of 9.6 per cent in the quarter ended March. Weighted average annualized yields for the 182-day and 364-day treasury papers fell to 11.4 per cent and 12.3 per cent respectively in June, from respective rates of 14.0 per cent and 14.0 per cent in March 2013. Although yields fell on average during the quarter, they were highest in June following increased issuances of Treasury bills during that month. Out of the Shs. 760 billion issued in the quarter ended June, which is Shs. 144 billion higher than the amount issued in the previous quarter, Shs. 240 billion was issued in the month of June.

Likewise, Shs. 300 billion out of the total bond issuances of Shs. 700 billion were issued in June, leading to higher yields in June relative to other months. Nevertheless, the 3-year and 5-year Treasury bond yields fell on average to 13.4 per cent and 14.4 per cent respectively from 14.7 per cent and 14.5 per cent. There was no bond auction of a 10-year tenor while the 2-year bond yield rose to 13.6 per cent from 12.3 per cent in the previous quarter. Generally, the yields reflect lower inflation expectations going forward. However, the trend is likely to be reversed if there is substantial government paper issuance in the near term. ***Figure 3,*** below, highlights the trend in Treasury bill yields.

Figure 3: Treasury bill yields



Source: Bank of Uganda

Like in the primary market, secondary market yields for treasury securities fell during the quarter to June 2013 with exception of the less than 91-day paper. Annualized rates for securities of less than 182-days and less than 364-days declined to 11.1 per cent and 12.2 per cent respectively, compared to respective rates of 13.5 per cent and 14.6 per cent in the previous quarter. However, annualized rates for securities of less than 91-days rose to 15.9 percent from 13.8 per cent in the previous quarter.

The weighted average annualized yields for papers of less than 91-days may be heavily skewed due to low trading activity. The overall volume of Treasury bills traded in the secondary market decreased to Shs. 151.9 billion in the quarter to June 2013, from Shs. 273.3 billion in March. The bulk of the trading was on securities of less than 364-days. ***Table 1*** presents a summary of secondary market activity for Treasury bills in the quarter ended June 2013.

Table 1: Secondary Market Activity on Treasury bills

	91-days		182-days		364-days	
Bid and offer yield-to-maturity rates (per cent per annum)						
	Bid	**Offer**	**Bid**	**Offer**	**Bid**	**Offer**
Minimum	8.86	8.22	10.60	10.49	11.02	10.90
Maximum	9.71	10.14	11.77	11.60	12.98	12.86
Simple average	9.17	9.04	10.98	10.84	11.59	11.44
Total trading activity						
Transactions	29.30		3.23		119.50	
Horizontal repos	0.00		0.00		0.00	
Outright sales	29.30		3.23		119.50	
Average discount rate	13.97		10.24		10.97	
Average yield-to-maturity	15.91		11.06		12.20	

Source: Bank of Uganda

There was notable preference for longer dated paper as the turnover in bonds outstripped that of bills. Secondary market trading for Treasury bonds rose over the quarter to June 2013 to Shs. 490.6 billion, from Shs. 233.3 billion the previous quarter. The average yield to maturity of Treasury Bonds of less than 2-years, less than 3-years, less than 5-years and less than 10-years stood at 11.4 per cent, 13.4 per cent, 13.7 per cent and 13.9 per cent respectively in the quarter. ***Table 2*** presents a summary of indicative bid and offer quotes and the Treasury bond secondary market trading.

Table 2: Summary of rates in the Treasury bond secondary market

	2-year		3-year		5-year		10-year	
Bid and offer yield-to-maturity rates (per cent per annum)								
	Bid	**Offer**	**Bid**	**Offer**	**Bid**	**Offer**	**Bid**	**Offer**
Minimum	11.9	11.5	12.1	12	12.5	11.6	14	13.15
Maximum	14.05	13.9	14.6	14.5	14.75	14.65	14.9	14.8
Simple average	12.42	12.3	13.01	12.88	13.38	13.25	14.17	14.05
Total trading activity								
Outright sales	231.5		187.99		233.9		68.42	
Average yield-to-maturity	11.37		13.4		13.74		13.87	

Source: Bank of Uganda

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

The cost of local currency denominated credit has been gradually falling since January 2012 in line with the monetary policy stance. Despite the fall, lending rates on local currency denominated credit remain persistently high relative to those charged on loans offered by commercial banks in other East African Countries (EACs). In the three months to May 2013, the weighted average lending rates on Shilling loans averaged 24.0 per cent compared to 24.8 per cent and 26.8 per cent in the three months to February 2013 and May 2012 respectively. In comparison, interest rates on foreign currency loans are lower than those charged on shilling loans and averaged 10 per cent, 9.3 per cent and 9.2 percent respectively in the three months to May 2013, February 2013 and May 2012.

Banks have in the recent past attributed and continue to point expensive shilling denominated loans to the high cost of deposit mobilization; indeed, the average shilling time deposit rate for the three months to May 2012 was 19.9 per cent but gradually came down to an average of 13.1 per cent and 11.2 per cent for the three months to February 2013 and May 2013 respectively. The foreign currency time deposit rate has on the other hand continued to register higher percentages in 2013 compared to 2012. Having averaged at 4.2 per cent in the three months to May 2012, rose to a weighted average of 6.8 per cent in January 2013 and has averaged 5.3 per cent and 4.9 per cent respectively, in the three months to February and May 2013. The rise in the time deposit rates especially on foreign currency deposits stresses the need to raise more foreign currency deposits so as to meet the demand for foreign currency loans.

This increased demand was spurred by the low cost of foreign currency loans and as a result, pushed the lending ratio close to the statutory rate of 80 per cent for shilling loans and over the prudential rate of 82.5 for foreign currency loans respectively. In the three months to May 2013, the loan to deposit ratio for all deposit-taking institutions supervised by the BoU averaged 74.8 per cent and 98.6 per cent for local currency and foreign loans respectively. The rise in the weighted average foreign currency time deposit rate notwithstanding, foreign currency time deposits remain favourable to the borrower especially with a relatively stable exchange rate over the period. This however, poses a dollarization risk as Other Depository Corporations have to increase foreign currency liabilities if they are to lend more. ***Table 3*** presents commercial banks' monthly weighted average interest rates.

Table 3: Banks' weighted average lending and deposit rates

	Domestic currency denominated loans			Foreign currency denominated loans		
	Average lending rate	Time deposit rate	Spread	Average lending rate	Time deposit rate	Spread
Sep 12	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	23.7	10.8	12.9	10.4	2.6	7.8
Dec	24.8	12.7	12.1	8.8	4.4	4.4
Jan 13	24.2	13.4	10.9	9.8	6.8	3.0
Feb	24.3	13.2	11.1	9.3	4.8	4.5
Mar	24.0	11.9	12.1	9.9	4.7	5.2
Apr	24.6	10.0	14.7	10.3	5.0	5.3
May	23.5	11.8	11.7	9.9	5.0	5.0
Average rates						
2012	26.2	16.2	9.9	9.4	4.2	5.2
Apr-May 12	26.4	18.0	8.4	8.8	6.0	2.8
Oct-Dec 12	24.5	12.1	12.4	10.0	3.8	6.1
Jan-Mar 13	24.2	12.8	11.3	9.7	5.4	4.3
Apr-May 13	24.0	10.9	13.2	10.1	5.0	5.1

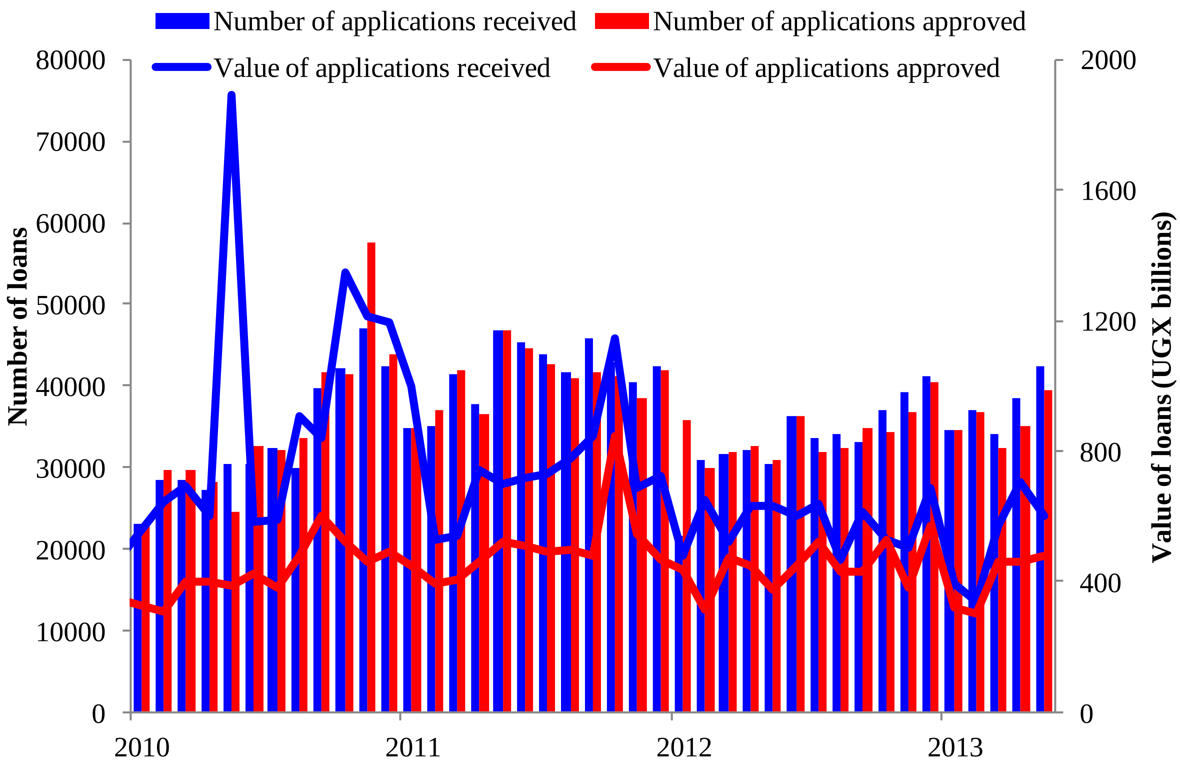
In May 2013, the prime lending rate[1] (PLR) for all commercial banks was a simple average of 21.4 per cent. According to the indicative PLRs reported by banks for June 2013 relative to the simple average for May 2013, 11 banks would charge lower PLRs, 1 bank would charge a higher PLR of more than 2 percentage points and 11 banks would charge higher PLRs of between 1-2 percentage points. With the banks that expect to charge lower PLRs almost as equal as those that intend to maintain or even raise them, lending rates are likely to remain sticky in the near term. Persistently high lending rates on Shilling denominated loans are detrimental to lending and remain a downside risk to economic activity and also pose a risk of dollarization to the economy. The BoU continues to use moral suasion as way of pursuing banks to reduce lending rates on shilling denominated loans.

2.3.2 Loan supply and demand

In the three months to May 2013, the number of loan applications (proxy for demand for credit) increased to 115,036 applications from 112,771 applications received in the previous quarter. Contrary, loan approvals (proxy for credit supply) fell to 107,086 in March-May from 111,635 in the previous quarter. The lower credit approvals relative to credit applications received (even if they do not necessarily have to be at par) reflects the degree of information asymmetry. A summary of loan applications and approvals is shown in ***figure 4.***

[1] The interest rate commercial banks charge their best customers.

Figure 4: Loan applications and approvals



Source: Bank of Uganda

In terms of loan value, Shs. 1,877 billion was the total amount applied for during March-May while Shs. 1,404 billion was approved during the same period. In the three months to February, the loan amount applied for was Shs. 1,417 billion while Shs. 1,191 billion was approved during the same period. The lower credit approved relative to the amount demanded signals a possibility of credit rationing by deposit-taking institutions given the borrowing sectors. In the three months to May, the Building, Mortgage, Construction & Real Estate and Trade sectors have dominated lending with an average share of 23 per cent and 22 percent respectively whereas they account for 55 per cent of total non-performing loans[2].

2.3.3 Loan Extensions and Recoveries

An analysis of the loans extended also confirms that credit supply has been increasing albeit lower than loan recoveries. In the three months to May, credit extended by all depository taking institutions stood at Shs. 2,440 billion; Shs. 163 billion lower than the loan recoveries for the same period. In the previous quarter, Shs. 2,691 billion was extended and this was Shs. 102 billion more than the loans that were recovered during that period. The lower credit extension versus credit recovery in the quarter ended May is most likely due to increased risk aversion by banks following lower loan quality concerns, the NPA[3] ratio increased to 4.7 per cent in March 2013 from 4.2 percent in December 2012.

Foreign currency lending which has been on an upward trend till December 2012, presented positive net recoveries equal to Shs. 317 billion in the quarter ended May, as loan recoveries increased and loan

2 As at March 2013
[3] NPA Ratio is the share of Non Performing Loans in Total Loans.

extensions fell. Shilling denominated lending, on the other hand, reflected a net extension of Shs. 154 million in the same period, driven by greater loan extensions versus lesser loan recoveries. The positive loan recoveries in Shilling denominated loans relative to those of foreign loans reinforces the possibility that banks' foreign loans peaked with any additional borrowing calling for increased foreign currency deposits. The growth of Shilling denominated loan extensions versus the decline in foreign currency denominated loan extensions notwithstanding, increasing disbursement of foreign exchange loans could expose businesses to exchange rate depreciation risks. ***Table 4*** presents net loan extensions in foreign and domestic currency.

Table 4: Loan Recoveries and Extensions

	Domestic currency denominated			Foreign currency denominated		
	Extensions	Recoveries	Net extensions	Extensions	Recoveries	Net extensions
Sep 12	418.3	-431.9	-13.6	323.3	-324.7	-1.5
Oct	529.4	-516.5	12.9	370.9	-236.4	134.5
Nov	439.6	-404.0	35.6	438.2	-436.6	1.6
Dec	508.4	-518.2	-9.8	540.8	-494.0	46.8
Jan 13	432.0	-349.9	82.1	395.6	-436.6	-41.0
Feb	409.2	-426.7	-17.5	405.3	-364.8	40.5
Mar	376.0	-342.2	33.8	323.8	-474.0	-150.2
Apr	515.0	-426.0	89.0	377.0	-440.0	-63.0
May	472.0	-442.0	30.0	375.0	-479.0	-104.0

Source: Bank of Uganda

With lower credit supply noted in the previous sections for the quarter ended May relative to the previous quarter, the stock of Private Sector Credit (PSC) declined in the same period following a slowdown in foreign currency denominated loans. Quarterly PSC growth which has been declining since March 2013 stood at *minus* 2.3 per cent in May, compared to 1.5 per cent in February. In annual terms, PSC stock grew by 6.5 per cent lower than 12.9 per cent noted in February 2013. The slower growth in PSC is attributable to the decline in foreign currency denominated loans. Foreign currency denominated loans grew by 25.9 per cent on an annual basis in May, much lower than the 52.1 per cent growth registered in February, whilst Shilling denominated loans declined by 2.1 per cent from a 3.3 per cent decline over the same period.

On a quarterly basis, foreign currency denominated loans declined by 5.7 per cent in May contrary to the growth of 5.7 per cent registered in February, whilst Shilling denominated loans grew by 0.4 per cent contrary to the decline of 0.7 per cent over the same period. The fall in credit in the three months to May is mainly attributed to increased risk aversion by banks and the high cost of credit on shilling loans that have constrained supply and demand respectively. The closure of the land registry office which had adversely affected lending in the previous quarter is no longer a major factor as the offices are now fully operational. ***Table 5***, below, presents lending to the private sector.

Table 5: Private Sector Credit Growth by Currency

	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)
Sep 12	1.7	-0.5	5.9	2.9	4.4	-5.0	27.1	42.1
Oct	3.7	-1.7	14.8	10.1	7.5	-7.7	48.5	49.0
Nov	5.7	-0.7	18.1	10.2	9.0	-7.1	50.2	43.3
Dec	6.1	-0.3	18.0	11.8	11.8	-5.9	56.3	45.0
Jan 13	4.1	1.6	8.8	5.5	13.4	-3.9	58.6	38.5
Feb	1.5	-0.7	5.7	7.5	12.9	-3.3	52.1	36.5
Mar	-1.7	-1.3	-1.9	1.6	8.1	-2.9	31.2	27.3
Apr	-1.3	-0.7	-2.6	-0.1	7.9	-1.5	27.7	23.2
May	-2.3	0.4	-5.7	-3.9	6.5	-2.1	25.9	20.7

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 as well as poor economic growth.

In line with BoU's monetary operations in May that resulted into increased liquidity from REPO maturities, base money grew by 2.8 per cent, compared to a decline of 9.1 per cent in April. On a monthly basis, M1, M2 and M3 grew by 1.5 per cent, 2.3per cent and 2.3 per cent respectively in May, compared to respective declines of 5.2 per cent, 2.2 per cent and 1.8 per cent respectively in April. This rise in monetary aggregates was mainly on account of a 3.3 percent increase in time and savings deposits.

On a quarterly basis, M1, M2 and M3 declined by 4.6 per cent, 0.3 per cent and 0.9 per cent respectively in the quarter to May, compared to respective declines of 4.8 per cent, 0.2 per cent and 1.2 per cent respectively in the three months to April. The decline in monetary aggregates was largely due to a fall in demand deposits of 4.8 per cent and a decline of 2.6 per cent in foreign currency deposits following an exchange rate appreciation. Time & savings deposits however, increased by 6.3 per cent over the same period. Quarterly developments in monetary aggregates are shown in ***table 6***.

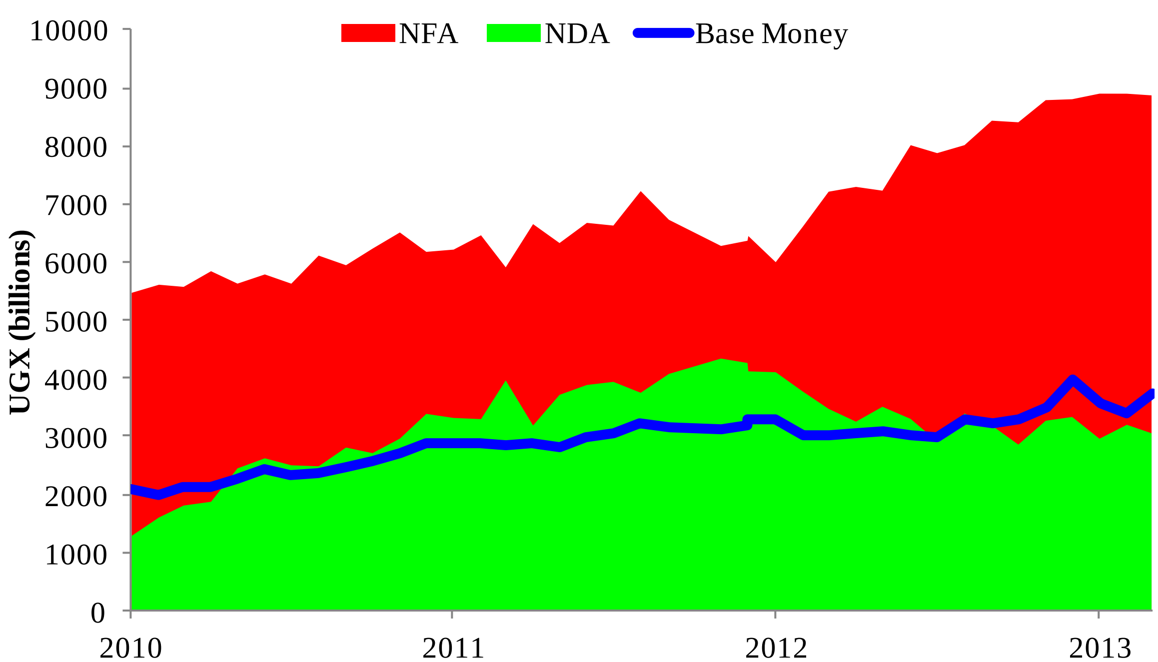
Table 6: Evolution of Monetary Aggregates and Private Sector Deposits

		Monetary Aggregates			Private Sector Deposits			
	Base Money	M1	M2	M3	CIC	Demand	Time & Savings	Forex
Jul 12	-1.4	-5.3	-0.1	2.3	2.7	-10.9	7.3	8.5
Aug	7.7	4.0	5.5	6.2	8.7	0.7	7.7	8.1
Sep	7.2	8.1	6.6	2.7	1.8	13.0	4.6	-5.6
Oct	10.1	11.6	5.0	4.4	2.3	19.2	-3.3	3.1
Nov	5.5	14.9	6.6	5.7	6.7	21.0	-4.4	3.5
Dec	23.1	13.2	7.5	4.5	13.8	12.8	-0.5	-2.9
Jan 13	8.6	11.7	7.6	5.3	12.7	11.0	1.6	-0.3
Feb	-2.4	0.4	1.2	0.3	-0.1	0.7	2.6	-2.0
Mar	-5.9	-1.7	-0.6	-1.8	-4.2	0.0	1.2	-4.9
Apr	-5.1	-4.8	-0.2	-1.2	-8.3	-2.2	7.2	-4.0
May	2.7	-4.6	-0.3	-0.9	-4.3	-4.8	6.3	-2.6

Source: Bank of Uganda

On an annual basis, monetary aggregates followed a similar trend with M1, M2 and M3 growing by 14.4 per cent, 13.5 per cent and 11.6 per cent respectively. The annual growth in monetary aggregates since November 2012 has to a large extent been driven by expansion of the Central Banks' Net Foreign Assets (NFA). In May 2013, NFA of BoU grew by 21.0 per cent while NFA of other deposit-taking Institutions grew by 10.7 per cent. The trend of base money versus the banking system's NFA and NDA is shown in ***figure 5.***

Figure 5: Evolution of base money and its components



Source: Bank of Uganda

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.

3.1.1 Real 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.

In the quarter ended June 2013, global economic activity remained positive but weak and prospects for economic recovery in 2013 continued to dim. Growth indicators such as the JP Morgan Global All-Industry Output index measured global manufacturing and service sector activity at a lower average reading of 52.1 for Q2 2013, from 53 recorded in Q1 2013, indicating growth in global economic activity but at a declining pace. The slower pace of increase was driven mainly by deceleration in service sector growth in the United States and contraction in China's manufacturing activity. Job creation was positive during the quarter and the level of new business orders increased. International trade volumes, as shown in ***Table 7***, also indicate global trade activity growing at a weak pace.

Table 7: International Merchandise Trade Flows (Volume Indices 2005=100)

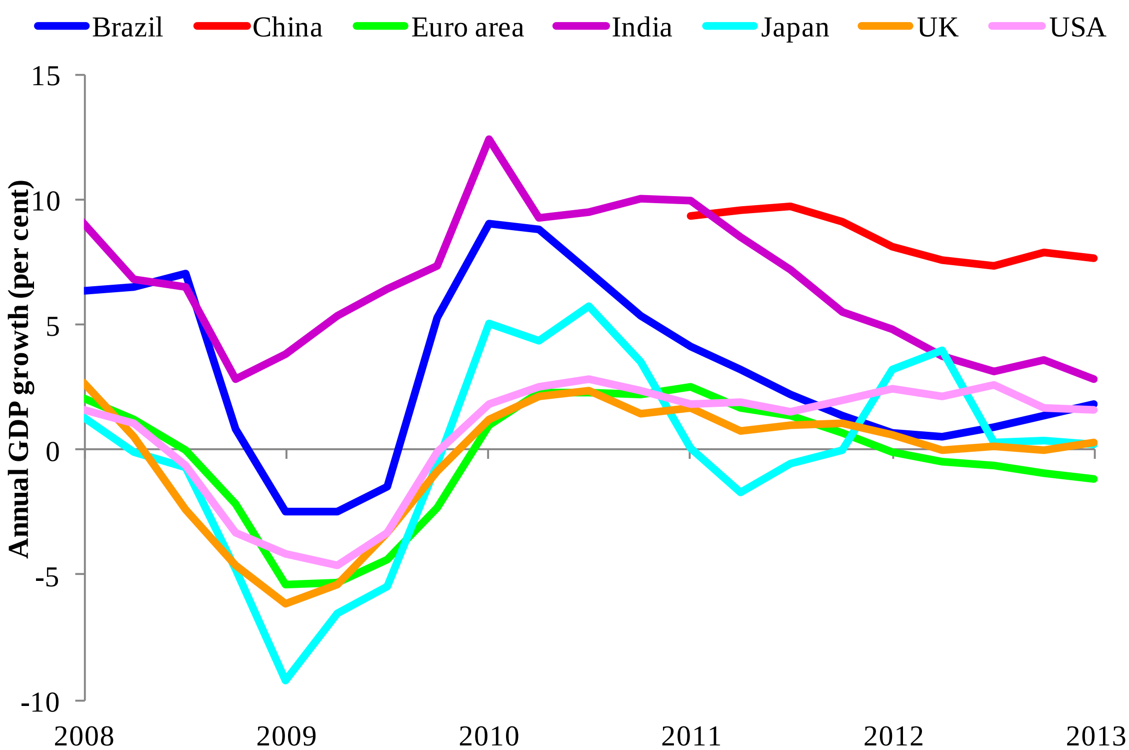
	2012		2013		Growth in 2013 Q1	
	Q1	Q4	Q1	April	Quarterly growth	Annual growth
World trade	126.9	128.3	129.1	130.3	0.6	1.7
World imports	125.1	126.8	127.2	128.2	0.4	1.8
Advanced economies	105.7	103.8	103.5	103.1	-0.3	-2.0
United States	105.6	106.1	105.2	105.5	-0.9	-0.4
Japan	105.8	103.5	106.7	104.8	3.1	0.9
Euro area	104.3	100.8	101	100.2	0.1	-3.2
Emerging economies	158.7	166.6	168.4	171.7	1.1	6.1
Emerging Asia	156.6	168.4	167.7	170.9	-0.4	7.1
Africa & Middle East	164.5	168.7	172.2	175.2	2.1	4.7
World exports	128.7	129.8	131	132.4	0.9	1.7
Advanced economies	112.9	110.9	112.1	113.3	1.1	-0.7
United States	136.6	137	136.9	138.6	0.0	0.3
Japan	116.8	108.8	110.4	113.7	1.5	-5.5
Euro area	111.2	109.1	110.5	110.4	1.2	-0.6
Emerging economies	151.2	156.5	157.6	159.4	0.7	4.3
Emerging Asia	168.9	179.1	180.5	181.7	0.8	6.9
Africa & Middle East	110	108.1	109.6	110.7	1.3	-0.4

Source: CPB World Trade Monitor

According to the International Monetary Fund's July 2013 update to the World Economic Outlook, the weak global economic recovery observed so far in 2013 is on account of a deeper than expected recession in the Euro zone and deceleration of economic activity in key emerging market economies due to infrastructure constraints, weak external demand and low commodity prices. The recession in the Euro zone has been protracted by tight fiscal and financial conditions. While the US has recorded positive economic performance in the first half of 2013, the expansion has been at a slower than anticipated rate largely due to the fiscal consolidation drive which tapered the growth in private demand. Japan has recorded stronger than projected economic activity in the first half of 2013, driven mainly by the aggressive monetary easing program announced by the Bank of Japan in April 2013 which has so far weakened the Yen and improved net exports.

The weaker than projected economic performance of key emerging countries is expected to dampen growth in sub-Saharan African economies, most of which are Uganda's export destinations. The weak external demand for Uganda's exports poses a risk to economic growth if growth in domestic demand does not pick up the slack. ***Figure 6*** presents the trend of annual GDP growth for selected countries.

Figure 6: Annual real GDP growth



Source: OECD Statistics

3.2 Domestic economic 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 Real economic activity

Economic activity is measured using GDP figures. 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 9 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, yet 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 which provides information on economic developments in the country on a more timely and frequent basis compared to actual GDP. The monthly CIEA[4] rose by 0.3% from 159.8 in April 2013 (revised) to 160.35 in May 2013 implying growth but at a declining rate towards the close of FY 2012/13 (***see figure 7***). The observed slight improvement in monthly economic activity is attributed to an increase in mainly exports which contributed 0.14 percentage points to aggregate growth. On quarterly basis as estimated by UBOS, the level of economic activity reduced by 0.4 per cent in the quarter ending March compared to 1.6 per cent growth in the same period last year. However, CIEA estimated a 1.9 per cent increase in activity for the same quarter suggesting a dampening of the economic development from what had been forecast. Forecasts by the CIEA for the quarter ending June 2013 indicate a growth of 1.2 per cent. (***See Figure 8***)

[4] The index aggregates Trend cycle (*data excluding seasonal and calendar effects*) estimates of real data on excise duty, VAT, Government Current expenditure, government development expenditure, private sector import of capital goods, total exports and imports.
[5] Please note that the index is intended to show the direction of growth as opposed to its magnitude.

Figure 7: Monthly CIEA

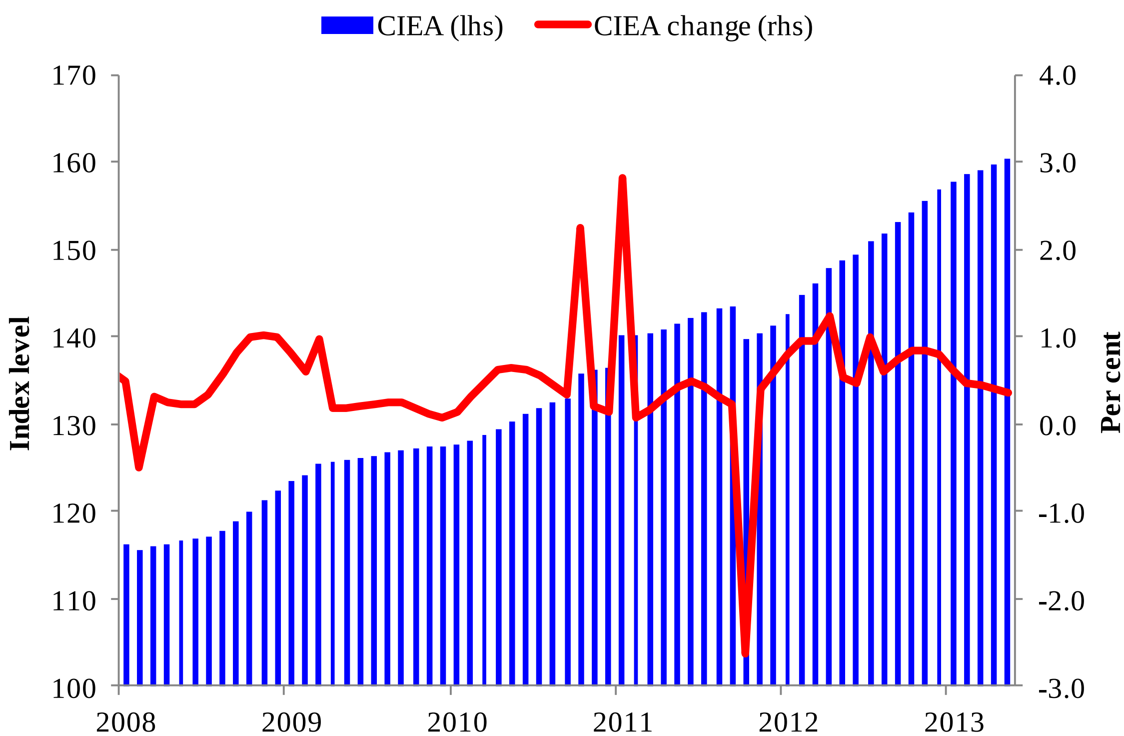
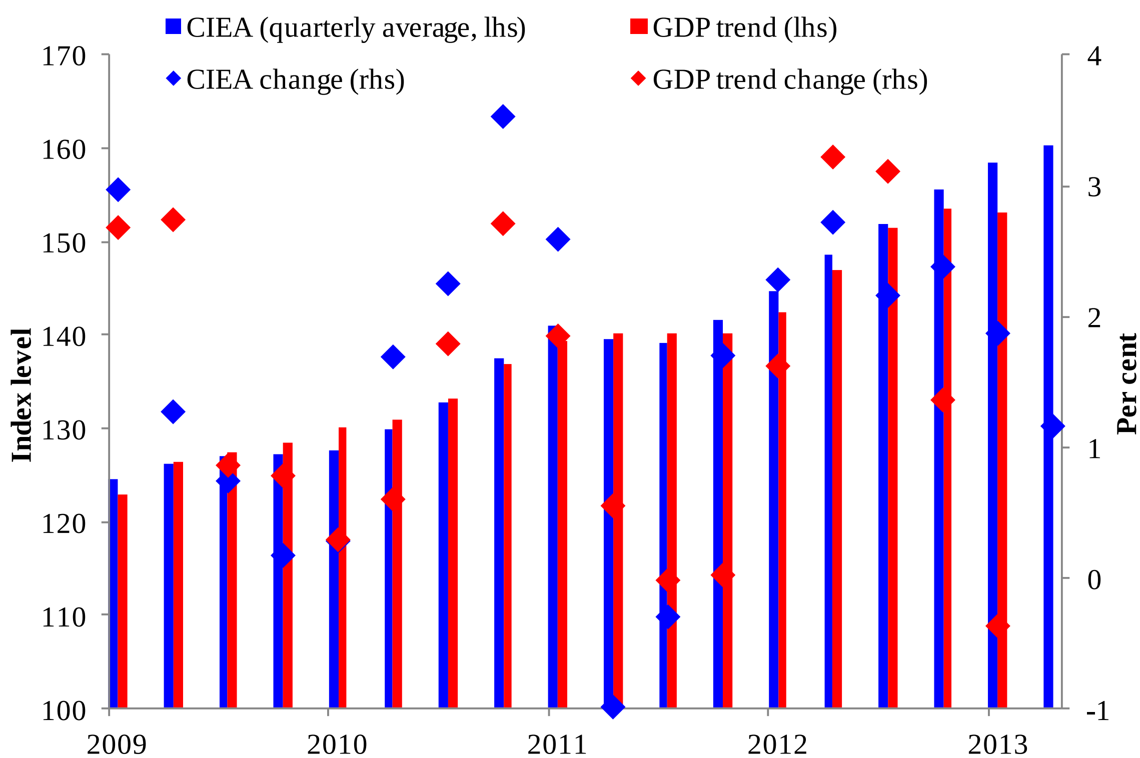


Figure 8: Quarterly CIEA and GDP trend cycle



3.2.1.1 Sectoral developments

Growth in activity in the three major sectors (Services, Industry and Agriculture) is compared using indices: Services Index, Index of Industrial Output (IOP) and Index of Agricultural Production (IAP), which are obtained using seasonally adjusted data to filter out the combined seasonal and calendar effects.

Figure 9 shows that during the months of March, April and May 2013, the industrial sector estimated by the IOP posted negative growth while the services and agricultural sectors registered increases in growth. In the quarter to March 2013, activity declined by 3.6 per cent and this was mainly on account of beverages & tobacco, chemicals, metal, textile, clothing & footwear. On an annual basis, the manufacturing sector is estimated to have declined by 3.2 per cent during May 2013 when compared to the same period last year.

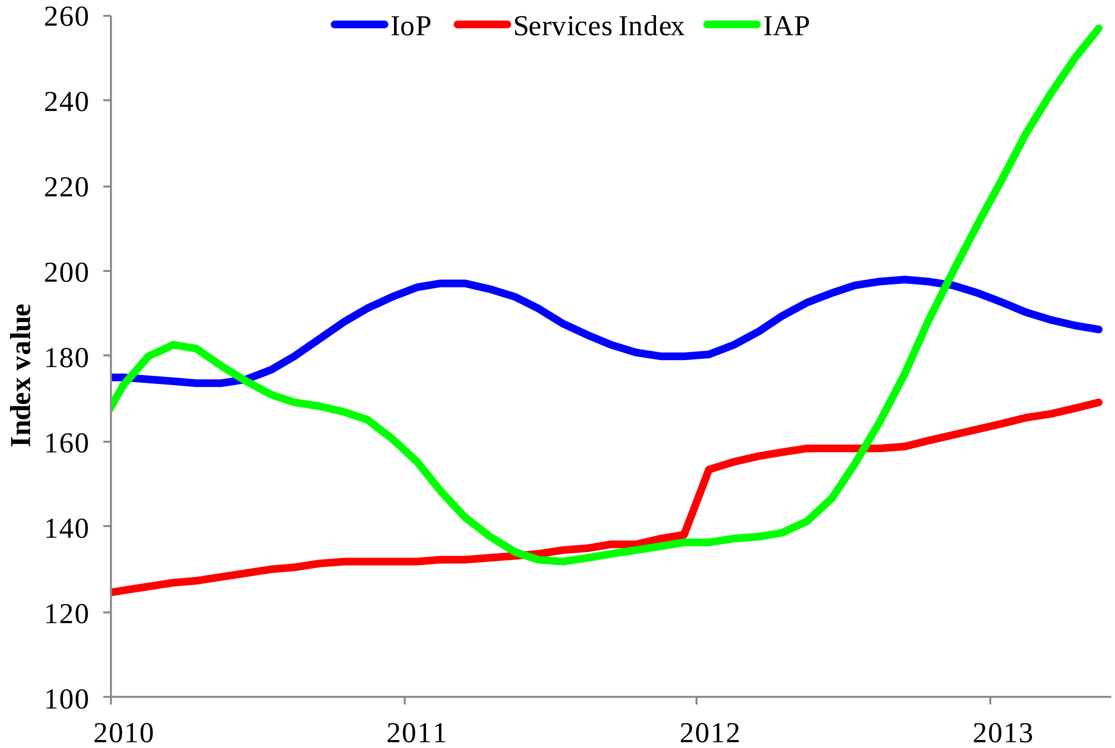
The monthly services index[6] rose by 0.8 per cent to 169.1 in May 2013 from 167.8 in April 2013, suggesting continued growth of the sector (***see Figure 9 and Table 8***). The observed slight improvement in economic activity in this sector was mainly due to transport, communication and Hotel & Restaurants, which contributed 0.36, 0.35 and 0.30 percentage points respectively, to the overall growth. The services sector in the quarter to June 2013 is estimated to have grown by 2.3 per cent to 169.2 from an index of 165.4 in the quarter to March 2013. On an annual basis, the services sector is estimated to have grown at a rate of 7 per cent.

The monthly IAP increase during the months of March, April and May 2013 averaged at 4 per cent with the highest change recorded in March at 4.2 per cent and the least in May 2013 at 2.8 per cent. Since November 2012, there has been a slowdown in the increase of market deliveries from 6.4 per cent to 2.8 per cent during May 2013.

On a quarterly basis, there was an increase in agricultural production of about 16 per cent when compared to the previous quarter and this may be attributed to mainly three commodities i.e. Fresh cassava, Sweet Potatoes and Matooke (***see Figure 9 and Table 8***). The increase in the IAP points towards the reduction in inflation rates, which would lead to increase in economic growth.

[6] The index aggregates Trend cycle estimates of real data on vehicles & motorcycles licensed, petroleum _excise duty, non interest income, VAT, total arrivals at Entebbe, base metal &other products.

Figure 9: Sectoral indices (services on the secondary axis)

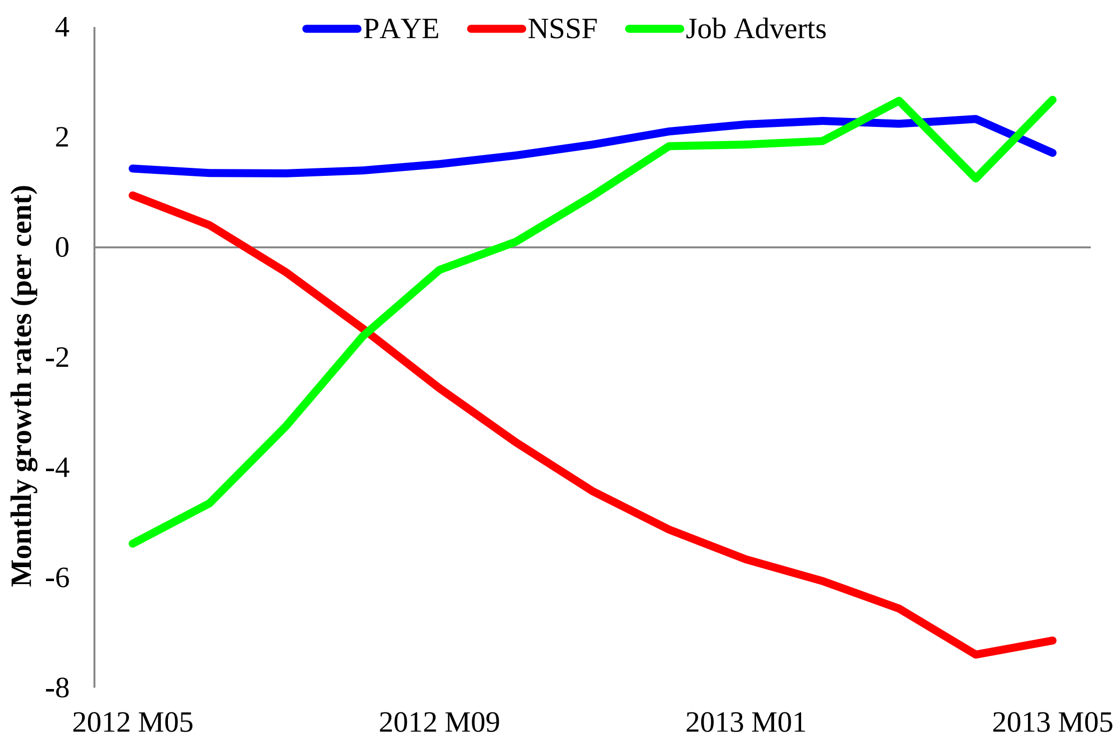


3.2.1.2 Employment Index

The monthly employment index based on number of Jobs advertised indicates a 2.68 per cent increase in Job opportunities during May 2013 when compared to April 2013. This is consistent with the Index of PAYE that posted a positive growth of 1.72 per cent. However, the employment index based on the number of new registered employees that contribute to NSSF indicated a decline of 7.14 per cent in May 2013. (***See figure 10 & table 8***)

Over the past three months, Job opportunities have increased at a rate of 2.66 per cent and 1.25 per cent in March & April respectively. Similarly, PAYE increased at 2.25 per cent & 2.33 per cent in March and April respectively. On the other hand, new registered employees contributing to NSSF declined at a rate of 6.56 per cent in March & 7.4 per cent in April 2013. The decline in employees contributing to NSSf points towards an increase in the unemployment numbers while the increase in the PAYE might be on account of the increased wages to the already employed workers.

Figure 10: Percentage in Jobs Advertised, PAYE & NSSF



3.2.2 Confidence Surveys

3.2.2.2 Consumer confidence

The Consumer Confidence Index (CCI1) increased slightly in June 2013 by 0.9 points from 40.6 in May to 41.5 but generally continued to fluctuate within the pessimism zone. It's important to note that despite the increase as compared to last month, the June CCI is lower than that of April which was 42.3. The Current Economic Condition Index increased to 39.9 in June 2013 from 30.8 and 30.2 in May and April respectively. The Expectation Index dropped significantly from 50.4 in April and 47.2 in May to 42.8 in June. The three indices show that consumers were more pessimistic about economic conditions and Jobs availability and expected financial conditions to worsen.

Table 8: Consumer Confidence Indicators

	2012		2013					
	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Overall Consumer Confidence Index (CCI)	43.1	39.4	45.9	42.1	48.6	42.3	40.64	41.5
Current Economic Condition Index (CECI)	29.9	23.8	31.3	30.5	36.3	30.2	30.8	39.9
Present Economic conditions	32.8	29.2	34.7	29.3	37.7	31.6	28.4	44.5
Previous Job availability	27	18.4	27.9	30.7	34.9	28.8	33.2	34.4
Consumer Expectation Index (CEI)	52	49.8	55.6	50.2	56.9	50.4	47.2	42.8
Economic condition in next 3 months	57.5	48.8	56.8	50.6	59.9	52.2	46.8	41.2
Job availability in next 3 months	45.3	46.2	49.9	42.1	49.4	44.5	40.3	39.9
Financial conditions in next 3 months	53.1	54.3	60.2	57.8	61.3	54.5	54.5	47.4
Price expectation index	20.6	19	21.2	24	28.2	26.7	27.6	15.2
Buying Intention	52.3	53.4	50.5	41.2	45.7	47.2	41.5	45.2

3.2.2.2 Business Confidence

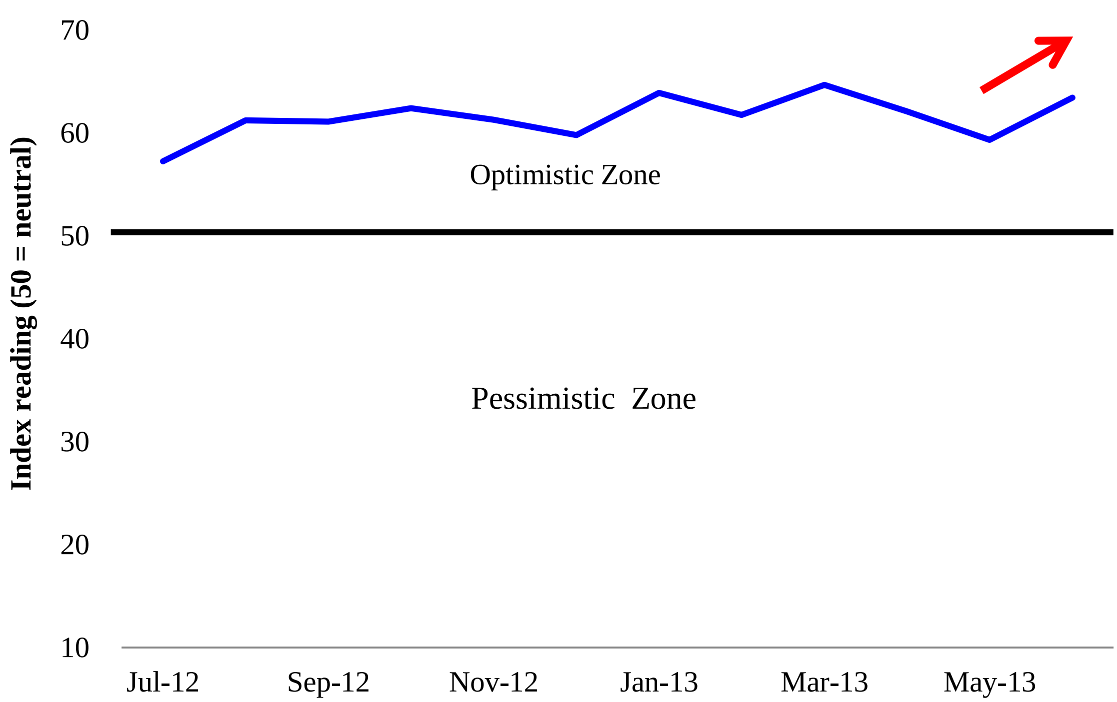
Businesses were more upbeat in their outlook on the economy in June 2013 with the overall confidence Index (CI)7 rising to 63.4 points from 59.3 points recorded in May 2013. (**See figure 11**). However, tracking sentiments on the quarterly outlook, business confidence were less upbeat but nonetheless remained optimistic at a level of 61.6 points in the quarter ending June 2013 compared to 63.5 points recorded in the quarter ending March 2013 (**See figure 12**).

Tracking the sectoral trends, the sentiment of businesses in all sectors was quite positive in June 2013. The most bullish was the other services sector with a confidence index of 69.1 points, up from 64.9 points in May 2013. The confidence of firms in construction, manufacturing and wholesale and retail trade sectors stood at 56.3, 59.4 and 55.9 points up from 51.7, 57.1 and 52.3 points, respectively (**See Figure 13**).

The business confidence and expected developments during the next three months continues to be more favourable in all the sectors. The CIs for construction, wholesale & retail trade and other services sectors rose from 65, 61.2, and 70.2 points in May 2013 to 73.5, 69.4 and 78.7 points, respectively (). Business Confidence in the manufacturing sector remained unchanged at 68 points.

Deteriorating domestic demand, high cost of borrowing and competition within sectors were the top three constraints identified by over 50 percent of the firms surveyed.

Figure 11: Overall Business Confidence Index



[7] The CI is computed as the percentage of firms that answered in the affirmative plus the percentage of firms that were indifferent with respect to their views on a given indicator. The diffusion index varies from 0 to 100 as extremes, with 50 as the mid-point. A value of 50 indicates an exact balance, a value below 50 shows pessimism and a value above 50 indicates optimism.

Figure 12: Quarterly outlook on the Economy

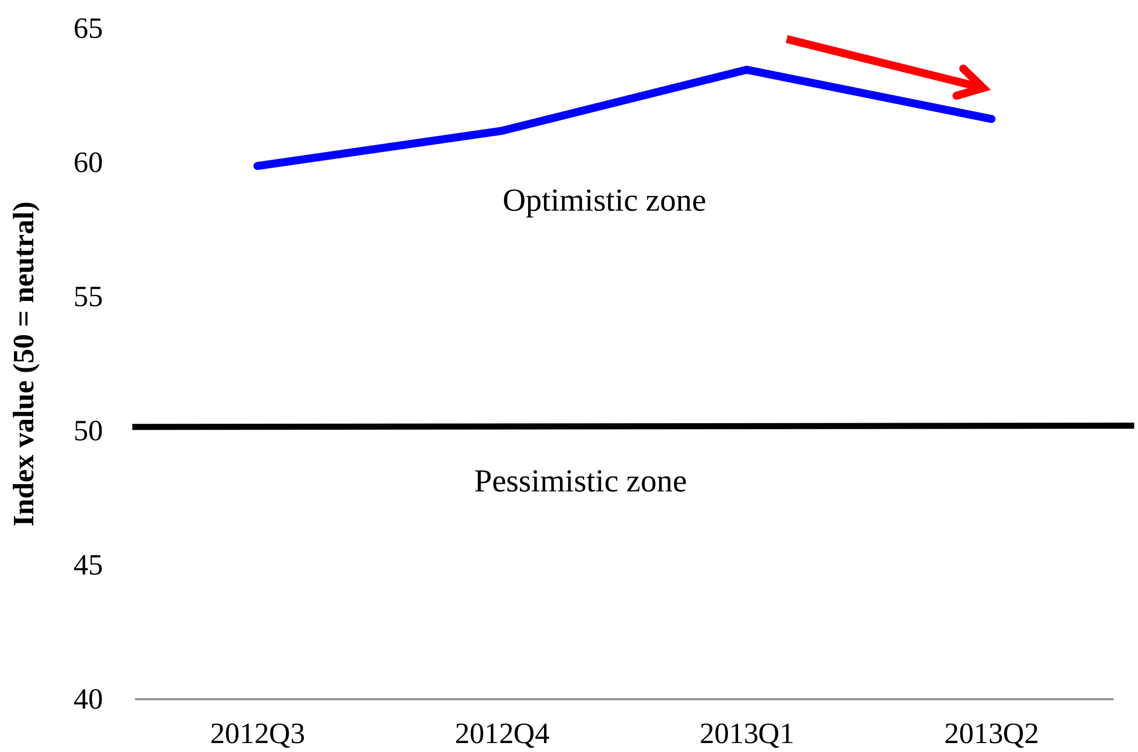
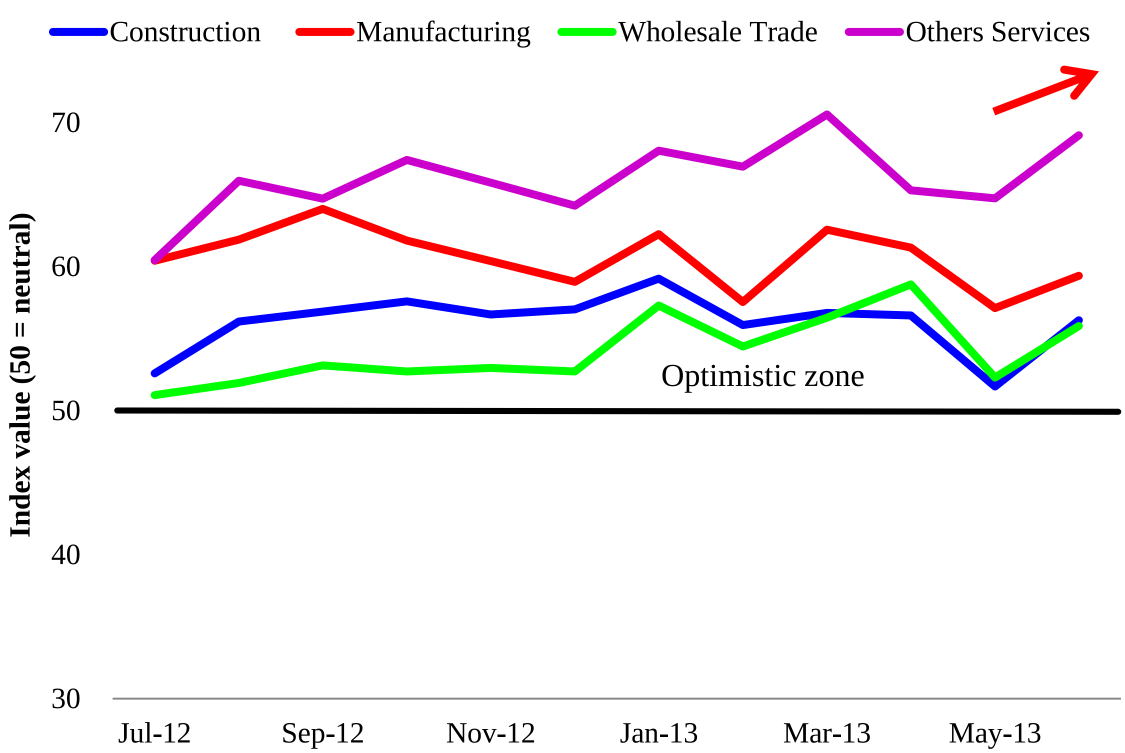


Figure 13: Business Confidence across Sectors

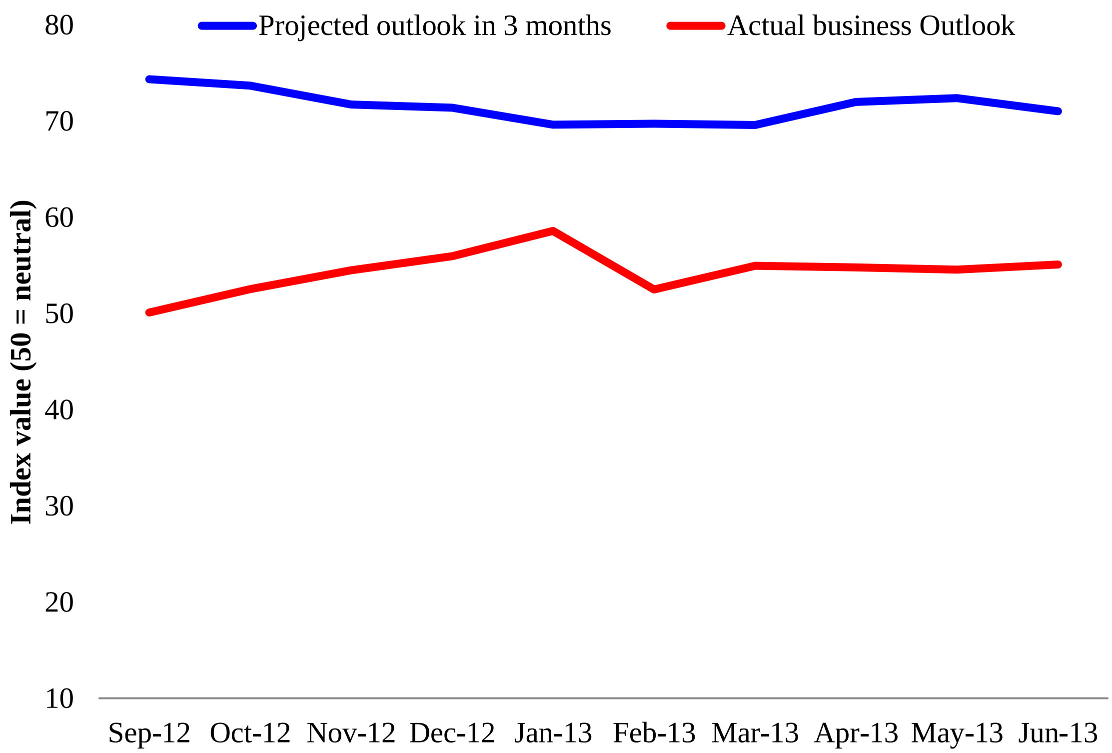


3.2.2.3 Trends in Business Situation Indices

Figure 14 shows the divergence between the projected and the actual business outlook. Generally, both the projected and actual business situation indices moved in the same direction.

The projected business outlook was 71 points yet the actual outturn in June 2013 was 55.1 points. However, both indicate optimism indicating continued growth and the stability in the gap signifies less uncertainty among the business community.

Figure 14: Trends in Business Situation Indices



3.2.3 Fiscal activity

Fiscal operations were less buoyant in the quarter to May 2013 relative to the performance registered in the quarter to April 2013. The lower fiscal performance was on account of a shortfall in tax revenue collections and lower external assistance. Government significantly increased issuance of treasury securities to reinforce the low external assistance and as a result increased further the stock of government securities to private sector credit above the 2013 draft debt strategy threshold. The domestic interest cost indicators, however, remained within the debt strategy threshold, albeit at slightly higher levels than in April 2013.

Tax revenue collections are expected to improve in the month of June 2013 on account of heightened vigilance by URA and this anticipated improvement in government revenue, coupled with end of year expenditures by government spending units may be expected to bolster fiscal performance in the forthcoming quarter.

Table 9: Summary of fiscal operations

	Approved Budget 2011/12	Cumulative March - May 2012		Approved Budget 2012/13	Cumulative March - May 2013		January - March 2013
	(UGX billions)	*(UGX billions)*	*(per cent of approved budget)*	*(UGX billions)*	*(UGX billions)*	*(per cent of approved budget)*	*(per cent of approved budget)*
Revenues and grants	**7756**	**1721**	**22**	**8699**	**1887**	**22**	**22**
Revenues and grants	***6402***	***1572***	***25***	***7456***	***1786***	***24***	***24***
URA	6169	1471	24	7285	1754	24	24
Non-URA	121	29	24	171	31	18	15
Oil revenues	-	73		0	-		
Grants	***1466***	***148***	***10***	***1243***	***101***	***8***	***9***
Budget support	635	45	7	481	39	8	10
Project support	831	103	12	762	62	8	9
Expenditure and lending	**9869**	**2118**	**22**	**10927**	**2440**	**22**	**24**
Current expenditures	***4963***	***1376***	***28***	***5607***	***1375***	***25***	***29***
Wages and salaries	1809	475	26	2141	561	26	31
Interest payments	520	187	36	840	232	28	27
Domestic		*157*		*714*	*193*	*27*	*27*
External		*30*		*127*	*39*	*31*	*31*
Other recurrent expenditures	2114	713	34	2626	582	22	28
Development expenditures	***4667***	***749***	***16***	***5296***	***649***	***12***	***18***
Domestic	*2790*	*284*	*10*	*3304*	*234*	*7*	*16*
External	*1877*	*466*	*25*	*1993*	*415*	*21*	*22*
Net lending/ repayments	39	-12	-30	-12	410	-3475	-
Domestic arrears repayments	279	4	2	35	6	17	7
Overall fiscal balance (excluding grants)	**-3580**	**-546**	**15**	**-3471**	**-654**	**19**	**24**
Overall fiscal balance (including grants)	**-2114**	**-398**	**19**	**-2228**	**-553**	**25**	**33**
Financing	**2114**	**398**	**19**	**2228**	**553**	**25**	**33**
External financing (net)	***1176***	***251***	***21***	***1249***	***201***	***16***	***28***
Disbursements	1411	297	21	1500	261	17	28
o/w budget support loans	*366*	*-*	*0*	*269*	*0*	*0*	*0*
o/w project support loans	*1045*	*297*	*28*	*1231*	*261*	*21*	*34*
Amortization (net)	-189	-47	25	-250	-59	24	27
Domestic financing (net)	***938***	***40***	***4***	***979***	***683***	***70***	***40***
Bank financing (net)	838	-354	-42	754	565	75	31
Non-bank financing (net)	100	395	395	225	118	53	69

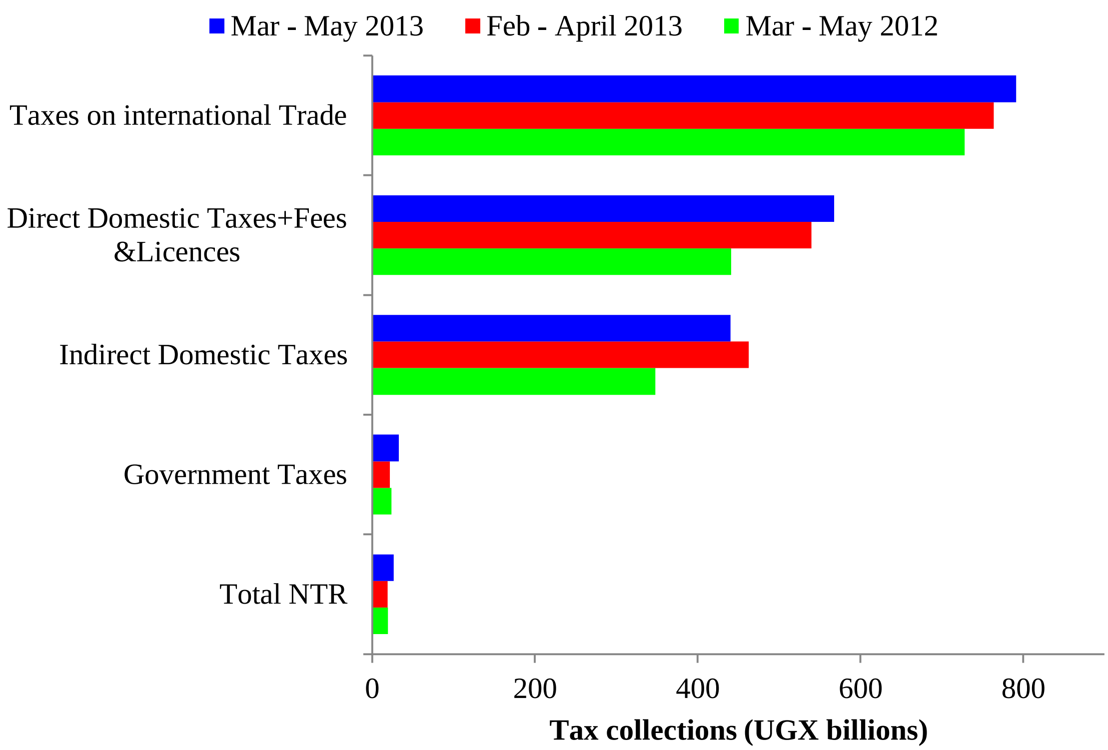
Source: MoFPED and BoU

3.2.3.1 Revenue performance

Total government revenue as a proportion of the approved budget improved slightly from the quarter to April and the quarter to May 2013, but remained below the performance registered in the corresponding period in 2011/12 (**Table 9**). The improvement in revenue performance was on account of higher tax and non-tax revenue collections relative to the previous period; both budget support and project support grants performed below the previous period and the corresponding period in 2011/12.

Tax collections for the quarter to May 2013, however, fell short of the target by Shs. 43.0 billion (2.4 per cent) on account of a shortfall in tax collections from international trade, which accounted for the largest portion of total tax collections (**Figure 15**). The Ministry of Finance Tax Policy Department attributed the underperformance in international trade taxes to lower than projected CIF values for the top 100 paying items, some of which were cigarettes, self-propelled bulldozers and motor vehicles for the transport of goods. Direct and indirect tax collections, however registered surpluses

Figure 15: Tax Revenue Performance (Shs. Billion)



Source: Statistics Dept, BoU

3.2.3.2 Expenditure performance

Government execution of the budget in the quarter to May 2013 was slightly lower than the similar period to April 2013 and also performed below the budget execution registered in the corresponding period in 2011/12. This performance was manifested in both current and development expenditure, but to a greater extent in development expenditure. The lower development expenditure was on account of lower domestically funded development expenditure while the lower recurrent expenditure resulted from lower government payments on wages and salaries and other recurrent expenditures (expenditure other than wages and salaries and interest payments). Government interest payments increased slightly on account of higher domestic interest payments.

3.2.3.3 Financing

External Financing

The quarter in review registered lower foreign loan inflows than the previous quarter and the corresponding period in 2011/12. This was on account of lower project support loans; there were no budget support loans received during the quarter. As shown in table 10 below, total external assistance was lower than in the previous quarter, in both the budget support and project support disbursements.

Table 10: Overall External Assistance (Shs. Billion)

	Approved Budget 2011/12	Cumulative March - May 2012		Approved Budget 2012/13	Cumulative March - May 2013		January - March 2013
	(UGX billions)	*(UGX billions)*	*(per cent of approved budget)*	*(UGX billions)*	*(UGX billions)*	*(per cent of approved budget)*	*(per cent of approved budget)*
Total Disbursements	2,877.0	445.7	15.5	2,742.3	361.7	13.2	19.2
Budget Support (grants & loans)	1,001.0	45.1	7.1	749.5	39.0	5.2	6.3
Project Support (grants & loans)	1,876.0	400.6	40.9	1,992.8	322.7	16.2	24.1

Source: MoFPED & Statistics Dept, BoU

Domestic Financing

Domestic financing was significantly higher in the quarter to May 2013 accounting for 69.3 per cent of the approved budget compared to 39.5 per cent in the quarter to April 2013, which may be attributed by government's need to reinforce the low external financing. As shown in **Table 11 and Figure 16**, developments in the government securities market between June 2012 and May 2013 culminated into a net accumulation in the stock of government securities by Shs. 634.7 billion. Consequently, the outstanding stock of government securities increased sharply from Shs. 6,016.3 billion to Shs. 6,946.8 billion (20.2 per cent) between the two periods. This was much faster growth in the stock of government securities compared to 4.1 per cent growth in the previous quarter, but lower than 36.3 per cent growth registered in the corresponding period in 2011/12.

The increased issuance of government securities has caused the stock of government securities to private sector credit to trend above the 2013 draft debt threshold of 75 per cent; the stock of government securities to private sector credit increased from 78.5 per cent to 91.2 per cent between April and May 2013. The domestic interest cost indicators remained within the debt strategy threshold, albeit at slightly higher levels than in April 2013.

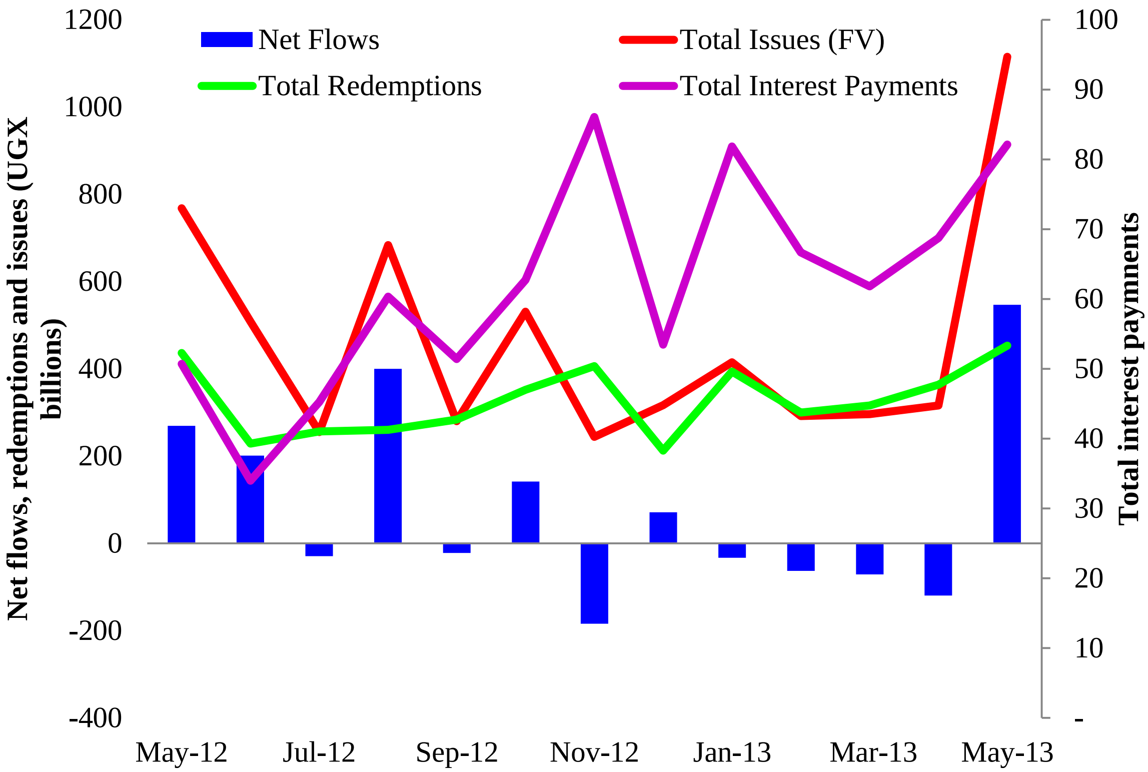
Table 11: Government securities flows (Shs. Billion)

	Cumulative government securities flows		
	July 2011 to May 2012	July 2012 to April 2013	July 2012 to May 2013
Total issues (at face value)	3968.2	3628.3	4743.3
Total issues (at cost)	3422.9	3314.0	4336.9
Total redemptions	2557.2	3143.1	3596.0
Total repayments	2151.2	2587.6	2982.0
Total interest payments	406.0	638.2	720.3
Discount interest	157.5	344.3	402.8
Sum of coupon payments	248.5	293.8	317.4
Net flows	865.7	88.2	634.7

Source: Statistics & Financial Markets Depts, BoU

Note: Net Flows are computed on the Issues at cost value

Figure 16: Government Securities Flows (Shs. Billion)



Source: Statistics Dept, BoU

3.2.3.4 Fiscal Outlook

The Ministry of Finance Tax policy Department has projected strong tax revenue performance for the month of June on account of heightened URA administrative efforts in this month. This anticipated improvement in government revenue, coupled with end of year expenditures by government spending units is expected to bolster fiscal performance in the forthcoming quarter. However, government is faced with high redemptions in June 2013, which may moderate this positive outlook.

4 Exchange rates and balance of payments

4.1 Exchange rates

Exchange rate movements stem from changes in 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 for the cost for inflation. A depreciation of the nominal effective exchange rate will increase the cost of imports, which is likely to feed through to domestic price and reduce aggregate demand.

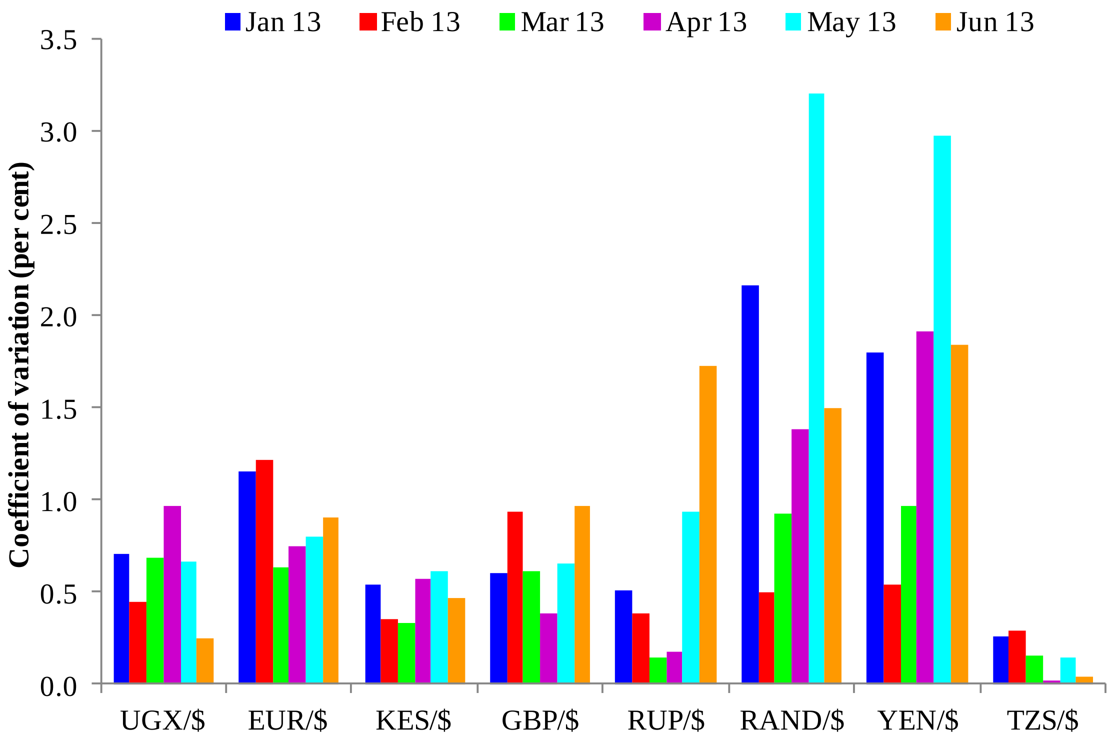
The shilling exhibited decelerating volatility in the quarter ending June 2013 as depicted by **Figure 17**. After an appreciation drive that persisted up to the beginning of Q2-2013, the unit backtracked to a depreciation path in May 2013 (**see figure 18**). The shilling stayed on this trajectory in June 2013, depreciating against the US Dollar at the same pace of 0.3 per cent as in May 2013 on a monthly basis. The appreciation followed tapering of the persistence of bearish sentiments triggered by suspension of budget support by donors, increased inflows from portfolio investors, remittances and exports. On the other hand, behind the depreciation in May, lies a rebound in import demand for investment and reversal of portfolio investments subsequent to reductions in the Central bank rate.

On an annual basis however, the shilling has been depreciating. The pace had somewhat slowed in April 2013 to 2.9 per cent but heightened to 4 per cent in May and June 2013. Accordingly, the Shilling traded at midrates of Shs. 2,586 and Shs. 2,593 per US dollar in the months of May and June, respectively. On the overall, the unit appreciated by 2.8 per cent quarter on quarter and depreciation by 3.9 per cent on an annual basis.

The volatility of the Uganda shilling- Dollar rate which had sharpened in April 2013, progressively declined to a substantially low level in June 2013, reflecting in part the impact of BOU interventions of US$32.25 million in April 2013 and targeted Purchases of US$20.0 million in May 2013 in the Interbank Foreign Exchange Market (IFEM). In addition, BoU made targeted sales and purchase for reserve build-up amounting to US$52.23 million and US$20.0 million, respectively during the quarter under review, resulting into a net sale of foreign exchange amounting to US$20.02 million in the IFEM.

The stability of the shilling in June 2013 reflects reduced and relatively matched activity in the IFEM.

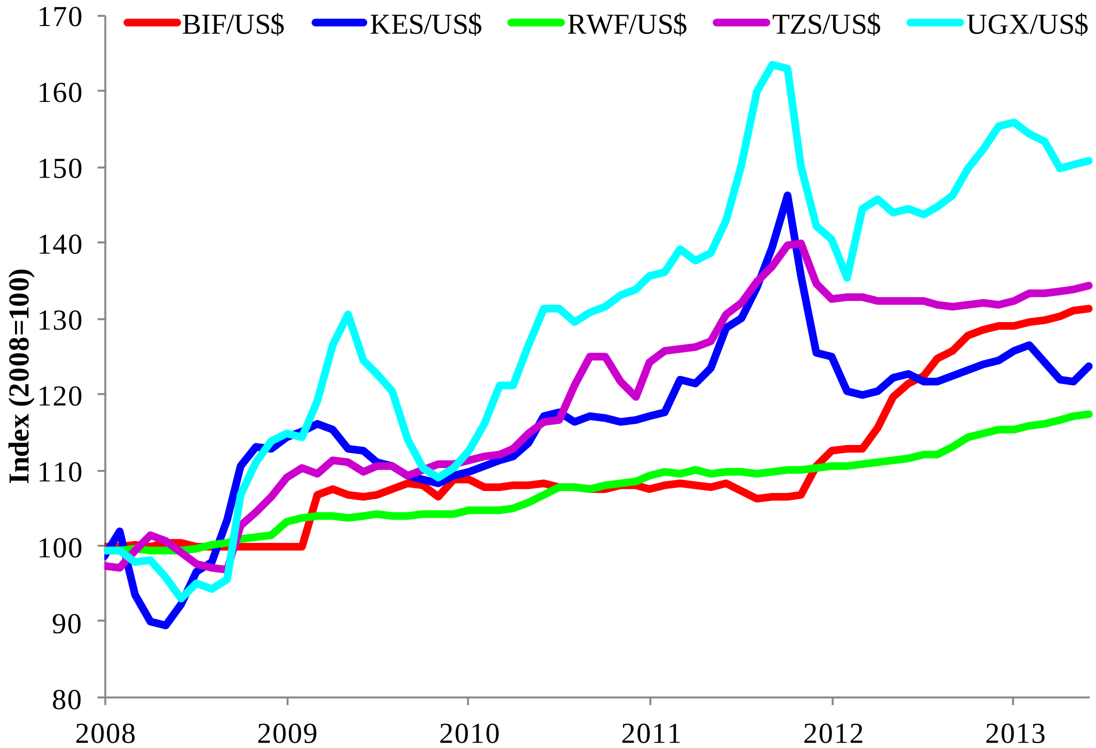
Figure 17: Volatility of selected currencies



On a regional front, the Kenya Shilling has been experiencing increasing volatility although marginally declined in June 2013, whilst other currencies in the EAC region demonstrated generally and substantially lower volatility during the quarter.

Figure 22 reveals that the Kenya shilling continued to mimic the movements of the Uganda shilling although it depreciated more on quarterly basis but by less on annual basis. The Kenyan shilling depreciated on account of profit booking by foreign investors in capital markets. It depreciated against the US dollar by 2.2 percent quarter on quarter and by 2.7 percent annually in 2013-Q2 averaging at KES86.45/US$. The Tanzania shilling, Rwandan and Burundi Francs also depreciated during the quarter under review. The Tanzania Shilling depreciated by 0.7 percent quarterly and 1.9 percent annually on account of strong dollar demand from importers while the Rwandan Franc depreciated by 0.6 percent and 5.8 percent over the same period possibly on account of fifteen (15) fraudulent foreign exchange dealers who have since lost their licences. The Burundi Franc was the most depreciated currency in the region and depreciated at a rate of 10.6 percent on annual basis.

Figure 18: Movement in EAC currencies against the US Dollar



Source: BoU

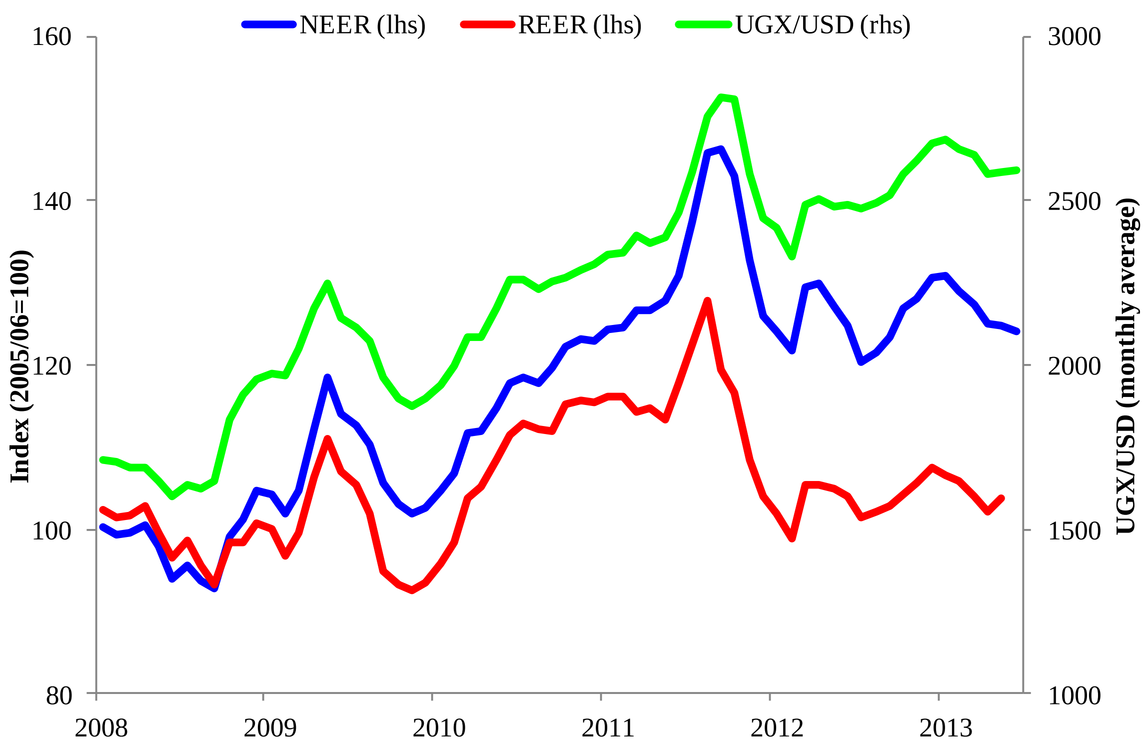
4.1.1 Nominal and real effective exchange rate

The Nominal Effective Exchange Rate (NEER) stayed on an appreciation path in Q2 2013. On a monthly basis, it appreciated by 0.5 percent in June, 0.2 percent in May and 1.9 percent in April while on annual basis it gained by 0.2 percent in June, 1.9 percent in May and 3.9 percent in April.

The NEER appreciation was largely on account of the gaining of the shilling against the Rand (8.3%), Yen (9.4%), Indian Rupee (4.7%) and the Euro (3.8%) on a quarterly basis, the combination of which contributed 2.4 percentage points to the 3.5 per cent quarter-on-quarter NEER appreciation. The 2.1 per cent year-on-year appreciation during the quarter, however, majorly accounted for by the appreciation of the Uganda Shilling against the Sudanese pound (33.7%), Yen (15.7%) and Rand (10.9%).

In line with NEER, the Real Effective Exchange Rate (REER) appreciated during the quarter. On annual basis, it appreciated by 2.2 per cent in April and 0.2 per cent in May of 2013 while it appreciated by 2 per cent in April and depreciated by 1.7 per cent month-on-month. The month-on-month depreciation in the REER was largely on account of increase in the price deferential most especially with Sudan. The REER appreciation mirrors weakening external sector competitiveness for Uganda's Economy. **Figure 19** shows the evolution of the effective exchange rates. In May 2013, Notable real shilling appreciation were recorded against the Sudanese pound (18 per cent) which is evident through the reductions of exports to Sudan, Japanese Yen (22 per cent) and South African Rand (8 per cent), which is an implication of low imported inflation.

Figure 19: Evolution of the NEER and REER



Source: BoU

In the short-term, the shilling is expected to undergo a mild depreciation if the rebound in imports continues to mount. However, exports are also expected to post a buoyant performance which will moderate the depreciation pressures.

4.2 Balance of payments

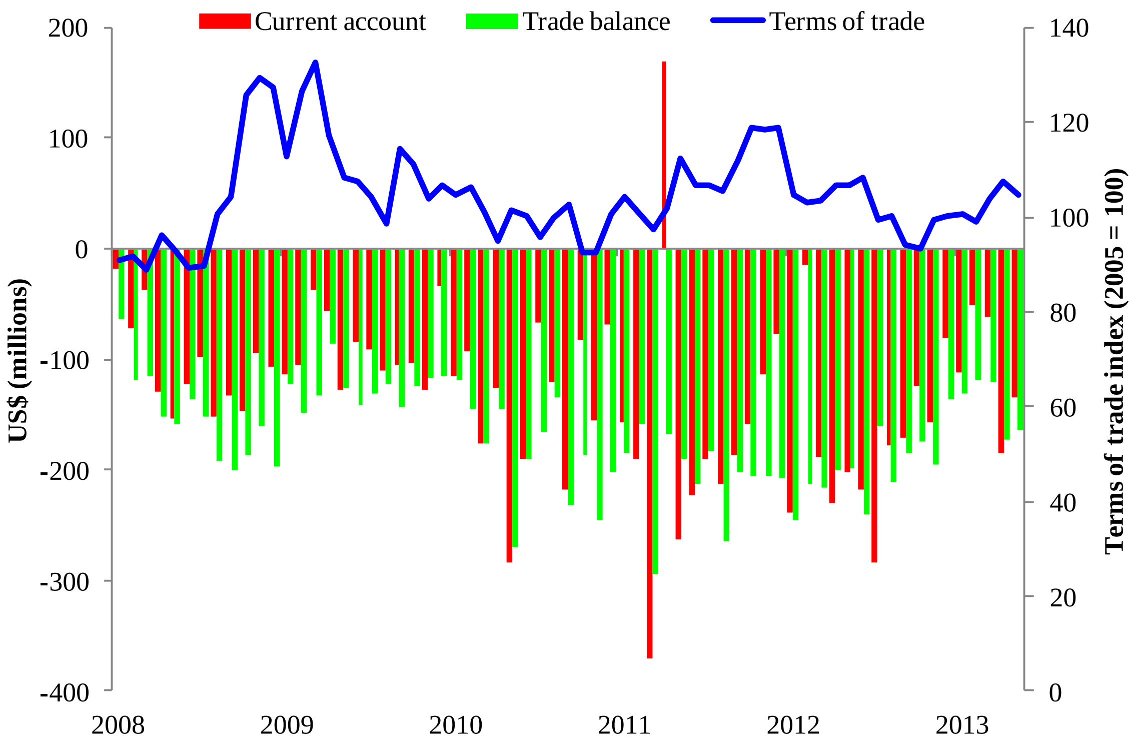
Increased economic activity, deeper financial market structure, stable and positive inflation and exchange rate depreciation will act to attract capital inflows and increase export demand, thereby contributing to a balance of payments surplus. In the long-term, the balance of payments should be neutral, 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.

Preliminary data indicates that the Balance of Payments (BOP) came under some pressure in the three months period to May 2013, registering an overall deficit of US$21.2 million on account of the wider current account deficit (see Table 12). The current account weakened to a deficit of US$380.1 million in the period under review, which is a 56 per cent movement from the deficit recorded in the three month period to February 2013. At the back of the current account deficit widening, lies a rally in import of goods and services and a slump current transfers.

The imports of goods, most especially for investment purposes significantly rebounded in April and May 2013 accelerating at 18 per cent quarter-on-quarter to US$1,206.9 million during the period March to May

2013. On annual basis however, imports of goods was still 25.8 per cent below the level observed in the same period of 2012 (**See Figure 20**). The export of goods' performance on the other hand, which though picked up in May 2013 and was modestly above the 2012 level, was thin given the two months consecutive declines since January 2013. The feeble export performance can be partially explained by weaker demand from the European market though a bit stronger than last year's to the Middle East, Sudan and generally exports to the COMESA. In the three months period to May 2013, the exports of goods amounted to US$750.5 million, 0.8 per cent and 7.3 per cent higher on quarterly and annual basis.

Figure 20: evolution of the current account



Realistically, the net effect of stronger imports and weaker exports is the wider trade deficit. This would be much worse but thanks to the 5 per cent improvement in the terms of trade on account of lower oil prices.

In addition to widening of the deficit on the goods account, the deficit on services account almost quintupled to US$73.2 million in the three months to May 2013, quarter-on-quarter though much narrower on an annual basis. The widening of the deficit was mainly driven by a sharp fall in transport receipts and an increase in payments of the same. The reduction in current transfers was mainly driven by an increase in outward workers' remittances and fall in grant disbursements specifically project support.

Weaker Capital and financial account: Provisional numbers show a 15 percent quarterly decline in the surplus on the capital and finance account which stood at US$679.8 million in the three months to May 2013, although it is 22.7 per cent superior on annual basis. Despite strong Foreign direct Investments (FDI) inflows buttressing the financial account. The financial account was weighed down by the reduction in other investments, reflecting net foreign assets build up in form of currency and deposits by banks and exit of portfolio investors partly attributable to CBR cuts and a rally in the US and other advanced economies' growth prospects, and a slump in project aid loan disbursements. The FDI grew by 15 percent to US$439.1

million in the review period, whilst reversal of portfolio investments stood at US$11 million compared to an inflow of US$42.5 million in the three months period to February 2013. The other investments inflows contracted by 39.1 per cent quarters-on-quarter to US$221.2 million of which 37.1 percentage points was on account of Banks building up currency and deposits assets, 4.2 percentage points was due to reduction in liabilities to non-residents in form of Currency and deposits, and 8.6 percentage points was due to reduction in project support loan disbursements.

The developments in the balance of payments led to a drawdown on foreign reserves to the tune of US$21.2 million. Consequently, the gross foreign reserves amounted to US$2,996.0 million equivalent to 4.4 months cover of future imports.

In the short to medium term, the Balance of payments is likely to come under some pressure. This is based on three grounds. First, the slow-down in growth prospects for China, the major export destination for minerals from Africa implies lower income from exports and financial support for these countries majority of which comprise the main exports destinations for Uganda's exports; Secondly, inflation in India, one of Uganda's major import sources is on the rise and therefore poses a risk of imported inflation and a worsening trade balance, although the imported inflation could be absorbed by the weakening of the Indian Rupee; And third, the Government's planned investments in the energy sector is likely to increase government imports thus negatively affecting the current account and the country's reserves as government makes payments to meet its external financing obligations related these projects.

Table 12: Monthly Balance of Payment developments

	Mar-12	Apr-12	May-12	Mar-May 12	Dec-12	Jan-13	Feb-13	Dec 12-Feb 13	Mar-13	Apr-13	May -13	Mar-May 13
Current A/c Balance	**-189**	**-231**	**-202**	**-621**	**-80**	**-112**	**-51**	**-243**	**-61**	**-185**	**-134**	**-380**
Goods Account (Trade Balance)	-216	-201	-198	-615	-137	-131	-120	-387	-120	-173	-164	-456
Total Exports (fob)	238	216	245	700	228	251	266	744	248	231	271	751
Coffee exports	30	22	36	88	30	43	42	115	38	31	48	117
Total Imports (fob)	-454	-417	-443	-1,315	-365	-381	-386	-1,131	-368	-404	-435	-1,207
Government imports	-31	-30	-19	-80	-30	-23	-36	-89	-15	-47	-26	-88
Private sector imports	-418	-382	-420	-1,220	-329	-354	-345	-1,028	-349	-353	-404	-1,105
Services Account (services net)	-52	-42	-30	-123	5	-38	17	-16	-18	-41	-14	-73
Income Account (Income net)	-42	-48	-35	-125	-49	-41	-37	-127	-36	-42	-31	-109
Current Transfers (net)	121	60	61	242	100	98	88	287	113	71	74	258
Capital & Financial A/c Balance	**65**	**249**	**240**	**554**	**286**	**240**	**275**	**801**	**143**	**309**	**228**	**680**
Capital Account	0	0	1	1	3	5	2	11	4	8	17	30
Financial Account	65	249	240	553	282	235	273	790	139	300	211	650
Direct Investment	143	143	143	429	90	146	146	383	146	146	146	439
Portfolio Investment	7	17	4	28	21	18	4	43	-5	-6	-0	-11
Financial derivatives, net	-1	0	-0	-1	1	1	0	1	1	0	-0	1
Other Investment	-84	89	93	98	171	70	123	364	-4	159	66	221
Overall balance (A+B+C)	**-28**	**8**	**94**	**74**	**92**	**85**	**82**	**258**	**-53**	**-5**	**37**	**-21**
E. Reserves and related items	**28**	**-8**	**-94**	**-74**	**-92**	**-85**	**-82**	**-258**	**53**	**5**	**37**	**21**

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, which might induce 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 effect 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**).*

Global inflation declined further in Q2 2013 and remains generally subdued, driven mainly by low commodity prices, weak global demand conditions and low inflation expectations anchored by central banks' credibility. However, while inflation has been on a general declining trend, it remains elevated in emerging market and developing economies due to past high inflation and domestic challenges. ***Table 13*** below, shows the trend of inflation in selected countries.

Table 13: Consumer Price Inflation Developments

	2012				2013		
	year average	Q1	Q2	Q4	Q1	April	May
Japan	0.0	0.3	0.2	-0.2	-0.6	-0.7	-0.3
United Kingdom	2.8	3.5	2.8	2.7	2.8	2.4	2.7
United States	2.1	2.8	1.9	1.9	1.7	1.1	1.4
Euro zone	2.5	2.7	2.5	2.3	1.9	1.2	1.4
Brazil	5.4	5.8	5.0	5.6	6.4	6.5	6.5
China	2.6	3.8	2.9	2.1	2.4	2.4	2.1
India	9.3	7.2	10.1	10.1	11.7	10.2	10.7
South Africa	5.7	6.3	5.8	5.7	5.8	5.9	5.5

Source: OECD & Euro Stat

Over 25 per cent of Uganda's imports are sourced from India making inflation developments in the country important to Uganda. Although declining, the level of annual inflation in India remains notably elevated above 10 per cent, largely on account of a pass through of Rupee depreciation, increases in administered prices and imbalances related to food supply.

In May and June 2013, the Indian currency depreciated by 5 per cent mainly due to a sell off by foreign institutional investors, triggered by apprehension surrounding the possible withdrawal of cheap US Fed QE liquidity. The depreciation was also partly attributed to a widening trade deficit occasioned by a surge in seasonal imports. The Reserve Bank of India however projects a continuance of the decline in inflation supported by weak commodity prices and downward revisions to administered prices. Food inflation however remains persistent.

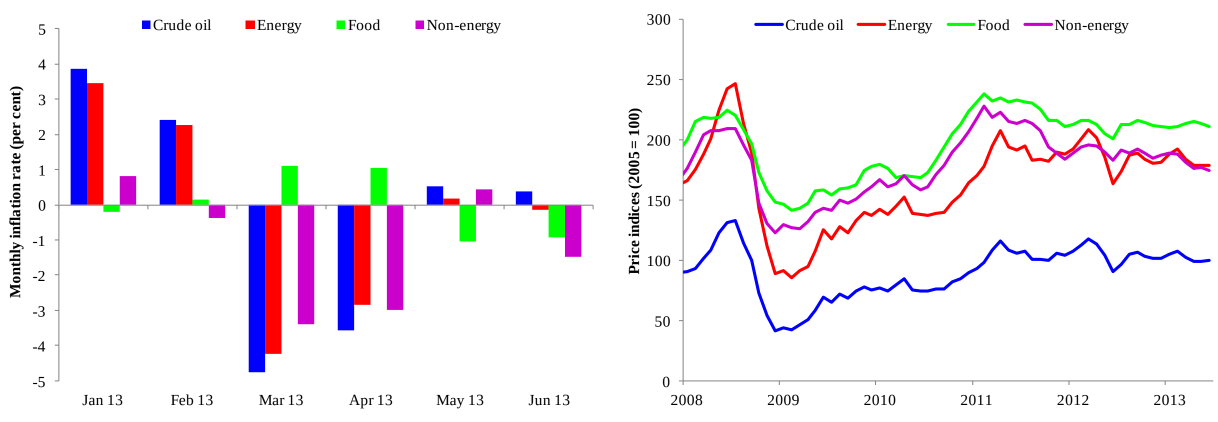
Inflation remains subdued in the rest of Uganda's import source countries. In Q2 2013 so far, annual inflation has declined in Kenya, China, Euro zone, South Africa, US and UK to 4 per cent, 2.1 per cent, 1.4 per cent, 5.5 per cent, 1.4 per cent and 2.7 per cent, respectively, recorded in May 2013 compared to the rates recorded at the end of March 2013. In Japan the deflation reduced to 0.3 per cent from minus 0.9 percent at the end of March 2013. The continued decline in inflation of these import source countries should at least partly offset any effects from the persistence of elevated inflation in India.

5.1.1 Commodity prices

International commodity prices presented mixed developments during Q2 2013. While average crude oil prices declined by 3.4 per cent and 5.5 per cent on quarterly and annual basis, respectively in Q2 2013, average food prices increased by 3.5 per cent and 0.8 per cent, respectively, over the same period. Subdued demand for oil, due to weak global demand, coupled with strong supply, particularly from Non-OPEC producers, buoyed by new production technologies and increased use of alternative oil resources, such as shale oil and gas, have contributed to the downward pressure on crude oil prices. On the other hand food prices have risen in Q2 2013, mainly pushed by prices of dairy products which were affected by shocks to New Zealand's dairy output.

While commodity prices have generally been on a downward trend since Q2 2011, they remain elevated compared to their historical trend as indicated in Figure 21.

Figure 21: Commodity market developments



Source: World Bank and FAO Statistics

On account of the fact that Uganda is a net importer of both oil and food, international crude oil and food prices have direct implications for domestic pump and food prices, and therefore headline inflation.

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 an 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

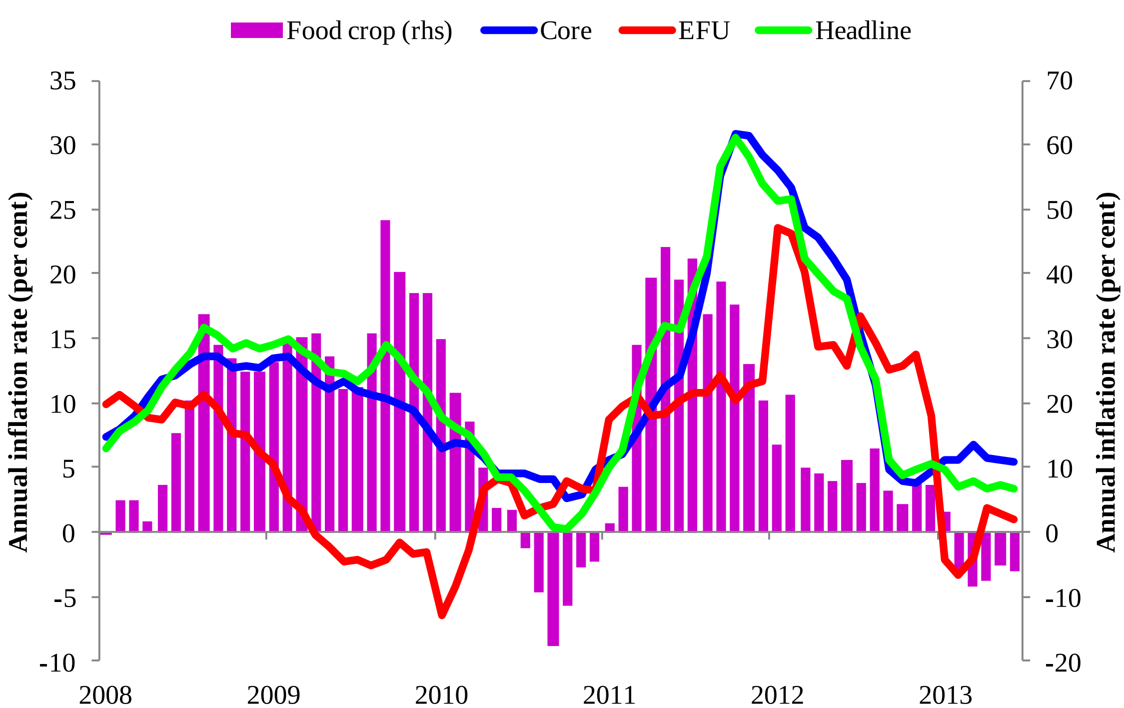
In the last three months of the quarter ending June 2013, annual headline and core inflation declined to averages of 3.5 and 5.6 per cent from 4.1 and 6.0 per cent respectively in the three months of the quarter ending March 2013. Inflation pressures eased in the Q2 2013 largely on account of improved food supply to the markets and stability of the nominal exchange rate. Similarly in the second quarter of 2013, annual food crops and food inflation declined to averages of minus 6.3 and minus 2.0 per cent from minus 3.9 and minus 1.0 per cent respectively in the previous quarter. Favourable climatic conditions have contributed towards healthy harvests and thus an improvement in overall food supply to markets and minimal food inflationary pressures. In the quarter under review, EFU inflation registered an increase of 3.9 percentage points to 1.4 per cent. This increment can be attributed to unfavourable base effects in the quarter as international commodities prices have declined. Non-food inflation marginally decreased to 6.3 per cent in the second quarter of 2013 from 6.6 per cent in the previous quarter.

Table 14: Consumer price developments

	2012			2013					
	Apr	May	June	Jan	Feb	Mar	Apr	May	June
	Monthly changes (per cent)								
Food crops	7.6	-1.5	-5.0	-6.9	-2.2	3.9	8.8	0.9	-6.0
EFU	-3.7	0.6	-0.3	0.4	-0.2	0.9	0.1	0.1	-0.6
Core	1.2	0.2	0.5	0.9	0.9	0.3	0.2	0.1	0.4
Headline	2.0	-0.1	-0.4	-0.3	0.4	0.9	1.4	0.2	-0.7
Food	5.5	-0.1	-3.3	-2.4	0.2	2.3	3.7	0.4	-2.6
Non-food	0.3	0.0	0.8	0.6	0.6	0.3	0.4	0.1	0.3
	Annual changes (per cent)								
Food crops	9.1	8.0	11.3	3.0	-6.2	-8.5	-7.4	-5.2	-6.2
EFU	14.3	14.5	12.9	-2.1	-3.3	-2.0	1.8	1.3	1.0
Core	22.8	21.2	19.6	5.6	5.6	6.8	5.8	5.6	5.5
Headline	20.0	18.6	18.0	4.9	3.5	4.0	3.4	3.7	3.4
Food	15.0	13.7	12.8	0.0	-2.0	-0.9	-2.6	-2.1	-1.4
Non-food	22.3	21.0	20.4	7.2	6.0	6.5	6.6	6.8	6.2

On a monthly basis, between April and June 2013, headline inflation accumulated 0.2 percentage points less than the first quarter of 2013. The increase in headline inflation during Q2 2013 can be attributed to 4.9 percentage increase in food crop inflation in the month of April 2013. Core inflation accumulated 1.5 percentage points less than quarter ending March 2013. The disinflationary trend in quarter ending June 2013 reflects a continued decline in core inflation.

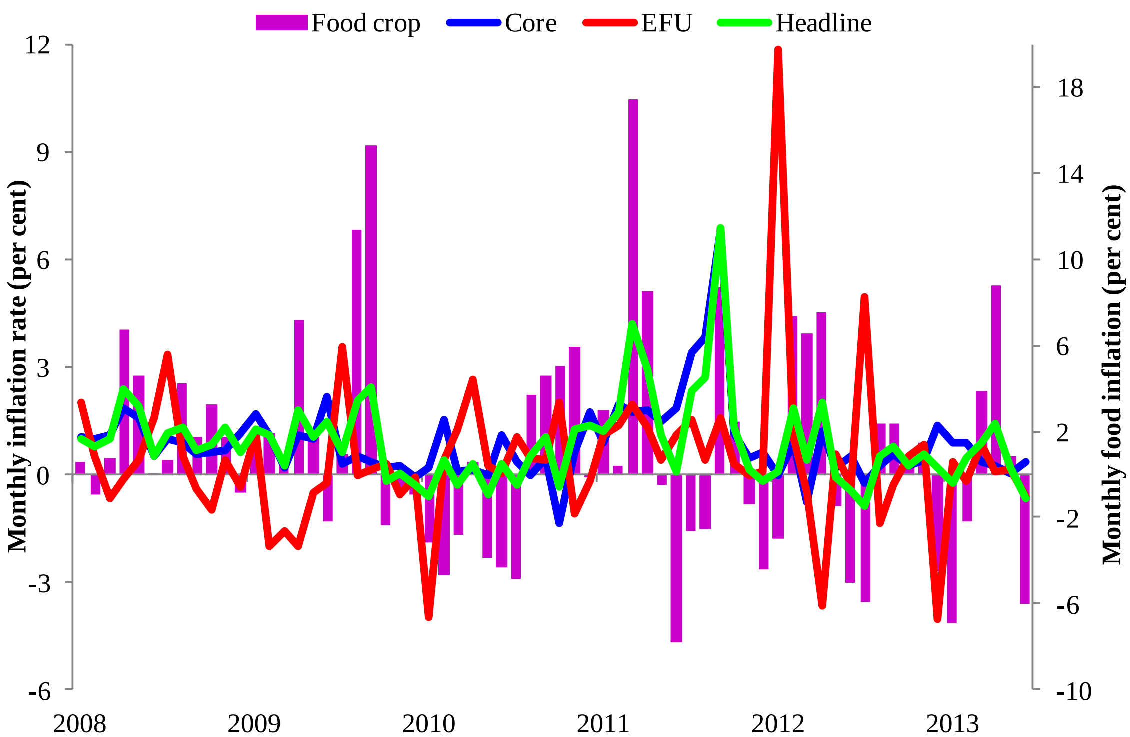
Figure 22: Annual inflation developments



Food crop prices had a positive incidence on inflation between the months of April and June 2013, which contrasts with the negative incidence from Q1 2013. This change is attributed to an increase in prices of staple food crops such as matooke, Irish potatoes and sweet potatoes in the month of April, largely due to decreased supplies to the market.

The cumulative monthly EFU had a negative incidence in the quarter ending June 2013, which contrasts with a positive incidence from January to March of this year. This development is attributed to the recent declines in global commodities prices of petroleum products.

Figure 23: Monthly inflation developments



In terms of contribution to headline inflation by category, all the rest of the categories had a positive incidence on inflation in the last three months, while food as category of CPI continued to be negative.

In general, the continued disinflation in the recent past can be explained by seasonal factors and basis effects. Basis effects have particularly been pronounced in EFU inflation in second quarter of 2013. As foresaid, seasonal factors such as favourable climatic conditions are behind the fall in annual CPI inflation as good harvests have led to a decline in food prices.

Figure 24: Contributions to annual CPI by category

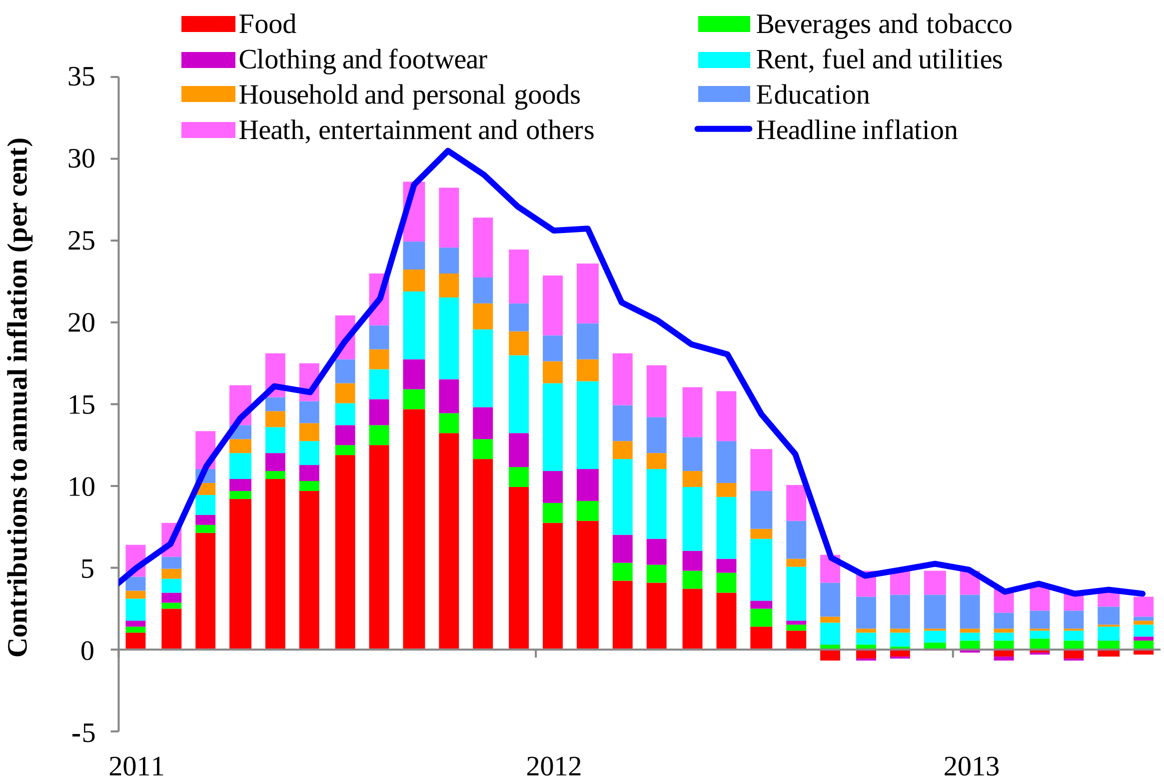
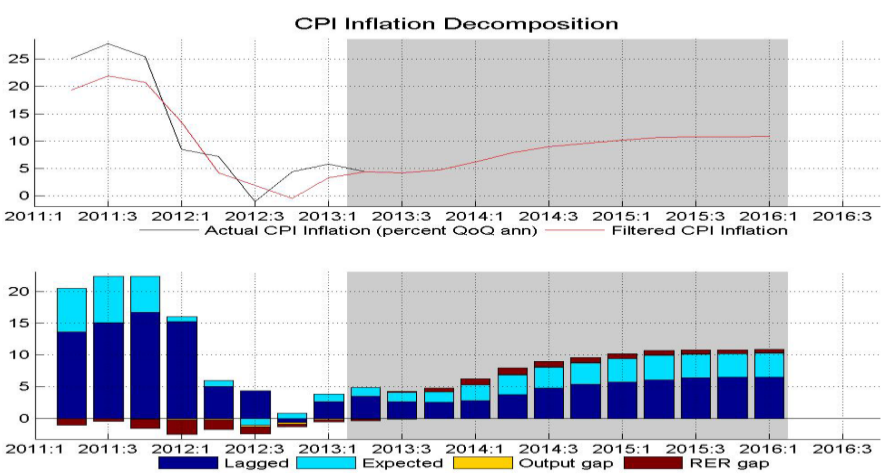


Figure 25: Inflation outlook



The Bank estimates that headline inflation will edge up slightly this year reflecting the increase in fuel taxes, metered water and food prices. With this expectation, effects of the tax increase are expected to wash out by mid-2014; hence, inflation will slowly converge towards the medium-term target rate.

The overall upward pressures on consumer prices will increase in the near future as the inflationary effect of import prices strengthens due to a slight shilling depreciation. The effect of the domestic economy will be slightly anti- inflationary until early 2014. Consistent with the forecast is a slight increase in market interest rates, followed by a rise in rates in 2014.

6 Economic outlook

*It takes approximately two years for the effect of monetary policy to be fully realised in an economy like Uganda where the financial sector suffers from structural inefficiency, 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 (**6.1**) and domestic (**6.2**) 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 global financial markets

The outlook for global financial markets is mainly hinged on the likelihood of unwinding the US Federal Reserve monetary policy stimulus program. Monetary policy normalization is likely to lead to tight financial conditions, lead to increase in interest rates, initially, in the advanced economies, which may result in capital flow reversals and currency depreciations, particularly, in emerging market and developing economies. The US Dollar is also expected to effectively strengthen on account of the unwinding stimulus. The IMF asserts that the ensuing financial markets' volatility will not be sustained due to the fact that scaling back of QE will cause only a one-off revaluation of risk. However, if the capital reversals are sustained, resumption of stability in global financial markets will take longer.

Rising interest rates can be expected to curtail recovery in credit supply and further delay global economic recovery. Furthermore, the increasing interest rates, particularly in advanced economies, will reduce the positive interest rate differential that has been enjoyed, mainly, by emerging market and developing economies and thereby further advance capital flow reversals. On the other hand, rising interest rates in advanced economies where the Bank invests its reserves, will increase the Bank's income and therefore its ability to respond to short term capital outflows.

Volatility in the global financial markets is likely to spill-over to the domestic financial market, resulting in exchange rate disturbances. This may however be mitigated by substantial foreign direct inflows which are expected to keep coming on account of oil.

6.1.2 Outlook for global economic activity

Prospects for global economic recovery continue to dim. The IMF in its July 2013 update of the World Economic Outlook activity, revised world GDP growth downwards to 3.1 per cent and 3.8 per cent for 2013 and 2014, respectively, from 3.3 per cent and 4 per cent projected in April 2013. The downward revision was prompted mainly by the slower growth in key emerging market economies, which were the basis for the earlier more positive forecasts, and a protracted recession in the Euro Zone.

Growth in emerging market and developing economies is expected to evolve at a slower pace of 5.0 per cent for 2013 and 5.4 per cent for 2014, compared to the April 2013 forecasts. Economic growth in China is expected to decelerate to 7.8 per cent in 2013 and lower to 7.7 per cent in 2014, tapered by weak external demand. In India, growth is expected at a moderate pace of 5.6 per cent due to infrastructure bottlenecks, supply constraints and subdued investment sentiment. Growth in Sub Saharan Africa was also notably revised downwards to 5.1 per cent and 5.9 per cent for 2013 and 2014, respectively compared to the April 2013, forecasts, largely due to weak external demand, domestic constraints and low commodity prices.

Table 15 below summarises the trend of growth prospects for the world economy and select regions and countries.

Table 15: IMF WEO Growth Forecasts

	2012 outturn	Apr 2013 Projections		July 2013 Projections	
		2013	2013	2013	2014
World	3.1	3.3	3.3	3.1	3.8
Advanced economies	1.2	1.2	1.2	1.2	2.1
US	2.2	1.9	1.9	1.7	2.7
Euro zone	-0.6	-0.3	-0.3	-0.6	0.9
Japan	1.9	1.6	1.6	2	1.2
UK	0.3	0.7	0.7	0.9	1.5
Emerging market and developing economies	4.9	5.3	5.3	5	5.4
China	7.8	8	8	7.8	7.7
India	3.2	5.7	5.7	5.6	6.3
Brazil	0.9	3	3	2.5	3.2
Sub-Saharan Africa	4.9	5.6	5.6	5.1	5.9
South Africa	2.5	2.8	2.8	2	2.9

Source: IMF WEO

Given the outlook of subdued global economic activity, particularly in emerging market and sub Saharan economies which are the main destination for Uganda's exports, external demand for Uganda's exports can be expected to decline. In addition the Ugandan Government's commitment to commence some large infrastructure projects in 2013 into 2014 implies that Uganda is expected to conduct large imports of capital goods. Consequently, Uganda's current account balance is expected to worsen. Therefore, Bank of Uganda should stand ready to alleviate the resultant exchange rate depreciation pressures.

6.1.3 Inflation outlook

Global inflationary pressures are expected to be minimal throughout 2013, although might pick up marginally towards 2014. The dominant catalysts behind the anticipated low inflation are food and fuel prices, which are expected to remain suppressed due to recent harvests and low global demand respectively.

The April 2013 WEO estimates that inflation in the advanced economies will average 1.7 per cent in 2013 and 2.0 per cent in 2014. This presents a slight upwards revision when compared to the January 2013 projections of 1.6 per cent and 1.8 per cent respectively. The upward revision stems from the Bank of Japan's increasingly expansionary monetary policy, which is expected to support a steady rise in domestic inflation, with global consequences. Inflation in the emerging market & developing economies is expected to be relatively contained over the next two years, averaging 5.9 per cent in 2013 and 5.6 per cent in 2014, attributed largely to lower food and energy prices.

Given that 83.0 per cent of Uganda's imports originate from emerging market and developing economies, the global inflation outlook poses only a minimal saving in Uganda's import bill. Nonetheless, the global inflation outlook should improve Uganda's balance of payments to some degree.

In line with the declining prospects for strong global economic recovery, the outlook remains for lower global inflation in 2013, with a slight uptick in 2014. The IMF projects average consumer price inflation in advanced economies to decline to 1.5 per cent in 2013 and rise slightly to 1.9 per cent in 2014, on account of lower commodity prices. Inflation in emerging market and developing economies is expected to remain elevated but lower at 6 per cent for 2013 and 5.5 per cent in 2014. The projections for overall low inflation are based on expectations of lower food and energy prices.

Low inflation implies generally low imported inflation for Uganda. However, the ultimate impact on Uganda's inflation will arise from the inflation outlook in individual countries from which Uganda imports. For instance in India, which is Uganda's single most important import source, inflation is expected to decline but currently stands at notable high levels of above 10 per cent. Thus the outturn of India's inflation will largely determine the impact of foreign inflation on Uganda's inflation.

6.1.3.1 Outlook for global commodity prices

Commodity prices are expected to fall very slowly over 2013, but to fall considerably over 2014 as global oil supply escalates; oil prices are estimated to decline by 2.3 per cent in 2013 and by 4.9 per cent in 2014 on account of strong growth in non-OPEC supply. However, the rate of decline in oil prices has slowed from the January WEO, which forecast oil prices to fall by 2.9 per cent and 5.1 per cent in 2013 and 2014 respectively. Non-fuel commodity prices are also projected to decline in over the next two years, by 0.9 per cent in 2013 and 4.3 per cent in 2014, on account of anticipated good weather. Reduced international commodity prices, particularly low oil prices, should ease Uganda's import bill somewhat.

The outlook for commodity prices is a notable decline in 2013 and 2014, as supply conditions continue to improve and global economic activity remains subdued. Oil prices are estimated to decline by 4.7 per cent both in 2013 and 2014 on account of strong growth in non-OPEC oil supply. This is a larger decline compared to the IMF's April 2013 forecasts which predicted oil prices to decline by 2.3 per cent in 2013 and by 4.9 per cent in 2014.

Non-fuel prices are projected to decline by a larger 1.8 per cent in 2013 and by 4.3 per cent in 2014, on account of anticipated good weather.

Lower international commodity prices are expected to be the main influence on global inflation in 2013 and 2014. Notably, while low oil prices will favour Uganda's trade balance, the low non-fuel prices which include prices of commodities that Uganda exports will also reduce the export earnings and deteriorate the trade balance. The impact of low commodity prices on Uganda's balance of payments position therefore remains mixed.

6.1.4 Key risks and uncertainties

The unwinding of the US Fed QE program poses the risk of tighter global financial conditions and capital flow reversals in emerging market and developing economies. The manner of adjustment of global financial markets to the commencement of the US Fed's monetary policy normalization will determine the degree of disruption to global financial markets and the protraction or lack thereof of capital flow reversals and currency depreciations. Further, risks related to the Euro Zone recovery remain until the financial stability of its member states is completely resolved.

Notably, a number of emerging market and developing economies have been in pursuit of macroeconomic policies that support growth that had been subdued by the past monetary policies of 2011/12 to reign in the second round effects of high inflation. These economies will have to strike a critical policy balance to continue pursuing growth recovery while containing the capital outflows.

The main downside risks to the outlook for economic activity are associated with the deceleration of key emerging market economies, mainly China, and its impact on other emerging market, developing economies and on commodity exporting countries. Given that China is currently the biggest investor and export destination, especially for mineral exports of developing countries, its continued deceleration poses a major downside risk to the growth outlook of economies, like Uganda, that depend on it.

The main upside risk to the inflation outlook relates to rising domestic food prices related to domestic supply shocks. The main upside risks to the commodity price outlook include, geopolitical tensions in the Middle East and North Africa (MENA) region and weather/related shocks.

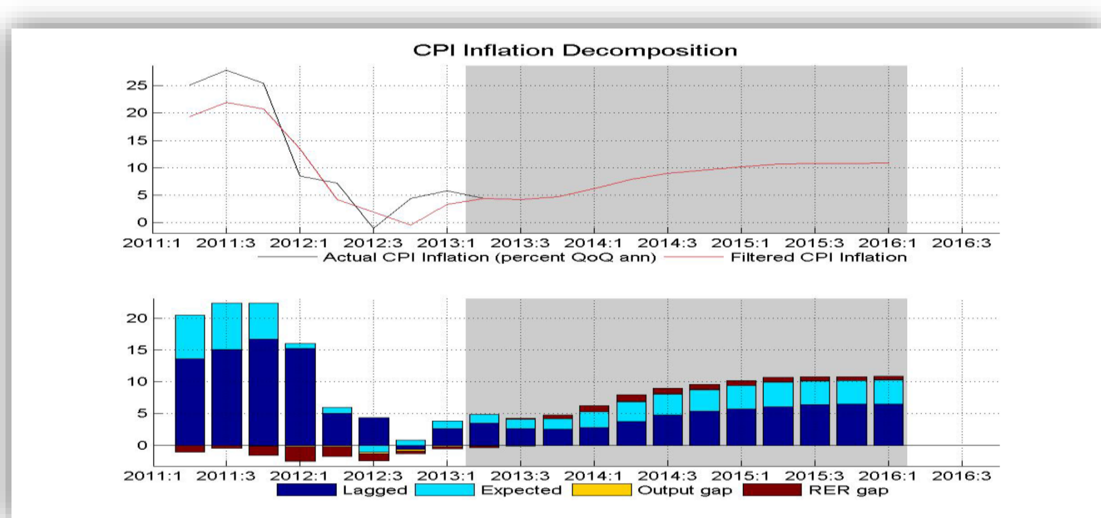
6.2 Domestic economic outlook

6.2.1 *Outlook for economic activity*

The quarterly outlook for domestic economic activity remains largely unchanged compared to that in the previous quarter ended March: The CIEA points to an increase in economic activity though at a slower rate than the previous quarter. The current growth in monetary aggregates may also point to increasing aggregate demand and therefore underlying inflationary pressures, although this may be contained by the falling domestic currency denominated lending. Additionally, the current growth in the agricultural sector indicates that agriculture should support any growth momentum, although adverse weather conditions will always risk stalling economic growth. Finally, the business confidence index also provides a positive economic outlook, particularly over the coming months.

6.2.2 *Inflation outlook*

Figure 26: Inflation outlook



The Bank estimates that headline inflation will edge up slightly this year reflecting the increase in fuel taxes, metered water and food prices. With this expectation, effects of the tax increase are expected to wash out by mid-2014; hence, inflation will slowly converge towards the medium-term target rate.

The overall upward pressures on consumer prices will increase in the near future as the inflationary effect of import prices strengthens due to a slight shilling depreciation. The effect of the domestic economy will be slightly anti- inflationary until early 2014. Consistent with the forecast is a slight increase in market interest rates, followed by a rise in rates in 2014.

6.2.3 Key risks and uncertainties

The high policy rates and increasing yields on the global financial markets may pose a risk of capital flow reversals and currency depreciation on Uganda's financial market. Further, the increase in interest rates, particularly in advanced economies, will reduce the benefits of the interest rate differential and hence the BoU may have lesser ability to shield the economy from the effects.

As earlier mentioned, the risks to inflation have increased over the quarter mainly due to; increased Government expenditure, growth in monetary aggregates, potential expansion of private sector credit (though currently it's on a declining trend), persistently sticky interest rates, anticipated tax increases and unfavourable climatic conditions. These factors may threaten the domestic inflation outlook. Similarly, poor global economic growth or commodity price shocks may affect the global inflation outlook, which in turn would create imported inflation to Uganda.

In case government expenditure increases towards the end of the financial year as anticipated, inflation pressures may increase through money growth. Moreover, if Government expenditure successfully stimulates economic growth then this may have second round inflationary effects, although such effects are less of a concern. Nonetheless, donors hint at increasing project financing partially in place of budget support, increased infrastructure investment may create a real boost to growth, which would require caution surrounding the inflationary implications. The anticipated tax increases for the upcoming financial year as the Government seeks to cover the donor budget cuts, will also exert upwards inflationary pressures.

Monetary aggregates have continued to increase mainly due to a rise in time and saving deposits, but also partly on account of incomplete sterilisation of forex purchases, which have also created structural liquidity surpluses in the financial system. In the event that private sector credit increases, as a reaction to the liquidity surplus, then monetary aggregates may expand further and pose an inflationary risk. Furthermore, the unrelenquishing high interest rates charged would exacerbate any inflation emanating from private sector credit growth.

The prevailing weather conditions are the major drivers of food crop harvests; therefore, unfavourable weather conditions may cause a poor harvest, which would reduce food supplies and hence trigger inflation. Food crop prices which constitute 13.5 per cent of the inflation basket would be directly affected by the climatic conditions, but overall food prices, 27.2 per cent of the inflation basket, would also be indirectly affected by food crops inflation. Given the high proportion of food prices to the inflation basket, food inflation may have considerable repercussions for the overall domestic inflation figure. Yet, at the moment, food prices are responsible for exerting considerable disinflationary pressures, and so favourable climatic conditions may similarly maintain low inflation.

7 Monetary policy decision

The Bank of Uganda seeks to foster economic growth through price and output stability. 5 per cent medium-term core inflation is targeted in order to achieve Uganda's potential long-term output growth of 6-7 per cent. Inflation is targeted through the Central Bank Rate, which should steer short-term interbank money market rates, thereby affecting long-term interest rates, which will subsequently determine the monetary policy transmission into prices and output growth. Additionally, the Bank of Uganda may intervene in financial markets to address a liquidity shortage or excess, and thus to improve the channel by which the Central Bank Rate determines the interbank money market rate. This section explains the Bank of Uganda's monthly policy decision given the recent data outturns and projections.

Due to the aforementioned upward risks, inflation was expected to trend higher but remain moderate and converge to BoU's target in the medium term. Although they exist, the upside risks to inflation remain relatively weak. The output gap had narrowed slightly but remained negative, but the underlying economic momentum was expected to remain positive. Given the need to further stimulate the economy in order to close the negative output gap, a more accommodative monetary policy stance is desirable. Thus, the CBR was reduced to 11.0 per cent in June 2013 from 12.0 percent in May 2013. The band on the CBR was maintained at +/- 2 percentage points on the CBR, and the margin on the rediscount rate to 3 percentage points on the CBR. The Rediscount Rate and the Bank Rate were also set at 14.0 per cent and 15.0 per cent respectively in June 2013.