Bank of Uganda

Monetary Policy Report

September 2013

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1 Overview

Annual headline and core inflation rose in the last three months to September 2013. During the quarter, annual headline and core inflation averaged 6.8 per cent and 6.7 per cent respectively, up from 3.6 per cent and 5.7 per cent respectively in the quarter ending June 2013. Food prices were the main drivers of the pick up in inflation over the quarter.

However, global inflation declined further in Q3 2013, driven by low commodity prices and weak global demand conditions. Among the advanced economies, inflation was low due to weak economic conditions; while amongst emerging and developing economies, inflation trended comparatively higher on account of exchange rate depreciations, improved domestic demand pressures and, in some economies, due to domestic supply shocks.

If the global economic recovery is to be spearheaded by the advanced economies, as the outlook proposes, this is positive news for Uganda; advanced economies are more likely to drive Uganda's external demand, which should increase exports and improve the current account balance.

Fiscal operations over the quarter ending July 2013 fell below potential, as total government expenditure fell, despite rising government revenue.

The Ugandan Shilling has followed a mild and stable appreciation trajectory over 2013 Q3, especially when compared to the recent period from 2012 Q4 where the Shilling demonstrated a trend of depreciation yet heightened volatility. The improved exchange rate position may be a result of improved market confidence, particularly when compared to the bearish sentiment observed in 2012 Q4 following the suspension of donor budget support.

On a quarterly basis, the Shilling appreciated by 0.2 per cent over the three months to September 2013, which is less than the 2.8 per cent appreciation experienced over the three months to June 2013, although the Q2 appreciation was exaggerated by larger than usual appreciation pressures in April 2013. The quarterly appreciation was driven by significantly reduced dollar demand, despite lesser supply also. Nonetheless, there were increased dollar inflows from offshore players over the quarter, due to the weak dollar position.

The current account deficit, which narrowed throughout 2012, has widened in recent quarters. In the quarter ending September, the current account deficit expanded to USD 601.5 million, from USD 373.2 million in the previous quarter. The growing current account deficit has been driven by deterioration in the trade balance, lesser remittances and increased 'other business services' payments.

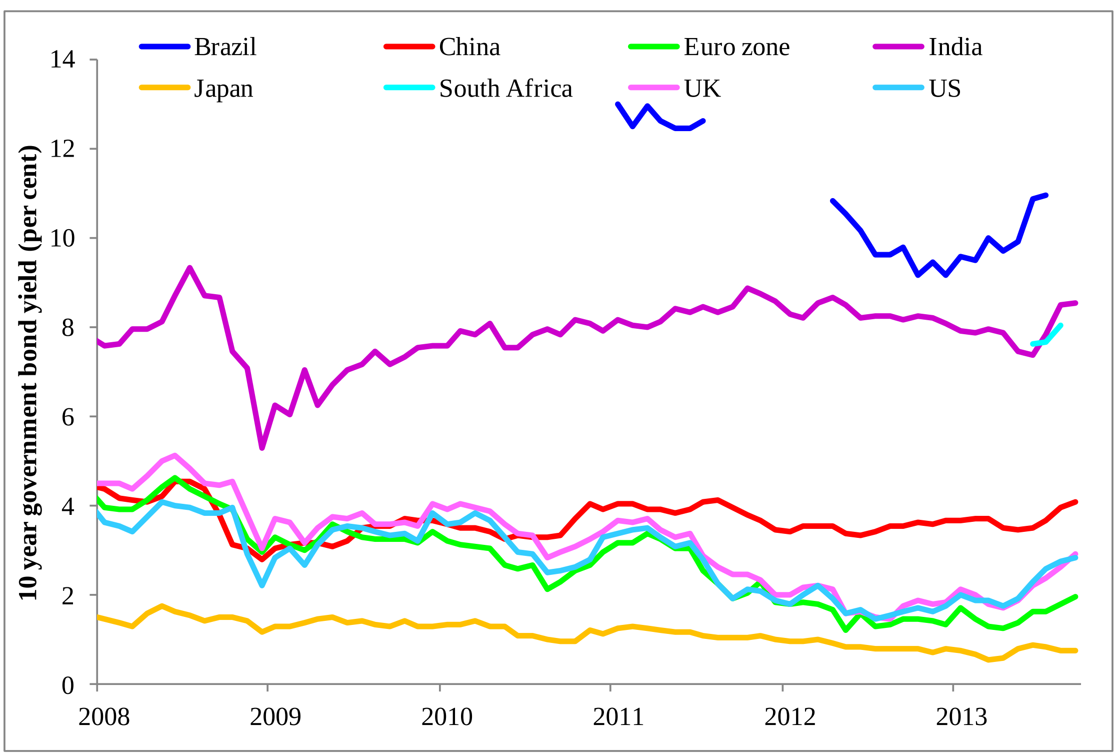
2 Money and credit

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

Global financial markets were volatile during Q3 2013; although some stability was noted from September 18th 2013 following the US Federal Reserve's decision to maintain its Quantitative Easing (QE) program, thereby continuing to inject cheap money into the financial system through the monthly purchase of US$85 billion worth of securities. The initial announcement by the US Federal Reserve that it may taper its quantitative easing program led to an increase in long term yields in the US and other advanced economies and strengthened the US Dollar. Ten year government bond yields in the USA rose from an average of 2.0 per cent in Q2 2013 to 2.7 per cent in Q3 2013. Similarly, ten year government bond yields rose in the UK and Euro zone. ***Figure 1*** below shows the trend of 10-year government bond yields in selected countries.

Figure 1: 10-year Government bond yields



Source: Bloomberg

The rise in long term yields in advanced economies led to some desirable and some less desirable adjustments in emerging market economies. One more desirable adjustment was exchange rate depreciations, especially in economies such as Brazil where the currency was considered overvalued. A less desirable adjustment was the disposal of 'risky' assets, which caused capital outflows from emerging economies. In addition, many emerging economies are faced with major domestic constraints, such as infrastructure and financial sector vulnerabilities that have aggravated capital outflows. Emerging market economies are now facing a period of more volatile external conditions and higher risk premiums.

Following the initial announcement that the US Federal Reserve might taper its quantitative easing program, the US dollar gained against most world currencies; although the US Dollar index declined to 81.9 in Q3 2013, from 82.6 in Q2 2013. Nonetheless, policies implemented by emerging market central banks to contain the exchange rate volatility and taper the outflows are expected to gain traction. In addition, markets recognise that while scaling back the QE program cannot be postponed for much longer, the withdrawal will be gradual. These factors are expected to achieve relative stability in emerging market currencies.

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.*

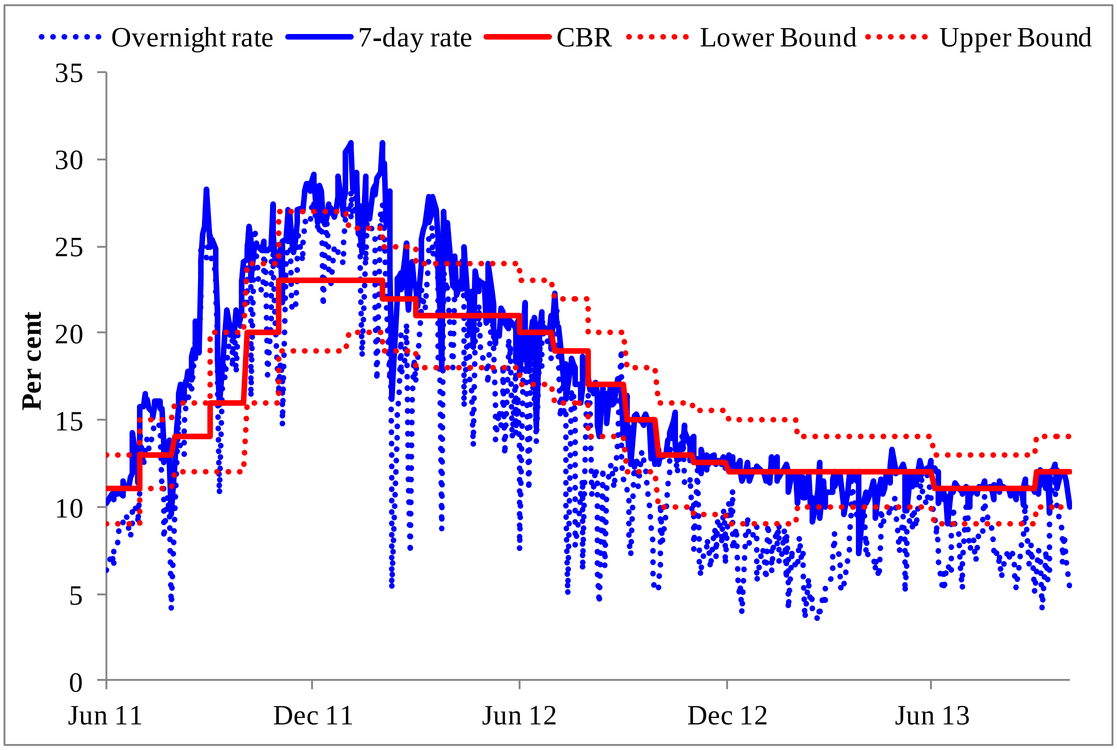
2.2.1 Interbank money markets

Commercial banks' activity in the interbank money market increased by 15 per cent to Shs. 5,976 billion in the three months to September 2013, from Shs 5,102 billion in the three months to June 2013. Trading activity was dominated by overnight trades, which accounted for about 66 per cent over the quarter: increasing to Shs. 3,959 billion, from Shs. 3,690 billion in the previous quarter. The 7-day tenor, which constituted 29 per cent of total trading, increased to Shs. 1,722 billion worth of interbank trades from Shs. 1,233 billion during the same period. The dominance of overnight trading dates back to Q4 2012 and coincides with the prevalence of a structural liquidity surplus in the banking system.

In a bid to sterilize the structural liquidity, BoU withdrew Shs. 4,098 billion from the market using the REPO instrument; only Shs. 327 billion remained outstanding at the end of the quarter. Consequently, the monetary base fell by Shs. 110 billion over the quarter to September, following a decline by Shs. 205 billion in the previous quarter.

The weighted average 7-day interbank rate trended within the lower bound of the CBR for most of the quarter, although it rose above the CBR in the second half of July. The 7-day weighted interbank money market rate averaged 11.0 per cent in July and August when the CBR was 11.0 per cent and averaged 11.8 per cent in September when the CBR rose to 12.0 per cent. ***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



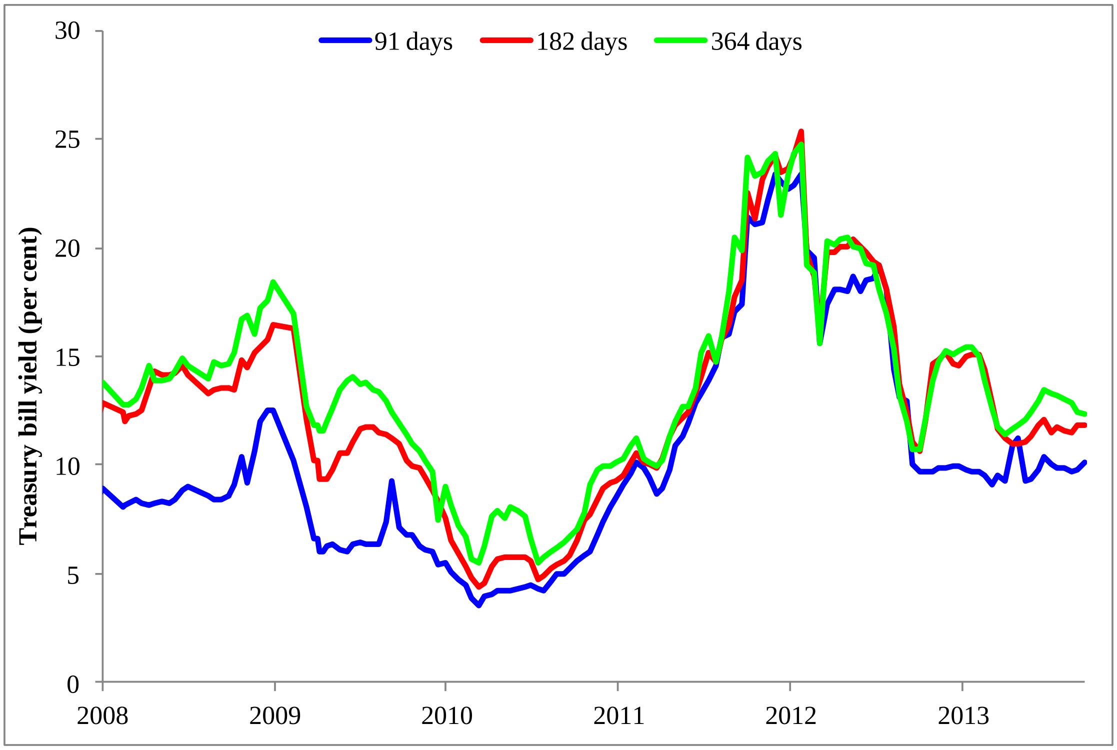
Source: Bank of Uganda

2.2.2 Treasury securities market

In line with fiscal financing needs, BOU conducted six Treasury bill auctions and three Treasury bond auctions during the quarter ending September 2013. On average, the Treasury bill auctions registered higher yields for all tenors relative to the previous quarter save for the 91-day Treasury bill, which declined to 9.9 per cent from an average of 10.0 per cent in the previous quarter. Weighted average annualized yields for the 182-day and 364-day treasury papers rose to 11.7 per cent and 12.9 per cent respectively in September, from respective rates of 11.4 per cent and 12.3 per cent in June. Although yields rose on average during the quarter, they declined at each subsequent auction between June and September 2013.

In contrast, average yields on Treasury bonds declined during the quarter reflecting lower inflation expectations. The 2-year, 3-year 5-year and 10-year Treasury bond yields fell on average to 12.9 per cent, 14.0 per cent, 13.9 per cent and 14.8 per cent from respective rates of 14.2 per cent, 14.6 per cent, 14.7 per cent and 15.1 per cent in the previous quarter. ***Figure 3***, below, highlights movements in Treasury bill yields.

Figure 3: Treasury bill yields



Source: Bank of Uganda

Reflecting developments in the primary market, secondary market yields for treasury securities rose during the quarter to September 2013. Annualized rates for securities of less than 91-days, less than 182-days and less than 364-days rose to 9.6 per cent, 11.4 per cent and 12.4 per cent respectively, compared to respective rates of 9.1 per cent, 11.1 per cent and 12.2 per cent in the previous quarter. The overall volume of Treasury bills traded in the secondary market decreased to Shs. 129.9 billion in the quarter to September 2013, from Shs. 151.9 billion in June. The bulk of trading was for securities of less than 364-days. ***Table 1*** presents a summary of secondary market activity for Treasury bills over the quarter ending September 2013.

Table 1: Secondary Market Activity on Treasury bills

	91-days		182-days		364-days	
	Bid	Offer	Bid	Offer	Bid	Offer
Minimum	9.39	9.29	11.05	10.94	12.08	11.96
Maximum	10.14	10.14	12.44	12.16	12.98	12.86
Average (simple)	9.63	9.51	11.45	11.33	12.55	12.42
	Total trading activity					
Transactions			9.40		237.20	
Horizontal repos						
Outright sales			9.40		237.20	
Average discount rate	9.27		10.81		11.44	
Average yield-to-maturity	9.57		11.39		12.49	

Source: Bank of Uganda

As in the previous quarter, the turnover was greater for bonds than bills reflecting preference for longer dated paper. Secondary market trading for Treasury bonds rose over the quarter to September 2013 to Shs. 533.2 billion, from Shs. 490.6 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 13.5 per cent, 13.8 per cent, 14.2 per cent and 14.6 per cent respectively in the quarter. ***Table 2*** presents a summary of indicative bid and offer quotes for 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	Offer	Bid	Offer	Bid	Offer	Bid	Offer
Minimum	12.70	12.60	13.10	13.00	13.70	13.60	14.20	14.10
Maximum	14.10	14.00	14.50	14.40	14.55	14.55	14.90	14.80
Average (simple)	13.57	13.46	13.83	13.73	14.27	14.17	14.61	14.50
	Total trading activity							
Outright sales	93.13		298.64		73.78		66.67	
Average yield-to-maturity	13.51		13.78		14.22		14.56	

Source: Bank of Uganda

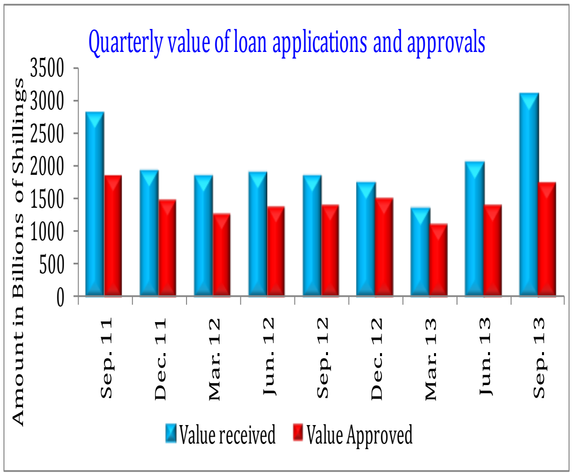
2.3 Monetary aggregates and private sector credit

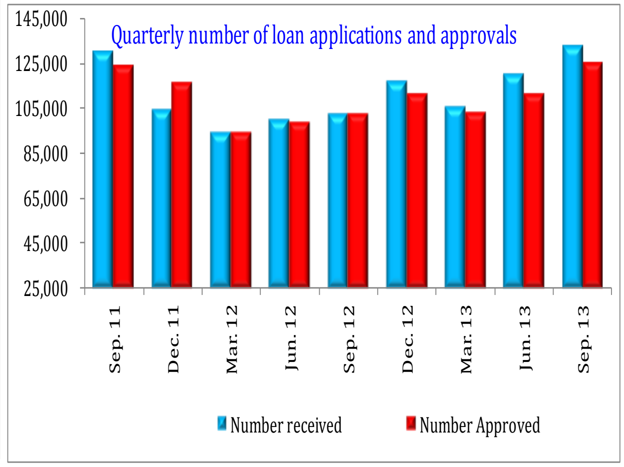
*Responsible credit growth is also necessary to economic expansion, as may be evaluated with respect to lending and deposit rates and credit growth. Very low commercial bank interest rates are likely to increase credit demand, but also credit demand for risky projects, as the borrower has less to lose. 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 Loan supply and demand

In the quarter ending September 2013, credit demand and supply peaked at levels similar to those last observed in September 2011, just before the apex of high inflationary pressures experienced in October 2011. The number of loan applications (proxy for credit demand) increased to 133,249 applications over the July to September 2013 period, from 120,509 applications over April to June 2013. Likewise, loan approvals (proxy for credit supply) increased to 125,334, from 111,805 over the same period. Concern surrounding borrower's collateral continues to be the main reason behind lesser credit approvals than applications received (although one would naturally expect applications to exceed approvals). A summary of loan applications and approvals is shown in ***figure 4***.

Figure 4: Loan applications and approvals





Source: Bank of Uganda

Demand continues to outstrip supply in value terms also, reflecting the possibility of credit rationing by deposit-taking institutions. In the three quarters of 2013, the Building, Mortgage, Construction and Real Estate Sector, Personal and Household loans and the Trade sector have dominated lending, accounting for 63 per cent of all loans and 65 per cent of total non-performing loans1. For the quarter ending September 2013, loan applications totalled Shs. 1,054 billion, while loan approvals only amounted to Shs. 349 billion. The most recent quarter does present a credit constraint when compared to the quarter ending June 2013, where loan applications totalled Shs. 714 billion and loan approvals Shs. 284 billion. Nonetheless, the sustained increase in both credit demand and supply throughout 2013 reflects a credit recovery from the low levels experienced in 2012, and presents an optimistic picture for economic growth.

2.3.2 Loan Extensions and Recoveries

A flow analysis of loans extended by ODCs also confirms that credit supply has increased, and at a faster than credit recovery. In the three months to September, credit extended by all depository taking institutions stood at Shs. 2,932 billion; Shs. 268 billion higher than loan recoveries over the period. Comparatively, over the three months to June 2013, Shs. 2,649 billion was extended, of which Shs. 2,645 billion was recovered, presenting a net extension of only Shs. 4 billion..

Foreign currency lending has registered a positive net recovery throughout 2013 due to both increasing loan recoveries amidst falling loan extensions; this may be partly an effect of new commercial bank regulation to observe prudential requirements with respect to foreign lending. Shilling denominated lending, on the other hand, presented a net extension over the period, driven by both increased loan extensions and lesser loan recoveries. However, despite the lesser

1 As at March 2013

loan recoveries in Shilling denominated loans, the NPA[2] ratio remained stable at 4.0 per cent in September 2013. ***Table 3*** presents net loan extensions in foreign and domestic currency.

Table 3: Loan Recoveries and Extensions

	Shilling Loans			Forex Loans			NPA
	Extensions	Recoveries	Net Extensions	Extensions	Recoveries	Net Extensions	
Sep-11	1432.24	1156.01	276.23	745.59	650.83	94.76	1.81
Dec-11	1383.19	1409.19	-26.00	998.14	1011.38	-13.24	2.21
Mar-12	1059.50	1349.80	-290.31	1053.06	745.43	307.63	3.40
Jun-12	1263.29	1334.56	-71.27	1083.63	976.71	106.92	3.92
Sep-12	1351.22	1281.14	70.08	1017.62	1031.58	-13.95	4.65
Dec-12	1477.32	1438.69	38.63	1351.16	1166.17	184.99	4.23
Mar-13	1217.11	1118.76	98.35	1124.70	1275.32	-150.62	4.66
Jun-13	1514.01	1298.54	215.47	1134.56	1346.93	-212.37	3.97
Sep-13	1750.91	1415.61	335.30	1181.00	1248.63	-67.63	

Source: Bank of Uganda

On a quarterly basis, PSC grew by 3.8 per cent in September and was predominantly driven by growth in Shilling denominated loans equal to 2.9 per cent. Over the quarter, foreign currency denominated loans also grew by 0.8 per cent in Shilling terms, or by 1.7 per cent in Dollar terms. Comparatively, Shilling denominated loans grew by 0.9 per cent in the quarter ending June 2012, whilst foreign currency denominated loans contracted by 0.9 per cent. Although Private Sector Credit growth was greatest in the most recent quarter compared to the rest of 2013, it remains relatively subdued due to the large differential between interest rates on domestic and foreign currency, which has skewed lending in favour of large corporations and upper income individuals: those who are able to access foreign currency denominated credit. Consequently, large corporations and upper income individuals account for nearly all growth in PSC over the quarter. ***Table 4***, below, presents a summary of lending to the private sector.

[2] NPA Ratio is the share of Non Performing Loans in Total Loans.

Table 4: Private Sector Credit growth by currency

	Claims on the Private Sector	ODCs' Loans shs.	ODCs' Loans fx	ODC Forex Loans in USD
Sep-11	8.58	5.97	12.30	3.04
Dec-11	-0.91	-0.77	3.77	8.04
Mar-12	1.70	-2.69	19.21	10.14
Jun-12	1.88	-0.50	5.42	6.84
Sep-12	1.71	-0.28	6.33	3.56
Dec-12	6.09	1.21	9.26	5.17
Mar-13	-1.71	-1.69	-1.42	1.25
Jun-13	0.27	0.89	-0.91	-0.75
Sep-13	3.84	2.89	0.76	1.67

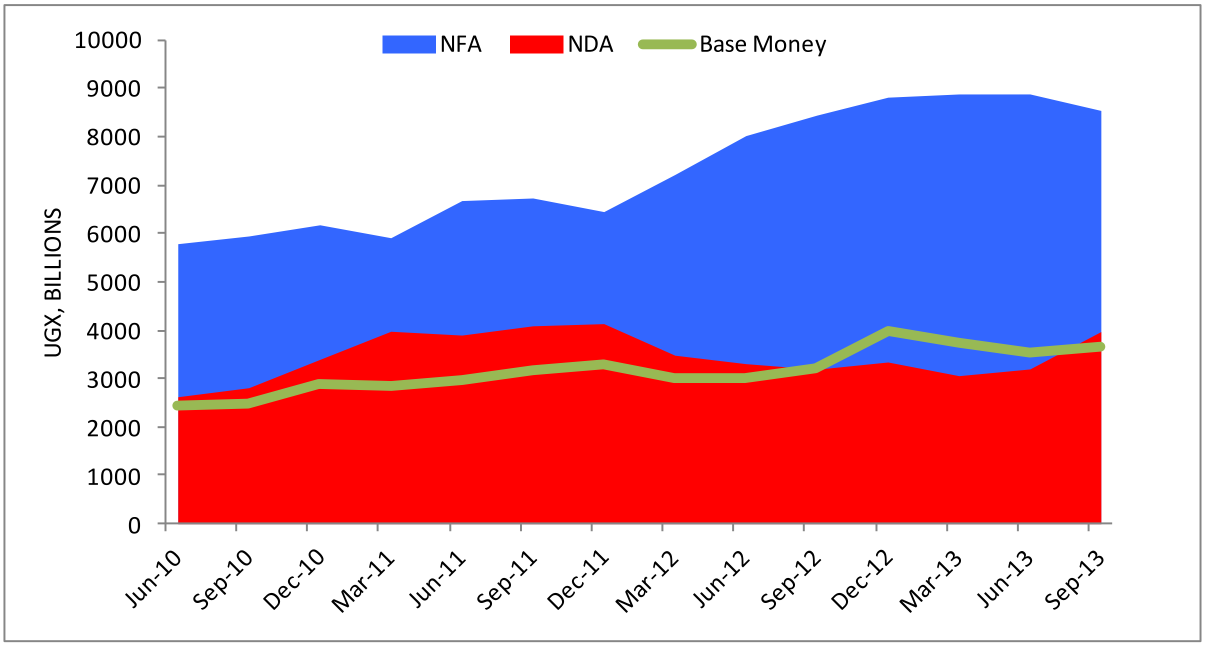
Source: Bank of Uganda

2.3.3 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 net liquidity injections into the banking system, base money grew by 3.1 per cent in the quarter ended September 2013 contrary to a quarterly decline of 5.4 per cent registered at the end of June 2013. Net Domestic Assets of the banking system continued to drive base money, and grew by 24.1 per cent over the quarter ending September 2013, compared to 4.5 per cent over the quarter ending in June. NFA, on the other hand, fell by 3.8 per cent over the quarter, from a position of Shs. 8.9 trillion that had been maintained since March 2013. Growth in NDA was spearheaded by increased holdings of Government securities by Other Depository Corporations (ODCs), holdings of which grew by 10.6 per cent in the three months to September, compared to 3.9 per cent in the three months to June. Movements in base money, NFA and NDA is shown in ***figure 5.*** Similarly to base money, M3 grew by 3.5 per cent over the quarter, compared to 1.2 per cent previously. M3 growth was largely driven by an accumulation in foreign currency deposits, amounting to 12.0 per cent, as many banks were forced by requirement to pause their foreign currency lending until their reserves had been re-established.

Figure 5: Evolution of base money and its components



Source: Bank of Uganda

Currency in circulation (CIC) on the other hand continued to fall by 0.1 per cent over the quarter ending September, compared to a decline of 0.5 per cent in the quarter ending June 2013.

Other monetary aggregates did not grow as fast as M3 over the quarter: M1 grew by 0.4 per cent in September, relative to a decline of 1.4 per cent in June; while M2 fell by 0.6 per cent over the quarter, contrary to a growth of 1.6 per cent previously. The lower growth in M1 and the decline in M2 over the quarter resulted from slower growth in demand deposits and in time and savings deposits. Demand deposits grew by 0.8 per cent in September relative to 2.1 per cent in June, while time and savings deposits also grew by 0.8 per cent compared to 6.2 per cent previously. Quarterly growth in monetary aggregates is shown in ***table 5.***

Table 5: Evolution of Monetary Aggregates and Private Sector Deposits

	Monetary Aggregates				Currency	Private Sector Deposits		
	Base Money	M1	M2	M3	CIC	Transferable	Time and Savings	Foreign Currency
Sep-11	6.27	-3.17	-2.65	2.31	4.46	-8.31	-1.92	18.38
Dec-11	4.67	0.10	-1.03	-2.18	5.38	-3.95	-2.58	-5.27
Mar-12	-8.62	0.54	0.25	1.11	-9.12	8.68	-0.16	3.51
Jun-12	-0.13	-3.19	-0.79	5.89	2.67	-7.31	2.63	23.90
Sep-12	7.23	8.06	6.58	2.73	1.79	12.95	4.60	-5.58
Dec-12	23.08	13.20	7.48	4.47	13.77	12.79	-0.46	-2.88
Mar-13	-5.91	-1.73	-0.60	-1.77	-4.21	0.03	1.18	-4.91
Jun-13	-5.37	-1.41	1.60	1.16	-0.48	-2.05	6.23	-0.09
Sep-13	3.08	0.43	0.59	3.54	-0.14	0.82	0.81	12.01

Source: Bank of Uganda

Notes: Transferable=Demand; CIC=Currency in Circulation

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

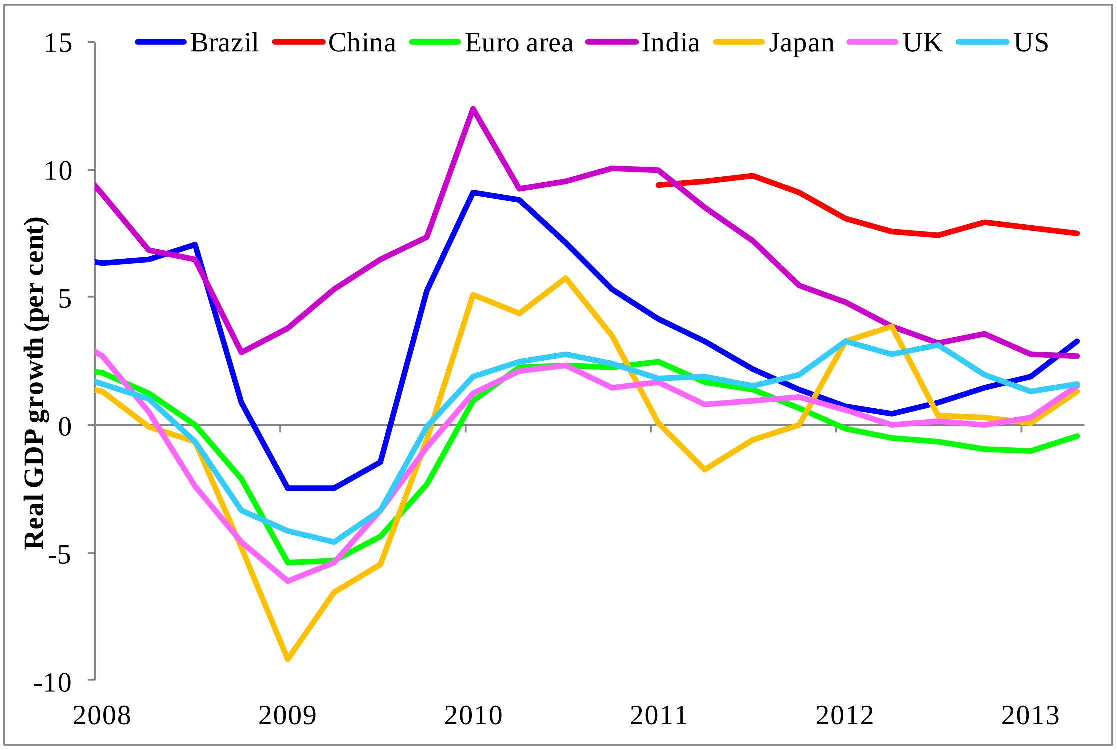
Although outside the control of Ugandan policymakers and business leaders, global economic forces play a critical role within the Ugandan economy. The small size and relatively open nature of the Ugandan economy make it highly vulnerable to global economic developments, particularly via financial flows, 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.

Global economic activity continued to grow at a modest pace during Q3 2013, although slow growth was noted amongst the major emerging market economies, particularly India, China and Brazil. In a turn of events, advanced economies led the global economic upturn. Global economic growth, as indicated by the JP Morgan Global All-Industry Output Index, continued to improve, rising to 53.5 in Q3 2013 from 52.1 in Q2 2013. The Index was boosted from increased growth momentum in the manufacturing sector.

In accordance with relatively subdued global economic activity, world trade continued to be weak during Q3 2013, which caused the IMF to downcast their projections for world trade volume growth to 2.9 and 4.9 per cent in 2013 and 2014 respectively, from 3.1 and 5.3 per cent in the July 2013 forecast. The IMF further emphasised that the slowdown in global trade has reduced trade surpluses amongst oil exporters and reduced global trade imbalances.

Figure 6 presents annual GDP growth for selected countries.

Figure 6: Real annual GDP growth (per cent)



Source: OECD Statistics

Growth in emerging market economies came under pressure over Q3 2013 as potential growth fell. China and India experienced lower growth as their potential output decreased from tighter financial market conditions; similarly, South Africa and Russia experienced lower growth on account of cyclical factors. The slowdown in emerging market economies has exerted downward pressure on international prices, but has also tapered the global economic recovery.

Conversely, growth improved in the advanced economies over Q3 2013. Specifically, the euro zone picked up somewhat, as indicated by an improvement in the Markit Euro zone Composite Output Index for both the manufacturing and services sectors. The US continues to display stronger economic performance, marked by solid private sector demand, although public sector demand continues to decline on account of the sequester.

The slowdown in EMEs and DEs might lead to a decline in Uganda's export earnings since these economies make up the largest proportion of Uganda's export market. On a positive note, the recovery that is starting to take hold in the EU, although still very soft, is a positive for our export sector as the EU is the largest export destination for coffee, Uganda's main export commodity.

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) provides information on economic developments in the country on a more timely and frequent basis compared to actual GDP. The monthly CIEA[3] rose by 0.6 per cent, from 161.2 in July 2013 (revised), to 162.2[4] in August 2013. This presents a slight increase from the 0.5 per cent average growth estimated since January 2013 (see ***figures 1*** and ***2***). The slight improvement observed in monthly economic activity may be attributed to an increase in private sector investment and in wholesale and retail activities, with each contributing 0.2 percentage points to aggregate growth. Economic activity over the quarter to August 2013 grew by 1.6 per cent, compared to 1.4 per cent over the quarter to May 2013.

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 1*** *shows that during August 2013, the services sector registered an increase in activity while the rest declined.*

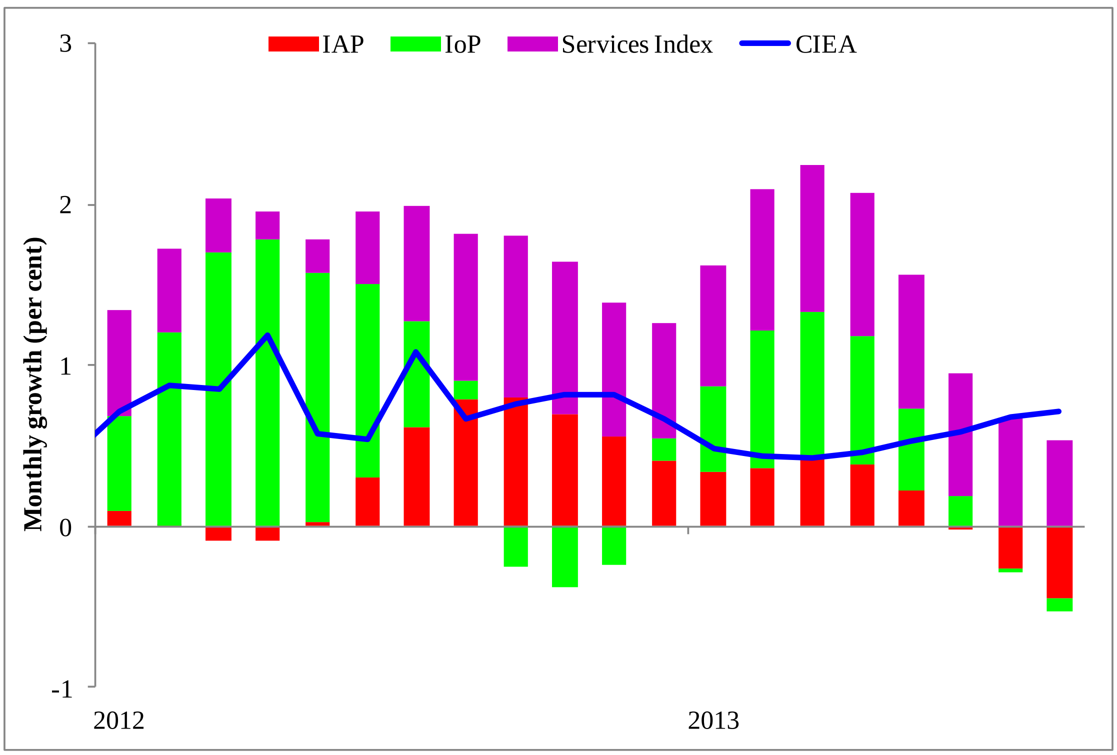
Industrial activity is estimated to have declined by 0.1 per cent in August 2013, as shown by a decline in the IoP from 202.7 in July 2013 to 202.5 in August 2013. The food processing, beverages and tobacco, textile and footwear subsectors were most accountable for the decline in August 2013. However, on a quarterly basis, the IoP grew by 0.7 per cent from 201.1 in the quarter ending May 2013, to 202.6 in the quarter ending August 2013. However, this is low growth, especially when compared to the 2.3 per cent growth that was estimated in May 2013.

[3] 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 gross credit extension, total exports and imports.
[4] Please note that the index is intended to show the direction of growth as opposed to its magnitude.

The monthly services index5 rose, but at a lesser rate: by 0.5 per cent, from 173.8 in July 2013 to 174.8 in August 2013, suggesting continued growth of the sector (see ***figure x, table 1*** and ***Appendix 3***). The observed improvement in economic activity in the services sector was mainly due to wholesale and retail activities and to financial services activities, which contributed 0.3 and 0.2 percentage points respectively to service sector growth. The services sector is estimated to have grown by 2.3 per cent in the quarter to August 2013 to 173.7, from an index value of 169.9 in the quarter to May 2013.

Monthly agricultural production is estimated to have declined by 0.4 per cent in August 2013. This is shown by a decrease in the IAP from 112.5 in July 2013 to 112.0 in August 2013. The decline may be attributed to the prolonged drought that mostly affected market deliveries of maize grain, sweet potatoes, Irish potatoes and cassava. On a quarterly basis, the IAP declined by 0.1 per cent in the quarter to August 2013 to 112.4, from 112.5 in the quarter ending May 2013 (See ***figure 7, table 1*** and ***Appendix 4***).

Figure 7: CIEA and Sector indices



[5] The index aggregates Trend cycle estimates of real data on vehicles & motorcycles licensed, petroleum _excise duty, non interest income, VAT, travel expenses by non-residents, base metal &other products.

3.2.1.2 Employment Index

The monthly employment index, which is based on the number of jobs advertised, indicates a 1.2 per cent decline in job opportunities during August 2013, when compared to July 2013. This is consistent with the number of newly registered employees that contribute to NSSF, which posted a contraction of 5.6 per cent over the month. ***Figures 8a*** and ***8b*** present the index values, and growth in, the employment indices.

Figure 8a: Employment indices

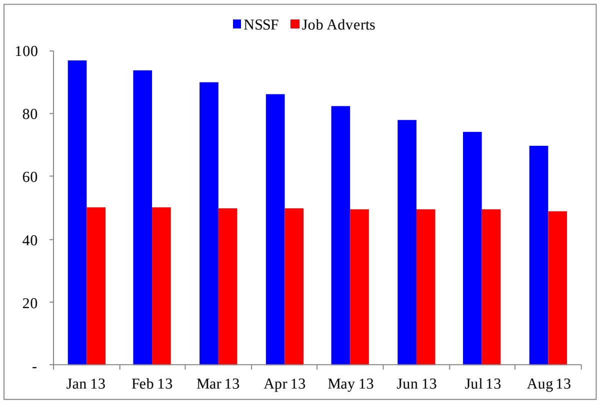
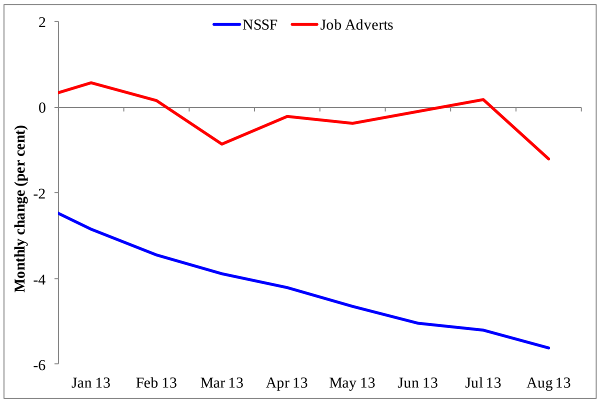


Figure 8b: Employment growth



3.2.2 Confidence Surveys

3.2.2.2 Consumer confidence

The overall Consumer Confidence Index (CCI6) remained pessimistic in September. The index slid to 42.9, from 44.8 points in August 2013. The two sub components of the CCI: Current Economic Condition Index (CECI) and Consumer expectation (CCI) both deteriorated over the month (***figure x***).

The CECI decreased to 34.2, from 34.6 points in August 2013, mainly due to low confidence levels in the present general economic conditions index, which decreased from 28.9 in August 2013 to 26.9 points in September 2013. The expectations index also declined to 48.6 points over the month, from 51.5 in August 2013. All sectors express continued concern over an increase in unemployment. Consumers remain optimistic over their financial condition in the coming 3 months, though the level of optimism declined from 57.4 in August 2013 to 56.7 in September 2013. Buying intentions remain positive, but slightly less so as the index fell from 51.8 in August to 51.0 in September.

6 CCI is derived from Diffusion Indices (DI), which is calculated as: DI = 100 (P + E/2) Where; P is the fraction of positive (+) replies in the total, E are the fraction of equal (=) replies in the total. Implying DI varies from 0 to 100.

Table 6: CCI and Component Indicators

	Feb 13	Mar 13	Apr 13	May 13	Jun 13	Jul 13	Aug 13	Sep 13
Overall Consumer Confidence	42.1	48.6	42.3	40.6	38.3	34.0	44.8	42.9
Current Economic Condition Index (CECI)	30.5	36.3	30.2	30.8	31.5	26.2	34.6	34.2
Present Economic conditions	29.3	37.7	31.6	28.4	28.6	25.0	28.9	26.9
Job availability	30.7	34.9	28.8	33.2	34.4	27.3	40.3	41.5
Consumer Expectation Index (CEI)	50.2	56.9	50.4	47.2	42.8	39.3	51.5	48.6
Economic condition in next 3 months	50.6	59.9	52.2	46.8	41.2	36.5	45.5	42.9
Job availability in next 3 months	42.1	49.4	44.5	40.3	39.9	36.5	51.6	46.3
Financial conditions in next 3 months	57.8	61.3	54.5	54.5	47.4	44.9	57.4	56.7
Price expectation Index	24.0	28.2	26.7	27.6	15.2	13.5	19.5	17.3
Buying Intention	41.2	45.7	47.2	41.5	45.2	44.4	51.8	51.0

3.2.2.2 Business Confidence

Business confidence remained upbeat in September 2013; the overall Confidence Index (CI)7 increased by 0.5 points to 62.8 in September 2013, from 62.3 points in August 2013 (See ***figure x*** and ***table 3***). On a quarterly basis, business confidence was positive at 61.5 points over the quarter to September 2013, compared to 60.4 points over the quarter to June 2013 (See ***figure 6*** and ***table 3***).

At the sectoral level, business sentiment was optimistic across sectors in September 2013, scoring 64.4, 60.2, 56.2, 69.1 and 62.4 points in the construction, manufacturing, wholesale and retail trade, agriculture and ‘other’ sectors respectively. All sectors, with the exceptions of wholesale and retail trade and ‘other’ sectors, furthermore experienced increased optimism. On a quarterly basis, business confidence improved across all sectors, again with excluding wholesale and retail trade, which remained constant, and ‘other’ sectors. The confidence indices for construction, manufacturing, wholesale and retail trade, agricultural and ‘other’ sectors stood at 60.1, 57.5, 56.9, 63.3 and 64.7 points respectively for the quarter ending September 2013, compared to 54.9, 59.3, 56.1, 57.0 and 67.6 points respectively in the quarter ending June 2013.

Businesses remained upbeat surrounding their outlook for three months ahead. The confidence indices for construction, manufacturing, wholesale and retail trade, agricultural and ‘other’ sectors were 77.6, 70.5, 68.6, 75.0 and 73.1 points respectively over the quarter (see ***table 3***).

Competition, the high cost of finance, low demand, high input costs and delays in payment were cited by businesses as the major factors limiting business activity across sectors.

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.

Other sector-specific issues included: limited capital, delays at the land registry offices and opaque government procedures, particularly within the construction sector. The manufacturing sector complained of unavailability of raw input materials and from counterfeit products, while the agricultural sector cited seasonal changes and price fluctuations as factors limiting production. 'Other' sectors mentioned that low economic growth has affected business activity.

Figures 9a and 9b: Overall Business Confidence Index

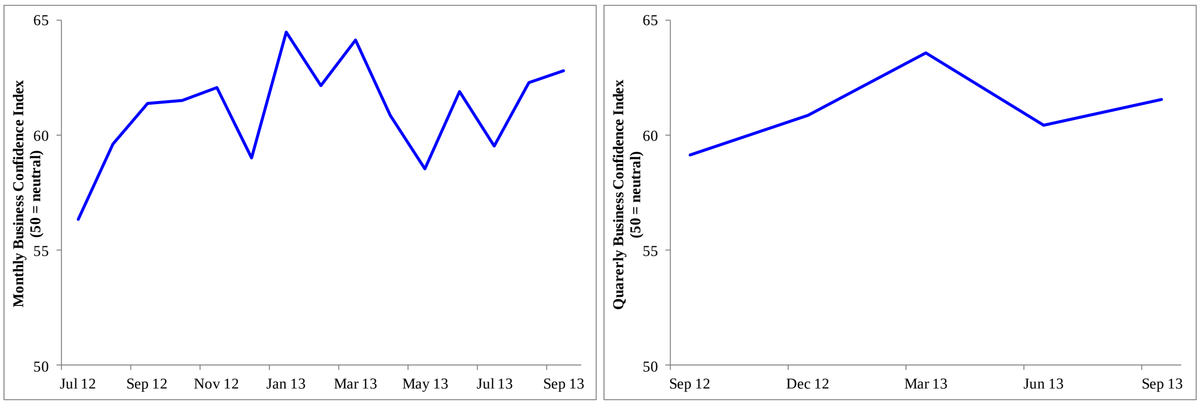
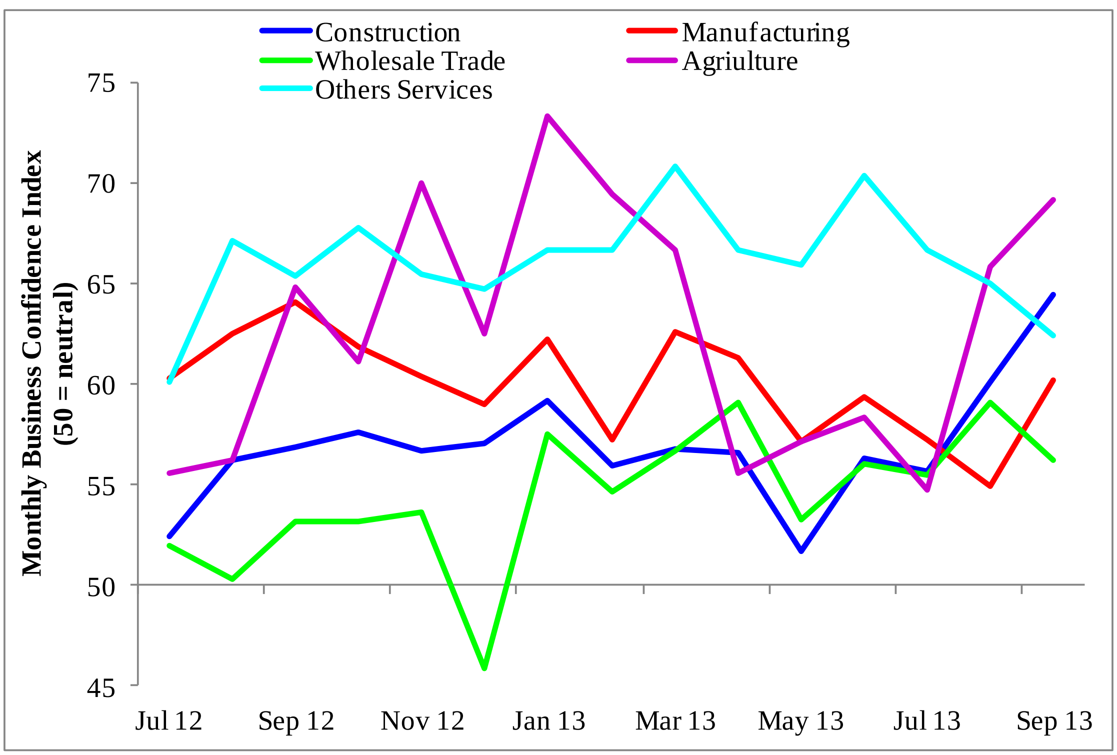


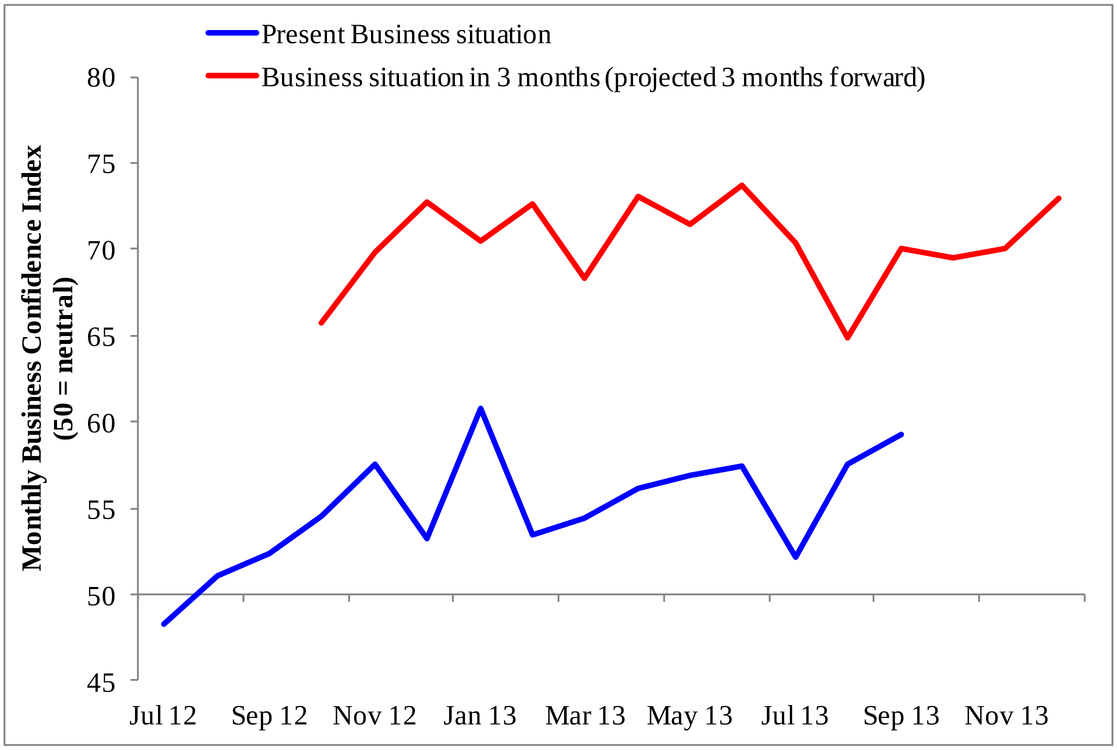
Figure 10: Business Confidence across Sectors



3.2.2.3 Trends in Business Situation Indices

Figure 11, below, shows the divergence between the projected and the actual business outlook, although like movements in direction. Reassuringly, business confidence always lies above the actual outturn.

Figure 11: Trends in Business Situation Indices



3.2.3 Fiscal activity

Government operations in the three months to August 2013 resulted in a net borrowing position of Shs. 793.6 billion, which was significantly higher than the net borrowing position of the previous period, and above that experienced in the corresponding period of 2012. The higher net borrowing was a result of higher government expenditure, which overwhelmed the buoyant revenue performance during the period (***Table 7*** and ***Appendix 1***).

Table 7: Fiscal operations (UGX billions)

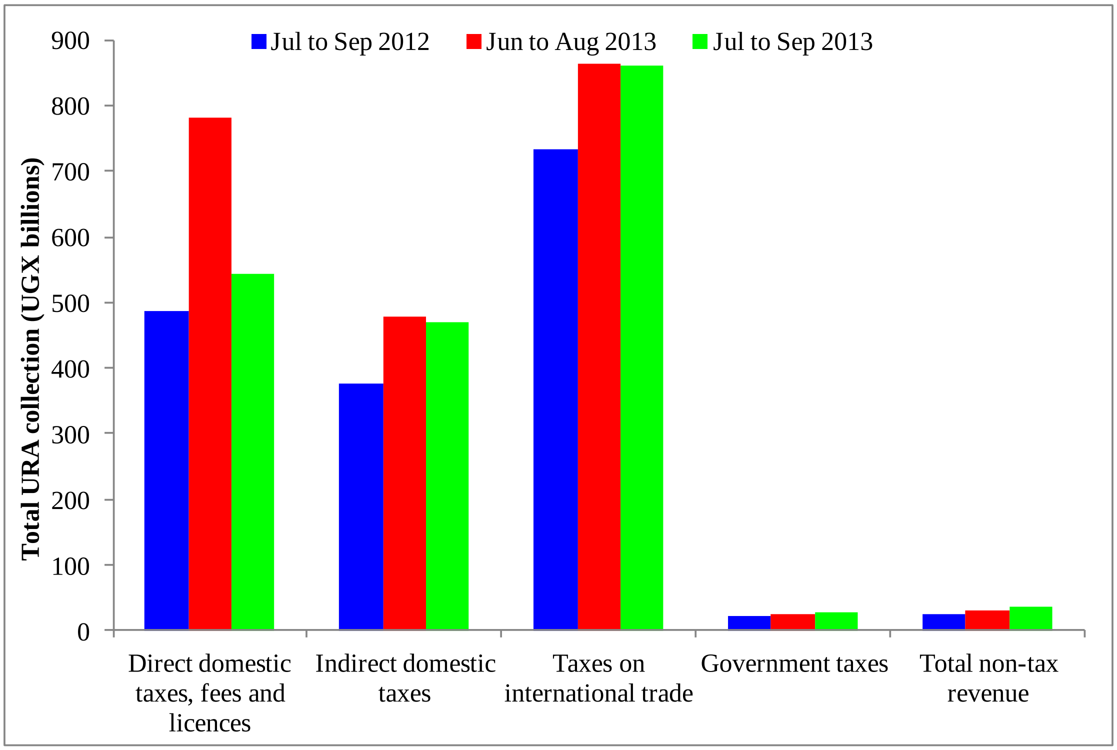
	June to August 2012	March to May 2013	June to August 2013
Revenue	2088.4	1881.9	2201.2
Taxes	1792.8	1754.2	2054.9
Social contributions			
Grants	247.0	96.5	109.8
Other revenue	48.6	31.2	36.4
Expense	1859.8	1621.6	2249.6
Compensation of employees	330.4	360.2	374.2
Purchase of goods and services	411.0	368.0	532.2
Consumption of fixed capital			
Interest	200.4	228.9	210.5
Subsidies		1.5	15.7
Grants	773.7	557.1	915.7
Social benefits	78.2	52.2	100.9
Other expense	66.2	53.7	100.4
Gross operating balance	228.7	260.3	-48.4
Net operating balance	228.7	260.3	-48.4
Transactions in nonfinancial assets:			
Net Acquisition of Nonfinancial Assets	670.4	411.9	745.2
Fixed assets	651.6	403.1	686.4
Change in inventories			
Valuables			
Nonproduced assets	18.8	8.8	58.8
Net lending / borrowing	-441.8	-151.6	-793.6
Transactions in financial assets and liabilities (financing):			
Net acquisition of financial assets	572.3	-180.2	890.6
Domestic	572.3	-180.2	890.6
Foreign			
Monetary gold and SDRs			
Net incurrence of liabilities	979.7	291.3	1754.6
Domestic	600.7	86.9	1111.9
Foreign	379.1	204.4	642.7
Errors and Omissions	-34.3	319.9	70.3

Source: Ministry of Finance, Planning & Economic Development (MoFPED)

3.2.3.1 Revenue performance

Government revenue for the three months to August 2013 amounted to Shs. 2,201.2 billion, which was stronger than in the previous three months or the previous year. Strong performance from all government revenue sources: grants, taxes and non-tax revenue, led to the improved performance. Higher tax collections over the period resulted from surpluses in direct tax collections in July and August 2013 (***Figure 12*** and ***Appendix 2***); the best performing tax heads were Pay As You Earn (PAYE), import duty and VAT on imports. Higher grant revenues arose from higher project grant receipts during the period.

Figure 12: Revenue performance (UGX billions)



Data Source: Ministry of Finance, Planning and Economic Development

3.2.3.2 Expenditure performance

Total government expenditure8 followed the upwards trend presented over recent months. Higher development expenditure, reflected by a higher net acquisition of non-financial assets by government, continued to play a key role in this trend. Government interest payments remained broadly stable relative to the three months to May 2013 and to the corresponding period in 2012.

3.2.3.3 Financing

Fiscal operations were financed by Shs. 863.9 billion worth of financing, which was significantly higher than in the previous period and in the corresponding period of 2012. Foreign financing accounted for a large proportion at Shs. 642.7 billion, compared to Shs. 221.2 billion of domestic financing.9

[8] Expense and Net acquisition of Non-financial assets
[9] Financing is the difference between the net incurrence of liabilities and the net acquisition of financial assets in Table 1.

The stock of government securities at the end of the quarter ending August 2013 was Shs. 6,970.2 billion, which was 2.2 per cent more than in the previous period and 20.8 per cent higher than in the corresponding period of 2012 (***table 8*** and ***Appendix 3***). The growth of government securities mainly occurred within the three year and ten year treasury bonds and the 364-day Treasury bill. The ratio of the stock of treasury bonds to treasury bills remained at 63:37, which reflects a continued convergence of the ratio towards the desired annual target, although little change over the quarter. The 70:30 target is aimed to support the issuance of longer dated maturities and thus hedge against interest rate and refinancing risk.

Table 8: Stock of government securities (UGX billions, end of period)

	Aug 12	Jul 13	Aug 13
Total stock	5768.0	6819.5	6970.2
Treasury bonds	3249.9	4262.2	4402.2
2 year	1050.0	1065.4	1065.4
3 year	1090.0	1525.4	1605.4
5 year	705.0	1125.0	1125.0
10 year	404.9	546.5	606.5
Treasury bills	2518.1	2557.2	2568.0
91 day	60.3	96.7	77.5
182 day	196.7	310.0	300.0
364 day	2261.1	2150.5	2190.5
Bonds:bills	2.4	2.7	2.7

Source: Bank of Uganda

4 Exchange rates and balance of payments

4.1 Exchange rates

Exchange rate movements stem from changes in interest rates and price deferential; low domestic interest rates or high inflation will create exchange rate depreciation, as explained through the interest rate parity condition. This relationship is however not unidirectional, since the exchange rate is also an important determinant of inflation with an estimated path through of 0.4 to domestic prices for Uganda. A domestic real depreciation improves competitiveness of Uganda's exports sector with growth benefits whilst making imports costly.

This is through, the real effective exchange rate (REER) which adjusts the nominal effective exchange rate (NEER) for relative price levels. A depreciation of the effective exchange rate will increase the marginal cost of imports, which is likely to reduce import demand through expenditure switching from foreign to domestic goods or increase domestic inflation. This section reviews the exchange rate movements and the exchange rate management actions by the BOU during the second quarter of 2013.

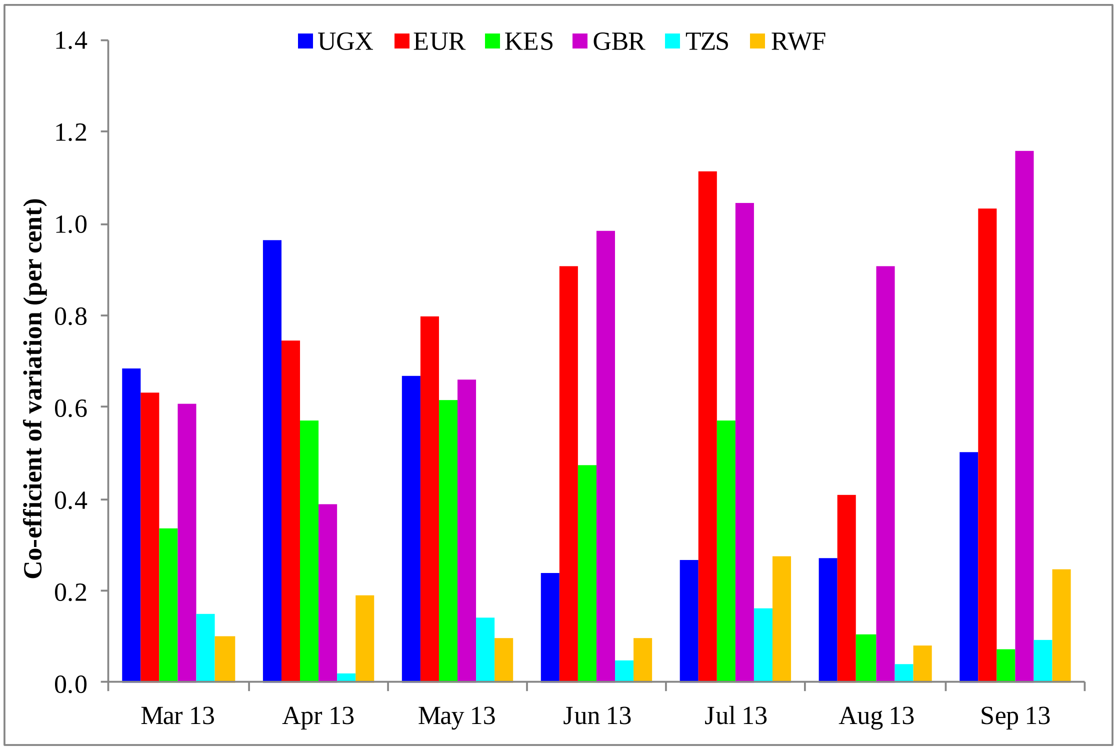
The Ugandan Shilling has stabilized along a mild appreciation trajectory over 2013 Q3, particularly when compared to 2012 Q4, which was characterised by heightened volatility and a depreciatory trajectory. Exchange rate volatility, as measured from the coefficient of variation, has dropped from a peak of 1.8 per cent in 2012 Q4, to 0.5 per cent in current quarter (see ***figure 13***). The current exchange rate stability may be a result of improved confidence, following a marked drop in confidence triggered by the suspension of donor budget support in 2012 Q4.

On a quarterly basis, the Shilling appreciated by 0.2 per cent over the three months to September 2013, which is less than the 2.8 per cent appreciation experienced over the three months to June 2013, although the Q2 appreciation was exaggerated by larger than usual appreciation pressures in April 2013. The quarterly appreciation was driven by significantly reduced dollar demand, despite lesser supply also. Nonetheless, there were increased dollar inflows from offshore players over the quarter, due to the weak dollar position.

On an annual basis, the shilling remained depreciated, yet the prevailing depreciation pressures have lost momentum since 2012 Q4. The Shilling depreciated by 3.4 per cent in 2013 Q3, which is slightly lower than the 3.9 per cent depreciation posted in 2013 Q2, and much lower than the 2013 Q1 peak of 10.4 per cent. Accordingly, the Shilling traded at an average midrate of UGX 2,579 per US dollar over 2013 Q3.

The exchange rate stability necessitated no Interbank Foreign Exchange Market intervention by the BoU during 2012 Q3; this contrasts with the US$32.3 million of intervention purchases conducted during 2013 Q2 to smoothen the high volatility observed in April 2013, precipitated by the then mounting bullish sentiments. Nonetheless, BoU conducted targeted sales and purchases for reserve build-up amounting to US$52.6 million and US$132.2 million respectively during the quarter under review, resulting in a net purchase of foreign exchange equal to US$79.5 million from the IFEM.

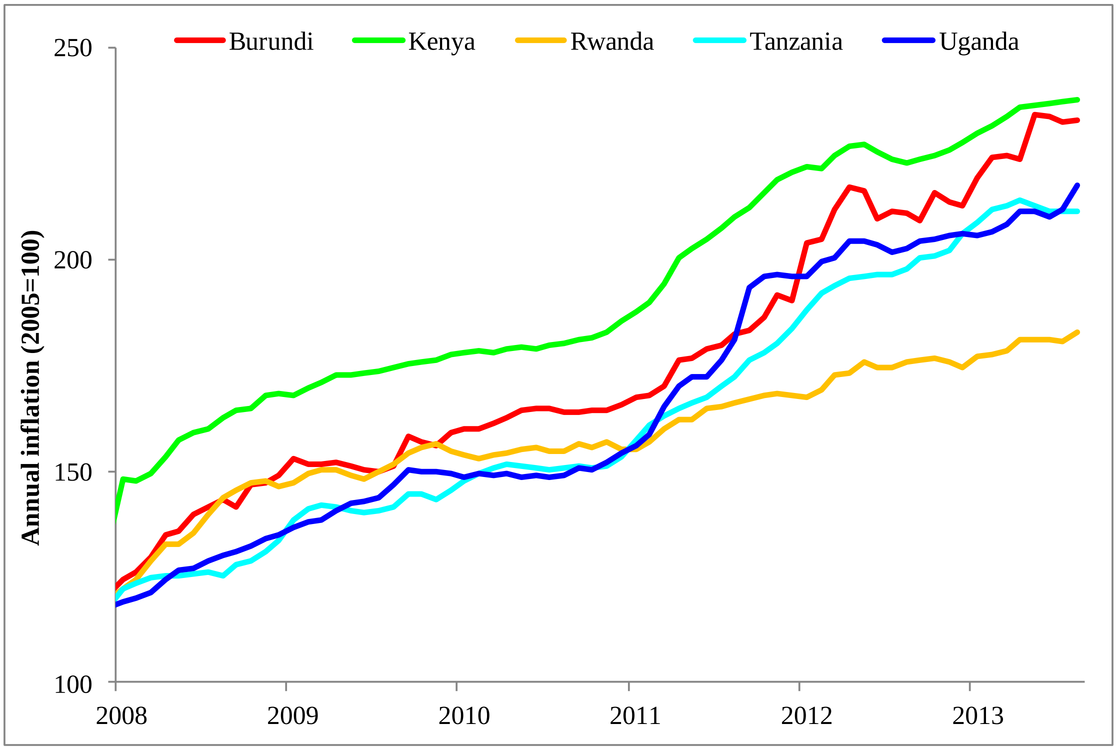
Figure 13: Volatility of selected currencies



Source: Bank of Uganda

Whereas most EAC currencies have been demonstrating increased stability against the dollar, the Rwandan Franc may be becoming more volatile (***Figure 13***). Unlike the Ugandan Shilling, other currencies in the region have depreciated both on a quarterly and on an annual basis. The Kenyan Shilling depreciated by 3.1 per cent over the quarter and by 3.5 per cent over the year; while the Tanzanian Shilling depreciated by 2.2 per cent over the quarter and by 2.5 per cent over the year. The Rwandan and Burundi Francs both depreciated by 1.5 per cent over the quarter and depreciated by 5.6 per cent and 7.0 per cent respectively over the year. However, the Ugandan Shilling is the most depreciated in the region when compared to 2009 levels (***figure 14***). Nonetheless, all East African currencies appear to be driven by similar events, albeit with different impacts dependent upon the openness of the exchange rate regime.

Figure 14: Movement of EAC currencies



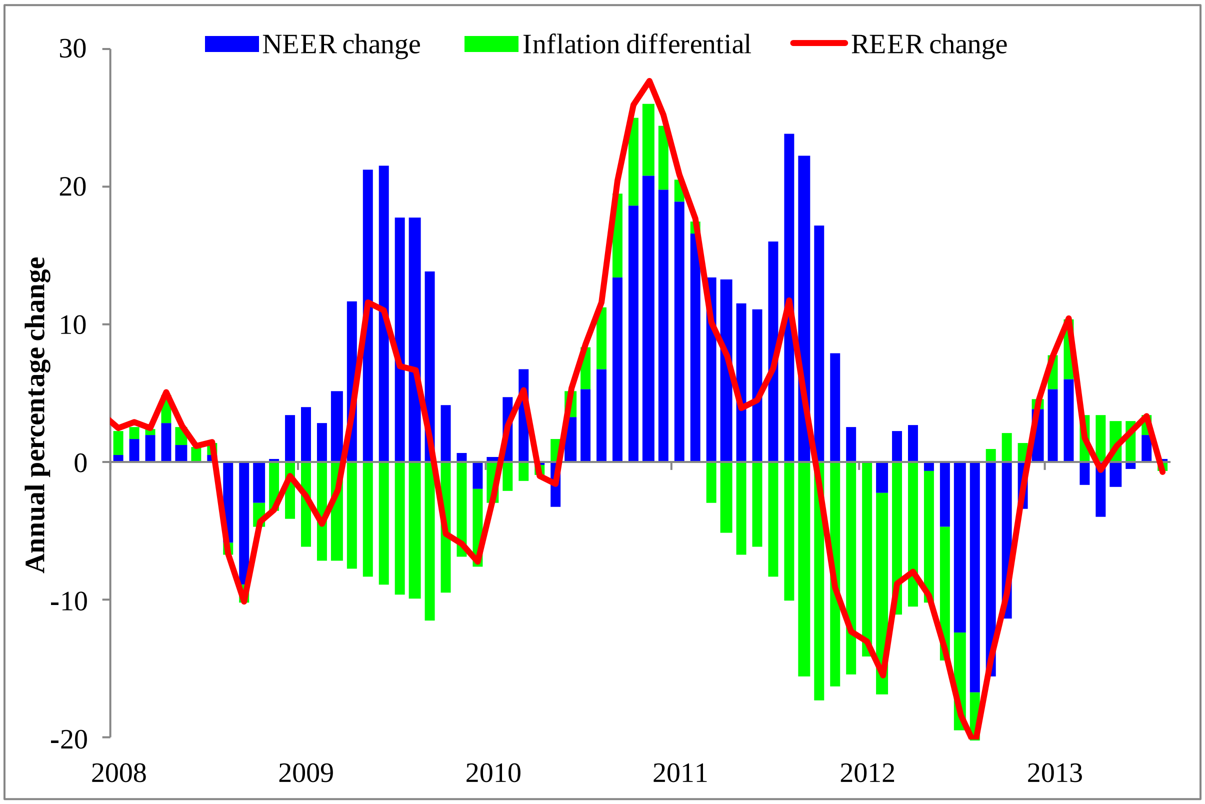
Source: Bank of Uganda

2.5.2 Nominal and real effective exchange rate

The Nominal Effective Exchange Rate (NEER) continued to appreciate over the quarter. However, the extent of appreciation fell to 2.3 per cent in 2013 Q3, compared to 3.6 per cent in 2013 Q2. On an annual basis, the NEER was more or less stable relative to 2013 Q2 (***figure 15***). The quarterly appreciation was largely on account of the strengthening of the Ugandan Shilling against the Indian Rupee (12.4 per cent), the South African Rand (5.4 per cent) and the Indonesian Rupee (8.7 per cent); the aforementioned currencies suffered the most from capital flow reversals, triggered by the announcement of imminent tapering of the US Federal Reserve's quantitative easing program.

In line with the NEER, the Real Effective Exchange Rate (REER) also appreciated by over 2.0 per cent over the quarter, largely due to the strengthening of the Shilling against major trading partners' currencies and due to higher domestic than overseas inflation. The quarterly appreciation presents reduced competitiveness for the Ugandan economy. Yet, on an annual basis, the REER was stable (***figure 15***).

Figure 15: Drivers of REER movements from 2008 to present



Source: Bank of Uganda

In the short-term, the shilling is expected to trade more strongly against the dollar amidst heightened dollar inflows. Strong inflows are expected to come from personal transfers, as the festive season approaches, and from coffee exports, as the coffee season begins.

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.

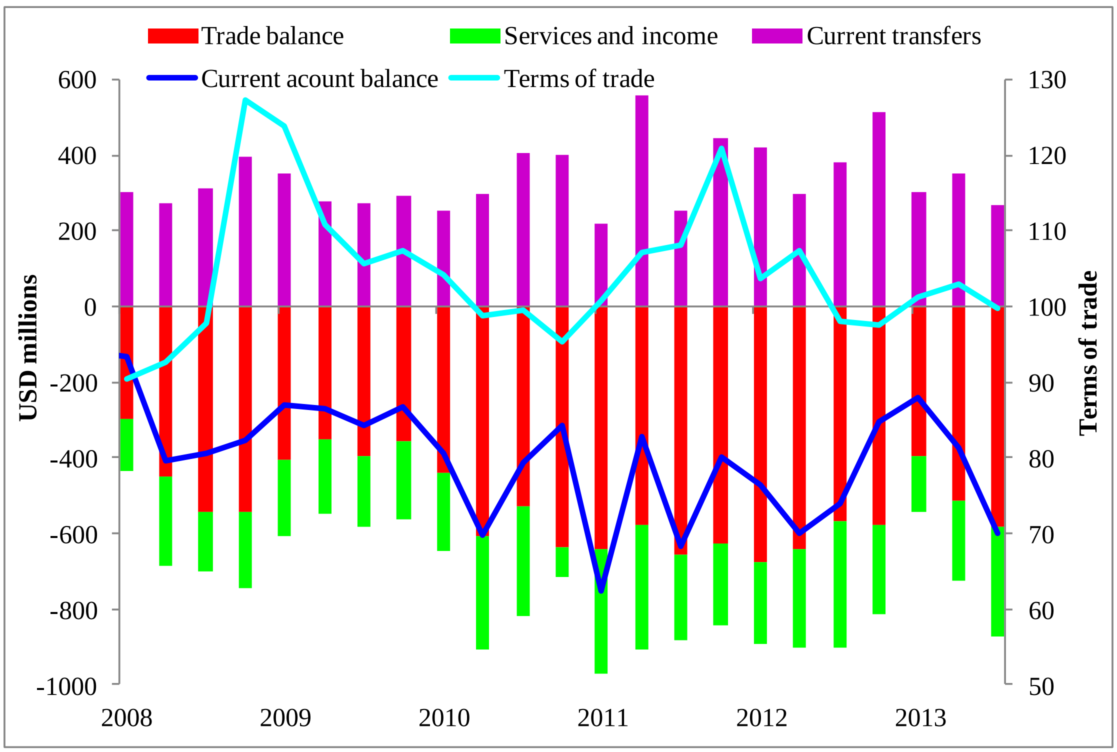
Provisional data indicates that the balance of payments improved somewhat in 2013 Q3, despite the widening current account deficit. The overall balance of payments position stood at a deficit of US$4.7 million in 2013 Q3, from a deficit of US$ 31.5 million the previous quarter (***table 9***).

The current account deficit, which had been narrowing since 2012 Q2, began to widen in 2013 Q2 and continue to in 2013 Q3. The deficit grew to US$601.5 million in 2013 Q3 (***figure 16***), which is 61.2 per cent wider than the deficit in 2013 Q2 and 15.4 per cent wider than in 2012 Q3.

The growing current account deficit has been driven by deterioration in the trade balance, lesser remittances and increased 'other business services' payments.

The goods account deficit grew by 13.1 per cent on a quarterly basis to US$583.4 million, reflecting 3.2 per cent deterioration in the terms of trade (TOT) over the quarter. Although the trade balance declined, the level of decline was restrained to some degree by weak private sector imports, which declined by 17.6 per cent over the quarter. In line with the deterioration in the TOT, export values fell by 11.9 per cent over the quarter or by 4.5 per cent on an annual basis. Both coffee and non-coffee export values declined, by 12.9 per cent and 14.9 per cent respectively over the quarter. However, coffee export values declined primarily due to a global price decline on account of excess coffee supplies in Brazil and Vietnam. Furthermore, exports to Europe declined by 36.4 per cent over the quarter; whilst regionally, export volumes declined as the recent drought diminished domestic export supplies.

Figure 16: The current account



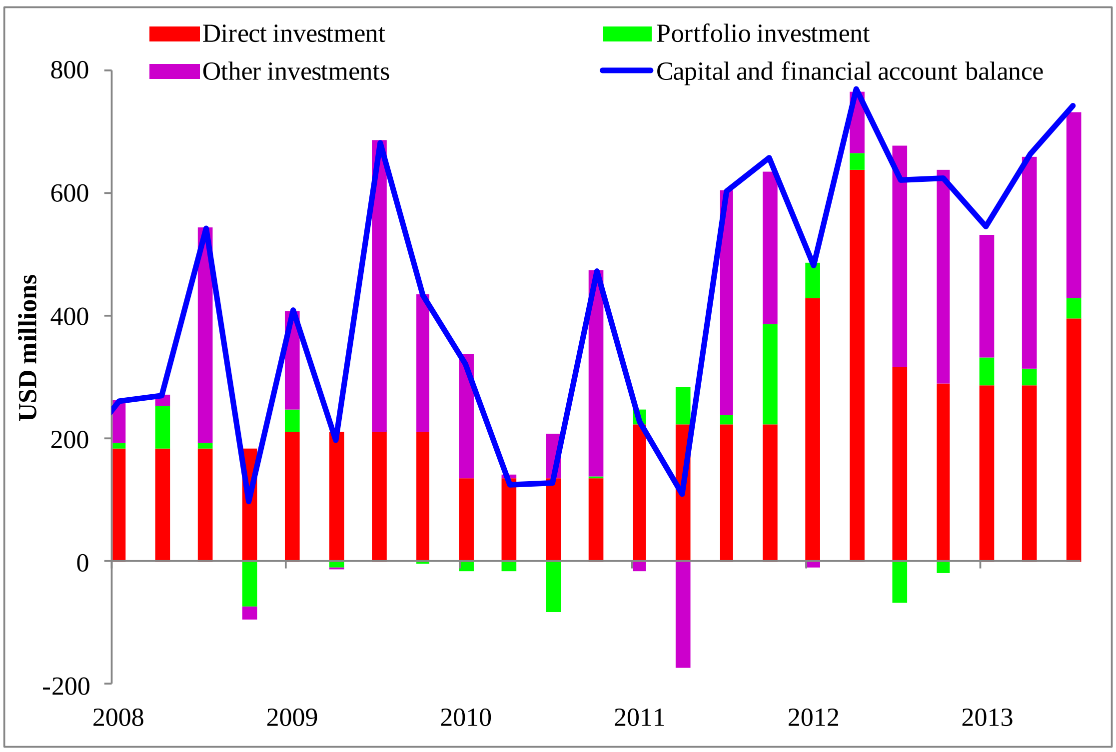
In addition to the widening trade deficit, the services account balance worsened to a deficit of US$179.9 million in 2013 Q3, from a deficit of US$90.2 million in 2013 Q2. Payments for other business services were responsible for the worsening services balance, as they grew by 54.7 per cent over the quarter or by 72.4 per cent on an annual basis to US$148.2 million in 2013 Q3.

Thirdly, the surplus in current transfers declined over the quarter, by 23.5 per cent on a quarterly basis or by 29.3 per cent on an annual basis to US$269.1 million in 2013 Q3; the deterioration was driven by reduced inflows of workers' remittances and remittances to NGOs.

Provisional numbers show that in 2013 Q3 the surplus in the capital and financial account grew by 11.9 per cent on a quarterly basis, or by 19.6 per cent on an annual basis, to US$740.9 million. The improvement in the capital and financial account arose mostly from foreign direct investments (FDI) inflows, which grew to US$205.5 million over the quarter, more than double that observed in the previous quarter. Portfolio flows also benefitted the financial account, increasing by 20.3 per cent over the quarter to reach a net inflow of US$34.9 million.

However, 'other' investments, which decreased by 11.7 per cent over the quarter, weighed down upon the financial account, largely due to lesser loan disbursements to general government. Loan disbursements in budget support experienced a net outflow of US$2.4 million over the quarter, from a historically high net inflow of US$110.9 million in 2013 Q2. Similarly, project support loan disbursements shrunk by 57.7 per cent on a quarterly basis to US$64.84 million in 2013 Q3.

Figure 17: The capital and financial account



Source:

Developments in the balance of payments led to a reserve drawdown of US$1.0 million. Consequently, gross foreign reserves amounted to US$2,883.4 million in September 2013, equal to 4.3 months' cover of future imports.

Table 9: Balance of Payments developments

	2012				2013		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
A. Current Account Balance (A1+A2+A3+A4)	-472	-602	-521	-304	-242	-373	-602
A1. Goods Account (Trade Balance)	-676	-642	-569	-578	-398	-516	-583
a) Total Exports (fob)	677	709	719	698	785	780	687
b) Total Imports (fob)	-1353	-1351	-1289	-1276	-1183	-1296	-1271
A2. Services Account (net)	-90	-124	-128	-84	-40	-90	-180
a) Inflows(credit)	516	486	514	512	591	536	541
b) Outflows(debit)	-607	-610	-642	-596	-631	-626	-721
A3. Income Account (net)	-127	-136	-204	-153	-106	-119	-107
a) Inflows(credit)	7	8	8	6	10	5	9
b) Outflows(debit)	-134	-143	-212	-159	-116	-124	-116
A4. Current Transfers (net)	421	299	381	512	302	352	269
a) Inflows (Credit)	461	339	435	525	335	419	321
b) Outflows (Debits)	-40	-40	-55	-14	-33	-68	-52
B. Capital & Financial Account Balance (B1+B2)	483	767	620	622	545	662	741
B1. Capital Account	3	2	10	6	11	5	9
B2. Financial Account; excl. Financing items	480	765	609	616	534	657	732
a) Direct Investment	429	636	316	289	285	285	394
i) Direct investment abroad	0	0	0	0	0	0	0
ii) Direct investment in Uganda	429	636	316	289	285	285	394
b) Portfolio Investment	58	30	-66	-19	46	29	35
Assets	0	0	0	0	0	0	0
Liabilities	58	30	-66	-19	46	29	35
c) Financial derivatives, net	3	1	1	-2	2	0	0
d) Other Investment	-11	98	359	348	201	343	302
Assets	-255	-194	212	184	9	-27	192
Liabilities	244	292	147	164	193	369	110
C. Errors and Omissions	82	18	112	-270	-190	-320	-144
D. Overall balance (A+B+C)	93	183	211	48	114	-31	-5
E. Reserves and related items	-93	-183	-211	-48	-114	31	5
a) Reserve assets	-90	-183	-208	-48	-111	34	1
b) Use of Fund credit and loans	-1	0	-1	0	-1	0	0
c) Exceptional Financing	-2	0	-2	0	-2	-3	4

In the short to medium term, the current account is likely to be increasingly squeezed from reduced export performance and improved import performance. Exports may continue to be subdued by lower global prices for Uganda's main export commodities, by reduced export supply following the recent drought and by weak economy recovery in Uganda's major export destinations. However, the seasonal end-of-year increase in remittances may offset some of the weak exports. Comparatively, imports are likely to increase as many planned large-scale public investments take place and energy receipts rise. Yet, loan disbursements to finance the above may boost the capital and financial account, as might imports financed from FDI.

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 affect upon Uganda through affecting global economic activity and investor sentiment. High and volatile inflation tends to reduce market confidence globally.

*Commodity prices are typically the largest contributor to global inflation, and may depict a sensible forecast for future inflationary pressures. Therefore, an analysis of monthly commodity prices is also important to understand global inflationary patterns. The overall effect of global inflationary developments to the Ugandan economy depends upon the underlying inflationary pressures, as will be discussed in the remainder of this section, with particular relevance to commodity prices (**5.1.1**).*

Global inflation declined further in Q3 2013, driven by low commodity prices and weak global demand. Inflation was contained within the advanced economies by weak economic conditions, while inflation tended to pick up in emerging and developing economies on account of widespread exchange rate depreciations and increased domestic demand; some economies also struggled from domestic supply shocks. ***Table 10*** presents inflation developments in selected economies.

Table 10: Consumer Price Inflation Developments

	Annual	Quarterly			Monthly	
	2012	2012 Q4	2013 Q1	2013 Q2	Jul 13	Aug 13
Japan	0.0	-0.2	-0.6	-0.3	0.7	0.9
United Kingdom	2.8	2.7	2.8	2.7	2.8	2.7
United States	2.1	1.9	1.7	1.4	2.0	1.5
Euro zone	2.5	2.3	1.9	1.4	1.6	1.3
Brazil	5.4	5.6	6.4	6.6	6.3	6.1
China	2.6	2.1	2.4	2.4	2.7	2.6
India	7.5	7.3	6.7	4.8	5.8	6.1
South Africa	5.7	5.7	5.8	5.6	6.4	6.4

Source: OECD & Euro Stat

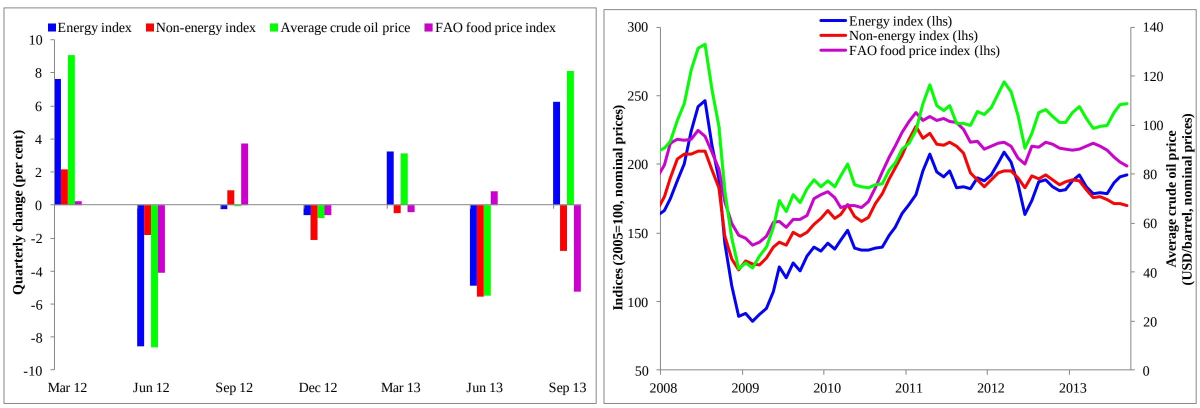
Annual inflation continues to be relatively high in India, a key trade partner with Uganda. India accounts for approximately 25 per cent of Ugandan imports and therefore presents a threat of imported inflation; however, quarterly inflation has been falling in India and the overall inflation level is comparable with that in Uganda. Similarly, inflation has been rising in Kenya, which accounts for 11 per cent of Ugandan imports; increased fuel prices and new VAT legislation drove Kenya's inflation up to 7 per cent over the quarter.

International Commodity prices

International commodity prices followed no uniform direction in Q3 2013, as shown in ***figures 18a*** and ***18b*** below. Energy prices rose by 6.2 per cent over the quarter, whilst non-energy prices declined by 2.8 per cent. Energy prices have been largely driven upwards by geopolitical tensions in the Middle East and North Africa, which have caused the average price of crude oil to rise by 8.0 per cent over the quarter to US$107.4 per barrel. Amongst the non-energy commodities, the prices of food and metal dropped the most.

The main driver for future commodity prices will be the pace of economic activity in emerging market economies, particularly China, as these economies are the largest commodity consumers. Since Uganda is a net oil importer, future oil price developments have a direct impact on domestic pump prices and sequentially domestic inflation.

Figures 18a and 18b: Commodity Market Developments



Source: World Bank and FAO Statistics

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 (**5.2.1**) and supply (**5.2.2**) side influences.*

Both annual core and headline inflation rose on a monthly basis of the quarter ending September 2013. Over the quarter, annual core and headline inflation averaged 6.7 and 6.8 per cent respectively, from 5.7 and 3.6 per cent respectively over the quarter ending June 2013. Food prices exerted strong inflation pressures during the quarter; annual food crops and food inflation increased to average 9.7 and 7.9 per cent respectively over the quarter, from minus 6.3 and minus 2.0 per cent respectively in the previous quarter. Food based inflation was predominantly an effect of the prolonged drought. Non-food inflation remained stable at 6.6 per cent, while energy, fuel and utilities (EFU) inflation was relatively stable and declined marginally to 1.3 per cent from 1.4 per cent in the previous quarter (table 11).

Table 11: Inflation developments

	Annual percentage changes					
	July	August	September	2013 Q1	2013 Q2	2013 Q3
Headline inflation	5.1	7.3	8.0	4.1	3.6	6.8
Core inflation	6.4	6.6	6.9	6.0	5.7	6.7
EFU inflation	0.3	1.6	2.1	-2.5	1.4	1.3
Food inflation	2.8	9.1	11.7	-1.0	-2.0	7.9
Food crops inflation	-0.3	12.9	16.2	-3.9	-6.3	9.6
Non-food inflation	6.5	6.8	6.6	6.6	6.6	6.6
	Monthly percentage changes			Quarterly percentage changes		
	July	August	September	2013 Q1	2013 Q2	2013 Q3
Headline inflation	0.6	2.6	1.4	0.4	0.3	1.5
Core inflation	0.4	0.4	0.8	0.7	0.2	0.6
EFU inflation	4.2	0.0	0.2	0.3	-0.1	1.4
Food inflation	0.4	7.6	3.4	0.0	0.5	3.8
Food crops inflation	0.0	15.9	5.3	-1.7	1.2	7.1
Non-food inflation	0.6	0.4	0.5	0.5	0.2	0.5

Monthly headline inflation accumulated 1.2 percentage points upon the previous quarter. Similarly, core inflation increased by 0.4 percentage points over the quarter. All of the main categories exerted a positive influence upon inflation over the quarter, but food exerted the greatest upwards pressure (figure 19). The contributions of food crop and food inflation to the headline figure grew by 5.9 and 3.3 percentage points respectively during quarter, while other categories only increased marginally in comparison.

Figure 19: Contributions to annual CPI by category (percentage)

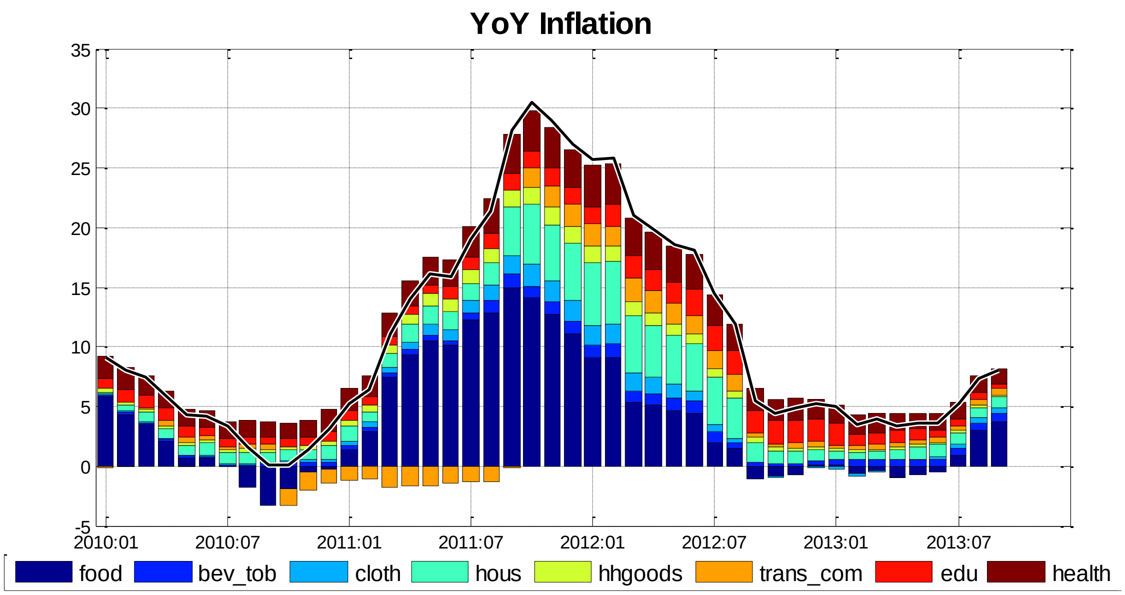


Table 12 shows the breakdown of food inflation by category. Food price inflation is presented to be mainly attributed to a rise in the prices of fresh vegetables, fish, milk and eggs, which again is largely due to their decreased supplies to markets over the period.

Table 12: Contributions to food crops by category (percentage)

	July	August	September
Staples	-3.9	-0.1	1
Fresh fruit	0.2	0.3	0.4
Fresh vegetables	1.7	2.5	2.7
Dry vegetables	0.1	1.3	1.7
Meat and poultry	0.3	0.1	0.2
Fish	1.6	1.7	2.2
Milk and eggs	1.2	1.9	2.2
Bread and cereals	-0.3	0	0.5
Sugar, tea and spices	1.9	1.5	0.4
Oils and fats	0	0	0
Food total	2.8	9.1	11.7

The recent elevation in inflation may be explained by one-off seasonal factors. As aforementioned, the prolonged drought is the main driver behind the increase in annual CPI inflation: low harvests have led to an increase in food prices.

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 (**5.1**) and domestic (**5.2**) economic outlook in order to determine the optimal monetary policy response and to explain the actions taken on the month.*

6.1 Global economic outlook

6.1.1 Outlook for global financial markets

The main factor influencing the outlook for global financial markets remains US monetary policy, with respect to their QE program. The IMF believes that US monetary policy has reached a turning point given the solid domestic economic recovery observed. The IMF further believe that the US Federal Reserve will shift to a more accommodative monetary policy stance, which necessitates tapering their QE program. Changes to US monetary policy are likely to cause further global market adjustments and expose systemic vulnerabilities. A tighter US monetary policy stance will increase interest rates amongst the advanced economies and thus may shift investor sentiment from assets deemed to be more risky in emerging markets. The IMF note that the pace of capital outflows from emerging economies is higher than usual and thus part of the observed volatility in global financial markets may be attributed to 'markets moving ahead of the real economy'. Tighter external financing conditions and lower net capital inflows are likely to reduce economic activity in emerging market economies in the near future. Global financial markets may also remain volatile if a structural change in interest rate spreads triggers portfolio readjustments. Higher interest rates in the US are also likely to strengthen the US dollar and reduce global liquidity, posing slower growth prospects for the global economy.

Uganda may well be affected by volatility in global financial markets, especially if it triggers capital outflows from Uganda and heightened volatility for the Shilling. However, Uganda may well also benefit as its foreign reserves invested overseas enjoy higher returns from the increased interest rates. A rise in foreign exchange reserves is important to meet the country's debt obligation, especially considering the currently depreciating Shilling.

6.1.2 Outlook for global economic activity

Global economic activity is expected to improve, but at a moderate rate as serious downside risks remain. In its October 2013 World Economic Outlook, the IMF made downward revisions to global economic growth: to 2.9 and 3.6 per cent for 2013 and 2014 respectively, from 3.2 and 3.8 per cent in its July 2013 outlook. The downward revision was attributed to disappointing economic performances in emerging market economies. As aforementioned, global economic activity in the near term might be influenced by US monetary policy, with respect to its Quantitative Easing Program, but also may be influenced by lack of complete resolve of the US debt crisis and the likelihood that Chinese growth will slow compared to previously.

In a turn of events, the IMF now predicts that advanced economies will spearhead global economic recovery; this is due to stronger than expected US economic performance, and a more widespread slowdown in fiscal tightening amidst continued accommodative monetary policies. However, the IMF has not made any changes to its growth projections for advanced economies in the October 2013 outlook: economic growth is expected to be 1.2 and 2.0 per cent in 2013 and 2014 respectively. Japan is set to have the strongest economic expansion amongst the advanced economies. Yet lack of resolve surrounding the US debt ceiling and the extended shutdown of US Federal government could have long-term effects on the pace of US economic recovery, despite its recent success. In addition, even though some recovery may be seen in the Euro Zone, it is still soft and susceptible to fall back into a recession.

Emerging market and developing economies are now expected to grow at a slower pace than earlier forecast. The IMF forecasts that emerging market and developing economies will grow by 4.5 and 5.1 per cent in 2013 and 2014 respectively, from earlier forecasts of 5.0 and 5.5 per cent respectively. The downward revision is due to poor domestic economic performances, resulting from tightened capacity constraints, narrowed credit facilities compared to previously and stable or falling commodity prices. Furthermore, tapering of the US Quantitative Easing program poses greatest concern for emerging market economies, which are most likely to suffer from an investor shift to 'safe' assets in advanced economies. China is forecast to grow at a slower pace of 7.6 and 7.3 per cent for 2013 and 2014 respectively, from 8.0 and 7.7 per cent respectively in earlier forecasts. Growth for Sub-Saharan Africa was also revised downwards to 5.0 per cent in 2013, from 5.1 per cent before; however the 2014 forecast was maintained at 6.0 per cent, assuming that commodity related projects will boost growth. ***Table 13,*** presents selected growth prospects.

Table 13: IMF WEO Growth Forecasts (Year on Year)

	2012	July 2013 projection		October 2013 projection		Deviation	
		2013	2014	2013	2014	2013	2014
World	3.2	3.2	3.8	2.9	3.6	-0.3	-0.2
Advanced economies	1.2	1.2	2.0	1.2	2.0	0.0	0.0
US	2.2	1.7	2.8	1.6	2.6	-0.1	-0.2
Euro zone	-0.6	-0.3	1.0	-0.4	1.0	-0.1	0.0
Japan	1.9	2.1	1.1	2.0	1.2	-0.1	0.1
UK	0.9	1.5	1.5	1.4	1.9	-0.1	0.4
Emerging market and developing economies	4.9	5.0	5.5	4.5	5.1	-0.5	-0.4
China	7.8	7.8	7.7	7.6	7.3	-0.2	-0.4
India	3.2	5.6	6.2	3.8	5.1	-1.8	-1.1
Brazil	0.9	2.5	3.2	2.5	2.5	0.0	-0.7
Sub-Saharan Africa	4.9	5.2	6.1	5.0	6.0	-0.2	-0.1
South Africa	2.5	2.0	2.9	2.0	2.9	0.0	0.0

Source: IMF WEO OCT 2013

If global economic recovery is to be spearheaded by advanced economies, this may be positive for Uganda if it acts to improve global demand and thus net exports and the current account balance.

6.1.3 Outlook for Global Inflation

Global inflation is expected to remain subdued in 2013, largely on account of lower commodity prices as supply improves and emerging market demand, especially that from China, declines. Furthermore, advanced economies are not expected to narrow their output gap and so inflationary pressures are not expected.

Accordingly, the IMF projects that average inflation amongst the advanced economies will be 1.4 per cent in 2013 and 1.8 per cent in 2014, from 1.6 and 1.9 per cent respectively in their July 2013 projections. A recovery in the active labour force is also expected to contain US inflationary pressures through wages, whilst poor economic growth in the euro zone is expected to keep inflation below the ECB target: at 1.5 per cent compared to 2.0 per cent targeted.

Inflation is forecast to pick up marginally amongst the emerging and developing economies to 6.2 per cent in 2013 and 5.7 per cent in 2014, compared to 6.0 per cent and 5.6 per cent respectively in earlier forecasts. Despite lower commodity prices and reduced growth, emerging market and developing economies might still face increased inflation from domestic capacity constraints and the pass-through of exchange rate depreciations.

6.1.3. Outlook for global commodity prices

Commodity prices are expected to decline throughout 2013 and 2014, due to improved supply and lower demand from key emerging market economies, particularly China. According to the IMF, oil prices are expected to decline to 0.5 and 3.0 per cent respectively in 2013 and 2014. Average oil prices[10] are predicted at US$104.5 and US$101.3 per barrel in 2013 and 2014 respectively, from a high of US$105.0 per barrel in 2012. Similarly, non-oil commodity prices are expected to decline to 1.5 and 4.2 per cent in 2013 and 2014 respectively. The major risk to this outlook remains the geopolitical tensions in the Middle East and North Africa (MENA), which might lead to supply outages and thus higher oil prices.

The outlook for lower oil prices may contain domestic inflation for Uganda, a net oil importer. Low oil prices would also favour Uganda's trade balance, although subdued non-oil prices may somewhat counter this effect, as it includes commodities that make up the bulk of Uganda's export sector.

6.1.4 Key risks and uncertainties

The main downside risk to the global economic outlook is pegged on the likelihood that the tapering of the US Federal Reserve's QE program might tighten global financial conditions. The

[10] Average prices for UK Brent, Dubai Fateh and West Texas Intermediate (WTI)

cut back is also likely to trigger capital outflows from emerging and developing economies, thus causing exchange rate depreciations and slower economic activity in these economies.

Slower economic growth amongst the emerging and developing economies, particularly China, will lead to lower commodity prices through reducing global demand. This will in tandem lead to lower earnings and slower growth and investment for commodity exporting economies, such as Uganda. In addition, geopolitical tensions in the MENA region might downplay the impact of lower commodity demand from emerging economies and could cause a rise in oil prices. The maintenance of low and stable oil prices is dependent on a softening of geopolitical tensions in the MENA region.

The slow pace of recovery in advanced economies: their weak banking systems, high levels of public debt and unemployment, might pose a risk to the pace of global recovery and could unintentionally lead to new crises. In the US, the large public debt stock, accentuated by the need to raise the debt ceiling, may pose a risk to the fairly strong economic performance observed in the US economy over the last quarter. In addition, the uncertainty surrounding the on-going shutdown of the US Federal government is likely to have an impact on both the US and global economic recovery if it continues.

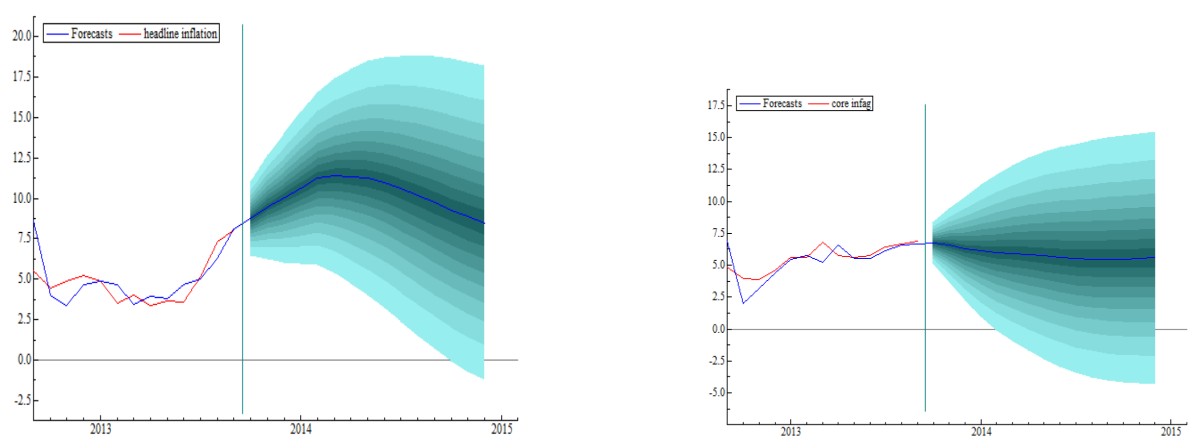
6.2 Domestic economic outlook

6.2.1 Outlook for economic activity

The CIEA points to an increase in economic activity in the quarter to August compared to the quarter to May 2013. The improvement observed in monthly economic activity is largely attributed to an increase in private sector investment and to wholesale and retail activities.

6.2.2 Inflation outlook

Figures 20a and 20b: Inflation forecasts



The Bank of Uganda estimates that headline inflation will continue to edge up slightly this year and into the beginning of next year on account of rising food prices, taxes and the festive season.

Furthermore, the Shilling's current depreciation trajectory is expected to exert some inflationary effect on import prices, which may filter through to consumer prices.

However, these effects are expected to wash out by mid-2014, when inflation is expected to slowly converge towards the target rate.

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.

Uganda continues to face a supply-side shock to agriculture on account of drought, which has temporarily pushed up food prices and headline inflation. However, low global food commodity prices are expected to combine with a base effect towards the beginning of 2014 and push down domestic food price inflation. Furthermore, low global inflation and the appreciation of the Shilling are expected to exert downwards domestic inflationary pressures.

Nonetheless a modest increase in the CBR should not greatly suppress short-term growth prospects, but should prevent the pass-through of food crop inflation to the headline figure and consequently promise improved medium term growth prospects.

Therefore, in September the Bank of Uganda raised the CBR to 12.0 per cent. The bands around the CBR were maintained at +/- 2 percentage points around the CBR and the margin on the rediscount rate at 3 percentage points above the CBR. Thus in September the rediscount rate and Bank Rate stood at 15.0 per cent and 16.0 per cent respectively.