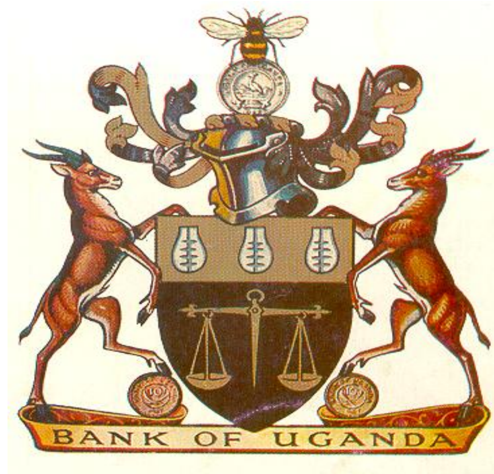
Bank of Uganda



Monetary Policy Report

April 2015

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Acronyms and Abbreviations

AEs	Advanced Economies
BIF	Burundi franc
BMI	Business Monitor International
BoP	Balance of Payments
BoU	Bank of Uganda
BPs	Basis Points
BRL	Brazilian Real
CA	Current Account
CBR	Central Bank Rate
CIC	Currency in Circulation
CIEA	Composite Index of Economic Activity
DCs	Depository Corporations
ECB	European Central Bank
EFU	Energy, Fuel and Utilities
EMEs	Emerging Market Economies
FAO	Food and Agricultural Organization
FOMC	Federal Open Market Committee
FY	Financial Year
GDP	Gross Domestic Product
HPPs	Hydro Power Projects
INR	Indian Rupee
JPY	Japanese Yen
KES	Kenya shilling
MoFPED	Ministry of Finance Planning and Economic Development
NDA	Net Domestic Assets
NFA	Net Foreign Assets
ODCs	Other Depository Corporations
OECD	Organization for Economic Co-operation and Development
P5+1	US, UK, Germany, France, Russia and China
PP	Percentage Point
PSC	Private Sector Credit
PSI	Policy Support Instrument

QE	Quantitative Easing
REER	Real Effective Exchange Rate
REPOs	Repurchase Agreements
Shs	Shillings
T-Bills	Treasury bills
T-Bonds	Treasury bonds
TZS	Tanzania shilling
UBOS	Uganda Bureau of Statistics
UK	United Kingdom
URA	Uganda Revenue Authority
US	United States
USD	United States Dollar
VAT	Value Added Tax
Y-o-Y	Year-on-Year

Executive Summary

i. Global growth prospects have improved in recent months partly on account of low global oil prices, favorable policy mix in AEs and supportive global financial conditions. Compared to the November 2014 forecast, the OECD predicts a modest pick-up in global economic activity to 3.7 per cent in 2014 and 4.0 per cent in 2015, but that growth could become increasingly uneven between predominantly large commodity importers and exporters. In the AEs and particularly the US, economic activity continues to be buoyant, although growth could disappoint in Q1-2015 due to adverse winter conditions. Nonetheless, the effect is expected to be short-lived.

ii. Global financial market conditions remained accommodative, in part because of the expansionary monetary policy being pursued in a number of Advanced Economies. However, this has caused considerable exchange rate depreciations, particularly in emerging market economies (EMEs), which may threaten financial market stability.

iii. Global inflation continued to be subdued on account of falling commodity prices particularly oil. Nonetheless, while forecasts point to low global inflation, upside risks to inflation have emerged in EMEs, particularly those experiencing sharp depreciation pressures with inflation spikes observed in Brazil, Russia, India and China. Inflation remained low in advanced economies.

iv. The Interbank Money Market activity remained buoyant as commercial banks continued to source for funds to meet their daily liquidity needs. The volume of interbank trades increased by 29 per cent to Shs 5,603 billion in the quarter ended March 2015 from Shs 4,344 billion in the quarter to December 2014. Notwithstanding the tight liquidity conditions, overnight trades continued to dominate trading activity in the Interbank Money Market, accounting for about 76.4 per cent, of the total volume of trades during this period.

v. Yields on government securities, have however maintained an upward trend increasing by about 3 percentage points (PPs) on average over the last two years. This is in part a reflection of increased auction amounts to meet government borrowing requirements and

heightened inflation expectations, given the depreciation pressures in the foreign exchange market. The lending rates also continue to be relatively elevated and sticky downwards, in part reflecting asymmetry of the monetary policy transmission mechanism, lagged response to monetary policy impulses, structural rigidities in the economy and high risk aversion by commercial banks.

vi. Growth in private sector credit (PSC), a leading indicator of the financial sector's contribution to economic activity, has been robust since Q2-2014. PSC grew by 17.1 per cent on an annual basis in March 2015, up from 13.9 per cent in the year to December 2014. PSC growth in FY 2014/15 has so far averaged 14.2 per cent, which is close to the PSI projection of 15.6 per cent.

vii. Leading indicators of domestic economic activity point to continued improvement in economic performance. The Composite Index of Economic Activity, a high frequency indicator of real economic activity, indicates that economic activity was stronger than projected in 2014, increasing by 7.0 per cent compared to 4.6 per cent in 2013. The strong performance of the economy is largely driven by domestic demand, evidenced by strong growth in PSC and domestic direct taxes, as exports of goods and services remained subdued. There are, however, substantial risks to growth including the persistently low global oil prices, decline in FDI to the oil sector and the likely increase in domestic financing requirements which may constrain PSC.

viii. The fiscal stance for FY 2014/15 is focused on supporting economic activity by addressing the infrastructural constraints in the economy. Although most of the expenditure on infrastructural projects is of external nature (imports), which means that its multiplier effect on growth will be limited in the near-term, it is nonetheless expected to boost growth in the short-to-medium-term. However, in the first eight months of FY 2014/15 government expenditure was less expansionary than programmed, largely on account of lower than programmed expenditure on Karuma and Isimba HPPs, which were delayed because the associated external financing was not secured in time.

ix. The current account balance remained fragile, registering a deficit of USD 527.1 million in the quarter to February 2015. This was however lower than the deficit of USD 541.9 million in the quarter to November 2014, but higher than the deficit of USD 431.5 million registered in the quarter ended February 2014. The trade deficit remained relatively fragile on account of subdued exports and the increasing import bill. The capital and financial accounts continues to register surpluses which have in part funded the current account deficit. In the quarter ended February 2015, the capital and financial account registered a surplus of USD 276.0 million.

x. The depreciation pressures continued in March 2015, with the Shilling depreciating by 16.5 per cent, year-on-year, against the USD to a monthly average exchange rate of Shs 2,951.7 per USD, hitting an all-time-high of Shs 3,115/USD on 12th March 2015. On a trade-weighted basis, the shilling depreciated by 8.7 per cent, year-on-year, in part reflecting that the USD had also strengthened against the currencies of Uganda's trading partners.

xi. Consumer price inflation remains subdued and below BoU's medium-term target of 5.0 per cent. The low rate of inflation is driven by the food prices, low global inflation, and falling oil prices. Annual consumer price inflation has averaged 3 per cent in the last 12 months. However, the disinflation pressures have dissipated and the inflation outlook in the short to medium-term indicates slightly higher inflation in the range of 8 -10 per cent. Therefore, the BoU decided to take pre-emptive measures to forestall a rise in consumer price inflation over the medium-term target of 5 per cent. Accordingly, the CBR was raised by 1 percentage point to 12 per cent. The band on the CBR will be maintained at +/-2 percentage points on the CBR and the margin on the rediscount rate at 3 percentage points on the CBR. The rediscount rate and the bank rate have consequently been increased to 15 per cent and 16 per cent respectively.

1 Monetary Policy in the Previous Period

1.1 Monetary Policy Stance

The Bank of Uganda (BoU) continued to pursue a cautious monetary policy stance, maintaining the CBR at 11 per cent since June 2014. The band on the CBR was maintained at *plus/minus* 2 percentage points (PPs) and the margin on the rediscount rate at 3 PPs on the CBR. Consequently, the rediscount rate and the bank rate were maintained at 14 per cent and 15 per cent, respectively. This stance was premised on the projected inflation and output path. Inflation remained subdued and outlook suggested that core inflation would fluctuate around BoU's medium term target of 5 per cent over the 24 months forecast horizon. Real GDP growth in FY 2014/15 was projected at 5 – 5.5 per cent, mainly supported by public investment in infrastructure, recovery in private domestic consumption & investment demand, and a rebound in agriculture.

The heightened upside risks to the projected inflation and output path, emanating from a mix of factors pertaining to the domestic and external environment, warranted a cautious monetary policy stance. The continued exchange rate depreciation and the spill-over effects from the volatile international macroeconomic environment could change the inflation trajectory over the short-term. The continued decline in international commodity prices could slacken export earnings and foreign direct investment (FDI) inflows to the commodity sectors, thereby exacerbating depreciation pressures, which would feed through to domestic inflation.

The impact of the envisaged risks to the projected inflation and output path however, remained broadly balanced. Maintaining a cautious monetary policy stance was therefore critical, not only to support the continued recovery of the economy but also to insulate the economy from uncertainties and risks from both the domestic and external economic environment.

1.2 Monetary Policy Implementation

The Bank of Uganda continued to use Repurchase Agreements (REPOs), reverse REPOs and outright sales of recapitalization securities in the secondary market to align liquidity

conditions in the domestic financial system with the desired monetary policy stance. As at the end of March 2015, outstanding stock for reverse REPOs stood at Shs 159 billion, while the outstanding stock of re-capitalization securities stood at Shs 399 billion.

2 Money and Financial Markets Developments

One of the important requisite conditions for the accelerated development of an economy is the existence of a well-developed and dynamic financial sector. A robust and well developed financial market mobilizes savings and channels them into investment. However, financial markets are very susceptible to sudden changes in investor sentiments. In an open economy, any sudden changes in investor sentiments regarding global and domestic developments and prospects generate financial market volatility, with implications for credit conditions, exchange rates, interest rates and consequently the real economy.

2.1 Global Financial Markets

Global financial markets conditions remained relatively stable in advanced economies (AEs). Notwithstanding the on-going United States (US) tapering of its asset purchase program, monetary policy continued to be relatively accommodative in AEs in general, with the ECB and central bank of Japan instituting a number of accommodative monetary policy measures in an effort to revamp their economies.

The strong performance of the US economy however led to the global strengthening of the United States Dollar (USD). Consequently, most emerging market and developing economies (EMDEs) experienced sustained depreciation pressures, which have kept their financial markets jittery. The Brazilian Real (BRL) depreciated by about 20 per cent since the beginning of 2015 to an 11-year low of BRL 3.31 per USD in March 2015. In order to moderate the inflationary impact of the depreciation, the Central Bank of Brazil raised interest rates from 12.25 per cent to 12.75 per cent. Nonetheless, economic forecasts point to weak economic activity and further depreciation pressures in the short-term. The Chinese Yuan Renminbi (CNY) and the Indian Rupee (INR) also depreciated largely on account of the global strengthening of the USD.

In the bond market, there was a general decline in 10 year government bond yields in both the AEs and EMEs during Q1-2015. The US, UK and Eurozone 10-year government bond yields declined to 2.0, 1.6 and 0.4 per cent in Q1-2015 from 2.3, 2.2 and 0.8 per cent in Q4-2014. The decline in yields is attributed to positive economic data amidst an uncertain global growth outlook and ultra-loose monetary stimulus from some of the central banks. Amongst the EMEs, the Chinese long-term bond yields also declined to 3.50 per cent in the quarter to March 2015 compared to an average of 3.74 per cent in the quarter to December 2014. This could lead to an outflow of capital, which could exacerbate depreciation pressures. Yields on Indian Treasury securities were however relatively stable over the period, with yield on the 10-year government bond remaining stable at 7.75 per cent in Q1 2015. Given the current growth momentum, which is expected to last throughout 2015 and 2016, coupled with the slowdown in China and Brazil, India is likely to become an increasingly favourable emerging market destination for investors looking forward.

2.2 Domestic Financial Markets

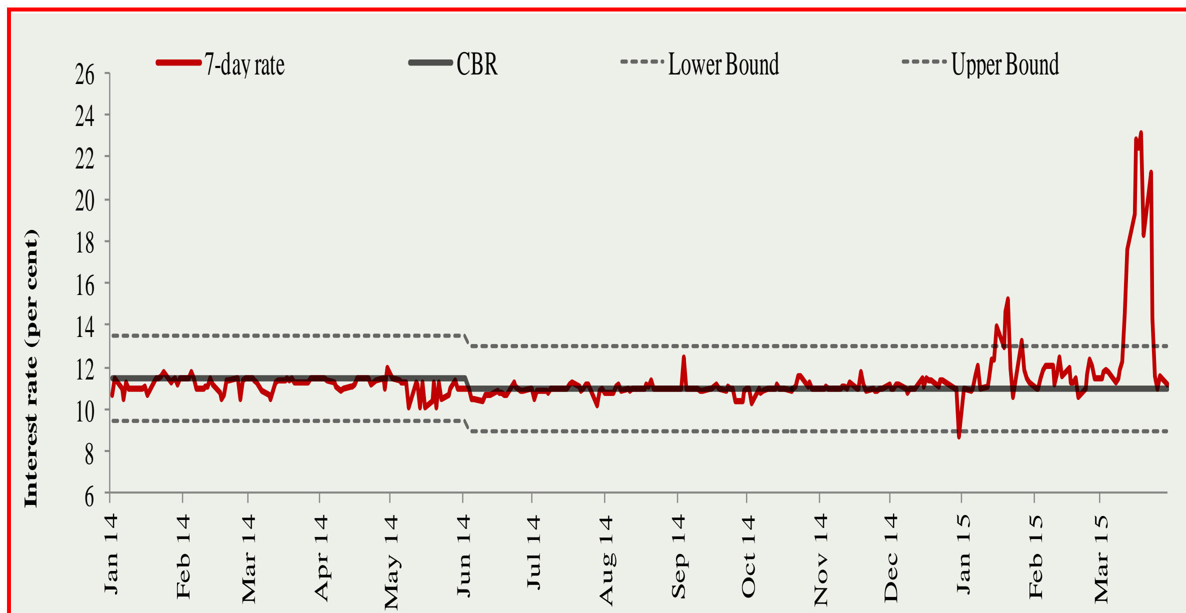
2.2.1 Interbank Money Market

The Interbank Money Market activity remained buoyant as commercial banks continued to source for funds to meet their daily liquidity needs. The volume of interbank trades increased by 29 per cent to Shs 5,603 billion in the quarter ended March 2015 from Shs 4,344 billion in the quarter to December 2014. Notwithstanding the tight liquidity conditions, overnight trades continued to dominate trading activity in the Interbank Money Market, accounting for about 76.4 per cent, of the total volume of trades during this period.

Interbank money market rates rose due to the tight liquidity conditions in the domestic money market, which were in part necessary to contain speculative activity in the domestic foreign exchange market. The weighted average 7- day rate rose to 14.1 per cent in March 2015 from 11.8 per cent in February 2015, which was higher than the CBR of 11 per cent for this period. During the quarter ended March 2015, the weighted average 7-day interbank money market rate rose to13.3 per cent compared to 11.0 per cent in the previous quarter. The overnight and overall rates also rose to 10.5 per cent and 11.0 per

cent, respectively, during the same period of time. The evolution of the 7-day interbank money market rate is shown in **Figure 1**.

Figure 1: Evolution of the interbank money market rate



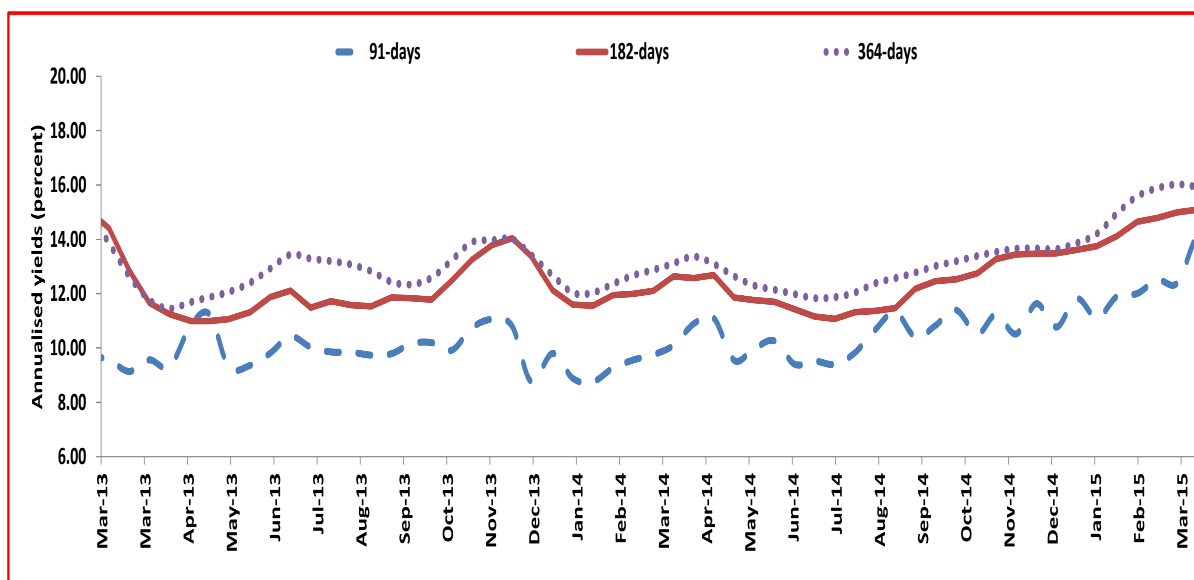
Source: Bank of Uganda

2.2.2 Treasury Securities Market

The BoU conducted six Treasury bill (T-bill) and three Treasury bond (T-bond) auctions during the quarter ended March 2015. In line with the governments financing requirements for FY 2014/15 and the redemption profile for the quarter, BoU offered T-bills and T-bonds worth Shs 1,035 billion and 540 billion, respectively. Yields on government securities have however maintained an upward trend increasing on average by about 3 percentage points (PPs) over the last two years. This is in part a reflection of increased auction amounts to meet government borrowing requirements and heightened inflation expectations given the depreciation pressures in the foreign exchange market.

The average annualized yields for 91-day, 182-day and 364-day T-Bills rose to 12.3 per cent, 14.6 per cent and 15.4 per cent in the quarter ended March 2015 from 11.1 per cent, 13.2 per cent and 13.6 per cent, respectively in the previous quarter. The trajectory of yields in Treasury securities is shown in **Figure 2**.

Figure 2: Treasury bill yields



Source: Bank of Uganda

The yields on T-bonds also rose in line with developments in the T-bills market. The yields for the 2-year, 5-year, 10-year and 15-year government bonds rose to 16.5 per cent, 17.0 per cent, 17.0 per cent and 17.4 per cent compared to 14.0 per cent, 14.2 per cent, 14.8 per cent and 15.9 per cent, respectively in the previous quarter. Secondary market yields also rose in line with developments in the primary market.

The average annualized rates for securities of less than 91-days rose to 12.8 per cent from 11.6 per cent during the previous quarter. The average annualized rates for securities of less than 182-days and less than 364-days also rose to 13.3 and 14.9 per cent compared to 12.9 and 13.4 per cent, respectively in the previous quarter.

The overall volume of securities traded in the secondary market increased to Shs 261.2 billion, up from Shs 198.6 billion traded in the previous quarter. The bulk of trading, about 84 per cent of the total volume of trades, was for securities with a maturity of less than 364-days. The summary of secondary market activity over the quarter ending March 2015 is shown in **Table 1.**

Table 1: Secondary Market Activity for T-Bills

	91-day		182-day		364-day	
	Bid	Offer	Bid	Offer	Bid	Offer
Minimum	11.49	11.38	13.18	13.07	13.55	13.43
Maximum	13.62	13.51	14.55	14.43	15.48	15.35
Average (simple)	12.05	11.95	14.01	13.89	14.83	14.70
	Total trading activity					
Outright sales	28.89		9.05		218.29	
Average discount rate	11.88		12.21		13.15	
Average yield-to-maturity	12.80		13.30		14.93	

Source: Bank of Uganda

The volume of secondary market trades for T-bonds also rose; increasing to Shs 696.8 billion, compared to Shs 316.1 billion in the previous quarter. The bid/offer quotes also rose in line with developments in the bid/offer rates for T-bills. The summary of secondary market activity in Treasury bonds during the quarter to March 2015 is shown in **Table 2.**

Table 2 Secondary Market Activity for T-Bonds

	2-year		5-year		10-year		15-year	
	Bid	Offer	Bid	Offer	Bid	Offer	Bid	Offer
Minimum	14.88	14.78	15.04	14.94	15.16	15.06	15.55	15.45
Maximum	16.31	16.21	16.81	16.71	17.00	16.90	17.21	17.11
Average (simple)	15.84	15.74	16.31	16.21	16.57	16.47	16.74	16.64
	Total trading activity							
Outright sales (billions)	237.88		184.67		91.67		71.33	
Average yield-to-maturity	15.94		16.50		16.50		16.81	

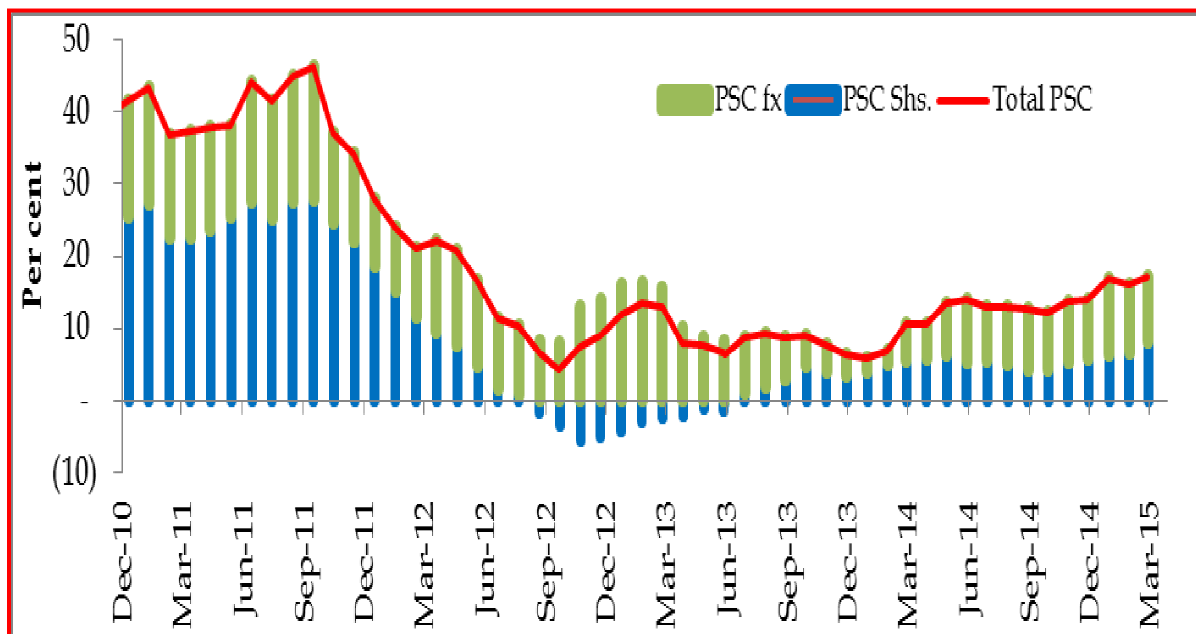
Source: Bank of Uganda

2.2.3 Private Sector Credit

Growth in private sector credit (PSC), a leading indicator of the financial sector's contribution to economic activity, has been robust since Q2-2014. PSC grew by 17.1 per cent on an annual basis in March 2015, up from 13.9 per cent in the year to December

2014. PSC growth in FY 2014/15 has so far averaged 14.2 per cent, which is within the PSI projection of 15.6 per cent. Developments in private sector credit growth in the period to March 2015 are shown in **Figure 3.**

Figure 3: Contributions to Annual PSC growth



Source: Bank of Uganda

Over the nine months of FY 2014/15, PSC growth has averaged 13.9 per cent compared to 9.1 per cent in the corresponding period of FY 2013/14. Non-Performing Loans (NPLs) as a share to total loans declined to 4.1 per cent in December 2014 from 5.3 per cent in September 2014, reflecting an improvement in asset quality. Sustained growth in PSC is expected to support private consumption and investment, which will stimulate growth. Nonetheless, trends in bank credit extension to the private sector continues to reflect tightening credit conditions for households, while credit to mining & quarrying, manufacturing, building mortgage & construction remains buoyant.

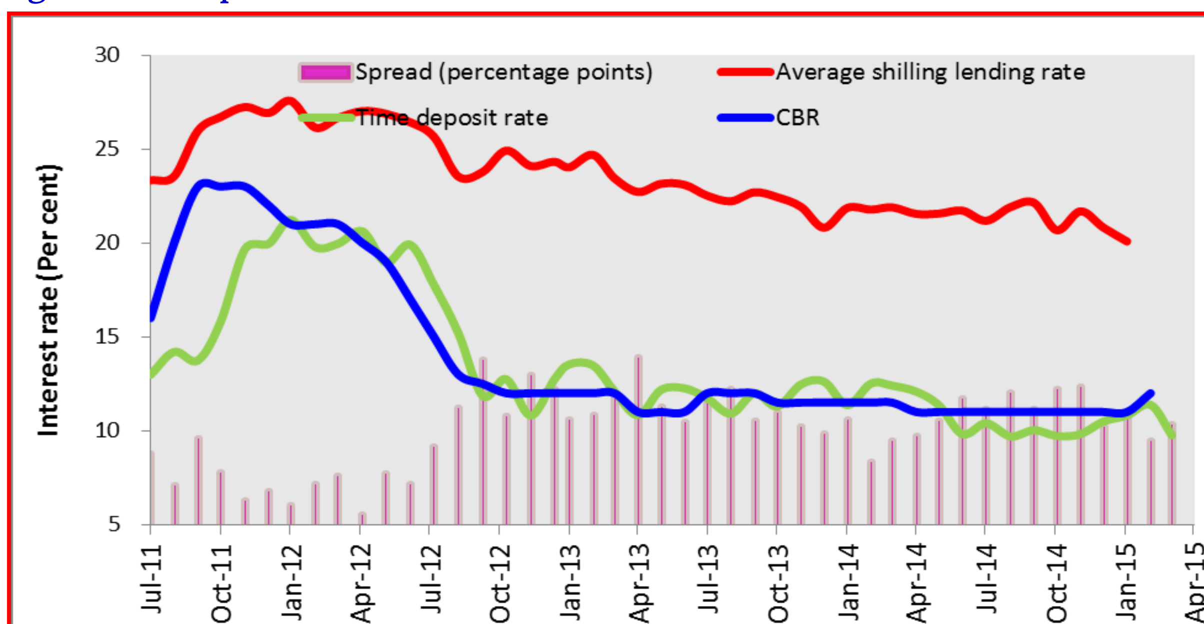
Demand and supply conditions, as proxied by the value of loan applications and approvals also remained buoyant. In the quarter to March 2015, loan applications amounted to Shs 3,425 billion, up from Shs 3,084 billion in the previous quarter. The value of loan approvals also rose to Shs 2,105 billion, up from Shs 1,802 billion in the previous quarter.

2.2.4 Lending and deposit interest rates

The lending rates continue to be relatively elevated and sticky downwards, in part reflecting asymmetry of the monetary policy transmission mechanism, lagged response to monetary policy impulses, structural rigidities in the economy and high risk aversion by commercial banks. Over the last 12 months, lending rates on shilling denominated loans have averaged 21.5 per cent, declining only marginally to 20.9 per cent in the quarter to March 2015. Over the same period, the average time deposit rates have averaged 10 per cent, leading to a spread in excess of 10 PPs. Moreover, in March 2015, most commercial banks adjusted their base lending rates upwards, in part due to the increase in yields on risk-free government securities and increased inflation expectations on account of the heightened depreciation pressures in the foreign exchange market.

The weighted average lending rate on foreign currency (USD) denominated loans has also remained sticky at about 10 per cent, declining only marginally to 9.5 per cent in the quarter to March 2015. Over the last 12 months, time deposit rates on foreign currency denominated loans averaged 4.0 per cent in the , increasing to 4.3 per cent in the quarter to March 2015. The evolution of Shilling time deposit and lending rates is shown in **Figure 4**.

Figure 4: Developments in interest rates



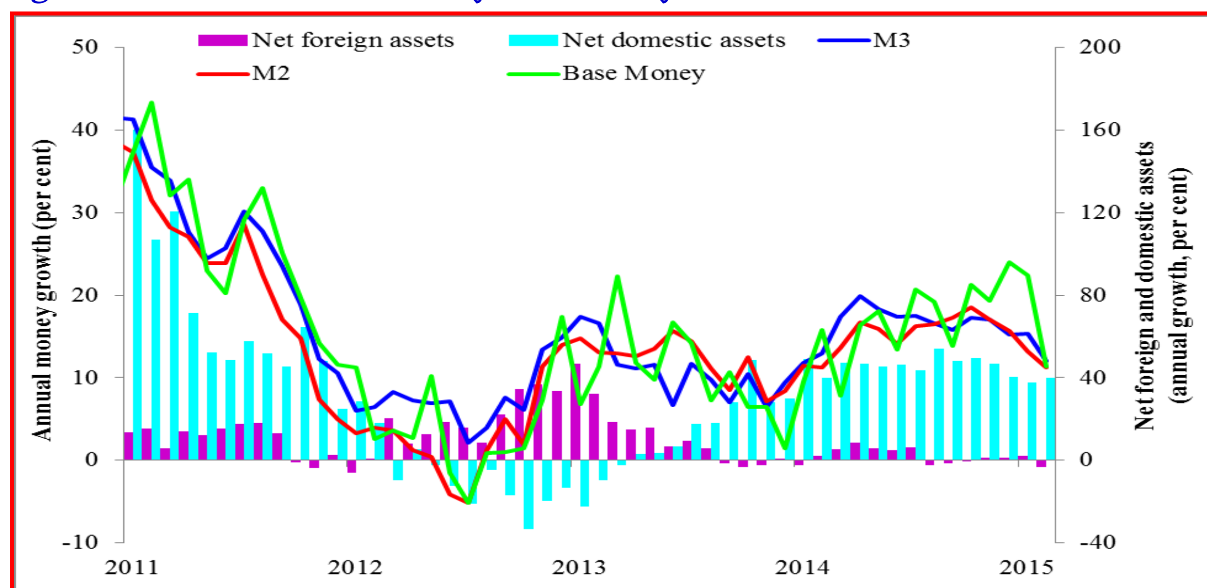
Source: Bank of Uganda

2.2.5 Other Monetary Aggregates

Growth in monetary aggregates continues to be robust, although some deceleration was registered in March 2015. Broad Money (M3), which comprises commercial bank deposits plus currency in circulation (CIC), grew by 9.1 per cent Y-o-Y in March 2015, down from 12.0 and 15.3 per cent in February and January 2015, respectively. Annual growth in M3 averaged 15.1 per cent in the first three quarters of FY 2014/15 which is close to the PSI projection of 17.5 per cent for FY 2014/15.

In the quarter to March 2015, M3 declined by 0.2 per cent, relative to growths of 6.3 and 5.4 per cent in the quarters to December 2014 and March 2014, respectively. This decline in M3 growth was mainly attributed to contraction in the Depository Corporations' Net Domestic Assets (NDA), which more than offset the growth in Net Foreign Assets (NFA). NDA contracted by 2.6 percent over the quarter to March 2015, compared to an increase of 3.5 percent, recorded in the quarter to December 2014. On the other hand, NFA of the Depository Corporations sector expanded by 1.7 percent in the quarter ended March 2015, compared to an increment of 8.6 percent in the previous quarter ended December 2014. The growth in NFA was mainly attributed to an expansion in the NFA of ODCs, which offset a contraction in the Central Bank's NFA. Developments in monetary aggregates are shown in **Figure 5**.

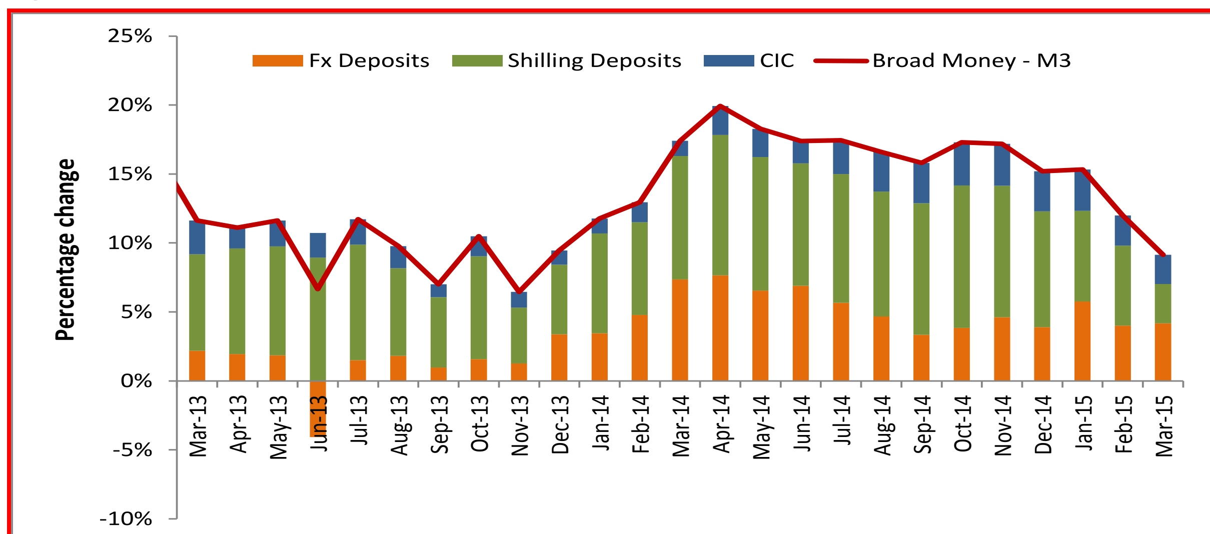
Figure 5: Movements in base money, broad money, NFA and NDA



Source: Bank of Uganda

Over the quarter, M1 and M2 fell by 5.5 and 3.6 per cent compared to increases of 7.9 and 5.8 per cent respectively over the quarter to December 2014. The monetary aggregates declined on account of a drop in currency in circulation as well as shilling denominated deposits. CIC declined by 6.5 per cent in the quarter to March 2015 following a strong growth of 12.8 per cent in the quarter to December mainly on account of seasonal factors. Similarly, shilling denominated deposits declined by 2.7 per cent following 3.7 per cent growth in the period to December 2014.

Figure 6: Contributions to Annual M3 Growth



Source: Bank of Uganda

3 Economic Activity

Although monetary policy has lived under many guises, it generally boils down to adjusting the supply of money in the economy to achieve some combination of inflation and output stabilization. It is generally agreed that in the long run, output—usually measured by gross domestic product—is fixed, so any changes in money supply only cause prices increases. Nonetheless, in the short run, because prices and wages are sticky, changes in money supply affect the actual production of goods and services and aggregate demand in the economy.

3.1 Global Economic Activity

Global growth prospects have improved in recent months, partly on account of low global oil prices, favorable policy mix in AEs and supportive global financial conditions. Compared to the November 2014 forecast, the OECD predicts a modest pick-up in global economic

activity to 3.7 per cent in 2014 and 4.0 per cent in 2015, but that growth could become increasingly uneven between predominantly large commodity importers and exporters. In the AEs and particularly the US, economic activity continues to be buoyant, although growth could disappoint in Q1-2015 due to adverse winter conditions. Nonetheless, the effect is expected to be short-lived.

The fall in unemployment rates and the consequent increase in consumer confidence in the US and the UK are expected to stimulate aggregate demand and growth. Retail sales and consumer sentiments also picked-up in the Euro Area, in part because of the increasingly favorable financial conditions and low oil prices, which have increased real household incomes. Indicators for consumer confidence and improving economic activity in the Euro Area reached multi-year highs in Q1-2015. Nonetheless, downside risks to growth in the Euro Zone remain, driven by bloated debt burdens, soft demand and muted consumer confidence.

Growth prospects in EMEs also remain cloudy, as economic activity is projected to slacken in commodity exporting EMEs, particularly Brazil and Russia, in part due to falling commodity prices. In addition many EMEs have been adversely affected by the strong USD, the slowdown in China, prolonged weakness in the Euro Area and expectations of an interest rate hike in the US, which have caused sustained depreciation pressures in many EMDEs. Going forward, the growth prospects for Brazil are projected to weaken further, because of severe exchange rate depreciation pressures and related domestic cost pressures, which may continue to weaken investor confidence in the economy.

The Russian economy is also projected to contract in 2015, in part driven by low commodity prices, depreciation pressures and associated domestic inflation. Real growth in China is also forecast to average 6.7 per cent in 2015, down from 7.5 per cent in 2014. On the contrary, growth in India is projected to remain robust, with India overtaking China as the fastest growing EME in 2015. The OECD revised the 2015 growth forecast for India upwards by 1.3 PPs to 7.7 per cent, although structural rigidities remain and annual growth in bank credit to the private sector decelerated to 9.5 per cent in March 2015. Indeed, the Reserve Bank of India is expected to reduce its policy rate further to stimulate credit growth.

Sub-Saharan Africa remained relatively resilient to the global economic murkiness, despite low export demand and falling commodity prices. Economic activity in the region increased by 4.8 per cent in 2014, supported by large public infrastructure investments, which are expected to provide more long-term growth benefits to these economies. Growth in 2015 is projected at 4.9 per cent, contingent on continued macroeconomic stability and public infrastructure investment. The global growth projections are presented in **Table 3**.

Table 3: Global GDP projections

	2014	2015		2016	
		March 2015 projection	Difference from November outlook	March 2015 projection	Difference from November outlook
Global growth	3.7	4.0	0.1	4.3	0.2
United States	2.4	3.1	0.0	3.0	0.0
Euro area	0.9	1.4	0.3	2.0	0.3
Japan	0.0	1.0	0.2	1.4	0.4
Germany	1.6	1.7	0.6	2.2	0.4
France	0.4	1.1	0.3	1.7	0.2
Italy	-0.4	0.6	0.4	1.3	0.3
United Kingdom	2.6	2.6	-0.1	2.5	0.0
Canada	2.5	2.2	-0.4	2.1	-0.3
China	7.4	7.0	-0.1	6.9	0.0
India	7.3	7.7	1.3	8.0	1.4
Brazil	0.0	-0.5	-2.0	1.2	-0.8

Source: OECD, March 2015

3.2 Domestic Economic Activity

Leading indicators of economic activity point to continued improvement in economic performance. The Composite Index of Economic Activity (CIEA), a high frequency indicator of real economic activity, indicates that economic activity was stronger than projected in 2014, increasing by 7.0 per cent compared to 4.6 per cent in 2013. The strong performance of the economy is largely driven by domestic demand, evidenced by strong growth in PSC and domestic direct taxes, as exports of goods and services remained subdued.

The outlook for FY 2014/15 is therefore a much narrower output gap, as growth is projected in the range of 5-5.5 per cent, which is close to the potential growth of the economy. Nonetheless, substantial risks to growth remain, emanating from both the

domestic and external environment. The persistent low global oil prices may continue to reduce FDI to the oil sector, which will constrain growth and exacerbate depreciation pressures in the foreign exchange market. On the domestic scene, increased domestic financing requirements for public infrastructure projects may constrain PSC, which will in turn hold back private investment.

4 Fiscal Policy and Developments

4.1 Government Expenditure and Revenue

The fiscal stance for FY 2014/15 is focused on supporting economic activity by addressing the infrastructural constraints in the economy. Although most of the expenditure on infrastructural projects is of external nature, implying a lower multiplier effect on growth in the near-term, it is nonetheless expected to boost growth in the medium-term. However, in the first eight months of FY 2014/15 government expenditure was less expansionary than programmed, largely on account of lower than programmed expenditure on Karuma and Isimba HPPs, which were delayed because the associated external financing was not secured in time.

In the first eight months of FY 2014/15, total Government expenditure and net lending amounted to Shs 9,572.8 billion, which is Shs 1,382.8 billion or 12.6 per cent lower than the programmed expenditure for this period. Net lending/repayments and development expenditure underperformed by Shs 1,092.1 billion and Shs 346.6 billion, respectively. The recurrent expenditure on the other hand over-performed by Shs 42 billion.

Total Government revenue (including grants) for the period to February 2015 amounted to Shs 6,871.5 billion, which was higher than the projected amount by Shs 36.5 billion. The outturn represents growth of 18.4 per cent of the revenue collections over the corresponding period of last financial year. Direct domestic tax collections registered a surplus of Shs 33.0 billion. International trade taxes posted a surplus of Shs 11.9 billion largely on account of over-performance in value added tax (VAT) collections on imports, while Indirect domestic tax collections registered a shortfall of Shs 47.3 billion, mainly on account of a shortfall in VAT collections on electricity. Grants, on the other hand, registered

a cumulative shortfall of Shs 120.7 billion, relative to the projected amount but were Shs 63.0 billion higher than what was realised in 2013/14, mainly on account of higher budget support grants.

The fiscal deficit (including grants) in the first 8 months of FY 2014/15 amounted to Shs 2,701.3 billion, which is higher than the fiscal deficit of Shs 2,006.7 billion during the corresponding period of FY 2013/14. The deficit was financed through a draw down on savings amounting to Shs 1,195.2 billion, domestic financing through issuance of Government securities of Shs 688.7 billion and external financing of Shs 525.5 billion. The drawdown of savings was specifically used to finance expenditures related to the public infrastructure projects. Details of fiscal developments in are shown in **Table 4.**

Table 4: Fiscal Operations in billions of shillings

	July 2013 – Feb 2014	Preliminary : July 2014 – Feb 2015	PSI Program: July 2014 – Feb 2015	Deviation
Revenue & Grants	**5,805.4**	**6,871.5**	**6,835.0**	**36.5**
Revenue	5,267.8	6,270.8	6,113.7	157.2
Grants	537.6	600.6	721.3	-120.7
Expenditure & Lending	**7,812.2**	**9,572.8**	**10,955.7**	**-1,382.8**
Current Expenditure	4,405.1	5,048.0	5,006.0	42.0
Development Expenditure	3,389.2	3,255.8	3,602.3	-346.6
Net lending/repayments[1]	6.5	1,166.2	2,258.3	-1,092.1
Domestic arrears repayment	11.4	102.8	90.0	12.8
Deficit (including grants)	**-2,006.7**	**-2,701.3**	**-4,120.7**	**1,419.3**
Financing (net)	**2,006.7**	**2,701.3**	**4,120.7**	**-1,419.3**
External Financing (net)	596.4	525.5	1,369.0	-843.5
Domestic financing	613.5	688.7	563.3	125.4
Draw down on savings	387.4	1,195.2	2,188.7	-993.5
Errors & Omissions	409.5	291.9	-0.3	292.3

Source: MoFPED and Bank of Uganda

4.1 Public Debt Stock

Total public debt stock (in nominal value) is estimated to have increased by 11.7 per cent relative to Shs 21,589.9 billion as at end February 2015 relative to June 2014. The increase was mainly driven by public domestic debt which grew by 16.5 per cent, while the public external debt stock grew by 8.1 per cent in shilling terms but declined by 2.9 per cent in USD terms. External debt, which in February accounted for 55.6 per cent of the total public debt continued to make up the bulk of the total public debt. Developments in public debt are shown in **Table 5.**

Table 5: Total Public Debt Stock

	Jun-14	Jan-15	Feb-15
Total Gross Public Debt	**19,333.0**	**21,243.6**	**21,589.9**
External Debt (USD, Mn)	4,300.7	4,149.9	4,177.4
External Debt (Shs Bn)	11,180.6	11,896.9	12,090.2
Domestic Debt (Nominal)	8,152.4	9,346.7	9,499.7

Source: Bank of Uganda

The stock of domestic public debt remains concentrated in T-bonds, in line with government's domestic debt risk management strategy. The ratio of T-bonds to T-bills remained stable at 67:33 between June 2014 and February 2015.

5 Balance of Payments and Exchange rate Developments

A large current account deficit usually implies an external imbalance in the economy, which in a flexible exchange rate regime is corrected by depreciation of the exchange rate. Persistent current account deficits may however signal structural constraints in the economy, in which case adjustment in the imbalance may not be entirely achieved through the manipulation of monetary variables. In such cases, structural changes in the economy are necessary in enhancing productivity and growth and consequently the current account adjustment.

5.1 Balance of Payments

5.1.1 Current Account Developments

The current account balance (CAB) remained fragile, registering a deficit of USD 527.1 million in the quarter to February 2015. This was however lower than the deficit of USD

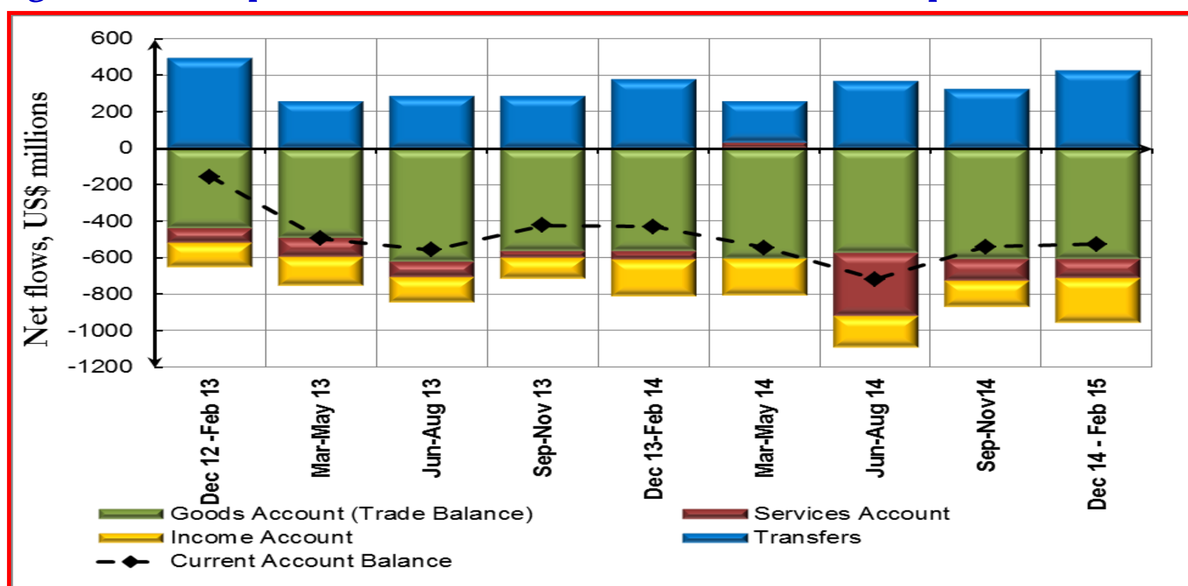
541.9 million in the quarter to November 2014, but higher than the deficit of USD 431.5 million registered in the quarter ended February 2014. The trade deficit remained relatively fragile on account of subdued exports and the increasing import bill. The total export receipts, increased by just 0.6 per cent to USD 665 million compared to USD 660.8 million in the previous quarter. Notwithstanding the improved coffee exports revenues, which increased by 22.5 per cent to USD 106.4 million, compared to USD 86.9 million in the previous quarter while non-coffee exports declined by USD 16.2 million.

Coffee export volumes rose to 826,107 (60kg) bags from 657,309 (60kg) bags exported during the preceding quarter, although this was a decline compared to 1,004,297 (60 kg) bags exported in the quarter to February 2014. The average unit price declined to USD 2.15 from USD 2.22 in the previous quarter in line with a decline in international commodity prices. The import bill increased to USD 1,271.6 million from USD 1,266.2 million in the quarter ended November 2014, mainly driven by government imports which more than doubled to USD 95.4 million in the three months to February 2015.

The deficit on the services account improved by USD 16.8 million to USD 104.2 million compared to a deficit of USD 121.0 million in the previous quarter in part because of lower payments for government services compared to the preceding quarter when payment for Hydro Power Projects (HPPs) was effected. On the other hand, the deficit on the income account deteriorated by USD 102.2 million to USD 242.3 million from USD 140.2 million in the previous quarter largely on account of higher direct investment income payments. Personal transfers however more than doubled to USD 406.6 million compared to USD 180.8 million during the preceding quarter.

Total official transfers, including Highly Indebted Poor Countries (HIPC) relief and transfers to non-government organisations (NGOs) declined to USD 39.2 million and USD 64.5 million compared to USD 82.5 million and USD 105.0 million, respectively during the preceding quarter. The trends of the CA balance and its components are shown in **Figure 7.**

Figure 7: Developments in the Current Account Balance and its Components



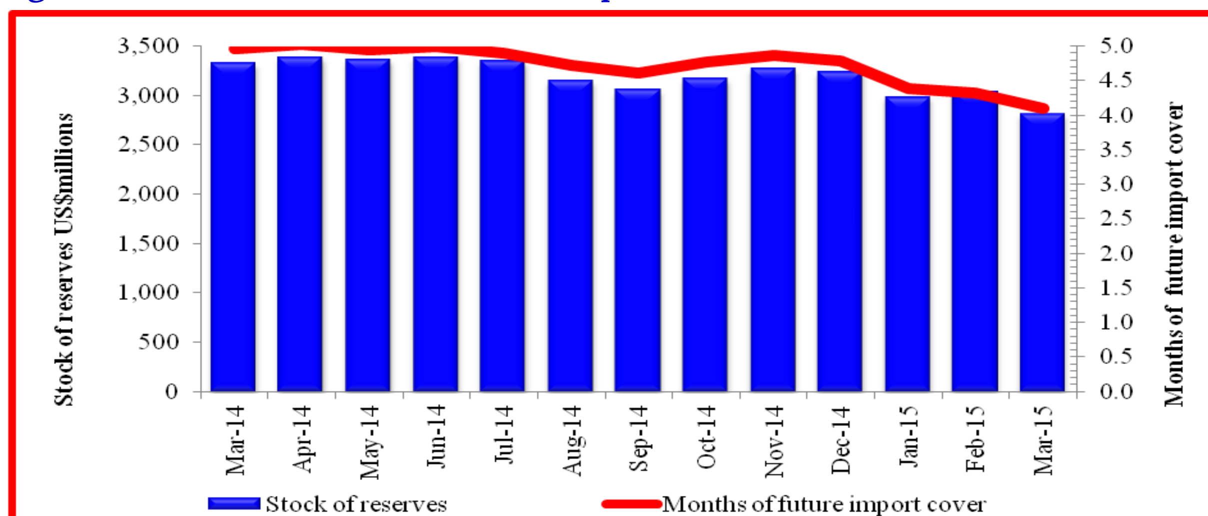
Source: Bank of Uganda

5.1.2 Capital and Financial account

The capital and financial accounts continues to register surpluses which have in part funded the current account deficit. In the quarter ended February 2015, the capital and financial account registered a surplus of USD 276.0 million. This was however lower than the net inflows of USD 534.2 million realized in the quarter to November 2014. The capital account surplus declined to USD 29.1 million from USD 38.4 million during the previous quarter due to lower capital inflows; while the balance on the financial account was a net inflow of USD 246.9 million, down from USD 495.8 million during the previous quarter largely due to an increase in net foreign assets of the banking system.

Foreign direct investment (FDI) net inflows are estimated at USD 289.3 million, which is higher than what was realized in the previous quarter by USD 22.4 million. Portfolio flows on the other had recorded a net outflow of USD 58.4 million during the same period of time. The overall BoP position was a deficit of USD 174.0 million, resulting in a net drawdown of reserves assets of USD 168.8 million during the quarter ended February 2015. The stock of reserves as at the end of February 2015 stood at USD2,972.4 million, which is equivalent to 4.2 months of future imports of goods and services. Developments in stock of reserves are shown in **Figure 8.**

Figure 8: Stock of Reserves and Months of Import cover



Source: Bank of Uganda

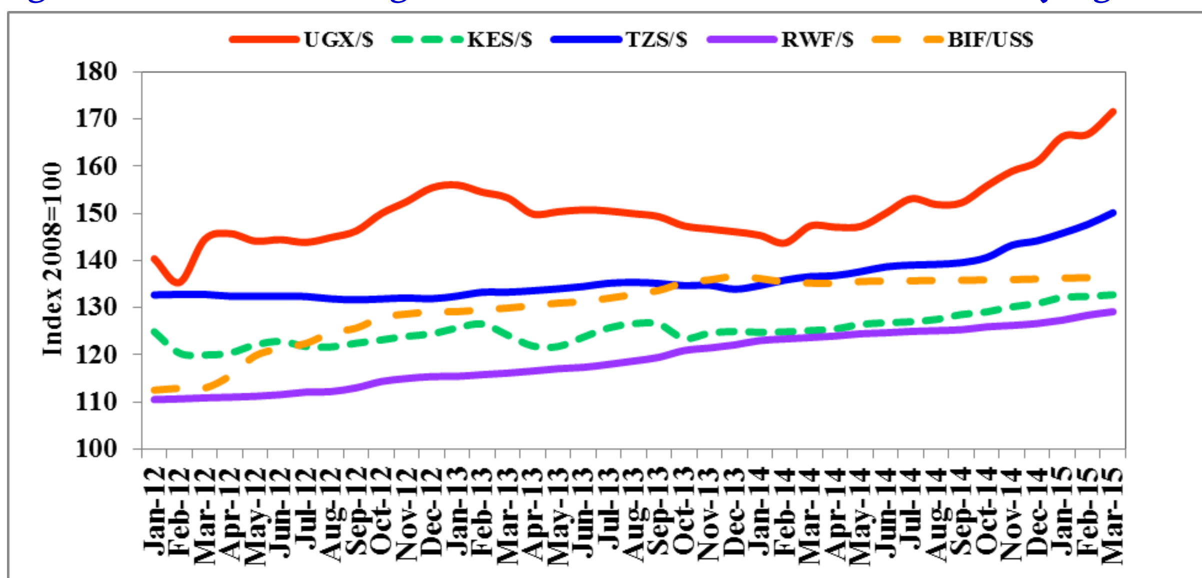
The outlook, at least in the short-to-medium-term, is for continued fragility of the CAB balance on account of the projected increase in both private sector and government imports, especially public infrastructure investment-related imports. FDI is expected to decline going forward on account of lower investment in the domestic oil sector as global oil prices remain low. Tourism receipts are also expected to weaken in line with continued terrorism threats.

5.2 Exchange Rate Developments

The depreciation pressures continued in March 2015, with the Shilling depreciating by 16.5 per cent, year-on-year, against the USD to a monthly average exchange rate of Shs 2,951.7 per USD, hitting an all-time-high of Shs 3,115/USD on 12th March 2015. The depreciation pressures were largely driven by the global strengthening of the USD, continued weakening of the current account and speculative tendencies in the foreign exchange market. On a trade-weighted basis, the shilling depreciated by 8.7 per cent, year-on-year, in part reflecting that the USD had also strengthened against the currencies of Uganda's trading partners. Indeed, the USD had strengthened globally against major international currencies, as well, in part driven by strong performance of the US economy and expectations of eminent interest rate hike, which has seen capital flow back to the US.

As at end March, 2015, the Euro and the Japanese yen (JPY) had depreciated by 28 per cent and 18 per cent, respectively, year-on-year, against the USD. The Pound Sterling and the South African Rand also depreciated by 11 per cent and 12 per cent, respectively, year-on-year, against the USD. As is shown in the figure below, most of the EAC regional currencies have been on a depreciating trend. The Kenya shilling (KES) and the Tanzanian shilling (TZS) depreciated by 6.0 per cent and 10 per cent, respectively, year-on-year against the USD. The Rwandese franc (RWF) also depreciated by 4.4 per cent, year-on-year against the USD.

Figure 9: Bilateral Exchange Rate Movements in the East African Community Region



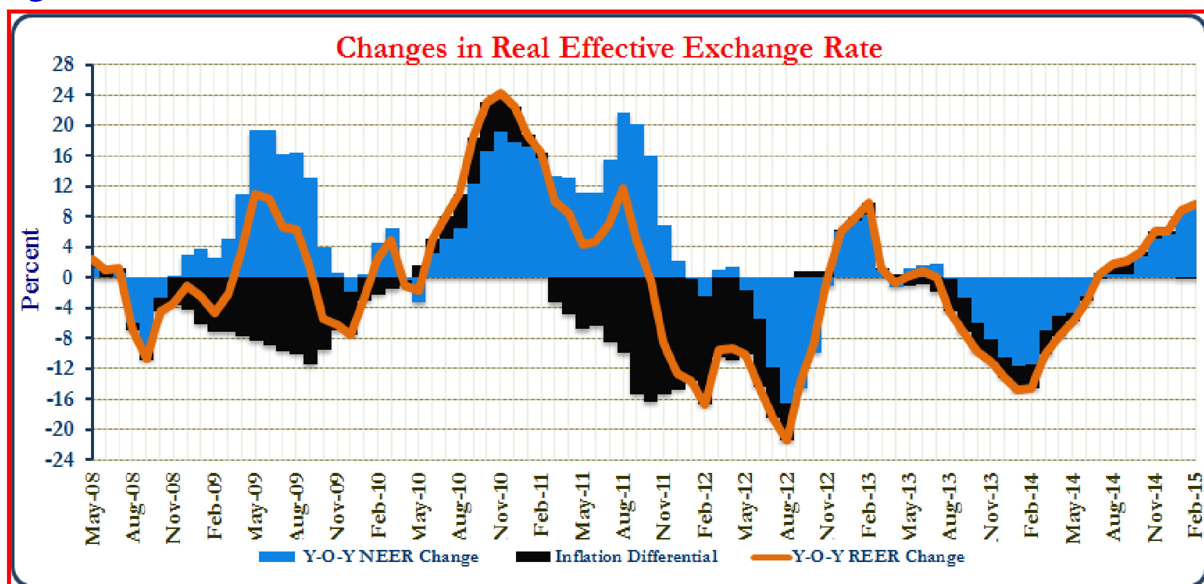
Source: Bank of Uganda

The depreciation pressures in the domestic foreign exchange market were also caused by vulnerabilities in the domestic economy relating to the perpetual current account deficit. Indeed, during the quarter, there was elevated dollar demand mainly from manufacturing, telecom, trading and energy sectors amidst lower inflows partly on account of lower international commodity prices. In addition, depreciation pressures were also exacerbated by noise in the market in part relating to expectations about the future direction of fiscal and monetary policy, continued exit of offshore players and the correction of overvaluation that occurred during FY 2013/14. In order to stem exchange rate volatility, BoU stayed purchases for reserves build-up on days of excessive volatility and also intervened in the

interbank foreign exchange market (IFEM), selling USD 228.2 million in the three months to March 2015.

The Real Effective Exchange Rate (REER) also depreciated in line with the depreciation of the trade-weighted nominal exchange rate, depreciating by 5.2 per cent year-on-year in the quarter ended March 2015. Indeed, as shown in **Figure 10**, about 95 per cent of the real depreciation in the quarter ended March 2015 was accounted for by the nominal depreciation of the shilling, with changes in the price differential accounting for only 5 per cent of the overall real depreciation during this period.

Figure 10: Drivers of REER movement



Source: Bank of Uganda

Although exchange rate depreciation is expected to restore competitiveness, previously lost due to appreciation in the second half of FY 2013/14, it has nonetheless created financial market volatility thus increasing uncertainty and inflation expectations. This may in turn undermine the profitability of the tradable goods sector, thus worsening the current account imbalance, thereby impeding growth.

Going forward; the depreciation pressures may continue; at least in the short-to-medium-term on account of the global strengthening of the USD; the widening current account

deficit; likely retreat of FDI to the oil sector in view of the declining crude oil prices, which are projected to remain low at least in the short-term.

6 Inflation

Domestic inflation is contingent on both domestic and external economic factors. The importance of the external economic environment in determining domestic inflation dynamics depends on the economic linkages between the domestic and global economy. A careful assessment of the evolution and outlook of both domestic and external factors is therefore critical in the design of an effective monetary policy stance, which in Uganda is designed to deliver a medium term core inflation target 5 per cent and to ensure that output is not only as close to potential as possible, but also consistent with the inflation objective.

6.1 Global Inflation and International Commodity Prices

6.1.1 Global Inflation

Global inflationary pressures remain muted, largely driven by subdued global demand conditions and low oil prices, which are expected to last through 2015. Low commodity and energy prices, abundant spare capacity, low aggregate demand, and well-anchored inflation expectations have kept inflation muted and below the respective central banks' medium-term targets in most AEs. Some EMDEs have however experienced inflationary pressures largely driven by the heightened exchange rate depreciations pressures in these economies. Nonetheless, global inflation in 2015 is projected at 2.8 per cent, down from 3.2 per cent in 2014.

In the US, consumer price inflation declined to ***minus*** 0.1 per cent in Q1-2015, from 0.9 per cent in Q4-2014, on account of low commodity and energy prices. Although inflation is expected to pick up later in the year on account of strong private demand, it is nonetheless projected to average 1.5 per cent in 2015, which is still below the Federal Reserve's inflation target of 2.0 per cent. Inflation in the UK also declined to 0.1 per cent from 0.9 per cent in Q4 2014 on account of declining food and energy prices. Inflation in the Euro Zone also remains subdued, initially driven by the negative output gap, but also in the recent past largely as a result of low oil prices. Japanese inflation also fell to 2.3 per cent in Q1-2015

from 2.6 per cent in Q4-2014. Inflationary pressures in Japan are projected to remain muted, despite the impact of expansionary monetary and fiscal policy.

Inflationary pressures, however, ensued in some EMEs, largely driven by the pass-through of exchange rate depreciation to domestic prices. In Brazil for example, consumer price inflation rose from 6.5 per cent in Q4-2014 to 7.6 per cent in Q1-2015, largely driven by the depreciation of the Real and increases in electricity prices and taxes. In Russia, the relentless depreciation of the Ruble during 2014 caused a dramatic pick-up in consumer price inflation, which rose to 16.2 per cent Q1-2015 from 9.6 per cent in Q4-2014; although weak economic activity and household demand is forecast to exert disinflationary pressures in the second half of 2015.

Consumer price inflation in India also rose to 6.6 per cent in Q1-2015 from 5.0 per cent in Q4-2014, while in China inflation rose marginally to 1.4 per cent, which is still below the Central Bank medium-term target of 4.0 percent. Inflationary developments in selected AEs and EMEs are shown in **Table 6.**

Table 6: Global Consumer Price Inflation Developments

	3-month average			Monthly average		
	2014		2015	2015		
	Q3	Q4	Q1	January	February	March
Euro Area	1.2	1.0	0.4	0.2	0.4	0.5
Japan	3.3	2.6	2.3	2.4	2.2	2.3
UK	1.4	0.9	0.1	0.3	0.0	0.0
US	1.8	1.3	-0.1	-0.1	0.0	-0.1
Brazil	6.6	6.5	7.6	7.1	7.7	8.1
China	2.0	1.5	1.2	0.8	1.4	1.4
India	6.8	5.0	6.6	7.2	6.3	6.3
Russia	7.7	9.6	16.2	15.0	16.7	16.9
South Africa	6.3	5.7	4.1	4.4	4.0	4.0

Source: Organization for Economic Co-operation and Development

6.1.2 International Commodity Prices

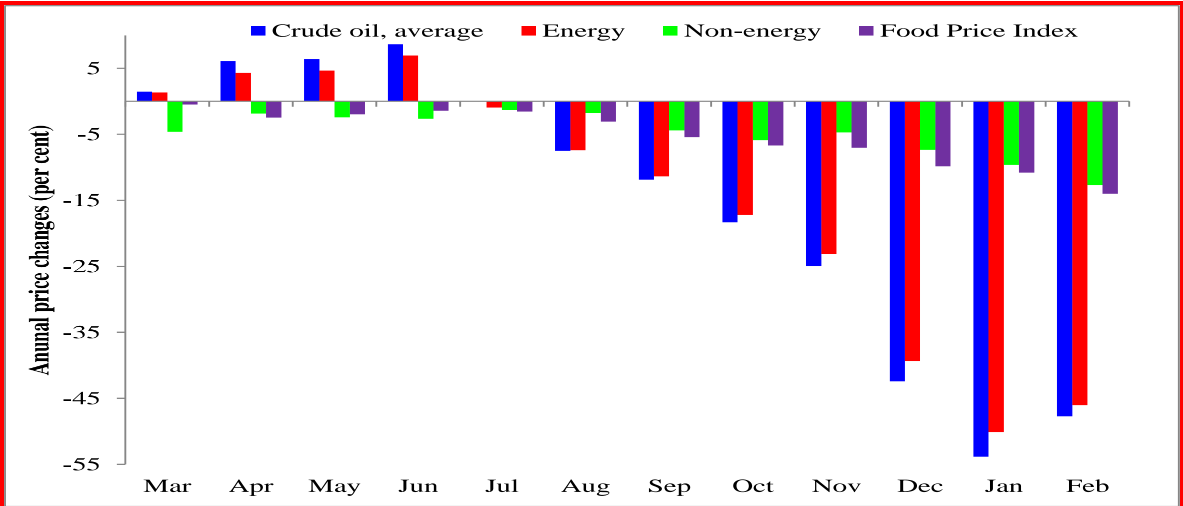
International commodity prices remain relatively subdued, in part caused by relatively abundant supply capacities coupled with moderate demand as the global economic

performance remains cloudy. However, oil prices rose in February and March relative to January 2015, with the monthly Brent crude oil prices averaging USD 56 and USD 58 per barrel in February and March 2015, respectively compared to USD 48 per barrel in January.

The outlook, however, remains for subdued oil prices, at least in the near-to-short-term. Although the US rig count has reduced oil production somewhat, which could in effect trigger upward pressures on oil prices, a nuclear agreement between Iran and the ***P5+1*** (US, UK, Germany, France, Russia and China) looks increasingly likely, which would eliminate some trade embargos and introduce Iranian oil back into the global market thus putting downward pressure on oil prices. Oil demand from China is expected to fall as inventories in the Strategic Petroleum Reserve vaults are close to full capacity. The continued growth in inventories is likely to keep global oil prices dampened, at least over the near-to-short-term.

Global food prices have also remained relatively soft, largely on account of favorable weather conditions that have boosted global food supplies. Indeed, the Food and Agriculture Organization (FAO) food price index declined on an annual basis by 2.5 per cent and 0.9 per cent in January and February 2015, respectively. Developments in global commodity prices are shown in **Figure 11.**

Figure 11: Annual commodity price changes



Source: World Bank, Food and Agricultural Organization

6.2 Domestic Consumer Price Inflation

Consumer price inflation remains subdued and below BoU's medium-term target of 5.0 per cent. The low rate of inflation is driven by the food prices, low global inflation, and falling oil prices. Food crop prices, for example, declined further by 6.5 per cent in Q1-2015 compared with a decline of 0.9 per cent in Q4-2014. Energy, Fuel and Utilities (EFU) inflation also decline to 1.9 per cent from 2.2 per cent during the same period, in part reflecting the impact of low oil prices. Nonetheless, there are indications that the disinflation pressures of 2014 have dissipated. Annual headline and core inflation rose to 1.9 per cent and 3.2 per cent in Q1-2015 from 1.6 per cent and 2.5 per cent, respectively in Q4-2014.

On a monthly basis, annual core inflation rose to 3.7 per cent in March 2015 from 3.3 per cent and 2.7 per cent in February and January 2015, respectively. Over the same period, annual headline inflation increased to 1.9 per cent from 1.6 per cent and 1.3 percent, respectively. The upward trajectory in domestic inflation is largely a reflection of the edging-up of inflation of *"other goods"* category, which is strongly influenced by exchange rate movements. Inflation in the *"other goods"* sector rose to 1.9 per cent in the Q1-2015 from 0.7 per cent in Q4-2014, largely reflecting the impact of the pass-through of exchange rate depreciation to domestic inflation.

Services inflation, which can be used as a proxy for *"non-traded goods"* inflation has remained relatively elevated, averaging about 5.0 per cent since the beginning of FY2014/15. This indicates that notwithstanding the relatively low inflation, domestic demand conditions may still be robust. Developments in domestic inflation are depicted in **Figure 12.**

Figure 12: Domestic Inflation Developments

Source: Uganda Bureau of Statistics

7 Economic Outlook and Risks

Monetary policy impacts on inflation and real economic activity with a lag. A critical assessment of the future trajectory of inflation is therefore crucial in the design of a forward-looking monetary policy framework. This requires a thorough understanding of the outlook and risks to the external and domestic economic environment.

7.1 External Economic Environment

The global economic outlook is still subject to a considerable degree of uncertainty and developing countries including Uganda remain vulnerable to the volatility in global economic environment, which has implications for growth and inflation. The spill-overs from the unwinding of the US "*quantitative easing*" programme, structural vulnerabilities and fragilities in emerging market and developing economies (EMDEs), uncertainty about the Euro Zone, and risks associated with geopolitical tensions and terrorism constitute serious challenges for the global economy.

Although relative stability in the global financial system was observed in the preceding period, financial markets remain vulnerable to instability. While the United States is gradually exiting unconventional expansionary monetary policies, the Euro Zone is

introducing more unconventional expansionary monetary policies. Consequently, EMDEs may continue to experience more financial markets volatility. Indeed, exchange rate volatility remains a significant risk to growth and stability of financial markets in EMDEs, including Uganda.

The beginning of the normalisation of US monetary policy has been associated with a turn in investor sentiment, a reversal of capital flows and strong pressures on exchange rate. The capital outflows, especially from government securities, have intensified. Recent data on portfolio investment indicates a net outflow of US$58.4 million in the three months ended February 2015. These developments were mirrored in foreign exchange market, with the shilling depreciation putting pressure on BoU's international reserves. If capital outflows continue, this will cause faster exchange rate depreciation than what is currently being projected and this will pass through to higher inflation.

The geopolitical tensions and the threat of terrorism remain elevated, including the conflicts in the Middle East, Russia and Ukraine. This could have a significant impact on consumer and business confidence, such that investors and consumers hold back on spending, which could reduce aggregate demand further, thereby constraining international commodity prices and economic activity, with adverse implications for exports. On the upside, low commodity prices may however lead to increased real consumer disposable incomes, which may stimulate demand conditions in the global economy.

7.2 Domestic Economic Environment and Outlook

A wide range of indicators suggest that strong output growth has been progressively absorbing spare capacity over the past few quarters and continues to do so. Following the rebasing of the GDP, the best estimate of the output gap suggests that it is positive, by at least one percentage point of potential GDP. The exchange rate volatility may however weaken the economy in the remaining part of the year. Nonetheless, the anticipated strengthening in the global economic recovery may have a supportive effect on growth in the domestic economy. Although it is not clear on the likely evolution of economic activity, the balance of risks point to possible positive output gap.

The depreciation pressures in the foreign exchange market have continue to be driven by the global strengthening of the USD as well as the twin fiscal and current account deficits. The current account deficit for FY 2014/15 is projected at 10.3 per cent of GDP compared to 6.2 per cent in FY 2013/14, and is projected to remain around 10 per cent in the next 4-5 fiscal years, in part reflecting the increase in government spending on services and capital goods imports used in the increased capital spending. The fiscal deficit is also projected to rise, reflecting the increased spending on public infrastructure.

Inflation is expected to rise gradually as economic activity strengthens, both globally and in the domestic economy. However, several factors are creating uncertainty about how rapidly inflation will rise going forward. International oil prices have fallen substantially over the last six months, which has led to lower energy prices. This will dampen inflation both directly via lower fuel prices and indirectly via lower price increases for other goods and services. It is indeed difficult to determine the magnitude of these indirect effects.

There are upside and downside risks to the inflation outlook. While low global inflation, declining global commodity prices, and subdued domestic food prices constitute a downside risk to domestic inflation, exchange rate depreciation and buoyant demand may keep domestic inflation elevated. Moreover, the steep decline in inflation in FY 2014/15, produces a strong base effect in 2015/16, and when combined with a depreciated exchange rate, could result in a double-digit inflation.

8 Conclusion

Annual consumer price inflation has averaged 3 per cent in the last 12 months, held down largely by food prices and international factors. However, the disinflation pressures have dissipated and the inflation outlook in the short to medium-term indicates slightly higher inflation in the range of 8 -10 per cent. BoU therefore decided to take pre-emptive measures to forestall a rise in consumer price inflation over the medium-term above BoU's policy target of 5 per cent. The CBR was accordingly raised by 1 percentage point to 12 per cent. The band on the CBR will be maintained at +/-2 percentage points on the CBR and the margin on the rediscount rate at 3 percentage points on the CBR. The rediscount rate and the bank rate have consequently been increased to 15 per cent and 16 per cent respectively.